OVERVIEW
The pros and cons of low interest rates

US
Confident, prudent consumers

ASIA
Development of an Asian trading bloc

SPECIAL FOCUS
ECB President Christine Lagarde

Surface serenity, underlying uncertainties
Financial markets, on the surface, have been calm for much of 2019. Global equities and bonds have made solid gains. Yet uncertainty about the global economy and policy remains at elevated levels.

Surface serenity, underlying uncertainties

The calm in global financial markets seen for much of 2019 has been associated with new highs in many equity markets; government bond yields reaching new lows; and credit markets doing well. All this has been in an environment of low volatility. In the US, the S&P 500 index at the end of September was more than 25% higher than its low point in late 2018. At that time, there were heightened concerns about the strength of the global economy, the US-China trade war and political developments in a number of countries. Most of these uncertainties (Italian politics being one notable exception) have not eased. Indeed, political rhetoric in the US and UK has taken on a more disturbing tone. One measure of economic uncertainty\(^1\) shows it to be even higher than during periods of intense concern in the past: higher than during the global financial crisis, the eurozone crisis, the Brexit vote and President Trump’s election. Many investors are nervous about prospects for markets and economies. In the US, funds have flowed out of equities and into the perceived safety of government and investment grade bonds during the year.\(^2\) Why have financial markets been so calm in this uncertain economic environment?

Change in interest rate expectations

One explanation is that policymakers have reacted to the concerns about global growth by adjusting policy. Most notably, interest rates in the US have been cut twice (see Figure 1). Financial markets, initially sceptical, may have come to accept that this was an appropriate “mid-cycle correction”, as it was described by Fed chairman Jerome Powell.\(^3\) Such adjustments have been made before – for example in the mid- and late-1990s. Then, as now, they were in response to a slowing of economic growth and they were effective in avoiding a recession.

Other central banks have also cut interest rates (see Figure 2) and the European Central Bank (ECB) has announced that quantitative easing (QE) will restart in November. In many cases these cuts have represented a complete reversal of previous increases. This raises a more worrying interpretation. That is, that interest rate increases cannot be sustained in an environment of still subdued inflation and economic growth. Indeed, financial futures markets expect that US rates will fall back to close to 1% (such expectations are, however, notoriously fickle).

Missing 2%

With the exception of the UK (an open economy that has seen two major currency depreciations in recent years), central banks have consistently failed to hit their 2% inflation targets since the global financial crisis. Substantially sub-target inflation performance is expected to continue in the eurozone and Japan, while the UK and US are expected to be closer, but

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\(^1\) Source: Global Economic Policy Uncertainty Index, Bloomberg, 1 October 2019.

\(^2\) Source: Informa Financial Intelligence, 1 October 2019.

\(^3\) https://www.cnbc.com/2019/07/31/fed-chief-powell-says-rate-cut-was-a-mid-cycle-adjustment.html
still below target. The cumulative divergence between where
the price level would be if 2% inflation had been maintained
and where it is now is still large in the US, eurozone and Japan
(see Figure 3). In that context, a case can be made for inflation
above 2% for some time to correct this undershoot. That
implies interest rates can stay low.

4. The pros and cons of low interest rates

**PROs**
- Cheap financing for investment/infrastructure
- Help start-ups and ‘creative destruction’
- Benefit borrowers

**CONs**
- Reduce incentive to de-lever/cut debts
- Help ‘zombie’ firms stay in business
- Disadvantage savers

However, low interest rates have attracted criticism, notably
in the eurozone. Among the disadvantages of low rates are
that they discourage savers, reduce the incentive to delever
debt and enable ‘zombie’ firms to stay in business (see Figure
4). The rising number of such firms, defined as those that are
unable to cover debt servicing costs from current profits over
an extended period, has attracted increasing attention.4

On the other side of the argument, low interest rates benefit
borrowers, cheap financing should facilitate investment and
infrastructure spending and start-up companies may also
benefit, aiding the process of creative destruction.5

There is one further concern regarding monetary policy: that
quantitative easing (QE), which will be relaunched by the ECB
in November, may not be effective in reducing longer-term
interest rates and bond yields. The US experience (see Figure
5) is that bond yields actually rose during periods of US
Federal Reserve (Fed) QE. The argument used to explain that
relationship is that QE started when the economy is
particularly weak and inflation is subdued (and hence when
bond yields are low) and terminated when the economy and
inflation are recovering (and hence when bond yields tend to
be higher).

Deglobalisation

Although these technical aspects of the conduct of monetary
policy continue to attract a great deal of attention, more
fundamental concerns about the global economy remain. The
US-China trade war is clearly having an effect, notably in
the slowing of global trade. Indeed, deglobalisation – a declining
share of goods exports relative to world GDP is now clearly
apparent (see Figure 6).

6. From globalisation via crisis to deglobalisation

**Fiscal boost**

That is likely to mean that as we move into 2020, much more
emphasis is placed on fiscal policy to support economic
activity. In many economies years of belt-tightening have
stabilised government debt/GDP ratios (see Figure 7) but led to
‘austerity fatigue’. A reassessment of the role of public
spending in the economy, particularly in relation to
environmental initiatives, seems increasingly likely.

5. US QE did not push down bond yields

6. Government debt levels

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4 BIS Quarterly Review September 2018. [https://www.bis.org/publ/qtrpdf/r_qt1809g.htm](https://www.bis.org/publ/qtrpdf/r_qt1809g.htm)

Asset market performance

World equity markets produced positive returns of 18.1% in US$ terms in the first three quarters of 2019 (see Figure 8) on the basis of the MSCI World Index. This came after a weak final quarter of 2018. Global bond market returns were also positive, by 6.3% on the basis of the Bloomberg Barclays Global Aggregate Index. The main influence was lower government bond yields, pushing up government bond prices. Indeed, a large part of the global bond market (notably, German, Swiss and Japanese government bonds across the maturity spectrum) traded on negative yields by the end of September.

The US dollar was up 3% on the basis of its trade-weighted index during the first three quarters: the main gains were against the New Zealand and Australian dollars and sterling; but the US dollar weakened against the yen and Canadian dollar. In the main developed markets, equities produced higher returns than bonds; but the opposite was true in emerging markets.

Bond markets

10-year US government bonds produced total returns of 11.7% in the first three quarters of the year, as capital gains (resulting from a decline in yields) added to coupon income. Local currency returns from the eurozone market were a little lower, but at 9.1% were still strong. This reflected: the renewed move back into negative territory for German 10-year bond yields; the first-ever move to negative yields in France; and particularly strong returns from Italian bonds, after a pro-EU coalition replaced the previous government.

A fall in Australian 10-year bond yields was due to a changed view on prospects for policy interest rates and translated into total returns of 13.7%, although these were offset in US$ terms by currency depreciation. Japanese 10-year bond yields moved into negative territory, producing returns of 2.5% in yen terms, boosted in US$ terms by yen strengthening.

Equity markets

The US equity market (on the basis of the total returns from the MSCI US index, shown in Figure 10) produced total returns of over 20% in the first three quarters of the year. That was a sharp turnaround from the weakness seen in the final quarter of 2018. Almost all developed and emerging equity markets produced positive returns in both local currency and US$ terms. Argentina was a notable exception, as the economy plunged into another crisis. The UK equity market produced total returns of 14% in sterling terms but returns were undermined in US$ terms as continued Brexit uncertainty weighed on sterling’s value. Russia, benefiting from higher oil prices and a recovery in the currency, produced US$ returns of over 30% in the first three quarters.
With more than two-thirds of US GDP accounted for by consumer spending, it is the key to economic growth. The good news is that the consumer is confident and in a good financial position.

**Consumers are confident**
US consumers have rarely been so confident. Confidence is at levels well above the 100 neutral level and is higher than immediately before the global financial crisis and US recession of 2008/9 (see Figure 11). That, of course, might indicate an impending fall. But consumers seem far from overly-exuberant. Strong consumer confidence seems to be well-grounded in the sense that it is based, not only on a strong labour market and rising pay, but also on strengthened consumer finances.

**Consumer finances are stronger**
Overall US household wealth stands at US$113.5tr, setting a new record relative to GDP (of over five times, see Figure 12). That total takes into account total assets of US$130tr less household debt of US$17tr. Of the US$130tr asset total, US$90tr is in financial assets and US$40tr in real estate. Many, of course, will dismiss this total as reflecting the highly unequal distribution of wealth. But rich Americans are not the main explanation. Recent research shows that the richest Americans (81,000 have a net worth of US$30m or more) have total wealth of US$10tr (less than 10% of the total). More ordinary households have been doing two main things to strengthen their finances post-financial crisis. First, they have been paying down debt and, in particular, have proved reluctant to take out revolving home equity loans (see Figure 13). “Using your home as an ATM” – withdrawing accumulated home equity using such home equity loans was a key feature of the pre-financial crisis landscape, of course. Second, contrary to the experience of previous economic recoveries, consumers have increased, rather than run down, savings. The savings ratio has increased to 8% from barely 2% shortly before the financial crisis (see Figure 14).

**Resilience to shocks**
With this strengthening of household finances, the consumer looks resilient. That suggests that any economic downturn, if it were to be driven by other sectors of the economy – such as a deteriorating trade position – would be relatively mild in nature. It is most unlikely that the experience of the 2008/9 downturn will be repeated.

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Leaving the EU is proving far from straightforward. Even if a deal is agreed, the subsequent transition period will take several years. Meanwhile, Brexit uncertainty coupled with global trade tensions weigh on the UK economy.

From ‘non’ to ‘vote leave’

General de Gaulle of France famously vetoed UK membership of the European Common market (the forerunner of today’s EU) in 1963. He did so again in 1967. The UK finally managed to overcome French opposition and join in 1973, only to have a referendum in 1975 on whether membership was indeed the right thing – it was deemed to be so. So, ten years or more were taken to join the EU; it may well take that long to leave. If a revised withdrawal agreement is agreed between the UK and EU by the latest deadline (31 October 2019) there will, after that, be a substantial transition period (probably until end-2022, but that could be extended) where current EU-UK trading arrangements largely apply. Leaving with no deal is still possible, although the chances appear slim. Staying in the EU, after a general election or a second referendum, is also possible.

When the UK first joined the (now) EU in 1973, it had a history as the ‘sick man of Europe’. Growth lagged behind that in continental Europe (see Figure 15): the UK had repeated (balance of payments) crises, troublesome labour relations, big inefficient government and an inflexible economy. UK growth pulled up towards continental European levels after membership, but it was the free market reforms started in the late 1970s which gave the UK economy the flexibility it still has today.

UK asset valuations

Nevertheless, the attractions of the UK as a base to do business and an economy in which to invest have been tarnished by the difficulties surrounding Brexit. That has been reflected in sterling's weakness. The weak pound has attracted some opportunistic inward investment but UK assets are not clearly at bargain basement levels. The UK equity market trades at close to its long-run historic valuation, for example (see Figure 16).

Unfortunately, a recent attempt at easing access to housing finance (the Help to Buy scheme) has had various distortionary effects, mainly due to the fact that the scheme stimulates demand (in a relatively narrow section of the market) when the essential problem is a shortage of supply. The UK's housing market issues may take even longer to resolve than Brexit.
EUROZONE

The eurozone slowdown is centred on manufacturing and the exporting sector, but domestic conditions are better. The ‘crisis countries’ are improving and, in Germany, fiscal expansion may finally come.

Growth slowdown centred in manufacturing
The eurozone slowdown is centred on manufacturing and exports. But domestic conditions are holding up reasonably well, the crisis countries are doing better and German fiscal expansion may finally come. The ongoing tariff war between the US and China has adversely affected European (particularly German) exports to China, with the auto sector notably affected. Geopolitical tensions in the Gulf region and continued uncertainty about Brexit have compounded the problems. Nevertheless, survey indicators, such as the composite Purchasing Managers’ Index (PMI, see Figure 18, which takes into account the more buoyant service sector as well as the manufacturing sector) suggest that the eurozone economy will see low growth rather than an outright recession. And there are some bright spots: consumer confidence has held up quite well; and the former crisis countries – Spain and Portugal in particular – have fared much better than the ‘core’ economies recently.

Escaping the doom loop
In Italy, after concern about the direction of the former populist coalition unsettled financial markets, the formation of a new pro-European coalition has seen a marked rise in bond prices and drop in bond yields (see Figure 19). If sustained, these much lower yields will mean that financing the government’s debt becomes cheaper. That will bring a reduction in Italy’s fiscal deficit, which in turn will generate some flexibility for fiscal easing in the future. That benign interaction will, if handled appropriately, also help to strengthen bank balance sheets. Instead of the doom loop of the eurozone crisis, when bank and government finances deteriorated together, both could improve simultaneously.

Easier policy
However, it is other eurozone countries that have the greatest degree of flexibility on fiscal policy (see Figure 20). In Germany, notably, with a government budget surplus and debt below the 60% Maastricht limit, it seems that attitudes are already becoming more accepting of greater government spending. In particular, this looks set to be focused on environmental projects. In the important sense that this relieves pressure on monetary policy to support growth it will be welcome, not least by the ECB. (We discuss their priorities under Christine Lagarde’s presidency in the Special Focus section on page 11.) Nevertheless, with the eurozone facing long-run demographic challenges (not dissimilar to those seen in Japan) and continued very low inflation, the challenges faced by the region remain very real.
At the last meeting of the Swiss National Bank (SNB) the policy rate was left unchanged at -0.75%. The room for supporting the economy under the current monetary policy strategy seems to be almost exhausted: new tools are called for.

Weaker growth and inflation
Swiss economic activity has weakened in recent quarters. GDP growth has been revised downwards and in Q2 2019 it fell to 0.3% year-on-year. Business confidence (measured by the KOF indicator, see Figure 21) deteriorated during the summer, reflecting downside risks to the global outlook which still persist. In 2019, GDP is forecast to grow between 0.5% and 1%, much less than the 2.8% growth rate recorded last year.

The worsening of the outlook would normally justify a more expansive monetary policy. Nevertheless, in September the SNB left its policy rate unchanged. The central bank recognised that the foreign exchange situation remains fragile, that the Swiss franc is highly valued and confirmed its readiness to intervene as needed. It is clear that the room to make monetary policy more accommodative is exhausted.

SNB President Jordan noted recently that central banks need to consider that “maybe some additional monetary policy instruments are necessary in a low interest rate environment”. His observation raises the issue of whether the SNB’s monetary policy strategy is still appropriate.

SNB strategy review
The SNB adopted its current monetary policy strategy in 2000. It is based on three elements: a definition of price stability (0-2% inflation), a medium-term inflation forecast and a target for the short-term interest rate. Since 2009, the SNB has added other unconventional instruments to its toolkit. Quantitative easing (QE) was briefly adopted to respond to the deflationary risk following the 2008 crisis. The SNB then purchased large amounts of foreign currency and financial assets to counter the appreciation of the franc. Previous interventions, represented by an increase in banks’ sight deposits at the SNB, are shown in Figure 23. Between September 2011 and January 2015, the SNB set a floor to the euro/franc exchange rate. After abandoning the floor in January 2015, the SNB implemented a negative interest rate policy accompanied by tiering to mitigate the adverse consequences for financial intermediaries. A review of the SNB’s monetary policy strategy would allow an assessment of its effectiveness, would explore what new tools could be used and would help extend its success in maintaining price stability in Switzerland.

Inflation remains at the lower end of the SNB’s target range of between 0 and 2% (see Figure 22). Between July and August the CPI rose by an average of 0.3% year-on-year, less than the SNB had previously forecast. In September the SNB lowered its forecast for the current year to 0.4% from 0.6%. For 2020 the SNB is now expecting inflation at 0.2%, much lower than its June forecast of 0.7%. Indeed, low oil prices and the strong Swiss franc risk pushing inflation below the 0-2% target range.

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* Jordan quoted by Reuters, 6 September 2019. He spoke of central banks in general, although he probably had Switzerland particularly in mind.
China’s trade surplus with the US is narrowing slightly, but only as its surplus with other countries increases. As the US and China continue their trade war, a freer trading system within Asia is developing.

**China’s trade surplus**
China’s trade surplus with the US looks likely to have narrowed a little in 2019 (see Figure 24). That may help appease the US. However, China’s overall trade surplus is set to have increased sharply. Two main factors explain this. First, to avoid US tariffs, some of China’s exports to the US appear to have been directed through other Asian countries, such as Vietnam. Second, with Chinese domestic spending slowing, domestic net savings have increased, raising the external surplus.

![24. China’s trade surplus](image)

Although China has increased tariffs on US goods (see Figure 25), mainly in retaliation to US tariffs on Chinese goods, tariffs on the rest of the world have fallen slightly. That is largely due to a reduction in MFN, most favoured nation, tariffs. These are the tariffs China imposes on other countries that are members of the World Trade Organisation (WTO). All China’s trading partners in Asia (apart from Bhutan and North Korea) are members of the WTO.

![25. China’s tariffs on the US and the rest of the world](image)

**China and India**
Rivalry between India and China often centres on comparisons of their GDP growth rates. Up until 2013, China was the clear winner. More recently the pattern has been mixed (China is set to overtake India again this year). Longer-term, however, India has much more favourable demographics than China. It has a large cohort of young people set to enter the workforce in coming years (see Figure 26). Longer-term growth in any economy depends on three factors: population growth, participation (the proportion in employment) and productivity. India has the first of these building blocks. However, finding employment for all those entering the workforce and increasing productivity are both proving more challenging. Indian productivity growth has notably lagged that in China. Sustained improvement will require structural forms to create a more efficient economy. In that respect, the recent surprise, large cuts in Indian corporate taxation are encouraging.

![26. Population pyramids: India and China](image)

**27. Asia: productivity trends**

![27. Asia: productivity trends](image)
The largest economies in Latin America – Brazil and Mexico – normally attract the most attention. Smaller, more flexible and often better-run economies are, however, now becoming more of a focus.

**Productivity**

Paul Krugman, Nobel prize-winning economist, has commented that “Productivity isn’t everything. But in the long run it is almost everything”. That is, the amount produced per person employed is the key to longer-term economic growth. In this respect, there are important differences between Latin American economies. In the largest economies, Mexico and Brazil, productivity growth since 1991 (see Figure 28) has been quite weak, running at annualised rates of 0.2% and 0.7%, respectively.

Chile has been the stand-out success story over that period, with annual average productivity growth of 2.2%. That success was due, initially, to Chile’s adoption of free market economic and market reforms, and more recently to sustainable fiscal and sound monetary policies.

How likely are the economies in the middle of this productivity ranking, economies such as Peru and Colombia, to fare? Can they emulate Chile’s success?

**Peru**

In Peru, the signs are encouraging. The country’s macroeconomic stability over the last 20 years has been the result of the implementation of orthodox economic policies and adherence to fiscal discipline. GDP growth in the country has outperformed the average for Latin America over the last 10 years and is projected to reach 3.7% and 4.1% in 2019 and 2020 respectively. Recent economic growth has been driven by strong domestic demand and gross capital formation. The unemployment rate in the country, currently at 6.6%, is below the average of the region (around 8%). With inflation under control at 1.3% real wage growth will provide a boost to private consumption, estimated to grow by 3.4% in 2019. Earlier in the year Peru’s central bank cut interest rates by 25bps to 2.50%, taking advantage of a benign inflation environment. On fiscal policy, Peru’s budget deficit has deteriorated in recent years due to low revenue collection and a continuous increase in expenditures aimed at supporting economic growth in the country. However, the adherence to a fiscal rule since January 2000 has enabled the country to engage in countercyclical fiscal policies that have contributed to a smoothing of the economic cycle during years of weak commodity prices.

**Colombia**

Colombia has had less success than Peru in bringing inflation and interest rates down but has still made encouraging progress. Inflation remains slightly above the central bank’s target of 3%. This has mostly been attributed to supply shocks that affected food and tradable goods prices. Interest rates have remained stable at 4.25% and the central bank has recently kept interest rates unchanged, highlighting the need to keep inflation close to its central target.

Colombia, alongside most of the Latin American smaller economies, has followed a strategy of opening its economy to the world (see Figure 29) by creating appropriate institutional conditions for investors and a competitive tax framework. The country aims to reduce its fiscal deficit to 2.4% of GDP in 2019 and 1.5% in 2022, in line with its fiscal targets. The Colombian economy is expected to grow by 3.2% in 2019 and to pick up further in 2020, according to projections from the central bank. This reflects contributions from stronger domestic consumption and investment in machinery, equipment and infrastructure.

On balance we think these two economies are in a good position to see sustainable growth, coupled with sound economic policies, over the medium term.
Christine Lagarde takes over as president of the ECB on 1 November 2019. What can we expect from her? How will she differ from her predecessor, Mario Draghi? And how difficult will her task be?

As Christine Lagarde assumes the presidency of the ECB on 1 November, we see five important challenges which lie ahead for her. Effectively managing these will be the key to whether her term is judged successful when it concludes in 2027.

**A review of the strategy**
The first element will, we think, be a review of the ECB's monetary policy strategy. That is especially likely given the review currently being carried out by the US Fed and with other central banks likely to follow. Such a review will probably concentrate on the ECB's definition of price stability. The "below, but close to, 2%" formulation of the inflation objective appears to be interpreted in different ways by members of the Governing Council and does not help in setting policy, in our view. The ECB could remove the ambiguity in the words 'close to' by setting a point target, perhaps via a tolerance range, to provide clarity to the public and Governing Council members about what its monetary policy aims to achieve.¹⁰

**An inspection of the toolkit**
That review may also comprise an assessment of the ECB's toolkit. This has already been expanded and now contains a range of unconventional instruments. Their effectiveness needs to be assessed and they may benefit from sharpening from time to time. It is, after all, a poor workman who blames her tools.

The tools include control over three key interest rates, asset purchases, targeted longer-term refinancing operations (TLTROs) – which provide cheap ECB finance to support banks' lending – and outright monetary transactions (OMTs). The latter were announced in 2012, shortly after President Draghi's commitment to do "whatever it takes" to preserve the euro; but they have never been used. They involve potentially very large purchases of sovereign bonds. However, this comes with a requirement that the country has agreed to an economic and fiscal adjustment programme (like, for example, those of Greece, Ireland and Portugal in the past). The latter requirement is a potentially large obstacle to its use; many governments would undoubtedly hesitate to pay the political costs associated with such conditionality.

**Questioning of the monetary-fiscal policy mix**
Third, we think there will be a continued questioning of the eurozone monetary and fiscal policy mix. President Draghi set the scene when he recently commented that "It's high time, I think, for fiscal policy to take charge. In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space should act in an effective and timely manner."¹¹ The attraction to governments is that more expansionary fiscal policy in the eurozone would allow the ECB to adopt a less expansionary monetary policy and raise interest rates sooner and by more than otherwise.

Christine Lagarde, having been finance minister in France and given her IMF (which some think stands for Its Mainly Fiscal) background, will be well suited to press the case for such action, which could be presented by governments as increased spending on environmental initiatives. While some countries would be unable to increase spending because of the EU's fiscal rules, Lagarde would be well-placed to push for a review of them.

**Consensus building**
Fourth, we think she will place an emphasis on consensus building among the 19 Governors of the participating countries and the ECB Executive board. That is no easy task, demonstrated by the discontent with the ECB's September easing moves expressed by several northern European central banks. The policy choices made by the Governing Council depends on where its centre of gravity is. We think she will be very effective in building broad alliances behind policy proposals, perhaps at the cost of making them a little blander so as to forge broader agreement.

**Clear messaging**
Given that a fundamental vulnerability of the eurozone is still perceived to be the gap between the frugal north and the profligate south – a perception which is now clearly out of tune with reality – a good deal of patient and careful messaging will be needed to correct this misperception. We think Mme Lagarde will rise to that challenge.

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¹ See EFG infocus, June 2019: ‘How might the Fed’s strategy review affect US monetary policy?’
¹⁰An argument made by Stefan Gerlach, Time to Untie the ECB’s Hands, Project Syndicate, 12 July 2018.
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