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OUTLOOK
6 June 2019

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Global Macro Outlook 2019-20 (June 2019 Update)

Global growth prospects at risk from increasingly uncertain US trade policy

Summary

» **Recent escalation in US-China tensions has clouded the global economic outlook**. While global growth had shown signs of stabilization, two recent policy developments have created significant uncertainty. First, the US-China trade dispute has intensified, with each side imposing additional tariffs on the other. If the tensions drag on or escalate, they will leave a lasting impact on the global economy. Also, the new US threat to impose tariffs on all imports from Mexico is a reminder of the uncertainty of US trade policy. Second, a worsening of tensions between the US and Iran could tip an already delicate balance in the Middle East, potentially sending oil prices soaring and further complicating economic decisions in an already uncertain environment. Other key risks remain intractable. For example, three years after the British electorate voted to leave the European Union (EU), the UK's path toward Brexit remains unclear.

» **Risks of a sharper slowdown have risen**. The recent trade and geopolitical developments could put the economy at risk if they result in a significant retreat of global financial markets and an abrupt tightening of financial conditions.

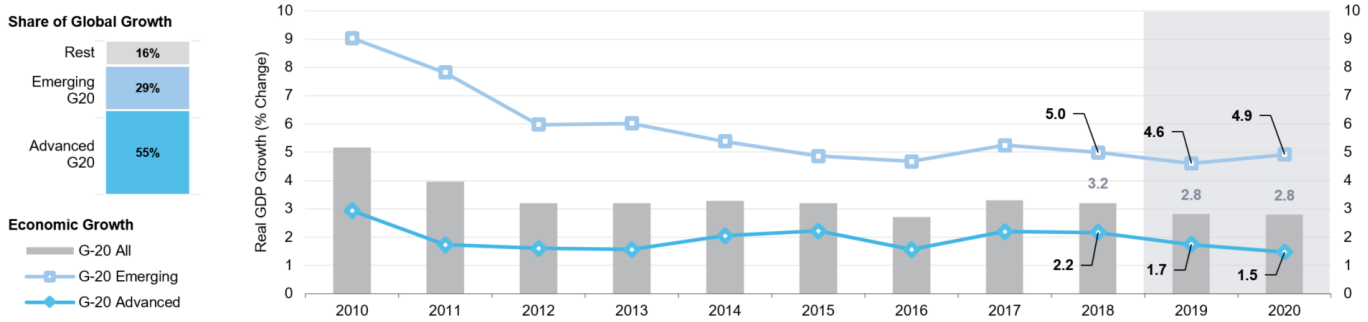
» **Pace of economic activity is clearly slowing in a number of economies.** We examine three potential outcomes of the US-China trade dispute that could affect growth. In our baseline, we expect global growth to slow to 2.8% in both 2019 and 2020, from an estimated 3.2% in 2018 (see Exhibit 1). The forecast reflects a deceleration of growth in the US, China, the euro area and in developed Asia. In advanced industrialized G-20 economies, we forecast a secular decline in real economic momentum from an above-trend 2.2% in 2018 to 1.7% in 2019 and only 1.5% in 2020. While emerging market countries, excluding China, have reached a trough, we do not see prospects of a strong rebound. Growth in G-20 emerging markets will decline from 5% in 2018 to 4.6% in 2019, followed by a pickup to 4.9% in 2020.

THIS REPORT WAS REPUBLISHED ON 12 JUNE 2019 WITH CORRECTION TO SCENARIO 3 IN EXHIBIT 5.

Exhibit 1

G-20 economic growth

Year-over-year % change



Source: Moody's Investors Service

Exhibit 2

Global macroeconomic outlook for G-20 countries, 2019-20 (June 2019 update)

Economies	Real GDP Growth 2				Inflation 3				Unemployment			Monetary Policy		
G-20	17	18	19F	20F	Target	18	19F	20F	18	19F	20F	18	19F	20F
Advanced	2.2	2.2	1.7	1.5										
US	2.2	2.9	2.3	1.7	2.0%	1.9	2.1	2.1	3.9	3.7	4.0	▲	■	■
Euro area 1	2.5	1.8	1.3	1.4	2.0%							▲	■	■
Japan	1.9	0.8	0.8	0.4	2.0%	0.3	2.0	0.8	2.4	2.4	2.8	■	■	■
Germany	2.2	1.4	1.0	1.3	2.0%	1.7	1.8	1.9	3.4	3.2	3.0			
UK	1.8	1.4	1.2	1.4	2.0%	2.0	2.0	1.9	4.0	4.0	4.2	▲	■	■
France	2.2	1.6	1.5	1.5	2.0%	1.9	1.6	1.2	9.1	8.5	8.3			
Italy	1.7	0.9	0.4	0.8	2.0%	1.2	0.5	1.5	10.6	10.6	10.5			
Canada	3.0	1.8	1.3	1.7	2.0% (+/-1.0%)	2.0	1.9	2.0	5.8	5.9	6.1	▲	■	■
Australia	2.4	2.8	2.5	2.5	2.0%- 3.0%	1.8	2.3	2.5	5.3	5.5	5.5	▲	▼	■
South Korea	3.1	2.7	2.1	2.2	2.0%	1.5	1.5	1.8	3.8	4.1	4.2	▲	▼	■
Emerging	5.2	5.0	4.6	4.9										
China	6.8	6.6	6.2	6.0	3.0%	1.9	2.4	2.4	--	--	--	▼	▼	■
India	6.9	7.4	6.8	7.3	4% (+/-2.0%)	2.1	4.0	5.0	--	--	--	▲	▼	■
Brazil	1.1	1.1	1.3	2.0	4.5% (+/-1.5%)	3.7	3.9	4.0	--	--	--	■	■	■
Russia	1.6	2.3	1.6	1.5	4.0%	4.3	4.6	4.0	--	--	--	▲	▼	▼
Mexico	2.1	2.0	1.2	1.5	3.0% (+/-1.0%)	4.8	3.3	3.5	--	--	--	▲	▼	▼
Indonesia	5.1	5.2	4.9	5.0	3.5% +/-1.0%	3.1	2.5	3.0	5.2	5.2	5.2	▲	▼	■
Turkey	7.4	2.6	-2.0	2.0	5.0% (+/-2.0%)	20.3	18.5	13.0	--	--	--	▲	■	■
Saudi Arabia	-0.7	2.2	2.5	2.5	USD Peg 4	2.5	-0.7	2.2	--	--	--	▲	▲	■
Argentina	2.7	-2.5	-1.5	1.5	Monetary Base 5	47.6	35.0	25.0	--	--	--	▲	▲	▼
South Africa	1.4	0.8	1.0	1.5	3.0% - 6.0%	4.4	5.1	5.4	--	--	--	▲	▼	■
All	3.3	3.2	2.8	2.8										

Growth Forecast Adjustment from the previous outlook

- **X.X** Adjustment < 0.3 pp
- **X.X** An upward adjustment ≥ 0.3 pp
- **X.X** A downward adjustment ≥ 0.3 pp

Monetary Policy Directions

- ■ Maintain current policy
- ▼ Accommodative
- ▲ Tightening

1. G-20 Euro Area forecasts include 19 countries. 2. See our previous Global Macroeconomic Outlook, "Global economy will continue to weaken throughout 2019 and into 2020," 28 February 2019. 3. Dec-to-Dec % Change. 4. Exchange rate arrangement is conventional peg to the US dollar 5. Argentina's central bank replaced its inflation targeting regime with a target of zero growth in nominal terms in the monthly average of the monetary base from October 2018 until June 2019.

Source: Moody's Investors Service

Summary continued

» **In the event of a significant global deceleration, advanced industrial G-20 economies have limited monetary and fiscal policy space for stimulating global aggregate demand.** Nevertheless, the prevailing accommodative bias among global central banks supports benign financial conditions, stimulus measures in China remain substantial and domestic demand in the US and core euro area economies continues to be robust. Together, these factors will likely provide a counterbalance to the adverse impact of increased trade frictions and uncertainty.

Trade and geopolitical concerns dent global growth prospects yet again

Global economic trends have generally evolved in line with our long-standing expectation that growth will lose pace this year after peaking in 2018. The pace of economic activity is clearly slowing in a number of economies, including the US, China, the euro area and developed Asia, to lower longer-term trend rates, in tandem with weakness in indicators such as industrial output, PMIs and international trade volumes. The escalation of tariffs and other protectionist trade policies of the US and China, and the related rise in uncertainty, has had a clear negative impact on manufacturing sentiment across a number of countries.

While incoming data suggests that growth is lackluster and uneven, the mood is not entirely downbeat. Some tentative signs of stabilization have emerged in the euro area and in China. Strong employment and wage trends continue to support domestic demand in major advanced economies, even as investment momentum fades. However, many emerging market countries are struggling to pick up the pace. In the event of a significant global deceleration, advanced industrial G-20 economies have limited monetary and fiscal policy space for stimulating global aggregate demand. Nevertheless, the prevailing accommodative bias among global central banks supports benign financial conditions, stimulus measures in China will likely remain substantial and domestic demand in the US and euro area economies remains robust. Together, these factors will continue to provide a counterbalance to the adverse impacts of increased trade frictions and uncertainty.

But two recent policy developments have created significant uncertainty. First, the US and China have intensified their trade dispute, with each side imposing additional tariffs on the other. If the tensions drag on, they will leave a lasting impact on global economic linkages. Second, a worsening of tensions between the US and Iran could tip an already delicate balance in the Middle East, potentially sending oil prices soaring and further complicating economic decisions in an already uncertain environment. Other major regional risks remain intractable. Three years after the British electorate voted to leave the EU, the UK's path toward Brexit remains unclear. EU elections also point to continued fragmentation in the union.

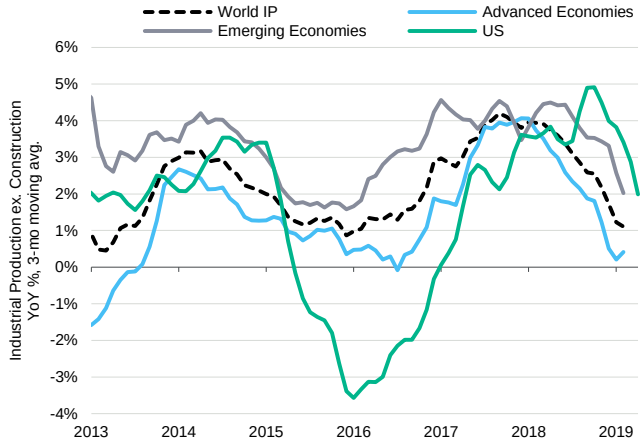
We expect global growth to slow to 2.8% in both 2019 and 2020. In advanced industrialized G-20 economies, we forecast a secular decline in real economic momentum from an above-trend 2.2% in 2018 to 1.7% in 2019 and 1.5% in 2020. In contrast, growth in G-20 emerging markets will decline from 5% in 2018 to 4.6% in 2019, followed by a pickup to 4.9% in 2020.

The above-trend growth rates of advanced economies in 2017 and the first half of 2018 were never sustainable. Thus, the deceleration in advanced economies to very low-trend growth rates reflects two secular factors: modest underlying productivity growth and aging populations. Many emerging market economies, on the other hand, have reached a trough. We forecast weaker real GDP growth in 2019 for a number of emerging market countries, including China, India, Russia, Mexico and Indonesia, as a result of secular and temporary country-specific issues and slower trade growth. Except for China, whose growth will continue to decelerate, most other G-20 emerging market economies will likely strengthen in 2020. But absent strong external demand, lackluster productivity growth will limit growth potential in Brazil, Mexico and South Africa.

Exhibit 3

Global industrial production

Annual % change, 3-month moving average

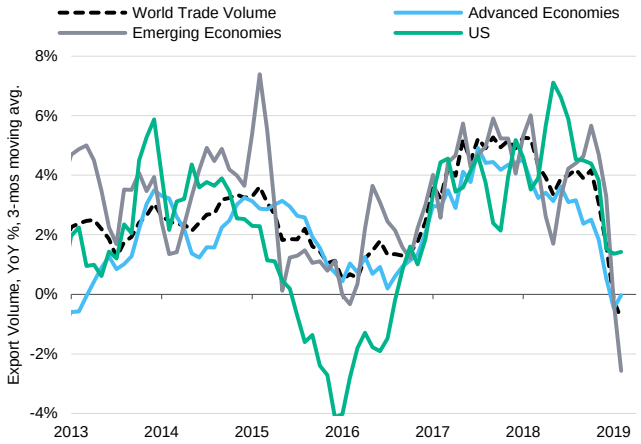


Source: Haver Analytics

Exhibit 4

Global export volume

Annual % change, 3-month moving average



Source: Haver Analytics

US-China tensions have unexpectedly intensified

Just as signs of stabilization in global growth were emerging, a sharp escalation in US-China tensions now cloud the global economic outlook. Meanwhile, US President Donald Trump has threatened to impose 5% tariffs on all imports from Mexico on June 10, which would increased to 25% in the following months, if Mexico fails to stem the flow of migrants from Central America to the US border.

Last month, trade talks between the US and China broke down and the US administration increased tariffs on $200 billion of imports from China to 25% from 10%. In addition, the US Trade Representative's office is now seeking public input on the possible imposition of 25% tariffs on all imports from China in the absence of further progress in trade negotiations. China announced a retaliatory increase in tariffs on $60 billion of US imports, ranging from 5% to 25%, starting June 1. The US decision to ban Huawei from doing business with US companies, a step that essentially cuts its access to Google's android software and to hardware including Intel's chips, is also a major escalation.

The breakdown of talks was unexpected but not entirely surprising. During the negotiations, it initially appeared that the two countries had found some common ground, with Chinese negotiators seeming to accept US demands for reducing the trade surplus and cutting import duties to match US levels. Under these requirements, China would have to buy more US-made products, including agricultural goods, energy and commercial aircraft, which China's economy needs. However, the negotiations ended because the US and China could not agree on certain core issues that will likely remain sticking points. It appears that the US administration insisted that China curb subsidies to its state-owned enterprises in strategic sectors, a requirement that China finds unacceptable because these subsidies are central to its industrial policy and Made in China 2025 strategy.

We also understand that China preferred to enforce any trade deal through incremental regulatory changes, while the US administration wanted credible enforcement in the form of changes to China's laws and oversight mechanisms, which China appeared to be unwilling to undertake. Other differences included the US administration's stance that any trade deal include, in writing, all commitments made in principle. And the US also appeared unwilling to lift existing tariffs before verifying enforcement of the trade deal.

As a result of these issues, we do not think that an agreement will be reached at the G-20 summit in Osaka, Japan on June 28–29 when US President Trump and China's President Xi Jinping are expected to meet.

From a US political perspective, hurdles to a significant trade deal are also growing as the 2020 presidential election nears. Trade and economic relations with China will likely feature prominently in the election. There is a small window of opportunity for a trade deal to be reached before the first Democratic presidential candidates' debate, which is scheduled for June 26-27. Many of the Democratic candidates are generally more inclined to take a hard view of a trade deal with China. So not only will the bar for a trade deal be high

as the presidential election approaches, but even if the Trump administration were to strike a trade deal, uncertainty surrounding the trade relationship would remain high well into 2020 and possibly longer.

For China, any deal that appears to make China yield more concessions than the US would be politically unpalatable. Thus, we believe that a viable trade deal is unlikely to meaningfully address contentious issues and therefore, China may be positioning itself for a protracted trade conflict. Moreover, even if the two sides reach an agreement, the US would likely continue to pursue measures restricting access of Chinese companies such as Huawei to US technology. (For details, see US-China relations to remain contentious, clouding global credit conditions, December 4, 2018.)

The way forward – three scenarios

Three plausible scenarios could unfold on the US-China trade front: (1) the status quo scenario, in which there is no trade deal, but no further escalation of tensions as trade talks continue well into 2020; (2) hardened stance scenario, in which trade tensions ratchet up, with both countries placing punitive tariffs on all of each other's imports and imposing other restrictive measures; or (3) the significant softening scenario, which envisions a resolution of some differences within the next month or so that results in a trade deal and the lifting of at least some of the existing tariffs.

The first scenario is our baseline, to which we assign a 45% probability. We believe this scenario is the most likely outcome because the prospects of a significant deal remain slim given the paucity of trust between the two sides as well as considerable differences on core issues. Also, although the likelihood of an escalation to a full trade war (scenario 2) is very high, the economic and financial costs could deter the two countries from taking such steps. Under scenario 1, the tariff escalation would shave a modest 0.10 percentage point off US growth and about 0.20 percentage point off China's growth this year through direct trade channels. However the overall impact could be larger depending on the resilience of sentiment, the degree of risk aversion and the impact of persistent policy uncertainty.

We assign a 40% probability to the second scenario. The Trump administration has threatened to impose additional tariffs on China if no progress is made in trade negotiations. Given that the two countries are far apart on several key issues, we therefore consider this a highly likely scenario. Addition

ally, the US administration is likely to remain steadfast in its desire to draw a hard line with China as long as the US economy continues to add jobs, wage growth remains solid and the financial market reaction to the swings in trade tensions remains relatively modest. On the Chinese side, the recent developments with respect to Huawei adds complications to the dispute.

Under this scenario, the impact on economic activity in the US, China and the rest of the world could be more than twice as severe as the base case. Under this scenario, the tariffs would result in US consumers paying higher prices for everyday items such as electronics, clothing, footwear and toys. This escalation would shave an additional 0.3 percentage point from US growth and 0.5 percentage point from China's growth in 2019 through direct channels. The magnitude of the total macro impact would be much larger because of second-order indirect negative effects on sentiment and the financial sector, in addition to the direct trade channels. This escalation would add considerable policy uncertainty, and could increase risk aversion and lead to an abrupt re-pricing of risk assets globally. Tighter financial conditions, notwithstanding the Fed's more dovish policy stance, would pose a negative confidence shock that drags global growth significantly lower. Spillovers on investment and through the global production chain would be much larger and no sector would be spared.

The third scenario, to which we assign only a 15% probability, is more benign and envisions a trade deal in the near term that ends hostilities and allows for lifting of some of the tariffs now in place. Such an agreement would remove much of the uncertainty around US-China trade relations and be positive for sentiment in financial markets and for growth.

For the first two scenarios, the second round indirect effects on economic activity through higher policy uncertainty, reduced business and consumer sentiment and tighter financial conditions could be sizable and trigger a negative feedback loop that would be more detrimental than the direct exposure through direct trade channels.

Exhibit 5

Three scenarios for the outcome of the US-China trade dispute

US-China trade friction - Three macroeconomic scenarios

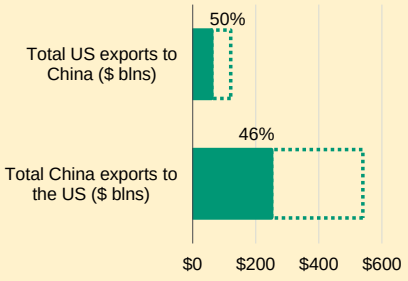
Last month, the **US** increased tariffs on $200 billion of imports from China to 25% from 10%

China announced a retaliatory increase in tariffs on $60 billion of US imports, ranging from 5% to 25%, starting June 1

SCENARIO 1 - Status quo (45% probability)

25% tariffs on **$250 billion** of US imports from China

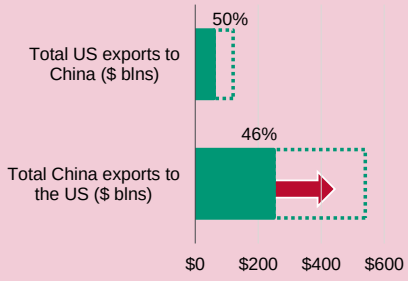
- No trade deal, but no further escalation of tensions as trade talks continue
- Threat remains of 25% tariffs on all imports from China, but these tariffs not implemented
- Trade with China remains a contentious issue
- No auto tariffs
- Threat of new tariffs on US imports from Mexico not applied



SCENARIO 2 - Hardened stance (40% probability)

25% tariffs on **all** US imports from China; China retaliates in equal measure

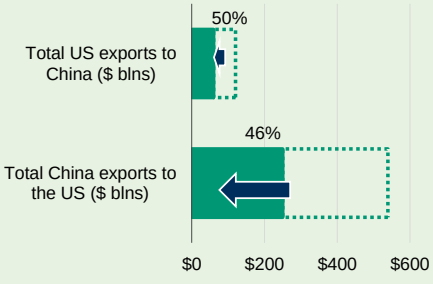
- No auto tariffs
- Trade with China remains a contentious issue
- Threat of new tariffs on US imports from Mexico not applied



SCENARIO 3 - Significant softening (15% probability)

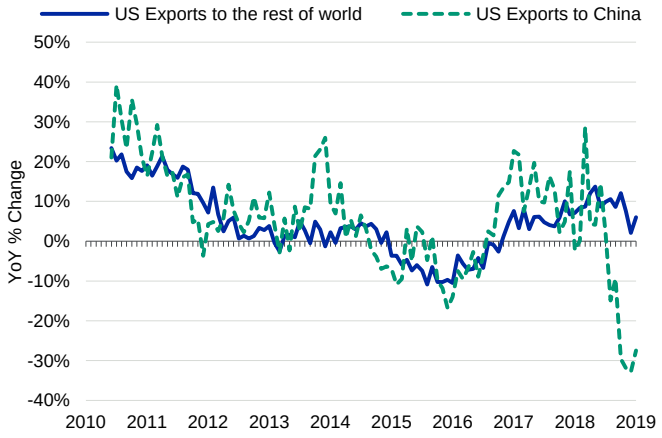
US and China reach a **deal** during G-20

- US President Trump and China President Xi reach mutual understanding on the sidelines of the G-20 meeting in Osaka on June 28–29, followed by a trade deal that ends hostilities
- Trade policy uncertainty remains high
- Threat of new tariffs on US imports from Mexico not applied



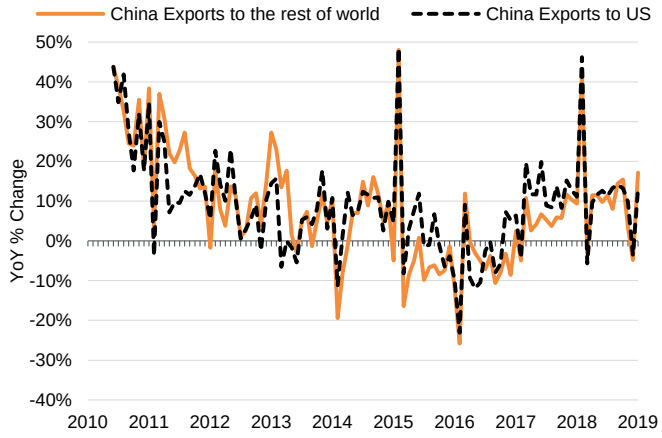
Source: Moody's Investors Service

Exhibit 6
US exports to China and the rest of world
Annual % change



Source: IMF Direction of Trade Statistics

Exhibit 7
China's exports to the US and the rest of world
Annual % change



Source: IMF Direction of Trade Statistics

Economic fallout on China, the US and other economies

In China, the recent tariff increase will have a significantly negative impact on export sector growth in an already slowing economy. In our view, the tariffs will affect the economy through increased uncertainty and weaker business sentiment, which will lead private sector businesses to delay or scale back investment decisions and limit hiring. Further policy easing will mitigate only some of the impact, particularly for the outward-oriented private sector, which is made up of small and micro-sized firms with limited shock absorption capacity.

In the US, the recent tariff increase on $200 billion of Chinese imports will result in significant one-time price increases for a number of products. Input costs will rise significantly for producers who rely on tariffed capital goods. These tariffs will undoubtedly have a detrimental impact on companies in several US sectors. Affected companies, which already face rising employment costs, will likely seek to raise prices in the coming months and quarters.

The dispute will have negative spillover effects for several other countries, particularly for Asian economies that are integrated in the global supply chain. Over time, however, some of these countries may benefit from relocation of production and investment by companies looking to reduce their exposure to US trade policy uncertainty. ASEAN and South Asian countries, as well as Mexico, could benefit from a relocation of supply chains in the long run. Similarly, some countries might benefit in the short run from a shift in import demand. For example, Japan and Europe could see such a shift in demand from China, away from US producers.

A delay in auto tariffs is welcome news, but risk remains high

The US administration on May 18 postponed the deadline for imposing global auto tariffs by 180 days. But the delay does not take away the risk of auto tariffs, potentially targeted at the EU, if broader US-EU trade negotiations run into hurdles.

The EU and the US are highly interconnected, and they are each other's largest trade and investment partners. While the talks will likely be long and contentious, our baseline assumptions do not involve the US administration carrying through with the threat of 25% tariffs on European autos and parts. That said, the risk remains high.

Tariffs: channels of impact

Tariffs are accrued to the government that imposes them and are essentially a transfer from other economic agents. Tariffs act as a tax, the incidence of which can be potentially spread across a wide range of economic agents along the supply chain. For instance, in the case of US tariffs on imports from China, the burden could in theory be borne by Chinese exporters, suppliers and US buyers, including businesses and households. Exchange rate depreciation can cushion the effect of tariffs on exporters, but they increase the costs to importers of other goods. In many instances, Chinese exporters, being one node along a long global supply chain, may also be importers. The extent to which the tariffs are split between different agents depends on the availability of substitutes and demand elasticities, which in turn determine the ability to pass forward the costs of tariffs.

In the short run, tariffs affect economic activity in the country imposing them through a number of channels, both direct and indirect. These protectionist measures negatively affect aggregate economic activity in the country that is the target of tariffs as well as the one that imposes tariffs. These negative effects are only compounded in the case of retaliation. First, tariffs measure increase the costs of imported products for consumers and businesses, reducing their demand and depressing exports of the targeted country and overall trade flows. While higher prices dampen purchasing power, potentially decreasing overall demand (income channel), this could be offset by a shift in demand from imports to domestic substitutes, where such substitutes are available (expenditure switching channel).

Two recent working papers "The return to protectionism" by Pablo D. Fajgelbaum, Pinelopi K. Goldberg , Patrick J. Kennedy, and Amit K. Khandelwal and "The impact of the 2018 trade war on US prices and welfare" by Mary Amiti, Stephen J. Redding and David Weinstein, estimate the pass through of tariffs that the US has imposed so far on domestic prices. They find evidence for near-complete pass through to prices, implying that the burden of US tariffs has been largely borne by US importers and consumers. Thus, the final goods price on a number of products will rise significantly at a time that firms already face cost pressures from wages.

Oil prices will remain volatile as geopolitical risks rise

An escalation of US tensions with Iran also has resulted in a significant increase in downside risks to the global economy. In May, the US administration imposed new sanctions on Iran's industrial metals, the second largest source of export revenue for Iran after oil. This action comes weeks after the US let lapse the waivers from oil sanctions granted to a few major oil importers.

Along with the rise in trade tensions, these developments will likely make oil markets more volatile. We continue to expect crude oil prices to remain on average in the $50-$70 per barrel range. But we expect oil prices to be more volatile than usual, occasionally drifting outside the range for short periods.

US economy on track to record longest expansion on record but escalating trade disputes pose risk

In the US, the Q1 2019 headline real GDP annualized growth rate of 3.1% came in stronger than the comparable 2.2% rate in Q4 2018. But digging beneath the robust headline number reveals lackluster final domestic demand growth of only 1.4%. Real personal consumption expenditures (PCE) rose only 1.3% in Q1, a sharp deceleration from 2.5% in Q4. Likewise, fixed investment spending slowed to a meager 1.0% in Q1 from 3.1% in Q4. An anomalously large contribution of net exports (1 percentage point) and inventories (0.6 percentage point), which will revert in Q2, drove the increase in headline GDP.

We expect consumer spending to pick up in Q2 on the back of strong payroll gains coupled with wage growth, and robust consumer sentiment that is at a 15-year high. But the fall in retail sales, which declined by 0.2% in April (excluding autos, retail sales rose by a paltry 0.1%), and the hint of a moderation in the demand for consumer loans in the May Senior Loan Officer' Survey, suggests that the rebound in household spending will be modest.

Incoming data on factory output and business investment in the US economy also confirms that the economic momentum is moderating. Inventory buildup and trade tensions are weighing on the industrial sector data. Growth in industrial production slowed to 0.9% in April from a year earlier. And even before the latest round of tariffs start to bite, a sharp decline in the May manufacturing PMI reading to 50.6 from 52.6 in April, and its subcomponents, hints at a broad-based slowdown in output and employment. In addition, demand for new orders in May fell for the first time since 2009.

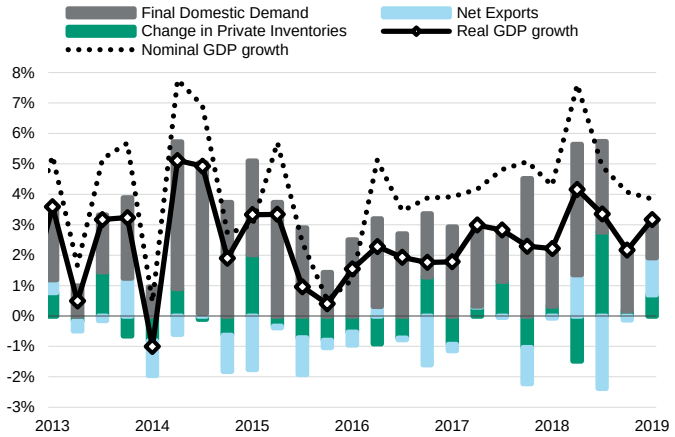
The rate of job creation remains extremely strong, with the addition of 205,000 nonfarm jobs on average every month since the beginning of the year. While the pace will gradually slow, we expect tight labor market conditions to remain conducive for wages to grow modestly faster than inflation.

After raising the federal funds rate every quarter, the Federal Open Market Committee softened its monetary policy stance in January, communicating clearly its desire to be patient with additional changes to the benchmark policy rate. The Fed has essentially been on hold since then, without any compelling development that would call for a change in interest rates in either direction. The Fed's favored inflation gauge, PCE core inflation, came in at 1.6% in March, below the 2% symmetric target. Subdued inflationary pressures argue against additional rate hikes until there is a sustained uptick in inflation. Additionally, minutes of the FOMC's May meeting indicate that some members may be inclined to let the economy temporarily run hot after many years of below-target inflation.

Importantly, the heating up of the US-China trade dispute, and the potential for financial conditions to tighten further with a sharp increase in risk aversion, will likely deter the Fed from additional rate increases. The Fed will likely cut the federal funds rate later this year if financial conditions significantly tighten. However, the bar for decreasing the policy rate remains high. As long as current conditions of moderately slowing growth and inflation around 2% remain, we would not expect the Fed to feel strong pressure in either direction to raise or cut the policy rate.

Exhibit 8

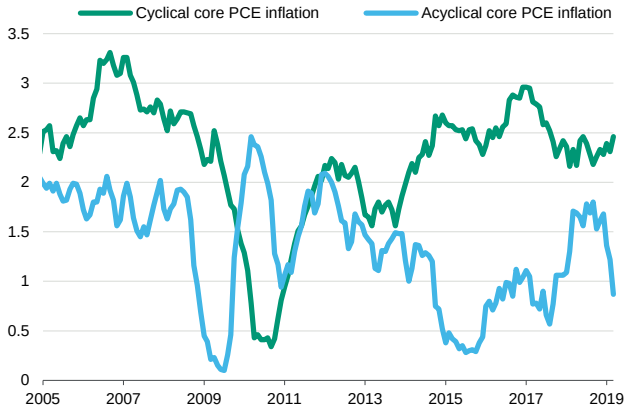
Contribution of aggregate demand components to US GDP growth



Source: Haver Analytics

Exhibit 9

Cyclical components of inflation index remain subdued



Source: Haver Analytics

China's economy is stabilizing but trade exposure skews risks to the downside

With trade tensions likely to remain elevated, we expect China's economy to grow by 6.2% in 2019, followed by 6.0% in 2020, down from 6.6% in 2018. The Chinese government has announced a 6.0%-6.5% growth target for 2019. Without the latest escalation of the trade dispute, we would have forecast slightly higher growth, closer to the upper bound of the target range.

A declining working age population is a key structural driver of slowing potential growth. Additionally, slower growth in investment and therefore capital stock accumulation, as the economy shifts toward services and consumption, is not offset by accelerating productivity growth. The government's deleveraging and de-risking policies in 2017 and 2018 were intended to facilitate rebalancing toward consumption as well as to reduce credit risk in the economy, even though there has been some re-weighting of policy goals back toward support for growth more recently. The eruption of the trade dispute last year served to further exacerbate the slowdown and to spur more stimulus.

The government is already undertaking significant fiscal easing and monetary measures to facilitate a gentle slowdown. It is expected to aid the stabilization of the economy over the next few quarters. Fiscal support has come in the form of tax cuts and fee reductions for households and companies, amounting to around 2 trillion yuan ($300 billion). This is a different form of fiscal stimulus than previously undertaken in China. It is therefore difficult to know for sure how effective it will be in stimulating domestic demand and supporting growth. If the trade war hits confidence, it could encourage higher precautionary savings rather than spurring consumption.

Monetary policy measures have focused on increasing liquidity to the banking system through open market operations, lower required reserve requirements and the targeted medium term lending facility to provide stable funds to commercial banks and encourage lending to small and micro-sized entities.

But data continues to be mixed. The economy grew by 6.4% in Q1 from a year earlier, on the back of 6.4% growth in Q4. But looking below the headline figures shows that domestic demand contributed just 5% to the real GDP growth rate, down from 7.2% in 2018. An increase in the contribution of net exports offset the lower contribution of consumption and investment, as imports fell more than exports. While high frequency data can be quite volatile, the recent softer high frequency indicators, including industrial production, PMI and retail sales, suggest that the elevated economic uncertainty may be continuing to weigh on economic decision making. In particular, softer retail sales suggest that elevated uncertainty may be deterring households from spending.

Maintaining robust growth and stability remain key goals of the Chinese government, even as the trade outlook continues to deteriorate. We expect the government to take additional easing measures to partially offset the adverse impacts of the higher tariffs on employment and output. The measures could be in the form of cuts to the required reserve ratio for banks, additional public infrastructure spending as well as tax cuts to reduce production costs and stimulate household consumption.

Nevertheless, risks to growth are skewed to the downside. If the US were to impose tariffs on all imports from China, we would expect aggregate economic activity to decelerate to below 6%, despite additional stimulus measures.

Euro area growth shifts to a lower gear

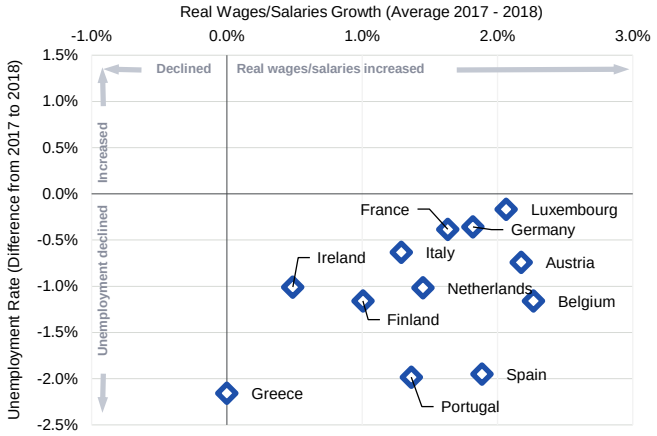
We expect the euro area economy to grow by 1.3% in 2019 followed by 1.4% growth in 2020, considerably weaker than the 1.8% growth in 2018. In Q1, the euro area's real GDP grew by 0.4% on a sequential basis, an acceleration from 0.2% in Q4 2018. Italy emerged from a technical recession and grew by 0.2% during Q1. In both France and Germany, household consumption demand primarily propelled growth by 0.3% and 0.4%, respectively.

Better-than-expected Q1 hard data indicate tentative stabilization of the economy, helping alleviate some of the concern about the economic slowdown. Overall, domestic demand in core euro area economies has remained resilient, supported by the steady improvements in the labor market. Household incomes continue to increase as a result of rising employment and wage growth. Business investment remains steady on the back of low interest rates and an ample supply of credit. Plus, many of the one-off factors that adversely affect growth in individual economies are fading. These include the *gilets jaunes* or "yellow vest" protests in France, and the woes of German auto manufacturers. The German car industry is slowly clearing the backlog from compliance issues with new EU emission tests. But adverse external factors related to a slowing of the global economy, trade concerns and Brexit worries continue to dampen business sentiment and weigh on growth prospects. The manufacturing sector in particular, which has been at the heart of the slowdown in Germany, faces persistent challenges amid escalating trade tensions.

Exhibit 10

Real wages growth (x-axis) and unemployment rate (y-axis)

Annual % change, % of total labor force

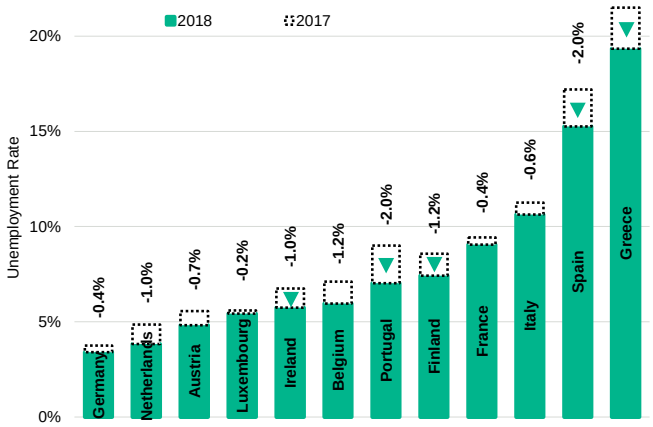


Source: Statistical Office of the European Communities

Exhibit 11

Unemployment rates in the euro area

% of total labor force

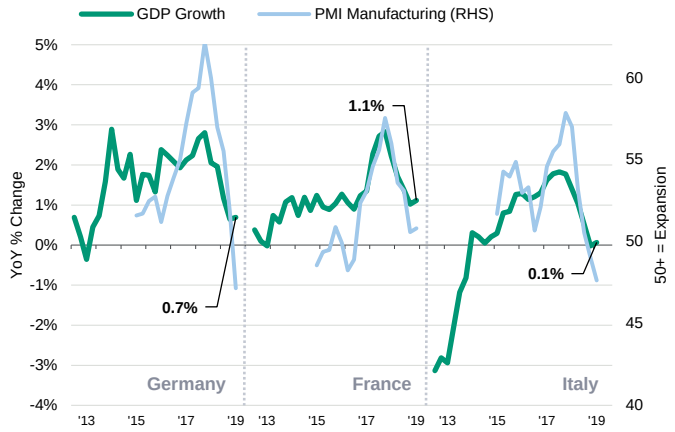


Source: Statistical Office of the European Communities

In the euro area, survey indicators remain relatively more downbeat than hard data. Business confidence has steadily weakened since mid-2018. The May reading of the euro area manufacturing PMI eased below 50 to 47.7. The May IFO business confidence index for Germany fell to its lowest level since late 2014, at 97.9. The solid growth performance in Q1, despite a deterioration in many of the leading sentiment and PMI indicators, suggests that the survey indicators may be accurately portraying a modest deterioration in sentiment but overstating the actual level weakness in the economy.

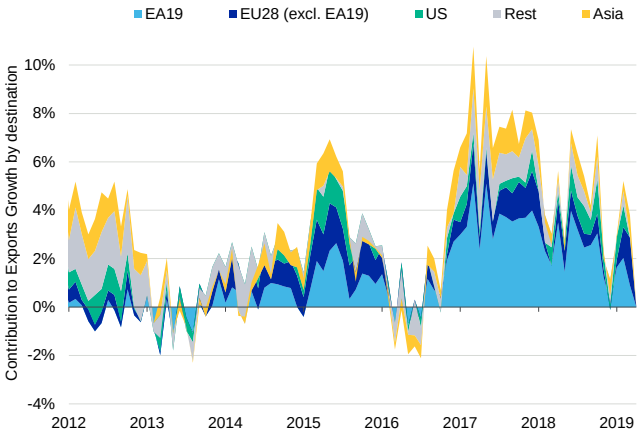
Still, persistently downbeat sentiment indicators suggest that the economy remains fragile. We expect the external backdrop to remain challenging for the highly open manufacturing sector, particularly in Germany, a major source of drag. However, domestic demand remains resilient, supported by an accommodative monetary policy, fiscal loosening, rising employment and wage growth.

Exhibit 12
Real GDP and PMI manufacturing
Annual % change, PMI Index



Source: Haver Analytics

Exhibit 13
EA 19 exports growth by destination
Annual % growth



Source: Statistical Office of the European Communities

On the policy front, fiscal policy has turned supportive in Germany, France and Italy. The German government raised its planned spending outlays for 2019. The German cabinet has also approved a draft bill to provide annual tax incentives worth 1.25 billion euros ($1.39 billion) for companies undertaking R&D investments. In France, recent measures to bolster household incomes, including an increase in minimum wages and pension payouts announced in December and income tax cuts announced in April, will support consumer demand. Italy's coalition government is keen to pursue expansionary policies including tax cuts and increased social welfare expenditure in the 2019 budget. However, the EU has warned Italy it is in breach of EU budget rules owing to concerns over the country's debt trajectory.

Monetary policy will also remain considerably accommodative given subdued growth and inflation in the euro area. In March, the European Central Bank (ECB) signaled that the first hike is unlikely this year and announced a third round of targeted longer-term refinancing operations. We expect the central bank to maintain its accommodative stance by keeping the main refinancing and deposit policy rates unchanged at 0% and -0.4%, respectively, through mid-2020. As for the central bank's balance sheet, we believe that the ECB will continue to maintain the size at the current level by reinvesting funds from maturing securities.

Political developments heighten no-deal Brexit risk

We expect sluggish growth in the UK this year and in 2020 as a result of persistent Brexit-related policy uncertainty and slowing external demand. We forecast 1.2% economic growth in 2019 and 1.4% in 2020, following 1.4% growth in 2018.

The UK economy expanded by a solid quarterly growth rate of 0.5% in Q1 (1.9% over the same quarter last year). Strong domestic demand from both consumers and businesses drove growth, partly as a result of stockpiling ahead of the UK's possible departure from the EU on March 29 without an exit deal, and then again on April 12. This Q1 inventory buildup will take away from growth in Q2. But a pickup in real wages is also supporting consumption spending and should continue to do so.

In April, the EU agreed to push the deadline for the UK to leave the European Union to October 31 after Parliament rejected UK Prime Minister Theresa May's exit deal. May subsequently announced she will step down as leader of the Conservative Party and as prime minister. But it is unclear if a new leader will be able to forge a consensus in Parliament on Brexit, with the recent European election results for the UK underscoring the way in which Brexit has polarized and frustrated the British electorate. The risk of a no-deal Brexit has increased, and we continue to believe such an outcome would lead to the UK economy falling into recession, followed by a continuation of weak growth. That said, support for remaining in the EU is also strong in the British parliament, which keeps the possibility of a new referendum alive.

Japan muddles along

Japan's economy is experiencing one of its longest stretches of growth since World War II, but the pace of expansion remains meager. We expect the economy to grow by 0.8% this year, the same rate as in 2018, followed by 0.4% in 2020.

Domestic demand drivers lost momentum in Q1 2019, after rebounding in Q4 2018 from the adverse, transitory shock on manufacturing and consumption from natural disasters. Although real GDP grew robustly by 0.5% quarter-on-quarter (0.8% year-on-year) in Q1, exceeding market expectations, a fall in imports boosted the headline figure. Q1 real GDP data showed a pullback in private consumption and business investment, which declined by 0.1% and 0.3%, respectively, from Q4. Along with continuously weakening consumer sentiment, this data indicates that domestic drivers of demand are fragile. Industrial production and PMI data also continue to point to weakness in the manufacturing sector, where external demand is tepid. In March, industrial production, excluding construction, fell by 2.7%, following a 1.4% decline in February. Similarly, the manufacturing PMI for May slipped below 50, reflecting rising pessimism among businesses.

We expect slowing growth of Japan's main export partners to continue to be a drag on export and industrial output, and to weigh on the industrial sector outlook. However, our forecasts assume a pickup in consumption spending in the coming quarters, supported by low unemployment in a tight labor market. We also assume that Prime Minister Shinzo Abe's government will increase the consumption tax in October, which would bring consumption forward, although the possibility of a further delay has emerged recently. Business investment and public spending will continue to receive support in the coming quarters from corporate profits and an expansionary fiscal-monetary policy mix, which remain key to the continuing expansion of the economy. But the consumption tax will be a net drag on growth over 2019-20, even if the proceeds have been earmarked for social spending.

Softer growth across emerging market countries in Q1 is a reminder of continuing growth challenges

Emerging market countries, excluding China, are at a growth trough, but we do not see prospects of a strong rebound. Slowing growth across major advanced economies and China, as well as rising protectionist trends, is denting export prospects and economic growth in a number of other economies. Capital flows have slowed despite benign global financial conditions. As a result, Q1 economic data across emerging market economies looks soft. With export growth likely to remain under pressure, emerging market countries will become increasingly reliant on domestic demand to facilitate continued economic growth. The outlook is therefore far from uniform, with idiosyncratic factors dominating the narrative for individual countries.

Emerging market economies in Asia will see negative spillovers from the weaker external backdrop. While the region is the most vulnerable to a deterioration in the US-China economic relationship, it will remain the fastest growing as a result of its relatively strong domestic fundamentals. In Latin America, on the other hand, the recovery continues to stall despite relatively benign global financial conditions.

Argentina: Risks are heavily skewed to the downside

Argentina's economy shrank by 2.5% in 2018 after expanding by 2.7% in 2017, as multiple shocks led to a broad-based collapse in economic activity. A combination of the country's prolonged currency crisis and significant fiscal and monetary tightening under the country's Stand-By Arrangement with the IMF led to a collapse in domestic demand, which fell by 11.7% in Q4 2018 from the same period a year earlier. We forecast that the economy will shrink further in 2019, by around 1.5%, followed by weak but positive growth of 1.5% in 2020. But there is enormous uncertainty around these forecasts and risks are heavily skewed to the downside.

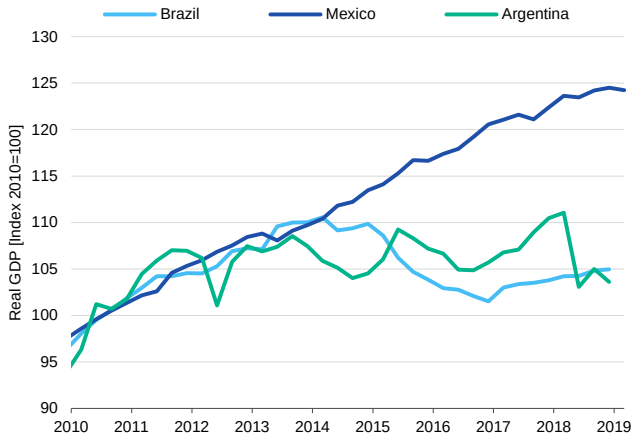
After a historic drought last year, a healthy soy harvest will support a recovery in the agricultural sector, which contributes about 10% of GDP. Thus, the agriculture sector will likely prove to be an important driver of growth. However, high and sticky inflation, very tight financial conditions and austerity measures under the government's program with the IMF will keep activity subdued overall. The

recovery of private consumption will depend on support for real incomes from falling inflation. But, so far, inflation has continued to climb, to 55.8% in April 2019, from about 25% a year earlier.

While the pause in the US interest rate cycle will provide much needed relief, we expect Argentina's central bank to continue to follow a very tight monetary policy in an attempt to restore policy credibility. Thus, we do not expect an easing of the policy stance anytime soon.

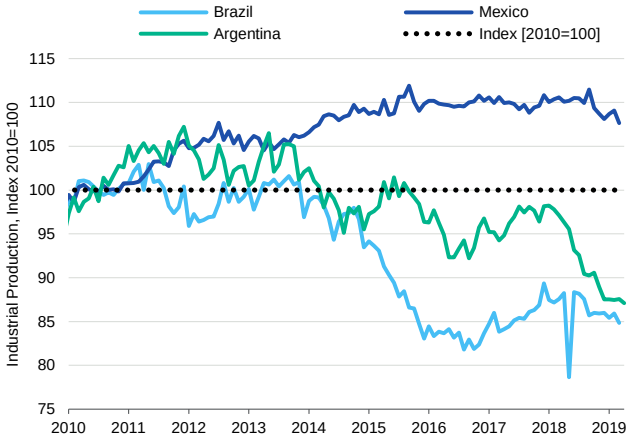
President Mauricio Macri's job approval ratings have declined in tandem with the weakening of the economy. High and lingering inflation will likely continue to weigh on his approval ratings and re-election prospects as purchasing power erodes and tight monetary policy punishes economic activity. Amid the backdrop of the October 2019 presidential elections, the prolonged recession and the need for continued fiscal austerity and monetary restraint will pose risks to policy continuity and, consequently, to Argentina's ability to comply with the targets set in the IMF program. If public sentiment leans toward candidates who advocate policy proposals inconsistent with the IMF's fiscal targets, IMF funding could be compromised, leading to pressure on the exchange rate and increased liquidity risks. Such a scenario could set in motion a downward spiral for the economy.

Exhibit 14
Real GDP



Source: Haver Analytics

Exhibit 15
Industrial production



Source: Haver Analytics

Brazil's economy struggles to gain traction

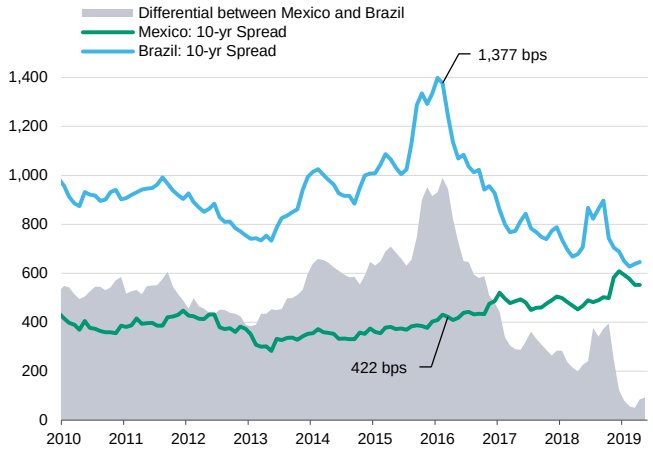
Brazil's economy contracted in Q1 by 0.2% on a sequential quarter-on-quarter basis, and grew 0.5% year-on-year. We expect Brazil's real GDP growth to remain tepid. We forecast very slight acceleration over the next two years from 1.1% growth in 2018 to 1.3% in 2019 and 2.0% in 2020. The economy clearly lacks internal dynamism. After two years of positive growth, aggregate economic activity remains around 4.5% below its 2014 pre-recession level.

Although the recovery has been subdued, it reflects modest but positive contributions from consumption and investment supported by accommodative monetary policy. However, most recent indicators show that the economy lacked momentum in Q1. The unemployment rate remains in the double-digit percentages, climbing to 12.7% in March 2019 from 11.6% in December 2018. The economy is simply not growing fast enough to create adequate jobs. The deterioration in economic conditions is also evident in the erosion of optimism among consumers and businesses since the start of the year.

Adoption of major economic reforms, particularly pension reforms, is widely believed to be key to further boost investment and overall economic activity. In our baseline, we assume that in the fall Brazil will pass a watered-down version of a pension reform bill put forward by President Jair Bolsonaro's government.

Exhibit 16

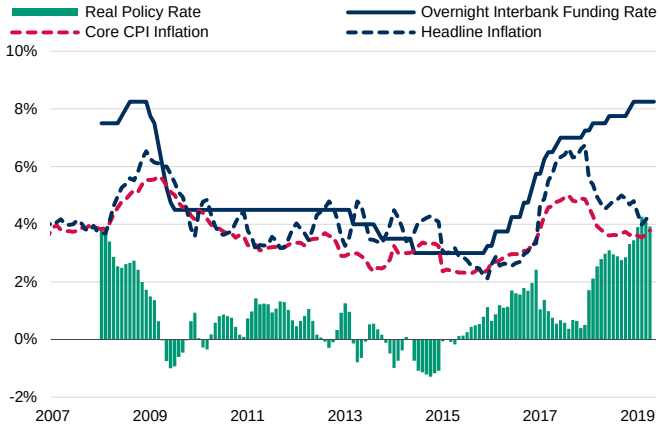
Brazil's interest rate spread in relation to the US has narrowed



Source: Haver Analytics

Exhibit 17

Real policy rate in Mexico at pre-2008 high



Source: Haver Analytics

Mexico's economy is stalling

The Mexican economy contracted by 0.2% in Q1 on a sequential basis and recorded annual growth of just 0.14%. We forecast real GDP to grow at a lackluster pace of 1.2% this year and 1.5% next year, down from 2.0% in 2018. Our forecasts assume positive growth in the remaining quarters of this year.

President Trump's threat to impose new tariffs on all imports from Mexico presents a major downside risk to our forecasts for the Mexican economy. This unexpected escalation is also a reminder that US trade policy will remain uncertain under the current administration even after reaching trade agreements.

On trade, our baseline forecasts assume ratification of the US-Mexico-Canada Agreement (USMCA) sometime next year, which would partially reduce trade uncertainty and support a revival of investment. The lifting of US tariffs on steel and aluminum from Canada and Mexico was a positive step toward the finalization of the USMCA, although it still faces challenges in the US Congress. But downside risks to our forecasts are high.

A combination of uncertainty over the ratification of the USMCA, delays in public spending, policy unpredictability and high interest rates has taken a toll on business fixed investment, weakened the pace of job creation, and is weighing on consumption spending. Industrial production decreased for six straight months as of March, in large part resulting from the persistent decline in oil extraction. Mexico's monthly economic activity indicator shows a sharp decline in March, mainly from contraction in the construction and manufacturing sectors, in addition to the continued shrinking of the mining sector. The weakness in the auto sector, as a result of a leveling of auto sales in the US, is heavily weighing on industrial activity. Even the tertiary sector, which has offset the weakness in the industrial sectors so far, virtually stalled in March. Together, these trends indicate that economic activity in Mexico remains lackluster at best. Looking ahead, the close link between the manufacturing sectors in the US and Mexico suggests downward pressure on the Mexican manufacturing sector will continue, as the US industrial cycle continues to cool. The expected deceleration of the US economy will weaken potential support from foreign direct investment and exports to Mexico's economy.

Monetary policy in Mexico remains tight. Since December 2015, when the Fed raised its benchmark federal funds rate for the first time in the cycle, the Mexican central bank has increased the overnight interbank funding rate by 500 basis points. To be clear, the tightening of monetary policy was aimed at stemming depreciation of the peso and to rein in inflation. But the central bank continued to increase interest rates in 2018 despite a climb down in core and headline inflation. As a result, real policy rates in Mexico are as high as before the global financial crisis. Mexico's central bank continues to see an upward bias in the inflation rate and is inclined to keep its reference policy rate on hold. We expect a steady decline in the inflation rate as the economy cools to allow the central bank to lower the policy rate in the second half of this year.

Turkey's economy continues to shrink

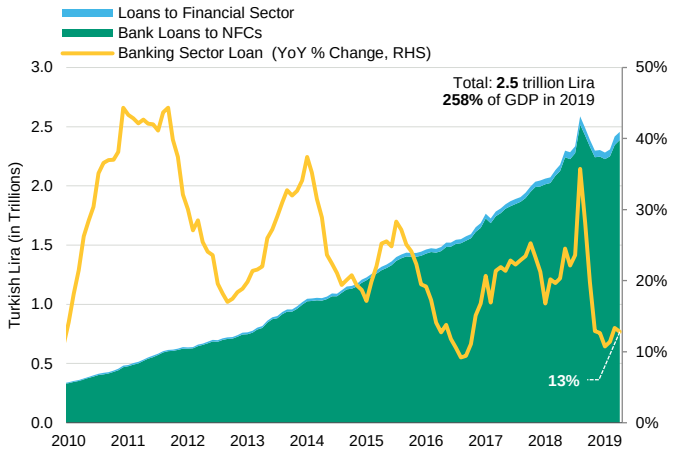
Like Argentina, Turkey is also undergoing a painful adjustment to last year's currency crisis. The economy is in recession, with real GDP contracting in the last two quarters of 2018 by 1.6% and 2.4%, respectively. Collapsing investment and private consumption drove the deterioration in economic activity. The resulting 2.6% real GDP growth for 2018 was notably lower than the overheated 7.4% pace of growth in 2017. We continue to expect the sharp deterioration in domestic demand and financing conditions to materially affect Turkey's growth prospects, although the Q1 growth numbers suggest that we may well see considerable volatility in the higher-frequency data.

We expect the economy to shrink further this year by 2%, followed by a slow recovery in 2020. Our baseline forecast assumes 2% real GDP growth in 2020; however, there is considerable downside risk given the volatility of the lira, uncertainty around the government's policy response to structural macroeconomic challenges, and geopolitical risks surrounding the S-400 missile purchase from Russia.

The economy has yet to show signs of stabilization. Consumer confidence has sharply deteriorated to the level last seen in November 2008. The unemployment rate has continued to climb, to 13.6% in February compared with 9.8% a year earlier. The high inflation rate, at 19.5% as of April, weighs on household purchasing power, although it has declined from a peak of 25% in October 2018. Together, these factors will continue to hold down consumer spending. Likewise, business investment continues to be held back as a result of the uncertain economic environment, high interest costs, the weak global trade backdrop and still-high leverage on the balance sheets of Turkish companies.

Exhibit 18

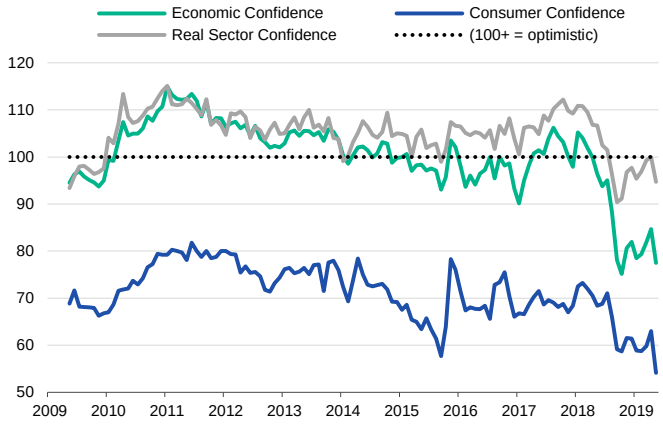
In Turkey, growth of bank credit has sharply fallen



Source: Haver Analytics

Exhibit 19

Sentiment indicators in Turkey remain weak



Source: Haver Analytics

The Monetary Policy Committee has kept interest rates at 24% since September 2018. However, various temporary tax cuts on consumer durables are responsible for the drop in the inflation rate. Inflation is also lower as a result of government pressure on companies to discount their prices or to refrain from undertaking new price increases. We expect the central bank to continue to hold rates steady over the next few months, even as inflation continues to edge lower. In our view, any decision to lower interest rates before inflation expectations are solidly anchored will risk depleting already-low levels of net foreign exchange reserves, undermining the value of the lira and exacerbating inflationary pressures in the economy.

South Africa: Elections offer hope for renewed reforms

South Africa's economy shrank by 0.8% in Q1 over the last quarter of 2018. Economic activity in almost every sector – agriculture, mining, industry, transportation and retail sales – declined. Fixed investment, which has declined every quarter since the beginning of 2018, fell by an additional 1.14% over Q4 2018. As a result, gross fixed investment is now 5% lower than at the end of 2017. The economy grew by 0.8% in 2018 after a technical recession in the first half of the year. Weak survey data suggests that the odds that the economy may experience another technical recession in 2019 are high. We attribute the persistent economic weakness to

lackluster domestic private sector demand — both household spending and investment, and the detrimental impact of widespread power outages on the manufacturing and mining sectors.

With the ANC winning the election with a clear majority under the leadership of President Cyril Ramaphosa, there are hopes of a renewed push for structural reforms aimed at igniting growth and reducing unemployment, which stands at 27%. Immediate policy priorities outlined by President Ramaphosa include restructuring the highly indebted state-owned monopoly electricity utility operator Eskom and shrinking the size of the bureaucracy. The president has also discussed longer-term plans to diversify the economy away from mining. However, South Africa faces complex economic problems. The task of reviving the economy will be challenging and reforms will take time to show effects. We expect a gradual pickup in real GDP growth in 2019, but we expect continued lackluster momentum. We project 1.0% growth in 2019 and 1.5% in 2020.

In May, the SARB Monetary Policy Committee kept its repo rate unchanged at 6.75% by three votes to two. At 4.4% in April, inflation remains well contained. We expect the central bank to cut the policy rate in the upcoming meetings, in support of the economy.

India's economy is slowing

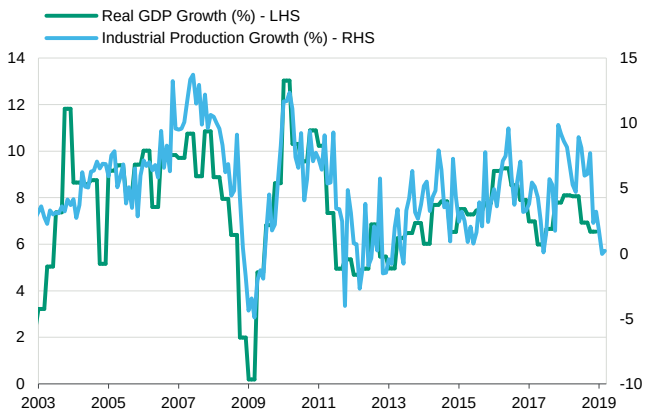
India's economic growth slowed perceptibly in the second half of 2018. The weak momentum appears to have carried into Q1, with real GDP growth slowing to 5.8% from the same quarter last year, well below its trend growth rate. Industrial activity remains muted since November. Industrial production contracted by 0.1% in March from a year earlier. Manufacturing, capital goods and consumer durables all showed a contraction.

We forecast slower real GDP growth of 6.8% in 2019, from 7.4% in 2018, but expect a pickup of 7.3% in 2020. Our forecasts assume that economic activity will accelerate later in the year. Tax benefits and support to farmers announced in the budget should boost consumption in the second half. The Reserve Bank of India's monetary policy stance will likely be supportive. While headline retail inflation has picked up slightly in the last few months, it remains low, below 3%, in part reflecting aggregate demand weakness. We expect the combination of benign inflation and softening growth to allow the central bank to maintain an accommodative bias.

While our baseline forecasts assume that economic momentum will pick up, there are downside risks. Slow employment growth is weighing on consumption. Inadequate transmission of the interest rate cutting cycle will hamper investment, with elevated borrowing costs for companies. Stabilizing the economy, including in the rural sector, and generating employment are likely to become policy priorities for the government, after having won the general election with a clear majority.

Exhibit 20

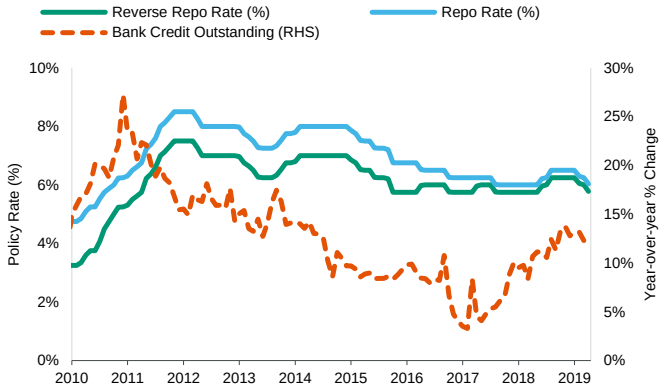
India's industrial activity has weakened



Source: Haver Analytics

Exhibit 21

Monetary policy in India will likely maintain a supportive bias with more rate cuts



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