The Global Economy:

All is Right with the World, and Yet Not

Simon Long examines the various stress-points in the global environment

Global financial markets have continued to defy gravity in recent months, surging to new highs the world over since the announcement of the election of Donald Trump and reviving especially as a centrist Emmanuel Macron was elected to power in France. Almost paradoxically, however, this is an unsettling time as economic and geo-political signals are both conflicting and worrisome.

THE US: A COMPLEX TANGO WITH, AND FOR, PRESIDENT TRUMP

In the United States, Wall Street's euphoria after Mr Trump's election as President was driven by an expectation that he would deliver on pro-business policies (tax cuts, deregulation, infrastructure spending) while holding back on his more reckless promises (immigration bans, punitive trade measures). The last few months, however, have been a reality check. The new President has used executive orders to push ahead in some areas – dismantling the encyclopaedic Dodd-Frank Act, for instance – but the internal battle in the United States, with all its checks and balances, has only just begun for Mr Trump. He has run up against Congressional opposition on infrastructure spending, with even his own party split between 'splurgers' and 'hawks' and

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repealing Obamacare has proven far trickier than expected. (Fortunately, a proposed 'Border Adjustment Tax' (which would have been the single-biggest tax measure in a century) was taken off the table when Mr Trump realised that it would simply amount to a new VAT, doing little to protect American jobs).

Externally, the US agenda is clear on two counts – climate change and international trade. And on both counts, it is inward looking. President Trump has used executive authority to pull the US out of deals like the Paris agreement on climate change and crucially, the Trans-Pacific Partnership that would have knitted the world's most significant economies into a mutual dependency from which most would have gained. Further, he has initiated the process of renegotiating NAFTA with Canada

North Korea: No Choice but 'Strategic Patience'

Developments with North Korea – a country that has confirmed its nuclear status through its Constitution and led by a completely unpredictable and therefore, dangerous President – remain a possible flashpoint not just between the US and North Korea but between China and the US. In turn, that will threaten the world's most crucial bilateral relationship. Viewed objectively, it is in both China's and US' interests to not allow the current situation to deteriorate. The US is hoping that China will step in whilst China itself is unlikely to do much as it fears a collapsing North Korea – with the prospect of millions of North Korean refugees streaming into China – more than it does a nuclear one. What haunts China is also the spectre of South Korea overrunning the North, bringing American troops to the Chinese border. All of this makes the current standoff both intractable and deeply worrisome.

and Mexico. The US has also begun an investigation into steel and aluminium dumping by China under its Trade Sanctions Act. (This might appear strange because China is no longer even in the top ten biggest steel exporters to America. However, the contention is that by dumping its exports around the world it has forced other countries to dump their own, bringing down steel prices and destroying US jobs in the process.) Should the charges be 'proven', the Act allows the President to impose unilateral measures, including a 25 per cent additional tariff, to protect 'US national interests'. In turn, that would set off a whole chain of trade disputes with Europe and NAFTA.

This will also bring front and centre the simmering tension between the US and China, potentially already at flashpoint with the US standoff with North Korea. That said, the strong and continued economic inter-dependence of both the US and China on each other – it is the world's most critical bilateral relationship - has clearly dawned on Mr Trump - he has neither imposed a 45 per cent tariff on Chinese imports, nor declared China to be a currency manipulator as he had threatened.

Regrettably, on the political side, gridlock has descended again on Washington, with a new viciousness in daily politics, the administration distracted by the Russia investigations. The divide between the Republicans and Democrats is clearer than ever.

A new 'Goldilocks' scenario? Not quite

Despite the political turmoil, from an economic standpoint, the US economy appears to be doing quite well. Inflation remains below target but well above zero, unemployment continues to fall even as employment figures keeps rising, with many of those, who left the labour force after the Global Financial Crisis (GFC) returning

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to the fold. The Federal Reserve, meanwhile, is poised to continue hiking rates, and to reduce its balance sheet. Encouragingly, too, all major banks passed a recent stress test.

That said, there are incipient signs of economic stress. Wages are stagnant, despite the labour market being so tight, and there is some amount of stress in terms of sub-prime consumer finance, and particularly so in the car-finance market. Crucially, while the overall market indices are at all-time highs, the shares of companies that were expected to do well – such as infrastructure firms, or those with large tax bills – have declined after the initial euphoria. The dollar has

given up nearly all its gains since the election, and inflation expectations have been marked down sharply.

The global challenge of swollen Central Bank balance sheets

A closer look also reveals a fair amount of similarity to the pre-GFC period. What is continuing to prop financial markets up not just in the US but the world over is that a 'tightening' cycle is yet to begin in earnest. Going by the Morgan Stanley Financial Conditions Index, central banks on the whole continues to loosen. On aggregate, the balance sheets of the world's three biggest central banks have more than doubled since 2009, to over USD 12 trillion. However,

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China has started tightening, and there are signs that the Fed, the ECB and the Bank of England will soon shift course, with Canada possibly getting ready to lead the way. As a result, bond yields have moved up in the last few weeks after a period of unearthly calm, though it is perhaps too early to call this a decisive turn in the bond-market cycle. (Some of the recent increases merely reverse declines earlier this year.) With the Chinese economy losing momentum, commodity markets slowing, and global debt much higher than it was a decade ago, a change in the rate cycle would, however, pose significant credit risks, especially in the emerging markets, in the months and years ahead.

THE CLOUDS START TO LIFT OFF EUROPE

At the other end of the developed world, Europe's mood has improved dramatically in the last few months. Emmanuel Macron won a huge mandate in France and Angela Merkel is now likely to stay on as Germany's Chancellor after elections later this year. The idea of anti-EU parties seizing control across Europe has firmly receded. Italy, though still economically vulnerable, has started to sort out its banking problems and Spain has emerged as the rich world's fastest-growing economy. (It still has residual banking issues and its youth unemployment is a staggering 40 per cent but this is declining.)

Germany's problem of success: Massive productivity

Looking ahead, though, there are two key issues that Europe will need to contend with. First, Greece's debt problem is far from resolved, and will, despite Germany's and the IMF's unwillingness to admit it yet, should be forgiven at some point. Second and more critically, Germany faces a serious 'problem of success'. Today, the Eurozone is running a current account surplus, but for Germany, it stands at over 8 per cent of GDP. (In contrast, Japan's is under 4 per cent and China's less than 2 per cent of GDP.) This is a marked departure from the pre-GFC years, when it was Asian – primarily Chinese (over 10 per cent) and Japanese – surpluses that were regarded as the primary cause of global imbalances.

Two main factors have created this situation. At one level, there is a 'design flaw' in the Euro, wherein monetary policy gets sets for the weaker members, rather than for stronger economies like Germany. Even allowing for this, however, Germany's labour reforms of the early 2000s and its culture of 'pay restraint' have kept labour costs down, which would allow it to be competitive even under a strong exchange rate. At one level, this reconfirms Germany's continued position as a globally competitive power with the world's only leader in Ms Merkel, who carries more than a hint of global statesmanship. However, these imbalances are bound to create tensions with Mr Trump's America. Not only does Mr Trump believe this is a conspiracy to steal US jobs, but at a personal level, he regards Ms Merkel – more popular than Mr Trump everywhere abroad but in Russia and South Africa – as a rival for leadership of the free world. Her instrumental role in concluding a recent Japan-EU FTA will only rub salt on the wound. (Still, given that Germany has no currency of its own to 'manipulate', Mr Trump would find it hard to brand it a manipulator).

THE UK AND BREXIT: NOTHING IS A GIVEN

The medium-term outlook for the UK hinges critically on how it manages the Brexit process. And so far, the prognosis is not good. The financial-market impact has been modest till now, with share prices holding up, bond yields in check, and the Pound gaining back some lost ground. At the same time, a weaker sterling has pushed inflation up and living standards, including among the upper classes, have taken a hit. What makes the situation so tricky is that when they voted to leave the EU Britons were made to believe that they could have their cake and eat it, too. Staying on in the customs union while getting back some control over immigration seemed, at the time, to be a viable option. For its part, the government, believing that it would win the referendum, had made no contingency plans for defeat. Having lost her majority in a recent election, Theresa May finds her position weakened, making it unlikely that she will be able either to win a favourable deal from the EU or follow through on her 'hard Brexit' stance. There is now a small chance of Brexit getting 'rolled back' to some degree, with a growing momentum in all the major political parties for a 'soft' exit that sees the UK staying inside the single market and customs union. However, this would imply either a very long transitional period, or a scenario where the UK continues to bear all the costs of membership but without any real decision-making power. This would satisfy almost no-one, but if the government decides to abandon Brexit altogether, it would leave the 52 per cent of 'Out' voters feeling cheated, and would certainly deepen the fault-lines that already exist.

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CHINA: MOVING THE NEEDLE

The potential return of the SOE...

In the east of the world, China slows in the context of the nation's massive aspirations for itself and the reality of a politically critical year for President Xi Jinping (the Chinese Communist Party's main plenum to elect its new leadership is in November this year). From an economic standpoint, China's gigantic public debt (now over 300 per cent of GDP) and the future course of its economic reforms are two critical areas of watch. With two-thirds of the overall corporate debt held by SOEs, China's public sector is facing a reckoning but interestingly, and contrary to the situation just a few years ago when President Xi assumed power, it is not entirely clear that the answer will lie in more reforms. The President appears recently to have backtracked in this respect, (though no one knows whether this is a temporary shift as he builds up his power base ahead of Plenum later this year). Evidence suggests that even if the market is given a more 'decisive role', the state will remain dominant, with liberalisation taking place only gradually. Illustratively, after falling for years relative to the more dynamic private sector, the SOEs' share in the economy has stopped shrinking. In fact, backed by a state investment fund, these companies are starting to invest huge amounts, buying up assets in new areas, including technology, where they were not present before. There is also a conscious effort to export Chinese over-capacity, including in infrastructure. In many ways, OBOR is ideally illustrative, although its ramifications are also geo-strategic.

...and China's huge external push

China is bidding for global leadership – including in areas like climate change, where it is seeking to fill a vacuum Mr Trump seems determined to leave. Its efforts to at least begin to level off its massive carbon emissions are illustrative. China is also setting up a parallel framework of institutions like the AIIB, the Shangri-La Dialogue, and the Shanghai Cooperation Organisation. Even as China has confined this effort to increasing the clout it enjoys in its own 'back yard' thus far, it is bound to provoke a backlash from America at some point, also as it starts to pre-empt America's military primacy in the Western Pacific.

It is unclear how far it will go, but for now, China's actions – creating 'facts on the ground' – are right out of the 'playbook' it has followed since at least the 1962 Sino-Indian war. It continues to take an incremental approach, pushing outwards as it gets stronger and more capable for regain the respect that it thinks it deserves. The way of achieving that has always been to build facts on the ground/water, whatever the legality of it. The most striking example is in the South China Sea, whose seven biggest land features have all been built by China, and which, sooner or later, will become military bases. Not even a strong American-led world order can stop that, and it will certainly not happen now.

China is also hardening its stance in certain respects. For years, it appeared to be happy with the gains it had made against India in 1962, but more recently, it seems to have changed its mind and now 'wants' all of Arunachal Pradesh, perhaps because of Tawang, the Dalai Lama's role there or for some other reason. With respect to the situation in Doklam, the Indian government is right to stand up to China and for its part, China would probably like to avoid an intensified stand-off. Its deeper interests do lie in a cordial and cooperative relationship with India with its large and fast-growing economy. It was probably unhappy about India's refusal to join in or cheer the Belt and Road Initiative, but to the extent that its business with India is profitable, it will continue. China will certainly not hurt itself to teach India a lesson: it will find other ways to make its point.

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GEOPOLITICS: A DANGEROUS SENSE OF DRIFT

America's continuing pullback from the global order it has nurtured since the early 1990s has created a power vacuum that is only deepening under President Trump. Clearly, whilst it is difficult to say whether the old, US-led world order is now entirely 'over', or instead, merely in remission under Donald Trump, the emergent scenario at least in the near term is a potentially more anarchic arrangement - one where there is no single power 'in charge', and where responses to different situations become more and more ad-hoc. (For all its faults, the US was the only agent of stability, or at least predictability, for the better part of almost three decades.) Russia – and its President, Vladimir Putin – idoks a good example of how the global order is changing. Inheriting a country in decline, Mr Putin has, through a series of shrewd moves, managed to make Russia central to issues – like Syria, and natural-gas supplies – of vital important to the West. By playing a debatable part in American politics, he has also cast a seed of doubt over the entire Trump Presidency, bolstering his own image in the process.

The impact of a changed America is most visible in the Middle East – a region that is now passing through a particularly dangerous period. With Mosul liberated only days ago and the Islamic State seemingly on the run, the hope is that Iraq's government will treat the situation delicately. But it was precisely this sort of power void and the ensuing marginalisation of the Sunnis that gave rise to IS in the first place. Moreover, while the Caliphate may have been destroyed, IS itself has no shortage of supporters. There is a very real chance, then, that in the absence of a coherent strategy, the whole cycle of marginalisation and extremism will re-start. All of this makes the unfolding situation with Qatar more alarming. (During his recent visit to Saudi Arabia, Mr Trump found himself persuaded by the Saudis that Qatar – a country that happens to host 11,000 American troops – is a hotbed of terrorism). As far as the Saudis are concerned, though, it is Qatar's growing closeness to Iran (Saudi Arabia's chief rival in the region and in a proxy regional Sunni-Shia war), and its sponsoring of the Al-Jazeera television network, that were its real 'crimes'. What resulted was a risky embargo, though it seems likely that the Qataris will find a way of working with America to resolve the impasse. ■

The contents of this paper are based on discussions of The India CEO Forum in New Delhi and Mumbai with Simon Long, Finance and Economics Editor, The Economist newspaper, in July 2017. The views expressed may not be those of IMA India.