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Shifting Macro Trends in the Aftershock Economy

PIMCO's Global Advisory Board discusses economic and geopolitical factors shaping the long-term global outlook.

PIMCO 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 Chair of the Federal Reserve Ben Bernanke, the Global Advisory Board meets several times a year and contributes to our economic forums.

Executive Summary

- Critical macroeconomic trends, including a shift in globalization and the continued rise of nationalism, may contribute to relatively low global growth over the secular horizon of the next five years.
- Tensions between the U.S. and China could escalate around capital flows, Taiwan, and other factors, potentially driving deeper international divisions in an increasingly multipolar world.
- However, the U.S. dollar will in all likelihood continue as the world's dominant currency over the secular horizon.
- Artificial intelligence may modestly increase global productivity, but it also could increase income disparity.

The 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 five-year horizon. The board's insights constitute a valuable input into PIMCO's investment process, and the views they presented helped inform the latest *Secular Outlook,* "The Aftershock Economy." The discussion below is distilled from their far-ranging conversation.

Q: WHAT ARE SOME GLOBAL MACROECONOMIC AND GEOPOLITICAL TRENDS THAT ARE LIKELY TO HAVE AN IMPACT OVER THE SECULAR HORIZON?

A: We see three seismic shifts. First, we are moving from a unipolar world centered on U.S. hegemony toward a more multipolar world, with the U.S. still the leading state but also multiple centers of power. Second, we are shifting from the neoliberal economics of the last 30 years to a neomercantilist economics, in which in various countries and to varying degrees the state is intervening far more in trade, technology, industrial policy, and much more. Third, and partly as a result of this, we are moving from what was an era of hyper-globalization to what we could call globalization-lite, with shorter supply chains, reshoring, and "friend-shoring" in vogue, but not deglobalization and not "slowbalization" (because trade in services is rising).

Underlying these three changes is rising nationalism – e.g., America First (or Buy America), China First, Russia First. This mindset sees the world in terms of a struggle between "us" and "them" and shifts away from a win-win economics through trade toward the dominance of a zero-sum scenario in which you have to lose for me to win. Such populist – and even xenophobic – nationalism and protectionism will lessen global trade, slow global growth, and contain within it inflationary and fiscal pressures, but also could pose an existential crisis if they leave no room for cooperation even if global problems such as climate change, pandemic preparedness, or financial stability require global responses.

We also see a new "resource nationalism" as countries with metallic resources take more state control in a race to acquire in-demand materials such as nickel in Indonesia, copper in Peru and Chile, cobalt in the Democratic Republic of the Congo, and rare earths in China.

In a fading unipolar world, traditional attachments are weakening, countries such as India are playing America, Russia, and China against each together, and we see opportunistic liaisons forming and increasing: the expansion of the BRICS group beyond the five countries of Brazil, Russia, India, China, and South Africa; a growing Saudi–China alliance, and South Africa–Russia–China military cooperation. At the same time, with its focus on regional and bilateral alliances, the U.S. seems less interested in leveraging international institutions it helped to create, including the G-20, the International Monetary Fund, and the World Trade Organization.

Big advances in the implementation of AI and related technologies could turbocharge productivity and growth by the end of the secular horizon, but ultimately, all these geopolitical trends above help explain and reinforce current forecasts of lower global growth.

Q: HOW IS THE RUSSIA-UKRAINE CONFLICT LIKELY TO PLAY OUT OVER THE NEXT FIVE YEARS?

A: It is difficult to foresee how the Russia-Ukraine conflict will be resolved, or even if it will be resolved, over the secular horizon. There are three scenarios to consider. The first scenario would be a decisive win on the battlefield by Russia or Ukraine that ends fighting, but we see little probability of such an outcome. The second scenario is a negotiated ceasefire or withdrawal of forces with a settlement on agreed borders, and that is about a 30% probability. The most likely case is a frozen conflict with Russian forces still present in the East and parts of Crimea and sporadic fighting, but with little change in the line of control. That's a 50% or greater probability.

The risk of nuclear escalation by Russian President Vladimir Putin is low, in our view, since his allies have raised objections and highlighted the costs to Russia of such a drastic strategy. It is still possible in theory, however, if Russia loses enough territory that Putin has nothing to show for the invasion, which could be a regime-threatening situation for him. But then, would the Russian military actually execute on a nuclear threat?

This invasion has set back Russia's military significantly, and it will likely take decades to rebuild. Yet, Russia likely can hold the Ukrainian population and critical infrastructure at risk indefinitely with missile and drone strikes, and can keep, or try to keep, Ukraine from recovering and returning to normalcy. Meanwhile, Ukraine is seeking to join the North Atlantic Treaty Organization (NATO), and to receive stronger support from the West for better equipment and training. Still, all signs point to a frozen conflict, which is tragic for Ukraine in the long run.

Q: WHAT IS THE OUTLOOK FOR THE U.S. DOLLAR OVER THE SECULAR HORIZON?

A: Market pundits have speculated on the dollar being dethroned for a few reasons. This year's battle over the U.S. debt limit sparked such comments, yet back in 2011, when we were watching the debt limit closely and the country seemed close to default – even prompting a downgrade from rating agency S&P – the dollar actually strengthened. U.S. bonds strengthened as well, reflecting a flight to "quality" as investors were fearful of the potential ramifications of default.

To be sure, a number of major countries routinely make and receive payments in non-dollar currencies, and pundits also muse on the impact of sanctions, which have forced some countries, including Russia, China, and Iran, to work around the dollar. However, we do not see major, long-term implications.

Indeed, we believe the dollar will continue, certainly through the secular horizon, to maintain its dominant position. The U.S. has the largest, deepest, and most varied capital markets, so holders of dollars can find places to put their money. The U.S. doesn't have capital controls. Also, notwithstanding the recent global experience, inflation has been overall low and steady in the U.S. for decades. In addition, there are what economists call network effects: People use the dollar because everyone else uses the dollar. Finally, there's no obvious substitute.

Q: AT THE TIME OF THE U.S. FEDERAL RESERVE'S LAST MONETARY POLICY REVIEW IN 2020, U.S. INFLATION WAS NEAR THE FED'S 2% OBJECTIVE AND THE FEDERAL FUNDS RATE WAS CLOSE TO ZERO. WHAT ARE YOUR EXPECTATIONS FOR THE NEXT FRAMEWORK REVIEW, DUE IN 2025?

A: The framework the Fed announced in August 2020 included a price stability objective of "inflation that averages 2 percent over time" along with maximum employment as a broad-based and inclusive goal. The inflation language was in the context of the zero lower bound for interest rates and the tendency of inflation, in the decade after the global financial crisis, to stay below target much of the time. Thus, the Fed was indicating it would overshoot its target moderately and temporarily if needed to get inflation to 2% on average.

Recently, though, inflation has been too high, not too low. In the next framework review, the Fed may consider revising again that language to indicate the goal is to maintain medium-term inflation expectations at or around 2%, which implies a willingness to either overshoot or undershoot temporarily as needed to keep expectations at target. But Fed officials don't want to be interpreted as moving the goal posts for inflation, either, which would damage credibility. So, no change in the official 2% target should be expected.

Regarding the framework and employment, it's important to acknowledge full employment is hard to measure, and one should look at several different indicators. Indeed, the Fed may have underestimated the tightness of the labor market in 2021, possibly contributing to the ensuing inflation. In their next framework, Fed officials may want to indicate that their decision-making will be flexible, taking into account their uncertainty about measuring full employment as well as the lags of monetary policy.

Q: CONTINUING THE DISCUSSION ON MONETARY POLICY AND INTEREST RATES, WHAT IS THE LONGER-TERM OUTLOOK FOR THE NEUTRAL RATE – THAT IS, THE ESTIMATED REAL RATE OF INTEREST THAT HAS A NEUTRAL IMPACT ON ECONOMIC GROWTH, NEITHER STIMULATING NOR HINDERING?

A: The forces that drive neutral rates tend to move slowly. But structural shifts underway across the global economy make it reasonable to expect some upward pressure on the neutral rate – which central bankers call "r*" or "r-star" – over the secular horizon.

There are opposing forces at play. Lower productivity growth (reinforced by deglobalization), ongoing demographic pressures, and rising inequality will continue to exert downward pressure on r*. Deglobalization may also drive greater dispersion in r* among countries, reversing the rising correlation over recent decades.

In parallel, upward pressure on r* is intensifying. The balance of global savings and investment is shifting as countries and companies invest in resilience, spending on healthcare, defense, energy security, sustainability, and derisking supply chains. While many of the world's major economies are increasing their structural fiscal deficits, industrial policy and the energy transition should support greater investment relative to GDP. The Inflation Reduction Act in the U.S. is one prominent example.

Also, we're finally seeing a broader shift in the risk-averse mentality that prevailed since the global financial crisis as much of the world's economy was on the cusp of a liquidity trap – a scenario where even low or zero interest rates can't coax savers to invest in higher-risk, potentially higher-yielding investments. This drove the demand for safe assets, pushing down r*. More recently, however, the structural forces driving inflation and resilience helped pull economies away from the liquidity trap, unwinding excess demand for safe assets, and reinforcing the drivers of higher r* over the medium term.

Q: IN LIGHT OF U.S. POLICYMAKERS' APPROACH TOWARD INVESTMENTS AND TRADE WITH CHINA, HOW COULD U.S. BUSINESS RELATIONSHIPS WITH CHINA EVOLVE OVER THE SECULAR HORIZON?

A: U.S. National Security Advisor Jake Sullivan, in a speech earlier this year to the Brookings Institution (read the speech here), discussed derisking and diversifying, rather than decoupling from China. This is an important distinction. He said the U.S. should keep investing in its own capacities and supply chains and pushing for a level playing field for workers and companies, while also continuing to enjoy bilateral trade with China.

There's widespread support on both sides of the U.S. political aisle for a strong stance on China, including restrictions on outbound capital investments in such areas as semiconductors, artificial intelligence, and quantum computing. And the Committee on Foreign Investment in the United States (CFIUS) may more closely scrutinize China's investments and engagements in the U.S. as well.

Washington is moving in the direction of treating China more as an adversary than a competitor, and some businesses in the U.S. have been scenario planning around expected hard-line policies for some time. However, it might be a step too far to say they are well-prepared for any outcome of the U.S.–China rivalry.

Outside of sensitive sectors, U.S. businesses generally expect to continue to market to the more than 1.4 billion people in China. However, it is important to differentiate between exporting to or producing in China *for the Chinese market* on the one hand, and importing or exporting *from China* on the other. While many U.S. businesses are continuing to invest in the former, in light of geopolitical tensions they appear increasingly cautious about the latter. In particular, those involved in critical supply chains are accelerating development of manufacturing facilities outside of China.

Q: IS EUROPE TAKING A SIMILAR APPROACH TO CHINA, WITH SIMILAR CONSEQUENCES?

A: European leaders have long seen relations with China as an economic issue and not a security issue and, in contrast to a U.S. distancing from China, almost every major European leader has visited Beijing in recent months. They recognize Europe's far stronger economic ties: around twice the percentage share of exports to China than from the U.S., and not far from twice the share of imports from China.

However, the long-term reality is that Europe – which is security-dependent on the U.S. – will likely remain far closer to the U.S., even if the term "derisking" (invented by Europe to replace "decoupling" and adopted by the U.S.) means something more to the U.S. – i.e., preventing Chinese technological leadership – than it means to Europe. Europe and the U.S. are not only linked by common security provision through a strengthened NATO but also share common ground on the big existential issues that divide the West from China, including intellectual property rights, preventing nuclear arms proliferation, the future of Taiwan, and human rights.

A new issue arises in relation to data and technology, with conceivably a tech decoupling that leads to a splinternet. There are huge secular ramifications of a potential "one world, two systems" future in which two sets of competing institutions reflect a China-centric world and a U.S.-centric world. In its efforts to counter what it views as a U.S. aim to stifle its growth and influence, China has expanded from sponsoring regional efforts like Belt and Road and the Asian Infrastructure Investment Bank (AIIB) and partnering on new global institutions like the BRICS and New Development Bank to going global on its own with the Global Development Initiative (which has more than 60 affiliated countries, according to the UN), the Global Security Initiative, and the Global Civilization Initiative. These initiatives attempt to set out a wholly different global future while appearing to work within the UN Charter, and they are generally built around persuading countries – particularly developing nations, many of which now owe significant debt to China – into supporting them.

A "one world, two systems" future could result in new security challenges and also create headwinds for global trade, which is already growing slower than many people expected.

Q: IS CHINA LIKELY TO HARDEN ITS STANCE TOWARD TAIWAN IN THE NEXT SEVERAL YEARS?

A: Much depends on Taiwan's elections in January 2024. More broadly, the baseline outlook for China's approach to Taiwan over the secular horizon is not the use of force, but the continued use of political and economic pressure to limit the island's ties to other countries and bolster international recognition of "one China." In this scenario, China's military would not be used to attack, but to intimidate. We've seen this already with military exercises being performed around Taiwan – especially in apparent response to Taiwan officials having high-profile meetings with the U.S.

Two other scenarios that are much less likely, but plausible in theory, in the next five years are blockade or invasion. China's military appears to have rehearsed blockade activity, and if it were to happen, Taiwan is not sufficiently resilient – it does not have the food and energy stockpiles to withstand a long period of time cut off from international commerce. But China's leadership is mindful of the international implications of a blockade, including the potential for a U.S. response.

An invasion of Taiwan appears even less likely, again given the potential risks and repercussions internationally as well as the potential for resistance in Taiwan; the powerful response of the people of Ukraine to Russia's invasion has set an example worldwide. However, any military accident or miscalculation could escalate the risk of confrontation.

Q: FINALLY, HOW MIGHT ARTIFICIAL INTELLIGENCE AFFECT THE MACROECONOMIC OUTLOOK OVER THE SECULAR, OR SUPERSECULAR, HORIZON?

A: We admit we are not experts in artificial intelligence (AI), but we recognize it may have a significant positive effect on productivity over time. The usual pattern for general-purpose technologies, like the internal combustion engine and electrification, is that it takes 20 to 25 years after invention for it to be fully integrated into the economy. However, it seems likely AI will be adopted more quickly because it fits more directly into current software protocols and the technology is advancing rapidly.

AI could have applications throughout the economy, from manufacturing to agriculture. In the near term, its greatest uses will likely be as a complement to the work of professionals such as doctors, architects, accountants, and coders. Skilled workers proficient in AI could see their earnings rise, while those less proficient or less skilled may earn less. Thus, one effect of AI may be to elevate concerns about the unequal distribution of income.

For PIMCO's insights into the longer-term trends shaping the global economy and market environment, please read the latest *Secular Outlook,* "The Aftershock Economy."

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