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Economic Research:

Global Economic Outlook 2019: Autumn Is Coming

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GLOBAL CHIEF ECONOMIST

Paul F Gruenwald

Singapore

(65) 6216-1084

paul.gruenwald
@spglobal.com

Key Takeaways

- The direction for the global economy in 2019 is clear: GDP growth will slow, led by the U.S., which will likely see the rate of expansion fall to around 2% by the end of next year. Chinese growth will moderate. Europe's growth will remain relatively low and stable.
- We see the risks around our baseline on the downside. These include worries about the entrenchment and expansion of the U.S.-China dispute, as well as market turbulence related to the path of interest rate normalization by the U.S. Federal Reserve. Brexit and Italy's fiscal woes may have an impact, but remain regional risks for the most part.
- All is not lost! Policymakers across the major economies can seize the opportunity to shed shibboleths and undertake bold (non-monetary) policy actions to mitigate the slowdown.
- We expect the path of growth and policy normalization next year and beyond to be orderly for the most part; more an arrival of autumn than a coming of winter. This global slowdown is both necessary and healthy. It's not the beginning of another global financial crisis.

The outlook for the global economy in 2019 is straightforward: GDP growth will slow in aggregate and in most major countries. The U.S. will lead the trend, as fiscal stimulus will wane and monetary policy normalization will continue, with both weighing on growth. China's expansion will continue to moderate despite a pause in corporate deleveraging, and we expect further policy easing as ongoing trade tensions and the effects on both business and investor confidence continue to bite. European growth will trundle along, weighed down by concerns about Brexit, Italy's budget, and Germany's new leadership ahead of a reshuffling of the European governance. Across emerging markets, tech and oil exporting economies may struggle in relative terms.

Moreover, the risks to this outlook are on the downside, driven in large part by two scenarios. First, the U.S.-China entanglement (it's not just about trade and never was) may worsen and broaden before it gets better. The pause in tariff escalation by Presidents Trump and Xi following the recent G-20 meeting in Buenos Aires was welcome, but much work lies ahead. Second, as our just-completed Credit Conditions Committee agreed, with the cycle turning, the possibility of surprises on the credit front is rising as well. These include debt affordability as well as access to

financing. (See footnote 1.)

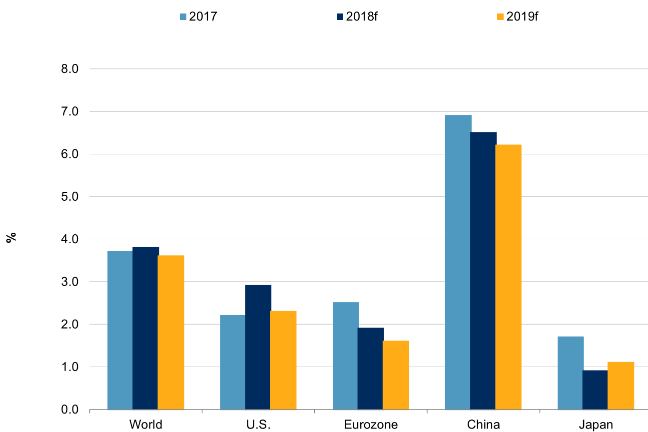
Despite this gloom, we are not jumping on the crisis bandwagon. In broad terms, we see the slowing of global growth as both necessary and healthy. We expect the process to be reasonably orderly, with recent bouts of market turbulence a reminder that slowdowns are not always smooth. It need not be the case that winter is coming, but the global synchronized upturn of 2017 has clearly passed, and we are entering the autumn of the long expansion that followed the global financial crisis.

2019 Looks Directionally Clear

We forecast global growth will ease from a six-year high of 3.8% this year to 3.6% in 2019 (see charts 1-4). This decline will take place in the two largest economies: the U.S. and China (comprising 40% of world GDP, as measured by purchasing power parity, or PPP). Neither will be hit particularly hard by the trade war, at least the direct effects (2). It's also true that growth will decline in the two economies that contribute most to global expansion: China and India (contributing 55% to global GDP in 2017 on a PPP basis). There may be outliers elsewhere, but they aren't big enough to move the global growth needle.

Chart 1

Growth Forecasts: December 2018 CCC Round



f--forecast. Source: S&P Global Economics.

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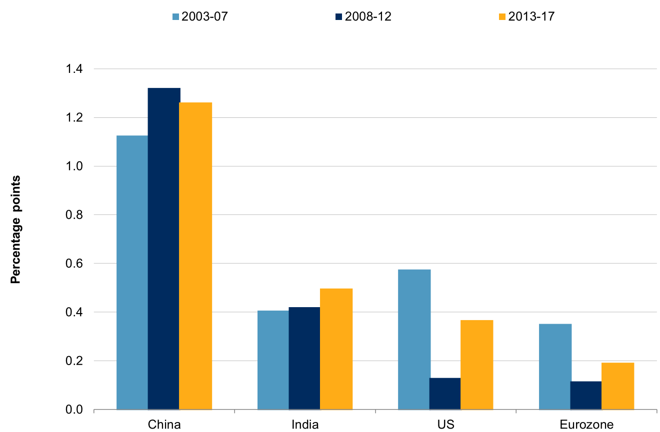
Chart 2

Contribution To Global GDP Growth



Source: CEIC, S&P Global Economics.

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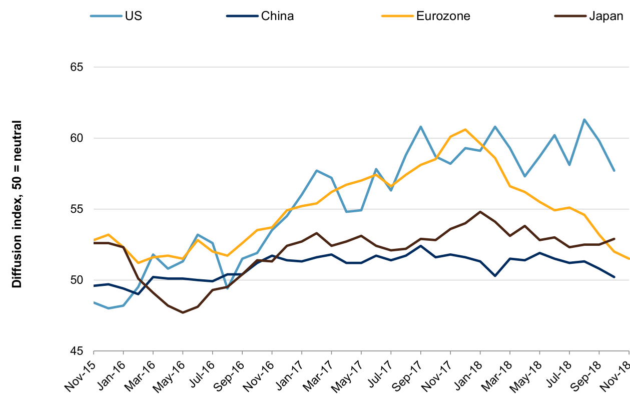
Chart 3

G4 Manufacturing PMIs



Source: CEIC, S&P Global Economics.

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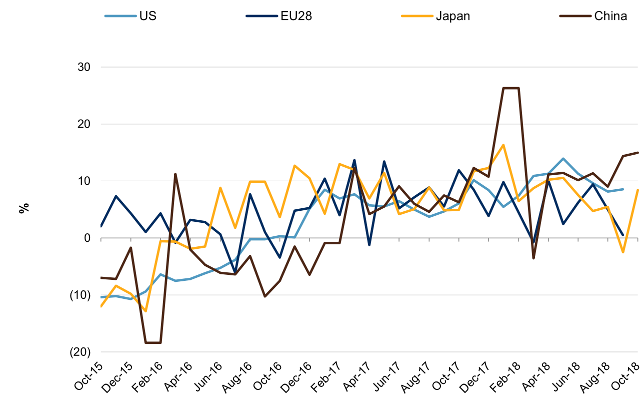
Chart 4

G4 Export Growth

Year on year rate



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Most of the action next year will come from the U.S. Growth in the world's largest economy, which peaked at 4.2% in the second quarter of 2018, will slow continuously, in our view. The drivers will be the waning fiscal stimulus from the personal and corporate tax cuts, as well as the continuation of gradual rate normalization by the Federal Reserve.

We see the fiscal impulse as moderately positive in 2019, assuming little or no spending increases by the new Congress. For the Fed, we forecast three more rate hikes next year, taking the benchmark Federal Funds rates to 3.00%-3.25%, above policymakers' current median estimate of neutral. We see a chance that the Fed turns more dovish after the recent rout in U.S. equity markets, some weakness in the macro data, and softer language from Fed Chair Jerome Powell.

The landing path for the U.S. economy reflects both the output gap and the potential growth rate. When the cyclical dust settles, the output gap will by definition need to be zero (it's currently 0.9%) and the annual rate of growth will need to be at the potential rate of 1.8% (it's now at 3.0%). Simple arithmetic implies that, in order to close the output gap, the economy must not only slow to its potential rate of growth but also fall below that rate to bring the output gap back to zero.

Note that this doesn't necessarily imply a recession; it depends how fast the output gap is closed. For example, to eliminate a 1% output gap, the economy can grow 1 percentage point slower than potential for one year (at a rate of 0.8%) or 2 percentage points slower than potential for two quarters (a contraction of 0.2%). The latter would be a recession, at least according to the widely used definition of two quarters of negative growth (3) while the former would not.

China's growth story will likely be less dramatic than that of the U.S., with the usual caveat about data quality. What is clear is that the deleveraging effort that began in late 2016 had begun to affect growth and economy-wide sentiment more than expected. As a result, the Chinese government put the effort on hold (4). On top of this, the expanding trade war with the U.S. has further weakened confidence, clouding the outlook for 2019.

In response, the authorities have taken a number of policy-easing measures, including lowering the reserve requirement for smaller banks and enacting fiscal stimulus in the form of ramped-up infrastructure spending. The net effects to date have been small--third-quarter growth came in at 6.5%--and there are some concerns that policy traction may be weaker now than in the past. Still,

we still see mild stimulus cushioning the slowdown, resulting in a continued steady decline in reported growth and a lowering of the official target in 2019.

Growth in Europe will continue to decline next year, in our view. We see domestic demand as the main driver of activity. Consumption will benefit from falling unemployment, rising wages, and lower energy prices. Business investment will benefit from solid credit growth, boosted by loose financial conditions and high capacity utilization. The weakness in the third quarter of this year was temporary in our view (with the German economy contracting, weighed down by a sharp decline in automobile production), and we are forecasting growth of 1.6% for 2019, from 1.9% this year.

We continue to factor in a "soft Brexit" in our baseline, although we acknowledge that the odds of that outcome have diminished in recent weeks.

Headline inflation in the eurozone will likely fall next year due to lower oil prices, but core inflation could converge gradually toward the official target of close to, but below, 2%. The European Central Bank (ECB) is set to end its bond-purchase program this month, and we expect an initial rate hike in the third quarter of next year. Nevertheless, the ECB's monetary stance will remain accommodative, with the reinvestment of maturing assets from its bond-purchase program and keeping open-end supply in liquidity to banks through the full allotment procedure. Liquidity provision might happen at shorter duration, since there is no big monetary policy case for relaunching a third round of targeted longer-term refinancing operations (or, TLTROs, which are essentially long-term bank loans at very low rates).

Major emerging economies, excluding China, will likely slow as well next year. We see India's GDP expanding by a still-healthy 7.4% in fiscal 2019, as the country heads into an election year. Outside of the fallout from recent global market volatility and the rise and fall in oil prices, the economy has been largely unaffected by global developments. Indonesia's growth looks set to stay stuck around 5% due to the cumulative effect of policy rate hikes and uncertainty ahead of next year's election. In Brazil, the election of President Bolsonaro in October was received positively by financial markets, loosening domestic conditions via lower interest rates on local and foreign debt. However, we remain cautious given the challenge of approving a comprehensive pension reform, which is needed to fully reactivate the economy.

In Russia, we think the strong macroeconomic policy framework will allow the economy to continue to largely absorb sanction-related shocks. We expect GDP growth to slow next year, to 1.5%, from 1.7% this year, due to the rise in value-added taxes, a slowdown in real wage growth, and tighter credit conditions. Finally, in Turkey, a severe downturn is underway following surging inflation, a sharp deterioration of the lira, and the resulting huge swing in the current account to a surplus, from a deficit of 7% of GDP in the first quarter of this year. We forecast growth of just 0.5% in 2019.

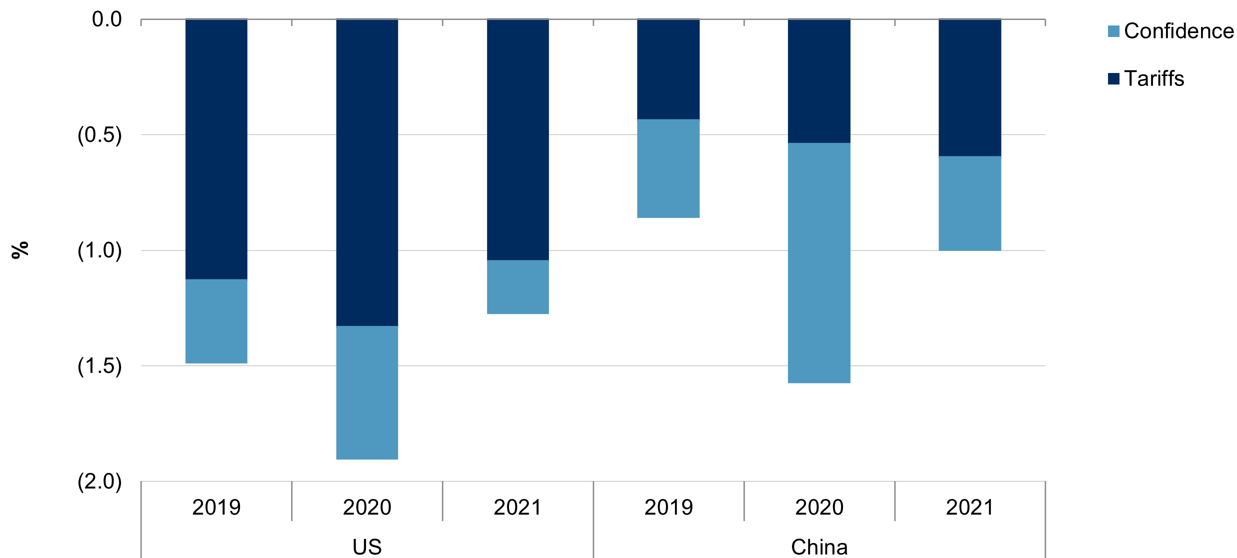
Our Key Global Risks

The top two downside risks to our global economic forecast remain an escalation and broadening of the U.S.-China trade war (see chart 5) and the collateral effects of U.S. interest-rate normalization.

Chart 5

US-China Trade War Effects

Cumulative deviation from baseline GDP, 2010 US$ prices



Sources: S&P Global Economics, Oxford Economics.

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The top risk remains the impact on business and consumer sentiment, spending, and, ultimately, growth from the (temporarily paused) U.S.-China dispute. As we have argued recently, the direct effects on growth in both countries from higher tariffs will be less than 1% of GDP (see chart 5). More difficult to measure are the second-round effects on confidence, spending (both discretionary consumer and investment), and growth. These have started to turn in many countries, although disentangling the cyclical effects from those related to the trade war is problematic.

Moreover, we think the time profile of the attendant risks has received insufficient attention. If what will actually move the growth needle is a slower transfer of technology to China from the West and the relocation of supply chains from China--both of which will take time--then the longer-term effects of the trade war are being underestimated and the shorter-term effects overestimated. The implication is that the substance of U.S.-China negotiations following the recent G-20 meeting, between trade measures and more structural policy measures, will need to be monitored closely. And this risk is not just regarding China. We will also be following U.S. trade policy more generally, where a number of negotiations, including with Japan and the EU, remain unresolved.

Our second key global risk relates to the potential for larger-than-expected effects from the normalization of U.S. interest rates. We would underscore that higher rates themselves don't constitute a risk to the baseline. The Fed, through various channels--including forward guidance and the "dot plot" showing the individual projections of policymakers on the Federal Open Market Committee (FOMC)--has signaled its intentions to the market. In terms of our forecasting, the

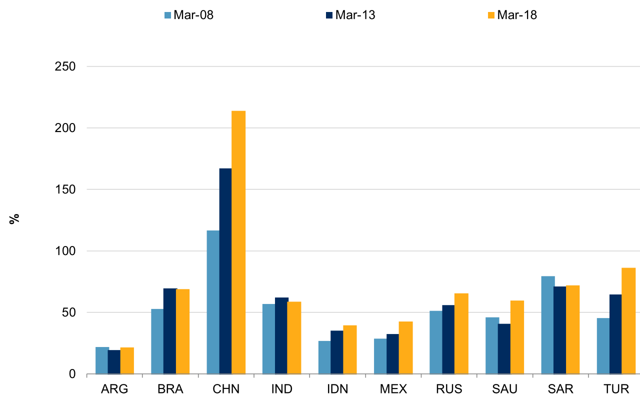
baseline path for U.S. rates is already baked in, including its effects on lending and refinancing costs, as well as assets prices, and the expected response of economic agents.

The risks around U.S. rate normalization are twofold. First, the response to higher rates may be materially different than we assume. For example, tighter financial conditions and a volatile market reaction to our assumed policy rate path could lead to some combination of asset repricing, volatile capital flows, and lower spending and growth. Second, our assumed path of rate increases could turn out to be incorrect, and the pattern of spending and growth along the new path could be materially different from our forecast (5).

The build-up in nonfinancial corporate debt and leveraged lending in the U.S. and elsewhere could become a source of instability if a financing squeeze pushes borrowing costs sharply higher and moves the credit cycle into a correction phase. A host of other macro risks are in play, as well, but these are more regional or country-specific in character and are unlikely to move the global needle. These include disruptions from relatively esoteric financial structures such as covered bonds; a disorderly Brexit; tensions around the Italian budget; questions around the pace of French reforms; and fiscal woes in Turkey and Argentina. (See charts 6-7.)

Chart 6

G20 Emerging Markets
Private non-financial corporate debt-to-GDP



Source: Bank of International Settlements.
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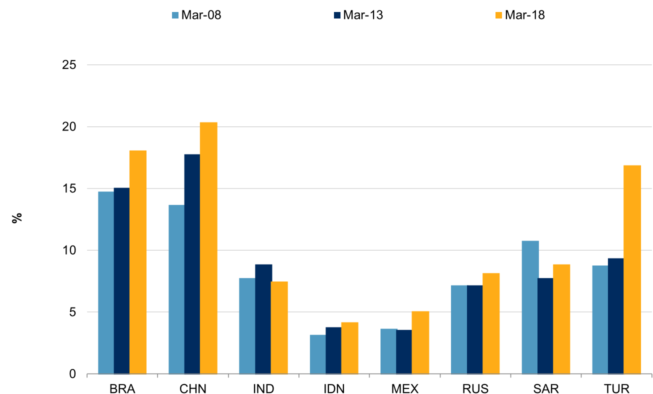
Chart 7

G20 Emerging Markets
Non-financial private sector debt service to income



Source: Bank of International Settlements.
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Is There An Upside?

While the outlook and negatively skewed risk profile are sobering, we want to be constructive and balanced. Is there an upside? What will lead us improve our risk profile, if not our baseline view? It's unlikely that central banks can lead the charge. Given that monetary policy has done the heavy lifting since the global financial crisis, everything below is either fiscal, trade-related, or structural in nature. We list three things from each major economy--the U.S., China and the EU--that could move the needle. These comprise, in order, a change in strategy or way of thinking, a key policy objective, and a stretch goal.

U.S.

Pivot from imposing tariffs against China to starting a new Strategic Economic Dialogue (SED 2.0). We don't dispute that there are areas of real contention between the world's two largest economies. These include intellectual-property rights, trade in sensitive technologies, the desire for bilateral investment symmetry and the ease of doing business, and playing by the rules in both letter and spirit. There is a need to sit down and work things out (the recent G-20 dinner is a start).

We disagree with the idea that imposing across-the-board tariffs is a good way to build trust, avoid collateral damage, and start the process in earnest. We see America's trade imbalance as more optics than anything; and we understand that it's easier to explain politically. But it can be fixed (in aggregate) by the U.S. through increased savings. Tariffs only change the composition of the trade balance, not its level (6). China isn't going away as a rising power, so re-energizing and refocusing the SED, which started under the George H. W. Bush Administration, would be a winner for global confidence, growth and trade.

Launch a Federal infrastructure program. When life gives you lemons, you make lemonade. When midterm elections in the U.S. give Democrats one chamber of Congress, the president should move on an issue that unites him and the opposition: infrastructure. In 2017, the American Society of Civil Engineers once again gave the U.S. cumulative infrastructure a grade of D+ (7). A modest, well-targeted and "shovel ready" plan could help to offset the diminishing fiscal impulse resulting from the expiration of the 2018 tax cuts.

Stretch goal: Stick a toe in the multilateral waters and revisit the Trans-Pacific Partnership (TPP). This would be a climb-down, but symbolism is important. We understand the frustrations with the World Trade Organization (WTO), but that doesn't mean that anything multilateral is toxic and against America's interests. Any long-term strategy around Asia-Pacific will need a framework for the U.S. to engage, and will show China a path toward improved cooperation with the rest of the region. With its focus on not only trade in goods, but services, intellectual property, e-commerce and dispute resolution, the TPP would seem to fit the bill.

China

Recognize that the country's economic model creates frictions with the existing global order. This isn't to say that China doesn't have the right to choose its economic system. Of course it does. China's rise reflects the hard work and ingenuity of its people. It was also greatly facilitated by the post-World War II, U.S.-led global order. The authorities seem unwilling or unable to see that their model creates tensions around "fair trade," the acquisition of intellectual-property rights in exchange for market access, the ability to invest in China as it invests elsewhere, the ability of foreign firms to compete on an equal basis with domestic firms, and transparency and predictability in general. In short, the flipside of issues noted above for the U.S. Recognition of these tensions, and the need to resolve them, would pave the way for SED 2.0.

Give the market a more decisive role in the economy, this time with feeling. This objective, revealed with much fanfare in the Party Plenum of November 2013, has never seriously taken root. Yet, when China does let markets flourish, as in new-economy sectors such as e-commerce, the benefits are often substantial. Progress toward creating a more market-based system with properly functioning credit markets--including more defaults--and rational resource allocation

would go a long way toward convincing the rest of the world that China is moving away from a largely state-led financial model. Moreover, extending domestic markets beyond the bank-centric system to allow for better credit assessment, including meaningful ratings, would widen the available asset classes and help spur growth of the fixed-income investor market.

Stretch goal: Retire the GDP growth target. As we have long argued (8), the official GDP growth target has outlived its economic usefulness. (We realize that it's political and linked to the "China Dream"). The argument is simple: Successful countries don't have growth targets, and China is a successful country. The consequences of continually setting the growth target too high are twofold. First, to achieve the target, the government, via state banks, has tended to pump too much credit into the economy. The target may be achieved but at the cost of low-quality growth as the debt-to-GDP ratio has doubled since the global financial crisis. And policy space has been greatly diminished. Second, since the target must be met or exceeded, the official GDP numbers look suspiciously stable, leading to questions about the reliability of the data. As with the suggested multilateral rapprochement by the U.S., this would be partly symbolic.

The EU

Germany should take the lead and reflate. The eurozone needs coordinated fiscal policy to complement its currency union. The solution could be collective (see our third point below) or could involve individual countries taking into account the externalities of their own actions on the rest of the eurozone. The latter most prominently includes German fiscal policy. While fiscal rectitude may be a virtue at home ("schuld" means both debt and guilt in German) it is suboptimal for the eurozone as a whole. For Germany--the world's fourth-largest national economy and the leader in the region--fiscal stimulus can help to lower an outsized current account surplus (although high corporate savings will still be an issue), including through incentivizing households to convert their high financial savings into household investment.

Italy needs to boost its productivity; fiscal rectitude is second-order. Per-capita GDP in Italy is the same as it was in the late-1990s, which doesn't exactly provide comfort that the future will be better than the past. To use a poker analogy, the young generation of Italians has been bequeathed a bad hand. Macro policy efforts haven't been lacking. Italy runs both a trade surplus and a primary fiscal surplus, and has for most of the recent past. The issue is a complete lack of productivity growth. Rather than turn the screws on fiscal deficit limits, perhaps Brussels could incentivize productivity-enhancing structural reforms to get GDP growing again. Of course, the Italian government needs to display a willingness to let the EU help it. The debt problem will never be solved without growth (see Japan).

Stretch goal: Make life easier for the periphery by partially mutualizing some debt. It is completely uncontroversial to say that the eurozone project needs to be completed. The shortcomings of a monetary union without some sort of fiscal union have been laid bare over the past decade. While the United States of Europe may not be in the cards, some partial and responsible debt mutualization is a necessary step in our view. This would carry benefits, both economic and symbolic--as well as risks (including a "free rider" problem)--and so would need to be carefully designed. But we think such a system is ultimately achievable and necessary. Importantly, such a move would strengthen political support for the future of the euro as it would remove some debt-legacy issues from the struggling periphery. Ongoing discussions over eurozone fiscal capacity go in that direction; however, the scope (0.2% of GDP) and aim (money for

reforms) don't qualify as a tax-stabilization mechanism.

Winter Isn't Necessarily Coming

Arguing that global growth must slow isn't the same as saying that a crisis is coming (9). Some recent commentary seems to conflate the two. We fully agree that global growth will decline in the next year or two. This will be both necessary and healthy. We also agree that the world's largest economy, the U.S., may see GDP growth halve (into the 1%-2% range, if not lower, annualized) between now and mid-2020. However, we don't jump to the conclusion that a crisis, however defined, is coming, or that the U.S. economy must enter into recession.

Ditto for China. We have argued previously that China's sustainable growth rate is around 5.5%, and that trying to maintain the rate of expansion above this rate by "throwing credit at the economy" is unsustainable (10). But again, the path of correction from the current path to a more sustainable one doesn't necessarily run through a hard landing.

At the risk of being Pollyanna-ish, our baseline forecast sees the global economy moving to a slower and more sustainable path in a reasonably orderly fashion in the next year or two. Market bumps and policy mistakes may be down the road. But a crisis outcome strikes us as far-fetched owing to the shallowness of the recovery and the general lack of excesses and major imbalances necessary for such a crisis to occur. The summer season of a 2017 synchronized global upturn may be behind us, but it doesn't follow that winter is coming.

Footnotes

(1)"Global Conditions Are Tightening As Trade And Economic Worries Mount," Dec. 5, 2018.

(2)"It's Hard To See Any Winners In A U.S.-China Trade War," Sept. 5, 2018

(3)The NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is a significant decline in activity spread across the economy, lasting more than a few months; see http://www.nber.org/cycles/cyclesmain.html

(4)"U.S.-China Economic Friction: Technology More Than Trade," Oct. 18, 2018

(5)The magnitude of this depends in part on "who is wrong," assuming that the prevailing Fed view is not priced by financial markets. If the market has to move to the Fed view, then (relative) prices need to change, portfolios need to be rebalanced and the macro needle could move. If the Fed moves to the market view, the risks would be lower.

(6)Combining the identities of $Y = C + I + G + (X - M)$ and $Y = C + S$ yields $S - I = X - M$. Or, savings minus investment equals exports minus imports. So the trade deficit (actually the current account since we are talking about goods and services) implies a shortfall of savings relative to investment.

(7)See https://www.infrastructurereportcard.org/americas-grades/.

(8)"Are China's GDP Growth Targets Bad For Financial Stability?", Sept. 16, 2014

(9)The 10th anniversary of the Global Financial Crisis is top of mind for some analysts, which raises an issue that behavioral economists have called "anchoring." This is a form of priming effect whereby initial exposure to a number (or event) serves as a reference point and influences subsequent judgments about value (see https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/anchoring-heuristic/).

(10)"Can China Close Its Credit Gap Without A Painful Adjustment?" Oct. 10, 2017

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