Global economy to remain resilient despite markedly high political and policy risks

AKIHIKO SATO
ECONOMIC RESEARCH OFFICE

MUFG Bank, Ltd.
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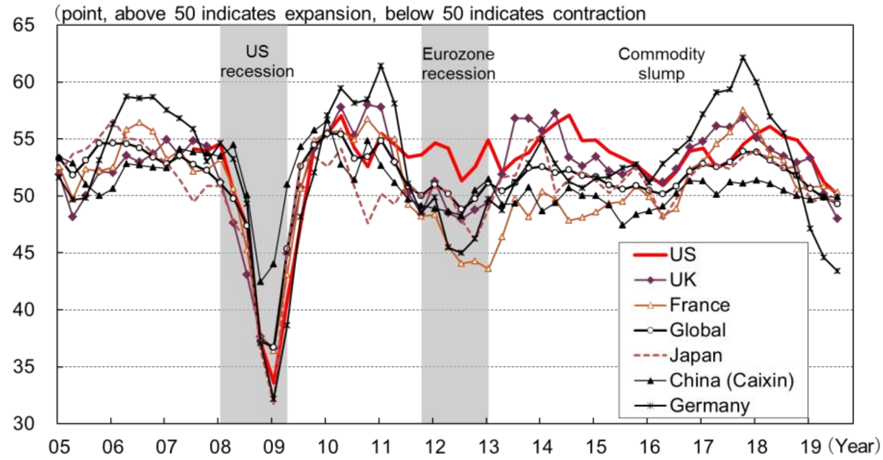
Political and policy uncertainties surrounding the global economy have grown further since our last Outlook report was released three months ago, and the global economy appears to be slowing, with a drag from the manufacturing sector.

In the April-June quarter, the UK and Germany were among key European economies that registered a quarter-over-quarter (QoQ) contraction in real gross domestic product (GDP). US growth rate moderated from the January-March quarter. While robust personal consumption expenditures drove the GDP growth, capital investment and net exports had negative contributions to the growth. Meanwhile, China drew attention for registering its slowest ever growth rate in quarterly GDP statistics. Many other emerging economies also logged lower growth rates than for the previous quarter. While some Asian emerging economies saw accelerated GDP expansion, most Latin American economies registered decelerated GDP expansion. Japan logged a solid 1.8% annualized QoQ growth rate in the April-June quarter, supported mainly by final demand in the private sector. Even so, the pace of growth has slowed from the January-March quarter as production and business sentiment languished.

At the center of the broad-based slowdown in growth and sluggish economic sentiment lies the manufacturing sector. Production indexes and purchasing manager indexes (PMIs) began sliding around late-2017 to early-2018 in Europe, Japan and China (Chart 1 next page). The same trend has been seen in the US since mid-2018. While almost all manufacturing industries have been struggling, this report will highlight protracted downtrends in key industries like automotive and semiconductors/electronic and electric equipment. These industries are in a cyclical downtrend following a boom seen in late 2016 to 2017 when economic growth was accelerating. In addition, they are currently faced with issues like the US-China trade conflict and the Brexit that would force manufacturers to revamp global supply chains. There is no sign of resolutions for these issues in sight, and this is weighing on the industries.

Chart 1：Manufacturing PMIs of Major Economies

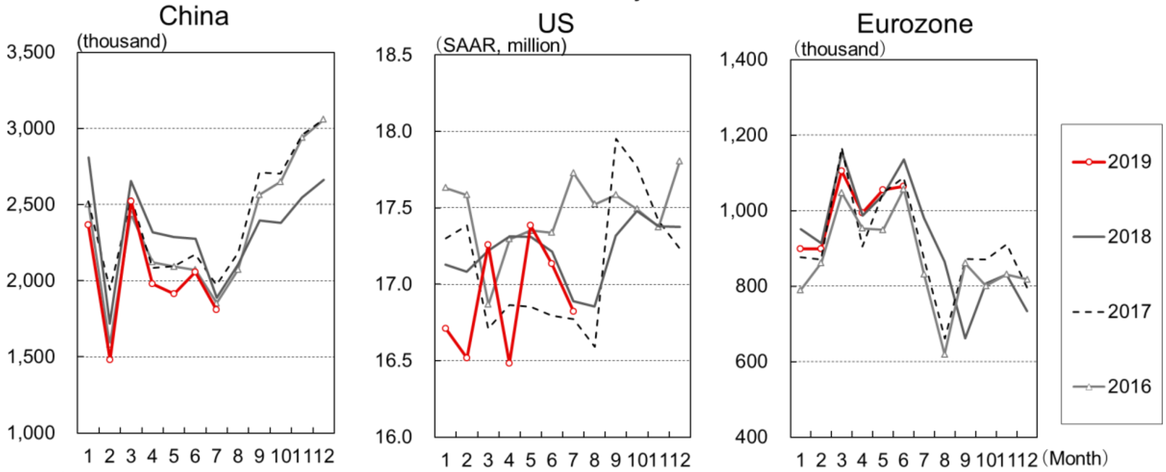


Note: For 2019 Q3, Global, UK, China PMIs are July-only figures, others are July-Aug average.
Source: IHS Markit, MUFG Bank Economic Research Office

For the semiconductor/electronics and electric equipment industry, a global decline in smartphone sales poses headwind. The industry also faces uncertainties because it lies at the heart of high-tech and digital realms, the main battleground of the US-China conflict. The conflict revolves around not only US trade deficit with China but also national security issues and rivalry for technology dominance. China has long functioned as a global supply hub for semiconductors as well as for electronic and electric equipment. Yet in this new age of trade frictions, US President Donald Trump recently told US companies in a Twitter feed: “Our great American companies are hereby ordered to immediately start looking for an alternative to China.” Concerns have heightened that US retaliatory tariffs would significantly erode the cost-competitiveness of Chinese exports to the US. As the top US official publicly urges American companies to shift away from China-reliant supply chains, companies around the world (not just in the US) are increasingly holding off investments to gauge the situation. Meanwhile, China’s deleveraging policy from late 2017, aimed at cracking down on shadow banking, is said to have hurt the financing environment for private-sector companies, especially small and medium-sized enterprises. With these factors at play, Chinese demand has languished for raw materials and capital goods including semiconductor production equipment, and the impact is being felt around the world through trade channels.

As for the automotive industry, the current downtrend is chiefly characterized as a drop-off from the global uptrend through 2017. Yet situations vary slightly from market to market (Chart 2 next page). In China, the world’s biggest auto market, year-to-date auto sales volume has been down by double digit percentages (YoY) consistently from the start of the year. A demand slowdown after the 2017 expiration of tax incentives is still lingering, and consumer worries over the escalating trade war with the US appears to be taking a toll as well. In Europe, sluggish sales in Southern Europe seem to be dealing a blow to the German auto industry, the biggest in the region. In North America and Japan, sales declines have been mild when compared with the conditions of other markets. Nonetheless, the outlook for the automotive industry is fairly murky as the US threatens tariffs to other countries on national security grounds. Another uncertainty factor is structural changes driven by environmental regulations and other changes such as the rise of vehicle-sharing services.

Chart 2: Auto Sales in Major Economies



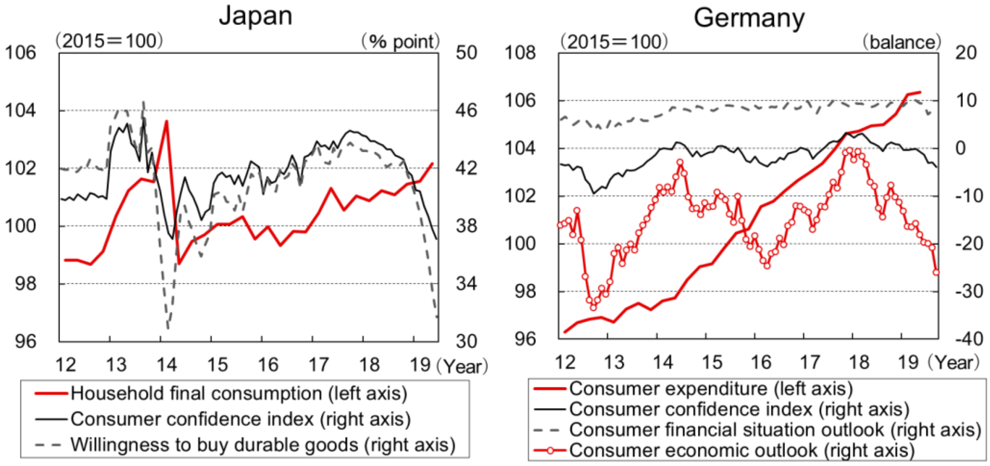
Note: SAAR indicates seasonally adjusted annual rate.
Source: Statistics from each country, MUFG Bank Economic Research Office

The manufacturing plateau thus may be stemming not only from business cycles but also policy variables on trade, national security, environmental regulations, as well as innovation and other changes for the future. Policy uncertainties are undoubtedly considerable. With the US presidential election scheduled for next year, the eventual outcome of the US-China conflict is difficult to predict, as is its impact on the global economy. Faced with great uncertainties over the US-China conflict, Federal Reserve Chairman Jerome Powell conceded in a recent speech that there are “no recent precedents to guide any policy response to the current situation.” Other key issues such as the Brexit are equally difficult to predict.

Nevertheless, the ongoing manufacturing slump is unlikely to lead to a serious economic downturn, albeit with a caveat that policy uncertainties are substantial. Negative factors that have dragged down business investment are expected to run their course in YoY changes, and clouds hanging over the economy likely will gradually clear from as early as the first half of 2020.

One reason is that the service sector is driving job growth. While manufacturing continues to be a very important sector, a manufacturing job decline generally does not lead to a broad-based decline in non-manufacturing jobs. This is true in both advanced and emerging economies, except for certain countries facing special circumstances. By and large, household income does not take a serious hit unless companies slash jobs and wages significantly. Consumer spending thus tends to grow in sync with income growth. This explains why consumer spending (i.e. retail sales) has been resilient even as various uncertainties have chilled household sentiment in a number of countries (Chart 3 next page). Solid consumer spending therefore has ample potential to absorb the sluggishness in business-sector demand (capital investment and inventory investment), as well as net exports. Because inventory investment and net exports tend to fluctuate widely, some countries may experience a technical recession, or two consecutive QoQ declines in real GDP. Yet a full-blown global recession characterized by a crash of consumption and the job market is highly unlikely. This view is supported by the fact that households in major economies are not exposed to great risks of asset value fluctuations combined with massive debts. Household balance sheet adjustments are hence unlikely.

Chart 3: Consumer Spending and Consumer Confidence



Source: Cabinet Office (Japan), Federal Statistical Office (Germany), European Commission, MUFG Bank Economic Research Office

The second reason is that central banks around the world are increasingly adopting a more accommodative monetary policy as a precaution, in view of the ongoing manufacturing slump, declined business sentiment, trade war uncertainties, and low inflation. Policy interest rates in major advanced economies are still at historically low levels. The Federal Reserve and the European Central Bank (ECB) were tightening monetary policy as of last year, and how much of an effect this had on curbing growth in the real economy (rather than uptrends in financial markets) is a question open to debate. By the same token, future monetary easing may have a limited effect, especially in stimulating real investment. Nevertheless, monetary easing still sends a positive message to the equities and other financial markets. This has prevented a vicious cycle of irrational flight to “quality” leading to an actual market crash. With interest rates already low and leaving little room for further monetary easing, some are turning focus to fiscal policy – the other macroeconomic policy tool – to stimulate the economy. Germany faces the biggest concern over an economic downturn among key advanced economies. That the country has a fiscal surplus (ample resources to carry out stimulus measures) is reassuring.

The third reason is that even the manufacturing industries where business sentiment has declined most notably (i.e. automotive, semiconductors etc.) are expected to eventually revert to an uptrend because of long-term demand growth. An assumption that these industries have hit a demand inflection point due to structural changes is unwarranted. In the semiconductor/electronics and electric equipment industry, technology is constantly evolving in the information and communications realm and digital realm, as represented by the 5G and artificial intelligence, for instance. Therefore, demand growth underpinned by structural changes is expected to absorb the short-term downward pressure causing inventory adjustments. The same holds true for capital goods such as semiconductor production equipment. In the automotive industry, demand is expected to grow steadily thanks to the ongoing motorization of China as well as the future motorization of India and other markets. Furthermore, factors including stricter environmental regulations in China, Europe and certain parts of the US are propelling structural changes for the industry, both in technology and business model. These considerations should diminish a gloomy outlook that the current demand slump will continue for the medium to long term.

For the above mentioned reasons, our outlook for the global economy through next year can be summarized as follows:

- The current manufacturing downtrend will likely continue through the first half of next year, based on analysis of past manufacturing business cycles.
- Solid household demand (i.e. consumer spending) is expected to bolster the economy, and business sector is projected to gradually revert to an uptrend after some time.
- Economies around the world would revert to a growth track where the pace of expansion is near their respective potential growth rates.

The reasoning for the above outlook is that if household final demand remains solid and there is no financial-market changes that drastically hurt the financing environment for companies, then businesses activity should undergo a cyclical (albeit mild) recovery. For companies, holding off investments too long, including for research and development, could do critical damage for future growth. Therefore, businesses are likely to continue investing while revamping global supply chains to adapt to a new trade order. Based on the above, we project that the US real GDP will grow by around 2% YoY, Eurozone real GDP by 1.4% YoY, and Japan real GDP by 0.7% YoY in 2020.

That said, uncertainties that could sway the course of events going forward should also be expounded. The biggest uncertainty, as we mentioned before, is the US-China trade friction. As has been clear from the start, the US-China conflict is driven by competition for technology dominance and national security issues rather than trade matters. A fundamental solution is therefore unlikely in the near term, and both countries are taking various steps to mitigate the impact on the domestic economy. One question to highlight is how to interpret the US decision to delay additional tariffs announced on August 1. The US announced plans to impose tariffs on $300 billion of imports from China including consumer goods starting September 1. Yet it decided shortly after to put off the tariffs until December for items that are difficult to source from elsewhere, out of considerations for impact on Christmas shopping. China accounts for high proportions of US imports in the product categories for which the tariffs will be delayed. One interpretation would be that the US is rethinking plans to impose the tariffs in full swing due to concern that the domestic economy will take a direct hit and how that may impact the presidential election next year. The other interpretation would be that the US will eventually go full force with the tariffs in order to propel a shift away from China-dependent supply chains, and that the delay is simply a temporary grace period because companies need more time to relocate supply chains. Some US companies that support the Trump administration's China policy have insisted that they need more time to relocate supply chains. And as noted before, President Trump himself has "ordered" US companies to look for alternatives to China. With these considerations in mind, it would be safer to assume the latter.

Should the trade war escalate further, the US economy is expected to take a hit mainly in consumer spending, and the Chinese economy would take a hit in domestic production and investment. If both countries come to impose 30% additional tariffs against each other on all items, we project the drag (through trade channels) on the US real GDP growth rate will be 0.4% point, and that on China's real GDP growth rate will be 1.2% points. The US would absorb the impact with growth potential in other areas of the economy. China would mitigate the impact through fiscal and monetary policies, as well as measures to shore up specific industries. At this point, it is difficult to predict the two countries' future actions and responses. Yet, based on recent steps taken by the Trump administration and the Chinese government's response, the US appears to believe that China's sore spot is concern over capital flight and the domestic economy, and China appears to believe that US sore spot is the 2020 presidential election. The two sides' respective negotiation strategies seem to be built on these assumptions, although there is much room for misunderstandings and misalignment in perception.

Another key area of uncertainty for the global economy is central bank monetary policies, especially of the Federal Reserve and the ECB. Even though the manufacturing sector is in a slump and inflation is low, unemployment rates are at historically low levels in many countries. Normally this condition would not warrant major interest rate cuts. A textbook scenario therefore would be to cut interest rates in small increments as "an insurance policy" and observe the situation. This aligns with our general projections as well. However, there is a good chance that this scenario does not play out. One key reason is that President Trump is exerting unprecedented pressure on the Federal Reserve to carry out major rate cuts in order to sustain growth in the domestic economy amid the US-China trade war and the 2020 presidential campaign. Separately, the ECB is considering monetary easing in view of declines in business sentiment and inflation rate. Combined effects of monetary easing by the Federal Reserve and the ECB could impact decisions by other central banks including the Bank of Japan. The underlying assumptions for next year's interest rate environment could be altered significantly depending on what happens by the end of this year between President Trump and the Federal Reserve, among other factors.

Other variables for the global economic outlook include the Brexit, political developments in Europe, Japan's consumption tax hike, Japan-US trade negotiations and the Middle East conditions. The outlook for the Brexit is increasingly murky as the Boris Johnson government pushes for an end-of October exit from the EU with or without a deal. The parliament may proceed with a vote of no confidence, which would dissolve the legislature and extend the Brexit deadline slightly as a result. Meanwhile, Prime Minister Johnson has decided to suspend parliament from September to October. How the issue will unfold going forward appears to depend on political maneuvers. If the UK and the EU manage to find a middle ground and the same happens between the Johnson government and the parliament, the possibility of a no-deal Brexit would diminish, and uncertainties surrounding the European economy would gradually fade. Business investments would then pick up and create a tail wind for the economy. If a no-deal Brexit becomes more likely, then the UK economy would be on course to a decline, as logistics operations go into turmoil. The EU would not be able to escape negative impact either.

As for Japan's consumption tax hike set to take effect in about a month, last-minute demand surge before the tax increase has not been substantial yet, but certain levels of demand rise likely will be seen in September. With many measures in place to mitigate the impact and even out demand, however, the drag on the economy is expected to be limited compared with past tax hikes. Employment and consumption have been solid in Japan, and capital investments have been resilient as businesses seek to compensate for labor shortages. While the global economy faces great uncertainties, Japan is slated to host the Tokyo summer Olympics next year, which is expected to shore up consumer sentiment. Thus, we project that Japan's real GDP will grow by about 0.7% YoY in 2020 as long as it stays clear of major shocks from abroad.

Table of Global Economic Forecasts

		Nominal GDP (2018)		Real GDP (YoY, %)			CPI (YoY, %)		
		Trillion USD	Japan=100	2018	2019	2020	2018	2019	2020
	World (41 economies) (GDP weighted average)	70.97	1,430	3.3	2.8	2.7	2.5	2.3	2.4
	Advanced economies	46.32	933	2.3	1.7	1.6	2.0	1.5	1.7
	Emerging economies	24.66	497	5.2	4.8	4.8	3.5	3.8	3.7
Asia & Oceania	Japan (FY)	4.96	100	0.7	0.8	0.7	0.8	0.8	0.8
Asia & Oceania	Asian 11 economies	21.50	433	6.0	5.4	5.5	2.3	2.3	2.3
Asia & Oceania	China	13.41	270	6.6	6.2	6.0	2.1	2.3	2.1
Asia & Oceania	India (FY)	2.72	55	6.8	6.8	7.0	3.4	3.6	4.1
Asia & Oceania	NIEs 4 economies	2.93	59	2.8	1.7	2.1	1.4	1.0	1.4
Asia & Oceania	Korea	1.62	33	2.7	2.0	2.2	1.5	0.9	1.4
Asia & Oceania	Taiwan	0.59	12	2.7	1.9	2.0	1.4	0.8	1.0
Asia & Oceania	Hong Kong	0.36	7	3.0	0.8	1.8	2.4	2.4	2.4
Asia & Oceania	Singapore	0.36	7	3.1	1.0	1.9	0.4	0.7	1.0
Asia & Oceania	ASEAN5	2.44	49	5.2	4.7	4.8	2.8	2.4	2.8
Asia & Oceania	Indonesia	1.02	21	5.2	5.0	5.1	3.2	3.1	3.6
Asia & Oceania	Thailand	0.49	10	4.1	2.8	3.1	1.1	1.1	1.2
Asia & Oceania	Malaysia	0.35	7	4.7	4.4	4.5	1.0	0.7	2.1
Asia & Oceania	Philippines	0.33	7	6.2	5.8	5.9	5.2	3.3	3.1
Asia & Oceania	Vietnam	0.24	5	7.1	6.5	6.2	3.5	3.1	3.5
Asia & Oceania	Australia	1.42	29	2.8	1.9	2.4	1.9	1.5	1.8
America	U.S.A	20.49	413	2.9	2.3	1.9	2.4	1.9	2.1
America	Latin America (6)	4.47	90	1.4	0.8	0.8	7.5	9.0	8.3
America	Brazil	1.87	38	1.1	0.7	0.5	3.7	4.0	3.8
America	Mexico	1.22	25	2.0	0.5	0.7	4.9	3.7	3.5
America	Argentina	0.52	10	- 2.5	- 2.0	- 2.0	34.3	50.0	45.0
Europe	Euro area (19)	13.67	275	1.9	1.2	1.4	1.8	1.3	1.4
Europe	Germany	4.00	81	1.5	0.6	1.4	1.9	1.4	1.5
Europe	France	2.78	56	1.7	1.3	1.4	2.1	1.3	1.4
Europe	Italy	2.07	42	0.9	0.2	0.7	1.2	0.8	1.0
Europe	U.K.	2.83	57	1.4	1.2	1.4	2.5	1.9	2.0
Europe	Russia	1.63	33	2.3	1.3	1.5	2.9	5.0	4.3

Reference

Weighted mean of 41 economies' GDP based on purchasing power parity		4.0	3.5	3.5	2.6	2.5	2.6

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

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta Tel: +81-(0)3-3240-3204

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