BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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Global growth remains sluggish

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The global economy is expected to grow by a full 3% annually in 2017–2018, i.e. only slightly faster than in 2016. World trade growth will remain slow relative to GDP growth, as in recent years. In the United States and China, economic growth will continue to be strong and will sustain global growth. A slight rise in the oil price will support gradual economic recovery in Russia. Euro area growth is expected to remain relatively brisk, driven by domestic demand. Brexit will cast a shadow over the growth outlook, particularly for the United Kingdom but also to some extent for the rest of Europe. Emerging economies will continue to develop at a relatively steady pace during the forecast period and are not expected to be much affected by the dip in European growth.

Brexit took financial markets by surprise

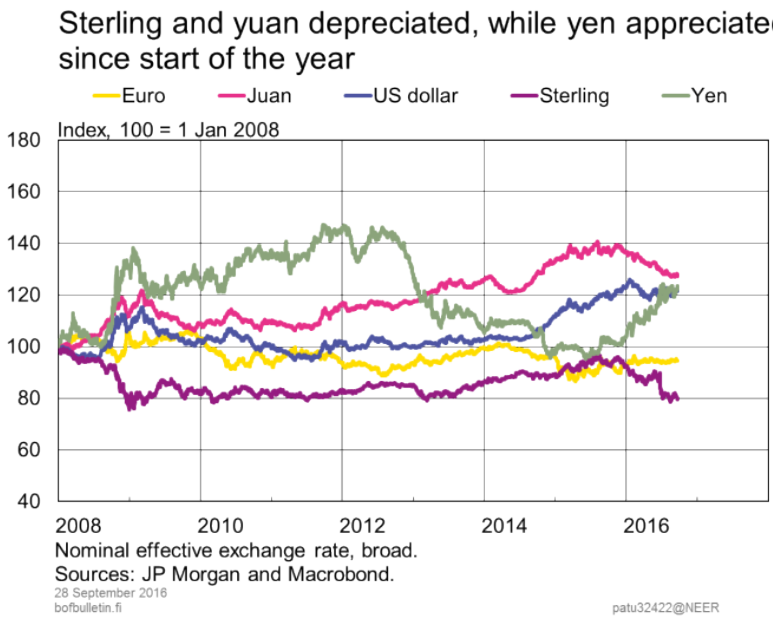
The first interest rate rise in the United States in December 2015 heightened concerns about the emerging economies in early 2016. This related particularly to the depreciation of emerging market currencies against the US dollar, which substantially increased the debt burden in domestic currency terms of companies holding debt denominated in US dollars.

So far, the first US interest rate hike has not been followed by others, and concern about the emerging economies has currently eased somewhat, reflected in rising share prices on both US and emerging markets. According to many analysts, the US economy has (at least) almost achieved full employment, and inflation – although still slightly below target – has picked up notably since 2015. Despite lacklustre GDP growth in early 2016, the US economy is projected to remain on its growth path.

Chart 1.

The tranquillity on the financial markets ended in late June with the UK referendum vote in favour of leaving the EU, which took the markets by surprise. However, except for the exchange rate impact, the immediate financial market effects of the Brexit vote were short-lived, and the markets have already mostly recovered. This recovery was buttressed by a substantial package of stimulus measures announced by the Bank of England in early August. However, the trade-weighted exchange rate of the pound sterling, which had already depreciated slightly prior to the referendum, has remained well below pre-referendum levels, while long-term-term sterling rates are lower than before.

Chart 2.

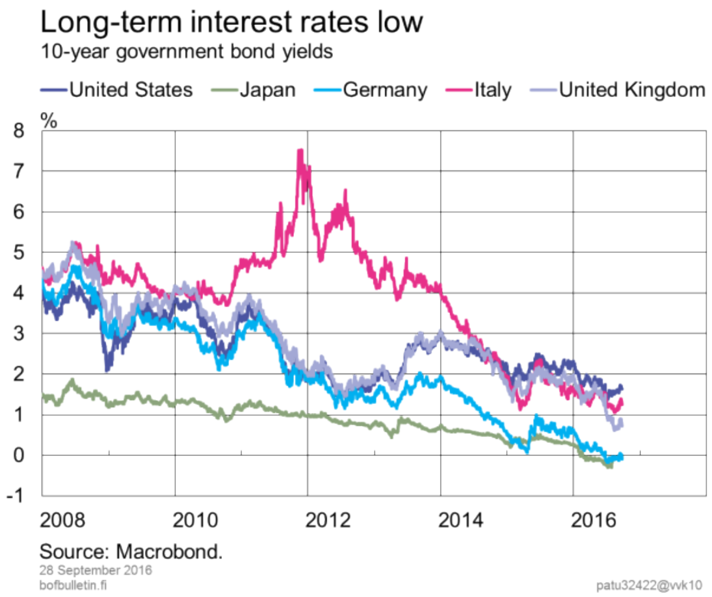


The longer-term growth prospects for the advanced economies have remained subdued, due e.g. to low productivity growth, while long-term interest rates have plunged to a record low during the course of 2016. The price outlook also remains subdued. Markets expect major central banks to keep their respective monetary policies accommodative for a prolonged period, although interest rates in the United States are expected to rise slightly. The European Central Bank (ECB) relaxed its monetary policy stance significantly in March. In September, the ECB Governing Council stressed that the measures will remain in place until it sees a sustained adjustment in the path of inflation consistent with its inflation target.

In Japan, growth and inflation trends have been particularly lacklustre, and additional measures have also been adopted by the Bank of Japan. Regardless of the monetary accommodation, the trade-weighted exchange rate of the yen has appreciated strongly in the course of 2016. By contrast, the trade-weighted exchange rate of the Chinese yuan has depreciated slightly since the start of the year. The Chinese economy performed steadily during the early part of the year.

The continued abundant supply of oil has kept the price of oil low, at just under USD 50 per barrel in early autumn. In the forecast period, the oil price is assumed to climb to around USD 55 per barrel, on average, in 2018. See Oil markets seeking a new balance.

Chart 3.



Global growth picks up only slightly

The global economy is projected to grow by a full 3% annually in 2017–2018, i.e. only slightly faster than in 2016. The outcome of the Brexit referendum and the expected lengthy negotiations over the exit process will cast a shadow over the growth outlook over the forecast period, particularly for the United Kingdom, but also to some extent for the rest of Europe. See Three months after the Brexit vote – the current state of play.

The immediate financial market volatility following the Brexit vote announcement was relatively short-lived, however. The impact of Brexit on the cyclical forecast is, therefore, mainly reflected in trade flows: UK imports will contract substantially in the immediate years ahead, cutting back European exports to the United Kingdom as well as investments in the export industry. In the forecast, Brexit is, on a European scale, a minor, slightly adverse shock to growth and inflation over the forecast years. This assessment is, nevertheless, subject to downside risks of the emergence of more profound and widespread implications for Europe and the global economy as a whole.

Euro area growth is also dampened by internal problems that are unrelated to Brexit, such as the renewed deterioration in the growth outlook for Italy and the difficulties of the Italian banking sector.

In the United States and China, economic growth will continue to be strong, and this will sustain global growth. After a temporary slowdown in 2016, US growth is projected to climb to a full 2%. China will see a controlled moderation in growth, in response to the restructuring of the economy away from investments towards private consumption. The Brexit-induced dip in the European economy will not have any notable effects on US and Chinese growth. The rate of US inflation is expected to increase to around 2%.

In the EU22 countries (euro area, UK, Sweden and Denmark) inflation trends are polarised: euro area inflation will pick up in the forecast period but still remain below the medium-term objective of just under 2%. The acceleration in inflation is stronger in the United Kingdom than in the euro area, with the Brexit-induced depreciation of the pound sterling fuelling import price inflation.

Japan's economic policy challenges will be considerable during the forecast period, and unless substantial changes are made to economic policy, the growth and inflation outlook will remain very subdued. However, due to the ageing of the population, the ratio of GDP growth to the working-age population will be reasonably good.

A slight rise in the price of oil will support economic recovery in Russia, with the pace of growth in the Russian economy picking up to around 1.5% in 2018.

The emerging economies will continue to perform at a relatively steady pace during the forecast period and are not expected to be much affected by the dip in European growth. Having been exceptionally lacklustre in 2016, world trade is projected to gather some momentum in the forecast period. As in the past few years, world trade growth will, nevertheless, remain slow relative to GDP growth throughout the forecast period.
See Why has world trade slowed?

Table 1.

GDP and the change in world trade

% change on previous year (previous forecast below)

GDP	2015	2016f	2017f	2018f
United States	2.6	1.6	2.3	2.2
	(2.4)	*(2.2)*	*(2.3)*	*(2.2)*
EU22	2.0	1.7	1.3	1.6
	(1.7)	*(1.6)*	*(1.8)*	*(1.8)*
Japan	0.6	0.4	0.9	1.0
	(0.5)	*(0.4)*	*(0.7)*	*(1.2)*
China	6.9	6.5	6	5
	(6.9)	*(6)*	*(6)*	*(5)*
Russia	–3.7	–1.0	1.0	1.5
	(–3.7)	*(–3)*	*(0)*	*(1)*
World	*2.9*	*2.8*	*3.1*	*3.1*
	(2.8)	*(2.8)*	*(3.2)*	*(3.2)*
World trade	2.3	1.5	3.2	3.5
	(1.4)	*(2.7)*	*(3.8)*	*(4.0)*

f = forecast

EU22 = euro area, Sweden, Denmark and UK.

Source: Bank of Finland.

Table 2.

Inflation in key economies

% change on previous year (previous forecast below)

Year	2015	2016^f	2017^f	2018^f
EU22	0.0	0.4	1.4	1.5
	(0.0)	(0.2)	(1.2)	(1.6)
United States	0.1	1.1	2.1	2.2
	(0.1)	(1.0)	(2.3)	(2.2)
Japan	0.8	–0.1	0.6	1.0
	(0.8)	(0.2)	(1.5)	(1.4)

f = forecast

EU22 = euro area, Sweden, Denmark and the UK.

Sources: National statistical authorities and calculations by the Bank of Finland.

Brexit dampens growth in Europe

For the United Kingdom, Brexit marks a great change, the full extent of whose implications will only be seen many years ahead. UK growth in 2017 will notably be much below pre-referendum forecasts. Against this backdrop, euro area, Swedish and Danish exports to the United Kingdom will decrease, which, at the same time, will reduce investments particularly in the export industries of these countries and slightly drag on growth.

The effects of Brexit are, however, shrouded in major uncertainties. In addition to the trade effects, Brexit may have several other implications for the economies of the euro area, Sweden and Denmark that have not been captured by the baseline forecast.

Euro area growth is expected to continue at a relatively brisk pace, driven by domestic demand, despite a minor slowdown in 2017. Growth will be buoyed by an accommodative monetary policy and a broadly neutral fiscal policy over the forecast period. Continued growth will support employment gains and boost inflation in the forecast period.

However, the slight moderation in growth due to Brexit will hamper euro area recovery and add to the fiscal challenges of many countries. The euro area public debt-to-GDP ratio will decline only marginally over the forecast period. Of the big euro area countries, the economic outlook for Italy in particular looks highly subdued, not least owing to the problems in the country's banking sector.

Overall, Brexit has a significant impact on the Bank of Finland's most recent forecast for the real economy of the EU22 countries. The growth forecast for the United Kingdom has been subject to the strongest downward revisions, but the effects of Brexit will also erode growth in other EU22 countries. Due to the downward revision of the forecast, the output gap, i.e. the difference between potential and actual GDP, will be wider than before at the end of the forecast horizon. EU22 inflation will still be low in 2016, but will accelerate in the years to come.

US economic growth and inflation gather pace

Industrial output and investment growth in the United States have been weak for more than a year already, which is above all related to the adjustment of the minerals industry to the low oil price. Oil production has been curtailed and overcapacity in the sector wound down, and this has also been reflected in many related sectors.

The contraction in investment in the minerals industry has been drastic. In the second quarter of 2016, the volume of investment was nearly 50% down on the year before and more than 62% lower than three years earlier. The forecast is based on the assumption that this adjustment is now largely completed, which will greatly improve the conditions for industrial output and investment growth.

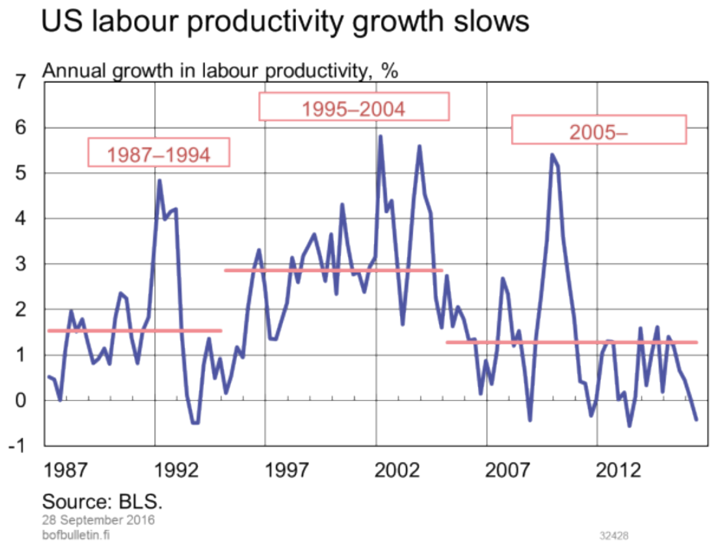
Owing to the weakness of the first six months of the year, GDP growth will reach only 1.6% in 2016 but will climb to 2.3% and 2.2% in 2017 and 2018, respectively. In the current year, growth will hinge on private consumption, but over the next couple of years it will also be supported by both fixed investment and housing investment. The growth contribution of net exports will remain weak throughout the forecast period, with the strong dollar bolstering imports and eroding exports.

The labour market has performed well and the unemployment rate has already dropped to slightly below 5%. Consumer price inflation will remain just above 1% in 2016, but is projected to rise above 2% next year already, as economic growth begins to revive and the oil price effect subsides.

US economic growth is hampered by slow improvements in productivity. Labour productivity growth has edged down for more than ten years already, but notably so during the past few years (Chart 4). In the second quarter of 2016, labour productivity even declined on the year before.

The deceleration in labour productivity growth also concerns a large group of countries other than the United States. The phenomenon may be partly related to unsatisfactory investment in the renewal of production capacity. However, the poor performance of total factor productivity is considered a more important explanation than subdued investment. Several explanations for this phenomenon can be found in the research literature, such as delays in the introduction of new technologies and their slower diffusion, as well as the fading of dynamics in the operating environment for non-financial corporations, e.g. in the face of slower reallocation of work and capital from unproductive to more productive sectors.

Chart 4.

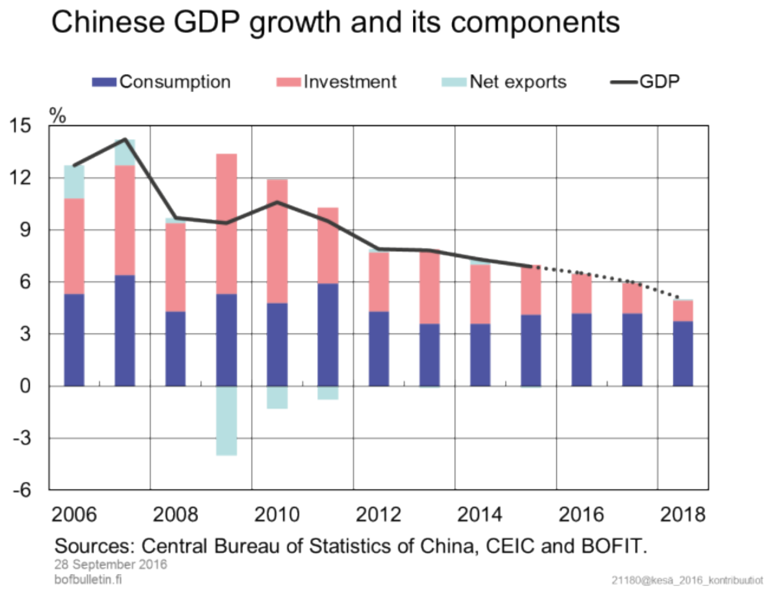


Chinese growth loses momentum amid mounting risks

In China, GDP growth to date in 2016 has been faster than expected, driven by the government's stimulus policy. Accordingly, the GDP growth forecast for 2016 was revised up from 6% to 6.5%. Growth prospects remain unchanged, however, and growth is expected to fall back to 6% in 2017 and 5% in 2018.

The deceleration in growth reflects a variety of factors, including contraction of labour, slower improvement in productivity and the ongoing process of economic restructuring that depresses investment growth. In the years ahead, the economy will be mainly bolstered by a stable and strong increase in domestic consumer demand. Consumer price inflation is expected to remain moderate, while monetary and fiscal policy are expected to remain accommodative.

Chart 5.



Concerns about economic developments in China have increased further and scenarios pointing to a much faster-than-predicted deceleration in growth cannot be ignored. The financial sector, in particular, is being put to the test. Corporate debt accumulation remains very high, with the debt concentrated in overcapacity sectors and inefficient state-owned companies, many of these with difficulties fulfilling their obligations and with meagre future prospects. In addition, the performance of many state-owned companies has weakened and an increasing number of companies have very high interest expenditure relative to earnings.

The large shadow banking sector blurs the picture of the financial sector and makes supervision more challenging. The links between financial sector participants have also increased, facilitating the spread of potential individual problems to other participants.

The forecast expects investment growth to slow steadily. In 2016, growth in investments has been largely government-driven, while annual growth in private real investment has been depressed. Considering that investment accounts for nearly half of the Chinese economy, a much faster-than-projected slowdown in investment growth would have a tangible effect on the economic outlook.

On the political front, the situation is difficult, with the liberalisation of the economy and the tightening of internal policy (including stricter and broader censorship, increasing internet restrictions and supervision of civil society) on a collision course. It also appears that members of the Chinese government do not see eye to eye on the focus of economic policy. While some are in favour of sustaining strong growth in line with official growth targets, others are pushing for reforms that would probably cause growth to fall below official targets in the short term. Foreign policy risks have also been increased by the situation in the South China Sea.

Growth and price outlook for Japan remains lacklustre

In Japan, economic growth remains lacklustre. The strong appreciation of the yen is eroding the cost competitiveness of the export sector, thus weighing on exports. Additional challenges are posed by the more sluggish growth in world trade and the moderation in growth in China, Japan's main trading partner.

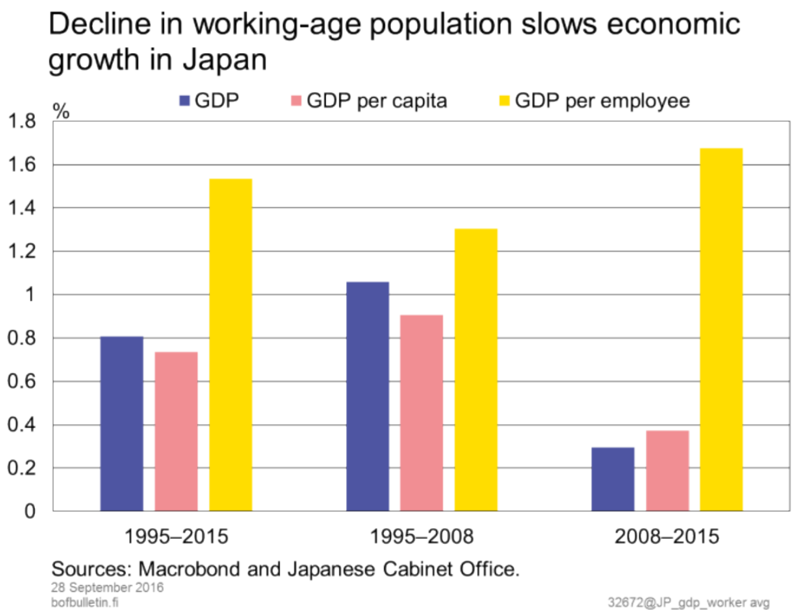
Domestic demand has also been muted. Private consumption growth continues to be restrained by moderate earnings development. Nominal wages have risen slightly and real earnings have been improved by the low inflation. However, this has coincided with an increase in the labour force share of low-income part-time and temporary employees, which erodes the total wage bill of the economy and, hence, growth in purchasing power.

Corporate appetite for domestic investment is, in turn, dampened by the ageing and shrinking of the Japanese population. Corporate profits are record high, but instead of making domestic investments, Japanese companies are seeking rather to expand abroad in search of brighter prospects.

In fact, growth in Japanese domestic demand will largely hinge on public consumption in the immediate years ahead. The Japanese government is endeavouring to boost economic growth by pursuing an expansionary fiscal policy. This expansionary fiscal stance, however, increases the indebtedness of the country and adds to the longer-term challenges of achieving debt sustainability.

As well as the economic trough, the changing demographic structure, too, weighs on economic growth. The elderly share of the population is increasing, while the working-age share is declining. In fact, measured against the working-age population, the Japanese economy has grown relatively briskly (Chart 6).

Chart 6.



Consumer price inflation has turned negative again in the face of lacklustre economic growth, a stronger yen and a persistently low oil price. The weakness of domestic demand has pushed core inflation down close to zero. The rate of inflation will continue to be moderate in the immediate years ahead, as inflation expectations are muted, the inflation-fuelling consumption tax increase was deferred until 2019 and no significant depreciation of the yen from current levels is foreseen.

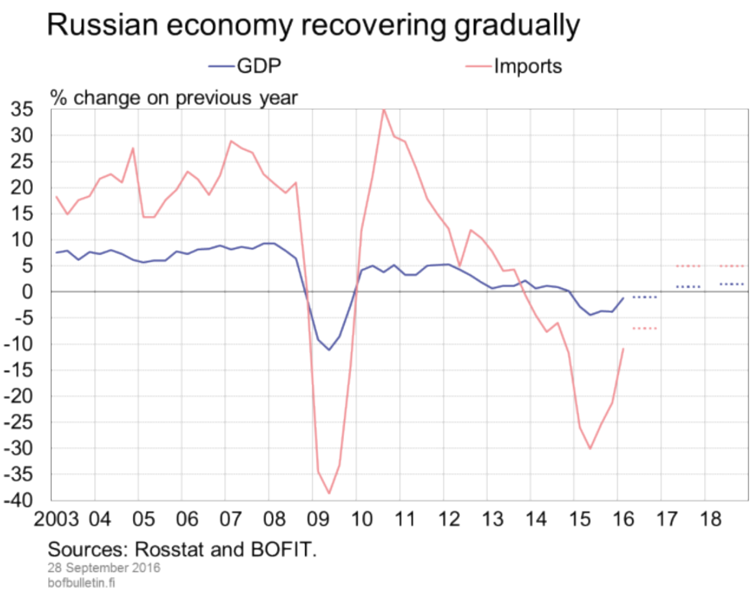
The Bank of Japan continues to pursue a highly accommodative monetary policy. At its September meeting, the central bank refined its strategy and, among other things, announced a shift of monetary policy focus towards a yield curve objective. The primary aim is to keep long-term 10-year sovereign bond yields close to zero. The Bank of Japan also announced that it would continue to expand the monetary base until it sees a sustainable increase in the rate of inflation above the 2% target.

Forecast for Russian economy revised slightly up

The Russian economy will contract slightly less in 2016, and recover slightly faster in 2017, than foreseen in the Bank of Finland's March forecast. This reflects the higher price of oil and the weak real exchange rate of the rouble, which has been substantially weaker in 2016 than a year earlier. Therefore, Russian imports have contracted to an unusually great extent relative to the GDP slide.

Russian GDP is down by 1% in 2016, while imports are down by 7%. Over the years 2017-2018, the economy will gradually recover in step with the rise in the oil price and the revival in imports. However, growth will be sluggish, considering that the long-term growth forecast remains unchanged (1-1.5% per annum).

Chart 7.



Russian exports are expected to gradually emerge from the dip witnessed in 2016. Private consumption will recover from the collapse in 2015–2016, with slower inflation bolstering growth in purchasing power. The increase in consumption is restricted by the slow improvement in productivity, which narrows the scope for private sector wage increases.

Fixed investments are expected to revive only slowly. This is partly related to the uncertainty surrounding the longer-term outlook for the economy. The volume of investments has been contracting ever since the beginning of 2013.

Central government expenditure will decline much less in real terms in 2017-2018 than in 2016, even assuming that the announced budget deficit reduction targets are met. The significance of monetary policy for economic recovery is likely to remain negligible.

Forecast risks remain elevated. Oil price developments may take a different path than assumed, and geopolitical risks cannot be ruled out. As before, the effects of these factors may pass through very quickly, particularly to the rouble, the rate of inflation and imports. The decline in people's living standards and the political pressures faced by the country's leaders may result in a more favourable development in central government expenditure than projected.

Tags

- forecast
- global economy
- gross domestic product
- inflation