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The global economy: Mid-year update - The lull before the squall?

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Over the past year global economic growth and world trade have picked up, commodity prices have stabilised, unemployment rates have fallen towards pre-2008 financial crisis levels, and inflation rates have edged closer to central bank targets, painting a picture of financial tranquillity. However, while near-term prospects are promising, significant risks loom in the medium term. Monetary policy is uncertain, while debt and low wage growth weigh increasingly on consumption and investment. In the background continues to lurk weak productivity growth, an unusually limited room for policy manoeuvre, and the ever-present shadow of disruptive technological change, especially from the unexpectedly rapid advances in artificial intelligence and the expanding internet of 'things'. Questions arise of how policy makers, markets, and investors should position themselves in this environment, and if emerging forces of economic nationalism and political populism will become more permanent features.

Direction of trouble for the world economy

Growth has been modest and variable across the globe; there has been little pick up in global economic powerhouses such as the United States and China, while growth across Europe remains inconsistent. The direction of the world economy and the oil price appear to be locked in tandem with low market volatility for the immediate future. Regarding Europe, a firming up of growth in problematic areas like Italy would be extremely helpful, not just to overall growth rates, but also in calming concerns over financial sector risks. Every effort will be made in Europe to stabilise concerns of debt issues and financial threats. Although the world is awash with money, there has been difficulty in transforming it into hard investments. There is plenty of money moving into financial markets, which is reflected in financial asset prices, the recovery in emerging market confidence and the money flowing into emerging market bonds and currencies. Savings are flowing, and regarding financial markets, globalisation and internationalism are still well into the forefront.

The handling of fiscal policies, the fallout from the debt accumulated since the crisis and even to a certain extent ultra-loose monetary policies have all been national efforts to save national economies. Furthermore, the decision on how to address such concerns is very much a national choice, and stirs tendencies for populations to be more vocal about national trends and well-being than global events. Domestic austerity has generated an apprehensive mood for external generosity towards international inequality. International development aid and assistance are not likely to be cut, but there is also limited desire for expansion.

There is a rather odd mix of favouring inequalities within domestic economies and broad concerns of inequality across the world. Global inequality has been increased significantly by globalisation, while many may feel that inequality within their own country has been mistreated. Part of the feeling of inequality, which has manifested electorally in the United Kingdom, the United States and elsewhere, is that wages and wealth have surged ahead for the sectors that were already wealthy but non-skilled and medium-skilled workers have tended to lose out. Wages have stagnated. Demands for higher pay could lead to greater battles over inflation and budget deficits as many of those demanding wage increases are in the lowest public-sector pay band.

Protectionism and the challenges to international governance of the global economy

World GDP growth is recovering, but neither trade nor productivity is growing fast. In fact, growth is only recovering to production levels of from before the crisis, using underutilised capacity instead of creating new capacity. There has been a change in the outlook of world leaders away from a belief in open markets and global collaboration towards a more nationalist approach. This has been reflected in the unwinding of various international trade arrangements. Greater weight has not only been placed on nationalism but also national economic security. This has manifested in arguments over the protection of steel markets in relation to arms production, increased concerns of energy self-sufficiency and increased protectionism of domestic firms. This feeling of mercantilism across the globe should not be discounted; increased economic nationalism risks inhibiting progress on international cooperation for the regulation of financial flows, on tax evasion and on international environmental issues.

The enormous debt overhang has the potential to produce economic turmoil. The excessively high levels of debt to GDP ratios in both the public and private sector is currently disguised by extraordinarily low real interest rates, suggesting that an increase in rates will have a significant effect on the stability of government finances and international capital flows. A financial crisis in the corporate debt markets could materialise, particularly if there are bankruptcies of firms in China and other emerging economies. Questions arise as to whether governments will seek to bail these firms out and how they will prioritise the protection of domestic firms.

The international community has failed to cooperate on resolving migration pressures. Although the economic consequences of this have yet to develop fully, the social consequences have left governments unwilling to invest in solutions to migration, which will continue to rise.

Energy markets

Compared to economic growth, energy markets continue to grow strongly. However, there are significant differences between OECD countries, where energy consumption growth is negative, and the developing world, where it has been strongly positive. Even though there are substantial investments in renewables and other non-carbon forms of energy, fossil fuels are still the most critical component of the energy matrix. Low oil prices have slightly recovered, in part due to OPEC's restriction of output and the recognition that it is difficult to make significant investments in extensive, new projects given prevailing price levels. This has led to a focus on smaller, incremental developments, such as onshore oil production in the United States, which, in turn, has led US production to recover more quickly than expected, affecting OPEC's ability to remove its stock overhang as a means of rebalancing markets.

Stock drawdowns have been used to meet increases in demand, keeping the oil price range-bound. While markets are still expected to come more into balance next year, a significant increase in oil prices is highly unlikely. Uncertainty persists on the supply side while demand will continue to grow slowly.

The three major markets, North America, Europe and Asia Pacific, are facing increasing market imbalances. US supply continues to outstrip demand, but demand in Asia Pacific is growing strongly between China and India. Furthermore, while Europe's demand is slightly increasing, supply has been weak. These imbalances are increasingly being met by liquefied natural gas (LNG), through a number of projects that were committed to when prices were higher. We are now in a period where supply is running ahead of demand, keeping prices low, narrowing regional price differences, and making it difficult to justify new projects. The recent decision by Qatar substantially to increase its production by 30% will destabilise many of these projects, making it more difficult to justify funding for larger developments. This is having a critical impact on projects in East Africa and Canada, which are becoming harder to rationalise.

Q & A Session

Capital spending recovery

Lethargy in investment has led to output being supported by old capital stock, and indecision about future investments. The financial means for investment are ample, but there has been an inability to make decisions for reasons ranging from regime change to potential fiscal restructurings and Brexit. Governments and businesses are hesitant to commit as they are uncertain of what is immediately on the horizon.

Regarding energy, the big uncertainty is how quickly the world might shift from using fossil fuels for transportation to using electric vehicles. While producing the necessary volume of electric cars may be feasible, it ignores the challenges that will be faced from placing more demand on electricity grids. India has a classic problem of not being able to provide enough electricity for normal use, which would only be exacerbated by a switch to electric vehicles. Huge capital spending will be needed to initiate these types of changes. This seems unlikely over the next couple of years.

Inequality

The most effective method of tackling inequality is job creation. This is difficult in the present climate due to the low levels of investment and growth, as well as the prospect of increased use of artificial intelligence. It is challenging to conceive of where reasonably high paying jobs could appear to replace the current demand for low-skilled jobs likely to be displaced by further automation.

This only leaves progressive taxation as a means of addressing inequality. With governments competing for investments by lowering corporate tax rates, there will likely be greater pressure on tax regimes to generate revenue, not necessarily through tax rates, but by harnessing the tax base more actively. The steady progress of the OECD BEPS (Base erosion and profit shifting) project, which seeks to ensure companies are taxed on their worldwide activities, and an increasing interest in beneficial ownership transparency is not only being driven by tax consideration, but also by security considerations.

Guaranteed minimum wage arrangements already exist in a form through universal credit and unemployment benefits. To some extent a universal wage is a method of tidying up the existing welfare system and making it more efficient; it is more of a reorganization project, rather than a new expenditure. All attempts made by governments to rationalise welfare systems are difficult to implement politically and technically, and will leave many disappointed. Innovative IT approaches tend to work better in countries which have no prior welfare system.

Fed policy and interest rates

Central bank-managed interest rates are moving upwards. It is possible that there could be some stalling by the Federal Reserve (Fed) on the back of the easing US inflation cycle, but there is doubt that any deflationary trend will persist. Markets are taking the move towards normalisation of monetary policy steadily. Central banks that put in the effort to re-float the world economy after the 2008 financial crisis are not likely to put their efforts at great risk.

One issue that is mildly concerning is the Fed process of divesting its assets as it starts to unwind its bloated balance sheet. This, coupled with the ECB's likely end to quantitative easing in 2018, if mishandled, could shock the bond market.

The difference of yield on 10-year US treasuries, at 2.4%, and Treasury inflation protector securities (TIPS), at 0.6%, suggests expected inflation of about 1.8%, which is quite low. The market is currently adjusting to short-term changes, but its long-term view is for a low rate of growth and inflation in the next ten years, which is why there is low investment, excess capacity, low growth expectations, and a high degree of uncertainty.

There is not a lot the Fed can do to manipulate the long-term yield curve, which is dominated by people's growth expectations and the underlying fiscal position of the government. The market is not only fixed in this view, but is supported in it by the ample flows of funds coming in. A potential threat is a halt to savings flows coming from Asia and Europe, on which the United States is dependent. Any turbulence will likely come from abrupt changes in outflows of funds from China, which could cease for a variety of reasons.

Impact of alternative auto fuel on the oil and gas sector

All of the signs point to increasing electrification of the vehicle fleet, particularly passenger cars. There is a role for natural gas as a vehicle fuel, notably in Pakistan, Argentina and Italy, where there are strong tax incentives towards vehicle purchases. Natural gas has advantages of lower emissions, particularly for urban areas. However, generally speaking, most governments view natural gas as a dead end for vehicle fuel, and would rather electrify vehicles.

Natural gas will play a significant role in marine transport, with a number of shipping operators looking to use LNG as a fuel for cruise liners. Compressed natural gas (CNG) trucks are also a possibility, although they tend to be used for short-haul journeys as LNG trucks get 60-70% more mileage.

While oil and gas will continue to contribute to Middle Eastern economies, it will not be enough to stimulate post-war recovery in Syria and Iraq. Recovery in other war-torn countries, such as Vietnam and Angola, experienced a slower recovery than anticipated due to the destruction of important institutions and the breakdown of vital sectors, such as agriculture. Further challenges for post-war recovery include absorbing large numbers of militiamen back into the civilian economy post-demobilisation and retrieving crucial refugee capital lost during conflict. Clear leadership and international cooperation will be needed to rebuild economies across the region.

Prospects for the Latin American economies

Mexico has more control of its fiscal and monetary policy than Brazil, a positive for its outlook. Over the past decade, Mexico stands out as one of the better emerging-market performers on structural reform. However, its high dependence on the United States for both export sales and remittances poses a significant downside risk given uncertain US foreign policy ahead.

In Brazil, the political crisis is likely to dampen hopes for any economic recovery this year. High unemployment and consumer debts will continue to constrain household spending. The government's weakness will make it more difficult, though not impossible, to pass and implement critical labour and pensions reforms. The scenarios to end-2017 range from modest recovery amid political turmoil to recession amid full-blown crisis.

In Chile, both domestic and international factors are likely to limit growth prospects this year; a series of interest rate cuts has failed to boost domestic demand. Longer-term growth prospects are no more impressive at present, regardless of the election outcome.

Key downside risks to the world economy

The European debt crisis may not be finished, as indicated by the higher Italian public sector debt level. Further increases in Italian debt could prove insuperable in a few years. A second, larger concern, is the potential for severe disruption in global trade routes, particularly in Asia. Lastly, although the timescale is further out, there is a clear risk that economic changes could exacerbate and accelerate climate change to a point where it becomes more immediately dangerous.