KIEL INSTITUTE FOR THE WORLD ECONOMY

AIECE Autumn General Meeting| Brussels, 16/17 November 2017

World Economic Environment

World Economy in Full Swing

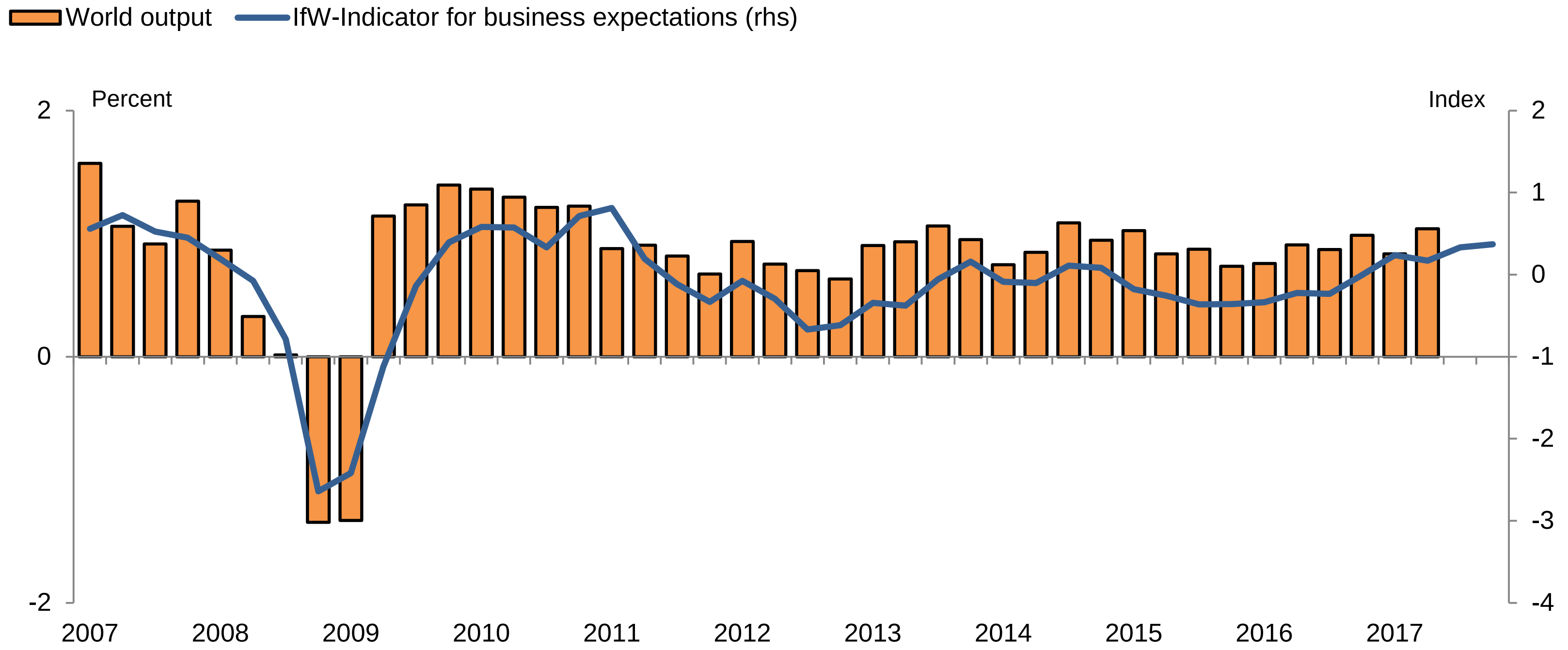
Kiel Institute for the World Economy

16 November 2017

Member of Leibniz Association

Global economy has gained momentum

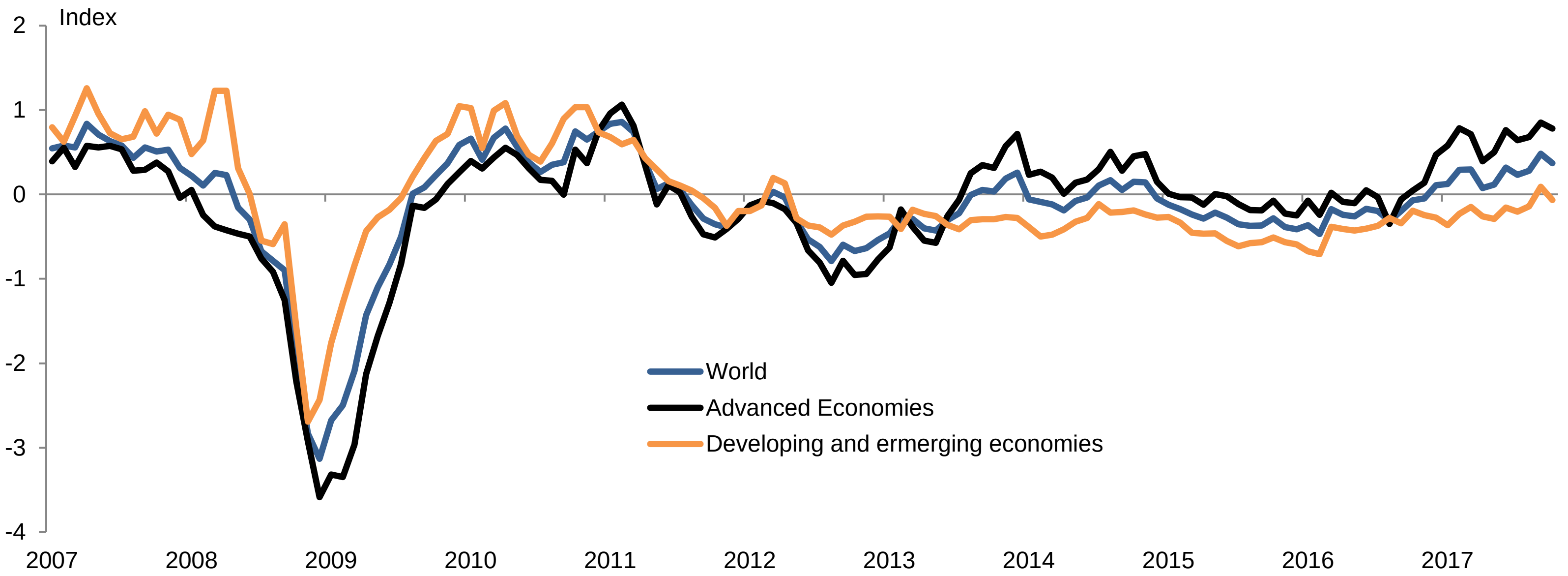
World Economic Activity



Quarterly data, seasonally adjusted. Indicator is based on business expectations in 42 economies. GDP: price adjusted, change over previous quarter.

Improvement of sentiment is more and more broad-based

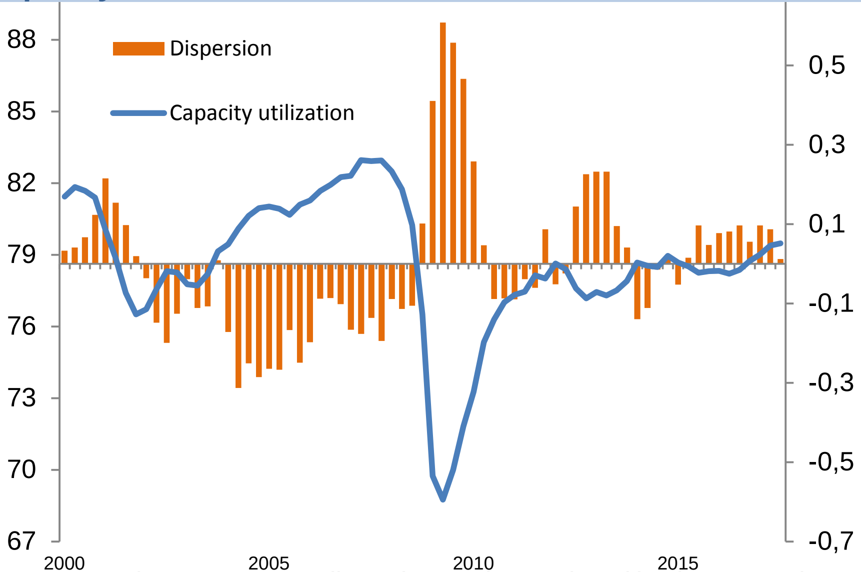
Business expectations by groups of countries



Monthly data, seasonally adjusted. Indicators are based on buisness expectations in 42 countries (33 advanced economies and 9 emerging economies).

Concerted expansion, not synchronized cycle

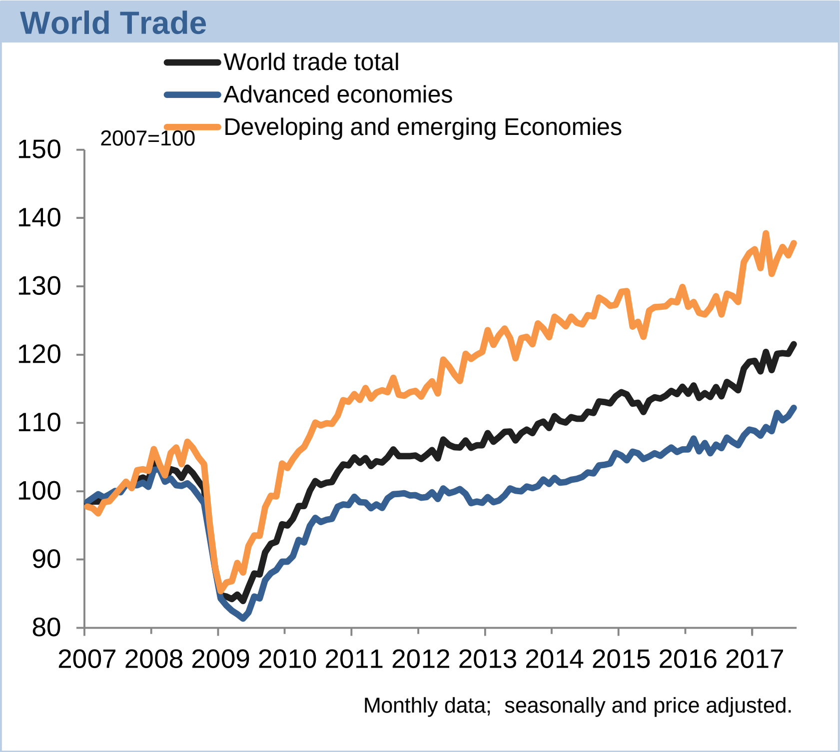
Global capacity utilization and dispersion of national capacity utilizations



Quarterly data; seasonal adjusted; World capacity utilization: capacity utilization in manufacturing in 40 countries, weighted with GDP at PPP; Measure of dispersion: Standard deviation, deviation from average.

- Synchronized upturn in the world economy for the first time in a number of years
- But economies are in different phases of the cycle, although uncertainty with respect to the output gap is large
- Dispersion of capacity utilization is still above normal
- Sustained acceleration of growth less likely with limited room for expansion in a number of countries

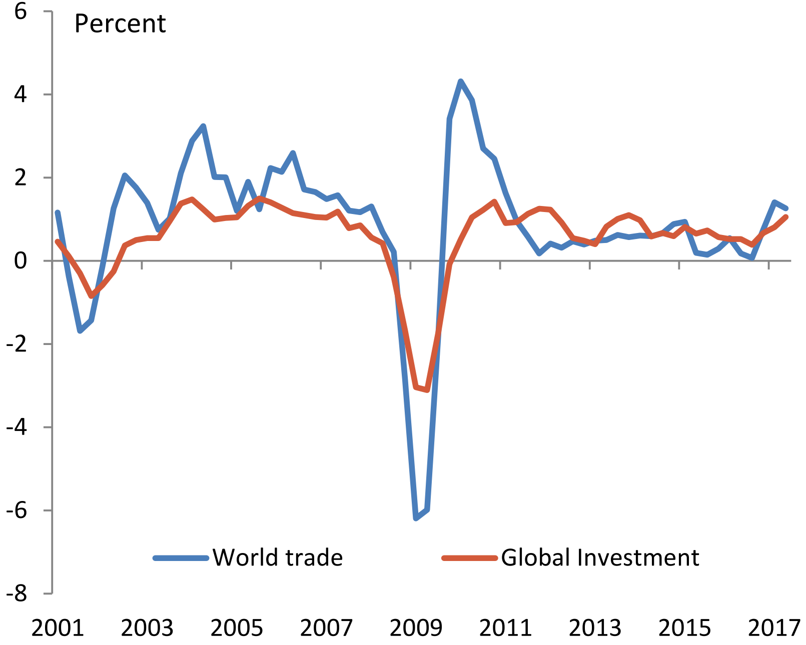
World trade has picked up



- World trade jumped in late 2016
- More moderate growth during 2017
- Y-o-Y growth is in for 4-5 %
- Structural or cyclical?

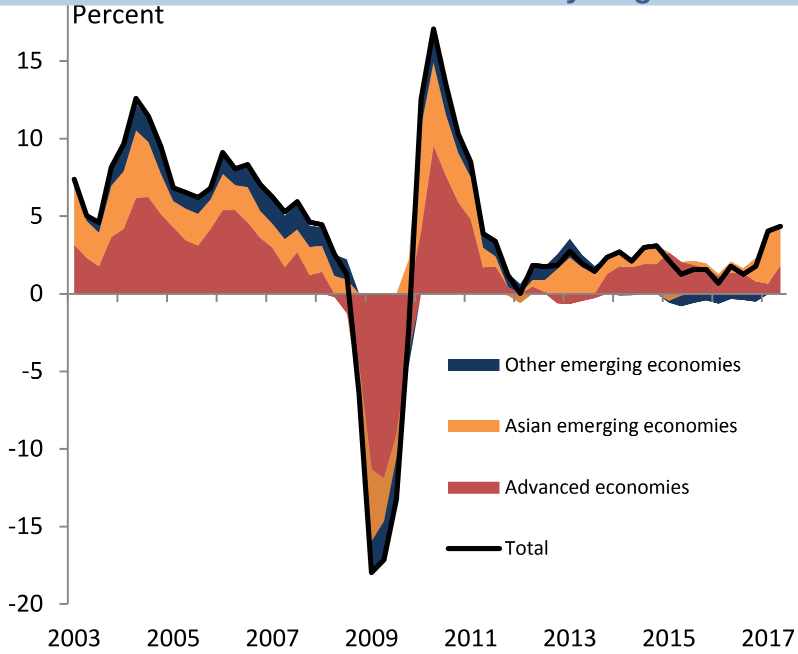
Investment and China are main explanations

World Trade and Global Investment



Quarterly data, seasonally adjusted, change over previous quarter, 3-month moving average; Investment: IfW-Index of 47 advanced and emerging economies.

Contribution to World Trade Growth by Region



Growth of imports according to *CPB World Trade Monitor* over previous year. Third quarter 2017: Average of July and August values.

Structural factors behind trade slowdow are still at play

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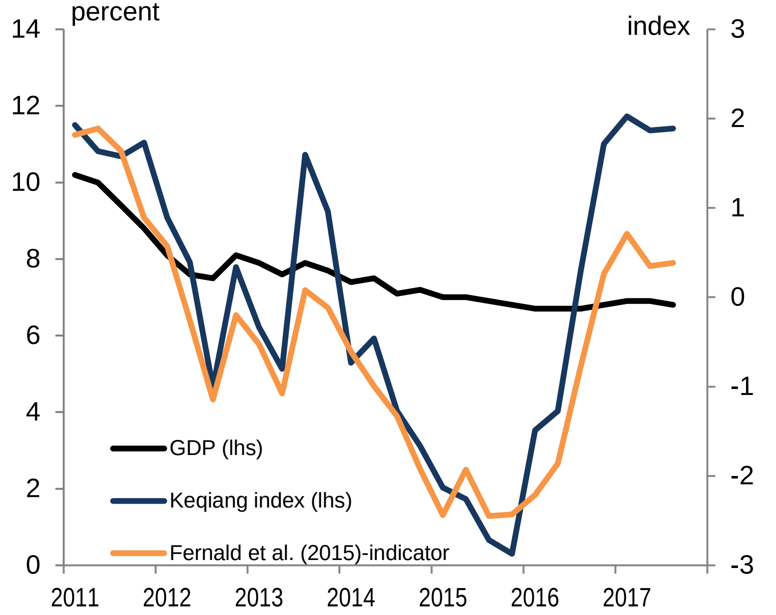
- Secular slow-down in China is expected to continue
- Trade liberalization has ceased to push trade growth
  - Negative impact of recent protectionist tendencies limited so far
  - But risk for the outlook
- Integration of China and Soviet block into the world economy has gone a long way
- Build-up of global value chains seems to have peaked
- Bottomline: Some improvement in trade elasticity from recent very low levels, but no return to exceptionally high levels of the 90s and early 2000s

China: Deceleration of growth to resume

China: GDP and alternative activity indicators 2011-2017

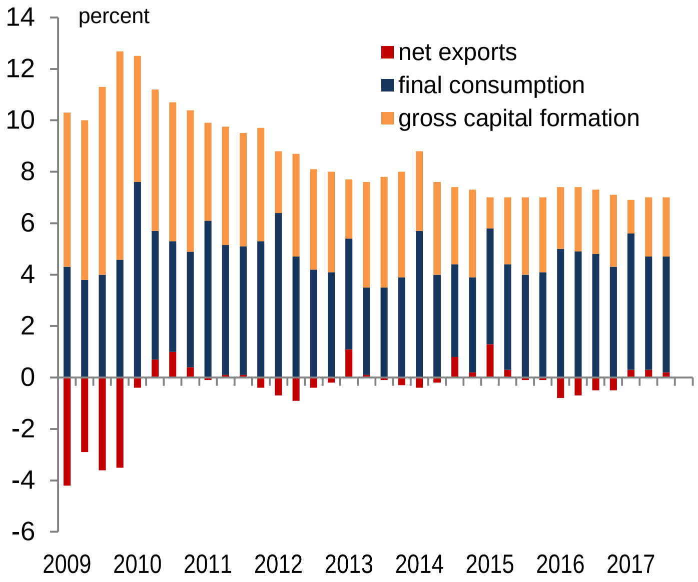


Quarterly data. Keqiang index is average of growth in energy consumption, railway transport and bank loans. Fernald Index includes also retail trade volumes to reduce bias towards heavy industry activity.

- Robust growth in manufacturing, with some moderation most recently.
- PMI suggests slowdown in other sectors
- Re-acceleration of growth is again biased towards traditional industries contradicting the new growth paradigm

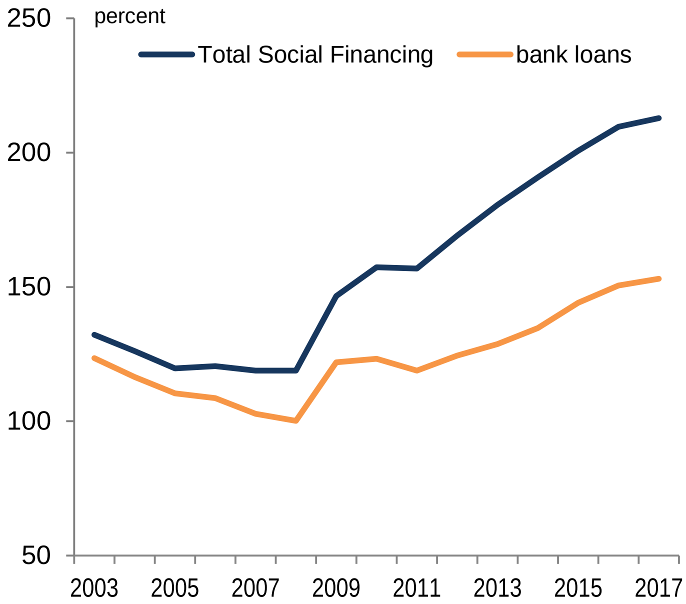
China: Official data show no increase of GFC contribution to growth; credit growth may have started to slow

China: Contributions to GDP growth



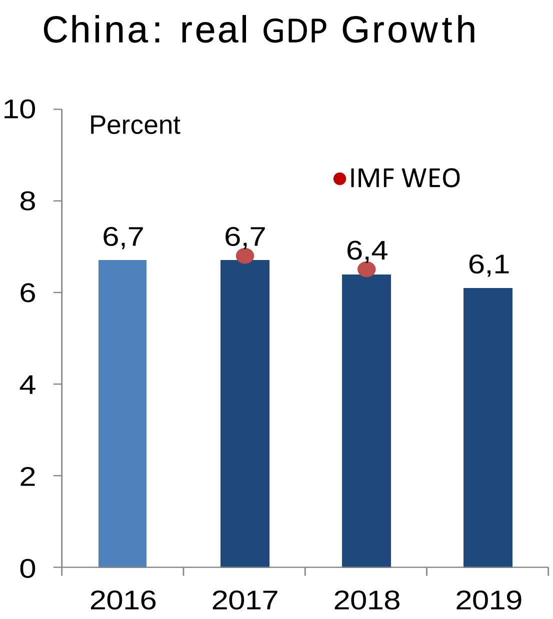
Quarterly data.

China: Outstanding credit 2003-2017



Annual data. In relation to nominal GDP. 2017: first three quarters

China: Deceleration of growth to resume



- Continued gradual transition to a lower growth trajectory after the Party Congress
- Structural problems (overcapacities in heavy industries) remain an issue
- Fiscal policy will remain supportive (infrastructure, military spending), but turn less expansive
- Tighter credit to reign in growth of debt in the private sector and local governments
- Liberalisation initiative for the financial sector

➢ Can we expect serious liberalisation?

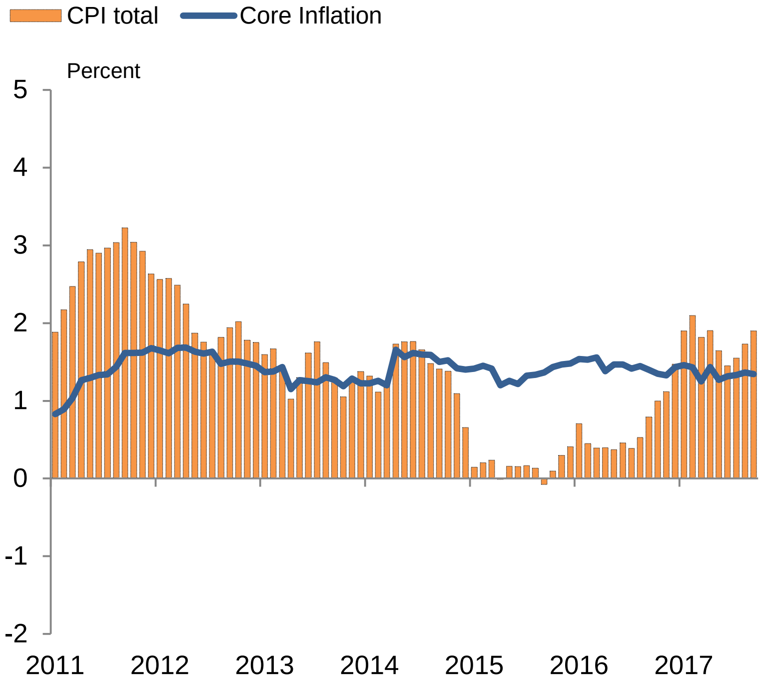
➢ Risk of a hard Landing?

Other emerging economies seem to have turned the corner

- Partial recovery of commodity prices supports growth in commodity exporting countries
- Stronger exchange rates have helped push down inflation and support consumption growth, allow substantial reduction of interest rates
- Recovery in **Brazil** finally there, but still political uncertainty
- Pick-up of growth in **Russia** also due to large-scale investment projects
- **Turkey** surprised on the upside (construction investment, tourism)
- Robust growth in **emerging Asia**
- Exception: Negative fallout in terms of growth from reform initiatives in **India** (currency reform, national VAT)

Inflation in advanced economies still moderate

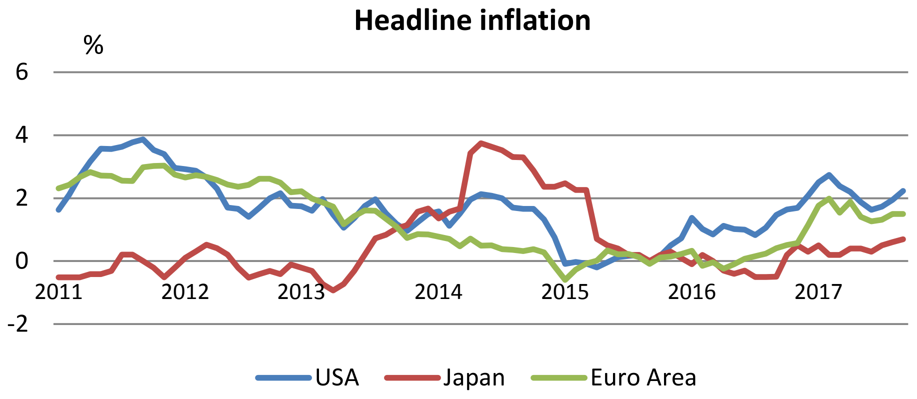
CPI Inflation in Advanced Economies 2011-2017

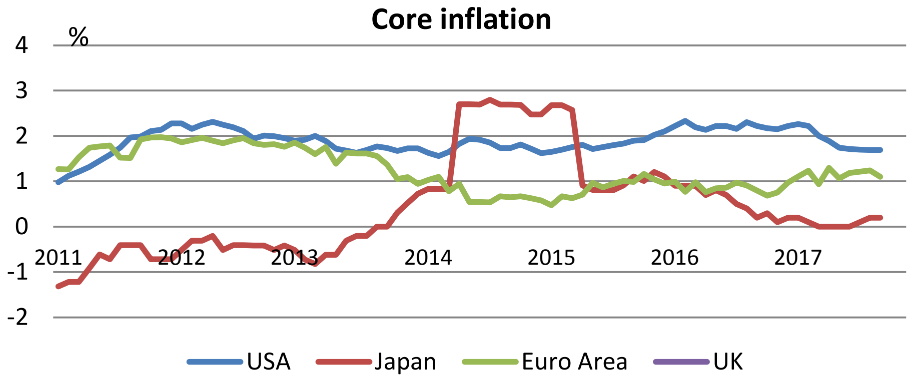


Monthly data; yoy-change in the United States, the Euro Area, Japan and the United Kingdom;
Core Inflation: CPI ex energy and food.

- Headline inflation slowing over the summer, but recovering more recently
- Core inflation stable at modest levels, although with diverging trends across countries

Inflation in advanced economies still moderate

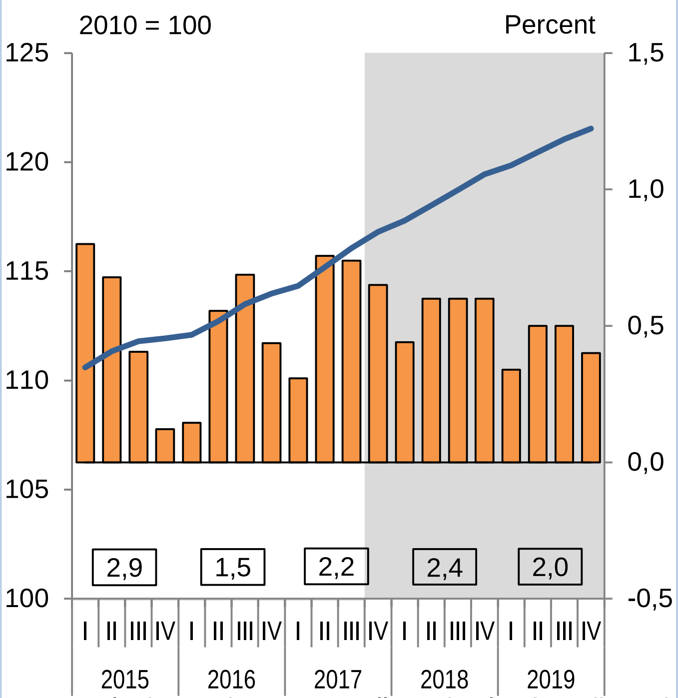




- Headline inflation slowing over the summer, but recovering more recently
- Core inflation stable at modest levels, although with diverging trends across countries
- Monetary policy normalization may take longer than forecast in spring

United States: Moderate upturn amid policy uncertainty

United States: GDP

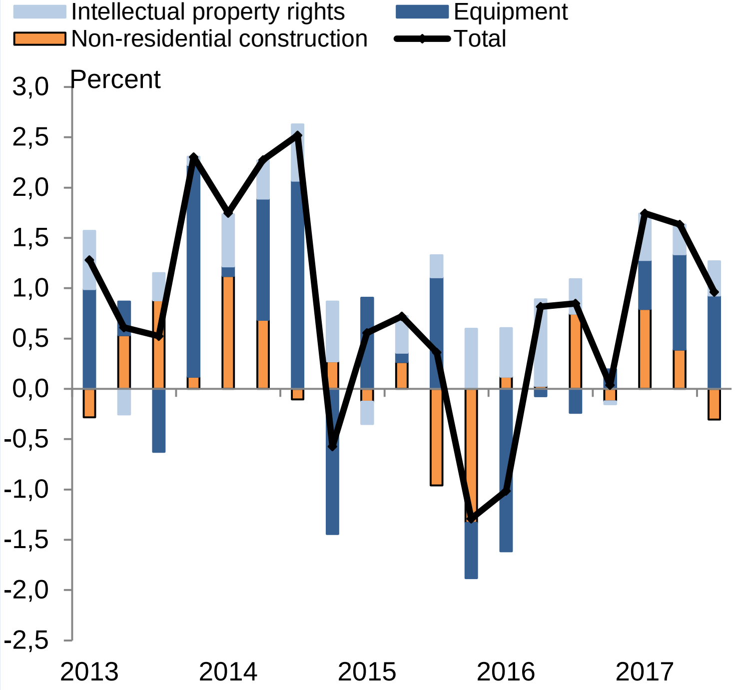


Quarterly data, price, seasonally and calendar adjusted, qoq-change.

- Robust growth of around 3 % annualized in Q“ and Q3 after slow start into the year.
- Robust private consumption
- Little negative impact of hurricanes in Q3
  - employment growth resumed
  - private consumption picked up on reconstruction spending, no visible effect of temporarily higher fuel prices
  - Some impact on investment growth which had just gained strength

United States: Business investment has picked up

USA: Business investment

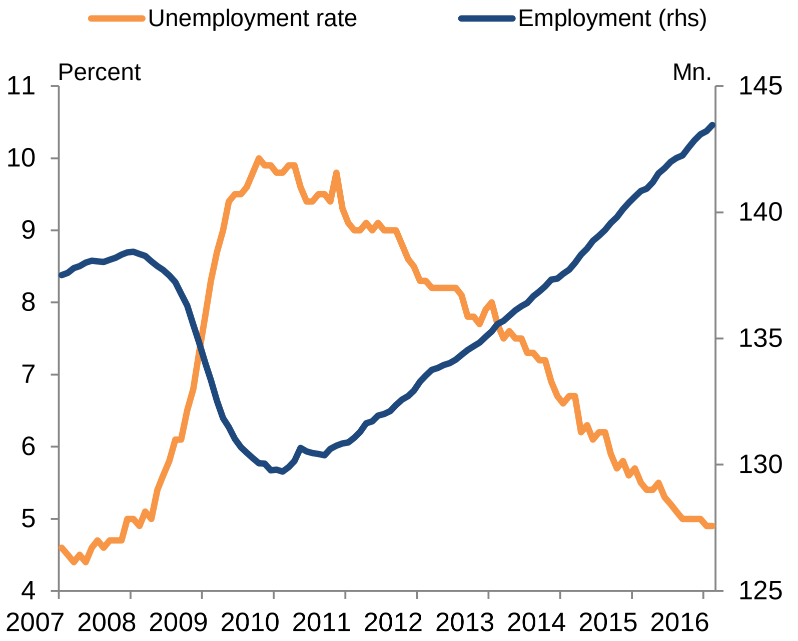


Quarterly data. Corporate investments: seasonally adjusted, qoq-change.
Equipment, Non-residential construction, Intellectual property rights: contribution to growth.

- Investment is recovering on the back of improving capacity utilization, easier financing and healthy earnings growth
- Recovery in non-residential construction amid renewed investment activity in energy sector
- Temporary dip in Q3 due to impact of hurricanes

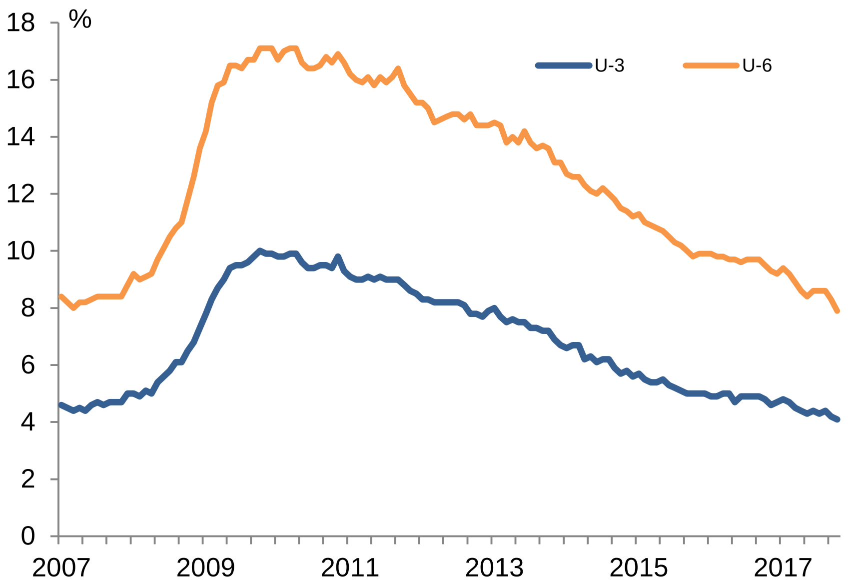
United States: Labour market is tightening

Labour Market in the United States



Monthly data; seasonally adjusted.

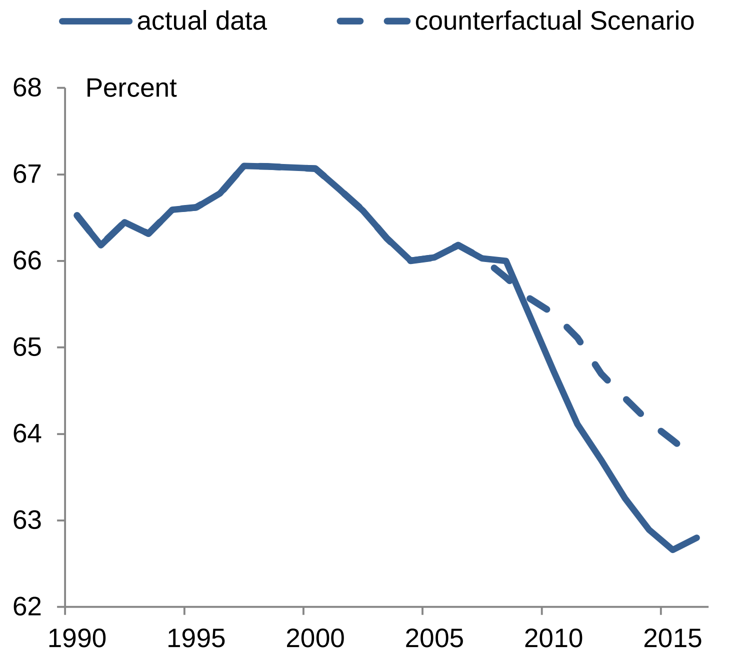
US unemployment rate



Monthly data.U6 includes marginally attached to the labor force as well involuntary part-time workers

United States: Structural decline of participation rate

USA: Participation rate



Annual data. counterfactual scenario: constant cohort-specific participation rate in all 13 age cohorts from 2007 onwards.

- Participation rate has decreased strongly after 2007
- Very moderate recovery recently
- Participation rate suggests that there may be more labour market slack than indicated by unemployment rate
- However, decline is to a large extent structural: Simulation with constant cohort-specific participation rate shows more than half of the decline is due to demographic reasons

➢ What is your take of the current capacity utilization in the US?

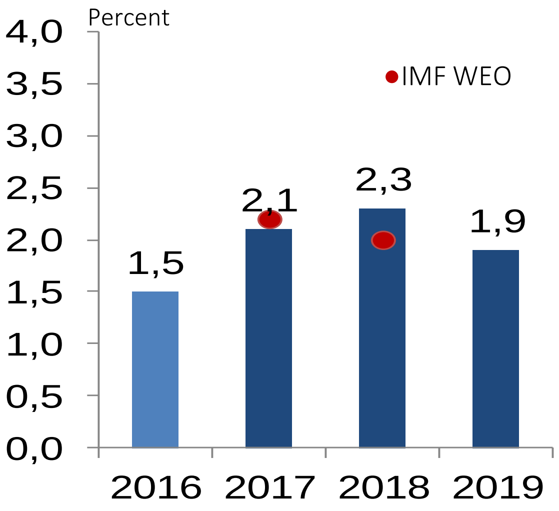
United States: Monetary policy gradually tightening – tax reform in the making

- FFR increased to 1-1.25 % in June, expected to be raised rate again in December
- We assume very gradual further increase to 2 %, slightly below market expectations
- Assumption: No fiscal stimulus, but a tax reform seems finally underway
  - Simplification of income tax (4 brackets, previously 7)
  - Lower corporate tax rate from 35 percent to 20 percent
  - Substantial elimination or reduction of exemptions, e.g. deductability of (mortgage) interest payments, state and local tax
  - Total cost: ~ 1.5 trillion over next 10 years
  - No border adjustment but 20 percent tax on intra-company transfers (details unclear)

➢ What is your assessment of tax reform outcome and its impact on the economy?

United States: Moderate upturn amid policy uncertainty

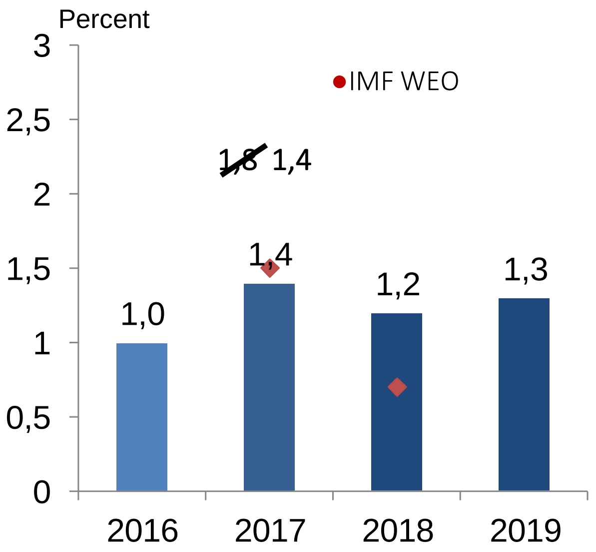
US real GDP Growth



- Rare downward revision from spring
- Less fiscal stimulus than expected
- Modest negative impact of hurricanes in Q3
- Economic expansion remains on track
  - employment growth to resume
  - Robust private consumption
  - Investment growth has gained strength
- Monetary policy tightening in response to diminishing slack, but slightly slower than expected in spring
- Major tax reform is a risk to the outlook

Japan: Continued moderate growth

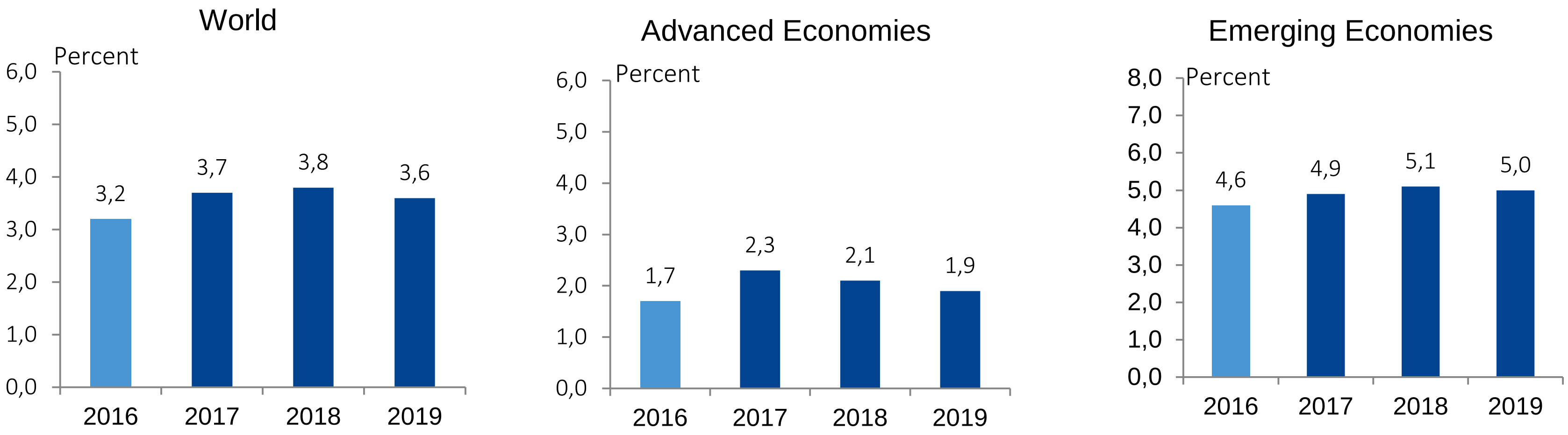
Japan: real GDP Growth



- Downward revision to Q2 has killed our growth forecast for 2017
- Expansion nevertheless looks robust
  - Still highest quarterly growth in 2 years
  - Investment has picked up
  - Exports accelerate
- Monetary policy tightening is not in sight
- Fiscal program to support the economy, revenues from VAT increase in 2019 will not be saved
- Yen/dollar exchange rate relatively stable at 110
- Inflation stuck around zero despite very low unemployment

➢ Will inflation finally emerge?

The global picture: Increased level of growth, with advanced economies gradually losing steam over the forecast horizon



Risks have shifted

- Geopolitical risks seem to have increased with the conflict with North Korea heating up
- Economic policy risks have diminished with drastic shifts in US policy having become less likely
- Protectionism less of a threat in the short term but scepticism against free trade could weigh on long-term growth
- Monetary policy is still expansive in large parts of the advanced economies, with risks emanating from necessary normalization process and failure to exit in time
- Changes in risk appetite could lead to volatile international capital flows potentially hurting emerging markets
- Correction in frothy asset markets (e.g. US equities) becoming more likely?

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Thank you!

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