The End of the Cycle?
Trade Wars, Fed Hikes & Financial Stress

2019 Global Outlook
From Bloomberg Economics
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2018 started with hopes of strong and coordinated global growth. 2019 will not. Expansion in major advanced economies is set to slow, with a marked divergence between the U.S. and the rest. Some emerging markets face recession – fallout from their 2018 currency crisis. Key uncertainties are the trajectory for Fed tightening and its impact on emerging markets, the intensity and economic fallout from U.S.-China trade wars, and the economics – and politics – of tighter financial conditions in the euro zone. The year ahead probably won’t bring the end of the cycle, but risks are growing and new sources of fuel are needed.

Published Dec. 5, 2018
All research appeared first on the Bloomberg terminal

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“Assumption is the mother of all screw-ups” — or so my first boss used to tell me. Yet forecasters got the big picture for global growth and inflation broadly right in 2018, despite getting plenty of key assumptions wrong. The betting for 2019 is for another year of moderate growth and stable inflation, with recession risks becoming more evident only as we approach 2020. But the details will matter — because what’s happening beneath the surface will determine whether we have years to come in this already long recovery or are entering the final straight.

One mistaken assumption from 2018 was that growth would continue to be more synchronized across regions. In fact, we saw the U.S. economy break away, once again, this time thanks to tax cuts and higher federal spending. Consumer inflation did rise broadly as expected in the developed economies, from 2.0% to 2.3%, but a key driver in many countries was higher oil prices. Core inflation frequently undershot.

The consensus also underestimated the political risks to the recovery in 2018. President Donald Trump has not, in fact, been all bark and no bite on trade, at least with regard to China. The prospect of another round of U.S. tariffs on around $250 billion of Chinese exports to the U.S. is probably the single largest risk factor for China’s economy in 1H — though the G20 talks have dialed down tensions.

Political risks didn’t go away in the euro zone either, despite the relative lack of elections. Instead they have intensified in Italy, with a provocative and potentially unstable populist coalition picking a fiscal fight with European authorities and so reminding investors of the euro zone’s Achilles’ heel.

Our Year Ahead publication contains Bloomberg Economics’ detailed country forecasts for 2019. Chief Economist Tom Orlik has also looked at how past recoveries have ended and the lessons for today. Here let me highlight one key issue shaping the short-term outlook and two others which should have greater significance over time.

The key short-term question mark relates to the future of President Trump’s trade wars and particularly their impact on China. This probably has the most potential to push global sentiment off course in 1H19, both through the direct impact on trade flows and the indirect effect on global confidence and investment. Chinese policy is now swinging firmly from tightening to stimulus as the leadership readies for the impact of tariffs. So far the aim seems to be merely to cushion the blow. But another round of tariffs, affecting all or most of Chinese exports to the U.S., would raise the stakes and the temptation to revert to old habits.

As our chief Asia economist, Chang Shu, explains, these were already going to be difficult transformative years for China’s
The Fed has not managed a soft landing in its history. But there's a first time for everything

- economy. The risk is that Trump will make them downright impossible, sending China's long-term strategy into reverse. That said, tariff barriers alone are not going to halt the global recovery. What matters more for the medium-term length of the cycle will be the response to — and management of — tighter global financial conditions and what happens to wages, productivity and investment.

Though the Fed has been raising rates since 2015, the combined balance sheet of the U.S., eurozone and Japanese central banks was still expanding on a monthly basis for most of 2018. Once the ECB stops buying bonds that will stop and G3 central bank liquidity will start to shrink.

The Fed has not managed a soft landing in its history. But there’s a first time for everything. Three years since the first increase in the federal funds rate, things could definitely be going a lot worse. If you want to know whether it’s continuing to go well in 2019, keep a close eye on the rate of corporate credit defaults in the U.S. Around half of the $6 trillion of U.S. investment grade corporate debt today is just one notch away from junk status.

Almost as important will be the politics of tighter monetary policy. Presidential tweetstorms don’t pose a real threat to the Fed’s independence, but tensions with the White House are only going to get worse, given the very large gap between the Fed’s view of the U.S. economy’s sustainable growth rate with unemployment at a 49-year low and the much rosier picture adopted by Trump.

In the eurozone the political pressures are in the other direction, and possibly more dangerous. Large parts of Europe’s financial and political elite are eager to normalize policy, but so far inflation is not giving the ECB any reason to speed up the timetable. If anything, the loss of economic momentum in the euro area in the latter part of 2018 has pointed the other way.

The trickiest decisions could come in 2H19, as the ECB considers how and when to begin the long path toward more normal policy rates. Right at the center of the conundrum will be Italy — whose public finances and financial sector are uniquely vulnerable to higher long-term rates and reduced central bank liquidity. Those looking for experienced hands at the tiller will be concerned to note that the ECB will have a new leader by the end of 2019 and Germany quite possibly a new chancellor.

Finally, keep your eye on what in the long term will matter most of all: the individual decisions of global businesses. It’s easy to get gloomy about the trifecta of negatives hitting global corporates, with confidence being hit by trade wars at a time when rising wage costs may start to eat into profits and the cost of finance is rising. But profit margins are at cyclical highs in many economies, demand is as good as it has been for several years and balance sheets still look strong. Technology is also throwing up historical opportunities to transform business operations — especially in services.

Capital spending has tended to lag far behind profit growth recently and 2018 was no exception. Productivity growth is still feeble too, at around 1% a year in the developed economies. But we have seen a virtuous circle of rising wages, investment and productivity prolong cycles in the past — notably in the late 1990s. It is not the most likely outcome now. In fact the latest surveys suggest both business sentiment and investment are weaker. But it’s surely not impossible at a time when capacity constraints may also start to bite.

This is the stage of the cycle when politics can often have the upper hand over economics. The end of year cacophony over Brexit will leave U.K. residents feeling that more than most. But beneath the noise, this is a global economy in its 10th year of recovery looking for a fresh source of fuel.
“There’s really no reason to think that this cycle can’t continue for quite some time, effectively indefinitely,” said Fed Chair Jerome Powell. In his view, a change in the way the economy works has made it easier to maintain low unemployment without inflation.

Fair enough. At the same time, the idea of an unending cycle is more familiar in Buddhism (or Australia) than the U.S. economy. With the current expansion pushing toward its 114th month — close to the 120-month record of the 1990s — it’s worth asking what could bring it to an end.

Stretching back to the 1950s, high inflation and Fed tightening have played a starring role in ending expansions. Powell’s thesis is that changing inflation dynamics mean this time is different. Independent, inflation-targeting central banks have tamed expectations of price increases. As a result, low unemployment can be sustained without triggering an upward spiral of wages and prices.

With inflation under control, the Fed has no need to push borrowing costs to punitive levels, and the cycle can continue — Powell hopes — indefinitely. So far, that thesis seems to be playing out rather well. The core personal consumption expenditure price index has been hovering at the 2% mark.

The Phillips curve, though, might prove steeper in some places than others. Unemployment is already at its lowest level since the 1960s. October wages notched a 3.1% annual gain. With the economy running above potential, 2019 will bring further advances.

There’s already a divergence between the Fed’s forecast and the market’s expectation. The dot plot points to rates ending the year with an upper threshold of 3.25%. Fed fund futures point to 2.75%. If the Fed has to move down into line with the market, that won’t be a problem. If the market has to move up into line with the Fed, it could be.

Of course, in the grand scheme of things, a move from 2.5% at end-2018 to 3.25% at the end of 2019, isn’t that exciting. In 1981, Fed Chair Paul Volcker’s tight control of money supply raised rates to 19.1%. To get from Powell’s cautious and gradual normalization to a cycle-ending blow to growth, there would have to be a confluence of negative factors triggering a significant sell-off in the markets.

One could be fiscal policy. Tailwinds from Trump’s tax cut are set to fade from 0.4 ppt of GDP in 2018 to 0.2 ppt in 2019 and then nothing in 2020, according to U.S. economist Tim Mahedy.

Another could be the trade war. An agreement between Trump and his Chinese counterpart Xi Jinping at the G-20 gathering in Argentina has dialed down the tensions. The planned increase in U.S. tariffs from 10% to 25% has been suspended, pending 90-days of talks. Even so, the 10%
tariff already in place remains substantial, frontloading of exports in 2018 will likely mean a drop off in the year ahead, and there’s continued risk tariff rates could rise - if the 90-day talks don’t produce sufficient concessions from the Chinese side.

Past cycles have been ended by financial blow ups. This one could be too. Bloomberg’s financial conditions index has tumbled from the start of October. The S&P 500 gave up all its gains for the year. Space for a further deterioration remains. U.S. corporate debt at close to 46% of GDP – near a postwar high – is a fault line, especially as much of the borrowing has been used for financial engineering rather than investment in productive assets. Low borrowing costs fueled the corporate debt boom; higher costs could unravel it.

Assume an unhappy confluence of events triggers a significant sell-off in U.S. markets. What kind of drag does that mean for the real economy? The global financial crisis is the most recent example, but likely not the best benchmark. Recessions in 1990 (following the savings and loan crisis) and 2001 (as the dot-com bubble burst) were both mild. Market crashes in 1987 and 1998 left no lasting impact on GDP.

How about external risks? Since 2015, when the Shanghai equity rout and yuan sell-off triggered a global panic, China has been high on the worry list. Heading into 2019, China faces a drag from U.S. tariffs, and a continued struggle against its own debt demons. Our view: China has taken significant steps to manage down financial risk, and retains adequate policy firepower to bolster demand. Despite signs of slowing growth, a hard landing in 2019 is unlikely.

That leaves a laundry list of exogenous shocks. Challenges in the old world look greater than those in the new. Deal or no deal, Brexit is set to be a drag – though one that markets have had ample time to anticipate. The combination of a free-spending budget and the end of European Central Bank bond purchases is already testing the market’s appetite for Italian debt.

Emerging markets might face another turbulent year. Our metrics show Turkey, Argentina and South Africa have the biggest vulnerabilities. Even so, the lesson of recent history is that even major crisis in emerging markets leave advanced economies unscathed. With the emerging market share of global output, and market capitalization, down since the 2013 taper tantrum, the chances of blowback are low.

In the 1970s, oil price shocks twice dealt a blow to growth. For 2019, with prices slumping to $60 a barrel, the chance of a repeat performance seems limited. Low oil prices are bad news for Saudi Arabia, Russia, and other producers. For oil importers – a group that includes most of the major economies – it’s a positive.

A war with North Korea would certainly not be pretty, but seems unlikely now that Trump and his counterpart Kim Jong Un “fell in love.”

At this point, it’s customary to note – sagely, but not particularly helpfully – that past cycles have been ended by unexpected events. The same could happen again. Summing up what can be said within the sphere of the expected, Powell’s nirvana of low unemployment, moderate inflation, and sustained growth, should persist for at least another year. Growth in the U.S., and the rest of the world, is expected to slow, not stop.

That said, forward-looking financial markets mean that once an end is anticipated, it can arrive sooner than expected. A number of things could go wrong. They would likely have to go wrong at the same time to bring the cycle to a premature end.

Who Slips If Oil Slips

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Source: Bloomberg Economics
Oil, Rates, Dollar – Shock Impact Ready Reckoner

By Jamie Murray and Tom Orlik

The final months of 2018 have underscored the potential for market shocks to throw the economy out of whack. To assess risks through 2020, we used NiGEM, a model of the global economy, to see what happens to growth if oil prices slump, U.S. borrowing costs surge, or a risk-off moment prompts dollar strength.

Bare bones quantitative work should be the start, not the end of the analysis. Still, the findings provide a rough gauge of the magnitude of the impacts and who the winners and losers might be.

Oil
Oil has been on a wild ride. The price of Brent crude touched a high above $86 a barrel in early October, only to slump to a little over $60 in late November. Much of that drop reflects weaker global demand. But what if a supply glut pushes oil costs even lower? We looked at what would happen to G-20 economies if oil sinks to $50 a barrel and stays there (that’s relative to a baseline of $65).

The results the model spits out show oil-producer Russia is the biggest loser. (Saudi Arabia would also suffer, but it’s not specified in the NiGEM model). At the other end of the spectrum, India and Japan – significant oil importers – see gains of 0.4% and 0.5% of GDP by 2020 relative to the baseline. The U.S. comes out slightly ahead, though in the wake of the shale revolution the benefit of low prices is reduced.

Dollar
So far, 2018 has proved a strong dollar year. With the Fed leading the way on normalizing monetary policy, rates differentials favored dollar strength. Turmoil in emerging markets, prompting safe haven demand, pulled in the same direction. As of late November, the broad dollar index is up about 9% from its February low. With emerging markets still on the ropes, we modeled what a further 10% gain driven by safe haven flows would mean for growth.

Turkey and Brazil do worst, with 2020 GDP lower by 1.7% and 1.3% relative to the baseline – a reflection of strains caused by capital outflows. Lost competitiveness and weaker external demand shaves 0.5% off U.S. output. Korea and Japan – trade surplus countries – are more resilient.

Rates
A decade on from the global financial crisis, banks are now better capitalized and more resilient. The chances of another credit meltdown look small but that’s not prevented the IMF from sounding the alarm on pockets of risk building in the financial sector – particularly in the leveraged loan market. To gauge how U.S. shocks can spill over to the rest of the world we’ve modeled the impact of a 100-basis point increase in U.S. borrowing costs.

Oil Drops to $50 a Barrel

Source: Bloomberg Economics, NiGEM
With the shock originating in the U.S., it’s no surprise that’s where the blow to growth is greatest. The model suggests GDP might be lower by a little over 1% in 2020. Close neighbors Canada and Mexico also slow noticeably. China feels the impact of reduced demand for its exports. Countries with weaker ties to the U.S. economy experience a smaller shock.

**Notes**

In our oil analysis we take account of the shale revolution on the U.S. economy by using net oil imports data to calibrate the impact of lower crude prices.

We did not make any adjustments for the changes to Canada’s oil exports, so we have excluded the results from the chart. There is also good reason to think that the relationship between oil prices and Russia’s economy has softened since the model was estimated. The direction is likely to be correct but the magnitude of the impact should be thought of as an upper bound.

The dollar analysis is conducted by increasing the risk premium on all other currencies in the global model to achieve a 10% appreciation in the effective dollar index.

The credit risk analysis is based on the assumption that short-term borrowing costs are raised by 100 basis points for a year, reflecting dislocations in the financial sector. Argentina is excluded from all our analysis because it is not specified in NiGEM.
China, Cars and Congress—Three Risks to 2019 Trade Outlook

By Shawn Donnan

If 2018 was the year that Donald Trump gave the world a new taste of an ancient phenomenon—trade wars—then 2019 is shaping up to be the one in which the combat risks being fiercest.

President Trump is as unpredictable a leader as a major economy has seen in generations. For that reason alone there are myriad scenarios—from de-escalation to all-out economic war between the world’s two largest economies, the U.S. and China—within the realm of the possible.

Yet there are also three clear battlegrounds on which Trump’s trade wars will be fought in 2019. And if things go wrong on any of the three the results could roil the global economy.

Uneasy Truce

While Trump and China’s Xi Jinping agreed during a December steak dinner in Buenos Aires to kick off 2019 with an uneasy truce and a pause in their tit-for-tat tariff war it may not take long for their conflict to resume.

The big question looming over the world’s two largest economies going into 2019 is how they can find a solution to what remain major differences on trade. Trump and his hawks have repeatedly set a high bar for Xi by insisting they want to see “structural” changes in the Chinese economy to rebalance the trade relationship. But it’s not clear that Xi will ever be willing or able to make those sorts of concessions.

Washington says it wants to see an end to the vast web of subsidies and cheap, state-directed loans that has fueled China’s economic rise and the international march of its state-backed champions. It wants to see wholesale reform to China’s intellectual property regime and an end to state-directed cybertheft. It also knows it is asking for the moon.

“If China were to say, well, we’re going to stop doing all that stuff, it would be left with an economy that would effectively lose its edge,” Peter Navarro, the White House’s most strident China hawk told a Washington thinktank, in November.

Still, Trump has been facing pressure from financial markets and farmers to strike a deal and has already demonstrated an ability to spin modest achievements on trade as epochal victories. There’s reason to believe he could do the same with China. But that also carries political risk for him going into 2020 with Democrats eager to poke holes in his populist trade appeal in key swing states in the Rust Belt.
For that political reason alone, the most likely scenario when it comes to China calls for an enduring frozen conflict rather than a grand armistice. That would mean the U.S. tariffs imposed in 2018 on $250 billion in Chinese imports — and the vast majority of the Chinese retaliation to those — remaining in place. It would also mean the rolling out of new export controls strictly limiting the sale of key emerging technologies to China and continuing scrutiny of inbound Chinese investment into the U.S.

That result may be better than a hot war. But it wouldn’t remove the possibility of the world’s two leading economies slipping into a new Cold War as many experts ended 2018 fearing.

**Autos Conflict**
If there’s one Trump trade conflict in 2019 that risks overshadowing the spat with China it’s the one over autos. The outcome of this conflict may also serve as a telling reminder of how Trump has set about rewriting America’s longstanding economic and strategic relationships and the shadow that casts over the global economy.

Trump’s ordering up of a national security investigation into U.S. imports of cars and parts followed the model he used to impose steel and aluminum tariffs in 2018. And he has since made repeated threats to levy a 25% import tax on cars from Europe and Japan.

Whether an imported Subaru or even a Porsche is a threat to U.S. national security is clearly debatable. But the investigation fits with what the administration insists is its broad definition of national security to include “economic security”. A strong manufacturing base, it argues, is as important to national security as a flotilla of aircraft carriers.

Canada and Mexico have secured exemptions from any new tariffs as part of the renegotiated North American Free Trade Agreement. The EU and Japan, meanwhile, have drawn promises of temporary exemptions from the auto tariffs while they negotiate trade deals with the U.S.

The negotiations with the EU and Japan are fragile, however. And Trump is not a patient man. Before the end of 2019, therefore, there is a real risk that at least a substantial portion of the more than $140 billion in finished cars and parts that the U.S. imports from Europe, South Korea and Japan could be hit with tariffs.

Such a move would be disruptive in itself. But there’s a risk, too, of a broader hit to supply chains if the tariff hits parts, which could affect both U.S. and foreign carmakers that now manufacture in the U.S.

**Congress**
Trump has claimed his renegotiation of Nafta, now rebranded the “U.S. Mexico Canada Agreement” (USMCA) as a major victory for his belligerent approach to tariffs and trade.

Experts continue to debate just how much of a meaningful change the new deal marks and what its economic impact will be. But no one doubts that Trump is facing a fight in 2019 to get the pact ratified by Congress. Particularly with hostile Democrats controlling the lower House of Representatives and thus wielding the power to block ratification.

Trump has responded by vowing to pull out of the existing Nafta altogether if Democrats don’t ratify the USMCA, a move that would again leave immense uncertainty hanging over the North American economy. And reinforce the fears that in his trade wars Trump’s most damaging trait may be his unpredictability.
Emerging Markets
Emerging Markets, Emerging Risks

Rising rates, trade tensions and domestic policy missteps roiled emerging markets in 2018. The year ahead will inherit those stresses — and bring some of its own. Who looks vulnerable? We rank countries on five metrics: the current account, short-term external debt, reserve coverage, government effectiveness and inflation. Red shows higher risk, green greater stability.

**Mexico**
Large and open trade and capital accounts imply significant exposure to risks from protectionism and tighter global financial conditions. Exposure appears high despite relatively manageable current account and short-term external debt obligations. Large non-resident holdings of local assets adds to the strain.

— Felipe Hernandez

**Egypt**
A program with the IMF and sizable reserves has kept Egypt relatively immune from the recent EM rout. The IMF program is set to expire in 2019. Lack of transparency on the composition of reserves raises questions on whether they provide an adequate buffer.

— Ziad Daoud

**Saudi Arabia**
Ample international reserves are key to the stability of the economy. But Saudi Arabia is still reliant on oil and reserves could face a sharp drawdown if the drop in prices persists. Political risks, both domestically and internationally, could lead to accelerated capital flight adding to the pressure on reserves.

— Ziad Daoud

**Colombia**
External financing needs are mainly explained by a relatively large current account deficit. Export revenues are sensitive to oil prices. Foreign direct investment that covers most external financing needs is also sensitive to oil related flows.

— Felipe Hernandez

**Peru**
International reserves provide a significant buffer against external shocks, particularly after considering the moderate current account deficit and low short-term external debt obligations. Exports and trade results are sensitive to copper prices.

— Felipe Hernandez

**Brazil**
Brazil’s main risk in 2019 comes from a stall in needed fiscal consolidation. Pension reform, privatization and a cap on the 2020 budget are all significant challenges. Selling excess reserves prior to fiscal adjustment could spur negative sentiment.

— Adriana Dupita

**Chile**
Combined current account deficit and short-term external debt obligations point to high external financing needs. Robust economic institutions partially offset risks. Export revenues are highly sensitive to copper prices.

— Felipe Hernandez

**Argentina**
Higher U.S. rates and lower commodity prices could add to Argentina’s funding needs, pressuring the peso, raising inflation, and postponing a growth recovery. Failure to meet fiscal targets could raise concerns over IMF disbursements and see the Fund request more austerity. Elections loom in October.

— Adriana Dupita

**South Africa**
High participation of foreign investors in South Africa’s bond market is a key risk. Repatriation of funds would hit the rand. Interest payments to foreign bondholders are widening the current account deficit, requiring an ever-larger trade surplus to maintain stability.

— Mark Bohlund
Russia
Russia is more vulnerable than the numbers imply. The economy remains under a cloud of geopolitical risk, with tighter U.S. sanctions on the way. Inflation is also set to spike in 2019. Growth, already sluggish, could slow to a crawl.

— Scott Johnson

China
2019 will be a tough year for China. Tariffs at their current level will mean a 0.5 ppt drag on growth, and that will increase if the U.S. pushes ahead with a threatened increase. High debt levels built up from previous stimulus episodes also constrain policy space, making a fast turn-around of the economy unlikely.

— Chang Shu

South Korea
A healthy current-account surplus, strong institutions and muted inflation all serve as forces for stability for South Korea. Its reserve coverage falls on the lower end of the IMF’s adequacy metric, but is still robust. A trade war roiling Asian supply chains is a significant risk.

— Justin Jimenez

Taiwan
As an export-oriented economy, the key risks for Taiwan in 2019 are external. These include heightened trade tensions between the U.S. and its trading partners, higher borrowing costs following U.S. interest rate hikes and the slowdown in the Chinese economy.

— Chang Shu

Philippines
The Philippine economy is domestic demand driven. It still relies on capital flows to fund investment and a small current account deficit. Oil is a swing factor. Low priced oil imports improve the trade balance, increase fiscal space and buoy household spending power.

— Tamara Henderson

Indonesia
Indonesia's primary risk in 2019 is a downward spiral for the rupiah. To minimize this risk, the government has introduced measures to narrow the current account deficit, and the central bank has aggressively increased interest rates.

— Tamara Henderson

India
The recent sharp drop in crude oil prices benefits India on all macro parameters – lower current account deficit, stronger currency, lower fiscal deficit, lower inflation and possibly even lower rates as a result of that. With those benefits, India is better positioned than the current numbers suggest.

— Abhishek Gupta

Thailand
Thailand has a large current account surplus, ample reserves and low and stable inflation. What's more, investors are attracted to the low volatility of its currency and bond returns. The primary risk stems from politics, though markets have tended to look through its turbulent history.

— Tamara Henderson

Malaysia
Malaysia's small open economy is less reliant on fuel exports than in the past. Even so, oil remains an important export for trade and government revenues. It can also be a swing factor for foreign capital flows.

— Tamara Henderson
North America
U.S. economic fundamentals for 2019 are solid but should not be taken for granted as the Fed strives to execute a soft landing for an economy coming down from a sugar high of fiscal stimulus.

While 2018 was a banner year for growth – likely the strongest of the cycle – a major risk for Fed officials is that they make the mistake of setting policy for the year that was (a great one), not the year ahead (good, but not great). Winding down rate increases at the same time the economy is overshooting both of the Fed’s dual mandates will require a steely resolve among policy makers, as critics will no doubt attempt to draw parallels to the monetary policy mistakes of the 1970s, which resulted in stagnating growth and excessive inflation.

Growth should remain above trend in 2019, but the trajectory will slow amid fading tailwinds from fiscal stimulus. GDP growth is set to decelerate from 3.1% in 2018 to 2.4% in 2019 and 2.1% in 2020. Policy makers will need to use a lighter touch on the brake lever to avoid overtightening rates and prematurely ending a cycle that is poised to be the longest in the post-WWII era.

If the expansion continues through the second quarter of 2019, it will tie the 40-quarter expansion of the 1990s for length, although the cumulative GDP gain will remain markedly smaller. In the 1990s cycle, real GDP increased 43%, whereas the current expansion has been only 23% so far. This slower pace of growth explains why policy makers should proceed cautiously.

While sluggish growth was unwelcome coming out of the global financial crisis, when the priority was to reduce labor slack, slower growth in the interim has enabled the economy to avoid the types of imbalances which would have otherwise required a more aggressive Fed response. Policy makers need not calibrate interest rates for an economy growing near 3% – this would justify a fed funds rate in the vicinity of 4%-5% – because a moderation toward trend (roughly 2%) is already underway. Bloomberg Economics anticipates three fed rate hikes in 2019 followed by an extended pause.

Importantly, consumer spending is poised to play a less exclusive role as a driver of growth while other mid-cycle engines, such as business investment and government spending, engage more appreciably. History shows it will be hard to knock the economy materially off balance given the fundamentals of sturdy household spending and diversified growth.

The type of shock that could potentially deal a debilitating blow to the economy would almost certainly require depressing consumer spending to such a severe degree that other economic drivers could not offset the drag. Under this
framework, it is hard to envision some of the well-advertised risks for 2019 — a disorderly Brexit, trade tensions or slowing global growth — weighing on the U.S. economy to a critical degree. We rate the recession risk for 2019 at just 15%.

The policy challenge for the Fed will be to set interest rates based on expected growth, not in response to reported growth. This will require a shift in Fed officials’ approach to policy decisions which will de-emphasize “data dependency” and instead lean more heavily on forecasts of activity. To be sure, officials will be less comfortable shifting toward “forecast dependency,” but this will be crucial to avoid excessive tightening as plenty of residual economic data reflect a prior period of well-above trend growth, which has since moderated. This is particularly true in the case of inflation.

Core inflation settled near the Fed’s objective in the latter half of 2018, after undershooting for most of the previous decade, but it is poised to drift higher in 2019. Recall that inflation is a lagging economic indicator. As the accompanying figure illustrates, inflation is highly correlated with the pace of economic growth when adjusted for a six-quarter lag. As a result, the blistering pace of growth in mid-2018 (second quarter: 4.2%; third quarter: 3.5%) will manifest in an inflation acceleration through the end of 2019. We project the core PCE deflator to rise toward 2.25% on a trend basis by the end of 2019, but this could entail eye-catching hot patches along the way. Inflation will ultimately moderate, in a lagged response to slowing growth, but it will accelerate in the year ahead.

Growth in 2019 will be sufficient to continue nudging the unemployment rate further below policy makers’ estimates of neutral. It will require a firm commitment from Fed officials to curtail rate increases in the latter half of the year, as growth, unemployment and inflation all run hot. But in doing so, they can ensure a soft landing for the economy into 2020.

Recent public comments suggest Fed officials are amenable to parking the fed funds rate near neutral, which most FOMC participants estimate near 2.9%-3.0%, and then pausing to assess the health of the economy as it adapts to less accommodative policy. Historically, the Fed has had little success returning a below-neutral unemployment rate back to neutral without overshooting and causing a recession.

Leaving the inflation-adjusted fed funds rate near 1% and pausing — as the economy cools down from its 2018 high — will give them a shot. Policy makers will need to remain confident that the appearance of an overheating economy will not last.

Inflation to Get Hotter Before It Gets Cooler

Source: BEA, BLS
Headwinds to the Canadian expansion will be relatively modest in 2019. While the pace of growth is likely to moderate as the Bank of Canada removes policy accommodation further, activity will still advance at an above-trend rate.

As the economy enters the later stages of the cycle, the composition of growth is changing. Consumer spending has been the primary engine of growth in the current expansion. However, household debt remains elevated, which means that rising interest rates will overpower the boost to consumption from expected wage growth. Rising rates, along with changes to mortgage lending rules, will also continue to weigh on the housing market. On the other hand, the economy is bumping up against serious capacity constraints. Business investment should pick up to meet above trend consumer demand, despite additional rate hikes.

The jobless rate hovered near record lows throughout 2018. Solid job gains are expected to further reduce unemployment, which will exacerbate labor shortages. Finding qualified workers is a principle concern for businesses in most sectors, and labor shortages should moderately boost wage growth. However, supply shortages are broader than just a dearth of qualified workers as evidenced by the capacity utilization rate’s climb toward the previous cycle’s peak. Supply constraints are likely to worsen in the near-term as aggregate demand remains elevated.

Investment will gain steam in 2019 as favorable economic conditions and capacity constraints boost capital spending. Business confidence is rising – companies in the fall BoC Business Outlook Survey noted strong investment intentions – yet tax changes in the U.S. could create competitive challenges for exporters.

Investment in the energy sector is expected to be modest next year due to a widening spread between crude prices in Canada and the U.S., potentially sluggish oil prices and a setback in construction of the Trans Mountain pipeline.

The trade accord between Canada, Mexico and the U.S. removed the biggest headwind to Canada’s outlook. We expect exports to rise amid foreign demand for Canadian energy and capital exports. Imports will also rise, but at a slower pace than exports. Low oil prices and cooling global demand pose risks to the external outlook.

Core inflation has hovered near the BoC’s target for much of 2018; it will likely rise in 2019. With a tight labor market and strong U.S. growth, the risks to the inflation outlook are on the upside. Added fiscal stimulus in the U.S., particularly an infrastructure deal, would further intensify inflationary pressures and push the BoC to quicken its pace of rate hikes.

**Canadian Economy Near Capacity**

![Graph showing capacity utilization and intensity of labor shortages](Source: Bank of Canada, Statistics Canada)
# Forecast Tables

## U.S. Forecasts

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China
The year ahead will be tough for China’s economy. A slowdown in 2019 looks assured. The extent will hinge on how a trade war with the U.S. evolves, how the government calibrates its response to external and domestic headwinds, and how policies are transmitted. A three-month truce agreed by President Trump and his counterpart Xi Jinping to allow for further trade talks means the outlook is less grim. Even so, the risks to China’s growth still tilt to the downside.

The challenges to the economy should be viewed from the perspective of a multi-year adjustment, with a potential reorganization of global supply chains and shifts in China’s industrial structure. As the changes proceed, the authorities are likely to try to smooth bumps to growth from short- and medium-term shocks, without incurring a further rapid debt buildup.

This background means China is unlikely to attempt to engineer a V-shaped rebound. That could be a long-term positive, particularly if short-term measures to support demand are consistent with reforms that enhance resource allocation and productivity.

Growth Scenarios
A lack of clarity on the trade outlook makes forecasting growth unusually tricky. The most likely scenario — though by slim margin — is de-escalation of trade tensions leading to a broadly balanced growth pattern. Assuming the U.S. tariffs stay unchanged at the current level for 2019, China’s growth would slow to 6.3%, from a projected 6.6% for 2018. The pace of increase in exports is forecast to slow to 7.0% from 13.7% so far in 2018. Investment would rise 8.2%, up from 5.7% so far in 2018. Inflation would edge up, but not enough to constrain accommodative policy. We attach a 50% probability to this scenario.

A less optimistic scenario, which assumes the tariff rate rises to 25% on $250 billion of Chinese goods in March, is for a deceleration to 6.2% in 2019 and for the growth mix to be less balanced. The main drag — a 3.9% decline in exports. In this scenario, policy would be stepped up to support domestic demand, with investment rising 11.1%. The risk that the U.S. and China fail to reach a longer-term deal on trade within the three-month window is considerable. We attach a 40% probability to this scenario.

In a worst-case scenario, where the U.S. slaps higher tariffs on a broader range of imports from China, the slowdown would be sharper and the growth mix even worse. A bigger boost to infrastructure investment to prop up the economy would fuel a further buildup of debt. Assuming higher U.S. tariffs on all Chinese goods are applied in 2H, China’s growth could slump to 5.9%. We attach a 10% probability to this scenario.

In 2018, the trade war was the dog that barked. In 2019, it will bite. Export growth accelerated to 13.7% in the first 10 months of
The Trump-Xi agreement to freeze tariffs at current levels for three months dialed down tensions

2018 – even as the U.S. and China ramped up tariffs. Companies rushed forward production and shipments to beat a threatened hike in U.S. tariffs on $200 billion of Chinese goods on Jan. 1.

The Trump-Xi agreement to freeze tariffs at current levels for three months dialed down tensions. If the talks lead to a more lasting truce in the trade war, it would be a huge relief for China’s external sector. Even so, slowing global growth coupled with likely payback from this year’s front-loading of shipments means conditions will be difficult for the external sector. Tax refunds for exports and a weaker currency might provide some support, but China’s net exports are likely to narrow in 2019.

With the challenging external environment, China will lean on domestic demand for growth. One problem, though, is that credit growth has continued to slow, despite policy accommodation in recent months. The People’s Bank of China has cut the reserve requirement ratio by 250 bps so far in 2018. But aggregate social financing – the broadest credit measure – has failed to turn around. The private sector has faced difficulty accessing funds, even as bank liquidity increased.

We expect more steps in 2019 aimed at unclogging lending channels. The PBOC could slash the RRR by another 150 bps and even lower its benchmark interest rate by 25 bps. Other measures may include: increases in re-lending and re-discount loans; credit support for private firms to obtain bond and equity financing; window guidance for bank lending; and adjustment in the macro-prudential assessment framework.

Infrastructure investment growth began to show signs of stabilizing in October, as government efforts to facilitate infrastructure projects gained traction. In 2019, we expect continuing efforts at stabilizing infrastructure growth—an area where the government has the most policy levers. Private investment may also see a pickup, as monetary accommodation and targeted assistance for private firms lead to better credit conditions. A potential corporate tax cut – which the government is studying – would provide a major boost. We see growth in overall investment accelerating to 8.2% in 2019 from an estimated 5.7% so far in 2018.

Private consumption has shown signs of weakening lately, reflecting slower income growth, poor sentiment and heavy burdens from education and medical care costs. Tariff reductions on consumer goods and personal tax cuts should offset some negatives in 2019.

We forecast real private consumption will increase 6.7% and retail sales 9.6%, compared with rises of 6.3% and 9.1%, respectively, so far in 2018.

Protracted Trade Tensions to Bite

Source: Bloomberg Economics; *Assumed; Bubbles show cumulative growth impact
China’s policy makers face the toughest combination of external and domestic challenges since the global financial crisis

Yuan’s ‘Bottom Line’
The yuan’s decline – about 6% against the dollar so far in 2018 – is likely to extend in 2019, but at a slower rate. Reduced trade tensions with the U.S. would take pressure off the yuan. Still, the slowdown in China, and a narrowing U.S.-China interest rate differential will continue to weigh on the currency.

The foreign exchange market has been largely calm even as the yuan approached 7 against the dollar – considered a key threshold. The PBOC is seen applying a less countercyclical stance than anticipated when it re-introduced the countercyclical factor into the fixing mechanism in August – a move that signaled a more hands-on approach to managing the currency. The daily fixings have mostly been close to market expectations since early October, with two-way movements. What’s more, market rates have traded close to the fixing.

The PBOC’s mention of a “bottom line” mindset to the exchange rate in recent months can be interpreted in two ways: it may refer to a particular level, or a situation that the central bank wants to avoid – probably a disorderly decline. We think there is a policy shift underway from an implicit line in the sand – the much discussed 7-per-dollar level – to managing an orderly depreciation. We see the yuan weakening to 7.18 per dollar by end-2019, with a breach of the 7-level possible in 1Q.

Risks Tilt to Downside
China’s growth outlook is clouded by considerable uncertainties. Trade talks are never plain sailing, even less so for these between two economies with such a wide gulf in expectations. It is possible that the U.S. tariff rate rises to 25% after all following the 90-day negotiation period. What’s more, escalation in the trade war, while unlikely, cannot be completely ruled out. In that case, there would be a more abrupt reversal in a shift away from investment-led growth over the last couple of years – leading to a worse mix of drivers for the economy.

Domestic risks are also substantial, pointing to the downside. Many longer-term policy goals – deleveraging the economy, tightening environmental regulation, and controlling local government financing – involve a degree of sacrifice on growth. Supporting growth without abandoning deleveraging and reforms is a lot harder to pull off than blasting out another major stimulus. With China’s leaders reluctant to give up hard-won progress necessary to sustain the economy in the medium term, the stabilization in growth could take longer.

Transformative Years
China’s policy makers face the toughest combination of external and domestic challenges since the global financial crisis. A shake-up of global supply chains that spurs a relocation of production outside China on a large scale would hurt growth.

Deleveraging has revealed significant vulnerabilities in the financial and corporate sectors. Even so, more must be done to de-risk the economy. Dynamic, emerging industries also need to be nurtured before they will be big enough to help drive growth.

Tackling these tasks will take years. There’s a small chance that reforms are rolled back. The bigger risk, though, is that policy makers turn a blind eye to further buildup of debt in the pursuit of growth. The year ahead will tell whether China has the finesse to manage the economy.

China Forecasts

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Japan
Tax Hike, Trade War Spell Slower Growth in 2019

By Yuki Masujima

The year ahead will be difficult for Japanese Prime Minister Shinzo Abe, as he tries to keep the economy on an even keel in the face of U.S. protectionism and another increase in the sales tax. Fiscal stimulus, continued monetary easing, and a mild yen decline should extend the growth streak in 2019 to seven years, if at a slower pace. But the costs of supporting growth now could involve a payback later.

Higher spending will require deeper cuts ahead to get debt under control. Financial imbalances building up as a result of the Bank of Japan’s easing will inevitably come back to bite. The risks to growth are to the downside. A benign outcome hinges on an absence of shocks from overseas risks, ranging from the U.S.-China trade war to political instability in Europe and sharp moves in oil prices.

Growth Easing

Bloomberg Economics forecasts growth will ease to 0.8% in 2019, down from an estimated 0.9% in 2018 and 1.7% in 2017. That outlook is based on three assumptions — a sales-tax hike to 10% from 8% going ahead in October 2019, the government boosting fiscal stimulus before and after the increase, and the BOJ making no major policy adjustments.

A slowdown in exports will be the main drag on growth, as the U.S.-China trade war dents supply-chain demand. Private capital expenditure is likely to weaken but still contribute to growth, underpinned by investment in new facilities and technologies. A 0.8% expansion would be on par with potential — just enough to keep reflationary forces from retreating.

OilPrices

The year ahead is likely to be frustrating for the BOJ. Core inflation will probably hover around 1% through the end of 2019 — where it was in September 2018, and only halfway to the 2% target. A recent tumble in oil prices, if sustained, would add to the challenges. What’s more, structural and statistical factors — beyond the BOJ’s control — are keeping prices in check, including falling mobile phone charges, and a downward bias in housing costs due to the way imputed rents are calculated.

The BOJ is likely to maintain stimulus, keeping cyclical factors supportive of its reflation drive. That said, with its assets now exceeding GDP, the risks are building. We expect the BOJ to steer a steady course, while keeping an open mind to tweaking its framework should the financial imbalances become too large.

Sales Tax

The sales-tax hike will be a hurdle. Even so, the economy may be better able to cope with the increase than it did the last one in 2014. This time around,
Fortunately for Abe’s reflation efforts, the economy is likely to continue feeling a tailwind from a weaker yen.

The year ahead will see much preparation for the 2020 Tokyo Olympics, which should be a source of support for domestic demand. Once the games have come and gone, though, the economy could be poised to slow. Policy support for growth in 2019 – which will give rise to more debt and financial imbalances – increase the risk of a deeper slump further out.

### Japan Forecasts

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India
India’s macroeconomic stability – hostage to the direction of crude oil – will benefit significantly from a recent collapse in prices. The economy is likely to register improvement on all major parameters in the year ahead. We expect a steady recovery in growth, narrower current account deficit, stronger currency, and lower inflation.

These conditions would be conducive to a looser monetary policy – though our baseline scenario is for the Reserve Bank of India to remain on a long pause, given its hawkish bias. Political risks will also come to the fore with Prime Minister Narendra Modi facing elections next year.

**Gradual Recovery**

We see GDP growth continuing to recover gradually in 2019, after adjusting for base effects. Structural reforms implemented by the Modi administration in the last few years have made the economy more resilient to external shocks.

Demonetization and a new indirect tax are yielding a higher tax-to-GDP ratio while a new bankruptcy law is supporting a stronger credit culture and banking system. India’s improved ease of doing business ranking is boosting investor confidence.

Recent joint policy measures by the government and central bank are also likely to support growth and address concerns about a liquidity crunch and strict macro-prudential banking norms. On a quarterly basis, GDP growth is expected to slow until mid-2019 due to adverse base effects. Once growth starts to pick up again, though, the output gap will start closing. We forecast a 7.6% expansion in the fiscal year through March 2020, up from a projected 7.2% in fiscal 2019 and 6.7% in fiscal 2018. We estimate potential growth at 8%-8.5%.

**Inflation Slowing**

Consumer price inflation has undershot the RBI’s 4% mid-point target for three consecutive months through October. Our conservative inflation projections, which assume Brent will average $70 per barrel, suggest a further slowdown in the months ahead. We expect inflation to average 2.6% in 2H fiscal 2019, below the RBI’s projected 4.2% average and down sharply from an average 4.3% in 1H. Inflation in fiscal 2020 is forecast to increase to 3.6% – still a significant undershoot of the RBI’s projected range of 4.5%-4.8%.

A number of factors are likely to temper inflation: the recent drop in crude oil prices; low food inflation due to advances in agricultural productivity; reduced indirect tax rates on goods and services; lower transportation costs due to efficiency gains in the trucking industry; and output growth that’s below potential.

**RBI’s Neutral Stance**

We expect slowing inflation to drive the RBI back to neutral at its upcoming policy review in December, from its current

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### GDP Growth Expected to Recover Gradually

<table>
<thead>
<tr>
<th>ANNUAL GDP GROWTH</th>
<th>GDP GROWTH</th>
<th>GDP GROWTH (ADJUSTED FOR BASE EFFECTS*)</th>
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<tr>
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<td>6%</td>
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**Source:** Bloomberg Economics, Ministry of Statistics and Programme Implementation
Our base case is for a long pause on rates through end-2019

stance of calibrated tightening. Given its strong hawkish bias, our base case is for a long pause on rates through end-2019. The consensus projection is for two 25 basis point rate hikes in 2019.

Lower Crude Price
Sustained weakness in oil prices would pose a risk to our baseline scenario. If Brent stays below $65 a barrel, inflation would likely breach the 2% lower end of the RBI’s target range by December. In our view, that would force the RBI to deliver a rate cut at its February policy review, albeit with hawkish commentary.

Stronger Currency
The rupee has roared back to life with the pullback in oil prices, after plunging to a record low against the dollar in October. We expect the rally to extend into next year, as cheaper oil prices reduce the import bill and help narrow the current account deficit. India’s equity and debt should also become more attractive to foreign investors, as growth prospects improve and inflation pressures ease. The result: a smaller current account deficit financed by increased inflows on the capital account.

Our currency forecasting model projects a further 4% appreciation in the rupee to 67 per dollar by March 2020, subject to seasonal variations, if Brent stays around $60 a barrel. Should Brent rebound to about $70, our model suggests the rupee would move in a range of 70 to 72 against the dollar.

Risks to Financial Markets
National elections around May 2019 pose a risk to political continuity. Another term for Modi’s government would bode well for further reforms and market sentiment. A win for a united opposition led by the Congress and constituted of smaller regional parties with different ideologies would likely hurt investor sentiment.

Further clarity is expected on a political stand-off between the government and the RBI. A committee to be set up to decide on the RBI’s surplus capital framework will submit a report in 2019. An early decision to transfer surplus funds to the government could help reduce bond yields.

India Forecasts

<table>
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<tr>
<th>INDICATOR</th>
<th>2Q18</th>
<th>3Q18</th>
<th>4Q18</th>
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Full year values represent the fiscal year ended March.
South Korea
South Korea’s economy is heading into 2019 facing multiple headwinds. At home, an anemic labor market and weak investment are weighing on growth. Abroad, slowing external demand and a U.S.-China trade war are threats to its exports.

The central bank has rolled back some of its monetary support to reduce risks from an extended period of low interest rates. A planned boost in government spending should help offset the drag from any reduction in monetary accommodation. Our baseline scenario is for growth of 2.6% in 2019, the same pace we expect in 2018 and 2019 as of October.

External threats to the economy did not fully materialize in 2018. That could change in 2019. Growth in China, the destination of about 25% of South Korea’s exports, is set to slow further as domestic demand faces headwinds and U.S. tariffs come into full force. South Korea’s export growth will likely continue to moderate as momentum in semiconductors slows. Exports account for about half of GDP.

At home, the weakness in investment in recent quarters is likely to persist into 2019. Rising labor costs, corporate restructuring in heavy industry, and trade risks are all potential negatives for private capital expenditure. Construction could suffer from policies aimed at cooling the property market.

The weaker job market will remain a focus in 2019. A 16.4% increase in the minimum wage in January 2018 was partly behind the rise in unemployment to a nine year high of 4.2% in August. A further 10.9% rise at the start of 2019 may add to the pressure.

The government has been trying to shore up the economy. The Moon administration’s record 2019 budget proposal aims for 470.5 trillion won in spending — equal to about 25% of GDP, and up 9.7% from the prior year. About 5% of that is earmarked for job-creation efforts.

A 15% fuel-tax cut from November to early May — combined with a recent slide in oil prices – should help reduce burdens on consumers and small businesses.

As the government ramps up fiscal support, the BOK has reduced monetary support – with a 25 bp rate hike at its November meeting. The objectives – to safeguard against financial risks, and rebuild a policy buffer. The last time the central bank raised its policy rate was November 2017.

Further out, heightened risks to the economy and muted inflation suggest another long pause on rates before the BOK’s next move. Price pressures remain relatively benign, with inflation averaging 1.5% year on year in the first 10 months of 2018 – below the 2% target for 2016-18.
Southeast Asia
A slowdown in exports weighed on Southeast Asia’s largest economies in 2018, though some have still managed to eke out stronger growth. The external headwinds may be stronger in 2019, with the U.S. threatening higher tariffs on Chinese goods all while U.S. growth is set to decelerate sharply. Even so, weaker growth prospects are unlikely to prompt Asean-5’s central banks to revert to easing. Rather, a desire to lure investment inflows will require maintaining a bias toward tighter monetary policy – at least until further tightening by the Federal Reserve can be ruled out.

Growth in the Asean-5 ebbed to 4.8% year on year on average in the first three quarters of 2018, down from 5.0% in 2017. Expansions in Indonesia, Singapore and Thailand ticked higher, while slowdowns in Malaysia and the Philippines were more pronounced. Only the Philippines and Thailand continued to outpace their 10-year trends in 3Q.

Asean-5’s exports weakened across the board, though this had little to do with the trade spat between the U.S. and China. 2019 will be much more challenging if the U.S. follows through with plans to lift tariff rates to 25% from 10% on about half of its imports from China. Front-loading of purchases in late 2018, ahead of more painful duties, will exacerbate the impact in 2019.

Recent Fed signals suggest a lighter touch on rate hikes next year. Absent a clear pause, though, concerns about over tightening will have scope to sap risk appetite. Both would be negatives for Asean-5’s investment outlook.

Domestic risks will add to the pressure on investment, at least temporarily. Elections will be held in Indonesia, Thailand and possibly Singapore, if an early poll is called in the city-state (as speculation suggests). Once policy uncertainty clears, though, investment could recover in 2H 2019.

In contrast with exports and investment, household spending has scope to support growth in parts of the Asean-5 in 2019. So far in 2018, private consumption growth has strengthened in most of the region – especially in Malaysia and Thailand, where incomes improved.

**Indonesia**

Investment prospects for Indonesia in 2019 face an additional hurdle from elections, which tend to sideline investors ahead of time. After the fact, investment should have scope to recover in 2H 2019.

Indonesia’s presidential election will be held on April 17. The incumbent and opposition have yet to spell out detailed economic agendas. Even if campaign promises are similarly prudent, a win for the opposition...
might prolong policy uncertainty for a bit longer. This is because of implementation risk and the time needed to install a new government.

Another source of support for investment in Indonesia in 2H 2019 may come from the central bank. Aggressive rate hikes by Bank Indonesia to stabilize the rupiah in 2018 could be unwound once the Fed signals a pause or as the growth gap with the U.S. starts to narrow.

Domestic demand in 2019 should also remain supported by households, with purchasing power underpinned by low and stable inflation. Bank Indonesia’s 175 bps of rate hikes so far in 2018 in the face of rupiah weakness will help keep prices in check. Government measures to narrow the current account deficit should also ease downward pressure on the currency.

**Thailand**

Thailand will also have elections, which are tentatively scheduled for Feb. 24. In addition to the policy uncertainty that elections bring, unrest may also resurface — weighing on investment and inbound tourism. This will be the first poll under a new king, new constituent boundaries and a new constitution, which makes the upper house fully appointed and formalizes the military’s role in parliament.

The election has potential to resurrect deep fissures between urban and rural constituents. The institutional changes may reduce the likelihood of coups, but they also pare back the influence of democratically-elected officials.

Parties linked to ousted former prime minister Thaksin Shinawatra won the last five elections, only to be unseated by the courts or military. Investment in Thailand has been soft since 2014 — the year General Prayuth Chan-ocha (the current prime minister) led a coup against the elected government.

Another obstacle for investment in 2019 comes from the Bank of Thailand, which is signaling tighter monetary policy ahead. It wants to start building policy space and is concerned about risks to financial stability from prolonged monetary accommodation.

Household spending may also slow. Private consumption growth in 2018 has been the strongest since 2012 — lifted by higher employment and wage growth in the run-up to elections. Low and stable inflation has also supported spending power. Sustained gains in the baht against trading partners have subdued inflation and allowed the central bank to keep policy accommodative. Even so, it seems only a question of when, not if, the Bank of Thailand will join its Asean-5 peers in tightening monetary policy. The baht has been underpinned by an
ample current account surplus and capital flows into the bond market.

**Singapore**
Weaker exports and investment due to fierce external headwinds are likely to weigh heavily on Singapore’s small, open economy. Private consumption may also continue to languish. This reduces the likelihood of an early election being called, in our view.

The government in 2018 rolled out more measures to cool the property market in order to avert a destabilizing correction amid rising interest rates and a strong pipeline of housing supply. Government measures to subsidize wage increases have not stemmed a slide in consumption growth.

**Malaysia**
For Malaysia’s small, open economy, the impact of stronger external headwinds on headline growth could be magnified, given its greater reliance on China’s final demand. The slump in oil prices, if sustained, will intensify the damage.

Malaysia is less dependent on fuel exports than it was in the past. Even so, oil remains an important crutch for trade and government revenues. The health of the oil sector can also be a swing factor for foreign capital flows and investment sentiment more broadly.

But all is not gloomy. A pickup in household spending in 2018 appears sustainable in 2019. Prime Minister Mahathir Mohamad’s new government will settle outstanding tax refunds from the previous administration, equivalent to about 2.2% of GDP, by our calculations. This will be funded from the retained earnings of the state oil company Petronas, rather than higher taxes.

**Philippines**
Philippine growth may prove to be more resilient than its Asean-5 peers in 2019. Household spending is the primary driver of the economy, which means less drag from external headwinds. What’s more, private consumption could pick up as inflation recedes.

Philippine households tend to have lower incomes, making them vulnerable to higher costs of living. With the Philippine central bank now working more aggressively to anchor inflation expectations, the spending power of households and businesses could improve significantly in 2019.

If the oil slump is sustained, lower priced oil imports will improve the trade balance, increase fiscal space and further buoy household spending power.
Australia, New Zealand
Australia and New Zealand are bracing for the impact if the U.S. ratchets up tariffs on its imports from China – their largest export market by far. Australia may cope a bit better than its neighbor, which could help its currency outperform in 2019.

Australia has an advantage in that its exports are less important for growth, and its export mix is more diversified. New Zealand also needs to attract more foreign inflows to fund its current account deficit – at 3.3% of GDP, it is on the high side for a developed economy.

The relative resilience to the U.S.-China trade war, and greater traction in domestic demand suggest the Reserve Bank of Australia may start to normalize policy with a rate hike before the end of 2019. The Reserve Bank of New Zealand is more likely to leave policy unchanged.

**Domestic Demand**

Growth in Australia is already slightly above potential and poised to increase further. After years of contraction, mining investment may finally stabilize in 2019.

Wages are also starting to respond to a sustained period of strong hiring. This, along with increased participation by females, puts households on a sounder footing to manage record debt levels.

Domestic demand in New Zealand is not as strong. Confidence has improved, but businesses remain pessimistic overall. Private investment rose just 4.3% year on year in 1H 2018, compared with 8.5% for Australia.

Like Australia, soft wages and high debt plague New Zealand households. Even so, leverage is lower and not rising as quickly in New Zealand.

Private consumption, which accounts for about 60% of GDP in both countries, rose 3% year
Australia’s coal and iron ore exports benefited from China’s massive fiscal stimulus during the global financial crisis

Made for China
Mirroring China’s weaker domestic demand, New Zealand’s exports have slowed steadily this year. But Australia’s exports picked up steam, owing to larger shipments of coal and natural gas to China and other trading partners. Next year, higher U.S. tariffs on Chinese goods would further crimp China’s growth, which in 3Q 2018 was already the weakest since the global financial crisis.

Farmers in Australia and New Zealand stand to benefit from China’s counter-measures against U.S. agricultural products – in theory. In practice, China’s slowdown has curbed demand for New Zealand’s premium foodstuffs – the lion’s share of its export base.

Meanwhile, severe drought limits Australia’s ability to meet higher grain demand. Also, only 14% of Australia’s merchandise exports come from the farm sector.

China has responded to its slowdown this year with stimulus, including a call to speed up infrastructure projects. Further support is likely in 2019 if U.S. tariff threats materialize, though an investment push may be limited by already-high leverage in China’s financial system.

Australia’s coal and iron ore exports benefited from China’s massive fiscal stimulus during the global financial crisis, but suffered later when China moved to rebalance its economy away from investment and manufacturing, toward consumption and services. In contrast, New Zealand’s exporters benefited from the push toward consumption.
Euro Area
In 2017, the euro-area economy expanded fast but wage growth was weak. In 2018, the economy slowed but pay packets thickened. This year’s mix suits the European Central Bank much better. So long as growth doesn’t dip too far below trend in 2019, cost pressure will keep building and the ECB will finally begin to withdraw stimulus.

- The slowdown experienced in 3Q partly reflects one-time items that prompted the German economy to shrink. We see growth picking up in 4Q and settling at 0.4% a quarter in 2019.

- Slack has largely been taken up in the euro-area economy. The conditions are right for pay growth to keep climbing to more normal rates.

- The clash between Rome and Brussels will rumble on. When the next big economic shock hits, the euro area’s survival could again depend on political will and monetary activism. Possible leadership changes mean one or both could be found wanting.

Growth slowed materially in 1H18 to 0.4% a quarter – that’s only a fraction above the economy’s potential growth rate. In 3Q, Germany’s economy shrank and the euro area expanded just 0.2% while the business surveys have softened further toward year-end.

There’s good reason to think much of 3Q was a blip, but the danger, of course, is that the rate of expansion dips further into 2019.

What’s behind the slowdown? Partly, 2017 was just a hard year to match – a substantial boost from trade was never likely to be repeated and there was still a decent margin of slack in the economy. But as the labor market has tightened it’s become harder for companies to fill vacant positions and there’s been no meaningful surge in productivity growth to maintain the pace of expansion.

For the ECB, this is a sign of success – we estimate that the wide output gap that opened up during the euro-area crisis has pretty much closed. This helps explain why the ECB is relaxed about bringing asset purchases to an end even as growth has slowed – enough progress has already been made.

It’s quite possible that more slack reveals itself as the expansion wears on, especially in the periphery, but probably not enough to prevent pay pressure from building. And, in any case, we expect the first line of defence in the event of a renewed slowdown or weaker-than-expected pay growth would be changes to forward guidance, not fresh bond buying.

With wage growth accelerating through 2019, the ECB should begin to withdraw stimulus. It will take baby steps. We expect the first to be a mini-hike to the deposit rate in September that restores the interest rate corridor to normality. The next should come later in the year with a

Slack in Euro-Area Economy Mostly Exhausted

<table>
<thead>
<tr>
<th>Year</th>
<th>Range of Model Estimates</th>
<th>Bloomberg Economics Estimate (Large Economies Only Before 2000)</th>
<th>Bloomberg Economics Forecast</th>
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<tr>
<td>2020</td>
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<td>-1%</td>
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</table>

Source: Bloomberg Economics
Rather than whatever it takes, the ECB may be limited to doing whatever it can

- 25bp increase in the main refinancing rate. We then expect two hikes a year to follow – slower than the Fed, but fast enough to prevent the economy from overheating.

**Draghi, Merkel**

Mario Draghi will leave the ECB next year and German Chancellor Angela Merkel could find herself out of office. That’s a huge worry for the future of the euro area, which probably owes its survival to their leadership in the last downturn. A continuity candidate looks most likely to take the helm at the ECB, though a more hawkish presidency can’t yet be ruled out.

Merkel’s departure, when it happens, could be the bigger problem. After more than a decade of relative political stability in Germany, nationalism is now on the rise. The risk is not that the Alternative for Germany party sweeps to power – though some tough decisions would need to be made about coalition partners if it ever gains enough seats in parliament. Rather the danger is that the AfD influences the stance of the more mainstream parties, as the euroskeptic United Kingdom Independence Party did in Britain.

A Germany focused on putting itself first could threaten the cohesion of the euro area at a time when it has serious problems to deal with – Italy’s debt burden being one. It’s worth remembering that the ECB’s success in reviving the economy depended in part on Merkel’s backing for unconventional policy.

It may not come in 2019, but when the next economic crisis hits, the political will to keep the euro area together could be weaker. That means, rather than whatever it takes, the ECB may be limited to doing whatever it can – and that may not be enough.

### Pay Gain Measures Have Accelerated

![Graph showing pay gain measures](source)

**Source:** Bloomberg Economics, Eurostat

### Euro-Area Forecasts

<table>
<thead>
<tr>
<th>INDICATOR</th>
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Risks Mounting in Europe’s Strongest Economy

By Jamie Murray

Even as crises raged elsewhere in Europe, Germany has been a reliable source of economic strength and political stability. In 2019, it may provide neither. Growth has slowed and mounting pressure on Chancellor Angela Merkel could cut short her premiership. China’s economic slowdown, the Trump administration’s fixation with autos and the rise of German populism add to the risks.

- Germany’s economy shrank in 3Q, for the first time in years. That shouldn’t be repeated in 4Q.
- Growth is stabilizing at a slower pace and trade will offer less support than in previous years.
- A change of leadership for the Christian Democratic Union party, European parliamentary elections and state voting could shake up government policy.

The main reason for the weakness from July to September was a terrible showing from the industrial sector, particularly from automakers. New vehicle emissions standards have shifted the timing of new car registrations and prompted fewer to roll off production lines. It would take another leg down in the sector to drag on growth again in 4Q – that’s unlikely.

But the chances of a big rebound are fading, too. Evidence from Bloomberg Intelligence on the earnings of auto parts suppliers makes for grim reading. Profit warnings and guidance in 3Q results calls suggest the industry’s woes are unlikely to have melted away completely in 4Q.

Assuming the services sector continues to hold up better, we expect Germany’s economy to finish the year with growth of 0.5% and to expand by 0.4% a quarter in 2019.

Tariff Measures
The big risk to Germany’s automotive titans is tariff measures the U.S. government is considering. If the fragile truce between Washington and Brussels breaks down in 2019, Germany would be among the EU countries most exposed to fresh auto tariffs. We estimate American consumers switching to lower-cost alternatives in the U.S. market could directly trim between 0.3 ppt and 0.4 ppt from Germany’s growth in 2019.

A weaker performance from

Growth Under Different Auto Tariff Scenarios

Source: Bloomberg Economics
A steeper slowdown in Germany or the euro area more widely would add to pressure on Merkel

Germany’s automakers is one reason growth has slowed, but there’s probably more to it than that. Supply bottlenecks are beginning to pinch as unemployment plumbs unprecedented lows – some slowdown was inevitable in that environment.

The fallout from the continued trade war between China and the U.S. may have already created a drag on German export growth. Intensification of that in 2019 is one key risk, as is a more pronounced deceleration in highly-leveraged China. About 7% of Germany’s exports go to the Asian nation.

Alternative for Germany
A steeper slowdown in Germany or the euro area more widely would add to pressure on Merkel. Heavy losses in regional elections have already prompted a search for her successor as leader of the CDU.

Whoever takes over, policy is likely to be influenced to some extent by the rise of Alternative for Germany – a party staunchly against immigration and previously a declared opponent of euro-area bailouts.

There’s the risk that European elections in May or state elections later in 2019 deliver a drubbing for either of the biggest parties – that could prompt the coalition to collapse. An early general election would inject deeper political uncertainty into the outlook.

Germany Forecasts

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The populist government in Rome has taken on the European Commission in a fight to loosen fiscal policy in Italy. No one knows how the standoff will end. That’s creating uncertainty for Italian households and businesses and they’ve become more cautious about their spending. This is likely to persist, impairing the public finances and deepening the conflict with Brussels.

- Bloomberg Economics expects a slight contraction in 4Q and a small increase in GDP growth in 1Q.
- Our core scenario for the medium term is more of the same. Slow growth, high yields, simmering tension with the EC and big risks.

GDP growth came to a screeching halt in 3Q. The failure to expand from July to September compares with an increase of 0.2% from April to June and 0.3% from January to March.

We estimate trend growth in Italy to be about 0.1% to 0.2%. So the pace of expansion was fast enough in 1H to chisel away at spare capacity, but no longer. The output gap stood at about 2.3% of potential GDP at the end of 3Q and will probably widen slightly in 4Q.

In all likelihood, an erosion of confidence induced by the brewing battle between Rome and Brussels spurred a pullback in spending, despite reasonably strong income growth. That’s a troubling sign for the outlook. Also, the surveys don’t provide much room for optimism about the final months of the year.

We therefore expect GDP to contract by 0.1% in 4Q. Assuming the economy ekes out a modest expansion in 1Q and returns to more normal growth rates thereafter, we forecast an increase of 0.5% in 2019 and 1.1% in 2020.

Unfortunately, the fiscal expansion promised by the government probably won’t provide much of a lift. Even if spending plans were implemented in full, a boost to the economy now looks likely to be dampened by weaker sentiment.

The evaporation of confidence and the resultant slower growth will almost certainly cause Italy to miss its borrowing targets next year. The EC is calling for spending restraint, which is at odds with the Italian government’s democratic mandate to spend more. There’s no clear path forward, but we see three potential scenarios.

**Scenario One — Italy Gets Lucky**
If Italy were to ignore the demands of Brussels and persist with its spending plans, the...
Our central scenario is that Italy’s recovery continues to be tepid.

- A boost to GDP growth could accelerate the recovery, lower unemployment and reduce the budget deficit. This could involve the economy expanding by at least 1.5% in 2019. The problem is higher sovereign yields may already be crimping demand and confidence would somehow have to be lifted. None of the latest data releases suggest this scenario will unfold.

**Scenario Two – Muddling Through**

Our central scenario – with GDP growth registering 0.5% in 2019 – is that Italy’s recovery continues to be tepid. Lackluster growth leaves the budget deficit uncomfortably wide for Brussels. The EC threatens to impose fines, but some agreement is reached before things get that far.

The main problem with this is the Five Star Movement and the League didn’t ride to victory by promising to maintain the status quo. And, if no agreement is reached or the Italian economy fails to show any signs of recovery, the third scenario becomes more likely.

**Scenario Three – Doom**

If confidence were to vaporize, a deep recession may follow. That would prompt a significant deterioration in the public finances and a fiscal crisis could ensue. Further rating downgrades could leave Italian debt ineligible to exchange for central bank liquidity.

Cut off from the European Central Bank, Italy would have to choose between a financial crisis, compliance with EU rules or departure from the monetary union. All three options would significantly deepen the recession. The economy could contract as much as it did in 2009, when output declined by more than 5%. The biggest risk for Italy is that euroskeptics in Rome succeed in pushing for the exit route.

### Bond Yields Remain Elevated

![Bond Yields Chart](source: Bloomberg)

### Italy Forecasts

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President Emmanuel Macron prompted a polemic in September when he told an unemployed gardener that he only had to “cross the street” to find a job in one of the nearby cafes and restaurants. As improvements in the job market seem to have stalled in 2018, this anecdote was a timely reminder that fixing France’s endemic unemployment problem remains the government’s key challenge.

After a freezing winter and a spring crippled by train strikes, activity has rebounded in 3Q and we expect growth to remain around its trend of 0.4% a quarter in 4Q and next year. In these conditions, the stagnation in unemployment at 9% since May was always going to be a passing trend and it’s reassuring that the decline in the jobless rate resumed to 8.9% in October. As growth picks up, moderate wage pressures should help bring inflation to around 2% from 2020 onwards.

A push by successive governments to lower labor costs, combined with a stronger economic performance, seem to have unlocked French employers’ animal spirits. Vacancies have soared since the end of 2015, across all sectors of the economy. In 3Q18, there were 160,000 vacancies, more than double the number recorded three years earlier and representing 1.2% of the stock of existing jobs.

This has helped create more than 600,000 jobs in the past three years. And while temporary contracts were initially the main contributor to job creation, this trend has reversed since the end of 2017, driving the share of temporary employment down to 14.8% in 2Q from 15.3% in 4Q17. This is an encouraging sign that labor market reforms and fiscal incentives to make permanent contracts more attractive to employers are bearing fruit.

But reducing unemployment ultimately depends on recruiters finding the right candidates and there are signs that employers are failing to satisfy their appetite for hiring. Recruitment difficulties have increased sharply. The share of employers reporting that labor was a limiting factor to the EC’s Business Climate Indicator survey in 4Q18 was twice as high as the historical average in all three sectors of the economy.

And indeed, despite the surge in vacancies, France’s labor market performance has disappointed since the end of last year. The employment level has remained broadly flat in the last three quarters and unemployment remains elevated. This suggests that the labor market is already hitting structural constraints.

So, Macron was right in a way: some jobseekers may need to change sector and relocate if we are to see deeper cuts in unemployment. Reforms of the vocational training system introduced this summer will help. But it will be a slow and difficult walk across the street for many, especially if snow and protesters keep getting in the way.
More than anything, it is the unemployed returning to work that has boosted Spain’s economy in recent years. About 2 million jobs have been created since 2013 and the jobless rate has fallen 11.4 percentage points from a peak of 26.3%. Even as the labor market recovery comes to an end, job creation may continue if migration flows return to more normal patterns.

We expect spare capacity to be eliminated next year and expansion to slow to our estimate of trend growth of 0.4% a year in 2020. With the economic recovery complete, migration flows will turn positive again and we see a boost to the labor force that contributes 0.1 ppt a quarter to growth.

The sharp fall in unemployment and high participation rates mean spare capacity in the economy is eroding fast. The jobless rate should keep declining as reforms help cut the structural rate of unemployment, but at a much slower rate.

There are already signs that the labor market is becoming tighter, with a growing number of companies starting to report labor as a factor limiting production, albeit from a very low base. Employment expanded in 3Q18 at its slowest pace since the start of 2014. Some of the increase in demand seems to have been met by lifting average hours worked by existing workers - but that can only continue for so long. Other sources of labor will be needed if growth is to remain high.

One such source is an increase in the working-age population. We now forecast that immigration will provide more of a boost to labor supply over the next few years. Large inflows of foreign citizens, from Romania, Latin America and Morocco in particular, supported strong population growth in the pre-crisis boom, making a major contribution to Spain’s economy over the period. This trend reversed during the recent crisis, as fewer migrants arrived and many residents left the country in search of work. Between 2009 and 2017, Spain lost more than 1 million of its working-age population, or almost 3.5%.

As economic conditions in Spain keep improving, there are signs that net migration flows are turning positive again. We estimate that about 190,000 Spanish citizens were settled abroad in response to the crisis by the end of 2017. Some of them are starting to return and we forecast about 20,000 will come back every year for the next few years.

We also expect net immigration of foreign citizens of some 175,000 a year. These effects will help lift the working age population by roughly 0.7% a year, offsetting a negative effect from demographics of 0.3% and boosting our estimate of trend growth by 0.4 ppt a year. Even if Spain’s cyclical labor market recovery has run its course, job creation may still continue at a decent pace in 2019.

### Migration to Support Population Growth Again

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Source: Instituto Nacional de Estadistica, Bloomberg Economics (forecast)
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U.K.
Britain’s economy is at a fork in the road. The balance of probability suggests the U.K. will exit the EU with a deal. If that happens, increased certainty should deliver a growth spurt in 2019. The Bank of England is likely to respond with two rate hikes. There’s still a risk Britain takes the other fork – leading to no deal, low or no growth, and despite soaring inflation, rate cuts.

In 2019, with a formal leaving date of March 29, the U.K. will finally face up to the reality of life outside the EU. A deal is already agreed between London and Brussels. It is now down to the U.K. parliament to decide whether or not to accept it.

The parliamentary maths for the vote, due on Dec. 11, doesn’t look favourable for Prime Minister Theresa May. More likely than not the vote will fail.

If that happens, fear that the U.K. will leave the bloc without a deal will reach fever pitch. An ignominious end to May’s premiership, general election, or second referendum cannot be ruled out.

Our view though, is that May will be given time to renegotiate with the EU. Despite saying the current deal is final, the bloc could offer up some cosmetic tweaks to mollify U.K. lawmakers. Add in a rising fear of no deal as the March 29 deadline looms and we think a second Parliamentary vote has a fighting chance of success.

For the economy, until a deal is signed, concern about the possibility of crashing out of the bloc is likely to keep a lid on growth. We expect output to rise by 0.4% in 4Q and 1Q from 0.6% in 3Q though the risks are tilted to the downside.

Looking further out, and assuming a smooth and orderly exit, the U.K. economy is likely to benefit from three cyclical tailwinds.

As uncertainty is lifted, firms will feel more confident about undertaking investment projects. A rally in the pound should offer a modest real income boost, buoying consumption. And the government will be able to go ahead and increase spending and cut taxes.

Those forces should lift the economy further above potential and offer the Bank of England a good reason to raise rates. That’s despite inflation dropping below target as the pound rallies and the lagged effects of past declines in the currency fade.

We think the next rate hike will come in May reflecting the risk that parliament only votes through a deal at the 11th hour, though it’s possible a rate increase comes as early as February if an agreement is in place by year end. Another hike will likely follow in November.

It’s unlikely the BOE will want to put its foot on the brake any harder – 50 bps of tightening should start moving demand back in line with supply.

A ‘no deal’ outcome would mean...
The severity of the slowdown will hinge on the willingness of both sides to keep goods flowing.

- a very different trajectory for the economy. Instead of 2%, we think annual growth would be closer to 1.3%. Hidden behind that annual figure is an economy that slows sharply on a quarterly basis, flirting with recession by the end of 2019.

The severity of the slowdown would hinge on the willingness of both sides to keep goods flowing between the U.K. and the rest of Europe. The BOE’s scenarios assume greater trade disruption which is partly why its estimates suggest output would fall sharply in 2019 if no deal is reached.

We also think that, despite inflation surging on the back of tariffs and a likely fall in the pound, the BOE would cut rates to support the economy.

The nature of the U.K.’s departure will have a fundamental bearing on the outlook for the economy beyond 2019. If May’s deal is accepted by parliament, it seems highly likely any future relationship will be underpinned by some form of customs union – two years of talks have failed to find an alternative way of keeping the Irish border open.

Our forecast now reflects that judgment and means we expect the economy to grow a little faster in the medium term compared with previous projections which assumed a Canada-style Free Trade Agreement.

Output is 3% lower by 2030 than it would have been if the country had decided to remain in the EU. That compares to a cost of 4% of GDP in the case of an FTA and 7% of GDP if the U.K. were to leave the bloc without a deal.

Below Target Inflation Is No Obstacle to Hikes

![Graph showing CPI inflation readings and inflation target](source: Bank of England, ONS)

U.K. Forecasts

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Russia
Sanctions to Stoke Russia Recession Risk in 2019

By Scott Johnson

Russia is heading for a mild slowdown in 2019. That’s partly by design, as policy makers pay for long-term stability with near-term growth. But tighter U.S. sanctions are still on the way. A shock at the wrong time could tip the economy into recession.

In historical comparison, GDP growth in Russia is already sluggish. A shrinking workforce, together with weakness in investment and productivity, is keeping the trend pace below 2% a year. Even the recovery from the 2015-16 recession has been slower than usual. Partly that reflects a shift toward a less volatile fiscal policy. The government has saved some of its oil windfall, damping a tailwind for growth.

A sharper slowdown lies ahead. The value-added tax rate is set to rise in January to fund investments in infrastructure, health care and education. That could lift the growth potential of the economy over the long run, particularly if policy makers succeed in jump-starting private investment. But in the short term it’s likely to push inflation toward 6%, well above the 4% target.

The squeeze on household budgets will weaken demand, bringing GDP growth to a crawl in 1Q on a quarterly basis. We expect the headline year-over-year rate to hover around 1% in 1H, recovering later in 2019.

Growth for the year as a whole should come in at 1.4%, compared with 1.6% for 2018.

Monetary policy won’t provide much support. The Bank of Russia needs to anchor expectations to its target to control inflation over the medium term. Record-low inflation through much of 2018 has helped, but an overshoot could endanger that progress. We see the key rate staying at 7.5% through most of 2019, above the 6-7% range that policy makers consider neutral. Most of the upward influences on inflation are temporary, which means the central bank could resume easing later in the year. Risks tilt toward another hike in the meantime.

Sanctions are the biggest threat. Though U.S. lawmakers have put aggressive proposals on hold, another round is still on the way. Unexpectedly harsh actions could renew the slide in the ruble, stoking faster inflation. The Bank of Russia would probably respond with tightening. If this were to unfold in 1H, the slowdown could become a contraction.

Not all of the risks are geopolitical. The pullback in household spending could turn out to be more severe than forecast. Cost pressure in the labor market might also force the central bank to do more to manage inflation. Another broad deterioration of risk appetite for emerging markets might see the ruble slide anyway, though Russia compares well with its peers. And oil prices will remain important to sentiment. The government can’t entirely insulate the economy from swings in crude.

### The Slowdown to Come

Source: Bloomberg Economics
## Russia Forecasts

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Middle East
Public Spending Is Only Game in Town for Saudi Arabia

By Ziad Daoud

Lower oil prices present Saudi Arabia with a dilemma. The government could either cut public spending or absorb the shock on its balance sheet by running a larger deficit. Political considerations suggest it would opt for the latter, sustaining non-oil growth at 2.6% in 2019.

The government slashed spending after oil prices fell in 2014, leading to a slowdown in non-oil growth. As oil prices began to pick up again, the government loosened the purse strings, helping the economy to recover somewhat. Higher public spending should continue into 2019—the government has recently revised up its spending plans for 2019 by 100 billion riyal (about 3.4% of GDP). It also reinstated annual pay rises for public-sector workers. On a recent tour of the country, King Salman unveiled projects worth billions of dollars in far-flung areas of the kingdom.

Higher public spending will drive non-oil growth to 2.6% in 2019. This is higher than the 2016-17 lows but lower than levels achieved before 2014—with oil prices below $100, government spending remains constrained by budgetary limits. Can the private sector fill some of the growth gap? Not really; consumers have been battered by the introduction of a value-added tax, reduced fuel subsidies, higher utility bills and expatriate levies. Domestic private investors have been rattled by the detention of businessmen, royals and officials in what the government called an anti-corruption campaign in November 2017.

Foreign investors, who have been slow anyway to commit to Saudi Arabia, are now facing increasing risks. There’s a possibility that their local partners could get caught up in another anti-corruption campaign. They could be frozen out of the kingdom, as was recently the case with firms from Germany and Canada. The dispute with Germany took almost a year to resolve. They could also face a backlash after the murder of journalist Jamal Khashoggi in Istanbul in October. Shunned by outside investors, the Saudi authorities are likely to double down on domestic support, by increasing public spending. Politics may prove more powerful than the recent decline in oil prices.

But that’s a dangerous path to take. The balance sheet is weaker today than in 2014: the kingdom has withdrawn nearly a third of its vast foreign-currency reserves and accumulated a significant foreign debt. If current spending patterns continue and the drop in oil prices persists, the currency peg could be under threat.

Vision 2030, a project promoted by the crown prince, aimed to break the link between oil revenue, which finances public spending and in turn drives growth. Yet the events of the last year made breaking that link harder and Vision 2030 is slipping further out of sight. The Saudi economy will be growing on the same old engine in 2019: public spending fueled by oil.

Growth to Stabilize

Source: General Authority of Statistics, Bloomberg Economics
Turkey’s High Rates, Lira Slide Spell Recession

By Ziad Daoud

We expect Turkey’s economy to shrink in the first half of next year. Tighter fiscal and monetary policy and the recent currency crisis should tip the balance. The recession is likely to be brief. High inflation, the large stock of external debt and political interference in monetary policy remain concerns.

After years of running the economy too hot, which led to the currency crisis of 2018, Turkey is paying the price. We see growth of 0.8% in 2019 down from an expected 3.6% in 2018. This is well below 2017, when Turkey was one of the fastest growing emerging markets.

The quarterly numbers reveal a more telling story. We expect the economy to shrink between 4Q18 and 2Q19 compared with a year earlier. Three factors are behind the slowdown. First, the fading fiscal stimulus of 2017-18, which drove much of the overheating in the economy in that period. Second, interest rates rose by 11.25 ppts in 2018, which is bound to slow consumption and investment. Third, the lira’s recent decline is hurting consumers via higher import prices, and businesses which borrowed in foreign currency.

Slower growth isn’t necessarily a bad thing – it’s an inevitable part of the rebalancing process. Together with lira depreciation, it should narrow much of the current account deficit, reducing a major source of risk. Slower growth should also eventually lead to lower inflation, once the impact of the currency depreciation is fully transmitted into domestic prices. We expect inflation to peak in 1Q19 and then gradually decline to 16.3% by the end of 2019. What does this mean for interest rates? The next move is likely to be down, assuming no further meltdown in the lira. But we don’t see a rate cut before 2Q19, as inflation begins to fall from its peak. We forecast a total 550 bps in rate cuts next year, reversing some of the recent tightening.

As the economy stands on the cusp of recession, further vulnerabilities remain. First, Turkey’s president has repeatedly stated his dislike of high interest rates, even when the economy was growing faster than its non-inflationary speed limit. His resistance may intensify as the economy slows, which could spook markets again.

Second, price gains are currently running at nearly five times the central bank’s target. Even after its expected fall in 2019, inflation would still be running at more than three times target. This could risk another run on the lira if people lose faith in the currency.

Third, Turkish companies have amassed significant foreign-currency debt. The lira’s decline is making these loans harder to service. We have already factored in the impact of this on growth but there’s a risk this could be more damaging than we forecast.

Recession Looms

Source: Turkish Statistical Institute
### Baltic Forecast Tables

#### Saudi Arabia Forecasts

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Latin America
A full agenda awaits Brazil in 2019. Jair Bolsonaro takes office aiming to stabilize public debt, reduce the size of the state and improve productivity. He has also vowed to maintain market-friendly economic policies, reform social security and sell off federal government assets.

The big question for markets will be whether Bolsonaro displays the political and executive skills to deliver on those promises. The answer will shape the outlook for the currency, yield curve, confidence and growth in the year ahead.

Bolsonaro’s main challenge will be stabilizing Brazil’s public debt, which has soared over the last five years to nearly 80% of GDP. This will require a sharp fiscal adjustment of around 3% of GDP, which must be executed over the next couple of years.

Bolsonaro’s proposals are still a question mark, as is whether he can gather the necessary congressional support for the fiscal measures.

The real tends to be very responsive to external drivers, like U.S. rates, global risk aversion, turbulence in other emerging markets and commodity prices. Absent surprises, the currency may oscillate around 3.70-3.80 per dollar, a little below its historical inflation-adjusted average.

Domestically, pension reform is key. Absent meaningful progress in 1H, the real could approach 4.00 per dollar. A positive outcome could bring it closer to 3.50. The range is somewhat limited by stable external accounts – low deficit, sound financing and high reserves – on one hand, and marginal tightening in external financing conditions on the other.

Balancing Budget Key to Stabilizing Soaring Debt

Persistent economic slack, in the context of anchored inflation expectations, should keep inflation tamed. Core inflation is expected to approach 4%, as is the headline, barring shocks in food, fuel or electricity prices. This leaves room to maintain accommodative policy. The Selic rate may hold at 6.5% until gradual normalization begins around the middle of the second half, with the rate reaching 7.25% by December – still below a neutral level estimated at 8.0%-8.5%. Longer-term interest rates are likely to respond to the international environment and the speed of Bolsonaro’s fiscal consolidation.

Pension reform is a necessary condition for this, but on its own insufficient. Most proposals do not reduce the already-high pension expenditure-to-GDP ratio – they only prevent further increases. Most other expenditures are mandatory, so two options are available: One, increase revenues, either from taxes or concessions in oil and infrastructure; and two, retire debt, using resources from privatization, for example.
Mexico’s growth should remain subdued in 2019. The Nafta replacement has reduced the risk of trade disruptions, but implementation doubts may weigh on private investment. Uncertainty about President Andres Manuel Lopez Obrador’s economic policies and tight monetary conditions should drag on growth; public-sector spending would provide support, but will be limited by fiscal constraints. Slower U.S. economic activity should moderate external demand.

We expect 2.1% growth in 2019 due to resilient private consumption. This is slightly below our forecast for 2.2% in 2018, near the long-term trend and consistent with little economic slack. Stimulus policies pose short-term risks of difficult-to-manage macro imbalances.

The new trade deal may stall with a split U.S. Congress. Slower-than-expected U.S. growth would pose a significant headwind. Since AMLO’s election, detailed government plans to increase social spending and public-sector investment contrast with vague ideas to boost revenue, pointing to wider deficits and mounting debt. Proposals to boost the minimum wage would erode competitiveness and higher labor costs could weigh on job growth.

Positive surprises could stem from early implementation of the trade deal or more stable conditions to attract private investment. Reforms aimed at increasing productivity and continued implementation of those approved by the current administration would help.

Inflation should gradually return to target. Abating fuel inflation on stable oil prices would provide most of the relief. Core inflation should also slow as the impact from price indexation and second-round effects moderates. We expect inflation to slow to 4.7% by end-2018 and 3.3% in 2019, versus a 3.0% +/- 1 ppt target. Core inflation should drop to 3.5% then 3.4%.

The risks are tilted to the upside. Potential supply shocks on food prices would pressure non-core inflation. A higher minimum wage and additional public-sector spending could see cost-push and demand-pull pressure on consumer prices. Amid high external risks and lingering uncertainty, further peso depreciation cannot be ruled out – further pressuring prices. Downside risks include lower oil prices or weaker domestic demand.

Policy is consistent with tight monetary conditions. Officials will stay cautious until they are more certain about external conditions and domestic economic policy. Inflation expectations should stay further hikes, but elevated uncertainty means they cannot be ruled out. We expect Banxico to keep rates at 8.0% until 25 bp cuts at the final two meetings of the year. Real rates would remain above, but closer to, the 2.5% level seen as consistent with long-term neutral monetary conditions.

### Uncertainty to Drag on Growth Despite U.S. Expansion

![Chart showing real GDP growth in Mexico and the U.S.](image)

**Source:** INEGI, BEA, Bloomberg
Argentina’s Adjustments, Elections to Fuel Uncertainty

By Adriana Dupita

For Argentina, 2019 may be make or break. The country is in the midst of an adjustment process – this has encompassed exceptionally high interest rates, a deep recession and a massive loss of purchasing power as the peso plunged and inflation rose.

At its completion, the economy should be better balanced on the fiscal, external and inflation fronts. Still, October’s elections may raise market concerns over a policy shift away from a steadying course. These themes will influence confidence and asset prices throughout the year.

High real interest rates, lower purchasing power and depressed business and consumer confidence don’t bode well. The economy will likely contract until midyear, and growth should average -1% in 2019. This is key ahead of the elections. While the electoral scenario is still unclear, popular dissatisfaction amid ongoing economic woes may fuel fears of policy changes after the vote.

Monetary policy is constrained by a target of nominal stability in the monetary base through mid-2019, a much stricter and more transparent rule than previously adopted inflation targets. This should help contain inflation expectations even as the peso floats freely – though intervention is allowable to avoid extreme movements. The target of monetary base stability constrains any issuance to finance the public sector, thereby enforcing the commitment to a balanced 2019 budget, as agreed with the IMF.

Under such a framework, the basic interest rate of the economy is set by market forces. If fiscal and monetary policies proceed as planned, we see the seven-day LELIQ rate at around 35% by the end of 2019, from above 70% in October 2018. Still, the country will likely see double-digit real interest rates for most, if not all, of the year.

The large current account deficit and the reliance of the public sector on external financing render the peso particularly vulnerable to global dynamics – even with sound policy making. Absent surprises, the peso is set for a 20% nominal decline in 2019 to around 47 per U.S. dollar. With volatility fueled by both external drivers and electoral uncertainty, we don’t rule out central bank FX intervention.

Absent new currency shocks, inflation should halve to 25% in 2019, onlyretreating to single-digits by 2021. Hence, the peso might end the year somewhat stronger than the current level, in real effective terms. Still, external imbalances should narrow in 2019 due to stronger harvests and weaker domestic demand.

Successful fiscal adjustment and commitment to new monetary rules may steady Argentina’s economy – if not in 2019, then soon after. Major setbacks in the global backdrop or in policymaking could alter this course.

Source: Indec and Bloomberg Economics

Negative Growth Likely Again in Argentina

Source: Indec and Bloomberg Economics
Andean economies should continue their cyclical recovery in 2019, mainly due to modest private consumption and investment. Growth should approach its potential, which remains capped by stagnant productivity.

We expect Peru to outperform with growth of 4% in 2019, up from 3.5% in 2018. The consolidation of President Martin Vizcarra’s power after the resignation of Pedro Pablo Kuczynski in early 2018 should reduce political uncertainty. Lingering tensions with opposition majorities in Congress and plans to reform the judiciary may pose risks.

In Colombia, we forecast growth of 3.0% in 2019, up from 2.7%. Mining and construction should no longer drag on activity, as oil output has finally bottomed and headwinds from corruption scandals abate. Still, fiscal imbalances remain a concern. Tax reform that increases the burden on consumers would be a drag, while a lingering fiscal gap could trigger bigger concerns about debt.

We expect growth in Chile to fall to 2.9% in 2019 from 3.8% this year, a rate that was inflated by the rebound following the 2017 strike at Escondida copper mine. Government plans for structural reforms could boost savings and investment and contribute to higher long-term growth.

Slower growth from the region’s two main trading partners, the U.S. and China, means Andean countries will face less external demand. Chile has the highest exposure as exports account for nearly 30% of GDP. Peru and Colombia are less exposed, with exports close to 20% and 15% of GDP, respectively.

Consensus calls for average oil and copper prices to be little changed in 2019, pointing to stable, but still favorable terms of trade. The outlook would support exports and domestic demand. Copper accounts for nearly half of export revenue in Chile and one-third in Peru. In Colombia, oil makes up about one-third of export revenue. Commodities also contribute to fiscal revenues through royalties in all three countries and direct ownership of Codelco in Chile and Ecopetrol in Colombia. Potentially lower prices pose significant risk for fiscal and external accounts. Room to accommodate potential shocks is more limited in Colombia; Chile also has constraints, while Peru has more flexibility.

Commodity price forecasts point to moderate current account deficits. They are also good enough to drive investment in capacity expansion, which should mean continued foreign direct investment that will cover the bulk of external financing needs. Short-term external debt obligations in Chile and non-resident holdings of local government debt in Colombia and Peru should not be problematic, but add exposure to risks from tighter external...
financial conditions. High international reserves in Peru and strong fundamentals in Chile provide some buffers, but lower commodity prices would be a significant negative shock.

Stable commodity prices would also support currencies in the region. Consensus suggests the U.S. dollar has peaked, indicating more moderate weakening pressure in 2019. Already weak currencies in real effective terms in Colombia and Peru also see more limited room for further depreciation. Exchange rate volatility should remain high in Colombia and Chile and capped by active central bank intervention in Peru.

Inflation should remain in-line with the 3% +/- 1 ppt target in Chile and Colombia and the 2.0% +/- 1 ppt target in Peru. Abating fuel inflation consistent with forecasts for stable average oil prices in 2019 would be a down-force on inflation in all three countries. Food inflation is likely to rebound, bolstered by supply shocks due to El Nino. Well-anchored inflation expectations should continue limiting the potential spillover and second-round effects from those supply shocks. Demand-driven pressure on prices would remain subdued, in-line with growth near or below potential.

We expect inflation in Chile to fall to 2.8% by the end of 2019 from 3% in 2018. Excluding food and energy, it would remain close to 2.4%. In Colombia, inflation would fall to 3.2% in 2019 from 3.3% in 2018. We expect inflation in Peru to increase to 2.5% by the end of 2019 from 2.2% in 2018. Excluding food and energy, inflation would increase to 2.4% from 2.2%, respectively.

Expectations for near-potential economic growth and inflation in-line with targets in all three countries point to less expansionary monetary policy — rather, closer to neutral. The Fed is expected to keep raising rates in 2019, suggesting that central banks in the region would probably support tightening monetary conditions to prevent further narrowing of interest-rate differentials, which could weigh on short-term capital flows.

We expect Chile’s central bank to continue the gradual adjustment that started late in 2018, lifting rates to 3.5% in 2019 through one 25 bp hike in each of the first three quarters. Rates in real terms would remain below 1-1.5% seen as consistent with neutral monetary conditions. In Colombia, the central bank should maintain rates until late in 2H, when it would start a slow adjustment and hike twice by 25 bps each for rates to reach 4.75% by year-end. In real terms, rates would be in-line with the neutral real rate that the central bank estimates is 1.5-2.%.

Peru’s central bank should raise rates to 4% in 2019 from 2.75% in 2018, with hikes starting in 2Q. Rates in real terms would be slightly above the 1.75% level estimated to be consistent with neutral monetary conditions.

Narrowing Interest Rate Differentials With the U.S.

Source: Bloomberg
# Forecast Tables

## Mexico Forecasts

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Africa
Elections to Determine Economic Fortunes

By Mark Bohlund

Elections next year in South Africa and Nigeria, Sub-Saharan Africa’s two largest economies, will shape the outlook for growth in the region. We expect a stronger push for economic reform in South Africa after the elections, but little change in Nigeria.

South Africa’s President Cyril Ramaphosa, who took office in February 2018, is likely to make a more concerted effort to reform bloated state-owned enterprises and cut spending following the election. The medium-term political risk is that this prompts a backlash among the swelling ranks of the country’s unemployed. South Africa’s jobless rate stood at 27.5% in 3Q, near a 15-year high.

Less change is likely in Nigeria. Though, pleas for devolved spending mean the next government may struggle to keep enough revenue at the federal level to service an increasing debt burden.

South Africa

There’s little doubt that the African National Congress will win the 2019 election, expected in May. But the margin of victory will help determine how long the party might maintain its dominant position in South African politics. The ANC won 62% of the vote in the 2014 national election, but this fell to 54% in municipal polls in 2016.

The ANC will enjoy two advantages that may keep its share of votes above or close to 60% next year. First, the ascendancy of Ramaphosa to the presidency should appeal to voters appalled by allegations that his deeply unpopular predecessor Jacob Zuma benefited his family and business associates while in office.

Second, infighting in the main opposition party the Democratic Alliance is likely to limit its success at the polls.

The main electoral threat to the ANC over the longer term is likely to come from the left-wing Economic Freedom Fighters which is appealing to younger voters frustrated by the lack of job opportunities.

Unemployment hovered near a record high in mid-2018, although this partly reflected an increased labour force participation rate as more educated applicants are seeking jobs in the formal sector rather than informal ones.
We expect spending to pick up in Nigeria ahead of elections as some parliamentary candidates seek to better their chances at the polls in February. The ruling All Progressives Congress party should retain power as President Muhammadu Buhari benefits from a higher perceived personal integrity than his challengers.

The commercial capital of Lagos and the southwest will probably decide the electoral contest. Regardless of the outcome, we expect little change in economic policy.

However, a key issue will remain the devolution of spending to state administrations.

The government has resisted so far, but may give ground as the election nears. This would come at the expense of spending control and make it harder to meet debt interest payments that are soaking up an ever-bigger share of revenue. Devolution is likely to remain on the political agenda following the vote.

Bloomberg Economics expects the Central Bank of Nigeria to maintain its policy rate at a record high to reduce pressure on the naira’s peg against the dollar as increasing domestic demand for imported goods and services erode the trade surplus.

We forecast growth will accelerate to about 2.5% in 2019 as consumption continues to recover from its decline in 2016-17. But we expect growth will slow to 2% in 2020 as consumption slows, with weaker oil prices raising the risk of a sharper slowdown.
Trade War Raises Hopes of Industrial Renaissance

By Mark Bohlund

There are very few winners in the escalating trade war between the U.S. and China. But one industry may stand to benefit as global supply chains are overturned – African manufacturing. Several auto makers have revealed plans in the past few months to open plants in Africa, raising hopes of a renaissance in the sector.

Morocco is likely to see a sustained increase in manufacturing output in the near term while Kenya and Ghana may become key countries for vehicle assembly serving regional markets over the medium term.

Trade Tariffs
U.S. trade tariffs imposed on China and Beijing’s focus on higher value-added functions may mean more manufacturing jobs move to Africa. Even before the trade war escalated, manufacturing in Africa was proving a rising star. Nissan, Volkswagen and China’s Sinotruk announced in 2H plans to open assembly and manufacturing plants in Ghana, boosting the authorities’ efforts to develop the industrial sector. These initiatives follow similar moves in Kenya by global vehicle manufacturers. Automakers are combining with ride-hailing companies to make new cars more affordable for African consumers.

These plans show that foreign investors are mainly seeking to locate manufacturing plants in Africa to serve local consumers rather than overseas markets. African manufacturers have struggled to compete with Chinese imports. Manufacturing has dipped to 5-15% of GDP in most economies.

But there are now signs of a renaissance. Those segments with comparatively high transport costs, like cement makers and brewers, have capitalized on the advantage of locating plants close to their fastest growing markets to gain an edge over imported goods.

Vehicle Assembly
Bloomberg Economics views vehicle assembly, especially trucks and utility vehicles, as the next rung on the manufacturing ladder for African countries with more developed infrastructure and access to regional markets.

But what we are likely to see in 2019 is a continued ramp-up in autos production primarily in Morocco, where French car manufacturers are replicating the outsourcing of lower-skilled operations that their German competitors have secured in the past decade. We also expect the Ivory Coast and Uganda to catch up with their peers in the production of cement and drinks. This output will be mainly focused on domestic consumption. Several African countries, most notably Ethiopia, have sought to attract Chinese manufacturers to economic free zones, with the aim of replicating the export-led development model that has lifted many Asian economies out of poverty.

But the results so far have been disappointing. Ethiopia’s textile exports have barely risen in the past five years. Still, export-led manufacturing efforts could get a new lease of life from the introduction of trade tariffs by the U.S. on Chinese imports.

Tariffs will probably accelerate the implementation of Beijing’s Made in China 2025 industrial policy. This aims to transfer a higher degree of industrial research and development to China while outsourcing tasks, such as final assembly and testing, to countries with lower wages. African countries are very unlikely to be subject to tariffs, making them highly attractive outsourcing destinations for Chinese manufacturers.

The development of the autos sector may represent a success story, drawing investment into other manufacturing segments. With growing domestic demand, a rising and better educated workforce and improving infrastructure, African nations may need little more than some investor confidence to start moving up the value chain.
## South Africa Forecasts

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Governments behaving badly— with populists and authoritarians flouting the rules and international relations fraying— pose some of the biggest risks to the world economy in 2019. Here’s a look at some of the political flashpoints that could derail growth.

Trade Wars
If there’s one thing Democrats and Republicans agree on, it’s that China’s rise is a challenge for the U.S. The risks from China include threats to the technology supply chain, Beijing’s military expansion, and the country’s efforts to undermine sanctions on North Korea according to the U.S.-China Economic and Security Review Commission, an annual report by a bipartisan congressional panel. On the other side of the Pacific, Xi has staked his reputation on managing China’s rise as a global power.

With the two countries apparently locked on a collision course, the biggest risk to the world economy remains the U.S.-China trade war. Even if the G20 truce holds, the dispute could represent the early stages of a prolonged economic cold war. If President Donald Trump follows through on threats to slap duties on all imports from China, Bloomberg Economics estimates a hit to China’s 2019 GDP growth of 1.5 percentage points. That would take growth down towards 5%, though a major policy response by China would soften that blow.

Italy
Italy’s populist government is locked in a tussle with Brussels over a planned spending spree, unnerving investors and European Union authorities. Next year could be make or break, not just for the populist administration, but also the EU’s ability to impose budget discipline on member states. The European Commission said in its annual review of euro-area nations’ spending plans that Italy’s budget is in “particularly serious, non-compliance” of EU limits. Tensions between the ruling coalition partners—the anti-establishment Five Star Movement and the anti-migration League—could see the alliance collapse before or after next May’s European Parliament elections, plunging Italy into another bout of political chaos. Even if the government endures, Italy could come under pressure in financial markets. The 10-year yield is already at the highest in more than four years.

Brexit
Britain’s ruptured political
landscape has obscured the nation’s exit path from the EU, with little consensus on how that will be eventually achieved. Amid a highly fluid situation the risk of a change in Prime Minister, or government, remains high. A no-deal Brexit could mean British GDP is about 7% lower by 2030 compared to remaining in the EU, according to Bloomberg Economics. A Brexit that involves the U.K. Staying part of a customs union with the EU would still involve a hit to the economy. Output would likely be 3% lower by 2030 in that scenario.

**Democrat-Controlled House**

In the U.S., the Democrat takeaway of the House of Representatives could cripple President Trump’s agenda, opening the way for unfettered investigations into his administration, his presidential campaign and his family’s business empire.

That would mean two years of policy gridlock, so forget about additional tax cuts and increased infrastructure spending and brace for periodic bouts of drama and threatened government shutdowns. A Democrat-controlled House could even launch an effort to impeach Trump – though if it went that far, the president’s ultimate fate would rest with the Republican-dominated Senate.

**Elections**

Next year will see elections in several major emerging economies, with far-reaching implications for their policy stance and market stability. Argentina, India, Indonesia, South Africa and Nigeria are among those headed to the polls. As Brazil’s recent election showed, strongmen with unconventional platforms continue to appeal. Voters are more keen on sending a message to the establishment than on signing off on more of the same. Of the major developed economies, Canada and Australia face elections, though radical policy shifts are less likely in either country.

**Oil**

Oil’s losing streak has pushed Middle East politics back into the spotlight. U.S. and Iran relations will be key, as will the direction of OPEC and its allies on any cuts to output. U.S. relations with Saudi Arabia are also under scrutiny. Trump has said he won’t let the murder of U.S.-based columnist Jamal Khashoggi jeopardize relations between both countries and has warned reporters that if the U.S. broke with Saudi Arabia, oil prices would “go through the roof.”

**Asia’s Waterways**

With North Korea halting provocations and pursuing diplomacy, East Asia’s waterways could be the biggest flash point in the region. The U.S. has boosted support for Taiwan and plans to step up freedom-of-navigation exercises in the South China Sea, increasing the risk of miscalculation that could spark a military confrontation with China. The East China Sea is also a perennial worry: Unlike disputed territory in the South China Sea, the U.S. is treaty bound to defend Japan in case of an assault on the islands.

**Black Swan**

“My biggest risk is less to do with a particular country, it’s a wild terrorist attack,” Robin Niblett, the director of Chatham House, said in an interview. An attack could take any form, including cyber, with knock on consequences for the world economy as a major incident could provoke a backlash from governments, Niblett said. While there were 10,900 terrorist attacks in 2017 - killing more than 26,400 people, the number of attacks declined for the third consecutive year, according to the University of Maryland’s National Consortium for the Study of Terrorism and Responses to Terrorism.
Contacts
Economist team

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