Interview with Ranil Salgado, Assistant Director, Regional Studies Division of the Asia and Pacific Department, International Monetary Fund

# The Global Economy & the Asian Economy — Issues & Challenges from the Short-Term & Long-Term Perspectives

By *Japan SPOTLIGHT*

**The IMF is a chief pilot in our globalized world, mapping out a route to economic growth against the background of increasing uncertainty. Dr. Ranil Salgado, a distinguished economist at the IMF, talked to *Japan SPOTLIGHT* about his current assessment of the global economy and its future prospects. In particular, as an expert on the Asian economy, he introduced key issues and challenges facing Asian countries in achieving healthy and sustainable growth.**

## Introduction

**JS: You have been working for the IMF for a number of years. Please describe your research history and your outlook on the Asian economy.**

*Ranil Salgado, Assistant Director, Regional Studies Division of the Asia and Pacific Department, International Monetary Fund*

**Salgado:** My research history is fairly varied. I moved to the Regional Studies Division in the Asia and Pacific Department (APD) in September 2015 and have been overseeing regional surveillance for the department since then, including leading the production of the 2016 APD Regional Economic Outlook (REO). That publication, released in early May, comprises a discussion of conjunctional issues: recent developments in Asia, the IMF outlook for the region, and key risks and policy recommendations. In addition, the REO has three analytical chapters, on trade and financial spillovers from China's transition and rebalancing; the short- and immediate-term impact of the evolving nature of China's trade for both commodity markets and advanced countries; and on inequality in Asia. In planning the next REO, we expect to discuss recent developments, the regional outlook, and potential policy recommendations, and look at the impact of demographics and productivity trends in Asia, broadly defined as East Asia, South Asia, and the Pacific. Regarding these issues, there are very different demographic trends across the region and overall productivity in economies has slowed down globally, including in Asia.

I worked earlier on Asian regional issues and on various country desks, including India, Australia, and New Zealand during 2000-2004. I've also led our teams on Myanmar, the Marshall Islands, and, for a short time, Nepal. I set up our Resident Representative office in Singapore and was there from 2005 to 2008, where I focused on regional financial markets. I had two periods in the IMF Research Department. In the 1990s I worked on the flagship IMF publication, the World Economic Outlook (WEO), when much of our research was related to emerging market crises, including the Asian financial crisis. I later worked in the Research Department on global economic surveillance in 2004. Finally, I have also led some work in the IMF policy department, on trade, capital flows, and conditionality in IMF-supported programs, among other topics.

## IMF Outlook for the Global Economy & Asian Economy

**JS: I am most impressed that the IMF is generally thought of as an economic organization but you also cover social issues and supply-side economic reforms, not only issue-wide but also region-wide.**

**Salgado:** Right now the importance of longer-run growth issues has come to the forefront, so we are focusing much more on structural issues.

**JS: Two or three days ago I thought the uncertainty of the global economy was decreasing, but now, after the US presidential election, it seems to be rapidly increasing.**

**Salgado:** To some extent, yes. Based on our assessment of uncertainty risks in the IMF's WEO, which was just released in October, we saw some positive developments but risks remained high and particularly medium-term prospects were somewhat uncertain. Now after the US election, there is some additional uncertainty because we are not yet fully sure of the economic plans of the new administration.

When we released the WEO last month, we thought growth for the global economy in 2016 would remain somewhat disappointing. We projected global growth at 3.1%, compared to 3.8% in the 20 years before the global economic crisis, 1988 to 2007. Since then, it has been only slowly recovering, not nearing the levels before the crisis. For 2017 we expected a pick-up in global growth, to about 3.4%, and that uptick would be primarily driven by emerging markets. Some emerging markets are recovering from deep recessions, such as Brazil and Russia. But we didn't expect growth in the advanced economies to pick up much, especially compared to the pre-global financial crisis experience. Data released since the WEO was published show a few positive signs. For third-quarter growth, many advanced economies were above expectations, particularly, the US, the eurozone, and the United Kingdom were quite resilient. In contrast, in the emerging markets, growth was mixed, some positive, some not so positive.

Asia remains the world's growth leader; this reflects supportive domestic policies, and accommodative global financial conditions. We predicted growth of 5.4% for the entire region for this year, and 5.3% growth for next year. Importantly, Asia continues to contribute to more than half of global growth, despite China's slowdown, which is an appropriate transition to slower, more sustainable growth.

Financial markets, particularly stock markets, remain buoyant and capital had continued to flow into Asia despite a short period of adjustment around the Brexit referendum. Then there was a fairly quick rebound. Domestic policies have mostly supported growth, with low interest rates and fiscal stimulus in some countries.

This week we've had the US elections. The financial markets reacted badly overnight, but seem to have rebounded fairly quickly. Overall markets have remained orderly, even when they had a negative reaction, and now seem to be somewhat buoyant.

One big risk has been uncertainty in the pace of US monetary policy normalization, which could lead to volatile financial conditions in Asia, especially for countries that rely on external financing. Also, some Asian countries with high private debt levels could be affected by tighter global financial conditions.

Over the medium term, a big concern is the subdued, uneven global recovery and sluggish global trade growth. This could undermine Asia's growth prospects. Asia is a big trader globally; a major part of its economic success is through trade. Now, even more, we need to think about the short- and long-term implications for globalization and trade, as we see tension in some advanced countries related to globalization. Another issue is spillovers and the potential for the "new mediocre" in advanced countries and some Asian economies, which means low growth, low inflation, and low interest rates. This could lead to weaker investment in the region, as external demand could remain weak.

## Slow Trade

**JS: Why is slow trade happening?**

**Salgado:** Recently, global trade growth has slowed both in absolute terms and relative to world GDP growth, particularly compared to the early 2000s, when trade was growing much faster than GDP. After the initial rebound following the global financial crisis, trade grew at about the same rate as GDP, but since 2015 it's been below, so trade growth has been weaker. This has been particularly pronounced for some emerging and developing countries in the last year. This is partly explained by the weak investment cycle in advanced countries. Investment is an important source of demand for imports. Weakening investment has led to weaker trade.

A slowdown in trade growth could also reflect other structural factors such as the maturation of global value chains. The rapid expansion of global value chains was one reason why trade growth had been much stronger than GDP growth in the early 2000s. Also, for some countries there was a deterioration in their competitiveness, and changes in trade policy appear to be have had an impact on trade.

On the changing relationship between trade and GDP growth or income, a good example is China, which is transitioning to slower, more sustainable growth. We call this process rebalancing, away from exports, investment and manufacturing towards consumption and services; the former are more import-demanding than the latter. So this shift is impacting China's potential import demand. In the APD REO, we explain how the changing structure of China's economy is affecting its import demand. The investment component is similar to what's happening in advanced economies. This is a significant concern overall for Asia. If global trade remains weak, we must think about the right growth model for Asia. We are also concerned about the global anti-trade sentiment for Asia, given that it benefits a lot from trade and globalization.

**JS: An increase in Chinese production capacity might lead to a decline in imports for Japanese subsidiaries, because of this global value chain.**

**Salgado:** In value chains, downstream manufacturing would typically occur in countries like China but the upstream, intermediate goods production — higher-value production — would occur in Japan or elsewhere. That was actually adding to trade for some time as value-added trade was increasing. The basic idea in economics is you do what is to your comparative advantage. But now as China moves up the value chain, it can affect advanced countries such as Japan and South Korea. There is evidence that some maturation of global value chains is ongoing in China, and some of the production for intermediate goods may be shifting to China.

## Possible Impact of US Exit Monetary Policy

**JS: Asian countries worry about exit policy, in particular the uncertain US monetary policy. Do you think the US exit monetary policy will affect Asian economies?**

**Salgado:** Yes, the pace of US exit is somewhat uncertain. Earlier people expected interest rates would be higher today than they are. We had one increase last year, and the market is now expecting a second increase in December. The Federal Reserve seems to be signaling that, but it is also signaling that the increases are expected to be gradual. Previous research found that if the US raises its policy rate because growth is picking up, that generally is positive for Asian economies, which trade extensively with the US. But financial conditions will tighten, and that's a negative. Generally, the trade factor on balance more than offsets the financial factor for Asia overall.

However, if financial markets become disorderly, there could be negative implications. So if the Fed is able to communicate these increases, and the increase is because growth is picking up, overall it won't have a negative impact on Asian economies, and could even have a slightly positive impact.

## Growth Potential of the Asian Economy

**JS: Regarding structural reform or the supply-side economy, how do you assess the growth potential of the Asian economy, including the diverse national growth potential?**

**Salgado:** What are some of the medium-term headwinds or constraints that could harm growth potential of the various Asian economies? I mentioned our concerns about the new mediocre. We see lower productivity growth generally globally including in emerging markets, such as in Asia. Also, slower investment growth could weaken activity. Finally, we have to think about demographic trends for Asia. Some Asian economies have rising old age dependency ratios and some have rising inequality. These could also have a significant impact on growth prospects. Asia is still a growth leader, with 5% to 5.5% growth versus 3.5% globally. In Japan, overall growth is not that strong but per capita growth is not so bad. In growth of GDP per worker, for the advanced countries, it's one of the leaders. A significant demographic factor in Japan is the shrinking labor force. There are similar concerns going forward for others, especially East Asian economies. For example, demographic changes will occur in South Korea, even China.

Meanwhile, you have some Asian economies that still have the potential for demographic dividends. The working age population will grow, in some cases substantially, for example, in India and Indonesia. That could help sustain potential growth, but sound policies are needed. India needs to continue with progress on various reforms, including steps to support business investment and FDI to further support growth.

**JS: Total factor productivity is very important; innovation enhances growth potential. How do you assess the innovation capacity of Asian countries?**

**Salgado:** Innovation matters most for advanced countries like Japan and South Korea. For others, for example India, innovation could be in a new area like IT. But generally for most Asian countries, we see the need for technological diffusion. How does it move to these countries? In the past it's been through FDI as companies moved there and taught the workers how to improve their technology.

So it's a mix of factors. For the wealthier countries in Asia, how do you spur innovation, and for those that are catching up, how do you ensure technological diffusion while still supporting the intellectual property rights of the countries that are developing the technology?

**JS: What is your view of Asian countries' potential capacity to achieve data-driven innovation, big data, and the Internet of Things?**

**Salgado:** Many parts of Asia have the capacity, human capital and education levels to be a big player. So why is Asia not more successful on this? Maybe in Asia we need to support entrepreneurship more. The innovators in Silicon Valley probably failed many times before succeeding. In parts of Asia there's a fear of failing, and there may also be legal issues related to bankruptcy. Many of the Asian countries have the skills and technology to pick up in this field; they just need to set up the proper environment.

**JS: You mentioned growing income inequality. Is this a key impediment to fully utilizing growth potential in Asia?**

**Salgado:** The main countries where there is growing income inequality are China and India. Apart from those two, it's a much more mixed story. There are some increases and some decreases. This is quite different from earlier in Asia when you had high growth and decreasing inequality. Recently, at least for India and China, inequality is growing.

How does high inequality affect growth? Well, it means less investment in education and less ability to start a business. Generally, poorer households are more likely to spend their income, so it could have an impact on overall consumption and domestic demand.

There are other impediments. In China there is the need to rebalance the economy from investment and credit growth to more balanced growth. Reform of state-owned enterprises (SOE) is important, because that helps improve the allocation and efficiency of investment. There are certain areas of excess capacity in China and this would be helped by SOE reform; financial and fiscal reforms could help the rebalancing process.

In an economy like India, growth is quite strong, over 7.5%, and the adoption of the Goods & Services Tax (GST) will be good for harmonizing the domestic internal market. They are implementing many reforms to boost business and investment; these support medium-term growth. India is also fostering improved labor market flexibility and product market competition. It has the potential for a demographic dividend, and these reforms will be needed to support huge job creation.

**JS: One important rationale to achieve labor market reform in Japan is to achieve mobility of human resources, and perhaps this is a key to full utilization of growth potential. Do you think regulations in Asian countries work as impediments to growth potential?**

**Salgado:** It varies a lot across Asia. In India it is an issue of formality, how to move people from informal into more formal sectors. Some of this is simply where a business of a certain size has to follow certain rules. So you end up encouraging smaller firms because they want to avoid the rules. In Japan the need for more dynamism in the corporate sector, the labor market duality of permanent versus temporary workers, and how to boost wages are key issues. Already the government is supporting increasing participation of women in the labor force.

**JS: We often discuss trade issues in Asia with our colleagues from many Asian countries. They are reluctant to take a leading role in the global economy, though their growth potential is so high. How can they be convinced of their responsibility to do so?**

**Salgado:** We estimate that Asia contributes about 60% of global growth. The Asian economy is up to about 40% of global GDP. So Asia is important, both in terms of its size and even more so its growth rate. High growth means it supports more of global growth. Asia is the one big important part of the world where there's a lot of support for trade and globalization. If Asia doesn't help support global growth, by making growth more balanced — not so reliant on exports and more reliant on domestic demand — and inclusive, and addressing the issue of rising inequality, the anti-trade and anti-globalization forces will hurt Asia anyway. Reforms to improve growth in the services sector are an example for Asia. That's not to say that things don't also need to be done in the rest of the world.

## Global Economic Governance in Future

**JS: That means relevant policies to achieve stable and sustainable growth of the global economy. How do you think global economic governance should put the economy onto the right track for growth, against a background of anti-globalization sentiment?**

**Salgado:** The IMF believes that coordinated and comprehensive policy actions are needed to support growth and combat damaging perceptions that policies are ineffective in boosting growth. We have a three-pronged approach. For advanced countries where you still have negative output gaps, wage pressure is generally muted and there has been no inflation or in some cases deflation, or the risk of it, monetary policy has to remain accommodative, and that could be relying on unconventional monetary policies; that's prong one. Prong two is that fiscal support remains essential for generating momentum where there is room for utilizing fiscal policy, including to support monetary policy.

The third prong is structural reforms. For advanced countries it is a medium- to long-term issue, how to boost potential growth, so we need important structural reforms, such as to improve labor markets in matching jobs and skills, to boost labor force participation, or to promote innovation and research and development, which support investment as well.

Macro-economic policies also need to support this. Some structural reforms such as product market reforms can have a positive impact on growth. Other structural reforms like labor market reform need to be along with supportive macro-economic policies such as supportive monetary or fiscal policy.

If you have more labor market flexibility, some workers could lose their jobs. If you want workers to be able to shift between companies, the short-term period could be negative. So you want to ensure that workers are supported when they're looking for new jobs. That could include income support or retraining. In Europe they have active labor market policies, but those can have a cost.

There are separate issues related to emerging and developing countries, which have a long process of convergence towards higher income, and need a set of policies and objectives to support that over the long term. This means to reduce distortions in product, labor, and capital markets. Also, long run, fundamental support for people is important, including investing wisely in education and health care. At the same time, for many countries financial sector reforms are also important, to make financial services more inclusive, and to ensure that markets are sufficiently deep to help safeguard against potential financial volatility. Capital markets for many emerging market economies are quite exposed to global financial markets, so financial markets should be developed to reduce potential financial stability risks, things like the ability to hedge and to avoid too rapidly rising private-sector debt, the potential mismatch of foreign assets and liabilities, including the maturity structure, and stronger risk management practices.

**JS: That kind of IMF analysis could work very well as peer pressure for each country's domestic policies, assuming that trade liberalization efforts may not work well for the time being. Such peer pressure on the basis of the peer review mechanism of the IMF or OECD should play an important role in achieving the best outcome for the global economy.**

**Salgado:** That's the basic idea of the IMF surveillance and review process. Our country staff reports are discussed by country representatives in our executive board and they provide comments as peers.

**JS: Does your analysis cover the increasing geopolitical risks we now face?**

**Salgado:** It already is factored into our WEO projections; for example, our growth forecast going forward includes broadly accommodative financial conditions and some increasing commodity prices, as well as an easing of geopolitical tensions. In some of our staff reports, in the risk assessment matrix there is an analysis of potential geopolitical risks: global, regional, and domestic. We also look at potential spillovers from this risk to other economies. JS

*Written with the cooperation of Jillian Yorke, who lives in New Zealand, where she is curator of the Japan Library:* Pukapuka, *as well as a freelance writer, translator, and interpreter.*