Global Economy

The emperor's new clothes

Expansión (Spain)

Julián Cubero

I'm sure that you all know the story of the emperor who was told by a group of con artists that they would dress him in a suit that was invisible to stupid people. The trick took a long time to be revealed because the emperor, like many of his subjects, was reluctant to admit his own shortcomings despite the evidence. Financial markets can resemble the emperor in the fable walking around naked, with absolute confidence in the power of central banks to manage the global economy.

Global GDP growth stands slightly above 3% in mid-2019, close to the 3.5% average seen over the last 40 years, but lower than just a few quarters ago — due the slowdown in the manufacturing industry and international trade. According to BBVA Research estimates, the volume of world trade in goods grew by 1.2% annually in the first half of 2019, three times less than in 2018 and six times less than in 2017, the last year before the USA launched an offensive against free trade that has led to a six-fold increase to the average tariff on imports from China. This is what economists classify as a (negative) supply shock, since it affects the production process, costs and value chains; and has harmful impacts on income, as well as consumer, investor and business expectations and aggregate demand.

Such a shock could have increased inflation or inflation forecasts, at least in the USA, which uses tariff increases more intensively in order to deter imports. However, analyst surveys, or the Fed's own forecasts, show that without significant changes to the growth prospects, inflation outlooks were revised minimally, but they were revised downward, moving away from the target of price stability. There are elements that more than offset, at least for now, evidence of increased costs of goods imports. The uncertainty regarding the probability of a recession in the USA, which is not negligible after looking at the available evidence and historical regularities, weighs on inflation expectations (as well as on the interest rates discounted by the markets). However, structural elements can also have an impact, such as demographic slowdown (as regards the growth rate and composition by age), slowdowns in productivity, which is growing less despite the age of digital disruption in which we are immersed, which in this case becomes a positive supply shock.

The emperor, the global markets and their confidence in the power of central banks, is naked; it is difficult to get out of the current situation without supply policies

In this situation, which is common in Europe with inflation expectations sliding away from the central bank's target, it seems risky to leave the task of sustaining growth exclusively in the hands of central banks, taking advantage of their margin to implement reflationary measures. It may not be enough, as we have seen unfold in Japan, even with all the differences between Europe and the USA that they wish to highlight. Furthermore, it does not seem sufficient with fiscal policies that, given the increase in public deficits, both aggregated and corrected by the effects of the cycle and debt interest payment, should mean boosted growth, both in the USA and in Europe.

As the OECD notes in its latest "Going for Growth" report, a review of how to promote productivity and employment growth, the time to implement reforms is now, while economies are still growing. But the pace does not seem to be accelerating. Quite the opposite. Following the urgency of the global crisis of 10 years ago, the pace of reform has slowed over the last five years and shows no signs of recovery in any of the economies, both developed and emerging, analyzed by the OECD. Despite evidence of their positive impact in the medium term, a lack of confidence in governments or parliaments without a strong majority, do not help reforms. Let us begin by insisting that the emperor is naked and that he must put some clothes on urgently. We will join the choir, for example, of the Fed or the ECB.

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ENQUIRIES TO:
BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 30 25
bbvaresearch@bbva.com www.bbvaresearch.com