



Global Economic and Financial Outlook

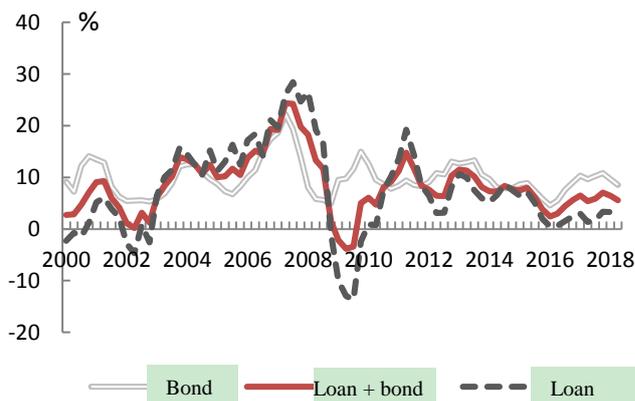
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Highlights

- In 2018, the global economic recovery continued but showed an obvious divergence, the growth rate of major economies reached a high point, and some emerging economies saw financial turmoils.
- Looking ahead, the global economy will be exposed to bigger downward pressure, and interest rate rises are expected in the monetary policies of major countries in 2019. In the meantime, we should pay more attention to potential risks in the following areas: the growth rate of US economy could reverse, escalating trade frictions between China and the US, and a heavier global debt burden.
- The economic expansion of the US has entered the final phase of this cycle, Europe is recovering at a slower pace, Asia-Pacific is stable generally but financial fragility is adding in some countries, and the economy of Latin America, the Middle East and Africa is expected to gradually recover with fluctuations.
- Presently, the landscape of international trade is changing, multilateral trade system is facing severe challenge, WTO reform has stagnated, and regional trade agreements are developing rapidly. The US dollar liquidity is gradually tightening around the world, and emerging economies are facing great challenges.

Growth of global USD liquidity is slowing



Sources: BIS, BOC Institute of International Finance

BOC Institute of International Finance

Global Economic and Financial Research Team

Team leader: Chen Weidong

Deputy leader: Zhong Hong

Team members: Liao Shuping

Chen Jing

Wang Youxin

Zhao Xueqing

Xie Feng

Liu Jinhan

E Zhihuan (Hong Kong)

Huang Xiaojun (New York)

Lu Xiaoming (New York)

Qu Kang (London)

Lin Lihong (Singapore)

Zhang Mingjie (Frankfurt)

Contact: Liao Shuping

Telephone: 010-66594052

Email: liaoshuping@bankofchina.com

Global Recovery at Turning Point: Divergence and Gaming

-- Global Economic and Financial Outlook (2019)

In 2018, the global economic recovery continued but showed an obvious divergence, the growth rate of major economies reached a peak, and some emerging economies saw financial turmoil. Looking ahead, the global economy will be exposed to bigger downward pressure, and interest rate rises are expected in the monetary policies of major countries in 2019. In the meantime, we should pay more attention to potential risks in the following areas: the growth rate of US economy could reverse, escalating trade frictions between China and the US, and a heavier debt burden.

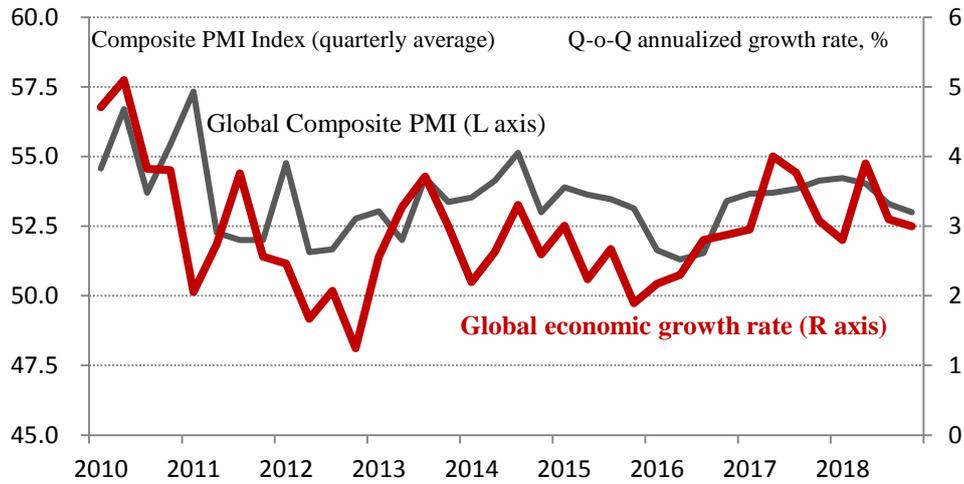
I. Global Economic and Financial Outlook for 2019

I.1 The real economic recovery is at a turning point

The world economy grew in lockstep in early 2018 as they did last year. Since April, however, the global economic expansion has become less balanced due to a variety of factors, including global trade frictions, tightening monetary policy of the Federal Reserve, USD appreciation, tightening global USD liquidity, geopolitical conflicts and crude oil market fluctuations. Growth rate of major economies is approaching its peak, while some emerging markets have experienced economic downturn and financial turmoil. The downside risk of global growth has gradually risen.

The global real economy may embrace an important turning point of recovery in 2019. **On the one hand, the impetus for economic growth still exists.** JPMorgan Chase's global composite PMI index remained above 53, with both the new orders index and the service index staying above 53.5. Manufacturing PMI declined slightly, albeit still maintained above 52. The global employment continues to improve, with the United States and Japan basically at full employment level. The global inflation has edged up, yet still moderate. It is conducive to enterprises expanding production and raising salary levels, thus giving impetus to investment in fixed assets and growth of household consumption. **On the other hand, the downside risk is increasingly prominent.** Global foreign direct investment (FDI) flows have declined for three consecutive years, down 2% YoY in 2016, down 23% YoY in 2017 and down 41% YoY in 1H2018, the largest drop since the 2008 global financial crisis, mainly because developed economies, as the leading force of global investment, pulled back from international investment. Under the shadow of trade protectionism, the growth of global trade has obviously slowed down. According to data from the Netherlands Bureau of Economic Policy Analysis (CPB), global trade in goods edged up 0.2% month on month (MoM) in August 2018, 1.3 percentage points lower than the previous month. Any continued escalation of global trade protectionism will severely undermine business confidence. Trade, which has long been an important driving force of economic growth, may become a drag on economic development.

Whether the future global growth will keep recovering or turn down depends on the wrestling between the two forces above. At present, the downside risk of global economy has increased, with global GDP growth preliminarily expected to reach 3.2% in 2018, down 0.1 percentage points YoY, and further fall by 0.1 percentage points to 3.1% in 2019.

Figure 1: Global GDP vs. Composite PMI

Source: Wind, BOC Institute of International Finance

I.2 Global financial markets are markedly divergent in trends

Overall, global financial markets have showed a tightening trend and greater divergence between developed markets and emerging markets in 2018. Developed economies are still in a loose financial environment on the whole. Stock and bond markets continue to grow. Volatility, though on the rise, is still relatively stable and below historical average level. The US stock market has marked the longest bull market ever. Despite of its sharp decline and fluctuations in the beginning of the year and October 2018, the US stock market still has outperformed other markets and attracted global capital inflows. Plagued by gloomy growth prospects, companies in Europe are less profitable than their US counterparts and many of them have bigger exposure to emerging markets, causing investors to be more cautious. Although the fundamentals of emerging economies have improved in recent years, they are still vulnerable to the normalization of monetary policies in developed economies and the appreciation of the US dollar.

Looking ahead to 2019, the global financial risks will increase, though still below the historical level. Some vulnerabilities that have grown over years may be revealed in the wake of drastic financial tightening. More central banks of developed economies may tighten their monetary policy. In some southern European countries, as the poor financial standing of corporations hampers banks' credit intermediary function, the public-sector and private-sector debt levels are at historical highs and will see further deterioration. These risks are intertwined, and the explication of any of them may intensify other risks and produce chain reactions. The main vulnerabilities of emerging markets are high leverage, huge demand for overseas financing, short-term foreign currency debts, unstable investors and trade risks. From a regional perspective, however, the emerging financial markets in Asia are relatively stable. Major risks in the future may be concentrated in "twin deficits" Latin American and emerging European countries.

I.3 US growth reaching its peak, US-China trade frictions and the global debt burden will be the major risks in the future

In 2019, the global economic and financial system is expected to be more volatile, experiencing more turbulences and uncertainties. The following potential risks deserve high vigilance.

First, the US economic growth is reaching its peak. After nine years of expansion, the United States is in the late stage of its ongoing economic recovery. On the one hand, as the Fed continues

to hike interest rates, short-term interest rates has continued to rise and triggered an inversion of the 10-year/2-year US Treasury spread. As shown in the past 40 years, each recession was preceded by such an inversion. In addition, the long-lasting low interest rate environment has increased the risk appetite of US investors and brought about overvalued stocks. Financial market vulnerabilities are accumulating. The Bank for International Settlements (BIS) warned that the next US recession may be an atypical business cycle, similar to those in 2001 and 2008, triggered by the collapse of the financial cycle. On the other hand, the fiscal stimulus policies that have been implemented, such as Trump's tax cuts, will see their effects gradually fading in 2020. Moreover, as the Democratic Party has regained control of the House of Representatives after the 2018 midterm elections, Trump will face more barriers to the implementation of fiscal policy in the next two years. In addition, such pro-cyclical fiscal policy has led to rising fiscal deficits and government debts, and will also undermine the growth potential in the long run.

Second, the US-China trade friction is likely to escalate. In 2019, the impact of trade friction will be further exposed as China and the United States continue to exchange new tariffs. In particular, given the high uncertainty in the Trump administration, the US-China trade friction will be a protracted process full of recurrences, and possibly will escalate and deteriorate. If so, it will severely influence the global economy and financial markets. The World Bank pointed out that the widespread rise in global tariffs will have a significant negative impact on international trade, which could drop by 9% by 2020.

Third, the global debt burden will rise. Rising interest rates in major economies will push up the global interest rates level. It will be a huge challenge for various entities accustomed to operating in a low-interest-rate environment in the past decade. At present, the leverage level in non-financial sectors of developed economies is high and rising. 2019 is also the year when debts will mature most intensively in emerging economies, with nearly USD2 trillion of bonds and loans to mature in the year. Moreover, their foreign currency debts in the non-banking sectors has reached 14% of GDP, only slightly lower than the historical high of 17% in 1999. As the US dollar continues to appreciate, financing costs rise and investors become more risk averse, the balance sheets of those countries that have borrowed massively in foreign currencies will be further stressed to increased pressure on debt service and refinancing.

Table 1: Forecasts for Key Economic Indicators of Major Economies in 2019 (%)

Region	Year /Quarter Country	GDP growth, %			CPI growth, %			Unemployment rate, %		
		2017	2018 ^f	2019 ^f	2017	2018 ^f	2019 ^f	2017	2018 ^f	2019 ^f
America	USA	2.3	2.9	2.6	2.1	2.5	2.3	4.4	3.9	3.6
	Canada	3.1	2.1	2.1	1.6	2.3	2.1	6.3	5.9	5.8
	Mexico	2.0	2.1	2.1	6.0	4.9	4.0	3.4	3.4	3.5
	Brazil	1.0	1.3	2.3	3.5	3.8	4.3	12.9	12.2	11.4
	Chile	1.5	4.0	3.4	2.2	2.5	3.0	6.6	6.9	6.5
	Argentina	2.9	-2.3	-0.6	23.6	33.7	35.3	8.4	8.9	9.1
Asia Pacific	Japan	1.7	1.0	1.1	0.5	1.0	1.2	2.8	2.4	2.3
	Australia	2.3	3.2	2.8	1.9	2.1	2.2	5.6	5.4	5.1
	China	6.9	6.6	6.5	1.6	2.2	2.3	3.9	4.0	4.0
	India	7.1	7.3	7.4	3.6	4.7	5.0	—	—	—
	South Korea	3.1	2.7	2.6	1.9	1.6	1.9	3.7	3.8	3.8
	Indonesia	5.1	5.2	5.1	3.8	3.3	3.8	5.5	5.4	5.3

Europe and Africa	Eurozone	2.4	2.0	1.8	1.5	1.8	1.7	9.1	8.3	7.9
	UK	1.8	1.3	1.5	2.7	2.5	2.1	4.5	4.1	4.0
	Russia	1.5	1.8	1.5	3.7	2.9	4.9	5.2	4.8	4.8
	Turkey	7.4	3.5	0.8	11.1	16.7	19.6	10.9	11.0	12.2
	Nigeria	0.8	2.0	2.8	16.6	12.1	10.9	18.8	-	-
	South Africa	1.3	0.7	1.7	5.3	4.7	5.5	27.5	27.3	27.7
Global		3.3	3.2	3.1	3.2	3.3	3.3	—	—	—

Source: BOC Institute of International Finance

Note: “F” stands for forecast.

II. Economic Review and Outlook for Major Regions

II.1 US economic outlook and its impact on Latin American countries

In 2019, the US economy will maintain positive growth but at a lower rate. This round of US economic expansion beginning in June 2009 is likely to be the longest up-cycle ever. Due to the out-of-sync political and economic cycles, after nearly eight years of economic expansion, Trump just introduced a series of economic stimulus initiatives centered on a proactive fiscal policy which to some extent has changed the trajectory of the US economic cycle.

Although the ongoing US economic expansion has far exceeded the historical level and entered the late stage, the following structural and cyclical factors may extend the expansionary period. Some sectors that have lagged behind in recovery or experienced a brief recession are still in the recovery or re-recovery phase. Though the business cycle has matured, infrastructure facilities are still in the trough. In terms of the business cycle, fixed investment, industrial output, exports and government spending lag behind and have large room for sustained growth. Industrial output, especially in the manufacturing and mining industries, has experienced a small recession and is still in the recovery stage. The capacity utilization rate has slowly recovered, still below the last cycle peak of 81% and the pressure boundary of 84%. Housing investment growth in the household sector lags behind, implying room for further housing market growth. The government spending expansion also lags behind, weaker than in the last three cycles since the 1980s and often turning negative. All these factors leave room for Trump’s economic stimulus policy to work. Tax cuts and fiscal stimulus will increase corporate, personal and federal spending, boost aggregate demand and thus continue to fuel economic growth.

Obstacles to the US economic acceleration include the following: As economic expansion is gradually maturing, the momentum of sustained growth is weakening, while the negative factors are gradually strengthening. It is likely that the Fed will continue to raise interest rates in 2019, especially when inflation or financial asset prices continue to increase, which will force the Fed to speed up rate hikes. The heavy private-sector debt burden will drive up financing costs and thus weigh on the private-sector spending growth. The uncertainty and negative effects of the Trump administration policies, especially trade frictions, have hindered and may continue to hinder the US export and investment growth. The Democratic Party taking control of the House of Representatives in the US mid-term elections may not change Trump’s trade policy much, but may affect his fiscal stimulus policy. In addition, if the global economy slows down, the external environment will also cast a shadow on the US growth outlook.

Considering the still-sound powerhouse for continued US growth and Trump’s pro-cyclical economic policy implemented gradually, we expect the US economy to keep growing in 2019, but

at a lower rate than in 2018, under the combined effects of positive and negative factors. Mainstream agencies' forecasts for the annual growth of the US real GDP in 2019 are currently concentrated at about 2.5%. A recession is very unlikely to occur in 2019. The Federal Reserve Bank of New York estimates a 15% likelihood of a recession in the next 12 months.

Latin American economies will gradually recover amid financial fluctuations. The Fed's accelerated interest rate hikes in 2018 have sent major Latin American countries into severe financial turmoils. Many countries have suffered a sharp currency depreciation and faced shocks more or less in stocks and bonds. Some countries even have experienced serious capital flight. The gradual rise in US interest rates will have an ongoing effect on financial markets in Latin America, making it normal to see local currency depreciation, capital outflows and sharp price fluctuations in the stock and bond markets.

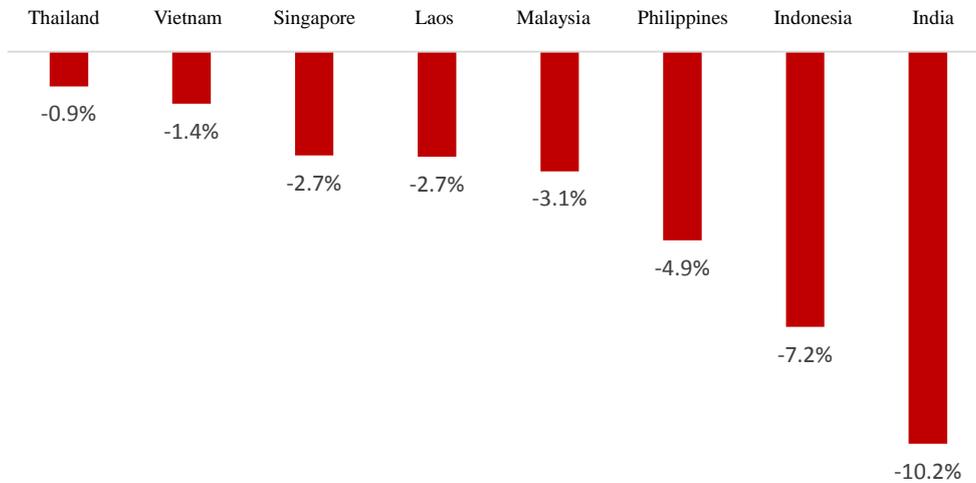
There are both positive and negative factors for the development of Latin American real economy. On the positive side, the ongoing solid US growth will boost the economic growth in Latin America. The expected good economic performance and salary growth in the United States in 2019, as well as the latest US-Mexico-Canada trade agreement, will warrant the rapid growth of import demand and consumption growth and give a boost to exports from Latin America. On the negative side, the strong USD index is detrimental to commodity price hikes and will weigh on Latin America's foreign exchange and government revenue growth. Overall, there are both positive and negative factors for Latin American economies at present, which will gradually recover amid fluctuations. The region's economic growth is estimated to be 1.2% in 2018 and 2.2% next year, mainly driven by private investment and consumption.

II.2 Economic outlook for Asia Pacific and the Belt and Road (B&R) region

1. Review and outlook of Asia-Pacific emerging economies

Overall economic growth is relatively sound. Asia-Pacific emerging economies have been maintaining good growth since the beginning of 2018, showing a solid rise in consumption and investment and sustained current account surplus. ASEAN's overall economic growth will exceed 5%, with the Philippines and Vietnam reaching about 6.7% and Indonesia and Malaysia reaching around 5.2%. However, these economies face more uncertainties in growth. In 2018, Asia-Pacific emerging economies experienced a downturn in export growth triggered by the rise of global trade protectionism. Export growth in the ASEAN dropped from 15.6% in 2017 to 12.8% in 1H2018. In addition, capital outflows have increased to exacerbate financial market volatility. Capital outflows from Indonesia, Malaysia, the Philippines and Thailand totaled USD98.5 billion in 1H2018, in sharp contrast to the USD129 billion of capital inflows in 2017. Asia-Pacific currencies have also depreciated to varying degrees. India, Indonesia and the Philippines saw their local currencies falling by 10.2%, 7.2% and 4.9% respectively against the US dollar since the beginning of the year, while other ASEAN currencies have fallen in value by 1% to 3%.

Fig.: Cumulative Depreciation of Currencies of Major Asian Emerging Economies against USD in 2018



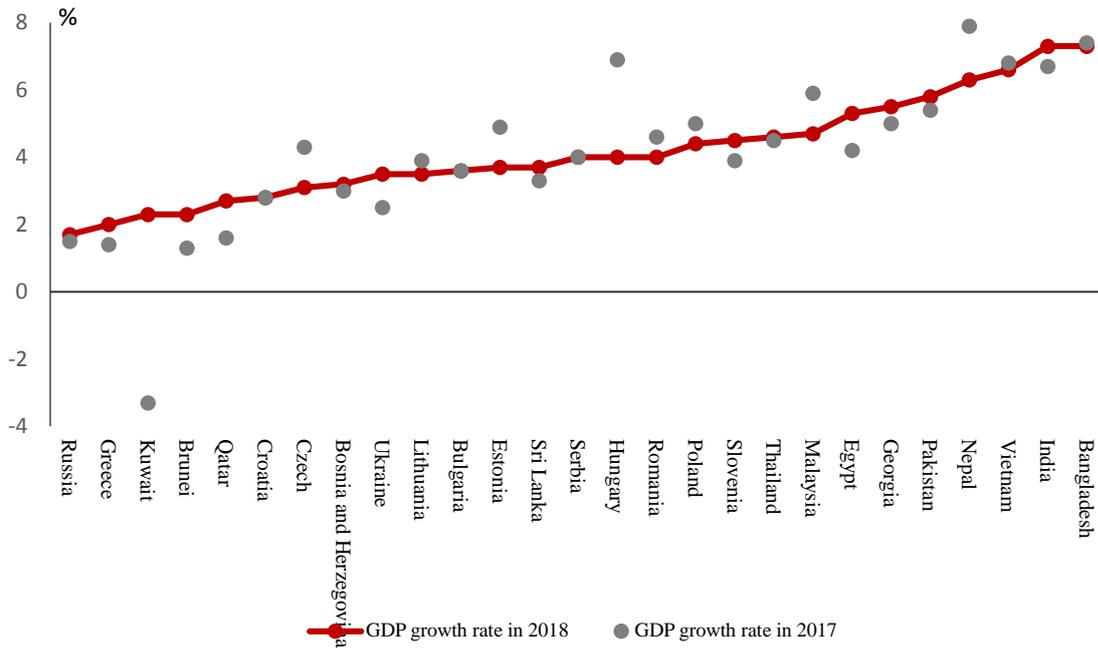
Source: Wind, BOC Institute of International Finance

Looking ahead to 2019, despite unfavorable external factors, the fundamentals of Asia-Pacific emerging economies will probably remain sound enough to support continued strong growth in the future. According to the IMF’s latest forecast, Asian emerging economies may grow by 6.3% overall in 2019, with India expected to grow most impressively at 7.4% and the ASEAN to grow by 5.2% as a whole. Countries with lower GDP per capita will grow faster, such as Cambodia, Laos and Vietnam, which are expected to grow by 6.7% to 7%.

2. Review and Outlook for B&R economies

The economic growth of B&R countries has steadily gained pace as a whole. Compared with the previous year, the growth of B&R economies was more stable and convergent in 2018, showing an overall upward trend. According to the latest IMF forecast, several countries in the B&R region are expected to grow by more than 6% in 2018, e.g. Bangladesh and Nepal are estimated to grow by 7.3% and 6.3% respectively, and Pakistan, Georgia and Egypt by more than 5%.

Fig. 3: Changes in GDP Growth of Selected B&R Countries



Source: IMF, BOC Institute of International Finance

Looking ahead, B&R economies will face both opportunities and challenges for growth. China entered into economic and trade cooperation with many countries under the framework of B&R Initiative in 2018. In September, the Forum on China-Africa Cooperation was closed with nearly 150 cooperation agreements inked. In particular, 28 countries and the African Union Commission signed cooperation documents with China to jointly build the B&R Initiative, laying a solid foundation for further advancement of the B&R Initiative in Africa. In October, China and Japan signed 52 third-party market cooperation agreements envisaging in-depth cooperation in the third-party markets, especially in the B&R region. In 2019, the above-mentioned cooperation will be gradually implemented to open up a new growth path for the B&R economies. However, it is noteworthy that many regional economic groups covered by the B&R Initiative have formed a number of free trade zones and single markets, coupled by the significant national disparities in economic size, trade volume, economic growth, industry mix, unemployment rate and inflation level. It is a long-term and arduous task to integrate resources in every respect and put forward well-targeted cooperation plans. Some countries manifest vulnerabilities in macro-economic management and economic and financial systems and should further establish and improve the risk prevention system.

II.3 Political and economic outlook for Europe: turnaround and reforms

Europe continued in recovery in 2018, yet sluggish in pace and divergent in national performance. According to Eurostat data, the Eurozone economic growth fell to a four-year low of 0.2% in Q3. Europe faces a significantly higher downside risk to growth due to its exposure to interwoven internal and external risks as well as interactive political and economic risks, including the escalation of global trade tensions, US interest hikes, uncertainties in Brexit negotiations and the radical budget conflicts among EU members.

Looking ahead to 2019, turnaround and reforms will become the defining features of European growth. From a positive perspective, the industry is transforming and upgrading,

employment and income will continue to grow steadily, and consumption is still the primary growth drivers in Europe. However, the interwoven political and economic risks, the wrestling between divergence and convergence and the drastic changes in the internal and external environment will bring many uncertainties to Europe's development. Eurozone's GDP growth is expected to further slow down to 1.8% in 2019. Key negotiations, key countries, key policies and key figures may push Europe to turn around and reform, which will have a significant impact on where the European economy goes.

Key negotiations - Brexit negotiations: “soft” Brexit still faces uncertainties. After long and hard controversy, “decisive steps” have been made to end Brexit negotiations. Britain and the European Union have reached an agreement on “divorce bill”, single tariff zone, transition period and citizenship. The draft agreement on “soft” Brexit has been formally approved by the British Cabinet. However, the draft agreement has been strongly opposed by the opposition and the “hard” Brexit faction of the Conservative Party in the UK due to the Irish border solution and Britain's inability to fully separate itself from the EU, making it very difficult to get through the parliament. It is still possible to see “black swan” incidents in the future, such as Brexit without agreement, renegotiation between UK and EU, UK general elections ahead of schedule and a second referendum on Brexit. In 2019, the UK will enter the post-Brexit transition period. The wrestling between “soft” and “hard” Brexiteers will produce uncertainties in the UK-EU landscape and economic arrangements.

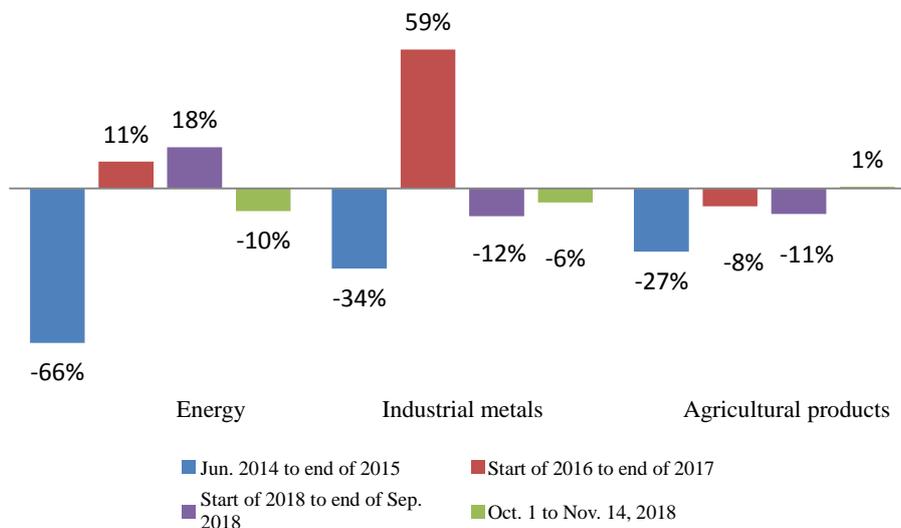
Key country - Italy: the budget deadlock mirrors the EU's systematic deficiencies. Italy's 2019 budget proposal sets the budget deficit at 2.4% of GDP. The radical plan was rejected by the EU, triggering a serious confrontation between the two sides. Italy's predicament is not surprising, which fully exposes the EU's systematic deficiencies. In 2019, though the Italian problem will remain under control, the specific solution will determine the future of European reforms.

Key policy - monetary policy: a critical step of the European Central Bank toward the phase-out of quantitative easing. In 2019, European monetary policy will be reversed to tighten liquidity, which will adversely affect economic drivers such as employment and consumption, and also will send shock waves to debt-ridden countries such as Italy. In addition, ECB President Draghi will leave office in October 2019 but his successor has not been determined, adding to the uncertainty in the future policy path.

Key figure - Merkel: the rise of populist forces and the political trend in Europe. German Chancellor Angela Merkel's announcement that she would not seek re-election indicates the rise of populist forces in Germany and the Europe. The credibility and authority of mainstream policies have been compromised greatly by sluggish structural reform, tough immigration issue and worsening social inequity.

II.4 African economy with commodity price fluctuations

After the sweeping decline in 2014-2015 and the gradual recovery in 2016-2017 in the commodity market, the commodity price trends have varied obviously across different types of commodities in 2018. In 1Q-3Q2018, international crude oil prices rose due to such factors as Venezuela's continued decline in production and the resumption of US sanctions against Iran. However, then crude oil prices began to turn down in October because US sanctions against Iraq were not as tough as expected and Saudi Arabia, Russia and the United States continued to expand production. As of November 14, Brent crude oil price had dropped 26% from its October peak, stepping into a bear market range. The Bloomberg Energy Index also fell by 10%.

Fig. 4: Bloomberg Commodity Index Changes (%) Since 2014

Source: Bloomberg, BOC Institute of International Finance

The demand side of the commodity market will be hardly strong in 2019. In the energy market, based on the current supply and demand fundamentals, we expect the average Brent crude price drop slightly to about USD70 in 2019, yet still at the risk of extreme rise and fall. As for industrial metals, the relatively weak demand from China, the major user, will still weigh on their prices in 2019. China's demand for main industrial metals accounts for more than 40% of global total. In the agricultural product market, the price of agricultural products will remain basically stable with a weak momentum of growth, regardless of the effects of extreme weather.

The economy of the Middle East and North Africa (MENA) will recover slowly. In 2018, due to oil production cuts continued and the US sanctions on Iran's financial sector and oil industry, economic growth in the MENA was weaker than expected at the beginning of the year. However, thanks to the pickup of crude oil prices and the government's implementation for economic reform and pro-growth policies, the regional economic growth has slightly rebounded to 2% from 1.8% in 2017. The regional fiscal position has improved, with the budget deficit expected to drop to 4.5% of GDP in 2018 from 10.7% in 2016. The balance of payments has improved significantly, with the current account balance as a share of GDP turning from a deficit of 4.4% in 2016 to a surplus of 1.9% in 2018. Driven by ongoing economic reforms and growing demand from China and Europe, economic growth in the MENA is expected to rebound to 2.5% in 2019.

Economic growth in sub-Saharan Africa is expected to accelerate. In 2019, economic growth in sub-Saharan Africa is expected to accelerate to 3.8% due to rising oil prices, subsiding drought, bigger agricultural output and less uncertainty about national policies. However, the regional economic growth will be challenged by the sluggish growth of per-capita income, which is a drag on domestic demand, the economic slowdown of major trade partners, USD appreciation and the tightening of external financing conditions.

III. Special Research

III.1 World trade has entered the era of fragmentation

1. New trends in regional trade agreements

The economic bonds between countries have been continuously strengthened in the context of economic globalization and trade liberalization. As multilateral trade has suffered many setbacks in recent years, however, more and more countries have turned to regional trade as an alternative way of developing international trade. The regional trade agreements (RTAs) have mushroomed to take up an expanding share of global trade, gradually becoming an important way to establish economic and trade cooperation and develop political ties between countries.

First, RTAs have been signed by a surging number of countries in an expedited process.

There were 456 RTAs signed worldwide from 1947 when GATT was signed to early 2018. RTAs developed slowly in the GATT era. From the establishment of WTO in 1995 to the outbreak of the subprime mortgage crisis in 2007, 147 new RTAs were signed. Another 210 were signed in the 10 years after 2007, showing a notable acceleration. From the efficiency point of view, early negotiations were time-consuming as both sides took a prudent stance. In recent years, however, RTAs can be signed anytime as long as the two parties desire to do so, as they usually have complementary strengths or share common political interests and thus can easily reach a consensus in negotiation.

Second, parties to RTAs and forms of cooperation are more diverse. RTAs involves an increasing number of members. All WTO members have signed at least one RTA, and the parties of RTAs are diversified. RTAs can be made between countries, between regional organizations, or between countries and regional organizations. RTAs between developed and developing countries, and those between developing countries, keep increasing fast. More importantly, as developing countries are better positioned in the international trade market, their willingness to join RTAs is growing. Many RTAs have been initiated by developing countries, indicating their attempt to gain more power in regional cooperation and thus make economic and trade cooperation more conducive to their own development. As for the forms of cooperation, free trade agreements are the primary form of cooperation, followed by economic integration agreements. Customs unions and preferential arrangements have been diminishing.

Third, the issues addressed by RTAs are expanding in breadth and depth. The main contents of early RTAs was to abolish tariffs and remove non-tariff barriers. Now the contents of RTAs have become increasingly broad-based and complex since the establishment of WTO, involving not only overseas rules but also domestic rules. RTAs now encompass all aspects of member nations' economic development and social policies, such as intellectual property protection, environmental standards, financial supervision, service trade, competition policy, SME development and anti-corruption cooperation.

Fourth, though economic factors dominate RTAs, political factors are becoming increasingly influential. The purpose of signing RTAs at present is not only to reduce trading costs and increase trade volume between members, but also takes into account political interests and competing for the right to establish international trade and economic relations. RTAs also take national security and foreign policy into consideration in addition to the strength in resources, technology, capital and markets.

Fifth, cross-regional and multi-regional economic members rise beyond geographical restrictions. Early RTAs usually took place between countries with geographical proximity. But in recent years there have been more cross-regional trade agreements, such as the US-Singapore agreement and the EU-South Africa agreement. Statistics showed that nearly one-third of RTAs in the world are made between countries in different regions. Meanwhile, many dual-status members have emerged across the globe that participate in the multilateral trading system and also enter into regional trade agreements. Global trade development has become increasingly complicated.

2. Divergence in WTO reforms and global trade rules

Since the start of the Doha Round of negotiations in November 2001, the global trade governance system represented by WTO has been facing increasingly severe challenges. Western developed countries are dissatisfied with the current WTO rules. Emerging economies and developing countries are also calling for more voice and rule-making power. Establishing new international trade rules has become a consensus among all parties.

The division between developed and developing countries cannot be bridged in the short term. Since 2017, developed economies such as the US, EU and Japan, have repeatedly expressed their urgent desire to reform the WTO and put forward many suggestions. Among them, the United States is trying to start a new stove and establish new rules that are more beneficial to the interests of the United States. The US criticism of the current WTO system includes the following points: First, trade negotiations are inefficient. The limited outcomes of the Doha Round of negotiations lasting for many years indicate that WTO lacks the basic ability to coordinate the stances of all parties for an agreement to be reached. Second, the United States tries to prevent the judges of the appellate body of the WTO dispute settlement mechanism from serving successive terms and accepting new ones, saying that the dispute settlement process is too time-consuming and non-transparent. Third, the United States alleges that the definition of “treatment of developing countries” has seriously deviated and provides some countries with access to special and differential treatment, such as extended transition period for implementing commitments, more trade opportunities and capacity building. The EU published the *WTO Modernization* proposal on September 18, 2018, becoming the first economy in the world to issue a WTO reform plan. The paper proposes three reforms: updating international trade rules, strengthening WTO supervision and improving the dispute settlement mechanism, so as to make the WTO more practical, adapt to the changing world and become more effective.

On the contrary, developing countries, including China, generally have come up with the following different opinions: First, WTO reforms cannot change the basic principles of MFN, national treatment, tariff restriction, transparency, special and differential treatment and the overall goal of trade liberalization. At the BRICS summit held in South Africa in July 2018, all participants said they would defend the WTO’s rules-based multilateral trading system and further improve the legal framework of the current multilateral trading system. Second, WTO reforms should focus on development and take care of the reasonable demands of developing members. All parties should push forward the reforms step by step on the basis of mutual respect, equality and mutual benefit. WTO reforms should not be dominated by developed countries alone, but should take into account the demands of developing countries and allow developed and developing members to jointly deal with various problems arising from current economic development.

In the short term, the division between developed and developing countries on WTO reforms is still too wide to bridge. However, the world has recognized the importance and urgency of reforming the WTO. Against the backdrop of US-China trade friction, the EU has tried to play the role of a bridge between the United States and China by issuing a tripartite joint statement with the United States and Japan on the one hand, emphasizing the settlement of unfair trade issues, and on the other hand establishing a joint working group on WTO reform with China, which has held many talks in Brussels and Beijing.

3. Impact and challenges for the global trading system

No matter where the WTO reforms go, it will have a far-reaching impact on the global trade governance system. The following changes may occur to the future global trade landscape:

First, the trade system is to be restructured. Developed countries, led by the United States, are unwilling to lead multilateral trade negotiations again and have embarked on starting a new stove to establish regional trade agreements as a counter-check on multilateral trading system. Developing countries hope to change the existing trade rules, reshape the global division of labor system based on the global value chain and bring about reorganization and reshuffling of the global trade landscape. The fierce gaming between developed and developing countries will become the theme of the future. The trade landscape will become more diversified and fragmented.

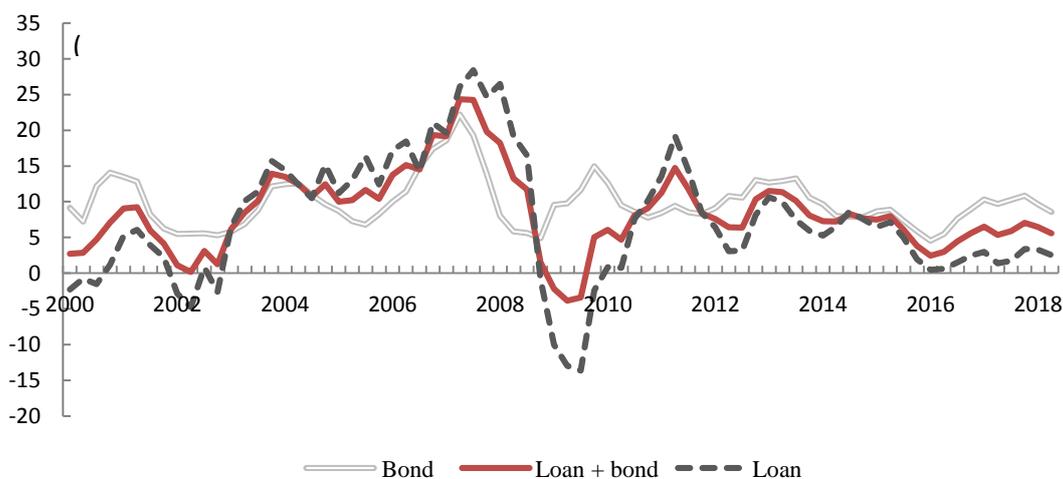
Second, trade rules are to be upgraded. Though the number of signatories of the Trans-Pacific Partnership Agreement (TPP) has been reduced from 12 to 11 after the withdrawal of the United States and the negotiation of the Transatlantic Trade and Investment Partnership Agreement (TTIP) has also been shelved, both agreements have put forward higher standards in terms of labor and environmental standards to create a market access barrier defended by higher level of liberalization. The newly concluded United States-Mexico-Canada Agreement (USMCA) adopts higher standards than those in existing trade agreements, including a “poison pill clause” exerting a big pressure on the negotiation of other subsequent trade agreements. The dominant position of developed countries will remain unshakable in the negotiation of global trade rules for some time to come. This means that the higher standards presented by the above agreements are likely to become the benchmark for bilateral or multilateral trade agreements. Emerging economies and developing countries, including China, will have to speed up their own reforms to adapt to the new rules.

III.2 Impact of the global USD liquidity changes

1. The tightening of global USD liquidity redirects international capital flows

The global supply of USD liquidity has slowed down. The global USD liquidity index compiled by the Bank for International Settlements (BIS) measures the global USD liquidity using the USD loans issued by the United States to non-banking sectors outside the United States and the USD bonds issued by non-residents. As of June 2018, USD credit (including bonds and loans) to non-banking sectors outside the United States reached USD11.5 trillion, up 6% from last year. The growth rate of this indicator has declined for two consecutive quarters since the 4Q2017.

Fig. 5: Slowdown in Global USD Liquidity



Source: BIS, BOC Institute of International Finance

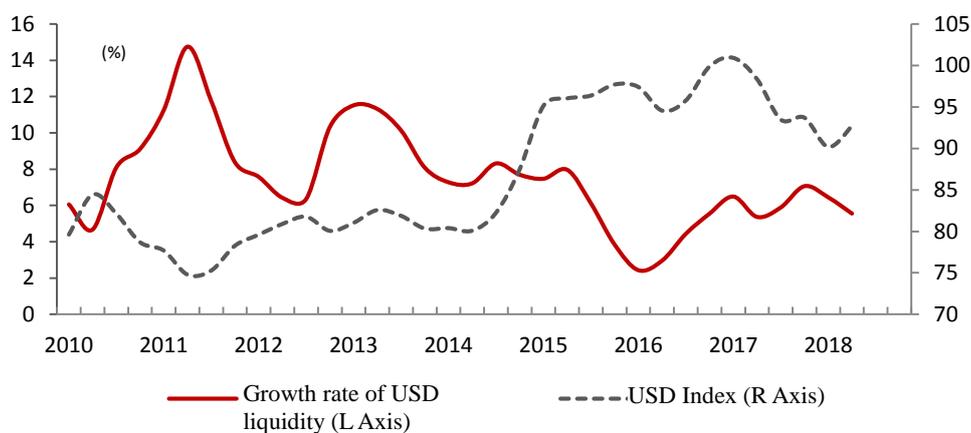
The reason is that the Fed, as the “master valve” of USD liquidity, keeps tightening its monetary policy. Since December 2015, the Fed has raised interest rates eight times and the target federal funds rate has increased by 200 bps accumulatively. In October 2017, the Fed officially began to shrink its balance sheet. The Fed’s balance sheet had shrunk by 7% as of November 14, 2018. In addition, the rising cost of global USD financing makes USD liquidity less affordable and accessible, which will affect the demand for USD liquidity. Since 4Q2017, the growth rate of international USD loans has decreased from 3.3% to 2.5%, and the growth rate of USD international bond issues has fallen from 10.8% to 8.5%. In the future, the Fed will continue to tighten its monetary policy. The ongoing tightening cycle of USD liquidity has not yet ended.

The growth of USD liquidity is highly related to US foreign portfolio investment. International portfolio investment, composed of equity investment and debt investment, outlines the change pattern of global short-term capital flows to some extent. International portfolio investment is highly volatile and sensitive to global policy adjustments, market sentiments and risk changes. The global USD liquidity growth has a high correlation with US foreign portfolio investment. The tightening of USD liquidity is often accompanied by a decline in US foreign portfolio investment.

Foreign portfolio investment in emerging economies turns from inflow to outflow. According to the monthly capital flow data of major emerging economies disclosed by the Institute of International Finance (IIF), the capital flow pattern in emerging economies has changed greatly since the beginning of 2018. From January to October 2018, the cumulative inflows of foreign securities investment into emerging economies stood at USD159.5 billion, down 50% YoY. In October 2018, USD7.6 billion of foreign portfolio investment flowed out of emerging economies, a reversal of direction from the previous month.

2. Tightening global USD liquidity supports a stronger dollar

This year, the USD index rebounded beyond market expectations. The USD index had rebounded 7.6% from its April low as of November 19, up 4.3% from the beginning of the year. Looking back on the USD exchange rate movements this year, it is obvious that each run of USD depreciation would be stopped by a strong support and did not continue long. Tightening USD liquidity and rising USD interest rates may be crucial supportive factors. Historically, the decline in USD liquidity growth was often accompanied by the appreciation of USD, and the USD index trend had an obvious negative correlation with USD liquidity growth. The arbitrage mechanism plays an important role in it. Since the beginning of the year, the gap between the 10-year US Treasury yield and the 10-year German Treasury yield has increased from 196 bps to 260 bps. The US/German 10-year treasury yield spread has reached a fresh high over more than 20 years, marking a historic change.

Fig. 6: USD Liquidity Growth vs. USD Index


Source: Wind, BOC Institute of International Finance

3. Emerging economies suffer a lot from the USD liquidity cycle

Growth in emerging economies fluctuates along with cyclical movements of USD liquidity.

The growth indicators of major emerging economies tracked by IIF show that the cyclical fluctuations of emerging economies moved together with the USD liquidity growth. Whenever the USD liquidity growth declines, emerging economies will experience a painful economic slowdown cycle. From 3Q2014 to 1Q2016, the global USD liquidity growth slowed down from 7.9% to 2.4% and USD index has strengthened, resulting in currency depreciation in and capital flight from emerging economies. The overall growth rate of major emerging economies dropped from 4.4% to 2.1%.

Emerging economies and developing countries rely on foreign capital and USD liquidity to develop their economies due to their less-developed financial systems and the limited internationalization of local currencies. Poor management may send them into such troubles as excessive foreign debts and currency mismatches. USD liquidity changes have their effects on businesses and individuals through exchange rates, capital flows and debt channels, triggering fluctuations in emerging economies. This year, the slowdown in USD liquidity growth and a stronger USD have already sparked currency crises in Argentina and Turkey. Most emerging economies have experienced a sharp fall in currency exchange rate and revised downward their economic outlook. It is noteworthy that IIF data shows that, in major emerging economies, the debts of non-financial corporations as a share of GDP rose from 87% at the end of 2Q2014 to 94% at the end of 2Q2018, and the total debts as a share of GDP increased from 186% to 212%. Moreover, the ongoing USD liquidity tightening coincides with the Fed's rate hikes and balance sheet contraction will likely produce a more drastic tightening effect.

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Institute of International Finance

1 Fuxingmen Nei Street, Beijing, 100818 China

Postal Code: 100818.

Tel: +86-10-66594052

Fax: +86-10-66594040