Global Economic Outlook: A Cocktail of Caution and Optimism

NEAR-TERM CAUTION, LONGER-TERM OPTIMISM

There is considerable near-term uncertainty about the global economy. After strong growth from the second half of 2016 until last summer, a number of key global indicators, including trade and the closely watched manufacturers’ purchasing managers indices (PMIs), pointed to a slowdown in the second half of last year.

This reflected a combination of factors, particularly tighter monetary policy in the US and escalating trade tensions between the US and China. Markets reacted aggressively to this in the last quarter of 2018, with equities in particular suffering. Although subsequent policy measures allowed financial markets to stabilise, and equities to rebound, concerns persist. This is seen in the low level of bond yields in western economies. The bear market in global bonds, evident from 2016 to the end of 2018, reversed last year, with yields declining, reflecting concerns over growth and an easing of worries about inflation.

It is not just the economic slowdown, but fears about escalating risks, such as high levels of debt globally, that have added to concerns about the outlook and the sustainability of growth.

The latest figures, from the Institute for International Finance, show global debt reaching $244 trillion last autumn, equivalent to 318% of global GDP. This is high and requires low rates and strong growth to sustain it. Debt appears to be rising across all major measures, but it is noticeable that government debt is now $65 trillion, versus $37 trillion at the time of the financial crisis. If global growth grows steadily, and subdued inflationary pressures allow interest rates to remain low, then this would be an environment in which global government debt to GDP ratios can fall. The trouble is that it is also a global backdrop against which household debt levels could continue to rise, led by a range of emerging economies. This adds to concern about how financial markets will perform. Performance will be uneven across countries, and possibly regions too.

While it makes sense to take near-term concerns about global growth seriously, at the same time there are many positive, longer-term drivers that warn against being too pessimistic. There is already much talk that we are in the early stages of a fourth industrial revolution, spanning a wide array of areas, including the green economy and the advance of artificial intelligence, all of which point to stronger future growth. This would suggest that the trend for the global economy is still upwards, albeit with possible setbacks and cyclical downturns along the way.

A MIXED BAG: US, CHINA, AND EUROZONE IN 2019

Since the financial crisis, more of global growth has come from emerging economies, led by China. We should expect to see even more growth from emerging economies, including many more across the Indo Pacific and Africa too. Last year China grew by 6.6% and this year is expected to grow between 6% and 6.5%. This is still a healthy growth rate. To put this in perspective, a 6.5% growth rate would see China grow by $921 billion, not far off the equivalent of adding an economy the size of The Netherlands, the 17th largest economy in the world. China’s size means even though it may be slowing its scale is colossal, and increasingly more on a par with the US.

This explains the dominant focus on the trade dispute between the world’s two major economies. Latest signs are that a politically acceptable trade outcome will be agreed. If so that would be a big positive. New trade corridors continue to evolve as a result of the growth and opening up of emerging economies, with increased flows of goods, services, capital and labour. For the UK, which alongside the US, is a dominant service sector economy, the prospects of a more open global trading system is a big plus. Despite occasional bursts of protectionism, the dominant trend in recent decades has been one of declining tariff rates and now there is scope for improvements in non-tariff barriers too, critical for future service sector trade.

One region that continues to perform poorly is Western Europe. The European Central Bank (ECB) downgraded its eurozone’s growth forecast for 2019 sharply from 1.9% to 1.3% last week. With underlying economic imbalances persisting in the euro area, and latest indicators suggesting the ECB will have to prolong its accommodative monetary policy. Indeed, the role of central banks, across all major economies, remains vital in determining the economic and financial path in the years ahead.

THE NEXT UNCONVENTIONAL MONETARY POLICY

Unconventional monetary policy has been a characteristic of the last decade. In the wake of the 2008 global financial crisis, monetary policy globally has been a shock absorber. This helped financial markets and economies to recover.

Although the major central banks effectively eased policy at the same time in the wake of the 2008 crisis, it has been clear that they would exit at different speeds, with the Fed clearly being ahead of others in raising rates and tightening, and in turn the dollar benefiting. Last year, the slowdown was partly a reaction to this Fed action, and also the fear that central banks elsewhere might tighten, and the market fear that they may do too much, too soon. The focus was on the scale and sequencing of monetary policy tightening, including the interaction between higher rates and a reversal of quantitative easing.

<table>
<thead>
<tr>
<th>Global growth summary</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.6%</td>
<td>3.3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>USA</td>
<td>2.9%</td>
<td>2.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.8%</td>
<td>1.0%</td>
<td>1.2%</td>
</tr>
<tr>
<td>UK</td>
<td>1.4%</td>
<td>0.8%</td>
<td>0.9%</td>
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More particularly, the economic message seemed to be the need for central banks to be sensitive to how economies and markets might react and that, regardless of when a country started to tighten monetary policy, rates which were low would need to rise gradually and peak at a low level.

The worry though, particularly in the US, has been that if rates peaked too low, this would limit the future policy stimulus that might be available in the next recession.

With Fed tightening effectively put on hold, there may now be a further, new dimension to future unconventional monetary policy, including price level targets, or not undershooting inflation targets, aimed at ensuring sufficient stimulus will be available, even if policy rates are low.

A RETURN OF ECONOMIC AND POLITICAL CYCLES

This leads to the key final area to focus on: inflation. In the UK, inflation has peaked twice over the last decade, in the wake of sterling devaluations, both after the 2008 financial crisis and again after the 2016 Referendum. Sterling is now at a very competitive level. Despite these inflation peaks, domestic inflation has remained low in the UK. Now, against the backdrop of a healthy jobs picture, wage growth is rising. A similar picture is seen elsewhere, including the US. The big risk is if wage pressures surge, it would feed into higher inflation.

But this seems unlikely. Recent decades have witnessed a declining share of wages in national income, attributed not just to a change in bargaining power but to globalisation, new technology and financialisation. With 90 per cent of growth set to emanate from outside of the EU in coming decades, and a fourth industrial revolution now unfolding, the likelihood is that inflation pressures will continue to be restrained.

While this may reassure markets, it may also feed the increasing political populism that has become more evident in the west, as more people, naturally, want to share in that success. Increasingly political risk will become more important as a focus for financial markets.

In recent weeks the OECD has cut its forecasts for global growth, and the likelihood is the IMF will follow suit in April, when it releases its Spring update. The OECD sees growth of 3.6% last year being followed by 3.3% this year. The biggest challenges are seen as being faced by both the UK and the euro area, while the rest of the world grows at a stronger relative pace but far slower than in recent years.

In the decade since the global financial crisis, the world economy has rebounded. Using the IMF’s measure, the size of the world economy at the start of the financial crisis was around $62 trillion. Despite all the problems in the west, by the end of last year, this had grown to about $87 trillion, an impressive performance. While some of this was inflation, the vast bulk was real growth.

But much of growth was helped by cheap money policies and doubts exist as to whether this can be sustained. In the wake of the crisis, financial markets benefited from both a liquidity cycle and an earnings cycle, as rates were low and earnings did well. As we move to the more traditional economic and political cycles, achieving sustainable non-inflationary growth and sharing the spoils of success will take centre stage in future political and regulatory agenda.

SOLVING THE PRODUCTIVITY PUZZLE

This makes productivity the last piece of jigsaw. A measure of output per person or per hour worked, productivity determines a country’s longer-term performance and living standards. Lifting productivity is key to not only the UK’s future after Brexit, but also the fate of most western economies in the years ahead.

As I write, it is still unclear when and how the UK will leave the EU, or indeed there is an outside possibility it may not leave at all. While Brexit dominates the immediate outlook, raw politics will determine the path taken.

Whatever route is taken, for the UK to maximise its prospects, it needs to get three areas right: its domestic economic and financial agenda, a sensible future trading relationship with the EU, and a competitive position with the rest of the world, from which the bulk of economic growth will be seen in coming decades.

In my view these reinforce the need for the UK to focus on a combination of domestic policy areas in the years ahead, aimed at increased innovation, infrastructure spending and investment, underpinned by the right business friendly incentive structure based on taxes, living wages and smart regulation.

About the author

Dr Gerard Lyons is Parker Fitzgerald’s Senior Economic Adviser. In his role, Gerard leads the firm in the identification of future trends and macro-risk arising from shifts in economic, political and regulatory policy.

A regularly-cited and respected economic forecaster of the global economy, Gerard was formerly the Chief Economic Adviser to Boris Johnson, the Mayor of London and Chief Economist and Group Head of Global Research at Standard Chartered, a position he held for 13 years in addition to a number of other senior roles within the bank.

He has been a regular speaker at major domestic and world financial conferences and meetings, including the annual meeting of the International Monetary Fund, the annual and spring meetings of the Institute for International Finance, the World Economic Forum in Davos, and many high profile events here in the UK.

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