Moderate expansion expected to continue even as global political and policy risk intensifies

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In the previous edition of the global outlook (published in February), we posited the existence of two cycles: a long term cycle (lasting around 10 years) bound by the output gap, and a short term business cycle (lasting 2-3 years) led by the manufacturing cycle. Following on from this, based on the lack of standout examples of financial instability in major countries and the fact that labour markets are robust, we suggested that the long term cycle was unlikely to trend downwards in the short term. Despite short term weakness in the business cycle, we proposed that the economy was likely to bottom out autonomously within a year.

Though this edition of the global outlook extends the forecast horizon to 2020, the fundamentals of this theory still apply. Based on data for major advanced economies and China since early spring, the downturn in manufacturing is ongoing. However, the situation could be worse. PMI data suggest that manufacturing is at a similar level to during the European debt crisis (2012-2013) and the collapse of the commodity market (late 2014-early 2016). The automotive and semiconductor sectors, which are particularly reflective of cycles within the manufacturing industry, have both experienced a downturn as a rebound from investment and healthy sales that lasted until 2017. That said, bringing the following into consideration, there is no need to be overly pessimistic about the state of the global economy:

1. monetary and fiscal stimulus measures are well underway in China (which has seen pronounced weakness in both the automotive and semiconductor sectors)
2. technological advances tend to support demand for semiconductors, and we expect a cyclical recovery from the current downward trend (the result of a slump in smartphone sales),
3. there has been a slump in automotive sales in the US and China (the two largest markets), but it is unlikely that the Chinese market would be saturated at around 30 million new auto sales per year, let alone the market in the US which is a mature advanced economy.

Based on the fact that employment and income conditions remain stable, final demand is expected to continue to expand unimpeded, and the manufacturing cycle is likely to exit its adjustment phase over 2019-2020. Business investment has been more robust than expected

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both in Japan and elsewhere, indicating that businesses' views on the outlook aren't necessarily bleak.

Even so, given recent economic developments, it is vital to hold downside risks at the forefront of our minds when looking at the economic outlook. This is down to political and policy factors in major economies, particularly in the US where the unpredictable nature of the Trump administration renders it difficult to predict the content and influence of foreign policies using conventional forecasting techniques. The two main issues that are currently in the news are the escalation of US-China trade frictions and US tariffs on Mexico related to illegal migration from Mexico to the US.

In terms of analysing the current policies, the US-Mexico trade issue seems to have been settled (for now) with the United States-Mexico-Canada Agreement (USMCA), a renegotiation of the North American Free Trade Agreement (NAFTA). In fact, 'trade friction' was never the reason why tariffs were put in place in the first place. The tariffs can be explained as president Trump's chosen method to force Mexico's hand in addressing the migration issue after he stood on an anti-illegal immigration election platform. Based on the fact that Mexico is also willing to be proactive with policies to prevent illegal migration, it seems likely that the US and Mexico will reach an agreement allowing them to avoid getting mired in tariff issues. The conflict with China on the other hand is more about technological supremacy and security than it is about trade issues, meaning that the US and China are likely to continue their tariff war. There is potential for some kind of temporary agreement, but considering the fact that the US would be involved in the potential verification of any agreement, it follows that the conflict would be likely to continue.

Of course, with these kinds of policy issues, it is often difficult to judge the length and extent to which policymakers will maintain a hard-line stance. This is especially true when it comes to the US where an election is due to take place next year. Some commentators claim that, given the fact that he is seeking re-election, Trump is unlikely to continue to put forward policies that would place considerable pressure on the economy or financial markets. However, given the fact that these policies could be framed in terms of security, or to build the Trump's image as a political strongman in the face of foreign policy issues, it is hard to say whether or not Trump will chose to prioritise the economy.

Another key issue here is monetary policy. Following instability in the financial markets in late 2018 and early 2019 and the global slowdown in economic growth centred on manufacturing, the Fed adopted a 'wait and see' approach to monetary policy in early spring. Following on from this, we have adjusted our interest rate forecasts from two hikes this year in February's Outlook to zero projected rate increases this year in this current edition. However, as Trump continues to walk along the largely untrodden path of unusually hawkish trade policy, an adverse reaction from households, corporates or the financial markets becomes increasingly likely. This being the case, it seems logical to expect the monetary easing to counteract this. In fact, President Trump has publicly (via Twitter etc.) made requests to the Fed to cut rates, and interest rates have fallen on US 10-Year Government Bonds on the back of market demand for interest rate cuts. In an advanced economy like the US, where observers place a high value on the independence of the Central Bank, we are hesitant to declare that rate cuts are likely to

take place as a result of presidential pressure. Nevertheless, it is worth bearing in mind that the Trump administration has already overturned a number of political and policy conventions. If the Fed maintains its current policy framework, it is possible that it could resume rate hikes in the context of the tight labour market after the presidential election at the end of 2020. However, the framework is currently under review, the outcome of which we will need to monitor closely.

To summarise the effects of the US-China trade war from China's point of view, there is no doubt that both the tariff war and economic sanctions on designated corporate entities are putting downward pressure on the economy. However there is room for discussion on whether or not Chinese growth rates can be mainly attributed to the tech sector (which has been the main battleground for the current friction with the US). China can be seen as currently undergoing rapid urbanisation similar to that which occurred in Japan in the 1960s. Though overinvestment can be observed in the short term, it is likely that the huge underlying demand for infrastructure and real estate investment will persist. This kind of demand for investment is a major driver of economic growth in China, making infrastructure investment an effective and quick-acting policy tool to counteract the effects of the US-China conflict. Following on from this, though we must monitor excessive debt related financial indicators, we expect infrastructure investment to support economic growth. This is likely to compensate for the US-China conflict, avoiding a potential drag on GDP growth of around 1.0 percentage point. We must also keep a close eye on the consequences of US tariffs and sanctions, with Chinese and foreign investors in high-tech industries likely to be forced to restructure supply chains, as well as potential for disruption to other sectors and financial markets.

The situation in Europe from late-2019 into 2020 also warrants our attention. In terms of Brexit, the focus is currently on the search for a successor to prime minister Theresa May, who recently resigned. No matter her successor, it is highly likely that Brexit related confusion will resurface in late October in the lead up to the next Brexit deadline. The EU and ECB's leadership teams are also due to change this autumn, making it difficult to forecast their policy direction for next year. However, setting political and policy related factors aside, heathy income and employment conditions will continue to support the European economy, and adjustment in the manufacturing sector is likely to bottom out early next year. This would bring the possibility of ECB interest rate hikes into the realms of possibility.

Looking lastly at Japan, the key talking points at the moment are the current assessment of the economy, and the planned rise in consumption tax. While the manufacturing sector is increasingly undergoing adjustment related to weakness in external demand centred on China, corporate earnings remain robust and both households' employment and income conditions and corporate incomes are stable. The consumption tax rise is also unlikely to lead to major economic stagnation because it will be packaged together with mitigating measure and policies to support household spending (consumption tax relief, expansion of free schooling). Consumer sentiment is likely to be supported into next year by the upcoming Tokyo Olympics, meaning that GDP growth could reach 0.7% YoY in both 2019 and 2020.

Table of Global Economic Forecasts

Region	Economy	Nominal GDP (2018)		Real GDP (YoY, %)			CPI (YoY, %)			Current Account (BillionUSD)		
		Trillion USD	Japan=100	2018	2019	2020	2018	2019	2020	2018	2019	2020
	World (41 economies) (GDP weighted average)	70.97	1,431	3.3	2.9	2.7	2.5	2.4	2.4			
	Advanced economies	46.32	934	2.2	1.9	1.5	2.0	1.6	1.8			
	Emerging economies	24.66	497	5.2	4.9	5.0	3.6	3.9	3.6			
Asia & Oceania	Japan (FY)	4.96	100	0.6	0.7	0.7	0.8	0.8	0.8	175	166	164
Asia & Oceania	Asian 11 economies	21.50	433	6.0	5.6	5.5	2.3	2.3	2.4	231	190	180
Asia & Oceania	China	13.41	270	6.6	6.2	6.0	2.1	2.3	2.1	49	48	40
Asia & Oceania	India (FY)	2.72	55	6.8	7.3	7.4	3.4	3.7	4.1	- 60	- 71	- 76
Asia & Oceania	NIEs 4 economies	2.93	59	2.8	2.0	2.2	1.4	1.4	1.6	221	208	215
Asia & Oceania	Korea	1.62	33	2.7	2.0	2.2	1.5	1.5	1.8	77	65	68
Asia & Oceania	Taiwan	0.59	12	2.7	1.9	2.0	1.4	0.8	1.0	68	68	70
Asia & Oceania	Hong Kong	0.36	7	3.0	2.2	2.3	2.4	2.2	2.2	11	10	10
Asia & Oceania	Singapore	0.36	7	3.1	2.2	2.3	0.4	0.8	1.0	65	65	67
Asia & Oceania	ASEAN5	2.44	49	5.2	4.8	4.9	2.8	2.5	2.8	21	6	2
Asia & Oceania	Indonesia	1.02	21	5.2	5.1	5.1	3.2	3.2	3.6	- 31	- 31	- 30
Asia & Oceania	Thailand	0.49	10	4.1	3.1	3.2	1.1	1.1	1.2	38	32	30
Asia & Oceania	Malaysia	0.35	7	4.7	4.4	4.5	1.0	0.7	2.1	8	8	7
Asia & Oceania	Philippines	0.33	7	6.2	5.9	5.9	5.2	3.3	3.1	-7	-9	- 10
Asia & Oceania	Vietnam	0.24	5	7.1	6.5	6.2	3.5	3.1	3.5	14	5	5
Asia & Oceania	Australia	1.42	29	2.8	2.4	2.6	1.9	1.6	2.0	- 30	- 33	- 38
America	U.S.A	20.49	413	2.9	2.5	1.7	2.4	2.0	2.1	- 489	- 494	- 499
America	Latin America (6)	4.47	90	1.2	1.3	1.9	8.1	9.4	8.1	- 90	- 84	- 93
America	Brazil	1.87	38	1.1	1.2	2.0	3.7	4.0	4.0	- 15	- 25	- 30
America	Mexico	1.22	25	2.0	2.0	1.7	4.9	3.8	3.6	- 22	- 23	- 24
America	Argentina	0.52	10	- 2.5	- 2.0	0.5	34.3	45.0	36.0	- 28	- 8	- 10
Europe	Euro area (19)	13.67	276	1.8	1.3	1.5	1.8	1.3	1.6	395	381	450
Europe	Germany	4.00	81	1.5	1.1	1.5	1.9	1.6	1.5	291	298	338
Europe	France	2.78	56	1.7	1.3	1.4	2.1	1.5	1.5	- 8	- 26	- 4
Europe	Italy	2.07	42	0.8	0.3	0.7	1.2	1.1	1.1	52	43	46
Europe	U.K.	2.83	57	1.4	1.3	1.3	2.5	1.9	2.1	- 109	- 95	- 94
Europe	Russia	1.63	33	2.3	1.3	1.5	2.9	5.0	4.3	106	85	74

Reference

			Real GDP 2018	Real GDP 2019	Real GDP 2020	CPI 2018	CPI 2019	CPI 2020			
Weighted mean of 41 economies' GDP based on purchasing power parity			4.0	3.6	3.5	2.6	2.6	2.7			

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, United States, 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: Statistics from each country, MUFG Bank Economic Research Office "

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