1. The global economy

Ángel Talavera (Oxford Economics)

Key findings

Global economy will accelerate in 2017.	After growing an estimated 2.2% in 2016 – the slowest pace since 2009 – the world economy is expected to accelerate this year and expand by 2.6%, boosted by stronger growth in the US and some emerging markets. However, this still represents a modest pace compared with historic standards and would be below the long-term average of 2.8%.
A year of higher inflation and higher bond yields.	This year will mark the return of inflation for many advanced economies, as the effect of lower oil prices in 2015–16 fades and expansionary policies in the US create additional inflationary pressures. A combination of higher inflation expectations and a gradual monetary policy normalisation in the US will see bond yields rising further in most developed economies.
Risks are unusually large this year, but go both ways.	The election of Donald Trump as US President and the unpredictability of some of his policies add an additional layer of uncertainty to forecasts this year. A case can be made for both stronger- and weaker-than-expected growth. Equally, there are fears that a heavy electoral calendar in Europe could yield destabilising results, but the common currency area proved remarkably resilient to shocks during a difficult 2016 and we think this year will be no different.

1.1 Introduction

World GDP growth was very weak in 2016. At an estimated 2.2%, the global economy expanded at its slowest pace since the global financial crisis and was some way below the 2.6% forecast at the time of the 2016 Green Budget.

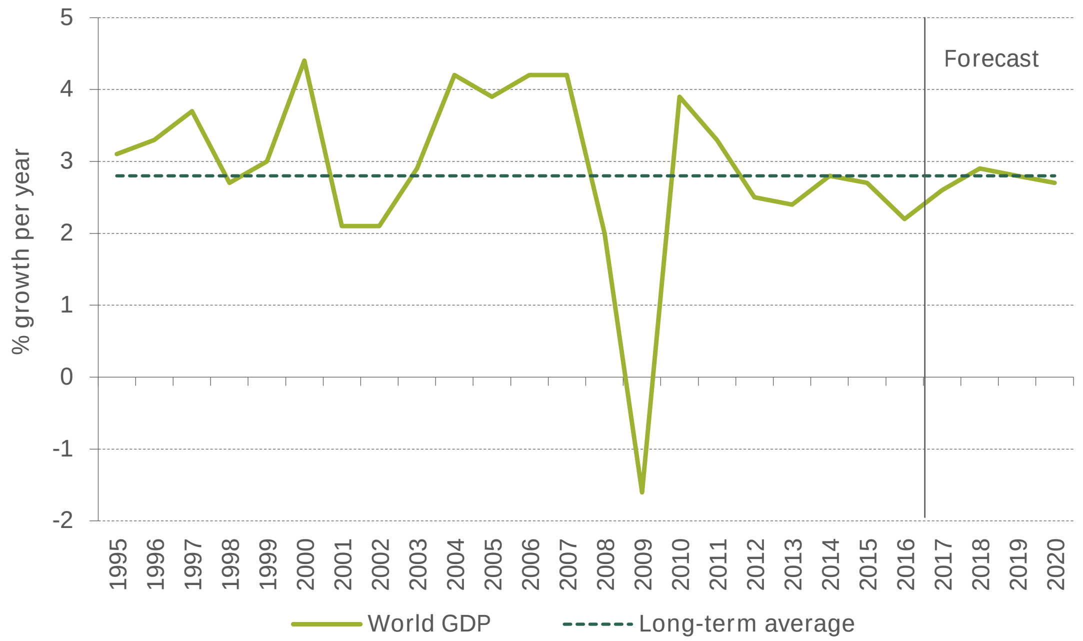
Last year was the year of Brexit and Trump. As far as the economy was concerned, both developments were considered likely to cause self-inflicted pain at first, but as the months pass the short-term repercussions appear not to have been as dramatic as initially feared and, in the case of the latter, could even turn into a positive for world economic growth. Ultimately, a disappointing performance in the US was the main reason for the 2016 undershoot compared with our forecasts of a year ago.

We expect world growth to accelerate in 2017 (see Figure 1.1), but only modestly to 2.6%, which would still be below the 2.8% a year average of the last 30 years. The global economy is expected to benefit from stronger growth in the US (up to 2.3% from 1.6% in 2016) and also from a better performance in emerging markets (with growth rising to 4.1% from 3.4%), as a further modest slowdown in China will be offset by faster growth in other large emerging economies. Growth should remain relatively resilient in Europe, including the UK, although slowing from 2016 rates. The impact of more expansionary policies in the US will not be fully seen until 2018 when we expect world growth to rise to 2.9%.

As in 2015, the main weak points of the global economy last year were trade and industrial activity. World trade grew by an estimated 1.4% (see Figure 1.2), below the already dismal 1.6% expansion seen in 2015. A key factor behind this was declining import volumes in most 'BRIC' economies (only China recorded positive growth, and even that was very low) as well as extremely weak import growth in the US.

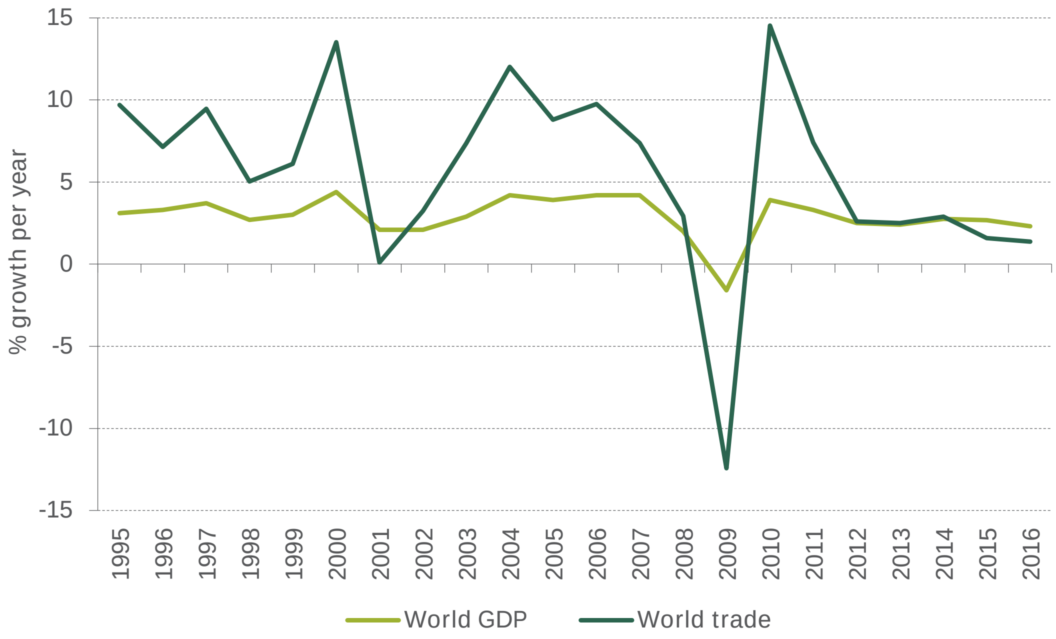
World goods trade bottomed out in mid 2016 and started to show some signs of recovery in the second half of the year. Growth in global trade will continue to improve this year, rising to 2.8%, helped by stronger import demand not just from the US, but also in Russia, Brazil and India – all of which were a drag on world trade growth in 2016. But while this year will mark an improvement from the very weak 2016, growth in trade will remain far below the long-term average of around 5% a year.

Figure 1.1. World GDP growth



Source: Oxford Economics, Haver Analytics.

Figure 1.2. World GDP and trade growth



Source: Oxford Economics, Haver Analytics.

Low global economic growth is an obvious culprit for the poor performance of trade, but we think there are some other fundamental reasons. Structural factors, such as the maturing of international supply chains and increasing protectionism in some areas, mean that there has been a significant drop in world trade elasticity – the ratio between trade growth and GDP growth – from over 2 in the 1990–2007 period to around 1.3.

Meanwhile, world industrial output rose just 1.6% in 2016 (also below an already weak 2015 and the worst performance since 2009), weighed down by a contraction in US and Japanese industrial output.

Services activity was generally stronger in 2016, helped by the boost to real incomes from low energy prices, rising employment and signs of improved wage gains in the US. Although the expected rise in inflation this year will cause real disposable income growth to moderate, we think that services can continue to grow at a robust pace, as employment dynamics remain positive in most advanced economies, and wage gains should continue to rise in more mature labour markets such as the US and Germany. In addition, monetary policy remains extremely loose in most advanced economies and property prices continue to rise in several of them, thereby supporting household wealth.

Equally important, global manufacturing PMIs (Purchasing Managers' Indices) showed a steady recovery in the second half of 2016, so we expect industrial output to bounce back this year, partially as a result of the improvement in global trade previously outlined.

There are some downside risks as well. We expect the Fed to raise rates twice this year, something not seen in more than a decade, so there is a question mark over whether the global economy will be able to absorb this. We believe it can, as monetary conditions will still be very accommodative by historic standards and financial markets ended a rather turbulent 2016 largely unscathed, with equities yielding double-digit returns in many countries and the VIX volatility index falling to its lowest level in a year. However, a more hawkish Fed poses increased risks to emerging markets, especially countries with large amounts of US$-denominated debt and those with large current account deficits which are more vulnerable to sharp changes in capital flows.

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

1.2 Global outlook

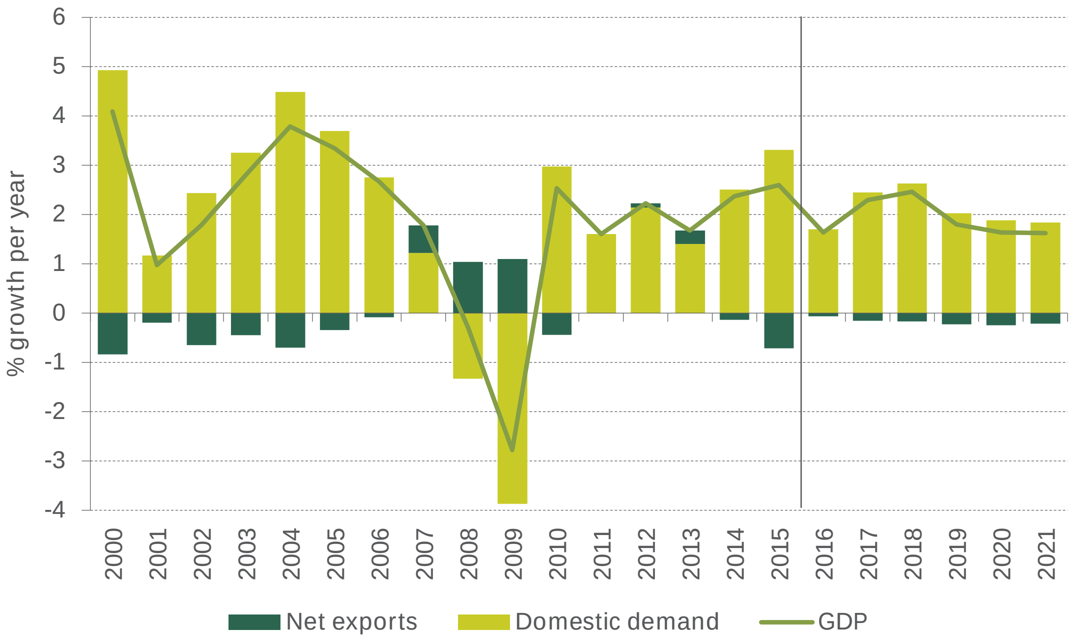
US

The US economy had a very disappointing year in 2016. GDP expanded by a weak 1.6%, the slowest rate in five years and well below our forecast of 2.4% growth at the start of the year. Growth was a meagre 1% in the first half of the year, which dragged full-year growth down despite a pickup in activity in H2.

The growth story in the US was one of duality. Household spending remained robust, expanding by 2.7%, as consumers continued to benefit from strong levels of job creation and a rise in disposable income owing to low inflation and some real wage gains. On the other hand, business activity was very weak, constrained by a strong dollar, sluggish global demand and a depressed energy sector. As a result, its contribution to economic growth was either negligible or even negative in some quarters. Similarly, the strong dollar also caused the contribution from the external sector to overall growth to be minimal as well.

We forecast that US GDP growth will accelerate to 2.3% this year (see Figure 1.3) due to a number of factors. Although the labour market is maturing and the unemployment rate is

Figure 1.3. Contributions to US GDP growth



Source: Oxford Economics, Haver Analytics.

now close to a bottom, the level of job creation is likely to remain healthy, which combined with firmer wage growth and lower taxes will continue to support household incomes. Simultaneously, although some of the headwinds seen in 2016 remain in place, business investment should recover this year, as potential tax cuts and business deregulation could unleash investors' 'animal spirits' and stimulate activity. On the external side, we expect some acceleration in US exports this year in spite of the strong dollar. However, exports will be outpaced by imports, which will grow at a stronger pace driven by solid domestic demand. Therefore, net trade will be a drag on growth this year.

However, risks around the central forecast are unusually large due to major uncertainties about policy direction from the Trump administration: a stronger fiscal stimulus and no protectionism or immigration curbs could see US growth heading towards 3%, but a trade war and sharp immigration cuts could dent economic growth heavily.

Following a 25bp increase in the Federal funds rate in December 2016, we expect the Fed to raise interest rates twice this year while allowing inflation to settle temporarily above its 2.0% inflation target. However, aware of the downside risks to growth, the Fed will maintain its cautious stance amid modest economic momentum. We expect long-term government bond yields to also rise in the near term, affected by expectations of a large fiscal stimulus and a widening federal budget deficit. Policy interest rate differentials against the rest of the world should maintain steady capital flows into the US and support the dollar again this year.

Eurozone

GDP growth in the eurozone was an estimated 1.7% in 2016. Although this was down from the 1.9% the year before, the 2015 figure had been artificially distorted by the exceptional 26% measured growth seen in Ireland, which was a one-off.

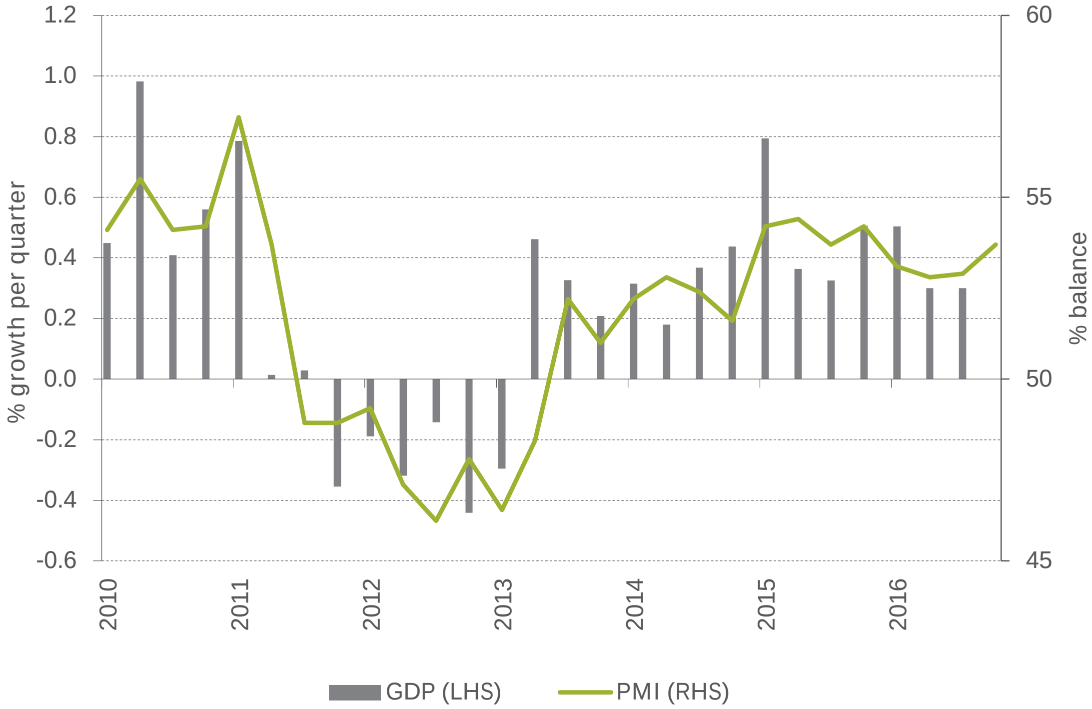
The solid 2016 performance was the result of several factors, most of them a continuation of the same driving forces behind the strong expansion of 2015: a gradual shift towards a more expansive fiscal policy; the ultra-loose monetary policy by the European Central Bank (ECB), including quantitative easing and negative interest rates, which helped lending continue the recovery initiated in 2014; and lower oil prices, which allowed consumers to loosen their purse strings as real disposable incomes were boosted by low inflation.

We expect the eurozone economy to remain solid in 2017. We think the economy has settled into a 'cruising speed' of around 0.3–0.4% a quarter (see Figure 1.4), so our growth forecast is 1.5% for the year, only slightly down from 2016. Growth will be supported by improving labour markets and solid money and credit growth, as the ECB continues to provide an extraordinary level of support this year.

Among the eurozone 'big four', we expect Spain will continue to outpace its rivals and grow 2.5%. Germany will experience average growth of 1.5%, France will see its economy expanding by 1.5%, up from 1.1% in 2016, and finally, Italy will remain the laggard and grow only 0.6%, affected by persistent political instability and a troubled banking sector.

An often-overlooked fact is that employment in the eurozone has actually been growing at a decent pace in the past three years. The unemployment rate, while still high at 9.8% in November, fell into single digits in 2016 for the first time in five years, and the eurozone

Figure 1.4. Eurozone GDP growth and PMIs



Source: Oxford Economics, Markit.

has created around 5 million jobs while reducing the number of unemployed by more than 3 million. This should help partially offset the decline in real wage growth caused by the expected rise in inflation – which will jump to 1.5% this year from an estimated 0.2% in 2016 – so we see consumer spending rising a still healthy 1.4% in 2017.

Meanwhile, the recent announcement of an extension to the quantitative easing (QE) programme at €60 billion a month starting in April means that the ECB will inject an additional €540 billion into the economy until the end of the year, while probably keeping interest rates at record lows. This continuing extraordinary level of monetary stimulus should help to support growth in the common currency area.

As interest rates differentials with the US widen further, we expect the euro to fall to close to parity against the US$ in the next 12 months. By late 2017, we expect the ECB to announce a tapering of QE as core inflationary pressures gradually build. Combined with our view that the political uncertainty in the continent will be resolved with relatively benign outcomes following the spate of national elections this year, this means we expect the euro to trough in late 2017 and then gradually strengthen thereafter. A weaker euro, combined with an improvement in global trade volumes, means that exports may provide a bit more support to growth in 2017 than last year. That said, export growth will still be fairly lacklustre in comparison with the pre-global-financial-crisis years.

We do not expect the eurozone economy to be significantly affected by Brexit-related developments in 2017 – we have long held the view that the effects of Brexit in Europe will be spread over many years rather than being one sharp, single shock, a notion that has been corroborated thus far by economic data since the UK referendum. We also think risks from ‘populist’ political movements are overstated and, under our baseline, we do not consider a break-up of the eurozone a serious risk. There are several reasons for this, such as the electoral system in France, which makes the election of a populist such as Le Pen less likely, but also the fact that the costs of leaving the common currency would be catastrophic. Despite the public discontent with several aspects of the EU and its economic policies, we do not think there is a real appetite to leave the union or the eurozone.

That said, increased political noise will be a constant throughout the year given the heavy electoral calendar – with presidential and parliamentary elections scheduled in Germany, France and the Netherlands, and possibly in Italy as well – and could have some impact on confidence, and by extension on economic growth.

Japan

The Japanese economy started 2016 on a strong footing, but lost momentum in the second half of the year and expanded by an estimated 1% overall, a fairly typical lacklustre performance. Both household spending and exports grew at a rather weak pace – the latter partially a function of slower growth in Japan’s key trading partners – but a decline in imports (an estimated 2.1% in 2016) meant that net trade contributed positively to economic growth.

We expect GDP to expand by only about 1% again in 2017, but with a healthier composition of growth. Consumer spending will grow by 0.9%, supported by government cash handouts to low-income households and solid employment growth. Export growth will also accelerate (from an estimated 0.2% in 2016 to 0.7% in 2017) boosted by the weaker yen, which has lost 10% against the US dollar since the US elections in November, driven by a widening in the US–Japan yield differential.

Although fixed investment will accelerate slightly this year on the back of stronger growth in corporate profits, the outlook remains soft. However, an increase in government infrastructure spending will partly offset the forecast decline in business investment. Residential investment is also expected to record another solid year of growth in 2017.

We expect the yen to continue to depreciate versus the US dollar this year, breaking above the 120 yen/US$ barrier. However, despite the weaker yen projection, we do not think that it will be enough to boost inflation expectations materially and inflation will still fall short of the Bank of Japan (BoJ)’s 2% inflation target. Consequently, we expect the BoJ to continue to target the 10-year yield at ‘around 0%’ in 2017 and 2018. Faced with ongoing upward pressure on Japanese yields, we expect the BoJ to announce further fixed-rate money market operations.

Emerging markets

Following an already poor 2015 (when emerging market (EM) aggregate growth was 3.5%), EM growth slowed further to 3.4% in 2016, 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: Russia and Brazil still saw declines in GDP (of –0.6% and –3.4% respectively), although both countries started to emerge from recession towards the end of the year, in particular Russia. Chinese growth decelerated to the slowest pace in 25 years, but at 6.7% was broadly in line with expectations and the target set by the Chinese authorities. Finally, India was the best performer among this group, with GDP growth reaching 7.1%.

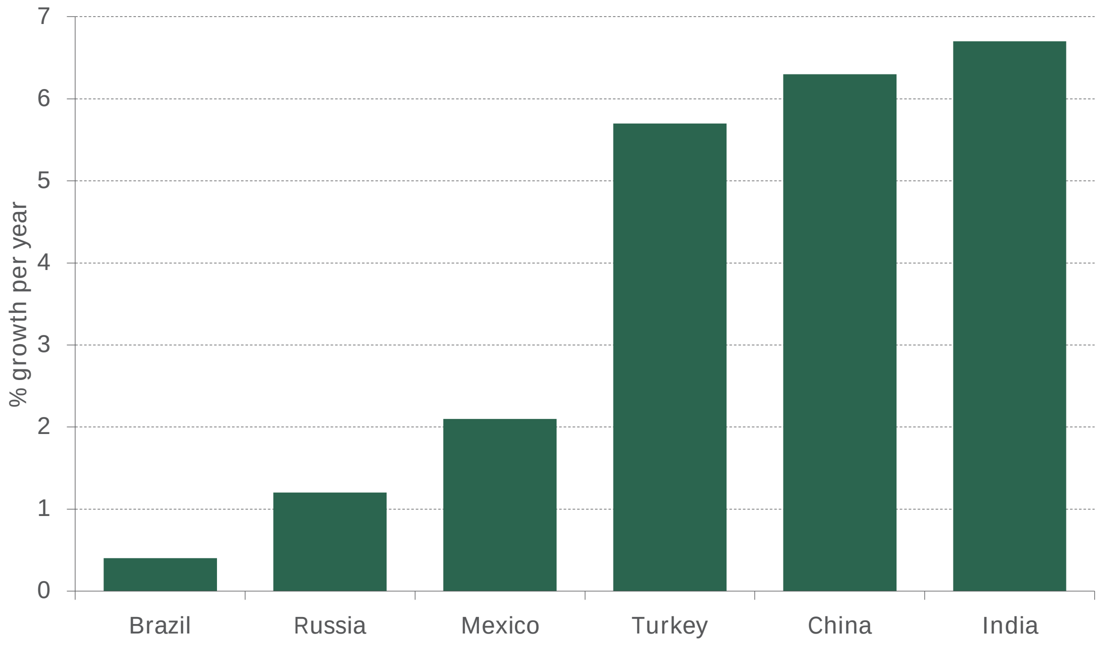
For many emerging markets, Trump's policies will largely determine their futures this year. Emerging market assets have recovered some of their losses since Trump's election victory, but EM currencies have suffered the brunt of the shock. Although some central banks have already moved to contain the impact, we expect EM currencies to remain under pressure as the Fed tightens policy further this year.

It seems increasingly clear that the Trump administration will pursue an expansive fiscal policy, including higher infrastructure spending. This could boost demand for commodities and lead to a pickup in US growth, both of which would be beneficial for EM prospects. But serious risks lie ahead for the EMs, even if the protectionist element of Trump's platform takes a back seat in actual policymaking. Greater optimism about US growth prospects could lead to the Fed hiking rates more aggressively, resulting in a stronger dollar and higher bond yields. And EM corporate debt levels have risen sharply in recent years, increasing their vulnerability to higher US rates and raising refinancing risks for their large stock of US$ debt.

Against this backdrop, concerns about the outlook for emerging markets are likely to persist. Higher interest rates in developed economies will weaken capital flows to emerging markets. Countries with large current account deficits (such as South Africa and Turkey) that are not covered by sufficient foreign direct investment (FDI) flows are likely to be most at risk.

Focusing on China, we think the Asian giant should benefit from a possible pickup in US growth from Trump's more expansionary fiscal policy this year. But the increase in uncertainty and risk of China-specific trade restrictions will weigh on exports. Overall, we expect a slight improvement in the export outlook this year, helped by some strengthening of global demand and the depreciation seen in the renminbi.

Figure 1.5. Emerging markets' 2017 GDP forecasts



Source: Oxford Economics.

Domestically, infrastructure investment should remain solid, in the year of a major leadership reshuffle in the Communist Party. And corporate investment should benefit somewhat from renewed profit growth. But the recent tightening of housing purchasing restrictions in many large cities will weigh on real-estate investment and consumption will probably slow further on moderating wage growth. Overall, we expect China's GDP growth to continue to decelerate gradually, with expansion seen at 6.3% this year (see Figure 1.5). However, this falls in line with a more flexible approach by Chinese policymakers to interpret growth targets less rigidly and to start shifting their focus towards risk management.

Our estimates suggest capital outflows from China have been creeping up again in recent months and outflow pressures are likely to persist, if not strengthen, in 2017 as US interest rates rise. We expect the People's Bank of China will continue to walk a fine line, allowing some further weakening of the renminbi against a globally strengthening US dollar but continuing to dampen the depreciation pressures, while at the same time containing financial capital outflows in order to limit foreign exchange (FX) reserve depletion. We expect policymakers to continue with this approach rather than letting the CNY weaken more significantly, because of the impact on confidence in the currency domestically and unfavourable reception abroad. To contain FX pressures, we expect policymakers to continue to tighten up enforcement of foreign exchange regulations and restrictions.

Global outlook

Although this year's world growth forecast of 2.6% (see Table 1.1) represents a modest improvement over 2016, it nevertheless implies a continuation of the overall trend of subdued growth that we have witnessed for most of the decade. The forecast is not only well below the 4% rates seen in the pre-crisis period of 2004–07, but more significantly it also remains below the long-term average.

Growth will accelerate in both developed and emerging economies this year. Developed economies will see growth rising to 1.8% from 1.5% in 2016 on the back of stronger US growth. Emerging market growth will also strengthen, to 4.1% from 3.4% last year, as Brazil and Russia finally emerge from their long slumps, while Turkey experiences some acceleration following a weak 2016.

In terms of policy settings, monetary policy is set to remain expansionary in the eurozone, the UK and Japan this 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 further exchange rate movements. We expect another year of US dollar strength, with the euro/US$ falling to parity by the end of 2017 and the yen/US$ rate moving to 124 from 117 at the end of 2016.

This year will also see the return of inflation to most advanced economies, as the effect from higher energy prices feeds into headline consumer prices. Inflation will comfortably exceed 2% in the US and the UK and, at close to 1.5% in the eurozone, it will be at its highest level in five years. Inflation will also be higher in some emerging markets,

Table 1.1. Summary of international GDP forecasts (annual % change unless stated)

	2015	2016	2017	2018	2019	2020	2021
North America							
United States	2.6	1.6	2.3	2.5	1.8	1.6	1.6
Canada	0.9	1.3	1.7	1.8	1.9	2.0	1.8
Europe							
Eurozone	1.9	1.7	1.5	1.5	1.4	1.3	1.3
Germany	1.5	1.8	1.5	1.4	1.1	1.0	0.9
France	1.2	1.1	1.5	1.5	1.5	1.5	1.3
Italy	0.6	0.9	0.6	1.1	1.1	1.1	1.0
UK	2.2	2.0	1.6	1.3	1.6	2.1	2.3
EU27	2.1	1.8	1.6	1.6	1.5	1.6	1.5
Asia							
Japan	1.2	1.0	1.0	0.9	0.6	-0.3	0.6
China	6.9	6.7	6.3	5.9	5.7	5.6	5.4
India	7.2	7.1	6.7	7.2	6.9	6.6	6.3
G7	1.9	1.5	1.8	1.8	1.5	1.3	1.4
World	2.7	2.2	2.6	2.9	2.8	2.7	2.7
World 2010 PPPs	3.2	3.0	3.3	3.6	3.5	3.4	3.4
World trade	1.6	1.4	2.8	3.2	3.7	3.7	3.8

Source: Oxford Economics.

especially those suffering from strong currency depreciation, such as Turkey or Mexico. For the world as a whole, inflation will rise to 3.2% from an estimated 2.8% in 2016.

1.3 Risks to the global economy

There are significant risks to our global forecasts for 2017 and beyond. Below, we outline two of our key scenarios for the global economy in which global growth could diverge significantly from our baseline, both to the upside and to the downside. We assess their possible implications for the UK economy in Chapter 2.

US growth surges amid Trump fiscal stimulus

Our baseline forecast assumes a compromise between President Trump and Congress, with a modestly expansionary fiscal package and targeted trade protectionist measures, but the degree of policy and political uncertainty is unusually elevated in 2017. In this scenario, we explore the upside potential from a greater relaxation of fiscal orthodoxy in exchange for a less protectionist trade stance.

The result of congressional negotiations is a significantly more expansionary fiscal package than assumed in the baseline. The package is larger, with $1 trillion worth of personal income and corporate tax cuts and a $250 billion public infrastructure investment plan. Notably, this benefits lower-income households, which have a higher propensity to spend additional income, to a greater extent than the package assumed in the baseline.

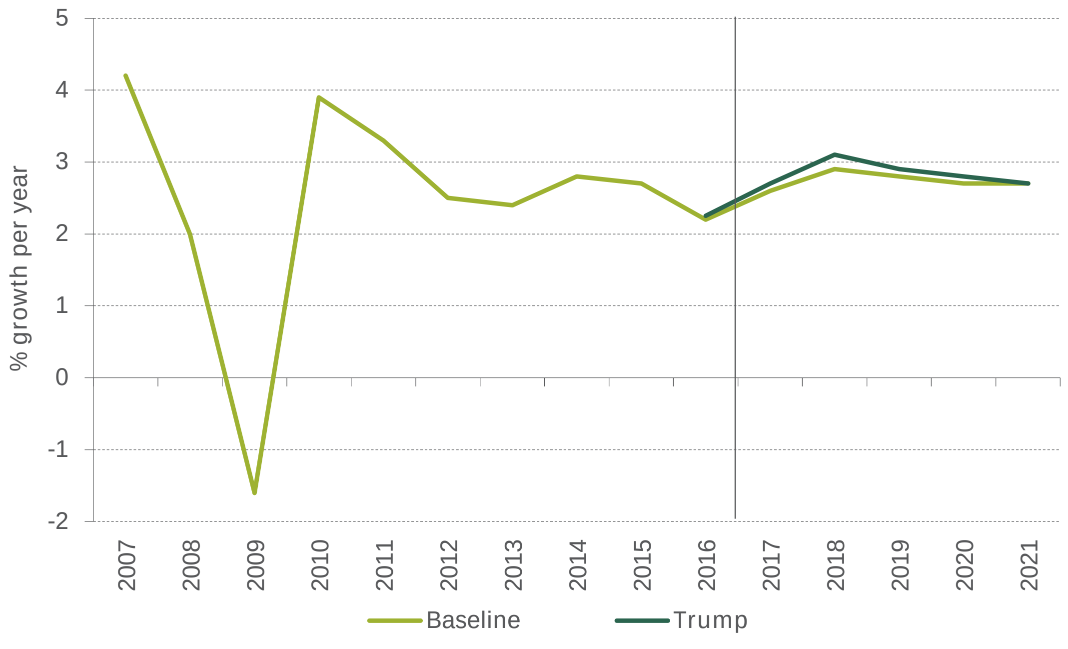
Trump negotiates the relaxation of fiscal orthodoxy from Republicans in exchange for a less protectionist stance than he campaigned on. As a result, he refrains from substantial tariff hikes except in some specific cases.

As a result, the US economy grows more quickly than in the baseline in the short and medium term, when the effects of an expansionary fiscal policy are mostly felt but the impact of higher deficits is still not fully felt. The economy benefits not only from the initial impact from lower taxes and increased infrastructure spending, but also from increased confidence in the ability of Trump and his team to govern. In 2017, GDP growth picks up to 2.5% (compared with 2.3% in the baseline); in 2018, when the boost from fiscal stimulus and private sector confidence peaks, growth reaches 3% (compared with 2.5%).

The global economy grows more quickly as stronger US growth spills over, fears over increased protectionism dissipate and confidence improves. World growth reaches 2.7% in 2017 and 3.1% in 2018 (see Figure 1.6), 0.2–0.4 percentage points above baseline. The impact varies across countries, reflecting policy and market developments, but most economies around the world benefit from renewed confidence, stronger global trade and more buoyant equity markets.

But, as the Fed brings forward its tightening cycle (with the ECB and Bank of England following suit), a stronger dollar and higher dollar interest rates reduce the attractiveness

Figure 1.6. World GDP growth under ‘positive Trump’ scenario



Source: Oxford Economics, Haver Analytics.

of emerging market assets. As capital flows from emerging markets to the US amid investor concerns over the impact on emerging market balance sheets and reduced incentives to 'hunt for yield', credit conditions tighten in more vulnerable emerging market economies and the boost to activity is at least partially eroded.

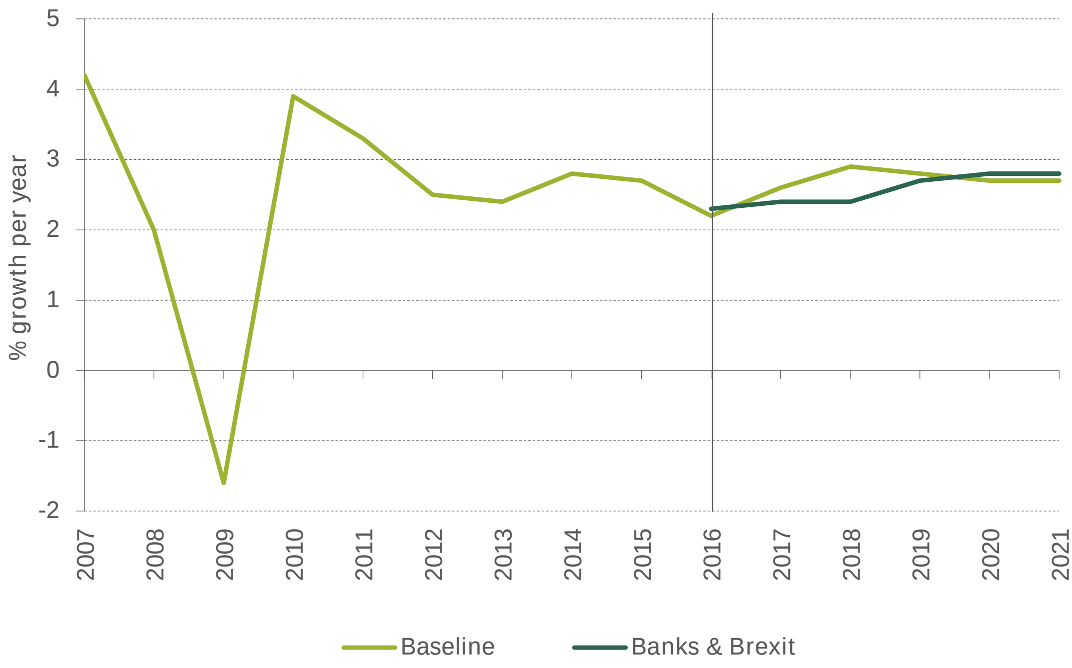
Banks and Brexit hit European activity

In this scenario, we explore how Brexit-related weakness in the UK and structural banking problems in the eurozone could result in a lower trajectory of growth for Europe as a whole.

In the UK, economic activity has held up reasonably well since the vote to leave the EU in June 2016, largely because the impact on consumer sentiment has been muted. But some of the effects of the vote may be yet to be seen. At the same time, problems in the eurozone banking system may be returning to the fore. In recent months, we have revised down our baseline forecast for eurozone growth, inflation and bond yields, highlighting the ongoing concerns over structural challenges facing banks as the macroeconomic backdrop weighs on net profit margins.

In this scenario, we consider both sources of potential European weakness. In the UK, the post-referendum depreciation of sterling feeds through more strongly to UK inflation than assumed in our baseline forecast – with the impact on consumer prices exacerbated by renewed falls in sterling as exit negotiations get off to a rocky start. Higher inflation increases the squeeze on the consumer sector, while sentiment is adversely affected by the challenging start to negotiations. Private sector retrenchment ensues. In the eurozone, the combination of rising unprovisioned non-performing loans (NPLs) and renewed downward pressure on bank equities adds to challenges facing the banks, weighing further on the supply of credit.

Figure 1.7. World GDP growth under 'Brexit and European banks' scenario



Source: Oxford Economics, Haver Analytics.

The UK and the eurozone see the largest hit to growth in this scenario. The rest of the world does experience some negative spillovers in the form of weaker trade, a fall in asset prices and a deterioration in their competitiveness as sterling and the euro weaken. However, the global economic impact is muted (see Figure 1.7). That is also the case for commodity and asset markets, with oil prices and policy rates outside Europe only modestly affected.

1.4 Conclusion

The year 2016 was similar to 2015 inasmuch as the pattern of a 'dual economy' that we outlined a year ago continued to dominate the world economy for most of the past 12 months. Consumer spending and growth in services were generally much stronger than growth of manufacturing and other tradables in the face of weak global demand.

This year, we are looking at a different picture: manufacturing activity started outpacing that of services in many countries towards the end of 2016, and had the best performance in two years in Q4. This is also in line with the incipient recovery in world trade that we started to witness in H2 2016. Global trade in 2015 and 2016 saw its worst two-year period since the global crisis, but we expect it to accelerate this year, a phenomenon that is likely to go hand in hand with the recovery in manufacturing activity.

Risks around the forecast are unusually large this year, but they are more balanced and there is an increasing chance that forecasts may be too pessimistic and could be subject to upward revision.

Another big theme this year will be the return of inflation. Inflation is a double-edged sword: it will erode real disposable incomes, causing household consumption growth to slow, but it will also help highly-indebted countries as it will give a much welcome boost to nominal GDP, reducing debt relative to national income. Overall, a move towards more 'traditional' rates of inflation should be seen as a welcome development, as it signals that some of the scars following the Great Recession are starting to heal, if only partially and very unevenly across regions.

This will also be the year when the UK activates Article 50 and when the next leaders of Europe will be elected. Political 'noise' will be constant throughout 2017 and we expect to see and hear a lot about populism and the potential for a eurozone break-up. We think these fears are overstated and that there are enough mechanisms in place to prevent such a traumatic event.