

Ravi Menon: The global economy – securing a return to normalcy

Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Citibank 10th Annual Asia-Pacific Investor Conference, Singapore, 30 January 2013.

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Mr Stephen Bird, Asia Pacific CEO, Citigroup,
distinguished guests, ladies and gentlemen, good morning.

The long shadow of the financial crisis

1. The global economy is stuck in a hesitant and uneven recovery. In a way, we should not be surprised. The seminal work by Carmen Reinhart and Kenneth Rogoff suggests that exits from severe financial crisis take at least a decade. By this metric, we have already passed the mid-way point of the healing process. But the experience of countries emerging from the long shadow of the 2008/2009 financial crisis has been different.

US: steady deleveraging plagued by fiscal uncertainty

2. The US economy has already exceeded its pre-crisis peak. This is encouraging, considering that the recent recession was the deepest the country had experienced since the Great Depression.

- Fiscal and monetary stimuli have been decisive, putting the US on a stronger recovery compared with Europe.
- Private sector deleveraging has proceeded steadily. Household debt has come down to 113% of disposable incomes in Q3 2012, from 134% in Q3 2007.
- The biggest drag on the economy – the housing market – is turning around. House prices have been rising steadily since February 2012 and new houses are being built at a healthy pace.

3. Fiscal uncertainty has, however, emerged as the clear and present danger facing the US economy. The partial deal in Congress earlier this month has prevented the economy from falling over the fiscal cliff. But three inter-related fiscal challenges remain.

- First, the deferred budget sequester or spending cuts that kick in from March this year.
- Second, the debt ceiling that needs to be raised, beyond just the next six months.
- Third, and most important, a medium-term deficit reduction deal.

4. As it is, the partial expiry of previous tax cuts and exemptions could already be causing a fiscal withdrawal of about 1–1½ percentage points of GDP. If Congress fails to reach an agreement, the automatic spending cuts could impose an additional drag of 0.4% of GDP.

Europe: strengthening the fiscal union while fighting a crisis

5. Europe has fared less well. As of 2012, the Eurozone economies have recovered less than 60% of the output lost during the crisis. For the last two years, the Eurozone has been caught in a vicious cycle between weak sovereigns and weak banks. The crisis has exposed basic design flaws in the architecture of the European Monetary Union, chiefly the absence of a fiscal union.

6. The challenges facing European policymakers are not trivial. They have to put in place the structures and policies necessary to address the design flaws of the currency union, while at the same time fight a recurrent crisis of confidence in the financial markets. Restoring market

confidence, in turn, requires achieving fiscal sustainability while spurring economic growth. Some have described the task as akin to redesigning an aircraft in mid-flight amidst severe turbulence!

7. Nonetheless, important progress has been achieved and the situation today is visibly better than it was even six months ago.

- The European Central Bank's Outright Monetary Transactions programme has materially reduced the tail risk of a disorderly breakup of the monetary union.
- Sovereign bond yields in Italy and Spain have come down, on average, some 200 basis points from their peak levels in the middle of last year.
- Bank deposits in the peripheral countries of Greece, Ireland, Portugal and Spain have shown signs of stabilisation.

8. But Europe remains mired in recession. There is still no compelling growth agenda. Domestic demand is weak amidst fiscal consolidation. Banks are not lending amidst an uncertain investment environment. And several structural issues remain unresolved. It will not take much to reignite financial market stresses. In short, the crisis in the Eurozone is not over.

Japan: dealing with deflation, demographics, and a natural disaster

9. Japan has a different set of problems. Its economy has recovered less than two-thirds of the output lost during the crisis. It has fallen prey to weak external demand and is still reeling from the aftershocks of a major natural disaster.

10. Japan is caught in the pincer grip of prolonged deflation and unfavourable demographics. Real interest rates in Japan are probably higher than warranted by the state of its economy. But the effects of further monetary easing are not expected to be decisive. Nor is it clear that fiscal stimulus will lift the economy on a sustained basis.

11. The biggest drag on the Japanese economy is its demographics. Japan's working age population has been growing by just 0.2% per annum over the last ten years. Together with a declining participation rate, the labour force has contributed negatively to GDP growth in almost every year since 1998. A firm turnaround in the Japanese economy requires a sustained increase in productivity, which entails structural reforms to enhance product market flexibility and spur competition and innovation in the services sector.

Emerging Asia: the rise of domestic demand

12. In comparison, Emerging Asia has weathered the financial storm best, with the region's total production now one-third higher than what it was in 2008.

13. China secured a quick and vigorous rebound from the depths of the global trade collapse in early 2009. It has since reined in inflationary pressures and indications are that it has achieved a "soft landing" of its economy, registering an estimated 7.8% growth last year on the back of solid consumer demand and infrastructure investment. While China faces significant economic restructuring challenges, its impressive growth trajectory appears intact for now.

14. India too rode through the global financial crisis comfortably but is now going through a weak patch. But if it regains its reform momentum and begins to address its infrastructure deficit, growth should pick up to levels closer to those seen in the last decade.

15. In the ASEAN-4 economies of Indonesia, Malaysia, Thailand and the Philippines, domestic demand has displayed surprising resilience. This has held up economic growth, despite prolonged weakness in external demand and continuous terms-of-trade shocks.

16. But Emerging Asia is also not without its risks. While the advanced economies are deleveraging, Emerging Asia is re-leveraging. Credit growth has been climbing steadily, from an average 8% in 2009 to 15% in 2011, before easing to 12% in last year. The private

credit-to-GDP ratio for the region, at 120%, is higher than during the Asian financial crisis. There is good reason for policymakers to be on their guard.

Macro policies: the unfinished agenda

17. So, where is the global economy on its post-crisis journey? While economic prospects for 2013 look slightly brighter and tail risks have diminished, the global economy and financial markets remain fragile and vulnerable to shocks.

18. But this halfway point provides us, perhaps for the first time since the crisis, the opportunity to look ahead and pose the question of what is required to ensure a smooth return to normalcy.

- The advanced economies need to achieve fiscal consolidation alongside economic growth and chart an effective exit strategy from unconventional monetary policies.
- The emerging market economies need to deal with a weak external environment and incipient domestic cost pressures especially in the context of volatile capital flows and asset market pressures.
- And both advanced and emerging market economies must undertake structural reforms to boost their economies' potential and create jobs for their people.

Let me elaborate on each of these three themes.

Advanced economies: restoring time-consistent macroeconomic policies

19. First, the advanced economies need to restore time-consistency in their macroeconomic policies. Governments are borrowing money and central banks are printing money. This is unsustainable.

Implementing growth-consistent fiscal consolidation

20. The choice in Europe and in America is not between growth and austerity. Debt sustainability requires both a reduction in the numerator, by reducing deficits and borrowing, as well as an increase in the denominator, by restoring economic growth. Focusing excessively on the former will lead to an ever-deepening recession that will only make the debt trajectory unsustainable. Equally important, fiscal consolidation should not compromise long-term growth potential.

21. The debate on fiscal policy should focus on the pace and composition of fiscal consolidation and not just its scale.

22. Pace matters. It is more important to reduce the fiscal deficit of 2016 than of 2013. But it is equally important that something be done in 2013 that will reduce the 2016 deficit than to leave it to 2016 to do so. Only then will markets have confidence that policies are time-consistent. A growth-consistent fiscal strategy entails making binding commitments now that will deliver medium-term fiscal savings rather than achieve immediate deficit reduction. Tax and pension reforms are good examples.

23. Composition matters even more. Consolidation should focus on broadening tax bases and cutting non-productive entitlement spending. Programmes that underpin future growth – for example, infrastructure, education, and worker retraining – should not be cut sharply. It is not just the macroeconomics of fiscal policy that matters but the microeconomics as well.

Unwinding unconventional monetary policies

24. The unprecedented crisis of 2008/2009 evoked an unprecedented response from fiscal and monetary policy-makers around the world. This decisive response helped avert a global depression. But five years after the emergency resuscitation measures, monetary policy settings in the advanced economies are still in “crisis mode”. Interest rates are close to zero and central bank balance sheets have seen a relentless expansion.

25. Nearly every major central bank in the advanced world is buying non-traditional assets to resurrect its domestic economy.

- The US Fed is buying mortgage-backed securities. Its balance sheet has more than tripled to US\$3 trillion, or 19% of GDP.
- The ECB has made long-tenured loans to banks through its LTRO programme and is prepared to buy sovereign bonds through its OMT programme. The Eurosystem's balance sheet has more than doubled to €3 trillion, or 31% of GDP.
- The Bank of Japan is buying government bonds, but has also purchased corporate bonds and real estate investment funds. Quantitative easing by the BoJ has amounted to 100 trillion yen, or 21% of GDP.
- The Bank of England is buying gilts, and some commercial paper and corporate bonds. Its Asset Purchase Programme is now £375 billion, or 24% of GDP.

26. Central banks cannot expand their balance sheets indefinitely. The incremental benefits of further monetary easing are diminishing while the potential costs are increasing.

27. On the benefit side, it is not clear that additional monetary stimulus is an appropriate tool at this stage of the cycle. We would do well to remember the words of John Maynard Keynes in 1936, "If money is the drink which stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip."

28. The problem is not liquidity but credit. Capital-strapped banks are unwilling to lend and the private sector is unwilling to borrow, a reflection of uncertainty over fiscal policies, high indebtedness, and low income growth.

29. And we should be vigilant of the potential costs of cheap money. As market stresses subside and money multipliers recover, the abundance of liquidity could fuel a strong monetary expansion with adverse consequences for prices, which would eventually require large hikes in interest rates to counter. Easy money over a prolonged period can also lead to a mispricing of risks and unsustainable asset prices, compromising both price stability and financial stability.

30. Given the long lags in monetary policy, central banks must look forward now and prepare a strategy for a smooth transition back to normalcy.

Asian economies: dealing with desynchronised global macroeconomic cycles

31. The second key aspect in securing a return to normalcy is the adjustment of macroeconomic policies in the emerging market economies to spillovers from the advanced world. I will speak with reference to Emerging Asia.

Continually shifting gears in monetary and fiscal policies

32. In the early stages of the financial crisis, most Asian countries responded with expansionary macroeconomic policies to dampen the effects of a collapse in exports. Between August 2008 and August 2009, policy rates across Asia were more than halved, on average. Substantial fiscal stimulus was injected, ranging from higher investment spending in China to significant tax cuts in Indonesia. Fiscal deficits across Asia widened from an average of 0.6% of GDP in 2008 to 3.0% in 2009.

33. From 2010 onwards, a two-speed recovery took hold in the global economy, with advanced economies growing sluggishly and Emerging Asia staging a vigorous rebound. Incipient inflationary pressures prompted central banks in the region to raise policy rates from mid-2010 onwards. Although renewed risks stemming from the Eurozone crisis led to a fresh round of easing in some economies in late-2011, policy rates in Emerging Asia are on average 75 basis points higher now vis-à-vis their troughs during the crisis.

34. Fiscal stimulus has also been withdrawn progressively. As of 2011, fiscal deficits in the region have narrowed once more to an average of 1.1% of GDP.

35. Asian economies must continually recalibrate their monetary and fiscal policies, as external demand conditions and domestic cost pressures pull in opposite directions. Maintaining flexibility in macroeconomic policies must go hand-in-hand with reforms to strengthen domestic demand.

Breaking new ground in macroprudential policies

36. The de-synchronisation of global macroeconomic cycles between the advanced economies and emerging market economies poses more challenges for the latter than the former. As long as monetary conditions in the advanced economies remain easy, emerging market economies face the risk of misallocated resources and disruptive capital flows, which in turn can affect both price stability and financial stability.

37. Low interest rates and abundant liquidity have contributed to asset price accelerations in some Asian countries, especially in real estate markets. Residential property prices in Korea, Taiwan, Hong Kong, and Singapore, for example, have increased by 35% on average since 2009, while nominal wages have risen by only 13%.

38. No doubt, increased capital flows to emerging market economies reflect the superior growth prospects of these economies. There is a structural rebalancing of global investment portfolios towards emerging markets in general, and Emerging Asia in particular. A multi-pronged policy response is needed to ensure that inflationary pressures remain contained in the face of this “wall of money” – including a gradual appreciation of nominal effective exchange rates. And indeed, since mid-2009, when capital flows began to return to Emerging Asia, most regional currencies have appreciated by 3–10% in nominal effective terms.

39. But exchange rates alone cannot shoulder the burden of adjustment to low global interest rates and large capital inflows. In fact, strong and sustained exchange rate appreciation may well attract even more capital inflows. And excessively rapid currency appreciation runs the risk of sharply curtailing exports and dragging down the economy. Nor is it clear that exchange rate appreciation alone could have mitigated the increased demand for credit and consequent surge in property prices that we have seen in Emerging Asia.

40. Likewise, interest rates are too blunt a tool to deal with sector-specific excesses, such as in real estate. An interest rate policy that is sufficiently aggressive to affect credit conditions and asset prices is likely to impose quite a high cost on the rest of the economy.

41. Asian policymakers have therefore been experimenting with a variety of so-called macroprudential policies, to rein in asset price inflation and avoid a build-up of imbalances amidst a low interest rate environment. Macroprudential measures as practised in Asia fall into two broad categories:

- One, prudential measures to restrain credit extended to the property market. These include loan-to-value ratios, debt service ratios, and caps on property lending.
- Two, fiscal measures to discourage property transactions of a speculative nature. These include transaction taxes, such as stamp duties and capital gains taxes.

42. With multiple policy objectives and a challenging economic environment, macroprudential tools have given additional degrees of freedom to Asian policymakers who want to avoid a build-up of financial imbalances and unsustainable asset prices, but do not want to give up domestic monetary sovereignty, allow excessive exchange rate appreciation, or impose capital controls.

43. While these targeted interventions have achieved a measure of success, macroprudential policies in Emerging Asia have been deployed in a relatively eclectic and even ad-hoc manner. As these countries return to more normal times, there is a need to

formalise and institutionalise the modus operandi of these policies, for greater transparency and policy effectiveness.

Reforms to strengthen the underlying potential of economies

44. Let me now turn to the last, and perhaps most important, set of policies that will determine how successfully the global economy secures a return to normalcy. These are the structural reforms needed to strengthen the underlying potential of economies. Let me highlight those which I think are most important.

Advanced economies: labour reform, tax reform, pension reform

45. In the advanced economies, I would put labour market reform, tax reform, and pension reform at the top of the list.

46. Labour markets need to become more flexible, especially in Europe. Even in the US, production patterns are changing rapidly, increasing skills mismatches and generating structural unemployment. Labour market policies must seek to facilitate the shift of workers from domestically-oriented sectors facing weak demand to export-oriented sectors, and from depressed regions to resurgent ones. And wages must become more flexible, so that firms can ride out cyclical downturns without losing competitiveness.

47. Next, tax reform. The debate needs to shift from the rate of taxation to the structure of the tax system. The US could do with a broader tax base, simpler tax codes, and less exemptions. In Europe, similarly, there are opportunities to increase the efficiency of the VAT system including in broadening its base.

48. Lastly, pension reform. Government spending in many advanced economies needs to be overhauled in the face of impending demographic challenges. Effective pension reform requires a judicious combination of increases in the statutory retirement age and reductions in the generosity of benefits, with the balance varying from country to country.

Emerging Asia: domestic demand, financial deepening, productivity

49. In Emerging Asia, the key structural reforms are in the areas of boosting domestic demand, deepening financial markets, and raising efficiency and productivity.

50. Boosting domestic demand is perhaps the most important medium-term imperative for Emerging Asia. Public and private sector deleveraging in the advanced economies has at least dented, if not extinguished, the export-powered growth model that has been largely responsible for the “Asian Miracle”. Reforms are needed to stimulate private consumption in some Asian economies, and investment in others.

51. In China, the issue is consumption, not investment. China needs to lift its consumption ratio from its current low of 36%. Ongoing efforts to bolster the social safety net, enhance consumer protection, reform tax systems, and liberalise interest rates, are steps in the right direction.

52. In India and the ASEAN economies, the challenge is to increase investment spending, especially in infrastructure. This will not only generate indigenous demand, but also alleviate supply-side constraints that have become increasingly evident in recent years.

53. Second, Asia must deepen and broaden its financial markets. Asia needs to do a better job in efficiently intermediating its large savings pool, as well as directing capital inflows towards more productive investment in the region. Asian financial systems are still too dependent on banks. Deep corporate bond markets can play a complementary role in enabling private and institutional investors to invest for the long term.

54. Third, increasing productivity. Countries in Emerging Asia are still far from the technological frontier, and there is ample room for gains in productivity. However, unlocking these gains will require different policies across the region.

55. China can unleash higher productivity by removing inefficiencies and distortions in its economy. The prescriptions are well-known – overhaul state-owned enterprises, liberalise the financial sector, instil cost of capital discipline. But delivering them will take determination and political will. In India and the ASEAN countries, improvements in governance and regulation will be key to attracting investments that can raise supply capacity and productivity.

Conclusion

56. Let me conclude. The world has coped relatively well with the numerous shockwaves that have rocked the global economy in the wake of the financial crisis. Now that we are advancing on the road to recovery, policy-makers must lay the ground for a return to normalcy. We would do well to recall the words of Winston Churchill, “Success is not final, failure is not fatal: it is the courage to continue that counts”.

Thank you, and I wish you a successful conference.