

## 2019 IMF/WB Fall Annual Meetings – Geopolitical issues restrict capacity of policymakers to react

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- **Global economy is slowing down, but not falling into recession yet**
- **Nevertheless, uncertainty generated by geopolitical risks, along with other idiosyncratic and structural factors are limiting the capacity of economic policy to work**
- **Monetary conditions will continue to ease, but central banks' leeway is narrowing, with enough space for fiscal policy, particularly in some economies**
- **In the medium-, and long-term, global economy faces challenges having to do with productivity, sustainability, and technological change**

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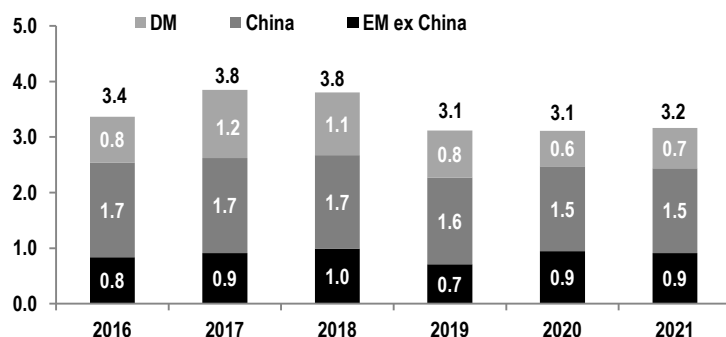
**Banorte delegation in DC.** As every year, a delegation made up by some members of the Banorte research team participated in the International Monetary Fund/World Bank Fall annual meetings. This time, the meetings took place in Washington, DC. In this note, we present our takeaways from the conferences and meetings held by the IIF (Institute of International Finance), S&PGlobal, Euro50 Group “75<sup>th</sup> Anniversary of Bretton Woods” event, and the G30 breakfast, as well as conversations with global investors.

**Very special meetings.** This year, the annual meetings were special in the sense that the IMF and the World Bank, two institutions that were born right after World War II, in the Bretton Woods global agreement, are celebrating its 75-year anniversary with both, applause and criticisms. There is no doubt that the inability of the IMF staff to foresee the global financial crisis back in 2008-2009 sent the global institution to the back seat of the world, leaving the driver's seat available for the G20 to take it. Nevertheless, the increasingly less-cooperative governments in the past few years has once again put the IMF in the front seat. Moreover, under the IMF architecture, central banks have done such a great job fighting inflation that now governments want to assign many other responsibilities far beyond their power, and beyond their remit, up to the point of risking its independence. This issue was thoroughly discussed throughout the meetings, in which the most common conclusion was that governments have never taken price stability as seriously as independent central banks. As a result, the traditional split of price stability responsibilities to central banks, and growth to governments should continue to hold.

**Global growth prospects – Softer for longer.** Consensus is that the probability of a recession is low but that the global economy will remain weak, at least from what real economic indicators are telling us. Against this backdrop, financial market indicators are pointing towards recession driving a wedge between financial conditions and the real economy, raising some concerns in terms of stability if such divergence is not reduced at some point. In this context, the general view validates IMF expectations that global economic activity is slowing down more than expected this year to 3% in 2019 from 3.2% in July (and 3.7% October last year). For next year, growth is expected to recover only slightly on the back of easing monetary conditions. The rationale here is that lower rates are bound to boost aggregate demand and that, in fact, they are creating space for fiscal policy to also support growth. Nevertheless, the concern is that geopolitical risks have created such state of uncertainty that consumption and investment plans, both in the public and the private sector, are being delayed, therefore, limiting economic expansion. On top of this, idiosyncratic factors are also playing a very important role for economic prospects in the next few years.

**We expect below trend growth in the next two years.** In this context, we expect global growth at 3.1% in 2019-2020 with a marginal recovery in 2021, as shown in the chart below. We expect contribution from developed market economies (DM), as well as from China, to come down in the next two years, while other emerging economies (EM) will briefly reduce it 0.1%-pts this year but will return to its average contributions in 2020-2021.

**Global growth prospects**  
% contribution

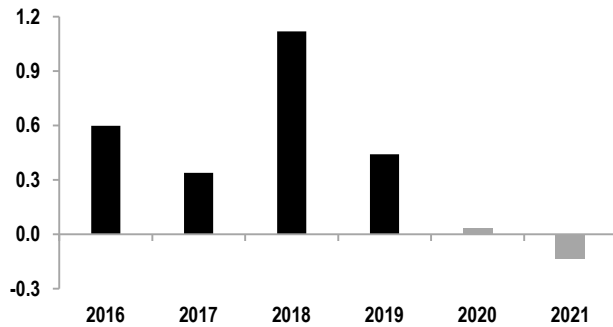


Source: Banorte with data from Bloomberg

**Soft landing is a more likely scenario than a recession for the U.S. economy.** In the case of the U.S., even though consumption has remained strong, investment has been subdued. Looking ahead, growth rates are expected to moderate to below trend levels in the next couple of years, which some analysts consider that it is just a reversion to trend as the fiscal thrust is ebbing away, as shown in the chart below on the left. We tend to agree with that outlook with the economy moderating its expansion from 2.3% this year to 1.7% in 2020, which would be both below the long-term trend and the average growth in the last five years (see chart below on the right).

### U.S. fiscal thrust

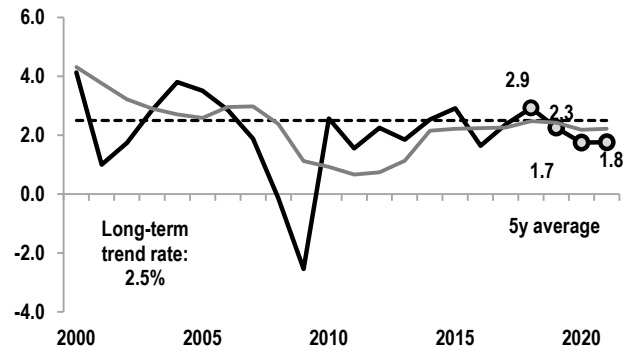
Change in primary balance\* as % of potential GDP



Source: Banorte with data from IMF Fiscal Monitor  
\*Cyclically adjusted primary balance

### U.S. GDP forecast

% y/y



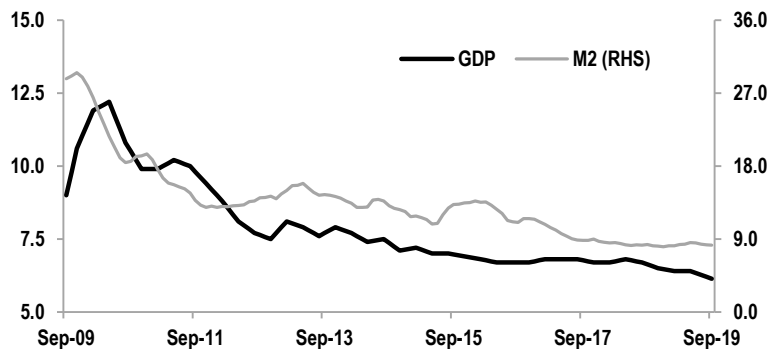
Source: Banorte with data from BEA

**Growth in China will remain subdued in the next few years.** Even though there is the idea that tensions with the U.S. have taken a toll to growth rate, which passed from 6.7% at the beginning of 2017 to 6 % in 3Q19, the lowest rate of expansion since the 90's, the Chinese economy was already slowing down before the trade war. Such trend is explained not only by structural reforms -aiming among others to create a sustainable financial system-, but also by measures taken by the government to avoid bubbles in the financial sector.

**Prudent monetary policy.** In this context, the central bank (PBoC) has been very cautious and prudent, not responding as aggressively as expected to trade tensions, as its main concern remains leverage levels along with shadow banking and housing sector risks. Nonetheless, the central bank has allowed the depreciation of the currency in the face of the increases in tariffs, being even labeled by the American government as a '*currency manipulator*'. Looking ahead, we expect the Chinese economy to show rates of growth of 6% in 2020, while we cannot rule out other monetary policy actions soon that would include, among others, cutting the central bank's lending facility rate and reserve requirements ratios (RRR).

### China GDP and M2 growth

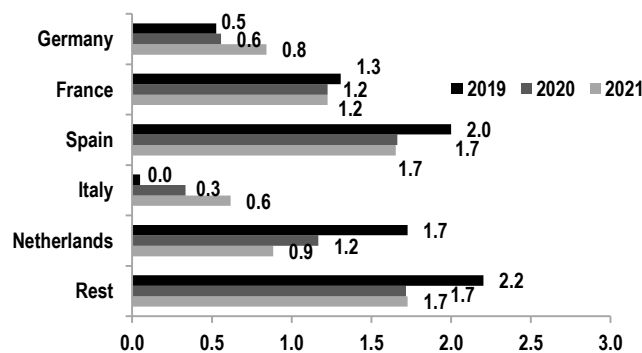
% y/y



Source: Bloomberg

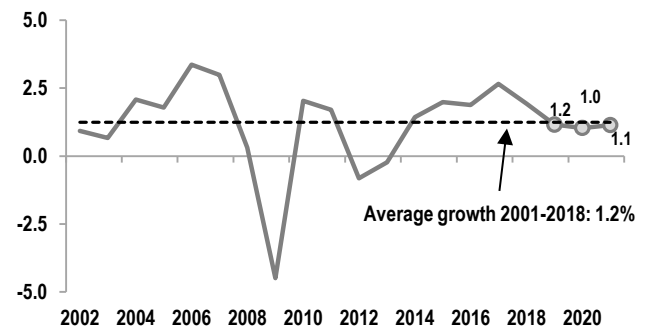
**In the Eurozone, prospects seem to be slightly positive, despite recent softness.** Such optimism comes on the back of the idea that Germany has enough fiscal space to boost economic activity, while the rest of the region is showing positive dynamics. Nevertheless, risks are on the downside as it is still to be seen if (1) Germany uses its fiscal space and (2) the decision of President Trump to apply tariffs on the auto-industry is still pending. We expect the German GDP to fall into the definition of recession (two consecutive quarters with negative growth) in the third quarter of this year. In addition, we think the new government in Italy is going to increase confidence levels promoting a slight recovery of economic activity, while the rest of the countries in the region will moderate slightly, as shown in the chart below on the left. We are forecasting economic growth at 1.2% this year, to then expand around 1% in the next two years (see chart below on the right).

**Growth forecasts in Eurozone's selected countries**  
% y/y



Source: Banorte with data from Eurostat

**Growth prospects in the Eurozone**  
% y/y



Source: Banorte with data from Eurostat

**Finally, prospects for Latam economies are probably the least positive.** On top of country specific shocks, such as the case of Argentina and more recently Ecuador, growth in the two largest economies in the region, Brazil and Mexico, -which account for a bit more of 60% of regional GDP-, is stalled. Expectations for next year are that these two economies will observe only a mild recovery, which will set the tone for the whole region.

**Geopolitical risks are the main factor for a cautious global outlook.** As we have already mentioned, geopolitical issues have increased levels of uncertainty, thus limiting the ability of policy decision making. Among others: trade wars, *Brexit* and Middle East tensions.

**Trade tensions reduced, but not gone.** Everybody welcomed the first hints of an agreement between China and the U.S. but agreed in the fact that trade is just the sideshow to a more critical geopolitical issue that is mainly related to technology transfer. As China keeps slowing down, it will need to increase productivity levels, for which it needs Western technology. In this context, even though tensions seem to have ebbed away, nobody thinks negotiations will be over soon. Apart from China, it is worth noting that USMCA still needs to be ratified by U.S. Congress while Europeans are concerned about possible tariffs on auto industry.

**Tensions in the Middle East.** After September's drone attacks to Saudi Aramco plants in Abqaiq and Khurais, tensions seem to have receded, revealing the unwillingness of both the U.S. and Saudi Arabia to engage in military action with Iran. Moreover, Saudi Arabia remains vulnerable from the domestic side as Crown Prince Mohamed bin Salman will probably face domestic pressure regarding the Yemen war and other of his initiatives in Syria and Iraq. Instability in this country poses a risk to global oil supply. In this context, sanctions have hurt Iran a lot, but not as much as it was thought. The economy has stabilized although there has been strong damage to exports, trade balance and fiscal accounts. During 2019 the economy will fall into negative territory and inflation is at 43%. In this context, Iran's decision-making is random and if the U.S. extends sanctions this could motivate additional provocation, escalation and, once again, oil supply disruption in the region.

In the meantime, Turkey's incursion into Syria was an attempt by President Erdogan to confront the Syrian Kurds and prevent a Kurdish-controlled continuous border with Syria, defusing attention from his weakened domestic position. The impact of U.S. sanctions has had a very negative effect on the Turkish economy, making it difficult for the central bank to continue cutting rates as the currency and other financial assets could suffer even further.

**Brexit unfolding during the discussions.** Uncertainty surrounding *Brexit* continues to be high and, although it was mentioned as one of the main geopolitical risks, events were taking place during the event, so no conclusions were reached. In this context, the general view was that no matter what the outcome is, it seems that other countries that were thinking about getting out of the EU are no longer interested in doing so. In the meantime, the initial impact on both regions is thought to be negative.

**Is there light at the end of the tunnel for the UK?** After Johnson's defeat in the UK Parliament on Saturday, he wrote a letter to the EU asking for an extension of the exit date until January 31, as the *Benn Act* stipulated. Nevertheless, he will still try to get the UK out of the UE at late October, pushing legislation needed to implement his deal through Parliament in less than two weeks. The *Withdrawal Agreement Bill* will start its process probably next week, not without the prime minister trying first to call for another vote on the exit agreement as soon as Monday.

**Are economic policies exhausted?** One of the main discussions in almost every conference was the role of monetary and fiscal policy and how far can they get to deliver more economic growth. The general view is that, while the former has been doing all the job in recent years, fiscal authorities have been more than cautious. Against this backdrop, softer financial conditions have not necessarily passed on to real economy, so the question now is how much room is left for monetary policy instruments. The most common answer to this question, particularly in those countries where central banks have been easing monetary conditions, was that the room to maneuver in the case of an adverse shock is limited. The main issue here is the opportunity costs of using monetary policy, particularly in terms of possible risks building up in terms of financial stability.

**The Fed has more room to cut the reference rate.** Consensus expects another rate cut in October, in line with our own expectation, but the scenario looking ahead has become more uncertain, amid lower trade tensions but with softer economic data and the absence of inflation pressures. In this context, the FOMC remains under a *risk management* mode, trying to maintain the expansion, given the narrow leeway they have now vs. other episodes. It is worth noting that in the previous two recessions, the FOMC lowered rates in about 500-520bps while right now they only have 187.5bps left. In terms of other unorthodox measures, such as asset buying programs (QE), political arguments against weigh more than economic rationale.

**Monetary policy is exhausted in the Eurozone.** There is a wide consensus that the ECB has exhausted monetary policy as an instrument to boost growth, among others given that population has aged, and consumer patterns are changing. Analysts consider that in Europe there is plenty credit availability with negligible impact on growth prospects, while at the same time negative rates could be building up some sources of instability. In this context, European financial system has the challenge of developing alternative sources of financing, such as the integration of capital markets as European banks finance about 75% of the economy vs. 25% in the US.

**Mexico – Fiscal hawks fixing Pemex, and prudent easing stance.** In our view, the three main takeaways investors got from the Mexican government delegation, led by Ministry of Finance Herrera, as well as central bank Governor Díaz de León and two Vice Governors (Espinosa and Guzman) were: (1) Fiscal responsibility is a reality and that this will continue to be one the current administrations' characteristics; (2) the government is fixing Pemex' financial structure so they can focus on increasing crude oil output. In this context, Herrera stressed that the recent liability management operations significantly improved the state-owned company's debt maturities profile and the government capital injections to Pemex should clear investors' doubts about the oil company's debt repayment capabilities. As a result, the 1.9 million barrels per day target for FY2020 will be the first annual increase in the past 14 years; and on the central bank side, (3) we perceived that while Governor Díaz de León and Vice Governors Espinosa and Guzman are not pre-committed to any particular policy ahead -due to the current global uncertainties-, increasing the current easing cycle pace to 50bp is not part of their current plans.

**Medium and long-term challenges for the global economy.** Apart from short-term issues, discussions also took place regarding more structural issues, such as: (1) How to increase productivity; (2) sustainability; (3) technology; and (4) regulation. In the first case, with aging population, both in developed and some emerging economies, along with technology disruption, countries need to find ways to improve productivity levels in order to increase long-term growth prospects. In this context, structural reforms continue to be necessary, amid persistently weak medium-term growth and limited fiscal space in some countries. Nevertheless, while the economic rationale behind reforming is clear, the political impact is less settled, as reforms entail a trade-off between short-term pain in some sectors and long-term benefits. This takes place in a context in which those affected may be highly vocal and organized, making politicians hold back on reforms amid fears of being penalized at the ballot.

In terms of sustainability, climate change and other social criteria are increasingly affecting everyday life decisions. The financial system plays an important role in this area as, by integrating environmental and social risk into their own models, they can deliver mechanisms that protect nature and drive sustainable business practices.

Regarding technological change, while it is widely recognized that new players, such as *Big Tech* companies, could deliver efficiency gains, at the same time they also pose some systemic risks. In this context authorities need to consider measures to mitigate such risks. In the financial sector for example, *big cloud* firms are rapidly emerging as key infrastructure providers to banks, raising the question over whether they should be supervised similarly to other institutions in the sector.

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