WORLD ECONOMIC OUTLOOK: CHALLENGES TO STEADY GROWTH

October 2018

International Monetary Fund

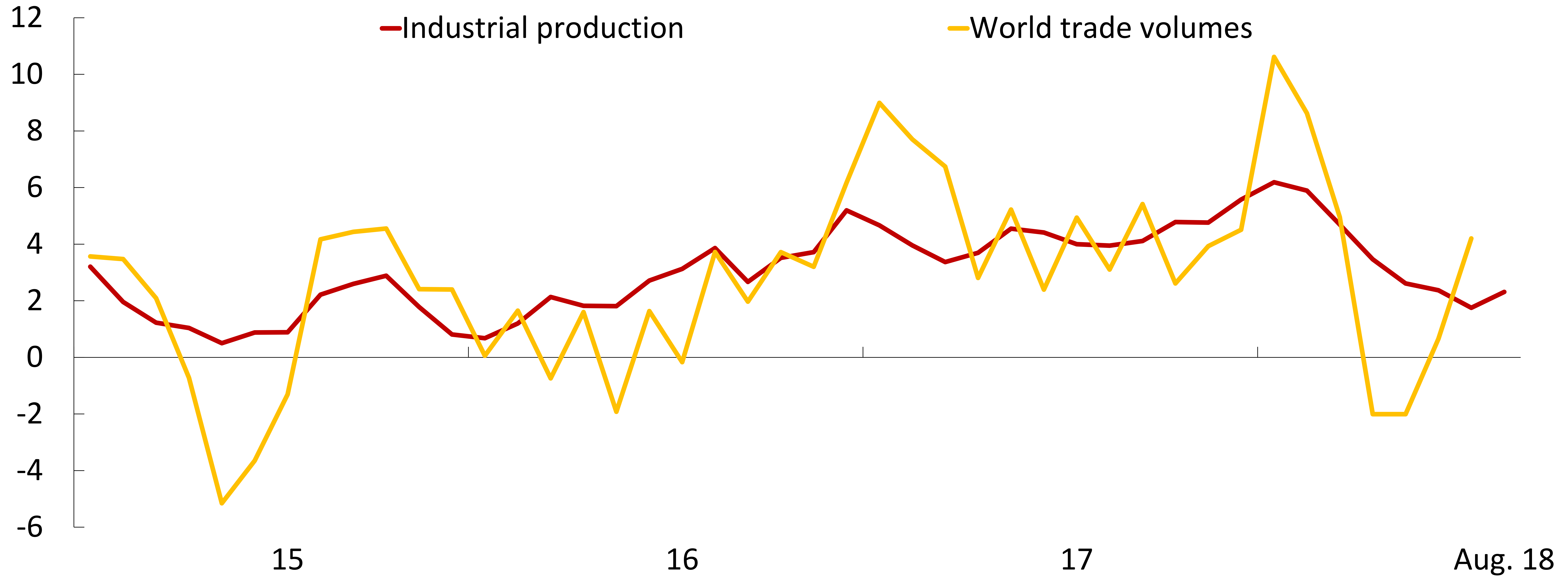
Overview

- Recent Developments
  - Softer, more uneven momentum; global trade slowed in 2018 H1, after rapid growth last year
  - Higher oil prices have lifted headline inflation; core generally remains subdued
  - Financial conditions tightened for some EMs, but remain broadly accommodative
  - Sentiment generally strong; some trade-sensitive indicators have weakened
- Outlook
  - Global growth for 2018-19 projected to remain steady at 2017 level, moderating thereafter
  - Advanced economies: above-trend near-term growth, expected to decline into the medium term
  - Emerging markets and developing economies: stable growth into the medium term for the group, differences in regional prospects
- Balance of Risks
  - tilted to the downside in a context of high policy uncertainty

Industrial production and world trade slowed this year….

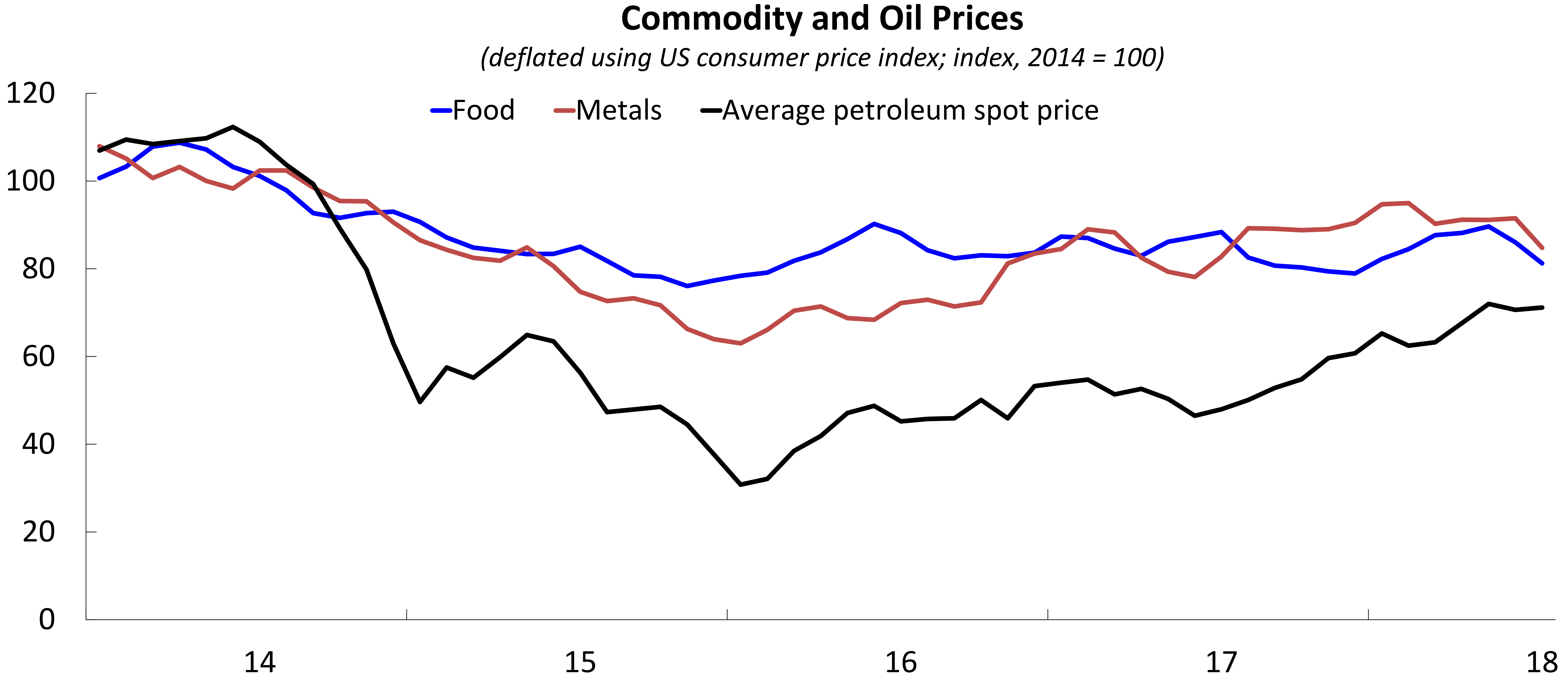
World Trade, Industrial Production

(three-month moving average; annualized percent change)



Sources: Haver Analytics; and IMF staff estimates.

Higher oil prices - mostly reflecting supply factors

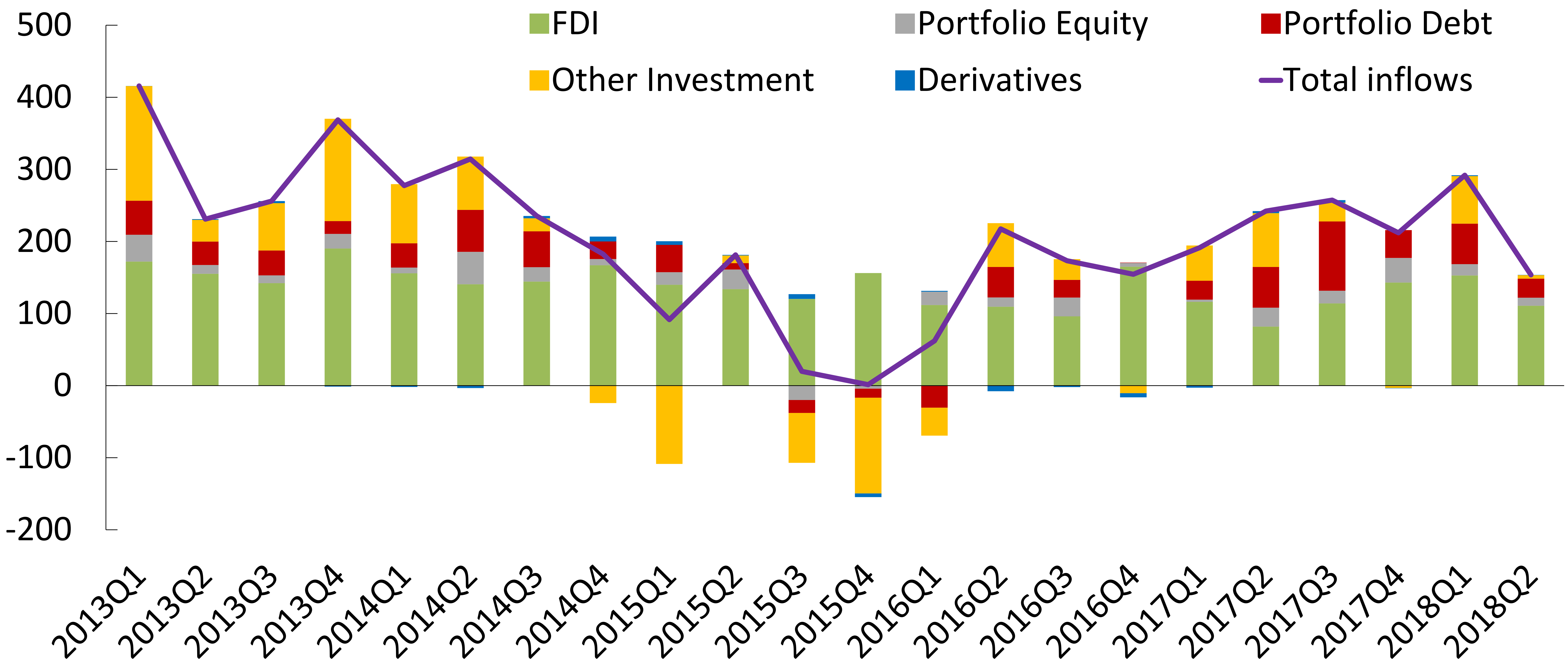


Sources: IMF, Primary Commodity Price System; and IMF staff estimates.

Capital flows to EMs weakened considerably in 2018 Q2

Capital Inflows to Emerging Market Economies

(billions of U.S. dollars)

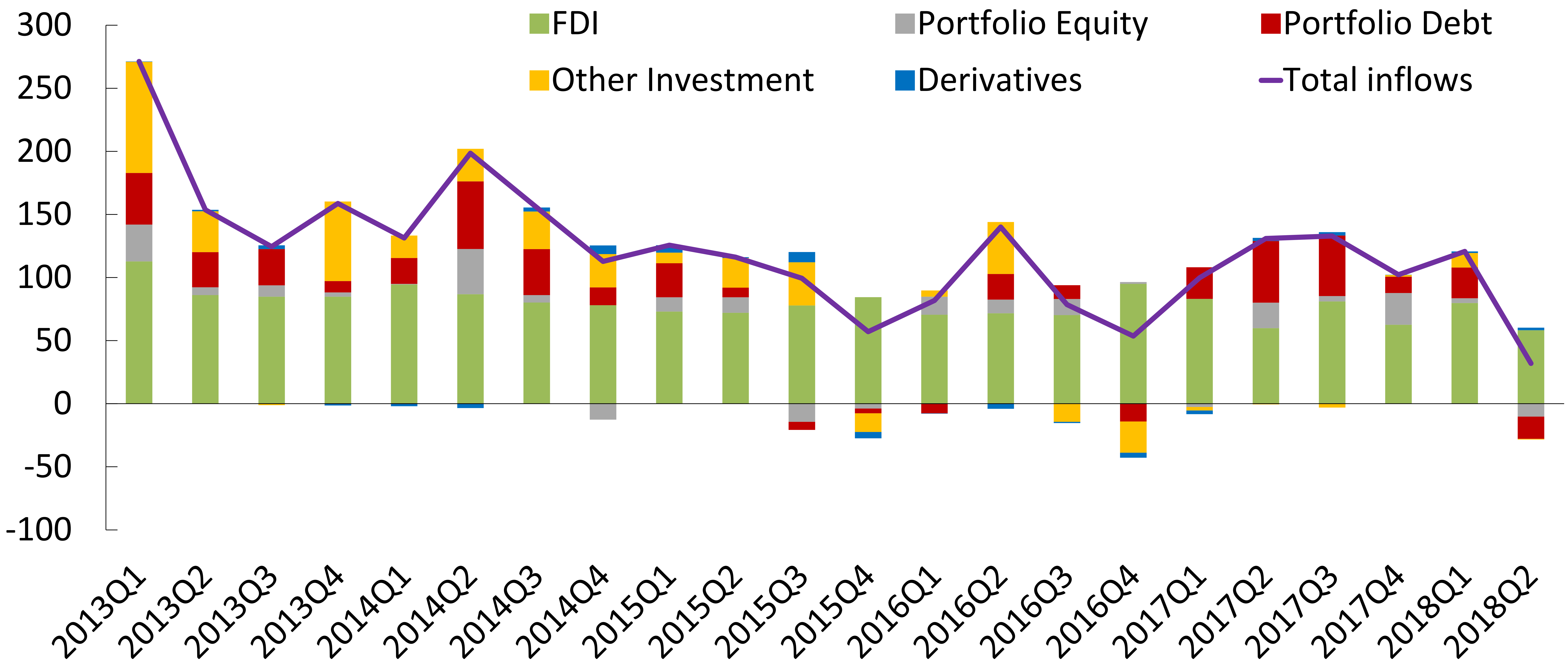


Sources: Haver Analytics, and IMF staff estimates.

Capital flows to EMs weakened considerably in 2018 Q2

Capital Inflows to Emerging Market Economies Excluding China

(billions of U.S. dollars)



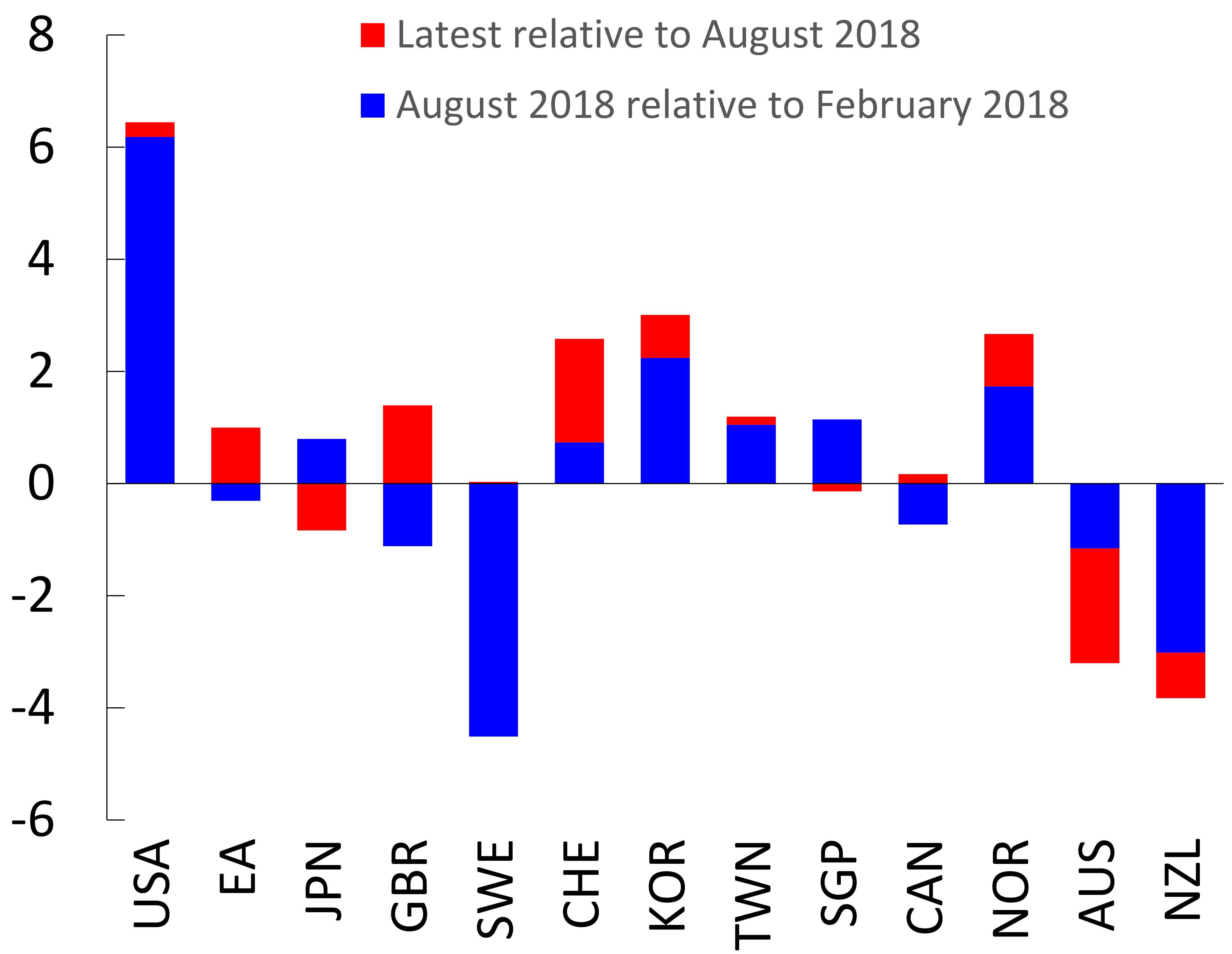
Sources: Haver Analytics, and IMF staff estimates.

Dollar strengthening, weaker EM currencies

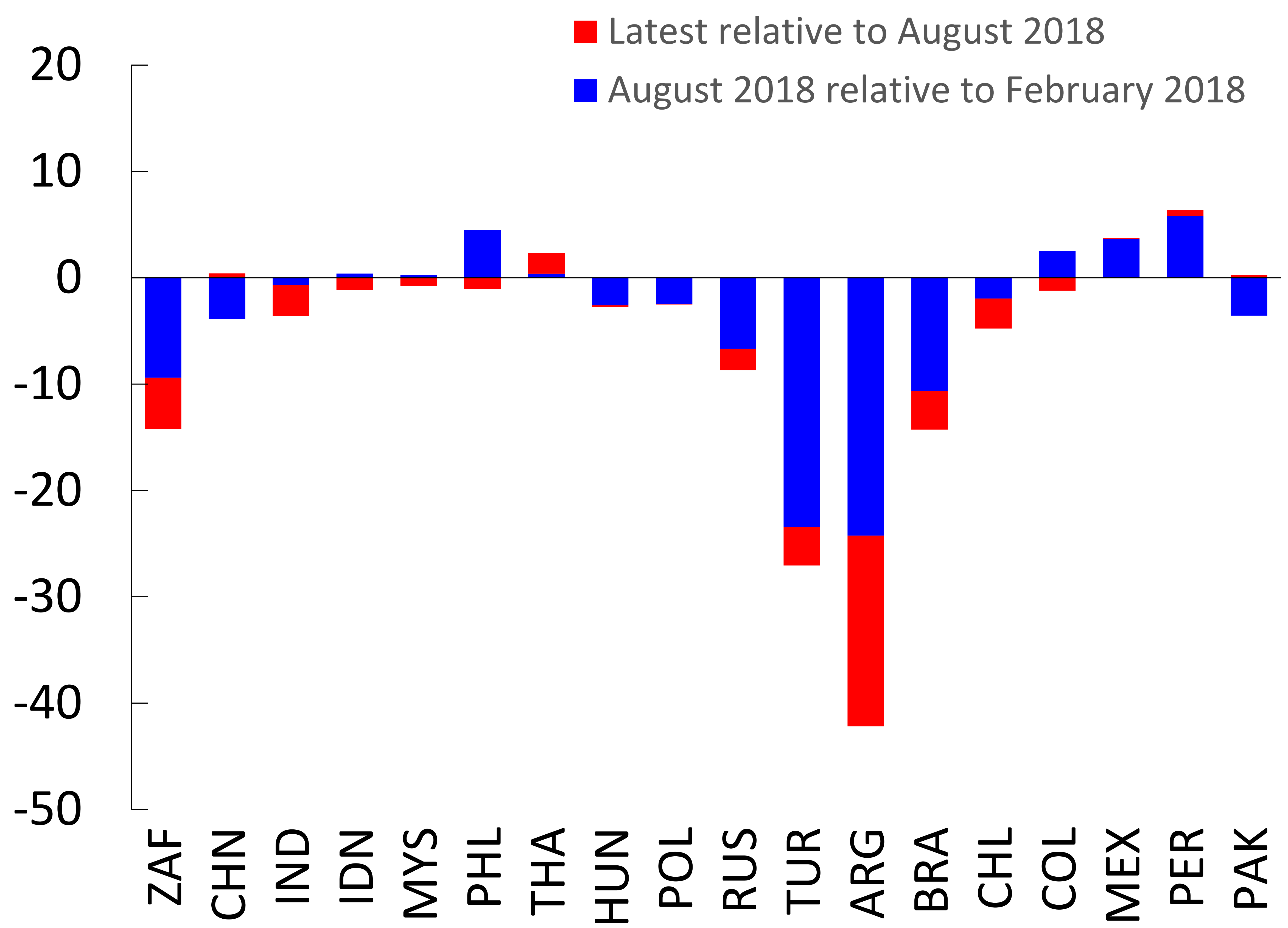
Real Effective Exchange Rate Changes, February – September 2018

(Percent)

Advanced Economies



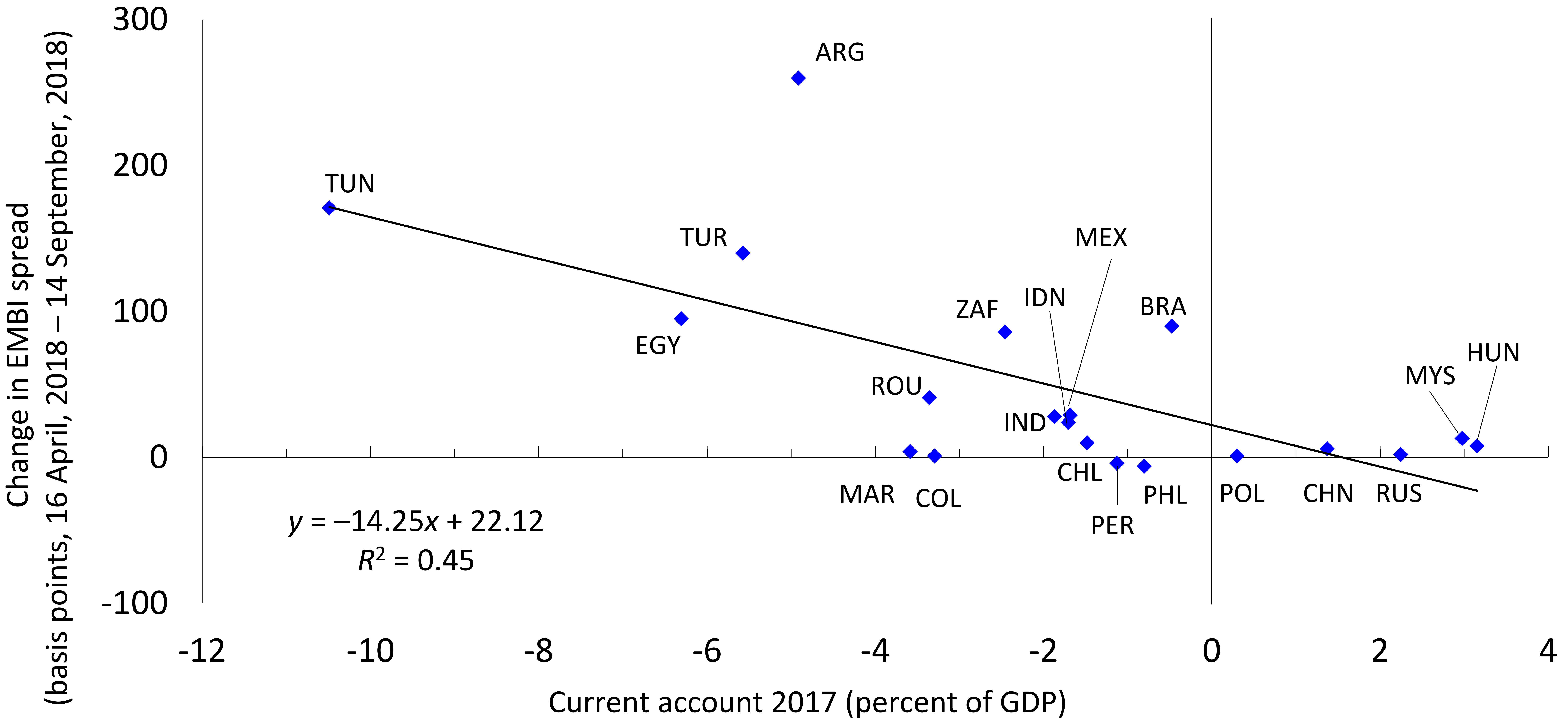
Emerging Market Economies



Source: IMF staff calculations.

Investors are differentiating across EMs: spreads widened more in economies with higher external financing needs

EM: Current Account Balance and Change in EMBI Spreads



Source: IMF staff calculations.

Forces shaping the outlook

near term…

Advanced economies

- Rising trade barriers, policy uncertainty
- Diverging cyclical positions
- Global effects of US fiscal policy changes
- Generally accommodative monetary policy

Emerging market and developing economies

- Rising trade barriers, policy uncertainty
- Higher oil prices: diverging prospects for fuel exporters and importers
- Localized financial market pressures
- Idiosyncratic factors – political uncertainty, conflict

…medium term

Advanced economies

- Demographic headwinds
- Lackluster productivity growth

Emerging market and developing economies

- Group aggregate: growth stabilization close to current level; offsetting regional prospects
- 45 EMDEs, accounting for 10 percent of global GDP (PPP), falling further behind AE income levels over projection horizon

Growth projections: Advanced economies

(percent change from a year earlier)

	World	Advanced Economies	U.S.	U.K.	Japan	Euro Area	Germany	Canada	Other Advanced Asia
2017	**3.7**	**2.3**	**2.2**	**1.7**	**1.7**	**2.4**	**2.5**	**3.0**	**3.0**
2018	**3.7**	**2.4**	**2.9**	**1.4**	**1.1**	**2.0**	**1.9**	**2.1**	**3.0**
Revision from Apr. 2018	–0.2	–0.1	0.0	–0.2	–0.1	–0.4	–0.6	0.0	0.2
2019	**3.7**	**2.1**	**2.5**	**1.5**	**0.9**	**1.9**	**1.9**	**2.0**	**2.6**
Revision from Apr. 2018	–0.2	–0.1	–0.2	0.0	0.0	–0.1	–0.1	0.0	–0.2

Sources: IMF, *World Economic Outlook* October 2018; and IMF, *World Economic Outlook* April 2018.

Growth projections: Emerging markets and LIDCs

(percent change from a year earlier)

	Emerging Market and Developing Economies	China	India	Brazil	Russia	ASEAN-5	Commodity Exporting Economies	Low Income Developing Countries
2017	**4.7**	**6.9**	**6.7**	**1.0**	**1.5**	**5.3**	**2.2**	**4.7**
2018	**4.7**	**6.6**	**7.3**	**1.4**	**1.7**	**5.3**	**2.1**	**4.7**
Revision from Apr. 2018	–0.2	0.0	–0.1	–0.9	0.0	0.0	–0.8	–0.3
2019	**4.7**	**6.2**	**7.4**	**2.4**	**1.8**	**5.2**	**2.6**	**5.2**
Revision from Apr. 2018	–0.4	–0.2	–0.4	–0.1	0.3	–0.2	–0.6	–0.1

Sources: IMF, *World Economic Outlook* October 2018; and IMF, *World Economic Outlook* April 2018.

Risks: tilted to the downside

- Potential for upside surprises has receded, downside risks have become more pronounced
- Sequence of tariff actions
  - Has set the stage for possible further escalation of tensions to an intensity that carries systemic risks
  - Escalation could severely dent business confidence, harm financial market sentiment and increase volatility, slow investment and trade
- Financial conditions
  - Despite some localized pressures in EMs, financial conditions have generally remained easy
  - Could tighten sharply (for example, sparked by trade actions, higher political and policy uncertainty, or inflation surprise in US)
  - Sudden tightening would expose financial vulnerabilities accumulated over years of ultralow interest rates
- Other factors
  - Geopolitical strains
  - Declining trust in mainstream political parties, regional and national institutions
  - Climate shocks
- Interlinked risks could exacerbate effects: materialization of one could trigger realization of others

Narrowing window of opportunity for implementing reforms to lift potential growth and contain vulnerabilities

Advanced economies

- Monetary policy: support closing of output gaps where needed; gradually normalize where inflation is rising toward target
- Orient fiscal policy more toward medium-term goals
  - Start rebuilding buffers where needed
  - Shift budget composition to lifting potential growth and enhancing inclusiveness (infrastructure, workforce skills, participation rates)
- Structural reform policies to boost potential and ensure benefits shared widely

Emerging market and developing economies

- Priorities differ based on diverse cyclical positions and country-specific vulnerabilities
- Common objectives: bolster financial resilience, boost potential growth and enhance inclusiveness
- Strengthen fiscal positions where needed (particularly LIDCs, commodity-dependent economies), focusing on revenue mobilization, limiting recurrent expenditure, and curbing poorly-targeted subsidies
- Promote economic diversification (commodity exporters, countries particularly vulnerable to climate events) – judicious macro management, improving access to credit, investing in infrastructure and workforce skills

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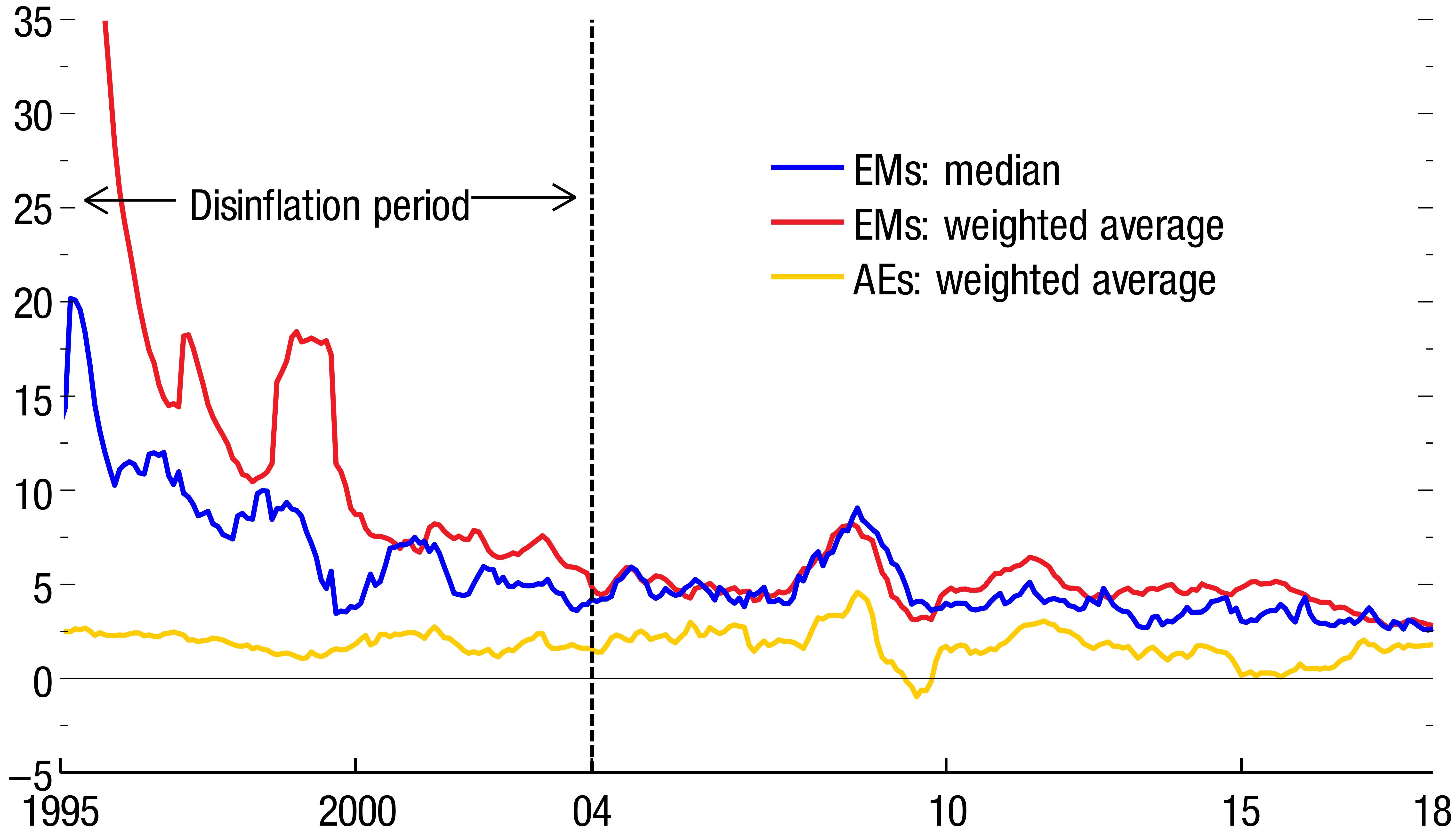
Challenges for Monetary Policy in EMs as Global Financial Conditions normalize

Rudolfs Bems, Francesca Caselli, Francesco Grigoli, Bertrand Gruss, and Weicheng Lian,
With support from Ava Yeabin Hong, Jungjin Lee, Cynthia Nyakeri, and Jilun Xing

Inflation in EMs since the Mid-2000s: Low and Stable

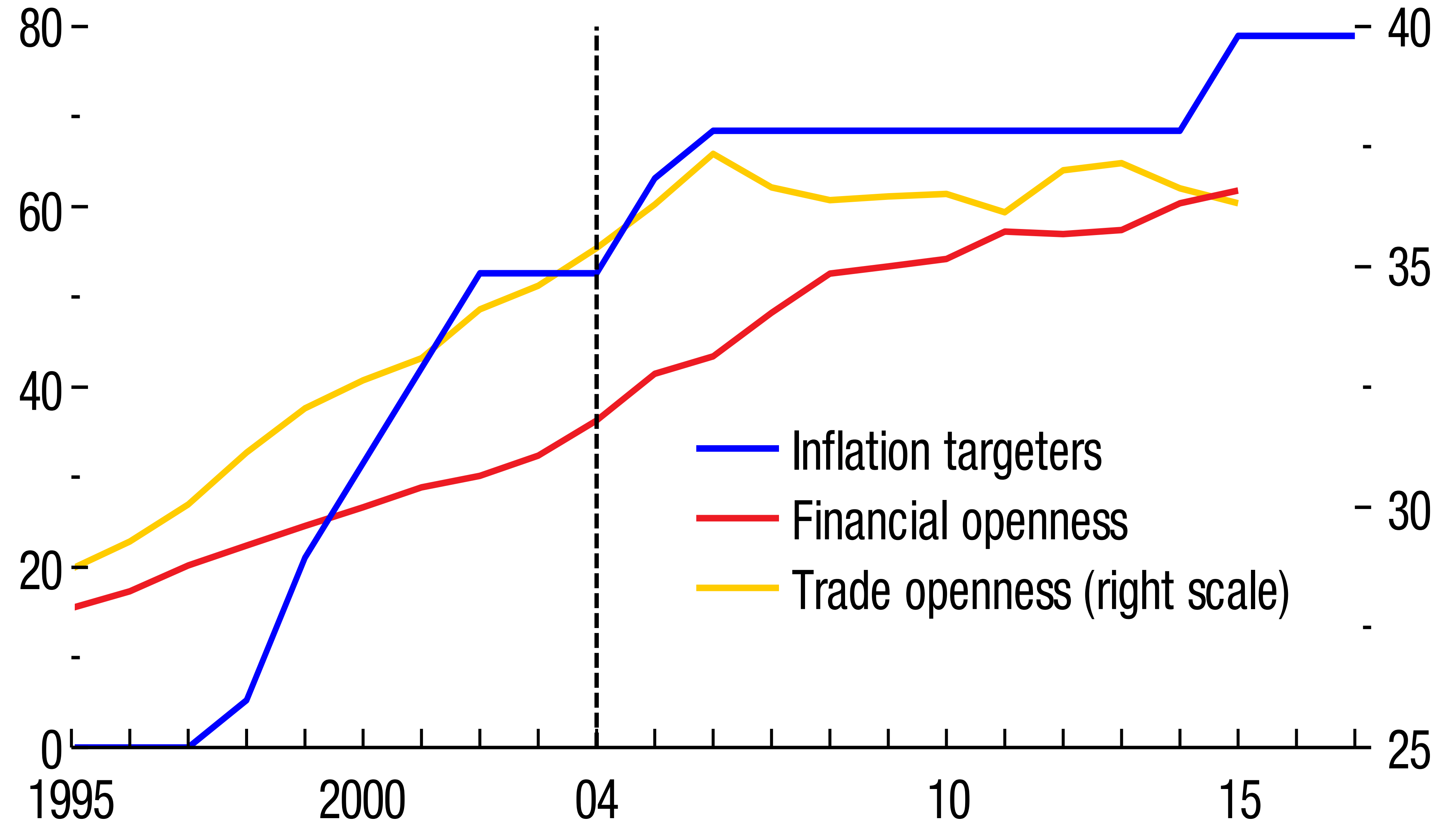
Headline Consumer Price Index Inflation (Percent)



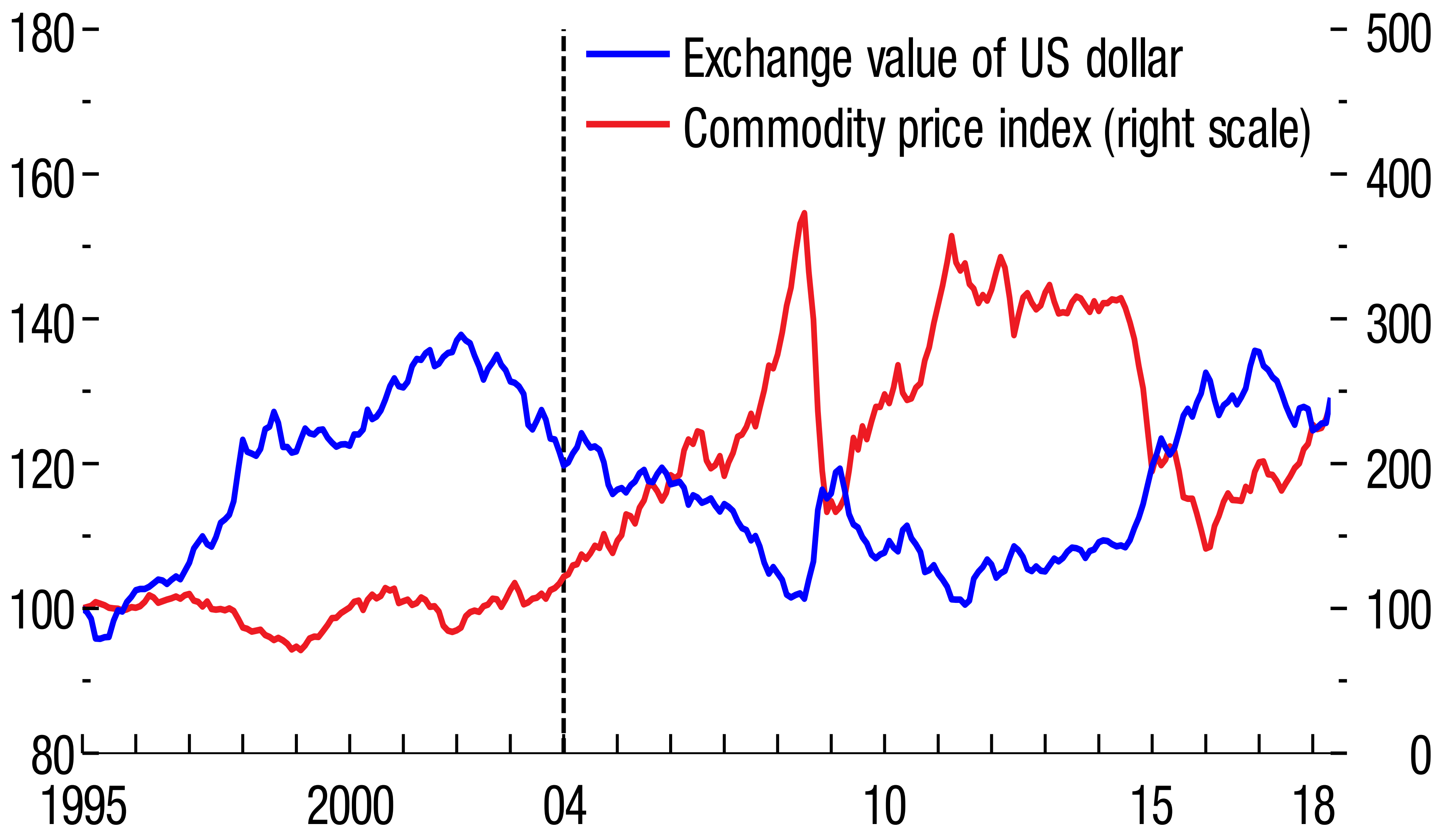
Sources: Haver Analytics; and IMF staff calculations.
Note: AEs = advanced economies; EMs = emerging markets. Weighted average is constructed using weights of nominal GDP, expressed in US dollar terms, for 2010–12. The vertical dashed line distinguishes the disinflation period from the rest of the sample.

Institutional and Policy Changes. Large Global Shocks

Inflation Targeting and Openness in EMs (Percent)



Global Shocks (Index)



Sources: Haver Analytics; JPMorgan Emerging Market Bond Index; Lane and Milesi-Ferretti (2018); and IMF staff calculations.
Note: EMBIG = emerging market bond index global; EMs = emerging markets. Inflation targeters expressed as percent of countries in the sample. Trade openness defined as imports in percent of GDP (five-year moving average). Financial openness defined as the sum of foreign direct investment and portfolio equity liabilities in percent of GDP (five-year moving average). Exchange value of US dollar is the nominal broad trade-weighted exchange value of the US dollar (Jan-95=100). The commodity price index is based on prices in US dollars of a broad set of commodities (Jan-95=100). The vertical dashed line distinguishes the disinflation period from the rest of the sample.

Global or Domestic Factors? Anchoring of Inflation Expectations

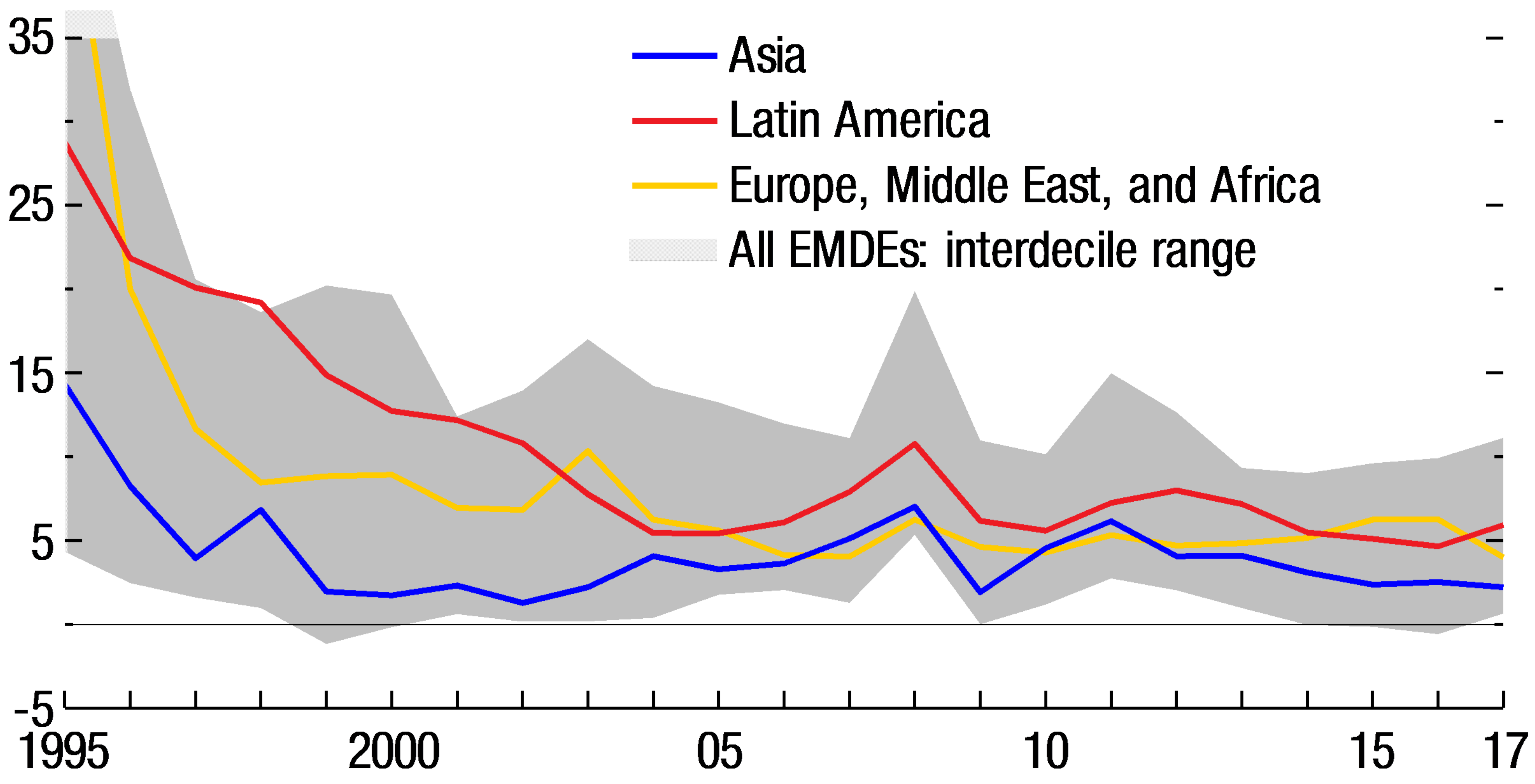
1. Will the gain in inflation stability diminish when global conditions shift?

2. How has the anchoring of inflation expectations in EMs evolved in recent decades?

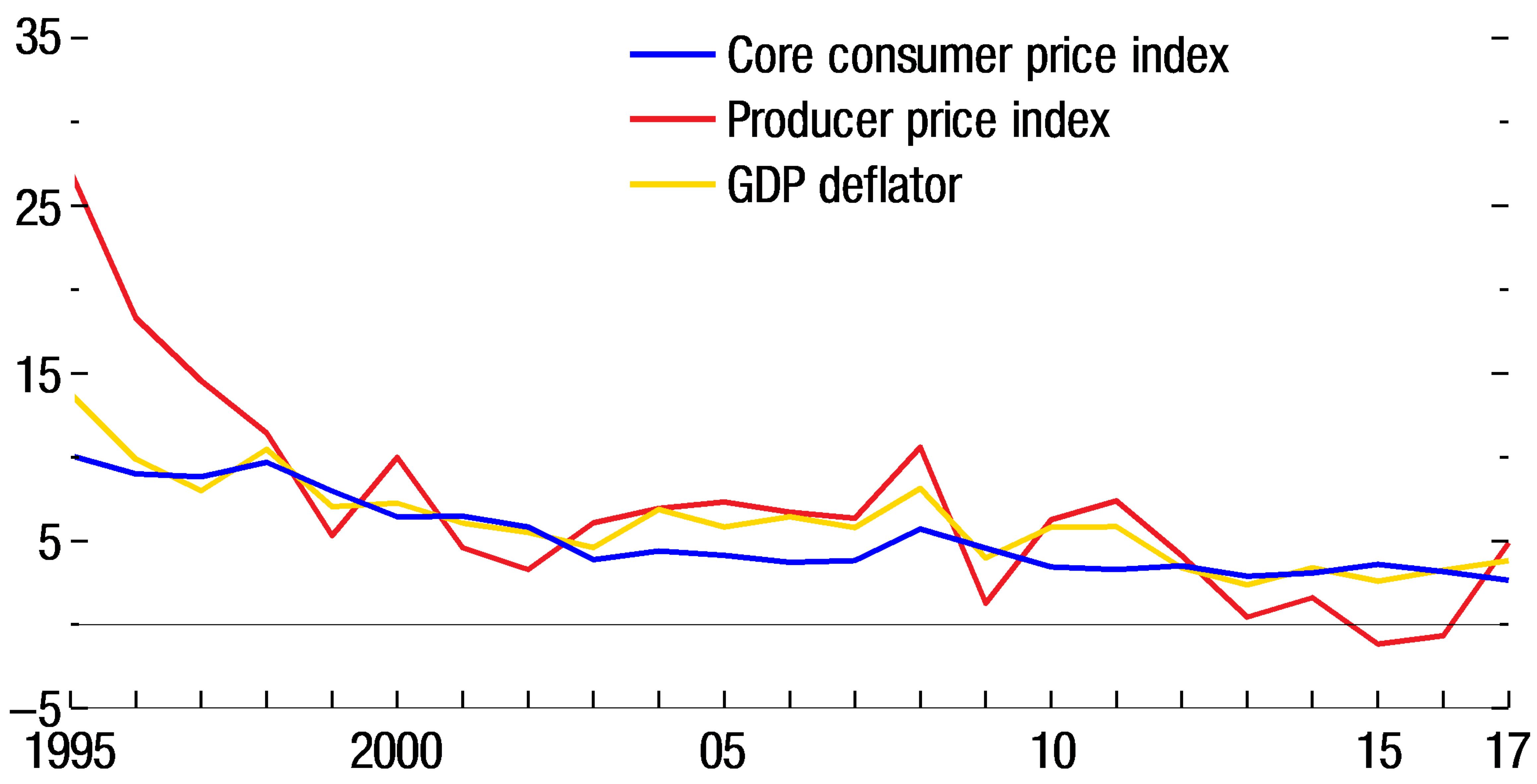
3. What are the implications of more anchored inflation expectations for monetary policy?

Decline in Inflation: Common across EMs and Measures

Inflation by Region (weighted average, percent)



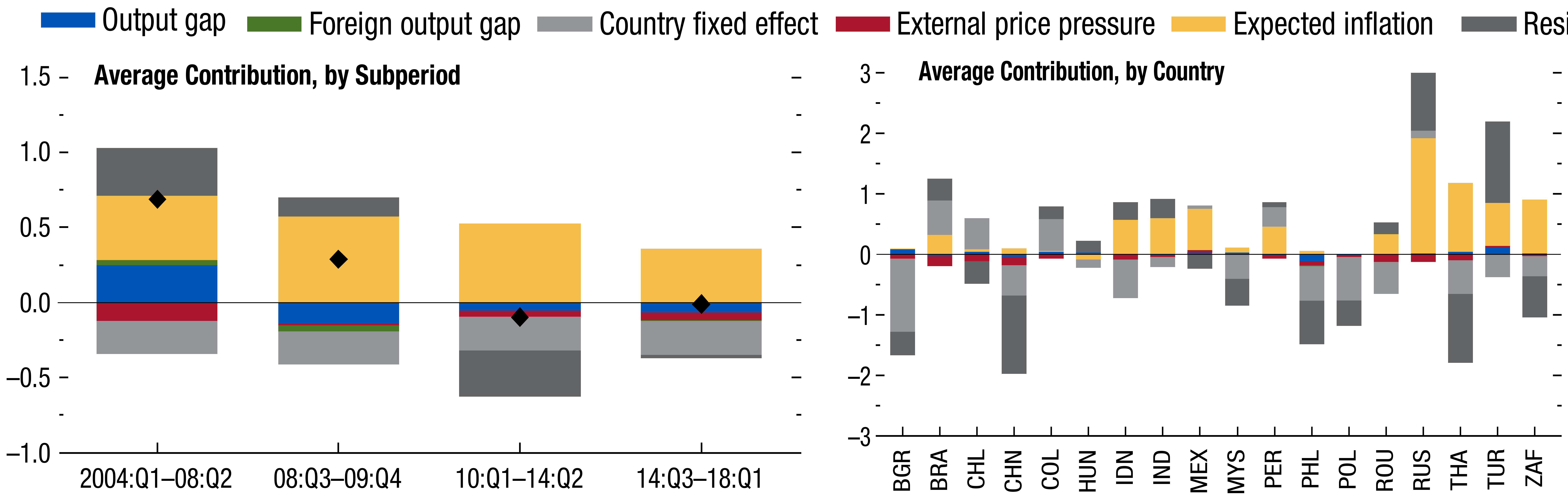
Other Measures of Price Inflation in EMs (Percent)



Sources: IMF staff calculations.
Note: EMDEs = emerging market and developing economies. Lines in right panel denote medians across sample emerging markets of each indicator.

Inflation Level: Expected Inflation, Key Contributor

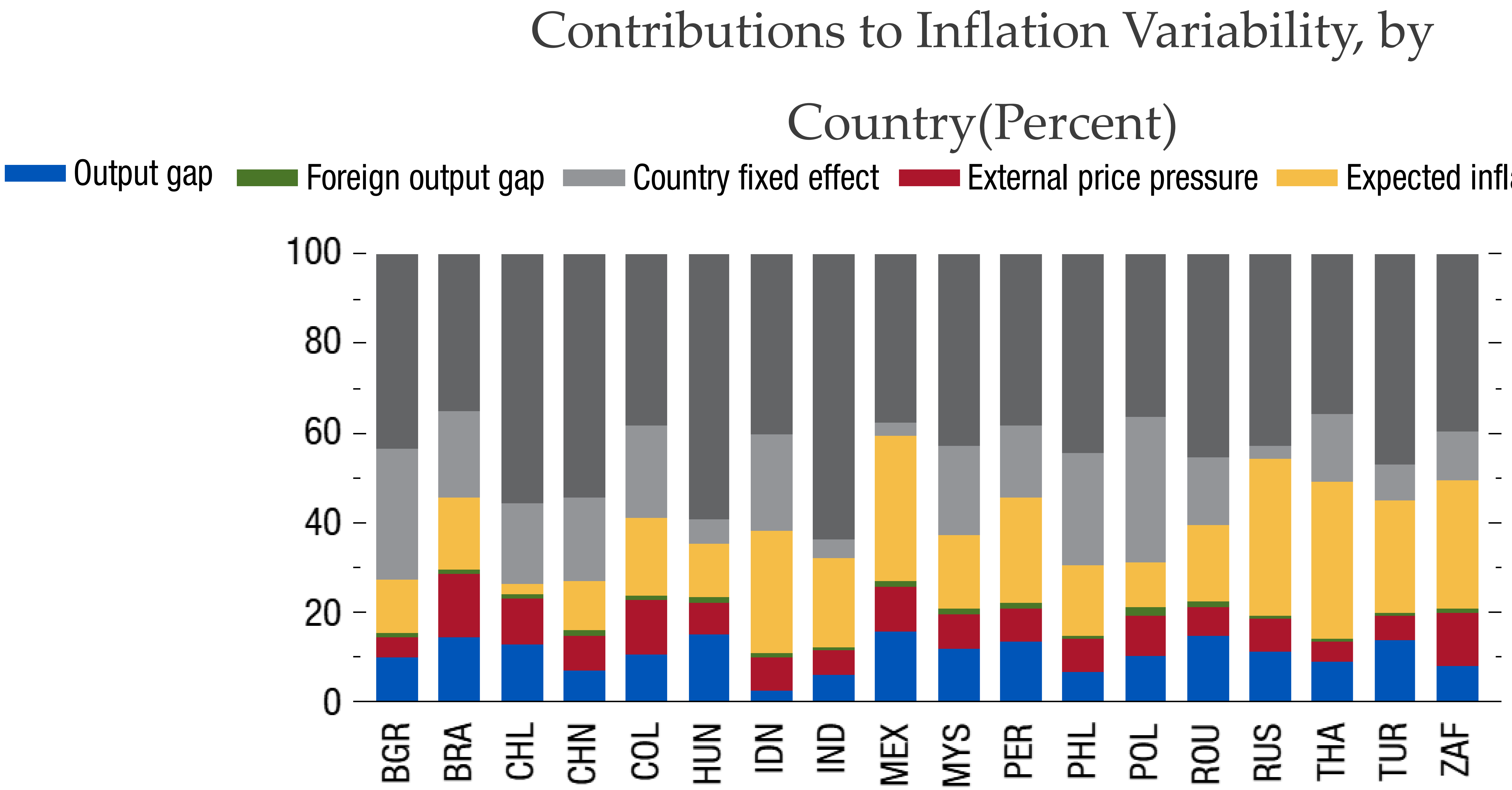
Contributions to Deviation of Core Inflation from Target (Percentage points)



Source: IMF staff calculations.

Note: The bars in left (right) panel represent the simple average contribution of each factor averaged across countries (periods). The diamonds in left panel represent the overall deviation in inflation.

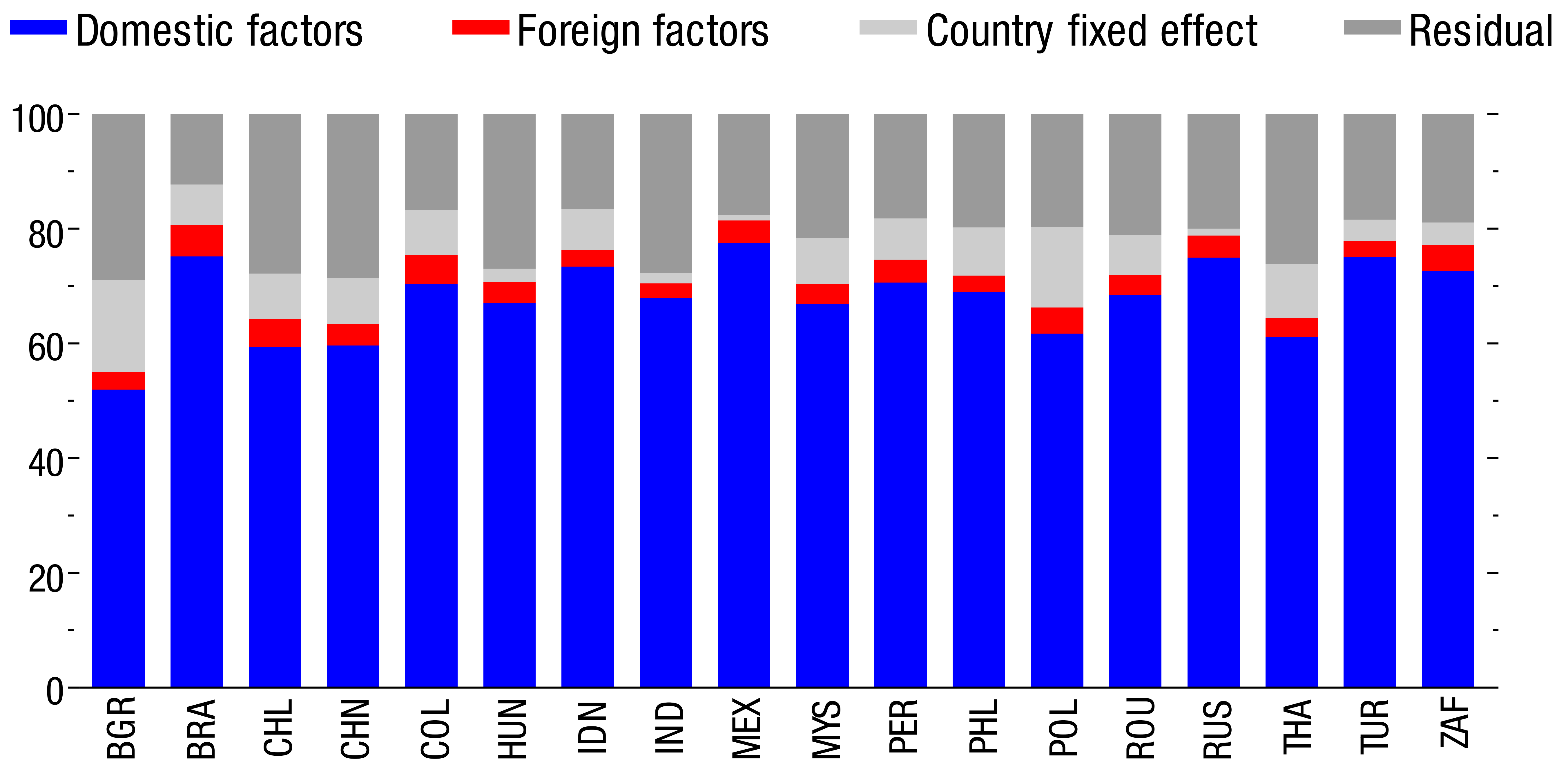
Inflation Variability: Expected Inflation, Largest Contributor



Source: IMF staff calculations.
Note: The figure shows the simple average of the absolute values of country-specific contributions across periods, expressed as percent of the overall deviation of core inflation from target.

Inflation Dynamics: Mostly Domestic Factors

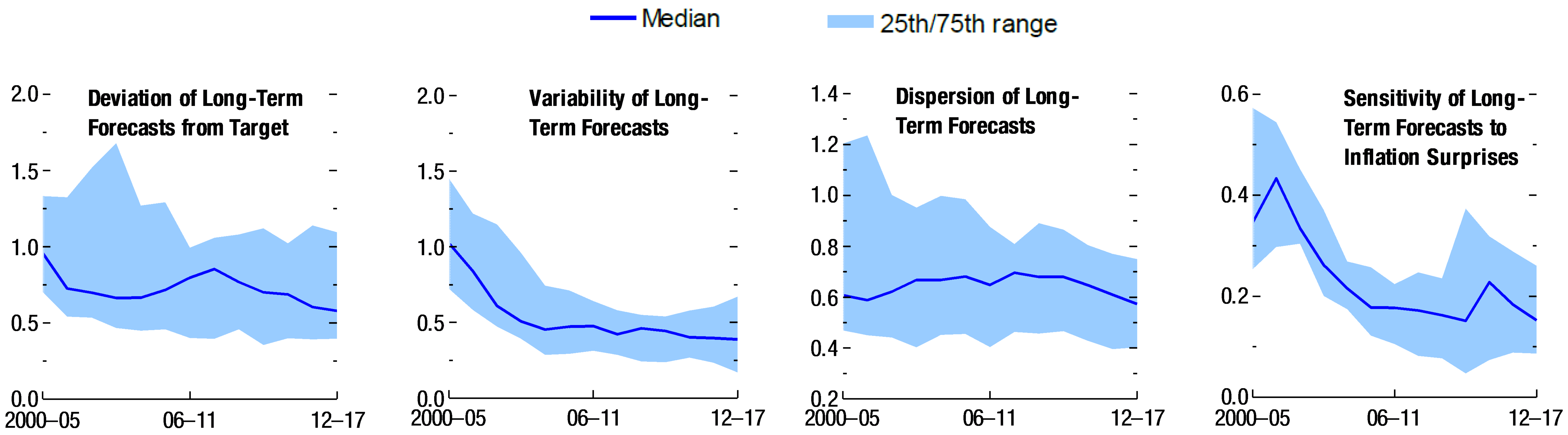
Contribution of Domestic and Foreign Factors to Core Inflation Dynamics (Percent)



Source: IMF staff calculations.
Note: Domestic factors include inflation expectations and the output gap. Foreign factors include external price pressure and foreign output gap.

Inflation expectations are increasingly anchored in EMDEs…

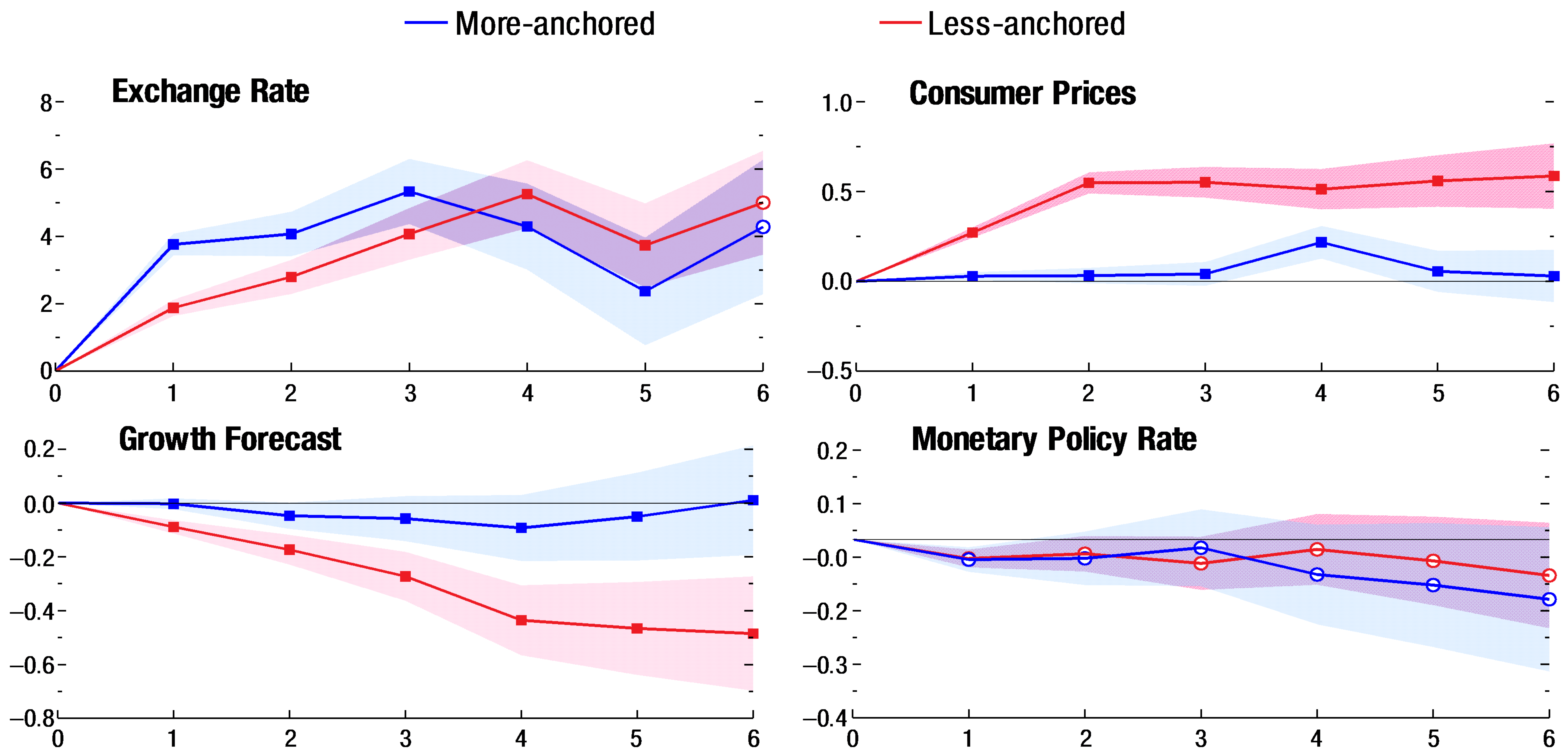
Evolution of the Degree of Anchoring of Inflation Expectations, 2000-17
(Percent)



Source: IMF staff calculations.
Note: The figure shows the evolution of the degree of anchoring of inflation expectations over six-year rolling windows. The lines denote the median across countries. The shaded areas denote interquartile ranges. The measures on the degree of anchoring of inflation expectations are defined in Annex 3.3. In all panels lower values denote more-anchored inflation expectations.

Economic Resilience to Adverse External Shocks: Anchoring Matters

Response of Key Macro Variables to the Taper Tantrum (Percentage points)

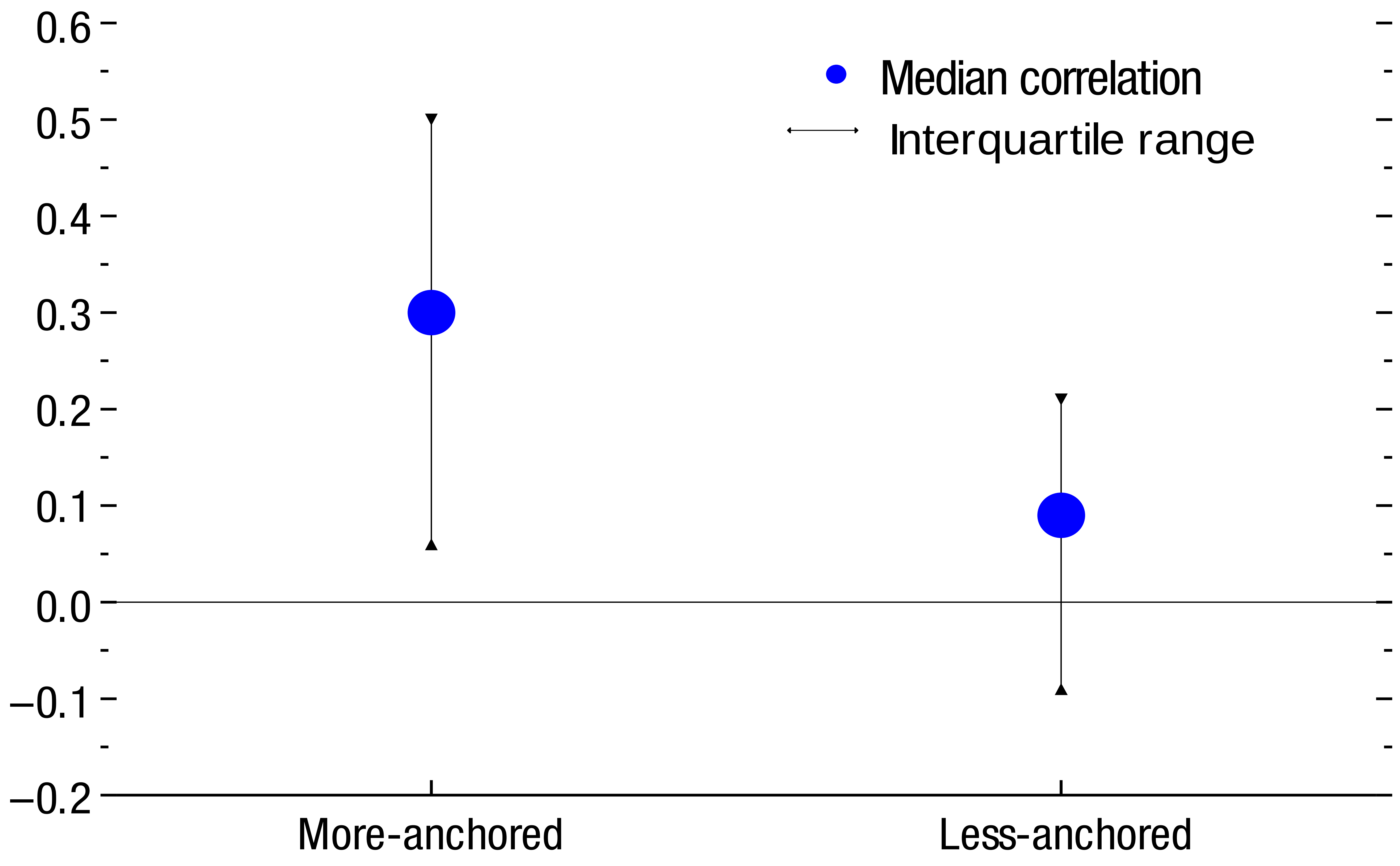


Source: IMF staff calculations.
Note: The figures show the cumulative impulse response to the taper tantrum episode. An increase in the exchange rate denotes a depreciation. The shaded areas correspond to 90 percent confidence intervals.

Monetary Policy: More Anchored, More Counter-cyclical

More counter-cyclical monetary policy

Correlation between Detrended Policy Rate and Output Gap (Percent)

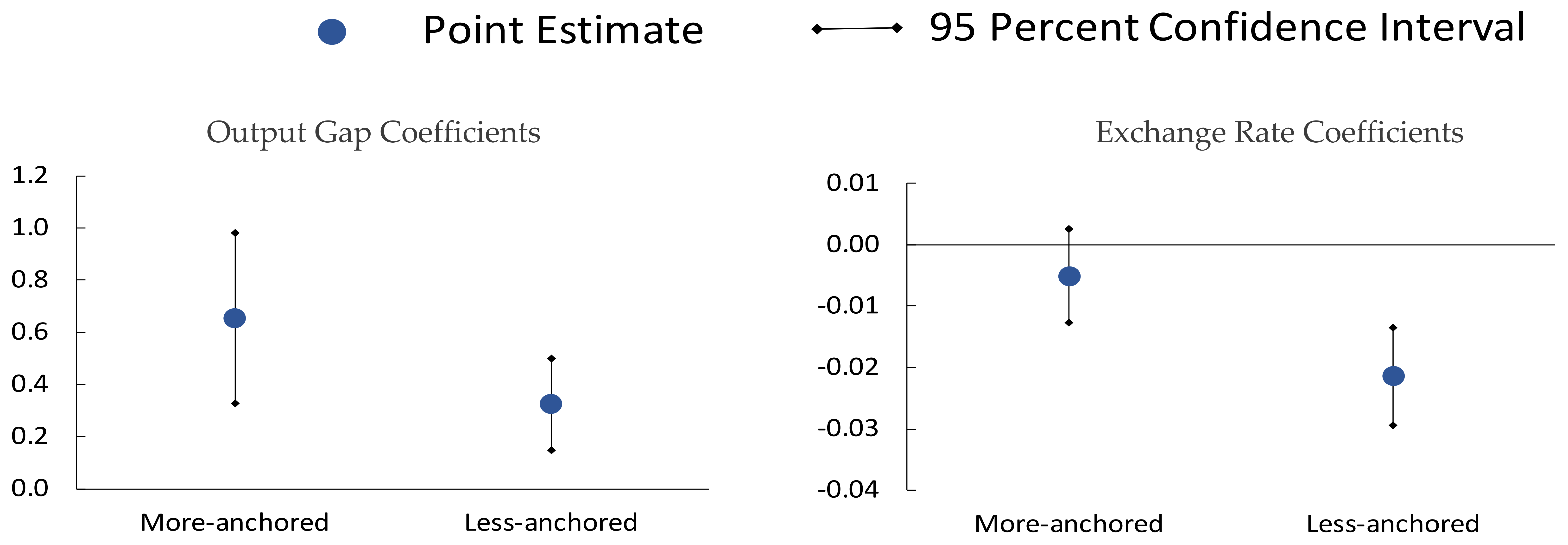


Source: IMF staff calculations.
Note: Detrended policy rate is defined by using a HP filter to take out the trend of the policy rate. Positive correlation implies an increase in the policy rate when the output gap is positive. Timeframe: 2004Q1-2018Q1.

Monetary Policy: More Anchored, Less Constrained by Currency Depreciation

Estimation of monetary policy reaction functions

More counter-cyclical monetary policy



Monetary policy less constrained by currency depreciation

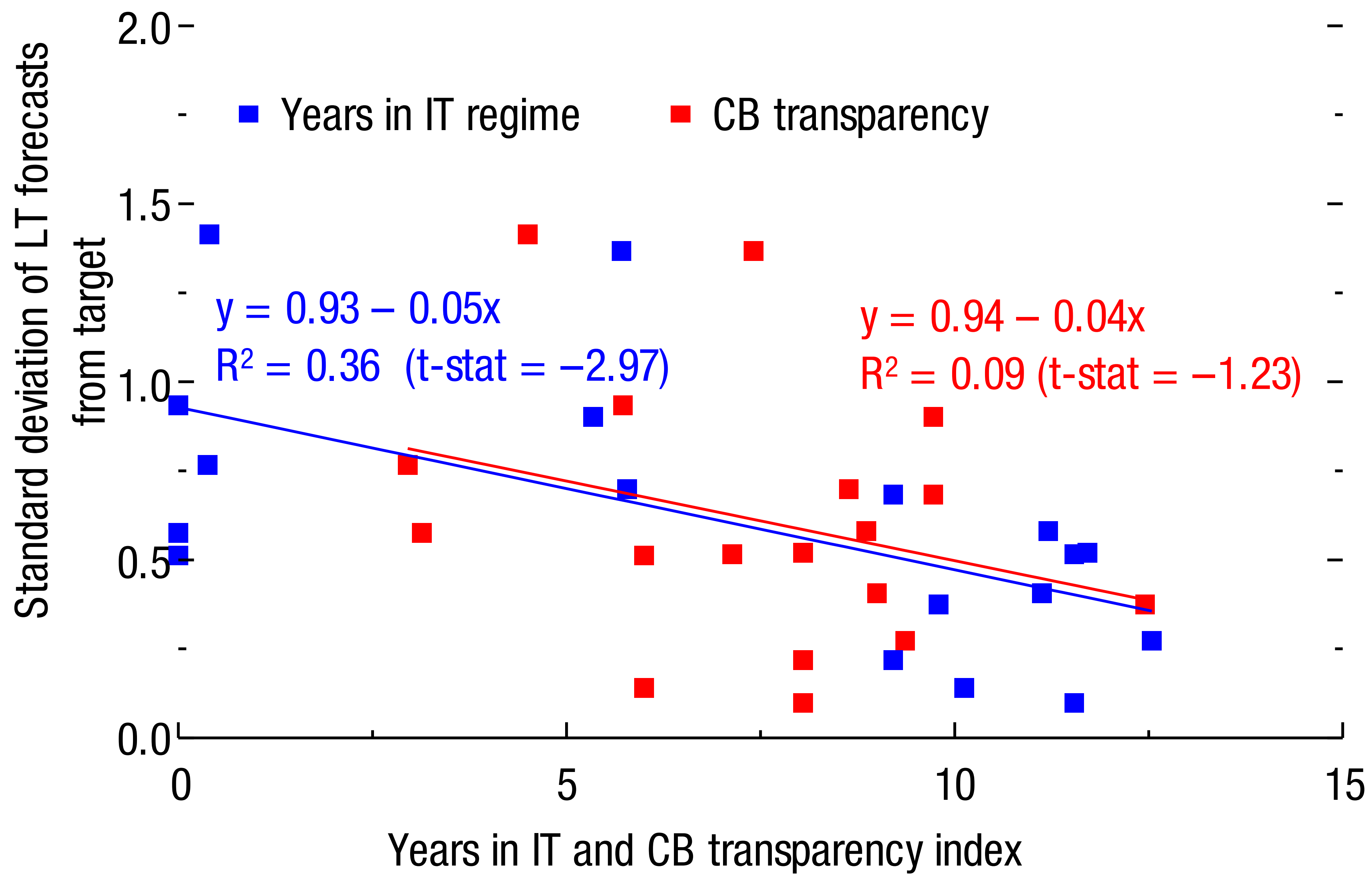
Source: IMF staff calculations.

Note: Positive output gap (exchange rate) coefficients imply an increase in policy rate if the output gap is positive (the currency depreciates). Timeframe: 2004Q1-2018Q1.

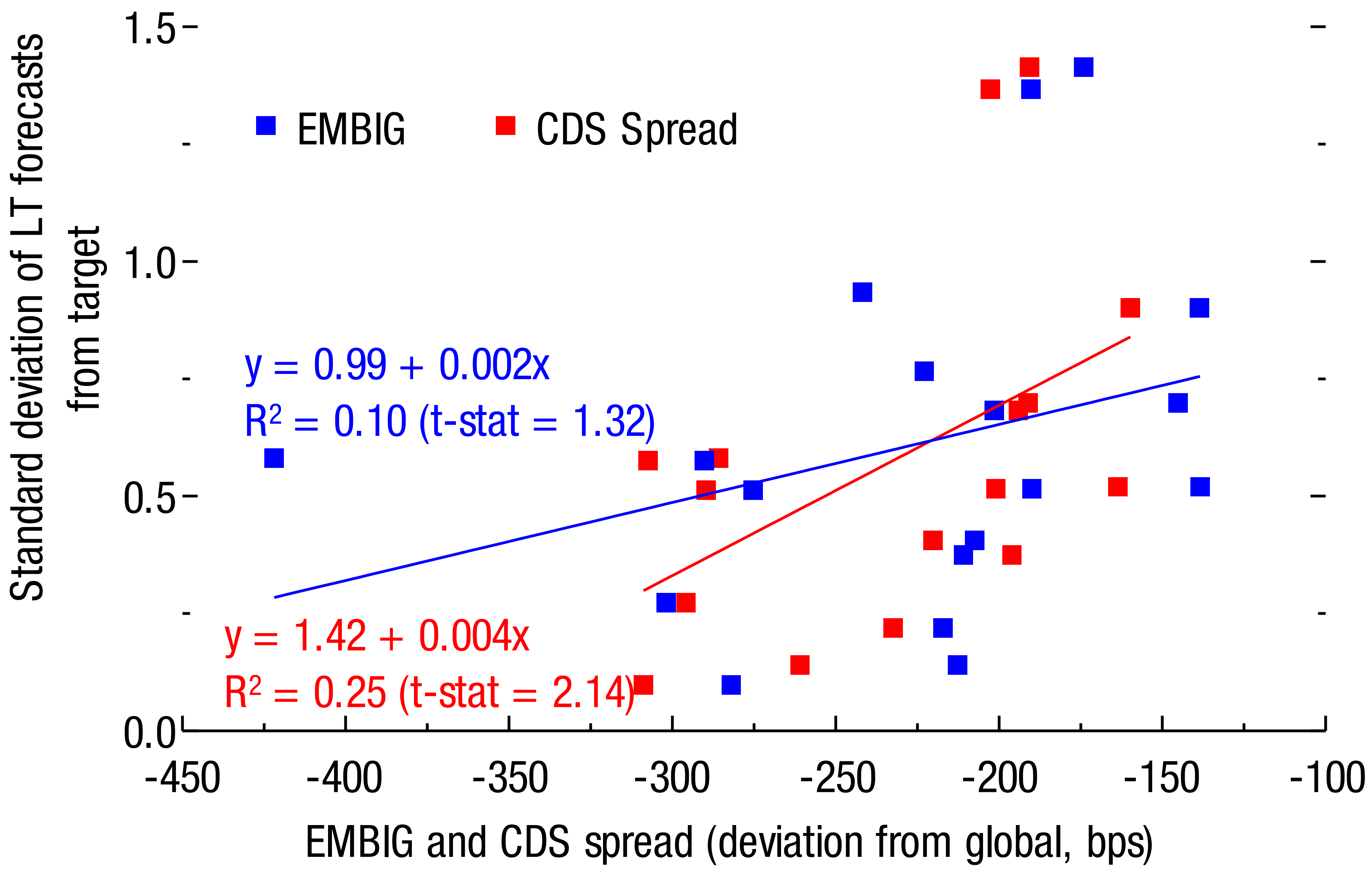
Institution Matters: Fiscal and Monetary Frameworks

Anchoring of Inflation Expectations and Policy Frameworks
(Percent, unless noted otherwise)

Years in IT and CB Transparency Index



EMBIG and CDS Spread



Sources: Dicer and Eichengreen 2014; JP Morgan; Thomson Reuters Datastream; and IMF staff calculations.
Note: bps = basis points; CB = central bank; CDS = credit default swap; EMBIG = emerging market bond index global; IT = inflation targeting; LT = long-term. EMBIG spreads and CDS spreads are the residuals from a regression on time fixed effects. For the CB transparency index higher values indicate higher degree of transparency. Argentina is excluded from the figures as an outlier. Its inclusion would further strengthen the depicted relationships.

Summary

Fluctuations in inflation expectations are a key determinant of inflation dynamics in EMs

Degree of anchoring of inflation expectations has improved, but sizable heterogeneity in anchoring across EMs remains

Better-anchored inflation expectations

1. Reduce inflation persistence
2. Improve monetary policy trade-offs and economic resilience to adverse external shocks

Policy Implications

EMs are not bystanders to global forces

Strengthen the long-term sustainability of public finances

1. fiscal rules
2. preserving and rebuilding fiscal buffers when necessary

Improve the credibility of central banks

1. independence of central banks
2. timeliness, clarity, transparency, and openness in communications