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Macro Insights From PIMCO’s Global Advisory Board

In May 2016, PIMCO’s Global Advisory Board (GAB) met in Newport Beach to assess global economic trends and, for the first time, discuss their views with PIMCO’s investment professionals participating in our annual Secular Forum. Richard Clarida, PIMCO’s global strategic advisor, discusses the role of the board and how it contributes to our forum process. Next are highlights from the board’s meeting, presented in Q&A format. Libby Cantrill, PIMCO’s head of public policy, facilitated the board’s discussion – board members Dr. Ben Bernanke, former Chairman of the Federal Reserve, Dr. Gordon Brown, former UK Prime Minister and former Chancellor of the Exchequer, and Ng Kok Song, former Chief Investment Officer of the Government of Singapore Investment Corporation, attended the board meeting and investment forum.

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.
Richard Clarida: We hold four investment forums a year: three Cyclical Forums and the Secular Forum each May in which we focus on the key long-term forces that will drive monetary and fiscal policy, the global economy and financial markets over the next three to five years.

We greatly benefited from having PIMCO's Global Advisory Board participate in the Secular Forum – although Chairman Bernanke has previously participated and Dr. Brown was previously a guest speaker, this was the first time we formally integrated board members into the Secular Forum process. The board is a team of world-renowned macroeconomic thinkers and former policymakers who contribute their insights to PIMCO on global economic, political and strategic developments and their relevance for financial markets.

The Global Advisory Board conducted a closed session, and then joined our full forum for an engaging, wide-ranging conversation. Although not all board members attended the meetings, Chairman Bernanke, former Prime Minister Brown and Mr. Ng thoroughly covered the world's major economies and actively participated in a broad discussion of consequential macroeconomic issues. The board's expertise and insights have helped inform our overall secular outlook and constitute a valuable input into our investment process.

**Highlights from the Global Advisory Board meeting in May 2016**

**Libby Cantrill:** Let’s begin with an overview of developments in China, which will be critical for the global economy over the next few years. What are China’s prospects over the secular, three- to five-year horizon? And what is the risk of a “hard landing”?

**GAB members:** China’s continuing challenge is to navigate the transition from a growth model based on heavy industry, construction and exports to an economy that emphasizes consumer spending and services. If the transition is successfully managed, China should be in a good position to achieve a GDP growth rate in the vicinity of 5.5% to 6.5% per year over the secular horizon, slower but more sustainable than the growth rates of the past decade.

The need for reform is understood by the leadership, and China has substantial resources available to smooth the process: For example, outstanding debt of the central government is relatively low, at about 40% of GDP, and the stock of international reserves remains high.
That’s not to say that China doesn’t face critical challenges, however, including achieving political support for further reform, managing the country’s debt buildup and dealing with an uncertain external environment.

To be sure, a hard landing is not the GAB’s baseline expectation for China but it could occur if the reform process stalls, a tail risk that could lead to a marked increase in internal dissension and sharply slowing growth.

Achieving needed reforms is technically demanding, but the greatest potential barriers to reform are political. For example, shifting resources from heavy industry to services will be resisted by state-owned enterprises (SOEs) and regions dependent on steel and coal production and could possibly lead to widespread social unrest. In the minds of some officials, short-run stability (achieved, for example, through further fiscal stimulus) should be a higher priority than structural reforms focused more on the longer term.

President Xi Jinping has expressed support for continued reforms as the best way for China to avoid the “middle income trap” (the tendency of many developing countries to plateau before reaching high per capita levels of income). However, for now, reforms may have been put on hold to some extent as President Xi prepares for the vital October 2017 Congress, where he would want to consolidate power.

**Cantrill:** What about the risks posed by China’s debt buildup?

**GAB members:** Debt has indeed increased rapidly in China, especially debt of corporates and local governments. The massive debt buildup reflects in part the Chinese government’s practice of using the directed allocation of credit, especially bank credit, as a development tool and as a substitute for direct government spending.

Since many SOEs are now loss-making, and since infrastructure and housing are seriously overbuilt in some parts of the country, it is not surprising that some of this debt is of dubious quality. The debt problems are in large part the financial manifestation of the traditional growth model having reached its limits.

The fiscal capacity of China’s central government helps mitigate the risks of the debt buildup. Also, most debt is denominated in yuan, rather than dollars or other foreign currencies, and much of it is financed by Chinese savers, as opposed to foreign investors, making it less vulnerable to shocks. China continues to run a significant current-account surplus (that is, it is a net exporter of savings). With the government presumably standing behind the banks, the risk of a near-term financial crisis precipitated by leverage consequently appears limited. Nevertheless, debts will have to be managed carefully to allow for the orderly absorption of potential losses.
Cantrill: What is the outlook for China’s currency and the outlook for U.S.-China relations?

GAB members: Regarding the yuan, if reforms continue and growth moderates to a sustainable level, as envisioned in the baseline projection, then China should be able to maintain its managed float of its exchange rate, avoiding any sharp devaluation or disorderly moves. Indeed, pressures on the currency and China’s international reserves have abated since the February G-20 meeting in Shanghai, where Chinese officials communicated clearly their intention to avoid large currency moves.

Over the secular horizon, the stability of the currency will depend importantly on the government’s ability to push through reforms and achieve moderate growth. In the hard landing, tail risk scenario, in which the reforms are unsuccessful, loss of confidence on the part of Chinese savers and foreign investors could lead to sharp capital outflows and powerful downward pressure on the yuan.

Developments in the U.S. in coming years will be critical to the China outlook, including its currency. In the relatively near term, decisions by the Federal Reserve about the pace of U.S. monetary tightening will affect global financial conditions, which in turn could ease or complicate China’s management of its currency and influence its growth prospects. Even more important, the U.S. presidential campaign and its outcome could lead to greater protectionism and anti-Chinese rhetoric.

Military and diplomatic relations between the superpowers will be influenced by the economic rhetoric. The GAB’s assessment is that, at least in the near term, China is not interested in challenging the U.S. militarily on a global basis. Indeed, President Xi has referred to the importance of solving the “Thucydides problem,” which is the challenge of integrating newly rising powers (like China) into the global system without military conflict. China is also committed to cooperation through the G-20, over which it is currently presiding. At the same time, China wants to assert regional leadership, and if the government loses political support it might be tempted to appeal to the public’s nationalism.

Cantrill: Let’s shift the discussion toward the outlook for central banks and monetary policy.

Starting with the U.S., how is Federal Reserve policy likely to evolve over the secular horizon?

GAB members: Fed policy must, of course, react to developments in the U.S. economy. The GAB’s baseline for the U.S. is continued, moderate recovery, driven by consumer spending and strengthening residential investment, but held back to some extent by the adverse effects on U.S. exports of global weakness and a strong dollar. Notably, a disappointing aspect of the recovery has been the slow rate of growth of labor productivity, which has resulted in real GDP growth at only about 2% on average during the recovery, despite the creation of millions of new jobs.

The Fed’s response to these economic conditions, in turn, can be interpreted in terms of two conceptual pillars. The first is the classic Phillips curve, which says that inflation is determined by the public’s inflation expectations and the amount of “slack” in the economy, as measured for example by the unemployment rate and other measures of labor utilization. According to the Phillips curve theory, so long as inflation expectations are reasonably stable, continued improvement in labor markets will put upward pressure on wages and prices, lifting inflation toward the Fed’s 2% target. Ultimately, that implies a need for rate increases, to avoid an inflation overshoot.

The second pillar is the Fed’s risk management strategy, or its plans for dealing with left tail or right tail outcomes. Fed policymakers have been particularly concerned with downside risks (the possibility that the economy will be weaker than expected), because the Fed’s ability to respond to a slowdown is hampered by the fact that rates are close to zero. Concerns about downside risks, particularly those emanating from abroad, led the Federal Open Market Committee (FOMC) to delay its planned rate hike last fall and to take a dovish
stance earlier this year. But policymakers must also pay attention to the upside risk that growth and hence inflation will be stronger than expected, which could force them to play catch-up. Over the secular horizon, developments in the economy largely determine Fed policy, with risk management mostly affecting the timing of policy actions on the margin.

Putting it all together, if the economy tracks the baseline outlook over the secular horizon, we expect the Fed will raise short-term rates quite gradually, watching carefully to assess the effects of each action before proceeding further. The slow pace of increases will be the result both of downside risk management and the likelihood that, consistent with PIMCO’s New Neutral view, the terminal fed funds rate is quite low.

The FOMC does not seem to have determined finally whether it will leave its balance sheet (holdings of Treasuries and mortgage-backed securities) close to its current size or to shrink it somewhat. Contrary to earlier communications, it seems possible that the balance sheet will be allowed to remain large indefinitely, consistent with the practices of most other major central banks. However, if the Fed does decide to shrink its balance sheet, that would also be done very gradually and not until the process of lifting the short-term rate is well underway.

**Cantrill: How would the Fed respond in the event of a new economic slowdown?**

**GAB members:** The GAB’s baseline outlook is for a continuing, moderate U.S. recovery, and there are no obvious imbalances threatening the expansion. Nevertheless, there are certainly downside risks, including those arising from weak global economic and financial conditions. The economy could confront new shocks, or the recovery could prove more dependent than thought on the continuation of very low interest rates.

The Fed has tools at its disposal that it could deploy against a slowdown. Beyond its available space for cutting short-term rates, the Fed could reinstitute forward guidance (qualitative or quantitative commitments to hold rates low for some time); extend the maturity of its portfolio (as in “Operation Twist”); restart quantitative easing (purchases of assets); or, possibly, consider the pegging of medium-term interest rates. We aren’t likely to see negative interest rates or so-called helicopter money.

Although the Fed is not out of ammunition, the tools it has would be insufficient to offset a severe slowdown. A mix of monetary and fiscal actions would be more effective in that case. Moreover, monetary policy can do little about the factors that determine long-term growth, such as productivity and demographics. Fiscal and structural economic policies aimed at promoting longer-term growth need greater priority, both in the U.S. and in other developed countries.

**Cantrill: Looking more broadly, what is the GAB’s outlook for other major central banks and economies? And what is the board’s view on the expected long-term path of interest rates?**

**GAB members:** The European Central Bank (ECB) has been aggressive in its accommodative policies, with some evidence of success, as European growth has picked up a bit. However, with medium-term inflation expectations still significantly below 2% and with growing public unease about negative interest rates, the ECB is now testing the limits of monetary policy.

Like the ECB, the Bank of Japan (BOJ) has been struggling to reach its inflation target, pushing monetary policy toward its limits. Its experiment with negative rates has proved unpopular and has led to dissension within the BOJ. The government is more supportive of the central bank in Japan than in Europe, however.

The UK has had a recovery comparable to that of the U.S., but the Bank of England (BOE) has remained quite cautious. Currently, the BOE is on hold awaiting the June 23 referendum on whether the UK will leave the European Union (aka the “Brexit” vote). It’s not entirely clear how a “leave”
decision would affect British monetary policy; that outcome would probably cause the economy to slow further, arguing for a rate cut, but the inflationary impact of a falling pound would work in the opposite direction. A “wait-and-see” strategy would probably be the BOE’s approach.

For the secular horizon, the key questions are whether actions taken thus far by central banks will prove sufficient, and, if not, to what extent other policymakers will be willing to lend their support.

Turning to the global outlook for interest rates, we are likely to remain in a low rate environment over the secular horizon. Among the factors contributing to low longer-term yields are low inflation; low economic growth rates, the result of both aging workforces and slow productivity gains; high global saving; historically low risk premiums on government debt and a strong demand for “safe” and liquid assets, like U.S. government securities.

Although longer-term rates will remain low on a historical basis, some factors suggest modest upside risks to yields over the secular horizon:

First, in the U.S., assuming no recession, inflation is likely to pick up modestly. In this respect, a dovish Fed could lead to higher rather than lower interest rates over the medium term.

Second, U.S. productivity growth, which is currently below even the most pessimistic longer-term projections, seems likely to improve, particularly as the effects of the global financial crisis – on capital investment, research and development, and business formation – recede.

Third, fiscal policy looks likely to become somewhat more expansionary in the U.S., Canada and Japan – and possibly even in Europe, as the most intense phase of austerity has ended, and as the need to fund large intakes of refugees increases government spending in some countries.

Fourth, the global glut of savings appears to be moderating somewhat, as the Chinese current account surplus shrinks and as oil producers adjust to low energy prices.

Finally, term premiums on government bonds are historically low and could revert toward more normal levels. If deflation risk is perceived to decline, for example, then government bonds will lose some hedging value, causing yields to rise.

**GAB members:** In the developed world, particularly in Europe, the UK and the U.S., the most striking trend is a new wave of populism. While the ultimate consequences are unknowable, populist politics pose risks to growth and stability over the secular horizon, perhaps most importantly through its chilling effects on economic integration, globalization and international trade.

The forces underpinning the populist trend (rising inequality, distrust of elites, nationalism, etc.) are not likely to dissipate anytime soon. That said, populist politicians have not become national leaders of major countries (though Donald Trump securing the Republican nomination is a notable development), and populist parties have not been able to win governing majorities. But they still can have important influence on policy and politics.

As of the time of the GAB’s meeting in mid-May, the odds seemed slightly in favor of UK voters electing to remain in the European Union (EU). If the “leave” supporters win, the economic consequences would be mostly negative. Uncertainty about the referendum outcome has already contributed to a slowdown in British capital investment and growth and a decline in the pound. A vote to leave would also cloud the prospects for British trade relationships and for key British
industries, such as finance. Although the UK could negotiate new agreements with the EU, on net its position would likely end up being less favorable than it is today.

The EU would also suffer economically if the UK left, and concerns would increase about other potential exits. The various uncertainties associated with a "leave" vote would likely have significant adverse effects on global financial markets, at least in the short run.

However, on the question of whether the eurozone will remain intact, over the secular horizon the answer is probably "yes." The political desire to keep the eurozone together, in order to promote peace and cooperation on the continent, is strong, despite the centrifugal forces.

The greater secular risk is that, economically, Europe will continue to "muddle through," or worse. Many of the fundamentals are poor: Adverse demographics, slow productivity growth, high structural unemployment, policy incoherence and populist-inspired resistance to globalization and economic integration will be obstacles to growth. The inflow of migrants will only increase, leading to more populist, nativist and protectionist politics. There are perhaps a few brighter spots: The large current account surplus of the euro area signals some macroeconomic room for maneuver, the sovereign debt crisis has led to some needed structural reforms in several countries, and immigration could ultimately contribute to some additional growth.

Cantrill: Finally, what is the GAB's outlook for emerging markets (EM), outside of China, and for the future of oil prices and production?

GAB members: Populism is proving relevant in emerging markets, as well. Although living standards have risen, expectations have risen as well, stoked by communications technologies that allow EM citizens to see how people live in the developed countries. As expectations rise, people also become frustrated by official corruption and incompetence and by the lack of adequate education and public services. High expectations can be economically positive if they lead to better government performance, but they can also lead to short-sighted policies.

Actual economic performance and prospects vary considerably across emerging markets. EM countries differ in their policies and politics, in their roles as commodity producers and consumers and in their attitudes toward reform. The more robust EM economies include India, Korea, Taiwan, Mexico and even Argentina. Despite the important differences among EM countries, there are also common risk factors, some of which may be more favorable over the secular horizon. Notably, continued growth in China and modestly higher commodity prices, which are our baseline, would help emerging markets as a group. The U.S. dollar has been relatively stable since last fall, reducing financial pressures.

Of course, there are plenty of precarious situations as well, including Russia, Brazil and several Middle East countries suffering from war or threat of war.

Regarding oil, short-term factors, including the decline in U.S. production, point to modest increases in oil prices from current levels. Over the secular horizon, however, oil prices are likely to remain low. Saudi Arabia is likely to keep production high, and on the demand side, climate change concerns and new technologies should slow oil consumption somewhat, at least in the developed economies.

The ever-present possibility of political upheaval or regime change in the Middle East is the main tail risk to the more benign scenario.

Cantrill: Thank you to the members of the PIMCO Global Advisory Board for sharing their views and joining our discussions of likely paths over the secular horizon.
All investments contain risk and may lose value. Investors should consult their investment professional prior to making an investment decision.

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