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Economic Briefings

20 July 2015

Update outlook global economy

The world economy continued to improve gradually. As was clear from recent economic data from the United States, the euro area and even China. Growth in the Western countries is being driven to a significant extent by increasing consumer spending, supported by an ongoing decline in unemployment. The persistently low oil price, meanwhile, continues to underpin real income growth. Headline inflation remains low, but will gradually start to rise in the months ahead. With US unemployment also falling to a level equated with full employment, the Fed is probably preparing its first interest-rate hike for as early as September. However, given the very loose monetary policy in the rest of the world economy, especially in the euro area, this need not result in a spike in bond yields of the kind that occurred in 1994. Certain economic risks nevertheless remain. While Europe eventually arrived at an extremely late and maybe only temporary solution for Greece's debt problem, a number of vulnerable emerging economies could run into difficulty when the Fed begins to tighten policy. This will not, however, jeopardise the recovery in world economic growth.

World economic outlook continues to brighten

The most recent economic indicators paint a mixed but – on balance – positive picture of the world economy. Producer confidence in US manufacturing industry in particular and also, to a somewhat more modest extent, that in the euro area, suggest that the recovery in worldwide growth is continuing. The only false note was struck by the decline in UK producer confidence, but the British labour market also remained in good shape.

The pace of Chinese quarterly growth accelerated from 1.3% in the first quarter to 1.7% in the second.

The most recent numbers for Japanese producer confidence were also down a little, but we ought not to forget that the Japanese economy is still close to full employment. On the other hand, second-quarter Chinese growth brought good news. The Chinese economy grew 7% compared to the second quarter of 2014. More important however, was the fact that the pace of quarterly growth accelerated from 1.3% in the first quarter to 1.7% in the second. Chinese policy-makers announced, moreover, that both monetary and budgetary policy would be loosened further if economic growth were to dip below the adopted target. If necessary, investment and exports would be stimulated once again at the expense of growth in private consumption.

Consumers are the driving force

Overall growth in the world economy is driven first and foremost by growth in private consumption, especially in the Western countries. Unemployment rates continued to fall gradually in the US, the UK and many euro area countries. US unemployment has dipped close to the level that the Fed equates with full employment, while in Germany, Eurostat data shows that the jobless rate has actually already fallen below that level. Provided there is no new negative shock, the world economy will continue to grow faster than its potential tempo, resulting in the further decline of the underutilisation of economic capacity, as expressed in the cyclical unemployment rate in particular. This will gradually exert increasing pressure on pay levels and will also bring underlying core inflation closer to the target level set by the leading central banks.

Oil price remains growth-friendly

The price of oil recently eased a little to around 58 dollars per barrel of Brent crude (graph 1). This is in line with our scenario in which, due to new shale technology, the negative price shock of 2014 has taken on a permanent character and the oil price will continue to fluctuate within a band that is clearly lower than in the first half of 2014. We expect the oil price to rise only gradually to 70 dollars a barrel for Brent crude towards the end of 2015. This also means that relatively low energy prices will continue to underpin real pay growth and hence also the consumer-driven recovery in the US and Europe. The political agreement with Iran regarding its nuclear programme will also result in a gradual lifting of economic sanctions against the country and in higher oil exports. This too will mean that the oil price will struggle to rise in the medium term.

Headline inflation fell marginally to 0% in the US in May and to 0.2% in the euro area in June, due primarily to slightly lower oil prices. The key difference between the two economies, however, lies in core inflation (excluding energy and food prices). Whereas the 1.7% rate in the US is not far off the Fed's inflation target, core inflation in the euro area is still less than half the ECB's target rate. Both central banks are pursuing an inflation rate in the medium term of (just below) 2%.

The political accord with Iran regarding its nuclear programme will lead in the medium term to higher Iranian oil exports and will contribute to a weak oil price.

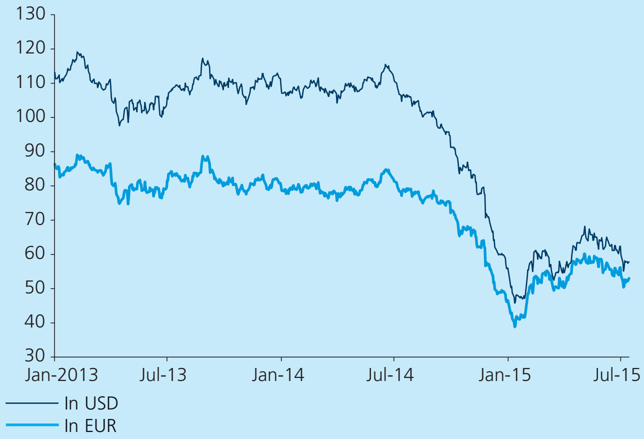
Spectre of deflation disappears

All the same, the declining inflation trend has come to a definitive end and the financial markets' fear of deflation has virtually dissipated. Unless a substantial new negative oil price shock occurs (bearing in mind that this would also provide an additional boost to economic growth), headline inflation will rise steadily in the months ahead toward 2015 year-end. This will be substantially due to the fact that the high oil prices of the first half of 2014 will be stripped from the year-on-year comparison.

In addition to the rise in headline inflation, core inflation too will gradually pick up once again. This is due to the gradual reduction in unused economic capacity thanks to growth that will exceed its potential tempo in most Western countries in 2015 and 2016. This process will, of course, be considerably slower in the euro area compared to the US.

Graph 1 - Low oil price continues to boost growth

(price per barrel of Brent crude)

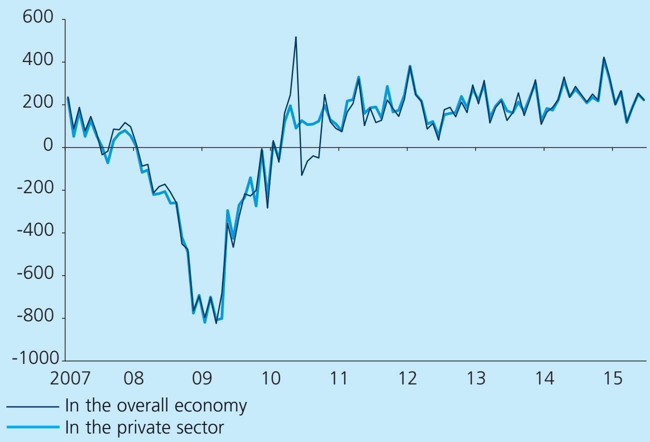


Fed at the starting gate

We still expect the Fed to embark on its cycle of rate hikes in September. Unless there are any further unexpected developments, the two most important conditions set by the Fed for a hike of this kind seem to have been met. The Fed indicated in its most recent statement, following its June policy meeting, that before it raises its key rate, it wanted to see a further improvement in the employment market and also to be reasonably certain that inflation would return to the 2% target in the medium term. Well, June saw the net creation of 223 000 new jobs (graph 2), while unemployment has fallen to 5.3%, which is a clear improvement. What's more, the current level of core inflation and the expected rise in headline inflation in the

Graph 2 - Further improvement in US labour market opens door to first rate hike

(monthly net employment creation, in thousands)



months ahead make it highly likely that inflation too will return to a level of around 2% in the near future.

The expectation of a first interest-rate hike by the Fed in September after almost seven years of a zero rate policy is an important driving force in our scenario of gradually but steadily rising bond yields in the US and Europe. The correlation between the main bond markets remains intact and strong. Higher bond yields in the US will therefore be accompanied by higher German bond rates, despite the fact that the ECB will probably hold its policy rate at just five basis points until some time in 2017. We also expect the ECB to continue its current purchase programme as planned until September 2016.

A repeat of the 1994 scenario on the bond market is unlikely.

Repeat of 1994 unlikely

In our view, however, a repeat of the 1994 scenario on the bond market is unlikely. A divergence in policy between the US Fed (tightening) and the German Bundesbank (loosening) also occurred in 1994, when a steep rise in US bond yields also drove up German rates sharply.

Unlike then, statistical data suggests that the direction of the causal link today is at least partially reversed. The extremely loose monetary policy being pursued by the ECB (including its purchase programme) and by a number of emerging market central banks seems to be having a downward impact on US bond yields, rather than the other way around.

This view was also suggested in the most recent report of the Bank for International Settlements – the central banks' bank. If this analysis is correct, a first rate hike by the Fed in September, which the markets have yet to price in, need not cause bond yields to spike, so long as monetary policy in the rest of the world economy remains highly accommodating. This is the most important argument in favour of our scenario that ten-year bond yields will only rise slightly toward the end of 2015, to a level of 2.75% in the US and 1% in Germany. Given that we still expect a divergence in monetary policy between the Fed and the ECB, we confirm our forecast that the euro will ease to parity against the US dollar towards the end of 2015.

Greece's debt problem cannot be solved once and for all without some form of debt restructuring.

Risks have not yet disappeared however

The most acute problem currently facing the euro area – i.e. the immediate threat of Grexit – has dissipated for the time being. The accord – assuming it is actually carried out – reached between Greece and its creditors (the European Commission, the ECB and the IMF) consists in brief of the following elements:

- Firstly, the Greek parliament approved all the so-called 'prior actions'. These are reforms and consolidation measures to restore the damaged trust in Greece's willingness to restructure.
- The second step is for the parliaments of a series of euro countries, including the German Bundestag, to approve the commencement of negotiations on a third bailout for Greece. This package would run for three years and would amount to a total volume of around 85 billion euros. It also looks as though a bridging loan of around 7 billion euros will be approved. This would enable Greece to repay ECB loans falling due in the next few months and to pay off its arrears to the IMF.
- Once the negotiations on the third bailout package are complete (which we do not expect to occur until September), the result will have to be approved by the parliaments of the relevant euro countries.

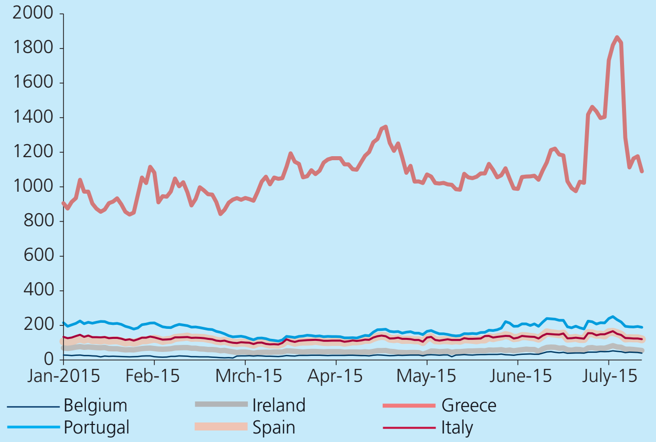
Our provisional view is that a lot could yet go wrong, and that little enthusiasm exists on either side of the agreement. The latest accord has, at least, won a little time; we will have to wait and see whether the agreed terms can hold. We can be certain, however, that Greece's debt problems cannot be solved permanently without some form of debt restructuring. As the IMF calculated in a recent analysis, Greek government debt is, after all, unsustainable on its current trajectory. Since an explicit debt write-off is beyond the pale for political and/or legal reasons, a substantial extension of the term of Greece's outstanding debt held by the European Support Fund EFSF/ESM is the most obvious way to ease the burden of that outstanding government debt.

So far, anyway, there have been few signs of 'contamination' of other European economies by Greece's debt problems. There was a slight increase in volatility on European bond markets, but spreads between German government paper and that of other euro countries continued to narrow (graph 3). This could indicate that the bond markets always assumed that an agreement would be reached at the last second. It is more likely, however, that exposure to Greece's debt issues has been so reduced by now that they no longer have the potential to significantly affect the financial markets.

Apart from the Greek question, there is still the potential risk that the forthcoming rate hike by the Fed could trigger a reversal in international capital flows from the emerging economies. Something similar already occurred in 2013, prompted by the possible ending of quantitative easing by the Fed. The Fed's forthcoming tightening cycle might now once again highlight the vulnerability of several emerging economies.

Graph 3 - Greece's debt issues have no net impact on European bond markets

(spread in ten-year government bond rates compared to Germany, in basis points)



Countries with macroeconomic imbalances, such as large external deficits, could come under particular pressure, examples being Turkey and Brazil.

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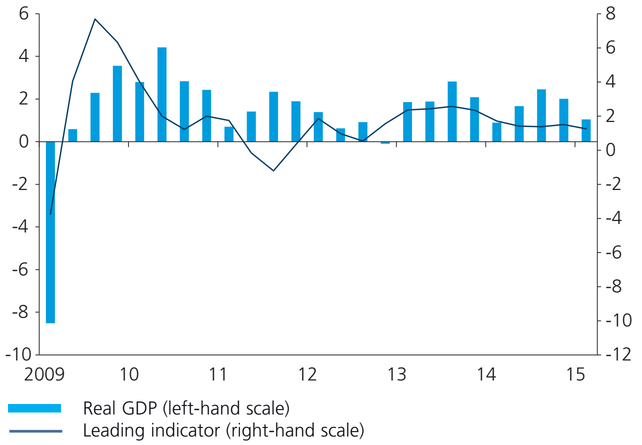
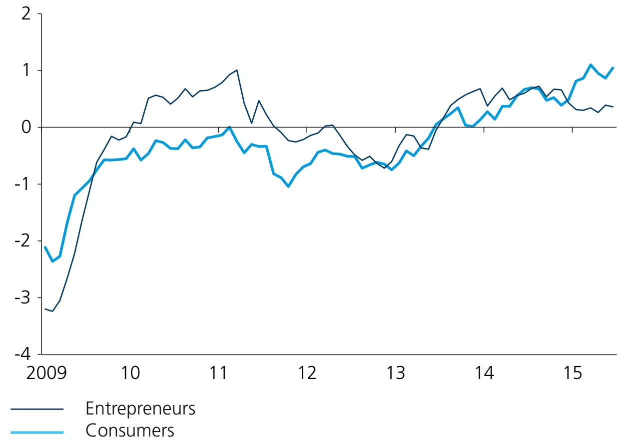
Economic activity in the OECD

(annualised quarterly change in %)



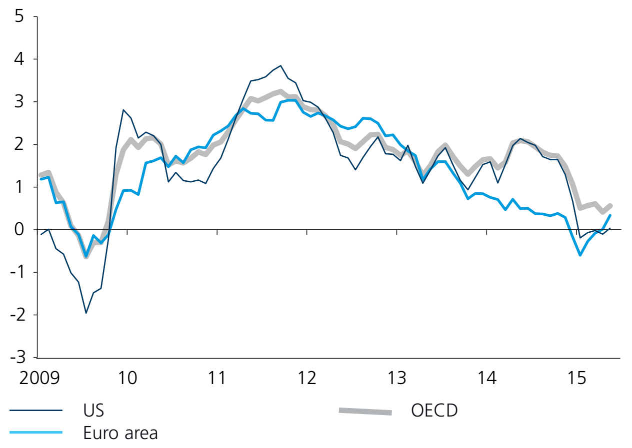
G4 confidence

(standard deviation from the long-term average)



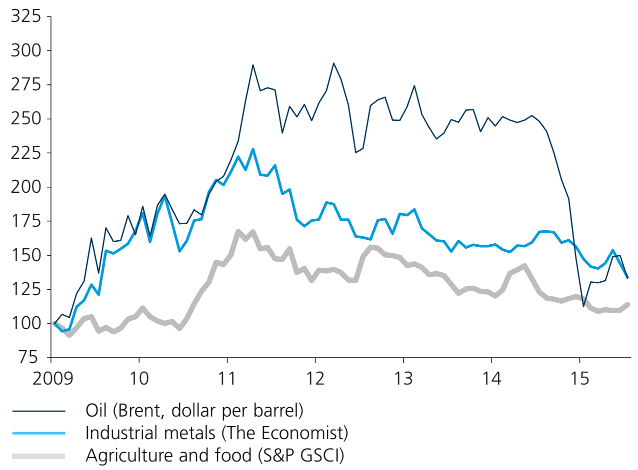
Inflation

(consumer price index, y-o-y change, in %)



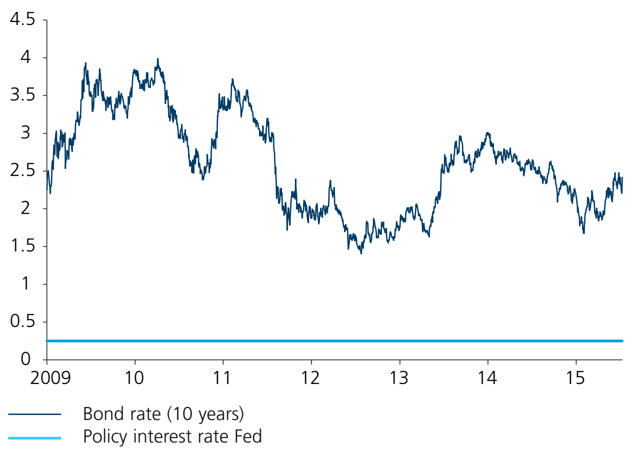
Commodity prices

(January 2009=100)



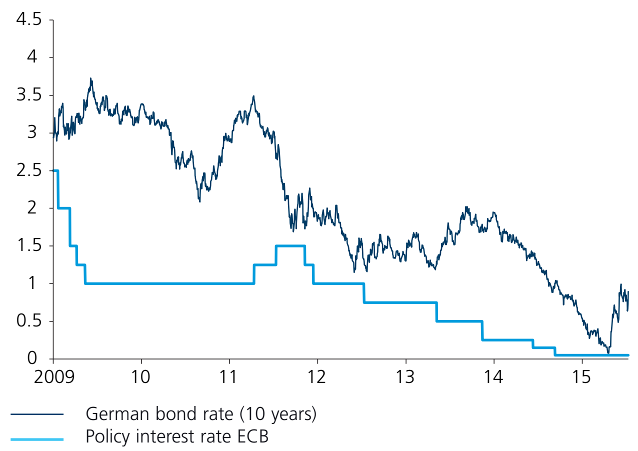
Interest rate movements US

(in %)



Interest rate movements euro area

(in %)



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	Real GDP growth		Inflation	
	2015	2016	2015	2016
US	2.3	2.8	0.4	2.7
Euro area	1.5	2.0	0.4	1.7
Belgium	1.4	1.7	0.5	1.5
Germany	1.8	2.1	0.2	1.8
Ireland	4.5	3.8	0.1	1.0
UK	2.7	2.4	0.5	1.6
Sweden	2.5	2.6	0.3	1.6
Norway	1.6	2.1	2.2	2.3
Switzerland	0.6	1.1	-1.0	0.0
Slovakia	3.0	3.2	0.0	1.3
Poland	3.6	3.9	-0.4	1.7
Czech Republic	2.8	2.6	0.4	1.6
Hungary	3.1	2.5	0.3	2.7
Bulgaria	1.7	2.0	-0.3	1.0
Russia	-3.0	0.5	13.0	7.3
Turkey	3.0	3.6	7.0	6.6
Japan	0.9	1.3	0.7	1.3
China	6.8	6.5	1.5	2.1
Australia	2.3	2.9	1.8	2.5
New Zealand	2.9	2.6	0.6	2.0
Canada	2.0	2.2	1.1	2.1

Policy rates

	17-07-2015	+3m	+6m	+12m
US	0.25	0.50	0.50	1.00
Euro area	0.05	0.05	0.05	0.05
UK	0.50	0.50	0.75	1.25
Sweden	-0.35	-0.35	-0.35	-0.35
Norway	1.00	1.00	1.00	1.00
Switzerland	-0.25	-0.25	-0.25	-0.25
Poland	1.50	1.50	1.50	1.75
Czech Republic	0.05	0.05	0.05	0.05
Hungary	1.50	1.50	1.75	2.00
Romania	1.75	1.75	1.75	1.75
Russia	11.50	11.00	10.50	10.00
Turkey	7.50	7.75	8.00	8.25
Japan	0.10	0.10	0.10	0.10
China	4.85	4.85	4.60	4.60
Australia	2.00	2.00	2.00	2.00
New Zealand	3.25	3.50	3.50	3.75
Canada	0.50	0.50	0.50	0.75

Exchange rates

	17-07-2015	+3m	+6m	+12m
USD per EUR	1.09	1.05	1.00	1.00
GBP per EUR	0.70	0.69	0.67	0.66
SEK per EUR	9.33	9.30	9.30	9.30
NOK per EUR	8.87	8.90	8.50	8.25
CHF per EUR	1.04	1.05	1.05	1.05
PLN per EUR	4.10	4.14	4.10	4.05
CZK per EUR	27.03	27.40	27.20	27.10
HUF per EUR	308.63	310.00	310.00	310.00
RON per EUR	4.42	4.42	4.42	4.42
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	61.81	56.70	54.00	54.00
TRY per EUR	2.88	2.94	2.90	3.00
JPY per EUR	134.94	130.20	125.00	125.00
RMB per USD	6.21	6.20	6.20	6.20
USD per AUD	0.74	0.74	0.72	0.70
USD per NZD	0.65	0.68	0.66	0.64
CAD per USD	1.30	1.25	1.28	1.31

10-year rates

	17-07-2015	+3m	+6m	+12m
US	2.34	2.40	2.75	2.85
Germany	0.81	0.90	1.00	1.25
Belgium	1.14	1.25	1.25	1.45
Ireland	1.44	1.55	1.55	1.65
UK	2.07	2.15	2.30	2.40
Sweden	0.82	1.00	1.10	1.35
Norway	1.64	1.70	1.80	2.05
Switzerland	0.07	0.20	0.30	0.55
Slovakia	1.23	1.20	1.20	1.45
Poland	2.93	3.30	3.40	3.70
Czech Republic	1.22	1.30	1.40	1.60
Hungary	3.77	3.70	3.60	3.75
Bulgaria	3.30	3.35	3.40	3.45
Russia	10.32	11.00	11.00	11.00
Turkey	9.09	9.80	10.35	10.65
Japan	0.43	0.50	0.55	0.60
China	3.55	3.30	3.10	3.10
Australia	2.93	3.10	3.45	3.55
New Zealand	3.49	3.90	4.25	4.40
Canada	1.55	1.90	2.25	2.35

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