Chief economist's comment

What's happening everywhere else?

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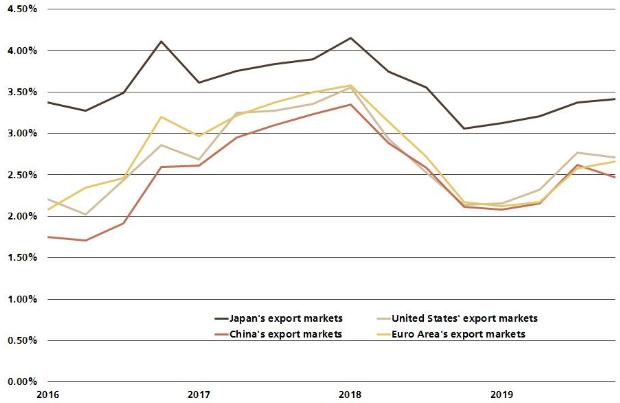
- The growth in demand in export markets slowed over the course of 2018. It should stabilize in 2019.
- Old-fashioned export data is not a useful way to think about export demand. Supply chains are complex; exports can pass through many countries before ending up in the country that is actually driving demand.
- Company investment spending growth is more important to export growth than it is to the overall economy.
- China's importance in driving export growth tends to be overstated. The importance of the Chinese consumer to export growth is definitely overstated.

There is a point in every economic cycle when economists say "my country is doing fine; it is the rest of the world I worry about." We seem to have come to that point now. In each part of the world there are more worries that other countries will hurt the local economy. The worries seem overdone.

Fig. 1: Export market demand growth[1]
Quarterly data, % y/y



Source: UBS calculations using OECD Trade in Value Added data and Oxford Economic Forecasting (OEF) model

[1]Growth in export market demand is calculated by looking at the importance domestic value added in foreign investment, and domestic value added in foreign consumer spending (goods and services). Countries covering around 90% of export demand were included for most exporters. These weights are applied to real growth rates for investment and consumption from the OEF economic model, including projections. For ASEAN and for central and south American investment, real GDP is used in the absence of more detailed data.

How fast will export markets grow in 2019? It depends who you export to, and what you export. 2019 export market demand is likely to slow relative to 2018. However, most economies should see slightly faster export demand growth than they had at the *end* of 2018.

One problem with looking at what is happening with foreign demand is that normal trade data is largely useless. Trade data has always suffered from rather bad quality. Export and import numbers never add up correctly. Today's complex supply chains make that worse.

Suppose that Korea exports an LCD screen to China. In theory the Korean exporter cares about Chinese demand. What happens if that LCD screen is then used to make a phone that China exports to Germany? China only demands the screen because Germany demands the phone. The Korean exporter *really* cares about German demand. Chinese consumers are of no interest to the Korean exporter. Similarly, a German exporter sending car parts from a US plant to Thailand for a car exported to China *really* cares about Chinese demand.

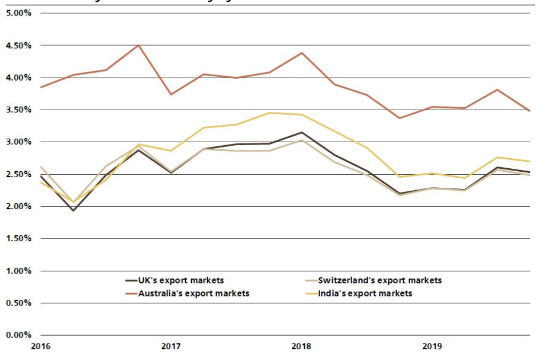
There is data that looks at where goods and services *finally* end up. We can use this data to work out how important economies are to a country's exports. We can also split exports for investment from exports for consumers. This matters as investment spending and consumer spending may grow differently. A country that exports for investment may have weaker demand than a country that exports for consumers.

This fact helps to explain why exports and export market demand are not necessarily the same. In 2018, the growth in the volume of EU exports to China slowed sharply. However, the growth of Chinese demand for the sorts of things the Eurozone sells to China slowed far less. Chinese demand does not justify the slowdown in the Eurozone export numbers. There are several possible explanations for this development.

- Eurozone goods suddenly became less competitive and lost market share (unlikely)
- A Eurozone supply shock reduced export supply while Chinese demand was unaffected (unlikely. There was a supply shock for the Eurozone sector, but over half of Eurozone's exports to China are investment goods)
- Demand for Chinese exports from other countries fell, and exports of Eurozone components that are used in those exports therefore fell (likely, in the context of the US-China trade dispute)
- Eurozone goods that were exported to China are now exported to a third country (e.g. Thailand) before being re-exported to China (possible. There is some anecdotal evidence of this, in the context of changing supply chains)
- China put in place tariff or non-tariff barriers to Eurozone imports (did not happen)
- Transport disruption e.g. constraints in shipping supply or the typhoon season slowed the supply of Eurozone exports to China (some evidence, but mainly third quarter).

Fig. 2: Export market demand growth

Quarterly data, % y/y



Source: UBS calculations using OECD Trade in Value Added data and Oxford Economic Forecasting (OEF) model

The complexity of modern supply chains therefore means that just looking at export data does not help identify risks to a country's trade position. It is also not enough to look at consumer demand—generally investment spending is two or three times more important to international trade than it is to the economy.

In 2018, US exports faced lower demand mainly because Canada and Mexico invested less. About a third of the slowdown in US export market growth was due to Canada and Mexico. Investment demand growth slowed more than consumer demand growth. Uncertainty about the NAFTA trade deal may have played into this. If the new version of NAFTA reduces that uncertainty and allows investment to resume, US export demand should pick up in 2019.

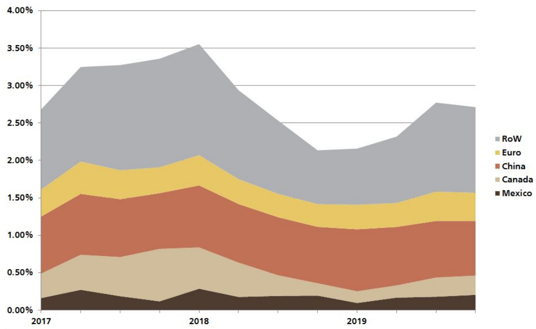
The Eurozone's export market growth slowed because company investment spending slowed in several foreign markets. The Eurozone supplies relatively more investment goods than many other countries. As a result, Eurozone export demand is hurt by slower investment spending. There was also an exceptional drop in demand in the Turkish market. Turkey is quite a large trading partner for the Eurozone. Stabilization of company investment should help Eurozone export demand stabilize in 2019.

For all the concerns about a China slowdown, Chinese demand does not seem to be very important to exporters in most of the rest of the world. Chinese demand does matter for a country like Australia. What Australia exports to China will tend to stay in China. What Europe and the US export to China tend to end up somewhere else.

Globally, export demand is likely to grow more slowly in 2019 as a whole than in 2018 as a whole. However, the end of 2018 saw a dip in external demand for many countries. If investment spending recovers in North America, and if European domestic demand holds up, some of the late 2018 slowdown should be reversed. Global trade growth should generally follow the steady growth of export market demand.

Fig. 3: Demand growth in various export markets of the US

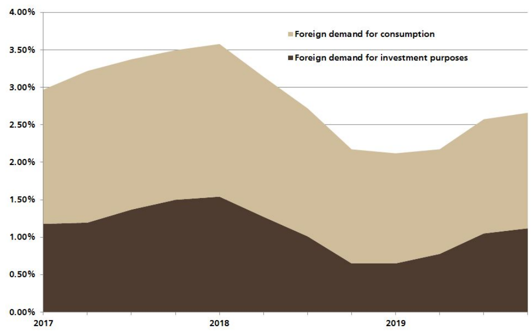
Quarterly data, % y/y



Source: UBS calculations using OECD Trade in Value Added data and Oxford Economic Forecasting (OEF) model

Fig. 4: Where might Eurozone exports end up, investment or consumption?

Growth in Eurozone export market investment, and Eurozone export market consumption



Source: UBS calculations using OECD Trade in Value Added data and Oxford Economic Forecasting (OEF) model

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