1. The global economy

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Summary

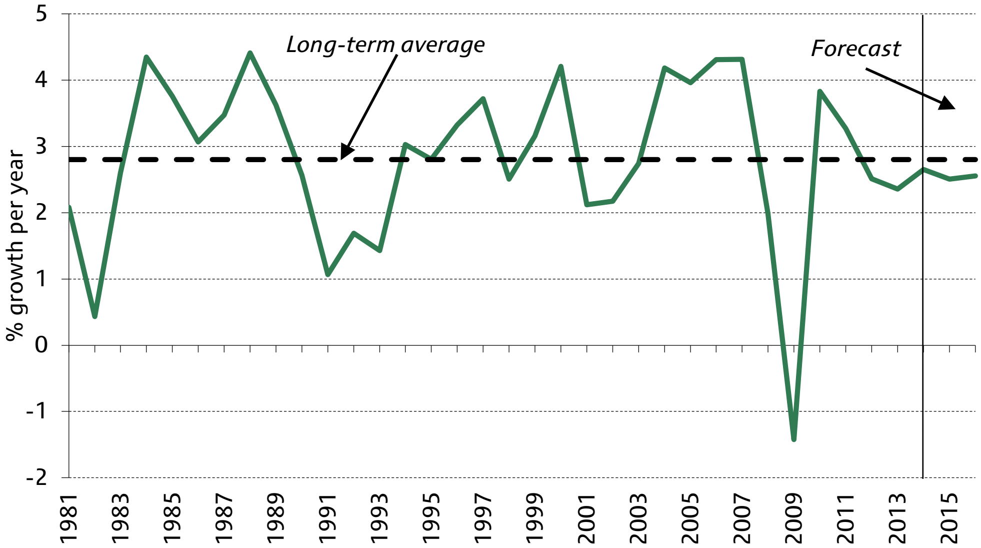
- The global economy in 2016 is expected to grow by 2.6%, only slightly faster than the 2.5% estimated growth in 2015.
- World growth will therefore remain relatively modest for a recovery period and below the long-term average of the last 30 years of 2.8% per year.
- US growth is forecast at 2.4% in 2016, the same as in 2015. Growth will be supported by solid growth in consumer spending and a robust labour market, while a strong dollar and weakness in the energy sector will be drags.
- Eurozone growth is expected to firm to 1.8% in 2016 from 1.5% in 2015 helped by expansionary monetary policy by the ECB and a competitive exchange rate. Germany will lead the eurozone, with growth of 2.1%.
- Emerging market growth is expected to remain subdued in 2016 at 3.8% (2.2% excluding China and India). Recessions will continue in Brazil and Russia, with a further slowdown in China. India will be the best-performing large emerging country, with growth above 7%.
- Headwinds to growth for emerging markets include tightening monetary policy in the US, lower capital inflows and (for commodity exporters) unfavourable terms of trade.
- For the UK, the relative resilience that we forecast for key advanced economies such as the US and the eurozone is a positive given its particular trade orientation. The UK's trade exposure to a slowing China and to the more troubled parts of the emerging market world such as Brazil and Russia is relatively limited.
- A key downside risk to our forecast is a faster-than-expected slowdown in China, which would hit world growth through a variety of real and financial market channels. A plausible upside scenario is a supply-driven further slump in oil prices, which would boost private sector activity in the advanced economies, more than offsetting the hit to oil producers.

1.1 Introduction

World growth in 2015 was relatively sluggish at just 2.5%, with momentum ebbing in the final months of the year. This was below the 2.9% forecast for world growth at the time of the 2015 Green Budget. The main sources of this forecast undershoot were slower-than-expected growth in the US and in a number of emerging markets. Weakness in the emerging markets reflected in part an unexpectedly large slump in commodity prices. In the US, robust consumer spending was offset by sluggish exports and investment, with the sharp dollar strengthening and weak world trade growth being key factors here.

With financial market volatility also picking up at the start of 2016, the chances of this year proving a 'take-off' year for the global recovery have receded. This year's global GDP growth forecast is 2.6%, only marginally stronger than in 2015 and below the average of

Figure 1.1. World growth



Source: Oxford Economics.

the last 30 years, which stands at 2.8%. So the world looks set to remain stuck in the sub-par growth phase that began in 2011 (see Figure 1.1).

The main weak points of the global economy in 2015 were trade and industrial activity. World trade grew by an estimated 1%, well below the long-term average pace of around 5% per year. A key factor behind this was declining import volumes in the 'BRIC' economies, including China. Meanwhile, world industrial output rose just 1.8% in 2015 with G7 industrial output rising a meagre 0.7%.

Services activity was generally more buoyant, helped by the boost to real incomes in oil-importing countries of falling energy prices and by rising employment and signs of improved wage trends in some of the advanced economies.

A key issue for 2016 is whether services growth can remain robust in the face of the negative trend in industry, the beginning of monetary policy tightening in the US and weakening stock markets.

On balance, we believe it can: labour markets should tighten further in the major economies this year, boosting wage growth, and real incomes will get a further boost from the recent additional decline in oil prices. Monetary policy settings are expansionary in the eurozone, Japan and China. Property prices are also still rising, and expected to continue rising, in most advanced economies – and these are arguably a more important source of 'wealth effects' than stock prices for consumers in the advanced economies, including the UK.

There are nevertheless considerable downside risks to our baseline forecast for world growth in 2016. One critical uncertainty relates to how global growth will hold up as US interest rates rise, following the initial Federal Reserve rate hike in December 2015.

Arguably, global financial conditions have already tightened somewhat since mid 2015, with world stock markets showing double-digit declines and widening junk bond spreads. Surveys of bank credit conditions have also shown tightening conditions in emerging markets and also a modest tightening in the US. In addition, our forecast is for only two US rate hikes this year, which we think the global economy can absorb. But notably the Federal Reserve's own projections look somewhat more aggressive.

Emerging markets are another locus of risk. Emerging market growth slowed significantly in 2015 and remains under pressure from factors including economic deceleration in China and weak commodity prices. With emerging markets now accounting for 35% of world GDP (up 10 percentage points on a decade ago), slow growth among them has the potential to be a major drag on the wider world.

Our forecast for the global economy is set out in Section 1.2, while Section 1.3 describes the key risks to this forecast. Section 1.4 concludes.

1.2 Global outlook

Eurozone

Eurozone growth picked up to an estimated 1.5% in 2015 from 0.9% the year before. This improvement was the result of several factors: a reduced pace of fiscal tightening; expansionary monetary policy by the European Central Bank (ECB) including quantitative easing and negative interest rates; and further signs of 'healing' in the financial sector, resulting in a modest recovery in credit supply.

Set against this, external demand conditions were unfavourable, with the eurozone's export markets (weighted by shares in eurozone exports) growing only around 0.5% on the year, down from 3.4% the year before. But the competitive euro, the trade-weighted exchange rate of which declined 7% in 2015, nevertheless allowed goods export volumes to rise by a respectable 2.3% last year.

Consumer spending in the eurozone has benefited from the collapse in global oil prices and the related boost to real incomes, a factor which should continue to underpin spending in 2016. Consumer spending is also benefiting from improved labour market conditions. In the six months to last November, there was a reduction in unemployment of almost 800,000 (taking the unemployment rate down from 11% to 10.5%). Survey-based measures of firms' employment intentions suggest an improving picture across all the main sectors in Q4 too.

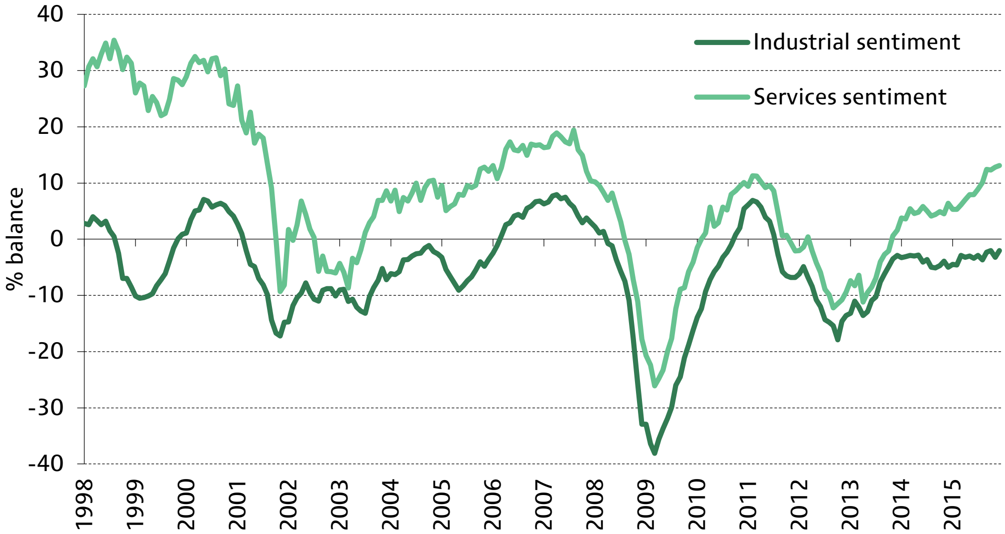
The strengthening labour market means that, this year, we expect households' real disposable incomes to grow at their fastest pace since 2001. This will be helped by very subdued inflation. We expect headline CPI inflation at just 0.7% this year after 0% in 2015.

The improvement in consumer fortunes is being mirrored in an improved outlook for services, with service sector sentiment rising to its highest levels since 2007 towards the end of 2015 (see Figure 1.2). But the picture looks much less rosy in industry, where activity is more tied to international conditions. Industrial output probably contracted for the second straight quarter in 2015Q4.

International developments mean we are relatively cautious about the outlook for investment in 2016. Strong business sentiment, increased capacity utilisation and the profits boost from the weak euro should be supportive factors for capital spending but uncertainty about final demand will tend to discourage it. Overall, we expect another year with investment growth around 2% – much better than the stagnant period from 2010 to 2014 but well below pre-crisis rates of growth.

On the policy front, the ECB's efforts at monetary stimulus have, in our view, borne considerable fruit. Apart from weakening the euro, eurozone broad money growth has

Figure 1.2. Eurozone business sentiment



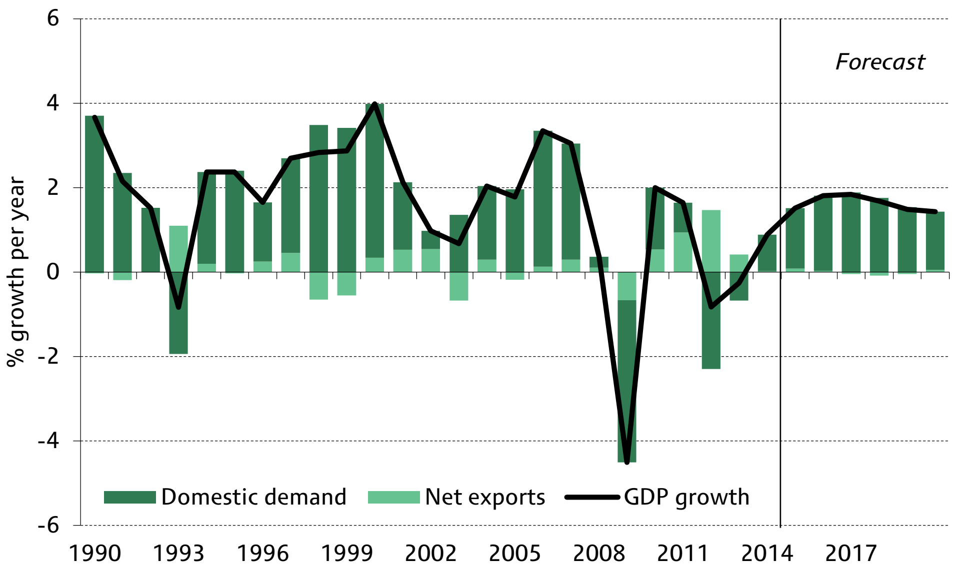
Source: Haver Analytics, Oxford Economics.

recovered from the anaemic pace of growth of 2011–14 to around 6% currently. Credit growth has also turned moderately positive having been negative in 2012–14.

That said, inflation this year is set to remain below 1% for the third year running, and long-term inflation expectations are hovering close to their lows of 2015. As a result, some further monetary action by the ECB (probably a move to more negative interest rates) this year remains a possibility, especially if recent stock market turbulence continues. But our baseline forecast remains that the ECB will not extend the asset purchase programme beyond the initial planned termination date nor increase the size of monthly asset purchases.

Overall, the eurozone is forecast to grow by 1.8% in 2016, the best performance since 2010 (see Figure 1.3). This will be a positive development for the UK, given that the UK

Figure 1.3. Contributions to eurozone GDP growth



Source: Haver Analytics, Oxford Economics.

sends 44% of goods exports to the eurozone (while deriving around 37% of its current account credits from the eurozone). Progress will be led by Germany, which is forecast to grow by 2.1% helped by solid consumer spending. We also expect another strong year of growth in Spain, with GDP up 2.9% after 3.2% growth in 2015. Less impressive performances are expected in Italy and France, although their forecast growth rates of 1.4% and 1.5% respectively represent considerable improvements from 2015.

Emerging economies

Emerging market aggregate growth slumped to 3.4% in 2015, the slowest pace since 2009 and well below the average pace of 6% from 2000 to 2014. Performance among the 'BRIC' economies (Brazil, Russia, India and China) was very uneven but overall poor. Russia and Brazil saw deep recessions, with GDP dropping around 4% in both countries. Chinese growth decelerated to the slowest pace in 25 years, with particular weakness in heavy industry and the real estate sector. The best performance was in India, where GDP rose 7.4%, although this figure may flatter the underlying picture.

The external environment for emerging markets was very unfavourable in 2015 and remains so at the start of 2016. China's deceleration has contributed to sharp drops in key commodity prices including for metals and coal (due to China's dominant position as a consumer in many commodity markets), undermining export revenues and budget positions for commodity exporters. The collapse in oil prices has also hit oil producers.

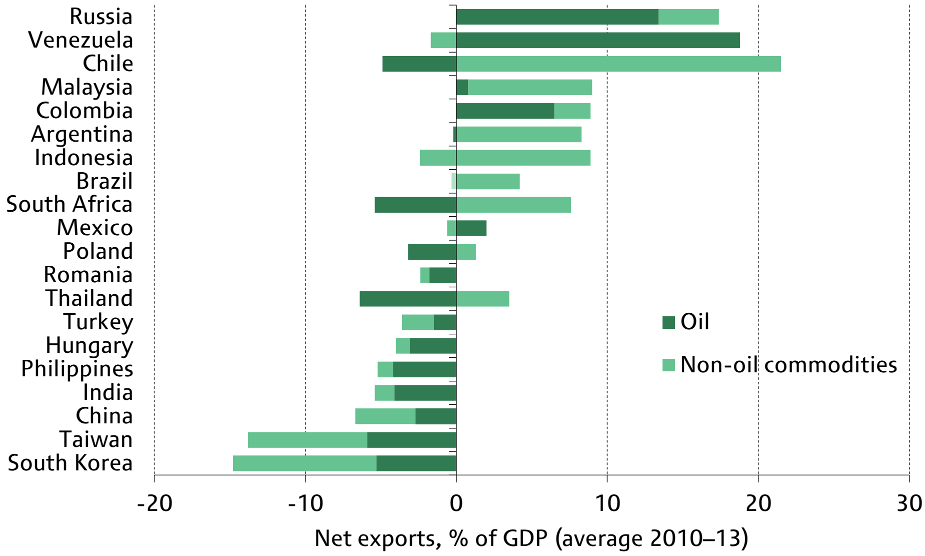
Financial conditions have also deteriorated. Survey evidence suggests banks have been tightening credit standards in many emerging countries, and portfolio capital inflows have slumped. The MSCI emerging market stock market index has collapsed by 35% from its peak of May 2015. Finally, the end of quantitative easing in the US and the start of rate increases there have pushed up the costs of external financing and put downward pressure on local currencies – and in some cases upward pressure on domestic interest rates.

For 2016, we expect another year of recession in Brazil. The upward pressure on inflation from rapid currency depreciation is likely to lead to further increases in interest rates in the coming months from their already-high levels. With commodity export prices also likely to remain under pressure, we forecast a further contraction in GDP of 2.6% this year after a 3.7% fall in 2015. Elsewhere in Latin America, we expect some improvement in Mexico and Chile in 2016 but continued weakness in Argentina and Venezuela.

In Russia, the growth outlook also remains bleak, with our forecast being for a 1% decline in GDP in 2016 after a 3.8% decline in 2015. The balance of payments position remains fragile thanks to the collapse in world oil prices, ongoing capital flight and the lingering impact of financial sanctions. Weak oil prices are also undermining the fiscal position and the currency. Currency weakness is likely to limit the scope for the central bank to reduce interest rates to support growth.

We forecast a further deceleration in Chinese growth from 6.9% in 2015 to 6.3% in 2016, as the authorities attempt to manage the economy towards a more moderate but more sustainable path of growth. The slowdown so far has been particularly concentrated in the real estate and heavy industry sectors, resulting in quite substantial spillovers to the rest of the world given the import- and commodity-intensive nature of these sectors. Policymakers continue to face a dilemma, with monetary easing aimed at cushioning the slowdown putting downward pressure on the exchange rate. There have been two mini-

Figure 1.4. Emerging market commodity dependence



Source: Oxford Economics, UNCTAD.

devaluations since August and we expect some further moderate currency depreciation in 2016, taking the CNY/US$ rate to 6.8 by mid 2016.

In India and China, the fall in global oil prices is a positive, with both being net importers (see Figure 1.4). India's current account deficit has narrowed, to just 0.9% of GDP last year, helping shield it a little from less favourable investor sentiment towards emerging markets, and inflation has also declined allowing interest rates to fall. GDP growth is forecast at 7.4% in 2016, the same pace as in 2015, though the new system of national accounts (which has produced figures sometimes hard to square with other indicators) may flatter these figures a little.

Overall, emerging market growth is forecast to pick up slightly in 2016, to 3.8% from 3.4% in 2015. But the two years together will still be the slowest period of emerging market growth since 1998 and 1999. Moreover, if we strip out China and India, we expect growth in the remaining emerging markets to total just 2.2% in 2016, after 1.4% growth in 2015 and average growth of 4.3% in 2000–14.

This very weak performance in large part reflects the problems of commodity exporters and risks to growth in this group of countries remain, in our view, skewed to the downside. This is especially the case given that the commodity downturn seen so far still looks relatively modest compared with previous historical episodes. From a UK perspective, some comfort may be taken from the fact that the UK has relatively modest exposures to the more troubled parts of the emerging market world. UK exports to Russia and Brazil account for only around 2% of UK exports. Exposure to the slowdown in China is higher, with UK goods exports to China around 5% of the total (and around 7% if Hong Kong is included), but is still relatively modest.

Japan

Japan's economy lost momentum in the second half of 2015 and grew by an estimated 0.7% in the whole of 2015. This reflected a number of factors including the decline in the stock market and the depressing effect on exports of slower growth in Japan's key trading partners – export volumes to China and to Asia more broadly were down 4% on the year in November.

For 2016, we expect some improvement, with a forecast expansion of 1.2%. The economy continues to face headwinds including the decline in the stock market since mid 2015 and the recent strengthening of the yen (the result, in our view, of 'flight to safety' capital flows). But set against this, we expect exports to improve as world trade growth picks up from 2015's very weak pace. In addition, we expect a further round of quantitative easing by the Bank of Japan in July.

We are also relatively positive on the consumer outlook. Real wages showed a modest upswing in 2015, helped by continued low inflation, and the labour market shows signs of tightening. Consumer confidence is also above its long-term average.

Business investment increased by around 2% in 2015, helped by the boost to profits from yen weakening (on average, the effective exchange rate dropped 6% in 2015). This pace of growth remains a little disappointing, however, and may in part reflect companies reining in spending in response to uncertainty about the global economy and emerging markets in particular. There have been some positive signals from indicators such as machinery orders of late, though, so we expect investment to firm a little more in 2016.

The two main downside risks to growth are a faster-than-expected slowdown in China (which takes 20% of Japanese exports) and an insufficient level of policy stimulus by the authorities, such as a failure to expand quantitative easing as we expect. With Japan only accounting for 1.5% of UK goods exports, however (and 2% of total current account credits), these downside risks are of relatively limited importance for the UK.

US

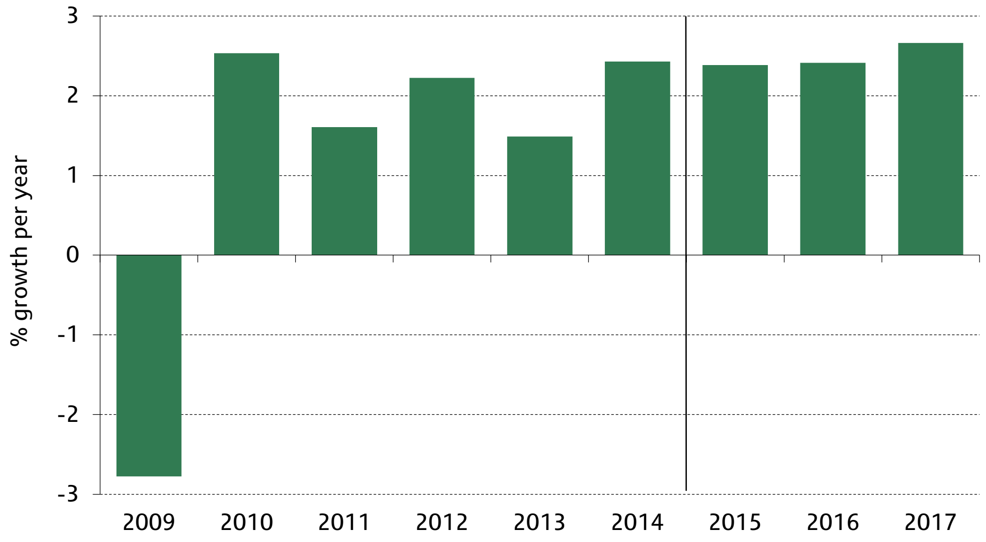
US economic growth is estimated at 2.4% for 2015, the same as in the previous year. Growth was supported by consumer spending, which rose an estimated 3.1% during the year, but held back by slowing export growth and some moderation in investment growth in the second half of the year. These negative factors can be traced to the impact of a significant strengthening in the dollar, of around 13% on a trade-weighted basis, sluggish growth in some of the US's key export markets and a downturn in the energy sector.

For 2016, we expect a broadly similar pattern. Net exports are likely to remain a drag on growth, albeit less so than in 2015. But we expect the labour market to continue tightening, supporting consumer spending. Employment growth has been running at a healthy 200,000 or so per month and we expect it to remain robust in 2016. We also expect wage growth to provide more of an impetus to incomes this year. Overall, we expect consumer spending growth to come in at around 2.8% for 2016.

Business investment has been constrained by strong headwinds facing the energy-related and export-oriented sectors in recent quarters. These factors will continue to act as a check to investment in 2016, dissipating only gradually, so that capital spending will advance at a modest pace. Residential investment was more buoyant last year, rising around 8%, and will be supported by low mortgage rates and firming housing demand. Overall, we expect investment growth to pick up to 4.2% this year from 3.8% in 2015.

Taking all these factors into account, we expect US GDP growth in 2016 at 2.4%, unchanged from the previous year (see Figure 1.5). Continued solid growth in the US should be good news for the UK, given the importance of the US as a trading partner. Around 13% of the UK's goods exports go to the US, and the fractions of services and

Figure 1.5. US GDP



Note: Data points to the right of the vertical line are forecasts.
Source: Oxford Economics.

foreign income receipts that the UK derives from the US are even higher. A stronger US should also have positive knock-on effects for other important UK trading partners, including the eurozone.

The main risk areas for the US are in financial markets. Despite some sell-off over recent months, US equity valuations remain stretched according to many key measures. A sharp stock market sell-off could hit business and consumer confidence. Lower oil prices are also not an unambiguous positive for the US as they will mean slower growth in the shale oil sector.

A related area of risk is the extent of monetary tightening by the Federal Reserve. Our forecast is for a very cautious pace of rate increases by the Fed in 2016, with just two 0.25 percentage point increases on top of last December's initial move. But this forecast is well below the central projections published by the Fed itself, reflecting our concerns that the US economy might react adversely to a faster pace of monetary tightening. More aggressive Fed tightening could prompt a very negative financial market reaction, feeding back into weaker growth.

Global outlook

This year's world growth forecast of 2.6% represents only a marginal improvement on 2015 and implies a fifth straight year of subdued global growth (see Table 1.1). Not only is the forecast pace of growth below the long-term average, it is also well below the 4% rates seen in the pre-crisis period of 2004–07.

Growth will improve in the advanced economies this year, with G7 GDP growth rising to 2% from 1.7% in 2015. This will be the fastest pace of G7 growth since 2010. Emerging market growth will also strengthen, to 3.8% from 3.4% last year. But this will remain a weak pace of growth compared with the average of 6% per year recorded in 2000–14. Excluding China and India, emerging growth will look weaker still, at just 2.2%. Taken together, 2015 and 2016 will be the worst two-year period for emerging market growth since 1998 and 1999.

Table 1.1. Summary of international forecasts

Real GDP	2014	2015	2016	2017	2018	2019
North America						
United States	2.4	2.4	2.4	2.7	2.4	2.3
Canada	2.5	1.2	1.7	2.2	2.5	2.5
Europe						
Eurozone	0.9	1.5	1.8	1.8	1.7	1.5
Germany	1.6	1.5	2.1	2.0	1.6	1.1
France	0.2	1.1	1.5	1.7	1.7	1.7
Italy	-0.4	0.7	1.4	1.2	1.1	0.9
UK	2.9	2.2	2.2	2.5	2.2	2.2
EU27	1.4	1.8	2.0	2.1	1.9	1.7
Asia						
Japan	-0.1	0.7	1.2	1.2	1.0	1.1
China	7.3	6.9	6.3	6.0	5.9	5.7
India	7.1	7.4	7.4	7.2	7.0	6.8
World	2.7	2.5	2.6	3.0	3.0	3.0

Source: Oxford Economics.

For the UK, the relative resilience that we forecast for key advanced economies such as the US and the eurozone is a positive given its particular trade orientation. The UK's trade exposure to the more troubled parts of the emerging market world such as Brazil and Russia is also quite limited. Goods trade exposures to China are also modest, though adding in services and financial exposures increases the risks to the UK from a faster-than-expected Chinese downturn.

In terms of policy settings, monetary policy is set to remain expansionary in the eurozone and Japan next year. Meanwhile, although the US is forecast to raise rates further, we expect it to do so at a very modest pace by historical standards. Moreover, the Federal Reserve will not start to shrink its balance sheet this year, so the overall monetary stance in the US will tighten only gradually.

Divergent monetary policy in the US, Japan and the eurozone will contribute to significant exchange rate movements. We expect the US dollar trade-weighted index to strengthen by an average of around 10% in 2016 versus 2015. The euro/US$ rate is forecast to decline to 1.05 by end 2016 from 1.09 a year earlier and the yen/US$ rate to move to 126 from 121 at end 2015.

Global inflationary pressures are expected to remain subdued in 2016. In the US, eurozone and UK, headline inflation is forecast at around 1%, while Chinese inflation is expected at 1.6%. Inflation will be higher in some other emerging markets, especially those suffering from strong currency depreciation such as Russia and Brazil. But world inflation is expected at 2.6%, the same rate as in 2015.

1.3 Risks to the global economy

Some significant downside risks remain to our global forecasts for 2016 and beyond. But there are a number of possible alternative scenarios, in which global growth could diverge significantly from our baseline. We cover two key scenarios for the global economy below.

China hard landing

Concerns about Chinese growth have been to the fore throughout 2015, including fears about a possible 'hard landing'. A possible hard landing scenario centres on the possibility of a drying-up of Chinese domestic demand, especially investment.

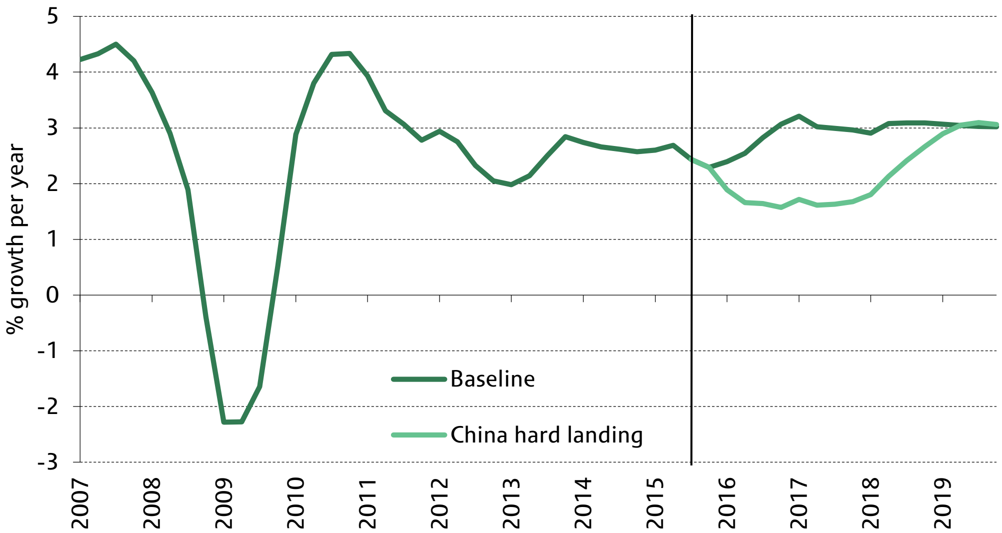
In this scenario, Chinese investment is hit through a variety of channels. Residential investment is dragged lower on the back of sharp drops in new housing construction – by as much as 50% from its 2013 peak – as developers run down housing inventories and the outlook for the sector deteriorates amid renewed declines in prices and sales volumes. Other private investment expenditure is also scaled back, hindered by slowing domestic demand and strained balance sheets. And, amid worries over a loss of confidence in the economy's prospects, foreign direct investment (FDI) inflows drop significantly and the stock market sell-off already incorporated in the baseline forecast gathers pace.

Overall, GDP growth in China slows to 2.9% in 2016 and 2.4% in 2017, and only returns to 5% by 2019. Investment growth contracts in 2016 and 2017 and remains 15% below baseline by the end of the decade.

The shock to Chinese growth spills over to countries across the globe. While policymakers respond where feasible, many are constrained – by proximity to the zero lower bound on interest rates, for some central banks, and by a need to defend rapidly-depreciating currencies, for others. Out of a sample of 46 economies, only around half (representing a third of global GDP) are able to mitigate the transmission of the shock to their domestic economy through conventional monetary policy measures.

As a result, world growth slows sharply, to just 1.7% in 2016 compared with 2.6% in the baseline (see Figure 1.6). Advanced economies are affected, but the impact on emerging markets is far greater, in particular because commodity markets are badly hit, including the oil market. By the end of the forecast period, emerging market GDP is more than 5% down relative to our central forecast.

Figure 1.6. World GDP under 'China hard landing' scenario



Note: Data points to the right of the vertical line are forecasts.
Source: Oxford Economics.

Oil prices plunge as global growth surges

As well as the downside scenario outlined above, there are also possible upside risks to our central forecast. Our baseline forecast takes a cautious view about a number of unfolding developments in the global economy and this could prove too conservative.

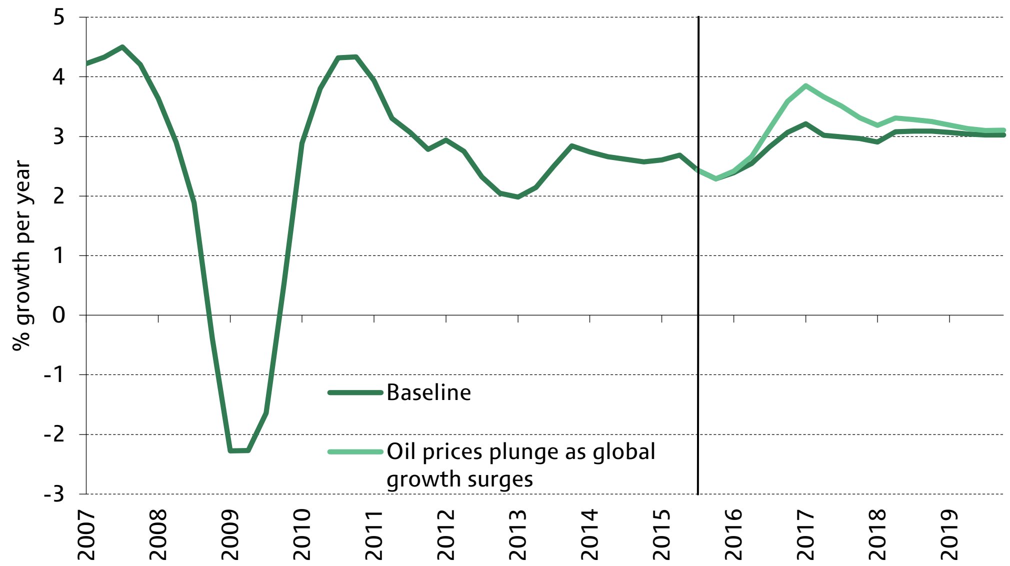
One plausible upside scenario relates to a further substantial drop in world oil prices, driven by a supply surge. In such a scenario, US and OPEC oil production is assumed to rise relative to the baseline, driving oil prices down around 25% below our baseline forecast by end-2017 (to US$36 per barrel versus US$49 per barrel in the baseline). The decline in oil prices acts as an effective tax cut for oil importers, amplifying strengthening private sector activity in the US and the eurozone, and more than offsetting the adverse impact on oil exporters from lower oil revenues.

In this scenario, US GDP growth would accelerate towards 3% in 2016 and 2017. Inflation would initially fall below baseline but then accelerate into 2018 on stronger demand. The Federal Reserve would also raise rates faster than in the baseline. In the eurozone, growth would move above 2% with inflation remaining fairly subdued.

China would also see stronger growth than in our baseline forecast, thanks to lower oil prices and faster export growth. More broadly, emerging market growth would improve to around 4.5% per year by 2017, though there would be some weak spots including Russia (which would suffer a deeper and more protracted recession) and other large oil producers.

Overall, world GDP growth would accelerate to around 3.5% by 2017, the best performance since 2010 (when world growth was 3.8%), with global inflation remaining below baseline thanks to the sharp drop in energy costs (see Figure 1.7).

Figure 1.7. World GDP under oil decline / growth surge scenario



Note: Data points to the right of the vertical line are forecasts.
Source: Oxford Economics.

1.4 Conclusion

A 'dual economy' pattern has developed during 2015, including in the UK, featuring solid growth in services and consumer spending but subdued or flagging activity in tradable sectors in the face of weak global demand growth.

For 2016, the international backdrop looks likely to be broadly similar to that in 2015. We expect a pick-up in growth in the G7 economies, including in the eurozone, which will support external demand for UK goods and services. But activity will remain weak in much of the emerging market world, with continued recessions in Brazil and Russia and the purchasing power of commodity producers more broadly sapped by unfavourable terms of trade.

The further recent drop in oil prices will also be a bonus for the UK and many of its key trading partners. Although there are also major losers from this development, the UK's economic exposure to these countries is relatively limited. Lower oil prices will support income growth along with a tightening labour market.

Some downside risks to global growth still exist. A sustained sharp drop in world equity prices – for example, in response to rising US interest rates – could hit world growth. There is also the danger of a faster-than-expected deceleration in growth in China as the authorities there engage in the difficult process of rebalancing the Chinese economy away from exports and investment to a more consumer-driven model.

There are also upside risks to world growth. A sustained further big drop in world energy prices could help world growth rise to around 3.5% by 2017, by boosting consumer and business confidence and equity prices and generating a faster upturn in investment and world trade growth.