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GLOBAL ECONOMIC PROSPECTS AND RISKS

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The global economy is currently immersed in a slow economic growth mode. This report details the challenges that European and Asian nations face in reviving their economies.

Key topics covered in the report include:

- The Soft Recovery in Advanced Countries
- Emerging Markets Decelerate
- Inflation Dynamics and Deflation Risks in Advanced Economies
- Monetary Policy and the Specter of Low Interest Rates
- Policies for Growth in a World Tilted with Downside Risks

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The global economy is recovering but at a slow and disappointing pace.

The pace of growth in the eurozone and Japan remains feeble. Among advanced countries the U.S., Canada, and the U.K. have done somewhat better than the rest. However, both productivity growth and labor force growth have slowed in advanced economies. Inflationary pressures are subdued and well below central banks' inflation targets. Highly accommodative monetary policy, low short-term interest rates, low inflation, and tepid growth have caused long-term interest rates on government bonds to be low and even negative in advanced countries.

Meanwhile, economic activity has also slowed in emerging markets since 2013. The slowdown in China, the slide in commodity prices and various domestic factors have affected the emerging markets. Overall risks to the global economy are tilted to the downside.

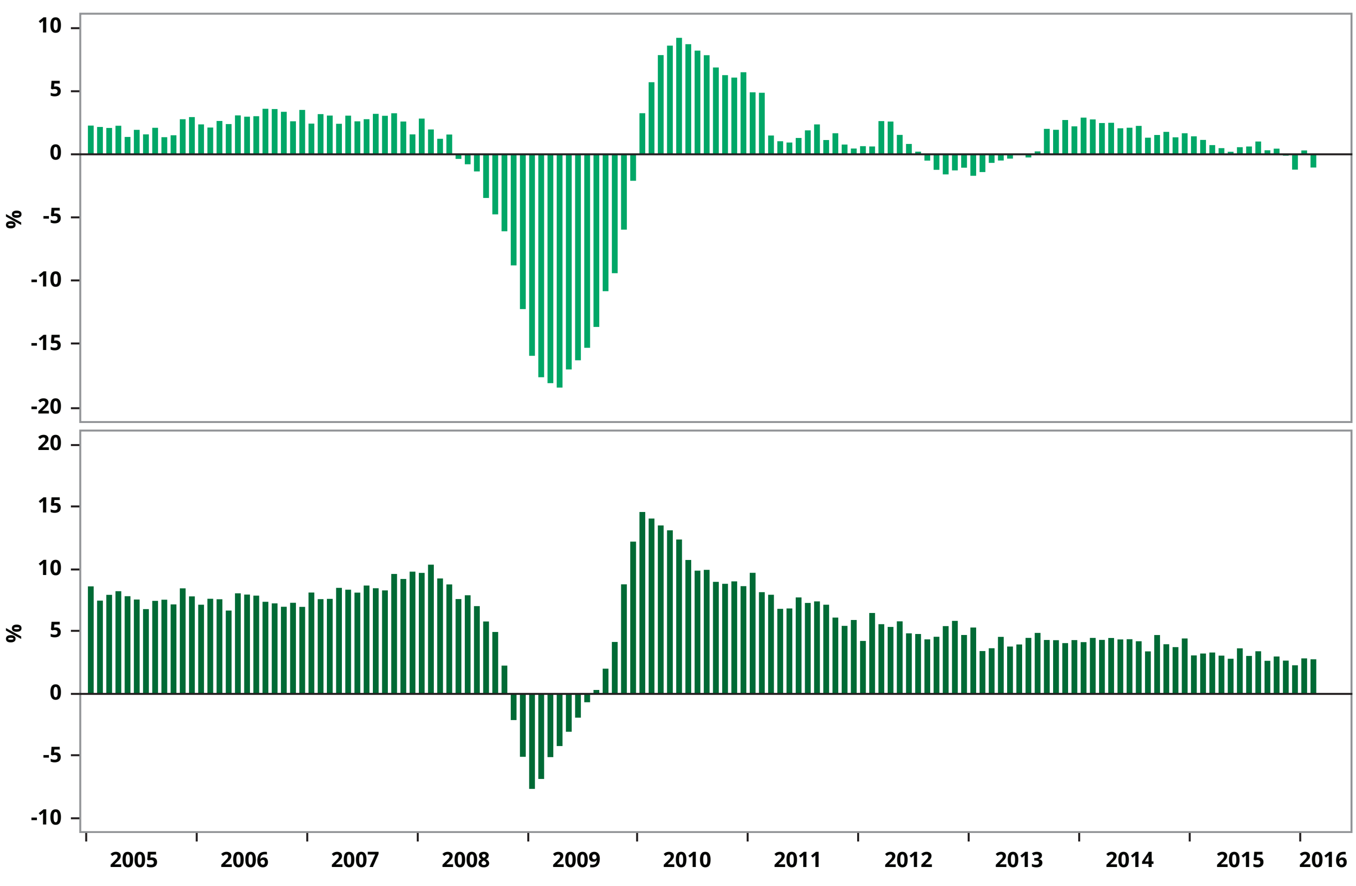
The Soft Recovery in Advanced Countries

The global economy is still soft. Monitoring the growth in industrial production gives valuable clues about the state of economic activity because industrial production reflects economic fluctuations. It is a leading indicator of the direction and magnitude of economic activity. Industrial production, measured as percentage change on a year ago, in advanced countries has been quite weak since the beginning of the year, while industrial production in emerging markets, measured on the same basis, is still growing but at a much softer pace than previously (see Figure 1).

Industrial production in the key regions of advanced economies, namely the United States, the eurozone, and Japan, are all soft (see Figure 2). The pace of industrial production in the main countries of the euro zone, such as Germany, France, Italy and Spain, is still disappointing and growing at a tepid pace.

Figure 1: Global Recovery Still Soft

Advanced Economies & EMs, Industrial Production, SA



Source: Macrobond

The post-crisis recovery in economic activity in advanced countries has been feeble. The U.S. has done better than the other major advanced countries, but its performance since the global financial crisis compared to its post-recession recoveries in the past is poor. Real GDP in the U.S. is up by nearly 25% compared to the first quarter of 2008, while in the U.K. real GDP is up merely 7% compared to the same period (we're predicting 3+ % GDP growth for UK this year). Real GDP in Germany and in Japan is around the same level today as it was in the first quarter of 2008.

The two key drivers of economic growth are (i) increase in the available labor force and (ii) increase in labor productivity. Since the global financial crisis both of these have waned in advanced countries, resulting in slower economic growth. Due to the aging of the population and lower fertility rates, the working age population is growing much more slowly in the U.S. and the eurozone than in the past, while in Japan the working age population is actually shrinking. Labor productivity growth has slowed notably in all advanced countries, including the U.S. Since the global financial crisis, labor productivity growth is much lower than its historic norm in the U.S. Labor productivity growth has also markedly slowed in the eurozone, the U.K., Canada, Japan, and other advanced economies.

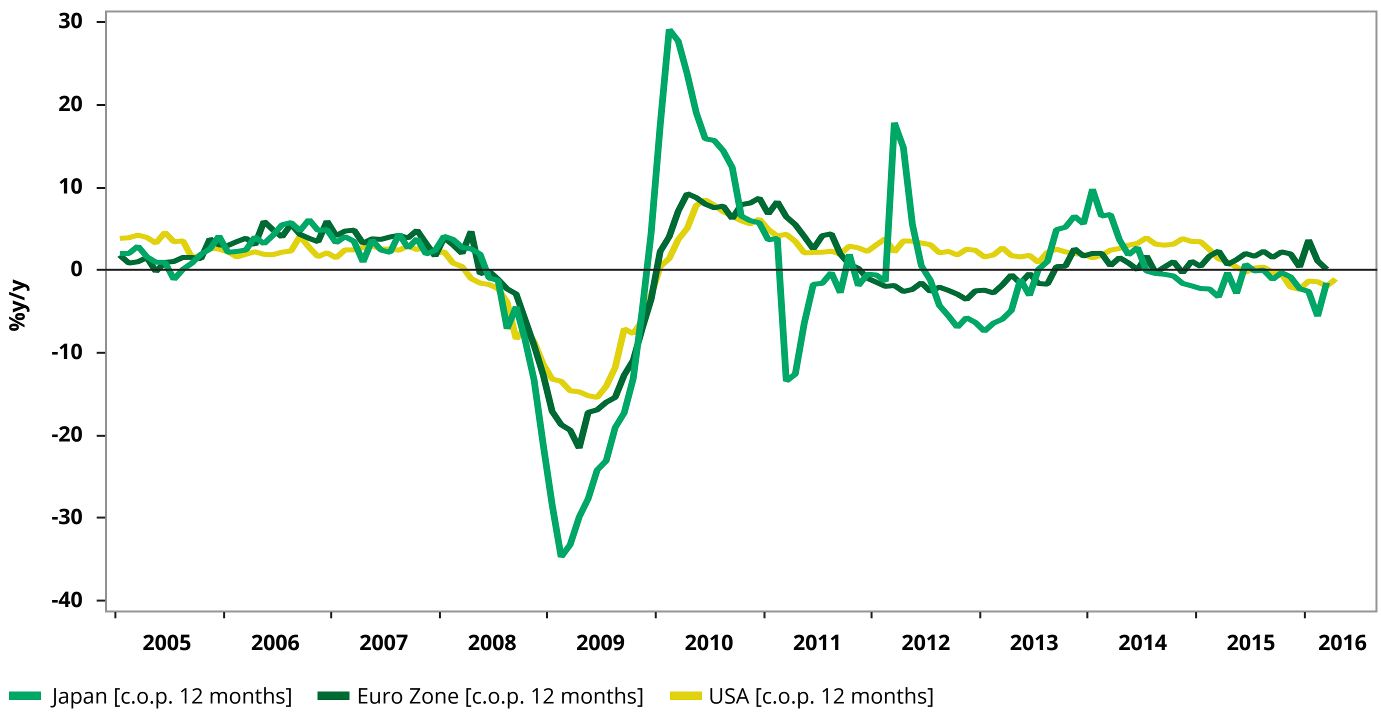
The decline in labor productivity growth is troubling. The decline in working age population implies that labor force growth is unlikely to occur unless advanced countries are willing to increase the rate of immigration. But at this time, most advanced countries are unlikely to make their immigration more open. Hence labor productivity growth is likely to be the sole source of growth. This means that increases in productivity growth will be essential to ensure higher real income. However, productivity growth has slowed notably since the global financial crisis.

Policymakers will need to address and overcome this slowdown in productivity growth. Firms have to be incentivized to invest in equipment, intellectual property, and technology to raise productivity, rather than merely to hoard cash. More tangible and intangible capital, improvements in technology, better management and a more skilled workforce tend to raise labor productivity.

The public sector needs to invest in infrastructure, support basic research and foster skill formation in the workforce of the future. Collaboration among private firms, research institutions and the public sector will be crucial to reap the benefits of wide range of new and disruptive technologies, such as cloud computing, advanced robotics, artificial intelligence, internet of

Figure 2: Industrial Production in Key Advanced Economies is Muted

Major Advanced Economies, Industrial Production, SA



Source: Macrobond

things, self-driven cars, new genomics, energy storage, 3D printing, advances in oil/gas extraction and recovery, and renewable energy.

Emerging Markets Decelerate

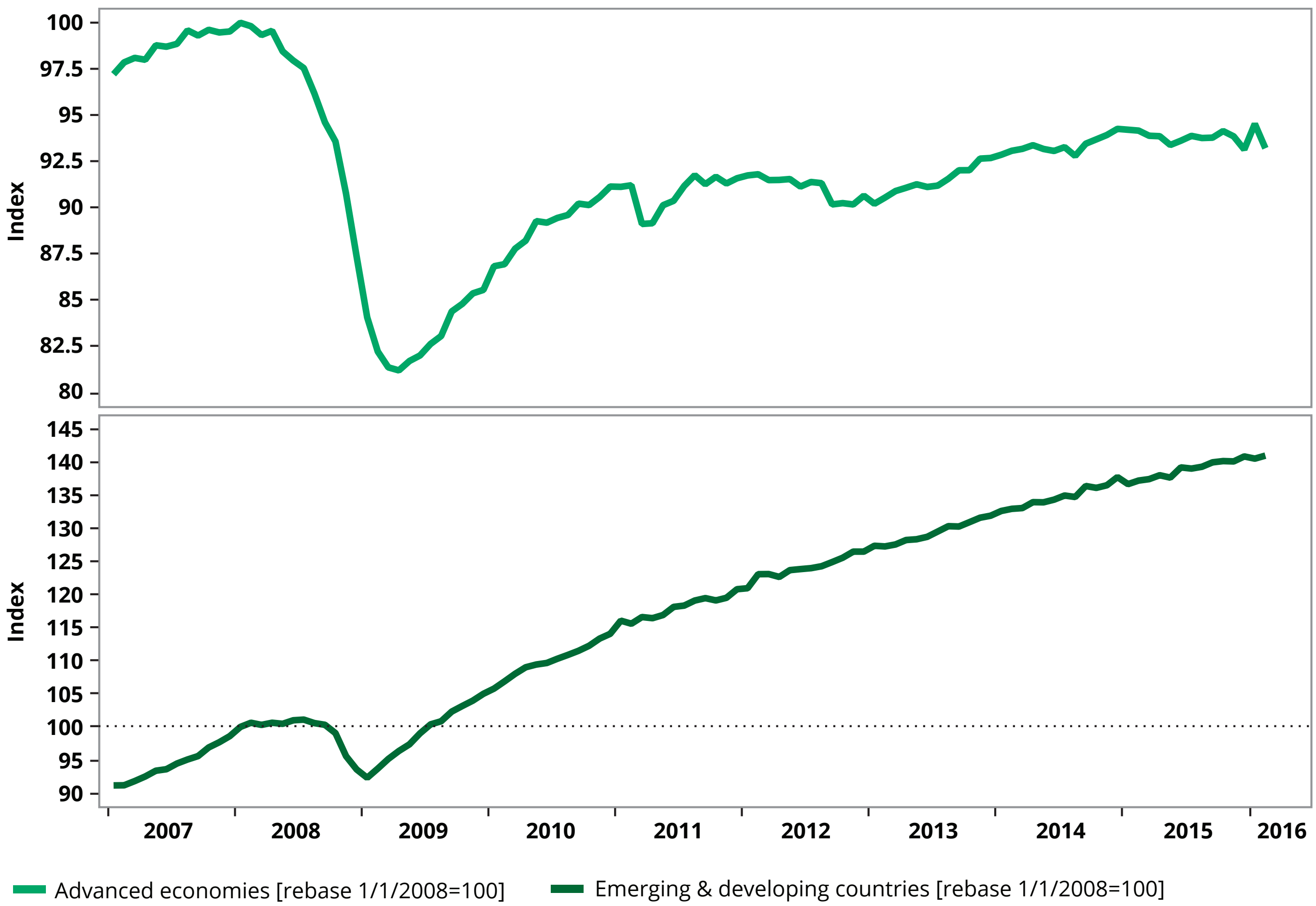
Emerging market countries fared much better than advanced countries following the global financial crisis. The contraction in economic activity and industrial production in 2008-2009 was much smaller in the emerging markets than that of in advanced countries. Industrial production has risen by nearly 40% in emerging markets since 2008, whereas industrial production in advanced countries is still below its pre-crisis level (see Figure 3). Among emerging markets, Asian countries, such as China, India and Indonesia, fared very well, with real GDP rising sharply. In contrast, several emerging markets in Latin America, such as Brazil, Mexico, and Argentina, and elsewhere, such as Russia and Turkey, also saw decent rise in real GDP but at a more restrained pace than that of Asian emerging markets, after the global financial crisis.

Since 2013, however, growth rates in most emerging markets have slowed down due to a number of factors:

1. A slower pace of activity in China meant that one of the key locomotives of global growth was pulling along other emerging markets at a softer pace.
2. The weaker global demand growth for commodities has resulted in tumbling commodity and energy prices, which has dragged down commodity producing emerging markets, such as Argentina and South Africa.
3. Poor management and unstable political conditions affected several emerging markets, like Brazil and Russia. Industrial production in

Figure 3: Emerging markets fared better than advanced economies until the 2013 slowdown

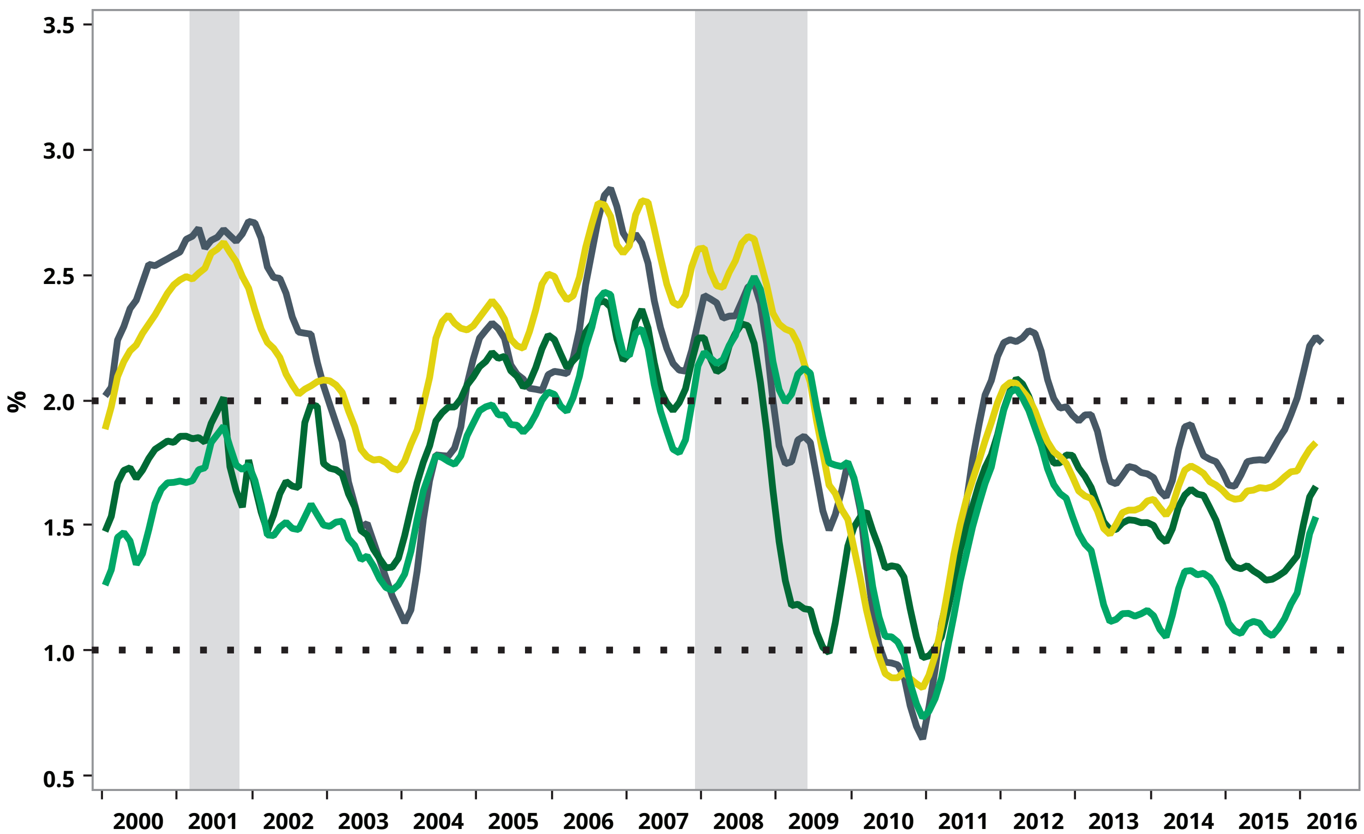
Advanced Economies & EMs, Industrial Production, SA



Source: Macrobond

Figure 4: U.S. inflationary pressures are subdued and below Fed inflation target

USA "Core" Consumer Prices, SA



Source: Macrobond

Brazil and Russia has been sliding for more than the past six quarters.

4. A number of oil-exporting countries, such as Saudi Arabia, have had to scale back their fiscal spending in light of declining revenue from the exports of crude oil. However, energy prices have improved in recent weeks as investors have been concerned about possible supply disruptions, slowdown in exploration and investment, and risks.

5. Financial inflows to emerging markets have declined as investors become more concerned about economic and financial conditions in these countries.

6. Leverage in the corporate sectors in a number of emerging markets had risen, making these economies vulnerable to shocks and risk reversals.

Inflation Dynamics and Deflation Risks in Advanced Economies

The weakness in effective demand in advanced countries has resulted in subdued inflationary pressures. The rates of inflation in the major advanced countries are well below their central banks' inflation targets. Inflationary pressures in the U.S. are muted. Various measures of inflationary pressures, such as core Consumer Price Index (CPI), core Personal Consumption Expenditure (PCE) index, and market-based core PCE, confirm that inflation remains subdued in the U.S. (see Figure 4).

Headline inflation in the eurozone is essentially zero or lower, while core inflation, as calibrated by Harmonized Consumer Price Index (HCPI), is substantially below the European Central Bank's (ECB) target of inflation just lower than 2.0% on a year ago basis. In Japan, core inflation is weak. Although the Japanese economy grew more than expected in the first quarter of 2016, deflationary pressures are likely to resume in Japan since wages are still feeble and aggregate demand is still weak.

Inflation and inflationary expectations are muted in advanced countries. Both market-based measures of inflation expectations and survey-based measures of inflation expectations in most advanced countries suggest that inflationary expectations are low and well below the central banks' inflation target.

Investors are weary of the risks of debt-deflation scenarios. Underlying the weakness of inflation dynamics is the weakness in nominal wage growth and growth in overall labor costs. The price level depends on the nominal wage, other input costs, productivity, and markup. Of these the nominal wage is the most important factor that determines the price level. Nominal wage growth affects inflationary pressures.

Since wage growth is soft in most advanced countries, it is not surprising that inflationary pressures are in check. Wages are soft due to the weak bargaining positon of the working class, de-unionization, decline in manufacturing industries, the rise in the service sector, and the globalization of production.

Official unemployment rates in several advanced countries, such as the U.S., the U.K., Germany and Japan are indeed low, but increases in nominal wages have been fairly restrained because workers are not organized and their bargaining position is weak and has become weaker. It is hard to conceive of inflationary pressures resuming without a rise in nominal wages in advanced countries.

It is possible that adverse supply shocks, such as higher energy and commodity prices, and higher consumption taxes, may cause inflation to rise but these are unlikely to be sustained and its effects would wane over time. In essence without sustained rise in nominal wages it is unlikely that there would be inflation in the central banks' target rates in advanced countries.

Monetary Policy and the Specter of Low Interest Rates

The highly accommodative monetary policy in advanced countries has led to the specter of extraordinarily low interest rates. Central banks' policy rates in the U.S., the U.K, and Canada are low. The Federal Reserve raised the Fed funds target rate in late 2015 after keeping it unchanged for around seven years.

The Bank of England (BOE), which kept its policy rate unchanged since 2009, recently cut the policy rate. The Bank of Canada (BOC) had raised its policy rate in 2010 but it was forced to cut its policy rate twice due to the weakness of the Canadian economy since late 2014. The ECB had raised its policy rates in early 2011, but it had to abandon its hawkish stance quickly with rate cuts starting in later 2011 and occurring every year since then.

Starting from mid-2014 the ECB's policy rate on its deposit facility has been negative and subsequently reduced several times (see Figure 5). The Bank of Japan's (BOJ) policy rate had been near zero for many years as the country appears to be caught in a "liquidity trap" (Akram 2014 and 2016). However, in the beginning of this year, the BOJ decided to switch to negative interest rates.

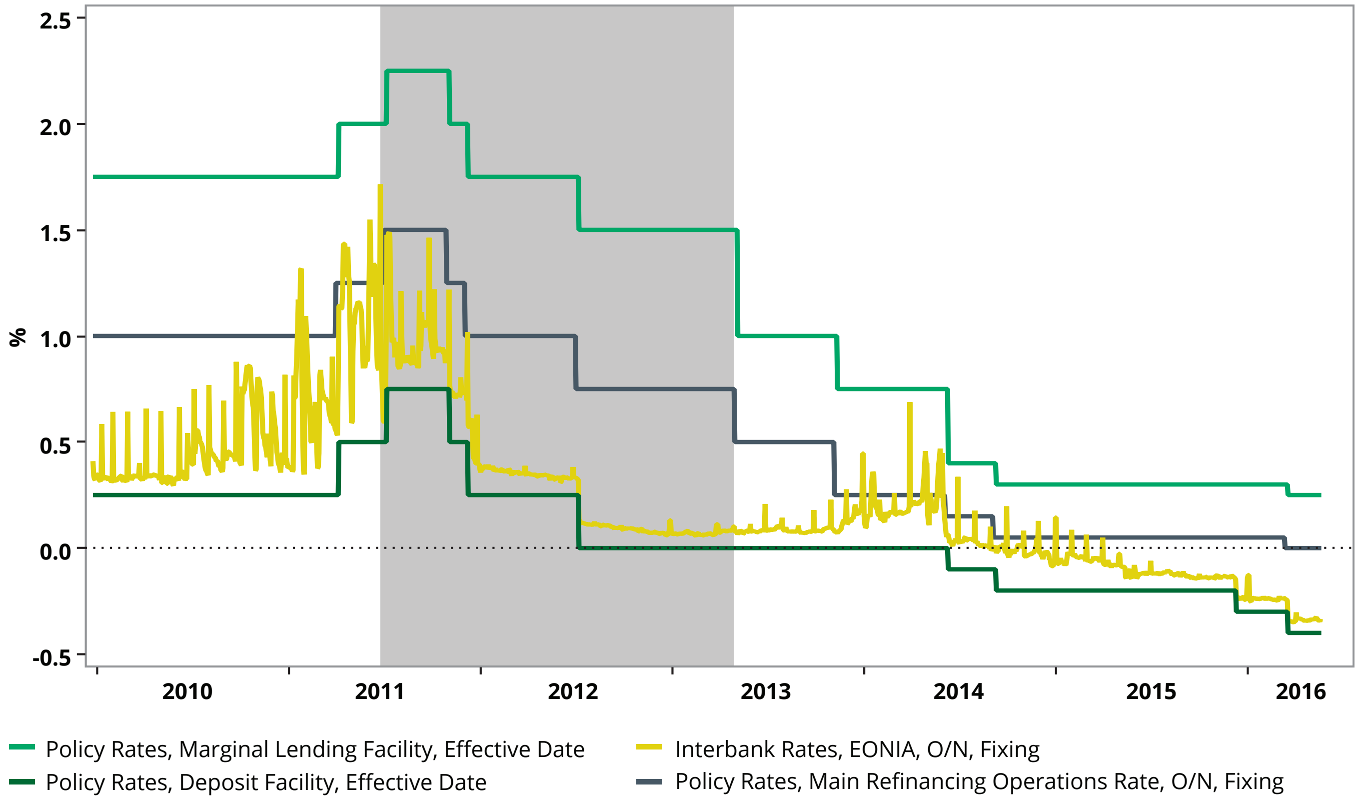
Long-term interest rates fell sharply in 2008 in most major advanced countries with the onset of the global financial crisis (Akram 2015). Since then long-term interest rates in the U.S., the U.K., and Canada have largely moved in tandem with some minor variations (see Figure 6). Interest rates have remained low in these countries despite the recovery in economic activity, which admittedly has been moderate, slow and delayed.

The path of long-term interest rates in the eurozone has been different than in the Anglo-Saxon countries. In the eurozone, long-term interest rates had converged with the creation of the monetary union. However, this convergence proved to be illusionary. After the global financial crisis, interest rates on government bonds in the eurozone diverged. In several periphery eurozone countries, such as Portugal, Spain, Italy, Ireland, and Greece, interest rates spiked in mid-2012.

Though each of these periphery eurozone countries is different, investors had become generally skeptical about fiscal sustainability of peripheral countries. Since these countries had voluntarily surrendered their monetary sovereignty, their government bonds were no longer denominated in their own currencies. Therefore they would be unable to service their debt payments unless they had sufficient inflows of euros into their Exchequer. As a result, investors doubted the ability of the peripheral countries to repay their debt and began to question the viability of the currency union.

Figure 5: Negative policy rates in the eurozone

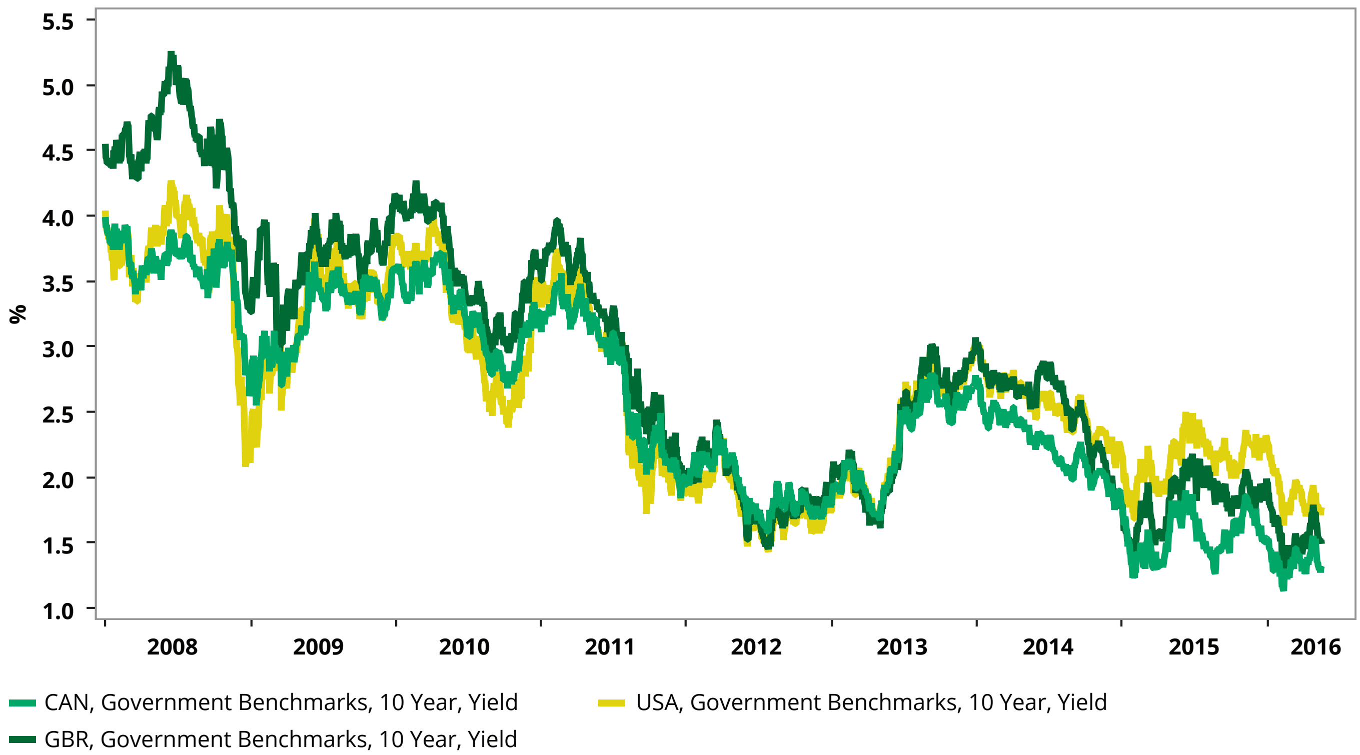
Euro Zone, ECB Policy Rates and EONIA



Source: Macrobond

Figure 6: Very low long-term interest rates in U.S., U.K. and Canada since 2008

Government Benchmarks, 10 Year, Yield



Source: Macrobond

Interest rates for the peripheral countries remained high until Mario Darghi was compelled to state that the ECB would be willing to whatever it takes in order to preserve the euro. Assorted actions by the ECB, including long-term refinancing operations (LTROs), negative policy rates, and quantitative easing, have led to a marked declined in long-term interest rates on government bonds in the euro zone, including those of the peripheral countries. Interest rates have declined noticeably for Spain and Italy, while interest rates for German and French government bonds in the front end and the belly of yield curve are in the negative territory.

Elsewhere in Europe, negative interest rates prevails in a number of countries, such as Switzerland, Sweden, and Denmark, as policymakers had to lower policy rates due to various reasons. The Swiss authorities and the Danish authorities were compelled to act in order to either prevent currency appreciation or maintain the currency peg, or excessive financial flows. Policymakers in Sweden have been concerned about low inflation.

Interest rates on long-term government bonds in Japan have been low for more than two decades (Akram 2014; Akram and Das 2014a, and 2014b). Since January 2016 interest rates turned negative as the BOJ announced negative policy rates.

Interest rates on long-term government bonds are low for a variety of reasons. The most important factors that influence government bond yields are the central bank's policy rates and the short-term interest rates (Akram and Li 2016; Keynes 1930 and 2007 [1936]; and Kregel 2011). Other determinants of long-term interest rates, such as the rate of inflation, inflationary expectations, and economic activity, have been aligned to reinforce low interest rates in advanced countries. Subdued inflation and continuing risks of deflation or inflation below central banks' target rate contributes to keeping long-term interest rates low. The tepid pace of economic activity in advanced countries and the softer growth in emerging markets contain upward pressures on interest rates.

The Federal Reserve's stance on tightening monetary policy is gradual, cautious, and contingent on incoming information. The Fed's balance sheet remains elevated. It amounts to nearly $4.5 trillion as of April 2016. Meanwhile two major central banks, the ECB and the BOJ, continue to aggressively pursue quantitative easing. The first order effect of quantitative easing is downward pressure on domestic interest rates across the yield curve on government securities. But there is also a spillover effect of low rates in major advanced countries, which is to keep interest rates low in other major markets for government bonds.

Last but not the least, there is a strong and continuing demand for safe assets among global investors. The strong demand for safe arises from heightened uncertainty about economics prospects in Europe, concerns about "Brexit" and its repercussion, slowdown in China and several other emerging market economics, and the trajectory of commodity prices.

The global financial crisis forced the major central banks to be innovative, bold, and audacious. Quantitative easing and other actions by central banks were perhaps necessary, if only to ensure that the payment system remains intact. But the major central banks engaged in quantitative easing and asset purchases to stabilize the financial system, prevent runs on banks and various financial institutions and ensure that aggregate demand does not collapse.

Quantitative easing, low policy rates and other actions have kept long-term interest rates low in the key advanced countries. Low interest rates and particularly low mortgage rates appear to have supported the housing sector in the U.S, and the recovery in global auto sales. Lower interest rates have benefitted U.S. borrowers, as evidenced by the steep decline in household debt service and financial obligations ratios.

While the audacious interventions by the Fed, the BOE, the ECB and the BOJ may have been necessary, but today the central question is: What is to be done next?

Monetary policy actions alone may not be sufficient to revived effective demand. Investment spending has not risen in advanced countries despite many years of low interest rates. Low interest rates over a protracted period can have adverse effects on financial services industry, including banks and insurance companies. In a recent study (Claessens, Colerman and Donnelly 2016), the

Fed's staff researchers note that "banking systems in many low interest countries will face challenges. Until lost income can be offset through other actions, lower profitability will reduce financial institutions' ability to build and attract capital, increase their vulnerability to shock and declines in market confidence and undermining their ability to support the real economy." Even though interest rates are low, bankers and loan officers in financial institutions are unlikely to lend to borrowers unless they see that prospects of sales are promising and that effective demand will pick up.

Policies for Growth in a World Tilted with Downside Risks

Policymakers will need to institute polices to raise effective demand. Higher growth and higher inflation can lift interest rates. The highly accommodative monetary policy and low interest rates may have been necessary but it is clearly that these measures have not been enough to revive effective demand, generate private investment and create high-quality employment that provides decent wages and salaries. Employment growth in the U.S. has been decent for nearly four years, but real wage growth and real disposable income growth are still weak and labor productivity growth has been markedly tepid. A moderate rise in interest rates would benefit net lenders and savers, senior citizens, retirees, and provide net interest incomes to households and the private sector. A moderate increase in interest rates would not harm housing recovery as long as employment growth remains decent and if real disposable income rises. The benefits from low interest rates do not appear to have been very strong. Indeed the benefits have been far less so than convention wisdom would suggest.

The challenge ahead is to raise productivity growth, real wages, and real disposable income, which in turn would lead to rise in inflation closer to central banks' targets. Tighter monetary policy would support higher interest rates. However, it may be awhile before advanced economies get there. It is unlikely to happen in 2016. A desideratum should not be mistaken for a forecast! In the meantime, investors will struggle to find a suitable combination of higher return and low risk opportunities. Investing in countries with higher government bond yields, such as Argentina, is not without various risks!

Risks to the global economy are tilted to the downside. Near-term risks are the implications of Brexit and the U.S. Presidential elections, and the possibility of the renewed of financial instability in the euro zone. Medium-term risks include problems in the Arab world, particularly the Syrian revolution and the refuges crisis, protracted slowdown in China and road bumps in the transformation of the Chinese economy, and the deteriorating relationship between the West and Russia that could invoke a new and bitter cold war. Long-term risks to the world economy come from the demographic transition and the effects of global warming. It will require concerted actions both in the private sector and the public sector to create congenial environment for higher growth and to mitigate various downside risks that are ahead. ■

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