Economic Research

2 September 2019

IHS Markit

Week Ahead Economic Preview

Global overview

- **Worldwide PMI surveys**
- **US employment report**
- **Australia and South Korea GDP**
- **Central bank meetings in Australia and Russia**
- **Special reports on Australia and Italy**

PMI surveys form the highlight of the week, providing updates on global business conditions midway through the third quarter which could prove influential in steering central bank policy decisions. July's surveys pointed to global growth running at one of the weakest rates for three years. The latest policy action meanwhile comes from Australia and Russia, where pressure is mounting for more stimulus. The week also sees US and China both raise tariffs, while Brexit turmoil looks set to foster growing political uncertainty.

In the US, non-farm payrolls and PMI data from IHS Markit and the ISM will be eyed for clues as to whether the Fed is likely to add more stimulus. Policymakers were split on the need for July's quarter-point rate cut, but since then the flash US PMI recorded the weakest growth of new business for a decade as the manufacturing downturn showed further signs of spreading to services (see page 3).

In Europe, UK PMI data will be especially closely watched for risks that the economy could slide into recession after contracting 0.2% in the second quarter. Brexit uncertainty has heightened in recent days and has the potential to further dampen business and consumer spending. The extent of any new European Central Bank stimulus is also likely to be affected by PMI survey data for August, the flash numbers for which showed manufacturing enduring a summer slump which was only partially offset by the service sector. Nowcasts suggest that Germany in particular looks susceptible to falling into recession (page 4).

In Asia, the impact of trade wars and – in the case of Hong Kong – political unrest will be under scrutiny via PMI data, trade numbers for China and South Korea's GDP (page 5). Recent PMI data for China hinted at a stabilisation in manufacturing, while services growth appeared to be being supported by domestic stimulus.

This week's special reports look at Australia's economic ties with China (page 8) and the fiscal situation facing a new Italian government (page 6).

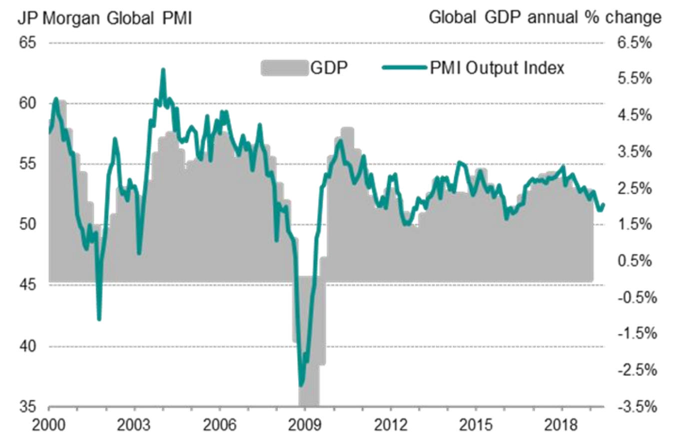
Contents

1 Global overview
2 Key diary events
3 US week ahead
4 Europe week ahead
5 Asia Pacific week ahead

Special reports

6 Italy: a new coalition government, same fiscal headaches
8 Australia's Deepening Economic Ties with China: A Double-Edged Sword?

IHS Markit's worldwide PMI surveys are updated for August. July's data showed global economic growth running close to three-year lows



Sources: IHS Markit, JPMorgan.

A big question is whether the deteriorating picture for global manufacturing worsened in August as trade wars intensified, and whether weakness spilled over to services

Sources: IHS Markit, JPMorgan.

Key diary events

Monday 2 September

Worldwide release of IHS Markit manufacturing PMI (Aug)

Thailand and Indonesia inflation (Aug)

Tuesday 3 September

Brazil trade balance (Aug)

South Korea GDP (final, Q2), inflation (Aug)

Australia retail sales (Jul)

RBA interest rate decision

Singapore SIPMM manufacturing PMI (Aug)

US IHS Markit and ISM manufacturing PMI (Aug), construction spending (Jul)

Wednesday 4 September

Worldwide release of IHS Markit services PMI, includes Jibun Bank Japan PMI and Caixin China PMI (Aug)

Australia GDP (Q2)

Euro area and France retail sales (Jul)

US trade (Jul)

Thursday 5 September

Philippines inflation (Aug) and industrial output (Jul)

Australia trade (Jul)

Germany construction PMI (Aug), factory orders (Jul)

US ADP employment (Aug), factory orders (Jul)

US IHS Markit services PMI and ISM Non-manufacturing PMI (Aug)

Friday 6 September

Japan average cash earnings, housing spending (Jul)

Taiwan inflation (Jul)

Germany, Czech industrial production (Jul)

UK Report on Jobs, Halifax house price index (Aug)

France trade balance (Jul)

Euro area GDP (3rd Est, Q2)

Russia interest rate decision

Brazil inflation (Aug)

US non-farm payrolls, earnings, jobless rate (Aug)

For further information:

If you would like to receive this report on a regular basis, please email economics@ihsmarkit.com to be placed on the distribution list.

For more information on our products, including economic forecasting and industry research, please visit the Solutions section of www.ihsmarkit.com

For more information on our PMI business surveys, please visit www.ihsmarkit.com/products/PMI

Click here for more PMI and economic commentary.

For all further information, please visit
www.ihsmarkit.com

Chris Williamson

Chief Business Economist

IHS Markit

Email: chris.williamson@ihsmarkit.com

The intellectual property rights to the report are owned by or licensed to IHS Markit. Any unauthorised use, including but not limited to copying, distributing, transmitting or otherwise of any data appearing is not permitted without IHS Markit's prior consent. IHS Markit shall not have any liability, duty or obligation for or relating to the content or information ("data") contained herein, any errors, inaccuracies, omissions or delays in the data, or for any actions taken in reliance thereon. In no event shall IHS Markit be liable for any special, incidental, or consequential damages, arising out of the use of the data.

Purchasing Managers' Index® and PMI® are either registered trade marks of Markit Economics Limited or licensed to Markit Economics Limited. IHS Markit is a registered trademark of IHS Markit Ltd.

United States Week Ahead

PMI surveys, non-farm payrolls and trade data

By Siân Jones

Economist, IHS Markit, London

Email: sian.jones@ihsmarkit.com

Amid expectations that the Fed could continue to cut interest rates in September, the release of final PMI data will allow a glimpse into business conditions across the US private sector halfway through the third quarter. What's more, with strong labour market conditions having often been used as an example of strength in the US economy, an update to non-farm payrolls will further shed light on the policy outlook.

Final PMI data

PMI data for manufacturing and services from IHS Markit and the ISM come at a time when Fed Fund futures almost entirely pricing in a further 25bp cut to interest rates in September's FOMC meeting. Flash PMI data for August showed the first fall in manufacturing operating conditions since 2009, and a notable slowdown in the service sector. The weakness further extends the drop-off in growth since the start of 2019. The PMI data will provide a good insight into GDP growth in the third quarter, and so far hint at some downside risks. The flash PMI data pointed to a modest 1.5% annualised rate of increase, whereas our forecasting team currently expects to see 2.1% growth.

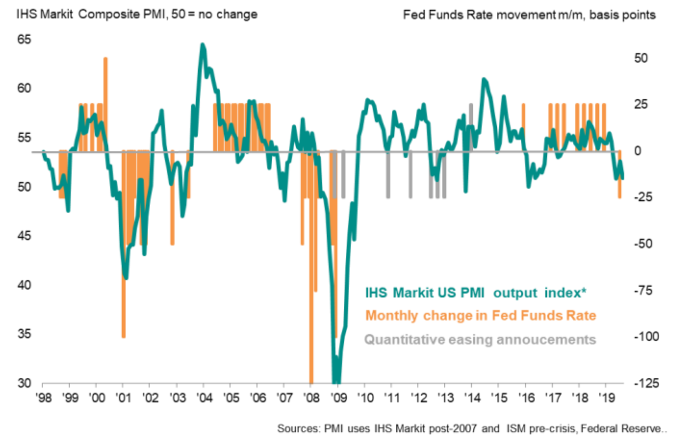
Non-farm payrolls

Non-farm payrolls growth looks set to soften, according to August flash PMI data. Although the consensus expects employment to have risen by 150,000 in August, early private sector PMI data points to a more lacklustre improvement in labour market conditions. A less robust expansion comes on the heels of the greatest downward adjustment by the Bureau of Labour Statistics to prior jobs data, with 500,000 fewer jobs created in the year ending March 2019 than previously thought.

Trade data

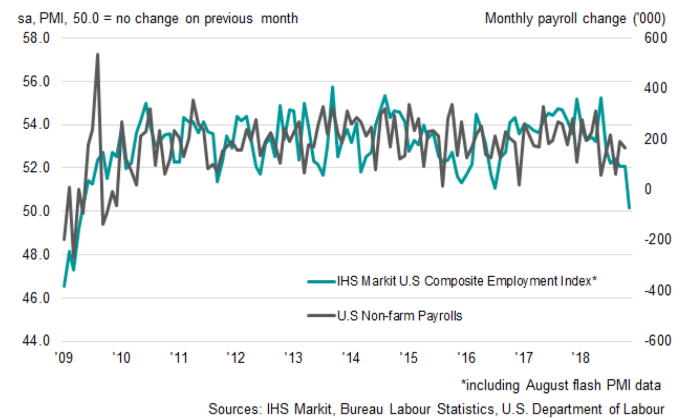
The ongoing impact of tariffs and trade wars weighed heavy on the minds of private sector firms, as new export orders fell further according to the latest flash PMI data. Already identified as an area of weakness in GDP figures, soon-to-be released export numbers are not expected to paint a rosy picture.

IHS Markit Composite PMI and FOMC decisions



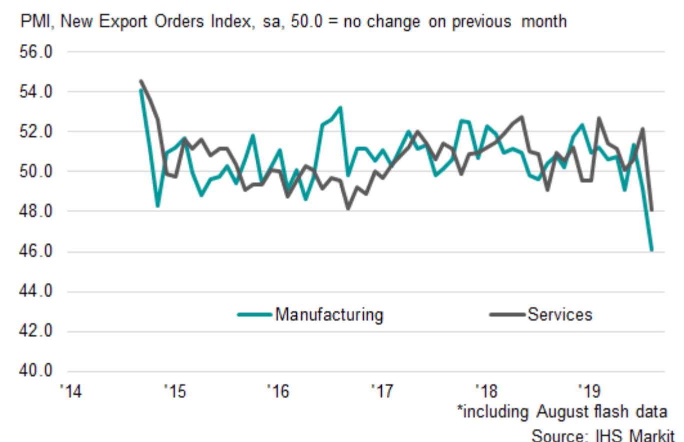
Sources: PMI uses IHS Markit post-2007 and ISM pre-crisis, Federal Reserve..

Employment growth set to ease



*including August flash PMI data
Sources: IHS Markit, Bureau Labour Statistics, U.S. Department of Labour

External demand conditions weighing on new business



*including August flash data
Source: IHS Markit

Economic Research

2 September 2019

Europe Week Ahead

August PMI data to provide vital steer for European policymakers

By Joe Hayes

Economist, IHS Markit, London

Email: joseph.hayes@ihsmarkit.com

PMI releases are the pick from the European data calendar, providing crucial insight into economic conditions across the continent at the midway point in the third quarter. August flash numbers indicated that weak growth has persisted in the euro area. Fresh UK PMIs will be eyed to gauge 'technical' recession risks, as will Germany factory orders and industrial production data for July. UK parliament resumes (briefly) following summer recess. Sessions are likely to be eventful after the prorogation announcement.

Policy guidance from eurozone PMI data

Euro area PMIs will provide instrumental updates ahead of the European Central Bank's September meeting, where we expect to see the launch of fresh stimulus measures. Flash PMI data indicated that growth remains soft, while survey data have also showed persistently weak inflationary pressures, helping to crank up the odds of policy loosening. PMI data from the wider reaches of the continent will also be useful for assessing the export climate, with external weakness adding pressure on the ECB to act.

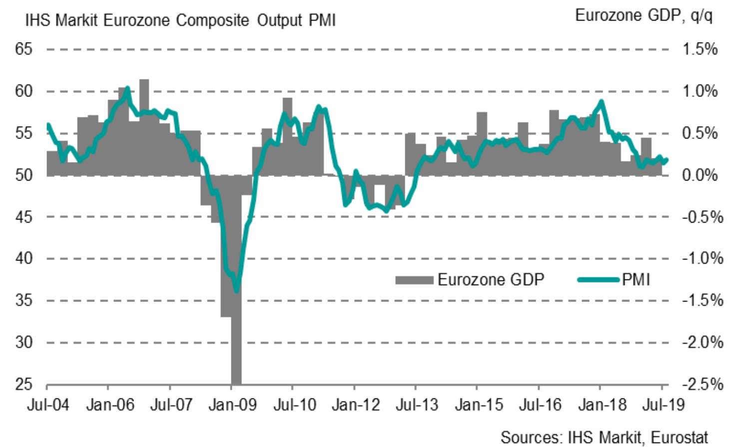
Factory output and orders data from Germany for July are also due and will be key in guiding expectations for third quarter GDP. Our nowcast suggests that Germany looks susceptible to dipping into a recession.

Recession risk in the UK

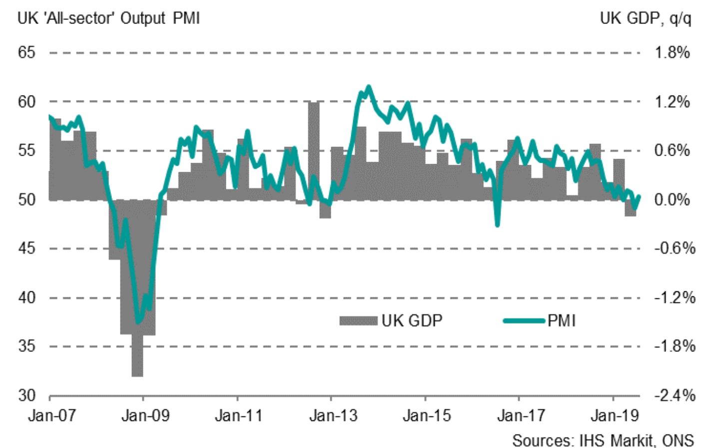
Survey data for the UK will warrant extra attention as the likelihood of the economy entering a recession has increased following the contraction in GDP during the second quarter. Our PMI survey data have shown below-par growth in the service sector so far in 2019, while manufacturing production has been impacted by the global trade slowdown and Brexit uncertainty. Report on Jobs data will also provide a fresh update on the labour market, which has been a bright spot for the UK amid low unemployment and nominal wage growth. Here, however, signs of cooling conditions have begun to appear, which could have negative implications on wages and consumer spending.

Meanwhile, parliament resumes after the summer recess. Following the announcement to suspend parliament, developments in the House of Commons will be scrutinised for Brexit guidance, as well as risks of a general election.

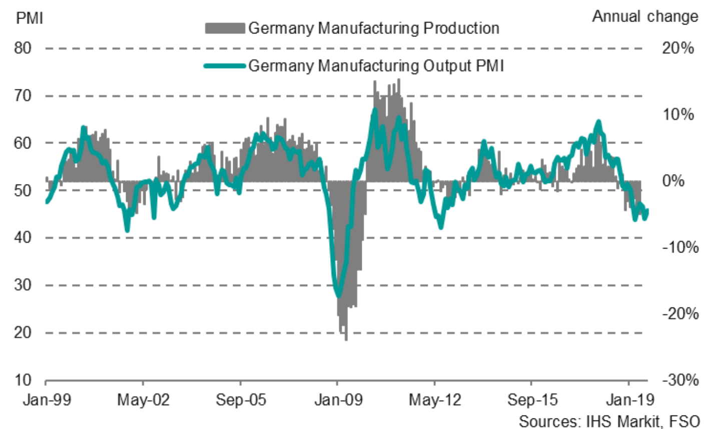
PMI data in third quarter so far point to anaemic growth



Recession risk for the UK economy



Germany's manufacturing slump remains at large



Asia Pacific Week Ahead

August PMI data, China trade, Australia GDP and monetary policy

By Bernard Aw
Principal Economist, IHS Markit, Singapore
Email: bernard.aw@ihsmarkit.com

The highlight next week is the worldwide release of August PMI results, with Asia eyeing surveys from China, Japan, South Korea and Hong Kong SAR in particular amid escalating trade tensions. China's trade data will also be scrutinised for trade war impact. Australia meanwhile releases second quarter GDP figures and sets monetary policy, and inflation data for a number of Asian economies should gather interest.

PMI clues of third quarter growth

With the global outlook becoming increasingly gloomy, August PMI data will provide a more complete view of third quarter economic trends and price developments. China watchers will monitor Caixin and NBS PMI surveys for clues into the extent of the economic slowdown, while the Hong Kong PMI will be highly anticipated by investors for assessing the probability of the economy heading into a recession amid trade wars and local protests. South Korea's manufacturing PMI will also be parsed for insights into the effects of rising trade tensions with Japan.

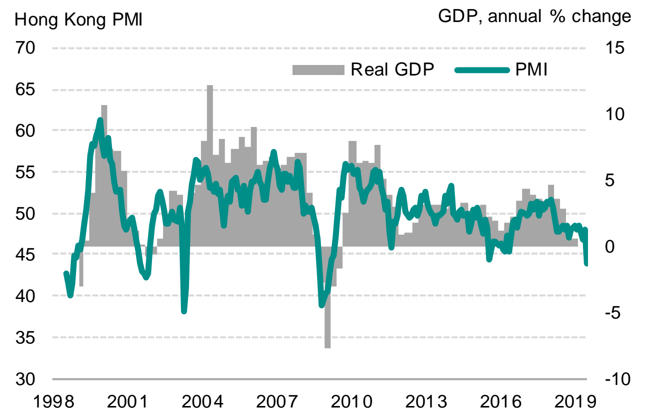
Analysts will also monitor the August update to China's trade figures for trade war impact. While export performance will be scrutinised, import data will provide clues of Chinese demand for regional goods. Caixin manufacturing PMI new orders index, which exhibits a near 70% correlation with official imports when applied with a two-month lead, hint at an improvement in demand.

Australian GDP and monetary policy

Australia's economy is likely to have expanded at an annual rate of just 1.6% in the second quarter, according to our forecast, which will be the weakest growth for nearly a decade. Flash August PMI surveys hint at further subdued growth in the third quarter, which will increase the pressure on the Reserve Bank of Australia for more monetary support.

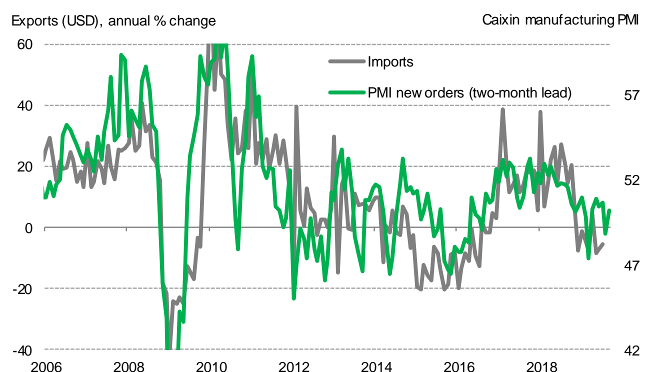
Australia's policy rate now stands at just 1.0%, and financial markets are pricing in another 25bps cut later this year, with another reduction to 0.5% in February next year. Weak inflation and subdued employment growth remain key determinants for further RBA action, which could come as early as November.

Hong Kong PMI in July points to falling GDP



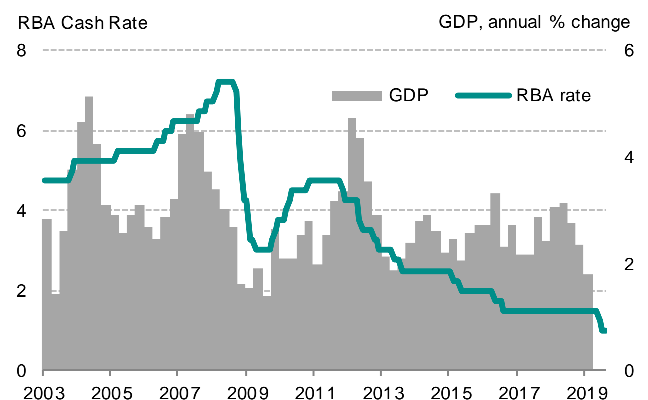
Sources: IHS Markit, C&SD

Caixin PMI hints at improved imports ahead



Sources: IHS Markit, Caixin, China Customs

Australia monetary policy and economic growth



Sources: ABS, RBA

Europe Special Focus

A new Italian coalition government, same fiscal headaches

By Raj Badiani

Economics Director, IHS Markit, London

Email: raj.badiani@ihsmarkit.com

Italy's latest political developments mirrored our baseline assessment of intensifying turmoil in the latter stages of 2019. Our sober growth assessment for this year and 2020 already assumes that confidence-sapping political discord in the latter half of 2019 would exert further pressure on already misfiring economy that slipped into technical recession in the second half of 2018 and has broadly stagnated to date in 2019.

New coalition government, same prime minister

Italian Prime Minister Giuseppe Conte resigned on 21st August 2019 before a vote of no confidence motioned by the far-right League party (Lega) could be held. The vote was called by Deputy Prime Minister Matteo Salvini after a contentious vote on the Turin-Lyon (TAV) high-speed railway project split the coalition government between his own Lega and the anti-establishment Five Star Movement (Movimento Cinque Stelle: M5S).

Surprisingly, the Democratic Party (PD, centre left coalition) is about to form a new governing coalition with MS5, which would have a working majority and be led by a reinstated Conte. Nicola Zingaretti, the head of PD believes the coalition is a "real turning point" for Italy and stressed that it was "not just a handover of power".

President Sergio Mattarella will decide what happens next, but his spokesman Giovanni Grasso has confirmed Conte has been invited to meet with the President on the evening of 29th August.

We had assumed the Europhile president would favour a technocratic arrangement to provide Italy a greater opportunity to honour its past fiscal pledges to the European Commission, beginning with an austere 2020 fiscal footprint. We had assumed this could be an attractive option to the main political parties, allowing them to step away from making some difficult fiscal choices in order to assure the European Commission and sovereign debt markets.

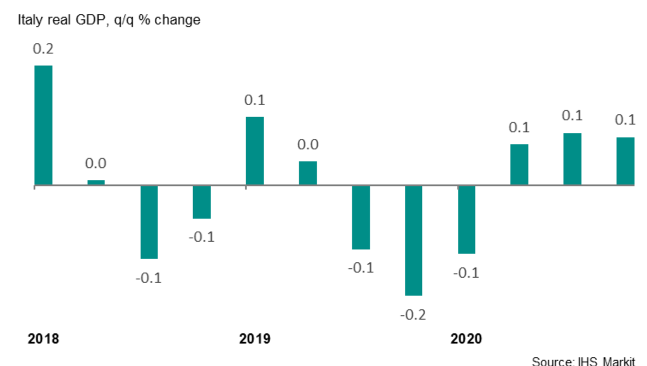
Despite avoiding the immediate risk of snap elections, the proposed new coalition government still faces difficult discussions regarding the 2020 fiscal priorities, with Italy on course to overshoot its fiscal targets at a time when the economy is hovering around recession.

Political turmoil ramps up pressure on struggling economy

Our baseline already assumes that confidence-sapping political turmoil in the latter half of 2019 would add further distress to a misfiring economy that slipped into technical recession in the second half of 2018 and has broadly stagnated to date in 2019.

We expect GDP to shrink by 0.1% in 2019 and 0.2% in 2020, according to our August forecast, which implies a mild technical recession during the second half of 2019 and early 2020 (see first chart). And the risks are tilting to the downside, given the threats to the global economy, alongside Italy's significant fiscal and political challenges. Given the latest political developments, the economy is on course for more pain in the next few quarters, reflecting nervous households, struggling exports, and poor investment trends.

Italy GDP forecast



New government faces awkward 2020 budget discussions, the economy under further pressure

The PD and FSM coalition complicates the possible fiscal pathways for 2020. The main challenge remains to address a general government budget deficit that is likely to be 2.8% of GDP in 2019 and 3.1% in 2020, due to the impact of poor economic activity on tax receipts and increased welfare spending, namely the stretched introduction of the citizenship income and several provisions on pensions, including a new early retirement scheme.

We assume that the FSM's red line for its new partnership with PD will be the continued introduction

of a means-tested citizens' income for the poorest households and pensioners. The citizens' wage basic income ranging from EUR480 to EUR780 (the annual family income of the applicant must be less than EUR9,360, whereas family real estate cannot exceed EUR30,000, excluding the first house). Some estimates suggest the citizens' income scheme will cost the government around EUR7-8 billion per year.

The continuation of the scheme diminishes the fiscal space in Italy, already likely to overshoot its 2019 public-sector budget deficit target of 2.04% of GDP. The now defunct FSM-Lega government had pledged some moderate fiscal corrective measures for 2019, but the country faces some challenging 2020 budget decisions, and remains some distance from delivering a past pledge to balance the books by 2020. Therefore, we expect the European Commission to ramp up pressure on Italy to activate a safeguard VAT rise from 1st January 2020, from 22.0% to 24.2%, raising an estimated EUR23 billion (or 1.3% of nominal GDP in 2020). The VAT hike clause is an instrument introduced in 2011 to be triggered to safeguard fiscal budgetary targets pledged to the European Commission. However, every government since 2011 has either postponed the VAT hike or proposed other fiscal tightening measures.

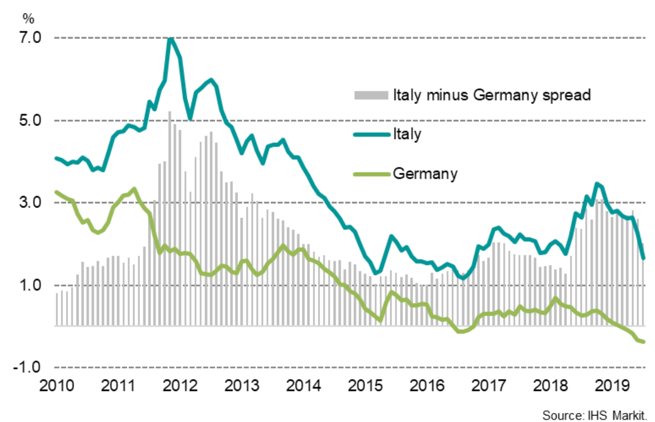
The new coalition government will be under considerable pressure from its core supporters to cancel the VAT hike, but this will need to be offset by deep spending cuts. Clearly, Conte's administration will be under pressure almost immediately to make some difficult fiscal choices ahead of presenting its 2020 budget draft outline to the European Commission on 20th October. In addition, given low nominal growth and a larger deficit, the public debt ratio (on a Maastricht basis) is projected to edge up the public debt ratio which stood at 132.2% of GDP in 2019, adding to the frustrations at the European Commission.

Our baseline already assumes significant fiscal tightening will occur in 2020 as a result of Italy wishing to avoid pressure from the European Commission, and the risk of being placed on Excessive Deficit Procedure (EDP) for debt risks, which it narrowly avoided in 2019. An EDP could result in possible sanctions. This includes initially a fine of up to 0.2% of its GDP, increasing to 0.5% for continued fiscal indiscipline. At this stage, we don't assume the VAT hike in early 2020, but significant fiscal corrective measures in its place.

Interestingly, the Bank of Italy warns that the budget deficit could stand at 3.4% of GDP in 2020 if the government doesn't activate the safeguard VAT hike, followed by 3.3% in 2021 and 3.0% in 2022. Meanwhile, the OECD predicts the fiscal shortfall in Italy widening from an estimated 2.4% of GDP to 2.9% in 2020, which assumes that only half of the planned VAT hikes in 2020.

The possible collapse in the likely FSM and PD government is on the risk radar given the awkward 2020 budget negotiations, and this could prompt a general election in the next few months. The latest opinion polls point to Lega win, with probably at least 35% of the vote, ensuring it is the senior partner in a new coalition government. A Lega-led government would probably spark a new clash with the European Commission over Italy's 2020 fiscal priorities. Salvini would have more policy clout and could be under greater pressure to deliver broader and unfinanced tax cuts from his supporters. He would be more emboldened to ramp up fiscal stimulus in 2020, taking strength from a strong election showing and the recent retreat in Italian sovereign borrowing costs (and the narrowing spread between Italian and German 10-year bond yields: see chart). A more forceful Lega government could unsettle the markets given Salvini's past hostility to the European Commission.

Long-term government bond yields



We cannot discount the possibility of a technocratic government being formed at some stage before a new general election takes place during 2020. A non-partisan government could be tasked to repair the fiscal accounts to appease the European Commission and not to disturb the relatively calm sovereign debt markets. We would expect a more severe fiscal tightening approach from a technocratic government, led by a VAT rise from 1st January 2020, is likely to be triggered. If a technocratic government is given greater license to restore some fiscal discipline, the anticipated recession could stretch further into 2020, and trigger a real GDP contraction in excess of the anticipated 0.2% during the year.

Asia Pacific Special Focus

Australia's Deepening Economic Ties with China: A Double-Edged Sword?

By Rajiv Biswas

Asia-Pacific Chief Economist, IHS Markit

Email: Rajiv.Biswas@ihsmarkit.com

Over the past two decades, Australia's economic ties with the People's Republic of China have deepened considerably, with mainland China now accounting for around one-third of total Australian exports worldwide. China's rapid pace of economic development since 2000 has resulted in buoyant growth in mainland China's demand for a wide range of Australian commodities, led by iron ore, coal and LNG. As a result, Australian exports of goods and services to mainland China have risen from just AUD 8.8 billion in 2001 to AUD 136 billion by 2018.

Australia has benefited considerably from the rapidly growing trade ties with China, which have insulated Australia from the shock waves of the Global Financial Crisis and have helped to allow the Australian economy to avoid a recession for the past 27 years. However, the far-reaching transformation of Australia's direction of exports within just two decades has considerably increased Australia's vulnerability to the risk of a protracted slowdown in the Chinese economy, or a low probability but high impact scenario of a "hard landing" for the Chinese economy.

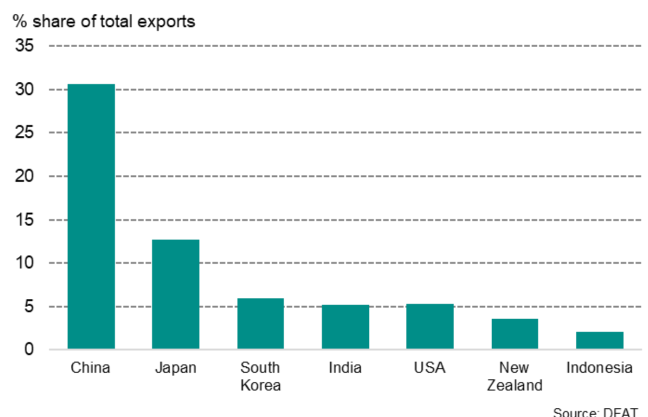
With anxieties mounting about the impact of the US-China trade war on the Chinese economy and the broader Asian manufacturing supply chain, this has become an increasing source of vulnerability for the Australian economy.

China has become a key growth engine for Australian economy

Since 2000, the size of the Chinese economy has grown at a staggering pace. The total value of China's GDP measured in nominal USD terms having increased from USD 1.2 trillion in 2000 to USD 13.6 trillion by 2018. The rapid expansion of the Chinese economy has transformed the bilateral economic relationship with Australia, with mainland China accounting for 30.6% of total Australian exports of goods and services in 2017-18, compared with just 5.7% in 2000-01. When the Hong Kong Special Administrative Region (Hong Kong SAR) of the People's Republic of China is included, mainland China and Hong Kong SAR together accounted for 34.2% of total Australian exports of goods and services in 2017-18.

Exports of iron ore and concentrates have played a key role in the rapid growth of total Australian exports to China over the past two decades. In 2001, Australian exports of iron ore and concentrates to China were just AUD 1.4 billion, but have grown to AUD 50.1 billion by 2017-18. China's investment into the Channar Iron Ore Joint Venture in Western Australia in 1987 created the foundation for the subsequent strong growth in Australian iron ore exports to China. With Chinese steel production having risen from 151 million tonnes per year in 2001 to 928 million tonnes by 2018, this has driven buoyant growth in Australian iron ore exports to China.

Key Australian export markets in 2017-18



New Export Sectors

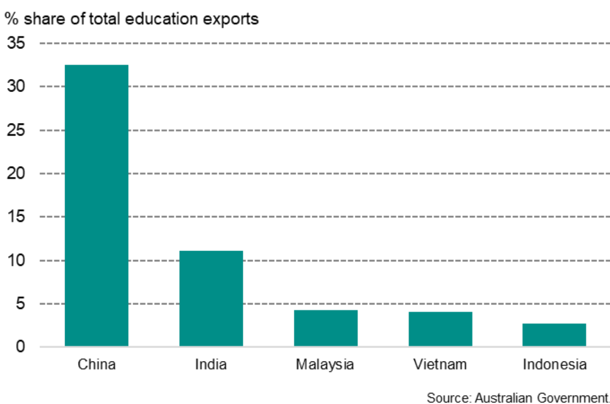
While the main driver of Australian exports to China over the past two decades has been China's rapidly growing demand for Australian commodities, new export sectors have also emerged, notably education and tourism.

As the size of China's consumer market has continued to grow rapidly, with per capita GDP having risen from just USD 1,000 per person in 2001 to around USD 9,500 per person by 2018, this has unleashed buoyant growth in demand for international tourism and education in mainland China. Australia has benefited considerably from the rapid growth of Chinese tourism and education spending in Australia. In 2018, total mainland Chinese spending on travel to Australia related to tourism and education was estimated to have reached AUD 15.8 billion, which was equivalent to around 11.6% of total Australian exports to mainland China.

China was consequently the leading source of international tourism for Australia in the year to March 2019, with an estimated 1.3 million visitors and total Chinese tourism expenditure in Australia estimated at AUD 12 billion. This was around 30% of total international tourism spending in Australia.

The importance of mainland Chinese students to Australia's overall exports is similar in terms of expenditure to Chinese tourism, with total Chinese student spending estimated at AUD 10 billion in 2017, which was around 33% of total Australian education exports in that year. With China's per capita GDP forecast to rise to USD 22,000 by 2030, this will drive further rapid growth in mainland Chinese tourism and education expenditure in Australia.

Australian education exports by country, 2017



Australia's food processing industry has also benefited from the rapid growth of China's consumer market. Australian wine exports to China have more than doubled in the past three years, from AUD 543 million in 2016-17 to AUD 1.2 billion in 2018-19. China now accounts for just over 40% of total Australian wine exports in value terms.

The implementation of the China-Australia Free Trade Agreement since it entered force in December 2015 has reduced tariff barriers on a wide range of Australian food exports to China, with the wine industry being a key beneficiary. From 1st January 2019, China has eliminated tariffs on Australian wine imports, which were previously set in a range of around 14% to 20%. This is expected to provide a significant boost to Australian wine exports to China over the medium term. Other Australian food sectors that will benefit from elimination of Chinese tariffs under the bilateral FTA over the medium term are dairy and beef exports, both of which are important sectors for Australia's agricultural industry.

The China-Australia FTA, when fully implemented over the next decade, will also gradually eliminate tariffs on exports to China of a wide range of Australian manufactures as well as resources and energy products.

Australia's increasing vulnerability to a China economic slowdown

While the long boom in Australian exports to China has been an important growth driver for the Australian economy, it has also considerably increased the vulnerability of the Australian economy to any significant economic slowdown in China. With China accounting for approximately one-third of total Australian exports, Australia's export sector is exposed to any significant fluctuations in Chinese demand for Australian goods and services.

While a China "hard landing" scenario still remains a relatively low probability risk, the direct shock waves to the Australian economy through trade, investment and capital markets channels in the event of such a China "hard landing" pose a key source of vulnerability for the Australian economy. With many other Asia-Pacific industrial economies such as Japan, South Korea, Malaysia and Singapore also vulnerable to any significant slowdown in China's pace of economic growth, the impact to the Australian economy would also be felt via Australia's trade and investment ties with other major Asia-Pacific economies.

Manufacturing exports

Over the medium to long-term, a key strategic implication for Australia is the need to diversify its export markets towards other major emerging markets economies, notably India and Indonesia. While India's total GDP is still considerably smaller than China, it is nevertheless set to become the world's fifth largest economy in 2019, with its GDP set to reach USD 3 trillion, overtaking the UK. Meanwhile Indonesia has

also emerged as one of developing Asia's largest economies, with a total GDP exceeding the USD 1 trillion threshold since 2017.

Despite these potential risks, the Australian economy will continue to benefit from the strong bilateral trade and investment ties with China over the long-term, as a key source of mineral resources, energy and food products as well as education and tourism exports for China's fast-growing consumer market.