Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

ECONOMIC UPSWING AT RISK? PROBABLY NOT

Berenberg Macro Flash

Is the economic upturn at risk? The sell-off in European equity markets is now slightly worse than the correction of September/October last year that was driven mostly by irrational deflation fears. At the time, the economic impact of the market gyrations was marginal, possibly dampening business investment slightly. Instead, consumers celebrated low oil prices by buying more cars. Do we now have to worry more about economic fundamentals than 10 months ago? Probably not, at least not yet. Barring major policy mistakes, the developed economies will likely get through the current anxiety without deep or lasting damage despite some short-term wobbles.

STARTING SITUATION

- Driven by domestic demand, the US and UK economies are expanding at a pace of 2.5% or slightly above.
- While still fragile, the eurozone has overcome the euro crisis and started to grow at an annualised pace of around 1.5%, just slightly below its trend rate.
- Low oil prices provide a major tailwind for all commodity users including virtually all developed economies, China, India and many other emerging markets.

FOUR PROBLEMS

China: In its transition from fast, dirty and industry-driven catch-up growth to less wasteful, less dirty and more market- and service-based growth, China has hit a rough patch. Once again, financial modernisation and liberalisation, while necessary and ultimately inevitable for a more rational allocation of scarce capital, has turned out to be tricky.

Emerging markets: those that had gorged on capital inflows and/or inflated prices for their commodity exports until mid-2014 face serious trouble. In many cases, the return of commodity prices to more normal levels and the prospect of Fed rate hikes to come have exposed deep-seated structural problems.

J-curve effect of oil prices: even in countries that ultimately benefit from the fall in oil prices, some short term costs can initially obscure the benefits. While oil producers slash their investment, the much more numerous oil users may step up their spending only gradually. Bond markets focus on the problems of debtors from the energy business much more than on the widely dispersed benefits of companies that benefit from cheaper energy.

Market overreaction: Ever since the disorderly collapse of Lehman Brothers triggered the worst recession in the Western world in late 2008, financial markets are hyper-nervous. Whenever a modest problem appears, markets are prone to smell a rat, with some investors inclined to sell first and ask questions later. For a while, contagion effects and negative feedback loops can reign supreme until economic fundamentals reassert themselves. The serious capital outflows out of emerging markets point to some contagion effects among these markets.

POTENTIAL POLICY RESPONSES

When things get rough, investors often look for a policy response to break negative feedback loops and restore confidence. What is the potential for such a response now?

Emerging markets can try to stem capital outflows though higher interest rates and bolster confidence through more prudent fiscal policies. Unfortunately, doing so is risky and can be self-defeating in some extreme cases. As such policies hurt domestic demand, they can initially impair economic performance and political stability which, in turn, can exacerbate the capital flight for a while. For many exposed emerging markets, the advice is simple: get serious about pro-growth structural reforms and let the currency take the short-term strain. Put differently, the exposed emerging markets cannot do much to stabilise global markets near-term.

China. Unlike the exposed emerging markets, China is huge and not very vulnerable to hot money outflows. It sits on the biggest pile of foreign exchange reserves in the world, has a strong savings rate (more than 40% of disposable income), has earned a lot of policy credibility at home and abroad and faces no inflationary pressures. As a result, China could use all levers of monetary and fiscal policy to support domestic demand, including possibly an expanded "quantitative easing" type programme to reduce the municipal debt burden.

Fiscal policy: In the wake of the post-Lehman surge in public debt, notably in the US, the UK and Japan, much of the Western world has little leeway for a fiscal stimulus. In the Eurozone where public debt has risen by much less, the political will for a fiscal stimulus is virtually zero.

Monetary policy: Inflation is low across the Western world. As a result, monetary policy can be geared towards the needs of the real economy without major constraints. If any external shock puts the upturn at severe risk, monetary policy could react.

Fortunately, the country that global markets are most concerned about, China, is the one which could most easily deliver a policy response if its leaders really wanted to. They won't do so for the sake of global equity markets. But the legitimacy of China's ruling party rests on the economic results it delivers. If the Chinese economic slowdown threatens to affect the labour market, I would expect China to resort to a more traditional monetary, fiscal or credit stimulus again for a while despite the waste which such measures often entail. Conversely, if the Chinese slowdown is not bad enough to hit the domestic labour market hard, then the world outside China should not have a reason to worry a lot.

Of course, a second potential response could come from the US Fed. We project a first 25bp rate hike for September, followed by very gradual further increases next year. That is our base case. But the Fed has left its options open. If the situation were to get rough, the Fed could delay the first hike. While there is no room for rate cuts, steering expectations about the future path of Fed rates could have an impact on yields and hence financing costs in the US somewhat akin to that of a rate cut. It might also dampen the urge to move capital out of emerging markets into developed bond markets.

All in all, the options for a policy response in the Western world are somewhat constrained. Fiscal policy could not or would not do much. Monetary policy has no room for rate cuts. But central banks could still react if that were to be required. As long as China (13% of world GDP) avoids a really hard landing, the problems of other emerging markets should not hit the Western world hard and for long. Fundamentally, the US and the European Union (with roughly 23% of world GDP each) are in better shape to cope with a modest external shock than they have been for at least the last 5 years.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7889
www.berenberg.com
holger.schmieding@berenberg.com