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Debt Accumulation and Deleveraging Shaping the Global Business Outlook

Medium-term Projection for the World Economy until 2019

Debt Accumulation and Deleveraging Shaping the Global Business Outlook. Medium-term Projection for the World Economy until 2019

The marked decline of oil prices gives some impetus to business activity in the euro area. However, medium-term prospects are dominated by lack of aggregate demand and very low inflation; moreover, the lacking possibility of currency de- or re-valuation, notably the under-valuation for Germany, is weighing on the growth outlook. Prospects for the USA are markedly more favourable since excess private debt was reduced rapidly via bankruptcies and by accepting generous government deficits after the financial market crisis. In China, both prosperity and indebtedness are rising quickly. In Japan, the investment-inhibiting unwinding of corporate debt will wear off in the years to come. Another financial market crisis is looming in Russia, despite the country's moderate degree of foreign indebtedness.

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The present projections covering the period 2015-2019 have been established using the Oxford Economics (Global Economic Model). For definitions see "Methodological references and glossary of terms", <http://www.wifo.ac.at/wwwdocs/form/WIFO-BusinessCycleInformation-Glossary.pdf>.

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Since the middle of 2014, the price for crude oil has fallen almost by one-half. At the end of last year, it was below \$ 60 per barrel. The fall was preceded by supply increases in the USA and declining demand from China and parts of Europe. Speculative behaviour in the context of the Russian crisis further added to the momentum of the oil price fall. Since speculation always goes along with higher volatility (overshooting), some upward correction to an annual average \$ 75 per barrel for 2015 appears likely. The present projection expects a rebound to \$ 105 by 2019, implying an average oil price roughly \$ 15 below the one underlying the WIFO medium-term forecast of 2013.

The lower oil price provides some support to business activity in the euro area, although the persistently high debt overhang in the private sector still acts as a constraint to consumption and investment. Government support to aggregate demand is generally too weak as to allow a reduction of excess private debt. In addition, the German economy – the largest in Europe – is growing, via high current account surpluses, at the expense of its trading partners, instead of using the favourable financing conditions for fiscal expansion. Where risk premia have been raised by the financial market crisis, they weaken private demand even more. Sluggish demand in turn dampens inflation which further complicates deleveraging and raises real interest rates. Apart from low inflation, tighter fiscal rules will weigh on demand and output growth going forward, since tight liquidity constraints in the private sector do not allow for any expansionary Ricardian effects (i.e., additional private spending in anticipation of future tax cuts). The new growth initiative by the European Commission

mainly provides for guarantees to private investors, which however does not address the root cause for the investment shortfall, i.e., poor sales prospects due to insufficient income growth. Government bond purchases by the ECB will flatten the yield curve and provide relief for government budgets. They would also prevent financial market stress from re-emerging in case of euro area turbulence such as Greek exit. Medium-term growth of real GDP in the euro area is projected at 1.3 percent p.a.

Table 1: The international environment

	Ø 2005-2009	Ø 2010-2014	Ø 2015-2019
	National currency per euro		
<i>Exchange rates</i>			
Dollar	1.35	1.33	1.20
Pound sterling	0.75	0.84	0.76
Yen	145.4	120.0	145.9
Renminbi/Yuan	1.82	1.59	1.58
Zloty	3.91	4.14	3.93
Forint	259.1	290.0	296.9
Czech koruna	27.46	25.70	26.37
	Dollar per barrel		
<i>Oil price</i>			
Brent	70	103	95
	Ø 2004-2009	Ø 2009-2014	Ø 2014-2019
	Year-to-year percentage changes		
World trade	+ 2.1	+ 5.8	+ 4.4

Source: Oxford Economic Forecasting, WIFO.

Table 2: Growth of real GDP by countries and regions

	Ø 2004-2009	Ø 2009-2014	Ø 2014-2019
	Year-to-year percentage changes		
World	+ 3.8	+ 3.9	+ 3.7
EU	+ 0.9	+ 1.0	+ 1.6
Euro area	+ 0.8	+ 0.7	+ 1.3
Industrialised countries ¹	+ 0.9	+ 1.7	+ 2.1
USA	+ 0.9	+ 2.2	+ 2.8
Japan	- 0.3	+ 1.5	+ 1.0
Germany	+ 0.6	+ 2.0	+ 1.3
France	+ 0.7	+ 1.0	+ 1.0
Italy	- 0.4	- 0.4	+ 0.7
Spain	+ 1.6	- 0.4	+ 1.7
UK	+ 0.7	+ 1.8	+ 1.9
CEEC 5 ²	+ 3.6	+ 2.1	+ 2.9
Emerging markets	+ 6.2	+ 5.4	+ 4.9
China	+ 11.4	+ 8.5	+ 6.4
India	+ 8.6	+ 6.4	+ 6.2
Russia	+ 3.9	+ 2.8	+ 2.5
Brazil	+ 3.6	+ 2.7	+ 2.4
Latin America	+ 3.7	+ 2.3	+ 3.0
Africa	+ 4.8	+ 3.6	+ 4.4

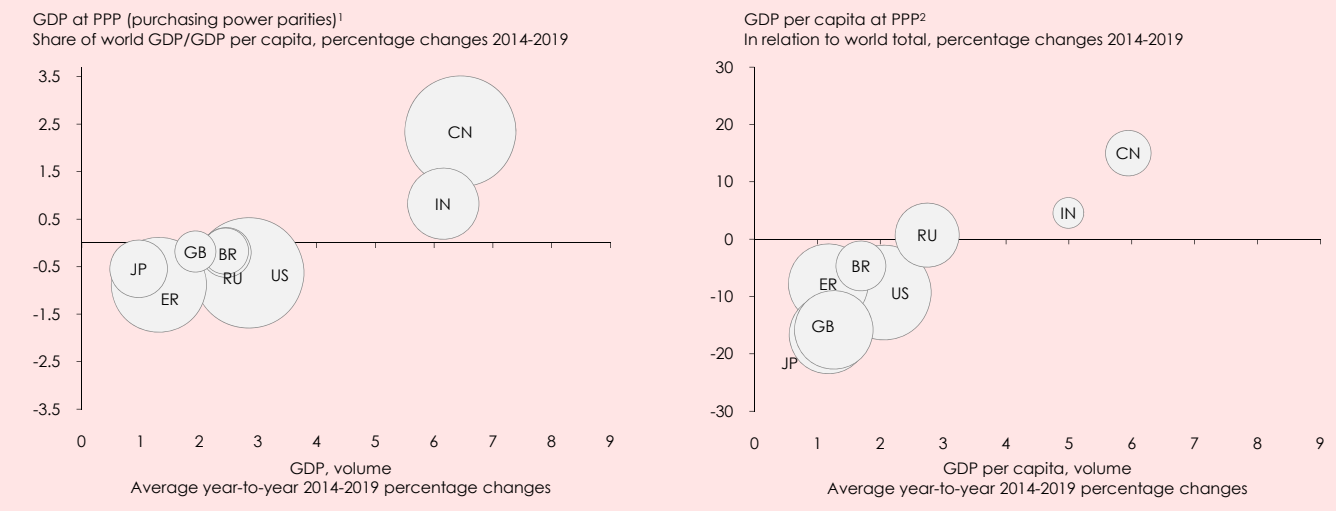
Source: Oxford Economic Forecasting, WIFO. – ¹ 30 OECD countries. – ² Poland, Slovakia, Slovenia, Czech Republic, Hungary.

Germany's current account surplus, generated by wage restraint, remains high over the medium term, since (national) currency appreciation is impossible and with the euro rather losing ground on account of further monetary easing. However, German exports suffer from slackening demand from emerging market countries (notably China); on the other hand, the disadvantages of the implicit under-valuation, i.e., foregone imports from close trading partners like France weighing on their output, are becoming increasingly visible. The common currency will thus dampen economic activity in the years to come. The medium-term performance of Italy, Austria's second-most important export market, will be undermined not only by weak demand, but also by shortcomings of its (institutional) policy framework. According to the Doing-Business Report issued by the *World Bank* (2014), the Italian judicial system

is extremely inefficient when it comes to the enforcement of contractual claims. Italian companies' administrative burden related to tax declaration is by far the heaviest within the EU.

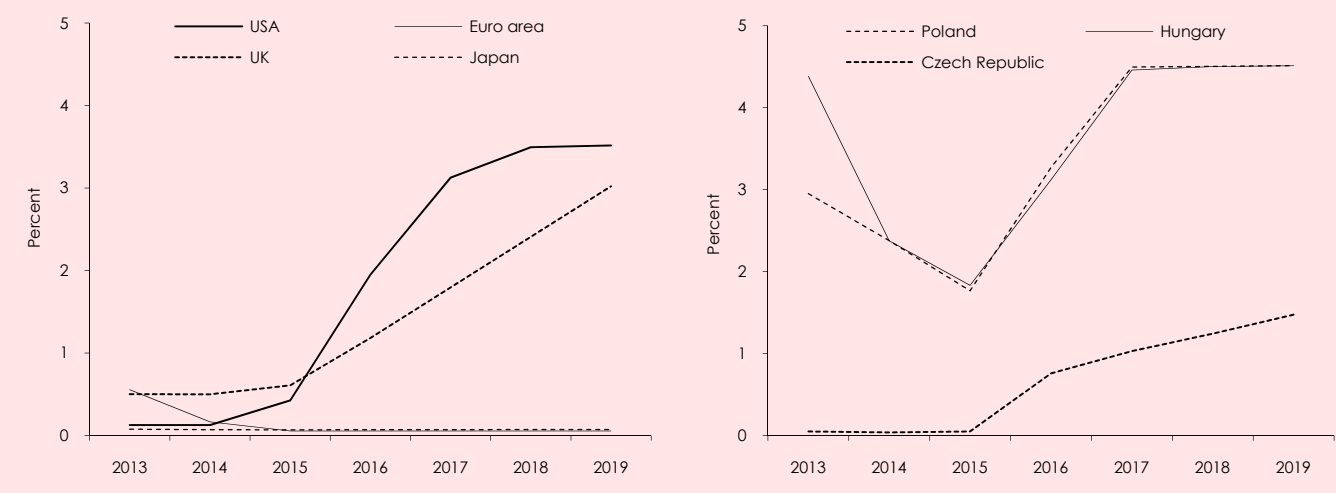
Like in the 2013 vintage of the WIFO medium-term forecast, the outlook for the USA is the most favourable one worldwide. A debtor-friendly bankruptcy legislation facilitated a speedy reduction of excess private debt after the financial market crisis. In addition, government deficits provided generous cyclical support. The public debt ratio is not rising over the medium term – unlike in the euro area, where not only budget deficits are markedly lower, but also GDP growth and inflation. Medium-term growth of US real GDP is projected at 2.8 percent p.a.

Figure 1: Growth of GDP and GDP per capita for selected economies 2014-2019



Source: Oxford Economic Forecasting, WIFO. BR . . . Brazil, CN . . . China, ER . . . Euro area, GB . . . UK, IN . . . India, JP . . . Japan, RU . . . Russia, US . . . USA. – ¹ The size of the bubbles represents the share in 2014. – ² The size of the bubbles represents the value in 2014.

Figure 2: Key interest rates until 2019



Source: Oxford Economic Forecasting, WIFO.

On the basis of re-calculated international purchasing power parities, China has probably replaced the USA as the world's largest economy. Although the pace of growth continues slowing down, it is still higher than anywhere else. Substantial private income gains during the last years have boosted purchasing power and welfare, and the currency is appreciating. However, excessive investment fuelled by public subsidies and the implicit misallocation of resources is weighing on the growth outlook. Rapidly rising debt has been outsourced into poorly transparent "shadow

banks" that pose a threat to financial market stability. Medium-term real GDP growth in China is projected at 6½ percent per annum. Japan may be ready to pull out of the balance sheet recession that has crippled the country over the last years, since corporate deleveraging has come to a close. A major barrier to investment has thereby been removed. The policy stance is altogether accommodating, although the second stage of the VAT increase planned for 2017 remains a cyclical risk. The Russian economy will contract in 2015 as a consequence of the fall in oil prices. The devaluation of the rouble is fuelling inflation and adds to payment defaults on foreign-currency debt, thereby destabilising foreign banks operating in Russia. On the other hand, the weaker currency dampens the adverse effects of the oil price slump on export earnings and the government budget. Also the medium-term outlook for the Russian economy remains clouded after the end of the commodity price boom that, like in Brazil, has been hiding for years the structural deficiencies in the economy.

Economic growth and welfare in a cross-country comparison

Real GDP adjusted for purchasing power differences measures the size of an economy, while real GDP per capita indicates a country's level of welfare. Figure 1 shows different dimensions of these key macroeconomic indicators: the relation vis-à-vis other countries for the base year 2014 (bubble size), the medium-term rate of change (x-axis) and the change in cross-country relations over the forecast period (y-axis).

Already the last edition of the WIFO medium-term forecast for the world economy (Schiman, 2013) had emphasised the special role of China as dynamically growing large economy. After the revision of purchasing power parities by the World Bank in the context of its International Comparison Program, China's GDP at purchasing power parities has once again be revised upwards. According to the new calculations, China has overtaken the USA as the world's largest economy already in 2014, rather than by 2018, as predicted by the 2013 forecast. In 2019, China's share in world GDP is expected at 19 percent, compared with 16 percent for the USA. The US share is set to decline slightly, although growth exceeds that of other industrialised countries (but not the rate of global growth). The respective shares of Japan (4 percent in 2019) and the euro area (11 percent) in world output will also decline. More limited losses in world output shares are projected for the UK, Brazil and Russia as economies of comparable size. Among the countries and regions analysed here, only China and India will be able to raise their shares in global output.

The indicator of GDP per capita confirms China's status as emerging market economy, despite a significant upward revision of the purchasing power parity figure. GDP per capita of the affluent industrialised societies is substantially higher and thus growing less strongly than that of the emerging markets. Compared with the level of development of the industrialised countries on the one hand, and of China on the other, the projected pace of growth for Brazil is extremely slow. The catching-up potential for India is also very large. The prospects for the Russian economy are in keeping with the pattern of convergence as outlined for China towards the industrialised economies, provided the absence of another financial market crisis and assuming an average oil price of \$ 95 per barrel. Among the most advanced regions, the USA will enjoy above-average growth of per-capita GDP.

Compared with the WIFO medium-term forecast of 2013, growth prospects for China and India have converged: while the annual average rate of GDP growth for China has been taken down by 1 percentage point, the downward revision for India amounts to only 0.5 percentage points. The current projection is also more cautious on the growth outlook for Russia and Brazil.

1. Financial market speculation dampens oil prices

Oil prices have fallen steadily since June 2014. One barrel of Brent cost on average \$ 109 in the first half of 2014. After a terrorist attack on Iraq's biggest oil field, the price climbed to a peak of \$ 115.2 on 19 June 2014, before moving to a downward trend. By mid-December 2014, the reference price had fallen below \$ 60, a slump by almost one-half within six months, driven by both supply and demand factors. 20,000 new oil wells in the US have raised national oil output by about one-third from 2010; meanwhile, daily oil production is only one-tenth below that of Saudi-Arabia (Economist, 2014). At a conference end-November 2014, the OPEC Members, for their part, decided against the expectations of market participants to maintain output levels, thereby accelerating the price fall. On the demand side, slower growth in many oil-importing countries, notably in China and parts of Europe, is bearing down on prices. These circumstances, while being conducive to the oil price decline, have not been its direct cause. On today's commodity markets, price corrections are of-

The economic sanctions taken by the USA and the EU against Russia have triggered downward speculation on oil markets.

ten triggered by events whose repercussions are amplified by speculators' market reactions (herd behaviour). In this respect, there seems to be a close connection between the Russian crisis and the oil price fall. The economic sanctions against Russia taken by the US and the EU in mid-2014 after a diplomatic crisis lasting for months gave rise to concerns that the conflict would seriously damage the Russian economy. With oil being Russia's major export commodity, prices came under downward pressure and to the significant cyclical slowdown expected by market participants. Also the momentum of the price decline suggests that speculation and overshooting play an important role. A slight upward correction, to an average level of \$ 75 per barrel, is expected for 2015, followed by an increase to \$ 105 by 2019.

2. Weakness of aggregate demand in the euro area remains unresolved

The significant downward revision, compared with *Schiman* (2013), of the oil price assumption implies altogether positive effects for business activity in Europe, since the impact of lower energy cost will outweigh the loss of demand from oil-exporting countries. However, excess private debt and high real interest rates will weaken demand and output growth in the euro area in the next few years.

In the course of the financial market crisis of 2008, many companies and private households suffered sizeable and unexpected losses on their assets. This goes particularly for industrialised countries with a large financial sector and where financial services are highly liberalised. At the same time, private sector indebtedness that had been fuelled by booming business conditions and real estate markets remained high or increased even further. The resulting debt overhang compelled debtors to cut back on consumption and investment in order to accommodate for the higher debt service cost (Koo, 2014). Hence, the global recovery is advancing at a sluggish pace and remains prone to further crises. Both holds to a large extent for the euro area, where government deficits during the last years have not been large enough as to offset the higher appetite for saving of companies and private households. Aggregate demand and income growth were thereby held back, and debt reduction was not achieved to the extent desired (savings paradox).

This growth-inhibiting mechanism was reinforced by a further element that triggered another financial market crisis in some euro area countries and weighs on demand and output until today: countries with dominating private household indebtedness and which were forced by the financial market crises to deleverage, were also those with a negative external net asset position (Ireland, Greece, Spain, Italy, Cyprus, Portugal, Slovenia). The loss of financial market confidence that they suffered and that they were unable to counter by an autonomous monetary policy, rendered them vulnerable to further crisis. As from 2010, bond yields rose drastically (Greece, Ireland, Portugal) or at least noticeably (Spain, Italy, Slovenia), while at the same time the rise in interest rates caused by excess debt – whose unwinding would indeed have required a decline in rates – was decidedly harmful to business activity.

The fiscal impulse that would have been necessary in order to compensate the implicit slump in demand (i.e., deficits well above the Maastricht ceiling of 3 percent of GDP) was precluded by the interrupted access to liquidity. An overhasty austerity policy narrowed fiscal capacities also in cases where capital market refinancing was substituted or supplemented by international lenders (Troika). Euro area countries with positive net external asset position and with the majority of households being net lenders (Belgium, Germany, Malta, the Netherlands, Austria, Finland) saw their interest rates decline. Yet, this did not generate additional demand since the income of net lenders shrinks when interest rates fall. Poor sales prospects prompt companies to invest less and less, giving rise to a savings glut.

Overcoming this unpleasant situation will take still some years, since the weakness of demand has meanwhile brought inflation down to close to zero. This complicates the unwinding of debt, because the transactions agreed in debt securities are usually not linked to price developments, but are rather fixed ex-ante with regard to an expected rate of inflation. If actual inflation turns out lower than expectations, the real value of debt rises and debt servicing requires larger sacrifices of consumption

Policy support for aggregate demand in the euro area will not suffice for debt reduction in the private sector.

The interest rate shock of the euro area crisis and fiscal retrenchment exacerbated the demand shortfall and the savings glut.

Low inflation raises the opportunity cost of investment and complicates debt reduction.

and investment. Moreover, the deceleration of inflation raises real interest rates to the same extent since nominal rates (net of risk premia) cannot drop below zero. Yet, higher real interest rates mean higher opportunity costs for investment projects and lower returns. Disinflation will also boost unemployment since nominal wages are downward-rigid and real wages can therefore not fully adjust to lower labour demand.

Table 3: Key economic indicators of the euro area and Japan

	Euro area		Japan	
	Ø 2009-2014	Ø 2014-2019	Ø 2009-2014	Ø 2014-2019
	Year-to-year percentage changes			
Gross fixed investment, volume	- 0.9	+ 1.6	+ 2.2	+ 0.8
Population of working age	+ 0.1	- 0.1	- 1.0	- 0.9
GDP, volume	+ 0.7	+ 1.3	+ 1.5	+ 1.0
GDP per capita, volume	+ 0.4	+ 1.2	+ 1.6	+ 1.2
Consumer prices	+ 1.7	+ 1.1	+ 0.4	+ 1.2
Real-effective exchange rate	- 2.0	- 2.2	- 5.4	- 4.1
	Ø 2010-2014	Ø 2015-2019	Ø 2010-2014	Ø 2015-2019
	Percent			
Unemployment rate, as a percentage of labour force	11.0	10.8	4.3	3.7
Long-term interest rate	3.4	2.1	0.9	0.8
World market export share	27.7	26.4	4.4	4.2
	As a percentage of GDP			
Current account balance	0.9	2.7	1.6	0.3
General government financial balance	- 3.9	- 1.8	- 8.6	- 3.7
Gross government debt	89	100	211	231

Source: Oxford Economic Forecasting, WIFO.

In addition, the tightening of budgetary rules further narrows governments' scope for fiscal action. Because of the high number of households and companies facing liquidity constraints, Ricardian expansionary effects (additional private spending now, in anticipation of future tax cuts) should not be expected. According to the new fiscal rules for euro area countries, the general government deficit, adjusted for cyclical variations and one-off factors, must not exceed 0.5 percent of GDP. Moreover, the EU Member States must reduce their government debt ratio each year by one-twentieth of the amount exceeding 60 percent of GDP. Finally, the stagnation of the labour force will dampen potential output. Over the forecast period 2015-2019, average annual growth of real GDP for the euro area is projected at 1.3 percent. High unemployment threatens to ossify in many countries. Hysteresis effects, notably with respect to youth unemployment, would reduce the growth potential even in a long-term perspective. The euro area unemployment rate is projected at an average 10.8 percent over the forecast period, following a gradual downward trend. The rate of inflation of 1.1 percent p.a. remains clearly below the ECB benchmark, prompting further relaxation of monetary policy. Purchases of government bonds would flatten the yield curve and ease budgetary constraints. It would also prevent financial market stress in case of renewed euro area turbulence, such as related to an exit of Greece. The new growth initiative by the European Commission, which is susceptible to deadweight losses, mainly provides for public guarantees for private investment projects; it does, however, not address the root cause of anaemic investment, namely poor sales prospects due to sluggish income growth.

The tightening of fiscal rules dampens business activity due to widespread liquidity constraints.

3. Impossibility of currency revaluation keeps German current account out of balance

Developments of the German economy over the last ten years were shaped by a steady improvement in the current account balance: a deficit at the time of the euro introduction in 1999 eventually turned into a surplus corresponding to over 7 percent of GDP. Germany therefore produces substantially more goods and ser-

vices than are consumed domestically and accumulates net foreign assets. Thanks to the expansion of credit to foreign borrowers, Germany's private sector debt and government deficits can be reduced at the same time. The high foreign trade surplus cannot be explained by quality differentials: as shown by *Vandenbussche* (2014), the quality of German exports is in the medium range among EU member countries, excelled by that of the Nordic countries. Nor is the quality of German export goods superior to those from France, the UK, Italy or Austria.

The more likely reason for the increase in net exports is rather wage restraint. German nominal unit labour cost has been flat since the introduction of the euro, while in France it has increased by an average 2 percent per year. As this increase corresponds to the ECB's inflation target, France's wage policy has been more appropriate than that of Germany. Yet, price competitiveness and world market shares of French exports have been steadily declining. This long lasting divergence reinforced the dichotomy between debtor and creditor countries and adds to the unfavourable growth prospects: on the one hand, wages in France, Italy and Spain will increase more slowly than German wages in order to compensate the losses in competitiveness, but at the expense of domestic demand in these countries; German wages, on the other hand, will rise somewhat more strongly, due also to the introduction of a minimum wage in 2015. Germany's current account surplus will nevertheless remain high since Monetary Union prevents the currency appreciation necessary for the rebalancing of external accounts. Because of sluggish activity and the widening negative interest rate differential vis-à-vis the dollar, the euro exchange rate will even weaken over the medium term. Due to the slackening demand from emerging market economies (notably from China), German exports are lacking momentum despite the under-valued currency; however, the drawbacks of this under-valuation for other euro area countries (lack of demand for their exports and thus lack of stimulus for their domestic activity) are becoming more and more manifest. Overall therefore, Monetary Union will inhibit growth of demand and output in the next few years. Due to the swing from deficit towards surplus in the current accounts of Italy, Spain, Portugal, Ireland, Slovenia and Malta, together with the persistently high or further rising surpluses in Germany and the Netherlands, the current external surplus for the entire euro area will widen markedly, to an estimated 2.7 percent of GDP on average for the forecast period 2015-2019.

Because of Germany's high foreign trade surplus, both the private and the public sector can deleverage at the same time.

4. Inefficiency of judicial and administrative authorities impeding the Italian economy

In Italy, Austria's second-most important export market, demand and output will again decline in the current year. Growth may tentatively resume as from 2016, as major impediments undermine private investment and innovative capacity. According to the *Doing-Business Report* of the *World Bank* (2014), the quality of Italy's policy framework has improved, climbing to rank 56 among 189 countries, but still trails far behind that of other euro area countries such as Germany (rank 14), Austria (21), France (31) or Spain (33), whose positions have also strengthened in the last two years. The efficiency of the Italian judiciary with regard to the enforcement of contractual claims in trade disputes holds rank 147 and is thus below the level of some developing countries. In a very recession when the number of legal disputes increases, such as on account of payment defaults, this deficiency may damage mutual confidence, add to uncertainty and delay a recovery. Economic performance is also hampered by a high tax burden and the tedious and time-consuming procedures of tax collection; in this category, Italy holds rank 141. Further severe problems for companies, as cited by the *World Bank Report*, concern access to electricity and the receipt of building permits.

5. Favourable outlook for the US economy

The recovery of the US economy continues. Debt of private companies and households has decreased steadily since 2009, and private demand has strengthened. Between 2009 and 2013, private sector debt has fallen by almost half the amount by

which it had accumulated since 2000. Deleveraging was facilitated, first of all, by a rather debtor-friendly insolvency legislation (Gros, 2014): in case of illiquidity, debt is redeemed with the transfer of the real estate to the mortgage lender, even if the value of the object at that time is lower than the outstanding debt. In those Federal States where such non-recourse mortgages are not applied, speedy private insolvency procedures provide for timely debt reduction. Admittedly, these regulations caused in 2009 painful evictions and foreclosures, as well as high losses for creditors; many banks had to declare bankruptcy. On the other hand, this prepared the ground for a speedy recovery with simultaneous debt reduction.

A second important factor that promoted deleveraging of private households during the last years was the readiness of public authorities to accept relatively high budget deficits. This connection should be understood in the context of the sectoral financial balances of an economy: if the desire of the private sector to save is higher than the demand for consumption and investment, the unwinding of debt without harming business activity can only be achieved via higher credit to foreign borrowers (like in Germany) or to the government, if interest rates cannot fall further. Although the US general government deficit has meanwhile declined to less than half the rate recorded at the peak of the crisis (12 percent of GDP in 2009), it was still rather high in 2013, at 5.7 percent of GDP, compared with the ratio of 2.9 percent for the euro area. Also over the forecast period 2015-2019, US fiscal policy is set to stay expansionary, with a deficit averaging 4.6 percent of GDP. Due to the expected solid growth of GDP, the public debt ratio (2013: 123 percent of GDP) will edge down slightly to an average 120 percent of GDP. In the euro area, however, GDP growth and inflation are too low for the debt ratio to stabilise; the latter will hence rise further, from 93 percent to 100 percent of GDP on a 5-year average, although current deficits averaging 1.8 percent of GDP p.a. are expected much lower than in the USA.

Non-recourse mortgages and speedy insolvency proceedings allowed excess private debt in the USA to unwind quickly after the financial market crisis. Generous government deficits help sustain business activity, such that the public-debt-to-GDP ratio does not increase further.

Table 4: Key economic indicators of the USA and the UK

	USA		UK	
	Ø 2009-2014	Ø 2014-2019	Ø 2009-2014	Ø 2014-2019
	Year-to-year percentage changes			
Gross fixed investment, volume	+ 3.3	+ 5.1	+ 3.8	+ 1.8
Population of working age	+ 1.0	+ 0.9	+ 0.8	+ 0.8
GDP, volume	+ 2.2	+ 2.8	+ 1.8	+ 1.9
GDP per capita, volume	+ 1.4	+ 2.1	+ 1.0	+ 1.3
Consumer prices	+ 2.0	+ 1.9	+ 2.9	+ 1.1
Real-effective exchange rate	- 0.9	+ 0.7	+ 2.2	+ 1.5
	Ø 2010-2014		Ø 2015-2019	
	Percent			
Unemployment rate, as a percentage of labour force	8.0	5.4	7.5	6.5
Long-term interest rate	2.5	3.7	2.8	3.1
World market export share	10.6	10.6	3.8	3.6
	As a percentage of GDP			
Current account balance	- 2.7	- 2.0	- 3.4	- 1.6
General government financial balance	- 8.4	- 4.6	- 7.4	- 2.8
Gross government debt	120	120	83	90

Source: Oxford Economic Forecasting, WIFO.

The repercussions of the financial market crisis and the Great Recession – debt overhang, high unemployment, sluggish bank lending – appear to have been overcome in the USA: private debt has decreased, unemployment has fallen below 6 percent of the labour force, and credit growth has returned to normal. Hence, the business outlook for the five years to come is nowhere as encouraging as for the USA. Real GDP is expected to expand by 2.8 percent per year over the period 2014-2019. While such a pace is clearly above the projections for any other of the major advanced economies, it is still below the one observed in the 1990s. Two elements point to a slowdown of the growth potential since that time, whereby the full utilisation

Smaller productivity gains and receding labour force participation weigh on the growth potential.

tion of productive capacities would be reached already at lower growth rates of output: first, the advance of productivity has lost momentum; the "shale gas revolution" has not equalled the high and widespread productivity gains triggered by the information technology innovations of the 1990s. Second, demographic change is kicking in also in the USA. Although the population of working age has expanded markedly in the last ten years (2004-2014 +1.1 percent p.a.) and will grow further in the next five years (+0.9 percent p.a.), labour force participation has – unlike in most EU countries – been declining since 2000, and more strongly so since the Great Recession. Whereas the participation rate had been 67 percent in 1999 (compared with 71 percent in the euro area), only 63 percent of the working-age population were part of the labour force in 2013 (against 76 percent for the euro area).

6. Growth slowing down in China, but remaining one of the highest worldwide

The slump in global demand in 2009 hit China in particular, since the country's strong GDP growth was hinging on high foreign trade surpluses. In order to counter the slowdown, business activity has for years been sustained by public investment. Stimulus is provided mainly at the regional and local level, to a large extent via special purpose vehicles ("shadow banks") in order to circumvent the stricter rules governing the regular banking sector. This has given rise to major misallocation of capital, excess capacity and debt overhang which now increasingly constrain economic performance. Marginal returns on investment, which in 2013 rose to a record high of 47.5 percent of GDP, are receding. This holds in particular for the ending real estate boom where meanwhile entire urban quarters stay empty. Nevertheless, a "hard landing", i.e., financial market crisis sparked by excessive credit expansion and overheating in the real estate sector does not appear likely from today's perspective: the high national savings have generated sizeable foreign currency reserves such that even major credit losses may be accommodated without disruptions on the external side (capital flight). Moreover, while the strict credit regulations are partly responsible for the mushrooming of the shadow banks, they also reduce risk of crisis in the regular banking sector.

While fiscal stimulus by local government authorities is sustaining business activity in China, it is also responsible for important misallocation of capital.

Table 5: Key economic indicators in the CEEC and Russia

	CEEC ⁵¹		Russia	
	Ø 2009-2014	Ø 2014-2019	Ø 2009-2014	Ø 2014-2019
Year-to-year percentage changes				
Gross fixed investment, volume	+ 1.8	+ 4.3	+ 3.5	+ 4.7
Population of working age	- 0.3	- 0.4	- 0.5	- 1.0
GDP, volume	+ 2.1	+ 2.9	+ 2.8	+ 2.5
GDP per capita, volume	+ 2.1	+ 2.9	+ 3.0	+ 2.7
Consumer prices	+ 2.3	+ 1.8	+ 6.9	+ 5.2
Real-effective exchange rate	-	-	+ 1.3	+ 3.7
Percent				
Unemployment rate, as a percentage of labour force	9.6	8.2	6.0	5.9
Long-term interest rate	4.7	3.9	8.2	8.1
World market export share	3.0	3.1	2.4	2.2
As a percentage of GDP				
Current account balance	- 2.0	- 1.1	3.7	- 0.0
General government financial balance	- 3.1	- 2.0	- 0.2	- 1.5
Gross government debt	55	53	9	12

Source: Oxford Economic Forecasting, WIFO. – ¹ Poland, Slovakia, Slovenia, Czech Republic, Hungary.

A further factor in the transition from export- to investment-led growth is the appreciation of the yuan. In real-effective terms, the currency has gained some 40 percent since 2005, against the dollar it has climbed by 35 percent. The current account surplus has moderated from over 10 percent of GDP in 2007 to 2 percent in

With rising wages and growing private welfare the appreciation of the yuan is set to continue.

2013. Over the forecast horizon, the real-effective exchange rate will mount further, by an average 3.1 percent per year, with the current account surplus dropping below 1 percent of GDP. This goes along with strong wage gains and the rising importance of a middle class. Between 2002 and 2012, per-capita wages and salaries increased by an average 14 percent per year, for the period 2015-2019 a gain by almost 9 percent per year is expected. GDP growth is projected to abate from 8.5 percent p.a. in the last five years to 6.4 percent p.a. up to the forecast horizon, still remaining one of the strongest pace worldwide.

7. India not fully exploiting its growth potential

India's economy is projected to grow at an average 6.2 percent per year in the years to come – unlike in China on the basis of a strongly expanding labour force and smaller productivity gains. Another difference to China is the deficit in the current account, which in 2013 has led to strong capital outflows following the announcement by the US Federal Reserve of a tightening of monetary policy. The economy nevertheless recovered quickly, not least owing to the professional handling of the situation by the Indian Central Bank. Expectations for the new government to relax trade restrictions and cut back on bureaucracy and red tape have so far not been met. Given the low per-capita income, India could mobilise a higher growth potential, but misses opportunities to do so.

8. Protracted balance sheet recession in Japan about to end

Japan is expected to overcome in the next years its worldwide unequalled spell of sectoral debt accumulation and deleveraging: the debt overhang generated in the early 1990s following a slump in real estate values and the hesitant policy response prompted companies to embark on a long-lasting process of debt reduction. Since nominal interest rates cannot fall below zero and the balance sheet recession (debt reduction via restraint on investment) and the implicit demand shortfall led to deflation (whereas inflation would have been essential for debt reduction), corporate debt relief came at the expense of mounting government debt. Between 1991 and 2010, gross fixed investment fell by 25 percent in volume terms, while in the USA it rose over the same period by 70 percent and in the euro area by 46 percent. Since 1999, the Japanese corporate sector has been a net creditor. Conversely, Japan's government debt skyrocketed from 65 percent of GDP in 1991 to 222 percent of GDP in 2013. More recently, since 2010, the corporate financial surplus has been diminishing, and gross fixed investment has expanded by an average 2.2 percent p.a. during the last five years. The accommodating policy stance may be successful in taking credit demand onto an upward trend going forward. On the other hand, the outlook is clouded by the planned second step of VAT increase from 8 percent to 10 percent, which has been postponed from October 2015 to April 2017. A rebound in corporate credit demand will provide relief for the government budget, such that the current deficit may narrow from an average 8.6 percent of GDP to 3.7 percent per year. Real GDP is projected to grow by 1 percent p.a. over the medium term.

For the first time since 1999, the Japanese corporate sector may turn from a net saver to a net debtor. The VAT increase remains a cyclical risk.

9. Oil price and currency shock putting stress on the Russian economy

The slump in oil prices is putting severe strain on the Russian economy. The current projections assume a benchmark price averaging \$ 75 per barrel in 2015, leading to a fall in real GDP by 1.6 percent. If oil prices were to drop to \$ 55, demand and output would shrink by almost 4 percent. Activity promises to stay sluggish in the medium run, as export revenues from past high commodity prices tend to mask structural deficiencies in the economy, like in Brazil.

If oil prices were to stay low, payment defaults in Russia may spread and threaten the stability of the banking system.

Permanently low oil prices would also be problematic for public finances: in order to achieve a balanced budget, oil prices would have to rise to about \$ 115 per barrel (NIESR, 2013); over the next few years, the budget deficit will average 1.5 percent of

GDP. In an alternative scenario based upon an oil price of \$ 55 in 2015, rising gradually to \$ 90 in 2019, the annual budget deficit would slightly exceed 3 percent of GDP. Financing constraints due to the economic sanctions may lead to disruptions in refinancing or even refusals of payment by the Russian State. While Russian government debt, at less than 10 percent of GDP, is comparatively low, about one-third of the total is held by foreign investors. External debt of the private sector is about ten times higher than that of the State. Overall therefore, the Russian economy is indebted to foreign creditors to around 35 percent of GDP. Payment defaults by companies would cause major difficulties for banks operating in Russia.

Table 6: Key economic indicators of India and China

	India		China	
	Ø 2009-2014	Ø 2014-2019	Ø 2009-2014	Ø 2014-2019
Year-to-year percentage changes				
Gross fixed investment, volume	+ 6.6	+ 5.7	+ 8.9	+ 6.4
Population of working age	+ 1.7	+ 1.4	+ 0.4	- 0.2
GDP, volume	+ 6.4	+ 6.2	+ 8.5	+ 6.4
GDP per capita, volume	+ 5.0	+ 5.0	+ 7.8	+ 5.9
Consumer prices	+ 9.5	+ 6.1	+ 3.2	+ 2.9
Real-effective exchange rate	+ 3.0	+ 2.6	+ 3.3	+ 3.1
Percent				
Unemployment rate, as a percentage of labour force	5.7	5.7	4.1	3.8
Long-term interest rate	8.2	7.9	3.8	5.1
World market export share	2.3	2.5	9.9	10.7
As a percentage of GDP				
Current account balance	- 3.3	- 1.5	2.6	0.9
General government financial balance	- 5.2	- 3.5	- 0.9	- 3.9
Gross government debt ¹	51	47	16	24

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

In parallel with the fall in oil prices, the rouble has steadily lost ground since the economic sanctions were introduced by the USA and the EU in August 2014. Had the exchange rate hovered around 35 rouble per dollar in the first half of 2014, it fell to 55 rouble in December, having at times been as low as 70 rouble per dollar. The Central Bank counters the depreciation only hesitantly, although the current account surplus of the past years (on average 3.7 percent of GDP per year) generated high foreign currency reserves; the Bank probably values higher the positive effects of depreciation than the inflation-accelerating impact and the payment defaults on foreign currency debt. Since crude oil is invoiced in dollar, the price decline is compensated by an equivalent currency devaluation. This effect is beneficial not only for the Russian oil industry, as the weaker rouble also dampens the negative repercussions of the oil price slump on the government budget. In an extended alternative scenario in which the rouble is assumed to fall from 40 to 55 rouble per dollar in the medium term, the annual growth rate of real GDP is boosted by 0.2 percentage points, while the government balance improves by 0.7 percent of GDP. However, these positive effects would come at the cost of very high inflation: the annual increase in the price index which in the baseline scenario is 5.2 percent and edges down to 5.0 percent in the alternative lower-oil-price scenario, would jump to almost 13 percent with the weakness of the rouble. Moreover, the depreciation would complicate the redemption of foreign currency debt, heightening the risk of payment defaults.

The devaluation of the rouble heightens the risk of default on foreign currency debt, but cushions the decline in export earnings and government revenues.

10. Summary

The marked decline of oil prices gives some impetus to business activity in the euro area. However, medium-term prospects are dominated by lack of aggregate de-

mand and disinflation, caused by fiscal policy focussing on the budget balance and by the lacking possibility of currency de- or re-valuation, notably the under-valuation for Germany. Excess private debt is sapping demand, whereas in the USA it was reduced more rapidly by bankruptcies and by accepting generous government deficits after the financial market crisis. In China, both prosperity and indebtedness are rising quickly. In Japan, the investment-inhibiting unwinding of corporate debt will wear off in the years to come. Another financial market crisis is looming in Russia, despite the country's moderate degree of foreign indebtedness.

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