



Global Economic and Financial Outlook

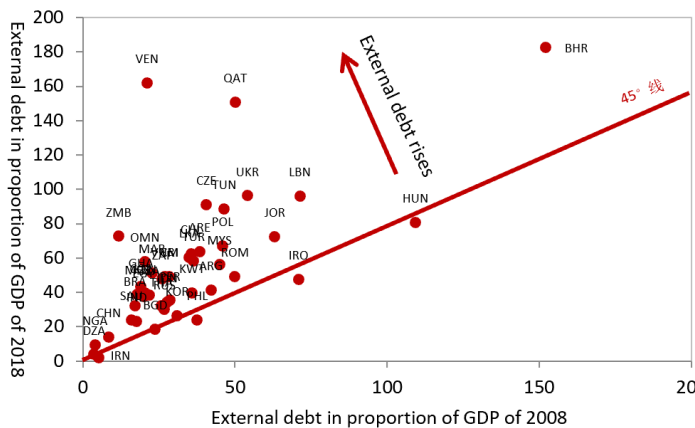
2018Q4 (Issue 36)

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Highlights

- In the third quarter of 2018, the divergence of global real economy became more noticeable. The growth rate of US economy remained high, while the impact of trade friction began to appear in Europe, Japan and emerging economies.
- In the future, the global economy will face the multiple challenges of trade decline, inflation rise, liquidity contraction, financial fluctuation of emerging economies, etc.
- Financial turbulence occurred in many emerging markets typified by Turkey. Emerging market countries will face more challenges against the backdrop of consistent appreciation of US dollars and constriction of external financing.
- Protectionism has spread gradually from the field of trade to investment, which slowed the growth of global FDI, and more seriously, will even threaten the economic recovery. The risk of examination generalization and rule fragmentation rises.
- US currently is in mid-late period of economic cycle. Loose fiscal policy, contractionary monetary policy, resulting government debts, etc. have become potential risk.

The change of external debt in the main emerging economies in last 10 years



Source: IIF, BOC Institute of International Finance

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Global Economy Faces a Variety of Challenges

-- Global Economic and Financial Outlook (2018 Q4)

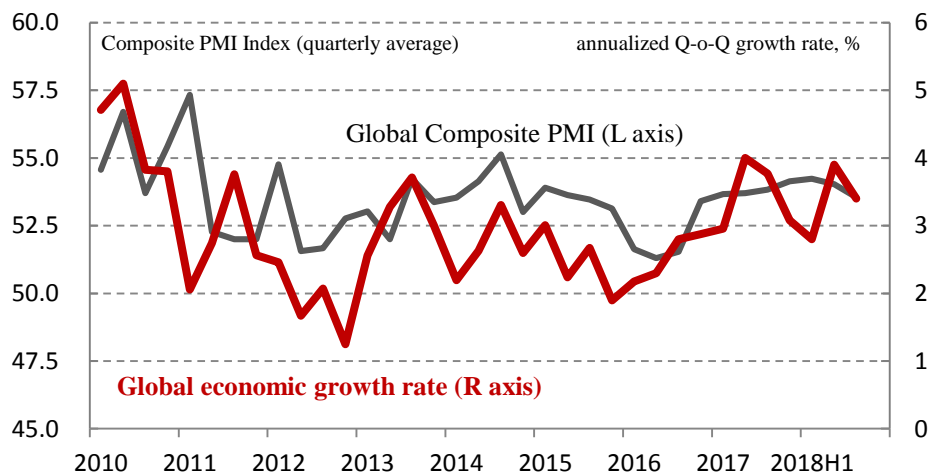
Global economies showed divergent recovery trends in the third quarter of 2018. The US economy grew strongly, the Eurozone and Japan maintained mild overall growth in spite of slight slowdown, and some emerging economies were losing momentum. Looking ahead, we anticipate a world economy challenged by various factors such as declining trade, rising inflation, global liquidity crunch and financial volatility in emerging economies.

I. Global Economic Review and Outlook

I.1 The global real economic recovery is becoming increasingly divergent

Since the beginning of 2018, the global real economic growth has shifted from last year's Europe-US resonance to divergent recovery trends. This situation became even more notable in the third quarter. The United States maintained a high growth rate, while the impact of trade frictions began to show up in Europe, Japan, and emerging economies. Non-economic factors such as geopolitics and US sanctions became an important trigger for financial market fluctuations. In August, JPMorgan Chase's global composite PMI index was 53.4, down 0.3 ppts from the previous month. Manufacturing PMI and service PMI were 52.5 and 53.5 respectively, down 0.3 and 0.5 ppts from the previous month respectively, indicating weaker momentum of global economic growth. The annualized quarter-on-quarter (Q-o-Q) growth rate of the global economy is preliminarily estimated to reach 3.4% in the third quarter of 2018, 0.5 ppts down from the previous quarter (Figure 1).

Figure 1: Global GDP vs. Composite PMI



Source: Wind, BOC Institute of International Finance

I.2 Four insidious threats to the current world economy

First, trade is in decline. In the current landscape of global value chains, the trade conflicts started by the US which the owner of core technologies would cut off the global industrial chain, trigger chain reactions and weaken the growth of world trade. According to data from the Netherlands Bureau of Economic Policy Analysis (CPB), global trade volume fell by 0.8% month on month in June, down 1.5 ppts from the previous month, resulting in zero growth in global trade volume in

the second quarter. Since August, the Baltic Dry Index (BDI) has soared to nearly 1,800 and then started to fall back, down to about 1,400 in late September. CPB predicts that the volume of trade will grow by only 3.4% in 2018, down 1.5 pts from 2017.

Second, inflation is on the rise. Since 2018 began, inflation in major economies is on the rise amidst the ongoing global recovery. The US inflation rate has remained at 2.9% for two consecutive months, with the core inflation rate staying above the 2% target for five consecutive months. Inflation rose slightly in the Eurozone, with medium-term inflation expectations stabilizing at about 1.9%. In addition, WTI crude oil prices have stabilized above USD70/barrel this year to date, triggering imported inflation in oil importing countries such as India.

Third, global liquidity is contracting. Global liquidity has fallen below its pre-crisis level this year due to shrinking current account surpluses in emerging economies and the contracting balance sheet of the Federal Reserve. A global shortage of US dollars has surfaced. In the future, as the Federal Reserve continues to shrink its balance sheet and the European Central Bank may also begin to downsize its balance sheet in December, global liquidity, especially the US dollar liquidity, will be even more in short supply. However, rising inflation will accelerate the normalization of monetary policies in major countries and intensify the contraction of global liquidity.

Fourth, emerging economies experience financial fluctuations. As the US dollar continues to appreciate and financing costs rise, the balance sheets of emerging economies that have borrowed heavily in foreign currencies will be further stressed, increasing their debt burden. The continued slowdown in global trade will further reduce the foreign exchange revenue in emerging economies, widen the current account deficit and make access to refinancing more difficult to foreign debt-ridden enterprises, which may become an important factor to spark the next wave of financial turbulence.

I.3 Recovery trends and policies of major economies

The US economy is growing strongly. The annualized Q-o-Q growth rate of US GDP reached 4.2% in the second quarter, next only to 4.9% in September 2014. According to the data from the US Bureau of Economic Analysis (BEA), the effective rate of individual income tax in the US has dropped to 11.7% from 12.1% at the end of last year due to tax reform. The US unemployment rate remained at 3.9% in August, the lowest level since the subprime mortgage crisis, with a steady increase in the number of new jobs and a pick-up in salary levels. Driven by a number of factors including tax reduction, employment and salary, the personal consumption expenditure has grown at a faster speed. As for leading indicators, Sentix Investor Confidence Index retreated in September, and the University of Michigan Consumer Sentiment Index also dropped to the second lowest level in the year, indicating the US economy's lack of stamina to grow. The US combination of "easy fiscal policy and tight monetary policy" is currently unsustainable and the debt outlook and fiscal situation may deteriorate further, laying a hidden danger for the US economy. The Q-o-Q annualized growth rate of US GDP is expected to be 3.0% in the third quarter. Following its interest rate hike in September, the Federal Reserve is expected to further raise interest rates in the fourth quarter.

The Eurozone economy grows moderately. The economic growth of the Eurozone in 2018 weakened slightly from the previous year due to the high base in 2017 and increasing uncertainty in the trading environment, albeit maintaining moderate overall growth. The labor market reform sparked by the European debt crisis has yielded certain results to add more and more jobs, giving an impetus to consumption growth. In a relatively easing overall financial environment, corporate profits rebounded and the real estate market staged strong growth to jointly boost investment in the real economy. The Eurozone's GDP is expected to grow at an annualized Q-o-Q rate of 2.0% in the

third quarter. Although inflation in the Eurozone has reached 2% for three consecutive months since June, ECB believes that it is necessary to continue an easy monetary policy and the probability of raising interest rates is low by June next year.

Japan's economy is back on the rise. After a recession in the first quarter, Japan recorded an annualized Q-o-Q growth rate of GDP of 3% in the second quarter, the highest since the first quarter of 2016. Japan's pickup was driven mainly by the sharp rise in capital expenditure and the growth of domestic demand. In sharp contrast to domestic demand, however, net exports dragged down economic growth by 0.1 ppts. Natural disasters have hit Japan frequently since this summer. Floods, typhoons and earthquakes have affected the economic activities of enterprises and consumers. We estimate that economic momentum in the second quarter can hardly continue into the third quarter. The annualized Q-o-Q rate of GDP growth will be 1.4%. The Bank of Japan maintains a loose monetary policy. But its monetary policy decision made in July to conduct purchases of long-term Japanese government bonds "in a flexible manner" indicates the central bank's tolerance for temporary long-term rate rises, laying the groundwork for future normalization of the monetary policy.

Growth in emerging economies has slowed. Growth in emerging market economies has decelerated since the second quarter. In particular, the financial turmoil in some countries has highlighted their economic and financial vulnerabilities and challenged the sustainability of growth. The IIF EM Growth Tracker dropped to 4.1% in August, down 0.2 ppts from July, the lowest since April 2016. The overall growth rate of emerging markets is expected to drop to about 3.8% in the third quarter in consequence of deteriorating international trade environment, tightening global liquidity and wider exchange rate fluctuations. Some economies including Philippines, Turkey, and Indonesia have raised interest rates this year in response to the Federal Reserve's rate hikes, expected to be joined by more countries in the future. The monetary policy developments in India and other countries deserve special attention.

II. Global Financial Review and Outlook

II.1 Developed markets are relatively stable while emerging markets are more volatile

After transient turbulence in the first quarter and smooth recovery in the second quarter, global financial markets began to face new uncertainties and instability in the third quarter.

Developed markets are relatively stable, yet showing divergent performance between Europe and the US. Though the US economy is wrestling with rate hike expectations and the trade war, such factors as tax cuts, rising corporate profits and good macroeconomic performance have propelled the US stock market higher and attracted global capital inflows. Other developed economies see weaker stock market performance than the US. European companies are less profitable than their US counterparts and many of them have a big exposure to emerging markets, causing investors to be more cautious about European markets. The stock markets in developed economies have a potential risk in investors' strong optimism and large risk appetite, with the overall valuation remaining above the long-term average. This is even more obvious in the US. As the US economic expansion cycle draws to a close, the stock market will gradually show its fragile side and the cyclical stocks will be hit harder than defensive ones in the future.

Emerging markets have become more unstable and uncertain. In the context of global liquidity crunch, developed markets will rely more on foreign capital, thus worsening the capital flight of emerging markets. In addition, the risk of bank credit crunch in emerging markets is also on the rise to further deteriorate the access to financing. Historical data shows that US interest rate rise and US dollar appreciation are important contributors to the financial turmoil in emerging markets, especially to local currency depreciation and capital outflows. Many emerging economies saw their

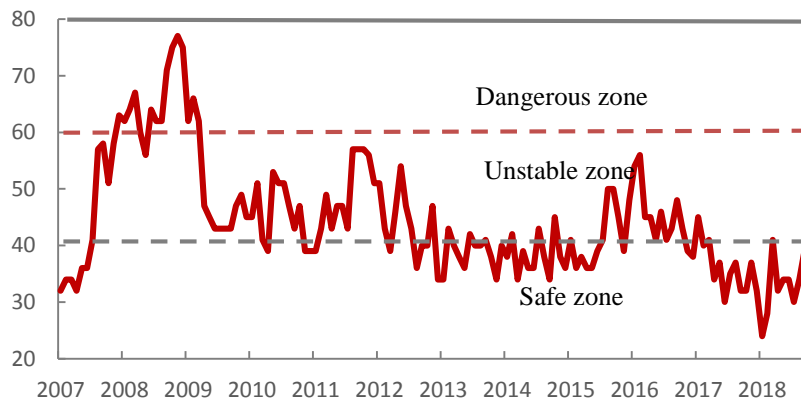
currencies falling in value in the third quarter. Some economies raised short-term interest rates sharply to curb currency depreciation and inflation, resulting in greater volatility of cross-border capital flows. Asian stock and bond markets are still showing a net inflow while European emerging markets are relatively stable. Latin America, Africa and the Middle East are most affected, showing marked currency depreciation and net capital outflows.

II.2 ROFCI stays within the safe zone despite its proximity to the unstable zone

The US risk of financial crisis index (ROFCI) was on the rise in the third quarter, with its monthly average edging up to 34.33 from 34 in the preceding quarter, still within the safe zone. But the index reached 39 in September, close to the floor of the unstable zone (Figure 2). This index reveals the following financial market characteristics: stable stock market, optimistic investors and limited risk premium; unsustainable improvements in credit risk profile of companies; stable non-financial money market and USD foreign exchange market; stabilized inter-bank capital market, moderated liquidity risk, steady-going indicators related to bank assets and liabilities, low risk of systemic defaults, and volatile bank stocks with higher risk.

The US financial market may pose a more uncertain overall risk profile in the fourth quarter mainly due to the following factors: The Trump administration has imposed tariffs on China and its allies successively; US monetary and fiscal policies and their impact are still uncertain; emerging markets are increasingly vulnerable. Given the rate hike cycle of the Federal Reserve, the confidence of financial market participants will likely be shaken by doubts about the sustainability of US economic growth and uncertainties in the cyclical economic movements. ROFCI may edge up in the safe zone and get close to the unstable zone.

Figure 2: US Risk of Financial Crisis Index (ROFCI)



Source: BOC Institute of International Finance

III. Special Research

III.1 Impact of Emerging Market Turbulence and Future Concerns

III.1.1 Impact of the current emerging market turbulence

Another wave of turbulence hit emerging markets in August 2018, leading to a slump in emerging market currencies, especially in Turkish lira. This wave of emerging market turmoil shows two evident characteristics:

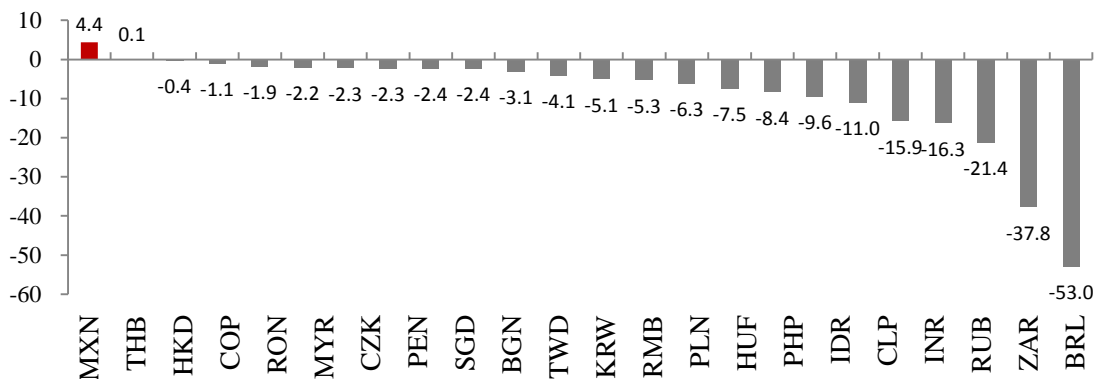
First, the turmoil was an extension of the trade war launched by the US on a global scale. As a counter-measure to Turkey placing an American pastor under house arrest, the US Department of the Treasury announced economic sanctions against Turkey's Interior Minister and Justice Minister,

followed by US President Trump’s announcement that steel tariffs with respect to Turkey would be raised to of 50% and aluminium to 20%, sending Turkish lira into a sharp decline in value against the US dollar. The Turkish lira crisis sparked financial market turbulence.

Second, the current round of emerging market turmoil was closely related to US dollar index adjustments, which is essentially a direct result of the strengthening of the US dollar in an interest rate hike cycle. The impacts of a stronger US dollar on emerging markets are as follows:

First, local currencies are under a bigger depreciation pressure. Emerging market turmoil suggests new divergent trends in the foreign exchange markets of emerging economies. Apart from the slight appreciation of Mexico’s currency against the US dollar, other major emerging economy currencies have generally depreciated in varying degrees since the beginning of the year. Six countries have seen a double-digit fall in value of their currencies (Figure 3). Brazil, India, Indonesia, Turkey and South Africa, the “Fragile Five” coined by Morgan Stanley before, are now in different regions in this currency crisis. A new fragile camp has taken shape.

Figure 3: 2018 YTD Changes in Value of Emerging Economy Currencies against USD



Source: Bloomberg

Second, capital flight has accelerated. The USD interest rate hikes have rendered previous high yield emerging economies less attractive to foreign investors and diverted more international capital into mature markets, including the US. According to the latest data, August this year became the first month of capital outflow for emerging economies since June, witnessing a capital withdrawal of USD4.8 billion. The net inflow of foreign capital shrank to USD2.2 billion, down over 80% from USD13.7 billion in July.

Third, stock markets were dragged down. As the world’s major economies have entered a monetary tightening cycle, the continued hikes in US interest rates has brought a great uncertainty to the global economic outlook. The currency crisis in emerging economies has further shattered confidence in financial markets, triggering an asset price slump and a major sell-off in the stock market. The Philippine stock market has fallen by 13.4% since the beginning of this year, compared with a fall of more than 15.4% in Greece and 16.6% in Turkey.

Fourth, economic growth was weighed down. The currency crisis in emerging economies has sent broad-based simultaneous shocks to foreign exchange markets, bond markets and stock markets through financial market ripples, adversely affecting the global investment climate and economic prospects, thus dragging on real economic activities. In addition, emerging economies

have generally raised interest rates to stabilize local currency value and ease capital flight, which will further tighten domestic credit supply and liquidity, increase cost of refinancing, and eventually worsen the debt burdens of governments and corporates.

III.1.2 Two major vulnerabilities of emerging economies

Compared with the economic conditions in the previous two rounds of financial market turbulence in 2013 and 2015, the emerging markets' fundamentals have improved and their risk resilience has been enhanced. **First**, the global economic growth has reached a decade high. According to our forecasts, the global growth rate will be 3.3% in 2018, providing a favorable external demand environment for emerging markets. **Second**, commodity prices have rebounded to benefit some countries (such as oil exporters). Brent crude oil has stabilized above USD70 since the second quarter of this year. **Third**, some resource-based emerging market countries have undergone a major correction since 2015. Emerging market economies as a whole are expected to grow at 4.9% in 2018, up 0.5 ppts from 2015. Compared with the previous two rounds of financial turmoil, therefore, in this round, emerging market turmoil is relatively mild, and investors have not rushed for a sell-off of all emerging market assets; instead, they opted for a selective sell-off based on economic fundamentals, growth prospects, fiscal conditions, credibility of monetary policy and external vulnerabilities.

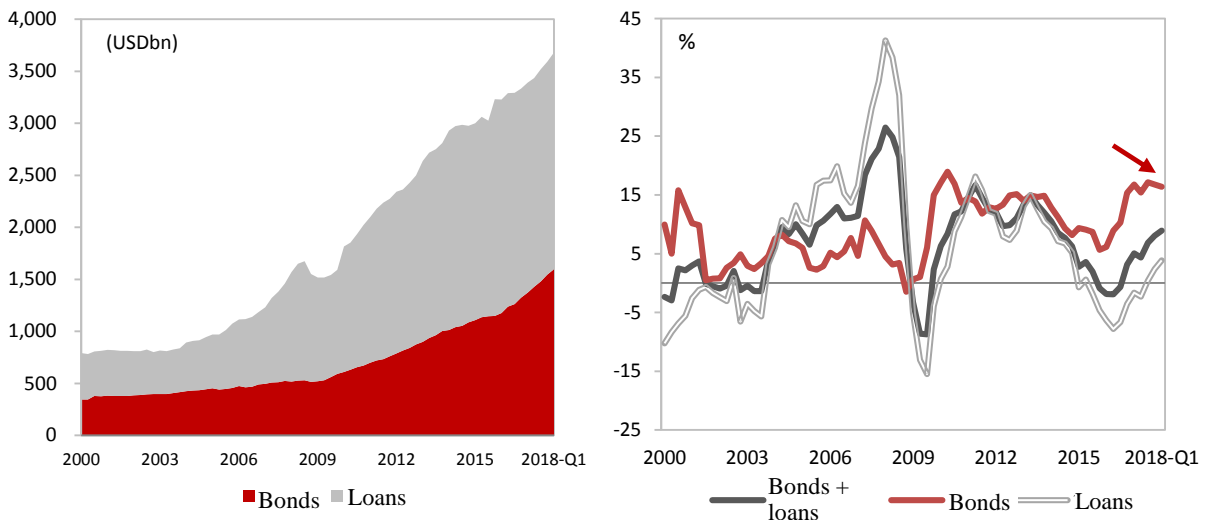
In the next stage, the main risks facing emerging markets will be escalating trade frictions, increasingly stronger US dollar and tightening external financing environment. Countries with fragile economic fundamentals, unsound policy framework, geopolitical conflicts and high domestic political risks will be further tested. **The following two vulnerabilities deserve extra attention in the future:**

First, there are structural problems inherent in some emerging economies. Some emerging economies have not fundamentally improved their inherent structural problems uncovered by the international financial crisis. For example, Turkey's excessive economic stimulus has driven up government deficits and resulted in a balance of payments deficit. Argentina's fragile economic fundamentals and high inflation levels remain long unsolved. Brazil, Russia and some other economies rely heavily on commodity exports. Their internal vulnerabilities are worsened by unclear development, simple duplication of Western political and economic systems, and political instability. The global monetary relaxation pumped massive funds into emerging economies after the international financial crisis, which boosted economic prosperity and also masked problems to some extent and delayed structural adjustments. Any escalation in internal economic contradictions will uncover risks intensively as the external situation has been changing, including the intensification of bargains between big powers, the shift of global monetary policy, and the rise of geopolitical risks.

Second, the supply model of global USD liquidity has changed. Global dollar liquidity is showing new features: the way dollar liquidity is provided is changing from bank loans to bonds. From 2016Q1 to 2018Q1, outstanding USD bonds as a share in the total USD liquidity increased from 36% to 43% (Figure 4, Left). Bond issuance changes lead the overall USD liquidity changes, with their inflection point always preceding that of overall USD liquidity (Figure 4, Right). In the future, global USD bond issuance will decline at an accelerated pace as the Federal Reserve further tightens its monetary policy. Global liquidity is expected to be tightened at a faster pace. Relative to stock investors, bond investors are more risk averse. Once the market reverses, they may take

the lead in selling off assets. Though the central banks of emerging economies hold more foreign exchange reserves than before and the macro risk of capital flow reversal has been reduced, the credit contraction of USD bonds will directly impact bond issuers. The foreign exchange reserves held by central banks can provide no immediate buffers for these enterprises.

Figure 4: Scale (Left) and Growth Rate (Right) of USD Liquidity Supply to Emerging Economies



Source: BIS, BOC Institute of International Finance

III.2 Global FDI Landscape Reshaped by Trade Frictions

III.2.1 Protectionism has spread from trade to investment

In the face of intensifying international competition, national governments have been playing policy games and wrestles in order to safeguard their own interests. As a result, the frictions in global economic and trade relations have escalated, expanding protectionism from trade to broader areas.

National governments have taken tougher protective measures to tighten foreign investment reviews. With the rising uncertainties in trade outlook, national governments are seeking more effective and even tougher countermeasures and negotiation strategies to protect their own interests. Since Trump started a trade war, there has been a marked decrease acquisitions by foreign investors: In May 2018, the Canadian government stopped an infrastructure company acquisition on national security grounds. In June, the UK government issued the *New Rules for Screening of Foreign Investments in the UK* and then immediately put a stop to the acquisition of Northern Airlines. From July to August, the German government blocked two potential acquisitions by Chinese companies. All G7 members have formulated policies on foreign investments or public interests. In particular, Japan, Germany, the UK and the US have recently issued new standards for foreign investments (Table 2). France and Germany are also planning to further strengthen their own framework for foreign investment reviews. To safeguard the strategic interests of Europe, the EU has accelerated its push for the draft review framework proposed in September 2017. Despite different opinions among EU member, it is the prevailing trend to launch the foreign investment screening mechanism.

Table 2: G7 and EU Policies on Foreign Investment Review

Country	Is there a FDI review process in place	Review areas	Review trigger		Progress and trends
			Annual turnover of investee	Equity or market share of investment	
US	Yes	No specific industry is identified; mainly targeting three types of threats: Leakage of sensitive technologies; restrictions on the supply of original materials; system data monitoring or destruction	N/A	10%	In August 2018, Trump signed into law the <i>Foreign Investment Risk Review Modernization Act</i> to expand the jurisdiction of the Committee on Foreign Investment in the US (CFIUS) to scrutinize inbound investments, imposing stricter supervision and restrictions on foreign investment in the US
Japan	Yes	Defense, dual-use, energy, telecommunications, space transportation, pharmaceuticals, agriculture, forestry, aquaculture, oil exploitation, leather manufacturing, etc.	JPY5 billion	10%	In October 2017, new standards for foreign investment review were formulated
Italy	Yes	Defense, energy supply, finance, shipping, transport, telecommunications, agricultural products, tourism, etc.	No unified rules; reviews are specific to industry	No unified rules; reviews are specific to industry	Laws were enacted in 2014 to specify the enforcing authorities and procedures for the review and restriction of foreign investments in defense and national security sectors, and to determine the scope of activities of strategic importance in defense and national security.

UK	Yes	Defense, electricity, telecommunications, media, airports, ports, financial service, dual-use, advanced technologies;	The target company has a turnover of more than GBP 1 million (formerly GBP70 million)	25%	In June 2018, the <i>New Rules for Screening of Foreign Investments in the UK</i> was passed to expand the jurisdiction over military, dual-use and advanced technologies. The UK government is seeking to significantly expand the scope of national security review without setting a screening threshold for transactions
Germany	Yes	Defense, public infrastructure, telecommunications, information sectors, transportation, etc.	No unified rules; reviews are specific to industry	25%	The German government is formulating rules for strengthening the review of foreign investments in sensitive German industries, especially defense, key infrastructure and security-related civilian technologies, is and considering further lowering the current equity acquisition threshold from 25% to 15% within the year
France	Yes	Public order and security, national defense, energy, water supply, transportation, media, etc.	N/A	33.33%; any investment of over 20% in the media sector is prohibited	The French government will adopt the revised regulations on foreign investment to further protect critical industries, especially high-tech industries. The draft regulation was completed in June 2018 and is currently under consideration by the relevant legislative bodies
Canada	Yes	Defense, culture, finance, aviation manufacturing, mining,	CAD5 million (non-WTO member);	N/A	At present, there is no new tightening policy launched

		telecommunications, fishery, energy, real estate, etc.	CAD300 million (WTO members)		
EU	The proposal has entered the legislative process	Critical infrastructure, critical technologies, supply of critical inputs and access to sensitive information or the ability to control sensitive information, which has an effect on interests of the EU.	N/A	N/A	The new proposal at the EU level is expected to be finalized by the end of 2018. It will grant the European Commission new authority to review and give an opinion on foreign investments and build a cooperation mechanism between national governments and the EU European Commission.

Source: Compiled by BOC Institute of International Finance according to publicly available data

III.2.2 Four factors have led to a downturn in global FDIs

The global downturn in transnational investments is in sharp contrast to economic recovery.

In recent years, global transnational investment has been in the doldrums and FDI flows have declined continuously, changed the previous mixed trends. The global FDI flows amounted to USD1.43 trillion in 2017, down 23% year on year, in sharp contrast to the global economic recovery. In particular, global FDI investment in developed countries has decreased significantly, especially in Europe and the US. FDI inflows to developed economies were USD712.4 billion in 2017, down 37% year on year. FDI inflows into the US dropped by 40% to USD275 billion; FDI inflows to the UK fell by 92% to USD15 billion.

Overall, the global FDI downturn stems from the following four deep-seated factors:

First, the global return on investment continued to decline. The continuous decline in global return on investment in recent years has weakened the willingness and enthusiasm of enterprises to invest abroad, casting a shadow onto the long-term FDI prospects. The global average return on foreign investment was 6.7% in 2017, lower than the level of 8.1% in 2012. In particular, the return on investment generally showed a downtrend across regions, with Africa, Latin America and the Caribbean seeing the largest drop in return on investment.

Second, global economic and trade tensions are on the rise. Protectionism has become the biggest threat to the global economic recovery. De-globalization hinders trade, investment, monetary and financial ties between countries, resulting in increased economic and trade frictions and stifling FDI investment. Trade tensions have escalated rapidly in 2018. The trade war started by the US has rendered market prospects more uncertain, making global enterprises more cautious about long-term cross-border investment.

Third, the host countries' FDI review policy is stricter. Recently the host countries have taken a cautious attitude towards transnational investments and strengthened FDI reviews. Developed economies, including the US and Europe, have legislatively strengthened their FDI screening

systems. The US Senate and House of Representatives proposed reforming the Committee on Foreign Investment in the United States (CFIUS). The European Commission proposed strengthening the review of mergers and acquisitions by foreign investors. These moves will add uncertainty and difficulty more or less to transactions.

Fourth, the division of labor along global value chains has slowed down. There is a positive correlation between global value chains and FDI. The slowing expansion of global value chains has curtailed FDI growth to some extent. The United Nations data on global value chains show that the participation in global value chains by either developed or developing economies has started to lose momentum in recent years. Foreign added value accounted for 30% of global trade in 2016-2017, down 3 pts from the 2010-2012 level. In addition, as the major participants in international industrial cooperation and FDI, multinational corporations have also been retreating to show a marked deceleration in the expansion of overseas assets.

III.2.3 Outlook on global FDI landscape changes

FDI reviews tend to be generalized worldwide. The term “national security” has been redefined to be increasingly more inclusive across countries, expanding from the traditional military and defense sectors to critical technologies regarding energy, telecommunications, aviation, integrated circuits, artificial intelligence and advanced materials, and to service sectors such as finance, data utilization, user information collection and media. In addition, national governments have become even tougher on foreign investment reviews and increasingly lowered the triggers for screening acquisitions by foreign investors in certain fields, such as lowering the market share or equity ratio threshold of target companies, and even created an automatic review mechanism for specific sensitive industries. This not only increases the transaction cost of investors, but also increases uncertainty in acquisitions.

The risk of global fragmentation of investment rules is on the rise. Protectionism has spread from trade to FDI. Major economies have escalated their moves from exchange of tariffs to FDI restrictions and have set up their own review mechanisms, intensifying vicious competition in foreign investment supervision. Against the backdrop of the US trade war against China, the US frequently sets up “roadblocks” to inbound investments from China, taking advantage of multinational companies to play the role of “indirect intervener” and to deeply implement Trump’s administration philosophies. Europe has strengthened the cooperation mechanism for foreign investment reviews and strengthened the FDI dual screening system of member states against situations that may affect national security or public order. In addition, national governments impose various penalties for violation of FDI rules. For example, the French government is planning to impose a fine of twice the amount of non-complying investment or 10% of non-complying investors’ annual revenue. The risk of rule fragmentation, deep-seated in global FDIs, has become a major obstacle to long-term capital flows.

Developing countries are expected to play a bigger role in global FDIs. While both global FDIs and FDI inflows to developed countries were shrinking, FDI inflows to developing countries reached USD670.7 billion in 2017, up from 36% in 2016 to 47% as a share in global FDIs. FDIs have become one of the largest external sources of funding for developing countries. Despite the recent currency crises in Turkey and Argentina, the risks in these countries cannot substantially change the overall growth potential or economic vitality of developing countries. In terms of growth momentum and return on investment, many developing countries, especially the Asian region, are still significantly attractive to FDIs. China’s Belt and Road Initiative also provides a broad-based platform for global capital. Some countries like China firmly uphold globalization and multilateralism by accelerating opening-up and providing a better business environment for foreign investors.

III.3 How Long Will the US Economy Remain on the Fast Track of Growth?

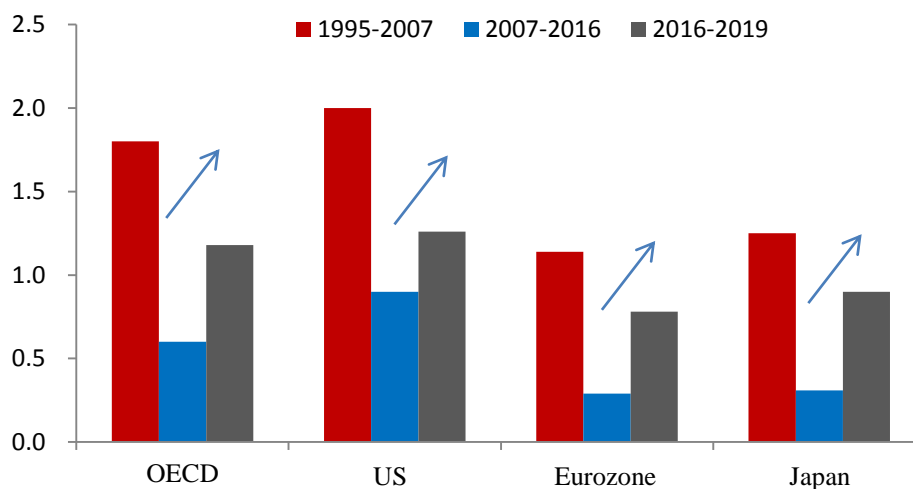
III.3.1 Groundwork for growth and current situation of US economy

Though the global financial crisis originated in the US, it has become the first developed economy to emerge from recession and recovered, fully demonstrating that the US economic system is a highly mature one with good self-healing ability and endogenous sustainability for growth momentum.

The US taking the lead in coming out of the recession, in advance of all other developed economies, was mainly driven by the following factors: **First, strong fiscal and monetary policies were in place.** In a recession, the US government usually introduces strong macro-regulation policies to boost the economy. As early as in the Great Depression during 1929-1933, the US government saved the economy through the Roosevelt's New Deal. After nearly 90 years of development, the US government has a broader spectrum of more mature macro-regulation tools in place to ensure higher efficiency of fiscal-monetary policy coordination. After the financial crisis erupted in 2008, the US government gradually restored the market confidence by introducing an extremely loose monetary policy with direct capital injection into financial institutions, interest rate cuts and government bond purchase. After taking office as US President when the QE policy was tapered, Trump implemented a proactive fiscal policy including aggressive tax cuts and large-scale infrastructure construction to underpin continued economic growth.

Second, the re-industrialization strategy has boosted total factor productivity (TFP). The Obama administration launched the re-industrialization strategy in 2010, hoping to seize the commanding heights of the new round of technological and industrial revolutions and to add a smart dimension to manufacturing through technological innovation. As a result, the US TFP growth picked up. According to estimates, US TFP has grown at 0.8% a year on average since 2009, obviously lower than the 1995-2007 average, but much higher than Germany (0.1%) and Japan (0.3%) over the same period. In addition, the US labor productivity also grew better than other developed economies (Figure 5). From this perspective, it is not difficult to understand why the US has staged a stronger recovery.

Figure 5: Annual Growth Rate of Labor Productivity in Major Developed Economies (%)



Source: OECD Economic Outlook Database, BOC Institute of International Finance

Third, huge capital inflows have been built up. First, the US household sector has been experiencing deleveraging since the financial crisis eruption, with the balance sheets of individuals

and households gradually repaired. In 2017, the total personal savings and household income increased by 26% and 53.6% respectively from 2008. The gross household savings/GDP ratio has also been gradually restored to the pre-crisis level. Second, the US has the most developed financial market in the world. After the financial crisis broke out, its good liquidity, market depth and relative safety have once again made it a magnet attracting global capital flows. The three major US stock indexes have remained bullish for nine consecutive years. Third, corporate investment has increased rapidly with the recovery of profitability. The proportion of corporate investment in the total economy has returned to its pre-crisis level by 2014. Private investment has been positive for seven consecutive quarters, the longest period since 2005.

III.3.2 Potential risks lurking in US economy

Though the US economy is growing steadily on track for the longest expansion ever, potential risks are gradually surfacing. The following factors may hinder economic acceleration and become potential factors to end the ongoing US economic expansion.

First, Trump's policies have uncertainties. As shown by historical experience, Trump's radical tax reforms, though implemented, will mainly have short-term effects but diminish over the long run. Moreover, the government has made slow progress in supervision, education, infrastructure and so on. Since many new policies involve legislative procedures, their implementation will not be as strong as expected. Trump's current trade policies have triggered trade frictions and disputes with many countries, arousing countermeasures and retaliatory measures detrimental to the US economic growth. Bank of America Merrill Lynch (BAML) and Morgan Stanley estimate the trade war's direct impact on US GDP growth to be 0.3-0.4 ppts, even more serious than the drag on China (0.2- 0.3 ppts).

Second, the monetary policy is too radical. The 10-year/2-year US Treasury yield spread went negative before each recession in the past 40 years, mainly because the Federal Reserve raised interest rates quickly to curb inflation. The Federal Reserve's continued interest rate hikes have driven the spread below 50 bps recently, close to the pre-recession level in 2007. According to the *Wall Street Journal's* survey of economists in May, about 59% of respondents expect the ongoing economic expansion to end in 2020 and 22% expect it to happen in 2021, while 62% of respondents base their forecasts on their belief that the Federal Reserve is likely to tighten monetary policy too quickly due to overheated economy.

Third, excessive fiscal deficit and debt burden are looming. The Trump administration attaches greater attention to the short-term effects of policy. It has adopted a pro-cyclical fiscal policy to keep spending more during the economic expansion and pay less attention to budget balance, which will push up the fiscal deficit as a percentage of GDP. This policy poses a greater risk. Its success is conditioned by sustained and faster GDP growth, which enables the government to meet the deficit and reduce the debt burden with an expanding tax base. If an economic downturn or recession occurs in the future, the US will find itself in an economic (especially fiscal) policy dilemma and worse positioned in recession.

III.3.3 How long will the US economy remain on the fast track of growth?

At present, the US economy is in the middle or late stage of its longest ever expansion. US economic growth will gradually slow on the above constraints for a longer period than in the previous cycle.

Trump's economic policies target the long-term, structural and supply-side factors that affect the sustainable and faster growth of the US economy, trying to go beyond short-term stimulus on the demand side to break structural bottlenecks and tap into the potential for medium- and long-term

growth. These policies mainly include the following: Proactive fiscal policy focused on tax cuts; necessary deregulation to ensure that only the “return > cost” rule is imposed on the America; add USD1.5 trillion of infrastructure investment subject to a shorter approval process, which will be implemented in two years if possible, introduce new investment ideas to fully unleash the role of state and local governments, and adopt public-private partnership (PPP) to address fund shortage; revise trade policies, improve the North American Free Trade Agreement (NAFTA) and other agreements, and negotiate new and better trade agreements; strengthen intellectual property protection and cyber security to reduce economic losses caused by intellectual property theft; ensure a pro-innovation environment and encourage private-sector innovation; tap the labor force and support disadvantaged communities; increase the labor force participation rate and maximize growth and opportunities.

These policies may further extend the expansionary cycle. New economic policies are turning investment, industrial output, exports and government spending into new drivers of growth. In addition, these new policies help boost demand expansion and potential output, likely to form a dynamic balance and virtuous circle between aggregate supply and demand.

As for future trends, the new economic policies will first boost the cyclical demand growth. This may lead to a relative lag in aggregate supply before 2020, resulting in faster-than-potential GDP growth. In the medium term, supply-side improvements will drive aggregate supply and demand toward an equilibrium level and narrow the gap between potential GDP and real GDP, or even result in a stronger potential GDP than the latter. In the long run, GDP growth will fall back to a level closer to potential as the effects of tax cuts and fiscal spending are diminishing and as interest rates are rising. If risk factors are not properly handled, the US economy may also sink into a significant downturn or recession in the next two years.

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