Global economy expected to remain stable despite manufacturing sector adjustment

~Political and policy risks remain~

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Looking at the global economy from the point of view of cyclical theory, there are currently at least two cycles affecting economic growth. The first of these is the change in the output gap (the discrepancy between current demand and supply capability). A negative output gap suddenly opened up (mainly in developed countries) after the Global Financial Crisis (GFC) in 2008, and gradually closed over the following 10 years. At present, the output gap seems to have almost disappeared or turned positive (excess demand/tight resources). This essentially means that concern over inflationary pressure owing to tight resources has overtaken worries over deflation. Current indications suggest that central banks are finding it increasingly difficult to justify highly unconventional monetary policy (in fact, central banks in developed countries, led by the US, have been searching for an "exit" from easing policies for the last few years).

The second cycle is the shorter business cycle: economic growth started to speed up in mid-2016, peaked in early 2018, and is currently in the process of slowing down. This is the third slowdown that has occurred during the closing of the output gap (discussed above), following on from the slowdown around 2012 due to the European debt crisis, and the slowdown around 2015 due to the commodities market slump. The current slowdown lacks a particular trigger such as a debt crisis or collapse of the commodity market. Rather, it is likely to be the cumulative result of a number of factors: the manufacturing inventory cycle, the slowdown in Chinese private enterprises that followed tighter shadow banking regulation, and more recently, the effects of the European introduction of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP).

As these two cycles overlap, trends of weak business activity and robust employment and household income conditions have emerged. Growth in business activities has stagnated, particularly in the manufacturing sector where inventory adjustment is underway. On the other hand, the labour market is tight enough for the kind of labour shortages indicated by the closure of the output gap. A major labour market correction remains unlikely, and we have seen sustained growth in both employment and wages. At present, we can point to an economic slowdown across almost every region of the world, driven mainly by weakness in the manufacturing sector (see our regional economic outlook reports for further detail). Aside from a handful of emerging economies which are in crisis due to idiosyncratic issues, there are currently very few countries experiencing a major deterioration in their labour markets.

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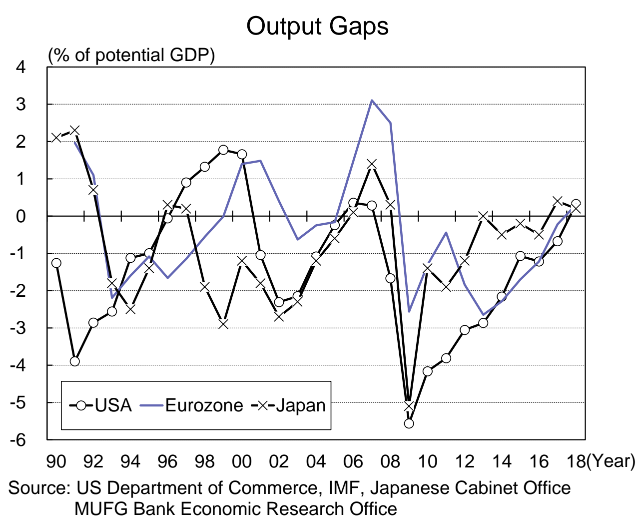
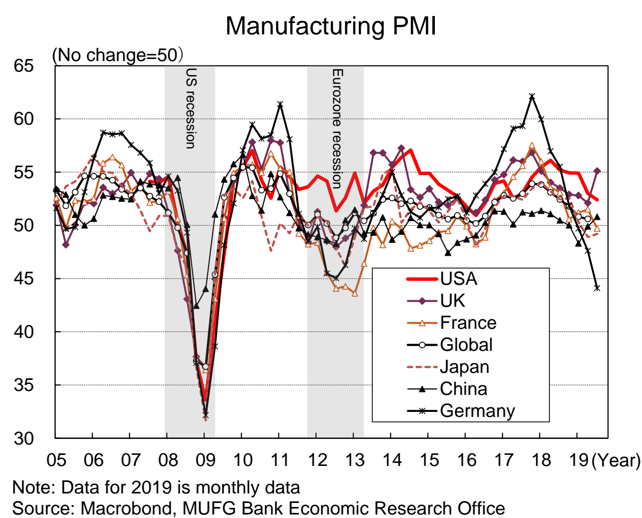


Source: US Department of Commerce, IMF, Japanese Cabinet Office
MUFG Bank Economic Research Office



Note: Data for 2019 is monthly data
Source: Macrobond, MUFG Bank Economic Research Office

The issue is how the current cycles will develop. At least when forecasting over the next year or so, the business cycle (in this case the manufacturing inventory cycle) is likely to bottom out rather than develop into a major downturn, following a similar path to the previous two business cycles mentioned above. This is because at present, there are no particular examples in developed countries of debt expansion (deeply linked to medium-long term change in the output gap) with potential to cause an asset bubble and bust. This means that households and corporates are unlikely to shrink their balance sheets (i.e. prioritise debt repayment over expenditure), and we can expect the economy to bottom out autonomously. However, from the perspective of the output gap cycle, the closure of the gap (utilisation of spare resources) is likely to put a physical constraint on growth. The final result is that growth is likely to remain around potential, especially in developed countries. In Japan, the consumption tax rate will be raised later this year, but the government's accommodative policy response means that the effects of this will be limited and that there is scope for growth around potential.

Nevertheless, there are a few points that should be kept in mind. Firstly, the current business cycle has seen a number of events rooted in political and diplomatic issues: tensions between the US and China, domestic political conflict in the US, and the UK's withdrawal from the EU. These events have exacerbated existing economic uncertainty. For example, the conflict between the US and China has become an unprecedented tit-for-tat tariff war. On top of this, in the fight for technological supremacy, the conflict has escalated to the point where the US and China exclude designated corporate entities from each other. There are fears that this could result in unintended consequences if the secondary or tertiary effects of the trade war intensify. Even if the US and China ultimately reach some kind of agreement on the specific topic of correcting their trade imbalance, uncertainty is unlikely to be easily dispelled. There is no denying that this situation has the potential to disrupt the business cycle. In Europe too, both the outcome of Brexit, and the possibility that a change in the balance of power between populist and established political parties in the European Parliament elections in May could lead to more uncertainty in the financial markets. Having said this, even in the case of a 'no deal Brexit', which would cause major disruption to the UK economy through supply chain disruption (and other factors), the impact on the Eurozone would be limited because the UK only accounts for a relatively small percentage of the region's trade. This means that Brexit-related risk does not figure in the top few global or European risks.

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A second risk is the trend in the real economy of China, one half of the US-China conflict. Real GDP growth has seen a moderate slowdown to around 6.5% YoY. However there are clear indications of a marked stagnation in automotive sales, trade statistics, and the performance of Japanese corporates based in China. In addition to this, there are signs both of the effects of punitive US tariffs, and that shadow banking regulation brought in to tackle debt issues has led to funding problems in private enterprises. China has put policies in place to combat these headwinds, such as monetary easing (starting with cuts to the required reserve ratio) and infrastructure investment. Following on from this, our main scenario is that a sudden slowdown will be avoided. However, we must bear in mind that the issues involved are complex, and that it will take time for central planning to spread to the regions. The possibility of contagion is a major risk for Japan, which has strong economic links with China compared to other developed countries.

Finally, we must pay close attention to the movements of the Federal Reserve Board (Fed) in the US. The Fed has raised rates because the output gap closed to the point that large scale monetary easing could no longer be justified. This is down to the Fed recognising the need to neutralise its monetary policy stance (in order to secure rates at a level whereby they could be cut effectively in response to the next recession). However, the Fed’s rate hikes happened to coincide with political and policy-based concerns and the cyclical economic slowdown. This made investors (and US president Trump) uneasy, leading to a large scale correction in the stock market around late 2018-early 2019. At this point, the Fed chose to pivot away from judgements based on prescriptive monetary policy rules (which aim to anticipate policy effects 6-12 months in advance) towards 'data-dependent' monetary policy judgements. The result of this was a move towards a 'wait-and-see' approach (a temporary suspension of interest rate rises), and an early end to balance sheet reduction. This has had a dramatic soothing effect on financial market volatility. In fact, there has been little change since December 2018 in the major sources of uncertainty that affect the financial markets like news on China-US trade frictions or economic data. The only major change has been in the Fed's monetary policy position. Aside from clearly demonstrating the impact of monetary policy, this shows that business leaders, investors and consumers are expecting too much of monetary policy. Historically, there have been many examples of economic entities’ reliance on monetary policy resulting in asset bubbles. Whilst it would be wrong to say that the current situation is particularly setting off alarm bells, reliance on accommodative monetary policy by households, corporates and financial markets is a medium-long term risk that needs monitoring. There is a risk that this reliance could restrict the Fed's monetary policy decisions. Assuming that the economy and the markets remain stable, this could cause the Fed to turn away from data-dependent decision making, switching back to a rule-based approach. As a consequence, there remains potential for the Fed to make around two further interest rate hikes with a view to neutralise policy rates. In the short term, all eyes will be on the forward guidance given at the March meeting of the Federal Open Market Committee (FOMC), and on the financial market's reaction to it.

Table of Global Economic Forecasts

Region	Economy	Nominal GDP (2017)		Real GDP (YoY, %)			CPI (YoY, %)			Current Account (Billion USD)		
		Trillion USD	Japan=100	2017	2018	2019	2017	2018	2019	2017	2018	2019
	World (41 economies) (GDP weighted average)	66.83	1,353	3.3	3.3	3.0	2.2	2.6	2.3			
	Advanced economies	43.77	886	2.3	2.3	1.9	1.7	2.0	1.7			
	Emerging economies	23.07	467	5.3	5.2	5.0	3.1	3.9	3.4			
Asia & Oceania	Japan (FY)	4.94	100	1.9	0.7	0.8	0.7	0.8	0.8	197	167	152
Asia & Oceania	Asian 11 economies	19.62	397	6.1	6.0	5.7	2.0	2.3	2.3	401	234	193
Asia & Oceania	China	12.01	243	6.8	6.6	6.2	1.6	2.1	2.2	165	49	34
Asia & Oceania	India (FY)	2.60	53	7.1	7.3	7.5	3.6	3.4	3.6	- 49	- 60	- 71
Asia & Oceania	NIEs 4 economies	2.78	56	3.2	2.8	2.4	1.4	1.4	1.6	237	227	222
Asia & Oceania	Korea	1.54	31	3.1	2.7	2.5	1.9	1.5	1.7	78	77	71
Asia & Oceania	Taiwan	0.57	12	3.1	2.7	2.1	0.6	1.4	1.1	83	75	72
Asia & Oceania	Hong Kong	0.34	7	3.8	3.0	2.4	1.5	2.4	2.4	15	11	10
Asia & Oceania	Singapore	0.32	7	3.6	3.2	2.5	0.6	0.4	1.0	61	65	68
Asia & Oceania	ASEAN5	2.32	47	5.4	5.2	5.0	3.0	2.8	2.9	48	18	9
Asia & Oceania	Indonesia	1.02	21	5.1	5.2	5.1	3.8	3.2	3.6	- 16	- 31	- 28
Asia & Oceania	Thailand	2.32	47	5.4	5.2	5.0	3.0	2.8	2.9	48	18	9
Asia & Oceania	Malaysia	0.31	6	5.9	4.7	4.5	3.8	1.0	1.3	10	8	8
Asia & Oceania	Philippines	0.31	6	6.7	6.2	6.1	2.9	5.2	3.9	-2	-7	- 8
Asia & Oceania	Vietnam	0.22	4	6.8	7.1	6.5	3.5	3.5	3.8	6	14	7
Asia & Oceania	Australia	1.38	28	2.4	3.0	2.8	1.9	1.9	2.0	- 36	- 36	- 36
America	USA	19.49	394	2.2	2.9	2.4	2.1	2.4	2.1	- 449	- 472	- 477
America	Latin America (6)	4.65	94	1.7	1.3	1.9	6.9	9.4	6.6	- 73	- 82	- 85
America	Brazil	2.06	42	1.1	1.1	2.2	3.4	3.9	4.0	- 6	- 13	- 30
America	Mexico	1.15	23	2.1	2.0	2.0	6.0	4.8	3.7	- 19	- 23	- 23
America	Argentina	0.64	13	2.9	- 2.4	- 1.4	24.0	44.0	25.0	- 32	- 25	- 10
Europe	Euro area (19)	12.63	256	2.4	1.9	1.4	1.5	1.8	1.5	411	404	371
Europe	Germany	3.70	75	2.2	1.4	1.2	1.7	1.9	1.6	295	294	267
Europe	France	2.59	52	2.3	1.5	1.3	1.2	2.1	1.5	- 15	- 20	- 13
Europe	Italy	1.94	39	1.6	0.8	0.3	1.3	1.2	1.1	54	53	48
Europe	UK	2.63	53	1.8	1.4	1.3	2.7	2.5	1.9	- 88	- 110	- 90
Europe	Russia	1.58	32	1.5	2.3	1.3	3.7	2.9	4.2	33	106	85

Reference

	Nominal GDP (2017)		Real GDP 2017	Real GDP 2018	Real GDP 2019	CPI 2017	CPI 2018	CPI 2019	Current Account		
Weighted mean of 41 economies' GDP based on purchasing power parity			3.8	3.9	3.6	2.4	2.9	2.5			

Note 1: CPI for Japan is on a general basis excluding perishable items, in the Eurozone and UK are based on the EU Harmonised Indices of Consumer Prices (HICP)

Note 2: Published figures for Japan, India are on a fiscal-yearly basis (April-March the following year). "41 economies" "Advanced economies" and "Emerging economies" are based on the calendar year

Note 3: According to IMF classification, "Advanced Economies" are Japan, NIEs economies, USA, the 19 Eurozone countries, UK. "Emerging Economies" are China, India, ASEAN5, Latin America and Russia.

Note 4: "Latin America" includes Columbia, Chili, Peru as well as Brazil, Mexico, Argentina.

Source: Each country's national statistics, MUFG Bank Economic Research Office

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