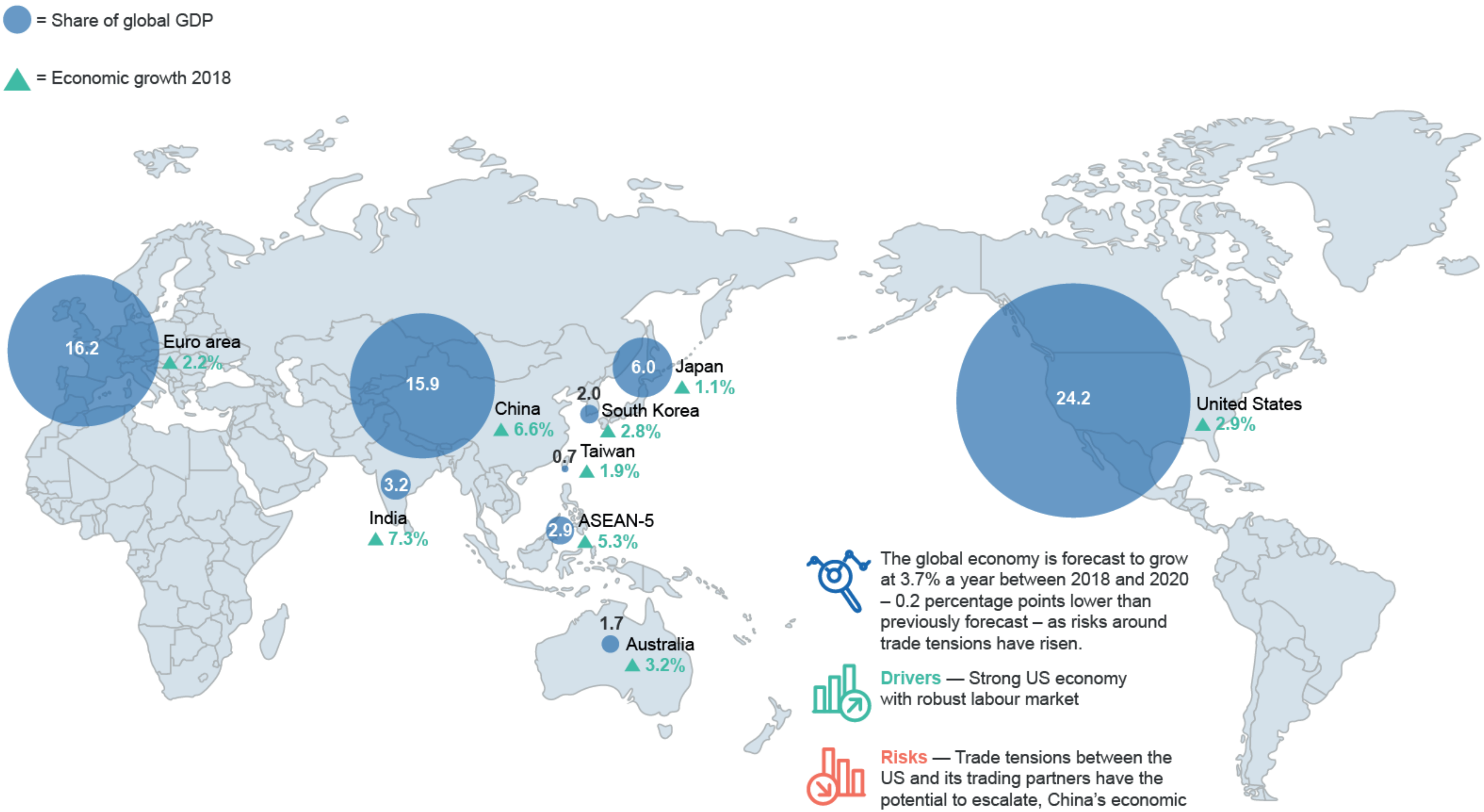
Macroeconomic Outlook

Resources and Energy Quarterly December 2018



The global economy is forecast to grow at 3.7% a year between 2018 and 2020 – 0.2 percentage points lower than previously forecast – as risks around trade tensions have risen.

Drivers — Strong US economy with robust labour market

Risks — Trade tensions between the US and its trading partners have the potential to escalate, China's economic slowdown, global stock market vulnerabilities

2.1 Summary

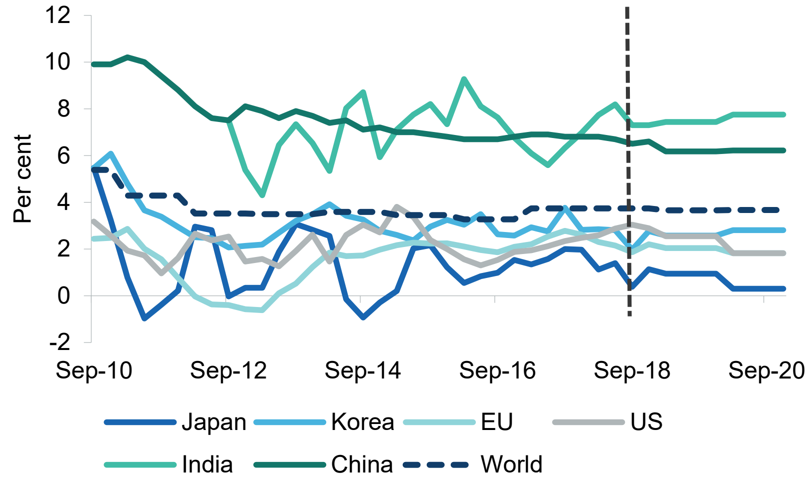
- The global economy is forecast to grow at 3.7 per cent a year between 2018 and 2020 — 0.2 percentage points lower than previously forecast. This primarily reflects the impact of tit-for-tat US-China adverse trade measures: slower foreign trade and investment.
- The US economy continues to grow strongly, but is expected to slow once the impact of the tax cuts wash through and recent interest rate hikes start to exert a larger effect. In China, domestic economic growth is decelerating. Eurozone economies recorded their weakest growth in four years in the September quarter.
- The outcome of the US mid-term elections in November 2018 has raised the prospects of legislative gridlock. Trade tensions between the US and its trading partners have the potential to escalate, and volatility in global stock markets is expected to continue through 2019. Geopolitical tensions in the Middle East may rise, following the recent reimposition of US sanctions on Iran.

2.2 Global economy

The September quarter 2018 saw the global economy expand at a slower pace than in the June quarter, with growth falling in both advanced and emerging economies (Figure 2.1). Growth in world manufacturing activity has started to ease off. The global manufacturing Purchasing Managers Index (PMI) was at 52.0 in November 2018, down from a cyclical high of 54.5 in December 2017. China, the US, Japan and the EU all have manufacturing PMIs above the 50 level (which indicates expansion), but downward movements are evident, which could have implications for global commodity demand (Figure 2.2).

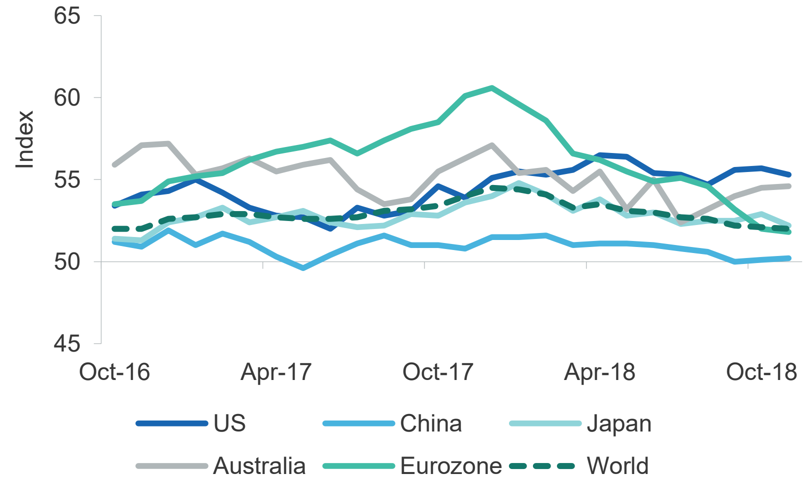
In October 2018, the International Monetary Fund (IMF) cut its global economic forecasts for the first time in two years, citing escalating trade tensions and stresses in emerging markets. Global economic growth is expected to fall below the July 2018 economic outlook, reaching 3.7 per cent annually in 2018, 2019 and 2020.

Figure 2.1: Global and major economies real GDP, YoY growth



Source: International Monetary Fund (2018)

Figure 2.2: Manufacturing Purchasing Managers Index (PMI)



Source: Markit (2018)

Other emerging economies — Indonesia, Brazil, Argentina, Mexico, Turkey, Iran and South Africa — are expected to suffer from rising US interest rates and capital outflows, with the growth forecast for developing economies cut by 0.2 of a percentage point in 2018 and 0.4 of a percentage point in 2019.

Steep falls in global stock markets since October 2018 have raised fears that escalating trade tensions could trigger a global stock market crash reminiscent of 2008, when US equity markets plunged by 25 per cent over a couple of days. Such a shock would be felt in markets around the world. Global share markets have already lost around US$7 trillion in value terms since October 2018. The benchmark US Standard and Poor 500 Index has dropped by 7.5 per cent, in line with the fall over the same period in the Chinese stock market. Despite these falls, the current value (US$72 trillion) of world equity markets is still three times higher than it was in the wake of the 2008 global financial crisis, when it fell to US$26 trillion.

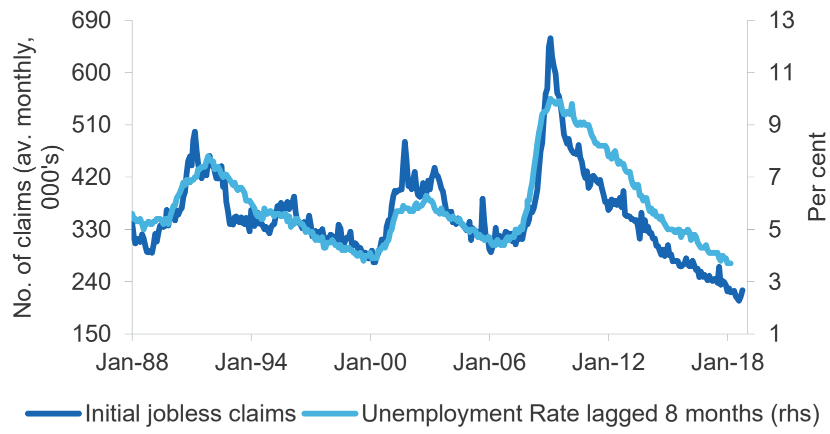
2.3 United States

US economic growth slowed to 3.0 per cent year-on-year in the September quarter. While still robust, US growth has been partly constrained by China's retaliatory tariffs on US exports, which have seen exports of soybeans, petroleum and non-automotive capital goods falling significantly. Imports of consumer goods and motor vehicles continue to rise, as businesses seek to build stockpiles before US import duties come into effect.

Despite slower economic growth, the US economy remains fundamentally solid. The US manufacturing activity in November continued to expand, with the US Institute for Supply Management (ISM) Manufacturing Index increasing to 59.3 in November 2018, from 57.7 in October. Consumer spending remained strong, and the unemployment rate at a near 50 year low of 3.7 per cent in November 2018 (Figure 2.3).

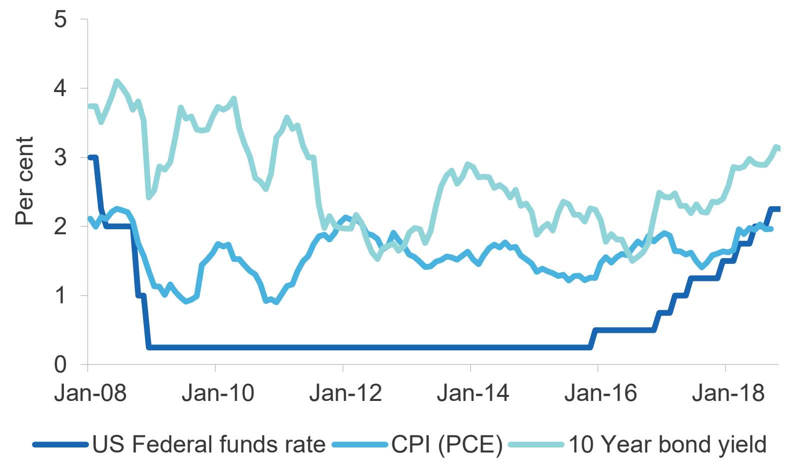
However, the US economy is likely to face several pressures in the short term. The results of the November mid-term elections have dampened

Figure 2.3: US unemployment rate and Initial jobless claims



Source: US Department of Labour (2018); Bureau of Labour Statistics (2018)

Figure 2.4: US Federal funds rate, CPI and 10-Year bond yield



Source: US Federal Reserve (2018) Federal Funds Rate; US Bureau of Labour Statistics (2018) US Personal Consumption Expenditure (PCE) Core Price Index

prospects for further stimulatory tax cuts over the next two years. Tariffs imposed on a wide range of imports from China (totalling US$517 billion) are expected to push inflation and interest rates higher, dampening consumer and business confidence. Median weekly wages rose by 1.1 per cent in the September quarter 2018 compared to the June quarter 2018, suggesting that the labour market is tightening. Higher interest rates are pressuring the US housing markets, which contracted at their steepest pace in more than a year in the September quarter.

The US Federal Reserve is expected to reassess its timetable of interest rate rises for 2019, leaving the Federal fund rates unchanged at 2.25 per cent in November. At the time of writing, a rate hike is still expected following the next meeting on 18 December 2018 (Figure 2.4).

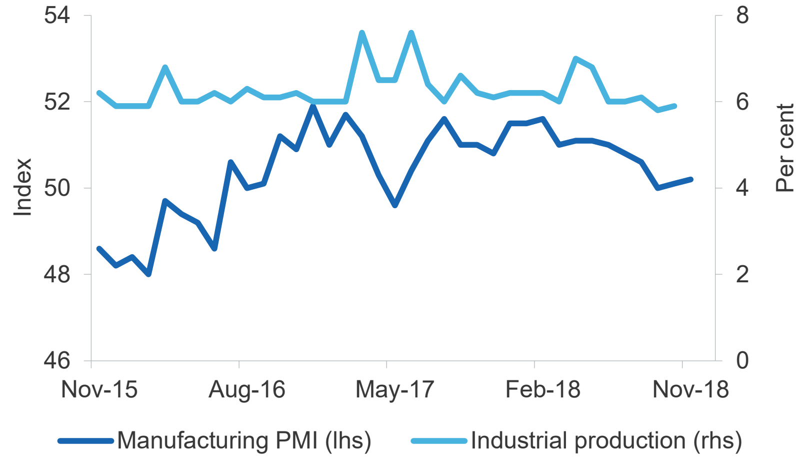
2.4 China

The Chinese economy grew by 6.5 per cent year-on-year in the September quarter 2018. This is the lowest growth rate since the aftermath of the global financial crisis (GFC), and reflects escalating trade tensions with the US and increased borrowings by local governments.

China's industrial production increased at a slower pace in October 2018 (5.9 per cent year-on-year), down from a 6.8 per cent rise in August 2018. This was the second lowest growth since February 2016, and mainly reflects a slowdown in manufacturing output. The manufacturing Manufacturers Purchasing Managers' Indices (PMIs) were at or close to neutral territory (indicating no growth in activity or contraction on a monthly basis) in November. China's official PMI fell to 50 in November from 50.2 in October. The Markit manufacturing PMI in November rose to 50.2, up slightly from the 16-month low of 50.1 in October 2018 (Figure 2.5).

On 31 October 2018, the Chinese Renminbi traded at 6.9737 per US dollar — the lowest level against the US dollar in more than a decade. The currency dropped nearly 9 per cent against the US dollar in 2018, and may drop further should trade tensions continue to heat up (Figure 2.6).

Figure 2.5: China's industrial production and Manufacturing PMI



Source: Markit (2018); Netherland CPB (2018)

Figure 2.6: The US dollar/Chinese Renminbi

Source: Thomson Reuters (2018)

Exports are still strong, but will face greater pressure as higher US tariffs come into effect. China's property sector is not expected to provide as much support for commodity demand as it has in the recent past. China's economic growth is forecast to slow to 6.2 per cent in 2020, as a result of lower internal demand and tightening financial regulations.

The Chinese Government has introduced a number of targeted measures aiming at offsetting the impact of the US trade measures on the economy. These measures include:

- Increased spending on urban infrastructure has risen, with recent projects including a 78.7 billion Yuan urban rail project for Changchun, a 95 billion Yuan subway network project for Suzhou, and transport projects for Guangdong worth 1.36 trillion Yuan.
- Increased export tax rebates, effective October 2018, will apply to 397 products, including steel, chemicals, lithium batteries, light-emitting diodes, multi-component semiconductors, machinery products, and books and newspapers.
- Import tariff cuts on consumer goods from July 2018 — these will reduce the price of nearly 1,500 consumer products, ranging from cosmetics, washing machines, refrigerators to other home appliances. The average tariff rate was cut significantly — from 15.7 per cent to 6.9 per cent. Tariff cuts have also been made on industrial goods.
- Personal tax-free thresholds were raised, effective October 2018, from 3,500 Yuan to 5,000 Yuan per month.
- New personal tax deductions — effective from January 2019 — allow homeowners and tenants to get tax free allowance for their mortgage and rental payments, and parents to claim tax deduction against their children's education expenses.

Some immediate impact is evident in construction, with the construction activity index in the services PMI lifting by 5.4 points year-on-year in October 2018, to 63.9. The measures are likely to have a rising impact over time.

2.5 Other economies

Japan

Japan's economic growth contracted by 0.6 per cent on quarter in the September quarter 2018 — the steepest contraction since the June quarter 2014 — as a result of several natural disasters. Private consumption, which accounts for 60 per cent of GDP, dropped by 0.2 per cent, following a 0.7 per cent increase in the June quarter. Trade tensions between the US and its trading partners impacted Japan's exports, which declined by 1.8 per cent in the September quarter.

Japan's economic growth is forecast to slow to 0.3 per cent in 2020, as a rising consumption tax, ageing and shrinking of the working population, and trade tensions, which all impact on consumption. A rise in Japan's consumption tax rates (by 2 percentage points, to 10 per cent, from 1 October 2019) is intended to fund growing pension expenses and support fiscal consolidation. However, it may also reduce consumption in 2020. Japan's fiscal and monetary policies are already stimulatory, and there is limited room to respond to external shocks including trade tensions with the US.

Europe

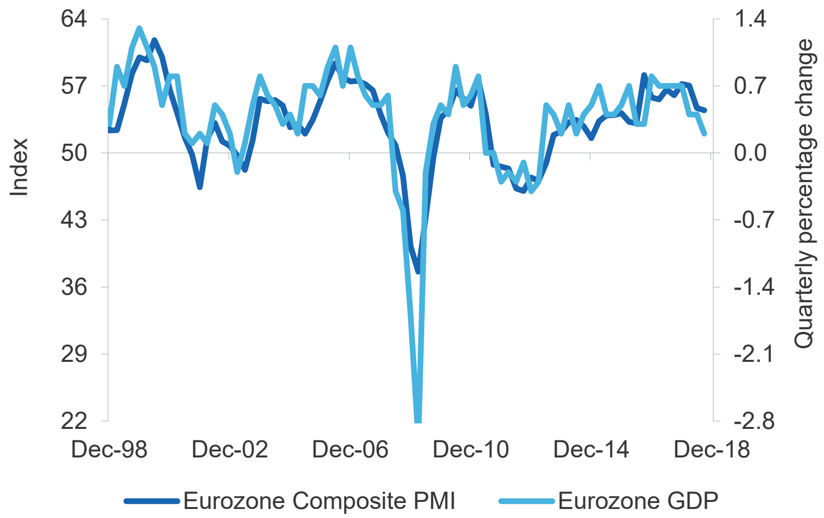
The Eurozone economy grew by 1.9 per cent year-on-year in the September quarter — the weakest growth in four years — as Italy's economy stalled. The Eurozone's manufacturing PMI fell to a 27-month low of 51.8 in November 2018, amid worries about the trade tensions and rising prices (Figure 2.7).

The Eurozone's inflation rate is expected to pick up, supported by a tightening labour market. Eurozone unemployment remained at a post global financial crisis low of 8.1 per cent in October 2018. This is 4 percentage points down from a high of 12.1 per cent in 2013, but there is a significant divergence across the Eurozone. Germany's unemployment rate fell to a thirty-year low of 3.3 per cent in October 2018, but unemployment rates in Spain (14.9 per cent) and Italy (10.6 per cent) remain stubbornly high.

Eurozone economic growth is expected to slow further in the next few years. Italy's debt and deficit problems and Brexit pose risks to growth. A potential threat is US protectionist measures against Europe's automotive vehicles and automotive parts sectors. The International Monetary Fund has revised the Eurozone economy forecast down by 0.4 percentage points for 2018 and 0.1 percentage points for 2019.

The European Central Bank (ECB) has committed to end its stimulatory US$2.6 trillion asset purchase scheme by the end of 2018, despite the weaker economic growth outlook. The Eurozone's interest rates are also likely to rise in the second-half of 2019, as wage rises push up inflation.

Figure 2.7: Eurozone Composite PMI and Real GDP



Source: Bloomberg (2018); International Monetary Fund (2018)

South Korea

South Korea's economic growth slowed to 2.0 per cent year-on-year in the September quarter 2018. This was the weakest growth in nine years, and reflects a sharp 7.8 per cent fall in construction in the September quarter. Slower growth was also recorded in private consumption (which expanded by 2.6 per cent in the quarter) and government expenditure (which grew by 4.7 per cent).

South Korea's economic growth is forecast to slow to 2.8 per cent in 2018 from 3.1 per cent in 2017, and to 2.6 per cent in 2019, as trade tensions between the US and its trading partners have spillover effects on South Korean exports of intermediate goods. The South Korean government announced an expansionary 2019 budget in late August 2018. South Korea's industrial production rebounded in October 2018, up 10.7 per cent year-on-year. However, South Korean companies are expected to adopt a cautious approach amid the uncertain global trade environment.

India

India's real GDP growth rate rose to 8.2 per cent year-on-year in the June quarter, as the post goods and services tax (GST) recovery gathers pace. The growth was supported by strong urban and rural demand, and improved industrial activity.

India's economy remains one of the fastest growing economies in the world. The GST — introduced from 1 July 2017 — has provided the government with additional revenue to spend on social and infrastructure projects, and low wages are improving India's competitiveness. The Indian government is also undertaking projects to increase the quality of India's ports, including the development of a transhipment hub. Real GDP is forecast to grow by 7.3 per cent in 2018, rising to 7.7 per cent in 2020.

Rising oil prices and global trade tensions represent the primary risks to the Indian economy, which otherwise continues to perform solidly.

Table 2.1: Key world macroeconomic assumptions

Per cent	2017	2018[a]	2019[a]	2020[a]
Economic growth[b]				
Advanced economies	2.4	2.4	2.1	1.7
Australia	2.3	3.2	2.8	2.7
Eurozone	2.7	2.2	2.0	1.8
France	2.3	1.6	1.6	1.6
Germany	2.5	1.9	1.9	1.6
Japan	1.7	1.1	0.9	0.3
New Zealand	3.0	3.1	3.0	3.1
South Korea	3.1	2.8	2.6	2.8
United Kingdom	1.7	1.4	1.5	1.5
United States	2.3	2.9	2.5	1.8
Emerging economies	4.7	4.7	4.7	4.9
ASEAN-5[d]	5.3	5.3	5.2	5.2
China[e]	6.9	6.6	6.2	6.2
Chinese Taipei	2.8	2.7	2.4	2.3
Emerging Asia	6.5	6.5	6.3	6.4
India	6.7	7.3	7.4	7.7
Latin America	1.3	1.2	2.2	2.7
Middle East	2.2	2.0	2.6	2.9
World[c]	3.7	3.7	3.7	3.7

Notes: a Assumption; b Year-on-year change; c Weighted using purchasing power parity (PPP) valuation of country gross domestic product by IMF; d Indonesia, Malaysia, the Philippines, Thailand and Vietnam; e Excludes Hong Kong

Source: IMF (2018) World Economic Outlook; Department of Industry, Innovation and Science

Table 2.2: Exchange rate and inflation assumptions

	2017	2018	2019	2020
AUD/USD exchange rate	0.77	0.75	0.74	0.77
Inflation rate				
United States	97.6	100.0	102.2	103.4
	2016–17	**2017–18**	**2018–19**	**2019–20**
Australia	95.9	97.8	100.0	102.4

Notes: The inflation rate for Australia is used to covert Australian export values to real 2018–19 dollars.
The inflation rate for the United States is used to convert commodity prices denominated in USD to real 2018 dollars.

Source: Department of Industry, Innovation and Science (2018); Bloomberg (2018) Survey of economic forecasters

Box 2.1: Trade Tensions

Over the course of 2018, the US administration implemented several restrictive trade policies which vary between trade partners and mostly involve the use of tariffs or quotas on imports. Some trading partners of the US responded by imposing tariffs on imported goods from the US.

China is Australia's largest export destination for iron ore, bauxite, copper ores and concentrates, and the second largest destination for metallurgical coal. The imposition of US trade tariffs on global imports of steel and aluminium (for which Australia has negotiated an exemption), as well as tariffs on Chinese imported goods — many of which contain high amounts of steel, copper and aluminium — has the potential to reduce China's demand for steel making imports, namely iron ore and metallurgical coal, as well as imported copper (refined, ores and concentrates) and aluminium (and inputs alumina and bauxite).

However, because China's domestic consumption is large compared to their exports to the US of products containing these commodities (Table 2.3) — and not every product subject to the US tariffs contains steel, copper or aluminium — the OCE expects the direct impact on Australia's export earnings from the US-China tariffs will be negative but small.

Table 2.3: China's use of major commodities, 2017

	Steel	Copper	Aluminium
Net production and imports (million tonnes)	788	17	34
China's domestic consumption	86%	63%	72%
China's export to the world	14%	37%	28%
- China's export to USA	1%	6%	5%

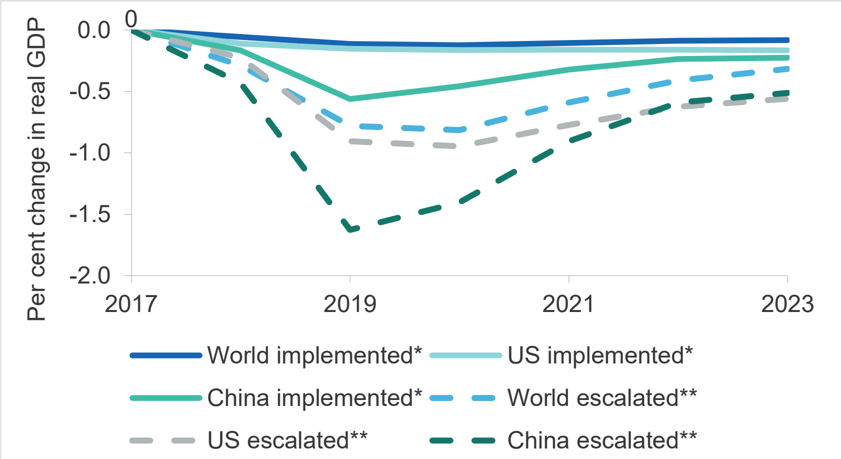
Notes: Domestic production calculated by subtracting world exports from net production and imports for each commodity.

Source: Department of Industry, Innovation and Science (2018); International Trade Centre (2018)

Importantly, the indirect impact of trade tensions — which could negatively impact on the pace and direction of global economic growth (especially in China and the US) — may weigh on commodity prices and therefore have a much larger impact on Australia's export earnings.

In the October 2018 World Economic Outlook, the International Monetary Fund revised down GDP forecasts for a number of countries, attributed to rising trade tensions. For 2019, world GDP growth has been revised down by 0.2 per cent to 3.7 per cent, US down by 0.2 per cent to 2.5 per cent, and China down by 0.2 per cent to 6.2 per cent. Figure 2.8 shows the estimated change in the level of real GDP, which is negative for the next five years. Peak impact comes in 2020, with world GDP, US and China 0.8, 0.9 and 1.4 percentage points lower, respectively, than they otherwise would have been.

Figure 2.8: Change in real GDP: Trade tensions scenario



Note: * Implemented measures include $50 billion of tariffs on steel, aluminium, solar panels and washing machines, $50 billion and $200 billion of tariffs that have already been imposed on Chinese imports. ** Escalated measures include $267 billion of tariffs that is likely to impose on Chinese imports should the trade tensions escalate.

Source: International Monetary Fund (2018)