



The Global Outlook

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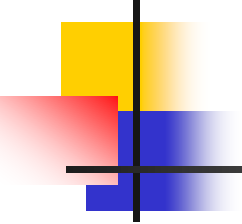


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Outline

- All major global engines are now firing.
 - US recovery is the longest post war expansion but recoveries don't die of old age. Typically, comes to an end with tightening.
 - Europe growing above potential – lending picking up from low levels and offsetting ECB tightening. Still plenty of slack in periphery.
 - China managing its slowdown to sustainable growth.
 - Commodity-intensive EMs like Russia, Brazil, and South Africa stabilizing. EMs better placed with lower trade deficits and higher reserves but political developments critical.
 - Brazil pensions

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- Investment should pick up as labor markets get tighter.
 - Apart from hard-to-gauge geo-political risks, key risks include
 - Disruptive monetary policy normalization – either too fast and too slow
 - Trade frictions
 - Clean-up in the Chinese financial sector
 - Risk of populist excess



United States

- Consumption has been leading growth so far.
- Business investment looking up as labor market tightens.
- Reforms
 - Bonfire of regulations, lighter enforcement
 - Tax reform– adds to corporate profitability, already growing by double digits
 - Infrastructure investment?
- Recovery long in the tooth. Typically ends with significant monetary tightening. Is that likely?



Should we expect higher rates?

- Labor market tight
 - Unemployment down, and across the world.
 - Shortage of skilled labor
 - Wage growth up 2.9 percent
 - Core inflation up 0.35 % m/m in January
- Tax reforms good for long term, but timing poor, and worse on fiscal discipline: fiscal deficit 6% in 2019 and 2020
- Fed likely to continue tightening
 - Front of mind – growing inflationary pressures
 - Back of mind – financial sector risk taking



Market adjustment

- Leverage high because of long period of accommodation:
 - Covenant lite loans
 - Withdrawal of liquidity could create financial stress
- Markets not fully absorbed change in central bank behavior
 - Risk spreads widen as search for yield lessens. Risky asset prices will adjust.
 - Central bank put less needed as growth picks up.
- Volatility as the market adjusts



Risks

- Monetary policy will normalize steadily, with greater risk that central banks will fall behind than they will move too fast
 - Asymmetric aversion to moving too fast
 - Not hyperinflation but some disruption



- Trade

- US tax reforms add to stimulus

- Trade deficit will grow

- Blame it on unfair trade

- Section 201 safeguards: Tariffs against solar cells and washing machines

- Section 232 national security: Tariffs/quotas against aluminum and steel

- Section 310 unfair trade practices: China forcing firms to share IP

- NAFTA: 3-4%

- Retaliation?

- Other protectionist moves to raise tariffs...



Risks

- China

- Shift towards sustainable growth
- Deleveraging financial sector especially shadow financial system
 - Many bonds issued by local government vehicles due from this year
 - Raising cost of short term financing to curb issuance of wealth management products curbed
 - Fast growing private companies – Anbang, Dalian Wanda, Fosun, and HNA curbed
- Once again risks of moving too fast or too slow
- Growing authoritarianism may be problem for medium term



Risks

- Growing inequality and rise of populism
 - Solutions are hard and long term
 - Political pressure for solution is today
 - How do we prevent the present from becoming the enemy of the future.



Bottom Line

- Recovery broad based
 - Investment picking up
 - Productivity growth still tepid
- Interest rates will go up
- Elections (Italy, Brazil) will make year interesting
- Fix the house while the sun is shining.