Prospect

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The global economy 2015

Will the next crisis start in Rome?
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Plus Jay Elwes, Nick Carn, David Hale and Malcolm Grimston

In association with GPS: Group of Producing Countries from the Southern Cone

GPS
GRUPO DE PAÍSES PRODUCTORES DEL SUR
Contribuyendo a la producción global sustentable de alimentos
Contributing to the global sustainable food production

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**Be an active participant as a non-public organization at forums where governance, production standards, and trade regulations issues are discussed, to state our position on these issues*

**Implement, disseminate, and strengthen sustainable use of and improved management of resources, with special care on environmental and social factors.*

** Promote joint efforts and integration of production and trade among the four member countries.*

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The global economy in 2015

The coming year looks likely to bring a reversal of recent fortunes: a revival of some western economies, and a stalling in China and others that have been growing fast. But that reversal brings new strains. As Wolfgang Münchau points out (p4) the eurozone is as close to break-up as it has been for two years, and Italy may prove the trigger; anyone who thinks that crisis is solved is enjoying an unjustifiably sunny dream. China is struggling to re-orientate its economic model (George Magnus, p10) and the surging economies of South America—Brazil and Chile among them—so buoyant in the aftermath of the financial crisis, are beginning to stall (see p9). The United States has provided a crutch to these nations, the Federal Reserve's ultra low interest rates maintaining a healthy level of liquidity and easy credit conditions throughout global markets. But the Fed has now ended its programme of quantitative easing, meaning that access to credit will now become more difficult, especially in those emerging markets that had come to rely on it to sustain growth.

Meanwhile Russia remains an alarming, corrosive presence on Europe's east flank. A sharp decline in the oil price, combined with sanctions after its invasion of Ukraine, are depressing its growth and threaten its long-term prospects. As Wolfgang Münchau points out, Russia's decline is affecting Germany, which has close economic ties to Russia—it supplies Germany with energy and buys its cars. Germany's weakening output is bad for the eurozone, and a weak eurozone is bad for everyone.

Conversely, as Loretta Mester, President of the Cleveland Federal Reserve Bank, points out (p8), the US economy is looking strong. She expects growth of 3 per cent in 2015, saying that wage growth will also strengthen, not only in the US but in the United Kingdom. This is good news for British consumers, who are struggling with higher energy bills, which, Malcolm Grimston says on p14, are likely to rise. But there remains a strong feeling that the UK economy is fast returning to health, so much so that Marian Bell (p12), a former member of the Bank of England committee that sets interest rates, says that the bank should "get a move on" and start raising interest rates.

> "Anyone who thinks that the eurozone crisis is solved is enjoying an unjustifiably sunny dream"

Food prices, however, are declining. As Nick Carn explains on p15, the cost of food is closely tied to the oil price, which fell sharply in October. Wheat has declined in price by 28 per cent this year. Price reductions of this sort for a range of commodities will cause food prices to fall especially in developing economies, though the effect will be felt less in the developed west.

Cheaper food will help stave off the threat of inflation in the surging economies of Africa, where several nations are beginning to enjoy substantial growth rates. Nigeria, for example, is forecast to have growth in 2014 of 6.2 per cent, rising to 6.75 per cent in 2015. Earlier this year, the country even overtook South Africa to become the continent's largest economy, with a GDP in 2013 of $509.9bn, a clear indication of the colossal untapped potential for economic progress that resides on the continent. The International Monetary Fund predicts that sub-Saharan Africa will grow at 5.8 per cent in 2015, while acknowledging the threat posed by the spread of Ebola.

2015 will be a year of fragile recovery in the US and UK. Their model, blamed with some justification for the crash of 2008, has shown more resilience than many expected, even if central questions of financial regulation remain unanswered and the eurozone remains precarious. The question for 2015 is whether this more cheerful outlook can hold good if other parts of the world slow down.

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The eurozone—still likely to crack

Possibility of a breakup is at its highest for two years

Wolfgang Münchau

The German economy has transformed itself through economic reforms. Mario Draghi, President of the European Central Bank, ended the eurozone crisis with a promise to support the euro in all circumstances. Spain goes through a miraculous economic recovery. The threat of a breakdown of the eurozone is averted.

We can tell ourselves these and similar stories over and over again. Most people believe them. They have become part of the standard narrative. But as plausible as each one of those statements may seem, they are all wrong.

The real story is that the eurozone fell into a recession in the fourth quarter of 2008, and has been stuck there, more or less, ever since. When recessions last that long, they do real, lasting damage. Many of the young people who have not worked in the last six years, may not work in six years' time either, if ever. The recession has permanently reduced the productive capacity of the economy. Investment rates have fallen, as member states are struggling to meet the fiscal rules of the monetary union. A fall in investment today means lower growth tomorrow. And lower growth tomorrow traps the public sector in Greece and Italy and the private sector in Spain and Portugal in a debt trap. The eurozone's existential crisis is economic. It is not just financial.

What is widely known as the eurozone crisis of 2010-12 was only the financial crisis. Investors pulled out of bond markets, drove bond prices lower and interest rates higher. That specific crisis ended with the lender-of-last resort guarantee by Draghi in 2012. That guarantee encouraged banks and global investors to come back, thus stabilising the sovereign debt markets.

By 2013 the world had already moved on. At the annual meetings of the World Bank and the International Monetary Fund in October 2013, the eurozone had ceased to be the central topic of conversation. Everybody talked about China, and about how the United States will normalise economic policy, by ending its programme of quantitative easing. A year later, in October 2014, the situation reversed. The eurozone was back in the dock.

The trigger was the 4 per cent decline in German industrial production during the month of August. It was one of the biggest falls ever recorded in modern German history, and brought back the fear of a renewed recession. Those of us who read the economic data month by month have learned from experience to be cautious with any set of numbers. German statisticians have great difficulties accounting for the various seasonal and calendar effects. Germany has many bank holidays that do not always fall into the same month each year. The 16 German *Länder*, the federal states, operate a complex rotation system for their summer holidays. The combination of these effects produces some freak data. But there is no question that the German economy has been slowing down markedly. The mood among German industrialists changed from euphoric during the first quarter, to pessimistic by September.

> "One country can be more competitive than another, but the world cannot increase its competitiveness as a whole"

The German economy is in reasonable shape, but not nearly as robust as is widely believed. Over the previous years, Germany benefitted from a serious of fortuitous circumstances, which have changed since the beginning of this year. The investment booms in China and Russia, as well as in many emerging markets, greatly benefited German industry. For a country its size, German industry is unusually specialised. Its main area of excellence is high-end engineering, mechanical, electrical and chemical. German companies sell high-tech plant and machinery, power plants and gas turbines, to foreign states or utility companies.

Germany has been the great beneficiary of global imbalances. One of those was the clearly unsustainable investment boom in China, where investments make up more than 40 per cent of GDP, about twice as high as investment in other advanced countries. The issue for Germany is not whether China can grow by 7 or 7.5 per cent, but how much of this is accounted for by investment spending.

China is now doing the inevitable: rebalancing towards consumer spending. China does not have to fall into a recession for Germany to feel the pinch—China just needs to revert to a more sustainable position. The success of the German economy was based to a large extent on unsustainable investment booms elsewhere.

Germany does not have a particularly strong entrepreneurial culture. It used to, in the 19th and early 20th centuries, and then again after the war. But this is no longer the case. There has been not a single globally successful information technology start-up in Germany since SAP, the software company, in the 1970s.

Germany is not a leading player in the biotech sector either. The services sector remains largely unreformed. The professions and trades are protected. There are still a few successful upmarket consumer durable goods producers, but these serve comparatively small markets. The legends of companies like Porsche or Leica are much greater than their contribution to Gross Domestic Product. They are not insignificant, but Germany is a country with 80m people and a GDP of €2.5 trillion (about £2 trillion). The bread and butter comes from highly specialised pieces of metal.

The other market that has broken away is Russia. The impact of Vladimir Putin's aggression against Ukraine has been widely underestimated because economists focused only on the direct trade links, which would not have suggested such a big impact. But in an age of just-in-time production, and global distribution networks, small shocks can have a big impact. If you feel that Putin's actions destabilise not only Ukraine, but also other parts of central and eastern Europe, you are more likely to hold back any investment projects in the entire region. When companies do not invest, they save more. And since the German government, too, saves more because it has tied its own hands with a constitutional balanced-budget rule, there is nothing that could offset the shock from the export markets.

The same happens to an even greater extent elsewhere in the eurozone. Austerity is not something they did for a year or two. It has become a way of life. Add to this

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The headquarters of Volkswagen in Wolfsburg. But modern Germany "does not have a particularly strong entrepreneurial culture"

the process of deleveraging in the private sector, and you have the ingredients for a self-reinforcing slump. It does not feel as bad as the 1930s because modern welfare systems buffer the worst parts of the shock. What is particularly disturbing is that the public, by and large, endorses austerity. In Germany, austerity wins you elections. Only the Left Party, the descendants of the old communists of East Germany, supports fiscal expansion right now. If you advocate a Keynesian fiscal response in Germany, I am afraid your only friends are communists.

For now, the prevailing narrative dominates: Germany is doing better than the rest because it reformed its labour market, while France, Spain and Italy did not. Germany pursued a more conservative fiscal policy while the others were running large deficits. According to this narrative, the threat of a crisis will vanish once everybody becomes like Germany, when everybody moderates their wages like the Germans, saves like the Germans, and exports like the Germans.

The logical flaw in this proposition is obvious to anybody who knows that, on a global level, trade surpluses and deficits must all add up to zero. One country can be more competitive than another, but the world cannot increase its competitiveness as a whole. Of course, we can all become more productive, but that is a different concept from competitiveness.

When in October the news of the fall in German industrial output came out, commentators and politicians predictably demanded that the solution to this problem is for Germany to improve its competitiveness further. Yet the issue is not a lack of competitiveness, but a lack of global demand, China's rebalancing and Putin's aggression. Even now, Germany is still running massive trade surpluses. So is the eurozone as a whole. A lack of competitiveness can hardly be the problem.

The real problem is rather different. It is a lack of aggregate demand, and specifically a lack of investment. The situation is particularly extreme in Germany. The Bundeswehr, the armed forces, is essentially dysfunctional because its equipment is in an extraordinary state of ill-repair. Many bridges and roads have turned into public safety hazards. The country is not spending enough on education either. We know that low levels of investments induce lower growth in the long run, and this, in turn, will reduce future tax revenues, laying the ground for more austerity, and even less investment. Germany would be saving itself towards a slow death, were it not for the dissaving in other parts of the world.

As the reality and narratives about Germany are beginning to diverge, the eurozone narrative must change as well. The establishment's view of crisis resolution has been that Germany provides interim support to the entire system, while everybody else reforms their economies and becomes like Germany, ▶

Will France "want to plough on in the role of Germany's permanent junior partner?"

balancing the budget each year, running current account surpluses, and keeping wage growth moderate for the sake of competitiveness. But if this strategy does not even work for Germany itself, it cannot work for the eurozone. As we are seeing in France and Italy, there is a lot of political opposition to the reforms. With global demand not supporting an export-led strategy, the economy remains weak until domestic or global demand pick up. The domestic economy is relatively stable, and feathers the fall in global demand a little. But it is hardly buoyant. And once the global economy recovers, which it will eventually, it is not clear that it will benefit German manufacturers in the way it did in the past.

With a weakened Germany, the whole edifice of our optimistic post-crisis narrative crumbles. France and Italy will not be following the German model. Italy had 15 years of stagnating productivity growth. One reason clearly is the high level of debt—now over 130 per cent of GDP. It is hard to see how it can return to positive growth rates in a eurozone with tight fiscal constraints. Unlike Germany, Italy did not manage to preserve a large exporting sector, having come under competitive pressures from emerging markets in the early 2000s. This has something to do with the nature of Italian products—less high tech, more replicable—but also with the lack of wage restraint. Italian industry is not a position to generate growth even if global demand were to pick up. A debt restructuring will not bring any relief either, since most of the debt is held domestically by banks. The only imaginable relief could be through transfers from other eurozone countries, some form of debt mutualisation, for example, through the conversion of Italian debt into eurozone debt, or ultimately through an Italian withdrawal from the eurozone.

If Italy's economic situation does not improve until the next elections, scheduled for 2017, there is a big risk that the anti-euro Five Star Movement could win that election. The party is promising a referendum on the euro. The outcome of such a referendum would be wide open. Should Italy leave the eurozone, the future of the whole project is in danger. Do we know whether France will want to plough on in the role of Germany's permanent junior partner? If the Italian economy were to recover after a euro exit, would this not encourage other countries to do the same? If the eurozone were to shrink to a small core group of countries around Germany, would the resulting euro not be a super-strong currency that would kill off the export industries of those countries as well?

It is impossible to predict whether and how the eurozone will unravel, but the situation is unstable, and any unstable situation will lead to some kind of resolution, one way or the other. Unlike a generalised run on the bond markets of 2010-12, this is a type of instability that the central bank will find harder to bring under control. If people were to conclude that the monetary union itself is responsible for their loss of wealth and income, they might vote for parties that promise an exit from the regime. So far, the majority of Europeans have not blamed the currency regime. They still believe in the narrative that labour market reforms will do the trick. But when they find out that this is not so, will they continue to support the euro? I have my doubts, although I cannot predict when this will happen.

In the case of Germany, labour market reforms were followed by a period of higher growth, but the reforms were hardly the reason. The reason was a long period of wage moderation over many years, a process that started well before the reforms in the late 1990s. The reforms did, however, have an important effect. They brought about a fall in the structural rate of unemployment and produced more low-wage jobs. That is a perfectly desirable outcome in its own right, but it has not made the German economy any stronger. On the contrary, the lack of investment, which was needed to support the austerity policies, has weakened the country in the long run.

The same goes for the eurozone at large. The current policy of forbearance and austerity may have stabilised the situation in the short run, but has done so at the expense of more instability tomorrow. My reading of the situation is that Germany will stick to its policies to the bitter end. It will not accept a fiscal union, mutualised debt, or fiscal transfers. This is why I believe the probability of an eventual break-up of the eurozone is higher now than it was two years ago when Draghi promised to do "whatever it takes."

Wolfgang Münchau is an Associate Editor and European economic columnist for the Financial Times

"Oh no! The growth we haven't experienced yet is stalling"

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The US: lift-off in 2015

Policymakers face a critical decision on interest rates

David Hale

The US economy is showing signs that its growth rate is accelerating from a little over 2 per cent during the past five years to 3-3.5 per cent. There have been large employment gains during the past few months. There was a large increase in new home sales during August. The state and local government sector is boosting output after a long period of contraction. The US economy has several growth locomotives. The business capital stock is now the oldest since 1958. If firms are to bolster productivity, they will have to increase investment.

The average age of a US motor vehicle has increased from 8.5 years two decades ago to 11.4 years today. As new cars are far more fuel efficient than older models, consumers have a strong incentive to buy a new vehicle. Housing starts are just below one million per year. As a result of new household formation and houses being demolished, the US needs about 1.6m new homes per year. The number of housing starts should rise to 1.2m next year and 1.6m by 2017.

The US is also in the midst of an oil and gas boom. Oil output has risen from 5.5m barrels per day (mb/d) five years ago to a present level of over 8.5mb/d. It could rise to 10 mb/d in the next three years. The oil and gas boom has created a great demand for capital goods.

Janet Yellen, Chairman of the US Federal Reserve, stresses that future monetary policy will be very data dependent. If the data suggests a good recovery, the Fed could decide to raise interest rates as early as next March. If the recovery is more subdued, she could wait until June or later. There are four district presidents in Philadelphia, Kansas City, Richmond and Dallas who would like to raise interest rates in the near future, but they cannot command majority support. Two of the hawks in Philadelphia and Dallas will also retire next March and April.

The disagreements at the Fed centre on how to interpret recent employment data. The unemployment rate has fallen to 5.9 per cent. The doves at the Fed believe there is still a great deal of slack in the labour market. They point to the fact that wage growth was flat in September and has risen only 2 per cent year on year. Fed governors will want to see signs of wage acceleration before they raise interest rates.

In September, the Republicans approved resolutions to fund the government through December because they did not want to create a crisis right before the mid-term elections.

Senate Republicans have an ambitious agenda. They want to approve the Keystone XL Pipeline. They want to approve new free trade agreements in the Pacific and with Europe. They want to speed up federal approvals for new natural gas projects. They want to repeal the tax on medical devices which was enacted to help fund Obamacare. They want to reform the corporate tax system by lowering tax rates and switching to a territorial tax system for multinational companies—most OECD countries use the territorial tax system.

The US has made progress in reducing its fiscal deficit. In the fiscal year just ended, the deficit fell to $483bn, or 2.8 per cent of Gross Domestic Product, compared to 9.8 per cent back in 2009. The deficit has declined because of both improvements in tax receipts and the imposition of a sequester—automatic spending cuts. Now that the US is returning to an air war in the Middle East, Congress may have to stop the declines scheduled to occur in military spending.

One of the Fed's challenges next year will be determining the country's potential growth rate. Once the economy achieves full employment and has little slack in the labour market, the Fed will have to decide how to set monetary policy. The long-term growth rate of the US economy has been above 3 per cent, but many economists believe it may now be less than 2 per cent. Productivity growth during the past two years has been only 0.9 per cent compared to 2.7 per cent during 1950-1973. The growth rate of the labour force has also slowed to only about 0.6 per cent per annum from over 2 per cent 25 years ago.

This data suggests the US may have a potential growth rate of only 1.5-2 per cent after 2016. If the Fed accepts that potential growth is less than 2 per cent, it could be forced to raise interest rates back into the 3-4 per cent range by 2017. The Fed's own survey of the members of the Federal Open Market Committee, the body that sets interest rates, suggests they expect rates to rise back to 3.75 per cent by 2017. The one factor which could delay rate hikes is the weakness of the global economy, especially Europe, and the strength of the dollar. Economic models suggest that a 10 per cent appreciation of the dollar can reduce output growth by 1 per cent within 12 to 18 months, by depressing exports and boosting imports. The dollar has been strong as investors discount the possibility of the Fed raising interest rates while the European Central Bank and the Bank of Japan pursue a more aggressive easing policy.

The US economy has grown by 11.5 per cent during the past five years compared to 22.4 per cent during the first five years of previous recoveries in the last six decades. This business cycle is now 63 months old compared to an average life of 72 months for earlier recoveries. There is no reason for this business cycle to end during the next two or three years. Inflation is still only 1.5 per cent and could decline during the fourth quarter because of falling petrol prices. Many Fed governors do not want to tighten policy until inflation exceeds 2 per cent.

Either the Federal Reserve or the Bank of England will be the first central bank to raise interest rates during the first half of next year. Both countries now have growth rates exceeding 3 per cent while unemployment has fallen sharply. As the recent volatility of financial markets will testify, investors are trying to determine when the Federal Reserve will finally act. The Fed's communiques are saying it will not raise interest rates for a considerable time. This is a confirmation that many senior Fed officials are afraid that hiking rates prematurely could jeopardise the recovery. As a result of the legacy of the financial crisis, they don't want to repeat the mistakes the Fed made in 1937 by tightening policy after the economy escaped from the 1929-1933 depression.

The US will finally have lift-off next year, but by 2017 the big issue will be the economy's potential growth rate. It is declining and will impose constraints on growth once the economy achieves full employment.

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Wage growth will improve

Bonds being received at the Federal Reserve Bank of Cleveland in December 1942

Interview: with the newest regional Federal Reserve President
Loretta Mester

"I think that again we, like the United Kingdom, have seen very slow wage growth, so far," says Loretta Mester, President and Chief Executive Officer of the Federal Reserve Bank of Cleveland. "But again as the economy picks up some momentum and unemployment continues to fall and firms continue to hire, I expect wage growth to pick up." Loretta Mester took charge of the Cleveland Fed in June. She is also a voting member of the Federal Open Market Committee—the body chaired by Janet Yellen, the Chairman of the Federal Reserve Bank—which sets US interest rates.

Mester spoke exclusively to *Prospect* on a wide range of subjects, including the concept of secular stagnation. This theory was first posited by the economist Alvin Hansen in 1938 and recently resurrected by Lawrence Summers, the former United States Treasury Secretary. The theory states that economies can experience long periods of weak demand, which cannot be overcome even by near-zero interest rates.

"I am probably a little bit more optimistic about the US economy, I think fundamentals are very good here," says Mester. "We have made a lot of progress. I am not as negative as some on longer-term growth. I am still thinking that there will be around 2.5 per cent—I admit that this is a little bit slower than I would have had before the financial crisis."

Mester says that "there has been some decline," in economic growth for the US and other developed economies, "but that reflects things like demographics." In her remarks she also addressed the connection between technological innovation and growth, which some experts, most notably Professor Robert Gordon of Northwestern, have suggested is ruptured.

"I am more positive on innovation," says Mester. "I think that some people are saying that innovation—we have basically gotten all we can out of tech innovation—and I don't buy that. I think we have more to do there and I am more positive."

According to the International Monetary Fund, the US will experience Gross Domestic Product growth of 2.8 per cent in 2014—UK GDP growth is expected to be 3.1 per cent. But just as significant as the economic growth itself is what happens to wages.

"Research has shown that wage growth picks up with inflation, it doesn't necessarily lead inflation," she says. "I am expecting as growth picks up here we are going to see some acceleration in wage growth," though as David Hale points out (see p7), there is disagreement at the Fed centre on how to interpret wage and employment data.

It is an analysis that would please the UK government. The opposition has attacked the government's economic record on precisely this point, maintaining that there is a "cost of living crisis"—that the economy is fundamentally broken, no longer capable of passing on the benefits of economic growth to the broader population. Mester disagrees.

Before wages can rise, productivity must increase: output per employee must rise. The current consensus is that productivity growth is weak, but Mester challenges this. "I take lessons from the 1990s," she says, "when many economists were concerned about the low productivity growth." However, she says, "those numbers got revised up and productivity growth ended up being stronger than it was anticipated to be."

"If you look at the innovation that's going on in the economy, I think that productivity growth is going to pick back up. I am not extrapolating out the weak productivity growth that we have seen."

For that reason, Mester says that, "the US economy is probably on firmer footing than it's been in some time," citing the declining unemployment rate, improving business and consumer sentiment and stimulative policies from the Federal Reserve. She also adds that because of declining spending by the US government, "fiscal policy is less of a drag—and no drag this year—probably and turning to a bit of a positive next year." She also expects inflation to rise gradually, held down by recent declines in oil prices.

However, she also notes that there are "still a significant number of long-term unemployed," in the US. Could this be in part due to the effects of the continued slump in the eurozone?

"Certainly export growth will be affected and we have a stronger dollar and that affects our economy," says Mester, who forecasts growth in the US next year of 2.5 per cent. This level, she says, takes account of "some of the drag, if you will, from Europe on the export side."

Interview by Jay Elwes, Deputy Editor, Prospect

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South America's shift

Bad news for Brazil, good for Mexico

Ciro Echesortu
Ivan Aftalion

The year 2015 may prove to be a humbling one for South America. In the next 12 months, there will be elections in Bolivia, Uruguay and Argentina, and many incumbent parties will win re-election—just as in Brazil's recent election. Politicians are still benefitting from the effects of external economic trends, which in the 10 years leading up to 2013 delivered something of a golden decade for the continent. But that trend is set to change.

Economic growth in Asia during the 2000s and the expansive policies in China and the United States following the financial crisis, led to a unique combination of commodity price strength and low interest rates. This boosted growth in the so-called "Brazilian Cluster" of South American nations: those countries that are net exporters of commodities to other emerging economies and which have limited trade links to developed markets. By contrast, the so-called "Mexican Cluster" of nations—those dependent on trade with developed countries and which are importers of commodities—fared less well. Now, as US growth improves and commodity prices decline, there is likely to be a reversal of fortunes between these two clusters.

The eurozone is trying to head off deflationary pressure, the US is beginning to move towards interest rate normalisation and China is attempting to develop a more service-oriented economy—all of these factors are slowing demand for commodities and Latin America will feel this reduction in demand. The region only has itself to blame. A decade of unique external circumstances led to strong growth and substantially improved social conditions. But governments failed to capitalize by conducting institutional reform, or forging effective regional trade agreements; governments were even weaker on educational reform, and on increasing investments in technology.

> "In a way, the pattern of the two-speed global economy is replicated in South America"

Now, US-linked economies (such as Mexico and Colombia) are set to perform better than Asia-linked countries (such as Chile, Peru, and Brazil)—without a recovery in Asian demand, the outlook is dim for these latter nations. In a way, the pattern of the two-speed global economy is replicated in South America.

Argentina suffered from high-profile financial disorder during 2014 and its overextended social spending acted as a drag on growth. Venezuela's political and economic outlook is even more uncertain, as the austerity measures necessary to compensate for lower oil revenues would require strong social and political support.

The case of Bolivia stands out, not only for the government's tight control of public finances and inflation, and its strong balance of payment situation, but also for the unexpected rise in foreign investment after the partial nationalisation of its energy sector. Paraguay has also enjoyed the benefits of being financially insulated from global markets and an improving business climate.

The region has enjoyed easy credit conditions on account of generous monetary policies by central banks in developed economies. But changes in those conditions have left some South American countries—Venezuela, Argentina and recently Brazil—with little room for manoeuvre. These nations have undergone a deterioration of their fiscal balances.

There are social consequences for this, as the conditions enjoyed during the golden decade, characterised by economic wellbeing and social mobility, come under threat of decline, notably again in Venezuela, Argentina and Brazil. Although, until now, inertia has been enough for incumbent parties to win re-election, they will find it increasingly hard to maintain their strong appeal.

As employment levels are high and excess capacity is limited, there is little scope for a pick-up in growth without generating further macroeconomic imbalances. Unless the rest of the continent carries out the kinds of structural reforms seen in Mexico and Colombia to promote competitiveness, economic performance could continue to disappoint, which would in turn put at risk the region's social advances.

In the short term, productivity weakness must be tackled, or else there is a risk that South America's so-called "golden decade" will come to be seen as an anomaly, after which the region will sink back into former levels of long-term weaker growth. Hopefully, the expected recovery in developed economies will allow Latin America to avoid a toxic combination of lower growth and social unrest.

The time has come to lift growth the harder way, via increased investment—and in South America, not everyone will be able to take the strain.

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Ivan Aftalion is Head Analyst for EM Finance of LDC

South American nations—their economic output and unemployment levels will start to diverge

	Real GDP			Unemployment		
	2013	2014e	2015f	2013	2014e	2015f
Mexico	1.1	2.4	3.5	4.9	4.8	4.5
Brazil	2.5	0.3	1.4	5.4	5.5	6.1
Argentina	2.9	-1.7	-1.5	7.1	8.8	9
Colombia	4.7	4.8	4.5	9.7	9.3	9
Venezuela	1.3	-3	-1	7.5	8	10.4
Chile	4.2	2	3.3	5.9	6.6	7
Peru	5.8	3.6	5.1	7.5	6	6
Ecuador	4.5	4	4	4.7	5	5
Uruguay	4.4	2.8	2.8	6.6	6.8	6.9
Bolivia	6.8	5.2	5	6.4	6.3	6.2
Paraguay	13.6	4	4.5	5.4	5.5	5.5

"e" = "expected" "f" = "forecast"

SOURCE: IMF WORLD ECONOMIC OUTLOOK 2014

Is China heading for trouble?

The past is not always a good guide to the future

George Magnus

In the wake of a sustained slowdown in China's economic growth, from about 11 per cent between 2006-11 to a little over 7 per cent in 2014, some people are wondering whether China could stall. That would hurt economic and social stability in China, and would add to recession and deflation risks in the world economy. But why would the world's largest economy stall?

The empirical evidence doesn't support the idea that economies get blown off-course simply because they are growing slowly or slowing down before they succumb to a sudden stop. Research conducted by the Federal Reserve Board and the Bank for International Settlements in the last few years, for example, found scant evidence of any low-growth threshold that preceded a stall, and concluded that some sort of shock was needed to produce a "knife-edge" moment.

With China slowing down to 7 per cent, it ought to be nowhere near stall speed, but if we look at the sudden growth stops that struck emerging markets in the 1990s, for example in Thailand, South Korea, Russia, Mexico and Brazil, they showed no evidence of decelerating growth before they crashed. On the contrary, in these and some other cases, growth was actually elevated or accelerating before they did. Their circumstances at the time were different from China's today in many ways, but this doesn't mean that China's growth is assured.

For the first time, the International Monetary Fund is predicting that China will slow over the medium-term, to 6.3 per cent by 2019. I would go further. The serial downgrades to China's growth forecasts since 2011 are likely to continue for the foreseeable future and I expect growth to fall to about 4 per cent— over the next several years. In and of itself, this need not be a disaster, but if it happened quickly, say in 2015-16, it would constitute precisely the kind of stall that would send strong shockwaves around the world.

China's spectacular economic ascent over the last 10-15 years has been unprecedented. The past, though, is not necessarily a good guide to the future. No country has been able to sustain much more than a decade of double-digit growth. The extraordinarily benign and rapid globalisation of trade, finance and investment, on which China was able to piggy-back, is over. In some respects, globalisation itself has stalled, if not gone into reverse, and western consumer markets, in particular, have become much more sober. Moreover, the speed of China's leap up the global size league has been achieved on the back of unrepeatable accomplishments. Some things you can only do once, for example joining the World Trade Organisation; the higher educational attainment from enrolling most children in secondary schools; the productivity growth from shifting labour from rural activities to urban manufacturing; and the efficiencies from building essential infrastructure.

Consider also that Chinese wage costs are climbing significantly. Relative unit labour costs have risen since 2000 much faster than in the United States, Europe, Japan and other major emerging markets. Productivity growth has cooled off a lot, and China's debt to Gross Domestic Product ratio has soared by 100 per cent of GDP to 250 per cent since 2004, with more and more credit needed to produce increments of growth in GDP.

Put another way, the economic development model that brought China out of poverty to what it is today is no longer fit for purpose. It has to be rebalanced. China's economy has been allowed to develop serious structural imbalances. Capital investment has grown from 33 per cent of GDP in 2000 to around 50 per cent at the expense mainly of the share of consumption. The investment-centric economy, however, is now marked by declining productivity growth, and because so much investment has been financed by credit creation, debt, leverage, and bad loans are becoming increasingly problematic. Manufacturing growth has outpaced the development of household services. State-owned enterprises, banks and agents of development have enjoyed preferential

Working in Shanghai: the Chinese economy is now facing stiff headwinds. The IMF, for the first time, is predicting that it will slow

access to resources and favours, compared with those in the private sector.

Economic rebalancing, then, is about shifting China's growth model towards household goods and services, and reallocating capital from the state sector to private and family firms. This shift can only be done effectively in the context of lower economic growth as the investment rate falls back, allowing the consumption share of the economy to expand more significantly. Rebalancing has certainly begun—though progress has not been rapid—and is bound to continue. The major question, and one that is highly relevant to the issue of a stall, is how it happens.

The key to a relatively orderly transition is the implementation of comprehensive

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economic reforms spanning, for example, land ownership and property rights, state-owned enterprises, the use of markets in allocating resources, financial liberalisation, local government finances and governance, urban residency registration, social safety nets, and the legal system.

Although the authorities have started to work on a host of reform proposals aired at the Communist Party's Third Plenum at the end of 2013, we should be under no illusion that politically more contentious reforms will be carried out, or that reform, itself, can be implemented without a cost to economic growth.

In addition, President Xi Jinping is still waging a robust anti-corruption campaign, designed not only to remove political enemies, but importantly also to *purify* the party, to use the Leninist description, so as to make cadres and officials more compliant, and less resistant to awkward reforms. This, too, has resulted in a significant cooling off of, for example, ostentatious consumption.

The biggest risk over the next 12 months, though, lies in the residential property market, where investment amounts to 13 per cent of GDP, and perhaps 16 per cent including construction materials and housing-related manufacturing. Investment growth has fallen from 35-40 per cent in 2011 to less than 15 per cent, and is still falling. This sector, which was the leading edge of growth over the last decade or so, is now fading with transactions volumes and prices falling, and inventories of unsold homes rising to 25-45 months of supply in a growing number of cities, away from Beijing, Shanghai and Shenzhen. Household mortgage volumes are rather limited in China, and so the financial risks lie with state and other companies, which have leveraged up in the property market, and with local governments. Over-supply, and over-investment, along with new regulations affecting land development, people resettlement and environmental standards will continue to suppress residential investment, despite palliative measures to improve mortgage terms and banking liquidity, and lower interest rates.

The latest consensus growth forecast for China in 2015 is 7.1 per cent but the headwinds are gaining in strength. The radical change in China's growth environment, economic rebalancing, the struggle to implement reforms including the anti-graft campaign, and downswing in credit creation and the property market are all leaning heavily on the consensus.

Even if growth were to slip to "only" 5-6 per cent next year, it would look as if China's economy were beginning to stall.

George Magnus is Senior Economic Advisor to UBS

Raise rates now

Monetary policy should be used to slow the economy, not stop it

Marian Bell

As with the United States, attention has turned to the timing of the first interest rate increase in the United Kingdom; to how far and how fast rates will rise, and what the impact on the economy will be.

The Monetary Policy Committee (MPC) of the Bank of England, which sets rates, responded to the financial crisis and the subsequent deep and prolonged recession by sharply reducing the bank's interest rate to a historically low 0.5 per cent, and by buying £375bn of assets from the non-bank private sector, in a process known as quantitative easing. The aim was to reduce long-term interest rates, boost the money supply and support asset prices. This dramatically loosened monetary stance was fully in place by July 2012.

Earnings, when adjusted for inflation, have been falling, so it will not feel like a recovery to many people—but the UK's economic output has now surpassed its 2008 pre-recession peak, marking the end of an unusually long slump in output, and the economy is expanding at a brisk pace, with business investment growing strongly. The pick-up in growth and confidence is particularly marked in the southeast, and in the service sector. Forecasts are for the economy to grow by more than 3 per cent this year—the fastest among the world's advanced economies—and close to that rate next year.

As the economy returns to normal, the "exceptional monetary stimulus," as the MPC itself has described it, is no longer appropriate. There is probably still a fair amount of slack in the economy—output per head remains below pre-recession levels—and there is little sign of inflation. But the MPC should start raising the bank rate—which it sets—from the current abnormally low level long before spare capacity is completely eroded and inflation starts to rise above target, not least because rate rises will have to begin gradually.

There is considerable uncertainty about the impact an interest rate increase will have after a sustained period of unusually low rates, particularly the effect on highly indebted households. Nor is it clear how the commercial rates faced by savers and borrowers will respond to a rise in the official bank rate. By the time the economy is running at full capacity and inflation is threatening, it will be too late to start a process that may have to proceed very slowly, calibrating the effects of higher rates as it goes. The purpose of a gradual tightening of monetary policy starting now would be to slow the economy gradually, not to stop it in its tracks.

Abnormally low interest rates are creating the wrong incentives to spend and borrow, when households still need to improve their financial position. They risk building up problems for the future. Moreover, the banking system has enjoyed a long period of easy access to low-cost funding to allow its balance sheet to repair, and financial markets may have responded to easy monetary policy by under-pricing and taking on too much risk. It is time to stop the spoon-feeding and reduce the dependency.

> "Abnormally low interest rates create the wrong incentives to spend and borrow... They risk building up problems"

The MPC has indicated that the bank rate will rise gradually, and then only to a level well below its historic average. Before the financial crisis, it tended to be around 5 per cent. Mark Carney, the Governor of the Bank of England, has suggested the new normal might be closer to 2.5 per cent. There are good reasons for this in the short term, and not just from the "headwinds" the UK is facing from the eurozone and uncertainty about the world economy. The difference between the interest rate set by the bank and interest rates offered on the high street has widened considerably since the crisis began, suggesting the bank's rate may need to be significantly lower to achieve the same commercial interest rates and economic impact.

However, that spread has partially eased back and may compress further. Moreover, there is little reason to believe the neutral equilibrium bank rate will be permanently depressed. In June, departing Deputy Governor Charlie Bean said that a rise in the bank rate to 5 per cent is conceivable in around 10 years—well within the lifetime of a mortgage. Once the bank starts to raise the interest rate, the MPC has said that it will review its quantitative easing programme. It has already stopped adding to it. Allowing the programme to decline gently over time would effectively tighten monetary policy and relieve some upward pressure on the bank rate.

One thing that should not be a prime factor in the decision on interest rates is that British and media obsession: house prices. Of course, housing and house prices matter hugely; any government with a social conscience would want to ensure its population is adequately housed. There are legitimate grounds for involvement: in the demand for and supply of housing; in land policy; regional policy; consumer protection and financial education; and to ensure financial stability. But house prices are not primarily a matter for monetary policy, which should be concerned with the economy as a whole rather than with one price within it. To target house prices with interest rates could lead to a considerable and unwarranted loss and volatility of output, income and employment.

House prices in any case appear to be slowing, on the back of the Mortgage Market Review, the Bank of England's new capabilities and demand and supply factors, including a tendency for more people to live together. If a modest rise in the bank rate towards the new normal were to have a significant effect on the housing market, far from a reason for not acting, it would be evidence of imprudent mortgage lending and unsustainable house prices.

UK monetary policy is on an extraordinarily loose, emergency setting. The MPC should start to tighten now, in response to faster growth and a return to normality in the UK economy. Fears of a future sharp global slowdown or renewed financial market volatility should not be a reason for not acting now. Rather, higher rates would give more room to cut in response to any future deterioration in conditions. To start to raise the bank rate well before next year's general election would also avoid any suspicion that politics may be influencing policy.

Rates will have to be moved in small steps, at least initially; the MPC should bite the bullet and get a move on.

Marian Bell is a former member of the Bank of England's Monetary Policy Committee

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Energy bills will rise

Fracking: the process that has led the US to energy independence

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Price caps will only increase energy bills

Malcolm Grimston

One of the many challenges for energy investors and planners concerns timescales. Energy investments involve huge amounts of capital with long payback periods, and operating lifetimes generally counted in decades. Yet market sentiment, and energy prices, change rapidly. A glance at the oil price over the last 50 years illustrates the point.

As had been the case in the 1970s, the five-fold increase in the price of oil through the 2010s was a major factor in the revival of interest in both coal and nuclear power, as well as driving a huge rise in energy costs generally. The oil price crossed the $100 a barrel level in 2010 and has remained there ever since (except for a short period in 2011). The gas price, of much more importance to electricity generation and heating in most areas of the world, tends to shadow the oil price to a considerable degree. Until recently, that is. Having stood at $115 per barrel in June, by October the price had slipped to around $85, despite conflict in the Iraq region.

A variety of factors have contributed to this. Hydraulic fracturing (fracking), not just of gas but also of oil, in the United States has had a major effect. In 2005 the US imported 60 per cent of its oil; by 2014 that was down to 30 per cent, with every prospect that the US will become an oil exporter. The end of the US embargo on Iranian oil and the restitution of Libya's oil infrastructure, damaged during the overthrow of Muammar Gaddafi, have boosted global supplies. The risk of a global recession and the slowdown in China in particular have reduced demand forecasts, as has the prospect of Japan reopening some nuclear plants. In addition, vast new reserves have recently been discovered in the eastern Mediterranean, Brazil and the South China Sea.

Of course, as the situation in the United Kingdom (not atypical of many developed countries) illustrates, falling wholesale prices are not the end of the story. Household power bills can be divided into five components. In the UK the wholesale price of power in the marketplace, a bit less than half of the total, depends heavily on the price of gas. Getting the power from the power station to our homes accounts for roughly another sixth. Operating costs (running an office, meter reading) make up a tenth, plus a profit margin of around 7 per cent. The other quarter, government costs, includes the costs of environmental and social schemes.

The availability of generating capacity is important for wholesale prices. If a few plants break down or have to be taken off line for safety checks, this tends to raise wholesale prices. It forces the use of more expensive, often dirtier, alternatives while the fear of shortages increases the price people are willing to pay for secure supplies. Unplanned power outages are extremely expensive for consumers. The wire network, by which electricity is delivered, is a regulated monopoly. A new grid capable of connecting to current levels of reliable power stations when the wind isn't blowing, and windfarms and other variable renewables when it is, will cost tens of billions. The costs of social and environmental schemes similarly are likely to continue to rise.

Social measures to help the fuel poor are of course highly worthwhile. Renewables have many attractions—a very efficient way of transferring money from hard-pressed bill-payers to rich landowners, manufacturers of equipment and an army of lobbyists and researchers. What they are not so good at is providing electricity when we need it and not when we don't. This imposes huge costs on the system, requiring for example the reintroduction of capacity payments to incentivise reliable generators to keep their plant available even when it is not earning money because, say, the wind happens to be blowing. Direct green taxes have largely been moved onto the backs of taxpayers but wider system costs will show up in bills, even ignoring the near-doubling of offshore wind costs during the last decade.

The power cuts and astronomical prices in California in 2000-01 show the acute dangers of price caps—a capping regime has at least three potential negative effects on fuel bills. First, companies will buy more gas further in advance to hedge against price rises which could not be passed on to consumers. This would lead to higher prices than a mix containing a higher proportion of short-term contracts. Second, companies are nervous of passing on falls in wholesale prices to customers in case they get stuck with rising wholesale prices. And third, with rates of return already as low as 7 per cent an impression that even these levels are under threat will drive out necessary investment. In the very short term this may reduce bills, but at an enormous cost in the medium to longer term.

So next year's bills probably won't change much whoever wins the general election. Decisions we take will cast long shadows on future costs and reliability. But if wholesale fossil prices continue to fall we may see a slowing of price rises, maybe reductions—until the screw turns again.

Malcolm Grimston is a Senior Research Fellow at Imperial College London

The cost of food

The cost of chocolate is unlikely to rise

Nick Carn

Food prices have moved substantially in the course of the last decade. The single most important short term influence on wholesale food prices is the price of oil—not the edible type but the black sticky stuff over which wars are fought. Making artificial fertiliser is very energy intensive and it is the cost of fertiliser that affects food prices at the margin. The oil price soared between 2006 and 2008 and food prices rocketed too. Rice rose by 217 per cent, wheat by 136 per cent and soy by 107 per cent. The effect of rising energy costs was further exacerbated by the diversion of crops and acreage to the production of biofuels. Combined with anxieties about climate change and soil degradation this produced widespread fear of a "commodity supercycle"—a long, upward trend in prices.

If there really is such a thing, it certainly went into remission with the recession that followed the financial crisis. Within less than a year of coming close to $150 a barrel, oil was trading in the mid $40s and food prices had accompanied it down. They subsequently rose again, peaked in 2011 and have now fallen back. This year, in spite of steep rises in the price of some minor commodities such as cocoa, two important staples—wheat and corn—have continued to fall, by 28 per cent and 23 per cent respectively. The weakness in the oil price suggests that overall pressure on wholesale prices is likely to be modest.

In poor countries it is mainly the price of raw commodities that determines food prices. Consumers in rich countries are at the end of a long value added chain of processing, packaging and branding. Even with a 70 per cent rise in the price of cocoa butter this year, Hershey's, the world's biggest producer of chocolate, is planning to raise its prices by only some 8 per cent—a price rise which retailers may well choose not to pass on. In the United Kingdom, the effects of the current supermarket price war are likely to overwhelm changes in raw material prices.

The longer-term influences on food prices are very different, and difficult to disentangle from the effects of the ups and downs of the economic cycle. The change in dietary habits which goes with increased affluence increases pressure on resources. Animals are inefficient converters of food. It takes about 7kg of feed grain to produce 1kg of beef and a shift towards consuming more meat, seen in much of Asia, puts relentless pressure on resources.

But the development of artificial fertilisers transformed yields and made it possible to bring into production land which previously was not viable. It is in the area of creating new crop varieties, however, that the future looks most interesting. In spite of the publicity given to "Frankenstein" foods and transgenic organisms, it is further developments in more established technologies that are currently moving the frontier forward. Mutagenesis, the deliberate altering of genetic information—first developed in the 1920s—is widely used and more than 2,700 mutation-derived crop varieties have been obtained worldwide in the last 60 years. More recent developments in biotechnology, in particular Marker Assisted Selection, which allows indirect selection of particular traits have yet to be applied to major subsistence crops, although it has begun to produce some significant results such as the development of a pearl millet hybrid with resistance to downy mildew disease. Knowledge of DNA markers was applied to develop a flood-tolerant rice variety used by three million farmers in India in 2012. Transgenic technologies that involve introducing genetic material from another species are the next stage, and, in reality, not the sea change that is often depicted.

The influences on food prices are both cyclical and technological. Technology has transformed crop yields partly through the development of artificial fertilisers and partly through selective breeding of which transgenic techniques are the latest manifestation. The falling cost of genetic analysis will lead to acceleration in this and related areas. Meanwhile, the cyclical influences on food prices, in particular the fall in energy prices, are likely to lower global wholesale prices.

How that affects the shopping basket of the western consumer is another question. That shopping basket is a complex amalgam of promotional costs, wages, rents, taxes and transport costs as well as a small component of global raw food prices. In the short term, the effect of a concerted retail price war, or not, will readily overwhelm the underlying trends.

Nick Carn is founder of Carn Macro Advisors

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