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# Global Economic Prospects in 2017: Take Nothing for Granted

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## OVERVIEW

***Markets showed impressive resilience in the face of a range of geopolitical shocks in 2016, but recent market moves suggest this year could be different. A greater range of possible, if unlikely, political challenges, as well as U.S. monetary policy normalization, could bring a crisis back to the fore.***

## CRISIS RISKS FOR 2017

Regular readers know that I enjoy the January tradition of searching for creative ways that the world could go off-kilter in the coming year. Because I am surrounded by colleagues here at the Council on Foreign Relations, it is easy for me to see a world fraught with geopolitical risks that could readily create chaos in global markets. Last year, for example, I highlighted risks emanating from China, high levels of emerging market debt, and a rising dollar. I was particularly worried that rising populism would hamstring policymakers' capacity to respond to problems. Not bad predictions, though, along with many others, I missed both the Brexit vote and the U.S. election. I also did not anticipate that China's massive fiscal stimulus would take Asian risk off the table, at least temporarily. However, continuing capital outflows from China have required intensified capital controls and I see this as a debt crisis deferred, not resolved. Last year's political and financial surprises did occasionally roil markets, and the sustained upward movement in interest rates, stock markets, and the dollar after the U.S. election does signal a meaningful change in market expectations. Looking at 2016 as a whole, the most striking lesson was not the absence of a crisis, but rather the resilience of markets as they shrugged off most of the shocks that did occur.

There are good reasons to believe that 2017 will be different. It should be the year that global geopolitical risks provide the volatility in markets that I, and many other economists, have been predicting for some time.

## A PREPONDERANCE OF HARD-TO-QUANTIFY RISKS

The list of global risks that could create turmoil in markets is well known, including frictions with China, a chaotic Brexit, pressures on the European Union (EU) that could result in a return of the euro-area crisis, continued chaos in the Middle East, and rising tensions on the Korean Peninsula. With the exception of a trade war with China, each of these risks share the characteristic that the channels through which they affect markets are diverse and difficult to quantify. The policymakers who will confront these challenges will in many cases be new to their positions, or facing elections, making policy more difficult than usual to predict.

In Europe, the challenge from populism is not so much the risk that alternative candidates could ascend to power, but rather that mainstream candidates could tilt policies to address populist concerns and become hamstrung in responding to shocks. Italy is a telling example. Although the failure of the December 2016 constitutional referendum reduces the likelihood that the populist Five Star Movement will assume power in 2017, Italy's inability to move forward with a reform agenda that tackles politically difficult labor-market and pension reforms bodes poorly for long-term competitiveness within the eurozone. In addition, the Italian bank bailout will be larger than originally estimated, and although the decision to limit financial losses imposed on

investors—thus, arguably, gutting the new EU banking rules at the first hurdle—makes sense politically, it adds to the burden of state debt. Conversely, it appears that electoral politics in Germany will make it harder, not easier, for leaders to show flexibility on debt and financing for other EU countries. Similarly, although the British government says it will invoke Article 50 by March, serious negotiations are unlikely to begin until after German elections in the fall, creating an extended period of uncertainty that could be destructive for markets. From this perspective, 2017 could well be the year that the “doom loop” linking banking troubles to concerns about government creditworthiness returns to the European headlines.

In the United States, I continue to see markets priced for perfection. Markets anticipate a surge in growth with low inflation, backed by financial market and regulatory reforms that also raise the long-run growth potential of the economy. Since November, shares in the cyclical stocks (measured by the MSCI World Index) have risen more than 10 percent, more than twice the increase in safer stocks, and in relative terms are now at their highest since 2008. Any disappointment of those hopes—either because legislation falls short of election promises or because passed tax and stimulus bills add pressure on wages and force the Federal Reserve to raise interest rates faster than currently expected—creates the risk of a sharp retracement of stock prices and market volatility across a wide range of financial assets.

#### *EMERGING MARKETS AT RISK FROM MAJOR CENTRAL BANKS*

There is broad consensus that the anticipated tightening of monetary policy in the United States represents a significant shift in global monetary conditions, and that the resulting divergence of monetary policy in the United States, Germany, and Japan (also known as the Group of Three, or G3), with interest rates in Japan and the Euro zone expected to remain near zero, could challenge policymakers. But 2017 could also see the European Central Bank (ECB) begin to taper its quantitative-easing program and the Bank of Japan pull back from earlier monetary commitments, signaling the start of a broader turn in global monetary conditions.

In sum, central banks can no longer be expected to be at the vanguard of demand support and crisis response. The Federal Reserve has begun a process of gradual normalization. This means that fiscal and structural policies need to play a greater role in the event of a new global shock. Although U.S. and European fiscal policies have become slightly more stimulative after years of cuts, there seems little appetite for additional moves outside of the United States, and support for global growth could be unbalanced and uncertain in a downside scenario.

Historically, the roughest time for emerging markets comes when the Fed begins to raise interest rates, triggering a wave of capital outflows that exposes policy mistakes that until that point had been covered by a flood of easy money. A further strengthening of the dollar, which could be the natural consequence of Fed tightening, would further expose countries that have borrowed in dollars to an additional debt shock.

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Such risks are particularly significant for commodity exporters that have been squeezing and tightening their belts for a few years following the collapse of prices in 2014–2015. Oil and other commodity prices are off their lows, but for many exporters the easy buffers have been exhausted and the belt tightening is growing weary. High levels of corporate debt and leverage in emerging markets remain reasons for concern. These concerns go beyond those countries in a full blown economic crisis, to

countries that are more directly important for investors, including Turkey, South Africa, and Brazil. Any shock that weakens the outlook for these countries, even something seemingly unrelated such as trade tensions between China and the United States, can be the trigger for systemically important capital outflows.

This year also could see simmering crises in Greece and Venezuela come to a head, which could set precedents in how crises are resolved. For Greece, an agreement seems within reach that would address International Monetary Fund (IMF) concerns about debt sustainability by capping interest payments over up to fifty years. However, creditor countries (most vocally Germany, but they are not alone) remain wary about any agreement that transparently transfers resources to a Greek government with a slipping commitment to reform. Indeed, recent moves by the Greek government to reinstate pension and labor market benefits, while understandable given the weak government standing and over-performance elsewhere in the budget, is a clear reversal of previous commitments made by the Greek government to creditors.

One should always be wary about predicting a collapse of the Venezuelan economy and default on over \$125 billion in debt, but the government's economic policies are on a clearly unsustainable track, reflected in hyperinflation and a continued severe economic decline. The state energy company's recent difficulties making debt payments and the government's fire-sale efforts to raise end-year financing suggest a worsening financial situation. These are the sort of financial shenanigans that often occur immediately before default, but it could be some time before a government is in place that can work with the West on a rescue program. Although Venezuela may not be on the radar screen of most investors, it matters for a number of reasons. First, it could be an early test (along with Greece) of how the Trump administration views the international financial institutions as in support of a U.S. economic agenda, and whether Trump's economic team would support a large rescue package led by the IMF. Second, any comprehensive rescue package would require a restructuring of debt owed by the government to public and private creditors. China is Venezuela's largest creditor, and the restructuring of its debt will set the tone for private creditors. Moreover, the agreement will set a precedent for a large number of over-indebted, commodity-exporting countries that may need relief on their debt to China in coming years. How this is handled could have broader consequences for U.S.-China relations as well.

## CONCLUSION

Markets have rallied in recent months on hopes of stronger U.S. growth and a receding of deflationary pressures worldwide. Such optimism may be warranted, but an equally compelling argument can be made that markets are priced for perfection. The list of potential crises and confrontations is long, and the capacity of policymakers to respond to major challenges is constrained by economic considerations and the election cycle. In his recent *Foreign Affairs* piece, former Secretary of Treasury Timothy F. Geithner argues that the "U.S. economy is less vulnerable to a modest crisis but more vulnerable to an extreme one." He highlights the legal restrictions on policymakers put in place in the aftermath of the financial crises that constrain the capacity to act quickly in the face of a shock. Add in populism, elections, and the increased complexity of international economic relations, and the concern has global relevance.

## Looking Ahead: Kahn's take on the news on the horizon

**Venezuela's** hyperinflation and recent payment difficulties point to intensified economic pressures that increase the risk of default.

New capital controls in **China** look unlikely to stem pressures on the currency.

**Greece** and its European government creditors continue to inch toward a deal that will extend debt relief (by locking in low interest rates) and restart its IMF program, but Greece remains uncompetitive within the eurozone.