UniCredit

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Macro Research

Chief Economist´s Comment

Sunday Wrap

Good Sunday morning from Washington DC,

I spent most of this past week at the IMF annual meetings here in Washington, shuffling between one-on-one meetings, grand policy presentations and debates at the IMF and the parallel IIF meetings, smaller analytical presentations, and the coffee shops and meals for the chats. All very enjoyable, not least as it included seeing so many old friends.

I have collected my impressions from these past few days under the following three headings:

- **My general impressions from the meetings etc.**
- **My thoughts on the IMF's three key publications, issued to set the agenda for these meetings.**
- **The latest Brexit misery and why the much needed restoration of a degree of predictability is nowhere in sight.**

1. My general impressions from the IMF and IIF meetings.

If I should sum up my impressions of the overall mood among the participants these past few days, it would be one of a good deal of confusion about the exact present state of affairs, and of substantial anxiety about the outlook for policies and therefore for growth.

As we all know, global growth is weak. The IMF calls it a synchronized downturn, but I don't think that's quite accurate. The weakness is heavily concentrated in manufacturing and global trade, so countries like Germany are suffering much more than countries with greater weight in services and domestic demand. And, throughout the world, households are holding up quite well, which was noted by virtually all the bank CEOs on the various panels as a reason for some optimism that things won't get too bad.

That said, I found nobody who believes the IMF's central forecast of a modest global recovery next year – and I strongly doubt that the IMF believes it themselves. But neither did I find many who were prepared to go as far as signing on to our forecast of a US recession in 2020.

We all know the root cause of the weakness, namely Trump's attack on trade and the implication for sentiment and hence investment. The IIF had a great trade session on Friday where the consensus was that even the "Phase 1" trade agreement announced between the US and China is nothing more than a short-term convenience-play by both sides, with little chance of a Phase 2. Former New York Fed president Bill Dudley noted that the question of a US recession the next year or two very much depends on how aggressive Trump turns out to be on trade during the next year.

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The sad state of global politics was discussed in virtually every coffee break, and in this Mecca of Multilateralism you don't find anyone sympathetic to the policy conducts by the misguided missile in the White House or by Boris Johnson and his allies in London. And the usual enthusiasm among business leaders for opportunities in China and beyond via the Belt and Road Initiative has clearly been put on hold as people evaluate the implications of China's now blatant demand for political loyalty from foreigners doing business in China. Meanwhile, ECB policies have come under quite a bit of criticism here (more on that below), while participants are puzzled about the European – read "German" - resistance to engage the fiscal tool box.

…. And this widespread disappointment in the political leadership is all before we get to the widely recognized challenge of how to tackle climate change. We know where Trump stands, and we also know – broadly – what China and other EM countries think of their share of global obligations, so it leaves a big task for Europe. Surely, we all have to do our part, but as a very senior person said to me as we sat listening to a session in the IMF Atrium titled "Can Central Banks Fight Climate Change?": "Is this not yet another example of our elected politicians trying to push their responsibility on to the central banks?"

One of the best one-liners I heard this week came at this session from ECB chief economist Philip Lane, who observed (kindly tweeted by the ECB's head of media relations, Michael Steen): "The imperative is the world adopts correct climate policies and then [dealing with it] is bread and butter for central banks".

Finally, an IMF meeting is not an IMF meeting without concern about financial stability, insufficient fiscal tightening and the lack of structural reforms. The policy panels and chatter in the corridors included a lot of pretty well articulated concern about the impact of low interest rates on corporate (and EM) debt, and on the financial system in Europe, which I'll come back to in the next section.

But I also note that I must be getting old, because hearing top officials call for fiscal consolidation and structural reforms at this state of affairs really feels like yesterday's breakfast. Very well timed, OECD and European Commission chief economists, Laurence Boone and Marco Buti, published a much recommended piece in Vox, calling for a better policy mix. It's here: Right here, right now: The quest for a more balanced policy mix

2. Thoughts on the IMF's three key publications, issued to set the agenda for the meetings.

The IMF issues three key publications aimed at setting the agenda for the annual meetings: The World Economic Outlook (the WEO), the Global Financial Stability Report, and the Fiscal Monitor. I'll briefly comment on each:

The IMF's flagship publication, the WEO, is always an interesting read, but this year I think it struggles in a number of ways.

First, and most importantly, it suffers from the inherent problem of bridging the increasing divide between, on the one hand, the natural caution for an institution like the IMF dictated by big-country politics, and, on the other hand, realism at a time when precisely those big countries have taken the wrong exit, whereby they are playing havoc with the outlook.

As noted above, and widely discussed in the media, the IMF has revised down this year's global GDP growth number to 3.0% (the lowest since the financial crisis), but they forecast a modest rebound already next year to 3.4%, fueled mostly by the eurozone (seen to accelerate from 1.2% growth this year to 1.4% next year) and a handful of EM countries, including India, Brazil and Russia, assumed to come off their 2019 weakness. The IMF forecasts US growth to cool from 2.4% this year to 2.1% next year, and China from 6.1% to 5.8%.

To be frank, these forecasts seem driven largely by an assumption of mean-reversion, which – I suspect – starts with an assumption that also global trade will return towards its long run growth rate already next year. Sure, if global trade accelerates from about 1% growth now to 3%-4% growth next year, eurozone GDP will accelerate again – as will many other countries, but that really seems too optimistic to me - and I rather suspect the IMF thinks so too.

If you read IMF chief economist Gita Gopinath's excellent foreword to the WEO, you can't help but to notice her concerns: She reflects on the "broad-based [2019] slowdown in manufacturing and global trade", but she provides no real arguments for why it should get better next year. And there is the aggressive monetary easing already delivered (which is estimated to have supported growth by 0.5pp in both 2019 and 2020 - thank you very much, central banks – offsetting more than half the 0.8pp drag caused by the US-China trade war), but, she writes, the key central banks "may have little [ammunition] left when the economy is in a tougher spot". So, not surprisingly, "Downside risks to the outlook are elevated", concludes Gopinath.

There are two key reasons for this deep division between the IMF's base case forecast and the tone of the WEO: One legitimate (if highly inconvenient), and a regrettable one.

The legitimate, yet inconvenient, reason is that the IMF – like the OECD and other international organizations, but contrary to private sector forecasters – cannot include in their base case forecast any expected policy changes. The fact that the global slowdown has been caused by the trade infringements initiated by Trump, and retaliated by the attacked countries, is acknowledged, of course, but even as Trump threatens further tariffs already in November, these cannot be included in the base case until formally announced.

The regrettable reason is political correctness and a pretty consistent historical refusal to forecast trouble. And, of course, most economic models tend to predict a return of growth towards trend. So, even as most recession probability models predict a measurable US slowdown next year, the IMF forecasts only a very mild easing of US growth to 2.1% in 2020, which is almost certainly still above trend. We at UniCredit may be wrong on our 2020 US recession call, but my money is very heavily on US growth well below 2% next year. And the IMF's China growth forecast will surely not deviate more than marginally from the Beijing's forecast. So, all in all, these forecasts become – in my view – a bit meaningless.

Be that as it may, the WEO should then discuss the key issues for everyone to ponder – but here I find the reports a bit of a hit-or-miss. There are some great boxes (my favorite is Box 1.4, which concludes that existing techniques may significantly underestimate potential output, and hence output gaps, and therefore "provide premature alarms about the risk of overheating" – Hello, critics of ECB easing…), and chapter 3 on the role of structural reforms in low-income countries is helpful.

On the other hand, what about the very hot topics in the economics debate right now, like the effect of negative interest rates, fiscal stimulus, trade war, etc.?

In particular, I found it regrettable that the WEO had nothing at all to say on low-for-long interest rates and the stimulus to the real economy vs the burden on the financial sector, which – ultimately – could lead to instability. As noted, Chief Economist Gita Gopinath referred in her foreword to a sizable estimate of a boost of 0.5pp per year from monetary stimulus, but there is no other reference to this issue in the entire WEO.

In contrast, the IMF's Global Financial Stability Report does a great job on the vulnerabilities stemming from the low interest rate environment. It points out that the key weaknesses reside not with the banks or sovereigns in the advanced economies, but predominantly with the non-financial corporates, insurance companies and (potentially) asset managers. (Related, the European Insurance and Occupational Pensions Authority, EIOPA, published their huge stress test report this past week, pointing out – between the lines – the deeply worrisome state of affairs among insurance companies because of the mismatch between assets and liabilities due to low interest rates. Solvency, if that's the right word, is claimed by discounting future liabilities with a rate more than 3pp higher than market rates.)

Hence, with the IMF's key publications staying quiet on the positive effects on growth of the monetary policy stance (apart from one line in the WEO's foreword), while providing substantial discussion of the risk stemming from the policies, it may not be so surprising that the overall flavor of the annual meetings on the issue of ECB policies turned out somewhat one-sided – and rather critical.

Finally, I want to tip my hat to the authors and the IMF's Fiscal Monitor. For years, this was a report that could put even the most dedicated fiscal nerd to sleep, but – to put it in a nutshell - this year they dedicated the entire report to the need for carbon taxation. Brave and relevant – well done!

3. The latest Brexit misery and why the much needed restoration of a degree of predictability is nowhere in sight.

As I'm sure you have seen, on Thursday the UK the European Commission agreed on a new Brexit deal. It's not materially different from Theresa May's deal, apart from the important issue of the Irish backstop. In this latest deal, it's done via a massive fudge which really boils down to creating a border in the Irish Sea. As Tony Blair's chief of staff from 1995-2007, Jonathan Powell, writes in this weekend edition of the FT under a headline that says that the "deal brings a united Ireland closer", this all "means a soft Brexit for Northern Ireland and a hard Brexit for the rest of the UK". Not surprisingly, DUP is opposing the deal, while – as pointed out by Powell – Scotland should want a similar treatment as Northern Ireland…

The EU27 leaders immediately signed it off, handing Boris Johnson the job of getting approval from the parliament – after which the European parliament needs to ratify it.

But it did go to (Boris Johnson's) plan. Parliament was called in yesterday to approve it, but – as you surely know - in the end, there was no "meaningful vote" on the deal because Oliver Letwin's amendment, passed by 322 votes to 306, withholds approval of the deal until the primary legislation needed to implement the deal (the EU Withdrawal Agreement Bill) is in place.

While Letwin's amendment could be seen as a wrecking operation, it actually seems quite reasonable to me because it sets out to prevent a "no deal Brexit by accident" – or by design. This is so because if Boris Johnson's deal had received the consent of the Commons on Saturday then Johnson would not have been required to request an extension to Article 50 (which he did last night, as legally obliged to do, but with the usual Boris theatrics.) Mr. Letwin and many other MPs feared that if there was no extension and the legislation needed for the deal to take effect in UK law was delayed or derailed this coming week when it will be introduced, then the UK would leave without a deal on 31 October, which they wanted to rule out.

So the farce continues. The EU leaders will be in no hurry to consider the extension request. They have agreed that they would only take a decision after meeting in person, so it will require an emergency meeting to be scheduled. I rather suspect they'll push this to after next week (shortly before the 31 October deadline) in order to put pressure on UK MPs to come to a positive decision this coming week. After all, there is no longer any appetite in the European capitals for this absurd theatre – or any real desire to rescue the UK in the EU.

My guess is that the House of Commons will indeed approve Mr. Johnson's deal this coming week, although the vote will likely be close. (Of course, opposition MPs are unlikely to go down without a fight this week. They will try to amend the bill in all sorts of ways, most prominently in favour of a second referendum, or a customs union, but it's difficult to see a majority in the current parliament for either a second referendum or a customs union.)

If I am right on this, the UK will leave the EU very shortly (probably after a brief technical extension). Until the end of next year (and possibly extended by up to two years), the UK will live in transition, i.e. they'll live with all EU rules, regulations and legislation, but without any vote or influence on changes. This is when the optimists hope the UK can strike new trade deals with the US, China etc., - but that's of course impossible to achieve in such a short period of time – unless the UK surrenders to all the demands of the other sides, which I never heard to be the objective of Brexit.

This leaves me to remind you that even if Johnson gets his deal through parliament this coming week, the uncertainty is far from over. The deal is nothing more than the "divorce bill", while all the arrangements for how the UK wants to live, trade and invest with other countries still needs to be negotiated. As often quoted, it took Canada and the EU seven years to negotiate their trade deal (and another year to ratify it), and that doesn't even include anything on services…

And once it's all done, will the UK then keep the EU's regime for standards, or use their new-found freedom to introduce their own new standards for products and services? If the latter is the case (again, presumably so, since this was all about "taking back control"), new uncertainties will be imposed as testing and negotiations will need to take place before such new standards will be accepted – if accepted – by the trading partners.

Make no mistake about this: The lack of clarity imposed by the Brexit vote in 2016 for trade investment between the UK and the rest of the world have only just begun. We are in for a decade of ongoing uncertainties, and that'll almost certainly cause the UK to underperform its peers in growth terms for years to come.

And on that note, I'll be heading out for the first of today's meetings, before leaving Washington late afternoon.

Best

Erik

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