THE STATE OF THE WORLD ECONOMY :

INCREASING VULNERABILITIES OF DEVELOPING COUNTRIES

Yılmaz Akyüz

South Centre, Geneva

12 March 2015, Palais des Nations, Geneva

www.southcentre.int

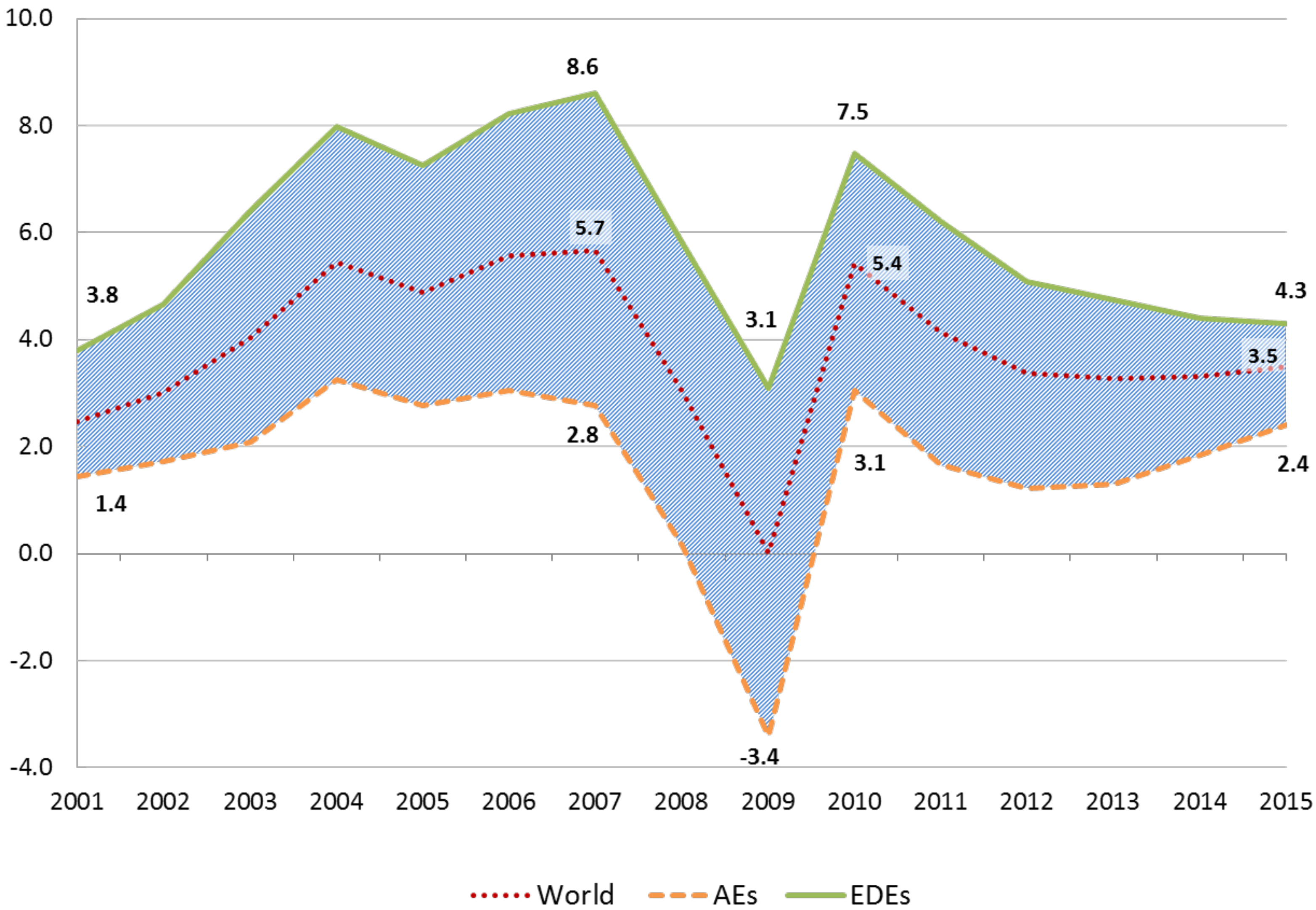
OVERVIEW

- Global economy is underperforming; growth is below par
- Slowdown is more marked in Emerging and Developing Economies (EDEs)
- Global trade is slowing relative to income
- Trade balances moving against EDEs
- Commodity super-cycle seems to be over
- Capital inflows to EDEs are weak and unstable
- Growth prospects for EDEs are not very bright
- EDEs are vulnerable to a new bout of international financial instability.

GLOBAL ECONOMIC GROWTH

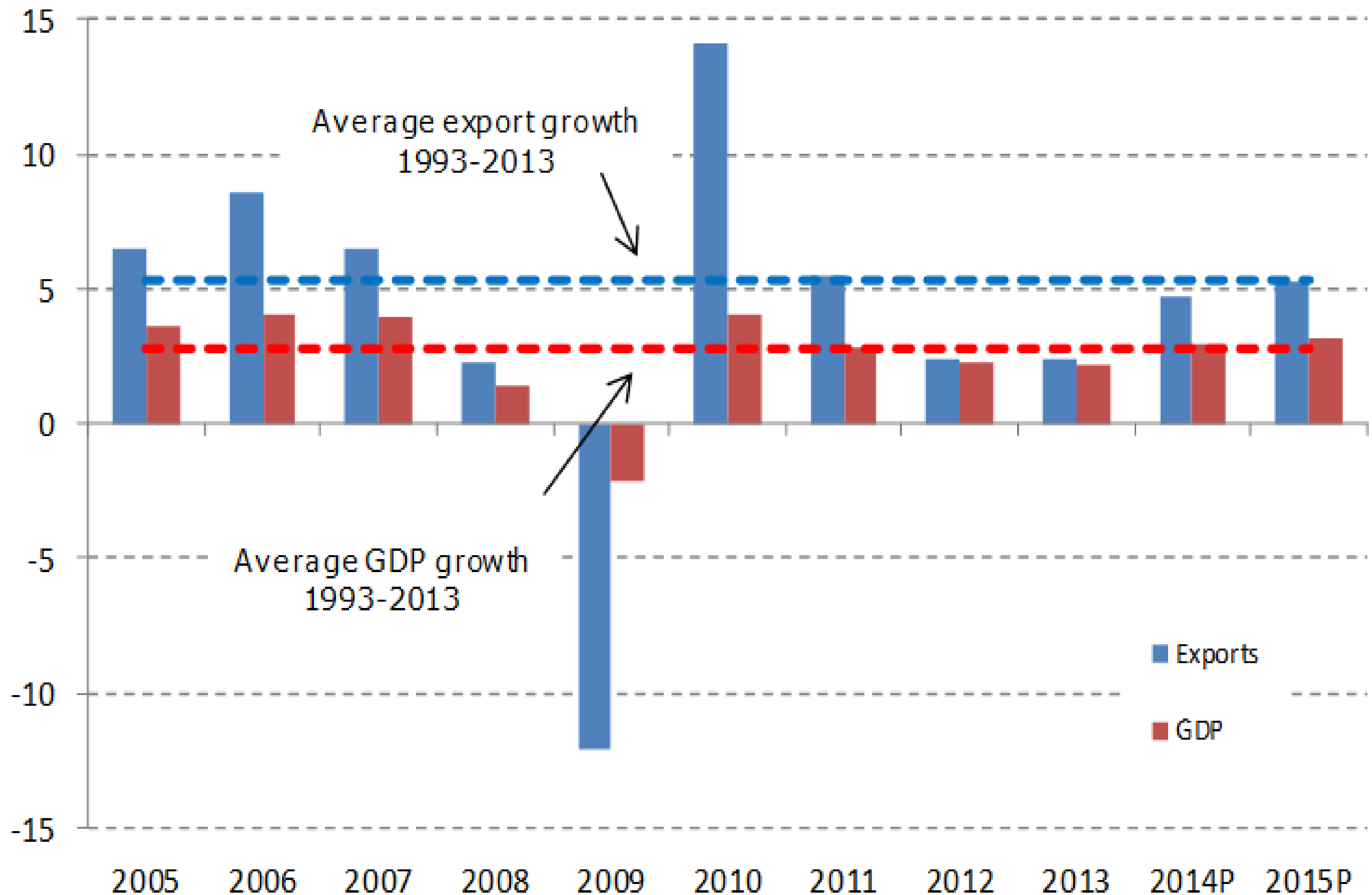
- Global economy is operating well below potential.
- Potential growth (capacity expansion) rates falling in both AEs and EDEs.
- Global growth down from over 5% in pre-crisis years to some 3% in post-recovery years (**Chart**)
- Slowdown is more marked in EDEs; growth differential between EDEs and AEs fell from over 5.0 pp to 2.0 pp despite problems in EZ and Japan. Decline in EDEs and hence global growth is perhaps higher than that indicated by official data for China and India.
- Growth in EDEs not expected to pick up relative to AEs in the coming years.

Global Growth



WORLD TRADE

- World trade growing at 3% against 6-7% in past two decades. Now barely matching growth in world GDP **(Chart).**
  - No more big-bang liberalization
  - Limits of export-led growth; activity depends more on domestic demand
  - Slowing vertical specialization: many activities that previously involved cross-border movement of goods are now taking place within national borders; a larger proportion of demand is now met by home production rather than imports; import substitution.
- Supply-chain trade between US and China, two largest economies, is slowing. Chinese exports to US generating less imports from its suppliers of parts and components. Share of imported parts and components in China’s exports fell from 60% to 35%.


15
10
5
0
-5
-10
-15
Average export growth 1993-2013
Average GDP growth 1993-2013
Exports
GDP
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014P
2015P

WTO

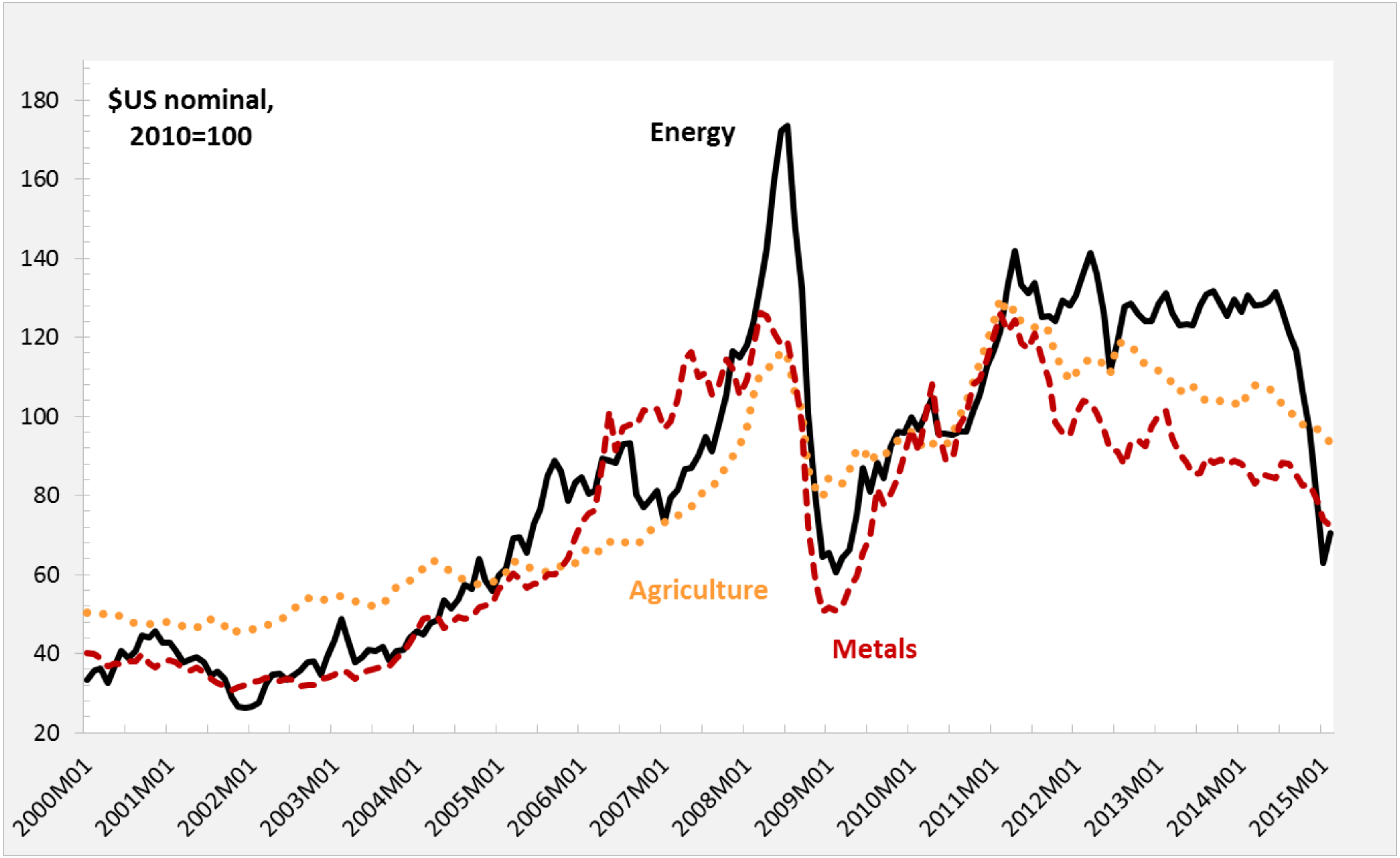
TRADE IMBALANCES

- Trade balances moving against EDEs.
  - Surpluses of East Asian exporters of manufacturers falling: Chinese CA surplus is down from 10% of GDP to less than 2%
  - Surpluses of oil exporting EDEs falling even more rapidly.
  - LA and SSA are running higher deficits.
- AEs are now in surplus:
  - US CA deficit almost halved from a pre-crisis peak of $800b; falling from some 6% of GDP to 2.5%.
  - EZ has a large surplus, draining demand from rest of world. German surplus is now $240b (over 6% of GDP) against $180b in China (below 2%).

COMMODITY MARKETS AND PRICES

- Super cycle/boom ending? (**Chart**)
- Historically rapid increases always followed by sharp drops; recent boom faster and steeper than previous ones (financialization). Prices likely to remain weak for several years.
- Non-oil falling first. Oil fell by over 60% and non-fuel by 30% from peak. US shale oil adding 3m barrels a day since 2012. Demand is weaker because of slow growth and strong dollar. Financialization accentuating decline.
- The impact of commodity price weaknesses (notably oil) on global growth is likely to be neutral.
- Overall impact on the South is likely to be negative and on the North positive.

Commodity Prices



FINANCIAL MARKETS AND CAPITAL INFLOWS TO EDEs

- Non-resident capital inflows recovered after Lehman, but are weak; they fell from 8.5% of GDP in 2007 to 4% in 2014. **(Chart)**

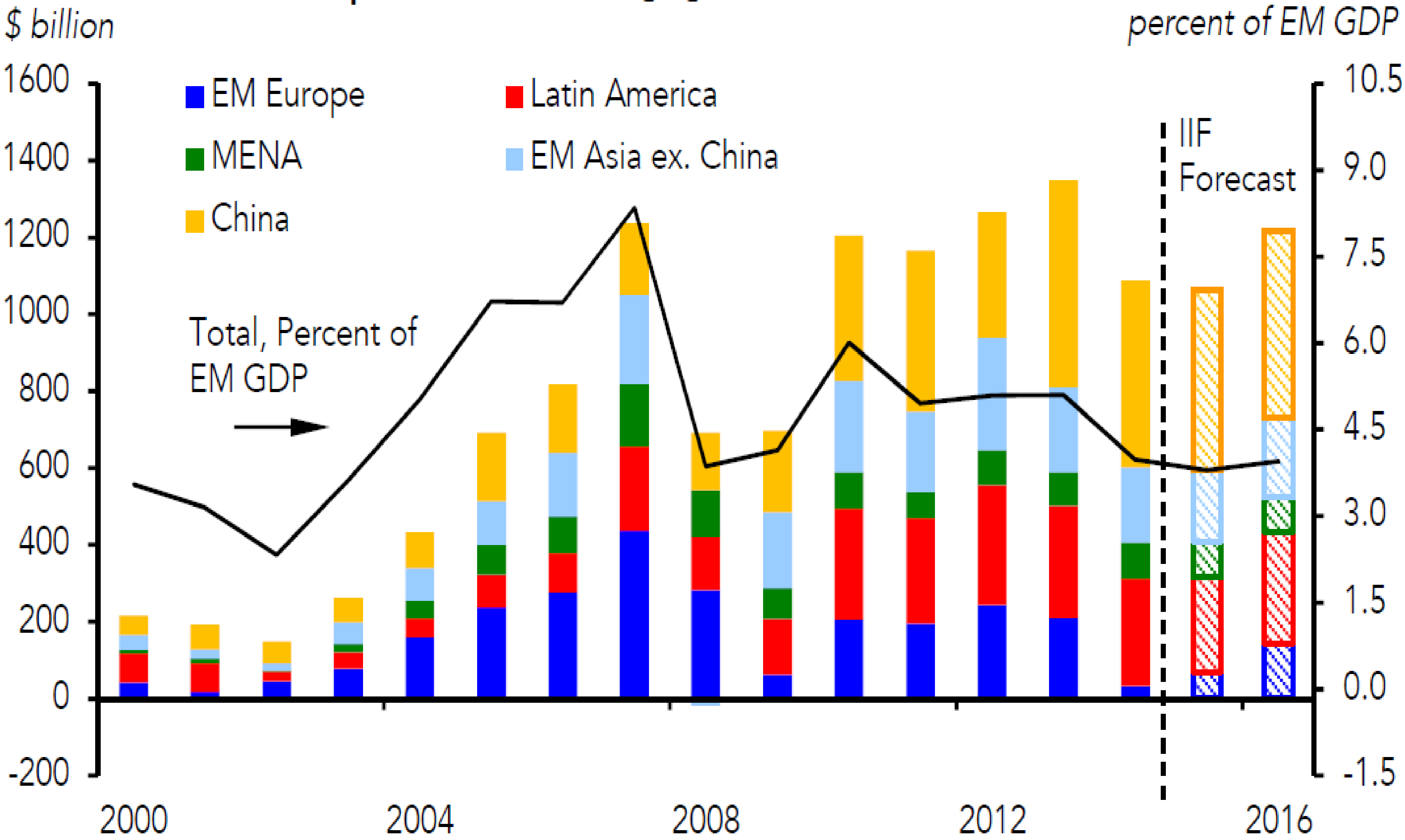
- They are also unstable; fell sharply in May 2013 when US Fed revealed its intention to start tapering its bond purchases (taper tantrum), triggering a large exit from domestic financial markets of EDEs. Also a generalized sell-off of assets and currencies of EMEs in early 2014 and again mid-October.

- They are highly susceptible to news from EZ and uncertainties about Fed's policy and the oil market as well as political risks.

- Still, the boom that started in the early 2002 has not yet ended with a generalized bust (exit) of the kind seen during the Lehman turmoil.

Chart 1

Private Non-Resident Capital Inflows to Emerging Markets



CRISIS AND RECOVERY IN THE NORTH

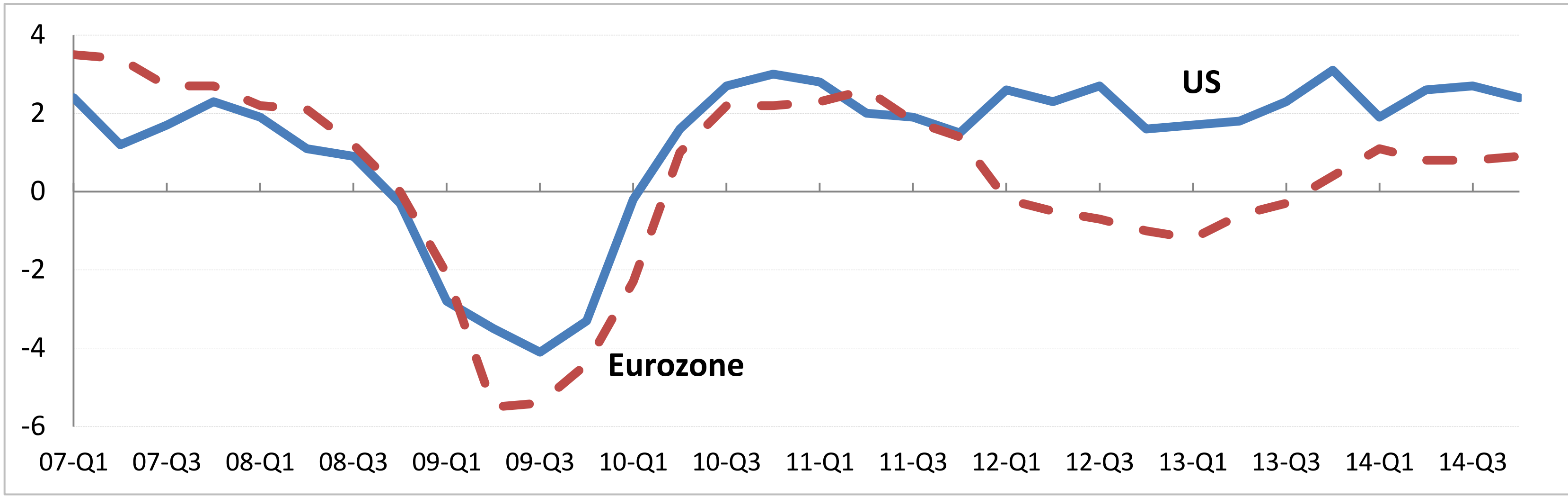
- Growth in AEs is uneven. US recovery looks complete but EZ and Japan trapped in deflation-cum-stagnation (**Chart**).

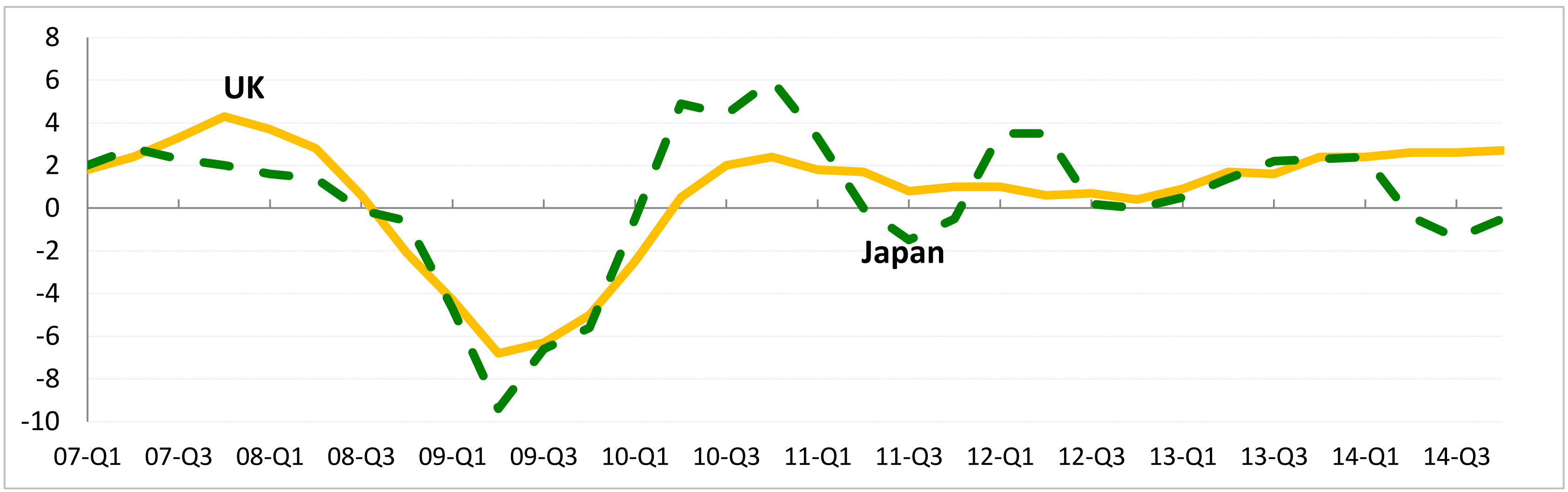
- Since the beginning of the crisis, EZ had negative growth rates in 13 quarters out of 24. Japan in 12.

- Potential growth in AEs is down because of weak investment and declines in labour participation.

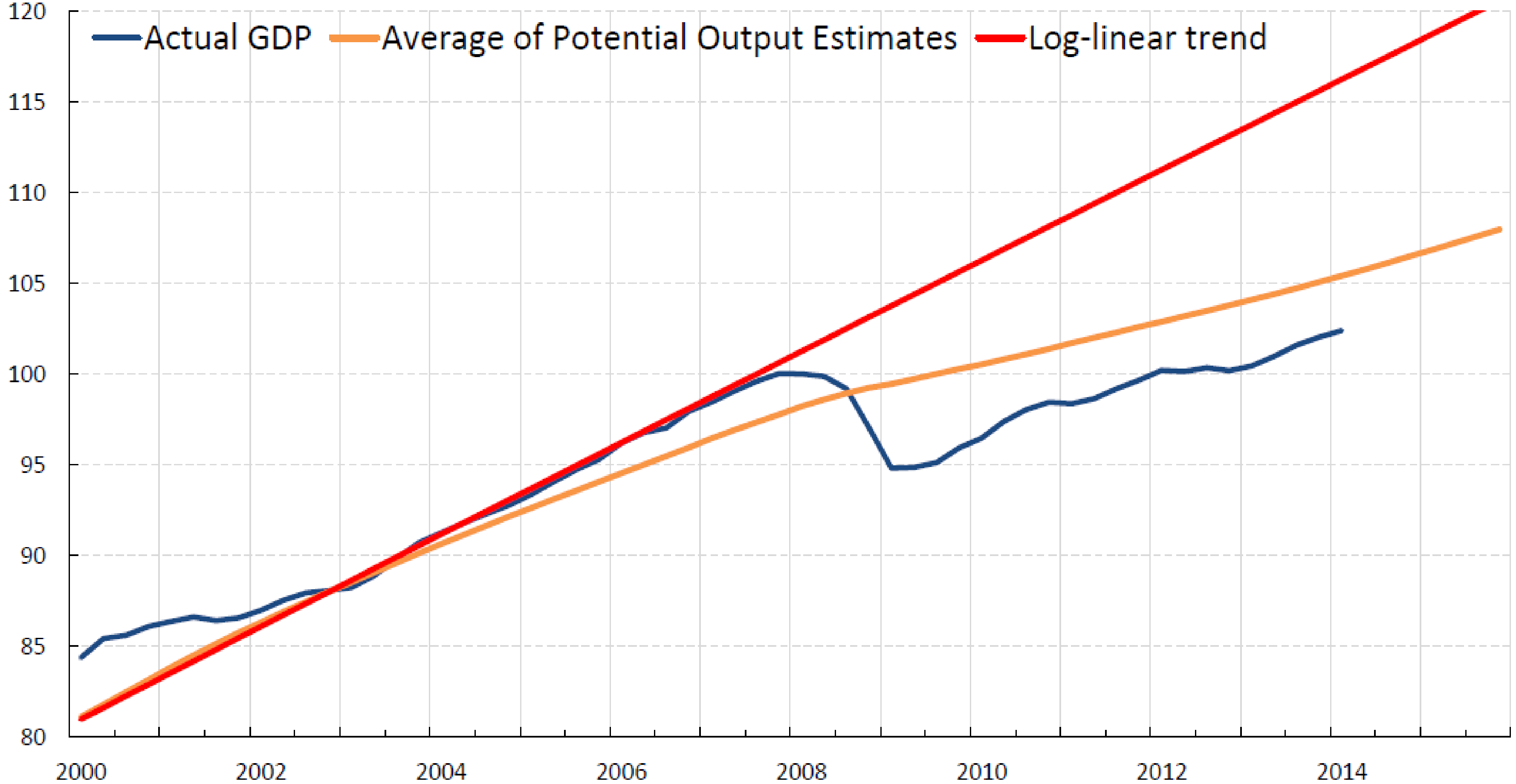
- For G4, potential output now below pre-crisis trend by 12% and actual output by 15% (**Chart**). Actual output may catch up with potential, but would remain well below pre-crisis trend.

GDP Growth in Major AEs





Aggregate G4 (US, Euro Area, Japan, UK) GDP: Actual, Potential and Trend
(Index 2007 Q4 = 100)



Note: Potential Output is the average of IMF and OECD aggregate estimates. The latter are calculated as PPP weighted averages of individual countries' estimates. The log-linear trend is a projection based on the data from 2000 to 2007.
Source: Haver Analytics, Fulcrum Asset Management LLP

THE FALL AND THE RISE OF THE US (OR FALL OF THE REST)?

- Great Recession => Decline of the US, rise of the South?

- Recent US performance is better than other major AEs and some EMEs, though quite weak compared to past recoveries:
  - Jobless rate is down (5.5%), capacity utilization restored pre-crisis rates
  - But wages and productivity growth sluggish, distribution worsened
  - Labour participation is lower and capital accumulation slower
  - Unlike past cycles long-run potential growth is now lower than pre-crisis trend, implying permanent output losses

- Status of dollar as a reserve currency stronger but only because of uncertainties surrounding Euro; recent appreciation likely to continue.

- US regaining its weight in oil markets thanks to shale oil; its supply is more flexible but cost is also higher.

THE STAGGERING RISE AND FALL OF GROWTH IN EDEs

- SC: *"EDEs rapid growth before and recovery after crisis were due to exceptional global conditions rather than fundamentals and not sustainable"*

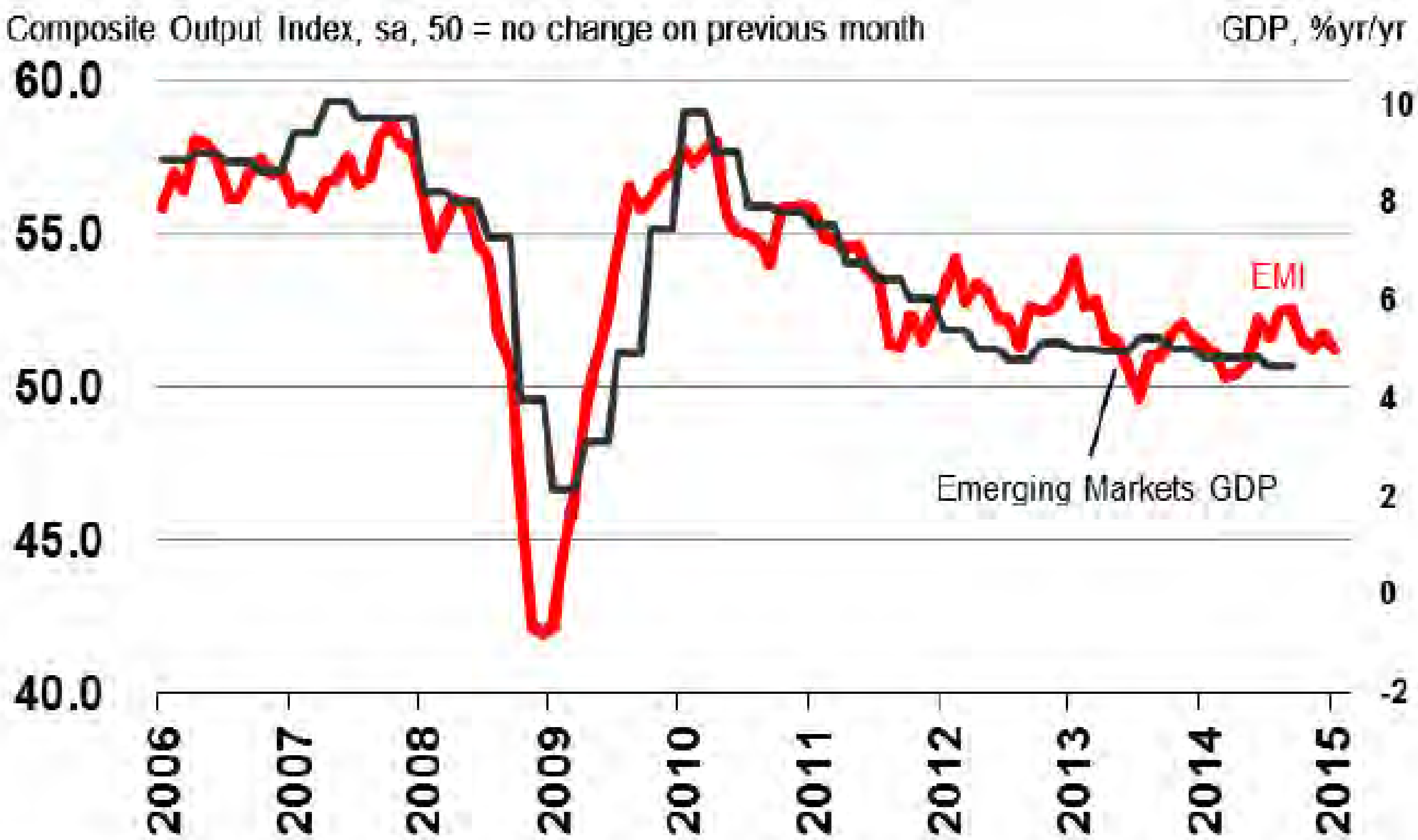
- Growth in EMEs is half pre-crisis peak (**Charts**). BRICS no longer shine. Brazil stagnating, Russia contracting. India and China slower (official data overstating growth). China now slower engine to EDEs in trade in manufactures and comm.

- Weak commodity prices and capital inflows hit LA severely. Growth barely matching population. Poverty is up again after a decade of progress (CEPAL).

- Macroeconomic policy space now much narrower than in 2009; twin deficits and pressures on currencies; unlike 2009, policy in many EDEs is now procyclical.

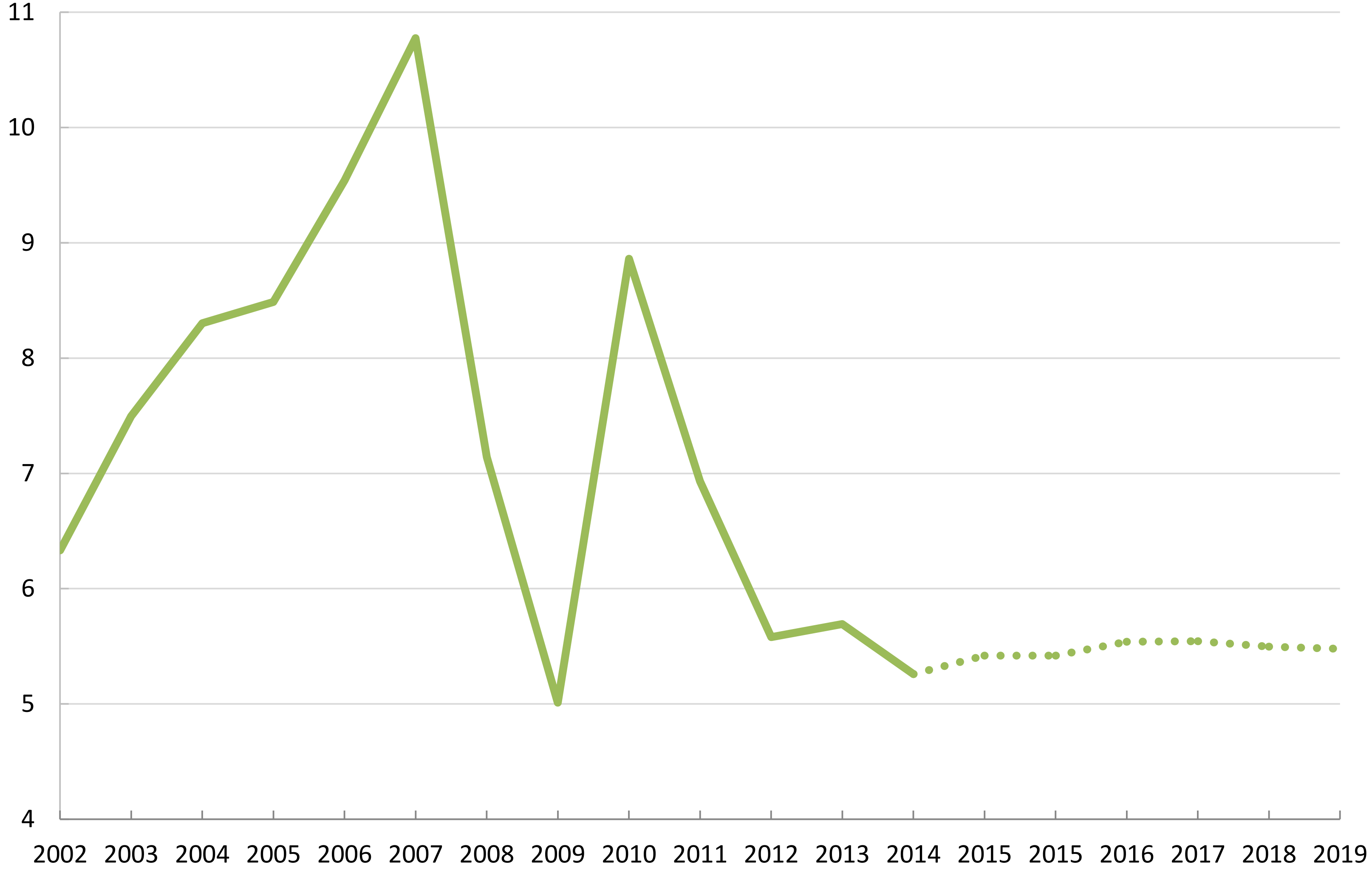
- EDEs not expected to return to pre-crisis rates soon. Potential rates are down, notably in commodity exporters. Extended period of sluggish and erratic growth even without a major crisis.

HSBC Emerging Markets Index

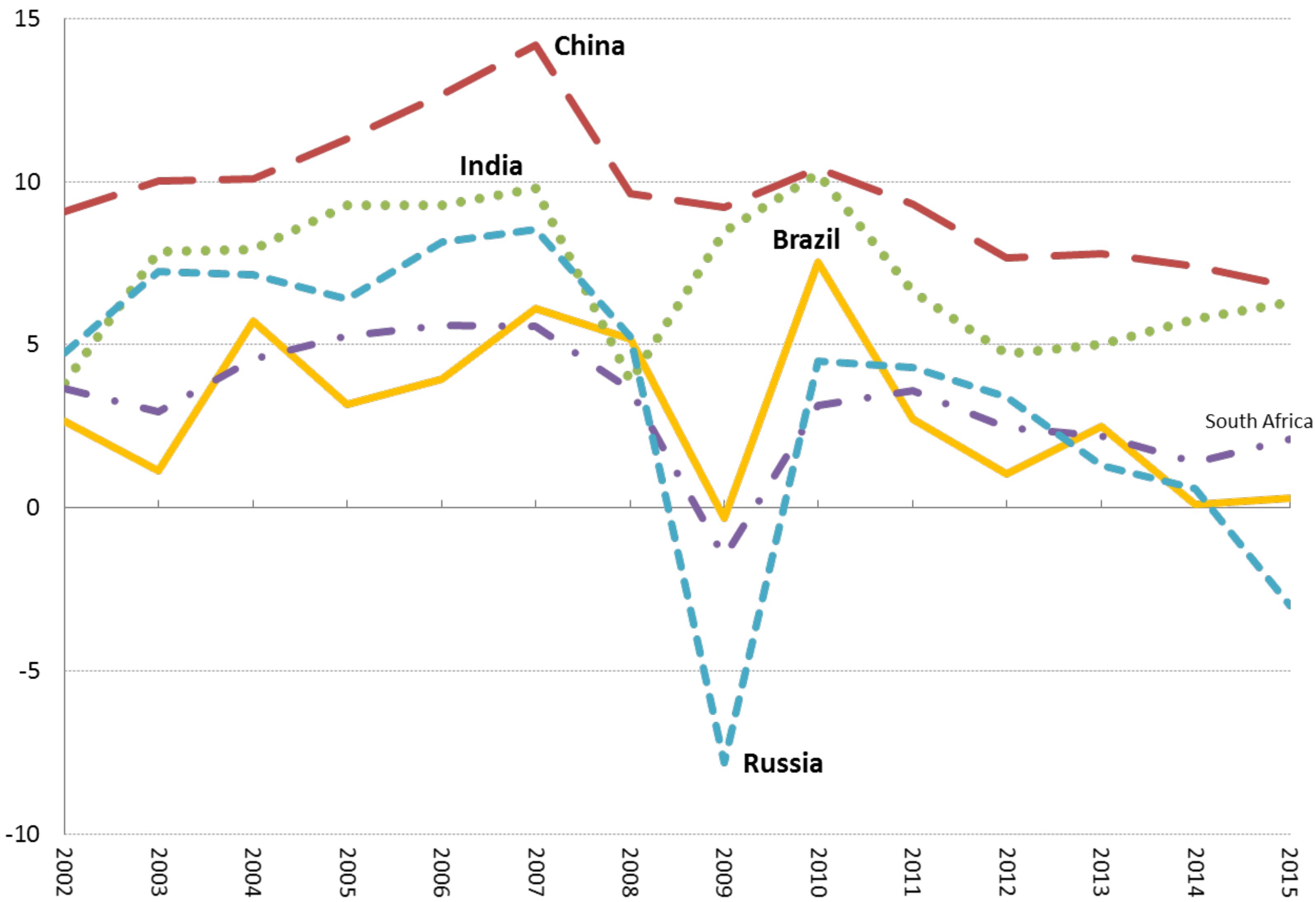


Sources: HSBC, Markit.

Growth in BRICS



Growth in BRICS



GLOBAL FINANCIAL FRAGILITY

- Potential sources of instability:

1. Intensification of financial stress in the EZ (Grexit)
2. Rapid normalization of monetary policy in US as slack in labour market is exhausted and pressures build up on wages and prices; EDEs damned if US grows rapidly (producing stronger dollar, higher interest rates and tighter global financial conditions), damned if it does not (reducing export opportunities)
3. Financial turmoil in China; excessive debt build-up due to its policy response to the crisis; not Lehman-like meltdown but significant loss of growth
4. Rapid turnaround in global risk appetite, particularly on expectations of any one of the above happening.

- EDEs now more vulnerable than in 2008 – internationalization of finance.

INTERNATIONALIZATION OF FINANCE IN EDEs

- Driven by liberalization and global financial conditions (easy money), creating fragility and new vulnerabilities (**SCRP 60**):
  - Rapid build-up of hard-currency corporate debt; $2tn up from $500b in 2007
  - Governments in frontier economies traditionally dependent on official finance have been borrowing in international bond markets; maiden issues in SSA
  - Foreign presence in credit, bond, equity and property markets unprecedented.
  - Internationalization of domestic sovereign debt in EMEs (more than US, UK)
  - Sharply increased foreign bank presence (50%, 20% in OECD); contribute to build-up of external fragility and transmit shocks from home countries (as seen in EZ).

EXTERNAL VULNERABILITY AND REASONS FOR OPTIMISM

- All EDEs vulnerable irrespective of external positions, though in different ways
  - Stability of domestic banking and asset markets is susceptible even in EDEs with strong external assets and BOP positions.
  - Those dependent on foreign capital are prone, in addition, to external financial instability (liquidity and debt crises).

- Are there reasons for optimism? Three developments cited compared to 1990s:

1. Adoption of more flexible exchange rates:
   - Effective if booms are managed judiciously, appreciations, deficits, debt build-up prevented. But this is not the case in many EDEs.
   - They cannot absorb severe shocks and prevent collapse (Indonesia in 1997).

RESERVES AND IMPROVED FISCAL POSTURE

2. Large stocks of reserves; how much self insurance?

- Adequacy; short-term debt + CA deficit + foreign asset holdings + capital flight
- They are mostly borrowed, not earned; can be easily drained.

3. Improved fiscal posture: reduced debt/GDP and borrowing in local currency:

- Contribution of favourable global conditions; reversible.
- Underreported- excludes locally-issued external debt (Malaysia).
- Currency risk lower but interest rate risk higher; more debt held by foreigners, more vulnerable. Domestic bond markets not liquid, a small foreign exit could cause collapse (seen during Lehman and taper tantrum).
- Only one of last 8 major crises due to sovereign external debt (Argentina). Others domestic debt (Mexico, Russia) or private debt (Asia, Brazil, TR). Private debt crises invariably leading to higher public debt (socialization).

CONCLUSIONS

- Pendulum gone too far in financial integration; increased fragility at a time of growing global financial instability.

- Response to renewed shocks: As usual? Borrow from IMF, bail out private debtors at home and creditors abroad, keep capital account open, use austerity.

- Unorthodox response:
  - Debt standstills, exchange controls; not using reserves to finance outflows
  - S-S cooperation in liquidity provision; but CMIM and CRA not adequate
  - A large SDR allocation as dollars are withdrawn.

- Systemic reforms: multilateral surveillance over policies of US and EZ, reserves system; debt workouts, IMF reform etc.

- Economic management in EDEs; need to manage booms better and improve fundamentals; graduation.