Global Economy

The Great Experiment

The global economy is not growing fast enough for the comfort of policymakers in most of the major economies. We expect future years to be marked by a grand experiment when governments become more significant contributors to global growth. We believe governments and central banks will, by hook or by crook, be working much more closely together. Heavily indebted governments will need central banks to buy into the new Modern Monetary theory that allows central banks to fund government largesse through printing money. The rest of the developed world is set for its Japanification – the proverbial liquidity trap.

Table 1: IMF forecasts for Global Economic Growth

	Average 2001-2010	2018	2019E	2020E	2024E	Average 2019-2024 Projected
World	3.9	3.6	3.0	3.4	3.6	
United States	1.7	2.9	2.4	2.1	1.6	2.0
Euro Area	1.2	1.9	1.2	1.4	1.3	1.3
Japan	0.6	0.8	0.9	0.5	0.5	0.6
EM and Developing Economies	6.2	4.5	3.9	4.6	4.8	4.4
China	10.5	6.6	6.1	5.8	5.5	5.8
India	7.5	6.8	6.1	7.0	7.3	6.8

Most of the world's major economies are struggling to shake off the weak average growth rates of 2001-10 that incorporated a global financial crisis. Over the next five years, the IMF forecasts that growth rates in major economies will not be materially away from those experienced over the past ten years. However, in emerging countries, the IMF envisages a marked slowdown in growth.

We would probably take issue with the IMF's relatively rosy picture of developed market growth. But that being said, we believe that policymakers in developed countries will try to achieve growth rates that improve on those that were seen in the past ten years. However, in our view, the global economy is particularly vulnerable at this moment. The usual levers of growth are stagnating or are, at the very least, less effective than at any previous stage of the modern economy.

Population growth - Down

Global population growth is slowing. The current 10-year growth rate of 1.2% is well down on the 2.0% plus growth rates seen through the 1980s and 1990s. The current population growth rate is also highly dependent on relatively poor countries. Over the next thirty years, nine countries will be responsible for half of projected population growth, with the United States (ranking 9th) the sole developed country on the list.

Productivity growth - Down

Global productivity growth slowed to just 1.9% in 2018 compared with 2.9% between 2000-07. Even in emerging markets, productivity growth has slowed in recent times. China's productivity growth has more than halved to 4.0% compared to 8.9% between 2000-07.

Globalisation - Going into reverse

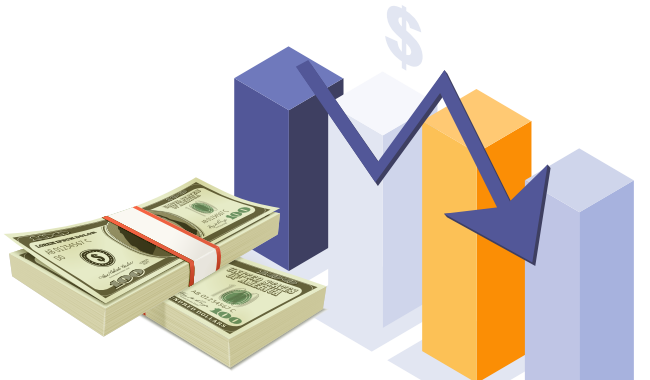
For the past twenty years, the global economy benefitted in many ways from globalisation. However, the challenges of Donald Trump's trade wars through 2018/19 have put many of these positive effects into reverse, as have an outbreaks of populism in other parts of the world. The World Economic Forum has calculated that a persistent US-China trade war would take 0.7% off global growth.

Consumer Spending

Income growth is a critical component of the ability of consumers to increase their spending. The trends remain troubling. In 2017 global real wage growth slipped to the lowest level since 2008. Hence, despite growth and rising employment, wage-earners still struggled to gain a larger share of national income. 2018 and 2019 do not appear to have been too different, with wage earners struggling to negotiate materially higher salaries. The US has seen some improvement, with real wage growth most recently at around 0.6%, the most significant increase since 2016. But even that wage growth appears to lack breadth or momentum. In Europe and Asia, salary growth remains low. The old world is in sharp contrast with the new world where wage growth has been more vibrant and where consumer spending remains a source of significant demand growth in the future.

Investment Spending

Investment spending plans were already hesitant even before the trade wars hit, with companies confused about future supply lines and customer bases. US companies, after the tax inspired splurge on capital investment in 2018, have markedly reined in their investment plans in recent quarters.



In 2017 Global Real Wage Growth Slipped To The Lowest Level Since 2008

Governments to Spend More

The structural challenges of ageing populations and highly indebted governments are likely to unleash government action on the back of a new wave of economic thinking in the global economy.

Given the lack of other drivers, an increase in government spending ends up being the default policy for driving growth in the global economy. Such spending becomes all the more likely when you consider that geopolitically, the world seems to be in a phase of populist governments. By design, populist governments try to be popular. One way for a government to be popular is to spend money. Governments can mask their expenditure increases as necessary under the headings of infrastructure spending and 'green' budgeting.

The OECD launched the Paris Collaborative on Green Budgeting in December 2017. The aim was to encourage governments to align their expenditure and revenue process with climate and environmental goals. The initiative doesn't per se encourage additional spending. However, governments can undoubtedly use the 'excuse' of trying to achieve climate and environmental goals to increase government spending. In September, for example, the German government announced a Euro 50bn spending package through to 2023 that would help the country meet their 2030 carbon reduction goals. However, the net impact on the economy is offset by a carbon dioxide emissions tax on transport and heating in buildings from 2021.

The pressure for additional government spending may also come from the need for governments to cover contingent liabilities of social security, pension and healthcare in both the public and private sectors. Public and private sector pensions liabilities are woefully underfunded. Healthcare costs are likely to balloon. In our view, governments will be forced to make good the gaps by more substantial social and healthcare spending.

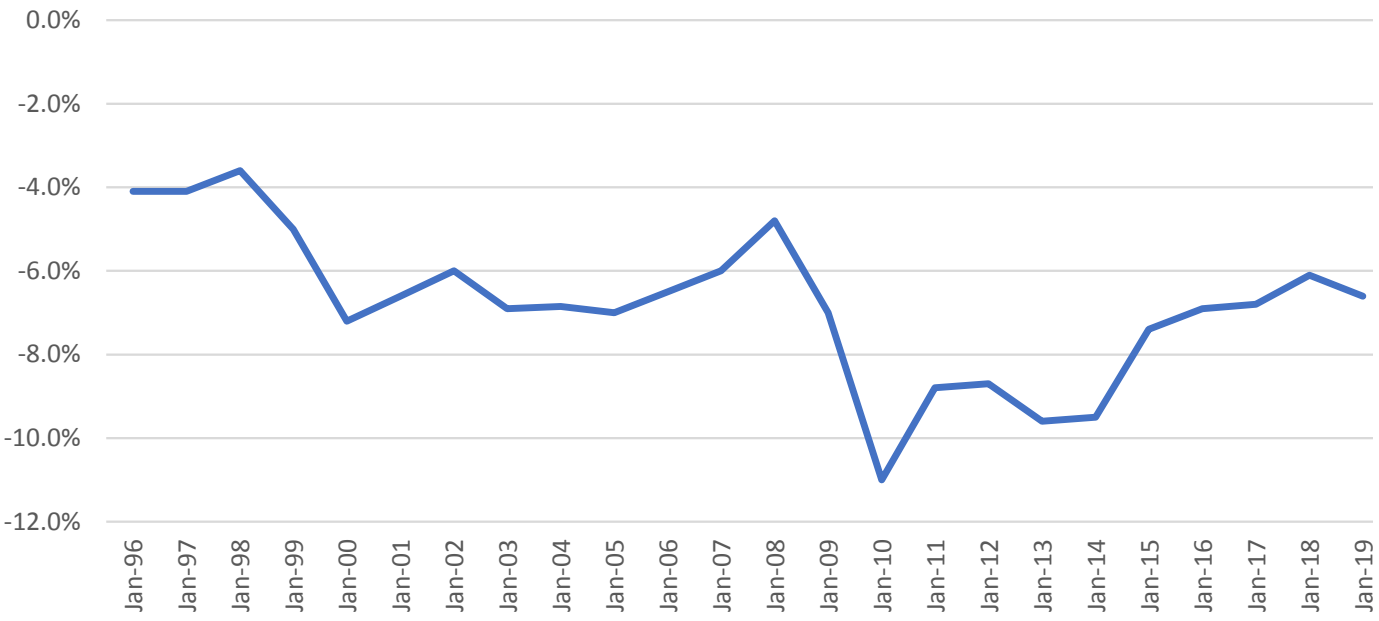
Modern Monetary Theory encourages central banks to support high spending governments.

With government debts already very high relative to GDP, one could ask how they are going to fund spending? The simple answer is that central banks will increasingly be pressured to monetise government debts through quantitative easing. This may seem shameful; however, the new Modern Monetary Theory provides an academic framework/excuse for doing just that. Put simply, the government spends money and runs a higher government deficit. This will require the government to raise funds from the market through the issue of bonds. However, in the absence of investors buying the newly issued debt, interest rates would rise, nullifying some of the positive impact of higher spending. Hence, to keep a rise in long term interest rates in check, the central banks would need to print money to buy the bonds.

We still fear that prolific government spending will at some stage end in tears. Conventional wisdom is that governments are not the best allocators of capital. Their spending does not typically have a multiplier that generates long term sustained growth. Hence spending in any one year often has to be followed by spending in another year as the benefits of the spending fall away.

Chart 1: Japan's government deficit just never goes away

Government aggregate deficit (before bond issuance) as a percentage of GDP



Source: Bloomberg

The Bottom Line

The Japanification of developed countries is underway. Higher government spending helped by a supportive central bank is a hallmark of the Japanese economy over the past two decades. As Japan experienced, such policies can mask the underlying problems for only so long, if at all. But as a marker the Bank of Japan owns 97.1% of the Japanese Government Bond market, the Federal Reserve owns 'just' 11.2% of the US bond market.

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