1. Global economic outlook

1.1. GLOBAL OVERVIEW: TIME TO PANIC?

by Richard Grieveson

› **The global economy is slowing, and this year and next will almost certainly be the worst since the global financial crisis. By recent standards, 2020 will also be a subdued year.**

› **Our baseline scenario is that the downturn is unlikely to develop into anything more serious. As the US election approaches, President Donald Trump will be keen to keep the economy running at a decent speed, and may well continue to dial down his trade war.**

› **He will also try to refrain from foreign policy adventures that could push up the oil price. Weaker global growth will also probably act to keep down Brent crude costs. This is positive for growth in most big economies.**

› **We have made a substantial downward revision to our 2019 euro area growth forecast. However, economic growth in the euro area should recover a bit next year, with domestic demand providing some relief from the steep manufacturing downturn.**

› **Major political opposition will stop monetary easing going much further in the euro area, but additional cuts are quite likely in the US. As a result, as the interest rate differential narrows, the euro could recover somewhat against the dollar from current levels.**

› **Over the longer run, a Japan-like scenario for the euro area of low inflation and growth looks quite likely.**

› **For CESEE, it is *not* time to panic. Given the region's high level of exposure to global trade, it cannot expect to emerge from the current downturn unscathed. However, it should continue to show an impressive level of resilience. Sectors exposed to euro area final demand should continue to do quite well, while monetary conditions remain very loose, supporting growth.**

Table 1.1 / wiiw autumn 2019 forecasts, annual averages

	Autumn 2019			Changes since summer		
	2019	2020	2021	2019	2020	2021
Euro area real GDP growth, %	1.1	1.4	1.3	-0.5	-0.1	-0.1
USD/EUR exchange rate	1.13	1.12	1.12	0.01	0	0
Front-month Brent crude, US$ per bbl	64	61	60	-1	0	0

1.2. MACRO TRENDS AND OUTLOOK: GLOBAL GROWTH AT POST-CRISIS LOWS

The global economy is in the midst of a fairly severe slowdown. US protectionism (in general, but especially that directed towards China) is weighing heavily on global trade. The uncertainty surrounding Brexit has negatively impacted investment plans, both in Europe and more widely. Meanwhile the latent risk of a repeat of 2018's emerging markets crisis – then centred on Argentina and Turkey – remains lurking in the background and is keeping businesses and investors wary.

In its most recent World Economic Outlook (WEO), released in October, the International Monetary Fund (IMF) projected global growth at 3% for this year, the lowest level since the global financial crisis. Although the Fund expects a bounce-back to 3.4% next year, this is based on an expected improvement relative to previous forecasts in crisis-hit countries like Turkey, Argentina and Iran. This may well prove too optimistic.

Figure 1.1 / Real GDP growth, % – China

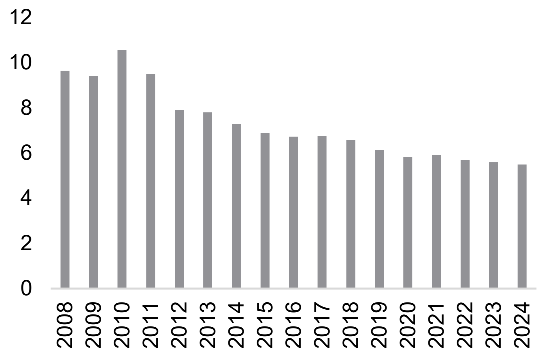
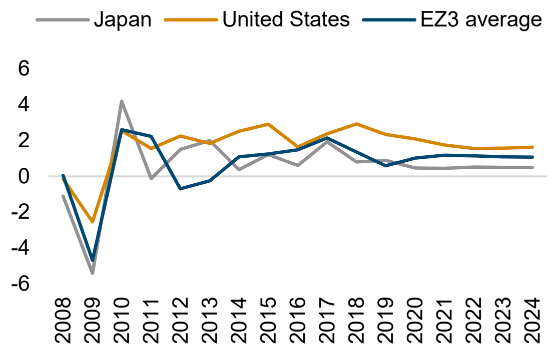


Figure 1.2 / Real GDP growth, % – US, Japan, Germany, France and Italy



Note: EZ3 average = simple average of France, Italy and Germany.
Source: IMF WEO.

So far, a great deal of the negative momentum appears to have been confined to the manufacturing sector. The most recent German manufacturing Purchasing Managers' Index (PMI) showed output at 41.7 in September (anything below 50 indicates contraction), its worst reading since the depths of the global financial crisis. Chinese automotive production has fallen by double digit percentages so far in 2019. Even US manufacturing is in contractionary territory.

For a time after the manufacturing downturn started, it appeared that the rest of the global economy was quite resilient. This matters, as the services sector is a much greater share of GDP, even in Germany. However, more recent data for the big global economies suggest that services activity – while still positive – is also slowing.

How bad will it get?

While services activity has slowed recently, domestic consumption appears to be holding up quite well in most of the key global economies. Labour markets in China, the US and Germany remain in a healthy state. Interest rates and inflation are both at low levels, and are likely to remain so (see below). Political risk notwithstanding, the oil price is unlikely to rise much from current levels. At least for the euro area, some kind of moderate bounce-back in economic activity in 2020 is quite realistic.

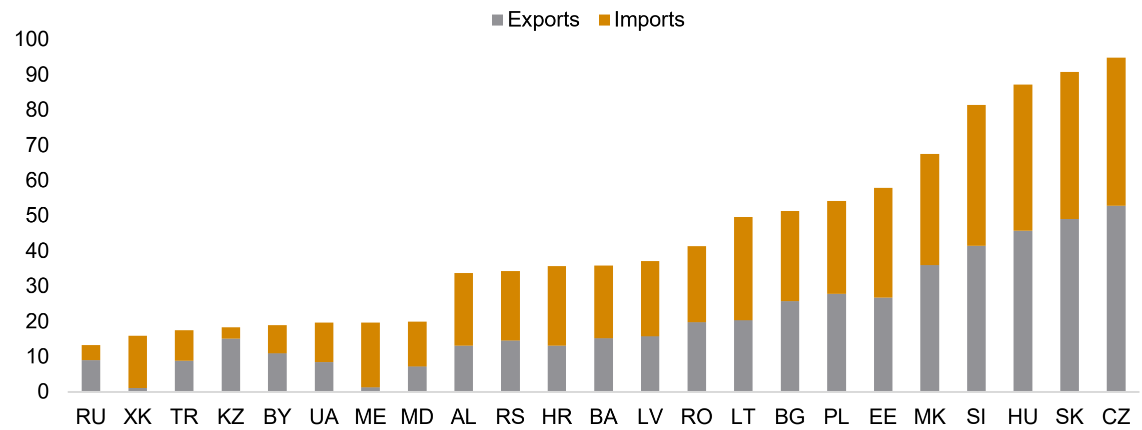
Much depends on what happens with US policy. Donald Trump is up for re-election next year, and will want to make sure the US economy is strong as voting approaches. He will therefore attempt to wind down the trade war somewhat before then (a recent partial deal with China hinted at this direction), and will be wary of conducting foreign policy initiatives that could exert upward pressure on the oil price (this matters in particular for his policy towards Iran). Of course, as with everything related to Mr Trump, there is a high degree of uncertainty surrounding his actions. Nevertheless, his desire for re-election is clear.

Impact on CESEE

As we have detailed in previous reports, our region is highly sensitive to global growth. The direct links to Western Europe are significant (Figure 1.3), and we already see a clear blow-back from the downturn in the German manufacturing sector (see chapter 2). Nevertheless, so long as domestic demand in countries like Germany holds up, CESEE will continue to benefit from tailwinds. Western Europe is also an important source of remittances, tourism and foreign investment. Meanwhile those exporters from CESEE for whom Western consumers are the source of final demand will also continue to do well.

CESEE is also exposed, however, to final demand around the world. Many of the region's exporters sell only intermediate goods to Germany, which are then used in the production of goods for which the final demand is in places like China and the US.[1] At least to an extent, it is these firms that are already struggling, for example due to this indirect exposure to the Chinese automotive market. But here as well, if the trade tensions do indeed subside in the run-up to the US election, there should be some relief for CESEE.

Figure 1.3 / Merchandise trade with the EU-15, % of GDP



Source: wiiw.

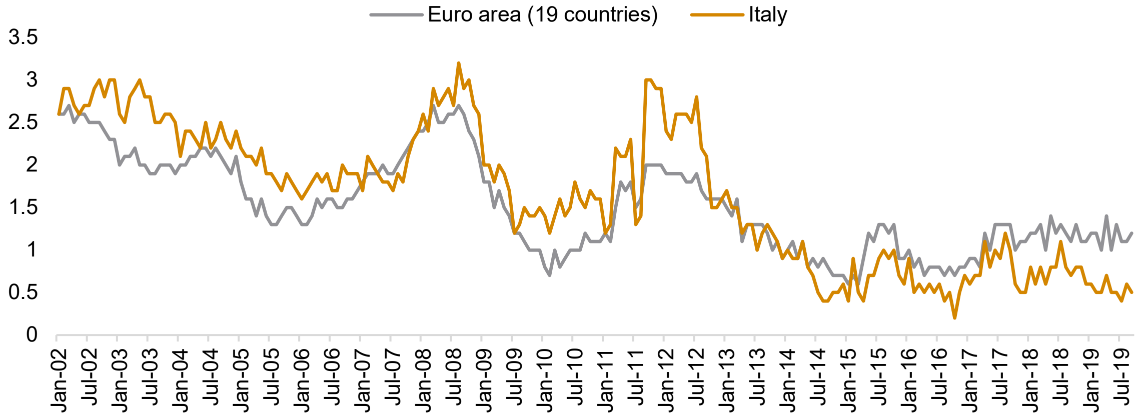
1 https://www.imf.org/en/Publications/CR/Issues/2016/12/31/German-Central-European-Supply-Chain-Cluster-Report-Staff-Report-First-Background-Note-40881

1.3. THE POLICY RESPONSE: OUT OF AMMUNITION

Policymakers in the big economies are already trying to respond to this global growth slowdown, but especially in the euro area the burden of response (as has been the case for a decade) is falling heavily on monetary rather than fiscal policy. The European Central Bank (ECB) cut its deposit rate to a new low of -0.5% in September and restarted bond purchases. In the same month, the Fed cut rates by 25 basis points, its second cut since July (which had been the first for a decade).

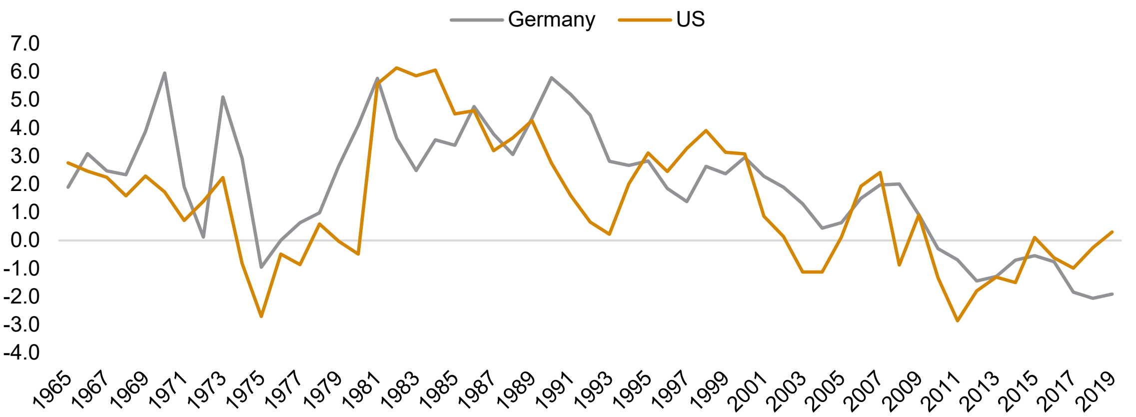
As Figure 1.4 shows, using core inflation (headline excluding energy and unprocessed food), the ECB has not hit its price growth target of just below 2% since 2012. The bank launched quantitative easing (QE) in 2015. Although this may have prevented a larger fall in price growth, it has failed to get core inflation much above 1%. Some of the economies of the euro area, perhaps most worryingly Italy, are edging closer to deflation.

Figure 1.4 / Harmonised index of consumer prices (HICP); ‘core’ measure (excluding energy and unprocessed food); % change, year on year



Source: Eurostat.

Figure 1.5 / Real short-term interest rate, consumer price index adjusted, %



Note: 2019 data are wiiw estimates.
Source: OECD.

However, there is little more that monetary policy can do to help, especially in the euro area. As Figure 1.5 shows, even accounting for currently weak inflation, interest rates in both the US and the euro area (but especially the latter) are already at historically very low levels. Since at least the mid-1960s, and in practice probably much longer, German real short-term interest rates have never been as low as they are now (and have been for 5-6 years).

German concerns about ultra-low interest rates have been mocked in the international media. However, worries about the spill-overs from this policy are growing much louder, particularly in the wake of the ECB's latest interest rate cut. In response, a group of former ECB economists (including from countries not considered hawkish, such as France) published a memo criticising the decision.[2] Information leaked to the *Financial Times* suggested significant dissent within the bank's current staff, including among board members, over the recent decision.[3] The banking and insurance industries have long been vocal about the perceived damage that low interest rates and the flattening of the yield curve are doing to their business models.

Increasing focus on the side effects

Monetary policy has saved the day in the global economy, and maybe especially in the euro area, over the past decade. However, there is now a serious risk that it is contributing to the next crisis. In reality, the 'mystery' of persistently low inflation is hardly a mystery at all: the extreme levels of global liquidity released by the Fed, ECB and Bank of Japan may have had some impact on consumer price inflation, but the biggest effects can be seen in asset markets, including housing. Between Q1 2014 and Q1 2019, house prices in the euro area rose by 18% according to Eurostat, compared with 4.3% for core inflation over the same period (the ECB launched QE initially in March 2015). For many euro area countries, the rates of increase were much higher, including over one third in Ireland, Latvia and Portugal.

Figure 1.6 / Shiller P/E ratio

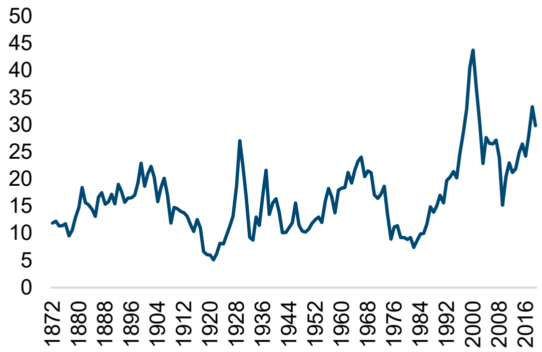


Figure 1.7 / German 30-year sovereign bond yield, %

Sources: Investing.com; Shiller.

Evidence of inflation is also clear in other asset markets. In the case of equities, the Shiller price/earnings ratio – which measures how expensive (or cheap) US stocks are, relative to the

2 https://www.ft.com/content/71f90f42-e68f-11e9-b112-9624ec9edc59

3 https://www.ft.com/content/de4a958a-eab3-11e9-a240-3b065ef5fc55

underlying earnings of the companies – is currently close to its second-highest ever level (Figure 1.6). It is well above 1929 levels, and only below the late 1990s, just before the dot-com bubble burst. Meanwhile in the bond market, even more extreme levels have been reached. According to recent data, US$ 16 trillion of bonds around the world currently have a negative yield (for context, this is somewhere between Chinese and US annual GDP). German sovereign debt returns a negative yield out to a 30-year maturity (Figure 1.7).

Next moves could push the euro a bit higher

The ECB's own projections, which we roughly agree with, suggest that the bank will not meet its inflation target in the next three years. We have discussed in previous reports why inflation is so low, but in short, the structural factors (including the so-called 'Amazon's Antitrust Paradox',[4] as well as demographic trends[5]) seem to explain a large part of it. As a result, any tightening of monetary policy is highly unlikely during our forecast period. However, given the growing internal and external opposition to further loosening, we see additional cuts as also quite unlikely. As a result, our base case is that in three years the ECB deposit rate will be where it is now.

More likely is further monetary easing from the Fed. Although inflation is higher in the US than in the euro area, and will remain so, inflation expectations are falling. Moreover, the central bank finds itself under sustained pressure from President Trump to further loosen its policy. At least one more rate cut during the current cycle looks highly likely. As a result, the dollar may weaken somewhat against the euro from current levels.

Turning Japanese? Time to remove the question mark

Monetary policy cannot do much more for inflation or growth in the euro area. A strong fiscal stimulus would probably have a bigger impact, but that looks unlikely for political reasons. As a result, the outlook is quite weak. For the euro area specifically, a Japan-like future of low growth, inflation and interest rates over many years appears quite likely. The bond market appears to be pricing this in, reflecting inflation trends (see Figures 1.8 and 1.9).

For CESEE central banks, this means that a continuation of loose monetary policy is highly likely. Even for those central banks with officially inflation-target regimes, the ability to deviate significantly from the course set by the ECB is very limited. Eleven countries in the region already run negative real policy rates (Figure 1.10), including all CESEE EU Member States, except Croatia. During the forecast period, this number is more likely to go up than down.

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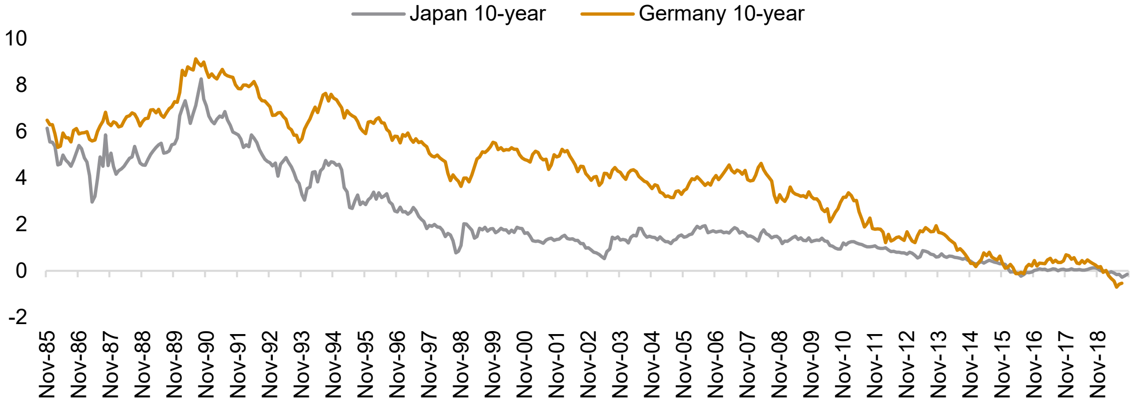
4 https://www.yalelawjournal.org/note/amazons-antitrust-paradox

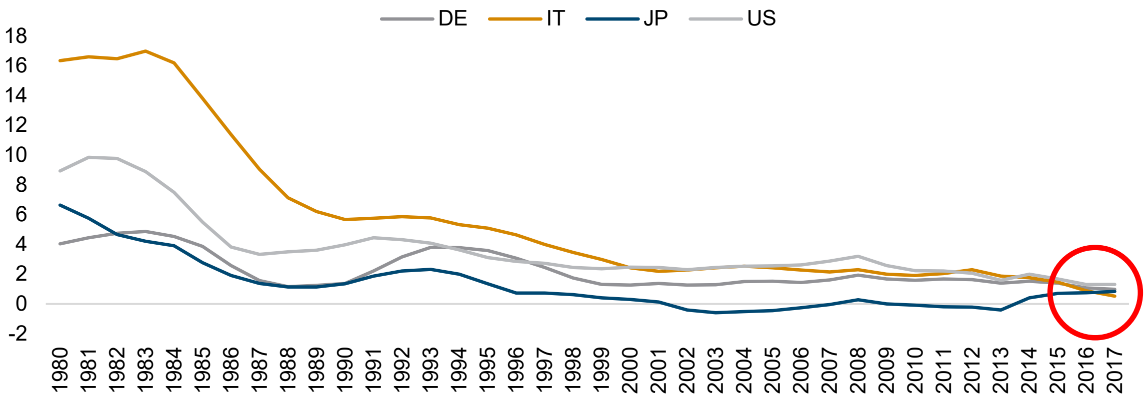
5 https://voxeu.org/article/impact-population-ageing-monetary-policy

Figure 1.8 / Turning Japanese #1 – sovereign bonds yield, %



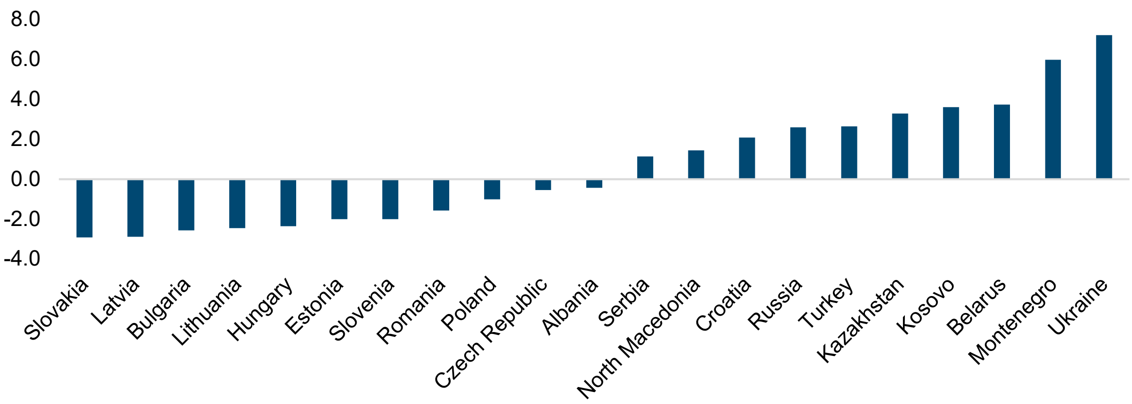
Source: Investing.com.

Figure 1.9 / Turning Japanese #2 – consumer price inflation, % per year, 5-year moving average



Source: OECD.

Figure 1.10 / CESEE real interest rates, consumer price index adjusted, %, August 2019



Source: wiiw.