The World Economy: Outlook and Issues

JICA – AFS Seminar

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Outline

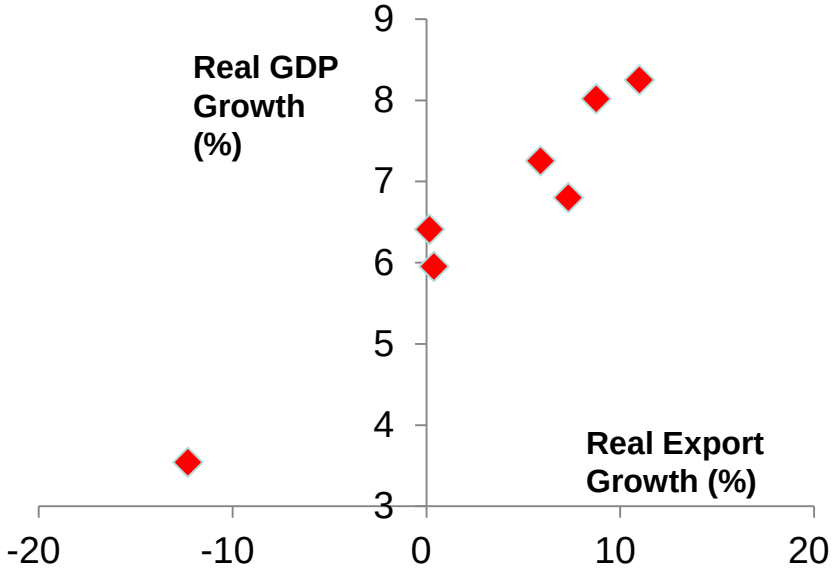
- External Environment and the Sri Lanka Economy
- The Global Economy Post-GFC
  - Causes and policies for the slow recovery.
- Baseline Scenario and Risks to the Outlook
- Monetary Policies: Normalization?
  - Impact, outlook and spillovers.
- Emerging Market Economy Slowdown
  - China Risk
- Back to Policies
  - Global baseline
  - Policies for Sri Lanka

Importance of External Environment for Sri Lanka

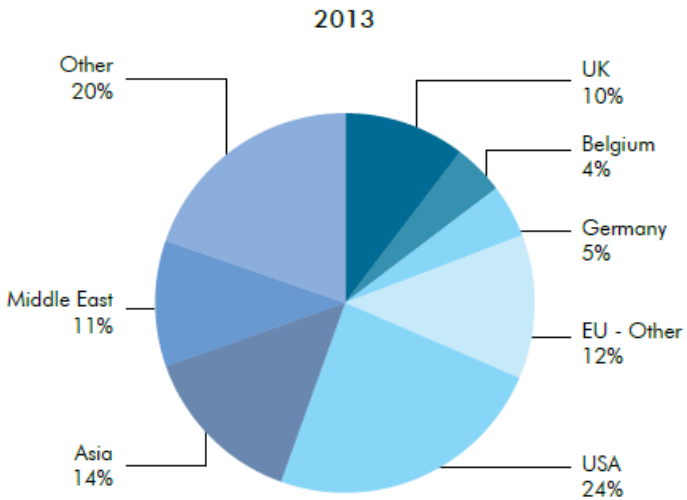
(Figures for 2013)

- Export of Goods and Services/GDP: 22.5%
- Personal Remittances/GDP: 9.6%

Correlation between real export growth and real GDP growth, 2007-2013



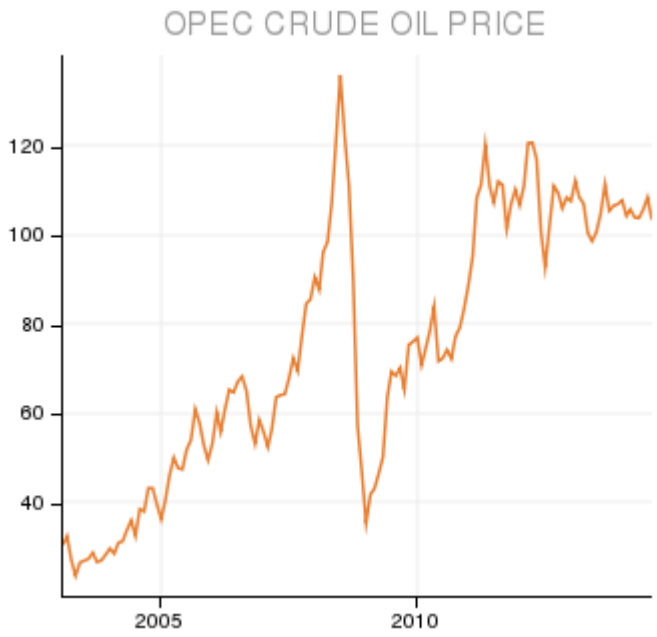
Export Destination
(Advanced economy share =68%)



Sources: World Bank WDI and CBSL Annual Report

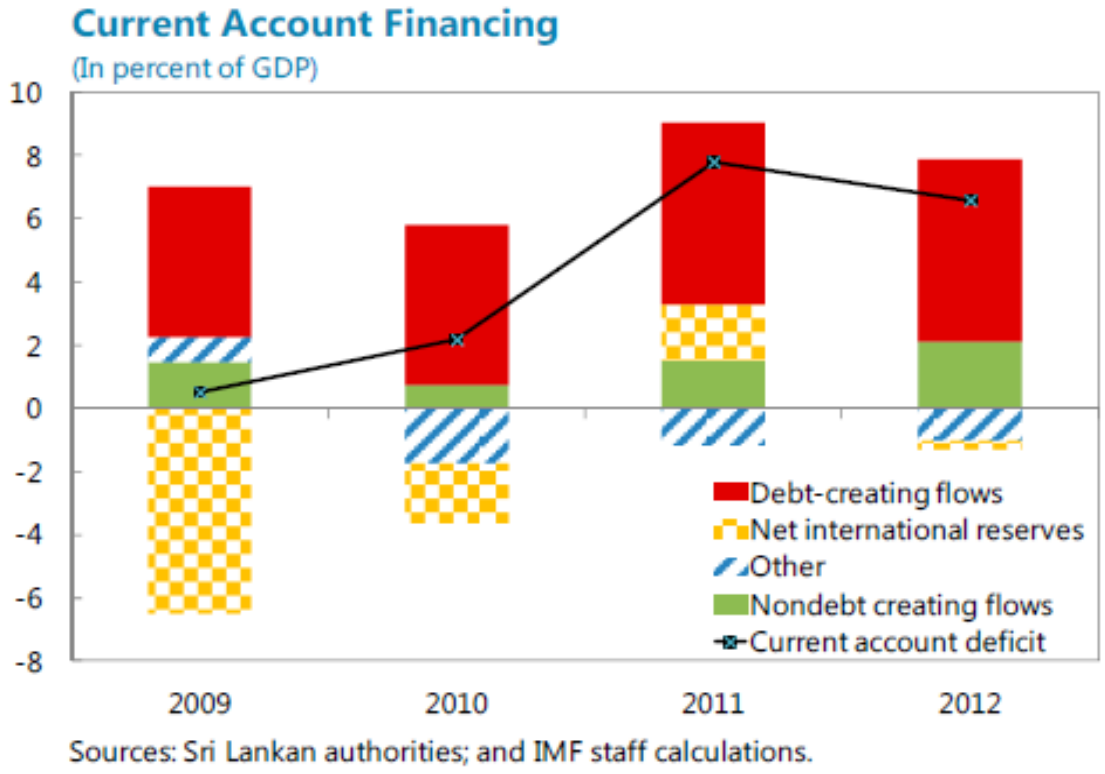
Importance of External Environment for Sri Lanka (contd.)

- Importance of the terms of trade effect on income:
  - Fuel imports account for 8.6% of GNI (2012)
  - Oil prices are volatile and subject to geopolitical and other shocks



Importance of global financial conditions for Sri Lanka

- Financing of C/A deficit relies on debt creating flows

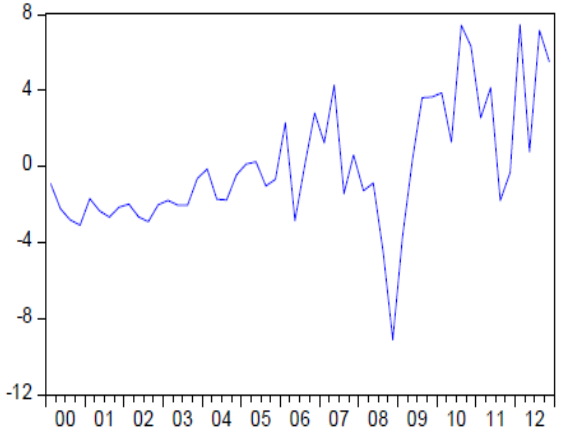


Sources: Sri Lankan authorities; and IMF staff calculations.

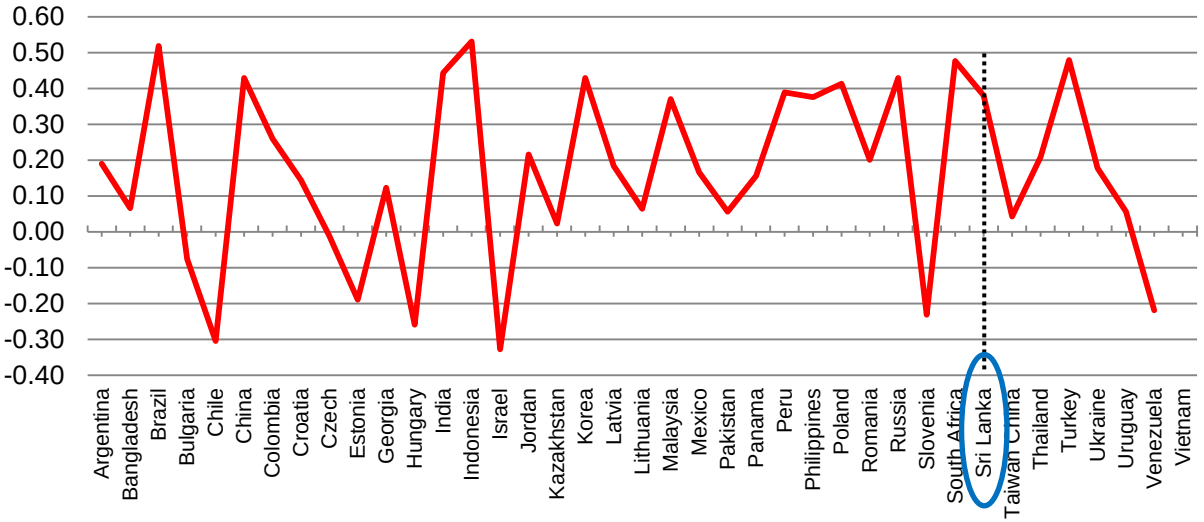
Importance of global financial conditions for Sri Lanka (contd.)

- Global push factor and Sri Lanka
  - Capital flows to emerging markets have been influenced by global investor sentiment (risk appetite) = global push factors.
  - The magnitude and volatility of these global factors have increased over time.
  - Sri Lanka's net capital flows appear to be fairly sensitive to global push factors.

Evolution of estimated global push factor



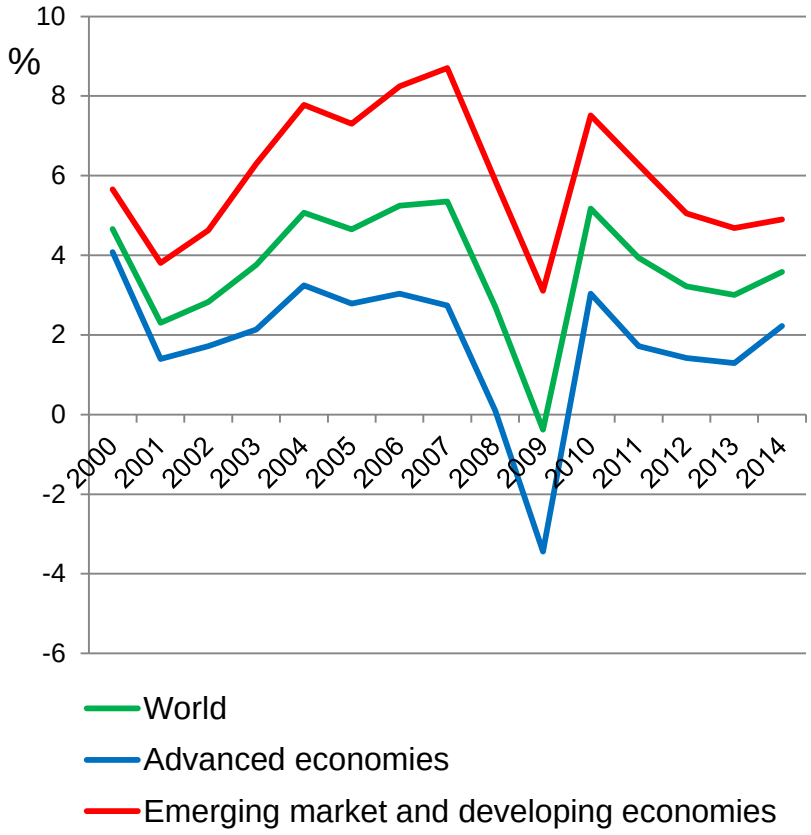
Correlation coefficients of net capital inflows with global push factor



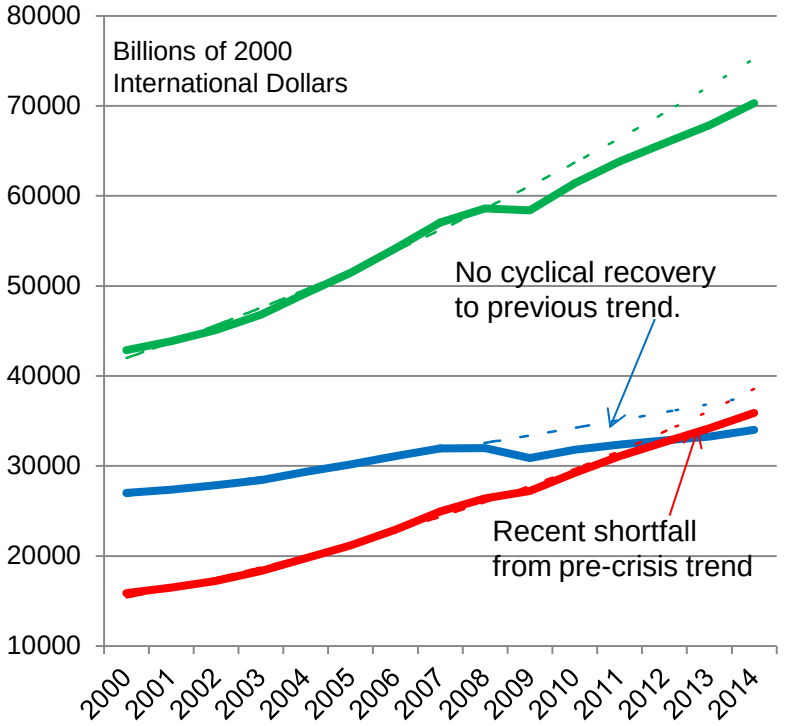
Source: S. Chen (mimeo, 2014)

Global economy post-GFC

Growth rates



Shortfalls from pre-crisis trend (dotted lines)



Source: IMF, WEO Database

Why do the (advanced) economies remain well below pre-crisis trend?: Three possibilities

- Prolonged adjustment to debt overhang.
  - Financial crisis induced recessions are deeper and more protracted.
  - Growth will not resume fully until the financial sector has been cleaned up.
- Reduction in potential growth rate.
- Something more fundamental: the secular stagnation hypothesis.

Reduction in the potential growth rate

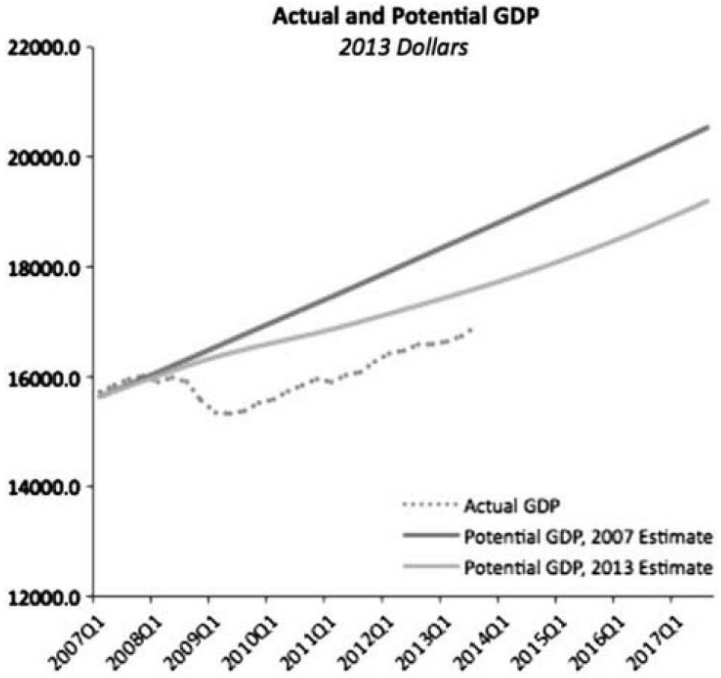
Y=F(A,K,L)

(K) Weakened financial system after crisis reduces intermediation and hence investment.

(L) Long period of high unemployment reduces employable workers.

(A) Reduced risk appetite weakens innovation.

Figure 1. Downward Revision in Potential GDP, U.S.A.



Source: CBO.

From Summers (2014)

- Persistent output gap remains even with downward revision of potential; why?

What is secular stagnation?

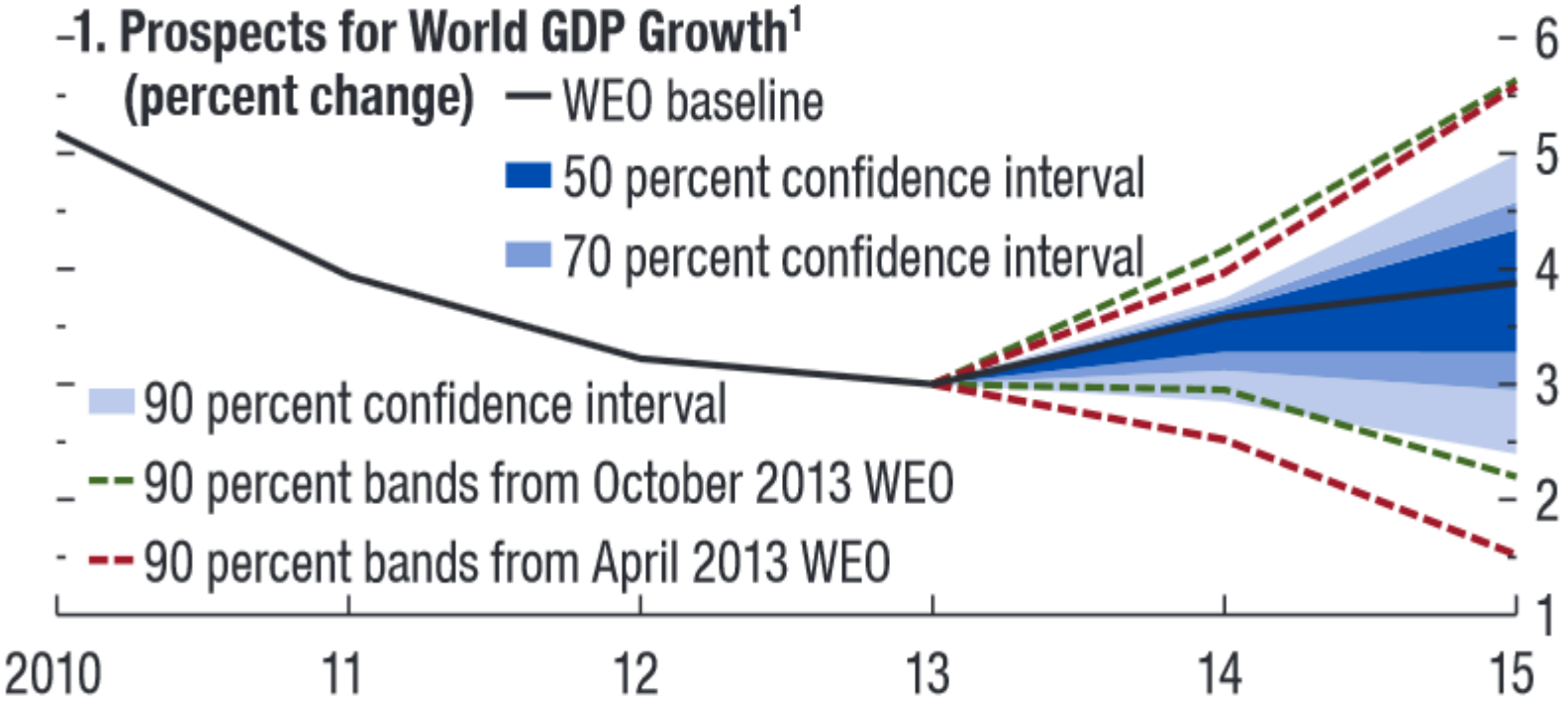
- Alvin Hansen's original proposition in 1938.
  - Reduced population growth and slowing innovation.
  - Reduced investment demand insufficient to maintain full employment
- Resurrected by Larry Summers (2013)
  - In addition to lower population growth and possibly slower technological innovation, excess of savings over investment results in low equilibrium real interest rate.
    - High savings from concentration of wealth (high savings rate), emerging market excess savings,
    - Low investment rate caused by lower price of capital goods, less capital intensive industrial structure.
  - Low inflation and zero lower bound for interest rates makes it difficult to lower real interest rate to equilibrium level, particularly during economic downturns.

Opposing views on correct policy response:

- Monetary Policy (FED/IMF s. BIS)
  - + Since equilibrium interest rate is low, then reduced policy interest rates and if necessary non-conventional policies are required to boost demand.
  - – Expansionary monetary policy does not increase productive investment, but rather creates asset price bubbles, which will cause problems when the bubble bursts.
- Exchange Rate Policy (Currency Wars)
  - + Depreciated real exchange rate can stimulate exports and fill in the domestic output gap
  - – Simultaneous depreciation of all major countries not feasible. Creates problems for other countries.
- Fiscal Policy (Keynesian vs. Ricardian)
  - + Fiscal policy needs to close the demand gap from excess savings. Fiscal policies are effective because multipliers are big during deep recessions. Investment in infrastructure will raise potential growth.
  - – Fiscal policy does not increase aggregate demand, as the private sector will increase savings to prepare for future taxes. Fiscal consolidation will increase private sector confidence and lead to higher investment, consumption and growth.
- Financial Sector Policy (BASEL III)
  - + A rapid cleaning up of the banking sector is necessary for growth to resume. Bank capital must be raised, and fiscal support for banks create moral hazard and risk creating future crisis.
  - – Too rapid consolidation of the banking sector reduces credit flows and risks prolonged recession. Strengthening of capital requirement when the banking system is still fragile is counterproductive.
- Structural Policies
  - + Structural policies must be pursued to increase efficiency and raise longer-term potential growth.
  - – Structural policies require time to generate positive growth impact, and possibly disruptive in the short run.

IMF Global Growth Outlook:

A gradual recovery with reduced economic risk, but risk still tilted to the downside



Source: IMF World Economic Outlook, April 2014

Major Economic Risks

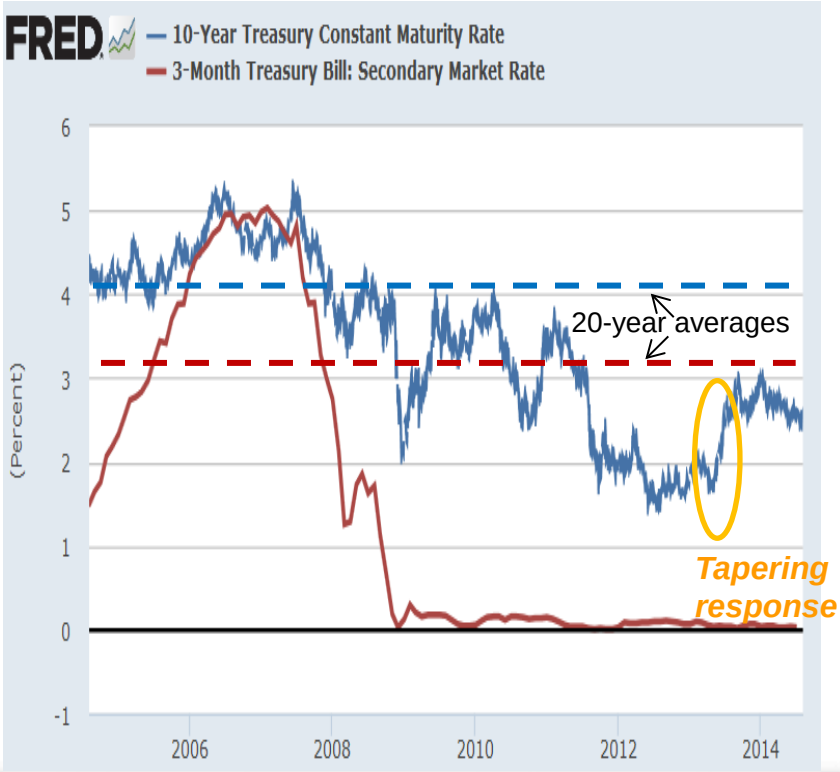
- Large negative impact from monetary policy normalization
- Marked slowdown of emerging market economies

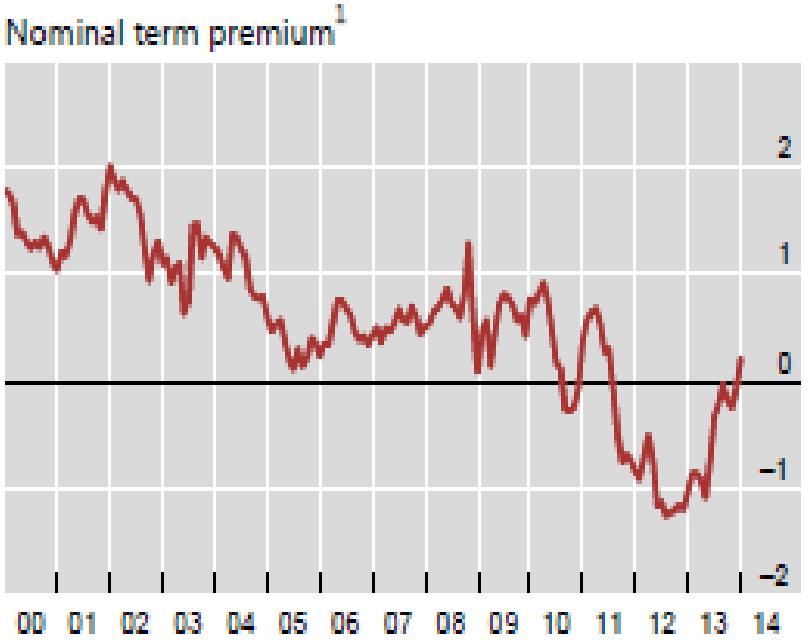
Political risk difficult to evaluate, but potentially large impact

- Ukraine and Russia: Spillovers to EU
- Iraq (and the Middle East): Implications for oil prices
- Tensions in East and South China Seas

Monetary policy 'normalization'

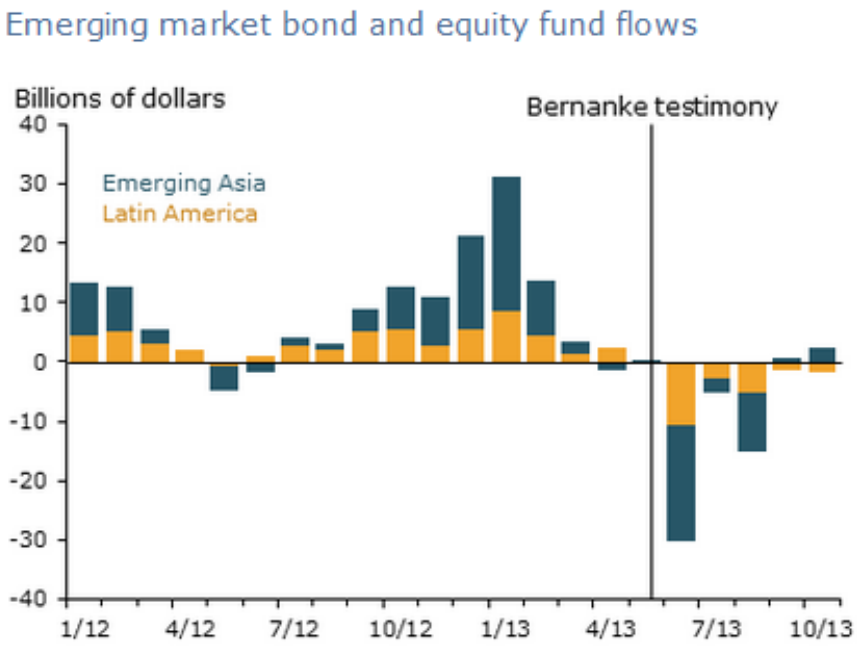
- US is most likely to return to full employment in the near future. This means that current extraordinary monetary policies must come to an end:
  - The 'tapering' shock: a sudden rise in long-term yields and unwinding of 'carry trades' due to correction in term premium.



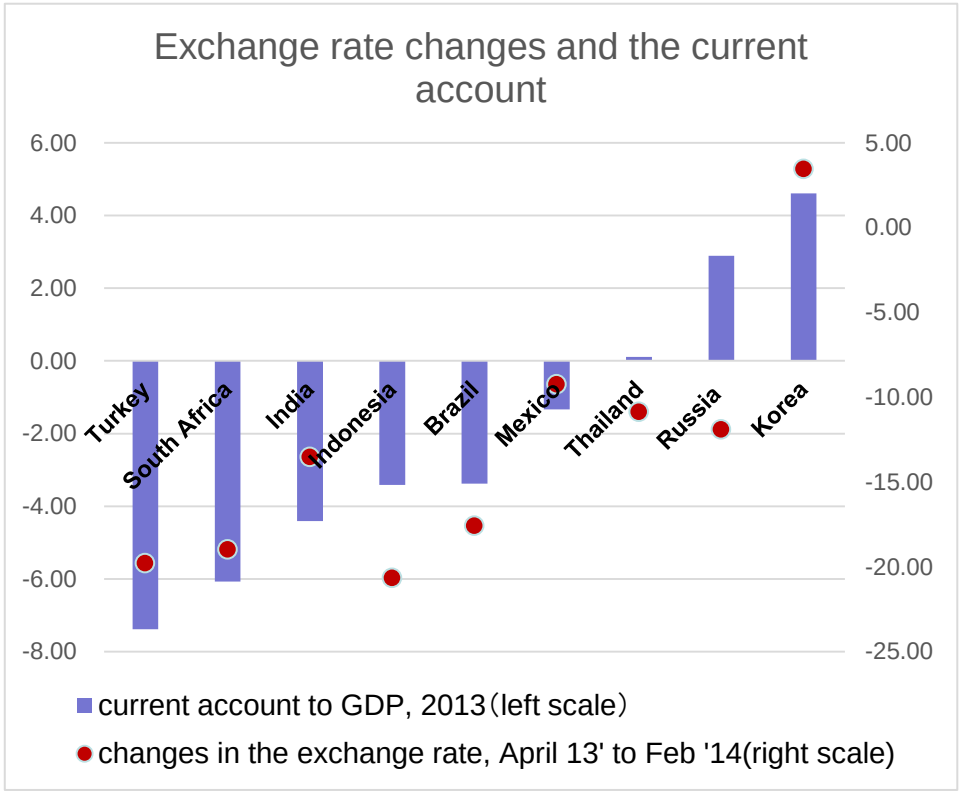


[1] Sum of inflation and real yield risk premia in the 10-year US Treasury yield.
Source: BIS calculations, taken from Philip Turner, "The global long-term interest rate, financial risks and policy choices in EMEs" *BIS Working paper No.441*, Feb. 2014

The international repercussions of tapering.

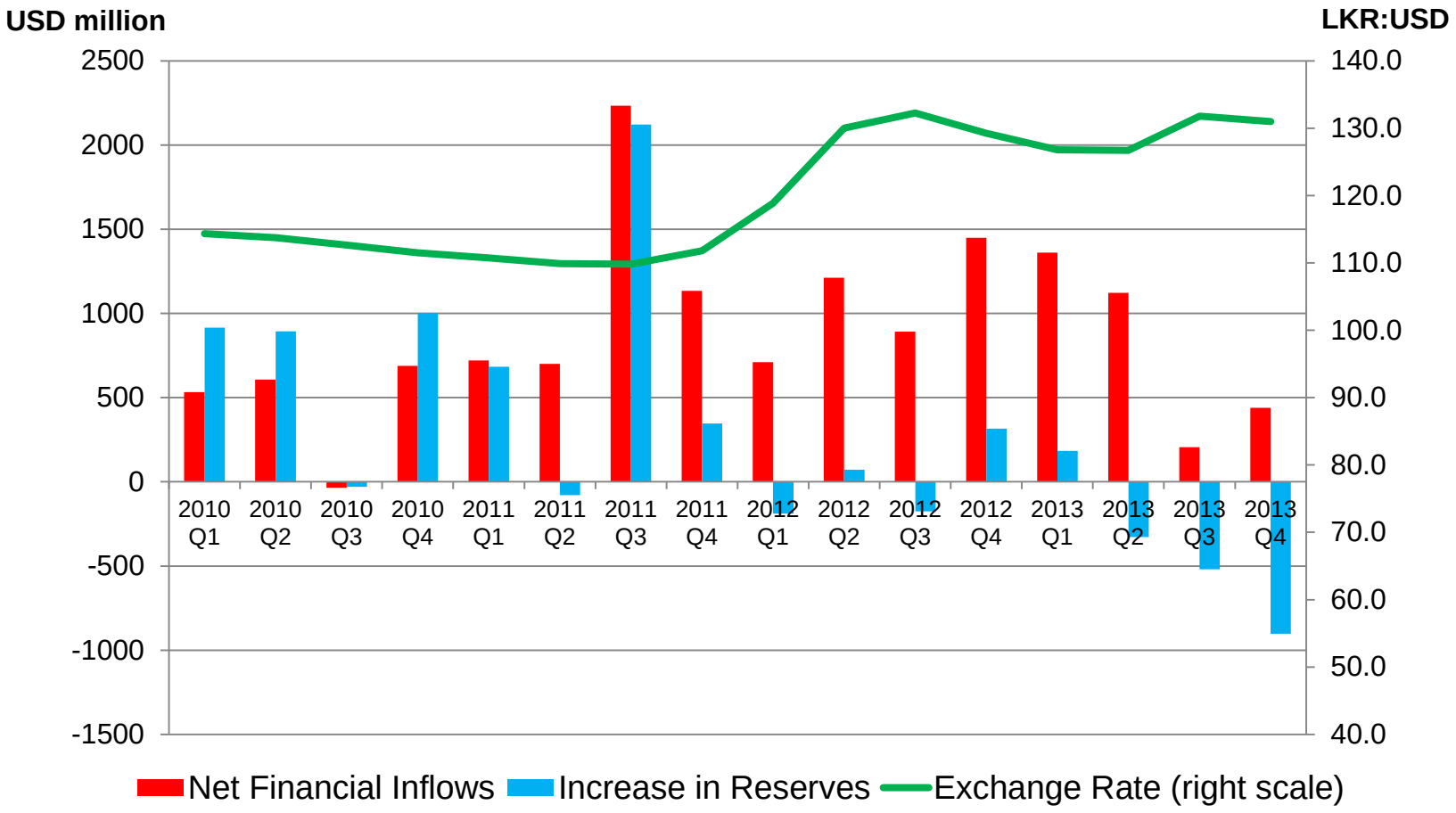


Source: IMF, GFSR



Data Source: IMF, IFS

Impact on Sri Lanka was substantial



Data Source: IMF, IFS and BOPS

Offsetting channels of transmission

- To the extent US monetary policy normalization is a reflection of recovery in the US, higher US domestic demand and stronger dollar should lead to higher exports for EME.
- US monetary policy normalization reduces capital inflows into EME and constrains their external financing and domestic growth.
- An unpleasant possibility under secular stagnation scenario in the US:
  - US monetary policy normalized with low growth, resulting in financing constraints without the benefit of increased external demand.

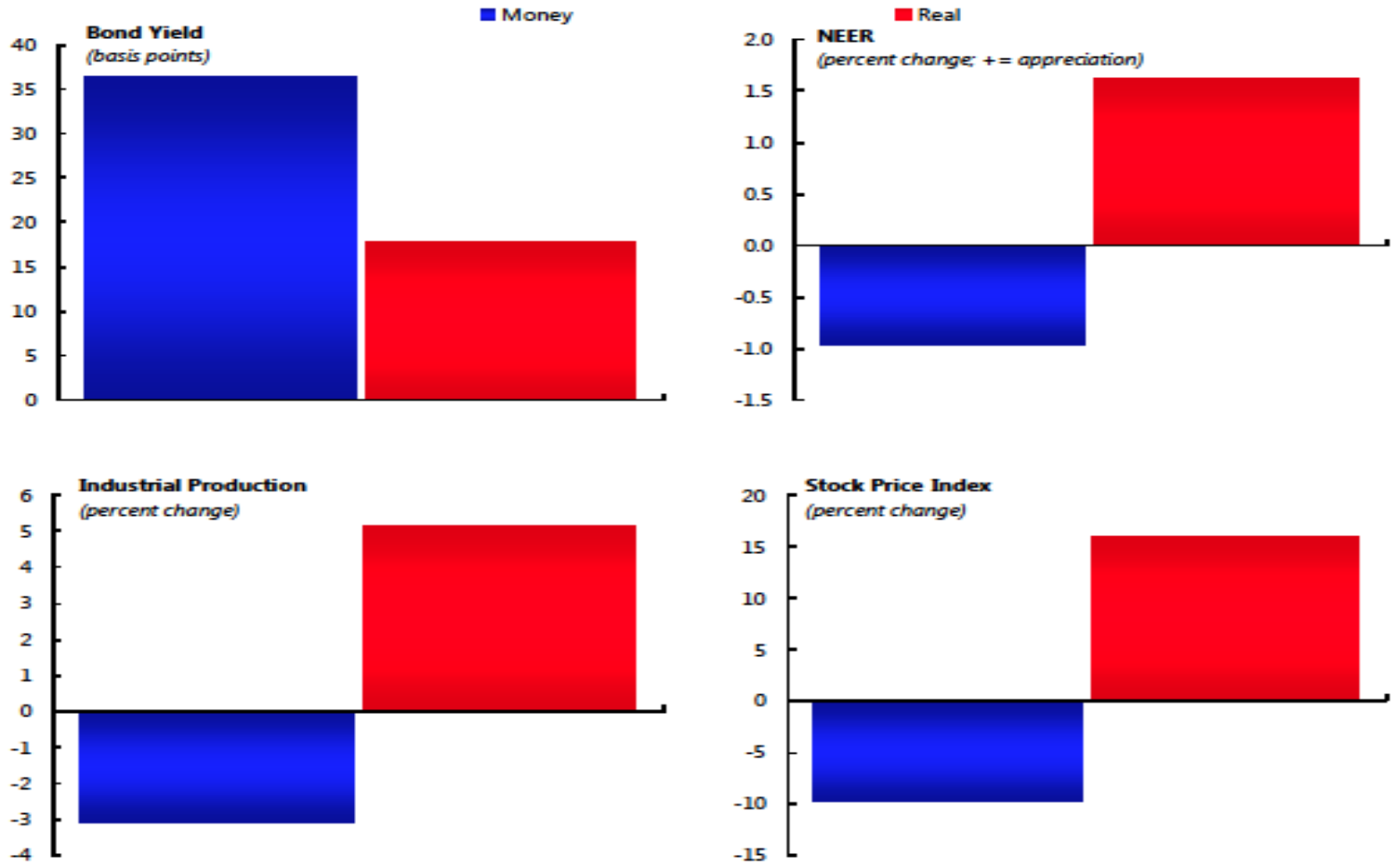
Tapering was just an announcement -- what will happen when monetary policy is actually tightened?
Must tightening always result in a large negative shock?

- If current long term rates properly reflect expected future rates (implying low growth and low inflation) rise in short and long-term rates will be gradual and limited.
- If current long term rates reflect excessive risk taking, then long-term rates could rebound sharply and cause a repeat of tapering induced disturbance.
- If rise in interest rates is the result of a better than expected recovery in the US (and other AE), then the result could be largely positive for EME.

Impact on EME depends on whether the shock is monetary or real

Figure 3. Spillovers to Emerging Market Economies from S4 Shocks[1]

(Average responses in the first 12 months to initial 100 basis point shock)

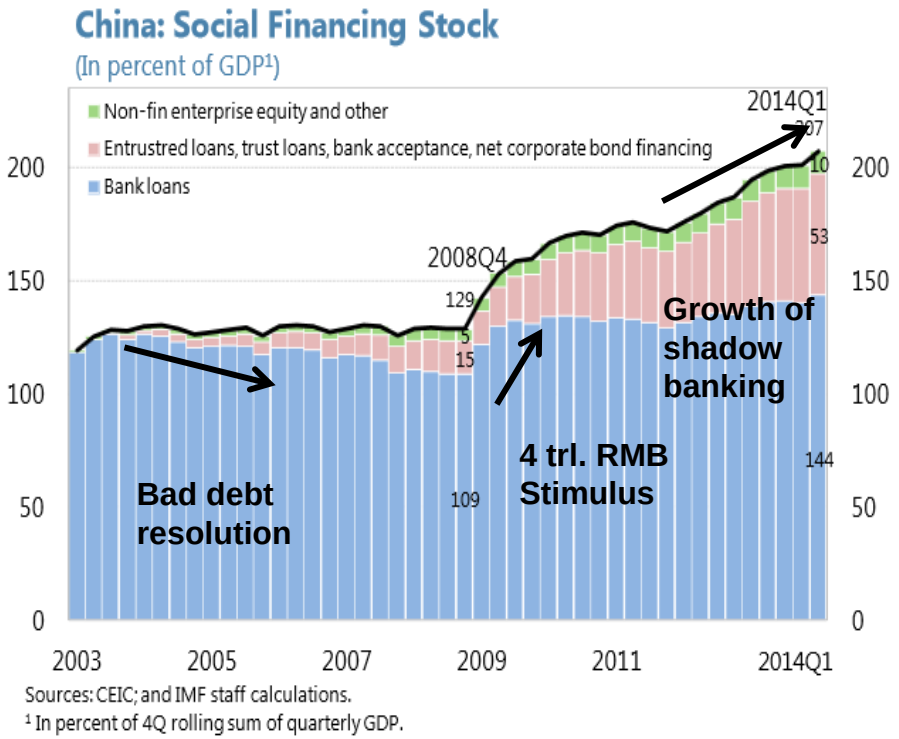


Source: IMF staff calculations.
Note: NEER = nominal effective exchange rate; S4 = systemic four (euro area, Japan, United Kingdom, United States).
[1]Responses to both shocks are significant over several months following the shock.

Source: IMF Spillover Report, 2014

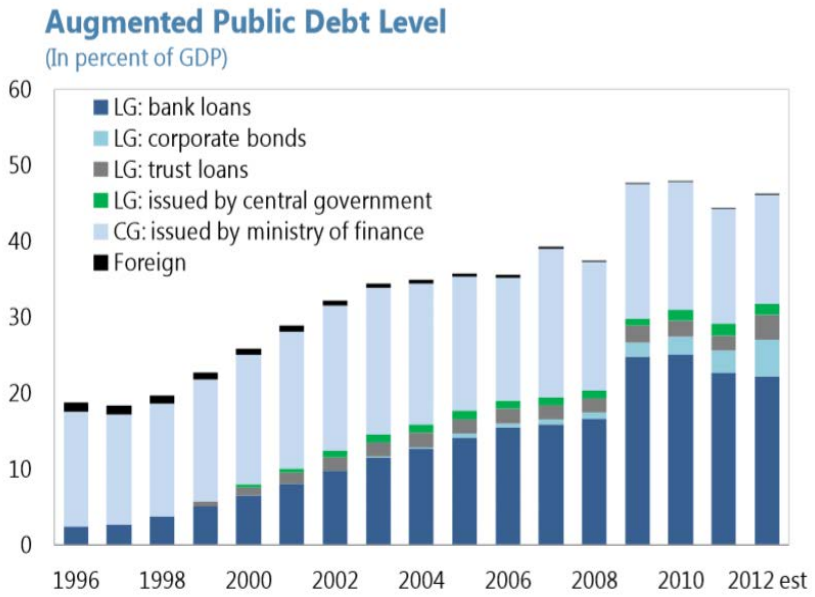
Risks of EM Slowdown: China's emerging financial problem

A surge in credits almost invariably leads to a financial crisis.



Sources: CEIC; and IMF staff calculations.
[1] In percent of 4Q rolling sum of quarterly GDP.

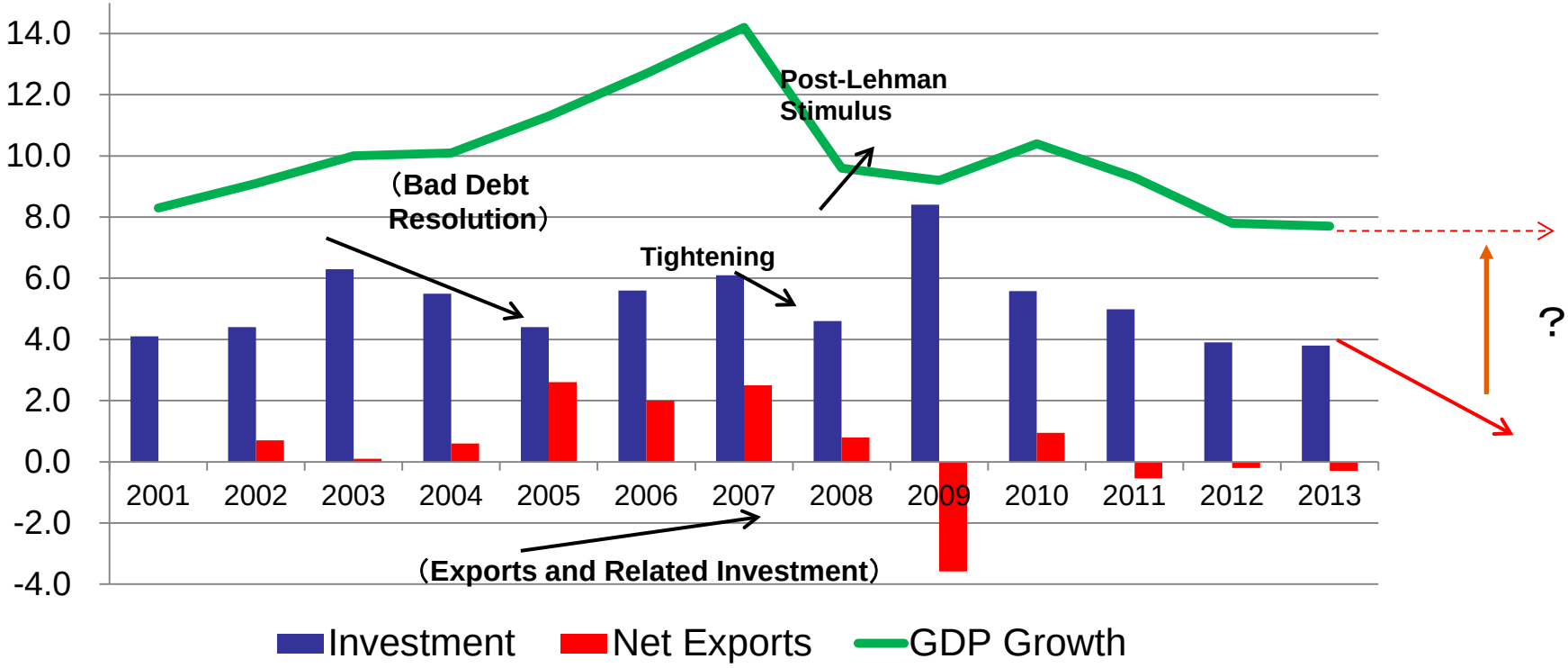
But China still has the fiscal space to assume the loss and prevent an open crisis.



Sources: CEIC, Chinabond, EUROSTAT, China Citic Press, China Trustee Association, NAO, and the Ministry of Finance; and IMF staff estimates.

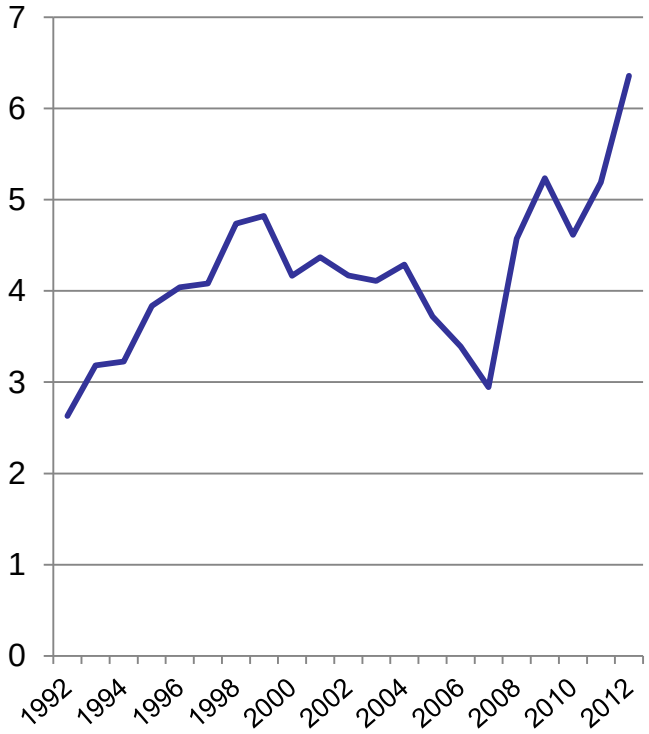
Sustaining growth in China is challenging

Contributions to China's GDP growth



Rebalancing is not that easy:
a simple illustration

Evolution of ICOR in China



Note: ICOR (Incremental Capital Output Ratio) is a rough measure of efficiency of investment. High ICOR implies inefficient investment. ICOR in Japan and Korea during their high growth periods were around 3~3.5.

	2013	2014～2018
GDP Growth rate	7.7	7.5
Investment Growth	8.1	2.3
Investment/GDP ratio	48	37.5（end period）
ICOR	6.3	5（end period）

In order to reach an ICOR of 5 in five years' time, The investment to GDP ratio must decline to 37.5% by 2018. However, to reach a target growth rate of 7.5% without contribution from external demand, real consumption has to increase by 11.5% per annum.
Government may need to continue to support demand, and be able to do so, but with consequences for longer-term public debt sustainability.

Policies: The Global Baseline

- Monetary easing complemented by macroprudential policies.
  - Still a lot of uncertainties about which macroprudential measures work.
  - Capital flows management (capital controls) might also have a role from macroprudential perspective.
- Short-term demand supporting fiscal stance as necessary, combined with credible long-term fiscal plan.
- Spillovers, but individual countries to pursue their domestic objectives, while others should address vulnerabilities and respond appropriately.

Implications for Sri Lanka

- Sri Lanka need not worry about secular stagnation: a small country has the possibility to grow by expanding trade, and Sri Lanka has room to increase openness.

- Need for debt-based current account financing leaves Sri Lanka vulnerable to external financial shocks. Monetary policy normalization in AE could have adverse impact.
  - Need to reduce vulnerabilities: Making sure external borrowing finances productive investment, increase FDI, consider macroprudential measures for banks' external borrowing.

- Slowdown in global growth will have impact, but US and EU growth more important than China and EM slowdown.
  - EM slowdown likely to put pressure off oil and commodity prices, so has positive elements (though lower oil prices may affect remittances from the middle east).

Thank you

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  - Two fully funded scholarships for APPP. Total of 15 places under JDS in public policy, development economics, business administration and environment and disaster management at various universities.
- Ideal for young aspiring officials to build a solid basis to become fully-fledged economists.
- Applications for entry in fall 2015 will open soon. (Closing date last year was November 8, 2013 for fall 2014 intake.)

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