MACRO PERSPECTIVE

Is the global economy seeking something new ?

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Since last summer, the perception of the global economic cycle has been wavering between a fairly optimistic view that reflects a return to growth and the end of the crisis, and a more worried image resulting from hurdles that interfere with or postpone the shift towards the more positive outlook.

To avoid focusing on and aggravating the more negative viewpoint by increasing uncertainty, key central banks have maintained neutral strategies. They will keep interest rates extremely low while emphasizing the impact of their use of "forward guidance" in their monetary policy to bolster the expectations of private players and influence the future.

Investors vacillate between positive and negative scenarios, which may lead to significant financial market fluctuations, especially for risky assets. However, there seems to be a tendency to invest in the assets of industrialized countries. Consequently, in these countries or areas, interest rates remain low without any indication of rising and risky assets are highly valued. As a result, stock market valuation indicators are high and returns on corporate and government bonds are low. Thus, emerging market assets have weakened. The perception of the global cycle is one in which industrialized markets, especially that of the United States, are strong and emerging markets are weak. This is reflected in transactions. This image has been enhanced by recent incertitude.

This general reticence should be explained to better understand the immediate effects on the economic cycle. The analysis reveals two explanations. On the one hand, there is a dichotomy between industrialized and emerging markets. On the other hand, there are questions as to whether or not industrialized countries can prolong growth and finally put an end to the crisis.

A cycle spearheaded by the United States

The most optimistic view of the situation has the United States at center stage. It is in this country that cyclic movements appear to be the most advanced and independent. The household debt that started the crisis fell in 2008/2009 (according to figures). By the end of 2013, the ratio of household debt to GDP was lower than that of the government and businesses. Since household debt - the source of the American crisis - has declined, American households now have more room to manoeuver. This was particularly evident in the second half of 2013, when consumer spending rose more sharply.

In other words, the shock to the American economy has been absorbed. The policies that were implemented helped ease the blow, and the country is once again enjoying growth driven by domestic demand. This independence in growth is typical of the United States, and is reassuring.

However, this does not mean that there is no longer any risk. Even though overall household debt has dropped, due in part to the decline in mortgage debt, consumer credit is once again on the rise. Consumer credit promotes spending and offsets the downward trend in income, particularly wages. This situation is worrying because the ratio of consumer credit to household income in January 2014 was at its highest since January, 1959 (according to monthly data). If income does not start to increase soon, this American growth cycle will be limited.

Still, this improvement has boosted world trade since the summer. It has also provided support for Asia, which was weakened by changes in China's economic strategy.

China

In the short term, this issue of China goes beyond the need to restore balance to their way of growth. There are serious questions regarding the current situation of the Middle Kingdom. In addition to the recent New Year effects, questions have been raised about the way in which China's current expansion will regain its strength. Monetary instruments, which recently were being observed closely, are no longer very clear. The People's Bank of China, China's central bank, announced a progressive liberalization of interest rates (by 2016) and a less restrictive monetary management policy, according to which Yuan fluctuation margins would be widened. Moreover, the already harshly capped domestic and foreign debt limits the country's ability to restart its economy.

This current Chinese fragility can be seen in the downward trend in commodity prices, and especially metals, such as copper. There is cause for concern because, even though the country is still experiencing growth of 7 to 7.5%, it seems to be having trouble managing its development. Furthermore, this situation diminishes the momentum that the Chinese economy, even recently, had contributed to global commerce and the emerging markets.

The Chinese situation is complex. Its growth is more tenuous due to domestic and foreign imbalances, while its financial regulations are undergoing profound change. Furthermore, the Chinese Prime Minister recently acknowledged that there have been corporate bankruptcies, and that this is a part of the way the Chinese economy works.

Currently, there are many possible outcomes for the months and years to come. The change in the way the Chinese authorities are exerting their control further increases the uncertainty of the future. The recent depreciation in the value of the Yuan and the widening of the currency fluctuation margin contribute to this growing incertitude. Since the value of Chinese currency is more volatile, there is less currency carry trade. This puts investors in a more uncomfortable position and causes a drop in short-term capital flows for the Chinese economy.

One may speculate that China will continue to enjoy strong growth because it can take advantage of a currently more robust global trade. One may also believe that the surplus in domestic debt will hinder the country's growth, leading to a protracted period of below-potential expansion.

Both scenarios seem plausible. The first requires strong, sustainable growth in the United States. This would reduce overcapacity in certain industries. The second scenario can be imagined given the limited global growth and stubborn financial imbalances, the multiplicity of which induces uncertainty and doubt.

The current Chinese economic situation generates concern for the emerging markets. Since the early 00s, these markets have generated strong growth. However, the slowdown in Chinese growth since 2012 has led to overall weakness evidenced by additional debt. The economic situation in some emerging markets is more fragile, leading to lower growth, a decline in commodity prices and an increase in foreign debt. All this creates a problem that is rather difficult to solve. In addition, as observed in Brazil and China, monetary authorities are ready to toughen their policies to fight inflation, even if these policies do lead to weaker growth.

Balance needs to be restored with a new geopolitical component

Otherwise stated, the global economy, which had been basking in the glow of Chinese growth since the early 00s, is shifting towards balance assured by industrialized countries, especially the United States. Therefore, given the aforementioned current situations, will the United States be able to regenerate their productivity, or will they be confined to a long period of limited growth to reduce their overall debt (the debt of the non-financial sector is stable, at approximately 250% of GDP since 2009)? This question was recently asked by Lawrence Summers, former Secretary of the Treasury during the Clinton Administration. If the United States were confined to a long period of low growth, this coupled with China's limited growth means the world would not have an economic leader. A period of global instability could not be ruled out. This would have a profound impact on the balance of power between countries.

A third, general question was asked regarding the recent geopolitical changes in Central Europe. The current Ukrainian situation has highlighted issues related to the balance of power between countries. This is another element that will affect the evolution of the global economy in the upcoming months. Will the current Crimean political situation lead to swift, firm reactions from Western countries? Will seeing Russia enter into conflict with a country largely composed of a long-standing population of European origin stir up a strong reaction from the Europeans? The impact on the energy market, and gas in particular, may be critical.

A new balance between the United States, China and the current geopolitical situation has yet to be found. There are numerous challenges and tensions. However, we can see by the way the balance is being established that Europe is not in the foreground.

Questions on the short-term outlook in industrialized countries

In addition to the global picture, there is an immediate, regional issue that is hindering the global economic recovery.

The United States

In the short term, questions remain on the situation in the United States. The extended, harsh winter negatively affected commerce in January and February. Will this effect be short-lived? Will the economy spontaneously return to its previous trajectory, or will the recovery take longer than originally imagined? The profile mentioned in the first part of this newsletter seems more likely, but there are still unanswered questions about the short-term situation. My feeling is that the American recovery is robust.

In Japan

There is also uncertainty in Japan. The inflation rate is no longer rising and a closer look at growth suggests that, by the end of 2013, domestic demand had shifted. The country had ended its deflation, but in a way that was not beneficial to its citizens. For the Japanese, the increase in wages was insufficient to offset the accelerated inflation. Japanese households that had strongly supported Shinzo Abe during the December 2012 elections became less optimistic and perceived the environment as practically having returned to pre-election December 2012 levels. Given this situation, the expected increase in VAT scheduled for 1 April contributes to uncertainty. The absence of structural reforms for offsetting the effect of this country's ageing population means that growth will not be as strong as imagined.

And...in Europe...

The European situation is also complex. Although growth is once again present in the United Kingdom, growth in the Eurozone is limited. Subsequently, the contribution of Europeans to global economic growth cannot add to the improvement seen in the United States. In other words, because of the fragile Eurozone market, the area's economy is largely based on what happens elsewhere in the world. If American growth is strong, the Europeans will benefit from this.

However, Europeans are not able to develop their domestic demand and generate more independent growth. This is the result of pre-crisis imbalances. This weak domestic demand is evidenced through a very low inflation rate and a real possibility of deflation in some countries.

There are two points to be underlined. The first is the way in which the Eurozone economy adjusts. The fact that each member state wants to remain competitive creates pressure to decrease costs and prices. The second is the absence of a reaction from the European Central Bank. This lack of reaction means that the ECB is reinforcing the value of the Euro with respect to other currencies as well as increasing deflationary pressures and competitive pressure in the Eurozone.

With a currency that is expensive, the Eurozone is aggravating its export difficulties and obliging its member states to increasingly compete among themselves. Deflation would quickly raise issues regarding the sustainability of debt, both in the private sector and the public sector. The situation within the Eurozone is still not stable enough to indicate sustainable public debt levels for many of its countries. Inflation needs to be introduced and demand in the area needs to be enhanced to stabilize public debt, or the ECB will reverse its course.

Conclusion

If nothing else, there are great differences seen in all that was presented. The fairly stable situation that existed prior to the crisis no longer prevails. This implies that it is necessary for each global region to seek greater independence in growth. Although the economy is global, each country and each region wishes to develop and expand. This is the current duality that characterizes the global economy. Products and services are global, but there is a desire for local development that will increase to address employment-related issues, especially if global growth remains limited. This would likely lead to episodes of currency devaluation in countries wishing to find a quick solution to these problems, which could, in turn, lead to destabilizing contagion effects.

The global economy is becoming multifocal. Geopolitics will become more significant due to challenges raised by energy, which is often produced by public companies. It is the public companies that will make a significant impact in the upcoming years.

Written on 17 March 2014

Natixis Asset Management
Limited liability company - Share capital €50,434,604.76
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This document is published by Natixis Asset Management's Communications Department.