

Weekly Economic Briefing

24 April 2014

Uneven improvement

In its most recent World Economic Outlook, published earlier this month, the IMF forecasts global economic growth to accelerate to 3.6% in 2014, from 3% in 2013. This improvement is expected to be driven mostly by the developed economies, where growth is projected to rise from 1.3% to 2.2%, although they also anticipate that growth in emerging markets will edge up to 4.9% from 4.7% (see table 1). Growth close to 5% would constitute the third weakest outturn of the past decade, with emerging markets still accounting for around two-thirds of global growth.

With the first quarter of the year now behind us, how realistic are the IMF's forecasts? For the advanced economies the projections are looking quite good. Euro-zone indicators are consistent with a moderate but increasingly secure recovery, even in the periphery. The UK economy continues to go from strength to strength, which has forced the IMF to admit that it badly misjudged the outlook last year. Japan started the year strongly, although this is mostly due to activity being pulled forward in advance of April's sales tax hike. It will be a few months before the economy's underlying strength becomes clearer. The US is the one major developed economy where activity has disappointed in the first months of the year. However, the available indicators for March suggest that this was mostly due to bad weather in January and February and growth should bounce back in Q2. The forecasted improvement in emerging markets is more in doubt, partly because developed economy growth is proving less import intensive than in the past, but also because their own fundamentals are less favourable than before the crisis. The IMF is expecting the Chinese economy to grow by 7.5% this year, but activity will have to accelerate strongly in Q2 to hit that target after expanding at less than a 6% annualised pace in Q1. Official sector forecasts are also looking a touch optimistic in India. The current account deficit is coming down but some of this adjustment is coming via weaker domestic demand; similar forces are at play in Turkey. The Russian outlook is clouded by the conflict with Ukraine. If there is any further deterioration, Putin may find that he has precipitated a recession. What price conquest?

Table 1: IMF growth forecasts

Real GDP % p.a.	Advanced Economies					Emerging Markets					
	Agg.	US	EZ	Japan	UK	Agg.	China	India	Russia	Brazil	Turkey
2013	3.0	1.9	-0.5	1.5	1.8	4.7	7.7	4.4	1.3	2.3	4.3
2014 (f)	3.6	2.8	1.2	1.4	2.9	4.9	7.5	5.4	1.3	1.8	2.3
2015 (f)	3.9	3	1.5	1	2.5	5.3	7.3	6.4	2.3	2.7	3.1

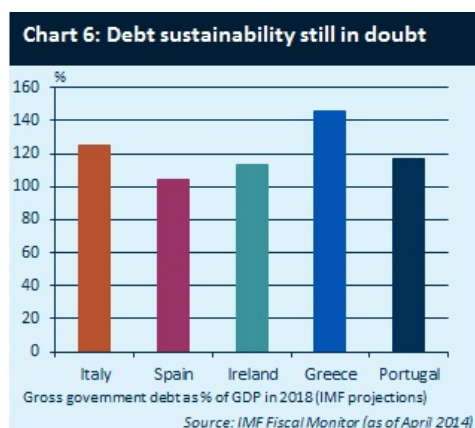
Footnotes: Agg. denotes aggregate for advanced/emerging economies, EZ denotes Euro-zone, (f) denotes IMF forecast

Source: IMF World Economic Outlook (as of April 2014)

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Go for gold!

Against the backdrop of a deflation scare in the Euro-zone, **it is easy to lose sight of the fact that activity rates in the currency union actually strengthened over the first quarter of the year.** Indeed, we continue to see the “moderate recovery” expected by the European Central Bank (ECB) taking hold, following the shift out of recession this time last year. The European Commission (EC) Economic Sentiment Indicator has increased steadily over Q1 and currently signals the strongest activity rates seen since 2011 (see chart 5). Industrial production has been firm, despite the impact of unseasonably warm weather on energy output, with the manufacturing sector in particular providing cause for encouragement. Purchasing Managers’ Indices in the region have generally strengthened over recent months, with the services sector close to a three-year high in March. Overall, these data suggest that GDP growth could hit 0.5% quarter-over-quarter (q/q) in Q1, the strongest reading seen during the recovery thus far.



However, there are reasons to believe that the upturn will remain moderate in the Euro-zone. Firstly, there looks to be a significant amount of spare capacity in the region, which will weigh on domestic demand. This is certainly true in terms of the labour market, with many parts of the currency union still experiencing chronically high unemployment rates. While there have been tentative signs of a return to employment growth, we do not expect to see unemployment fall rapidly. This has knock-on effects for domestic consumption which is likely to remain subdued. It is always difficult to discern how much spare capacity there is in industry. The EC measure of capacity utilisation in the manufacturing sector suggests that it is still comfortably below pre-crisis levels. This puts less pressure on Euro-zone firms to invest, given the lack of constraints on production. Secondly, the export channel does not look sufficiently powerful to single-handedly generate a robust recovery. We have noted in previous editions that the relationship between global growth and international trade is likely to be weaker during the current economic cycle. Furthermore, the strength of the euro erodes competitiveness, making any export-led recovery more difficult.

Is a moderate recovery really good enough? Inflation data suggest not. **Despite the recent improvements in economic activity, we continue to see signs that price pressures in the Euro-zone are softening.** This partly reflects temporary factors such as the euro exchange rate and international commodity prices. It also indicative of weak domestic cost pressures, as the surfeit of spare capacity weighs on price growth. While this may not in itself trigger outright deflation, a low inflation environment is still troublesome for highly indebted countries (see chart 6). The ECB has the ammunition to speed things up. Additional stimulus would allow member states to extinguish the spare capacity in their economies more rapidly and would also bolster the competitiveness of exports by weakening the euro. This would improve the outlook for growth and, in turn, inflation across the region. Finally, this nominal growth mix would support member states struggling with sovereign debt mountains, if accompanied by fiscal restraint.

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