What’s Next for the Global Economy?
A World Economy Fraught With Misunderstanding and Uncertainty

PRESENTATION SUMMARY

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The world economic outlook and economic policy should be simple at this time. The world economy and many of its economies are operating in a sweet spot. Having recovered from the 2008 financial crisis and 2009-10 recession, these economies are operating around their level of potential output, the level of activity that would be generated if resources were being employed at normal levels of intensity. Inflation is well-contained in most of these economies.

Economic growth should gradually slow, reflecting the fact that the output gap (the difference between the level of actual and potential output) has closed reflecting and the reality of lower potential growth due to ageing populations and hence slower labour force growth.

Monetary policy should be normalizing through both moving policy interest rates to “neutral” levels—being the spot where output stays around its potential level and inflation remains on target—and through phasing out the extraordinary liquidity interventions introduced a decade ago. That “neutral” level is subject to legitimate uncertainty, but it is certainly somewhat higher than the policy rates current in place in many economies.

Fiscal policy should be geared toward containing the run-up in debt in many countries, not in a drastic, knee-jerk fashion, but gradually. The policy actions would help contain the explosion of public and private debt, which has elevated economic risk. Having learned some lessons from the financial crisis, liquidity and other parameters in the financial sector would remain well regulated. Efforts to offset the natural slowing in growth due to demographic factors would manifest in policies attempting to raise the labour force and productivity.

Reality is far from the scenario just described. Many economists, policy makers and economic observers are failing to appreciate the slowdown in potential output growth and that many economies and the world economy in aggregate are operating around their potential capacity. Instead, they are alarmed by the slowing in economic growth, and they call for policies that will expand aggregate demand. Hence the demand for interest rate cuts, which many central banks, including the Federal Reserve Board, have acquiesced to, so far rather tentatively. Many economies are continuing to run up large public deficits and debt. Interest in tighter liquidity provisions is already wearing thin in many countries, demonstrating once again that even when lessons are learned, they are quickly forgotten.

The misinterpretation of the economic situation substantially elevates risk in the global economy. The expansionary demand policies may eventually lead to inflation above target. In any case, they contribute to the build-up of public and private debt that could choke sustained economic growth. The financial sector could become just as risky as it was leading into the financial crisis.

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These phenomena can be easily illustrated using the U.S. economy as an example. The Congressional Budget Office estimates that the potential growth rate of the U.S. economy is 1.8 percent from 2019-2023. Further, they estimate actual output is somewhat above the potential level. So actual growth rates of 1.8 percent, and even a bit less, should be considered normal. They should not be cause for alarm nor for action to expand aggregate demand. To the degree they are deemed unacceptable, efforts should be focused on expanding aggregate supply.

Instead we have a reversal in the Federal Reserve Board’s gradual move to restore interest rates to neutral. We have an expansion in federal government debt as far as the eye can see and likely beyond. From 77.8 percent of GDP last year, the Congressional Budget Office projects debt help by the public to rise to 95.1 percent by 2029.

The U.S. economy is not alone in facing slower potential growth and operating around its potential level of activity. The OECD’s estimate of the world output gap is so small, it is in the second decimal place. The potential growth rate of Japan, thought to have been 4-5 percent per annum in the mid-1980s, is just barely positive. The Canadian Government estimates the potential growth rate in Canada to be 1.7 percent, and this is in the range of estimates by the Bank of Canada. However, a 2015 study by the Centre for the Study of Living Standards pegged potential growth to be only around 1.5 percent.

As if the risks associated with misinterpreting and misreacting to economic developments did not provide concern on their own, we now have the uncertainty associated with a raging trade war between the world’s largest economies. There is really no way of predicting how that will turn out and how it will interact with the already heightened economic risks. Hopefully the trade wars of the 1930s do not provide a relevant precedent.

One thing is clear from all this misunderstanding and these risky policy moves. The economic environment will remain challenging for those individuals in a net saver position as interest rates, across the yield curve, will remain very low. Indeed, all the focus on central banks’ actions misses the larger point that markets have already voted with their money to drive most interest rates way down. The policy rates of central banks will only have a limited impact on short-term yields. Debtors, on the other hand, will continue to face favourable circumstances and will likely continue to respond to incentives to piling up what they own.

The world economy and the economies of most countries could have been in a sweet, simple place. But misunderstanding of economic developments is leading to inappropriate policies that are piling up the risks. The trade war is like pouring gasoline on an already combustible scene. It is not possible to predict if and when the fire will extinguish. In the meantime, the situation in economies and markets will not be pretty.