1. Global economic outlook

1.1. GLOBAL AND EUROZONE OUTLOOK: HEADING INTO INCREASINGLY STORMY WEATHER

by Richard Grieveson[1]

Despite a slightly less optimistic outlook than in the Spring, the global economy remains buoyant, powered above all by strong activity in the US. Global growth should remain fairly robust by post-crisis standards throughout the forecast period. However, the risks to the outlook have continued to rise, and are tilted heavily towards the downside. Tighter US policy, a possible Chinese slowdown, and uncertainty around Italy and the eurozone are the main things to watch.

1.1.1. Global economy: growth still looks good, but risks rising

The international environment has become more challenging since our Spring Forecast Report, reflecting tighter US monetary policy, rising trade protectionism and the impact of international tensions on economic sentiment. As the International Monetary Fund (IMF) pointed out in its most recent World Economic Outlook (IMF, 2018), not only has global growth moderated this year, but has also become less synchronised.

Rising US interest rates are a challenge for the global economy, and many emerging markets are already suffering as a result. The dollar has strengthened notably since April, as higher US rates and various idiosyncratic risks have pushed investors back from emerging markets to the relative safety and now higher returns of the US (see Figure 1). Much of the global economy – and particularly corporates in emerging markets – has become addicted to cheap dollar credit, and will struggle to cope as US rates rise. Our sense remains that the exit of major central banks from ultra-loose monetary policy (the European Central Bank (ECB) will start tightening monetary policy next year, according to current projections) will continue to cause a serious amount of instability in international financial markets and will have economic consequences, including in our region.

Higher US rates have significantly increased the chances of an emerging markets crisis, and have already (and will continue to do so) depressed growth rates in many economies. We have seen this already in our region with Turkey (see chapter 2.1 and the Turkey country report), but others around the world, notably Argentina, have also been affected. A continued adjustment of these countries' current account deficits – already quite savage in the case of Turkey – will have to happen. Exports should provide some relief (helped by much weaker currencies and a likely expansion of the US current account deficit), but it is likely that the brunt of the adjustment will be borne by domestic consumption and investment (as is already happening in Turkey), meaning much lower growth. In

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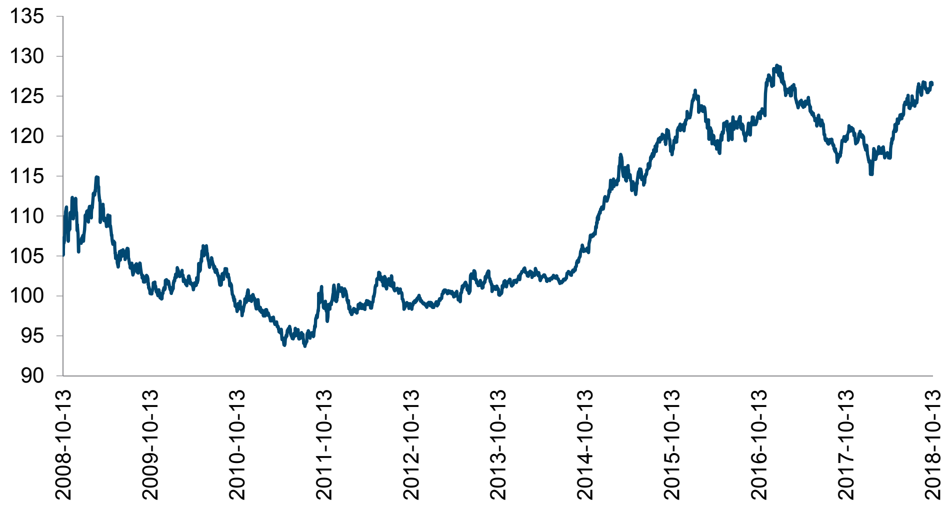
October, the IMF reduced its growth forecasts for several key emerging markets, notably India, Argentina, Brazil, Mexico, Iran and Turkey.

Figure 1 / Trade-weighted US dollar index

Broad measure, 1997=100



Note: Index is a weighted average of the value of the US dollar against a broad range of trading partners' currencies.
Source: St Louis Fed.

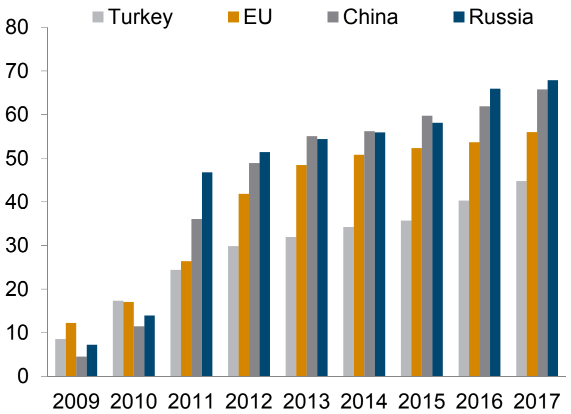
A global trade war – which has been a risk ever since the election of Donald Trump as US president – is now partly under way, adding to the headwinds facing the world's economy. In late September, the US imposed tariffs on US$200 billion worth of Chinese imports, and China responded with measures against the US. China so far does not appear inclined to back down, and has several incentives for not doing so (Frankel, 2018). Further exchanges of sanctions between the US and China would certainly make the situation even worse (see CESEE risk matrix). It is also clear that uncertainty about future tariff changes is negatively affecting economic sentiment and production and investment plans in many key economies.

A full-scale US–China trade war would harm global growth, but it is important to note that in some ways this would only continue a process of increasing restrictions on trade between major economies that has been under way for almost a decade. As Figure 2 shows, since 2009 the US has significantly increased the share of imports from other parts of the world that it subjects to 'harmful' trade restrictions. As a share of global GDP, international trade rose relentlessly from the 1980s until the time of the global financial crisis. Since then, it has largely been flat (Figure 3), albeit with a significant increase in the EU and a decline in China.[2]

[2] This is a useful illustration of how much the EU has leaned on demand from the rest of the world to drive its recovery from the crisis, and partly reflects how much domestic demand in the bloc has been compressed over the past decade.

Figure 2 / Share of imports into the US subject to 'harmful' trade restrictions, by exporter

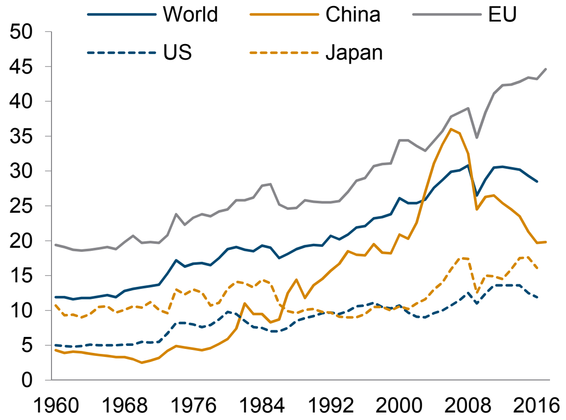
in %



Note: 'Harmful' trade restrictions include both tariffs and non-tariff measures. For a full list see Simon J. Evenett and Johannes Fritz (2017), The Global Trade Alert database handbook, Manuscript, 14 July 2017.
Source: Global Trade Alert.

Figure 3 / Exports of goods and services

% of GDP

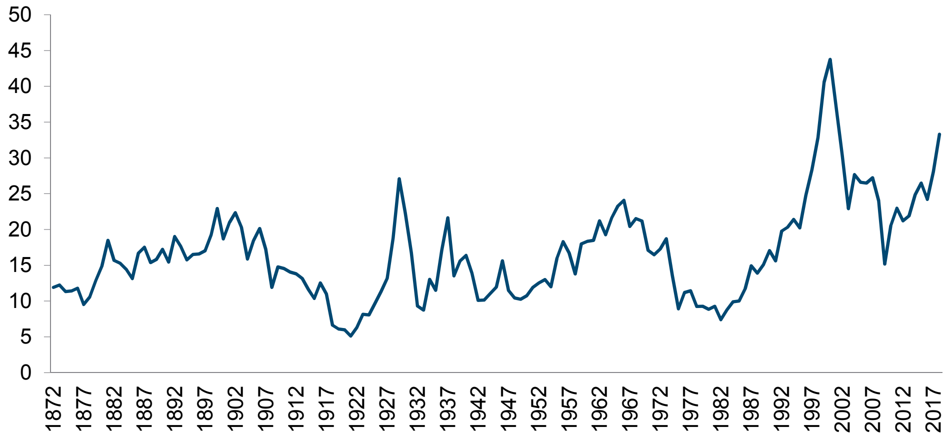


Source: World Bank.

There are increasing signs that the Chinese economy is also slowing, which is a further issue from the perspective of global growth. The IMF sees growth dipping to 6.2% in China next year, down 0.4 percentage points on this year's estimate, and a 0.2 percentage-point downgrade from last time. Attempts in China to deleverage the economy (and especially the shadow banking sector) after years of strong credit growth have led to weaker domestic investment activity, and as such are reducing important demand, with knock-on effects for the global economy.

As we highlighted in our last Spring Forecast, global financial markets are signalling various reasons for concern. A decade of ultra-loose global monetary policy has significantly pushed up prices across various asset classes, including stocks, bonds and property. The Shiller price/earnings (PE) ratio for the S&P 500 is at its second-highest level on record (see Figure 4), below only the 'dot com' bubble. However, many have been expecting a US stock market collapse for years, and have been wrong. US tightening is likely to be the trigger for any broader crisis, although this will depend very much on how fast the Fed moves. Markets more generally do appear to be suggesting the late stage of the cycle, consistent with monetary tightening in the US. Ten years after the collapse of Lehman Brothers, it may well again be reasonable to assume that the next crisis is likely to come from something that few people are currently looking at.

Figure 4 / Shiller Cyclically Adjusted Price/Earnings Ratio (CAPE Ratio)



Note: The CAPE ratio is the price/earnings ratio for the S&P 500 using inflation-adjusted earnings over the last 10 years. This smooths out fluctuations in earnings caused by the business cycle.
Source: Robert Shiller

Oil prices have continued to rise this year, although it is likely that a sustained increase above US$100 a barrel (bbl) will be necessary for the global economy to be significantly negatively affected (parts of the eurozone may be an exception to this; see chapter 1.2). It is possible that the oil price will rise further in the short term on the basis of weaker output in Iran or Venezuela. However, on the flipside, Russia and the Organization of the Petroleum Exporting Countries (OPEC) agreed in June to increase production; US shale output will likely continue to cap prices; and weaker global growth will negatively affect oil demand. OPEC has so far refrained from a further official production increase, but pressure from Mr Trump on Saudi Arabia and others for more output is likely to increase ahead of US mid-term elections, and further increases in the oil price would prompt a response from Saudi Arabia and others. Media reports indicate that Asian refiners in particular have been asking Middle Eastern suppliers for more cargoes. As a result, we currently think that oil will spend 2019 in the US$70–80/bbl range.

While risks are clearly rising, US growth is still strong, US inflation is still relatively subdued (which will limit the pace of further monetary tightening), and China's policy-makers have the means and incentives to respond to any downturn in their country. The IMF projects global growth at 3.7% this year and next, which is the same as in 2017. Meanwhile, US growth for 2018–19 will be quite a bit better than 2016–17. Perhaps most importantly in the case of the US, there still appears to be some slack in the labour market, which will keep a lid on inflation and make it likely that the pace of future monetary tightening is quite measured. Meanwhile, twice in the past decade the Chinese economy has been hit by external shocks (2008–09 and 2013–15) and each time the domestic policy response has been significant, with a focus on credit expansion and infrastructure investment. Although this time higher debt loads and a deleveraging cycle suggest that a policy response could be less likely, there is still room for significant fiscal easing, if required, while the pressure to deleverage has already been relaxed, and monetary policy could also be eased further if necessary.

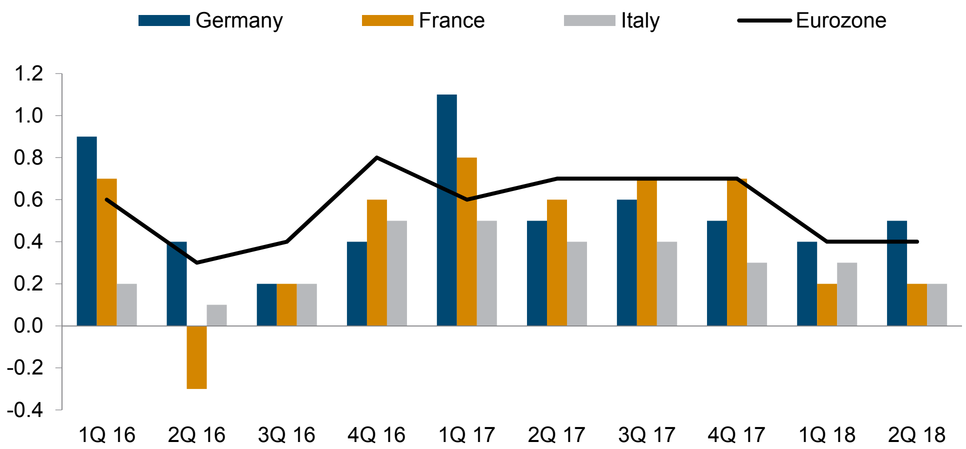
More fundamentally the post-World War II international and political economic order is showing increasing signs of strain, and the chances of coordinated action at the global level to restore stability are low. This is for two main reasons: a one-in-a-century rise of a new great power (China) and an erratic US president backed by a largely acquiescent Republican Party. The peaceful political, military and economic rise of China is in no way guaranteed, particularly considering the current occupant of the White House. As shown above, globalisation appears to have stalled, and is under attack from politicians in many countries. The EU is likely to remain focused on internal issues and, under German direction, appears incapable of a strategic approach to anything.

1.1.2. Eurozone economy: slowing, and increasing worries about Italy

Within the eurozone, Germany is still growing strongly. However, the pronounced cyclical upswing recorded in the bloc last year has faded badly, notably in France and Italy. For Germany, although the risks have risen (Germany is unusually open for a big economy, and so would suffer disproportionately from a downturn in global trade), the outlook is still reasonably positive. Growth has slowed a bit this year, but remains at historically strong levels (see Figure 5). However, outside Germany, momentum has slowed markedly, especially in France and Italy, the second- and third-biggest economies in the bloc.

Figure 5 / Real GDP

Seasonally and working-day adjusted, % change quarter on quarter



Source: Eurostat.

There are three mains reasons for the eurozone slowdown: capacity constraints, higher oil prices and the impact on sentiment of global trade tensions. At the turn of the year, firms were unable to keep pace with demand, and capacity constraints emerged particularly in terms of capital (although also on the labour side in some places).[3] Meanwhile, outside Germany, domestic demand appears to be too weak to allow firms to pass on higher input costs (chiefly from oil) to consumers.

[3] Sentiment surveys at that time – for example, the purchasing managers' index (PMI) compiled by IHS Markit for major eurozone economies, consistently showed significant backlogs of work, as firms struggled to keep up with orders.

The ECB will end its asset purchase programme this year, but is likely to start tightening policy only very slowly, starting in late 2019 at the earliest. We have already expressed our scepticism about a sharp hiking cycle. Core inflation trends, especially outside Germany, continue to look very weak. This will keep the euro weak against the dollar, which could bring some relief for eurozone exporters.

Meanwhile, two major developments in EU and eurozone politics have continued, and will have big economic implications: the rise of the far right and the fragmentation of parliamentary representation. European Parliament elections in May 2019 may provide a further indication of both trends. The roots of the significant political changes happening across the EU are deep and complex, but there is little indication of a 'return to normal'. A shift to the far right[4] in response to the migration crisis has been clear in many countries, and there is no real EU-wide solution in sight to this issue (see chapter 1.3). However, this is far from the whole story (see, for example, the success of the Green Party in Germany[5]). Centrist parties are losing vote share to the extremes on both the right and the left, leading to broader and messier coalition governments that will struggle to achieve meaningful reforms. Economic factors have also been important in driving increased support for non-centrist parties on both the right and the left, and in particular the austerity-dominated response to the eurozone crisis pushed by Germany and some smaller Northern European allies (see, for example, Scazzieri, 2018). The importance of supply-side reforms in Southern Europe is widely recognised – particularly the opening up of product and service markets to greater competition. However, the unwillingness of Germany to allow support from the demand side during a tough period of adjustment has needlessly made the situation worse, and could prove corrosive to the European project in the long run (Heimberger, 2017).

As we have previously highlighted, the most problematic country is Italy, which now has an anti-establishment government with a far-right presence. This matters for three reasons. First, Italy is a systemically important member of the eurozone, and a crisis there would be much more difficult to solve than was the case in Greece. Second, it creates additional problems for the Italian economy, which is already struggling with very high public debt and decades of negligible growth. Under the current government (which is on a collision course with the EU over its budget), a debt crisis has become much more likely (Blanchard et al., 2018). Third, it makes the chances of reform of eurozone architecture more difficult. Without progress on fiscal and banking union, we do not think it makes sense to talk about the 'eurozone crisis' in the past tense (see chapter 1.2).

1.1.3. Brexit: a monumental unforced error where nobody wins

It has been over two years since the Brexit vote, and negotiations over the terms of withdrawal and future relationship have been very bruising for the UK. The unwillingness on the part of much of the UK government to face up to the trade-offs that Brexit entails (rather than 'having our cake and eating it', in the infamous words of the hapless and destructive former UK foreign secretary, Boris Johnson) has brought the country to the brink of an economic and political crisis. From here, all options

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[4] This can be seen not only in the increased vote share of hard- or far-right parties, but also in the adoption of parts of the far-right agenda by centrist parties.

[5] In the recent Bavarian election, for example, the centre-right Christian Social Union (CSU) lost more votes to the Free Voters of Bavaria (FW), the Greens and voters dying than the hard-right Alternative für Deutschland (AfD).

remain on the table, and it is not unthinkable that the UK will crash out of the EU without a deal. It is also far from impossible that this will herald a return to conflict in Northern Ireland.

Assuming that some kind of deal is reached, there are two realistic long-term options for the UK–EU relationship: the so-called 'Canada plus' option and something like the Norway model (i.e. staying in the single market). The first would mean significantly more restrictions on UK–EU trade than is currently the case (both for goods and, especially, services), and would require much greater checks on trade between Great Britain and Northern Ireland, something that would have significant political consequences in the UK. Meanwhile the Norway model is basically the so-called 'Brexit in name only' (BINO), which would mean the UK largely staying in the EU, but with little or no say over the rules (Wren-Lewis, 2018). On balance, the first option looks more likely, albeit with a fairly lengthy transition period, during which the whole of the UK remains in the single market and customs union. A collapse of the current government is now also far from unthinkable, and if there is then a general election and Labour comes to power, this could mean BINO becoming permanent. However, a collapse of the whole process, and a second referendum in the UK, is no longer unthinkable. Whatever happens, the scenarios for the UK economy range from somewhat negative to disastrous. Key UK trading partners in the EU, such as Germany, will also be affected, leading to knock-on effects for CESEE.

The political fallout may be even more significant, for both sides. It is clear that the UK's status on the world stage has been dramatically diminished by the shambles of its Brexit negotiations, and that this will take some time to recover from. Meanwhile, from the EU side, although Brexit has been a powerful unifying force (as we expected), this will not last. Brexit is in fact far from the most important issue that the EU has to deal with, and it is almost impossible to imagine that the high degree of consensus among the EU-27 on Brexit will be repeated for issues like migration, reform of the eurozone, and the future budget (see CESEE risk matrix for more details).

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