

# THE RETURN OF RISK

LONG-HERALDED TRADE TARIFFS, ITALY'S ELECTION RESULT AND RISING COSTS HAVE SHIFTED THE BALANCE IN THE GLOBAL ECONOMY

In one respect, 2018 is much the same as 2017. Fundamentals in the global economy are still in good shape. Household spending and business investment remain in the Goldilocks zone – not too weak that the upswing feels sluggish, but not so fast either that inflationary pressures are likely to build up quickly. These are the key earmarks of a long cycle. In the absence of major excesses in credit, production, inflation or investment, there is no reason to expect a corrective recession soon.

In another respect, things are quite different in 2018. Last year, political waters turned mostly calm as the year progressed. Macron won the election in France. In the US, President Trump did not follow up on the trade-war threats he had campaigned on in 2016. This year, from US-led trade tensions and the rising oil price to the election of a populist government in Italy, risk has returned to the agenda.

Trump seems ready to upset the global order, taking aim at China and the EU, but not sparing the US's neighbours north and south of its borders either. In March 2018, Trump announced US tariffs on steel and aluminium. Initially, Trump had exempted the EU, Canada and Mexico – delaying the imposition of these trade barriers on a rolling monthly basis.

By holding the tariff threat over the heads of the US's allies, Trump was hoping for concessions. In the end, he imposed the tariffs after none of them budged much. The key issue now is how far the ensuing tit-for-tat spiral will go. China, the EU, Canada and Mexico have all promised measured retaliations, and Trump now seems to be priming for fresh tariffs on US auto imports.

All sides would have too much to lose from a genuine trade war. If Congress can prevent Trump from taking the conflict much further, and if the US's trading partners strive to defuse the tensions, the overall economic damage will be small.



## The advanced world is in better shape now

But the mere uncertainty could weigh on medium-term economic performance.

What about the latest rise in the oil price? If the price of a barrel of Brent crude remains at around \$75, it should not be a major issue. A more modest rise to, say, \$80 or even \$85 a barrel, may begin to show up a bit in slower consumption growth. But when the economic backdrop is strong, demand growth typically remains resilient as the oil price rises.

Chances are that, because global oil supplies are more price-elastic in the age of fracking than before, prices may come down a bit towards the end of 2018, as the recent price rise makes more oil sources profitable and production rises.

Finally, there is the Italian risk. Following the hung-parliament election

on 4 March 2018, Italy's two main anti-establishment parties, the right-wing Lega and left-wing Five Stars, have formed a government. Italy is a half-reformed country with long-term fiscal challenges. If the radicals follow up on their joint-manifesto promises to expand government spending through borrowing and reverse the reforms that Matteo Renzi and other past prime ministers introduced, they could put Italy on a dangerous trajectory.

Until the eurozone deploys tools to contain contagion, another flair-up of Italian risk could jolt European markets and hamper economic growth in Italy's neighbours for a while, possibly even causing a potential – but temporary – pause in growth in the eurozone, in the highly unlikely case that Italy were to leave the euro.

However, the risk that the current Italian problems could turn into a systemic crisis for the eurozone system as a whole seems low. The eurozone has powerful instruments to contain contagion risks if need be, with support from the European Stability Mechanism or the European Central Bank's Outright Monetary Transactions programme.

Risks are a part of life. When fundamentals are healthy, the global economy can weather the occasional headwind. Importantly, the advanced world is in better shape now than it was before the financial crisis. With a bit of luck, none of these risks will materialise in a major way. ♥



**Kallum Pickering**  
is senior  
economist at  
Berenberg Bank