Long-lasting shock on the world economy
My weekly column

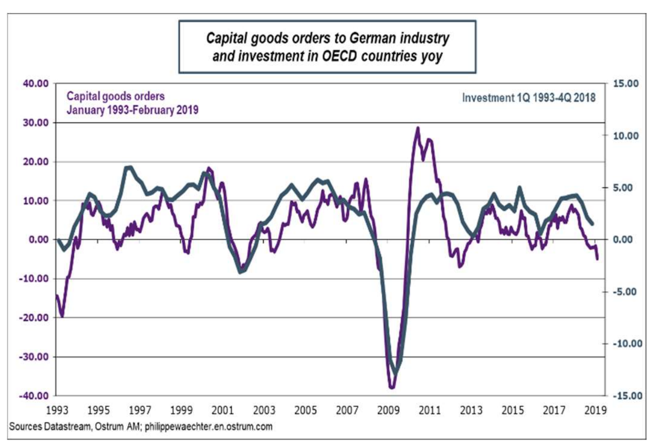
Concerns and uncertainties on world economic activity having been gathering pace **since the fall.** The swift decline in world trade reflects this change in pace**,** moving into the red with a contraction of 0.4% in January vs. yoy growth of 4% in September 2018. This turnaround has triggered concern from the OECD and the ECB, prompting them to slice back growth projections for the euro area in particular.

The very heart of this economic question is whether this shock is permanent and persistent, and in this respect, there are two interrelated questions worth noting, as well as another third aspect.
The first point is the political explanation for this downturn. Trade tariffs applied by the White House have shifted the balance of trade between the US and China, leading to a swift slowdown in trade in Asia since the start of the fall and acting as the main contributing factor behind the decline in world trade as a whole. By targeting China directly, Donald Trump is actually damaging the entire region.
The other aspect is the uncertainty triggered by the White House's political choices, as doubts on trade following border tariffs are further heightened by the threat of fresh trade moves. A case in point is the German automotive sector, which could be hampered by a border tax of 25%, as the US threatens to impose tariffs on $11bn in European exports to the US in retaliation for European subsidies to Airbus. The WTO will have the final say, but there is also a further threat as Boeing is now struggling with recent problems on its 737 Max.

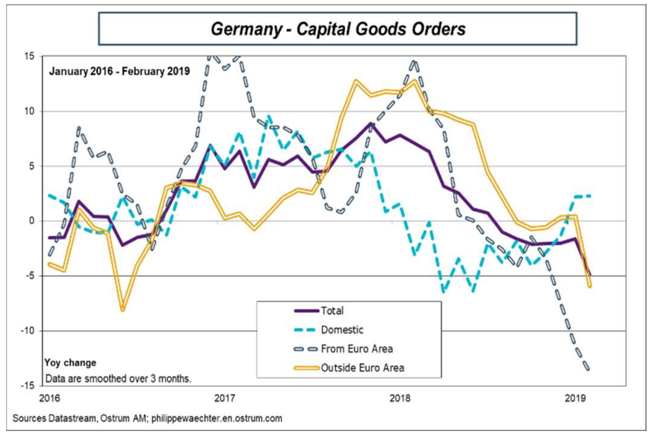
This situation could swiftly be resolved if a trade agreement were first signed between the US and China as this would set new rules and dramatically reduce uncertainty: investors want to believe this can happen so that they can return to a situation that is conducive to sustainable growth. However, it looks unlikely as the stakes are high with both sides playing for technological leadership, and neither wanting to relinquish superiority by giving in to the other. However, with the White House now turning its eyes to Europe, it looks like the trade issue is still high up on the agenda in Washington.

The third area of uncertainty is the Brexit fiasco. The Brexit process is dragging on, leading to uncertainty for all business leaders I meet. The options deemed possible range from a no-deal Brexit to no Brexit at all, so in light of this situation, what options do business leaders really have? It is understandable if they decide to sit tight while they wait for the clouds to clear.

When it comes down to it, the real risk is that the shock from all this uncertainty takes hold and hampers the world economic outlook on a long-term basis. If projections shift towards this view, then investors will change their behavior. Clear visibility on the future encourages risk-taking and investment, but uncertainty makes the future hazy, and makes it harder to plan ahead, even when a company's finances are in good shape. When faced with this situation, investment dwindles.
We are probably in the midst of this change in attitude, and to gain a greater insight, I assessed capital goods orders in Germany and compared them to investment trends in OECD countries.
We can see that the two indicators have been consistent since 1993, which is logical in light of Germany's importance in capital goods sales.
The drop in orders reflects investors' fears that the current uncertainty could last a long time.



Trends witnessed in Germany are also visible in France, where capital goods orders are plummeting, thereby triggering a risk of a sharp downturn in investment. This is also the case in the US, where orders are not very robust and do not point to a swift turnaround in corporate investment (see charts in appendix)

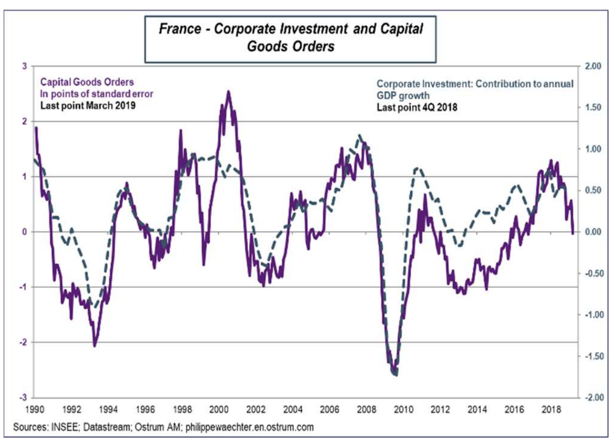


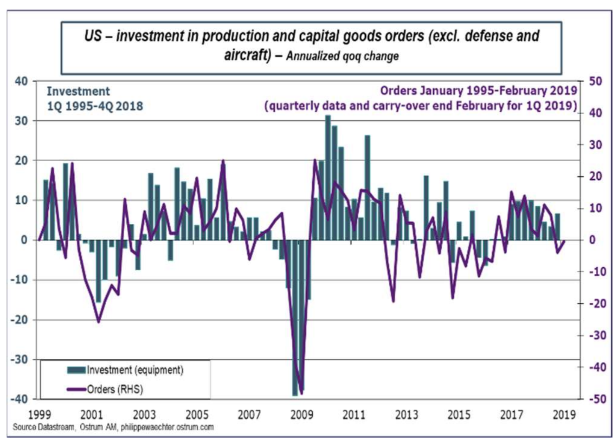
Another source of concern is the geographical breakdown of German orders. The decline in orders is particularly marked in the euro area, but more curtailed outside, which definitely suggests that the worldwide adjustment is happening in the euro area. Capital goods orders from the euro area dropped close to 15% yoy in February vs. 6% for the rest of the world, so we should expect a deterioration in investment in the euro area over the months ahead.

The macroeconomic shock has its roots in politics, but the adjustment is primarily visible in the euro area, which reflects both the bloc’s limited scope for recovery due to sluggish productivity and the area’s inadequate economic policy, which is in no way sufficient to deal with external shocks. The policy mix in the region is still hampered by overly restrictive fiscal commitments as compared to the extent of the shock it faces, and the ECB no longer has any definite leeway to offset this excessively strict approach.

Current uncertainty for the global economy could trigger a drop in investment during 2019, further worsening the slowdown in activity and denting the prospects for both growth and jobs. The shock that the world economy is suffering is probably a long-term phenomenon and the euro area is a major source of adjustment as on the one hand it is very open to outside influences, and on the other because it does not have a coordinated policy to help prop up domestic demand and offset the negative effects witnessed across the rest of the world. Yet this type of approach would help set the economy back on a more robust trend for both growth and jobs.

Appendix





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