

# WORLD ECONOMY RESISTS POLITICAL DOWNFORCE

MARKET INSIGHT, SEPTEMBER 2018

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# STRONG OUTLOOK DESPITE HIGHER RISK

The global economy continues to forge ahead. A recovery in investment from its slump in the wake of the 2008 financial crisis will keep driving growth this year and in 2019. Labour markets are strong in many parts of the world, while wage growth remains modest and inflation has yet to gain momentum. As a result, central banks are taking a cautious approach to – or abstaining from – raising interest rates, in spite of high resource utilisation and strong output. Moderate inflation and low interest rates are keeping household spending up and private consumption remains a key economic engine. The fact that the global economy will peak this year can be seen from recent data showing a downturn in indicators such as Business Sweden's Export Managers' Index and consumer confidence – though it should be stressed that they remain at high levels.

Most economies are expanding, but the picture differs between North America, where growth will rise again this year, and Europe and Asia, where growth is cooling. The US economy has benefited strongly from tax cuts, while many emerging economies are enjoying a rebound in commodity prices.

Global economic risks have risen recently, however. At the time of writing, the biggest risks are: *a global trade war; a rapid slowdown in China; faster-than-expected interest rate rises in the US; loss of confidence in emerging economies with large current account deficits (such as Turkey and Argentina); a public debt crisis in Italy; and a no-deal Brexit.* The first two of these would have a major adverse impact on the global economy, while a no-deal Brexit would have more limited regional repercussions. The most probable risks relate to a global trade war, a crisis of confidence in emerging markets and faster-than-expected interest rate rises. However, the probability of any of these three occurring remains moderate or low at the current time.

The Swedish economy is performing strongly. The fiscal environment is stable and public debt is low, while the global upswing and weak krona are helping exports. Nevertheless, Sweden's heavy dependence on foreign trade makes it vulnerable to any significant increase in the economic risks outlined above. These risks are already putting a brake on consumption and global investment. Indeed, demand from several of Sweden's key export partners has been revised down this year. Swedish exports are expected to grow by 3.8 percent this year. In 2019, export growth is expected to quicken somewhat to 4 percent, which is in line with the annual average of the last 15 years.

At present, global economic risks are not clouding the outlook – in spite of slightly lower headline growth. But we know from experience that things can change quickly. The outbreak of the global financial crisis in December 2008, for example, was almost impossible to predict. Crises are always different and it is vital to listen to market signals and be prepared to act if conditions deteriorate. The absence of a clear strategy can result in costly panic measures.

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# GROWTH REMAINS STRONG

This year will see the global economy reach its peak for the current cycle. The recovery in investment from its slump in the wake of the 2008 financial crisis will continue to propel growth this year. The global economic outlook remains good, in spite of growing protectionism and other risks. Business and consumer confidence indicators have weakened since the start of the year but continue to show high levels of optimism. Unemployment is low in many countries and is expected to fall further. The normalisation of monetary policy by central banks is reducing the pace of the global economic boom. Global GDP growth is expected to end this year unchanged at 3.7 percent before falling to 3.5 percent in 2019.

The European economy peaked last year and major countries like Germany, France, Italy, Spain and the UK will all see slower growth in 2018. In the eurozone, domestic demand – especially private consumption but also investment – is the prime economic engine. Export growth has slipped from its lofty levels of last year amid rising concern over a global trade war and weaker international demand.

Lower growth in China and Japan has slowed the pace of expansion in Asia. The Chinese government has imposed a credit squeeze to protect financial stability and is also focusing increasingly on long-term sustainable growth that is more closely rooted in domestic consumption.

In the US, an expansionary fiscal policy and strong labour market will combine to deliver strong growth this year and next. This is good for the entire region because the US is by far the largest economy in North America.

## DOMESTIC DEMAND A KEY DRIVER AS PROTECTIONISM GROWS

In Europe, investment will remain an important growth driver despite the growing spectre of protectionism and its adverse impact

on investors' appetite, particularly in the UK. Private consumption will continue to provide the primary impetus for growth, both this year and next. Business and consumer confidence indicators have dropped since the start of the year but remain at high levels commensurate with full-year growth being slightly lower than in 2017. Meanwhile, export growth has slowed due to the growing protectionist tide. The primary risks to the European economy are the possibility of the UK leaving the European Union next March without a deal and a financial crisis in Italy due to weak public finances.

A general shift is ongoing in Asia towards an economic model more closely tied to domestic demand and private consumption. The transition to a more consumption-driven economy reflects the increasing ability of households to enjoy the benefits of higher wages. Solid growth and strong demand for labour will ensure that consumption continues to rise in Asia going for-

GDP GROWTH, %

Region	2017	2018F	2019F	Share of global GDP, 2017, %
Global *	3.7	3.7	3.5	100.0
Sweden	2.5	2.9	2.2	0.7
Asia & Oceania	4.9	4.5	4.0	35.4
Europe	2.4	2.1	1.8	27.7
North America	2.3	2.7	2.5	25.8
South America	1.1	1.0	1.9	5.5
Africa	3.5	3.1	3.7	3.0
Middle East	0.3	2.4	3.1	2.6

Note: All figures in fixed prices  
 \* GDP growth adjusted for purchasing power  
 Sources: Oxford Economics, Business Sweden (2018)

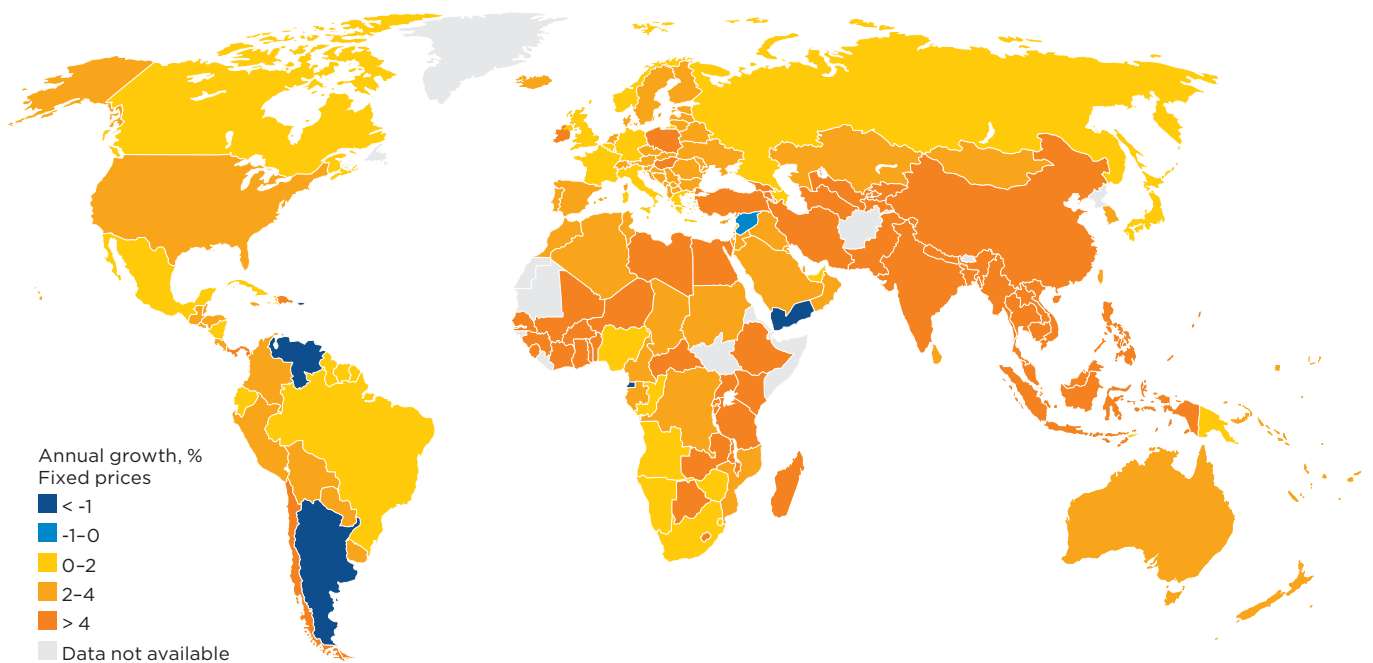
ward. However, any escalation of the current trade war between the US and China would pose a threat to this picture.

The current outlook is uncertain, with no clear end to the trade imbroglio in sight. Any slowdown of growth in China due to international trade disputes could potentially spread to neighbouring countries that depend on trade with China. Some 56 percent of Chinese imports come from other Asian nations (not including Australia and New Zealand). Another risk would arise if China's economy were to cool faster than expected. Chinese GDP is expected to rise by 6.5 percent this year, in line with the government's official target, before easing to 6.1 percent in 2019 as tougher lending policies and a tighter focus on long-term sustainable growth make themselves felt. A steeper drop in GDP growth, for example due to lower investment or price falls in Chinese commercial or residential real estate, could put a major dent in the global economy.

The US business cycle is well advanced and unemployment is low. Growth, which will peak this year, is being spurred by strong growth in private consumption and investment following major tax cuts.

Meanwhile, confidence levels have dropped in a number of emerging markets due to the strength of the USD, increased global trade tensions, higher oil prices and the economic travails of Turkey and Argentina. Although rising oil prices benefit oil-producing states like Russia, they disadvantage large oil importers such as India. The crises in Turkey and Argentina have had a knock-on effect as investors have reacted by scaling back their overall exposure to emerging markets. Alongside these external factors, emerging markets also face country-specific challenges that threaten GDP growth. These include high current account deficits and inflation in Turkey and Argentina, the risk of US sanctions in Russia and high levels of debt in China.

## FORECAST GDP GROWTH 2018



Sources: Oxford Economics, Business Sweden (2018)

## LESS EXPANSIONARY MONETARY POLICY

Higher resource utilisation in developed economies and the gradual rise of inflationary pressure have reduced the need for an expansionary monetary policy. In the US, which is leading the global economic cycle, high growth and full employment are expected to push inflation higher this year to just above the Federal Reserve's target of 2 percent.

The Fed has raised interest rates twice already this year and is expected to do so twice again during the autumn, meaning that the US will have seen four interest rate hikes during 2018. This pattern is projected to continue in 2019 and to take interest rates close to a neutral level, meaning a point at which they neither stimulate the economy nor cool it down.

Europe is behind the US in the business cycle and although economic growth is healthy, inflation still lags the European Central Bank's (ECB) 2 percent target level. The ECB is nevertheless beginning to normalise monetary policy, having curtailed its bond-buying programme at the start of 2015. Interest rates are not expected to be raised for about a year. After that, rates are likely to be increased gradually.

In the UK, the Bank of England has continued to tighten monetary policy, despite a weak start to the year and the prospect of further economic weakness going forward. Uncertainty over the future direction of monetary policy has risen due to Brexit.

In Japan, low inflation and increased global downside risk have prompted the Bank of Japan to maintain an expansionary monetary policy, with interest rates of close to zero and financial asset purchases that have added to the bank's balance sheet.

## GLOBAL ECONOMIC RISKS HAVE INCREASED

The global economy is performing well and the currently favourable paradigm looks set to continue. Risks have increased but as yet not sufficiently to affect the overall outlook. Any sudden deterioration in the risk climate could, however, dampen global growth considerably. The primary global risks are a global trade war, a sharp economic slowdown in China, market turbulence due to faster-than-expected interest

## FORECAST SWEDISH EXPORT GROWTH, %

Region	2018F	2019F	Share of exports 2017, %
Europe	3.4	4.1	72.2
Asia & Oceania	5.6	3.6	13.1
North America	4.3	3.2	8.2
South America	4.7	2.8	1.6
Africa	5.9	4.4	2.1
Middle East	2.5	4.7	1.9
Global	3.8	4.0	100.0

Note: All figures in fixed prices  
Sources: Oxford Economics, Business Sweden (2018)

rate increases in the US, instability in emerging economies with large current account deficits, a public debt crisis in Italy, and a no-deal departure from the EU by the UK in March 2019. These risks and their potential impact are described in more detail in the "Risks Facing the Global Economy" section.

## ROBUST GLOBAL GROWTH BENEFITS SWEDEN

Sweden has enjoyed four years of high economic growth, with GDP rising by almost 3 percent per annum. This is well above the 2 percent potential growth rate (the percentage annual increase in GDP if all resources are used efficiently). The outlook is favourable for the Swedish economy going forward, though a cooling next year will see growth ease to around 2 percent. Potential threats to Swedish exports include the risk of a global trade war, an Italian debt crisis and Brexit.

The global economy remains healthy and continues to be a key factor in Sweden's positive trajectory. High levels of investment, particularly in Europe, bode well for Swedish exporters, though export revenues were below expectations in the first half of the year.

Industrial investment is expected to rise (except for residential property) due to high capacity utilisation. Residential property spending is slowing and will dampen growth going forward as the market cools. Swedish GDP is projected to grow by 2.9 percent this year and 2.2 percent in 2019.



Employment has risen sharply in recent years and unemployment has fallen to 6 percent. A widespread skills shortage has yet to translate into significant wage inflation, though salaries are expected to rise gradually going forward. These increases, and the weak krona, are likely to see inflation hover at around 2 percent this year and next. Recent rises in energy and food prices will see the headline inflation rate breach the Riksbank's 2 percent target during the autumn, but the underlying rate remains low. It is likely that the Riksbank will start tightening monetary policy, with an initial interest rate increase expected in early 2019.

The biggest risks to the Swedish economy are a wider global trade war, which would hit the world economy and thereby adversely impact Sweden too, and further falls in residential property prices, which would cause difficulties for heavily mortgaged households.

The outcome of the general election in September remains unclear at the time of writing. Neither of the two parliamentary blocs won a majority and the identity of the next government has yet to be established. However, the effects of this political uncertainty are likely to be limited in the short term given the strength of the economy and a benign environment of high growth, low public debt and a current account surplus. Nevertheless, Swedish competitiveness and growth could suffer in the longer term if it proves difficult to form a government, or if a government composed of multiple small parties struggles to agree much-needed reforms in areas such as infrastructure and the housing and labour markets.

## **CONTINUED SOLID EXPORT GROWTH**

Global trade rose by 4.5 percent last year but has eased somewhat since the start of the year, and the resurgence that many key Swedish export markets have witnessed in recent years is slowing. Nevertheless, the outlook for Swedish exports remains sound. The underlying strength of the export sector can be seen in Business Sweden's Export Managers' Index (EMI), which despite an unexpected fall in sentiment among exporters during the third quarter remains at a high level and continues to indicate favourable conditions for Swedish exports. The EMI for

the third quarter reported a drop in projected export demand in all regions except Central and Eastern Europe, where export volumes were expected to rise. The most pronounced decreases – observed in North and South America and the Middle East, Turkey and Africa – reflected the widening trade conflict between the US and China, the economic crisis in Turkey and tougher US sanctions on Iran.

Nevertheless, global demand remains strong and exporters continue to benefit from a weak krona which, according to the trade-weighted KIX index, has lost 4 percent of its value in 2018. High levels of investment in Europe are also lifting Swedish exports, which consist largely of capital and intermediate goods, and there is the added prospect next year of a jump in investment in Norway and the UK. Total exports are expected to rise by 3.8 percent this year and by 4 percent in 2019, which is in line with the annual average for 2000–2015.

*RISKS FACING THE GLOBAL ECONOMY*

# POSITIVE ECONOMIC CLIMATE BUT HIGHER RISK

Downside risks to the global economy have increased recently. Were any of these risks to materialise, they would significantly impact global growth and the Swedish economy. However, this report sees no significant impact of these risks on global economic forecasts at the current time. Nevertheless, it is essential to understand the risks and to be prepared in case the status quo changes. We know from experience that events can unravel quickly, as during the financial crisis of 2008–2009.

## TRADE WARS

The biggest downside risk at the present time is that increasing international tensions over trade will trigger a global trade war. The tariffs imposed by the US and China this year on each others' imports are projected to have only a limited impact on the global economy. So far this year the US has unveiled two waves of tariffs on Chinese imports worth a total of USD 250 billion. The tariffs vary initially from 10–25 percent but will rise to 25 percent on all affected goods from 1 January 2019. China has responded by imposing tariffs of 5–25 percent on USD 110 billion worth of US imports. The US has also threatened to bring forward an additional USD 270 billion of tariffs, which would effectively impose duties on all imports from China.

The duties announced so far this year do not undermine the global economic outlook as they represent only a small portion of total US exports and their effect will therefore be marginal. However, they risk pushing up inflation and could force the Federal Reserve to raise interest rates more than currently expected. This would dampen private consumption and investment. It is probable that the Chinese duties imposed on US imports will have only a lim-

ited impact on the US economy. Similarly, the US tariffs on Chinese imports are unlikely to put much of a dent in China's growth. Any negative impact is likely to be offset by looser credit rules or a more expansionary fiscal and monetary policy.

All the same, there is now a higher risk that further tariffs and counter-tariffs could trigger a global trade war. The heavily integrated global trading system means that any such conflict would have the potential to deal a severe blow to global growth and the Swedish economy. Trade wars waged through the imposition of import tariffs have both a direct and an indirect impact. The direct effect of such a scenario is to reduce overall trade volume, disrupt global supply chains and make imports more expensive, which in turn drives up inflation. The indirect effect relates to higher uncertainty and its negative impact on private consumption and investment. Actual effects vary depending on the assumptions made regarding tariffs, what countries are involved and similar parameters. But the overall impact of an international trade war on global growth would be strongly negative in terms of both direct and indirect effects.

## HARD LANDING IN CHINA

China's growth is gradually slowing as the economy rebalances and the government adopts a longer-term focus on sustainable growth and tightens access to credit. China's total debt has risen sharply in the last decade and now stands at more than 300 percent of GDP. Non-financial companies, whose combined liabilities total more than 150 percent of GDP, hold most of this debt. Slower credit growth will curb the investment growth rate. Any fall in investment or domestic property prices would further dampen economic growth. The worst-case



scenario would see the Chinese economy endure a bumpy landing, a situation that could have serious repercussions for international growth. China is the world's second largest economy after the US and an integral part of the global supply chain.

Hence, any national economic crisis triggered by internal problems would also have major global consequences. One direct effect would be a fall in exports to China. The country accounts for more than 56 percent of the export revenues of other Asian countries. China is also a major export market for non-Asian countries. The US and Germany rely on China for 8 percent and 7 percent respectively of their total goods export revenue. There is also a risk of underestimating the extent of the turbulence on financial markets that would result from a sharp downturn in China. The indirect impacts involved are hard to quantify, but must be assumed to be substantial. In brief, a hard economic landing in China would have major consequences for the global economy.

#### **AGGRESSIVE INTEREST RATE POLICIES**

The market turbulence that could result from faster-than-expected interest rate hikes in the US is another risk that has grown more pronounced. Interest rates may be raised faster than expected if economic growth and inflation turn out to be higher than expected due to loose fiscal policy. Faster monetary tightening in the US might ignite turbulence on financial markets and cause share prices to fall if investors were to shift funds into bonds. A strengthening of the USD due to faster interest rate rises might prompt capital outflows from emerging markets, triggering currency weakness. Many developing economies have loan finance denominated in foreign currency. Such loans would become more expensive to service if the USD were to appreciate. This would adversely impact growth in these countries and also internationally due to lower demand for foreign imports.

#### **CONFIDENCE CRISIS IN EMERGING MARKETS**

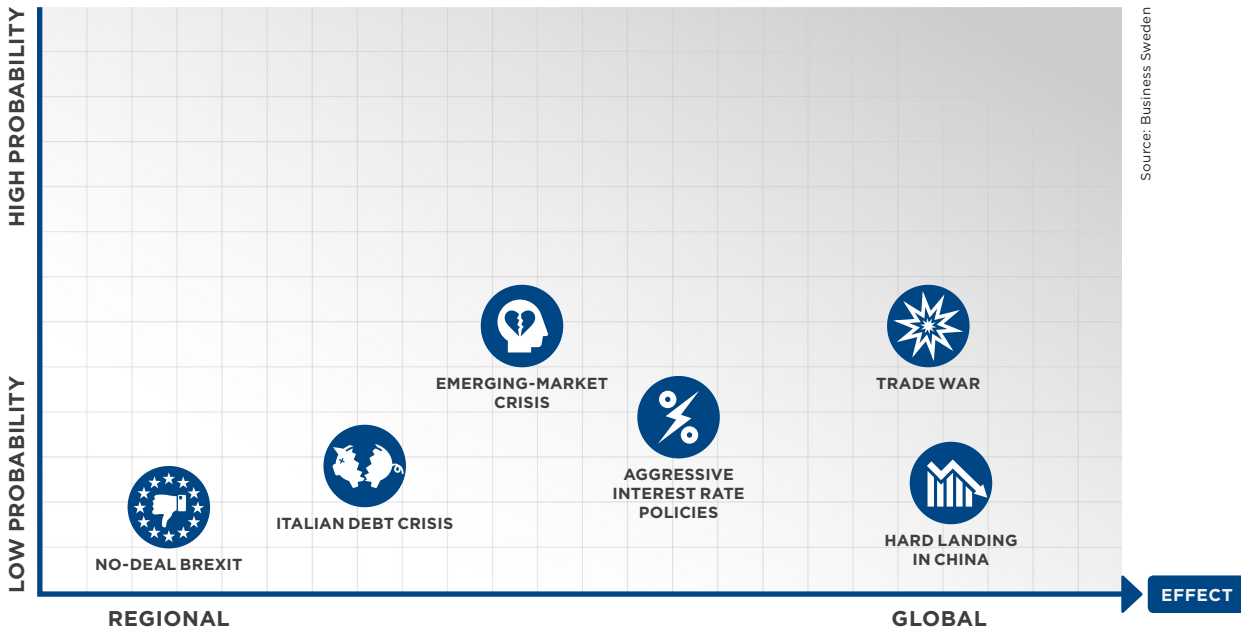
The Turkish lira has fallen sharply against the USD this year, with the depreciation gathering

pace during the summer as relations between Turkey and the US, already under strain, deteriorated further. As investors have sought shelter in more secure assets, the nervousness has spread to other emerging markets. The Turkish economy is on an unsteady footing. The current account deficit of 5.5 percent of GDP in 2017 has widened this year. The deficit is largely financed by foreign borrowing, exposing the country to currency speculation. Turkey also has a large foreign debt of more than USD 200 billion and high inflation, which has forced the central bank to raise interest rates. Further interest rate rises are likely to be needed, which would risk dampening economic growth. The report's baseline scenario is that Turkey's crisis will have only a limited impact on other emerging economies. Developing countries in Asia, for instance, have small current account deficits or even surpluses, as well as lower inflation. Nevertheless, the risk remains that the instability in Turkey (and Argentina, which like Turkey is running a large current account deficit and has high inflation) spreads, causing investors to scale back their investments in emerging markets generally. Such an outcome could have a considerable global impact.

#### **ITALY'S DEBT CRISIS**

The political turbulence in Italy poses a further risk. The new parties of government, the League party and the 5-Star Movement, have previously pledged to cut taxes and introduce a basic income for poorer citizens. Their proposals have raised concerns that Italy's public debt, currently running at 130 percent of GDP, will rise further. The risk that Italy will breach EU budget rules (eurozone regulations require member countries to keep public debt below 60 percent of GDP) remains, though recent movements in Italian share prices and bond yields can be seen as indicating that this risk has lessened somewhat. Prime minister Giuseppe Conte recently stated his commitment to keeping the public finances stable and reducing public debt. Nevertheless, concern remains that the public debt will rise if the country's debt-laden banks encounter further problems. In such a scenario, Italy would risk becoming mired in a fiscal crisis with the potential to cause a sharp slowdown in Italian and eurozone

## RISKS TO THE WORLD ECONOMY



growth. Such an eventuality would also affect growth globally, though to a lesser degree than in the eurozone.

### NO-DEAL BREXIT

The outcome of Brexit negotiations, currently approaching their final phase, will be critical for the UK economy. The baseline scenario, on which the forecasts in this report are based, envisages an agreement between the UK and EU to implement a two-year transitional period during which the UK effectively remains within the Single Market while negotiating the details of its future relationship with the EU. The cost to the EU, and especially to the UK, will be high if the two sides fail to reach a deal. Were the UK to leave the EU in March 2019 without a deal, it would face a significant risk of recession. In the absence of a deal, the UK would leave the Single Market, the Customs Union and the jurisdiction of the European Court of Justice. This would have consequences for the UK economy and for companies with exposure to the UK, such as foreign exporters. This report sees a lesser likelihood of the impact spreading internationally and therefore considers the risk to the world economy to be limited.

# A CLEAR SLOWDOWN

In Europe, the economic picture is split between a slowdown in Western Europe and a continued boom in Central and Eastern Europe. Over the continent as a whole, economic growth has slowed on the back of weaker global demand and a stronger euro that have reduced growth in export revenues. Industrial production flattened out in the summer and the purchasing managers' index has been dropping since the start of the year. All the same, the index remains at a high level and suggests the economy remains in an expansionary phase. Private consumption continues to underpin growth but is being dampened by moderate wage growth and higher inflation. The labour market is strong and EU-wide unemployment has dropped below 7 percent. Investment is rising, though not fast enough to compensate for slower export growth.

Though committed to keeping interest rates low, the ECB is likely to proceed with plans to curtail its quantitative easing programme at the end of the year and to defer any increase in interest rates until 2019 – probably the second half of the year. One area of concern is that inflation remains low despite strong economic conditions: underlying inflation, excluding the effect of rising energy prices, is around 1 percent.

European GDP growth is expected to fall from 2.4 percent last year to 2.1 percent this year and 1.8 percent in 2019. Alongside the risk of a global slowdown, political developments in the EU and eurozone pose the biggest threat economically. Divisions still remain entrenched over migration policy, but overall conditions have improved somewhat since the spring. In Germany, a governmental crisis was averted, while in Italy the new populist government has confounded sceptics by committing itself to keep the budget deficit in check. The EU and US have also avoided escalating their trade disagreement, for the time being at least. On the other hand, the likelihood of a no-deal Brexit

has risen, as has the risk of a trade war between the US and China. Both would hit the European export sector and cause economic damage.

## GERMANY EASES UP

The German economy remains strong, though growth rate is now slowing slightly. Robust private consumption, high employment and significant wage rises are driving demand, while household purchasing power is increasing despite higher inflation. Unemployment is falling and was just above 5 percent in August. A labour shortage is paving the way for higher investment, but the risk of an escalating US-EU or US-China trade war is curbing business enthusiasm to invest. Investment appetite is also being curbed by flatter global demand as order books shrink due to reduced demand for German exports. Exports are nevertheless projected to rise by 2.8 percent this year and by 3.5 percent in 2019.

The new coalition government of Christian Democrats and Social Democrats represents stability yet stands on uncertain ground. During the summer, Chancellor Angela Merkel was challenged on immigration by her own interior minister and the Christian Democrats' Bavarian affiliate, the CSU. Merkel ultimately agreed a compromise, after which the political temperature dropped. German GDP is projected to grow by 1.8 percent this year and by 1.6 percent in 2019.

In France, economic growth has slowed considerably in the last six months. Domestic demand has softened as rising inflation has eaten into household purchasing power. Social security contributions have also been raised – in effect an income tax increase – as part of President Emmanuel Macron's tax reforms. The reforms are front-loaded, meaning that offsetting measures, such as a cut in property tax, will not come into effect until the second half of the year. This enhances prospects for economic growth in 2019.

Private consumption is profiting from a robust labour market, where unemployment is now below 9 percent and falling. Industrial production has eased due to slack export growth caused by weaker demand and the stronger euro. That said, the outlook remains good for French exporters during the remainder of 2018 and in 2019. Solid investment growth is also contributing to France's economic health. National GDP is forecast to rise by 1.6 percent this year and by 1.7 percent in 2019.

The UK economy continues to slow and is expected to grow at just 1.3 percent this year and 1.4 percent in 2019. Uncertainty over the outcome of Brexit negotiations is casting a shadow over business and investment. An unusually cold spell of weather also impacted growth early in the year. Industrial production is weak and exports are expected to contract by 0.3 percent in 2018, as are imports.

Meanwhile, banks and financial institutions are relocating parts of their operations from London to mainland Europe. Manufacturing companies, which remain an important sector (albeit less so than in most EU countries), are reviewing their supply chains and expect costs to rise. Modest wage increases, higher interest rates and slower job creation are all acting as curbs on household consumption, while a low savings ratio mitigates against higher lending. Inflation is easing but not sufficiently to compensate consumers for lower purchasing power, while tight government fiscal policy acts as a further constraint on consumption.

The coming months will determine if the UK can strike a framework deal with the EU on Brexit and future economic and political ties before officially leaving the union on 29 March next year. The likelihood is that the two sides will agree on a proposed two-year transition period during which the UK effectively remains within the Single Market while negotiating the details of its bilateral relationship with the EU.

### ITALIAN FOG

In Italy, the favourable growth trend from last year has been interrupted as private consumption growth slows due to higher inflation. Job creation continues, but at a lower rate than before. Industrial production has stagnated and export growth has once again become

incremental. The purchasing managers' index has dropped to just over 50 – the boundary between economic growth and contraction. Buoyant investment remains a ray of light and the country's banks appear to be recovering after a series of government bailouts that have helped to shrink their distressed-loan portfolio.

The direction of the new government's economic policy is as yet unclear. In public statements, the 5-Star Movement and League party have shown little concern for the impact on the budget deficit and public debt of their proposed spending plans. A tussle is expected between the parties and the independent finance minister Giovanni Tria, also a supporter of Italy's euro membership. The outcome will give an indication of the country's future economic direction. Italian GDP is expected to grow by 1.2 percent this year and 1.1 percent next year.

The Spanish economy is also showing signs of cooling and private consumption growth has dropped. Consumer demand remains robust but modest wage increases are being eaten up by inflation, thus eroding purchasing power. Although many new jobs are being created, unemployment has yet to drop below 15 percent. Export growth is slowing, though remains at a high level, and GDP is projected to grow by 2.7 percent this year and by 2.3 percent in 2019.

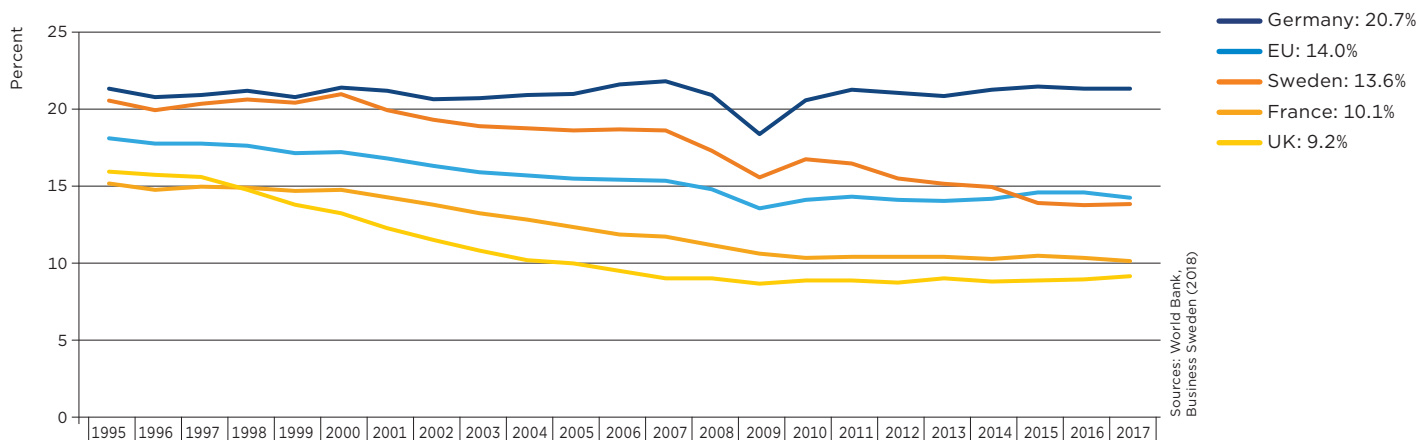
### GOOD TIMES REIGN IN EASTERN EUROPE

Central and Eastern Europe continues to revel in an economic upswing. The Polish economy is in rude health, with private consumption, investment and exports all buoyant. In the Czech Republic, industrial activity and export growth are cooling but investment levels remain very high. Hungary's economy remains robust and is benefiting from a further jump in private consumption and a hike in EU-funded investment. Of the larger countries in the region, only Romania is seeing a sharp slowdown in growth (albeit from an extremely high level). The Baltic states will experience a more gradual economic cooling this year and in 2019.

Russia is reporting relatively strong data as private consumption drives an economic upswing. Households are enjoying high wage increases and a credit boom that is boosting the retail sector and car sales. Inflation has levelled

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THE EUROPEAN  
ECONOMY  
PEAKED IN 2017  
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## MANUFACTURING INDUSTRY VALUE ADDED, PERCENTAGE OF GDP



off at 3 percent and industrial production is on its way up while investment growth is slowing. The rise in oil prices to almost 80 USD a barrel has strengthened the public finances and government creditworthiness. Despite US plans to tighten economic sanctions, the Russian economy is projected to grow by 1.8 percent this year and 1.4 percent in 2019.

### STABLE ECONOMIC CONDITIONS IN SCANDINAVIA

The Swedish economy remains strong, with a projected growth rate of 2.9 percent this year. The Finnish economy is also in excellent shape, though export growth this year will dip below last year's very high figure. Danish GDP growth will slow this year but will pick up again in 2019. Consumers are optimistic and investment is high, but exports are underperforming and will fall back somewhat this year. In Norway, growth is slowing as investment falls and exports flatten out. High oil prices are beneficial to the Norwegian economy but their impact is being offset by lower oil production.

# EXPORT UPSWING DESPITE GROWING PROTECTIONISM

Asian countries are enjoying steady economic growth. The robust state of the global economy and strong international demand are driving exports, especially in small open economies such as Taiwan and Singapore. Larger economies such as China, India, Japan, Indonesia, Malaysia, Vietnam and Thailand are also expected to grow their exports this year. However, export growth is going to slow due to reduced demand from China and increased protectionism.

Meanwhile, rising protectionism is suppressing demand for Chinese exports, and the risk of a global trade war is currently the greatest threat to Asian economic growth. The tariffs imposed by the US this year on Chinese imports are projected to have limited impact. However, the effect could be much larger were the US to impose further tariffs that prompt retaliatory duties of the same size or more.

## CONSUMPTION A GROWING ECONOMIC DRIVER FOR CHINA

Economic activity remains high in China despite the rising protectionist tide, with GDP growing at 6.8 percent in the first six months. Increasing tensions with the US over trade have prompted a review of domestic lending practices and looser fiscal and monetary policy in a bid to underpin domestic demand. Lower credit growth and the trade dispute with the US will challenge the country's growth path going forward, but this report sees the trade war having a relatively limited impact. Looser credit regulations or a more expansionary fiscal policy will in all likelihood offset the drop in export growth caused by the trade standoff. Looser fiscal policy, strong growth in private consumption and a robust service sector will be the major engines of growth in the coming months.

The next few years will see a flatter growth curve as the economy shifts towards a more sustainable-growth-based model. The government

is expected to take measures to reduce the flow of credit to China's highly indebted domestic economy and to continue orienting towards consumption-led growth – a strategy that will benefit the growing service sector. GDP growth is forecast to ease from 6.9 percent in 2017 to 6.5 percent this year and to 6.1 percent in 2019.

## BROAD-BASED GROWTH IN INDIA

India's economy will accelerate considerably in 2018. Last year's drop in growth to 6.2 percent appears to have been a one-off response to the introduction of a national value-added tax and the abolition of large-denomination banknotes to tackle corruption. GDP is projected to grow by 7.6 percent this year and by 7.2 percent in 2019 thanks to strong public and private consumption as well as infrastructure investment and export demand.

At the same time, higher oil prices and growing protectionism will hold back growth in the second half of the year. The recent rise in the oil price has pushed up the current account deficit, which is projected to reach 2.4 percent of GDP this year. Any further advance in the oil price will see the deficit rise higher.

The Indian currency, the rupee, has fallen sharply against the USD this year and any further widening of the current account deficit would increase national vulnerability to currency speculators and potentially trigger a capital outflows. Rising inflation, which is now approaching 5 percent, has prompted the Reserve Bank of India, India's central bank, to tighten monetary policy. Further interest rates rises are expected going forward. This, combined with the benign growth climate, suggests there is limited scope for further rupee depreciation.

India's long-term economic expansion will be driven by a young, growing middle class whose spending power will fuel an emergent service sector where unit costs are among the lowest of

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A GLOBAL  
TRADE WAR  
IS THE  
BIGGEST RISK  
AT PRESENT  
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the BRIC economies, creating a favourable cost base and strengthening India's competitiveness. Some infrastructure improvements have been implemented thanks to government efforts to broaden the tax base. These measures, which include the introduction of bankruptcy laws and VAT and currency reform, are positive steps that will support long-term growth.

Further structural reforms in areas such as education and property purchase legislation are nevertheless necessary for future growth. The low rate of workforce participation needs to rise, as does access to education. Favourable demographics in the last two decades have produced a fast-growing cohort of people of working age. Raising education standards and creating conditions for higher labour market participation will be imperative for future growth. However, the upcoming general election in spring 2019 and the government's desire to win as many votes as possible risks leading to key reforms being put back.

#### **HIGHER DOMESTIC ACTIVITY IN INDONESIA**

Indonesian growth is expected to continue at its current rate of around 5 percent for the next two years. This year, investment and public consumption are driving the expansion, while a weak rupiah and higher interest rates are keeping private consumption in check. Higher private and public investment reflects higher commodity prices and a government commitment to improve infrastructure.

However, investment risks falling short of expectations due to the government's desire to reduce the budget deficit from 2.6 percent of GDP last year to 2.2 percent in 2018 and the possible implementation of measures to reduce capital goods imports. Higher exports of capital goods had a negative impact on the current account deficit and the rupiah in the first half of the year.

The robust state of the international economy is fuelling demand for exports, which are expected to rise by more than 5 percent both this year and next. This is a slightly lower rate than in 2017, reflecting weaker demand from China for Indonesian exports and lower growth in world trade. Export growth will slow further if trade standoffs worsen.

Like many emerging market currencies, the rupiah has weakened since the start of the year. However, Asia's emerging economies appear better equipped to weather a loss of market confidence than many others due to the stability that comes from relatively low current account deficits (and in some cases surpluses) and low-to-moderate inflation. There is a risk that capital flight will accelerate if US interest rates continue to rise, especially if the Federal Reserve raises rates faster than expected. Around 40 percent of Indonesian government bonds are held by foreign investors, raising the prospect of large capital outflows as US interest rates rise.

In the long term, Indonesia's economic expansion will hinge on continued consumption growth among the country's young, affluent population and strong export growth. Structural measures including infrastructure investment and legal reforms will also play a part.

#### **HIGH GROWTH IN JAPAN BUT STRUCTURAL REFORMS NEEDED**

Japan's GDP rose by 1.7 percent in 2017, well above the country's potential annual growth rate of 0.6 percent. Growth is expected to ease to around 1 percent this year and next, which is nevertheless a high figure by Japanese standards. Domestic demand will be the main economic engine amid a strong labour market featuring record-low unemployment and historically high wage growth. Annual wage growth is nevertheless below 2 percent, which makes it difficult for the Bank of Japan to achieve its 2 percent inflation target. High capacity utilisation and construction projects for the 2020 Tokyo Olympics are both lifting investment growth.

Lower demand from China and the growing risk of trade disputes are likely to result in lower export growth going forward. However, high demand for Japanese capital goods is an offsetting factor. GDP growth is expected to continue slowing next year as the effect of fiscal stimuli wears off, Olympic construction programmes are completed and the government introduces a consumption tax of 8–10 percent.

To counteract low inflation, the Bank of Japan is holding interest rates negative at -0.1

percent and is operating a major asset-buying programme. Inflation is expected to continue to fall short of the bank's 2 percent target, so the loose monetary policy regime is set to remain in place for the next year or two.

Downside risks, namely an escalation of the trade war between the US and China and a sharp economic slowdown in China, have risen. Furthermore, any global increase in risk aversion would potentially strengthen the yen and hamper Japanese exports. Then there is the issue of the public debt, which at 235 percent of GDP is high by international standards. During the summer the prime minister, Shinzo Abe, was forced to defer the government's target date for balancing the budget from 2020 to 2025 and drop a proposed ¥500 billion cap on annual increases in social spending as the country's rapidly ageing population pushes up elderly care costs.

Major structural challenges thus remain, despite growth being historically high at present. Japan needs to confront these challenges, which include ageing, a declining workforce and low productivity growth due to over-regulation in some sectors, if it is to preserve long-term growth.

NORTH AMERICA

# MARKETS SHRUG OFF POLITICAL POLARISATION

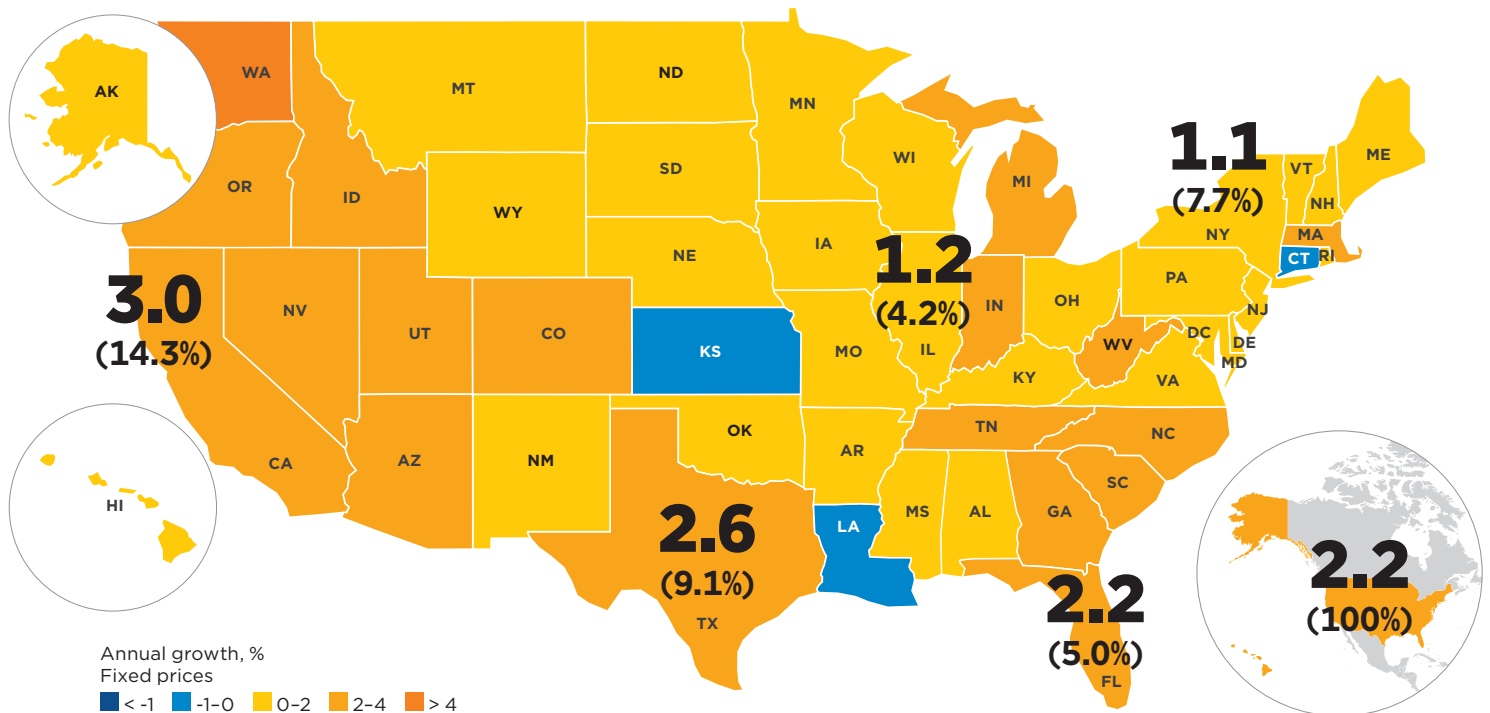
President Donald Trump continues to enjoy relative success in setting the US political and economic agenda, helped by a Republican majority in Congress and undiminished popularity among his core voters and in the business sector. Political polarisation is deepening ahead of the mid-term elections on November 6, when all 435 seats in the House of Representatives and 35 out of 100 seats in the Senate are up for grabs.

Relations with Canada have soured following a clash between Trump and Canadian premier Justin Trudeau at the G20 summit in Toronto in June. The background to this was Canada's decision to respond in kind to the

US's imposition of tariffs on steel and aluminium imports.

The renegotiation of the *North American Free Trade Agreement* (NAFTA) between the US, Canada and Mexico resulted in a preliminary deal between the US and Mexico at the end of August. So far, Canada remains outside the proposed agreement. The deal changes large parts of NAFTA. In the car industry, for instance, 75 percent of auto components must henceforth be manufactured in North America – and half of these by workers earning a wage of not less than 16 USD per hour. The average industrial hourly wage in Mexico is just over 2 USD.

GDP GROWTH 2017



Note: The map shows GDP growth in the five economically most important states – California, Texas, New York, Florida and Illinois – with their respective shares of total US GDP in brackets. All figures stated in percent.

Sources: Bureau of Economic Analysis (BEA), Business Sweden (2018)

Trump has threatened to sign a bilateral trade agreement with Mexico – and to impose tariffs on Canadian car exports – to pressure Canada into signing the NAFTA successor deal. The US Congress and industrial groups have urged the president to include Canada in a three-way deal, while the outgoing administration of Mexican president Enrique Peña Nieto just wants an agreement, whether it includes the Canadians or not. The strong US economy, which is benefitting from tax cuts, is good news for both Canada and Mexico, for which it accounts for 75 percent and 80 percent of their respective export revenues. North America is expected to see growth of 2.7 percent this year and 2.5 percent in 2019.

### HIGH ECONOMIC ACTIVITY IN THE US

The Tax Cuts and Jobs Act passed by Congress in December 2017 delivered a shot in the arm to an economy that was already booming. Private consumption is rising, aided by moderate wage growth and relatively low interest rates. The economy is close to full employment, with unemployment rate now below 4 percent. Business investment is growing, as are industrial production and exports.

On the other hand, the trade dispute with China is widening and in mid-September Trump imposed punitive tariffs of 10 percent on USD 200 billion of Chinese imports (rising to 25 percent from 1 January 2019). This came on top of earlier tariffs on USD 50 billion of Chinese goods. The latest tariffs apply to electronic goods, food, tools and household appliances, which will mean higher prices for US consumers.

Almost half of all US imports from China are now subject to punitive tariffs and Trump has threatened to slap tariffs on the outstanding USD 270 billion of imports if China retaliates. China responded immediately to the mid-September announcement by imposing tariffs of 5–10 percent on US goods worth USD 60 billion.

The Federal Reserve left interest rates unchanged at 1.75–2.00 percent at its August meeting but is expected to raise rates in September and December.

US GDP is projected to grow by 2.9 percent this year before edging down to 2.6 percent next

In South America, Brazil is experiencing a weak recovery after the recent deep recession. Economic growth of 1.1 percent is expected this year, rising to 2.3 percent in 2019. One of few bright spots is a small rise in domestic demand – notably in investment. Galloping imports have overshadowed a modest rise in exports, while rising inflation (the Brazilian real has lost 20 percent of its value against the USD this year) has hit consumer purchasing power.

Public spending is flat, but 2018 will again see a large budget deficit and a further increase in the rapidly growing public debt. The country's economic woes and a slew of corruption scandals may hit support for the established political parties in the October presidential election. The electoral ban on the jailed former president, Luiz Inácio Lula da Silva, makes the outcome even harder to predict.

Elsewhere in South America, both Argentina and Venezuela are in recession. South American growth is estimated at 1 percent this year, rising to 1.9 percent in 2019.

year. Performance differs rather widely at state level (see map), though manufacturing is robust nationwide and the mining industry in states such as West Virginia is enjoying an upswing.

### CLOUDS TO THE NORTH AND SOUTH

Canada's economy is showing moderate growth amid a clear cooling of private consumption as higher interest rates, slower employment growth and rising inflation erode consumer purchasing power. Investment is rising thanks to fresh optimism in the energy sector and public infrastructure investments, though export growth is weak. The Bank of Canada kept interest rates unchanged at 1.50 percent at its September meeting after four increases in the space of 12 months. GDP is expected to rise by 2.0 percent this year and by 1.7 percent next year. The outlook would worsen were Canada to

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FISCAL  
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remain outside the remodelled NAFTA but the risk of this occurring is seen as low.

Mexico's economy is moving slowly forward. Private consumption is driving domestic demand, with investment and public spending both ticking upwards. Inflation is rising, prompting Banxico, Mexico's central bank, to hold interest rates at 7.75 percent. Weak industrial production can be attributed partly to summer floods that disrupted automotive production. Activity also fell in the energy sector, where the problems are of a more structural nature. Promises by the newly elected president, Andrés Manuel López Obrador, known to Mexicans as AMLO, to raise public spending risk could jeopardise the fragile balance in the government budget. Economic growth is projected to drop to 2.0 percent this year but to pick up to 2.2 percent in 2019.

APPENDIX

# SWEDISH EXPORTS, GDP GROWTH AND INFLATION

Country/region	Swedish goods exports, current prices			GDP growth, fixed prices, %			Inflation, %
	Exports 2017, SEK bn	Change 2016–2017, %	% of Swedish exports	2017	2018F	2019F	2017
<b>EUROPE</b>							
Sweden				2.5	2.9	2.2	1.8
Denmark	89.5	7.5	6.9	2.3	1.5	2.2	1.1
Estonia	11.0	14.0	0.8	4.9	3.5	3.5	3.7
Finland	90.3	11.6	6.9	2.8	2.7	1.8	0.8
France	54.8	4.1	4.2	2.3	1.6	1.7	1.0
Netherlands	71.2	10.6	5.4	3.0	2.7	1.7	1.4
Italy	35.2	10.2	2.7	1.6	1.2	1.1	1.2
Latvia	3.7	-3.7	0.3	4.5	3.9	3.1	2.9
Lithuania	8.3	7.6	0.6	3.9	3.4	2.7	3.7
Norway	133.3	7.6	10.2	2.4	1.6	1.9	1.9
Poland	39.8	3.0	3.0	4.6	4.7	3.5	2.0
Russia	18.7	27.9	1.4	1.5	1.8	1.4	3.7
UK	81.3	13.0	6.2	1.7	1.3	1.4	2.7
Czech Republic	11.0	13.1	0.8	4.5	3.0	2.7	2.4
Germany	142.9	14.0	10.9	2.5	1.8	1.6	1.7
Spain	25.1	7.8	1.9	3.0	2.7	2.3	2.0
<b>AMERICAS</b>							
USA	90.0	3.4	6.9	2.2	2.9	2.6	2.1
Brazil	7.3	8.0	0.6	1.0	1.1	2.3	3.5
Chile	2.8	9.6	0.2	1.6	4.2	2.9	2.2
Colombia	1.0	32.2	0.1	1.8	2.7	3.3	4.3
Canada	10.3	-1.3	0.8	3.0	2.0	1.7	1.6
Mexico	6.5	8.8	0.5	2.3	2.0	2.2	6.0
<b>ASIA, OCEANIA</b>							
Australia	15.1	15.5	1.2	2.2	3.3	2.6	1.9
India	11.4	28.2	0.9	6.2	7.6	7.2	3.3
Indonesia	4.0	34.2	0.3	5.1	5.1	5.1	3.8
Japan	19.5	9.0	1.5	1.7	1.0	1.1	0.5
China	58.5	27.3	4.5	6.9	6.5	6.1	1.5
Malaysia	2.7	-6.6	0.2	5.9	4.9	4.6	3.8
South Korea	12.2	1.5	0.9	3.1	2.6	2.5	1.9
Thailand	4.5	-16.8	0.3	3.9	4.4	3.4	0.7
Vietnam	2.1	42.6	0.2	6.8	6.7	6.3	3.5
<b>MIDDLE EAST, TURKEY AND AFRICA</b>							
United Arab Emirates	6.3	8.3	0.5	0.8	2.0	3.1	2.0
Saudi Arabia	9.2	-1.0	0.7	-0.9	2.1	2.7	-0.9
South Africa	7.3	15.2	0.6	1.3	0.7	2.1	5.3
Turkey	14.1	18.9	1.1	7.3	4.1	1.1	11.1

Sources: Statistics Sweden, Oxford Economics, Business Sweden (2018)







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