Views on the Economy & The World: Holes in the Roof

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The global economic outlook

• The economy improved in most places in 2017.
• But in 2018, clouds are re-appearing.

Countries have failed to fix holes in the roof.

• 1 Dangers for EM countries, external & local.
• 2 The return of EM foreign-currency corporate debt.
• 3 The return of pro-cyclical fiscal policy.
• 4 The return of trade barriers?
  • Trade/GDP slowed during 2008-2016. 2017 was better;
  • But now...trade wars?
The economic situation improved substantially in 2017:

- globally, growth up from 3.1% in 2015-16, to 3.8%;
- in advanced economies, including even the eurozone...

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<tr>
<th>Projections</th>
<th>2017</th>
<th>2018</th>
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<td>World Output</td>
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<td>Advanced Economies</td>
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...and in EM/Developing Economies.

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IMF World Economic Outlook, April 2018.
China’s slowdown after 2010 was unavoidable, but it avoided the feared hard landing and even commodity exporters began to recover in 2017.

IMF World Economic Outlook, April 2018.
But some EM inflows returned in 2017.
1. Some dangers for EM countries in 2018

• External risks that may test EMs.
  – Global trade war, as in 1930s.

• Local vulnerabilities.
  – The return of $-denominated corporate debt.
  – The return of pro-cyclical fiscal policy.

• The lesson: Policy-makers should take advantage of good weather to “fix the holes in the roof.”
One possible external shock: “Risk on / risk off”
Flows to EMs fall when risk fears (VIX) are high, as in 2008.
↓ in graph

Notes: Data on private capital flows from IMF’s IFS database, Dec. 2013. Capital flows are private financial flows to emerging markets and developing economies. Volatility index measured by the Chicago Board’s VIX or VXO at end of period. 2013 data are estimates.

Another possible external shock: US interest rates

After Fed “taper talk” in May 2013, capital flows to Emerging Markets turned negative.

May 2018: Has the test arrived?

- Eurozone growth rate slowed by half in Q1.
- The VIX rose sharply in February.
- US interest rates are rising
  - as the US economy hits full-employment
    - April unemployment = 3.9%.
- The dollar is up this year as well,
  - in a return to the pattern of 2014-16,
  - particularly against some EM currencies.
  - E.g., Argentina,
    - where the central bank May 4 had to raise the interest rate to 40%.
The VIX, unnaturally low in 2017, rose in February 2018...

CBOE volatility index, May 2017-May 2018

...as have US interest rates (10-year Treasury)...

Source: Chicago Board Options Exchange

Source: Board of Governors of the Federal Reserve System (US)
The dollar, which is still a safe haven, rose as well.
2. One vulnerability: The return of foreign-currency denominated corporate debt

After the currency crises of 1994-2002, many EMs learned to reduce their vulnerabilities.

- Central banks hold more forex reserves.
- More flexible exchange rates.
- Less $-denominated debt,
  - to avoid the adverse balance-sheet effects from currency-mismatch + devaluation.
Currency composition in the post-2003 capital inflows shifted away from $-denomination, toward Local Currency.

Wenxin Du & Jesse Schreger, Harvard Business School, 2016, “Sovereign Risk, Currency Risk, & Corporate Balance Sheets,” Fig.3.
But corporate debt post-2008 swung back to $-denomination, away from Local Currency, in some EMs.
FX bond issuance by nonfinancial corporates has increased in Latin America since 2009, raising vulnerabilities.

Sources: Dealogic; and IMF staff calculations.

Cubeddu, Iakova, & Sosa  IMF, February 2015
3. Another vulnerability: pro-cyclical fiscal policy

Why do leaders fail to take advantage of boom times to strengthen the budget?

• People don’t see the need to “fix the hole in the roof when the sun is shining.”
  – They may see the mistake when the storm hits,
    • but then it is too late.

• Official forecasts are over-optimistic in boom periods,
  rationalizing the failure to act,
  – according to data from 33 countries.
Cyclical Policy of Fiscal Policy,

“What is the best fiscal policy, Austerity or Stimulus?”

• The question is as foolish as the question, “Should a driver turn left or right?”

• It depends where he is in the road.  
  – Sometimes left is the answer, sometimes right.
Keynes favored *counter-cyclical* policy:

– fiscal stimulus when under conditions like the 1930s -- depressed income, high unemployment, low inflation, low interest rates -- to moderate the downturn,

– but fiscal *discipline* during boom periods, -- to prevent over-heating -- & to maintain debt sustainability.

“The boom, not the slump, is the right time for austerity at the Treasury.” - John Maynard Keynes (1937)
Keynesian policy ("fine tuning") fell into disfavor in part because it was hard to get the timing right:
• by the time fiscal stimulus became law, the recession would be over.

But that is no excuse for *pro*-cyclical fiscal policy.

Definition of *pro*-cyclical fiscal policy: Governments raise spending (or cut taxes) in booms; and are then forced to retrench in downturns, thereby exacerbating upswings & downswings.
Correlations between Government Spending & GDP 1960-1999

G always used to be pro-cyclical for most developing countries.

Adapted from Kaminsky, Reinhart & Vegh (2004)
The procyclicality of fiscal policy, cont.

- An important development -- some developing countries were able to break the historic pattern after 2000:
  - taking advantage of the boom of 2002-2008
    - to run budget surpluses & build reserves,
  - thereby earning the ability to expand fiscally in the 2008-09 crisis.

- Chile, Costa Rica, Botswana, Malaysia, S. Korea...
DEVELOPING:
43% (or 32 out of 75) countercyclical. *The figure was 17% (or 13 out of 75) in 1960-1999.*

INDUSTRIAL:
86% (or 18 out of 21) countercyclical. *The figure was 80% (or 16 out of 20) in 1960-1999.*
Update of Correlation (Govt spending, GDP): 2000-17

After 2010, back-sliding among some countries.
The problem with counter-cyclical fiscal policy:

Countries running big deficits even when the economy is strong, will be in trouble when the next down-turn comes.

- No “fiscal space.”

Advanced countries can suffer pro-cyclical policy too.

- i) The euro periphery.
- ii) The US.
(i) Pro-cyclical fiscal policy in Europe:

When the euro crisis hit in 2009, the bigger recessions went with the bigger fiscal contractions.

Source: P. Krugman, 10 May 2012.
Why? A different kind of over-optimism: Effects of austerity were worse than the Troika had assumed. The evidence: the bigger the fiscal contraction, the bigger the GDP loss *relative to what had been officially forecast.*

Europe: Growth Forecast Errors vs. Fiscal Consolidation Forecasts

Note: Figure plots forecast error for real GDP growth in 2010 & 2011 relative to forecasts made in the spring of 2010, on forecasts of fiscal consolidation for 2010 & 2011 made in spring of year 2010.
With austerity, debt/GDP ratios continued to rise sharply: Declining GDP outweighed progress on reduction of budget deficits.

(ii) US fiscal policy

for the 1st time since WWII, has turned strongly expansionary at a time when the economy is at full employment.

Source: Bloomberg

“This is how the world’s biggest economy goes broke...” Tama Churchouse, Feb.26, 2018
In Dec. 2017, the Republicans cut taxes sharply although the US economy was already operating at its potential.
The US currently is showing the world how not to do it.

- Pro-cyclical fiscal policy.
- Reversal of financial regulation.
- Unilateral protectionist threats.
THANK YOU

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www.project-syndicate.org/columnist/jeffrey-frankel

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Appendices

• Appendix 1: More on 2018 as a cyclical top.

• Appendix 2: More on the case of Chile,
  – overcoming fiscal pro-cyclicality
    from optimism bias in official forecasts

• Appendix 3: The slowdown in trade
Appendix 1: More on 2018 as a cyclical top.

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<td>Middle East, North Africa, Afghanistan, and Pakistan</td>
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Economies are listed on the basis of economic size. The aggregated quarterly data are seasonally adjusted. 1Difference based on rounded figures for the current, January 2018 World Economic Outlook Update, and October 2017 World Economic Outlook forecasts. 2Excludes the Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries. 3For India, data and forecasts are presented on a fiscal year basis and GDP from 2011 onward is based on GDP at market prices with fiscal year 2011/12 as a base year. 4Indonesia, Malaysia, Philippines, Thailand, Vietnam.

IMF World Economic Outlook, April 2018.
Spanish exports have led its recovery.
US equity markets are still high

IMF World Economic Outlook, April 2018.
Asian equity markets are also high.

IMF World Economic Outlook, April 2018.
Appendix 2: More on Chile’s fiscal institutions

• 1\textsuperscript{st} rule – Governments must set a budget target,

• 2\textsuperscript{nd} rule – The target is structural: Deficits allowed only to the extent that
  – (1) output falls short of trend, in a recession,
  – (2) or the price of copper is below its trend.

• 3\textsuperscript{rd} rule – The trends are projected by 2 panels of independent experts, outside the political process.
  – Result: Chile avoided the pattern of 32 other governments,
    • where forecasts in booms were biased toward optimism.
Chilean fiscal institutions

• In 2000 Chile instituted its structural budget rule.
• The institution was formalized in law in 2006.
• The structural budget surplus must be...
  – 0 as of 2008,
  – where structural is defined by output & copper price equal to their long-run trend values.
• I.e., in a boom the government can only spend increased revenues that are deemed permanent; any temporary copper bonanzas must be saved.
The Pay-off

• Chile’s fiscal position strengthened immediately:
  – Public saving rose from 2.5 % of GDP in 2000 to 7.9 % in 2005
  – allowing national saving to rise from 21 % to 24 %.

• Government debt fell sharply as a share of GDP and the sovereign spread gradually declined.

• By 2006, Chile achieved a sovereign debt rating of A,
  • several notches ahead of Latin American peers.

• By 2007 it had become a net creditor.

• By Dec.2017, Chile’s sovereign rating had climbed to A+,
  • ahead of some advanced countries.

• => It was able to respond to the 2008-09 recession
  – via fiscal expansion.
The problem of over-optimism in official forecasts

• Statistically significant findings among 33 countries

- Official forecasts on average are overly optimistic, for:
  - (1) budgets &
  - (2) GDP.

- The bias toward optimism is:
  - (3) stronger the longer the forecast horizon;
  - (4) greater in booms.
Implication of forecast bias for actual budgets

• Can lead to pro-cyclical fiscal policy:
  – If the boom is forecast to last indefinitely, there is no apparent need to retrench.

• BD rules don’t help.
  – The SGP *worsens* forecast bias for euro countries
US official projections were over-optimistic on average.
Greek official forecasts were always over-optimistic.

Data from Greece's Stability and Convergence Programs.
German forecasts were also usually too optimistic.
Chile’s official forecasts were *not* over-optimistic.
Appendix 3. The trade slowdown

Trade used to grow twice as fast as GDP. Since the 2008-09 recession, it has grown much more slowly.

Since the rebound from the great trade collapse of 2008–09, when world trade fell by much more than GDP, global trade growth has slowed notably, both in absolute terms and relative to world GDP growth. This slowdown has been more pronounced in emerging market and developing economies, where it intensified in 2015. See Hoekman 2015 for a compilation of studies analyzing the drivers behind the recent trade slowdown.

Emine Boz, Eugenio Cerutti, & Sung Eun Jung (IMF, 2016).
Growth in trade was rapid during most of the post-war period—twice as fast as GDP.

*World trade growth has been significantly subdued in recent years.*

Note: World trade refers to total world imports. The historical trend is computed over the 1970-2014 period, smoothed using a Hodrick-Prescott filter.
But the trend of economic integration across national borders is not inevitable or irreversible, even if technological progress in transport and communication is one-directional.

– In the period 1914-1945, political forces worked to turn the clock back on globalization:
  • tariff protection,
  • discriminatory economic blocs,
  • and war.

– They had the effects one would expect: Trade fell sharply.

– It could happen again.
When the Global Financial Crisis hit in 2008...

- there was a fear that countries might revert to protectionism, as in the 1930s, with similar results.
  - The first two meetings of the new G-20 Leaders Summit in 2008 & 2009 pledged not to impose new protection.

- The fall in trade turned out to be worse than feared.
Since 2008, **global trade** has indeed slowed.
Why has trade slowed so much?

i. Global supply chains have matured
   -- Vertical specialization has largely run its course.

ii. Physical investment spending has slowed
    – which is trade-intensive.

iii. The structure of China’s economy is shifting
    – away from manufacturing, toward services;
    – away from exports, toward domestic demand.

iv. Protectionism?
(ii) The slowdown in trade was correlated with a slowdown in physical investment (which tends to be import-intensive).

IMF WEO, Apr 2018.

1Selected commodity exporters = Angola, Brazil, Ecuador, Nigeria, Russia.
(iii) The structure of China’s economy is “rebalancing.”

• China long had great success with manufacturing;
  – growth was led by exports and investment.

• But since 2013 it has moved toward services,
  – with growth led by consumer demand, appropriately.

• Services are less trade-intensive than manufacturing.
China’s exports & imports had risen especially fast, even relative to GDP, before 2008.

(Followed by the US. EU trade/GDP had been flat.)
China is shifting into services, judging by the available data.

Share of Tertiary Industry, 2002 – 1H 2015

Source: Nicholas Lardy, PIIE
Decline in China’s output of industrial products, 2010-2015

It’s good to look also at other data

% change (year-over-year)

Source: China National Bureau of Statistics, China Coal Transportation & Distribution
Trade’s relative importance in China has peaked, in part because services are less trade-intensive.

Source: Nicholas Lardy
(iv) Protectionist measures? They did not rise in the 2007-09 recession as much as they had in past recessions.

The WTO trade restrictiveness indicators – capturing border measures such as tariff increases, import licenses, or new customs controls – show a modest increase in the share of world trade covered by new import restricting measures since the Great Recession (Fig. 13). These findings suggest that protectionist trade policies are playing a negligible (if any) role in the current trade slowdown.

Constantinescu, Mattoo, and Ruta, 2015,
"The global trade slowdown: cyclical or structural?" IMF WP 15/6.
But Trump’s 2018 policies could indeed turn the clock back on trade.

• He is unlikely to get more than face-saving concessions,

• but he may undermine the multilateral trading system for the long-term.