WIFO ■ BULLETIN

No. 19/2015
November 2015

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Confidence in the USA, Uncertainty in the Euro Area, Fragility in the Emerging Markets

Medium-term Forecast for the World Economy until 2020

Confidence in the USA, Uncertainty in the Euro Area, Fragility in the Emerging Markets. Medium-term Forecast for the World Economy until 2020

After the cyclical reversal in 2015, the Chinese economy will grow at a slower pace also in the years to come. This keeps commodity prices down over the medium term and complicates recovery in Russia and Brazil where forward-looking investment had been neglected while raw material prices were booming. Sluggish investment is also compromising growth opportunities in the euro area. The lack of policy co-ordination heightens economic uncertainty, and priority given to respective national policy goals reinforces divergence of developments. Better are growth perspectives in the USA, where the financial market crisis and the recession and its consequences were overcome by a skilful mix of monetary and fiscal policy, and where the momentum of demand and output is driven by a growing labour force.

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JEL-Codes: F01, F44, F47 • **Keywords:** Medium-term forecast, world economy

For definitions see "Methodological Notes and Short Glossary", http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf.

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ISSN 1605-4709 • © Austrian Institute of Economic Research 2015
Impressum: Herausgeber: Karl Aiginger • Chefredakteur: Michael Böheim (Michael.Boeheim@wifo.ac.at) • Redaktionsteam: Tamara Fellinger, Ilse Schulz, Tatjana Weber • Medieninhaber (Verleger) und Redaktion: Österreichisches Institut für Wirtschaftsforschung • 1030 Wien, Arsenal, Objekt 20 • Tel. (+43 1) 798 26 01-0 • Fax (+43 1) 798 93 86 • http://bulletin.wifo.ac.at • Verlags- und Herstellungsort: Wien

The fractures in the world economy laid open by the financial market crisis and the Recession will continue to shape growth trends over the years to come. Two adverse factors deserve special consideration: the investment-constraining uncertainty in the euro area and the fragility of the emerging markets. The euro area is lacking policy instruments to effectively tackle the post-recession crisis and the divergence in member countries' economic performance. Basic deficiencies in the design of EMU, notably the lack of compensation and stabilisation mechanisms in wage and fiscal policy remain unaddressed. Uncertainty is therefore still high and the momentum of investment sluggish. Medium-term GDP growth is projected at 1.4 percent per year.

Emerging market developments are another retarding force. Manufacturing output in China has slackened significantly this year, a direct consequence of events since 2007: the slump in exports during the Recession was offset by massive public investment programmes. Over-production has now been corrected, with implicit dampening effects on world trade and commodity prices. Since the service sector meanwhile plays an important role in China and the public authorities still have some scope for intervention, the current "soft patch" will likely be overcome soon; nevertheless, projected GDP growth of 6 percent p.a. is slower than in the past. In addition, low prices for raw materials reduce prospects for commodity exporters, especially Russia and Brazil: investment opportunities missed during the commodity price boom ("Dutch disease") reduce medium-term growth perspectives to +1.7 percent p.a. and +1.3 percent p.a., respectively. India, on the other hand, being a net

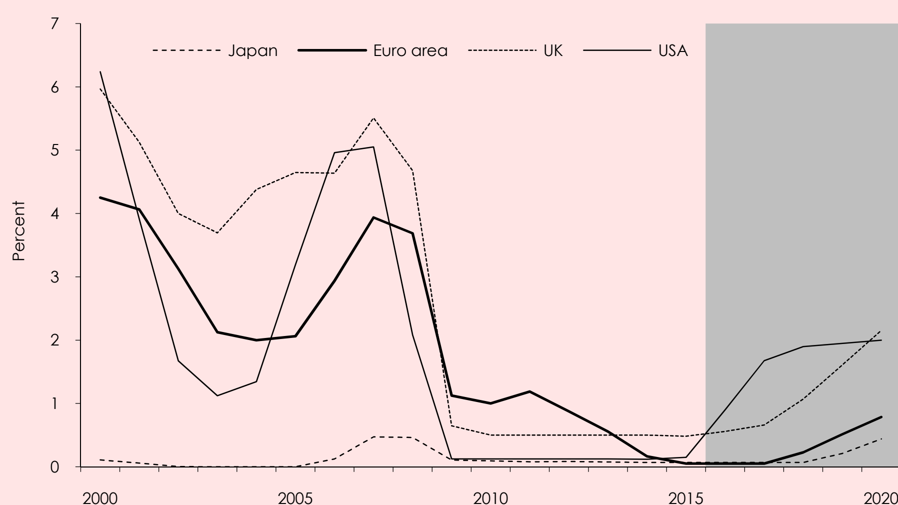
importer of commodities, stands to benefit from the low prices and, with a projected +7.2 percent p.a., may outpace China's GDP growth.

Table 1: The international environment

	Ø 2000-2005	Ø 2005-2010	Ø 2010-2015	Ø 2015-2020
	Year-to-year percentage changes			
GDP, volume				
World	+ 3.9	+ 3.9	+ 3.5	+ 3.6
USA	+ 2.5	+ 0.8	+ 2.0	+ 2.5
Japan	+ 1.2	+ 0.3	+ 0.7	+ 1.0
EU	+ 1.9	+ 0.9	+ 1.0	+ 1.7
Euro area	+ 1.6	+ 0.8	+ 0.5	+ 1.4
Germany	+ 0.5	+ 1.2	+ 1.6	+ 1.3
CEEC 5[1]	+ 3.7	+ 3.3	+ 2.3	+ 2.7
China	+ 9.8	+ 11.2	+ 7.8	+ 6.0
World trade (goods), volume	+ 5.1	+ 3.5	+ 2.8	+ 3.2
World market commodity prices[2]	+ 11.8	+ 8.7	– 7.3	+ 4
Excluding crude oil	+ 7.0	+ 10.7	– 5.7	+ 1
	Ø 2001-2005	Ø 2006-2010	Ø 2011-2015	Ø 2016-2020
	$ per €			
Exchange rate	1.09	1.36	1.29	1.15
	$ per barrel			
Oil price (Brent)	34	75	97	65

Source: Oxford Economic Forecasting, WIFO. – [1] Poland, Slovakia, Slovenia, Czech Republic, Hungary. – [2] Dollar basis, 2010 = 100.

Figure 1: Key interest rates up to 2020



Source: Oxford Economic Forecasting, WIFO.

Growth prospects for the US economy, taking into account the already high per-capita income, are still the best world-wide (+2.5 percent p.a.). The repercussions of the financial market crisis and the severe recession – excess debt in the private sector, high unemployment, sluggish credit growth – were overcome by a careful mix of monetary and fiscal management. While fiscal policy is set to remain expansionary in the next few years, interest rates will be raised in step with the solid economic performance. Conversely, the tighter fiscal rules introduced in the euro area are narrowing the scope of budgetary policy, whereas the monetary reins remain slack in view of anaemic growth and low inflation. Apart from the depreciation of the euro, the effect of monetary expansion on the real economy is nevertheless small, in the absence of support from the fiscal side.

The present projections, elaborated by means of the Oxford Global Economic Model, cover the period from 2016 to 2020. The model includes 77 countries, 47 of which are represented in detail, among them China, the USA, most EU member countries, India, Japan, Russia and Brazil.

1. China's crisis and capital drain weighing on world trade

World trade should pick up in the near future, without however moving to a faster medium-term growth trend.

Global merchandise trade is hardly expanding in 2015, rebutting projections before last summer that had expected growth above 3 percent (*WTO*, 2015, *Schiman*, 2015B). The now likely stagnation is mainly due to a sharp fall in trade flows to and from Asia. Particularly the downturn in China's manufacturing sector proved more severe and abrupt than anticipated in WIFO's Medium-term Projection for the world economy of January 2015 (*Schiman*, 2015A). According to an analysis by Oxford Economics whose macroeconomic model is the basis for the present forecast, the Chinese economy grew by only 3 to 4 percent year-on-year in the first half of 2015, whereas the National Accounts suggest a rate of 7 percent. Only during the crises of 2001-02 and 2008-09 had global trade slackened more sharply than in the current year, while the setback had been milder during the balance of payments crises of the 1990s in Mexico, Southeast Asia and Russia. For the first time now, a global trade shock is emanating from the emerging markets: apart from China, the current recessions in Russia and Brazil with massive capital outflows undermine global trade flows. The prospect of rising US interest rates further adds to the retreat of capital from the emerging markets and complicates financing of foreign trade.

In a medium-term perspective, world trade is projected to expand by an average 3.2 percent p.a. This expectation combines past experience of rather swift recoveries of trade flows from global shocks with the forward-looking assumption of non-accelerating growth in the emerging markets.

2. Oil prices remaining low

Against this background, the assessment of the oil price decline observed since the middle of 2014 needs to be adjusted. The WIFO Medium-term Forecast of January 2015 had seen the slowdown in China as one of the reasons for the price drop (next to the supply increase generated by fracking in the USA), but had believed in an upward correction of a supposedly exaggerated undershooting. However, in the light of the more lasting moderation in China, a significant rebound in oil prices as well as other industrial commodities now seems less likely, the more so as economic growth in the emerging markets will not accelerate markedly. At the same time, a reduction of oil supply is not in sight, since on the back of efficiency gains fracking appears to be profitable even at low oil prices and traditional oil producers embark on price competition in trying to maintain their market shares. Hence, the medium-term oil price forecast is taken down from an average $ 95 per barrel (2015-2019) to $ 65 for the period 2016-2020.

3. Euro area: fundamental deficiencies in the design of EMU clouding the investment climate

Business conditions differ widely across the euro area. Apart from Germany, activity is shaped by making up for setbacks suffered in earlier crises. Households in Ireland, Spain and Portugal are recouping the income losses incurred during the external balance crisis and the subsequent austerity policy. In other euro area countries, growth is feeble, with unemployment receding only hesitantly and inflation extremely low. The combination of slow output growth, labour slack and absence of inflation is a clear indication of lack of aggregate demand being the cause of stagnation.

The lack of demand has its origin in the losses of income and wealth since 2007 that have prompted households and firms to increase saving. Fiscal stimulus was not strong enough to compensate the restraint of private demand. One reason is that

compliance with fiscal rules and self-set budgetary targets received higher priority than counter-cyclical fiscal management. On the other hand, euro area countries have de facto limited fiscal room for manoeuvre since the lack of an autonomous monetary policy renders them more vulnerable to sovereign debt crises. Although this constitutional flaw of EMU has to some extent been mitigated by the ECB's new interpretation of its role as "lender of last resort", reservations against co-ordinated expansionary action remain. Since the dampening effects of the "savings paradox" (private sector saving efforts being frustrated) are self-reinforcing in the absence of positive external stimulus, the medium-term outlook for the euro area is overcast.

Table 2: Key economic indicators for the euro area and Japan

	Euro area		Japan	
	Ø 2010-2015	Ø 2015-2020	Ø 2010-2015	Ø 2015-2020
	Year-to-year percentage changes			
Gross fixed investment, volume	− 0.4	+ 2.0	+ 2.3	+ 1.0
Population of working age	+ 0.0	− 0.1	− 1.1	− 0.9
GDP, volume	+ 0.5	+ 1.4	+ 0.7	+ 1.0
GDP per capita, volume	+ 0.4	+ 1.3	+ 0.8	+ 1.3
Consumer prices	+ 1.4	+ 0.6	+ 0.7	+ 0.8
Real-effective exchange rate	− 2.6	− 0.1	− 7.2	− 3.8
	Ø 2011-2015	Ø 2016-2020	Ø 2011-2015	Ø 2016-2020
	Percent			
Unemployment rate, as a percentage of labour force	11.3	10.1	4.0	3.5
Long-term interest rate	2.9	2.6	0.7	0.3
World market export share	28.5	27.6	4.5	4.6
	As a percentage of GDP			
Current account balance	1.6	2.3	1.4	1.5
General government financial balance	− 3.0	− 1.5	− 8.2	− 3.9
Gross government debt	90.2	93.5	220	233

Source: Oxford Economic Forecasting, WIFO.

The easy monetary policy of the ECB has little effect on inflation. Tighter fiscal rules heighten the pressure on government households.

One reaction channel of this self-reinforcing mechanism is inflation: deficient demand inhibits price increases, the core rate of inflation (excluding energy and unprocessed food) has lately remained below 1 percent. This complicates debt deleveraging and pushes up real interest rates, undermining the profitability of investment and weakening demand further. In order to cut this self-reinforcing feedback loop, the ECB targets a higher rate of inflation. Since it does not achieve this target by conventional measures, it launched in March 2015 a large-scale programme of euro area government bond purchases. This measure has different effects: first, it provides relief for the financial sector, as the ECB demand raises the price of bonds and improves the asset position of banks and insurance companies holding these bonds or selling them to the ECB. Second, the price increase in euro-denominated fixed-interest assets lowers their yield and also the external value of the euro. Exporting companies benefit to the extent that the boost to demand for their goods outweighs the price increase for foreign-currency-denominated imports. Third, refinancing conditions for companies improve, as prices rise not only for government bonds, but via portfolio effects also for other financial assets like corporate bonds or shares. Fourth, higher asset prices (lower yields) facilitate the issuance of new debt.

Yet, euro area countries do not take advantage of this facilitation; they rather reduce new borrowing. In the medium term, tighter fiscal rules constrain governments' fiscal capacity even more. According to the new rule, the general government deficit, adjusted for cyclical variations and one-off effects, must not exceed 0.5 percent of GDP. In addition, the debt-to-GDP ratio must be reduced each year by one-twentieth of the amount exceeding 60 percent of GDP. Thus, apart from the euro depreciation that has already occurred, the bond purchases by the ECB will have no further expansionary and inflation-enhancing impact.

The focus on national policy goals will not be able to overcome the slow pace of growth in the euro area.

Also other major impediments to euro-area growth will not be removed in the short term. Economic policy in the EU gives priority to supply-side reform measures at the national level, which however does not resolve the problem of deficient demand. Neither are the shortcomings of the EMU architecture being tackled for the time being. What would be necessary is a fully integrated Economic and Monetary Union that could compensate the loss of monetary and exchange rate sovereignty of its members and conduct an effective stabilisation policy. In the existing vulnerable institutional set-up, uncertainty remains high; hence, gross fixed investment will expand by only 2 percent p.a. in the medium term, although sluggish growth during the past five years has accumulated sizeable need for replacement of production facilities.

Figure 2: Per-capita income and unemployment rate for the USA and the euro area

Source: Oxford Economic Forecasting, WIFO.

Macroeconomic challenges continue to be addressed at the national level, without appropriate consideration being given to the euro area as an economic entity. This approach does not only burden the overall investment climate, but perpetuates internal euro-area imbalances. Thus, while as a result of the crisis the current account balance of many countries turned positive, Germany's high surplus did not shrink, thereby preventing a reduction of intra-area trade imbalances. Moreover, Germany's surplus is set to remain high over the medium term, since currency revaluation is not possible within EMU and there is no institutional mechanism for rebalancing. Germany's trading partners carry the burden of the country's sustained under-valuation via insufficient demand for their exports. Fiscal policy faces a similar dilemma: countries with positive foreign assets or low external debt are less prone to balance of payments crises and can provide expansionary fiscal stimulus, notably with the ECB now credibly assuming the role of lender of last resort, particularly if (but not only) the government budget is in surplus, like in Germany. However, this potential is not being utilised as fiscal policy is geared towards national considerations.

With the institutional deficiencies and the related uncertain investment climate persisting, aggregate demand will remain subdued in the next few years, the more so as it is not countered by policy initiatives. GDP growth in the euro area will not exceed an average 1.4 percent p.a., with inflation remaining at a low 0.6 percent p.a. and unemployment heading down only gradually.

4. USA: interest rate turnaround will not harm growth prospects

Conditions for sustained medium-term growth of the US economy remain sound.

Demand and output in the USA remain firmly upward bound. Private household and corporate debt decreased steadily in the last few years, unwinding between 2009 and 2013 almost half of the amount accumulated from 2000 to 2009. Debt reduction was facilitated by a rather borrower-friendly legislation; thus, in case of failure to repay a mortgage, debt is considered redeemed with the transfer of the property to

the creditor even if the value of the property at the time is lower than the outstanding debt. Moreover, speedy private insolvency procedures make for swift debt reduction. Apart from the clean-up of private sector debt, the comparatively easy fiscal policy is a further supportive element for stable and sustained growth. Although the US general government deficit has narrowed from 12 percent of GDP in the crisis year 2009 to 5.0 percent of GDP in 2014, it is still above the long-term average and significantly higher than the deficit ratio of 2.4 percent of the euro area. With a projected average deficit of 4.6 percent of GDP, US fiscal policy is set to remain expansionary over the forecast horizon.

Table 3: Key economic indicators for the USA and the UK

	USA		UK	
	Ø 2010-2015	Ø 2015-2020	Ø 2010-2015	Ø 2015-2020
	Year-to-year percentage changes			
Gross fixed investment, volume	+ 3.9	+ 4.5	+ 4.0	+ 4.3
Population of working age	+ 1.1	+ 1.0	+ 0.8	+ 1.0
GDP, volume	+ 2.0	+ 2.5	+ 1.9	+ 2.4
GDP per capita, volume	+ 1.2	+ 1.7	+ 1.2	+ 1.7
Consumer prices	+ 1.7	+ 2.1	+ 2.3	+ 1.3
Real-effective exchange rate	+ 2.2	− 0.4	+ 3.2	+ 0.4
	Ø 2011-2015	Ø 2016-2020	Ø 2011-2015	Ø 2016-2020
	Percent			
Unemployment rate, as a percentage of labour force	7.2	4.4	7.1	5.4
Long-term interest rate	2.3	2.6	2.4	2.9
World market export share	10.8	10.9	3.9	3.8
	As a percentage of GDP			
Current account balance	− 2.5	− 1.8	− 4.2	− 3.1
General government financial balance	− 7.0	− 4.6	− 6.0	− 0.8
Gross government debt	123	125	86.9	85.0

Source: Oxford Economic Forecasting, WIFO.

Despite a slight downward revision, the new growth projection for the USA is the highest for all industrialised countries. From 2015 to 2020, real GDP is expected to expand by 2.5 percent per year, and gross fixed investment by 4.5 percent p.a. Growth of the labour force by an average 1.0 percent per year is strengthening the growth potential, whereas the labour force will contract in the EU, China and Japan. On the basis of the overall favourable growth prospects, policy-controlled interest rates will be raised step by step over the next years, albeit only gradually given the permanently low inflation risks. Asset price inflation on financial and real estate markets shall be kept under control by tighter supervision and regulation.

5. Sharp slowdown in China and other major emerging markets

Contrary to official statistics, the Chinese economy may have grown by only 3 to 4 percent year-on-year in the first half of 2015. Going forward, also the reported growth rates will abate.

The sharp fall of values at the Shanghai stock exchange in summer 2015 aroused fears of another world-wide financial market crisis and recession. A stock market crash wipes out private household wealth and firms' equity capital, with negative repercussions on private demand. However, such effects are negligible for China since the proportion of shares in total assets is much lower than in western industrialised countries. Besides, the stock market boom preceding the slump had set in only at the end of 2014 (with the admission of credit-financed purchases) and lasted just a couple of months. Stock market wealth is thus of little macroeconomic relevance for saving and financing in China, but is rather a form of "play money" with little impact on the real economy. Hence, while the risk of world-wide contagion is deemed low, the latest turbulences are rather an indication of the prevailing weak business conditions. Contrary to seemingly robust GDP growth suggested by official statistics (+7.0 percent year-on-year respectively in the first two quarters of 2015), the slackening of rail traffic, energy consumption and foreign merchandise trade as well as the

deflation of producer prices show that growth has significantly lost momentum, notably in manufacturing. According to an analysis by Oxford Economics, real GDP in the first half of 2015 may have gained no more than 3 to 4 percent.

Table 3: Key economic indicators for China and India

	China		India	
	Ø 2010-2015	Ø 2015-2020	Ø 2010-2015	Ø 2015-2020
	Year-to-year percentage changes			
Gross fixed investment, volume	+ 7.9	+ 5.4	+ 3.6	+ 7.2
Population of working age	+ 0.3	− 0.2	+ 1.7	+ 1.4
GDP, volume	+ 7.8	+ 6.0	+ 6.3	+ 7.2
GDP per capita, volume	+ 7.2	+ 5.5	+ 5.0	+ 6.0
Consumer prices	+ 2.8	+ 2.0	+ 8.3	+ 3.5
Real-effective exchange rate	+ 5.4	+ 0.7	+ 2.3	− 0.7
	Ø 2011-2015	Ø 2016-2020	Ø 2011-2015	Ø 2016-2020
	Percent			
Unemployment rate, as a percentage of labour force	4.1	4.0	5.6	5.6
Long-term interest rate	3.7	2.4	8.2	6.7
World market export share	9.8	10.1	2.4	2.6
	As a percentage of GDP			
Current account balance	2.3	2.8	− 2.8	− 1.9
General government financial balance	− 1.1	− 3.6	− 5.3	− 3.1
Gross government debt[1]	15.2	24.7	47.4	42.7

Source: Oxford Economic Forecasting, WIFO. – [1] Central government.

However, several considerations argue against a lasting economic crisis in China. The service sector which already accounts for more than half of China's production value, reacts more languidly than goods production and may cushion the downturn. Unlike with many other emerging market countries, the Chinese authorities still have sufficient scope for policy to counter-act: the key interest rate currently stands at 4.6 percent, the minimum reserve ratio for major banks at 18 percent. Both benchmarks may be cut further by the Central Bank. In addition, the government may resort to fiscal expansion without running the risk of triggering capital flight, since China has accumulated important foreign currency reserves thanks to long lasting current account surpluses. Yet, a comprehensive investment package such as introduced in 2009-10 is unlikely to be repeated, since it led to important misallocation of resources, particularly in construction, and contributed towards destabilisation of financial markets. Indeed, the main stimulus came from the regional authorities and was financed by special purpose vehicles ("shadow banks") in order to circumvent stricter rules in the regular banking sector. In 2013, nominal gross fixed investment reached a peak of 45 percent of GDP.

In all, the Chinese economy will grow more slowly than over the past five years, even if policy action should be able to bring the present weakness to an early end. Accordingly, also the officially reported growth figures should head further down, to a projected 6 percent p.a. for the period 2015-2020.

The drop in commodity prices hits Russia and Brazil, but benefits India.

Slackening economic activity in China and the accompanying decline in commodity prices carry substantial adverse effects for other emerging market countries, among them the larger economies of Russia and Brazil. As an exporter of oil, Russia benefited for many years from the high world market price. Also the Russian government budget depends to a high degree on revenues from the oil business. Likewise, the Brazilian economy relies heavily on exports of raw materials, the prices of which have eased with lower demand from China. The commodity price boom of the last few years has crowded out forward-looking investment in other areas. The outflow of capital and rising inflation compel Central Banks of the countries concerned to tighten monetary policy and raise interest rates. The consequences of this "Dutch disease" are not only reflected by the current crises in both countries, but risk

weighing on growth also in a medium-term perspective (Russia +1.7 percent p.a.; Brazil +1.3 percent p.a.).

Table 4: Key economic indicators for Brazil and Russia

	Brazil		Russia	
	Ø 2010-2015	Ø 2015-2020	Ø 2010-2015	Ø 2015-2020
	Year-to-year percentage changes			
Gross fixed investment, volume	− 0.3	+ 1.4	+ 0.5	+ 1.2
Population of working age	+ 1.3	+ 1.0	− 0.6	− 1.0
GDP, volume	+ 1.2	+ 1.3	+ 1.1	+ 1.7
GDP per capita, volume	+ 0.3	+ 0.5	+ 1.1	+ 1.8
Consumer prices	+ 6.7	+ 4.8	+ 8.5	+ 4.2
Real-effective exchange rate	− 4.4	− 4.1	− 4.7	+ 4.5
	Ø 2011-2015	Ø 2016-2020	Ø 2011-2015	Ø 2016-2020
	Percent			
Unemployment rate, as a percentage of labour force	6.2	8.1	5.7	6.9
Long-term interest rate	11.6	12.4	9.0	5.8
World market export share	1.3	1.2	2.4	2.1
	As a percentage of GDP			
Current account balance	− 3.6	− 4.0	3.7	3.7
General government financial balance	− 4.2	− 5.2	− 0.5	− 1.1
Gross government debt	56.9	71.1	10.7	15.4

Source: Oxford Economic Forecasting, WIFO.

India, for its part, being a net importer of raw materials, is benefiting from the low prices. A risk factor in this case is the projected turnaround in US interest rates. The present forecast assumes, however, that the move towards rising interest rates will cause less turbulence than the announcement of tightening by former Fed President Bernanke did in 2013, which at the time triggered heavy capital movements and notably capital drain from India. Nevertheless, the intelligent handling of that crisis has strengthened the reputation of the Indian Central Bank with market participants. Under assumptions of low commodity prices and the absence of financial market turbulence, the medium-term outlook for GDP growth in India is for a benign 7.2 percent per year.

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