The CAGE Background Briefing Series

No 48, July 2016

CAGE
Competitive Advantage in the Global Economy

Market volatility: More likely 'noise' than reason for concern

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The beginning of 2016 has seen dramatic developments in key markets, including falls in share prices, low oil prices, and a slowdown in some emerging market economies. This column summarises the views expressed on these issues by leading experts in the monthly Centre for Macroeconomics survey. While all recognise the considerable uncertainty in the world economy, fewer than a third fear that these events will have a significant negative impact on the UK's economic recovery. The prevailing argument is that any negative effects of lower foreign demand and market instability will be compensated by the benefits of lower oil prices.

The beginning of 2016 has been hectic in several dimensions. Oil prices have fallen to levels below $28 per barrel – a 12-year low and only a fraction of the levels we have seen over the past decade, when prices were above the $100 mark for sustained periods. Moreover, the International Energy Agency warns that the oil market "could drown in oversupply" and further price drops may be possible.

Early 2016 has also seen the announcement that China's GDP grew by 'only' 6.9% in 2015, its lowest growth rate in 25 years. Stock price falls followed. The Shanghai SE Composite Index dropped by 18% in the first two weeks of the year.[1] Stock market indices in several key markets also displayed substantial losses, though not nearly as big as the loss in the Chinese stock market. For example, the S&P 500 dropped by 6% over the same two-week period.

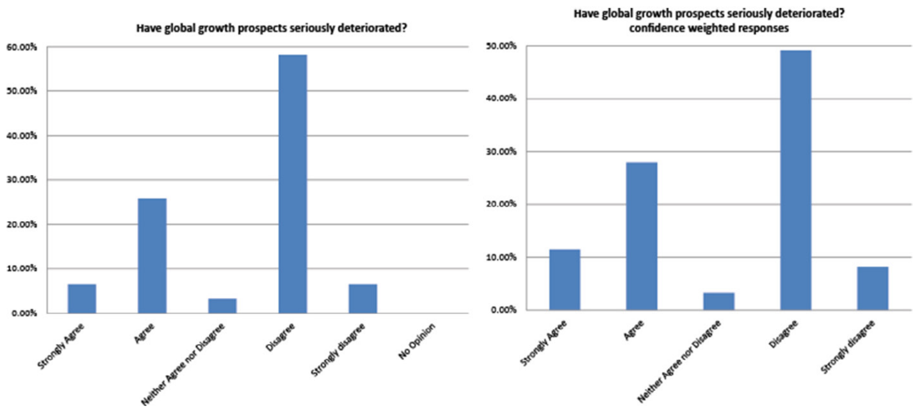
Nobel laureate Paul Samuelson famously said that "[t]he stock market has forecast nine of the last five recessions" – and it may very well be the case that recent turbulence in stock markets has little to do with serious problems in economic growth prospects. Alternatively, it may be that there are real reasons for concern.

Serious weakening of fundamentals?

The first question of this survey[2] asked respondents whether they think that economic fundamentals have worsened. In terms of the relevant period, we are thinking of the last six to 12 months.

Question 1: Do you agree that economic growth prospects for the global economy have seriously deteriorated?

Figure 1. Global growth prospects



Thirty of our experts responded to this question, of which a strong majority of two thirds either disagree or strongly disagree. Weighting the responses with confidence levels reduces this fraction to 58%.

Among those that disagree, several point to the positive effects of lower oil prices on economic growth. In addition, several simply do not see any changes in fundamentals. For example, Nicholas Oulton (LSE) points out that "the recent fall in the Chinese stock market looks more like a correction of a bubble than a reappraisal of fundamentals".

Two sets of arguments are used to justify agreement. The first is that there currently is a lot of uncertainty. Martin Ellison (Oxford) points out that "the VIX has been climbing steadily since the start of the year". Morten Ravn (UCL) argues that "central bank policies that were rolled out in the aftermath of the financial crisis may paradoxically also have left the economy vulnerable to another bout of financial instability".

There are several reasons why these results do not indicate that the experts are quite positive about the future outlook. First, several respondents who disagree with the question do think that there has been some deterioration of economic growth, but that this does not qualify as a serious deterioration. For example, Sushil Wadhwani (Wadhwani Asset Management) argues that "on the evidence so far, the deterioration in global growth prospects is relatively modest".

Moreover, several respondents who disagree do think that there is a substantial amount of downside risk and that the recent turbulence could seriously worsen this problem. Michael McMahon (Warwick) points out that "the most recent developments may reduce growth prospects somewhat. But the primary impact is to add to the downside risks to financial stability through direct credit exposures, second-round effects through macro-financial linkages, liquidity impacts, and currency-related risk."

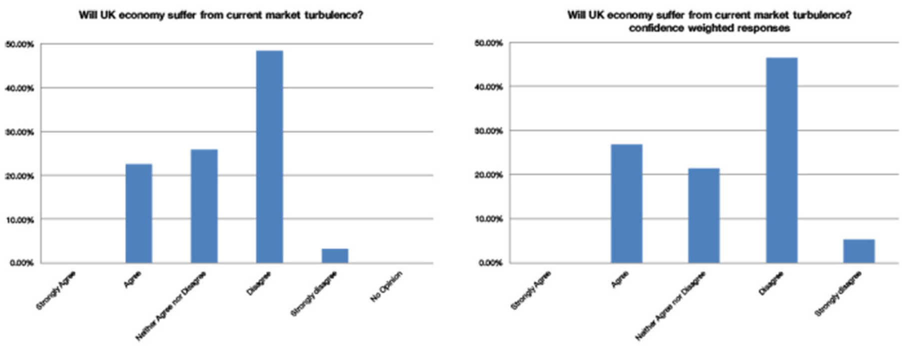
This view is echoed by Andrew Mountford (Royal Holloway), who writes that "the implications for the world economy in general of the Chinese slowdown and stock market volatility depend on the vulnerability of the Chinese and Western banking systems to these events. The UK, EU, and US regulators assure us that their banks have the capital to withstand such shocks. I hope they're right." Francesco Caselli (LSE), who also disagrees with the question, points out that "the psychological effects from the stock-market turbulence could have some significant effect on growth".

Importance for the UK economy

The second question focused on the consequences for the UK economy of the factors discussed above and asks whether the consequences could be severe enough to risk the recovery. There could be negative consequences because of reduced exports, a strengthening of the pound, increased uncertainty or exposure of UK banks to emerging markets economies.[3] These negative effects could be countered by the benefits of lower energy prices or other forces that keep the UK economy going.

Question 2: Do you agree that the falls in share prices, low oil prices, and the slowdown in some emerging market economies will have a significant negative impact on the UK's economic recovery?

Figure 2. Impact on UK economy



Thirty panel members responded to this question. Excluding the respondents that neither agree nor disagree, a majority of 70% disagree with the question.

A relatively large fraction – 23% – neither agree nor disagree, making clear that there is still substantial uncertainty. Tony Yates (Birmingham) writes "right now we don't know whether this [the fall in stock prices] is just noise, or a response to a slight reduction in growth prospects for China, or the harbinger of something much more serious."

The main argument given by those who disagree is that any negative effect due to lower foreign demand and market instability is compensated by the benefits of lower oil prices. For example, Ray Barrell (Brunel) points out that "lower oil prices have a clear and immediate positive impact on demand in the UK. Equity market declines have a limited short-term impact on demand as consumers take time to react to them, and firms do little investment through stock market issues."

The panel members who agree point to the negative effects of uncertainty. Joseph Pearlman (City) writes "the drop in oil prices presages high volatility in the cost of energy over the short to medium term, and such an environment of uncertainty will inevitably lead to lower investment". Another argument given by several respondents is characterised by Silvana Tenreyro (LSE) as follows: "The slowdown in emerging market economies will affect, directly or indirectly, the global demand for UK goods and services and weaken the UK recovery."

Several of our members point out that we must be careful in distinguishing causes and responses. Jagjit Chadha (Kent) argues that "the falls in share prices may be temporary and a response to the understanding that monetary policy will eventually normalise, which itself tells us that the economy is in recovery".

Footnotes

1 From a level of 3539.18 on 31 December 2015 to a low of 2900.97 on 15 January 2016.

2 Full survey results are available at www.cfmsurvey.org

3 The December 2015 Financial Stability Report of the Bank of England points out that UK banks have significant exposure to China, Hong Kong, and other emerging market economies, although the UK banking system should be able to withstand a severe reduction in growth in these countries.

About CAGE

Established in January 2010, CAGE is a research centre in the Department of Economics at the University of Warwick. Funded by the Economic and Social Research Council (ESRC), CAGE is carrying out a five year programme of innovative research.

The Centre's research programme is focused on how countries succeed in achieving key economic objectives, such as improving living standards, raising productivity and maintaining international competitiveness, which are central to the economic well-being of their citizens.

CAGE's research analyses the reasons for economic outcomes both in developed economies such as the UK and emerging economies such as China and India. The Centre aims to develop a better understanding of how to promote institutions and policies that are conducive to successful economic performance and endeavours to draw lessons for policy-makers from economic history as well as the contemporary world.

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This piece first appeared on Voxeu on 28 January 2016
http://voxeu.org/article/cfm-survey-january-2016-market-volatility-noise

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Research-based policy analysis and commentary from leading economists

Published by the Centre for Competitive Advantage in the Global Economy
Department of Economics, University of Warwick, Coventry CV4 7AL
www.warwick.ac.uk/cage

Artwork by Mustard, www.mustardhot.com