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OF CHINA, INDIA, AND A TEMPERED GLOBAL ECONOMIC OUTLOOK

Global Chief Economist of The Economist Intelligence Unit, Simon Baptist, discusses trends that are likely to shape the future global economic outlook, in this interview with Alvin Lee.

2018 is shaping up to be an interesting year for global economics. How do the coming months look for China and India, the world's most populous countries?

2017 was a pretty good year, a lot of countries did reasonably well, marked by a turnaround in Europe and Japan, and China's gentler-than-feared slowdown. Moving into 2018 it's looking just as good, but there are some clouds gathering.

I'm expecting a mild slowdown in China triggered from the investment sector. Unpaid corporate debt will lead to a slight cutback in bank lending, and I expect to see investment growth in China slow as a result. There will also be tighter controls over household loans.

While this is a challenge, chances are the Chinese government will be able to control what happens. China has a good track record of dealing with transitions, and it's likely they will do so again this time. China's banking system is not the same as that in, say, the U.S. and Europe where things can be market-led; everything in China is state-led. The government has all the levers to engineer a controlled slowdown instead of being at the mercy of changing sentiment or market forces.

Over the next five years, I am most optimistic about India. Although India has always had that potential, what makes things different now? The answer is politics. The political scene is less fragmented than before. The BJP now controls both the presidency and parliament. It's the first time in 35 years that one party has the majority in the Lower House, and they are on track to secure a majority in the Upper House as well. This has allowed the government to take some important steps. Financial regulations have made the banking system more robust. The central bank is run more effectively. And the Goods and Services Tax has harmonised taxes across Indian states, making India more of a national market.

India's growth will be services-driven rather than manufacturing-driven. I don't think India will become a manufacturing powerhouse the same way that China did. It's going to be a services powerhouse. From the industrial revolution in Europe, to Japan in the 50s, then South Korea, Hong Kong, Singapore and Malaysia to date, every country has achieved economic development through the manufacturing route. Yet India—and we'd put the Philippines into the same basket—is trying to go from lower- to middle-income status, and to higher-income thereafter, through the services sector.

So there is the open question: Can services deliver the same level of productivity growth? Can services deliver the same level of job creation needed to draw all those migrants from rural areas? How vulnerable is the services sector to things like automation and robotics? The answers will unfold with time.

The price of oil seems to be an area of concern in 2018. With oil prices now at their highest point in three years, are fundamentals pointing to a repeat of the days of US$120 per barrel? And what does that mean for the global economy?

I think there's very little chance of oil going back to US$120 a barrel. In fact, I think the current price of around US$70 is a little high. My feeling is that the long-term price of oil in the next 12 to 18 months will be between US$50 and US$65 per barrel, but it does depend on how well the OPEC countries can stick to their promises to cut production.

The big reason why we see the sudden rise in oil prices is that the U.S. has become a big oil producer. U.S. oil production is quite responsive to price. When prices go up, you see U.S. producers increase output, and when the prices decrease you see U.S. production decrease in response to market forces. It's a different dynamic to the past where price formation was more fully controlled by the OPEC countries—led by Saudi Arabia—which make decisions about output somewhat independently of the price. Governments make decisions on the basis of how they want to affect the global market; they're not responses to the market price. U.S. production, which is now significant and responds to the market price, will keep prices in a narrower band than before.

To what extent are oil prices affected by the shale producers? Are they back in the game now that prices are creeping up? Is oversupply likely as a result?

Absolutely. It's all about the shale producers. They are more easily able to respond to price changes and we are now seeing that. U.S. oil output has just reached its record level, surpassing any historical level of output. It is in direct response to the fact that prices over the last six to eight months have been going up, and oil producers have been increasing output.

It's a bit difficult to talk about over- or undersupply. Oil, like any product, is just a market. There's a demand and supply, and the price will just move and these things will find a balance. What I do think will happen is that the increased production from the U.S. is going to put a downward pressure on oil prices over the following six months as the increased production comes through. The shale producers in the U.S. must make sure they don't overinvest in new production, such that prices fall so much that they stop making money.

Is Jerome Powell, chairman of the U.S. Federal Reserve, likely to maintain the course of slow interest rate increases? What does that mean to the rest of the world and, specifically, Southeast Asia?

The new U.S. Fed is a bit more hawkish than the previous one. As such, they are going to be less worried about unemployment and more worried about inflation. The new Fed is more likely to prefer higher interest rates and lower levels of inflation than lower interest rates and higher levels of inflation. The bigger impact is the government spending increases and tax cuts announced in late 2017. These are going to create inflationary pressures and could cause interest rates to rise faster.

I wouldn't want to overstate that difference—it's just a shift in emphasis. We still expect three rate rises from the Fed in 2019. And next year, maybe instead of expecting two or three rate hikes like we had under Janet Yellen, we might now expect three or four. The long-term perspective on U.S. interest rates is that they are still pretty low but the normalisation process, which has already started as Yellen has signalled, is likely to continue. But low unemployment and rising government spending means that barriers to raising interest rates are lower than in 2017.

What does that all mean for Southeast Asia? There might potentially be some downward pressure of currencies as those high interest rates induce people to put money into the U.S. rather than elsewhere. Also, countries with big current account deficits, such as Indonesia, will have to be conscious about their domestic policy settings to make sure that they are attractive places for foreign direct investment, which is harder to move around compared to investment in the stock market or bond market that can more easily be shifted out and cause instability.

Stock markets have been on a bull run. Is a correction due? Do central banks and governments have the tools to control the fallout?

Asset bubbles are something the world has to be wary about at the moment. It's not just in the stock markets where there has been a big uptick in prices of assets. Many property markets have risen a lot in the last five years or so, so have stock and bond markets.

I do think the U.S. stock market is overvalued at the moment. The question you have to ask about the U.S. stock market is: Do you think U.S. tech companies are fundamentally changing the way we do business? And do you think those U.S. tech stocks are the companies who are going to reap future profits from that? Is the world going to use Amazon the way U.S. consumers use Amazon today? If you do, then you think all sorts of supermarket and retail businesses are going to go bust, and Amazon is going to get all the profits, for example. In this region, perhaps it's Alibaba who's going to be that company, perhaps Baidu, or maybe Lazada or some other regional firm. If so, we might think U.S. stocks are a little bit stretched.

Is 2018 the year of the cryptocurrency crash?

Like most economists, I'm currently a little sceptical about cryptocurrencies. But it's our nature to be sceptical about something that challenges a fundamental unit of economy such as money, which has been running for such a long time. Money is only useful to the extent that other people accept it. Money has no value in and of itself. The paper or plastic of which it is made is worth nothing, but it's worth something because the next person you give it to is going to accept it.

Therein lies the big challenge for bitcoin. I can see bitcoin, or cryptocurrencies in general, having uses in illegal transactions. Or where there is a need for some kind of secrecy desired by those taking part in the transaction. Or perhaps as in the case of China where people want to get around capital controls—it's an unofficial way of moving money in and out of the country. So that provides a base for cryptocurrency usage.

But I don't think governments are going to sit back and allow cryptocurrencies to take over the role of normal money. Governments do have the power to regulate these sorts of things. The supporters of cryptocurrencies say they are beyond the influence of governments, but that's just because governments haven't regulated cryptocurrencies yet. When governments see cryptocurrencies eroding their ability to raise tax, for example, I think they will intervene fairly quickly.

I think the tipping point is close. A lot of regulators are talking about cryptocurrencies as a top priority. Another thing that could happen is national governments could launch their own cryptocurrencies (ed: Venezuela launched the Petro on February 20, 2018, two weeks after this interview was conducted). You might say there are some benefits from blockchain technology that underlie those cryptocurrencies that could also be used by central banks and national governments themselves. If those benefits are real, then we will see governments setting up cryptocurrencies.

How significantly will Brexit affect global growth prospects for 2018? Will the associated issues–trade, immigration and finance–cast a wider shadow on EU reforms?

Brexit is affecting the U.K. economy already, but by less than most economists expected after the vote happened. I also expected it to have a more negative impact immediately. One of the reasons the British economy did well was that the currency crashed. U.K. exports became a lot cheaper, which helped the manufacturing sector. Also, the rest of Europe ironically had a good couple of years–there was a notable turnaround in France–and the rest of Europe is the biggest market for U.K. exports. Those two factors have come together. Additionally, consumer and business sentiment have held up pretty strongly after Brexit.

I think the change for this year that we can anticipate is that businesses are now getting a bit more worried. We're only one year out from when the exit has to happen based on the current timetable, and there is still no deal, not even a proper proposal. Businesses are holding off on some investments and waiting until things become a little clearer. But that all mainly affects the U.K. I don't think it has global ramifications at this point.

So in a nutshell, economic fundamentals point to the following outlook for the remainder of 2018: Oil prices will not reach US$120, more U.S. Fed rate hikes are expected, and Brexit's fallout will remain largely within Europe.

The World Bank, in its January 2018 edition of Global Economic Prospects, wrote that "growth in investment and in total factor productivity (TFP) has been declining over the past five years" and that demographic trends are likely to hold back future growth. What does that mean with regard to 2018?

The long-term productivity trend over the past 10 or 15 years has been downwards. Productivity growth in the OECD was running at three to four percent some 10, 15 years ago but now it's running at between zero and one percent, and in good years two percent.

Why is that? It's one of the biggest questions in economics at the moment. Over the last 12 months, the worries about the productivity slowdown being permanent have receded somewhat. There are two schools of thought. One is the technology optimists who think that new things are going to come along, such as automation and artificial intelligence, genetics, biotechnology etc. that are going to, in the coming decades, mean we are going to be a lot more efficient than we are now.

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However, there are other people who say, 'Well, all the big inventions have happened in the last century, or have been brought to scale in the last century.' These are things such as electricity, cars, running water, these sorts of things. Innovation today such as Facebook and Twitter—do these things add to productivity? Probably not. They make life more fun, which is worthwhile, but maybe Facebook is not going to have the same impact on the global economy as electrification did. So that's the pessimistic view.

Which one will win out? I guess we won't know. There have been many times in the past when people have been worried about innovation running out and that we've used up all the good inventions. Over the past couple of hundred years, societies have somehow managed to come up with new inventions. On balance, I'm probably an optimist.

This interview was conducted on February 5, 2018, following a talk by Simon Baptist at Singapore Management University.

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