

ANALYSIS

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Global Outlook: Weaker Growth, Pervasive Downside Risks

Global economic growth has passed the peak and is transitioning to a slower pace after being on an upswing for more than two years. Global GDP growth is forecast to slow to 3% in 2019 and 2.7% in 2020 after an estimated 3.1% in 2018. Slowing world trade, capacity constraints, and some tightening in financial conditions are behind the cooling (see Chart 1). Elevated geopolitical risk threatens to exacerbate the slowdown, including the continued uncertainty around Brexit and the trade war between the U.S. and China.

The U.S. will keep propping up global growth in 2019, but the earlier expansionary fiscal policy is losing steam. We forecast U.S. GDP growth to hit 2.7% in 2019 before slowing to 1.1% in 2020. Most other regions are forecast to cool over the next year (see Chart 2). China's economy is forecast to grow 6.3% in 2019 and 5.9% in 2020 after the disappointing 6.6% in 2018. Beijing has shifted focus to stimulus to stabilise slowing domestic demand, but pro-growth policies will be relatively measured compared with prior downturns, keeping a rebound off the cards.

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Global Outlook: Weaker Growth, Pervasive Downside Risks

BY STEVEN G. COCHRANE, KATRINA ELL, AND RUTH STROPPIANA

Global economic growth has passed the peak and is transitioning to a slower pace after being on an upswing for more than two years. Global GDP growth is forecast to slow to 3% in 2019 and 2.7% in 2020 after an estimated 3.1% in 2018. Slowing world trade, capacity constraints, and some tightening in financial conditions are behind the cooling (see Chart 1). Elevated geopolitical risk threatens to exacerbate the slowdown, including the continued uncertainty around Brexit and the trade war between the U.S. and China.

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Less external pressure

Major central banks, led by the Federal Reserve, have largely paused interest rate normalization in response to the slower growth outlook alongside elevated geopolitical threats and the more subdued outlook for core inflation. Consequently, nonwidening interest rate differentials and expected depreciation of the U.S. dollar have so far kept

external pressure off emerging markets compared with last year. Cumulative net non-resident portfolio flows have been relatively upbeat in 2019, according to the Institute of International Finance (see Chart 3).

But the risk that emerging markets will fall out of favour as they did in 2018 is elevated. Emerging markets with economic weak spots and governance issues were the most impacted by outflows last year and remain the most vulnerable. These include EM countries with large external imbalances such as Argentina, Turkey, India and Brazil.

Central banks in most emerging markets are expected to remain vigilant to reduce the risks of broader economic spillover in case of another flare-up. Bank Indonesia has paused monetary tightening after an aggressive 175 basis points' worth of hikes in 2018, but it has made it clear that external stability is the priority over shoring up domestic demand, so reversing the tightening is not in the baseline.

Easing bias in India

In contrast, the Reserve Bank of India has an easing bias. After reluctantly hiking in 2018 to alleviate capital outflow pressure with the rupee slumping to record lows at times, the RBI cut the policy rate by 25 basis

points in February to 6.25%, and an additional cut is expected in the first half of 2019 amid the low inflation environment.

Despite relatively calmer financial conditions, Latin America is underperforming and is forecast to grow 1.3% in 2019 after an estimated 0.3% in 2018. A handful of economies stand out for their weakness.

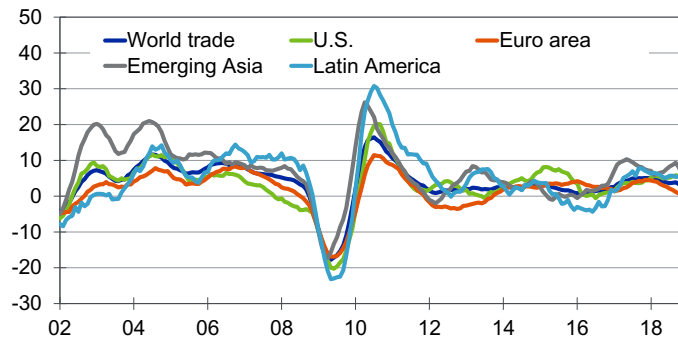
Argentina remains in a weak spot as it emerges from the 2018 currency crisis. High borrowing costs and the government tightening spending to meet debt obligations will contribute to GDP contracting by 1.4% in 2019 after the 2.1% fall in 2018. Political risk remains elevated ahead of the October general election. Venezuela is more worrisome, with GDP forecast to fall by 9.3% in 2019 after falling by 16% in 2018. Political discontent coupled with hyperinflation, shortages of essential consumer goods, and insufficient power supply is menacing, but there has not been spillover further abroad.

China shifts dial to more stimulus

Beijing has the complex task of stabilising slowing growth while carrying out the deleveraging campaign to ultimately deliver more sustainable growth. This is occurring against a backdrop of global demand's cooling trajectory and the complex trade nego-

Chart 1: Amid the Downswing

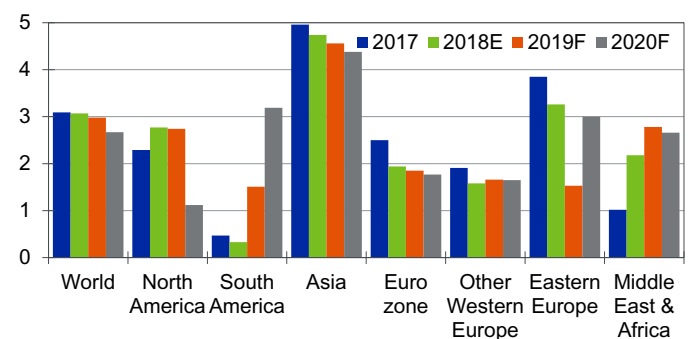
World trade volumes, % change yr ago, 6-mo MA



Sources: CPB Netherlands Bureau for Economic Policy Analysis, Moody's Analytics

Chart 2: Cooling Conditions

Real GDP growth, %



Source: Moody's Analytics

tiations with the U.S. to prevent further escalation of tariffs. Policymakers increasingly turned to stimulus over 2018 to prevent growth from being derailed, and additional stimulus will be unleashed in 2019.

Evidence of stimulus is emerging in China. Total social financing—a broad measure of credit and liquidity—has started to trend higher early in 2019 (see Chart 4), but liquidity remains relatively tight. The stimulus this cycle is about stabilising growth at the lower target range rather than reinvigorating the economy. The official GDP target for 2019 is 6% to 6.5%, down from the 'around 6.5%' target in 2018. The Moody's Analytics baseline is for GDP growth to hit 6.3% in 2019 and 5.9% in 2020 after 6.6% in 2018.

The government's quest to create more sustainable growth by reducing financial risks has not been abandoned, but it will be a slow journey. It will also be slower than was expected at the beginning of last

year, as the priority to stabilise growth has increased.

Fiscal policy will play a more supportive role this year, with the government noting it will be 'proactive, stronger and more effective.' The deficit-to-GDP target for 2019 is forecast at 2.8%, which is 0.2 percentage point higher than in 2018. But this largely hides the infrastructure spending push via local governments.

The increase in infrastructure spending will come from bond issuance at the local government level, rather than via shadow banking—outside the formal banking sector—which has occurred in the past. In 2019, the government plans on US\$321 billion in local government bonds, also known as special purpose bonds. It is estimated that more than 80% of the new infrastructure spending last year was funded by these special purpose bonds, with the majority occurring at the back end of 2018.

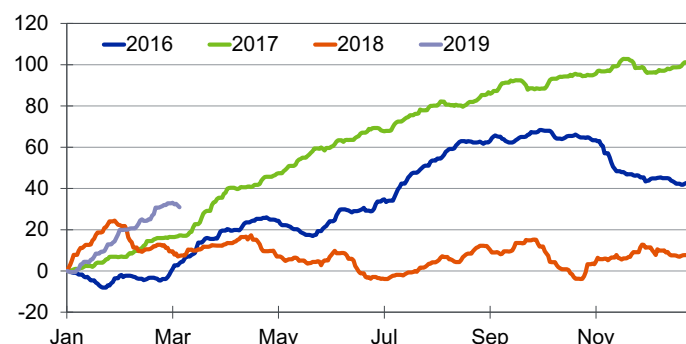
Japan's perennial struggle

Stronger wage growth in Japan is key to unlocking that elusive virtuous cycle of rising wages, prices and consumption in the country. Prime Minister Shinzo Abe is in the midst of the seventh straight annual campaign to compel firms to increase wages at the spring wage negotiations. While an official goal has not been announced, Abe said in December that his ideal would be to see firms increase wages by 5%, an unrealistic ask, particularly given the less favourable conditions compared with 2018, when an average increase of just over 2% was delivered.

Japanese corporates are notoriously cautious, so they are unlikely to release retained earnings to wages with any vigour. For decades Japanese firms have prioritized job stability over stronger income growth, a reasonable strategy given that deflation has gripped the economy for many years. Taking a leap of faith that the slowdown will not

Chart 3: A Better Start to 2019 for EMs

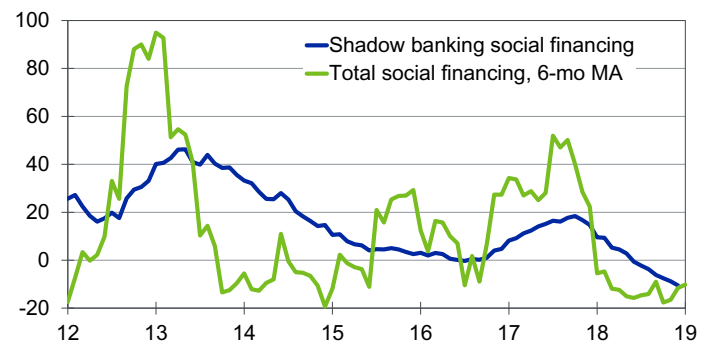
Nonresident cumulative portfolio flows to emerging markets, \$ bil



Sources: Institute of International Finance, Moody's Analytics

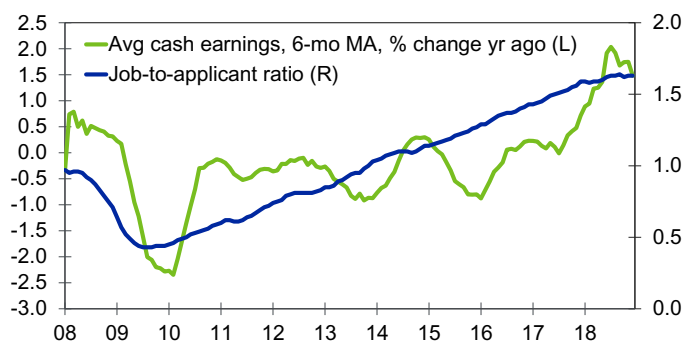
Chart 4: Liquidity Still Relatively Tight

China credit growth, % change yr ago



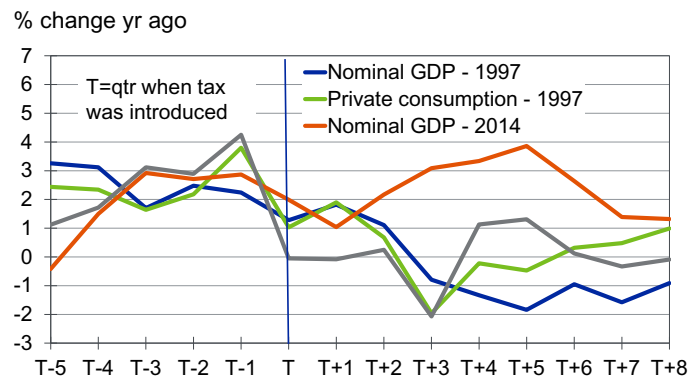
Sources: National Bureau of Statistics, Bloomberg, Moody's Analytics

Chart 5: Japan's Wage Growth Improved



Sources: Japan Statistics Bureau, Ministry of Health, Labour & Welfare, Moody's Analytics

Chart 6: Tax Hikes Derail Japan's Growth



Sources: Economic & Social Research Institute, Moody's Analytics

last seems unlikely. Indeed, March-quarter GDP growth is tracking at an uninspiring 1% q/q annualized, following the 1.9% expansion in the December quarter and 2.4% contraction in the third quarter.

Wages have advanced but not by enough to kick-start meaningful and sustained improvement in private consumption and inflation. The tighter labour market is at least partly to thank for the uptick in wages. In January the unemployment rate was a low 2.5%, where it has hovered for more than a year. The job-to-applicant ratio was 1.63, near its highest level on record. There is a reasonable correlation between Japan's vacancy rate and wages. As the vacancy rate rises, employers are forced to offer higher wages to secure the right candidate (see Chart 5).

The Bank of Japan is expected to stay quiet in 2019, licking its wounds after continually downwardly revising its inflation forecasts. Its latest core CPI estimate for fiscal 2019-2020 has been reduced by 0.5 percentage point to 0.9%, and the 2020-2021 forecast has been reduced by 0.1 percentage point to 1.4%, keeping the BoJ's 2% target out of reach.

Looming consumption tax hike

The next major obstacle for Japan's economy is the consumption tax hike from 8% to 10% scheduled for October. Private consumption, which accounts for around 60% of Japan's GDP, remains fragile at best. The economic track record after consumption tax hikes is not good; consump-

tion and GDP declined after the previous two sales tax increases, in 1997 and 2014 (see Chart 6).

We believe the tax hike will lead to a decline in consumption, and the economy could slip into a technical recession. However, the degree of slowdown may not be as severe as the aftermath from prior tax hikes, because ¥2 trillion out of the ¥5 trillion from the revenue will be diverted to fiscal stimulus. Although Japanese governments notoriously spend less on fiscal stimulus than originally planned, fiscal spending of some form will partially offset lower consumption. An increase in investment prior to Japan's Olympic Games in 2020 could also help.

ECB turns back to easing

The ECB has loosened the stimulus taps, responding to the weaker economic conditions and looming downside risks. Negotiations over the U.K.-EU withdrawal deal are not finalized, and uncertainty is a dark cloud on the outlook, not least because of the negotiation motto that nothing is agreed until everything is agreed.

At the March monetary policy meeting, the ECB launched new stimulus via Targeted Longer-Term Refinancing Operations that will start in September and run through March 2021. The central bank also ruled out interest rate hikes this year.

The ECB's significant downward revisions include euro zone GDP now expected to expand by only 1.1% in 2019, down from a previous forecast of 1.7% and down from

1.8% in 2018. Despite the downward revisions, the ECB maintained the balance of risks as tilted to the downside. This is not common practice for the bank, as it normally changes the balance of risks to 'broadly balanced' when it announces new stimulus. The dovish tone was reinforced when ECB President Mario Draghi insisted that the ECB is providing more stimulus to the economy instead of just avoiding unwarranted tightening.

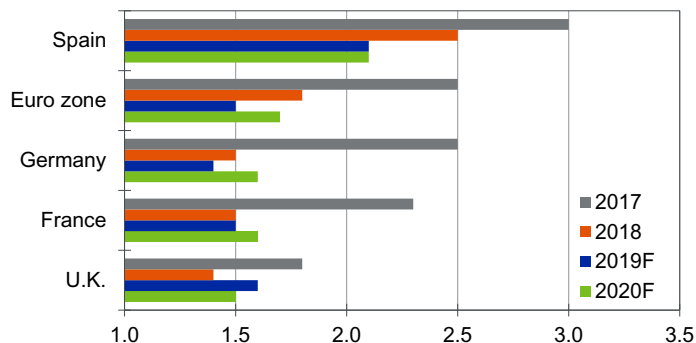
The likelihood of downward revisions from the ECB has been a long time coming. Data out of Europe have repeatedly fallen short of expectations, notably during the second half of the year. This was to be expected, as the record-high growth rates of 2017 were never to last (see Chart 7).

Germany narrowly avoided a technical recession in the second half of 2018. After contracting by 0.2% q/q in the third quarter, real GDP stalled in the three months to December. In year-ago terms, the growth rate decelerated to 0.6% from 1.2%. Italy was the biggest drag on the euro zone's fourth quarter. GDP retreated 0.1% q/q after a similar decline in the previous stanza, seeing the economy slip into a technical recession.

Households are, however, a bright spot. The tight labour market has boosted wages across the area—even if regional disparities remain—and inflation is losing ground, boosting consumers' purchasing power. But with broader conditions cooling, the labour market and households likely will pull back later in 2019.

Chart 7: Slower Conditions Abound in Europe

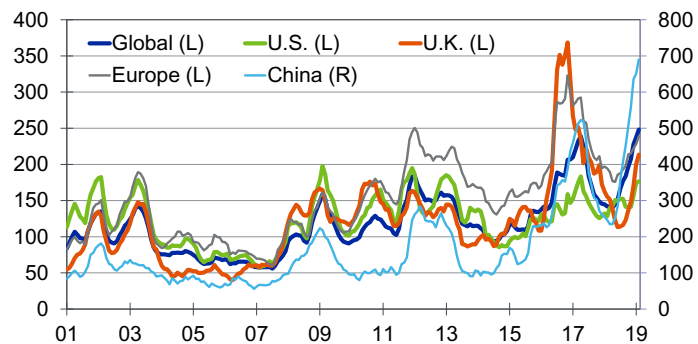
Real GDP, % change



Source: Moody's Analytics

Chart 8: Policy Uncertainty Elevated

Economic policy uncertainty index, 6-mo MA



Sources: Economic Policy Uncertainty, Moody's Analytics

Lacking ammunition

Major central banks across the globe have not had sufficient time to normalize monetary settings since the extraordinary stimulus was released a decade ago to help manage the global financial crisis. With most now having paused normalization, major central banks lack ammunition should a deeper downturn occur.

The heightened policy uncertainty across the globe helps to quantify the elevated downside risks plaguing the global economy (see Chart 8). Trade policy is the largest downside risk to the near-term outlook, and a resumption of tariff escalation between the U.S. and China would have meaningful adverse impacts on global growth. Political risk in Europe also remains elevated, with continued uncertainty around Brexit the most pressing downside risk. Also, the policy path

for Italy's populist government could create existential threats to the European project.

Role of fiscal policy

With relatively limited scope for additional monetary stimulus, the natural focus shifts to how fiscal policy could play a role. The International Monetary Fund has quantified the level of fiscal space national economies are estimated to have without jeopardizing their access to markets or putting debt sustainability into question. Australia, Germany and the Netherlands have substantial fiscal space, according to the IMF. This is a function of healthy public finances, access to stable and cheap funding from financial markets, and strong institutions.

In contrast, fiscal space is limited in Brazil, Italy, South Africa, Argentina and Spain, reflecting relatively high debt levels, fi-

nancing or servicing requirements, and elevated risks from funding in financial markets. In other words, there is a high probability these economies would encounter trouble using expansionary fiscal policy in a substantive downturn.

Sitting in between are the U.S., U.K. and China, which are estimated to have some fiscal space. The U.K. government posted its biggest budget surplus on record in January, which helped push the country's fiscal year-to-date deficit down to £21.2 billion, its lowest in 17 years. While the U.K. has increased its headroom in recent years to support growth in the event of a disorderly Brexit, it is not without limits. That, coupled with monetary artillery constrained compared with a decade ago, paints a concerning picture on the ability of stimulus to reinvigorate in the event of a crisis.

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