Global Economic Prospects

Global Economy in Transition

July, 2015

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Global Periodicals from the World Bank

- *Global Economic Prospects* – June 10
  (January and June)
- *Global Monthly* – June 23
- *Commodity Markets Outlook* – July 22
  (January, April, July, and October)

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Global Economic Prospects: June 2015

- Global and Regional Outlooks
- Hoping for the Best, Preparing for the Worst: *Risks around U.S. Rate Liftoff and Policy Options*
- After the Commodities Boom—*What Next for Low-Income Countries?*

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Global Economy: The Big Picture

Growth outlook

- Global growth: *weak start in 2015, yet another forecast downgrade*
- Global economy in transition: *normalization and divergence of monetary policies; low and volatile commodity prices*
- High-income countries: *divergence gradually narrowing*
- Developing countries: *growth slowing in 2015*

Risks

- Transition related risks: *pronounced for developing countries*
- Preexisting risks: *tilted to the downside*

Policies

- Monetary and fiscal: *different challenges for oil exporters and importers*
- Structural reforms: *needed to restore growth and increase resilience*

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Four Questions

1. What is the state of the global economy?
2. What are the potential implications of a “liftoff” in U.S. policy rates for emerging and developing economies?
3. How are low-income countries coping with the transition?
4. What are the major risks and policy challenges?

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Four Questions

1. What is the state of the global economy?

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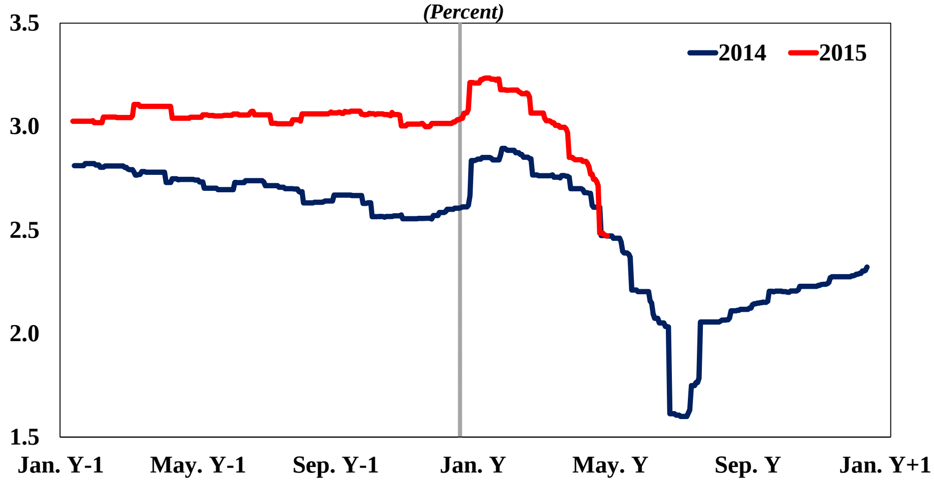
US Growth in 2014-15: History Repeating Itself?

US Growth Forecast, Consensus

(Percent)



Source: Consensus Economics.
Note: "Y" refers to 2014 and 2015 respectively.

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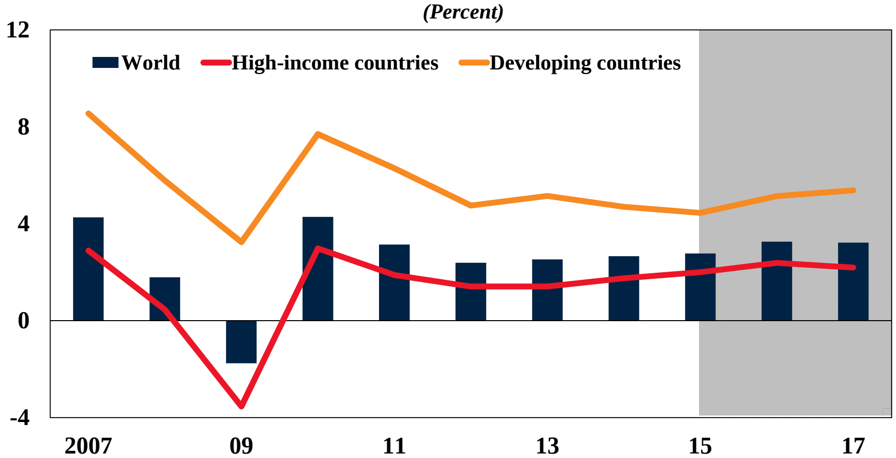
Global Recovery: Still Slow Moving

GDP Growth

(Percent)



Source: World Bank.

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Global Growth: Further Forecast Downgrades...

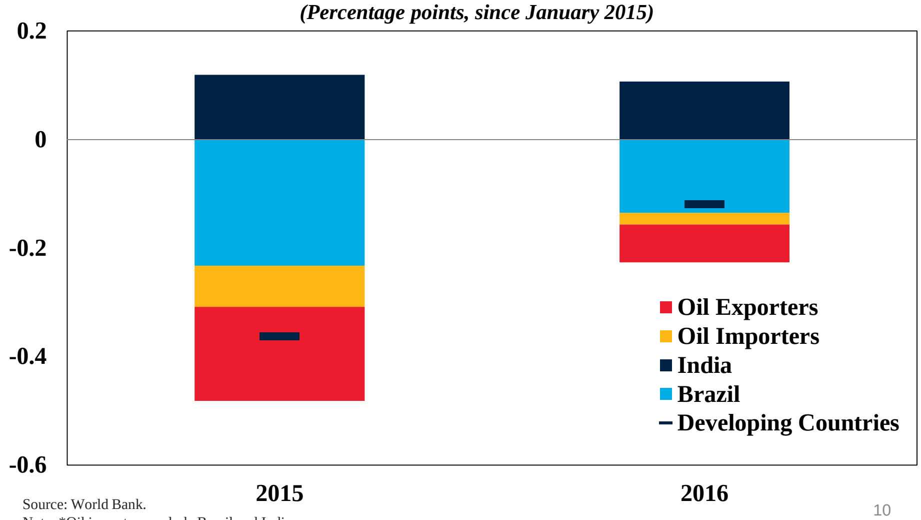
GDP Growth
(Percent)

	Current forecast				*Change from Jan 2015 GEP*	
	2013	**2014**	**2015**	**2016-17**	***2015***	***2016-17***
World	**2.5**	**2.6**	**2.8**	**3.2**	***-0.2***	***0.0***
High-income countries	**1.4**	**1.8**	**2.0**	**2.3**	***-0.2***	***0.0***
Developing countries	**5.1**	**4.6**	**4.4**	**5.3**	***-0.4***	***0.0***
East Asia and Pacific	**7.1**	**6.9**	**6.7**	**6.6**	***0.0***	***-0.1***
Latin America and Caribbean	**2.7**	**0.9**	**0.4**	**2.4**	***-1.3***	***-0.7***
Europe and Central Asia	**3.7**	**2.4**	**1.8**	**3.5**	***-1.2***	***-0.3***
South Asia	**6.3**	**6.9**	**7.1**	**7.4**	***1.0***	***0.7***
Sub-Saharan Africa	**4.2**	**4.6**	**4.2**	**4.8**	***-0.4***	***-0.2***
Middle East and North Africa	**0.5**	**2.2**	**2.2**	**3.8**	***-0.3***	***0.5***

Source: World Bank.

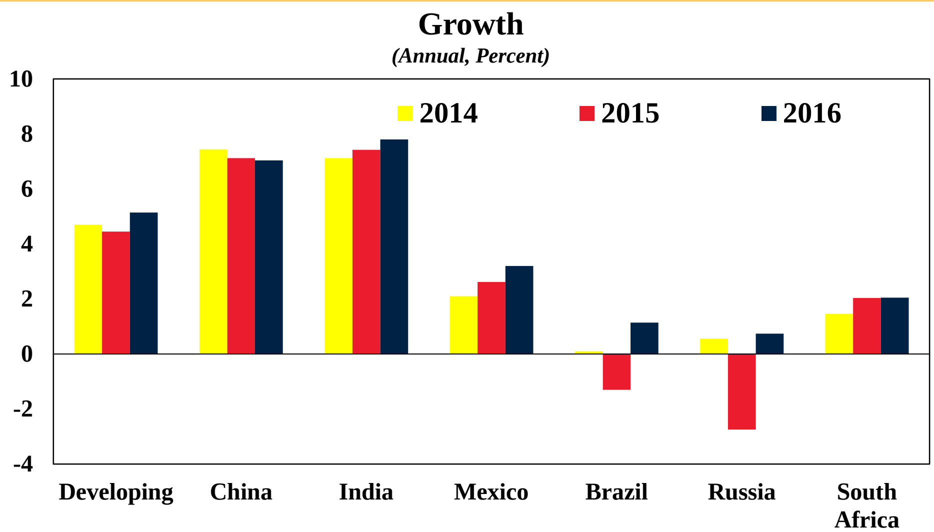
Developing Countries: Broad Weakness

Contributions to Developing Country Growth Revisions
(Percentage points, since January 2015)



Source: World Bank.
Note: *Oil importers exclude Brazil and India

Developing Countries: Growth Challenges



Source: World Bank

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Four Questions

1. What is the state of the global economy? *Still a slow moving recovery; further disappointments in growth*

2. What are the potential implications of a “liftoff” in U.S. policy rates for emerging and developing economies?

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Views from the US Federal Reserve Board: Expectations and Risks

- *"The actual **raising of policy rates** could trigger further **bouts of volatility**, but my best estimate is that the normalization of our policy should **prove manageable for the EMEs**."* Stanley Fischer, May 26, 2015

- *"We face a risk that **longer-term interest rates** will **rise sharply** at some point."* Ben S. Bernanke, March 1, 2013

- *"**Long-term interest rates** are at very low levels, and that would appear to embody low term premiums, which **can move, and can move very rapidly**…"* Janet Yellen, May 6, 2015

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The Liftoff: Hoping for the Best <u>but</u> Preparing for the Worst

- Baseline: *Hoping for the Best… Normalization…* The liftoff and the subsequent tightening cycle are expected to proceed smoothly, leading to only modest downward pressures on capital inflows to emerging markets.

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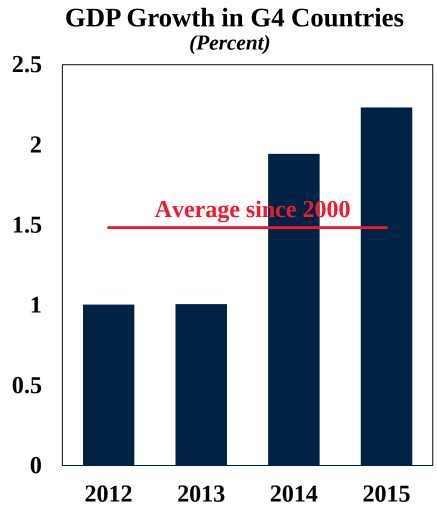
Improved Activity in Advanced Economies



Source: Bloomberg , Haver, World Bank.
Note: Left panel: Aggregate GDP growth of G4 countries (United States, Euro Area, Japan, and United Kingdom). Right panel: Blue bar shows the taper tantrum period in May-June 2013. The last observation is for April 30th, 2015.

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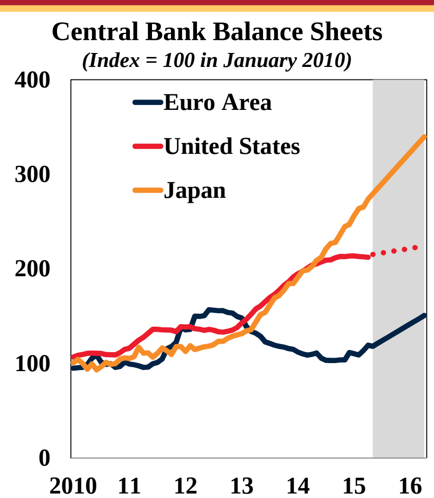
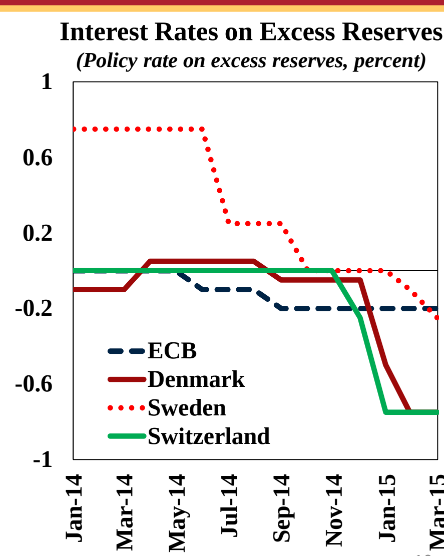
Policy Easing in (Other) Advanced Economies





Source: World Bank, Bloomberg.
Note: Left panel: The last actual observation is for April 2015. Right panel: The last observation is for March 2015.

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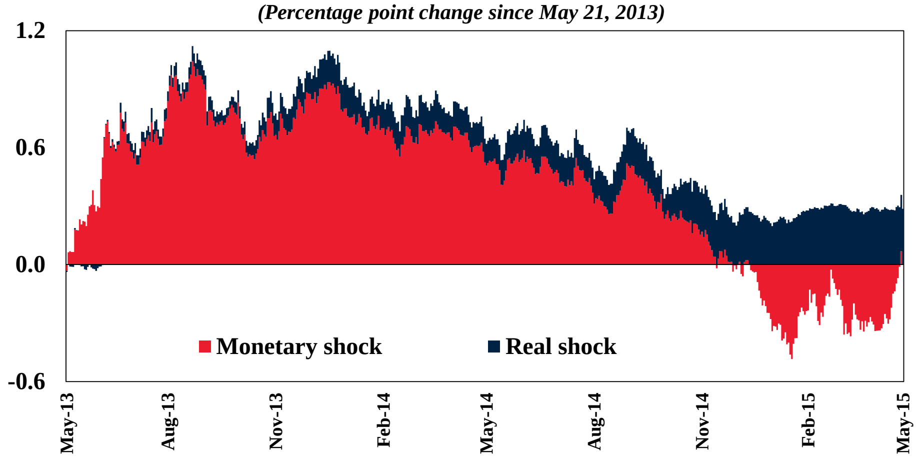
Drivers of U.S. Bond Yields: From “Monetary” to “Real”

Drivers of U.S. Long Term Yields – Monetary and Real Factors

(Percentage point change since May 21, 2013)



Source: Haver Analytics, World Bank estimates.
Note: Based on estimates from the model, identifying monetary and real shocks using sign restrictions. All shocks except the shock of interest are shut down by setting them to zero. The model is used to trace out the counterfactual long term rate. The exercise is performed separately for monetary and real shocks. The blue (red) counterfactual shows how long rates would have evolved only with the estimated monetary (real) shocks. Numbers shown are in percentage points. The model adopted daily data up until May 7th, 2015.

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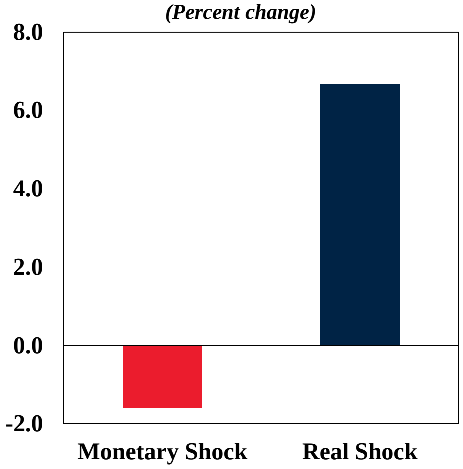
Real Drivers: Good for Emerging Markets!

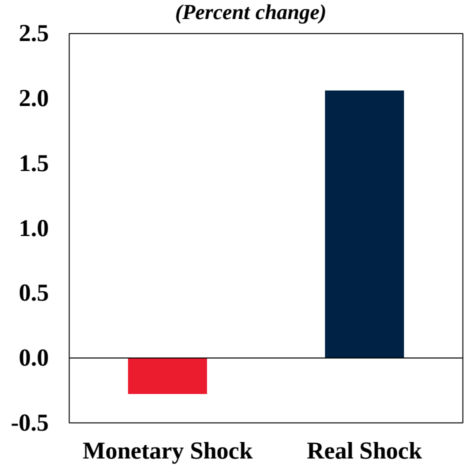
EM Stock Price

(Percent change)



EM Industrial Production

(Percent change)



Source: Haver, Bloomberg, World Bank estimates.
Note: Left panel: Stock price indices refer to the general price indices from Haver.

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The Liftoff: Hoping for the Best but Preparing for the Worst

- Baseline: *Hoping for the Best… Normalization…* The liftoff and the subsequent tightening cycle are expected to proceed smoothly, leading to only modest downward pressures on capital inflows to emerging markets.

- Risks: *Preparing for the Worst… Market reaction and vulnerabilities…* The liftoff could lead to abrupt changes in market expectations regarding monetary conditions that could prompt a spike in U.S. long-term yields and reduce capital flows to emerging markets. Just remember the "taper tantrum"!

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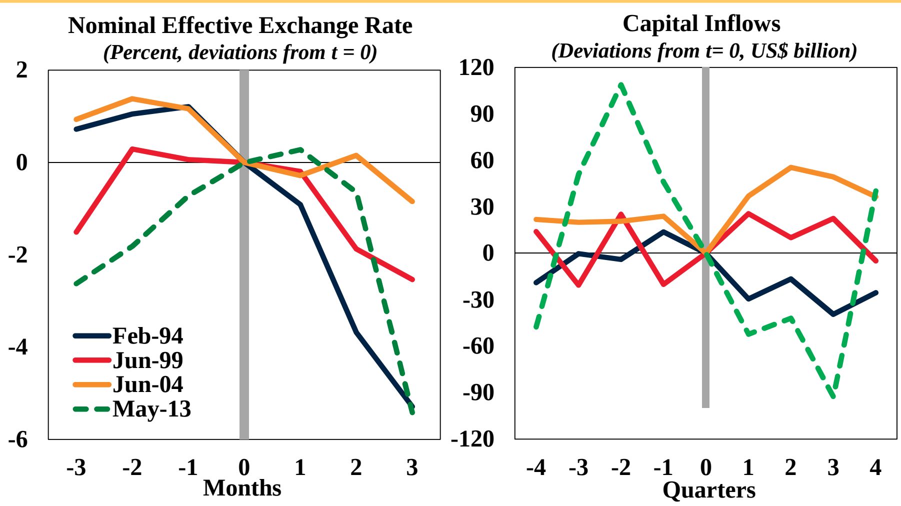
Past Tightening Episodes: Pressure on Currencies and Capital Flows



Sources: Bloomberg, Federal Reserve Bank of New York, World Bank, Haver Analytics.
Note: Left panel: Median of nominal effective exchange rate of BRICS and MINT countries, 3 months before until 3 months after the beginning (t=0) of U.S. monetary policy hikes. A decrease denotes a depreciation in effective terms. Russia is excluded from the sample of the 1994 episode. Right panel: The x-axis shows the number of quarters before and after t = 0, where t = 0 is February 1994, June 1999, June 2004, and May 2013. China is excluded.

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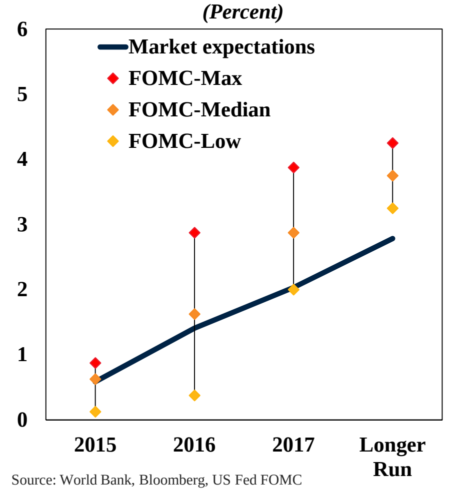
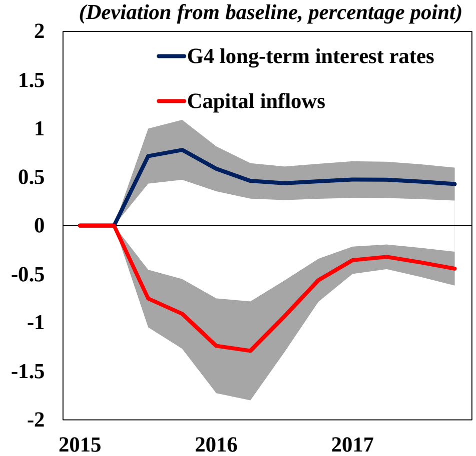
Sudden Rise in U.S. Yields: Tail Risk but Potentially Important Repercussions

Market Versus FOMC Rate Expectations
(Percent)



Impact of a Rate Hike on Capital Flows
(Deviation from baseline, percentage point)



Source: World Bank, Bloomberg, US Fed FOMC
Note: Right panel: VAR model simulations of a 100bp shock in U.S. 10Y Treasury yields. Grey area shows the range of estimates for different pass-through rates to bond yields in Euro Area, U.K. and Japan. In the median case, global bond yields increase initially by 70bp. The last observation is for Q4 2017.

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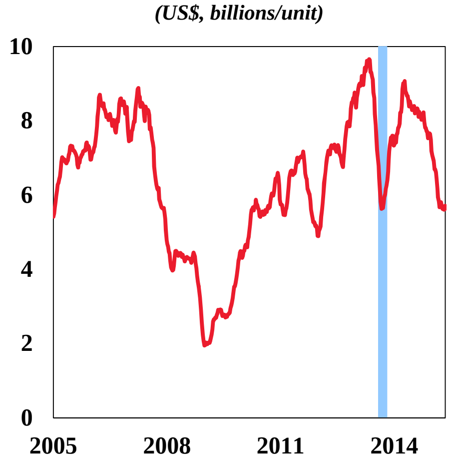
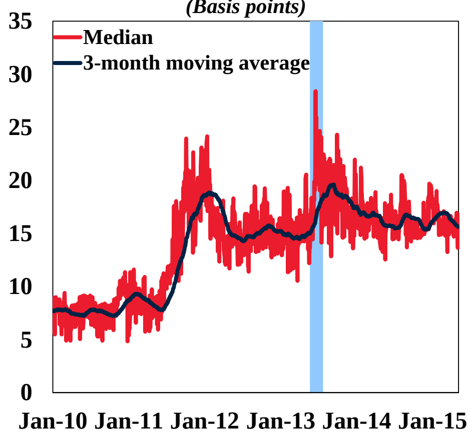
Fragility of Market Liquidity

Primary Dealer Treasury Transactions
(US$, billions/unit)



Bid-ask Spread on Emerging Market Foreign Currency Bonds
(Basis points)



Source: Federal Reserve Bank of New York, Bloomberg, World Bank.
Note: Blue bars show the taper tantrum of May-June 2013. Left panel: Line shows primary dealer Treasury transactions divided by the Merrill Option Volatility Estimate (MOVE index) (12-week moving average). Merrill Option Volatility Estimate (MOVE) is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. The last observation is for May 13th, 2015. Right panel: List of countries included Brazil, Chile, Colombia, Hungary, Indonesia, Korea, Lithuania, Philippines, Poland, Romania, Turkey, and South Africa. Median bid-ask spreads on 10-year government bonds. The last observation is for May 8th, 2015.

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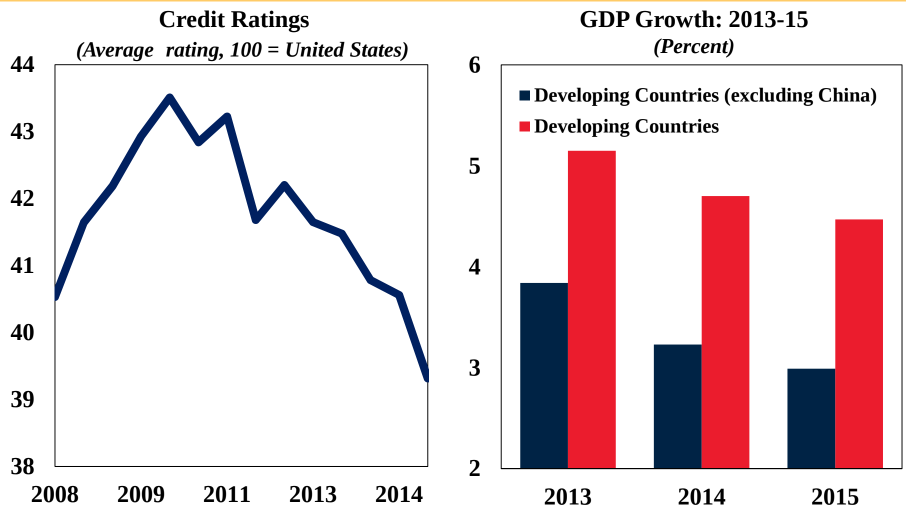
A Source of Vulnerability: Weakening Fundamentals in Emerging Economies



Source: World Bank, Bloomberg, Haver Analytics.
Note: Left panel: Sovereign rating is calculated based on a simple average of long-term foreign-currency credit ratings of countries by Standard & Poor's Rating Service.

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Hoping for the Best, Preparing for the Worst! Policy Responses to Financial Stress

- Allowing currency depreciation: Appropriate if it doesn't exacerbate vulnerabilities
- Increasing interest rates: Help stem depreciation and capital outflows
- Employing targeted measures: Use of currency reserves and prudential measures
- Restoring confidence: Improve fiscal and monetary policy credibility; undertake reforms (governance, financial sector) to support growth

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2. What are the potential implications of a "liftoff" in U.S. policy rates for emerging and developing economies?
   Limited risk in the baseline, but potentially large repercussions

3. How are low-income countries coping with the transition?

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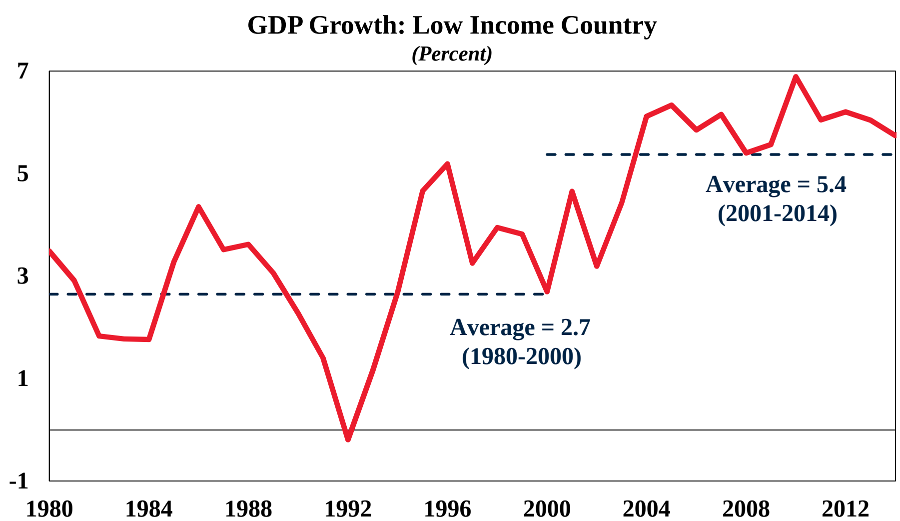
Low-Income Countries: A Robust Performance in 2000-14



Source: World Bank.
Note: The last observation is for 2014.

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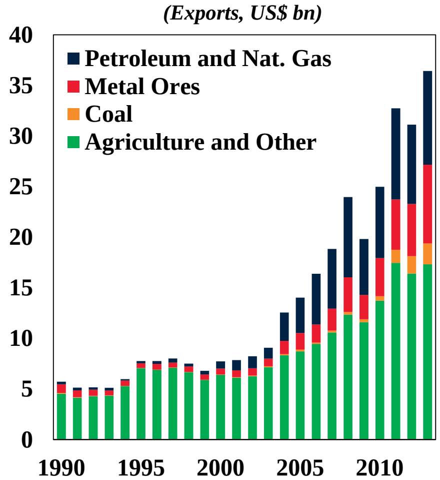
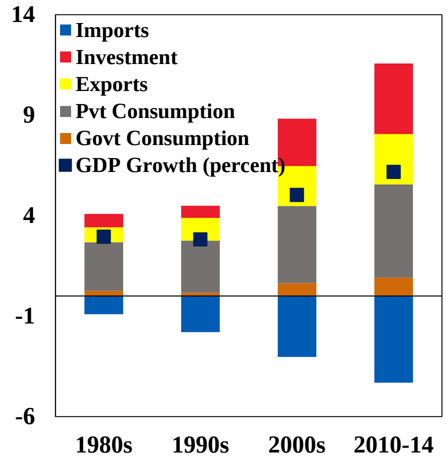
Past Commodity Boom: Supported Exports, Investment and Consumption

Primary Sector Exports
(Exports, US$ bn)



Contribution to GDP Growth
(Percentage points)



Source: World Bank, Comtrade, UNECA (2013).
Note: Left panel: The last observation is for 2013.

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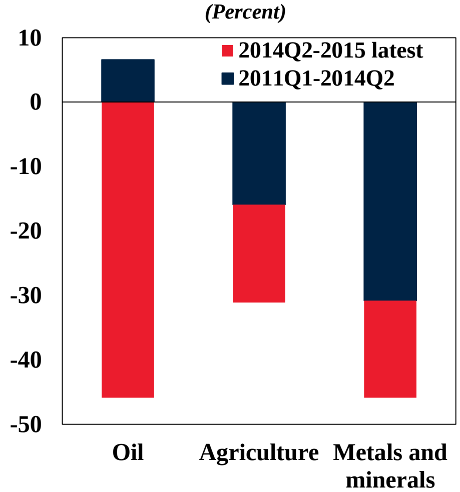
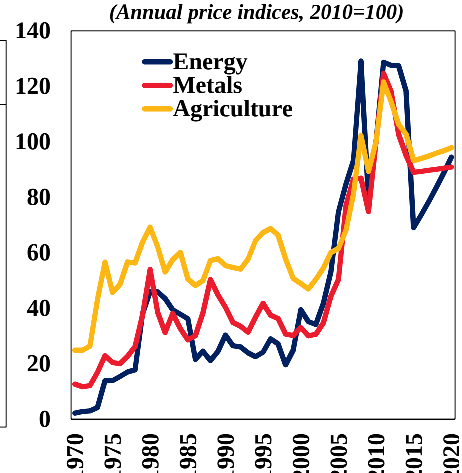
A New Phase of the Commodity Cycle?

Decline in Commodity Prices
(Percent)



Commodity Prices
(Annual price indices, 2010=100)



Source: World Bank.
Note: Right panel: The last observation is for April 2015.

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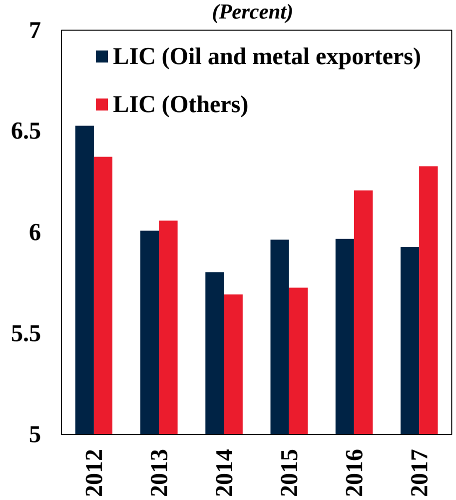
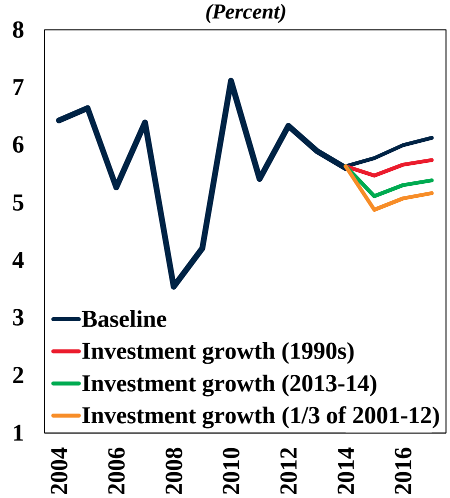
From Tailwinds to Headwinds? Still Robust Growth but New Challenges

GDP Growth
(Percent)



LICs: GDP Growth Scenarios
(Percent)



Source: World Bank.
Note: Right panel: LICs refer to metal and mineral exporting economies. The last observation is for 2017.

LICs: Policy Responses to Lower Commodity Prices

Consider available policy space

- Greater room in countries that have used windfalls from past commodity boom to build fiscal buffers and diversify their economy
- More disruptive adjustments in countries highly dependent on natural resource sectors, with large fiscal or current account imbalances

Secure medium term growth through reforms

- Reforms to support activity in the non-commodity sectors, invest in human and physical capital and improve institutions.
- Policies to improve investment climate and ease supply side bottlenecks

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3. How are low-income countries coping with the transition?
   End of commodity boom is a challenge but short-term outlook is still robust

4. What are the major risks and policy challenges?

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What Are the Major Risks?

- Transition related risks: *Disorderly adjustment to U.S. Fed tightening; commodity exporters vulnerable*
- Preexisting risks: *Contagion from Greece; Euro Area deflation (smaller); geopolitical tensions; disorderly slowdown in China (limited)*
- *Backdrop: weakening growth in developing countries*

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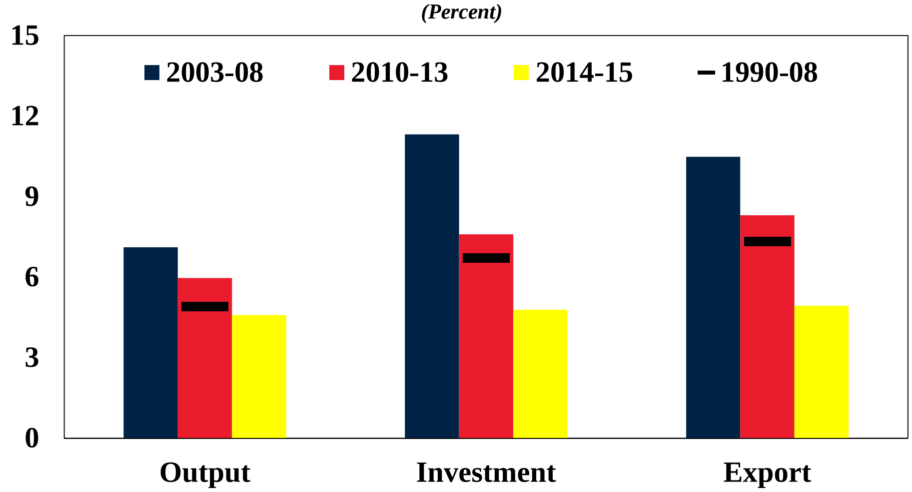
Backdrop: Growth Slowdown…

Growth in Developing Countries
(Percent)



Source: World Bank.

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What Are the Main Policy Challenges?

Monetary policy

- Oil importers: *temporary drop in inflation, positive effect on demand*
- Oil exporters: *balance growth, inflation and currency stabilization*
- Challenge: *decoupling monetary policy from the U.S. Fed?*

Fiscal policy

- Oil importers: *public debt still low but fiscal buffers have been depleted*
- Oil exporters: *significant pressure on revenues*
- Challenge: *availability and effectiveness of fiscal policy?*

Structural policy

- Reforms key to restoring potential growth
- Momentum picking up as challenges abound; time for differentiation

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3. How are low-income countries coping? *End of commodity boom is a challenge but short-term outlook is still robust*

4. What are the major risks and policy challenges? *Managing two transitions and risks associated with those*

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Questions & Comments
Thanks!

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