Oxford Analytica Global Strategic Analysis

PROSPECTS Q2 2015: Global economy

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Abstract (summary)

Prospects for the global economy in the second quarter.

Heightened geopolitical risk undermines the potential for any short-term strengthening of world economic activity. In the second quarter, global growth should be similar to that experienced in early 2015. Over the first half of this year, it will remain in the 3.0-3.5% range, similar to the 2014 growth rate of 3.3%. Many countries remain vulnerable to international tensions: there will be no early recovery in the commodity-producing economies of the Middle East, Africa and Latin America, or in Eastern Europe.

Full text

SUBJECT:Prospects for the global economy in the second quarter.

SIGNIFICANCE:Heightened geopolitical risk undermines the potential for any short-term strengthening of world economic activity. In the second quarter, global growth should be similar to that experienced in early 2015. Over the first half of this year, it will remain in the 3.0-3.5% range, similar to the 2014 growth rate of 3.3%. Many countries remain vulnerable to international tensions: there will be no early recovery in the commodity-producing economies of the Middle East, Africa and Latin America, or in Eastern Europe.

ANALYSIS: Strategic summary.

The steep decline in commodity prices and more turbulence likely ahead are curbing investment plans.

The positive impact of declining oil prices on private consumption has been modest thus far, but could filter through in the second quarter.

Governments need to foster an environment that encourages businesses and consumers to regenerate growth and jobs.

Political and military risks will have to be addressed to prevent escalating damage to investment and long-run growth potential.

The global economy has become more fraught with non-economic risks and more fractured with a wider range of risks across countries. Apart from the ongoing Greek bail-out renegotiations, elections in the United Kingdom (May) and Spain (December at the latest) could lead to policy shifts. However, these are unlikely to be visible in the first half of 2015 (see GREECE/EURO-AREA: Debt capitulation has political risk - February 26, 2015).

			Projections		Difference from October 2014 projections	
	2013	2014	2015	2016	2015	2016
World output	3.3	3.3	3.5	3.7	-0.3	-0.3
Advanced economies	1.3	1.8	2.4	2.4	0.1	-0
Emerging and developing economies	4.7	4.4	4.3	4.7	-0.6	-0.5

IMF revised forecasts, January 2015 (% year on year growth)
Source: IMF World Economic Outlook

In January, the IMF downgraded its global growth forecasts by 0.3 percentage points for both 2015 and 2016.

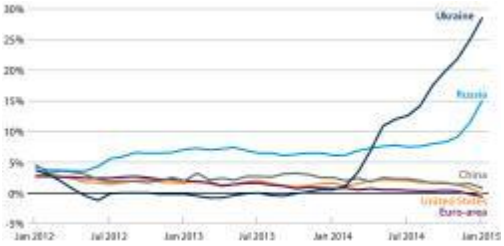
The advanced economies are now expected to grow by 2.4% in both 2015 and 2016. Growth projections for emerging countries were downgraded, by 0.6 and 0.5 percentage points for 2015 and 2016, to 4.3% and 4.7% respectively.

The IMF's revised projections for 2015 look plausible, albeit at the top end of most forecasts, especially those for emerging countries.

Baseline and alternative scenarios for short-term growth (year-on-year % growth)
Sources: IMF (January 2015 forecasts) and OA estimates

Deflation is a widespread and serious concern. A few economies with sharply weakening currencies (eg, Russia) may be experiencing higher inflation and rising interest rates, but other inflation drivers (eg, strong demand) are mostly absent. In most countries, consumer prices are dragged down by falling commodity prices and weak wage growth.

Many central banks cut interest rates in early 2015, in an escalating 'currency war' to keep real interest rates low despite the deflation threat (see INTERNATIONAL: Currency wars will break out worldwide - February 9, 2015).



Consumer price index (year-on-year % growth)
Source: Bloomberg

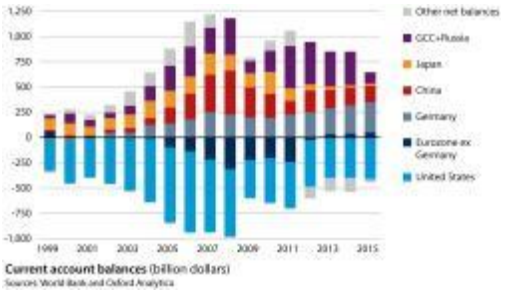
Despite global deflationary pressures and a rising dollar, there is a persistent concern over potentially higher US inflation in the medium term. US labour markets are starting to tighten. Some economists also fear eventual inflationary repercussions from the extraordinary monetary policies of recent years, but there has not been evidence of this so far. Current trends are unlikely to change in the second quarter.

Commodity prices.

Steep declines in commodity prices, especially oil, have lowered consumer prices in many countries. Yet a marked positive impact on GDP growth and commodity demand has still to emerge. Losers usually react faster than winners to most shocks, so positive outcomes take time to emerge. Some could be visible by the end of the second quarter although any rebound in prices, or even price volatility, could exacerbate uncertainty and stifle these effects.

Another effect of falling energy and commodity prices will be to shrink some countries' trade surpluses (just as others' will swell). Asian surpluses -- chiefly China's and Japan's -- have shrunk, and the US deficit has become smaller, benefiting from the surge in US oil and gas production.

With energy producers likely to move from large surpluses to smaller ones (or even deficits), the swelling German surplus remains an exception. The country gains from both the drop in energy prices and the weaker euro.



United States: dynamic growth.

The US economy is one of the few bright spots in the global economy. Domestic spending drove annualised 2.2% growth in the fourth quarter of 2014. The net trade deficit widened, as import growth outpaced export growth. Buoyant imports reflect accelerating domestic demand and a stronger dollar. US real GDP is expected to grow by 3.0-3.5% in 2015, helping reduce spare capacity, while domestic inflation pressures will pick up.

The labour market is buoyant, at least in raw job numbers. A net 257,000 jobs were created in January, marking the eleventh consecutive month in which more than 200,000 jobs were created. Non-farm payrolls increased by more than 1 million net new jobs in the past three months and by more than 3 million in the whole of 2014. The number now in employment stands at an all-time high.

The unemployment rate stood at 5.7% in January. Wage pressures are starting to emerge. Average hourly earnings grew by 2.2% year on year. The labour market should stay brisk in the second quarter.

Inflation declined sharply in January (down 0.1% on a yearly basis). Prices contracted for the first time since October 2009, led by a 9.7% monthly drop in energy prices. The core consumer price index (CPI, excluding food and energy prices) was up 1.6% year on year.

These developments stand in sharp contrast to what is happening in the euro-area and Japan. Diverging policy trends between the United States and other developed economies are showing up in the foreign exchange markets, where the dollar is strengthening (up 5.7% on a trade-weighted basis year-to-date), and in the expected direction of interest rates.

At its January meeting, the Federal Reserve's (Fed) rate-setting committee did not alter its policy stance, saying that it would be "patient" in 'normalising' monetary policy (ie, raising interest rates) while acknowledging the decline in inflation. Even if inflation stays low, the Fed is still likely to start raising rates mid-year, provided it believes inflation is on track to return to its 2% target over the medium term and labour markets continue to improve.

It could hold off if evidence emerges of low oil prices passing through to core inflation persistently or if rising geopolitical threats undermine US growth prospects.

Euro-area: ECB pushing for economy re-launch.

Euro-area real GDP grew by 0.9% in 2014 after a 0.4% contraction in 2013, supported by strengthening peripheral economies and an acceleration in German growth. Last year's GDP gain was supported by exports outpacing imports while domestic demand also strengthened.

The massive German current account surplus, at 7.3% of GDP and rising, testifies to persistent import weakness (up 2.8% in 2014 versus an export gain of 7.4%) and the benefits of a weakening euro (see GERMANY: Austerity shift risks 'wrong' lessons - January 30, 2015.

Growth of 1.0-1.5% is likely this year and will be supported by:

ECB sovereign quantitative easing (QE);

a weak euro;

cheaper oil;

less restrictive fiscal policy; and

some 'green shoots' in bank lending.

In the second quarter, manufacturing will be boosted by strong auto production, especially in Germany, while the latest purchasing managers' index surveys point to momentum building in services.

The labour market is starting to improve, with the unemployment rate falling to 11.2% in January, its lowest level since April 2012. Further downward movement is likely in the second quarter, but unemployment will remain high.

Prices fell on a yearly basis in the past three months, down 0.3% in February. Inflation is likely to stay negative for most of 2015 as the oil price drop takes a toll, despite upward pressure from a weakening euro. Core inflation should barely stay positive under modest wage pressures.

In January, the ECB expanded its private sector asset purchase programme to include bonds issued by euro-area governments, agencies and European institutions in order to fight deflation (see EURO-AREA: Sovereign QE could support inflation trends - January 23, 2015). Purchases will amount to a combined total of 60 billion euros (68 billion dollars) per month, starting in March. They will continue until at least September 2016 or until there is progress towards the central bank's medium-term inflation goal.

The resulting low interest rate regime may encourage recoveries in the weaker housing markets, including areas of France and Italy that should benefit from buyers exiting ever more expensive Switzerland for neighbouring countries (see SWITZERLAND: Economy faces challenges after SNB move - January 21, 2015). The QE-induced euro-weakness will help attract foreign property buyers, cashing in on recent gains in strong markets such as the United Kingdom.

The broader macroeconomic impact of QE will be clearer in the second half of 2015. Before that, it could be offset by the uncertainty caused by Greece renegotiating its bailout terms and by ongoing geopolitical tensions.

United Kingdom: May's elections.

UK economic activity remains brisk, despite a modest slowdown in real GDP growth at end-2014. In 2015, growth should be similar to the previous year (2.6%), though the second quarter will be shaped by May's general election.

The external balance remains a blight. The current account is moving into a larger deficit, as UK export growth is held back by poor growth in neighbours' economies. Financing this deficit does not seem to be a problem, given capital inflows into 'safe haven' markets such as the United Kingdom.

The unemployment rate was down to 5.7% in the three months ending in December, while signs are emerging of wage gains in the private sector. Some new jobs have poor pay. Nevertheless, the economy is benefiting from rising consumption and housing demand, with loan growth encouraged by improving sentiment and extraordinarily low interest rates.

In January, inflation plummeted to a record low of 0.3% year on year, brought down by energy prices. It could dip into negative territory in the second quarter, and is likely to be barely positive for the full year. Unlike the euro-area, in the United Kingdom spare capacity is disappearing quickly, partly offsetting the disinflationary impact of lower energy prices and of the pound's strength.

In its February Inflation Report, the Bank of England (BOE) stated that it would look through the current inflation dip, as it is mainly caused by lower oil prices that are expected to be transitory. Monetary policy will be assessed on the medium-term inflation outlook. Soft inflation data removes pressure to raise rates soon. The BOE is likely to push back the start of its tightening cycle to the second half of 2015.

Japan: disappointing growth .

Real GDP was unchanged in calendar year 2014 overall, but in the fourth quarter the economy exited its consumption tax increase-induced recession. In 2015, the economy should grow modestly, benefiting from cheaper oil and a related increase in household disposable income.

The supplementary budget for fiscal year (FY) 2014 approved in January may boost domestic momentum, while a planned corporate tax cut from April 1 should support capital investment (see JAPAN: Japan creeps towards fiscal balance - January 16, 2015). The government postponed the second leg of the consumption tax rise, originally scheduled for October 2015, amid signals of weak post-rise domestic demand.

The labour market is tight. Further yen depreciation should stimulate net trade, though exports may take time to accelerate. In any case, their second-quarter performance should be better than in the first quarter.

Inflation has been weakening, as the April 2014 consumption tax rise wears off. Allied to the effect of falling energy prices inflation will be barely positive in the second quarter.

After a surprise expansion by the Bank of Japan on October 30 of its qualitative and quantitative easing programme, further easing is likely if falling inflation passes through to consumers' inflation expectations.

Emerging Asia: concern over China.

China's economy is weakening. Real GDP growth is expected to fall below 7.0% in 2015, from 2014's 7.4%. Growth will weaken incrementally throughout this year as a result of a policy-induced property market correction, tighter controls on local government debt and deleveraging.

This slowing has been accompanied by falling inflation. The CPI dropped to 0.8% year on year in January, from 1.5% in December. In the second quarter, inflation should stay around this level.

The scale of the bad asset risks in China's financial system is a growing concern. A significant debt default of financial-institution failure, though manageable, would threaten a 'hard landing' for the economy.

The People's Bank of China cut its reserve requirement ratio for major banks by 50 basis points on February 4. It followed this on February 28, with 25 basis points cuts to both its benchmark one-year deposit and lending rates, to 2.50% and 5.35% respectively. Further monetary easing is likely this year, possibly through a further rate cut.

With China's economy worth more than 10 trillion dollars, any turbulence will be felt elsewhere with the shockwaves reaching neighbouring economies such as Hong Kong first. Hong Kong is particularly vulnerable; its dollar peg would keep its exchange rate high and make its exports ever more expensive and uncompetitive (see INTERNATIONAL: Main pegs will not follow the franc - January 27, 2015).

One side effect of China's slowdown, compounded by the anti-corruption drive, has been the fall in Macau's gambling revenues. This was exceptionally sharp at end-2014, boding ill for early 2015.

China's slowdown has not damaged all emerging economies in the region. The outlook for ASEAN countries is robust, with average growth remaining in the 5.0-5.5% range. Rising stars such as Vietnam (6.0% growth in 2014) offset poor performers such as Thailand, now looking set to recover from the damage domestic political turmoil has inflicted on its economy.

Prospects are also brighter for India, although forecasters are facing difficulties in assessing the state of the economy due to a change of GDP base-year from 2004-05 to 2011-12 among other methodological changes (see INDIA: GDP rebase may boost investor confidence - February 6, 2015). This led to upward revisions in growth rates by 0.3 percentage points for FY 2013 and by 1.9 percentage points for FY 2014, to 6.9% and 7.4% respectively. However, other indicators are not necessarily showing a commensurate pick-up in activity.

India is a winner from the fall in commodity and energy prices as well as the percieved business-friendliness of the

new Modi government. Announcing his first annual budget on Febraury 28, Finance Minister Arun Jaitley forecast that in FY2015 growth would rise to 8.0-8.5%.

CONCLUSION: Global growth and inflation will remain subdued in the second quarter. Despite the fragile euro-area recovery and weakness in Japan, the strengthening of the US economy should ensure some improvement in the advanced economies' average growth rate, around 2.0-2.5%. Emerging countries' growth could drop below 4.0% if Brazil experiences a prolonged recession or if major commodity-producing regions deteriorate more than expected. China will be a pivotal factor: a sharp drop in activity would spread shockwaves that could provoke financial market turmoil.

Indexing (details)

Subject	International; Economic conditions; Industry; Balance of payments; Capital movement; Consumer; Debt; Economic growth; Monetary policy; Public policy; Corporate; Employment; Energy policy; Foreign exchange rates; Financial institutions; Fiscal policy; Foreign investment; Government
Location	Africa, China, Greece, India, Japan, Latin America, United Kingdom, UK, United States, US, Brazil, France, Hong Kong, Italy, Macau, Middle East, Spain, Switzerland, Vietnam
Company	European Union, Association of Southeast Asian Nations, ASEAN
Identifier / keyword	International, Africa, China, Greece, India, Japan, Latin America, United Kingdom, UK, United States, US, Brazil, France, Hong Kong, Italy, Macau, Middle East, Spain, Switzerland, Vietnam, Economic conditions, Industry, Balance of payments, Capital movement, Consumer, Debt, Economic growth, Monetary policy, Public policy, Corporate, Employment, Energy policy, Foreign exchange rates, Financial institutions, Fiscal policy, Foreign investment, Government
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