

Outsights on Economic Uncertainties

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Outsights is a London-based consultancy helping clients to anticipate, interpret and act on external forces to achieve real change within their organisations. A leading practitioner of scenario planning, Outsights has worked in both the public and private sectors and with non-governmental organisations.

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Outsights on

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Introduction

The abolition of the business cycle has long been a dream of policymakers and congenial optimists. In the late 1990s this dream was revised for a while, with a growing belief that (a) growth was assured, at around 2-3% a year and as part of a long boom and (b) underpinned by the knowledge that policymakers are now highly skilled at running the global economy, no longer ignorant enough to make the mistakes that had been made in the 1930s with protectionist trade policies and the like.

Despite the spectacular crash of the stock markets the world economy hasn't fallen out of bed, the US economy has had a pretty standard recession and even the markets are picking up. So where are we heading? Picking through the key economic debates, six key areas of economic uncertainties stand out as we enter 2004. This paper seeks to identify the strands of each debate.

- 1. Do we face deflation or inflation?**
- 2. Are the twin US deficits sustainable?**
- 3. Where's the money? Capital flows and the dollar**
- 4. Is there a property bubble waiting to burst in the Anglo-Saxon style economies?**
- 5. How do we deal with the pensions challenge?**
- 6. Is Europe becoming ungovernable?**

....and concludes with a note on two longer term areas of focus, trade and the BRICs.

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Deflation or inflation

“The market and policymakers see the need to stop inflation from coming back as the new priority”

This is a quite straightforward “polarity” of uncertainty. *At one extreme* economies enter a period of deflation, at its worst meaning falling prices and eventually falling output. It is dangerous because most of us are not used to deflation so it can result in nasty surprises for which we are not ready. It is dangerous because when interest rates get to zero policymakers can find they can do little to stimulate the economy - in other words, they are in uncharted territory and the rudder has gone.

At the other extreme, after years of easy money, inflation comes back in a big way, driving up interest rates, bankrupting all those companies, individuals and governments who have become used to low interest debt, and plunging us back into the boom and bust cycles of the 1970s and 1980s.

If you produce manufactured goods you are experiencing deflation already, with prices being driven down by the cheaper goods competition from China and other emerging market manufacturers. If you live in Japan you have been used to deflation and the recessionary impact, for a decade. But the major economies have not spiralled into a Japanese cycle and indeed at least their banking systems are pretty well capitalised and not full of bad debts like that of Japan (or of China too for that matter). The US Federal Reserve can be congratulated (and probably congratulates itself) that it took rapid action, cut interest rates and didn't delay in the way that Japan did.

However straw polls of economists now are likely to show inflation coming back as the more conventional worry, that the risk of deflation is likely to be averted, with only a minority still seeing the deflation threat as serious. And with interest rates beginning to edge upwards again both the market and policymakers see the need to stop inflation from coming back as being the new priority.

The twin US deficits

“The big question economists cannot agree upon is whether or not these deficits are sustainable”

George W. Bush has presided over a rapid return to fiscal profligacy and the US current account deficit is growing larger every day. The dollar already has been falling as a result. The big question economists cannot agree upon is whether or not these twin deficits are sustainable. *Those who say they are not* stress the great need that the US now has to attract capital from the rest of the world: and we have all seen current account deficits all causing eventual problems for all economies at some point. We are back to the “twin deficits” (government and balance of payments on current account) that derailed the dollar in the late 1980s. Though in the 1990s the US also twinned a current account deficit with a private sector deficit this latter combination was reckoned to be more satisfactory (reflecting private sector investment) and was combined with a public sector surplus.

However, *the counterview* is that these present US deficits represent the fact that the US is the great driver of world growth, that it is the US which is demonstrating the great productivity improvements that justify the massive inflows of capital. No other part of the world is showing such dynamism. If Europe could get its act together then perhaps the flows would shift. In other words, this is all part of a correct and justifiable portfolio shift by world capital. We depend on the US importing our goods. China may be accumulating large dollar assets, but this is in effect financing the boom in China’s exports. However relying on a shift in growth patterns between the US and the rest of the world doesn’t look as if it could be enough to fix the US deficit: Mark Cliffe of ING suggests that for the US alone to slow down enough to get the deficit down just to 2% of GDP would require an 11% fall in GDP (an intolerable slump) or alternatively a 36% rise in growth elsewhere (a tall order) or a 34% fall in the trade weighted value of the dollar (a big shift). A combination of all three may be on the cards.

The connecting thread: follow the money

“Everyone wants growth but someone has to finance it”

“It is through money and currencies that the impacts are transferred from economy to economy”

There is a clear connecting thread between the themes of inflation and deficits: where is the money coming from in the future, what will be its real value and therefore the value of currencies? Some of these interconnections are brought out neatly by Martin Wolf of the FT, with the dollar future as his focus, building on the debate at an annual private meeting of economists that I attend in Vienna each December. America wants capital. China and others want to export. Everyone wants growth but someone has to finance it. Consumers all like cheap goods (their view of deflation) but cheap prices relate to over- or under-valued currencies (the Chinese renminbi or the dollar, respectively) which may not last for ever. Martin suggests four possible outcomes for the US deficit conundrum:

1. The dollar could decline further to say Euro1.60 and Yen 80 (citing recent suggestions by Mark Cliffe of ING), with resultant deflation impacts on these appreciating currency areas: i.e. deflation for the EU (Euro zone at least) and even more deflation for Japan;
2. European and Asian countries could help support the dollar, grow their economies faster through monetary expansion, providing an alternative stimulus to the world economy, but unlikely to be enough (with the result the world economy overheats and the dollar collapses later);
3. China and the Asian economies allow their currencies to appreciate (currently their strong currencies makes their goods cheap, boosting their exports and punishing the US and other fast importers);
4. A unilateral action by the US to control imports, perhaps like the Nixon *shokku* of 1971 when the US imposed a unilateral import surcharge and cancelled the convertibility of the dollar to gold at the promised rate (a form of debt default, through devaluation) – to be lifted when everyone agrees to revalue their currencies.

Option 3 is the US's favoured route, Option 4 would be a classic unilateral US action when it is not getting its way, Option 1 will be disruptive for the major industrial economies and Option 2 is not very sustainable.

The upshot is that things can't carry on as they are: significant change is to come. The flows of money impact on currencies, on inflation and deflation rates and long term savings and pensions schemes will drive long term flows of capital. And it is through the money and currencies that the impacts are transferred from economy to economy.

A property bubble?

“An obvious vulnerability in the UK and US recoveries”

The economic recoveries, in the Anglo-Saxon style economies at least, have been supported by the strong growth in house prices, boosting personal/consumer wealth when equity-based stores of wealth have been falling. But many are worried that the continued strength in residential property prices is looking uncomfortably like a bubble.

Bubbles get officially baptised as such when they have burst. Until then they are portfolio adjustments and if necessary reflecting important paradigm shifts. Or more prosaically, bubbles are periods of high valuation when people are buying for capital gain (i.e. prices are high and they hope they will go higher). Quite simply, the rise in property prices in the UK and to a lesser extent in the US (and Australia) is pushing the ratio of house prices to personal incomes to record levels, last seen before the previous bubble bursts. (The latest bubbles tend to be confined to residential property rather than commercial).

These levels however can be sustained while interest rates are low, so that the ratio of interest payments to income are not serious. What economists can't agree on is at what levels of interest rates personal debtors would get into trouble. Obviously as rates rise, some will. As mortgage debt has been a cheap way to finance consumption (much cheaper than credit card debt) rising rates will curb spending and slow economies. Thus a property bust would turn a main support of growth into a constraint.

Whilst the UK bubble looks more precarious than the US market, what does seem to be absent is any good strong case to justify why this particular asset should be rising (i.e. why the portfolio shift?) and frankly until a burst happens, there is no undeniable case to say why the rise can't be justified. Those who study these things show how bubbles do build when economies are strong, as ownership rises with strong confidence, as incomes rise, as more people hold jobs. The arguments start to get a bit circular. And they get just as circular when things burst.

“Property prices, bubble or not?” is a clear uncertainty and an obvious vulnerability in the UK and US recoveries to date.

The pensions challenge

“The real change has to come on the liability side as it is from the liability side (more pensioners) that the new challenge derives”

Ageing rich countries have a current and long term problem. The current difficulties relate to the collapse of the stock market bubble, the pension holidays taken in the boom, and the underperformance of portfolios - all set against a realisation of the size of the obligation in providing defined benefits (e.g. final salary schemes). Pensions are a classic area where regulation and tax incentives and pressures can have serious unintended consequences: in the 1990s tax systems encouraged pension holidays (not just being companies taking advantage of rising markets) and in the bust there is the risk that regulatory pressure for full provision may worsen the pressure.

The solutions for companies lie on the asset and liability side: *on the asset side*, rebuild pension funds; and *on the liability side*, end final salary schemes and push the savings obligation onto the employee. These two actions may help companies but don't change the long term dilemmas for society unless they result in overall greater savings for the long term. This may raise awareness and savings as employees are having to take more responsibility, but they still have to find a way to save safely for the long term. That is a tall order for individuals.

For ageing societies as a whole there are again two choices: *on the asset side*, devise ways of developing long term savings that will be available to pay pensions and *on the liability side*, try to reduce the size of the obligation. The long term savings issue, however funded (and it doesn't make much difference if a state system like the UK, for example, is fully funded) involves an intergenerational transfer: future earnings will have to pay future pensions. Future pensions will have to come from future yields on bonds, equities, property or from future taxes. Economists are trying to think of assets that will do better than equities, whose popularity as being the best asset in the long run has taken a hit of late (in the short run?) but inventiveness on the asset side won't fix the problem.

The real change has to come on the liability side as it is from the liability side (more prospective pensioners) that the new challenge derives: how far will rich societies come to terms with the need to totally revise people's expectations about the promise of some future cash flow that will look after them from a certain (or uncertain) date in the future. Long term denial of the real change in the underlying fundamentals (ageing) can prove disastrous. Postponing retirement dates can help but unlikely to be adequate unless radically changed. The whole concept of stopping work by choice at some date may need revision. The idea of a pension as being an insurance against living longer than one is able to work may need to return, keeping it down to a short number of years. At the same time the idea of linking pension savings with long term health care schemes may have to get further than it has so far.

Governing Europe

“The budget crisis is another strong leading indicator that the future disputes in Europe will be more and more over spending and fiscal policy”

Europe hit two governance crises in November and December: the “refusal” of France and Germany to stick to the Stability and Growth Pact (the deal to keep budgets below 3% of GDP) and the failure to agree on the new Constitution. Like all European crises they raise the question of whether the European integration process is showing serious and fatal cracks...or whether this crisis will be eventually weathered like all previous crises.

The budget crisis is another strong leading indicator that the future disputes in Europe, especially within the euro-zone, will be more and more over spending and fiscal policy. The fiction that European union doesn't mean fiscal union and convergence is revealed once again. The good news, nonetheless, has been that policymakers have ignored the artificial straightjacket of the Pact: almost every economist will celebrate the fact that fiscal austerity is not being pursued whatever the consequences. The worry is that if Germany and France can get away with it, how will budget/fiscal discipline be enforced when economists believe someone is being far too slack, risking inflation? Real politick suggests that the answer will be a result of the power structure: i.e. just because Germany and France can get away with something, smaller countries won't be so lucky. Which is where the battle over voting rights comes in: as the Union gets larger it is getting clearer that the future Europe is likely to stay a union of governments keen to retain their own sovereign powers, with big countries wishing to ensure they retain the benefit of size and small countries wishing to retain the excess power accorded to sovereign entities however small. Hence the unresolved clash over voting rights.

It also suggests that multi-tier Europe is the most realistic future: that opt-outs will become more frequent, that the more members the greater variety of approaches to the Union, or in Euro-parlance, “variable geometry”. Longer term, the way Europe develops will make a huge difference to the model to be followed when accession by Russia gets onto the agenda. The Russian economy may be small today, but like the old British Empire, the Russian empire punches above its economic weight.

Trade and the BRICs

“The two big uncertainties relating to the current trade round are those of fairness and protectionism”

“Look out for the BRICs....your pension may depend on them”

Finally, we should mention two other factors that will influence economics in both short and long term: trade and the large emerging markets.

The failure at Cancun was one of a series of failures in the current trade round (the 9th such trade round since the second world war). All trade rounds have had their points of tension (the WTO, devised in the Uruguay Round, nearly didn't make it). The two big uncertainties relating to the current trade round are those of fairness in the world trading system (where fairness between rich and poor countries is the main point at issue) and protectionism. The world trading system isn't fair and what is new is a growing consciousness that its unfairness is unsustainable, that subsidising rich country agriculture and then having to aid poor economies, for example, is both unfair and pretty stupid economics. The world trade system also isn't that free, but for over 50 years free trade has been the ideal. Protectionism has, ever since the beggar-my-neighbour disasters of the 1930s, been seen to be the enemy. But of late rich countries have been setting a poor example and if we do descend into a world of trade protection, with both the EU and the US quite capable of such an approach, then the unthinkable would become thinkable again. Thinking ahead just a quarter of a century (a few more trade rounds if this doesn't prove to be the last one, a few more business cycles) it would be wonderful if the centenary of the 1929 crash was a new era of free and fair trade (and a sound investment market). It would be more than a pity if it turned out to be a rerun of the 1930s.

This trade debate is very relevant in the context of the new emerging power of the emerging markets. In the past year or so the world's economists (and many others) are paying more attention to the sheer size and potential long run power of the large emerging markets. Four have been christened the “BRICs”, notable Brazil, Russia, India and China. A Goldman Sachs paper by Dominic Wilson and Roopa Purushothaman has suggested these four alone could together be half the size of the G6 (US, Japan, UK, Germany, France and Italy) by 2025 and larger than the G6 in 40 years time. Now much can go wrong of course for these countries but size is beginning to matter. It is the size of the flow of cheap goods coming from these and other emerging markets which is troubling rich ageing economies. And such countries are likely to be more important on the global political stage. For investors they will not want to miss the opportunities that these economies offer: so look out for the BRICs....your pension may depend on them.

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insights from the outside

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