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Good times, bad times; the world economy swings according to market sentiment

According to UNCTAD's latest estimates, global output decelerated to 2.2 per cent in 2016, down from 2.6 per cent experienced in both 2014 and 2015. A number of large emerging economies, in particular, suffered setbacks, registering weak or negative growth. Meanwhile, global trade continued to disappoint, growing at about 1.3 per cent over the year in volume terms, but marked by a general decline during the first half of 2016.

Cautious optimism has returned….

By contrast, several recent indicators have encouraged a more optimistic near-term outlook. For example, although global trade was apparently stagnant in the first month of 2017, the momentum from the last quarter of 2016, with a quarterly growth of 1.4 per cent, seems likely to continue, while an uptick in global commodity prices has also been taken as confirmation that a recovery of global demand is underway.[1] Similarly, weak growth in global manufacturing production in the first month of 2017 belies the stronger momentum registered in the last quarter of 2016, which also looks set to continue. Both indicators reflect the experience of developing and developed regions alike. Labour markets in advanced economies have also shown signs of continued tightening -- at least in terms of lower unemployment figures -- at the start of 2017. Financial indicators have signaled a much greater state of euphoria with leading stock and bond markets continuing to show unusual strength in early 2017, in some cases reaching record levels.

… but without breaking with the 'new normal'

The bout of market optimism since the start of this year appears to be more the product of short-term financial herding than a measured response to a more robust global growth path; quarterly capitalism with a happy face does not signal a break from the new normal. In the United States, for example, renewed optimism has turned heavily on the expectation of a growth strategy based on expansionary fiscal policy and infrastructure support, along with measures to protect employment, but with as yet little programmatic detail. The few signs of government action suggest, if anything, a more neutral fiscal stance, with for example increases in military expenditure against cuts in social and environment programmes.

[1] CPB trade monitor; Memo 24 March 2017

Net fiscal injections will more likely come from tax reductions on corporate and high-income earnings but these are likely to yield weak multiplier effects.

In Europe, there has been some impetus derived from currency depreciations (the euro and the pound) as well as from lower consumer prices, resulting largely from falling energy costs. In some cases, domestic demand has been supported by mild increases in the minimum wage. Improved sentiment has also played its part, since the somber prognosis of a Brexit economic shock and other political threats to the Union have not (yet) materialized. Despite some differences, Japan reflects a similar confluence: economic growth, especially derived from exports and consumer spending, may be picking up in response to a sustained depreciation of the yen and the fall in energy prices.

An easing of worries about China's financial stability has also helped to improve sentiment about global economic conditions. Over the summer of 2016, concerns about the size of the shadow banking system, rising levels of debt in the corporate and real estate sectors, gyrations in the stock market and unrelenting outflows of capital raised fears of a sharp deceleration of activity, with expected negative effects on global demand for commodities, world prices and global trade. As these fears subsided, and growth was maintained at 6.7 per cent in 2016, with employment and domestic wages growing along with public sector support, the Chinese economy helped sustain a revival of commodity prices and trade, including intra-Asian trade.

While developing countries in Asia may benefit from a rebound in regional trade, some are still vulnerable to changes in investor sentiment and unexpected shocks. An idiosyncratic case is India, where demonetization is likely to have adversely impacted consumption demand, but business confidence and stock market appreciations have helped maintain investment growth and capital inflows. Economic performance in other countries of East- and South-Asia was less buoyant than in India and China, but will likely prove to be relatively stable in so far as it continues to rely on a good mix of domestic expenditure, industrial activity and exports.

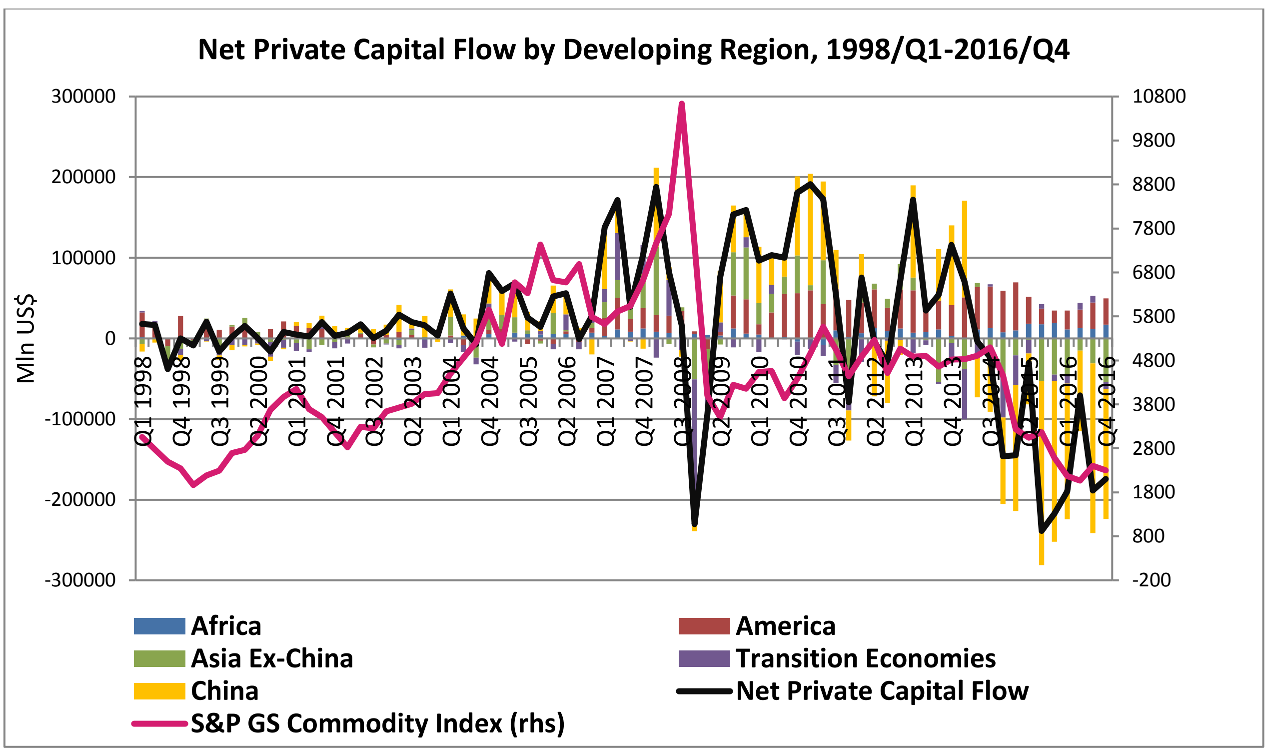
Current macroeconomic data from the African continent is scarce but it suggests that a rebound from the exceptionally low rate of growth of 1.7 per cent in 2016 may be underway, particularly if commodity prices and global trade activity continue to point upwards. Given that economic diversification has not happened in most African economies, financing for the required pace of investment to sustain economic growth will have to rely on either commodity exports or capital inflows. This makes African economies particularly vulnerable to changes of sentiment in commodity and capital markets.

Looking at other regions, it is perhaps countries in Latin America and the Caribbean and in the CIS where capital inflows, terms-of-trade and exchange rate movements have little connection with the evolution in their real-economic performance. The CIS (Georgia included) experienced a contraction of 3 per cent in 2015 and no growth in 2016; with the Russian Federation showing contraction of 3.7 and 0.5 per cent in these last two years, respectively. In Latin America and the Caribbean growth was practically nil in 2015 and minus 0.6 in 2016, with Brazil contracting by 3.8 and 3.6 per cent in these years, respectively. Yet, small improvements in terms of trade, along with repeated announcements of tighter fiscal discipline and further adherence to pro-market deregulation have provoked sudden improvements in investors' perceptions and business confidence. Such improvements have, moreover, coincided with an apparent cooling of investor enthusiasm in the United States, given the uncertainties surrounding its policy direction. As a result, these developing and transition economies are experiencing a rebound of capital inflows and, in turn a recovery of economic activity.

… leaving continued grounds for concern

Since the moves to liberalize capital accounts in the early 2000s, net private capital flows to developing and transition countries have increased dramatically. Until the global financial crisis of 2007-8, net private capital flows to these countries were positive and contributed to above average economic growth. However, in the aftermath of the crisis and following an initial strong rebound, net capital flows have been highly volatile, entering negative territory since the second quarter of 2014 mostly due to outflows from China. While some have attributed this to a substantial increase in Chinese FDI abroad, in particular since the second half of 2015, careful examination of the data suggests that this increase in outflows has been accompanied by a more pronounced decline of FDI into China, which began in 2013. Other developing regions are also affected by net negative capital flows or declining positive inflows. The only exception is Africa where the relatively stable positive capital flows are largely driven by FDI, historically delinked from shorter-term macroeconomic dynamics.

Despite some current estimates of an incipient turn-around in the case of steeply negative net capital flows to China (source, IIF), overall the trend towards negative net capital flows continues to pose a core challenge for developing and transition economies, in particular in view of the expected full return to a 'normalised' monetary and interest rate policy in the US.

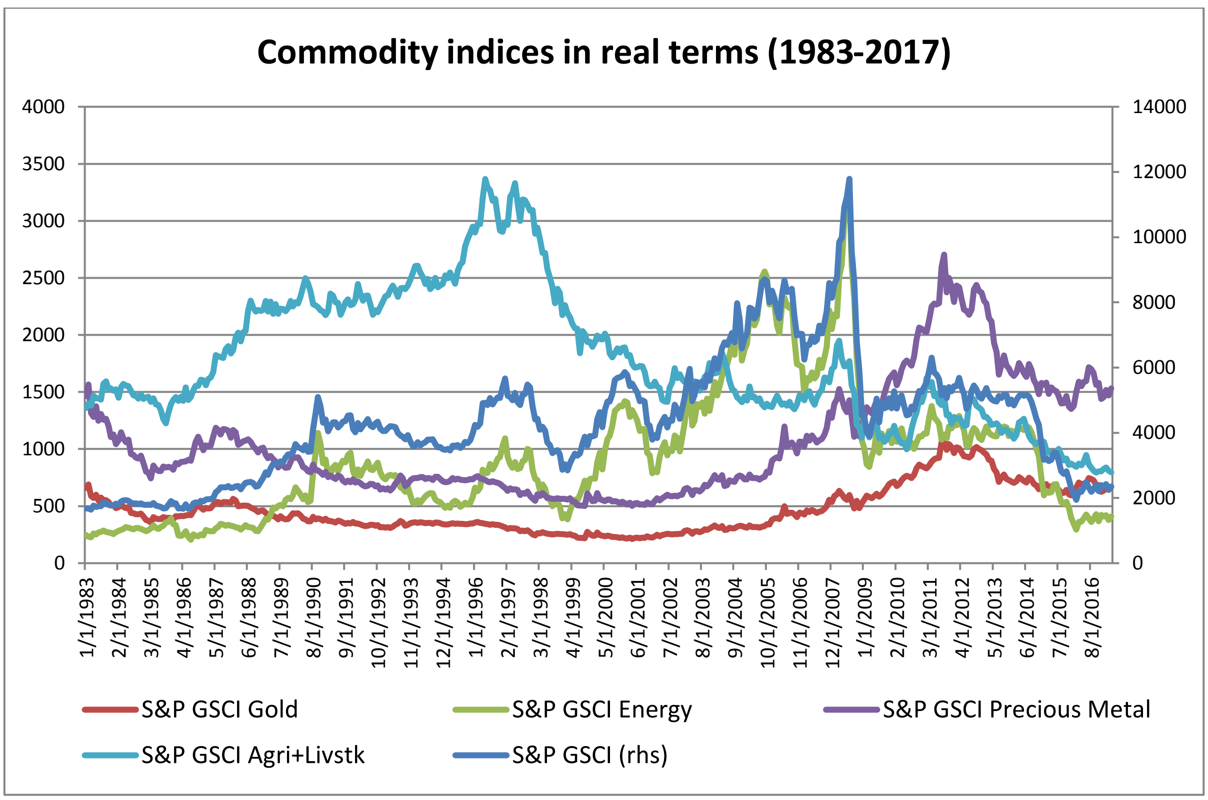


Source: UNCTAD secretariat calculations and Thomson Reuters.

…including depressed commodity prices….

All indications are that commodity prices are only slowly recovering from their earlier very low levels, and in some cases are not recovering at all. In real terms, commodity prices globally are at the levels of the late 1980s, albeit with major variations in the dynamics of the different commodity groups. In particular, agricultural commodities are at one of their lowest levels since the creation of the index in 1970. The only group of commodities currently performing above 1980s price levels is precious metals, that include gold, silver and platinum. With persistently low levels of aggregate global demand, expectations of a sustained improvement of commodity price levels over the coming months would clearly be premature.

With the onset of the financialization of commodity markets in early to mid-2000s, commodity prices have been positively correlated with net private capital flows in periods of high animal spirits, and negatively in periods when concerns about financial stress in developing and transition economies capture investor sentiment. Currently, this correlation is negative, providing a clear signal of rising concerns about growing financial vulnerabilities in these economies. A case in point are falling oil prices - the OPEC Reference Basket averaged $50.32/b in March 2017, representing a decline of 5.7 per cent to the previous month - , driven largely by financial investors, such as hedge funds, liquidating their large net long positions in crude oil amongst concerns about growing over-capacities relative to demand that remains in the doldrums.



Source: UNCTAD secretariat calculations and Thomson Reuters.

….and debt-dependent growth

Against this background, the growing stock of debt incurred by developing countries and transition economies, including in commodity-dependent developing economies, is bound to become a serious liability for their immediate future. At the global level, any growth recovery appears still to be strongly debt-driven. At the end of the third quarter of 2016, global debt levels had reached $217 trillion, thus surpassing the record level reached at the onset of the global financial crisis ($ 142 trillion) by a stunning $75 trillion. Despite strong credit growth in the nonfinancial private sectors of emerging markets, advanced countries still hold the largest share of total debt stocks. With such continued debt dependence, it is unsurprising that international financial markets are showing renewed signs of nerves. Large corporations are mostly saddled with a combination of high debt - often sold to buy back shares and inflate CEO remunerations - with high (and possibly over)-valued shares, making them decidedly vulnerable to any negative shocks to current investor expectations.

In emerging market economies, private sector non-financial debt overall now stands at over 140 per cent of combined GDP, with credit to the Chinese private non-financial sector having risen from 115 to 210 per cent between the third quarters of 2008 and 2016, respectively. According to IIF data, in these economies government bond and syndicated loans issuance grew at three times the pace of 2015, with China also accounting for the vast bulk of the new debt ($710 out of a total $855 billion).

While fears of a financial meltdown in China have for now been assuaged for the reasons already mentioned, ballooning debt and looming debt crises remain a major concern across the developing world, given the strong trends towards negative net capital flows to the developing world, persistent low levels of commodity prices and insufficient global aggregate demand, as well as rising US interest rates and a strong US dollar.

While external debt-to-GDP ratios remain relatively low by recent historical standards, rising from 21 percent in 2009 to 27 per cent by 2015, debt service and payment burdens have risen sharply over the past couple of years. For all developing countries, the ratio of debt service-to-GDP rose from 9.1 per cent in 2009 to 13.1 per cent in 2015. This increase in debt service burdens has hit the most vulnerable developing countries the hardest, including commodity exporters, countries dealing with large refugee inflows, and small island developing states.

Further signs of trouble on the horizon include a growing share of short relative to long-term debt in total external debt stocks (up from 21 per cent in 2009 to 27 per cent in 2016), as well as a significant slowdown in the growth of international reserves. These grew by only 4 per cent between 2009 and 2016, compared to 24 per cent between 2000 and 2008. The ratio of short-term debt to international reserves stood at just below 400 percent in 2016. While this is still substantially higher than the 230 per cent ratio at the start of the millennium, the relatively sharp decline since 2009, when this ratio stood at 580 per cent, is cause for additional concern.

Unsurprisingly, of the 67 low and middle income countries assessed recently (February 2017) by the IMF and the World Bank, only 12 were considered at low risk of debt default, 19 at high risk and 32 at medium risk, with 4 countries already in default.

This is not a situation that can be ignored, in particular since the main causes of this renewed high vulnerability to debt and financial distress in many developing countries are hardly under their control. As UNCTAD has argued for some time now, the downside of a rushed integration of developing countries into heavily under-regulated financial markets over the past two decades is now coming home to roost. Developing country debt compositions are also heavily tilted towards high risk exposure - to exchange rate fluctuations, maturity mismatches, interest rate risks and generally highly volatile and unreliable investor sentiments. It is more than doubtful whether short and cheap credit bonanzas, that by their very nature cannot easily be channeled into productive long-term investment projects, can make up for the huge potential costs of excessive risk exposure, in particular in developing countries with as yet shallow financial systems at home. Much more likely is the emergence of a new debt trap for developing countries: Once reversals of capital flows and worsening financial conditions set in, systemic failure in the private sectors leads to heavy additional debt burdens on public balance sheets, including bailout payments. Even if an outright financial meltdown can be avoided, private lenders are less obliging than governments when it comes to considering trade-offs between longer-term growth prospects and immediate repayment. Excessively harsh austerity responses are therefore likely, further undermining growth prospects and ultimately driving up relative debt levels. To avoid this kind of debt trap systematically spreading across the developing world will require a systematic international policy response rather than 'business as usual'.

…with the task at hand moving from the new normal to a global new deal

The global economy is in an equivocal state. On the one hand, there are some positive signs of a pick-up in trade and output, coming from both developed and developing countries and across regions. On the other hand, this recovery appears to be strongly anchored more in changes of investor sentiment than in a reconfiguration of demand that could ensure sustained rises in production and incomes. What is missing is a rigorous policy coordination effort centered on raising labour-incomes across the developed and developing regions, and sustained by proactive public policies supporting infrastructure and social investment while also offering impetus towards full and decent employment. But given the huge uncertainty that currently surrounds the pace of monetary and fiscal policy stances in the United States and the resolution of pending problems in Europe (ranging from the economic challenges to sustain employment and industrial activity while normalizing monetary policy to the political challenges of cohesion, immigration and fiscal solidarity), the apparent 'normality' of current trends could shift dramatically. In particular, to the extent that a resurgence of growth and trade in many developing and transition economies has continued to rely on external sources of funding, an incipient recovery may easily run into a serious cascade of external debt crises for which the current global financial system is ill-prepared.

Table 1 WORLD OUTPUT GROWTH (annual percentage change)

	2008	2009	2010	2011	2012	2013	2014	2015	2016*a*
World	1.5	-2.1	4.1	2.8	2.2	2.2	2.6	2.6	2.2
Developed countries	0.0	-3.6	2.6	1.5	1.0	1.2	1.8	2.2	1.6
of which:									
Japan	-1.1	-5.4	4.2	-0.1	1.5	2.0	0.3	1.2	1.0
United States	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.6
European Union (EU 28)	0.4	-4.4	2.2	1.7	-0.4	0.2	1.6	2.2	1.8
of which:									
Euro area	0.4	-4.5	2.1	1.6	-0.9	-0.3	1.2	2.1	1.7
France	0.2	-2.9	2.0	2.1	0.2	0.6	0.6	1.3	1.1
Germany	1.1	-5.6	4.1	3.7	0.5	0.5	1.6	1.7	1.8
Italy	-1.1	-5.5	1.7	0.6	-2.8	-1.7	0.1	0.7	0.9
United Kingdom	-0.6	-4.3	1.9	1.5	1.3	1.9	3.1	2.2	2.0
New EU member States after 2004	3.7	-3.5	2.0	3.1	0.5	1.2	2.9	3.6	2.8
South-East Europe and CIS	5.4	-6.6	4.7	4.7	3.3	2.0	0.9	-2.8	0.1
South-East Europe *b*	5.8	-1.9	1.5	1.7	-0.6	2.4	0.2	2.0	2.6
CIS incl. Georgia	5.3	-6.8	4.9	4.8	3.5	2.0	1.0	-3.0	0.0
of which:									
Russian Federation	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-3.7	-0.5
Developing countries	5.3	2.4	7.8	5.9	4.8	4.6	4.4	3.9	3.6
Africa	5.4	3.0	5.2	1.1	5.7	2.4	3.7	3.1	1.7
North Africa (excl. Sudan)	6.3	2.8	4.1	-6.6	10.2	-3.7	1.2	3.1	2.4
Sub-Saharan Africa (excl. South Africa)	5.9	5.3	6.8	4.9	4.8	5.8	5.8	3.8	1.8
South Africa	3.2	-1.5	3.0	3.3	2.2	2.3	1.6	1.3	0.6
Latin America and the Caribbean	3.7	-2.1	5.9	4.5	3.1	2.8	1.1	0.2	-0.6
Caribbean	2.6	-0.9	3.1	2.2	2.1	2.9	2.8	3.9	2.1
Central America (excl. Mexico)	3.8	-0.7	3.7	5.4	4.8	3.6	3.8	4.2	3.8
Mexico	1.4	-4.7	5.2	3.9	4.0	1.4	2.2	2.6	2.0
South America	5.0	-1.0	6.6	4.8	2.6	3.3	0.3	-1.4	-2.3
of which:									
Brazil	5.1	-0.1	7.5	3.9	1.9	3.0	0.1	-3.8	-3.6
Asia	5.8	3.9	8.8	7.0	5.3	5.5	5.5	5.1	5.0
East Asia	7.0	6.1	9.7	7.8	6.2	6.3	6.2	5.5	5.4
of which:									
China	9.7	9.4	10.6	9.5	7.9	7.8	7.3	6.9	6.7
South Asia	4.9	4.4	9.1	5.5	3.2	4.9	6.4	6.1	6.7
of which:									
India	6.2	5.0	11.0	6.1	4.9	6.3	7.0	7.2	7.3
South-East Asia	4.2	1.6	8.0	4.8	5.8	4.9	4.3	4.4	4.5
Western Asia	4.0	-2.0	6.2	7.7	4.0	3.4	2.6	3.0	1.9
Eastern, Southern and South-Eastern Asia	6.1	5.1	9.3	6.9	5.5	5.9	6.0	5.4	5.5
Asia and Oceania	5.8	3.9	8.8	7.0	5.3	5.5	5.5	5.1	5.0
Oceania	0.7	0.8	4.9	1.7	1.7	3.2	4.3	3.8	2.3

Source: UNCTAD secretariat calculations based on United Nations, Department of Economic and Social Affairs (UN/DESA), National Accounts Main Aggregates database and World Economic Situation and Prospects (WESP) 2016; ECLAC, 2016; OECD, 2016; IMF World Economic Outlook, October 2016; Economist Intelligence Unit, EIU CountryData database; J.P.Morgan, Global Data Watch; and national sources.

Note: Calculations for country aggregates are based on GDP at constant 2005 dollars.

a Preliminary estimates.

b Albania, Bosnia and Herzegovina, Montenegro, Serbia and The Former Yugoslav Republic of Macedonia.