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MARKET COMMENTARY

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How to get global growth back

By Jan Dehn

The IMF recently revised down global growth. After years of Quantitative Easing (QE) and a now weakening US economy, it is no longer clear what can be done to raise growth rates. Policy makers in developed economies have largely run out of ammunition and appetite for reform is non-existent. How can global policy makers get the global economy back to positive momentum?

Here is a suggestion. The Fed and other QE central banks should embark on a modest program of Emerging Markets (EM) asset purchases, notably local currency government bonds and infrastructure investments. As a complement to asset purchases, the Fed may have to consider introducing negative policy rates as well.

Why should the Fed buy EM local currency assets?

Because, it is by far, in our opinion, the most potent way of overcoming the distortionary effects of conventional QE on global asset allocation and thereby stimulate global growth. The easiest way to generate global growth is to enable EM countries to grow.

Capital ought to flow from developed economies to EM in the interest of global growth, allocative efficiency and global financial health. Unfortunately, conventional QE policies have perversely created the opposite effect on global asset allocation. Rather than helping to facilitate global growth by channelling capital to EM QE has instead sucked money out of EM. Without financing, EM countries cannot optimise their growth rates and hence cannot act as locomotives to global growth.

Global financial markets cannot be relied upon to allocate capital in a rational manner that maximises the opportunity for growth in the face of the enormous gravitational pull from conventional QE policies in developed economies. QE draws capital into already overvalued developed markets due to widespread market and institutional failures in the financial industry that cause global asset allocators to respond excessively to short term flow dynamics and insufficiently to relative fundamentals. Privately, most finance professionals would readily admit that money printing is not a sustainable way to create wealth.

A modestly sized Fed program of EM asset purchases would remedy the distortions in global asset allocation to help support global growth

EM does not need asset purchases for monetary purposes, so it would be highly inappropriate for EM central banks to engage in asset purchases. But even a modestly sized Fed program of EM asset purchases scaled to remedy the distortions in global asset allocation would be enough to channel significant volumes of global capital back into EM to help support global growth.

The best way to support global growth is to channel global capital to where it delivers the biggest bang for the buck in terms of growth, namely in EM

Given the importance of the Fed's thought leadership among the global community of central bankers it is likely that other central banks would soon follow the Fed's example.

The Fed should also be mindful of the potential impact of EM asset purchases on the US economy. On the positive side, such a policy would weaken the USD, which would be good for the US shale sector, commodities and global risk appetite as well as exports. Still, a program of EM asset purchases may have to be complemented with a move to negative interest rates in the US. Recent economic data shows that the US economy is weakening. Negative interest rates would not only ease economic conditions, but would also support the Treasury market. Unlike another dose of conventional QE, negative rates would not put upwards pressure on the US dollar nor blow further hot air into the stock market bubble. With the US dollar up 40% since 2011 the US needs a stronger currency like a hole in the head, while more conventional QE would hogtie the Fed to the performance of the stock market – a situation that poses significant risks to Fed credibility, in our view. The Fed should of course also stop U-turning on the question of the first hike in interest rates by no longer making any reference whatsoever to the timing of rate hikes this year or, indeed, in the foreseeable future.

Granted, a combination of modest EM asset purchases to correct distortions in global asset allocation and negative interest rates would not do much to help the real economy in the US. But then neither would conventional QE. The US and other developed economies need reform, not more money. As far as the US is concerned, Dollar weakness is now desirable because the US has gradually reduced its fiscal deficit and no longer needs a very strong currency to attract foreign bidders to Treasury auctions.

Continued overleaf

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In the end, the Fed may have little choice but to weaken the US dollar, especially if the economy slows further. There are precious few remaining easing options. Rates have already been cut to zero, the Fed has already done three rounds of QE and a Twist and the public debt stock is enormous, especially considering the roughly 200% of GDP in unfunded future medical liabilities for an ageing population. Sure, another round of fiscal stimulus is always possible – and US Treasury yields remain low – but it is risky to rely on a dysfunctional Congress that dislikes the Obama administration. Indeed, past experience shows that fiscal stimulus packages have had little permanent effect on growth and in the end they only add to the debt stock. The odds are that the job of supporting the economy will once again fall to the Fed and the US dollar is now the one obvious remaining policy lever.

Beyond the impact on the US, is it feasible to channel more capital into EM? Absolutely. Firstly, typical US and European pension funds and insurance companies as well as EM central banks are massively underweight EM, both in relation to EM's share of global market cap and particularly in relation to EM's share of global GDP.

Secondly, EM asset prices are now cheap, so bubble risks are very small. By contrast, bond and stock markets in developed economies are overvalued and returns are now negative for the year as the QE trades of the past few years are running out steam. Indeed, there is not a single asset in EM today – whether stocks, bonds or currencies – that is not materially cheaper than before the onset of QE relative to assets in developed economies.

Finally, EM fundamentals remain positive. True, financial conditions have been tightening for years as EM countries have faced a barrage of capital outflows, falling commodity prices and seriously weaker demand due to softer growth in developed economies. And yes, a small number of EM countries experience problems every year, but this is nothing new and can be remedied with active management. The vast majority of EM countries are healthy. They have managed to avoid major crises and continue to grow materially faster than developed economies.

The IMF in its recently issued growth forecasts sees the EM universe growing 4.0% in 2015 and 4.5% in 2016. Our view is that risks for EM growth are tilted to the upside because the currency weakness of the past four years has gone a long way to restoring export competitiveness. By contrast, advanced economies are expected to grow just 2.0% and 2.2% in 2015 and 2016, respectively. Here, the risks are tilted to the downside as currency overvaluation increasingly weighs on growth, especially in the US.

Obviously, it would be ideal if developed economies could generate on their own the high single digit growth they require to escape their twin problems of debt overhangs and productivity loss. But this seems unlikely on account of the widespread aversion to deleveraging and reform. The second best solution – and most likely one – is therefore that health is restored via a combination of inflation and/or currency realignment. While conventional QE policies have taken the global economy further away from this outcome, Fed purchases of EM assets would help by strengthening overseas demand and depreciating the US dollar.

Conventional QE programs have been instrumental in supporting business confidence by driving up stock prices and easing debt service costs by pushing down bond yields in developed economies. But QE policies have now become so distortionary in terms of global asset allocation that they are producing severe negative externalities for the global economy as a whole.

It is time to correct these distortions in the interest of global growth. This can be done without reversing of the benefits of conventional QE policies to developed economies if the Fed channels a modest part of its firepower into encouraging a more efficient allocation of global capital. In a highly imperfect global capital market rife with market and institutional failures the best way to ensure this happens is that the marginal unit of global capital goes where it will deliver the biggest bang for the buck in terms of growth, namely in EM.

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