Ravi Menon: Global economic outlook - renewed optimism, higher uncertainty

Speech by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the UBS' Wealth Insights Conference, Singapore, 16 January 2017.

* * *

Ladies and gentlemen, good morning.

The global economy in 2016 – resilient but uninspiring

2016 was an eventful year for the global economy.

- If you recall, we began the year with anxiety over China's financial markets but breathed easier over the course of the year as China steadied its economy and avoided the hard landing feared by many.
- We saw economic momentum in the US slip, and then pick up towards the end of the year, which also saw the second rate hike by the Fed in 10 years and an unexpected presidential election outcome.
- The EU economy was stirred but not shaken by the shock of the Brexit vote in June, with accommodative monetary policy providing support while domestic demand gradually improved.
- Japan saw further innovations in monetary easing – with negative interest rates and yield curve control – with some but not decisive improvement in growth outcomes.
- In the ASEAN economies, growth was respectable but below potential, as a pick-up in private consumption was offset by weaker investment and exports.

Overall, I would say the global economy in 2016 was resilient but uninspiring.

- Economic growth was sustained in the face of shocks but remains sub-par.
- Global GDP growth has averaged between 3.0 and 3.5% – a sub-trend outcome that we have not been able to break out of since 2011.
- This is significantly lower than the average of 3.8% that we witnessed before the global financial crisis, between 1990 and 2007.

There are some broad themes that have shaped economic outcomes during the last five years.

- In the advanced economies, there are accommodative monetary policies, fiscal consolidation, and deleveraging.
- In the emerging economies – a shift toward domestic demand, credit expansion, and a build-up in debt.
- In both advanced and emerging economies, we have seen slower growth in the key drivers of long-term prosperity – namely trade, investment, and productivity.
- Everywhere, the pace of structural reforms has been slow.

Outlook for 2017 – renewed optimism, higher uncertainty

What does 2017 hold for the global economy?

Let us consider first what financial markets are saying. Since late last year, the markets have been pricing in higher growth, higher inflation, and higher interest rates.

- Long-term bond yields have risen sharply in the advanced economies.
- Equity prices have surged.
- This reflation story has been particularly accentuated in US stock and fixed income markets.
  - Reflecting this, the US Dollar has appreciated sharply, rising to its strongest level against the major currencies since 2003.

The market narrative goes something like this:

- The new Administration in the US will inject a substantial fiscal stimulus – based on reduced corporate taxes and higher infrastructure spending.
- There will be significant deregulation of the economy – in key sectors like financial services, healthcare, and energy – unleashing animal spirits and new investment.
- The disinflationary drags from oil and commodity prices will fade and lift producer prices while a tightening labour market will feed faster wage increases.
- In response to higher growth and higher inflation, the US Fed will hike interest rates faster than previously forecast.
- The US Dollar will strengthen against most major currencies.

The most recent data give some support to the reflation story.

- The OECD's monthly leading indicators for October show signs of rising growth momentum – not just in the US but in other advanced economies as well.
- We are seeing an incipient upswing in the global manufacturing cycle.
  - Inventories have been drawn down significantly.
  - Purchasing managers' indices have recorded sharp improvements in many countries.

But how realistic or sustainable is the growth resurgence scenario? The broad elements appear probable – there are indeed grounds for some optimism. But there is considerable uncertainty over the details, and there are several risks on the horizon. The market's exuberance in recent months does not seem to have accounted for these uncertainties and risks. Perhaps realising this, the market has begun to retrace some of its steps in more recent weeks.

So, instead of providing forecasts – a risky enterprise that I will leave to the expert speakers at this conference – let me set out what I think will be the key driving forces for the global economic outlook and examine their implications:

- First, fiscal policy is on the rise, chiefly in the US but also in the other major advanced economies.
- Second, monetary dominance is giving way to monetary divergence and financial conditions are tightening globally.
- Third, the challenge of balancing growth and stability will become more acute in China and emerging Asia.
- Fourth, a rise in trade protectionism and, more broadly, a pushback against globalisation, can seriously undermine growth prospects not just in 2017 but also over the medium-term.

The rise of fiscal policy

Let me begin with the new kid on the block – fiscal policy. Since the global financial crisis, across the advanced economies, monetary policy used to be the only game in town as governments struggled to restore debt sustainability. Fiscal policy is now, for the first time since 2009, turning more expansionary.

According to the BIS, estimated cyclically adjusted primary balances in the advanced economies turned slightly negative in 2016.

This is likely to continue in the years ahead.

What is behind this shift in the balance of the policy mix?

- First, policymakers are increasingly recognising the limits to unconventional monetary policies and the associated financial stability risks.
- Second, public dissatisfaction with the economic status quo is forcing governments to re-consider fiscal policy, especially public spending and tax reforms that can potentially boost the economy's productive capacity.

It is in the US that the nascent rise of fiscal policy has attracted most interest.

- Historically, a clean sweep of Congress and the White House has led to expansionary fiscal policy.
- But the size of the fiscal stimulus will depend on the balance that will be struck between the ambitious spending plans of the White House and concerns about debt sustainability among House Republicans.

There is considerable uncertainty over not just the size of the fiscal package but its composition.

- There appears to be broad consensus on reducing corporate and personal income taxes, broadening the tax base, and offering a one-time tax holiday on repatriated overseas corporate profits.
  - But there is no clarity on the details and hence the size of the fiscal impact.
- On plans to increase defence and infrastructure spending, there is currently less consensus.
  - It is also not clear how these spending increases will be financed.

Besides uncertainty over the size of the fiscal stimulus, there is also uncertainty over the impact of a given stimulus on growth.

- This impact will depend on how much slack there is in the economy.
- Signs are that the US economy is close to full employment.
  - Unemployment is at or near the natural rate and wages are increasingly healthy.
- If the economy is close to its underlying potential, a fiscal stimulus will end up mostly in inflation rather than growth.

This brings us to the next broad theme of 2017: the return of inflation and the tightening of financial conditions globally.

The normalisation of US monetary policy

Global inflation, which was weighed down by the fall oil prices during the past two years, has started to gradually pick up again.

- Energy prices have rebounded off their lows and commodity prices appear to have bottomed out.
- On a global basis, producer prices have started to rise since early 2016, in tandem with the recovery of commodity and industrial input prices.

    - Even in China, producer prices have turned positive, following 4 years of deflation.

      Globally, we could see a stronger pass-through from producer prices to inflation in 2017.

In the US, to the extent that fiscal stimulus boosts demand and lifts inflation towards the Fed's target, it could precipitate a faster pace of interest rate normalisation than currently priced in.

- The normalisation of monetary policy is a good thing and is to be welcomed.
- It would be in line with stronger economic growth and waning deflation risks.
    - Faster growth in the US will be good for emerging Asia.
- A gradual rise in interest rates away from the zero lower bound will also be good for financial stability, helping to stem the build-up in debt and cool inflated asset prices.

But interest rate normalisation in the US is not without its challenges.

- First, it amounts to a de facto tightening of global financial conditions.
- Second, it accentuates a divergence in monetary policies among the advanced economies.

The tightening of financial conditions will have a dampening effect on spending in both advanced and emerging economies.

- Such is the strength of US monetary policy dominance that the recent back-up in long-term interest rates in the US has lifted bond yields everywhere – including in the EU, despite the ECB's ongoing asset purchase programme.
- Higher growth in the US will provide some support to emerging Asia through the trade channel.
    - Asian exports should benefit, especially if corporate investment picks up in the US.
- But the increase in US interest rates will weigh down on emerging Asia's prospects through the financial channel.
    - Higher interest rates will squeeze the debt servicing capacities of corporates and households in Asia, which have taken on more leverage in recent years amid the low interest rate environment.

The trajectories of economic growth, inflation and monetary policy between the US and the rest of the world are expected to diverge further.

- Headline and core inflation rates in the US are well above those in the Eurozone and Japan.
- While demand is expected to pick up slightly in the Eurozone and Japan this year, inflation will remain well below target.
    - Monetary policies are therefore expected to remain ultra-easy.

The divergence in monetary policies could mean considerable movements in exchange rates and capital flows.

This sets the stage for the third broad theme driving the global economy in 2017: the growing tensions in emerging Asia between growth and financial stability.

China and Emerging Asia: Balancing growth and stability

Let me illustrate these tensions using China. For the past few years, China has been managing a difficult trade-off: sustaining economic growth versus reducing financial vulnerabilities.

- The source of the trade-off lies in the high level of debt in the Chinese economy.
- Pursuing economic growth through credit and fiscal expansion adds to the debt burden and impinges on financial stability.
- Reducing debt levels requires painful structural reforms and risks slowing down the economy sharply.

China's policymakers have managed this trade-off reasonably well these past few years.

- In 2016, they managed to keep growth and employment on an even keel, using the old formula of fiscal stimulus and credit easing.
- While this has added to overall debt levels, there has been some progress in reducing financial vulnerabilities. Steps were taken to
  - curb lending to unviable enterprises
  - cool the property market in tier-1 cities, and
  - reduce over-capacity in the heavy industry sectors.

But with heightened expectations of global financial tightening and US Dollar strength, the trade-offs and tensions in China are likely to become more stark this year.

- As US interest rates rise, resident investors in China have been recalibrating their relative expected returns, thus adding to pressures on China's capital account and the exchange rate.
- Tightening domestic liquidity to stem the pressure on the RMB would lead to higher interbank lending rates.
- This could potentially dampen investment spending and economic growth

China has taken a balanced approach to these challenges: combining some degree of exchange rate flexibility, some controls on capital flows, and some amount of domestic tightening. Navigating the treacherous waters of international financial markets this year will require a fair amount of policy dexterity.

The rest of emerging Asia is also confronted with headwinds from financial tightening and US Dollar appreciation.

- The low interest rate environment since the global financial crisis has led to a dramatic build-up in debt among many Asian corporates and households.
- Over-extended borrowers face the double whammy of an increase in interest servicing costs and a rise in the foreign currency risks of unhedged debt.
- This could pose not just a threat to financial stability but also a drag on investment and consumption.

That said, emerging Asia is on a stronger footing to cope with the risks of global financial tightening.

- Asian economies have been proactive in implementing macro-prudential measures to limit the build-up of financial vulnerabilities.
- While there are several pockets of weaknesses, the household, corporate, and banking sector balance sheets are, on the whole, strong enough to ride through the coming turbulence.

The big unknown: whither global trade?

Finally, the big unknown: the future of global trade and economic integration.

Trade has been facing a combination of structural and cyclical headwinds since the global financial crisis:

- The global merchandise trade-to-income ratio has stagnated since 2010.
- China's imports of intermediate goods is growing at below 10%, compared to more than 20% in the early 2000s, creating a drag along supply chains across Asia.
- This is partly cyclical, reflecting slower growth in China.
- But it is also structural – reflecting a reconfiguration of supply chains and China's increasing insourcing of intermediate inputs.

As if these cyclical and structural headwinds are not enough, we are now facing the uncertain prospect of policy measures against free trade, especially in the US.

- There is talk of:
    - rejecting TPP and re-negotiating or even repealing NAFTA and other FTAs;
    - imposing a border tax adjustment that would in effect impose the corporate tax rate on imports; and
    - labelling major trade partners as currency manipulators and imposing hefty tariffs on them.
- Some of these actions may well attract retaliatory measures, leading to trade conflicts with disastrous consequences for the global economy.

In all likelihood, it may not be that bad.

- The contours of the incoming US Administration's trade policies are highly uncertain.
- There remains within various arms of the US establishment a strong belief in the benefits of an open global trading system and the risks of punitive trade restrictions.

But there could be some limited anti-trade measures such as targeted tariffs on selected products or industries.

- But even these could spread more widely through global supply chains and dampen any uptick in demand-driven trade flows.
- They could even backfire on the US given how integrated production networks are across countries.

In short, the growth spill-over from the US to the rest of the world will depend on the balance between fiscal stimulus on the one hand, and financial tightening and trade restrictions on the other. The current consensus is that the former will outweigh the latter. We will have to see.

Conclusion

On balance, chances are that global growth will be slightly higher this year compared to the last. Hope and confidence are important factors and recent improvements in business and consumer sentiments may well translate into higher investment and consumption.

A shift in the macro policy mix in the US, away from excessive reliance on monetary policy towards a bigger role for fiscal support, is to be welcomed.

- A well-designed fiscal policy can provide some modest stimulus in the short-term but more importantly help to augment the productive capacity of the economy in the long term.
- A successful outcome could encourage other advanced economies to seek a better balance between monetary and fiscal policies.

Some caution though is warranted.

- There remains considerable uncertainty as to the actual policy changes in store. They may not pan out as expected.
- There are serious downside risks on immigration and trade policies.
- Political uncertainties are on the rise, especially in the EU, which has to contend with Brexit negotiations and elections in France and Germany.
  - Populist movements are on the rise in many parts of the world.
  - They could precipitate a more radical shift in policies that could in turn dampen confidence and investment.

Finally, I have not said anything about the Singapore economy. I will leave that to MTI's Annual Economic Survey, the report of the Committee on the Future Economy, and the Budget Statement – all happening next month.

Suffice to say:

- The Singapore economy is expected to continue on its modest pace of expansion this year.
- GDP growth is likely to come in the 1-3% range.
- Modern services – including finance, business, and ICT – will be supported by continued growth in the region and our growing status as a hub.
- Our trade-oriented industries should benefit from the mild upturn in global and regional electronics.
- In fact, the strong showing in the last quarter of 2016 indicates that the Singapore economy retains the capacity to ride on cyclical upswings in demand for our exports.

That is not to say that all is well. Economic restructuring remains work-in-progress and we need to do more to raise productivity growth. Singapore will not be immune to the global tightening of financial conditions, volatility in capital flows, and potential stresses in the regional corporate sector.

But our macro fundamentals are sound and we will weather these storms. And as we continue to invest in the future – in skills, in technology, and in infrastructure, we will emerge a stronger and more dynamic economy.