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Burning Bridges

Unease Amongst Allies and Trading Partners

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I just returned from my annual meeting with 27 economists, representing every continent and nearly as many countries. The meeting goes by Chatham House Rules, which means I can't quote anyone directly, but can provide my take of our collective findings.

I found myself listening to Simon and Garfunkel's "Bridge over Troubled Water" at the end of each day, yearning to repair instead of burn the bridges that connect us. We collectively embraced the benefits of free trade without properly retraining or compensating those who it hurt. Large swaths of the population, most notably in the West, were left behind. They suffered a loss and are understandably angry. A rising tide did not lift all boats. We also lamented the rise of populist leaders, the attack on legal institutions, and the corruption that tend to accompany those shifts. History is littered with examples of the destructive economic policies that such leaders implement.

This special edition of **Economic Currents** provides a download of what we learned over the last week about the global outlook. The report is divided into five parts: the first provides a brief summary of the global economic outlook; the second looks at the rise of protectionism and the threat that a full-blown trade war poses; the third takes a deep dive into "The Fourth Industrial Revolution," which includes Artificial Intelligence (AI); the fourth provides a list of fragilities in the global economy, most notably in financial markets; the fifth examines the rise of populist leaders and how they could affect the global economy.

A Second Quarter Surge

The overall economy looks like it grew at a 4.8% pace in the second quarter, more than double the 2% pace of the first quarter. A rebound in consumer spending, a rebuilding of inventories, a surge in federal spending, and a narrowing of the trade deficit all contributed to those gains. The pickup in federal spending and improvement in trade mark a major shift. The fiscal year 2018 federal budget, which included substantial increases to spending, must all be spent in the second and third quarters. A portion of the jump in exports was due to one-time stockpiling ahead of tariffs.

Prospects for the second half of the year are not as good, but still robust. Growth is forecasted to average a 2.8% pace in the third and fourth quarters. Growth for the entire year should hit 3%, making it the strongest year of the expansion. Additional tariffs are the wild card for the outlook, but not likely to show up as a drag until 2019.

The Fed Moves Forward on Rate Hikes

Inflation and employment are both moving in the right direction for the Fed, while fiscal stimulus is providing an extra boost to near-term growth. Two additional rate hikes and further reductions in the balance sheet appear to be a done deal for 2018. The near-term risk is that the economy overheats a bit on inflation. Overshooting on inflation will be tolerated to balance the long period of undershooting we have already experienced. The Fed would like to see a little more momentum in wage gains.

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I. Global Economic Summary

The global economy continues to improve in 2018, but is expected to grow at a slower pace than in 2017. Inflation is picking up. This is welcome news for much of the developed world, which struggled to reflate in the wake of the crisis. Interest rates are also expected to rise. The narrowing of the yield curve in the U.S. is seen as worrisome, but partly a consequence of the Fed’s bloated balance sheet. It should widen as the Fed moves to further reduce the size of its balance sheet.

Rising rates are less welcome news for emerging markets, where a stronger dollar is increasing the cost of servicing their dollar-denominated debt. Emerging markets are also suffering from an unwanted rise in inflation and slower economic growth. Central banks in emerging markets are often forced to raise rates to defend their currencies when the dollar appreciates.

The risk of recession in 2018 is low for most countries, with the exception of Brazil and South Africa. Recession risks rise considerably in 2019; the concern is that a full-blown trade war will pull the global economy down. Those at highest risk for a trade-induced recession in 2019 are China, Canada, Mexico, the UK and the U.S. Germany was an outlier with one member confident it would muddle through a trade war despite its dependence on exports. Others worried it would take the Eurozone down with it.

Fiscal policy is generally considered to be too loose across most economies. Public debt replaced private debt in the wake of the crisis across much of the developed world. This, coupled with the upward pressure on spending associated with the aging of the population, will make the rise in debt we have seen even less sustainable. Private investment will be crowded out by the need to spend on pensions and health care.

Japan and China stand out from the crowd in their dependence on debt to grow. Japan has made significant progress on reforms with the exception of their addiction to debt. Japan is one of the few places in the world now encouraging immigration, albeit in small numbers. The irony is that Japan was historically one of the most closed economies. The reality of an aging labor force has finally set in and overturned at least a portion of the country’s well-established bias against foreign workers. China, for its part, has started to rein in private sector debt but failed to cut subsidies to state-owned enterprises. This is compounding inefficiencies, intensifying trade tensions, and could move China toward the brink of a financial crisis.

Venezuela is in a category of its own. The government is bankrupt but Nicolas Maduro is remarkably still in power. Our contacts in Latin America argue that there are still enough wealthy Venezuelans who have their fortunes squirreled away in dollars to keep him in power; they are still feeding at what’s left of the public trough. He also has support from the military, which is key. The human catastrophe for the masses is spilling over into the rest of the region and looks to be unsustainable. Most of us have been waiting for an uprising in Venezuela for the last three years and remain amazed at the staying power of Maduro. The bet is that he will eventually be overthrown, given the pain the population is enduring.

There are also concerns that monetary policy may be too easy, but those concerns are not as acute as they are for fiscal policy. The Federal Reserve and the European Central Bank (ECB) were ranked the best among central banks because of their perceived credibility and independence from political pressure. (Let’s hope the Fed can maintain that status.) Japan and Turkey’s central Banks were considered the worst.

The most underappreciated downside risks were:

- The rise in public debt and related shortfall in financing of pensions; and
- The rise of populism and the damaging economic policies that tend to accompany extremism.

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The most underappreciated upside risks were:

- The widespread reductions in poverty that we have seen across the developing world over the last two decades;
- Rapid technological advances, which have the potential to lift living standards if used to bridge the skills gap; and
- The return of synchronous world growth.

II. Full-Blown Trade War

The current situation is unprecedented; trade wars are typically accidental, not deliberate. The administration's stated goal is that it will force other countries to capitulate by levying tariffs. The results have been mixed, with most countries escalating with a tit-for-tat retaliation in tariffs. The exceptions are Germany and, more recently, China. Germany offered to forgo its vehicle tariffs in order to avert a tariff on their own vehicles but the rest of the EU is unlikely to agree. China has held back on announcing additional retaliation on the $200B in tariffs proposed by the administration in July.

That does not mean that China will not retaliate in less conventional ways. The government can hold up critical permits and close down access to key plants with "strategic road repairs." More ominous is China's military control of the South China Sea, which could disrupt supply chains. Roughly one third of trade traverses those waters; the costs of bypassing those disruptions are prohibitive.

There was also substantial debate about how trade wars affect economies. The intangibles of bridges burned and escalating uncertainty were seen to be as important as actual tariffs in their toll on growth. Fed Chairman Powell **acknowledged** that some firms are delaying investment decisions in the U.S. because of uncertainties surrounding tariffs. Europe has seen a more severe reaction in confidence and investment to tariff threats.

The UK and its Brexit vote provide a cautionary tale. Two years after the vote growth has slowed; inflation has accelerated; and consumer and corporate confidence have tanked. This is all despite the fact that the EU and the UK have yet to negotiate the terms of their divorce.

That said, there was little doubt that a full-blown trade war would trigger recessions across much of the world in 2019. Global growth could slow to a crawl or even go negative. China was the largest wildcard, as many fear that they are already slowing much more rapidly than they are reporting. The collateral damage of that slowdown could trigger other unwanted effects.

Many overlook that trade pacts are as much about diplomacy as economics, which means any erosion in trade flows will also have spillover effects to geopolitics. China is moving particularly aggressively to fill the void left by the U.S. in Asia, a trend that deeply disturbs its closest neighbors and Japan. This is at the same time that U.S. multi-nationals are becoming targets of foreign governments. The tariffs levied on Harley-Davidson, which prompted them to move abroad, come to mind.

The risks of a trade war in our own backyard are uncomfortably high. Mexico is now more optimistic than Canada about the prospects for NAFTA. This is despite the election of a much more leftist, anti-American government in Mexico. The largest threat to the global economy is the proposed tariffs on vehicles and parts. That would exacerbate the losses associated with an end to NAFTA, which was written with the interests of the auto industry in mind. (I actually worked on getting it passed in 1995.)

III. The Fourth Industrial Revolution

The Fourth Industrial Revolution is occurring at the nexus of machine learning and (accessible) big data. It is in some ways an extension of the tech revolution of the 1960s-90s, but has no precedent in the breadth and depth at which it could impact the economy and society more broadly.

The problem is that gains surrounding AI, much like the productivity growth that it promises, moves in fits and starts. Long upswings in innovation are followed by a drought of breakthroughs, which make timing its full potential to impact the economy difficult. This is nothing to say of the capital needed to leverage AI in an individual firm setting.

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The largest gains in AI have been occurring in the largest high tech firms—Facebook, Apple, Amazon, Netflix, and Google—who have almost unlimited access to capital and the available talent pool, at least for the moment. Many firms are adopting the commercial applications provided by those companies for marketing purposes. Few firms have the knowhow to harvest AI in their core businesses.

The financial crisis further set us back in adopting new technologies and boosting productivity growth because of the blow it initially dealt to financial markets; the commercial paper market collapsed while existing lines of credit were diminished. Later in the cycle, an extended period of exceedingly low rates allowed many firms to use financial engineering to boost stock market performance instead of investment. The result was an unusually large number of firms struggling with slower productivity and wage growth.

As for the macroeconomic effects of AI, we know it has the ability to replace more middle-income jobs that require some analytical skills. It is extremely good at monitoring work and streamlining best practices. It is less accomplished at executing what many would consider simple tasks, like having a robot pick up a sippy cup. We are even further from realizing the singularity or the full integration of machine and man. There are some things the human brain is just better at accomplishing than a robot, which I find to be reassuring.

The landscape of firms able to reap the benefits of AI and the productivity growth it promises remains uneven. Firms who are thoughtful and methodical about how they apply and scale existing technologies will win; those who spend without a full integration plan will lose. The service sector could also benefit along with the manufacturing sector, but the way in which AI is used will matter.

IV. Market Fragilities

One of the largest global problems we face is a surge in public debt, which was used to replace defaults in private sector debt in the wake of the crisis. Worse yet, few countries have enacted reforms to ensure those debts are paid while others—the U.S.—have exacerbated their debt problems by enacting unfunded tax cuts and spending increases. Add the rise in debt needed to care for and provide pensions to aging populations, and we eventually hit a wall on our ability to service our collective debts.

China, the most egregious borrower, is slowing. That will make its debt even harder to service. Italy, which has to rely more on external financing, recently suffered a rise in interest rates as markets reacted to the populists brought to power in their elections. The bet on Japan—another one of the world's most indebted countries—is that they will eventually print money or inflate their way out of their current debt problems.

Emerging markets are suffering from the appreciation of the dollar and threats of a trade war. Efforts to counter dollar appreciation with rate hikes of their own ups the ante on a larger financial crisis across emerging markets and broader financial market contagion.

The private sector debt carried on nonfinancial balance sheets is also at a new record. No one is quite sure how fast those firms will default once interest rate increases move from benign to biting.

Banks in the U.S. are in better shape than they were prior to the crisis, although there are a lot of worries about what is happening in FinTech and cryptocurrencies. Much of that lending is riskier than lending by traditional banks and is occurring outside of the purview of regulators. A similar phenomena, with deep tentacles into the banking system, helped seed the subprime crisis.

Banks in the Eurozone are much more fragile. There are some efforts to integrate capital markets and lessen the region's reliance on bank lending, which accounts for more than 60% of all lending in the Eurozone versus about 20% in the U.S. Of course, nonbank lending in the EU would involve the same hazards as in the U.S. Proposals for further financial integration are not welcome by electorates that are now trying to reassert their independence from laws handed down by Brussels.

German and Italian banks are in a precarious state. A good portion of the German bank problem can be linked to the low (negative) interest rate regime in the Eurozone. Italy's problems are more deep-seated and tied to their actual portfolios. They lend to a disproportionate share of smaller and middle-market firms that are more cyclically sensitive to downturns. This is in addition to the sovereign debt they were forced to buy when they had to pick up the slack left by other market participants.

The only consensus is that much of the developed world will not have much leeway to stimulate via fiscal or monetary policy when the need arises. Short-term interest rates remain too close to zero to cut much, while ballooning public debt will limit our ability to stimulate via fiscal stimulus. The market volatility we have seen return in 2018 will likely intensify and be more global in scope.

V. The Rise of Populism

There are at least two distinct reasons for the recent rise in populism across countries and support for leaders that upend political establishments:

1 A loss in living standards by a large part of the population; and

2 Rapid cultural change.

The labor share of income in advanced economies has been on a downward trend since the 1970s. Technological change is widely considered the largest factor in that shift. Next up is the shift in the power owners of capital now yield over workers, which is embodied in everything from labor market to tax reforms. The "elites" are now able to extract more rents than in the past from workers. Globalization ranks lowest on the list of factors, but is the easiest for politicians to blame.

On the cultural front, we have seen major advances across a broad specturm of countries in rights for women, minorites and, more recently, the LGBTQ community. The pace of change in legal rights for the LGBTQ community has been particular rapid in recent years. All of these changes can be percieved as a threat to people who hold more traditional values.

Older workers and retirees have experienced the most actual and percieved losses, which is important because they vote. In response, they have gravitated toward strongmen who promise to derail the current political establishment and turn back the hands of time. Their targets include: globalization, immigration, the press, and existing government instutions, including the judicial system. The leaders of both Poland and Hugary have attempted to replace judges associated previous adminstrations. The leader of Turkey has actually jailed reporters and people he feared were critics of his regime.

Corruption tends to rise as those types of leaders reward their political allies and seek to maximize their own fortunes. Recent examples include the Brazil and South Africa, where previous leaders are either in jail or being charged on criminal grounds.

The good news is that corruption and weaker growth is also what usually ousts autocratic leaders from power. The bad news is that it takes time to oust corrupt leaders and undo the damage they have done to government institutions and civil society. South Africa cannot stimulate, despite a change in leadership, until it eradicates the corruption that infected institutions at all levels of its government.

Bottom Line

The global economy has finally emerged from the financial crisis and, by most measures, is doing fairly well. However, this isn't my first rodeo. I have learned to be cautious when others are complacent. The undercurrents we face can quickly turn into troubled waters. The only time to really hedge against a downturn is when the economy is still humming. That means now.

Economic forecast — August 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP[1]	2.3	3.0	2.4	2.9	2.0	4.8	2.7	2.9	2.3	2.1	1.6	1.4
Personal consumption	2.8	2.4	2.5	4.0	0.9	2.7	2.4	2.5	2.5	2.6	2.3	2.3
Business fixed investment	4.7	6.7	4.3	6.8	10.4	3.7	5.8	5.9	4.3	3.6	2.5	2.1
Residential investment	1.8	1.2	1.7	12.8	-1.1	0.9	0.9	-0.1	1.7	3.0	3.1	2.3
Inventory investment	15.2	47.1	77.1	15.6	13.9	36.0	61.9	76.5	81.2	81.1	76.5	69.6
Net exports	-621.8	-635.3	-733.6	-653.9	-656.8	-594.0	-632.6	-657.6	-689.3	-720.3	-749.1	-775.7
Exports	3.4	5.0	5.3	7.0	3.6	10.4	0.2	6.5	5.1	5.5	5.6	6.4
Imports	4.0	4.4	7.5	14.1	3.2	-0.9	5.6	8.7	8.4	8.5	8.2	8.4
Government expenditures	0.1	2.0	2.3	3.0	1.3	2.5	3.0	3.5	2.7	1.6	1.2	0.7
Federal	0.2	3.5	4.1	3.2	1.7	4.8	6.8	7.3	4.5	2.2	1.1	0.0
State and local	0.1	1.1	1.2	2.9	1.0	1.1	0.7	1.1	1.6	1.1	1.2	1.1
Final sales	2.4	2.8	2.2	3.4	2.0	4.3	2.1	2.5	2.2	2.1	1.7	1.6
Inflation												
GDP deflator	1.8	2.2	2.7	2.3	2.2	2.1	3.0	2.5	2.7	2.7	2.6	2.8
CPI[4]	2.1	2.6	2.1	3.3	3.5	1.7	2.9	2.1	1.2	2.5	2.2	2.7
Core CPI[4]	1.8	2.2	2.4	2.2	3.0	1.8	2.4	2.4	2.4	2.5	2.4	2.5
Special indicators												
Corporate profits[2]	2.7	13.4	2.7	2.7	6.8	13.5	11.8	13.4	12.5	6.1	3.7	2.7
Disposable personal income	1.2	2.2	3.0	1.2	3.6	1.9	1.7	3.6	4.4	2.6	2.5	2.1
Housing starts (mil.)	1.2	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.4	1.4
Civilian unemployment rate	4.4	3.8	3.5	4.1	4.1	3.8	3.7	3.5	3.4	3.4	3.5	3.6
Total nonfarm payrolls (thous.)[3]	2176.7	2483.6	1262.9	556.3	632.3	589.3	654.4	607.6	469.3	318.4	291.2	184.0
Vehicle sales												
Automobile sales (mil.)	6.3	5.5	5.3	6.3	5.6	5.5	5.4	5.4	5.3	5.3	5.3	5.2
Domestic	4.5	4.0	3.8	4.6	4.1	3.9	3.9	3.9	3.8	3.8	3.8	3.7
Imports	1.7	1.5	1.5	1.7	1.5	1.6	1.5	1.5	1.5	1.5	1.5	1.5
Lt. trucks (mil.)	10.9	11.8	11.3	11.5	11.5	12.0	11.9	11.7	11.7	11.4	11.1	10.8
Domestic	9.0	9.5	9.1	9.4	9.3	9.6	9.5	9.4	9.4	9.2	9.0	8.8
Imports	1.9	2.3	2.2	2.1	2.2	2.4	2.4	2.3	2.3	2.2	2.1	2.0
Combined auto/Lt.truck	17.1	17.3	16.5	17.8	17.1	17.5	17.3	17.1	17.0	16.7	16.4	16.0
Heavy truck sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4
Total vehicles (mil.)	17.5	17.7	16.9	18.2	17.6	18.0	17.8	17.6	17.5	17.1	16.8	16.4
Interest rate/yields												
Federal funds[4]	1.0	1.8	2.8	1.2	1.5	1.7	1.9	2.3	2.4	2.7	3.0	3.1
10-year treasury note[4]	2.3	3.0	3.3	2.4	2.8	2.9	3.0	3.2	3.2	3.3	3.4	3.4
Corporate bond BAA[4]	4.4	4.8	5.2	4.3	4.5	4.8	4.9	5.1	5.1	5.2	5.3	5.3
Exchange rates												
Euro/Dollar[4]	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.1	1.2	1.2	1.2	1.2
Dollar/Yen[4]	112.1	109.1	106.5	112.9	108.3	109.1	109.8	109.1	108.0	106.8	106.0	105.1

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.
4. 2018:2 figures are actual.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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