3. The global economy

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Summary

- The global economy is expected to grow faster in 2015 than in 2014, but with considerable variation in momentum across countries.
- World growth will pick up from 2.6% last year to 2.9% – broadly in line with the average pace of expansion over the last 20 years.
- The US is expected to lead the advanced economies in 2015, with GDP rising by 3.3%. Conditions now seem to be in place for a firmer consumer upturn in the US, with solid employment gains and signs of a firming in wage growth.
- A modest improvement is likely in the eurozone, thanks in large part to more supportive fiscal and monetary policies and an improvement in external demand. Germany is likely to grow fastest of the larger eurozone economies, with overall eurozone growth at 1.5%.
- The sharp drop in global oil prices since mid-2014 will benefit most of the advanced economies in 2015–16. But big oil producers will be losers, most prominently Russia.
- Chinese growth is set to slow further while Brazil remains stagnant. Growth will improve in India but overall emerging market growth will dip below 4%, the slowest pace since 2009.
- A key downside risk to our forecast is a widespread retreat from risk by investors, resulting in a considerable decline in asset prices. A plausible upside scenario relates to a faster improvement in wages and consumer and business confidence in the US and Europe, pushing world growth to around 4% by 2016.

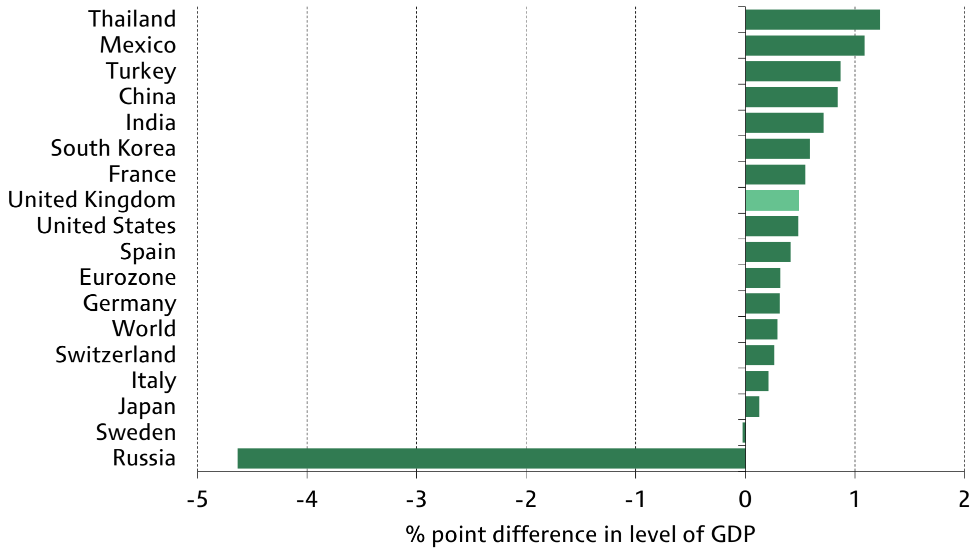
3.1 Introduction

The global recovery remained patchy and lacking in momentum in 2014. World GDP rose by an estimated 2.6%, only marginally higher than in 2013. This represented the third straight year of global growth running at about 2.5%, a rate well below the roughly 3% average pace seen over the last 20 years.

Once again, world trade growth was subdued in 2014 at 3.4%. Although this was an improvement from 2012 and 2013, it was considerably below the long-term average pace of around 5% per year. Slow world trade growth remained a constraint on growth for heavily export-oriented economies and for those seeking to achieve export-led expansions in the face of weak domestic activity.

In the second half of 2014, however, the global economy received a considerable boost from a sharp and largely unexpected collapse in world oil prices. By early 2015, Brent Crude prices were over 50% lower than their peak levels of July 2014 at less than US$50 per barrel. This slump can be traced to both demand- and supply-side factors, but with a sufficient contribution of the latter to make it an overall positive development for the world economy. With Saudi Arabia now emphasising market share goals, supply is

Figure 3.1. Estimated impact of lower oil prices on global GDP, 2015



Note: The figure compares GDP in 2015 under two Oxford Economics forecasts for average world oil prices in 2015: the June 2014 forecast of US$106 per barrel and the current forecast of US$55 per barrel.
Source: Oxford Economics.

unlikely to correct downwards for some time, so that oil prices are likely to remain low for several quarters. We expect oil prices to average US$55 per barrel in 2015 and US$67 per barrel in 2016.

From a UK perspective, the fall in oil prices is a clear positive. While the UK remains a significant oil producer, it has been a net importer for some time. Lower oil prices will cut business costs and boost real consumer incomes, the latter especially welcome given still-subdued wage growth. The boost to business and consumer confidence could also help increase demand for credit.

Simulations with the Oxford Global Economic Model suggest that the decline in oil prices since mid-2014 could, all else equal, add around 0.5% to UK GDP in 2015 (see Figure 3.1). The simulations also suggest considerable boosts to growth in the US and the eurozone, implying likely improvements in demand for UK goods from these key trading partners. Among the emerging markets, the picture is more diverse. Yet while Russia will be a major loser from lower oil prices, as will some countries in Latin America and Africa, the giant emerging economies of China and India should both gain.

Our forecast for the global economy is set out in Section 3.2, while Section 3.3 describes the key risks to this forecast. Section 3.4 concludes.

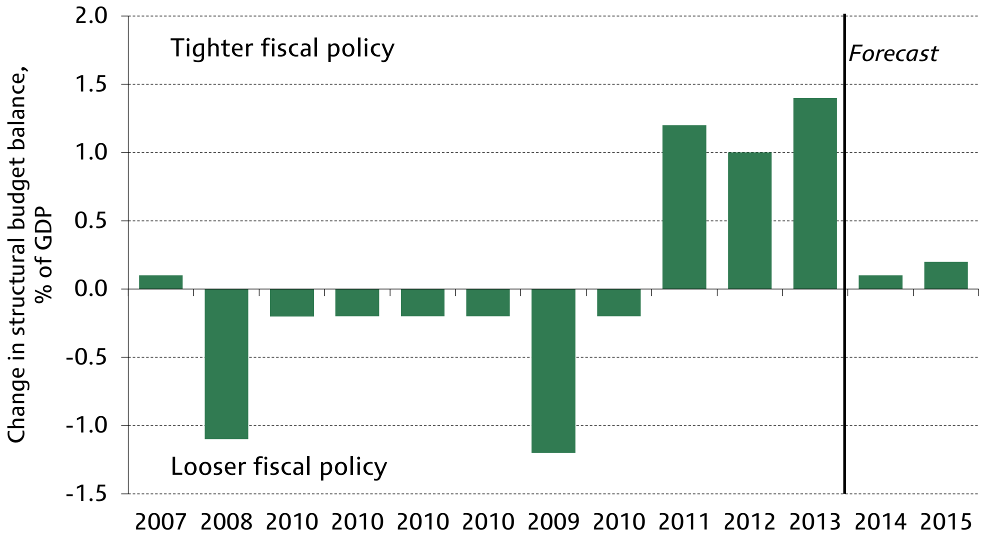
3.2 Global outlook

Eurozone

Eurozone growth remained weak in 2014, at just 0.9%. During the year, the pattern of growth shifted away from externally-focused manufacturing sectors and towards more domestic sectors. In particular, retail sales volumes picked up somewhat, rising at an almost 2% annualised pace in the six months to November.

The collapse in global oil prices should help underpin consumer spending in 2015, and there are also some signs that it may be helping business confidence, including a rise in

Figure 3.2. Eurozone fiscal stance



Source: Haver Analytics, Oxford Economics.

the expectations component of the German Ifo Business Climate Index in November and December of 2014.

Activity will also benefit in 2015 from more supportive fiscal and monetary policies. On the fiscal side, we expect fiscal policy in the eurozone to be broadly neutral in 2015 for the second year, having been restrictive in 2011–13 (see Figure 3.2).

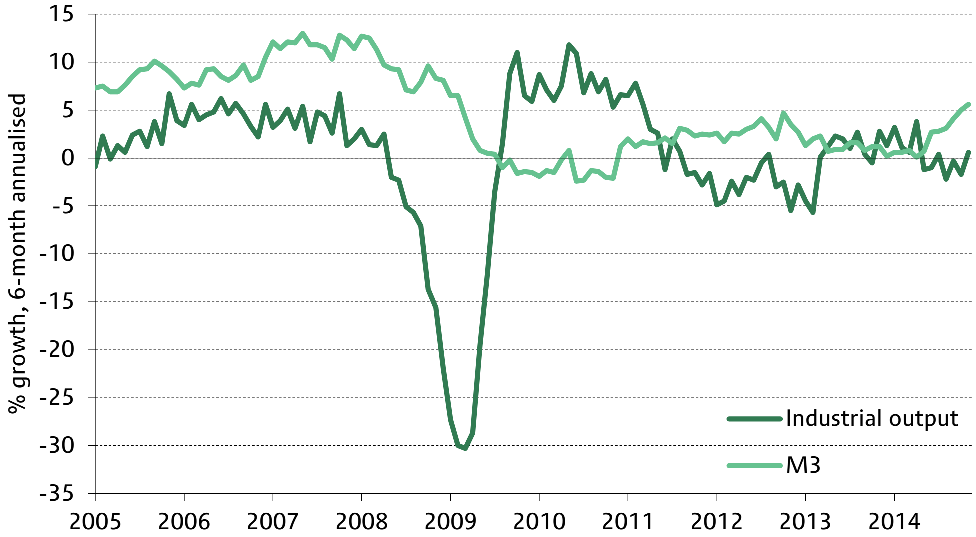
High unemployment will remain a drag on consumer spending. Unemployment edged down through 2014, and further declines will be slow. We expect the unemployment rate to remain above 11% at the end of this year and above 10% even by 2018. Nevertheless, thanks to lower energy prices and broadly neutral fiscal policy, we expect household real disposable income to rise about 2% this year and consumer spending by 1.6%.

On the monetary policy side, the European Central Bank (ECB) loosened policy in a number of steps in 2014, cutting interest rates (including introducing negative rates on banks' deposits at the ECB), providing new cheap targeted long-term refinancing operations (TLTROs) to banks and engineering a fall in the euro exchange rate of around 15% versus the dollar.

The cumulative impact of these actions is already showing up. The ECB balance sheet rose by €150 billion in December in response to the TLTRO offer that month, reversing the decline seen over the previous year. Broad money supply growth has also become markedly stronger. The M3 broad money supply rose by over 5% annualised in the six months to November (see Figure 3.3), compared with around zero growth in the six months to April. Given the lengthy lags between money supply trends and activity, the stronger recent growth should start to be reflected in firmer output growth in the latter part of 2015.

Moreover, the ECB looks likely to add still further monetary stimulus this year, as the oil price decline sees headline inflation turning negative and because the ECB balance sheet will start to shrink again otherwise as banks repay previous loans to the ECB. A major announcement is likely in late January, which we expect will include an asset purchase programme totalling about €500 billion. Along with further TLTRO operations (worth

Figure 3.3. Eurozone broad money supply and industrial output



Source: Haver Analytics, Oxford Economics.

about €600 billion), the ECB balance sheet could rise by around €1 trillion over the next year.

Overall, the eurozone is forecast to grow by 1.5% in 2015, improving to 1.8% the year after. Indeed, 2016 will be the strongest year of growth since 2010. Progress across the eurozone will be uneven, however. Germany is set to post growth of 2% this year, helped by robust consumer spending, with Spanish growth even better at 2.4%. But French growth is expected at just 1.2%, while Italy sees virtual stagnation with GDP up only 0.2%.

The risk of a slide into deflation in the eurozone remains a key downside risk. Headline inflation turned negative at the end of 2014 under the influence of lower oil prices. Although core inflation (excluding food and energy) remains positive, it is also below 1%. Given upward measurement biases in inflation,[1] the real position in core inflation may also be deflationary. Against this background, the danger remains that long-term inflation expectations will slump, raising the risk of sustained deflation and damage to economic growth as firms and business react by delaying expenditure and prioritising debt reduction.

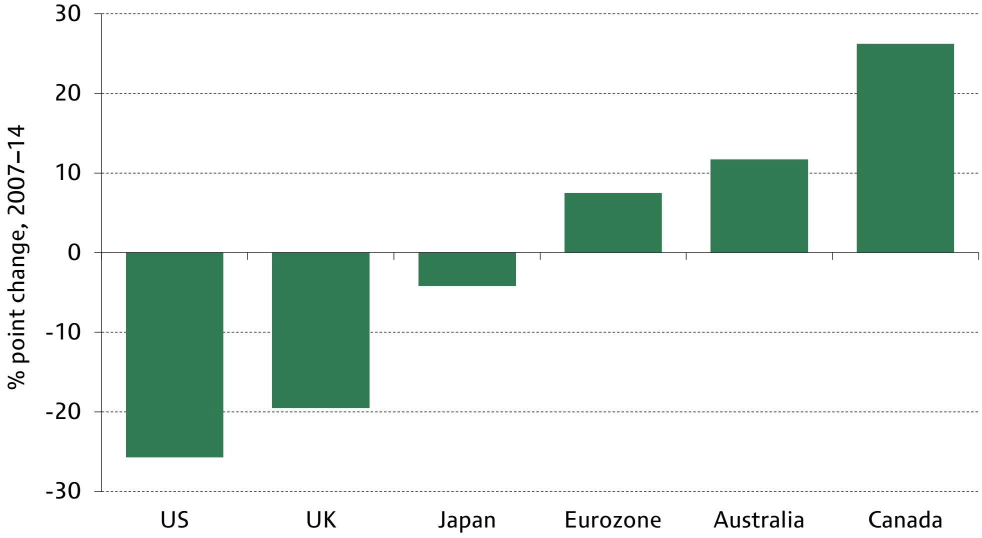
US

US economic growth improved as 2014 proceeded, with annualised GDP growth hitting 5% in Q3. After a weak start to the year, GDP for the whole of 2014 is expected to have expanded by a relatively modest 2.4%, but the outlook for 2015 is much better. Growth is expected to rise to 3.3%, the strongest pace since 2005.

In particular, conditions now seem to be in place for a sustained pickup in consumer spending. Consumption already showed notable signs of improvement in late 2014 thanks to continued robust growth in employment and signs of stronger wage rises. In

[1] For evidence of upward biases in the measurement of inflation in the Eurozone, see M. Wynne, 'An estimate of measurement bias in the HICP', Federal Reserve Bank of Dallas, Working Paper 0509, October 2005. For the US, such biases were identified most famously in the Boskin Commission Report of 1996.

Figure 3.4. Change in the household debt to disposable income ratio between 2007 and 2014: advanced economies



Source: Oxford Economics.

2015, these factors are expected to remain in place and real incomes will receive an additional boost from the steep decline in global oil prices.

Another factor likely to support US consumption in 2015–16 is the improvement in household balance sheets over recent years. The ratio of consumer debt to disposable income has dropped from 134% in 2007 to an estimated 108% in 2014, the best performance among the large advanced economies (see Figure 3.4). Indeed, in recent quarters, consumers in the US have shown signs of being willing to take on new debt, and this trend may be strengthened by improved consumer confidence linked to higher real income growth.

Business investment is also set to grow solidly in 2015, by around 6% – a similar pace to 2014. Financing conditions are favourable, and will remain so as interest rates rise only slowly. Housing investment should also pick up in 2015 after a subdued 2014, helped by lower mortgage rates and stronger real income growth increasing housing demand.

Policy settings in 2015 will remain generally growth-supportive. Fiscal policy is likely to be mildly restrictive, as it was in 2014. Monetary policy meanwhile will tighten, with Federal Reserve asset purchases having ended in 2014Q4 and with short-term interest rates starting to rise from mid-2015. However, with the Federal Funds rate still at only 1% at end-2015, the stance of monetary policy will still be relatively expansionary. The decline in long-term interest rates in late 2014 and at the start of 2015 will also provide some stimulus over the coming year (30-year mortgage rates have declined to 18-month lows).

The upswing we forecast in the US should be good news for the UK, given the importance of the US as a trading partner. Around 13% of the UK's goods exports go to the US, and the fractions of services and foreign income receipts that the UK derives from the US are even higher. A stronger US should also have positive knock-on effects for other important UK trading partners, including the eurozone.

The main risk area for the US is probably financial markets. The main US equity markets have enjoyed a remarkable bull run since 2009, which has left long-term valuations stretched on many key measures. A sharp stock market sell-off could puncture some of the improved business and consumer confidence seen of late. Lower oil prices are also not an unambiguous positive for the US as they will mean slower growth in the shale oil sector. A weaker outlook for energy firms has already prompted a significant sell-off in high-yield corporate debt, although the impact of this on the real economy is likely to be limited (energy-related high-yield corporate debt amounts to less than 4% of total US corporate debt outstanding).

Japan

Japan's economy disappointed in 2014, with GDP growth estimated at just 0.1%. Although the economy began the year in reasonable health, it slipped back into recession in Q2/Q3 thanks mostly to the impact of a sharp rise in the consumption tax from 5% to 8% in April.

Economic weakness in mid-2014 has now led to the authorities shifting course, however, and implementing more stimulative fiscal and monetary policies. The second planned consumption tax rise (originally set for this year) has now been delayed to 2017 and monetary policy is now very expansionary. The Bank of Japan in October increased its planned asset purchases to ¥80 trillion (over 15% of GDP) per year. Meanwhile, 10-year bond yields have dropped to less than 0.3%.

The yen also weakened further in 2014, by around 6% on an effective basis, and further depreciation is likely in 2015–16 thanks to loose monetary policy and a rising yield gap between the US and Japan. This should contribute to inflation remaining in positive territory, although it is unlikely to reach the Bank of Japan's target of 2% (excluding consumption tax effects).

Overall, Japanese GDP growth is expected to pick up to 0.9% in 2015 and briefly jump to 1.8% in 2016 (as spending is dragged forward in anticipation of the second consumption tax rise in 2017). Key downside risks are a faster-than-expected slowdown in China (which takes almost a fifth of Japanese exports) and further policy mistakes by the authorities such as a premature curtailment of monetary easing.

Emerging economies

Economic growth in the emerging markets was again disappointing in 2014. Emerging market GDP growth slipped to 4.1%, from 4.6% in 2013. Performance across the 'BRIC' economies (Brazil, Russia, India and China) was relatively poor. Both Brazil and Russia saw GDP growth near zero or negative, while Chinese growth slowed further to an estimated 7.4% – the weakest pace since 1990. Indian growth improved to an estimated 5.3% but remained subdued by recent standards. Indeed, the three-year period 2012–14 saw the slowest average annual growth (at 5%) in a decade.

A broadly similar pattern among the BRIC economies is likely to be seen in 2015. Brazil continues to suffer from a combination of weaker key commodity prices, high interest rates, an overstretched consumer and a lack of progress on reforms. GDP growth is forecast at less than 1%.

In Russia, the growth outlook is extremely bleak. Economic sanctions and investor caution related to the conflict in Ukraine have isolated Russia from global financial markets. Added to this, the slump in world oil prices is undermining the balance of payments and weakening the fiscal position. Meanwhile, the currency lost half its value in

2014 and domestic interest rates soared to 17% in late 2014 as balance-of-payments and inflation pressures mounted. GDP is now expected to slump by some 6% this year.

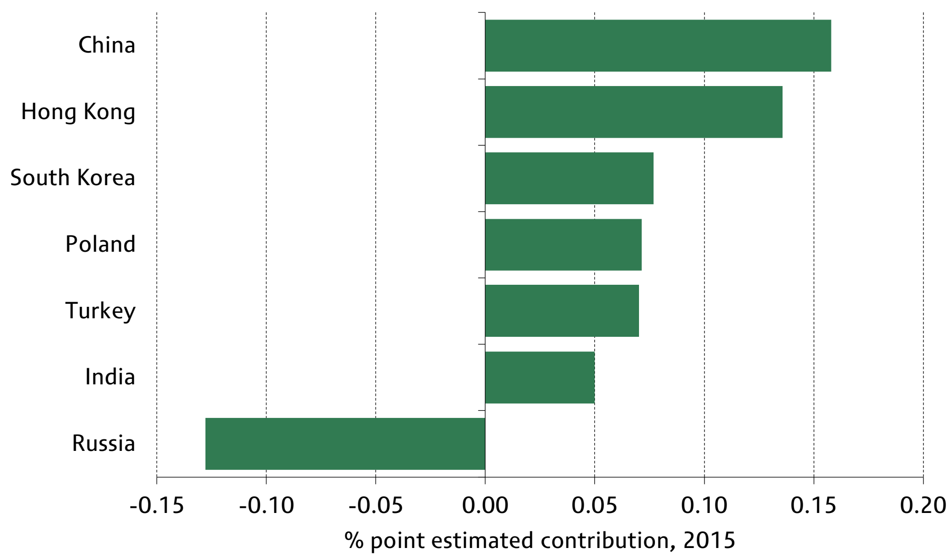
Chinese growth continues to decelerate as the authorities attempt to manage the economy towards a more moderate but more sustainable path of growth and to head off financial risks related to the property and shadow banking sectors. Some 'alternative' indicators such as freight volumes and electricity production suggest that GDP growth is already running somewhat below the official figure of around 7%, and we expect growth in 2015 to come in at below 7% and to slow further over the medium term to around 5.5% per year. This will reflect China's increasingly unfavourable demographics and a slowdown from unsustainably high rates of investment and productivity growth.

India should see a further modest improvement in GDP growth to around 6% in 2015 and 2016. The fall in oil prices is a positive for India – curbing inflation, narrowing the current account deficit and allowing interest rates to fall. The election of a more reform-minded government under Prime Minister Modi should also help growth over the medium term, although many structural barriers to sustained strong growth remain.

Other emerging markets such as Turkey and South Korea should also benefit from a combination of lower world oil prices and a gradual firming in world trade growth. As a result, we expect any impact on UK growth from the deep economic recession in Russia to be limited. Russia accounts for less than 1% of UK exports, so even though Russian imports are forecast to contract some 15% in 2015, the negative impact on UK exports will be small (at around 0.1%) and easily offset by growth in exports to more important emerging market destinations such as China, Hong Kong, India and South Korea (see Figure 3.5).

Nevertheless, emerging market growth is forecast to slow again in 2015, to just 3.9%. This will be the slowest pace of growth since 2009. Commodity-dependent economies will remain under pressure, with external financing conditions also starting to tighten as a result of rising interest rates in the US. Economic performance is set to be especially poor in Latin America, where GDP growth is expected to total only around 1% for the second straight year. As well as slow growth in Brazil, the outlooks in both Venezuela and

Figure 3.5. Emerging market contribution to UK export growth



Source: Oxford Economics.

Argentina are very bleak, with financial crisis and social unrest likely to accompany economic weakness. Fortunately, these two markets amount to just 0.2% of UK exports.

Global outlook

The forecast improvement in world growth to 2.9% this year and 3.1% in 2016 represents a gradual return to something around a trend rate of expansion after three years of subdued activity. World growth will nevertheless not return to the 4% rates seen in the boom period of 2004–07 (see Table 3.1).

The improvement in growth forecast for 2015 will mostly be seen in the advanced economies, including the US and the eurozone. GDP growth in the G7 economies is forecast to pick up from 1.6% in 2014 to 2.3% in 2015 and 2.4% in 2016. By contrast, emerging market growth is set to edge down further in 2015, to below 4%, before picking up a little the year after.

From a UK perspective, this pattern of global growth is not too unfavourable, given the large share of UK exports delivered to other advanced economies. The UK is also fortunate in that its exposure to the most troubled emerging market locations such as Russia and parts of Latin America is limited.

Economic policy settings will remain stimulative in the UK's main trading partners. Fiscal policy is no longer a major drag on growth in the eurozone or US and monetary policy overall will remain expansionary despite a rise in interest rates in the US. Indeed, given the announced large expansion of asset purchases in Japan and the eurozone, total 'non-standard' policy support by major global central banks (asset purchases plus lending to banks) is set to be greater in 2015 than it was in 2014.

Loose monetary policy in Japan and the eurozone is likely to push down the euro and the yen, but set against this the dollar is set to strengthen somewhat in 2015, by around 9%

Table 3.1. Summary of international growth forecasts

Real GDP	2013	2014	2015	2016	2017	2018
North America						
United States	2.2	2.4	3.3	2.9	2.7	2.7
Canada	2.0	2.5	2.4	2.2	2.4	2.2
Europe						
Eurozone	–0.5	0.9	1.5	1.8	1.7	1.6
Germany	0.2	1.5	2.0	2.1	1.7	1.2
France	0.4	0.4	1.2	1.7	1.6	1.6
Italy	–1.9	–0.4	0.2	0.9	1.0	1.0
UK	1.7	2.6	3.0	2.8	2.7	2.5
EU27	0.1	1.4	1.9	2.1	2.0	1.9
Asia						
Japan	1.6	0.1	0.9	1.8	0.8	0.5
China	7.7	7.4	6.8	6.1	5.7	5.5
India	4.7	5.3	6.1	6.2	6.3	6.4
World	2.5	2.6	2.9	3.1	3.2	3.1

Source: Oxford Economics.

on average on an effective basis. As a result, the sterling trade-weighted exchange rate is expected to be broadly unchanged in 2015.

The strengthening recovery we expect in 2014 and 2015 will be accompanied by very muted inflationary pressures. The sharp drop in global oil prices means that headline inflation will be close to zero or negative for at least part of 2015 in many advanced economies. World inflation is expected to drop to 2.3% this year, from 3.2% in 2014, before edging back up to 2.7% in 2016.

3.3 Risks to the global economy

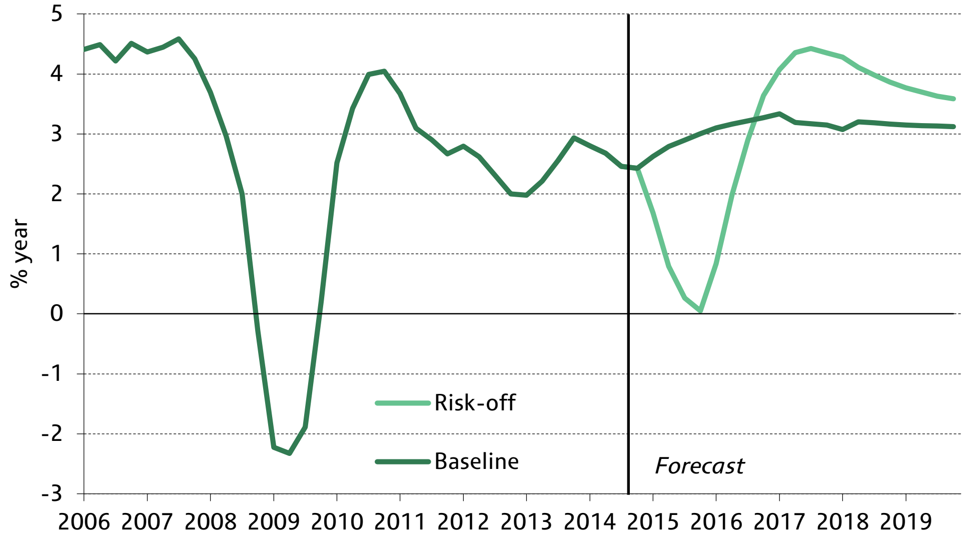
We expect stronger global economic growth in 2015–16 but some significant downside risks remain. As a result, we ascribe a probability to our baseline economic forecast of only 50% and there are a number of possible alternative scenarios, in which global growth could diverge significantly from our baseline. We cover the key scenarios for the global economy below and assess their possible implications for the UK economy in Chapter 4.

Risk-off – turmoil in financial markets

October 2014 saw a severe bout of financial market jitters including steep – albeit temporary – drops in key asset prices. A key downside risk going forward is that the withdrawal of economic stimulus in the US, along with the elevated level of many asset prices, leads to a broad-based retreat from risk by investors – in both emerging and advanced economies.

There are a number of potential triggers for such a move, including a strong market reaction to possible downside surprises to global growth. A possible scenario could involve a slump in stock prices of 20–30% in the major advanced and emerging economies and a sharp widening in emerging market bond spreads of around 1%. This would represent an average of the asset price moves seen in previous crashes, notably

Figure 3.6. World GDP under 'risk-off' scenario



Source: Oxford Economics.

the global setbacks of 1998, 2001–02 and 2008–09, the eurozone crisis of 2011–12 and the 'tapering tantrum' of 2013.

In this scenario, the decline in prices would be relatively short-lived, and met with a monetary policy response with central banks leaving interest rates lower for longer. Nevertheless, the impact on world growth would be considerable as negative wealth effects hit consumer confidence and spending and business confidence and investment.

US GDP growth would slow to less than 1% in 2015 and below 2% in 2016, versus around 3% in both years in our baseline forecast. The eurozone would return to negative growth in 2015, with GDP sliding by around 1%, followed by growth of about 1% in 2016. Emerging market GDP growth would slump to around 2% in 2015, before recovering to around 4% in 2016, while world growth would be less than 1% in 2015 and around 2% in 2016 (see Figure 3.6). We ascribe a 10% probability to this scenario.

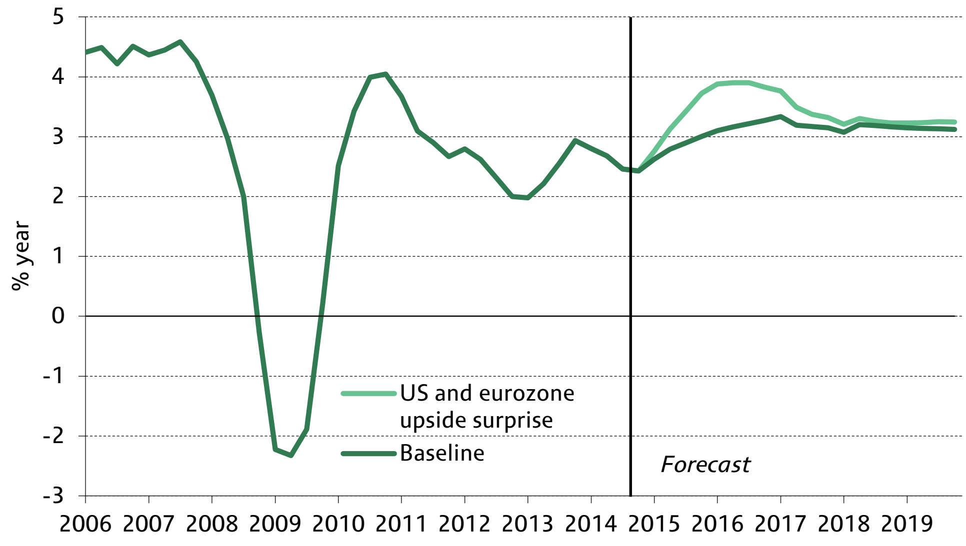
US and eurozone upside surprise

As well as the downside scenario outlined above, there are also possible upside risks to our central forecast. Our baseline forecast takes a cautious view about a number of unfolding developments in the global economy but this could prove too conservative.

Though the US economy grew by around 2.5% in 2014, annualised growth in recent quarters has been substantially higher than this. In an upside scenario, this strong trend might be extended with US growth beating expectations in 2015 after years of falling short. The primary catalysts of this could be rising real wages, a strengthening labour market and buoyant private sector confidence. Witnessing stronger sales, businesses could also feel more confident about increasing hiring and investment, feeding back again into better consumer income growth and spending. In such a scenario, US GDP growth could top 4% in 2015.

Such a scenario could also include a stronger eurozone economy. A weaker euro, improved efficacy of ECB actions, looser credit conditions and stronger investment in Germany could together see the eurozone outperforming our baseline forecast. Eurozone growth could be around 2% in 2015. Stronger growth in the US and the eurozone would

Figure 3.7. World GDP under US and eurozone upside surprise scenario



Source: Oxford Economics.

also be engines for a more robust expansion at the global level, with world GDP rising by around 3.5% in 2015 and 4% in 2016 (see Figure 3.7). We attach a 5% probability to this scenario.

3.4 Conclusion

Solid domestic demand growth in the UK has allowed growth to proceed at a decent pace despite relatively slow growth in external demand. However, the outlook for the world economy remains important, especially if the UK wishes to see a balanced growth pattern.

While 2014 again saw only moderate world growth, the improvements in the US – and to a lesser extent the eurozone – as the year proceeded bode well for 2015. This year should see firmer external demand for the UK, helped by improved demand in the advanced economies and despite a further slowdown in growth in the emerging markets. More supportive fiscal and monetary policies in the eurozone and Japan will play a key role in bolstering G7 growth, which will run at its fastest pace since 2010.

The sharp drop in global oil prices since mid-2014 will also be a bonus for the UK and many of its key trading partners. Although there are also major losers from this development (most notably Russia), the UK's economic exposure to these countries is small. On the whole, the fall in oil prices will support real household incomes in the UK and other advanced economies and should also boost business confidence.

Some downside risks to global growth still exist. In the eurozone, the risk of deflation has not entirely receded, and global growth could suffer in the event of a sharp correction in global financial markets resulting from reduced US monetary accommodation and elevated asset prices.

There are also upside risks to world growth. In particular, it is possible that consumer and business confidence could rise more rapidly in the US and Europe in response to improving labour markets and stronger real income growth. This could create a virtuous circle of higher consumer spending, higher investment and increased employment.