Deloitte.
デロイト トーマツ

トーマツ.

Deloitte Touche Tohmatsu LLC
Center for Risk Management Strategy (CRMS)

2017 Global Risk Outlook
Will the Trump presidency bring an inflation or deflation?

Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy(CRMS) /Deloitte Asia Pacific Risk and Capital Management Leader
January 29, 2017

For risk management professionals, 2016 was truly a year full of upheaval. No matter how much fuss the media made in advance, we may have become so accustomed to settling on the world of pre-established harmonies (which the media itself predicts) that we have not built up “immunity” to a series of consequences that completely contradict the foreseen scenarios. The unexpected consequences, needless to say, refer to acceptance of Brexit at the U.K. national referendum last June as well as the election of the Republican candidate Mr. Trump at the U.S. presidential election in November. Further, the “Trump market-rally” with sored stock prices, high interest rates and strong dollars that appeared after his election, and the rise in the post-referendum British economy greatly defied the pessimistic predictions.

Three new trends that emerged in 2016

#1. “Globalization” to “Fragmentation”
Now, what would the global economy look like in 2017? The key to read into this lies in the unanticipated events taken place in 2016. The events in the U.S. and the U.K., particularly in the former, have a potential to largely alter three trends that have dominated the world economy thus far.

The three trends include “globalization,” “ultra-loose monetary policy,” and “strengthening regulations.” These are about to be replaced by three new waves, namely “fragmentation,” “fiscal stimulus,” and “deregulation.”

Globalization evidently signifies liberalization and vitalization of cross-border flows of goods, services, people and capital, and furthermore, standardization of financial regulations and such beyond nations’ borders. This tide of globalization, after the 2000s, brought rapid growth of emerging economies including China, while enhancing interdependence of the worldwide economy, including advanced economies, through expansion and sophistication of supply chain. However, this trend simultaneously caused a downfall of the manufacturing industry and its working-class in the U.S. and others, which then led to the “unexpected” birth of President Trump.

Globalization is exhaustive utilization of “comparative advantage,” and in this sense, it has drastically increased welfare not only in emerging economies, but also in overall advanced economies such as the U.S. It is another issue, however, whether its distribution is considered “fair” by the American citizens for instance. Indeed as a result of globalization, the U.S.-based multinational companies have grown their profits, augmenting the income of business owners and the wealthy. Meanwhile the American working-class are exposed to the competition against those in emerging economies, with their income plateauing at best, or declining in many cases, or their job being just lost. Surely it is possible for them to make a career change to find another IT related opportunity on the West Coast, but if this field is dominated by bright Indian and Chinese immigrants, the white Americans from the Rust Belt would find themselves at a dead end.

In the midst of these situations arose the anti-globalization movement, and anti- immigration and trade sentiments formed among the white middle-class Americans from the Midwest and those outside of city of London in the U.K. In other words, this would be a “modern-day Luddite movement.” These voices gave birth to the new regimes of President Trump and Prime Minister May that promote policies to restrict immigration, in addition to shifting to protectionism in the U.S. as well as independence from the EU system in the U.K. These policies of the new American and British governments sweepingly change the direction from “globalization” to ”fragmentation,” aiming for isolation and independence in aspects of flows of people and goods over borders, and rule-making processes.

In fact, this type of movement does not originate solely in political incidents in these two countries. In financial regulation in particular, the “Basel Process,” led by the Basel Committee on Banking Supervision to formulate international financial regulation, is on the verge of collapse; the Basel III agreement is postponed despite its plan to be reached by early this year. As discussed in a later section, this can be understood as a reaction to extreme cross-border standardization of regulations, in the same manner as the reaction to excessively tightened regulation after the financial crisis.

#2. “Ultra-loose monetary policy” to “Fiscal stimulus”

The second tide that has ruled the global economy is the “ultra-loose monetary policy.” It is still fresh in our memory that many of the advanced economies faced the danger of deflation in the course of long-term saving glut and lowering productivity, particularly after the global financial crisis during 2008 to 2010. The central banks of these countries actively took on “ultra” monetary easing policy as a countermeasure. “Ultra” means to go beyond ordinary monetary easing measures, and specifically refers to “quantitative easing” which forcefully expands the “quantity” of monetary base within the limitation of zero interest rates, and further “negative interest rates” which break the conventional idea of zero bound. Till date, European and Japanese central banks employ both measures while the Federal Reserve Bank still maintains its swollen balance sheet as a result of the past quantitative easing.

Although this type of policies are said to have provided certain stimulating effect on the macroeconomy (especially through currency devaluation and a rise in asset prices), the hike in asset value notably incurred a side effect to further widen the income gap between the affluent and the low- and mid-income households. Then the middle class’ repellence against the wealthy, and the financial industry which directly receives the benefits from rising asset prices, serves as a significant factor in the “rebellion” in the U.S. and the U.K. In contrast, the new American and British governments are setting forth the positive adoption of fiscal package such as expansion in infrastructure investment. While mitigating the excessive dependence on monetary policies, this also leads to direct grant of benefits to the working class through public investments and improved investment environment with infrastructure development, which softens the dissatisfaction of the bourgeoisie, the middle-working class.

#3. “Strengthening regulations” to “Deregulation”

Lastly, the third tide that has dominated the global economy is the "strengthening regulations." A representative example would be tightening of financial regulations after the global financial crisis, but environmental regulations have also been enhanced due to concerns over the global warming for instance. Although such enforcement of regulations is led by the supervisory authorities or governmental agencies, it is also strongly supported by the general public fed up with the greed of major financial institutions in the case of financial regulations, and by groups concerned for the environment for future generations in the case of environmental regulations.

The new American and British governments are drastically changing this trend of greater regulatory controls. For example, while the U.S. Treasury Secretary candidate, Steven Mnuchin claims to "preserve the Volcker Rule," the seats for SEC (Securities and Exchange Commission) Chairman and CFTC (Commodity Futures Trading Commission) Chairman are expected to be assumed by those close to the financial industry, or supporters of deregulation. The new board of governor of the FRB, who will also serve as the Vice Chairman of bank supervision and will greatly influence the prudential regulations, is yet to be appointed, but the recent personnel assignment makes us to expect a similar appointment in favor of deregulation. Furthermore, for the environmental regulation, President Trump has indicated a principal change in direction by nominating Mr. Pruitt, who has been against stricter regulation, as the EPA Administrator while immediately approving the plan for Keystone pipelines which the Obama administration was reluctant to approve due to environmental concerns. Also in the U.K., for the financial industry such as the City of London that will lose the privilege from the single-market access passport system upon Brexit, complete transition might be possible from the traditional route of strict regulation to bold deregulation.

It is questionable whether these moves speak for the white middle-class who voted for the new governments in the U.S. and the U.K. Rather, it is reasonable to interpret this shift in trend as representation of the voice of industries that have accumulated discontent. This also implies the potential risk to evoke criticism from the government supporters who feel bitter about the financial and energy industries.

The global economy in the light of new trends

Three new tides mentioned in this article still remain only within the U.S. and the U.K., and it is uncertain if they will become the new trends worldwide. However, considering the fact that the past three tides were promoted by these two states, and their strong presence in international regulation making as well as the overwhelming economic influence of the U.S., the transition in tides in the U.S. and the U.K. is highly likely to bring a trend shift in the entire world.

Hence it is crucial to consider the impact of the three new tides when speculating on economic performance in 2017. Here, impact refers to influence over various imbalances which shape long-term trends, in addition to short-term effects on economy.

First, let's look into the impact of the shift from "globalization" to "fragmentation". From a short-term perspective, this will certainly downturn the macroeconomy. Since fragmentation negates the global division of labor based on comparative advantage, the economic efficiency is sure to decline. Consequently the distribution of profits derived from the previous efficiency will suffer not only in emerging economies which have enjoyed much of the profits, but in advanced economies including the U.S. and the U.K. (i.e. Import substitution with domestic products causes inflation). Many institutions forecast that the introduction of protectionism in the U.S. Trump administration and Britain's separation from EU will produce significantly negative impact on their macroeconomy.

On the other hand, an action to put the brakes on the excessive globalization is vital as a means to release dissatisfaction of the middle-class "abandoned" by the government in the past. If such discontent intensifies, it could develop to extreme nationalism and geopolitical adventurism. In this regard, if the movement toward fragmentation and protectionism stays "controlled" enough for the governments to indicate their solicitude for the middle-class, it might achieve stable administration of economy and politics in the mid- to long-run.

Secondly, on the impact of the change from "ultra-loose monetary policy" to "fiscal stimulus," this will bring boosting effect on the short-term economy. With the limits of monetary policies in the face of zero interest rates, and the growing adversity of ultra-loose monetary policy, international organizations including IMF, for a long time, have urged the U.S. to take on the expansionary monetary policy given its room for financial growth. If the Trump administration, as pledged, implements major tax reduction as well as fiscal expansion through increased infrastructure investment, these will certainly contribute to underpin the macroeconomy. The same applies to the policy of the May government in the U.K. to extend infrastructure investment in rural regions. The U.S. today, however, enjoys near-full employment, thus further fiscal stimulus would most probably induce inflation and rise in interest rates, which then would result in strong dollars. This would further bring down the manufacturing industry including exporting firms as well as increase in trade deficit. In short, it could cause a consequence to betray the Trump constituency.

What types of influences would be brought to the imbalances in the U.S. by this shift from the "ultra-loose monetary policy" to "fiscal stimulus"? The abnormal soar in asset prices (asset bubble), accompanying the excessive dependence on monetary easing, might be restrained as the interest rates goes up in the future. On another front, what is worrisome is future increase in fiscal deficit and a current account deficit stemmed from proactive fiscal policies. If the substance of investment become exceedingly close to "consumption," the concerns for wasting public funds would intensify. Notably fiscal expansion at the cost of globalization may strengthen the infrastructure foundation for growth as is the case for emerging economies, but growth acceleration by rising technological innovation, of which originally the U.S. is at the comparative advantage, may not be attainable.

Lastly, the shift from "greater regulatory controls" to "deregulation" would produce positive effects in a short term particularly by facilitating resource development such as shale gas. In regards to financial regulation, although it is difficult to abolish already established regulations like the Dodd-Frank Act, by preventing the adoption of new restrictions, or castrating the previous ones, regulatory burdens on financial institutions can be alleviated, enhancing the financial intermediation function. Indeed after the victory of Mr. Trump at the U.S. presidential election, the stock market has anticipated these effects, pushing up the financials and the energy stocks prices, and the stimulant effect has already materialized through the rise in asset prices.

In a medium- and long-term standpoint, impact over the long haul is alarming, such as stability of the financial system in the U.S. and others as well as global warming. It is safe to acknowledge that the current global financial system including the U.S. has become highly resilient to potential risk phenomena thanks to various measures introduced after the Global Financial Crisis. At the same time, concerns have recently grown in regards to imposing further capital rules on major financial institutions, or direct intervention of supervisory authorities to its management. Therefore the correction of extreme regulation, as swing-back of a pendulum, is by no means negative even in terms of financial system stability. However, as previously mentioned, it is a separate discussion whether the American citizens would be convinced with such a direction. Simultaneously in the aspect of environmental regulation, in addition to the long-term burden on the environment, its divergence from the American majority's awareness, can very well cause political instability.

The baseline scenario for 2017 global economy and how to read Trump risk

What influence in total will the new three trends bring to the global economy in 2017? When looking at the short-term impact on macroeconomy, "globalization" to "fragmentation" will be negative, "ultra-loose money" to "fiscal stimulus" will be positive, and "strengthening regulations" to "deregulation" will also be positive. With these three effects combined, in my opinion, the year 2017 will experience overall positive impact.

As elaborated later, this is because I believe the new American administration's policy shift to protectionism, which represents "fragmentation," will realistically remain limited despite the President's flashy performance. Moreover there is a presupposition that the new administration and the Republican Party will reach a certain level of agreement in the early stages on corporate tax reduction and government expenditure on infrastructure, which lead to the actual fiscal expansion after this autumn. In this case, in the 2017 U.S. economy, a reflation effect from a rise in asset prices expecting fiscal disbursement and deregulation in the first half, and the effect from actual fiscal expansion in the latter half of this year, will drive up the economy. During the same period, the adverse wind of high interest rates and strong dollars will blow, but this is an "outcome" of the reflationary effect, which can partially diminish the effect, but not completely demolish it. Simultaneously it is also possible for advanced economies including Europe and Japan to fully enjoy its benefits through currency devaluation and export increase. To the contrary, emerging nations will experience a year with dwindling economy as increased production of shale gas stagnates crude oil prices, and high interest rates in the U.S. cause capital outflow, resulting in currency depreciation, and consequent inflation and monetary tightening.

Meanwhile, as for risk scenarios, there are several potentials: 1) The president and the Cabinet members, or the Republican Party, have conflicting perspectives, which delays policy implementation for fiscal expansion and deregulation. Consequently the Trump market-rally ends up with a complete rewind, 2) Policies to promote fragmentation are extensively implemented, and this puts downward pressure on the worldwide economy including the U.S. through shrinking trade and rising import prices, 3) America's aggressive attitude towards China and Middle East policies escalates military tension and incurs accidental military conflict, which as a result intensifies the global risk-off trend, 4) Since slack in the U.S. labor market turns out to be unexpectedly little, increased fiscal expenditure leads to steep inflation and consequent drastic rise in interest rates, which will be followed by significantly stronger dollar.

Among above, (1) and (2) are deemed not as main scenarios but risk scenarios, because I assume that the Trump administration will eventually orient toward realistic policies. Mr. Trump was unique in, rather than talking about sympathy for their feelings "from the top" like many Washington elites, gaining the support of these "abandoned" middle-class by acting and speaking like them, thus, allowing people to see their actions and comments reflected through Donald Trump himself. This is why his tactics in the presidential election are said to adhere to reality shows in which he has been greatly successful.

The question here is how far this type of reality-show performance can be systematically applied as policy measures, for example, in the area of trade. If the ultimate policy targets are confined to restricting rule of origin for the production in Mexico, imposing anti-dumping taxes on certain products from China, and re-enforcing total volume control over automobile import from Japan, the impact on the American and international economy would be limited. In contrast, if a solid action is taken to levy flat tariffs on Mexican and Chinese imports at 35% or 45% respectively, the global economy including the U.S. would fall into a maelstrom. I anticipate that President Trump's intension extends to no more than sustaining his constituency until the next mid-term election just by the "reality show" performance.

Opportunities and Challenges for Japan

Finally let's examine the scenarios that Japan will encounter in 2017. The baseline scenario reads that under the new trends in the U.S. and others, robust economy maintains itself while pressure intensifies toward inflation. In addition to the improved income environment, with some underpinning factors such as yen depreciation and steady crude oil prices lining up, prices in Japan have a great chance to invert and move upward after finally stopping falling. This would be more applicable if the interest rates in the U.S. enter an upswing trend. For Japan, momentum is at last gathering for a long-dreamed "inflation."

If a more evident sign shows for inflation, the position of the Bank of Japan (BOJ) towards its monetary policy might prove problematic. For example, 1) when to lift the interest rate for 10-year government bonds that is currently controlled around 0%, 2) Concerning the "overshooting commitment" introduced during last year's reform in the monetary policy framework, how to specifically define overshooting, and 3) how to interpret the targets for commitment (be it -0.1% benchmark policy rate, 0%-level interest rates for 10-year bonds, or bond purchase around 80 trillion yen per year, etc.), are not necessarily clear yet. If effective communication does not take place with the market on these points, unanticipated situations might occur such as a temporary surge in long-term interest rates.

Concurrently, with a replacement of the Governor of BOJ approaching in April 2018, the government might add pressure to BOJ to hinder the removal of monetary easing policy. Since a soar in interest rates directly links to substantial increase in fiscal deficit, decisions on the consumption tax raise in October 2019, and attitude toward achieving the goal of a primary balance surplus by 2020 will be questioned. Thus a possibility should be kept in view that BOJ's action for monetary tightening may be delayed. What happens then might be free-falling yen and unstoppable inflation.

The challenge of 2017 lies where, in addition to above inflation scenarios, deflation scenarios also remain as before. If the Trump market-rally winds back, once again an exponential yen appreciation might present itself. Hypothetically if the Trump administration tries to adopt the reality show performance into actual policies, just like China and Mexico, Japan would be another easy target to be a "villain." Furthermore if America's aggressive attitude toward China escalates the military tension, Japan would necessarily face extensively negative impact. By this means, the year 2017 for Japan largely depends on the Trump administration's actions in many ways.

(This article was written on 29th, January, 2017)

Tsuyoshi Oyama
Partner
Head of Center for Risk Management Strategy
Deloitte Global Financial Services Industry Asia Pacific Risk and Capital Management Practice Leader
Deloitte Touche Tohmatsu LLC
Tel: 03-6213-1162
Email: **crms_contact@tohmatsu.co.jp**
