The Outlook for the World Economy

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ifw

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After the synchronised downturns of 2012, the world economy seems to have turned around again as of the beginning of this year. Sentiment indicators have improved, both in advanced and in emerging economies. This is reflected by the IfW Indicator on the world economy, which includes survey data from 42 countries. However, as of yet the tendency of this growth is neither steadily nor strongly directed upwards. Some caution is also warranted, because hard data on new orders and production do not yet signal a widespread breakthrough to higher growth rates in advanced economies. As far as world trade is concerned, acceleration can so far be observed mainly for emerging economies, particularly in Asia. Nevertheless, the development of world financial markets also suggests that some optimism concerning the outlook has returned, as stock markets in some countries have reached new record highs.

Again and again in the past few years, the upturn, especially in several advanced economies, has been interrupted because of new shocks, mainly from the crisis in the Eurozone. This was the case, for example, in the middle of 2011, as well as in the summer of last year. In 2012, the statement by the president of the ECB, Mario Draghi, ended the uncertainty about the future on the European Monetary Union –for the time being. As a consequence, the volatility of financial markets, as well as the spreads between government bond yields of various countries, has declined. All this can be visualised by the IfW Indicator on the financial stress in the Eurozone, which includes several measures of volatility and interest rate spreads, as well as foreign exchange markets. This indicator has recently fallen almost to its normal level, after peaking in 2008 (Lehman bankruptcy) and again in the wake of the sovereign debt crisis in 2011 and in 2012.

IfW-Indicator and world economic activity: Some improvement since the end of 2012

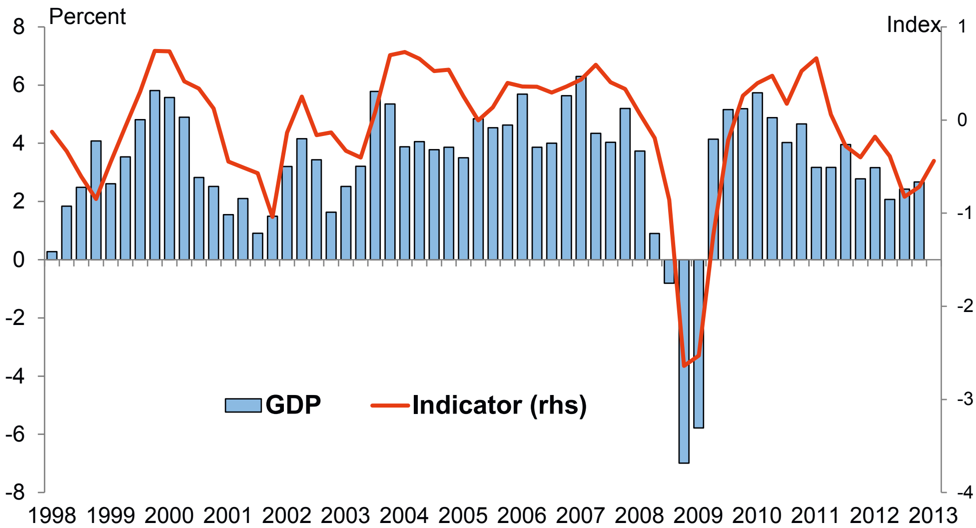

Fig. 1

Calculations by IfW.

IfW-Financial Market Stress Indicator: Relief after the announcement by M. Draghi

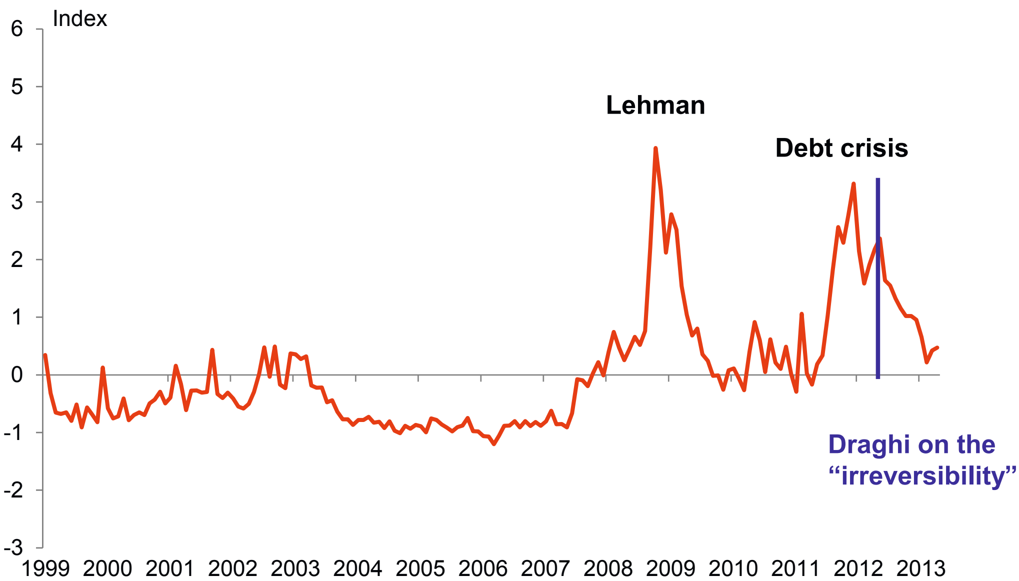

Fig. 2

Calculations by IfW.

Because of all these shocks, the economic outlook had worsened again and again, and forecasters repeatedly had to "postpone" the next stage of the recovery to the following year. Therefore, it is fair to say that the present expectation of a slight acceleration of economic activity in the world economy critically relies on the assumption that there will not be another escalation of the crisis in the Eurozone. A further crucial assumption concerns the political situation in the United States, or in other countries where monetary and fiscal policies do not look sustainable and therefore may be a source of new turbulences.

Modest growth in the world economy

The outlook is for a modest acceleration of growth in the world economy over the course of this year and – if nothing happens – also next year. Overall, real GDP should increase by about 3 ½ % and by 4 % in 2014, with the main improvement coming from advanced economies. World trade is expected to increase by about 3.5% this year and some 5% next year, with the main impulses stemming from the relatively strong demand of emerging economies.

These growth rates are modest compared to earlier boom periods in the world economy, but the 'good times' we saw in the years before 2008 seem to be over. One reason is that the expansion of emerging economies has slowed down somewhat, both as a consequence of weaker impulses from advanced economies and of weaker domestic factors arising from a more moderate trend growth in productivity. All in all, GDP growth rates in these economies will now be closer to what can be considered trend growth, with the estimates for the medium term varying between 5.5% and 6%. Such a lower speed will also be beneficial for macroeconomic stability in these countries, as it helps to avoid overheating and inflationary risks. In any case, the emerging economies – above all China, but more and more also India – will continue to be the locomotives of the world economy. In the years 2012 and 2013, the emerging and developing economies will account for about 80% of worldwide growth, while the contribution of advanced economies remains disappointing.

Real GDP growth in the world economy 2008 - 2014

Country/Group	2008	2009	2010	2011	2012	2013	2014
Advanced economies	***0.2***	***-3.5***	***3.0***	***1.6***	***1.2***	***1.2***	***2.0***
- United States	-0.3	-3.1	2.4	1.8	2.2	1.8	2.5
- Japan	-1.0	-5.5	4.5	-0.6	1.9	1.2	1.5
- Euro Area	0.3	-4.3	1.9	1.4	-0.6	-0.2	1.0
Emerging+Dev. economies	***6.0***	***2.8***	***7.4***	***6.4***	***5.2***	***5.9***	***6.0***
- Brazil	5.1	-0.3	7.5	2.7	0.9	3.0	4.5
- Russia	5.2	-7.8	4.3	4.3	3.3	3.5	3.8
- India	6.4	5.7	10.1	7.7	3.7	6.5	7.5
- China	9.6	9.2	10.4	9.3	7.8	8.0	7.5
World	**2.8**	**-0.4**	**5.1**	**4.0**	**3.1**	**3.4**	**4.0**
World trade	*2.9*	*-11.3*	*12.6*	*6.0*	*2.7*	3.5	5.0

Table 1

Calculations and forecast by IfW.

Advanced economies will continue to show subpar growth

A major reason for the moderate expansion in the world economy i1s the relatively weak performance of the advanced countries: GDP growth in 2013 will probably not be significantly higher than it was last year. In some of them, real GDP has just about reached the level it held prior to the crisis in 2008/2009; in several crisis countries in the Eurozone, production is even much lower than it was 4 or 5 years ago. All in all, the recovery up to now has been much slower than after most recessions in the past, which is a disappointment for policymakers in many countries as they have resorted to very massive and often unconventional measures to stimulate their economies.

The relatively modest expansion in recent years can be 'explained' by the consequences of the financial crisis, which are typically caused by a collapse of the housing market and/or the banking sector. Empirical evidence shows that during recoveries after a 'normal' recession, which we observe every 7 years or so, GDP returns to its trend relatively quickly, i.e. after 3 or 4 years. However, after a financial crisis things are different: while GDP does pick up, the recovery is not strong enough to bring the level of production back to its old trend even after several years. This is exactly what we observed after the Great Recession: in many economies like the United States and the Eurozone, the gap between the trend and actual GDP has not become smaller at all, but instead remains relatively large. This can also explain the weakness of the labour market, because unemployment has declined only modestly (like in the US) or even continued to increase (like in the Eurozone).

This is the typical pattern which was observed everywhere in the periods after the financial crises of the past century, as analysed by scholars like Reinhart and Rogoff as well as others. In extreme cases, such as in Japan or in Scandinavian countries in the early 1990s, the gap between actual GDP and its trend even increases for many years. This can currently be observed for in Spain, the country which has been severely hit by its housing bubble bursting and then by its subsequent sovereign debt crisis. There are exceptions to this rule: in Germany, the current recovery looks almost 'normal' – i.e. real GDP behaves like after a normal recession – because this country, while being indirectly af-

Recovery after the crisis: United States

The typical pattern

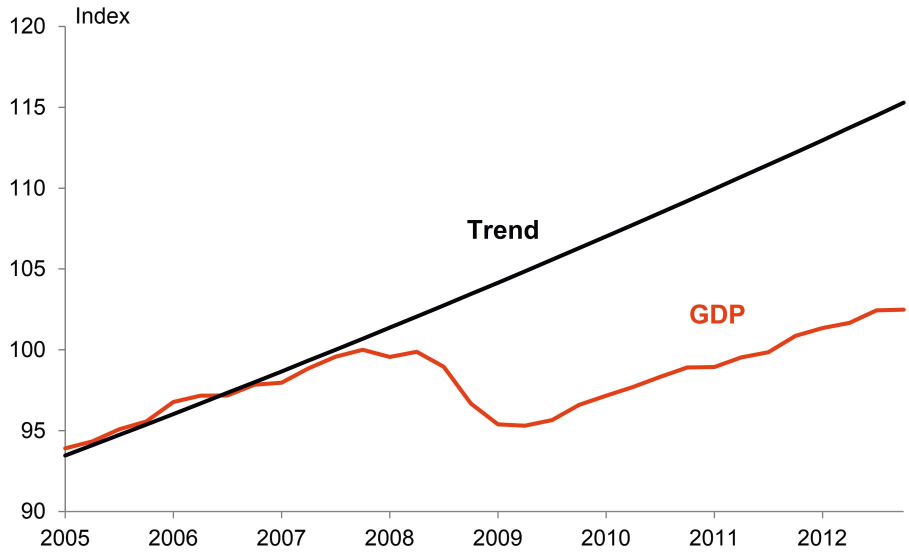

Fig.3a

Calculations by IfW.

Recovery after the crisis: Euro Area

Also the typical pattern

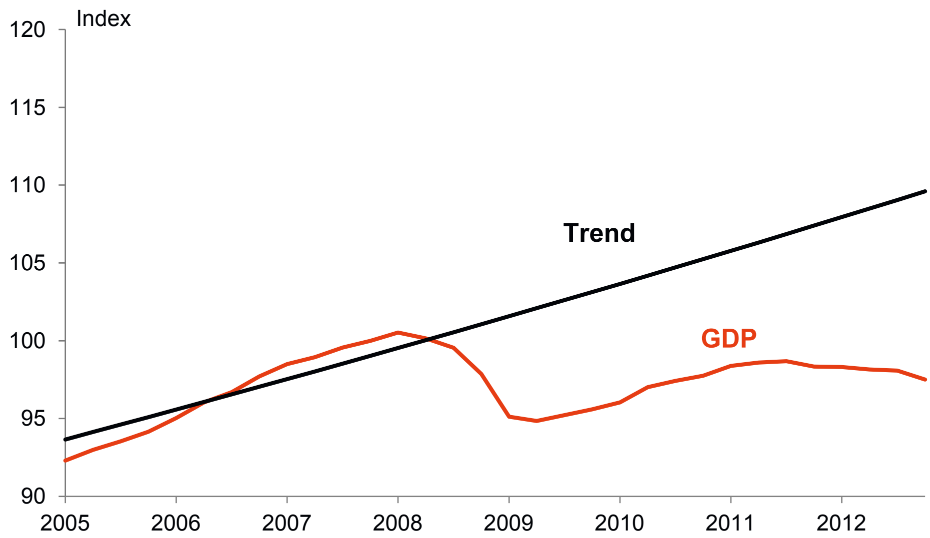

Fig. 3b

Calculations by IfW.

fected by the crisis in many other countries, did not experience a 'homemade' crisis in, for example, the housing sector.

All of this has implications, not only for the economic outlook over the coming years, but also for economic policy. It should not be expected that the advanced economies will show very high rates of growth in the near future. In fact, the old trend may not be reached at all because potential output, which was assumed to be there and is the idea behind the trend level of output, is no longer a good guide for the production possibilities of those countries hit by a crisis. In fact, empirical studies show that severe crises also have an effect on the long-term potential level of output in an economy, due to misallocations and the fact that the investments that were taken did not deliver the expected profitability. For example, the housing market bubbles in several countries raised production in the short run and also, technically, led to an increase of the capital stock. However, this capital stock does not appear to be profitable anymore and cannot be used for future production.

A key feature of a crisis like the one we have experienced recently is that it has led to substantial misallocations in the economy, usually driven by the very low interest rates that were the case in most countries hit by the recent crisis. Thus, the production structure of the economy has to be corrected, and this process takes time. In several countries, the housing sector and/or the banking sector have become too big, and the adjustment to a new production structure requires a lot of new investment and also a reallocation of the labour force. Much time is also needed to reduce the excessive debt that accumulated during the previous boom in the private sector – e.g. mortgages – as well as in the public sector. Even if economic policies could support the necessary adjustments, the correction will need many years, as experience shows.

The implications of this finding of weak economic performance also have dramatic consequences for economic policy. The output gap (i.e. the difference between potential and actual GDP) is probably much lower than suggested by previous estimates of trend output. Since the output gap is one factor affecting inflation, the risk of inflationary pressures could be higher than is commonly assumed. Therefore, this poses a risk for central banks with a target for price stability. As far as fiscal policy is concerned, budget deficits are commonly adjusted for the cycle (structural deficit). If the (negative) output gap is much smaller than previously estimated, the structural deficit would be higher, indicating a much greater need for fiscal consolidation. This poses an even greater challenge for governments right now, since many countries currently experience low growth and high unemployment.

Consequently, it is very difficult today to predict what major central banks and governments will do in the future, especially given the fact that they have been in crisis mode for about 5 years now. This uncertainty about economic policy has been at an elevated level since the crisis began and may also explain the weakness of economic activity in many advanced economies.

Uncertainty about economic policy in the United States and in the Euro Area: One reason for the weak recovery?

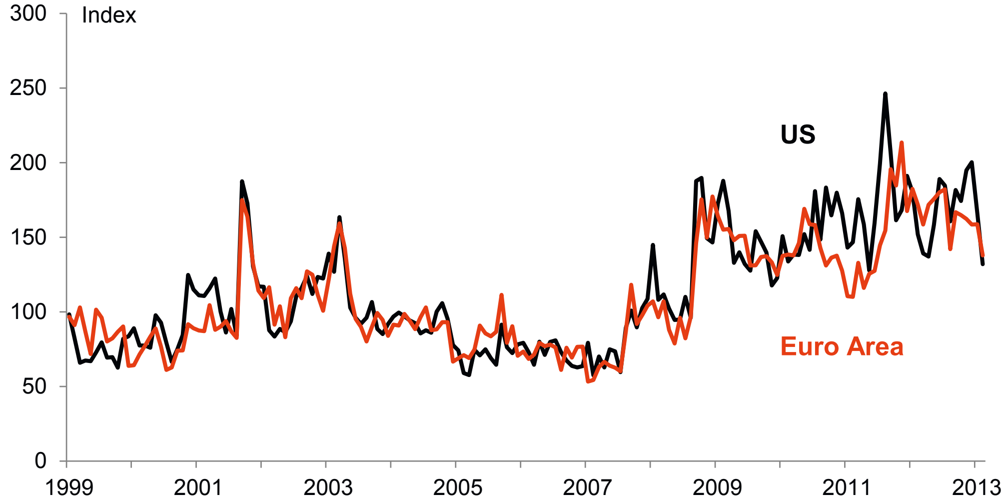

Fig.4

Source: http://www.policyuncertainty.com

Economic policy goes to the limits – risks for stability are high

Monetary policy in advanced economies continues the expansive stance of recent years. Not only will interest rates remain at their historical lows, at least until the end of next year, there has also been another shift towards more stimulative measures. The US Fed has announced that it will buy additional mortgage-backed securities and government bonds on a grand scale every month, which will lead to a further strong increase of the Fed's balance sheet. The ECB not only lowered the key interest rate again in early May this year; it is also considering more specific measures to improve the financing conditions in some countries. The Bank of Japan has raised its inflation target to 2% and has announced that it will act more aggressively in order to stimulate the economy. Finally, the Bank of England is also expected to increase its purchases of assets and government bonds.

However, it remains questionable whether, under the present circumstances, an additional stimulus of monetary policy can really jumpstart the economy in the aforementioned countries. Instead, the risk of further misallocations or even bubbles increases with the continuation of the policy of very low interest rates and ample liquidity in the economy. This may lead to turbulence in financial markets and pose a risk to macroeconomic stability in the medium term.

Fiscal policy has been under pressure – not only from financial markets through higher risk premiums – to reduce budget deficits in order to return to a more sustainable path as far as government debt is concerned. However, due to poor performance in some countries, and high or even rising unemployment in particular, there have been more and more moves to postpone or at least prolong the process of budget consolidation, especially in several Eurozone countries. While 'buying more time' may take off some pressure from governments, it is uncertain whether international investors remain confident that fiscal policy is indeed on a path towards sustainability of public finances. Budget deficits have indeed reduced rather slowly, which implies that the debt-to-GDP ratio will continue to increase in many countries over the next few years; in some cases a stabilisation is not in sight at all.

Given the already high levels of the debt ratios, it remains critical whether the governments are credible enough to avoid major turbulences. A sharp increase of government bond yields due to a perceived insolvency risk would probably put pressure on central banks to intervene and to buy – possibly in large quantities – government bonds.

Budget balances and debt in selected countries: Consolidation is quite slow

Country	2007	2008	2009	2010	2011	2012	2013	2014	Ratio 2013
Germany	0.2	-0.1	-3.1	-4.2	-0.8	0.2	-0.1	0.3	80
France	-2.7	-3.3	-7.6	-7.1	-5.2	-4.6	-3.8	-3.8	108
Italy	-1.6	-2.7	-5.4	-4.3	-3.9	-2.9	-3.0	-3.0	130
Spain	1.9	-4.5	-11.2	-9.7	-9.4	-10.2	-6.4	-5.9	100
Britain	-2.8	-5.0	-10.9	-10.1	-7.8	-6.3	-7.2	-6.1	110
Japan	-2.1	-1.9	-8.8	-8.4	-9.3	-9.5	-10.4	-9.5	224
United States	-2.9	-6.6	-11.9	-11.4	-8.7	-7.0	-5.3	-3.8	113

Table 2

Calculations and forecast by IfW.

The ECB has announced that, in order to guarantee the Euro, it will indeed do that, should such problems emerge. It remains to be seen whether such a policy like the OMT program by the ECB will be interpreted as a monetisation of government debt and will lead to a situation in which inflationary expectations will no longer be firmly anchored. The interplay between monetary and fiscal policy has attained a new dimension as central banks have effectively lost their independence now. However, the independence of a central bank is a crucial condition for a successful stabilisation policy. Inflationary episodes in the past have shown that a loose fiscal policy can be a factor contributing to an inflationary monetary policy.

This is certainly not the case today, because inflation seems to be contained as far as goods and services are concerned, and inflationary expectations are near their respective targets. However, the risk increases the longer the massive stimulus continues.

All in all, while the expansive policies may help to support economic activity in the short run, they run the risk of major disruptions and macroeconomic instability in the medium term. Therefore, it is fair to say that the risks to the economic outlook are clearly on the downside

Long-term trends: Emerging economies will gain even more importance

The trend of economic growth in the world economy over the past two decades has been shaped by the strong performance of emerging economies, especially in Asia. Needless to say, the growth performance of China stands out: real GDP today is about 250% higher than it was 15 years ago. While the expansion is likely to slow down somewhat in the short and also in the medium term, even the more modest rates will lead to a substantial shift in favour of the emerging economies, at the expense of the importance of advanced economies. In about 2 years, China will be the largest economy in the world, at least if measured in terms of PPP. In the longer term, India will also gain more importance. While very long-term forecasts have to be taken with some caution, the consideration of productivity trends, demographics and other factors affecting potential output growth can be a basis for a prediction of income levels in the distant future. The OECD recently published such estimates, which are in line with other studies. They imply that while China's share in world GDP will reach some 28% by 2030, and India will be close to the share of the Eurozone about 20 years from now.

Trend GDP growth in selected countries

Country	1995-2011	2011-2030	2030-2060
United States	2.5	2.3	2.0
Germany	1.4	1.3	1.0
France	1.7	2.0	1.4
Turkey	4.2	4.5	1.9
Mexico	2.6	3.4	2.7
Brazil	3.3	4.1	2.0
Argentina	3.6	3.6	2.2
China	10.0	6.6	2.3
India	7.5	6.7	4.0
Russia	5.1	3.0	1.3
World	3.1	2.8	1.9
World per capita	*2.3*	*2.2*	*1.8*

Table 3

Source: Johansson, Å. et al. (2013), "Long-Term Growth Scenarios", *OECD Economics Department Working Papers*, No. 1000, OECD Publishing. http://dx.doi.org/10.1787/5k4ddxpr2fmr/en

World GDP:
Share of countries or country groups in 2011

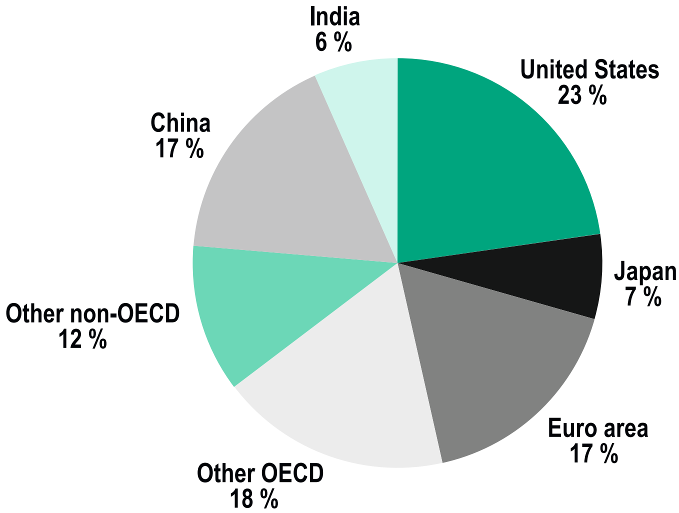

Fig. 5a

Source: Johansson, Å. et al. (2013), "Long-Term Growth Scenarios", *OECD Economics Department Working Papers*, No. 1000, OECD Publishing. http://dx.doi.org/10.1787/5k4ddxpr2fmr/en

World GDP:
Share of countries or country groups in 2030

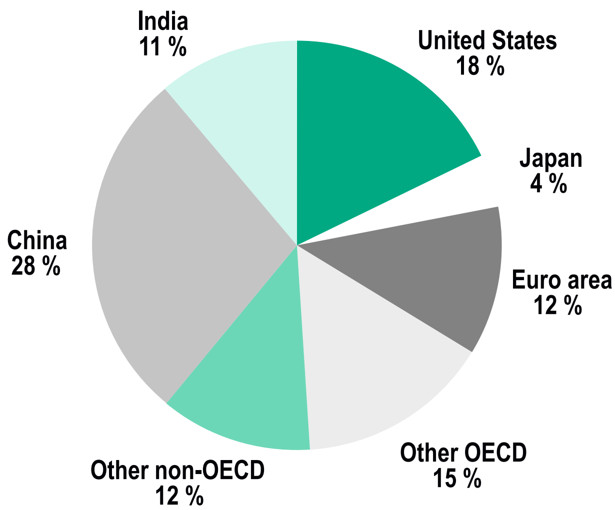

Fig. 5b

Source: Johansson, Å. et al. (2013), "Long-Term Growth Scenarios", *OECD Economics Department Working Papers*, No. 1000, OECD Publishing. http://dx.doi.org/10.1787/5k4ddxpr2fmr/en

To be sure, there will still be a large gap between the advanced and the emerging economies as far as per-capita income is concerned. However, their relative size will almost surely have an impact on international economic policy when, for example, China and India are much larger than the United States and the Eurozone combined. While these two economies will remain, by far, the strongest locomotives for the world economy, other countries like Brazil and Turkey will gain impor-

Trend GDP growth in selected countries

Country	1995-2011	2011-2030	2030-2060
United States	2.5	2.3	2.0
Germany	1.4	1.3	1.0
France	1.7	2.0	1.4
Turkey	4.2	4.5	1.9
Mexico	2.6	3.4	2.7
Brazil	3.3	4.1	2.0
Argentina	3.6	3.6	2.2
China	10.0	6.6	2.3
India	7.5	6.7	4.0
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World per capita	*2.3*	*2.2*	*1.8*

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tance, too, while the 'old' centres in North America and in Europe lose more and more importance.

While it may be difficult to judge the possible geo-political implications of these developments, the importance for export industries in Europe can hardly be underestimated. On the one hand, they will face substantial competition from these rapidly growing countries in terms of products which require relatively low-skilled labour. On the other hand, the opportunities to export will increase tremendously if the European countries focus on the needs of the most dynamic countries, in particular high quality investment goods.

Highlights of the forecast for major economies

In the *United States*, the economy has improved in important areas. The housing market has overcome its weakness: house prices, as well as construction activity, have increased since the beginning of last year. Investment spending by firms has picked up as well, supported also by the continued improvement of the United States' international price competitiveness. The labour market is also improving. However, the reduction of the unemployment rate since the Great Recession is, to a large extent, due to a decline in the participation rate, as many persons have become disappointed and have simply given up on looking for work. In fact, compared to the normal employment situation, about 10 million jobs are still missing. A crucial factor is the budget situation, which is mainly a political problem, as no agreement has yet been reached between the Executive and Congress on a long-term plan to consolidate the budget. The medium-term risk is that the Fed will, sooner or later, have to raise interest rates, which will have a fast and substantial effect on interest payments as much of the government debt is short term. The risk is that this will make the budget situation worse, since more consolidation needs to be done in order to reduce the deficit.

In the *Eurozone*, the recession has continued in several countries. On average, real GDP will fall again for most crisis countries and even for the Eurozone as a whole, which also implies that unemployment is still on the rise. Given the slight improvement of sentiment indicators – although starting from a very low level – there is some hope that the contraction should end over the course of this year, followed by a moderate increase in 2014.

This forecast is based on the 'usual' assumption that the crisis in the Eurozone will not escalate,

Real GDP growth in the European Union
2008 - 2014

Country/Group	2008	2009	2010	2011	2012	2013	2014
Germany	1.1	-5.1	4.2	3.0	0.7	0.6	1.5
France	-0.2	-3.1	1.6	1.7	-0.1	0.0	0.9
Italy	-1.2	-5.5	1.8	0.6	-2.4	-0.9	0.7
Spain	0.9	-3.7	-0.3	0.4	-1.4	-1.4	0.4
Euro Area	***0.3***	***-4.3***	***1.9***	***1.4***	***-0.6***	***-0.2***	***1.0***
Britain	-1.0	-4.0	1.8	0.9	0.2	0.5	1.2
EU 27	**0.7**	**-4.1**	**2.0**	***1.6***	***-0.3***	***0.0***	***1.2***

Table 4

Calculations and forecast by IfW.

because otherwise new turbulence in the financial markets could lead to another setback for economic development. The critical issue in the crisis countries is when economic growth will finally return and when the labour market will at least stabilise. This is crucial, especially for the governments in question, since the willingness of the population to accept further measures may not last very long. However, it is very difficult to predict when the adjustment will finally be successful or complete. While the correction which has taken place after the crisis was substantial, with sometimes substantial output losses, it seems that the adjustment takes longer than, for example, it did in the Baltic states of Estonia, Latvia and Lithuania in 2008 and 2009. In those countries, the correction of external imbalances and competitiveness was more radical and led to a sharp but short contraction of output. However, they have overcome the crisis relatively quickly and have now returned to a sound growth path.

It has to be kept in mind that the downturn in the problem countries in the Eurozone was not an outside shock or the result of a tighter fiscal policy stance, but, at least in part, a correction of the misallocations which had led to the crisis in the first place. The previous boom was not sustainable because it led to bubbles in important markets, especially the housing market, driven by very low or even negative real interest rates. To be sure, all countries have made – often even considerable – progress in terms of improving their competitiveness, reducing their current account deficits and also their budget deficits. However, it takes a long time – in some cases certainly a few more years – for the debt-to-GDP ratio to stabilise, which is seen as an important pre-condition for the return to a sustainable fiscal situation. At present, new doubts may emerge as some countries are asking for 'more time' to bring down budget deficits. This may lead to a situation in which the confidence of investors does not return, which implies that the solvency risk remains high, leading to higher interest rates. For example, it is likely that the budget deficit (in relation to nominal GDP) of France in 2014 will be above 3% for the seventh year in a row, although this country is not in a severe crisis.

Economic policy in *Japan* has become more aggressive with the intention to stimulate the economy and raise the inflation rate. The BoJ lifted the inflation target and announced it would double the monetary base within the next two years. This massive policy shift already had a substantial impact on the exchange rate: the yen haslost 20% to 30% of its value against other major currencies within the past 6 months. Fiscal policy is again on an expansive stance with a new stimulus program. While these policies may have a positive effect in the short term – exports will surely be boosted by the weaker yen – it is doubtful that economic growth in Japan will be substantially higher in the next few years. At the same time, the problem of sustainable fiscal policy becomes more relevant, posing a major risk for the medium-term outlook.

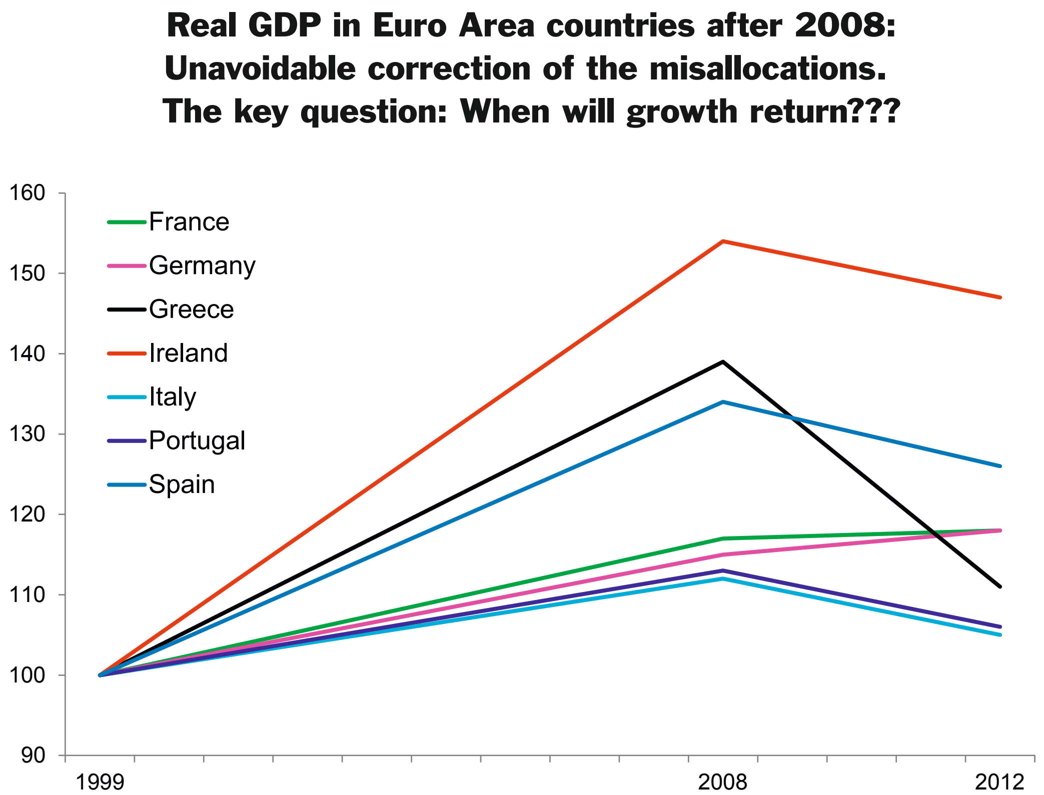

Fig. 6

Calculations by IfW.

Emerging economies are likely to show slightly higher growth in 2013 and 2014; however, their expansion will be more moderate than it was in previous years. The larger countries are faced with different problems. China is experiencing a slowdown of productivity growth and labour supply. India's macroeconomic stability is shaky because of a persistently high rate of inflation and a deficit in the government budget which appears to be hard to control. On top of that, poor infrastructure has become more and more an impediment to economic growth. Brazil, too, is suffering from insufficient infrastructure, and private investment is hampered by government intervention. Russia is still heavily dependent on oil revenues and on exports of raw materials in general. Apparently, an increasing number bottlenecks in the production process may cause the economy to not benefit substantially should world raw materials prices rise again.

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