Interview with Will Denyer, US Economist at Gavekal Research Hong Kong Office

World Economic Outlook for 2020 – Optimism with Prudence About Policy Uncertainties

By *Japan SPOTLIGHT*

As political risks around the world continue, such as the US-China tech cold war, concerns about their negative impact on the world economy are also increasing. Economic forecasts today are simply analyses based on econometric models. Business economists are perhaps better qualified to estimate the future trends of the economy rather than theoretical economists.

In the following interview Will Denyer, a Hong Kong based economist at consulting and research company Gavekal Research, offers his insights into the current global economy and its prospects in the near future.

(Interviewed on Oct. 28, 2019)

General Assessment of Current World Economy

JS: First of all, looking at your general assessment of the world economy and Asian economies, would you say you are somewhat optimistic about both?

Will Denyer

Denyer: Yes, I am relatively optimistic on global growth in 2020. My first reason for optimism is that financial conditions are generally supportive. The biggest change of recent months has come from the United States, where the Federal Reserve shifted from a tightening policy to easing over the course of 2019. Other major central banks have either maintained accommodative policy stances, or made them even more so. Long-term interest rates are also depressed – not just for government bonds but also private sector borrowing rates. All this does not rule out a recession, but it makes it less likely.

This perhaps separates me from some other commentators; some people see the recent decline in bond yields and the resulting yield curve inversions in the US and elsewhere as a sign of a looming recession. That is understandable given that in the US at least an inverted yield curve has been a pretty good indicator of recessions one or two years later.

However, inverted yield curves do not cause recessions. Too high interest rates do. Quite often those two things happen together, hence the relatively good track record of predicting US recessions. But sometimes the yield curve inverts, despite interest rates across the curve remaining relatively low. This is when we get false positives. And this is the situation today.

Interest rates get "too high" when, in real terms, they exceed the prospective rate of return on capital in the US. If entrepreneurs cannot expect to generate a return in excess of their borrowing cost, they will not borrow to invest. Growth suffers and a recession becomes likely. At Gavekal, we call this a negative "Wicksellian Spread", after the late Swedish economist Knut Wicksell who made this simple observation. Today, the Wicksellian spread, between the return on capital and its cost, is quite positive – at least in the US, where I have the best data; though it seems likely to be true in other parts of the world as well.

The second reason I am relatively optimistic on growth outside the US is that the highly-valued US dollar gives US businesses and consumers more purchasing power to buy imports from the rest of the world. Already, we are seeing a gradual deterioration of the US trade balance (despite the support of the US shale energy boom). I expect the US dollar to weaken from here, but it will be some time before it swings back to undervalued territory. In the meantime, this should be supportive of US imports and rest of the world growth.

Of course that story has been complicated by the trade war and Brexit uncertainty. Both of these geopolitical concerns have damaged growth around the world, but more so in countries that have relatively high exposure to trade (such as in Europe and Asia) and to Brexit (which has hurt not only the United Kingdom but also its biggest trading partners in Europe). While parts of the US economy have also been impacted, the overall US economy has relatively less exposure to trade, and thus the US has outperformed.

Thus, my final reason for optimism for global growth, and particularly growth outside the US, is that there seems to be tentative signs of improvement on the trade war and Brexit fronts. It is too soon to celebrate, but there is reason to hope for at least marginal improvements. That would be more good news for global growth in 2020.

Impact of Policy Uncertainty on the Global Economy

JS: I am curious about your assessment of the effect of uncertainty on policy making. Today, uncertainty is increasing, and that would be a negative factor in particular for private investment. How would you assess the impact of policy uncertainty on private investment?

Denyer: I think that policy uncertainty is very detrimental to investment. Companies like to know the rules of the game; they like to make projections. They have an expected rate of return on expected capital, which they have to compare to their cost of capital. The more policy uncertainty there is, the more margin of error there is in their return on capital projections. So I do think that policy uncertainty does significantly weigh on investment and is a reason why I think investment in the US and elsewhere has been weaker recently than you would expect given the accommodative financial conditions – it is absolutely a large counter-force.

On the trade war, right now we have two elements of uncertainty. One is the tariff uncertainty, and the second is export controls. It looks right now like the US is potentially de-escalating the tariff war, and that would be a good step in the right direction. But there is also the risk that the US ramps up the export control war. Both of those are detrimental to investment. At the specific company or industry level, export controls can be even worse than tariffs.

In addition to the tariff and export control wars, obviously you have uncertainty surrounding Brexit. Recent developments suggest the risk of a no-deal Brexit has gone down, or at least been significantly pushed back, but there is still a lot of uncertainty around that. Once potential investors in British assets have some more clarity on what are the rules of the game in the UK, that should be a positive for investment growth in the UK and also for anybody who exports to the UK (most notably other countries in Europe). So I do think that for Europe, a resolution to Brexit – however it is resolved – will help businesses to plan accordingly.

Stepping back to talk a little more structurally, we could be witnessing the start of a regime change in the global security system. Since World War II, the US has been the dominant force in the world. It has surely made mistakes. But generally speaking, the US has used its military power to ensure relative peace and stability around the globe. Critical to the global economy, the US has used its military force to secure shipping lanes, and this underpins a lot of the globalization that we have seen.

That, however, is not a cheap endeavor. And the US fiscal outlook is now deteriorating, thanks to an aging population and a pay-as-you-go welfare system. Combine that with recent exhaustion over wars in the Middle East and the fact that the US has found a way to extract a ton of oil from shale, and there doesn't seem to be a lot of appetite in the US for continuing to be as interventionist as it was in the past, continuing to be the police of the world to keep shipping lanes secure. There are instead more efforts to get major powers around the world to finance their own security and to secure their own shipping lanes and boats as they travel around the world, and to secure their own regions. That doesn't necessarily need to be a disaster – there are arguments that a multipolar world might be more secure in some ways, more equitable and better for global trade. But that is a big if, and when you have a big regime change there is always the risk of disruption and uncertainty during the transition, and frankly we don't know how it is going to come out on the other side.

So, while my base case is for relatively decent global growth in 2020, there are risks.

Another Important Structural Question – Demographics

JS: You raise another structural question regarding demographics. You say real yields will be higher due to the change in demographic structure globally. Could you elaborate on this point?

Denyer: I think demographics play an important role in determining the cost of capital. We have seen a structural decline in the cost of capital around the world since the early 1980s. You can see that in all major countries whether you look at real interest rates on bonds or the earnings yield in the equity markets, they have all shown a structural decline since the early 1980s. Why? I think age demographics have a lot to do with it, and perhaps for reasons that others may interpret differently.

All prices are the result of the intersection between the intensity of demand and the willingness to supply something – and the same goes for the cost of capital. You don't need any statistics to tell you that a person's propensity to supply versus demand capital changes over their lifetime. When you are young, you tend to demand a lot of capital and produce little. For example, you demand diapers, food, healthcare, education, and a roof over your head. And since you are producing nothing at all at first, and then relatively little in the first part of your career, most of this has to be financed either by gifts from your parents or the state, or else borrowed.

Regardless, you are a net consumer of capital, and that tends to put upward pressure on the cost of capital. It is probably not until somewhere around your mid-30s that you start to make a lot of money and start to hit your prime earning potential. By this point you have probably already finished your education and bought your first home. You are still consuming, but now not as much as you produce. On net, you become a saver. This means you are now a net supplier of capital, and thus tend to have a negative influence on the cost of capital.

People tend to be net "capital providers" between the ages of 35-64.

It is not a coincidence that a demographic bulge (known as Baby Boomers in the US and some other parts of the world) started to reach their mid-30s in the early 1980s. Over the last four decades, more and more of that demographic bulge reached their peak savings years. The result was a growing savings glut that drove down the cost of capital.

The issue now is that this demographic bulge is starting to retire, or at least pare their working hours. Meanwhile, they are starting to consume more services like healthcare. They are becoming net consumers of capital again, putting upward pressure on real yields. It is not clear exactly where the turning point is, but it is somewhere around now, give or take a few years. I think this demographic change is likely to cause a structural rise in real yields over the coming decades.

JS: Japan has had an aging population for many years already. Why haven't interest rates already started to rise in Japan?

Denyer: Japan is part of a global capital market, and thus its real yields are subject to the global demographic situation. Capital moves around the globe and is competitive. Thus, while nominal interest rates differ in various parts of the world with different levels of expected inflation, real yields on bonds of similar quality (e.g. government bonds in the US, Japan, Germany and the UK) tend to track each other over the long term. If I am correct that the global demographic picture is now nearing an inflection point, then we should see real yields in Japan, and elsewhere, start to rise going forward.

JS: This increase in interest rates - would it lead to inflation or not?

Denyer: It depends on how the central banks respond. If the central banks do not recognize that the natural rate is rising because of this demographic shift, fail to adjust accordingly, and thus get "behind the curve", then you could get inflation like we got in the 1970s. In the 1960s and 1970s you had a deteriorating capital provider ratio (that is a shift toward net capital consumers), and I don't think that the central banks of the world appreciated that, and we had inflation. It could happen again. But it is also possible that central banks have learned from that experience, will not fall behind the curve, and thus will keep inflation rates basically stable. Even if they do that, you are going to see a rise in real and nominal interest rates. You just don't need to have an increase in the spread between real and nominal interest rates. They would just rise together.

Possibility of a Currency War

JS: Regarding the possibility of a currency war, you are not so pessimistic, is that correct?

Denyer: While I can't rule out a currency war, I have reasons for optimism. First, economic theory as well as experience – including the experience of the 1930s – show that trade wars and currency wars generally hurt both sides. Both countries in a trade war or currency war are hurt. Hopefully this serves as a deterrent. President Donald Trump has been making a lot of protectionist moves and pronouncements, and the general global view toward that action has been negative and has continued to be negative to this day. I don't hear a lot of other countries agreeing with Trump about turning protectionist. There are people who think Trump may be justified in using tough negotiating tactics to try to get China to change its practices, and some think Trump may be correct to renegotiate some trade deals that weren't fair, but I don't think that the general view in the world is that protectionism is a good thing. In fact, while there has been this major trade dispute between the US and China, at the same time free trade agreements have been signed between other countries. Even the US has negotiated some new trade agreements.

The second reason for hope is more about the stick than the carrot. The US seems more ready than ever to punish countries that it deems to be currency manipulators; we will see how effective that is, but the US does have quite a bit of leverage there and it should be a disincentive to currency manipulation.

People typically complain that the European Union has a hard time agreeing to major changes. In this case it could be a benefit. With so many parties involved, it is unlikely that the euro area would adopt a policy of active currency depreciation – especially since Germany has bad memories of currency debasement. China has obviously shown itself to be willing to devalue its currency in the past; however, all indications we have are that China is quite serious about trying to internationalize the renminbi and to improve its reputation globally. If China starts doing major currency devaluation then that is going to undermine that goal, not to mention angering the US and other global trading partners. And so far, China has not devalued its currency. It has allowed its currency to adjust to external shocks, such as the US tariffs, but as far as we can tell it has not done active devaluation, and we don't see it on the radar right now.

These are the reasons why I don't see us descending into an international currency war.

JS: You mention the internationalization of the Chinese renminbi. Do you think the renminbi's global status is going to rise significantly?

Denyer: The US dollar is obviously the dominant reserve currency today, followed by the euro. China has a lot of progress to make before it challenges either of those two major currencies, but things do seem to be gradually heading in that direction.

China is doing a lot of the right things to promote global use of the renminbi. For example, it has been setting up bank branches around the world; it has currency swap agreements with many central banks. It is doing a lot of trade and international investment. These are all things that make the renminbi more attractive to foreigners. These are all things that increase its convenience and the stickiness of its demand.

There are still issues that China needs to work on. Negatives include still having at least a partially closed capital account, although that is opening more and more every month. Also, it is not a democracy. China has a one-party system and there are questions about whether this matters or not for trust in the currency. But generally speaking I think the balance of evidence points to the renminbi gradually rising in global status going forward.

At the same time, the US is increasingly using the dollar payment system to achieve geopolitical aims – the so-called "weaponizing of the US dollar". I am not casting a broad judgment on whether the US should do that or not, but the fact that it is doing it undermines the global status of the dollar. Countries, companies and people who cannot rule out someday having a disagreement with the US government now have to question their reliance on the US dollar. For those not willing to take the risk of having their assets frozen or becoming unable to make international payments, it is time to consider alternative currencies.

At the same time, the US fiscal outlook is worsening quite substantially. The last time we had a major change in the global currency leadership role was when the US dollar overtook the British pound, and this occurred in the decade following 1913. It was a result of a number of factors, one being that World War I was very detrimental to the fiscal outlook for the UK.

Moreover, after 1913, the US encouraged its banks to start branching out around the world, and it had a new central bank supporting the market for trade credit. Basically, the US had re-geared its policy structure to encourage the dollar to become a global currency. There are a lot of similarities with what China is doing today.

For all those reasons, I expect the renminbi to gradually take market share away from both the dollar and the euro.

Innovation Stifling Due to US-China Cold War

JS: This US-China technology cold war would be bad news for trade and investment, but also for innovation. Perhaps more Chinese companies will be put on the US blacklist for a ban on trade and investment. That would have negative impacts on innovation as well.

Denyer: Absolutely. It does look as though the tariff war may be easing, while the war of export controls could linger on or even ramp up further. One key question is: what does the US truly seek to accomplish with its increased use of export controls? Is it really about forced technology transfers, technology theft, and human rights violations? If so, then there is at least the possibility that the Chinese government and other relevant actors might change their behavior enough to satisfy the US, and then export controls may soften.

However, if the true goal of the US is to either slow China's development or get China to fundamentally change the way it manages its economy, then it becomes extremely unlikely that China will somehow satisfy the US. In this case, the export controls are likely to stay – at least until there is a change of strategy from the US. For now, export controls are a feature of the investment landscape, and so long as they exist, they will stifle innovation.

JS: Such stifling of innovation could have crucially negative impacts in other countries, as global innovation itself could be retarded by this kind of cold war. Would you concur?

Denyer: Absolutely. I think that there is no way that two of the three largest economies in the world can be retarding information sharing without that being negative for global innovation. If it were two tiny countries then it probably wouldn't matter, but two very large countries putting up barriers to information sharing has to be negative for global innovation, and that is especially true because of the way that the US is imposing its export controls. The controls apply not only to US-made products, but also to some products made overseas using a sufficient amount of controlled US-origin technology. This will have global ramifications.

Role of International Organizations in Mitigating Uncertainty

JS: I believe that such policy uncertainty comes from a lack of rules and international cooperation. How can we mitigate policy uncertainty? Could international organizations or forums such as APEC mitigate that kind of negative impact emanating from the US-China trade war?

Denyer: I concur wholeheartedly. Having free trade and clear rules of the game encourages growth and innovation for all those involved. It can also serve as a good example for others to follow. The US has in the past led by example. Since World War II, the US has not only secured global shipping lanes, as previously discussed, but also led by example in terms of promoting free trade. The US has tended to have relatively low import tariffs and non-tariff barriers to trade, encouraging others to follow suit. That has significantly reduced policy uncertainty in the world, because the world could count on the US being committed to free trade, even when others were not. That has arguably gone away, because now the US is tired of leading by example and is starting to use the carrot as well as the stick to try to get behavioral change, to put it nicely. To the extent that an organization like APEC or a country like the UK or a region like the EU can continue to lead by example regardless of what the US and China may do, that would lower policy uncertainty and promote global growth. JS

Written with the cooperation of Joel Challender, who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.