Downside Risks to the Global Economy in 2019 and Implications

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Recession in the real sector and financial instability for the global economy are expected to continue into 2019. These are mainly attributable to a reversal in the US economy from strong growth to a slowdown, continuing sluggish economic growth in China coupled with prolonged trade tensions with US, and likely financial instability in emerging market economies resulting from the US interest rate hikes. In such global financial environment, Korea should continue its efforts to increase economic growth potentials in the long term and maintain financial stability, in particular, to counter increasing capital outflow pressures. From the capital market perspective, it also needs to strengthen risk management while being more flexible and more prudent in responding to the changes in global monetary policy.

Global economic prospects for 2019 from major international organizations do not portend well for Korea. While real sector growth in advanced economies continues to decelerate, financial markets remain highly uncertain due to various risk factors. The International Monetary Fund (IMF), in its October 2018 Global Financial Stability Report (GFSR), expressed concern about growing downside risks to the world economy in 2019 by warning that 'the winter is coming.' This article discusses risks facing the global economy in 2019 and their implications for the Korean economy.

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* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Downside risks to the global economy in 2019

The biggest risks to the world economy next year are the global real economy's contraction, China's economic slowdown, continuing trade tensions between the United States and China, the US interest rate hikes, and likely financial instability in emerging market economies.

- **The global real economy's contraction**

In October 2018, the IMF said that the global economy is expected to grow at 3.7% in 2019, which is down 0.2%p from its July forecast. Growth in advanced economies is projected to slow from 2.4% in 2018 to 2.1% in 2019. The US growth is also projected to slow from 2.9% this year to 2.5% next year. More recently, the Federal Reserve signals slower pace of interest rate hikes than originally expected, and short-term and long-term interest rates are converging. These suggest that the US economic expansion, which has remained exceptionally strong, is nearing its peak. Some investment banks are pessimistic about the outlook for the US economy by predicting its growth rate to fall below 2%. Furthermore, recovery is not yet visible in other advanced economies, as evidenced by the fact that economic growth in Germany and Japan turned negative in the third quarter of 2018 due to temporary factors. The growth forecast for emerging market economies was also revised down by 0.4%p from the July outlook. Notably, China's growth forecast for next year was marked down to 6.2%. The downward revision to growth prospects is more pronounced in commodity exporters amid lowering prices for oil and commodities. The growth outlook for Korea in 2019 was also lowered to 2.6%, down 0.2%p from the previous estimate of 2.8%. The growth projection has been revised downward by 0.3%p in three months.

Table 1. Global growth outlook

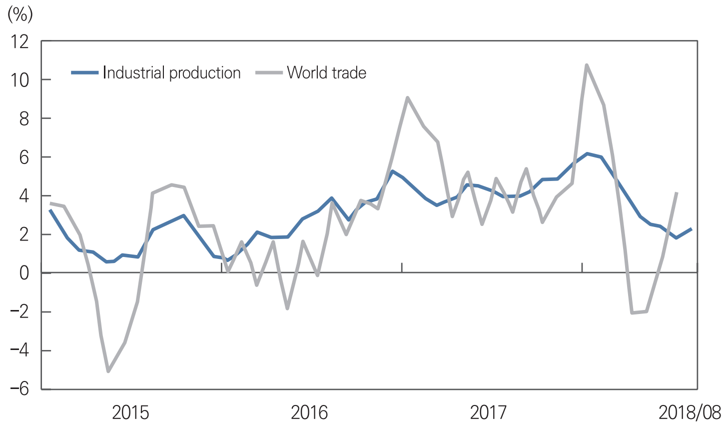
(Unit: %)

	World	Advanced economies	US	Euro Area	Japan	Korea	Emerging market economies	China
2017	3.7	2.3	2.2	2.4	1.7	3.1	4.7	6.9
2018	3.7	2.4	2.9	2.0	1.1	2.8	4.7	6.6
Difference from July 2018	-0.2	0.0	0.0	-0.2	0.1	-0.2	-0.2	0.0
2019	3.7	2.1	2.5	1.9	0.9	2.6	4.7	6.2
Difference from July 2018	-0.2	-0.1	-0.2	0.0	0.0	-0.3	-0.4	-0.2

Note: Based on the World Economic Outlook released in October 2018
Source: IMF

The downward revisions to growth forecasts largely reflect the slowdown in world trade and industrial output. While growth in global industrial production has slowed gradually since the second half of 2017, the volume of global trade exhibited negative growth in the first half of 2018 owing to the spread of protectionism and the US-China trade dispute. These trends are projected to continue in 2019, adversely affecting Korea and other countries whose contribution of exports to economic growth is high.

Figure 1. World trade and industrial production



Note: Three-month moving average; annualized percent change
Source: IMF

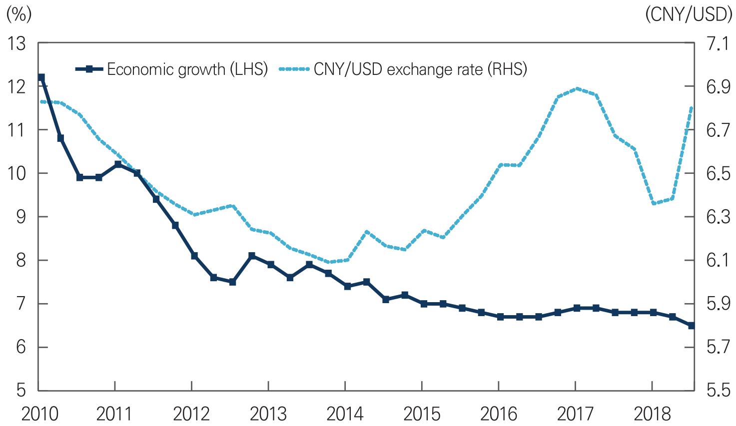
▪ **China's economic slowdown coupled with trade tensions with the US**

China is forecast to continue to experience slower growth in 2019 following the sharp drop in its economic growth rate this year. Amid sluggish investment and consumption, the manufacturing purchasing managers' index (PMI) and new export orders index have also shown a drastic decline since the second half of 2018. Only exports have remained strong. But some argue that is partly because Chinese exporters rushed to make shipments before the US raises tariff rates on Chinese goods. There are concerns that its exports could plunge when higher US tariffs on Chinese imports take effect next year.

China's sluggish economic growth are mainly attributed to a shift in the focus of the economic policy from quantitative expansion to qualitative growth starting in 2018 and the trade tensions with the US. First, the Chinese government changed the direction of the economic policy towards qualitative growth this year and pushed for corporate deleveraging. Accordingly, it tightened liquidity supply and curbed credit growth to discourage excessive debt-financed investments, reduce corporate and local government debts, and bolster risk management. These efforts thwarted local governments' infrastructure projects and made more and more companies hit by credit squeeze. To alleviate the adverse effects of the policy measures, the Chinese government has been trying to control the pace of deleveraging and increase fiscal stimulus. Nevertheless, it would be difficult for China to restore its growth resilience because it is expected to maintain the aforementioned policy stance for next year.

Second, the US and China agreed on temporary trade war ceasefire at the G20 summit held in early December, but many thorny issues are left unsolved. While the Trump administration continues to stick to its protectionist stance, the trade truce just means a three-month window for talks on trade tariffs between the two countries. The widely prevailing view is that a protracted trade war is highly likely because a rough ride is expected for negotiations on the details of tariffs. The IMF expects China's growth rate to be 1.2% lower than initially foreseen if the US imposes additional tariffs on Chinese products as it has warned. For the same reason, several investment banks such as Goldman Sachs and JP Morgan projected that China's growth rate will decline below 6% in 2019.

Figure 2. China's economic growth and CNY/USD exchange rate



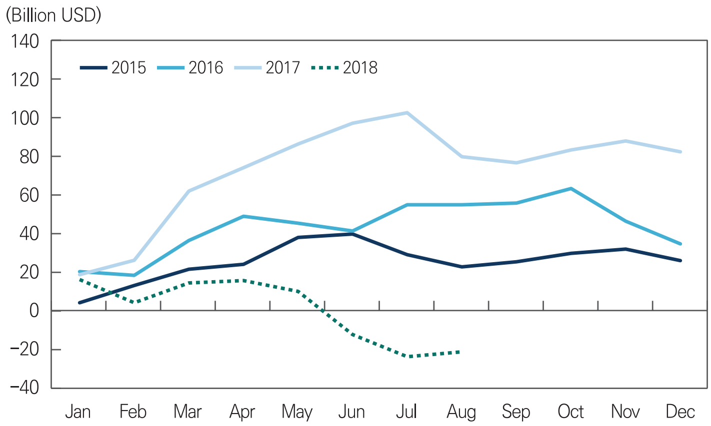
Note: Based on year-over-year growth rate
Source: Bloomberg

The US-China trade dispute is hurting export-dependent Asian countries much more than others. The resulting slowdown of the Chinese economy is expected to have negative impacts on Korea. If China's economy is headed for a hard landing due to a reignition of trade tensions, this would increase the likelihood of yuan depreciation and raise the specter of designating China as a currency manipulator. If these fears come to pass, the trade war could evolve into a currency or financial war. Moreover, if China's economic slowdown is accompanied by a sharp fall in the stock market, financial markets would be jittery with increasing volatility next year. The trade conflict could be a factor heightening volatility in the Korean financial market.

▪ **The Fed's interest rate hikes and financial vulnerabilities in emerging markets**

Looking back and ruminating over the past, when the US interest rate rise pushed up global interest rates, a crisis often hit emerging markets some time later. It is difficult to say that the interest rate increases in the US had nothing to do with the Latin American debt crisis in the 1980s, the Asian financial crisis in the 1990s, and the global financial crisis in 2008. The US, albeit at a slower pace, is projected to keep gradually raising interest rates as planned during 2019. On the other hand, emerging markets and the global economy do not have much room to ratchet up interest rates because of the real sector recession, meaning that the existing gap between local and foreign interest rates could be widened further. In this case, capital outflows from emerging market countries, more specifically, portfolio investment outflows observed since the second half of 2018, are likely to accelerate further next year.

Figure 3. Net portfolio investment flows to Asia



Note: Monthly cumulative sum of net portfolio investment flows for each year
Source: The Institute of International Finance (IIF), IMF

In addition, growing cross-border capital movements amid economic contractions worldwide are expected to increase volatility in prices of financial assets such as stocks. Expansionary monetary policies in the US and other advanced economies and affluent global liquidity underpinned the global economy and helped emerging markets avoid large swings in their financial markets. However, the US interest rate increases and monetary policy normalization feed growing concerns about possible deterioration in global financial stability. Rising interest rates are turning the global debt growth supported by ample liquidity into a risk. For Argentina and Turkey whose foreign exchange vulnerability dominated headlines this year, difficulties in formulating an appropriate policy response are highly likely to continue into next year. Given the projected fall in global commodity prices, the possibility that a crisis in emerging market economies relying heavily on commodities exports will spill over to the rest of emerging markets cannot be ruled out.

Implications for the Korean economy

The downside risks to the global economy discussed earlier have the following implications and challenges for the Korean economy: First, Korea is expected to see growth above 2.5% but below 3% in 2019. However, this growth level may be hardly achievable if the global economy's downside risks mount. It will not be easy for Korea to find new economic growth engine in a short period of time. In this situation, China's economic slowdown and the US and China trade dispute together could weaken the building blocks of Korea's economic growth because its growth rate has exhibited closer correlation with the Chinese economy than the US economy since 2010. Maintaining robust growth is very important and should not be overlooked for a country to achieve financial stability in that it helps keep the real economy healthy while shoring up sovereign creditworthiness, thereby reducing the possibility of capital flight when the country is hit by an external shock. Therefore, it is hardly necessary to say that efforts should be made to enhance the economy's growth potential and resilience from the medium and long-term perspectives.

Second, Korea has experienced modest capital outflows this year in spite of the US interest rate rises and dollar strength when compared to other emerging market countries. But it should be noted that the likelihood of capital outflows from Korea will increase if the widening gap between domestic and US interest rates comes together with unstable global financial market conditions. Gradual increases in the key US interest rate by the first quarter of 2020 and a pickup in Treasury bond yields to 3.5% in 2019 are projected. On the other hand, Korea's interest rates are expected to remain stable, reflecting sluggish domestic demand and slowing economic growth. Subsequently, the interest rate gap between the US and Korea is likely to increase further.[1)] The recent interest rate reversal between the US and Korea- that is, the US interest rates are higher than Korean interest rates-is a far cry from the past rate reversal in terms of extent and duration. A further rise in the interest rate differential would add capital outflow pressures, making the country more difficult to sustain its financial stability. Accordingly, meticulous policy efforts seem to be necessary.

Third, a more conservative and prudent approach, which reflects the global economic conditions, is desirable from the capital market perspective. Korea's stock market has trended downward since its all-time high in January 2018. And it is projected to stabilize in the second half of 2019 and thereafter because of weakening upward momentum in the US stock market, the likelihood of greater volatility in the Chinese stock market, and financial instability in emerging markets during the next year. Attention should be also given to the possibility of larger asset price volatility that may arise when market expectations of asset prices such as stock prices become unstable in the course of monetary policy normalization in the US. In addition, stronger risk management efforts are required because the financial market could become more volatile next year as a global liquidity contraction and debt payment pressure pose risks to emerging market economies.

1) See the KCMI press release (November 29, 2018) entitled, "Economic and Capital Markets Outlook for 2019" to learn more.