THE VIEW

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THE BIG SWITCH: REWIRING THE WORLD?

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EXECUTIVE SUMMARY

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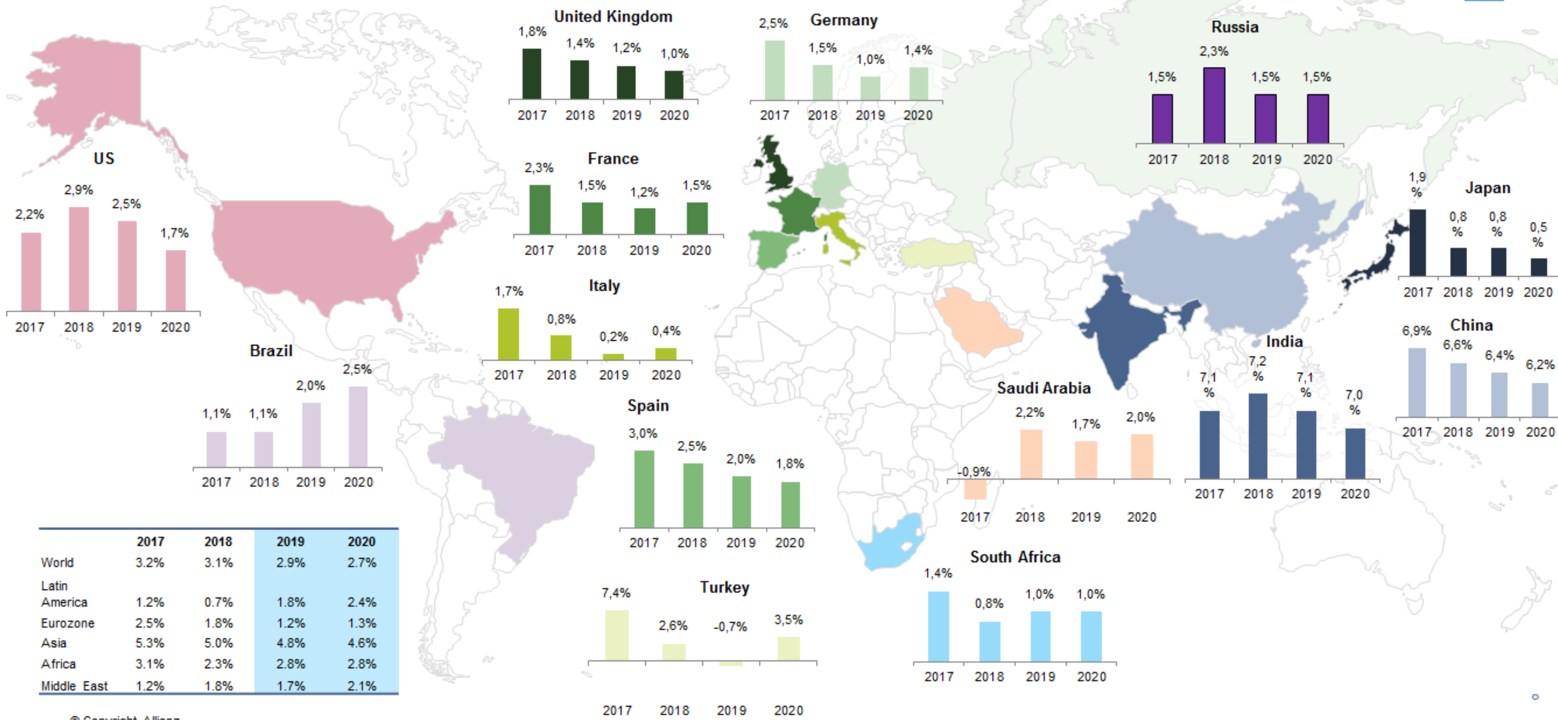
- The world economy is about to experience a "big switch" in three ways:
  - The US - China switch, a shift in the world growth-maker: Our global macroeconomic scenario bets on a rapid deceleration in the US from 2.9% in 2018 to 2.5% in 2019 and 1.7% in 2020. In the meantime, economic growth in China is set to remain relatively resilient (+6.4%), thanks to a proactive stimulus package (CNY 4.15 trillion, 5% of GDP). As a result, we expect China to replace the US as the main source of global growth in 2019 and 2020.
  - The monetary policy switch or a renewed dovishness of central banks: Monetary policy is changing tack around the world. Following a generalized phase of tightening, declining inflation is pushing major central banks to re-explore expansionary moves. Most central banks, including the US Fed and the ECB, have already significantly changed the stance of their communication towards more accommodative orientations.
  - The uncertainty switch, a de-escalation of trade risk is possible: This year, trade could experience its own big switch, with a reduction of uncertainty after a phase of accumulating risks (US-China tariffs) that subtracted -0.45 pp from the growth of global trade in 2018. A positive outcome of US-China trade discussions is expected to play a stabilizing role for global trade and growth.
- Emerging markets are best positioned to benefit from the combination of these three factors, and we expect they will be the winners in 2019 and 2020. The "big switch" is also good news for export-driven economies, including those in Europe, which have especially struggled in the face of the US-China trade war and Donald Trump's threat of tariffs on auto imports. For Germany, which slipped into an industrial recession in the second half of 2018, we think the worst is finally over.

GROWTH: COUNTRY FORECASTS



	2017	2018	2019	2020
World	3.2%	3.1%	2.9%	2.7%
Latin America	1.2%	0.7%	1.8%	2.4%
Eurozone	2.5%	1.8%	1.2%	1.3%
Asia	5.3%	5.0%	4.8%	4.6%
Africa	3.1%	2.3%	2.8%	2.8%
Middle East	1.2%	1.8%	1.7%	2.1%

+2.5% y/y

US economic growth in 2019, compared to +2.9% y/y in 2018

INTRODUCTION

Since Q4 18, the news has been dominated by four main features: a particularly long and brutal government shutdown in the US, a sharp deceleration of growth in the Eurozone, the recovery of global equity market (in particular emerging equity) - after the selloff of end-2018 - and the confirmation that China has organized a new bazooka fiscal stimulus. All these factors have paved the way for a "big switch" in the global economy in 2019.

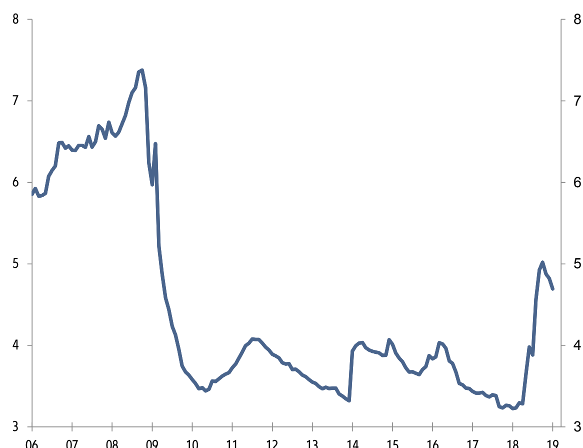
The US - China switch, a shift in the world growth maker

US public debt has increased by USD 2 trillion since President Trump took office and a balanced budget is expected only by 2034. This combined with the record high partisanship in the Congress leads us to expect disorderly budget negotiations, leading to new episodes of shutdowns and possible threats of a downgrade of US debt at the end of the year. This shock of uncertainty will impair the investment cycle from Q3 19 onward and stall the US economy in H1 20. We expect a slowdown in growth to +2.5% y/y in 2019 and +1.7% y/y in 2020, compared with +2.9% y/y in 2018.

Meanwhile, China will manage to decelerate at a slower pace in 2019 and 2020, thanks to a powerful policy mix designed primarily to support domestic demand. Different from past expansionary packages, the latest stimulus is more focused and balanced, with 48% based on tax cuts and 52% based on infrastructure spending. Monetary measures are about boosting liquidity in the financial system (Reserve Requirement Ratio cut), increasing banks' capital, supporting other regulated lenders (financial markets, for e.g.) and improving capital allocation towards the private sector. While the first quarter will likely disappoint due to weaker growth in global trade and slower growth in private consumption, the remainder of the year should see a modest improvement as the government's stimulus starts to bear fruit.

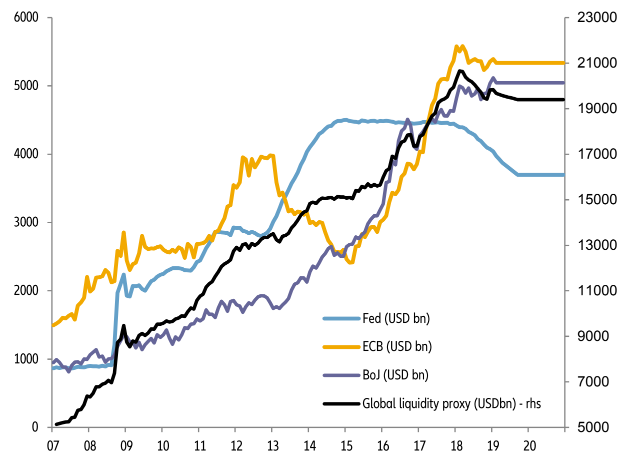
We expect a modest acceleration of growth in H2 19 (from +6.2% in Q1 to +6.4% in in Q3 and Q4). This will make China a driving force of the global economy with a continued contribution of 1pp to global growth in 2019. The expected powerful impact of China's stimulus can be illustrated by the strong correlation between China aggregate financing to the real economy and the Loan Approval Index. The pace of loan approvals clearly points toward the prospect of an acceleration of total social financing, despite the messages of moderation of authorities in terms of credit policy. Separately, we have calculated the response of world GDP growth to a similar size of Chinese stimulus in the past and got a positive reaction by 0.15 pp at a horizon of three quarters following the budgetary impulse.

Figure 1 World average official interest rate (%)



Sources: Euler Hermes, Allianz Research

Figure 2: Central banks' balance sheet policy



Sources: Euler Hermes, Allianz Research

The monetary policy switch, a renewed dovishness of central banks

This year has already seen two radical shifts in monetary policy. First, in February, the US Fed advocated "patience" in normalizing its monetary policy and announced that a comeback to pre-crisis level for the size of its balance sheet was not conceivable. This re-orientation took place amid global trade uncertainties, a long-lasting government shutdown (the longest in US economic history) and a concomitant degradation of advanced indicators. In March, Jerome Powell confirmed that it was unlikely to see a rate hike in 2019. At the same time, the Fed also confirmed that the pace at which it is shrinking its asset portfolio will be reduced.

At its March meeting, the ECB chose to jump ahead of the curve with its policy announcements, exceeding already quite dovish market expectations. Based on sharp downgrades to its macro forecasts, in particular for the 2019 outlook, the ECB adjusted its forward guidance, with key interest rates now seen on hold for at least the remainder of 2019. In addition, it also announced another round of TLTRO financing aimed at countering any unwarranted tightening in lending conditions - given the Eurozone banks' financing cliff in mid-2019 - to ensure the functioning of the monetary policy transmission channel.

The Fed and the ECB aren't the only central banks adopting a more dovish stance on monetary policies, as seen in our indicator that calculates the average of official rates for 38 different countries. It clearly points to a turning point in the general orientation of monetary policies from November 2018 onwards.

We now expect other major central banks to follow suit, given a context of falling global inflation. We believe we reached a peak in global CPI inflation in October 2018 (last available data November 2018) and our global inflationary pressure index confirms the view that we will observe a moderate decline in global inflation in the coming months.

We now expect the US CPI inflation to reach 1.8% y/y on average in 2019 and 2.1% y/y in 2020; core inflation is expected to be stable at 2.2% both in 2019 and 2020. In this context, the Fed won't move in and envisage a rate cut as early as 1Q 20 in a context of strong doubts over US debt sustainability. In the meantime, the Fed will have slowed the pace of unwinding its assets portfolio with a stabilization in the size of its balance sheet from October 2019 onwards.

In the Eurozone, domestic headwinds (below potential growth and the very gradual rise in core inflation) and external ones (the Fed further loosening policy as the US economy enters a technical recession in H1 2020) will force the ECB to further postpone its post-crisis rate lift-off date to fall 2020.

The uncertainty switch, a de-escalation of trade risk is possible

We have estimated that tariffs cut global trade growth by -0.3 pp in 2018, while uncertainties related to trade negotiations cost another -0.45 pp. So overall, there has been a strong impact of the trade conflict. We expect 2019 to be a denouement year in terms of trade negotiations with a positive outcome expected from the China-US and Europe-US negotiations (even if President Trump could initially restart discussions with Europe on a somewhat aggressive manner), in line with our "trade game" scenario (cf our economic insight "Protectionism: Trade games, trade feud or trade war?"). The reduction of trade uncertainties will contribute to normalize trade growth in 2019 after a trough in Q1 19. All in all, the global trade of goods and services growth should slow to +3% in 2019 (following an estimated +3.8% in 2018) due to the continued adverse effect of US trade policy in the first half of the year. But we expect a better second half of the year as tensions between China and the US de-escalate, and China's stimulus bears fruit.

EUROPEAN ECONOMIES TO BENEFIT FROM "TRADE NORMALIZATION"

Europe is experiencing a longer than expected soft patch in growth as it was faced with an industrial recession in Germany, a consumer confidence mini-shock in France and a - for now still mild - recession in Italy with elevated fiscal policy uncertainty weighing on domestic demand. On top of that, the trade dispute between the US and China is estimated to have subtracted close to -0.2pp from Eurozone growth in 2018 - as much as the Brexit-related uncertainty. Finally, the confidence mini-shocks experienced in Italy and France are estimated to have shaved around -0.2pp from the region's growth cumulatively.

But Europe is expected to fare well overall under the big switch thanks to five main factors: (i) resilient real wage growth, given relatively muted inflation rates; (ii) a positive fiscal impulse (+0.2pp on real GDP growth) for the first time since 2009; (iii) a still very accommodative monetary policy stance allowing refinancing rates to remain very low until late 2020; (iv) higher demand from China in H2 and (v) rising economic confidence as key risks fail to materialize, including an escalation of the US-China trade dispute, tariffs on US car imports and a no–deal Brexit.

Germany

In 2018, the high-flying German economy experienced a sharp deceleration. The combination of some key characteristics of Europe's largest economy - including its export-dependence, high degree of openness, large share of industry, dominance of the car sector and geographic export concentration (China and the UK account for almost 15% of exports) -was unfavorable in the global environment of 2018 and saw Germany slip into an industrial recession in the second half of last year. While in early 2019 high-frequency data is still a mixed bag, we think the worst is behind us. A V-shaped recovery in the car sector is not in the cards, but there are encouraging signs of stabilization. We expect production to gradually restart over the coming months as the stock accumulated in 2018 is drawn down. Moreover, with the big switch underway, we anticipate a stabilization in global trade as the Chinese stimulus starts to bear fruit. Thanks to the weak (industrial) start to 2019, we expect the German economy to expand by only +1% this year with annual growth accelerating to +1.4% in 2020.

France

France is still affected by the poor income growth observed in 2018, and demand is still quite subdued, since private consumption in goods remains below its November 2017 peak. However, we expect a gradual recovery with q/q growth set to recover to +0.4% from Q2 19. Half of this should be driven by better purchasing power dynamics (+1.9% in 2019), jointly explained by lower inflation (+1.3% in 2019 after +1.8% in 2018) and a fiscal impulse (+0.5pp), and half should be driven by external demand (German and China consumer-targeted fiscal impulses).

Italy

The prospects for the Italian economy are rather dim due to a combination of cold external but also domestic headwinds. So the big switch will provide some much needed external support to the Italian economy. For one, the reacceleration in Chinese growth, and in turn the stabilization of global trade, will help boost demand for Italian exports from H2 2019 onwards. Moreover, the ECB's more dovish forward guidance but also its helping hand to Eurozone banks in form of another TLTRO financing round is good news for Italy. A delay in ECB monetary policy normalization by at least another year will soften concerns about the sustainability of Italian government debt and support demand for Italian government bonds as investors will continue their search for yields. Meanwhile cheap ECB loans will help keep lending conditions favorable in Italy. We expect Italian GDP to expand by +0.2% in 2019 and +0.4% in 2020.

UK

While the uncertainty will be slightly lower during the Article 50 extension, the fact it lasts for longer is a bad news for the UK economy, which will grow by a weak +1.2% in 2019. Companies will continue to stockpile in the absence of a legally binding motion that the government will do "whatever it takes" to avoid a no Brexit deal. Stockpiling will weigh on their financials even further by year-end. Business insolvencies are expected to continue to rise (+9% after +10% in 2018). During the extension period, we expect a consensus to be built around a softer Brexit (permanent custom union), but a second referendum and/or early elections/Theresa May resignation cannot be excluded.

Overall, we expect a temporary catch-up in the Eurozone in H2 2019 that will lose steam again in H1 2020 as the US enters a technical recession and the impact of the Chinese stimulus measures start to fade. Hence, the region will come back in 2019 to average quarterly GDP growth rates of +0.3% q/q, which brings it below potential.

EMERGING MARKETS TO BE THE WINNERS

A less aggressive global monetary policy, the implementation of a powerful fiscal stimulus in China, a global decline in inflation and a progressive reduction of trade uncertainties represent the perfect alignment for emerging economies. These countries are the best positioned to benefit from the more stable environment created by the big switch.

Emerging Europe sees lower risk of over-heating

The Emerging European region as a whole will experience a cyclical downswing in 2019, followed by a moderate rebound in 2020. However, the regional downswing will be mitigated by easing price pressures. Inflation has already returned to the central banks' target ranges or below in Central Europe and should remain in check in Russia despite the temporary uptick there stemming from a VAT rise. As a common feature with emerging economies at a global level, those countries will be able to maintain an accommodative stance of monetary policy and operate a soft landing on the back of lower trade uncertainties as well. In all, economic growth in the Emerging European region as a whole is projected to decelerate from +3.1% in 2018 to +1.7% in 2019 and then pick up to +2.5% in 2020.

Latin America

In Latin America, the three aspects of the big switch will act as stabilizing factors in a context where domestic conditions are expected to become challenging for new administrations. In 2018, the tightening of the Fed's monetary policy operated was a big constraint for the most fragile emerging economies, which experienced significant downward pressures on their currencies in case of policy mistakes. This time, the easing stance of the Fed will allow emerging economies, and in particular these new administrations, to pursue reforms at their own pace without feeling the immediate sanction of the market.

But we expect an incoming reality check as hard data disappoints, progress on policies keeps us waiting and the leeway for fiscal impulse remains limited. In Brazil (+1.1% in 2018, +2% in 2019, +2.5% in 2020) the outlook for private consumption is only mildly positive. Mexico's growth should be capped at +2%, meaning AMLO will under-deliver on his campaign pledges. In Argentina (-2.4% in 2018, -1.5% in 2019, +2% in 2020), the IMF, market participants and voters will scrutinize the slow rebalancing of the economy. Inflation remains high (50%), and while a reelection of Macri in October remains likely, the Peronist opposition needs to be monitored.

Asia

Any shock in the Chinese economy has very important repercussions for the rest of Asia because of densely integrated supply chains and important trade connections. As a result, the attenuation of trade tensions between China and the US is very important and positive news. Besides this, in emerging Asia, countercyclical policies will help keep growth at a decent pace. Inflationary pressures have decreased and there is more room to ease monetary policy, the second element of our big switch scenario. India already begun with a policy rate cut of 25bp. We expect some central banks in the region to follow the same path (Malaysia, Indonesia by -25bp) by the end of this year. In advanced economies in the region (South Korea, Taiwan, Hong Kong, Australia, for e.g.), we see fiscal policies as a key driver for growth, as well as the normalization of trade relations between the US and China.

Middle East

The big switch will create a safety net not just for global trade but also for commodity prices, in particular energy prices. We expect Brent oil prices to be broadly stable at USD 68 per barrel in 2019. The fact that the Fed won't be aggressive in its monetary policy is also very important for the region since currencies of these countries are pegged to the USD and their monetary policies follow the Fed's orientations. All these factors will mitigate the impact of OPEC's agreed oil production cuts on growth. Annual growth is forecast to ease from +1.5% in 2018 to +1.2% in 2019 and pick up moderately to +2% in 2020.

Africa

There is a significant divergence in Africa between economies where growth has not and will not recover to 2014 levels and those where the momentum has remained the same. In the first group are key commodity exporters (hydrocarbon, industrial metals), including Nigeria and South Africa, which are confronted by domestic challenges. The big switch will alleviate pressures on these economies. Meanwhile, top reformers will benefit from their achievements (+6.7% growth in 2019 in East Africa), particularly low-income or lower middle income ones, such as Ivory Coast and Kenya (where our analysis of the business environment is upgraded this quarter). These economies are able to invest and increase their capital stock.

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