WORLD ECONOMY UPDATE

April 4, 2014 | Vol. 4 No. 14

Is More Investment the Answer to Deficient Global Demand?

ISSN 2233-9140

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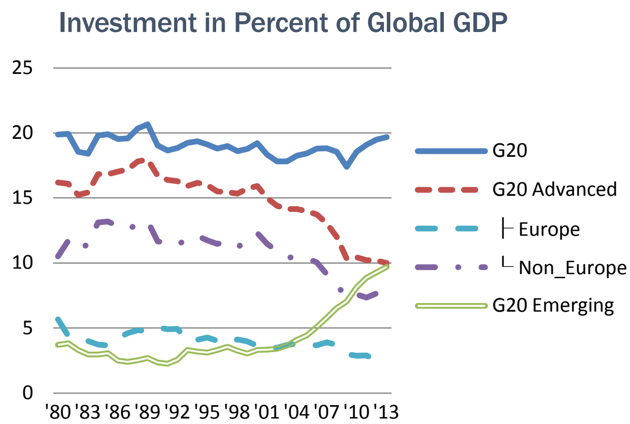
To address low growth and high unemployment, the G20 countries are formulating country specific growth strategies that together could attain critical mass to uplift global growth. To address global demand deficiency, common policy objectives identified are to promote investment especially on infrastructure, reduce global imbalance, and foster free trade.

Reviewing investment at the regional level, however, indicate that allocation, rather than an absolute shortage, of investment appears to be holding back faster economic recovery. For instance, investment in US dollar terms rose by an annual average of 9 1/2 percent during the last decade, which compares well with 5 1/2 percent of the past two decades even after accounting for inflation. Investment as a percentage of global GDP by G20 economies has remained largely stable at around 19 percent. Yet, this aggregate picture hides the drastic substitution of investment between the G20 advanced markets (AMs) and the EMs. Investment of non-European G20 AMs has stabilized at a lower level while that of the European G20 AMs are still inching down.

Various methods are being applied to assess the amount of capital needs including a simple comparison of countries' per capita income and per capita capital stock, and quantitative analysis projecting the capital gap forward using parameters obtained from a country's own past developments.



Source: IMF, World Economic Outlook Database (Oct 2013).

What may be more relevant than estimating the capital gap, however, is the speed with which to close the gap. Limited absorptive capacity in economies may lead to waste of investment if the gap is closed too rapidly. For example, a road that was constructed too far ahead of demand may depreciate before proper usage. On the other hand, deficient road network may impede economic development.

We use the approach used by Lee *et al.* (IMF WP/13/83) to estimate the optimal levels of investment for G20 Countries (Panel first-differenced GMM). Optimality is defined as a level of investment that is thought to minimize waste while attaining efficiency, i.e., where the marginal return of investment is equal to the cost of investment.

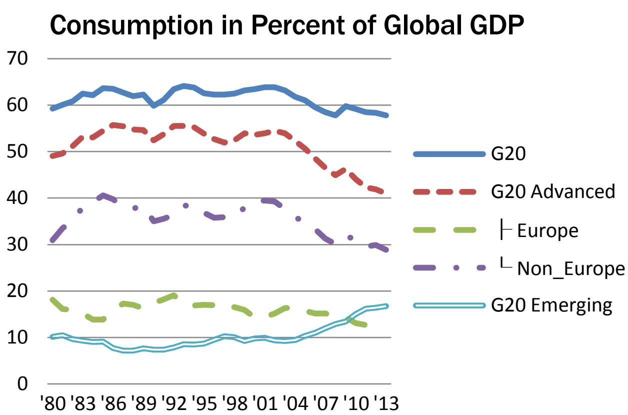
Table 1. Estimated Level of Optimal Investment

In percent of Global GDP	S	I	I+	I-I+	S-I	S-I+	(S-I)*
G20	18.83	19.02	18.93	0.09	-0.19	-0.08	-0.42
G20 Advanced	9.81	10.27	10.46	-0.19	-0.46	-0.63	-0.56
├ Europe	2.84	2.75	2.74	0.01	0.09	0.10	0.03
└ Non_Europe	6.97	7.52	7.72	-0.20	-0.55	-0.73	-0.59
G20 Emerging	9.02	8.75	8.47	0.28	0.27	0.55	0.14

Note: average of recent 3 year; I+ represents the level of optimal investment; and (S-1)* is the desired level of net savings reported in the 2013 IMF's External Stability Report (shown here as a reference).

We found that the G20 countries (Table 1) as a whole are investing 0.09 percentage point of global GDP above the desired level. More specifically, the non-European AMs need to raise investment by 0.2 percentage point of global GDP while the G20 EMs should reduce investment by 0.28 percentage point of the global GDP. Thus, to obtain additional lift for global economic growth from efficiency gains, a part of investment in EMs would need to be used for investment in non-European AMs.

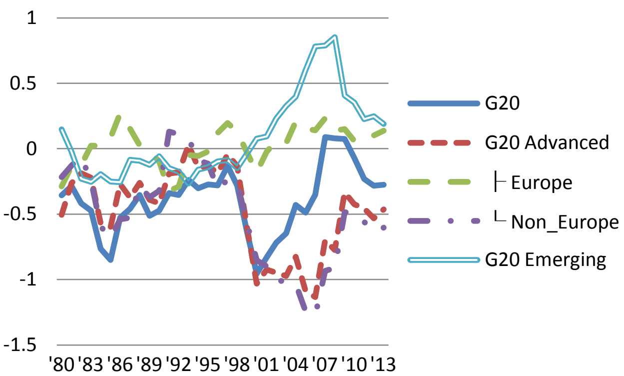
Such reallocation of investment would also help strengthen consumption in advanced economies where contribution to global demand has been declining, reflecting falling share of advanced economies in the global GDP. A sudden drop in investment in EMs may also undermine consumption in the said economies. As such, a reallocation of investment should be gradual, so as not to undermine the existing growth dynamics.



Source: IMF, World Economic Outlook Database (Oct 2013).

Investment needs resources, i.e., savings. The G20 as a group is a net borrower of resources from the rest of the world. Within the G20 group, the EMs and the European AMs are providers of net savings while non-European AMs are users of net savings. EMs contribute most to the global consumption growth while also providing net savings. European AMs, on the other hand, provide net savings, but their contribution to global consumption is declining. The non-European AMs are net users of savings, but their consumption remain stable at a lower level.

S-I as Percent of Global GDP



Source: IMF, World Economic Outlook Database (Oct 2013).

The implications are as follows. EMs need to reduce savings and investment as a percent of GDP. This can be achieved relatively easily as the latter will slow GDP growth, and assuming consumption does not fall faster, savings will decline. The European AMs need to raise both consumption and investment, while reducing savings. This can be achieved if additional growth from higher investment is spent on consumption. Finally, the non-European AMs need to raise both savings and investment. Growth from higher investment should be saved, and not be consumed.

The key question is how to facilitate a rebalancing of investment and net savings from one region to another. On the former, if there are no barriers to cross border investment, a well-functioning market would ensure investment is efficiently allocated across borders. Thus, providing an environment conducive to investment will be important. For cross border investment, any multilateral initiative that would reduce governance risks in cross border investment will help reduce the cost of financing. On the latter, relative price adjustments could help. A stronger currency could help ensure that savings fall faster than investment, and thereby reduce net savings. For European AMs, a strong currency would definitely help (except the complication that they are part of the Euro). For non-European AMs, a weaker currency could help. KIEP