

# 1. The global economy<sup>1</sup>

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## Summary

- The outlook for world growth at the beginning of 2013 looks brighter than a year ago, thanks to a decline in key ‘event risks’ such as a eurozone break-up, a Chinese hard landing and the ‘fiscal cliff’ in the US.
- US growth is expected to outpace growth in the other major economies over the next two years, reaching around a 3% annual rate by 2014. Upside risks to growth are also more prominent in the US than elsewhere.
- Although financial tensions have eased, the eurozone is likely to continue to contract in 2013, in part because of further fiscal tightening. Fiscal tightening will affect many of the UK’s other key trading partners, including the US and some emerging countries. Despite looser monetary policy, growth across all advanced economies will likely be modest in 2013 and not contribute meaningfully to higher world growth until 2014.
- Emerging economies such as China and India showed some signs of improvement in late 2012, and growth is expected to accelerate in both countries in 2013 and 2014, helped by policy stimulus during 2012 feeding through.
- World growth is forecast to rise from 2.3% in 2012 to 2.4% in 2013 and 3.4% in 2014. A key downside risk to this forecast remains the threat of a break-up of the eurozone, although the probability of this has diminished significantly since mid-2012. Plausible upside risks relate to more decisive policy action and a faster recovery of business confidence leading to a more rapid pickup in consumption and investment.

## 1.1 Introduction

Global growth decelerated during 2012 and is estimated to have dipped below 2% per annum in the final quarter of the year, which would be the slowest pace since the final quarter of 2009. World trade growth also fell back sharply to around 2%, from over 6% in 2011. This was an unfavourable backdrop for countries hoping for export-led recoveries, especially those simultaneously undertaking sizeable fiscal consolidations such as the UK.

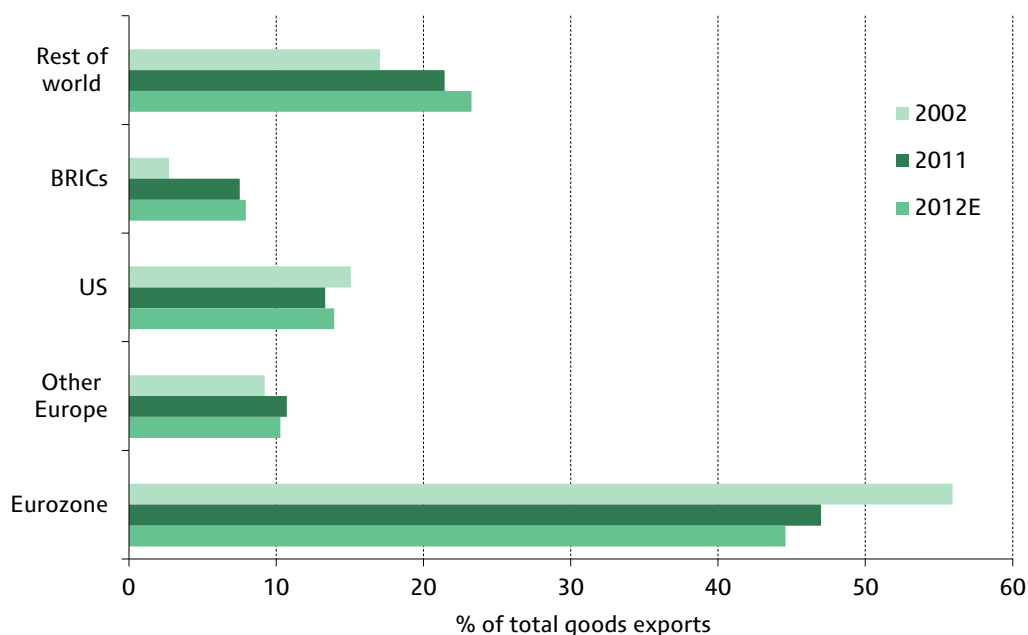
From a UK perspective, the descent of the eurozone back into recession was a particularly negative feature of the economic environment during 2012. The eurozone currently accounts for just under half the UK’s goods exports but the eurozone’s total imports shrank by an estimated 0.6% in 2012. Although other markets were more buoyant, the weakness of the eurozone was a heavy drag on UK export performance.

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<sup>1</sup> The Green Budget 2013 is funded by the Nuffield Foundation

UK export prospects will remain heavily dependent on eurozone economic developments despite a significant shift in export orientation towards non-eurozone markets in recent years, which continued in 2012 (see Figure 1.1). There should be some offset to muted

Figure 1.1. UK trade exposure



Source: Haver Analytics, Oxford Economics.

eurozone demand in the shape of a stronger US, however, and from key emerging markets such as China and India.

The UK also remains at risk from financial shock waves from the eurozone. The severe financial tensions seen in the eurozone in the first half of 2012 had a notable negative impact on the UK banking sector, forcing up its funding costs. Although eurozone financial tensions eased in the second half of the year, the risk of renewed surges in tensions remains high given the weak state of public finances and banking sectors in much of the eurozone. The chronic weakness of economies in the troubled 'peripheral' eurozone states such as Spain and Greece is also creating serious social and political tensions, which could still ultimately result in the splintering of the eurozone.

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

The eurozone financial crisis remained acute in the first half of 2012, with severe pressures on government bond markets in the fiscally-troubled 'peripheral' eurozone states such as Spain and Italy. Greece was obliged to undertake a significant sovereign debt restructuring in the first quarter and concerns that Greece might be forced out of the eurozone remained high for much of the year, peaking in May and June when the country held two general elections (the first proving indecisive). Markets also became very concerned about the situation in Spain as estimates of potential losses in the banking sector rose in the face of property market weakness and rising non-performing loans.

As eurozone break-up fears increased, the ‘peripheral’ states saw a significant drain of deposits from their banking systems, which led to a sharp monetary squeeze. The European Central Bank (ECB) was obliged to respond with a massive increase in lending to the banking systems of the ‘peripheral’ countries, with lending soaring by €500 billion in the first half of 2012.

With fiscal policy also tightening in the ‘peripherals’ by around 2% of GDP, output in this group of eurozone countries fell steeply in the first half of 2012, by just under 2% on a year earlier – continuing the bleak trend of recent years (see Table 1.1). In the ‘core’ eurozone states such as Germany and France, economic performance was more resilient, but the deep recessions in the ‘peripherals’, added to fiscal tightening and a slowdown in world growth, pushed these countries towards recession also as 2012 proceeded.

Table 1.1. Eurozone GDP and unemployment since 2008, selected countries

	<i>Change, 2008–12</i>	
	<b>GDP (%)</b>	<b>Unemployment (% points)</b>
<b>‘Core’ countries</b>		
Germany	2.7	–1.0
France	0.1	2.5
Netherlands	–1.9	2.6
<b>‘Peripheral’ countries</b>		
Ireland	–4.3	8.4
Spain	–4.9	13.7
Italy	–5.3	3.9
Portugal	–5.6	7.9
Greece	–19.5	16.6

Note: Based on estimated GDP data for 2012.

Source: Oxford Economics.

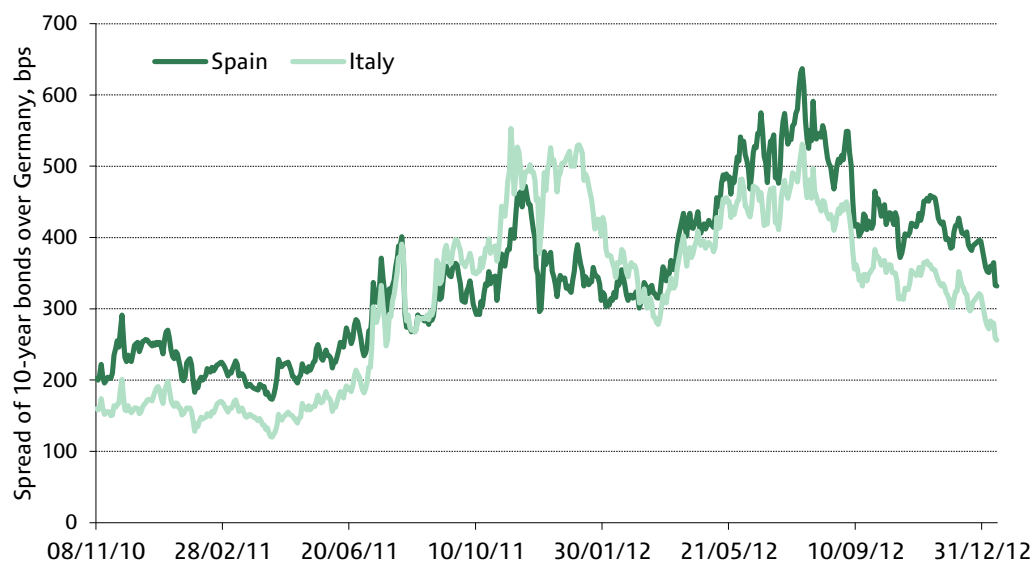
Financial tensions in the eurozone began to ease from the summer of 2012 in response mostly to significant action from the ECB, which promised at the end of July to ‘do what it takes’ to preserve the integrity of the eurozone. This was followed up by a plan allowing large-scale purchases of sovereign bonds by the ECB, if needed, to cap the borrowing costs of countries undergoing fiscal adjustment. There were also agreements to ease the fiscal adjustment programmes in Spain and Greece.

In the final months of 2012 and early 2013, financial tensions in the eurozone relaxed considerably. The ECB had not yet undertaken any of the government bond purchases promised earlier in the year, but its expressed willingness to do so if needed had proved an effective backstop for sovereign debt markets in the ‘peripherals’ and had started to stem the debilitating drain of bank deposits seen in these countries.

The spread between Spanish 10-year bonds and German bunds of the same maturity declined from nearly 640 basis points (bps, i.e. 6.4 percentage points) in July 2012 to 330bps by the second week of January 2013, as shown in Figure 1.2. There was also a sharp narrowing in the spread between Italian and German 10-year bonds over the same period, from 530bps to 260bps. Meanwhile, a surge in household deposits in Spain in November of €10 billion took them back to the level seen at the start of 2012. Even in

Greece, private sector deposits rose by €2.7 billion from September to November. Pressure on the ECB's balance sheet also eased from mid-2012, as demand from banks for

Figure 1.2. Eurozone government bond spreads



Source: Haver Analytics, Oxford Economics.

central bank loans eased. Loans to banks declined by €112 billion in the second half of 2012.

This recovery of bank deposits should help ease the severe monetary squeeze suffered by the 'peripherals' over the last eighteen months. At the eurozone-wide level, monetary conditions have also started to improve. Eurozone real broad money supply (M3) growth picked up from near-zero in mid-2012 to 1.7% on the year by November, the strongest expansion since mid-2009.

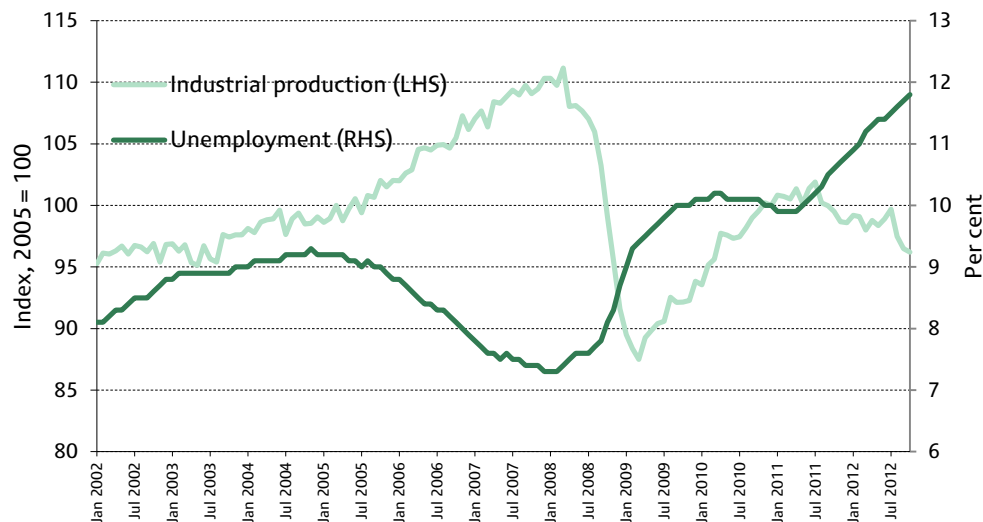
These monetary trends suggest a recovery in economic activity towards the end of 2013 and in early 2014. However, real activity in the eurozone has so far proved slow to respond to the easing of financial tensions. Eurozone GDP continued to decline in 2012Q3, and available indicators for Q4 point to a further contraction. The average level of industrial production in October–November 2012 was more than 2% down on that in Q3. In addition, the Purchasing Managers' Index (PMI) surveys suggested activity continued to contract in December in both manufacturing and services. Preliminary estimates suggest that the German economy, the eurozone's industrial heart, contracted by 0.5% in the final three months of the year compared with the previous quarter.

The slow response of output to eased financial tensions partly reflects time lags, but there are also other headwinds to growth in the eurozone.

First, while the banking system is no longer on the edge of the abyss, its condition remains precarious and credit conditions thus remain tight, curbing investment. Second, unemployment is continuing to rise, reaching 11.8% in November (see Figure 1.3). Unemployment is forecast to increase further to 12.5% by the start of 2014, as firms try to claw back losses in productivity seen in recent years.

Growth will also be held back by continued fiscal tightening, estimated to amount to just under 1% of GDP across the eurozone (compared with an estimated 1.3% of GDP in

Figure 1.3. Eurozone industrial output and unemployment



Source: Haver Analytics, Oxford Economics.

2012). Some recent evidence suggests that fiscal multipliers may be higher than previously thought,<sup>2</sup> potentially especially in the eurozone where individual countries cannot use monetary and exchange rate policy to offset fiscal cutbacks and where a group of countries with close trade links to each other are trying to achieve fiscal adjustment simultaneously. Against this background, a further contraction of eurozone GDP is expected in 2013 and it will not be until 2014 that growth resumes, with a forecast subdued rise in GDP of 1.1%.

This sustained weakness in economic activity, and the associated social costs, is likely to contribute to renewed bouts of financial tension in the eurozone, although the risk of a break-up of the euro currency in 2013 now looks reduced (see Section 1.3). The problem of low growth in the eurozone also looks set to persist well beyond 2013 and 2014. The need for substantial deleveraging by both the public and private sectors, plus a slow pace of economic and political reform, means that GDP growth is forecast to average only around 1.5% per annum from 2015 to 2019 – suggesting the eurozone faces ‘a lost decade’.

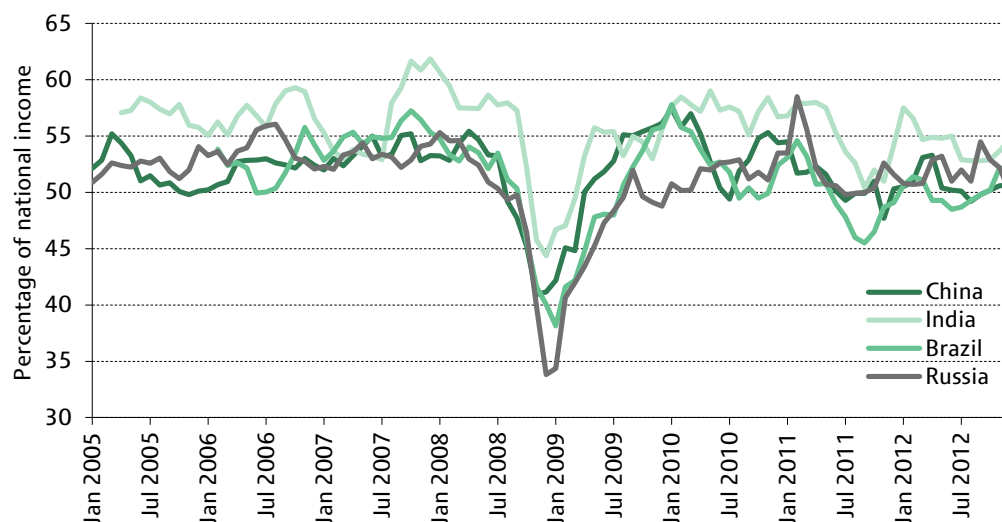
## Emerging economies

The main emerging economies also saw growth slowing during 2012. China’s GDP growth slowed from 9.3% in 2011 to an estimated 7.7%, India’s from 7.5% to 5.4% (the slowest pace for a decade) and, most strikingly, Brazil’s growth slowed from 2.7% to just 1.0%.

This slowdown was met with increased policy stimulus, including cuts in interest rates, and by the end of 2012 there was evidence that this was feeding through into firmer growth. Monthly indicators such as the manufacturing PMI surveys improved in China, Brazil and India (see Figure 1.4), with the Indian December PMI at a six-month high. Manufacturing activity also showed signs of strengthening in export-oriented Asian countries such as Korea, Taiwan and Thailand, suggesting an upturn in regional trade.

<sup>2</sup> See, for example, box 1.1 of IMF, *World Economic Outlook*, October 2012 (<http://www.imf.org/external/pubs/ft/weo/2012/02/pdf/text.pdf>) and O. Blanchard and D. Leigh, ‘Growth forecast errors and fiscal multipliers’, IMF Working Paper WP/13/1, January 2013 (<http://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>).

Figure 1.4. BRICs: manufacturing Purchasing Managers' Index



Notes: The PMI is an indicator produced by Markit Group by polling private sector companies. The chart shows results for activity in the manufacturing sector, with a reading above 50 indicating that activity is increasing. Source: PMI / Markit / China NBS.

As policy stimulus feeds through (and continues in some countries, most notably India), GDP growth in emerging economies is forecast to pick up this year. Growth is forecast to rise to 8.3% in China, 6% in India and 3.9% in Brazil. Further improvement is expected in 2014, with Chinese growth reaching 9%, Indian growth 7.5% and Brazilian growth around 5%. The rebound in Brazil will be helped by the strength of domestic demand. This is also a positive factor for Russia (offsetting some competitiveness issues), which is expected to grow by 3.6% this year and next.

One area that is lagging the general improvement in emerging countries is central and eastern Europe, which remains hobbled by its close trading links with the recession-hit eurozone. GDP growth is expected at close to zero in Hungary, slightly negative in the Czech Republic and just 1.6% in Poland.

The improved growth performance of the emerging countries in 2013 and 2014 should provide some help for UK exporters. Although UK firms have arguably been slow to respond to the economic opportunities in the 'BRIC' economies (Brazil/Russia/India/China) compared with exporters in countries such as Germany and the US, the picture is changing. Goods exports to the BRIC group reached almost 8% of the UK total in the first nine months of 2012, rising by around 11% year-on-year.

## Japan

The Japanese economy started 2012 brightly but deteriorated as the year proceeded. Government incentive schemes boosted household consumption in Q1, but this effect soon wore off and, with export demand damaged by slowing world trade and the strength of the yen, the economy returned to recession in Q3, with a further contraction in output likely to have occurred during Q4.

Prospects for 2013 look better as a result of a substantial weakening of the yen late in 2012, of around 10% on a trade-weighted basis. This followed promises of much more aggressive monetary easing by the new Liberal Democratic Party government, which won a landslide election victory in December. Part of the new policy approach may be a shift

to a 2% CPI target, up from 1% currently. The government has also proposed a fiscal stimulus of just over 1% of GDP for 2013, which should boost growth further. GDP growth is expected at 0.5% in 2013, rising to 1.7% in 2014. Demographic pressures will nevertheless weigh on domestic demand growth and on long-term potential GDP growth, which is estimated at less than 1% per annum.

## US

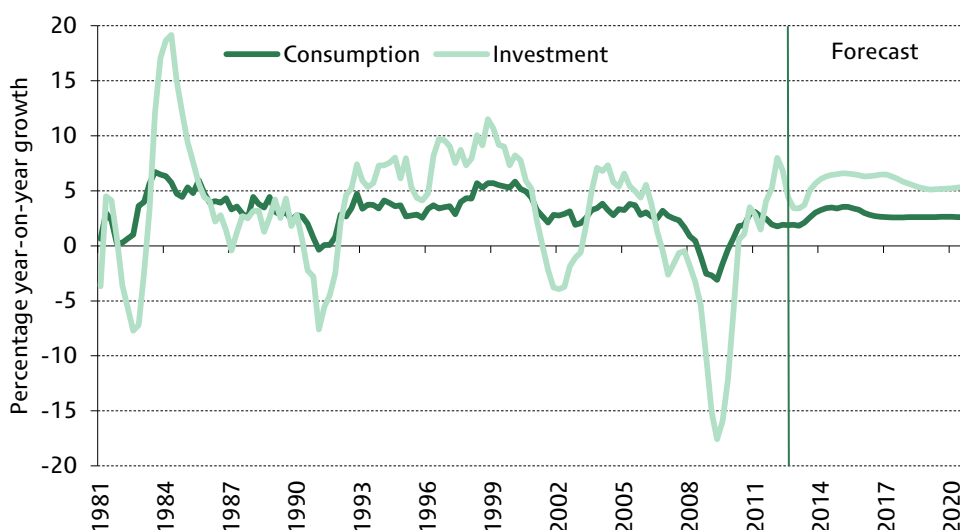
The US economy grew by an estimated 2.3% in 2012, a relatively modest pace (although one of the strongest performances amongst the major economies last year). Growth prospects have improved in recent months though, due to both political and economic factors.

On the political side, a deal in early January of 2013 averted the ‘fiscal cliff’, which risked a sharp tightening of fiscal policy and a renewed recession. The deal avoided sharp rises in taxation, although some increases on higher incomes were agreed. Some fiscal risks do remain, however. The sharp automatic spending cuts that were due to kick in at the start of 2013 have only been delayed until March, and it is unclear to what extent these will ultimately be scaled back. An agreement is also still needed to raise the debt ceiling.

On the basis of the deal agreed in January 2013 and assuming no additional near-term spending cuts (we assume substantial spending reductions are delayed into the medium term), the US is expected to see fiscal tightening of around 1.4% of GDP in 2013 and 1.0% of GDP in 2014. But this pace of tightening looks manageable (a fiscal tightening estimated at around 1% of GDP occurred in 2012).

Meanwhile, a number of key economic indicators showed signs of improvement in late 2012. In particular, consumer spending picked up strongly in November and consumer confidence has also improved. Core durable goods orders posted healthy back-to-back monthly rises in October and November, suggesting investment activity may be accelerating after a sticky patch in mid-2012. Both consumption and investment are forecast to strengthen during 2013 and 2014 (see Figure 1.5), with consumer spending supported by a fall in unemployment to 7% by end-2014 from 7.8% now.

Figure 1.5. US consumption and investment growth



Source: Oxford Economics.

Growth should also be underpinned by a steady recovery in the housing market, aided by Federal Reserve purchases of mortgage-backed securities, which will hold down mortgage rates. US house prices were up 4% year-on-year in October and housing starts were up over 20% year-on-year in November. Deleveraging pressures on US households have already showed signs of easing, and rising wealth should help maintain and even reinforce this trend.

US GDP growth is forecast at 2.3% in 2013, with annualised growth reaching 3% by the second half of the year and a 3% pace of growth maintained into 2014. Over the medium term, the US economy will also benefit from the 'shale gas revolution', which offers cheaper energy costs, and the substantial improvement in relative competitiveness achieved in recent years thanks to the weak dollar and relatively strong productivity performance.

Risks to the forecast look more balanced than a year ago. The reduction in 'fiscal cliff' risk may spur faster-than-expected investment growth through improved business sentiment. In addition, monetary stimulus has been increased in recent months even though US monetary trends were already improving. The Federal Reserve announced further asset purchases in December, taking its total planned purchases to US\$85 billion per month. Importantly, the Fed has also pledged to continue this rate of purchases until the labour market shows substantial improvement. Monetary conditions are already more favourable in the US than in the eurozone or the UK, with money supply and credit measures growing at a healthier rate in the US. So the Fed's pledge of strong additional monetary stimulus in our view adds to the likelihood that US economic growth will substantially outpace growth in Europe in 2013 and 2014.

Strength in the US should be good news for the UK, given the importance of the US as a trading partner. Some 14% of the UK's goods exports go to the US, and the fractions of services and 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.

## **Global outlook**

Overall, the outlook for global growth at the beginning of 2013 looks brighter than a year ago, when the main focus was very much on the danger of renewed recessions in a number of the advanced economies.

At the start of 2012, financial market strains centred in the eurozone had driven stock markets in the main advanced and emerging countries 10–20% down on the year, weighing on business and consumer confidence. At the start of 2013, by contrast, global stock markets are 15% higher than a year ago and European markets almost 20% higher.

This turnaround is largely thanks to a decline in key 'event risks' such as a eurozone break-up, a Chinese hard landing and the 'fiscal cliff' in the US. World growth is forecast to rise from 2.3% in 2012 to 2.4% in 2013 and 3.4% in 2014 (see Table 1.2).

Our forecasts for near-term growth are generally close to consensus, although it is worth noting that the range of forecasts for many key countries (for example, Japan and the UK) is relatively wide, implying significant remaining uncertainty about growth prospects (see Table 1.3).



Table 1.2. Summary of international forecasts

Real GDP growth	2011	2012	2013	2014	2015	2016
<b>North America</b>						
United States	1.8	2.3	2.3	3.1	3.3	2.9
Canada	2.6	2.0	1.7	2.9	2.8	2.6
<b>Europe</b>						
Eurozone	1.5	-0.5	-0.2	1.1	1.4	1.5
Germany	3.1	0.9	0.7	1.9	1.7	1.6
France	1.7	0.0	0.0	1.1	1.2	1.3
Italy	0.6	-2.1	-1.2	0.3	1.1	1.2
UK	0.9	0.1	1.0	2.1	2.4	2.5
EU27	1.6	-0.3	0.1	1.4	1.8	1.8
<b>Asia</b>						
Japan	-0.5	2.0	0.5	1.7	2.1	1.2
China	9.3	7.7	8.3	9.0	8.5	8.0
India	7.5	5.4	6.0	7.5	7.9	7.8
<b>World</b>	2.9	2.3	2.4	3.4	3.7	3.5

Source: Oxford Economics.

From a UK perspective, 2013 still looks likely to be another challenging year. Despite looser monetary policy, economic growth in the advanced economies as a whole will be modest in 2013 and they will not contribute meaningfully to higher world growth until 2014.

A key problem is weakness in the eurozone, stemming partly from fiscal tightening there. But fiscal tightening will also be significant in many of the UK's other key trading partners. Indeed, taking forecast fiscal adjustments across the UK's top 20 trading partners and weighting them by export shares,<sup>3</sup> the weighted average fiscal adjustment in 2013 is estimated at 0.8% of GDP, only fractionally down from 0.9% of GDP in 2012. As well as the eurozone, fiscal tightening in 2013 will be significant in the US and in emerging trading partners such as India, Hong Kong and Korea (see Figure 1.6).

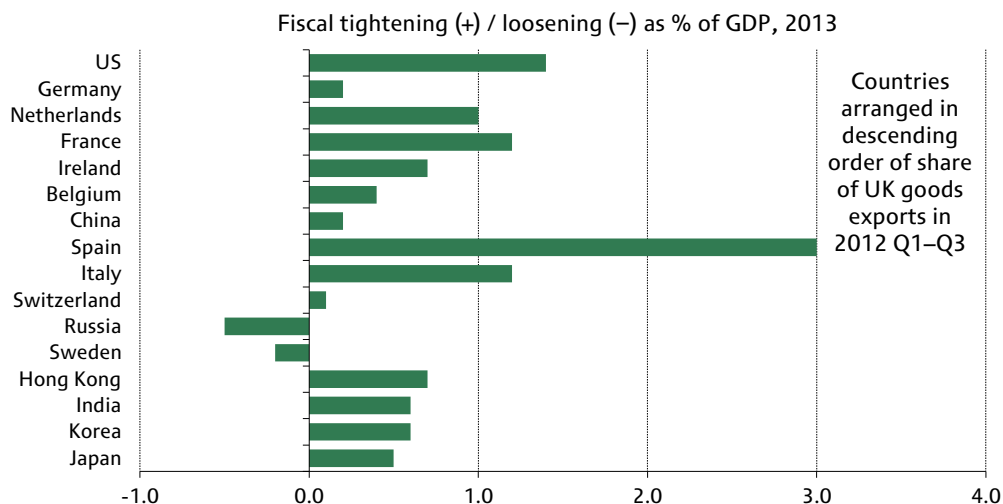
Table 1.3. Key GDP forecasts for 2013 compared with consensus

	OE forecast	Consensus	Consensus range
US	2.3	2.0	1.4 to 2.4
Eurozone	-0.2	-0.1	-0.8 to 0.5
Japan	0.5	0.7	0.2 to 2.2
UK	1.0	1.0	0.2 to 2.0
China	8.3	8.1	7.4 to 9.0

Source: Oxford Economics, Consensus Economics (14 January 2013 edition).

<sup>3</sup> Exports of goods only were used to calculate geographical export shares, due to availability of data for 2012.

Figure 1.6. Fiscal tightening in the UK's key trading partners



Source: IMF, Oxford Economics.

### 1.3 Risks to the global economy

The reduction in 'event risks' during 2012 means we have become more confident about our forecasts. We ascribe a 60% probability to an outcome similar to that shown in our central forecast, compared with a probability of 45% a year ago.<sup>4</sup> Nevertheless, there are still a number of possible alternative scenarios, in which global growth could diverge significantly from our baseline. We cover the key scenarios for the global economy below and assess their possible implications for the UK economy in Chapter 2.

#### Multiple eurozone Exits

The first set of alternative scenarios relates to the possibility that the eurozone financial crisis culminates in the exit of several countries from the euro currency. Although the likelihood of eurozone exits has arguably declined over the last six months, we still view this as a major downside risk for the global economy, and especially for the UK.

The most likely trigger of a eurozone break-up would be rising social unrest. Although policy actions since mid-2012, most notably by the ECB, have reduced the risk of countries being pushed out of the euro by market pressures, the outlook for many countries nevertheless remains one of grinding austerity for a lengthy period accompanied by rising unemployment. Against this background, remaining in the euro may become increasingly unpopular in the countries enduring the sharpest fiscal adjustments.

Meanwhile, as more bailouts appear necessary, creditor governments may find it increasingly difficult to get those transfers approved by their parliaments and electorate. In this context, some countries may either opt to leave the eurozone or be forced to do so. Greece would probably be the first country to exit given the size of its challenges, but we think that multiple eurozone exits are more likely than just a Greek exit. Indeed, the cost of keeping other 'peripherals' in the eurozone once one country leaves could be high, as

<sup>4</sup> See A. Slater, 'The global economy', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2012*, IFS Commentary 122, 2012 (<http://www.ifs.org.uk/budgets/gb2012/12chap1.pdf>).

exit by one country would be likely to set off a chain reaction of contagion in other 'peripherals', pushing up their government bond yields and leading to runs on their banks.

A number of possible variants of this kind of scenario exist, but for the purposes of the Green Budget we quantify the impact of Greece, Portugal, Ireland, Spain, Italy and Cyprus leaving the eurozone in 2014Q1. We assign a 15% probability to this scenario, compared with a 10% probability estimated at the time of last year's Green Budget and a 30% probability estimated in mid-2012.

Under the scenario, the new currencies in the exiting countries depreciate very sharply, reflecting the overvaluation of their real exchange rates after years of deteriorating relative competitiveness. The new currencies are also likely to undershoot their fair value. Moreover, the introduction of new currencies in the exiting countries gives rise to substantial costs related to the redenomination of contracts from euros into the new currencies, including legal costs. The depreciations lead to a surge in inflation, which the new central banks respond to by raising interest rates from 0.75% (the current ECB rate) to high single digits.

Banks in the exiting countries face runs as depositors try to place their money in safer institutions. For the residual eurozone and the rest of the world, the series of defaults on external debt by the exiting countries' governments and companies have a significant impact on banks' balance sheets. Credit conditions tighten by as much as they did in 2008-09.

The residual euro is likely to weaken initially, as turmoil significantly dampens the value and return prospects of investment in the eurozone. As activity stabilises and the eurozone emerges as a more stable entity, the euro exchange rate may appreciate.

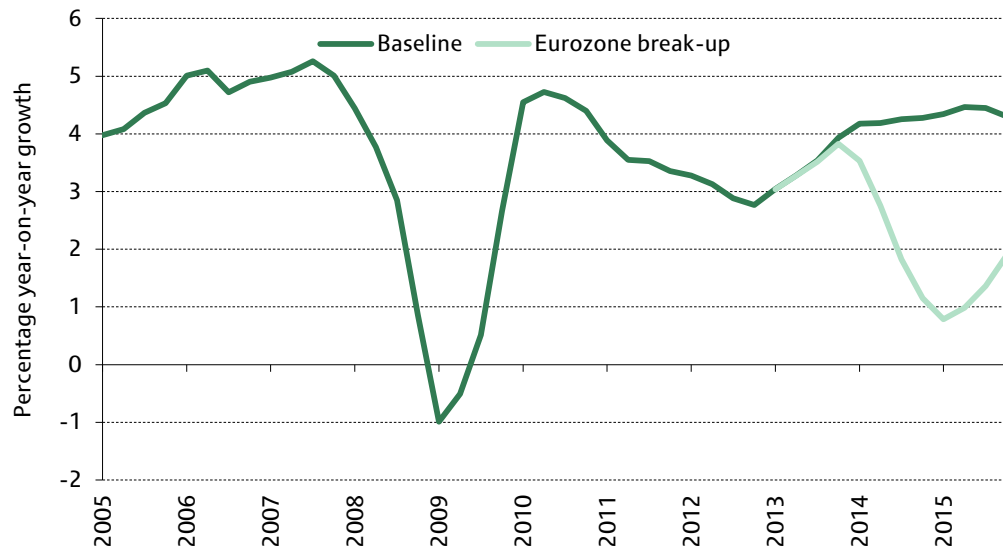
Outside of the eurozone, heightened uncertainty causes stock markets to sell off sharply. Business confidence is dampened by the weaker outlook and increased uncertainty. This in turn has a negative impact on investment spending and employment in all advanced countries. In addition, trade linkages with the eurozone depress demand for exports.

The results of this scenario in terms of the impact on economic growth are subject to considerable uncertainty, especially for the exiting countries, where it is unclear to what extent a sharp currency depreciation will offset the extreme shock to business and consumer confidence of a euro exit (this is especially the case for countries such as Greece where GDP has already dropped sharply).

Our estimate is that, in the near term, the negative shock effects of euro exit will dominate for the departing countries, so that they will initially suffer double-digit declines in GDP. The remaining eurozone countries would also be plunged into a deep recession, with GDP falling as much as 10% below the level in our central forecast.

The scale of the financial shock generated by the euro break-up would also be sufficient to have a severe impact on growth elsewhere in the world. US GDP would fall around 5% below the level in our central forecast, with a mild recession in 2014. The UK would suffer a more severe downturn due to its closer trade and financial links with Europe, with GDP forecast to be about 9% below baseline by 2016. Even in China, GDP growth would drop below 5% in 2015 (as opposed to our central forecast of 8.5% growth) thanks to the effect of weak world growth on exports and the large scale of the financial shock which would damage local asset markets and push down foreign direct investment (FDI). The

Figure 1.7. World GDP under eurozone break-up



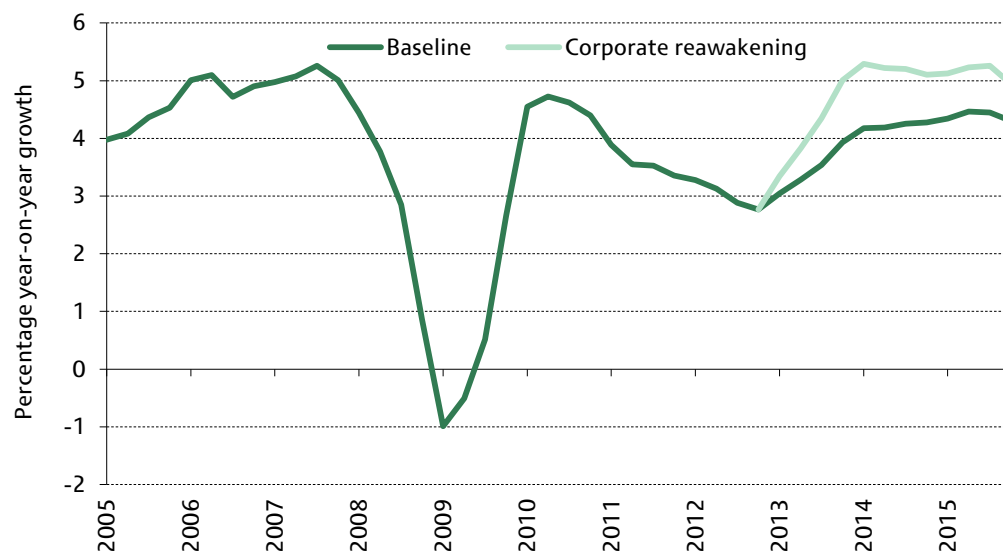
Source: Oxford Economics.

GDP impact on the smaller Asian emerging economies would also be large, especially for those highly geared to exports, such as Singapore and Taiwan.

### Corporate reawakening

As well as the downside scenario outlined above, there are also possible upside risks to our central forecast. Our baseline forecast assumes that the policy process in 2013 and beyond will be similar to that seen in recent years. In particular, in the eurozone, we expect piecemeal action on setting up a banking union and moving towards fiscal union. In the US, the most likely scenario is that, although the full fiscal cliff is avoided, no agreement is reached on a medium-term fiscal plan to reduce public deficits and debt.

Figure 1.8. World GDP under corporate reawakening



Source: Oxford Economics.

But positive surprises are possible. For instance, eurozone policymakers have sometimes taken action that surpassed our expectations, such as the ECB's very strong commitment to 'do what it takes' to save the eurozone last July.

More decisive policy action, such as a 'grand bargain' in the US to address the country's short- and medium-term fiscal challenges or a decisive move towards the institutional reform of the eurozone needed to secure the integrity of the euro currency, would create the right environment for companies to start using their large cash holdings more productively, raising investment and recruitment. This would enhance confidence, leading to a quick recovery in demand (Figure 1.8). In this scenario, US GDP would likely grow by over 3% in 2013 and accelerate to 4.6% in 2014, whereas in the eurozone economic activity would likely expand by around 0.4% in 2013 and 2.1% in 2014. We attach a slightly higher probability of 15% to this scenario, compared with 10% at the time of last year's Green Budget.

## 1.4 Conclusions

With the UK aiming to rebalance its economy towards exports and investment, the outlook for the global economy is of key importance. Recent months have seen signs that downside risks to world growth have diminished and growth prospects improved, and this bodes well for the UK.

However, external conditions will remain challenging for the UK in the near term at least. The eurozone economy is expected to contract again in 2013, and growth prospects are also weak for the eurozone in the medium term due to the damage wrought by the financial crisis there and the need to undertake substantial public and private sector deleveraging. Although the eurozone's importance as an export market for the UK is declining, it remains substantial, so weak eurozone growth will weigh on UK trade performance. The UK's financial links with the eurozone also make it vulnerable to any renewed upsurges in financial stress there (see Chapter 2).

Stronger growth in the US and emerging markets will help to boost world growth and trade in 2013, but the forecast pickup in world growth is modest and only in 2014 will something like trend rates of global growth be reached. One important factor holding back world growth in 2013 is that fiscal tightening will be undertaken in a wide variety of countries beyond the eurozone, including the US and some emerging countries. This will be offset to some extent by the impact of the loosening in monetary policy seen in recent months in the US and elsewhere.

Key risks such as a eurozone break-up, China hard landing and the US 'fiscal cliff' have diminished in recent months, but downside risks to global growth remain, including the possibility that some countries eventually leave the euro. Eurozone exits would have a severe negative impact on economic growth across the major advanced and emerging economies.

There are also upside risks to world growth – for example, from more decisive policy actions in the eurozone and US to tackle fiscal issues. This could lead to a faster recovery of business confidence and increased hiring and investment. The probability of a scenario of this sort appearing unfortunately remains low, however.