TOP 10

Economic Predictions for 2018

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The global economy finally broke out of the doldrums in 2017, putting to rest persistent fears of “secular stagnation.” The best performance since 2010 was the result of more rapid growth in the US, Eurozone, and Japanese economies. Emerging markets also contributed to faster global growth, as some of the worst-hit economies (e.g., Brazil and Russia) emerged from recession. The stage is set for sustained solid growth in the world economy in 2018. IHS Markit expects global growth of 3.2% in 2018, matching the growth rate of 2017 and well above the 2.5% rate of 2016. That said, the composition of growth is likely to change. The US economy will see a further pickup in growth, with or without a tax cut. On the other hand, growth in the Eurozone is predicted to have peaked in 2017. Similarly, the recent Japanese growth spurt looks set to fade. At the same time, the Chinese economy’s gradual deceleration is expected to continue. The good news is that the recovery in the emerging world will likely be sustained. Unfortunately, there is no shortage of risks facing the world economy, but most are low-level threats. The most worrisome are policy mistakes either in the United States (e.g., a fiscal shock or a trade war) or China (e.g., a mismanaged deleveraging).

1 The US economy will sustain above-trend growth.

The US economy began 2017 on a weak note, with a paltry 1.2% growth rate in the first quarter. Since then, growth has averaged nearly 3.0%. With the strong momentum at the end of the year, IHS Markit expects growth in calendar year 2018 to be 2.6%, above the 2.3% in 2017 and well above the 1.5% in 2016. With trend growth estimated to be around 2.0%, this means that the unemployment rate will be pushed down below 4.0%. Strong economic fundamentals will sustain this above-trend growth in 2018. Financial conditions remain supportive, household balance sheets are improving (thanks to rising equity and home prices), the US dollar is off its peak (helping US competitiveness), and capacity utilizations rates are high. These are strong tailwinds for consumer spending, capital expenditures, and housing. Moreover, there are no obvious imbalances that could threaten the expansion. Last, but by no means least, if the Republican Tax Cuts and Jobs Act is passed by the full Congress, it would raise growth by about 0.3 percentage point a year from 2018 to 2020, push the unemployment rate even lower and push up interest rates and the dollar even more. This could give rise to growth challenges in 2019 and 2020.

2 Europe’s expansion will slow a little, but remain solid.

The Eurozone economy has continued to surprise on the upside throughout 2017, and real GDP growth is expected to be 2.4%—the strongest since 2007. Most of the factors that helped growth in over the past year will also support growth in 2018. The relatively tame outlook for oil prices will limit the upside for inflation, which bodes well for real income growth. Meanwhile labor markets will continue to improve. The unemployment rate fell below 9% at the end of 2017, and is expected to keep sliding. A still competitive euro and strong global growth should also help Eurozone exports. Perhaps most important of all the policy backdrop continues to be growth supportive. In particular, the ECB is expected to proceed gradually with its tapering of bond purchases through the end of 2018. Nevertheless, in the context of the still large volume of non-performing loans in Italy and Spain, tapering could become a mild headwind over the next year. Moreover, political uncertainty in both the Eurozone (elections in Italy, coalition challenges in Germany, and separatist pressures in Spain) and the United Kingdom (the risk of a “hard” Brexit) could further undermine growth. As a result, IHS Markit expects Eurozone growth to ease to 2.2% in 2018, while UK growth will drop from 1.5% in 2017 to 1.2% in 2018.

3 Japan's growth spurt will fade.

Since the beginning of 2016, Japan has enjoyed seven quarters of uninterrupted growth—for the first time since the 1999-2001 period. Moreover, after three weak years, in 2017 Japanese growth quickened to an above-trend rate of 1.8%. While the economy will continue to grow in 2018, the momentum will ease relative to 2017. The weak yen (pushed down by wider US-Japan interest rate differentials) is likely to support exports and tourism, but this could be offset by softer growth in Japan's major trade partners, especially China. On the other hand, domestic demand will remain resilient. Consumer spending growth is likely to remain moderate but steady thanks to tight labor demand and increasing wage growth. Rising capacity utilization and the need to offset labor shortages will boost capital expenditures. Additionally, infrastructure projects ahead of the 2020 Olympic Games will support capex. Modest stimulus added about 0.3 percentage point to growth in 2017.But continued growth in exports and resilient private demand means that the government is unlikely to renew stimulus in fiscal year 2018. As a result, IHS Markit believes that Japan's growth will soften to 1.2% in 2018.

4 China's momentum will weaken.

China's economic stabilization in 2017 was mostly driven by government stimulus. Nevertheless, the fundamental problems of excess industrial capacity, debt overhang, and a housing glut have remained unresolved. The Chinese government will continue to address these problems through the ongoing "Supply Side Structural Reform" program, which is Xi Jinping's centerpiece economic reform policy in the near-to-medium term. The regulatory crackdown on shadow banking, sanctioned by Xi, will also continue in 2018. These structural problems and the government's policy response will be a drag on the economy, in general, and investment demand, in particular. Due to the structural factors that encourage a high saving rate, consumer spending growth will be insufficient to offset investment demand weakness. A wildcard in the 2018 outlook is whether the Chinese government will go to the stimulus well once again when growth slows. Thanks to stable labor market conditions, it appears that financial crisis prevention outweighs a moderate growth slowdown, in the Xi government's current calculus. A moderate weakening in China's growth momentum in 2018 thus appears to be in the cards. IHS Markit predicts that China's growth rate will diminish from 6.8% in 2017 to 6.5% in 2018.

5 The improved performance of the emerging world will be sustained.

At 3.9%, emerging-market growth in 2016 was the weakest since the Great Recession. Since then, the external environment for these economies has improved. In particular, growth in the developed world has picked up considerably and commodity prices have risen by more than 60% since the beginning of 2016. As a result, emerging-market growth rebounded to 4.8% in 2017. IHS Markit predicts this growth rate will be sustained in 2018. While the global environment will continue to be growth-supportive, and while some countries will see stronger growth in 2018, other countries and regions will face challenges, and growing debt burdens could become a risk for many of these economies. In Asia, India will recover from its twin policy shocks of demonetization and the imposition of the goods and services tax. At the same time Indonesia, Malaysia, the Philippines, and Vietnam will sustain 5.0–6.5% growth. Most of the economies in Latin America will also see also better growth in 2018. On the other hand, Emerging Europe will see slower growth, due to overheating and labor shortages. In the Middle East, the recovery from the oil slump will be slow and in Sub-Saharan Africa the big economies (Angola, Nigeria, and South Africa) will struggle to expand more 1%.

6 With the rally over, commodity prices will be range-bound and volatile.

After surging 44% in 2016, the IHS Markit Materials Price Index rose 17% in 2017. For a number of reasons, we see no big increases in 2018, and potentially a lot of volatility. First, China's growth is likely to slow this year and its composition is shifting in favor of services. Second, the winding down of loose monetary policies in the developed world and the deleveraging in China's economy will limit the upside on raw materials prices. Third, a still strong and mildly appreciating US dollar will also act as a constraint. Finally, with little upward pressure from oil prices, other commodity prices are unlikely to sustain rallies. While oil prices rose at the end of the year, and while OPEC and Russia did agree to extend production limits through December 2018, continuing growth in non-OPEC liquids (especially US tight oil production) will keep a lid on prices. That said, geopolitical risks (Iraq, Kurdistan, Iran, Venezuela, Saudi Arabia, Yemen, Qatar, etc.) could be a source of upside pressures. Barring such risks, the average price of Brent crude in 2018 (around $56 per barrel) is likely to be only a little higher than the average price in 2017 (about $54 per barrel).

7 Upward pressures on inflation will remain muted.

Over the past two years, the pattern of inflation in the world has been affected by puzzlingly low rates of price increases in the developed world and, at the same time, a surge in inflation in the emerging world. The latter has been the result of hyper-inflation in a few countries (e.g., Venezuela and Zimbabwe) and a broader response to the lagged effects of higher commodity prices and depreciating currencies. Recent evidence points to a (very) gradual increase in developed-economy inflation rates as output gaps continue to close, and as the disinflationary impacts of falling commodity prices dissipate. Nevertheless, structural factors such as technology and globalization will probably prevent any sharp rise in inflation. Moreover, it will be a few years before inflation reaches or exceeds the 2% target of central banks. In the US economy, there are growing indications that a very tight labor market is translating into a modest uptrend in wage inflation. In the emerging world, inflation rates have fallen and will continue to decline, thanks to more stable commodity prices and currencies. All told, inflation will slowly drift up in the next couple of years in the developed world and keep falling in the emerging world.

8 The Fed will keep raising interest rates—some other central banks may follow.

After the mid-December rate increase, the Federal Reserve is on track to hike interest rates another three times in 2018 (expected in March, September, and December). However, there is a chance that the Fed may raise interest rates more. To begin with, concerns about overheating may intensify, given strong growth and an unemployment rate that is expected to keep falling. In addition, the enactment of a large tax cut will probably further boost growth and put more upward pressure on inflation in 2018 and 2019. Thus, additional rate hikes in the next couple of years cannot be ruled out. Meanwhile, the European Central Bank and the Bank of England are unlikely to raise interest rates until 2019, and the Bank of Japan will wait even longer. The only other major central bank expected tighten in 2018 is the Bank of Canada. Outside the G7, countries with currencies pegged to the US dollar (Hong Kong, Singapore, and the Gulf States) will have little choice but to follow the Fed. Also, given strong growth rates, a number of Asian economies can be expected to tighten further in 2018, including India, Indonesia, Philippines, and South Korea.

9 The US dollar will be pushed up a little more.

After the rollercoaster ride of 2017, the dollar is likely to get nudged higher in 2018—although depending on political developments, volatility could also remain high. There are at least three reasons why the pressure on the dollar over the next year will be mostly upward. First, the Fed is well ahead of most other central banks in its tightening cycle. This means that, for the most part, interest rate differentials will be widening in 2018. Second, as US growth picks up in 2018, and as the growth rates of the Eurozone, Japanese, and UK economies slip, at the margin, investors will refocus on the US assets. Finally, the enactment of the US tax bill will further boost investor confidence in the United States and will probably result in higher growth and interest rates. Limiting the rise of the dollar will be the large US current-account deficit (growing in absolute terms, but stable as a share of GDP) and large current-account surpluses in other parts if the world, including Europe. IHS Markit predicts that, on a trade-weighted basis, the dollar will rise 2–3% over 2018. For the euro-dollar rate this means around $1.15 at the end of 2018, compared with around $1.19 in early December 2017.

10 With global growth momentum strengthening, and assuming no policy mistakes or “black swans,” the risks of a recession remain low.

Since the global expansion is now stronger and more synchronized, and with muted inflationary pressures, derailing it would require a large shock. The list of such shocks is long, but the probability of the any of them doing serious damage in 2018 is low. The Fed—or for that matter any other major central bank—is unlikely to raise interest rates high enough in the next year to kill growth. It is possible the major tax cut being contemplated by the US Congress could push up growth and inflation enough to make the Fed nervous, but any policy “clash” in the United States is probably a couple of years away. Deleveraging in China is fraught with risk, but the prospect that the Chinese government would do anything to seriously harm growth is remote. An oil shock is always possible, but with US and other non-OPEC oil production rising, it would take major geopolitical event in the Middle East to disrupt oil markets in a big way. And while the risk of a trade friction is uncomfortably high, the chances of an out-and-out trade war are low. Bottom line: the odds of a recession in 2018 are still low.