P I M C O

June 2017

Economic Growth Amid Policy Shifts

The five members of PIMCO's Global Advisory Board, a team of world-renowned macroeconomic thinkers and former policymakers, recently joined the discussion at PIMCO's annual Secular Forum, where they addressed critical factors likely to shape the global economy over the three- to five-year horizon. The board's insights constitute a valuable input into PIMCO's investment process. The discussion below is distilled from their far-ranging conversation.

GLOBAL ADVISORY BOARD

PIMCO's investment process is designed to encourage new ideas and differing points of view. One way we do this is by inviting outside experts to share their insights and help us test our thinking. These experts include the members of our Global Advisory Board, a team of world-renowned macroeconomic thinkers and former policymakers. Chaired by former Chairman of the Federal Reserve Dr. Ben Bernanke, the Global Advisory Board meets several times a year at PIMCO's Newport Beach office and contributes to our economic forums.

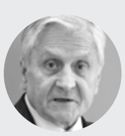
PIMCO GLOBAL ADVISORY BOARD

Ben Bernanke
Former Federal Reserve Chairman and Distinguished Fellow at the Brookings Institution

Gordon Brown
Former UK Prime Minister and former Chancellor of the Exchequer

Ng Kok Song
Former Chief Investment Officer of the Government of Singapore Investment Corporation (GIC)

Anne-Marie Slaughter
President and CEO of New America, Bert G. Kerstetter '66 University Professor Emerita of Politics and International Affairs at Princeton University, and former Director of Policy Planning for the U.S. State Department



Jean-Claude Trichet
Former President of the European Central Bank and present Chairman of the European group of the Trilateral Commission

Q: Over the secular horizon, developments in China will likely reverberate throughout the global economy. What is the outlook for China's policy and economic growth?

A: President Xi Jinping's political position is likely to strengthen after the 19th National Party Congress this fall. To secure his legacy, he is pursuing two important supersecular objectives for China: to achieve low-income, developed-country status by the time he leaves office in 2022, and to achieve advanced developed-country status by 2049 (the 100th anniversary of the Communist Party). To meet these objectives, China would likely need to see annualized growth between 5%–6.5% while simultaneously transitioning the economy away from low-cost manufacturing, escaping the middle income trap, deleveraging and de-risking the financial system, avoiding too-rapid currency depreciation, maintaining political stability and satisfying people's expectations regarding healthcare, housing, education, climate and employment. All these goals will be challenging to reconcile.

In the near term, President Xi will likely emphasize stability and growth (even if low-quality growth) to the detriment of reform efforts, though after he consolidates power as we expect this fall, growth estimates could be decreased and reform efforts accelerated. Risks remain that China's economy may not compensate for the loss in growth brought about by reforms and slower credit expansion. With that said, the government should have the fiscal flexibility to contain any large-scale financial system risks.

China's exchange rate policy can influence markets globally. Over the secular horizon, we believe China will pursue a "stable yuan" approach and may even let its currency appreciate for two primary reasons: to avoid being labeled a currency manipulator by the U.S., and to prevent additional loss of reserves, as would happen if ongoing depreciation became widely expected.

Q: Turning to another country undergoing a secular transformation, what is the outlook for the UK?

A: For now, the UK economy is holding up well, but Brexit and other developments pose longer-term risks. For example, the expected decline in immigration due to Brexit is likely to lead to downward pressure on trend growth. The risk of a UK recession during the secular horizon appears high, especially if the economy is unable to rebalance away from household debt and consumption to exports, and also rebalance exports away from mainland Europe to the rest of the world.

The debate over how Brexit will proceed is likely to escalate this fall, but given the massive complexity of the undertaking, the UK is not likely to leave the EU until after the formal date of March 2019. The longer the period of transition takes, the longer it will take the UK to negotiate new economic agreements. In the meantime, its economy could see significant adverse effects in the auto and financial sectors among others.

Q: What is the outlook for Europe?

A: Europe's economy is continuing to improve and its large current account surplus provides some room for maneuver, but its economic cycle is several years behind that of the U.S. Unemployment remains high and structural reforms are essential. Over the secular time frame, Europe may continue to struggle to rebalance trade flows and restore competitiveness in lagging economies. Some countries are highly indebted and greatly in need of reforms, which could make them more vulnerable to a eurozone exit (a risk, not a baseline scenario; we expect the eurozone to remain intact over the secular horizon).

Populism remains a trend to monitor over the coming years. Italy's populist Five Star party is looking ahead to the presidential election, the UK is more nationalistic after the Brexit vote, Marine Le Pen and the National Front will remain players in France, and we see increasing nationalism in other places such as Ireland. That said, Emmanuel Macron's victory along with developments in the Netherlands and Germany suggest that, at least for the moment, much of continental Europe is resisting the populist trend.

Q: Looking beyond Europe, what is the longer-term outlook for populist and nationalist movements globally?

A: Nationalism and populism persist globally. Populist sentiment – and anger – could increase if the recent populist victories do not lead to fundamental improvements for the workers who played a large part in those victories. This anger could (somewhat paradoxically) spur more nationalism and protectionism over time, which in turn could restrict the movement of capital and people and lead to downward pressure on global growth potential.

In the U.S., we see some signs of pushback, with opposition mobilizing against President Trump and nationalistic policies, and state and local politicians highlighting the benefits of globalization. Ultimately, we are unlikely to return to unfettered globalization in the U.S., but may move toward an attenuated approach of "slower globalization" instead of today's nationalist rhetoric.

Q: What are the key geopolitical trends and risks we should be monitoring over the secular horizon?

A: There is considerable uncertainty about how the Trump administration's foreign policy strategy will ultimately coalesce. His policies have three competing strands, including: 1) an "aggressive America First" approach (e.g., labeling China a currency manipulator, threatening to leave NAFTA); 2) a traditional "America as leader of the global order" approach (e.g., reinforcing NATO, strikes in Syria); and 3) a transactional "America as deal-maker" approach (e.g., negotiating with North Korea, pursuing deals with Russia).

In general, the risk of a catastrophic or highly costly event, though still low, is higher under the Trump administration given the lack of a clear policy framework. Until more clarity emerges, we could see an increase in regional alliances and growing potential for proxy wars. Situations to monitor include Syria, Venezuela, the increasingly tense U.S./Turkey relationship, and the potential for regional trade deals in Asia.

As for North Korea, since China and now South Korea (following the recent election) are unlikely to make major moves, President Trump will likely need to take some kind of action. However, the most the U.S. can hope to gain is for North Korea to agree to a freeze of its nuclear program (the nation has no rational incentive to give up the program entirely) and to stop the missile program (a concession the U.S. has never been able to get). That said, the impact to financial markets from developments in North Korea is likely limited, provided most investors see China and the U.S. cooperating on the matter.

Q: What is the longer-term outlook for major central banks? Have we reached the point of monetary policy exhaustion?

A: The Federal Reserve seems to have more confidence in the economic recovery. Risks have become more balanced, and labor markets continue to tighten. The Fed views the fed funds rate as its primary monetary policy tool and will look to decrease the size of its $4.5 trillion balance sheet, most likely starting in 2018. By the end of 2021, the Fed balance sheet could be in a range of $2.8 trillion to $3.4 trillion, still with substantial holdings of mortgage-backed securities.

Janet Yellen's term as Fed chair ends early next year, and while many are speculating about her possible successors (or her reappointment), we expect overall continuity in monetary policy, regardless of leadership. In the event of a downturn, the Fed still has policy tools to deploy if needed – conventional and unconventional – including cutting short rates, using forward guidance or expanding quantitative easing (QE). Over the secular time frame, to increase its firepower, the Fed may explore other policy frameworks, such as flexible price-level targeting.

In Europe, we expect overall continuity in European Central Bank (ECB) policies for the foreseeable future, even after President Mario Draghi's departure in 2019. Any change to current policy would be gradual and incremental, as inflation and inflation expectations remain below target. Though some observers believe negative rates are doing as much harm as good, the ECB is unlikely to raise rates until well after it has tapered and concluded its QE program.

Should the economy slow or inflation fail to pick up, the ECB has some unconventional tools at its disposal, but we see limited scope for further monetary easing. In that situation, the responsibility would fall to the fiscal authorities, particularly those in countries with large current account surpluses.

Of the major central banks, the Bank of Japan is likely closest to monetary policy exhaustion. If global conditions remain favorable, the current policy stance may be sufficient to bring inflation to target in the next couple of years; if not, fiscal-monetary coordination may be the only remaining recourse.

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com
blog.pimco.com

PC217_51491

CMR2017-0607-273153