Andrew Burns
World Bank
October 21, 2013

http://www.worldbank.org/globaloutlook
Global Outlook and Risks

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Main messages

• High-income countries are beginning to revive
• Despite recent weakness in some major middle-income countries, activity in developing countries is also strengthening and expanding in line with potential
• Risks remain:
  – Financial pressure from a renewed taper
  – Credit bubbles in East Asia
  – Uncertainty due to US debt ceiling brinksmanship
• Longer-term growth in developing countries will come under pressure from higher borrowing costs, doing better will depend on structural reform
Growth in high-income countries is strengthening

Quarterly GDP growth, annualized

Business confidence in high-income countries is improving

Purchasing Managers, indexes (50 or more indicates expansion)

High-spread borrowing costs have stayed down

Yields on 10 year sovereign debt, percent

Source: World Bank, DataStream.
But GDP in most European countries remains well below its pre-crisis level


Level of GDP in 2013, as a percent of 2008Q3
Developing countries

- Short-term cycle is strengthening
- Output gaps in most countries are closed
- Financing costs remain modest
- Forecast is for modest pickup in growth
- Longer-term focus needs to be on structural policies
Growth firming or solid in most developing countries

Industrial production growth, 3m/3m saar

Developing country business sentiment is pointing up

Balance of respondents (>50 implies expansion)

Manufacturing Purchasing Managers Indices ( +50: expansion)

Source: World Bank, Markit Economics
Pressure on developing country CDS rates has eased

Credit default swap rates, basis points

Source: World Bank, DataStream.
Commodity prices have eased or are stabilizing

USD price, 2005=100

Grain prices have eased on improved crops

USD price, index Jan 1 2005=100

Energy prices show signs of equalizing

USD Price per British Thermal Unit

Financial conditions will tighten over the medium-term

• Recent episode of weakness in developing countries due to fears of an end to quantitative easing is a wake up call
• Pressure is off but will return as long-term interest rates inevitably rise
• Countries with vulnerabilities have been granted a reprieve – need to act now
• Other countries need to rebuild buffers depleted during crisis
Talk of tapering-off undid between 25 and 35% of the long-term interest rate effect of QE

Sources: ECB, FED, BoE, BoJ and BIS / Turner
Most countries did not come under excessive currency pressure

Only 34% of developing countries depreciated between April 1 and August 28

62% have appreciated (4% unchanged)

Capital inflows fell as investors shifted into developed markets, but seem to have recovered.

Gross capital flows, billions, USD,

Most recently developing country stock markets have rebounded substantially.

Source: Bloomberg.
Downward pressure on developing-country currencies has eased even before tapering postponement

Nominal effective exchange rate, April 1, 2013=100

Developing stock markets have rebounded, but countries with poor fundamentals remain down.

Stock market indexes, April 1, 2013=100

Postponement of tapering offers developing countries a reprieve

Countries hit hardest were hurt because of:

**Relatively deep capital markets** – implying financial investors feel they can get in and out easily – therefore more volatile than less deep markets.

- **Commodity exporters**, whose prospects have been weakened by lower commodity prices (Brazil, South Africa, Indonesia, Malaysia).

- **Domestic imbalances**: Countries experiencing a combination of some (or all) of the following, namely slower growth, high or accelerating inflation and large current account deficits that are not expected to be financed fully by net FDI inflows (Turkey, India, Brazil, Indonesia).

- **Adequate but declining FX reserves** (India, Indonesia).
Outlook

• Projected pick up in growth to be led by high-income countries
• Developing-country growth in line with underlying potential
• Regional growth shows strengthening or stability going forward
• Slower growth in middle-income countries may reflect weaker than thought potential
A gradual pick up in growth, led by high-income countries

Regional growth strengthening or stable almost everywhere

Most developing countries have recovered from the crisis and are growing at close to potential

Output gap, % of potential output

Longer-term developing countries need to focus on structural policy

GDP and potential GDP, annual growth rate

- Developing
- Developing potential
- DEV (ex China)
- DEV (ex China) potential

Trend growth post crisis is lower than at the peak, but much higher than in pre-boom period.

Period of gradual acceleration in potential
- Boom Period
- Growth slower only relative to boom

Short-term risks

• Tapering-related risks have eased, but uncertainty will remain and future communication will be crucial
• East Asian banking-sector crises
  – Excessive leveraging in Indonesia, Malaysia, Thailand could generate domestic banking crises, possible provoked by rising interest rates due to tapering of quantitative easing
• Disorderly unwinding of investment / lending bubble in China
  – Potential impact of 3% of CHN GDP, c. 3% of regional GDP
• US default
  – Fiscal brinksmanship is back
  – Uncertainty likely to cut into Q3 growth (shut-down could cut 0.3 to 0.5% from quarterly growth)
  – Debt ceiling is riskier: technical default could have very serious consequences
    • Possibility of bank-crisis due to impact on risk-weighted financial-sector balance sheets
    • Real-side impact of higher interest rates
    • Confidence effects
  – An up-to-the-edge scenario without default would have similar but more muted effects
A rapid increase in credit provision is associated with increased risk of banking-sector crisis

Source: World Bank, IMF.
Excessive Chinese investment poses risks to activity and banking-sector

Chinese Investment as a share of GDP, %

- Average 1970-1990, 28%
- Average 1991-2003, 35%
- Average 2004-2008, 40%
- Average 2009-2013, 45%

High external debt increases vulnerability to changes in sentiment

But domestic debt can be problematic when interest rates rise

Developing countries have much less fiscal space than in 2007

General government deficit, % of GDP

High deficits makes several countries very vulnerable

General government deficit in 2013, % if GDP

Debt to GDP ratios have been rising as well

General government debt, % of GDP

Many countries have government debt levels in excess of 60% of GDP

Concluding remarks

• Strengthening recovery in high-income world will support developing country growth going forward
• But global financial conditions will tighten and commodity prices ease, acting as sustained headwinds for developing countries
• The turmoil associated with the phasing-out of quantitative easing is a warning
Policy recommendations

• Global environment remains fragile and the risk of further external shocks is real
• Countries with vulnerabilities (high current account deficits, large increases in credit, large government and private deficits and debt) need to move quickly to reduce these
• Other countries need to work to rebuild the buffers that helped them do so well in the 2008 crisis, but are now significantly drained
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US fiscal crisis could have important implications for developing countries

• Distinguish between 3 scenarios
  – Government shutdown: (living it) – small impact for US, negligible for developing economies
  – Near miss: (getting uncomfortably close) debt ceiling deadline approaches without movement, markets become volatile; default is avoided
  – Default: A technical default occurs, market uncertainty spikes, firms and households stop spending, US currency potentially downgraded with implications for CDS contracts and bank’s risk weighting of capital
Even a near miss on the debt ceiling has major implications

Developing country bond spreads and USD stock market prices, indexed June 1, 2011=100

August 2 2011

Dev. bond spreads increase by 75bp
Dev. stock markets drop by 15%

Spreads rose by as much as US yields fell, so borrowing costs were broadly constant.

Developing country bond yields and US 10 year treasury yield, indexed June 1, 2011=100

August 2 2011

Dev. bond yields broadly stable

US 10Y treasury yields drop 60bp

Even the close call event hit capital flows hard

Gross bond and equity flows to developing countries, index March 2011=100

Aug 2 2011
Dev. bond & equity issuance drops 50%

A major invent, like the 2008 crisis has similar but much larger impacts

Developing country bond spreads and USD stock market prices, indexed October 1, 2011=100

Sept 22 2008

Developing bond spreads increase by 500bp

Developing stock markets drop 50%

In 2008, developing country borrowing costs rose 500 bps

Slowdown post event was much steeper in 2008

Industrial production growth, % 3m/3m annualized

Deceleration in:
Developing
High-income

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<th>Developing 2008</th>
<th>High-income 2008</th>
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<tr>
<td>2008</td>
<td>-13.4pp</td>
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<tr>
<td>2011</td>
<td>-6.9pp</td>
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Impact was close to 100 percent during financial crisis

Gross bond and equity flows to developing countries, index March 2011=100