Growth and economic policies: a look to the future

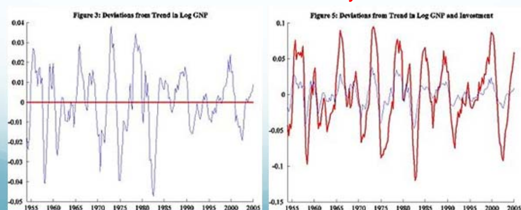
Lecture 6

Summary of previous lectures

The business cycle

MACROECONOMICS FOCUSES ON THE EXPLANATIONS FOR THE CYCLICAL VARIATIONS IN THE RATE OF GROWTH OF NATIONAL INCOME RELATIVE TO ITS LONG TERM RATE OF GROWTH

- Why do business cycles take place?
- What are the causes of business cycles?



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The theory of business cycles: Fisher – Minsky theory

1. **Inflation** depends on **growth of money**
2. **Asset bubbles** (and crashes) depend on **growth of** (decline in) **credit**

- **Instability is an inherent and inescapable flaw of capitalism** because it originates in the very financial institutions that make capitalism possible
- **The financial system** necessary for capitalist vitality and vigour – which translates entrepreneurial spirits into effective demand for investment – **contains the potential for runaway expansion, powered by an investment boom**. This runaway expansion can readily grind to a halt because accumulated financial excesses (high leverage, excessive debt) render the **financial system fragile**
- **Paradox**: **Financial stability can be destabilizing** (because it is extrapolated too far and therefore induces investors to "overprice"/"overtrade" risky assets and underprice "risk")
- **The debate between monetarists and Keynesians ignores the instability of credit and the fragility of the banking system, the negative impacts on production and prices when the credit system becomes paralyzed by defaults caused by price declines**: both school of thought take the well functioning of the "financial plumbing" of the economy for granted, which we will see its never the case during a crisis

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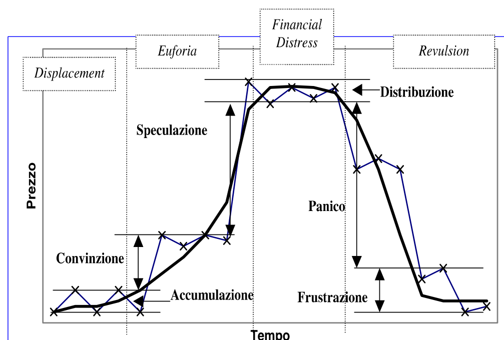
The Phases of a Financial Crisis



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Business Cycles & Financial Crisis: the three key elements

Business cycles leading to financial crisis are characterized by three elements:

1. **Changes in trade patterns**, due to:
   - New entrant(s) in the world markets (typically exploiting a "comparative advantage") [in the past: end of wars]
   - Lowering of trade tariffs
   - Change in terms of trade
2. **Technological innovation(s)**
3. Credit growth/unsustainable **increase in leverage**, often accompanied by financial liberalization/innovation

Crises are not "Black Swans" but "White Swans", **with remarkably predictable elements of boom and bust** (as illustrated in Reinhart-Rogoff "This time is Different")

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Challenges of modern economic development: the **structural response**

- **Modern economic development is a process of continuous structural change**: as EM accumulate factor endowments and their comparative advantage is upgraded they become competitive in more capital intensive and technologically sophisticated industries and start competing with DM also in these more advanced sectors
- **DM governments, especially in Europe but sometimes also in US, often resist market forces in the reallocation of labour to new sectors and industries, where DM maintain a competitive advantage**
- Such structural changes do not happen spontaneously and the public sector should be proactive in assisting the private sector and individuals to keep up with the changes
- DM, situated on the global technology and industrial frontier, should rely on creative destruction or the invention of new technologies and products for technological innovation and industrial upgrading
- DM governments adopt various measures to **support technological innovation, industrial upgrading and diversification**. They also should **build infrastructures** in key economics sectors such as transportation and IT networks **and provide financing for education and training** to build and upgrade the country's skill base in many advanced industries

DM governments should focus on "structural" issues, not just provide "cyclical" responses

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The **"cyclical" response**: "Let them eat credit"

- The difficult political answers to problems of "structural" unemployment and of rising income inequalities in DM would **require policymakers to tackle structural reforms of the education system and of the social security system** (both unemployment and health care benefits) as well as **changes in taxation and redistribution of incomes**: for most professional politicians the equivalent of "committing suicide"
- **The easy way out** – as in the past – has been to **increase access to credit and leverage**
- **Easy credit has large, immediate, positive and widely distributed benefits, whereas the costs lie in the future**: the ideal solution for politicians!
- **Affordable housing for low income groups** was the obvious, bi-partisan answer in the US: Fannie and Freddie the channels for the transmission of this policy
- Expansion of credit is a systematic development due to efforts to reduce transaction costs and holding of liquidity and money balances
- History of money is a story of continuing innovations so that the existing supply of money can be used more efficiently and of developments of close substitutes for traditional money in order to circumvent formal requirements applied to money
- **Innovation in financial instruments**
  - Derivatives
  - Structured credit
  - Credit Default Swaps
- **Innovation in the structure of the financial sector**
  - The "regulated" banking system
  - The "unregulated" shadow banking system

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The Shadow Banking System (SBS)

- **Credit, maturity, and liquidity transformation - the three functions of credit intermediation - are are three independent concepts. They are normally "lumped" together on the balance sheets of banks, but the securitization-based shadow credit intermediation process allows the separation of these three functions**
- **The SBS** can thus be interpreted as a system which **reallocates the three functions of banks across a variety of specialist, non-bank financial intermediaries, each of which has a distinctive comparative advantage**
- Unlike in the traditional banking system, however, in the SBS savers do not place their funds with banks, but rather with MMFs and similar funds (credit HF) – representing the liabilities of the SB - which offer investors a wide spectrum of seniority and duration, and correspondingly, of risk and return
- **SBS performs it activities without access to "explicit" public support** (e.g. central bank liquidity provisions or public sector credit guarantees): but **in a long and complex value chain where no one takes responsibility for the whole chain, the moral hazard is high** and may lead to the **"too interconnected to fail"** problem
- **Securitization-based credit intermediation potentially increases the efficiency of credit intermediation**. However, it also creates **agency problems** that do not exist when these activities are conducted within a bank. If these agency problems are not adequately mitigated, **the SBS is prone to excessive lowering of underwriting standards and to overly aggressive structuring of securities**

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The systemic risks of the SBS

The financial crisis has highlighted the systemic risks that the SBS can pose:

1. The securitization function to create private "safe" assets broke down, as it became apparent that the process ignored some aggregate risks. The breakdown had significant real and financial spill-overs
2. Collateral intermediation generated systemic risks, notably the inherent instability of the dealer-bank business model with risk of runs by customers and providers of short-term funding (both retail and institutional)
3. There was widespread regulatory arbitrage
4. High procyclicality of SBS (with implications for monetary policy)
5. Fiscal risks associated with crisis management in shadow banking

- The SBS has many links, internally and between the SBS and banks/SIFIs, involving complex contractual arrangements and many implicit commitments (**interconnectedness**)
- The design of financial instruments changes continuously with financial innovation, and the **risks involved in holding those new instruments are often not fully understoo**d by potential investors or even by those who design the instruments.

Complex systems are hard to resolve in times of stress

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Addressing the issues of the SBS

Three possible solutions:

1. Regulating the SBS so as to turn it into the "regulated" banking system
2. Developing dedicated regulations for each type of SB
3. Separating SB from traditional banks by severing links and establishing firewalls, and then leaving SB relatively unregulated

- So far regulators have come up with regulations combining ring fencing and specific SB regulations.
  - Basel III's general higher bank capital and liquidity requirements will enhance systemic stability. Basel III also includes a number of specific elements that should reduce the risks resulting from the SBS, e.g. heavier risk weightings for securitization exposure and off-balance sheet vehicles
  - Many regulatory efforts have involved SB regulations: MMF investment rules have been adjusted, Alternative Investment Fund Management Directive (AIFMD) in Europe and Dodd-Frank law in US have been approved and are in the process of implementation

Properly addressing SBS is still work in progress for regulators and policymakers

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The Great Recession of 2007-08 (GFC)

The roots of the GFC can be traced back to the **piling up of five major bubbles** that preceded it:

1. the "new economy" ICT bubble starting in the mid-1990s and ending with the crash of 2000
2. the real-estate bubble, in large part fuelled by easy access to large amounts of liquidity provided by the active monetary policy of the US Fed (that lowered the Fed rate from 6.5% in 2000 to 1% in 2003-04 in a successful attempt to alleviate the consequence of the 2000 "new economy" crash)
3. the innovations in financial engineering with the CDOs and other derivatives of debts and loan instruments issued by banks and eagerly bought by the market, accompanying and fuelling the real-estate bubble
4. the commodity bubble(s) on food, metals and energy
5. the stock market bubble peaking in October 2007

- As with other past crises, the **warning signs** should have been clearly visible:
  1. Large Trade & Current Account (CA) Deficits
  2. Sustained debt build-ups
  3. Markedly rising asset prices

  when coupled with slowing real economic activity
  are a clear signal of increasing risks of a financial crisis unravelling

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Global Pandemic of the GFC

Even though in late 2007 two large European banks - German IKB and British Northern Rock – had already collapsed, amongst the first victims of the GFC, in September 2008 the German Minister of Finance, Peer Steinbruek, declared: "**This crisis is above all an American problem**".

A few days later much of the **European banking system effectively collapsed** and Germany was forced to bail out the banking giant Hypo Real Estate. Ireland had to issue a very costly blanket guarantee for all liabilities (deposits and bonds) of its biggest financial institutions, other European countries followed suit and Britain effectively nationalized much of its banking system

Conventional wisdom – first promoted by Goldman Sachs analysts - that held that the rest of the world would "**decouple**" from the ailing US **was clearly proven wrong**

An old saying in financial markets states that "**when the US sneezes, the RoW catches a cold**"

The GFC spread globally though several channels:

- Money markets: the complex webs of borrowing and lending that bounds together the international financial system broke down after the Lehman default
- Stock markets: investors sentiment turned negative and the stock markets all over the world became the medium through which investors registered their growing aversion to risk, by dumping equities and piling into "riskless assets" (mainly T-Bills and T-Bonds and "**safe heavens**" currencies like US$ and Yen)
- Trade: letters of credit [that guarantee that goods in transit between trading partners would be paid when they reach their final destination] and trade finance became much more expensive and often unavailable at any price. As a result, **global trade came to a standstill**. At the peak of the crisis, in early 2009, exports were down 30% yoy in China and Germany, 37% in Singapore and 45% in Japan. World trade was 50% lower in 2009 than it 2008
- Commodities: Collapse of international commodity prices, especially oil (that fell to US$ 40 a barrel from over 110$) and copper, throwing commodities-exporting countries into fiscal crises

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"Contagion effect" or "home-grown problems"?

The crisis started in the US but the "**contagion**" **would not have spread to other countries had they also not been suffering from their own underlying vulnerabilities and weaknesses**, often similar to those of the US:

- **Housing prices in many countries around the world had appreciated at a relentless rate**, even higher than in the US: the Economist calculated that the total value of the residential properties in the world's developed economies had doubled from 2000 to 2005. This gain, a stunning $40 trillion, was equivalent to the combined gross GDP of all countries in question
- As house prices went up, households felt wealthier, **spending more and saving less**. The boom in residential property investments boosted these countries' GDP
- Low savings and high consumption and investment rates implies a **negative current account balance**: the imbalances need to be funded by foreign capital, private or public
- Private capital flows are intermediated by the traditional or the shadow banking system: when both systems seized up, the imbalances could not any longer be financed by private capital flows. **Deficit countries were forced to rebalance their trade flows in a very short period of time** - no financing was any more available - or had to resort to official support
- **Public spending as % of GDP in most countries kept growing after 2000**, notwithstanding the favourable growth cycle, but Government budget deficits generally remained well behaved because revenues were boosted by tax receipts linked to the financial and real estate boom. When the economy slowed down, **budget deficit expanded dramatically**
- **Leverage and risk taking was also high in the European banking and financial sector**: leverage ratios at European banks were even higher than their US counterparts (Credit Suisse 33:1, ING 49:1, Deutsche Bank 53:1, Barclays 61:1) and European banks were heavily involved in the financing of many high risk ventures, leveraged buyouts and had even heavily invested in American subprime loans
- Finally European banks had vastly increased cross-border financing, exposing themselves to **sovereign risk**, towards Central and Eastern European countries and towards "peripheral" euro countries

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The euro crisis

- The Euro Crisis reflects primarily the reaction of financial markets to over-borrowing by private households, the financial sector and governments in periphery countries of the Euro Zone (GIPSI - Greece, Ireland, Portugal, Spain, Italy). Yet at the heart of the euro debt crisis is an intra-area balance of payments crisis caused by seriously unbalanced intra-area competitiveness positions and the - largely private - accompanying cross-border debt flows

The euro area faces three interlocking crises that together challenge the viability of the currency union:

1. **a banking crisis** – where banks are undercapitalized and have faced liquidity problems
2. **a sovereign debt crisis** – where a number of countries have faced rising bond yields and challenges funding themselves
3. **a growth crisis** – with both a low overall level of growth in the euro area and an unequal distribution across countries

Crucially, **these crises connect to one another**:
Bailouts of banks have contributed to the sovereign debt problems, but banks are also at risk due to their holdings of sovereign bonds that may face default. Weak growth contributes to the potential insolvency of the sovereigns, but also, the austerity inspired by the debt crisis is constraining growth. Finally, a weakened banking sector holds back growth while a weak economy undermines the banks

Unless policy responses take into account the interdependent nature of the problems, **partial solutions will likely be incomplete** or even counterproductive

The euro area lacks:

- an institutional framework to deal with banking problems at the supranational level (that is, at the level of the entire euro area instead of at the national level)
- a unified debt market and as such, investors who want to hold euro area debt to must pick and choose amongst various national debt issues, making a possible default of one of the nation states more consequential than a default by a state or province within a country
- **the ability to manage "asymmetrical" shocks** that hit different parts of the euro area economy differently

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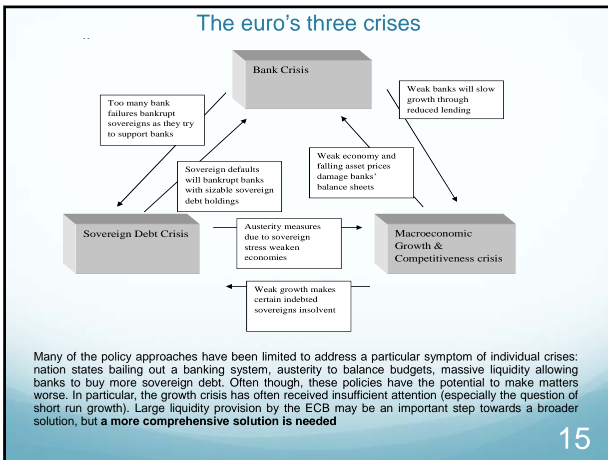
The euro's three crises



Many of the policy approaches have been limited to address a particular symptom of individual crises: nation states bailing out a banking system, austerity to balance budgets, massive liquidity allowing banks to buy more sovereign debt. Often though, these policies have the potential to make matters worse. In particular, the growth crisis has often received insufficient attention (especially the question of short run growth). Large liquidity provision by the ECB may be an important step towards a broader solution, but **a more comprehensive solution is needed**

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A look to the future

Outlook 2015

Eight years after the breakout of the GFC, for 2015 we can expect:

- (finally) **an acceleration of growth in Developed Markets** (DM) - but with still some downside risks in the Euro Area
- **a stabilization of growth in Emerging Markets** (EM), *[though still at relatively high levels, especially if compared with long term trend growth of DM]*
- **continued monetary accommodation by central banks**
- **structural issues still impairing a sound and resilient return to global growth**, both in DM and – more recently – also in EM

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Outlook 2015 - US

The US recovery has taken the leadership of the global economic cycle, courtesy of the **deep restructuring of the US economy** that took place post the 2007 "Great Financial Crisis"

This restructuring, based on:

(i) new technologies, new natural resources discoveries (shale gas & oil)
(ii) better use of existing technologies
(iii) improvements in human capital

has led to a strong increase in US "Total Factor Productivity" (TFP), a measure of strongly improved US competitiveness

Thanks also to **8 years of very loose monetary policies**, **the US private sector is done deleveraging, is resilient, and will lead US growth to a higher trajectory** as we go into next year

Corporates are sitting on a lot of cash and might boost their investment plans, if they become confident on future demand

Key risks: **Excessive dollar strength**. Rising dollar is likely an endogenous reflection of a US economy that is better in both absolute and relative terms. However, an aggressive rise in the dollar elicited concerns from the Fed and likely will be perceived by financial markets as an unwelcome deviation from a more acceptable steady trend, and hence an exogenous shock.

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I-Phone Index: US$ "Undervalued"

over (-) / under (+) valuation vs US$

Country	over (-) / under (+) valuation vs US$
Italy	-17%
France	-15%
Germany	-15%
Spain	-14%
Average Euro	-15%
Switzerland	-15%
Sweden	-7%
UK	-12%
US	0%
Canada	1%
Australia	-19%
HK	-9%
Singapore	-13%
Japan (x 100 yen)	1%
Korea (x 1000 won)	-17%

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Outlook 2015 - Europe

Eurozone is not out of the woods, yet

The euro area faces a serious deflationary threat caused by:

(i) high unemployment that is exerting downward pressure on wages
(ii) a banking system that is deleveraging and thus unwilling or unable to extend fresh credit
(iii) contractionary fiscal policies (fiscal compact)

The resolution of the euro area sovereign and banking crisis requires still some **bold choices**: certainly **a banking union** and possibly finally **a full fiscal union**, coupled with **the ECB being willing and able to be the lender of last resort** to governments
No currency can exist (or survive) without a lender of last resort

While the ECB has taken a decisive step towards fulfilling this role (thanks to Dragi's OMT and now to the announcement of some sort of QE), progress on banking and fiscal union remains painfully slow and full of setbacks

Key risks: "**Japanification of Europe**"

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"Japanification" of Europe

"Japanification" of the euro area is a clear and present danger. Japan suffered from:

- a prolonged post-bubble balance sheet recession
- a late and overly cautious monetary policy response
- periodic strong currency appreciation
- a failure to enforce a rapid clean-up of bank balance sheets
- a premature fiscal tightening in 1997 that pushed the economy back into recession
- a general institutional reform sclerosis

In addition euro area member states are not true sovereigns as they are indebted in a currency they cannot print themselves. Thus, markets refused to fund governments at reasonable interest rates and a sovereign debt crisis resulted. Therefore, **contrary to Japan, the euro area countries most affected by the crisis lost their ability to pursue countercyclical fiscal policies** and instead had to tighten policy into the downturn, thus aggravating the recession

The role of monetary policy in such a situation is to be **bold and unconventional**
But
Only recently did the ECB finally acknowledged the deflationary risks for the Euro economy, much too late, acting like the Bank of Japan before the onset of Japan's deflation

The role of fiscal policy in such a situation is to be **countercyclical**
But
Only recently did the European Governments and the European Commission agree to stimulate demand with a plan of infrastructural and strategic investments, still too small (only € 300 billion vs more than US$ 1tr in the US) and yet to be approved

The role of economic and industrial policy in such a situation is to push for **structural reforms**
But
Only recently did some European governments finally acknowledge the need to implement structural reforms, fighting the resistance of all vested interest and of established constituencies, still too few countries are really serious on this point and too few reforms are really fully implemented

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How to avoid "Japanification" of Europe

"Japanification" can still be avoided if Euro-area policy-makers heed three lessons from Japan:

1. Monetary policy should move early and aggressively before deflation manifests itself
2. Regulators should enforce a clean-up of bank balance sheets including a realistic assessment of bad assets and a swift recapitalisation where needed. The ECB's master plan is to achieve the balance sheet clean-up and recapitalisation in the run-up to banking union over the next 12 months or so. If successful, this could be an important catalyst for repairing the credit mechanism
3. Governments should avoid overly tight fiscal policies that could plunge economies back into recession

Finally, European policymakers must avoid falling into **the CRIC cycle – the cycle of Crisis, Response, Improvement and Complacency** – which leads to institutional reform sclerosis

This cycle arises from the interaction of two natural tendencies:

- The economy responds slowly to policy reforms
- Policy-makers tend to slow the reform process as the economy improves

Each economic crisis during the lost decades in Japan sparked a policy response, but the following economic and market improvements led to complacency by policy-makers, slowing down or unwinding of reforms, which in turn paved the way for the next crisis, a behaviour also followed until now by Euro-area policymakers

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The moment of truth

"It is often claimed that the Chinese and Japanese word for crisis,

***wēijī* or *kiki* (危机 or 危機),**

is made of the two characters meaning "danger" and "opportunity".

While there can be no doubt that *wēi* means "danger", I would rather understand *jī* as meaning the critical moment when things have to change – the ancient Greeks' *kairos*.

This critical moment has now arrived for Europe. Europe has emerged from the danger zone. It's time for us to get our act together, to reform, and to grow."

- *ECB's Benoît Cœuré at the Asia Europe Economic Forum in Beijing, October 28, 2013*

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Outlook 2015 – Monetary Policy

Don't expect DM central banks to tighten any time soon, even if economic recovery were to surprise to the upside, especially **as long as inflation expectations remain well behaved and there are not outsized risks of another asset price bubble**

Even when Central Banks will start to tighten monetary policy [Fed will be the first one], they will act slowly ["at a very moderate pace"] and with lots of advance warnings about the future path of interest rates [*"forward rate guidance"* starting from when to end outright bonds purchases, to pre-announcing how shallow the "*pace of tightening*", i.e. increases in policy interest rates, will be and when they will start to kick in, as well as "*conditional*" on economic development, meaning the raises in interest rates, even in the US, will anyway take place not earlier than late 2015]: Central Banks do not want to create crashes in asset prices that would damage the still weak recovery

Part of the solution to high government debts around the world is being found by **imposing artificially low, or even negative, real returns on captive investor** groups (so-called "financial repression" that was in place for more than 20 years after WW2 and enabled all countries to "grow out of" their World War 2 debt problems)

In the long term, **inflation** could be part of this solution, too

Key risks:

1. Loss of control on money supply – therefore on inflation - following huge increases in central banks' balance sheet size (quantitative easing): given current slack and overcapacity in world economies, not something to worry for at least a few more year

2. Igniting another asset bubble (in bonds?, stocks?, again Real Estate?)

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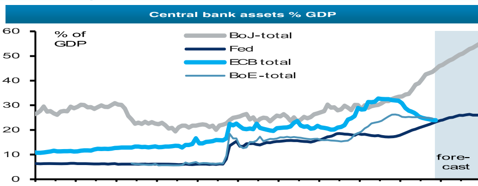
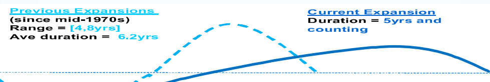
Central Banks to the rescue



As Growth remains "lower for longer"



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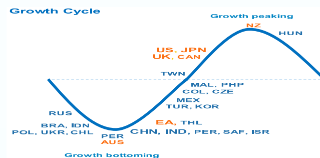
World economic growth: **un-syncronized**
Little risks of "overheating"
Little need of global strict monetary policy

Currently no risk of global joint "overheating"



Nor of global inflation pick-up

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Why monetary policy will not be tightened any time soon

Aggregate G4 (US, Euro Area, Japan, UK) GDP, Potential and Trend

Actual GDP
Consensus Forecast
Average of Potential Output Estimates
Log-linear trend

Note: Potential Output is Average of IMF and OECD estimates. PPP weighted average.
Source: Fulcrum Asset Management

- The blue line is actual GDP for the major four developed economies, which has only recently exceeded the last peak in 2007 by a couple of % points. Not only has GDP stagnated in absolute terms, it has fallen about 13% below the long term extrapolated trendline, shown in red
- This huge gap has led economists at the OECD and IMF to suggest that potential output has not actually followed the red line, but has instead followed a path sketched by the dotted orange line, reflecting the damage done to the capital stock and the effective supply of labour by the recession
- The current level of GDP is estimated to still be below the orange dotted line, which unfortunately cannot be directly observed. **This is the case for keeping monetary policy aggressively easy**, as long as policy makers believe that asset prices are not in bubble territory (something which Janet Yellen, next Fed Chairperson just confirmed)

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Outlook 2015 – EM Economies

EM economies face external and internal challenges that render their old, export-led growth models unsustainable and require "structural" changes

Externally

(i) weak consumers' demand from rich countries

(ii) onshoring back to DM of certain manufacturing activities (already happening in the US)

(iii) risks to capital flows

all will work against EM

In the future the US (and possibly Europe) **will more likely be a competitor, not any more a consumer, for EM:** in the US the combination of cheap shale energy, a decade of real US dollar depreciation and strong US corporates means that the relatively low-sophistication goods (from the US point of view) - that have been unprofitable to produce in the US for more than a decade - are likely to make a comeback. *[Some already have: the production of fabricated metals, chemicals, cars and construction equipment supporting shale production have all been steady performers in the US economy.]* However, those same goods represent a step up in terms of sophistication for most EM economies, a step up that EM economies need in order to maintain growth outperformance. **If the US is moving "*down*" the sophistication ladder, EM economies that need to move "*up*" the same ladder will find themselves in a '*battle of sophistication*'**

Internally

- focus on export-led growth has meant that **important sources of domestic demand in EM have been neglected**, especially in the service sector

Key risks: "Slowness in structural reforms", maintenance of excessive direct government intervention, crowding out of private entrepreneurship

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EM Economies – The "Great Unwind"

The unwinding – at around the same time – of:

1. US QE, generating higher real rates and eventually stronger US $
2. China's deleveraging, affecting the rest of EM through three channels:
   i. The trade of manufactured good
   ii. The trade of commodities
   iii. The impact of a slower Chinese economy on the terms of trade
3. EM domestic growth where it has been 'excessive' creates a very difficult environment for EM growth

This **triple unwind** affects:

(i) EM capital accounts via the impact of QE unwinding

(ii) EM current accounts via China's leverage unwind

(iii) EM domestic demand directly where economies that have allowed/encouraged/sought high credit growth now have to rein it in

EM economies are going through a very tricky phase thanks to this "Great Unwind"

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EM Economies – cyclical or structural?

Is it structural or cyclical? Cyclical factors are certainly weighing on EM growth, but the primary drag on growth comes from three structural impediments:

- **Capital misallocation is lowering growth and profitability in a regime of rising real rates, making it difficult to correct that misallocation:** Real rates are rising not just because of higher US real rates but also because of a mix of forced rebalancing (current account balances deteriorating, reflecting national savings falling faster than national investment, putting pressure on real rates) and higher risk premia
- **Global growth is becoming more of a zero-sum game,** with growth in the US and the euro area (and prospectively in Japan) coming at the expense of growth elsewhere, including growth in EM. The upshot is that export growth in EM will show a modest cyclical recovery, but it will not have the structural momentum of past decades
- **The 'Great EM Unwind':** A triple cocktail of an unwind of: i) US QE via higher real rates; ii) China's leverage; and iii) Excessive EM domestic credit growth) that will affect virtually all EM economies depending on their sensitivity to each factor

For potential output growth to rise, policy stimulus needs to go to the '**RIGHT**' sources of domestic demand: in particular **India and China need internal rebalancing – China needs to boost its consumption, India its investments**

While many are talking about structural reforms, the ability or willingness to deliver on such structural reforms is in shorter supply. The rigidities and unsustainable models of growth that are constraining emerging markets are the very source of their promise. Should these rigidities and unsustainable models be discarded, emerging markets can again convincingly outperform in terms of growth

EM Economies – different structural responses needed

Most EM economies need to deal with **capital misallocation** and **reorientation of their broken growth models** even as real rates rise and external demand is weak. Despite these similarities, **there are huge differences in the problems that EM economies face, and hence in the reforms each economy need**

Country	Old model	New model	Reforms needed
China	Export/investment-led, SOE domination subsidised by households (implies household consumption 'taxed')	Consumption-led, larger private sector involvement	Interest rate liberalisation to unlock consumption, reduce SOE presence and encourage private sector; 'smart' rather than aggressive urbanisation
Brazil	Dutch Disease (commodity + consumption lead, manufacturing lags); real rates unnaturally high and distorted	Manufacturing-led growth, with improving infrastructure; encourage savings growth to lower real rates and current account deficit	Improve (non-commodity) manufacturing competitiveness via: i) Industrial policy; ii) REER unwind; and iii) Pension and tax reform; BNDES lending to activities with positive spillovers only
Russia	Commodity-led, large public sector involvement	Balanced manufacturing, larger private sector involvement	Improve competitiveness of non-commodity sector – privatisation, industrial policy, pension reform
S. Africa	Under-invested in mining; manufacturing uncompetitive due to labour protection	Efficient mining-led growth with labour reforms to restore manufacturing competitiveness	Selective liberalisation of labour markets; raise competitiveness; improve mining logistics
India	Consumption/fiscal-led; investment and savings in decline	Investment-led; higher savings	Correct price distortions, labour market reform, improve business climate
Turkey	High credit growth; persistent current account deficit due to low savings	Curb credit growth; encourage savings to reduce current account deficit	Higher real rates and advances in pension coverage to raise savings; more macro-prudential emphasis in monetary policy
Indonesia	Dutch Disease (a milder version than in Brazil or Russia)	Manufacturing-led growth; encourage savings to reduce current account deficit	Raise competitiveness via: i) industrial policy; and ii) REER unwind; labour market policies to raise productivity and better infrastructure
Mexico	Export-led manufacturing; fiscal reliance on oil	Manufacturing led by exports and domestic reforms; reduce oil reliance further	Reforms in energy, fiscal, financial, labour market and education reforms (all on the agenda/in progress)

Source: Morgan Stanley Research

The need for structural reforms in EM

Reforms needed	Key reforms	Progress on reforms	Risk to reform process
CHINA: Interest rate liberalisation to unlock consumption, reduce SOE presence and encourage private sector; 'Smart' rather than aggressive urbanisation	Limited interest rate and exchange rate liberalisation; pilot schemes (including Shanghai FTZ) for several key areas; SOE reforms not addressed	Piecemeal reform described as 'acupuncture' by our China team. More aggressive reforms needed, but these create difficult trade-offs	Innovation faster than regulation as interest rates are liberalised; domestic trade-offs created by structural reforms
BRAZIL: Improve (non-commodity) manufacturing competitiveness via: i) Industrial policy; ii) REER unwind; and iii) pension and tax reform; BNDES lending to activities with positive spillovers only	Infrastructure package, some tax breaks, tariff cuts	Current policy addresses cyclical, not structural, issues. Focus on infrastructure but it is not the main reason for low manufacturing competitiveness	Focus on macro-policies ignores the sectoral mismatch; Upcoming elections make higher unemployment and lower wage growth unlikely
RUSSIA: Improve competitiveness of non-commodity sector via privatisation, industrial policy; pension reform and demographic-consistent solutions	Recent pension funding actions and renationalisation are steps in the wrong direction; fiscal and financial reform in the right direction	Progress on reforms on the oil sector but 'renationalisation' has over-shadowed privatisation; recent pension funding decision a step in the wrong direction, in our view	Very little bottom-up pressure to reform due to the dominance of SOEs in energy and banking; Governor Nabiullina could help by providing less monetary easing
INDIA: Correct price distortions, labour market reform, improve business climate	Fast-track investment projects, limit subsidies	Good performance from Sep 2012 to mid-2013; little progress since	Elections in 2014 may imply that real rates remain low but without accompanying reforms
TURKEY: Higher real rates and advances in pension coverage to raise savings; more macro-prudential emphasis on monetary policy	Pension reforms; social security, tax and agriculture reforms	Lower willingness to raise real rates since the summer increase in risk premia	CBT unwillingness to raise rates may delay the adjustment of the CAD and keep Turkey externally exposed
INDONESIA: Raise competitiveness via: i) Industrial policy; ii) REER unwind; labour market policies to raise productivity and better infrastructure	Reducing dependence on commodity-related exports and investment	Very little progress on reversing the Dutch Disease	Elections in 2014 could mean a lower willingness to bear higher real rates and an unwinding of the REER appreciation
MEXICO: Reforms in energy, fiscal, financial, labour market and education reforms (all on the agenda/in progress)	Energy and fiscal reforms in progress; financial, labour, telecoms also in the works	The reform process is in exactly the right direction, but implementation (as always) is the big challenge	Pax Mexicana shows strains, while investor expectations remain far too high

China – structural challenges

What Are the Structural Challenges in China?

- **A higher 'incremental capital-output ratio' that reflects capital misallocation, a current account surplus that reflects 'excessive' savings:** More of both physical and financial capital is now needed to generate the same amount of growth. Such an increase in the incremental capital output ratio was a key symptom during the onset of the Asian crisis. One of the reasons why a similar crisis is unlikely is because of China's current account surplus. However, the surplus (which equals the excess of savings over investment) is the result of 'excess savings'. Lower real interest rates provide household savings very little compensation, incentivising them to save more than they otherwise would have. In other words, the interest rate regime acts as a 'tax' on consumption as households consume less than they would have otherwise

Rising ICORs Suggest Capital Misallocation, Falling Productivity

Note: ICOR = change in capital stock, higher values indicate lower efficiency of investment.
Source: World Bank, World Development Indicators, and staff estimates

Very Little Protection for Household Savings

Source: Haver Analytics

China has built up a lot of leverage the past five years

	2008	2009	2010	2011	2012
Consumers	11.9%	16.2%	18.7%	18.8%	20.1%
Small business	34.5%	39.6%	52.6%	51.9%	53.5%
Mid/large corporates	73.6%	81.1%	83.5%	84.7%	99.2%
Local governments	15.8%	25.0%	25.3%	24.6%	27.7%
Central government	20.8%	21.6%	20.6%	18.9%	18.6%

Source: CEIC, CBRC, Wind, Morgan Stanley Research

China – policy trade-offs

- **China's liberalisation conundrum:** Raising interest rates to protect savings could lower household savings and raise consumption. However, as household savings fall, the implicit subsidy that State Owned Enterprises (SOEs) have received would fall too making the investment climate more hostile for these organisations
- **The deleveraging conundrum:** A rise in leverage in any economy also pushes up its 'neutral real rate of interest' (the real rate at which growth and inflation are steady). **Progress on deleveraging will mean the administration has to choose one of the two:**
  1) Keep real interest rates low and accept more investment-led growth even if returns to capital are falling (i.e., accept a delay in rebalancing towards consumption-led growth)
  2) Liberalisation of interest rates, higher consumption and rebalancing, but accept faster deleveraging and thus lower and more volatile overall economic growth
- **The urbanisation conundrum boils down to a choice to either:**
  1) Protecting near-term growth through a strong urbanisation drive, but risking a sharper downturn later if this aggressive programme cannot generate growth;
  2) Risking near-term downside to growth but ensuring a higher quality of growth through 'smart' urbanisation
- **Turning demographics:** China is aging fast, and its labour force has already started to shrink. This implies that some of the addition of capital will simply 'replace' lost labour. In other words, investment will have to run so that growth simply stands still. If not addressed via capital-intensive (i.e., labour-saving) investment, China's production function will suffer from a decline in growth as the supply of labour falls, as it has in Japan and Korea

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A more robust path to China's rebalancing

Objectives of China's reforms:

1. Consumption playing a bigger and structural role in growth
2. Smaller role for SOEs
3. Larger role for private sector investment that can deliver demographic-consistent capital accumulation (by using capital-intensive techniques to compensate for a shrinking labour force).
4. Regain financial stability through deleveraging. Though deleveraging is more a matter of macro-stability than reform, the transition to a new, consumption-led growth model will need a functional credit system to finance the creation of new assets.

A More Robust Path to China's Rebalancing

The Critical Role of Interest Rate and Exchange Rate Liberalisation (financial markets reform)

- Interest rate liberalisation is needed to raise the real interest rates that households can earn on their savings
- Higher interest rates will protect savings and lead to a decline in precautionary savings. IMF research argues that such a counter-intuitive relationship between interest rates and savings exists in China
- The decline in precautionary savings will have two consequences: i) To create a step change towards higher consumption growth (objective 1); and ii) To reduce the implicit subsidy that SOEs have received thanks to captive and 'excessively high' household savings, leading to a decline in SOE savings and a reduced incentive for them to play an aggressive role in the economy (objective 2)

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Reform Roadmap unveiled at Third Plenum

China has recently made major decisions about its economic future. On November 15, 2013, China announced dramatic new social and economic policies contemplating **much greater reliance on market forces** than it has in the past and inviting private-sector participation and foreign competition in industries long previously controlled by the central government. It also relaxed its one-child policy, opening the country and its people to vast new opportunities and inspiring new hopes and dreams

A detailed and profound roadmap was unveiled in the full transcripts of the Third Plenum of the 18th CPC Central Committee: The full version of "Decision on Major Issues Concerning Comprehensively Deepening Reforms" from the Third Plenum was released on November 15th, 2013 covering a wide-ranging reform agenda

The Third Plenary has firmly set reform directions to:

- allow markets to play a "decisive role" in resource allocation
- to level the playing field between SOEs and non-SOEs

What tops the agenda is the elevated role of market forces – now decisive, previously basic: the Third Plenum acknowledged the market's effective role in allocating resources

The principle of letting the market determine all prices that can be set in a market was established. **The market, not the government, is given the "decisive" role in allocating resources and for the first time the private sector and public sector are placed on an equal footing and the government committed to fostering the development of the private sector**

While the government reiterated the centrality of public ownership, it also limits its scope and encourages a mixed ownership model in which private capital can be invested in public sector companies – even to the point of taking control

The role of government is to protect property rights, ensure macroeconomic stability, regulate markets, provide social services and supply goods and services that are natural monopolies, manage investments in SOEs as a portfolio of assets (rather than directly running them) and ensure national security

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Key Reforms unveiled at Third Plenum

China's Third Plenary has put the country on the path of meaningful reform, which will have positive impacts on the real economy and on financial markets

- **Both the SOE and non-SOE sectors have been recognized as important components of the market economy**. The share of SOEs' earnings to be handed back will gradually increase to 30% (up from current 0-15) to improve people's livelihood. SOEs are still viewed as being central to the economy, but no longer dominant. Non-SOEs will also be encouraged, supported and guided to develop a mixed ownership economy
- **Fiscal system:** China will streamline the central-local government fiscal system, and ensure a transparent budgeting system. It stressed two needs: 1) to clarify the revenue and spending responsibility between the central and local government, and 2) to improve budget management and taxation systems to properly match their responsibilities with their spending. Tax reforms will emphasize direct taxes in addition to VAT reform and accelerate the introduction of a nationwide property tax. Remaining local government deficits will be financed via bond issuance or transfer payments
- **Financial sector liberalization is scheduled at a relatively fast pace.** China will push forward capital account liberalization, plus further deregulation of the exchange rate and interest rate regime, at a relatively fast pace. Restrictions on overseas investors are to be gradually lifted, and China will try to adopt a "negative list" to manage sector entry in accordance with international practice. Private investors will be permitted to establish small and medium-sized banks and other financial institutions. A deposit insurance system will be set up. Equity financing through the stock market will be encouraged. A bond market serving corporations and sub-national government levels will be developed. The government bond market will be reformed so that pricing better reflects genuine supply and demand

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Other Reforms unveiled at Third Plenum

- **Social security net:** Further efforts to improve social insurance coverage, transferability and portability, and potentially postponed retirement under study. China will deepen medical reform by enhancing medical insurance, encouraging private investment, and allowing multi-spot practice for doctors, etc.
- **Urban-rural development – more property rights will be given to farmers:** The urban-rural dual structure is a major barrier preventing the urban and rural integration of development. China will build a new and integrated system to unify land market, where urban land and rural land will be pooled in one market and have the equal rights for exchange. Rural land reforms will endow farmers with the right to transfer, inherit, lease, sell, or borrow against their homesteads and their agricultural land use rights. Fair, open and transparent markets for rural land are to be developed. Private investment in industrialized farming – to modernize the sector and increase efficiency - is encouraged. Control of the Hukou System will be gradually relaxed to promote further urbanization. A new form of urbanization is envisaged, in which qualified migrants will be given full legal status as urban residents, with equal claim to housing and social services and to equal pay for equal work. The Hukou system has been scrapped for small cities and townships and will be relaxed in medium-sized cities. Very large cities will still remain more restricted
- **Eco-civilisation:** The Plenum also vowed to establish a sound system for the protection and administration of the country's ecological environment. A 'red line' for ecological protection should be drawn, and a system of paid use of resources and ecological compensation should be implemented

A leading committee to promote reforms is established: To ensure the smoothness of the reform, China decided to set up a leading committee to carry out the comprehensive deepening of reforms. It aimed to reduce the low efficiency in reform promotion among ministries in the past

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Reforms Announced in the Decision of the Third Plenum of the 18th CPC Central Committee

Areas	Actual policy announced in the Third Plenum of the 18th CPC Central Committee	MS expectation	Actual policy announced in the Third Plenum of the 16th CPC Central Committee (October 2003)
Fiscal	To deepen fiscal and tax reform; Reallocate fiscal revenue and social responsibility	Reallocate fiscal revenue and social responsibility	Aimed to simplify the tax system
Finance	To further deregulate FX exchange rate and interest rate regime, and further progress in capital account open-up	Promote market-oriented interest rate and exchange rate system	Aimed to gradually push forward the interest rate and exchange rate liberalization
Government Administration	To streamline government administration, delegate power and outsource public goods	Streamline government administration and delegate power. Outsource public services	Aimed to transform its function to focus on serving the economy
SOE	Both public and private sectors are important to economy; to gradually increase SOE's profit contribution to fiscal revenue (30% of SOE profit in year 2020)	Reduce direct oversight of SOEs	Aimed to strengthen state asset management and supervision
Demographic policy	To allow urban families with either parent being single-child to have a second child	Allow urban families with either parent being single-child to have a second child, starting in pilot programs in certain regions	Not mentioned
Hukou	To gradually relax the control of Hukou System to promote further urbanization	Gradually relax the control of Hukou System to promote further urbanization	Aimed to deepen Hukou reform(no further details)
Social safety net	To improve social insurance coverage, transfer, portability; to study the progressive delay retirement policy.	Expand the coverage of social insurance on service and beneficiary coverage; Phase out the special social security plan for civil servants	Aimed to promote employment and strengthen the social safety net
Health care	To enhance medical insurance, encourage private investment, and allow multi-site practice for doctors, etc.	China will deepen medical reform by encouraging private investment, and allowing multi-site practice for doctors.	Aimed to improve medical coverage
Rural land	To grant farmers more property right; establish unified urban and rural land market, etc.	Allow rural residents to share a larger part of economic benefits from land price appreciation in the process of rural land acquisition	Aimed to protect the household contract responsibility system
Resource prices	To set up market-based resource prices system on water, oil, gas, electricity, transportation, telecom, etc.	Liberalize resource prices	Not specifically mentioned
Service Sector	To relax the entry barriers in service sectors (incl. financial services, education, culture and health care)	Remove entry barriers in service sectors. Liberalize the healthcare industry	Not specifically mentioned
Intellectual property rights protection	To enhance intellectual property rights protection and improve incentive mechanism for technology innovation	Enhance intellectual property rights protection	Not specifically mentioned
Environment and Infrastructure investment	To draw a "red line" for ecological protection and build a system of paid use of resources and ecological compensation.	Boost environment and infrastructure investment	Aimed to allow private capital to invest in infrastructure projects

Source: Xinhua, Morgan Stanley Research

Impact of China's Reforms on Growth

All of the above was essentially in line with, or went beyond, what was expected

China's Third Plenum Reform Roadmap is certainly going in the right long-term direction

What is clear is that China's medium- and long-term future looks much better now after these long awaited and comprehensive reforms have been announced than it would have through just minor rebalancing

What does a "decisive" role for market prices imply for China?

While the focus goes naturally to financial market prices, we should keep firmly in mind that rural land ownership, the relaxation of the one-child policy and Hukou reform are *all* moves towards a market-determined allocation of resources. What individuals do with land, where they decide to live and how they decide to plan their families are all resource allocation decisions guided to varying degrees by the prevailing economic environment

Removing constraints on these choices cannot but help resource allocation over the long run. On financial markets too, liberalising markets and allowing market prices to determine resource allocation is a model far superior to one where market signals are ignored

Like all reform stories, the tricky bits are in the implementation and how investor sentiment holds up during the transition to the new growth model

The sequencing and speed of reforms could determine the way growth plays out. Should reforms with a more social bearing (land ownership reform, relaxation of one-child policies and hukou reform) be advanced first, some of the complications of financial liberalisation in an environment of deleveraging could be avoided in the near term when the risks from deleveraging are the greatest

China watcher's attention will now be focussed on **how policy-makers intend to navigate the near-term challenges of implementation in an environment of deleveraging and on how the transition to a more sustainable model of growth will play out**

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Impact of China's Reforms on Growth

A key element in these reforms is financial and capital account liberalisation, which will eventually lead to higher interest rates as financial repression eases

Here's the problem: partly in response to these expected reforms, forward-looking bond markets in China have pushed up bond yields significantly recently, thus tightening financial conditions. Together with other recent policy measures to support deleveraging, this will likely produce a slowdown in economic activity over the next 6-9 months

So, **good news on Chinese reforms entails bad news on near-term growth**

Xi Jinping and other leaders have made it clear that China is willing to accept a slower growth pace if this will allow for a more sustainable, consumer-driven expansion of its economy

Some prognosticators are quick to conclude that China's economy will soon significantly slow down, especially because China's economy has sputtered following prior instances when the nation's leaders have effected such fundamental economic reforms (such as in 1978 and 1993)

The current dip in China's growth will not endure and that, under Xi's leadership, **China's economy is destined to continue growing at a rapid clip.** In fact, the reforms will contribute mightily to China's growth between now and 2020

As China clears the way for freer markets and increased foreign participation, fortifies the infrastructure of its burgeoning cities, and creates the social conditions for middle class families to grow in size, confidence, and spending power, watch for continued growth in the world's second biggest economy in 2014 and beyond

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