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The scourge of uncertainty

- It seems very likely that the downturn in the global economy started at the end of last year.
- Even so, the growth prospects of the US and the Eurozone remain positive.
- Large amounts of sovereign debt, exhausted (traditional) monetary policy tools of central banks and political risks greatly limit the ability of nations to respond if the current downturn turns out to be more than a mild business cycle recession.
- Worst scenario is a renewed systemic crisis that may lead to a systemic crash.

Several real economic indicators show that the downturn in the global economy is on its way. The major question is how will it play out? At a glance, the downturn seems like a normal downturn in matured business cycle. However, several risks in the world economy raise the uncertainty of the growth prospects. In this report, we list the biggest five.

Probably the biggest worry comes from the balance sheets of central banks (cb). In practice, all major central banks have exhausted their *publicly approved* methods of stimulating the economy and the tools left in their arsenal are extreme. Basically, the major central banks have three options left. First, they can begin the so called *helicopter drops* of money, where liquidity, from newly created money by the cb, is added to the deposit accounts of consumers. Secondly, cb:s can directly start to *monetize* the debt of sovereign states creating means for increasing the public expenditures (this is also sometimes referred as "helicopter money" although it is not what the term originally meant). Third, and the most radical, option is to introduce large negative interest rates to banks by charging interest on their deposits in the central bank (there are also other means for achieving this). This might be followed by restrictions on cash withdrawals. Some consider them crucial for the negative interest rate plan to work. If deposits can be transferred to physical cash, large negative interest rates will lead only to bank runs and to capital outflows to countries with positive rates, not to increased demand. Other, more subtle ways of introducing negative interest rates have been proposed (see, for example, the proposition by R. Agarwal and M. Kimball), but at least for now the use of negative rates has been limited. "Helicopter money" is not without problems either. It may be hard to implement and if the money could not be sent directly to consumers' bank accounts it would be just deficit financing of the government that would easily break down the independence of the central bank.

The second major source of uncertainty is the high level of both private and public sector debt in most economies. This seriously limits the ability of governments to provide fiscal stimulus and raise the likelihood of private and public sector defaults.

The third type of uncertainty is the appearance of the unknown unknowns or the *black swans* that may, once again, lurk in the financial sector. In the US, the failure of Lehman Brothers may have limited the risk appetite of financial institutions, but in Europe and especially in China there has been no such events limiting the *moral hazard* problem in the financial sector.

Fourth source of uncertainty is the political instability. Europe is facing an extraordinary number of overlapping crises. The migration crisis is testing the uniformity of the European project and risk of another full-blown crisis in the Eurozone is building up. Although several institutions have been put into place after the financial crash of 2007-

2008 and the European debt crisis that followed, their effectiveness during an acute and major crisis untested. European banking sector is very vulnerable with a high portion of non-performing loans threating its stability. In Great Britain, support for *Brexit*, or the exit of Britain from the EU, remains high. Support for nationalistic parties all over Europe is high and in many countries it is still rising. The terrorist attacks in Europe and geopolitical ambitions in Europe and in the Middle-East can lead to unpredictable political and military developments that can have long-term effects to global markets.

Fifth source of uncertainty is the matured commodity *super-cycle*, which has pushed down the prices of several commodities, like iron, copper and oil. If the cycle turns upwards and the prices of these commodities start to increase, this will lead to renewed inflationary pressures in the global economy. In this case, the policy options for central banks would grow extremely thin. They could be forced to raise the interest rates, which could push the world economy into recession.

Not many people know, but the crash of 2007-2008 was anticipated by many recession prediction models, including the ones we are using. There were signs in the financial markets that something troubling was going on. The biggest problem in the current situation in world markets is that central banks have hidden several market signals with unconventional monetary policies. QE's of world major central banks have pushed the risks of several asset classes to far ends of the probability distributions. What this means is that if the actual price of an asset does not meet its market-based value, the true level of risk is not properly priced in. Socialization of risks of private entities with monetary or fiscal measures hides the risks behind politically motivated decision. This is probably the biggest risk threating the world economy, that is, the mispricing of risk by an unknown magnitude.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of the Eurozone, Finland, and the United States. According to the forecasts, the real GDP per capita of the US would grow around 1.9 percent this year. The economies of Finland and the Eurozone would both grow around one percent this 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
2015	0.69	1.57	1.86
2016:1 (nc)	0.22	0.34	0.41
2016:2	0.22	0.21	0.53
2016:3	0.30	0.21	0.51
2016:4	0.21	0.22	0.43
2016	1.0	1.0	1.9
2017	1.4	0.9	2.2

What all the above sums up to is a notion that we currently face a highly uncertain future with a fairly decent growth prospects. In the worst case we are heading to another systemic event, which would have the potential to turn into a systemic crash under current conditions. At this point, we will not speculate what the systemic crash would look like, but it would be likely to engulf the political and economic systems of both rich and poor countries.

However, it is our view that the threat of a systemic event continues to be somewhat subdued, but the situation can change rapidly. We estimate that the likelihood of a new major economic crisis is 45 % for the next 12 months.

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 June 2016.

Contact information

Tuomas Malinen, PhD
Chief Economist

tel: +358 40 196 3909
email: tuomas.malinen@gnseconomics.com
http://www.gnseconomics.com