QNB Economics
economics@qnb.com
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Lower interest rates will support the global economy despite headwinds

The International Monetary Fund (IMF) lowered the forecast for global GDP growth in the July update to their World Economic Outlook. We see this as an acknowledgement of headwinds that have been building for some time, particularly the trade war between the United States and China. We agree that risks to the outlook are mainly to the downside. However, Chinese policymakers have already increased policy support and we expected both the Fed and ECB to follow through on their dovishness by easing monetary policy before the end of the year.

Here we take stock of the three main headwinds and the main areas of policy support, focusing on how high debt levels may be preventing central banks from raising interest rates to a more normal level.

The first major headwind to the global economy is increased protectionism from the United States (US) in its trading relationships with other countries. This is most evident in the trade war between the United States and China, but is also at play in the process to update the North American Free Trade Agreement (NAFTA) and trade tensions between the US and Europe. Our optimism about a deal in April was based on our understanding that the technical aspects of a deal had been discussed and broadly agreed by trade experts on both sides. US President Trump is pushing something that he can present as a deal to help with his campaign for re-election. However, we now believe that the long-term strategic rivalry between the US and China will prevent a substantive deal being agreed.

Second, political uncertainty is a headwind for growth in a number of countries and regions. Here we consider the example of Brexit and its impact on the European economy. Britain's new Prime Minister Boris Johnson has promised to deliver Brexit on the 31 October 2019 with or without a deal. We are sceptical that he will be able to achieve this given the impasse caused by a broadly balanced three-way split of positions in the House of Commons. Our view remains that a general election and/ or second referendum will be required to break the impasse. The main problem is a potentially severe disruption of trade between the European Union (EU) and the UK, which is currently the EU's second largest economy. If the UK leaves the EU without a deal, then trade will become slower and more expensive due to the likely imposition of tariffs and customs checks. This will directly hit GDP growth both in the UK and in the EU because they both represent large markets for each other. The persistent uncertainty around Brexit has already weakened both UK and EU growth indirectly via lower investment and weaker business and consumer confidence.

The third headwind comes from high levels of global debt (see chart 1). The low interest rate environment since the 2009 global financial crisis encouraged many countries and companies to borrow money. Debt is not a problem if it is used to finance productive investment. However, much of the borrowed money has been used to fund consumption rather than investment (e.g., Italian government debt) or may not have been invested wisely (e.g., Chinese ghost cities). Such debt is likely to be a burden to service (i.e., pay the interest) or may even prove unsustainable if interest rates rise significantly.

These and other headwinds facing the global economy have already prompted central banks to increase policy support. Therefore, easier financial conditions will support global GDP growth in 2020.

First, the Fed's recent interest rate cut and dovishness, may pose a risk to its independence after allowing Trump and financial markets to paint it into a corner. We now expect one further rate cut of 25 basis points in September or December.

Second, weak inflation has forced the ECB to commit to easing policy, most likely in September. However, limits on bond buying and the impact of negative policy rates on bank profitability mean that the precise details are likely to be complex and remain vague due to political sensitivities.

However, high levels of debt and low interest rates mean that monetary policy is becoming less effective at stimulating stronger economic growth. Interest rates have been falling for decades and have been ultra-low since the 2009 global financial crisis (see chart 2). Indeed, the global economy may have become trapped in a low-interest rate, low-growth equilibrium, in which central banks are simply unable to normalise policy by raising interest rates to higher levels for fear of triggering another global financial crisis.

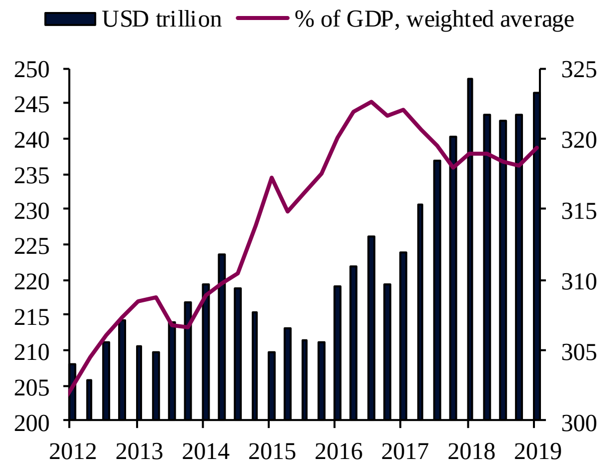
It was excessive risk taking within the global banking system that made the 2009 global financial crisis so severe. Fortunately, regulation of bank capital and liquidity has improved significantly and the introduction of macro-prudential policy should help make many major banks shock-absorbers rather than shock-amplifiers. Therefore, we do not expect the next crisis to be a re-run of the 2009 crisis.

The only real way out of such a low-rate low-growth equilibrium would be for governments to undertake a combination of fiscal stimulus and politically difficult structural economic reforms.

Chinese policymakers use monetary stimulus alongside fiscal stimulus to provide support to the economy. On the fiscal side, the government has already reduced VAT rates and social security taxes as well as special tax deductions for households. On the monetary side, the People's Bank of China (PBoC) is likely to use various tools to ease financial conditions in the interbank market and direct more loans to the private corporate sector rather than the bloated state-owned sector.

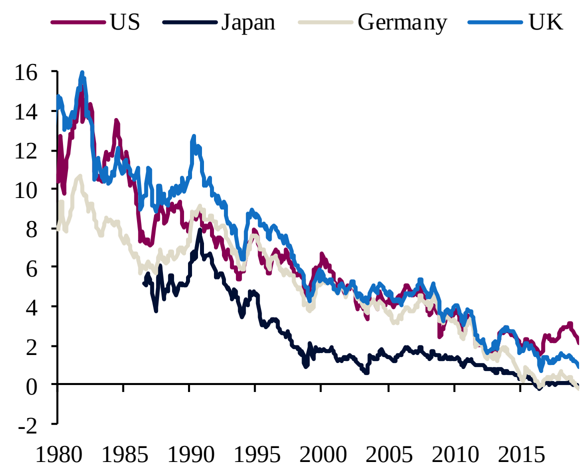
Global institutions like the IMF and the Organisation for Economic Coordination and Development (OECD) specialize in making recommendations for structural reforms. For example, increasing government investment to update and upgrade aging transport infrastructure would surely boost growth in both the US and Germany. Whereas, labour market reforms in Japan and France would increase both productivity and the availability of labour. Such reforms are politically difficult at the best of times, but are likely to be even more challenging in light of the headwinds we have presented here.

Chart 1: Total global debt
(USD trillion)



Sources: IIF

Chart 2: 10-year government bond yields
(yield, percent)



Sources: U.S. Treasury, Ministry of Finance Japan, Deutsche Bundesbank and Bank of England via Haver Analytics

QNB Economics Team:

James Mason*
Senior Economist
+974-4453-4643

Luiz Pinto
Economist
+974-4453-4642

Abdulrahman Al-Jehani
Research Analyst
+974-4453-4436

* Corresponding author