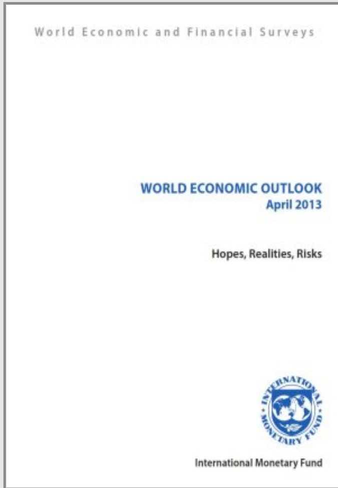

World Economic Outlook April 2013

Hopes, Realities, Risks

Olivier Blanchard
April 2013
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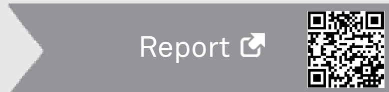

Rating

8 Overall

8 Importance
7 Innovation
7 Style

Focus

- Leadership & Management
- Strategy
- Sales & Marketing
- Finance
- Human Resources
- IT, Production & Logistics
- Career & Self-Development
- Small Business
- **Economics & Politics**
- Industries
- Global Business
- Concepts & Trends

Take-Aways

- The euro zone is dealing with its debt crisis, and the US avoided the fiscal cliff, so a global economic crisis is no longer a threat in the short term.
- Recovery from the recession has split the world's economies into three groups:
- China and emerging markets will lead the way with robust growth as high as 8%.
- The US, flanked by Canada and Japan, will be in the middle, with around 2% growth.
- Europe will lag; euro area economies will shrink in 2013 but grow about 1% in 2014.
- The uneven, three-tiered recovery creates challenges for emerging markets' central bankers who must adjust to avoid overstimulating their economies.
- The medium term presents several risks: a weakening euro zone, growing fiscal imbalances in the US and Japan, and backfiring "unconventional monetary policy."
- Commodity prices should ease in 2013, cutting back 2% from highs in 2012. Food and energy prices will dip in 2013; energy prices will rise slightly.
- As OPEC dictates oil prices and the weather moves food prices, China shapes the metals market, consuming 40% of worldwide metals.
- Inflation, while a medium-term risk, seems to be under control.

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Curated by: The Economist Intelligence Unit

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Relevance

What You Will Learn
In this summary, you will learn: 1) Why the global economic recovery looks secure in the short term, 2) What medium-term risks loom, 3) What the outlook for commodity prices predicts and 4) Why inflation is under control in a volatile world.

Recommendation
The International Monetary Fund has produced a clear outlook for the global economy. The picture is generally bright with a few issues on the horizon. If the global economy were a horse race, there would be three packs: China and emerging markets in front; the United States, Canada and Japan in the middle; and Europe lagging behind. For all the volatility the recession introduced, inflation has hardly shifted, suggesting that perhaps central bankers may have learned how to manage that important part of the economy. Though the paper's language can be stiff at times, it's tempered by the report's eye-catching graphics and illuminating insights. *getAbstract* recommends this authoritative look at the world economy to executives and investors.

Summary

A Three-Pronged Recovery
The global recovery from the recession that started in 2007-2008 split the world's economies into groups: Strong growth in the emerging markets and developing economies coincided with tepid growth in the developed countries. You can view the world now as a three-horse race, with the developing world leading the way, the United States remaining in the middle, and the euro zone bringing up the rear. The IMF expects emerging markets to grow at a pace of 5.3% in 2013 and 5.7% in 2014. China will lead the world with growth rates of 8% in 2013 and 8.2% in 2014. Well back in the pack – all the way behind India, Brazil and Mexico – is the US, with growth of 1.9% in 2013 and 3% in 2014. Canada and Japan are also in this group. The euro area should shrink by 0.3% in 2013 but grow by 1.1% in 2014.

"The global economy is on the mend again...but the road to recovery remains bumpy and uneven for advanced economies."

Regional Aspects
The US economy in 2013 is limping along too slowly to create the millions of jobs that the American labor market demands. But low interest rates and renewed interest in homes and durables will drive its economy in 2014. The US faces crushing debt. The sequester eased concerns about the immediate sustainability of the nation's debt burden, but it's a misguided approach. The fiscal crisis is under control for now, as the housing market bounces back.

"What was until now a two-speed recovery, strong in emerging markets and developing economies but weaker in advanced economies, is becoming a three-speed recovery."

In the euro zone, expect Germany to post growth of less than 1%, while France, Italy and Spain contract. Europe remains mired in "adverse feedback loops between weak banks, weak sovereigns and low activity." Britain's economic proximity to Europe drags it down, but it's outpacing its neighbors across the English Channel. The United Kingdom's growth is expected to hit 0.7% in 2013 and 1.5% in 2014, almost identical to Germany's outlook.

Japan faces a familiar road of stagnant development. After posting 2% growth in 2011, Japan is on pace to turn in 1.6% increases in 2013 and 1.4% in 2014. Dragged down by years of deflation, the country has embarked on a new regime of "quantitative easing" and "fiscal stimulus." Japan's public debt makes this an uncertain proposition, however – hence

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its apparent trajectory of a short-term rise followed by a slower pace of growth. Most of Asia is enjoying a period of low unemployment, tame inflation and strong consumption. For some Asian nations, demand from China and Japan has become as crucial as demand from the US and Europe.

"Given the strong interconnections between countries, an uneven recovery is also a dangerous one."

The uneven, three-tiered recovery creates new challenges for central bankers in emerging markets. There, policy makers must adjust to avoid overstimulating their economies. In the past, developing national economies boomed when commodity prices were high and interest rates were low – only to bust later. Officials in emerging markets seem to have learned how to handle influxes of capital. Modest growth in much of the developed world and slow growth in the euro zone highlights each nation's quirks and prospects.

Hungary and other emerging European countries, weighed down by public debt, will see feeble growth. Poland will advance a modest 1.25% in 2013 and 2.25% in 2014. Because its biggest export market remains the euro zone, weakness there acts as a brake on emerging Europe. Turkey's growth should hit 3.5% in 2013 and 3.75% in 2014. In Latin America and the Caribbean, recovery hinges on financial stability in the US and Europe, and continued demand for commodities from China.

"Among the risks ahead, the most insidious relate to debt overhangs and fiscal deficits in advanced economies and potential output growth and budding financial excesses in emerging markets and developing economies."

Moderate Short-Term Risks

The short-term global forecast bespeaks a crisis averted – the United States didn't plunge over the fiscal cliff; debt crises are not breaking up the euro zone; and emerging markets are not crashing. Some of the more frightening scenarios faded out of the realm of the possible, but oil prices remain a source of short-term volatility. Another risk comes in the form of "adjustment fatigue" in Europe. If European leaders fail to restructure banks and rebuild their financial infrastructure, the resulting loss of confidence could reverberate swiftly through weaker European economies. The US has resolved its budget crisis, but it must raise its debt ceiling in 2013.

"Notwithstanding old dangers and new turbulence, the near-term risk picture has improved as recent policy actions in Europe and the United States have addressed some of the gravest short-term risks."

High Medium-Term Risks

The world economy is improving, but medium-term risks loom. Five major threats that could derail the economy are:

1. **The fallen euro zone can't get up** – The euro zone, though apparently on the mend, remains a forecaster's nightmare. "Sovereign debt burdens," weak banks, low consumer demand, high levels of corporate and personal debt, hefty taxes – all these factors could conspire to dampen investment and put the brakes on the recovery. Europe's weaknesses raise the possibility of a downward spiral of pessimism.

2. **Trouble in the debt-burdened US or Japan** – No longer the most envied players in the global economy, these two giants continue to pursue unsustainable fiscal policies. In the US, political gridlock blocked reforms that could have created a healthier budget situation. Japan's policy makers launched a short-term stimulus without a medium-term plan for sustainability. The two lumbering titans must handle their deficits and debt as risk-averse investors snap up their bonds. Investors may be spooked by the two nations' rickety political situations, but as long as the US and Japan can lure investors while paying low interest rates, the picture will be sunny. But if the risk calculus changes, even a small jump in interest rates could create big ripples in the world economy.

"Risks are still high in the medium term...and tilt to the downside."

3. **A surprise bout of inflation** – Price spikes remain a wild card. A sudden bout of inflation, such as the one the US experienced in 1994, seems improbable. Gradually

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rising prices do seem likely. Central banks learned from the mistakes of the 1970s and early '80s, when US policy makers waited too long to control inflation and then hefty rate hikes shocked the economy. A more measured, less abrupt, response seems more likely today. Inflation is far less volatile than in the past.

"The bumpy recovery and skewed macroeconomic policy mix in advanced economies are complicating policymaking in emerging market economies."

4. **"Unconventional monetary policy" backfires** – The years after the recession have seen rock-bottom interest rates and atypical monetary policies. This combination produces risky lending and high leverage. Economists fret that emerging-market companies are borrowing heavily and taking loans in foreign currencies. A swift reversal of capital flows to emerging markets could wreak havoc. The Federal Reserve, Bank of Japan and Bank of England have been acquiring long-term debt securities. Selling them too quickly could unsettle markets or spur inflation.

5. **"Emerging market risk"** – While the developing countries have led the world in growth, that growth is slowing. Disappointing growth could turn off the spigot of investment and capital inflows, and the output of the BRICS – Brazil, Russia, India, China and South Africa – could shrink. The developing world could, for the first time, bring the global economy into recession.

"In many emerging market and developing economies, credit and activity are propelling each other."

Commodity Prices

The IMF commodity price index peaked in April 2011, then fell until June 2012. Since then, commodity prices have risen, driven by a recovering economy and supply disruptions. Weather issues pushed cereal prices up 10%, while lower OPEC production goosed energy prices 15%. Metal prices jumped 10%. But commodity prices should ease in 2013; overall, they will be down 2% from 2012.

Energy prices have swung widely: From June 2012, oil prices have jumped 19%, and US natural gas has soared 35%. Energy prices will dip nearly 3% in 2013 as a result of the strong growth of sources in North America. Geopolitical tensions are an ever-present force in oil prices, and turmoil in the Middle East and Africa could constrain supply. The US's sanctions against Iran and unplanned production interruptions in the North Sea have pushed up crude oil prices. New sources of energy also are an unknown: A surprise jump in shale gas production, for instance, could cause oil prices to fall. Price patterns vary by region, too. In Japan, liquefied natural gas prices rose after the Fukushima nuclear disaster, then fell, although prices remain high. European natural gas prices dipped as a result of weak demand, and coal slipped amid environmental concerns.

"There are a number of risks to the outlook of falling commodity prices – beyond those of weaker or stronger growth in the global economy and...in emerging markets."

Global demand for oil expanded by 1%, or 0.9 million barrels a day, in 2012. In 2013, emerging markets will account for all the growth in demand of about 0.8 million barrels a day. World oil supplies expanded by 2.5 million barrels a day in 2012, outpacing demand. The biggest factor was Libya's return to oil production. Supply won't exceed demand forever – OPEC has set $100 a barrel as its target price, indicating that the oil-producing nations are keen to rein in production.

"The lengthy period of very low short-term interest rates and unconventional monetary policies may encourage unduly risky lending, balance sheet mismatches and high leverage."

Food prices are forecast to dip by 2% as weather patterns return to normal and harvests improve. As always, weather is the wild card governing food prices. Corn is especially vulnerable to price spikes because of low supplies. Food prices are down from record highs in 2012, when a drought in Eastern Europe and central Asia, along with a sweltering summer in the US, hampered corn and wheat output. Rice prices, by contrast, have held steady for several years. Food and oil prices have become intertwined, as biofuels suck up excess crops once headed to dinner tables. Increasingly, ethanol and biodiesel use up corn and soybeans.

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Metal prices fell for much of 2011 and 2012 before recovering as demand rose in China. Expect these prices to rise 3% in 2013, pushed higher by Chinese buying. Just as OPEC dictates oil prices and the weather moves food prices, China shapes the metals market, consuming 40% of worldwide metals, though "growth in China's metal demand is expected to be moderate." Using futures contracts to hedge metal prices has proven to be ineffective. Copper prices doubled in 2009 and 2010, yet copper futures foretold a price move of only 3%. Futures markets for energy are more reliable than futures markets for metal.

"We find a dog that did not bark...Inflation has been remarkably quiet of late."

Inflation

During a recession, inflation historically plunges. But after the recession, inflation barely budged. The recession's legacy – "structural" unemployment – may explain this outcome. In a typical recession, the vastly greater number of unemployed people competing for fewer jobs dampens inflationary pressures on wages. But, as has happened recently, if job seekers, particularly the long-term unemployed, lack fresh skills to compete for available jobs, they have no impact on the wages of the employed, and thus none on prices.

A second theory holds that inflation has become less volatile partly because central bankers have grown more adept at staving it off. Inflation and people's expectations can become self-perpetuating cycles. Usually, if workers expect prices to rise, they demand raises, and employers pass on the resulting higher labor costs by upping prices. In long-term, low-interest-rate environments, however, inflation becomes "stickier." Because workers hate pay cuts, producers are reluctant to cut prices even in the face of falling demand.

"The combination of anchored expectations and credible central banks has made inflation move much more slowly."

Inflation can become "disanchored" – that is, prices can respond in unexpected ways. In the 1970s, the US suffered the illogical combination of rising unemployment and rising inflation. At the time, many central bankers didn't understand how to control inflation. President Richard Nixon imposed wage and price controls, which failed. The Federal Reserve had toiled for decades under the belief that the biggest threat to prosperity was 1930s-style unemployment and deflation, so the Fed wasn't especially concerned about inflation in the decades after World War II.

US inflation came under control only after President Jimmy Carter appointed Paul Volcker as Fed chairman. Volcker ran an independent central bank and tamed inflation. By contrast, Germany weathered the 1970s with less inflation, partially because of the impact on monetary policy of the catastrophic 1920s hyperinflation and of Germans' collective memory. As a result, Germany's central bank, the Bundesbank, stayed independent and made fighting inflation its top priority, so much so that a Bank of England governor once labeled it an "inflation nutter." But the inflation nutter bested the Federal Reserve in controlling inflation during a volatile time.

"Inflation has been muzzled. And, provided central banks remain free to respond appropriately, the dog is likely to remain so."

About the Author

Olivier Blanchard is economic counselor and director of research at the International Monetary Fund.

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