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Global Economic Outlook in 2016 - learning to live with higher uncertainty

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Paradoxically the disappearance of the uncertainty regarding the interest rate increase in the U.S. created, as most market observers predicted, a new set of uncertainties in global economy. And these uncertainties are not related to the monetary policy in the developed world: all major central banks - European Central Bank, Chinese Central Bank, Bank of Japan and the Bank of England- have confirmed emphatically that they will continue with their zero bound interest rate policies for foreseeable future. The central banks of the leading economies in the world will continue with their forward guidance on interest rates. But still there will be new sources of uncertainty in 2016 both in emerging economies and global financial markets.

It is possible to broadly categorise the emerging economies into those that export goods and commodities to China and to the developed economies, and those that import capital to finance their current account deficits and growth. Both types of emerging economies are likely to have economic growth problems because commodity prices will stay low due to lack of demand in their export markets and capital flows from the U.S. and Europe are likely to slow down or even reverse. Consequently these adverse developments are likely to put the emerging economy currencies, stock markets and indebted corporations under pressure. I do not think there is going to be a serious sovereign or banking crisis in emerging economies in 2016 because these sectors of the economy in emerging economies are resilient at the moment. I think it will be a testing year for China as China will start discovering how to achieve social objectives and international political ambitions under lower growth rates and increasingly complex financial markets both at home and abroad. Abenomics in Japan is not working and Japan is becoming increasingly financially fragile economy with its central bank basically eradicating free financial markets through its colossal balance sheet that keeps expanding. South Korea, on the other hand, will need to find new growth strategies otherwise their asset markets, currencies and financial institutions are likely come under pressure in 2016. The Eurozone will continue to have problems due to very low growth rates, high unemployment and highly indebted member states in the south like Greece, Italy and Portugal.

Although the Federal Reserve in the U.S. seems to think that the U.S. economy has finally recovered after the 2007 crisis we need to remember that the U.S. economy still runs on huge household debt not on high wages or investments in productive capacity. Therefore Janet Yellen was extremely careful in her wording of the rate rise last week to assure financial markets that this rate rise is not going to be followed by sharp successive rate rises. Her comrades who head the central banks of major economies supported her assurances by announcing publicly that they are not going to follow the U.S. in interest rate policy. Of course forward guidance by central banks does not mean that the currency markets could be kept under control when the U.S. interest rates diverge from the rest of the world. So there is going to be a rough ride for the central banks of the developed economies in balancing stability in financial markets and achieving macro-economic objectives.

Another source of uncertainty in the global economy is likely to emanate from the U.S. The Federal Reserve currently holds USD 2.5 trillion worth of U.S. Treasury securities and USD 1.8 trillion worth of mortgage-backed securities as a result of its quantitative easing policies over the last seven years or so. In order to support its low rate policy the Federal Reserve needs to sell the securities on its balance sheet back to the financial markets. The success of the Federal Reserve's new methods to reduce the size of its balance sheet will be as important as, if not more important than, making interest rate policy announcements in the future. The Federal Reserve can announce the policy rates but there is no guarantee that it will be able to control the pricing of credit risk and liquidity in the U.S. financial system when it starts reducing its balance sheet. Therefore there is now increased risk of financial instability in the U.S. economy.

The extraordinarily accommodating monetary policy in the U.S. together with Chinese fiscal policies to prevent economic recession after the 2007 crisis have created a fantasy world since 2007. 2016 is likely to be the year when the world economy will no longer be able to grow by creating artificial bubbles in financial markets and real estate markets. In that sense 2016 is likely to be finally the year of economic realism for the world economy after the historic 2007 banking crisis in the U.S. and Europe.