ISIS FOCUS

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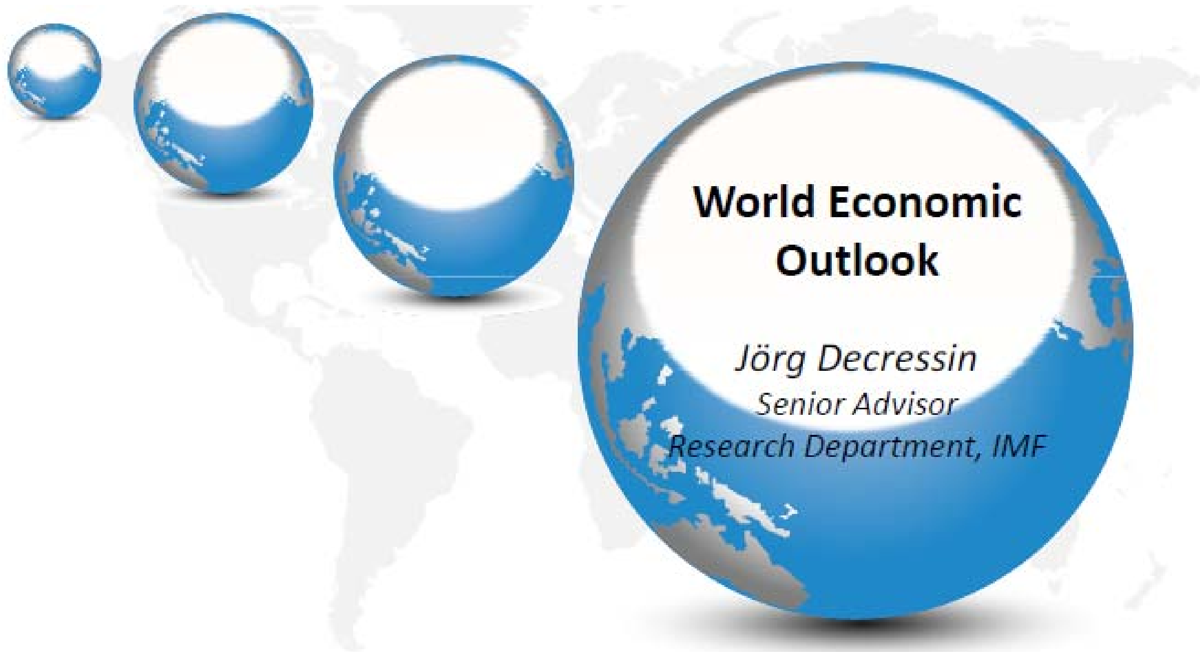
# ISIS International Affairs Forum




## Global Economic Prospects, Oil, and Capital Flows

INSTITUTE OF STRATEGIC AND INTERNATIONAL STUDIES (ISIS) MALAYSIA
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## ABOUT ISIS MALAYSIA

The Institute of Strategic and International Studies (ISIS) Malaysia was established on 8 April 1983, in realization of a decision made by the Malaysian Government to set up an autonomous, not-for-profit research organization, to act as the nation's think-tank. ISIS Malaysia was envisioned to contribute towards sound public policy formulation and discourse.

The research mandate of ISIS therefore spans a wide area. It includes economics, foreign policy, strategic studies, nation building, social policy, technology, innovation and the environment.

ISIS Malaysia today fosters dialogue and promotes the exchange of views and opinions at both national and international levels. It undertakes research in collaboration with national and international organizations, in important areas such as national development and international affairs.

ISIS Malaysia also engages actively in Track Two diplomacy, fostering high-level dialogues at national, bilateral and regional levels, through discussions with influential policymakers and thought leaders.

## RESEARCH

### Economics

Research in this area is generally aimed at promoting rapid and sustained economic growth and equitable development in the nation. We study specific (rather than generic) issues that concern the nation's competitiveness, productivity, growth and income. Areas of research include macroeconomic policy, trade and investment, banking and finance, industrial and infrastructure development and human capital and labour market development. The objective of all our research is to develop actionable policies and to spur institutional change.

### Foreign Policy and Security Studies

The primary aim of this programme is to provide relevant policy analyses on matters pertaining to Malaysia's strategic interests as well as regional and international issues, with a focus on the Asia-Pacific Region. These include security studies, foreign policy, Southeast Asian politics and military affairs.

### Social policy

Demographic and socio-cultural trends are changing Malaysian society and the social policy programme was established to respond to these developments. Research in this area is concerned with effective nation building, and fostering greater national unity. In particular, we look at issues involving the youth, women and underprivileged communities. In conducting its research, ISIS Malaysia networks with non-governmental organizations and civil society groups.

### Technology, Innovation, Environment & Sustainability (TIES)

The TIES programme provides strategic foresight, collaborative research and policy advice to the public sector, businesses and policy audiences, on technology, innovation, environment and sustainable development. Its focus includes green growth as well as energy, water and food security. Towards this end, TIES has been active in organizing dialogues, forums, policy briefs and consultancies.

## HIGHLIGHTS

ISIS Malaysia has, among others, researched and provided concrete policy recommendations for:

- Greater empowerment and revitalization of a national investment promotion agency;
- A strategic plan of action to capitalize on the rapid growth and development of a vibrant Southeast Asian emerging economy;
- A Master Plan to move the Malaysian economy towards knowledge-based sources of output growth;
- The conceptualization of a national vision statement;
- Effective management and right-sizing of the public sector; and
- Strengthening of ASEAN institutions and co-operation processes.

ISIS Malaysia has organized the highly regarded Asia-Pacific Roundtable, an annual conference of high-level security policymakers, implementers and thinkers, since 1986.

## INTERNATIONAL NETWORKING

As a member of the Track Two community, ISIS Malaysia participates in the following networks:

- ASEAN-ISIS network of policy research institutes;
- Council for Security and Cooperation in Asia and the Pacific (CSCAP);
- Network of East Asian Think Tanks (NEAT); and
- Pacific Economic Cooperation Council (PECC).

It is also a partner institute of the World Economic Forum (WEF).


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# 'Global Economic Prospects, Oil, and Capital Flows,'

***Dr Jörg Decressin,** Senior Advisor, Research Department of the International Monetary Forum (IMF) spoke at an International Affairs Forum on **'Global Economic Prospects, Oil, and Capital Flows,'** organized by ISIS Malaysia on 3 June 2011. **Dato' Dr Mahani Zainal Abidin,** Chief Executive, ISIS Malaysia moderated the Forum. ISIS Analyst **Zarina Zainuddin** reports.*

**Dr Jörg Decressin** said that global economic recovery is solidifying, led strongly by emerging markets (EM) whose economies are at an expansionary phase. The recovery is slowly gaining ground in advanced economies (AE) some of which have registered positive albeit low growth.

Many challenges remain and any one of them could derail the recovery. There is a danger of overheating in the emerging economies, the possibility of higher prices of oil and other commodities, and insufficient rebalancing of demands in Asian surplus economies. The advanced economies still face lingering, high unemployment, as well as insufficient fiscal adjustments and financial repairs.

Dr Decressin began with the equities market.

Charts of major world stock markets have revealed that stocks in Asia and Latin America are back at pre-crisis levels, indicating a lot of recovery is taking place in these financial markets. In the US, the Standard and Poor level is within 10 per cent of the pre-crisis peak, indicating that normalization has already taken place in the financial market. However bank credit growth is still struggling to return to normal and will remain so for some time.

For the EM, real growth rates in real terms are at 15-20 per cent, a substantial rate of growth.

*Jörg Decressin*

The IMF sees a multi-rates recovery, led by Asia with real growth rates of eight per cent, and Latin America with four per cent. In advanced economies the rate averages 2.5 per cent. The growth rates, particularly in the US, are much lower than expected, given the depth of the economic recession. (Fig 1) The Zamowitz rule — the harder the US falls, the faster it will bounce back — that prevailed previously does not hold this time around. To Decressin this means that the financial sectors are still deeply impaired and the imbalances that have built up in the housing sector are very large. It also means that high unemployment will linger for a longer time.

There are also important concerns, particularly 'everything that surrounds the nexus between high level of government debt of the advanced economies and the financial sector

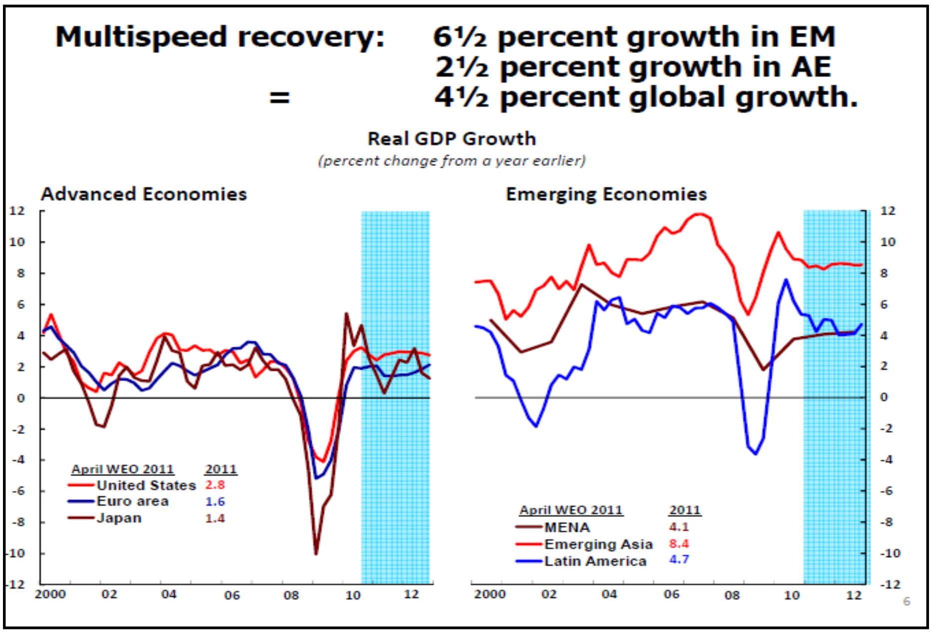


Fig 1

accompanied by substantial fiscal and monetary support. The same outcome is projected for the Fukushima earthquake-tsunami disaster; the question here is how will the disasters in Japan affect the rest of the world.

Three spillover effects are expected. Firstly, trade with Japan is expected to be affected negatively in the short run, although the IMF forecasts that it will recover by 2012. The effect on Asia is not likely to be great, given that Asia's exports to Japan only amount to the equivalent of 4-5 per cent of its total exports.

weaknesses,' that, if they materialize, will lead to lower than expected growth. It is a risk that is particularly pronounced in peripheral Europe and if it materializes, there is a risk that it will spill over and destabilize the global financial sector, leading to lower growth.

The second downside risk that the IMF is concerned about is related to oil supply concerns, and high oil prices. High oil prices negatively affect household disposable incomes and thus could undermine economic recovery.

**Twin Risks: Impact of Japan's Earthquake and Oil Prices**

Decressin focused on two 'special risks:' one pertaining to Japan's March 11 triple disasters, and the other, the high oil prices and their impact on global economic recovery.

Decressin discussed the possible outcomes of the recent disasters by drawing on the experiences of the 2004 Kobe earthquake.

The Kobe earthquake caused great disruption of activities in the short run, including power outages and supply chain disruptions. It was followed by significant rebuilding afterwards,

The second spillover effect is that on the supply chain, the automobile industry being a prime example. As substantial auto parts are imported from Japan, the earthquake has disrupted automobile production in other parts of the world. While the IMF cannot determine the actual impact, Decressin said the general view is that the disruption of the supply chain is relatively small. Also downstream producers' large accumulated inventory has helped to buffer and mitigate the impact of the earthquake on the supply chain.

The final spillover effect is that of the potential repatriation of funds from Japanese insurance companies. There is no evidence so far to suggest that this is happening. Even during the Kobe earthquake, profit repatriation was not big. In short, Decressin does not expect a big spillover effect on the rest of Asia, and even if these spillovers do materialize, the IMF expects a bounce back will happen in 2012. (Fig 2)

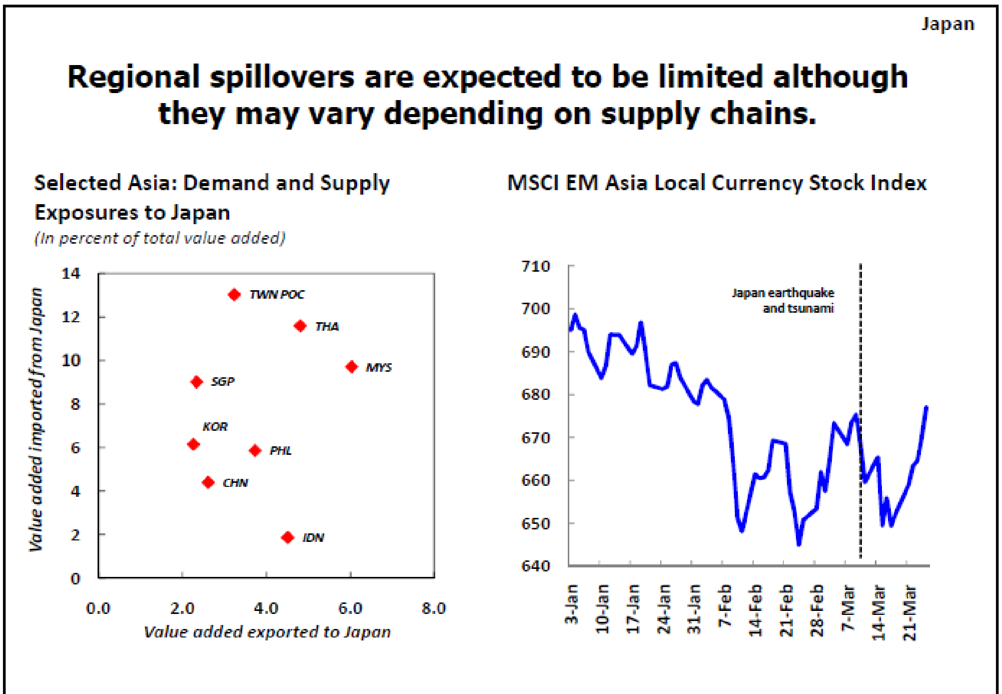


Fig 2

Oil prices, on other hand are increasingly becoming a matter of concern for the IMF. In real terms, oil prices have quadrupled from 1995, affecting in turn the prices of food. Three factors are responsible for driving oil prices, said Decressin.

The first is the fundamental strengthening of demand for oil from the fast growing emerging economies. The second is the recovery from the crisis, and the third is the unrest in Libya. Of the three factors, Libya has the least impact. The combined spare capacity of the Organization for the Petroleum Exporting Countries (OPEC), and government and industry stocks are estimated at 10 million barrels per day; Libya's share is about 1.5 million barrels per day. Hence, any shortfall in oil due to the crisis in Libya can easily be absorbed, and would have only a limited impact on oil supply, and hence prices. (Fig 3)

What is the risk scenario regarding oil prices? Decressin described 'the reasonable risk scenario' as that of oil prices topping US$150 per barrel before coming down. In March, the probability of that risk scenario happening was at 9.4 per cent; by May however, it dropped to three

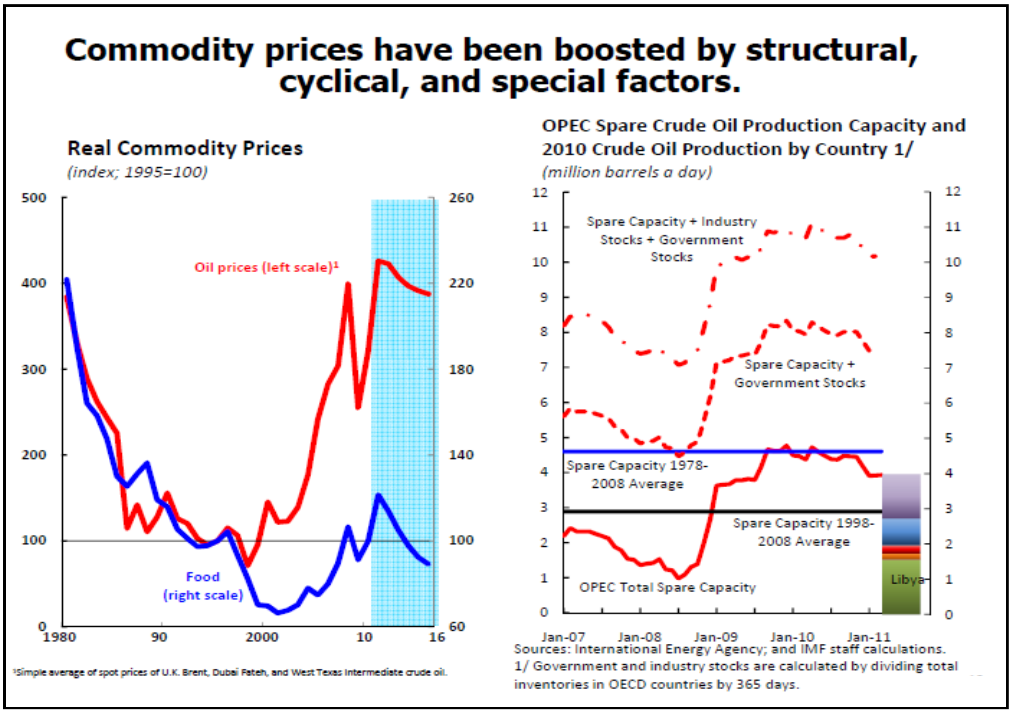


Fig 3

**Risks for prices spikes have diminisshed**

Probability of WTI price reaching $150 or above
(percent)

| | 3-Jan-11 | 7-Mar-11 | 23-May-11 |
|---|---|---|---|
| 3-mo forward | 0.0 | 2.3 | 0.0 |
| 6-mo forward | 0.8 | 6.8 | 0.9 |
| 9-mo forward | 2.3 | 9.4 | 3.1 |
| 2-yr forward | 6.2 | 12.3 | 6.6 |
| 3-yr forward | 8.4 | 13.2 | 8.8 |

Fig 4

per cent, indicating that oil prices are perceived as becoming less of a risk to global economic recovery. (Fig 4)

According to Decressin, in the short run, an oil shock is likely to have a bigger impact on developed economies than on emerging markets. Assuming an oil price of US$150 per barrel, the impact on advanced economies will be about 0.8 per cent of GDP; the corresponding figure for emerging Asia will be 0.7 per cent of GDP. (Fig 5)

However, the overall impact on Asia is less, given its high rate of economic growth, averaging at eight per cent, compared to the advanced economies' growth of 1-2 per cent.

The bigger concern is over what will happen to oil prices in the medium term. There is good reason to believe that 'oil prices will remain quite tense,' in the medium term, and a further increase in oil prices is likely.

Focusing on the supply side, the annual growth rate of oil supply, as estimated by the International Energy Agency (IEA), is 1.5 per cent per year for 2011-15. In comparison, in the 1980-90s, the corresponding average annual growth rate was 1.8 per cent. The world is therefore facing a situation of slower growth in oil supply and simultaneously, faster economic growth; so the pertinent question is, what will happen to oil prices?

The IEA forecast looks reassuring; it estimates the global growth of demand for oil to be 1.3 per cent, lower than supply growth. The IMF uses the same demand elasticity method as the IEA, although the IMF's are higher and depending on which elasticity is used, the demand for oil ranged from 1.3-3 per cent annually. (Fig 6)

Hence, if the growth in demand for oil is at three per cent annually while growth supply is at 1.5 per cent then there will be a significant increase in the price of oil. The increase in oil price will narrow the gap between demand growth and supply growth. Since supply cannot move too much, it would have to be demand that would

**Price spikes could significantly reduce output but losses need to be kept in perspective.**

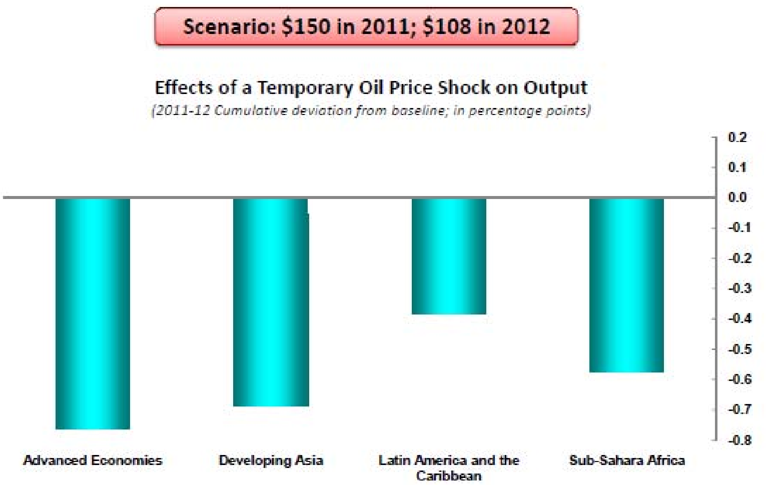


Fig 5

## Oil Demand-Supply Balance:
## Tensions are likely over the medium term!

Challenges to raising oil supply capacity include long and variable time-to-build lags, technological risks, drag from maturing fields, and restrictions on oil investment.

Result: downshift in oil supply trend growth and precarious demand-supply balance→ demand growth could exceed supply growth at unchanged prices.

**Oil Demand – Supply Balance**

*(annual change, in percent)*

| | Avg. 2011-15 |
|---|---|
| **Demand** | |
| World | 1.3 |
| Advanced economies | -0.7 |
| Emerging and developing economies | 3.2 |
| **Supply** | |
| World | 1.5 |
| Non-OPEC | 0.4 |
| OPEC | 3.0 |
| **Memorandum** | |
| Oil demand growth implied by WEO growth forecast[1] | |
| Short-term income elasticity | 3.0 |
| Long-term income elasticity | 1.3 |

Source: IEA, Medium-term Oil Market Report, updated December 2010; and IMF staff estimates.
[1]Estimates from Chapter 3 in April 2011 World Economic Outlook, (Table 3.1

Fig 6

need to move closer to supply and that would be through a large increase in the oil price.

Basically the price of oil will increase to a level where it will inhibit demand, bringing annual growth of demand for oil closer to that of annual growth of supply. The bottom line is that the IMF is 'quite concerned about the tensions in the global oil market.'

The movement in oil and energy prices in general has ramifications for food prices, due to their effect on the cost of fertilizers. Fertilizers are a major input in food production and the cost of fertilizers is directly affected by energy prices via transportation costs; natural gas is a key ingredient in the production of nitrogen based fertilizers.

There have been large increases in food prices, and according to the IMF, the hike is largely driven by structural factors, such as strong demand from emerging economies for oil and other forms of energy, and the bad harvests that plagued Europe and some food producing countries in the last couple of years.

Decressin expects the bad harvest situation to resolve itself within the next few years although the increase in food supply will be slow going by the existing low inventory. All in all, the IMF is not as concerned about the food price situation mainly because although there is concern in the short run due to the low inventory, there is a lot of room for increased food production. (Fig 7)

## The Policy Challenges

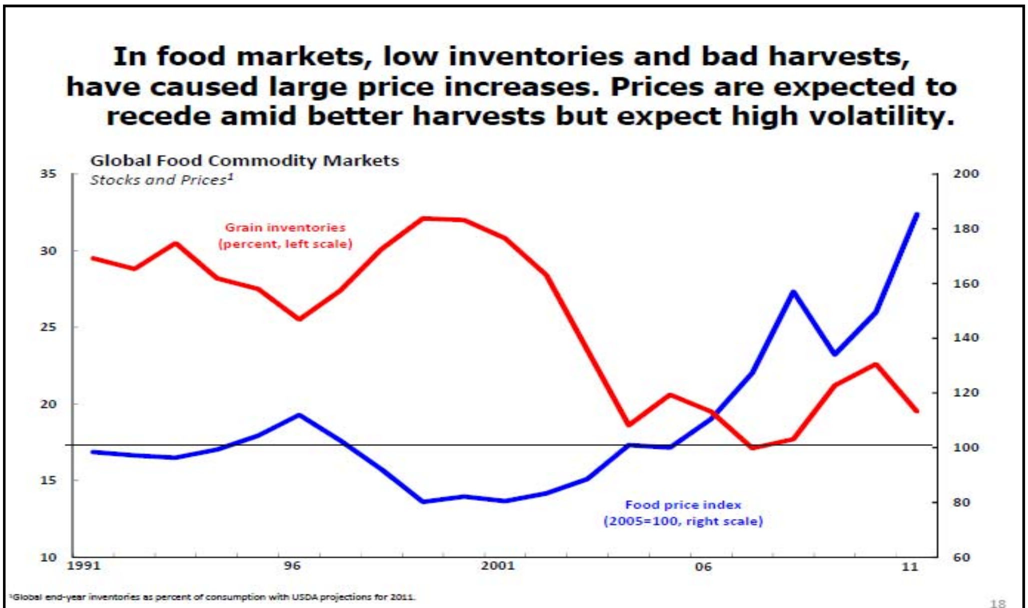

Fig 7

Policy challenges differ for both advanced economies and emerging markets due to the different economic cycles of these two entities. For advanced economies, GDP growth is below the pre-crisis level and inflation remains low, hence the policy rates for many of these countries can stay low. The challenge for advanced economies is mainly fiscal adjustments, specifically public debt. The IMF forecasts that by the year 2016, gross government debt of the advanced economies will exceed 100 per cent of their GDP level. It is a large amount and it raises concern. This is the main challenge for advanced economies -- how to rein in increasing debts and ultimately bring them down to an acceptable level.

He identifies Japan and the US as the advanced economies facing the biggest challenge in reducing public debt and hence achieving 'sound public finance' (defined here as 'bringing down public debt to 60 per cent of GDP by 2030.')

The situation is reversed in emerging markets, where the GDP growth rates are above pre-crisis levels and inflation is moving up. This is consistent with the situation where resource utilization has moved above capacity. In emerging markets, the interest rates are lower than before the crisis, but economic activities are above pre-crisis levels, a case where monetary rates have to rise, consistent with higher inflation.

Decressin said public debt in emerging markets as a percentage of GDP is on the declining trend. Fiscal balances are now lower than the pre-crisis levels, and he urged emerging markets to reduce fiscal deficits which would then rebuild capacity to enable room for policy manoeuvres in the event of future crisis.

A big challenge in emerging markets according to Decressin is credit growth. Fig 8 shows credit growth in per capita terms (real terms) for the period of 2005–10. If a country's credit growth is over the 100 mark, that means that credit has doubled over the last five years in both real and per capita terms. China, Brazil and Turkey have hit the 100 mark and Peru, Columbia, India and Indonesia have hit 60-70. This indicates a tremendous growth in credit in some emerging economies. He cautioned these countries to keep a close watch on the situation lest it escalates into a boom-bust cycle. This would require macroeconomic adjustments in terms of raising interest rates as well as micro-prudential tools (i.e raising capital requirement) to be implemented as required.

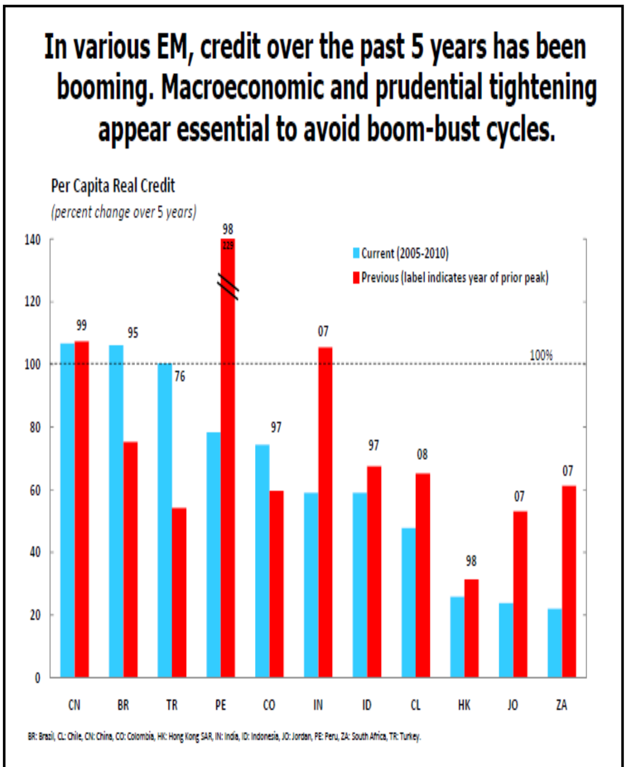


Fig 8

## Global demand rebalancing

Prior to the crisis, emerging markets on the whole were running current account surpluses and advanced economies were running current account deficits. There were large divergences between the two. The imbalance had narrowed, but at the price of a large global recession. In other words, the reason the global imbalance is narrowing is that consumption in the US and other advanced economies has crashed.

Unfortunately domestic demand in countries with excessive external surpluses has not accelerated relative to before the crisis. Therefore the collapse of deficit economies such as the US and other advanced economies has not been made up for by stronger expansion or stronger demand growth of countries with excessive surplus. This cannot happen overnight; it is difficult to stimulate demand or to build demand on a sustainable basis. The bottom line is that some rebalancing through negative factors and a large global imbalance still remains. Should oil prices increase, Decressin expects the imbalance will increase again over the medium term. (Fig 9)

The challenges with respect to global imbalances are for the demand in economies with large surpluses to accelerate and for the exchange rate to appreciate. The problem is, while a lot of currency appreciation is happening, it is only in selected economies — typically, countries with large external debts, i.e. the Latin American economies.

## Capital Inflows

Latin America and some Asian countries are struggling to cope with capital inflows. While the capital inflows to the emerging markets are not bigger than they used to be, specific countries such as Brazil, Turkey, South Africa are receiving

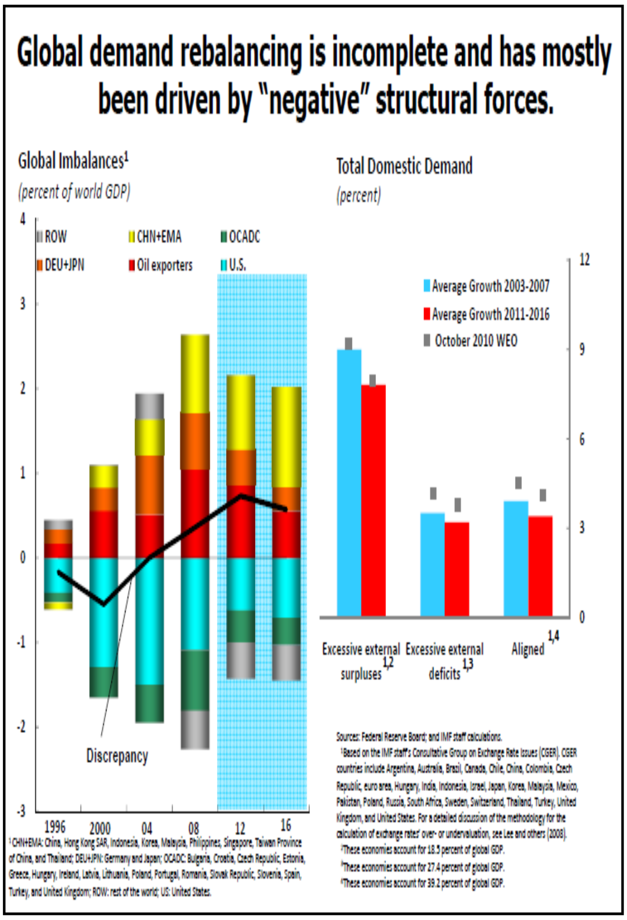


Fig 9

very large capital flows. The main concern with capital flows is that they are very volatile. Should the US economy begin to normalize and its interest rates start to rise, then the capital that has been pouring into the emerging markets would again rapidly flow out in favour of the US market. (Fig 10)

The interest rate is not the only factor determining capital flows. Structural factors play a big part as well, and these are the high savings in Asia, and the prevailing high oil prices. The bulk of the high savings are comprised of reserves from China invested in the form of US treasury bills. These investments drive the rate of returns of the treasury bills lower, to a point where they become unattractive to investors. Many of these investors, in seeking higher yields, end up in emerging markets.

High energy prices also play a role; they add revenue to the oil producing countries' coffers. These countries will save and invest the income generated by the high energy prices, particularly in light of the non-renewable nature of these resources. The bulk of these investments will go to US treasury bills and the same scenario as the high savings will present itself. These structural factors are likely to persist for a long while.

Capital flows are very volatile, and governments should pay attention to them. Interestingly, IMF views on measures to cope with capital flows have evolved. The IMF which used to be fairly adverse to capital controls measures, has made a complete about turn, going as far as to endorse the use of capital controls as part of policy-makers' tools to combat huge volatile capital flows. The question is when is it appropriate to implement capital controls, or as the IMF puts it, 'capital flow measures'? According to Decressin, the IMF thinks this would be during instances of a huge capital surge giving rise to macro-economic concerns and/or financial stability concerns. (Fig 11)

In macro economic risk concerns, the first line of defence in macro economic policy is the exchange rate -- let the currency appreciate. However if this fails, then the next recourse is to look at accumulated reserves, fiscal and monetary mixed inputs. If all these measures are not sufficient, or if all measures have been exhausted in dealing with the problem, then the IMF deems it justifiable to use capital controls. (Fig 12)

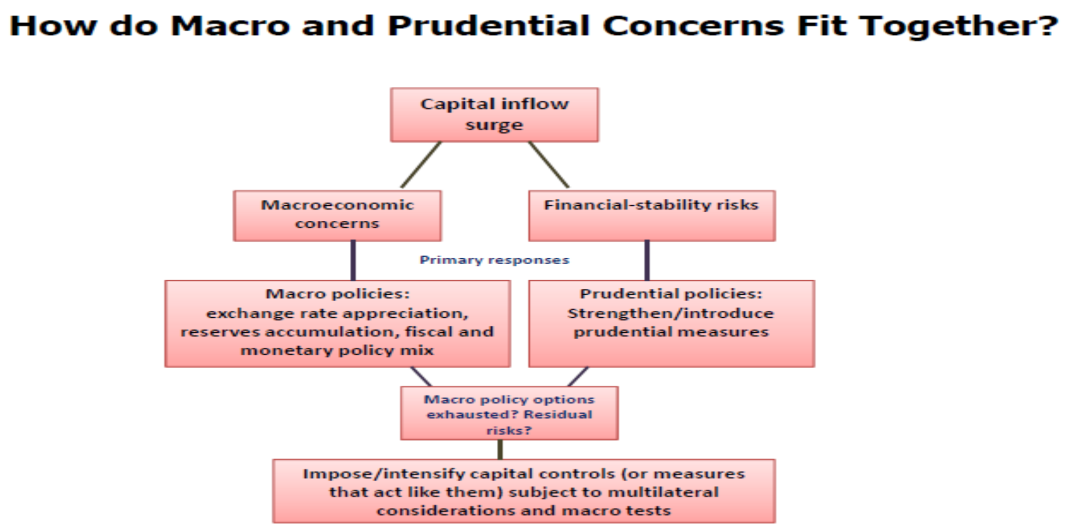


Fig 10

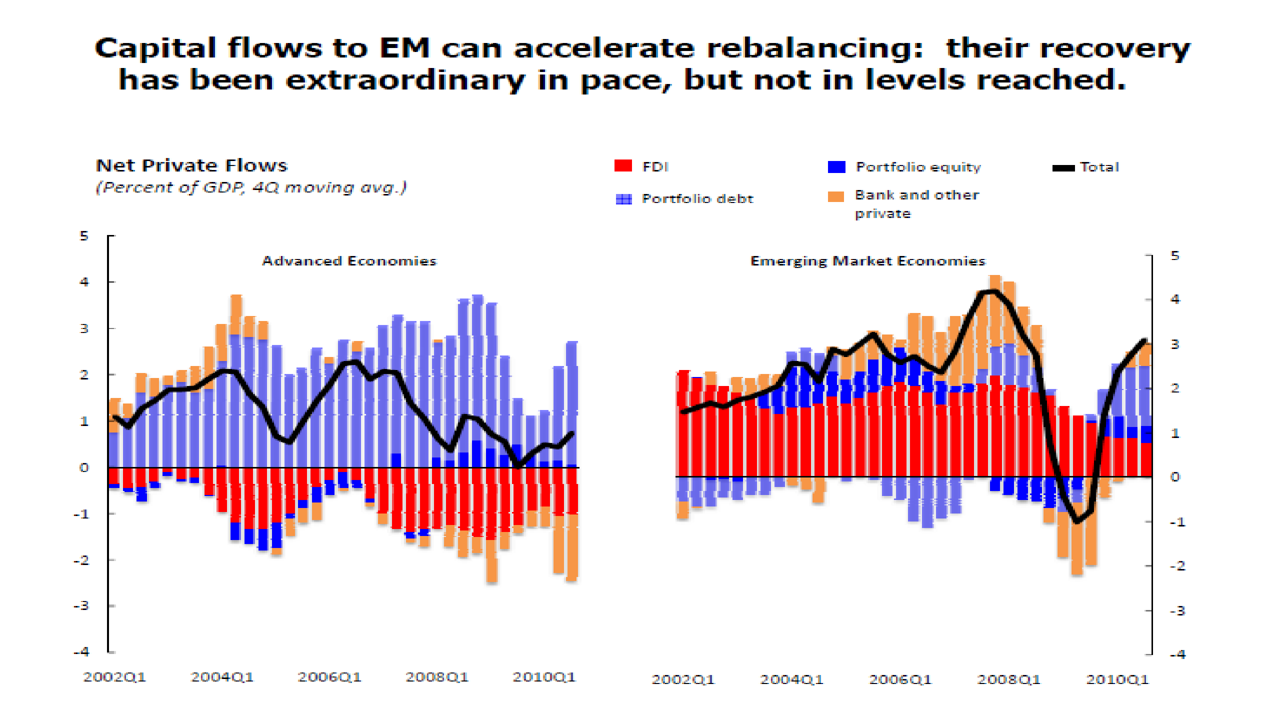


Fig 11

In conclusion, Decressin expects global economic recovery to solidify, led by faster economic expansion in emerging markets. Economic growth in advanced markets is expected to be limited given that most of them are still grappling with the lingering effects of the financial meltdown, property overhang and high unemployment.

## Recent Examples of Measures

**FX-related measures**

- Reserve requirements on foreign currency deposits (Peru)
- Limits on banks FX derivative positions in percent of bank capital (Korea)
- Capital requirements for FX loans (Peru)
- Limits on banks net open FX positions (Peru)
- Limits on ratio of banks FX loans and securities to FX borrowing (Korea)

**Other prudential measures**

- Reserve requirements for local currency deposits (Brazil, Turkey)
- LTV ratios (Korea, Peru, Thailand, Turkey)
- Levy on interest from consumer loans (Turkey)
- Capital requirements for specific loans (Brazil)

**Capital controls**

- Tax on equity and bond inflows (Brazil)
- Fee on NR purchases of central bank paper (Peru)
- Reserve requirements on NR deposits (Peru)

Fig 12

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