# Global Economic Themes for 2018

Beata Caranci, SVP & Chief Economist | 416-982-8067
Fotios Raptis, Senior Economist | 416-982-2556

January 8, 2018

Although 2017 started on a more upbeat note than 2016, few forecasters expected the positive surprises that the year had in store. Economic momentum proved to be stronger and persistent, particularly within G7 countries. A typically weak (residual-seasonality distorted) first quarter in the U.S. quickly gave way to sustained, above-trend growth thereafter. A virtuous global cycle finally kicked in, feeding into trade volumes and many emerging market economies.

More of the same is on the docket for 2018. We anticipate the global economy to grow by 3.8%, slightly firmer than the 3.7% pace from last year. Indeed, many of the same themes will act to support global economic activity. Advanced economies will remain fairly hot, with emerging markets gaining speed. Although monetary stimulus should continue to wane, there is no question that conditions will still be highly accommodative by historical standards. Labor markets will tighten further, but a rapid uptick in wage and price pressures is unlikely. In fact, this is a key pillar supporting the view of many analysts that monetary stimulus will be removed at a gradual pace. Any shift in this market perception or actual data can quickly become a game changer for central bankers and bond yields in 2018.

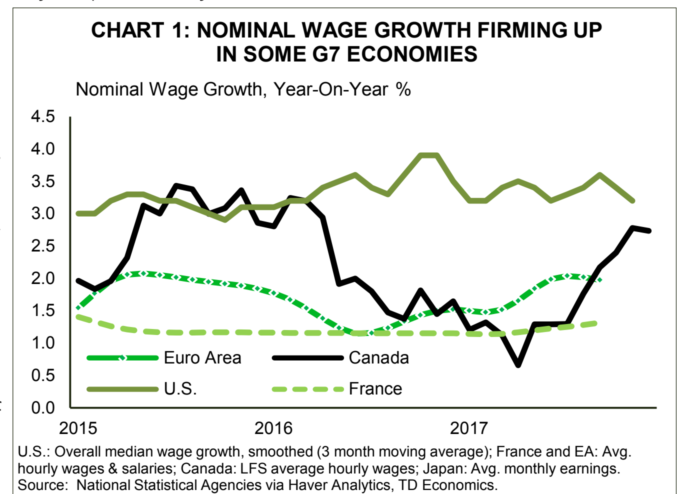
The year has barely started and an "everything-is-awesome" sentiment dominates the outlook. The global financial crisis, the euro debt crisis and the commodity price shock are all now largely in the rear view mirror. However, the true test of global health will be how economies adjust to less central bank stimulus after nearly a decade of priming the pump in favor of asset prices. And, this year will also give analysts a good look at how much politics will run interference with the international movement of goods and people.

We've identified six themes that we believe will shape the economic narrative for 2018:

## Theme #1: Global Reflation

In a note last fall, we highlighted a number of factors that may explain why inflation in G7 economies has been subdued despite strong economic growth and the rapid absorption of slack. Our empirical analysis showed that the link between economic slack and inflation still holds, but has weakened during the current cycle. However, weakened does not correspond to dead. It's just a matter of time before wage and price pressures respond to ever-tightening capacity conditions. Some signs are already evident in Canada and Europe, and various reports within the U.S. are reinforcing increasing wage pressures within the higher skilled segments of the labor force (Chart 1). With unemployment rates in advanced economies set to continue to plummet below historical norms, the laws of supply and demand favor increased wage-competition as labor becomes scarcer.

CHART 1: NOMINAL WAGE GROWTH FIRMING UP IN SOME G7 ECONOMIES




U.S.: Overall median wage growth, smoothed (3 month moving average); France and EA: Avg. hourly wages & salaries; Canada: LFS average hourly wages; Japan: Avg. monthly earnings.
Source: National Statistical Agencies via Haver Analytics, TD Economics.

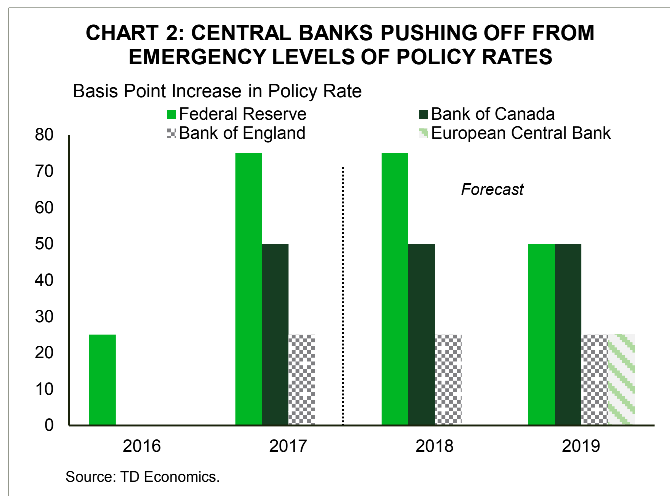
As with all economic forecasts, nothing is written in stone. But, a virtuous growth-cycle on a global scale does tilt the balance of risks more in favor to the upside for inflation, rather than downside. Certainly adding to this risk (and current reality) is that elevated geopolitical risks drive energy prices higher, pushing headline inflation up.

However, some aspects cannot yet be fully reconciled within forecast models, such as what's referred to as the "Amazonization" of prices, as well as the inherent imprecision that surrounds the calculation of output gaps and equilibrium interest rates across countries. We may find that inflation-targeting central banks will be more inclined to run their economies a little hotter than necessary, rather than risk tightening financial conditions too fast and ending the expansion prematurely.

## Theme #2: Rising global interest rates

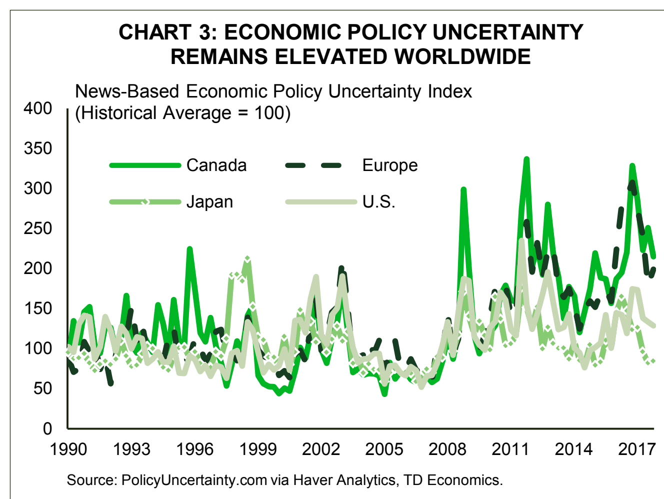
G7 central banks are on track to continue along the path of gradually removing stimulus. The Federal Reserve will have good company in raising its main policy rate by at least another 50bps, with both the Bank of England and the Bank of Canada each expected to follow suit with 25 bps and 50 bps hikes, respectively (Chart 2). Not to be left out, the European Central Bank has reduced its monthly asset purchases to €30 billion, and will likely cease altogether by year-end. This will leave Japan as the only G7 central bank continuing with a monthly asset purchase program through the end of 2018, and likely into 2019 as well.

**CHART 2: CENTRAL BANKS PUSHING OFF FROM EMERGENCY LEVELS OF POLICY RATES**




Source: TD Economics.

**CHART 3: ECONOMIC POLICY UNCERTAINTY REMAINS ELEVATED WORLDWIDE**




Source: PolicyUncertainty.com via Haver Analytics, TD Economics.

With central bank demand for bond-related purchases set to shrink, this may have knock-on effects to asset prices more broadly. There is the general sense that a decade of low interest rates has instilled a sense of complacency in investors, evidenced by ultra-low volatility in global stock and bond markets despite elevated policy uncertainty and geopolitical risks (Charts 3 and 4). It would not be unusual to see rising interest rates trigger bouts of financial market volatility in the coming months.

Historically, higher borrowing costs have triggered a selloff in asset markets. This suggests that the pace of wealth creation from asset price appreciation could slow or cease altogether as interest rates rise further and central banks withdraw from adding assets to their balance sheet. A surgical skill will be required of central banks to maintain credible communication, ensuring that balance sheet normalization be a boring process.

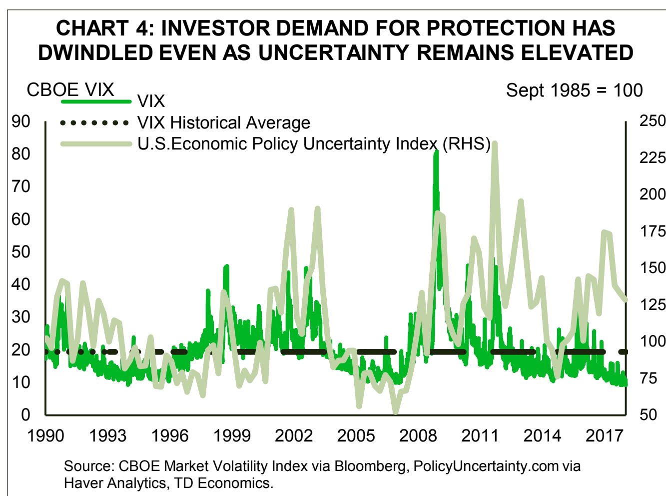
Of course, rising borrowing costs implies that servicing debt becomes more burdensome for borrowers. As such, higher rates should cool demand for housing, while also making highly speculative assets, such as high-yield debt and cryptocurrencies, less attractive to investors. Overall, we anticipate that the gradual pace of policy normalization is likely to do what policymakers intend: temper house price growth, slow asset price growth, and keep consumer spending and debt in check.

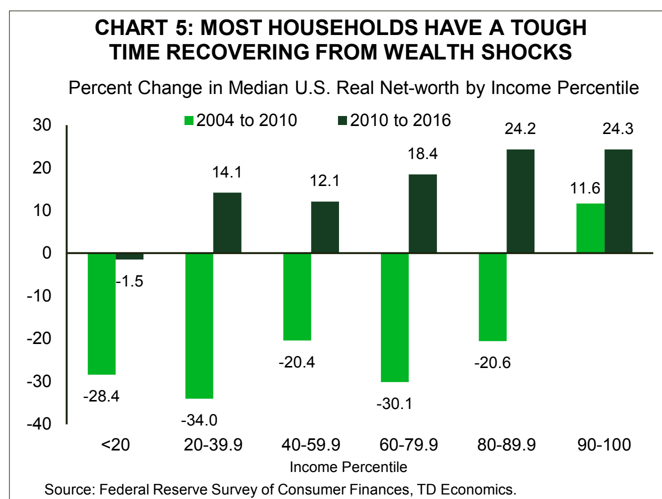
## Theme #3: Elevated debt levels

Given the forthcoming rise in debt service costs, there are concerns regarding the elevated levels of debt in G7 and emerging market economies. Within a global context, all sectors of the economy – households, firms, and government – have added leverage over the past decade. In its November update, the OECD provided an in-depth analysis of this rapid uptake in global debt. For businesses, the rise in debt is largely a consequence of the low cost of capital that resulted from monetary policy actions. However, increased leverage in household and government sectors is a little more difficult to unwind. Corporations have the option to switch to equity issuance and pay off debt. This amounts to reversing course of what has been years of financial engineering to minimize financing costs. This action poses relatively little economic risk, barring a sustained, adverse reaction by investors.

In contrast, although governments have the option of extracting more revenue from their tax base or cutting back expenditures, these are all options that tend to exert a drag on economic activity now, or in the future.

Conversely, households are most likely to have a difficult time adjusting to higher interest rates. Those economies that have high household leverage relative to incomes – like Canada and the UK – are now more interest-rate sensitive. In contrast, American households were one of the few to experience a true deleveraging cycle in the past decade. But,




these same households have only recently been able to taste the fruit of their labor with a recovery in wealth across income categories (Chart 5). What's more, most of the wealth-gains have been captured by higher income individuals, which still leaves many American households price-sensitive to movements in interest rates and income. Let's also not gloss over the fact that this economic cycle is long-in-the-tooth, particularly in North America. This does leave economies more susceptible to debt fatigue, policy errors, and asset re-pricing risks that can suddenly exacerbate debt conditions within the various segments of the economy.

Looking ahead, it's extremely difficult to forecast how each sector will respond to higher interest rates in G7 economies. But, in the absence of an unanticipated shock, 2018 is unlikely to be the year that a major deleveraging episode occurs in Canada, the U.S., Europe or Japan. Persistent above-trend income growth is a positive sign and the baseline view is that a gradual rise in interest rates shouldn't see debt service costs become too onerous. Instead, this is probably the year when the appetite for corporate debt finally slows after a decade long feast. The response of governments and households remains to be seen.

## Theme #4: Productivity growth ticking up

Strong economic growth over the last six quarters in G7 economies has partly reflected firming productivity gains (Chart 6). That is, the economy grew more than the amount of extra output result-

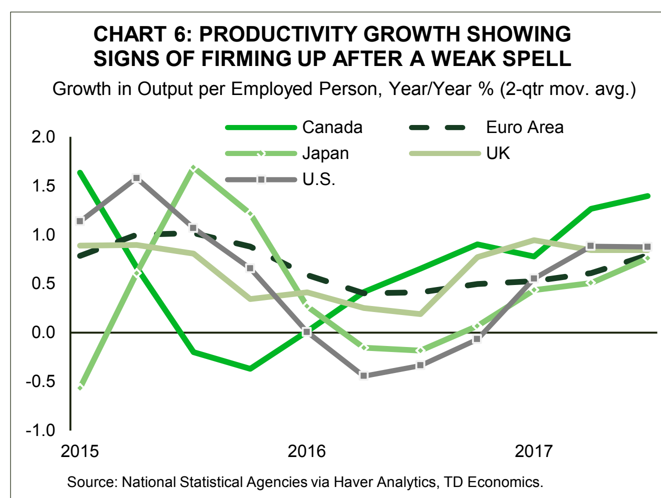
ing from the increased usage of labor and capital. Moreover, this recent uptick in productivity growth raises questions about existing trend estimates of its past and future path.

Labor productivity growth can be decomposed into the contribution from capital deepening (change in the additional investment in capital per unit of labor), and from total factor productivity. The post-crisis slump in productivity has been blamed on slower growth in both components. Indeed, slower business investment growth was puzzling especially in a historically low interest rate climate. Together with weak demand, the uncertain business climate after the Great Recession drove firms to prefer to return cash to shareholders instead of investing in their business. Less certain is why total factor productivity growth slumped. The most popular theory comes from Professor Robert Gordon, who theorizes that past waves of innovation have fully passed-through to the economy, leaving smaller influences stemming from the recent pace of innovation.[1]

Although it's still early days, the recent uptick in productivity growth, if it persists, may be a sign of a turning tide. Business investment globally has been ticking up in response to persistence of highly accommodative financial conditions and stronger demand. Although more difficult to assess, firmer productivity growth may also reflect a rebound in total factor productivity growth.

What's more, one of the greatest economic experiments is about to get underway. Will the massive, sudden drop in the U.S. corporate tax rate, combined with temporary full-expensing of capital investment, unleash the investment-beast in America? Economists say "no" to the beast, but "yes" to the jackrabbit. However, with investment momentum already accelerating last year, it will be difficult to fully untangle the sources of influences. Country comparisons will be useful in gauging impacts as we go forward.

Why does this matter? Trend estimates of productivity growth and its components feed directly into estimates of potential output. The estimated gap between actual and potential economic output helps




policymakers assess how much slack exists within the economy, ultimately determining the speed and level of interest rate adjustments. So, if productivity growth is indeed heating up in G7 economies, central banks will have to reassess how much economic slack remains, potentially altering the pace of policy normalization.

## Theme #5: Election outcomes

Elections and referendum results at times have become detached from polls in recent years. Markets were surprised by the UK vote to leave the EU, and the election of Donald Trump as President of the United States. With U.S. mid-term elections and general elections in parts of Europe this year, politics may once again shape market knee-jerk responses and economic outcomes.

Indeed, the U.S. economy performed very well last year, averaging just under 3.0% growth over the past three quarters. Moreover, the unemployment rate has plunged to a seventeen year low, with job gains likely to remain reasonably strong through at least the first half of 2018. Now that tax changes are a done deal, political focus will shift to NAFTA negotiations, immigration reform, repairing or replacing the Affordable Care Act, and maybe even an infrastructure plan. With mid-term elections this November, the Republican majority House would like to see progress in at least one of these areas before voters head to the polls. But, with a paper-thin Republican majority Senate at stake, posturing for mid-term elections and any shift in composition

thereafter could deal a blow to the ability for the U.S. administration to implement other long-lasting economic reforms over the remainder of its term.

Similarly, European economies outperformed expectations last year, as economic activity in the Euro Area expanded at a pace almost double trend estimates. Moreover, the outlook for Europe remains largely positive. There are good indications that momentum is carrying into the first half of this year and unemployment rates should continue to plummet, even in the periphery which is still in recovery mode.

Simply put, all signs point to a region that has moved beyond past economic crises. However, the outlook is not all roses. Anti-establishment political movements are likely to continue to cast a long shadow this year, threatening the stability of the euro and the European Union. Although the populist threat to core economies largely fizzled following electoral victories last year by more centrist candidates in the Netherlands and France, the election of the young, anti-migrant Austrian Prime Minister Sebastian Kurz and the entrance into parliament of the nationalist AfD party in Germany prove that anti-establishment policies remain attractive to voters.

Italians are first to head to the polls this year, with parliamentary elections scheduled for March. Although the anti-euro/EU M5S party is favored to win, currently polling at 27% of the popular vote, they are still far short of a majority. Moreover, recent electoral changes in Italy and M5S's refusal to negotiate a coalition reduce the chance that M5S will be able to form a government. However, an outcome that proves otherwise could be disruptive to market sentiment.

Flying somewhat below the radar are forthcoming elections in Eastern Europe. Hungary, Czech Republic, and Poland have all been vocal about EU immigration policies, or the lack thereof, and the current brand of soft Eurosceptic leadership is likely to remain after elections later this year. Although Poland isn't going to the polls, its dispute with European authorities regarding judicial changes that violate European laws resulted in a ruling last month which opens the door for the EU to impose sanctions on Poland until it returns independence to its judiciary. Initial sanctions are likely to include suspending Poland's ability to vote on EU articles. How the EU handles Poland could have implications for upcoming elections.

## Theme #6: Brexit, NAFTA, and geopolitical risks

Lastly, there are several overarching themes carrying over from last year that will intensify this year. The timeframe for Brexit negotiation and resolution will be shortening with each passing month. Although Phase 1 negotiations that largely dealt with Brexit costs wrapped up last month, Phase 2 is really where the rubber hits the road. Critically, negotiations this year will entail compromises by both the UK and the EU-27 in order to establish the necessary framework to avoid a hard Brexit in March 2019.

Other trade negotiations will also garner critical market attention. NAFTA renegotiations will continue behind closed doors probably (at least) through the first quarter of this year. Material changes could have substantial negative implications for the economies of Mexico and Canada. For example, if the U.S. were to pull out of NAFTA entirely, we estimate that a return to WTO trading rules could shave about 0.7% off of the level of our baseline view for economic activity in Canada within the first year. Although macroeconomic estimates of the impact on U.S. activity are much smaller, the indirect impacts both to the U.S. economy and global supply chains will be largely unobservable until after a complete withdrawal from NAFTA occurs. In addition, the U.S. would not be able to skirt a negative financial market reaction on a NAFTA withdrawal or changes that are materially unfavorable to the states/industries that have high growth-reliance on Canada and Mexico.

As U.S. interest in trade liberalization has waned, the rest of the world will continue to work to build closer relationships this year. The Trans Pacific Partnership (TPP) will remain in the headlines, as more countries, including Canada, seek to join New Zealand and Japan by having the agreement ratified by their

parliaments. China will also drive harder on building inroads on more new free trade agreements (FTAs), seeking to add an additional eleven to its current roster of seventeen over the next few years.[2]

Outside of trade packs, North Korea will likely remain as the most pertinent geopolitical risk. Thus far, North Korea's leadership has been reluctant to negotiate terms to abandon its nuclear weapons research and stockpile. Moreover, there is little comfort that the situation can deescalate while North Korea continues to fire ballistic missiles near its neighbors and conducts nuclear tests. Financial markets are betting that a large political misstep doesn't occur that causes a stumble into conventional or nuclear war.

## End Notes

1. 1. See Gordon, Robert J., 2012. "Is U.S. Economic Growth Over? Faltering Innovation Confronts the six Headwinds." http://www.nber.org/papers/w18315.pdf
2. 2. Source: China FTA Network from the Chinese Ministry of Commerce. http://fta.mofcom.gov.cn/english/ as of January 5, 2018.

## Disclaimer

This report is provided by TD Economics. It is for informational and educational purposes only as of the date of writing, and may not be appropriate for other purposes. The views and opinions expressed may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. This report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise the TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.