World View & Risks[1]

September 2021

Principal drivers[2]

The pandemic. Vaccination is reducing death rates. But uneven rates across countries will result in uneven recoveries. And various and varying restrictions on inter-regional travel are likely to persist, in some cases for several years.

Monetary policy. Advanced-economy central banks are starting to raise rates as GDP and unemployment regain pre-pandemic levels, vaccination levels reduce the risk of further lockdowns, and policy no longer needs to be ultra-accommodative. Already, in many EMs, where inflation expectations are less 'anchored', rates are on the rise.

Fiscal policy. Mid-year estimates suggested that the G20 economies taken as a group stood to withdraw 2/3 of their exceptional 2020 support by 2022.[3] And now the remaining US fiscal stimulus looks likely to be less than earlier assumed.

Investment. Although depressed by the recession, may recover, driven by COVID-changed patterns of demand, climate change; and the digitisation. The extent, however, will be a function of all-important growth expectations.

Climate change has moved centre stage, with growing recognition that something serious is afoot. Investor activism is increasing. COP26 will doubtless produce pledges. But actions are falling far short of the needs of the 2^0C scenario.[4]

Technological change. The '4th Industrial Revolution' (IR4),[5] still in its infancy,[6] is set to drive accelerating changes in what is demanded, produced, and where. Some countries are markedly better placed than others to benefit.[7]

Structural change[8] is impelled[9] by the virus,[10] global warming, technological change, and changing supply chains. Structural policies, a major determinant of productive potential[11] and resilience to shocks,[12] will differentiate countries.

Trade is recovering[13], but disrupted supply chains and heightened tensions between China and the West, alongside 'buy national' and other protectionist policies**,** are constraints. Carbon border taxes may become contentious,[14] but the WTO continues to function, [15] and appetite for new or expanded free trade agreements is evident in all regions.

Demographic change. Now having major effects as the baby-boom generation starts to retire. The direct effects on labour supply are clear; the indirect economic effects less so,[16] but one that is clear is pressure on social expenditure.[17]

Prospects and risks

GDP growth.[18] To date, in only 16 economies out of 51 has GDP so far got back to pre-pandemic levels. But more will get there; and increasingly a key issue will be the rate at which growth re-establishes itself.

Our base case is that the world economy will slow from 5½-6% this year to 4½-5% next, with growth of around 4% in the US and the EU. China will grow faster than that for some time yet, but its growth trajectory is slowing.[19] [20]

Risks. The coronavirus poses continuing threats, including new variants.[21] Meanwhile, a tightening of aggregate demand policy before GDP growth has become self-sustaining would threaten prospects of recovery.[22] *Watch for*:

- Fiscal tightening[23] before growth has consolidated –repeating the policy mistake made two years after the GFC.
- Investment not picking up in the way needed to support demand, climate change, and the new technologies.
- Insufficient being done in many economies to reform structural policies.

Inflation. Bottleneck spikes in the aggregate price level[24] continue through 2021, subside only somewhat in 2022.[25]

Risks. No slowdown of inflation in 2022, with wages starting to accelerate and a price/wage/price spiral developing. This risk is currently greater in the US[26] and the especially the UK than in Europe or Asia. *Watch for*:

- Nominal wages accelerating to more than 2 ppts above underlying productivity growth. Monitor particularly the US Bureau of Labour Statistics Employment Cost Index[27] and the Atlanta Fed Wage Growth Tracker.[28]
- Central banks tolerating unemployment lower than that previously thought consistent with stable inflation, but getting it wrong. Inflation as measured by 'core' and 'trimmed means' morphs into inflation in the main indexes.[29]

Official interest rates. Official rates will start to edge up in G7 economies, and in some smaller 'advanced' economies (Norway and Iceland have already moved, New Zealand soon will). 25 EM CBs have raised rates, and more will.

Risks. Interest rates increasing significantly as a result of rising inflation expectations. *Watch for*:

- A rising inflation risk premium. Monitor statistical measures of 'underlying' inflation produced by the Cleveland and Dallas Feds in the US, and similar measures in other markets.[30]

Bond yields remain historically low, but may edge higher in expectation of large sales of government debt, recovery, and (further out) inflation.[31] Some yield curves may steepen only slightly, being kept down by yield curve control.[32]

Risks. Investment pressure on savings seems a long way off, but rising inflation expectations could push yields up. And there is always risk of central bank miscommunication as central banks set about tapering.

US Dollar. A dog-leg evolution seems likely: at first, the dollar perhaps edges higher, impelled by buoyant growth that attracts long-term investment; and rising US interest rates that attract short-term capital.

Longer term, however, downward pressure from the ever-burgeoning US current account deficit becomes dominant.

Risks. Dollar strength persisting for too long, leading to persistent current account imbalances between the US and other regions, especially Asia and Europe, and the greater the likelihood of a disorderly reversal.[33] This could even be provoked by policy, as in the Plaza 1985 episode,[34] and then require offsetting action as in the Louvre Accord.[35]

DM Equities continue to edge higher, but become increasingly vulnerable. A quantitative evaluation,[36] such as Shiller's Excess Cyclically Adjusted P/E ratio, does not put the risk particularly high.[37]

But evaluated on a behavioural basis,[38] notably the Minsky typology, equities appear to be at stage 5 or possibly 6 of the full 9-stage process to crisis.[39]

Risks. Increased regulation of 'big tech' companies, and pressure for wage rises in 2022 and beyond.

EMs. Prospects are constructive, particularly longer-term,[40] for some Asian economies, most obviously Taiwan and South Korea, given their 'suitedness' to some of the new technological developments.[41] But, outside East and South-East Asia, many EMs have big current account deficits, and are held back by slow vaccine roll-out.

Risks. Problems stemming from poor governance, not least an inability to adjust their structures of supply in a world that is moving to being all-electric by 2050; and a rising dollar. *Watch for*:

- Governance problems, particularly in Turkey, South Africa, Colombia, Argentina, Brazil, and Egypt.
- Growing signs of stress on corporates and banks, particularly in Latin America, the Middle East, and Africa, that have borrowed heavily in foreign currency on world capital markets.[42]

EM Equities. At a PE of around 16, only around half that of the S&P 500,[43] some stand to enjoy recovery.

Risks. Higher bond yields and a rising dollar, hammering EM corporates[44] and banks indebted in foreign currencies.

Corporate credit. While global recovery supports bank lending, a rising proportion of corporate debt is sub-investment grade or BBB.

Commodity prices.[45] Oil currently just under $80, oscillates in a $50-$60 range, with downside risks long-term.[46] Many 'below-ground' commodities continue to follow oil,[47] but some continue to benefit from changes to energy and especially electricity generation in response to climate change – e.g. lithium, nickel, cobalt, copper, 'rare earths'. 'Above-ground' commodities rise slowly in real terms, driven by climate change and rising real incomes.[48]

Risks. Further sharp increases in demand for certain (electricity-related) commodities. Weakening of coal and maybe softness of oil as fossil fuel demand fades in response to climate policies; and also (eventually) iron ore when alternative sources of supply are brought to market (or China opts for different forms of economic stimulus).

Other risks

Non-sustainability of net asset positions.[49] Past flows can cumulate to produce an unsustainable configuration of stocks. International trade flows may cumulate into stocks of assets and liabilities, whether between the US and the rest of the world (principally Europe and Asia) or within Europe (principally between the north and the south).

Financial crisis. Six countries – the US, Japan, Germany, Taiwan, Sweden, and the Netherlands – seem the most vulnerable.[50] But crises often turn up where not monitored. Shadow banks could be a candidate. And house prices could be troublesome – the rise worldwide has been more broadly-based this time than it was in the lead-up to the GFC.

Public sector debt spiralling out of control. A plausible prospect only if, or where, the rate of interest on government debt exceeds the growth in nominal GDP by a margin, for a long period, and with little prospect of turnaround.[51]

Stagflation. 2009 to 2019 saw generally weak investment, and consequent low rates of interest and slow growth of GDP and productivity. The pace of investment will do much to determine the pace of recovery.

Structural change. Bottleneck inflation stands to sort itself out; but structural challenges, not least from climate change, risk being handled poorly by countries with poor structural policies, and conversely. Our analysis ranks: the Nordic economies highly, the big OECD economies middling, and southern European countries particularly poorly.[52]

Geopolitical crisis. Destabilising geopolitical developments could include: Russia invading Ukraine, North Korea again succumbing to 'relevance deprivation syndrome'; strains intensifying between 'illiberal Europe' (Hungary and Poland) and other EU members. A key uncertainty is how forcefully the US will come to identify China as an 'enemy'[53]

Climate change. Global risk has come down a bit, given that the US has come on side, and China looks cooperative. But risks nevertheless remain high unless or until action follows. A carbon tax would be the single most effective policy.[54]■

(Multi-page supporting argumentation, evidence, and references follow below).

World View & Risks

September 2021

Supporting argumentation, evidence, and references

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[1] ***World View & Risks*** presents, **in two concise summary pages:**

- Our judgement, generally in qualitative terms, about the likely behaviour, over the coming 1 to 2 years, of the current principal drivers of the world economy and financial markets.
- The most likely key economic and market outcomes.
- The greatest current inherent risks to those outcomes.
- The most important developments to *watch for* in order to see if developments are, or are not, evolving broadly as expected. Sometimes we also specify particular variables to monitor.

Underpinning these two summary pages is **a multi-page supporting document** that presents:

- The argumentation, reasoning, and evidence for all our forecasts and risks.
- References to particularly relevant literature and sources.

We generally take as our reference ....

[2] **'Drivers'**. In complex politico/economic systems, 'everything depends on everything else': almost all developments, from the stance of fiscal and monetary policies to the behaviour of consumption and investment, from the evolution of inflation to the path of interest rates, depend on what is, and often also what has been, happening elsewhere in the system. In such an interconnected, 'general equilibrium', system there are few, if any, truly exogenous forces.

However, at any given moment, just a limited number of factors are likely to be responsible for much of the impetus behind outcomes. Hence, in *World View*, 'Drivers' are taken to be those powerful forces that at present seem most likely to play the predominant role in shaping year-ahead outcomes. The importance of individual drivers can ...

[3] **A government's fiscal balance** is a function of the level of economic activity and the level of government net expenditure.

Hence *changes* in an economy's government fiscal balance are a function of (so-called cyclical) *changes* in the level of economic activity and of (so-called 'discretionary') *changes* in government net expenditure – whether as a result of discretionary changes in tax rates or discretionary changes in expenditure.

The size of the actual (or projected) discretionary *change* in a government's net expenditure – often dubbed the change in its fiscal stance – can therefore be calculated by ....

	Fiscal balance					
	% of GDP					
	Actual				**Projected**	
	2017	**2018**	**2019**	**2020**	**2021**	**2022**
G20 Adanced economies						
Overall fiscal balance	-3.0	-3.1	-3.6	-12.7	-11.5	-5.0
Hence change in overall fiscal balance		-0.1				6.5
Cyclically-adjusted balance	-2.8	-3.1	-3.7	-9.7	-9.6	-5.0
Hence change in cyclically-adjusted balance		-0.3				4.6
Hence Change in fiscal stance						
United States						
Overall fiscal balance	-4.6	-5.4	-5.7			
Hence change in overall fiscal balance		-0.8				
Cyclically-adjusted balance	-4.3					
Hence change in cyclically-adjusted balance						
Hence Change in fiscal stance						
Euro area						
Overall fiscal balance	-0.9					
Hence change in overall fiscal balance						
Cyclically-adjusted balance	-0.7					
Hence change in cyclically-adjusted balance						
Hence Change in fiscal stance						
Source: IMF Fiscal Monitor, April 2021						
https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021						

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[The cut-off date for information is 28 September 2021]