Interest Rates, Debt, and the Dollar: A Global Panorama

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Roadmap

Preamble: **Pre-2008 balance sheet fundamentals in emerging markets (EMs)**

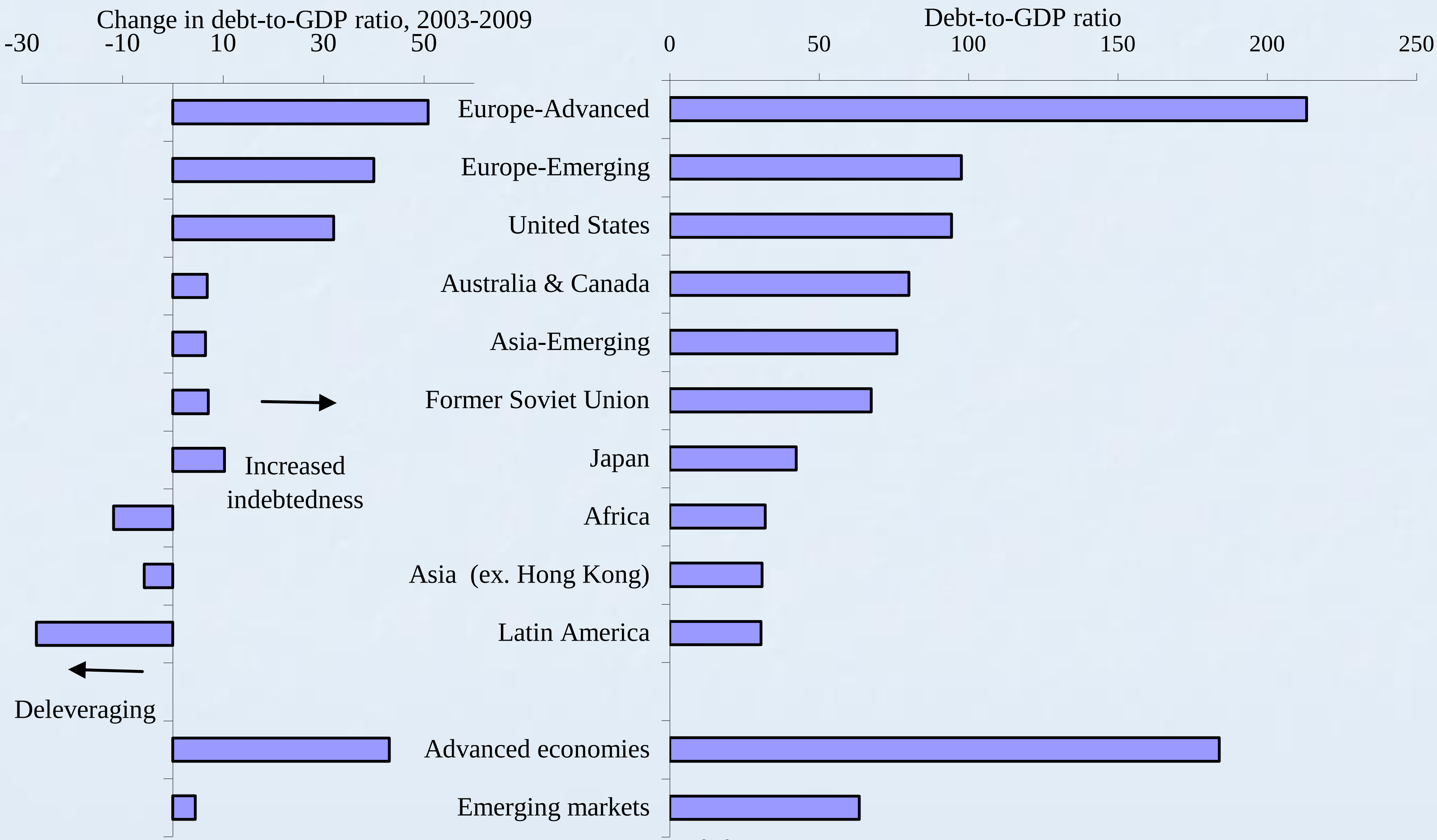
and a retrospective on the EM 2003-2013 "double bonanza" –capital inflows and commodity price boom

Looking ahead: **Global interest rates, capital flows, commodity prices and China**

Some challenges for Colombia and other emerging markets

Preamble: When the 2008-2009 crisis hit the advanced economies, EMs had strong debt profiles…

Gross External Debt as a Percent of GDP: Averages for Selected 59 Countries, 2003-2009
(in percent)



Following the "double bonanza," by early 2013, in many EMs

- Current account deficits had reappeared
- As did credit booms
- And currency overvaluation
- Growth had begun to slow
- In some cases, inflation had resurfaced as a concern

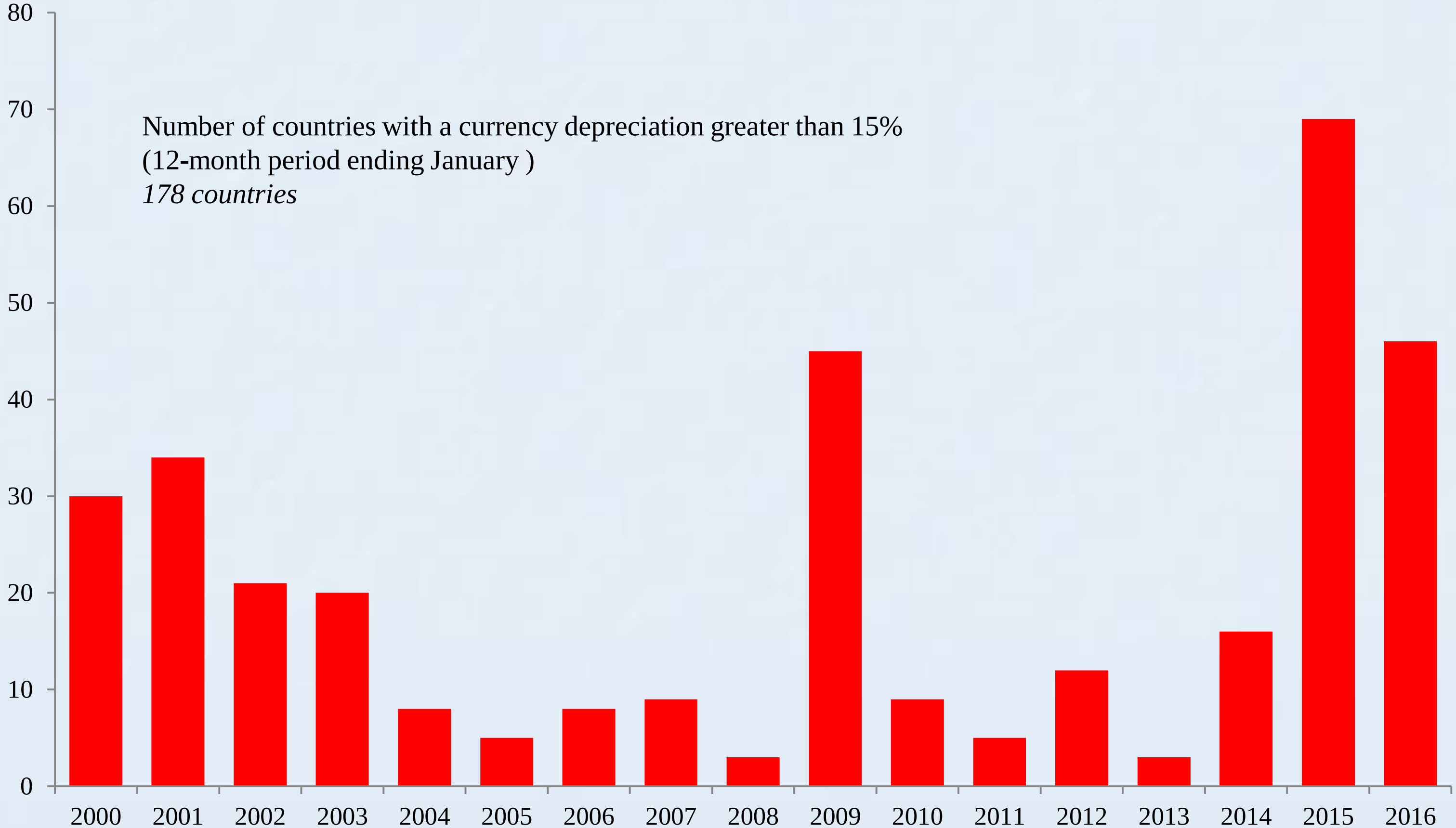
And then came the announcement of QE tapering…

Since the May 2013 tapering announcement, other global factors deteriorated

(i) commodity prices declined sharply;
(ii) China's slowdown intensified;
(iii) global investors turned to advanced economies equity markets in increasing numbers.

Downgrades and currency crashes returned to the EMs…

Number of Currency Crashes, 178 Countries: 2000-2016 Colombia's peso depreciation October 2013-February 2016 is 77.9%



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But, at least, interest rates in the US and other advanced economies remained historically low…

So, is the era of low interest rates over now?

Global interest rates:

The advanced economies

The sluggish recovery in advanced economies has been a significant factor in keeping interest rates low for so long…

The 2007-2009 Crisis: 10 years later

- Of the 11 advanced economies experiencing a systemic crisis starting in 2007-2008 only Germany and the US had reached their pre-crisis peak in per capita GDP by 2014
- 3 more (Iceland, Ireland and UK) by 2015
- Greece and Italy may set a record for the most delayed recovery.

Output, Crises and Recovery

Reinhart and Rogoff (2014) updated with World Economic Outlook, October 2016

11 Systemic banking crises in Advanced economies, 2007-2008

	Year	Country	% change Peak to trough	Number of years Peak to trough	Peak to recovery	Severity index	Double dip, yes=1
1	2008	France	-3.8	2	*9*	*12.8*	1
2	2008	Germany	-5.3	1	3	8.3	0
3	2008	Greece	-24.8	*6*	*15*	*39.8*	0
4	2007	Iceland	-7.6	3	*8*	*15.6*	0
5	2007	Ireland	-10.5	5	*8*	*18.5*	1
6	2008	Italy	-10.9	*7*	*15*	*25.9*	1
7	2008	Netherlands	-4.1	*1*	*9*	*13.1*	1
8	2008	Portugal	-7.0	*6*	*13*	*20.0*	1
9	2008	Spain	-10.3	*6*	*11*	*21.3*	0
10	2007	United Kingdom	-6.4	2	*8*	*14.4*	0
11	2007	United States	-4.8	2	6	10.8	0
	Summary:	Mean	-8.7	3.7	9.5	18.2	
		Median	-7.0	3.0	9.0	15.6	
		Standard deviation	5.9	2.3	3.7	8.8	
		Share of episodes with double dip					45.5

Note: The italics denote any calculations in which IMF estimates for 2016- are used.

Europe's recovery is even by the standards of the worst crises in history

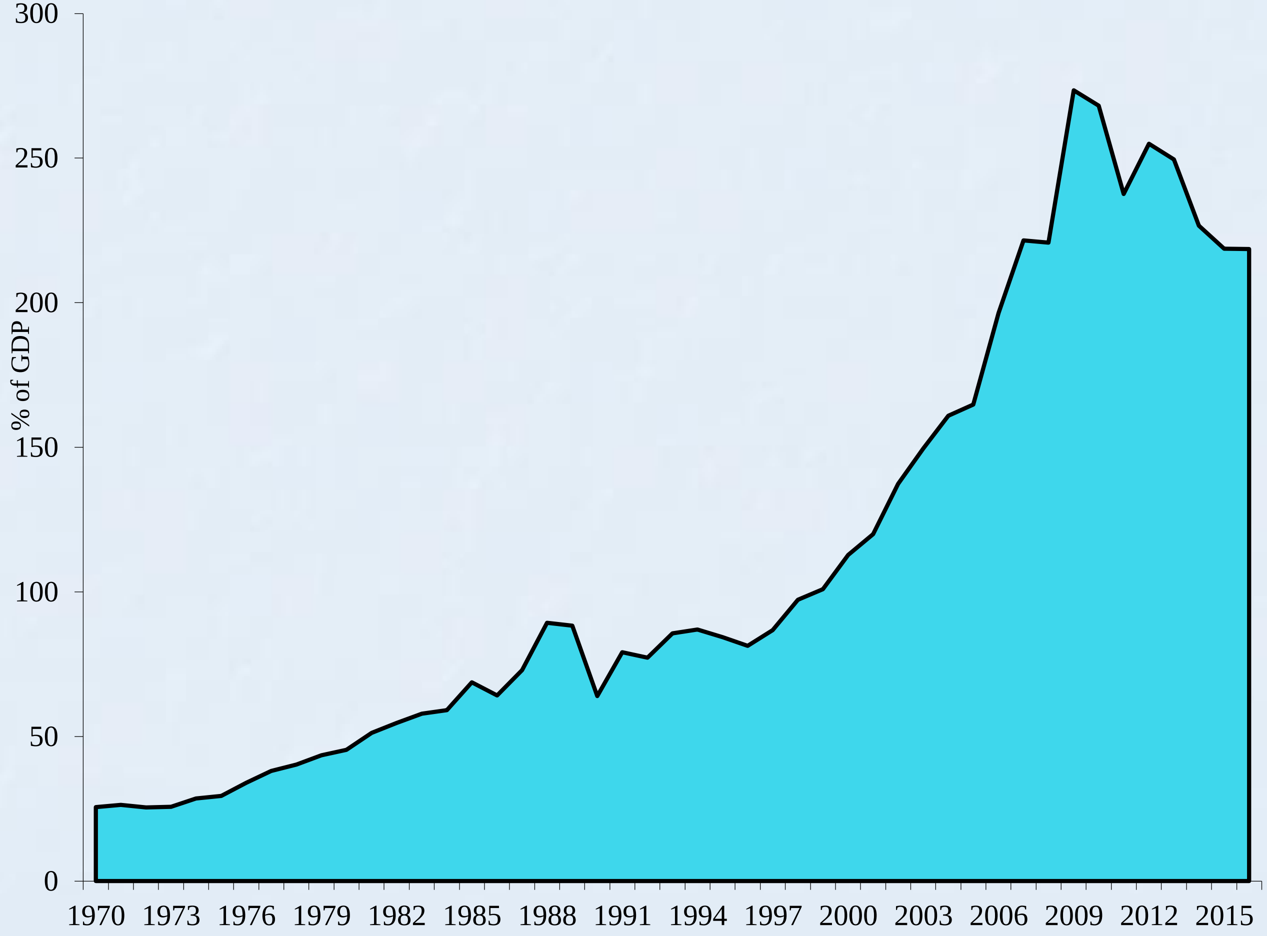
- The number of years to recover the pre-crisis peak in per capita GDP in 100 of the worst crises since the 1840s is about **8 years** (the median is **6 1/2 years**).

- In the 2007-2008 wave of crises, the average may come in closer to **10 years.**

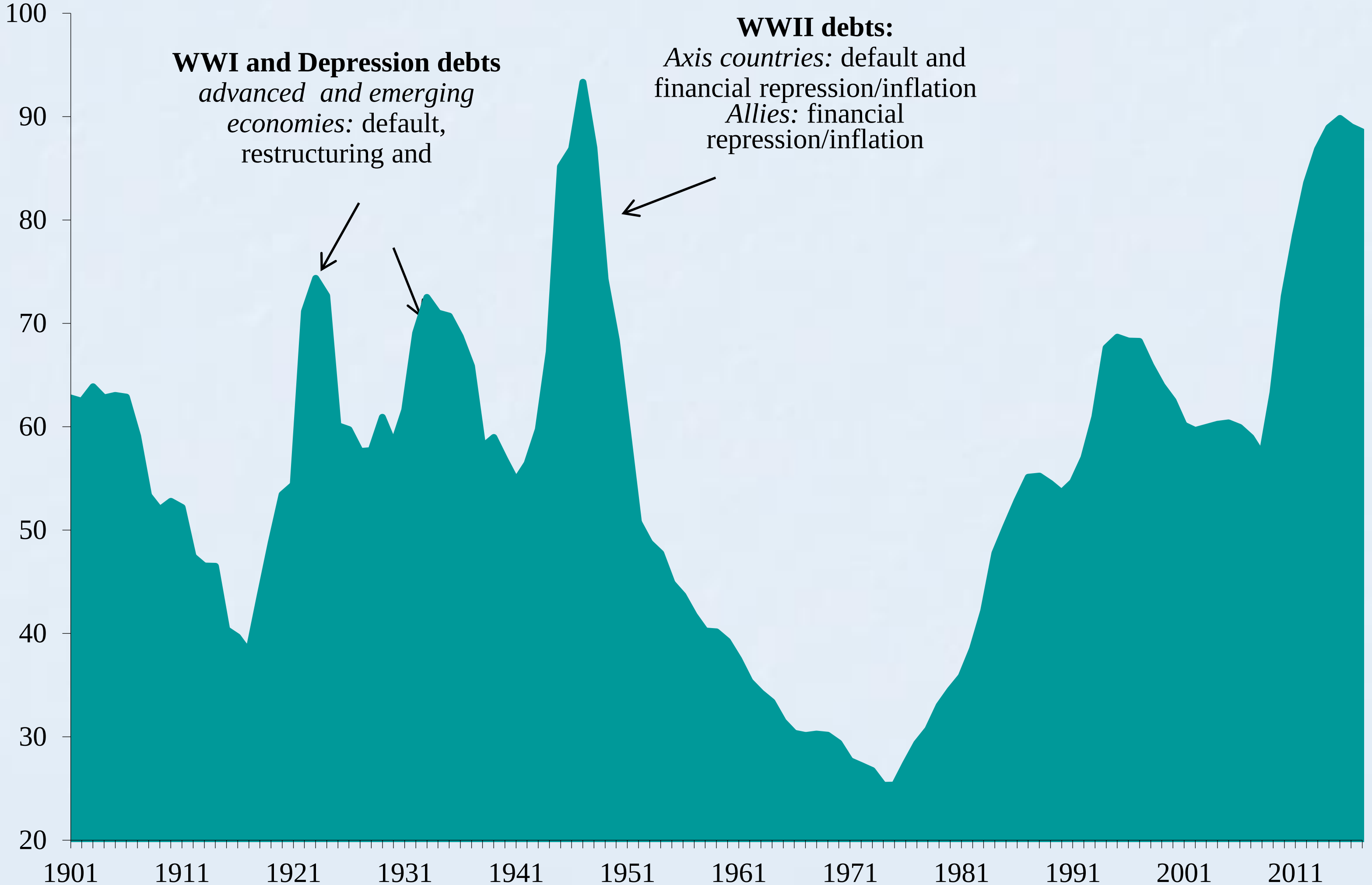
Apart from the lackluster recovery, debt burdens in advanced economies are at record levels.

This limits their ability to tolerate high interest rates…

Gross Total (Public plus Private) External Debt as a Percent of GDP: 22 Advanced Economies, 1970-2016



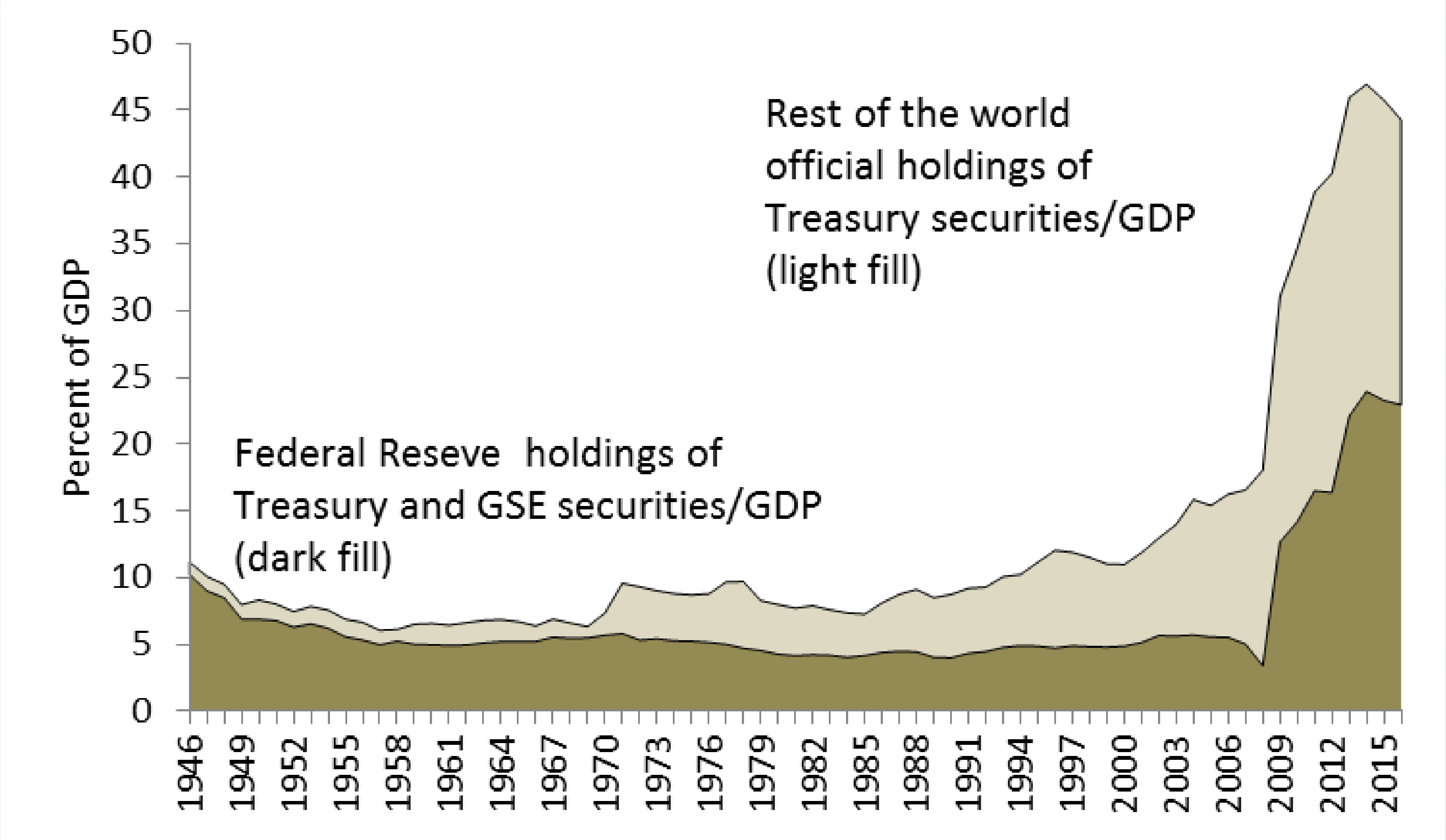
Public debt as a percent of GDP: Advanced Economies: 1900-2016



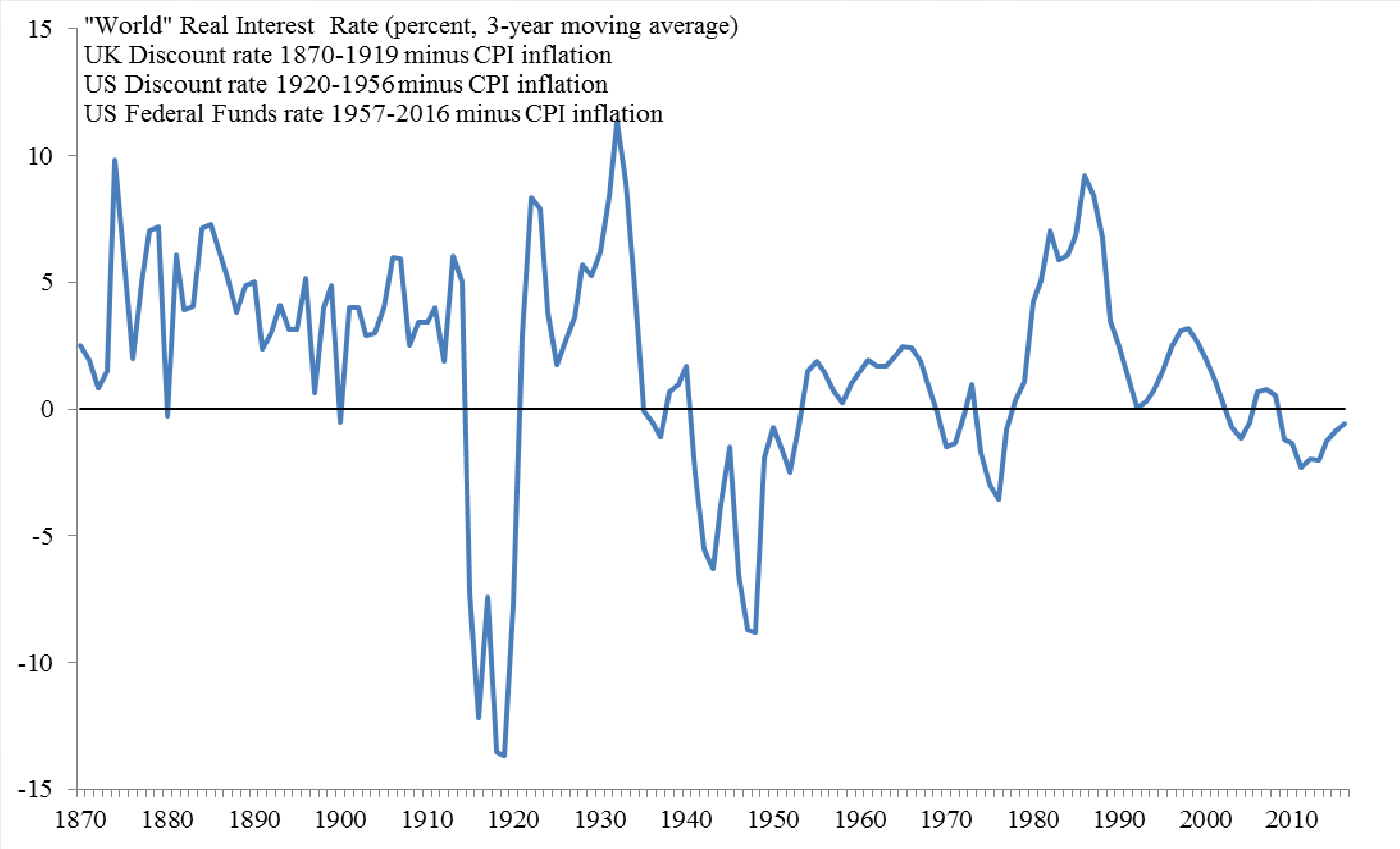
Financial repression has been another factor behind the low rates

- Saving glut
- Secular stagnation
- Monetary policy with a heavy dose of financial repression

The combined effect of domestic and official players calls into question to what extent interest rates remain "market-determined"

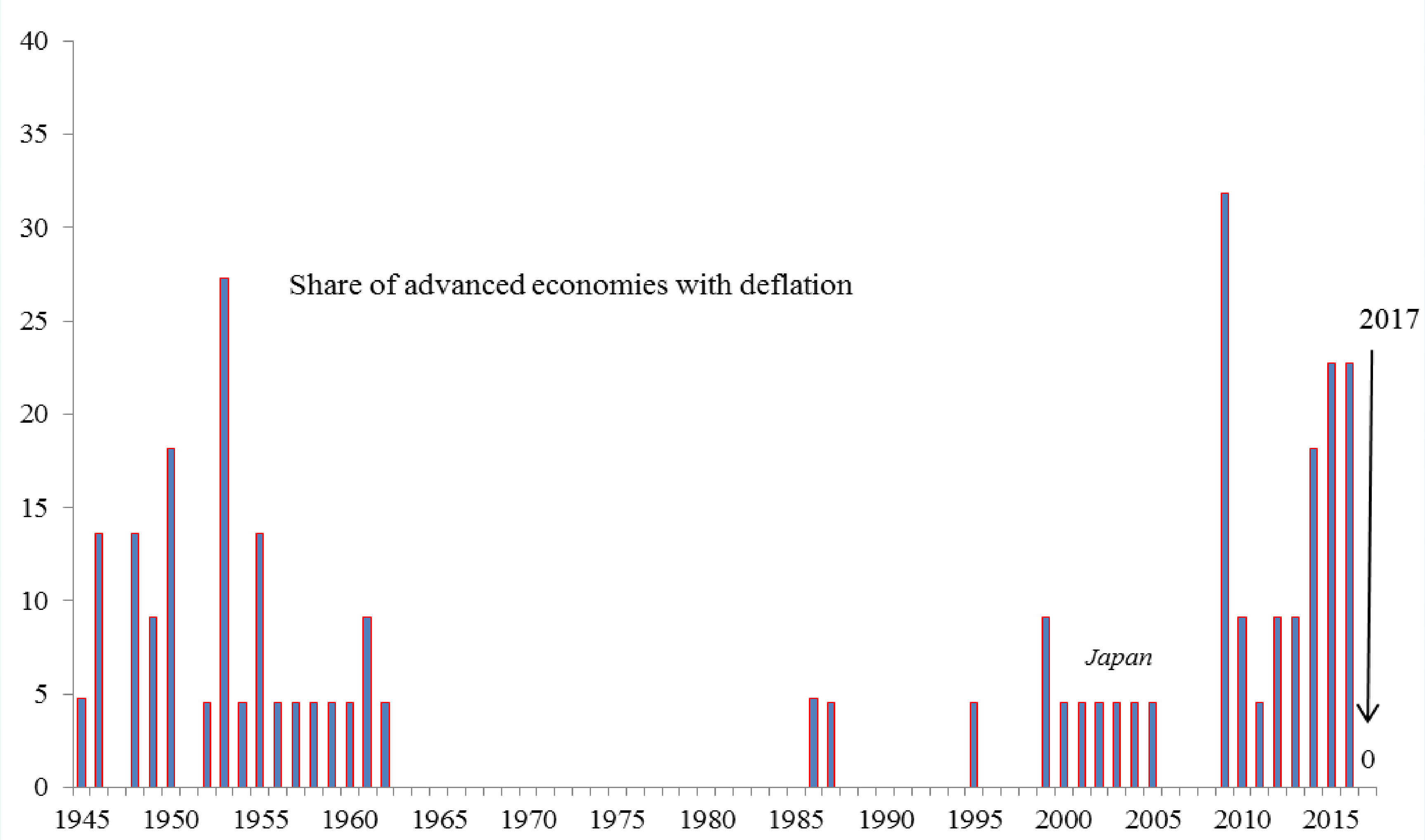


"World" Real Short-term Interest Rates, 1870-2016: Why are we surprised?



Is the deflation cycle over?

What's next for monetary policy



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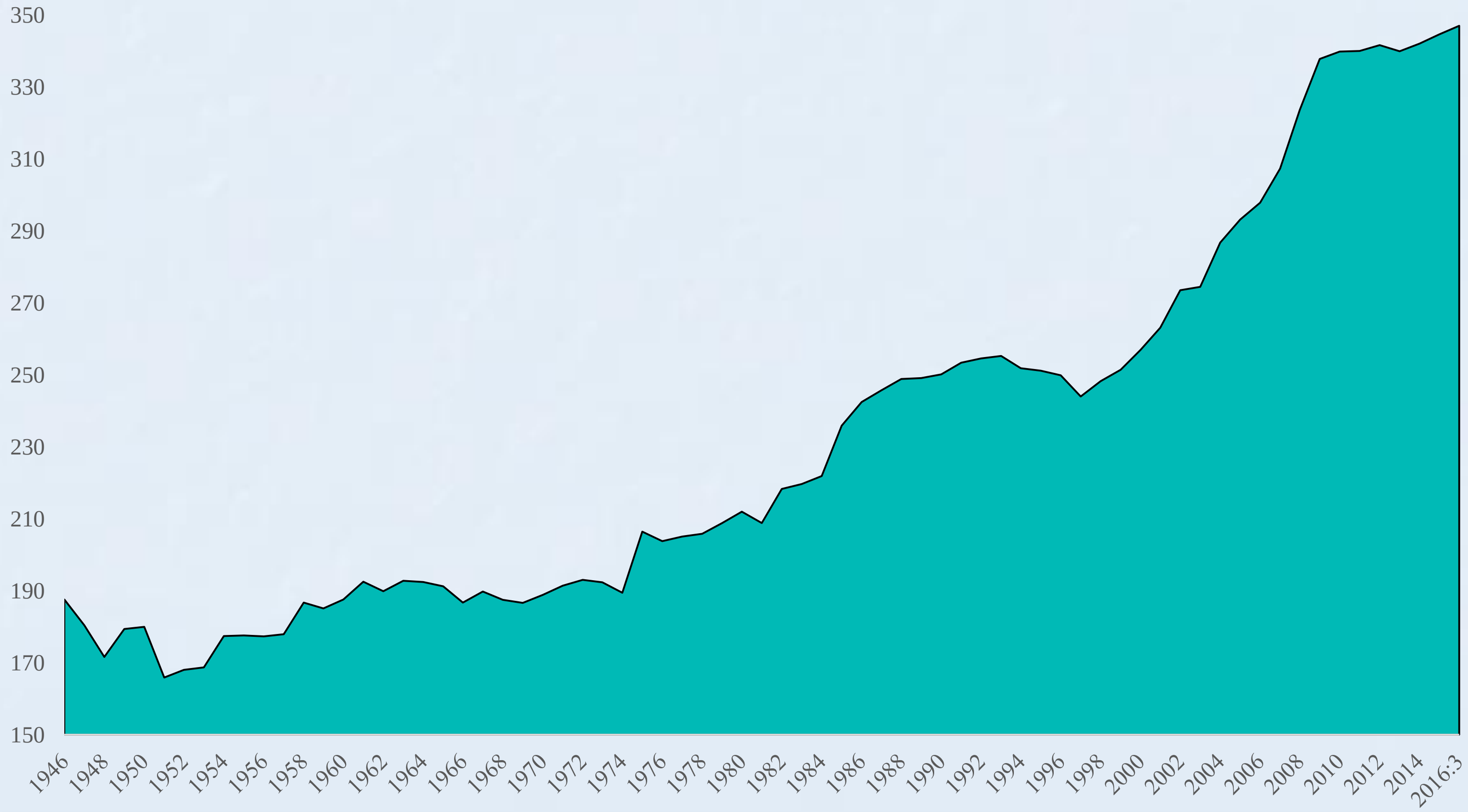
Is the era of low interest rates over?

Part I. The US and Challenges to Federal Reserve tightening: High debt, President Trump, and a strong dollar

United States, 1946-2016 Total Liabilities of the Nonfinancial Sectors as a Percent of GDP



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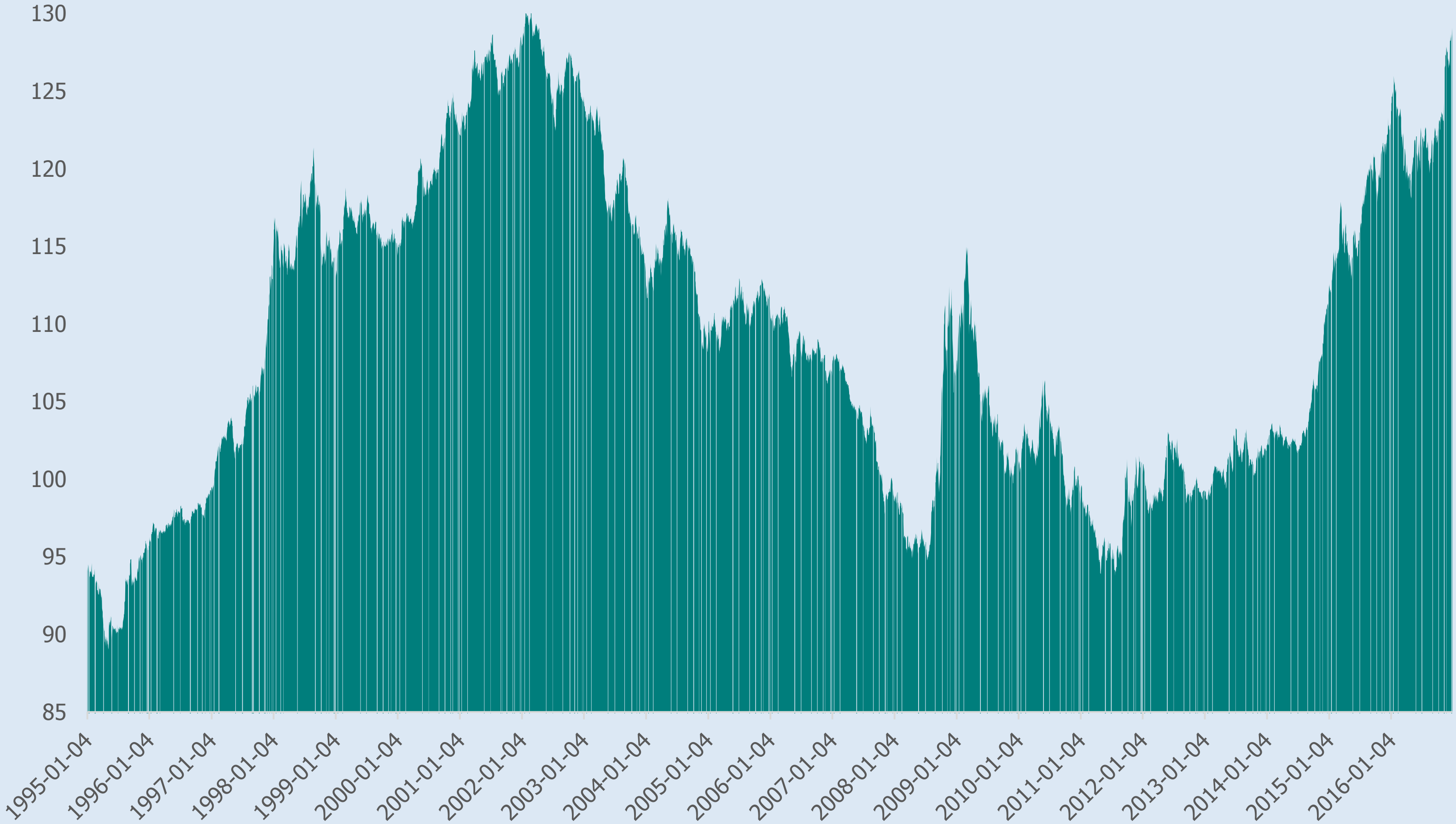
Trade Weighted U.S. Dollar Index: Broad, Index Jan 1997=100, Daily, Not Seasonally Adjusted 1995-2016



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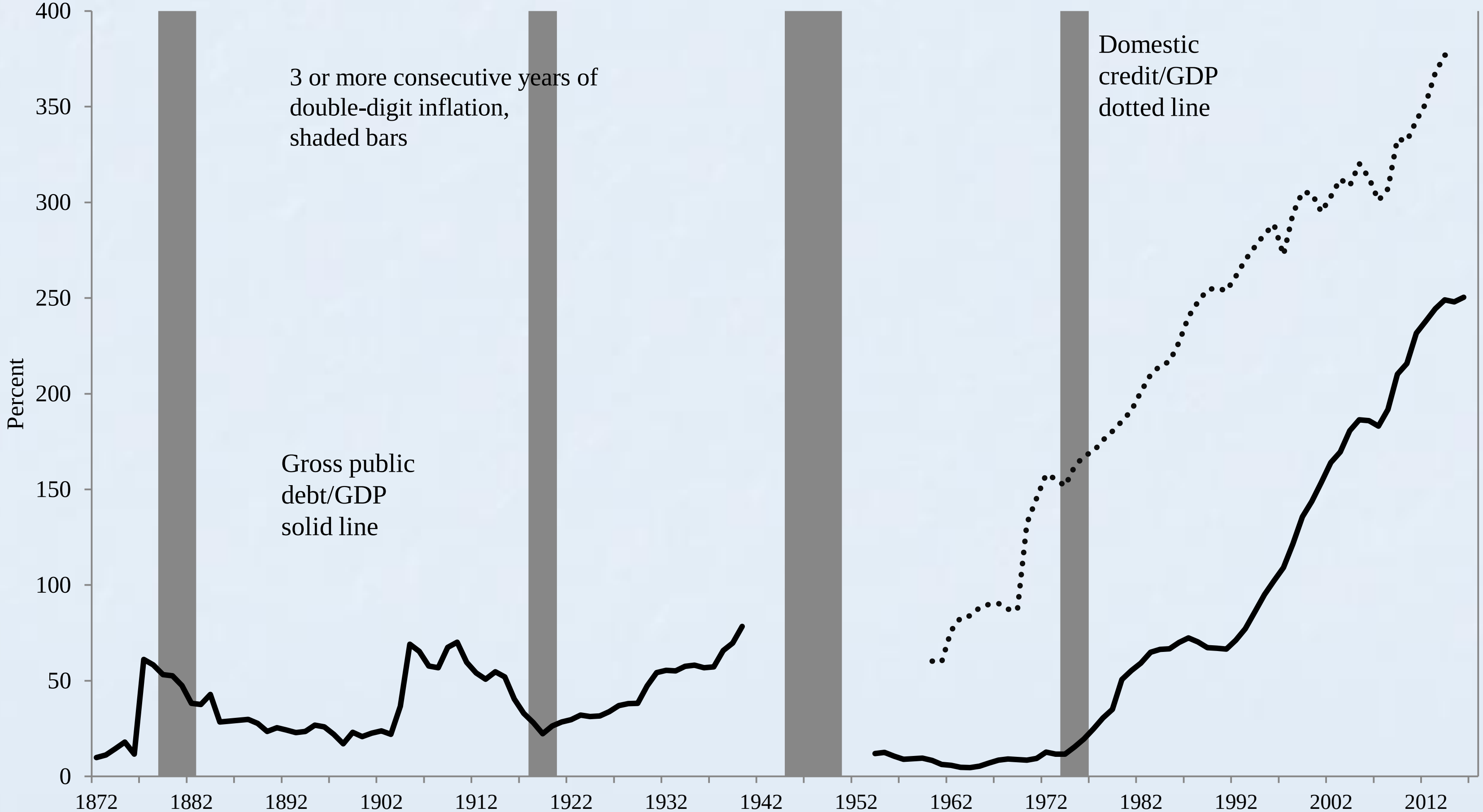
--There are at least three openings at the Federal Reserve's Board.
--There is a rift between the Board and the Congress, potentially threatening independence
--Chair Yellen has less than a year left in her term

Part II. Why does Japan needs inflation and continued monetary policy accommodation?

Public debt, private credit, and inflation: Japan 1872-2016



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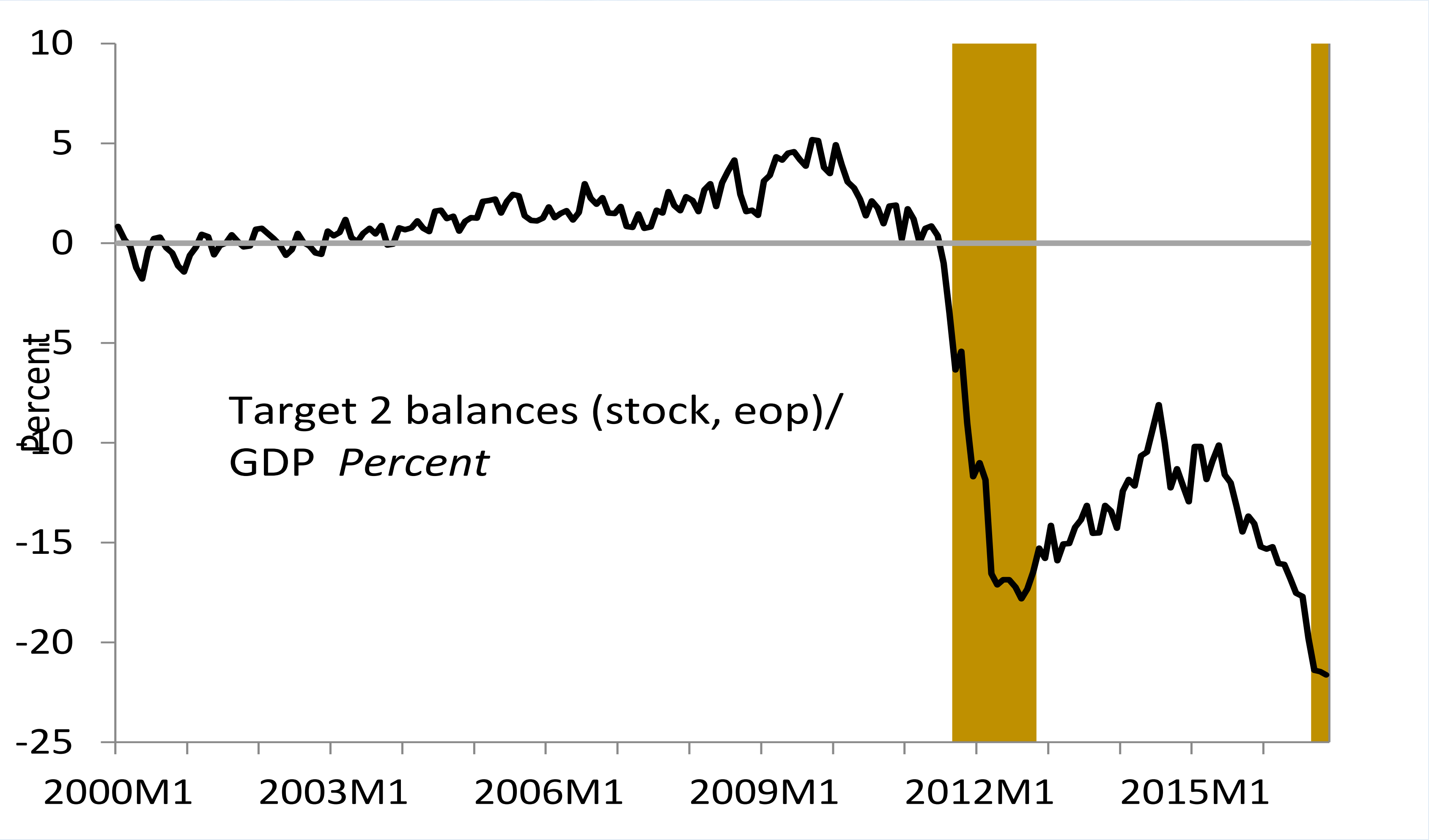
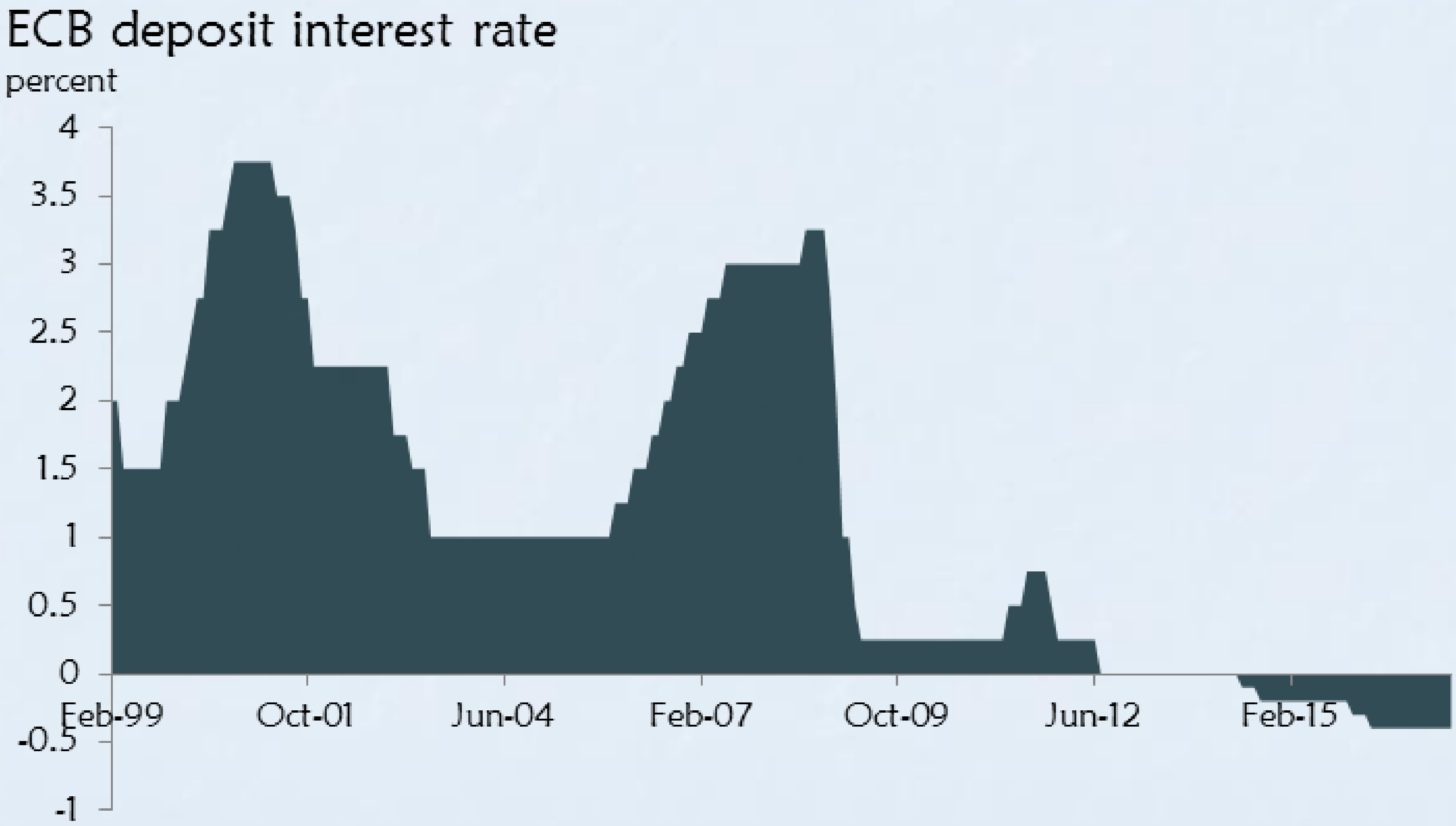
Part III. Eurozone’s North-South divide: Debt overhang, selected banking problems, and capital flight in the periphery (with a fixed intra-Eurozone exchange rate)

In the case of Italy (2000-2016), the decline in shadow reserves (Target 2) highlights the capital flight problem



ECB Policy Is Very Accommodative



Source: Bloomberg, accessed 5/3/2017.

Why policymakers worldwide may not want to "rock the boat" too much

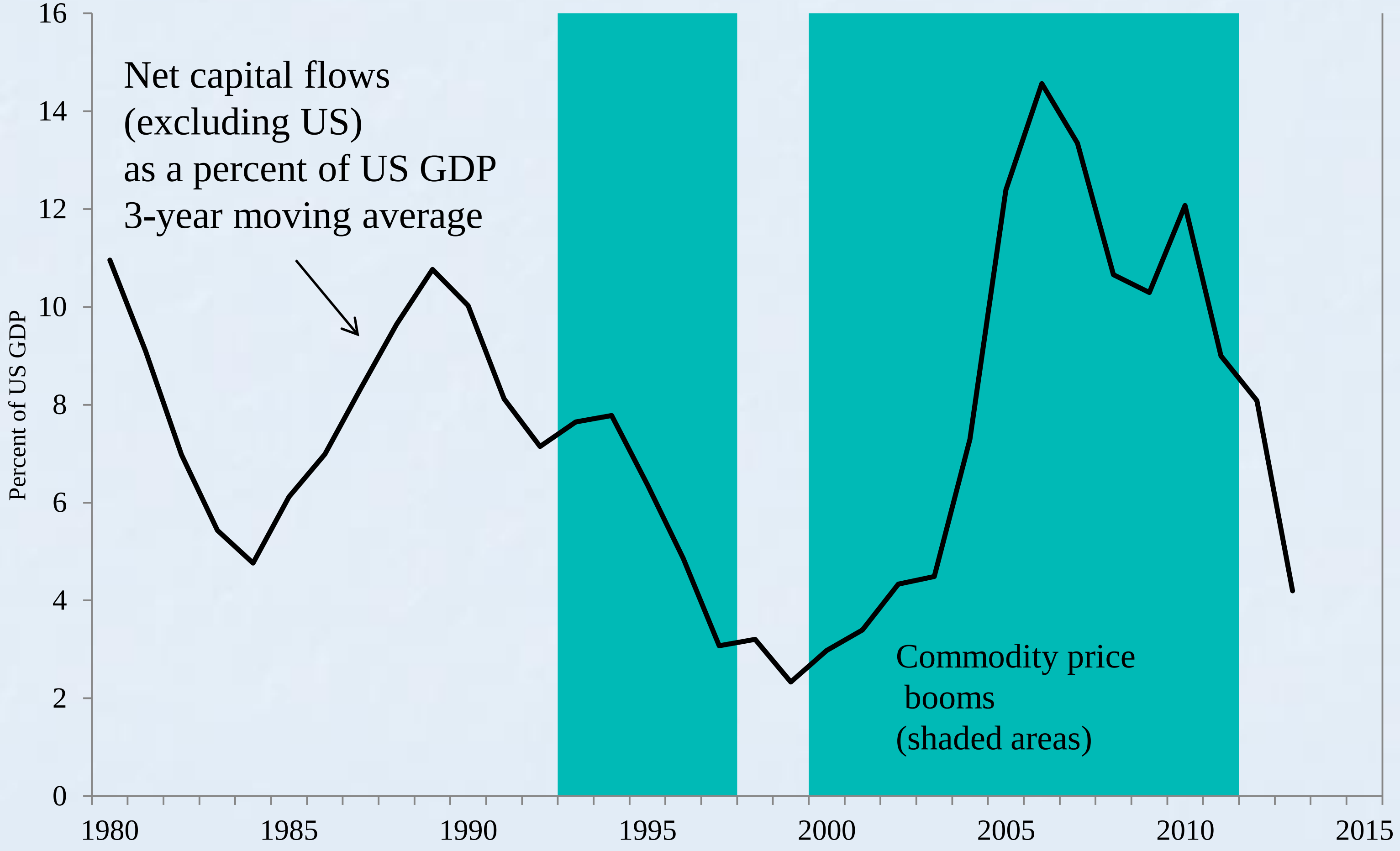
September 2017	November 2017	Spring 2018	November 2018
French and German elections	The Chinese party conference	The Saudi's IPO of Aramco	The US midterm elections

In sum, the near term, aggregate demand will expand slightly faster than slow aggregated supply, putting upward pressure on inflation and leading central banks to renormalize their policy stances.

Potential output growth has slowed around the world, suppressing real returns, compressing risk spreads, worsening the budget outlook, and challenging the political economy.

Capital flows, China, and commodity prices

While there is a modest revival post Brexit, capital flows to EMs have dried up in recent years…



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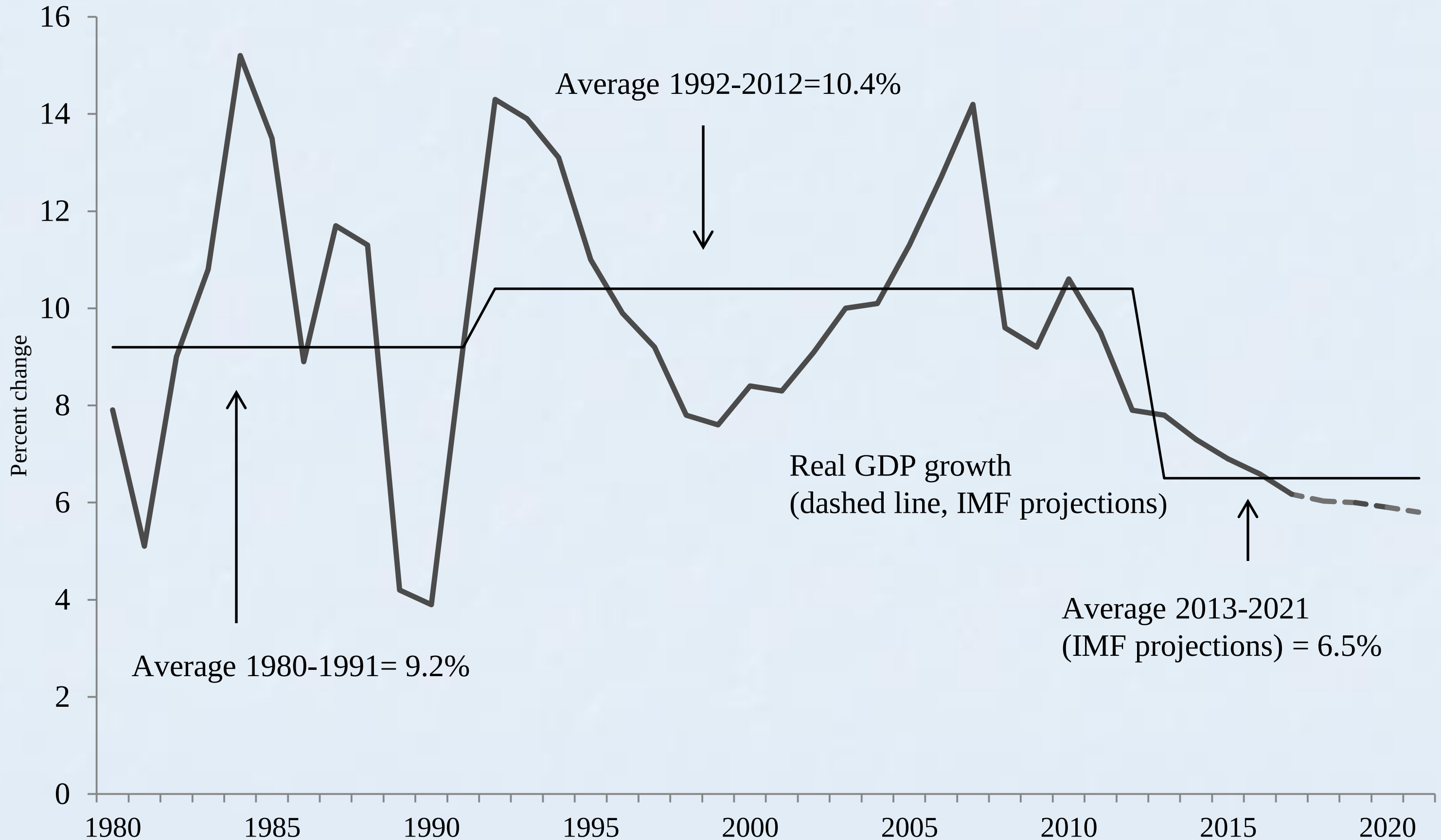
But given the low rate environment, the search for yield by portfolio managers is alive and well…

The slowdown and re-composition of China's growth has significant repercussions for the world and emerging markets in particular, 1981-2021

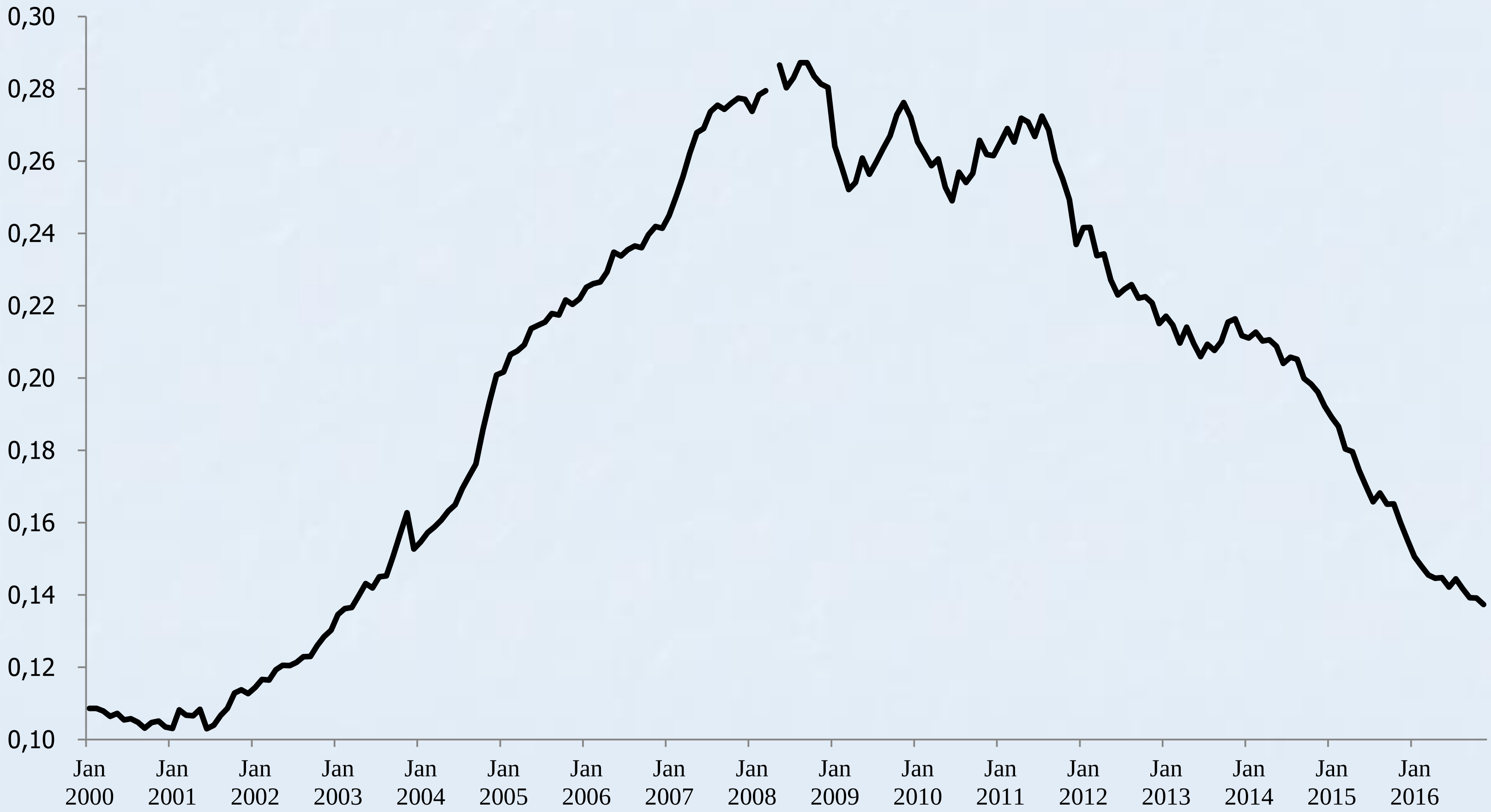


China's own capital outflow problem:

Another historical example of a central bank's policy inconsistency between a lender of last resort and a (semi) fixed exchange rate.

Usually—it is the exchange rate that gives.

China's Capital flight: Central bank reserves/M2 (broad money)—reserves are not the full story *2000 to 2016*



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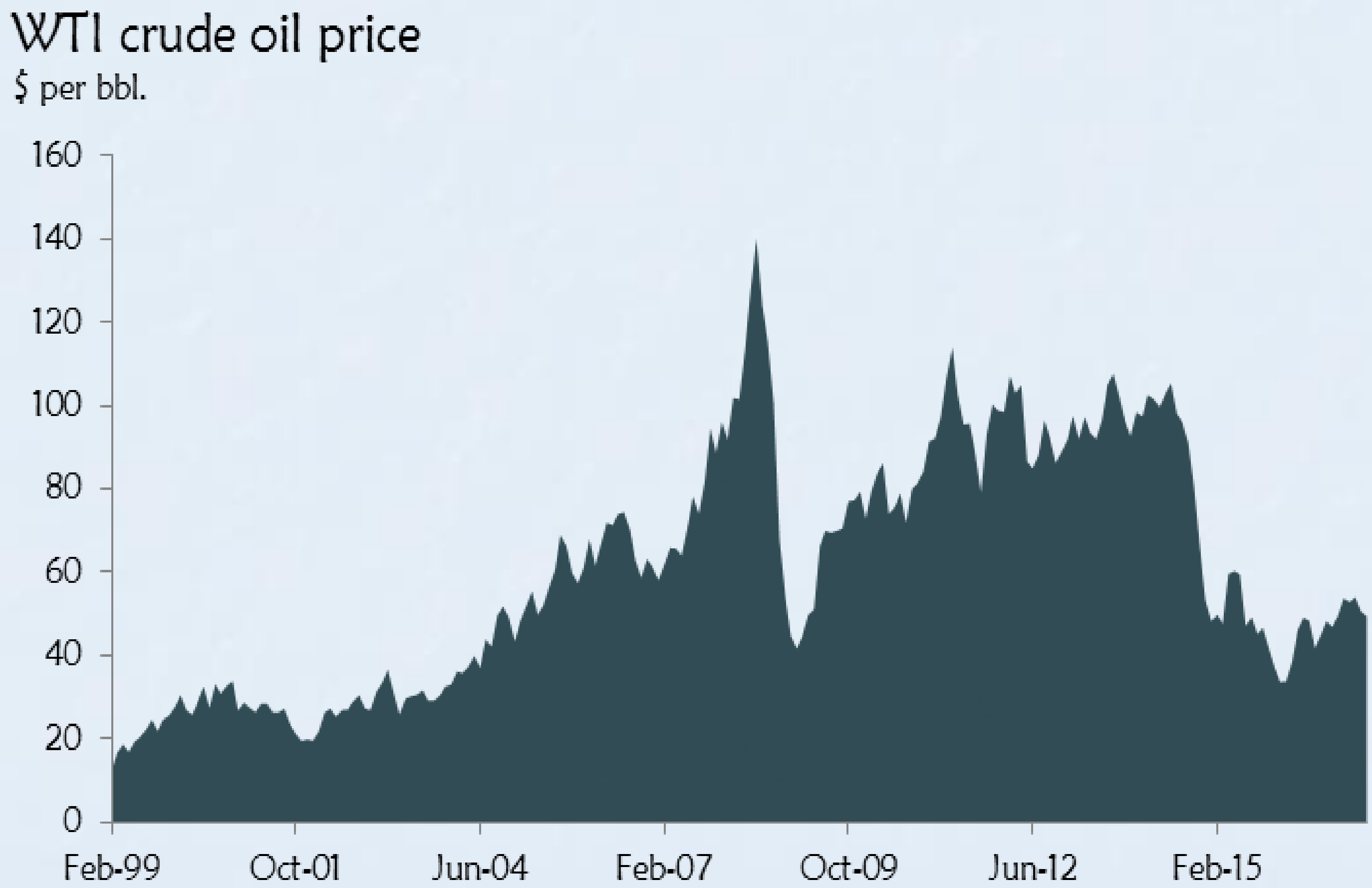
Commodity prices do not appear to be poised for an imminent recovery…

With Saudis Enforcing A Lower Bound And US Shale Producers Setting The Upper Bound



Source: Bloomberg, accessed 5/3/2017.

Emerging market vulnerabilities: Global factors recap

- Some tightening in global liquidity conditions-further increases in US rates
- Commodity/oil prices not poised for imminent recovery
- Rising protectionist leanings in the US and elsewhere are a source of concern.
- A positive global factor for the better managed EMs is the continued search for yield in the advanced economies.

Emerging market vulnerabilities: Some domestic factors

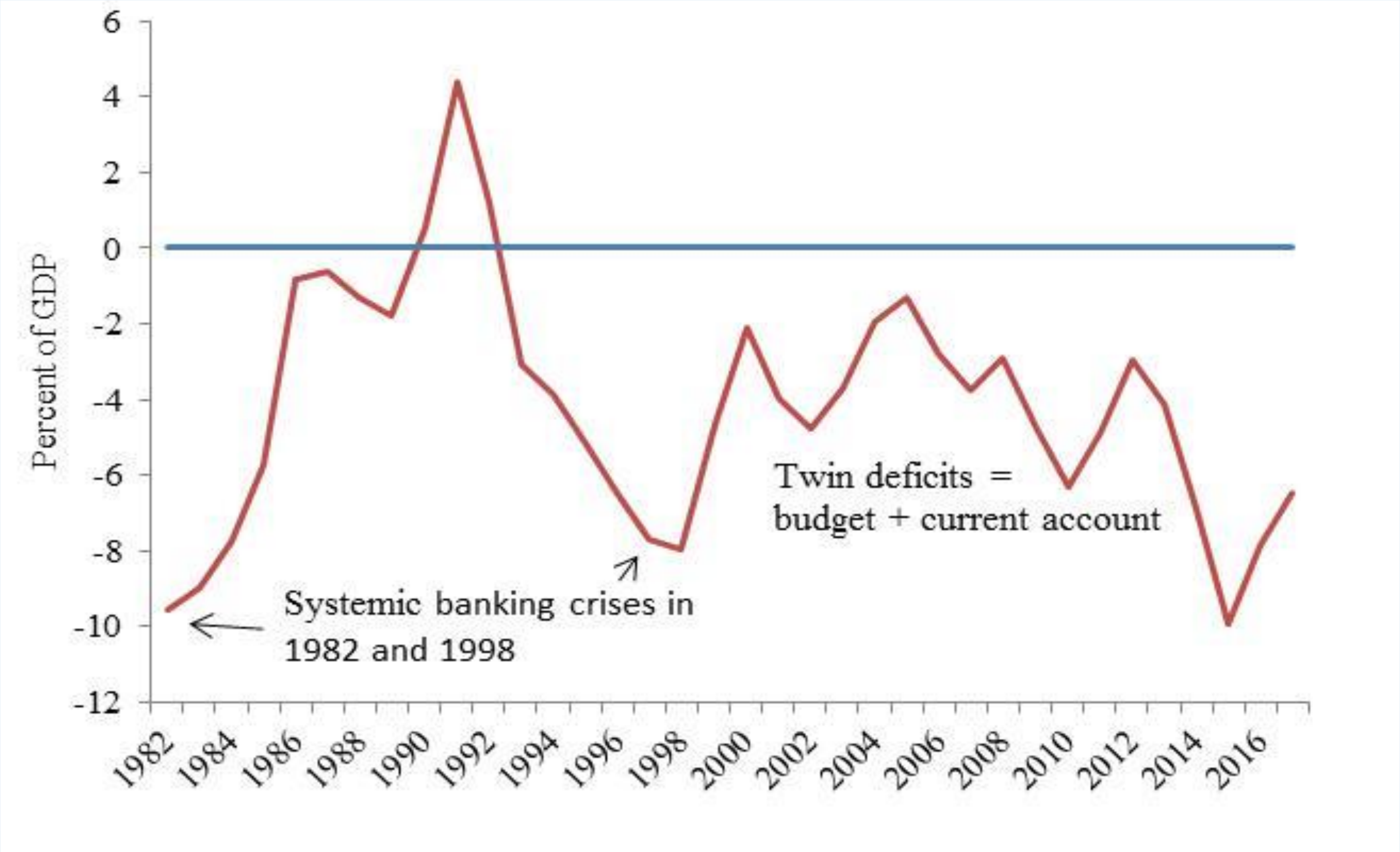
- Several oil and commodity producers are in their most fragile state since the debt crisis of the 1980s.
- Twin deficits are significant
- Hidden debts (including domestic arrears, sub-sovereign liabilities, off balance sheet) loom larger.
- Contingent liabilities (private sector external and internal debts) have risen dramatically
- Foreign currency debt (re-dollarization) has re-emerged
- Shortening of maturities is gives rise to potential liquidity and bunching problems

24 Oil Producers
Current Account and Fiscal Balances, 2015

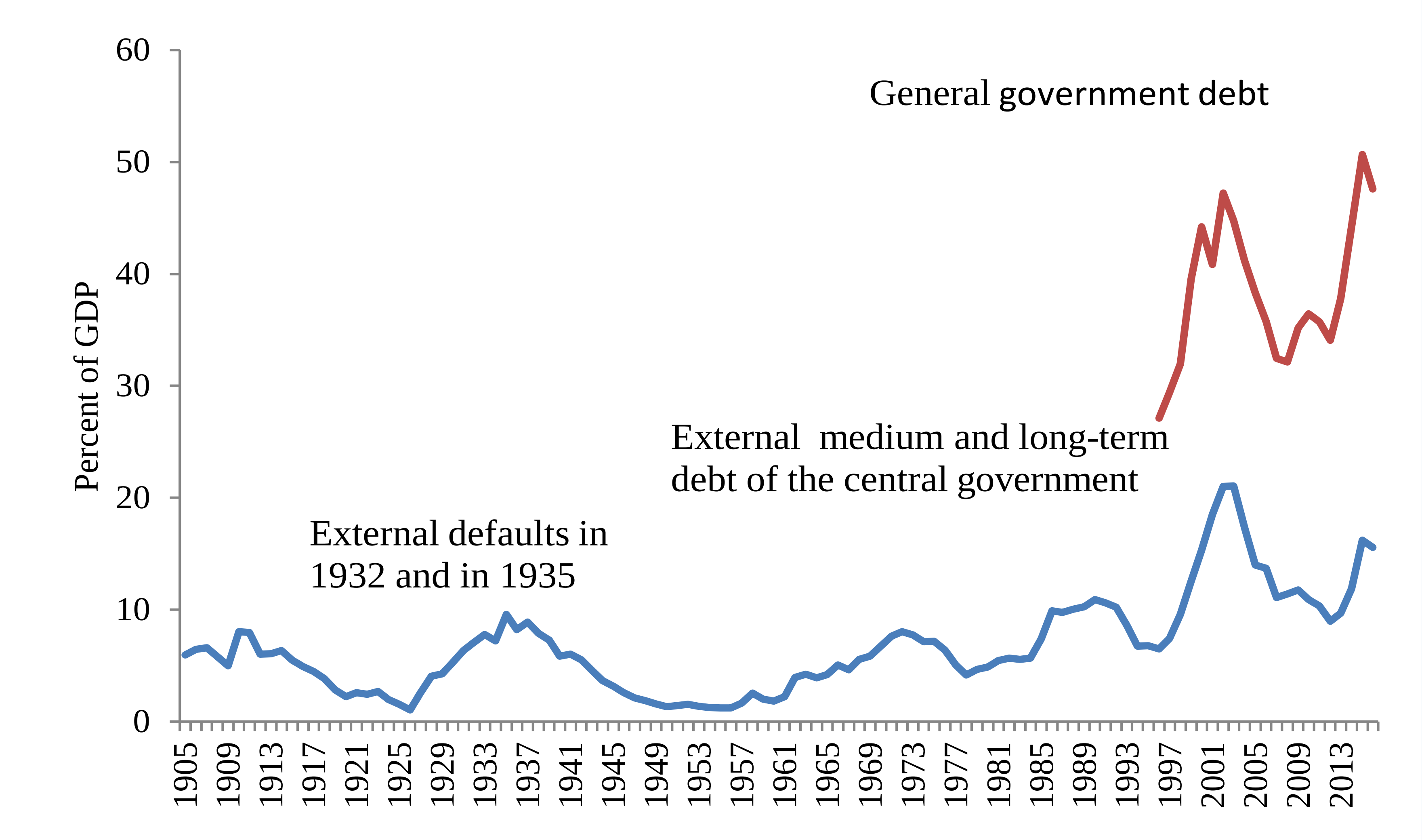
The numbers next to the country name are the sum of the current account and fiscal balance In the bottom right quadrant, these are the "Twin Deficits" in 2015.

General Government fiscal balance ↓ / Current account balance →	Surplus	Deficit
Surplus	Kuwait, 6.7 Qatar, 13.6 Norway, 14.5	
Deficit	Russia, 1.7 UAE, 1.2 Iran, 0.1 Malaysia, -0.1	Iraq, -20.9 Saudi Arabia, -24.2 Venezuela, -30.9 Oman, -34 Libya, -94.6 Algeria, -33.3 Azerbaijan, -7.2 Angola, -13.4 Nigeria, -6.8 Kazakstan, -9.2 Bahrain, -18.2 Bolivia, -12.6 Ecuador, -7.4 Indonesia, -4.6 Canada, -4.4 Australia, -7.5 Mexico, -6.9

Colombia's Twin Deficits: 1982-2017 (as a percent of GDP)



External central government and general government debt: Colombia 1905-2016 (as a percent of GDP)



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