


Economic Briefings

18 August 2015

UPDATE OUTLOOK GLOBAL ECONOMY
World economy sending mixed signals

The global economy currently presents a mixed picture. Although the US economy is at close to full employment and consumers are playing their traditional role as growth engine, growth in the euro area remains no more than moderate. In addition there continues to be a persistent growth divergence among the various euro countries. On the positive side, the third bailout package means that the potential risk of a Grexit has been averted for the time being. Among other factors the recent weakness of the Chinese economy led the central bank to liberalise its exchange rate policy, resulting in a further weakening of the renminbi. The contraction of real GDP in Japan in the second quarter also illustrates the current weakness of the Asian economies. A positive factor, on the other hand, was the fall in oil prices, due in particular to the agreement reached with Iran and the lifting of international trade sanctions to which this will give rise. Inflation expectations and bond rates came down worldwide as a result. For the western economies the lower oil price means a positive supply shock that will provide additional support for growth. The moderating effect this will have on headline inflation is, however, unlikely to prevent the Fed from taking a first step towards the normalisation of interest rates in September.

American consumers driving economic growth

The latest economic indicators paint a mixed picture of the world economy. On balance, however, they confirm our scenario of a gradual and continuing recovery. Although producer confidence in manufacturing industry fell slightly in the US in July, the monthly jobs report for that month confirmed that the dynamic of jobs creation remains unbroken. A net 215 000 jobs were added in July and the unemployment rate remained unchanged at 5.3%. While nominal wage increases may have remained very moderate, the low inflation has meant an increase in household purchasing power. This is illustrated by the fact that real GDP growth in the second quarter (+0.6% non-annualized) was on balance almost entirely attributable to the US consumer. Similarly the fact that net exports once again made a slight contribution to growth is an indication that the growth of the rest of the world economy was more robust than feared.

European growth if anything disillusioning

The latest round of indicators was mixed, with a net marginal fall in producer confidence in the euro area as a whole. Although the unemployment rate is still in a declining trend, it remained unchanged in July at 11.1% of the labour force.

Real GDP growth in the second quarter was not really poor (+0.3% in relation to the first quarter), but nevertheless disappointed. The most notable feature was the acceleration of growth in Germany (to +0.4%), driven by consumption and exports. The Italian economy (+0.2%) also confirmed that it had moved on from the stagnation that had lasted until the end of

2014. A positive outlier was Spain (+1.0%) which, together with Lithuania (+1.2%), was the strongest grower in the euro area. On the other hand the French economy disillusioned with zero growth. Admittedly this was due to a correction of the stock building in the first quarter, but the stagnation also underlines the structural challenges facing the French economy.

China liberalises currency policy

In China the latest confidence indicators underlined the current weakness of the growth dynamic. We should not however forget that in the second quarter the Chinese economy picked up to grow by 1.7% on the first quarter, after growth of 1.3% in the first quarter. Among other things the drop in consumer confidence in manufacturing industry and the weaker than expected growth of industrial production in July led the Chinese central bank to liberalise the daily reference rate for the renminbi against the US dollar. The bank indicated moreover that this rate would in future take account of the previous day's close, thereby bringing the exchange rate more closely into line with market forces.

Due to the weakening of the renminbi, the adjustment of the exchange rate policy not only provides support for Chinese exports but also serves a political objective, in that the Chinese government is hoping the renminbi will be included in the IMF's Special Drawing Rights currency basket. This would enhance the renminbi's prestige and its claim to a role as an international transaction currency. Given the relatively limited potential weight of the renminbi in the basket, its inclusion would be largely symbolic in nature. The composition of the basket is currently being updated, one of the criteria being that the exchange rate of candidate currencies must be determined in line with market forces and be freely usable. The higher volatility brought about by the central bank's decision goes some way towards meeting this requirement. The IMF will now need to decide whether the renminbi does effectively satisfy the criterion of a freely usable currency.

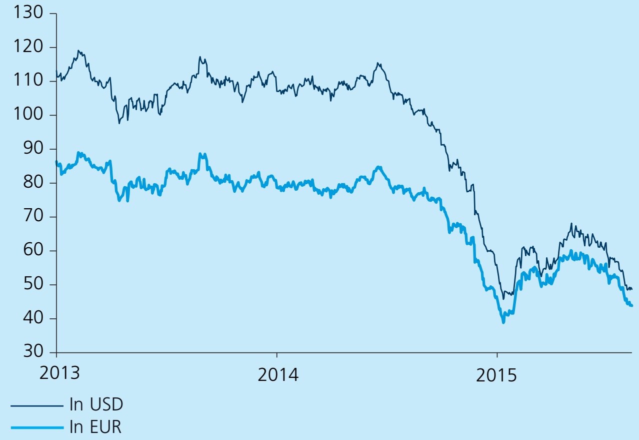
The adjustment of Chinese exchange-rate policy is also aimed at enabling the renminbi to be included in the IMF's Special Drawing Rights currency basket.

Commodity exporters under pressure

In the meantime a number of other emerging economies are coming under increasing pressure. Among other things this is related to the imminent turning point for the Fed's interest-rate policy. In particular, the low energy and commodity prices are working against commodity-exporting countries such as Brazil and Russia. The much stronger than expected contraction of Russian real GDP in the second quarter provides a clear illustration of the deep recession into which the Russian economy has slipped.

Graph 1 - New downward oil price shock

(price per barrel of Brent crude)

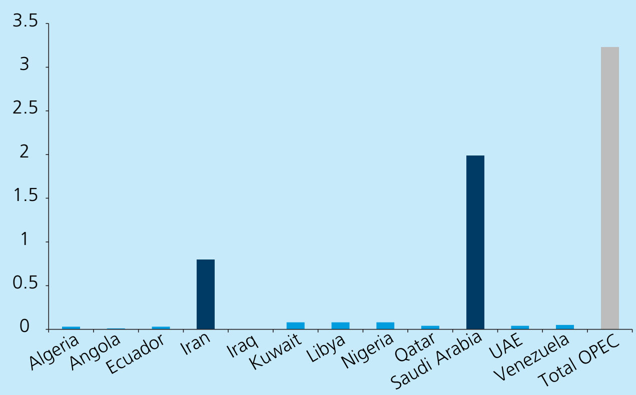


New downward oil shock

During the past month the oil price continued its recent downward trend to just below 50 USD per barrel of Brent crude (graph 1).The most important cause was the robust ongoing growth of global oil production. In particular the Iran nuclear deal reached in mid-July creates the prospect of the lifting of trade sanctions and a full resumption of Iranian oil exports. According to the most recent data of the International Energy Agency (IEA) virtually all OPEC countries are currently producing at full capacity, with the exception of Saudi Arabia and Iran. According to the IEA, Iran could increase its oil production on a lasting basis by 800 000 barrels a day within a period of 90 days, even with its obsolete technology (graph 2). It may well have been the prospect of this extra supply, in combination with the previ-

Graph 2 - Spare capacity* versus production in June 2015

(millions of barrels per day)



* Capacity levels that can be reached within 90 days and sustained for an extended period
Source : International Energy Agency (IEA), Oil Market Report, July 2015

ously accumulated Iranian oil stocks, that exerted downward pressure on oil prices in recent weeks.

If the trade sanctions against Iran are effectively lifted and the oil infrastructure can be modernised with the aid of imported technology, the production capacity as estimated by the IEA could be increased still further. That would mean that the oil price would be subject to downside risk in the medium term as well. On the other hand if the oil price falls too low, a number of sources (such as shale oil) would become unprofitable and would cease production until prices rise again (what is known as the 'cobweb'). On balance we are therefore assuming that the upside potential for the oil price is very limited and that it will fluctuate over the next few years within a fairly narrow band around the present level.

Lower oil price dampens inflation forecasts and weighs on bond rates

Over the past month the lower oil price also led to a worldwide decline in headline inflation. Notably, this applied not just to short-term forecasts but also to those for the longer term (graph 3). As a result leading 10-year bond rates also fell, despite the growing expectation of an imminent increase in interest rates by the Fed (graph 4). The duration of the downward pressure on bond rates will depend in the first place on the evolution of oil prices and the impact this has on inflation forecasts. Secondly it is uncertain how the bond markets will respond to an initial US interest-rate hike – something which they are almost certainly not taking into sufficient account at the present time.

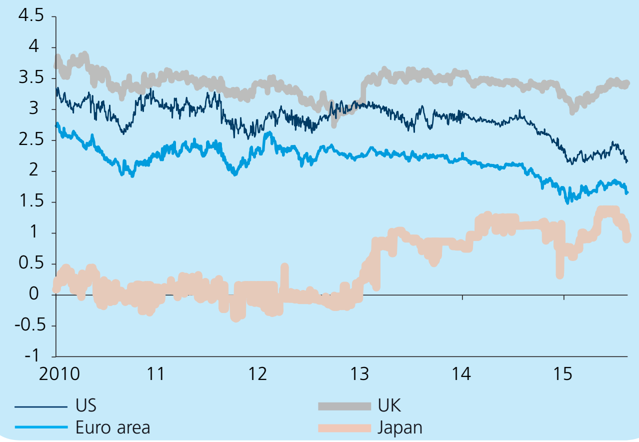
Iran could increase its oil production by 800 000 barrels a day within a period of 90 days, even with its obsolete technology.

US interest-rate policy on eve of a turnaround

Despite the low headline inflation the US Federal Reserve will in all probability take an initial step towards the normalisation of its policy rate in September. Following the termination of quantitative easing and the associated forward guidance, the reversal of the zero-interest-rate policy itself is now at hand, as the latest policy meeting suggests that the two conditions formulated by the Fed in this regard have been fulfilled. In the first place the US central bank wants to be reasonably certain that headline inflation will be reverting over the medium term to the Fed's inflation target of 2%. In the same press statement the Fed however confirmed that this condition has already been satisfied. The Fed's second condition for increasing interest rates was a further improvement of the US labour market. As noted previously, according to the labour market report for July 215 000 new jobs were created and the unemployment rate remained stable at 5.3%, just above the level regarded by the Fed as corresponding with full employment. Unless the labour market report for August provides evidence of a dramatic deterioration, we may also reasonably assume that this second condition of the Fed has been satisfied and that nothing now stands in the way of an initial interest rate hike in September.

Graph 3 - Inflation forecasts coming down because of lower energy prices

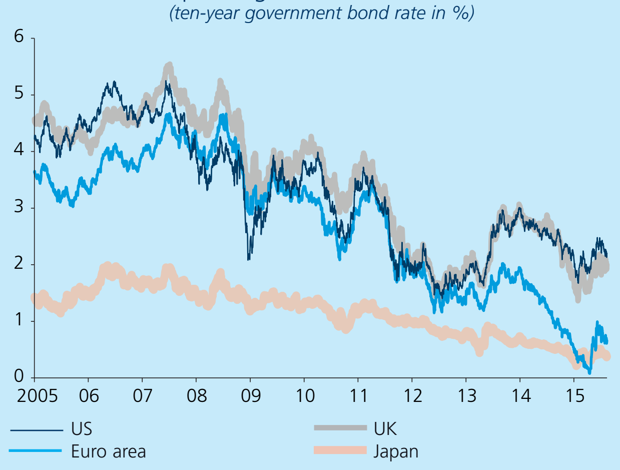
(average annual inflation for the five-year period, starting in five years' time, in %)



According to Federal Reserve Chair Janet Yellen the timing of an initial hike and the further course of interest rates are mutually independent. The timing and the order of magnitude of further interest rate steps will depend on the further development of the economic data, such as wage inflation, as well as reaction in the financial markets. At this point even an initial interest rate increase in September has not yet been fully factored in by the bond markets. An effective interest rate hike could consequently lead to greater volatility in global bond markets. The all-in-all moderate inflation environment gives the Fed room to adopt more of a wait-and-see stance after September than in earlier tightening cycles.

Graph 4 - Lower inflation forecasts are also pushing down bond rates

(ten-year government bond rate in %)



Grexit risk defused

Over the past month a solution averting a potential existential threat to the euro area, or Grexit, has emerged. In the absence of additional external financial aid Greece would have been unable to meet its obligations towards the ECB in July. In all probability this would have forced Greece out of the euro.

Bridging finance from the European Financial Stabilisation Mechanism (EFSM) bought time for further negotiations, ultimately leading to an agreement on a third bailout package for Greece. This will run for three years and be worth 86 billion EUR. Since this financial aid will be primarily used for the repayment of existing debts, which Greece is in no position to reduce to sustainable levels under its own steam, a final solution to the Greek debt problem will ultimately be unable to get around debt restructuring. This could take the form of the further extension of repayment periods and a reduction in interest charges; at this stage Europe is not politically ready for explicit debt forgiveness.

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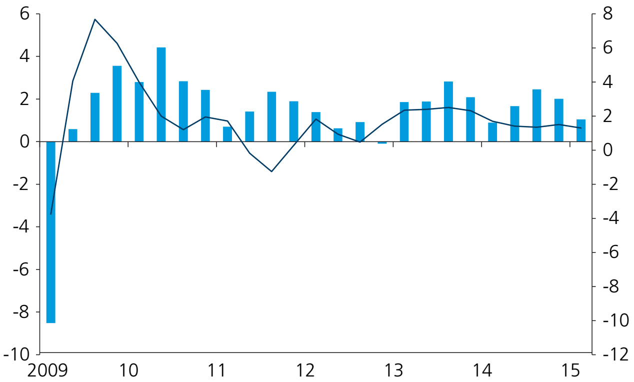
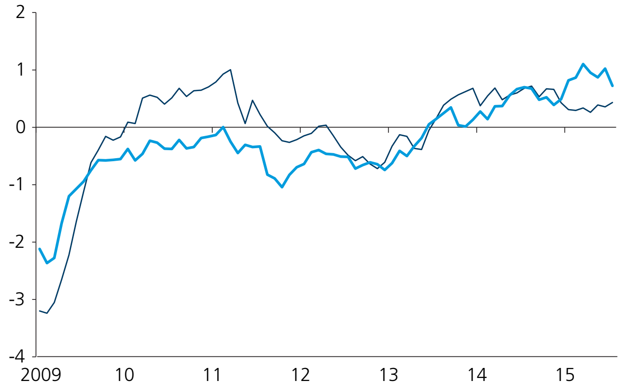
Economic activity in the OECD
(annualised quarterly change in %)



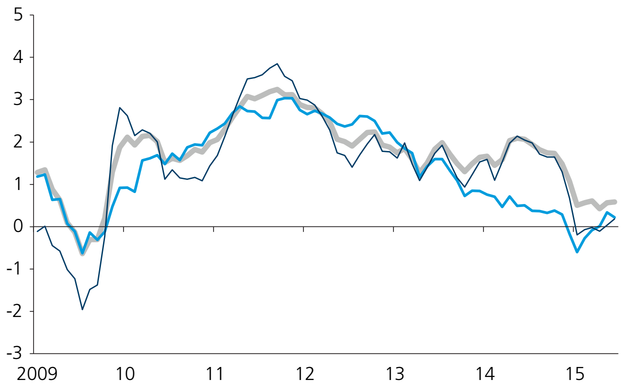
Real GDP (left-hand scale)
Leading indicator (right-hand scale)

G4 confidence
(standard deviation from the long-term average)



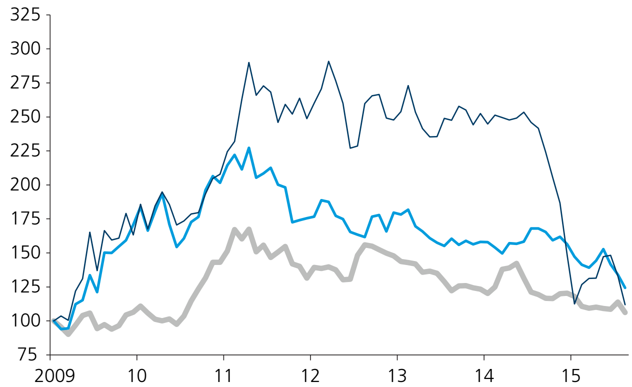
Entrepreneurs
Consumers

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



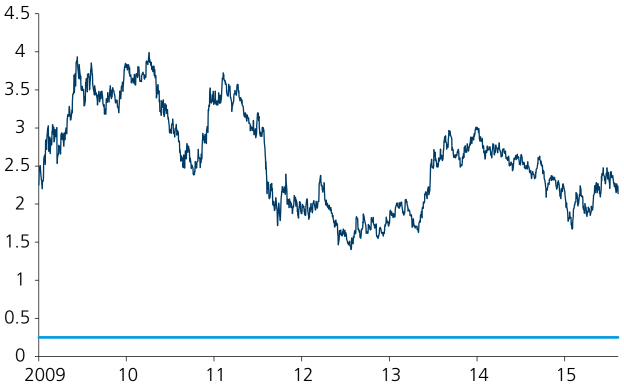
US
Euro area
OECD

Commodity prices
(January 2009=100)



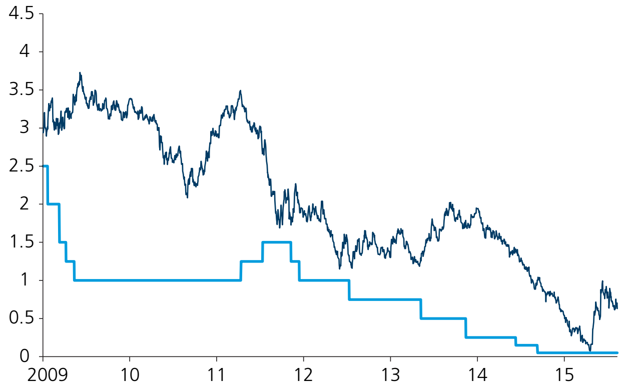
Oil (Brent, dollar per barrel)
Industrial metals (The Economist)
Agriculture and food (S&P GSCI)

Interest rate movements US
(in %)



Bond rate (10 years)
Policy interest rate Fed

Interest rate movements euro area
(in %)



German bond rate (10 years)
Policy interest rate ECB

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Economic Briefings Tables

	Real GDP growth		Inflation	
	2015	2016	2015	2016
US	2.3	2.8	0.3	2.5
Euro area	1.6	1.9	0.3	1.7
Belgium	1.4	1.7	0.4	1.4
Germany	1.8	2.1	0.2	1.8
Ireland	5.0	4.2	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	4.0	2.5	0.4	1.6
Hungary	3.1	2.5	0.5	2.8
Bulgaria	1.7	2.0	-0.3	1.0
Russia	-3.5	0.5	15.0	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

	17-08-2015	+3m	+6m	+12m
US	0.25	0.50	0.75	1.00
Euro area	0.05	0.05	0.05	0.05
UK	0.50	0.50	0.75	1.00
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	1.35	1.35	1.50	1.75
Romania	1.75	1.75	1.75	1.75
Russia	11.00	10.00	9.00	9.00
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	3.00	2.75	2.75	2.75
Canada	0.50	0.50	0.50	0.75

Exchange rates

	17-08-2015	+3m	+6m	+12m
USD per EUR	1.11	1.05	1.00	1.00
GBP per EUR	0.71	0.69	0.67	0.66
SEK per EUR	9.44	9.50	9.40	9.20
NOK per EUR	9.14	9.00	8.75	8.50
CHF per EUR	1.08	1.10	1.10	1.10
PLN per EUR	4.17	4.12	4.07	4.03
CZK per EUR	27.01	27.10	27.10	27.00
HUF per EUR	309.61	310.00	308.00	305.00
RON per EUR	4.43	4.43	4.43	4.43
BGN per EUR	1.96	1.96	1.96	1.96
RUB per EUR	72.64	70.35	70.00	70.00
TRY per EUR	3.17	3.05	3.00	3.10
JPY per EUR	138.09	130.20	125.00	125.00
RMB per USD	6.39	6.40	6.40	6.40
USD per AUD	0.74	0.72	0.71	0.70
USD per NZD	0.66	0.65	0.64	0.63
CAD per USD	1.31	1.32	1.33	1.34

10-year rates

	17-08-2015	+3m	+6m	+12m
US	2.16	2.50	2.80	2.85
Germany	0.64	0.90	1.00	1.25
Belgium	0.98	1.20	1.25	1.45
Ireland	1.25	1.55	1.60	1.85
UK	1.83	2.15	2.30	2.40
Sweden	0.67	0.90	1.00	1.25
Norway	1.45	1.75	1.85	2.10
Switzerland	-0.19	0.10	0.20	0.45
Slovakia	0.97	1.15	1.20	1.45
Poland	2.78	3.30	3.40	3.70
Czech Republic	0.90	1.00	1.10	1.35
Hungary	3.56	3.70	3.60	3.75
Bulgaria	3.30	3.35	3.40	3.45
Russia	11.16	12.00	12.00	12.00
Turkey	9.70	9.80	10.35	10.65
Japan	0.39	0.50	0.55	0.60
China	3.54	3.30	3.10	3.10
Australia	2.75	3.10	3.40	3.45
New Zealand	3.36	3.90	4.20	4.25
Canada	1.37	1.90	2.20	2.25

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