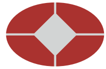

Challenges for the world economy: implications for Arab economies

Keynote speech by Agustín Carstens
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Global economy doing well, but some economies are under pressure

The global economy has recovered from the recession that followed the Lehman Brothers bankruptcy almost exactly a decade ago. The decisive monetary and fiscal response to the crisis prevented a larger collapse. Output dropped in many economies, but growth generally resumed within a year (Graph 1). Only in the euro area was the financial crisis followed by a sovereign debt crisis in a number of countries.

The initial recovery was rather tepid. In the United States, it took four years for output to recover to its pre-crisis level. In other economies, it took much longer. In the euro area as a whole, the 2007 level of output was regained only in 2015, and in Greece and Italy output is still considerably below 2007 levels.

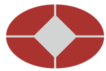
In the last two to three years, a tepid recovery has given way to a strong expansion. The US economy is growing rapidly, not least because of the fiscal stimulus. I shall return to this later. Growth is also solid in most other advanced economies.

There has also been a lot of progress in re-establishing the health of the financial system, both nationally and internationally. Banks are much better capitalised now and have high liquidity buffers. This is thanks not least to far-reaching regulatory reforms.

Emerging market economies (EMEs) were less directly affected by the financial crisis than advanced economies were, and quickly returned to their previous high rates of growth. Since then, the picture has been very mixed.

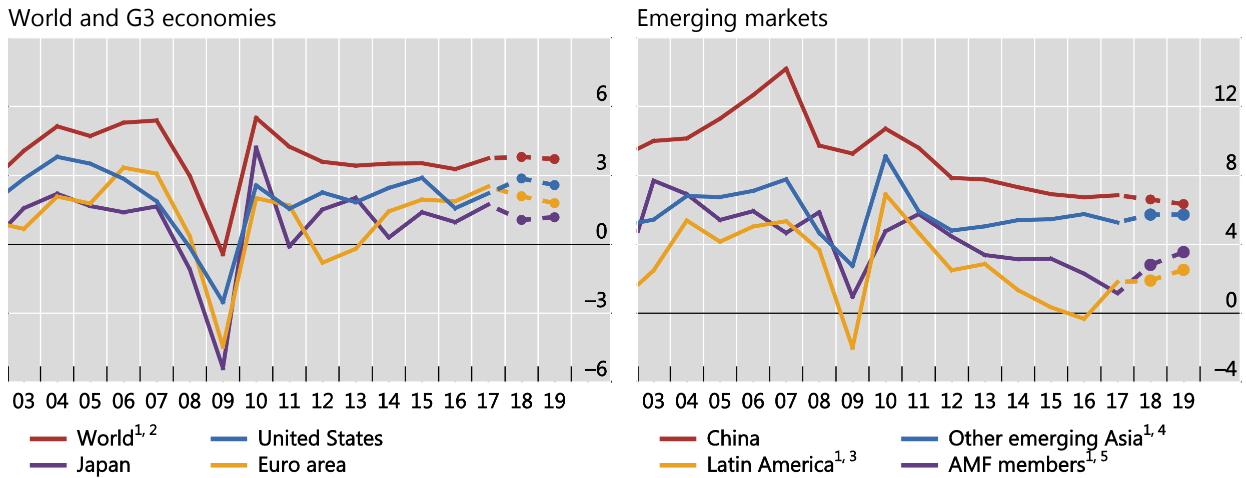
Growth in China has eased gradually to 6–7% per year. Other Asian economies have also done well, as have those in central and eastern Europe.

Many Latin American economies have been hit by the fall in commodity prices after 2014. While most economies in the region strengthened after 2016, sustained recovery has been elusive for both Brazil and Argentina. Argentina has come under very strong pressure recently, receiving massive assistance from the International Monetary Fund (IMF).



Forecasters expect solid growth to last

Annual percentage changes in real GDP, forecasts are shown as dots — Graph 1



[1] Weighted average of the economies cited, based on GDP and PPP exchange rates. [2] Countries and regions shown, plus Australia, Canada, the Czech Republic, Denmark, Hungary, New Zealand, Norway, Poland, Russia, South Africa, Sweden, Switzerland, Turkey and the United Kingdom. [3] Argentina, Brazil, Chile, Colombia, Mexico and Peru. [4] Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [5] Algeria, Bahrain, Comoros, Djibouti, Egypt, Jordan, Kuwait, Lebanon, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, United Arab Emirates and Yemen.

Sources: IMF, *World Economic Outlook*; Consensus Economics; Datastream; national data.

Unfortunately, the situation in the Arab economies looks more similar to Latin America than to Asia. Solid growth from 2010 to 2014 has given way to much lower rates of expansion, partly reflecting the commodity price cycle, in particular the price of oil.

Oil exporters have been hit by a lower-than-expected oil price since 2014, squeezing national budgets. War and civil unrest have disrupted some economies. And finally, competition from China and other EMEs has undermined growth in manufacturing, aggravating unemployment and lack of opportunity for large parts of the population.

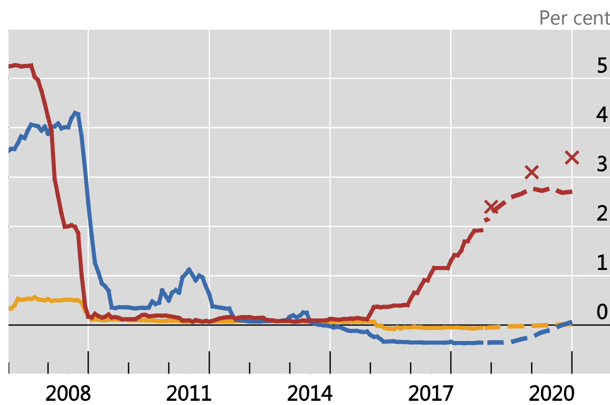
Many countries in the region have tried to smooth the impact by keeping up public spending in the face of declining revenues, or by running down their international reserves and other buffers. Central banks have lowered reserve ratios to blunt the effects of lower liquidity in the banking system. At the same time, they have sought to keep their exchange rates stable through direct currency interventions or administrative measures. In several cases, countries have raised debt in the international capital markets, taking advantage of the prevailing search for yield among institutional investors.

The solid economic growth of the last few years could make one think that the financial crisis and the recession do not matter anymore. While this is true in many respects, there is at least one major legacy of the crisis that will keep us busy for the next few years. This is monetary policy.

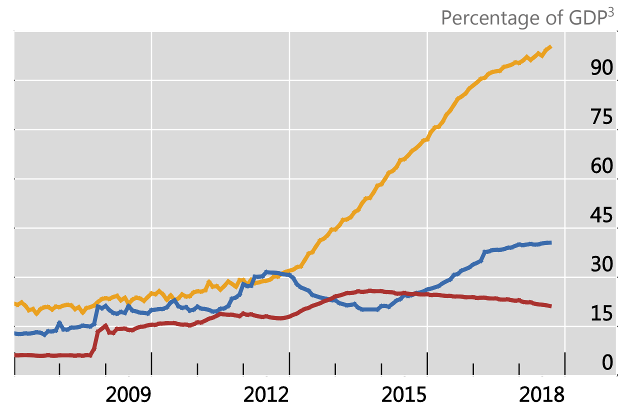
Graph 2 shows that, 10 years after the Lehman failure, monetary policy reference rates in the main advanced economies remain low and central bank balance sheets are still large. Of the top three advanced economy central banks, the Federal Reserve has started to increase interest rates and reduce its asset holdings. But in the euro area and Japan, policy rates remain negative and asset holdings continue to grow.

Policy rates remain low and balance sheets large 10 years after Lehman Graph 2

Short-term nominal rates[1]



Central bank total assets



[1] For actual: effective federal funds rate (US); EONIA (EA); one-month OIS rate (JP); monthly averages. For expected: OIS forward rates. As of 12 September 2018. [2] Summary of Economic Projections (SEP) of the US Federal Reserve Board members and US Federal Reserve Bank presidents. [3] For the last period, latest available GDP.

Sources: Bloomberg; national data; BIS calculations.

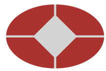
A second, closely related, legacy from the crisis is overstretched financial markets. Low interest rates and accommodative monetary conditions in major advanced economies have pushed investors to emerging markets in their search for yield. Governments and corporations in many EMEs have used the opportunity to lock in long-term funding and develop local currency debt markets. But even if much of this debt is long-term, it will have to be refinanced eventually. And the presence of foreign investors in domestic bond markets creates its own vulnerabilities, in particular when interest rates in advanced economies are expected to increase in the foreseeable future.

US fiscal expansion and trade worries complicate normalisation

As a case in point, the Federal Reserve is now in its third year of interest rate increases and its second year of unwinding its asset holdings, and yet financial conditions in advanced economies remain accommodative. A key reason is that the Fed has been very careful to signal its intentions and to move gradually, without surprising or disrupting markets. True, some EMEs have been under serious pressure, but this probably reflects country-specific factors as much as Fed policy.

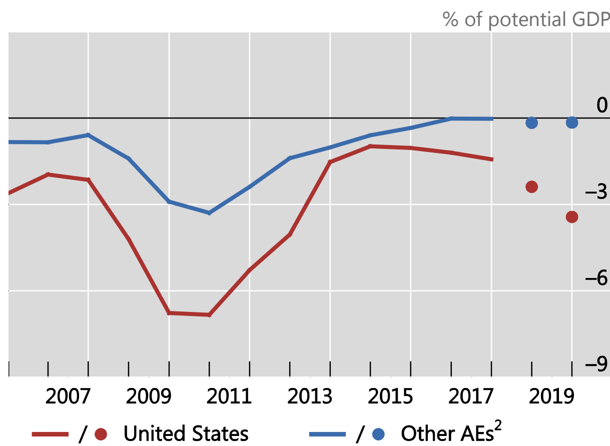
However, there are two factors that could pose major challenges to a smooth normalisation. Both could have major repercussion for EMEs, not least your own economies: US fiscal expansion and the possibility of a serious trade dispute.

The fiscal expansion in the United States is large. The Tax Cuts and Jobs Act will result in an estimated net revenue loss of $1.5 trillion over the next 10 years. The bulk of this is frontloaded. The OECD projects a US fiscal expansion of as much as 2% of GDP by the end of next year, as indicated by the widening of their forecast for the US cyclically adjusted fiscal deficit (Graph 3).

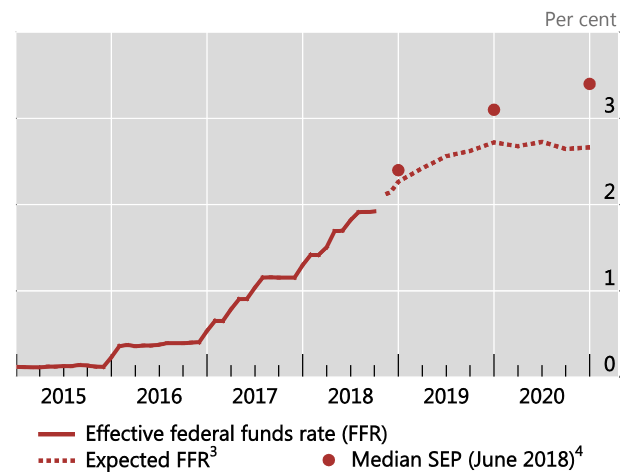


US interest rates may rise more quickly than expected — Graph 3

Cyclically adjusted primary fiscal balance[1]



Federal funds rate expectations



[1] Adjusted for the business cycle and for one-off transactions. Forecasts after 2017 (shown by dots). [2] Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. [3] Based on OIS forward rates as of 10 September 2018. [4] Summary of Economic Projections (SEP) of the US Federal Reserve Board members and US Federal Reserve Bank presidents.

Sources: Board of Governors of the Federal Reserve System; OECD, *Economic Outlook*, May 2018; Bloomberg.

US fiscal easing comes at a time when the US economy is already operating at full capacity. This increases the risk of overheating and boosting inflation above the Federal Reserve's target. So far, there are not many signs that this is imminent. But such signs could appear quickly and force the Fed to raise interest rates more rapidly than is currently priced into market yields. This could wrong-foot financial market participants, causing a "snap-back" in yields and driving up the US dollar.

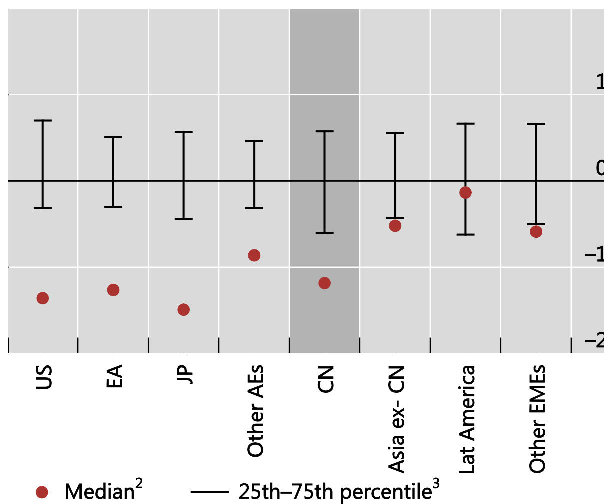
But even if there is no overheating and the Federal Reserve continues its policy of gradual tightening, the combination of the additional public debt issuance and the unwinding of asset purchases could drive up yields. BIS staff estimates suggest that the combined effect could amount to 70–130 basis points, depending on how far the market has already priced in the Federal Reserve's plans.

US fiscal easing also increases the likelihood of a trade war. The fiscal stimulus will very likely push up the US trade deficit, which in turn could fuel protectionism. In July, the US current account reached its widest deficit ever in dollar terms. To be precise, a trade war would mean a vicious circle of trade measures and countermeasures, moving from tariffs to quotas and other non-tariff measures. This could seriously hurt the global economy.

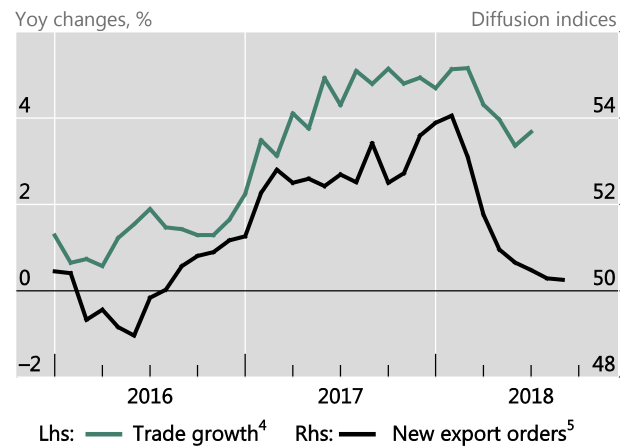
Financial market participants understand this. Stock prices around the globe, not only those in the United States and China, fell sharply on the days of such announcements (Graph 4). And if one looks closely at the data, one can already see the impact of trade tensions. Global trade growth has declined, export orders have stagnated and capital goods orders in advanced economies have slowed.

Trade tensions affect financial markets and activity data Graph 4

Stock returns on trade news days[1]



Global trade growth and new export orders expectations



[1] Aggregates are weighted averages based on 2017 GDP and PPP exchanges rates. Latin America excl. AR; Other EMEs excl. TR. [2] One-day event window (–1,0) where t=0 is set at the specified event date. 1 March 2018 (US President Trump announces intention to impose tariffs on steel and aluminium imports on Twitter); 22 March 2018 (United States announces strong actions against China following USTR Section 301 investigation); 23 March 2018 (China announces retaliatory tariffs); 19 June 2018 (additional $200 billion of Chinese imports to the United States subject to tariffs); 25 June 2018 (Harley-Davidson announces it will shift production overseas to offset the impact of retaliatory EU tariffs) and 10 July 2018 (USTR released a list of proposed tariffs on $200 billion of Chinese imports. [3] Interquartile distribution of daily returns on non-event days over the period 1 January 2018–31 July 2018. [4] Simple average of global import and export volume indices. Three-month averages; seasonally adjusted. [5] Manufacturing sector. Based on purchasing managers' index (PMI) survey. A value of 50 indicates that the number of firms reporting increase and decrease is equal; a value above 50 indicates increase.

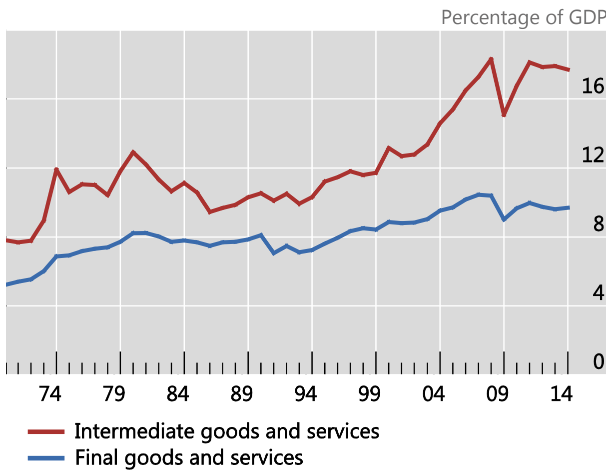
Sources: Bloomberg; CPB Netherlands Bureau for Economic Policy Analysis; Datastream; IHS Markit; BIS calculations.

The potential for an adverse global market response is that, in today's economy, any trade disruption could have a much broader impact than before. This is because trade in intermediate goods and services is now almost twice as large as trade in final goods and services (Graph 5). Many of the intermediate goods involved are highly specialised, particularly in manufacturing[1], which makes it very hard for companies to switch from foreign to domestically made inputs. Supply chains can also be extremely complex. Any disruption in the supply chain could therefore have adverse and unpredictable knock-on effects. Tariffs, particularly in the United States, could also push up prices, which might induce monetary policy to react more rapidly through rises in interest rates.

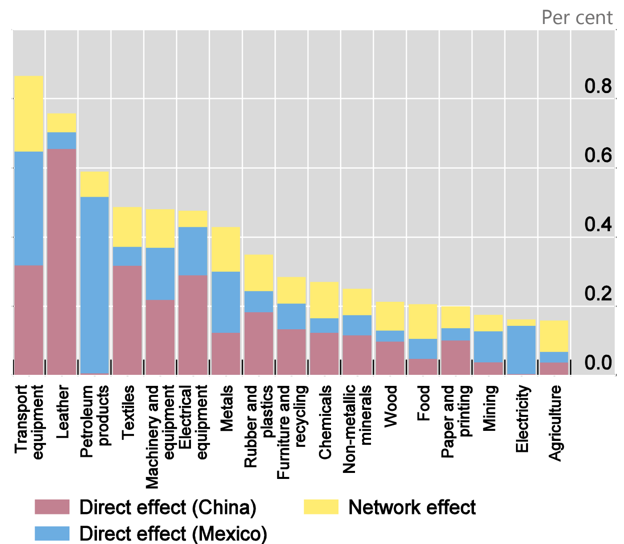
[1] R Johnson and G Noguera, "A portrait of trade in value added over four decades", *NBER Working Papers*, no 22974, December 2016.

High share of intermediary goods increases global impact of trade war — Graph 5

Intermediate goods and services dominate global trade



US costs from 10% tariff on imports from China, Mexico[1]



[1] Direct impact and higher-order effects on US sectoral production costs of a 10% import tariff on imports from China and Mexico.

Sources: R Auer, A Levchenko and P Sauré, "International inflation spillovers through input linkages", *Review of Economics and Statistics*, forthcoming; R Johnson and G Noguera, "A portrait of trade in value added over four decades", *NBER Working Papers*, no 22974, December 2016; M Timmer, B Los, R Stehrer and G de Vries, "An anatomy of the global trade slowdown based on the WIOD 2016 Release", *GGDC research memorandum*, no 162, University of Groningen, 2016; World Input-Output Database; BIS calculations.

Financial protectionism also risks unravelling the financial interdependencies that enable and encourage trade and investment links. This threatens to unsettle financial markets and reduce firms' capital spending, as investors take fright and financial conditions tighten.

To sum up, one could expect a range of outcomes in future years. Global financial conditions are likely to become less favourable for EMEs as the Federal Reserve continues to tighten policy and the ECB and Bank of Japan slow or stop their asset purchases and eventually begin to raise rates.

We should expect a lot more volatility in markets. Overstretched financial markets may react strongly to any type of event, even if the Fed's normalisation path remains as gradual and predictable as it has been and the ECB and Bank of Japan follow its example. The uncertainty stemming from trade tensions and the untimely US fiscal expansion add to the risks. Rapid interest rate increases and safe haven flows could push up the value of the US dollar, leading to tighter financial conditions in international capital markets and the possibility of "sudden stops" and even capital flight.

The baseline outlook for economic growth in the advanced economies continues to be bright. But trade tensions or a more rapid monetary policy tightening in response to higher inflation could seriously affect growth prospects and depress commodity prices.

Building resilience

The best way to deal with such a situation is to put one's own house in order. This means implementing structural reforms to diversify the economy and make it more flexible. It means reducing vulnerabilities, such as large current account or fiscal deficits. It means expanding external cushions such as international reserves or access to external liquidity assistance. This is because the first and best line of defence against market pressure is a diversified and resilient economy. Regional integration may also help to substitute for trade with the rest of the world in case of a trade conflict. Building a resilient economy takes time and there are always good reasons to delay structural reforms. But a diversified and resilient economy will remain out of reach unless reforms are started and sustained against any push-back.

The second line of defence is sound macroeconomic policies. Foreign investors have become much more discriminating over the last 20 years, focusing on current account and fiscal balances and on private and public debt levels as well as the state of the financial system.

The third line of defence is flexibility. This comes in various guises. Perhaps the most obvious is exchange rate flexibility. If the exchange rate is fixed, then there need to be alternative sources of flexibility, for instance in the labour market or the corporate sector, that adjust in response to shocks. For example, restrictive employment practices mean that the burden of adjustment will fall on those who are weakest and work in the informal sector. Similarly, structural rigidities that prevent the elimination of overcapacity could put the burden of adjustment on the public sector (through subsidies) and reduce activity in the more dynamic sectors of the economy.

Last but not least, countries might need extraordinary firepower in the form of sufficient international reserves and external support in case of stress. In recent years, the trend has been towards complementing the IMF with regional arrangements, for example the Arab Monetary Fund. However, for the last two decades the international community has not managed to agree to increase IMF country quotas in line with world economic growth and the dynamic evolution of capital flows. It is time to put in place an adequate global financial safety net. Let's not leave it until the next crisis comes knocking on the door.