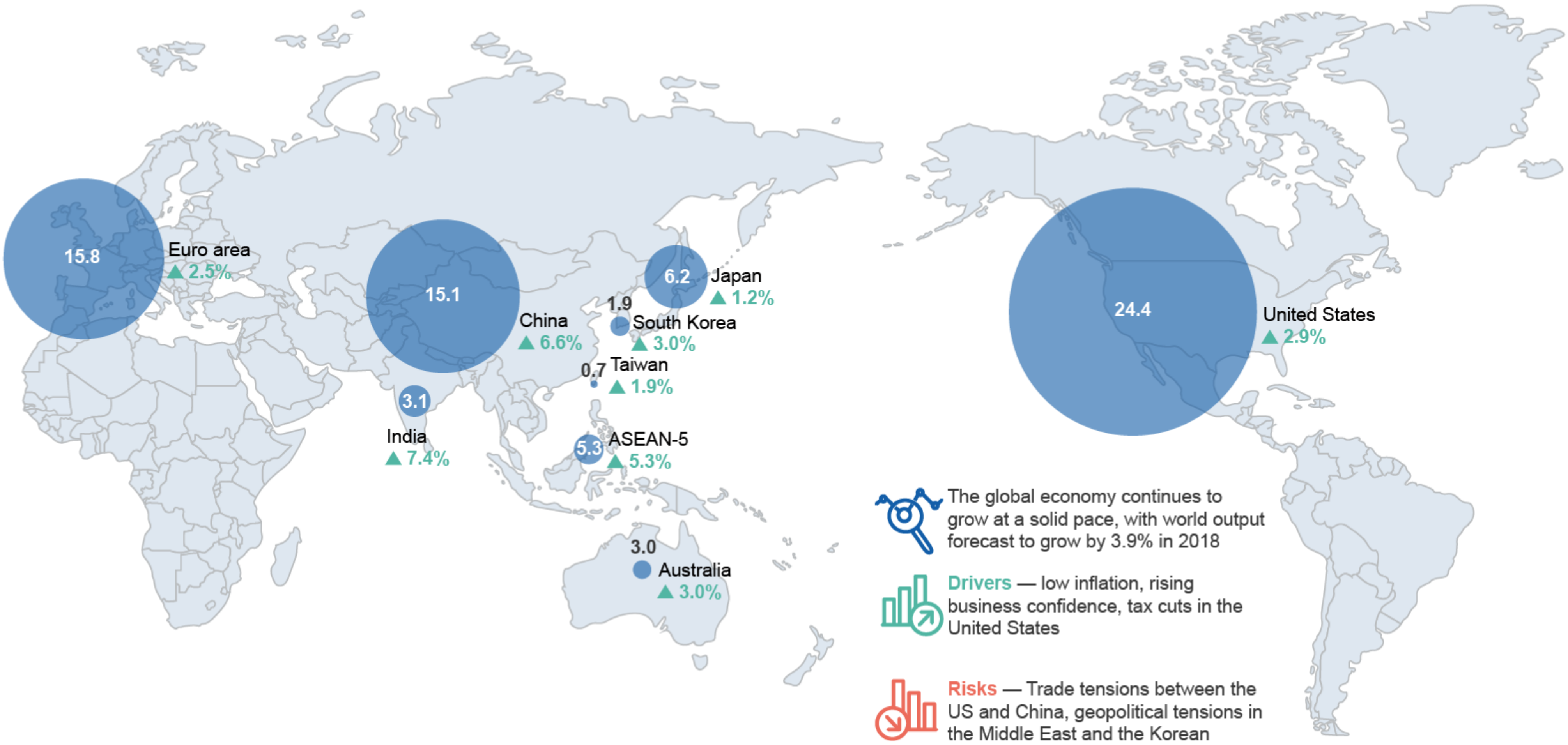
Macroeconomic Outlook

Resources and Energy Quarterly June 2018

= Share of global GDP

= Economic growth 2018



The global economy continues to grow at a solid pace, with world output forecast to grow by 3.9% in 2018

Drivers — low inflation, rising business confidence, tax cuts in the United States

Risks — Trade tensions between the US and China, geopolitical tensions in the Middle East and the Korean peninsula, rising debt levels in China

2.1 Summary

- The global economy continues to grow at a solid pace, with world growth forecast to be 3.9 per cent in 2018 and in 2019 and 3.8 per cent in 2020.
- Trade tensions between the US and its major trading partners present potential risks to confidence and global economic growth.

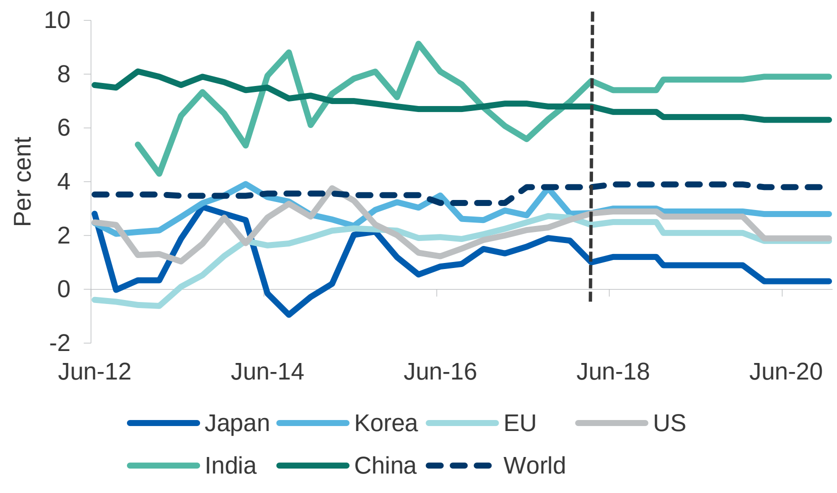
2.2 Global economy

The global economy performed well in the first quarter of 2018, led by stronger than expected growth in major advanced and emerging economies. The United States economy grew by 2.8 per cent year-on-year, Japan by 1.0 per cent, the Eurozone by 2.4 per cent and South Korea by 2.9 per cent. Of the key emerging economies, China grew by 6.8 per cent (year-on-year), while India grew by 7.7 per cent (year-on-year).

The strong growth in the global economy has been helped by rising manufacturing activity. However, manufacturing activity may have peaked. The global manufacturing Purchasing Managers Index (PMI) was at 53.1 in May 2018, down from a cycle high of 54.5 in December 2017, indicating the global manufacturing sector continues to expand, but at a slower pace. China, the US, Japan and the EU all have manufacturing PMIs above the 50 level, pointing to ongoing growth in the large manufacturing sectors in the short term, which should flow through to global metal demand.

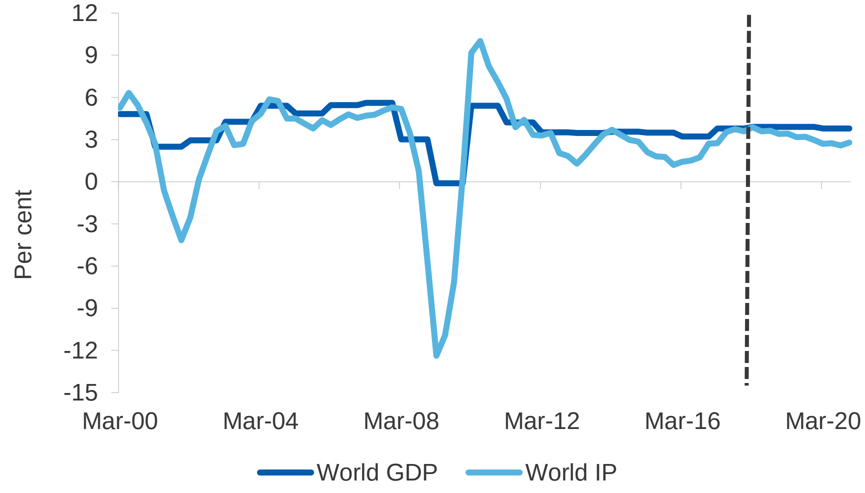
Global economic conditions are expected to remain firm over the next two and a half years. Uniform firm growth recorded in the March quarter is expected to continue. According to the International Monetary Fund's (IMF) World Economic Outlook released in April 2018, advanced economies are expected to continue to expand above their potential GDP growth rates until 2019, before decelerating. Economic growth in emerging and developing economies is also expected to rise before levelling off in 2020. The cuts to corporate and personal income taxes in the United States are likely to support global economic growth, but risk pushing up US interest rates further than they might otherwise go. Despite rising inflation in some advanced economies, and increased financial market volatility in early 2018, the IMF has projected the global economy to grow by 3.9 per cent annually in 2018 and 2019, and by 3.8 per cent in 2020.

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



Source: International Monetary Fund (2018)

Figure 2.2: Global GDP and industrial production, YoY growth



Source: Netherland CPB (2018); IMF (2018) World Economic Outlook

With the exception of the US, inflation and wage growth in most of the advanced economies remains subdued, and are forecast to gather pace only very gradually given slack in labour markets. Subdued wage growth in many advanced economies reflects low inflation and inflation expectations. Slow wage growth is constraining the demand for goods and services, and it is not yet clear when wage growth will pick up among advanced nations.

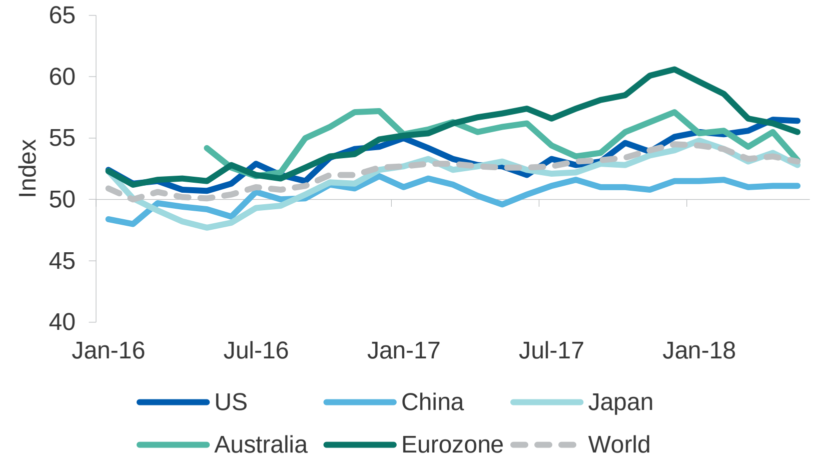
The risks to the global outlook seem skewed to the downside. Increased protectionism, geopolitical tensions in the Middle East, and the financial vulnerabilities of countries such as Italy and Argentina, all have potential to hurt global growth. Trade tensions between the US and its major trading partners have the potential to undermine confidence and hinder global economic output; the past decade has seen world trade as a proportion of world GDP rise noticeably. The US Administration has imposed US$50 billion in tariffs on US imports from China. China has retaliated by imposing US$50 billion in tariffs on imports of US products.

The US Administration has also exited from the Joint Comprehensive Plan of Action (JCPOA) — an agreement between Iran and six world powers (including the US) signed in 2015. The agreement removed economic and financial sanctions on Iran in exchange for curbs to the country's nuclear weapon program. The decision raises the risk of conflict in the Middle East, which could disrupt global oil supply and hurt household and business confidence.

Tensions could also reignite on the Korean peninsula, where there are ongoing negotiations between the United States and its allies and North Korea. The US is seeking changes in North Korea's nuclear armament program, in exchange for an easing of financial and trade sanctions by the major world powers. Territorial disputes in the South China Sea also remain a threat to regional and global security.

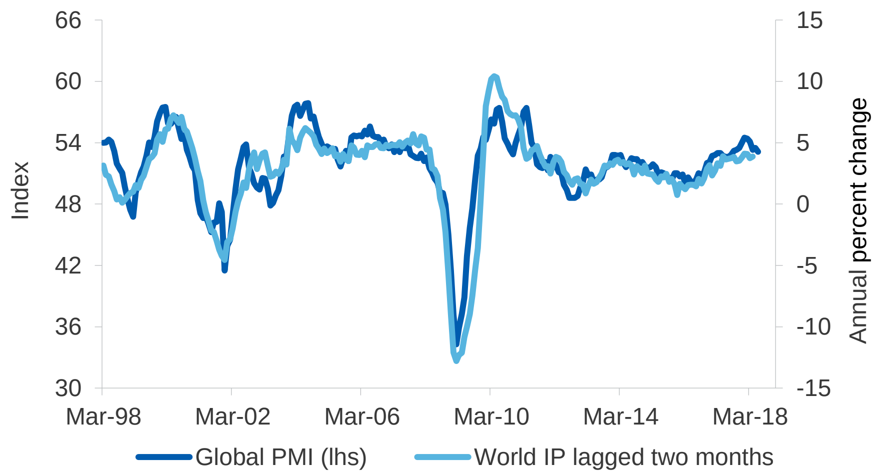
On the upside, monetary conditions in the major world economies are still relatively loose. The successful implementation of China's Belt and Road Initiative is also expected to facilitate greater regional integration over and beyond the outlook period.

Figure 2.3: Manufacturing Purchasing Managers Index (PMI)



Source: Markit (2018)

Figure 2.4: World industrial production and Manufacturing PMI



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

2.3 United States

The US economy grew by 2.2 per cent year-on-year in the March quarter 2018, as consumer spending grew at the weakest pace in nearly 5 years.

Partial indicators suggest strong GDP growth is likely to have been recorded in the June quarter. Manufacturing activity in the world's largest economy continued to expand. The US ISM Manufacturing Index rose to 58.7 in May 2018 from 57.2 in April 2018, as new orders, production and employment were stronger. The unemployment rate fell to 3.8 per cent in May 2018 — a multi-decade low. Initial jobless claims data point to a further decline in US unemployment over the near term. Wage growth is accelerating, and the likelihood is that the increase in labour costs will flow through to increased prices.

10 year US Treasury yields briefly reached 3.12 per cent on 17 May 2018 — the highest level in nearly 7 years — on indications of higher inflation and the potential for tighter monetary policy, i.e., faster/larger hikes in the official US (Federal Funds) interest rate. In the US, rising bond yields push up the cost of borrowing, hurting capital expenditure and dwelling investment.

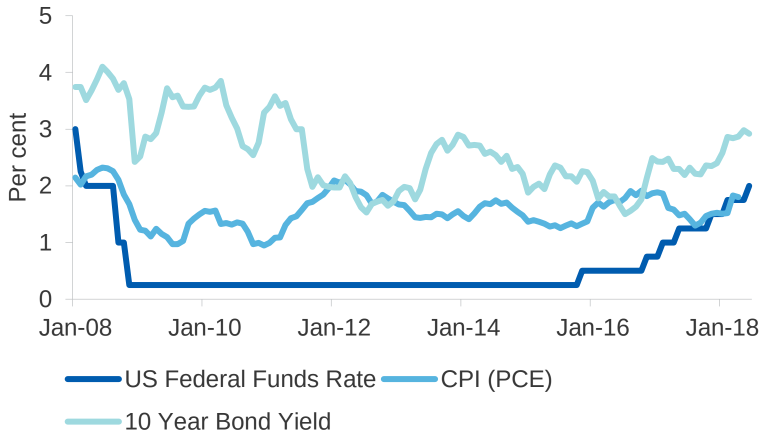
Large corporate and personal income tax cuts (US$1.5 trillion), strong US consumer confidence and a robust labour market, suggest that the world's largest economy will continue to grow firmly in the coming quarters. However, the US tax cuts and infrastructure spending measures are resulting in higher government bond issuance, also putting upward pressure on US bond yields.

The US Federal Reserve is expected to lift interest rates further over the coming eighteen months, in order to contain inflation. Increases in US interest rates have high potential to flow on to other nations, particularly those nations running large current account deficits. Already, capital flows back to the US (seeking the higher yields on offer) have led the central banks of nations such as Indonesia, Turkey and Argentina to raise interest rates to defend their currencies. Higher interest rates impact on economic activity in those countries, with flow-on effects to their trading partners.

Figure 2.5: US unemployment rate and Initial jobless claims

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

Figure 2.6: US Federal funds rate, CPI and 10-Year bond yield



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

2.4 China

The Chinese economy grew by 6.8 per cent year-on-year in the first quarter of 2018, propelled by a strong performance of the service sector — which grew by 7.5 per cent year-on-year. Strong exports helped offset the impact of weak infrastructure investment (up 7.5 per cent, slowing from the 18 per cent growth rate in 2017) and slumping property sales (up only 2.4 per cent, slowing from the 11 per cent growth rate in 2017), due to stricter financial regulations. As China's traditional growth engines — manufacturing and construction — slow, services need to take over as the driver of growth in the Chinese economy.

China's industrial production increased by 6.8 per cent year-on-year in May 2018, driven by increased output of manufacturing (up 6.6 per cent), and electricity, gas and water production (up 12.2 per cent). The output of the mining sector grew by 3.0 per cent, as steel and aluminium producers ramped up their production following the end of the winter production curtailments.

China's Markit manufacturing PMI was 51.1 in May 2018, unchanged from April but down from 51.6 in February 2018. The survey suggests that China's factories have maintained solid overall growth despite the government's tougher environmental policies, a slowing housing market and looming trade tensions with the United States.

Chinese authorities have implemented various property control policies since early 2017 — to limit speculative activities and a property bubble — and achieved some success in slowing property price growth. The newly built commercial residential buildings prices in China's 70 cities grew at a more moderate pace in early 2018, easing from a monthly average year-on-year growth of 8.5 per cent in 2017 to 5.5 per cent in the first five months of the year. The volume of residential buildings under construction increased by 2.7 per cent in 2017, and by just 2.1 per cent in the first five months of 2018.

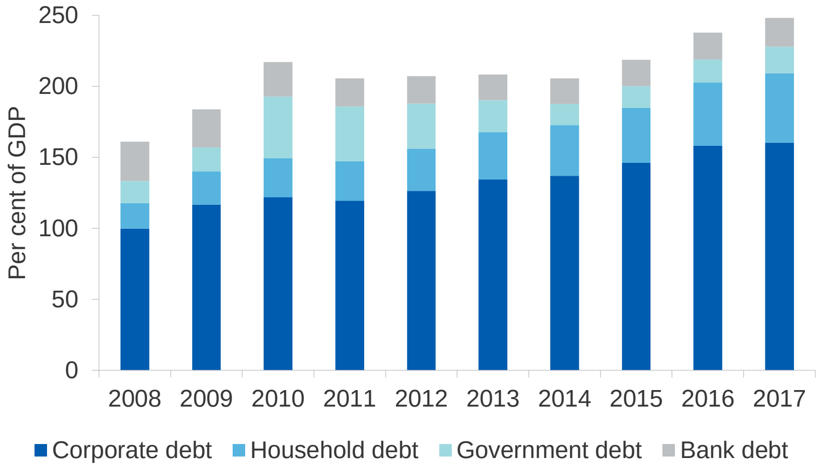
Figure 2.7: China's residential buildings prices and construction

Source: Bloomberg Intelligence (2018); National Bureau of Statistics of China (2018)

China's economic growth is expected to moderate to 6.6 per cent in 2018, 6.4 per cent in 2019 and 6.3 per cent in 2020. Growth is expected to slow as financial, housing and fiscal tightening measures take effect, measures to cut pollution intensify, and net exports diminish — due to the growing trade dispute with the US.

Growing concerns over debt levels in China represent the main risk to the outlook. As of 2017, the ratio of debt to GDP in China was 250 per cent — with corporate debt reaching 160 per cent of GDP, household debt 49 per cent, government debt 19 per cent, and bank debt reaching 20 per cent of GDP. To address the rising debt issue, the central government has vowed to take measures to deleverage the economy, including avoiding further large injections of central bank support. These measures are likely to have a direct impact on economic growth, with flow-on effects to commodity exporters.

Figure 2.8: China's debts



Source: Bloomberg Intelligence (2018)

China's Monetary Conditions Index fell to its lowest level in 29 months in April 2018. The People's Bank of China (PBOC) is expected to keep its lending rate unchanged at 4.35 per cent until at least the end of 2019. However, in late June, the PBOC announced that Reserve Requirement Ratio (RRR) — the amount of cash that some banks are required to hold as reserves — would be lowered by 50 basis points in July 2018. A further cut (of 25 basis points) is expected in 2019; this will bring the RRR down to 16 per cent by the end of 2019.

2.5 Other economies

Japan

The Japanese economy grew by 1.0 per cent year-on-year in the March quarter 2018, propelled by solid exports, private investment and spending toward the hosting of the Summer Olympics in 2020. Total machine orders rose 6.5 per cent year-on-year in May, to JPY 7.1 trillion. Japan's manufacturing PMI declined to 52.8 in May 2018 from 53.8 in April, as output and new orders rose at a slower pace and employment expanded at a slower rate. The economy is expected to grow at 1.2 per cent in 2018, as rising employment, income and consumer sentiment contribute to a recovery in domestic consumption.

Exports are expected to remain strong, in particular to the US and China, driven by stronger demand for machinery and equipment. Private capital expenditure is expected to grow firmly, underpinned by slowing but still elevated corporate earnings, the need to replace ageing capital stock, and construction investment for the Tokyo Olympics.

The Bank of Japan (BoJ) announced on 27 April 2018 that it is continuing with its quantitative and qualitative monetary easing, with inflation expected to approach its 2 per cent target in the coming year or two.

South Korea

South Korea's economy grew by 2.9 per cent year-on-year in the March quarter 2018, driven by strong domestic demand. Domestic demand rose, as job and wage growth accelerated, and the property market improved. Private consumption is expected to benefit from a recent rise in the minimum wage, and government support for employment and social programs. Investment growth is expected to remain positive, and net exports are also expected to contribute to growth.

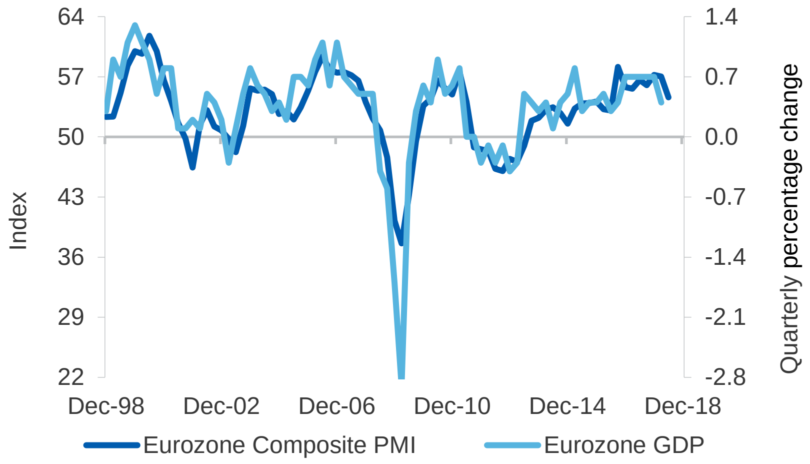
Economic growth is forecast to slow to 3.0 per cent in 2018, 2.9 per cent in 2019, and 2.8 per cent in 2020. While they appear to have started well, a failure in implementing the agreements signed between the US and North Korea at the Singapore summit could impact South Korean confidence.

Europe

The Eurozone economy grew by 2.9 per cent year-on-year in the March quarter 2018, largely driven by increased private consumption and investment. The latest Composite PMI readings points to another relatively soft GDP result in the June quarter 2018.

In May 2018, the Eurozone's manufacturing PMI continued to slide from its 3-year high of 60.6 in December 2017, falling to 55.5. Severe cold weather and some other temporary factors, such as an inconclusive German elections that spread over five months, were the main contributing factors to the fall. Despite this decline, the Eurozone's PMI is still well above 50 —

Figure 2.9: Eurozone Composite PMI and Real GDP



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

indicating that sentiment among manufacturers is positive. Economic growth is forecast to be at 2.5 per cent in 2018, before declining to 1.8 per cent in 2020. Moderate but sustained rises in wages and recovering asset prices, are expected to boost household incomes and wealth.

In the United Kingdom, GDP grew by just 0.1 per cent in the March quarter 2018. Economic activity is expected to rebound as winter weather disruptions recede. With inflation continuing to edge down, the Bank of England is under less pressure to tighten monetary policy.

In Italy, the new coalition government — the 5-Star Movement and Northern League — was formed in June 2018 after three months of political deadlock following inconclusive March 4 elections. The Italian Government has vowed to overhaul European Union (EU) rules on budgets and immigration.

In Germany, concerns are growing as Chancellor Angela Merkel's Bavarian allies threaten to defy her by implementing a plan to limit immigration. The decision is likely to destabilise the three-month old coalition government.

Another concern in Europe is the worsening economic and financial conditions in Turkey. The country's currency (the Lira) has depreciated by more than 17 per cent against the US dollar since the start of 2018. Turkey's central bank has raised interest rates sharply to try to stop the Lira from falling further. The President is planning to take more control over monetary policy following his election victory in June 2018. This intervention is expected to cause more concern to local and global investors. Turkey's inflation and interest rates are high, at 10.85 and 8 per cent, respectively. It has one of the largest trade deficits in the G–20 groups of nations.

India

India's real GDP growth rate rose to 7.7 per cent in the March quarter, as the economy recovered further from temporary disruptions related to the currency exchange initiative — which abolished high value currency notes in November 2016 — and the rollout of the goods and services tax.

A major recapitalisation plan for the public sector banks is now underway, which seeks to accelerate the work out of non-performing loans. Legal improvements are also coming into effect through new insolvency and bankruptcy laws. India still has reform challenges in its labour market and education systems, and also significant room to reduce trade barriers and deregulate the economy. Import tariffs in India, at about 15 per cent, are above average for the region.

Table 2.1: Key world macroeconomic assumptions

Per cent	2017	2018[a]	2019[a]	2020[a]
Economic growth[b]				
Advanced economies	2.3	2.5	2.2	1.7
United States	2.3	2.9	2.7	1.9
Japan	1.7	1.2	0.9	0.3
Eurozone	2.7	2.5	2.1	1.8
Germany	2.5	2.5	2.0	1.5
France	1.8	2.1	2.0	1.8
United Kingdom	1.8	1.6	1.5	1.5
South Korea	3.1	3.0	2.9	2.8
New Zealand	3.0	2.9	2.9	3.0
Emerging economies	4.8	4.9	5.1	5.1
Emerging Asia	6.5	6.5	6.6	6.5
ASEAN-5[d]	5.3	5.3	5.4	5.4
China[e]	6.9	6.6	6.4	6.3
Chinese Taipei	2.8	1.9	2.0	2.0
India	6.7	7.4	7.8	7.9
Latin America	1.3	2.0	2.8	2.8
Middle East	2.2	3.2	3.6	3.5
World[c]	3.8	3.9	3.9	3.8
Inflation rate[b]				
United States	2.1	2.4	2.2	1.9

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

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