Giddy markets and grim politics

Kenneth Rogoff | Harvard University | 17 January 2018

Economic growth worldwide picked up in 2017, and the best guess is that the global economy will perform strongly in 2018 as well. At the same time, a rising tide of populism and authoritarianism poses a risk to the stable democratic institutions that underlie long-term growth. And yet headlines seeming to portend political instability and chaos have not prevented stock markets from soaring. What gives?

First, the good news. Surely the largest single factor in the synchronised global upswing is that the world economy is finally leaving behind the long shadow of the 2008 financial crisis. Part of today's good fortune is payback for years of weak demand. And the rebound is not over, with business investment finally picking up after a decade of slack, thereby laying a foundation for faster growth and higher productivity gains in the future.

True, economic growth in China is slowing somewhat as authorities belatedly try to contain a credit bubble, but many other emerging markets - notably including India - are set to grow faster this year. Rising stock and housing markets may fuel inequality, but they also drive increased consumer spending.

Investors and policy wonks are also cheered by the resilience of central bank independence in the major economies. US President Donald Trump has not only largely spared the Federal Reserve the not-so-tender mercies of his wee-hour tweets, he has also nominated highly qualified individuals to fill Fed vacancies. Meanwhile, the German right has failed to pull the plug on European Central Bank policies that have helped prop up Italy, Spain, and Portugal, and the ECB remains by far the most respected and influential eurozone institution.

Elsewhere, things are pretty much the same. In the United Kingdom, British Prime Minister Theresa May, early in her tenure, once took a swipe at the Bank of England but quickly retreated. As Mohamed A. El-Erian has noted, many investors regard central banks as "the only game in town" and they are willing to overlook a lot of political noise as long as monetary-policy independence is upheld.

But while politics is not, at least for now, impeding global growth nearly as much as one might have thought, the long-run costs of political upheaval could be far more serious.

First, post-2008 political divisiveness creates massive long-term policy uncertainty, as countries oscillate between governments of the left and the right.

For example, the recent US tax overhaul has been advertised as a surefire way to boost corporate spending on long-term investment projects. But will it live up to its billing if businesses fear that the legislation, passed by a thin partisan majority, will ultimately be reversed?

Part of the case for trying to secure bipartisan agreement on major long-term policy initiatives is precisely to ensure stability. And policy uncertainty in the United States is nothing compared to the UK, where businesses face the twin disruptions of Brexit and (potentially) a Labour government led by the far-left Jeremy Corbyn.

Harder to assess, but potentially far more insidious, is the erosion of public trust in core institutions in the advanced economies. Although economists have endless debates about whether culture or institutions lie at the root of economic performance, there is every reason to be concerned that the recent wave of populism is a threat to both.

Nowhere is this truer than in the US, where Trump has engaged in unrelenting attacks on institutions ranging from the mainstream media to the Federal Bureau of Investigation, not to mention adopting a rather cavalier attitude toward basic economic facts. At the same time, the left seems eager to portray anyone who substantively disagrees with its proposals as an enemy of the people, helping fuel both economic illiteracy and a hollowing out of the center.

Beyond existential risks, there are near-term risks. One, of course, is a potential sharp growth slowdown in China, which more than any other major economy in the world today seems vulnerable to a significant financial crisis. Perhaps the number one risk to the global economy in 2018, however, is anything that leads to a significant rise in real (inflation-adjusted) interest rates.

Low interest rates and easy monetary policy have papered over a multitude of financial vulnerabilities around the world, from Italian and Japanese government debt to high corporate dollar debt in many emerging markets, and perhaps account for political support for trillion-dollar deficits in the US. Admittedly, markets see little chance of any significant rise in global interest rates in 2018. Even if the Fed raises rates another four times in 2018, other major central banks are unlikely to match it.

But market confidence that interest rates will remain low is hardly a guarantee. A plausible pickup in business investment in the US and northern Europe, combined with a sudden slowdown in Asian economies with surplus savings, could in principle produce an outsize rise in global rates, jeopardizing today's low borrowing costs, frothy stock markets, and subdued volatility. Then, suddenly, the economy's seeming disconnect from politics might end, and not necessarily in a happy way.

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