Stormy waters or calm seas ahead?
Macroeconomic outlook in a time of uncertainty

Prof Sir Charles Bean
(LSE & OBR)

Swiss Risk Association, Zurich
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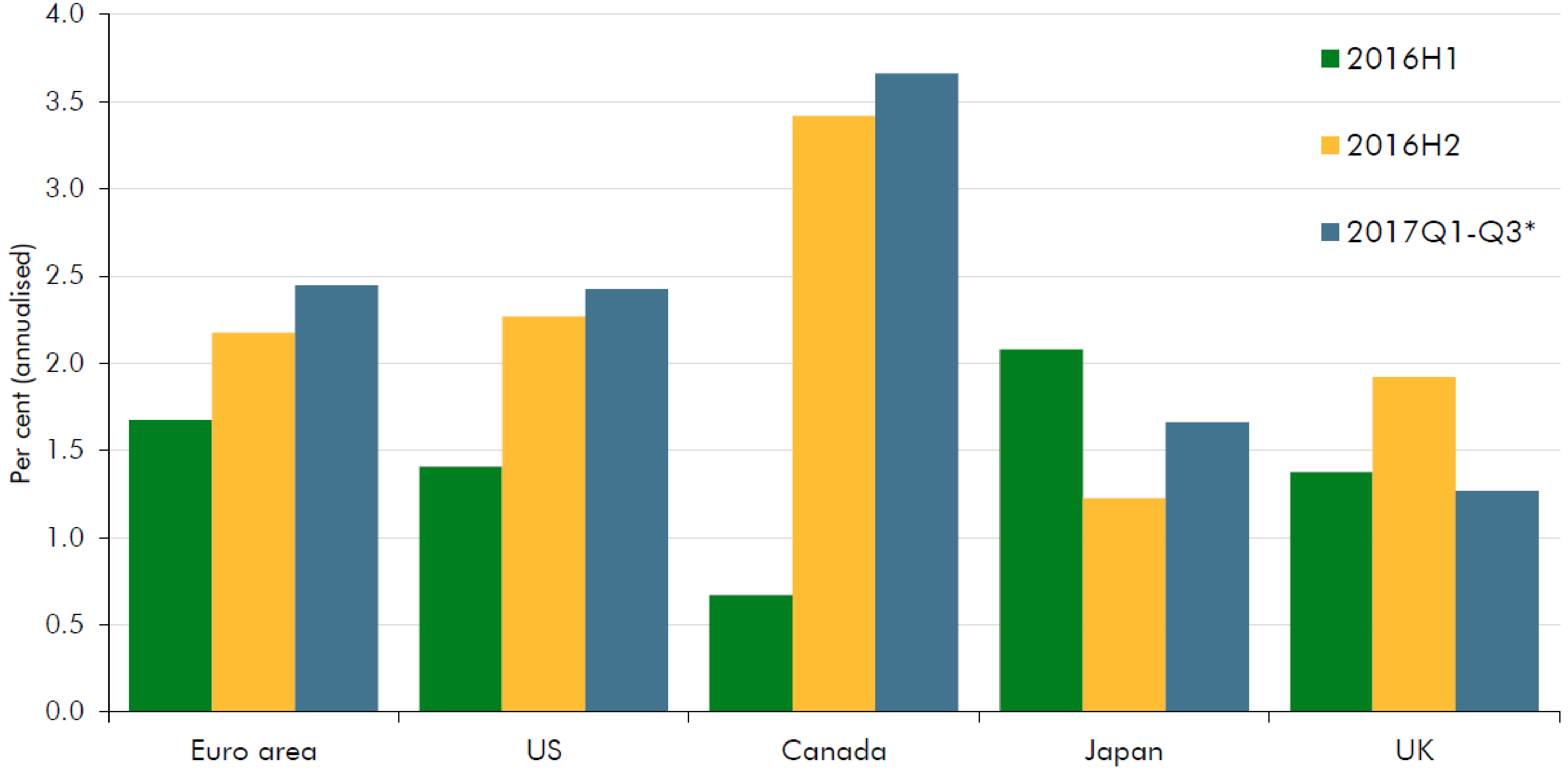
THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Office for Budget Responsibility

GDP growth has picked up (except in UK!) – will it last…?

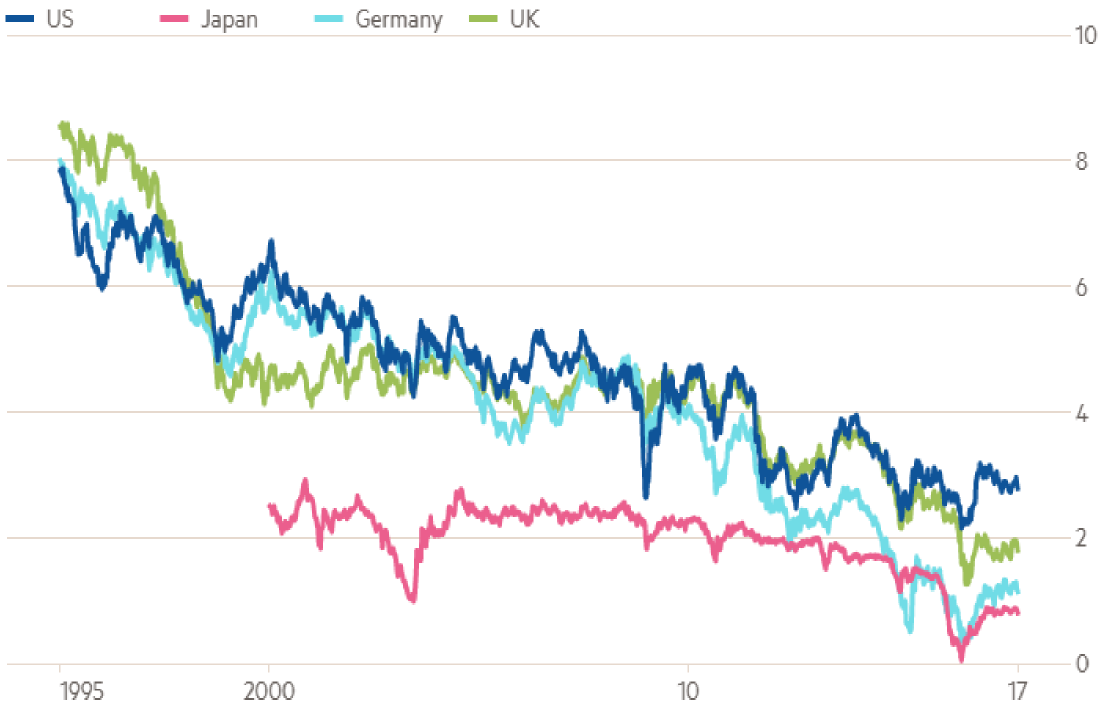


*Jan-Aug 2017 for Canada
Source: Datastream, Statistics Canada

Short term risks in financial markets

- A Chinese banking crisis?
  - Very likely! Key is how well it is handled.
- Assets too richly priced?
  - Nominal & real long-term rates are unusually low…
  - …and vulnerable to policy normalisation

30-year government bond yields (%)



Source: Thomson Reuters Datastream

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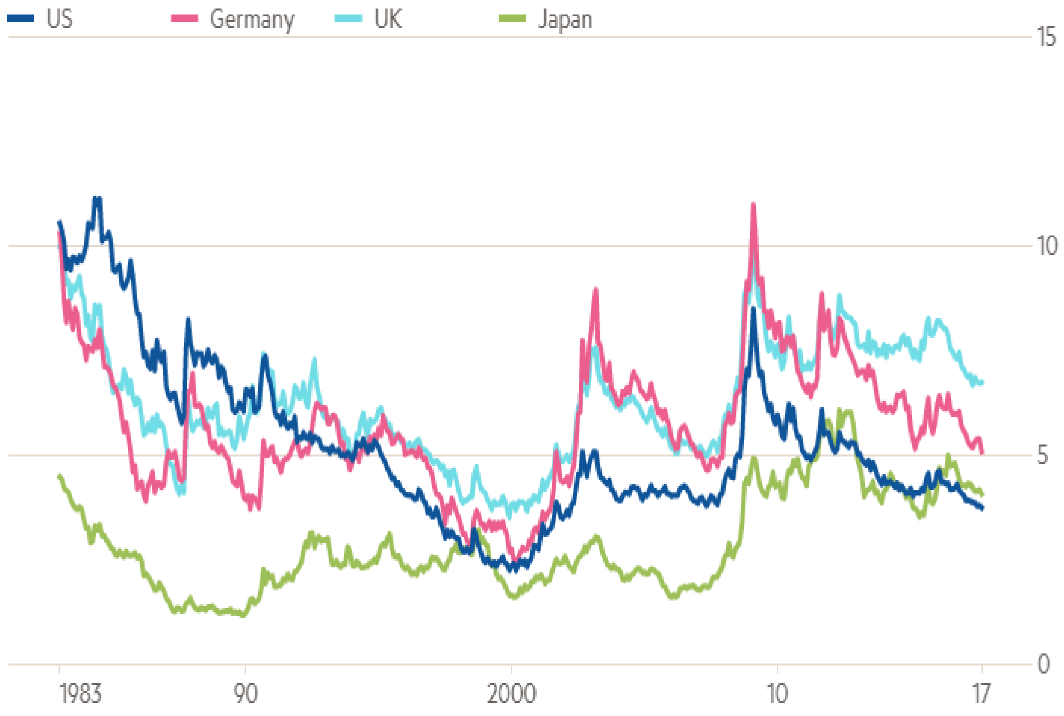
  - …and vulnerable to policy normalisation
  - …but *not* matched by equity yields

Cyclically-adjusted earnings yield on equities (%)



* On Datastream Total Market indices, deflated by national CPI

Source: Thomson Reuters Datastream, FT research

Long-term risks: Natural rate of interest

- Will present low "natural" rate of interest persist?
  - Low real rate implies lower bound on policy rates bites more often
  - Encourages search for yield and raises risks of financial instability

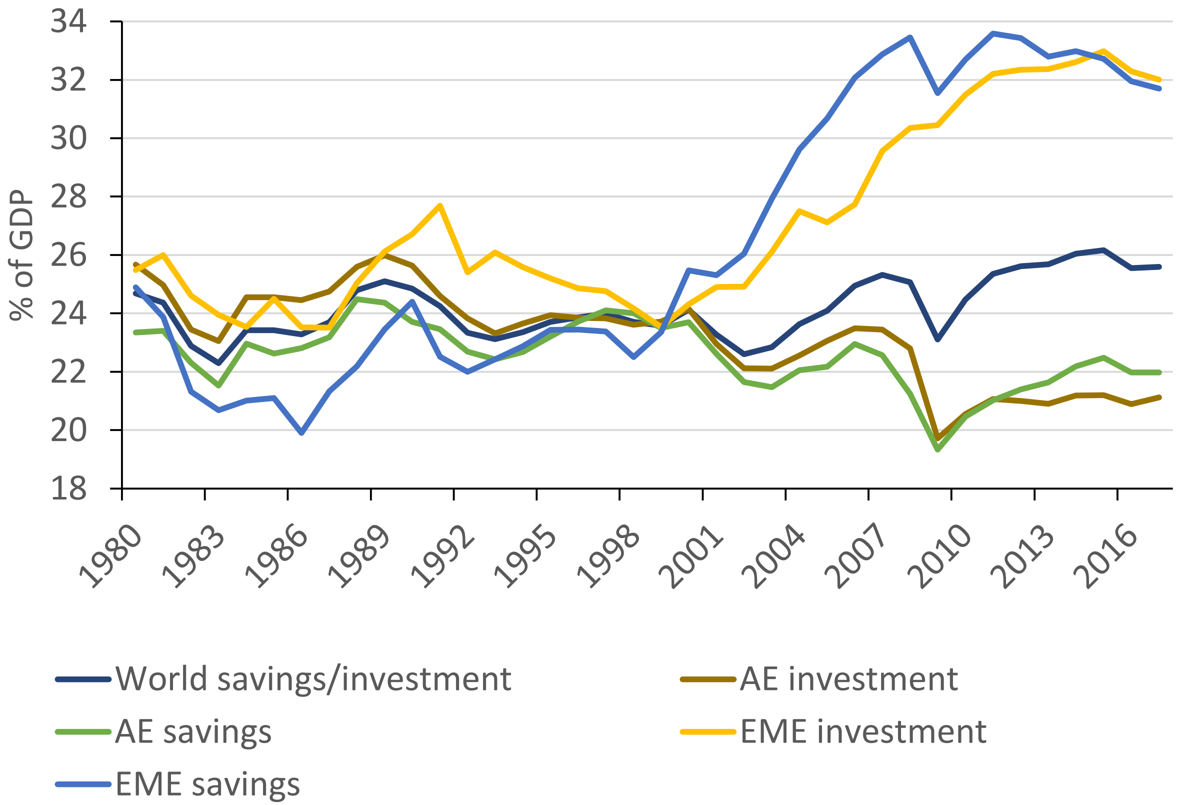
"World" 10-year risk-free real interest rate, 1985-2017

Source: King and Low (2014) updated.

Causes of decline in natural real rate

- Possible causes of low rate:
  - Savings 'glut' (China; balance sheet repair; demography)
  - Investment 'strike' (Productivity slowdown; post-GFC uncertainty)
  - Portfolio shifts favouring safe assets (GFC; QE)
- Both S and I shifts probably relevant

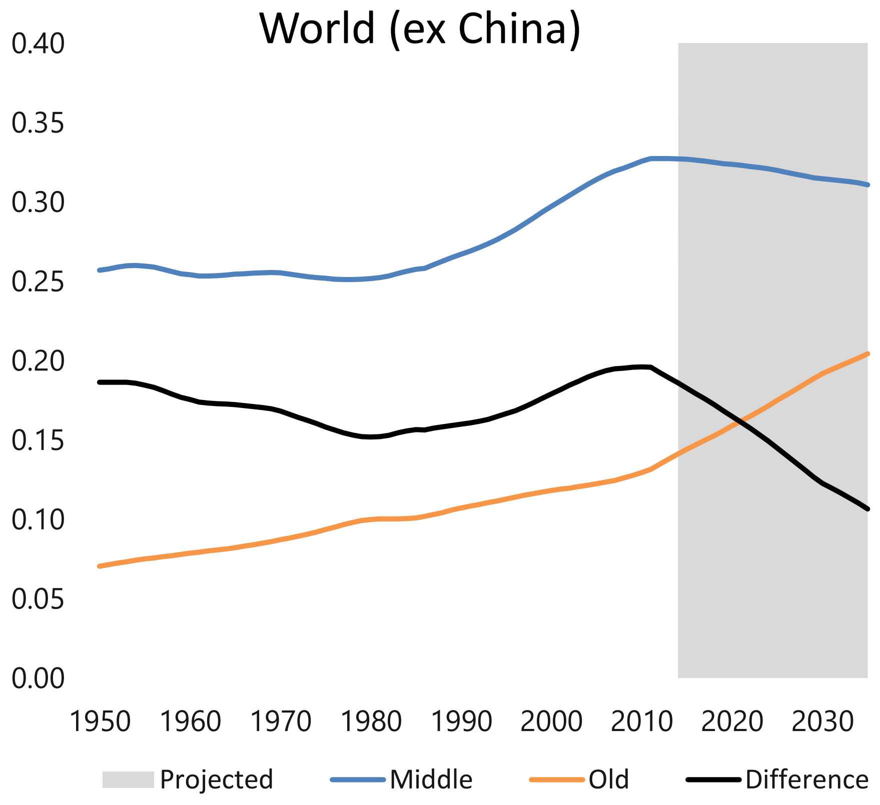
Savings and investment shares, 1980-2017

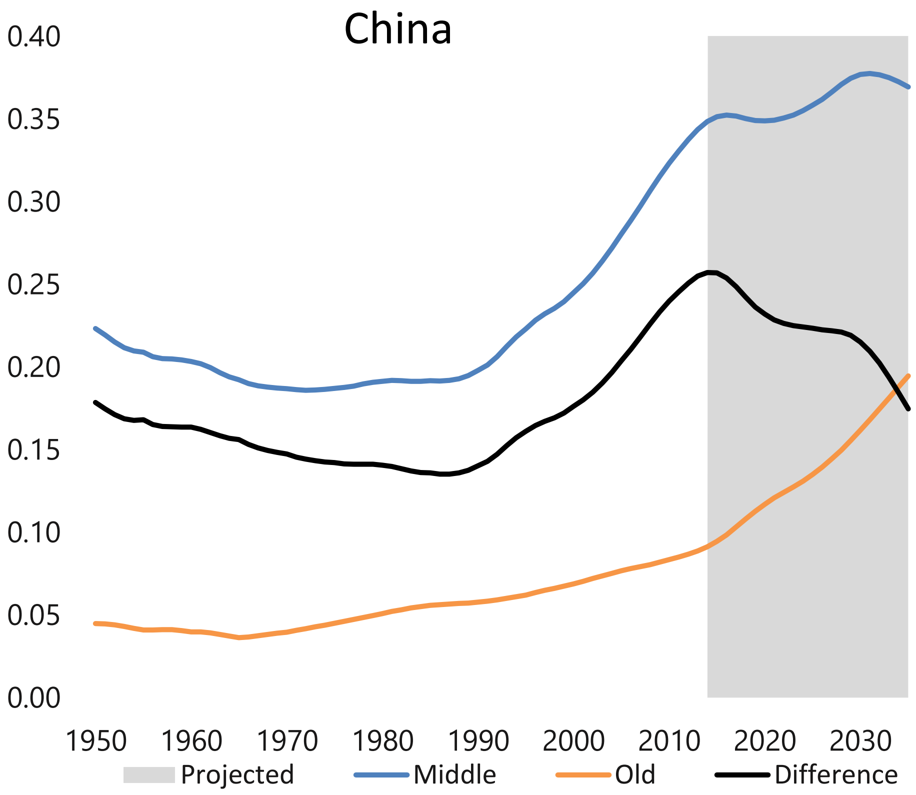


Source: IMF WEO database

But saving rates are likely to fall back…

Population shares

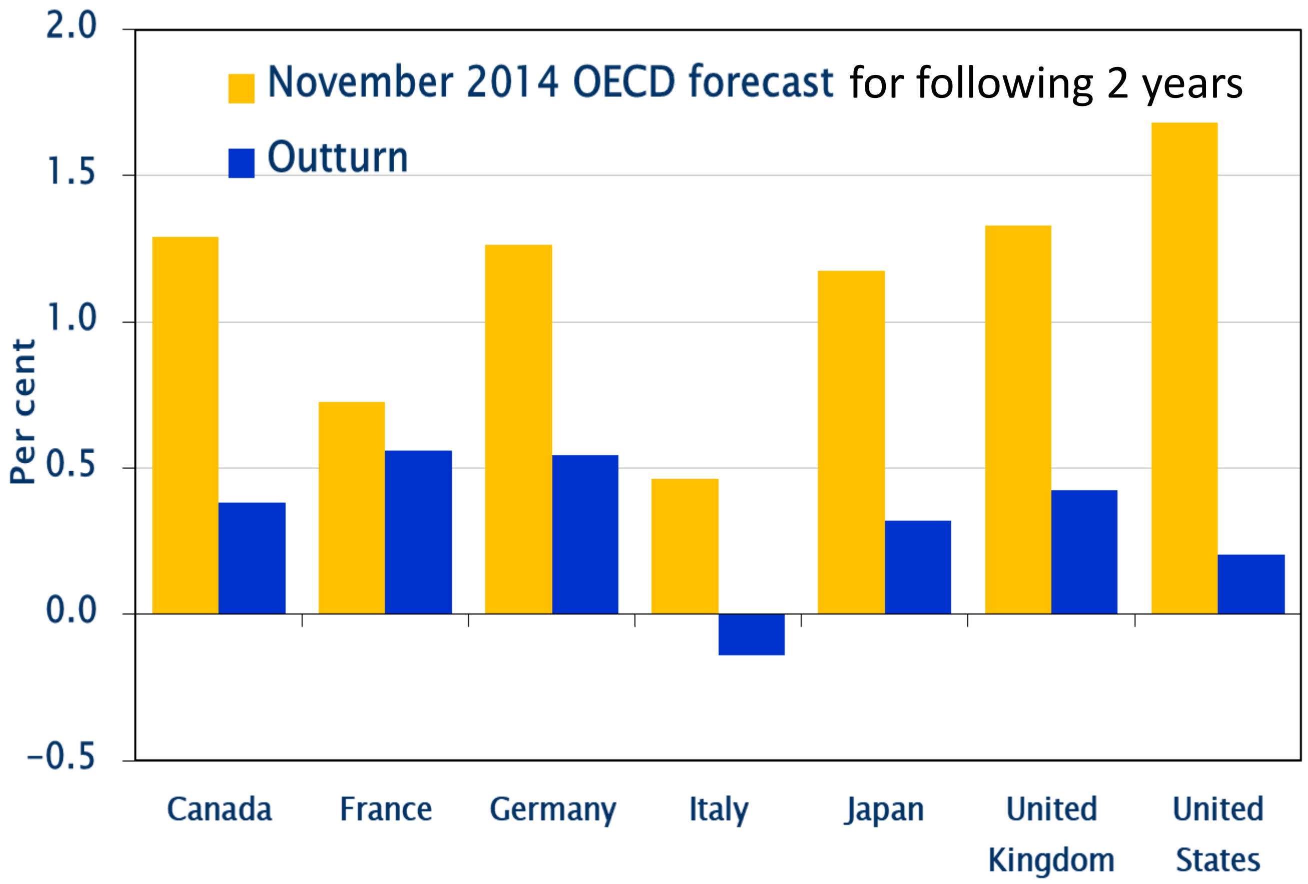




Source: United Nations.

Long-term risks: Productivity growth

- Productivity growth has disappointed everywhere. Will it continue to disappoint?
- *"Productivity isn't everything, but in the long run it is almost everything."* (Krugman, 1994)
- Stagnant productivity ⇒ stagnant living standards ⇒ rising populism & threat to support for capitalism



It is not so easy to foresee the future…

- ☞ *"Heavier-than-air flying machines are impossible."* (Lord Kelvin, President of the Royal Society, 1895)
- ☞ *"Everything that can be invented has been invented."* (Charles Duell, Commissioner, US Office of Patents, 1899)
- ☞ *"The wireless music box has no imaginable commercial value. Who would pay for a message sent to nobody in particular?"* (David Sarnoff's associates, RCA, 1920s)
- ☞ *"Who the hell wants to hear actors talk?"* (Head of Warner Brothers, 1927)
- ☞ *"I think there is a world market for maybe five computers."* (Thomas Watson, Chairman of IBM, 1943)
- ☞ *"There is no reason anyone would want a computer in their home."* (Ken Olsen, Chairman of DEC, 1977)

The bottom line

- Population ageing should lead savings rates to fall back and…
- …New technologies (AI, nano-technology, etc) should produce some recovery in investment and productivity growth…
- …But is likely to bring distributional challenges too…
- …So natural real (and nominal) interest rates likely to rise gradually.
- In meantime, central banks may need to continue to resort to "unconventional" measures such as QE from time to time.