The global economy's New Abnormal

Nouriel Roubini | Roubini Global Economics | 05 February 2016

Since the beginning of the year, the world economy has faced a new bout of severe financial market volatility, marked by sharply falling prices for equities and other risky assets. A variety of factors are at work: concerns about a hard landing for the Chinese economy; worries that growth in the United States is faltering at a time when the Fed has begun raising interest rates; fears of escalating Saudi-Iranian conflict; and, signs (most notably plummeting oil and commodity prices) of severe weakness in global demand.

And there's more. The fall in oil prices - together with market illiquidity, the rise in the leverage of US energy firms and that of energy firms and fragile sovereigns in oil-exporting economies - is stoking fears of serious credit events (defaults) and systemic crisis in credit markets. And then there are the seemingly never-ending worries about Europe, with a British exit (Brexit) from the European Union becoming more likely, while populist parties of the right and the left gain ground across the continent.

These risks are being magnified by some grim medium-term trends implying pervasive mediocre growth. Indeed, the world economy in 2016 will continue to be characterised by a New Abnormal in terms of output, economic policies, inflation, and the behavior of key asset prices and financial markets.

So what, exactly, is it that makes today's global economy abnormal?

First, potential growth in developed and emerging countries has fallen because of the burden of high private and public debts, rapid aging (which implies higher savings and lower investment), and a variety of uncertainties holding back capital spending. Moreover, many technological innovations have not translated into higher productivity growth, the pace of structural reforms remains slow, and protracted cyclical stagnation has eroded the skills base and that of physical capital.

Second, actual growth has been anemic and below its potential trend, owing to the painful process of deleveraging underway first in the US, then in Europe, and now, in highly leveraged emerging markets.

Third, economic policies - especially monetary policies - have become increasingly unconventional. Indeed, the distinction between monetary and fiscal policy has become increasingly blurred. Ten years ago, who had heard of terms such as ZIRP (zero-interest-rate policy), QE (quantitative easing), CE (credit easing), FG (forward guidance), NDR (negative deposit rates), or UFXInt (unsterilised FX intervention)? No one, because they didn't exist. But now, these unconventional monetary-policy tools are the norm in most advanced

economies, and even in some emerging market ones. And recent actions and signals from the European Central Bank and the Bank of Japan reinforce the view that more unconventional policies are to come.

Some alleged that these unconventional monetary policies and the accompanying ballooning of central banks' balance sheets were a form of debasement of fiat currencies. The result, they argued, would be runaway inflation (if not hyperinflation), a sharp rise in long-term interest rates, a collapse in the value of the US Dollar, a spike in the price of gold and other commodities, and the replacement of debased fiat currencies with cryptocurrencies such as bitcoin.

Instead - and this is the fourth aberration - inflation is still too low and falling in advanced economies, despite central banks' unconventional policies and surging balance sheets. The challenge for central banks is to try to boost inflation, if not avoid outright deflation. At the same time, long-term interest rates have continued to come down in recent years, the value of the USD has surged, gold and commodity prices have fallen sharply - and bitcoin was the worst performing currency of 2014-2015.

The reason ultra-low inflation remains a problem is that the traditional causal link between the money supply and prices has been broken.

One reason is that banks are hoarding the additional money supply in the form of excess reserves, rather than lending it (in economic terms, the velocity of money has collapsed). Moreover, unemployment rates remain high, giving workers little bargaining power. And, a large amount of slack remains in many countries' product markets, with large output gaps and low pricing power for firms (an excess-capacity problem exacerbated by Chinese over-investment).

And now - following a massive decline in housing prices in countries that experienced a boom and bust - oil, energy and other commodity prices have collapsed. Call this the fifth anomaly; the result of China's slowdown, the surge in supplies of energy and industrial metals (following successful exploration and overinvestment in new capacity), and the strong USD, which weakens commodity prices.

The recent market turmoil has started the deflation of the global asset bubble wrought by QE, though the expansion of unconventional monetary policies may feed it for a while longer. The real economy in most advanced and emerging economies is seriously ill and yet, until recently, financial markets soared to greater highs, supported by central banks' additional easing. The question is how long Wall Street and Main Street can diverge.

In fact, this divergence is one aspect of the final abnormality. The other is that financial markets haven't reacted very much (at least so far) to growing geopolitical risks either, including those stemming from the Middle East, Europe's identity crisis, rising tensions in Asia, and the lingering risks of a more aggressive Russia. Again, how long can this state of

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affairs – in which markets not only ignore the real economy, but also discount political risk – be sustained?

Welcome to the New Abnormal for growth, inflation, monetary policies, and asset prices, and make yourself at home. It looks like we'll be here for a while.

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