Global Economic Outlook 2019-20
The Peterson Institute View

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Global expansion will continue in 2019-20, but not with the rare breadth and speed seen in 2017-18:

- Advanced economies will slow by 0.25-0.50%, but overall should avoid recession well into 2020.
  - Brexit and the Japanese tax hike present significant downside risks to growth, but with very limited spillovers on other economies.
  - US expansion will continue to be fueled by fiscal stimulus and high job creation, as well as a more accommodative Fed and lower gasoline prices.

- Emerging markets overall proved to be more resilient than market forecasts, as PIIE predicted, and will for the most part benefit from dollar strength and lower energy demand in 2019 and 2020.
  - South America stands out as a region at underestimated risk, partly due to a misreading of Brazilian prospects, and partly due to spillovers within the region.
  - China continues to have a higher and more solid floor under its growth rate than some pundits fear (>6.0%), though credit misallocation is starting to impede trend growth.

Real GDP Growth (y/y)	2017	2018f	2019f
Global Output Growth (*PPP weights*)	3.8	3.7	3.3
US: fiscal-driven boom continues	2.3	3.1	2.5
Euro Area: slowing but still above-trend growth	2.4	1.7	1.5
Japan: slower growth with tax hike coming	1.7	1.0	0.8
UK: large downside risk from Brexit outcome	1.7	1.2	1.0
China: moderate slowing but solid floor	6.9	6.5	6.5
India: unsustainable stimulus push	6.7	7.3	7.5
Russia: mixed recovery dampened by oil price	1.5	1.7	1.5
Brazil: populist boom cut short by uncertainty	1.0	1.0	0.9

Source: Actual for 2017. PIIE forecast for 2018 and 2019. Specific PIIE 2020 growth forecasts will be made at end of first quarter of 2019.

- The growth picture for 2020 will be significantly slower, with greater variation across economies.
  - U.S., China, Japan, and Southeast Asia are likely to continue their expansion, with use of fiscal room and some trade diversion temporarily offsetting the drag from protectionism.
  - Brazil, India, Italy, and the U.K., as well as some smaller EM economies, however, will be past the limits of policy room. As in Argentina or Turkey, they will have to consolidate.
  - Uncertainty about the EU medium-term outlook is rising, with uncertain leadership in the core countries and ECB tightening in 2019. Political risk requires monitoring.

- China-U.S. economic conflict is likely to persist, even if Trump and Xi extend their standstill on expanding tariffs. There is broad bipartisan support in the US and in allies for sharp reduction of technology transfer and cross-border investment, with no easy path to reassurance.

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United States – Continued strong growth with low recession risk and limited inflation:

- The US economy is on track to grow 3 percent or more in 2018, a sharp pick-up from 2017. Growth has been fueled by a very large amount of fiscal stimulus.
- The tax cuts passed at the end of 2017 and the higher government spending levels authorized by the Bipartisan Budget Act of 2018 have raised growth in 2018 by 0.75%. Fiscal stimulus is likely to provide another 0.4% boost in 2019 before giving way to a small fiscal drag in 2020.
    - Tax cuts plus deregulation should have raised trend growth by around 0.2% annually, with some additional short-term boost to SME credit and energy extraction.
    - Increased investment in 2018 appears to have been driven by overall growth and credit conditions rather than corporate tax cuts. The risks to corporate investment are slightly to the downside for 2019 and 2020, depending upon Fed interest rate path.
    - Markets underestimate the likelihood of Congress passing an infrastructure spending package in 2019. If passed, it would likely be for three years of 0.3% of GDP year expenditure (which would offset most of the fiscal drag in 2020).
- Household fundamentals remain strong and should support solid consumption growth in 2019 and 2020. Despite the decline in equity prices, wealth relative to disposable income remains close to its highest level on record. Debt burdens are low, as are delinquency rates on most types of debt. The personal saving rate is considerably higher than it was in the decade leading up to the financial crisis.
- The US jobs machine is still going strong; at 3.7%, the unemployment rate is the lowest in nearly 50 years. With growth likely to remain above trend in coming quarters, the unemployment rate should fall further to 3.5% by the middle of 2019.
    - The Fed seems ready to see how low unemployment can go, and labor market optimists point out that we are just back to labor force participation levels seen pre-financial crisis.
- Meanwhile, inflation remains moderate. With the labor market so strong, we expect inflation to pick up next year, but it should overshoot the Fed's 2 percent core PCE target by only a modest amount.
    - Smoothing thru month-to-month noise, our point estimate forecast is for core PCE inflation to gradually rise to 2.25 by late 2019 with a further increase likely in 2020.
    - The bond market disagrees. Five-year inflation compensation in the Treasury market is 1.6%. Given that the Fed's target is 2%, that TIPS refer to CPI which typically runs 0.3 pp higher than PCE (and is currently 2.2%), and that there ought to be a positive inflation risk premium, the bond market may be wrong by almost a full percentage point for 2019=20.
    - Ironically, the bond market calm regarding inflation and the limited wage inflation to date may embolden the Fed to slow or pause its pace of rate hikes. The December FOMC meeting confirms this view at least temporarily. This both increases the risk of a recession arising from Fed tightening, due to need to catch up, but postpones it until late 2020.
- The Democratic majority in the House starting January 2019 obviously blocks major fiscal or other significant legislation. This increases gridlock risks and government turnover through investigations.
    - The few areas where the House Democrats and the White House are likely to agree are on continued confrontation with China, anti-pharma regulation, and possibly infrastructure.

<u>China – Stalled reform, tighter credit, and trade conflict slow trend growth, but expansion continues</u>:

- China remains capable of sustaining 6%-plus growth through 2020, with policy room for stimulus should growth falter. The service economy continues to be a major driver of growth.
  - Stimulus when used could finally take the form of limited, targeted tax cuts, that is fiscal measures rather than credit direction.
  - The quality of growth is, however, declining. The growth of industrial value added of private relative to state firms has now sunk to an all-time low, contributing to the marked slowdown in industrial growth.
- The risk for the 2019 forecast of 6.5 percent GDP growth is to the downside. If the Trump administration bumps up tariffs fully, growth will slow by 0.5%.
  - Implementation of the U.S. Export Control Reform Act signed in August will determine the flow of high technology goods to China. Short-term disruption is possible, but medium-term drag on productivity growth will be more important.
- By the end of 2018, growth of credit to the real economy was at the slowest pace in 15 years. This improves stability but represents a domestic headwind potentially larger than trade threats.
- China is less likely to resort to credit-fueled stimulus than many think. The authorities have learned that excessive credit growth is difficult to direct to productive sectors (e.g. not to housing investment).
- Chinese state-owned enterprise debt rose substantially through 2016 but since then growth has moderated.
- Credit through the shadow finance has been shrinking for most of 2018, imposing substantial stress on private firms. This could be reversed to support growth.
- Regulators in China are taking an increasingly tough line on fintech companies, moving closer to a more level playing field with traditional financial institutions that reduces regulatory arbitrage they have enjoyed for over a decade.
- Additional key indicators of credit contraction to watch going forward are:
  - Whether recent efforts to improve the flow of credit to private SMEs gain traction.
  - Whether supervisors continue credit tightening and deleveraging as growth slows
  - Degree of access of private (incl. foreign) firms to compete in closed service industries.

<u>Japan – Continued steady growth, with upside (trade) and downside (tax hike) risks:</u>

- Japan continues to quietly grow at a strong pace per capita, with very low unemployment, and increasing female labor participation.
- Monetary policy will remain accommodative indefinitely. Inflation, however, remains below desirable levels, and wage increases are limited.
- The Abe administration plans to increase VAT from 8% to 10% in October 2019. There is a risk of repeating a contraction as experienced after a consumption tax rise in 2014. That large drag was not anticipated at the time.

  - Olympic related spending and some planned social programs may be sufficient to limit the downside impact.

- The Japanese government has shown surprising international leadership on trade issues, both in the form of enabling CPTPP and mobilizing the E.U. and U.S. on WTO reform as a joint effort. Its role as G20 President for 2019 may reinforce domestic reforms as well as speed conclusion of narrow Japan-U.S. trade talks.

Korea – Political considerations dominate economic concerns, making forecast uncertain:

- South Korean political developments – domestic and with respect to North Korea – are dominating economic concerns, making a macroeconomic forecast unreliable.
  - Conveniently, external economic pressures have diminished as Chinese and U.S. attention have shifted.

- There is no progress on North Korean denuclearization. The South Koreans are moving forward with economic cooperation projects, nonetheless, and will at some point violate UN sanctions in the process. We expect the Trump administration to accept this outcome.

- The North Koreans are proceeding with their military modernization doing everything except (and these are big exceptions) further nuclear and ICBM tests.

Latin America – Major downside risks to growth, and a potential negative feedback within the region:

Argentina -

- Argentina faces a challenging 2019 as it tries to deal with the fallout from its economic troubles in 2018 while holding presidential elections later in the year. Argentina's GDP is falling about 2.5% this year and expected to decline about 1.5% next year.

- The $57 billion package approved by the IMF in September of 2018 has served to calm investors for the time being, halting the slide of the peso.

- Although the funding is enough to meet the country's external needs until 2020, short term interest rates and inflation are likely to remain stubbornly high. A combination of contractionary fiscal and monetary policies will deepen the economic recession.

- Macri losing support for reelection prospects could spook investors, who would worry that reforms agreed with the IMF could be interrupted. Domestic support for him, however, is likely underestimated by external observers.

- A weak peso and large foreign indebtedness mean the fiscal position is still very vulnerable to a sudden capital stop, irrespective of the election outcome.

Brazil -

- Consensus growth forecast for 2.25% growth in 2019 seem high and ignore significant downside risks.

- Brazil faces severe, mostly unresolved, but pressing fiscal problems: The primary deficits are likely to remain around 2 to 2.5 percent of GDP, and the nominal deficit is still at about 7.5 percent of GDP, despite a slow but ongoing recovery.

- Since 2015, interest rates have fallen from about 14 percent to 6.5 percent. The nominal deficit, however, has only come down by about 2 percentage points of GDP, despite the reduction in debt service costs.

- Notably, economic issues were largely absent from campaign speeches by incoming President Bolsonaro. Although he has signaled some pro-market and pro-reform views, he appears likely to prioritize his promises to fight corruption and reduce violence. Recent market euphoria may yet be disappointed.

- There is an urgent need for overhaul of the pension system, Bolsonaro has recently spoken of approving the reform in tranches, rather trying to pass a full constitutional amendment through Congress. Given the unpopularity of the reform, this approach would likely lead to approval of a retirement age followed by little else. Pension expenditures which currently stand at about 10 percent of GDP would then likely rise to around 15 percent over the next few years.

Mexico –

- AMLO is Mexico's first majority president in nearly two decades, and the only Latin American leader to control both the Executive and Legislative branches. With political mandate, potential for possible policy shifts is high, as is financial scrutiny:

- Although market reaction to his victory was somewhat muted during the long transition, investors have become more concerned over AMLO's populist leaning when he announced plans to scrap the new Mexico City airport. Concerns are that he could undo the energy reforms enacted in 2014, despite USMCA maintaining protections of them.

- On November 15, 2018 the Mexican Central Bank (Banxico) raised interest rates citing the peso devaluation. In an unprecedented commentary, Banxico specifically cited the decision to cancel the new Mexico City airport as a catalyst for exchange rate pressures.

- To stem these concerns, on December 15, 2018 the new government presented its first budget vowing "an absolute commitment to fiscal and financial discipline", as well as a primary surplus of 1 percent of GDP without the introduction of new taxes.

- Growth and inflation assumptions in the AMLO budget were slightly more optimistic than current market projections (1.8 percent growth for 2019 projected by investors versus 2 percent projected by the new government; 3.95 percent inflation projected by investors for the coming year versus 3.4 percent projected by the government).

- Looking ahead, one of AMLO's key campaign promises was to reduce inequality and labor market informality through a substantial reform of Mexico's social programs; his party's support means he has the political mandate to enact such a program.

- Mexico was previously expected to grow about 2.5% in 2019, but, given current business climate, this modest forecast has been downgraded to 2.0%.

Venezuela –

- As we had predicted in December 2017, Nicolás Maduro's regime has proven to be more resilient than investors previously anticipated, despite a looming debt default (especially with U.S. sanctions in place), and spiraling hyperinflation.

- The migration crisis – according to the United Nations, some 3 million Venezuelans have fled the country since 2015 – is proving beneficial to Maduro, who not only has fewer mouths to feed, but also faces much diminished opposition after the deadly demonstrations of 2017.

- Although Venezuela's oil production is collapsing, the regime is getting financial support from other sources, such as Russia, organized crime, terrorist organizations, and other rogue regimes/players who are using Venezuelan territory as base in the region.

- Throughout 2018 the Maduro regime announced a series of convoluted currency reforms in a bid to end hyperinflation. Not surprisingly, these efforts have failed.

- As the migration crisis deepens, tensions in the region could rise significantly. Specifically, some 1.1 million Venezuelans have fled to neighboring Colombia at a time when its new government is facing tough fiscal issues and the implementation of the peace agreement with the FARC.

- Also of note is the fact that Maduro's government has been coordinating with Nicaragua's *de facto* dictatorship under Daniel Ortega, allowing organized crime and narcotraffickers to prop up the two regimes by facilitating distribution routes in the region. This is also adding to tensions in the so-called Northern Triangle countries of Guatemala, El Salvador, and Honduras.

- All of these issues could come to a head if the Trump administration decides to take a tougher stance towards Venezuela, backed by friendly regimes in the region such as Brazil's new administration.

Europe – Decent economic fundamentals being undermined by emptying of the political center

- Bottom line, compared to 2017-18, the outlook baseline is that there would be just above potential growth, and there is risk of a significant growth slowdown between hard Brexit, continued turbulence in France, a crisis in Italy, Eastern European turmoil, and auto tariffs.

- Political pressures, however, will lead to fiscal ease in France and Italy, at least for 2019, with likely followers except Germany into 2020. We expect the multipliers on these stimulus packages to be very low, given labor market problems and financial market skepticism, as well as uncertainty about the duration of any government programs enacted.

- After much drama, the Withdrawal Agreement negotiated by Theresa May's government is likely to be adopted by Parliament, due to fears of hard Brexit, a referendum, and a possible Labour election. Its orderly implementation will bring the UK into the planned transition period, in which the country effectively remains in the European single market and customs union. But general uncertainty will remain as to the length of that transition and the nature of the eventual EU-UK relationship.

- German grand coalition will survive at least until June 2019. A disastrous European election result for either CDU/CSU, SPD, or both could lead to its collapse if either (1) the SPD panics and pulls out; (2) the CDU/CSU decides to remove Merkel. Both would likely trigger new elections, further eroding stability in Europe from the political and geographic center.

- In France, helped by the strength of the Fifth Republic institutions and his solid parliamentary majority, President Macron will rebound from the *Gilets Jaunes* unrest of late 2018. He will continue a meaningful program of structural reform albeit with more emphasis on "social" themes such as fighting poverty.

- Whether the current budget "offer" of the Italian government to the European Commission (a 2019 deficit target of just above 2.0 rather than 2.4 percent) will be enough for Italy to avoid the Excessive

Deficit Procedure is irrelevant. Markets will tolerate the deficit, with or without the EDP, and spreads may decline further if the Italian government delivers on its plans instead of exceeding them.

- But the Italian situation is very fragile. Given especially low multipliers on Italian fiscal policy, there could be a greater slowdown in growth next year than expected. That could lead to near-crisis territory (spreads 300-400 bps over Germany).

- Nationalist and anti-EU parties may have peaked.

    - The European elections in May 2019 will in the end yield only a small increase (less than 5%) to nationalist/EU-skeptic parties.

    - The Polish government will (under pressure in the ongoing EU budget negotiations) largely agree to the EU's demands on the judicial reform/rule of law.

    - Hungary will see an increase in political demonstrations, as people's power will begin to challenge Orban's increasingly repressive regime. A repeat of Ukraine/Maidan 2014 not impossible, though probably will not happen until Hungary is hit by an economic downturn.

- German Bundesbank President Jens Weidmann remains the favorite to become ECB president, but will be a weak president without a clear majority behind him on the ECB Governing Council. Hence in monetary policy terms his appointment may make little difference, while the position of ECB chief economist (likely from a more dovish state) takes on a more prominent policy shaping role.

Energy and commodity markets – Continued softening

- Oil prices are unlikely to rebound until the second half of 2019, if at all.

    - Market fears of tight supply due to re-imposed sanctions on Iran have been allayed by six-month waivers for, among others, India, South Korea, Japan, and China to continue importing Iranian oil. These waivers are set to expire in 2019, but we anticipate extensions, albeit at perhaps lower total quantities.

    - The biggest risk for energy markets in current environment is not Iran and the sanctions regime, but rather the increasingly erratic behavior of the regime in Saudi Arabia, due to the fallout from the ongoing war in Yemen and diplomatic tensions over the death of journalist Jamal Khashoggi. OPEC is further losing control of supply, despite the best efforts of Russia and Saudi Arabia at coordination.

- If the trend toward growing trade restrictions continues, we can expect lower demand and prices for base industrial metals like aluminum and steel.

    - Demand for rare earths will be an exception, as their use in part of a broader energy transition will outstrip supply. Sharp price increases could result if China attempts to use its dominant position in rare earths as a chip in trade negotiations.

    - While new suppliers are coming online outside of China, including in the U.S., these suppliers will do little to erode China's dominant position in the short or medium term.