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The Association of Accountants and Financial Professionals in Business

Global Economic Themes
February 2020

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February 2020

Executive summary

These pieces discuss long term, structural trends which inevitably have a longer shelf life than the short-term relevance of the GECS itself.

Over the last year we have published a thematic piece of research on a topical economic issue in each quarterly Global Economic Conditions Survey (GECS) Report. These pieces discuss long term, structural trends which inevitably have a longer shelf life than the short-term relevance of the GECS itself. So, we thought it would make sense to collect these pieces together in a single report as a way of discussing longer-term economic developments.

The first article focuses on the European single currency, the euro, assessing its performance in delivering growth and low inflation among member countries. The conclusion is that lower inflation has been achieved but at the price of weak and more volatile economic growth. The article also takes a view on likely future developments, noting that moves towards greater integration have been triggered after financial crises. A prime candidate for the next euro-zone crisis is Italy, where public sector debt is very high and the banking system looks increasingly fragile.

The next two articles take China and the US in turn and look at some of the long-term challenges and changes that both economies are currently facing. In China's case the combined effect of high levels of debt and a declining working age population cast doubt on the country's ability to make the difficult jump from a middle-income to high-income economy. The analysis also suggests that the recent slowdown in economic growth in China is permanent and structural in nature, rather than temporary and cyclical.

Meanwhile, in the US, the apparent shift in the relationship between unemployment and wages growth is studied, including the implications for monetary policy. In addition, the emergence of the US as the world's biggest oil producer is discussed. While bringing clear advantages in the form of self-sufficiency in oil, there are other potentially less benign consequences, such as much greater volatility in investment spending and GDP growth. Finally, the US public finances are assessed, namely the large budget deficit and rising public sector debt at a time when the economy is already buoyant. This casts doubt on the efficacy of fiscal policy in the next major downturn in US growth.

The final thematic piece in this report published in October looked at the possible wider economic effects of trade tensions between the US and China. While the direct effects of tariffs on the world's two largest economies should not be overstated, the wider impact on business confidence and investment has so far been more significant. But there are positives too, especially among some other Asian economies, such as Vietnam and Malaysia, where trade diversion has boosted exports to the US while those from China have contracted. This article is the most current of the four and there is a short update section at the end to reflect the recent improvement in US-China trade relations.

The articles reproduced in this report are largely as they appeared in the original GECS reports. Charts have been updated where possible and references to dates adjusted to reflect the passage of time.

I. The euro – the first and next 20 years

(Published January 2019, GECS Q4 2018 report)

The euro survived its first two decades, despite several financial crises that threatened its very existence. But the euro has failed to deliver the real economic convergence claimed for it at the outset and further significant reforms are required if it is ultimately to be considered a success.

In January 1999 the euro was launched with the irrevocable locking of exchange rates by its founder members and the assumption by the European Central Bank (ECB) of a single monetary policy. Early in 2002 12 countries introduced euro notes and coin, completing the process of creating a European single currency that had been first proposed as long ago as 1970 in the Werner Report. Many analysts doubted that the euro would come into existence – or if it did so that it would not survive for very long. They have been proved wrong and the euro survives – after 20 turbulent years of financial crisis, sovereign debt default and severe levels of systemic banking risk.

Of all the remarks made by the three Presidents of the ECB over the last 20 years the most significant by far was the one made by Mario Draghi, then President of the ECB in July 2012 when he said "[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." The fact that the head of a major central bank had to provide reassurance that its currency would survive speaks volumes about the existential threat to the euro at that time. But this did mark a turning point for the euro as Mr Draghi's comments went a long way to convince financial markets that the euro was indeed here to stay. Bond yields in some of the periphery countries fell precipitously in the weeks after Mr Draghi's statement, having previously increased sharply as fears of euro break up mounted.

But of course, survival does not equate to success. The euro has resulted in economic divergence between its members rather than the convergence it was supposed to produce. (By economic convergence we mean the tendency for the business cycles of economies to move together, to be positively correlated.) A one-size fits all monetary policy conducted by the ECB resulted in much lower interest rates in many peripheral economies, much lower than was appropriate for their domestic economic strength. This resulted in booming economies, often fuelled by red hot housing markets (Ireland and Spain being prime examples of this). Rapid economic growth led to higher inflation and a loss of competitiveness. Inevitably these booms led to busts, greatly exacerbated by the financial crisis of 2007/08. This cruelly exposed the lack of flexibility in a monetary union comprising greatly varying economies. With no exchange rate or interest rate to ease adjustment – and fiscal policy also constrained by rules limiting budget deficits, there was only one method by which these economies could restore lost competitiveness – deflate demand. The consequent austerity and severe recession only served to push debt to extreme levels, raising fears of sovereign default and even of countries leaving the euro in order to be free from the single currency economic straitjacket. Cue M. Draghi's commitment in 2012.

So, the euro has indeed survived. But it has produced economic divergence not the convergence required to cement a permanent monetary union. One way of illustrating this is by comparing the dispersion of growth between the euro-zone economies in the 18 years before the creation of the euro and in the subsequent 20 years. Statistical analysis shows that the variability of growth between these countries has increased in the euro period compared with the pre-euro period (see final column in table below).

Table 1: Main euro-zone countries pre and post-euro economic performance

GDP %											
Annual average	Austria	Belgium	France	Germany	Greece	Ireland	Italy	N'lands	Portugal	Spain	**Sdev**
1981–1998	2.2	2.0	2.1	2.1	1.6	4.5	1.8	2.6	3.4	2.7	**0.8**
1999–2018*	1.8	1.7	1.5	1.5	0.1	5.3	0.5	1.7	0.9	2.0	**1.3**
CPI %											
Annual average	Austria	Belgium	France	Germany	Greece	Ireland	Italy	N'lands	Portugal	Spain	**Sdev**
1980–1998	3.1	3.6	4.9	2.8	15.9	6.0	8.1	2.4	11.7	7.6	**4.2**
1999–2018*	1.8	2.0	1.5	1.5	2.1	1.7	1.9	1.9	2.0	2.2	**0.2**

* except Greece which joined in 2001
Source: Eurostat

While complete convergence is neither desirable nor achievable in any monetary union, some degree of convergence is necessary for the long-term sustainability of the euro. Moreover, continued divergence risks undermining the single currency, threatening its ultimate break up.

On a more positive note there has been reduced variability of inflation at lower average rates across euro members. To a large extent this reflects much lower average rates in previous high inflation countries, such as Spain, Portugal and Greece. In many cases this lower inflation has been achieved at the expense of reduced economic growth and higher unemployment rates. But there can be no doubt that the ECB has met its mandate of achieving "below but close to 2% CPI inflation" in the euro-zone as a whole.

THE NEXT 20 YEARS

The history of monetary unions is that they require political union in order to ensure long-term survival. The euro is no different. So while it has been saved its fundamental structural flaws remain. These will need remedying in the next 20 years. In the long-term the euro-zone will need a central finance ministry with a budget to operate a fiscal stabilisation policy. In addition, debt mutualisation will be necessary i.e. the euro-zone as a whole will have to guarantee each member's debts. Such developments would help cement the euro by providing - through a euro-zone budget – an alternative means of economic adjustment.

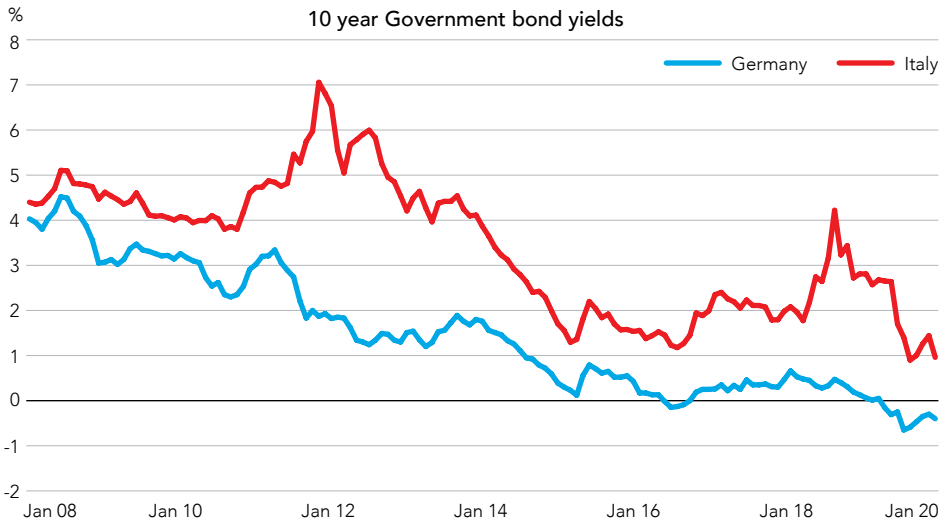
These issues are illustrated by the situation in Italy in late 2018. Italian public sector debt was around 130% of GDP and the European Commission insisted that the Italian budget should ensure that this debt level was on a declining trend. But the then recently elected Italian government insisted on a more relaxed budgetary stance as it attempted to tackle poverty and stimulate the economy. The stakes for Italy are high – its economy is over eight times larger than that of Greece, for example, so default and bail out would have serious economic consequences for the euro-zone as a whole. As chart 1 shows the spread between Italian and German 10-year Government bond yields widened towards the end of 2018, reflecting concerns about Italy's ability to both fund its debt and meet its debt servicing obligations. A deal in December 2018 effectively kicked the can down the road – as the Italian government agreed to delay some (but not all) spending measures and aim for a budget deficit in 2019/20 of 2% of GDP instead of the original 2.4% target. But Italy committed to raising VAT if the public finances do not improve from 2020 onwards. With Brexit and European Parliament elections looming in the first half of 2019 – as well as new budget issues in France – such a deal suited both the Italian government and the European Commission. But Italy's structural problems persist – an excessive level of public sector debt and a sclerotic economy barely larger than it was 20 years ago, at the launch of the euro. Italy's debt crisis has been postponed, not cancelled.

The Italian mini-crisis of late 2018 highlights continuing tension between euro-zone members on this issue. Some want to move towards greater fiscal integration at the earliest opportunity. President Macron of France is a proponent of this approach. But there is stiff resistance from Germany and the Netherlands which argue that nation states should retain responsibility for their own fiscal policies and the health of their public finances. The concern especially in Germany is that some countries, knowing that their debts are guaranteed at the euro-zone level, would pursue excessively lax policies, imposing costs on other euro-zone members.

So the euro will probably survive for another 20 years – indeed it may well have now passed the point of maximum danger. But by 2038 it will also look rather different than it does today and will almost certainly have expanded to include more than 20 members. Moreover, there will be in some form a euro-zone Finance Ministry with tax raising powers and a stabilisation remit. A euro-zone government bond market is also likely to have emerged. This will be achieved over time with a series of small steps usually triggered by crises – the traditional way in which the euro-zone has moved towards greater integration. More euro-zone crises over the next two decades are a fairly safe prediction. Less predictable is the extent to which there will be real economic convergence among euro members. That may have to wait until the euro has turned 40 or even 50.

The spread between Italian and German 10-year Government bond yields widened towards the end of 2018, reflecting concerns about Italy's ability to both fund its debt and meet its debt servicing obligations.

Chart 1: Italian and German government bond yields



Source: Federal Reserve Bank of St Louis Economic Databank (FRED)

II. China – a debt and demographics time bomb?

(Published in April 2019, GECS Q1 2019 report)

China has enjoyed huge economic success in recent decades. But in order to make the transition from a middle-income country to a high-income one China will have to overcome significant challenges – high levels of debt and poor demographics are two of the biggest of these.

For almost four decades from 1980 the Chinese economy expanded at an average rate of around 10% a year on the back of market-oriented reforms and integration into the global economy. The result is that China is now the second largest economy in the world. But recently growth has moderated and in 2018 the economy grew by 6.6%, its weakest rate since 1990. (2019 was even weaker at 6.1%) Such a rate would be welcomed in developed economies. But for China, where incomes per head are still at a level that puts it in the middle-income bracket, such a rate is cause for concern. That is why the authorities have recently introduced stimulus measures in an attempt to boost growth and hit the official target for GDP growth in 2019 of 6% to 6.5%. In this piece we will look at two long-term structural issues that are likely to exert a downward influence on the pace of Chinese economic growth in the years ahead – debt and demographics.

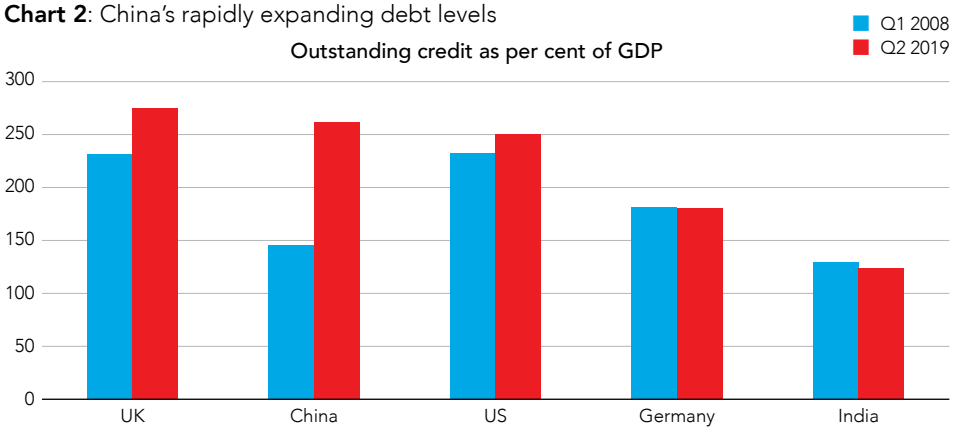
DEBT

Total debt in China has shot up over the last 10 years, reaching levels comparable to those in the US and UK and well above the levels prevailing in most emerging markets. (See Chart 2 below.) The increase in Chinese indebtedness, by 115% of GDP, is all the more remarkable given the pace of GDP growth over the period. But therein lies the issue for China – debt fuelled growth has now run its course and can no longer be relied upon as a permanent driver of rapid economic expansion.

The dramatic rise in Chinese debt began with its response to the global financial crisis of 2008/09 – the massive easing worked very well and the rise in debt helped to boost growth quickly and significantly and the Chinese economy bounced back more quickly from the financial crisis than Western economies. The bulk of the rise in debt occurred in the corporate sector, which includes State Owned Enterprises (SOEs) as well as purely private companies. High levels of corporate debt are the distinguishing feature of Chinese debt – household and central government debt levels are in line with those economies such as the US or euro-zone. True, some debt measured as corporate debt in China is ultimately local government debt funded through opaque vehicles called Local Government Finance Vehicles (LGFVs). But even assuming LGFV debt is not corporate debt still leaves corporate debt at 140% of GDP, higher than, say the US at around 80% and the euro-zone at 100%. Within Chinese corporate debt SOEs account for more than half of the total – 72% of GDP in 2017 according to the IMF. Moreover, SOEs were responsible for most of the increase in corporate debt between 2008 and 2016.

Of course, high levels of debt are not necessarily a problem – provided that the assets they support are of high quality, such that the debts can be serviced and ultimately repaid. Two areas of Chinese debt raise concerns in this respect.

Chart 2: China's rapidly expanding debt levels



Source: Bank for International Settlements (BIS)

First, there is the lending to SOEs. This was the main channel through which the easing of policy was conducted in the wake of the financial crisis. A lot of this extra debt was used by SOEs for directly boosting investment spending, thus lifting GDP growth. Unfortunately, many SOEs are not viable, profitable businesses so that investment by such companies has been wasteful and uneconomic. The Chinese State Council broadly defines nonviable firms as those that incur three consecutive years of losses, fail to meet environmental or technological standards, and rely heavily on government or bank support to survive. Such companies are nevertheless kept alive because they are major sources of employment and remain crucial to regional economies. The share of total corporate debt attributable to these so-called "zombie" firms is estimated to have been around 15% in 2016, the highest level since 2009. Such debt is of course unlikely to be repaid and represents a key element of China's bad debt problem. The resolution of this bad debt problem is likely to be through a gradual slow-burn process as lending to SOEs is curtailed and restructured – after all both the debtor (SOEs) and creditor (state- banks) are ultimately owned or controlled by the state.

The debt of the private corporate sector is more likely to trigger a traditional banking crisis. In particular, construction and real estate firms have taken on large amounts of debt in recent years, fuelling a real estate boom. Falling real estate prices would clearly expose this debt to write-downs and increase banks' bad debt provisions. In addition, while household debt is not at excessive levels judged by US or UK standards it has also increased rapidly in recent years. Economic slowdown or house price correction could expose households to the need to rebuild their balance sheets, squeezing consumption.

The influence of the Chinese state diminishes but does not eliminate the chances of a financial crisis. But the authorities are now clearly concerned about the level of debt – hence recent attempts to rein in the pace of credit growth. It is noteworthy that recent stimulus efforts have concentrated on fiscal measures, such as tax cuts rather than through monetary easing and boosting credit growth. If China is moving away from debt-fuelled growth - at the same time as moving towards a more consumption-driven and service sector economy – then a much lower trend rate of GDP growth is almost inevitable.

DEMOGRAPHICS

A highly predictable trend in China in coming years will be demographics – in particular a declining working age population. In 1970 the fertility rate in China (the number of children per woman during her child-bearing years) was more than six; now it is 1.6, lower than even the UK or US (both 1.8). The population is 1.4 bn and expected to peak slightly above this level by 2030. The working population is about 990mn, forecast to fall by around 50mn before 2030 and by 140mn by 2050. Meanwhile there are around 130mn retired people – a figure that is set to rise to about 360mn in 2030 and 510mn in 2050 – 35% of the population. A shrinking minority will have to pick up the tab for a growing majority. This is illustrated in Chart 3 below with the dependency ratio – the ratio of those of non-working age (young and old) to the working age population (aged 15 to 64). This ratio – expressed as a percentage – rises from 40% to almost 70% between 2020 and 2050 (see Chart 3 below). Put another way, this means the number of workers supporting each non-worker declines from around 2.5 to 1.5 over the period. In China with a relatively less developed welfare and pension system this demographic trend poses major economic and social problems.

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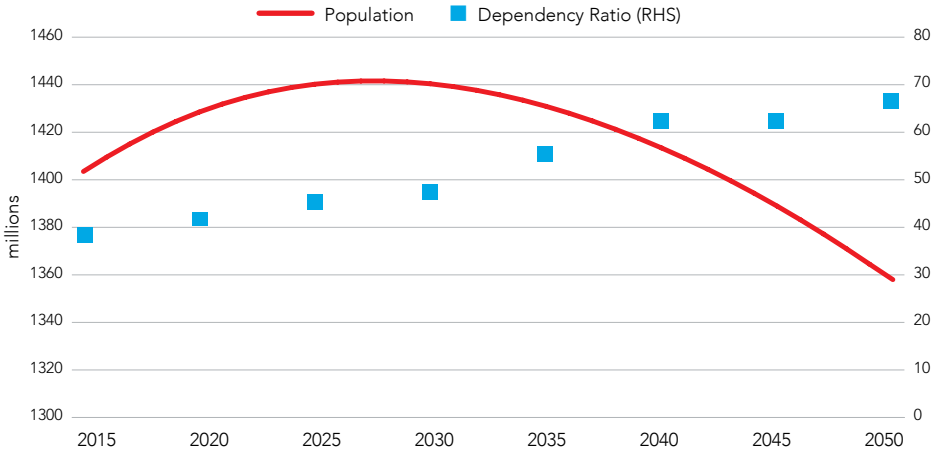
Chart 3: China's poor demographics



Source: UN Population Division Databank

An economy's potential growth rate is made up of changes in the working population and productivity growth.

An economy's potential growth rate is made up of changes in the working population and productivity growth. The working population is almost certain to shrink – even if a significant number of older people stay in the workforce beyond normal retirement age. China's rapid economic growth from the late 1980s onwards was fuelled by a rapidly rising working age population and a surge in productivity growth. The latter was driven by a huge shift in workers from countryside to city and in employment from agriculture to manufacturing. That process has now largely run its course and is in any case inhibited by the residential permit scheme – the hukou. Rising wages in recent years are clear evidence of a tightening jobs market that no longer has access to a plentiful additional supply of workers moving from the countryside to the city. As is now the case in Japan where the working population is in decline, fairly soon China will have to rely increasingly on boosting productivity to sustain economic growth. Hence this is one of the reasons for the authorities' policy of "Made in China 2025" an industrial policy intended to transform China from a low-end manufacturer to a high-end, high-tech producer of goods meeting demand from its own very large domestic market. Semiconductors and electric vehicles are a focus.

At points in the 20th century the Soviet Union was going to 'bury' the West in economic performance terms and then the Japanese economic model was about to dominate the global economy. Neither of course actually occurred. Many analysts have predicted that this century will belong to China. Indeed, China has great advantages, including a modern infrastructure, a large domestic market that allows firms to exploit economies of scale and an advanced digital economy. But as this article has illustrated, there are challenges that must be overcome if China is to succeed in propelling itself from a middle-income country to a high-income one.

III. America – a structurally changing economy amid growth (Published in July 2019, GECS Q2 2019 report)

The US economy has expanded continually for over 10 years. During this period the economy has undergone major structural changes, including in the jobs market and its relationship with inflation, a surge in oil and gas production and a deterioration in the public finances.

In July 2019 the US economy completed 10 continuous years of economic growth, the longest such period in over 150 years. This is a remarkable record, even if the pace of growth over this period has not been spectacular. But there are some significant structural changes that will affect the performance of the economy and policy over the longer term. In this article we look at three of these: the jobs market, the oil sector and the public sector finances.

UNEMPLOYMENT AND WAGES GROWTH

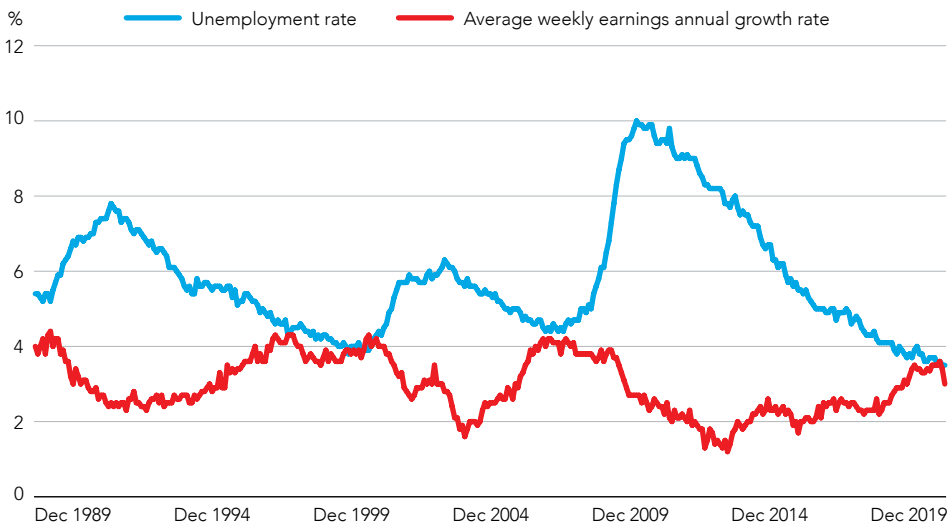
A surprising feature of the US economy in recent years has been the performance of the jobs market. Unemployment fell to a near-50-year low of 3.7% in June 2019. Over the last 10 years, since the economy emerged from the Great Recession of 2008–9, the US has created over 21 mn jobs – an increase of 16.5%. This performance is a testament to the flexibility of the US jobs market. But there also appears to have been a structural shift in the relationship between the unemployment rate and wages growth. The so-called Philips Curve suggests a negative relationship between the two variables, as intuition might suggest – as unemployment falls, the jobs market tightens, and wages begin to rise, and the pace of acceleration of such rises will increase as unemployment falls further. This relationship appears to have shifted, with a lower unemployment rate now associated with a more modest rise in wages. This is illustrated in Chart 4 below.

Wage developments have a strong bearing on the conduct of monetary policy because accelerating wages are one of the first signs of incipient inflationary pressures. Reliance on this relationship was illustrated in December 2012 by Janet Yellen, the then chairman of the Federal Reserve. She committed then not to raise interest rates until unemployment fell below 6.5%, suggesting that this was the rate at which inflationary pressures might begin to emerge. At that time, the unemployment rate was 7.9%. It fell below 6.5% in April 2014 and US interest rates were finally increased in December 2015, by which time the unemployment rate had fallen to 5% without generating signs of inflationary pressures.

So there appears to have been a shift in the relationship between unemployment and wages that means wage growth begins to increase at a lower level of unemployment than has been true in the past. As Chart 4 shows, there has been a modest revival in wages growth as the unemployment rate approached and then fell below 4%. But inflation remains well-behaved with no sign of acceleration above 2%. Indeed, the Federal Reserve's preferred measure of inflation – the Personal Consumption Expenditure price index – was around 1.5% for much of 2019.

What explains this shift? One explanation focuses on increased market power of the corporate sector relative to the power of workers. This has resulted in a greater share of total income accruing to capital rather than labor i.e. labor's share of

Chart 4: US unemployment and wages – a change in the relationship



Source: US Bureau of Labor Statistics

income has declined. This relative power shift is reflected in weaker wages growth even at low levels of unemployment. Rising inequality may also be a factor in overall wages growth: wages for the relatively few at the top of the earnings distribution grow much faster than for the vast majority of workers. Whatever the causes, the consequence is that monetary policy adjustments can take place at much lower rates of unemployment than before.

OIL PRODUCER AND EXPORTER

The shale boom has transformed the oil and gas sector and led to a surge in oil production in recent years (see Chart 5 below). The scale of this increase meant that by 2018, the US had become the world's biggest oil producer, overtaking Russia and Saudi Arabia. By mid-2019 US oil production had reached 12 million barrels per day (mb/d) and Russia and Saudi Arabia were each at around 11 (mb/d).

One effect of this has been an increasing share of oil-related investment in total business investment within the US. This has added volatility to the business investment cycle since oil-related investment is (not surprisingly) positively correlated with the oil price. According to the president of the Federal Reserve Bank of Kansas City (George 2018), between 2006 and 2014, as oil prices trebled to a peak of over $120 per barrel, total business investment increased by 41%, largely owing to a 125% rise in energy investment (non-energy investment increased by just 21% over the period). But then, between 2014 and 2016, oil prices collapsed back below $40 per barrel, triggering a 50% drop in energy investment. Non-energy investment increased by 2% over the period but the plunge in energy investment meant that total investment fell by 15%.

The recent boom in oil production now means that higher oil prices are likely to be a net positive for the US economy. This is in marked contrast to earlier decades, when higher oil prices were an unambiguous negative and were a primary cause of stagflation – the combination of high inflation with sluggish growth. This was caused by the tax effect of higher imported oil prices adding to consumer prices directly through higher gasoline prices and indirectly as businesses passed higher costs on to consumers.

This effect still operates today but its magnitude is reduced in a credible low-inflation environment. Moreover, it is now substantially offset by the increased investment and employment, and the profits that tend to flow to the oil sector when oil prices rise.

There is also a further positive influence on the US economy from higher oil prices (and negative from lower oil prices) and that is the emergence of the US as a net exporter of oil. Already, the power of Oil Producing and Exporting Countries (OPEC) has been diminished as rising US production has resulted in a big fall in US oil imports from the cartel. The International Energy Association (IEA) now forecasts that US exports of crude oil will almost double to nine million barrels a day by 2024, surpassing Russian exports and approaching Saudi levels (IEA 2019). This will represent a further and potentially greater threat to OPEC. But it will also have further implications for the US economy. So from a situation where higher oil prices push up US imports and drag economic growth lower, the effect in the future will increasingly be to boost exports and growth.

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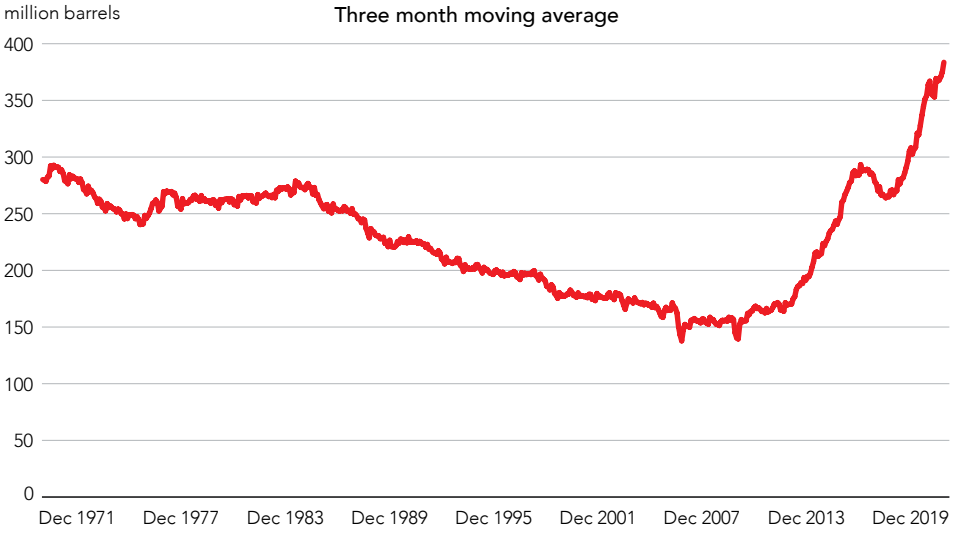
Chart 5: US oil production reaches record levels



Source: US Energy Information Association

PUBLIC SECTOR DEFICITS AND DEBT

The third structural change in the US considered here is the fiscal position measured by the public sector deficit and debt. The US reduced its budget deficit along with other developed economies as conditions stabilized after the financial crisis of 2008–9. In early 2018, Congress passed the Tax Cuts and Jobs Act, reducing corporate and personal income tax rates and easing fiscal policy at a time when the economy was already buoyant. In 2018, the US economy grew by almost 3%, while the public sector deficit increased by over 2% of GDP to 6.6% of GDP. This so-called pro-cyclical fiscal policy has boosted the deficit and level of public sector debt in the US – such increases are likely to be more permanent than similar ones incurred during an economic downturn. Chart 6 illustrates how US public sector net debt is on a rising trend and approaching 90% of GDP at a time when, on average, OECD economies are reducing the level of public sector debt.

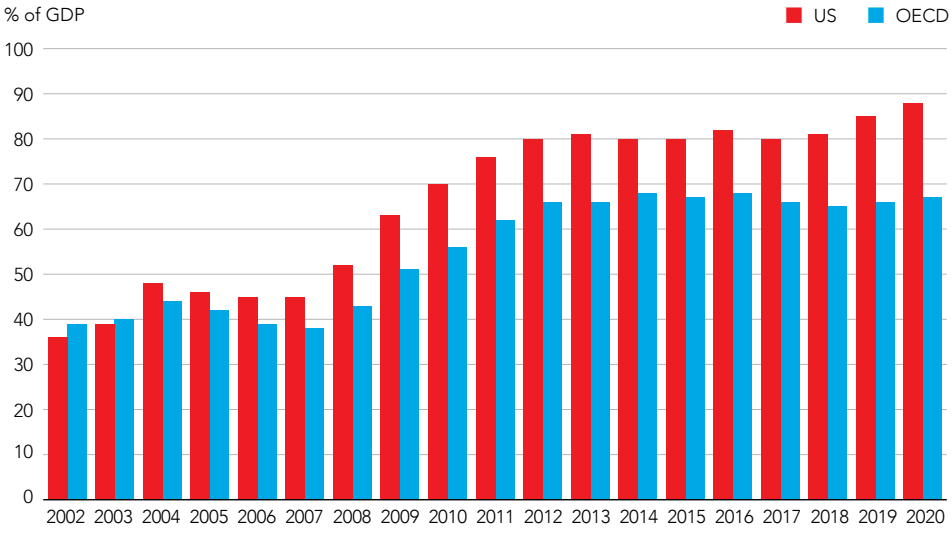
The IMF has warned about the consequences of high levels of public sector debt: as such debt reaches high levels, it becomes ever harder to stimulate the economy in a downturn (IMF 2018). The IMF singles out the US in this warning, noting that, with current projections, the US will be the only advanced economy where the debt-to-GDP ratio will increase over the next five years. Within the US, the Congressional Budget Office (2019) has warned that such high and rising debt would have 'serious negative consequences for the budget and the nation'.

CONCLUSION

The US economy remains the largest and, in many respects, the most successful in the world. But there are structural changes that represent challenges for policymakers. Perhaps the greatest concern arises from the level of public sector debt, which is on track to reach its highest level since 1946. More positively, the US can operate at lower levels of unemployment without generating upward pressure on inflation. Finally, the resurgence of the oil industry and the emergence of the US as a net exporter of oil is a positive for the economy. But again it is one that requires an adjustment in policy responses and may introduce greater volatility to the economic cycle.

Public sector debt is approaching the level at which fiscal policy may start to lose effectiveness.

Chart 6: US rising public sector debt



Source: OECD 2019

IV. The US-China trade war – can it trigger a global recession? (Published in October 2019, GECS Q3 2019 report)

Trade tensions between the US and China have had a wider economic impact than the direct effect of tariffs. Business confidence and investment in many regions has been negatively affected. But the overall effect on the global economy is not sufficient to cause recession.

There are several potential downside risks to the global economy at present, including a structural slowdown in China, the prospect of a no-deal Brexit, concerns about excessive corporate sector debt levels and the ever-present risk of a euro-zone crisis and geo-political risks in the Middle East. But the stand-out risk to the global economy according to analysts and economists is the trade war between the US and China. This began in May 2018 and has been on an erratic but escalating trend ever since. The current situation (early October) is that by the end of 2019 US tariffs will cover virtually all Chinese goods imports at rates of either 30% or 15%. Similarly, Chinese imports of US goods will have tariffs ranging from 5% to 25% applied.

So how much damage could a trade war do to the world economy? Could it be sufficient to push the global economy into recession? The short answer is no not by itself. But if other risks were to materialize, then the forces pushing towards a global recession would be considerable. The question then would be whether policy easing, which has begun already in many countries, would provide enough of a stimulus to maintain positive growth overall.

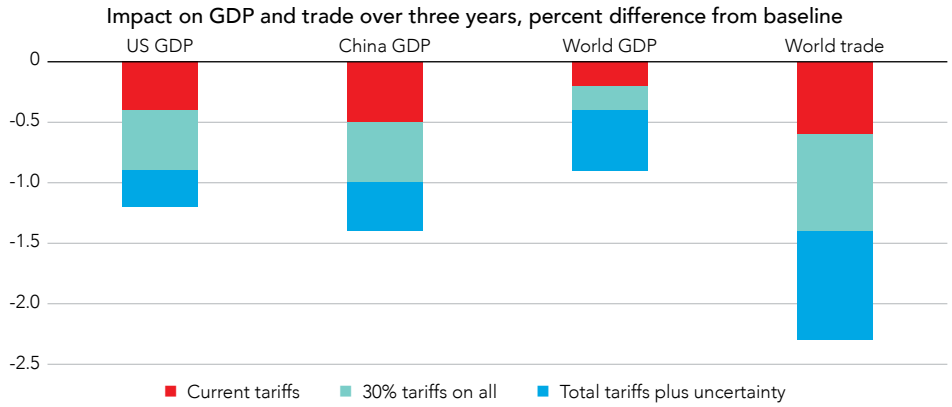
OECD estimates of the economic effects of the trade war on the US and China show a material but not dramatic negative impact. This is not surprising, given that both countries have huge domestic markets with economies that are not heavily export-dependent. For example, US imports account for 15% of its GDP and of this 21% comes from China – so Chinese imports to the US are equivalent to just 3% of GDP. The counterpart to this, Chinese exports to the US are equivalent to approximately 4% of China's GDP in 2016. (In China this is a more recent development as its growth model had previously been geared towards exports.)

The main direct route by which tariffs impact economic growth is through the effect on prices – they are, after all, a tax. By raising prices tariffs act to boost inflation, reducing real incomes and spending. The effect of a tariff on imports may also be to protect domestic producers from overseas competition, allowing them to raise prices (and output) too. For example, there is some evidence that US steel producers have behaved in this way. In terms of the overall effect on an individual economy there may be a boost to domestic production as imports are reduced and the global impact would be negligible of course.

The chart below shows estimates of the effect of the trade war. The risks from the 25% (or 30%) US tariffs applied to a range of Chinese imports are greater than the 10% (or 15%) tariffs that have dominated since the trade war started in May 2018. The imposition of 10% tariffs, while not exactly helpful, is not at such a level to do serious damage – in many cases a 10% tariff can be absorbed by margins or offset by exchange rate fluctuations. But tariffs at 25% or even 30% will have

The risks from the 25% (or 30%) US tariffs applied to a range of Chinese imports are greater than the 10% (or 15%) tariffs that have dominated since the trade war started in May 2018.

Chart 7: Trade war effects on GDP, world trade



Current tariffs are those in place as of 1st September 2019; 30% tariffs on all is 30% on all US (non-commodity) imports from China with reciprocal tariffs on China's US imports. Uncertainty is the effect of a 50bps incraese in investment risk premia in all countries.

Source: OECD/ACCA

A slowdown in global trade is clearly taking place, although it would be wrong to conclude that this is due entirely to the effect of trade wars.

a significant impact – tariffs at this level are highly unlikely to be absorbed elsewhere. Moreover, these tariffs are to be implemented mainly on consumer goods, such as toys and electronics. This implies a more immediate and significant upward influence on consumer prices and so a rapid impact on real incomes and spending. Anticipation of reduced future demand may also result in weaker investment spending.

According to the OECD, these "direct" effects are estimated to reduce growth in the US by a total of 0.9 percentage points (ppt), spread over three years. The effect on the growth rate in China is slightly greater at 1 ppt, but, of course, the Chinese economy has a trend growth rate higher than that of the US – even after the recent structural slowdown. The key point here is that in neither case is the impact sufficient to bring the economy close to recession, given their current projected growth rates.

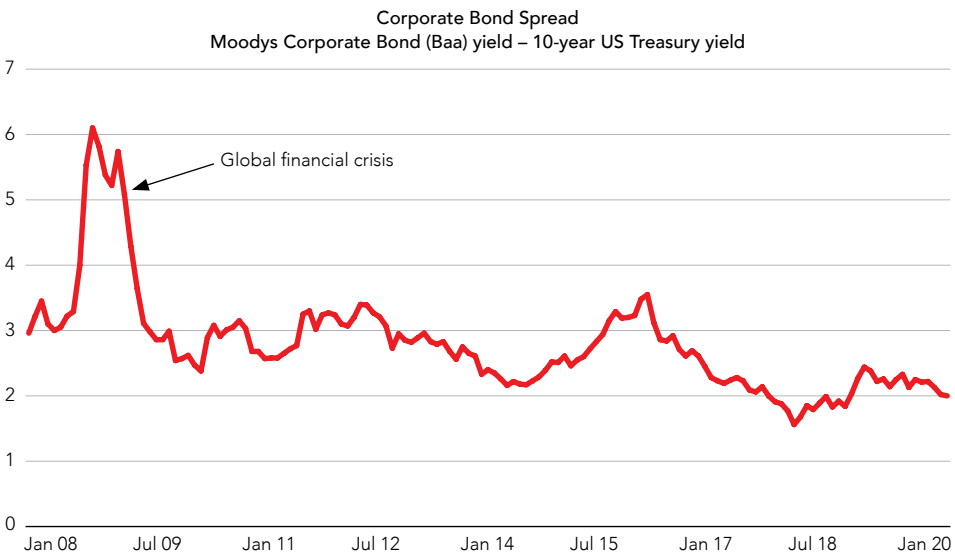
THE UNCERTAINTY FACTOR

But that is not the end of the story. The trade war is shrouded in uncertainty as to its ultimate resolution and there are increasing fears of an escalation. In addition, there is the issue of technology transfer between the US and China, encapsulated in the controversy surrounding Huawei. More recently, the designation of China by the US as a currency manipulator (triggered by the fall in the Chinese Yuan to below seven to the US dollar) has added a further element to US-China tensions. Together, these factors could potentially undermine business confidence, tighten financial conditions and provide a major additional transmission mechanism for a more broad-based negative effect on the global economy. So far, financial conditions have not tightened to any significant degree: for example, corporate bond spreads (the excess of corporate borrowing costs over the risk-free, government borrowing interest rate) remain at low levels (see chart). Stock markets also do not suggest a dominant trade war effect. True, equity markets have responded in the short term to 'news' on trade war developments. But by early October the US market (S&P 500) had gone up around 11% since early 2018 as trade tensions increased. This suggests that factors other than trade tensions are more important to the US equity market. But business confidence turned down in many countries around the middle of 2019 and the US-China trade war was undoubtedly an influence on this.

A slowdown in global trade is clearly taking place, although it would be wrong to conclude that this is due entirely to the effect of trade wars. Global trade was slowing before the outbreak of hostilities in the US-China trade war in 2018. The manufacturing cycle has turned down with falling production across many developed countries. Car production is part of this story as the sector is undergoing fundamental structural change and suffering from weak global demand.

There has been virtually no transmission of trade tensions through volatility in financial markets – corporate bond spreads have remained low.

Chart 8: No sign yet of stress in corporate bond markets



Source: Federal Reserve Bank of St Louis Economic Databank (FRED)

Of course, the trade war is not exclusively a US-China affair – there are (so far) bit parts for the European Union, Canada and Mexico. The most recent example of this is the imposition of US tariffs on $7.5 bn of imports from the EU as a result of a World Trade Organization decision on the long-running Airbus/Boeing illegal subsidy dispute. But China is the only Asian country that is subject to, or threatened by, tariffs on its exports to the US. Because of this there is increasing evidence of trade diversion – that is, other Asian economies are boosting exports to the US to replace those from China. Chart 7 illustrates this, showing the growth rate of exports to the US from China and from an aggregate of other Asian countries. The recent divergence in these growth rates, after a long period of fairly close correlation, illustrates this trade diversion as Chinese exports contract and those from other Asian economies increase. Vietnam has been a particular beneficiary of this, with its exports to the US up 33% in the first half of 2019 compared with a year earlier. The Asian Development Bank incorporated this effect in its latest forecasts (September 2019): in a worst-case scenario of 30% tariffs applied on all US-China goods trade growth in the region would be reduced overall by around 0.7 percentage points. But even here there would be winners receiving a boost to growth, including Vietnam, Malaysia, Thailand and Bangladesh.

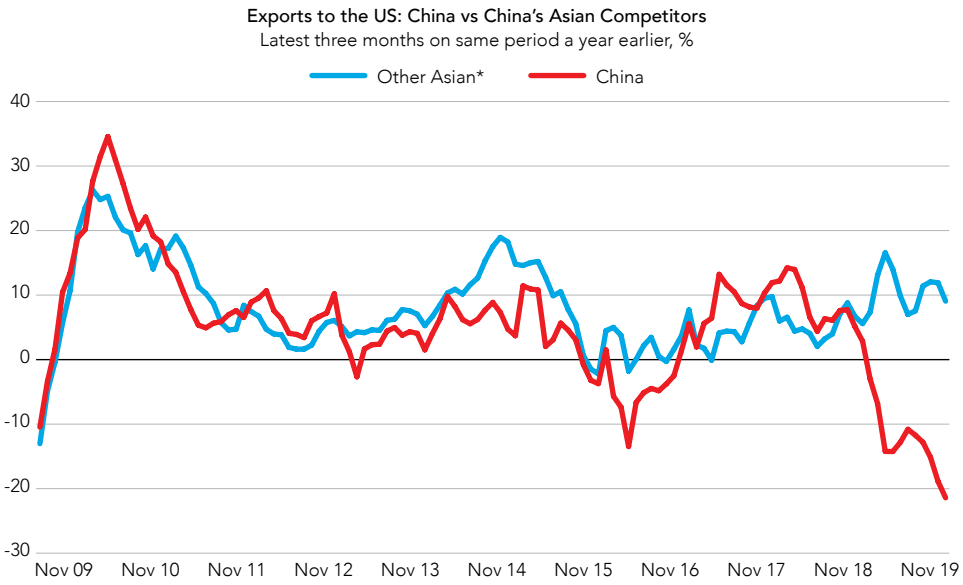
The US-China trade war is a significant risk to the global economy at a time when the economic cycle has already turned down. By itself it is not likely to be sufficient to push the global economy into recession. But the trade war is one of several downside risks to the global economy. If one or more of the other economic risks materialize then downward pressure on the global economy would intensify. Already the risks and uncertainties that have been increased by the US-China trade war have prompted monetary easing from the US Federal Reserve, ECB and others, such as those in India, Malaysia and New Zealand.

UPDATE FEBRUARY 2020

Since the article above was published last October there has been an improvement in US-China trade relations, culminating in the signing of a Phase One trade deal in January. The core of this agreement is that China commits to buying significant quantities of US agricultural and other produce and the US not only does not go ahead with further tariff increases (from 25% to 30%) but reduces tariffs on some $120bn of imports from 15% to 7.5%. Nevertheless, 25% tariffs remain on $360bn of Chinese imports with reciprocal tariffs on US imports. Compared with October the US-China trade outlook has improved, and downside risks diminished. Further progress in this area could boost business confidence and investment spending in the wider global economy as well as in the US and China. By contrast, a re-escalation of trade tensions would have a downward influence on the global economic outlook for 2020.

Some countries in Asia are winners in the trade war – boosting their exports to the US at the expense of those from China.

Chart 9: Winners in the US-China trade war



*Other Asian includes Vietnam, Thailand, Cambodia, South Korea, Malaysia, Philippines and Australia

Source: Federal Reserve Bank of St Louis Economic Databank (FRED)

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Global economic conditions continue to dominate business and political life. News and debates on economic issues are almost constantly the focus of media attention. While most national economies are now growing once again, it is far from clear how sustainable this growth is or how long it will be before a sense of normalcy returns to the global economy.

ACCA and IMA have been prominent voices on what the accounting profession can do to help turn the global economy around. Both bodies have published extensively on a range of topics, from the regulation of financial markets or the prevention of fraud and money laundering, to fair value or the role of international accounting standards, to talent management and the development of an ethical business culture.

ACCA and IMA aim to demonstrate how an effective global accountancy profession contributes to sustainable global economic development; to champion the role of accountants as agents of value in business; and to support their members in challenging times. Both professional bodies believe that accountants add considerable value to business, and never more so than in the current environment.

Accountants are particularly instrumental in supporting the small business sector. Small and medium-sized enterprises (SMEs) account for more than half of the world's private sector output and about two-thirds of all employment.

Both ACCA and IMA focus much of their research and advocacy efforts on articulating the benefits to SMEs of solid financial management and reliable financial information.

WHERE NEXT?

As countries around the world continue to consider strategies to promote stability and stimulate growth, the interconnectedness of national economies, and how they are managed and regulated, is now under close scrutiny. The development of the global accountancy profession has benefited from, and in turn contributed greatly to, the development of the interconnected global economy. The fortunes of the two are tied. ACCA and IMA will, therefore, continue to consider the challenges ahead for the global economy, and focus on equipping professional accountants for the uncertain future.

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