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GLOBAL ECONOMIC RESEARCH

GLOBAL MACRO PERSPECTIVES
TAILWINDS TURN TO HEADWINDS

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+ **Helped by a ceasefire in the US/China trade war, market perceptions of the economic outlook have improved. But there are reasons for caution: the recovery in manufacturing remains fragile, asset price gains continue to outpace fundamentals and the secular outlook is challenging. Against this backdrop, unforecastable events, like the coronavirus outbreak, could have a disproportionate negative impact.**

+ **Beyond these near-term considerations, structural factors are key. And their importance is still under-recognized. Prior to the global financial crisis (GFC), the global economy was supported by four secular tailwinds: a positive supply shock from demographics, a monetary framework geared towards rapid debt accumulation, government policies that favored capital over labor and a period of unprecedented international cooperation. All four are now moving into reverse.**

+ **The result is likely to be much lower growth and interest rates than we've been used to—and, eventually, higher inflation. Can economic policy break the global economy out of this rut? For overburdened monetary policy, the answer is almost certainly no. We have higher hopes for fiscal policy, but it faces a tough battle against the secular forces weighing on the outlook.**

The dominant force acting on the global economy last year was policy uncertainty stemming from the US/China trade war. This caused world-trade growth to turn negative for only the second time in 30 years and pushed the manufacturing sector into recession in many countries.

A key concern during the second half of the year was whether this weakness would spill over into other sectors and drag the global economy into recession. The good news, as we enter 2020, is that trade and manufacturing are starting to stabilize and that the ceasefire in the trade war between the US and China should lead to a reduction in policy uncertainty. So, should we be more optimistic on the global outlook?

The answer is probably yes. But, even before the coronavirus outbreak, there were reasons for caution:

- The recovery in manufacturing remains fragile, with some indicators suggesting that output is still contracting.
- The forces that gave birth to the trade war—populism, geopolitics—have not gone away; the outlook could quickly darken again.
- Much of the weakness in trade is structural. Between 1990 and 2007, world trade grew by 6.8% a year; since 2011 it has grown by just 2.5% a year. Even if policy uncertainty recedes, a strong rebound in world trade growth looks unlikely.
- There's a big disconnect between rampant asset-price gains and the more muted improvement in economic fundamentals. Markets could be vulnerable if growth fails to validate heightened expectations.

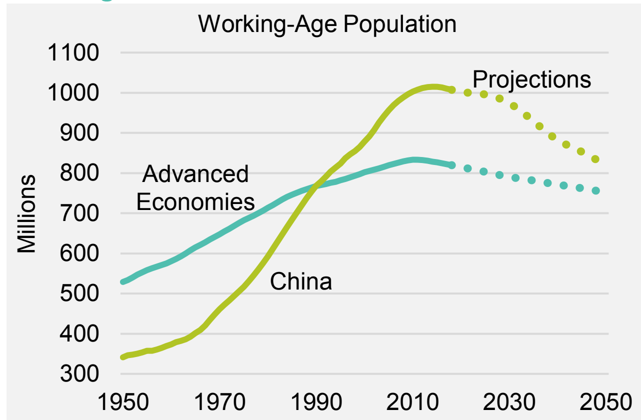
World Trade Remains Structurally Weak

2019 is January to November data only.
Source: Haver Analytics

SECULAR FACTORS UNDER-RECOGNIZED

But the most important caveat is that the secular backdrop remains challenging. For the last three decades, the global economy has benefited from four structural tailwinds: a rapidly rising labor force; a monetary regime that promoted rapid debt creation; government policies that favored capital over labor; and an unprecedented period of international economic cooperation. All of these have now turned, or are turning, into reverse. And as so often in the past, the transition from one regime to another is likely to be painful.

Running Out of Workers



United Nations Population Database medium-variant projections
Source: Haver Analytics

Labor: From Positive to Negative Supply Shock

Between 1950 and its peak in 2010, the working-age population (i.e., people who add to productive potential) in the advanced economies rose by 300 million people, or 0.8% per annum. This positive trend received an additional boost after 1990 as Chinese workers were integrated into the global supply chain. In other words, the global economy benefited from a positive supply shock which raised growth and helped lower inflation. Now, the working-age population in both the advanced economies and in China is shrinking. The world is facing a negative supply shock.

Debt Still Cripplingly High

Households, nonfinancial companies and government
Source: Haver Analytics and Jorda-Schularick Taylor Macrohistory Database

Pre-GFC: Buildup of Huge Debt Overhang

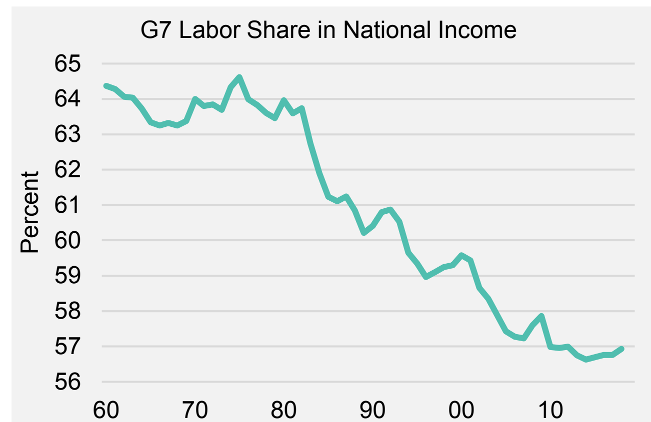
In the run-up to the GFC, central banks were spectacularly successful at controlling *consumer-price* inflation. But they ignored other forms of inflation, such as the huge increases in money, credit and asset prices that took place during this period. Not surprisingly, this was positive for growth at the time—to the extent that it probably masked a structural slowdown. But it resulted in the biggest crisis since the Great Depression and left the world with a crippling debt overhang.

The Battle Between Labor and Capital

For the last 40 years, government policy in the advanced economies has favored capital over labor. Viewed from the perspective of the late 1970s—when unionization, state ownership, and wage and price indexation were starting to take a heavy toll on economies—this was a welcome shift. But the pendulum has now swung to the opposite extreme.

One way of observing this shift is through the labor share in national income (the percentage of the economic pie that is distributed to labor in the form of wages rather than business in the form of profits) which has been on a sharp downward trend in the G7 countries since the early 1980s. This decline has happened in every single advanced economy but has been most acute in Japan, where it has fallen by a staggering 15 percentage points.

Labor's Share of the Economic Pie Has Fallen



G7 is the US, Germany, France, the UK, Italy, Japan and Canada.
Source: Haver Analytics

Just as government policy had swung too far in favor of labor at the end of the 1970s, so it has now swung too far in favor of capital. Wage growth has stagnated, wealth and income inequality have exploded, and rising populism has been the result. And populism is likely to play a key role in driving the pendulum back towards labor.

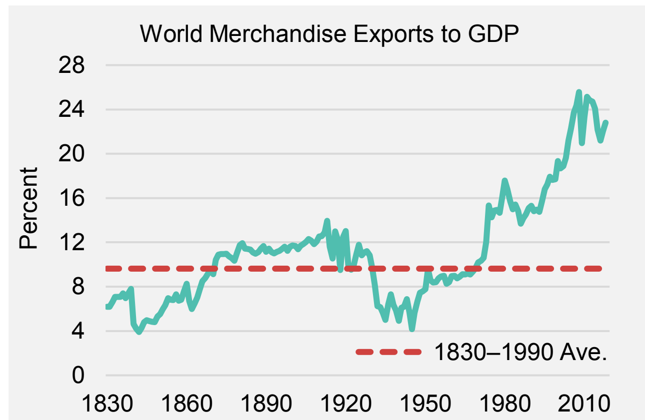
Our framework for thinking about populism focuses on three transmission channels: raising the drawbridge; institutional erosion; and redistribution. We have seen evidence of all three in recent years and all three are linked by a common thread: maximizing growth and corporate profits should no longer be seen as the overriding aim of government policy.

Populism will play out at different speeds in different countries. One country where it might play out quickly is the UK. At last year's general election, the Conservative Party (previously seen as the party of the rich and privileged) displaced the Labour Party as the most popular party with working-class voters and those without jobs. While much of this can be explained by Brexit and disillusionment with the Labour leadership, it still represents a huge opportunity for Prime Minister Boris Johnson to permanently disrupt the UK political landscape. To do so, though, he needs to address the concerns of people who voted Conservative for the first time in December and move to the left economically—in other words, implement policies that will shift the pendulum back towards labor and away from capital.

Mutually Beneficial Global Cooperation

The last 30 years have seen an unparalleled degree of international economic cooperation and integration—the share of exports in global GDP rose from 15% in 1990 to a peak of 26% in 2008, far above the long-term norm (10%, on average, between 1830 and 1990). China was at the heart of this process, with its share of advanced-economy imports rising from just 2% in 1990 to a peak of almost 16% in 2014.

Has Globalization Reached the End of the Road?

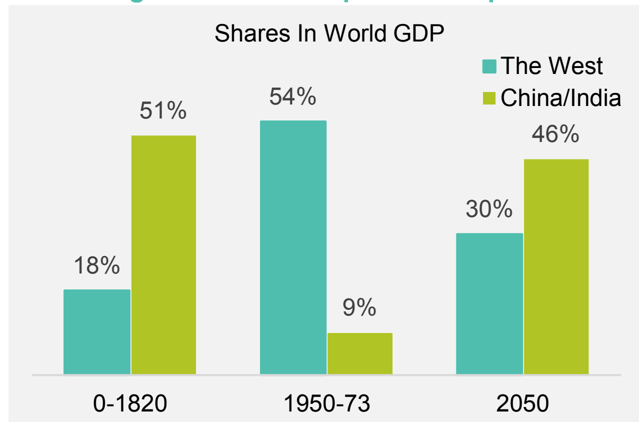


Source: "Back to the Future, International Trade and the Two Globalizations", Michel Fouquin & Jules Hugot (1830–1959); World Bank (1960 onwards)

Both sides gained from this mutually beneficial coincidence of needs. It helped China industrialize, start to catch up with the West and increase its military strength. And it allowed the West to buy cheap consumer goods—helped by the ready availability of low-cost credit.

Last year's trade war between China and the US is one of the most obvious signs that this mutually beneficial period is over. But rising tension between China and the US is about far more than trade. It's about a tectonic shift in the global balance of power, with China and India emerging from a long slumber and the West slowly declining in power and influence.

Redrawing the Global Geopolitical Map



Source: Haver Analytics, Maddison Project Database and AB estimates

The way in which we think about the world, and most of the rules that govern the world, reflect a relatively brief period in global economic history during which the West and its culture dominated. This reached a peak after World War II, when the West accounted for over 50% of global output and China and India less than 10% (combined). It wasn't always like this: between the year zero and 1820, China and India accounted for roughly half of global output and the West less than 20%.

Today, the balance of global economic power is changing very rapidly. From just 5% in 1970, China now accounts for 23% of global output. The numbers for India are less impressive, with its share of global GDP having risen from 4% to 9% over the same period. Nonetheless, rapid growth in coming decades means that China and India are likely to account for almost half of global output by the middle of the century. The West will remain important, but the days of western hegemony are over.

The shifting balance of global economic (and military) power is likely to have huge ramifications. In the past, similar changes have often ended in some form of conflict as the dominant power (understandably) seeks to defend the status quo and the rising power (understandably) seeks to assert its new-found power and influence. It's in this context that we should view the recent souring of relations between the US and China and the ebb and flow of the trade war.

Structural Tailwinds Turn to Headwinds

These are not, of course, the only secular forces at play. Technological progress and climate change will have hugely important impacts on the global economy in coming years. But the fact that four of the factors that contributed to strong growth and low inflation before the GFC are now moving into reverse is a significant development. The result is likely to be much lower growth and lower interest rates than we've been used to—and, eventually, higher inflation.

There's nothing unusual about weak economic growth. But policymakers are unlikely to regard this as an acceptable state of affairs—particularly with populism on the rise, debt levels elevated and huge unfunded spending commitments coming down the line. Barring a technology-driven boost to productivity growth, pressure for monetary and fiscal policy to provide an answer to low growth and inflation is likely to intensify.

BREAKING OUT OF THE RUT

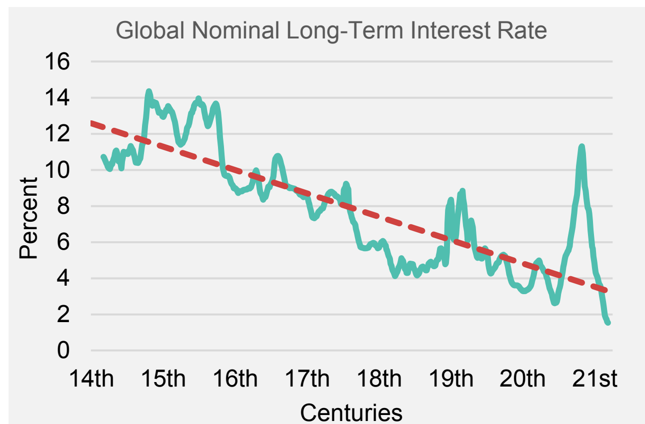
So, can economic policy help break the global economy out of a low-growth rut? For overburdened monetary policy, the answer is almost certainly no. Interest rates are already at record lows in many countries and even central bankers now admit that they're running out of ammunition. Moreover, the list of adverse side effects is rising fast, whether that be the impact of negative rates on the health of the financial system, an increase in the number of unproductive zombie companies or the creation of new asset-price bubbles and the associated risks to financial stability.

Monetary Policy: Have We Finally Broken It?

Because cutting interest rates works primarily by encouraging people to take on more debt, there's also a risk of pushing the economy into a debt trap, in which low interest rates begin to feed upon themselves. That's been the script for the past 30 years, with ever-lower interest rates being required to keep a lid on debt-servicing costs and prevent a financial meltdown.

In a particularly pessimistic take on the scope for central bank action, a recent Bank of England working paper identified a downward trend in real and nominal interest rates stretching back over the last eight centuries. The reasons for this trend are not well established, but it does call into question the whole concept of mean reversion and the widespread view that global interest rates are abnormally low. It also suggests that central banks will only be able to lift growth and inflation by taking interest rates much deeper into negative territory—something they're currently reluctant to do.

How Low Can You Go?



Seven-year rolling average
Source: "Eight centuries of global real interest rates, R-G, and the 'suprasecular' decline, 1311–2018", Bank of England Working Paper, January 2020

Fiscal and Monetary Policy: Joined at the Hip

Where central banks can help, though, is in facilitating fiscal expansion. Even though government debt ratios have risen to record highs in the advanced economies, a combination of ultra-low interest rates, quantitative easing and financial repression means that the costs of servicing this debt stand close to record lows.

Central Banks Have Lowered the Cost of Debt

G7 is the US, Germany, France, the UK, Italy, Japan and Canada.
Source: Haver Analytics

But while central banks have delivered on their side of this Faustian bargain, few governments have been prepared to exploit the resultant increase in fiscal space. The most striking example is Japan. Even though the Bank of Japan has bought a huge amount of government bonds in recent years (equal to roughly 90% of GDP), the thrust of Japanese fiscal policy has been contractionary.

The good news is that governments are finally getting the message. The bad news is that this is happening only slowly. We expect a fiscal stimulus equal to about 0.5% of GDP at the global level this year, broadly the same as in 2018 and 2019. That's simply not enough to make a material difference to the outlook.

Given the scale of the secular challenge facing the global economy and the limited scope for monetary policy to help, there's little doubt that fiscal policy is set to play a more prominent role in the battle against low growth and inflation. Ultimately, we expect this to extend to less conventional fiscal-policy tools, including various forms of monetization like helicopter money and Modern Monetary Theory. In the early 1980s, a radical shift in the policy regime had a huge impact on the macro landscape. We face another seismic shift today. And it's likely to have an equally dramatic impact on the macro backdrop—particularly inflation, corporate profitability and the distribution of income.

Global Economic Research

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