European Economic Network
EUREN

EUREN-News

3|2015
01|09|2015

Editorial: China and the World Economy

After having been an engine of the world economy for years, China now is sending out worrying signals. The slowdown of growth in particular in the industry sector seems to be more pronounced than expected, and share prices at the Shanghai stock exchange are tumbling.

Of course, these developments as well as the coincident devaluation of the Renminbi are by no means good news for the international economy. However, for several reasons it is far from clear, how strong the negative impact on global growth will be. Firstly, stock markets in China do not play the same role as they do in advanced economies, neither for the financing of investment nor for private saving. Thus the consequences for domestic demand in China will be limited. Secondly, a decline of share prices may increase volatility in the stock markets of other countries, but it will not cause a worldwide crash. Thirdly, lower Chinese demand for raw material is associated by declining raw material prices and will, thus, lead to terms of trade gains for net importers of raw materials. These gains will partially offset negative impulses coming from China. Therefore, the latest news from China most probably do not mark the start of a new global economic crisis.

Nevertheless, there is no reason to go back to normal. Most influential for the rest of the world will be the trade channel. China's share in global imports has jumped from 3.4% in 2000 to 10.4% in 2014. In future, this share could decline, because slower growth will be associated by a less buoyant growth of import demand. This effect could be accentuated, if the growth pattern in China will, as it is the plan of the government, shift in favour of consumption goods and services, which can be assumed to show lower import shares compared to capital good.

For the advanced economies the consequences will mixed. They will lose via declining exports, but since most of them are raw material importers, the also will experience measurable terms of trade gains. However, some industries such as car manufacturers could face hard times since they have become increasingly dependent the on Chinese market in recent years.

For the emerging markets, the negative effects can be expected to dominate. Many of them are raw material exporters and hence will suffer from lower prices. At the same time, in particular Asian countries often are suppliers to the Chinese manufacturing sector. Finally, they could be hurt by the devaluation of the Renminbi, since they compete with Chinese producers more often than producers in advanced economies do.

To some extent, these negative effects have already become visible in recent years, in which growth of world trade has been unusually low. A regional break down of the change in trade dynamics shows that it was mainly caused by the emerging markets. In the years to come, these effects could become stronger, if the Chinese economy will grow slower and to a higher extent driven by the domestic demand.

Contact: Roland Döhrn // doehrn@rwi-essen.de

UK: Will policy normalization derail the expansion?

Having endured a lacklustre recovery in the aftermath of the global financial crisis, and then been further damaged by the fallout from the Eurozone crisis in 2011-12, the recent performance of the UK economy has been more respectable. GDP growth of 3% in 2014 represented the strongest performance in the G7 and there looks to be a good chance that the UK will remain in the lead in 2015. But this improved performance has come against the backdrop of extremely stimulative policy settings, with Bank Rate still at 0.5% and a budget deficit of almost 5% of GDP. So the obvious question is whether the UK economy can continue to sustain these growth rates while also normalizing policy?

The robust performance during 2014 was founded on the strength of the domestic economy, where both the consumer and investment played key roles. In contrast, net trade disappointed, wiping around 0.6 percentage points (ppt) off of growth. These trends have continued into 2015 and, if anything, the two-speed nature of the economy has become more pronounced. In particular, the preliminary estimate of GDP growth for Q2 2015 reported firm growth in services output (+0.7% q/q), with those sub-sectors with strong links to the consumer doing particularly well, while manufacturing output contracted (-0.3% q/q) for the first time in more than two years.

If sustained, such a lack of balance would present a clear risk to the sustainability of the upturn. However, there are good reasons to believe that at least the worst of the excesses will be temporary.

The recent consumer strength has been founded on a robust improvement in household spending power, which still has some time to run. We expect CPI inflation to remain close to zero until the latter part of this year, with the odd negative reading likely. And while it should then rise back above 1%, once the base effects associated with last year's collapse in the oil price have begun to kick in, underlying pressures remain subdued so we expect to see inflation remain well below the 2% target throughout 2016. When combined with stronger wage growth, as a result of a tightening labour market, it should deliver a substantial boost to household spending power. As a result, we expect consumer spending to grow by 3.3% in 2015 and 2.8% in 2016.

However the momentum behind consumption is likely to weaken from 2017 as the deep cuts to in-work benefits announced in July's 'Summer Budget' are introduced. The Chancellor has announced plans to reduce spending on welfare by £12bn (0.7% of GDP) through a variety of measures, including: reducing the benefit cap from £23,000 to £20,000; halving the income threshold above which housing benefit and tax credits are progressively withdrawn and significantly increasing their rate of withdrawal; limiting child benefits to the first two children for new claimants after 2017-18; freezing working age benefits for four years from 2016-17; and ending automatic entitlement for housing benefit for those aged 18-21.

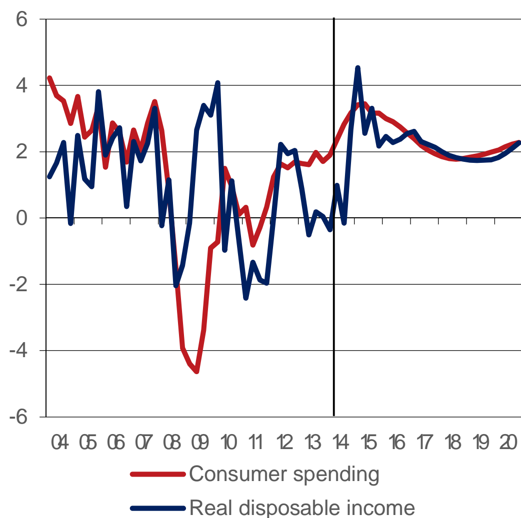
The Chancellor effectively forced companies to take on greater responsibility for supporting low-income households by combining the slashing of in-work benefits with the announcement of a new compulsory 'Living Wage' for those aged 25 and over. This will be introduced from next April at a rate of £7.20 an hour, with the intention of reaching £9 an hour by 2020. Achieving that £9 goal will require raising the present adult National Minimum Wage (NMW) by an average of 6.1% per year from 2016, well above the 4% average rise recorded since the NMW was introduced in 1999. Though there is likely to be some offset in the form of lower employment, this should increase income from wages and salaries amongst the lower paid. But overall,

we judge that the boost from the living wage is likely to fall short of the damage to household incomes from lower benefits. As such, household income growth is likely to slow, meaning that consumer spending growth cools to just 2% a year from 2017-19.

Graph 1

Consumer spending and income

% year



Source: Oxford Economics, Haver Analytics

One benefit of the greater focus on finding savings from the welfare bill is that it enabled the Chancellor to smooth out the departmental spending 'rollercoaster' that had emerged in the March Budget. But while the planned path of government spending is higher than before over the next five years, with the Chancellor determined to move the budget into surplus by the end of the parliament, fiscal policy as a whole will remain a sizeable drag on growth going forwards.

This desire to move the government sector into surplus means that another sector(s) will need to move into deficit. With the household sector likely to be reluctant to releverage – and banks and regulators likely to be similarly unwilling to allow them to – the corporate sector looks like the most likely candidate.

In this respect we are cautiously optimistic. The corporate sector is in a strong financial position, with profitability close to previous peaks and firms' cash holdings at record levels. And with the broader outlook brightening, firms have found the confidence to start making use of these funds; the data for Q1 showed the corporate sector running its fourth consecutive quarterly deficit, following 46 quarters of surpluses. Providing that confidence remains robust, we expect corporates to continue to run financial deficits, as they use their accumulated cash piles to fund strong business investment growth.

The relatively upbeat outlook for business investment is likely to be echoed in terms of residential investment. Though the housing market has cooled over the past year this has not deterred house builders, with residential investment up 9.6% on a year earlier in Q1. With government support schemes set to run for another year and demographics creating a strong flow of demand for housing, builders should have sufficient confidence to continue this strong recovery in house building. This will provide direct support to economic growth, as well as helping to keep a lid on house prices.

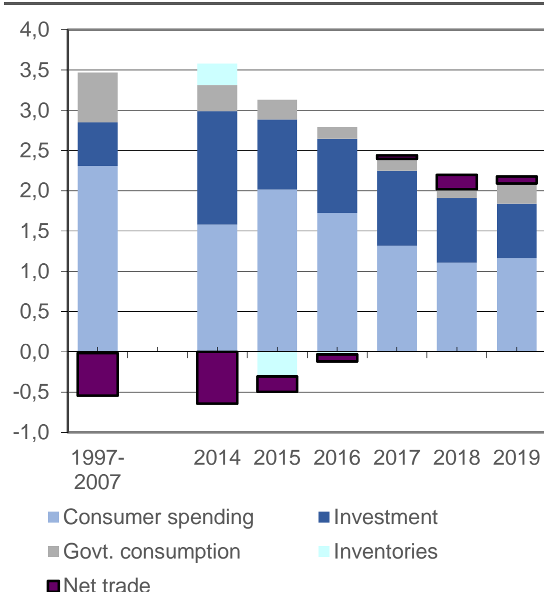
There is a much bigger question mark over whether net trade can step up to the mark. Business survey data suggest that the 10% appreciation of sterling against the euro since the start of 2015 has driven a substantial weakening in export order books. With divergent monetary policy prospects set to drive a further appreciation against the euro, at least in the short-term, it is difficult to see this situation improving markedly in the near future, although the prospect of the Federal Reserve moving earlier, and more aggressively, than the Bank of England at least suggests that sterling should weaken a little against the dollar.

Our forecasts do assume that both the US and Eurozone economies strengthen over the coming two years, which should provide some support to UK exports. But we do not expect net trade to make any meaningful contribution to GDP growth.

Graph 2

Contributions to GDP growth

Percentage points



Source: Oxford Economics, Haver Analytics

Therefore, it seems likely that once the boost from cheaper oil has started to wear off, GDP growth is likely to slow. We expect GDP to grow by 2.6% this year and 2.8% in 2016, before slowing to average 2.4% a year from 2017-19. The silver lining to this slowdown is that growth should become more balanced, at least from a domestic point of view.

Against this backdrop the Monetary Policy Committee (MPC) of the Bank of England will have to tread very carefully in normalizing monetary policy. The MPC has been sending mixed messages of late, with a series of hawkish speeches being followed by a relatively dovish Inflation Report and minutes in August.

We think it most likely that the MPC will make the first increase in interest rates in Q2 2016, by which time inflation will have started to move decisively away from zero, the Bank's measure of slack will have been largely eroded and some of the global uncertainties should have lessened.

However, we believe that there is a good case for the MPC to wait longer. As the MPC themselves acknowledge, the appreciation of sterling has already tightened monetary conditions without them having to. Furthermore, we believe that the MPC is under-estimating the degree of spare capacity in the economy, so there is more scope for keeping rates low without causing the economy to overheat. With the very tight fiscal stance also dictating that monetary

Table 1

UK forecast

Annual percentage change unless specified

	2014	2015	2016	2017	2018	2019
Domestic demand	3.5	2.8	2.8	2.4	2.0	2.1
Private consumption	2.6	3.3	2.8	2.1	1.8	1.9
Gross fixed capital formation	8.6	5.0	5.2	5.1	4.4	3.6
Change in inventories[1]	0.8	0.5	0.4	0.4	0.4	0.4
Public consumption	1.6	1.2	0.7	0.7	0.5	1.3
Exports of goods and services	0.5	4.6	3.6	5.0	5.1	4.5
Imports of goods and services	2.4	4.8	3.6	4.4	4.2	3.9
GDP[1]	3.0	2.6	2.8	2.5	2.3	2.3
Industrial Production	1.8	1.3	1.0	1.1	1.1	1.1
Consumer price (CPI)	1.5	0.0	1.4	1.8	1.8	1.9
Current account balance (% of GDP)	-5.9	-5.4	-4.5	-3.7	-3.0	-2.5
Government Budget Balance (% of GDP)	-5.3	-3.4	-2.1	-1.4	-0.4	0.3
Short Term interest rate (%)	0.5	0.6	0.8	1.3	1.8	2.3
Long Term interest rate (%)	2.6	1.9	2.4	2.9	3.3	3.7
Exchange rate (US-Dollar per £)	1.65	1.53	1.50	1.49	1.49	1.49
Exchange rate (Euro per £)	1.24	1.39	1.41	1.40	1.37	1.34

OEF Forecast

conditions need to remain relatively loose, even if interest rates do start to rise from early-2016, it is hard to envisage them rising by more than 50bps per year.

Contact:

Contact: Andrew Goodwin //
agoodwin@oxfordeconomics.com

Imprint

The European Economic Network (EUREN) is a network of European economic research institutes, which was formed in 1999. Members of EUREN are:
- Centre d'Observation Economique et Recherche pour l'Expansion de l'Economie et le Developpement des Entreprises (Coe-Rexecode), Paris, France
- Centre of Planning and Economic Research (KEPE), Athens, Greece
- Centro de Predicción Económica (CEPREDE), Madrid, Spain
- Institut für Höhere Studien (IHS), Vienna, Austria
- Institute of Informatics and Statistics (INFOSTAT), Bratislava, Slovakia.
- Kopint-Tarki Economic Research Institute (Kopint-Tarki), Budapest, Hungary
- Oxford Economics, Oxford, United Kingdom
- Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen, Germany
- Ref Ricerche, Milan, Italy

Editorial board: Roland Döhrn (RWI), Denis Ferrand (Coe-Rexecode), Jana Juriová (INFOSTAT), Scott Livermore (OEF), Katalyn Nagy (Kopint-Tarki), Fedele de Novellis (Ref Ricerche), Julian Perez (CEPREDE), Ekaterini Tsouma (KEPE), Klaus Weyerstrass (IHS)
Editor of this issue: Roland Döhrn

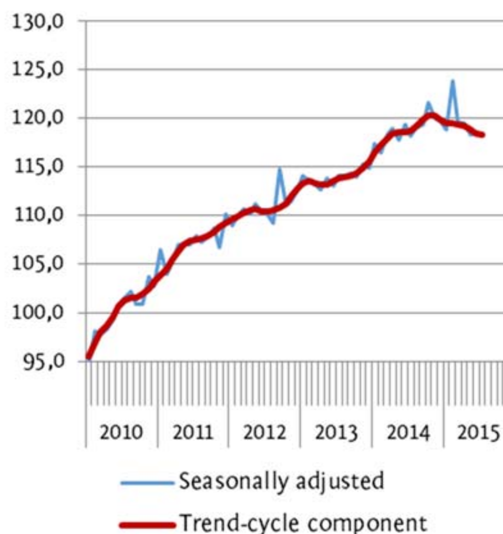
RWI/ISL Container Throughput Index: Continued decline

In July RWI/ISL Container Throughput index was more or less stable compared to June. Its trend-cycle component declined for the ninth month in a row. This can be interpreted as a strong sign that the period of lacklustre world trade is not yet over.

The index is based on data of 81 world container ports covering approximately 60% of worldwide container handling. The ports are continuously monitored by ISL as part of the institute's market analyses. Because a large part of international merchandise trade is transported by ship, the development of port handling is a good indicator for world trade. As many ports release information about their activities only two weeks after the end of the respective month, the RWI/ISL Container Throughput Index is a reliable early indicator for the activity of the global economy.

Updated August 21st, 2015

The data can be downloaded at http://en.rwi-essen.de/forschung-und-beratung/wachstum-konjunktur-oeffentliche-finanzen/projekte/containerumschlagindex/



RWI/ISL calculations. 2010 = 100. July 2015: flash estimate.

Contact: Roland Döhrn || doehrn@rwi-essen.de

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: Sep 1st, 2015

	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4	2014	2015	2016
May-14	1,5;*0,3*	1,4;*0,2*					1,2		
Jun-14	1,4;*0,3*	1,4;*0,2*					1,2	1,5	
Jul-14	1,4;*0,4*	1,7;*0,6*					1,3	1,7	
Sep-14	0,7;*0,3*	1,0;*0,6*					0,8	1,2	
Oct-14	0,6;*0,1*	1,0;*0,6*					0,8	1,4	
Nov-14	0,6;*0,2*	1,0;*0,5*					0,8	1,4	
Dec-14	0,8;*0,3*	0,9;*0,4*					0,8	1,3	
Jan-15	0,8;*0,3*	0,9;*0,3*	0,9;*0,3*	1,1;*0,1*			0,8	1,2	
Feb-15	[0,8;*0,2*]	0,8;*0,3*	1,0;*0,4*	1,2;*0,3*	1,6;*0,7*	1,6;*0,3*	0,8	1,3	1,5
Mar-15	[0,8;*0,2*]	[0,9;*0,3*]	1,1;*0,5*	1,4;*0,4*	1,7;*0,5*	1,7;*0,2*	[0,9]	1,5	1,7
Apr-15	[0,8;*0,2*]	[0,9;*0,3*]	1,1;*0,5*	1,5;*0,5*	1,8;*0,6*	1,8;*0,3*	[0,9]	1,6	1,7
May-15	[0,8;*0,2*]	[0,9;*0,3*]	1,2;*0,6*	1,5;*0,4*	1,7;*0,4*	1,9;*0,4*	[0,9]	1,6	1,7
Jun-15	[0,8;*0,2*]	[0,9;*0,3*]	[1,0;*0,4*]	1,4;*0,5*	1,8;*0,6*	1,9;*0,4*	[0,9]	1,5	1,7
Jul-15	[0,8;*0,2*]	[0,9;*0,3*]	[1,0;*0,4*]	1,5;*0,6*	1,9;*0,5*	2,0;*0,4*	[0,9]	1,6	1,7
Sep-15	[0,8;*0,2*]	[0,9;*0,4*]	[1,0;*0,4*]	[1,2;*0,3*]	1,7;*0,6*	2,0;*0,7*	[0,9]	1,5	1,6

In brackets: GDP data published by EUROSTAT. In italics: quarter on quarter rates.

Waiting for the second estimate of EUROSTAT for the second quarter, the HFM forecasts a qoq growth rate in Q2 of 0.3%. That means some downward revision compared to the estimate presented one month before. For the annual average the model forecast 1.5% for this year and 1.6% for 2016. Looking at the indicators already published for the third quarter, a slight rebound in qoq growth rates for the second half of the year can be expected, that could push up the yoy growth rate to more than 2% at the end of the year. The EUROSTAT data published on September 8th showed an upward revision of GDP rates which makes this scenario even more realistic.

Contact: Julián Pérez || julian.perez@ceprede.es