Global economy resilient to new political challenges

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The interplay between economics and politics was undoubtedly a dominant feature of analyses during 2016. As we know, it was difficult to foresee both election results and their economic consequences. It was certainly not strange that economists were unable to predict the Brexit referendum outcome or Donald Trump's victory, when public opinion polling organisations and betting firms failed to do so, but lessons might be learned from the economic assessment impacts they made. Economists probably tend to exaggerate the importance of more general political phenomena. While in the midst of elections that appear historically important, it is tempting to present alarmist projections about election outcomes that seem improbable and/or unpleasant. But **once the initial shock effect has faded, more ordinary economic data** such as corporate reports and macroeconomic figures **take the upper hand**.

Psychological effects often exaggerated

One important observation is that it is difficult to find any historical correlation between heightened security policy tensions and economic activity. **Households and businesses do not seem to be especially sensitive in their consumption or capital spending behaviour**. This is perhaps because uncertainty is offset by investments in a defence build-up, for example. Only when the conditions that directly determine profitability and investments are affected, for example via rising oil prices or poorly functioning financial markets, will the effects become clear.

Markets also seem to have a general tendency to assume that the economic policy makers can actually behave rationally in crisis situations, until this has been disproved. Both during the US sub-prime mortgage crisis of 2007-2008 and the euro zone's existential crisis a few years later, for a rather long time the market maintained its faith that a response would come. Not until after a lengthy period of inept actions by decision makers did these crises become genuinely acute, with large secondary effects as a consequence. This market "patience" is presumably based on a long-time pattern of recurring bailout measures by governments and central banks, **which usually benefit risk-taking** at the expense of caution or speculation that policy responses will not materialise.

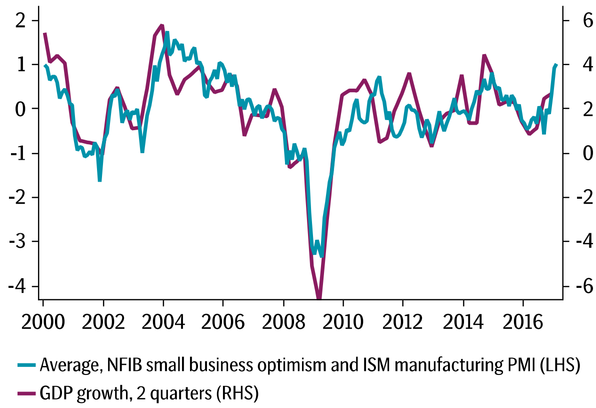
It is reasonable to assume that this may also underpin the rather cautious reactions to the risks associated with the Trump administration's agenda. Although one cannot complain about the administration's power of initiative, there is a fairly high probability that in important areas it will not go from words to actions. There may be various reasons for this, such as the inertia built into the separation of powers between the White House, Congress and the court system, or expectations that Trump's newly appointed cabinet secretaries and advisors will eventually take their cues from more established US positions.

Indicators point to a sharper upturn

From a forecasting standpoint, there are naturally many genuine uncertainties to deal with in the present situation. In *Nordic Outlook*, which was published on February 7, we adjusted our growth outlook somewhat higher. Business and household optimism has greatly strengthened during the past six months, both in the US and globally. At first it was hard to distinguish to what extent this was due to enthusiasm for Trump's new fiscal policies. But over time it has become **increasingly clear that underlying forces are actually strong**. In particular, this is reflected in the strong corporate reports of recent weeks, which could not reasonably have had time to be influenced by political events. We are probably now in a phase of the economic cycle where capacity utilisation has reached such high levels that it will trigger capital spending activity on a broader front. The oil price recovery has also benefited the world economy, easing pressure on producer countries while remaining low enough to have a stimulus effect on countries that are net importers of oil.

US: Increased optimism indicates GDP surge

Per cent and standard deviation



Source: Macrobond

In fact, the significant recent upturn in sentiment indicators points to a **substantially stronger growth wave than implied by our main scenario and to an even greater extent by the prevailing consensus forecast**. The risk picture thus includes unusually great potential for surprises during 2017-2018, but **stronger growth may be generated partly by factors that are neither desirable nor sustainable in the long term**. Such driving forces may include unfunded US stimulus measures, a de-prioritisation of global and national environmental targets that benefits the energy sector in the short term, a defence build-up due to increased security policy tensions or a phase-out of financial market regulations implemented in response to the financial crisis. These forces might then be amplified by underlying pent-up consumption and capital spending needs in many countries, where such factors as growing wealth and high household savings ratios represent a potential.

Why such optimism about Trumponomics?

Although there are reasons to de-emphasise the political aspects of economic optimism, it is still clear that "Trumponomics", despite its bizarre aspects, has awakened interest and hopes in financial markets and among economists. In various areas, economic policies since the financial crisis have reached an impasse – thereby creating fertile ground for challenges. For example, **the downside aspects of exceptional monetary stimulus measures** – in the form of widening economic gaps, inflated balance sheets and decreased reform pressure – were a popular theme last autumn. This generated speculation about a large imminent paradigm shift similar to the breakthrough of active fiscal policy in the 1930s, the collapse of the Bretton Woods system in the early 1970s or the breakthrough of the neo-conservative era around 1980 which included financial deregulation and inflation targeting.

Many leading economists have long advocated **classical Keynesian fiscal stimulus programmes, especially by means of infrastructure investments**. And although many people fear the threat of protectionism, there is also criticism of the trade agreements that now exist or were about to be signed. This criticism is based on the contention that these agreements arbitrarily benefit specific sectors and are designed in a way that will generate artificially high profits for financial institutions and multinational corporations. **The general efficiency gains that trade is theoretically supposed to create are far from obvious outcomes of the prevailing agreement structures**, according to influential economists. Meanwhile the relatively closed nature of the US economy may mean that it is less dangerous there to "play with protectionist fire", compared to the risks posed to small open economic such as the Nordic countries.

Another way of reasoning is that in a number of areas the Trump administration is now, albeit in often provocative fashion, pushing the US in a direction that was nevertheless unavoidable, considering the country's relatively weakened economic position. One clear example is Trump's questioning of the mission and financing of NATO. Corporatist tendencies that assign a greater role to cooperation, for better and worse, between business and government may also become a new trend. To summarise, "Trumponomics" is certainly not the solution to the prevailing economic policy problems, but in the best case it may ask challenging questions and **move the discussion forward by revealing weakness and dead-ends in once-predominant approaches**. More worrisome, of course, would be if the administration's often provocative behaviour should drive up the level of conflict in public discourse in ways that instead blocks fresh economic policy thinking.

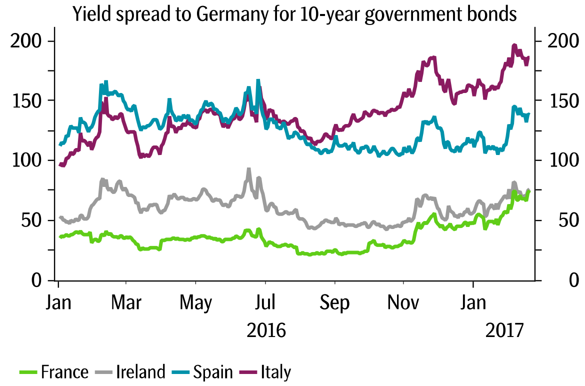
Too early to write off political downsides

Given such dramatic events as British withdrawal from the European Union and a Trump administration in the White House, it is still difficult to dismiss the risks of economic reversals. The domestic political conflict between the Trump administration and other key players in American society may deepen in more or less dangerous ways. The US may also change its policies so dramatically that it leads to trade wars or crucial disruptions in the functioning of international organisations like the United Nations, International Monetary Fund or World Bank. Although it may seem a bit cowardly to hedge in different directions, it is certainly true that **the probability of both positive and negative scenarios that diverge greatly from our main scenario is bigger than usual**, or to put it differently, we have a probability curve with unusually "fat tails".

In the near term, the focus will be on the risks that elections on the European Continent will increase uncertainty about the future of the EU. Dramatically unexpected election outcomes in Germany and France would have greater secondary political effects than recent votes in major English-speaking countries have had; **the EU can hardly exist without a strong commitment by its founding and core countries**. But despite the successes of the EU-critical German political party AfD in public opinion surveys, it is difficult not to believe that some kind of stable government led by the CDU (Angela Merkel) or SPD (Martin Schulz) can be formed after the September parliamentary election. The outcome of this spring's French presidential election is more uncertain, which is reflected in the widening of the spread between German and French yields (10-year government bonds) from 25 to 75 basis points in recent months.

France joins the trend towards higher risk premiums

Yield spread to Germany for 10-year government bonds



Source: Macrobond

It appears unlikely that right-wing populist Marine Le Pen will win the crucial second round, considering that in earlier elections the traditional right and left have joined forced to stop the National Front's candidates. But Republican candidate François Fillon's falling public support – due to questions about his alleged financial improprieties – have boosted uncertainty. The pattern of recent decades, in which control of the political mid-field has been crucial to success, also seems to have ended. Benoit Hamon's victory in the Socialist primary election is one example of this, and his radical programme – including a proposed living wage for all – may attract some votes from Communist sympathisers. **A second presidential round between Hamon and Le Pen would be a nightmare choice for middle-of-the-road nonsocialist French voters**.

Regardless of the 2017 election outcomes, it is difficult to foresee any positive shift that could rejuvenate the EU project. The euro zone is thus also vulnerable and dependent on European Central Bank stimulus. In such an environment, financial markets will continue to focus on politics and it is tempting to let this influence economic forecasts. But the lessons of 2016 indicate that it takes more than mere political uncertainty to bring the economy and financial markets to their knees.

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