A necessary correction

Why the world is in better shape than you might think
by David Marsh
Mon 25 Jan 2016

The world is thoroughly imperfect, and Europe’s in a mess, but stories that international uncertainty is at some kind of post-second world war high are distinctly wide of the mark. Remember the Cuban missile crisis, or the Soviet march into Afghanistan, or even the fall of the Berlin Wall, a development many observers (including Wolfgang Schäuble, now Germany’s finance minister) believed, shortly before it happened, might trigger a third world war.

Financial markets and those who write about them seem to be in the grip not so much of collective hysteria, more collective myopia. Perhaps this is inevitable in an age of round-the-clock instant information. Call it inanity masquerading as insight.

On 19 October 1987, the S&P stock market index fell 20%, making latest Wall Street fluctuations look puny. And yet, as noted by Nigel Lawson, Britain’s oldest living former chancellor of the exchequer (and author of the original ‘teenage scribblers’ jibe at his youthful City critics), the event hardly shows up in a chart of economic history.

Stock markets are enduring a necessary correction after some hype-induced 2014-15 overvaluations. Stock prices have recovered from New Year lows. They will no doubt bob around a bit more in response to whatever Mario Draghi, the European Central Bank president, says about the attractive yet fictional concept of ‘unlimited’ ECB action to get European inflation back on target.

The renminbi is falling against the strong dollar (but is reasonably steady against a basket of currencies, as my colleague Ben Robinson pointed out earlier today). Chinese growth is indeed falling – but by an amount (if Beijing statistics are to be believed) identical to that forecast by the IMF a year ago.

Here are six reasons for believing that the world as a whole and the outlook for markets are somewhat healthier than the direst forebodings indicate.

1. One seminal event that could have a negative effect on European and international sentiment – a post-referendum British exit from the European Union – looks less likely. Much depends on whether British Prime Minister David Cameron’s legendary luck holds for the next few months.

2. The oil price has fallen to lows that will probably soon spark a price rebound to $50-$60 a barrel, bringing inflation to a level more consistent with central banks’ medium-term 2% objectives.

3. Core European economies are in reasonably good shape as a result of the weak euro and low interest rates. This is one reason why any further ECB quantitative easing is likely to run into fresh German-led opposition when the ECB next debates the subject in March.

4. Angela Merkel, the German chancellor, who has had an unlucky streak over the past year – these things tend to go in five-year cycles – is likely to perform a U-turn over refugee intake in the next few weeks. While unpleasant for the refugees, this will help stabilise her own position and Europe’s.

5. China’s capital outflows will settle down. Beijing’s financial ‘liberalisation’ unquestionably follows well-managed Chinese principles. Bank of Japan Governor Haruhiko Kuroda’s call for Chinese capital controls contains more than a hint of schadenfreude. Tokyo wishes to remind the world that the renminbi is not totally ‘freely usable’.

6. The US has started to raise interest rates in an election year. If the Federal Open Market Committee can hold its nerve, we will see further quarterly interest rate rises over the next 12 months – hardly draconian, but a signal that the US recovery (despite everything) is still in business.

David Marsh is Managing Director at OMFIF.