FORECAST

Forecast: Upswing in the global economy

International economy | 11.10.2017

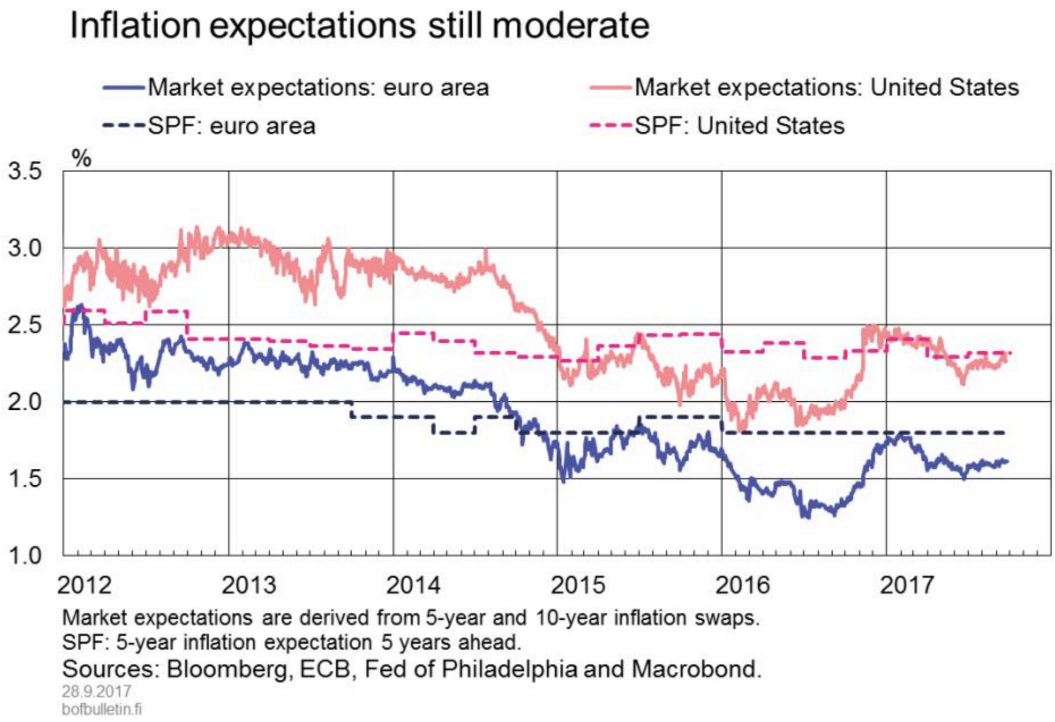
Global economic growth is broadly based and brisk in 2017. The Bank of Finland foresees global growth strengthening to 3.5% in 2017 and continuing at well over 3% throughout 2018–2019. World trade is experiencing a surge. Global inflation is, however, still subdued. Economic growth in the United States and the EU22 will continue, and Chinese growth will decelerate later than previously expected. Towards the end of the forecast horizon 2017–2019, the growth pattern of the global economy will dampen slightly. Despite the decrease in risks to growth, growth may be slower than forecast.

Euro has strengthened

In early 2017, there were still strong expectations in the US of stimulus measures, but these have now faded. This, together with the upcoming UK departure from the EU, has been reflected in exchange rates. Sterling depreciated already at the time of the Brexit referendum, whereas the US dollar began to weaken in spring 2017. The outlook for economic growth in the euro area has strengthened and political uncertainty has decreased, which is reflected in appreciation of the euro.

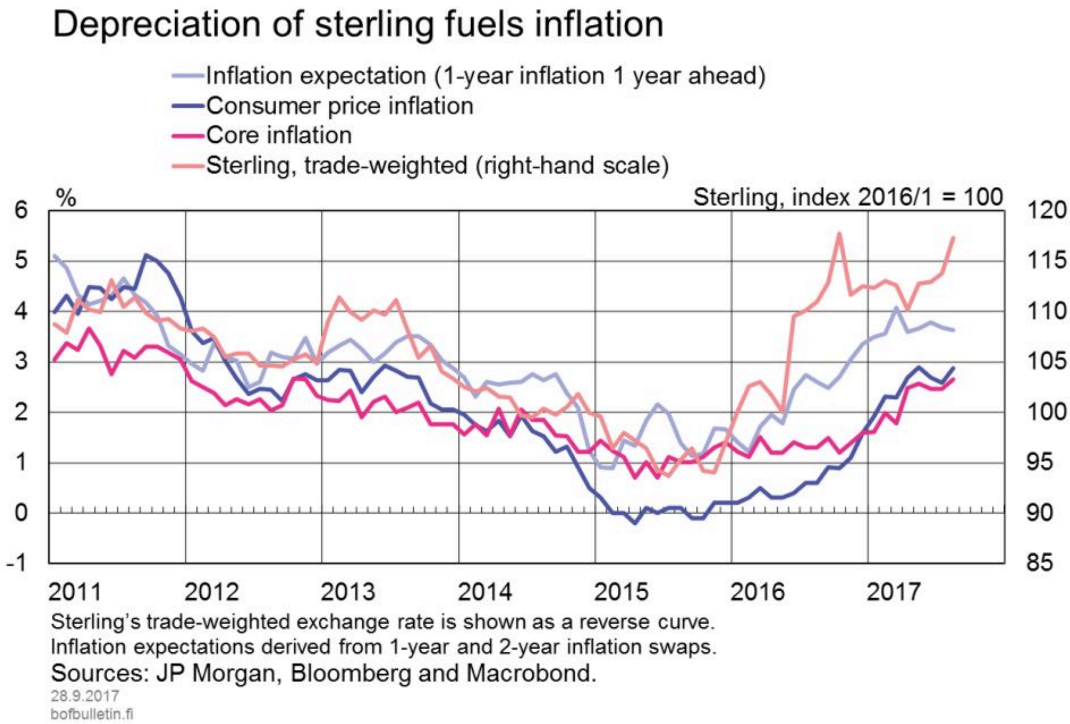
Real exchange rates (Chart 1) take account of the nominal exchange rate and price developments. If a strengthening of the nominal exchange rate is accompanied by slower inflation relative to global developments, the real exchange rate –one of the measures of cost-competitiveness – may remain unchanged. In the short term, changes in real exchange rates reflect mainly movements in nominal exchange rates, because typically the inflation rate does not react as rapidly as exchange rates.

Chart 1.



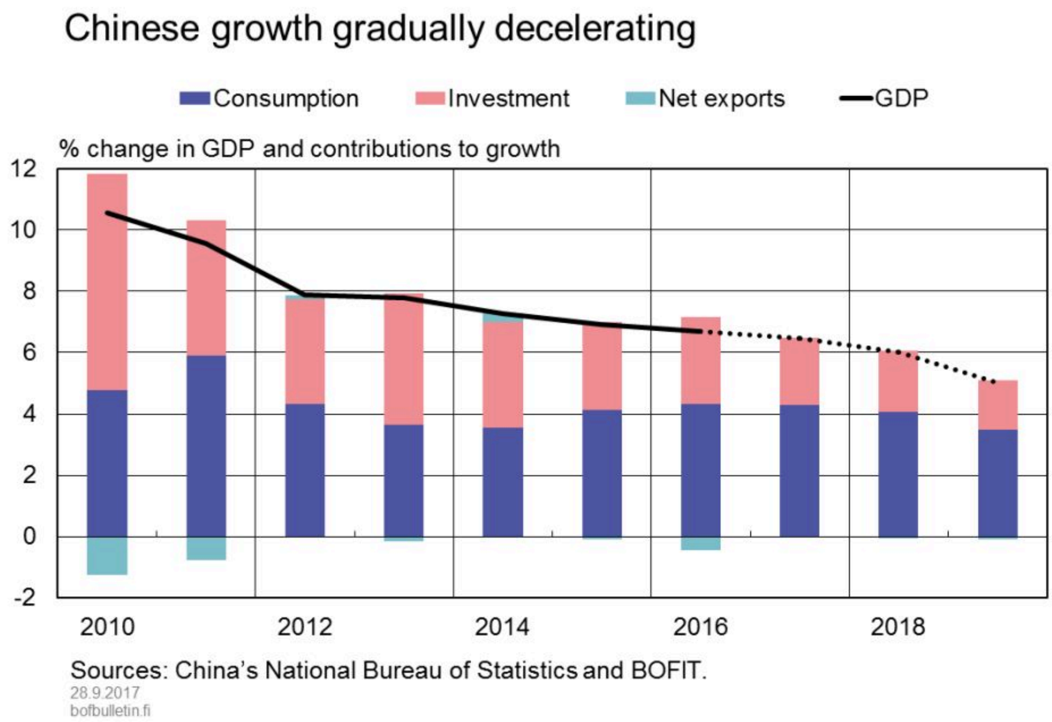
Expectations of US growth have moderated recently. This has slightly lowered long-term government bond yields and dampened inflation expectations that had strengthened at the turn of the year. Euro area inflation expectations, too, dampened in the early part of 2017, but they are nevertheless clearly stronger than in summer 2016 (Chart 2). (For a more detailed discussion on euro area financing conditions, see monetary policy article: 'Growth picking up but inflation remains subdued').

Chart 2.



The world market price of oil declined slightly in spring 2017, but has since returned to the level witnessed earlier in the spring, i.e. around USD 55 per barrel, where it is expected to remain in the immediate years ahead based on futures prices. Due to the moderation in expectations of US growth and the difficulties of oil producing countries in reaching an agreement on output restrictions, the fluctuations in oil prices have remained small. There was a general slight decline in commodity prices in the early part of the year, but prices have remained fairly stable recently (Chart 3).

Chart 3.



Growth stronger than anticipated, inflation expected to pick up

The Bank of Finland foresees world growth strengthening to 3.5% in 2017 and continuing at well over 3% throughout 2018–2019. Global trade growth is expected to accelerate markedly, to around 5%, following subdued dynamics in 2016. This growth spurt reflects the pick-up in trade in Latin America, China and other emerging Asian economies. Towards the end of the forecast period 2017–2019, the pace of growth will, however, dampen, approaching the level of global GDP growth, on the upside of 3%. Inflation is still subdued worldwide, and in many advanced economies there are expectations of an acceleration in inflation, supported by robust growth and relaxed monetary policy (tables 1 and 2).

US growth is expected to pick up, to slightly over 2%, following the dip in 2016, and to continue at a steady pace throughout the forecast horizon. The expectations in early 2017 of stimulus measures by the new US administration have faded. The favourable trend has, however, been sustained by continued strong corporate and household confidence. Inflation slowed slightly in the early part of 2017, but it is nevertheless expected to rise, to slightly over 2% as the economy continues to grow at a steady pace and the unemployment rate has fallen to the pre-crisis level.

Economic growth in EU22 (euro area, United Kingdom, Sweden and Denmark) will also accelerate in 2017, to over 2%. In the forecast period 2017–2019, the strongest phase of the cyclical upswing in the euro area will moderate slightly and the effects of Brexit will slow UK growth. Despite stable growth in the EU22 throughout the forecast horizon, inflation will not pick up significantly and will persist below 2%.

The ongoing rapid growth in the Chinese economy is still expected to decelerate, albeit slightly later than previously expected, to 6% in 2018 and 5% in 2019. Chinese growth has decelerated gradually during the current decade. This is a natural evolution for China as structural factors put a brake on growth. China is already the world's largest economy, the working-age population is shrinking, the composition of growth is shifting towards consumption, and the easiest productivity-enhancing reforms have already been made.

The Japanese economy has posted growth figures for six consecutive quarters already. After 2017, Japanese growth will, however, decelerate slightly, with the consumption tax increase in 2019 slowing growth towards the end of the forecast horizon. Inflation will remain subdued, with the exception of 2019, when the consumption tax increase will fuel inflation.

Russian GDP continues to rise by 1.5% in 2017–2019, as economic growth is already approaching its potential and the price of oil is expected to remain close to its current level throughout the forecast horizon.

Overall, the global economy is currently experiencing a strong cyclical recovery. Subdued potential growth in advanced economies and structural changes in China will, however, depress global growth slightly in 2019.

Table 1.

Changes in GDP and world trade

% change on the previous year (previous forecast below)

GDP	2016	2017f	2018f	2019f
United States	1.5	2.1	2.2	2.0
		(2.4)	(2.2)	(2.2)
EU22	1.8	2.1	1.8	1.6
		(1.8)	(1.7)	(1.6)

Changes in GDP and world trade				
Japan	1.0	1.5	0.9	0.7
		(1.1)	(0.8)	(0.7)
China	6.7	6.5	6	5
		(6)	(5)	(5)
Russia	-0.2	1.5	1.5	1.5
		(1.5)	(1.5)	(1.5)
World*	3.1	3.5	3.4	3.2
		(3.4)	(3.3)	(3.3)
World trade*	1.9	4.8	3.9	3.6
		(3.4)	(3.6)	(3.5)
f = forecast.				
EU22 = euro area, Sweden, Denmark and United Kingdom.				
* = Changes in country weights.				
Source: Bank of Finland.				

Table 2.

Inflation in key economies				
% change on previous year (previous forecast below)				
	2016	**2017[f]**	**2018[f]**	**2019[f]**
United States	1.3	2.2	2.2	2.2
		(2.5)	(2.5)	(2.4)
EU22	0.3	1.7	1.5	1.7
		(1.9)	(1.6)	(1.7)

Inflation in key economies				
Japan	–0.1	0.4	0.8	1.4
		(0.5)	(0.7)	(1.3)
f = forecast.				
EU22 = euro area, Sweden, Denmark and United Kingdom.				
Sources: National statistical authorities and calculations by the Bank of Finland.				

Steady growth in EU22; inflation still below 2%

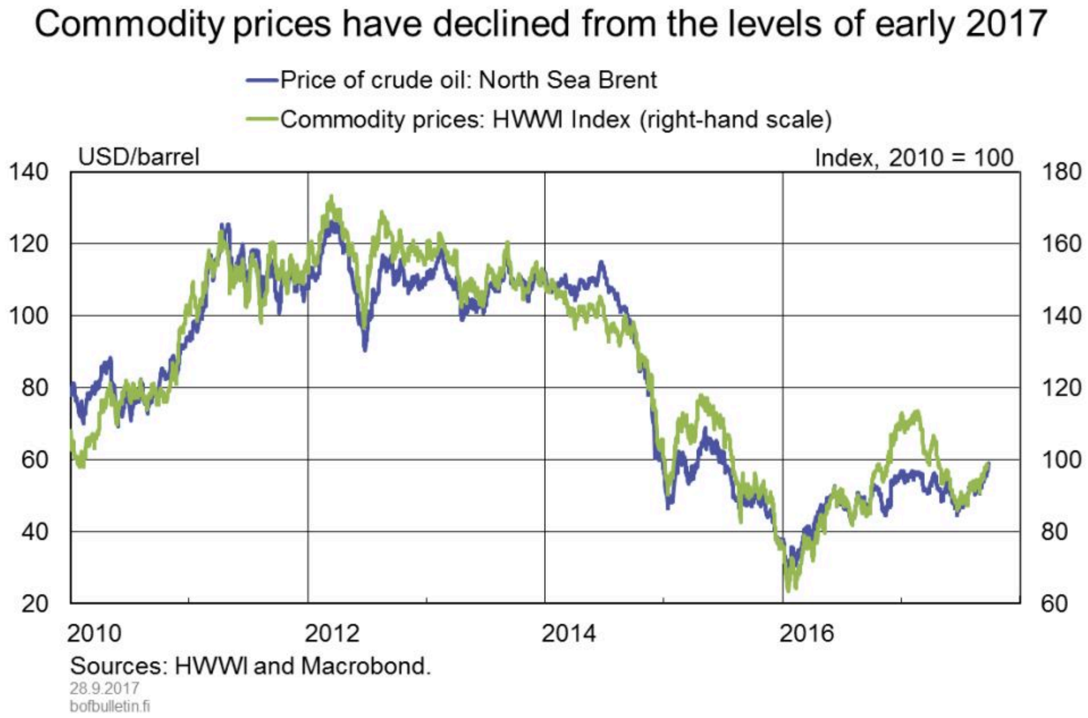
Economic growth in the EU22 (euro area, United Kingdom, Sweden and Denmark) will be fuelled in 2017 particularly by robust growth in the euro area. Thereafter, EU22 growth will dampen slightly, approaching the longer-term rate of growth. The expansion of the euro area economy is largely based on growth in domestic demand. Fiscal policy is neutral and the contribution of net exports to growth will be only moderately positive. Relaxed monetary policy and stable global economic growth will continue to support euro area growth. (Euro area monetary policy and the condition of the economy are discussed more closely here.)

Sterling depreciated by over 10% following the referendum[1] on the UK departure from the EU, which has fuelled inflation to nearly 3%, i.e. over the Bank of England's target of 2%. The pick-up in inflation will dampen growth in real incomes and thus consumption. The weakening of the exchange rate has not boosted exports as expected. In the first half of 2017, economic growth decelerated significantly. GDP growth is however expected to remain steady in the immediate years ahead.

In Sweden and Denmark, economic growth will be brisk in 2017, following robust growth in the early part of the year, but it is expected to slow slightly. In Sweden, growth will be broadly-based, private consumption and investment will pick up, exports have developed favourably and industrial output will expand. Household debt accumulation and a possible correction in housing prices remain the most significant risks to strong economic growth. In Denmark, the favourable trend in real incomes has boosted private consumption and retail trade. Exports, too have improved significantly.

EU22 inflation will accelerate partly due to temporary factors, such as the price of oil, to 1.7% in 2017, but will slow temporarily in 2018. In 2019, EU22 inflation will accelerate again, to 1.7%. Even though the depreciation of sterling will contribute to higher inflation in the EU22, the pace of inflation will remain below 2% until the end of the forecast period (Chart 4). Despite robust growth, thus far there are no signs of a significant pick-up in wage inflation. Financial market inflation expectations have also remained moderate.

Chart 4.



US economy will continue to expand, despite the uncertain course of economic policy

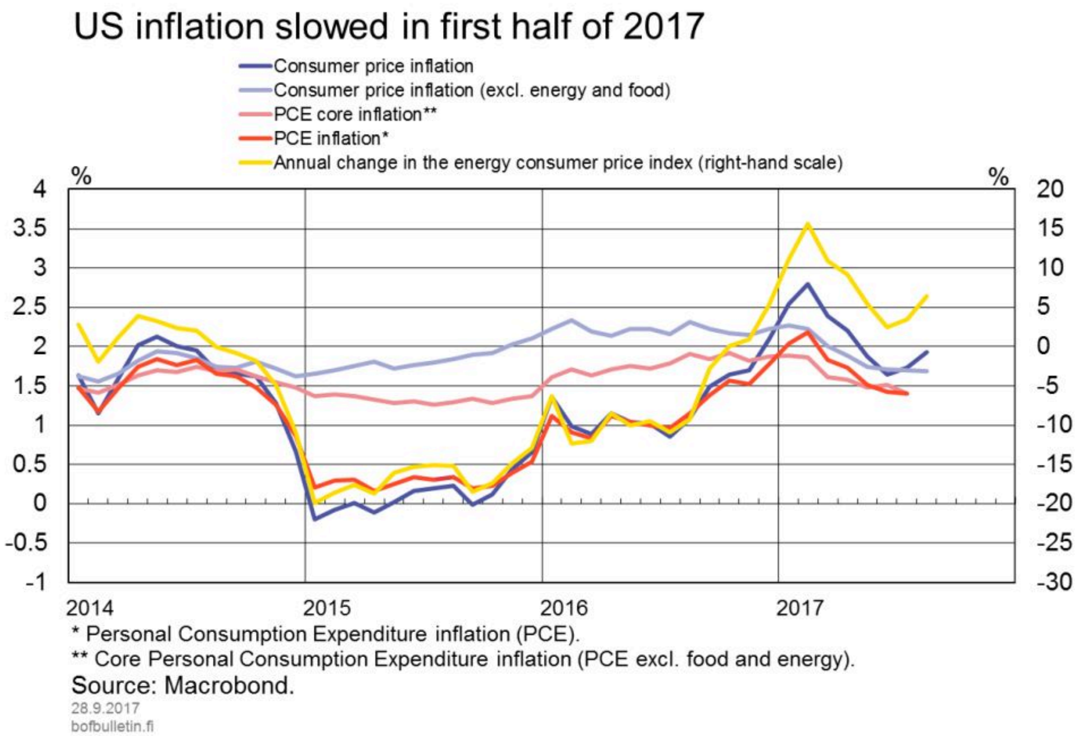
In the United States, the economic climate was filled with high expectations in the first stages of the new administration, but in recent months there have been signs of disappointment in the slow pace of reform. Despite the ongoing strength in corporate confidence and stock markets, the increase in political uncertainty has been reflected in a depreciation of the dollar.

The Bank of Finland forecast does not take account of possible fiscal stimulus measures by the new US administration, as no decisions have been taken on such measures. Fairly sluggish growth in the first quarter of 2017 depresses the growth forecast for 2017. US GDP will continue to grow at a steady rate of over 2% during the forecast period. Growth will be sustained particularly by private consumption. The contribution of net exports to growth will remain negative throughout the forecast period 2017–2019. In recent years, US potential growth has decelerated, possibly due to mainly demographic factors and weak productivity growth. Towards the end of the forecast period, actual growth will slow and approach its potential rate.

In the past couple of years, wages have risen by over 2.5% per annum, measured by average hourly earnings. Wage inflation has been dampened by the fact that, as the employment situation has improved, many of those who have returned to the labour market have been forced to start with lower hourly wages. The Federal Reserve Bank of Atlanta has developed the Wage Growth Tracker, a measure in which wages data is adjusted for changes on the labour market. According to this measure, the wages of persons who have maintained their position on the labour market have, in fact, increased at a higher pace than average hourly wages, on average 3.3% per annum.

US inflation has slowed significantly since the early part of the year, to well below 2% (Chart 5). Energy price fluctuations cause volatility in total inflation. However, core inflation (excl. energy and food prices) has also slowed after remaining clearly above 2% in 2016.[2] This is due to, for example, a decline in the prices of many imported goods and the slow rate of change in service prices. The subdued pace of inflation is, however, expected to be only a temporary phenomenon, and inflation is anticipated to remain at over 2% in the immediate years ahead. The expected pick-up in inflation and favourable developments on the labour market provide the US Federal Reserve leeway to continue with the interest rate rises begun in December 2015 and to dismantle its unconventional monetary policies (See 'US Federal Reserve normalising its monetary policy stance').

Chart 5.



Stability a top priority in Chinese economic policy; slow progress in reforms

The Chinese economy has recently been dominated by political issues. Even though structural factors – such as contraction in the labour force and the structural shift in the economy – from investment-driven growth towards a more consumption- and services-driven growth – are gradually slowing the natural rate of growth in the Chinese economy, China has kept to its target of doubling real GDP from 2010 to 2020. To achieve this, it has supported economic growth with expansionary policies. China's indebtedness has soared, and the rapid growth of debt has also continued in 2017.

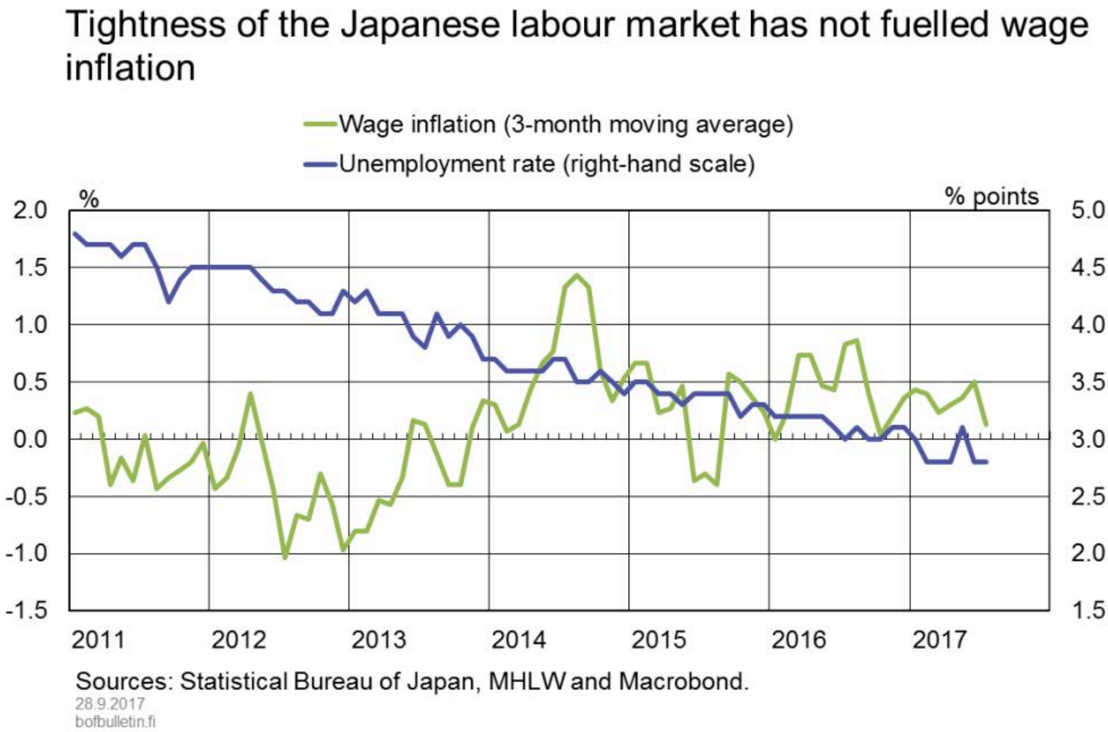
In October 2017, China will hold the National Congress of the Communist Party, in which new members of the Party's leadership organs will be selected. The power game, taking place mainly behind the scenes, has been reflected in economic policy so that excessive striving for stability has become a top priority of economic policy, and not much progress has been achieved in reforms. Economic policy has also been tightened somewhat in the name of stability, for example by introducing stronger capital controls.

China’s official GDP figures have shown exceptionally stable 6.5–7% growth for a couple of years now, in line with its long-term growth target. The uncertainty surrounding the official growth figures has, however, increased. At the start of the current year, officials revealed a massive statistical fraud in Liaoning province. In June, officials announced that they were also looking into suspected instances of statistics manipulation in two more provinces. These cases reflect the fact that the success of provincial leaders is assessed particularly based on their ability to reach the growth targets.

China's economic growth has decelerated gradually during the current decade (Chart 6). Growth is expected to slow also in the years ahead (GDP growth will be 6.5% this year, 6% in 2018 and 5% in 2019). Slowing economic growth is a natural evolution for China as structural factors put a brake on growth. Firstly, China is already the world's largest economy, and size in itself places a restriction on growth. Secondly, the Chinese population is ageing rapidly and the cohort of working-age persons is already shrinking. Thirdly, the economy's structure is changing. As a result of this change, investment growth will slow and correspondingly, the importance of domestic consumption demand and services will increase. In addition, there are signs of a decline in productivity growth as the easiest productivity-enhancing reforms have already been made. Moreover, there is little evidence to suggest any significant productivity leap during the forecast period 2017–2019. China’s environmental problems are also hindering growth.

Net exports make only a minor contribution to GDP growth, but for global trade it is of interest that China's foreign trade has grown at a much higher pace than expected. The volumes of goods imports and exports are up by roughly 10% year-on-year in 2017. Growth has been broadly based, by both country and product category. In addition to the slight recovery in the global economy, exports have been supported by the 10% depreciation in the yuan’s real effective trade-weighted exchange rate in the past year or so. In recent months, the yuan has, however, strengthened again. The rapid export growth, in turn, has encouraged a recovery in imports, as a third of exports are based on finishing or assembly of imported goods.

Chart 6.



According to the official figures, Chinese inflation has remained stable, at around 2%. In contrast, there have been swings in asset prices. The 2015 stock market bubble was followed by a rapid rise in housing prices. Official figures show housing prices still continuing to climb on average, even if the price explosion has ebbed in some of China's major metropolises.

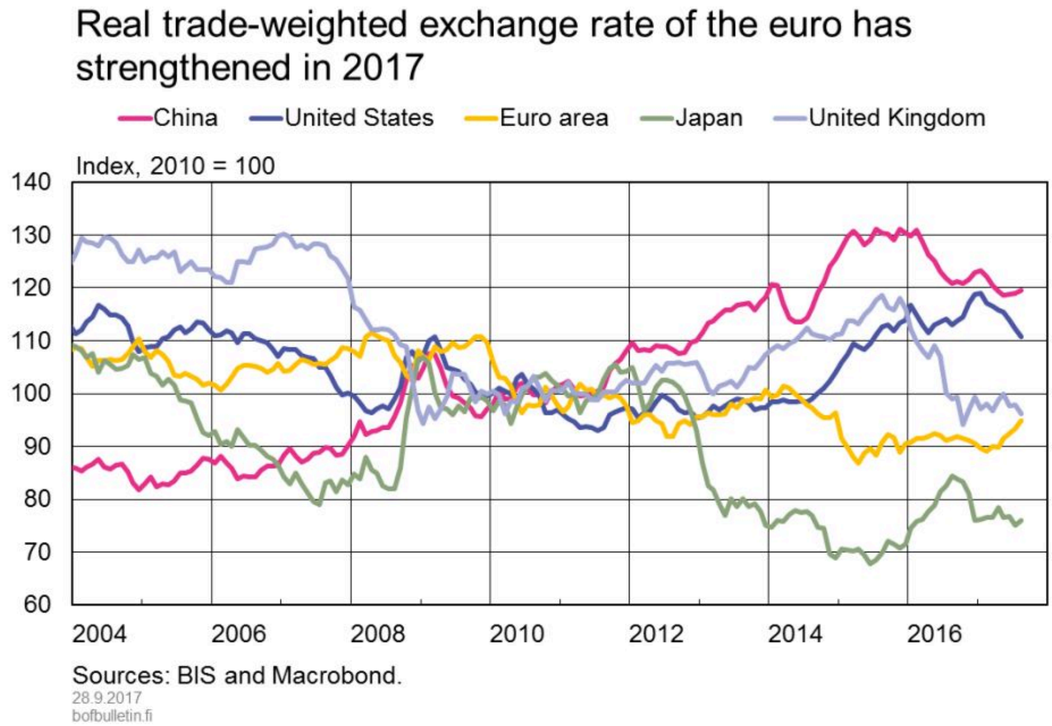
The accuracy of the Bank of Finland forecast for the Chinese economy is subject to a number of factors. China may continue to push GDP growth to the 2020 target, which would lead to higher-than-expected growth rates, but, at the same time, to even more unsustainable economic policy and growing distortions in the economy. This would fuel the build-up of debt, possibly at an accelerating pace, which in turn would increase the likelihood of a financial crisis and the possibility of China's economy slowing faster than expected. The possibility of a financial market crisis cannot be ruled out. In 2017, the top Chinese leadership has stressed the importance of mitigating the financial market risk. Risk mitigation would be advisable to ensure sustainable growth, but thus far the efforts have been modest. The National Congress of the Communist Party in October could be a turning point for Chinese economic policy. On the other hand, recent strong measures, aimed at, for example, increasing censorship and strengthening the power of the party, undermine trust in real market reforms.

Positive short-term outlook for the Japanese economy

In Japan, the economic sentiment is currently positive, with already six consecutive quarters of growth. Growth is based mainly on exports, which have been supported by the weakening of the yen since mid-2016. Growth has been bolstered also by expansionary fiscal policies. Now, however, domestic demand has also picked up, and private consumption and investment have been growing. The fundamentals for the continuation of growth are, nevertheless, not strong, as the Japanese Government cannot continue its expansionary fiscal policies for much longer, due to the high level of public sector debt.

The key bottleneck for Japanese growth is a lack of labour, caused by population ageing. The size of the working-age population is shrinking, and there is no labour available to replace it. There are 1.5 vacancies to every jobseeker. Pay increases have nevertheless remained very cautious, which weakens the growth potential of private consumption and thus also reduces companies' willingness to invest in the domestic economy (Chart 7).

Chart 7.



The Japanese economy is expanding at a rate higher than its potential. In the medium term, therefore, Japanese growth will slow to just under 1%, the country's estimated potential output growth. In an environment of shrinking population, even moderate economic growth is, however, sufficient for maintaining welfare, and Japan's per capita GDP growth has indeed been stable. In the longer term, the completion of structural reform is key to the achievement of sustainable growth and to turning the high indebtedness onto a downward trajectory.

Despite economic expansion and strong monetary policy stimulus, inflation is still slow. Subdued wage inflation and the forecast slowing of economic growth will dampen the rise in consumer prices in the forecast period, and inflation will remain just under 1%. Towards the end of the forecast period, inflation will be fuelled by the consumption tax increase planned for late 2019, but inflation will still remain under the central bank's target of 2%. The Bank of Japan has announced that it will continue with quantitative and qualitative monetary easing until inflation is above the target.

Russian economy recovering gradually

The Russian economy has turned to growth in 2017, as expected. Both domestic and export demand have recovered slightly faster than expected in the current year, but they have to a large extent supported an import rebound. As a result, Russian GDP rose in January–June at a modest pace of 1.5% per annum (Chart 8). Russian GDP is expected to continue to rise by 1.5% in 2017–2019, as economic growth is already approaching its potential and the price of oil is expected to remain close to its current level throughout the forecast horizon.

Growth will be bolstered by the gradual recovery in household consumption, which is supported by an increase in wages and borrowing. Investment will also grow, but investment demand will be depressed by the uncertain economic outlook and difficult business environment. Public sector expenditures will decrease, but more moderately than planned, due to adjustments in the budget framework in 2017. Presidential elections in spring 2018 may cause pressure to postpone expenditure cuts, which could accelerate growth temporarily. Domestic demand is supported also by the slowing of inflation, close to the central bank's target of 4%. The Bank of Russia has signalled that it may continue to relax its monetary policy by gradually lowering its key rate if inflation pressures remain subdued.

Russian imports have recovered strongly in 2017, on the back of domestic demand and the stronger rouble. Based on brisk growth in the early part of the year, the volume of imports is expected to rise by 15% in 2017 and the pace of growth to moderate to 6% in subsequent years. The strong recovery in imports has been counterbalanced by fairly rapid growth in exports.

Russia's short-term growth trend may deviate from the forecast if the price of oil does not develop as expected. The prospects for longer-term growth have not improved, because the badly needed structural reforms have not been conducted. The Russian economy is therefore expected to reach its potential growth rate of 1.5% and to maintain this rate throughout the forecast period 2017–2019.

Chart 8.

Risks to global growth have decreased, but remain tilted on the downside

Risks to global growth

The global economy is currently subject to a great deal of uncertainty regarding the course of US economic policy as well as the materialisation of the plans by the new administration. The fiscal policy plans of the US administration have thus far not been materialised. If the plans for tax reform and investment in infrastructure were to come through in full, they would boost economic growth. The effects would, however, depend on the financing of the possible measures. Deregulation may bolster growth in the short term, but financial market deregulation, in particular, increases the risks to financial stability in the longer term. For global growth, a cause for concern remains the border taxes and renegotiation of trade agreements planned by the new US administration.

Developments in the global economy may be weaker than expected, particularly if China's debt-driven growth were to decelerate strongly (see 'What if China's economic growth were to slow substantially?'). China's growth is largely debt-driven, which exposes the economy to risks from financial market disruptions. A drastic deceleration of Chinese growth would weaken confidence globally and raise the price of financing, which would put a substantial brake on global growth. A recent cause for concern has also been the increase in geopolitical tensions on the Korean Peninsula. An escalation of these tensions could have severe and unpredictable consequences.

The global economy is currently slowed by lacklustre productivity developments (see 'Weak productivity a drag on global economy'). Labour productivity growth has slowed in many advanced economies, and the exact reasons for this are not yet known. In recent years, labour productivity has grown at record low rates. This may, however, be a temporary phenomenon, and, for example, the next wave of digitalisation may fuel productivity growth.

Internal risks to growth in EU22

Concerns over the condition of banking sectors and public finances in some euro area countries have been alleviated somewhat, reflecting ongoing and strengthening growth in the euro area. Deleveraging and resolving the problems remaining in the banking sector will take time, however. European banks still have nonperforming assets as a legacy from the debt crisis, and the volume of these assets continues to shrink only slowly. The general government debt-to-GDP ratio will remain large in the euro area, and under less favourable conditions the considerable indebtedness could cause significant problems in some euro area countries. The outlook for the EU22 is also overshadowed by the upcoming UK departure from the EU, as there is uncertainty concerning the speed of the process and the outcome of negotiations.

Well-functioning economic structures have a positive impact on developments in employment and productivity, and hence on growth. Structural reform has thus been a key part of economic adjustment programmes for stressed countries in the euro area. The growth-enhancing effects of the reforms already implemented may show only after a time lag. Moreover, in many euro area countries the functioning of the economy could benefit further from structural reforms.

Footnotes

1. On 29 March 2017, the United Kingdom submitted an official notification of intention to withdraw from the EU. This triggered the withdrawal process under the Lisbon Treaty, with a two-year deadline. If the deadline is not extended by mutual agreement, the United Kingdom will withdraw from the EU on 29 March 2019. Negotiations on withdrawal from the EU have commenced, and the UK's ultimate goal is to have a

bilateral relationship with the EU based on a 'comprehensive, bold and ambitious' free trade agreement. Due to the lengthy free trade negotiations, the most likely outcome is a temporary agreement that would enter into force after the UK's departure from the EU in March 2019. As a result, the current situation may persist for years to come. ↑

2. Core PCE (Personal Consumption Expenditure) inflation monitored by the US Federal Reserve has in recent years remained significantly slower than core inflation as measured by the consumer price index. ↑

Key words

growth forecast for the global economy, inflation forecast, risks to growth