The rise of alternatives

Paul R. Krugman
As part of the second annual Alternatives Investments Conference, we interviewed Paul Krugman, Professor of Economics at the Graduate Center of the City University New York, Nobel Prize Winner on key topics which affect markets.

Paul R. Krugman is probably the most famous economist alive, he is also a noted policy advisor, opinion columnist and blogger for The New York Times. His cutting-edge research revolutionized the way we think about international trade and industry localities. His work initially won him the John Bates Clark Medal, awarded annually to a US economist under the age of 40. Winning the Nobel Prize was only a matter of time.

The 40,000 foot view on markets

Key highlights
- The origin of soaring food prices is not solely from the fallout of the crisis in Ukraine but also due to the ban of some exports from countries attempting to curb their domestic inflation.
- Consumers, firms and the financial markets expect elevated inflation over the next year or so but not over the longer term.
- The UK and US will continue to see monetary tightening to reduce inflation overheating while the path of the Euro Area is still uncertain.
- As globalization is mildly in reverse, there's a rise in bringing production back, the trend of 'reshoring' and 'nearshoring'.
- Despite some recent moves in the bond markets, Krugman's view is the structural forces that historically kept bond yields low are still in place.
- The role of the US dollar as a key currency is not currently under any threat.
- The US and China trade relationship will gradually decouple over time and not abruptly.

What has been the biggest fallout from Russia's invasion of Ukraine?
First, the impact of the economic fallout was less than expected. The economics of the war have been almost more unexpected than the military aspect. The bigger impact was on food prices as there was no way Ukraine's wheat production could reach global markets. To amplify the situation, countries including India responded by placing a ban on all exports of wheat, China banned exports of fertilizer, to hold down domestic inflation. This led to soaring food prices.

Second, there has been a collapse of imports into Russia. While sanctions against Russian exports have been minimal, sanctions on exports to Russia (Russian imports) have been astonishingly large.

Are you expecting this upward inflationary pressure on prices to continue?
We have multiple measures of inflation expectations from consumers, firms, and the financial markets, all of which expect elevated inflation for the next year or so of around 5% and then lower levels over the next five years. This could indicate a transitory shock whereby the inflation is not entrenched in the economy like back in 1980 which required an enormous sacrifice to bring inflation down.

How do you think central banks will respond to inflation?
Let us start with the US. My view is the same as the Fed's (US Federal Reserve) view and that is the economy is overheated but inflation is not entrenched, so they will keep hiking rates until clear signs inflation is declining to a tolerable level. The Bank of England is in a similar situation.

In the Euro Area, the policy is less clear due to demand destruction caused by higher food and energy prices.

Do you envisage an acceleration of deglobalization?
The 'Hyperglobalization' which peaked in 2008 allowed countries to vertically disintegrate production and spread it across countries, largely thanks to containerization, IT and trade liberalization. This era appears to be a one-time event as since then, globalization has slowly eroded. The logistics chains were too long and there was too much exposure to disruptions for the sake of small savings in costs. You can no longer count on the frictionless flow of goods that characterized Globalization. This does not mean a retreat to full self-sufficiency, but 'reshoring' or 'nearshoring'; bringing production back domestically or to neighboring countries, particularly for labor-intensive products. The world is now perceived a risker place. Globalization is probably mildly now in reverse.

How about capital markets, do you see fragmentation in global markets?
So far, capital flows remain large and the US is currently experiencing record capital inflows but we are probably going to see more controls on capital movement. I don't see further cases of major intervention in the capital markets such as the West's attempt to isolate Russia or further liberalization of China's capital markets. In advanced democracies, I don't see any real disintermediation or disassociation of capital markets, those are likely to stay quite open.

Has the War in Ukraine affected the role of the US dollar as a key currency?
On the surface it appears like a weaponization of the US dollar's role as a key currency but in many ways, it is more a weaponization of the dominance of New York and London financial centers.

Key currencies are associated with a very large economy, a deep and liquid bond market as well having no capital controls such as in China. While the Euro area was comparable in size, the Eurobond market has dissipated since the Euro Crisis in 2010 and individual countries now issue their own debt and trade at different levels. Despite some erosion, the US dollar continues to dominate as a key currency.

Looking deeper into capital markets, do you have a view on the outlook for bond markets?
In the next couple of years, the bond markets should look like that of 2019 and a secular stagnation scenario: ongoing weakness in investment demand relative to global savings. The forces keeping bond yields low are still in place. Globalization, technology, and demography were all weak. We now see deglobalization, little sign of technological advancement and a decline in working age population across several major economies, which results in less investment demand.

We are likely to see real bond yields turn positive while we disinflate but then turn negative again. Nominal bond yields could go higher if inflation becomes embedded in the global economy, though central banks are determined to avoid this scenario. In the next couple of years, my view is that inflation levels could return to 2% (or slightly higher) and bond yields could return to historical lows.

Do you think the large public debt levels pose a risk?
Japan still has debt levels that are far higher than elsewhere and there has not been the debt crisis that may have expected to happen for a long time.

The real interest rate has been less than the growth rate most of the time, in most economies. Interest rates are simply not high enough to create a kind of snowballing effect to fear. I am of the view that public debt poses a very small threat to the economy.

And finally, what is your view on the evolution of the US-China relationship?
Some of the tariffs imposed by Trump are coming off and we are going to see a return to near free trade among advanced democracies. However I think there will be a growing distancing between the US and China as there is no inclination on either side to restore a low tariff environment. The Chinese industrial ecosystem is not easy to break free from, but new ventures may sacrifice cheaper production for less exposure to political risk so I see a gradual de-coupling over time.

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