

Prospects for the World Economy

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AIECE meeting

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World overview

- Forecast for world economic growth in 2015 at 3 per cent
- Growth in emerging market economies has weakened further; hesitant recoveries in advanced economies
- Projected pickup in global growth next year supported by accommodative monetary policies and lower oil prices
- Increased risk of deflation in some advanced economies, especially Euro Area

Summary of the forecast

Percentage change, year-on-year

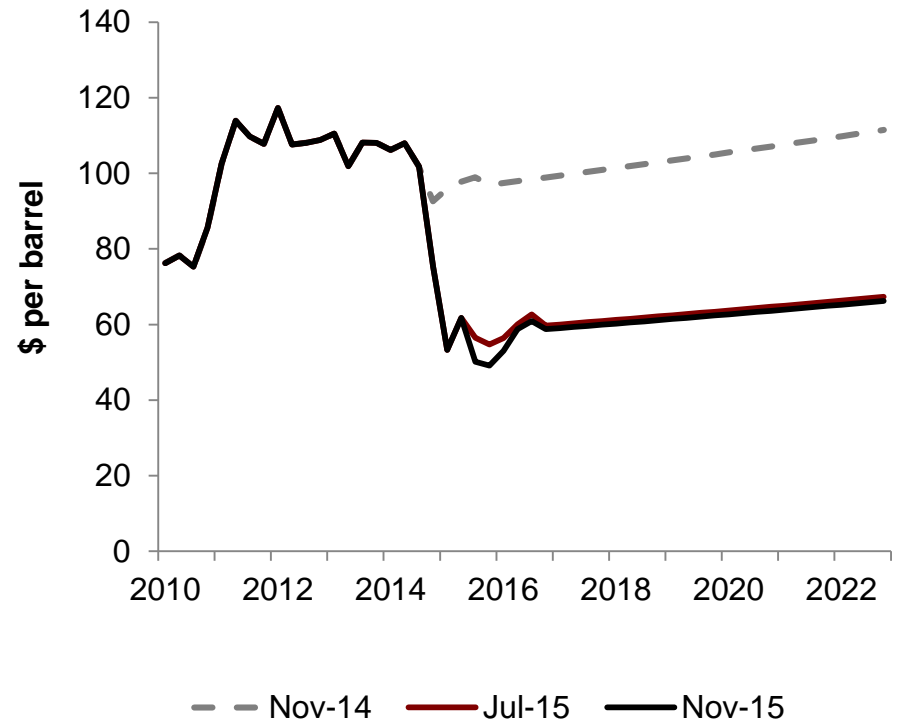
| | World economy | | | Real GDP growth in major economies | | | | |
|------|-------------------------|--------------------------------|----------------------------|------------------------------------|-------|-------|-----------|-------|
| | Real GDP ^(a) | Consumer prices ^(b) | World trade ^(c) | US | China | Japan | Euro Area | India |
| 2015 | 3.0 | 0.7 | 3.2 | 2.6 | 6.9 | 0.7 | 1.5 | 7.6 |
| 2016 | 3.4 | 1.4 | 6.4 | 2.8 | 6.6 | 1.4 | 1.7 | 7.7 |
| 2017 | 4.1 | 1.9 | 6.2 | 2.9 | 6.4 | 0.9 | 1.9 | 7.7 |

(a) Based on global PPP shares. (b) OECD countries. (c) Volume of total world trade.

Oil price developments

- Oil prices marginally lower in recent months
- Prices reached 6½-year lows in late August
- By late October, they had returned almost to the levels of late July
- The EIA projects around an 8 per cent increase in oil prices in 2016, leaving them \$50 lower than their nominal level in mid-2014

Evolution of oil price projections

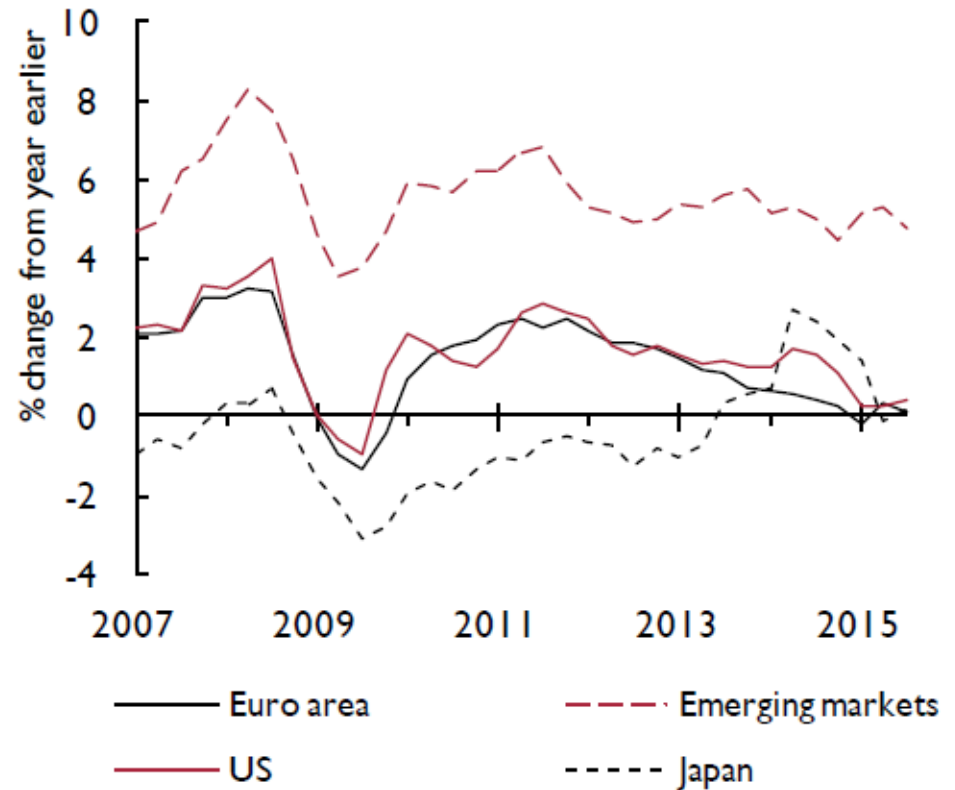


Source: EIA short-term forecasts (November 2014, July 2015 and November 2015); NiGEM database and NIESR forecast

Disinflation

- Weakness in oil and other commodity prices has halted increases in consumer price inflation rates in the advanced economies
- Inflation has fallen back to a little below zero in some cases, including the Euro Area and Japan
- Core inflation remains broadly stable

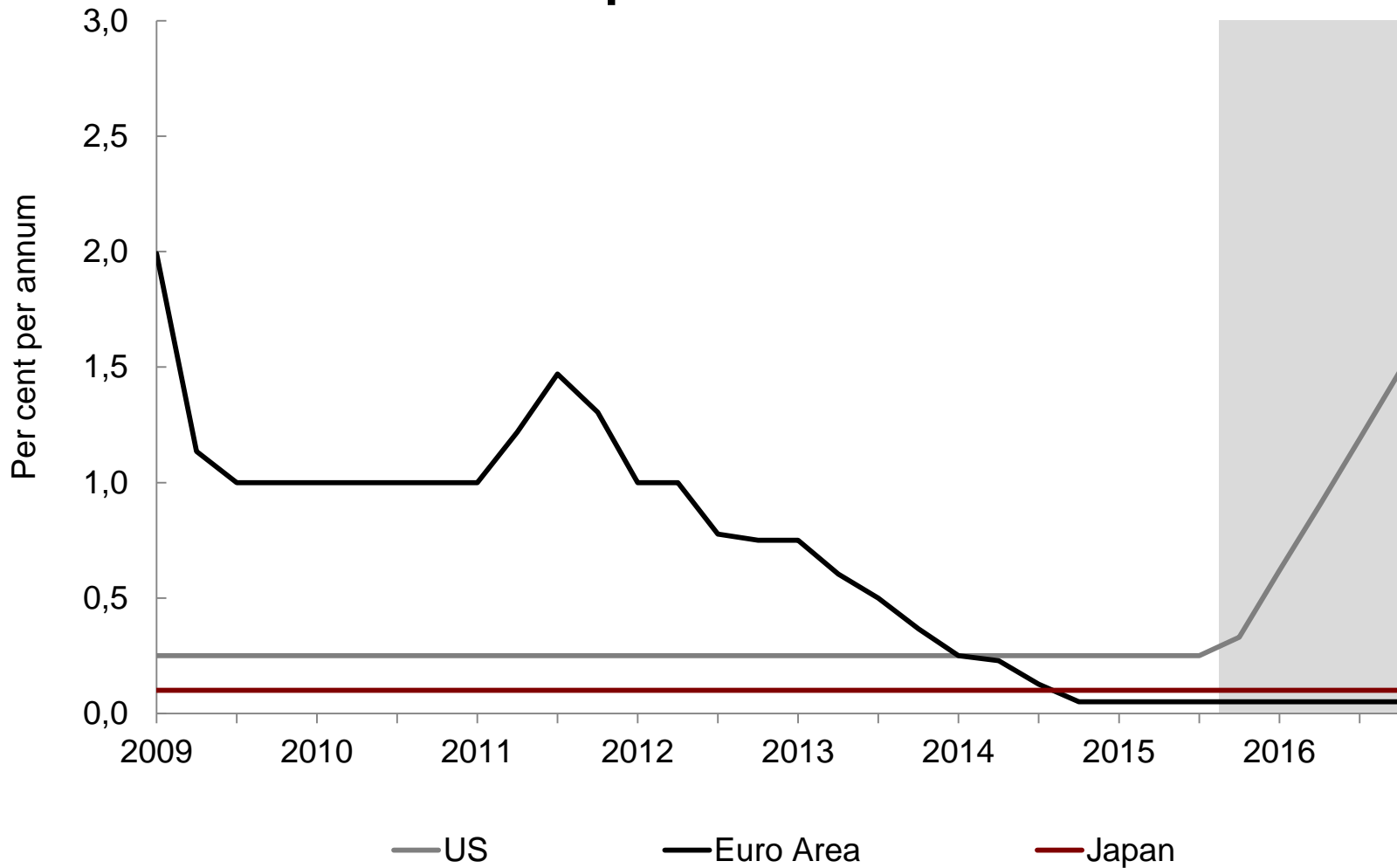
World inflation



Sources: NiGEM database and NIESR forecast.

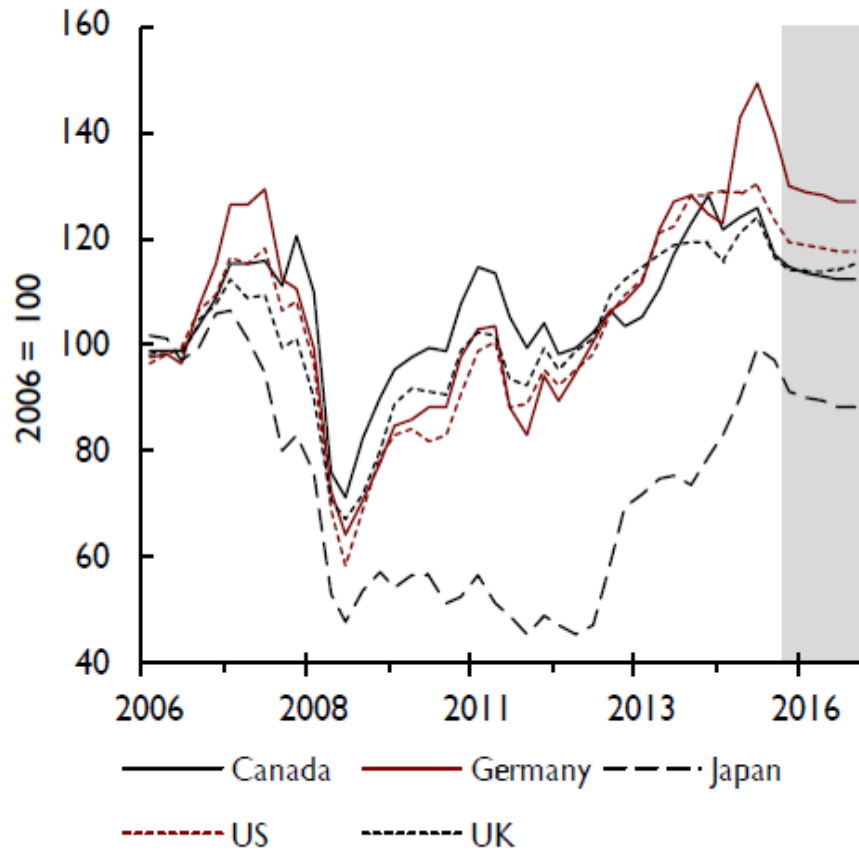
Notes: 2015 includes a forecast for Q3. Consumer expenditure deflator is used for the US, Euro Area and Japan, CPI for emerging markets. Emerging markets are a weighted average of Brazil, China, India, Indonesia, Mexico, Russia and Turkey.

Continued divergence in monetary policies



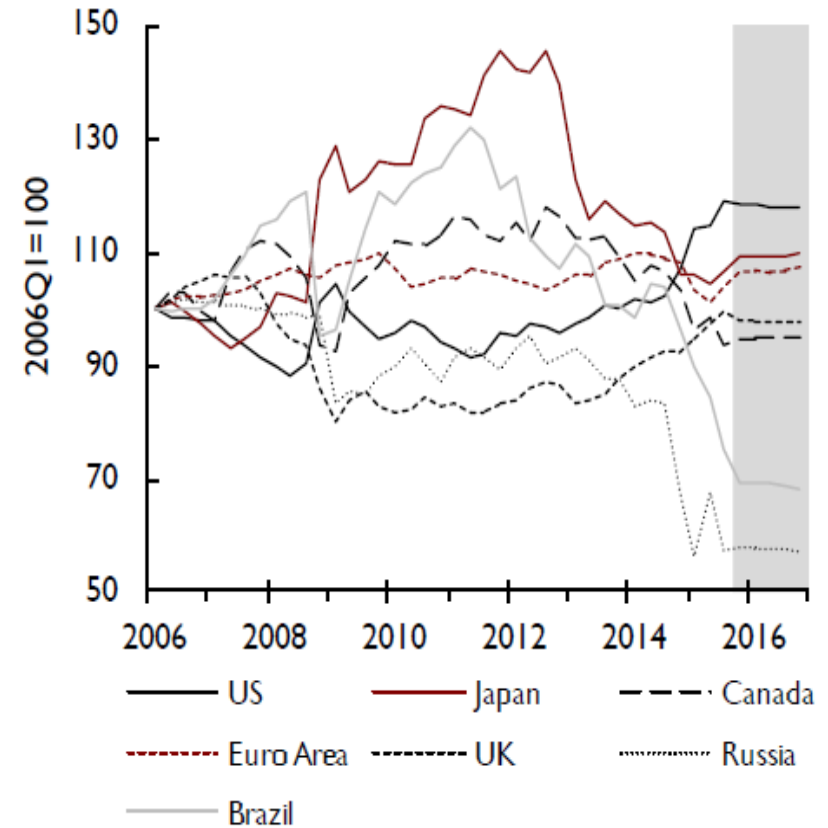
Turbulence in global equity markets, weakness in a number of emerging market currencies

Share prices



Source: NiGEM database and NIESR forecast.

Effective exchange rates

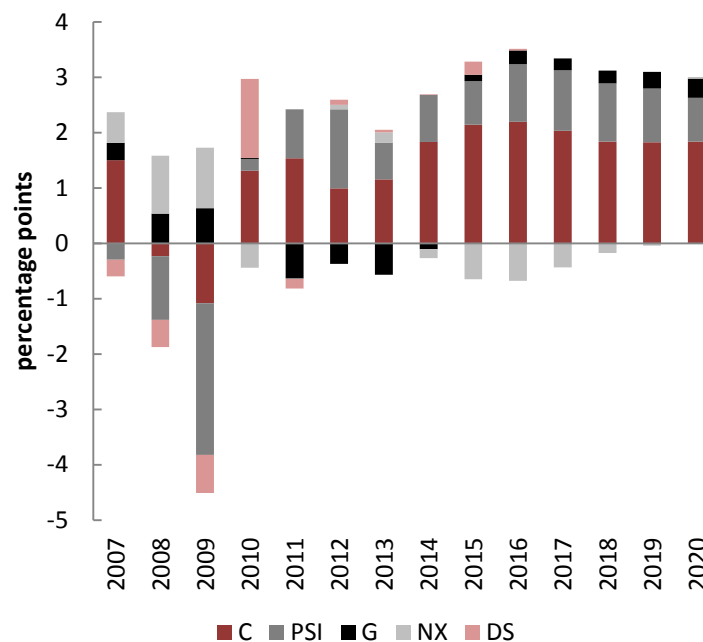


Source: NiGEM database and NIESR forecasts. Weights based on 2010 goods and services trade shares.

US – moderate growth continues

- Economy continues to grow, but at a pace somewhat slower than average of 2014
- Broad inflation remains close to 0, however, core inflation is 1.9 per cent
- Lower inflation should boost consumers' purchasing power and accommodative monetary policy should support consumer spending

Decomposition of US growth by component



Source: NiGEM database and NIESR forecast

Labour market

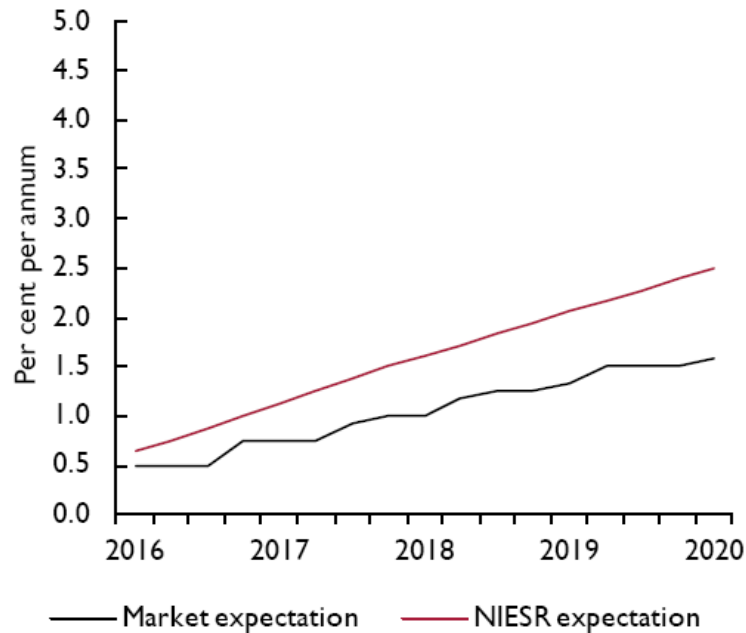
- Employment growth has eased this year
- Unemployment has fallen further, but other indicators suggest a wider margin of slack
- FOMC decision to raise to be “data dependent”, will labour market slack cause them to delay?



Source: NiGEM database

What would a delay imply?

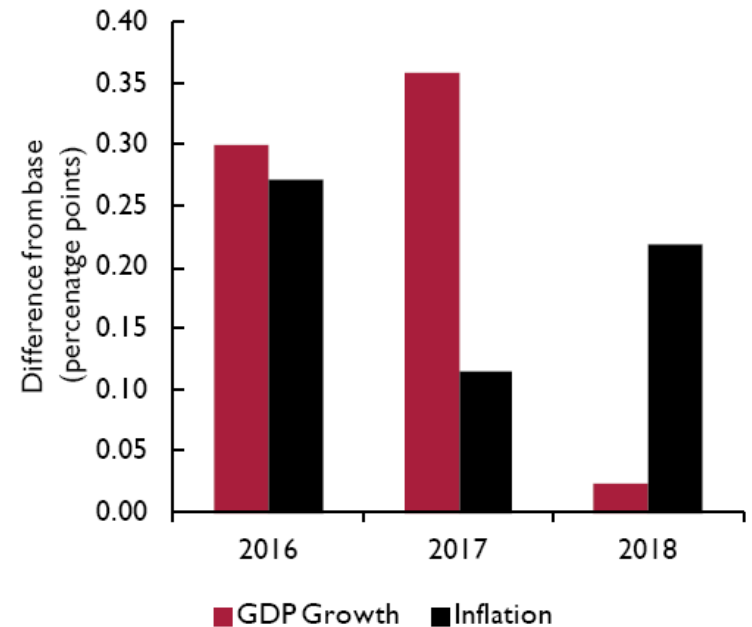
Expected paths for Bank Rate



Source: NIESR forecast, Bank of England.

Note: Market expectation is derived from the Bank of England's forward sterling overnight index swap yield curve.

Impact of imposing market path for Bank Rate on NIESR forecast

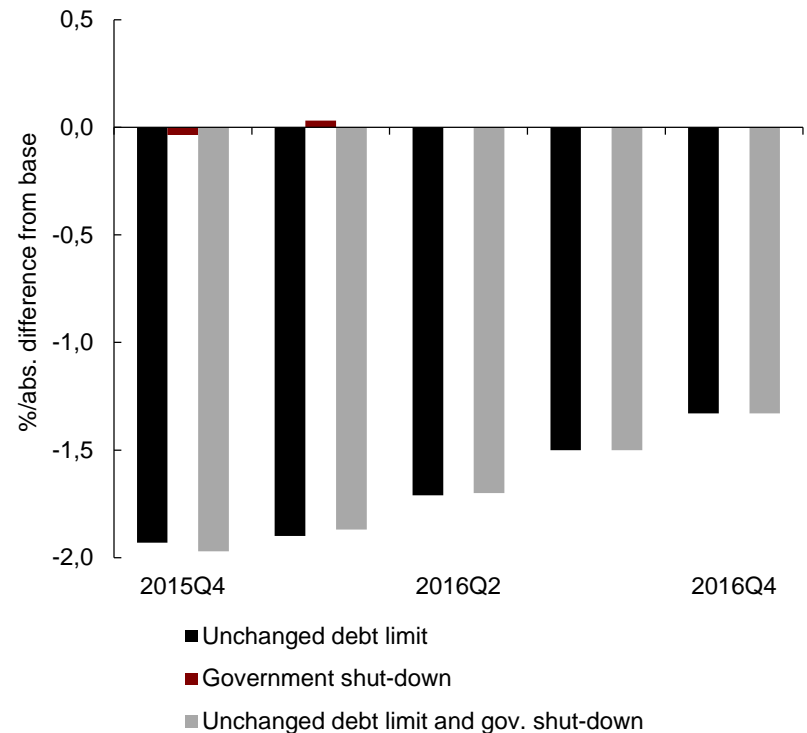


Source: NiGEM simulations.

The debt ceiling-what if?

- Temporary rather than permanent shocks to remuneration and government consumption
- The reduction in government spending from holding the debt ceiling flat would cause the largest effect
- Government shutdown only affects the remuneration of 2/5 government workers
- No modelling confidence or effects on financial markets

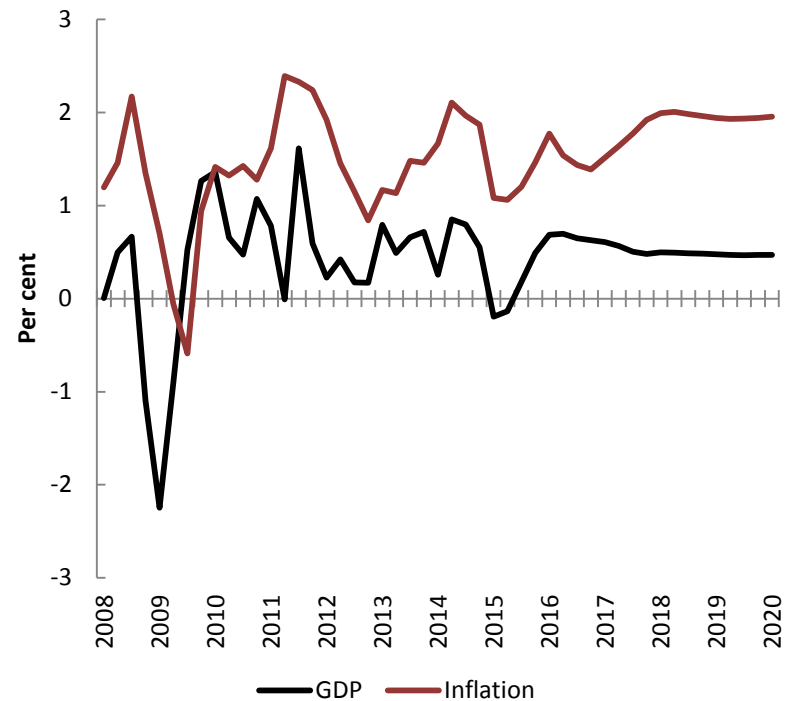
Failure to extend debt ceiling scenario



Source: NiGEM simulations

Canada

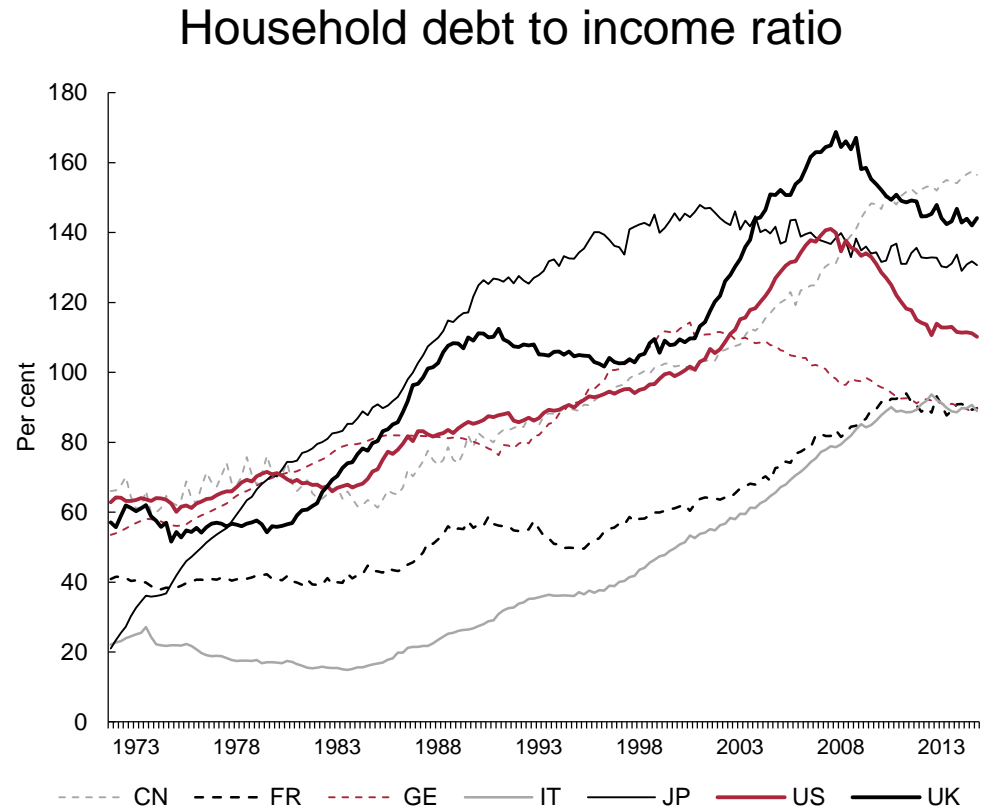
- Canada suffered a mild recession in the first half of 2015 but growth has since resumed
- Decline in oil prices led to a drop in investment in the energy sector and a fall in exports of energy products
- Recent depreciation of the Canadian Dollar and recovery in the US economy is expected to boost growth this year and next
- The effects on inflation of declining commodity prices and weak economic activity have been partly offset by depreciation of the Canadian dollar



Source: NiGEM database and NIESR forecast

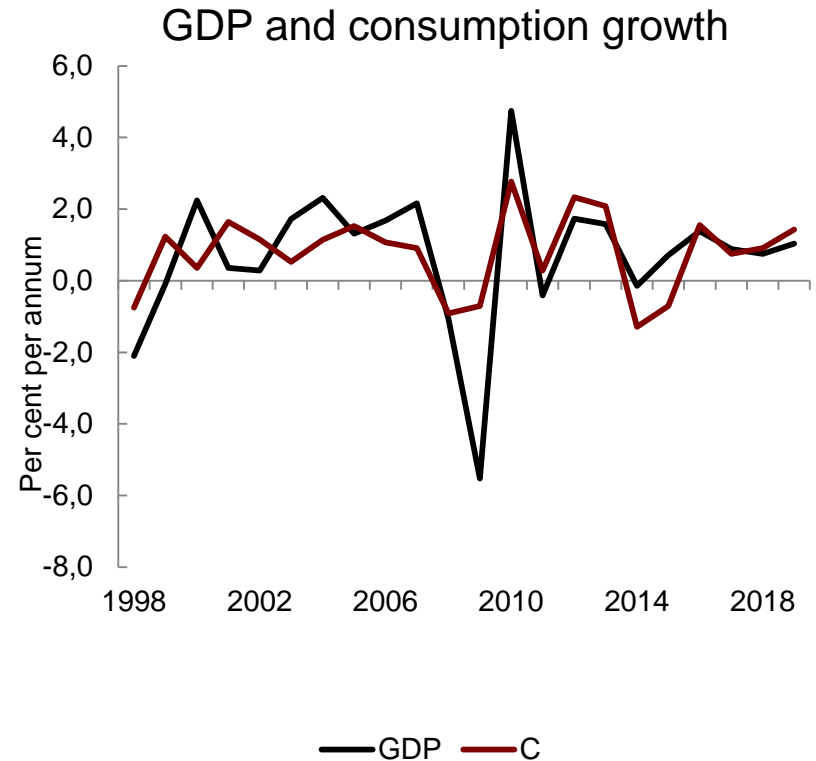
Household debt to income

- Canada's household debt to income ratio is the highest in the G7
- Much of this debt has been used for housing finance
- Households are vulnerable to a decline in income, increase in interest rate or a fall in house prices
- Potential housing market crash poses a downside risk to our forecast



Japan

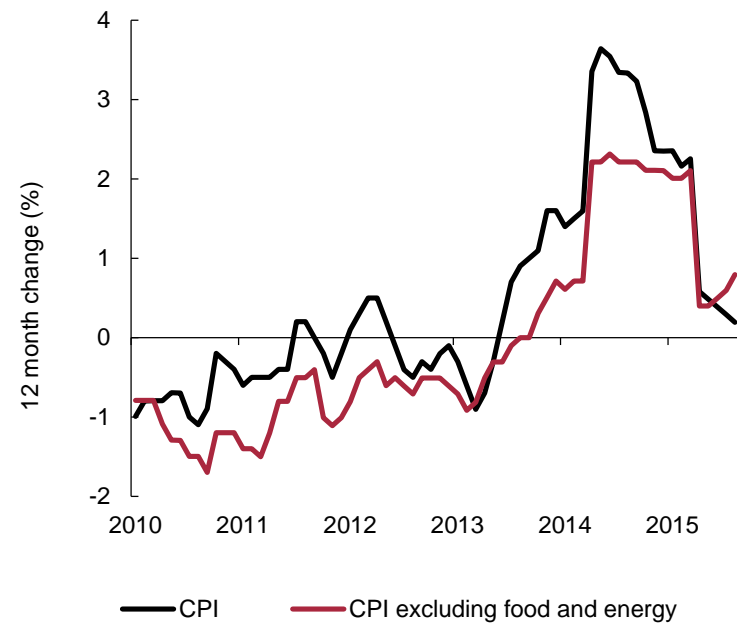
- Growth stalled in the second quarter, sharp contraction in private consumption and weak export growth
- Fears over the extent of a Chinese slowdown affected consumer confidence and trade throughout the region
- Indicators about prospects of recovery are mixed.



Source: NiGEM database and NIESR forecast

Inflation

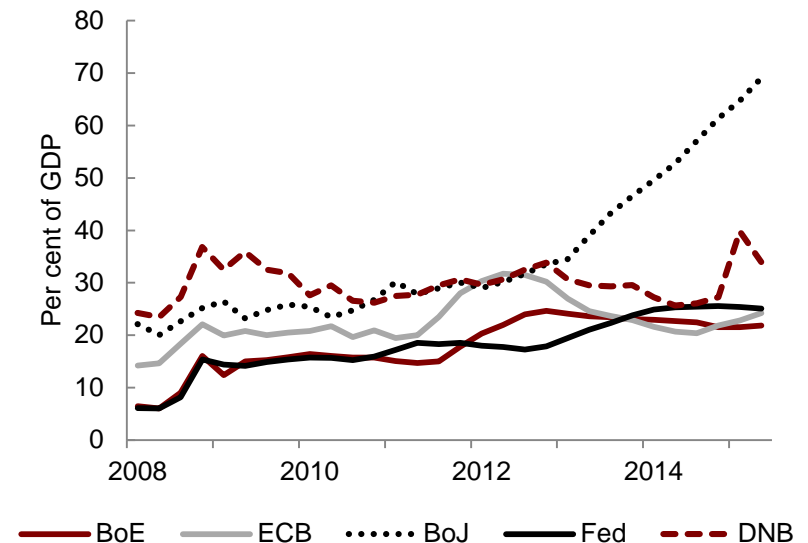
- CPI inflation at close to 0, but excluding energy and food, has increase by 0.8
- Despite low and stable unemployment, wage growth remains weak, 0.5 per cent in the year to August
- Speculation that the BoJ will increase it's rate of asset purchases



Source: NiGEM database and NIESR forecast

BoJ Balance sheet

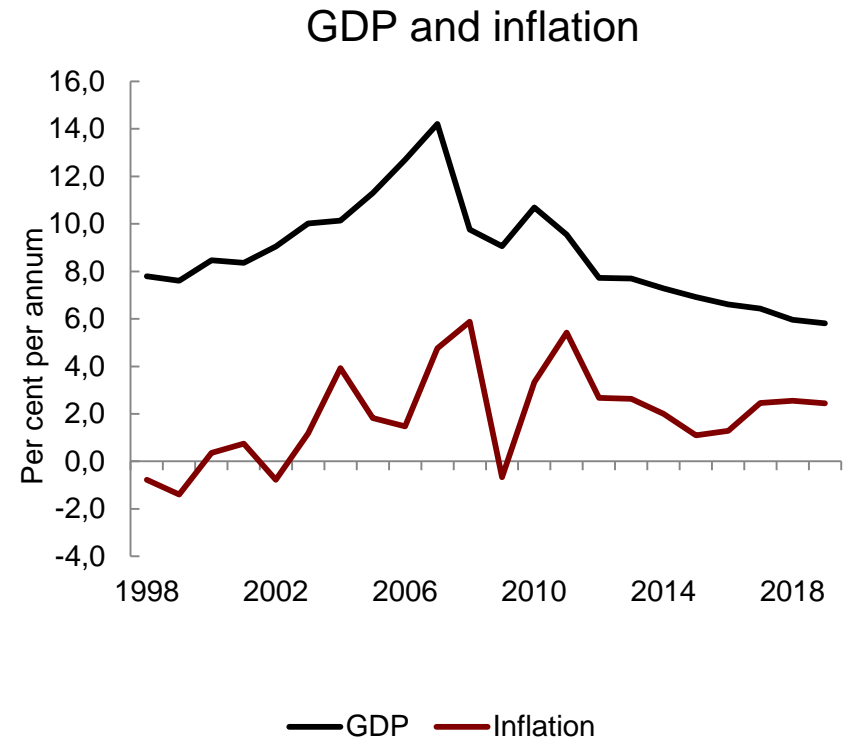
- Arslanalp and Botman (2015) suggest that at the current rate of purchases the BoJ will be forced to taper in 2017-2018
- Alternative policies could include:
 - Lengthening maturity profile, i.e. Operation Twist in US
 - Further purchases of private assets
 - Extending the securities lending facility



Source: NiGEM database, BoE, ECB, FRB, DNB and BoJ

China

- Despite concerns of a slowdown, economy expected to grow by 6.9 per cent this year
- Divergence between consumer and producer price indices
- We assume a “soft landing” in China

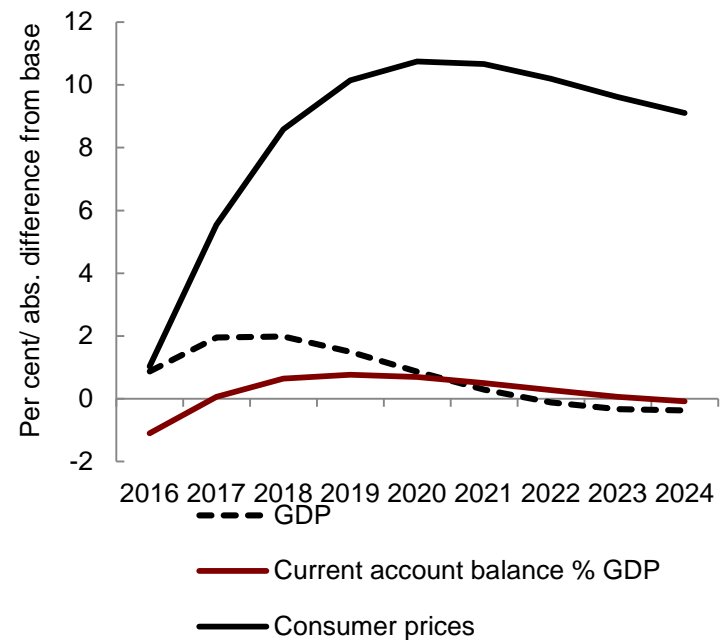


Source: NiGEM database and NIESR forecast

Central bank interventions

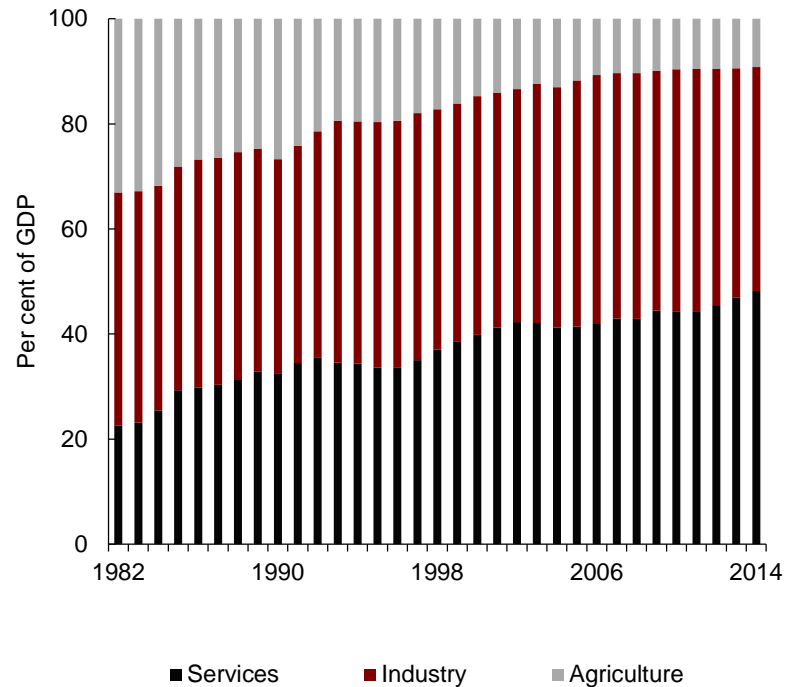
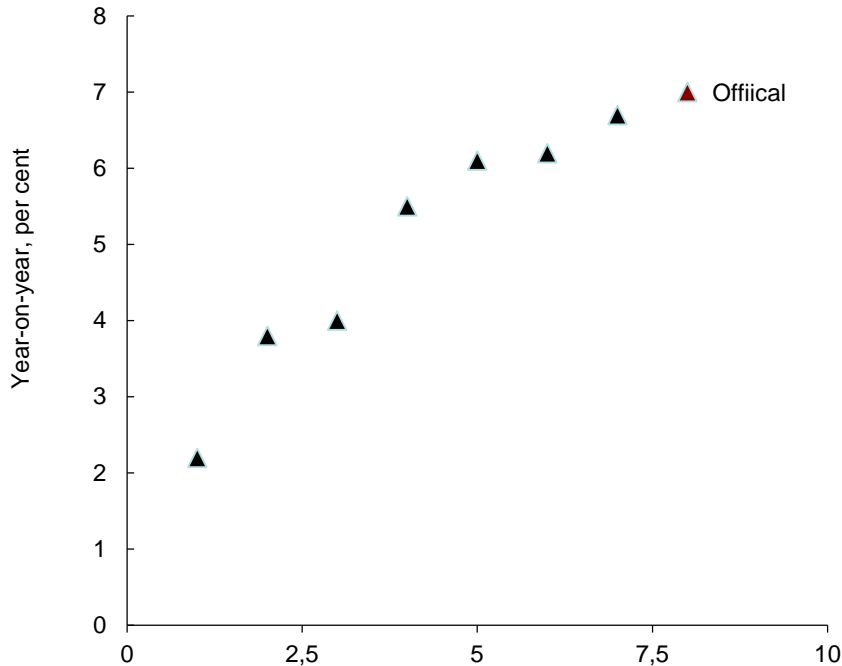
- PBoC has cut 1 year deposit rate twice since late August to 1.5 per cent
- Reduced the reserve requirement ratio
- Changed exchange rate arrangement, +/- 2 per cent centred on yesterdays closing price

Impact of a 10 per cent devaluation



Source: NiGEM simulations

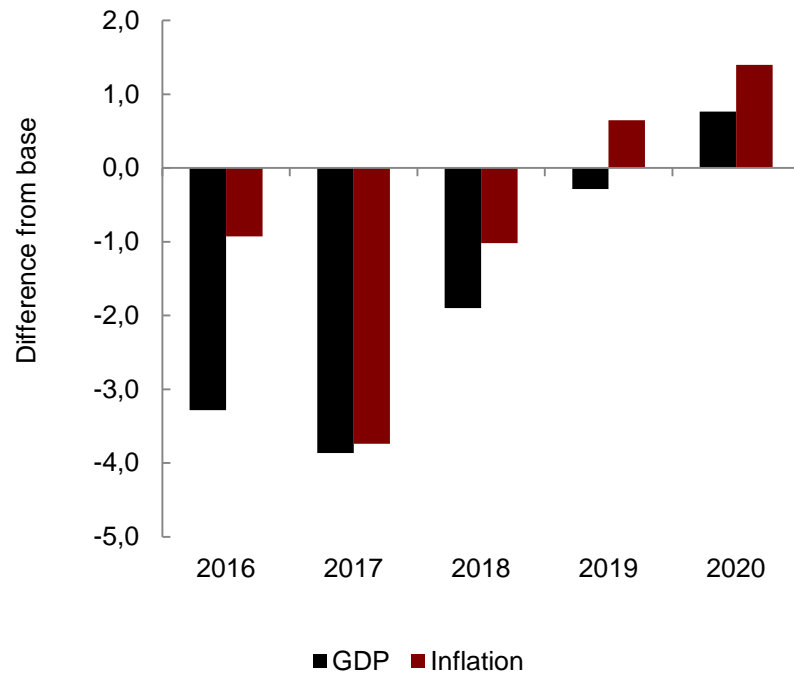
Official vs alternative GDP estimates



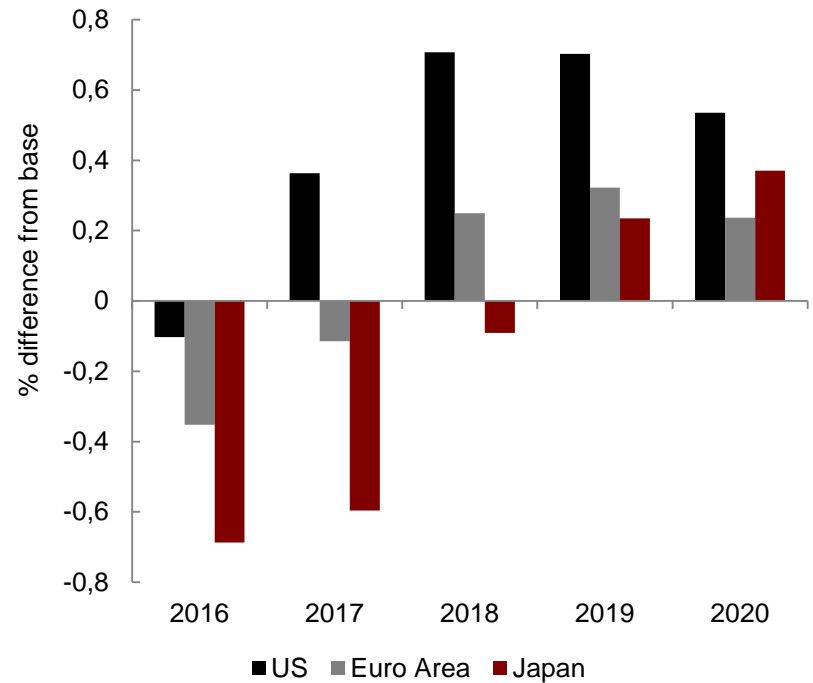
- Increased prominence of the service sector, are estimates based on manufacturing indicators reliable?
- Key question is what is the future path of GDP growth, not past revisions

Chinese hard landing

Effect on China



Spillovers to other countries GDP

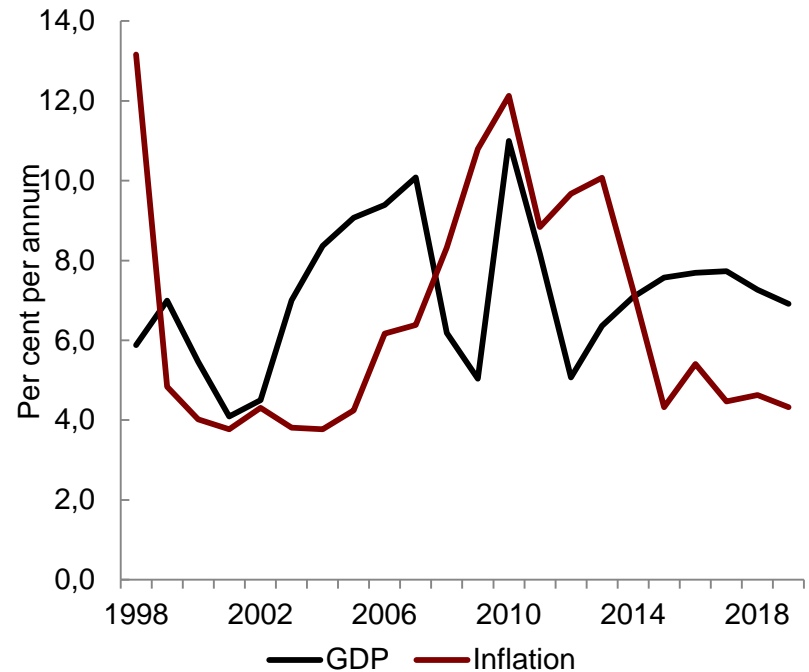


Source: NiGEM simulations

India

- Recovery of economic growth continuing
- Domestic demand on the back of improved purchasing power
- Commodity price falls leading to the easing of inflation
- Monetary policy cut by 125 basis point in 2015
- Reform agenda has stalled

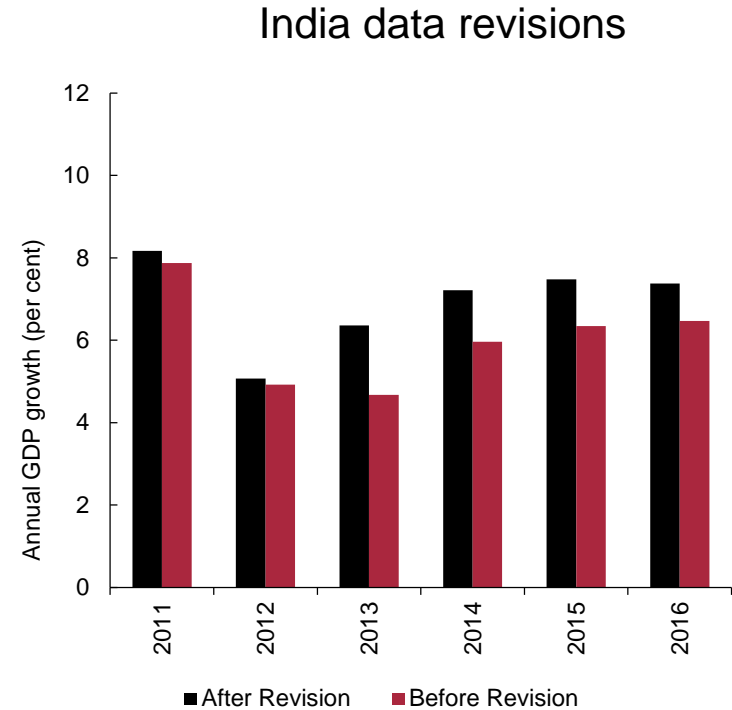
India GDP and inflation



Source: NiGEM database and NIESR forecast

Data concerns

- Adoption of SNA08 led to large upward revisions in GDP
- Appear to be weaker link to traditional indicators such as index of production than previously
- IMF provisionally accepts the accuracy of this data

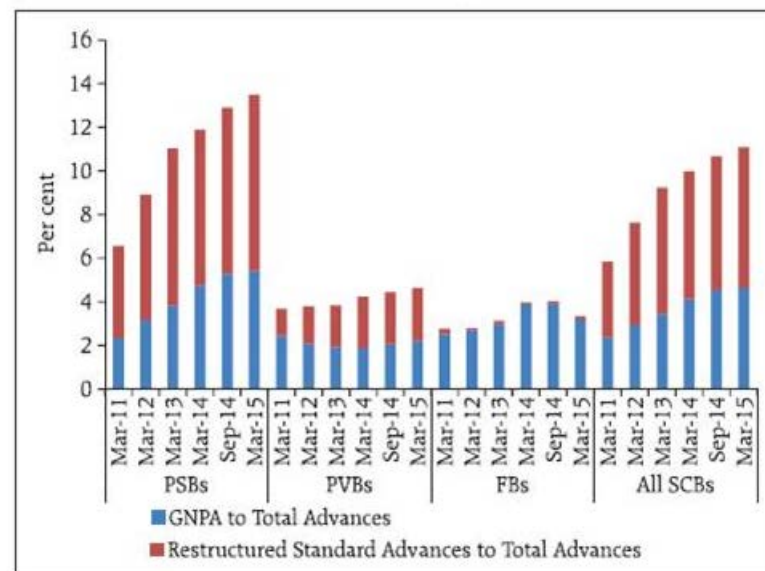


Source: NiGEM database and NIESR forecast

Deterioration of state owned banks' balance sheets

- Publicly owned banks are the largest component of India's financial sector
- Over last 4 years there has been a sharp increase in stressed assets
- Majority of these bad loans are to commodity producers and infrastructure projects

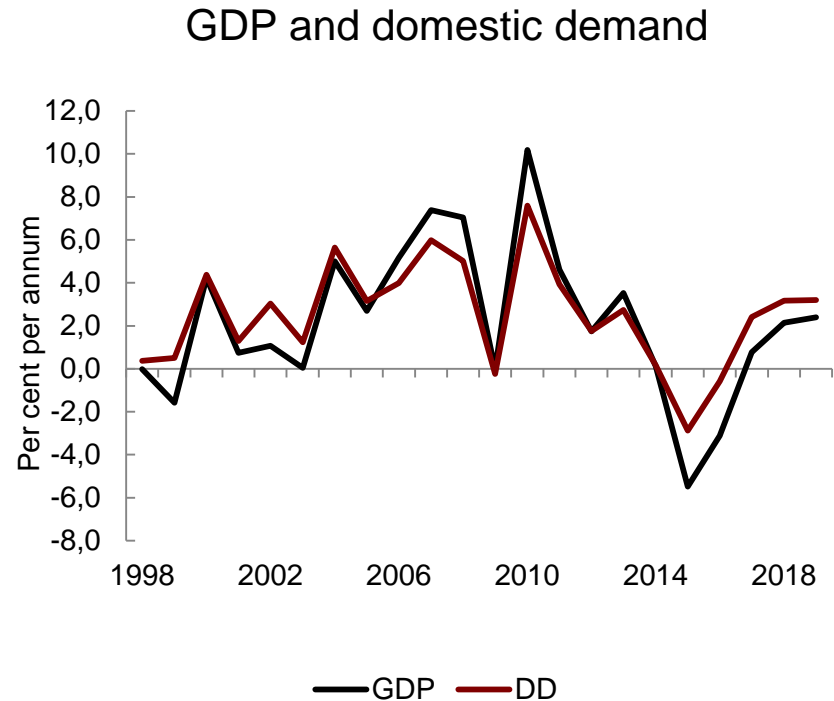
Chart 2.5: Asset quality of SCBs



Source: RBI supervisory returns.

Brazil

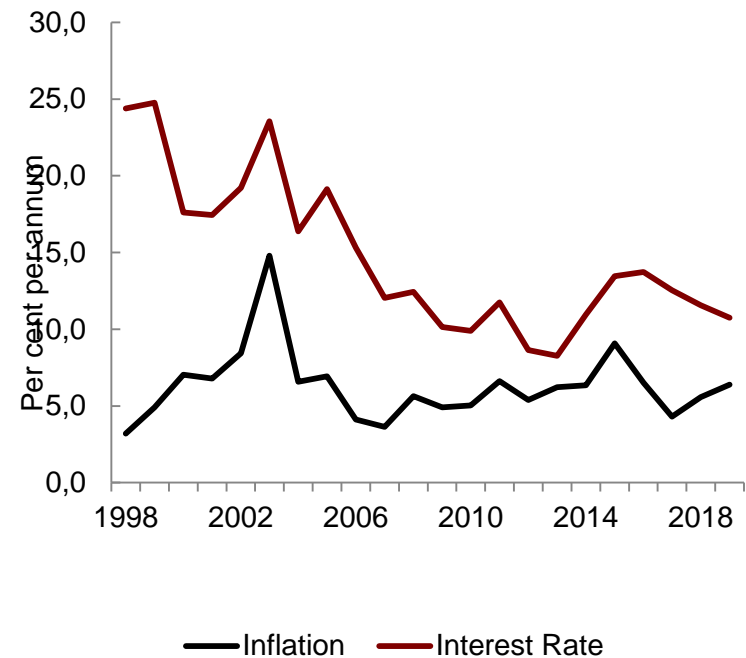
- Economy contracting sharply as a result of falling commodity prices
- Large depreciation has led to a terms of trade problem, and weak domestic demand
- Government interest payments are increasing as risk premia on yields increase
- Reducing government consumption will weigh on the recovery



Source: NiGEM database and NIESR forecast

Inflation

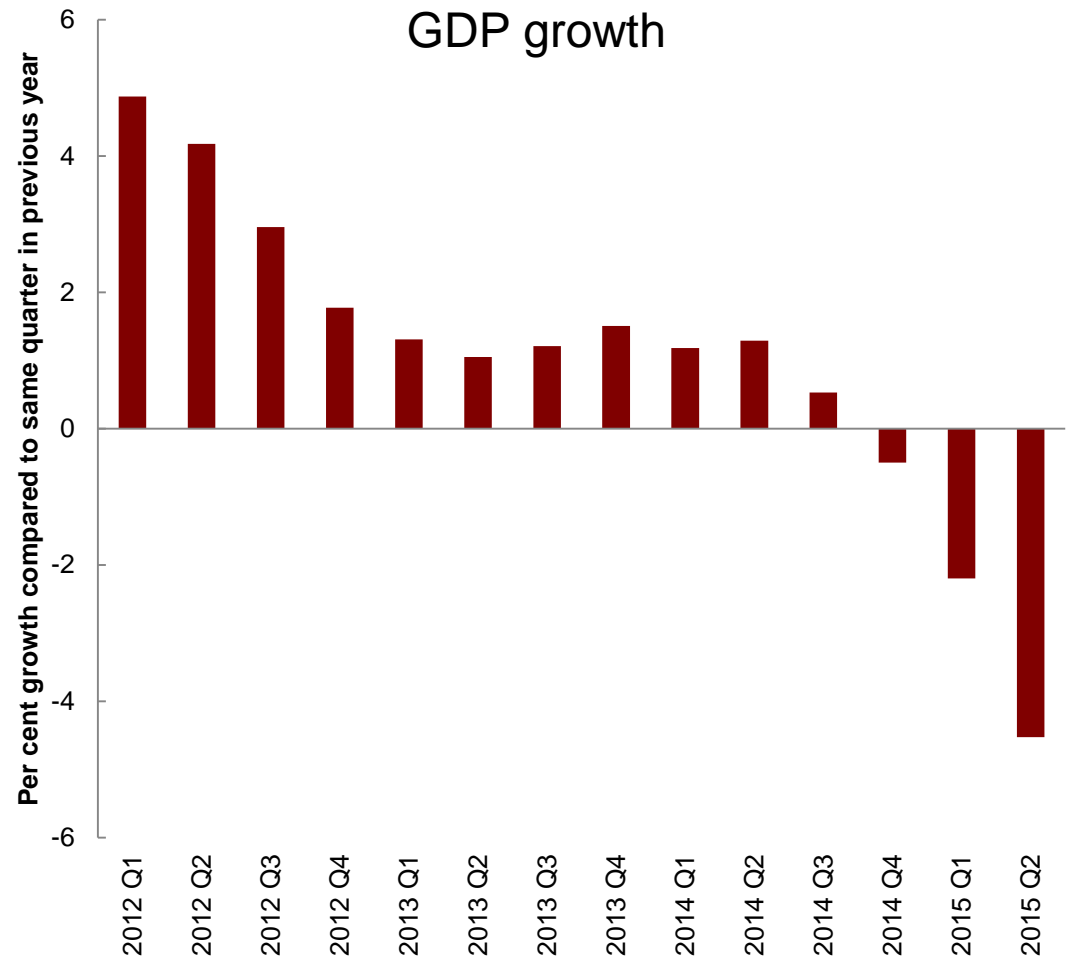
- Removing cap on regulated prices led to sharp increase in inflation
- Worsened by the depreciation
- The central bank has increased interest rates in order to control this spike
- Inflation likely to be transitory as these factors drop out of the calculation



Source: NiGEM database and NIESR forecast

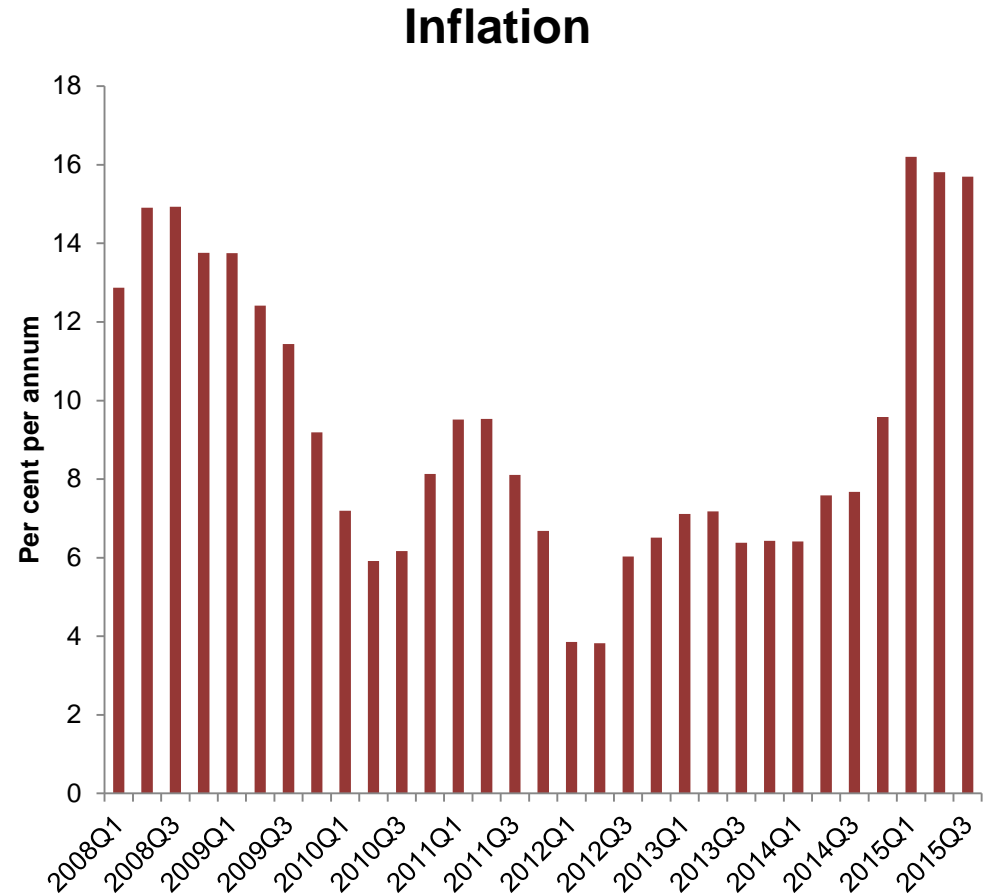
Russia

- Low oil prices and western sanctions have decimated Russia's economy
- There have been signs in recent months that economic activity has begun to stabilise
- Our forecast is for GDP to fall by 4.2 per cent in 2015 and to rise by 0.2 per cent in 2016



Inflation

- Depreciation of the rouble and western sanctions on imports have pushed up prices
- High inflation constrains the central bank's ability to ease monetary policy
- With inflation at over 15 per cent, the central bank's target of 4 per cent is perhaps not credible



Questions

- Why haven't we seen a larger pass through from the fall in oil prices to consumption in advanced economies?
- Should the Federal Reserve delay their interest rate rise into 2016?
- For emerging markets, are we likely to see a “tightening tantrum” as the Fed reaches the turning point of it's monetary policy cycle?
- How concerned should we be about the leverage ratio of households for Canada?
- If underlying inflation falls in Japan, what course of action should the BoJ take?
- Given the faltering reform policies of the Indian government, and the prospective weakness of the banking system, are we overestimating growth potential?
- As the CB of Russia is lowering interest rates at a time of heightened inflation, will we see expectations become de-anchored?