



## TEXTOS PARA DISCUSSÃO No. 2017/02

March 2017

### TRANQUILITY BEFORE THE STORM

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#### **An unsustainable combination**

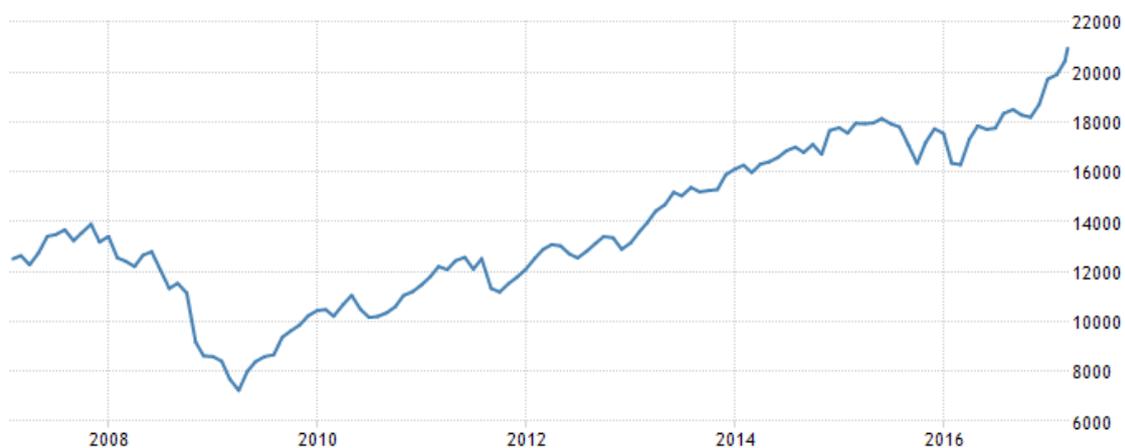
Asset markets

Since the election of Donald Trump as President of the United States, the US-American stock market has rallied and with it those in many other countries. Market values have risen by the trillions. There are reasons for doubt, however, whether gains of this dimension are justified. After all, interest rates have reached their bottom.

What will happen when interest rate start to rise?

The expansive monetary policies since the crisis of 2008 have led to historically low interest rates. In some countries, even negative rates have emerged. The concerns are justified that when the phase of extremely expansive monetary policy will end, the current levels of asset valuation must fall. The fear of some observers that a crash of historic proportions is in the making is surely justified.

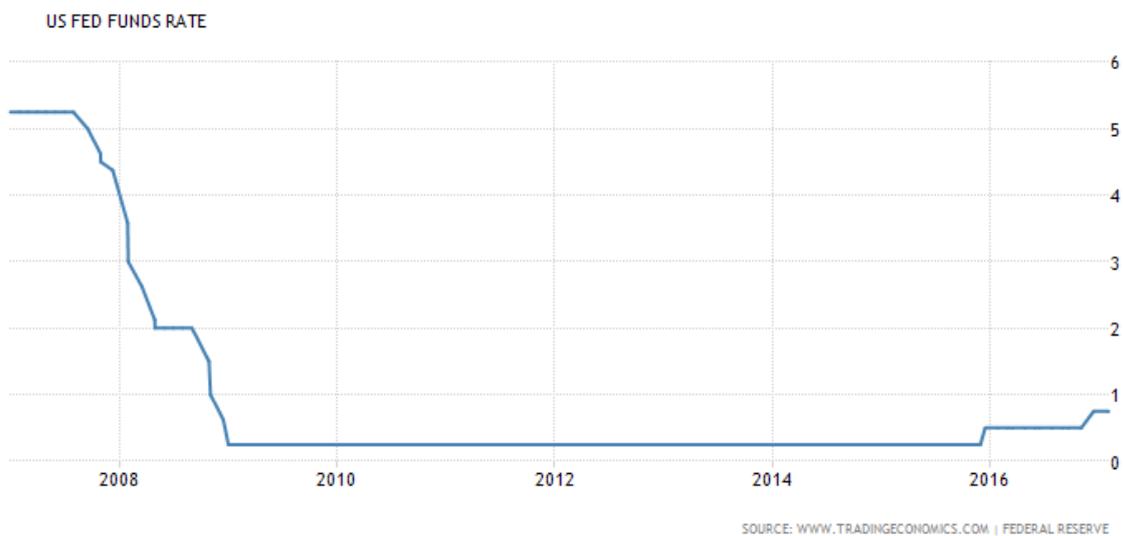
DOW JONES INDUSTRIAL AVERAGE



SOURCE: WWW.TRADINGECONOMICS.COM | DOW JONES

## U.S. interest rates

The American central bank has been waiting patiently for quite some time to get the timing right with a further interest hike. Such a step towards higher interest rates was not opportune during the presidential election campaign even if it was justified from a pure macroeconomic standpoint. In the meantime, the expectations as to economic growth have become more confident and the labor market in particular has shown a good performance recently. With the inflation rate rising, further procrastination with an interest rate hike can hardly be justified. It is unlikely that current assets valuation could withstand an increase of the interest rates that typically comes in various steps over an extended period.



## President in twilight

The new American President, Donald Trump, has not yet achieved full recognition of his authority. Large segments of the American population still show a deep-seated mistrust against him and his team. The President has had serious setbacks with his appointments to administrative top positions. Trump's announcement of protectionist measures has scared many foreign leaders, including friends and allies of the United States. The American relationship with Mexico is in shambles. The relationship with Europe has considerably cooled down. Tensions with China are on the rise.

## European elections

There will be elections in France and Germany this year and all eyes are on France where the right wing nationalist candidate Marine Le Pen is a front-runner for the presidency. A victory of her "*Front National*" in the upcoming elections in April 27 and the run-off on May 7 would be a disaster for the European Union and probably lead to a break-up of the euro zone.

German general elections will be held on September 24, 2017 with the current chancellor Angela Merkel as the top candidate for the ruling Christian Democratic Party and its Bavarian partner, the Christian Social Democratic Party. The Social Democratic Party (SPD) has launched Martin Schulz, a former European Union politician, as its candidate who is currently

leading a very successful election campaign in favor of the more social justice and a closer European Union. It is hard to imagine that if elected Schultz could cooperate with Le Pen as the new French President.

In the Netherlands, elections for the House of Representatives will take place on March 15, 2017 and provide a signal about the degree of xenophobia in Europe. One of the top candidates is Geert Wilders who leads the anti-immigration, anti-EU and anti-Islam “Party for Freedom” (PVV). Holland is a test case because this country has been traditionally one of the most open and liberal countries of Europe.

Surprisingly enough, the common European currency, the euro, has held relatively steady against the US dollar and has stabilized since the beginning of 2017.



## Widespread disequilibria

### Trade and foreign debt

In 2016, Germany was the country with the highest export surplus. Germany’s current account surplus is on the way to record a surplus of its current account of almost nine percent of its gross domestic product. The current account surplus comes largely from the trade balance. Germany’s annual exports amounts to EUR 1.2 trillion. A current account surplus of one country implies deficits in other countries, which, in turn, mean foreign debt accumulation. The current process is not sustainable, neither for the export surplus country nor for the debtor country.

The United States under Trump tries to do away with America’s persistent trade deficits, which have made the U.S the largest international debtor with a negative “net international investment position” of around eight trillion US dollars in mid-2016.

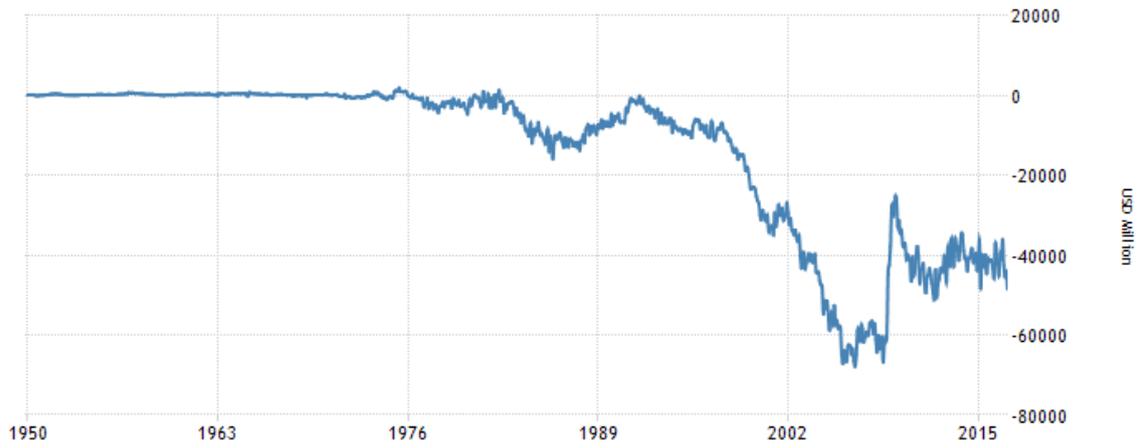
The dissolution of these unsustainable trade and debt positions will have massive impact about the exchange rates and the prevailing international monetary system.

GERMANY CURRENT ACCOUNT TO GDP



SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

US BALANCE OF TRADE



SOURCE: WWW.TRADINGECONOMICS.COM | U.S. CENSUS BUREAU

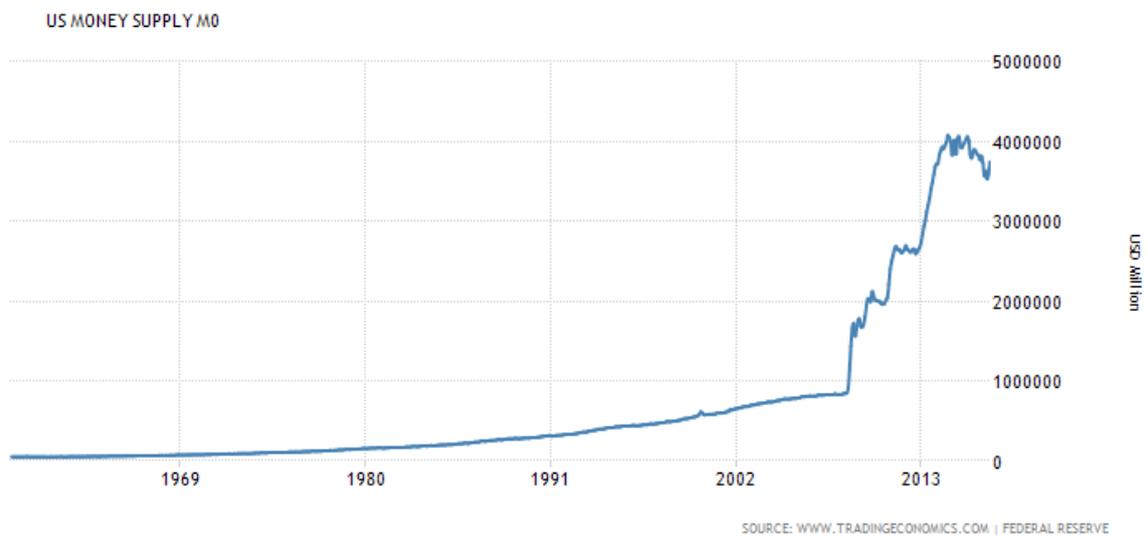
US NET INTERNATIONAL INVESTMENT POSITION

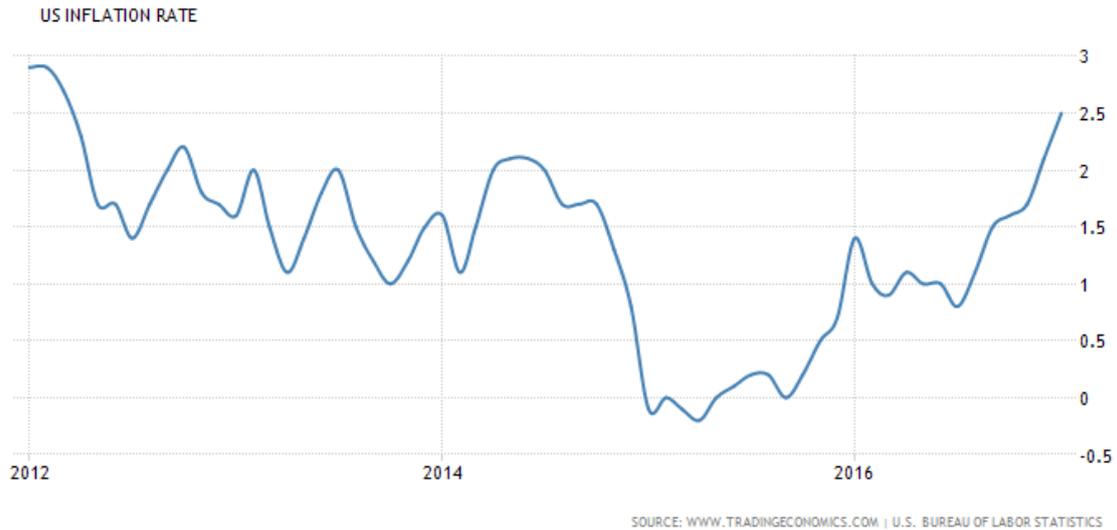


SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

## Prices and money

Since the financial crisis of 2008, there have been a series of quantitative easings in the United States and Europe. These have led to an unprecedented increase of base money (M0). The aim was to bring down interest rates. When interest rates hit zero bound, re-inflation became the aim monetary policy. In the meantime, price inflation is on the rise. The price inflation rate in the United States rose from under one percent in July 2016 to 2.5 per cent at the beginning of 2017, and in the Euro Area, price inflation accelerated from a negative rate in the first half 2016 to two percent at the beginning of 2017.

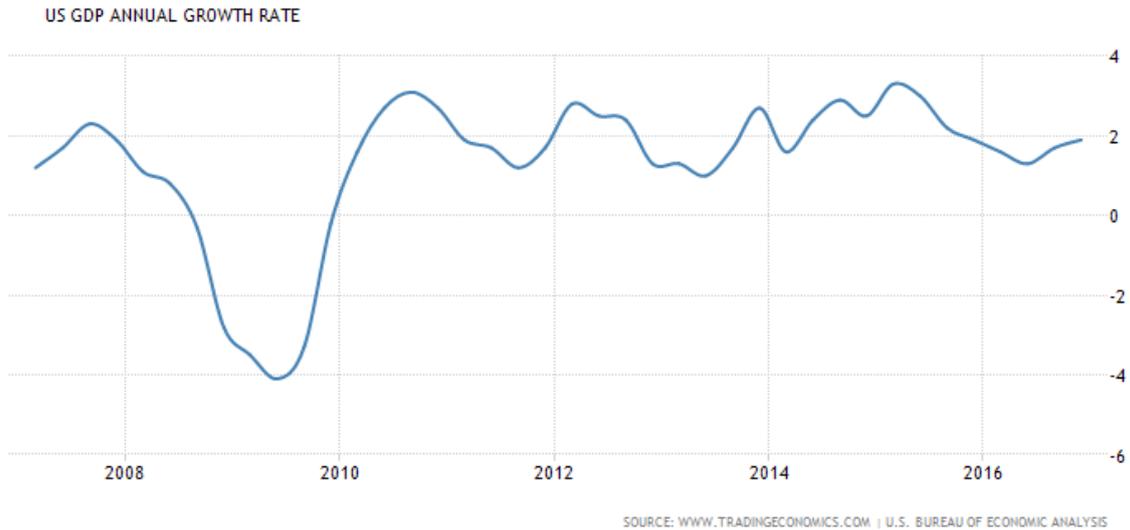




## Economic growth

Economic growth in the industrialized countries is not productivity-driven but the result of monetary expansion. In the United States, the annual economic growth rates was temporarily more than three percent in 2015 yet and has currently steadied about two percent in the beginning of 2017. In Europe, the annual growth rate of gdp oscillates between 1.5 and 2 percent since the beginning of 2015. As to the further outlook, all will depend on how markets react to a coming rate hike by the U.S. central bank.

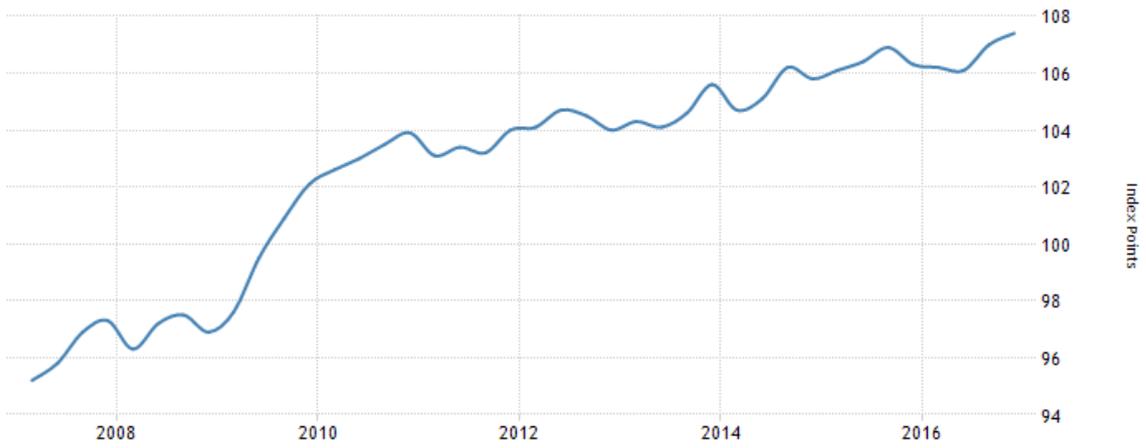
Economy growth will remain short-lived if productivity remains stagnant, as it is currently the case.



## Productivity

The greatest concern as to the long-run growth aspect of the industrialized countries is low productivity growth. After a rise in the aftermath of the financial crisis of 2008 due to lay-offs, productivity growth has been largely stagnant in the United States with the index rising from 104 to only 107. In the United Kingdom, productivity growth has been nil since 2005 as it has been likewise the case in Japan and Germany.

US NONFARM LABOUR PRODUCTIVITY



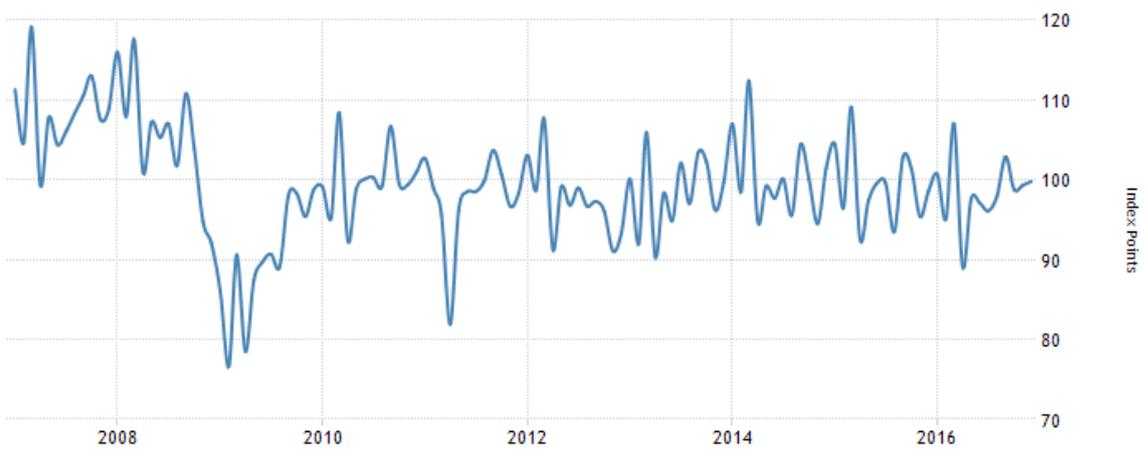
SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

UK PRODUCTIVITY

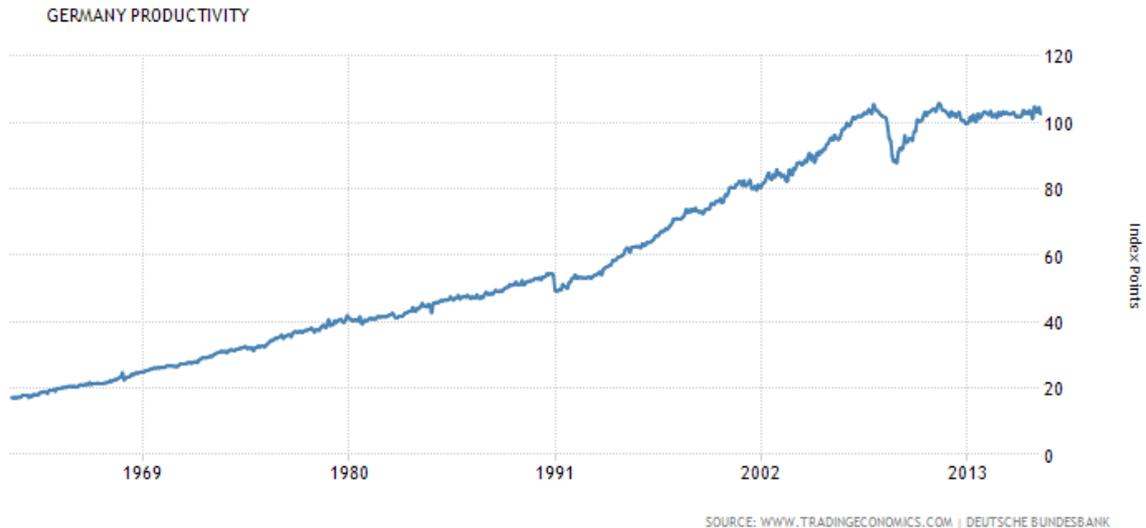


SOURCE: WWW.TRADINGECONOMICS.COM | OFFICE FOR NATIONAL STATISTICS

JAPAN PRODUCTIVITY



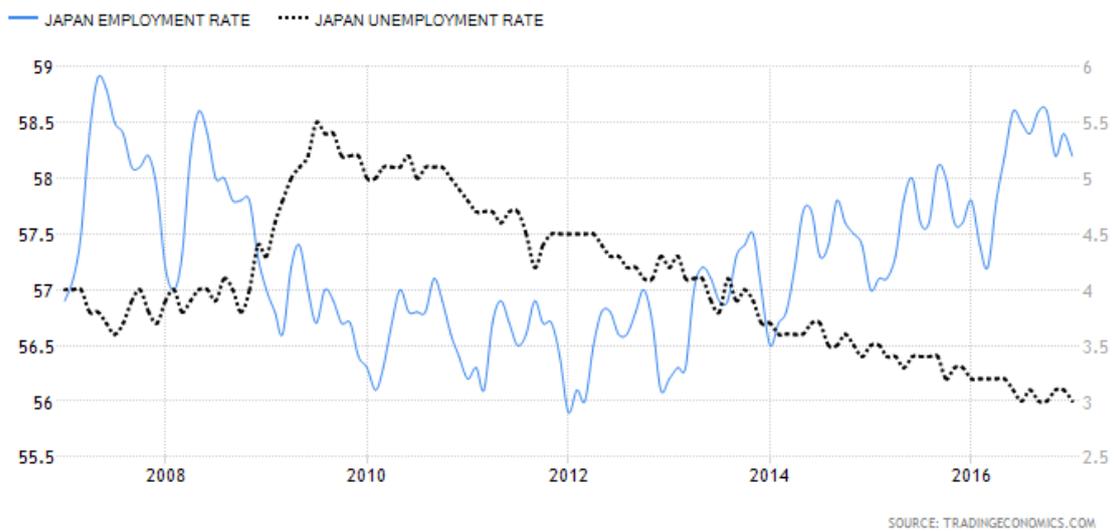
SOURCE: WWW.TRADINGECONOMICS.COM | JAPAN PRODUCTIVITY CENTER



## Employment

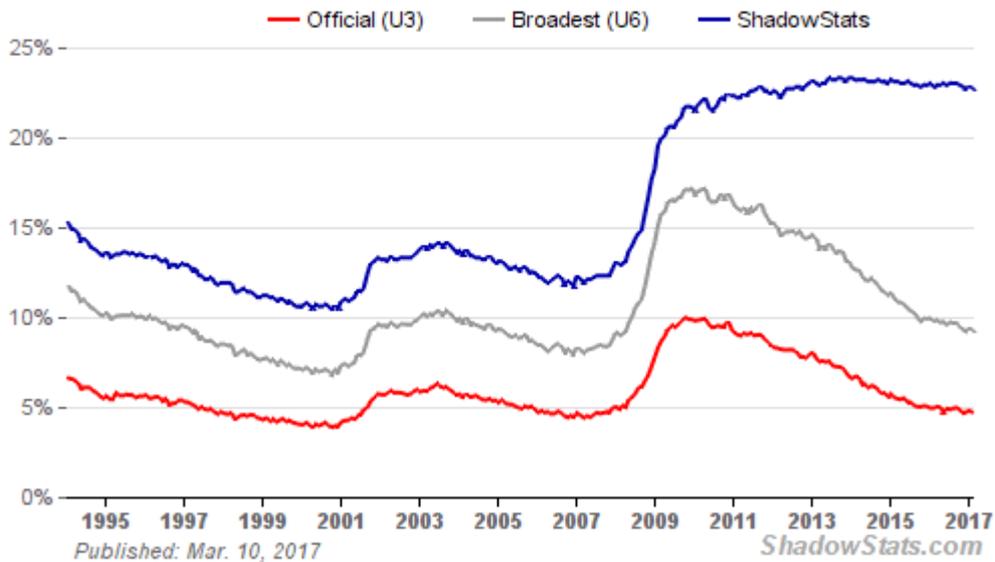
Employment is very strong in Germany with an unemployment rate of 3.8 % and a labor-force participation rate of 75 %. In the United States, the unemployment rate stands at 4.7 %, yet the employment rate is still weak at 63 %. Despite its several decade-long stagnation, the unemployment rate has held steady in Japan at around three percent. Yet the Japanese labor-force participation rate is very low at around of 58 %.

One should also note that “unemployment” escapes an exact definition and most countries in one way or the other try to paint a rosy a picture as possible. In the United States, for example, John Williamson’ “Shadow Government Statistics” provide a different record about U.S. unemployment than the official statistics (see chart below).



## Unemployment Rate - Official (U-3 & U-6) vs ShadowStats Alternate

Monthly SA. Through Feb. 2017 (ShadowStats, BLS)



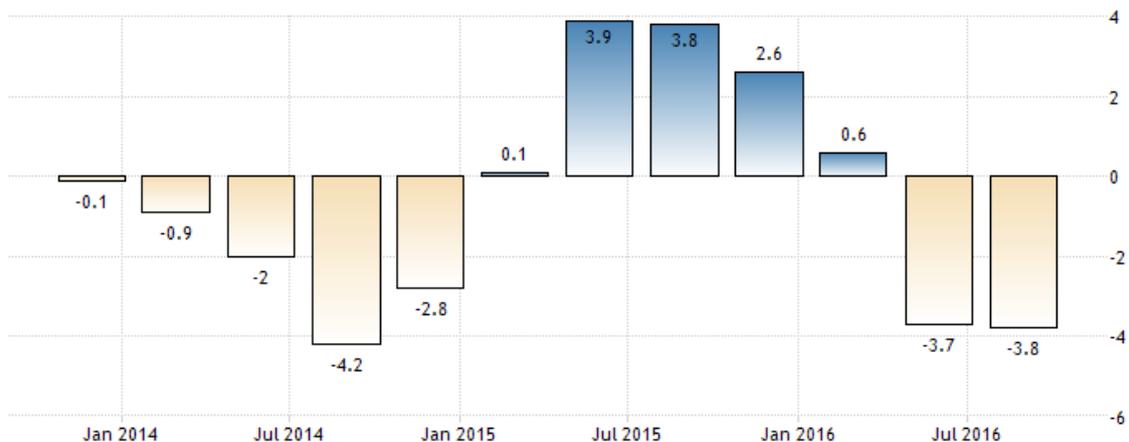
## Emerging Markets Blues

### Argentina

After a slight recovery from stagnation in the second half of 2015, Argentina fell back into recession in 2016. The economy contracted 3.8 percent on an annual basis in the third quarter of 2016, following 3.7 percent decline in the previous period. Gross fixed capital formation fell 8.3 percent, following a 4.1 percent drop in the previous period and private spending declined 3.1 percent. Yet government spending is on the rise again since January 2016. Unemployment has risen sharply in 2016 and stands now at 8.5 percent. The inflation rate was around 15 % in 2015, shot up in 2016 to over 40 percent.

One immediate reason for the resurgence of the Argentinean inflation rate is the expansion of the money supply M1.

ARGENTINA GDP ANNUAL GROWTH RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO NACIONAL DE ESTADÍSTICA Y CENSOS (INDEC)

ARGENTINA INFLATION RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO NACIONAL DE ESTADÍSTICA Y CENSOS (INDEC)

ARGENTINA MONEY SUPPLY M1

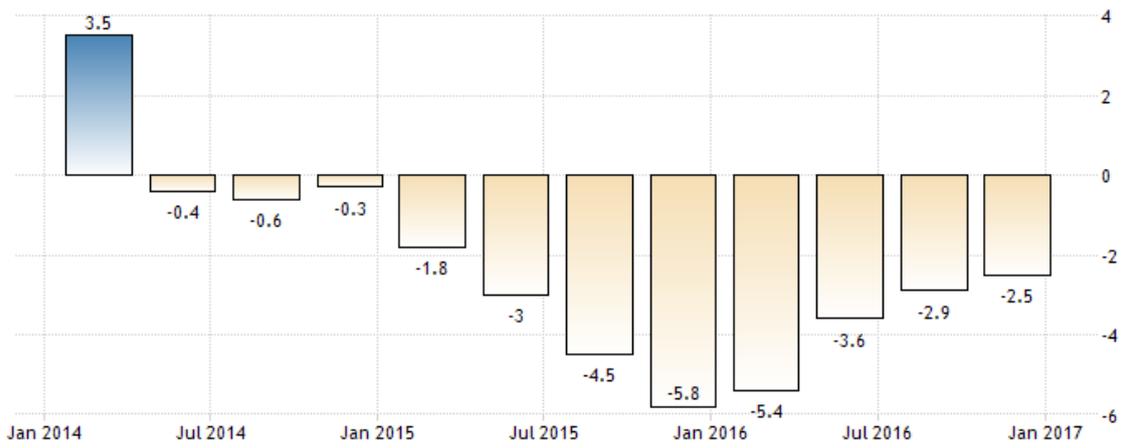


SOURCE: WWW.TRADINGECONOMICS.COM | CENTRAL BANK OF ARGENTINA

## Brazil

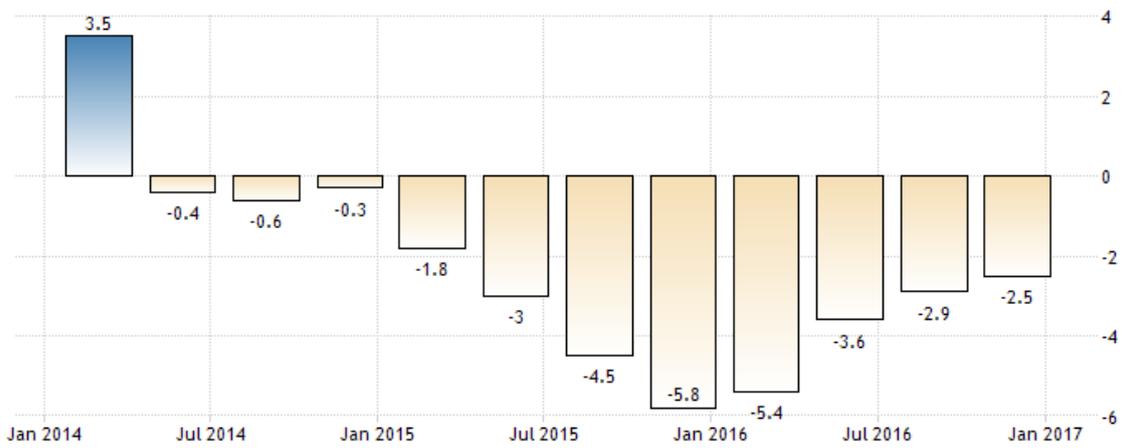
Different from prevalent expectations, the Brazilian economy has not yet recovered. In the last quarter of 2016, gross domestic product contracted by 2.5 percent on an annual basis after a fall of 2.9 percent in the previous period. The main factors that contribute to Brazil's economic contraction are sharp declines in household consumption and of fixed investment. After sharp falls in 2015 and 2016, industrial production is on the recovery and registered a 1.4 percent gain in January 2017. Brazil's economic contraction continues. Unemployment is on the rise and increased to 12.6 percent. A lower inflation rate – down from around 9 percent in 2016 to 4.76 in January 2017, has allowed the central bank to lower its policy interest rate by 75 basis points to 12.25 percent on February 22nd 2017.

BRAZIL GDP ANNUAL GROWTH RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA (IBGE)

BRAZIL GDP ANNUAL GROWTH RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA (IBGE)

BRAZIL INFLATION RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA (IBGE)

BRAZIL INTEREST RATE

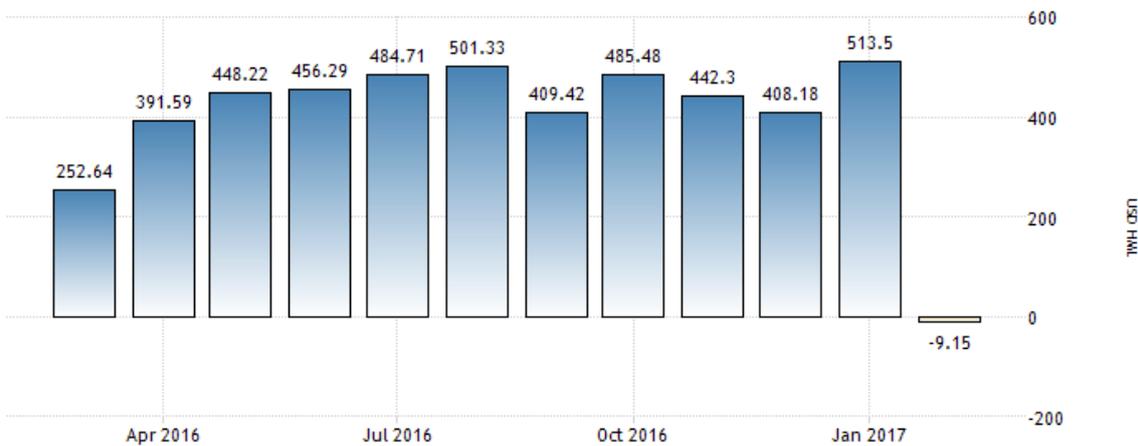


SOURCE: WWW.TRADINGECONOMICS.COM | BANCO CENTRAL DO BRASIL

## China

China unexpectedly reported a trade deficit of 9.15 billion dollar in February of 2017, compared to a surplus of 28.2 billion dollars the year before. While imports rose, exports fell in February 2017 by 1.3 percent compared to the same period last year while imports jumped by 38.1 percent. China's economic growth is slowing down but still relatively high at annual rates of over six percent since the middle of last year. Inflation is well under control as currently China's consumer prices rose 0.8 percent on an annual basis in February 2017, compared to a 2.5 percent annual rise in January.

CHINA BALANCE OF TRADE



SOURCE: WWW.TRADINGECONOMICS.COM | GENERAL ADMINISTRATION OF CUSTOMS

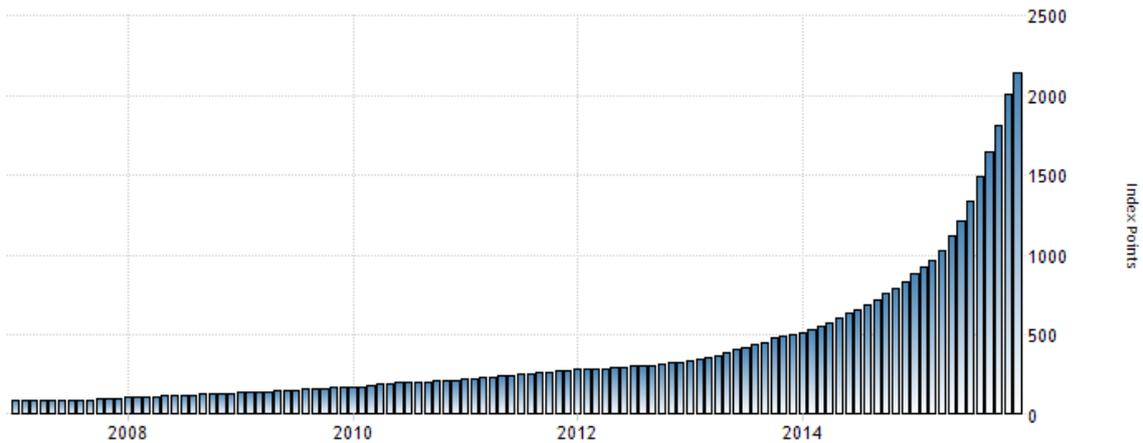


## Venezuela

Venezuela is on the brink of total collapse. International reserves are down to 10657 USD Million in January from 10977 USD Million in December of 2016. Inflation is rampant, reaching an increase of 800 percent in 2016. According to preliminary figures, the Venezuelan economy contracted by 18.6 percent in 2016, following a 5.7 percent decrease in 2015.

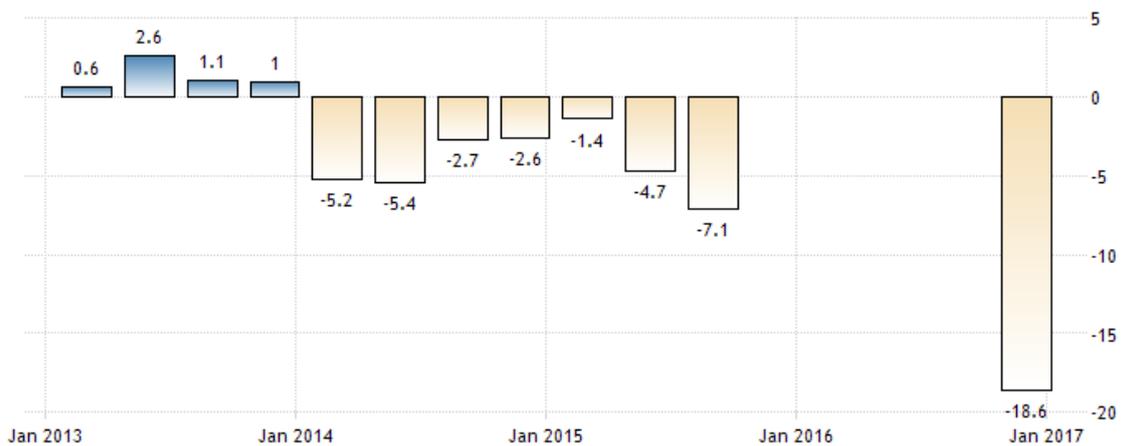


VENEZUELA CONSUMER PRICE INDEX (CPI)



SOURCE: WWW.TRADINGECONOMICS.COM | BANCO CENTRAL DE VENEZUELA

VENEZUELA GDP ANNUAL GROWTH RATE



SOURCE: WWW.TRADINGECONOMICS.COM | BANCO CENTRAL DE VENEZUELA

## Outlook

There has been a critical gap between the growth of production and the growth of productivity in the industrialized countries. The driving force of the economies over the past couple years was not technological progress but an unprecedented enlargement of the monetary base. Monetary expansion, however, has only partly fueled economic growth, the largest part of the creation of fresh money has found its way into the asset markets. With monetary expansion coming to an end and interest rates on the rise, the end to this game is coming.

In as much as economic growth happens in the emerging markets, it takes place in a very volatile manner. Many emerging market economies operate well below their potential. In the case of massive financial turmoil in the industrialized countries, the emerging economies will not be able remain isolated from the coming contraction.