Global Economic Prospects:

Coping with policy normalization in high-income countries

Andrew Burns
World Bank
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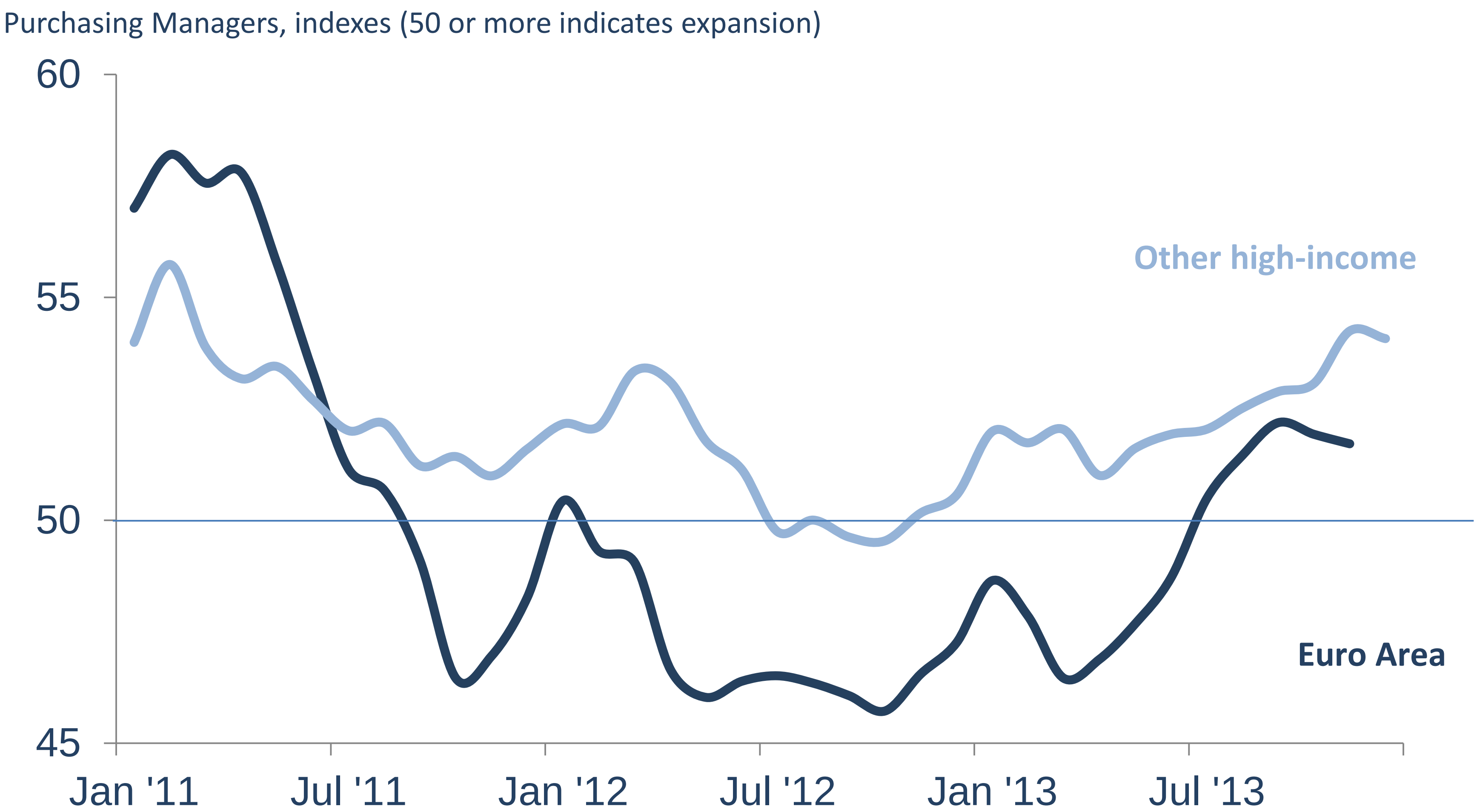
http://www.worldbank.org/globaloutlook

Main messages

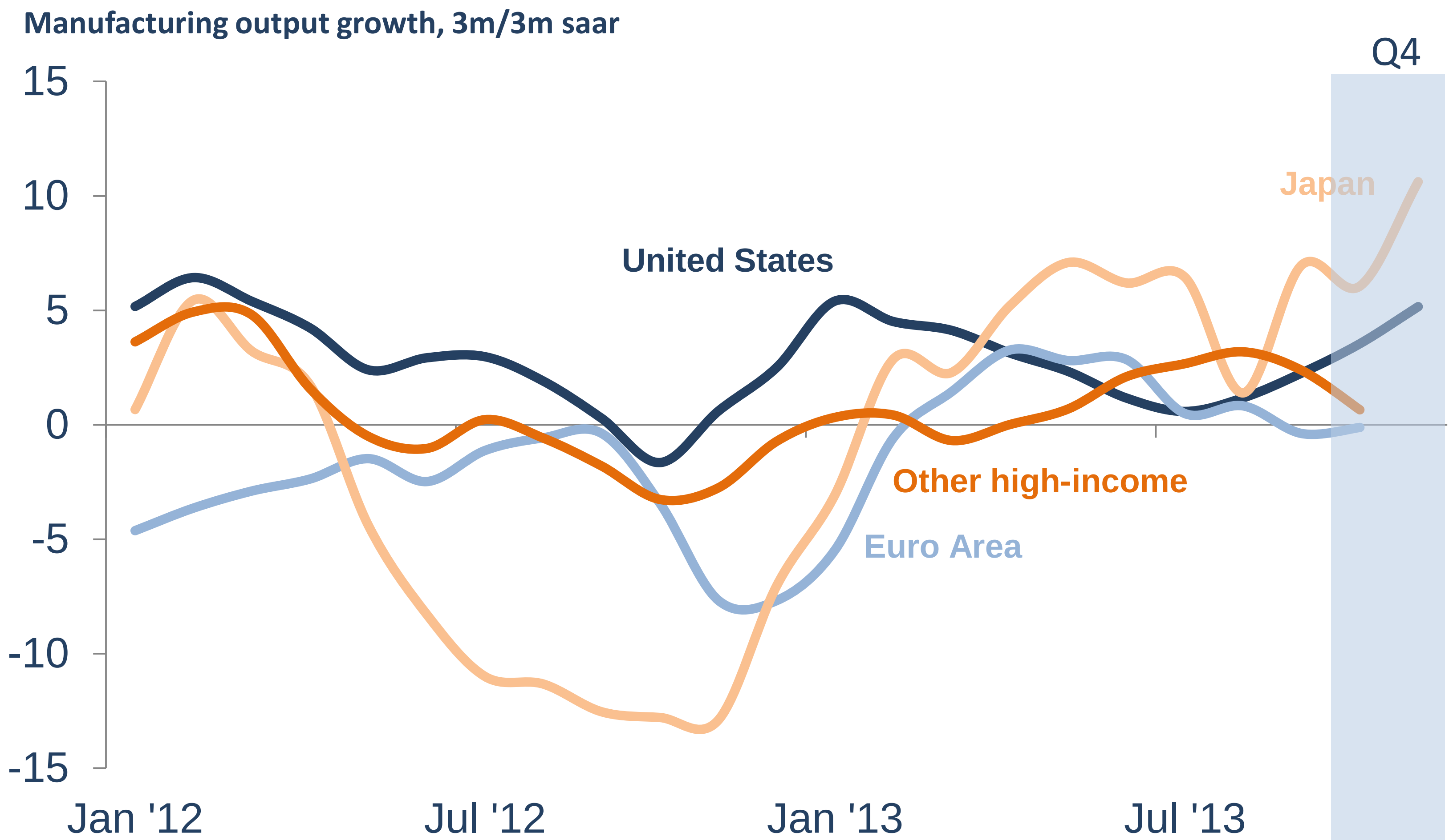
- High-income economies are beginning to revive
- Despite recent weakness, activity in developing countries is also strengthening and expanding in line with potential
- Risks remain:
  - Financial pressure from higher interest rates as macro policy in the high-income world normalizes
  - Credit bubbles in a number of economies
- Policy challenges from slower growth, doing better will depend on structural reform

Business confidence in high-income countries has improved markedly



Source: World Bank, Markit, Haver Analytics.

Fourth quarter manufacturing suggests continued strengthen in US and Japan, weakness elsewhere

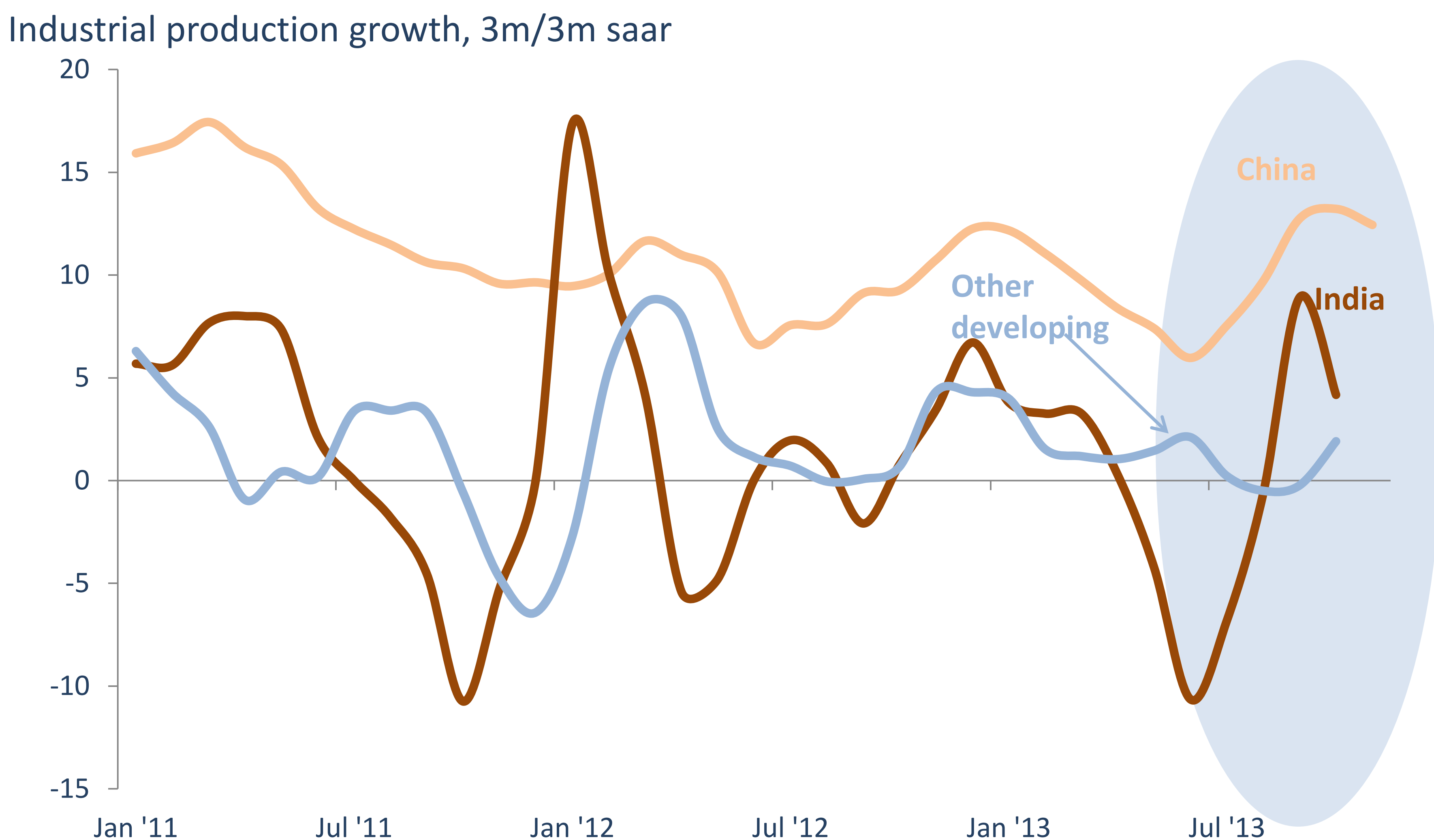


Source: World Bank, Datastream.

Developing countries

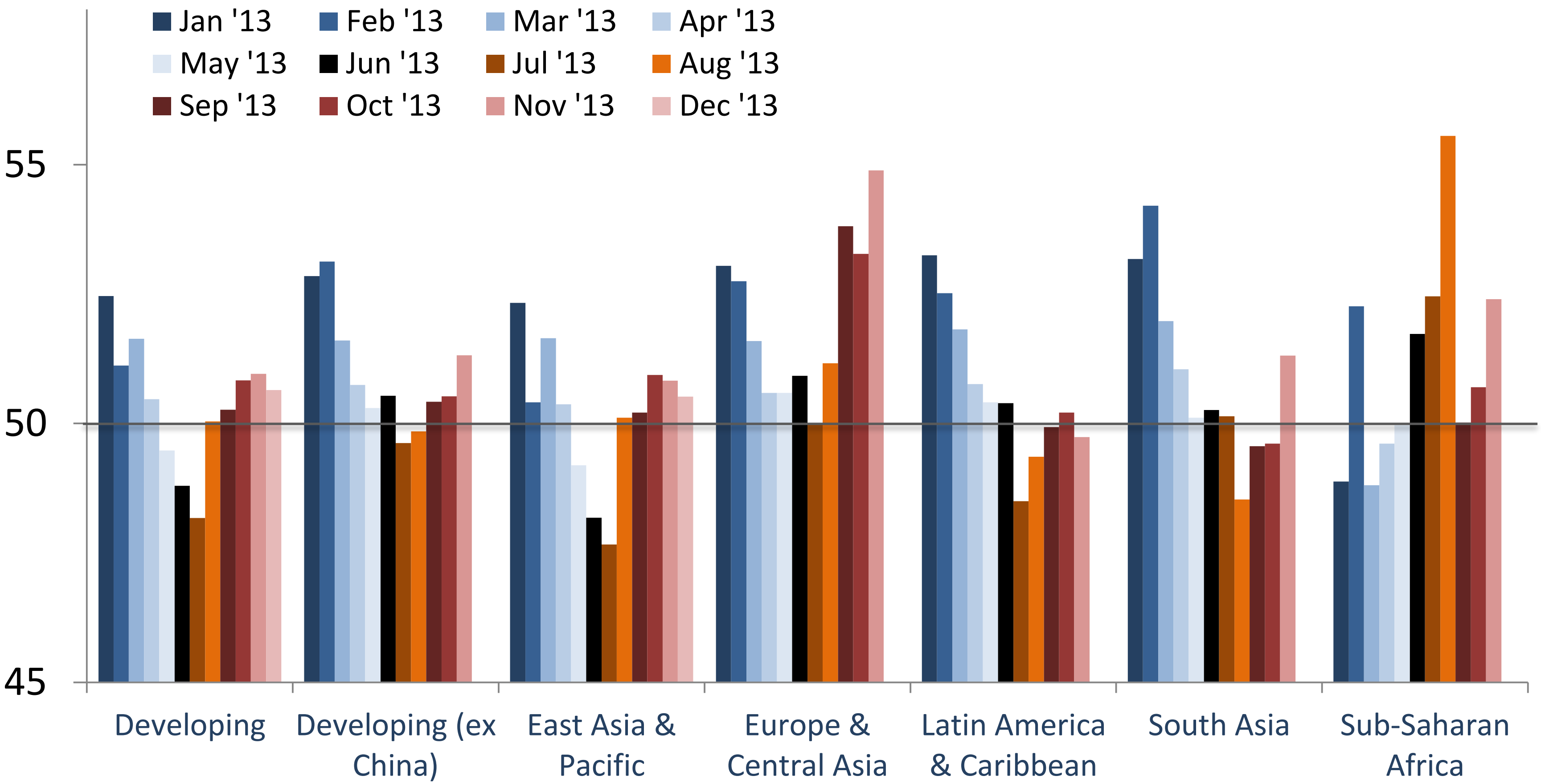
- Short-term cycle is strengthening
- Output gaps in most countries are closed
- Financing costs remain modest
- Forecast is for modest pickup in growth

Growth firming or solid in most developing countries



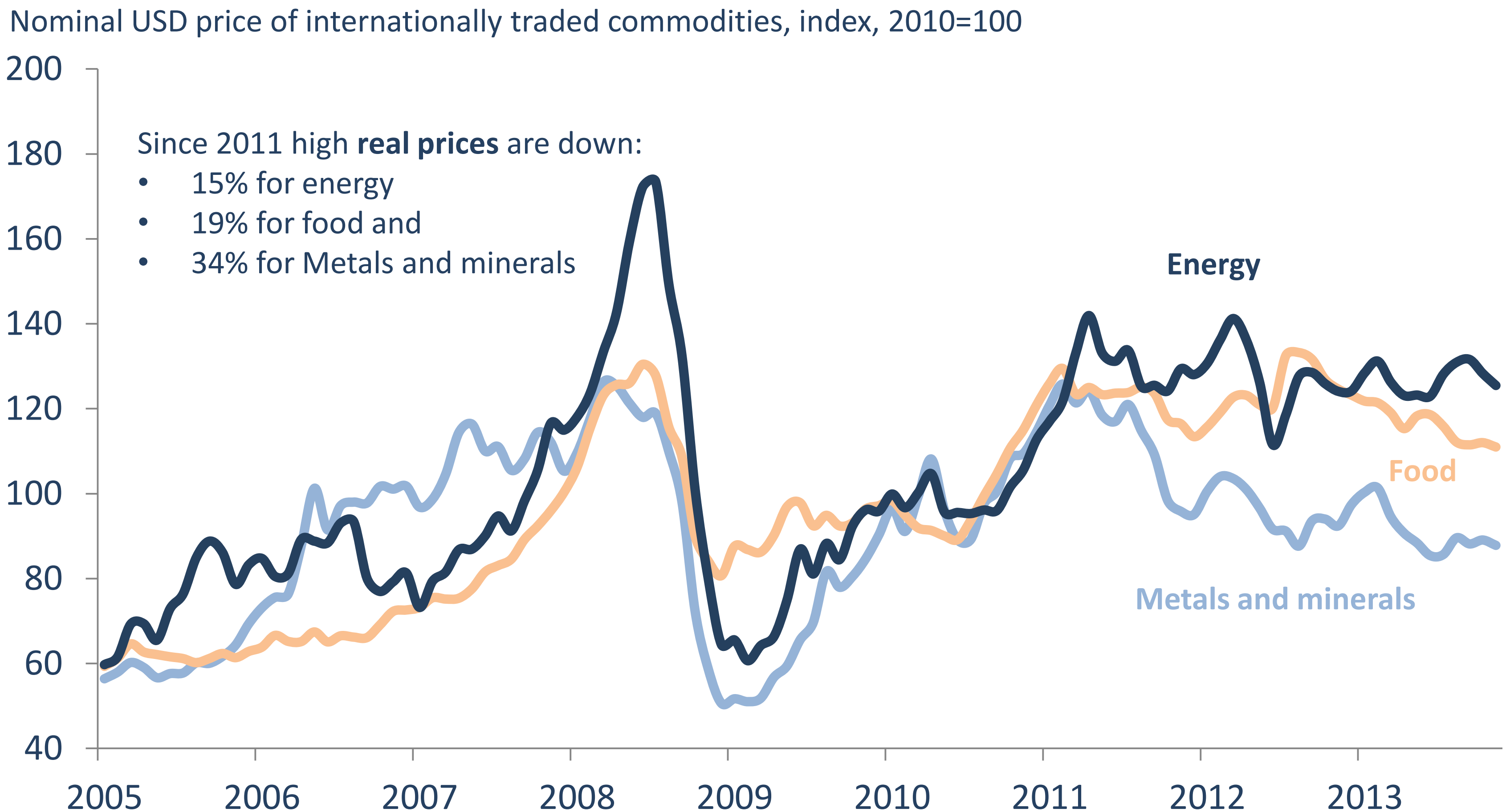
Source: World Bank, Datastream.

PMI's in most regions point to solid growth



Source: World Bank, Markit, national sources.

Commodity prices have eased or are stabilizing



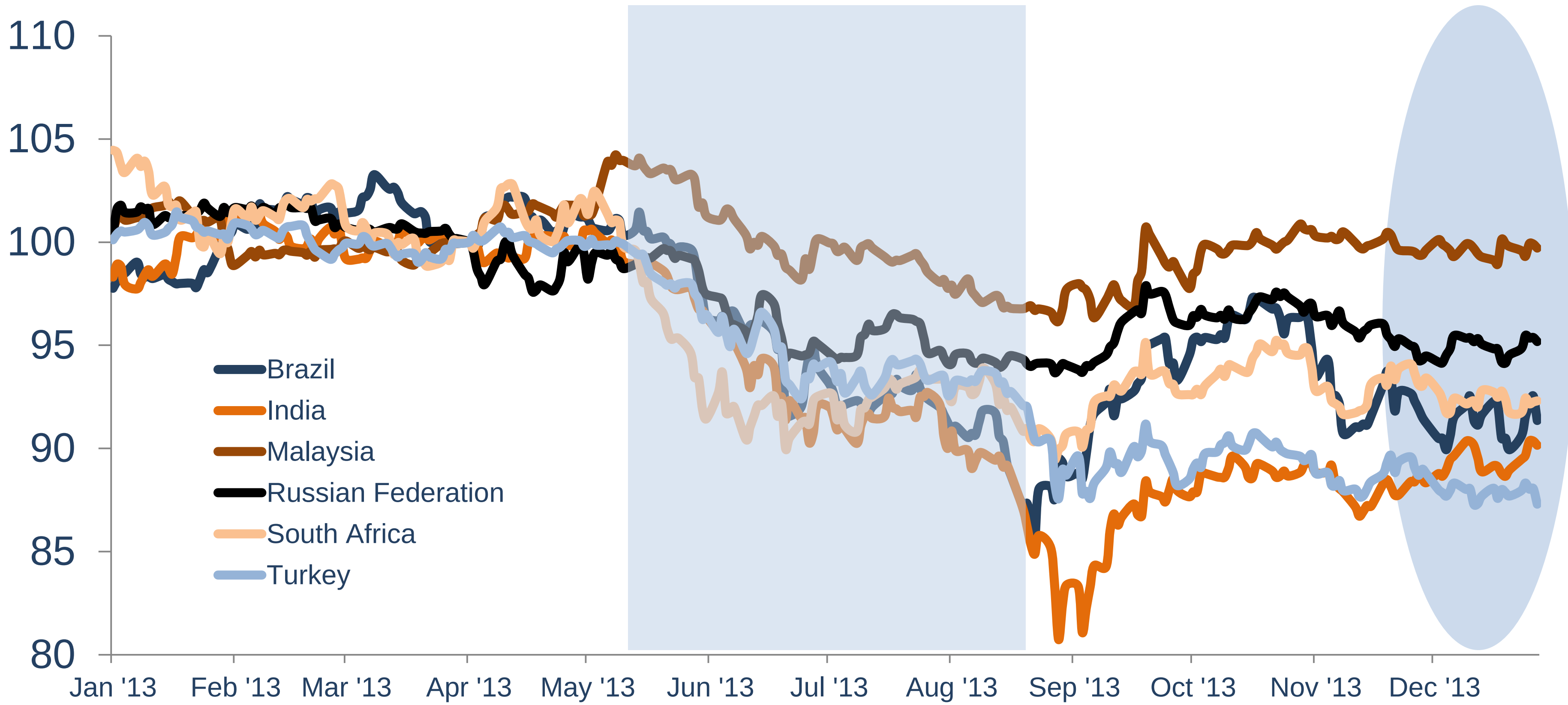
Source: World Bank, Datastream, Bloomberg.

Limited effects following announcement are encouraging, but disorder remains possible

- Since December 17, yields on 10-year treasuries are up 13 basis points to reach 300, versus 185 bp on April 1, 2013
- Financial markets in most developing countries have not been hit, Turkey and Thailand are notable exceptions
- Actual tapering only commenced the week of 6th Jan January 2014. Markets could still react.

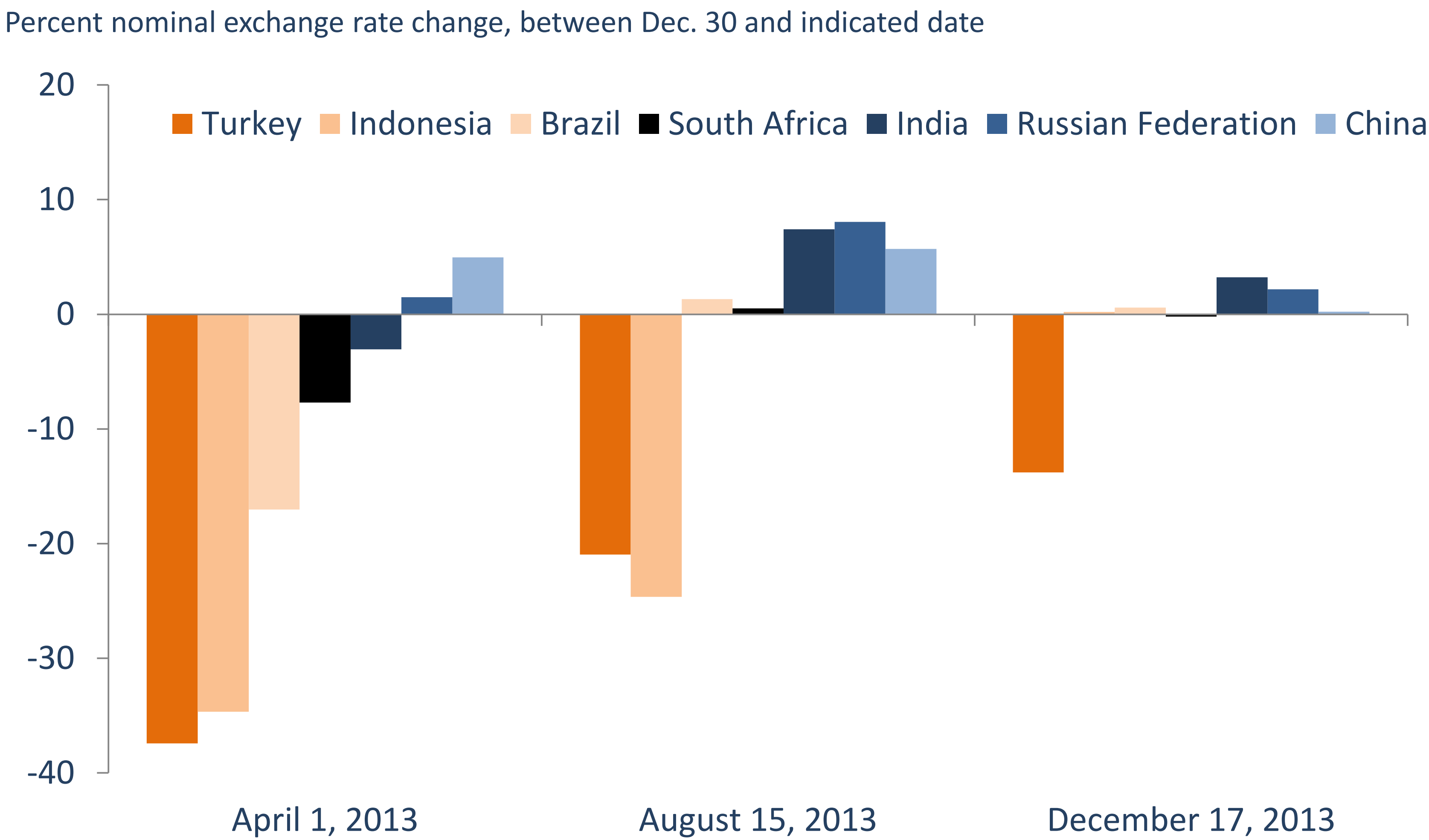
Markets have been calm since December announcement of January start to QE withdrawal

Nominal effective exchange rate, April 1, 2013=100



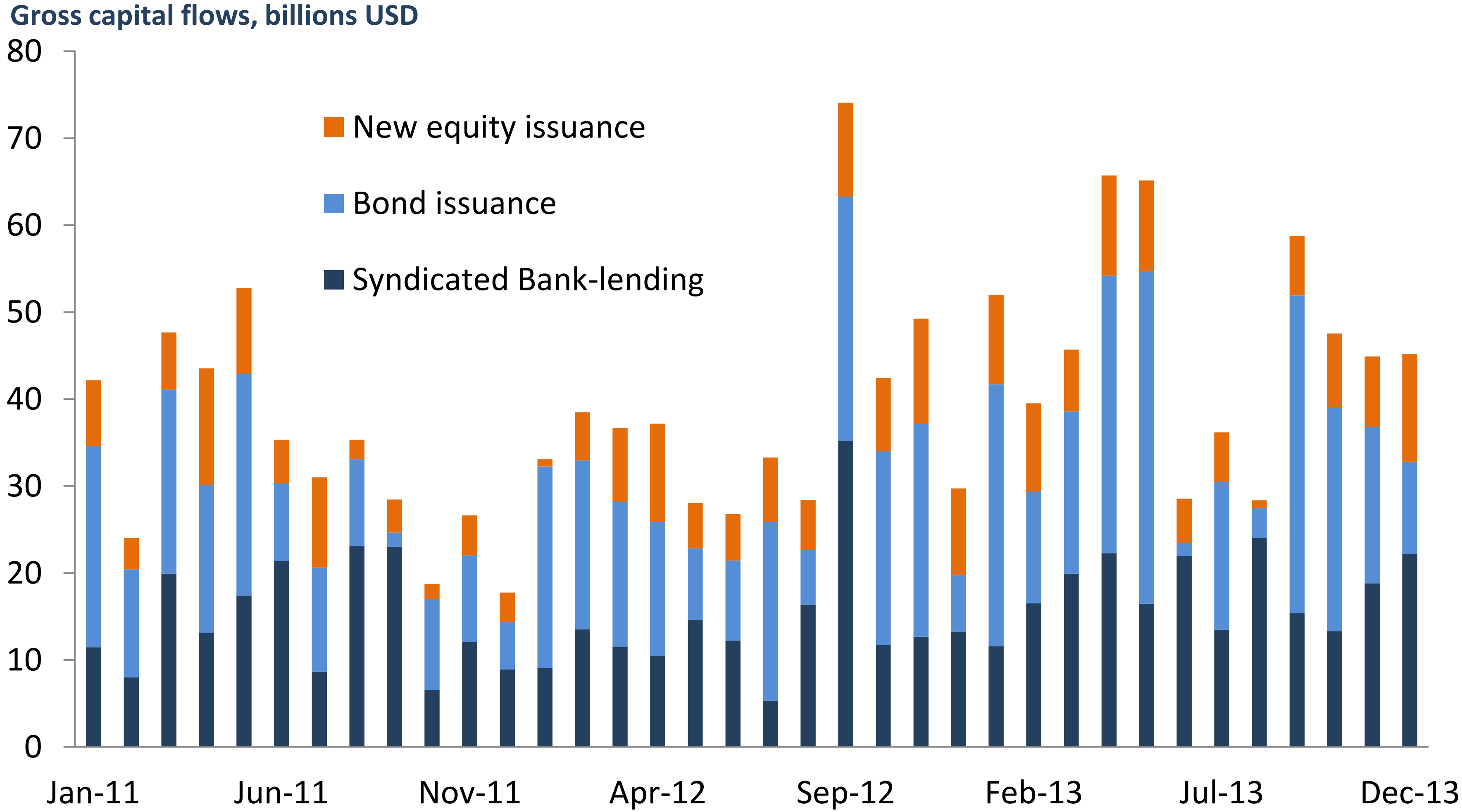
Source: World Bank, JP Morgan, DataStream.

Except Turkey, vulnerable countries did not depreciate after Dec. 18 Fed announcement



Source: World Bank, JP Morgan and IMF.

Capital inflows have partially recovered since the summer, with Q4 numbers 13% higher than in 2012

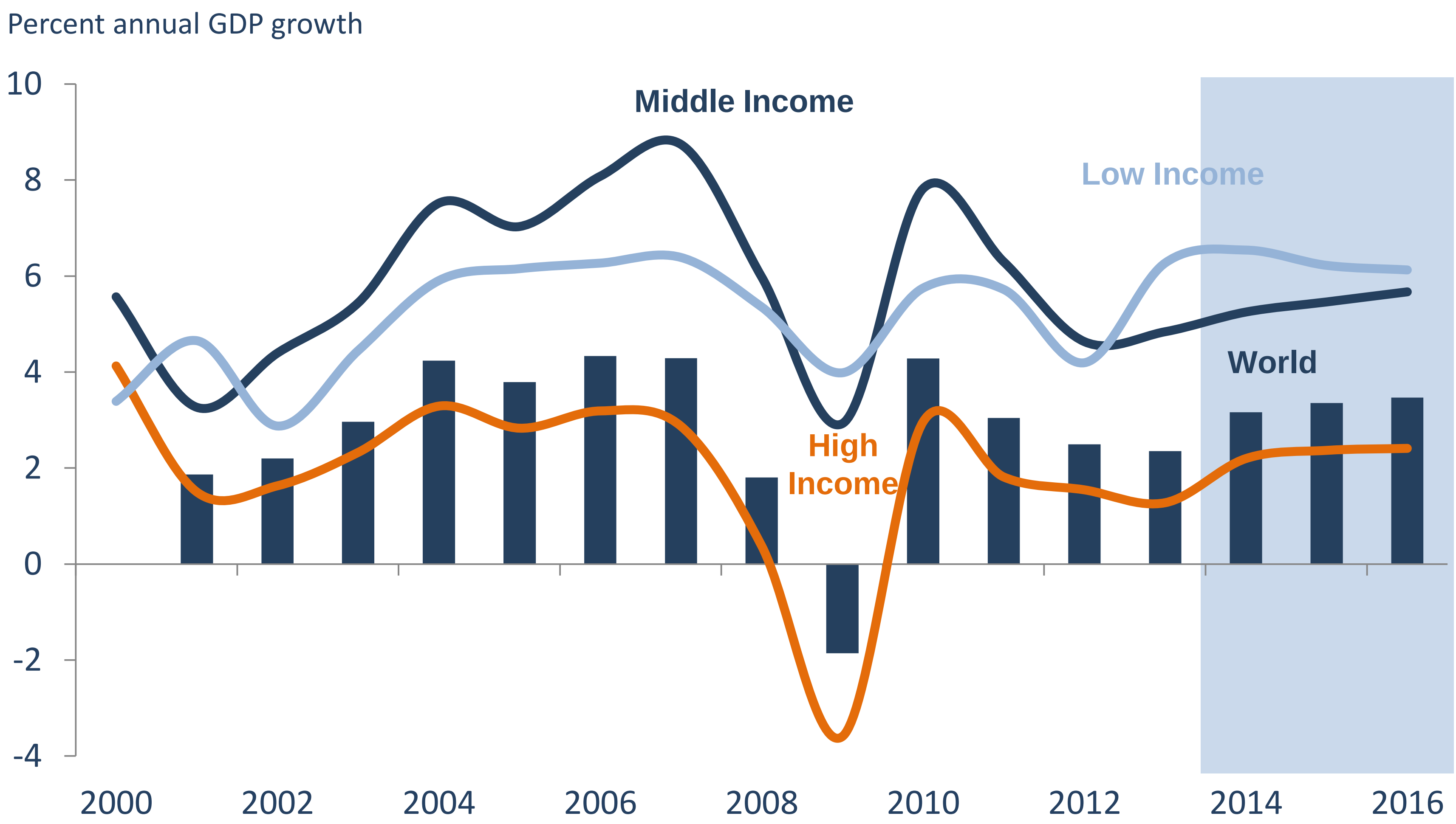


Source: World Bank, Dealogic.

Outlook

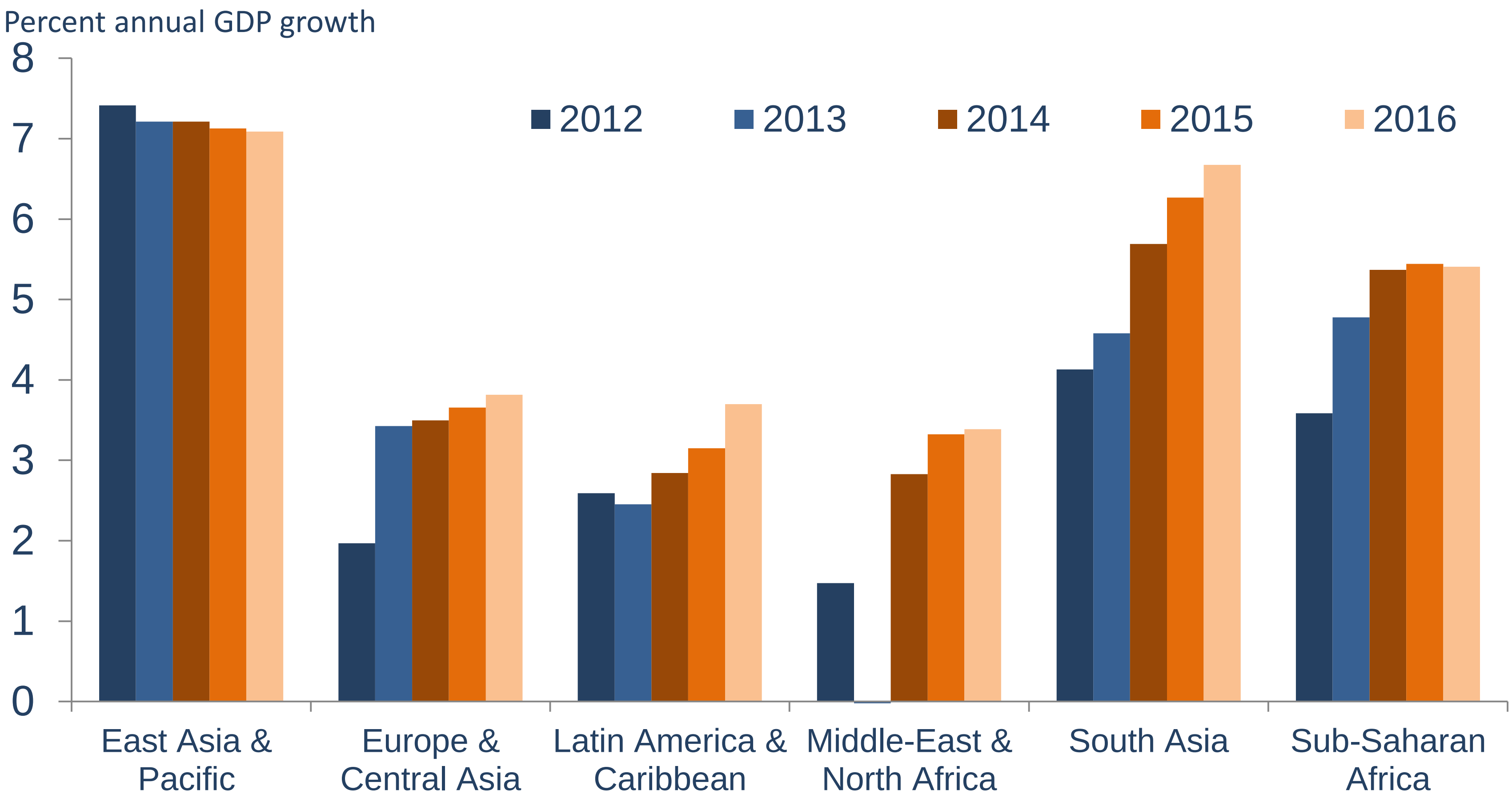
- Projected pick up in growth to be led by high-income countries
- Developing-country growth in line with underlying potential
- Regional growth shows strengthening or stability going forward
- Slower growth in middle-income countries may reflect weaker than thought potential

A gradual pick up in growth, led by high-income countries



Source: World Bank.

Regional growth strengthening or stable almost everywhere



Source: World Bank.

Taper-related risks

- **A smooth adjustment is the most likely scenario**, but uncertainty remains and period of volatility may ensue

- **Financial conditions will be tighter** over the next five years, implying weaker financial flows, higher capital costs and potential banking-sector stresses in economies that have seen large expansions in credit over past 5 years

Sources of vulnerability include:

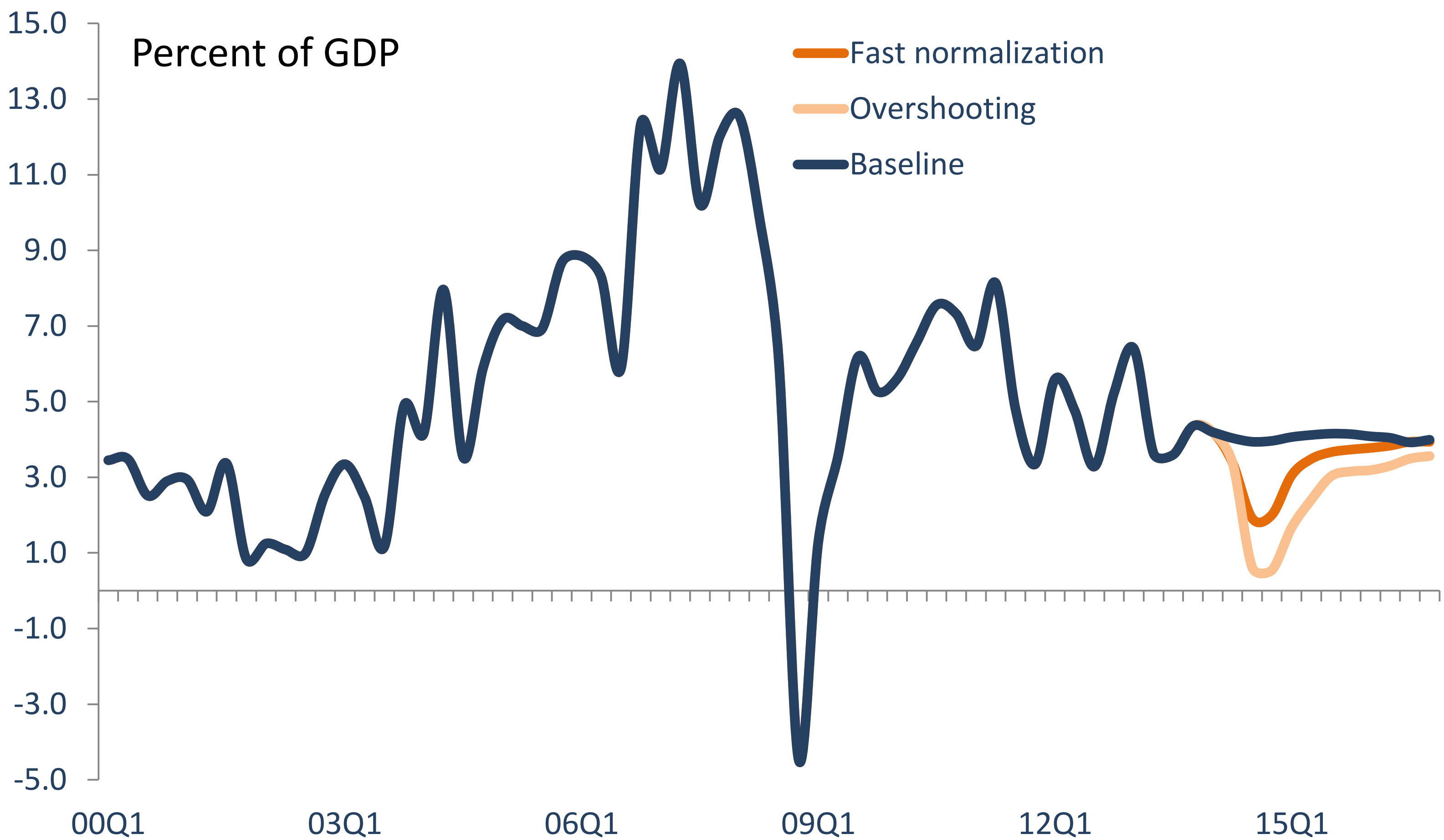
- **Weaker commodity prices:** may be an issue for those commodity exporters running large current account deficits or enjoying commodity-related investment booms

- **Domestic imbalances**: 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).

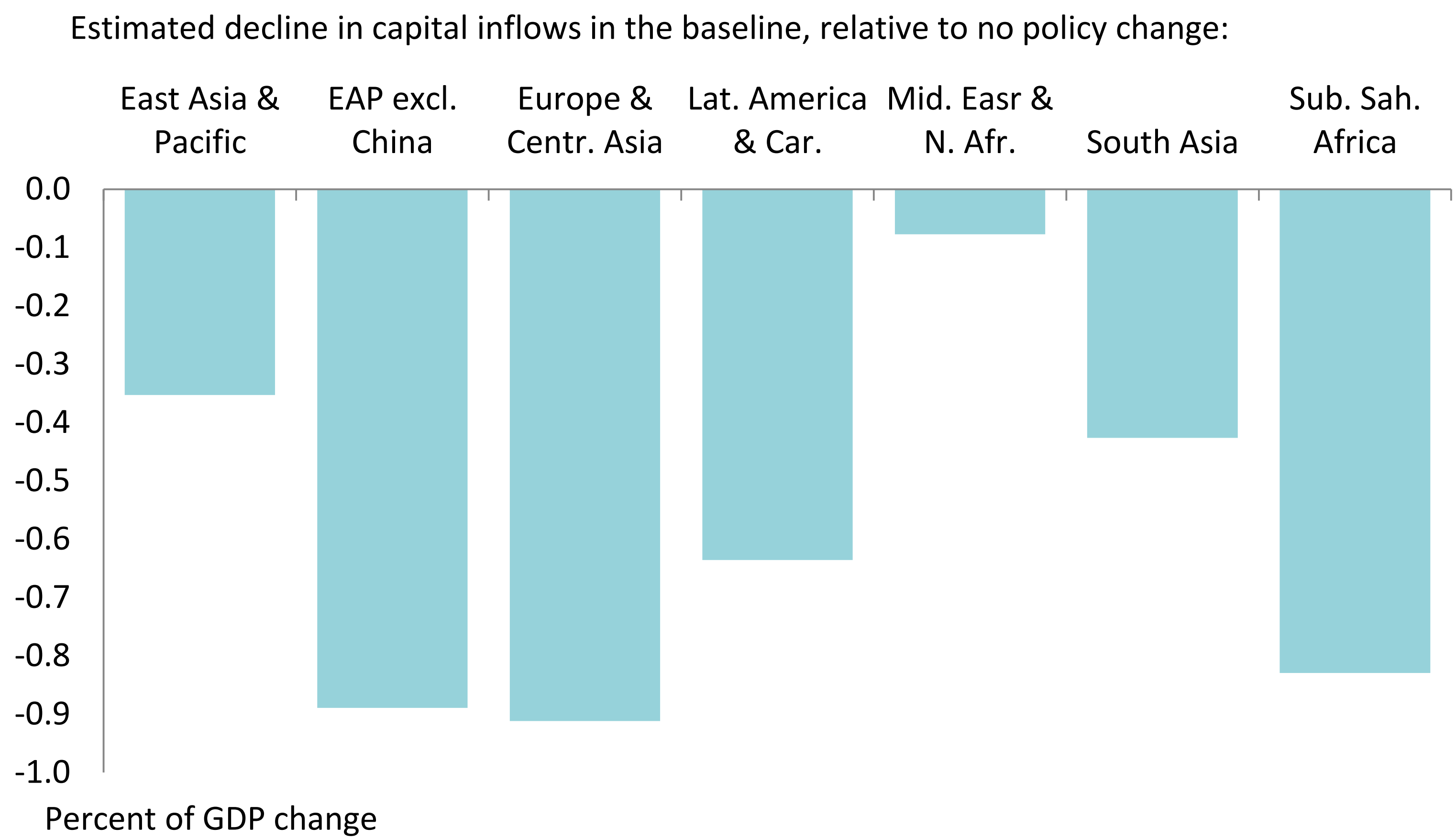
Global interest rates: baseline scenario and risks of more disorderly adjustments

Less orderly market reactions could lead to an abrupt deceleration of inflows



Source: World Bank.

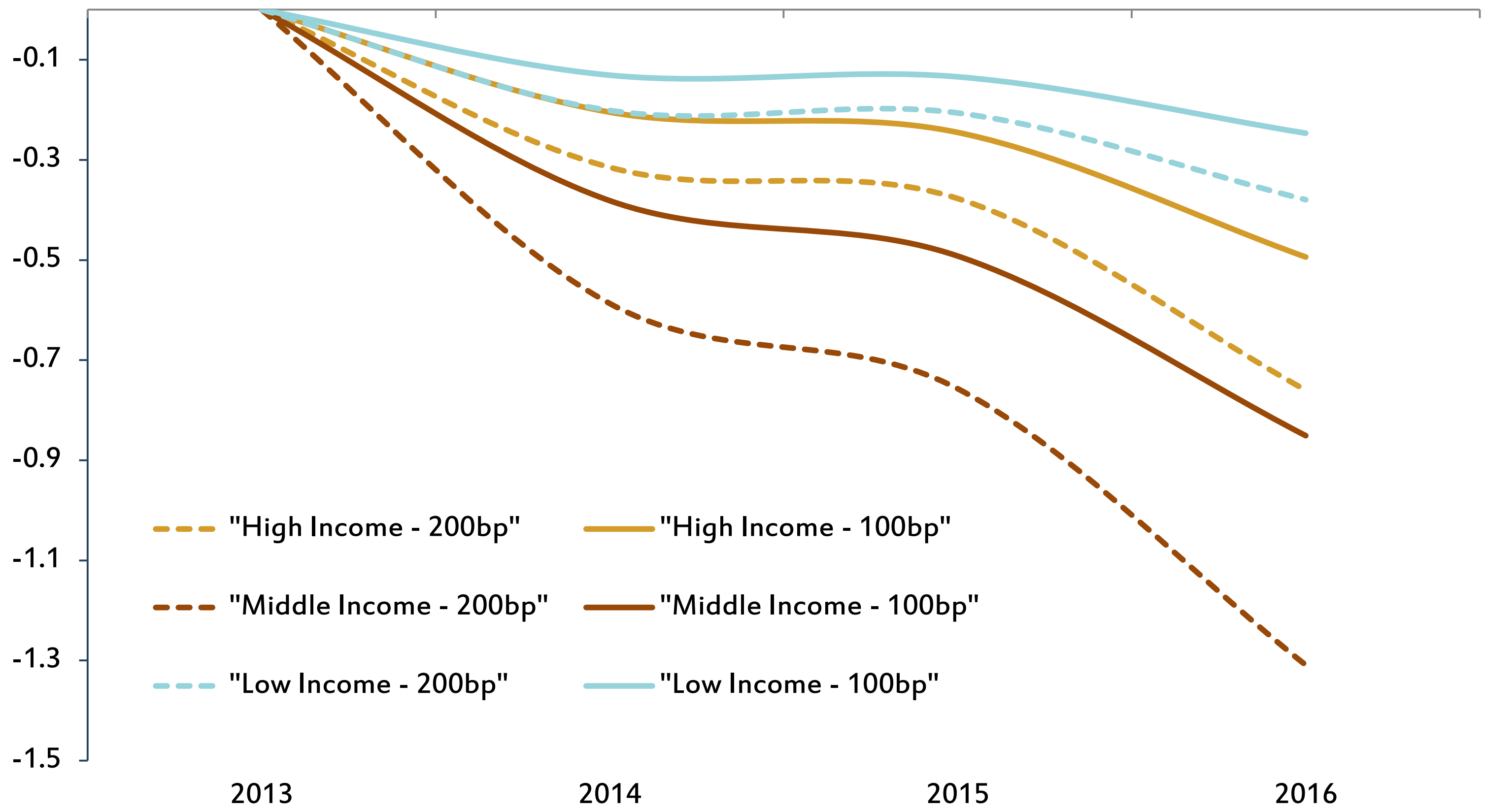
Regions will be affected differently, depending their exposure to portfolio inflows



Source: World Bank.

GDP impacts would be largest among middle-income countries

GDP, percentage point deviation from baseline, overshooting scenario

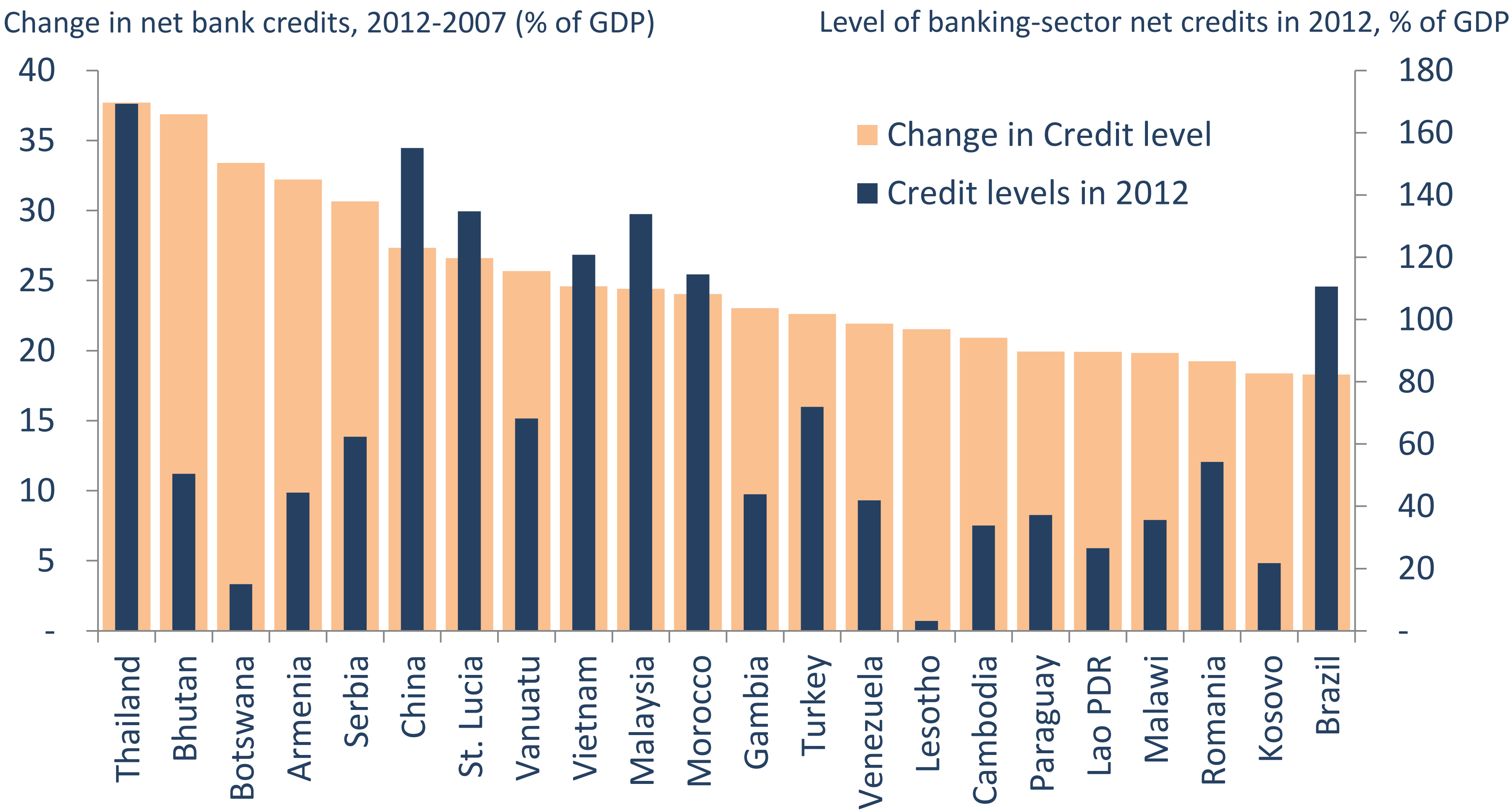


Source: World Bank

Financial conditions in developing countries are good, but many countries have vulnerabilities

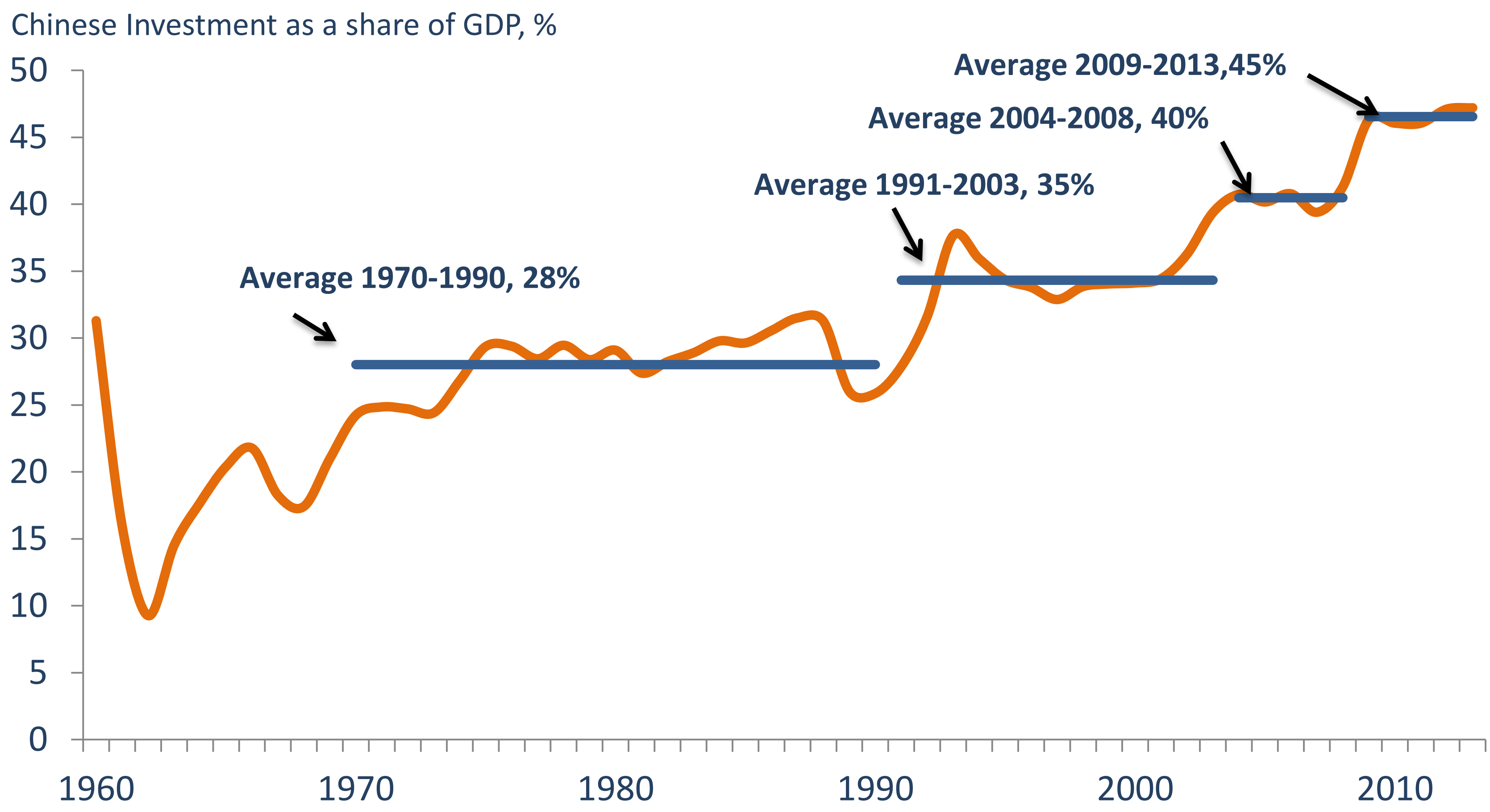
- Rapid credit expansion over past 5 years in many countries increases risk of banking-sector crisis as global conditions tighten
- Policy space is much reduced, with
- Other vulnerabilities include:
  - High levels of external debt
  - High shares of short-term debt
  - High fiscal deficits

Earlier rapid increase in credit increases the risk of banking-sector crises



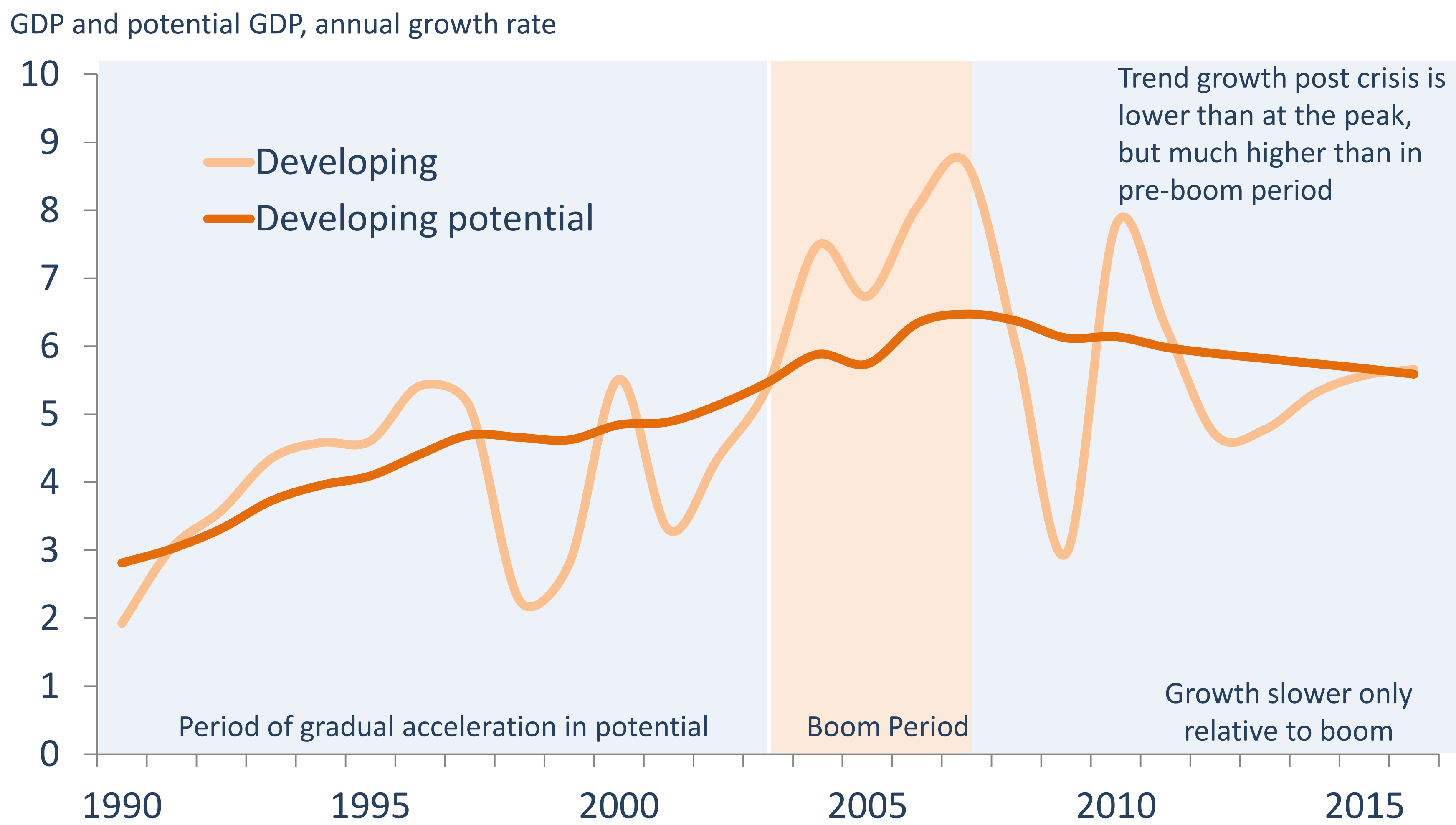
Source: World Bank, IMF.

High Chinese investment poses risks to activity and banking-sector



Source: World Bank.

Longer-term developing countries need to focus on structural policy



Source: World Bank.

Concluding remarks

- Strengthening recovery in high-income world will support developing country growth going forward
- Positive effects will be partly offset by tighter financial conditions and lower commodity prices
- Although progress thus far has been positive, turmoil associated with the phasing-out of quantitative easing remains a risk
- Structural reforms needed to boost productivity

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