GnS economics

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The age of uncertainty

- The economy of the U.S. is showing strength, but other major economies are struggling to obtain growth.
- According to our forecasts, the economy of the U.S. will grow 2.5 percent next year while the Eurozone and Finland will grow around 1 percent next year.
- China is facing increasing financial stress, which will test the ability of the government of China to reform the economy.
- The risk of a major global financial event has increased due to the lackluster global growth and high levels of high risk debt. Prolonged Russian currency crisis could trigger a financial event.

The world economy is driven by trends and uncertainty. Many countries have grown in a trend-like fashion for two centuries, whereas others have fallen behind or stagnated. While the over 200-year-old growth trend of the United States seems to be going viral again, many countries in Europe and Asia are struggling with growth slowdowns and recessions. Uncertainty of growth arises from shocks. Shocks are internal, if they are caused by the failures of domestic policies to support economy. Shocks are external, if they are a result of sudden and drastic change in global demand of different products, commodities and/or assets. In either case, economies need to adjust to return to their trend growth. Currently, world economy is suffering from both internal and external shocks.

In our first Q-review (1/2012, available only in Finnish) we predicted that the growth in China would slow down during the three years to follow. In addition, we warned that because the recovery efforts of China after the financial crisis of 2007-2008 relied almost solely on increasing funds (credit) for investments, there is a risk that majority of these will be misallocated. A recent report by Xu Ce and Wang Yuang from National Development and Reform Commission of China sets the total amount of unprofitable investments to $6.8 trillion, that is, around 73 % of the annual gross domestic product (GDP). Last month, the rating agency Standard and Poors issued a warning that some half of the local governments in China may warrant junk-level credit ratings. According to their estimates, the debt of local governments toppled $3 trillion last year. Chinese companies, on the other hand, are estimated to hold over $14 trillion, a world record, of outstanding loans. The foreign exchange reserves of China are estimated to total $3.3 trillion, a big amount, but the sheer size of bad loans tied to the unprofitable investments of firms and governments can still overwhelm them. There is also a risk that Chinese economy is heading to a middle income trap, where rapid growth slows or stagnates for years or decades. One of the key indicators of this is the fall in the total factor productivity (TFP), and productivity has fallen dramatically in China for the first time since the Cultural Revolution in the 1970's. In China, the share of men to women is increasing, capital inflows to GDP have been reduced and the share of investments to GDP is still extremely high. These are all factors that have been found to increase the probability of 'middle income trap'. If the economic growth of China would stagnate, the burden of unprofitable investments would become unbearable and China would face a profound and, possibly, a regime altering economic crisis.

However, the risk of an economic crisis remains subdued, because China has huge reserves and it

can take several policy actions, including strengthening the rule of law and easing of capital controls, to support the economy. Still, growth is likely to decrease clearly (below 6 percent) in the next few years. Effects of this kind of "hard-landing" to the global economy would be contained, because China is not the growth engine of the world, as some wrongfully claim. Its share of the world GDP is large, but its investments and goods consumption are only some 20 percent of global demand, while over half of global consumption comes from Europe, Japan and the USA. China is also running a large current account surplus, which means that China is saving and exporting a lot. If a growth slowdown causes consumption and imports to rise, it would actually help the global economy by stimulating demand.

In practice, there are two engines of global growth: the USA and Europe totaling over 40 % of global goods demand. The world economy is in trouble because one of them, Europe, fails to sustain strong growth. Just a year ago we wrote: "As the market-driven fears of an immediate breakup of the Eurozone have subsided, the prolonged recession and unemployment have turned these fears to long term issues" (p. 1, Q-review 4/2013). It seems that our "long-term" was much shorter than we expected. Crises in Ukraine and Middle-East have induced downward shifts in global growth projections. In their wake, the risk of a breakup of the Eurozone is about to be flare up again. The popularity of pro-default and euroexit is increasing in the South and yields of the sovereign bonds of Greece are on the rise. Unemployment remains high in the South and many countries in the euro area are experiencing extended growth slumps. Eurozone acts like a straitjacket holding uneven economies under the same growth regime, which is (currently) driven by Germany. What this means is that Germany sets the conditions, i.e. the level of productivity, that dictate the growth prospects of countries that operate under the fixed exchange rate. Modern Germany is highly productive and there is a minuscule change that countries in the periphery can ever reach its level. The solution for this is not to diminish productivity in the Germany (which is a preposterous idea), but to cover the losses to weaker countries. Without this, Eurozone will cause a permanent fall in the living standards in the periphery and in other countries that are unable to meet the standards of productivity set by Germany. The only other option to save the European economy is to return to sovereign currencies in the Eurozone, which would create its own set of problems.

The European central bank (ECB) is considering to take up its own quantitative easing (QE) program, where it would buy government issued debt of the Eurozone countries. However, achieving such a program would be more complicated than in the U.S. or Japan, because its legality is somewhat uncertain. The traditional targets of QE are excess reserves of banks or, more precisely, the quantity of currency in the banking system. The aim is thus to increase (or sustain) liquidity in the banking system. In the U.S., the first QE was launched to counter the diminishing liquidity caused by the fall of the "shadow banking sector". In Europe, the liquidity in the banking sector is already high due to the long-term refinancing operations (LTRO). European banks used that money to buy sovereign debt in the Eurozone. QE could be used to buy that debt, but there are no guarantees that this would lead to increase in lending. In the Eurozone, the effects of QE would thus probably be limited to those observed in the U.S.: a fall of the foreign value of the euro, an increase in the demand in high risk debt and a fall in the amount of good collateral (sovereign bonds). From these, only the first would be helpful. More demand on high risk debt and a fall of good collaterals in the banking system would just increase financial instability. More importantly, QE would be a "disguised" version of Eurobonds, because the members of the Eurozone

are liable for the capital (and losses) of the ECB through their national central banks. Thus, even if there would be no legal hurdles to QE, there may not be enough support for it in the governing council of the ECB. It is also certain that QE would not solve the productivity issues within the Eurozone. Therefore, the hope that the QE would be the "savior of the euro" is misplaced.

In spite of the massive QE-program of the central bank of Japan (BoJ), Japanese economy slipped back in to recession in the second quarter of this year. Currently, BoJ is buying the same amount of debt in the secondary markets that the government of Japan is issuing. Technically, this is just an extreme version of QE, but as BoJ is buying all the new debt, it is in practice monetizing the debt of the state of Japan. Therefore, BoJ became the first western central bank since the 1970's that started to monetize sovereign debt. As the sovereign bond market in Japan is one the biggest in the world, such a massive meddling with the market is extremely risky (see above). Moreover, the renewed problems of Japan reflect the limits of QE. Japan has a rapidly aging population and it seems to have lost some of its comparative advantage and competitiveness, because Japan has not really reformed its economy since the crash of 1991. It is not possible to fix structural issues with monetary policy. If QE has worked in the United States (the jury is still out), it has done so because it has provided liquidity and kept the exchange rate of the dollar low through the adjusting period of the real economy.[1]

Fortunately, the economy of the U.S. is gaining momentum and strengthening its role as the engine of global growth. The initial jobless claims have reached the lowest level since February of 2000 and, consumer confidence is on its highest level since August of 2007. Because the U.S. consumer is the most important actor in the global economy, high level of confidence is extremely good news. Their real disposable incomes (nominal income minus inflation) have started to rise and the fall in the oil prices helps the consumers. Even though the consumers spend more, their loans-to-GDP ratio keeps falling (it currently stand some 80 % of the GDP). Until this ratio stops diminishing, the U.S. economy will not gain its full momentum. Basically only the high leverage among high risk assets (see Q-Review 2/2014) is threatening the growth of the U.S.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of Finland, the United States and the Eurozone. According to our forecasts, real GDP of the U.S. will grow around 2.5 percent next year and 2.7 percent in 2016. Eurozone will grow around 1 percent next and 1.3 percent in 2016. Growth of the real GDP of Finland is forecasted to accelerate during the following two years and reach 2.2 percent in 2016.

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
2014:1	-0.36	0.32	-0.53
2014:2	0.39	0.07	1.12
2014:3	0.17	0.16	0.96
2014:4 (nc)	0.30	-0.17	0.78
2014	0.5	0.37	2.3
2015	1.1	0.9	2.5
2016	2.2	1.3	2.7

We listed the possible global triggers for financial crisis in June (Q-Review 2/2014). A financial crisis in Russia caused by the currency crisis could be one trigger, if it leads to contagion in BRICS –countries or in Europe.[2] The banking sector in

[1] BoJ still has one last option to jump start the economy, that is, the 'helicopter' drops of money, where it would distribute money straight to consumers. However, this has never been tried in modern economies and the unknown risks associated with such a move are likely to discourage BoJ from trying.

[2] BRICS –countries are: Brazil, Russia, India, China and South Africa.

Europe is especially vulnerable. Currently the (private and public) external debt of Russia stands at around $680 billion, but like China, Russia has rather large foreign reserves, which are estimated to total $420 billion. These can, and will, be used to stem the panic. However, reserves may not be enough to avert a crisis in a longer term, because there is not much to support the economy of Russia, which relies heavily on oil revenue. Political risks are also scaring investors leading to more capital outflows. Possibility of a credit event in Russia, unprofitable investments in China, slow growth in the euro area, and the high leverage among high risk products in the global financial system (see Q-Review 2/2014) have increased the risk of a renewed financial crisis. According to our estimate, the likelihood of a new global economic crisis is 30 % 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 2015.

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