THE AUSTRALIAN FINANCIAL REVIEW

Global economy struggling for growth despite limited good signs in US and China

John Kehoe, James Chessell, Lisa Murray, and Angus Grigg

April 23, 2016

When an earnest Glenn Stevens spoke to investors in New York this week, shares on Wall Street were nearing record highs, commodity prices rebounding and signsemerging that China's shaky economy was stabilising.

Yet investors cheering the market bounce may have been jolted from any complacency on hearing the Reserve Bank of Australia governor's sobering assessment of the world economy and financial markets.

"The relative 'calm' seems a little eerie – perhaps fragile," said Stevens, who had discussed the situation with finance ministers and central bank governors from leading economies in Washington in earlier days.

While the immediate fear of a China meltdown has passed – as Beijing unleashes new stimulus and the US Federal Reserve has soothed markets by winding back the pace of expected interest rate increases – the world economy remains anaemic.

GROWTH REMAINS SLUGGISH

Global economic growth has averaged about 2.5 per cent over the past five years, compared to about 4 per cent in the five years before the 2008 global financial crisis.

Stephen Roach, a former chairman of Morgan Stanley Asia, says the world economy is "dangerously close to stall speed" and lacks resilience. "We're a shock away from the next global recession," he says.

Of course, there is deep divergence across the globe.

The economies of Australia, the US and Britain are expanding at sub-standard, but not terrible, annualised rates of 2 to 3 per cent. Unemployment is below 6 per cent, though income growth is weak.

Developing commodity export markets like Brazil and Russia are mired in deep recession, while Japan, South Africa and Argentina are on the verge of going backwards.

The recovery in Europe has been sluggish and the outlook has worsened, leaving Europe vulnerable to a possible "Brexit" and Greece's ongoing budget problems.

Emerging markets like India and Indonesia are rare bright spots, though susceptible to emerging market troubles, especially if the Fed lifts rates faster than anticipated.

Most importantly for Australia, China is one of the few countries where short-term growth forecasts are being upgraded.

CHINA NOT ALL BAD NEWS

Spooked by the slowing economy and financial market turmoil in the new year, Beijing is pumping credit into the economy at the same pace as it did during the 2008-09 global financial crisis.

In the short term, this debt-fuelled strategy is proving good for Chinese growth and for Australia.

Chinese steelmakers have ramped up production for construction activity, mainly in the housing market, which government-directed banks have loosened credit terms for.

Australia's largest export, iron ore, punched through a 15-month high of $US70 a tonne before the weekend and BHP Billiton's share price lifted above $21 for the first time since November.

Economists worry the Communist Party is backtracking on its once grand plans for restructuring the old industrial economy and is unwilling to tolerate slower growth, even if it is more sustainable.

China's combined business and government debt to GDP ratio has hit more than 230 per cent of GDP, up from an already elevated 170 per cent in 2008.

Jonathan Anderson, the International Monetary Fund's former chief representative in Beijing, says China is in the middle of a "credit bubble" that will inevitably lead to a financial crisis or Japan-style stagnation.

But he says either scenario is not imminent. Anderson reckons China can keep pumping credit into the economy for at least five years.

SEARCH FOR SOLUTIONS

Internationally, there is little room for error, given other risks in indebted emerging market economies, oil price gyrations, geopolitical flux associated with Britain contemplating exiting the European Union and an outside chance of economic nationalist Donald Trump becoming US president.

Policymakers are debating how to resuscitate glacial growth and observers are arguing over who to blame for persistent mediocrity and stubbornly weak global inflation.

Pointedly, Stevens made a material contribution, by warning that monetary policy was reaching its limits and that talk of so-called "helicopter money" drops by central banks to governments or households was not the solution.

"Are we that desperate?" Stevens asked.

Stevens suggested that history showed it would be hard to turn off the free money, once the tap was turned on.

Moribund Europe and Japan are already among jurisdictions experimenting with negative interest rates, in an effort to ignite feeble inflation and revive their frail economies.

European Central Bank president Mario Draghi has described helicopter money as a "very interesting" concept. Former Fed chairman Ben Bernanke says it could be a "valuable tool" as a last resort.

German officials regard Draghi's comments as yet another example of the ECB's infatuation with cheap money.

German Finance Minister Wolfgang Schaeuble recently blamed the ECB's policies for being partly responsible for the country's anti-immigration Alternative for Germany party.

Other politicians criticised the move to negative rates for putting a "gaping hole" in pensions.

On Thursday, Draghi left ECB policy unchanged. He said the bank is ready to use "all instruments available", including diving deeper into negative rates.

Draghi clarified there would be "operational and legal difficulties" in launching helicopter money and indicated it was not a near-term option.

Nevertheless, the big problem in major developed economies and financial markets is that they are hooked on central bank stimulus, says Roach, now a senior fellow at Yale University's Jackson Institute of Global Affairs.

He argues that the unprecedented central bank liquidity to the financial system to ward off the 2008 financial crisis, is the the wrong medication for today's problems of a limp economy.

Furthermore, aggressive central bank asset buying and negative rates are taking the pressure off politicians to embark on growth friendly policies, he adds.

"By utilising monetary policy to create euphoric market outcomes, they undermine the incentives of fiscal authorities [governments] to do the heavy lifting that the structurally impaired economies require," Roach says.

Bank of Mexico governor Agustin Carstens said immediately after Stevens spoke in New York on Tuesday that part of the problem is too much of the "adjustment load has been placed on monetary policy".

"Monetary policy just doesn't have the capacity to influence in a persistent fashion potential GDP and productivity growth," Carstens said.

Monetary policy is limited in influencing short-term aggregate demand in the economy.

It is the responsibility of governments, through responsible budget spending and micro-economic reforms, to manage medium to longer term growth.

FOCUS ON REFORM

Mexico is one of the few countries in recent times to embark on an ambitious reform program. The monopoly energy and telecommunications sectors are being exposed to competition, education standards lifted by ending the overprotection of teacher union members, unfair dismissal laws loosened to encourage hiring, budget rules stiffened and the supervision of banks improved.

Though oil-rich Mexico has unavoidably been hit by the slump in energy prices, it is a relatively bright spot compared to neighbouring peers in Latin America and the Caribbean, many of whom are mired in recession.

Stevens urged political leaders from around the world to consider adopting Australia's successful economic reform playbook of the 1980s and '90s, to lift long-term growth rates.

And for those such as former US Treasury secretary Larry Summers worried about a lack of demand in the world economy and a shortage of real economic assets for capital to invest in, Stevens added that governments with fiscal capacity should spend on productive infrastructure projects by taking advantage of ultra-low borrowing costs.

Productive infrastructure investment could boost short-term demand and lift productivity by raising the economy's long-term supply capacity.

The catch is, politicians have a knack of picking bad projects, that tend to be popular with voters in marginal electorates but deliver poor value for taxpayers.

As Stevens alludes to, without actually naming any politician or party, the Bob Hawke and Paul Keating Labor governments, followed by the John Howard-led Coalition government, implemented bold economic reforms.

They reformed the tax system, slashed tariffs, floated the currency, privatised public assets, exposed protected industries to competition, increased labour market flexibility and deregulated the financial system.

Combined with the luck of the China boom and housing booms, the reforms have helped Australia deliver 24 consecutive years of economic growth.

BHP Billiton's Scottish-born chief executive, Andrew Mackenzie, says with interest rates at record lows and stimulus programs already running at full tilt, Europe is fast running out of options.

"The central bankers have to some extent run out of levers," Mackenzie says.

"It's up to the political process to try to drive the reforms that increase the size of the pie first and then find an equitable way to distribute the pie."

Beyond the necessity for micro-economic reform, another big problem in Europe is that since the 2008 crisis, its banks have not recapitalised as quickly as Wall Street lenders.

The onset of negative rates from the ECB is further hurting European commercial banks, by squeezing their profit margins and reducing incentives to lend.

Whereas credit growth in the US was a healthy 9 per cent last year, it was less than 3 per cent in moribund Europe. And lending is critical to generate economic growth.

European banks are stuffing away reserves at the ECB, instead of boosting lending to entrepreneurs and businesses.

The better capital position of US banks may be a reason the Fed's $US4 trillion bond buying program that ended in 2014, despite arguments over its efficacy on the real economy, appears to have been comparatively more successful than the ECB's bond purchases.

"Quantitative easing or negative rates don't work if you don't have a healthy banking system," IHS chief economist Nariman Behravesh says.

Paradoxically, George Selgin, director of the free-market Cato Institute's Centre for Monetary and Financial Alternatives, argues tighter regulation imposed on banks since the crisis is the real problem blocking the flow of credit to would-be productive borrowers.

In any event, politicians in the US, Europe, Australia and perhaps even reform-conscious China, are reluctant to wear the political pain of difficult economic changes.

In the US, presidential frontrunners Hillary Clinton and Trump are even threatening to reverse economic liberalisation by opposing international trade agreements and vowing to renegotiate deals.

The US economy hit a soft patch in the first quarter, with weak retail sales, a big drop in capital investment spending by energy producers due to the oil price drop and the export sector hurting from a high US dollar.

But Behravesh says the American consumer, which represents 70 per cent of the economy, is still doing well.

The economy should pick up in the months ahead due to modest income growth, job additions, the low oil price boosting spending in other areas and interest rates remaining low.

JPMorgan chief Jamie Dimon concurred last week, saying the balance sheet of the American consumer is "pretty good".

On Europe, Citi's chief economist Willem Buiter points to staggeringly high levels of youth unemployment in countries such as Spain, Italy, Portugal and Greece that threaten to create a lost generation that is forced to exist without a job or move abroad to find work.

The challenge facing European policymakers is exacerbated by a series of debilitating crises that has gripped the continent over the past two years: the potential exit of Greece known as "Grexit"; a string of deadly terrorist attacks; Russian aggression in the Ukraine; the worst migration crisis since World War II; and, more recently, the possible exit of Britain from the 28-member EU known as "Brexit".

Lingering opposition to austerity measures and concerns about immigration have given rise to populist politicians across the EU who advocate cutting ties with Brussels and argue for protectionist policies.

"Cyclically, the Euro area is experiencing a bit of a recovery," Buiter says.

"Yet [it] requires a transformation of economic policy and structural reform".

In China, the sudden reversal of policy from Beijing has seen economist scrambling to upgrade their growth forecasts recently, even as they express concern about China in the longer term.

UBS chief China economist Wang Tao believes the economy will grow at 6.6 per cent this year, up from her previous forecast of 6.2 per cent. And she sees growth at 6.3 per cent in 2017 rather than 5.8 per cent previously.

"The ongoing economic and property rebound has been clearly helped by a strong government-led credit expansion, which raises concerns on the sustainability of growth and China's medium-term debt dynamics," Wang said in a note to clients.

"We believe investors will become increasingly concerned about the profitability of growth, potentially larger excess capacity and bad debt problems, and the cost of any clean up."

Investors are thinking more short term.

The US Dow Jones Industrial Average this week popped through 18,000 points for the first time since July 2015, Australian shares rallied hard, the Australian dollar approached US80c and iron ore has surged 84 per cent since bottoming at $US38.30 in December.

In truth, much of the rebound is a reversal of the violent asset sell-off across the first six weeks of 2016.

Markets have been buoyed by China's stimulus, the Fed delaying raising rates and US corporate first quarter earnings falling less than predicted.

In New York, Treasury Partners chief investment officer Richard Saperstein says he is cautious on the recent "market melt up", because it is too dependent on central banks.

If the US dollar's recent decline continues on bets the Fed is in no hurry to tighten, J2Z Advisory principal Jay Pelosky says it will bring broader benefits to the world economy.

As well as boosting US exports, a weaker greenback would support Chinese state-owned enterprise reform by allowing the US dollar-linked yuan to weaken without devaluation, underpin commodity prices such as oil and support emerging market economies to repay US-dollar debts.

Yet many factors seen as boosting financial markets are hardly the economic reform foundations that Stevens says the world economy desperately need for long-term sustainable growth to lift living standards.