KIEL INSTITUTE FOR THE WORLD ECONOMY

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The Outlook for the World Economy

Downward risks are rising

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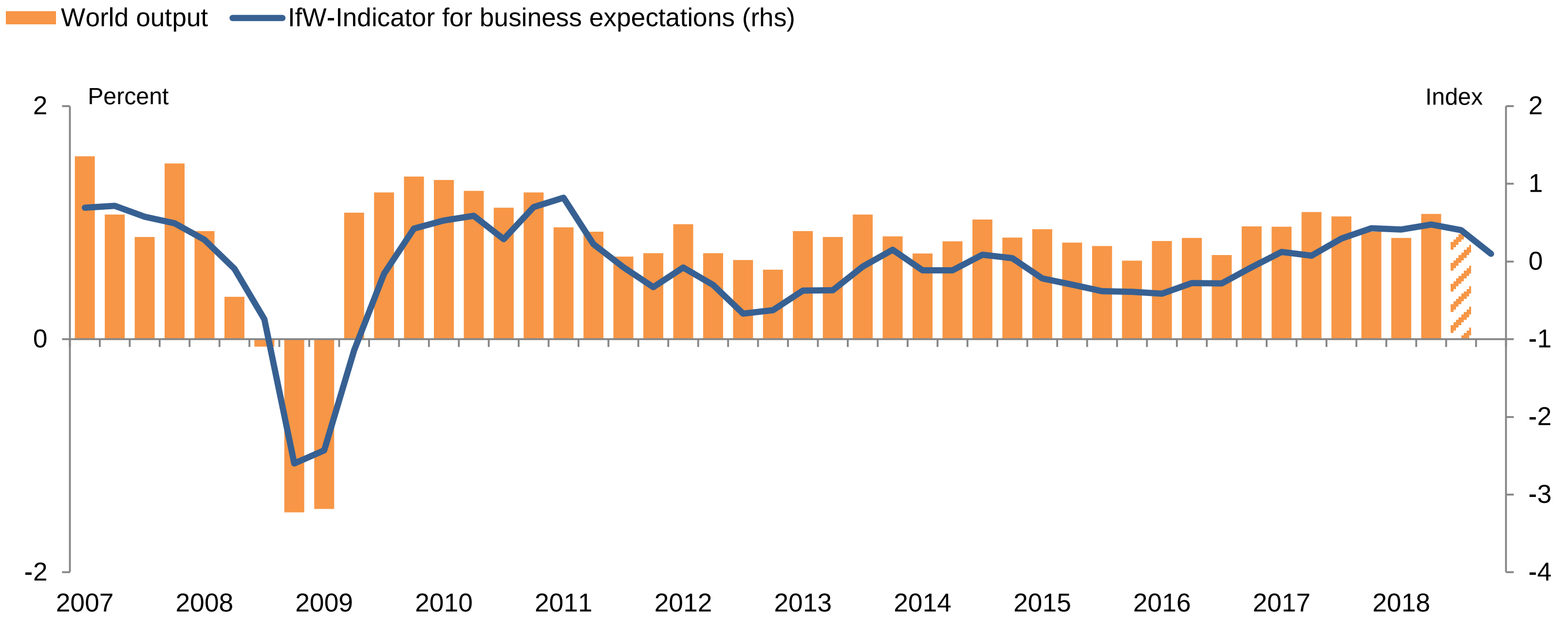
Global growth has peaked, despite strong Q2 growth

World Economic Activity



Quarterly data, seasonally adjusted. Indicator is based on business expectations in 42 economies. GDP: price adjusted, change over previous

Sentiment has weakened progressively, although confidence appears to be still clear from danger zone

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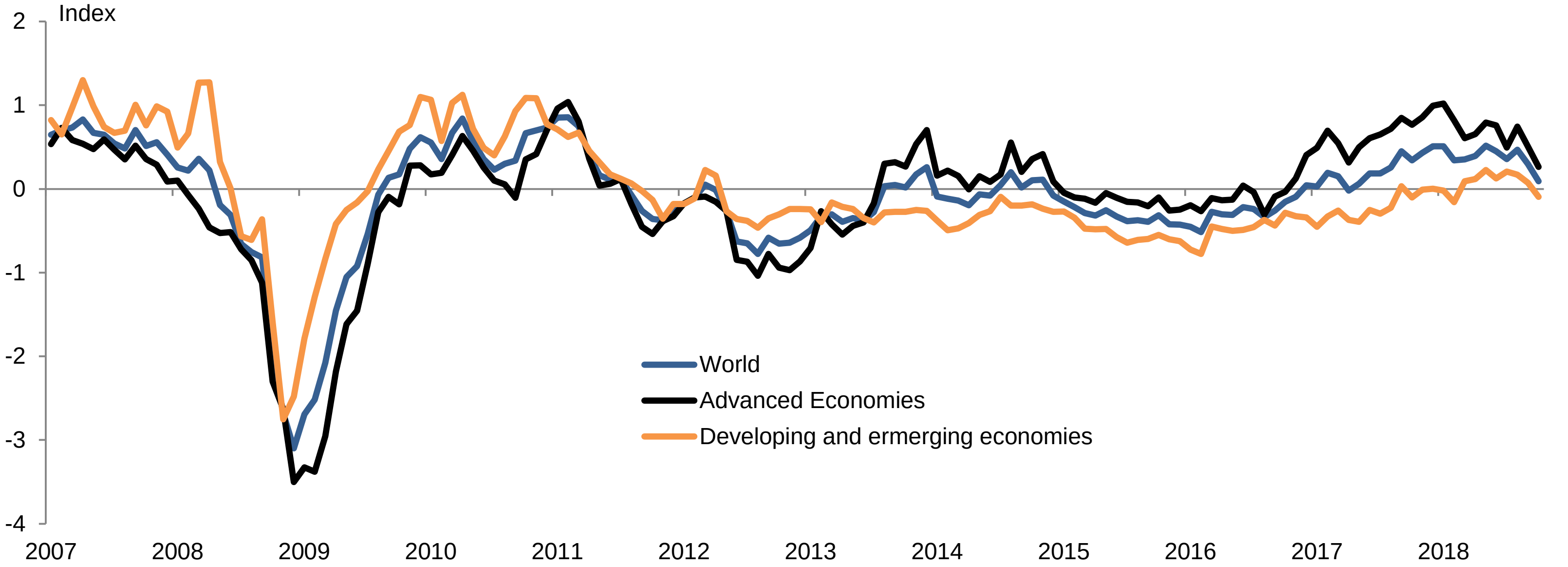
Business expectations by groups of countries



Monthly data, seasonally adjusted. Indicators are based on buisness expectations in 42 countries (33 advanced economies and 9 emerging economies).

Strong growth in Q2 and higher inflation – accelerated monetary tightening in the US

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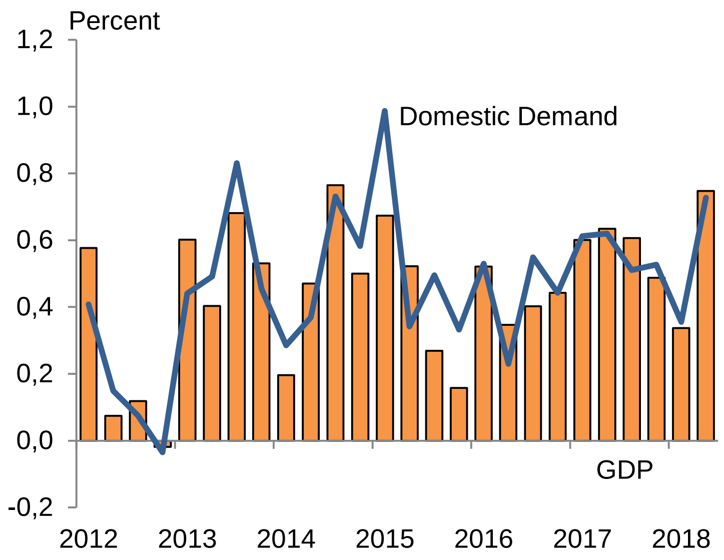
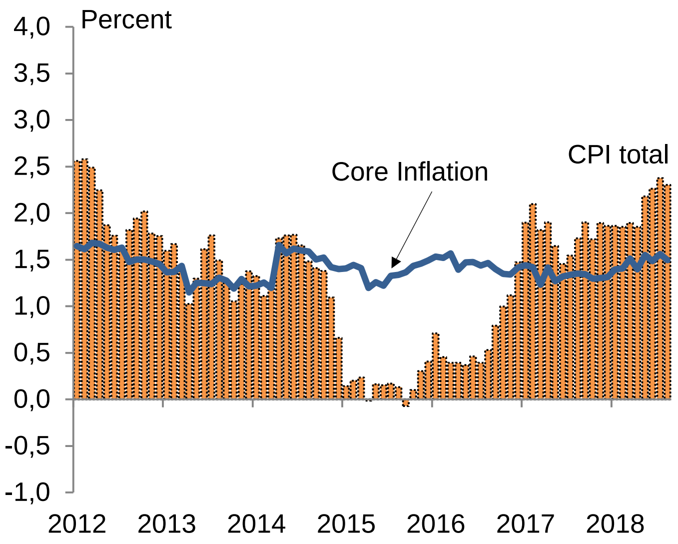
GDP and Domestic Demand in the G-7



Price adjusted; seasonally adjusted; y-o-y change. G7 consists of USA, Japan, Canada, Germany, France, Italy and UK.

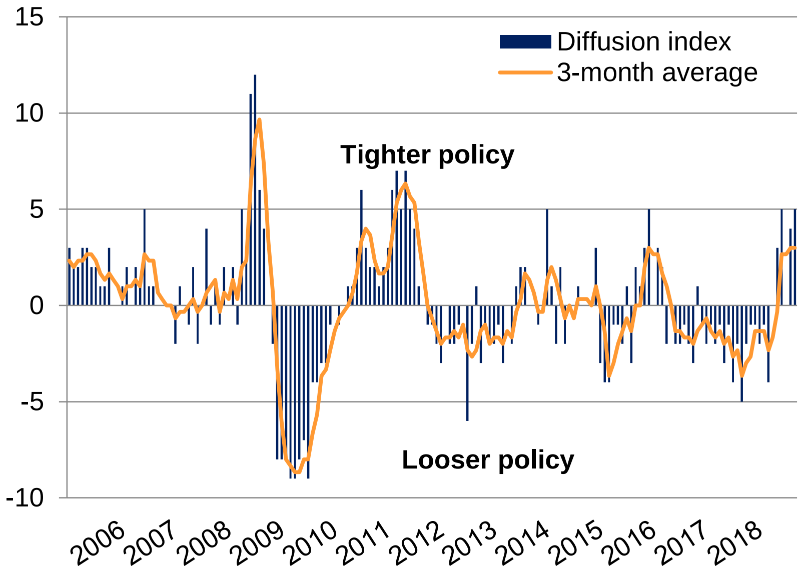
CPI Inflation in Advanced Economies 2012-2018



Monthly data; GDP-weighted y-o-y change in the United States, the eurozone, Japan and the UK. Core inflation: CPI excluding energy and food.

Financial environment for EE has tightened...

Monetary Policy in Emerging Markets 2005-2018

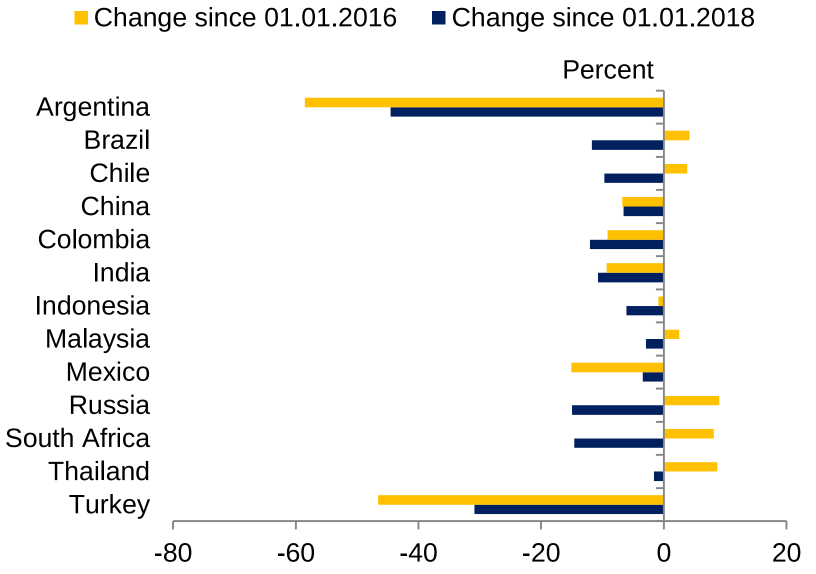


Monthly data. The diffusion index is the number of central banks raising policy rates less the number of central banks decreasing policy rates in a given month. Emerging markets included are: Argentina, Brazil, Chile, China, Colombia, Indonesia, India, Mexico, Malaysia, Peru, Philippines, Russia, Thailand, Turkey, South Africa.

- US interest rates rising faster than expected
- Capital inflows have dried up
- Downward pressure on exchange rates
- Monetary cycle in the emerging economies has turned towards restiction

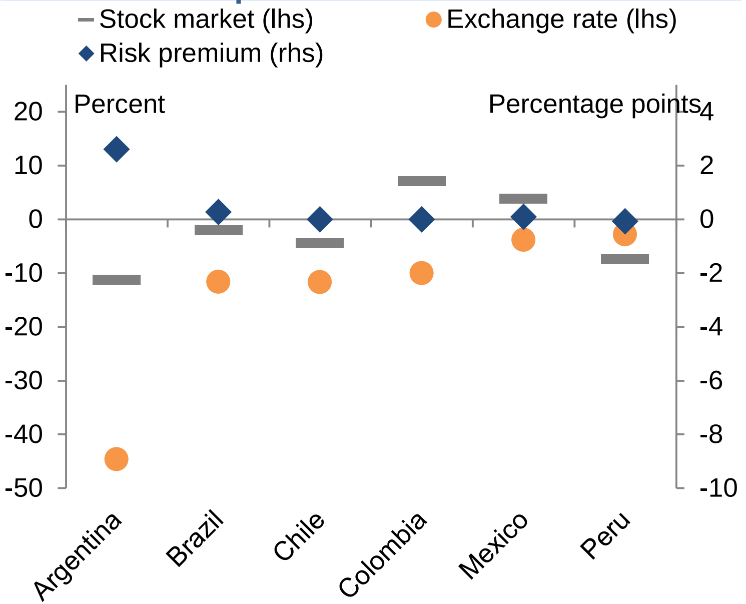
...but financial markets do differentiate

Exchange rate developments in emerging markets, 2016-2018



Last observation: 12.11.2018.

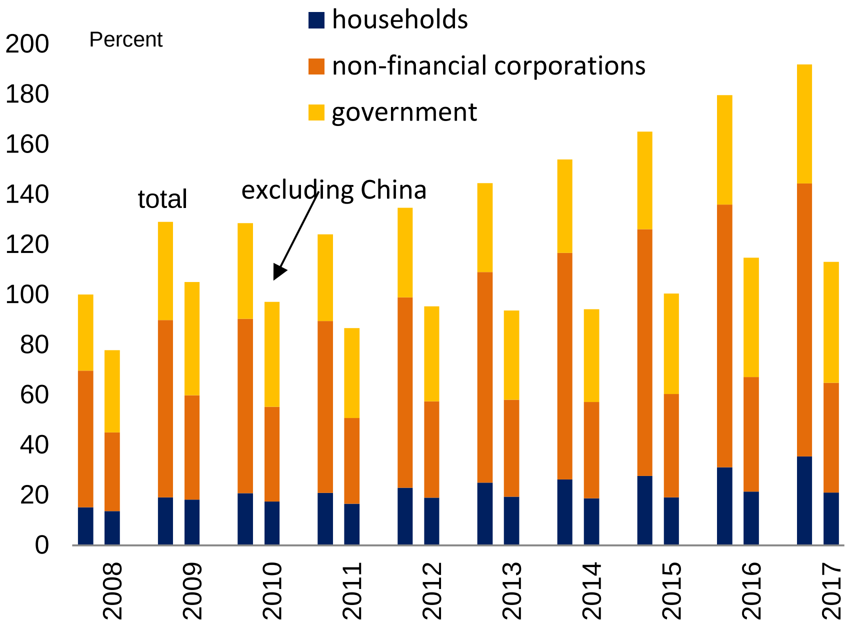
Latin America - Recent equity, bond and FX market developments



Changes since 01.04.2018 (last value: 11.10.2018). Exchange rate: in percent, a decrease indicates depreciation. Stock market: in percent, indices in local currency. Risk premium: in percentage points, EMBI Global spread over US treasury yields.

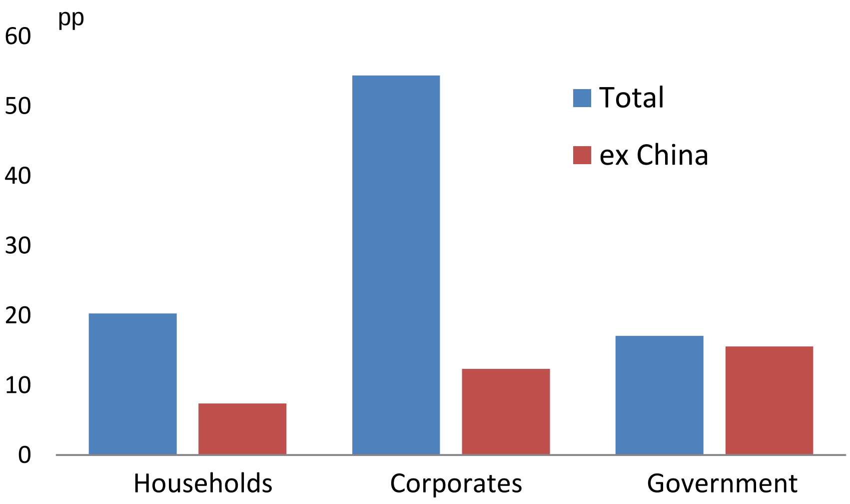
Higher interest rates meet economies with increased debt levels

Nonfinancial sector debt in emerging economies



In relation to nominal GDP. *Source:* BIS

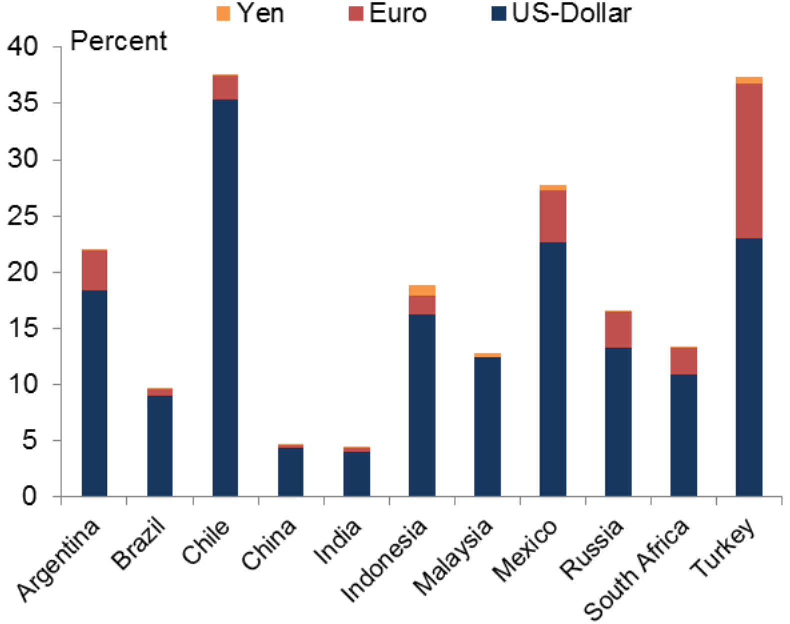
Change of nonfinancial sector debt in emerging economies from 2008 to 2017 by sector



In percent of GDP. *Source*: BIS.

Exposure to exchange rate shocks varies a lot

Emerging economies: Foreign currency liabilities



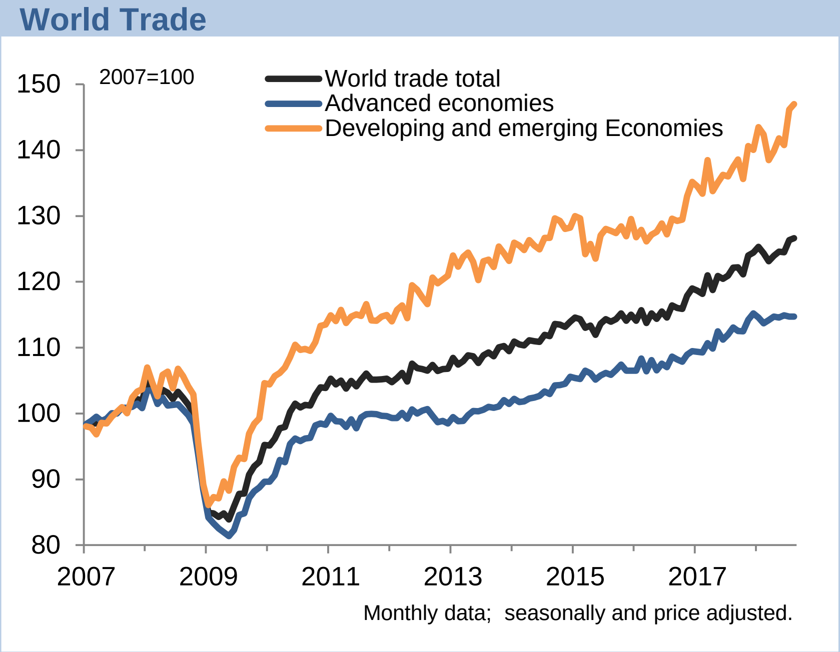
As of Q4 2017; in relation to nominal GDP. *Source:* BIS.

- Debt burden of foreign denominated debt rises with devaluation
- Exposure is particularly high in Turkey and Chile, Mexico and Argentina next
- Foreign denominated assets (e.g. fx reserves) need also be taken into account
- „Natural hedges“ from dollar denominated export revenues may be important (esp. commodity exporters)

Outlook for emerging economies increasingly diverse

- In addition to the fallout from US monetary tightening, continued fiscal adjustment to lower commodity prices and policy uncertainty from national sources work as a drag on growth
- Domestic expenditure in **Turkey** has already declined in Q2, and the economy is forecast to slip into recession in the second half of 2018. Short-term indicators have deteriorated dramatically.
- Severe recession in **Argentina** as high interest rates and fiscal adjustment force the economy on a more sustainable growth trajectory and agriculture is depressed by adverse weather
- **Brazil** on the verge of falling back into recession amid loss of confidence and policy uncertainty
- Forecast for **other LA** (except Venezuela) still expects robust growth
- Recovery in **Russia** has strenthend in mid 2018, but is expected to remain generally slow and uneven. Geopolitical stress is a downside risk, higher oil prices provide an upside.
- Growth in **emerging Asia** (ex China) still robust, but with somewhat reduced momentum going forward
- Economic activity in **India** to moderate somewhat after recovery from temporary slump after the introduction of reforms (currency reform, national VAT), but expansion so far not substantially affected by EE liquidity crunch

World trade growth has lost momentum



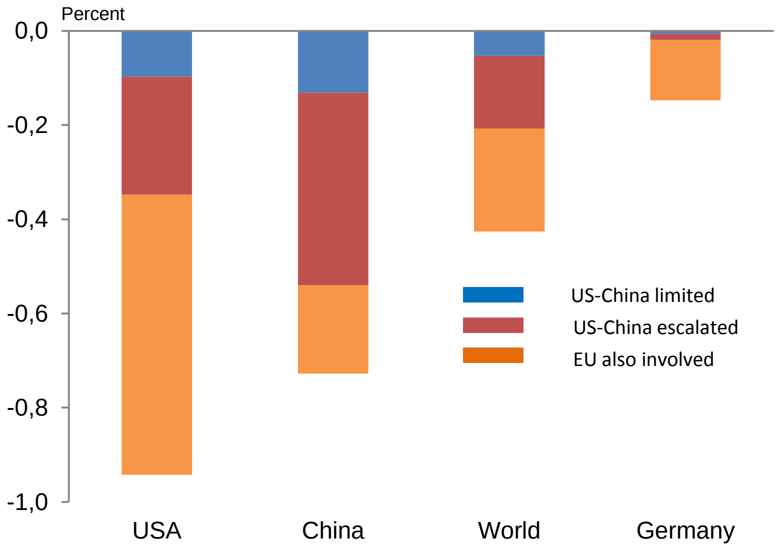
- Stagnation in the course of 2018, after strong growth in the end of 2017
- Annual growth poised to slow to below 3.5 % in 2018, following 4.5 % in 2017 (strongest result in 7 years)
- Return to „new normal“ or protracted weakness?
- Effects of trade conflicts?

Factors behind the trade slowdown are cyclical and structural

- Slowdown of growth in trade intensive Europe
- Investment on a weaker tone
- Deceleration of growth in China
- Build-up of global value chains seems to have peaked
- Trade policy a new negative
  - Direct impact of tariffs so far limited
  - Effects through sentiment perhaps more pronounced
  - Temporary positive impact possible as firms bring imports forward

Trade conflicts have a potential to signifcantly affect economic activity

GDP loss from tariffs in different scenarios



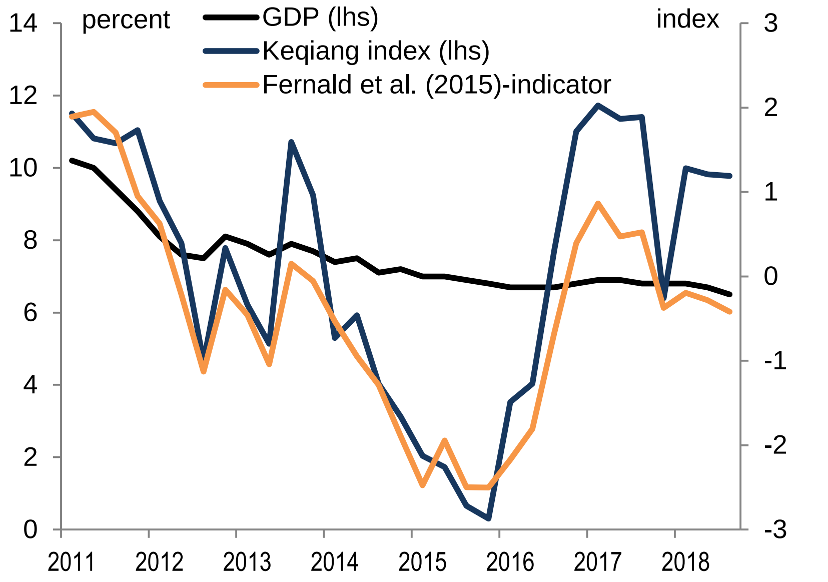
Deviation from baseline after three years.

Source: Kiel Institute calculations with NiGEM.

- Uncertainty about trade rules has generally increased and remains elevated despite recent agreement on „new NAFTA“ (USMCA)
- Tariffs put in place on a substantial share of US-China trade
- NiGEM simulation of three scenarios
  - (1) 25% tariff on 50bn of imports on both sides
  - (2) Additional 10% tariff on remaining imports in both countries
  - (3) Extension to US-EU trade with reciprocal introduction of 10% tariff on imports
- Only effects through the trade channel are modeled. Stronger impact on activity through confidence shocks possible

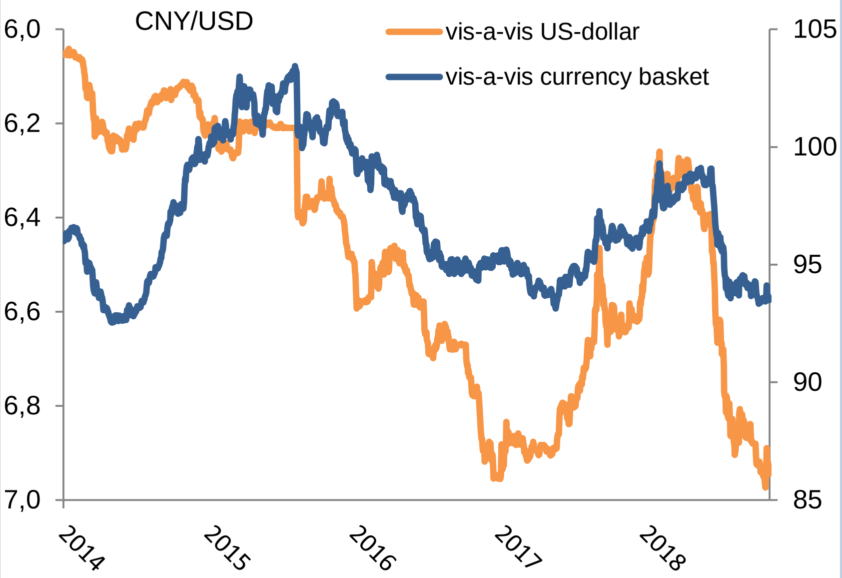
Growth in China on track for the time being, but financial markets send signals of weakness

China: GDP and alternative activity indicators 2011-2018



Quarterly data

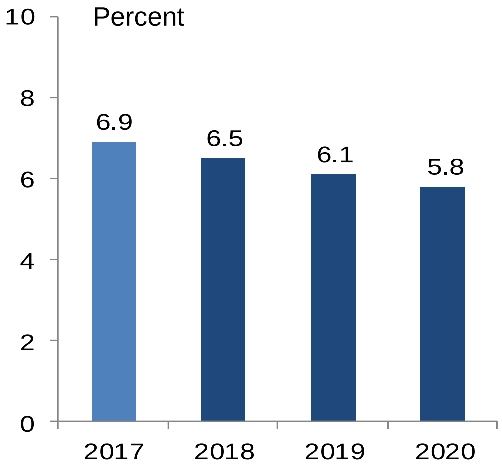
China: exchange rates 2014-2017



Daily data.

China: Deceleration of growth

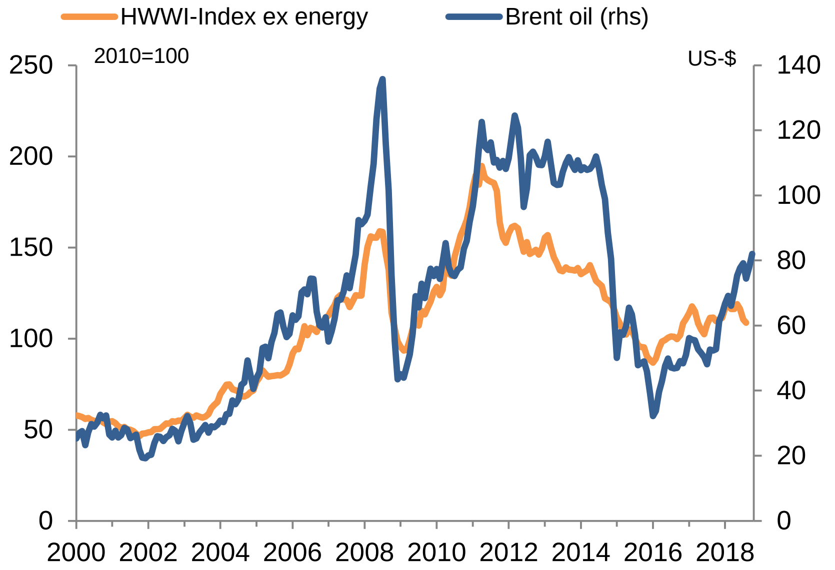
China: real GDP Growth



- Output growth so far consistent with growth target of 6.5% in 2018
- Service sector primary source of growth, moderation of growth in manufacturing
- Pronounced drop in the stock market and currency weakness indicate loss of confidence
- Policy priority seems to have shifted toward maintaining growth from reigning in growth of debt in the private sector and local governments
- Monetary policy has started to losen
- Fiscal policy will remain supportive (infrastructure, military spending)
- Still gradual deceleration of growth expected, in line with reduced potential growth

Tighter supply drives oil prices up

Commodity prices



Monthly data; commodities prices without energy: HWWA-index based on US-Dollar; oil price: Brent spot price.

- Oil prices have risen above 80$/b
- Stagnant commodity prices ex energy suggest that oil specific factors are at play
- OPEC/Russian production caps still in place
- Output in Venezuela (and other places) falling
- Strong growth in US production cannot fully accommodate rising demand
- Global market has slipped into deficit in the course of last year
- Iran sanctions threaten to substantially tighten supply further

United States: Fiscal policy pushes economy

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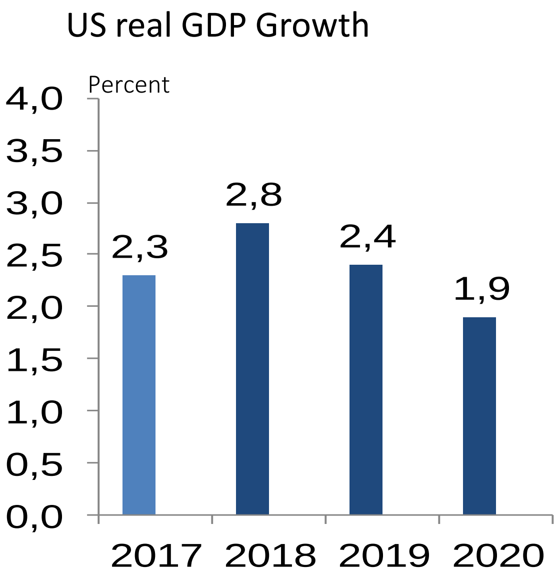
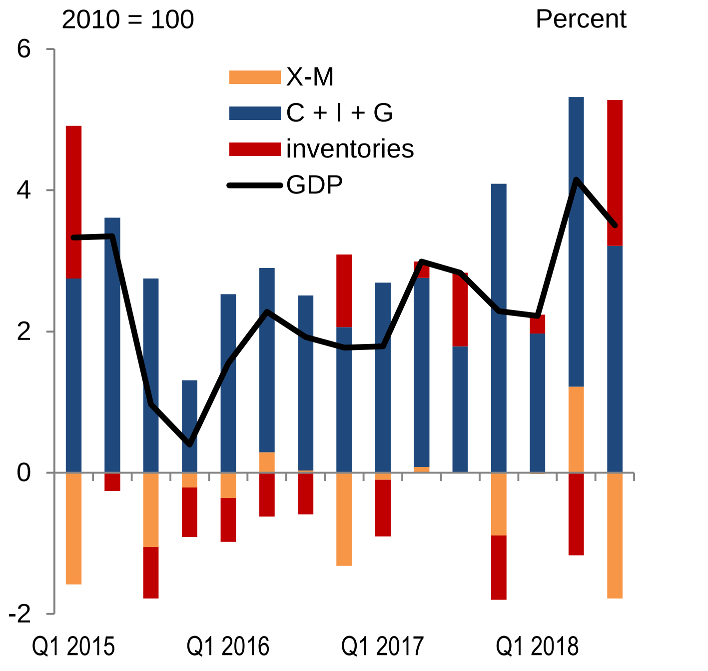


- Strong fiscal policy stimulus from tax reform and budget deal in an economy close to full employment
- Monetary tightening has been accelerated, more interest rate increases to come (3% FFR by end 2020)
- Economic expansion continues for the time being
  - Investment stimulus from tax reform, higher oil prices trigger more investment in energy sector
  - Continued strong gains in employment
  - Private consumption looks more solid after hefty upward revision to savings rate
  - Current account poised to deteriorate further
- Gradual deceleration of growth with fiscal stimulus fading and higher interest rates kicking in.

United States: Q3 not as strong as it seems

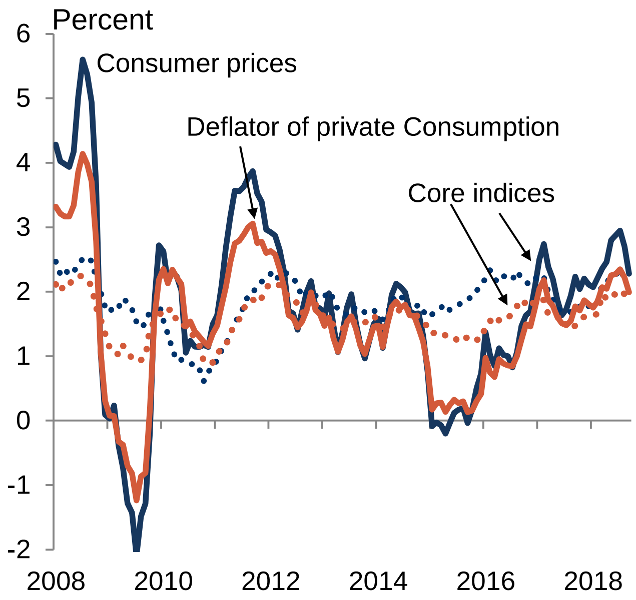
GDP in the United States 2016-2020



Quarterly data, price-, seasonally- and calendar adjusted, qoq-change, annualized.

- Strong contribution from inventories in Q3
- Investment slowed markedly (decline in structures, only slow growth of equipment, continuation of downturn in residential investment)
- Private consumption remained brisk (4%)
- Government expenditure up 3%
- Drop in exports after strong Q2 (-3,5%)
- Strong import growth (9%)

United States: Inflation scare over?



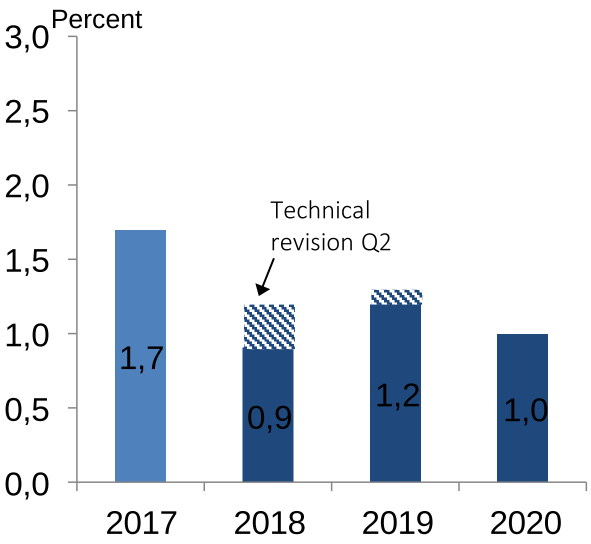
Monthly data; change over previous year. Core index: consumer prices excluding energy and food.

Source: US Department of Labor, *Consumer Price Index*.

- Inflation has slowed again recently
- Core rates steady at 2 %
- Wholesale price inflation above 3 %
- Nominal wages up 3,1 % y/y in October: first time above 3% since 2009, although partly due to base effects
- Long rates are continuing to rise (10-year bonds at 3,1 %)

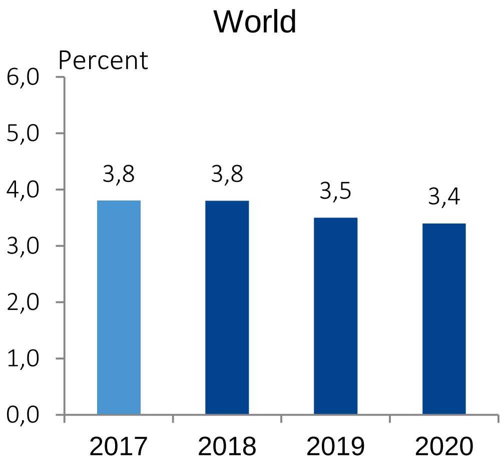
Japan: Moderate economic upturn

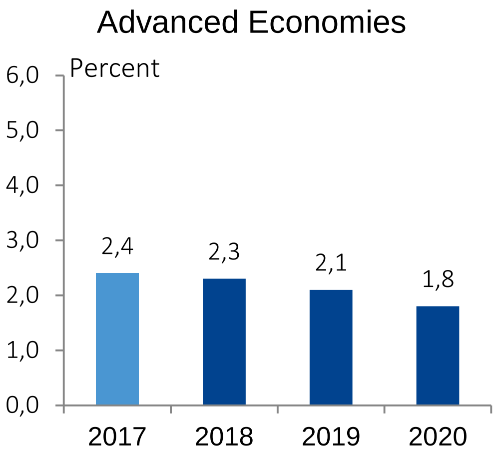
Japan: real GDP Growth

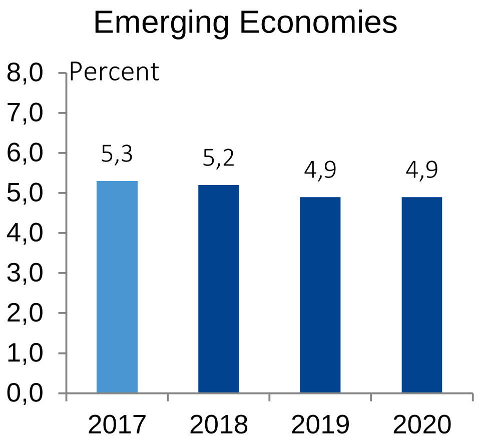


- Economy is fluctuating wildly with weak Q3 following on strong Q2 following on weak Q1. Temporary dip (Earthquake, Typhoon) depressed activity in Sep
- Technical increase of our forecast by 0.3 pp and 0.1 pp this year and next, respectively, following strong upward revision to Q2 growth estimate is obsolete
- Unemployment rate is on the lowest level in 25 years raising concerns about capacity constraints
- Inflation seems finally to pick up
- Monetary policy is continuing to target the long-term interest rate (at zero) for the time being.
- Short-term interest rate will not rise before 2020 given inflation still way below target
- VAT increase in the end of 2019 could weigh on growth in 2020

The global picture: Growth continues, but financial headwinds slow emerging economies while capacity constrains and reduced policy stimulus reduce economic momentum in the advanced economies







Risks from policy and the cycle

- **Geopolitical risks** are still high on the agenda, with the US-Russian relationship damaged substantially, Middle East continuing to be a source of concern
- Further escalation of **trade war** between US and China, extension to Europe amid rising US trade deficits
- **Oil prices** could become a serious negative for global growth
- **Brexit** is still a prominent source of uncertainty
- Confidence of investors in **Italian sovereign debt** could decline further triggering new uncertainties within Europe
- Low levels of slack in advanced economies may lead to excessive acceleration of **inflation** and sharper monetary tightening
- After many years of expansive monetary policies, financial markets and business models in AE may be vulnerable to a **restrictive MP shock**

Questions

- (How long) can the strong expansion of the US economy be sustained?
- Will inflation in the US finally pick up?
- How tolerant is the world economy to higher US interest rates?
- How big a risk to the outlook is a correction in asset prices in advanced economies?
- How dangerous is the aggressive attitude of the US government in trade issues for global growth?
- …..

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