

Policy Brief

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The Global Outlook, Secular Stagnation, and the MENA region

By Uri Dadush

Summary

Despite the gloomy tone of much discussion at the just-concluded IMF and World Bank annual meetings, the global economy is not in as bad shape as many think. The concerns about “secular stagnation” in advanced countries are also overplayed, and nor are developing countries directly exposed to such risks. By contrast, the pessimism about the prospects for MENA are unfortunately largely justified. Most importantly, at the global and at the MENA level the biggest concerns are not economic, but political, and how the political context affects economic policies and the confidence of investors.

The short-term global outlook: are the pessimists right?

The global economy continues to disappoint, with a ratcheting down of consensus, IMF and World Bank projections. Six months ago, I had expected global economic growth in 2016, expressed at market exchange rates, to come in at 23/4 % near the 3% 25 year trend; now it looks like I was too optimistic and we will pocket 2.5% at best in 2016. This means that the return to near the 25 -year growth average has to wait until 2017. Such an outcome would be in line with the forecasts put out by the IFIs, which I believe are plausible. But even if we hit somewhere near 3% in 2017 and 2018, that would hardly be a reason for cheer after so many years of below-trend growth. And no-one is expecting world import demand to return to its pre-crisis growth rate, greatly exceeding the GDP growth rate, anytime in the foreseeable future.

Still, there are good reasons not to be despondent. First, we have seen a sharp deceleration in the world population and of the world labor force over the last quarter century, so that 3% equates to about 2 % growth per capita, versus 1.5 % 25 years ago. Second, developing countries were not as affected by the Great Recession as many feared. They grew at 5.2% a year since 2007, and their GDP is up 50% since then; big gains on absolute poverty have continued in many countries. Even in the underperforming MENA region, GDP is up 32% since 2007. By contrast advanced countries have grown at just 1% since 2007, so their GDP in 2015 was just 8% higher, and, in several, relative poverty has increased. Next year and in 2018 income per capita growth in developing countries is projected at a little above 3%, enough to double incomes in a generation if sustained. This is about 1% slower than the (almost certainly) unsustainable pre-crisis average, but hardly a disaster. Third, I find remarkable the relative absence of a contagious balance of payments crisis affecting developing countries as happened many times,

most recently in the late 90s in Asia, Russia and Brazil. If someone had said to me in 2006 that a Great Financial crisis would hit the United States and Europe, that world trade and commodity prices would collapse, and that it would not be followed by a string of contagious balance of payments crises in the emerging markets, I would not have believed them. As it happens, developing countries now owe less than 20 billion SDRs to the IMF in total, and there are only 4 developing countries today that owe the IMF more than one billion SDRs (one SDR is equal to about 1.4 US \$). The largest credit is to Ukraine, and the next three are in the MENA region: Iraq, Jordan, and Tunisia. Egypt is in the midst of negotiation of a sizable IMF program. By far the largest borrowers from the IMF are EU members Portugal and Greece.

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There are many uncertainties about 2017 and 2018. Most importantly, the Fed's resumed tightening could hit stock markets and bond prices around the world hard, and may also induce a 2013-like flight to quality that deflects capital away from emerging markets. Yet, the Fed has shown considerable caution. Some believe, too much caution. And a cold-eyed assessment reveals important good news, not just bad news. The US economy is growing only at a moderate pace, but there is remarkable job-creation, and an absence of major imbalances. The US stock market looks about 20% overvalued based on price-earnings multiples, but earnings may recover as the one-time effects of the high dollar and low oil prices wanes. Germany's economy is in rude health. China is again using its deep pockets to renew stimulus policies. This may one day get it into deep trouble but that is unlikely to happen next year or in 2018. India is now easily the world's third-largest economy (PPP-adjusted) and is doing well. In advanced countries, there remains a thorny medium-term agenda of withdrawal of monetary stimulus and of public debt reduction, but, with inflation contained, indeed too low in several countries, it is one that requires gradual adjustment, and still leaves room for support of demand in 2017 and 2018.

The big worry now is not about economics, but about politics. Note, for example, that all the above-mentioned countries with IMF Programs (Ukraine, Iraq, etc.) , have been the prey of political divisions, wars, and waves of refugees, and not of garden variety macroeconomic imbalances. The outbreak of the global financial crisis

induced voters to effect a political changing of the guard, but a change confined to the mainstream parties. Of the incumbents in the large countries at the outbreak of the crisis, only Mrs. Merkel remains at the helm. The crisis has persisted longer than most of us thought, and the second changing of the guard is now upon us.

This change, however, could turn out to be far more radical than the first. The US election looms, as does a major referendum in Italy, and elections in France and Germany in 2017. The populist challenge to the established order embodied by the likes of Donald Trump and Marine Le Pen (there are remarkable similarities among their platforms) has deeper roots than the financial crisis itself: skilled-biased technological change and its effects on inequality, migration surges, trade dislocation, and the dysfunctional Euro arrangement to quote the most important. The Brexit referendum outcome must also be understood in the light of all these developments. The baseline forecast assumes that the new populism will be contained, or, at least, that it will not spill over in a major way on international trade relations. If it does (as Brexit may) we are in a new ball game, and in it for a long time.

Secular Stagnation?

This takes me to consider a different kind of risk – namely, worries about “secular stagnation” that we see in some advanced countries. There is no accepted definition of the disease, but I take it to denote something akin to stagnation or decline of per capita incomes over a decade or two. These concerns originate in the US, and come from the demand side (a chronic shortage of demand) and from the supply side (a shortage of really important technological innovations). I am profoundly skeptical about these ideas, even though they are held by brilliant economists such as Larry Summers and Robert Gordon. Like other technology optimists, I am seeing more, big, IT-driven productivity boosters coming our way (personally, I look forward to my autonomous vehicle and to handing in my drivers' license before my eyesight fails). I understand a shortage of effective demand as a temporary phenomenon but I struggle to comprehend it as a chronic condition, when 50 million Americans are in poverty, a billion people across the world have no reliable electricity supply, and, helped by counter-cyclical policies, the United States is generating jobs at a very rapid pace. I tend instead to impute the slowdown in advanced countries since the crisis principally to the long tail of the financial crisis, a prediction carefully articulated by Carmen Reinhart and Ken Rogoff in a book that long preceded the recent debate over secular stagnation. An

important and just-published Federal Reserve paper by Etienne Gagnon and others shows that demographic factors, namely a slowing in the population of working age and aging, have also played a significant role in the slowdown in the United States and across the advanced countries.

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But, let us assume the worst and that we have something like secular stagnation in the advanced countries – implying no growth of per capita incomes over, say, the next ten years. What will it mean for developing countries? Without doubt, they will confront less favorable terms of trade and receive less FDI of the outsourcing/offshoring variety. But while that will dent growth in the developing world, it is unlikely to stop their rapid advance. Developing countries have plenty of unmet and effective domestic demand and are far from the technological frontier. In poor countries, spreading electricity, sanitation, roads and motorization will determine medium-term growth outcomes, as they did in the US during its great leap forward which began about 100 years ago. The ability to adapt existing innovation depends also on the cost of doing so. From the perspective of development, IT, the effect of which techno-pessimists tend to downplay, has the great virtue of spreading rapidly at relatively low cost. I believe, however, that long-term GDP growth in developing countries is on a slowing path for two reasons unrelated to secular stagnation in advanced countries. Slowing population is the most important; however, slowing population need not spell a slowing of per capita incomes. For per capita income, more important is the slowing of the population of working age. Over the last 25 years the 15-64 cohort grew at 1.9% a year in developing countries. It is projected to grow at just 0.8% over the next 25. Despite this, many developing countries, including in MENA still have many years of demographic dividend ahead of them. The second reason is the end of transition of 2-3 billion people to the market, which began some 25-30 years ago, and which is symbolized by the fall of the Berlin Wall. That is why expectation for long-term growth in China, for example, is 5-6% not 10%. China will see a shrinking work-force, and much lower productivity growth than in the past as it narrows the gap from the technology frontier.

The MENA Outlook

Just a few years ago, you could build a MENA economic forecast on four assumptions: strong central governments (a euphemism), the American hegemon, a robust Southern European economy (the critical market for Maghreb countries), and a high oil price. None of these four assumptions can now be held with confidence. By far the most important change owes to the Arab uprising, which has blown the lid off deep tensions within Arab nations which are not going to be quickly resolved. We knew these deep divisions existed and suspected that the autocracies could not last, but we did not know when the change would come.

Looking forward, some countries, such as Tunisia, may settle in an uneasy compromise, or, like Morocco, may eventually evolve into a vibrant democracy, or, in contrast, like Egypt – an economy in very deep trouble - may end up again being held together by the force of arms for a very long time. However, we are nowhere near the end of the turmoil. Not only are the four major wars (Libya, Iraq, Syria and Yemen) ongoing but sooner or later, there will be more radical change in places where the autocracies still resist. The underlying tensions are not, as in the West today, about more or less social spending, progressivity of taxes, or more or less trade and immigration. The divisions in MENA are fundamental: they are about the salience of religious or secular rule, the equality of women, the brand of Islam, ethnicity and tribal affiliation, democracy or the rule of a strong man, and about monarchy or republic. These are, of course, the kinds of issues over which Europe fought wars for several hundred years. But today's wars cannot last a hundred years because modern arms in an urbanized economy are too destructive.

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The challenge to central rule within many countries has coincided with a shift in the regional balance of power. America's misguided and disastrous invasion of Iraq and its subsequent reluctance to engage affects the whole region, not just Iraq. Where the US has engaged, it has often been half-hearted and confused in its aims, as in Syria and in Egypt. Europeans have a vital interest in containing refugee flows and terrorist groups, and would be natural keepers of the peace, but they are absorbed by their own huge challenges, and are in no way coordinated

or powerful enough to replace the United States. The Islamic State is the product of this power vacuum as much as of ethnic and religious rifts. Plenty of room has now been created for regional powers, such as Russia, Turkey, and Iran to pursue their own agendas, for better or worse, adding other layers of complexity and uncertainty.

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The Southern European economies were hard hit by the Euro crisis and have now stabilized at a very low level. However, their troubles are far from over. Unemployment exceeds 20% in Greece and Spain and is near 12% in Portugal and Italy. France was less affected but remains mired in slow growth, rigidities and an oversized welfare state. Italy's lost competitiveness and fragile banking sector are the greatest causes for worry not just about the prospects of the Mediterranean region but of the long-term viability of the Euro arrangement.

From MENA region standpoint, the collapse of the oil price and the uncertainty surrounding it play a crucial role. As investment in high marginal cost oil production locations declines, the logic for a full recovery of oil prices a few years from now is apparently strong. However, the uncertainties that could keep oil prices lower for longer are enormous. High-cost oil producers are finding unexpected cost savings. Iran, Iraq, Libya and Venezuela have plenty of room before they return to historic production levels, and, in some cases, to expand their capacity. Efficient use, digitalization, production technology and regulation are also pointing to contained oil prices. For example: will fracking spread outside the United States? Will technologies enable much greater oil production in the high seas or the arctic? Will the cost of renewables continue to fall, and will longer battery lives and lower prices enable electric cars? Will regulation push harder to contain fossil fuel consumption as climate worries continue to mount? And, how big is the expected deceleration in global growth and how rapid will be the relative decline of energy-intensive manufacturing? In the oil exporters, there is an understandable desire to diversify, yet the large uncertainty surrounding oil prices is in itself a deterrent for investment not only in energy – where prices could stay low for longer – but also in agriculture and manufacturing which, if instead oil prices surge again, could quickly become uneconomical.

In MENA, these external and political challenges are compounded by domestic policy weaknesses. These include rigid labor markets which combine with the youth bulge and large investments in education into a combustible mix of unemployment and unfulfilled expectations. The region's unhealthy preference for fixed exchange rates reduces its capacity to adjust to shocks and deters much needed financial integration with the rest of the world.

Policy Implications

The Arab uprisings occurred against a background of many years of pretty rapid economic growth and relative peace. Over the 15 years to 2012, the MENA region grew in excess of 5% a year on average. Reserves built over that period helped buy peace or at least contain turmoil. Now the MENA region is growing at 2.5-3%, fiscal and external deficits have soared in most countries, and poverty is increasing. This is not a recipe for stability. A global recovery, especially if Europe does better, will help the region. Higher oil prices will help oil exporters whose economies account for the lion's share of the region's GDP but also penalize the oil-importers such as Morocco. Secular stagnation, should it take hold in the advanced countries will certainly not help the MENA region, but it will not determine its development outcome, either. Under any scenario, more than any time in memory, MENA's prospects will depend not so much on external factors, but on its ability to bridge its internal divisions.

«Projects and reform programs should be robust under alternative political scenarios.»

In these highly fluid circumstances the role of external aid agencies, such as the Bank, the Fund, the ADB, EU and USAID is more challenging, but also more important. Yes, more countries need money, but independent, sound advice is even tougher to find when divisions are so deep. Governments are changing, and the IFIs do not get to choose the governments they must help. We all prefer democracy to autocracy. We like to have both democracy and stability, but faced with having one or the other but not both, as development economists we are sometimes justified to favor stability. Projects and reform programs should be robust under alternative political scenarios, and projects that bring people together are especially important in today's MENA context.

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