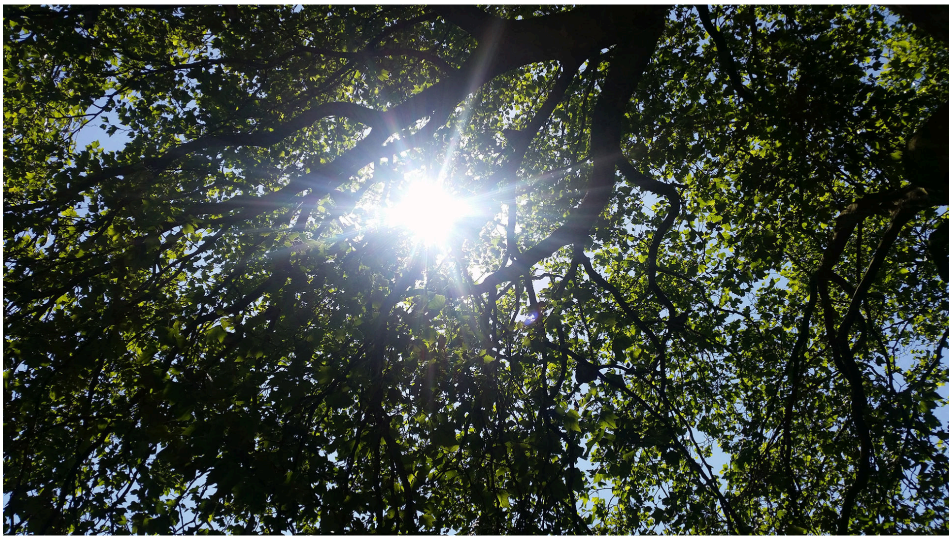
FORECAST FOR THE GLOBAL ECONOMY

Global economy to grow steadily

4 May 2017 – Forecast – International economy

The Bank of Finland foresees global growth strengthening relative to 2016 and continuing at a rate over 3% in 2017–2019. Improved confidence in both the United States and more broadly will reinforce favourable developments over the short term. Economic growth in the EU22 (euro area, United Kingdom, Sweden and Denmark) and the United States will remain fairly rapid throughout the forecast horizon. Growth in China will slow in an orderly manner, thus dampening global activity towards the end of the forecast period. Oil price increases will push up inflation in 2017 but will simultaneously support the recovery of the Russian economy.



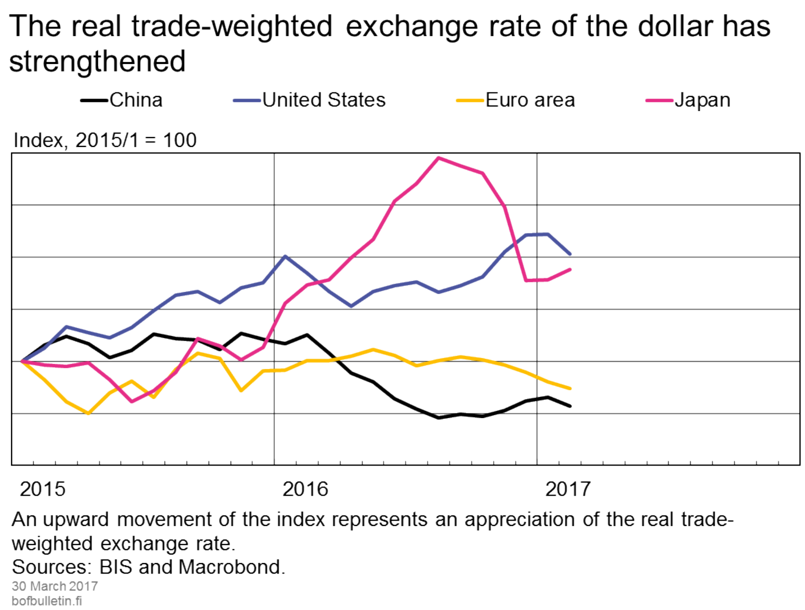
Markets expect US growth to accelerate

The fiscal stimulus and deregulation planned by the new US administration are predicted to fuel growth, at least temporarily. These market expectations have been reflected in, among other things, higher stock market valuations in the United States since the presidential elections in November 2016. There has been a broadly based increase in stock prices compared with last summer.

Chart 1

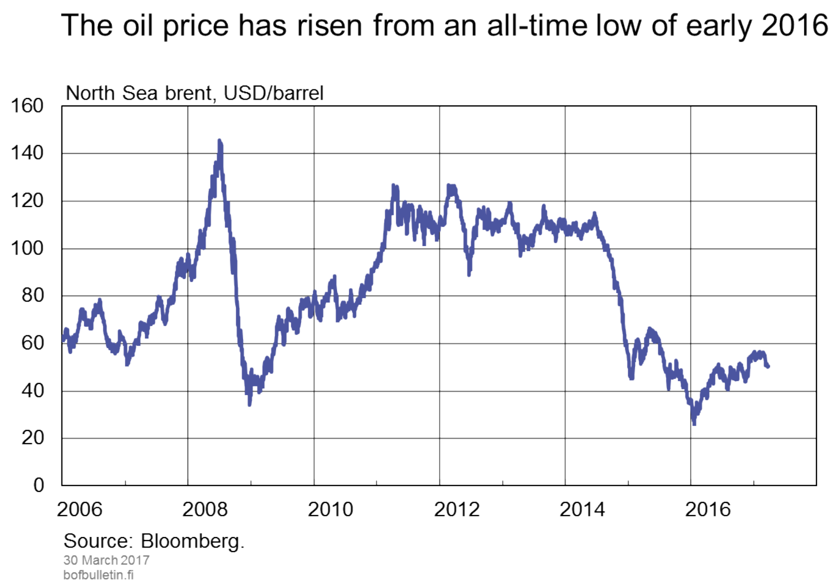
In addition, expectations of an acceleration in US economic growth and inflation have raised long-term government bond yields and strengthened the real trade-weighted exchange rate of the dollar. The real trade-weighted exchange rate of the euro has recently witnessed mild depreciation.

Chart 2



The world market price of oil has risen by approximately 10% since autumn 2016, and it is expected to remain at around USD 55 per barrel in the period ahead. The oil price has been pushed up by both higher growth expectations and voluntary output restrictions set by key oil producers.

Chart 3



China’s fading growth reins in global growth

The Bank of Finland foresees global growth proceeding at a pace of well over 3% in 2017–2019, i.e. slightly faster than in 2016. The risks to the global economy are discussed in the article ‘Favourable developments and new concerns in the global economy’ from the perspective of euro area growth and inflation developments.

Table 1. Growth forecast for the global economy 2017–2019

Change in GDP and world trade

% change on previous year (previous forecast below)				
GDP	**2016**	**2017f**	**2018f**	**2019f**
United States	**1.6**	**2.4**	**2.2**	**2.2**
	(1.6)	(2.3)	(2.2)	
EU22	**1.8**	**1.8**	**1.7**	**1.6**
	(1.7)	(1.3)	(1.6)	
Japan	**1.0**	**1.1**	**0.8**	**0.7**
	(0.4)	(0.9)	(1.0)	
China	**6.7**	**6**	**5**	**5**
	(6.5)	(6)	(5)	
Russia	**–0.2**	**1.5**	**1.5**	**1.5**
	(–1.0)	(1.0)	(1.5)	
World	**2.8**	**3.2**	**3.1**	**3.1**
	(2.8)	(3.1)	(3.1)	
Word trade	**1.7**	**3.4**	**3.6**	**3.6**
	(1.5)	(3.2)	(3.5)	

f = forecast

EU22 = euro area, Sweden, Denmark and United Kingdom.

Source: Bank of Finland.

In the United States, economic growth is expected to pick up to 2.4% this year, after the dip experienced in 2016. The recent improvement in confidence will strengthen growth over the short term. The forecast does not, however, take account of a potential future fiscal stimulus or other changes in economic policy, as no decisions on these are yet available. During the forecast horizon, the pace of US economic growth will nevertheless remain good and maintain global growth. US inflation is expected to edge up to markedly over 2%, as output exceeds its potential level, thereby causing price pressures to mount.

Economic activity in the EU22 countries in 2016 turned out to be better than anticipated, with near-term growth envisaged to continue at a pace of slightly below 2%. EU22 inflation will rise to around 2% in 2017, on the back of temporary factors (increases in oil and unprocessed food prices). In 2018–2019, inflation in the EU22 countries is forecast to slow to some extent amid still moderate price pressures and muted inflation expectations.

Chinese economic growth will decelerate in an orderly manner, but will nevertheless significantly sustain global growth. Even so, the slowing of growth in China to 5% means that global growth will not accelerate during the forecast period. The consumption tax increase in Japan, taking place in 2019, will slow Japanese growth and correspondingly boost inflation.

The elevation of the oil price will bolster growth in the Russian economy during the forecast period. The stable developments in the emerging economies will continue. Global trade growth will firm up during the forecast period, but will only slightly exceed global GDP growth, as in recent years.

Table 2. Inflation forecast for the global economy 2017–2019

Inflation in key economies

% change on previous year (previous forecast below)

	2016	2017f	2018f	2019f
United States	**1.3**	**2.5**	**2.5**	**2.4**
	(1.1)	(2.1)	(2.2)	
EU22	**0.3**	**1.9**	**1.6**	**1.7**
	(0.4)	(1.4)	(1.5)	
Japan	**–0.1**	**0.5**	**0.7**	**1.3**
	(–0.1)	(0.6)	(1.0)	

f = forecast

EU22 = euro area, Sweden, Denmark and United Kingdom.

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

Ongoing steady growth in EU22

The impact of Brexit on the short-term growth rate of the United Kingdom and, by extension, of the EU22 countries looks set to remain more limited than previously anticipated. According to the Bank of Finland's estimate, growth in the EU22 will continue at a steady pace of just under 2% in 2017–2019. Economic activity will be largely based on higher domestic demand. Brexit will, however, cloud the outlook for the United Kingdom, in particular. The accommodative monetary policy and stable global growth will continue to support favourable developments in the EU22.

EU22 inflation will pick up over the short term on the back of temporary factors. These include the elevation of oil and non-processed food prices. Wage developments in Europe have been very stable, with so far no signs of second-round effects on wages from higher oil prices.

UK inflation will increase as a result of the depreciation in the exchange rate. Euro area monetary policy and economic activity are discussed more closely in the article 'Favourable developments and new concerns in the global economy'.

US growth much quicker than 2016

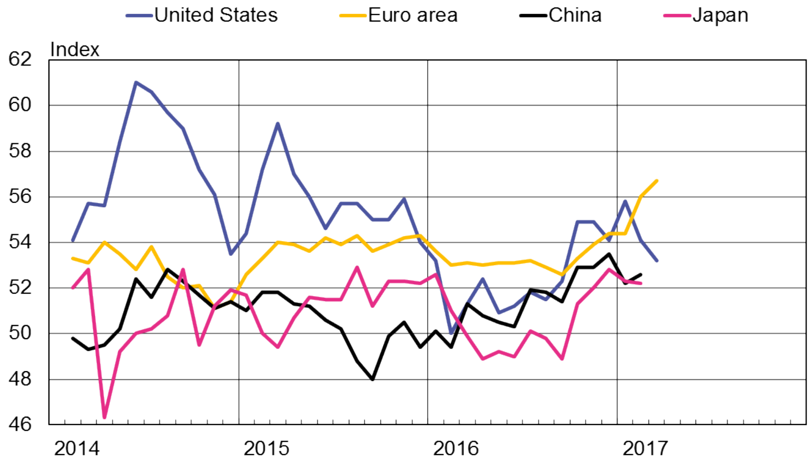
GDP growth in the United States in 2016 was a modest 1.6%. Growth was sustained by private consumption. Towards the end of the year, negative net exports dampened growth. The Bank of Finland predicts growth to accelerate significantly in 2017, to 2.4%.

The planned measures of the new US administration are expected to add momentum to the country's economic growth. However, as no concrete decisions have yet been made on fiscal measures, such as tax reform and infrastructure investment, they have been taken into account in the risk assessment instead of the baseline forecast. Expectations of stimulus measures have pushed up confidence indices. Admittedly, the indices may have been affected by many other factors, such as the recovery on the labour market and nominal wage increases. A higher degree of confidence will reinforce near-term growth, and investment in particular is expected to be up from last year.

Chart 4

Improving confidence strengthens near-term growth

Purchasing Managers' Index (PMI), composite index



Source: Macrobond.

30 March 2017

bofbulletin.fi

Contraction in US industrial output came to an end and output expanded towards the end of 2016. The measures and plans of the new administration for deregulation and the recovery in the mining and quarrying industry caused by the higher price of oil will buttress the corporate sector. For example, the decisions on the construction of two large oil pipelines will be significant for the mining industry and reverberate across other sectors, too. The strong exchange rate will, however, subdue exports and bolster imports, meaning that the contribution of net exports to growth is expected to remain mildly negative throughout the forecast horizon.

In the absence of new growth-friendly economic policy decisions, the US GDP growth rate is projected to slow moderately, to 2.2% in 2018 and 2019. Even this rate of growth is, however, somewhat faster than the estimated US potential growth rate, i.e. the rate at which the economy can grow without stoking inflation when its resources are fully utilised. However, if the new administration's growth-enhancing measures were to materialise, the country's economic growth in 2018–2019 would be a good 0.5 of a percentage point stronger than forecast here (See 'Scenario based on US economic policy plans').

US inflation accelerated to approximately 2.5% at the beginning of 2017. According to the inflation indicator (Personal Consumption Expenditure, PCE) monitored by the US Federal Reserve, the rate of increase in prices still remained marginally below the targeted 2%.

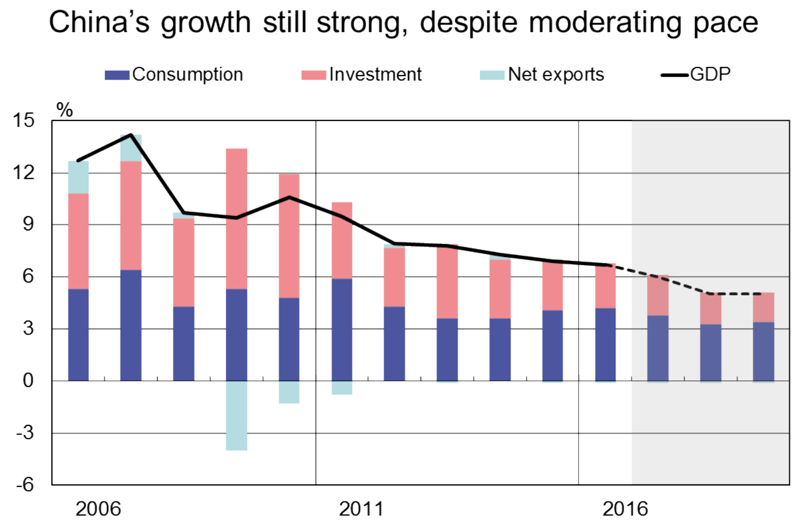
The measures of the new administration are expected to fuel inflation, which is reflected in strengthening inflation expectations on the financial markets. Inflation will also be driven by labour market tightening and higher wage inflation. Inflation measured in terms of the consumer price index is projected to remain at a pace of about 2.5% in the immediate years ahead. Rising inflation will have a dampening impact on increases in real wages. Good employment developments will, however, support private consumption, which is predicted to remain strong over the near term.

China needs a determined reform policy

China's GDP growth in 2016 according to the Chinese statistical authority, the National Bureau of Statistics of China, was 6.7%, which is marginally less than in 2015. Growth is expected to slow further still but in an orderly manner, and the baseline forecast is therefore positive. The Bank of Finland sees GDP growth in China slowing to around 6% in 2017, after which it will fall to some 5% in 2018–2019.

Easy ways of increasing Chinese output are becoming hard to find. Growth will be dragged down by population ageing, the shift of the production structure towards services, and environmental problems. The scope for fiscal stimulus will be narrowed by growth in indebtedness, currency flight and higher inflation, even if price increases are not yet presenting any immediate threat to economic policy.

Chart 5



Sources: National Bureau of Statistics of China, CEIC and BOFIT.
30 March 2017
bofbulletin.fi

Investment activity in China decelerated considerably in 2016, as public investment underpinned by expansionary policies was unable to fully replace the slowing of private investment growth. Meanwhile, rapidly improving private consumption as a driver of growth has come to play a more pronounced role. However, private consumption cannot entirely compensate for the slackening of investment growth, as growth in Chinese incomes has slowed to about 6%. The computed contribution of net exports to growth will be very small during the forecast period, as in recent years.

Sluggish growth and ongoing debt accumulation form a combination likely to cause problems, and the resultant uncertainty is reflected in capital outflows and expectations of a weakening of the yuan on the financial markets. The current account surplus, which dropped to less than 2% of GDP in 2016, has for a long time been insufficient to cover the net outflow of capital, and as a consequence foreign reserves have contracted. This serves to reinforce the vicious circle of capital outflows and downward pressures on the yuan.

The authorities have sought to calm the situation by tightening restrictions on capital movements and interfering in a number of ways in the operation of the foreign exchange markets. In February and March 2017, China's central bank also marginally raised its policy rates. Despite bringing temporary relief, the restrictions have eroded the international credibility and use of the yuan. Increasing the flexibility of the exchange rate (in the final analysis, the floating of the yuan) and bringing more clarity to domestic monetary policy would be a solution for the current deadlock. A system change in the monetary and exchange rate policy regime would naturally give rise to tensions of its own, but it would also force the pursuit of other reforms.

As slower growth and a higher debt burden are hampering the already complex system change, China's development is set to be tinged with a variety of market disruptions over the forecast horizon. A new threat is looming in the form of the freshly inaugurated US administration's potential measures targeted at China.

In order to solve its home-grown problems and strengthen its fundamentals for growth, China would need a determined reform policy. Economic policy, however, has difficulties in keeping pace with the changes in the country. For example, the National People's Congress in March still failed to abandon the 6.5% growth target that is a barrier to economic policy, threatening to aggravate the debt problem and encourage the distortion of statistics. The real willingness and ability of Chinese policymakers to invest in economic reforms will be measured after the party conference in autumn 2017 at the latest, by which time President Xi is expected to have sealed his position via personnel changes made at the party conference.

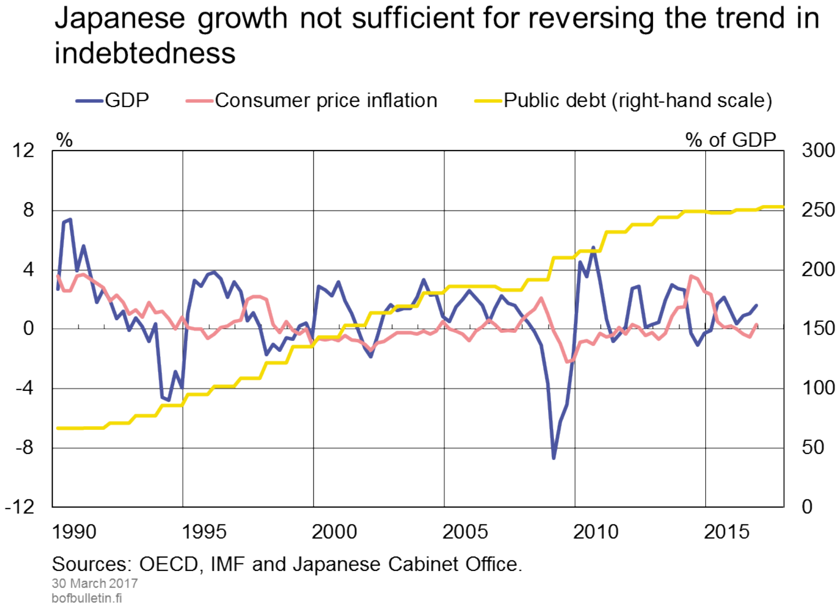
Japan's growth around 1%

The Japanese economy rebounded slightly in 2016, with GDP 1.0% up on the previous year. There are, however, problems in the sustainability of growth. Firms' good earnings capacity is not reflected in wages and salaries, and labour market negotiations lay emphasis on the importance of durable employment rather than pay increases. Subdued wage inflation, a contracting population and the increasing proportion of pensioners deter private consumption growth and reduce firms' willingness to invest in the home country.

Looking ahead, the Bank of Finland estimates Japanese economic growth to remain at just under 1%, which corresponds to the country's potential output growth. Economic activity in 2017 will be supported by a boost in exports and growth in public consumption. The consumption tax increase due to come into effect in October 2019 will reduce domestic demand towards the end of the forecast horizon. Reversing the trend in the public sector's high indebtedness would require determined implementation of structural reforms.

Japan's inflation will persist only slightly above zero. Despite monetary accommodation, inflation has not increased significantly. The higher price of oil and the weaker yen will create some short-term inflationary pressures, and the consumption tax increase will lead to a one-off inflationary spike towards the end of 2019. Achievement of the targeted 2% inflation rate will, however, require higher wage inflation.

Chart 6



Russian economy returns to growth

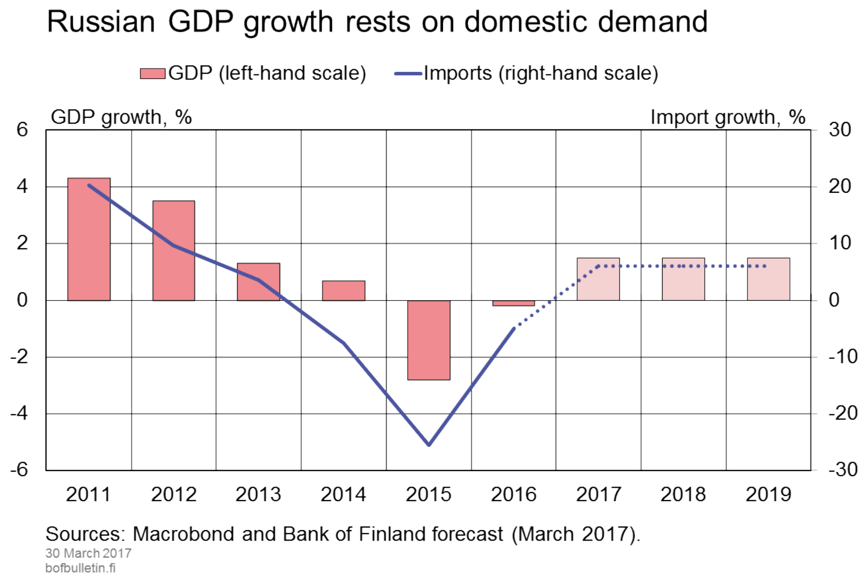
The forecast for Russian GDP growth in 2017 has been slightly upgraded in response to the higher oil price and more favourable developments in the preceding years than predicted. According to the preliminary estimate of the Russian statistical authority, the Russian Federal State Statistics Service, the country's GDP in 2016 contracted by only 0.2%, i.e. by distinctly less than expected on the basis of GDP data for the early part of the year. The projection for GDP performance in 2015 was also revised upwards.

The Bank of Finland expects Russian GDP to move into growth of 1.5% in 2017, and the same rate of growth is also anticipated for 2018–2019, meaning the economy will grow at its potential rate of growth. Growth will rest mainly on domestic private demand, as household consumption in particular is expected to eventually recover somewhat from its deep downward drift. Moderate investment growth is also envisaged. By contrast, public expenditures are expected to contract slightly in accordance with the budgetary frameworks adopted for 2017–2019.

Russian export growth is predicted to remain subdued on the back of both demand and supply constraints. Imports are expected to post growth of 6% following a strong contraction in recent years, bolstered by demand recovery and the robust appreciation of the rouble. Despite imports growing faster than exports, the trade balance is expected to remain in positive territory throughout the forecast horizon.

Oil price movements could slow or speed up growth in Russia compared with projections. Moreover, growth could accelerate if public expenditures were increased, as a deviation from the plans, ahead of the 2018 presidential elections. Instead, growth could be hampered if imports were to emerge from the trough more strongly than expected or if export performance were to prove weaker than forecast.

Chart 7



Tags

forecast, gross domestic product, global economy, inflation