THE WORLD ECONOMY

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World Overview

Recent developments and the baseline forecast

The past three months have been marked by significant upturns in global oil prices and financial markets, a decline in financial market volatility, and a downturn in the exchange value of the US dollar. Market sentiment has improved in many respects, thanks partly to the actions of central banks, but global growth has remained mediocre.

Recent data on demand and activity have indicated continuing modest, though steady, growth in the Euro Area, with conditions still varying widely among member countries, but a further slowing in the United States and particularly disappointing performance in Japan, where output fell in the fourth quarter of 2015. Among the major emerging market economies, the slowing of

Table 1. Forecast summary *Percentage change*

	Real GDP(a)												World trade(b)
	World	OECD	China	EU–27	Euro Area	USA	Japan	Germany	France	Italy	UK	Canada	
2012	3.5	1.3	7.7	–0.4	–0.8	2.2	1.7	0.6	0.2	–2.9	1.2	1.7	2.7
2013	3.3	1.2	7.7	0.3	–0.2	1.5	1.4	0.4	0.7	–1.8	2.2	2.2	2.9
2014	3.4	1.8	7.3	1.4	0.9	2.4	–0.1	1.6	0.2	–0.3	2.9	2.5	3.2
2015	3.1	2.1	6.9	1.8	1.5	2.4	0.5	1.4	1.2	0.6	2.3	1.2	2.9
2016	3.0	1.8	6.5	1.7	1.5	2.0	0.2	1.7	1.3	0.7	2.0	1.7	4.4
2017	3.5	2.1	6.2	2.0	1.7	2.5	–0.1	1.7	1.4	1.0	2.7	2.1	6.2
2006–2011	4.0	1.3	11.0	1.1	1.0	0.9	0.3	1.7	1.0	–0.1	0.7	1.5	4.7
2018–2022	3.8	2.3	5.9	1.8	1.6	2.6	0.9	1.1	1.4	1.8	2.3	2.0	4.6

	Private consumption deflator									Interest rates(c)			Oil ($ per barrel)(d)
	OECD	Euro Area	USA	Japan	Germany	France	Italy	UK	Canada	USA	Japan	Euro Area	
2012	1.9	1.9	1.9	–0.9	1.6	1.4	2.7	1.8	1.3	0.3	0.1	0.9	110.4
2013	1.5	1.2	1.4	–0.2	1.3	0.8	1.2	2.3	1.4	0.3	0.1	0.6	107.1
2014	1.5	0.5	1.4	2.0	0.9	0.0	0.2	1.7	1.9	0.3	0.1	0.2	97.8
2015	0.7	0.2	0.3	0.2	0.7	–0.1	0.1	0.2	1.1	0.3	0.1	0.1	51.8
2016	0.9	0.2	0.8	0.0	0.4	0.0	0.2	0.3	1.2	0.5	–0.1	0.0	35.1
2017	1.8	1.3	1.8	1.0	1.6	1.1	1.4	0.9	2.0	1.5	–0.4	0.0	41.6
2006–2011	2.0	1.8	2.0	–1.0	1.3	1.4	2.0	3.3	1.3	2.1	0.2	2.3	79.8
2018–2022	2.1	1.6	2.1	0.5	1.6	1.2	1.9	2.1	1.7	3.2	–0.3	1.2	50.0

Notes: Forecast produced using the NiGEM model. (a) GDP growth at market prices. Regional aggregates are based on PPP shares, 2011 reference year. (b) Trade in goods and services. (c) Central bank intervention rate, period average. (d) Average of Dubai and Brent spot prices.

*All questions and comments related to the forecast and its underlying assumptions should be addressed to Simon Kirby (s.kirby@niesr.ac.uk). We would like to thank Jessica Baker for compiling the database underlying the forecast. The forecast was completed on 27 April, 2016. Exchange rate, interest rates and equity price assumptions are based on information available to 13 April 2016. Unless otherwise specified, the source of all data reported in tables and figures is the NiGEM database and NIESR forecast baseline.

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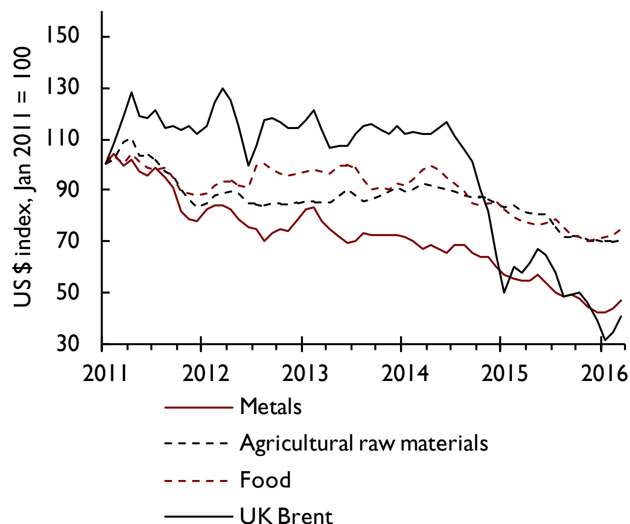
Figure 1. Commodity prices in US dollars



Source: Datastream

growth in China has continued, with some indicators becoming more positive recently. In Russia, activity has begun to stabilise after a two-year contraction, while in Brazil conditions have deteriorated further amid a political crisis. India remains the fastest growing major economy.

Taking into account recent developments, our projection for global growth this year has been revised down from the February *Review*, from 3.2 to 3.0 per cent, marginally below last year's outturn. The expansion this year is therefore now expected to be the slowest since the 2009 recession. A moderate strengthening of growth is projected for 2017 and beyond, supported by accommodative monetary policies; lower oil prices, which are still assumed to remain well below their levels during 2010–14; and the gradual normalisation of conditions in stressed emerging market economies.

Annual core consumer price inflation in the United States has recently been close to the Federal Reserve's 2 per cent objective, but the all-items rate has remained more clearly below target, at about 1 per cent. In the other advanced economies, inflation has remained well below targets, recently fluctuating around zero in the Euro Area. Wage increases have remained notably subdued, even in those advanced economies where unemployment is now quite low – such as the US, Japan and Germany. Above-target inflation rates in Brazil and Russia have moderated, while in China inflation has recently picked up towards official objectives.

Since late January, central banks in Japan and the Euro Area have acted to ease monetary conditions further in pursuit of their inflation objectives. At the end of January, the Bank of Japan announced a reduction in the interest rate on one tier of bank reserves to marginally below zero. In March, the European Central Bank (ECB) announced several measures to increase monetary accommodation further, including another reduction in its deposit rate, already negative since June 2014, and an expansion by one-third of its monthly asset purchases. In the US, the Fed has maintained its target range for the federal funds rate at the level to which it was raised last December, while reducing the gradient of its expected path of future rate increases. Monetary conditions have also been eased since early February in China and several other economies, including Hungary, Indonesia, New Zealand, Norway, Singapore, Sweden and Taiwan.

Partly reflecting adjustments in actual and expected monetary conditions, 10-year sovereign bond yields have generally declined since late January – by about 10–15 basis points in the US and most major economies of the Euro Area and 30 basis points in Japan. In Japan, 10-year sovereign yields have been negative since early March. The notable exception among advanced economy bond markets is Canada, where comparable yields have risen by about 25 basis points, as expectations of a further cut in official rates have receded with the introduction by the new government of an expansionary budget. Government bond yields have also declined in emerging markets, most markedly in Brazil, by about 350 basis points, reportedly reflecting increased expectations of a business-friendly change in government and policy regime.

In foreign exchange markets, the US dollar has depreciated against all other major currencies except sterling since late January. Its trade-weighted value, which in January reached its highest in almost thirteen years, has since fallen by about 7 per cent.[1] This is the largest reversal since the dollar's appreciation of recent years began in 2011, although its trade-weighted value in late April was still about 32 per cent above its mid-2011 trough. The reversal seems to be related to downward revisions to expectations about tightening by the Fed and about the associated widening of yield differentials in favour of dollar-denominated assets. Among the currencies of the advanced economies, the strongest in recent months have been the Canadian dollar, which has risen by about 12 per cent against the

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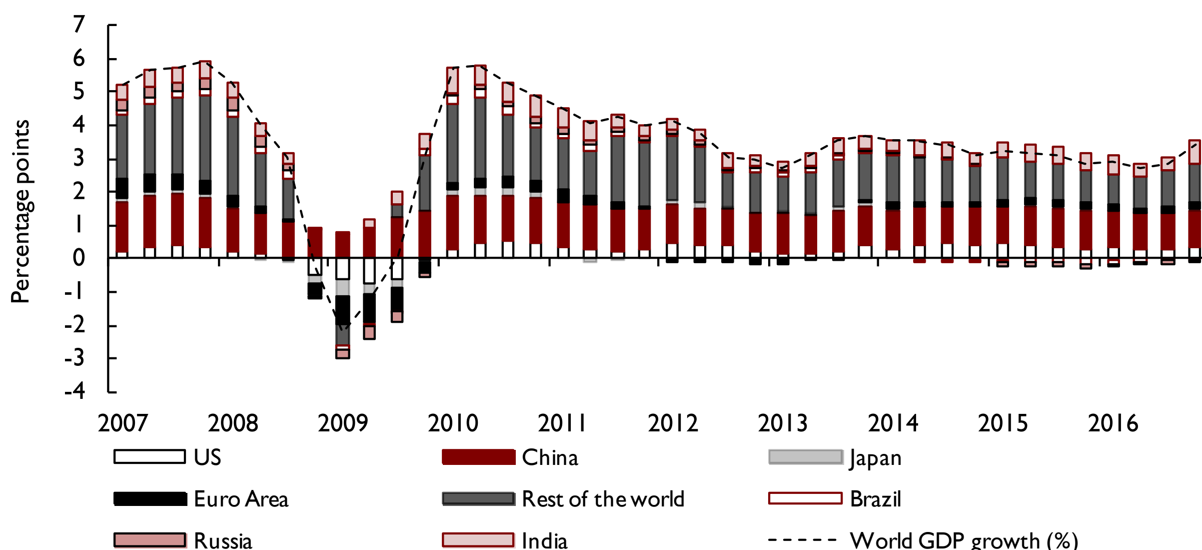
Figure 2. World GDP growth (from four quarters earlier)



Source: NiGEM database and NIESR forecast.

US currency, and the yen, which has risen by about 7 per cent. The Canadian dollar's rise seems attributable to the shift in interest differentials referred to above. The rise of the yen may reflect a relative decline in expected inflation in Japan, which could have shifted relative real yields in its favour. Major emerging market currencies have also risen against the US dollar in the past three months, most markedly in the cases of the Brazilian real, up by about 15 per cent, apparently mainly on political developments, and the Russian rouble, up by 20 per cent apparently reflecting the recovery in the oil market.

The US dollar's recent depreciation can account for only a small part of the upturn in the dollar prices of oil since late January. They bottomed out at about $26 a barrel on 11 February and by late April had risen to about $45, the highest levels since last November. An initial trigger for the turnaround seems to have been speculation around an announcement on 16 February that some major oil producers, including Saudi Arabia, might cap production at January 2016 levels, conditional on agreement by other producers. However, a subsequent meeting of oil producing countries, in Doha on 17 April, failed to reach any agreement. A more important factor has been growing evidence that non-OPEC production has been significantly reduced and that the surplus of production over demand is diminishing. In April, the US Energy Information Administration lowered its forecast of US output in 2016–17, with 2017 production now expected to be 15 per cent below its 2015 peak. Also, the International Energy Agency estimated that investment in oil production had been cut by about 40 per cent in the past two years, and forecast that the fall in non-OPEC production this year would be the largest in 25 years; it expects the market to return to balance in 2017. Other commodity prices generally also bottomed out in early February. The Economist all-items index in late April was about 9 per cent higher than in late January – an increase that can be accounted for largely by the dollar's depreciation.

Equity markets, after slumping in January, have generally risen, apparently in association with the rise in oil prices – a correlation discussed in the February 2016 *Review*, F9–10. Markets have also become less volatile. By late April, benchmark stock market indices (in domestic currency terms) had risen by about 5 per cent in most major European economies, by about 10 per cent in the US, Canada and China, by about 40 per cent in Brazil and about 30 per cent in Russia. One possible explanation is that the partial recovery of oil prices has reduced the financial pressures on oil-producing companies and countries, including indebted ones, and also on their lenders. The recent decline in bond yields has been another factor boosting equity markets. Although equity prices generally have risen, bank stocks have weakened in some countries, reportedly in part because of fears of the effects on banks' interest margins of negative official rates.

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Risks to the forecast and implications for policy

A number of the risks discussed in recent issues of the *Review* have receded with developments over the past three months, but they have not been eliminated.

First, the downward shift in the expected path of US short-term interest rates has helped to reverse capital outflows from emerging market economies and downward pressure on their currencies. In fact, the Institute of International Finance has estimated that portfolio inflows to emerging markets reached a 21-month high in March 2016. Second, the depreciation of the dollar associated with the shift in expectations about US monetary policy has alleviated the debt burdens of dollar borrowers outside the US. Third, the recent upturn in oil and other global commodity prices has reduced the widespread risk of deflation as well as providing limited relief to commodity exporting countries whose terms of trade have deteriorated in recent years. Fourth, the recent data showing improved demand and activity in China have reduced the likelihood of a severe downturn in that economy in the short term.

Yet the risks associated with the prospective normalisation of monetary policy in the advanced economies remain, including the risks arising from the relatively advanced position of the United States in the recovery, with its implications for relative yield differentials and the dollar's exchange rate. Similarly, the stubbornness of below-target inflation and of wage stagnation, even in economies apparently close to full employment, after several years of extraordinary monetary accommodation, is not well understood, and the risk of its continuing persistence, and even deflation, cannot be easily dismissed. Again, recent developments in China may be encouraging in terms of its short-term growth performance, but the authorities' further resort to monetary stimulus and the limited progress in reducing corporate debt, as well as the steady effective depreciation of the renminbi over the past six months – made less obvious by its appreciation against the dollar for part of the period (see figure 11) – are less reassuring with regard to progress with the planned and needed restructuring of the economy away from reliance on investment and exports.

Significant risks also remain with regard to oil prices. The recent upturn in prices has been sustained for longer than some analysts expected and, with production continuing to exceed demand this year, a significant reversal remains possible in the short term. Alternatively, the upturn in prices could strengthen if there are further production cutbacks or supply disruptions, or if demand strengthens. But not only is there uncertainty about the future path of prices relative to our baseline assumption: there is also a newer uncertainty about the economic effects of oil price movements. The dramatic fall in prices since mid-2014 has had more obvious negative effects on growth and imbalances in oil-producing countries; on investment, profits and liquid asset holdings in the energy sector; on expectations about the profitability of lenders to oil producers; and also, apparently, on equity markets, than it has had positive effects on global aggregate demand. The positive response of private consumption has generally been less apparent than might have been expected from past experience, perhaps because households have chosen to save their windfalls as they have expected the price fall to be transitory, or perhaps because past evidence was distorted by accompanying reductions in interest rates, which have not occurred this time because rates were already at or close to their zero lower bound. In the former case, maintenance of lower prices could eventually raise demand by more than we are now assuming: this is an upside risk to our growth forecast. But there are also clearly downside risks from oil market developments.

Among political risks, one that has gained prominence in many advanced economies is the pressure for defensive, protectionist policies to address weak income growth and growing income inequality – complex issues that are often attributed simply to features of globalisation, including international trade and migration. Such policy reactions could seriously exacerbate the problems they are meant to address. More constructive would be a strengthening of policies to help those who are the losers from structural economic change, including improved training and re-training programmes and other active labour market policies.

Another set of risks concerns the reliance on increased monetary accommodation in several advanced economies. In an increasing number of cases, central banks have resorted to negative interest rates on at least some bank reserves: in the past three months, Japan has joined this group of countries, which already included Denmark (the pioneer, in July 2012), the Euro Area (since June 2014), Sweden (since July 2014), and Switzerland (December 2014). It is generally acknowledged that the scope for lowering interest rates below zero is limited. Commercial banks have so far been unwilling to pass on negative interest rates to their retail depositors, or are legally prohibited from doing so: to impose charges on retail deposits would be to discourage business and

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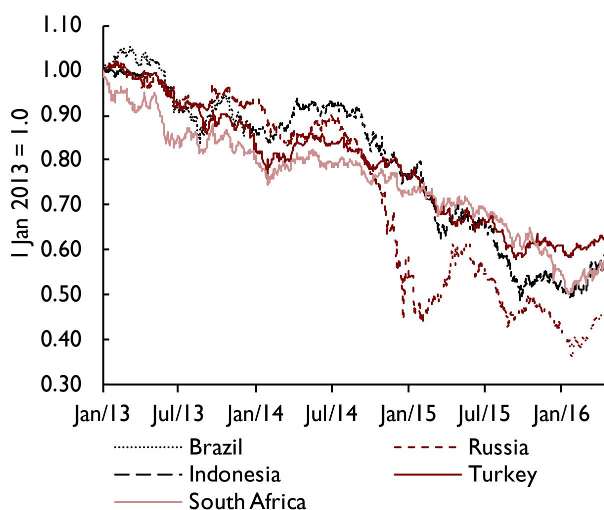
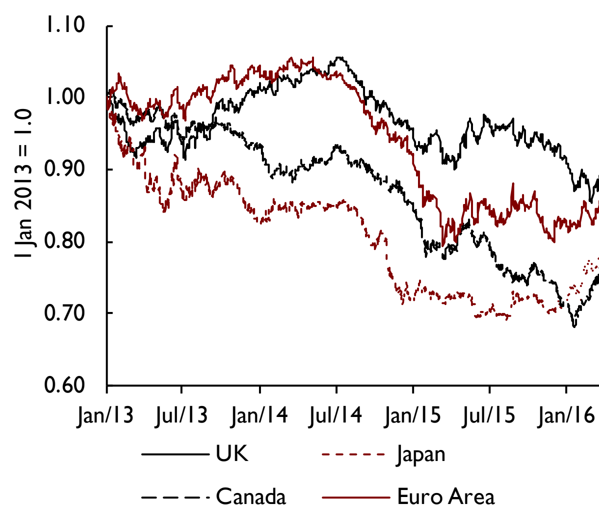
Figure 3. Exchange rates against $US for selected emerging markets



Source: Datastream and authors' calculations.

Figure 4. Exchange rates against $US for selected advanced economies



Source: Datastream and authors' calculations.

encourage the hoarding of cash. With zero thus being a fairly hard lower bound for banks' retail deposit rates, reducing central bank rates below zero intensifies the compression of banks' interest margins that is associated with low interest rates. This seems to have been reflected in declining prices of bank equity in some countries, including Japan, in recent months.

However, the effect on interest margins will vary among banks with different business models, and these margins are also subject to other influences. In his April press conference, President Draghi of the ECB noted that aggregate data for the Euro Area showed that banks' net interest income had risen in 2015, the first full year of negative interest rates, but he also acknowledged that the aggregate picture might "conceal different realities", and noted that although the ECB's Governing Council "gives a positive judgment about the past experience, [it] is increasingly aware of the complexities that this measure [negative interest rates] entails". For various legal and institutional reasons, some banks may be severely affected, with adverse implications for financial stability. Reducing interest rates further into negative territory may, therefore, at least in the absence of substantial financial sector reform, have adverse consequences that would need to be weighed against their macroeconomic benefits and the gains for banking business and banks' profitability that such benefits should entail. As Draghi also said, "the issue of negative interest rates is not so much an issue of yes or no; it's an issue of extent".

This is another indication of the risks that might be involved in proceeding further with negative interest rates and of the consequent constraints. Particularly given the continuing weakness of global growth and the persistence of below-target inflation shown in our forecast, the need for countries to adopt more balanced policy mixes, which has been discussed in earlier issues of the *Review*, has become even more apparent. As agreed at recent meetings of the IMF and other international bodies, continuing accommodative monetary policies need to be accompanied by structural reforms – particularly reforms that raise confidence and demand – and the use of fiscal space, particularly to increase productive investment expenditure, including in infrastructure. Such investment could be financed by borrowing at historically low interest costs, and it would not only boost demand: it could enhance potential growth, which seems to have suffered globally in the wake of the crisis.

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