BANKING ON KNOWLEDGE

Monetary tightening: to be or not to be?

By Dr R Seetharaman

Global growth moderated more than expected in the first quarter of 2014, from an annual rate of 3.75% in the second half of 2013 to 2.75%. In the United States, the larger than expected inventory overhang at the end of 2013, leading to a stronger correction. A harsh winter further dampened demand, exports declined sharply after a strong fourth quarter, and output contracted in the first quarter of 2014.

In China, domestic demand moderated more than expected, reflecting the authorities' effort to rein in credit growth and a correction to real estate activity. Activity in Russia decelerated sharply as geopolitical tensions further weakened demand. In other emerging market economies, weaker-than-projected growth resulted both from weaker external demand, notably from the United States and China.

According to the IMF's July 2014 economic outlook, the global growth projection for 2014 has been marked down to 3.4%, reflecting both the legacy of the weak first quarter, particularly in the United States, and a less optimistic outlook for several emerging markets.

The Advanced economies have been brought down to 1.8% for 2014. Global growth is expected to rebound from the second quarter of 2014, as some of the drivers underlying first quarter weakness such as the inventory correction in the United States, should have only temporary effects. US economy growth was brought down to 1.7% for 2014 from earlier forecast of 2.8%.

The UK and Japan were revised upwards to 3.2% and 1.6% respectively for 2014. Euro Region growth brought down marginally to 1.1% for 2014. Recent data indicates US economy grew at annually rate of 4% in 2nd quarter of 2014, which reflects strong rebound, shaking off the negative effects of an unusually harsh winter and stirring hopes that it might finally be establishing a solid enough footing to put the lingering effects of the recession squarely in the past. However, the Fed last week stated that growth had "rebounded," but described the chances of faster growth as roughly even with the chances that the expansion would slow down and made clear that it had no plans to raise interest rates anytime soon. The US economy added 209,000 jobs in July 2014, the job growth slowed a bit and the unemployment rate edged up to 6.2%.

According to IMF July 2014 economic outlook, the Growth for Emerging and Developing economies have been brought down to 4.6% for 2014. In China, the authorities have resorted to limited and targeted policy measures to support activity in the second half of the year, including tax relief for small and medium enterprises, accelerated fiscal and infrastructure spending, and targeted cuts in required reserve ratios. As a result, growth in 2014 has been brought down to 7.4 %.

In India, growth appears to have bottomed out, and activity is projected to pick up gradually after the postelection recovery in business sentiment, offsetting the effect of an unfavourable monsoon on agricultural growth, growth is expected to remain at 5.4% for 2014. In Brazil, tighter financial conditions and continued weakness in business and consumer confidence are holding back investment and dampening consumption growth, growth brought down to 1.3% in 2014.

In Russia, investment is expected to remain weaker for longer, given geopolitical tensions and growth brought down to 0.2% in 2014.

Middle East, North Africa, Afghanistan and Pakistan expected to grow by 3.1% in 2014.

IMF has highlighted the challenge for central banks of smoothly unwinding the ultra-loose monetary policy they brought in to support advanced economies during the financial crisis. It also warns that emerging market economies slow down poses risks to the rest of the world in terms of trade and finance. Rising interest rates in advanced economies and a slowdown in emerging markets could combine to cut global growth by as much as 2%.

When advanced economies normalise monetary policy as their economic outlook improves, it will tend to tighten financial conditions globally, but the accompanying boost to growth should potentially offset the negative effects of tighter borrowing costs. However, if the tightening of monetary conditions is not driven by higher growth but is instead triggered by financial stability concerns, spillovers could have a negative impact on growth elsewhere, especially in vulnerable emerging economies.

The Global economic recovery is now dependent on appropriate timing of the exit of easing measures by various Central Banks and they are also deliberating on the appropriate timing of monetary tightening.

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