Sukhdave Singh: Global economic outlook and financial landscape – what has changed since the global financial crisis?

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I would like to thank ASLI for the invitation to address you today. Given that I am speaking right before your lunch, I do realise that I have been cast into the role of an appetiser and therefore, that I should be brief so that you can quickly get on to the main course.

I plan to briefly go over the state of the global economy and its implications for the Malaysian economy. The news here is largely good. However, there are a number of concerns that could impact the quality and sustainability of growth going forward, and I will also discuss these.

Global economic outlook and the changing financial landscape

The good news is that after five years of rather turbulent conditions and what has been a rather bumpy economic ride, the global economy seems to be finally on the verge of sustained growth. The key to this development is the improved growth conditions that have emerged in many of the advanced economies (AEs), economies that were at the heart of the crisis. While we continue to believe that the growth in the advanced economies will remain low relative to historical levels, and there are a number of reasons for that, the signs are that these economies are finally able to achieve steady growth. And that is obviously good for the global economy.

As for the emerging market economies (EMEs), they have done relatively well in the years since the crisis. Domestic demand had been supported by high commodity prices as well as expansionary fiscal and monetary policies. However, growth in the EMEs now seems to have hit a bump in the road. The commodities boom has tapered off and this has impacted incomes. The fiscal stimulus has increased government debt making further fiscal expansion less sustainable. On top of that, the low interest rate environment has led to an increase in household debt. These developments are now beginning to act as a brake on economic growth. This experience highlights the risks and limits of domestic demand driven by easy monetary policy, cheap credit and fiscal stimulus. Therefore, domestic demand in EMEs will grow at a slower pace. Nevertheless, EMEs will still be contributing a bigger share to global growth than the AEs. The re-emergence of growth in the crisis-affected AEs could be expected to strengthen external demand for the exports of EMEs, thereby mitigating the effect of slower domestic demand.

Among the Asian economies, we do expect to see similar trends. Again, sustained domestic demand, while lower than in the past, will continue to support growth. There has been a lot of concern about the Chinese economy for obvious reasons – it having become the second largest economy in this world. And among many regional economies, it is now their most important trading partner. So, if the Chinese economy catches a flu, we will all feel the effects of its sneezing. Having said that, the Chinese economy will continue to grow and the policymakers there seem to be determined in ensuring that it does.

Implications to Malaysia

Malaysia will certainly benefit from the more positive growth environment, especially given the better growth of its major trading partner economies. The Malaysian economy is projected to grow by 4.5–5.5%. This outlook is supported by the strong growth of 6.2% in the first quarter of 2014. The outlook has improved due to better external demand conditions. After growing by only 2.4% in 2013, Malaysia's exports have grown by almost 13% so far in 2014.

For a small open economy like Malaysia, and others like it, the experience of the crisis and the years since has certainly brought home the vulnerabilities and risks of being integrated with the global economy. But, I believe that it has also highlighted our dependence on the global economy and the need to be even more integrated with the global economy. At the risk of a slight diversion, allow me to elaborate a bit on this point.

After the crisis, there was some excitement about domestic demand being the driver of growth, and there was some justification for such enthusiasm. There was certainly a component related to the growth in incomes and private demand. But there was also a significant component related to public spending and the rapid growth of domestic credit. The outcome is higher debt levels for both households and the Government. This is clearly not a sustainable strategy for growth. Indeed, the experience has shown that there are limits to how fast and how sustainably we can grow by relying on domestic demand alone. Therefore, going forward, while domestic demand will continue to support growth, we really need to strengthen our integration with both the regional and global economy, and by implication, strengthen our overall level of economic competitiveness, if we are to achieve sustainable growth over the long term.

Returning to the economic outlook, the good news is that we are seeing more sustained growth around the world and that is already beginning to benefit Malaysia and creating more balanced growth of the Malaysian economy.

Now what are the potential clouds over this rather sunny outlook? There are several, but in the interest of time, I will just mention five.

The first of this is the slow recovery of investment in the AEs after the crisis.

It has been noted that this recovery, unlike recoveries from past recessions, has been accompanied by rather lackluster investment. This is despite the fact that companies are sitting on large piles of cash.

What have companies been using those cash piles for? Well, either they have been returning that cash in bucket-fulls to shareholders or using it to support their share prices through share buy-backs. It was reported in yesterday's *Financial Times* that during the first three months of this year alone, the S&P 500 companies in the US spent a record US$241 billion to repurchase shares and pay cash dividends. While this may help to keep share prices high, they do not create new sources of growth. Meanwhile, capital spending by the S&P 500 companies has grown by an average of just 3.6 percent per year over the last five years. Ultimately, the quantity and quality of investment will determine the quality of growth now and well into the future.

The second issue facing these economies is that despite the drop in unemployment, productivity growth has remained weak.

The way we understand the recovery process, when demand picks up, companies will first try to meet it using its existing workers. Productivity increases. However, as demand continues to grow, the increase in productivity of existing workers will be insufficient and companies have to hire new workers to increase production. So employment increases. Therefore, an increase in productivity is accompanied by an increase in employment. We have not witnessed that phenomenon this time. In the US, the unemployment rate has fallen from its peak of 9.8% to 6.3% in May 2014 but productivity was only growing 1%, less than half of what it was in the years prior to the crisis.

There are a number of possibilities as to what is going on:

- In the UK and US, it has been noted that the number of business start-ups has increased significantly in the post-crisis years. One interpretation of this is that, increasing number of people have given up on gaining employment and have decided to become self-employed. If this is true, it would help to explain the decline in unemployment and low productivity growth. Being in business means you are no longer unemployed and new businesses generally do not have very high productivity.
- Another interpretation is that a significant part of the fall in unemployment has come not so much from more people being employed but rather from people leaving the labour force. The labour force participation rate in the US has fallen from 66% prior to the crisis to its current level of 63%. Essentially, the labor force is shrinking. In which case there would be no reason to believe that the decline in unemployment should be preceded by rising productivity. Another factor undermining productivity could be the fact that the number of part-time workers has also increased – in the US, from 3% of the working population to 5% in 2014:Q1.
- The question of low productivity growth is not unrelated to the preceding issue of low investment. The rate of productive investment is a key determinant of the future growth and productivity of an economy.

Whatever the reasons, if productivity does not pick up, it would have a dampening effect on the growth of wages and incomes, and consequently, on the strength of economic growth going forward.

The third issue is related to the policy risk.

There is what I call the "monetary policy pendulum". In the post-crisis period, monetary policy in the AEs has gone where no central banker has gone before. My analogy to the pendulum simply means that the further out you pull on something in one direction, the further it is likely to go in the other direction when you let go. There is the risk that the process of normalisation from the extreme policy positions could create undesirable outcomes, especially given the level of risk taking that we have seen in the extended period of very easy global liquidity conditions and the resulting desperate search for yields. If economic conditions change faster than currently anticipated by policymakers, would a rapid and potentially large reversal of policy be possible, and if so, what could be the potential side-effects? It would certainly not be helpful to stability in the global financial markets. There has been increased interest among policymakers in these economies in also using macro-prudential tools to manage the build-up of risks in the low interest rate environment. The use of such tools may be helpful in these economies, but it also poses a potential risk to the rest of the world. For example, it could push even more capital flows in the direction of emerging economies like Malaysia.

The crisis has also stretched the fiscal position of governments, both in the advanced and emerging economies. In some cases, such deterioration was related to dealing with the effects of the crisis (e.g., from bank rescues) and the low GDP growth post-crisis, in others it reflects the outcome of years of unwise fiscal spending. Whatever the reasons, constrained fiscal positions mean a reduced capacity to support economic activity and a reduced ability to deal with future crisis and shocks. It also means that monetary policy may be called on to do more than it can realistically deliver – a phenomenon we are already witnessing in the advanced economies.

A related policy issue has to do with structural reforms.

This is a topic that has been much discussed in the post-crisis years. The trans-Atlantic crisis was a blow-up of large imbalances and distortions – both real and financial – built over many years. It reflects policymakers delaying or ignoring needed reforms. The experience has once again provided the lesson that the longer such imbalances are ignored and allowed to pile up, the bigger the mess when the whole pile finally comes crashing down.

Structural reforms are certainly needed in many of the crisis affected advanced economies. But they are also needed in many EMEs, including in Malaysia. They are needed to ensure that economic growth is based on strong foundations and therefore will be more sustained and sustainable. Yet, the pace of structural reforms in most economies has been very slow and has lacked momentum. The main reason behind this inertia is often the stranglehold of vested interest.

On this point, let me quote Mr. Travis Kelanik, the founder of the taxi service app *Uber*, which last week caused the black cab drivers in London to go on strike. He was reported in the *Wall Street Journal* as saying:

"…there's so much corruption and so much cronyism in the taxi industry and so much regulatory capture that if you ask permission up front for something that is already legal, you'll never get it. There's is no upside to them."

Clearly, the taxi industry is not the only one that has this characteristics, nor is it the only one that would be resistant to competition and structural change.

Another reason for the inertia is that structural reforms often entail short-term pain even if they do provide long-term gain. Note the protests that have occurred in the crisis-affected economies in response to structural measures that governments in those economies have been forced to implement. The short-term pain makes structural reforms a politically difficult decision. There are sectors of society that would be adversely affected by these reforms and they will not take it kindly. Therefore, it takes political courage. The other point is that while reforms are occurring, they can adversely affect the pace of economic growth due to the dislocations caused. However, assuming that the Government has the fiscal strength, some of these dislocations can be mitigated through the use of fiscal policy.

Therefore, in terms of the growth outlook, if countries seriously undertake structural reforms it may temporarily reduce growth, but would likely lead to much stronger longer-term growth. If such reforms are not undertaken, it would create a low and unstable growth path for the affected economies. The collateral consequence of this later outcome could be increased cross-border frictions.

The fifth and final point I would like to mention has to do with income inequality.

You cannot but have noticed that it has become a hot topic of discussion in the post-crisis period. The French economist Thomas Piketty, has become a superstar by writing a book on it. The reasons for this are obvious. Well-paid bankers caused the crisis and after the crisis most of them continue to have well-paid jobs. Many low and middle income workers lost their jobs, suffered sharp declines in their economic welfare, and many even lost their homes. Furthermore, the crisis has highlighted the large disparities in income in the AEs, and the fact that in the preceding period of prosperity, the benefits of growth have largely gone to a relatively small group in society.

You can say that the crisis has let the genie out of the Gini-coefficient.

How governments deal with this income disparity will not only be reflected in social and political outcomes, but also economic ones as it is the low and middle income groups that have the highest marginal propensity to consume. Similarly, a lack of success in dealing with the high youth unemployment in the crisis affected economies could have lasting consequences and put these young people on a permanently lower earnings path, further contributing to both income inequality and weaker growth.

To conclude, let me summarise my key message:

Economically, things are looking better than they have been in a long time. However, the legacy of the crisis remains and will remain with us for some time yet. And this will continue to cloud the outlook and will be a concern and challenge to policymakers as they try to steer the global economy out of the crisis on to a more sustained and sustainable growth path.