Difficulties in emerging economies weigh on global growth

13 Apr 2016 – Bank of Finland Bulletin 1/2016 – International economy

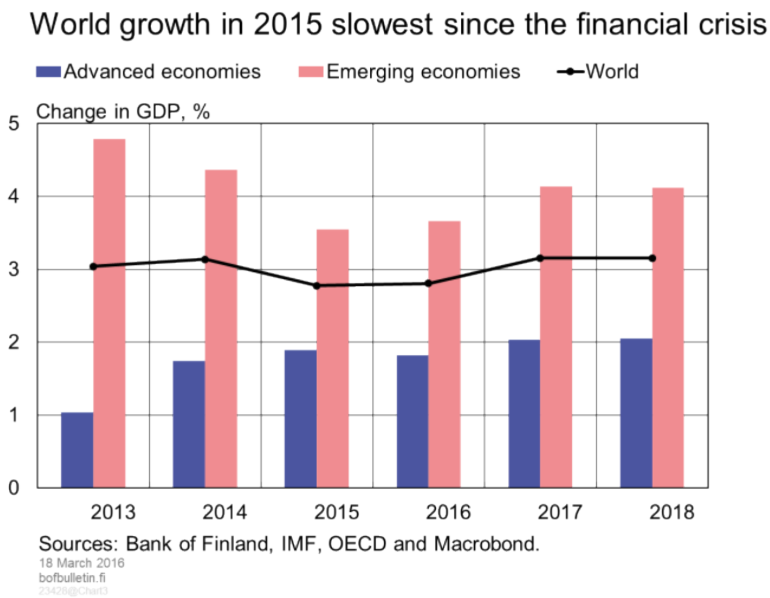
The Bank of Finland forecasts a global growth rate of 2.8% in 2016, rising only slightly to 3.2% in 2017–2018. The growth pick-up reflects a recovery of the emerging economies suffering from the recession. World trade growth in the forecast period will be close to world GDP growth.The forecasts for the United States and the EU22 are more moderate than previously, but growth should still exceed the estimated potential growth rate. The growth forecast for China in 2016–2017 remains at 6%, from which it is expected to slow to 5% in 2018.

2015 a good year for advanced economies

2015 was a good year for the advanced economies. In the United States, GDP growth slightly exceeded estimates of the growth rate of potential output. Employment increased and unemployment fell to around 5%. However, exports and private fixed investment increased only modestly.

For the euro area, 2015 was definitely strong. The area's GDP improvement exceeded estimates of potential growth by more than in the United States. Euro area growth was based on domestic demand, in particular. The unemployment rate declined by one percentage point, but is still over 10%. Investment growth also remained subdued in the euro area.

Chart 1.



The deceleration of world growth was due to difficulties in the emerging economies. Accordingly, the year 2015 was marked by concerns about the Chinese economy. While global economic growth has slowed as expected, it is structural changes in the economy and high debt levels resulting from expansionary policies following the financial crisis that are adding to the uncertainty. The Russian and Brazilian economies have slipped into deep recession. Of the BRICS (Brazil, Russia, India, China, South Africa) countries, which were the growth miracles at the beginning of the new millennium, only India's prospects have not deteriorated.

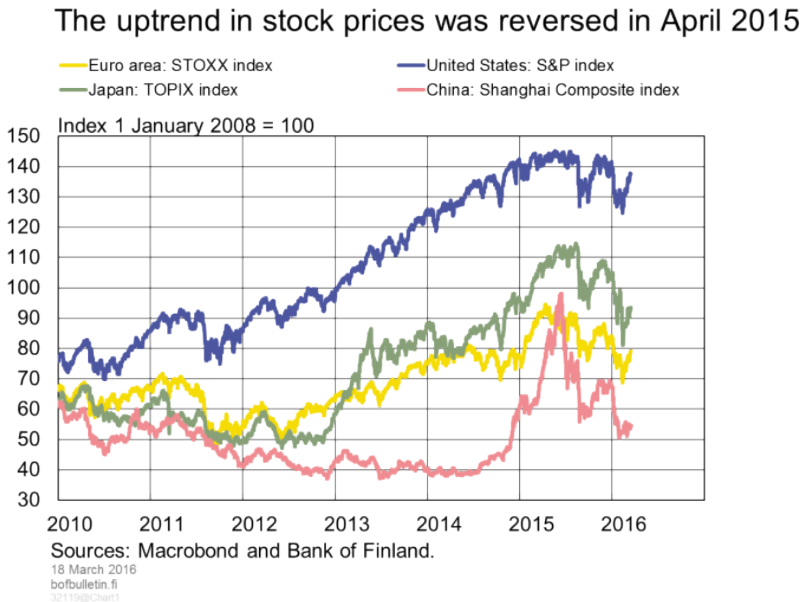
Growth in the United States, the euro area and China has been driven by the domestic markets. While consumption and services developed favourably, industrial production and investment were lacklustre. Against a backdrop of subdued industrial production, world trade growth remained exceptionally sluggish.

The weakness of world trade and the emerging economies is due partly to the price of oil, which has plunged twice since mid-2014. This is attributable to both demand and supply factors. Slower world growth and more efficient overall use of energy have reduced the demand for oil, while supplies have remained abundant.

Although there have been cutbacks in investment, the impact on oil production will take some time. In the United States, shale oil production has been surprisingly resilient to the low oil prices, and the removal of economic sanctions on Iran is increasingly boosting oil supplies on the world market.

Financial market uncertainties have also had an impact on oil price movements: daily fluctuations have been so large that they cannot be explained solely by changes in expected demand or supply. Some factors are pushing in the opposite direction. The liabilities of energy sector companies are the assets of financial sector companies.

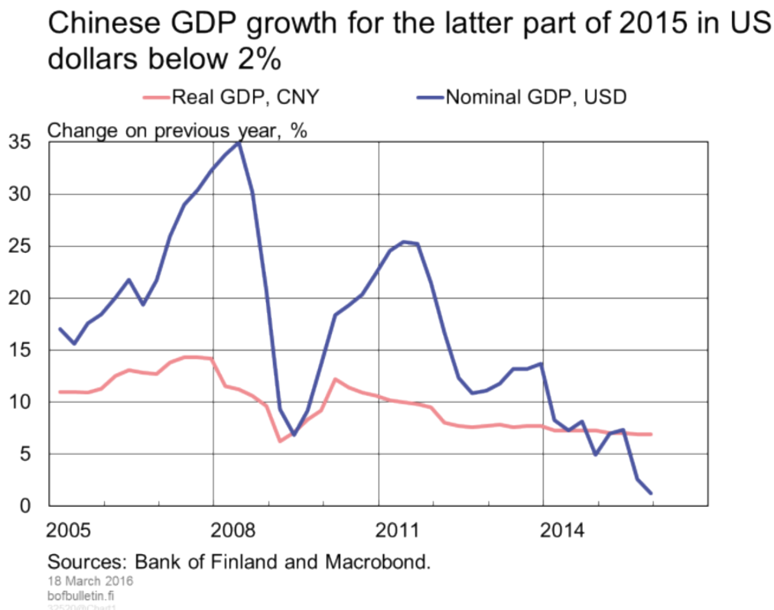
Chart 2.



Financial market valuations peaked in spring 2015 and by late April were trending downward. Stock prices reflect expectations of future growth and interest rates.

Growth forecasts for the world economy have already remained below previous projections for several years, and the secular stagnation thesis is now a hot topic of discussion. If a low level of interest rates mirrors expectations of accommodative monetary policy, stock prices should respond positively to further monetary stimulus; but if it is a reflection of secular stagnation, stock prices are likely to decline.

Chart 3.

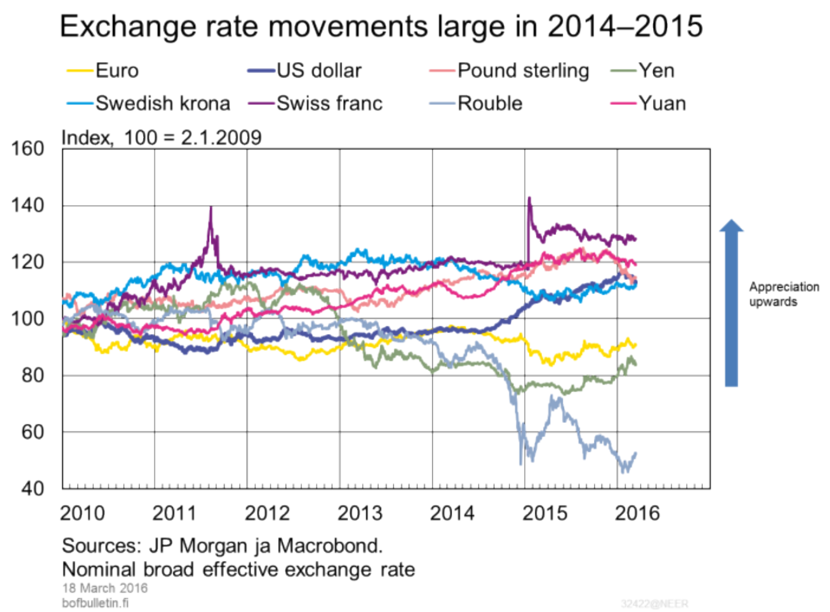


In August 2015, there was a stock market correction, which was seen to derive from uncertainty about the Chinese econonomy. Another correction occurred in January 2016. Although China's real GDP in yuan terms grew at an annual rate of just under 7% in the latter half of 2015, the growth rate as measured in current US dollar terms was just under 2%. One year earlier, these two growth figures were virtually equal. The main currency on international financial markets is the US dollar, which helps explain strong reactions in international markets to the Chinese situation since summer 2015.

The outlook for monetary policy is polarised: The US Federal Reserve made its first interest rate hike in December 2015, whereas the euro area and Japan increased the level of accommodation. Inflation is muted in all the main economic regions. The price of oil has a large impact on short-term changes. However, underlying inflation (which excludes the impact of energy prices) is also subdued. In the wake of the financial crisis, it is increasingly difficult to estimate the size of the output gap and its effect on the tightness of the labour market and wage inflation. China's low inflation environment is also a reflection of over-supply and production restructuring.

Trade-weighted exchange rates in the main economic regions have undergone wide fluctuations in recent years. However, the strengthening of the US dollar and the Chinese yuan has subsided at least for the time being.

Chart 4.



Growth and trade will remain sluggish

The Bank of Finland foresees global growth continuing at a rate of around 3% throughout the forecast period 2016–2018. Growth forecasts for the United States and the EU22 are more moderate than previously.

The situation for net exporters of oil and several other emerging economies is currently difficult. The pick-up in growth mainly reflects a recovery of economies now suffering from recession.

Table 1.

World trade growth held back by srtuctural factors

% change on previous year

(below previous forecast in brackets)

GDP	2015	2016f	2017f	2018f
United States	2.4	2.2	2.3	2.2
	(2.6)	*(3.0)*	*(2.8)*	
EU22	1.7	1.6	1.8	1.8
	(1.7)	*(1.8)*	*(1.9)*	
Japan	0.5	0.4	0.7	1.2
	(0.6)	*(1.1)*	*(1.0)*	
China	7	6	6	5
	(7)	*(6)*	*(6)*	
Russia	–4	–3	0	1
	(–4)	*(–2)*	*(1)*	
World	*2.8*	*2.8*	*3.2*	*3.2*
	(3.0)	*(3.2)*	*(3.5)*	
World trade	1.4	2.7	3.8	4.0
	(1.8)	*(3.7)*	*(4.5)*	

f = forecast

EU22 = Euro area, Sweden, Denmark and the UK.
Forecasts for 2016–2018 have been revised to correspond to the EU22, instead of the euro area.

Source: Bank of Finland.

World trade growth is being held back by a number of more permanent structural factors (see 'Why has world trade slowed?'). The most important of these is the change in China's growth model, which entails a decline in its propensity to import. World trade growth in the forecast period will thus remain close to world GDP growth.

Table 2.

The impact of the oil price broadly reflected in the inflation outlook

% change on previous year

(below previous forecast in brackets)

Inflation	2015	2016f	2017f	2018f
EU22	0	0.2	1.2	1.6
	(0)	(1.1)	(1.7)	
United States	0.1	1	2.3	2.2
	(0.2)	(1.6)	(2)	
Japan	0.8	0.2	1.5	1.4
	(0.4)	(1.1)	(1.6)	

f = forecast

EU22 = Euro area, the UK, Sweden and Denmark.

Sources: National statistical authorities and calculations by the Bank of Finland.

In the EU22, private consumption set to expand

In the next few years, economic growth in the EU22 (euro area, UK, Sweden and Denmark) will depend mainly on private consumption. Investment growth will only slowly gain momentum.The export outlook is clouded by weakening growth prospects for the emerging economies and for world trade. The low oil price and monetary policy will support growth and fiscal policies will also be mildly expansionary.

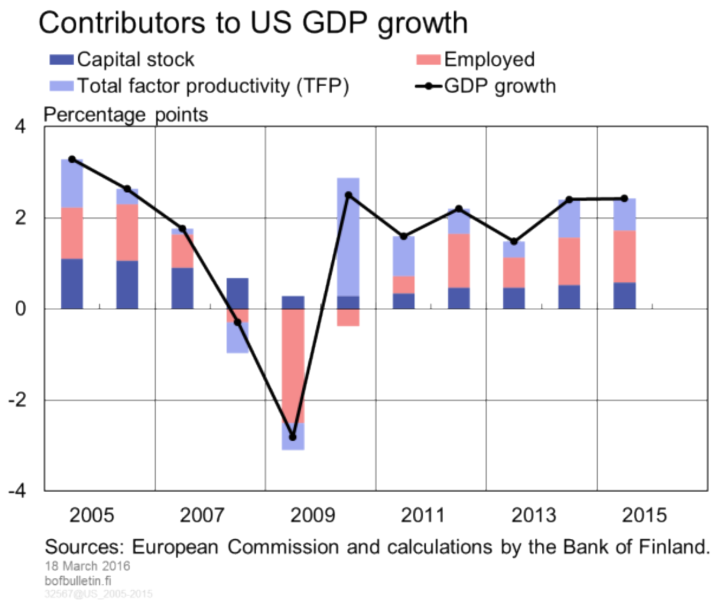
In the euro area, the problmes of private sector debt-servicing, which has been a barrier to domestic demand growth; fiscal tightening; and weakness in the labour markets are all easing. With the low price of oil underpinning real earnings growth, the employment situation continuing its slow recovery, and financial conditions remaining favourable, private consumption will continue to strengthen throughout the forecast period. Investment growth will not begin to regain strength until the latter part of the period.

An acceleration of inflation in the EU22 during the forecast period 2016–2018 will be supported by a halting of the fall in oil prices, the ongoing accommodative stance of monetary policy, and the narrowing of the output gap. Unemployment will continue to decrease, and the capacity utilisation rate will rise gradually. The risks to the forecast are on the downside. (See 'Why can't Finland keep up with its peers?')

The US economy subject to both upside and downside risks

The Bank of Finland's revised forecast sees a lower US growth rate. This is due to a slowing of international trade growth, the downward impact of the already stronger dollar on export competitiveness, and continued lacklustre growth of private fixed investment. During the forecast period, economic growth will be close to potential output growth.

Chart 5.



The main driving force of the US economy during the forecast period will continue to be private consumption, bolstered by good employment dynamics. Developments in disposable real income will also be buttressed by moderate inflation and particularly by low fuel prices.

Industries' confidence in the United States weakened in 2015. This is largely ascribable to the challenging situation in the oil sector. Against a backdrop of modest perspectives in industry, expansion in private fixed investment has receded. In contrast, residential investment has posted a robust performance.

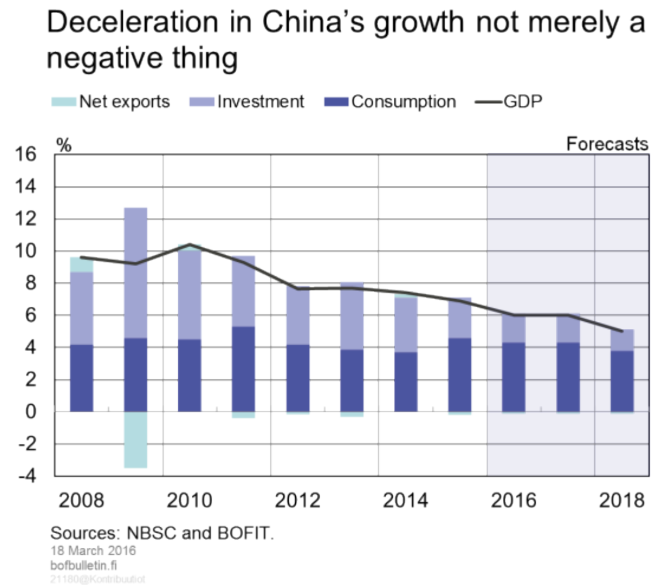
US fiscal policy is predicted to be somewhat more expansionary, especially in 2016, than in the previous years.

China's growth model changing

In accordance with the previous Bank of Finland forecast, Chinese growth is projected to slow to around 6% in 2016 and 2017. In 2018, growth will continue to decline, to about 5%.

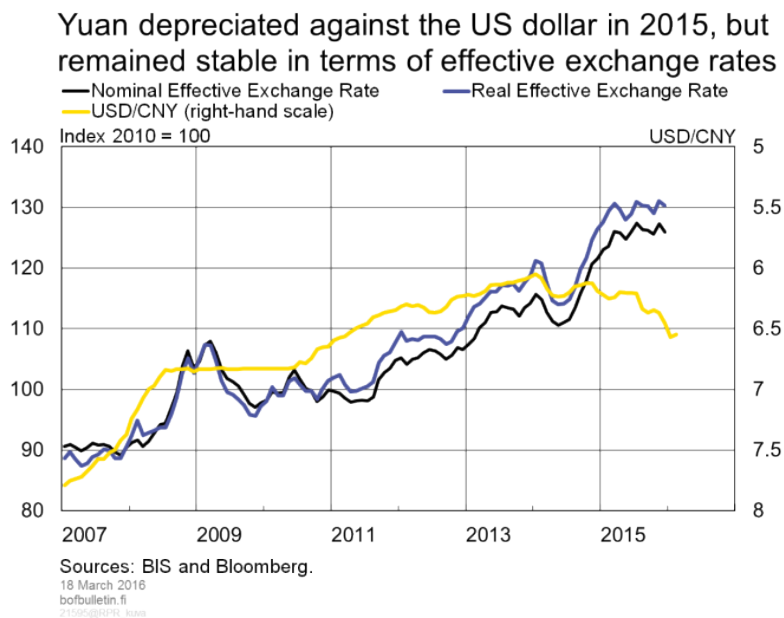
The envisaged deceleration in growth is not merely a negative thing. The Chinese economy has become so large that the rate of growth must inevitably subside. At the same time, the country's growth model is being transformed by economic reforms and structural changes. In 2015, the service sector already comprised more than half of the economy. With investment growth slowing and heavy industry suffering from weak demand and considerable overcapacity, the service sector and domestic consumption will assume expanding roles as drivers of growth.

Chart 6.



The biggest risk is the inability to keep the rapid debt build-up in check. China's debt ratio (excl. financial sector debt) has already risen to approximately 250% of GDP, which is exceptionally high compared with that of countries with corresponding earnings levels. As problems accumulate, there is another risk that well-intended reforms will remain on the back burner. (See 'Rising indebtedness increases risks in China')

Chart 7.



The rise in consumer prices has remained at about 2%, but producer prices have fallen for four years. Negative price developments in industry are also mirrored in the evolution of the GDP deflator, which also turned negative in 2015. Although, based on price developments, there would be room for monetary stimulus, expansion in domestic debt levels and pressures related to currency depreciation and accelerating capital outflows are holding back any extensive stimulus.

In Japan, growth still anaemic and inflation low

Japanese economic growth is projected to be close to ½% in the current year. Going forward, growth will pick up to about 1%, i.e. close to its potential growth rate. Active monetary policy and the resultant persistently weak yen will give traction to exports in the near term. The low price of oil will benefit consumers, thereby stimulating private consumption.

The labour market is tight. In 2015, slight pay increases were already discernible, and wage negotiations suggest that further rises can be expected. The corporate tax cut and record corporate results in recent years are boosting the appetite for investment. However, given that structural reforms are still pending, the growth outlook for the immediate years ahead remains muted.

Despite monetary policy measures, the inflation rate has been low. The Bank of Finland foresees inflation in Japan remaining around zero in 2016. Looking ahead, inflation will pick up to around 1½%. Fiscal consolidation is projected to continue, but at a slower pace than in previous years. (See 'Abenomics: three years – a big ship turns slowly')

The Russian economy will continue to deteriorate substantially in 2016

In 2015, Russia saw all domestic demand components contract, and there are no clear signs of an end to the declines. The surge of inflation in winter 2014–2015 brought prices in 2015 up to a level over 15% higher than in 2014. This depressed private consumption which, in particular, decreased by a tenth (by more than in the 2009 slump).

According to the Bank of Finland autumn 2015 forecast, the sharp drop in the price of oil in the latter half of 2014 will continue to cause a contraction of Russian GDP as late as 2016. Now that the oil price is assumed to be significantly lower in 2016 than in 2015, the estimate of GDP contraction has been revised to approximately 3% and GDP is envisaged to remain unchanged in 2017. Imports may decline by about 10% in 2016 and remain flat in 2017.

The mild rise in the oil price will gradually push the Russian economy onto an upward trajectory in 2018, which will cause imports to recover little by little. However, growth will be tepid, as long-term GDP growth estimates are largely within a range of 1–1.5% p.a.

The risks to the forecast are still high. Potential deviations of the oil price from its assumed path would naturally affect the economy and the rouble, inflation and imports. Geopolitical tensions may change. Despite objectives for cuts in government expenditure, public spending increases cannot be ruled out with the approach of Duma elections in September 2016 and presidential elections in March 2018. (See 'Russia's economy and imports to contract further')

Tags

global economy, gross domestic product, inflation, forecast