TÜRKİYE CUMHURİYET
MERKEZ BANKASI

Main Risks Ahead for the Global Economy and Policy Implications

Meeting of the Central Banks and Monetary Authorities of the OIC Member Countries

September 2018 | ANTALYA

Risks clouding the global outlook

1

- Capital outflows from emerging market economies (EMEs)

2

- Escalating trade tensions and policy uncertainty

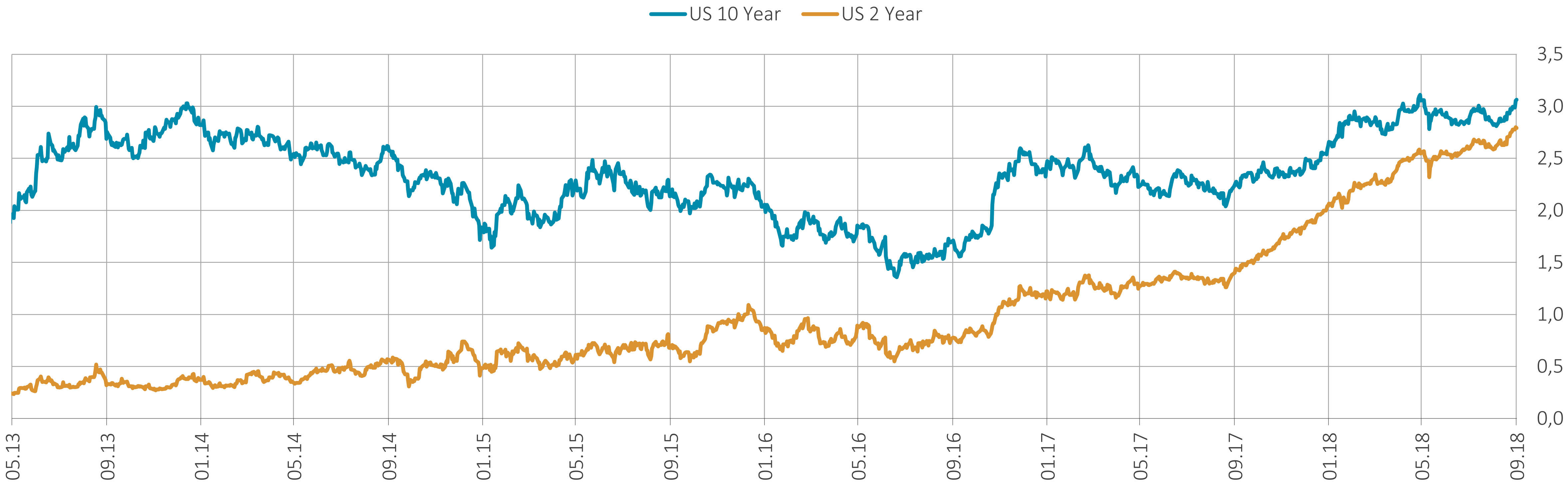
3

- Other Risks
  - Slowdown of growth, particularly in major emerging economies
  - Expansionary fiscal policies in advanced economies

Main Risks:
1. Capital Outflows from EMEs and Stronger USD

Global financial conditions have tightened.

Bond Yields (%)

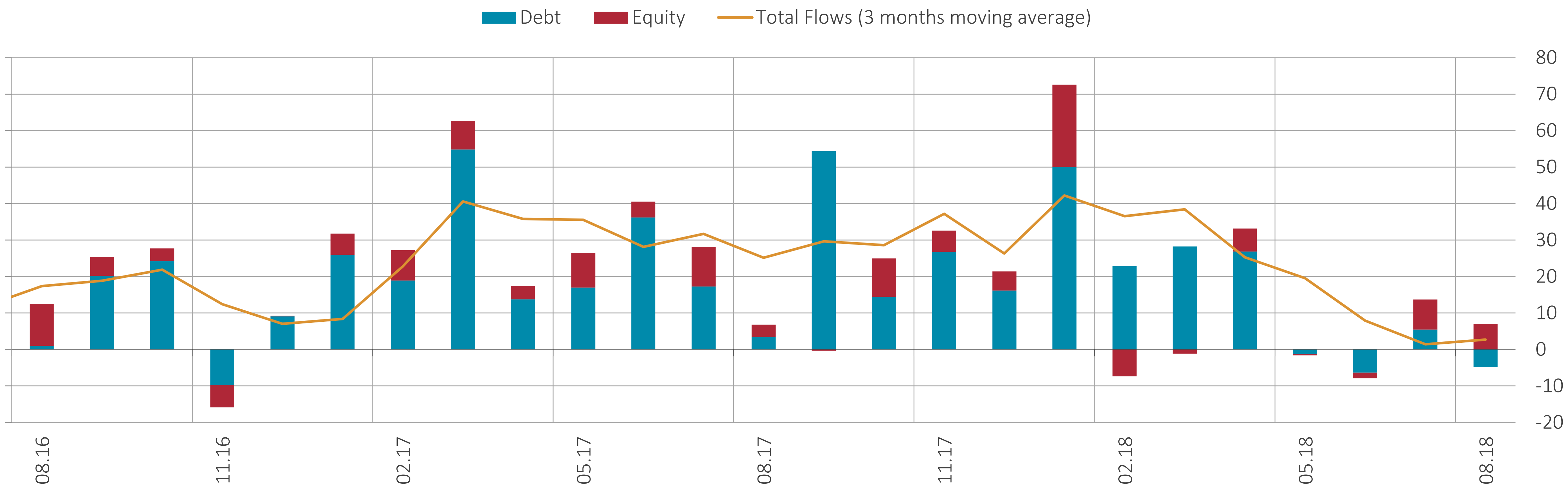


Bloomberg

19.09.2018

EMEs have experienced capital reversals recently.

Net Non-resident Portfolio Inflows to EMEs (by asset class, USD billion)

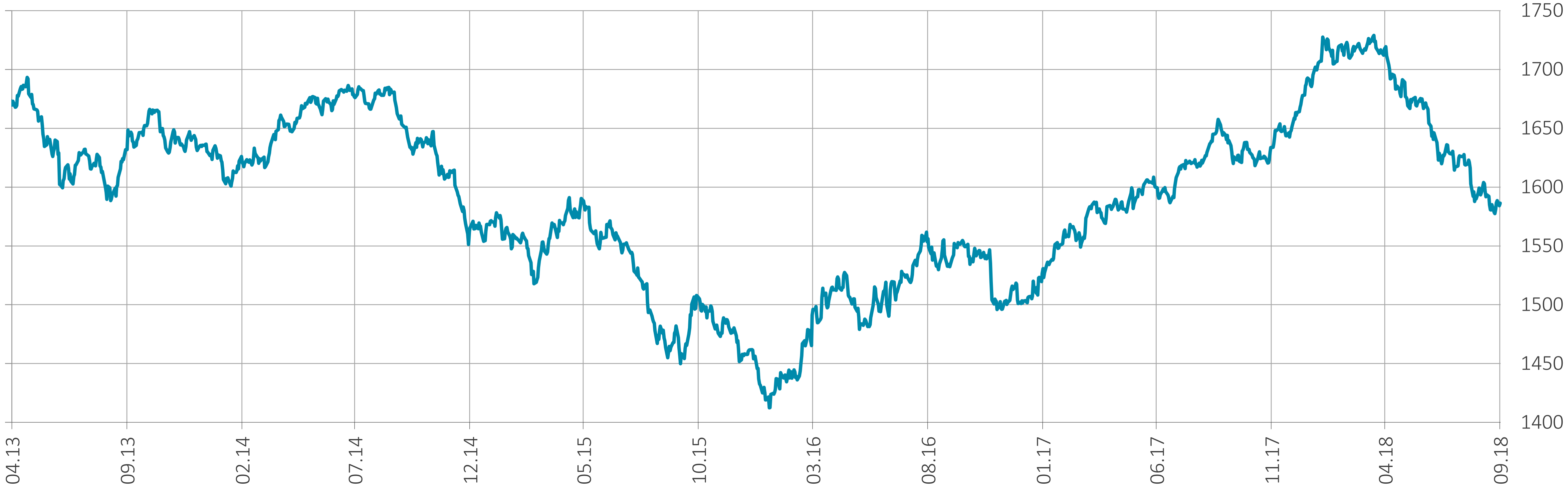


IIF

August 2018

EMEs’ currencies have started to depreciate.

MSCI EMEs Currency Index



Bloomberg

18.09.2018

Depreciation have increased inflationary pressures in emerging economies.

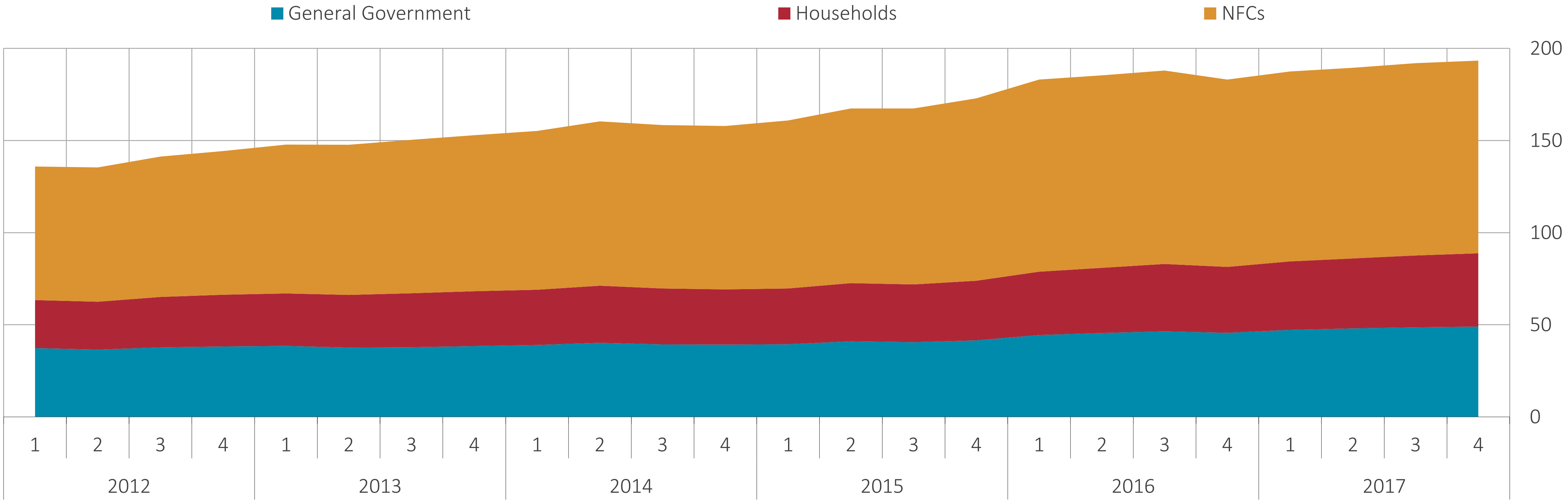
CPI in EMEs (YoY, %)

OECD

July 2018

Rising rates and depreciation of currencies have raised debt service costs.

Total Credit to Non-financial Sector in EMEs (% of GDP)

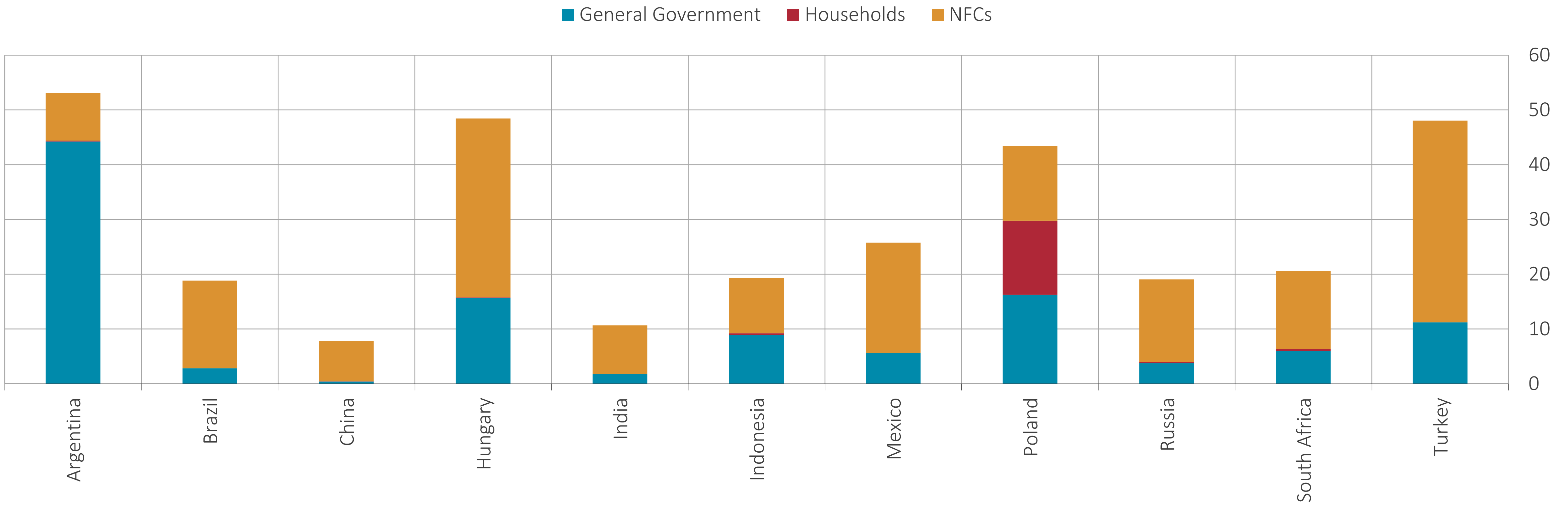


BIS

2017 Q4

Countries with high foreign currency denominated debt are the most affected.

Foreign Currency Denominated Debt (% of GDP)



IIF

2018 Q1

EMEs are more resilient to external shocks compared to the past.

- Many EMEs have improved their policy frameworks by:
  - *Using more flexible exchange rate regimes*
  - *Building larger international reserve buffers*
  - *Adopting more credible inflation targeting regimes*
  - *Keeping fiscal balances in reasonable limits*
  - *Strengthening financial regulatory and supervisory frameworks*

But some countries still have imbalances.

Country	Currency Depreciation (%, since January 1, 2018)[1]	Current Account Balance (% of GDP)[2]	CPI (YoY, %)[3]	Budget Balance (% of GDP)[4]
Argentina	-49	-6,1	34,4	-0,5
Turkey	-42	-6,3	17,9	-2,0
Brazil	-19	-0,7	4,2	-9,2
South Africa	-16	-5,3	5,0	-4,2
Hungary	-8	2,7	3,4	-2,9
Russia	-15	4,3	2,5	-1,0
Poland	-6	-0,9	2,2	-1,2
India	-10	-2,3	5,6	-3,5
China	-5	-0,5	2,3	-3,7
Mexico	-3	-1,8	4,8	-1,2

OECD, Bloomberg

[1] 31.08.2018
[2] 2018 Q1 *(2018 Q2 for Brazil and Mexico)*
[3] August 2018 *(July 2018 for South Africa, Russia, India, Mexico)*
[4] 2018 Q2 *(2018 Q1 for Hungary, Russia, Poland, China)*

Policy responses - I

- Tightening the monetary policy is essential but it can cause a trade-off by:
  - *Attracting capital, diminishing exchange rate and inflation pressures*
  - *Curbing growth in the short term*
- Central banks that have firmer anchored inflation expectations by credible policies could better respond to changes in business cycle.
- FX interventions help to stabilize exchange rates and smooth external adjustment. But their effectiveness depends on:
  - *Strength and persistence of pressures*
  - *Whether they are used for depreciation of appreciation*

Policy responses - II

- The banking system should be subject to stress testing and resolution and recovery planning. Preserving capital and liquidity buffers are crucial.
- Fiscal positions should be strengthened. Fiscal buffers will help mitigate risks and support sustained economic growth.
- Capital restrictions can help to reduce capital outflows in the short term. But they also create negative market perceptions.
- Securing the availability of Global Financial Safety Nets will help in stressed periods.
- Effective communication of policies is important.

Main Risks:
2. Protectionism and policy uncertainty

Trade conflicts between the US and other countries have escalated.

Jan 22
Tariffs on Chinese solar panels
Higher trade tariffs by the US on solar panels mainly from China

Mar 9
Tariffs on steel and aliminium
Higher tariffs on steel and aluminum by the US (including the EU and NAFTA countries)[1]

March 23
China puts tariffs in retaliation for tariffs on steel and aliminium
China imposed tariffs between 15-25% on more than 128 products worth $3 billion

Apr 2
Additional Tariffs on Chinese products
Additional tariffs by the US on Chinese imports for a set of products

June 1
Retaliatory tariffs by EU, Canada and Mexico
EU provided the WTO with a list of US products that will face 25% additional tariffs

Jun 15
More tariffs by US
Tariffs by the US on $50 billion in Chinese goods, effective by July 6

Jun 16
Retaliatory tariffs by China
China retaliated by tariffs of $50 billion after the US tariffs became effective

Jun 22
US threatened the EU
After the EU announced its retaliatory measures, the US threatened to impose a 25% duty on motor vehicle imports from the EU

Sep 18
More tariffs by the US on China
Tariffs by the US on $200 billion in Chinese goods, 10% effective by September 24, 25% in 2019

More tariffs proposed on $267 billion in Chinese goods

Sep 19
China announced retaliation
China announced retaliatory tax increases on $60 billion worth of US imports, effective by September 24

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[1] These measures were temporarily deferred for some countries (e.g. Canada, Mexico and the EU) but finally imposed on June 1st. The US announced it agreed on a new deal with Mexico on August 27th.
*Source: Bloomberg News (Only main milestones in tradewar are shown)

Trade volumes have retreated since the beginning of 2018.

World Trade (YoY, %, 3 months moving average of volume index)

Bloomberg

August 2018

Further escalation in trade tensions and potential shift-away from multilateral trade system could have significant costs on the global economy.

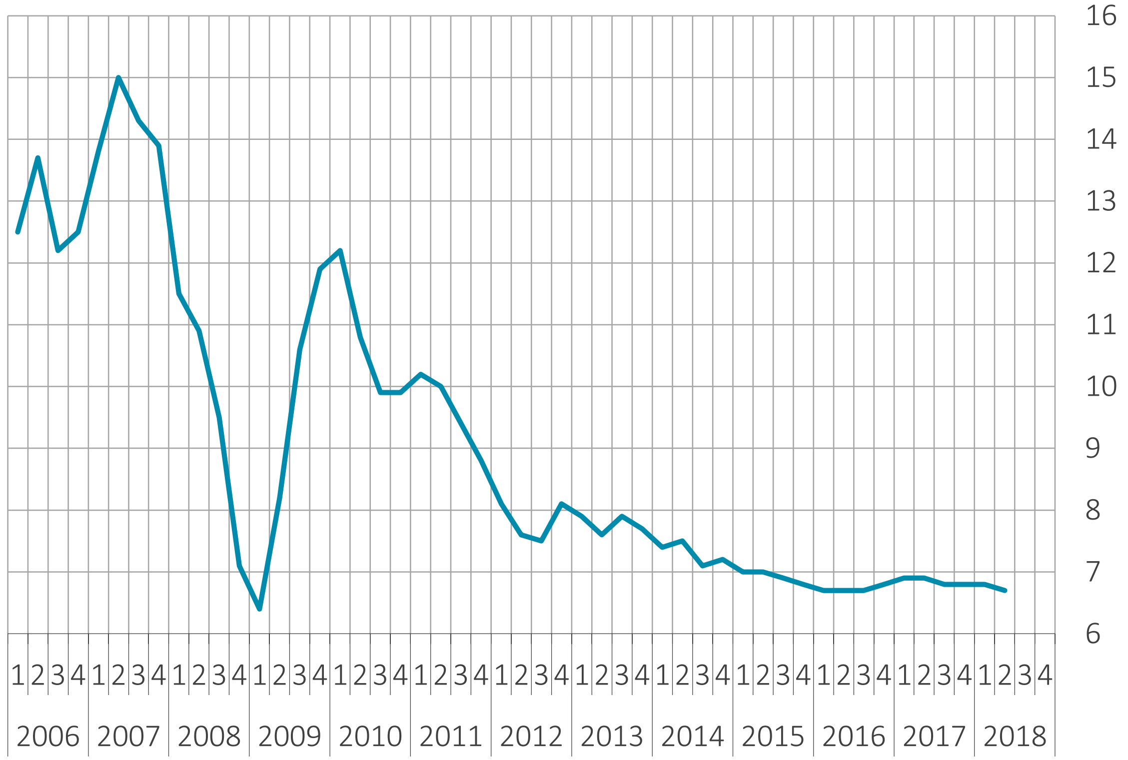
- Higher import tariffs and retaliatory measures could affect global economy through various channels
  - *Dent business and financial market sentiment*
  - *Trigger financial market volatility*
  - *Disrupt global supply chains and slow the spread of new technologies*
  - *Slowdown investment and trade*
  - *Increase inflation pressures*
  - *Ultimately lower productivity and welfare: Global GDP would fall by more than 0.7 percent in 2019 and remain more than 0.3 percent lower in the long term compared to a scenario of no trade tension**
- Sticking to multilateralism is vital in sustaining global expansion and enhancing prospects for a strong and inclusive growth

* WEO April 2018

Other Risks:
3. Slowdown in major EMEs and fiscal stimulus in the US

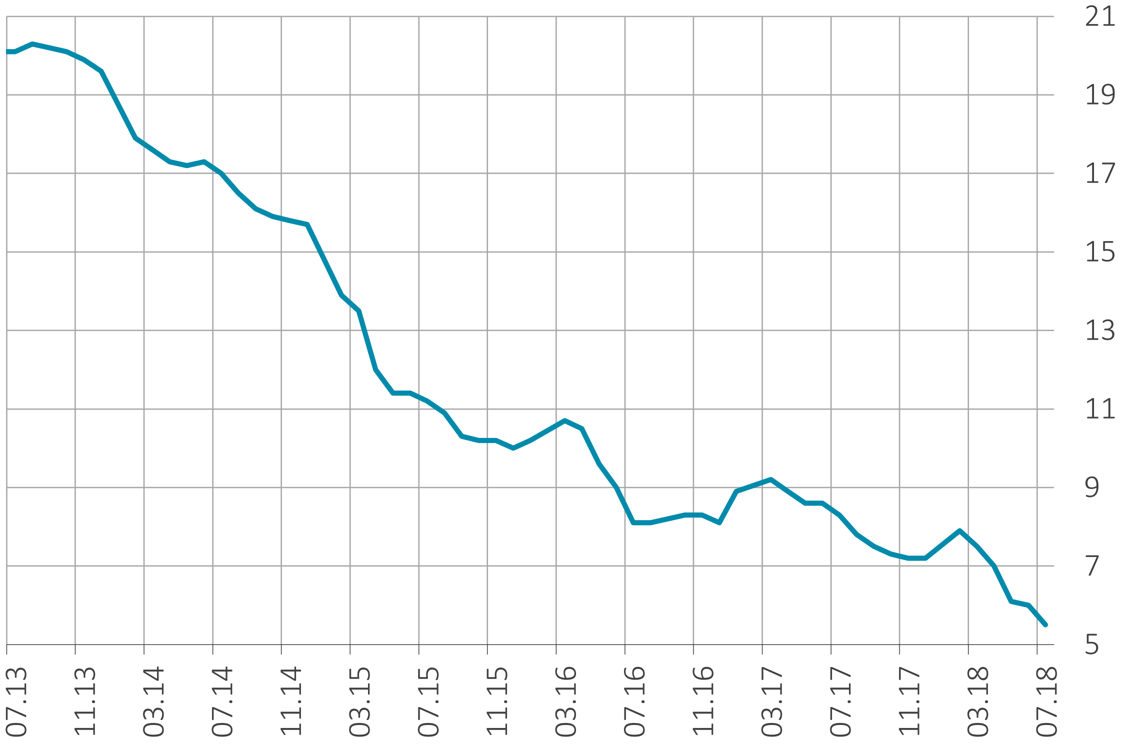
Growth momentum has slowed down in China.

GDP (YoY, %)



Bloomberg 2018 Q2

Fixed Asset Investment (YoY, %)



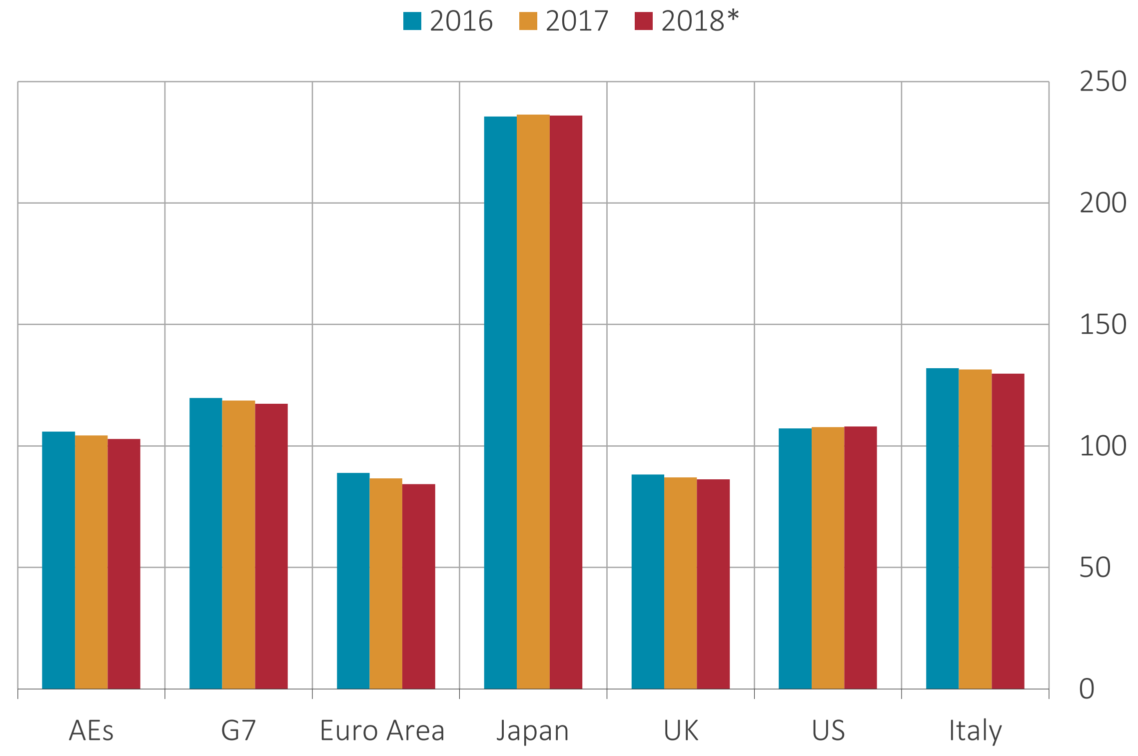
Bloomberg July 2018

The slowdown of Chinese economy could have effects on the global economy.

- Chinese economy is rebalancing from exports and public investment to consumption, and from manufacturing to services
- Chinese slowdown could have adverse repercussions for the global economy through weaker trade, commodity prices, and confidence
  - Weaker demand from China could add downward price pressure on commodity markets
  - Countries with closely integrated supply chains and commodity exporters would be the most affected from the slowdown
  - Uncertainties about smooth rebalancing of Chinese economy could hurt investors' sentiment and lead to risk aversion, translating into higher global financial volatility.

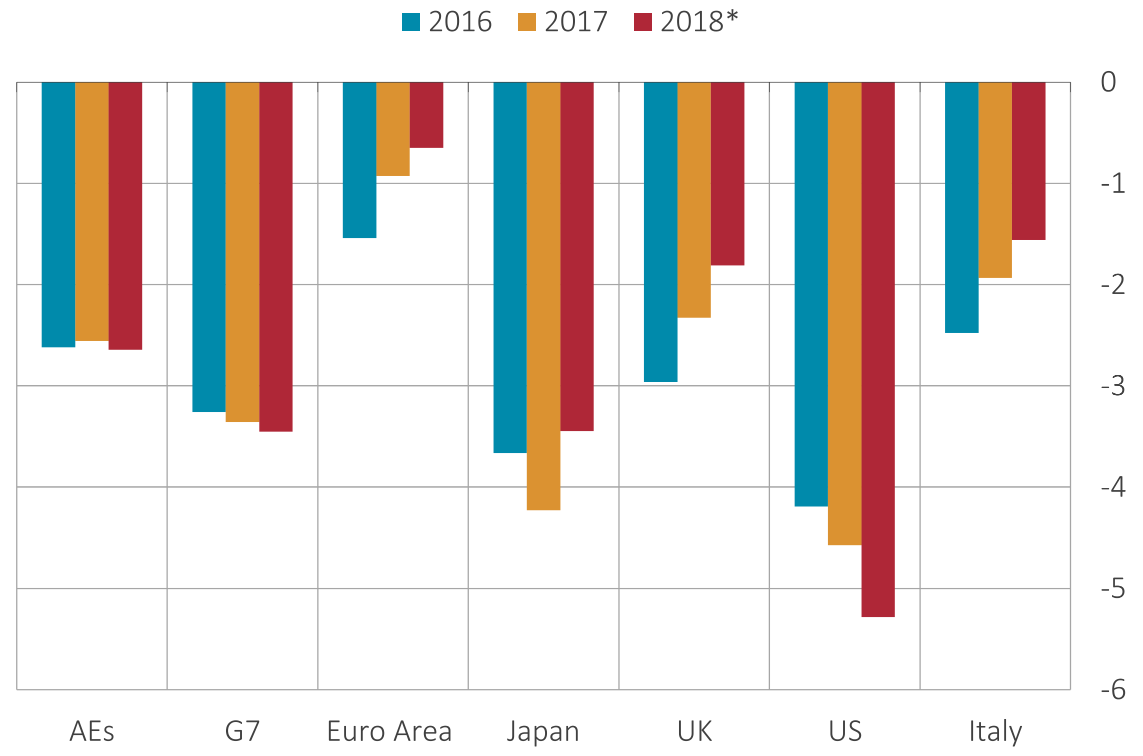
Government debt is high in some AEs and deficits raise questions about current fiscal policies.

General Government Gross Debt (% of GDP)



IMF WEO April 2018 2018

Budget Balance (% of GDP)



IMF WEO April 2018 2018

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* Forecasted values

Expansionary fiscal policies in AEs could increase imbalances.

- With the US economy already operating above potential, the expansionary fiscal policies could lead to an inflation surprise
- Higher inflation could increase prospects for faster normalization and uncertainty
- Faster normalization means stronger US dollar and tightened financial conditions for EMEs
- Appreciation of US dollar could increase current account deficit in the US
- Widening deficits could further fuel protectionist sentiments
- *Increase the prospects for negative spillovers to the world economy - particularly for EMEs*

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