LSR View

UNSTABLE EQUILIBRIUM IS GLOBAL

Charles Dumas

- **Our central forecast remains 'steady as she goes'**
- **But the risks have increased – notably the threat of trade war**
- **Yet that could mean a continued cheap euro, helping EA growth . . .**
- **. . . and plenty of money flowing into the US, holding down rates there**
- **Meanwhile the techies are still innovating, and capex is picking up**
- **Even Italy's troubles have their bright side – fiscal stimulus could help**
- **And China remains in the background, with 6% growth and contained debt**

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Summary

The world has yet to shake off the post-crisis blues, though expansion has mostly been steady, if modest, for nine years now – though only five in the euro area. The disappointments of years of only moderate recovery have fuelled numerous examples of populist voter revolt that threaten growth even as they respond to the lack of it. Conventional centrist politicians have yet to come up with convincing policies to foster the rapid improvements in living standards that are needed to allay voters' frustrations. But the supply side continues to innovate and adapt constructively.

The unstable equilibrium we describe in the world is one in which conventional economic analysis suggests the next 12 months should see continued above-potential growth and some further gains in stock market prices. But the equilibrium is that of a ball resting on the top of a hill – only a small impulse is needed to cause it to fall sharply in one direction or another. The risks to our central, moderately optimistic view have mounted.

In the monetary field, there is a strong contrast between apparently easy money and plentiful liquidity, and the ability of that liquidity to freeze up in a panic. Even in the US, short-term rates remain below inflation, and in Europe they are below zero even in nominal terms – despite inflation rising moderately, as in the US. Yet this easy monetary regime, with excess reserves at 10% of GDP on both sides of the Atlantic, has not prevented stock markets scudding sideways since their late-January peak.

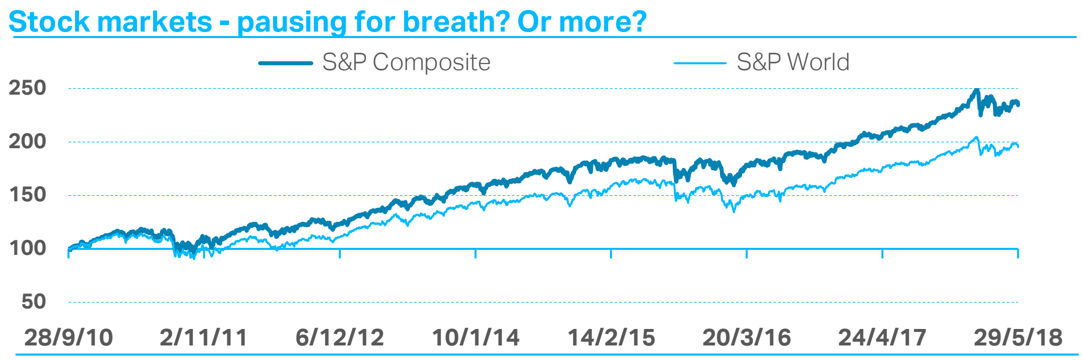
Does Trump want to fight the mid-term elections on a trade-war platform? For rallying the 'base' it could hardly be improved on. Maybe a deal can be done with China to give him a 'win' over North Korea, but then attention could switch to the true counterpart of America's trade deficit: continental Europe, Germany in particular with its current account surplus over 8% of GDP. Yet both this prospect and the latest bout of nerves over Italy are reasons why the euro could stay, as it is now, unreasonably cheap, adding to EA demand and preserving EA and Japanese inflows to US Treasuries, thus holding down US rates and yields as the up-cycle matures.

A more sanguine view of US prospects – an upside risk – is that the positive capex cycle now getting under way will combine with whatever tech 'miracle' is next in line to generate faster productivity growth. In this scenario, an economic downswing would only be mild, even though inflation and higher rates are likely to cause one in 2019-20. The flip side of this, however, is that abundant liquidity could revive the 'melt-up' that was brought to a halt in February, initially by the Fed's tightening but subsequently by a host of politically inspired fears.

Another upside point, at least for the short term, is that Italy's new government may seem quite successful in a year's time. The country needs growth stimulus. Structural reforms tend to cut demand – clearly so in the case of labour market liberalisation, which generally means lower wages. Italy is already well below potential, with unemployment of 11% versus 6% pre-crisis. Voters who supported the anti-establishment parties now in power have certainly not been prepared for structural reforms anyhow. But fiscal stimulus is a given, and the economy could look better for it in a year's time. Germany and the Brussels bureaucrats may fulminate on the sidelines, but the known willingness of the governing parties to contemplate exit from the euro should be enough to keep their protests minimal.

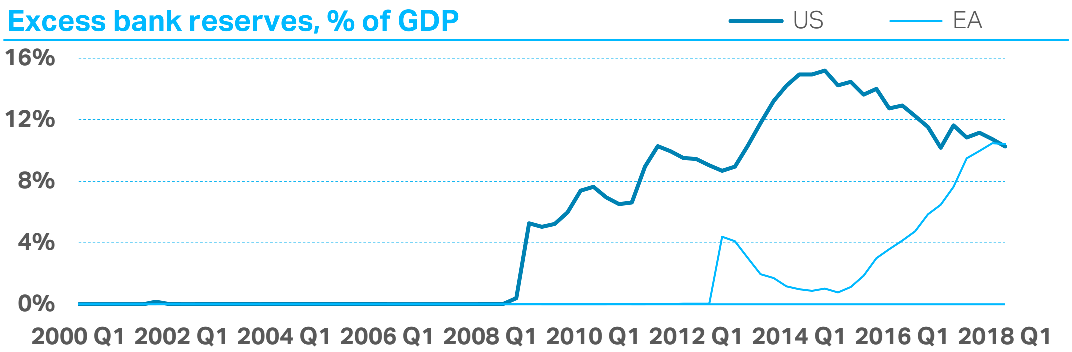
Meanwhile in the relative background, China has become a stabilising economic force, and the rebalancing of its economy means continued 6% growth may prove possible without the blight of escalating debt that marred 2012-16. It is a patchwork world, with plenty for investors to worry about – and to get excited about.

Unstable equilibrium



Source: Datastream, TS Lombard

Anxiety has broken out in world financial markets since February, a further example of unstable equilibrium that prevails after ten years of post-crisis frustration. But the world is now enjoying fairly steady growth, well balanced and much less dependent on debt than in 2003-07. Liquidity remains lavish. In relation to economic prospects in the normal sense, monetary policy is unduly stimulative and liquidity probably excessive. But fear of a 'bolt from the blue' affects market memories still scarred by the shock of the financial crisis. Markets can turn on a dime from confident to anxious, from risk-on to risk-off. Greater volatility is a given. Does this threaten world growth or the resumption of stock market gains?



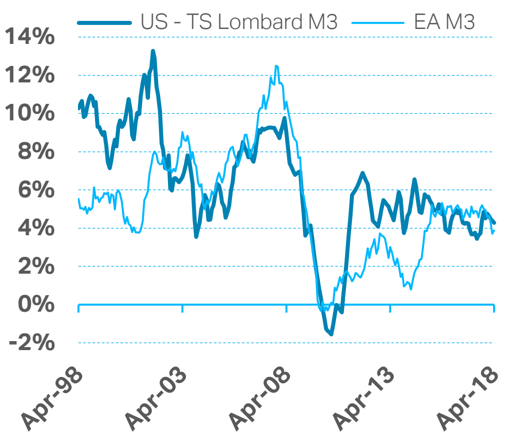
Source: US Fed, Datastream, TS Lombard

It might seem surprising that the ECB's extravagant QE has only led to a level of excess reserves equal to the US as a percent of GDP. But any bank facing the ECB's minus 0.4% on reserves would not raise them any higher than absolutely necessary to hold onto vital deposit business. The chart above vividly illustrates the scale of excess liquidity by past standards. Regulations may have changed, making some of the US 'excess reserves' necessary. But domestic US liquidity concerns have been lessened by the shift in US Treasury debt issuance to T-bills, reducing the pressure that might be expected from the Fed's quantitative tightening.

Another factor supporting US domestic liquidity has been the reflow of funds previously parked in tax havens like Dublin. The new tax rules were specifically designed to promote this. While this has no direct exchange-market consequences – the bulk of the cash was in dollars abroad, and is now in dollars in the US – it adds liquidity in the US, and subtracts it abroad. The talk about dollar shortage stems from this, and accounts for some of the greenback's recent strength.

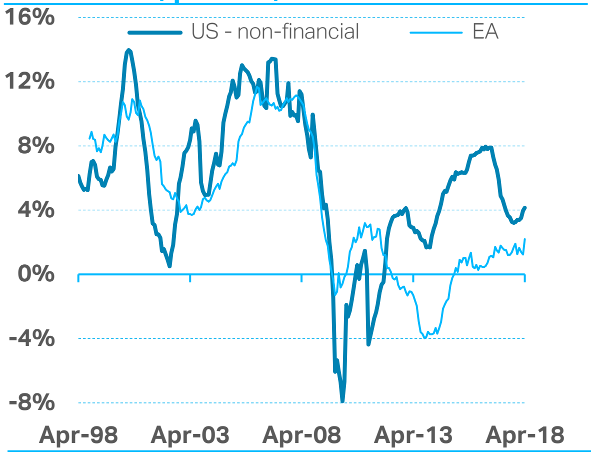
Given the health of the world economy, with the US, China and the EA as effective locomotives, it is little surprise that monetary tightening is widely discussed. Not so widely practised, however. In quantitative terms, growth is sufficient to abundant. In price terms, money remains remarkably cheap. As regards quantity, as the charts below show, broad money in the US modestly exceeds the sum of trend growth as measured (1¾%) and the inflation target of 2%. EA broad money has been growing 4-5%, significantly higher than the sum of trend growth – which few think to be above 1½%, with most suggesting less than that – and the inflation target of a little under 2%. The data on loan growth to the private sector are also quite adequate, given significant funding from private sector financial surpluses in the EA, if not the US (once households are included).

Broad money, % YoY



Source: Datastream, TS Lombard

Bank debt, private, % YoY



Source: Datastream, TS Lombard

When it comes to the price of money, interest rates are plainly on the low side, though lessened in their stimulus in the US case by the large spread of Libors over T-bills, etc. The current Fed funds rate is 1.7%, which remains below core inflation of 2% that is in any case rising slowly. The very fact of higher inflation suggests the economy is overheated, as is hardly surprising with the unemployment rate now below 4%. The long-run average for the real Fed funds rate has been 2% since the 1950s, and while few would argue that this is the neutral real rate now, even fewer would say the neutral real rate remains negative (though it probably has been at times in the 2011-2015 period). At the other end of the curve, the 10-year Treasury yield of 2.9%, with only the 0.9% being real yield, compared with an average premium of long-dated Treasury yields over inflation of 2½% over the past 100 years. The 10-year inflation-protected TIPS yield .9%.

Our mainstream forecast is therefore an unstable equilibrium. Good prospects for the next year or so, with the likelihood of a marked slowdown starting later in 2019, is a view exposed to larger risks than we are used to accommodating in our forecasts. Here we summarise four such variants, two upside and two downside in their short-term effects:

- Upside variants include two very different scenarios. In the first, the upward shift of capex in the US and German-centred Europe leads to gains in productivity growth that mean any slowdown is as mild as in 2015 – when the low point for US YoY real GDP growth was 1¼% – especially if the mid-2018 Chinese slowdown is succeeded by policy stimulus supporting global activity into 2019

- The second scenario is only an 'upside' in the short term: financial markets get over currently wobbly confidence by the autumn and the combination of lavish liquidity and cheap money causes a 'risk-on' boom or melt-up – though with the danger that central banks then over-react and tighten too much too late

- The biggest downside variant is obviously Trump either deliberately or inadvertantly fighting the US mid-term elections on a trade-war platform – as likely to be versus Europe as versus China – and/or a revival of EA existential troubles, most likely in Italy

- A second downside scenario that is also only such for the short term would be a tech-sector supply-side slowdown, heralded by the recent slowing of smart-phone sales, with satiation of tech appetites – in this case with the likelihood that such a slowdown would be mild and temporary as new forms of AI come on stream

Major risks – trade war, Italian populism

The natural 'pause for breath' in stock markets that started in February has morphed into a deeper nervousness owing to President Trump's willingness to risk US self-harm by means of import restrictions against China. The resolution of this involves three other relevant factors:

- US anxiety about loss of its 'No 1' hegemon status in a world moving from uni-polar (post-Cold-War) to multi-polar as China, in particular, becomes a larger economy than the US and increasingly willing to use its strength
- US grievances about technology transfer to Chinese firms
- North Korea

China had used North Korea as a bargaining chip for a long time. Every time Pyongyang engaged in a particularly aggressive move, US officials would pour into Beijing asking the Chinese to get it under control. The Chinese would be polite, ask for whatever they wanted in return, and basically do nothing. The big change now has been the willingness of the US to 'self-harm' by restrictions on imports alongside substantially greater potential harm to China and other net exporters. This has hastened the shift already under way in China's calculus, in favour of restraining North Korea – with potentially dramatic results in terms of North-South peace and nuclear disarmament.

Xi Jinping remains the ringmaster, and was starting to rein in North Korea, whose economy is in parlous condition, before the trade war fracas heightened tensions in March. By delivering President Trump a major Korean 'win', and making some intellectual property concessions (that it will probably expect to flout in practice – this issue could be ongoing)) China could secure:

- the end of import restrictions that in any case raised major domestic hostility in America (including US people likely to be damaged by Chinese and other countries' retaliation)
- shelving for now of US concerns about no longer being global No. 1

The 'who is No. 1 issue' is unlikely to go away, however. And neither will the issue of US overseas deficits and the predatory exchange rate behavior engaged in by savings-glut countries to secure the corresponding surpluses. The former means Sino-US tensions are virtually certain for the indefinite future. The latter, however, switches to focus to Europe and Japan, now that China's surplus is minimal and its excessive saving and capex receding (if only gradually).

In theory, a big rise in the euro, should slash the EA surplus. Meanwhile, Japan is an ever less important part of the world economy, so its surpluses could cease to be a concern.

But there is a timing problem. Germany's shift away from its current major domestic imbalances could take ten years – but the next US downswing is likely within two. And even with German rebalancing and a major euro appreciation, Germany would probably still end up with a surplus and Italy a deficit. On the way, Italy would have had a recession, with consequences for the whole EA, and therefore the world economy.

Meanwhile, the US trade hawks are fully aware that measures based on bilateral trade deficits – as between the US and China – may be politically appealing in relation to the 'who's No. 1' issue, but is economically obtuse. The overall US deficit has its global counterpart in continental Europe and Japan. If a US economic downswing starts just in time for the 2020 election year, the attack will switch from China to Europe. And intellectually the US trade hawks will have the better of the argument, for all the benefits of free trade, because of the malignant effects of intra-euro imbalances until the 2010-13 crisis, and their resolution purely by deflation, followed by the ECB's adoption of what amounts effectively to a beggar-my-neighbour monetary policy in 2014-15. For an economy in massive surplus to devalue to create export-led growth is globally anti-social The EA's troubles have always been a global problem, not just local or regional.

The assumption in this LSR View is that after a period in which negotiators advance strong positions and 'hang tough', a settlement of the US-China issues will be achieved in the August-September time-frame, in time for the US to claim a 'win' in the campaigns leading up to November's mid-term elections. And that trade-war contagion of Europe, and particularly Germany, though it may occur this year, will not have severely negative impact in the short run, though damage is quite likely before the next Presidential election in 2020.

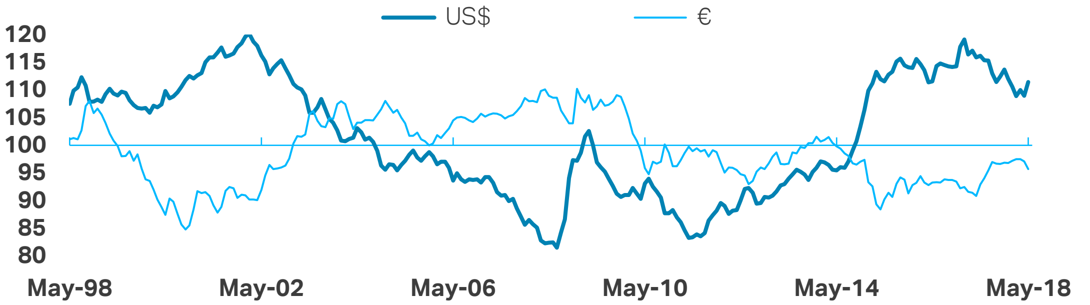
The risk factor for the markets and eventually economies would arise if Trump either decides or shifts inadvertently into fighting the mid-term elections on a trade-war platform. This might happen, for instance, if US-Europe disputes got pulled centre-stage and became arguments of principle, with each side taking entrenched position. But one effect could be continued restraint in the otherwise likely buoyancy of the euro, at least for several months. This would both increase the chances of prolonged above-trend growth in the EA, and sustain the downward pressure on US interest rates and yields as capital outflows sustain US Treasuries. Oddly, this could be modestly stimulative on both sides of the Atlantic.

The Italian problem is altogether less pressing, at least for the coming 6-12 months. Italy has shaken off the crisis of two weeks ago, and formed a government that can probably last a year. Its policies may not impress either he rest of the EU, or the world commentariat. But they do not look as unsound or likely to fail as many have asserted in recent weeks. We cover these policies in a section of this LSR View below (p. 11-12).

Dollar bounce unlikely to last

Dollar & euro real FX rates, PPI-based

long-run average = 100



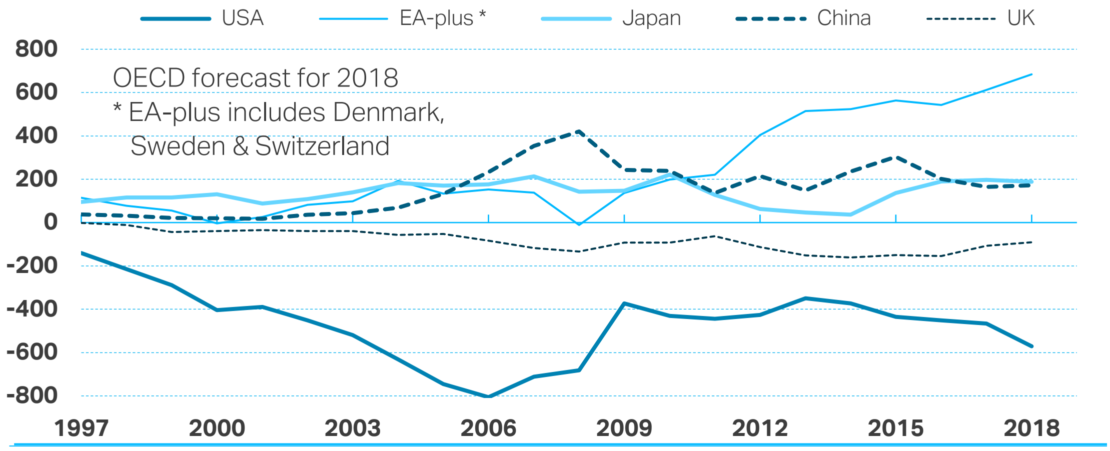
Source: Datastream, TS Lombard

The May sell-off in the euro and yen has knocked the former down by 6-7% and the latter by 4%. The trade-weighted dollar index is up by about 2%, and the real FX rate by 2½%. This shake-out is modestly positive for the longevity of the current up-cycle. The danger of the previous rapid euro/yen upswing was that reduced appetite for dollar exposure would deter the inflows from continental Europe and Japan to take advantage of higher US government bond yields. As a result, it seemed likely that US rates would go up faster than financial markets were expecting and that the rise in the euro would create trouble for Italy in mid to late 2019. For example, the fixed-income capital outflow, having averaged more than €150 billion a quarter during 2017, fell to €40 billion in Q1, as the ECB's QE lessened. It no longer offset the EA's massive current account surplus. But the euro (and yen) fall since mid-April has shifted the tone of the market.

The fall of the euro rate from $1.23-24 to about $1.17 is unlikely now to extend further. The troubles over Italy's new government formation represented a particular depressant for the euro. With an Italian government now in place, the fear factor is now much reduced. But the likelihood now is that the end of the ECB's QE that we had previously slated for September when the current programme ends will now be postponed until the end of the year.

The primary aim of the ECB 'doves' is to hold down the euro, preserving such competitiveness as Italy has, and this goal has clearly gained credibility as a result of the government crisis. So it may be a while before the euro regains its early-2018 swagger, though we remain fundamentally bullish. The former presumed slowdown of flows into US bond markets from savings-glut countries – primarily Europe and Japan – could now come through more slowly, keeping for longer the external downward pressure on US bond yields.

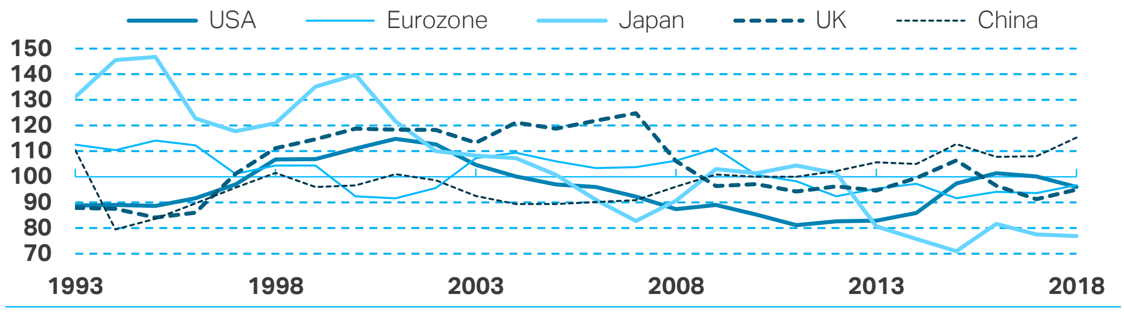
Current account balances, $ billion



Source: OECD, TS Lombard

Resumed appreciation of the euro is most likely because of the massive and growing surplus on current account. The undervalued exchange rate that helps generate this surplus is what the ECB may wish to preserve as long as possible. But as well as indicating potential overheating and rising inflation it is also a standing provocation to the Trump administration. The US deficit is the chief counterpart of the EA surplus, and correspondingly growing – despite the US benefiting from significant growth of oil and gas exports now that the ban on them has been lifted. Germany's surplus, forecast at $340 billion in 2018, 8¼% of GDP, is particularly egregious and likewise The Netherlands at $100 billion, 10 ½% of GDP. German-centred Europe is becoming extremely vulnerable to the US trade-war hawks unless there is a major appreciation of the euro. But a shift in trade-war rhetoric against the EA might actually hold the euro down in the short term.

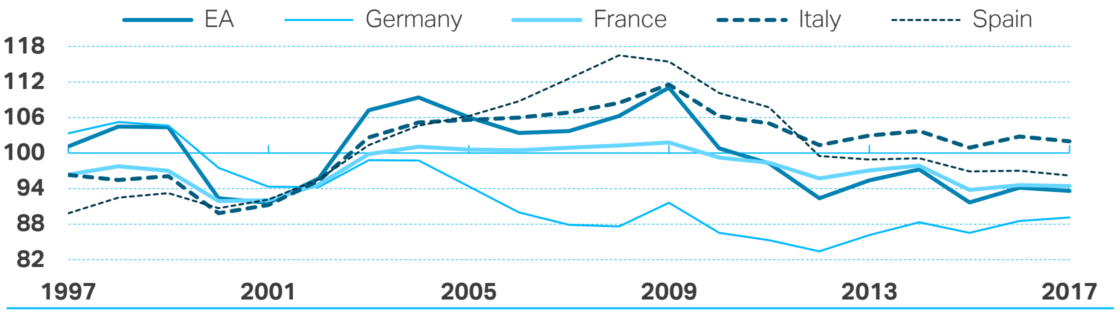
Real FX rates, relative labour costs, long-run av. = 100



Source: OECD, JP Morgan, Datastream, TS Lombard

This chart shows the global development of real effective exchange rates on a labour-cost basis, which measures the EA as being 6% below its long-run average in 2017, versus rather less undervaluation as measured by relative producer prices. This labour-cost measure has the advantage that the OECD computes it by country within the EA (see below) rather than just for the EA as a whole. But this measure understates the relative value of the dollar, as the producer-price measure has the dollar 10% overvalued (see chart on p.7 above). The reason for this divergence in the two measures is that labour income has gone from being too high relative to prices in the 1970s to much lower now. The producer-price measure is the one that for the US has reverted to mean over the long run, and now shows overvaluation, though by less than a year ago. In the chart above, the Chinese line is based on producer prices not labour costs as the latter are not properly measured in China. China is now in significant danger of overvaluation.

Real effective FX rates, long-run average = 100



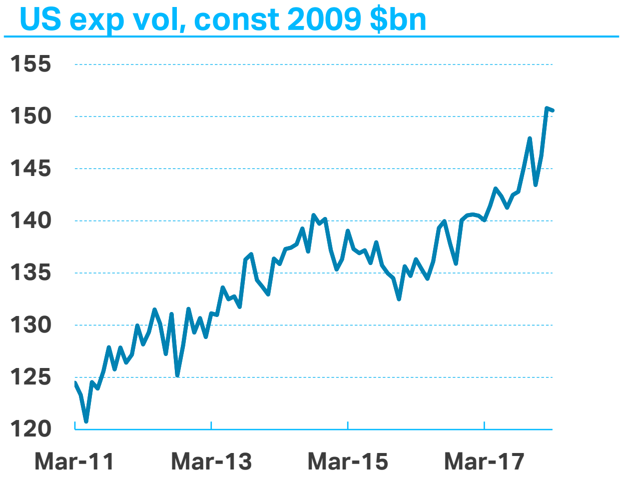
Source: OECD, TS Lombard

Unlike the JP Morgan producer-price measures of the real FX rate, the OECD's breaks the EA down by country, with the big-four EA countries shown above. Germany's major austerity was in 2002-05, and by 2006 the divergence between it and Italy had risen to 16 percent-points owing to the effects of relative cost inflation in the fixed euro system. Spain became even more overvalued than Italy in the run-up to the crisis, and then engaged in violent deflation to get its costs under control. But the differential between Italy and Germany – which has remained more than 10% undervalued for a dozen years now – had only narrowed to 13 percent-points by 2017. This means that if the euro moved to par or overvaluation on this basis, then Italy could be 8-10% overvalued, and in serious difficulties.

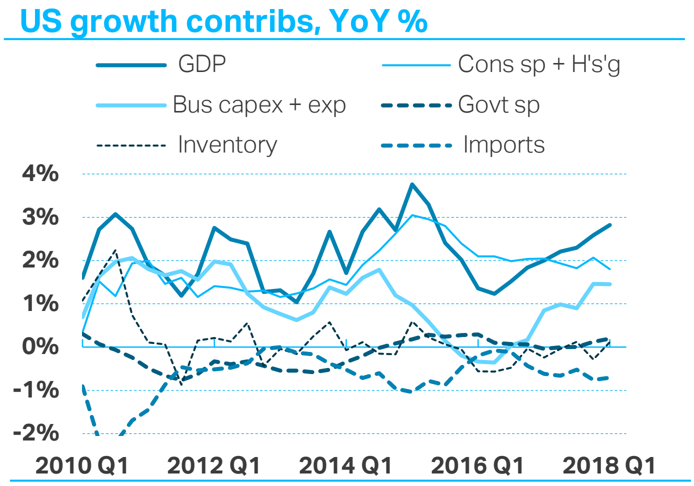
As may be seen, the exchange market moves, notably a rising euro, needed to reduce global imbalances are such as to provoke malignant consequences from the ongoing internal EA imbalances – most obviously between Germany and Italy. Italy's situation is viable with the 2% overvaluation relating to the euro being 6% undervalued, because it is able to tag along in the supplier wake of Germany's strong manufacturing performance. But the needed substantial euro upswing would probably slow German manufacturing somewhat as well as rendering Italy much more significantly overvalued, hurting both its intra-EA and extra-EA business.

Capex phase in the US cycle

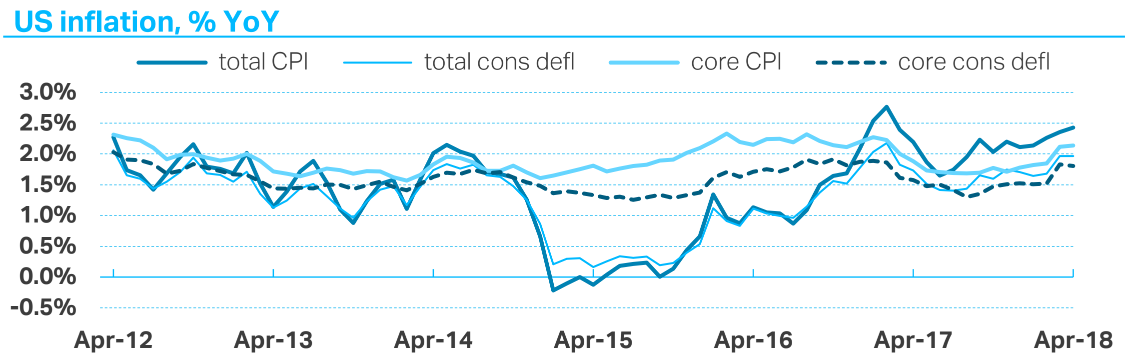
US growth is shifting away from consumption towards business investment, with a healthy breadth of demand including housing and exports. The upswing from 2015's mid-cycle slowdown has been helped by the end of an inventory correction, but is chiefly driven by exports and business capex. The right-hand chart below, showing the contributions to growth on a four-quarter basis, proves the point. Exports are grow g rapidly – even if imports are even more buoyant. Business capex in Q1 was up nearly 7% from the year before, with Q1 the strongest of the latest four quarters.



Source: Datastream, TS Lombard

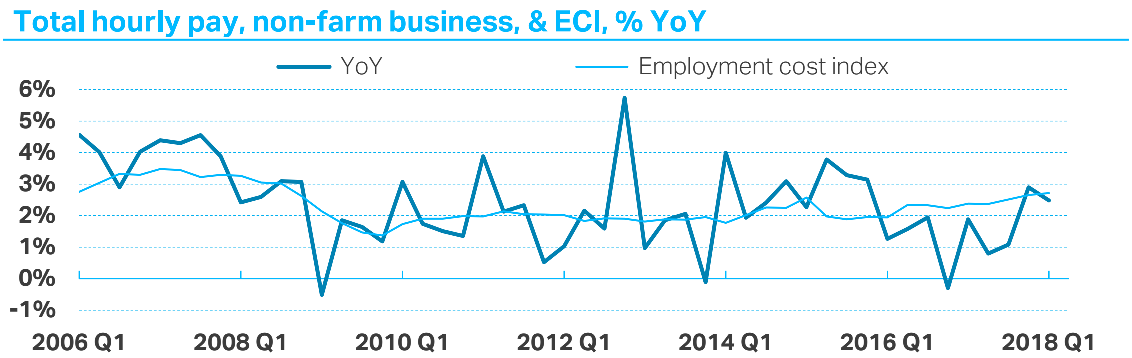


Source: US BEA, Datastream, TS Lombard



Source: Datastream, TS Lombard

Jobs growth consistently running at more than 1½%, versus underlying labour force growth below 1%, has brought the unemployment rate down to 3.8%. This is below the lowest rate in the peak year 2000, and well below the lowest in 2006-07. Unsurprisingly, given above-potential growth, core inflation has started to rise, after a dip in early 2017 that partly reflected the strong dollar, and partly an 'echo' effect (via modest wage inflation) of 2015's zero headline inflation.



Source: Datastream, TS Lombard

The US Employment Cost Index (ECI) moves in relatively stable fashion, and has now risen to 2.7% inflation. The total hourly pay measure, which includes annual bonuses (spread over the year by statisticians with difficulty), dipped between mid-2016 and mid-2017 to the 1-2% range, partly reflecting the 'echo' benefit to real wages of 2015's zero inflation. In effect, this implies 1-2% real wage gains. With unemployment now even lower than then, and headline inflation of about 2%, this makes it possible that hourly pay gains by mid to late 2019 will have shifted up well above 3%. Core CPI inflation would in that case be in the 2½-3% region.

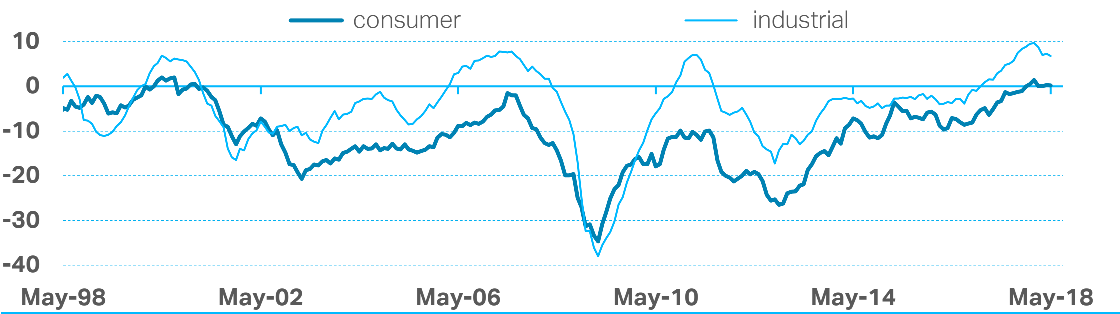
What does this mean for Interest rates and Treasury yields? The long-run average margin of long-dated US Treasury yields vis-à-vis inflation has been 2½%. After five years of real yields below ½% for TIPS (Treasury Inflation Protected Securities) the rate is now about 0.9%. In all probability this real yield will not mount to its long-run average. But even if it gets to half of it, ie 1¼%, by the middle of next year, say, then adding 2½-3% inflation would lead to a nominal yield approaching 4%. This could well be enough to produce a cyclical slowdown in growth.

For the Fed funds rate, the current real rate of minus ¼% implies continued quarterly increases of ¼%. From a nominal 1.7% now, this would mean 2½%-plus by mid-2019, probably still marginally below the core inflation rate, though by less than now. A peak Fed funds rate of 3% by end-2019 seems quite possible in this cycle.

Less EA slowdown than meets the eye

Much has been made of the EA slowdown in the first half of this year, and Q1 GDP duly slowed to 0.4% growth from 0.7% in the latter three quarters of 2017. But growth was still above-potential, which is perhaps now up to 1½%, and also likely to rebound later this year. The PMIs are down to the levels of late 2016, when quarterly growth was rising through 0.6% towards 0.7%. The PMI levels reached at the end of last year were consistent with 0.9% quarterly growth, which nobody though likely to happen.

EA Confidence indicators



Source: Datastream, TS Lombard

A glance at the official confidence indicators gives a sense of perspective. The balance of consumer confidence has only been positive this century for a few months in 2000, and so it has remained so far this year – ie close to its all-time high. The same is true of industrial confidence. It might be feared that the Italian imbroglio last week would damage confidence. But the quick reversion to success is forming the anti-establishment government means its confidence effect elsewhere in the EA is likely to be minimal. The German orders data for April, showing a sharp drop in orders from the rest of the EA, confirm that the slow Q1 result could be repeated in Q2, with further above-trend growth likely later in the year.

Meanwhile, in Italy itself the impact of the political developments is more likely to be positive than negative, and the ECB could continue its QE beyond the current September deadline, adding stimulus to the EA generally.

Italian politics adds EA stimulus

In monetary effect the Italian political brouhaha last week added stimulus in two ways, first by lowering the euro, and second by making probable another extension of ECB QE. Italy's overvaluation remains about 3% vis-à-vis its long-run average, and this accounts to a great degree for its weak growth performance. Italy has grown at about a 1¼% rate in the past couple of years, mostly dragged along by good world trade growth, and especially its supplies to the German export sector. But the overall economy remains depressed, with GDP still 5½% below its pre-crisis peak ten years ago (2008 Q1). Unemployment is over 11%, versus 6% pre-crisis. This persistent weakness has ensured less imports and thus a trade surplus. Stagnation and decline reflect both poor supply-side performance and consistent overvaluation in an economy that has always depended on cost-competitive exports.

The new Italian government was formed after last week's drama over who should be finance minister. In the event, the two major anti-establishment parties, the Five Star Movement (M5S) and the Northern League ('Lega'), are now taking over the reins about a quarter-century after a previous clean sweep of Italian politics – 'Tangentopoli' – led via brief renewal of centre-left coalitions to the long predominance of Silvio Berlusconi. The policies of the new coalition include attention to the need for stimulus with little in the area of supply-side reform, such as labour market liberalisation.

Labour market liberalisation almost without fail tends to lower wages in the short term. The lack of it right now is therefore not to be lamented. Italy needs the salve of stimulus, demand growth, to create the momentum within which labour market liberalisation and other market-freeing supply-side reforms could operate to release people's talents and energy. With euro-exit ruled out, only fiscal stimulus can supply this. In that regard, the policies of the new coalition are likely to work well for a couple of years. The snag is the lack of plans, let alone voter support, for the badly needed supply-side follow-up.

But so much commentary has focussed on the lack of proposals for supply-side reform that the relatively benign prospects for the economy with fresh fiscal stimulus are underplayed. And amongst those paying attention to the likely tax cuts and fiscal stimulus, too many approach the question from the dubious premise that the EA's fiscal compact (aka 'Stability and Growth Pact', SGP) is likely to be deplorably breached. But in the early years of the euro Germany's flouting of (its own) SGP did little harm while Spain's compliance with it was no protection from the slump. There will be EU ructions over the Italian fiscal measures once they emerge – especially the mis-named 'flat tax'. But with the new coalition known to contain people that would not be unhappy with exit from the euro, it is unlikely the rest of the EA will press too hard, at least to start with.

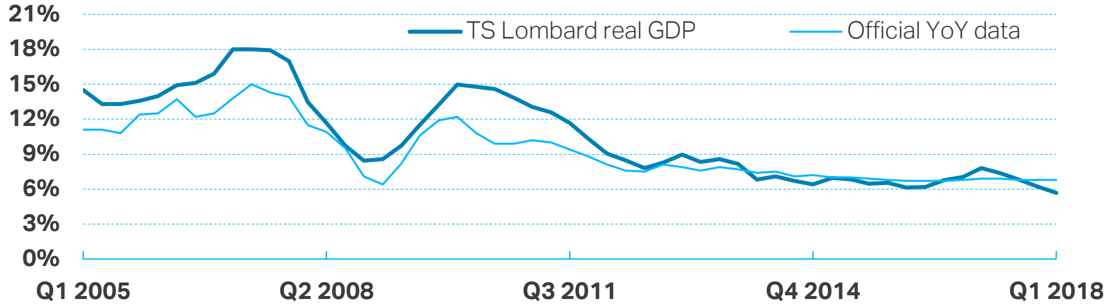
The risk for Italy lies in a year or two's time as the current government debt burden, which has been easing a little recently, remains too high for deficit financing to be sustained for long. The underlying primary budget balance of around 2% of GDP is holding the deficit down to about 2% of GDP, 1½% cyclically adjusted (by the OECD), leaving room for significant stimulus before even the 3% barrier is breached. And current growth rates are likely to be strong enough to ensure little rise in the near-130% ratio of net government debt to GDP, which is currently falling.

The Five Star Movement has little experience of government at any level, and the Northern League few figures with anything other than regional and city government on their CV. The coalition will need to learn fast to develop supply-side policies to take advantage of what could well be relatively benign conditions over the next year or so – no doubt to the surprise of the dour EU establishment, whose grim expectations are otherwise in danger being fulfilled in subsequent years.

Chinese real FX rate mounts

China has been in the news a lot less than previously these last two years, and has been a global economic stabiliser. It provided stimulus in 2016, when the world needed to recover from the 2015 slowdown, and then slowed during 2017. One result is that the non-financial debt ratio to GDP levelled off during 2017, after rising at a dangerous rate for the previous five years. Also, at 256% of GDP, China's non-financial debt ratio is still below the advanced countries' average, and well below the ratio of countries significantly at risk, such as Japan.

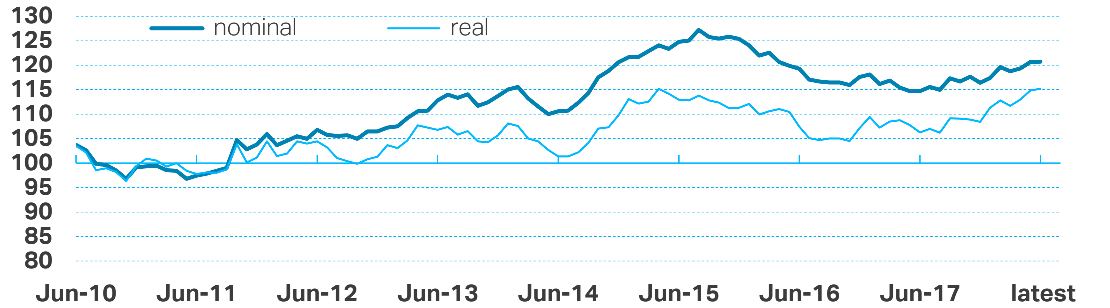
Chinese real GDP growth, % YoY, w. TS Lombard recalculation



Source: CEIC, Datastream, TS Lombard

To some extent China is still vulnerable to risks from a debt upswing if it resumes faster growth, particularly if the rest of the world is slowing at the same time. But this is not a scenario we expect over the next 12 months, though it could be a risk in 2020.

Chinese yuan, trade-weighted FX rates, 2010 = 100



Source: JP Morgan, Datastream, TS Lombard

The more significant risk arises from the real FX rate having returned to its 2015 peak. This is partly because the chief rate set is generally vis-à-vis the dollar, and the greenback's recent strength, though waning, has dragged it up. The yuan has depreciated 2% against the dollar, less than its trading partners such as Japan (4%). On our forecast, the euro and probably the yen will return to appreciation against the dollar, and this should erode the yuan's real FX rate a little. But it still looks uncomfortably high, and the real contribution of net exports to growth has been negative for seven of the past nine quarters, despite quite good world trade growth and the slide in real GDP growth to 5.7% in the year to Q1.

China's real growth could stay below par for the middle quarters of 2018 as the housing side stays sluggish. But we expect policy stimulus later in the year to revive growth. On that basis, the economy could continue to be a global stabiliser as its strength could mount during 2019 as the US and European economies start to slow.

China's gradual shift downward of excessive saving and capex offers the best hope of avoiding the 'middle income trap'. The key point is that saving (by households and business's retained profits) has tended to get parked in banks, and then lent out to dubious investment projects. As the demand side of the economy shifts from excessive capex to great consumption, and the supply side from too much metal bashing and heavy industry towards services and hi-tech, the debt ratio should be restrained. This depends on the authorities sticking to the policy shifts of the past few years, but so far they seem steadfast enough.

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