Economic Briefings

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UPDATE OUTLOOK GLOBAL ECONOMY
World economy still on the road to recovery

Domestic demand continues to drive world economic growth. The contribution from international trade remains weak, although there are substantial differences between countries. What's more, stronger than expected data from China reduces the short-term risk of a hard landing for the Chinese economy. The recent rise in commodity prices is also supporting growth in many other developing economies. This makes it a lot less likely that a fresh crisis will emerge from these markets. In the meantime, the sharp fall in the value of sterling is preventing the UK from sliding into recession following the Brexit decision. This is because the weak pound is boosting the competitiveness of British exporters. Sooner or later, however, the rising inflation resulting from this will begin to weigh on consumer spending via lower real income growth. Elsewhere in the Western world, inflation is still strikingly low. Falling import prices remain an important factor in this regard, and are indicative of persistent and significant overcapacity at global level. The debate surrounding the duration and precise conditions of the ECB purchasing programme nevertheless prompted a limited rise recently in German ten-year bond yields and in rate spreads within the euro area. We will probably get more clarity regarding future ECB policy in December. We also expect the Federal Reserve to carry out a further interest-rate hike in December, which means the euro is likely to remain under some limited downside pressure.

Domestic demand driving economic growth

Producer confidence in manufacturing industry continued its recent recovery trend in the developed economies last month. The equivalent development was somewhat weaker in the emerging economies. In the service sector, by contrast, which is geared more closely to domestic demand, producer sentiment stabilised worldwide more or less at a level that continues to point towards vigorous growth. Consequently, world economic growth continues to be underpinned by domestic demand, against a backdrop of persistently weak growth in international trading volumes.

This is particularly clear in the US. American growth is chiefly being sustained by private consumption, which is being stimulated in turn by persistently robust job creation (156 000) in September and by growth in real pay. The increasing tightness of the US labour market sparked a moderate increase in average hourly pay (2.4% in September). Thanks to low inflation, this resulted in a tangible increase in real incomes. The latter will support growth in private consumption, despite a household savings ratio that is high by American standards.

Growth in the euro area too is chiefly being driven by private consumption. Now that the positive impact on incomes of the sharp fall in energy prices has gradually played itself out, it is chiefly the gradual improvement in the European employment market that is driving consumer spending growth. There are, however, substantial national differences (ranging from August unemployment of just 4.2% in Germany compared to 23.4% in Greece (in June)). The unemployment rate for the euro area as a whole is on a downward trend, despite the stabilisation in recent months. It was 10.1% in August, having still amounted to 10.7% a year earlier (graph 1).

Western investment remains weak…

Investment growth remains the economy's Achilles heel in both the US and the euro area. The contribution to growth from investment rose in the US for the second quarter in a row, but remains negative. What's more, uncertainty regarding budgetary policy after the US presidential election will continue to weigh on investment growth until at least the end of 2016.

Investment growth remains lacklustre in the euro area too, failing to contribute at all to growth in the second quarter. As stated, increasing private consumption is contributing significantly to growth in the euro area, just as it is in the US. The big difference compared to the US economy, however, lies in the much greater importance of net exports to the European economy.

This expresses the fact on the one hand that structural reforms to restore competitiveness are bearing fruit. However, it also reflects a strict budgetary policy over several years, which has sharply increased the national savings ratio of the euro area. Following a long period of external equilibrium, the euro area's current account surplus relative to its own GDP is now greater than China's and comparable with Japan's. The downside of this dependence on the export sector is the increased vulnerability to potentially disappointing world economic growth and to an appreciation of the euro. The recent stability of the euro's trade-weighted exchange rate is, however, reassuring in this context. What's more, the anticipated depreciation of the euro in the course of this and the following year is likely to give a further boost to net exports.

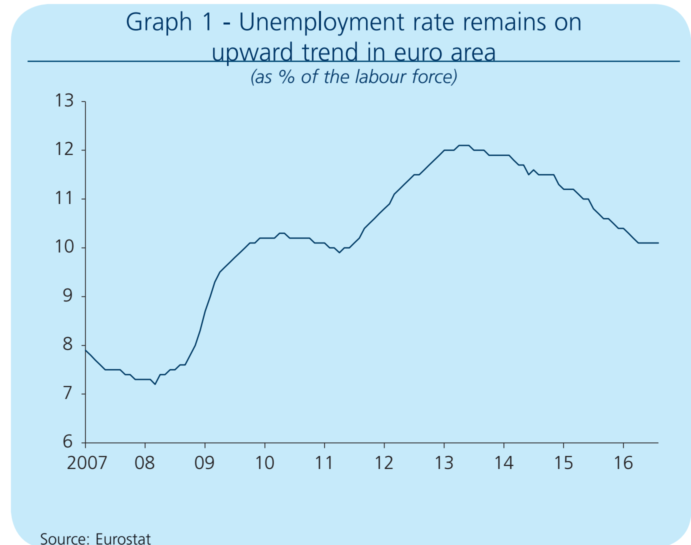
Net exports determine European economic growth much more than that in the United States.

… while the emerging economies stabilise

The fact that the most recent economic indicators in China exceeded analysts' expectations is also reassuring, as it reduces the risk of a hard landing for the Chinese economy. The further gradual increase in commodity prices is likewise good news for a number of developing economies. Latin America and Russia, amongst others, are benefiting from the increase in their key export prices. This provisional stabilisation of economic growth in the developing economies in turn reduces the economic risk for their developed counterparts.

Brexit so far an economic non-event

Contrary to what we feared, the British economy has displayed remarkable resilience since the UK's decision to quit the EU. General British producer confidence, for instance, improved again sharply in August, which was confirmed by a strong September number. Sterling nevertheless fell sharply once again. The pound had already lost ground in the run-up to the British EU referendum, and has slid further since. We expect this downward trend to continue in the quarters ahead.



The weak pound is a double-edged sword. On the one hand, the UK economy owes most of its current resilience to this weakness, as it is providing a boost to the competitiveness of manufacturing industry and hence the UK export sector. As a result, the British economy has (so far) avoided the feared slide into recession. This is also reflected in the strong performance of the UK stock market. On the other hand, import prices are rising swiftly due to the weak pound, thereby fuelling inflation. The harmonised inflation rate in the UK stood at 0.6% (source: Eurostat). There is a fairly substantial risk that this rising inflation will weigh heavily on real income development, as it did in the Great Recession, stifling the growth in private consumption. Since private consumption is the largest spending component in British GDP, this means the economy could still wind up in recession.

This uncertainty was recently heightened by fears of the 'hard Brexit' that British Prime Minister Theresa May seems to be targeting. According to this scenario, the UK will give greater priority to full sovereignty in terms of immigration policy, for instance, than to unrestricted access to the European single market. A negotiating stance of this kind would be totally counter to the interests of the UK export sector and so enjoys anything but a consensus. The uncertainty created by this debate is likely to increase the volatility and risk aversion of the financial markets in the quarters ahead.

Low inflation

Worldwide inflation remains strikingly low, against the backdrop of a generally favourable pattern of global economic growth. We note, however, that inflation in the US (1.5% in September) is considerably higher than in the euro area (0.4%). In its 'World Economic Outlook' for October 2016, the International Monetary Fund (IMF) once again defended the proposition that

inflation is being determined more and more by global factors and less and less by national ones. The IMF stressed, for instance, that (overly) low inflation is significantly attributable to falling import prices, which are the result in turn of substantial overcapacity in key exporting countries. China stands out particularly in this regard. A second important cause of low inflation according to the IMF remains the persistently high average cyclical unemployment rate – in other words, that part of total unemployment that could be cancelled out by higher economic growth.

The hypothesis that within a highly integrated world economy low inflation is caused by overcapacity at global level means, in concrete terms, that inflation is likely to remain low for some considerable time yet. Low inflation is not necessarily harmful to growth. Especially in the case of economies that can benefit from it via low import prices (improvement in their terms of trade) and from lower input bills for their companies.

Deflationary effect of commodities gradually played out

Headline inflation rose in September in the euro area from 0.2% to 0.4% (source: Eurostat, graph 2). We were expecting this increase, given that the year-on-year change in energy and commodity prices is gradually returning to positive and is thus once more contributing positively to general inflation. This factor will remain in play until 2017. The increase will remain temporary, however, for as long as underlying inflation (excluding energy and food prices) stays low. Unlike the rise in headline inflation, underlying inflation in the euro area stagnated in September at 0.8% according to Eurostat. It has been below 1% for some considerable time. Falling import prices and the persistently high cyclical unemployment rate in the euro area will head off any pay increases worth mentioning. Underlying inflation will therefore remain well below the ECB target of just under 2% for some considerable time yet.

Fear of a 'hard Brexit' is fuelling uncertainty about UK economic growth.

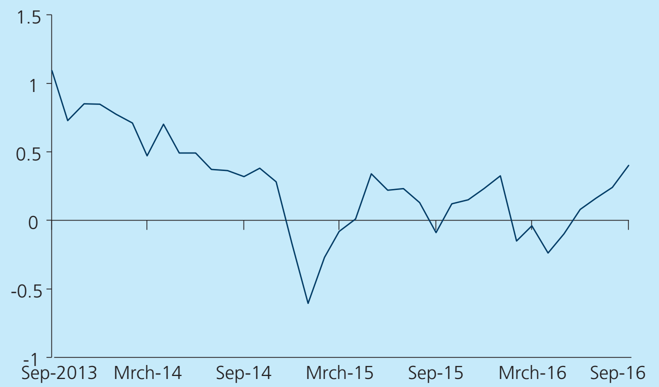
Bond yields: quo vadis?

Through the unconventional measures it has adopted, worldwide monetary policy has contributed to a sharp fall in the general level of interest rates in recent years. This reflects the introduction, for instance, of negative policy rates and the large-scale purchase of financial assets by the central banks. The net result was the historically unprecedented fact that many important bond yields, even long maturities, turned negative.

This also applied to German ten-year rates, which function as the reference in the euro area. These reached a low of around -0.20% at the end of September 2016. They have recently risen again, however, to just above 0%. This upward movement was a worldwide phenomenon: US ten-year rates, for instance, rose to around 1.8%.

Graph 2 - *Euro area headline inflation past turning point*

(consumer price index, y-o-y change, in %)



Source: Eurostat

One important reason for this increase is the growing debate about the future of the European Central Bank (ECB)'s purchase programme. As the decisions currently stand, this will run until at least March 2017. The financial markets are assuming, however, that the programme will be significantly extended, given the low level of inflation in the euro area. Two factors threaten to derail this assumption. Firstly, concern has been growing for some time – within the ECB too – as to whether monetary policy remains sufficiently effective to rekindle economic growth and inflation. Meanwhile, the question is increasingly raised as to whether enough appropriate financial assets remain for the ECB to be able to continue its purchase programme beyond the end of 2017.

Consequently, reports to the effect that the programme might taper off sooner than expected – with the purchase volume scaled down to zero by the end of 2017, for instance – have impacted recent rate movements. We expect the decision regarding the remaining term of the purchasing programme as well as that on the composition of the basket of relevant assets to be taken together at the ECB's December policy meeting.

We will also find out in December whether the US Federal Reserve (Fed) will take a further step towards normalising its policy rate. We think it will. The combination of a robust labour market, strong consumer spending growth and inflation not far below the Fed's inflation target, will allow it. The widening spread in short-term rates between the US and the euro area to which this will give rise will further weaken the euro against the dollar. Recent exchange-rate patterns show that the financial markets too are starting to take account of a scenario along these lines.

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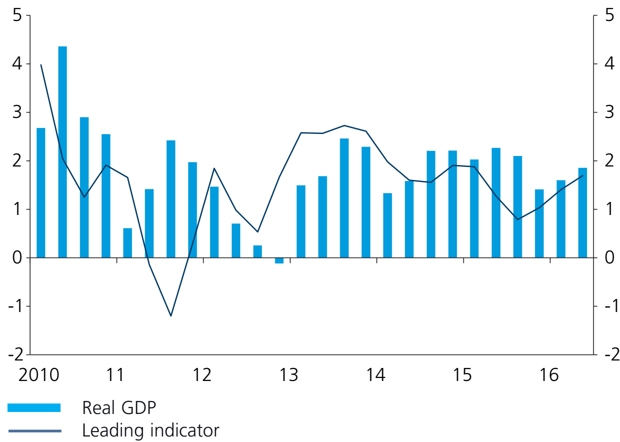
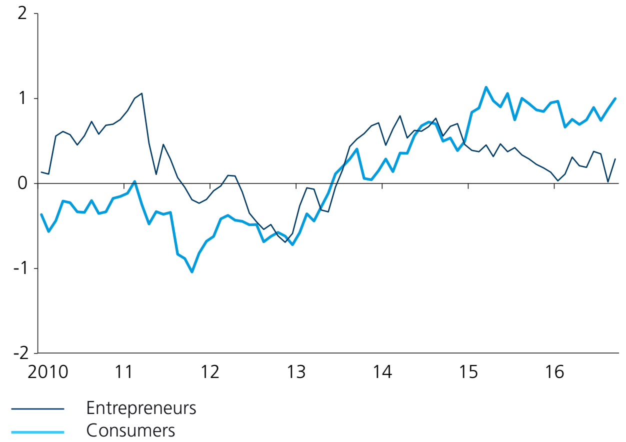
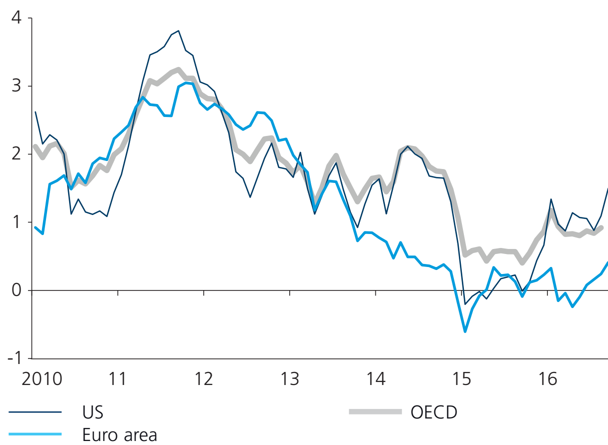
Economic activity in the OECD
(annualised quarterly change in %)



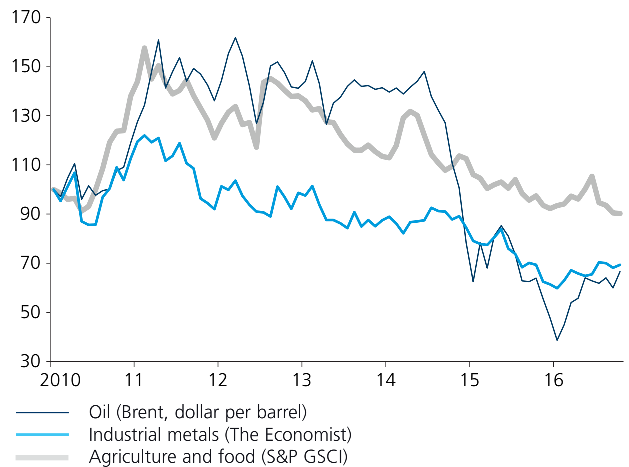
G4 confidence
(standard deviation from the long-term average)



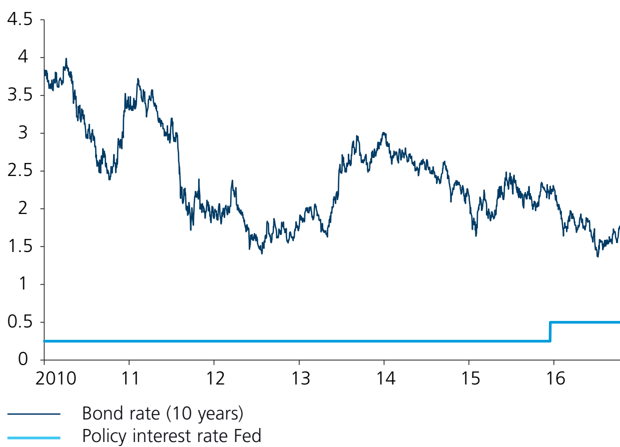
Inflation
(consumer price index, y-o-y change, in %)



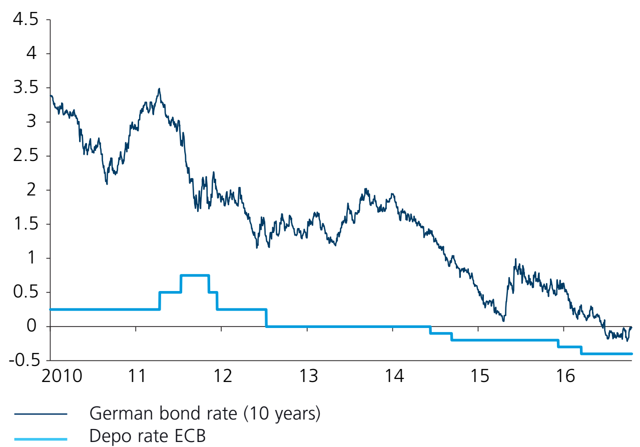
Commodity prices
(January 2010 = 100)



Interest rate movements US
(in %)



Interest rate movements euro area
(in %)



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	Real GDP growth		Inflation	
	2016	2017	2016	2017
US	1.4	2.1	1.3	2.6
Euro area	1.4	1.3	0.2	1.5
Belgium	1.3	1.2	2.0	1.6
Germany	1.6	1.5	0.3	1.5
Ireland	4.0	3.0	-0.1	0.5
UK	1.8	0.5	1.0	2.5
Sweden	3.3	2.8	0.9	1.2
Norway	1.1	1.6	3.0	2.5
Switzerland	1.1	1.4	-0.6	0.2
Slovakia	3.2	3.0	-0.5	0.5
Poland	3.4	3.2	-0.6	1.4
Czech Republic	2.5	2.3	0.6	1.6
Hungary	2.0	2.6	0.5	2.2
Bulgaria	2.4	2.6	-0.7	0.9
Russia	-0.7	1.3	7.5	6.0
Turkey	3.1	3.5	8.0	7.5
Japan	0.7	0.8	0.2	0.5
China	6.5	6.3	2.0	2.3
Australia	2.6	3.0	1.3	2.0
New Zealand	2.4	2.6	0.8	2.0
Canada	1.5	2.1	1.7	2.0
World	2.8	3.2	-	-

Policy rates

	17-10-2016	+3m	+6m	+12m
US	0.50	0.75	1.00	1.25
Euro area (refi rate)	0.00	0.00	0.00	0.00
Euro area (depo rate)	-0.40	-0.40	-0.40	-0.40
UK	0.25	0.10	0.10	0.10
Sweden	-0.50	-0.50	-0.50	-0.50
Norway	0.50	0.50	0.50	0.50
Switzerland	-0.25	-0.25	0.25	-0.25
Poland	1.50	1.50	1.50	1.50
Czech Republic	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90
Romania	1.75	1.75	1.75	1.75
Russia	10.00	9.00	8.00	8.00
Turkey	7.50	7.50	7.50	7.50
Japan	-0.10	-0.10	-0.10	-0.10
China	4.35	4.35	4.35	4.35
Australia	1.50	1.50	1.50	1.50
New Zealand	2.00	2.00	2.00	2.00
Canada	0.50	0.50	0.50	0.50

Exchange rates

	17-10-2016	+3m	+6m	+12m
USD per EUR	1.10	1.08	1.07	1.06
GBP per EUR	0.90	0.95	1.00	1.00
SEK per EUR	9.70	9.71	9.71	9.71
NOK per EUR	9.02	9.05	9.00	8.95
CHF per EUR	1.09	1.10	1.10	1.10
PLN per EUR	4.33	4.25	4.20	4.15
CZK per EUR	27.00	27.02	27.00	26.90
HUF per EUR	307.05	310.00	309.00	309.00
RON per EUR	4.50	4.50	4.50	4.50
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	69.05	66.96	65.27	63.60
TRY per EUR	3.40	3.35	3.37	3.39
JPY per EUR	114.37	113.40	112.35	111.30
RMB per USD	6.74	6.75	6.80	6.85
USD per AUD	0.76	0.76	0.77	0.78
USD per NZD	0.71	0.72	0.73	0.74
CAD per USD	1.31	1.30	1.29	1.28

10-year rates

	17-10-2016	+3m	+6m	+12m
US	1.78	1.60	1.75	2.00
Germany	0.07	0.00	0.00	0.20
Belgium	0.32	0.25	0.25	0.45
Ireland	0.50	0.40	0.40	0.65
UK	1.16	1.00	1.00	1.20
Sweden	0.30	0.25	0.25	0.45
Norway	1.35	1.25	1.25	1.45
Switzerland	-0.46	-0.55	-0.55	-0.35
Slovakia	0.53	0.40	0.30	0.40
Poland	3.07	2.90	2.85	2.80
Czech Republic	0.39	0.40	0.40	0.40
Hungary	3.10	2.70	2.70	2.70
Bulgaria	2.11	2.00	1.90	2.00
Russia	8.47	8.30	8.30	8.50
Turkey	9.81	9.80	10.20	10.60
Japan	-0.05	-0.05	0.00	0.00
China	2.74	2.90	3.10	3.30
Australia	2.31	2.05	2.20	2.45
New Zealand	2.56	2.35	2.50	2.75
Canada	1.23	1.00	1.15	1.40

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