Global Outlook: Stable Growth as Uncertainty Wanes

BY STEPHEN CICARELLA — AUGUST 3, 2017

www.economy.com
Global Outlook: Stable Growth as Uncertainty Wanes

By Stephen Ciccarella
AUGUST 03, 2017

View the Moody's Analytics Global Forecast.

- Growth in the euro area has surged amid heightened confidence and stronger trade.
- Economic momentum in the U.K. appears to be slowing amid Brexit uncertainty.
- China's economy is exhibiting sustainable growth and is expected to meet its official growth target.
- Japan is gaining traction, but stagnant wages will put a lid on domestic demand and keep inflation muted.
- Moody's Analytics forecasts global growth to be 2.8% in 2017 and 2.9% in 2018.

The global expansion will accelerate in 2017, driven by increased fiscal stimulus measures in developed economies, stabilizing commodity prices, and more robust global trade.

A series of favorable electoral outcomes in Europe has reduced political uncertainty, elevating business and consumer confidence. Key support for global growth will come from China and the U.S. Proposed fiscal policy measures by the Trump administration, albeit less expansive than earlier anticipated, are expected to provide a near-term boost in real GDP growth from 1.6% annualized in 2016 to 2.4% in 2017. The euro area will also contribute to growth through momentum in domestic demand, which increased robustly in the first quarter. Increasing global demand in developed economies will boost growth in export-oriented emerging markets.

**Euro area activity surges**

Economic activity in the euro area has surged as political uncertainty from high-stakes elections in the Netherlands, Austria and France earlier this year has abated and Italy's banking crisis appears contained. While Europe awaits the German election, and potentially elections in Italy, Eurosceptic sentiment has diminished but remains a concern.

Highly accommodative monetary policy, stronger trade activity, and multiyear highs in business and consumer confidence have boosted both the external sector and domestic demand, increasing euro area real GDP by 0.6% q/q in the second quarter, or 2.1% y/y, its best rate in five years. Accelerating growth in Spain and France contributed primarily to the gains, while real GDP for Germany and Italy will be reported in mid-September.

Although the euro area performed above expectations in the first half of 2017, we do not believe this rate of growth is sustainable. The IHS Markit Flash Composite PMI moved lower for a second consecutive month to 55.8 in July, a six-month low, from 56.3 in June, which could be a warning sign.

The euro has strengthened by 12% against the dollar so far this year, undermining the price competitiveness of the euro zone's exports. Ten-
year German government bond yields, a European benchmark, have surged around 30 basis points in recent months.

Although the euro zone’s jobless rate dropped in June to an 8½-year low of 9.1% from 9.2% in May, the high share of underemployed part-time workers and discouraged workers remains a concern. Without more job openings and a lower unemployment rate, wages won’t increase much and domestic consumption will stay in the doldrums. The expected slowdown in trade with the U.K. and possible U.S. protectionist measures pose further threats.

While the labor market may be putting upward pressure on core inflation, we don’t believe the European Central Bank is ready to significantly change its expectations for near-term monetary policy and will remain extremely accommodative. The euro zone’s preliminary harmonized consumer price index was up 1.3% on a year-agio basis in July, matching the increase in June. However, core inflation came in a touch better than expected, rising 1.3% y/y compared with 1.2% in June.

Core inflation in the euro zone remains low, and the appreciation in the euro over the past few months could put more downward pressure on core inflation soon. The ECB expects core inflation to average 1.1% this year and 1.4% in 2018. While the ECB is likely to turn slightly more hawkish later this year, we expect it to maintain its bond-buying program until mid-2018 and keep its main refinancing rate at current settings at least until mid-2019. Inflation will have to show clear signs that it is coming in hotter for the ECB to adjust its expectations for monetary policy.

We expect y/y real GDP growth in the euro area to accelerate from 1.7% y/y in 2016 to 1.9% in 2017, decelerating to 1.6% in 2018. Individual nations in the euro area will continue their divergent growth patterns in 2017. Among the major economies, France and Italy will accelerate, while Germany and Spain will slow.

U.K. economic momentum slowing
While euro area growth has surged amid substantial uncertainty rising from the U.K.’s impending exit from the EU, preliminary second quarter GDP numbers add to the increasing evidence that Britain’s economic momentum will slow sharply this year. Real GDP grew at 0.3% q/q in the second quarter, or 1.7% y/y, half the quarterly growth rate in the euro area. We expect real GDP to decelerate from 1.8% y/y in 2016 to 1.5% in 2017 and 1.2% in 2018.

The second quarter details show that growth depended entirely on services, while factory growth and construction declined. The momentum in services is not expected to last, since its growth was mainly supported by a mean reversion in retail sales, which had plunged in the first quarter.

In addition, the decline in manufacturing confirms our concern that the economy will fail to rebalance from consumption towards foreign trade and investment. We believe manufacturing will get little support from the slump in the pound because manufacturers raised prices rapidly to compensate for higher import costs, offsetting most gains to U.K. competitiveness from the weaker currency. Construction also contracted, suggesting that the recent slowdown in the U.K. economy is broad-based.

We expect the Bank of England’s Monetary Policy Committee to stay put at its August meeting, especially given how inflation surprised on the downside in June. Recent inflation data gave the BoE a breather, as U.K. consumer price growth unexpectedly decelerated in June to 2.6%, from 2.9% previously, marking the first time in nine months that inflation eased.

We still expect inflation to average 2.8% over 2017 and peak at 3% by the fourth quarter, overshooting the central bank’s 2% y/y target and its current 2.7% expectation. But we don’t think this will tempt the committee to change its view that monetary policy should remain supportive, given the weak growth figures. With growth expected to disappoint in coming quarters, as real wages fall and Brexit-related uncertainty persists, the bank likely won’t raise rates until at least the beginning of 2019.

**Sustained growth in China**

China’s GDP rose 6.9% y/y in the second quarter, identical to its first quarter result, driven by healthy domestic demand and a strong external sector.

The world’s second largest economy is expected to easily meet the 2017 GDP target of 6.5% to 7% growth. The government sounds increasingly confident that the economy is moving in the right direction and will focus on financial market stabilization ahead of the important 19th National Party Congress in November.

At the twice-a-decade National Financial Work Conference in mid-July, President Xi Jinping announced the creation of a cabinet-level committee to coordinate financial oversight amid the ‘eternal theme’ of preventing systemic risk. The president said China’s government will use prudent monetary policy and prioritize reducing leverage in state-owned enterprises. The nation’s financial markets continue to be in the spotlight, highlighted by MSCI’s decision to include Chinese A-class equity shares in its benchmark emerging market equity indexes, a milestone showing China’s further integration into the global economy.

**Upbeat June data**

The Chinese hard data for June were mostly upbeat. Industrial output rose 7.6% y/y from a 6.5% increase in May. Tech production is
expected to remain elevated in the second half thanks to the rollout of new products. Meanwhile, retail trade accelerated to 11% on a year-ago basis from 10.7% in May thanks to strong income growth.

China's Caixin manufacturing PMI for July was more upbeat about the third quarter than the official PMI, which fell 0.3 point to 51.4, but remained above the neutral 50. The Caixin PMI rose to 51.1 in July, from 50.4 in June, the second straight improvement in manufacturing sentiment. The details were positive, as both output and new orders rose at the fastest pace in five months because of stronger new export sales.

However, firms remain cautious about the length of the upturn and as a result maintained a cautious stance on employment. Business confidence about the next year dipped to an 11-month low. Our outlook calls for real GDP growth in China to accelerate from 6.7% y/y in 2016 to 6.8% this year.

One factor driving growth is the continued use of credit. Bank lending, predominantly used for mortgages, makes up almost 80% of all credit growth in China. This is partly due to the crackdown on forms of shadow financing, but it also reflects the keen interest in property. In the second quarter total social financing was equivalent to 8% of nominal GDP, a share little changed for more than two years. Managing China's debt situation remains a key risk for the economy.

**Japan gains traction**

Japan's economy is gaining traction, boosted by rising exports and an increase in business sentiment, as evidenced by the Bank of Japan's Tankan survey, whose index reached a three-year high in the second quarter. While a weaker yen supported large export-oriented manufacturers, the improvement in sentiment for small businesses was not as robust, reflecting the weak state of the domestic economy.

Wage growth in Japan remains limited despite tight labor market conditions, and unfavorable demographic trends do not support a sustained increase in domestic demand over the medium term. We expect real GDP to be 1% y/y in 2017, similar to the rate in 2016, and decelerate to 0.7% in 2018.

Nonetheless, the June hard data for Japan point to a strong close to the second quarter for Asia's second largest economy. Household expenditure was a particular bright spot, rising by 7.2% y/y in June, the fastest annual increase since March 2014, when spending spiked in anticipation of the following month's sales tax hike. Low base effects are helping lift growth; spending in June 2016 hit a cyclical low. The growth rate of 0.5% m/m is below the 12-month average of 0.6%.

Headline commercial sales were similarly upbeat, rising 2.1% y/y, but the details are less so. Spending has been lifted by rising fuel costs at the pump, and sales of discretionary items remain subdued given stubbornly soft wage growth.

Japan's unemployment rate fell to 2.8% in June, down from 3.1% in May. The labor market tightened further in June, as evidenced by the jobs-to-applicants ratio rising to 1.51, from 1.49 in May. Job growth in medical-related industries remains strong because the country's aging population demands more and higher-quality health services.
The laggard in the data was inflation. Core consumer prices, which exclude fresh food, rose 0.4% y/y in June, unchanged from May's pace. Core prices were flat on a monthly basis. Core-core prices (excluding food and energy) were flat over the month and in annual terms. What little inflation occurred in consumer prices over the past few months has been mostly driven by global commodity prices, and that effect looks to be fading. Price growth outside energy is essentially zero.

Japan's manufacturing sentiment cooled somewhat in July. The manufacturing PMI was 52.1, following 52.4 in June. Nevertheless, this marks the 11th straight month of improvement in operating conditions for Japan. While overseas tech demand remains strong, respondents reported slower orders. As a consequence, new export orders rose for an 11th straight month, but at the weakest pace so far, and July marked the first time since January that new work outstanding had fallen.

Despite cooling conditions, Japanese manufacturers remained upbeat; the Future Output Index reached a series record high with many citing the 2020 Tokyo Olympics for the new business potential.

**Risks are to the downside**

Moody's Analytics forecasts global real GDP growth to be 2.8% in 2017 and 2.9% in 2018. While expected fiscal stimulus measures will accelerate global growth, risks to the outlook are tilted to the downside.

After unprecedented monetary accommodation in developed economies following the global financial crisis, there is vulnerability that removal of accommodation could lead to market volatility. A wider U.S. deficit could also increase demand for protectionist trade policies. While political uncertainty in Europe has diminished, Eurosceptism remains a concern, as geopolitical tensions related to terrorism and North Korea hang over the global economy.
About Moody's Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. With its team of economists, the company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research, and financial risk management. By offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

Concise and timely economic research by Moody’s Analytics supports firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our economic research publications provide in-depth analysis of the global economy, including the U.S. and all of its state and metropolitan areas, all European countries and their subnational areas, Asia, and the Americas. We track and forecast economic growth and cover specialized topics such as labor markets, housing, consumer spending and credit, output and income, mortgage activity, demographics, central bank behavior, and prices. We also provide real-time monitoring of macroeconomic indicators and analysis on timely topics such as monetary policy and sovereign risk. Our clients include multinational corporations, governments at all levels, central banks, financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Moody's Analytics added the economic forecasting firm Economy.com to its portfolio in 2005. This unit is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.