

3. The global economy

Adam Slater (Oxford Economics)

Summary

- The outlook for the global economy in 2014 is for an improving growth picture overall, but with considerable divergences in economic performance among key economies and regions.
- We forecast US growth to top 3% in 2014, with a similar pace of growth next year. Consumer spending is picking up and will be supported by improved labour market conditions and wealth gains. An easing of fiscal austerity will also bolster US growth from 2014.
- The outlook is more mixed in the Eurozone, where trends among member states are very varied. A reduced fiscal squeeze will help growth from 2014, as will improving external demand. But while Germany should post respectable growth this year, growth will remain weak at around 0.5% in Italy, France and Spain.
- Emerging economies slowed in 2013 and while we expect Chinese growth to level off at around 7% in 2014–15, growth is set to remain below trend this year in Brazil, Russia and India, where structural obstacles to continued rapid growth are becoming evident.
- World growth is forecast to rise from an estimated 2.2% in 2013 to 2.9% in 2014 and 3.2% in 2015, representing a gradual recovery towards a trend rate of expansion.
- A key downside risk to this forecast is the possibility of a slide into deflation in the Eurozone. Plausible upside risks relate to a faster recovery in the US and to more decisive reforms in the Eurozone and Japan.

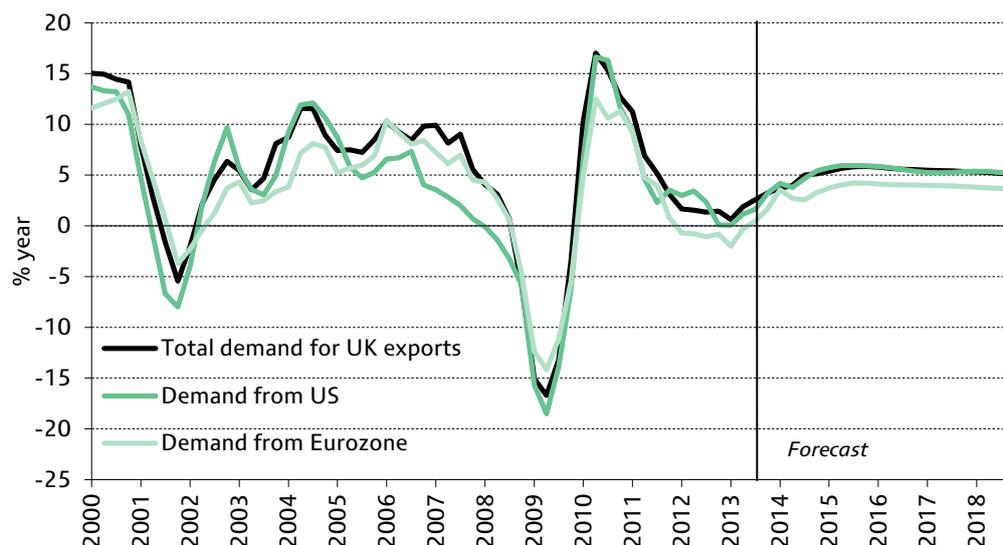
3.1 Introduction

Global growth ran at a below-trend rate estimated at 2.2% in 2013, down from 2.3% the year before. Once again, world trade growth was also weak in 2013, at an estimated 2.7% – the same rate as in 2012 and well below the average rate of 6% per year seen over the last two decades. This was a limiting factor for heavily export-oriented economies and for those seeking to achieve export-led expansions in the face of weak domestic activity.

One factor behind the slow growth of world trade was continued economic weakness in the Eurozone. Although the Eurozone returned to slightly positive growth in the second half of the year after six quarters of recession, import volumes were stagnant over the year, and the Eurozone accounts for around a quarter of world trade.

From a UK perspective, the sluggish Eurozone was a considerable drag on export performance despite more buoyant markets elsewhere and some rebalancing of UK exports away from the Eurozone and towards the rest of the world. Eurozone imports will continue to grow more slowly than those in other key UK trading partners, but a stronger US will nevertheless help overall UK export demand firm considerably in 2014–15 (see Figure 3.1). The slow growth of the Eurozone forecast for 2014 will continue to

Figure 3.1. UK export demand



Source: Oxford Economics / Haver Analytics.

constrain UK export performance, although this will be offset to some extent by a stronger US.

Overall, the Eurozone represents less of a threat to UK growth prospects than was the case a year ago, thanks to a considerable decline in financial stress in the region. The risk of a splintering of the Eurozone has receded considerably, even though deep-seated economic and financial problems remain in some of the ‘peripheral’ Eurozone states such as Greece and Portugal, as has the danger of further sovereign debt defaults. The Eurozone banking system, while still troubled, is also less likely to transmit further financial shocks to the UK. Probably the more potent near-term risk for the UK now is that the Eurozone slides into deflation, which would be likely to mean an even weaker growth outlook for the region.

Our forecast for the global economy is set out in Section 3.2, while Section 3.3 describes the key risks to this forecast. Section 3.4 concludes.

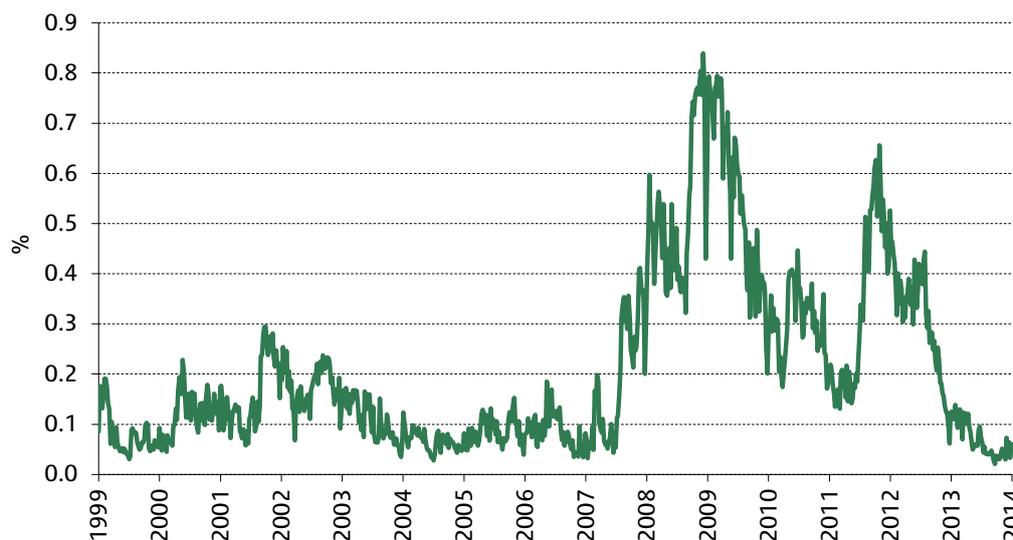
3.2 Global outlook

Eurozone

Financial stress has receded considerably in the Eurozone over the last year. The European Central Bank (ECB)’s composite measure of financial strain fell steeply in the second half of 2012 and an additional decline was seen in 2013 so that in recent months it has been running at its lowest level since 2006 (see Figure 3.2). Concerns about the fiscal positions of the troubled ‘peripheral’ economies also lessened over the year, with a marked drop in government bond spreads in countries such as Spain, Portugal and Ireland. The financial crisis in Cyprus in March/April showed that Eurozone financial problems have not receded entirely, but this crisis proved to be contained, not leading to significant contagion to other Eurozone member states.

This improvement in financial conditions in the Eurozone occurred even though the ECB was not obliged to follow through on its promise from 2012 to do whatever was necessary to preserve the integrity of the euro currency – specifically, undertake large-

Figure 3.2. Eurozone financial stress



Note: ECB composite measure of financial stress.

Source: Oxford Economics / Haver Analytics.

scale government bond purchases. The ECB's expressed willingness to engage in such measures has so far proved an effective backstop for sovereign debt markets in the 'peripherals'.

The relaxation of financial tensions in 2012 and 2013 has slowly fed through to the real economy in the Eurozone. The region emerged from a six-quarter recession in 2013Q2, and survey indicators of activity firmed as 2013 proceeded. The composite PMI indicator improved from 48.6 in January, indicating contracting activity, to 52.1 by December - clearly above the 50 level indicating expanding output.¹

The hard data in the Eurozone have, if anything, lagged the survey indicators, with GDP growth only 0.1% in 2013Q3. Against this background, there is a risk that the Eurozone could slip back into technical recession in 2014, although on balance we think this eventuality will be avoided. Aside from the survey evidence, industrial output in October–November was 0.3% above the quarterly average of Q3 and consumer spending also showed signs of life in November, with Eurozone retail sales rising by 1.4% on the month and 1.5% on the year.

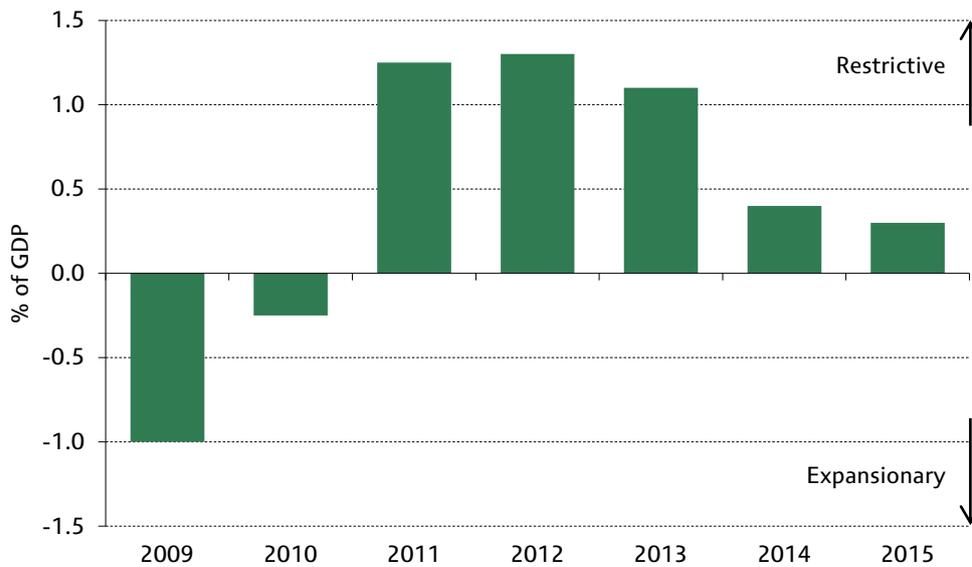
The very modest recovery we expect for the Eurozone in 2014 will nevertheless remain a fragile one, heavily dependent on improving external demand. Export growth is forecast to rise from 1% in 2013 to 3% in 2014, with net exports accounting for around half of total GDP growth. A further acceleration in export growth to 4% is expected in 2015.

This implies downside risks to growth if world activity fails to pick up as we expect, and also if the euro does not depreciate as we expect. We currently forecast a decline in the euro/dollar rate to 1.27 year-end, from around 1.36 at the start of 2014.

Another factor supporting a pick-up in growth in the Eurozone in 2014 and beyond should be an easing in fiscal austerity. Although fiscal policy will continue to tighten, the squeeze will be far less severe than was the case in 2011–13. We estimate that Eurozone

¹ The purchasing managers' index (PMI) is an indicator produced by Markit Group by polling private sector companies.

Figure 3.3. Eurozone fiscal tightening



Source: Oxford Economics.

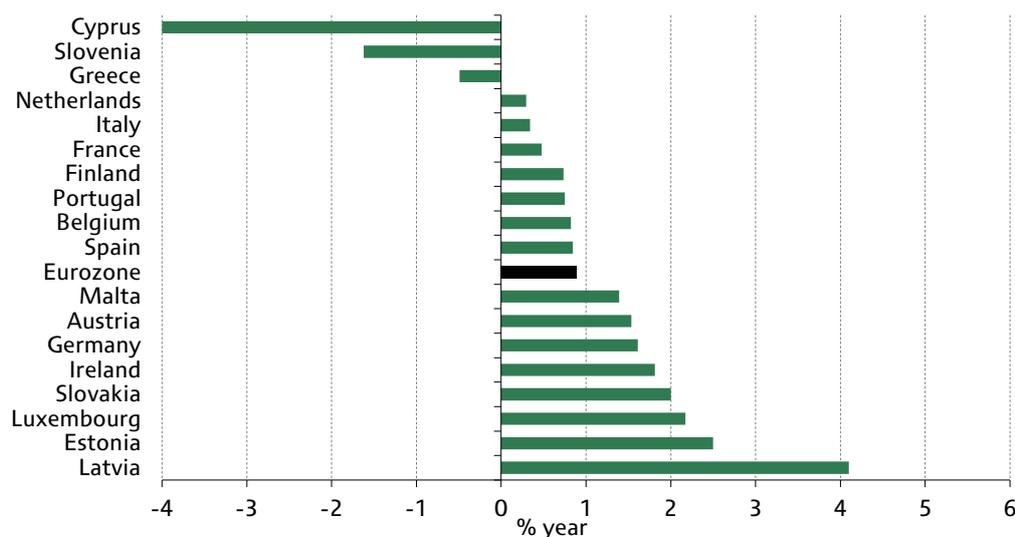
fiscal tightening will be 0.4% of GDP in 2014 and 0.3% in 2015, compared with around 1% of GDP per year in 2011–13 (see Figure 3.3). Reduced pressure from financial markets and the European Commission may even allow a little fiscal slippage, constituting a modest upside risk to our GDP forecasts.

On the monetary policy side, the outlook is more clouded. The ECB did cut interest rates twice in 2013, to 0.25%, but money and credit measures remain subdued. Broad money supply growth in November was very muted at just 1.5% on the year, well below the medium-term reference level of 4.5% the ECB has used in the past, and credit to the private sector continues to contract. Loans to non-financial firms were some 6% lower on the year in November and loans to households were down by 0.3%.

Meanwhile, inflation in the Eurozone declined sharply in the second half of 2013, and stood at just 0.8% year-on-year in December. With prices already falling or static in a number of Eurozone states, there are now concerns that the region as a whole could slide into deflation. The ECB has stated that it is prepared to take further monetary policy action to ward off this risk, but with interest rates already close to zero the limits of ‘conventional’ monetary policy have almost been reached. As yet, it remains unclear what alternative approaches the ECB might take if deflation risks persist. A shift to full-blown quantitative easing still looks to be unlikely in the face of political and institutional obstacles, but a cut in the rate paid on banks’ deposits at the ECB or a fresh injection of liquidity into the banking sector are possibilities.

Fiscal and monetary forces are operating unevenly across the Eurozone and this is contributing to an uneven pace of growth across the region, which we expect will continue into 2014. Germany already has a balanced budget and moderate private debt levels, has benefited from capital inflows from weaker countries (boosting domestic liquidity and asset prices) and has a strong competitive position thanks in part to key reforms over the last 15 years. We expect GDP growth to reach a respectable 1.6% this year.

Figure 3.4. Eurozone: forecasts for GDP growth in 2014



Source: Oxford Economics.

But growth is likely to be much weaker in the other large Eurozone economies – France, Spain and Italy – at around 0.5% (see Figure 3.4). These countries still face significant headwinds from fiscal tightening, impaired banking sectors and (especially in the case of France) a lack of structural reforms. These countries also suffer from excessive private sector debt, and the need to reduce private debt burdens will be a drag on growth into the medium term. Ongoing deleveraging will be one of the factors, added to poor demographics and a slow pace of economic and political reform, that will constrain Eurozone GDP growth to an average of only around 1.5% per annum from 2015–18.

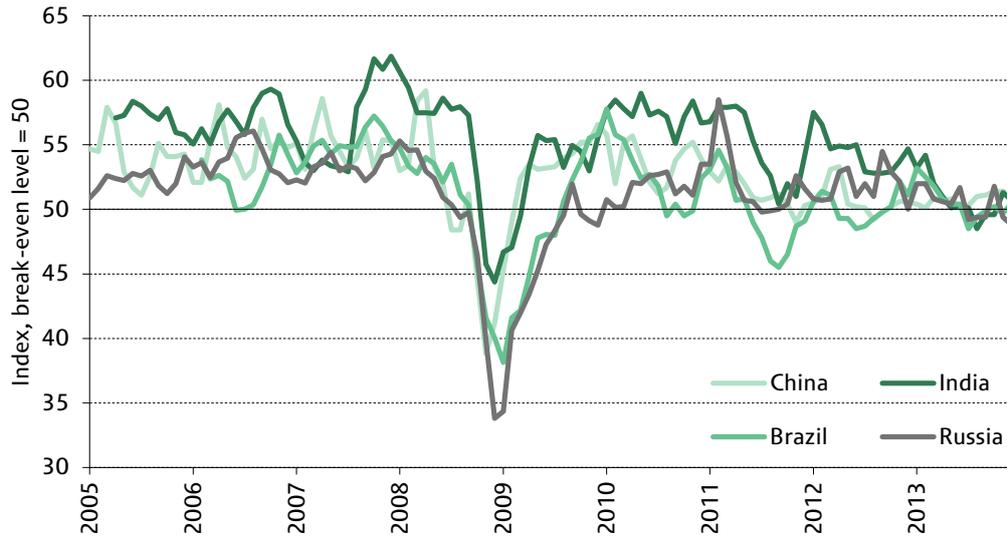
Emerging economies

The main emerging markets had a generally disappointing year in 2013, with growth slowing notably. One factor behind this was the efforts by the Chinese authorities to switch away from an investment- and export-driven growth model to one more focused on consumer spending. The problems with managing such an adjustment were illustrated during the year by a number of significant spikes in interbank interest rates, and import growth remained relatively subdued by the standards of recent years, constraining the expansion of regional trade and proving a challenge for the smaller export-oriented economies of Asia such as Korea and Taiwan.

Chinese growth came in at 7.7% for 2013 but we expect it to slow to just above 7% in 2014–15. This will be a more modest pace than over most of the last decade, but hopefully a more sustainable one. Economic underperformance has been more marked in the other three 'BRIC' economies – Brazil, Russia and India – which appear to be facing structural impediments to continued rapid growth. As 2013 drew to a close, monthly indicators suggested few signs of an upturn. The PMI indicators for India, Russia and Brazil were all suggesting either contraction or very slow growth (see Figure 3.5).

Many emerging economies also suffered a financial shock from mid-2013 onwards as the Federal Reserve began preparing markets for its tapering of asset purchases. This forced up US bond yields, drawing capital away from emerging countries and resulting in sharp falls in some emerging market currencies. This in turn raised inflationary pressures, hurting consumers, and forced up interest rates in many emerging countries, further

Figure 3.5. BRICs: manufacturing purchasing managers' index



Note: The purchasing managers' index (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 / Haver Analytics.

damaging growth. A number of key emerging countries (especially those with vulnerable external positions – for example, large current account deficits) were obliged to conduct essentially pro-cyclical economic policies – tightening monetary conditions in the face of slow growth.

We expect these negative factors to ease only slowly through 2014, especially as US interest rates are likely to drift higher as Federal Reserve tapering proceeds. As a result, both Russia and Brazil are forecast to post below-trend GDP growth of 1.9% and 1.7% respectively this year. In India, growth is expected to improve only slightly, to 4.9%, and 2013 and 2014 are set to be the weakest back-to-back years for India's economy in a decade.

Overall, emerging market GDP growth is forecast at 4.5% for 2014, up from 4.2% in 2013. This compares with 7–8% growth in the period prior to the global financial crisis of 2008–09. Nevertheless, the emerging markets should still offer significant opportunities for UK exporters, especially compared with the Eurozone where growth will be much lower. In November 2013, UK export volumes to the EU were down 1.4% on the year while exports to non-EU countries were up 8.6% on the year. UK goods exports to the BRIC countries were up around 9% on the year in value terms in the first 11 months of 2013, with sales to China especially buoyant.

Japan

Japan's economy reacted positively to the strong fiscal and monetary stimulus policies undertaken during 2013, and especially to the weakening of the yen, which depreciated around 20% over the year. Economic growth is estimated at 1.7% for last year, and we expect the positive momentum to continue into 2014, with growth reaching 1.8%.

Surveys of business sentiment are buoyant, with the Tankan survey at its strongest since the end of 2007 and the manufacturing PMI at a seven-year high. The Bank of Japan also

plans to engage in asset purchases of over 10% of GDP this year for a second successive year, with a strong chance that monetary stimulus will be extended even beyond this. Meanwhile, Japan has made considerable progress in escaping from deflation, with the headline consumer price index (CPI) reaching 1.6% in November 2013 from -0.9% last March. By contrast, government bond yields have remained contained at just 0.7% in the 10-year maturity, implying a shift from strongly positive to negative interest rates.

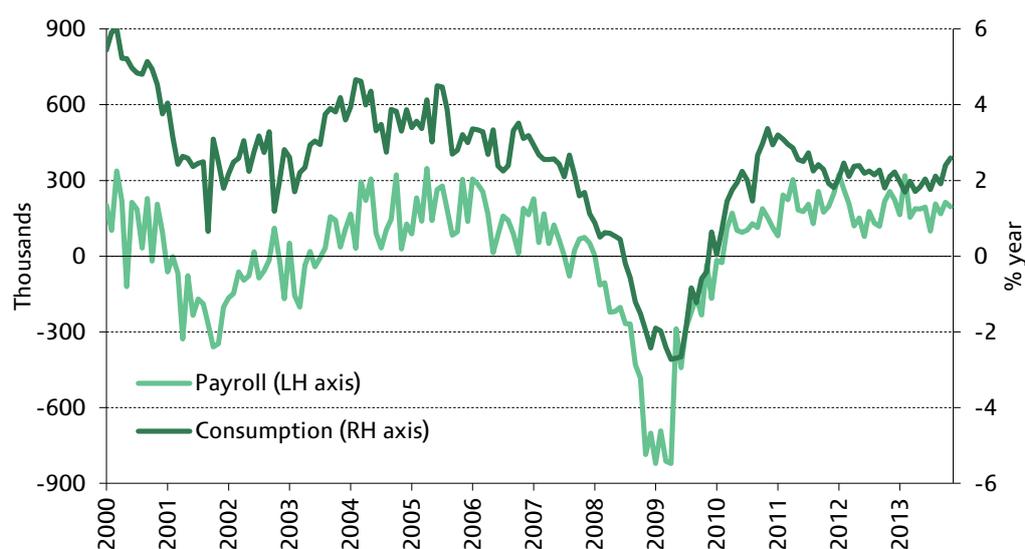
We expect further yen weakening during 2014 and 2015 thanks to loose monetary policy and a generally stronger dollar environment, which will help support growth in Japan. There is a significant downside risk to growth over the next two years in the form of the large planned increase in the consumption tax (from 5% to 10% in two steps, the first in April this year). Given that this increase has been announced well before the event, we may see a boost to spending prior to April, but spending is likely to fall back sharply in the aftermath and the net effect will be negative. However, with the labour market gradually improving and exports and investment expected to pick up further, the consumption tax rises should not derail the current economic expansion.

US

US economic growth accelerated in the second half of 2013 but is nevertheless estimated to have reached 1.9% for the whole year, a relatively modest pace. Growth was held back by the considerable fiscal tightening that resulted from political disputes over the budget in the early part of the year. This fiscal tightening amounted to an estimated 1.4% of GDP for the year as a whole, with further disruption caused when renewed political wrangling resulted in a temporary government shutdown in October.

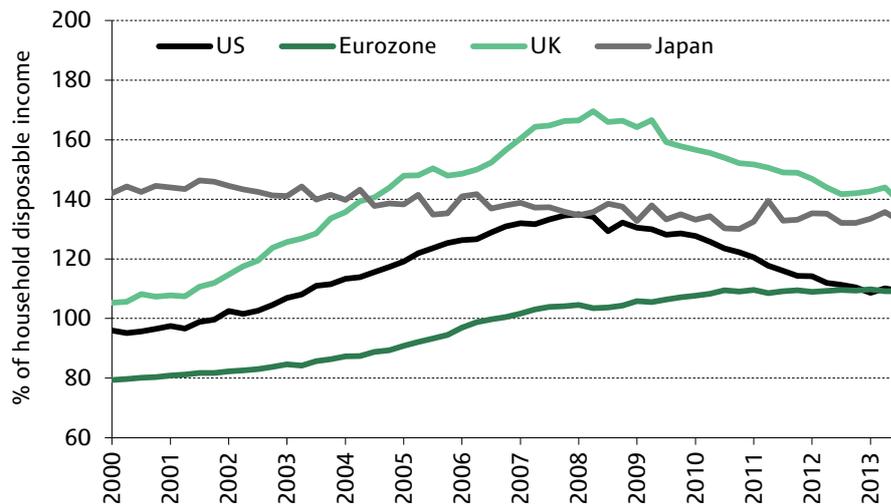
Despite the drag from fiscal policy, however, GDP growth looks to have exceeded 3% at an annual rate in the second half of 2013. Importantly, consumer spending, which was subdued for much of 2013, accelerated in the final months of the year (see Figure 3.6), rising at a 5% annualised rate in the three months to November. This may be traced to a combination of an improving labour market (with jobs growth averaging around 190,000 per month in 2013) and strong wealth gains resulting from rising stock and house prices.

Figure 3.6. US: changes in consumption and employment



Note: 'Payroll' shows change in private payroll on a year earlier.
Source: Haver Analytics.

Figure 3.7. Household debt-to-income ratios



Source: Haver Analytics.

We expect economic growth to exceed 3% in both 2014 and 2015, underpinned by a number of positive factors. Consumption should remain robust, helped by a further improvement in the labour market and stronger wage growth, and business surveys also suggest corporate investment should pick up. The housing sector should also remain a positive factor, despite a recent moderation in its growth. Finally, the bipartisan budget deal struck in late 2013 will reduce the degree of fiscal tightening in 2014.

On top of these cyclical factors, the US is set to benefit from structural factors such as the shale oil boom, which is boosting US manufacturing through cheaper energy and a strong external competitiveness (US relative unit labour costs have fallen significantly against key competitors in recent years, partly thanks to a weaker dollar). The US is also less constrained than some other advanced economies by the need for private sector deleveraging, as significant progress in this area has already been made (see Figure 3.7).

One area of potential risk relates to the Federal Reserve's decision to start reducing or tapering its asset purchases from January 2014.² We expect asset purchases to cease entirely by Q3 of this year, removing what has been a very significant monetary stimulus. This has already pushed up US long-term interest rates, with 10-year bond yields up over 100bp since last April to around 3%. The Federal Reserve softened its announcement about tapering by stressing that short-term interest rates would be likely to remain very low for some time yet (we expect no rate hike until 2015Q3) but the decision to start tapering does nevertheless involve risks. The Federal Reserve has judged that the economy is now strong enough to absorb tapering, but it is possible that tapering could spark a sell-off in the stock market, which has been closely correlated with Federal Reserve asset purchases over recent years.

The upswing we forecast 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.

² The US is still engaged in quantitative easing. However, in December 2013, it announced that it would start to 'taper' its asset purchases, which involves progressively slowing the pace at which it buys assets.

Global outlook

Overall, global economic growth is expected to improve over the next two years. World growth is expected to strengthen from an estimated 2.2% in 2013 to 2.9% this year, with a further improvement to 3.2% in 2015. This represents a gradual recovery towards a trend rate of expansion; world growth will remain somewhat below the 4% rate seen in the boom period of 2004–07 (see Table 3.1).

This improvement in the growth picture will be uneven. We expect the US to grow by over 3% per year, and a continuation in the robust recent expansions in Japan and the UK. The Eurozone will remain a lagging region, however, and growth will also remain below trend in a number of key emerging countries.

But from a UK perspective, 2014 overall looks likely to see a more hospitable external environment than 2013, thanks to a return to growth in the Eurozone (even if very slow) and the strong expansion in the US. The reorientation of UK exporters towards emerging markets should also allow them to benefit from continued economic expansion there.

Reduced fiscal tightening in the US and the Eurozone, the UK's two largest trading partners, will be a significant positive. On the monetary side, the picture will be mixed. The end of Federal Reserve asset purchases in the US will reduce global stimulus, though this will be partially offset by aggressive monetary expansion in Japan. Exchange rate movements could have a significant influence, as the end of tapering and a growing growth differential between the US on the one hand and the Eurozone and Japan on the other are likely to mean downward pressure on the euro and the yen during the year. Our

Table 3.1. Summary of international forecasts

Real GDP	Annual average growth rate (%)		Annual % change					
	1997–2007	2007–2011	2012	2013	2014	2015	2016	2017
North America								
United States	3.0	0.3	2.8	1.9	3.1	3.2	3.0	2.9
Canada	3.2	1.1	1.7	1.7	2.2	2.6	2.8	2.8
Europe								
Eurozone	2.3	–0.2	–0.6	–0.4	0.9	1.4	1.5	1.6
Germany	1.7	0.7	0.9	0.5	1.6	1.7	1.5	1.6
France	2.3	0.1	0.0	0.1	0.5	1.1	1.3	1.4
Italy	1.5	–1.1	–2.6	–1.9	0.3	1.2	1.4	1.4
UK	3.2	–0.8	0.3	1.9	2.6	2.4	2.6	2.6
EU27	2.6	–0.2	–0.4	–0.0	1.4	1.8	1.9	2.0
Asia								
Japan	1.0	–0.7	1.4	1.7	1.8	1.4	0.9	1.1
China	9.9	9.6	7.7	7.7	7.3	7.2	7.2	7.2
India	7.0	7.9	5.1	4.7	4.9	5.1	6.0	6.6
World	3.2	1.6	2.3	2.2	2.9	3.2	3.2	3.3

Source: Oxford Economics.

forecasts suggest this will mean a stronger effective sterling exchange rate, which will blunt some of the advantage coming from stronger global demand.

The strengthening recovery we expect in 2014 and 2015 will be accompanied by muted inflationary pressures. With sharp competition in export markets, global export prices are weak and there is still considerable spare capacity in many economies. We expect global inflation at 2.2–2.3% in 2014–15.

3.3 Risks to the global economy

We expect stronger global economic growth in 2014–15 but the improvement will be patchy and some significant downside risks remain. As a result, we ascribe a probability to our baseline economic forecast of only 50%³ and there are 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 4.

Eurozone slides into deflation

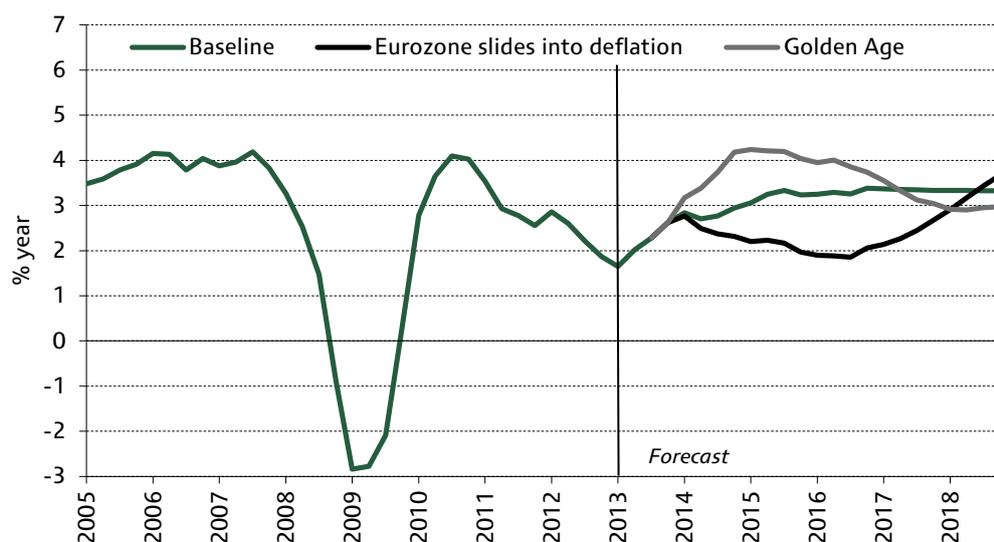
A significant downside risk to our global forecasts is the possibility of a slide into deflation in the Eurozone. Inflation has reached strikingly low levels in the Eurozone, and with a significant negative output gap (estimated at 4% of GDP), high unemployment and slow growth forecast, inflation could well fall further. The risk of deflation would then become real. In a region characterised by high levels of public and private debt, a sustained fall in the general price level would have devastating effects.

In this scenario, a stronger euro and weaker economic growth combine to push the Eurozone into deflation in 2015–18. Weaker growth and deflation significantly raise the real burden of public and private debt, particularly for the ‘peripheral’ economies, but even for France issues of debt sustainability become much more serious in this scenario. For Greece, prolonged deflation has the potential to trigger renewed concerns about whether the country can remain in the Eurozone and, without additional debt relief (including write-downs of debt owed to other European governments and institutions), Greece could well be forced out of the Eurozone.

The slide into deflation leads to a renewed Eurozone recession lasting from mid-2014 to mid-2016, with unemployment rising to 16% by 2018. Weaker demand from the Eurozone, combined with increased global risk aversion, would also take its toll on emerging market growth. GDP growth in the BRIC economies would fall to 5% in 2015–16 versus around 6% in the baseline. US growth would also be affected, due to slower world trade growth and more fragile global economic confidence. US GDP growth would decline to just 2% by 2016, versus around 3% in our baseline forecast. In this scenario, the UK would be one of the countries hardest hit outside of the Eurozone because of its strong reliance on the Eurozone for exports, its financial linkages and the likely negative impacts on consumer and business confidence.

³ The probability of a detailed economic forecast covering a number of variables being exactly correct is obviously very low. The probabilities presented in this chapter relate to the likelihood of an outcome with the same broad shape as that described in the scenario – they are presented in this way to enable users to derive a risk-weighted forecast. The baseline forecast represents the scenario that we believe is most likely to happen.

Figure 3.8. World GDP under Eurozone deflation and under Golden Age



Source: Oxford Economics / Haver Analytics.

Overall, world growth would decline to around 2% in 2015 and 2016, or around 1 percentage point lower than in our baseline forecast (see Figure 3.8). We attach a 15% probability to this scenario.

Golden Age

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, but this could prove too conservative.

For the US, growth could turn out stronger than we expect if the gains in competitiveness already achieved lead to larger increases in market shares or the benefits of technological revolutions currently under way, including the exploitation of shale oil and gas, prove larger than we currently assume.

For Europe, the reform process under way in the 'peripheral' economies could yield larger benefits than we currently assume. There has already been a strong rise in exports from some of these countries and this might last longer than we currently forecast. There are also potential upside risks to the UK economy.

Our baseline forecast is also cautious about productivity growth, so that if productivity performance surprises on the upside, overall economic growth will also be higher.

Japan is another source of potential upside risk. The stimulatory policies launched last year are a major economic experiment and if the so-called 'third arrow' of these policies – structural reforms – proves successful our long-term growth forecast for Japan could prove too pessimistic.

We quantify the impact of some of these upside risks in a 'Golden Age' scenario, which features higher world growth. Although the scenario has its roots in advanced economy developments, emerging markets would also benefit from higher world trade. Increased risk appetite would also be likely to bolster capital inflows, especially foreign direct investment into emerging markets.

In this scenario, US growth rises sharply, reaching 4.5% at an annual rate in late 2014 (although this is still below the peaks reached in the early 2000s). The upside potential is more limited for the Eurozone than for the US, but Eurozone growth nevertheless reaches 2.4% in 2015. Japan's GDP, meanwhile, grows by over 2.5% in both 2014 and 2015, considerably higher than in our baseline scenario. Emerging markets benefit from rising global demand, with Chinese growth above 8% through to mid-2015. Given the relative importance of the US and Eurozone to UK exports, the UK would be ideally placed to take advantage. Similarly, a growing risk appetite would be expected to bolster corporate confidence and convince firms to implement capital spending plans more aggressively.

World GDP growth accelerates, with global growth exceeding 4% in 2015, the strongest growth rate since 2000 (see Figure 3.8). We also attach a 15% to this scenario.

3.4 Conclusion

Although the UK is arguably less reliant on external demand to sustain its recovery than was the case a year ago, the outlook for the world economy is still of key importance – especially if the UK wishes to achieve a balanced upturn with a strong role for exports and investment.

Although 2013 was on the whole a sub-par year for the global economy, there were encouraging developments late in the year, in particular the acceleration of GDP and consumer spending growth in the US and the revival in Japan. In 2014, these two economies should grow robustly, which will bode well for the UK, as will the return to growth in the Eurozone. A faster pace of world trade growth, helped by an easing of fiscal austerity in the US and in Europe, will make rebalancing the UK economy a more realistic prospect.

Nevertheless, global growth will remain below trend in 2014, with considerable variations among countries and regions. As a result, export market competition will remain sharp. This is already visible in declining export prices in many economies and is likely to change only slowly given the continued need of many economies to boost exports to offset subdued domestic demand. Sharp currency depreciations in emerging markets over the last year may add to deflationary pressures on world export prices.

Some downside risks to global growth also still exist. The advent of US tapering has forced up global bond yields and could yet have a negative effect on asset prices. In the Eurozone, there is a significant risk of a slide into deflation which, if prolonged, would lead to very negative developments for economic growth and possibly also financial stability in the Eurozone.

There are also upside risks to world growth. Our baseline forecast takes a cautious view of the likely upsides from technological changes in the US (and elsewhere) and the reform process in the 'peripheral' Eurozone states and in Japan. Should these developments bring more positive impulses than we expect, the global growth environment could be considerably stronger in 2014–16 than in our baseline forecast.