Annual Economic Report 2019: Editorial

The year in review

It was perhaps too good to be true. In 2017, it was unusual to see a synchronised global expansion at rates above estimates of potential so late in the upswing and, moreover, to project it to continue well into the future. Some deceleration was on the cards. But when it came, in the second half of 2018, it appeared much stronger than expected. It caused tremors in financial markets and anxiety about a possible impending recession. Faced with the prospect of a weaker economy and with an abrupt tightening of financial conditions, the major central banks put the very gradual monetary policy tightening on pause. The recession has not materialised. Still, as always, the question everyone is asking is: "What next?"

Looking back, decomposing global output into its components – a purely accounting exercise – provides some insight into the factors behind the slowdown. In the second half of the year, global trade came to a halt, manufacturing decelerated and investment lost pace. By comparison, services and consumption held up relatively well, propping up the expansion.

But while it is straightforward to identify the accounting categories behind the slowdown, it is much harder to identify the underlying forces at work. That said, it is possible to point to a number of cross-currents.

Multiple forces exerted downward pressure on growth. First, quite prominently, political factors left their imprint on the economy and weighed on the minds of economic decision-makers. Besides some country-specific political factors, trade tensions loomed large. Doubtless, related uncertainty and concerns inhibited activity, especially investment. Second, China slowed as the authorities sought to bring about the much needed deleveraging of the economy to make growth more sustainable. Given China's heft and tight interconnections in the global economy, the slowdown quickly spread around the world. Global value chains acted as a powerful transmission channel. Third, financial conditions tightened somewhat in parts of the world as US monetary policy continued to normalise until late 2018 and the US dollar strengthened. While holding up remarkably well by past standards, emerging market economies (EMEs) came under some pressure, given the heavy reliance of their firms on dollar financing. Finally, in several advanced small open economies and a number of EMEs, financial cycles – best captured by the joint behaviour of credit and property prices – appeared to shift from expansion to contraction, weighing down on expenditures.

The slowdown would have been sharper without resilience elsewhere that served to buffer weakness from manufacturing and trade. One supporting factor was the continued strength of labour markets, accompanied by a modest pickup in wage growth. Employment expanded further, pushing unemployment rates to multi-decade lows in several economies. Other than in economies where the housing market began to falter, consumption was thus a relative strength. Another factor, at work in some of the large economies at the heart of the Great Financial Crisis (GFC), was the financial cycle upswings, most notably in the United States. In those cases, the post-crisis household deleveraging provided room for the corporate sector to re-leverage, to the point of creating some vulnerabilities (see below).

At the time of writing (late May), financial markets have become jittery again, especially owing to an intensification of trade tensions. Nevertheless, consensus forecasts, while noting downside risks, continue to see a global economy in a soft patch. The forces supporting the expansion are expected to prevail.

What, then, about the outlook and risks beyond the next few quarters? In order to assess how the global economy might evolve over that horizon, it is useful to identify the more systematic forces at work behind the business fluctuations we have been seeing more generally – forces which were in evidence in the period under review. These deeper forces can influence business fluctuations either directly or indirectly, by affecting policy. After considering these forces, we evaluate possible risks to the outlook before turning to policy considerations.

The longer-term forces at work

Four such key forces have arguably been at work, providing the backdrop for recent developments.

The first force is the inflation process, which has been pivotal in determining the monetary policy stance. Inflation has remained very subdued despite many economies operating close to, or above, standard estimates of economic potential and with record low unemployment. Much ink has been spilt over this surprising development. Some, like us, have for a long time stressed globalisation and technological advances. In addition, demographics-induced changes in the labour force may have led to underestimates of economic slack. What is clear is that labour has been struggling to regain the bargaining power lost over the past decades. And while wages have finally been responding more clearly to tighter labour markets, firms have shown little sign of reacquiring pricing power. For instance, even as wages have been rising faster than productivity in many countries, prices have not kept up.

Less appreciated is the fact that ever since inflation has been low and stable, starting some three decades ago, the nature of business fluctuations has changed. Until then, it was sharply rising inflation, and the subsequent monetary policy tightening, that ushered in downturns. Since then, financial expansions and contractions have played a more prominent role.

Which brings us to the second force: finance and its role in the economy. The GFC was just the most spectacular instance of this role. This justifies the greater attention policymakers now pay to financial markets, credit developments and real estate prices. Moreover, in a financially highly integrated world, capital flows across borders hold sway. And smaller economies are generally at the receiving end; hence the high sensitivity of EMEs to global financial conditions.

The third force is productivity growth, or rather the lack thereof. Growth accelerations of the type experienced in 2017 could only lead to sustained growth at a new, higher pace if a level shift in productivity growth takes place. Productivity growth has been on a marked downward trend in advanced economies as a group for a long time. And the slowdown became more marked following the GFC. The impaired financial system is likely to have played a role in impeding the allocation of resources to their best use. And it is surely no coincidence that trade has lagged behind output and that investment has been correspondingly weak. Whatever the actual reasons, lower productivity growth is constraining sustainable expansions, at least in the advanced economies, where the frontier for the rest of the world is set.

The fourth force, of more recent vintage, is the political and social backlash against the open international economic order that has grabbed all the news

headlines recently. The trade and political tensions in the period under review are just the most glaring manifestation. By no means all of the recent slowdown can be ascribed to trade conflicts and protectionism – the slowdown in trade and productivity predates the retreat into protectionism in the last two years. However, the sound and the fury of trade conflict and the associated uncertainty have imparted a downward twist to the slowdown. Nor should we take the longer-term challenges lightly. From a historical perspective, it is not unusual to see such surges of sentiment in the wake of major economic shockwaves: the Great Depression marked the end of the previous globalisation era. It is too early to tell how this surge will evolve; but it will clearly be a force to contend with in the years to come.

From the short-term to the medium-term outlook

If the four listed above are the deeper forces at work, then they should hold clues to charting the future. Of these forces, political factors, in particular those related to trade policies, will continue to cast a long if unpredictable shadow over the world economy. In addition, the factors underlying productivity growth are slow-moving, providing the backdrop to business fluctuations. Therefore, perhaps the forces that can be explored in more depth are finance and the inflation process. And as one would expect of this institution, we focus on assessing possible financial vulnerabilities and how they might play out under different conditions – our comparative advantage.

It has been a long journey since the GFC for the global financial system. Yet the imprint of the crisis is still discernible in how financial developments will be influencing the evolution of the economy in the years ahead.

In many of the countries less affected by the GFC, financial expansions have reached an inflexion point. As a group, these economies account for around one third of global GDP. Private sector credit growth has slowed relative to GDP and, in a number of cases, property prices have started to fall. After the strong credit expansion, these countries are now saddled with historically high household debt levels, and some with high corporate debt as well. A specific feature of EMEs has been the rapid growth of FX debt, mostly in the corporate sector – although it has not quite reached previous peaks in relation to GDP. Size-wise, the only systemic economy in this group is China, where the authorities are engaged in the delicate balance of deleveraging the economy without slowing down growth, adapting policy as circumstances, including the trade tensions, evolve. If past experience is anything to go by, the contraction phase of the financial cycles in this group of countries is likely to continue, acting as a drag on growth.

Countries that were at the heart of the GFC, such as the United States and a number of European economies, have tended to see marked differences at the sectoral level. Household debt in relation to incomes has declined after a long phase of balance sheet repair and is on a stronger footing. By contrast, the corporate sector in some countries has shown clear signs of overheating. In these, the overall financial expansion will remain a source of strength for the economy for now.

Perhaps the most visible symptom of potential overheating is the remarkable growth of the leveraged loan market, which has reached some $3 trillion. While firms in the United States – and, to a lesser extent, the United Kingdom – have accounted for the bulk of the issuance, holdings are spread out more widely. For quite some time, credit standards have been deteriorating, supported by buoyant demand as investors have searched for yield. Structured products such as

collateralised loan obligations (CLOs) have surged – reminiscent of the steep rise in collateralised debt obligations that amplified the subprime crisis. Should the leveraged loan sector deteriorate, the economic impact would depend on the potential amplification mechanisms. These can run right through the banking system, linked to unstable wholesale funding, and other parts of the financial system that hold leveraged loans and CLOs, via price adjustments. The probability of these factors taking effect is best assessed against the backdrop of the longer-term deterioration in credit quality of the corporate sector in some advanced economies, visible in the concentration of the outstanding stock of securities in the triple-B segment – just above non-investment grade ("junk" status).

The condition of the banking sector is, in some respects, paradoxical. Country differences aside, it is much better capitalised thanks to the post-crisis regulatory reforms. However, asset growth among the major banks has slowed sharply since the GFC. Book equity growth has been similarly lacklustre. The slow growth of book equity reflects, in part, banks' chronically low profitability, particularly in many euro area countries. This matters. Profits are the first line of defence against losses and, as by far the primary source of capital, they are the foundation for banks' ability to lend and support the economy. Some of the reasons for low profitability can be traced to legacies from the GFC and the macroeconomic environment, most notably persistently and unusually low nominal interest rates. Others reflect more structural factors, especially excess capacity in a number of key banking systems.

Looking ahead, a looming competitive threat to banks comes in the form of the big techs. In this Annual Economic Report, we devote a special chapter to these huge companies that have started making inroads in financial services, leveraging the vast customer bases they have secured through their activities (eg social media, e-commerce and search engines). Payments, retail lending, asset management and even insurance have already seen deep incursions by these behemoths, whose market capitalisation far exceeds that of banks. Drawing on their unique combination of vast amounts of data, the power of networks and their diversified activities (their "DNA"), these companies have the potential to make further thrusts into financial services and bring about large efficiency gains. They represent a wake-up call for banks, which need to raise their game in order to compete effectively. But at the same time, the presence of big techs is giving rise to major policy issues (see below).

The overall landscape is one of a global economy that has been unable to jettison its debt-dependent growth model. Indeed, aggregate debt (public plus private) in relation to GDP, while it plateaued in the past year, is much higher than pre-crisis. At the same time, interest rates – nominal and real – remain historically low, even as economies hover around estimates of potential. And financial conditions in advanced economies, notably in the largest among them, remain accommodative from a longer-term perspective. As a result, should the global economy slow down at some point, it is hard not to imagine that the debt burden would increase further.

Against this backdrop, the evolution of inflation plays a key role. Should inflation start to rise significantly at some point, it would induce central banks to tighten more. This could cause tensions in financial markets and put heavily indebted borrowers – private and public – under pressure. Should inflation remain subdued and below central banks' objectives, despite their forceful attempts to push it up, current economic conditions could continue. But this would also extend risk-taking, increasing vulnerabilities.

Policymakers can successfully negotiate this terrain. But as the pause in the monetary policy normalisation process indicates, the narrow path we described last year has proved to be a winding one.

Policy considerations

A number of policy implications flow from this diagnosis. For clearer skies to appear, the policy mix needs to be rebalanced. Higher sustainable growth can only be achieved by reducing the reliance on debt and reinvigorating productive strength. In the process, this would relieve some of the burden monetary policy has been bearing since the GFC and avoid the expectation that this policy can be the engine for sustainable growth. Its more appropriate role is that of a backstop, given that its main focus is delivering price stability while supporting financial stability.

Indeed, since the GFC, monetary policy has found itself in a complex position. After fighting the fires of the crisis, it took over – successfully – much of the burden of supporting the recovery. But given the persistence of economic weakness and, even later on, an inflation rate stubbornly below objectives, interest rates have been kept unusually low for unusually long, and central bank balance sheets have ballooned. As a result, the room for policy manoeuvre has narrowed considerably. Moreover, the very low rates, which prevail even as economies are hovering around potential, have contributed, in part, to some of the financial vulnerabilities we now see.

As we discuss in more detail in the body of the Report, this points to the possibility of some delicate intertemporal trade-offs. Depending on circumstances, it is possible that actions that yield clear benefits in the near term may risk generating costs in the longer term. One such example is the relationship between low interest rates and short-term economic activity, on the one hand, and risk-taking and debt accumulation over the longer run, on the other. Another is the high sensitivity of financial markets to policy tightening once they have grown dependent on prolonged monetary policy accommodation. In turn, both of these factors can potentially reduce the future room for manoeuvre and complicate normalisation. Central banks are fully aware of these delicate and complex trade-offs. Central banks and other authorities have implemented policies to reduce the possibility of adverse future outcomes. Notably, they have adopted far-reaching financial sector reforms. So far, adverse outcomes have been avoided, but this does not give licence for complacency, including with regard to monetary policy.

EME central banks have been contending for some time with a complex environment, which is why we devote a special chapter to the evolution of monetary policy frameworks in the emerging world. The specific challenge in this instance results from the high sensitivity of these economies to global financial conditions: waves of capital flows and exchange rate pressures can put a strain on these countries' balance sheets. As a result, much as when a number of advanced small open economies pioneered inflation targeting, monetary policy practice in EMEs has moved ahead of theory. Rather than strictly sticking to inflation targeting with freely floating exchange rates, the vast majority have combined it to varying degrees with foreign exchange intervention. And all of them have complemented it with the active use of macroprudential measures. That way, they have gained a measure of freedom to better reconcile price and financial stability over the medium term. Questions remain about how to deploy and coordinate the various instruments, adapting them to country-specific circumstances and avoiding some of the pitfalls involved. At a more structural level, the key challenge is to develop domestic financial systems so as to reduce the sensitivity to global financial conditions in the first place.

The experience of EMEs showcases one way to achieve a more balanced policy mix. This is having a strong prudential framework, with respect to both micro- and macroprudential dimensions: dealing with individual institutions and the financial system as a whole, respectively. With primary reference to the microprudential

dimension: now that most of the post-crisis financial reforms are in place, the key challenge is their full, timely and consistent implementation. In the process, regulators and supervisors should resist unwarranted pressures to backslide and weaken standards. Just as there is a business cycle and a financial cycle, there is also a regulatory cycle. As the memories of the GFC fade, those pressures will intensify. As regards the macroprudential dimension, a lot has been done to put in place full-fledged frameworks and to deploy and activate the tools. As discussed in detail in last year's Report, this is a very welcome development.

Appropriate fiscal policies can also help achieve a more balanced policy mix. In countries where sustainability is in danger, the objective should be to bring public finances under control, to avoid fiscal dominance and limit risks to the financial system. But where fiscal space is available, it should be used judiciously to boost sustainable growth and, if the need arises, to support aggregate demand. Suitable measures include, in particular, making the tax system and expenditures more growth-friendly, not least through well chosen infrastructural investments where productive opportunities exist. Reducing the bias of the tax system in favour of debt is an obvious example. In doing all this, it is important to avoid the trap of carrying out procyclical policies. One reason why public sector debt-to-GDP ratios have been increasing at the global level is precisely the asymmetrical use of fiscal policy, increasing deficits during contractions but failing to consolidate during expansions. Hence the reduced room for policy manoeuvre compared with pre-crisis.

But the most important set of policies is structural. Hard as it is politically, it is essential to revive the flagging efforts to implement policies designed to boost growth. We have already discussed in previous Reports what those policies could look like. In this year's Report, the analysis of the regulatory response to big techs' inroads in finance offers rich material to examine more closely and concretely some of the challenges involved. The objective is to ensure that one can reap the potentially large benefits that such technological innovations can bring about while managing the potential risks. This requires tackling delicate issues that range from financial stability to competition and data privacy. At the core of this triangle is the treatment of data, which the digital revolution has brought to the fore. Ensuring a level playing field that promotes competition under an adequate regulatory umbrella is key. Whatever the precise answer, it will require more than ever the close cooperation of different authorities, both nationally and internationally.

The skies are not clear yet. The path is narrow and winding. But the means to negotiate it exist. They should be deployed.