GnS economics

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Where from here?

- The decision of Brits to leave the European Union, the *Brexit*, was a shock to many, but its implications for global markets has not been fully understood yet.
- Global trade and earnings have peaked and strong signals tell that the US economy has already passed the peak of the current upturn. This may harm the struggling economy of Finland.
- There are limits in the ability of the central banks to stimulate the economy and we are now close to those limits, a fact, which has not yet been fully understood.
- The "stress" tests conducted by the European Banking Authority were fundamentally flawed and European banking sector continues to be the biggest threat to global financial stability.
- We forecast that the US economy will grow 1.7 percent this year while the economies of the Eurozone and Finland will grow 1.4 and 1.2 percent this year.

The decision of the Brits to leave the European Union, or *Brexit*, was an unanticipated shock to many. The idea that a nation could break off from the half-a-decade old European integration was "unimaginable". Although the details of the exit are yet to be determined, one thing is clear. European project, the EU, is facing its most difficult task. That is, to bridge the large gap between the European elite pushing for more and closer integration and the citizens of the EU who, with vast majority, object to it. The initial shock of Brexit to the markets has also calmed down, but it is an eerie calm. Brexit-vote showed the unpredictability of political decisions. This is troubling because global markets are currently driven almost purely by political ambitions.

Like we mentioned in our last forecast (Q-review 2/2016), several indicators imply that the world economy reached a peak of the current business cycle late last year, despite the fact that global industrial output is still growing but slowly (see the Appendix). Credit spreads have been increasing and global earnings have been flat since 2012. Probably the most telling signal of the onset of a downturn is the fall in the global trade, which peaked at the end 2014 and again at the end of 2015 (see the Appendix). Late 2014 also happens to be the peak of US industrial production (see the Appendix). Hanjin bankcrupty and sea transport indexes also give some indications of the state of the world trade. BRICS and also oil producers are finding ecomic conditions increasingly difficult and are struggling with growth and government budgets. Venezuela is on a brink of collapse and it's not looking rosy for Brazil. Their woes are, however, likely to remain local. The economies of BRICS are keenly dependent on what happens in the US and in Europe. This applies also to Finland.

Although the economy of the US seems to be pushing forward, some cracks have appeared on the facade of the seven year old upturn. Like mentioned above, industrial production peaked in the last quarter of 2014, In 2015, first time since 2009, corporative profits declined and lending standards tightened. On the first half of this year investment on equipment and structure as well as on residential property fell. In the second quarter of this year, even restaurant industry declined, in some parts with considerable margins. These all are signs that something is "up" with the US economy. It seems very likely that these signal for a business cycle downturn. The real problem is that if the US economy is heading to a recession, the Fed has very little useful means to revive the economy. However, because the recovery has been nascent, the seven year upturn may be a resilient one.

Despite of the possibility of a negative Brexit-effect, economic recovery in Europe has somewhat gathered steam during the summer. In Britain, the falling value of pound has actually created a boom in tourism and the economy of the Euroare has continued to grow. If Europe would return to solid growth, it would partly offset the effect of slowing US economy on the world economy. Still, if the US economy starts to contract, Europe and world economy will follow.

There are increasing number of risks in the global economy. The geo-political tensions in Europe, Middle-East and in Asia are on rise. EU leaders seem unwilling to come to grasp with the real message of the Brexit vote stating that EU cannot proceed as before. There is a great risk and based on recent comments it's likely that EU leaders will use the aftermath of the Brexit vote to drive deeper integration against the hardening public opinion. "Never let crisis go to waste" has been the guiding principle in the EU integration process in the recent years. As UK has been the major force against integration movement, many can't hide their eagerness to get rid of. Federalisation at all costs policy would lead to further rises in populistic movements and would threaten the survival of the EU. We currently estimate that a likelihood of a large political crisis in the EU during the next 12 months is 40 percent. This probability rises from three factors:

1. Euro is still creating unemployment and income disparaties in the Europe
2. There is a rather large discrepancy between the message and actions of the EU leaders what comes to the desire of citizens and the need for further integration.
3. Ongoing refugee crisis threatens the political fabric of Europe by rising the support of nationalistic parties.

All three factors generate volumes of discontent young males with lots of spare time and bleak future prospects, which is a recipe for disaster.

Whereas Russia and China with aggressive military stance could have wider implications. China is flexing it's muscles and is making South China Sea it's own one Reef at time. As expected, the neighboring countries are not happy and rhetorics is getting more and more hostile. Add in the recent North Korea's nuclear tests and Philippines changing allegiances. It's increasingly looking "when" question than "if" there will be an escalation. Russia is stuck in Ukraine and Syria. Neither conflict is showing any signs of resolution, mostly due lack of face saving resolution (for USA and Russia) and lack of political will to do so. Russia is also quickly burning through its crisis funds. Syria and it's neighboring countries have become one, big, messy theather of war. ISIS being the only common nominator that has joined it's enemies. If it's successfully removed, there are still dozens of warring factions left.

Despite of the geo-political tensions, the biggest threat to global economy lies in the heart of our current financial order. As we have pointed out several times, we are currently not living in an actual market economy. The *unorthodox* means taken by the central banks (CB:s) have transformed financial markets to a strange and scary hybrid of direct government manipulation and speculation. Risks have been socialized behind practically invisible wall of political decision making in the central banks and governments. This creates four types of problems for the markets:

1. It is very difficult to determine in what stage of the business cycle major economies currently are.
2. The newly created "free" money that central banks use to buy different assets has created bubbles.
3. These bubbles will eventually burst, but anticipation on their location and time of demise has been made extremely difficult by the fact that they are eminently dictated by political decisions.

4. There are limits on the omnipotency of central banks, which are not being yet fully acknowledged by the markets.

Markets act like an enourmous computer, processing massive amounts of data and yielding conclusions based on that data. These are reflected in the prices of assets and goods, which can be used to draw information on the health of the economy. However, if prices become obscured in some way, this information becomes distorted. This is what central banks have done. Using their (seemingly) unlimited powers to create money, central banks have taken a position as an active participant in global markets. Because markets now include a buyer that does not need to care about any budgetary limits (i.e., on the fundamental economic law of scarcity), there are no actual market prices either. Reach of the policies of central banks is wide, as prices become distorted also in those markets, where CB:s do not actively participate, because liquidity in other markets spills into them looking for a decent return. Therefore, many financial assets are not priced freely by the markets but prices are influenced by governments via CB actions. Global financial markets are transforming into a sort of socialistic utopia. History and ongoing experiment in Venezuela makes us very wary about this development.

Because these rigged markets do not reflect the reality of the underlying economy, their prices are likely to be too high (because of the excess demand by the CB:s). This means that prices of many assets are in a *bubble*. Bubbles do eventually burst, but timing their demise is notoriously difficult. More so, as prices and the faith of bubbles are determined by the central banks in their closed-door meetings.

Markets are also likely to over-estimate the ability of central banks to do "whatever it takes" for them. Firstly, central banks do not control the public sentiments, a fact, alleviated by the Brexit-vote. Second, we know that central banks can go broke. Failure of the central bank of Zimbabwe (Reserve Bank of Zimbabwe) is a recent example. Central banks, like commercial banks, have the ability to create money out of "thin air", but the value of money is based on a social contract. If it fails, there will be hyperinflation and/or *dollarization* where some other currency takes the position of domestic currency as a mean of exchange. Major economies and their central banks may still be rather far from this, but there is no doubt that the newly created money cannot be pushed in to the markets without any reaction from the users, namely corporations and citizens. Central banks, we believe, are very aware of this.

If central banks would, for example, start the helicopter drops of money thus providing free liquidity to ordinary consumers, they would run a serious risk of undermining the social contract on the value of money. Once started, it would be politically extremely difficult to scale the helicopter drops back, as people tend to like free money. This could create a dangerous loop, where political pressure diminishes the independence of central banks and forces it to direct monetization of consumer and government debt (analogous with effects of the QE and it's different forms). This would eventually lead to the destruction of the value of the money with the aforementioned consequences. Negative interest rate poses a different kind of limit to the extent of power of central bank over the economy. If rates drop low enough, it will become profitable for the banks and consumers to start to hoard cash. This could create a liquidity squeece in the economy. More importantly it would seriously diminish the ability of the central bank to control the interest rates, as going deeper into negative would only lead to extended hoarding of cash. In principle, commercial banks need to ask permission to convert their holdings, reserves, to cash from central bank, but there are no such limits for consumers, at least yet. Banning cash would also lead to increasing use of other means of payment, including the cryptocurrencies like the Bitcoin.

To summarize, global economy is facing some serious challenges which, if interpreted correctly, should have become visible after the Brexit-vote. In the previous report (Q-review 2/2016) we raised the likelihood of a new financial crisis commencing in the following 12 months to 55 %. According to our updated estimate, the risk has remained the same. This risk arises from asset bubbles created by central banks, on the unpredictable political decisions driving those bubbles, and from the European banking sector.

European Banking Authority (EBA) conducted large scale stress tests to major and systemically important banks of Europe and found no reason for any bigger concern. We are not convinced on their findings for five reasons:

1. The adverse scenario, the annual GDP growth rate of -1.2 %, -1.3 % and 0.7 % in Europe, is a relatively mild one in historical standards.
2. Greek and Portugese banks were not included.
3. The effect of negative interest rates, currently in effect in the Eurozone and elsewhere, was not analyzed.
4. The shocks to long-term interest rates, varying from around 1.5 % in Germany to around 3 % in Italy and around 10 % in Greece, are mild to say the least. If ECB would, for example, decide to remove its support from the sovereign bond markets of any of the peripherial countries, their rates would rise considerably more than 3 %. If ECB would stop both QE and OMT (outright monetary transactions) programs altogether, rates of bonds of most European countries would multiply. This is purely a political decision, and thus a plausible adverse scenario.
5. If markets would lose faith on the ability of central banks to support the bond and other asset markets, there would be a rapid and violent bond market breakdown. This scenario may also be closer than we tend to think and was not analyzed by the EBA.

So, the tests of the EBA really tell a story of a mild business cycle recession and they do not include any real "stresses" that the banks could face in the current economic and political climate. This probably explains why European banking shares continued to fall after the release of the results of the "stress" tests, although they have recently pared some losses.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of the Eurozone, Finland, and the United States under a consensus scenario. According to our forecasts, the economy of Finland would grow 1.2 percent this year and one percent next year. The economy of the Eurozone would grow 1.4 percent this year and 0.8 percent in 2017. The economy of the US would grow 1.7 percent this year and 1.9 next year.

Table 1. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2016:1	0.29	0.51	0.21
2016:2	-0.04	0.30	0.27
2016:3 (nc)	0.54	0.31	0.71
2016:4	0.41	0.21	0.48
2016	1.2	1.4	1.7
2017	1.0	0.8	1.9

What would happen if the world economy would face another financial crisis? In table 2 we present simulations for a crisis scenario, where financial crisis hits the world economy at the first quarter of next year and continues till the end of the year. Crisis were modeled to commence from Europe.

Table 2. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland in a crisis scenario. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2016:1	0.29	0.30	0.21
2016:2	-0.04	0.27	0.27
2016:3 (nc)	0.54	0.31	0.71
2016:4	0.28	0.20	0.36
2016	1.1	1.3	1.6
2017	-5.7	-3.3	-1.6
2018	-2.2	-0.4	0.6

Simulations in table 2 show that Finland would suffer the worst with the real GDP falling cumulatively by around eight percent during 2017 and 2018. GDP would fall around four percent in the Eurozone and around on percent in the US.

Where are we now heading? Even though economies are still growing rather fast around the world, the uncertainty about the future has grown considerably. The large role of political decisions in deciding the prices of wide variety of financial assets increases the uncertainty especially in forecasting turns in the business cycle. For example, if there would be a recession in the US, what would the Fed do? Would it start the so called helicopter drops of money and/or would it push for negative interest rates? How would banks, consumers and financial markets react to this? We can hope that we will never find it out, but at the same time we need to be prepared for very high uncertainty and volatility in the financial markets and also in the real economy going forward. In any case, this is not the time for large risky bets in financial markets or business in general.

Appendix: World trade and industrial production volumes

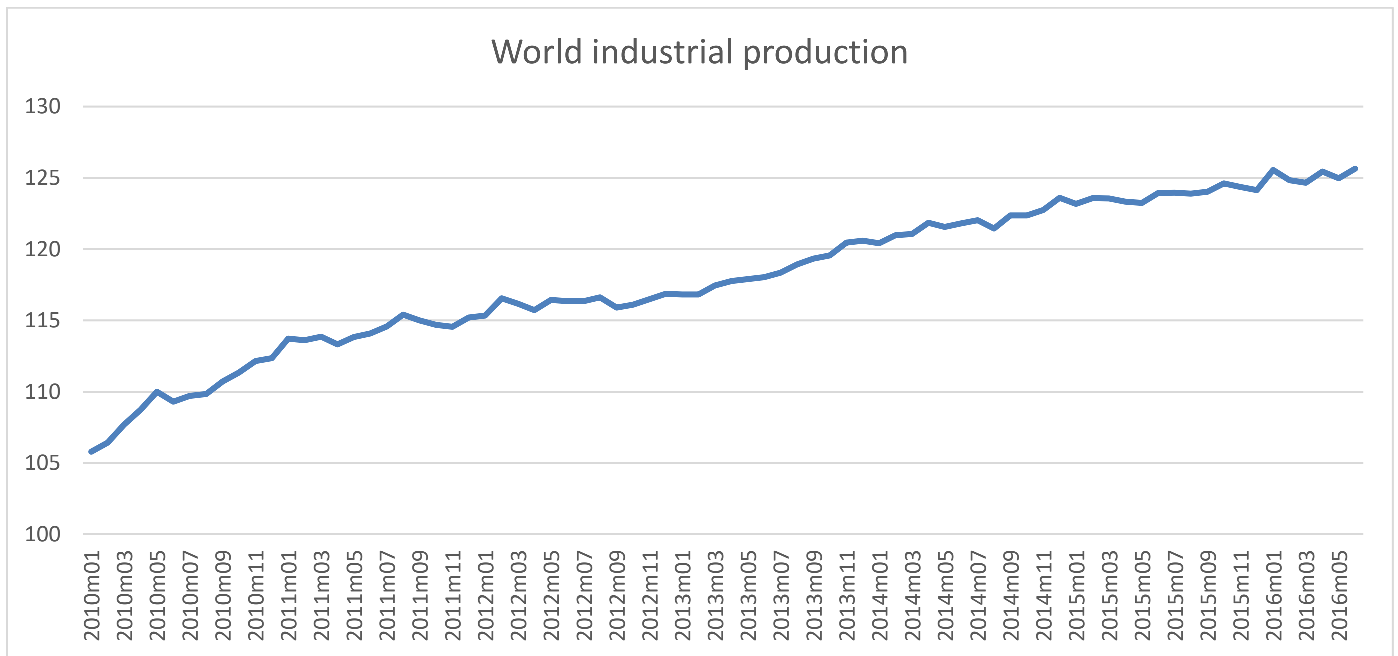

Figure 1. World industrial production excluding construction. Base year 2005 (=100). Source: CPB World Trade Monitor.

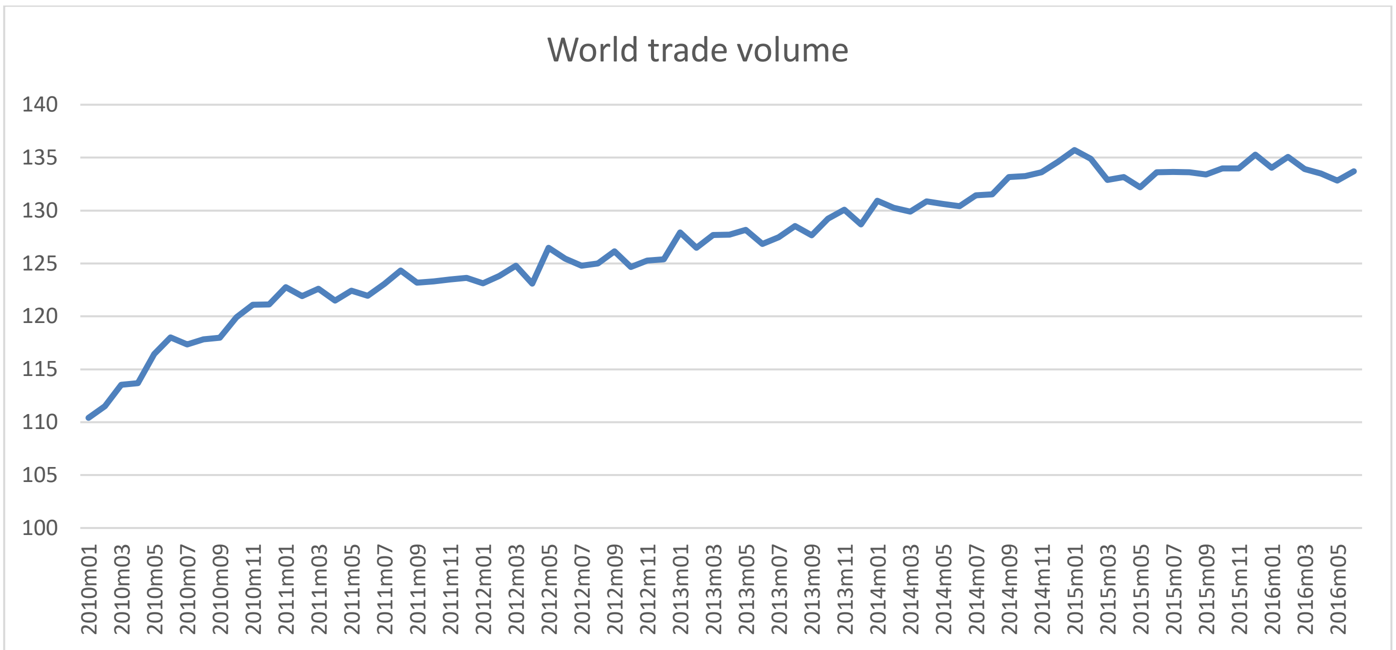

Figure 2. World volume of merchandise trade. Base year 2005 (=100). Source: CPB World Trade Monitor

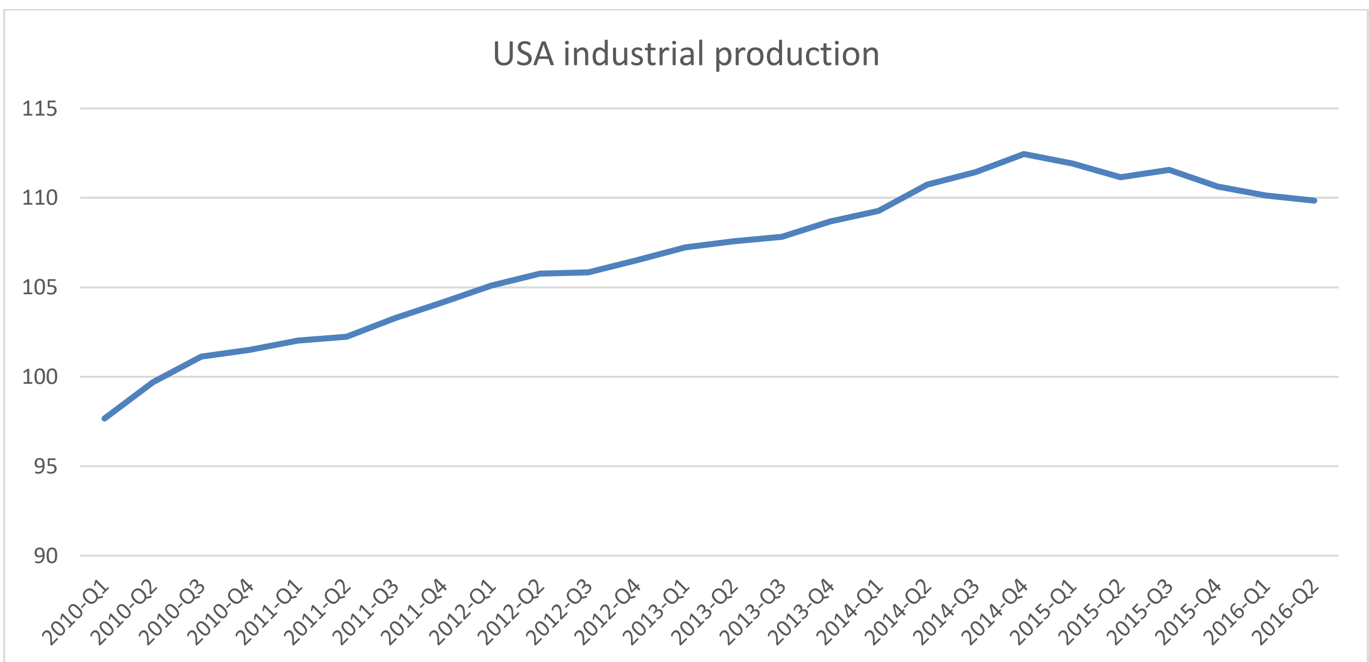

Figure 3. Industrial production in the US excluding construction. Base year 2010 Q2 (=100). Source: OECD.

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state

of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

The next Q-review will be published in December 2016.

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