

AS THE WORLD TURNS

(SLUGGISHLY)



When we last looked at the global economy, growth was uneven or even decelerating. Jump to this year, and global gross domestic product growth is still weaker than expected, with a number of developing economies flagging and some euro zone countries flirting with recession. How will the world face this latest economic setback? Stay tuned...

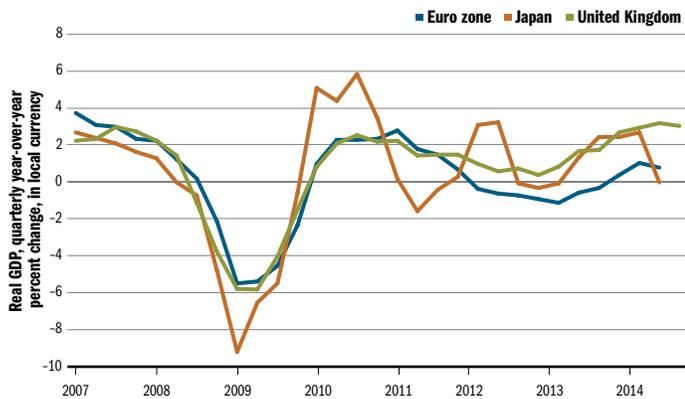
This year has been another disappointing one for the global economy, as the hoped-for acceleration in growth has not materialized. Global gross domestic product (GDP) continued to expand at a subpar rate in 2014, much slower than the robust growth of the middle of the last decade and the year after the recession ended. To be sure, economic growth remained positive, inflation was tame, the number of jobs grew, and incomes rose in virtually every part of the world. But prospects for robust growth are still largely elusive in many large economies, and downside risks to the current moderately optimistic outlook have increased.

Europe's economic recovery flags

In the developed world, the struggling euro zone appears to be the most vulnerable (see chart 1 on page 18). The region endured two recessions during the past seven years. The first recession was caused by turmoil in the global financial markets, and the second was brought on by the region's sovereign debt crisis. As the debt crisis subsided, the euro zone's economy returned to growth in the second quarter of 2013, but that recovery stalled just a year later. Economic performance worsened in the euro zone's three largest economies. Germany's vigor flagged, France's growth stagnated, and Italy slipped back into recession.

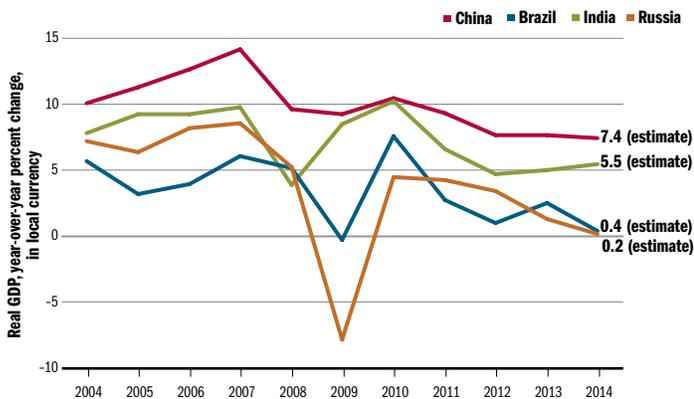
Although preconditions for continued growth in the euro zone seem to be in place—for example, fiscal policy is less restrictive and credit conditions have improved—concerns about another recession have risen as economic data softened and

Chart 1
Economic Growth in Major Foreign Developed Economies



Sources: Haver Analytics/EUROSTAT, national statistical agencies

Chart 2
Economic Growth in Major Emerging Markets



Sources: Haver Analytics/national statistical agencies; 2014 estimates are from October Blue Chip Consensus Forecast

deflationary pressures built. In response, the European Central Bank stepped up its efforts to stimulate the economy by implementing a number of policy-easing measures in 2014.

Japan loosens monetary policy to stimulate its economy

Another major central bank, the Bank of Japan, also eased its policy in a surprising move in October. Japan's economy had actually fared pretty well over the past few years, growing at a 1.5 percent annual pace in 2012 and 2013, an impressive rate for

a country that's suffered deflation for years and has a declining labor force. However, in the first half of 2014, Japan's economic growth swerved when the government increased the consumption tax. (In April, the rate went from 5 percent to 8 percent.) Not surprisingly, consumers moved their big purchases to the first quarter, which boosted GDP growth, and then sharply reduced their purchases in the second quarter, causing GDP to plunge. Unexpectedly, GDP also declined in the third quarter.

Standouts on the world stage

There were two notable bright spots in 2014 among major developed economies: the United States and the United Kingdom. The strong performance of the latter was a surprise to many observers, given the country's increased fiscal austerity and large exposure to the weak economy of the euro zone. Even in the face of those headwinds, the United Kingdom's GDP has grown at a robust rate of about 3 percent, helped by higher consumer spending and business investment, and a strong recovery in residential construction. U.S. economic growth rebounded to an above-trend rate after a weak first quarter, helped by rising consumer spending and business investment. In addition, the labor market showed continued improvement, with solid job gains and falling unemployment.

Emerging economies' growth sputters

Economic fortunes in 2014 also varied among the largest emerging-market countries: China's economy continued to decelerate gradually, Russia's growth halted, and Brazil went into a technical recession (two consecutive quarters of negative GDP growth) in the first half of the year. Meanwhile, India's expansion picked up after nearly two years of disappointingly slow growth (see chart 2).

China's moderating pace of growth continues to be a key component of the global economic picture. After 10 years of growing at annual rates of more than 9 percent, the economy expanded by approximately 7.5 percent in 2012 and 2013 and appears to have slowed a bit more in 2014. The current growth pace is still consistent with the government's target of around 7.5 percent and its efforts to rebalance the country's economy away from its reliance on exports and business investment and toward higher consumption. One of China's main economic stories this year was the ongoing broad slowdown in residential investment. Real estate has been a significant driver of China's economy for a number of years, but the sector's rapid growth led to an oversupply of properties in many cities. To correct those mounting imbalances, China's government has attempted to cool the housing sector, in the process adding to the downward pressure on the overall economy.

Russia's economic growth has been weakening for several years now. In 2014, that weakening was exacerbated by capital flight, decline in investment, and Western sanctions imposed

on the country in response to Russia's military involvement in eastern Ukraine and the annexation of part of Ukraine's territory. Brazil's economy has also lost much of its luster. Inconsistent government policies dampened business confidence, and consumer spending slowed as real wage growth weakened, largely because of higher inflation. Low business confidence and the deteriorating economic outlook held back investment, thus undermining Brazil's longer-term economic prospects.

At the same time, India's growth strengthened, benefiting from reduced political uncertainty that boosted business and consumer sentiment.

The outlook for 2015

As we look ahead, the major trends in the global economy aren't likely to change much in 2015 compared to 2014. Global growth is expected to accelerate, albeit slightly. Forecasters are putting their faith in the apparent strength of the U.S. economy and its ability to lift those economies that derive a major part of their growth from exporting to the United States. However, many

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downside risks and uncertainties are fueling concerns that global growth could fall short of expectations yet again.

Among the key risks are a potential recession and a deflationary spiral in the euro zone; China's possible hard landing; financial market shocks, perhaps related to the expected increase in U.S. monetary policy rates; and a gamut of geopolitical risks.

What are the broad contours of the 2015 global economic outlook? Among major developed economies, the United States and United Kingdom are forecast to grow at the fastest rates, while growth in Japan is likely to be anemic. Growth is expected to improve only slightly in the euro zone. The expectations of a pickup in that region are predicated on diminishing fiscal drag, continued accommodative monetary policy, and an improving credit environment. Economic prospects vary within the region: growth is likely to strengthen in Germany, France, and Spain, but Italy could continue to struggle. However, there's an elevated risk that the euro zone's recovery could falter and deflation would set in, further raising the debt burden, which is still quite high in a number of countries. The euro zone's economy is one of the biggest in the world and an important trading partner for most countries. Therefore, any significant deterioration in the region's economy would negatively affect all parts of the world.

In 2015, emerging markets should continue to account for the largest share of global GDP growth. China, the most important emerging economy, is forecast to maintain its growth rate

of around 7 percent. A sharp slowdown in the real estate sector and the huge negative impact that such a slowdown would have on China's financial sector are the biggest risks to a generally optimistic outlook. The slowdown in China has been a headwind for the rest of emerging Asia, although it is still likely that Asia will outperform other regions. China is also a major consumer and importer of commodities, so a crisis there would significantly affect commodity-exporting countries. China's measured slowdown has already led to declines in commodity prices.

Lower commodity prices have dampened the outlook for many countries in Latin America, where growth is unlikely to improve much from 2014's low levels. Moreover, Brazil's expected economic weakness would hold down the growth rate for Latin American countries as a group. Similar to Brazil, Russia's economic malaise will likely continue, as the recent decline in oil prices adds to the pressures from sanctions and the central bank's tightening of monetary policy to stem inflation. The forecast for growth in India, on the other hand, is that it will accelerate.

One of the most important risks to emerging markets in 2015 will be the tightening of U.S. monetary policy, which may lead to economically damaging capital outflows, which happened in 2013.

As we look ahead to 2015, the risks to the global economy are abundant. The outlook is for continued rising prosperity in most parts of the world, with global growth on par or slightly up from this year. ■

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