

Rogoff: Risks to the Global Economy in 2019

Over the course of this year and next, the biggest economic risks will emerge in those areas where investors think recent patterns are unlikely to change. They will include a growth recession in China, a rise in global long-term real interest rates, and a crescendo of populist economic policies, **writes Kenneth Rogoff**



Kenneth Rogoff,
Professor of Economics
and Public Policy at
Harvard University

Where will the biggest economic risks emerge?

As Mark Twain never said, “It ain’t what you don’t know that gets you into trouble. It’s what you think you know for sure that just ain’t so.” Over the course of this year and next, the biggest economic risks will emerge in those areas where investors think recent patterns are unlikely to change. They will include a growth recession in China, a rise in global long-term real interest rates, and a crescendo of populist economic policies that undermine the credibility of central bank independence, resulting in higher interest rates on “safe” advanced-country government bonds.

A significant Chinese slowdown may already be unfolding

A significant Chinese slowdown may already be unfolding. US President Donald Trump's trade war has shaken confidence, but this is only a downward shove to an economy that was already slowing as it makes the transition from export- and investment-led growth to more sustainable domestic consumption-led growth. How much the Chinese economy will slow is an open question; but, given the inherent contradiction between an ever-more centralized Party-led political system and the need for a more decentralized consumer-led economic system, long-term growth could fall quite dramatically.

The many challenges ahead

Unfortunately, the option of avoiding the transition to consumer-led growth and continuing to promote exports and real-estate investment is not very attractive, either. China is already a dominant global exporter, and there is neither market space nor political tolerance to allow it to maintain its previous pace of export expansion. Bolstering growth through investment, particularly in residential real estate (which accounts for the lion's share of Chinese construction output) – is also ever more challenging.

Downward pressure on prices, especially outside Tier-1 cities, is making it increasingly difficult to induce families to invest an even larger share of their wealth into housing. Although China may be much better positioned than any Western economy to socialize losses that hit the banking sector, a sharp contraction in housing prices and construction could prove extremely painful to absorb.

Any significant growth recession in China would hit the rest of Asia hard, along with commodity-exporting developing and emerging economies. Nor would Europe – and especially Germany – be spared. Although the US is less dependent on China, the trauma to financial markets and politically sensitive exports would make a Chinese slowdown much more painful than US leaders seem to realize.

The threat of a steep rise in interest rates

A less likely but even more traumatic outside risk would materialize if, after many years of trend decline, global long-term real interest rates reversed course and rose significantly. I am not speaking merely of a significant over-tightening by the US Federal Reserve in 2019. This would be problematic, but it would mainly affect short-term real interest rates, and in principle could be reversed in time. The far more serious risk is a shock to very long-term real interest rates, which are lower than at any point during the modern era (except for the period of financial repression after World War II, when markets were much less developed than today).

The far more serious risk is a shock to very long-term real interest rates

While a sustained rise in the long-term real interest rate is a low-probability event, it is far from impossible. Although there are many explanations of the long-term trend decline, some factors could be temporary, and it is difficult to establish the magnitude of different possible effects empirically.

One factor that could cause global rates to rise, on the benign side, would be a spurt in

productivity, for example, if the so-called Fourth Industrial Revolution starts to affect growth much faster than is currently anticipated. This would, of course, be good overall for the global economy, but it might greatly strain lagging regions and groups. But upward pressure on global rates could stem from a less benign factor: a sharp trend decline in Asian growth (for example, from a long-term slowdown in China) that causes the region's long-standing external surpluses to swing into deficits.

The explosion of populism

But perhaps the most likely cause of higher global real interest is the explosion of populism across much of the world. To the extent that populists can overturn the market-friendly economic policies of the past several decades, they may sow doubt in global markets about just how "safe" advanced-country debt really is. This could raise risk premia and interest rates, and if governments were slow to adjust, budget deficits would rise, markets would doubt governments even more, and events could spiral.

The notion that additional debt is a free lunch is foolish

Most economists agree that today's lower long-term interest rates allow advanced economies to sustain significantly more debt than they might otherwise. But the notion that additional debt is a free lunch is foolish. High debt levels make it more difficult for governments to respond aggressively to shocks. The inability to respond aggressively to a financial crisis, a cyber attack, a pandemic, or a trade war significantly heightens the risk of long-term stagnation and is an important explanation of why most serious academic studies find that very high debt levels are associated with slower long-term growth.

It's not all bad news

If policymakers rely too much on debt (as opposed to higher taxation on the wealthy) in order to pursue progressive policies that redistribute income, it is easy to imagine markets coming to doubt that countries will grow their way out of very high debt levels. Investors' scepticism could well push up interest rates to uncomfortable levels.

Of course, there are many other risks to global growth, including ever-increasing political chaos in the United States, a messy Brexit, Italy's shaky banks, and heightened geopolitical tensions.

But these outside risks do not make the outlook for global growth necessarily grim. The baseline scenario for the US is still strong growth. Europe's growth could be above trend as well, as it continues its long, slow recovery from the debt crisis at the beginning of the decade. And China's economy has been proving doubters wrong for many years.

So 2019 could turn out to be another year of solid global growth. Unfortunately, it is likely to be a nerve-racking one as well.

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Author

Alissa Lefebvre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Robert Carnell

Regional Head of Research, Asia-Pacific

robert.carnell@asia.ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com