

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

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RCC at HARVARD EXECUTIVE PROGRAM

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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...

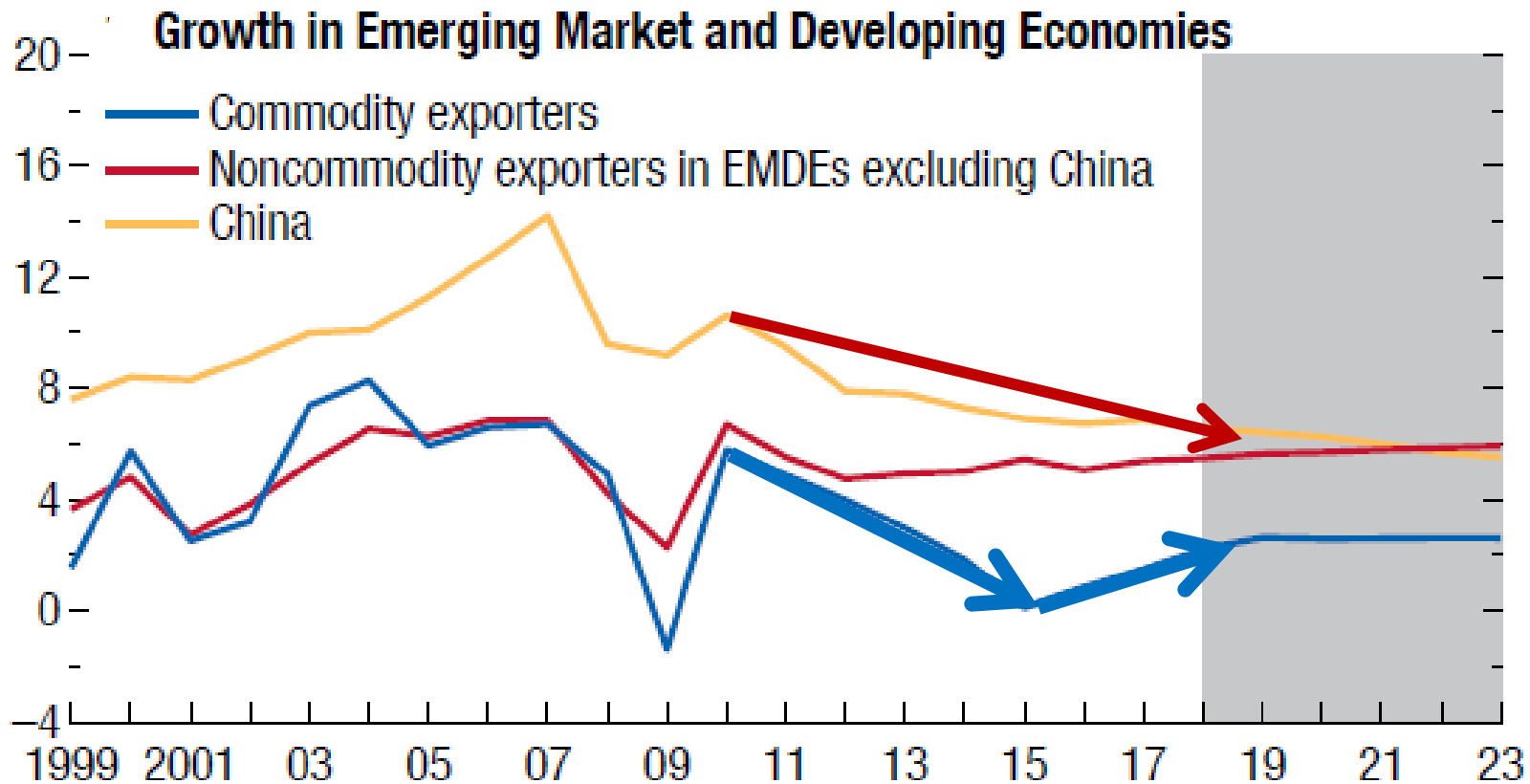
	2017	Projections	
		2018	2019
World Output	3.8	3.9	3.9
Advanced Economies	2.3	2.5	2.2
United States	2.3	2.9	2.7
Euro Area	2.3	2.4	2.0
Germany	2.5	2.5	2.0
France	1.8	2.1	2.0
Italy	1.5	1.5	1.1
Spain	3.1	2.8	2.2
Japan	1.7	1.2	0.9
United Kingdom	1.8	1.6	1.5
Canada	3.0	2.1	2.0

...and in EM/Developing Economies.

		Projections	
	2017	2018	2019
Emerging Market and Developing Economies	4.8	4.9	5.1
Emerging and Developing Asia	6.5	6.5	6.6
China	6.9	6.6	6.4
India	6.7	7.4	7.8
Latin America and the Caribbean	1.3	2.0	2.8
Brazil	1.0	2.3	2.5
Mexico	2.0	2.3	3.0

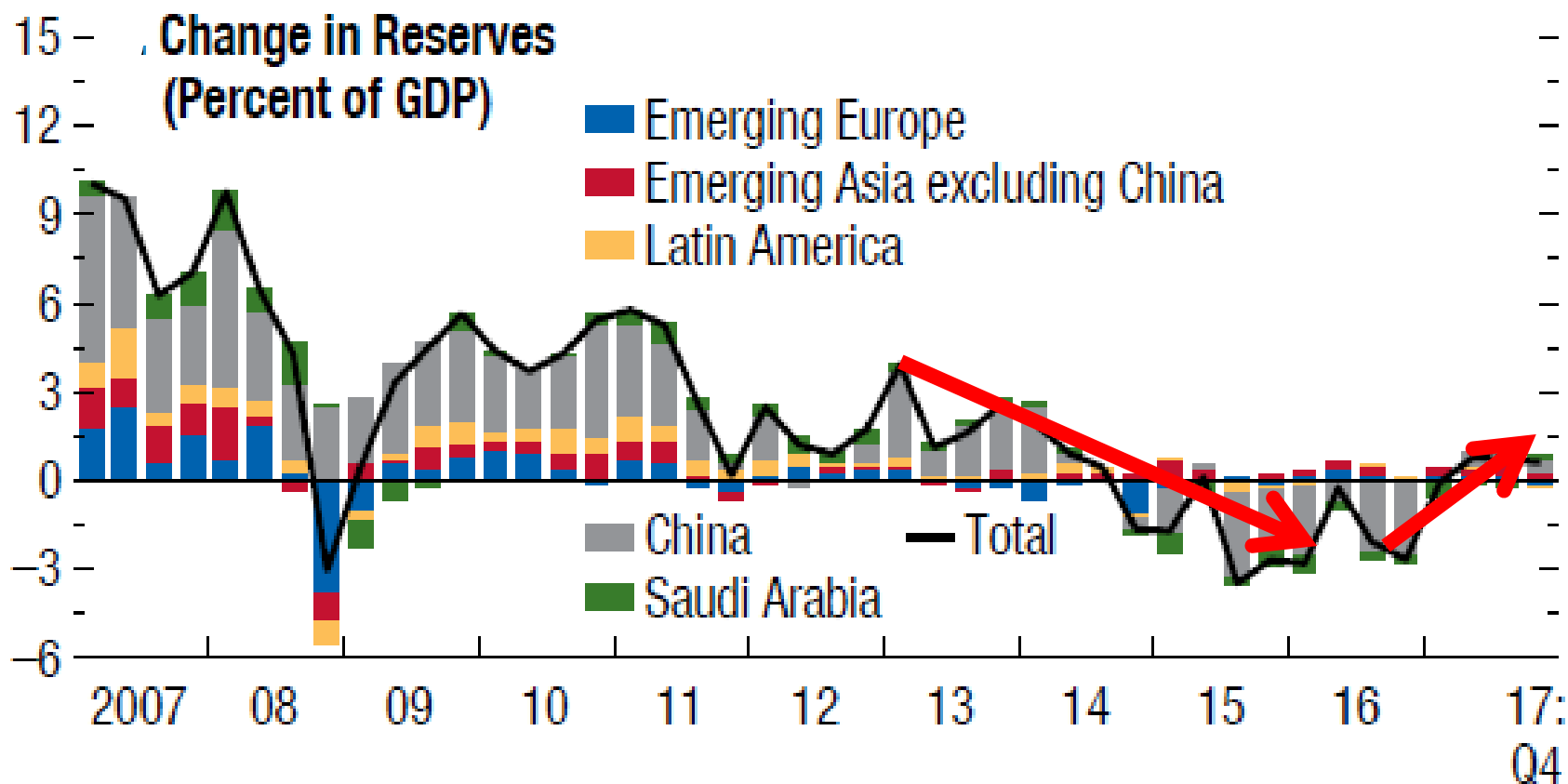
China's slowdown after 2010 was unavoidable,
but it avoided the feared hard landing

and even commodity exporters began to recover in 2017.



IMF *World Economic Outlook*, April 2018.

EMs suffered outflows 2014-16
partly due to the taper of Fed QE in 2013
& fall of commodity prices in 2014.
But some EM inflows returned in 2017.



IMF *World Economic Outlook*, April 2018.

1. Some dangers for EM countries in 2018

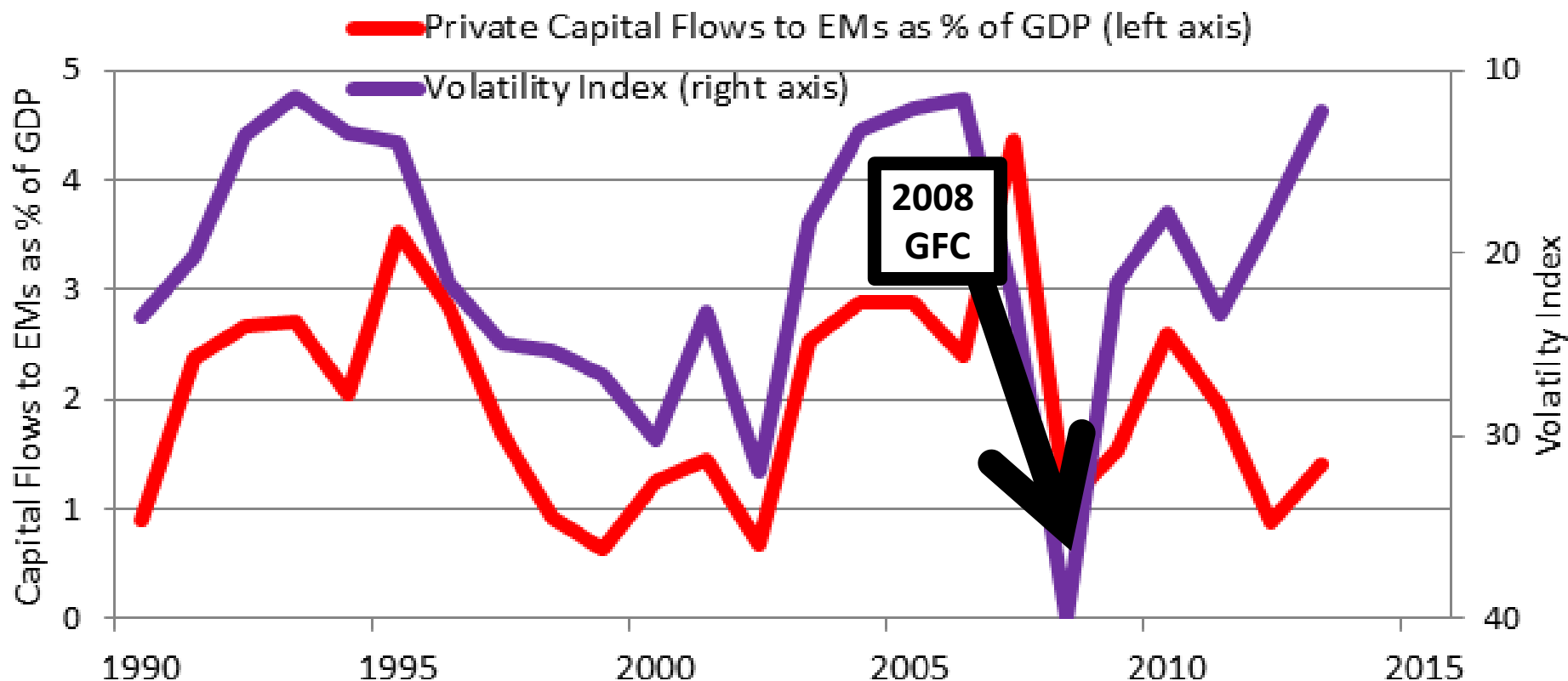
- External risks that may test EMs.
 - “Risk off” environment, as in Global Fin. Crisis of 2008.
 - Fed tightening, as in 1981, 1994, & 2013 taper tantrum.
 - Global trade war, as in 1930s.
- Local vulnerabilities.
 - The return of \$-denominated corporate debt.
 - The return of pro-cyclical fiscal policy.
- 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)



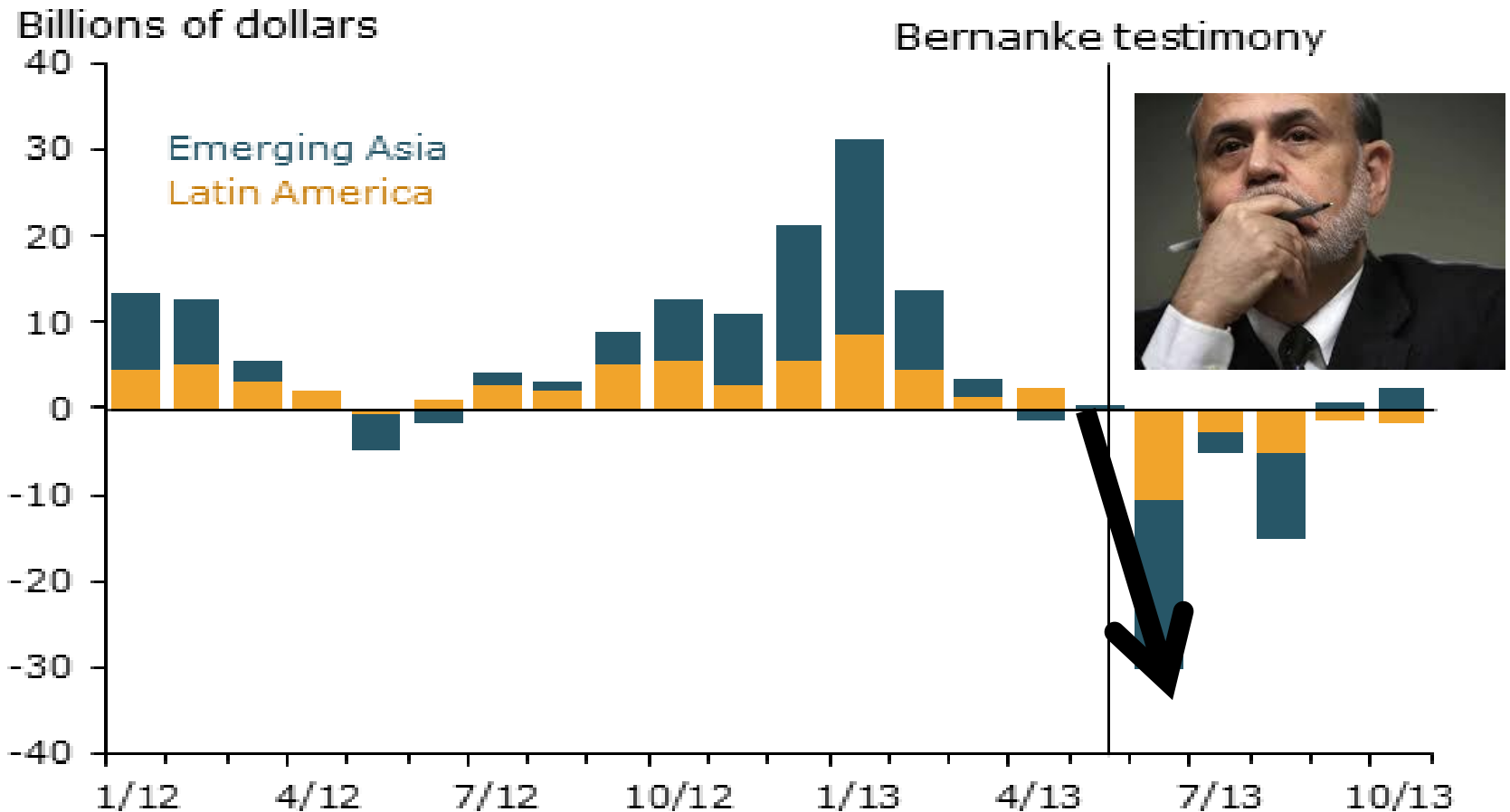
Kristin Forbes, 2014 <http://www.voxeu.org/article/understanding-emerging-market-turmoil>

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.

See K.Forbes & F.Warnock (2012), “Capital Flow Waves: Surges, Stops, Flight and Retrenchment”, *J. Int.Ec.*

Another possible external shock: US interest rates

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



Jay Powell, 2013, “Advanced Economy Monetary Policy and Emerging Market Economies.”
Speech at the Federal Reserve Bank of San Francisco Asia Economic Policy Conference, Nov.
<http://www.frbsf.org/economic-research/publications/economic-letter/2014/march/federal-reserve-tapering-emerging-markets/>

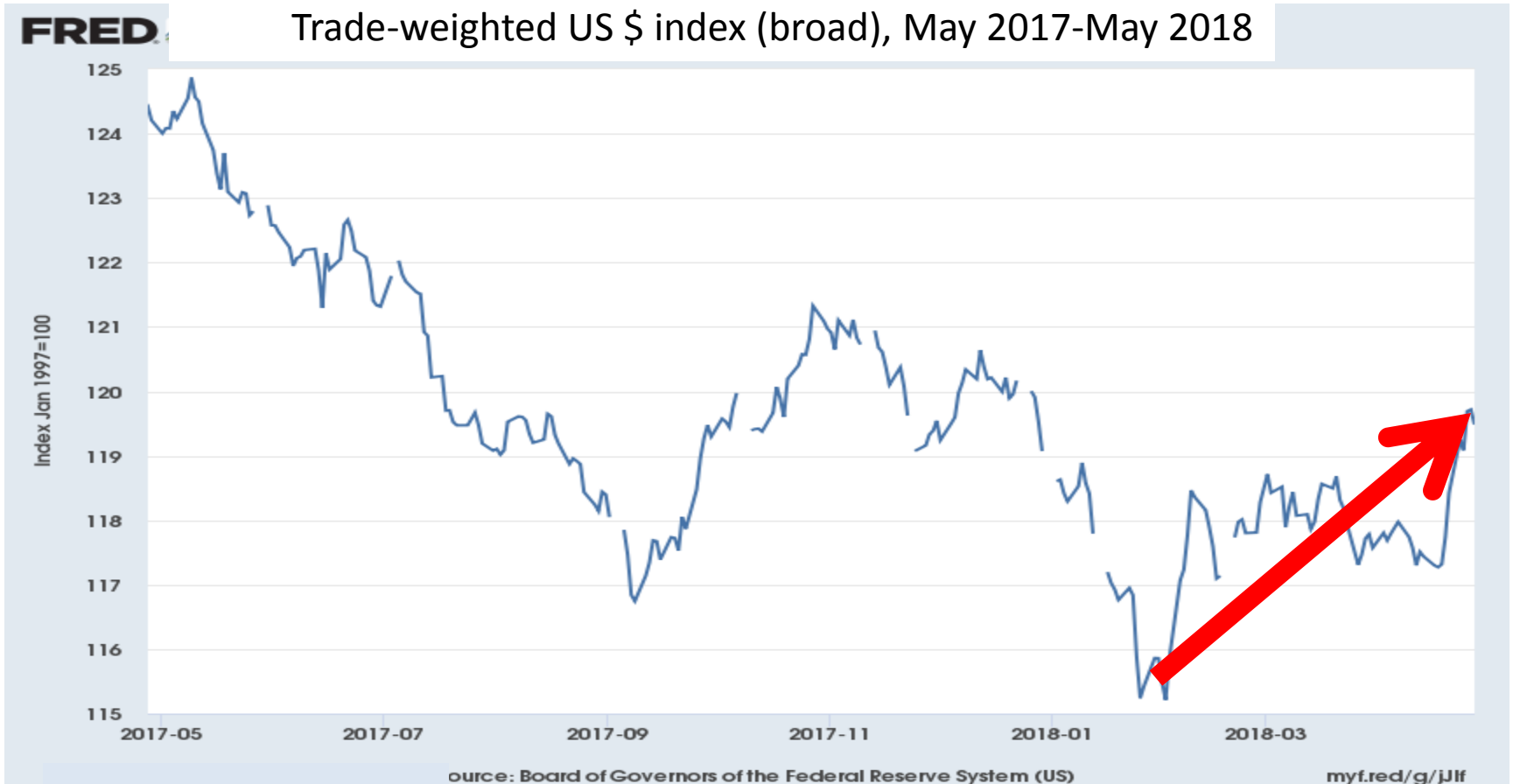
May 2018: Has the test arrived?

- 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...



The dollar, which is still a safe haven, rose as well.

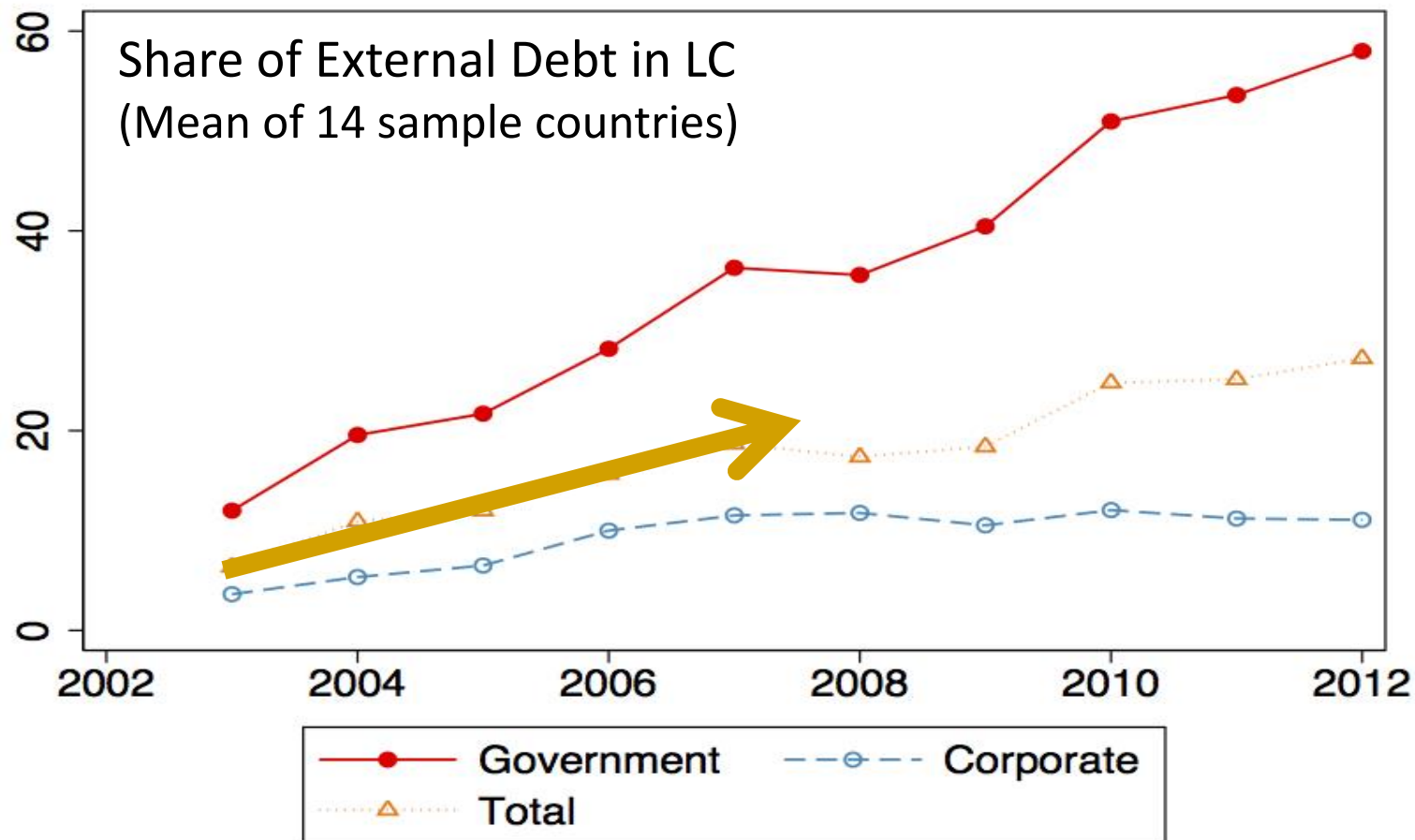


2. One vulnerability: The return of foreign-currency denominated corporate debt

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.

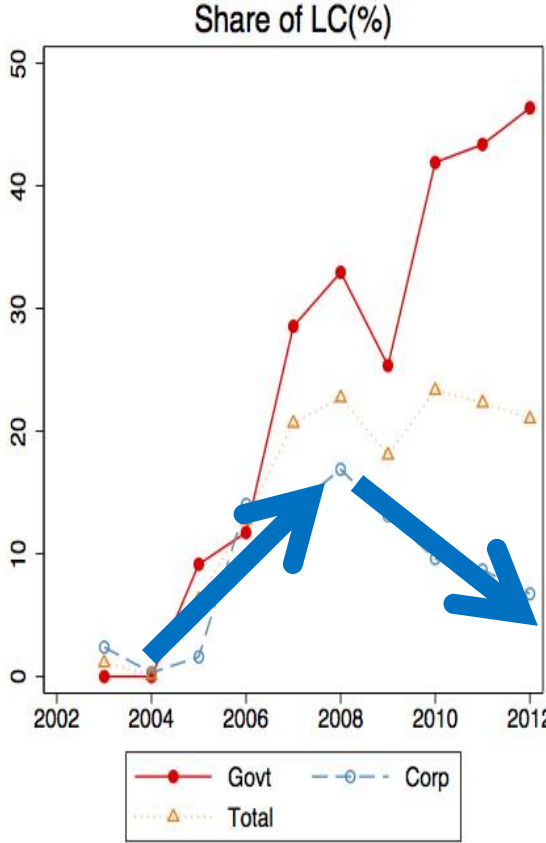
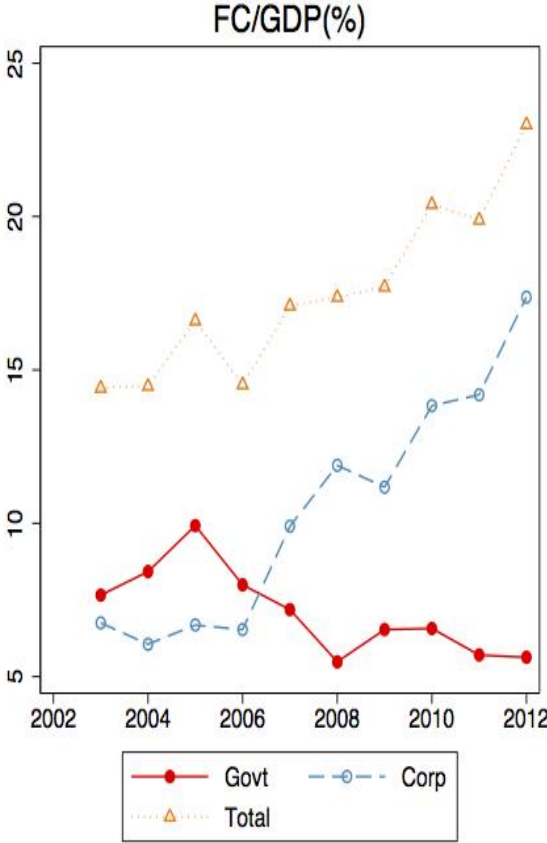
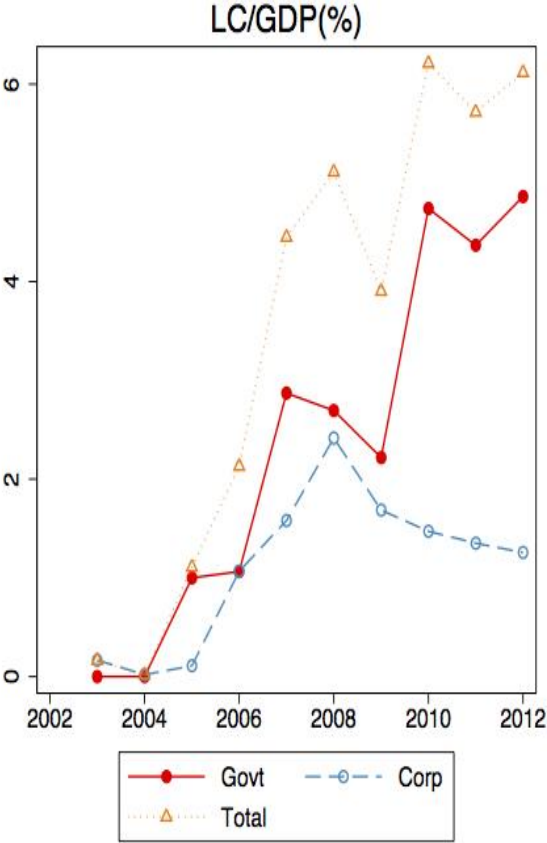
Currency composition in the post-2003 capital inflows shifted away from \$-denomination, toward Local Currency.



But *corporate* debt post-2008 swung back to \$-denomination, away from Local Currency, in some EMs.



Peru External Debt

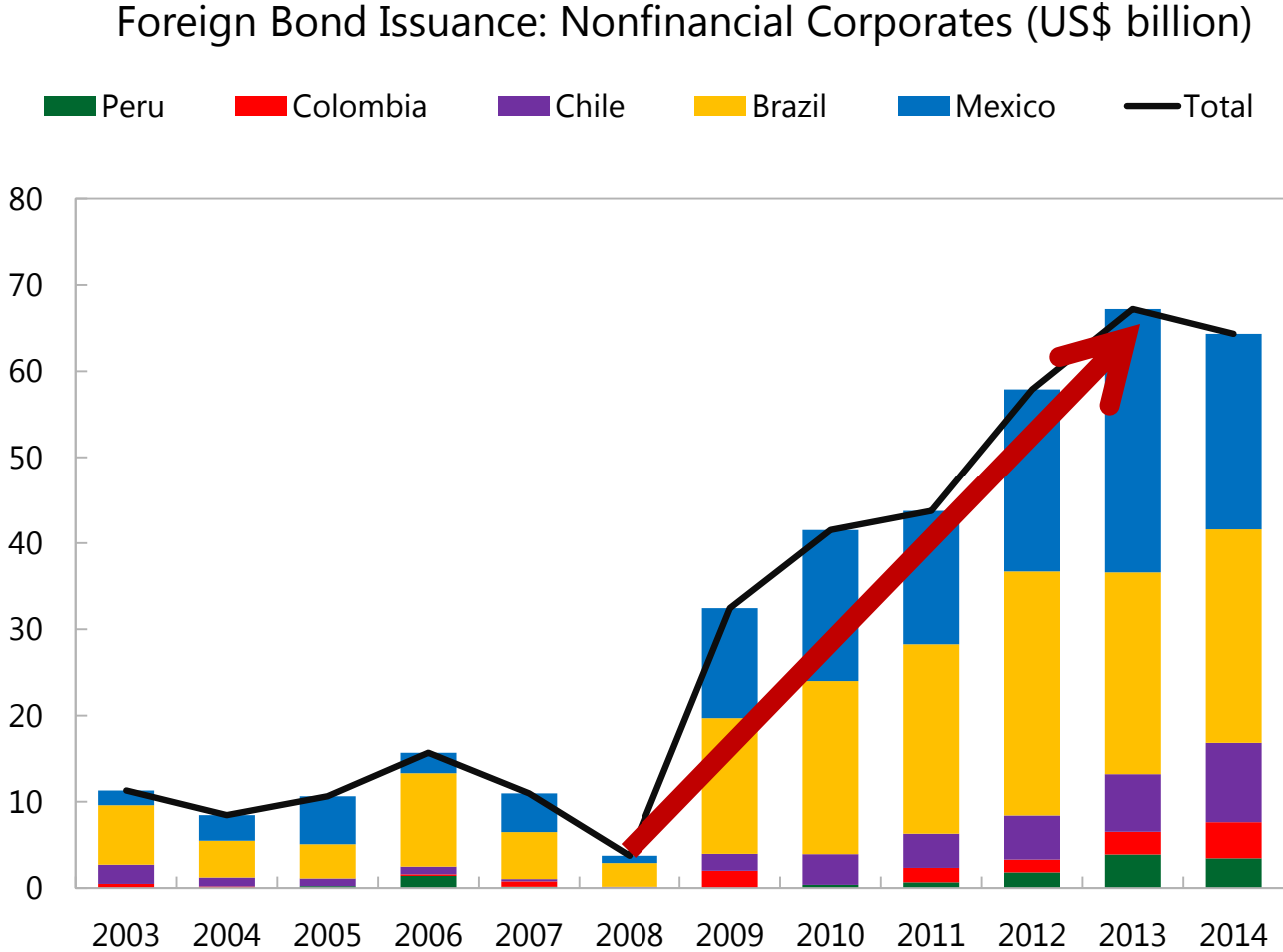


Wenxin Du & Jesse Schreger, Harvard Business School, 2016, "Sovereign Risk, Currency Risk, & Corporate Balance Sheets" Fig. A2.

Country-Level Currency Composition of External Debt

Figure 10: Currency Compositions of External Debt by Country, percentage

FX bond issuance by nonfinancial corporates has increased in Latin America since 2009, raising vulnerabilities.



Sources: Dealogic; and IMF staff calculations.

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.



Cyclicality of Fiscal Policy,

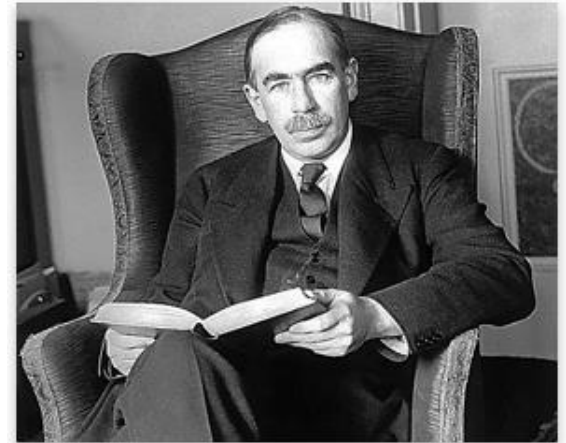
“What is the best fiscal policy, Austerity or Stimulus?”

- 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.



Cyclicalty of Fiscal Policy, continued

- 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)



Cyclical Policy of Fiscal Policy, continued

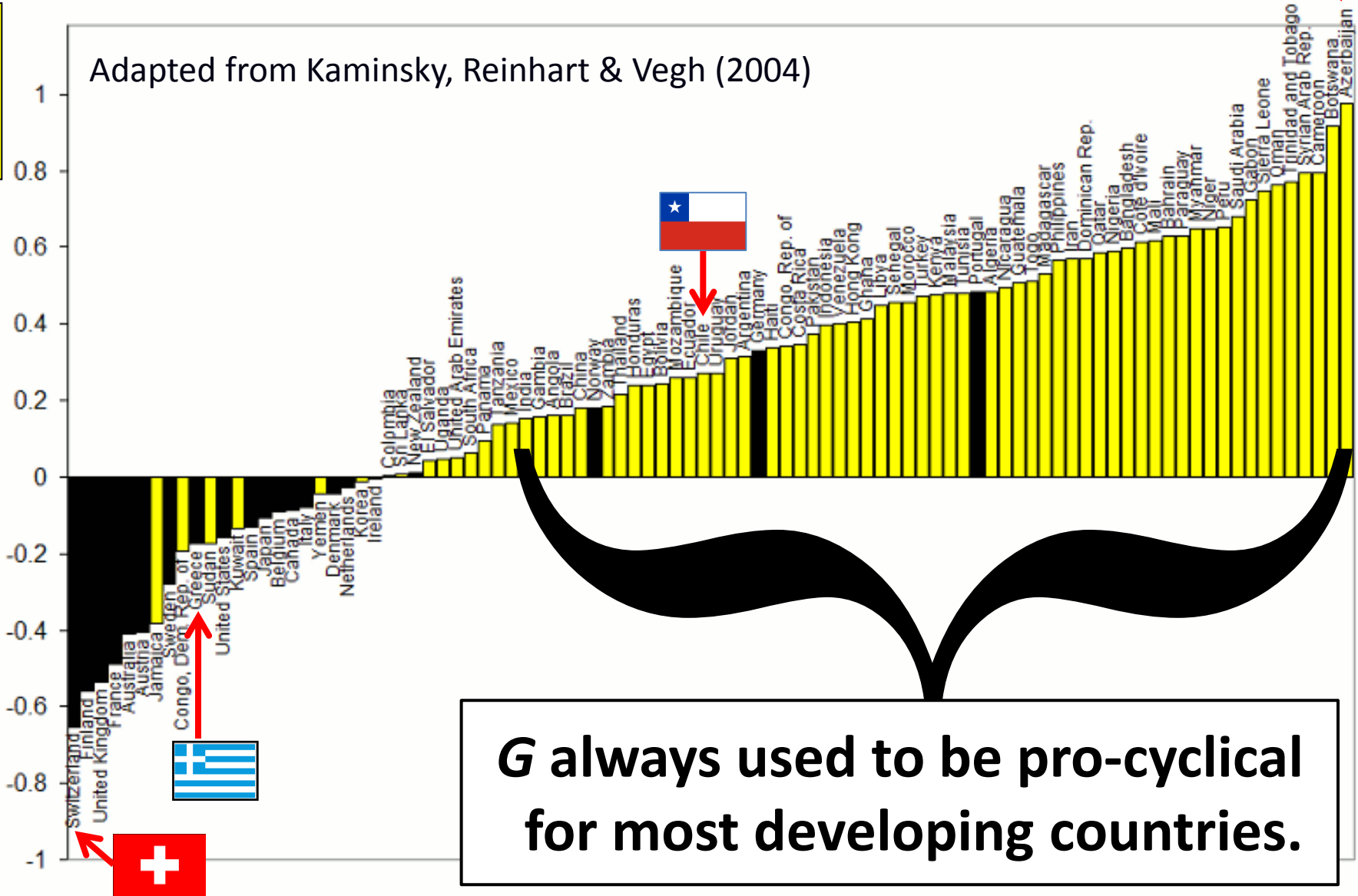
- Keynesian policy (“fine tuning”) fell into disfavor in part because it was hard to get the timing right:
 - by the time fiscal stimulus became law, the recession would be over.
- But that is no excuse for *pro-cyclical* fiscal policy.
- Definition of *pro-cyclical* fiscal policy:
Governments raise 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

procyclical

countercyclical

Adapted from Kaminsky, Reinhart & Vegh (2004)



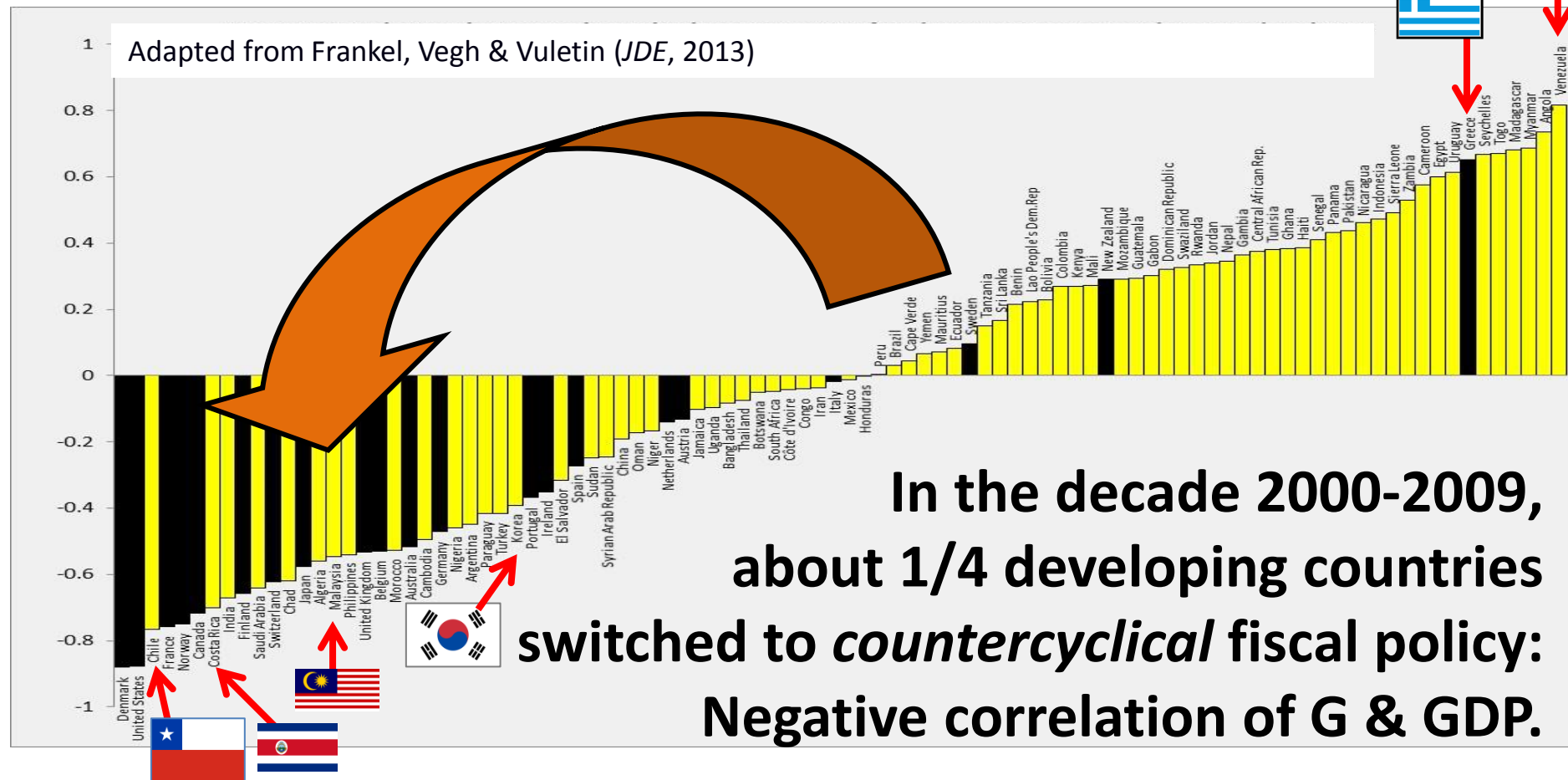
G always used to be pro-cyclical for most developing countries.

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...



Correlations between Government spending & GDP 2000-2009



DEVELOPING:

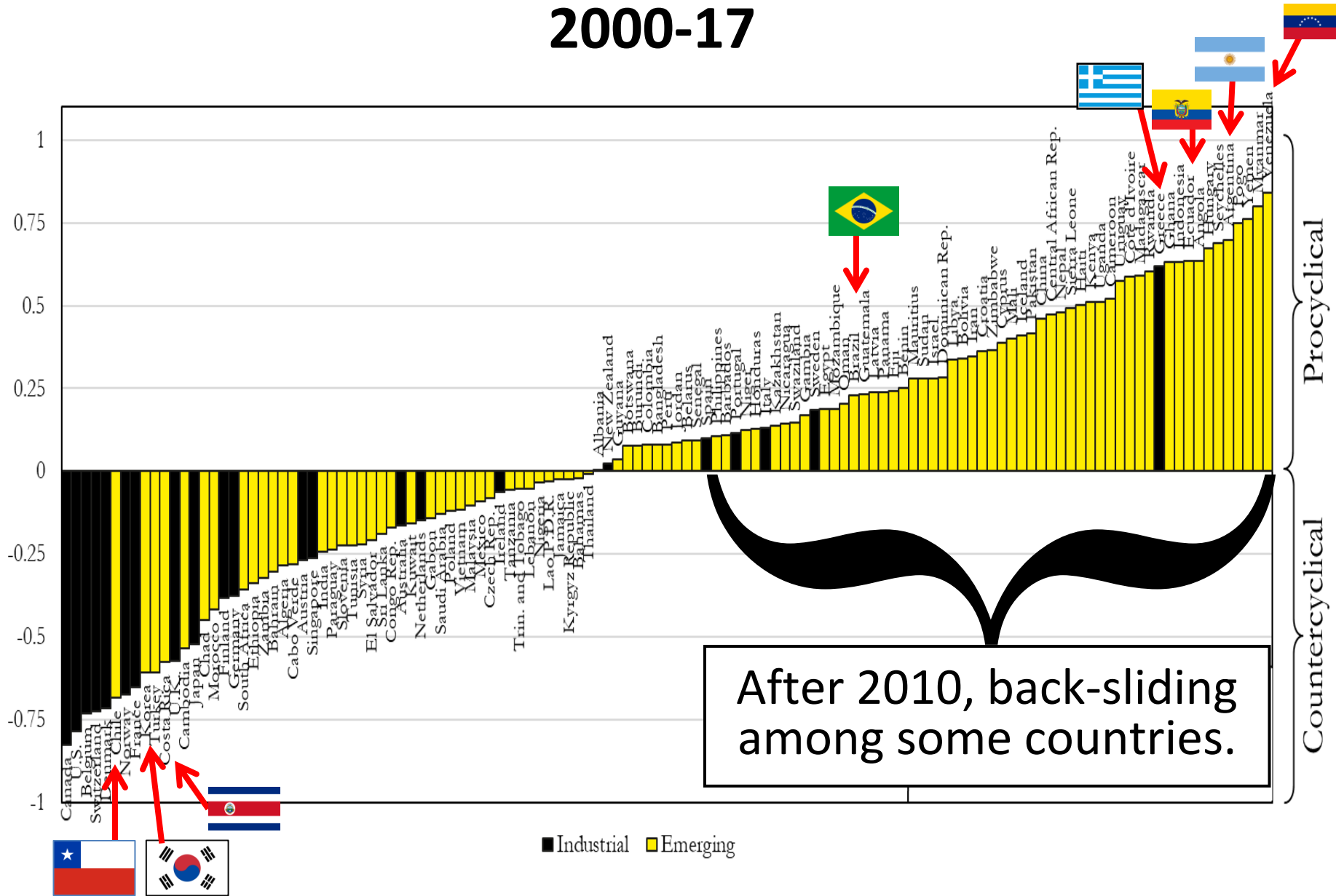
43% (or 32 out of 75) countercyclical. *The figure was 17% (or 13 out of 75) in 1960-1999.*

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

Correlation between cyclical components of real government spending and real GDP 2000-2017



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.”

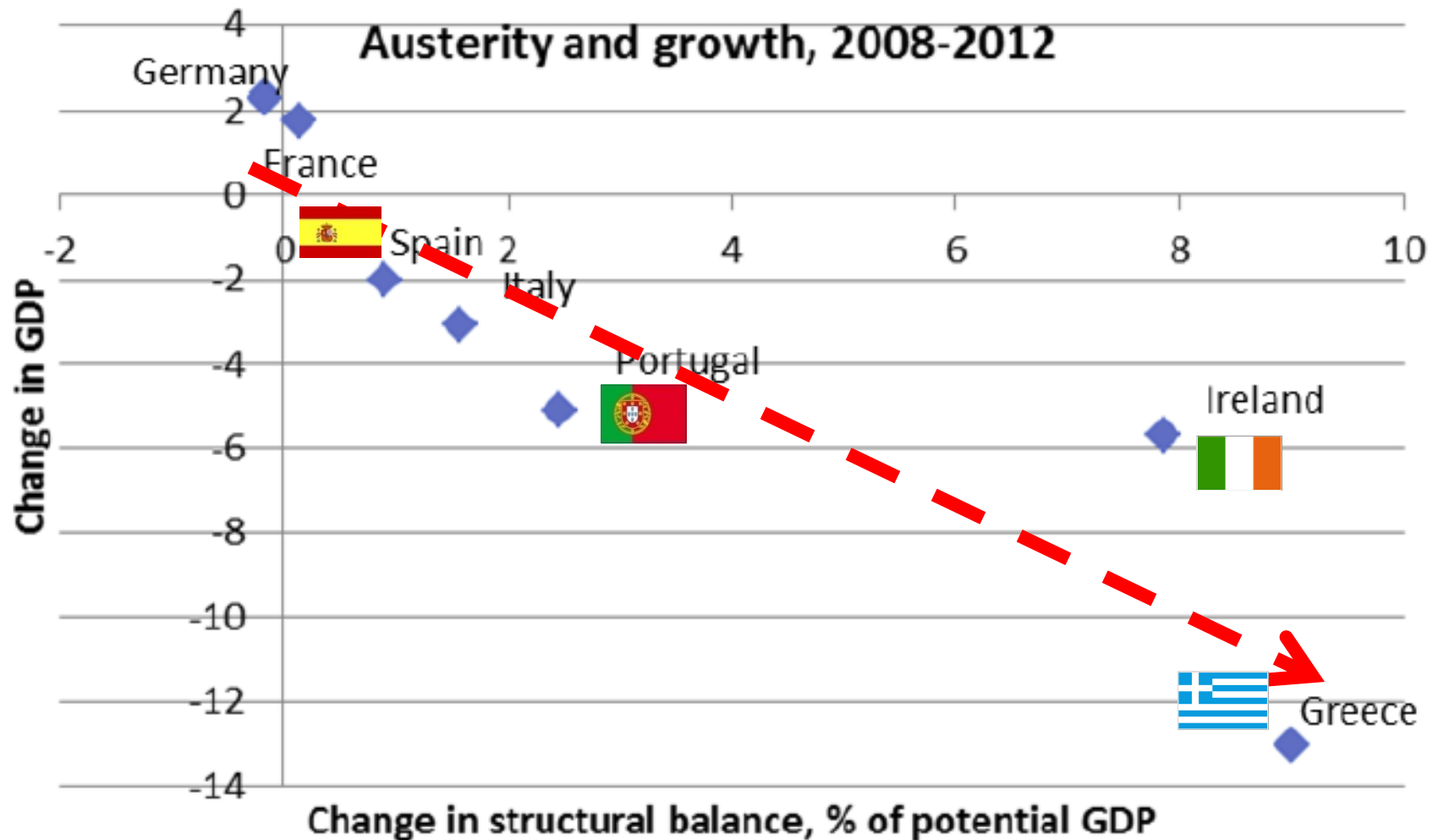
Advanced countries can suffer pro-cyclical policy too.

- 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.



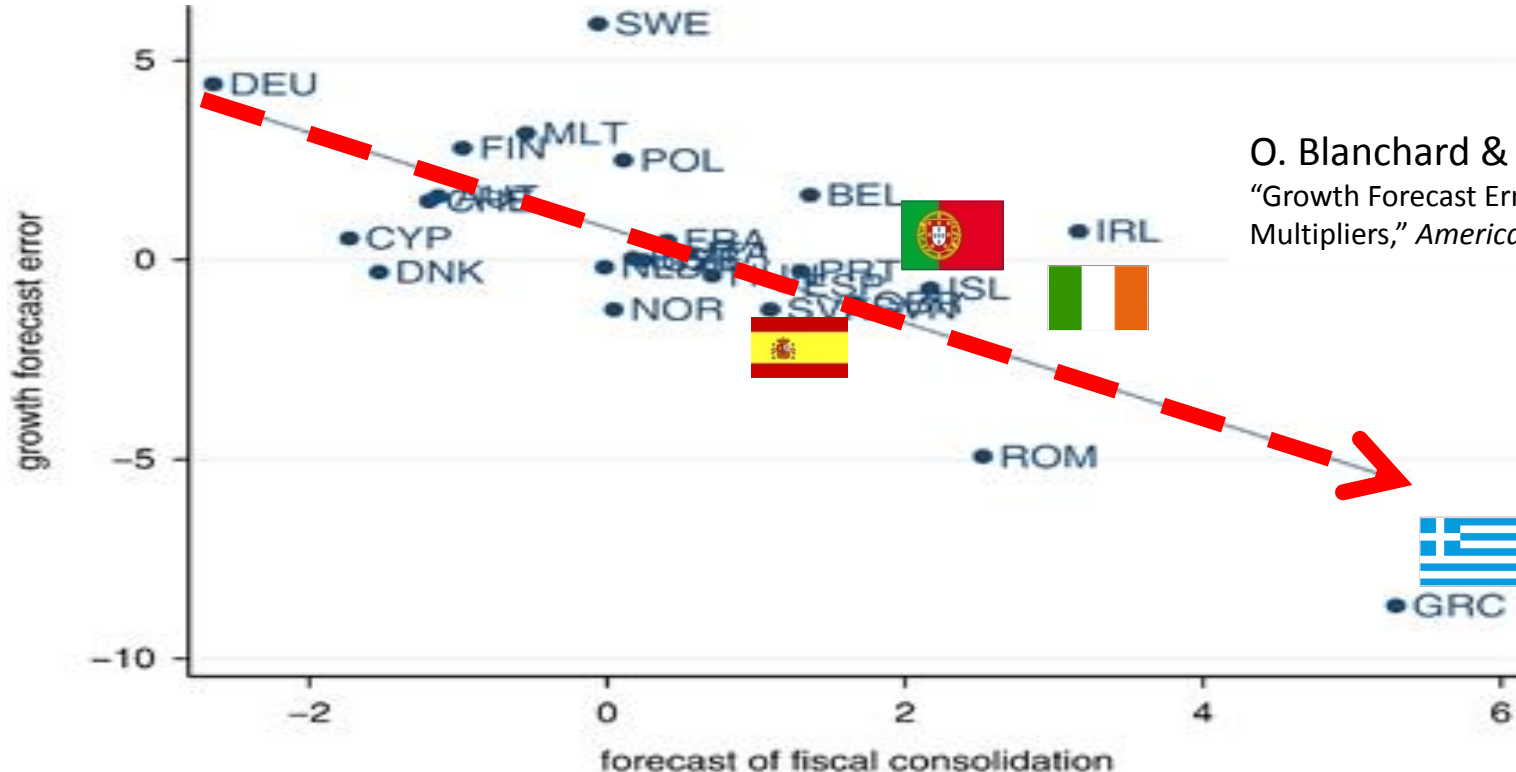


Why? A different kind of over-optimism:

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

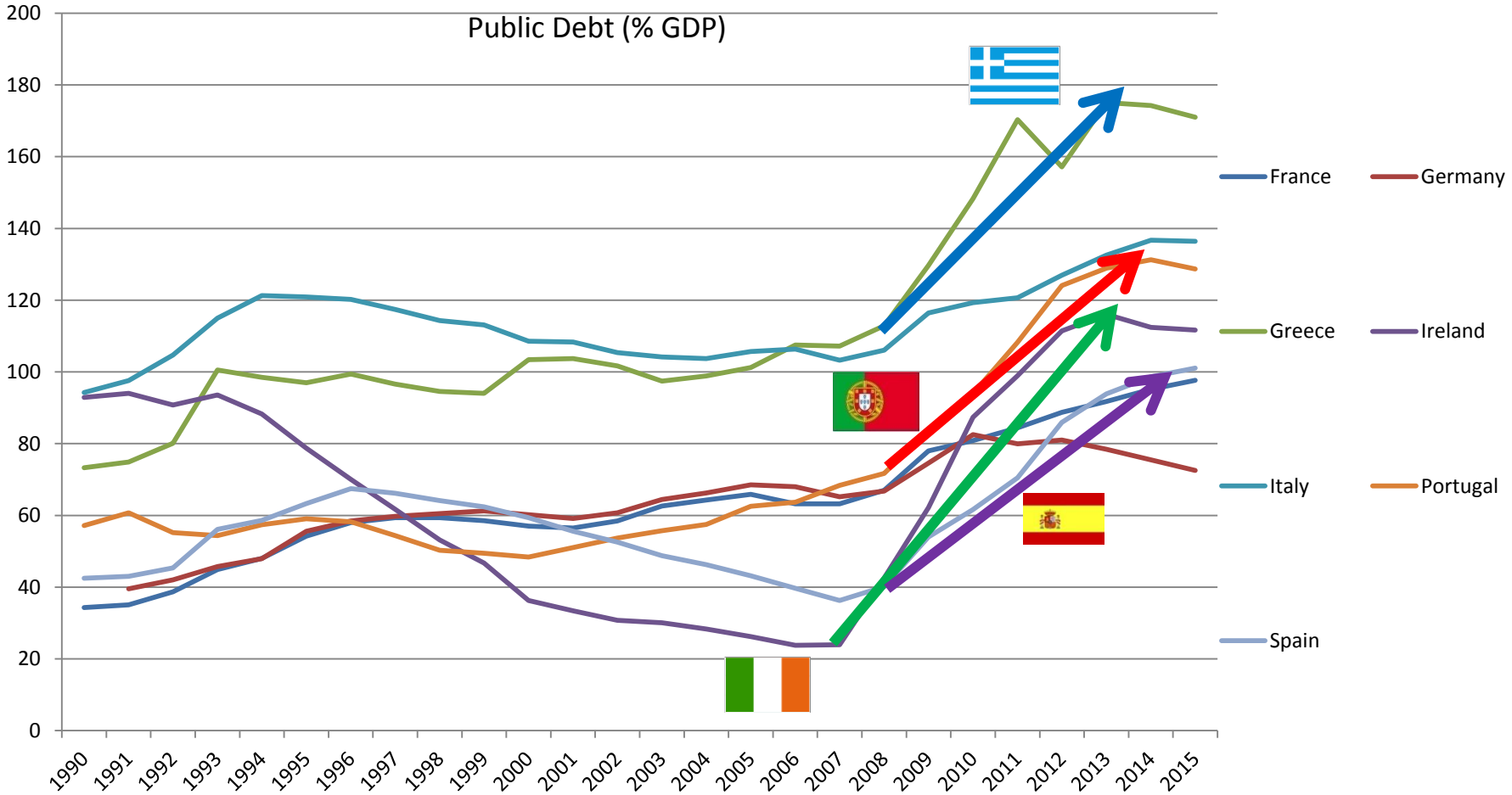


O. Blanchard & D. Leigh, 2014, "Growth Forecast Errors and Fiscal Multipliers," *American Economic Review*.

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.

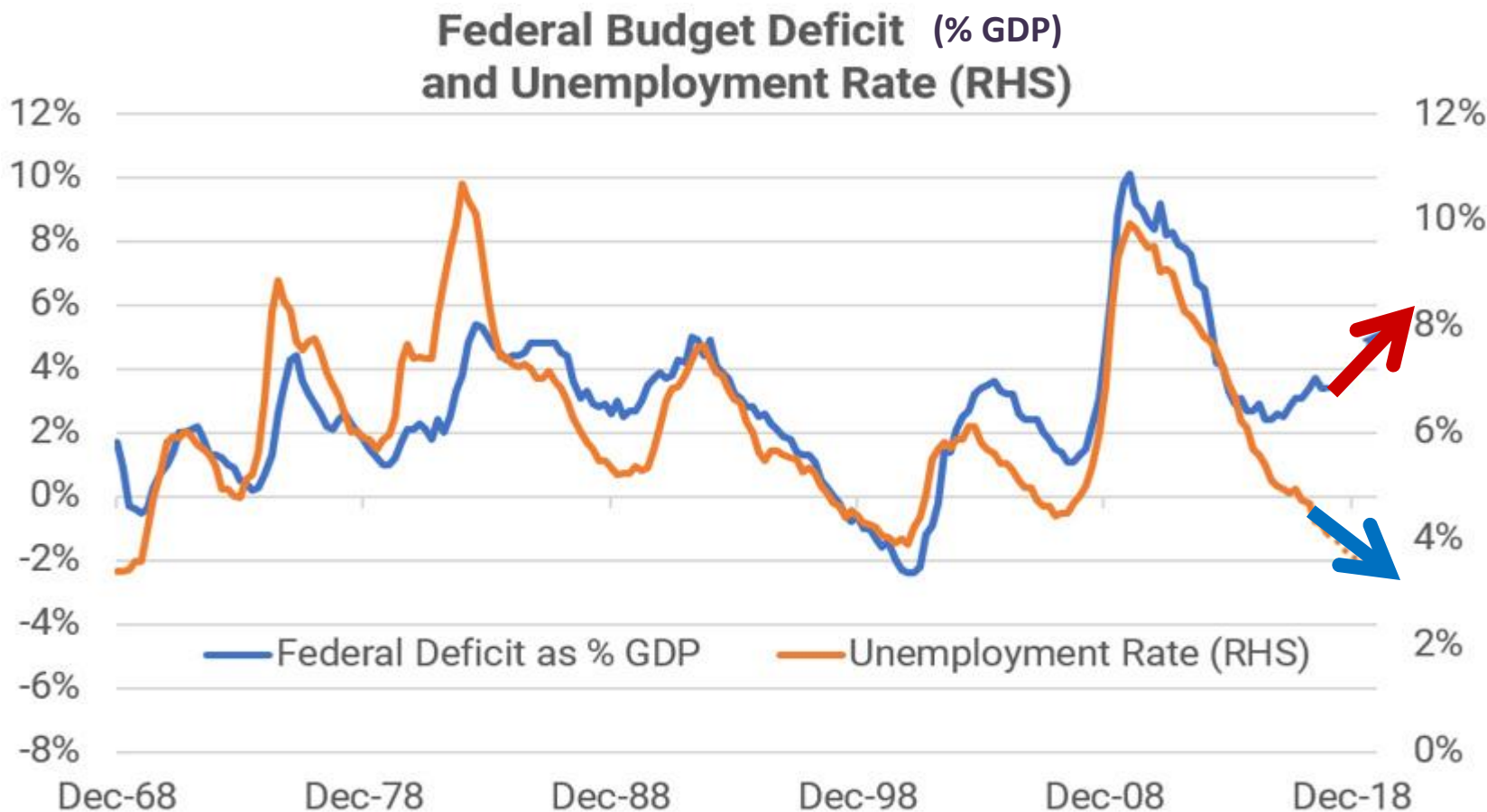


From Remi Bourgeot, Fondation Robert Schuman. Data source: IMF WEO, Oct. 2014.



(ii) US fiscal policy

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



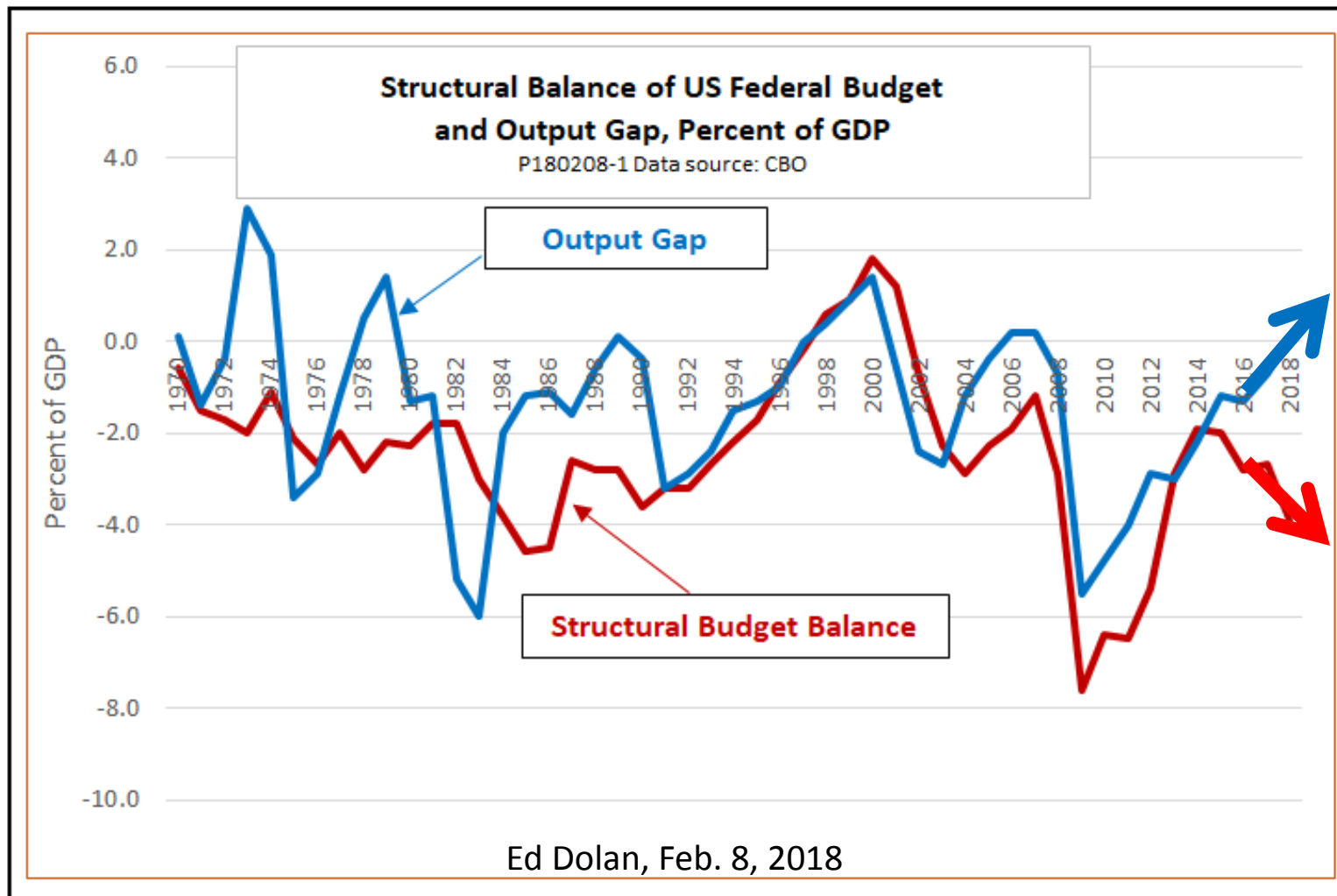
Source: Bloomberg

www.stansberrychurchouse.com

“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

Prof. Jeffrey Frankel



Website: <https://scholar.harvard.edu/frankel>

Monthly column:

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



twitter.com/JFrankelEcon

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.

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

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Spain	3.1	2.8	2.2
Japan	1.7	1.2	0.9
United Kingdom	1.8	1.6	1.5
Canada	3.0	2.1	2.0
Other Advanced Economies ²	2.7	2.7	2.6
Emerging Market and Developing Economies	4.8	4.9	5.1
Commonwealth of Independent States	2.1	2.2	2.1
Russia	1.5	1.7	1.5
Excluding Russia	3.6	3.5	3.6
Emerging and Developing Asia	6.5	6.5	6.6
China	6.9	6.6	6.4
India ³	6.7	7.4	7.8
ASEAN-5 ⁴	5.3	5.3	5.4
Emerging and Developing Europe	5.8	4.3	3.7
Latin America and the Caribbean	1.3	2.0	2.8
Brazil	1.0	2.3	2.5
Mexico	2.0	2.3	3.0
Middle East, North Africa, Afghanistan, and Pakistan	2.6	3.4	3.7
Saudi Arabia	-0.7	1.7	1.9
Sub-Saharan Africa	2.8	3.4	3.7
Nigeria	0.8	2.1	1.9
South Africa	1.3	1.5	1.7

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.



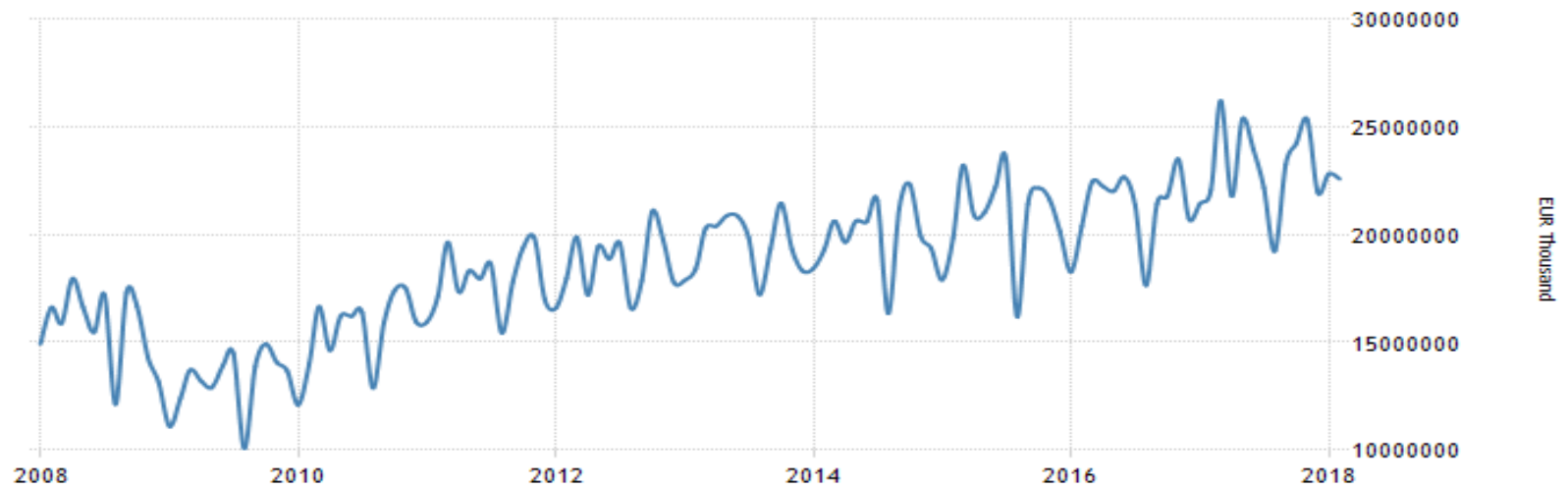
Spanish exports have led its recovery.

SPAIN GDP GROWTH RATE



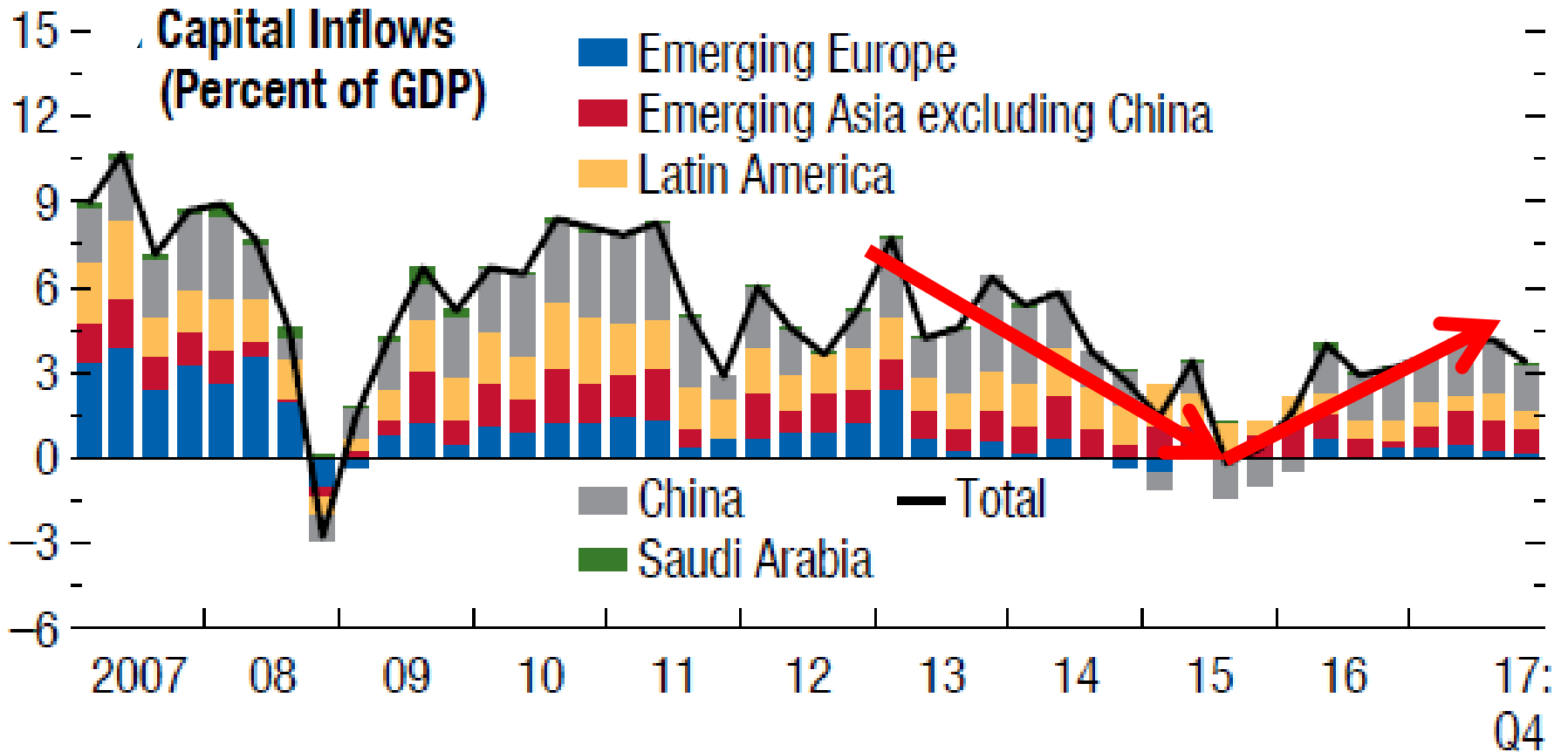
SOURCE: TRADINGECONOMICS.COM | NATIONAL STATISTICS INSTITUTE (INE)

SPAIN EXPORTS



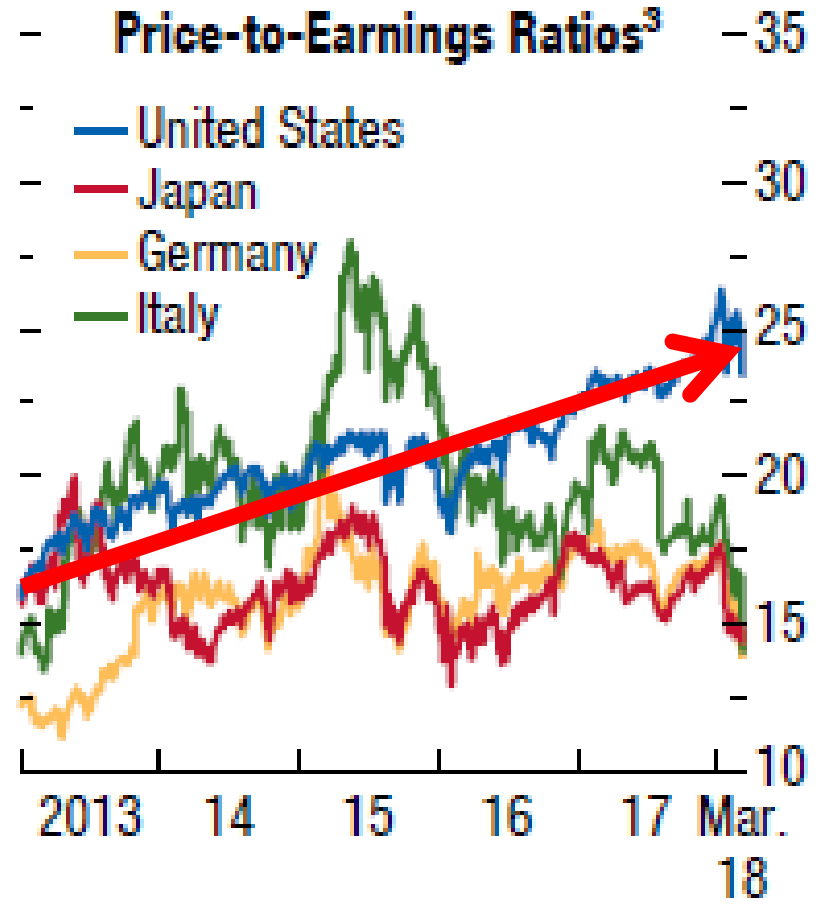
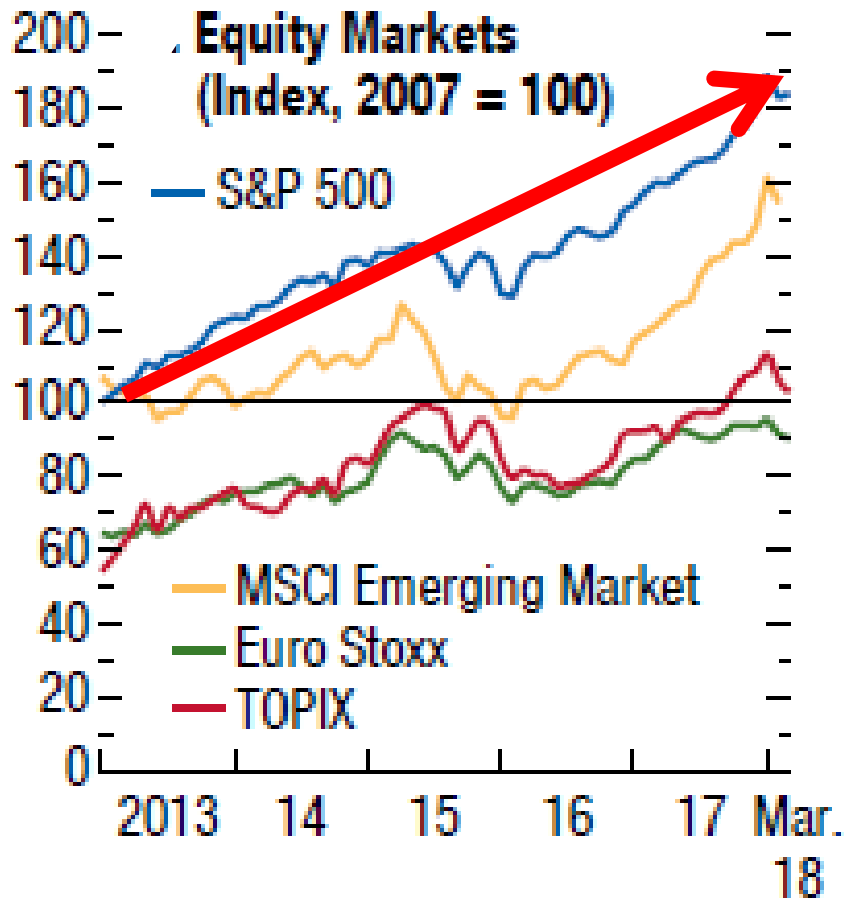
SOURCE: TRADINGECONOMICS.COM | MINISTERIO DE ECONOMIA Y COMPETITIVIDAD

EM capital inflows recovered in 2017.

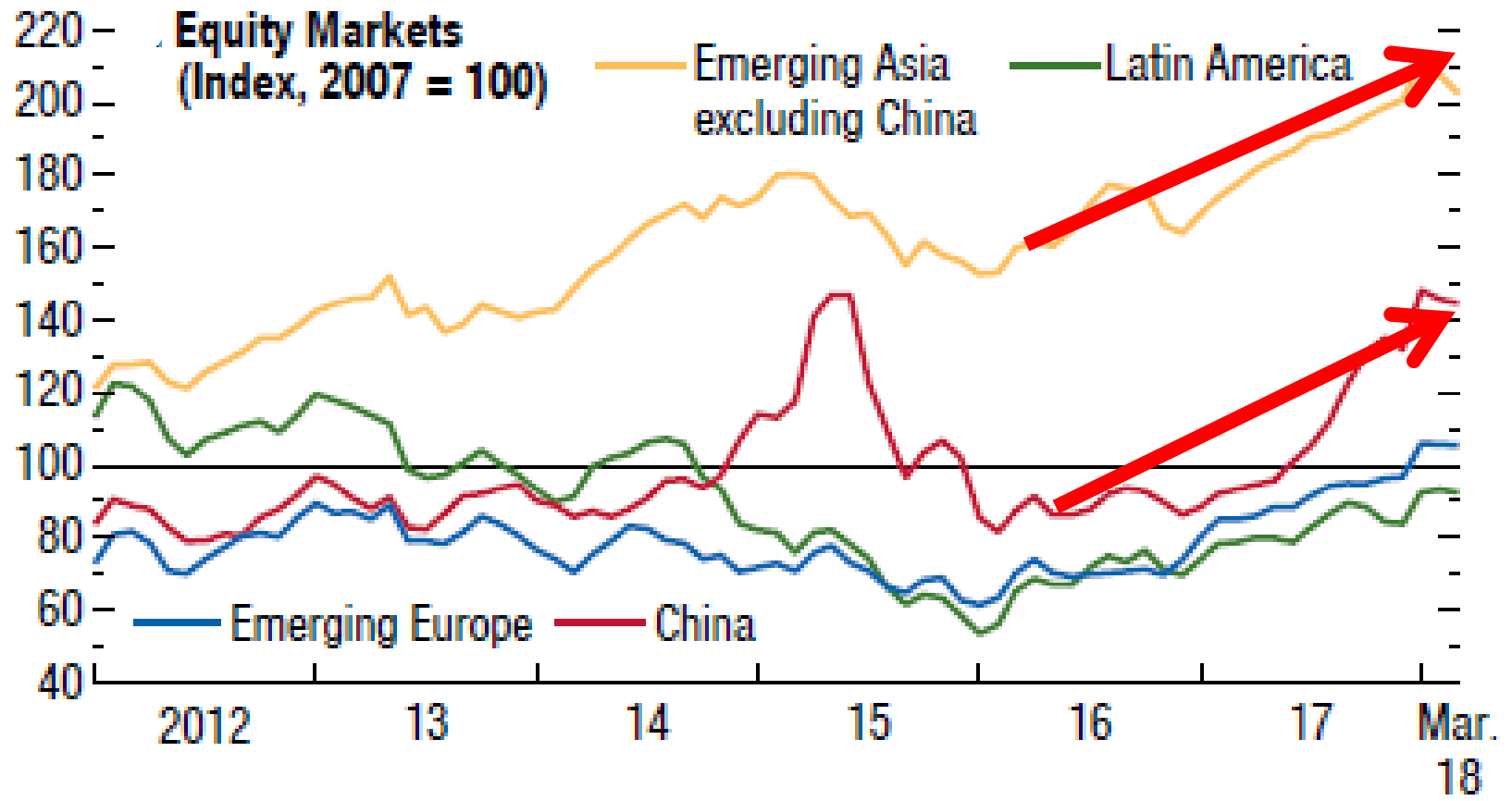


IMF World Economic Outlook, April 2018.




US equity markets are still high



Asian equity markets are also high.



Appendix 2: More on Chile's fiscal institutions

- 1st rule – Governments must set a budget target, 
- 2nd 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.
- 3rd 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.2007, 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.

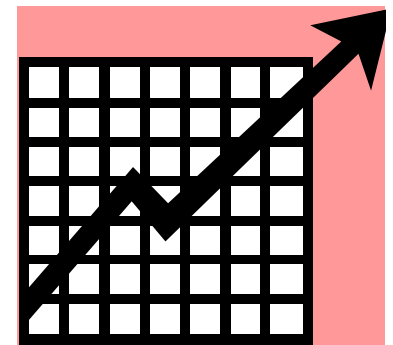
The problem of over-optimism in official forecasts

- 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.



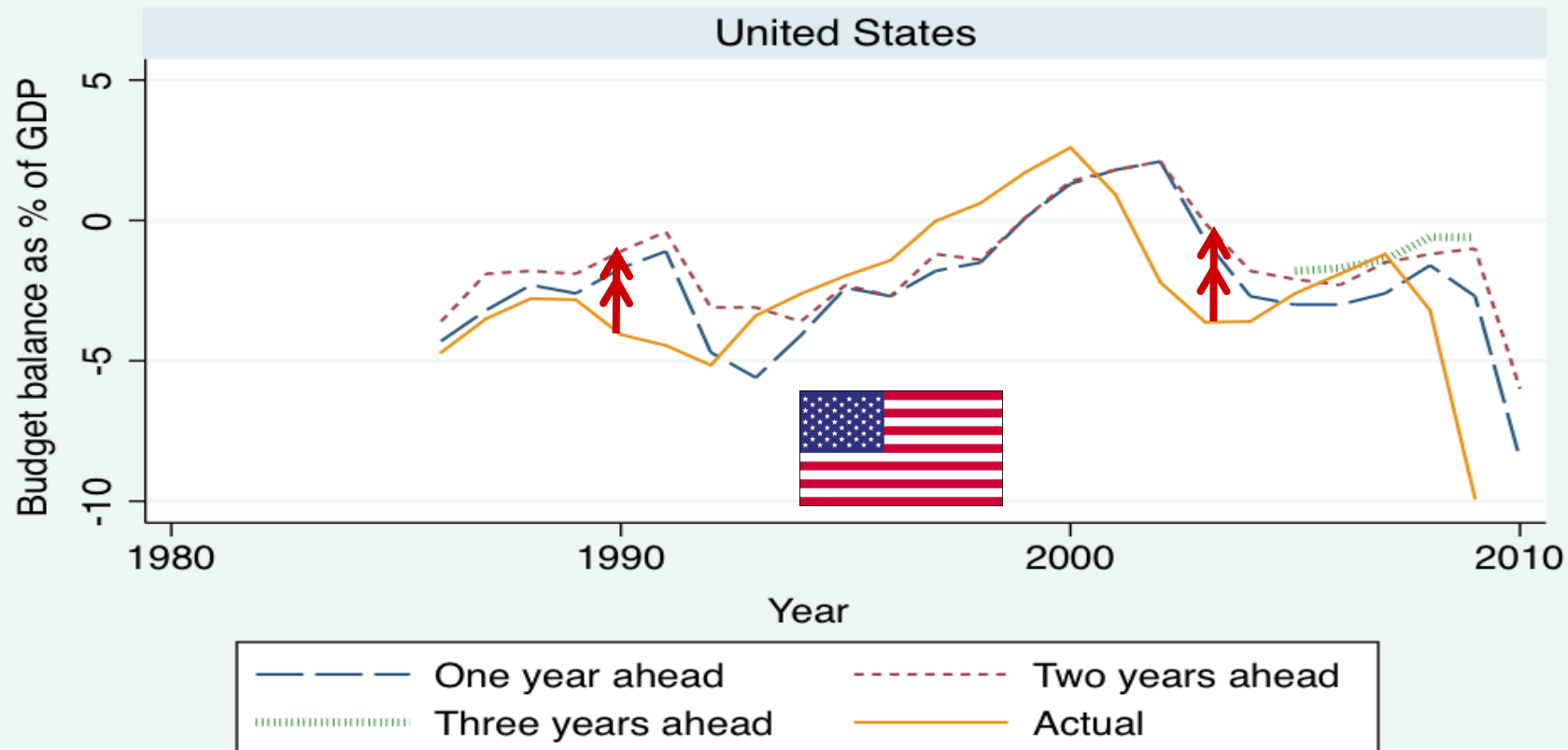
Implication of forecast bias for actual budgets

- 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



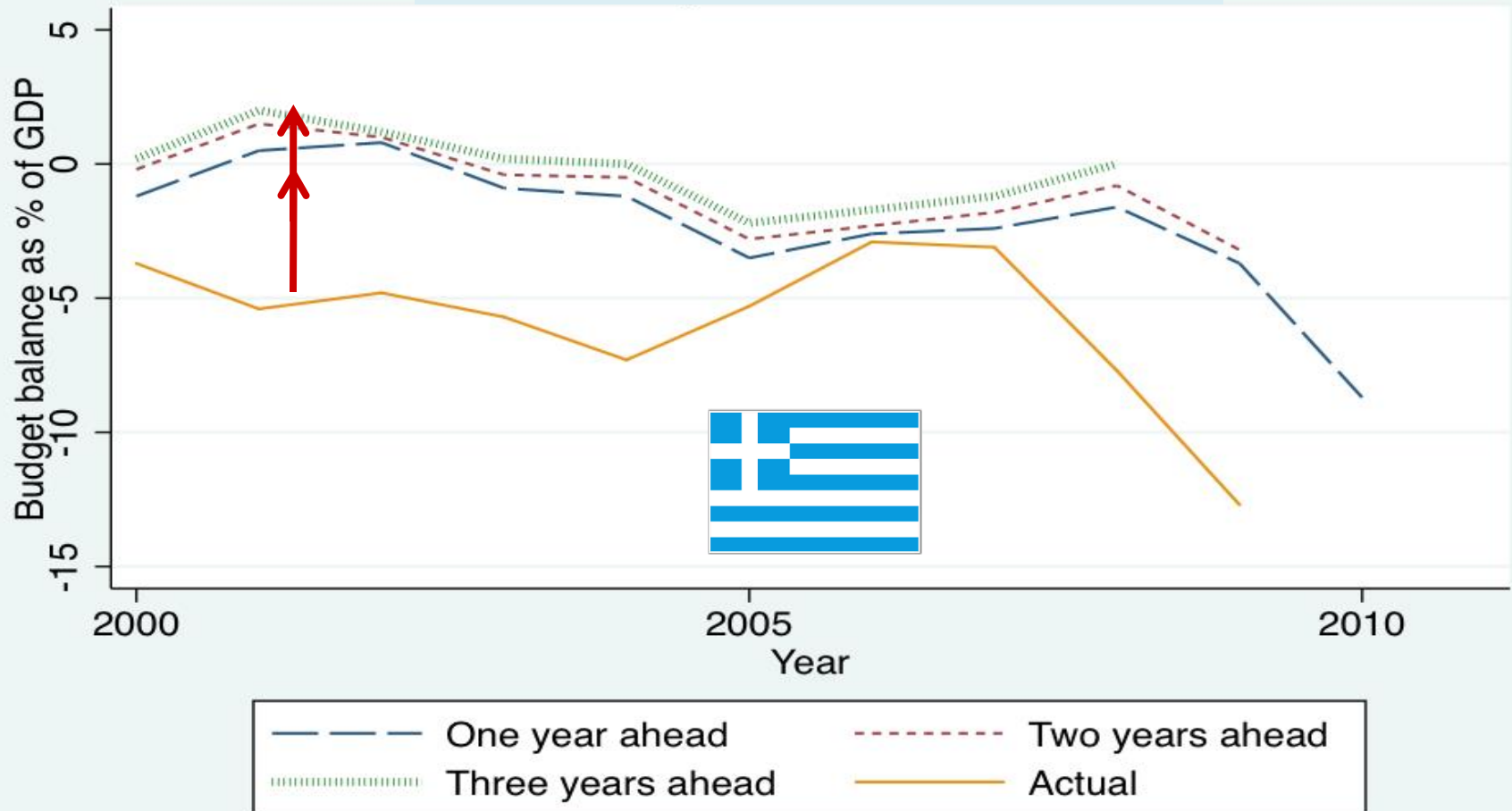
US official projections were over-optimistic on average.

Forecasts of budget balance, one-three years ahead



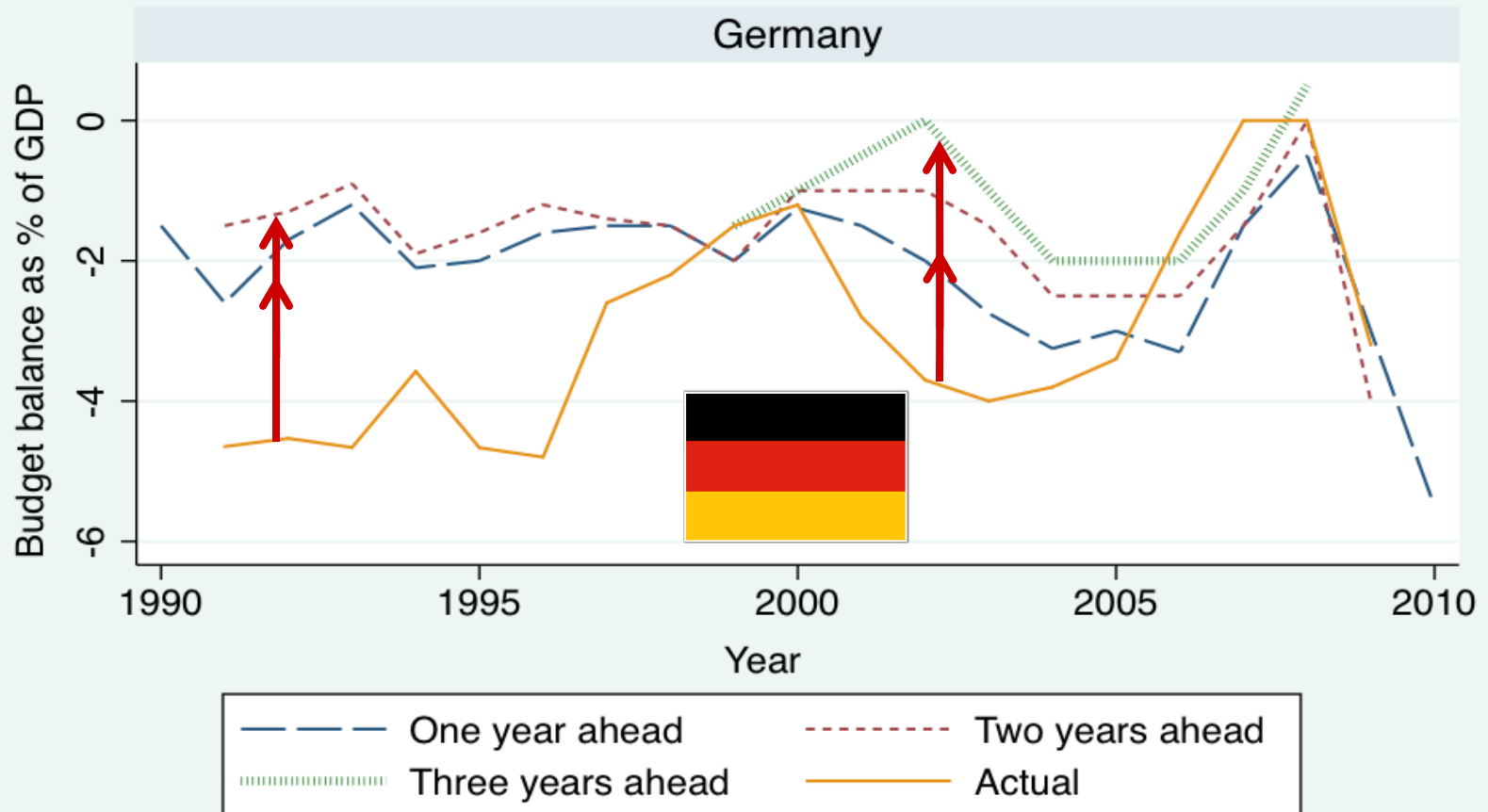
Greek official forecasts were *always* over-optimistic.

Greek forecasts of budget balance, one-three years ahead



German forecasts were also usually too optimistic.

Forecasts of budget balance, one-three years ahead

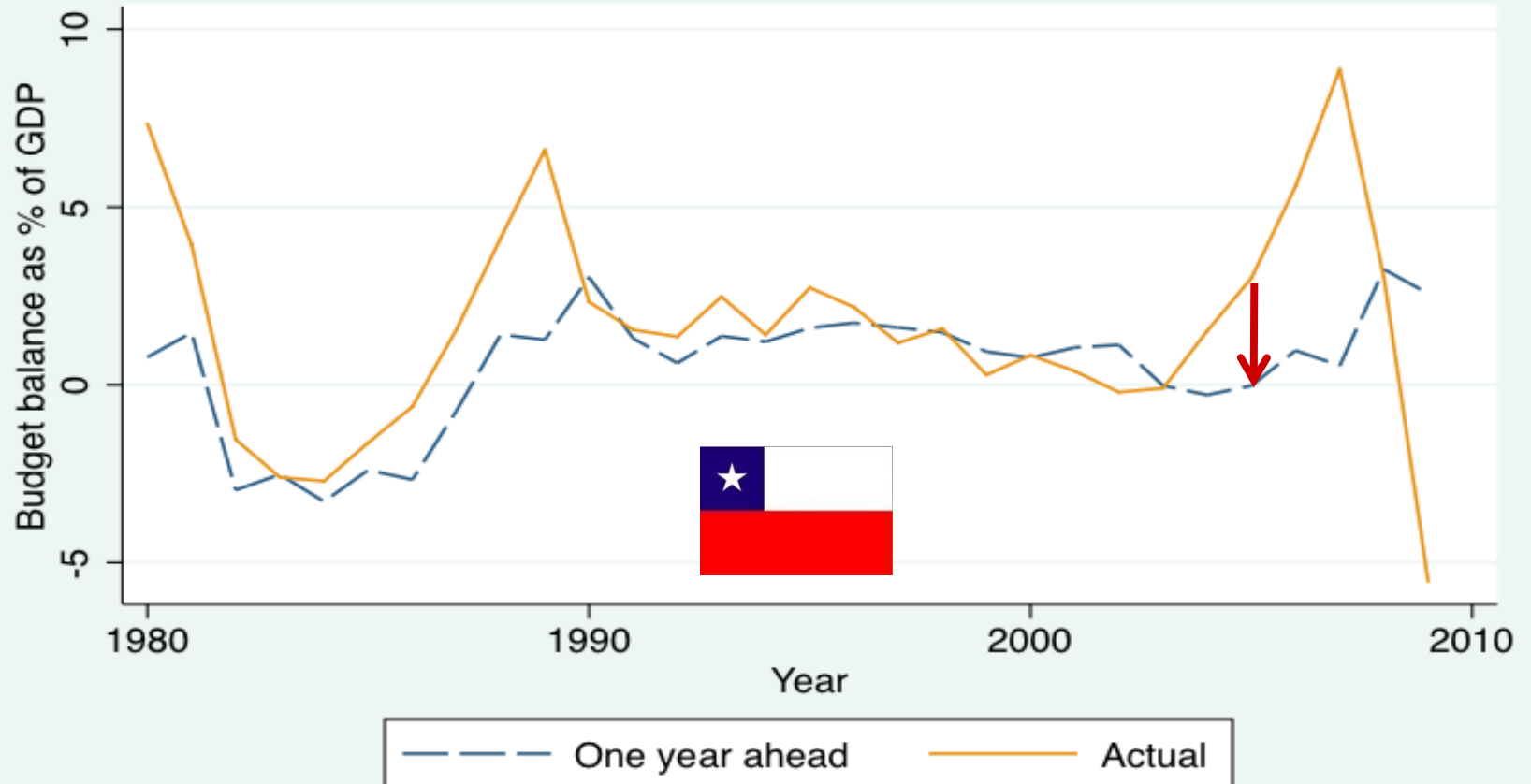


Chile's official forecasts were *not* over-optimistic.

Forecasts of budget balance, one-three years ahead

Year indicates year that forecast is made

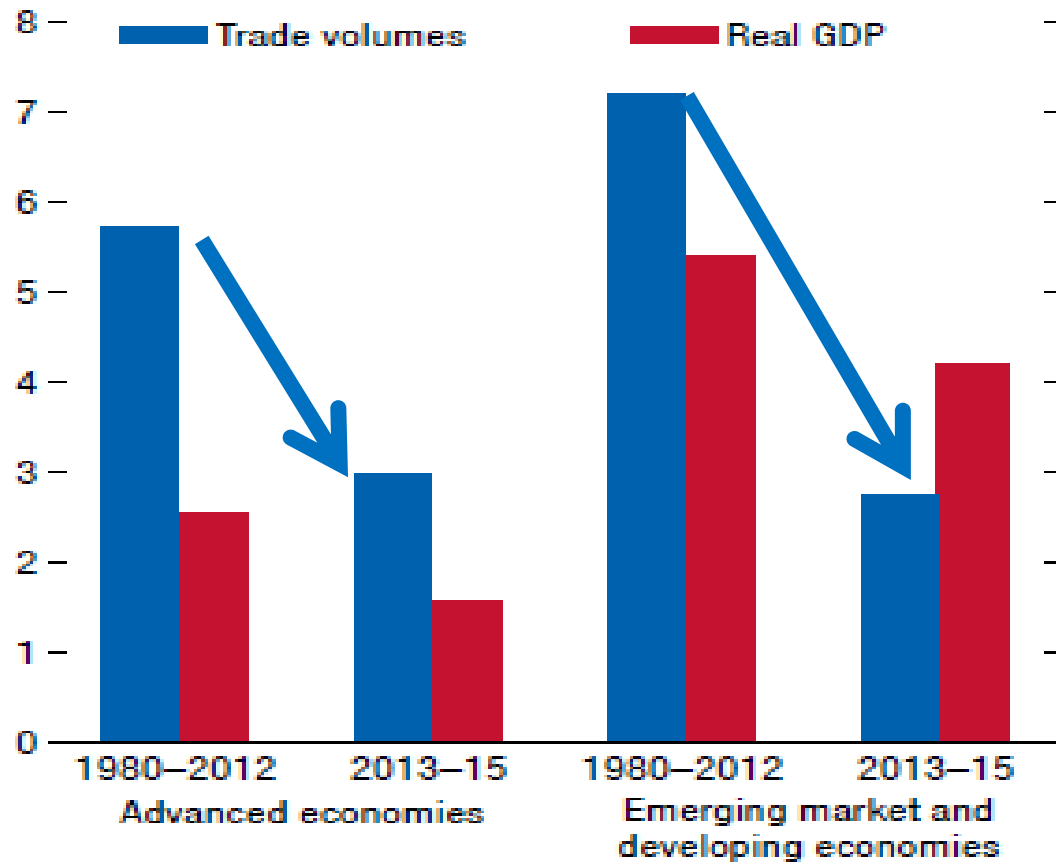
Chile



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.



Emine Boz, Eugenio Cerutti,
& Sung Eun Jung (IMF, 2016).

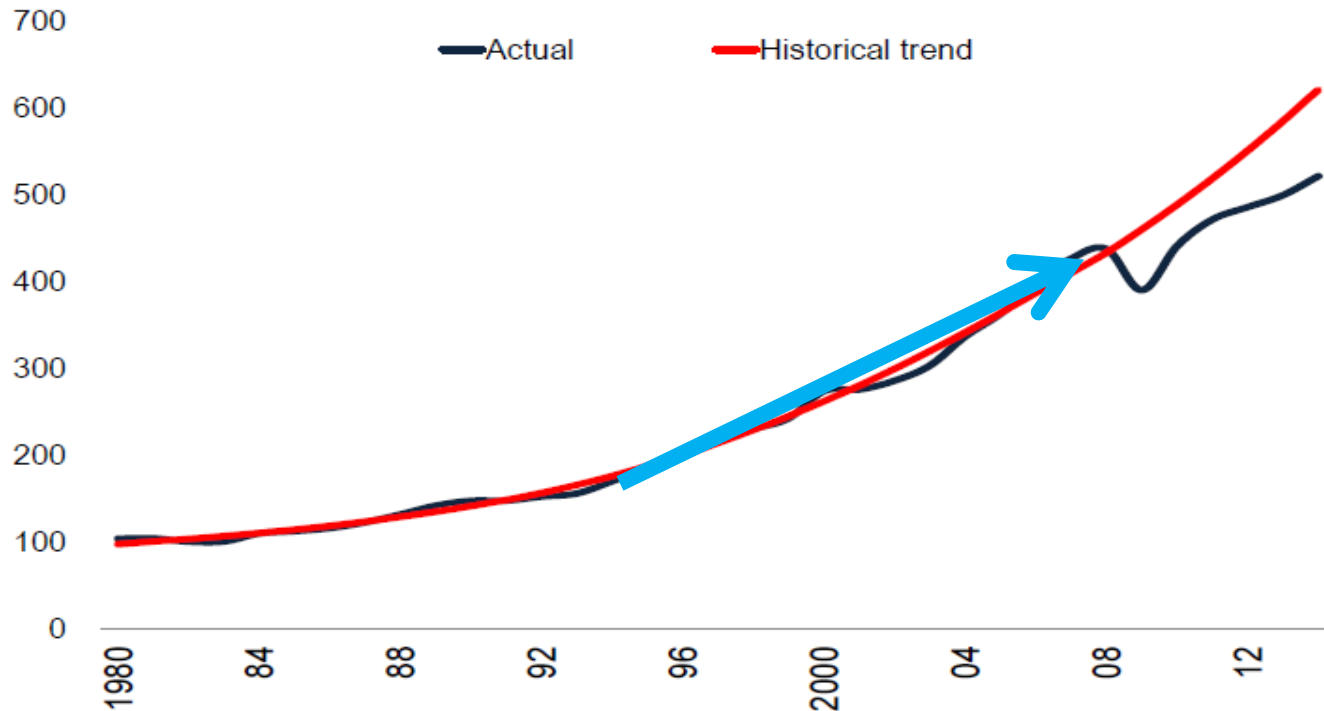
Since the rebound from the great trade collapse of 2008-09, when world trade fell by much more than GDP, global trade growth has slowed notably, both in absolute terms and relative to world GDP growth. This slowdown has been more pronounced in emerging market and developing economies, where it intensified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

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.

Index, 1980 = 100



Source: World Bank.

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.

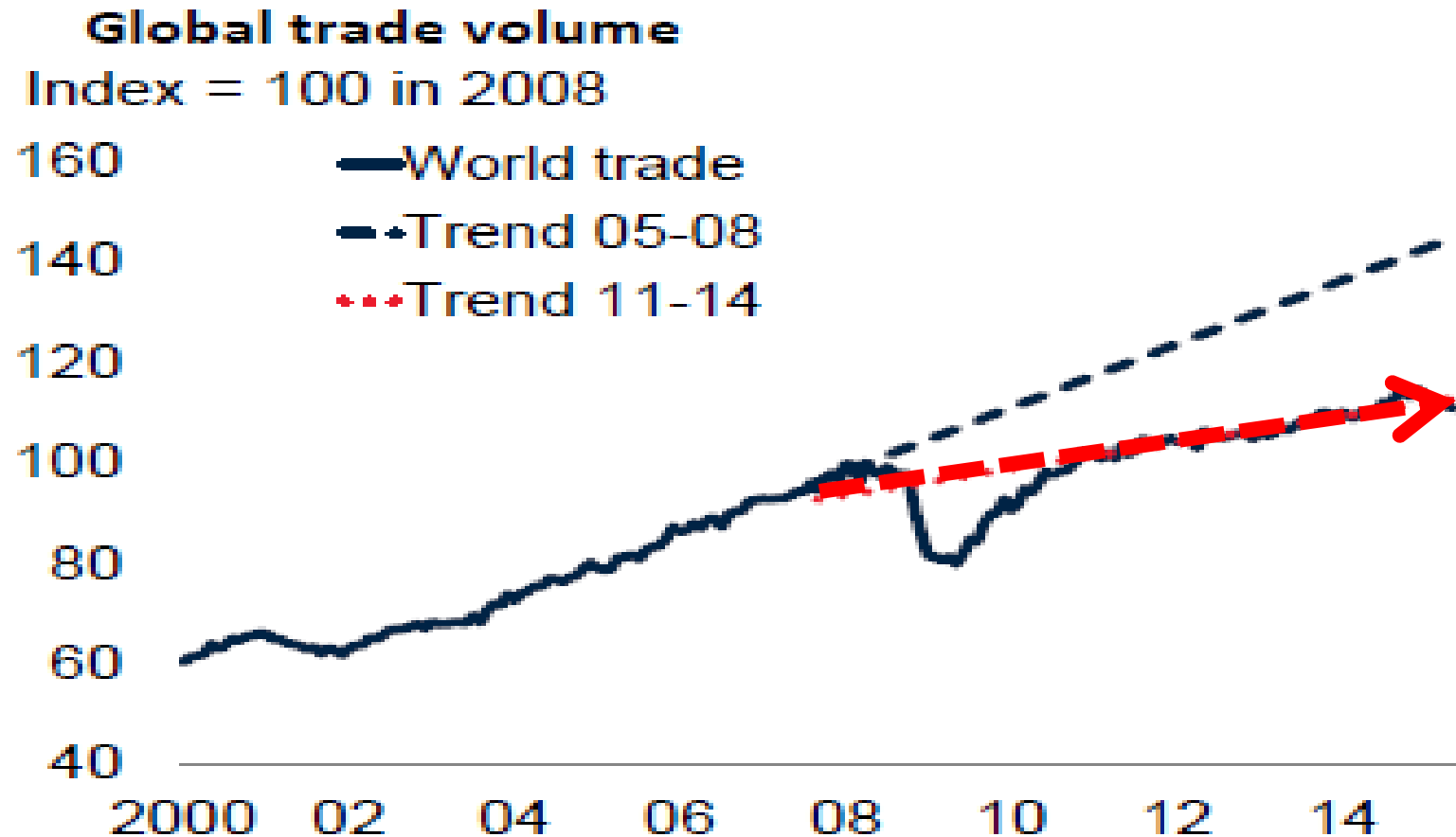


When the Global Financial Crisis hit in 2008...

- 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.



Source: World Bank, World Trade Monitor.

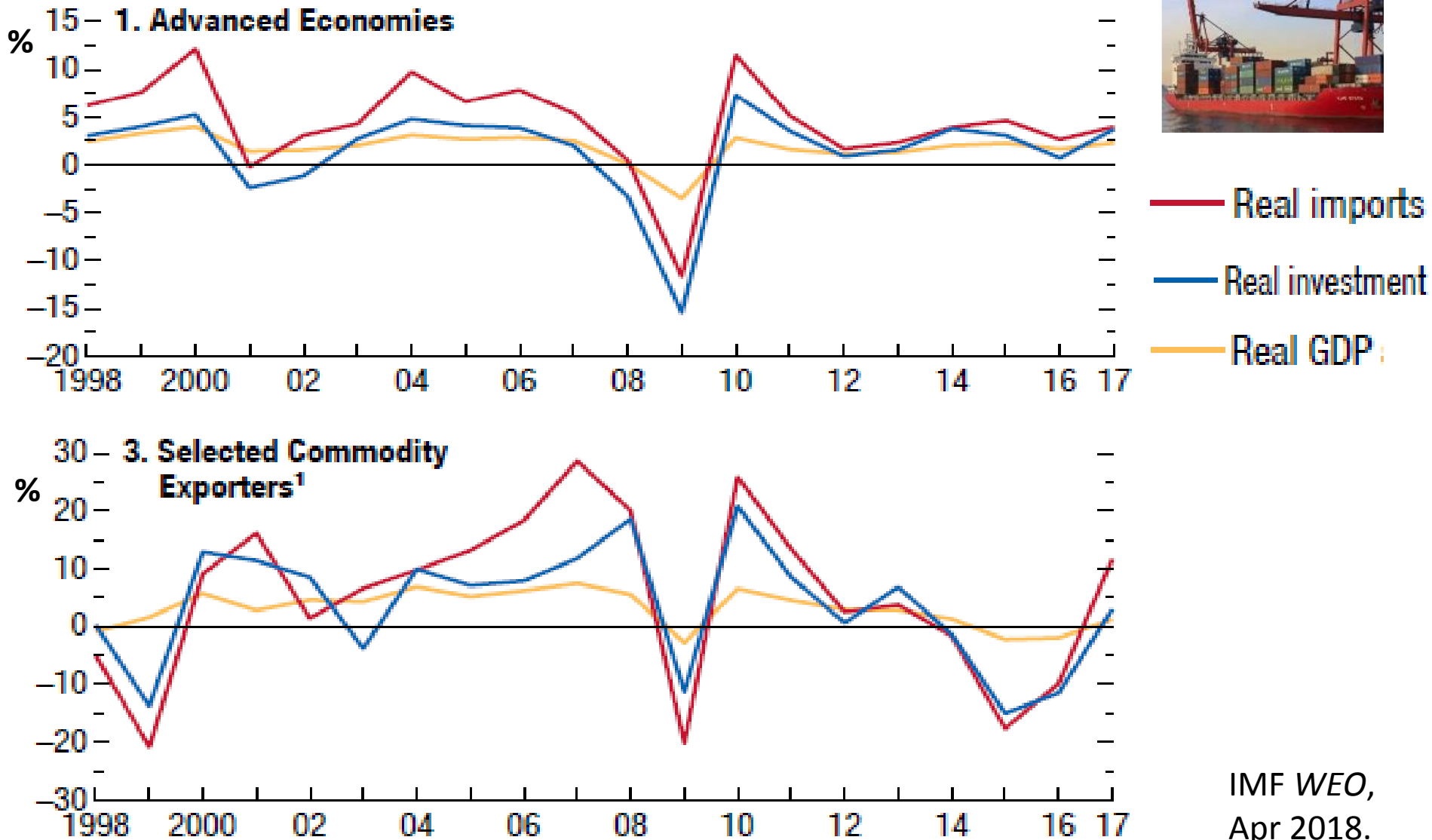
Last observation: June 2015.



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).



¹Selected commodity exporters = Angola, Brazil, Ecuador, Nigeria, Russia.



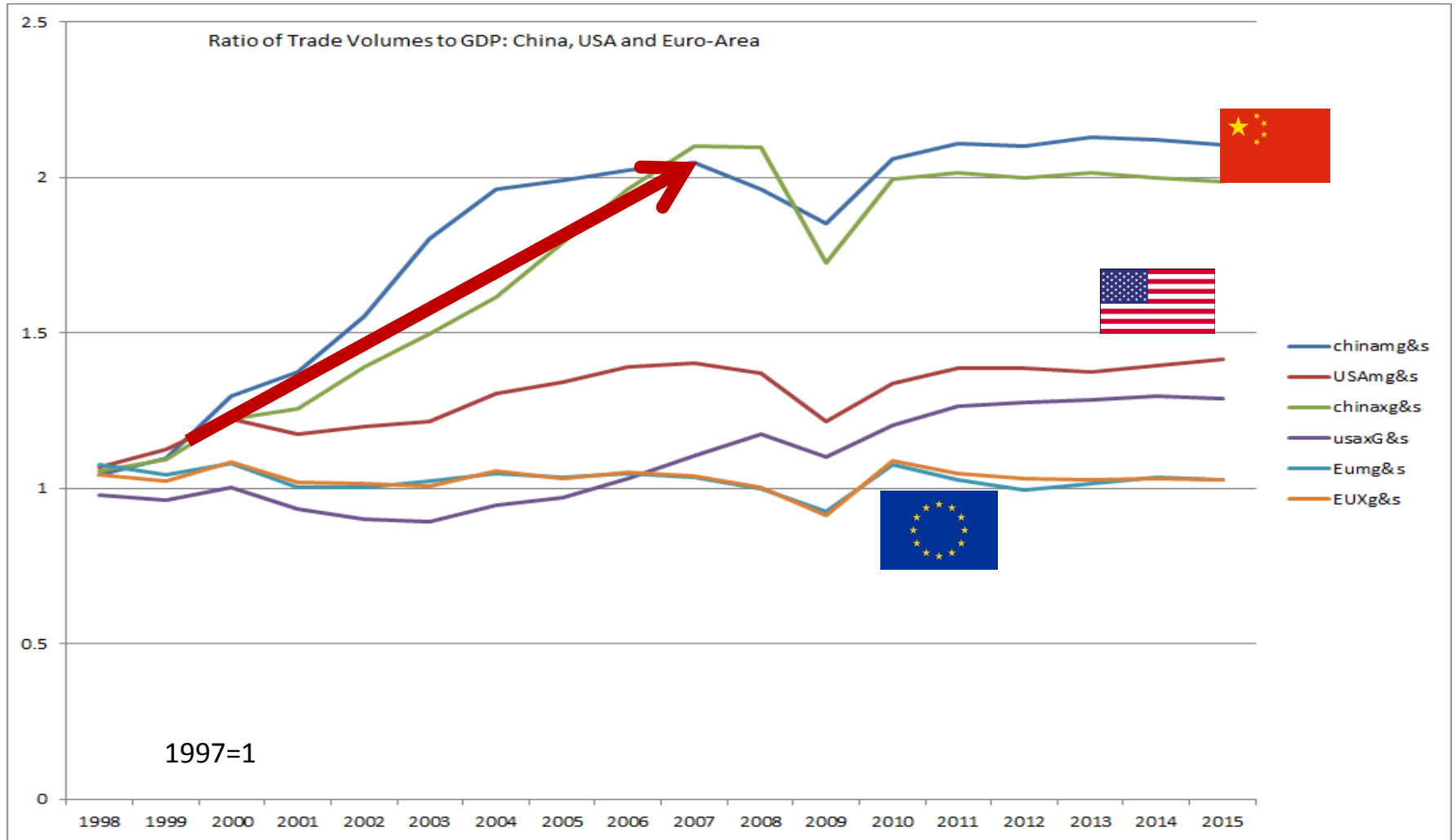
(iii) The structure of China's economy is "rebalancing."

- 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.)

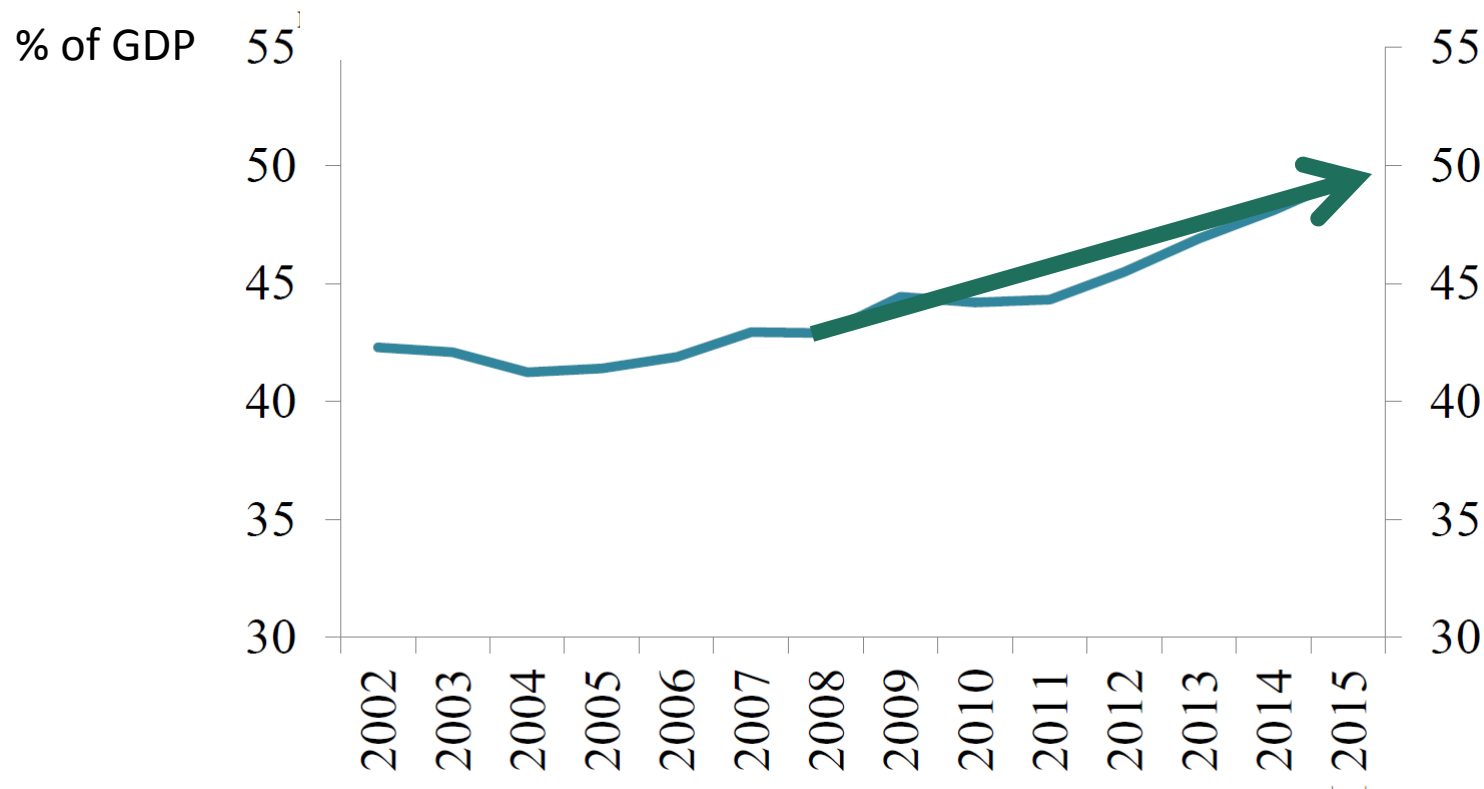




China is shifting into services,
judging by the available data.

Share of Tertiary Industry, 2002 – 1H 2015

Peterson
Institute for
International
Economics



Source: Nicholas Lardy, PIIE

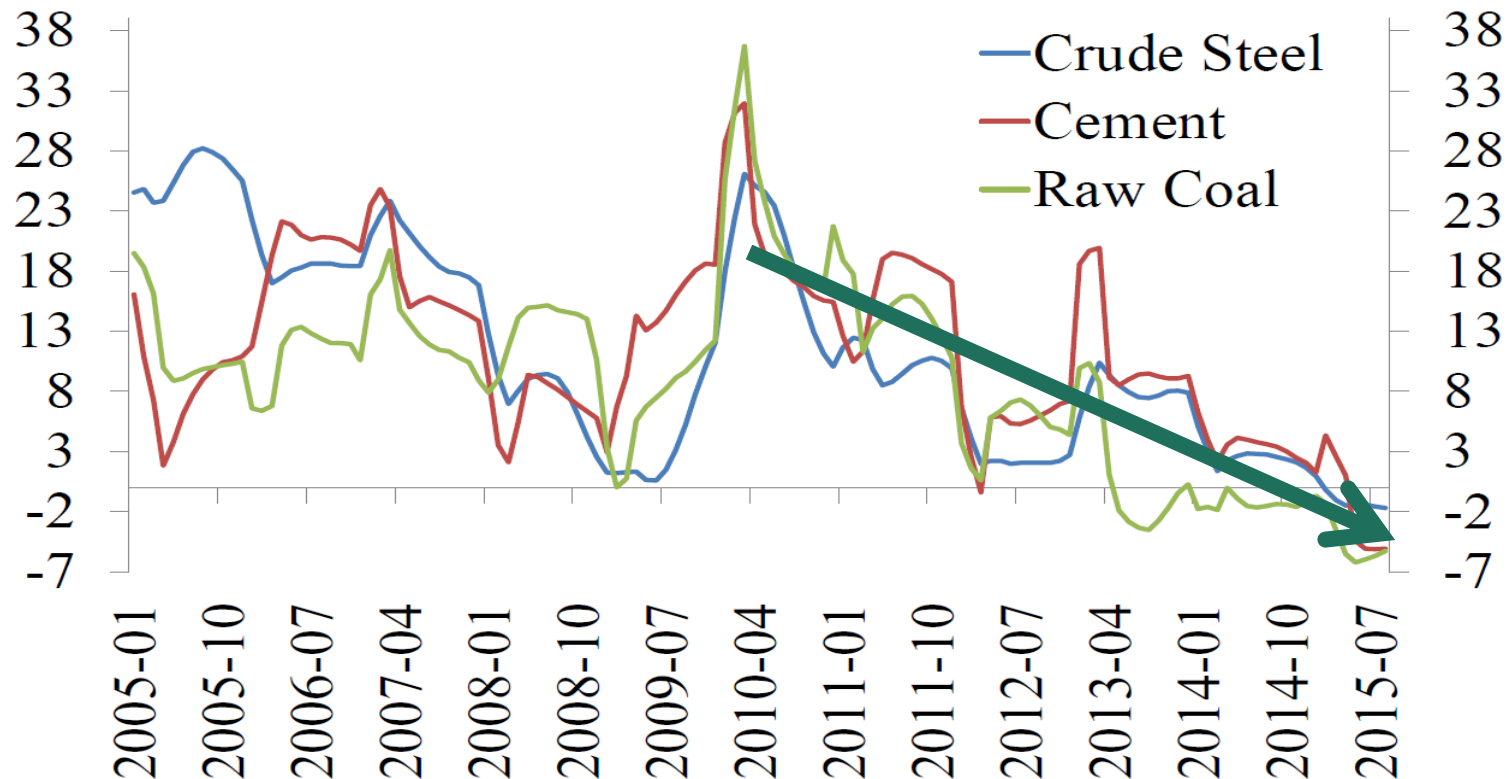
It's good to look also at other data



Decline in China's output of industrial products, 2010-2015

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Economics

% change (year-over-year)



Source: China National Bureau of Statistics, China Coal Transportation & Distribution

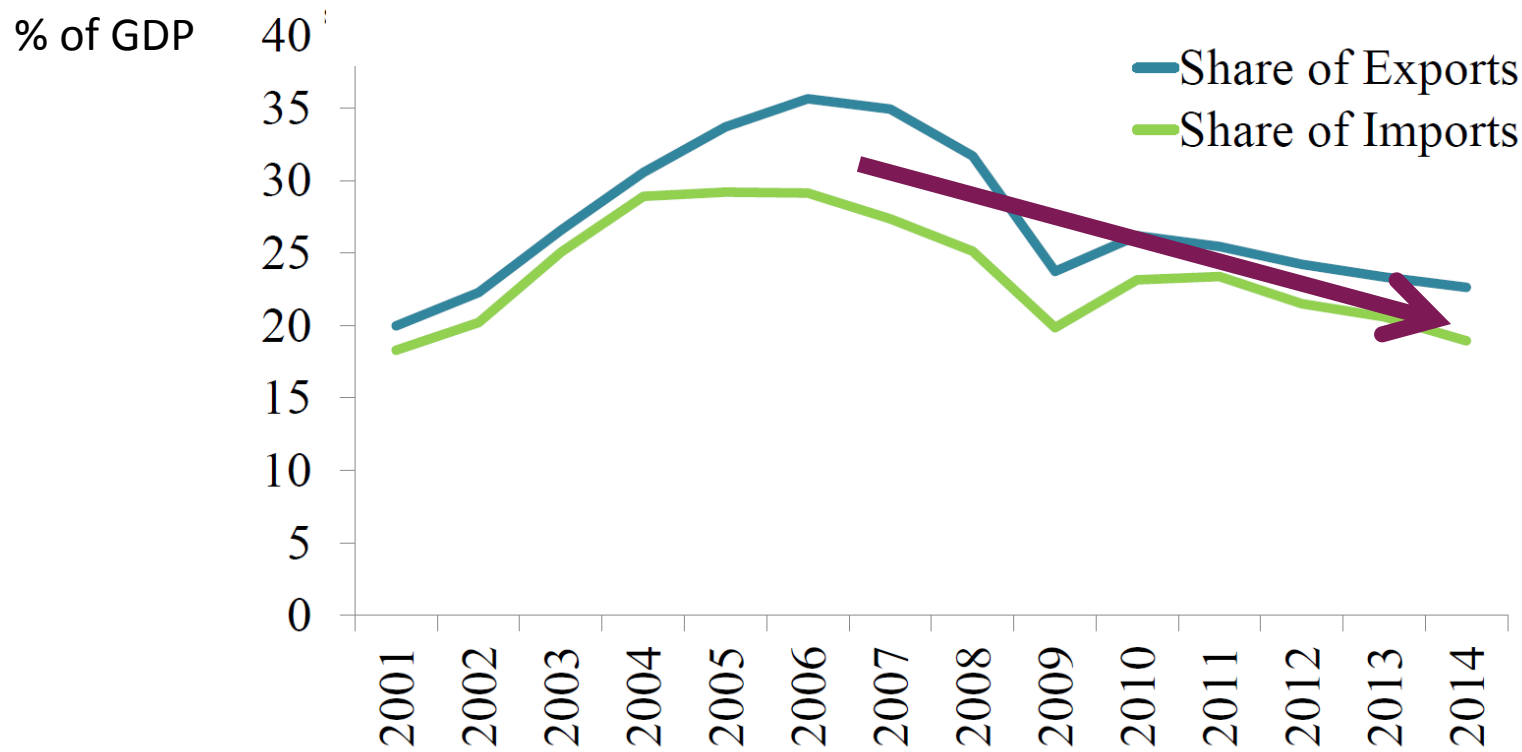
Source: Nicholas Lardy



Trade's relative importance in China has peaked, in part because services are less trade-intensive.

Imports and Exports, 2001 – 2014

Peterson
Institute for
International
Economics

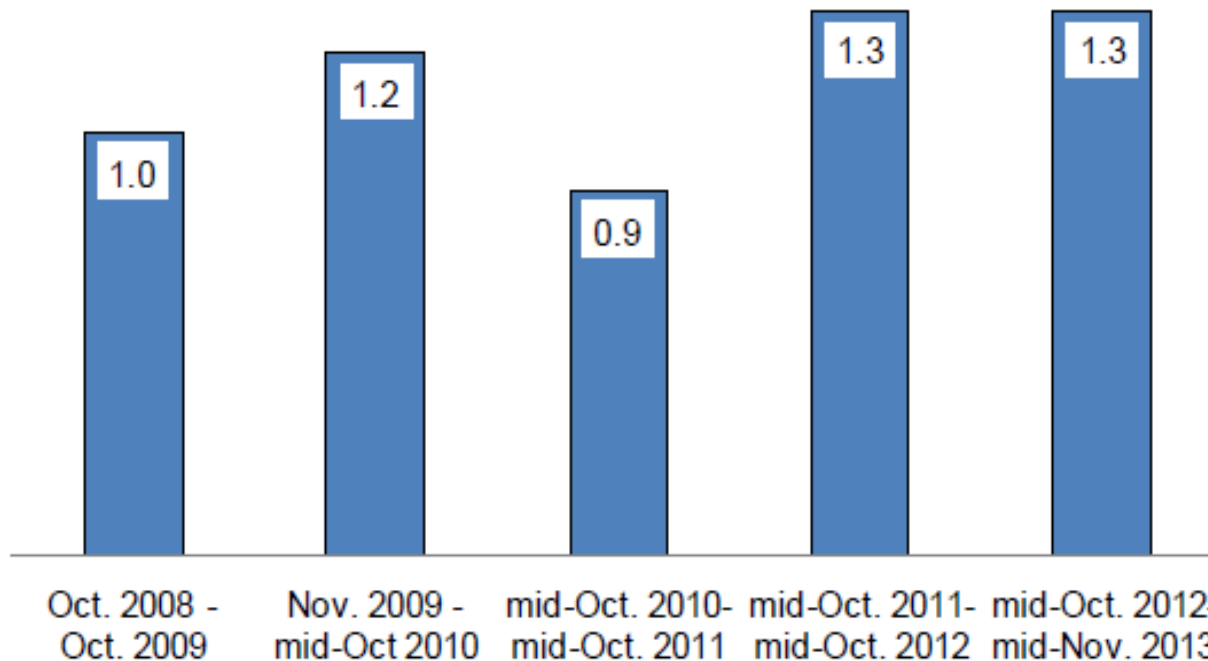


Source: Nicholas Lardy



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

Trade Covered by Import-Restrictive Measures of All WTO Members and Observers (percent of world merchandise imports)



Data source:
WTO

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...

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.