25/10/18
9h00 – 10h30, avenue de Ségur
75007 Paris

Les Matinales du Club

World Economic Outlook October 2018
Challenges to Steady Growth

Compte-rendu

SEANCE PRESIDEE PAR ***CHRISTOPHE DESTAIS****, Deputy-Director, CEPII*

Intervenants

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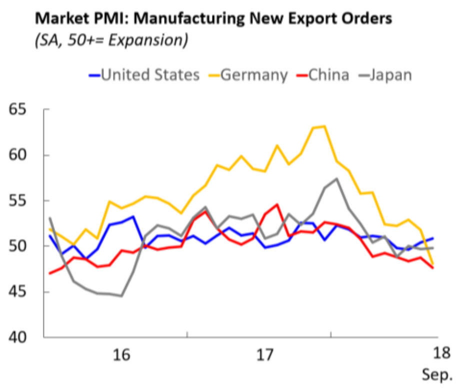
Anne-Laure Delatte, *Deputy-Director, Responsable of the scientific program International Macroeconomics and Finance, CEPII*

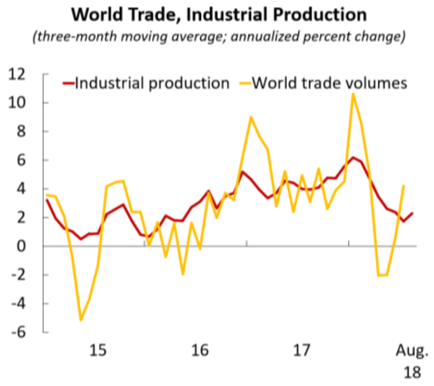
Mico Mrkaic

1) Chapter 1: WORLD ECONOMIC OUTLOOK: CHALLENGES TO STEADY GROWTH

The first chapter will talk about recent debate in policy.
The recent development is a softer development relative to 2017 because of different global factors that put the growth down in the first half of the year. Indeed, **growth is moderated among advanced economies** in the first half of the year and it roughly reduce of 0.1 to 0.2 relative of our expectation in April. In Emerging market, **the growth could be a little bit stronger** that what we thought in April.

What is the background of these outturns? The two following charts will show that.



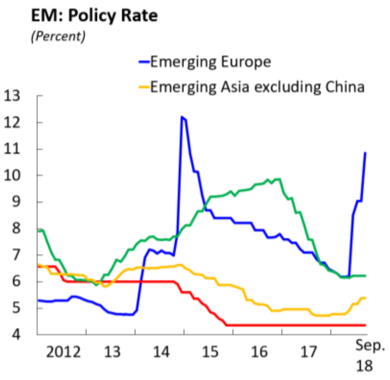


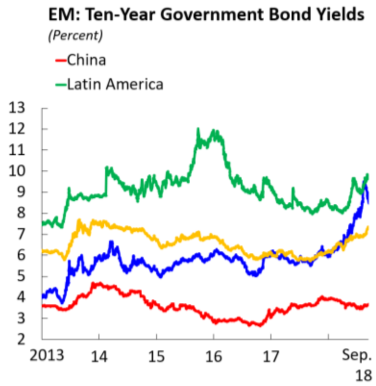
If we look the chart on the right-hand side: we can see that after a rapid growth in 2017, the world trade volume decline quite significantly in the first half of the year. The global industrial production also slows down: growth rate is significantly lower that it was, but it is not below zero.
Why? One the left-hand side, the PMI (Purchasing Manager's Index) measures the expectation of Purchasing Manager's in the export sector: we see that those curves have declined quite strongly since the second half of 2017. The chart can be read as follow: everything that is above 50 signified an expansion and everything that is below 50 signified a contraction. On the average, we can see that countries going to strong expansion to roughly mutual trend. The stronger decline was seen for Germany: from 62 to below 50.

Inflation:

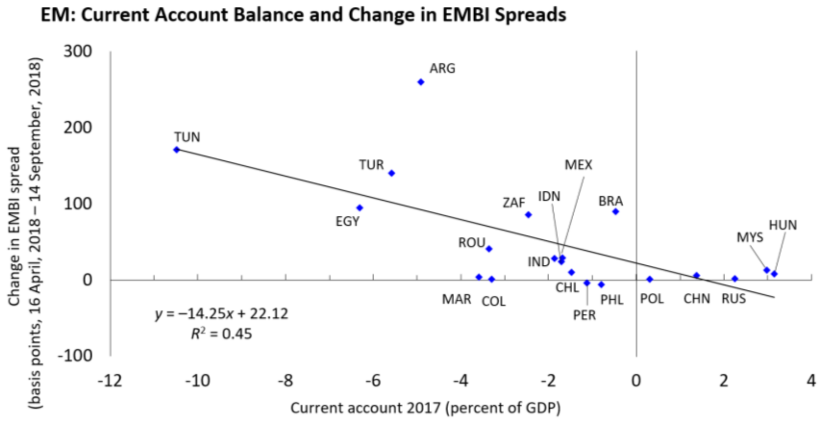
We still living in the post-crisis and the low inflation is still present in the advanced economies. The increase in oil price that boost inflation mostly happen with supply factors. Some supply constrains in Venezuela and Iran due to US sanctions. The curve of the inflation is growing up by almost 0.3%. The headline inflation has approached the target on average. The core inflation has also grown up a little but is still below the long run target. Most of the movement in the core is due to the US, in the Euro zone there is not much movement. For Emerging market, the increase is in both core and headline rate.

An important picture in the April report was the titling of financial conditions on the downside risk in the Emerging market. The risk has been materialled in policy rate and longer government bonds. On the left-hand side: we can see the average of policy rate. On the second half of the year, the raise of the blue line is the result of much higher policy rate in Turkey. For some reasons, Argentina is not including in this chart but if we add it: it will raise such as Turkey. On the right-hand side: The Ten-year Government bonds also increase, expect to China, long term yields include the default premium and it increase too.



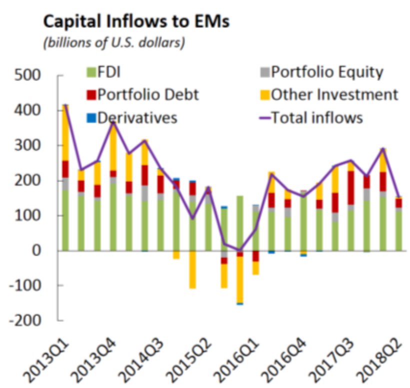


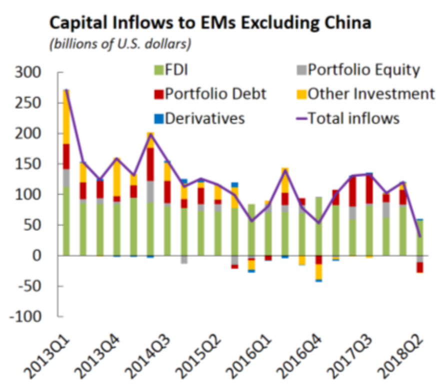
Are we close to contagion? Are markets still differentiated between their idiosyncratic characteristic? In the following chart, the horizontal line represents the current account of last year and the vertical line represents the change in EMBI 's spreads. We can see how much the risk profile has changed since April.



On the one hand, Argentina and Turkey, have a current account deficit around 5% of the GDP, these countries have seen their spread increase, which mean that their procedure is riskier. On the other hand, in Poland, Russia or China there is no change which means that they have good financing. If we talk about contagion, then of course all countries would be hit roughly but this is not the case. Then we will see that there is some tilted in capital inflow in Emerging economies.

If we look the composition of capital inflow, one thing that is obviously is that the main components of inflows are FDI and Portfolio debt. We can see that both components drop quiet significantly in the first half of the 2018. When we exclude China from the sample we find that the bond position shortens which means that the net borrowing by emerging market from the rest of the world is decreased. It is consistent with tilted financial conditions in Emerging countries.





The financial inflows differences directly impact currencies. The US have growth potential for few more year and addition to that, they have high expected interest rate, thus the US attract more bond and equity flows. The dollar has suffered a strong appreciation between February and September of 2018, while the euro depreciate related to the dollar, but the real effect turns directly around 0. The picture is very different in Emerging market: specially for Turkey, Argentina and Brazil which suffer of a strong depreciation (more than 40% for Argentina).

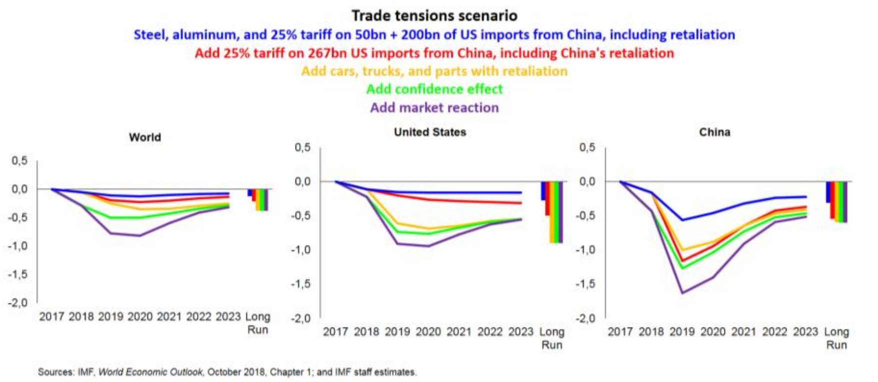
Forces shaping the outlook

At the near-term, for the Advanced economies, the cyclical position is diverging: US headline growing faster than their potential (until 2020), US fiscal policy have some impact on trading partner and on global growth but not super large. That increases the demand and they have raised trader barriers and policy incertitude. The monetary policy in generally has been accommodative: policy rate is still quite low (around 0 or maybe less), but the position of monetary authority has changed relative to the phase of cycle. The Fed is tightened, and the European Central Bank is announced to continue the asset product program and a slower rate.
At the medium-term, the most important point is the demographic headwinds: there is a pressure on reduction in labor force, that is coupled with the lackluster in productivity growth.
At the near-term, in Emerging market, the increase in oil prices is good for exporter but bad for importer. Then, trader barriers influence localized financial market pressures and policy uncertainty.
At the medium-term: 45 Emerging Market and Developing Economies accounting for 10 percent of global GDP falling further behind advanced countries: so, they are not converging, they are falling behind and that's really worrying.

Projections for 2019 growth in advanced economies and emerging countries

The world is expected to growth roughly at the same rate than as before about 3.7%. In general, the economic slowdowns, but the picture is very different between countries. The US is growing roughly almost three times faster than Japan. In Euro area, for Germany and France the growth has been reduced roughly from 0.5%/0.6% relative to the April's report. For the emerging market, the headline for the all group does not change, but there is some differentiation between countries: for example, China expected to slow down during the next year and India expected to growth more than 7% of the GDP.

I give you some example of downside risk: the tariff on trade barriers, the tilted of financial conditions and other factors like geopolitical strains, declining trust in mainstream political parties but also the climate change. With all these factors, it is difficult to say that everything come out of geopolitical strains; anything can put the growth downward. They do a simulation of effect of trade tensions: big global model to show what happen if additional shocks were materials.



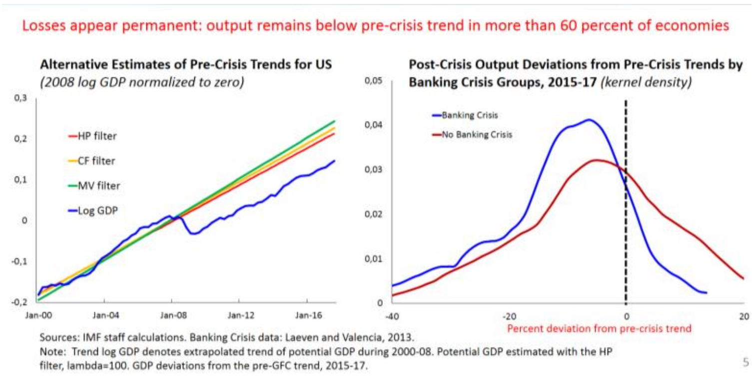
The blue line, the base line, shows what is already happened: it is the slowdown in growth relative to April. But if we keep adding more tariff on China's goods and retaliations, if we add US tariff on cars, trucks and associated parts in China, growth can shade of 1% of growth. If we look the growth of the world: the potential downward is very serious that's why we are concerned about.

<u>Reforms to lift potential growth and contain vulnerabilities</u>

In **Advanced economies**, monetary policy should support closing output gap when needed but should adapt to different phase of the cycle. For the fiscal policy, in the countries where it's possible, fiscal buffers should be rebuild. It's important to shift the composition of expenditure to world increasing productivity to potential growth. Concerning the structure reform policies: we must improve infrastructure and investment education.
In ***Emerging market and developing economies****:* The most important point is to promote economic diversification: we have countries that depend almost exclusively on oil or other commodities, and there are in very risky position because if something happens to their main export: external position and fiscal position can be weaker. It is also the case in poor countries and that why they must diversify and increase their share of manufacturing services of GDP.

2) Chapter 2: **The Global Economic Recovery 10 Years After: the 2008 Financial Meltdown**

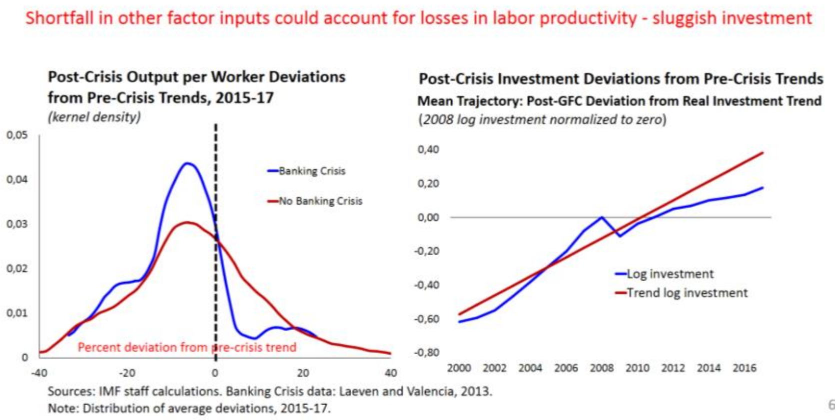
In this chapter, we are trying to quantify GDP losses and see how the associated components (capital, labor inputs, total factor productivity) advance after the crisis. We will also look at the variation in post-crisis performance and ask why it's so different between countries.
To measure the losses, we use the deviation from the pre-crisis trend: GDP in US on the left-hand side. We can see that before the recession there is some sustained growth with some acceleration in 2007 but after GDP drops on the line that is almost parallel with the pre-crisis trend. The pre-crisis trend is the trend between 2000-2008.



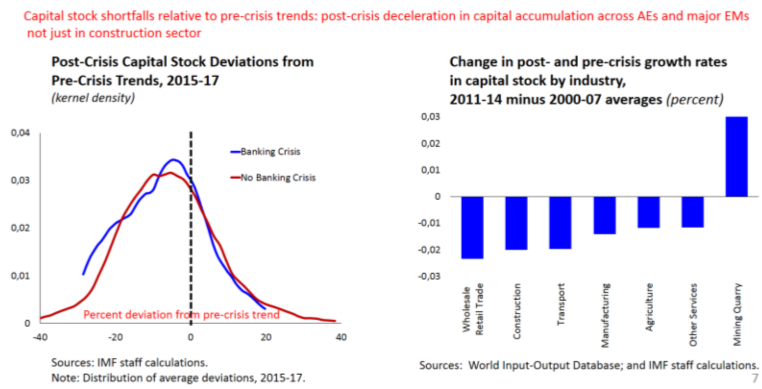
On the right-hand side: the spread of the deviation (losses) is the distance between the vertical line (pre-crisis trend) and the actual GDP. If we look the period between 2015-2017, this difference on average for countries with banking crisis may be -10%, some countries it is go down to -30%. For the countries that they don't have banking crisis the performance was better, at least the slowdown is less negative but still the shock has much contagion.

The question that we ask is how much this is an employment story.

We can say that is not an employment story because on the left-hand side: the same analysis is done for output per worker and we see similar thing: a strong negative deviation, in effect roughly of the damage to GDP was due to productivity shocks no due to employment. This productivity short fall because of the investment that has been slower than before the recession and we see that on the right hand-side. We see that both banking crisis countries and countries with no banking crisis are below to the pre-crisis trend their capital stock.

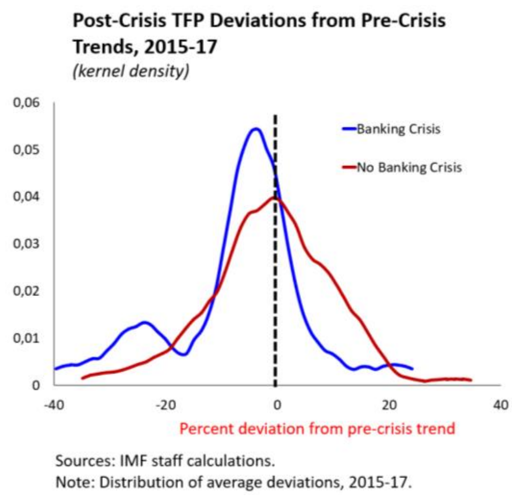


Then we are concentrated in a few industries: we did the similar calculation for different sectors.



On the right-hand side: we can see that, expect Mining quarry, other industries experienced declining capital accumulation. It was no surprising that global shock put down all these different sectors almost but not exactly with the same extend. There is less capital to work with that could impact the productivity directly.

If we look the total factor productivity (TFP) before and after the recession: we see a similar picture: for countries with banking crisis and countries with no banking crisis the left tail is much faster than the tail on the right-hand side.



The shock of productivity was not only due to less capital, but it was also because of less efficient. It happens because of misallocation of capital due to incomplete information. We find that 80% of

the decline of output is due to TFP and 20% is due to investment. The TFP decline include the technology growth.
If we look deeper on the GDP shortfall: another explanation could be the Research and Development Expenditure. We can see that countries with high losses are associated to less R&D than countries with low losses. Then that led to slow down in TFP in the countries with high losses. Another component to contribute to the lackluster of productivity growth: the adoption of new technology. The diffusion of robot appears slower in countries with higher GDP losses.

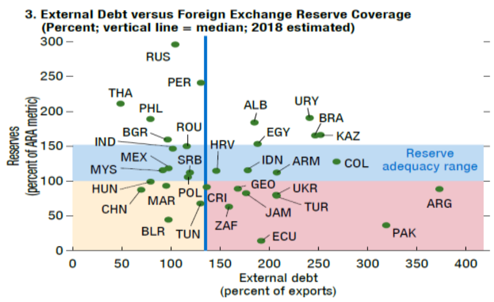
What cause different between countries?
We use a regression analysis: we compare pre-crisis conditions (credit growth, growth in public debt, flexibility between 2005 and 2008) and we study the effect on the output deviations. This is a simple regression to see the effect of different policy on the output.
The findings of this regression are the following: old stander policies work quite well. To sum up, countries with rapid credit growth, with public debt that increase a lot before recession, with inflexibility labor market or exchange rate regime, with a large current account deficit compare to the rest of the world and with banking crisis; suffer more during and after the crisis.

If we look the impact of the regulation on the economy, we find that countries with weak regulation have more chance to be affect by the crisis whereas strong regulation increase the probability to avoid crisis. We want to see, during the recession, how countries perform best. We find that fiscal support, capital injection in financial institution and fiscal guarantees are significant policies that work. However, the correlation between inequality and the output losses is almost 90% that is extremely strong. For a large majority of countries these losses are permanent. Inequality in countries with large losses increase more. We have on the annex of the report more analysis on the fertility rate, that show that fertility rate has decline in countries with big losses.

The persistence of losses following the crisis is widespread, not just in countries with banking crisis, through some channels. One of these channels is the sluggish investment associated with long-lasting capital and TFP shortfalls. Other channels are the reduction in R&D investment and technology adoption which appears slower in countries that suffered from larger losses.
The policy implications that discharge from these results are that we should follow our standers and pursue policies with more flexibility in labor market and in the exchange rate regime. We should rebuild fiscal buffers when it's possible. But also, having a stricter banking regulation to help to avoid crisis and not abending macroprudential regulation.

Anne Laure Delatte

In the first chapter, I would like to add some points: Recently we have received a lot of calls from journalist report asking us if the crisis on Argentina, Turkey and South Africa have any contagion effect which can impact the other emerging economies, like in 1997 for example. The main message is that there is no risk of spillover with countries with strong fundamentals. In the report, there is the following chart, that correlated external debt and forex reserves.



We can see that emerging market with a lot of external debt and low forex reserve are precisely

Turkey, Argentina and South Africa but the rest of emerging countries are on the good part of the chart. The fundamentals are stronger than in 1997. This is a good new.
The conclusion for the first chapter: the bad news is that we have some issues with global policies corporation, it is more difficult to address that together. We have less fiscal and monetary ammunition to address a widespread recession.
On the second chapter, for the last 15 years: we have proved our understanding of the real effect of the financial crisis. You show not only the common pattern on countries which have been affected by financial crisis but the widespread on countries they are not affected by themselves but by contagion. The second important point is the long-term effect, the permanent damages to output due to this recession. The damages have dear consequences on employment, income distribution, fertility rate…
I'm going to promote the CEPII's work about two topics. Firstly, the CEPII did a work to complete the analysis on the trade tensions. We have a model and some analytic tools different to the IMF: we look to sector break down instead using an aggregate pre-work. We look the effect of the trade measures on different sector (publish two mouth ago by Bellora, Jean and Santori, the scenario was made in June 2018) to see the impact on the tariff on aluminum and steel in the short run. We look the impact on prices and cost production: we find that the total impact of these two trade measures will increase by 0.67% the production cost and almost 0.6% the consumer prices index. When we look at the consequences of these trade measures not only on GDP, but directly on the short run, this will accelerate inflation and will probably boost the change of monetary policy which have broad consequences on the rest of the world. In the long run, there is no effect on the Europe, but we find stronger effect on China GDP in 2030: -0.9% and -0.6% on US GDP.

CEPII also published an article about the anniversary chapter, written by Couppey-Soubeyran and Renault. The main point is that risk is not declined, but it is more concentrated. The size of the balance sheet of banks has increase compare to 2007. The level ratio has increased from 5.4% to 7.2% in Europe. It is probably quite modest compare to the strong effort made by the regulatory policy. The systemic banks, where the risk should be limited and controlled, in Europe have a lower capital ratio than the average bank in Europe. Shadow banking in Europe has increased to 50% compare to 2007. And there is a large presence of banks in tax haven (it could be considered as a downside risk).
To conclude, there is a chapter on climate change in the previous report (last year). Given to recent IPCC report: this climate change will probably happen in our life time and the increase of temperatures will happen before 2050. And given to the Nobel price William Nordhaus and Paul Romer promoting the carbon tax. I would like to know if the IMF have a stand on the carbon tax: Have you assess the effect of this carbon tax?

Questions & Answers

Olivier DE BOYSSON, *Société Générale (Specialist of Sub-Saharan Africa Economy):* You mention a group of countries with a long term of prospects that cannot anymore catch up this develop economy. Could you elaborate a little bit more what is this group of countries and why they would not benefit of development?

Mico MRKAIC: I didn't say that they would not benefit from future development. There are countries that are falling to catch up. I don't know the list of these countries. There are more inequalities in poor countries than in the rich ones, so they are already excluded from education, from labor market and financial market. We know that poor countries have already suffered and the climate change touch them more, so we are going back to the importance of monetary policy that mustn't abandon them. We must reduce this catastrophic climate change event. It could take a long time to improve the access to gender to education or the labor market without any discriminatory measures. I'm not saying that the policy will close the gap. For example, we suggest some measures: the access to labor market: a lot of women were not working and that influence economic growth.

Olivier DE BOYSSON: You don't answer to the question. My question was why in your longer forecast; this group of countries won't catch up.

Mico MRKAIC: No, I said in the medium run (next 5 years) but we hope that with some international help, these countries will catch up.

PHILIPPE D'ARVISENET *(ex-economist):* I have two questions: one which is relative to Argentina, South Africa: one thing that we must deal with is the fact that as to do for fertility rate. For example, in Niger: on average the number of children per family is somewhere between 8 or 12 children and if we take in count the rate of growth of population: we double the population in 20-25 years. How this are managed? Given the prospected to absorb people on the labor market. Another question is about debt ratio: both public and private talk about this since the end of crisis, and that improve a lot of concern for many countries. How long can it last like this?

Mico MRKAIC: I'm not an expert on demographic. Concerning the debt ratio in many countries is growing up since the end of the recession. Lagarde says that we must repair the roof when the sun is shining and right now the sun is broadly shinning and reducing debt level, it's a long-term effort we cannot do this overnight. We must start with the first step.

Michel AGLIETTA, *CEPII:* Just in the end, you assuming that inequality is an exogenous event: that is a problem because it may be the reason of everything since the 80s, because inequality has a consequence of shifts in growth regime, the abandonment of growth regime where the wage profit rate was regulated. We have seen since the 80s, an increasing power by corporate sector: what we call "Share hold Value Principal" and had a consequence and related to the role of what we call the financial cycle, that is the importance of finance in determining macroeconomic condition. In fact, I'm on the side of people who say that with this type of distribution of income that goes to more concentration of the firms especially in corporate sector but also in finance, the fragmentation of society, that is a consequence, increasing credit cycle is necessary to avoid a permanent stagnation. We try to see the consequence in the estimating in the same type of regression the potential growth, the natural interest rate and the natural employment rate. If we insert within explanatory variables, financial determinant at the increasing credit cycle: we see a beta estimation of the consequence of the drift in downward of natural rate and inflation rate. We must go to the logic of the macroeconomics related to this type of capitalism. Do you think that is absolutely necessary?

Mico MRKAIC: I didn't take inequality as an exogenous variable. One thing that is important is the technical change. Inequality has increased because new technology hurt worker with different level of education differently: those with higher education stay with the same benefits and those with lower education must base on their labor force and must work for a lower wage. One of the answers to this is that we must invest on education and investment in skills. People expect to keep the same job for thirty year but the situation since the 70s change, the growth was there, that's why we have to invest a lot of in skills and education.

Michel AGLIETTA: In Europe, from the early 80s to right now the decline is to 50% of the ratio public expenditure to GDP. European government has done exactly the opposite in reducing the investment and specially the investment in human capital.

Mico MRKAIC: Answer to Anne Laure Delatte's question on the carbon tax: we think that carbon tax can have benefit on climate change.