Ravi Menon: The Goldilocks economy - will the three bears return?"

Speech by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the UBS Wealth Insights Conference, Singapore, 15 January 2018.

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Mr Edmund Koh, UBS Head of Wealth Management Asia-Pacific,

Ladies and gentlemen, good morning. Let me first wish everyone a happy 2018. And also thank UBS for the invitation to speak at this conference.

Global growth about as good as it gets

2017 has been a good year for the global economy.

- World GDP is estimated to have grown by 3.8%, significantly higher than the 3.2% registered in 2016.
- This is the strongest pace of expansion since the rebound from the global financial crisis in 2010.

All indications are that 2018 will be another good year.

- Most of the world's major economies are expected to continue strengthening over the course of this year.
- The IMF expects growth in 2018 to be even better than 2017.

There are good reasons for optimism. The most encouraging is investment.

- Investment expenditure, which had been largely missing from the GDP growth numbers since the global financial crisis, is coming back.
- Global fixed investments have rebounded by almost 6% in 2017, after contracting in the previous two years.

Trade is another piece of good news.

- Growth in global trade has almost doubled to 4% in 2017, outpacing world GDP growth.
- This has arrested a worrying trend since 2011, with global trade growing slower than global GDP.

The industry trends underlying the pick-up in trade are encouraging. The global electronics sector is on a strong upswing.

- Semiconductor exports surged by 20% in 2017.
- This reflects both a cyclical upturn as well as a structural uptrend, as products ranging from smartphones to automobiles and home electronics become increasingly chip-intensive.

The broad-based, geographical spread of the current economic expansion is perhaps the strongest basis for its durability. The rising tide is lifting most boats.

The advanced economies are leading the charge.

- The US economy is expected to grow at or above trend, driven by strength in consumption, a healthy labour market, and better prospects for business fixed investment with the enactment of the tax reform package.

- The Eurozone economy was probably the most pleasant surprise of 2017, with a strong recovery in household spending and private investment. There is still slack in the economy, suggesting that the growth momentum is likely to be sustained.
- The Japanese economy has recorded the longest growth streak in 16 years, with a resurgence in exports and investment.

Emerging market economies – especially in Asia – are benefitting from the positive spill-overs from the advanced economies as well as healthier macro fundamentals.

- Emerging Asia is benefiting from the pick-up in the global electronics cycle, recovery in commodity prices, steady domestic demand, and benign financial conditions.

China is likely to see a moderation in growth this year but not cool off sharply.

- The government is expected to rein in local government spending, tighten curbs on residential property purchases, and seek to reduce excess industrial capacity.
- But the slowdown is likely to be measured and the risk of a "hard landing" has narrowed.

A Goldilocks economy but three grumpy bears may not be far away

A striking feature of the global economy is how subdued inflation has been despite broad-based economic expansion and highly accommodative monetary policies.

- This benign inflation environment provides the runway for very gradual monetary policy tightening and credit conditions remaining accommodative for longer.

Many analysts have characterised the current configuration of healthy growth, low inflation, and easy financial conditions as a Goldilocks scenario: a global economy that is chugging along, not too hot, not too cold.

- And financial markets see this happy scenario as self-reinforcing, sustained, and accommodated over multiple years.
- This has supported high equity valuations, low bond yields and narrow credit spreads.

But as David Skilling reminded us recently, the Goldilocks story is not complete without the three bears.

- The absence of the bears does not mean they do not exist. They could return any time.
- There are unseen risks out there – that we ignore at our peril.

Each of us will have our own list of three bears. Let me share with you what I see as the three bears that might return to spoil Goldilocks' happy stupor.

- My "papa bear" is inflation; "mama bear" protectionism; and "baby bear" financial instability.

"Papa Bear" - Inflation

Let me start with "papa bear" inflation. On conventional wisdom, he should be making an appearance by now.

Historically, inflation comes from high wage growth in a tight labour market during the late stages of the business cycle – a relationship economists describe as the Phillips Curve.

- Cyclical conditions are now tight in major economies, especially in the US.
  - US unemployment rate has fallen to 4.1%, well below the Fed's estimated Non-

Accelerating Inflation Rate of Unemployment (NAIRU) of 4.6%.

- Yet, wage growth has remained at around 2.5%, below the pre-crisis average of 3.5%.

Whenever central bankers gather these days, this phenomenon of "missing inflation" is often the main topic of discussion.

- Many wonder whether the Philips Curve has permanently flattened – meaning whether the negative relationship between the unemployment rate and wage growth has fundamentally weakened.
- Some even ask if the Philips Curve is dead – if the relationship no longer exists.

Why has "papa bear" inflation been missing to-date?

The first and simplest explanation is that the headline measure of unemployment may be understating the level of slack in the economy.

- In the US, the IMF estimates that the output gap between actual and potential GDP has only just closed.
- The output gaps in the EU and Japan are still some way off from closing.

There may also be quite some slack in the labour market that may not be fully apparent.

- Part-time workers now make up about a third of the US work force, and many of them want to transit to full-time jobs.
- The labour force participation rate in the US remains near a cyclical low, at 63%.
- Even after accounting for the retirement of baby boomers, a meaningful segment of the population could re-join the workforce.
- If the labour market in reality is not as tight as the unemployment number suggests, then it is not surprising that wage growth has been weak.

A second reason for low inflation has to do with the effects of globalisation.

- The integration into global production chains of workers from China, India, and the ex-Soviet republics during the 1990s and 2000s is estimated to have nearly doubled the size of global labour supply.
- This labour supply shock, facilitated by expanding global value chains, has exerted significant downward pressure on tradable goods prices.
- And the international outsourcing of production appears to have dampened the "pricing power" of labour and hence wage growth.

A third explanation is technology.

- Industrial automation has exerted downward pressure on manufacturing wages.
- Likewise, advances in software programming and artificial intelligence are automating knowledge work and dampening wage increases in the services sector.
- More broadly, the spread of e-commerce has been eroding the monopolistic pricing power of traditional retailers and wholesalers of goods and services – the so-called "Amazon Effect".

I think it is premature to declare the Phillips Curve dead.

- Inflation will return when tightening cyclical factors outweigh the structural disinflationary forces.
- And the US could be the first country to show signs of a turnaround in inflation.

- Its output and unemployment gaps are more or less closed.
- And the recently announced tax cuts could end up boosting aggregate demand beyond the productive capacity of the economy.

The structural factors could well be having a "one-off" effect on prices, rather than a continuing dampening impact on inflation. The disinflationary effects of globalisation may not persist for much longer.

- The world has already globalised considerably over the last two decades.
- With populist pressures, it is unlikely the trend will continue at the same pace.

Technological change may still have some legs to run and its disinflationary effects may persist for a while longer.

- But will they be strong enough to offset the short-term inflationary pressures from tightening cyclical conditions?

So what happens if inflation returns sooner or comes in higher than expected?

- Central banks will obviously have to tighten monetary policy faster and by more.
- That in itself should not derail economic growth as long as the tightening is done judiciously and credibly.
- No central bank wants to cure inflation by creating a recession.

But monetary policy tightening has always been a tricky business fraught with risk.

- More so now, with the economy attuned to a prolonged period of very low interest rates for such a long time.
- An increase in interest rates could put considerable strain on debt service ratios and lead to sharp cutbacks in household and corporate spending.

For investors, inflation is the biggest bear to watch because monetary policy could tighten at a quicker pace than expected by the markets.

- Markets are currently pricing in only about three Fed rate hikes to end-2019, so it may not take much to unsettle the markets.
- Equities, whose valuations are premised on low discount rates, could sell off in a hurry.

"Mama Bear" - Protectionism

Let me now turn to "mama bear" *protectionism*. And let us not take a hibernating bear for a dead one. This is a bear that may not wake up for a very long time, maybe never. But if it does, it could be ferocious.

Protectionism was the biggest fear this time last year.

- There were populist backlashes against globalisation, represented most vividly by the results of the Brexit referendum in the UK and presidential elections in the US.
- The great relief of 2017 was that this risk did not materialise sufficiently to threaten the global economy or financial markets.

But globalisation continues to face challenges.

- The WTO ministerial meeting last month ended inconclusively.

- The US pulled out of the Trans-Pacific Partnership (TPP) early last year and has threatened to leave NAFTA.
- In Europe, the risk of a hard Brexit is not trivial.
  - If negotiations break down, both the UK and EU will bear high disruption costs.

Protectionism can do much harm to the global economy because its reach extends beyond the flow of goods and services, to the flow of capital and technology. Large countries have been toughening restrictions on foreign acquisitions and flow of technologies.

- The US Committee on Foreign Investments objected to a record number of requests by overseas investors in 2017.
- The EU is planning to implement a screening framework for cross-border acquisitions.

US tax reforms may potentially have adverse consequences for international trade and investment flows.

- The finance ministers of France, Germany, Italy, Spain and the UK have written to the US, warning that some provisions of the US Tax Cuts and Jobs Act may contravene international trade agreements and tax treaties.
  - For example, a 20% excise tax could be imposed on payments an American company makes for buying goods or services from its foreign subsidiary.

We will do well not to get complacent about the return of "mama bear" because the underlying causes for populist anger and support for protectionism are deeply rooted.

- Income inequality in many advanced economies remains wide.
  - According to research by McKinsey, two-thirds of households in the US and Western Europe have experienced stagnating or falling real income between 2005 and 2014.
- Trade and immigration are the obvious scapegoats for voters frustrated by the stagnation in living standards.

The risk remains that some countries may erect trade and investment barriers and others may do so in retaliation.

- A protectionist spiral will almost certainly derail the growth momentum, not just for 2018 but beyond.

"Baby Bear" - Financial Instability

And finally, the "baby bear" of financial instability. A financial crisis is a sure way of thwarting economic growth, as we saw nine years ago. What is the risk now?

From one perspective, the wide-ranging post-crisis regulatory reforms have made the global financial system more robust and resilient.

- Large banks are stronger, more liquid, less leveraged.
- Derivative markets are safer, with central clearing covering more than 90% of OTC derivatives trades in the major jurisdictions.

Yet, from another perspective, the risk of financial instability is not small. This is mainly due to the build-up of leverage in recent years.

- In the G7 economies, the ratio of government debt to GDP has increased by 45 percentage points since the crisis and is now at its highest since World War II.

- In emerging Asia, corporate debt issuance has ramped up to about US$200 billion p.a. since 2014, three times the average volume in the preceding five years.
- Household debt has built up sharply in many advanced as well as emerging market economies, with escalating house prices a key driver.

High leverage is a risk factor for financial instability.

- I spoke earlier about how an increase in interest rates in a high leverage environment can create debt servicing pressures.
  - If these pressures lead to widespread credit defaults, financial instability is usually not far off.
- Another channel of causation from high leverage to financial instability is through sharp corrections in asset prices, particularly real estate prices.

The financial stability risks in the US and China warrant close monitoring, simply given the size of their economies and financial markets, not to mention the build-up of leverage.

In the US, financial stresses are most apparent in the credit markets.

- Corporate debt has increased by 30% since the crisis, and much of the funds raised has gone into stock buybacks or to highly leveraged corporates.
- The Institute of International Finance estimates that about 8% of US firms (by assets) are unable to cover their annual interest payments.
  - Unanticipated increases in lending rates or a slowdown in earnings growth could tip these vulnerable firms into bankruptcy.

In China, the Bank for International Settlements has estimated total leverage in the system has reached nearly 260% of GDP in 2017.

- The risk is of a hard landing in the overheated Chinese property market, which has been fuelled by rapid lending by trust companies and asset managers.
- Chinese authorities have made reducing systemic financial risks a key priority but have to tread very carefully to avoid destabilising the financial system in the process.

Conclusion

Let me conclude.

There are good reasons to be optimistic about growth in 2018.

- The Goldilocks scenario – at least for this year – is a reasonable baseline view.
- But we need to be watchful of the three bears who may show up at the front door any time: inflation, protectionism, financial instability.
- And of course, there are other creatures in the wild that we must pay heed to: geopolitical risks like the situation in the Korean peninsula, the South China Sea, and the Middle East.

Unlike fairy tales which tend to have a “happily ever after” ending, the real world is characterised by cycles of good times and bad times.

- Let us hope and work for the former, but also prepare for the latter.
- And the best way to prepare for bad times is to avoid excesses and build up buffers during good times.

Thank you, and wishing everyone once again, a good year ahead.