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Harr's View

Spring is in the air

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Good evening all

Today, I reflect on my trip to the IMF/World Bank spring meetings in Washington this week and highlight where our views differ from the views of the Fund. The sentiment at the meetings was naturally different from last spring, when the global economy was at its peak. Nevertheless, I still found the mood cautiously optimistic, as there was a perception that policymakers have the room to react to the recent downturn and that there are green shoots in the global economy. IMF's Chief Economist Gita Gopinath articulates the situation well when she says that 'this is a delicate year for the world economy'. In my view, the global economy is at a 'T-junction', to use Mohamed El-Erian's term, and the actions of policymakers, companies and households will determine the road ahead.

The IMF expects global growth to be weak in H1, but to rebound in H2 supported by the stimulus in China and the easing of global financial conditions on the back of the Fed's substantial policy shift. Sentiment should also improve in Germany as car production rebounds following the emission debacle last year. **We expect global growth to pick up speed in Q2 supported by the rebound in China and rising expectations of a US-China trade deal.** This week, we received a new set of strong Chinese data and we believe that a US-China trade deal will emerge within 4-6 weeks (see our China economist Allan von Mehren's comment *here*). Interestingly, hard data in the Eurozone such as industrial production in Germany, France and Italy is rebounding (supported by China). **I am confident that the global economy will experience a modest cyclical recovery in the next couple of quarters.** In the Eurozone, the IMF stresses the fiscal easing in Germany this year as a supportive growth factor, where the drop in Germany's structural government balance is the largest since 2010. Jens Weidmann, the Bundesbank President, said on Friday that it estimates the impact on 2019 GDP to be between 0.25% and 0.50%. In my view, Germany could ease further, but this year's stimulus is a step in the right direction. Encouragingly, it appears that there is a change in the public debate in Germany, as people recognise that growth is weak.

As such, we expect that global and Eurozone growth will pick up speed sooner than the IMF believes, but my concern is with the medium-term outlook. The IMF forecasts that global growth will return to 3.6% in 2020 from 3.3% in 2019, but I do not believe the IMF has high confidence in those forecasts. First, the call for stronger growth in 2020 partly predicates on a stabilisation in crisis-hit economies such as Argentina (where CPI is above 50%) and Turkey. Such forecasts are highly uncertain, as the IMF knows. Instead, I believe that lower growth in China, US and Japan in 2020 will dampen global growth. Second, the IMF forecasts Italy's budget deficit will reach 3.4% in 2020, which assumes that the government fully implements the planned pension reform, citizen income and public investment, while the Fund assumes that the government postpones the VAT hike in line with recent years. **I believe that Italy's fiscal challenge and a possible clash with Brussels will return as a market theme in the autumn, when the Italian government has to submit its 2020 budget to the EU.** Third, the Fund believes that trade tensions are likely to remain in place even in the case of the US-China deal. This week, Trump threatened to impose tariffs on USD11bn of EU goods, while the EU has drafted a list of USD12bn of US goods, which could face tariffs. Finally, this week's medium-long Brexit extension does not eliminate the risk of a hard Brexit, which suggests that the current stock-piling and postponement of investment projects by UK-related companies are set to continue.

The IMF continues to believe that inflation will edge higher in advanced economies, similar to other large official institutions such as the ECB and the Fed. In the US, the IMF believes core PCE will rise above 2% in 2019, while the Fund expects that wage growth in Germany will continue to edge higher during 2019. In my view, the case for higher inflation in the US and the Eurozone should improve in coming quarters, as demand returns. In this regard, I note that US 5y5y inflation expectations are currently close to the highest level since December, which reflects the sharp policy shift by the Fed. The Fed reacted very fast to the market collapse in December last year and some of the IMF people I met argued that perhaps the US central bank reacted too fast given the green shoots in the economy, while markets might become too reliant on a 'Fed put'. The IMF believes that the Fed will raise rates in H2, while the ECB will most probably not need to do more than delay rate hikes. There is an active debate in the ECB about a tiered deposit rate system, but it cannot be a subsidy to selective banks (see our pieces *here* and *here*). The IMF believes that the ECB would be willing to restart QE, but the inflation outlook will need to get a lot worse for it to consider that. In case the ECB restarts QE, it could buy lower rated corporate debt, bank bonds and equities. Finally, the IMF views a sudden sharp tightening of financial conditions among the most significant risks to the global economy and financial system. The next crisis is going to be very different from the previous ones, as risks have migrated to the corporate sector and non-bank financial institutions, while sovereign vulnerability remains elevated in many countries.

That was all for today's comment. I wish you a great Sunday night and coming week, best regards, Thomas

Disclosures

Danske Bank A/S ('Danske Bank') has prepared this research report. The author of this research report is Thomas Harr, Global Head of FI&C Research.

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