Policy Paper - 02

Global Economic Outlook

In the Context of the Global Financial Services Sector

2019

مركز الكويت للسياسات العامة
Kuwait Public Policy Center

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Executive Summary

The global economy ended 2017 on a positive note. Advanced economies saw steady growth throughout the year while emerging economies tended to show strong performance across all regions. Despite this, however, economists and central banks, believe that neither global nor regional growth will attain its full potential. The positive economic performance in emerging economies in 2017 compared to 2016 was primarily attributed to a weaker U.S. dollar, which helped export-driven economies as well as emerging economies dependent on U.S. dollar-denominated debt.

A key element in developing an economic forecast for the next three to five years is understanding where we are in the economic cycle. The economic cycle is the natural fluctuation of the economy between periods of expansion (growth) and contraction (recession). Economic cycles are present in every economy, though each economy has its own cycle, which may not necessarily coincide with that of another country or region Over the years, governments and central banks have attempted to manage these cycles in order to prolong the expansion stage and reduce the contraction stage. The main tool that governments use to control the cycle is fiscal policy - increasing or decreasing taxes and spending. Central banks, on the other hand, employ monetary policy - controlling interest rates and credit.

During the global financial crisis in 2008, governments in North America, Europe and Asia reacted to the crisis by passing stimulus packages and offering support, including bailouts, to their financial systems. There were also some coordinated efforts on the global level to help minimize the effects of the crisis and help economies regain their growth momentum. They proposed new international financial regulations, agreed to take actions to stimulate employment and pledged not to resort to any protectionist measures. They also committed to maintaining the supply of credit by providing more liquidity and recapitalizing the banking system.

Trillions of dollars were deployed to support the financial system with the hope of ending the crisis and regaining economic growth. These stimulus programs worked, for the most part, and the crisis officially ended in 2010. However, the quick solutions applied during the crisis have not addressed the underlying issues in either the global economy or the global financial system. As a result, global growth remains below its historical trend. This can also be said for the major economies in North America, Europe, Asia and the Middle East/North Africa (MENA) region. The sluggish and lackluster growth over the past ten years is creating other problems in the global economy, namely, chronic high debt levels, stubbornly high unemployment levels in the E.U., a weaker financial system and a rise in populism.

What does this mean for the current economic cycle? Economic forecasts by the World Bank and the International Monetary Fund (IMF) shed some light on the current state of the global economy. Both reports offer detailed insight into current economic conditions and discuss the key risks that can negatively impact the global economy. The reports, however, underestimate the potential effects these risks could have on global and regional economies. Moreover, the reports do not focus on the maturity of the current economic cycle and the likelihood of a global recession soon. In fact, the IMF and World Bank raised their outlook on the global economy. Therefore, we remain skeptical as to their accuracy and foresight for five primary reasons:

1. Aging economic cycle
2. Volatility of commodities
3. Effects of rising oil prices on global growth
4. Slowing GDP at a time when credit growth is rising faster
5. Structural problems go unaddressed

With the current economic expansionary cycle nearing an end, there are three main factors that trigger a change in the cycle to a contractionary cycle (recession). They are: a) the price of oil; b) the global financial services sector and credit cycle; c) global central bank policies and their impacts on the financial services sector.

a. The price of oil

When looking at the future outlook for the price of oil, we considered fundamentals (supply demand dynamics) and market sentiment (trader dynamics). In both cases, the future outlook for oil is weak. On a fundamental basis, the main driver of demand over the last decade – China - is no longer be able to drive further demand growth. In addition, advanced economies are experiencing technological and regulatory change. These changes are going to negatively affect the demand for oil in what can be described as a paradigm shift toward other energy sources.

On a market sentiment basis, the price of oil is in the hands of the big banks, market traders and, increasingly, speculators using hedge funds. The big banks who helped launched complex derivative products off of oil and other commodities are being restricted by Basel III rules. They are not able to hold on to large derivative contracts as they have in the past. The influence of hedge funds on the oil market can been seen today. OPEC has been courting hedge funds publicly and requesting that they work together in supporting the price of oil. This would not be the case if these funds did not have a significant influence on the market.

b. Global financial services sector and credit cycle

The global financial services sector has gone through significant change over the past ten years. New regulations imposed on them in reaction to the financial crisis have affected their speed of recovery in some regions and restricted some of other their activities in other regions. The three major regulations are: the Dodd–Frank Wall Street Reform and Consumer Protection Act in the U.S.; the Bank Recovery and Resolution Directive (BRRD) in the E.U.; and Basel III globally.

The state of the global financial services sector since the financial crisis began has been mixed. The sector has largely recovered to pre-crisis levels in the U.S. and Asia, but it has yet to do so in the E.U. This is primarily due to the massive bad debts in the banking system, new regulations, and a lack of political will to address the underlying debt problem facing E.U. banks.

Emerging economies, on the other hand, witnessed a record amount of new credit growth. What is worrying for these economies is the amount of foreign currency credit growth. Credit issued in foreign currencies grew at a record pace placing these economies at a higher risk of default.

Upon reviewing the financial and credit conditions across all regions, we believe that the current credit cycle is mature and at extreme levels in some countries, including Australia, Canada, China, South Korea and Turkey. The next economic cycle downturn will affect these economies with greater intensity than other economies.

c. Global central bank policies and their impact on the financial services sector

Since 2008, central banks have been transformed from regulators of monetary policy to lenders of last resort and, lately, investors across a wide range of asset classes. Overnight, the major central banks switched from being regulators to buyers of government bonds, corporate bonds, mortgage-backed securities and stocks. Within a few short years, these central banks became among the largest investors in the world, larger than most sovereign wealth funds.

Not only have the latest central bank policies and monetary experiments, such as Quantitative Easing (QE), inflated asset prices around the world. They have also forced investors, especially those invested in sovereign wealth funds and pension funds, to seek out riskier assets in order get higher returns. Central banks may have saved the global economy from an even bigger disaster in 2008, but in doing so they have created other problems. The misallocation of risk and distortion of interest rates are causing investors to seek higher returns and much higher levels of risk than they would normally take. During the next economic downturn these investors, including those in the GCC sovereign wealth funds, will be hit hard.

Based on our review of the global and regional economies, it is clear that they are in the late stage of an expansionary cycle. The next stage will be a contractionary cycle, contrary to the forecast by the leading international agencies and central banks. The question now is not "if" we are headed for a recession but rather, what type of recession will it be?

There are five major risk factors that will affect the length and severity of the next recession. These risk factors, on their own, can be enough to spark another global financial crisis. These risks are:

1. Rising rates and their effects on emerging markets rates
2. Oil prices
3. Global trade war
4. Euro Area crisis
5. China crisis

Based on our study of global economic conditions, economic cycles and risk factors, we have modeled our forecasts assuming that there will be a normal recession in the coming years. Though we feel the probability is high that one or more of the five risk factors will materialize in the near future, it is too difficult to model a forecast based on high-risk assumptions. Therefore, we have assumed a normal global recession in our outlook.
Please note, however, if any of these risk factors materializes, the ensuing crisis will be more severe than the Global Financial Crisis of 2008.

Our global economic forecast calls for a global recession beginning in 2019. As a normal cycle recession, we expect global GDP to begin growing again in 2020. Some economies, however, will not recover as quickly, namely, commodity producers and oil producers.

For Kuwait, we looked at two existing scenarios: the World Bank and the Oxford Economics Baseline Scenario. In addition, we developed our own scenario. In our scenario, we assume that government spending remains as currently planned, while oil prices fall sharply as they did from 2014 to 2016. The main purpose for this was to see how the national economy can withstand external recessionary forces. The scenario proves that Kuwait can avoid a severe recession by maintaining its current spending plans. However, in doing so, it will require that the government to take on a higher debt load.

The conclusion of this report contains our policy recommendations for Kuwait. Recommendations have been divided into two categories: economic policy recommendations, which are general recommendations for the national economy; and financial service specific policy recommendations, which are intended to mitigate any negative outside risks to the national financial services sector.

Introduction

The global economy finished 2017 on a high note. Economic growth in developed countries continued to improve, especially in the U.S. Emerging market economies also showed overall improvement as commodity prices rebounded from their 2016 lows. Kuwait and other Gulf Cooperation Council (GCC) countries continued to recover from the oil price collapse that began in mid-2014. Saudi Arabia, however, experienced a short recession in 2017, but has since recovered as of Q1 2018.

It has been over ten years since the last global recession. International agencies, such as the World Bank and the International Monetary Fund (IMF), are predicting continued global growth for the next few years. In addition, the world's leading central banks are confident that their policies have improved the stability of the financial system. Therefore, they do not expect a repeat of the Global Financial Crisis of 2008 anytime soon.

With this in mind, we take a closer at these economic forecasts in order to understand their assumptions before determining whether we agree with them. The economic cycle is the first factor we examine. Economic cycles are important in understanding where we are today and where we expect to be in the near future. The last global recession was one of the worst recessions in recent memory, and it required an extraordinary policy response by governments and central banks. As such, we also need to have a better understanding of the policies and programs in order to determine whether they will prevent another financial crisis from causing a global recession.

Regardless of when the next global recession occurs, what is certain is that there will be another one. This has been the case throughout economic history. As with past global recessions, the next one will have a negative impact on oil prices, asset prices, trade and commodities in general. The effects on the global economy, and on Kuwait in particular, will depend on the severity of the recession. As a rule of thumb, a global recession caused by a normal downturn in the economic cycle tends to be short and less severe. A global recession triggered by a financial crisis tends to be long and severe, especially on the financial sector.

In looking at the various scenarios that could play out in the global economy, we pay special attention to the price of oil as the leading contributor to the Kuwaiti economy. We will also look at how these scenarios could impact the financial services sector in Kuwait. In addition, we will outline the key risks facing the global economy and Kuwait. This will help in determining the severity of the next global recession.

Finally, and in anticipation of the next global recession, we outline an appropriate policy response to manage any negative impact on the financial sector.

1. Overview of the current state of the global economy

Economic growth in 2017 witnessed a noted improvement across nearly every region. Advanced economies saw steady growth during the year. The leading economists and central banks, however, still believe that growth has yet to reach its full potential. Emerging markets improved their performance, which was as expected. The improved growth in 2017 versus 2016 was mainly attributed to a weaker U.S. dollar. The weaker dollar helped export-driven economies as well as emerging markets dependent on U.S. dollar-denominated debt.

United States

U.S. Gross Domestic Product (GDP) in the First Quarter (Q1) of 2018 was 2.8% on a year-on-year basis. Although it has been one of the best performing advanced economies, as defined by the IMF, its GDP growth is still below its historic average of 3.2% annually (from 1948 to 2018). This suggests that the economy is not reaching its full growth potential. Since the end of the recession in Q4 2009, the U.S. economy has maintained an average annual GDP growth of around 2%.

Other notable economic indicators include a near-historic low unemployment rate of 3.8% as of Q1 2018, which suggests that the U.S. economy is at full employment. In addition, the U.S. is the only advanced economy that has been steadily raising interest rates, which may be attributed to the steady rise in inflation to (or above) the stated Federal

Reserve Bank (the central bank) target rate of 2%. The current rate of inflation as of Q1 2018 is 2.5%.

European Union

Euro Area member countries' GDP growth in Q1 2018 was 2.5% on a year-on-year basis. Since 2017, Euro Area annual GDP growth has remained above 2% for the first time since 2011. This improved performance has not been equal across all member countries. Germany, the largest Euro Area economy, recorded GDP growth of 2.3% year-on-year in Q1 2018, while Italy, the third-largest economy, recorded an anemic annual GDP growth of 1.4% over the same period. A few notable performers in the Euro Area over the same period include Ireland 8.4%, Austria 3.4%, and Spain 3.0%.

This notable variance in economic performance among Euro Area economies can be attributed to stubbornly high unemployment rates, especially youth unemployment in Southern European countries, high government debt levels and high government budget deficits. The cause of this is structural, due to such factors as a complex tax system and employment laws.

The official unemployment rate in the Euro Area is 8.5% as of April 2018 and has been steadily declining from its peak of over 12.1% in 2013. However, the youth unemployment rate, which refers to unemployed persons from 15- to 25-years-of-age, is much higher, registering 17.2% in April 2018. It, too, has been steadily declining from its peak of 24.7% in 2013, yet it remains a major issue for member countries. Here again, not all countries are the same. Germany, for example, had an unemployment rate of 3.4% as of April 2018, which is considered to be the level of full employment. Its youth unemployment rate was 6% over the same period. This is in contrast to Spain, which had an unemployment rate of 16.7% and a youth unemployment rate of 34.4% over the same period.

TABLE 1

Key economic indicators for the largest 20 economies plus the Euro Area. All figures are as of Q1 2018 except where indicated. Gov. Budget and Current Account are a percentage of GDP

	GDP ($ billions)	GDP 2017	GDP Q1 '18	Interest rate	Inflation rate	Jobless rate	Gov. Budget	Debt/ GDP	Current Account
United States	18,624	2.80%	2.20%	1.75%	2.50%	3.80%	-3.50%	105.40%	-2.40%
Euro Area	11,886	2.50%	0.40%	0.00%	1.90%	8.50%	-0.90%	86.70%	3.50%
China	11,199	6.80%	1.40%	4.35%	1.80%	3.89%	-3.50%	47.60%	1.30%
Japan	4,940	1.10%	-0.20%	-0.10%	0.60%	2.50%	-4.50%	253.00%	4.02%
Germany	3,467	2.30%	0.30%	0.00%	2.20%	3.40%	1.30%	64.10%	8.00%
United Kingdom	2,648	1.20%	0.10%	0.50%	2.40%	4.20%	-2.30%	85.30%	-4.10%
France	2,465	2.20%	0.20%	0.00%	2.00%	9.20%	-2.60%	97.00%	-0.80%
India	2,264	7.70%	1.80%	6.25%	4.58%	3.52%	-3.53%	68.70%	-0.70%
Italy	1,850	1.40%	0.30%	0.00%	1.10%	11.20%	-2.30%	131.80%	2.80%
Brazil	1,796	1.20%	0.40%	6.50%	2.86%	12.90%	-7.80%	74.04%	-0.48%
Canada	1,530	2.30%	0.30%	1.25%	2.20%	5.80%	-0.90%	89.60%	-3.00%
South Korea	1,411	2.80%	1.00%	1.50%	1.50%	3.80%	-2.00%	38.00%	5.60%
Russia	1,283	1.30%	-0.38%	7.25%	2.40%	4.90%	-1.50%	12.60%	1.80%
Spain	1,232	3.00%	0.70%	0.00%	2.00%	16.74%	-3.10%	98.30%	1.90%
Australia	1,205	3.10%	1.00%	1.50%	1.90%	5.60%	-1.90%	41.90%	-3.10%
Mexico	1,047	1.30%	1.10%	7.50%	4.51%	3.40%	-2.90%	46.40%	-1.60%
Indonesia	932	5.06%	-0.42%	4.75%	3.23%	5.13%	-2.46%	28.70%	-1.70%
Turkey	858	7.40%	2.00%	17.75%	12.15%	10.60%	-1.50%	28.30%	-5.50%
Netherlands	771	2.80%	0.50%	0.00%	1.70%	3.90%	1.10%	56.70%	10.20%
Switzerland	660	2.20%	0.60%	-0.75%	1.00%	2.40%	1.20%	29.70%	9.80%
Saudi Arabia	646	-1.20%	1.00%	2.25%	2.50%	6.00%	-8.90%	13.10%	-3.70%

Source: Trading Economics.

On the government debt side, the Euro Area as a whole suffers from the strain of too much debt. The government debt-to-GDP ratio as of April 2018 stood at 86.7%, which may seem high, yet manageable. However, in looking at member countries separately, the picture is much different. Italy, for example, has one of the highest debt levels in terms of total debt outstanding (€2.3 trillion as of March 2018) as well as in terms of debt-to-GDP ratio, which as of April 2018 was 132%. This is an alarming figure for any country and even more so for a country with very low GDP growth and a high unemployment rate. Compare this to one of the more fiscally prudent countries in the Euro Area, such as the Netherlands, which has a government debt-to-GDP ratio of 56.7%.

Governments within the Euro Area have yet to address these structural issues, which will only hurt the economy more in the long run. The problems in the Euro Area represent a risk to the global economy, and these are discussed later.

East Asia

East Asia is represented by China, Japan and South Korea. All three are among the top exporting countries in the world. As of April 2018, GDP growth in China was 6.8% year-on-year. In 2010, China became the second-largest economy in the world; it took over from Japan, which had held that position for 42 years. China's impressive growth began in the early 1990s as the country transformed itself into the manufacturing center of the world. The country's growth level is still higher than that of most other countries, yet it has been steadily declining from a GDP growth of 14.9% in 2007.

Japan and South Korea have had mixed performance recently. As of April 2018, their GDP growth year-on-year was 1.1% and 2.8% respectively. Japan has been unable since 1990 to return to a high-level of GDP growth. For the past 28 years, the country has had to live with much lower growth rates and a much higher frequency of recessions, as globalization led Japanese manufactures to move to cheaper countries, such as China. Since 1990, the country has been in and out seven recessions. Today, GDP growth is slowing again, which could lead Japan into another recession very soon.

South Korea is considered to be a bellwether for global trade as its economy is highly dependent on manufacturing exports. Exports from South Korea increased by 13.5% in May 2018 from a year earlier, led by exports of microchips (up 44.5%), petrochemical goods (up 26.8%) and machinery (up 15.8%). However, its economy overall looks like it is starting to behave as Japan's did in the 1990s. Since the Global Financial Crisis, GDP growth has been unable to return to its previous trend above 5% annually. Instead, it has been in the range of 2-4%.

Fiscally, South Korea is in a much stronger position than Japan and China. South Korea has been better able to manage its budget deficits, which was 2% of GDP in 2017. Compare this to the budget deficits in Japan and China over the same period, which were 4.5% and 3.5%, respectively (Table 1). South Korea has also been able to manage a slower growth in government debt-to-GDP ratio. As of April 2018, it was 38%. The government debt-to-GDP ratio in Japan for the same period was 253%, the highest in the world and a sure sign of disaster down the road for the country.

China's government debt-to-GDP ratio in April 2018 was a manageable ratio of 47.6%. However, this does not include the debt from government wholly- or partially-owned enterprises, which constitutes a large part of the economy. Over the past 10 years, these companies have borrowed trillions of dollars, mainly from Chinese banks, all of which are implicitly or explicitly guaranteed by the Chinese government. The high level of overall debt in the Chinese economy represents a major risk to the global economy, and will be discussed later.

Other Emerging Markets

Some of the other leading emerging markets include Brazil, India, Russia and South Africa. Together with China, these countries are known as the BRICS. With the exception of In-

dia, which registered a GDP growth of 7.7% as of April 2018, the remaining countries have displayed a lackluster economic performance over the last couple of years. Brazil has been recovering from its worst economic recession in more than 100 years only to descend into political turmoil, which has sparked mass protests and is affecting the recovery.

South Africa and Russia, both dependent on commodity exports, also are affected by politics. For Russia, the issues have been geopolitics and economic sanctions; for South Africa, domestic politics and protests. All of these countries, including India, are dealing with internal or external matters that are affecting their economic performance.

Turkey can also be added to this group. As of April 2018, Turkey registered a GDP growth of 7.4%, yet geopolitics and internal strife are affecting its performance.

Currencies in all of these countries have depreciated against the U.S. dollar. This has put further pressure on their economies, their foreign reserves and their ability to repay their foreign currency debts. If the U.S. dollar were to continue to strengthen over the next year, it will directly impact these emerging markets and may cause economic and/or financial crises.

Middle East & North Africa (MENA)

Outside of the GCC, the leading MENA economies are Egypt, Morocco and Jordan. They registered a marked improvement in economic growth in 2017 over the previous year of 5.3%, 3.9% and 1.8% respectively. These figures are constrained by systemic high unemployment rates that affect the entire region. The official unemployment rate as of December 2017 was 11.3% in Egypt, 10.2% in Morocco and 18.4% in Jordan.

In the GCC, Saudi Arabia was in recession for two quarters in 2017 and has since recovered. GDP growth was 1% year-on-year in December 2017. Oman has also recovered from a recession that began in 2016. GDP growth in 2017 was 0.7%. The U.A.E. and Qatar witnessed slow growth in 2017, recording a GDP growth rate of 1.5% and 1.8% respectively. Kuwait and Bahrain both had negative GDP growth in 2017. For Kuwait, GDP growth in 2017 was -2.5% and for Bahrain it was -2.8% according to IMF data.

The high dependence on a single commodity (oil) coupled with both geopolitical tensions and youth unemployment (and under-employment) are among the key factors to blame for this economic performance.

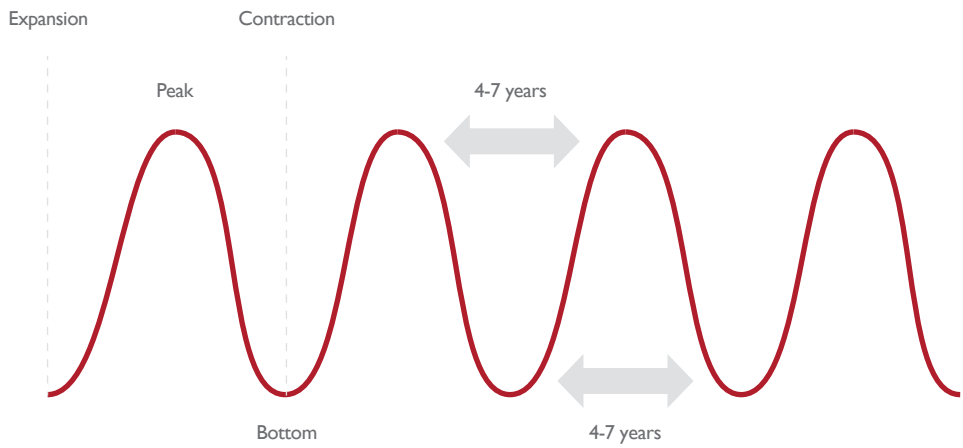
a. Economic cycles

An economic cycle, also referred to as the business cycle, is the natural fluctuation of the economy between periods of expansion (growth) and contraction (recession). An economic cycle has four stages: expansion (growth); peak; contraction (recession); and bottom.

During the expansion phase, the economy experiences a moderate- to high-level of growth, interest rates tend to be low, production increases and inflation is relatively low early on in this stage. The cycle's peak is reached when growth hits its maximum output and inflationary pressures rise. In the peak stage, growth usually creates some imbalances

FIGURE 1

The economic cycle theory



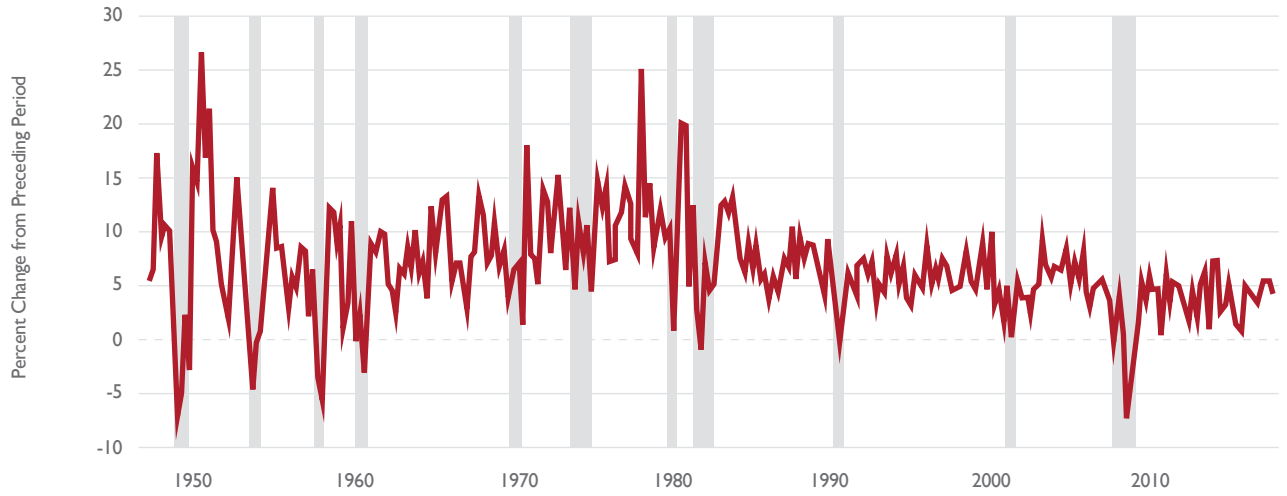
The contraction stage beings when growth slows, employment falls and prices stagnate due to over-production. The bottom of the cycle is reached when the economy hits a low point in growth, at which time a recovery can begin. Factors such as a high-level of debt (both consumer and business) coupled with slowing demand and rising unemployment can trigger a financial crisis, which leads the economy into contraction.

The economic cycle is a natural feature in an economy. There is, however, some debate as to what causes cycles to exist in the first place. The monetarist school of economic thought links the economic cycle to the credit cycle. Changes in interest rates can increase or decrease economic activity by making it more – or less - expensive for households, businesses and government to borrow. In other words, lower interest rates stimulate credit growth that, in turn, stimulates economic growth. On the opposite side, higher interest rates depress credit growth. And that, in turn, slows economic growth.

The Keynesian school of economic thought argues that changes in aggregate demand, caused by instability and volatility in investment demand, are responsible for generating cycles. A third school of economic thought, the neoclassical school, argues that there is no such thing as equilibrium and therefore, economic cycles exist because the economy naturally shifts across a range of disequilibrium as producers who are trying to match ever-changing consumer demands constantly over- or under-invest and over- or under-produce.

FIGURE 2

U.S. annual GDP growth rate from 1947 to Q1 2018



Source: Federal Reserve Bank of St. Louis.

The theories developed to understand economic cycles, as well as the differing interpretations, have little relevance in this report. What is relevant, however, is to recognize that economic cycles have always been part of the economy, and they will continue to occur. A good example of economic cycles can be seen in Figure 2. The figure shows the percentage change in U.S. GDP from 1947 to Q1 2018. During this period, the U.S. economy experienced 12 cycles. The twelfth cycle is not yet complete. In other words, during this period, the U.S. economy has had 11 recessions of varying lengths and degrees of severity. The shortest economic cycle was just over one year (15 months), and the longest cycle is the current one, which began in 2009 surpassing the previous longest cycle from 1990 to 2000. The average length of a cycle has been 6.2 years.

Managing economic cycles

Over the years, governments and central banks have attempted to manage these cycles in order to prolong the expansion stage and reduce the contraction stage by wielding one main tool: fiscal policy.

i. Fiscal policy

In order to end a recession, for example, the government will employ expansionary fiscal policy to stimulate economic growth. The core principal behind this is to increase aggregate demand by increasing government spending and cutting taxes. Lower taxes will increase consumer spending because such an action increases disposable income. The flipside is that fiscal policy tends to worsen the government budget deficit, prompting the government to increase borrowing. Governments view this policy as a necessity in order to drive up growth. Once the economy is on a stable growth trajectory, the government can ease off on the fiscal policy while its finances begin to improve. This is as a result of increased taxation from higher economic growth.

Conversely, the government will use contractionary fiscal policy to stop the economy from overheating. This involves decreasing aggregate demand. On this basis, the government will cut government spending and increase taxes. Higher taxes will reduce consumer spending and improve the government's budget deficit.

ii. Monetary policy

Monetary policy is in the hands of the central bank. It uses monetary policy to help manage and control the economic cycle. Monetary policy involves using interest rates and other monetary tools to influence consumer spending levels and aggregate demand. The aim of monetary policy is to stabilize the economic cycle by keeping inflation low and avoiding recessions.

When the cycle bottoms, the central bank will implement an expansionary monetary policy by lowering interest rates in order to induce aggregate demand. When it raises rates, also known as a contractionary monetary policy, its objective is to manage and slow an economic expansion to prevent it from peaking.

Both fiscal policy and monetary policy have been ineffective in preventing a recession or changing the pattern of the economic cycle. At best, they have been able to prolong an expansion or reduce the length and severity of a contraction.

In some cases, fiscal and monetary policies have been blamed for causing the recessions they were attempting to prevent. A recent example of this dates to the year 2000. Immediately after the dot-com bust in the U.S., both the U.S. government and the Federal Reserve (Fed) implemented policies to try to stem the inevitable recession. The Fed lowered interest rates in order to stimulate lending, and the government encouraged consumers to buy homes through partially-subsidized mortgages. It also guaranteed these mortgages through its two quasi-government lending agencies (Freddie Man and Fannie Mae) and offered incentives to attract lower-income consumers.

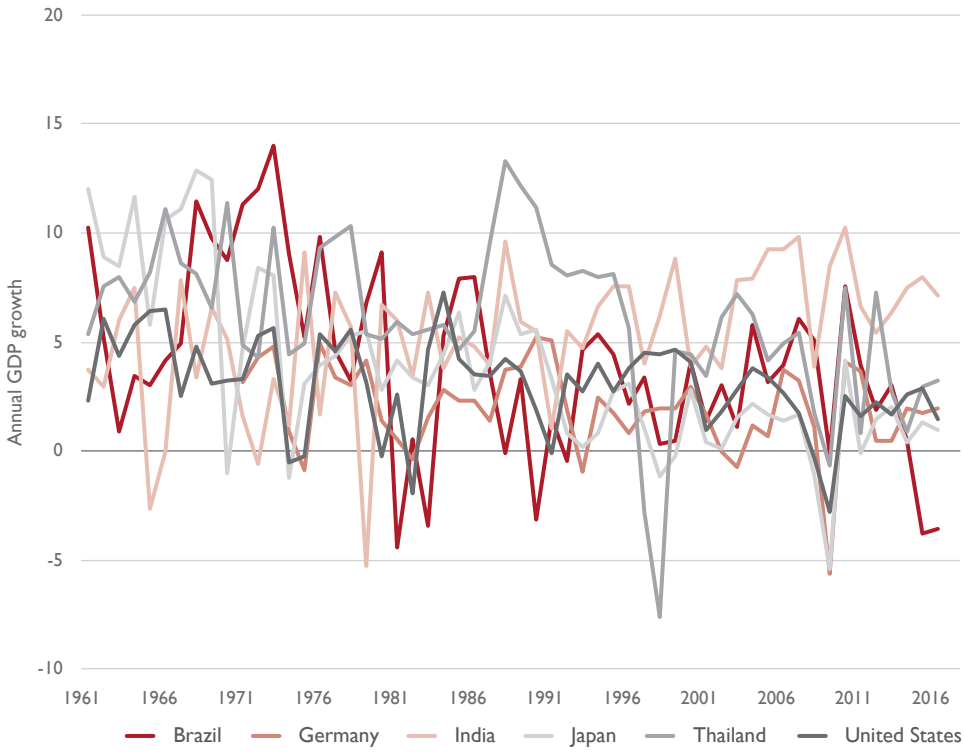
The U.S. did not avoid a recession, though it turned out to be short-lived. This was not due to the fiscal and monetary policies, but rather to the fact that it was a stock market-based asset bubble and not a debt-based bubble, which tend to be longer in duration and more severe. The unintended consequences of these policies, however, gave rise to the debt-based housing market bubble from 2003 to 2008, which resulted in the Global Financial Crisis.

The global economic cycle

Clearly, the U.S. has had a very active cycle, but what about other countries around the world? Do they have similar cycles? The answer can be found by examining Figure 3. The figure dates to 1961 when the most consistent data is available. Since it is pre-Euro Area, Germany was selected as the example for Europe. At least one country from each region of the world was selected to compare the economic cycle pattern. GCC countries were deliberately excluded from this chart due to their volatility around oil prices.

FIGURE 3

Percentage change in GDP in select countries from 1961 to 2016



Source: World Bank.

The other countries in the figure include: Japan to represent East Asia; Thailand to represent the young emerging markets; Brazil to represent emerging South America; India to represent South Asia; and the U.S. to represent North American and the largest economy. China is not represented here because its economic data was not consistent in the 1960s and 1970s.

The first and most obvious observation is that every country/economy has an economic cycle, there is no escaping it. The second observation is that each country's economic cycle does not necessarily align perfectly with that of other countries. Some countries may experience a recession when others are in the middle of a growth cycle. This was the case in 1990. Brazil was in recession while India, Japan and Thailand were expanding. At the same time, the U.S. was contracting and heading for a recession. During the Asian Financial Crisis in 1997, Thailand and other Southeast Asian countries were in a severe recession, but this had little effect on the U.S., India and Germany.

However, there are occasions when many countries enter a recession simultaneously. This was the case during the Global Financial Crisis. Both advanced and emerging economies fell into recession in 2008-2009. Even though this was a global recession and a global financial crisis, it did not necessarily mean that every country in the world was in recession at the same time. From 2008 to 2009, all of Australia, China, Colombia, India, Indonesia, South Korea and a few other, smaller economies avoided a recession.

The third and final observation about Figure 3 is that most regions of the world, with the exception of South America represented by Brazil, have been in an expansionary cycle since 2009. Thus, it is safe to conclude that these countries either have reached their peak stage or are close to reaching it. Over the next few years, we are more likely to see these economies contract than we are to see a continuation of their expansionary cycle.

b. Impact of last recession on current cycle

The recession that began in 2008 and ended in 2009 was different from typical recessions in three ways. First, it affected a majority of the world's economies, hence the reference to it as a "global recession." Second, it was the most severe recession in living memory. Third, the recovery from it took much longer than the recovery that followed other recessions. Some countries, to this day, have not fully recovered.

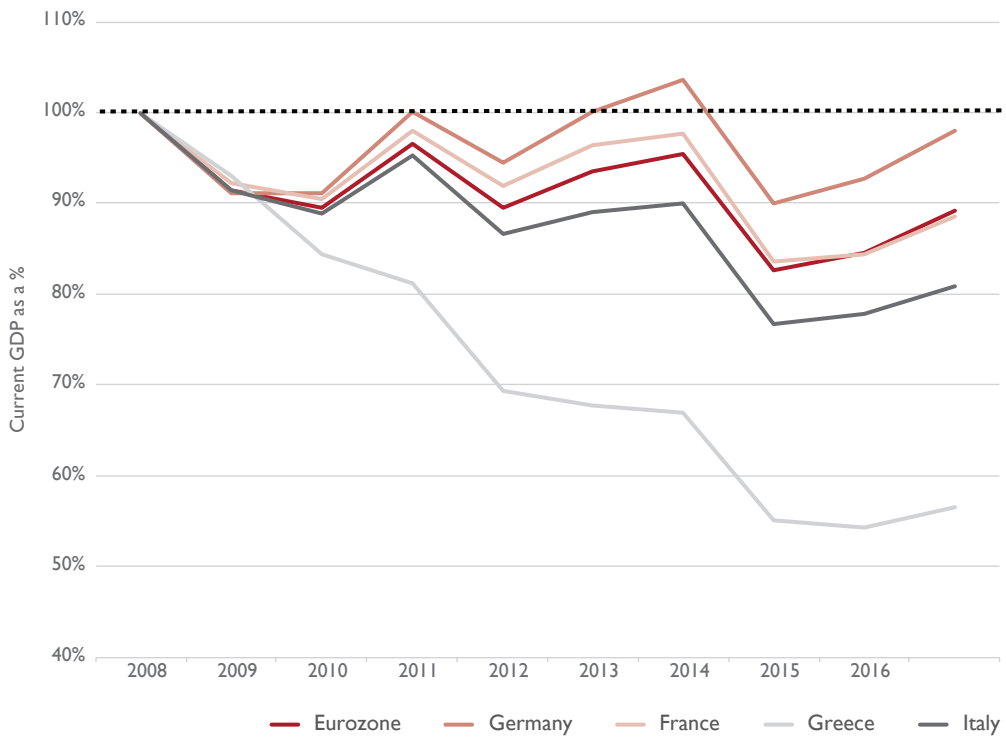
If we look at the Euro Area, which has been the worst-performing region since 2008, we can see that GDP across the region has yet to recover to 2008 levels. Figure 3 highlights Euro Area GDP since 2008, along with a select group of other Euro Area countries. Euro Area annual GDP in 2016 was 16% below GDP in 2008. Even Germany, with the region's strongest and largest economy, saw its GDP briefly rise above 2008 levels only to fall back to 8% below 2008 levels by 2016. The hardest-hit has been Greece. Its GDP in 2016 was 45% below its 2008 GDP. Italy, too, has been among the hardest-hit, having its GDP fall 23% from 2008 to 2016.

The main reason for the region's inability to recover is political. Since the launch of the Euro as a unified currency in 1999 and subsequent issuance of the first euro notes in 2002, weaker countries have been unable to devalue their currencies to retain any competitive advantage. Thus, numerous industries and businesses relocated to more competitive countries within the E.U., such as Eastern Europe for low-cost manufacturing or Northern Europe for high-tech industries and services. This left Southern Europe being slowly drained of its resources, including talented job seekers who left their homes in Southern Europe to compete in Northern Europe with other top talent from there.

The political solution to this would be to integrate politically and not just economically, becoming more like a United States of Europe. However, the populist movements that have swept across Europe since 2008 have left this a distant dream. Today, the best political option would be to allow weaker countries to exit the euro and reissue their own currencies. This seems like a drastic move. But Denmark, Norway, Sweden and the U.K. have never adopted the euro, have remained competitive - and the euro has not collapsed.

FIGURE 4

Change in Euro Area and select county GDP from 2008 to 2016



Source: Trading Economics.

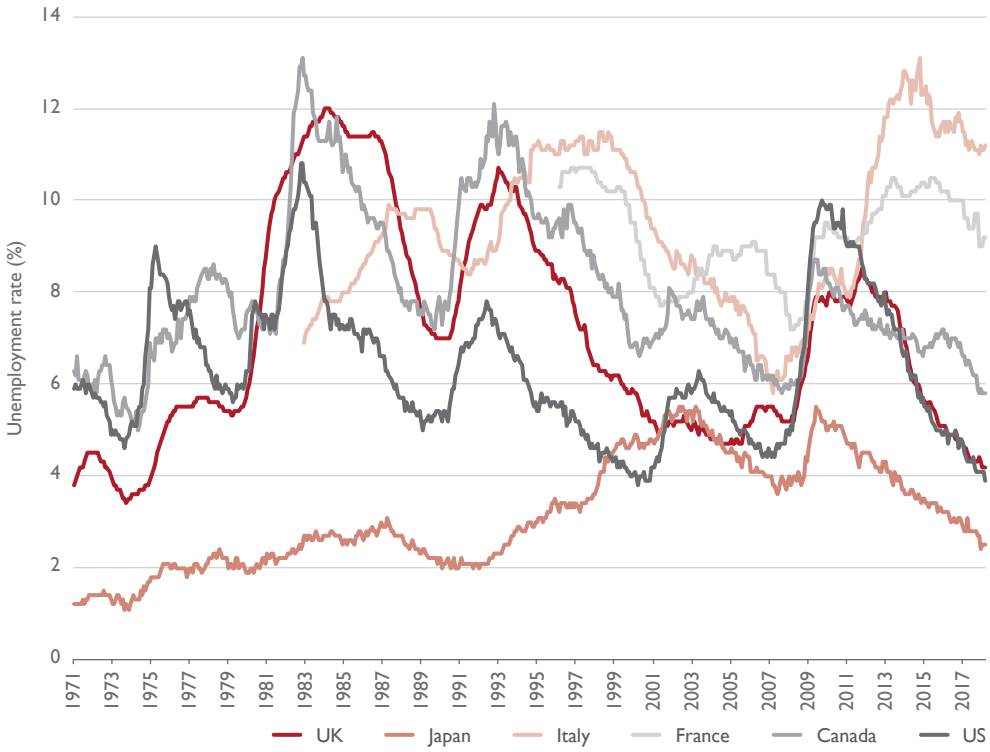
Another factor to consider is the recovery of employment in affected countries. The severity of the recession caused a quick spike in unemployment levels in most affected countries. This tends to be normal during a recession. However, what was different in this case was the time it took to recover.

In the U.S., the unemployment rate jumped from a low of 4.4% in 2007 to 10% in 2009, a level not seen since 1982. The level of unemployment in the U.S. has recovered and as of Q1 2018 is at a near-record low of 3.8%. However, it took ten years for the job market in the U.S. to fully recover, much longer than in previous recessions.

This has not been the case in some other countries, especially Euro Area countries. The unemployment level in France has yet to recover to 2007 levels, though it has been steadily improving since 2015. Italy, on the other hand, saw its unemployment level continue to rise even after the recession was declared to be over. Unemployment in Italy rose steadily from 5.8% in April 2007 all the way to 13.1% in November 2014 before finally coming down slightly to 11.2% as of April 2018. Japan and Canada recovered much like the U.S. had - in a slower-than-normal fashion.

FIGURE 5

Change in the unemployment rates in select countries from 1971 to Q1 2018



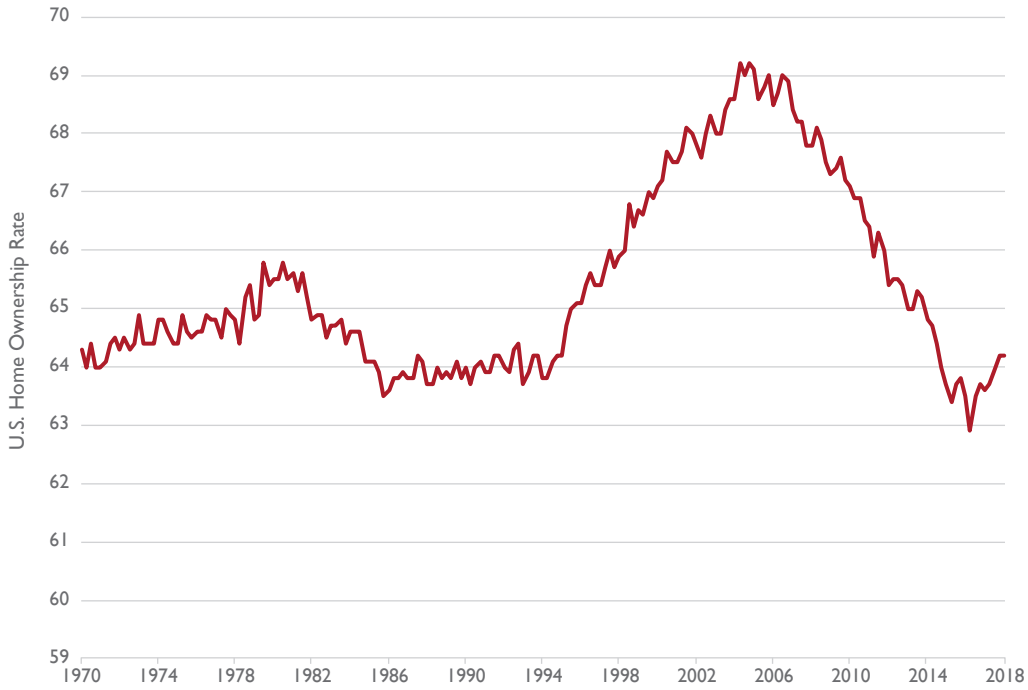
Source: Trading Economics.

Though the recovery across countries was not uniform, it also was not uniform across different industries within each country. In the U.S., for example, home ownership rates are far from recovering to pre-crisis levels. In fact, the level of home ownership reached a low not seen since the 1960s. The irony here is that the government and Fed policies to increase home ownership have had unintended consequences. This left home ownership rates well below the level they were at when these policies were implemented.

The housing market in the U.S. recovered in terms of home prices, but not in terms of home ownership rates. There are two main reasons for this. First, the slow recovery of the job market forced many to seek employment in lower-paying jobs; as a result, they could no longer afford a home. Second, a majority of the new jobs created since the recovery have been lower-skilled and lower-paying jobs. Though on the surface the job market is considered to be very strong at the moment, a different picture emerges under the surface. The quality of jobs available today is lower than it was ten years ago.

FIGURE 6

Changes in U.S. homeownership rate from 1970 to Q1 2018



Source: Trading Economics.

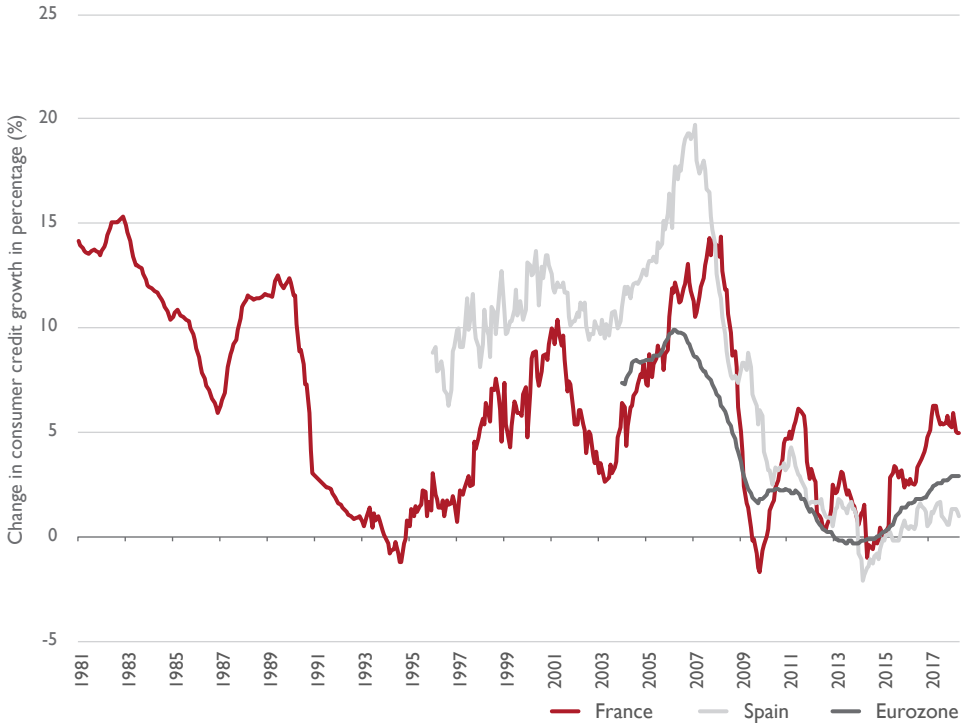
In the Euro Area, we can look at a different metric - growth in consumer credit. As stated earlier, the monetarist school of economic thought links the economic cycle with the credit cycle. A rise in credit drives economic growth, and a fall in credit contracts growth. If we examine Euro Area consumer credit growth since 2007, we can see from Figure 7 that it is a long way from recovering.

The countries with the weakest credit recoveries are those that had the highest credit growth before the crisis, namely Spain and other Southern European countries. France has also seen a slump in credit growth, which is a symptom of structural problems in its economy.

Since consumers were unable to increase their borrowing, corporates and governments needed to step in and borrow more to induce economic growth, or so the theory goes. Corporates, however, were facing their own issues related to recovering from the economic slowdown. Only the largest multinational corporates have been borrowing large sums to fund their operations and acquisitions. Medium- to small-sized companies were locked out of the credit markets due to their perceived risks and European banks' inability to give out riskier loans as they had done before the crisis.

FIGURE 7

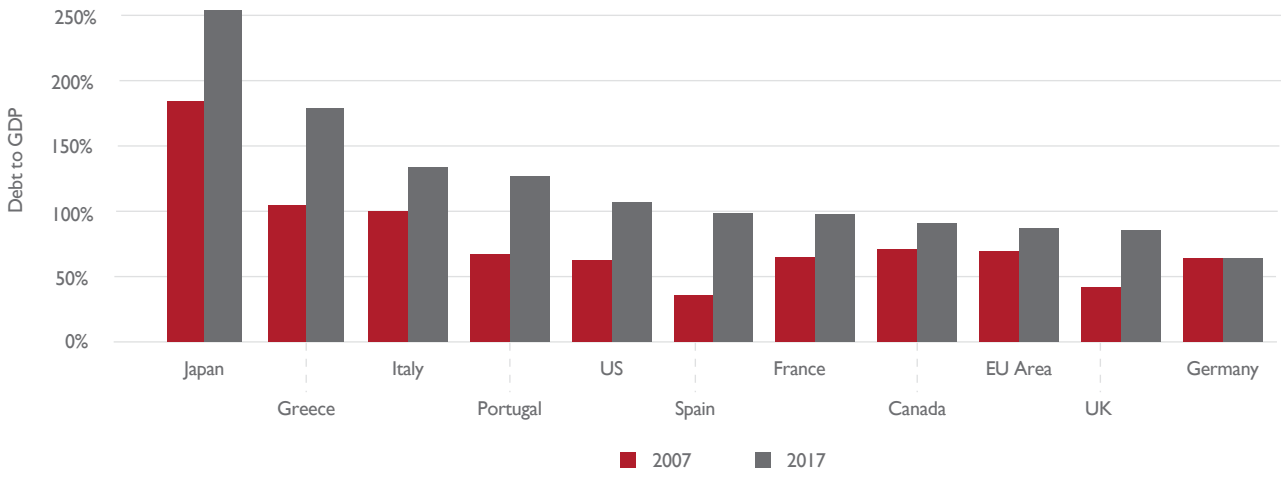
Percentage change in consumer credit growth from 1981 to Q1 2018



Source: Trading Economics.

FIGURE 8

Change in government debt to GDP ratio from 2007 to 2017 in select countries



Source: Trading Economics.

With consumers and corporates unable to step in and increase credit, the task was left to the governments. Another irony here is in the view on debt held by Euro Area governments. During the crisis, one of the leading problems blamed for the severity of the crisis/recession was the high level of debt. Yet E.U. governments and many others opted to increase the level of debt as a "monetarists" solution to the problem.

Figure 8 highlights the change in government debt levels from 2007 to 2017. Japan, for example, has been trying to borrow its way out of its demographic problems over the past 28 years, the symptoms of which include slow growth combined with low inflation (or even deflation) and a rising level of debt. Government debt level in Japan reached 253% of GDP as of 2017, the highest level any country has ever reached. Given Japan's long-term demographic problems, there is no scenario in which Japan is able to repay all of its debt. It will be facing default at some point in the future.

Some governments in the E.U. are no better. Greece, for example, received over €300 billion in European Central Bank (ECB) and IMF bailouts. But it still saw its debt-to-GDP ratio rise to a record-high of 179% in 2017. Italy today is suffering economically as a result of its government's inability to reduce its debt load, which reached 132% in 2017.

This points to structural problems in the E.U. as well as in other countries and regions around the world. The E.U. suffers from a high level of bureaucracy, high taxation, stringent employment laws, too much debt, too much bad debt locked up in its banking system and a lack of political will to make painful yet necessary changes.

c. Policy responses to the last recession[iii]

Government response

In 2008 and 2009, governments in North America, Europe and Asia quickly responded to the crisis by passing stimulus packages and offering support, including bailouts, to their respective financial systems. There were also some coordinated efforts on the global level to help minimize the effects of the crisis and help economies regain their growth momentum. The Group of Twenty Finance Ministers and Central Bank Governors (also known as the G-20) held two summits, one in November 2008 and one in April 2009. They proposed new international financial regulations, agreed to take actions to stimulate employment and pledged not to resort to any protectionist measures as they had during the Great Depression. They also committed to maintaining the supply of credit by providing more liquidity and recapitalizing the banking system.

In the U.S., lawmakers passed the Emergency Economic Stabilization Act of 2008 authorizing the Treasury to buy up $700 billion in troubled mortgages. The Treasury, however, quickly changed the plan to recapitalizing banks instead of buying mortgages, as we discussed in the previous chapter. The bigger policy change came after the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act, also known Dodd-Frank. The act had four objectives: promote financial stability by improving accountability and transparency in the financial system; end "too big to fail" financial institutions; protect the American taxpayer by ending bailouts; and protect consumers from abusive financial services practices. Dodd-Frank, which took up more than 2,200 pages of text, has so far made little headway in meeting its objectives. On the flip side, it has created a new regulatory headache for financial institutions.

The new regulatory requirements from Dodd-Frank have put pressure on smaller banks as they struggle to keep up with all the new regulatory requirements. What was meant to end "too big to fail" instead ended up institutionalizing it. One good thing to emerge from Dodd-Frank, however, was the Volker Rule, which instituted a ban on proprietary trading by commercial banks.

In Europe, the European Commission proposed a €200 billion European stimulus plan to help its member countries cope with the effects of the crisis. In the U.K., the government came up with a £500 billion bank rescue plan. The plan had three parts. Part one included injecting £200 billion into the financial system to improve bank liquidity. Part two consisted of £50 billion to recapitalize weaker banks, also known as nationalizing the banks, similar to what was done in the U.S. Part three included £250 billion to support banks in writing off bad loans.

In Asia, governments from Japan to India launched stimulus plans aimed at supporting their economies, the largest of which was from China. The Chinese economic stimulus program was a RMB¥ 4 trillion ($586 billion) stimulus package.

These stimulus packages had a common theme – big banks would not be allowed to fail. Governments supported big banks any which way they could, even if it meant nationalizing them. Authorities from Belgium, Luxembourg and the Netherlands, for example, partially nationalized Fortis, one of the largest financial institutions in those countries. In Germany, the government bailed out Hypo Real Estate, a real estate financing bank, to the tune of €112 billion. In the Middle East, governments from Kuwait to the United Arab Emirates gave direct support to their local banks and did not allow any to fail.

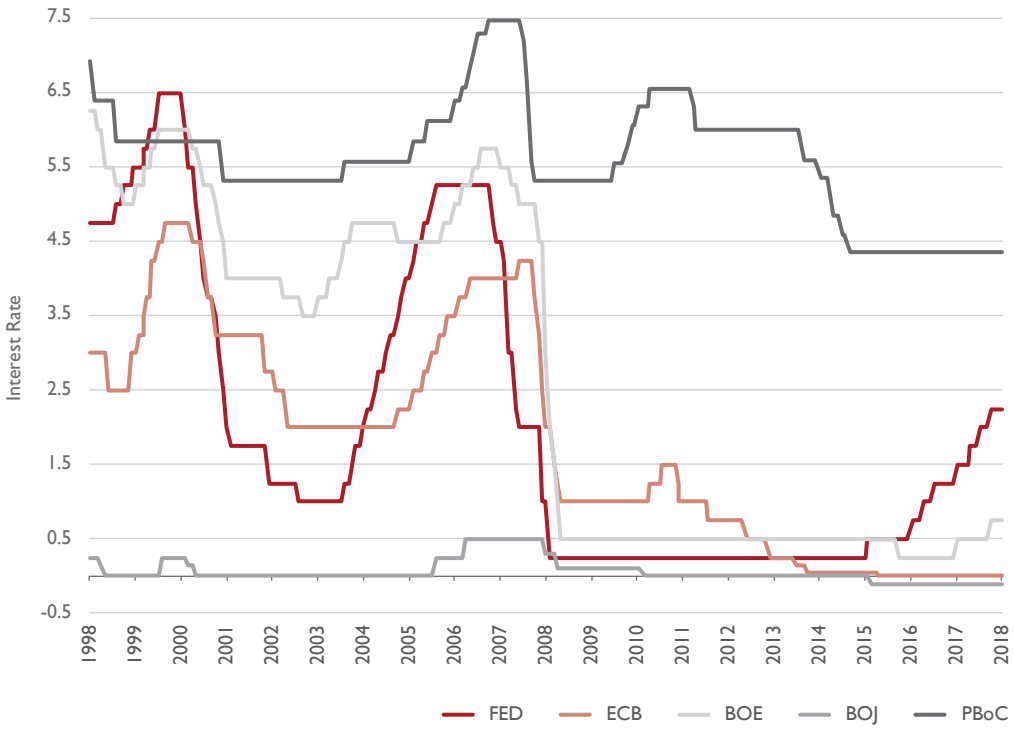
Central bank response

The trillions of dollars in support and bailouts given by central banks would put the government bailouts to shame. First, central bankers around the world pledged to maintain low-rate policies as long as necessary. Then, they agreed to inject trillions of dollars of liquidity into the market in order to kick-start credit markets. Finally, they opened up their credit lines and emergency lending facilities offering even more trillions of dollars to financial institutions.

The Fed alone is said to have offered up to $29 trillion in credit lines and lending facilities. Of this amount, over $8 trillion was lent to the European Central Bank, $919 billion to the Bank of England, $466 billion to the Swiss National Bank and $387 billion to the Bank of Japan. Thus, the Fed bailout was nearly twice the U.S. annual GDP. It not only bailed out U.S. banks, it also bailed out "too big to fail" banks around the world.

FIGURE 9

Changes in select central bank interest rates from December 1998 to May 2018



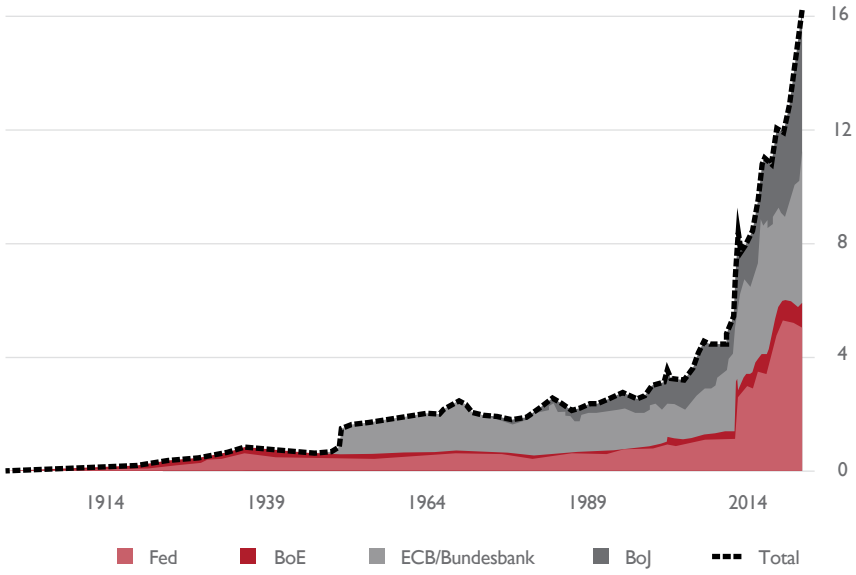
Source: Trading Economics.

As central banks lowered interest rates near zero and even below zero, their balance sheets ballooned with bonds and other debt, known as quantitative easing. The Fed embarked on an unprecedented quantitative easing program, buying $600 billion in mortgage-backed securities that resulted in a near-doubling of its balance sheet of $870 billion from August 2007. Four months later in March 2009, the Fed was holding $1.75 trillion of bank debt, mortgage-backed securities, and Treasury notes. It also announced that the program would be expanded by an additional $750 billion in purchases of mortgage-backed securities and bank debt, and $300 billion in purchases of Treasury securities. This debt-buying program was halted in June 2010. But two months later, the Fed decided that the economy was not growing fast enough, so it embarked on another $600 billion bond-buying program that lasted until June 2011. This new program became known as QE2.

As if this wasn't enough to get the economy going again, the Fed embarked on yet another QE program, which was even more ambitious than the first ones. QE3, as it was known, called for the purchase of: more than $1 trillion of debt per year, or $85 billion per month; $45 billion in Treasury securities; and $40 billion in mortgage-backed securities. QE finally ended in October 2014 with the Fed's balance sheet reaching a record $4.5 trillion.

FIGURE 10

Increase in central bank balance sheets to a level never before seen in history



Source: Deutsche Bank, Global Financial Data, Haver, official websites of central banks.

Other central banks followed the Fed's lead by launching various forms of QE programs. In May 2009, the European Central Bank (ECB) announced a program to buy up to €60 billion of covered bonds, a form of corporate debt. The ECB continues to this day with its QE program. Its balance sheet as of May 2018 stood at €5.3 trillion. In the U.K., the Bank of England bought gilts (government securities) from financial institutions, along with a smaller amount of relatively high-quality debt issued by private companies. The QE program initially called for the purchase of £165 billion in debt in September 2009, but quickly became a multiple QE program mirroring the Fed's QE programs. As of May 2018, the total size of the Bank of England's balance sheet reached £590 billion.

The Bank of Japan was even more ambitious than the Bank of England. In October 2010, the Bank of Japan announced that it would purchase of ¥5 trillion ($60 billion) in assets. The objective was to weaken the yen in order to stimulate export growth; it did not work. In October 2011, the Bank of Japan expanded its asset purchase program by ¥5 trillion ($66 billion) to a total of ¥55 trillion ($726 billion). When this did not work, the Bank in April 2013 expanded the program by $1.4 trillion over the next two years. As of May 2018, the total size of the Bank of Japan's balance sheet reached ¥540 trillion ($4.9 trillion).

d. Leading international agencies' forecast for global economy

The global recovery is finally taking hold and has shown continued, though not uniform, momentum in 2016 and 2017. The economic recovery is best seen in the U.S., where unemployment is at a multi-decade low, GDP has been growing within the expected range and corporate earnings are strong. The recovery remains the weakest in Europe, especially among Euro Area countries. Within Europe, the U.K. has been the best performer among the largest economies, whereas, Ireland and Spain have been the overall best performers.

Based on this recent performance and looking back at past economic cycles, where are we today, and where can we expect to be in the coming years? The World Bank and International Monetary Fund (IMF) are among the most respected international agencies in their field. Their economic outlooks and forecasts are used by many governments around the world, and in some cases used at the basis for their own forecasts. Let's take a look at their most recent outlook and forecast for the world economy.

World Bank

The World Bank published a flagship report titled *Global Economic Perspectives: The Turning of the Tide*, in June 2018. The report covers the bank's outlook and forecast for the global economy from 2015 until 2020.

TABLE 2

World economic outlook projections from the World Bank's Global Economic Prospects, June 2018 report

	2015	2016	2017e	2018f	2019f	2020f
World	2.80	2.40	3.10	3.10	3.00	2.90
Advanced Economies	2.30	1.70	2.30	2.20	2.00	1.70
Emerging and Developing	3.70	3.70	4.30	4.50	4.70	4.70
USA	2.90	1.50	2.30	2.70	2.50	2.00
Euro Area	2.10	1.80	2.40	2.10	1.70	1.50
Japan	1.40	1.00	1.70	1.00	0.80	0.50
China	6.90	6.70	6.90	6.50	6.30	6.20
Saudi Arabia	4.10	1.70	(0.70)	1.80	2.10	2.30
Kuwait	0.60	3.60	(1.00)	1.90	3.50	3.50
Oil Price* (annual average)	52.35	43.55	54.25	70.00	69.00	65.40

* Average oil prices from 2015-2017 are from Statista.com.

Here is a summary of the bank's global outlook:[v]

Global growth remains robust but has softened in recent months, as manufacturing activity and trade have shown signs of moderation. The ongoing withdrawal of monetary policy accommodation in advanced economies has led to some tightening of global financing conditions, while oil prices are substantially higher than previously expected. Global inflation is trending up, but only gradually and from low levels.

In advanced economies, activity continues to grow above potential, notwithstanding some recent moderation, while additional fiscal stimulus measures are expected to provide a further lift to near-term growth in the United States. Labor markets have improved steadily. With output gaps nearly or already closed, inflation expectations have crept up and monetary policy is becoming less expansionary. Inflation, however, remains below central bank targets in many advanced economies.

Among emerging market and developing economies (EMDEs), the recovery in commodity exporters has continued, as consumption and investment firm. The upturn in many energy exporters is still lagging that of exporters of other commodities, reflecting ongoing adjustments to the 2014-16 collapse in oil prices and production cuts in key oil exporters. Across commodity exporters, inflation is generally moderating as the impact of past currency depreciations wanes.

Activity in commodity importers continues to be robust. Growth in China is gradually slowing, but remains resilient, while constraints to growth are dissipating in other large commodity importers— notably India and Mexico, where investment is recovering. Inflation remains broadly stable so far, despite higher commodity prices and limited remaining slack.

Notwithstanding the ongoing global expansion, only 45 percent of countries are expected to experience a further acceleration of growth this year, down from 56 percent in 2017. Moreover, global activity is still lagging previous expansions despite a decade-long recovery from the global financial crisis. Accordingly, after reaching 3.1 percent in 2018, global growth is projected to moderate in 2019-20, edging down to 2.9 percent by the end of the forecast period. Global growth projections are above estimates of potential, suggesting that capacity constraints will become more binding and inflation will continue to rise during the forecast horizon.

Growth in advanced economies is expected to decelerate toward potential rates over the forecast period, as monetary policy stimulus is pared down, higher energy prices weigh on consumption, and the effect of U.S. fiscal expansion wanes. A projected deceleration of capital spending in these economies, combined with that in China, will contribute to more moderate global trade growth in 2019 and 2020. Shifts in the policy mix of advanced economies—most notably, monetary policy tightening and fiscal policy loosening in the United States—are expected to result in a faster-than-previously-anticipated increase in global interest rates, and hence in EMDE borrowing costs.

As international trade and financial conditions become less supportive, and the cyclical upturn in commodity exporters matures, overall EMDE growth is projected to plateau, reaching 4.7 percent in 2019 and 2020. Over this period, only about half of commodity exporters, and less than half of commodity importers, are expected to grow above their pre-crisis long-term averages. In the longer term, absent policy reforms, potential growth in EMDEs is expected to weaken, reflecting softening productivity and demographic headwinds. Progress in per capita income growth will be uneven. Per capita growth in Sub-Saharan Africa, where nearly half of the extreme poor live, is projected to remain below or around 1 percent, while it is expected to reach 6 percent in South

Asia, a region that includes the second largest number of people in extreme poverty.

Uncertainty around global growth projections has risen, partly driven by the possibility of policy shocks from major economies. While a synchronous upturn in large economies could lead to further growth upgrades in the near term, risks remain tilted to the downside, with some becoming more acute. In particular, the possibility of financial market disruptions has increased amid shifting monetary policy expectations in major advanced economies.

A sudden tightening of global financing conditions, combined with disorderly exchange rate movements, would leave highly indebted EMDEs particularly vulnerable, with rising debt service costs hampering investment and heightening financial stability risks. The risk of mounting trade protectionism has also intensified. A worldwide escalation of tariffs up to the limits permitted under existing international trade rules could lead to cumulative trade losses equivalent to those experienced during the global financial crisis in 2008-09, with particularly severe consequences for EMDEs.

Other risks include the possibility of increasing policy uncertainty and geopolitical tensions. A further rise in oil prices, while beneficial for oil exporters, could amplify current account fragilities in some oil-importing EMDEs.

The probability of an abrupt slowdown in global growth has risen and could increase further if one or several downside risks materialize. Many countries would be unprepared to confront such an outcome, in view of their depleted policy buffers and the moderating outlook for potential growth. In this context, both advanced economies and EMDEs face acute policy challenges.

The immediate policy challenge for advanced economies is to calibrate their fiscal, monetary, and trade policy stances to nurture the recovery and to avoid disorderly financial adjustments. In the longer term, they need to confront the slow pace of potential growth and demographic pressures through structural reforms that boost productivity, labor force participation, and fiscal sustainability.

In EMDEs, monetary and fiscal buffers need to be rebuilt in order to prepare for monetary policy tightening in advanced economies and restore the scope for policy support against negative shocks. In particular, rising global interest rates will heighten corporate vulnerability and raise EMDE debt-service costs and fiscal sustainability gaps. In the longer run, EMDE policy makers also need to confront intensifying structural challenges and accelerate measures to tackle poverty. The decisive implementation of growth-enhancing structural reforms is critical in light of the likelihood of weaker-than-expected long-term growth outcomes—which, given past experience, is a material possibility.

For commodity exporters, prospects of a secular slowdown in demand for commodities call for accelerated efforts to diversify and transform their economies as a way of boosting income per capita and mitigating volatility.

The report goes on to discuss the bank's outlook on each region of the world, highlighting the upside potential as well as pointing out any potential downside risk.

International Monetary Fund (IMF)

The IMF has a slightly more optimistic outlook on the world economy than does the World Bank. Its forecast is only for 2018 and 2019, but it nevertheless offers a good perspective on where the agency believes the global economy is heading.

TABLE 3

World economic outlook projections from the IMF's World Economic Outlook, April 2018 report

	2016	2017	2018f	2019f
World	3.20	3.80	3.90	3.90
Advanced Economies	1.70	2.30	2.50	2.20
Emerging and Developing	4.40	4.80	4.90	5.10
USA	1.70	2.30	2.50	2.20
Euro Area	1.80	2.30	2.90	2.70
Japan	0.90	1.70	1.20	0.90
China	6.70	6.90	6.60	6.40
Saudi Arabia	1.70	(0.70)	1.70	1.90
Kuwait	2.20	(2.50)	1.30	3.80
Oil Price* (annual average)	43.55	54.25	62.30	58.20

* Average oil prices from 2015-2017 are from Statista.com.

The following is a summary from the IMF's World Economic Outlook, April 2018[vi]:

The upswing in global investment and trade continued in the second half of 2017. At 3.8 percent, global growth in 2017 was the fastest since 2011. With financial conditions still supportive, global growth is expected to tick up to a 3.9 percent rate in both 2018 and 2019.

Advanced economies will grow faster than potential this year and next; euro area economies are set to narrow excess capacity with support from accommodative monetary policy, and expansionary fiscal policy will drive the US economy above full employment. Aggregate growth in emerging market and developing economies is projected to firm further, with continued strong growth in emerging Asia and Europe and a modest upswing in commodity exporters after three years of weak performance.

Global growth is projected to soften beyond the next couple of years. Once their output gaps close, most advanced economies are poised to return to potential growth rates well below precise averages, held back by aging populations and lackluster productivity. US growth will slow below potential as the expansionary impact of recent fiscal policy changes goes into reverse. Growth is projected to remain subpar in several emerging market and developing economies, including in some commodity exporters that continue to face substantial fiscal consolidation needs.

While upside and downside risks to the short-term outlook are broadly balanced, risks beyond the next several quarters clearly lean to the downside. Downside concerns include a possibly sharp tightening of financial conditions, waning popular support for global economic integration, growing trade tensions and risks of a shift toward protectionist policies, and geopolitical strains. The current recovery offers a window of opportunity to advance policies and reforms that secure the current upswing and raise medium-term growth to the benefit of all. Such policies should focus on strengthening the potential for higher and more inclusive growth, building buffers to deal

more effectively with the next downturn, improving financial resilience to contain market risks and stability concerns, and fostering international cooperation.

Economic activity in 2017 ended on a high note—growth in the second half of the year was above 4 percent, the strongest since the second half of 2010, supported by a recovery in investment. Outcomes exceeded the October 2017 World Economic Outlook forecasts in the euro area, Japan, the United States, and China, and continued to improve gradually in commodity exporters. Financial conditions remain supportive, despite the recent volatility in equity markets and increases in bond yields following signs of firming inflation in advanced economies. With broad-based momentum and expectations of a sizable fiscal expansion in the United States over this year and the next, global growth is now projected at 3.9 percent for 2018–19, a 0.2 percentage point upgrade for both years relative to the October 2017 forecast.

Tis positive momentum will eventually slow, however, leaving many countries with a challenging medium-term outlook. Some cyclical forces will wane: financial conditions are expected to tighten naturally with the closing of output gaps and monetary policy normalization; US tax reform will subtract momentum starting in 2020, and then more strongly as full investment expensing is phased out starting in 2023; and China's transition to lower growth is expected to resume as credit growth and fiscal stimulus diminish. At the same time, while the expected recovery in investment will help raise potential output, weak productivity trends and reduced labor force growth due to population aging constrain medium-term prospects in advanced economies. The outlook is mixed across emerging market and developing economies. Prospects remain favourable in emerging Asia and Europe, but are challenging in Latin America, the Middle East and sub-Saharan Africa, where—despite some recovery—the medium-term outlook for commodity exporters remains generally subdued, with a need for further economic diversification and adjustment to lower commodity prices. More than one-quarter of emerging market and developing economies are projected to grow by less than advanced economies in per capita terms over the next five years, and hence fall further behind in terms of living standards.

Risks around the short-term outlook are broadly balanced, but risks beyond the next several quarters are clearly to the downside. On the upside, the growth spurt in advanced economies may turn out to be stronger and more durable than in the baseline, as slack in labor markets can be larger than currently assessed. Furthermore, the ongoing recovery in investment could foster a rebound in productivity, implying higher potential growth going forward. On the downside, financial conditions—which remain easy despite the onset of monetary policy normalization—could tighten sharply and expose vulnerabilities that have accumulated over the years, with adverse repercussions for growth.

In the United States, financial conditions could tighten faster than expected, triggered, for example, by an adjustment in market pricing of the future path of monetary policy, higher realized or expected wage and price inflation, and/or a sudden decompression of term premiums. Tighter financial conditions in the United States would have spill-overs to other economies, including through a reduction in capital flows to emerging markets. Very expansionary fiscal policy in the United States, at a time when the current account deficit is already larger than justified by fundamentals, combined with persistent excess current account surpluses in other countries, is projected to widen global imbalances. Anxiety about technological change and globalization is on the rise and, when combined with wider trade imbalances, could foster a shift toward inward-looking policies, disrupting trade and investment. Recent import restrictions announced by the United States, announced retaliatory actions by China, and potential retaliation by other countries raise concerns in this regard and threaten to damage global and domestic activity and sentiment. Similarly, changes in US tax policies are expected to exacerbate income polarization, which could

affect the political climate for policy choices in the future. Climate change, geopolitical tensions, and cybersecurity breaches pose additional threats to the subdued medium-term global outlook.

The report highlights several risks facing the global and regional economies over the next few years and suggests fiscal and structural reforms to help mitigate any downside risks.

e. Reasons to be skeptical about these forecasts

Both reports offer detailed insight into current economic conditions (globally and regionally) as well as a discussion on the key drivers that can push growth to the up or down side. The reports, in our view, were concise and covered the major risks facing the global as well as regional economies. However, in highlighting these risks, the reports were dismissive or optimistic on the ability to overcome them and, in some cases, underestimate the potential effects these risks could have on global and regional economies.

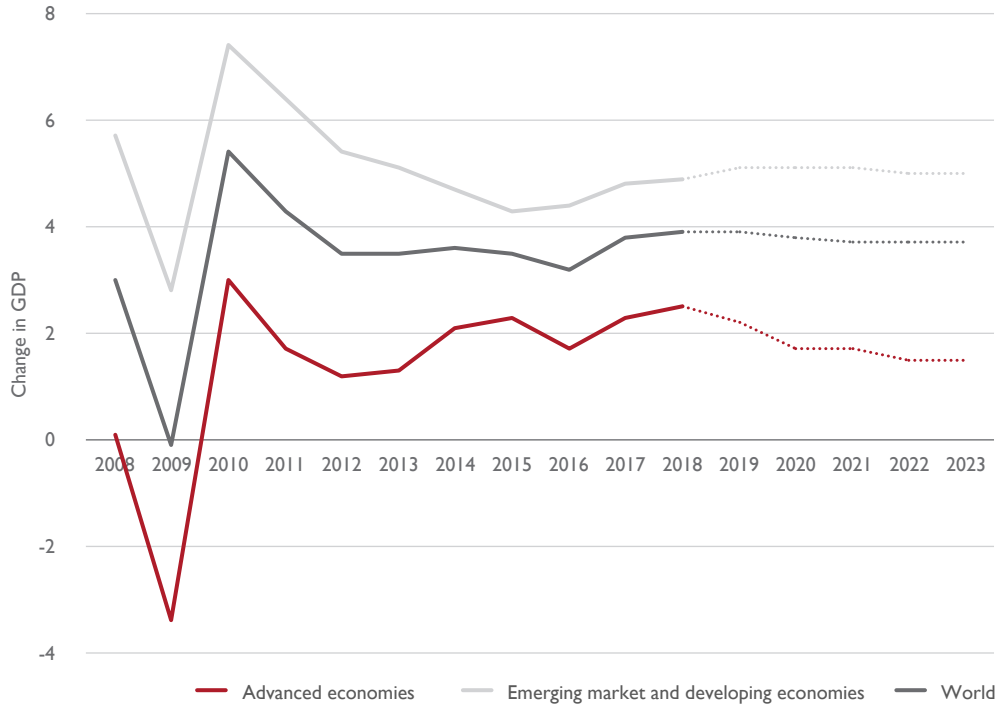
Therefore, upon reviewing these two economic outlooks and forecasts, we remain skeptical about their accuracy and foresight. Keep in mind that leading economic forecasts by other institutions offer similar conclusions on the direction of the global economy, discounting the potential effects from risks they highlight. The following are five reasons to doubt these forecasts:

i. Aging economic cycle

The most obvious issue with the World Bank and IMF forecasts is that they assume economic growth continues (albeit at a slowing rate) beyond 2019 (IMF) and 2020 (World Bank). If this were to happen, it would be unprecedented, as it means that the economic expansion cycle would have lasted over 12 years. There has never been a time in the past 200 years of economic history where a region of the world has avoided a recession for this length of time. To suggest this is misguided.

FIGURE 11

Actual GDP growth rates in Advanced economies compared with Emerging/Developing economies and the World



Source: International Monetary Fund (IMF).

The reports mention that the expansionary cycle is aging but give no forecast on when to expect a recession. In fact, the reports suggest that a recession will be avoided, but the world will have to live with slower growth, despite the risks mentioned, which could further slow growth.

The truth is that the World Bank, IMF and major central banks have never predicted a recession or seen one coming in their outlooks. Looking back at all past economic crises, we see that none of these institutions predicted such an event. This renders their forecasts useless.

ii. Volatility of commodities

Commodities, including oil, have a long history of volatility. The reports discuss this along with the oil price collapse from 2014 to 2016. They also discuss the rise of commodities, particularly oil, since 2016 as a risk facing the global economy. And yet, they fail to include this volatility in the forecasts. Instead, both reports expect oil to rise this year and gradually decline thereafter. Geopolitical risks and supply/demand issues are mentioned in the reports but are not taken into consideration in the forecast. Perhaps this is because volatility is unpredictable. Alternatively, the reports should have discussed scenarios in which commodities continue to rise and scenarios in which commodities decline or fall sharply, as they did in 2008 and again in 2014.

iii. Effects of rising oil prices on global growth

The rapid rise of oil prices has always reduced global growth. While this tends to be a windfall for GCC and other oil-producing countries, it is a drag on economic growth in developed countries. That is why it was a surprise to see that in January 2018, both the World Bank and IMF raised their growth outlook for the world economy. This goes against their past forecasts in which rising oil prices caused them to lower their outlook. The price of oil has risen from a low of $26/bbl for Brent Crude in January 2016 (the low of the price collapse that began in June 2014) to over $70/bbl in mid-January 2018 when their revised forecasts were published. In other words, oil has risen by 170% in two years and the World Bank and IMF expect it have a positive effect on global growth.

iv. Slowing GDP at a time when credit growth is rising faster

The biggest driver of economic growth over the past decade has been China, which managed to help lift the global economy out of recession in 2009. China, along with a few other notable commodity-producing countries that provided the fuel for China, such as Australia and Brazil, offered a counter-balance to negative GDP growth in developed countries. The high GDP growth China has been witnessing for the past couple of decades is coming to an end, as both reports highlight. China's GDP has been slowing for the past few years while at the same time, credit growth in the country continues to rise to record-levels. High credit growth and slow GDP growth tend to lead to financial issues in the future.

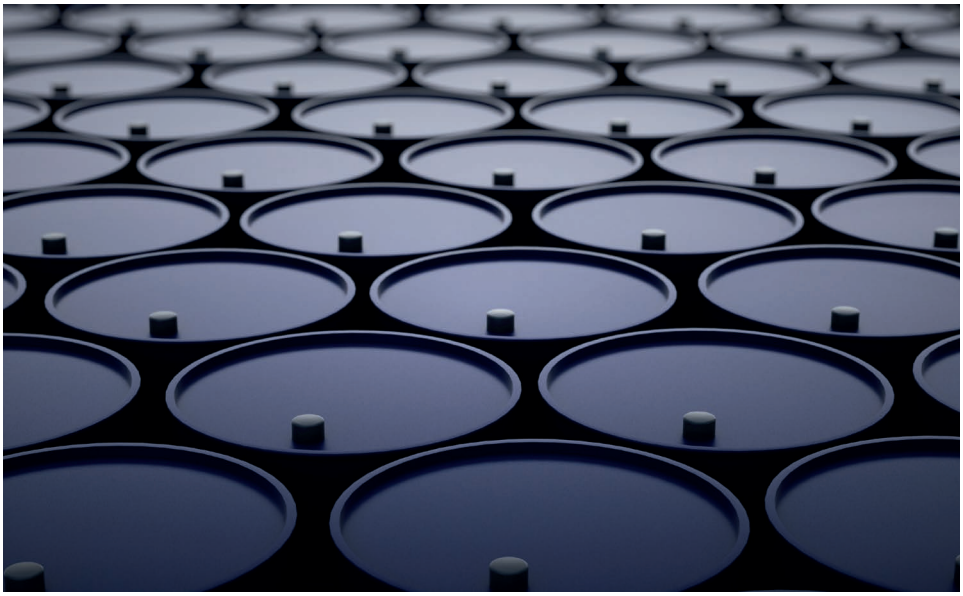
The rise of credit faster than GDP is not unique to China. This scenario is playing out across nearly every region, especially in Europe, North America and Oceania. High credit growth at a late expansionary stage of an economic cycle has been shown in the past to increase the severity of the next recession.
Both reports discount the high risk of China's slowing GDP growth on its high credit growth.

v. Structural problems are not being addressed

The reports discuss the need for structural reform, especially in the MENA region, as a fiscal policy to overcome slowing GDP growth, yet they fail to mention the lack of political will in the E.U. to make the necessary structural changes. The E.U. has had ten years to make structural economic reforms, as well as reforms to its banking system, and has so far failed to do so. The lack of movement on this front has placed the E.U. on the front line of another financial crisis, at which point it will be forced to make hard choices quickly.

This leads us to conclude that we should take these forecasts with a grain of salt. Though they clearly discuss the current state of the economy and present the risks that the global and regional economies face, the forecasting track record of the World Bank and IMF has not been very accurate in the past. Above all, they fail to consider where we are today in the economic cycle, and they discount the potential effects the risks they mention can have on the economy.

II. Leading economic factors affecting the global economy and anticipating the next economic cycle downturn



With the current economic expansionary cycle nearing an end, there are three main factors that trigger a change in the cycle (i.e. to contractionary cycle). These are: the price of oil; the global financial services sector and credit cycle; and global central bank policies and their impact on the financial services sector. Special attention will be paid to how each of these factors can affect Kuwait's economy.

There are other factors as well, such as global trade growth, manufacturing growth, inflation, … etc. However, the factors discussed below drive the others. An example would be a slowdown in the credit cycle would, by default, cause a slowdown in trade and manufacturing sectors, as they rely on credit to grow. Another example would be a rapid rise in oil prices, which causes global GDP to slow especially in industrialized countries.

a. Analysis of the price of oil

Oil trades like other commodities. It is sensitive to changes in demand/supply dynamics and is a relatively good gauge of global economic health. A steady rise in demand, for

example, together with a rise in price is a sign of good economic health. Oil behaves in a manner similar to other "mined" commodities. Oil, coal, natural gas and other energy commodities play a more important role than other commodities because energy is a major growth driver for the world economy. There is a direct correlation between energy consumption and economic growth.

Supply/demand dynamics are not the only factors that determine oil prices. The way oil is traded also factors in to its price direction. Oil, like other commodities, is traded on futures exchanges where contracts to purchase oil for delivery at a date in the future are traded. There is no spot price for oil, only a future price with a delivery date set months or, in some cases, years in advance.

This puts the price of oil in the hands of traders and speculators who buy and sell contracts for oil to other traders and speculators. Most of the oil contracts are not initiated by end-users of the oil who plan on taking delivery. On the contrary, most oil futures contracts are traded among other traders, speculators and, lately, hedge funds - which are looking to profit by taking a position on oil; they either believe that the price will rise - so they buy oil contracts - or they believe that the price of oil will fall - so they sell contracts. Thus, investor sentiment – the market's view on supply/demand, geopolitical news, expectations on the future outlook …etc. – all play a role in the price of oil.

Therefore, there are two sides of oil that need to be analyzed to try to determine the future direction of the price: supply/demand dynamics; and trader/speculator dynamics. The latter is what can be referred to as the financialization of the oil market – trading of oil as a financial instrument and tool for speculation rather than having market fundamentals set the price. Both dynamics will be discussed, but we strongly believe that financial factors are the stronger determinant of oil price today than fundamental factors.

Supply/demand dynamics

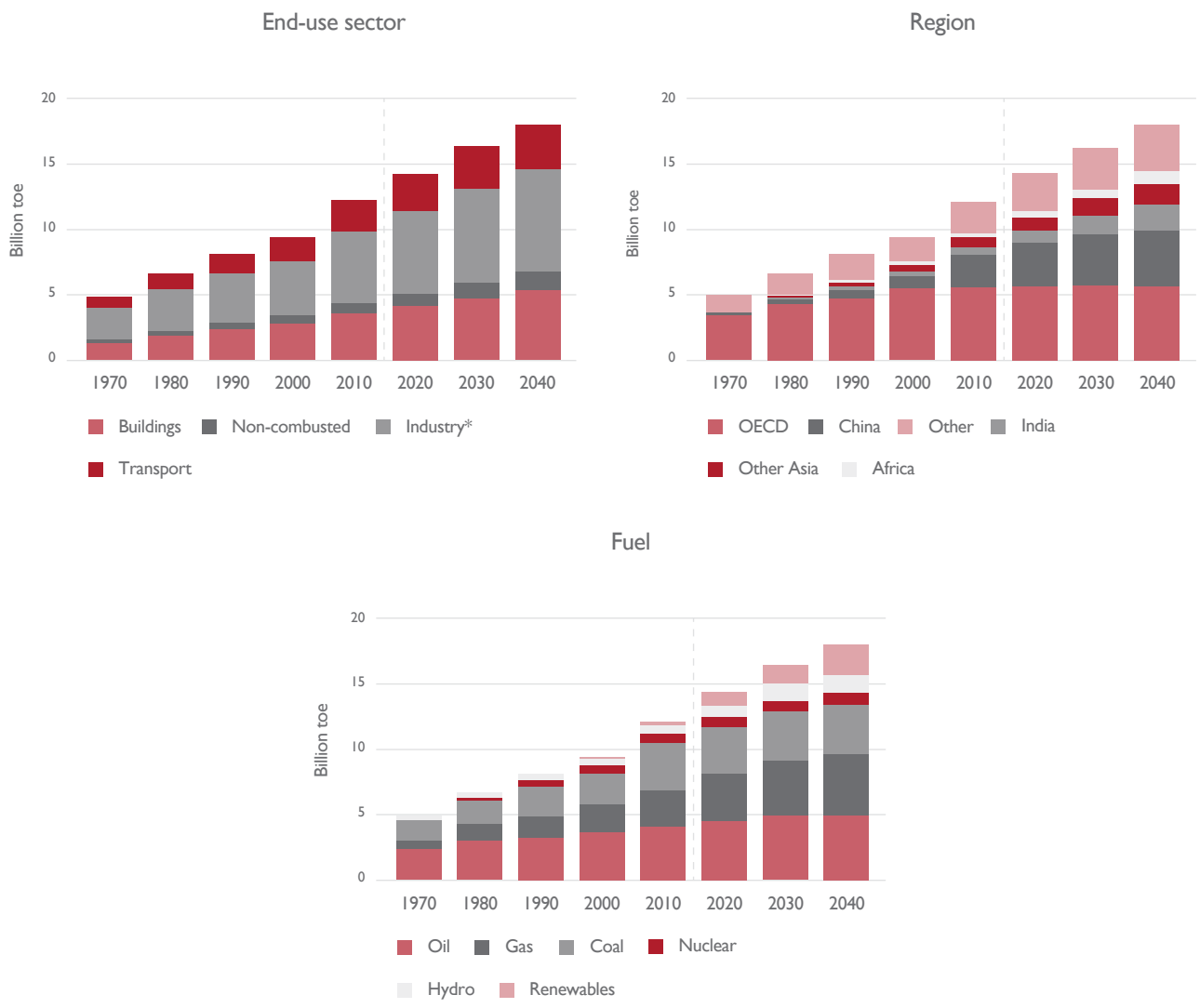
The historical indicator for the direction of oil prices has been supply and demand fundamentals. The effects of this on oil price can be seen during the two oil shocks of the 1970s. The Organization of Petroleum Exporting Countries (OPEC) restriction of the oil supply to many advanced economies caused the price of oil to rise rapidly. This quick jump was a windfall for OPEC members, but caused recessions in advanced economies and led to resentment of OPEC members around the world.

Since the 1970s, OPEC members have worked toward maintaining a balance between supply and demand in order to maintain stable prices. In doing so, their policies depend on long-term trends in the oil and energy markets, in general.

Today, with new technologies and new government policies on CO2 emissions in advanced economies, the long-term outlook for oil demand is weak. The change expected in the oil and energy markets over the next two decades will be like nothing we have experienced in the past. Since the rise of oil consumption beginning in the early 1900s, the trend has always been toward rising consumption. There has never been a period – until now - where the trend was toward lower consumption.

FIGURE 12

Forecasted change in energy demand by end use sector, region and fuel type in billions of tons of oil equivalent (toe)



Source: BP Energy Outlook 2018 Edition.

*Industry excludes non-combusted use of fuels

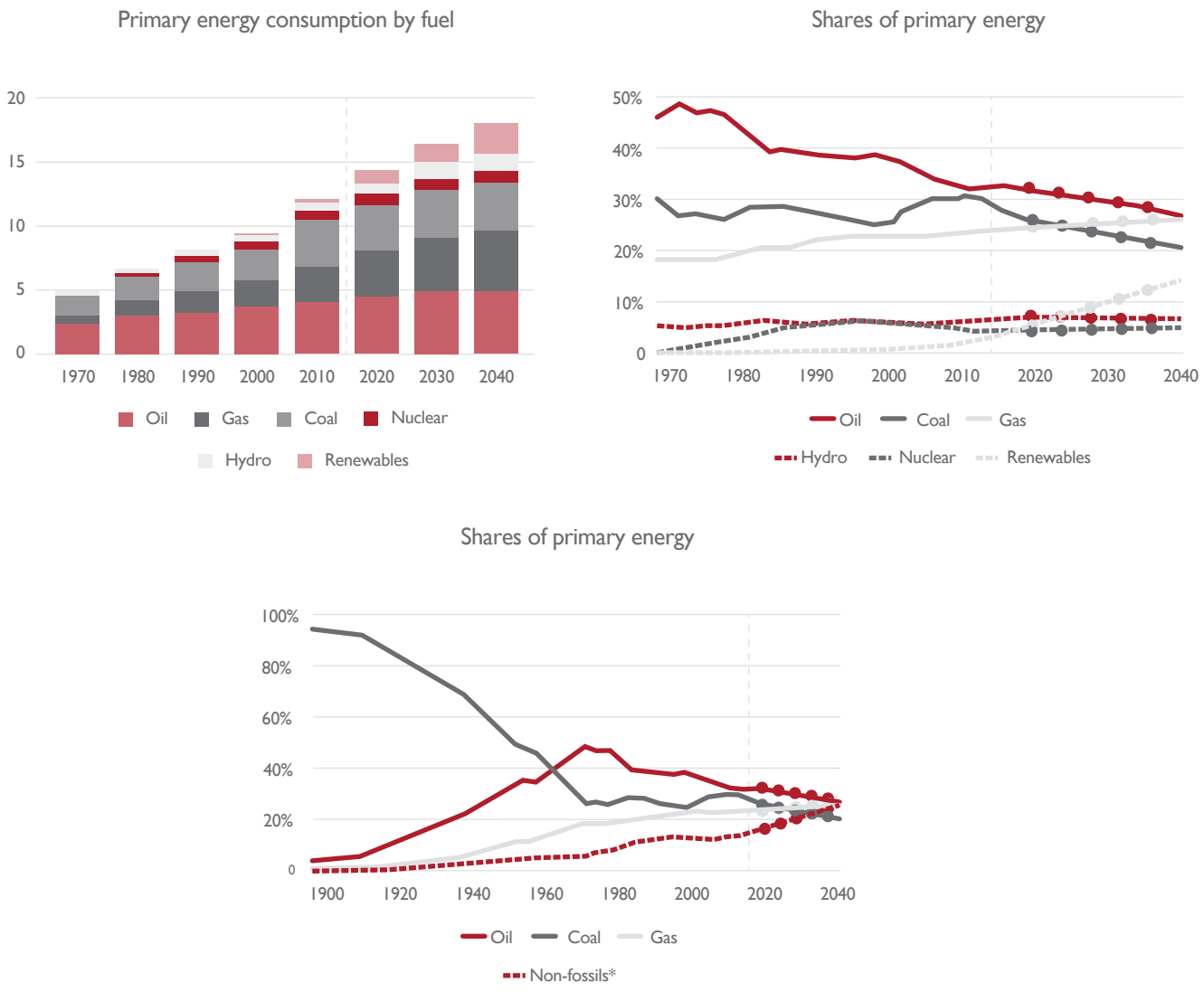
In its most recent outlook on the energy market, BP – the multinational energy giant - projects the coming shift in global energy demand. The report forecasts energy supply and demand out to 2040 and accounts for the recent changes in technology, government regulations and the rise of alternative energy.

Figure 12 shows the rise in demand for energy from 1970 to today, with a forecast for the next two decades. Though demand is expected to rise across all sectors and regions, the point to highlight is the expected slowdown and eventual decline in oil consumption (far right graph). Also note the expected decline in energy consumption in Organisation for Economic Co-operation and Development (OECD) countries beginning in the next decade. Keep in mind that this reflects broad-based energy consumption - not just oil.

Oil consumption is expected to plateau around 2030 globally as other energy sources, most notably natural gas and renewables, overtake it. The only bright side for oil is in the non-combusted segment. Although demand for liquid fuels (gasoline, diesel) is expected to fall, demand for petrochemicals is expected to rise throughout the entire period.

FIGURE 13

Primary energy consumption growth by fuel type and its change in share of primary energy over time



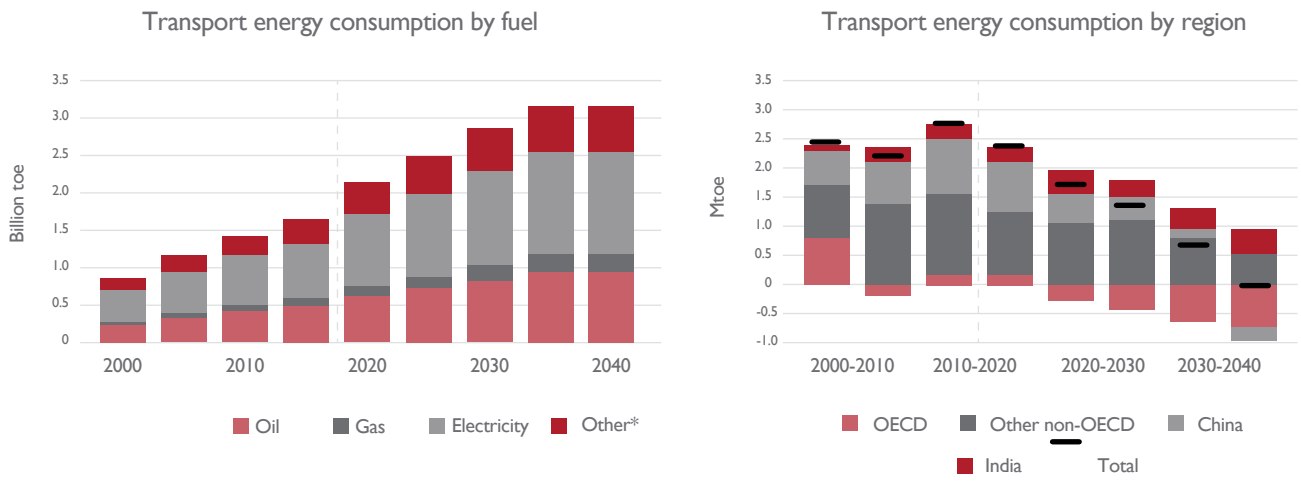
Source: BP Energy Outlook 2018 Edition.

*Non-fossils includes renewables, nuclear and hydro

Oil is expected to take on a smaller role as an energy source going forward (Figure 13). Natural gas is expected to become the largest energy source by the next decade.

FIGURE 14

Forecasted change in type of transportation fuel consumed and consumption growth by region

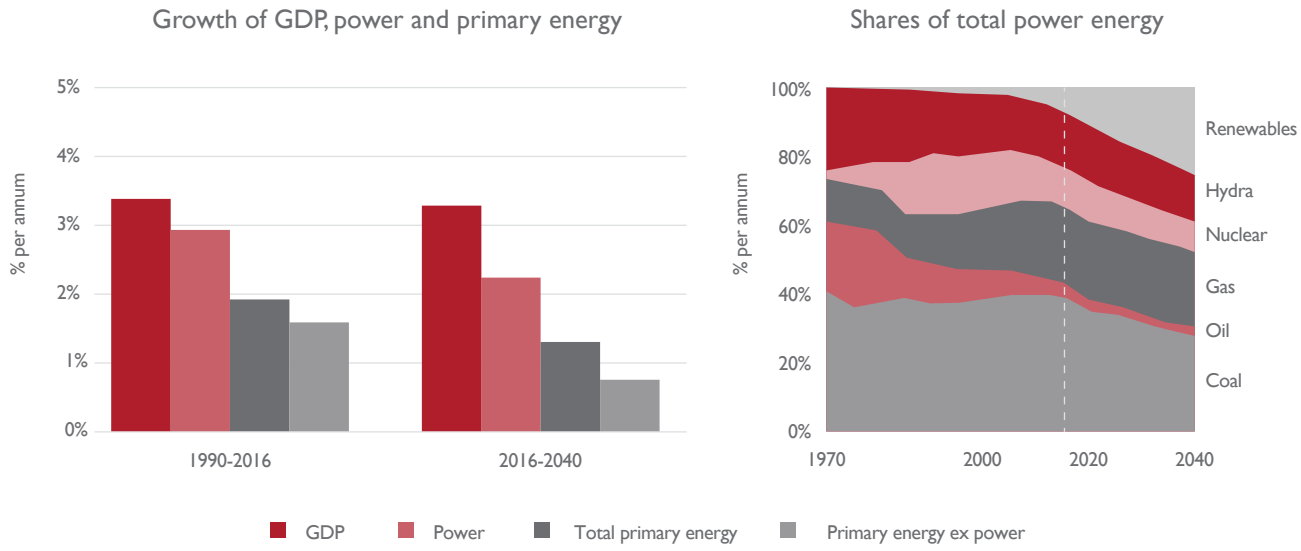


*Other includes biofuels, gas-to-liquids, coal-to-liquids, hydrogen

Source: BP Energy Outlook 2018 Edition.

FIGURE 15

Growth of GDP, power and primary energy compared to the forecasted change in type of energy used in power generation



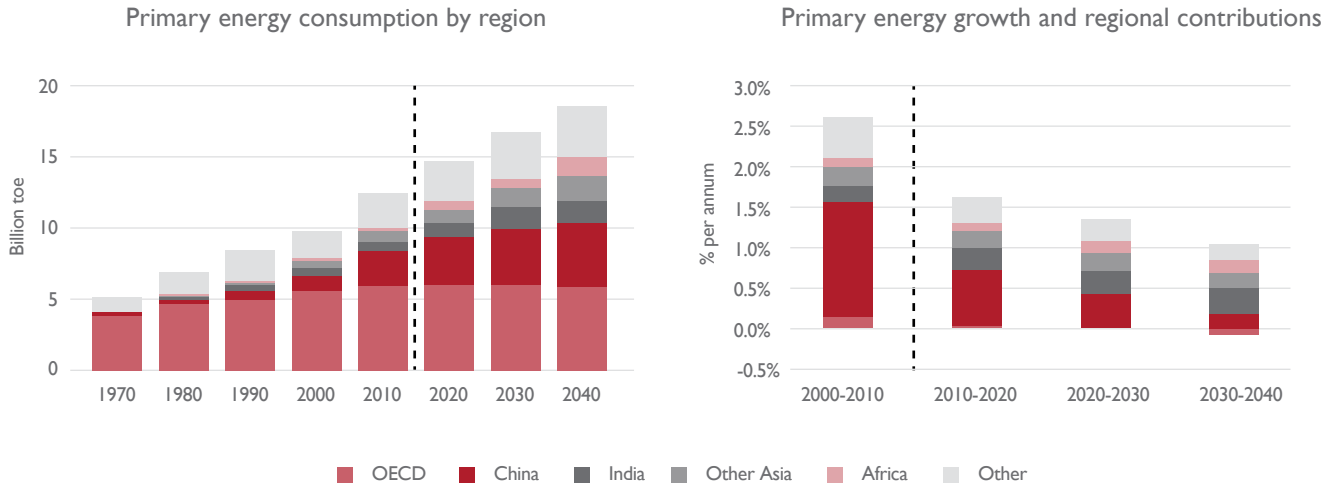
Source: BP Energy Outlook 2018 Edition.

Oil is still expected to play the primary role in the transportation industry (Figure 14). Yet here, too, demand in this sector for oil (gasoline, diesel) is expected to plateau as other energy sources make inroads to transportation. A note to highlight here is that China, India and other developing countries have been the primary growth drivers of oil demand in the transportation sector. This rise in demand (growth level) is not expected to continue, especially in China where demand is expected to fall as early as 2020.

In power generation, oil already plays a small role, which will continue to shrink along with coal use (Figure 15). Renewables and natural gas will begin assuming larger shares in power generation.

FIGURE 16

Growth in energy consumption by region in billions of tons of oil equivalent (toe) as well as a percentage growth by decade



Source: BP Energy Outlook 2018 Edition.

Energy consumption in advanced economies has peaked or is close to peaking (Figure 16). The heavy industries that dominated these countries over the last century have been moving to developing economies with China taking on the largest share. Future energy growth is expected to come from these developing countries.

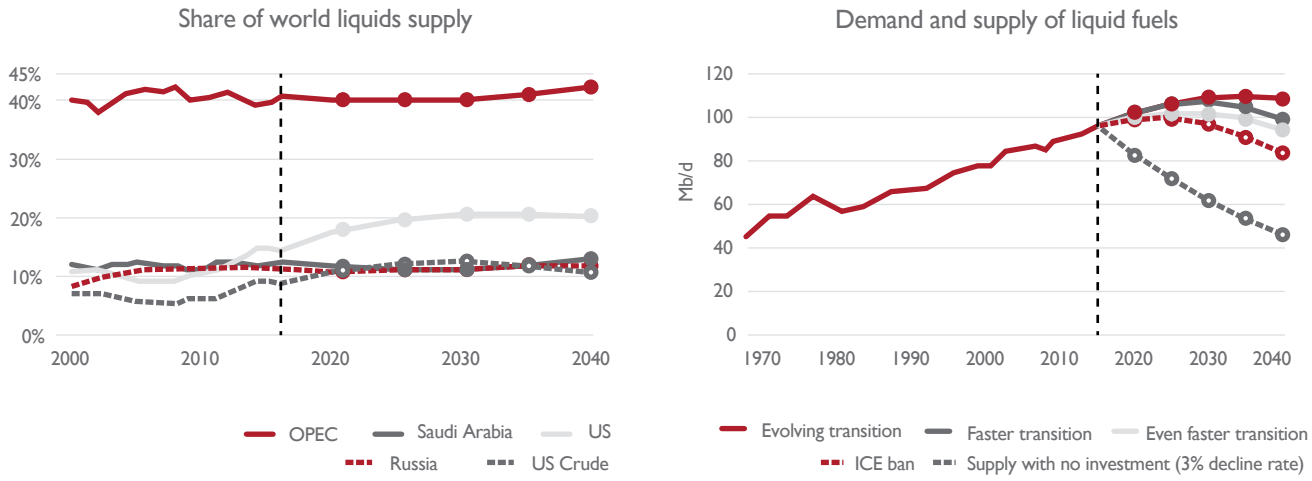
Over the past two decades, the world has witnessed China's rapid industrialization and hyper-growth, which has propelled it to become the second-largest economy in a short period of time. Rising global energy demand, especially for oil, has been driven by China's every-increasing appetite for energy. Oil producers have relied on this appetite for a long time, and they are not ready for the market to change.

The spectacular rise in energy consumption in China will not be repeated for the rest of this decade or the next. The country has already industrialized and built enough factories and power plants to retain its position as the manufacturing center of the world. Government policies toward rapid industrialization and economic growth have lead to over-building of manufacturing facilities and infrastructure. Today, China is awash in excess manufacturing capacity and has no need to continue building factories at such a rapid pace.

As Figure 16 shows, the growth in energy demand in China has peaked and is expected to decline going forward. This will have enormous ramifications on the oil market as demand from the world's largest importer of oil begins to slow.

FIGURE 17

Forecasted change in share of liquid energy supply by producer as well as forecasted change in demand based on various scenarios



Source: BP Energy Outlook 2018 Edition.

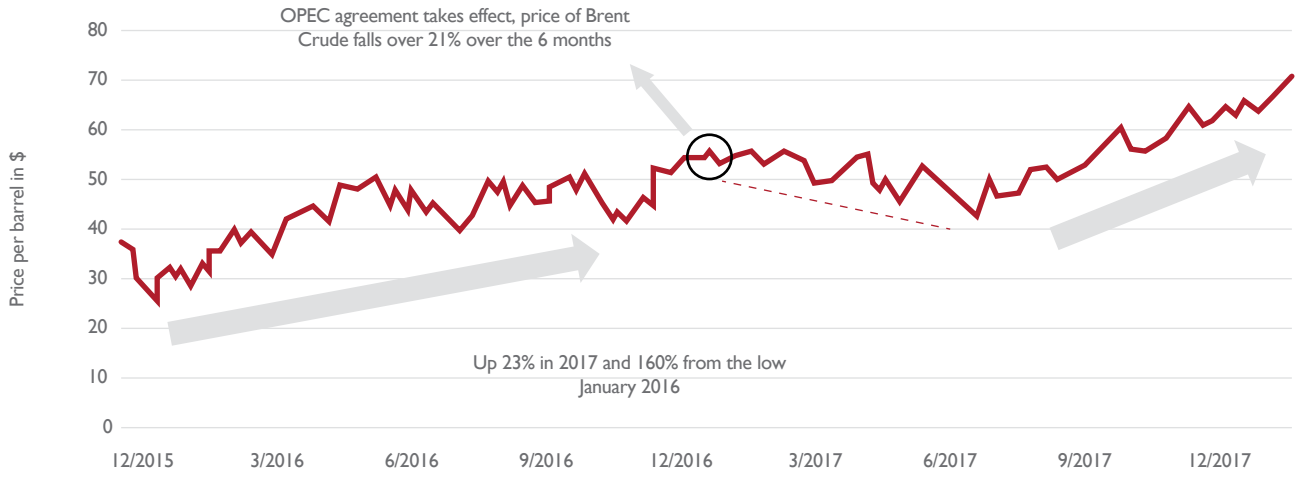
On the supply side, OPEC is no longer the source of new oil supply on the global stage. Due to geopolitical issues (MENA regions), internal political strife (Venezuela) or under-investment in expanding oil production, OPEC has failed to increase its production capabilities in a meaningful way. The U.S., on the other hand, has taken a leading role in this over the last decade and is expected to become the main source of new oil supplies in the coming years (Figure 17).

Trader/speculator dynamics

In trying to understand an oil price change, we tend to seek links to recent news events. But connecting a news event to a change in price direction is tricky business. It may make the change easier for us to understand and accept, but it does not necessarily yield the correct explanation. For example, if the price of oil were to rise, any news about OPEC would be used to link it to such a rise. In reality, this is not always the case.

FIGURE 18

Price of Brent Crude from December 2015 to December 2017



Source: Thomson Reuters.

In January 2017, a historic OPEC production-cut agreement took effect. It was historic in the fact that OPEC managed to get non-OPEC members, including Russia and Mexico, to come to a unified agreement on production cuts in order to keep the price of oil from falling further. While OPEC takes all of the credit for the rise in the price of oil since then, it is not very accurate. In fact, the price of Brent Crude bottomed in January 2016 at around $26/bbl. In the following 11 months that it took OPEC to come to an agreement, the price of Brent Crude, the industry benchmark, increased to $55/bbl, an increase of more than 110%. This happened without an OPEC agreement in place. The price of Brent Crude fell by 21% in the six months following the OPEC agreement, yet industry experts said nothing.

From June 2017 onward, the price of Brent Crude continued to rise steadily - topping at $80/bbl in May 2018. The credit for this rise has gone to OPEC, for the success of its agreement, and to China, for its strong demand. The price chart, however, tells a different story. At this point, it's important to go back in time and more closely examine the price of oil.

i. The price collapse from 2014 to 2016

In June 2014, the price of Brent crude began to fall. It had been trading above $100 per barrel since 2011, but events in June 2014 led to a sharp price drop. On the 19th of June, oil was trading at over $115 per barrel and then began to drop rapidly before reaching just over $55 per barrel by year-end 2014 - a drop of over 50% in six months. The blame was quickly placed on Saudi Arabia, Kuwait and other OPEC members.

International media called it a price war launched by Saudi Arabia and supported by OPEC members in order to drive American shale oil producers from the market. Shale oil production rose rapidly beginning in 2007, and oil industry experts claimed that it was hurting OPEC producers. Below are some of the news headlines in 2014 and 2015 from the major international media:

BBC: "Why is Saudi Arabia using oil as a weapon?" – *December 3, 2014*

CNN: "The story behind Saudi Arabia's oil games" – *December 31, 2014*

Bloomberg: "Saudis' Oil Price War Is Paying Off" – *February 27, 2015*

Wall Street Journal: "Gulf Oil Producers Ramp Up Price War" – *September 14, 2015*

The Guardian: "OPEC bid to kill off US shale sends oil price down to 2009 low" – *December 7, 2015*

In the months following the fall in oil prices, a particular narrative developed: Saudi Arabia, supported by OPEC and helped along by slowing Chinese demand for oil, was pushing U.S. shale producers from the market. A slowdown in China and India meant that rising production from OPEC would only push the price of oil lower unless oil producers cut production. However, a more careful look at the oil price history reveals a different story.

FIGURE 19

Price of a barrel of Brent Crude from April 1991 to 15 June 2018

Source: Thomson Reuters.

ii. The story of oil prices since 1990

Figure 19 shows the price of Brent Crude oil from April 1991 to mid-June 2018. Key points in the chart are marked 1 to 5 and explained in detail below.

Point 1

From 1991 to the middle of 2004 the price never traded above $40 per barrel. This 13-year period included: the end of Iraq's invasion of Kuwait; the Asian Financial Crisis; the Russian Ruble Crisis; the dot-com bubble; the September 11 terrorist attacks on America; the U.S. war in Iraq and Afghanistan; and many more events that financial experts would say could have caused the price of oil to rise rapidly. But that did not happen. Why?
Demand for oil was rising in emerging markets such as China, India and Brazil, while the oil supply was rising at a slower rate. There U.S. had no major shale oil production at this time.

Point 2

In late 2004, the price of oil rose above $40 per barrel and continued to rise to the astronomical level of $143 per barrel by July 2008. Industry experts attributed this rise to a rapid increase in global demand driven by the emerging markets' growing appetite for oil, and combined with a slow rate of global oil production. This would make sense if emerging markets had started to grow rapidly beginning in 2004. But they had been growing rapidly since 1999. China, in particular, had been growing at a fast pace since 1990. It made no sense to associate an oil price jump of unprecedented global levels solely to a rapid rise in demand. Something else was driving the price of oil higher.

The answer can be found in financial derivatives. When the story of derivatives is added to the story of oil, everything starts to make sense. Modern financial derivatives were developed in the 1990s as hedging instruments, primarily to hedge against currencies, interest rates and, later, stocks and bonds. There were no derivatives on commodities.

In 2000, in response to heavy lobbying by big banks, U.S. financial regulators loosened the regulation of financial derivatives. The Commodity Futures Modernization Act of 2000 (CFMA) opened the door for financial institutions to freely trade derivatives, so they began trading in energy futures and other commodities among themselves (over-the-counter vs. on a regulated exchange).

Prior to 2004 there were no oil derivatives. The launch of oil derivatives gave banks and speculators a new financial instrument that they could use to play with the price of oil. The small size of oil derivatives, compared with interest derivatives, meant that oil derivatives were more volatile, thus making it easier for speculators to move the market in oil. Though derivatives do not directly invest in oil, they are linked to price movements in oil, meaning that trades in oil support the derivative contracts and their trading.

As a result of the growing interest in speculating in commodities and oil, the market for derivatives grew faster and faster as the price of commodities and oil continued to rise. Industry experts and international media justified the rising prices of commodities and oil on growing economies and increased demand, completely ignoring the effect derivatives had on the market.

Point 3

In 2008, the price of oil and other commodities began to fall. The price of Brent Crude fell at a record rate, dropping from $143 in July 2008 to $34 by year's end; that is a 75% drop in five months, which has never happened in the history of oil. The drop was attributed to the Global Financial Crisis, which was sparked by the collapse of Lehman Brothers. Again, the reason was only partially correct. The Global Financial Crisis did send many of the world's economies into a recession, thus reducing demand for oil. But that crisis alone does not explain such a rapid price drop in such a short time.

When we add in the derivatives story, we again see that the narrative starts to make more sense. The collapse of Lehman Brothers caused shockwaves throughout financial markets worldwide. International credit markets were frozen, and banks stopped lending to each other because of lack of trust. The major banks all feared that they may be the next to collapse. This lack of trust and lending between banks caused the global derivatives market to come to a halt. Derivatives, after all, are not transparent and are not traded openly on markets, meaning that their true pricing and value is not clear. The market is traded from one bank to another. One bank issues a derivative and the other buys it and can trade it to another bank or investor. Thus, if an investor or trader believes that XYZ bank might fail, the investor will immediately stop buying and trading its derivatives. Frozen credit markets and a lack of trust meant that the derivatives market also stopped; and with that, oil and commodities came crashing down. The derivatives market was supporting the high valuation of oil and other commodities.

Point 4

The oil market quickly recovered, and by early 2011 Brent Crude was again trading above $100 per barrel. The international media attributed this to the global economic recovery and the return of the demand for oil. However, what really recovered was the derivatives market. Once governments and central banks in the U.S. and Europe bailed out their banks, trust and credit markets began to open up again, and these banks began issuing and trading derivatives again.

Point 5

Finally, we come to where we are today. The price of oil fell again from June 2014 to January 2016. It has since recovered to around $80/bbl today. The financial media suggested that this price drop was due to the price war started by Saudi Arabia and supported by OPEC in order to drive out U.S. shale producers. A slowing in emerging markets also was said to play a role. While these factors are partially to blame, they do not tell the full story.

Much of the blame for the collapse in the price of oil can be attributed to Basel III. After the Global Financial Crisis, the Basel Committee, which is operated by the Bank for International Settlements in Switzerland, came out with new rules for banks. It had hoped the new standards would fix some of the problems that had caused the crisis, such as trading in derivatives. While global financial regulators saw the dangers of derivatives and sought to increase their regulation, they failed to do so. The derivatives market became so large, in the trillions of dollars, that regulators feared adding more regulations would cause another panic and spark another financial crisis.

The Basel Committee, foreseeing that regulators may be slow to regulate derivatives, placed some of its own restrictions on how banks trade derivatives. Specifically, they increased the margin requirements for banks holding derivatives in order for them to be in compliance with Basel III rules. Today, all Kuwaiti banks meet these requirements and have little to no exposure to derivatives. But this is not the case for U.S. and European banks.

The increased margin requirements meant that banks were forced to reduce the size of their derivative holdings by January 2015. Consequently, banks began unwinding these holdings during the second half of 2014, which is when the price of oil started to fall. At Deutsche Bank alone, its financial derivatives fell by over 12.7 trillion euros - from 54.6 trillion euros in 2013 to 41.9 trillion euros in 2015, per the bank's annual reports. According to the Bank for International Settlements, commodity derivatives fell over 45% from June 2014 to year-end 2015. For Deutsche Bank, commodity derivatives fell more than 60% over the same period.

Thus, the claim that Saudi Arabia, Kuwait and other OPEC members were behind the fall in oil prices is false. The real reason for the rapid rise and fall in the price of oil is due to the entrance of a new class of speculator into the market since 2004. This can be better described as the "financialization" of the oil market. In addition, Basel III rules, which today are forcing banks to reduce the size of their holdings of derivatives, are playing a key role in limiting banks' exposure to all types of derivatives, including oil derivatives.

Outlook on the price of oil

When looking at the future prospect for the price of oil, we can look at fundamentals (supply demand dynamics) or trader/speculator dynamics (market sentiment). In both cases, the future outlook for oil is weak.

On a fundamental basis, the main driver of demand over the last decade (China) is no longer able to drive further demand growth in the coming decade. This is in addition to the technological and regulatory changes taking place in advanced economies. These changes are going to negatively affect the demand for oil in what can best be described as a paradigm shift toward other energy sources. This leaves the future demand for oil in its weakest position in living memory. On the supply side, OPEC has been unable to increase production to gain market share. Instead, the U.S. has stepped in as the world's main producer of new supply and is expected to gain a larger share of the market in the coming years.

On a trading basis, the Basel III rules are limiting the big banks that had helped to launch complex derivative products off oil and other commodities. Big banks are not able to hold on to large derivative contracts as they had in the past. What remains are the larger trading houses and hedge funds that stepped in beginning in 2014 at the request of OPEC to help support the price. It is no secret that these market speculators have been increasingly playing a larger role in the oil market.

OPEC, for the first time, has acknowledged the role they have played in supporting the price of oil. The real problem will arise when these speculators decide to remove their support. A slowdown in economic growth or a drop in demand from China could be among the many reasons they change their view on oil. Speculators, by their nature, are not long-term investors. In fact, they are not investors at all, which poses a real problem for OPEC trying to support a price range for oil.

FIGURE 20

Actual price of Brent Crude from January 2005 to June 2018 and forecast thereafter

Source: Thomson Reuters.

The outlook for oil on all fronts is weak. Looking at Figure 20, we expect Brent Crude to trade within the narrowing trading band (black dotted lines). The price of oil trading above $100/bbl as we saw in 2008 and again from 2011 to 2014 seems highly unlikely in the coming years. The more likely scenario is that oil will reach lower highs and lower lows, as shown in the red arrows in Figure 20. We do not expect the price of Brent Crude to trade above $90/bbl over the next five years, nor do we expect it to trade below $20/bbl over the same period. If it were to break out above (or below) the indicated range, it would be short-lived - as we saw in 2008, 2009 and 2016.

The trend toward mass-speculation in the oil market since the liberalization of the derivatives market is over. The oil market is returning to a more normal trading pattern, more akin to what we had seen in the 1990s (Figure 19). Fundamental forces of supply/demand do not support high oil prices, which should eventually spill over into the speculative market.

Because we are at a late stage in the economic expansion cycle, any further upside in the price of oil will be limited. This is in addition to the new U.S. producers, who seem willing to increase production every time the price rises. This should further dampen any jump in prices. Once the economic cycle switches over to a contractionary cycle, expect the price of oil to decline substantially from its current level. There is potential for price shocks to the upside in the event of a major geopolitical event, such as a war, or a disruption of supplies. Downside price shocks also pose a risk in the event a regional or global recession

sparks another financial crisis. In such a case, we would expect the price of Brent Crude to fall below its previous crisis level of $26/bbl.

b. Analysis of the global financial services sector and credit cycle

The global financial services sector has gone through significant change over the past ten years. New regulations imposed in reaction to the financial crisis have affected the sector's recovery speed in some regions while restricting some of its other activities in other regions. Going forward, new innovations and technological disruptions in this sector are slowly transforming the shape and structure of banking. In ten years, banking will be completely different than it is today. Needless to say, the biggest banks will be the ones most affected because they are the least able to handle industry disruptions. An example of this is the mass-acceptance of mobile banking over the last decade. Large banks have invested most heavily in their branch networks, so they will be slower to move away from this distribution channel. Another example is the rise of blockchain, which is the most significant industry disrupter in decades.
For this report, however, we will focus on the recent regulations that have been placed on the global financial services industry and how those new rules have affected the industry's performance. We will also discuss this performance in the context of the economic and credit cycles.

Banking regulations

Over the past ten years, there have been three significant regulations enacted in the financial services industry: the Dodd–Frank Wall Street Reform and Consumer Protection Act in the U.S.; the Bank Recovery and Resolution Directive (BRRD) in the E.U.; and Basel III throughout the world. All three regulations have had global implications.

i. Dodd–Frank Wall Street Reform and Consumer Protection Act

The Dodd–Frank Wall Street Reform and Consumer Protection Act, commonly referred to as Dodd–Frank, was enacted in the U.S. in 2010 in response to the financial crisis of 2008. That act brought the most significant changes to financial regulation in America since the Glass-Steagall Act in 1933 following the Great Depression. Dodd-Frank made changes in the financial regulatory environment that affected all financial regulatory agencies and touched every part of the country's financial services industry.

Major components of the act include:

- Consolidation of regulatory agencies, elimination of the national thrift charter, and an introduction of a new oversight council to evaluate systemic risk.
- Increased transparency of the opaque multi-trillion-dollar derivatives market, which was the main reason that the U.S. subprime mortgage crisis became a global financial crisis.
- Establishment of a consumer protection agency and uniform standards for financial products as well as strengthened investor protections.
- Creation of new tools for dealing with financial crises, including a "resolution regime" to allow for an orderly winding down of bankrupt firms, as well as a proposal to give the Federal Reserve authorization to extend credit in "unusual or exigent circumstances" to financial institutions and other central banks.

- Creation of the Volcker Rule, named for former Federal Reserve Chairman Paul Volcker who proposed it, to restrict U.S. banks from making certain kinds of speculative investments that do not benefit their customers. The rule is often referred to as a ban on proprietary trading by commercial banks, whereby deposits are used to trade on the bank's own accounts.
- Other measures aimed at increasing international standards and cooperation, including improved accounting and added regulation of credit rating agencies.

The most significant regulatory change in this act was the Volcker Rule. The large financial institutions were blamed for the massive losses they recorded in their proprietary trading books during the financial crisis. The Volcker Rule attempts to close this business down in order to protect the U.S. banking system from another financial meltdown. Because this type of trading was a lucrative (yet risky) business for the big banks, they lobbied exhaustively for a delay in its implementation. The rule finally took effect in July 2015. Subsequently, in August 2016, several large banks requested (and received) a five-year delay to exit illiquid investments (i.e. derivatives).

The cumbersome regulations imposed by Dodd-Frank on the entire U.S. banking system caused a significant strain and financial burden on smaller banks. These banks have had a harder time complying with the new regulations, which were designed to protect against the failure of another large financial institution. Smaller banks were not engaged in proprietary trading. These banks have blamed Dodd-Frank for their lackluster performance over the past few years.

In order to alleviate some of the stress and financial hardship facing smaller banks, parts of Dodd-Frank were repealed on 24 May 2018. The new measures exempt smaller banks from tighter regulation by raising the threshold for closer Fed oversight from $50 billion to $250 billion in assets. Thus, banks below the new threshold will no longer be automatically subject to annual stress tests and capital buffers meant to protect large firms from severe financial crises.

ii. Bank Recovery and Resolution Directive (BRRD)

Following the financial crisis, European financial regulators took a slightly different approach to their banking system. The European Banking Authority (EBA) enacted stress-testing measures to ensure the orderly functioning and integrity of financial markets and the stability of the financial system. The EBA, in cooperation with the European Systemic Risk Board (ESRB), was mandated to monitor and assess market developments as well as to identify trends, potential risks and vulnerabilities across the banking system. These stress tests were designed to assess the resiliency of financial institutions to adverse market developments, as well as to contribute to the overall assessment of systemic risk in the financial system.

Though this development was welcome, it was mainly seen as a quick fix and a public relations move to appease politicians and the public who had became frustrated with the multi-billion Euro bailouts handed to E.U. banks.

In 2014, following the collapse of the banking system in Cyprus, the E.U. adopted the Bank Recovery and Resolution Directive (BRRD). This new directive was designed to keep governments from ever again using taxpayer funds to bail out troubled financial institutions. A bank resolution occurs when authorities determine that a failing bank cannot go through

normal insolvency proceedings without harming the public interest and causing financial instability. The directive requires banks to prepare recovery plans to overcome financial distress. It also grants national authorities powers to ensure an orderly resolution of failing banks with minimal costs to taxpayers.
BRRD includes rules to set up a national resolution fund that must be established by each E.U. country. All financial institutions must contribute to these funds. Contributions are calculated on the basis of each institution's size and risk profile.

The new rules ensure that banks' shareholders and creditors pay their share of the costs through a "bail-in" mechanism. If that is still not sufficient, the national resolution funds set up under the BRRD can provide the resources needed to ensure that a bank can continue operating while it is being restructured.

The key phrase in BRRD is "bail-in." No bank can be bailed out with public money until creditors accounting for at least 8% of the bank's liabilities have paid up. Bail-ins typically mean wiping out creditors' investments, slashing their value or converting them into shares in the bank. Keep in mind that a bank's creditors also encompass its insured and uninsured depositors. Uninsured depositors, those with more than €100,000 in their accounts, could get caught along with professional investors, as happened in Cyprus in 2013. Uninsured depositors in failing Cypriot banks were forced to bail-in the banks by converting 47.5% of their cash deposits into the failing banks' shares. Most of the uninsured depositors included local companies who kept large balances in banks in order to meet their payroll and purchasing needs. This resulted in massive layoffs and bankruptcies in the country.

During the global financial crisis, bailouts were the quickest way to support failing financial institutions. From 2008 to 2012, the E.U. approved €592 billion in bailouts to financial institutions. These bailouts were deemed necessary to protect depositors' money. If these banks were allowed to collapse, economic chaos would ensue.

The consequence of these bailouts was the ballooning of government debt, which contributed to the euro crisis. The main idea behind BRRD is that investors, not taxpayers, should have to help pay the cost of rescuing or closing down banks. The main principle is that shareholders should take the first loss as owners of the bank. If that is not enough to stabilize the bank, subordinated bondholders should step in next, as they accepted the risk of investing in the bank's debt. Next in line are senior bondholders and, finally, uninsured depositors. Insured depositors should not be touched. Unfortunately, bail-ins are harder in practice than in theory. What happed in Cyprus is the best example.

iii. Basel III

Basel III is an international regulatory accord designed to improve the regulation, supervision and risk management within the banking sector in order to reduce the risk of system-wide shocks. The Basel Committee on Banking Supervision, responsible for the Basel accords, published the first version of Basel III in late 2009. It gave banks three years to satisfy all requirements. As with the other new regulations enacted in the U.S. and E.U., Basel III was in response to the financial crisis.

The main difference in Basel III - in comparison to Basel I and Basel II - was the introduction of tighter capital requirements. Banks' regulatory capital is divided into Tier 1 and Tier 2. Tier 1 is subdivided into common equity Tier 1 and additional Tier 1 capital. The distinc-

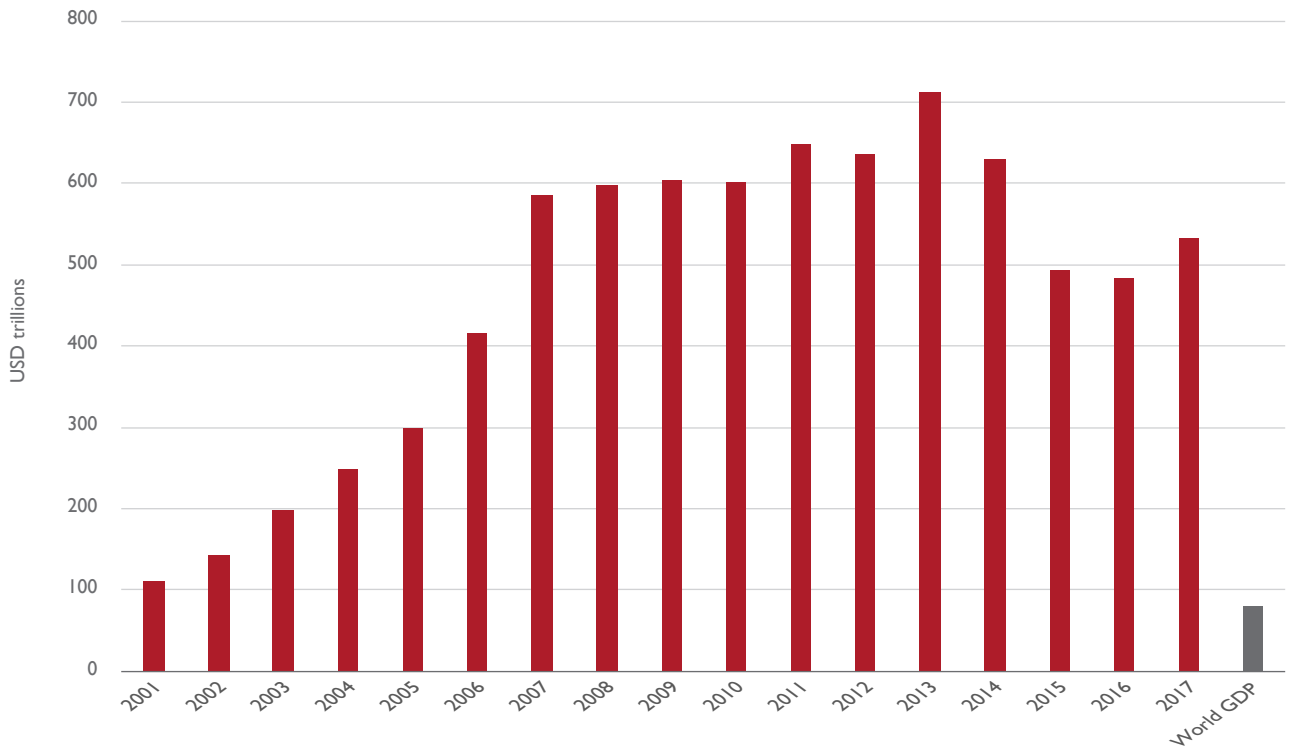
tion is important because security instruments included in Tier 1 capital have the highest level of subordination. Common equity Tier 1 capital includes equity instruments that have discretionary dividends and no maturity, while additional Tier 1 capital includes securities that are subordinated to most subordinated debt, have no maturity, and have dividends that can be canceled at any time. Tier 2 capital consists of unsecured subordinated debt with an original maturity of at least five years.

In comparison to Basel II, Basel III strengthened regulatory capital ratios, which are computed as a percent of risk-weighted assets. In particular, Basel III increased minimum common equity Tier 1 capital from 4% to 4.5%, and minimum Tier 1 capital from 4% to 6%. The overall regulatory capital was left unchanged at 8%.

Basel III also introduced new requirements in regulatory capital for large banks to cushion against cyclical changes on their balance sheets. During credit expansion, banks have to set aside additional capital, while during the credit contraction, capital requirements can be loosened. The new guidelines also introduced the bucketing method, in which banks are grouped according to their size, complexity and importance to the overall economy. Systematically-important banks are subject to higher capital requirements.

FIGURE 21

Growth in over-the-counter derivatives from 2001 to 2017 compared to World GDP in 2017



Source: Bank for International Settlements (BIS) and the IMF.

In addition, Basel III introduced leverage and liquidity requirements to safeguard against excessive borrowings and ensure that banks have sufficient liquidity during periods of financial stress. In particular, the leverage ratio, computed as Tier 1 capital divided by the total of on- and off-balance assets less intangible assets, was capped at 3%.

The banks that were most affected by Basel III were E.U. banks following the financial crisis and Euro Area debt crisis that began in 2010. E.U. banks were left in a weak capital position stemming from the extraordinary high-level of non-performing loans (NPLs) on their balance sheets. The knock-on effect of this was the difficulty of E.U. banks' ability to raise capital in order to meet Basel III requirements. In addition to having historically high NPL ratios, the largest E.U. banks were holding large positions in over-the-counter derivatives, which lacked transparency and were deemed to be high-risk securities according to Basel III.

New rules raised the margin requirements on banks holding derivatives. This meant that these banks had to set aside a larger share of their capital to continue holding their derivative portfolios. Thus, banks were faced with two choices: either raise their capital or sell some of their derivative holdings. As Figure 21 shows, banks opted for option 2 due to the poor environment for raising capital.

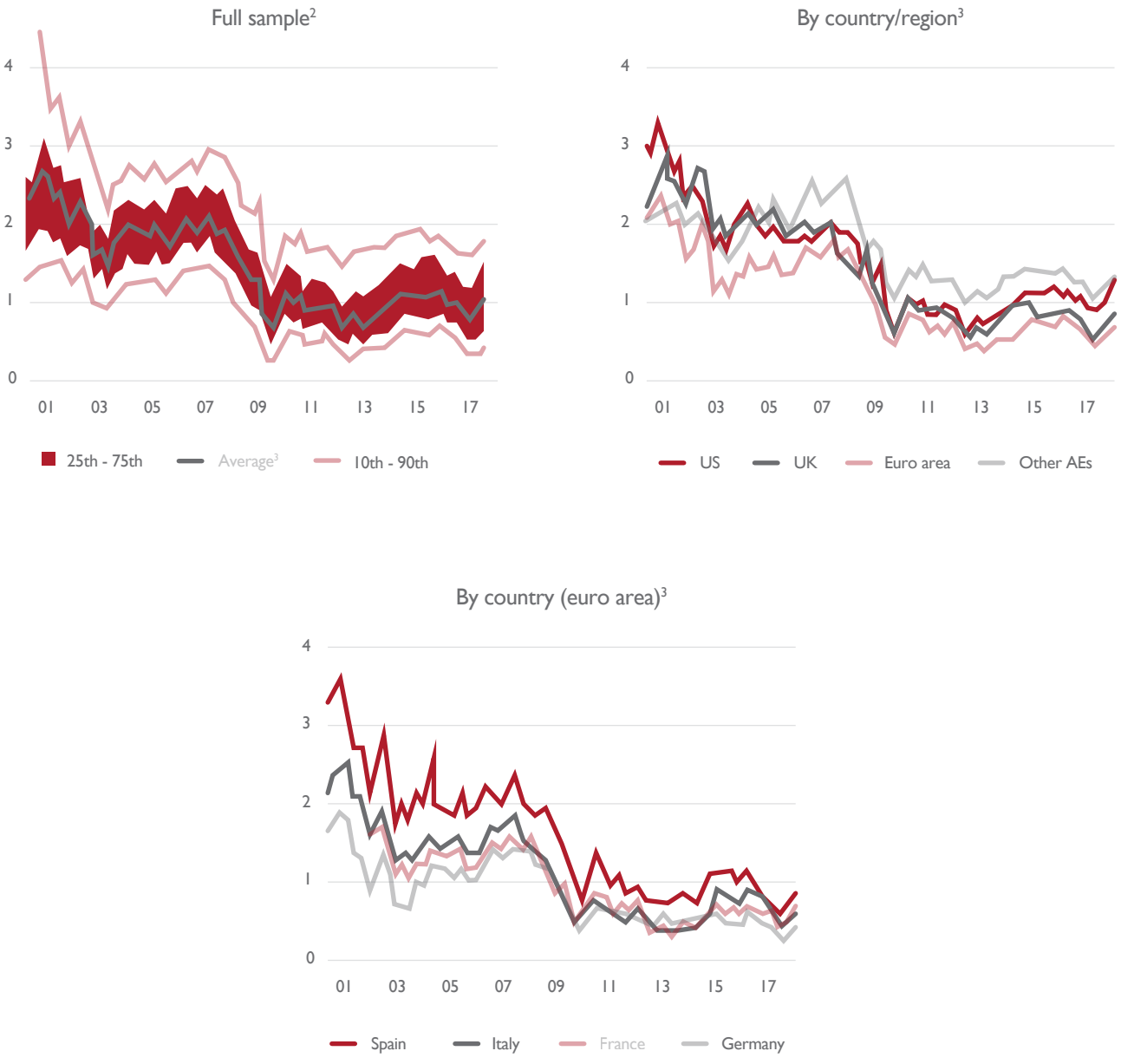
What is important to note here is that all new regulations were enacted following a crisis. In other words, financial supervisors and regulators around the world are reactive and not proactive. It takes a crisis to enact new regulations. It also means that financial supervisors and regulators, who are tasked with protecting the financial system and ensuring that it is working properly, cannot foresee a crisis.

Current state of the global financial services sector and credit cycle

The state of the global financial services sector since the financial crisis has been mixed. While the sector has largely recovered to pre-crisis levels in the U.S. and Asia, it has yet to do so in the E.U. This is primarily due to the massive bad debts (NPLs) in the banking system, new regulations as discussed above, and a lack of political will to address the underlying debt problem still facing E.U. banks today.

FIGURE 22

Price-to-book ratios of major international banks from 2000 to 2017



[2]The sample covers 72 banks in advanced economies (AT, AU, BE, CA, CH, DE, ES, FR, GB, IT, JP, NL, SE and US)

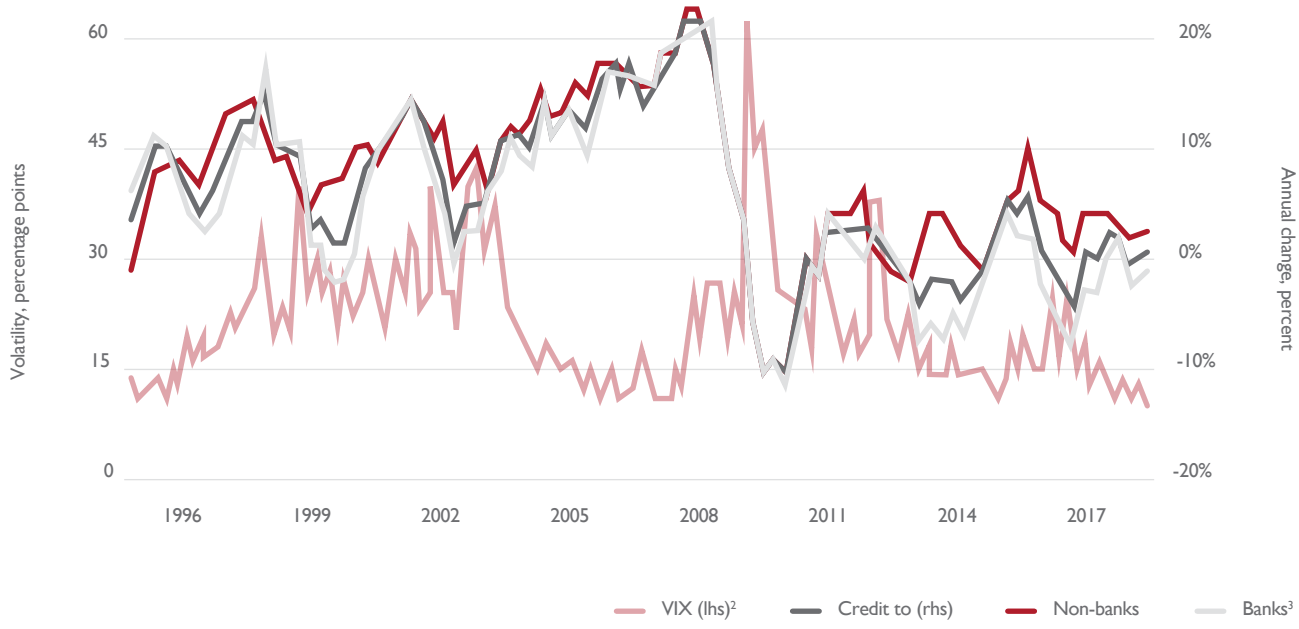
[3]Weighted averages across countries/regions/full sample)

Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

A common metric for valuing banks is the price-to-book ratio. As Figure 22 shows, bank valuations in the U.S. have only recently recovered to pre-crisis levels, yet they remain below their record-high valuation in 2001. Banks in the E.U., on the other hand, have not recovered, with German banks, in particular, showing poor valuations. This can be attributed to the high level of lending German banks granted to borrowers in peripheral countries, such as Spain and Italy.

FIGURE 23

Growth of international bank credit from 1994 to 2017



Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

²Chicago Board Options Exchange S&P 500 implied volatility index: standard deviation, in percentage points per annum. ³Including intragroup transactions

Since the financial crisis, the global credit cycle has been muted compared to past cycles (Figure 23). Though total new credit overall has been growing, its growth level is lower than previous cycles. This is due in part to the slow credit growth in the E.U., whereas credit growth in emerging markets has been rising quickly, especially in U.S. dollar-denominated credit, which will be discussed later. This below-historical-trend credit growth is one of the top reasons cited by central bankers for the slow global economic recovery.

FIGURE 24

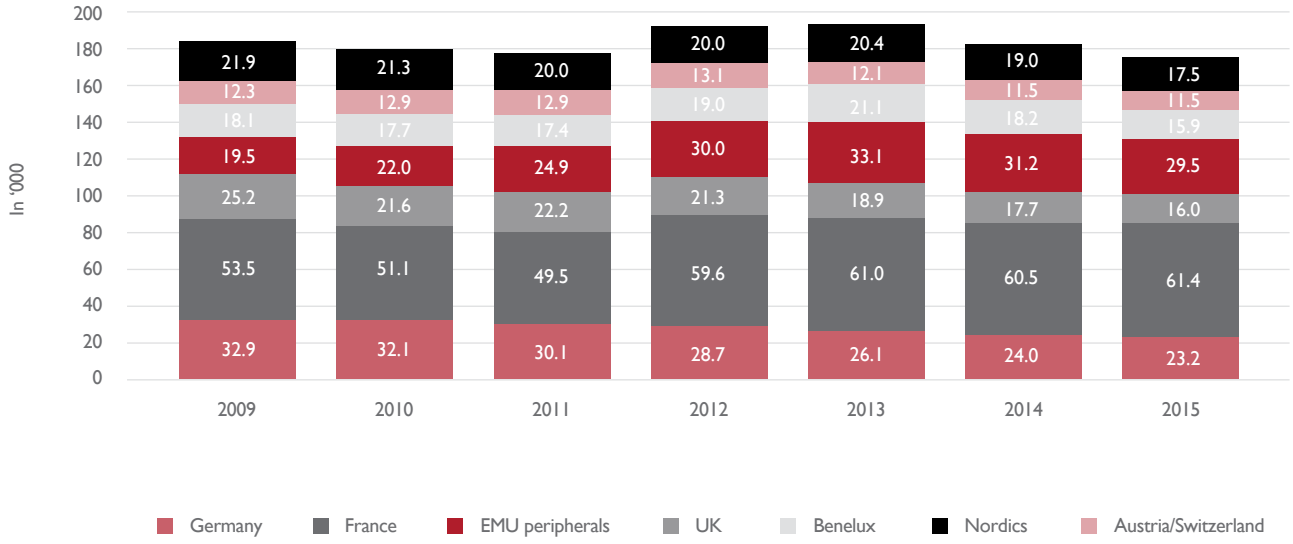
Net interest income from the largest European banks and year-on-year percentage change in lending growth to the private sector

Source: European bank performance 10 years after the crisis, 21 March 2018. Deutsche Bank.

Strain on the E.U. banking system can also be seen in its bottom line. Profitablity among the 20 largest European banks (Figure 24) has been declining. Record-low interest rates are partially to blame for falling interest income. Tighter credit conditions, which have forced banks to limit lending to all but the most credit-worthy borrowers, has been another contributor to declining profitability.

FIGURE 25

Trend in corporate insolvencies (bankruptcies) in Europe from 2009 to 2015



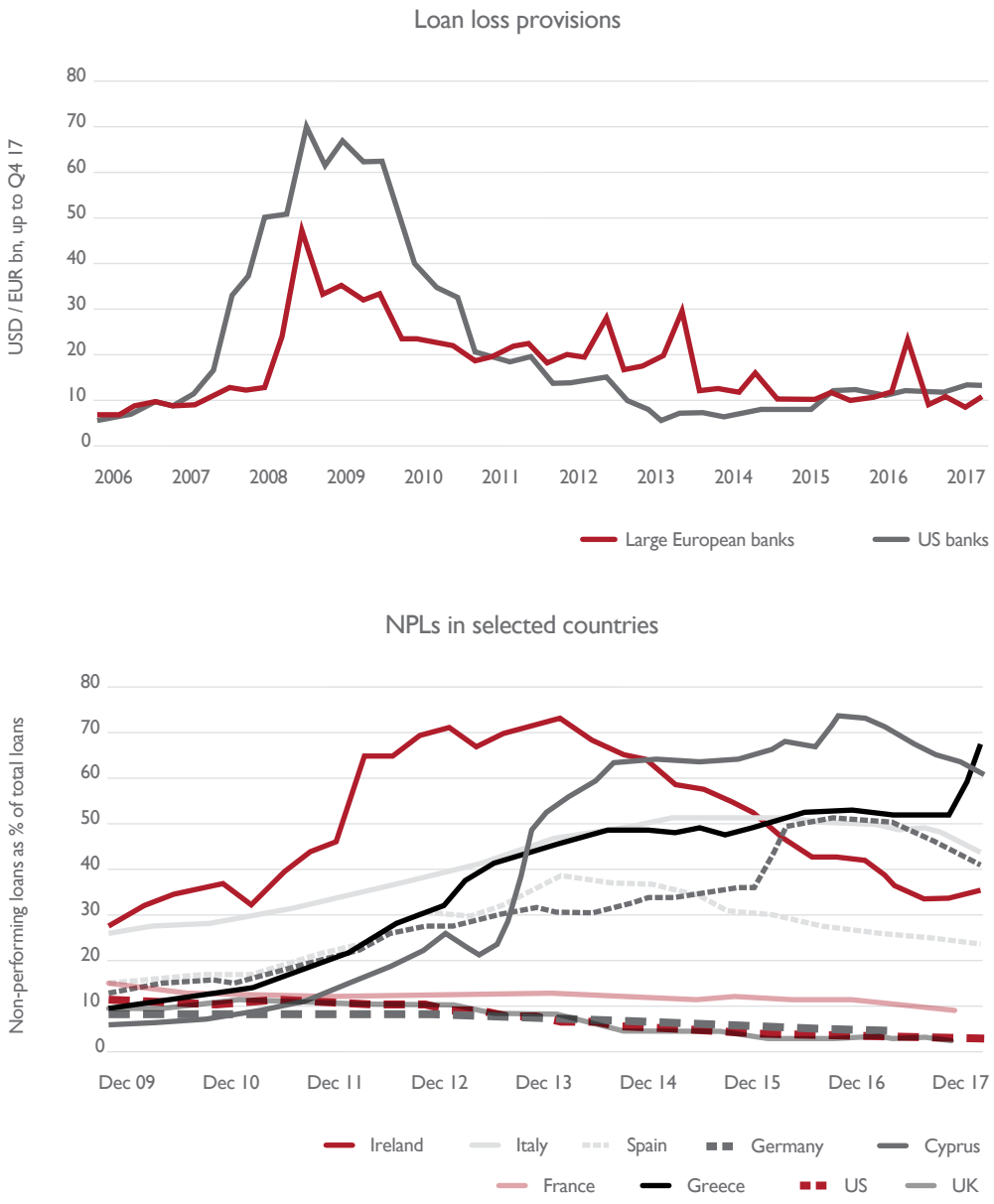
Source: European bank performance 10 years after the crisis, 21 March 2018. Deutsche Bank.

Tighter credit conditions also have contributed to the high number of corporate insolvencies in Europe (Figure 25). European banks have been unable to escape this viscious circle of tightening their credit standards to improve their balance sheets only to see their credit growth and insolvency rates deteriorate.

Corporate insolvencies for most of Europe have been slowly declining, except for peripheral countries (Portugal, Ireland, Greece and Spain) and France, which has the highest number of corporate insolvencies.

FIGURE 26

Loan loss privisions (EU compared to US) along with NPLs in select EU countries



Source: European bank performance 10 years after the crisis, 21 March 2018. Deutsche Bank.
No data available for Q1 and Q3, data for Germany only available for Q2.

European banks have been diligently working to improve their financial standing amid tough regulatory monitoring. Loan loss provisions have come down from their highs in 2009, but NPLs remain extremely elevated in many countries (Figure 26). Greece, which went though a severe economic crisis and a collapse of its banking system, still has unsustainably high NPL ratios in that banking system. However, Greek banks are not the biggest worry for the European financial system; Italian banks are of even greater concern. Of the estmiated €1 trillion in non-performing loans in the E.U. banking system, roughly €276 billion is held in Italian banks.

FIGURE 27

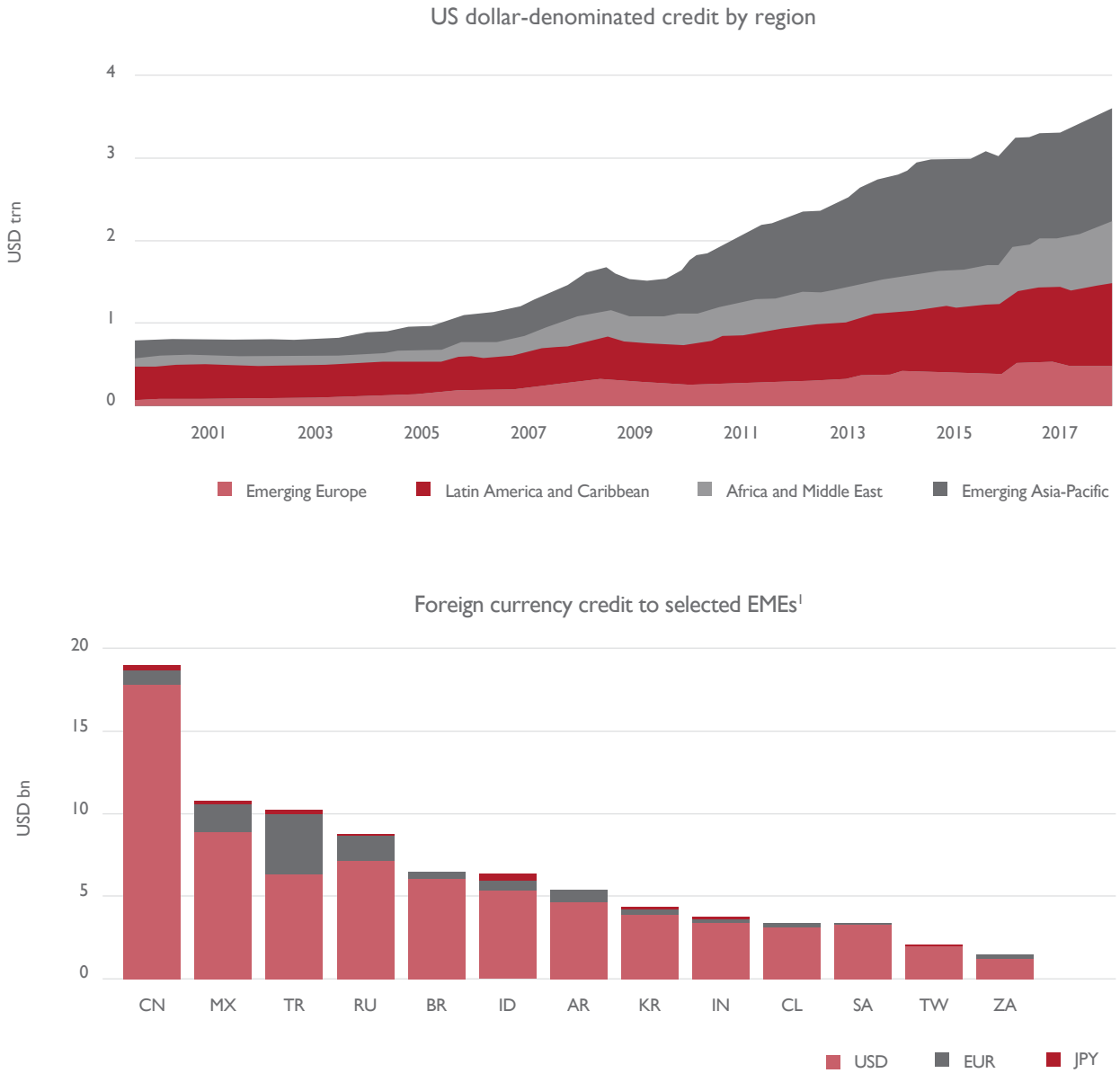
Change in net income and revenues of US banks vs. large European banks

Source: European bank performance 10 years after the crisis, 21 March 2018. Deutsche Bank.

The net result for European banks has been a disaster. While their U.S. counterparts have returned to solid growth and improved profitability, European banks have been stuck. The largest European banks have been unable to improve profitablity by focusing on growth. Instead, they have resorted to downsizing in order to improve their bottom lines. Total revenues for the 20 largest European banks are down over 14% from Q1 2006 to Q4 2017, yet this has not resulted in improved profitablity at this time.

FIGURE 28

Foreign currency credit to non-banks in emerging market economies (EME) from 2000 to 2017



Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

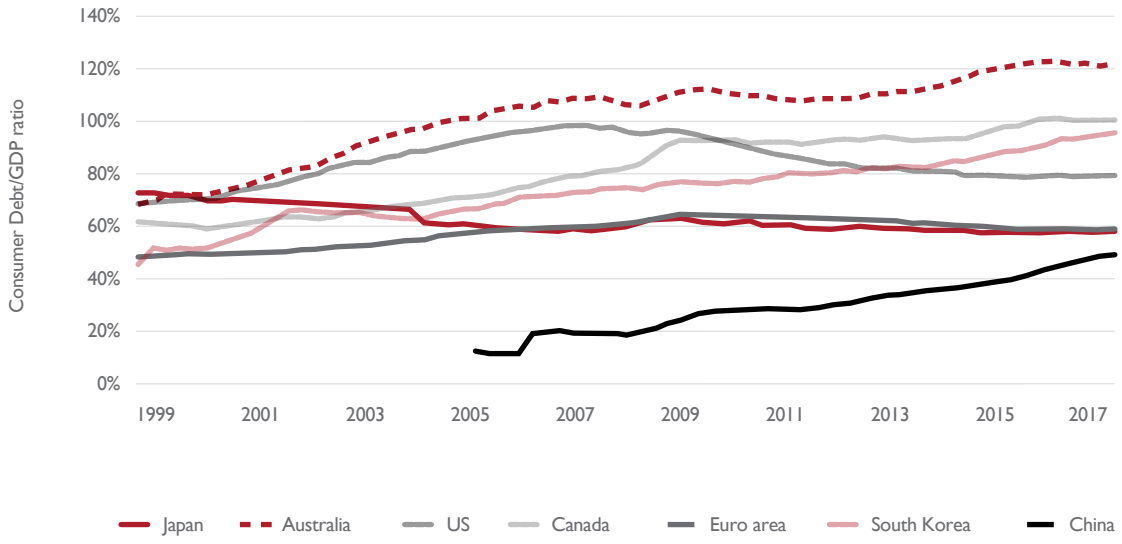
[1]Amounts outstanding for the latest available data

Emerging markets have witnessed a record amount of new credit growth. Credit has expanded in in every region except in emerging Europe. But the amount of foreign currency credit growth is worrying. Credit issued in foreign currencies grew at a record pace in Latin America and the Caribbean, led primarily by Argentina, Brazil and Mexico. These countries face a higher risk of default - especially when their currencies depreciate - which is the case today across the entire region. The region today is primed for a repeat of the credit crisis it suffered in the late 1980s. Today, however, the amount of credit (debt) outstanding is much larger.

Emerging markets in Asia were no different. The region saw the highest level of foreign currency credit issuance, led primarily by China. China's record pace for issuing credit has been worrying for some time. The leading credit agencies - Fitch, Moody's and S&P - have sounded the alarm on the record level of new debt in China along with a lack of transparency in the financial system. Chinese banking regulators have pushed back at these accusations, saying they feel confident their banks are able to manage this credit cycle. They state that the Chinese economy continues to grow at a faster rate than the economies of other countries or regions of the world. The Chinese also feel that their foreign currency risk is limited, due to the fact that they have able reserves and their currency is closely tied to the U.S. dollar.

FIGURE 29

The rise of consumer debt to GDP ratios in select countries



Source: Trading Economics.

On the consumer side, consumers in the E.U., U.S. and Japan have been more prudent. Throughout the past decade, they have been slowly deleveraging (Figure 29). Thus, the growth in credit in these markets has been led by corporates and governments. This has not been the case in other countries. Many emerging markets saw a rapid rise in consumer credit. However, as a result of the under-development of their financial markets, the overall consumer debt ratio remains comparatively low. In Turkey and Mexico, for example, two countries that have seen a rapid growth in credit, the consumer debt/GDP ratio remains low, 17.4% in Turkey and 16.1% in Mexico as of Q1 2018.

South Korea and China, on the other hand, have seen a dramatic rise in the consumer debt/GDP ratio, which as of Q1 2018 was 94.8% and 48.4% respectively. A ratio near or above 100% poses a high risk for a country's financial system. High ratios typically are driven by a housing and/or credit bubble that will result in a financial crisis at some point. The ratio in China seems comparatively low. Keep in mind, however, that the rapid rise in consumer debt in the country from 11% in 2006 to 48.4% of GDP as of Q1 2018 is a cause of concern.

Two countries face an extremely high risk of experiencing a consumer credit bubble - Australia and Canada. An economic contraction in these countries will pop the consumer credit bubble and their respective housing markets along with it.

Early warning indicators (EWIs)

The Bank for International Settlements (BIS) issues a special report on what it refers to as early warning indicators (EWIs) in a country's banking system. The BIS has formally assessed the performance of household and international debt as EWIs for banking distress. These variables contain useful information about banking system vulnerabilities, similar to that of their more widely-used counterparts based on aggregate debt. Particular emphasis is placed on the household debt service ratio, which is the ratio of total required household debt payments to total disposable income. In addition, the BIS uses cross-border claims to GDP instead of foreign currency debt, as it believes that claims are a better indicator of international debt. Below is a summary table of the current EWIs for the countries covered in the report.

TABLE 4

Early warning indicators for banking stress in domestic banking systems

	Credit-to-GDP gap	Debt service ratio (DSR)	Debt service ratio (DSR)	Cross-border claims to GDP
Australia	-8.1	1	1	21.3
Brazil	-6.4	-0.9	---	0.5
Canada	9.6*	2.9*	0.7*	33.1*
Central and eastern Europe	-12.5	-1.9	---	11.4*
China	16.7	5.1	---	-27.9
Finland	-5.2	0.9	0.8	-22.4
France	4	1.6	0.5	2.7
Germany	-2.1	-1.6	-1.9	6.9
Hong Kong SAR	30.7	6.9*	---	-12.3
India	-7.8	0.5	---	-30.6
Indonesia	6.9*	0.5*	---	-10.9
Italy	-18	-1.2	0	-10.8
Japan	7.6*	-1.8		20.5*
Korea	-1.3	0.1	1.7	-13.9
Malaysia	4.0*	0.4*	---	-1.6
Mexico	6.2	1.1	---	17.9
Norway		-0.3	1.1	34.4
Russia	-4.6	1.8	1.8	-24.9
South Africa	-2.2	0	-0.3	22.1
Spain	-50.7	-3.6	-1.6	-19.5
Sweden	-11.2	-0.4	1.1*	-1.9
Switzerland	10.0*	0.7*	---	7.5
Thailand	6.7*	-0.6	2.8*	-16.6
Turkey	5.4	6.1	---	-1.2
United Kingdom	-17.7	-1.3	-0.8	0.6
United States	-6.9	-1.1	-1.5	-15.2

Legend				
	Credit/GDP gap>9	DSR>1.8	DSR>1.4	XB claims>34
	4<Credit/GDP gap>9	0.1<DSR<1.8	0.6<DSR<1.4	18<XB claims<34

The threshold for red cells minimises false alarms conditional on capturing at least two thirds (90%) of historical crises with a cumulative three-year prediction horizon. Asterisks highlight a signal of the combined indicator when property price gaps were above 11 at some point during the last three years.

Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

According to the bank's EWIs, the countries of Canada, China (including Hong Kong), Russia and Turkey are flashing red in terms of their debt service ratios. This indicates that these economies are fragile and sensitive to slowdowns.

The overriding conclusion is that the financial services sector has recovered in the U.S. and emerging markets. The financial services sector in Europe, however, remains weak and unable to grow out of or fix its bad debt problems. This makes it vulnerable to future credit shocks.

Upon reviewing the financial and credit conditions across all regions, we believe that the current credit cycle is mature and at extreme levels in some countries, including Australia, Canada, China, South Korea and Turkey. The next economic contractionary cycle down will affect these economies with greater intensity than other economies.

c. Analysis of global central bank policies and their impact on the financial services sector

In late 2008, the term "quantitative easing," or QE, began to be commonly used. Few understood what it meant and nobody, not even the central bankers, understood how it would affect economies and financial markets. Nevertheless, they proceeded to launch it. The unprecedented nature of the crisis in 2008 called for an unprecedented response. Governments and central bankers needed to act quickly to save the global financial system. Governments were slow to act, so the burden to find a quick solution fell on central bankers. Their solution was quantitative easing which, at the time, was somewhat of an experiment and still in the theoretical stage. Having found no other quick solutions, central bankers jumped on it.

Never before in the history of central banking has such a massive-scale experiment been carried out. Overnight, the major central banks switched from being the regulators of monetary policy and lenders of last resort to buyers of government bonds, corporate bonds, mortgage-backed securities and stocks. Within a few short years, these central banks became among the largest investors in the world, larger than most sovereign wealth funds.

By doing so, they were successful in saving the financial system. The global economy slowly emerged from recession, bank liquidity returned, lending resumed and asset prices (such as stocks and real estate) began rising again all while interest rates remained locked at or near zero percent. The success of QE has not come without criticism. This criticism has grown because of the economic data showing the distortions that QE has caused in markets.

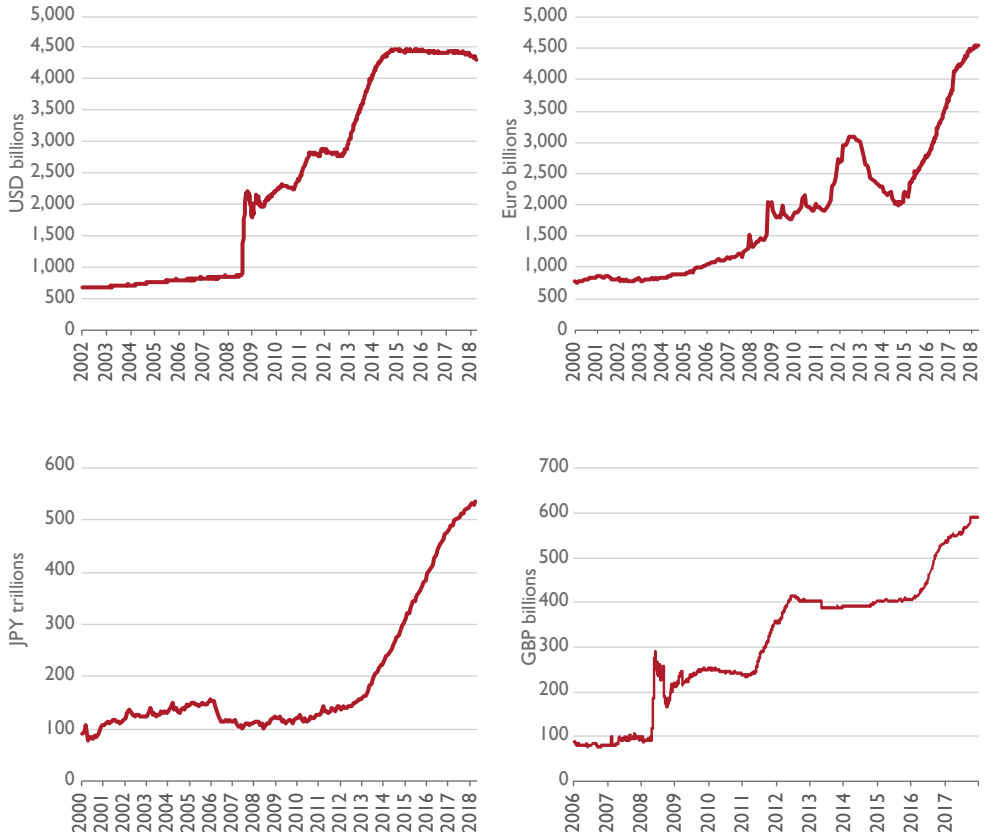
QUANTITATIVE EASING (QE) DEFINED:

Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. Quantitative easing is considered when short-term interest rates are at or approaching zero and does not involve the printing of new banknotes.

Source: Investopedia.

FIGURE 30

Growth in central bank balance sheets of the Federal Reserve, European Central Bank (ECB), Bank of Japan and Bank of England



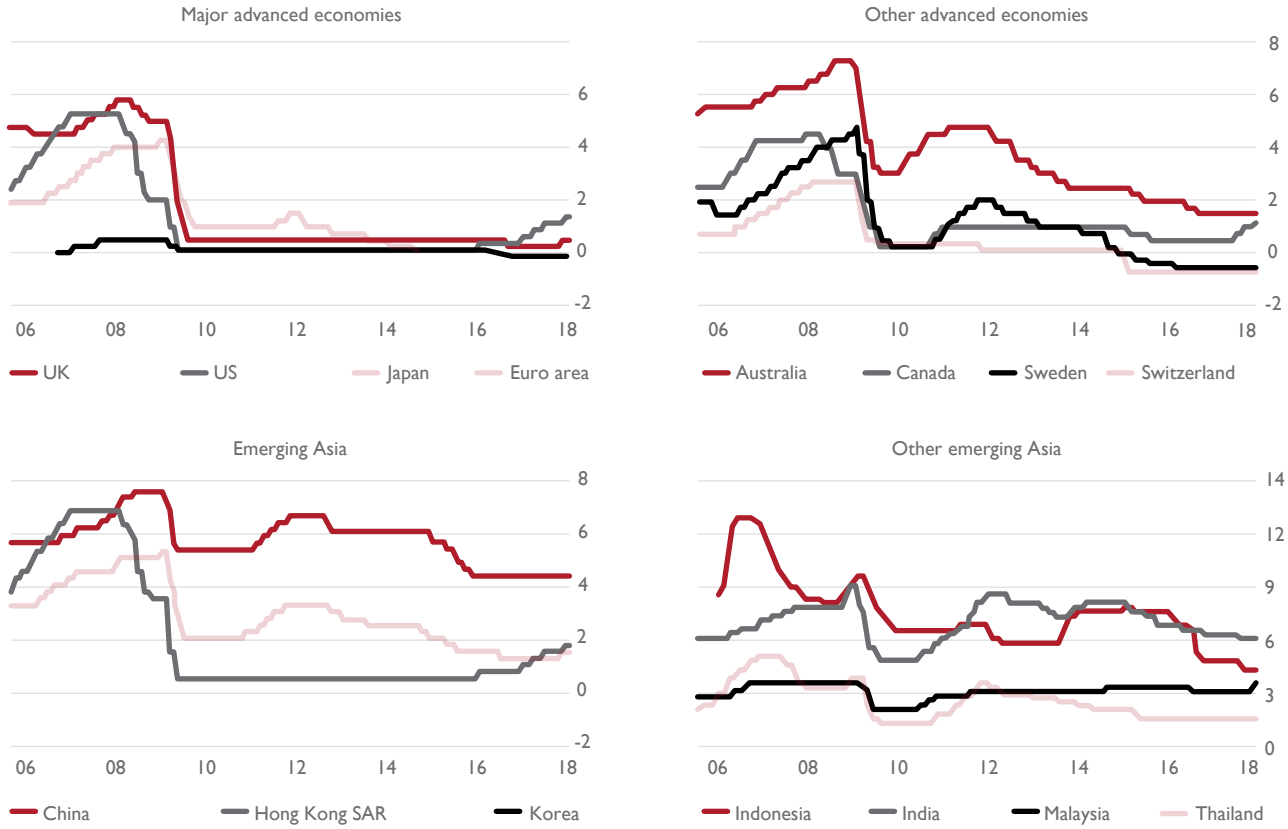
Source: Trading Economics.

Balance sheets of the four largest central banks - the Fed, Bank of England, European Central Bank (ECB) and Bank of Japan - grew from roughly $4 trillion in 2008 to over $15 trillion by the end of 2017 and are still growing. This $11 trillion in newly-created money went into buying a range of financial assets, but primarily government bonds, corporate bonds, mortgage-backed securities and, more recently, stocks. The primary motive in doing so was to force interest rates down and provide liquidity to the market so that banks could go back to lending to consumers and corporations.

The overriding motive, however, was to stimulate economic growth (by encouraging lending) and to create inflation. During the financial crisis, much of the world entered a period of deflation, which is the worst possible scenario for debtors. Deflation means the cost of servicing debts rise. By contrast, inflation means that over time, the cost of servicing debt goes down as inflation slowly eats away at the value of money.

FIGURE 31

Effective central bank policy interest rates from 2005 to 2017



Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

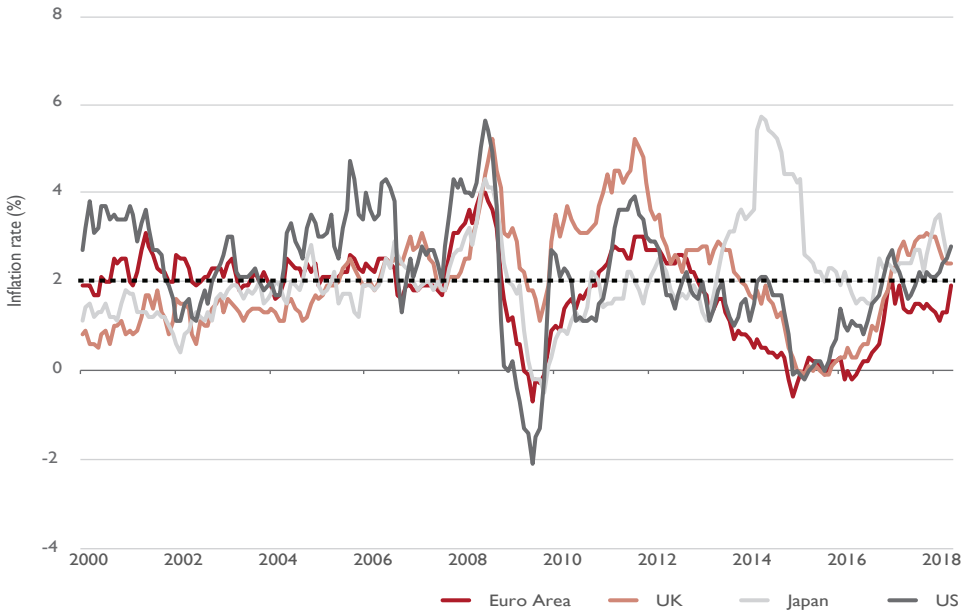
In November 2008, the Fed began its first QE program pledging to buy $600 billion in mortgage-backed securities. The Fed went on to do two more rounds of QE, a second one in 2010 and a third in 2012. After seeing mixed results, the Fed decided to halt the program in October 2014, at which time the Fed's balance sheet had grown from $800 billion in 2007 to $4.5 trillion, the largest in the bank's history.

The mixed results the Fed was seeing were the distortions it was creating in the market. Asset prices were rising, but they were not benefiting the wider economy. The gap between rich and poor was rising to levels not seen since the Great Depression. The unemployment rate was falling, but it was not leading to rising wages, a result that the Fed cannot explain to this day. Above all, and after trillions of dollars spent buying assets, inflation was not rising.

The puzzle of why QE was not having the desired effect on the economy led the Fed to commission a report. The result was a 2015 working paper titled Current Federal Reserve Policy Under the Lens of Economic History: A Review Essay. It failed to prove a link between quantitative easing and either increased economic activity or increased inflation. It goes on to highlight the fact that the two counties with the longest history of QE, Japan

FIGURE 32

Inflation rates in select countries from 2000 to May 2018 along with target inflation rate of 2% set by central banks (dotted line)



Source: Trading Economics.

and Switzerland, actually have seen the reverse outcome - low inflation and even deflation - proving that the central bankers' theory of QE is flawed.

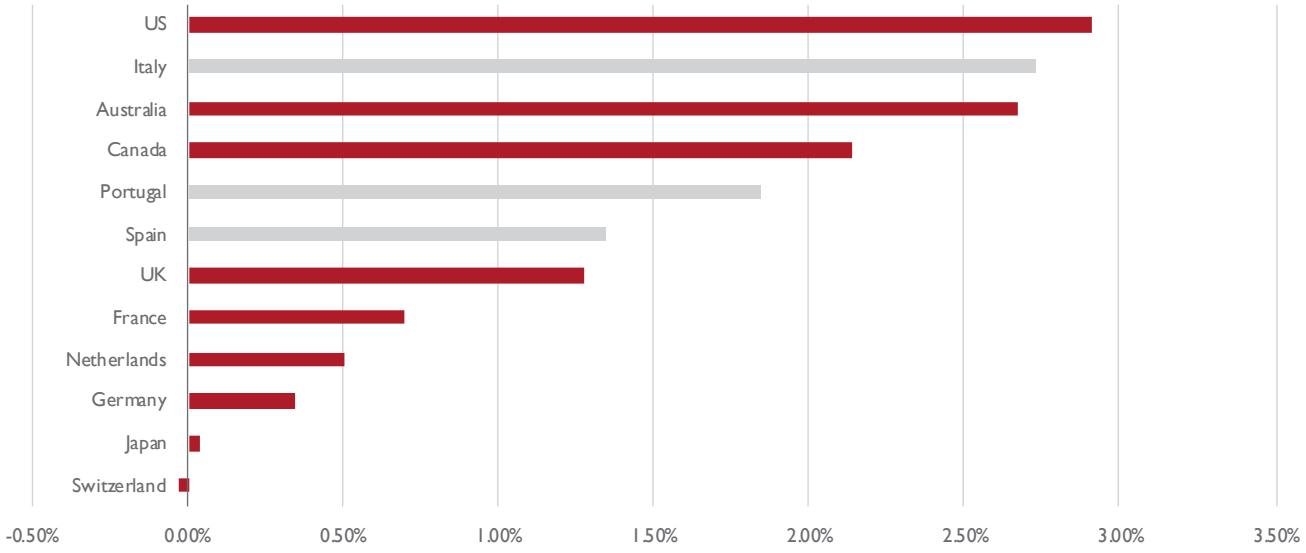
The logical conclusion after trying QE for several years without the desired effect would be to stop trying it. But except for the Fed, many prominent banks are even more determined to make QE work, including the ECB, Bank of Japan and Swiss National Bank. In October 2014, the Bank of Japan launched its most ambitious QE program to date; it would buy ¥80 trillion per year in assets, which included Japanese stocks by way of exchange-traded funds (ETFs). It would continue doing so until inflation climbed above 2%. As Figure 30 shows, as soon as this QE program began, inflation dropped. Three years later the Bank of Japan shows no sign of ending this program. Along the way, it has created an unimaginable mess for itself. According to Bloomberg, the Bank of Japan currently owns close to 80% of all Japanese ETFs, has become one of the largest shareholders of nearly every company in the Nikkei 225 index and is running out of bonds to buy.

The Swiss National Bank (SNB) is on a similar path. But instead of limiting its purchases to domestic stocks and bonds, it opened the door to buy international stocks and bonds. Today, the SNB has a U.S. stock portfolio valued at over $85 billion and has become one of the largest shareholders of Apple, with a stake valued at over $3 billion according to the SNB's own reports. There has been no other time in history where central bankers have become stock-pickers and shareholders, which goes to show the level of absurdity we are living in today.

The ECB is no different. In March 2015 it announced it would buy €1.1 trillion in European government and corporate bonds annually into the foreseeable future until it hits its inflation target. The only advanced economies hitting their inflation targets today are the U.S. and U.K., which not only stopped QE, but also began raising interest rates again. As such, both economies also have the best economic indicators out of the other advanced economies still engaged in QE and active zero-interest-rate policies.

FIGURE 33

10-Year government bond yields of select countries as of 21 June 2018



Source: Trading Economics.

Not only has central bank QE inflated asset prices around the world, it has also forced investors, especially sovereign wealth funds and pension funds, to seek out riskier assets in order to get higher returns. This has caused a huge misallocation of risk across a wide range of assets. Take, for example, 10-year government bond yields. Due to the ECB's QE program, bonds across the Euro Area have abnormally low yields. The longer the ECB keeps blindly buying all Eurobonds, the worse this distortion will become. Figure 33 highlights this effect. Today, bond yields in Italy, Portugal and Spain are lower than Australia and the U.S. which, under normal circumstances, would suggest that investing in Italian, Portuguese or Spanish bonds carries a lower risk than U.S. Treasuries or Australian government bonds. The distortion becomes much worse when looking at yields in emerging and frontier markets. In order to meet their investment return targets, pension funds and sovereign wealth funds are buying bonds in Mongolia, Ecuador, Ivory Coast and Argentina, a country that has defaulted on its bonds more than 14 times over the past 100 years and is heading toward another default soon.

GCC sovereign wealth funds are no better. Some have even stated publicly that they are changing their investment allocation to allow for riskier assets, such as private equity, and increasing their allocation to emerging markets. This chase for yield will land GCC sovereign wealth funds in trouble during the next economic downturn, at which time they will have trouble explaining to their boards why they decided to change their mandate from preserving sovereign wealth to going after higher returns.

The big questions for central banks are: how do they intend on selling off these assets in the future; and what effect will that sale have on the markets? In 2017, the Fed began gradually reducing its balance sheet over the next few years. Although market analysts claim that the market is ready, the truth is that nobody knows how markets will react once the Fed policy is fully implemented. In the past month, central bankers from India and Indonesia have asked the Fed to slow its balance sheet reduction program because it is causing U.S. dollar liquidity issues for emerging markets and putting pressure on their currencies.

Central banks may have saved the global economy from an even bigger disaster. But in so doing, they have created another problem. The misallocation of risk and distortion of interest rates are causing investors to seek higher returns and much higher levels of risk than they normally would take. During the next economic downturn these investors, which include the GCC sovereign wealth funds, will be hit hard. Trust in central banks will greatly diminish, as they will be blamed in the end for causing the next financial crisis.

III. Key risks facing the global economy and Kuwait

In the first section of this report, the current state of the global economy was discussed along with a review of economic cycles. The purpose was to understand that economic cycles are part of the normal functioning of the economy. Accordingly, we must determine where we are in the cycle in order to forecast where we expect to be in the near future.

The previous section discussed three key factors that affect the global and regional economies. Understanding the function of oil prices on the global economy is key, because the world is dependent on energy for growth. Reviewing the current state of the global financial services is another important factor. Financial services have been referred to as the oil that lubricates the global economy and ensures that capital flows to where it is needed. Central banks, on the other hand, have been carrying an extra burden since the financial crisis began, ensuring that the global economy is functioning properly. Some of their policies, such as quantitative easing, are causing other problems in the economy.

Based on the previous two sections, it is clear that the global economy as well as regional economies are in the late stage of an expansionary cycle. The next stage will be a contractionary cycle, contrary to the forecast by the leading international agencies and central banks. The question now is not "if" we are heading for a recession, but rather what type of recession it will be. Recessions are part of the normal economic cycle, but there are different types of recessions.

i. Boom-and-bust recession, also known as a normal recession

Recessions frequently occur after a previous economic boom. During the expansionary cycle, economic growth is well above the long-run trend rate of growth. This rapid growth causes inflation to rise at a faster rate, and the economy's current account deficit grows. This growth trend becomes unsustainable, so it falls into contraction – a bust.

Typically, when the government and central bank see that inflation is getting out of control, they respond by implementing tight monetary policy (higher interest rates) and tight fiscal policy (higher taxes and lower government spending). In addition, consumer confidence soars during the expansionary cycle. As a result, the savings ratio tends to fall and private borrowing tends to rise to finance higher spending. Thus, rising debt finances the economic boom. When the economy changes (i.e. it peaks or begins to contract), consumers radically change their behavior; rather than borrowing, they seek to pay off their debt and the saving ratio increases - causing a fall in spending.

An example of a boom-and-bust recession is the dot-com bubble from 2000 to 2001.
Key features of boom-and-bust recessions:

- They are usually short-lived.
- If caused by high-interest rates, reversing rate increases can lead to a quick recovery.
- Can be avoided by keeping growth close to long-run trend rate and inflation low.

ii. Balance sheet recession

A balance sheet recession occurs when banks and firms see a large decline in their balance sheets due to falling asset prices and a rapid rise in bad debt. As a result of large losses, bank lending is restricted leading to a fall in investment spending and economic growth. In a balance sheet recession, asset prices tend to fall. For example, a fall in housing prices causes a decline in consumer wealth and increases bank losses. This is another factor which causes lower growth.

An example of a balance sheet recession is the 2008 global financial crisis.
Key features of balance sheet recessions:

- Last longer than boom-and-bust recessions.
- Cuts in interest rates may fail to cause economic recovery due to liquidity trap.
- No quick recovery.
- More susceptible to a double-dip recession.

The only way to avoid a balance sheet recession is to avoid a credit and asset bubble. Targeting inflation and unemployment are useless.

iii. Other recessions

Variations of the above two main types of recessions include a depression. A depression is a prolonged and deep recession, where output falls by over 10% and unemployment rates rise to very high levels. A balance sheet recession is more likely to cause a depression because falling asset prices and bank losses have a long-lasting impact on economic activity. An example of a depression is Greece from 2008 to 2015.

Other types of recessions include supply-side shock and demand-side shock. A spike in oil prices, as witnessed in 1973, could cause a recession due to a decline in living standards. The tripling in the oil price caused a sharp fall in disposable income and also caused lost economic output due to lack of oil. Supply-side shocks cause lower output and higher inflation, referred to as stagflation.

Demand side shock is caused by an unexpected event that leads to a sharp fall in aggregate demand. An example of this is the short-lived recession of 2001 (GDP fell only 0.3%), which was caused partly by a fall in consumer confidence as a result of the 9/11 terrorist attacks.

Thus, supply and demand-side shocks tend to be caused by unpredictable factors such as geopolitical events and terrorist attacks. In contrast, a boom-and-bust recession and a balance-sheet recession can usually be spotted early on by monitoring economic and financial data.

So today, are we more likely heading for a boom-and-bust recession or a balance-sheet recession? To help answer this, we need to consider some of the risk factors facing the global economy. We also need to consider their likelihood of causing a contagion effect (via a crisis) leading to another global recession versus a contained regional or national recession/crisis.

Note: All the risk factors outlined below have the potential to cause a global financial crisis – contagion effect.

a. Rising rates and their effects on emerging markets rates

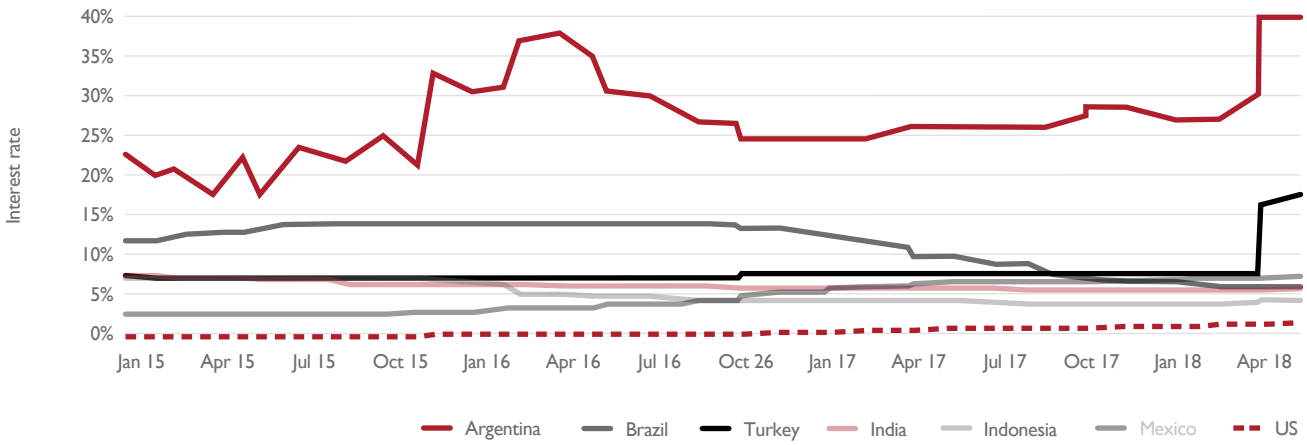
Emerging markets have had a difficult year so far. In May 2018, foreign investors pulled over $12.3 billion out of emerging market stocks and bonds, according to data from the Institute of International Finance (IIF) that was published by Reuters. Approximately $8 billion was pulled out of Asia and $4.7 billion from Africa and the Middle East combined. In April this year, foreign investors also pulled money out of emerging markets, making the April/May period the second-longest streak where investors withdrew from emerging markets according to IIF records. The longest streak followed the election of U.S. President Donald Trump in November 2016.

Economists have not been able to point the finger at a single reason to explain this sell-off, instead believing that a combination of factors was at play, such as: domestic issues in Argentina, Brazil and Turkey; trade war fears in China; and political uncertainty in Italy and Spain. The overriding factor, however, has been the higher global borrowing costs and a stronger U.S. dollar. Year-to-date money flows still remain positive for the year, but are sharply lower than during the same period last year – a net $46 billion (Jan. to May 2018) flowing into emerging markets compared to $134 billion (Jan. to May 2017).

Not all emerging markets have seen net outflows for the year, which is good news for now. Net flows to Turkey were $10 billion in April (May data was still not available at the time of this report) and $8 billion to Mexico, their highest levels since January 2015. Net flows to Brazil were flat and net flows to Argentina and India both turned negative for the first time since May 2017 and February 2016, respectively. The IIF estimates that a 10% appreciation in the trade-weighted value of the U.S. dollar would reduce annual net capital inflows to emerging markets by $95 billion. Thus, a stronger dollar together with

FIGURE 34

Change in central bank interest rates in the U.S. vs. G20 emerging markets



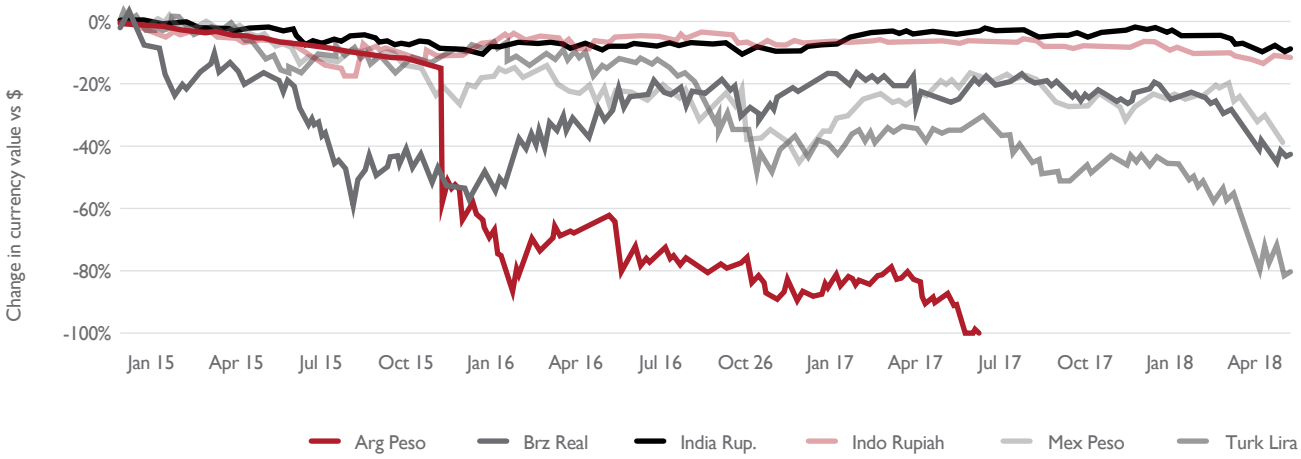
Source: Trading Economics.

record-high foreign currency debts in emerging markets is the wrong combination for these markets at this time.

Figure 34 shows how emerging markets in the G20 responded to the U.S. interest rate rises. There are six emerging markets within the G20: Argentina, Brazil, India, Indonesia, Mexico and Turkey. Argentina is an anomaly as it has been in and out of a financial crisis for much of its recent history. Among the remaining five countries, Mexico responded immediately in 2015 with corresponding interest rate rises. Nevertheless, the Mexican peso has depreciated over 35% against the U.S. dollar since January 2015 (Figure 34). Brazil was reeling from a severe recession that began in 2014 and cut its interest rate beginning in November 2016. This, too, did not help the Brazilian real, which has depreciated over 43% against the dollar. India, Indonesia and Turkey decided to hold rates relatively stable when the Fed began raising rates in December 2015. The currencies of India and Indonesia were not under as much pressure as the others and were able to hold off on raising interest rates until April this year, when their currencies began to fall against the rising dollar. The Indian rupee is down 10% against the dollar, and the Indonesian rupiah is down 12.1% since January 2015. The Turkish lira, on the other hand, has been one of the worst-performing emerging market currencies this year. The Central Bank of Turkey's failure to raise rates sooner proved to be a mistake. The lira has depreciated over 80% against the dollar since January 2015.

FIGURE 35

Percentage change in the value of G20 emerging market currencies vs. U.S. dollar



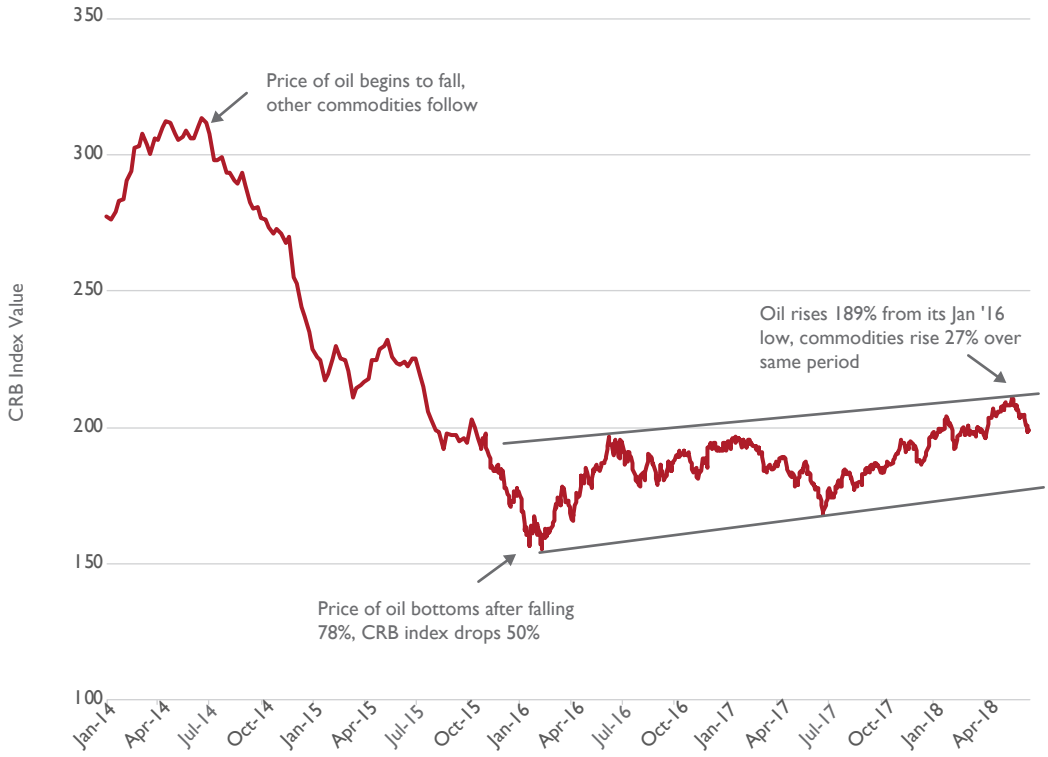
Source: Trading Economics.

The risk to a crisis in emerging markets is coming from three fronts. First, a rising U.S. dollar might be good for their exports, but it is terrible for their foreign debt payments, which today stand at a record-high level. Second, the rising current account deficits that result when foreign money leaves these markets coupled with higher foreign debt payments increase the pressure on the currencies. The result is further depreciation. These economies become trapped in a vicious cycle, which can be difficult to change without triggering a crisis. Third, many of these emerging markets are dependent on commodities as their main export and income-earner. Though the price of oil has recovered nicely since the lows of January 2016, the rest of the global commodities have not.

From June 2014 to January 2016, the price of oil fell by 78% and the Thomson Reuters'

FIGURE 36

Performance of the Thomson Reuters CRB Index, a broad-based index of commodities

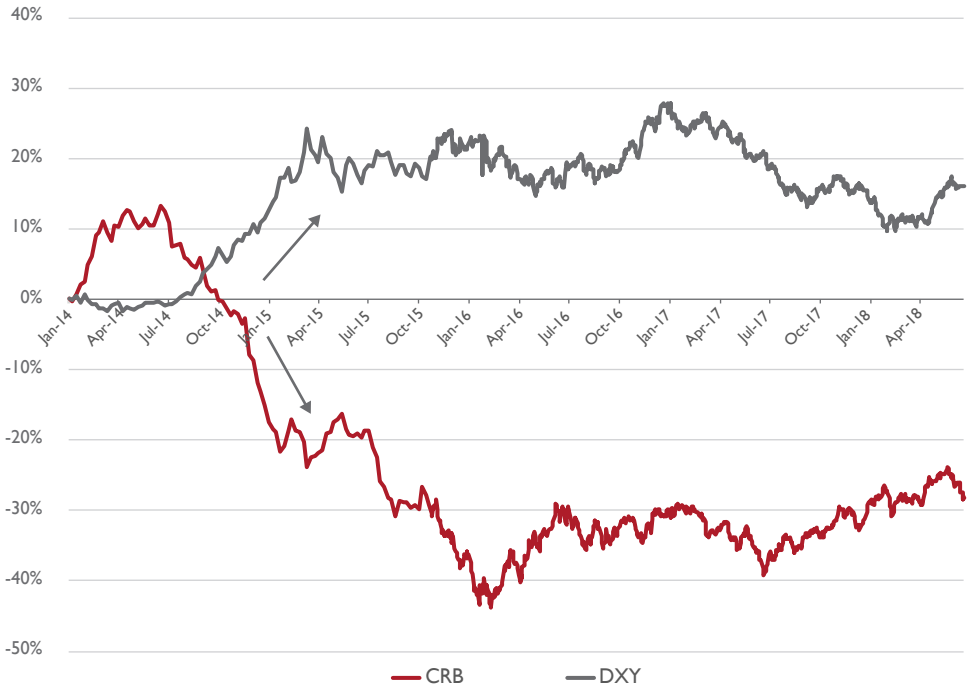


Source: Trading Economics.

CRB Index fell by 50% (Figure 36). The CRB index is a broad-based commodity index comprising a basket of 19 commodities. The highest-weighted commodity in this index is oil at 23%.

FIGURE 37

Performance of Thomson Reuters CRB Index vs. the U.S. dollar index (DXY)



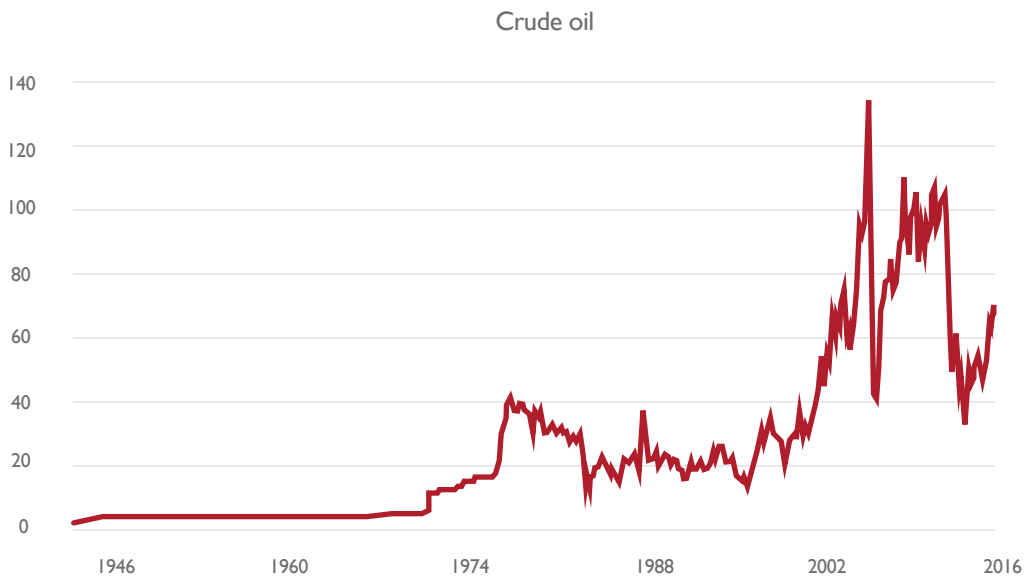
Source: Trading Economics.

From January 2016 to the end of May this year, oil has risen 189%, whereas the CRB index has risen only 27%. Much of the rebound in this index can be attributed to the rise in oil. Many of these commodities have yet to recover from their 50% drop.

For commodity export-dependent economies, this is a growing problem and risk to their economies. Add in the appreciating U.S. dollar (Figure 37) and you can see the pressure these economies feel today. Lower foreign currency income from exports - along with a stronger dollar - is increasing the chances of one or more emerging markets defaulting on its foreign currency debt. Argentina has already defaulted, but the IMF came to its rescue in June 2018 with a $50 billion loan. The loan, the largest in the IMF's history, was extended to prevent what the IMF feared would be a contagion effect on other emerging markets. The problem is that Argentina was the weakest, but not the only, country that will soon need a bailout. There will be a crisis in emerging markets, and it is difficult to tell at this point the extent of the potential contagion effect. We believe that the IMF will not be able to bail out all of the countries; some will be forced to default. China, by the way, is a special case and is discussed below.

FIGURE 38

Oil price from 1946 to June 2018



Source: Trading Economics.

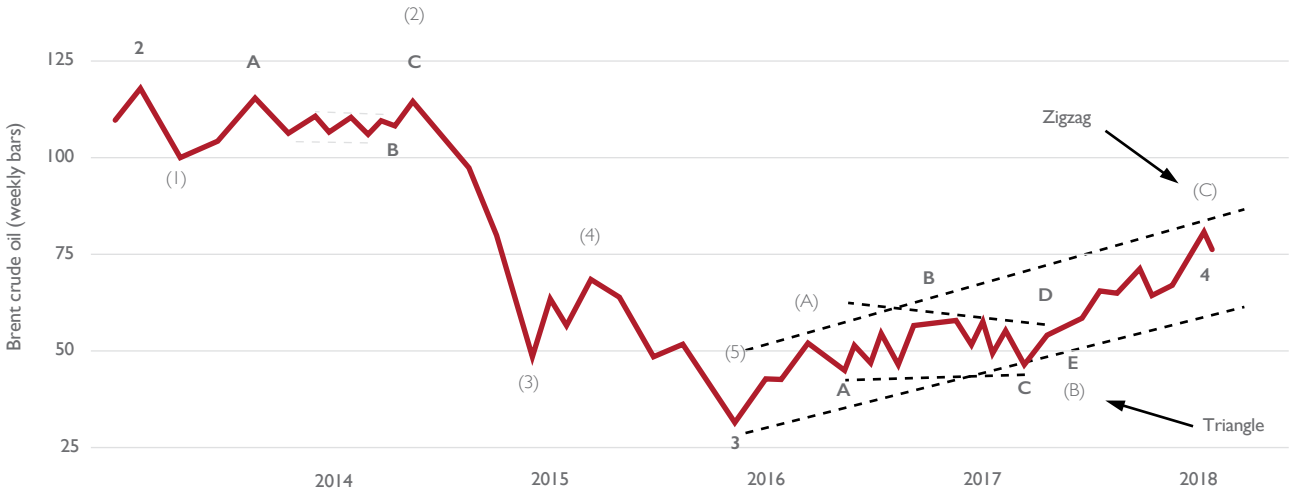
b. Oil price

Oil and its outlook were discussed in the previous section. We would like to highlight oil again, as we see the potential for a repeat rapid price drop like we saw in 2008 and again in 2014.

It's important to note that since 2005, oil has traded differently than at any previous time in recent memory (Figure 38). The record highs and rapid price swings, we believe, are not a sign of a rapid rise in demand. Rather, they are a result of a change in how oil is traded and who has been buying it, namely hedge funds and other price speculators. As we explained in the previous section, changes in technology, the rise of alternative energies and a slowing demand from advanced economies are all factors that put pressure on any further rise in oil prices. In addition, new banking regulation resulting from Basel III and traders'/speculators' sensitivity to the changing dynamics of oil demand will negatively affect the price of oil. The question is, will it be a sudden effect as we saw in 2008 and 2014, or a slow one, as we saw in the 1980s? All of which, by the way, were negative for GCC economies.

FIGURE 39

Trend forecasting the price of Brent Crude over the next year



Source: Elliott Wave International.

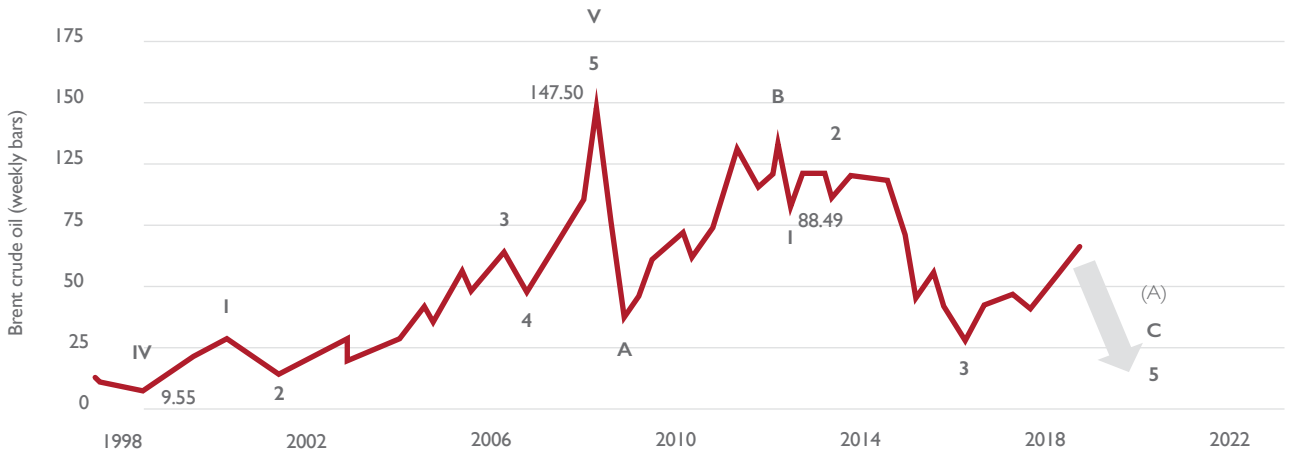
A market forecasting firm in the U.S. called Elliott Wave International, which provides technical analysis and forecasting on stocks, bonds and a range of commodities, offers its outlook on the price of oil. The firm's clients include hedge funds and speculators who tend to use technical analysis over fundamental analysis when making investment decisions. In 2008, for example, as the price of Brent Crude hit an all-time high of $143/bbl, Goldman Sachs called for it to hit $200/bbl by year end 2008.

Elliott Wave, on the other hand, called for the price of oil to sharply decline. The firm made a similar call in 2014, and it was correct on both accounts. More recently in 2018, the firm forecast a drop in the price of oil by year-end 2018 to the $50/bbl range (Figure 39), which also ended up being accurate. The longer-term forecast is even more bleak. Elliott Wave expects the price of Brent Crude to reach a similar low to the one it reached in 1998, below $10/bbl by 2020 (Figure 40). The firm mentions several key factors for this forecast, but mainly cites a shift in investor sentiment and confidence due to a long global recession. This recession will cause stocks, bonds, and nearly all commodities to drop in value similar to the Global Financial Crisis of 2008.

Our forecast is similar but we do not necessarily expect the price of oil to reach such a low in a short period of time. As noted earlier, from the record high price of oil in July 2008, the price of oil has been making lower highs ($142/bbl in July 2008 – $129/bbl in 2012 – $113/bbl in June 2013 – $81/bbl May 2018) and lower lows ($35/bbl in December 2008 – $26/bbl in January 2016). We, as well as other financial forecasting firms, expect the price of oil to be much lower over the next three- to five-years.

FIGURE 40

Trend forecasting the price of Brent Crude to 2022



Source: Elliott Wave International.

What's important to note here is that a rapid drop in the price of oil is nothing new or unexpected in recent history. On the contrary, the market has become accustomed to such volatility. However, a sudden and prolonged drop in the price of oil will not only be detrimental to GCC economies, it will also signal that there is something wrong in the global economy, such as a looming financial crisis.

c. Global trade war

A global trade war has begun, sparked by the actions of U.S. President Donald Trump against China, and has now spread to Europe and India. Contrary to common belief, this trade war was not started by the U.S., but rather China. The actions by the U.S. this year were in response to anti-competitive trade practices by China that have been going on for many years. Previous U.S. administrations simply ignored them to avoid a trade war during a time when the U.S. was concerned about the fragility of its economic recovery.
Nevertheless, the world is now in a trade war with no signs of it ending anytime soon. Nearly every economist believes that the president's actions have been too damaging and extreme and did not need to involve close allies, such as the E.U. Based on our research into the effects of trade wars, we agree with this, as well. There are no winners in a trade war. All sides lose. Any "wins" are solely political in nature, not economic.
The current trade war began on 1 March 2018 when Trump announced his intention to impose a 25% tariff on steel and a 10% tariff on aluminum imports from all countries. On 8 March, he signed an order to impose the tariffs effective after 15 days. Canada and Mexico were exempted from the order as part of his on-going negotiations with them for a new North American Free Trade Agreement (NAFTA). On 22 March, the U.S. announced that in addition to Canada and Mexico, it would suspend the tariffs on the following countries: the E.U., Argentina, Australia, Brazil, and South Korea, until May 1, 2018. The tariffs on all other countries took effect 23 March 2018.

However, on 31 May 2018, the trade war escalated when the U.S. imposed tariffs on steel and aluminum imports from Canada, Mexico, and the European Union. In order to sidestep legal action from the World Trade Organization (WTO), the U.S. cited Section 232 of the Trade Expansion Act of 1962. That section states that, under certain circumstances, a president may impose tariffs based on the recommendation from the U.S. Secretary of Commerce if "an article is being imported into the United States in such quantities or under such circumstances as to threaten or impair the national security." This section has rarely been used prior to 1995 and has never been invoked since the WTO was established in 1995. China initiated a WTO complaint against the U.S. on 9 April and the E.U. filed a similar case with the WTO on 1 June.

Canada supplies 16% of U.S. steel imports, followed by Brazil at 13%, South Korea at 10%, Mexico at 9%, and China at only 2%. From 2013 to 2016, Canada was the largest source of aluminum imports to the U.S. Thus, the logic of targeting steel and aluminum to punish China does not make sense. The top U.S. allies were being harmed by this action more than China.

However, on 22 March 2018, Trump signed a memorandum under Section 301 of the Trade Act of 1974, instructing the U.S. Trade Representative (USTR) to apply tariffs on $50 billion worth of Chinese goods. The president stated that the tariffs would be imposed due to Chinese theft of U.S intellectual property. U.S. companies active in China immediately started to feel the pressure, as the value of their stock began declining over fears that China would retaliate against U.S. tariffs by targeting them.

In response, China's Ministry of Commerce implemented its own tariffs on 128 U.S. products on 2 April 2018. About 120 of those products, such as fruit and wine, will be taxed at 15% and the remaining eight products, including pork, will receive a 25% tariff. On 3 April 2018, the U.S. responded by publishing an initial list of over 1,300 Chinese goods that would be subject to levies, including televisions, weapons, satellites, medical devices, aircraft parts and batteries.

On 4 April 2018, China's Customs Tariff Commission announce additional tariffs of 25% on 106 items on products including automobiles, airplanes, and soybeans. Soybeans are the top U.S. agricultural export to China.

On 15 June, President Trump published a list of $34 billion of Chinese goods that would face a 25% tariff, starting in July 2018.

Economists correctly fear that a trade war could lead to a recession. An American economist at Bank of America, Michelle Meyer, said that a major trade war would lead to a significant reduction in growth globally, not only in the U.S. Despite this, the escalation continues. After the E.U. threatened to impose retaliatory tariffs on the U.S., President Trump countered with a threat to impose tariffs on European car manufacturers.
The U.S. currently imposes a 2.5% tariff on imported passenger cars from the E.U. and a 25% tariff on imported pickup trucks, while the E.U. imposes a 10% tariff on all imported U.S. cars. Therefore, criticism of President Trump's statements of unfair trade practices are mainly unfounded. In 2017, the U.S. trade deficit with the E.U. on cars was approximately $40 billion annually.

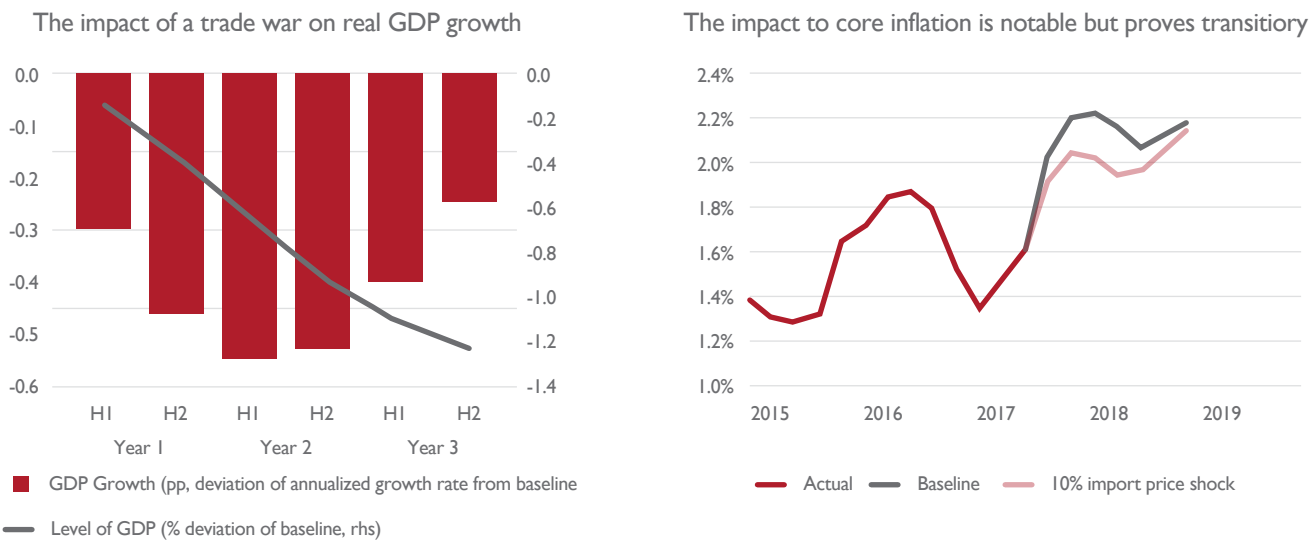
Bank of America Merrill Lynch Global Research published a report on its scenario for an escalating trade war. Below is an excerpt from the report:[xii]

For simplicity, we assume a full pass-through of tariffs onto trade prices and impose 3 shocks to the model: 1) 10% import price shock 2) 10% export price shock 3) 10% appreciation in the real trade-weighted exchange rate.(*) The results are as follows:

***GDP Growth:** The simulation results show a notable drag on growth (Chart 1). Annualized growth rate of real GDP declines by 0.3-0.4pp relative to baseline in the first year and shaves*

FIGURE 41

Bank of America Merrill Lynch expected trade war impact on US economy



Source: BofA Merril Lynch Global Research.

Note: Simulations based on FRB/US model. Results shown as deviation from baseline

an additional 0.5-0.6pp in the second year before the negative impact slowly fades. This suggests that the boost to growth expected from fiscal stimulus (e.g. tax cuts and greater federal government spending) will essentially be offset by the negative trade shock. The negative growth shock leads to a 0.5pp cumulative decline in the unemployment rate relative to baseline. All told, the level of GDP at its nadir is roughly 1.2% lower than the baseline model.

***Inflation:** The 10% import price shock leads to a transitory pickup in core inflation. According to FRB/US, core PCE inflation accelerates modestly by about 0.1pp in the first two years before it starts to converge back to baseline. Note that the impact of higher import prices are somewhat offset by our assumption that the dollar would likely appreciate in a trade war. In a scenario where there is less response from the dollar, we would expect a greater pass-through of higher import prices to consumer prices. Nevertheless, these results are broadly consistent with our partial equilibrium inflation model based on former-Chair Yellen's inflation model.(*) Based on this model, core PCE inflation is about 0.2pp higher in the first year of the shock before readjusting back to baseline (Chart 2).*

***Monetary Policy:** Results from FRB/US show that, initially, the Fed would likely stay on course, maintaining its current path of policy. However, starting in year 2, the material weakening of aggregate demand should ultimately force the Fed to slow the pace of hikes by getting in roughly 2.5 fewer hikes relative to baseline, implying that the terminal rate would end up approximately 50-75bps lower at around 2.50-2.75%. The decline in the path of the fed funds rate is greater than the response in 10yr Treasuries leading to a steepening of the curve as expected by our*

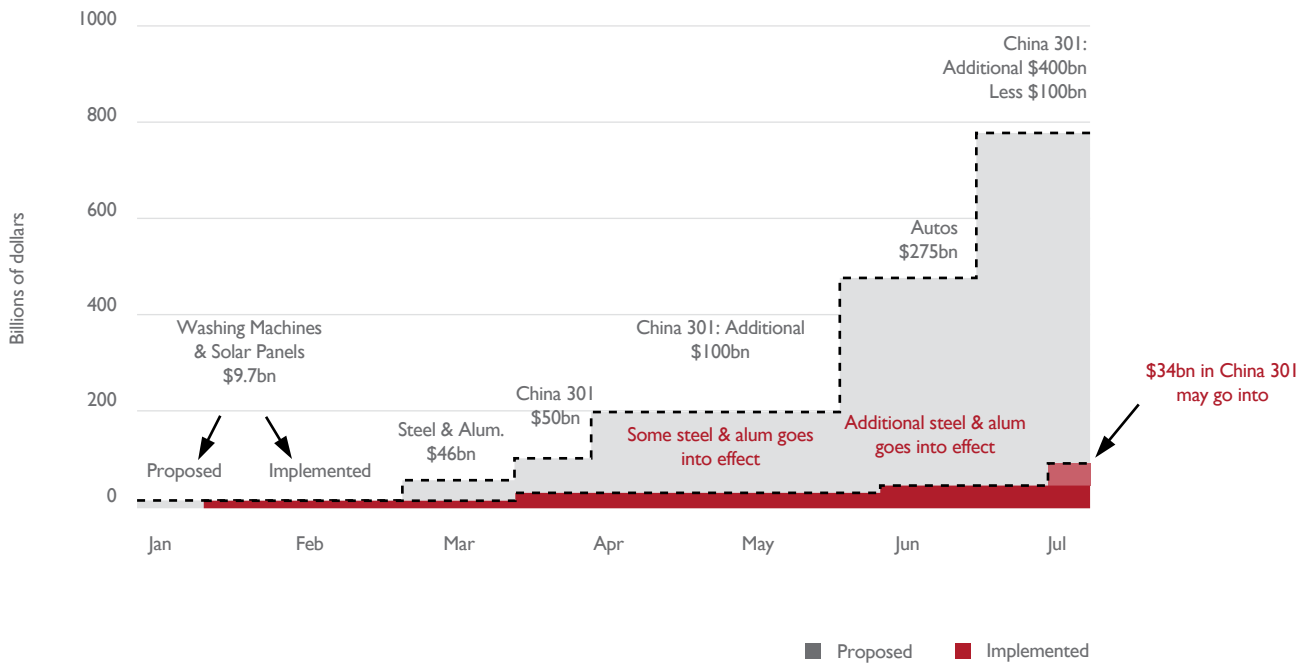
rates strategy team.

The somewhat good news so far is that far fewer tariffs have been implemented than proposed (Figure 42). It is in every country's interest if matters stay this way.
The results were devastating. U.S. imports decreased 66% from $4.4 billion (1929) to $1.5 billion (1933), and exports decreased 61% from $5.4 billion to $2.1 billion over the same period. GNP fell from $103.1 billion in 1929 to $75.8 billion in 1931 and bottomed out at $55.6 billion in 1933.

Using panel data estimates of export and import equations for 17 countries, Jakob B.

FIGURE 42

Tariffs implemented vs. proposed



Source: Goldman Sachs Global Investment Research.

Economists are almost unanimous in agreeing that an escalating trade war could push the global economy into recession (Table 5). The last time the world faced such a trade war was in 1930 following the Great Depression. A global trade war was sparked after the enactment of the Tariff Act of 1930, commonly known as the Smoot–Hawley Tariff Act. The Act raised U.S. tariffs on over 20,000 imported goods.

TABLE 5

List of published reports all suggesting that a trade war could push the global economy into recession

Paper	Shock Imposed	US GDP Impact	Global Growth Impact
IMF (2013)	10 percentage point increase in US tariffs on imports from all regions	-1.00%	-0.30%
IMF (2016)	Global trade war where tariff and nontariff barriers raise import prices by 10%	N/A	-1.75%
Obstfeld (2016)	20% tariff on imports from emerging East Asia (with retaliation)	1.40%	N/A
OECD (2016)	Impact of across-the-board tariffs of 10 percentage points by US, China and EU	-2.20%	-1.40%
Noland et. al. (2016)	45% tariff on nonoil on China, 35% tariff on nonoil on Mexico (with retaliation)	5.00%	N/A
Mckibbin & Stoeckel (2017)	10% tariff increase on all imports (with retaliation)	-1.30%	-1.4% to -4.4% (varies by region)
Linde & Pescatori (2017)	10% import tariffs on all imports (with retaliation)	N/A	-0.50&
Sposi & Virdi (2018)	25% tariff on steel, 10% tariff on aluminium on all countries (excluding Canada & Mexico), US & EU impose "high tariff" on all goods-producing industries, US & China impose "high tariffs" on all industries	-3.50%	-0.7% (EU), -1.7% (China)
Penn Wharton Model	"Trade war" (no assumptions provided)	-0.90%	N/A

Source: BofA Merrill Lynch Global Research.

Madsen (2002) estimated the effects of increasing tariff and non-tariff trade barriers on worldwide trade during the period 1929–1932. He concluded that real international trade contracted somewhere around 33% overall.

The most recent trade war initiated by the U.S. was in 2002 during the presidency of George W. Bush. Tariffs of 8-30% were imposed on steel imports in order to protect American steel companies from what the U.S. determined was a detrimental surge in steel imports. More than 30 American steel makers had declared bankruptcy in the years leading up to the tariffs. Steel producers had originally sought a tariff of up to 40%. Canada and Mexico were exempt from the tariffs because of penalties the U.S. would face under NAFTA. The E.U. immediately filed a lawsuit with the WTO and threatened the U.S. with retaliatory tariffs. Japan, Korea, China, Taiwan, Switzerland, Brazil and others joined with similar cases. In November 2003, the WTO came out against the steel tariffs, saying that they were a violation of the U.S.'s WTO tariff-rate commitments. The ruling authorized more than $2 billion in sanctions, the largest penalty ever imposed by the WTO against a member state, if the U.S. did not immediately remove the tariffs. Escalation of a trade war

was averted as President Bush backed off on further tariffs and eventually removed the steel tariffs. It was later estimated that the impact of the tariffs on the U.S. ranged between a gain of $65.6 million (0.0006% of GDP) to a loss of $110 million (0.0011% of GDP). It was also estimated that that around 200,000 jobs were lost as a result.

Today, however, the current trade war has already escalated well beyond the 2002 trade war. President Trump seems determined to show his strengthen in the face of international criticism. Our fear is that continued escalation would not only lead to a global recession, as most economists believe, but would spark a crisis in one part of the world that could spread to other parts and cause an economic contraction that was more severe than expected.

d. Euro Area crisis

The Eurozone Crisis may have ended in the eyes of the media, but the problems the E.U. faces have not been resolved. In fact, they are even worse today than they were in 2010. Slow economic growth and high unemployment across the E.U. are not separate problems, but they are a symptom of the overall problem - which is structural in nature. The main structural issue, and the reason why the Euro Area had a debt crisis, is because of the design of the Euro.

In 1997, Milton Friedman, a Nobel laureate in economics and one of the most well-known economists of our time, said the Euro would never work. Here is an excerpt from one of his published articles at the time[xiv]:

A common currency is an excellent monetary arrangement under some circumstances, a poor monetary arrangement under others. Whether it is good or bad depends primarily on the adjustment mechanisms that are available to absorb the economic shocks and dislocations that impinge on the various entities that are considering a common currency. Flexible exchange rates are a powerful adjustment mechanism for shocks that affect the entities differently. It is worth dispensing with this mechanism to gain the advantage of lower transaction costs and external discipline only if there are adequate alternative adjustment mechanisms.

The United States is an example of a situation that is favorable to a common currency. Though composed of fifty states, its residents overwhelmingly speak the same language, listen to the same television programs, see the same movies, can and do move freely from one part of the country to another; goods and capital move freely from state to state; wages and prices are moderately flexible; and the national government raises in taxes and spends roughly twice as much as state and local governments. Fiscal policies differ from state to state, but the differences are minor compared to the common national policy.

By contrast, Europe's common market exemplifies a situation that is unfavorable to a common currency. It is composed of separate nations, whose residents speak different languages, have different customs, and have far greater loyalty and attachment to their own country than to the common market or to the idea of "Europe." Despite being a free trade area, goods move less freely than in the United States, and so does capital.

The European Commission based in Brussels, indeed, spends a small fraction of the total spent by governments in the member countries. They, not the European Union's bureaucracies, are the important political entities. Moreover, regulation of industrial and employment practices is more extensive than in the United States and differs far more from country to country than from American state to American state. As a result, wages and prices in Europe are more rigid, and labor less mobile. In those circumstances, flexible exchange rates provide an extremely useful

adjustment mechanism.

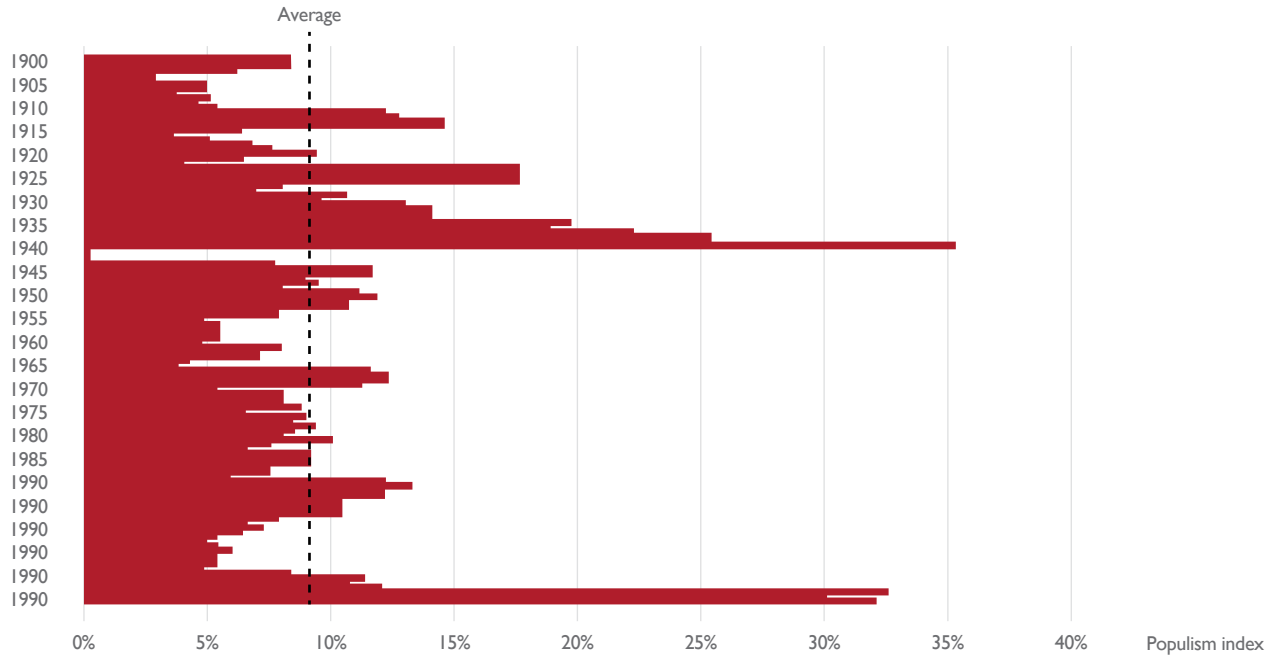
The drive for the Euro has been motivated by politics not economics. The aim has been to link Germany and France so closely as to make a future European war impossible, and to set the stage for a federal United States of Europe. I believe that adoption of the Euro would have the opposite effect. It would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavorable conditions will prove a barrier to the achievement of political unity.

Indeed, Friedman was right. The Euro cannot work without a fiscal union, which is opposite to the direction in which E.U. member countries are moving today. Just as Friedman predicted in 1997, the Euro is having the opposite effect of its intended objective to bring Europe closer. Instead, it is breaking Europe apart.

Since the Eurozone debt crisis in 2010, the world has seen a rise in populism (nationalism),

FIGURE 43

The rise of populism from 1900 to 2016 in select countries

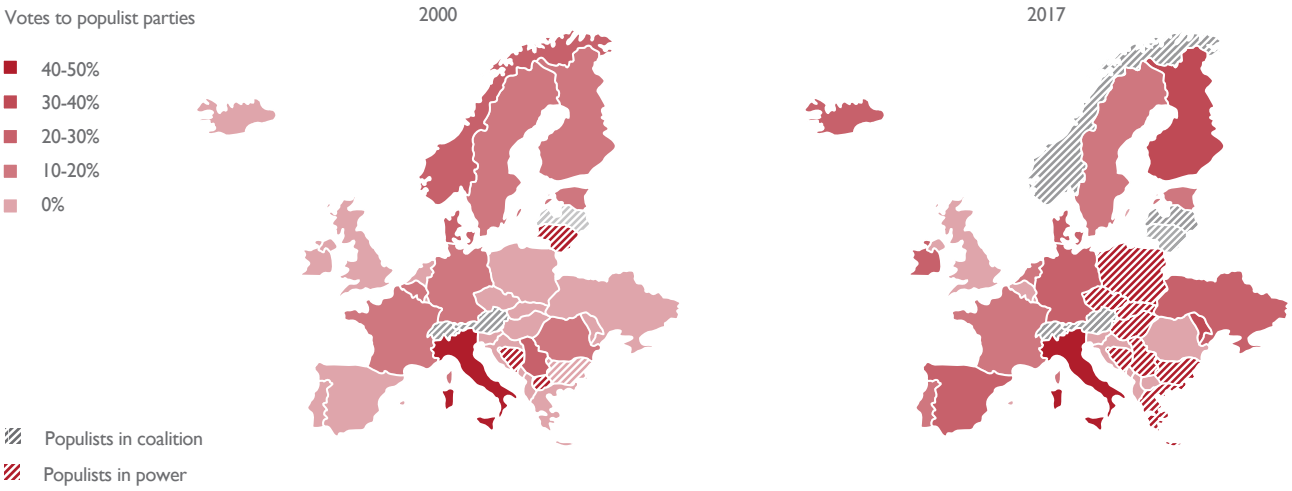


Source: Deutsche Bank.

which has changed the political landscape globally. The wave of anti-immigration policies and push back against globalism is directly related to the rise of populism. According to a Deutsche Bank report (Figure 43), support for populism today is the highest it has been since the rise of Adolf Hitler just before the breakout of World War II.

FIGURE 44

Change in the political landscape of Europe from 2000 to 2017 and the rise of populism



Note: Parties are classified on the basis of the Trans-Regional University of Melbourne Populism Dataset. The authors considered different party characteristics that are generally accepted as indicators of populist politics in the academic literature. For example, they recorded whether a party opposes the political class, financial institutions, immigrants or ethnic minorities.

Source: Deutsche Bank.

Another Deutsche Bank report highlights the rise in populist political parties across Europe. The momentum shows no signs of slowing and one-by-one, populist political parties are rising to power and taking out the established parties of yesterday. The biggest factor driving this change has been the effect of the euro on these economies.

Friedman may have been the most outspoken critic of the euro, but he was not the only one. Otmar Issing, one of the architects behind the, euro, is now saying that the euro is not going to work. The reason, he argues, is that politicians lack the will to make the necessary changes (the structural problem). Specifically, the E.U. needs to have a central fiscal authority, similar to the U.S. Federal Government. And given the rise of populism, this is not going to happen any time soon.

Here are a few comments from Issing on whether the E.U. will be able to make the changes necessary for the euro to survive:

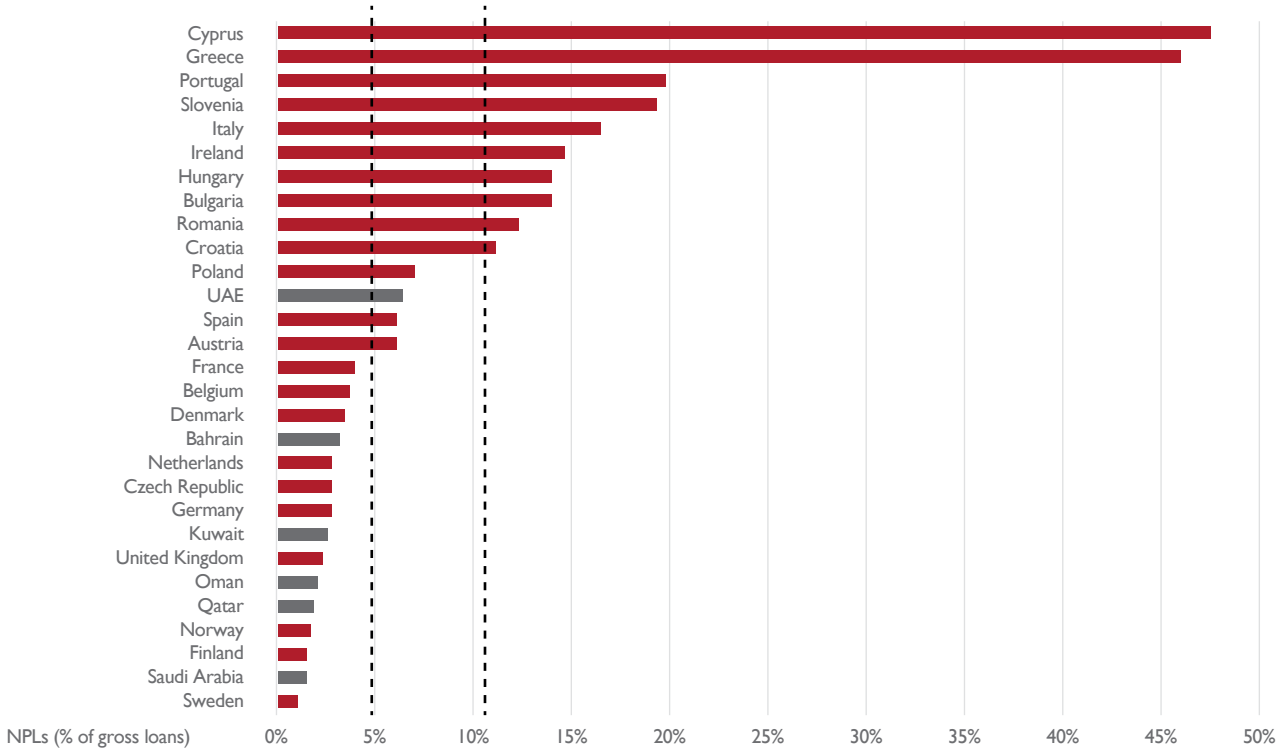
Realistically, it will be a case of muddling through, struggling from one crisis to the next one. It is difficult to forecast how long this will continue for, but it cannot go on endlessly. Governments will pile up more debt – and then one day, the house of cards will collapse.

The essential problem is that we've got to have some method of economic management. If we can't use interest rates and exchange rates to deal with asymmetric shocks then we've got to use fiscal policy instead. The eurozone has the one currency and thus the one monetary policy. Over such a diverse area this will only work if there is also a fiscal policy in place to compensate. It needs something like the US Federal Government, collecting and disbursing some 20% of GDP, to give us that room for fiscal policy. But the eurozone doesn't have that.

There is no chance of political union or the creation of an E.U. treasury any time in the foreseeable future. This would require sweeping changes to the German constitution, for example, an impossible proposition at this time. Imagine German taxes being used to pay for Greek pensions. This is not going to happen in the current political climate.

FIGURE 45

Bank non-performing loan ratio as of 2016 comparing E.U. banks vs. GCC banks

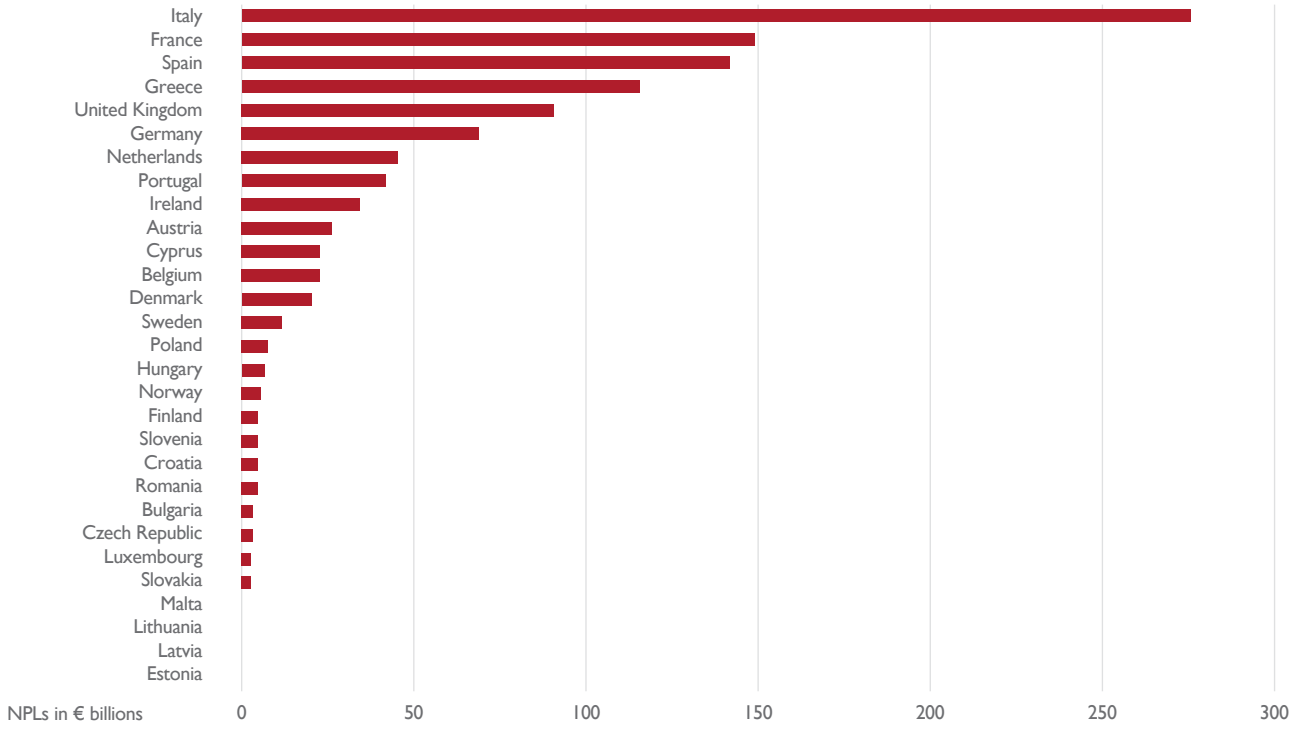


Source: European Banking Authority (EBA) and GCC Central Bank reports 2016.

Looking at where we are today, you can see the mess facing Euro Area banks (Figure 45). Central banks around the world begin to sound the alarm on their banking system once non-performing loans (NPLs) reach 5%. However, there are currently 10 E.U. countries with over 10% NPLs in their banking system. Simply put, banks in these countries cannot function properly and are facing a crisis of existence. Banks in Cyprus and Greece are clearly bankrupt, as Figure 44 shows. Italy, however, is the country to watch. NPLs in the Italian banking system have risen above 15% and have remained there for years. This translates into €276 billion of NPLs in the Italian banking system.

FIGURE 46

Gross non-performing loans in the E.U. banking system by country as of 2016



Source: European Banking Authority (EBA) and GCC Central Bank reports 2016.

E.U. banking regulators have responded to the Italian banking crisis by giving banks more time to sort out their bad debts. The result of this strategy can be seen today in Figures 45 and 46. In fact, when comparing banks in the E.U. to banks in the GCC, GCC banks are in much better shape. To go a step further, GCC banks are safer than E.U. banks. Not only are they less likely to fail, but if they were to fail, GCC governments would step in to help them. This is unlike the E.U. today, which implemented the BRRD regulation calling for failing banks to attempt to save themselves first before receiving any state assistance. This has put depositors' money at risk.

Banks across the E.U. regardless of their country of residence are in a risky position today. None is riskier than the largest bank in the E.U., Deutsche Bank. The bank has been struggling with managing its bad debt problem along with a list of other problems, including accusations of money-laundering and fraud in the U.K. and U.S. as well as solvency issues. In June this year, the Federal Reserve designated Deutsche Bank's U.S. business as being in a "troubled condition," a rare designation for a major financial institution. The "troubled condition" status is one of the lowest designations employed by the Fed and is typically given to financial institutions that it believes are likely to fail in the near future. In addition, Fed examiners expressed frustration at what they described as the bank's inability to calculate, at the end of any given day, its exposures to what banks and other clients had in specific jurisdictions, and over what duration. If this had been a smaller bank, it would have been shut down. However, as a systemically-important bank to Germany, the E.U. and the global financial system, Deutsche Bank has been given a lot of flexibility and time to mend itself. Yet so far, it has failed to do so.

Deutsche Bank is only one example of troubled banks in the E.U. There are many more, albeit on a smaller scale. But a small crisis in the E.U. can quickly escalate into a full-blown banking crisis. The interconnectedness of E.U. banks to the global financial system means that a banking crisis in Europe can instantly become a global financial crisis.

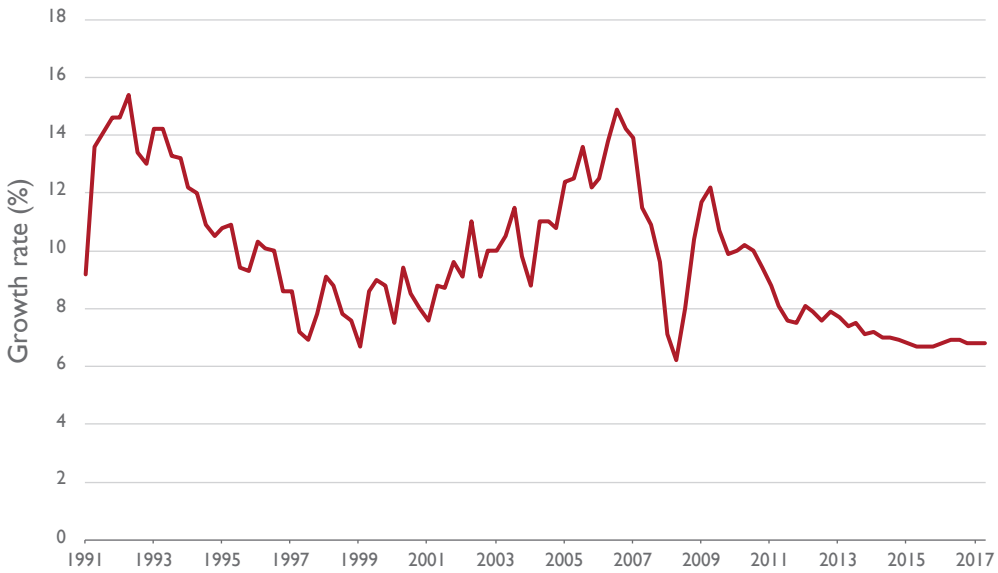
e. China crisis

In 2007, China's GDP reached $3.55 trillion and was growing at a rate of over 10%. The country not only avoided the Global Financial Crisis, it was actually credited with lifting the global economy out of recession fueled by its rapid investment in infrastructure, construction and manufacturing. By 2010, China became the second-largest economy in the world, overtaking Japan. By 2016, the country's GDP grew to over $11.2 trillion.

This rapid rise in economic growth brought with it an even faster growth in debt. At the time, policymakers in China paid little attention to this. In fact, they actually encouraged debt as a way to achieve government-mandated economic growth targets. When the growth rate is high, led by exports and investments, rising debt is not a problem for the economy. However, when economic growth slows, debt suddenly becomes a problem, and this is what policymakers in China are faced with today.

FIGURE 47

China GDP growth rate from 1991 to Q1 2018



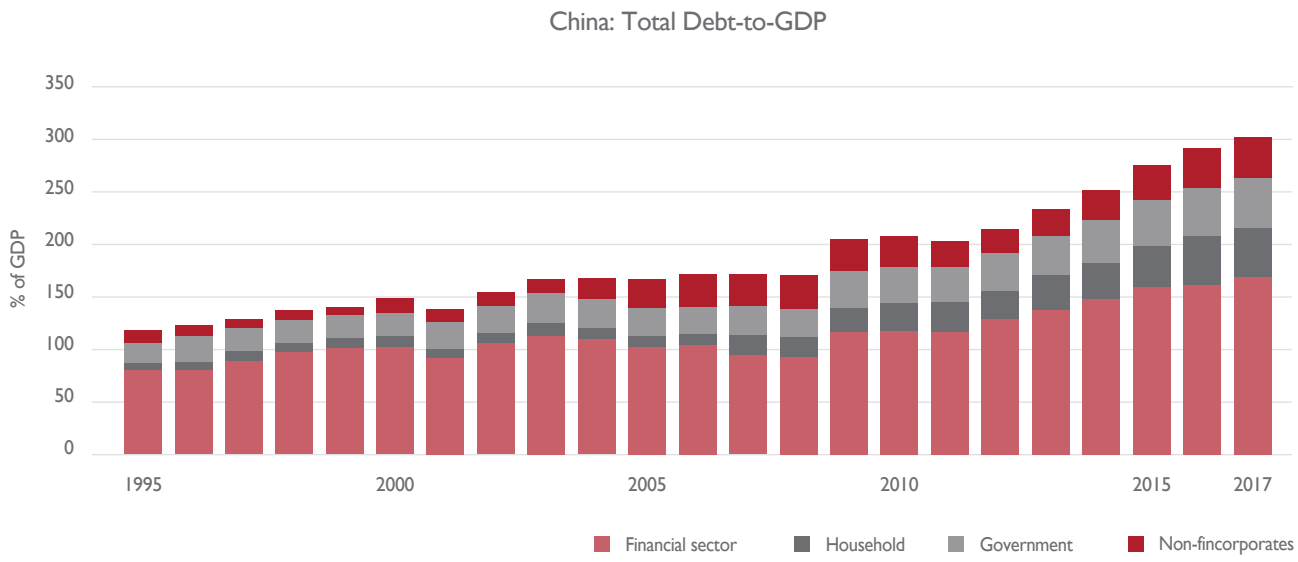
Source: Trading Economics.

There has been much talk about Chinese policymakers' plans to manage a slowdown in the economy. This came after the IMF called for China to cool its economy before it bursts. The reality is that no country has been effectively able to manage an economic slowdown. It always turns out differently than what policymakers planned – and worse than they had expected. This will be no different for China. Except in China's case, the outcome will be a lot worse than its policymakers expect.

Since 2010, China's GDP has been steadily slowing, reaching an annualized growth rate of 6.8% in Q1 2018. This is the slowest GDP growth rate since it hit 6.2% in Q1 2009. The problem for China's economy begins here. The slowdown in GDP does not coincide with a slowdown in debt growth. Instead, growth in debt has accelerated.

FIGURE 48

Growth in debt-to-GDP in China by sector



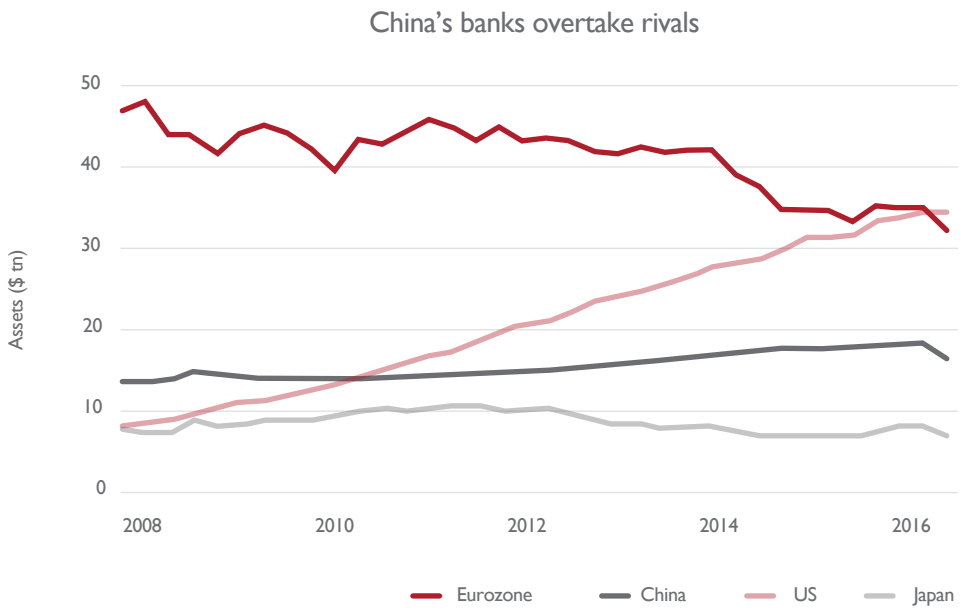
Source: Institute of International Finance (IIF).

As Figure 48 shows, at the same time GDP began to slow, growth in debt began growing at a faster rate. This is true across all sectors of the economy, but is especially true for non-financial corporates. Government GDP has remained relatively low and is manageable.

What is worrying for economists and policymakers is the level of debt Chinese banks and corporates in the country have assumed. In 2007, total assets (i.e. debt issued) of Chinese banks was about the same size as Japanese banks (roughly $8 trillion). It was a distant third compared with Euro Area bank assets ($45 trillion) and U.S. bank assets ($12 trillion). By 2016, it overtook both the U.S. and Euro Area banks with total assets topping over $3 trillion, while Euro Area bank assets declined to ($31 trillion).

FIGURE 49

Growth in country bank assets from 2007 to 2016



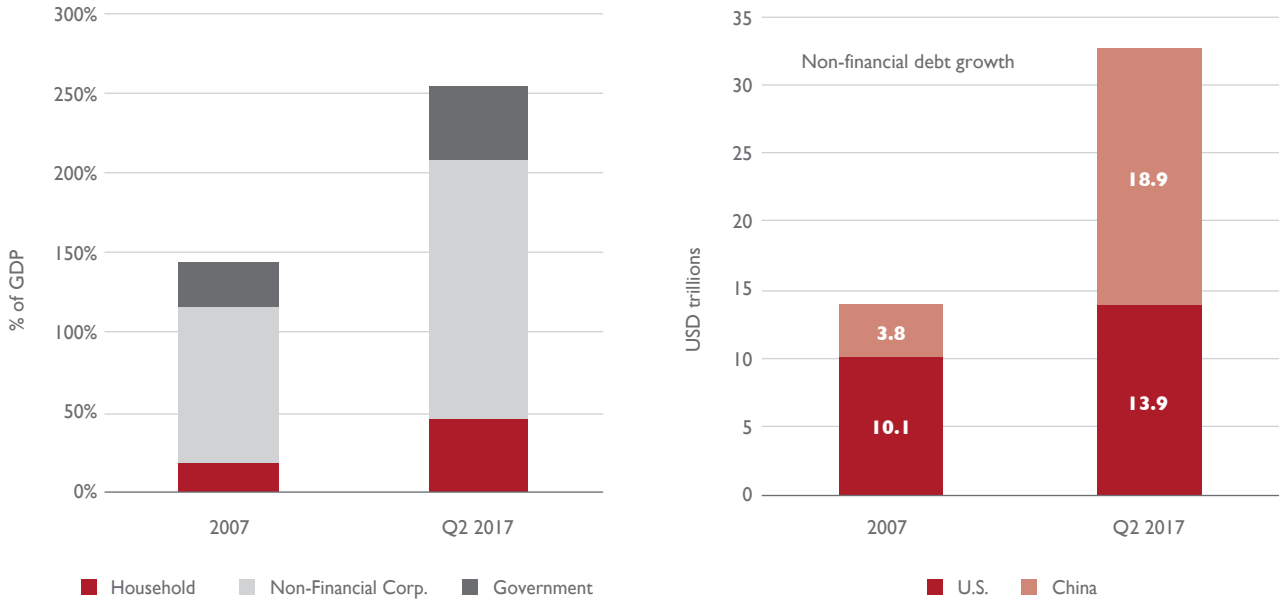
Source: Financial Times.

If we examine, which sector is responsible for most of the debt growth, another problem emerges. Debt grew in China across all sectors, which is normal for a growing economy and a rising consumer base. However, if one sector is growing at a disproportionately high rate compared to other sectors, it needs to be examined.

As Figure 50 shows, the largest contributor to debt growth has been the non-financial corporate sector. Corporate debt in China has grown by $15 trillion in less than 10 years making it larger than U.S. corporate debt.

FIGURE 50

Left, China debt growth by sector as a percentage of GDP; Right, Comparison of non-financial debt growth between China and the U.S. in trillions of dollars



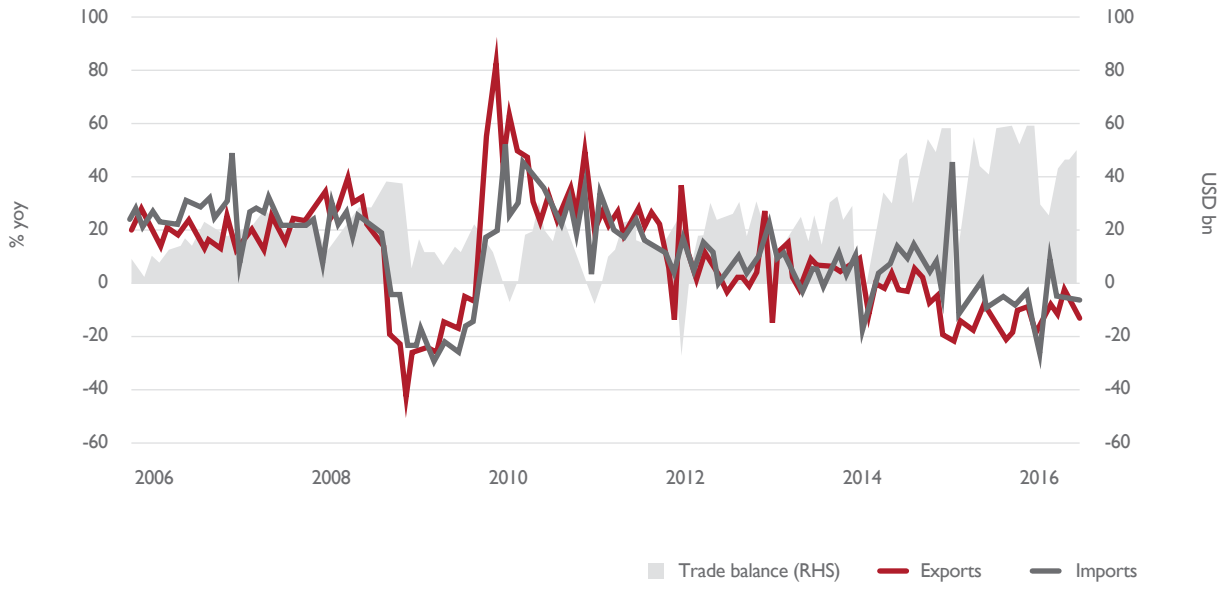
Source: McKinsey Global Institute.

This growth rate in corporate debt is unheard of in financial history. Chinese corporates are borrowing more and more debt, yet GDP slows. Some industry experts, both inside and outside China, conclude that new debt is not being used for productive purposes, meaning that it most likely is being used to pay off old debts while taking on new debt to fund ongoing operations.

Fitch Ratings, the international rating agency, went a step further and believes that there are billions of dollars in debts that are non-performing. Fitch suggested that NPLs in China's banking system are on par with some E.U. countries, such as Italy. It publicly stated that NPLs in China are most likely ten times higher than official figures indicate. They have not been able to determine the exact size of the NPL problem because of a lack of transparency. The largest banks in the country are government owned or controlled. Thus, they have been keeping unprofitable government companies afloat by continuing to extend them new credit while repayments are extended later into the future.

FIGURE 51

China's export and import growth trend



Source: Goldman Sachs.

Rising debts and slowing GDP come at a time when the country's exports and imports are slowing as well. The growth driver for China has been its manufacturing exports and this, too, has been slowing. Over the past decade, the country has greatly expanded its manufacturing capacity and has gone on a global commodity buying spree. Today, the country is awash with excess manufacturing capacity that is sitting idle. The problem is not only in manufacturing; excess capacity exists in multiple industries from office buildings and shopping malls to airports and steel mills. China has overbuilt everything, one reason why the rise in commodities is over. China no longer has a bottomless appetite for commodities, making the economic models of commodity-exporting countries such as Australia and Brazil unsustainable.

FIGURE 52

Change in growth rate of industrial production, retail sales and fixed asset investment

Source: Topdown Charts, Datastream, NBS.

The current slowdown in China is broad-based. Industrial production, fixed-asset investment and retail sales are all down from their highs, as Figure 52 shows. Fixed-asset investment - the investment into building new productive facilities such as factories - is now at its lowest point in decades. This, alone, shows how the commodity boom will not be returning anytime soon. Add to this a slowdown in industrial production (i.e. factory output) plus the excess capacity problem in China and it is clear that the economic slowdown is getting worse.

IV. Global, regional and national economic and financial outlook

China today is the second-largest economy and, no doubt, is the manufacturing hub of the world. However, its rapid growth over the last two decades is not the miracle we so often hear about. It is merely a debt-fueled growth binge that will end in disaster for the country. The biggest unknown is to what extent a financial/debt crisis in China will spillover and become another global financial crisis?

Based on our study of global economic conditions and economic cycles, we believe that the global economic expansion cycle is nearing an end, contrary to the predictions of international agencies such as the World Bank and IMF. It is clear that the growth cycle is mature, and what will follow is a contractionary cycle (recession).

We have modeled our forecasts, shown below, based on the expectation of a normal recession in the coming years. This means that not all economies will be experiencing a recession at the same level of intensity. We also outlined, in the previous section, the risk factors that can lead to a severe recession or another global financial crisis. Though we feel that the probability of one or more of these risk factors materializing in the near future is very high, it is too difficult to model a forecast based on high-risk assumptions. Therefore, we have assumed a normal global recession in our outlook.

One important note: based on our research and analysis, should any of these risk factors materialize, we expect the ensuing crisis to be more severe than the Global Financial Crisis of 2008. All of the underlying factors that helped spark and spread the last crisis (contagion effect) are not only present today – they are also larger.

a. Global and regional outlook

Our global economic forecast calls for a global recession beginning in 2019. As a normal cycle recession, we expect global GDP to begin growing again in 2020. Some economies, however, will not recover as quickly, namely, commodity producers and oil producers.

TABLE 6

Scenario A is the World Bank forecast and Scenario B is our forecast

	Scenario	2015	2016	2017	2018	2019	2020	2021	2022
World	A	2.80	2.40	3.10	3.10	3.00	2.90		
	B	2.80	2.40	3.10	1.82	(1.74)	2.50	3.20	2.45
USA	A	2.90	1.50	2.30	2.70	2.50	2.00		
	B	2.90	1.50	2.30	1.78	(0.29)	(2.78)	2.50	1.60
Euro Area	A	2.10	1.80	2.40	2.10	1.70	1.50		
	B	2.10	1.80	2.40	0.44	(4.50)	(1.00)	1.50	1.80
Saudi Arabia	A	4.10	1.70	(0.70)	1.80	2.10	2.30		
	B	4.10	1.70	(0.70)	1.85	(2.10)	(2.00)	3.00	5.20
Kuwait	A	0.60	3.60	(1.00)	1.90	3.50	3.50		
	B	0.60	3.60	(1.00)	2.48	(7.10)	(2.37)	3.40	2.90
Oil Price ($)	A	52.35	43.55	54.25	70.00	69.00	65.40	65.00	65.00
	B	52.35	43.55	54.25	65.00	49.50	40.70	52.50	55.00

Scenario A in Table 6 is the World Bank forecast. Scenario B is our forecast. Our scenario assumes a global recession. We followed a recession and recovery cycle that was similar to the last global recession and then modeled all regions and countries on that similar trajectory. We also took oil prices into consideration and used a similar pattern of oil price performance as the last cycle.

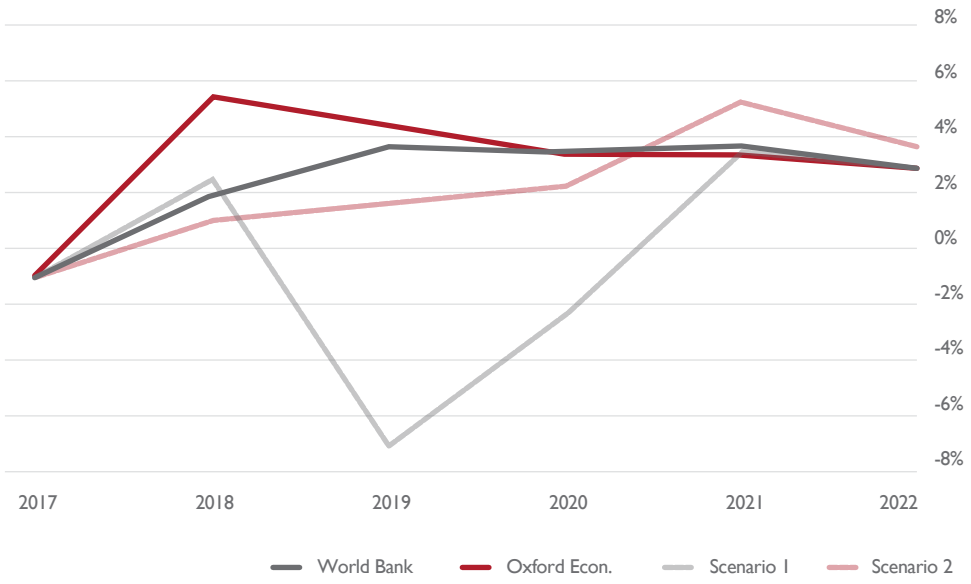
b. National outlook

For Kuwait, we looked at two existing scenarios, the World Bank and the Oxford Economics Baseline Scenario. We then developed two additional scenarios, a modified World Bank scenario and our own scenario. The modified World Bank scenario takes into consideration the bank's existing forecast for Kuwait with the added assumption of a small decline in government spending vs. what is currently planned. The oil price used was the World Bank's forecasted oil price, which is lower than what Oxford Economics is forecasting.

In our scenario, we assume that government spending remains as currently planned, while oil prices fall sharply as they did from 2014 to 2016. The main purpose for this was to see how well the national economy could withstand external recessionary forces.

FIGURE 53

Four scenarios for Kuwait GDP forecast



Source: World Bank and Oxford Economics.

As Figure 52 shows, the modified World Bank scenario (Scenario 1) performs poorly if there is a recession in 2019. GDP will contract sharply if the price of oil were to fall sharply, as it has twice in the past 10 years. Oxford Economics and the World Bank's original forecasts are the most optimistic for Kuwait and the price of oil. Both forecasts assume no recession in the next five years.

Our model (Scenario 2) shows that even with a global recession and a sharp decline in oil prices, Kuwait's economy would avoid a severe recession. On the flipside, to be able to maintain current budgeted spending levels, the government would need to borrow heavily. Such a scale of borrowing would require tapping international markets, as the local financial institutions would not be able to satisfy the demand.

Below are additional details of both the modified World Bank scenario (Scenario 1) and our own scenario (Scenario 2).

i. Scenario 1: Modified World Bank – Slightly lower oil price and government maintains planned spending

ii. Scenario 2: A repeat of the fall in oil price and government maintains planned spending

TABLE 7

Scenario 1: Modified World Bank – Slightly lower oil price and government maintains planned spending

		2018	2019	2020	2021	2022
World oil price, Brent crude spot, $pb	BASELINE	77.7	82	75.8	73.2	75.3
World oil price, Brent crude spot, $pb	SCENARIO	70	69	65.4	65.4	65.4
Scenario (baseline=100)	SCENARIO	90.1	84.1	86.3	89.3	86.9
Government revenue, oil	BASELINE	17,803.50	21,195.60	21,201.70	21,039.00	21,254.30
Government revenue, oil	SCENARIO	16,063.00	17,918.40	18,379.90	18,865.10	18,544.60
Scenario (baseline=100)	SCENARIO	90.2	84.5	86.7	89.7	87.3
Government revenue, non-oil	BASELINE	2,297.40	3,135.20	3,600.60	4,049.30	4,586.30
Government revenue, non-oil	SCENARIO	2,262.20	3,044.60	3,484.80	3,913.90	4,403.60
Scenario (baseline=100)	SCENARIO	98.5	97.1	96.8	96.7	96
Government revenue, total, LCU	BASELINE	20,100.90	24,330.80	24,802.40	25,088.30	25,840.60
Government revenue, total, LCU	SCENARIO	18,325.10	20,963.00	21,864.70	22,779.10	22,948.20
Scenario (baseline=100)	SCENARIO	91.2	86.2	88.2	90.8	88.8
Government expenditure, total, LCU	BASELINE	18,796.60	19,848.00	20,912.80	22,024.00	23,137.30
Government expenditure, total, LCU	SCENARIO	18,447.50	19,369.90	20,338.40	21,355.30	22,423.10
Scenario (baseline=100)	SCENARIO	98.1	97.6	97.3	97	96.9
GDP, real, LCU	BASELINE	40,609.10	42,412.40	43,835.90	45,306.40	46,601.70
GDP, real, growth rate	BASELINE		4.4%	3.4%	3.4%	2.9%
GDP, real, LCU	SCENARIO	40,263.40	41,710.80	43,137.20	44,721.70	45,997.80
GDP, real, growth rate	SCENARIO		3.6%	3.4%	3.7%	2.9%
Scenario (baseline=100)	SCENARIO	99.1	98.3	98.4	98.7	98.7
Consumption, private, real, LCU	BASELINE	13,212.90	13,649.00	14,031.10	14,452.10	14,871.20
Consumption, private, real, LCU	SCENARIO	13,158.30	13,514.70	13,837.30	14,240.50	14,649.30
Scenario (baseline=100)	SCENARIO	99.6	99	98.6	98.5	98.5
Employment, total	BASELINE	2,118.80	2,152.80	2,186.70	2,219.90	2,253.00
Employment, total	SCENARIO	2,106.20	2,126.10	2,158.00	2,193.50	2,225.40
Scenario (baseline=100)	SCENARIO	99.4	98.8	98.7	98.8	98.8
		2018	**2019**	**2020**	**2021**	**2022**
Consumer price index	BASELINE	113.6	116.4	120.2	123.9	127.6
Consumer price index	SCENARIO	113.5	115.8	118.9	121.8	124.9
Scenario (baseline=100)	SCENARIO	99.9	99.4	98.9	98.4	97.9
Government balance, share of GDP	BASELINE	3	9.2	8	6.1	5.2
Government balance, share of GDP	SCENARIO	-0.3	3.7	3.5	3.1	1.1
Scenario (pp diff)	SCENARIO	-3.3	-5.6	-4.5	-3.1	-4.1
Current account of balance of payments in LCU, share of GDP	BASELINE	13.2	16	11.9	8.7	7.7
Current account of balance of payments in LCU, share of GDP	SCENARIO	9.7	10.5	7.5	5.7	3.8
Scenario (pp diff)	SCENARIO	-3.6	-5.5	-4.4	-3	-3.9

TABLE 8

Scenario 2: A repeat of the fall in oil price and government maintains planned spending

		2018	2019	2020	2021	2022
World oil price, Brent crude spot, $pb	BASELINE	77.7	82	75.8	73.2	75.3
World oil price, Brent crude spot, $pb	SCENARIO	65	49.5	40.7	52.5	55
Scenario (baseline=100)	SCENARIO	83.7	60.4	53.7	71.7	73.1
Government revenue, oil	BASELINE	17,803.50	21,195.60	21,201.70	21,039.00	21,254.30
Government revenue, oil	SCENARIO	14,915.30	12,896.20	11,489.10	15,220.90	15,637.70
Scenario (baseline=100)	SCENARIO	83.8	60.8	54.2	72.3	73.6
Government revenue, non-oil	BASELINE	2,297.40	3,135.20	3,600.60	4,049.30	4,586.30
Government revenue, non-oil	SCENARIO	2,246.20	2,931.00	3,273.10	3,724.20	4,191.90
Scenario (baseline=100)	SCENARIO	97.8	93.5	90.9	92	91.4
Government revenue, total, LCU	BASELINE	20,100.90	24,330.80	24,802.40	25,088.30	25,840.60
Government revenue, total, LCU	SCENARIO	17,161.40	15,827.10	14,762.20	18,945.10	19,829.60
Scenario (baseline=100)	SCENARIO	85.4	65	59.5	75.5	76.7
Government expenditure, total, LCU	BASELINE	18,796.60	19,848.00	20,912.80	22,024.00	23,137.30
Government expenditure, total, LCU	SCENARIO	18,787.80	19,839.90	20,911.30	22,019.60	23,142.60
Scenario (baseline=100)	SCENARIO	100	100	100	100	100
		2018	**2019**	**2020**	**2021**	**2022**
GDP, real, LCU	BASELINE	40,609.10	42,412.40	43,835.90	45,306.40	46,601.70
GDP, real, growth rate	BASELINE		4.4%	3.4%	3.4%	2.9%
GDP, real, LCU	SCENARIO	40,107.90	40,773.30	41,674.00	43,848.40	45,436.10
GDP, real, growth rate	SCENARIO		1.7%	2.2%	5.2%	3.6%
Scenario (baseline=100)	SCENARIO	98.8	96.1	95.1	96.8	97.5
Consumption, private, real, LCU	BASELINE	13,212.90	13,649.00	14,031.10	14,452.10	14,871.20
Consumption, private, real, LCU	SCENARIO	13,168.90	13,438.90	13,587.30	13,982.00	14,461.20
Scenario (baseline=100)	SCENARIO	99.7	98.5	96.8	96.7	97.2
Employment, total	BASELINE	2,118.80	2,152.80	2,186.70	2,219.90	2,253.00
Employment, total	SCENARIO	2,100.50	2,091.30	2,101.30	2,153.10	2,194.30
Scenario (baseline=100)	SCENARIO	99.1	97.1	96.1	97	97.4
Consumer price index	BASELINE	113.6	116.4	120.2	123.9	127.6
Consumer price index	SCENARIO	113.4	115.2	117.1	118.6	120.8
Scenario (baseline=100)	SCENARIO	99.8	99	97.3	95.7	94.7
Government balance, share of GDP	BASELINE	3	9.2	8	6.1	5.2
Government balance, share of GDP	SCENARIO	-4.2	-11.2	-18.2	-7.6	-7.8
Scenario (pp diff)	SCENARIO	-7.2	-20.5	-26.2	-13.8	-12.9
Current account of balance of payments in LCU, share of GDP	BASELINE	13.2	16	11.9	8.7	7.7
Current account of balance of payments in LCU, share of GDP	SCENARIO	6.9	-1.2	-8.5	-0.6	-1.1
Scenario (pp diff)	SCENARIO	-6.3	-17.2	-20.4	-9.3	-8.7

V. Policy response for a negative impact on the financial sector and how to mitigate risk

The conclusion of this report contains our policy recommendations for Kuwait. Recommendations have been divided into two categories: economic policy recommendations, which are general recommendations for the national economy; and financial service specific policy recommendations, which are intended to mitigate any negative outside risks to the national financial services sector.

Economic policy recommendations:

- Prepare for a lower oil price scenario, but do not cut or reduce planned spending on projects. Cutting spending while economic growth is declining will magnify the negative effects on the national economy.
- Evaluate spending plans and look to implement the ones that add economic value to the national economy, such as building a new airport, building/expanding a new petrochemicals facility, establishing a fund to help national businesses/entrepreneurs.
- Cut spending on plans that do not add economic value or produce a return, such as constructing a new government building, increasing subsidies, raising salaries.
- Hold off on implementing a tax system until subsidies have been reduced or eliminated.

Financial services policy recommendations:

- Insist that the sovereign wealth fund re-evaluates its investment policies towards lower-risk investments and away from yield-chasing investment in emerging countries, and higher-risk investments such as private equity.
- Enhance the competitiveness of the financial services industry so that it can better compete with regional peers before considering developing a financial center.
- Recommend that local banks eliminate or reduce their dealings and exposure to high-risk banks, especially E.U. banks.
- Re-evaluate Capital Markets Authority regulations on company listings to make it easier and more attractive for companies to list on the national exchange.

Notes & References

i. Advanced Economies as defined by the IMF include; Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Demark, Estonia, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, South Korea, Latvia, Lithuania, Luxembourg, Macao, Malta, Netherlands, New Zealand, Norway, Portugal, Puerto Rico, San Marino, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan, United Kingdom, United States. For details see https://www.imf.org/external/pubs/ft/weo/2018/01/weodata/groups.htm#ae

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