Economics

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Global Economic Prospects 2014

World Bank's Global Economic Prospects indicates that there are signs of the global economy bouncing back this year, driven mainly by a recovery in high-income economies. Developing country growth is also firming due to a recovery in high-income economies as well as moderating, but still strong growth in China. Growth prospects for 2014 would depend a lot on the impact of the tapering of monetary stimulus in the United States and the structural shifts taking place in China's economy.

Main Highlights

- Global GDP is projected to grow from 2.4% in 2013 to 3.2% this year, stabilizing at 3.4% and 3.5% in 2015 and 2016, respectively, with much of the initial acceleration reflecting a pick-up in high-income economies.
  - For high-income countries, the drag on growth from fiscal consolidation and policy uncertainty will continue to ease, accelerating economic growth from 1.3% in 2013 to 2.2% this year, stabilizing at 2.4% for each of 2015 and 2016.
    - Amongst high-income economies, the recovery has been sharp in the US, with GDP expanding for 10 quarters now and a diminishing government deficit. The US economy is projected to grow by 2.8% this year (from 1.8% in 2013), firming to 2.9 and 3.0% in 2015 and 2016, respectively.
    - Growth in the Euro Area, after two years of contraction, is projected to be 1.1% this year, and 1.4 and 1.5% in 2015 and 2016, respectively. Estimation of a relatively slow growth in the Euro region is attributed to the deep adjustments required in the balance sheet of the private sector.
    - In Japan, large doses of fiscal and monetary stimulus have sparked a strong cyclical upturn, but sustaining this will require structural reforms. Japanese Yen is likely to depreciate against the USD on account of the persistent monetary easing in Japan vis-a-vis the gradual tightening by the Fed which is soon to commence.
  - The Report forecasts growth in developing countries to pick up from 4.8% in 2013 to 5.3% this year, 5.5% in 2015 and 5.7% in 2016.
    - Growth in East Asia & the Pacific eased for the third year to an estimated 7.2% in 2013, reflecting slower growth in Indonesia, Malaysia and Thailand,
    - These countries were affected mainly by weak commodity revenues, and policy tightening to address domestic overheating.
    - Domestic vulnerabilities generated during the years of expansionary policies remain a negative for the region.
    - GDP in China is projected to stay flat in 2014 at 7.7%, slowing to 7.5% for the next two years, reflecting deleveraging and less reliance on policy-induced investment. The region is vulnerable to risks of disorderly unwinding in Chinese investment and abrupt tightening in global financing conditions which could potentially push the Chinese growth rate down by 3%. Commodity exporters are also vulnerable to sharper than expected declines in commodity prices.
    - Domestic demand growth has moderated, notably in Brazil, although activity is starting to recover in Mexico and exports are rebounding in Central America,

partly supported by the Panama Canal expansion. Strong export growth, along with steady consumption growth, is expected to nudge Brazil's growth to 3.7% in 2016. Hinging on the pickup in the United States, Mexico is expected to grow by 3.4% in 2014, accelerating to 4.2% in 2016. Downside risks for the region include a disorderly jump in global interest rates and a prolonged and deeper slump in commodity prices.

- South Asia growth is projected to improve to 5.7% in 2014, rising to 6.7% in 2016, led mainly by recovering import demand by high-income economies and regional investment. The projected pickup, however, will depend on macroeconomic stability, sustained policy reforms, and progress in reducing supply side constraints. The main risks to the outlook are fiscal and policy reforms going off-track; uncertainties related to elections in Afghanistan, Bangladesh and India; entrenchment of inflation expectations; and a disorderly adjustment of capital flows in response to US tapering.
- India's growth is projected to rise to over 6% in FY2014-15, increasing to 7.1% by FY2016-17 amid expectations of a cyclical recovery in investment and external demand owing to improving global economic prospects.

The tapering impact

2014 starts off with the withdrawal of quantitative easing in the United States. The most likely scenario is for the taper to follow a relatively orderly trajectory and for global interest rates to rise only slowly – reaching 3.6% only by mid-2016. The impact of an orderly tightening of financial conditions on developing-country investment and growth is expected to be modest, with capital flows to developing countries projected to ease from about 4.6% of developing country GDP in 2013 to 4.1% in 2016, as investors take advantage of higher yields in high-income countries.

What has been the reaction so far and how does the road ahead look?

Market reactions to the announcement and the first few days of the taper have been subdued. However, if markets react sharply as the process evolves, the impact on developing countries especially for those with financial vulnerabilities could be significant. If long-term interest rates move up quickly they could provoke a rapid and disorderly adjustment in portfolios. In such a scenario, the following are the possibilities:

- Flows to developing countries could weaken sharply, as they did in the summer of 2013.
- Private capital inflows to developing countries could decline by 50% or more for several months, causing their GDP to decline by as much as 1.2%.
- Economies with large current account deficits, and those that have experienced significant increases in bank lending over the past few years of low interest rates would be most at risk in such a scenario.

Therefore, it is all the more important that India continues to keep its policies in place to ensure that the CAD is within limits and not consider immediately easing gold imports.

Markets just got savvier

Financial market pressure was much more focused on a few developing countries. The currencies of nearly two-thirds (62 percent) of developing countries were stable or appreciated during the May through September period while currencies of countries like India fell. The impact of the portfolio adjustment on developing-country financial assets and currencies on account of the news of tapering was most pronounced among countries like Brazil, India, Indonesia, Malaysia, Turkey, and South Africa. They were hit because they have relatively deep financial markets, and therefore the investors seeking to rebalance their portfolios actually had money in these economies to withdraw. But other economies, like Peru, Mexico, and China, have also received large inflows but were much less affected by the adjustment. What distinguishes these two sets of economies from each other is the extent to which they had been characterized by growing external and domestic imbalances (including current account deficits, government deficits, and rising inflation). With markets reprising risk, those economies with relatively weaker macroeconomic fundamentals and growth prospects came under more pressure than others.

What about trade?

Tight financial conditions will act as a headwind for developing countries. This will probably be countered by stronger demand in high-income countries. However, it should be pointed out that the contribution of the external sector to developing country incomes and demand will continue to be tempered by weaker commodity prices. Between their early-2011 peaks and recent lows in November 2013, the real prices of energy and food have declined by 9 and 13%, respectively, while those of metals and minerals have fallen by 30%. These downward pressures on commodity prices are expected to persist, in part reflecting the coming on-stream of additional supply. In general, price risks remain weighted to the downside in commodity markets.

Policy direction for developing economies

Most of the developing countries responded to the global financial crisis by going in for fiscal and monetary stimulus. However, public sector and current account deficits are quite high in most countries. Given the risks that developing countries are facing, policy makers need to give thought now to how they would respond to a significant tightening of global financing conditions.

- Countries with adequate policy buffers and investor confidence may be able to rely on market mechanisms, counter-cyclical prudential policies to deal with a decline in flows.
- Where the scope for maneuvering is more limited, countries may be forced to tighten fiscal policy to reduce financing needs or raise interest rates to incite additional inflows.
- Where adequate foreign reserves exist, these can be used to moderate the pace of exchange rate adjustments,
- Loosening of capital inflow regulations and incentives for foreign direct investment might help smooth adjustment.

By improving the longer term outlook, credible reform agendas can go a long way towards boosting investor and market confidence. This could set in motion a virtuous cycle of stronger investment, including foreign investment and output growth.

Some numbers to remember for 2014

Variable	2013	2014
GDP (%)		
Euro region	-0.4	1.1
USA	1.8	2.8
Japan	1.7	1.4
China	7.7	7.7
Indonesia	5.6	5.3
Brazil	2.2	2.4
Mexico	1.4	3.4
India (fiscal year)	4.8	6.2
South Africa	1.9	2.7
Global trade volume	3.1	4.6
Non-oil commodity prices	-7.2	-2.6
Oil Price ($/bbl)	104.1	103.5
Capital flows to DLCs as % GDP	4.7	4.3

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