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The Voice of German Industry

GLOBAL GROWTH OUTLOOK

Trump`s dollar.

New chapter for global economy

January 2017

- **The global economy is set to pick up substantially in 2017.** Growth is expected to reach 3.5 percent, gathering pace by 0.5 percentage points. Global trade should accelerate by three to four percent. The German economy will grow by 1.5 percent.
- **The biggest impetus is likely to come from the United States as of the summer.** The Trump administration and Congress are planning to cut corporate and income tax and step up defence spending. These developments will increase the federal budget deficit and the current account balance accordingly. The new protectionism harbours big dangers, however.
- **Under Donald Trump, the dollar is expected to surge by five to ten percent against the main global currencies in the course of the year.** At least initially we will see increased volatility in the currency exchange rates. Adjustments will be fuelled by transatlantic differences in economic and interest rate development as well as profit repatriation.
- **This will moderately boost net exports and investment in the euro area and Japan, further consolidating economic recovery in the EU.** The downward pressure on the renminbi, in contrast, will hamper China's stabilisation efforts.
- **In key emerging countries, rising interest rates and an appreciating dollar will increase vulnerability to high dollar debt in the private sector.** High-dollar debtors will face increasing financial risks.

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Sluggish global economy in 2016

The world economy is expected to finish 2016 with flat growth. The first six months of the year, with assumed average growth of 2.9 percent, were only an imperceptible improvement on the 2.8 percent seen in the second half of 2015 (IMF 2016a). A similarly minute improvement is likely to have occurred in the second half of 2016. With around three percent real growth in economic output in 2016, no greater momentum was seen than in the previous year. Industrial production gathered pace by around two percent, staying flat in industrialised countries while picking up by four percent in emerging countries. The purchasing managers' indices pointed to stagnation for a long time, before rallying slightly towards the end of the year. In the emerging countries, economic activity will strengthen this year.

Forecast summary: Growth in real GDP 2016/17/18

	2016			2017			2018		
	IMF[1]	OECD[2]	EU-COM[3]	IMF[1]	OECD[2]	EU-COM[3]	IMF[1]	OECD[2]	EU-COM[3]
World	3.1	2.9[4]	3.0	3.4	3.3[4]	3.4	3.6	3.6	3.5
USA	1.6	1.5	1.6	2.3	2.3	2.1	2.5	3.0	1.9
China	6.7	6.7	6.6	6.5	6.4	6.2	6.0	6.1	6.0
Japan	0.9	0.8	0.7	0.8	1.0	0.8	0.5	0.8	0.4
EU			1.8			1.6			1.8
Euro area	1.7	1.7	1.7	1.6	1.6	1.5	1.6	1.7	1.7
Germany	1.7	1.7	1.9	1.5	1.7	1.5	1.5	1.7	1,7
France	1.3	1.2	1.3	1.3	1.3	1.4	1.6	1.6	1.7
Italy	0.9	0.8	0.7	0.7	0.9	0.9	0.8	1.0	1.0
Spain	3.2	3.2	3.2	2.3	2.3	2.3	2.1	2.2	2.1
UK	2.0	2.0	1.9	1.5	1.2	1.0	1.4	1.0	1.2
India	6.6[5]	7.4	7.4	7.2[5]	7.6	7.4	7.7	7.7	7.5
Brazil	-3.5	-3.4	-3.1	0.2	0.0	0.9	1.5	1.2	1.5
Russia	-0.6	-0.8	-1.0	1.1	0.8	0.6	1.2	1.0	0.8

1: IMF (January 2017),
2: OECD (November 2016)
3: European Commission (November 2016)
4: Forecast on the basis of 70 percent world GDP (PPP of 2013)
5: Information on India for the fiscal year in current prices

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Global economy in weak equilibrium

Throughout the last year, the global economy remained stuck in a weak equilibrium of low growth in demand, weak investments and low productivity growth rates (OECD 2016, Ollivaud et al. 2016, IMF 2016a). As in the previous years, the markets in 2016 once again had to downwardly revise their growth forecasts in the face of persisting post-crisis effects such as faltering bank systems accompanied by financing difficulties for the private sector, demographic aging in industrialised countries and China, and weak productivity trends. The unexpectedly low growth in productivity indicates reduced future growth potential, goes hand in hand with a lower equilibrium interest rate, dampens expected earnings, keeps inflation below expectations and considerably complicates the monetary and fiscal policy of most national economies. One of the effects of this syndrome has been a drastic correction in expectations for the most important financial market price, the key interest rate of the US FED. Four years ago, the market predicted that the interest rate would now be at two percent, far above its current level of 0.5 to 0.75 percent (IMF 2016a).

Disappointing performance of industrialised countries

With around 1.6 percent economic growth in real terms, industrialised countries performed below expectations, in particular the United States were private consumption was the only factor driving growth. Growth in developing and emerging countries stabilised the overall level of growth to just over four percent. In a rare constellation, the euro area and the United Kingdom rounded off the year with higher growth than the US and Canada.

Companies and the financial markets have already acclimatised to the low rate of growth since 2013. Expectations regarding future demand and earnings remained modest, as did investments. Government bond yields were correspondingly low in Japan and Europe, as they were in the US until the autumn. With 2.3 percent growth, global trade once again lagged behind overall economic production in 2016. Employment, at least, posted moderate growth with unemployment dropping slightly across the board.

Inflation remains weak

In this kind of environment, inflation barely managed to make any headway in climbing to the target rates set by the central banks. Industrialised countries closed the first half year with 0.5 percent inflation, following 0.3 percent in 2015. No momentum was seen in emerging countries either. Very low key interest rates and quantitative measures are still required in most regions. Core inflation rates, however, trod water. The US is the only region showing any signs of normalisation. The commodity prices created some buoyancy. While prices for oil surged by 50 percent, coal by over 30 percent and for commodities (metals and foods) over ten percent, gas prices dropped slightly due to high-level production in Russia and weak Asian demand. The oil market in particular was shaped by slumps in production. Prices here were gradually recovering from their ten year low at the start of the year.

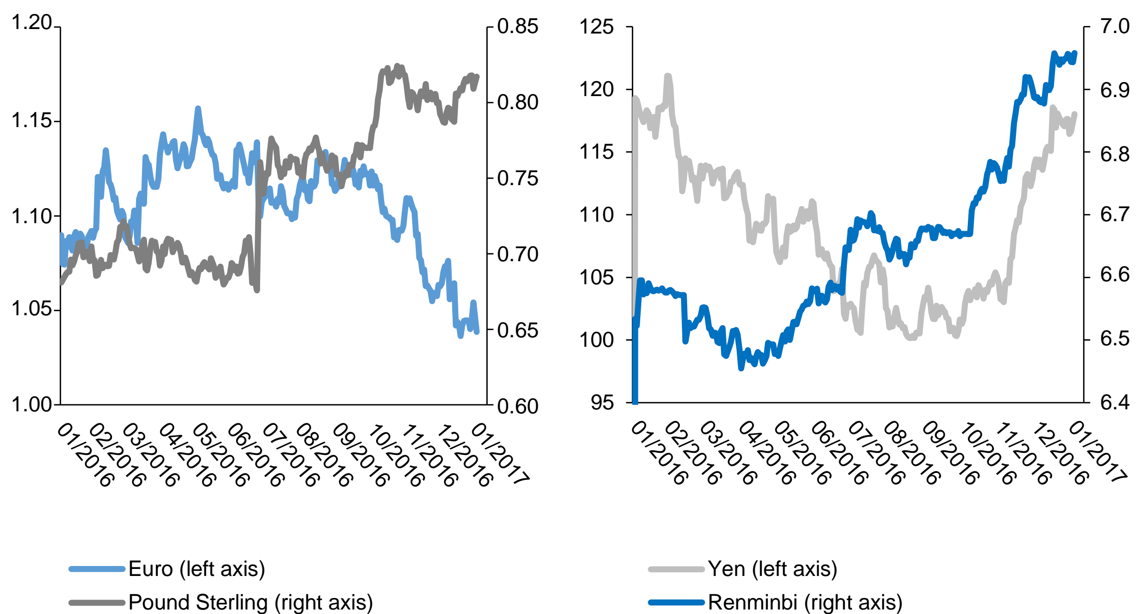
Monetary policy provided support, financial policy remained neutral, no sign of structural reform

The last two years of flat economic growth have been shaped by a macroeconomic policy mix that is now likely to come to an end. The central banks of the major economic regions stuck to their rigorous expansion strategy, achieving some success in terms of monetary stabilisation and growth stimulation. Fiscal policy remained largely neutral overall, with minor regional divergences. Structural reform remained a rarity despite the various G20 commitments agreed to by the major economies. All in all, monetary policy was the only stabilising force, or “the only game in town” (El-Erian 2016). This rightly led the central banks to call for more support through fiscal policy and structural reform.

Foreign exchange markets calmed down in the course of the year – except the British pound

Following the turbulence in currencies at the start of the year, Chinese macroeconomic stabilisation in the spring restored some calm to the foreign exchange markets down until the outcome of the UK referendum on EU membership triggered a major devaluation of the pound. The external values of the Brazilian, Japanese and Russian currencies recovered in line with the economic situation, while the Chinese renminbi, though remaining stable against the currency basket used as a guide, still slipped six percent against the dollar.

Development of the exchange rate to the US-dollar



Source: Macrobond

Weak recovery in the United States

The world's largest economy continued its moderate course of recovery in 2016, though real growth remained slow and is expected to clock in at 1.5 percent. Following two extremely weak quarters at the beginning of the year with quarter-on-quarter growth at 0.2 and 0.3 percent respectively, the economy only gathered pace in the third quarter with 0.8 percent growth. The weak performance in the first six months was due to low energy prices, scant activity in the energy sector, and the strong dollar impacting on industrial value added and exports. Further exacerbating factors were weak capital investment in equipment and inventory reductions by business. The pickup seen since the summer has been fuelled by private consumption, minor growth in net exports, federal expenditure and inventory effects, while investments and spending on the other government levels curbed growth. In the first three quarters overall, growth fell well short of the expectations of the majority of observers at the start of the year.

Weakest post-war upturn ever, but recovery on the labour market

All in all, it can be said that since 2009, the US economy has experienced its weakest post-crisis recovery of the entire post-war period. With growth averaging at 2.1 percent since the second quarter 2009, it is 0.7 to five percentage points below the ten other upswing phases recorded since the Second World War. This is a clear indication of the gravity of the 2008/09 crisis. Growth potential also continued to drop, due both to demographic change and insufficient investments. Hourly productivity has only increased by just over one percent in the last two years, which is only half the rate seen in the six decades prior to the major crisis of 2008/09. On a positive note, the labour market continued its upward trend, performing better than could be expected given the meagre overall economic growth. Employment is estimated to have risen by 1.7 percent in 2016. Unemployment dropped to 4.6 percent, which the FED regards as a long-term viable level. There is still, however, a high level of involuntary part-time work. Public budgets managed to reduce the federal deficit to a sustainable level, but overall the public deficit remained constant at a problematic 5.5 percent of economic output. Government debt increased to around 116 percent. In view of the foreseeable demographic burdens for the social security system in the United States, medium-term consolidation efforts on all government levels and a consistent pro-growth policy for infrastructure, innovation, education and integration into the labour market are not only required but are absolutely essential.

FED driven by courage and poor data

Given the muted economic data, the FED pursued its expansionary monetary policy. The core inflation rate increased slightly by a quarter point to reach 1.7 percent, but the inflation rate itself remained at 1.2 percent in September, well behind the target rate of two percent. Although FED chair Yellen had signalised fiscal tightening repeatedly throughout 2016, the data ultimately did not encourage swift action. The weak level of investments, industrial production and net exports, the disappointing growth in productivity, demographic trends, and above all the structural decline in the labour force participation rate, which has dropped from over 67 percent in 2001 to around 63 percent today – primarily due to a growing number of persons retiring from working life or reducing their labour contribution – and low wage growth severely constrained the upward trend in prices. It was only in December 2016 that the FED hiked its benchmark interest rate by another quarter point to a corridor of 0.5 to 0.75 percent. It signalled that three further interest hikes are likely in the course of 2017. The FED decision-makers are also anticipating that, on average, price increases will gather pace slightly in the course of 2017.

Fiscal and structural policy did not help growth in 2016

Fiscal policy also failed to provide momentum for growth, while structural reform to increase productivity and investment has not been seen in the US for years due to political blockades. The FED thus signalised several times in the course of the year that it would be good to temporarily inject the US economy with a somewhat larger dose of expansion than usual to strengthen growth, while not falling below fiscal tightening requirements (Yellen 2016a, b, Fischer 2016, see also Hooper et al. 2016 on the debate). The FED may yet change its tactics in light of the election of Donald Trump as the next US president and the effects this has triggered on the financial markets. The surge in the dollar and clear increases in capital market yields already seen on the one hand and the fiscal stimulus on the other will need to be considered very carefully with regard to their overall impact on inflation and full employment, requiring the FED to strike a fine and difficult balance. President Trump could also exert influence through the appointment of two vacant governorships. Furthermore, the term in office of the chair and vice chair of the board of governors expires in 2018.

China's political economic cycle

Throughout 2016, the Chinese economy largely followed the political stipulations and monetary and financial policy stimulus measures issued at the start of the year. Growth in real economic output is estimated to be at

6 ¾ percent for 2016, as we had already forecast at the start of the year. The inflation rate is currently at the very low level of just over two percent.

Sharp structural transformation

China's structural transformation towards an economy based more strongly on services and the domestic market showed rapid progress in 2016. Investments pointed the way, with investment in fixed assets increasing by slightly more than eight percent year on year until October. Industrial investment, on the other hand, only rose three percent, while investment in services boomed, shooting up by 19 percent year on year. Construction investments recorded nominal growth of over seven percent. In some cities, prices for commercial property and high-end apartments rose sharply yet again. In response, the Chinese leadership took regulatory measures to throttle lending to the property sector. Private investment, which accounts for over 60 percent of total investment, only increased by a meagre three percent, while state-owned enterprises expanded their investments by a good 20 percent. This shows that the trend is being driven by industrial policy efforts and the economic stimulus packages in infrastructure. Following a long period of trending sideways at a stagnant level between March and August, the purchasing managers' indices pointed clearly upwards from September onwards, with services recording values of just under 55 and thus already in a strong phase of expansion. Producer prices also bottomed out this summer from their downward trend of several years and picked up slightly. Private consumption also posted solid growth at just under nine percent in comparison to the previous year in nominal terms. Chinese foreign trade, on the other hand, moved sideways in 2016. The overall volume stayed almost constant until October, with exports dropping by 3.2 percent in national currency and imports increasing by the same percentage.

Balance of payments showing symptomatic weak points

While real economic growth stemmed to a high degree from state-triggered structural transformation with little drive coming from the private sector, the problems in the financial sector and in the balance of payments remain serious. China's monetary policy is aimed at stabilising the renminbi against a basket of currencies. And the renminbi did, in fact, remain stable against the basket in 2016. Against the dollar, however, the currency dropped in value by over six percent. In real and trade-adjusted terms, the renminbi was also down, depreciating four percent in the first ten months of the year. While emerging countries experienced portfolio capital inflows in 2016 overall, China battled against a syndrome of official and informal capital outflows. Firstly, Chinese companies had to continue settling substantial dollar debt. Secondly, companies appear to have taken the "go abroad" policy of 2016 somewhat too literally and embarked on an international shopping spree of hotels, sport and recreational facilities, real estate and service providers. While Chinese companies are estimated to have acquired assets and participations abroad for around 170 billion dollars in 2016, foreigners overall sold more assets than they bought in the country. Informal capital exports via the various available channels also escalated once again. Foreign currency reserves dropped sharply at the beginning of the year, then stabilised for the next few months before once again coming under substantial pressure after the summer. It is highly likely that the government actively supported the foreign exchange markets. This situation prompted the leadership to step up interventions in current account transactions and transactions on the capital account of balance of payments. It is thus not clear at present to what extent foreign companies are permitted to transfer earnings, while the authorisation requirements for the international activities of Chinese enterprises on key strategic industrial and technology acquisitions have been slimmed down. In view of the foreseeable appreciation of the US dollar, the Chinese currency will be facing increasing pressure in 2017, although individual drivers have been curbed by the government for the time being through regulation.

Chinese leadership likely to accept slighter lower growth

2017 is set to be a politically decisive year in China, with the first significant power shuffle among the Chinese leadership under Xi Jinping scheduled for November. For this reason, it will be essential to stick to the political business cycle in order to keep the good economic news rolling. A slight slowdown in growth between 6 ¼ to 6 ½ percent should be tolerated by the leadership as this is compatible with the long-term targets. Given the continued slightly excessive growth rate in borrowing, which again rose by well above ten percent in comparison

to the previous year, the Chinese leadership is bound to make further use of financial leverage in 2017. The credit-to-GDP ratio has increased steadily and steeply from 120 percent in 2010 to its current level of 160 percent. The IMF has repeatedly warned that the medium-term financial risks of Chinese policy are serious and are likely to trigger a shock adjustment with substantially lower growth (IMF 2016a). These problems could have a faster impact via the dollar than would be opportune for the Chinese leadership on account of the global consequences of Donald Trump's anticipated economic policy and the subsequent accelerated adjustment in US monetary policy. Increased interventionist countermeasures are therefore to be expected in China's foreign trade relations. This in turn presents a certain risk to growth in itself. It is not without reason that the Economist has pointed out that the vicious circle of expected depreciation, capital outflows and increasing capital controls could have a negative impact on economic growth within the space of a year and thus also affect politically sensitive targets for the important year 2017 and it is therefore expected to be managed with the greatest degree of rigour (Economist 2016). The zombification of the Chinese economy is therefore expected to continue in future.

Europe's economy posts moderate but stable growth

The upturn in the EU and in the euro area has remained surprisingly stable despite a large number of external and internal risks. The unexpected outcome of the US presidential election and geopolitical tensions on the one hand and the results of the British and Italian referendums on the other have pulled growth down slightly. In 2016 growth was at 1.8 percent in the EU and 1.7 percent in the euro area (European Commission 2016a). For 2017, growth is expected to be slightly lower at 1.6 percent for the EU and 1.5 percent for the euro area. The European Commission's spring forecast (2016b) had predicted 0.3 percent higher growth for both regions. The biggest driver of growth in the EU is still private consumption, which is expected to contribute 0.9 percentage points to growth in 2017. The contributions of public sector spending and investment are predicted to be 0.3 and 0.5 percentage points respectively. The trade balance is expected to add zero percentage points to growth. Unemployment rates are still trending downwards, having dropped from their highest levels of eleven percent in the EU and twelve percent in the euro area in 2013 to currently slightly above eight percent in the EU and just under ten percent in the euro area.

Monetary policy remains expansive in response to low inflation

The rate of inflation in the euro area increased steadily since recording down 0.2 percent in April, but at 1.1 percent in December 2016 was still far below the target inflation rate of below but close to 2 percent. For 2017 the ECB (2016b) expects the inflation rate to increase to 1.3 percent. The output gap in the euro area in 2016 was at around one percent and should drop to 0.7 percent in 2017. On the basis of these forecasts, the ECB decided on 8 December 2016 to extend its asset purchase programme until December 2017. From April 2017 it will buy 60 billion euros of assets each month, down from 80 billion euros.

Growth-focused financial and structural policy curbed by election

It is clear that monetary policy needs more support from financial policy and structural reform in the member states. Some countries, including Germany, have the financial policy space to increase investments. Other countries have considerable potential to shift government spending towards growth and to implement reforms on the product, services and labour markets in order to increase productivity. The backlog in investments and disinclination to implement reform have pulled growth in labour productivity down to between 0.5 and one percent a year (Eichert and Frisse 2016). The willingness to implement fiscal and structural policy to stimulate growth is currently being significantly curbed by the upcoming elections in major EU member states. The main burden of economic policy therefore remains with the ECB (Eichert 2016).

Japanese growth surprisingly positive

Growth and potential slightly stronger after revision of statistics system

The Japanese economy seemed to have been treading water for the past few years. But it turns out that things weren't that bad after all. In December 2016, Japan finally adapted its system of national accounts to international standards (SNA 2008), in which research and development expenditure is included in investment. This led to a revision of the country's economic data, rather like in Germany and the US in the last few years. Nominal economic output is now around 30 trillion yen or 5.8 percent higher than according to the old statistical standard of 1993. Its growth potential is also to be rated as slightly higher due to the higher level of investment activity now recorded. It has become clear that both nominal and real economic output has increased quite steadily since summer 2012. The Japanese economy has also digested the 2014 hike in VAT well. Private consumption performed better than presented so far and investment has picked up quite strongly since 2010. At over 80 trillion yen per year, the level of investment following the revision now exceeds the high pre-crisis level of 2008. A look at the individual components of investment activity reveals that capital investment on equipment already picked up in early 2012, while research investment only pointed down for a short period in 2010/11, and residential construction managed to turn around and achieve growth in 2011 following a downward correction that lasted for more than a decade.

2016 growth at around one percent

Between 2012, when Prime Minister Abe took office, until 2015 the Japanese economy registered year-on-year growth of 1.5, 2.0, 0.3 and 1.2 percent respectively, well above potential growth of around 0.5 percent. Following quarter-on-quarter growth in the first three quarters of 0.7, 0.5 and 0.3 percent respectively, real GDP growth for 2016 overall is estimated at slightly over one percent. The Japanese economy proved surprisingly robust, given that net exports were weighed down on account of the weakening Chinese economy, low momentum in regional trade and an appreciation of the yen until November by over ten percent. The yen only depreciated sharply again in the last few weeks. Private consumption was the steady driver of growth, flanked by residential construction and, at times, investment. Wage and price growth remained below the targets set by the government and the central bank. Wages have increased by an average of 0.75 percentage points in the last three years. The growth in wages is however expected to pick up in the next two years due to scarcer labour. The inflation rate in 2016 was just below zero (following 2.8 percent in 2014 and 0.8 percent in 2015), but should turn positive again in 2017/2018. Core inflation without food and energy prices was at two, one and 0.4 percent in the last three years. The low unemployment rate of three percent and the high labour force participation rate of the Japanese population (75 percent) also indicate a healthy labour market. The macroeconomic stabilisation in Japan has been satisfactory overall so far, although it did require huge intervention from the central bank with ongoing interventions on the stock markets since 2012 through quantitative and qualitative measures which have so far expanded central bank assets to 90 percent of GDP in 2008 (compared to around 30 percent of GDP in the case of the FED and ECB, IMF 2016a: 9). Moreover, the financial policy situation did not improve as originally planned due to the decision by the Japanese government to delay the second hike in VAT scheduled for 2017, instead launching an economic stimulus package to the volume of 1.5 percent of GDP in 2016. The primary budget deficit of around five percent was thus too high. The government is, in fact, aiming to achieve a budget surplus in 2020.

Japanese growth set to stabilise at just over one percent

The prospects for the next two years look moderately positive. We expect to see growth of slightly over one percent in the next two years. The OECD (2016) forecasts growth of one percent in the current year and 0.8 percent in 2018, while the IMF predicts slightly lower growth in January 2017 of 0.8 percent for 2017 and 0.5 percent for 2018. Both organisations have not yet factored in the revision of the statistics system. The financial policy will slightly decelerate the course of consolidation, while the central bank is expected to keep on course. Japan should also benefit considerably from the strong dollar which will correct the recent appreciation of the yen.

This, in turn, will impact on corporate earnings, particularly those of the large corporations, stimulating wages and raising inflation a little. Capital investment on equipment should also pick up somewhat. An accelerated pace of structural reform would be the best way of stabilising the country's growth potential. These primarily include measures to better integrate women and foreigners in the labour market, deregulation of product markets and a tax reform that combines higher revenues with a reduction in the tax on labour.

Stimulus after US election changes global outlook

The "new normal" of slower growth in supply and demand could change in this year and the next. Alongside stabilisation in Brazil and Russia, this will be due mainly to the possible consequences of US economic policy, whose exact nature will only become clear in the course of 2017. Businesses and markets are already anticipating a wide range of changes. Of great importance are business expectations about tax policy of President Trump. Grave risks for the US and global economy can emerge from any protectionist measures and major trade conflicts.

History doesn't repeat itself – or does it? Parallels to Reaganomics

The global economic outlook has rarely changed as much in the last few decades following a US presidential election as it did in 2016. It is only comparable with the change in course initiated by the Reagan administration in 1981. "Reaganomics" pursued a strongly expansionary fiscal policy, involving above all tax cuts and increased government defence spending, and deregulation of the financial markets and other industries, triggering an economic upturn with precarious consequences for the country's public budgets and external economic relations. The FED initially continued its policy of pushing inflation down in the US and the global economy with extremely high key interest rates. The external value of the dollar climbed to record highs as a result of the tripling of the budget deficit and high interest rates. Between 1980 and 1984 the dollar appreciated by 40 percent in real terms and trade-weighted. President Reagan supported the radical course to combat inflation taken by the FED under Paul Volcker, welcomed the capital flowing in from direct and portfolio investments and paid little regard to fiscal consolidation. This led to massive "twin deficits" with huge US budget and trade deficits from 1983, prompting debate about a possible crash. Concerted action taken by the central banks and governments to drive down the dollar (Plaza Accord by the Group of Five in 1985 and the Louvre Accord by the Group of Seven in 1987) under the political leadership of James Baker, Reagan's treasury secretary in his second term, ultimately managed to achieve a soft landing. Transatlantic conflict about this policy mix was initially huge, and the international discord remained loud and strong for many years despite cooperation (on this subject, see Marris 1985, Henning 1990, Niskanen 1988, Bergsten 1991, Putnam und Bayne 1987 on diplomacy in the G7 at the time and Funabashi 1991 on the Plaza Accord). The major difference to the current situation is the macroeconomic environment which is no longer characterised by an oil price induced recession, key interest rates of between nine and 19 percent, real interest rates between seven and nine percent and massive capital inflows to the US on account of the high transatlantic differences in interest rates. Nonetheless, the current Republican political leadership does seem to be heading in the same direction.

US economy facing new policy mix

Already in the first few days following the presidential election, the financial markets and economic agents anticipated a change of course in financial and structural policy under Donald Trump and the Republican majorities in both houses of Congress. With only a mixture of election campaign statements, economic policy programmes from Trump consultants (Navarro, Ross 2016) and known plans of Congress on individual fields of policy to go on at present, much still remains mere speculation. Nonetheless, there is some evidence that the new administration will be able to reach agreement with Congress on several legislative packages in the course of 2017. The macroeconomic centrepiece is a tax policy that is designed to stimulate investment and private consumption through massive tax cuts for private households and businesses. Sharp tax cuts are included in the plans that

will certainly not make it through Congress in their current form (Tax Foundation 2016). Treasury Secretary-Designate Mnuchin did however emphasise that he is planning to increase growth to between three and four percent which would require very high tax cuts. Furthermore, the tax plans of the incoming president fit with similar plans that House Speaker Paul Ryan already prepared years ago. However, it is to be expected that the group of fiscally conservative senators will restrict the expansion of the federal budget deficit to some extent. It should be noted that the stimulus proposed by the US administration for the US economy is not set to meet any of the tttt criteria (timely, targeted, temporary and transformative) now commonly called for in fiscal stimulus measures; at present, only amendments to tax legislation have been proposed that would lead to a permanent reduction of tax revenue of three to four percentage points of GDP. The OECD's medium scenario (see below) predicts that Congress would only approve measures that would not increase the federal budget deficit by more than two percentage points of GDP per year (in nominal terms: around 400 billion US dollars).

Medium political scenario already significantly impacts the economy

The OECD has attempted to assess the economic policy outlined by Trump in his election campaign in quantitative terms and is working with a medium scenario (OECD 2016). The OECD factors in an increase in both the volume of public consumption and public investment of 0.25 percentage points of GDP for 2017/18, a reduction in income tax to the volume of 0.5 percentage points and a reduction in corporate tax to the volume of 0.75 percentage points of GDP in 2018. This would limit the overall stimulus to between 1.5 and two percent of GDP per year. A complete implementation of the incoming president's tax plans in the field of income tax would have a substantially higher impact (tending towards 1.5 percent of GDP for this measure alone). Reducing the corporate tax rate to 15 percent without increasing the tax base, more favourable options for depreciation overall (so-called expensing, a first-year tax write-off option) and special incentives for construction investments would together also account for a volume of one to 1.5 percentage points of GDP. Figures for increased spending on defence and infrastructure were not provided during the campaign and would need to be added.

The overall economic impact of OECD's medium scenario amounts to an increase in growth of 0.4 and 0.8 percentage points in 2017 and 2018 and an increase in the rate of inflation of 0.1 and 0.4 percentage points respectively. Interest hikes of the FED would presumably amount to 0.25 percentage points in 2017 and 0.75 percentage points in 2018 above the pace of tightening anticipated so far. Further expected developments are a clear increase in investment of over five percent, a further drop in unemployment of 0.5 percentage points and an increase in imports of over three percent by 2018. Factoring in the impact on growth and tax revenue, the budget deficit would increase by 0.5 percentage points in 2017 and by 1.5 percentage points in 2018 (without factoring these in: up 0.75 percentage points 2017, up 1.75 percentage points in 2018). Capital market yields should increase by 40 basis points, and the external value of the dollar should increase sharply due to this divergence from Europe and China. Depending on the extent of deregulation and the course of trade policy, further effects from capital inflows (of a positive nature) or from disruptions in global trade through protectionist measures (of a negative nature) would need to be included. But too little is known as yet about both fields of policy. Global economic growth would increase by 0.1 and 0.3 percentage points.

Markets can anticipate and overreact

In this medium scenario, however, expectations could in fact drive stronger effects in capital flows, the external value of the dollar and foreign trade, especially since the capital market yields have just recently risen sharply in anticipation of more radical changes in policy. The FED would have to take a stronger line of response and accelerate monetary tightening. Should President Trump succeed in getting significant aspects of his programme through Congress, the US economy should be able to pick up to over 2.5 percent growth. This would certainly prompt the FED to increase the interest rate to over 1 percent. The extent of the adjustment will certainly be data-driven. An increase in the capital market yields of ten-year bonds to over three percent (up from currently around 2.5 percent) would also be likely in this case. This scenario would also involve the dollar appreciating against the euro and the yen by over ten percent.

This is all the more likely as the labour market is already approaching full employment and wages are set to pick up rapidly with inflation rising faster than anticipated to date. Furthermore, Trump's planned regulation to give companies that hold high assets abroad the option to repatriate these assets within a limited period of time at a low tax rate of ten percent is likely to have a one-off effect on the appreciation of the dollar over a period of several months. The volume of foreign assets covered by this regulation is estimated to be two to three trillion US dollars, of which an unknown proportion would actually be repatriated. It is also not yet clear whether it will actually be possible to reduce corporate tax rate to 15 percent, or whether a political compromise of a rate of between 20 and 25 percent is the more likely outcome. Halving the tax rate without tangible corrections to the tax base, which was used in Reagan's tax reform to offset the tax cuts, would mean that tax revenues – most recently around 380 billion US dollars – would drop by over 50 percent, which is one whole percentage point of GDP. It is also not yet clear to what extent Congress would agree to cutting the seven income tax brackets down to three (to 12, 25 and 33 percent), to reducing the taxation of capital gains and dividends, and to eliminating federal estate tax, which would altogether reduce taxes by 1.1 to 2.5 trillion US dollars over a period of ten years. Nor is it clear just how the planned tax concessions and increased public spending on infrastructure investment are to be achieved.

Turnaround in the regulation of key industries?

In general, the fiscal stimulus measures are easier to predict than the regulatory changes that Trump proposed during his campaign for the energy and financial industries and which would first need to be defined in painstaking legislative work. It is conceivable however, that international investors (both real investors and portfolio investors) will take an optimistic view of the situation and make corresponding decisions on portfolio investments and direct investments. The general upshot of this could be that the dollar, driven by the capital account, is lifted slightly above the fundamentals for a few years and the turnaround in economic policy under Trump becomes the dominant "game in town" of the global economy. The ECB has recently conducted corresponding scenario analyses. An additional ten-percent drop in the value of the euro against the dollar and rising foreign demand for goods from the euro area would in themselves be enough to trigger a tangible few tenths of a percentage point in impetus for real growth and the growth of inflation (ECB 2016a).

Impact of policy mix will remain controversial

Whether the new policy mix in the United States would change the long-term weaknesses in productivity growth and income distribution is difficult to assess at present. The stimulation of investment activity normally has a favourable impact on productivity, although it remains to be seen if this can still be expected once US policy has taken shape. As they stand, the planned changes to the tax rates would regressively exacerbate income distribution. The tax cuts favoured by Trump in his election campaign would overall probably not trigger optimal fiscal impetus, but rather weaken the fiscal situation in the medium term. It also remains to be seen whether the capital markets will respond to rising deficits so strongly as to cancel out the stimulus delivered by fiscal policy. It is particularly doubtful whether more favourable tax conditions for PPP will lead to a noticeable increase in infrastructure investment. The planned tax credits of over 80 percent are very unusual in any case. Furthermore, the greatest shortcomings are in educational institutions and transport routes where it is not generally possible to make the necessary projects commercially attractive. Many of the individual measures will remain controversial over the next few years, but there is much to suggest that income distribution will at any rate continue to deteriorate while the impact on growth of a direct implementation of the election campaign statements would probably remain low (see, for example, Summers 2016a, b).

Stronger convergence in regional economic development

Latin America back to growth

While 2016 was marked by a strongly divergent development in the different regions of the world, 2017 is set to be a year of converging trends. This is largely due to the fact that Brazil and Russia are poised to emerge from their recession. The **South American** economies are heading for the largest upswing, returning from a decline of over 0.5 percentage points (down 0.6 percent) in 2016 to growth of over one percent. **Brazil's** economy under President Temer has embarked on a course of stabilisation. The country is gradually shaking off the impact of the negative shocks in the last few years and the high degree of political uncertainty in 2015/16. Inflation is still well above the central bank's target rate and a clear political framework for structural reform in the areas of the tax system, infrastructure and trade liberalisation as well as for the medium-term budget development is still lacking. **Argentina's** economy should also find its way out of recession and grow by over 2.5 percent in 2017. Venezuela and Ecuador will have to cope with another year of recession. In Columbia and Chile, commodity prices and macroeconomic policy had a dampening impact in 2016, but growth is set to gather pace again in the course of the current year. The outlook for the states of **Central America** and the **Caribbean** is largely unchanged from the previous year (up 4.1 percent and up 3.6 percent). In North America, Mexico at two percent is on a path of moderate growth. However uncertainty about the trade and investment relations with the United States are likely to dampen the outlook. Growth was low in Canada in 2016, estimated at 1.2 percent and will only pick up this year to just under two percent.

Russia and its neighbours emerging out of recession

Russia and the Caucasus and the Central Asian countries comprise the second sluggish region, although it did benefit somewhat from the increase in oil prices. In Russia, Belarus and Azerbaijan, total economic output dropped in 2016 but should gradually improve in 2017 and then start growing again in 2018. Russia's recession with just over one percent contraction seems milder than expected with marginal growth within reach next year. The whole region should return to positive figures within the current year with around one percent growth expected. The other energy exporters in the region (Kazakhstan, Uzbekistan and Turkmenistan) will have to get used to dropping momentum. The economy of the Ukraine, in contrast, should start to grow again.

Growth to remain moderate in Middle East, North Africa and Africa overall

The oil exporting countries of the **Middle East and North Africa** can expect growth of 3.4 percent in the current year remaining level with the pace of growth in 2016. Most countries are continuing to consolidate their budgets, which impedes a rapid recovery. The economies of Iraq and Iran had a good run last year, while Saudi Arabia's economy only rose slightly and is expected to lose momentum in 2017.

For **Sub-Saharan Africa** the growth prospects were also weak in 2016. Commodity prices and financing conditions curbed growth, keeping it down to 2.9 percent. The situation will remain as weak this year too. **Nigeria** even experienced a slight recession (down 1.7 percent) caused by disruptions in production in the oil industry and lingering scepticism on the part of the capital markets. **South African** and **Angola** have been stagnating for quite some time. The smaller economies of the region are booming in comparison with five percent growth.

Asia's emerging markets set for growth of over 6 percent

The **emerging Asian and Pacific countries** are still heading for continued economic growth of just over 6.3 percent, the **ASEAN-5** countries for average growth of around 5.1 percent. Economic growth should slightly pick up compared to the previous year. While Vietnam and Malaysia lost steam slightly in 2016, Indonesia, the Philippines and Thailand picked up. The situation improved moderately across the region. **India's** economy is expected to show strong growth in 2016/17 at roughly 7.5 percent, driven by private consumption and rising investments. Inflation remains under control at around five percent with trade balances showing no signs of any larger-

scale problems. Tax reforms have also had a positive impact. Further structural reforms in the energy industry, on the labour market and in the banking system are still needed. The sharp drop in commodity prices has considerably improved the Indian economy's terms of trade over the last few years. The demonetization of the 500 and 1,000 rupee banknotes caused significant troubles at the end of 2017. The measure aimed at tackling corruption led to liquidity shortfalls and problems of the payment system.

Regional economic outlook for 2017	
South America	1.1
Central America	4.1
Caribbean	3.6
Asia-Pacific, Advanced economies[1]	1.6
Asia-Pacific, Developing economies[2]	6.3
CIS-States[3]	1.3
Middle East, North Africa, Afghanistan, Pakistan	3.4
Israel	3.0
Sub-Sahara Africa	2.9

[1]Japan, South Korea, Taiwan, Singapore, Hong Kong, Australia, New Zealand, Macau
[2] including China and India
[3] Russia, Ukraine, Georgia, Turkmenistan, Caucasian and Central Asian States

S ource: IMF (October 2016)

Developed Asia making sluggish progress, strong growth in Australia

The same is true of the developed economies in the Asia-Pacific region. Singapore and Hong Kong saw only marginal growth in 2016 of 1.7 and 1.4 percent, while Korea and Taiwan gathered pace modestly with 2.7 and one percent growth. Production is expected to pick up in 2017 in line with the recovery of global trade. Australia's economy registered considerable momentum with around 2.8 percent growth last year which it should be able to maintain in 2017.

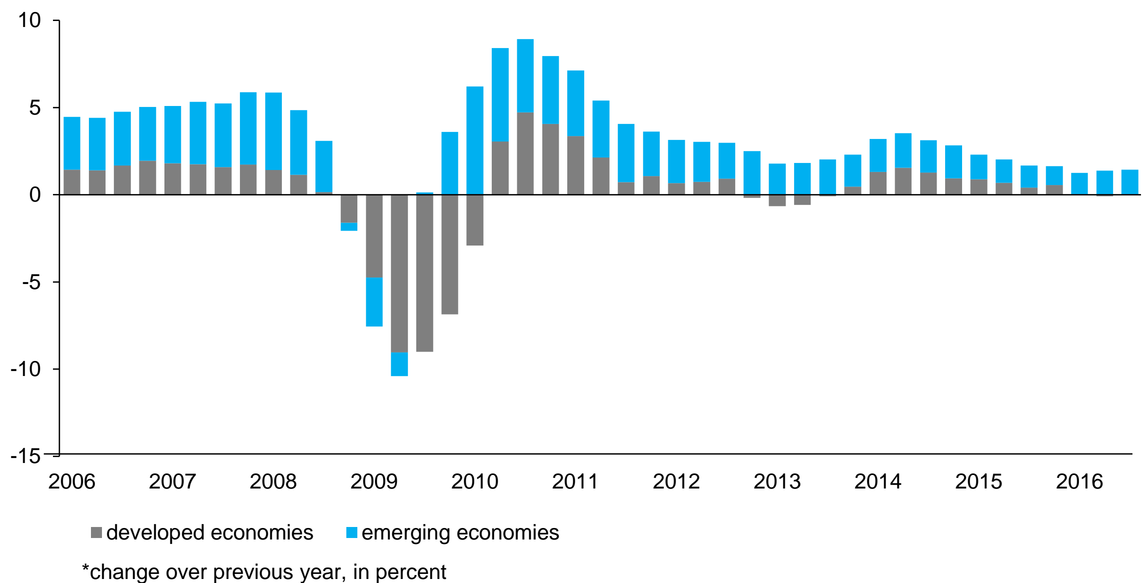
Is global industrial production: bottoming out?

Global industrial production in 2016 is unlikely to have increased as much as it did the year before. According to figures from the CPB Netherlands Bureau for Economic Policy Analysis, industrial production increased by just over one percent in the first nine months of 2016 in comparison to the same period last year. Since early 2013 the increase in global industrial production has steadily lost pace. At the turn of the year 2015/2016 the production index just managed to nudge up by one percent. In the further course of 2016 the pace of expansion picked up slightly, continuing into the early summer months. If the level achieved in late summer was maintained until

the end of the year, global industrial production should have increased by a total of 1.5 percent for 2016 as a whole.

In the **developed economies**, where meanwhile only just over 53 percent of industrial value added is produced, output followed divergent regional trends. In Japan and the United States, industrial production decreased over more than eight and four quarters respectively in comparison to the previous year. At the same time, industrial production has grown steadily since late 2013 in the euro area and in the other developed economies. Overall, industrial production decreased slightly in the first nine months of the year. The latest figures now indicate an upward trend. In the last two months, industrial production (two-month average) increased seasonally-adjusted in almost all countries monitored in comparison to the previous period. The purchasing managers' index registered its highest level in two years in October, which also signals an expansion towards the end of the year. If production levels seen throughout the year so far were maintained in the last three months, industrial production in the developed economies in 2016 could even have nudged up by 0.1 percent.

Development of industrial production* in developed and emerging economies



Sources: Netherlands Bureau for Economic Policy Analysis

While industrial production is still rising in the **emerging economies** it is losing steam every year. It even seems that the comparably low rise in production of 2.7 percent seen in 2015 will not have been topped in 2016. Even though the pace of growth is slowing in emerging countries, they still have the potential to further increase their production, principally in Asia where – including China – over half the industrial production in emerging countries takes place. If the current growth rate was maintained in the last quarter, this region is set to achieve an increase in production of over four percent. Industrial production is also rising in Africa and the Middle East, a region that has experienced an upward trend in this sector since mid-2014. Close to one fifth of industrial production in emerging countries takes place in this region. Developments in Latin America are cause for concern. The region has been in recession for the last three years with the downturn even gathering pace in the third year of the crisis. Industrial production is estimated to have slipped by more than four percent in 2016. In Central and Eastern Europe, industrial production will record another slight decline, largely due to economic heavyweight the Russian Federation. But the downward trend seems to have bottomed out here. Overall industrial production in emerging countries for 2016 is estimated to have increased by around 2.5 percent.

Global trade: weak growth in 2016 but recovery on the horizon

Global trade grew by 2.3 percent in 2016 over last year according to International Monetary Fund estimates. Growth here was relatively strong particularly in the third quarter, up 0.5 percent compared to the previous quarter according to preliminary estimates from the Netherlands Bureau for Economic Policy Analysis (CPB). The main invigorating factor in the third quarter was demand from emerging countries where imports rose 1.1 percent. The Latin American countries in particular increased their imports (1.5 percent). Growth in imports to industrial countries was much lower in the same period (0.5 percent). On the exporting side, however, it was the industrialised countries who benefited most from the third-quarter growth (up 0.6 percent). Exports from emerging countries dropped moderately (down 0.2 percent), due to declining exports from Asian countries (down one percent). The RWI/ISL Container Throughput Index, which measures capacity utilisation of the world's major ports, shows that global trade trod water in the last few reporting months. For 2017 the IMF is anticipating an increase in world trade of 3.8 percent overall.

Foreign direct investment: sharp drop in 2016

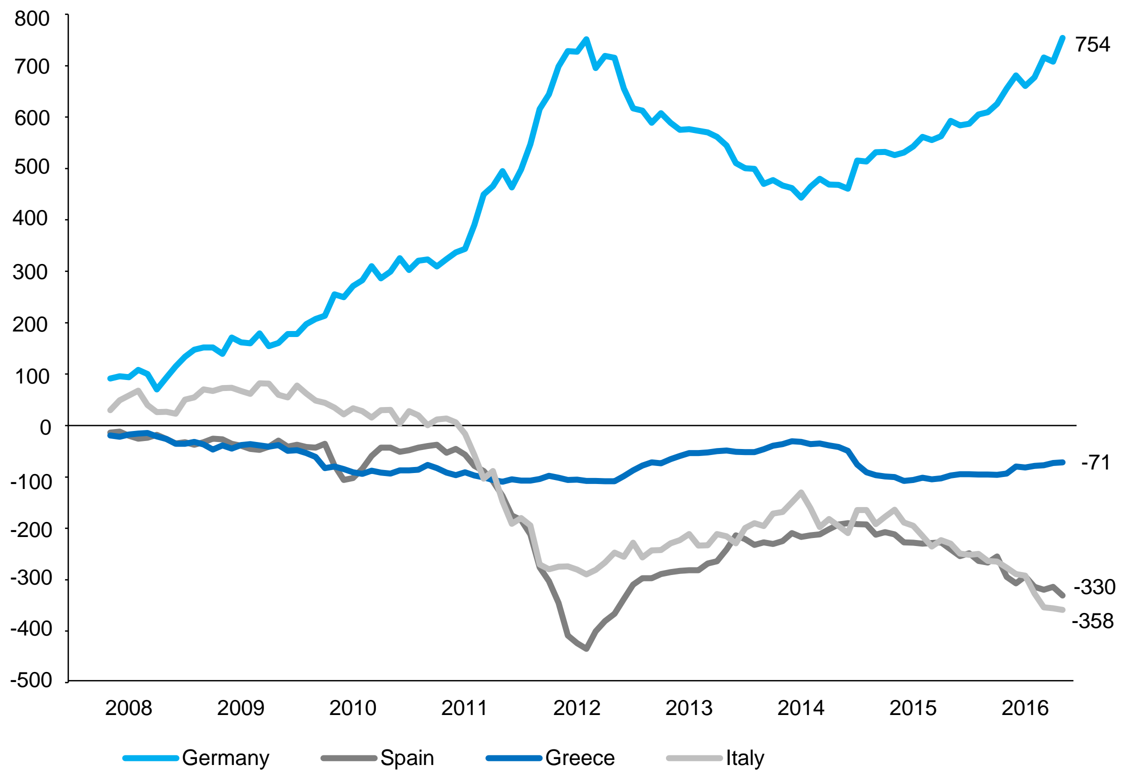
A key parameter of global economic development is cross-border direct investment. Preliminary figures from the UNCTAD (the United Nations Conference on Trade and Development) show a drop in global investment flows in 2016 of ten to 15 percent compared with 2015. Reasons for this slump include the fragile state of the global economy and continued weak global demand. The emerging countries experienced a slightly greater decrease in FDI inflows (down twelve to 16 percent) than the industrialised countries (down ten to 14 percent). This year, FDI flows are expected to turn positive with estimates at seven percent growth and eight percent growth in 2018. According to a UNCTAD survey of the 100 largest transnational corporations, not including the finance sector, 48 percent of those surveyed are planning to expand their cross-border investments through to 2018. This proportion is higher among transnational corporations in emerging countries (55 percent) than those in developed countries (45 percent). Service providers showed a higher propensity to invest (56 percent) than industrial enterprises (44 percent). In the UNCTAD survey the factors that topped the list of surveyed transnational corporations as most positively affecting FDI flows were the state of the economy in the United States (71 percent), the conclusion of free trade agreements such as TTIP (52 percent) and economic conditions in Asia (52 percent). Only 44 percent of those surveyed said that the state of the EU economy plays a part in their international investment decisions.

Capital flows: turnaround in emerging countries?

The net capital flows in emerging countries have recovered according to IMF calculations (2016a), following a sharp drop in the second half of 2015 and a weak start in 2016. Driving the turnaround is the recovery of commodity prices and improved sentiment in the financial markets towards emerging countries. Above all, investments in funds specialised in emerging market portfolios have increased. The data from the few countries with an equilibrium in the balance of payments confirm an increase in capital flows. China recorded further capital outflows, along with a decrease in foreign currency reserves, though at a considerably slower pace than in the second half of 2015 and early 2016.

According to IMF (2016b) the emerging countries are still vulnerable to fluctuating sentiment among investors and changes in the monetary policy adopted by the large central banks. In view of the fact that the growth prospects of emerging countries are only muted, the recent recovery in their capital flows appears to be influenced by external developments rather than improved fundamental economic data. An economic shock or a swing in market sentiment could annihilate the positive current trend in capital flows.

TARGET 2 balances in billion euros



Source: Macrobond

Regarding the United Kingdom following the Brexit referendum vote, the IMF (2016b) sees a risk that long-winded negotiations on the part of the UK government could lead to long-term lower foreign investments in and capital flows to the United Kingdom and therefore pull down long-term growth.

There are considerable capital flows in the euro area. In summer 2012 when the euro crisis peaked, imbalances in the ECB's payment system Target 2 reached a record high. Claims and liabilities between the central banks then decreased, before rising again since 2014. During the last six months they rose sharply once again. As of 30 November 2016 the Deutsche Bundesbank Target 2 claims amounted to around 754 billion euros. The claims of one central bank are netted out by the liabilities of other central banks. The total Target 2 liabilities of Spain and Italy total well over 300 billion euros each. The renewed rise in Target 2 imbalances is partially a result of the ECB's monetary policy and its asset purchase programme. If the Banca d'Italia, for example, buys a bond from a German trader on behalf of the ECB, the Italian Target 2 liabilities automatically increase. Until the asset purchase programme expires, the balances are set to drift further apart.

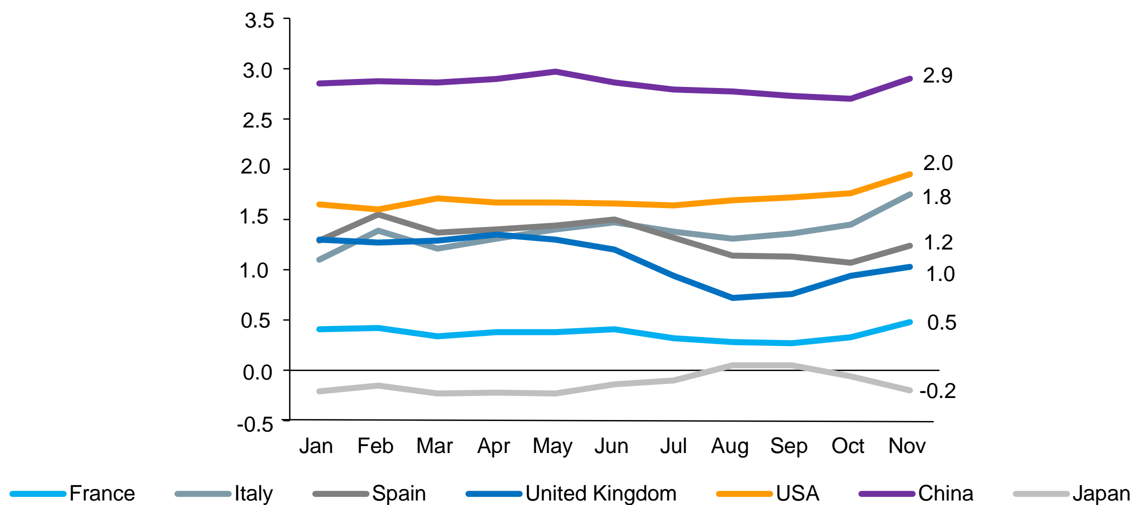
International financial stability remains fragile

Compared with the last issue of this series in June 2016 the short-term risks in the global financial system have declined. In many developed economies, particularly in the euro area, expansive monetary policy has helped stabilise the equity and bond markets. Exporting emerging countries are benefiting from the rise in many commodity prices. Upheavals that might have been expected in the course of the Chinese economy's transformation

towards more consumption-driven rather than investment-driven growth have not really occurred. Political events such as the British and the Italian referendums and the outcome of the US presidential election led to a short-term surge in volatility on the financial markets which then levelled off.

New medium-term risks have emerged (IMF 2016b). Global growth prospects largely remained weak in the course of the year, while populist tendencies are additionally exacerbating political uncertainty. The future economic orientation of the United Kingdom and the course of fiscal policy in the US are two big question marks hanging over 2017. If these political risks materialise, risk premiums that are currently stagnating on a relatively low level could rise rapidly as a result.

Spreads of selected government bonds* for the year 2016 in percent



*Difference between government bond yields with ten-year maturity compared to Germany

Source: Macrobond

There are additional sources of instability in the international banking system. The banks in the euro area are particularly hard hit by a combination of low profitability and low nominal growth. These structural and cyclical factors are complicating the reduction of non-performing loans and the buildup of equity. The IMF (2016b) estimates that 25 percent of the banks in the developed economies will remain weak and vulnerable even after an upturn. Bad loans also remain a problem in the emerging countries. Around eleven percent of corporate loans outstanding (over 400 billion dollars) relate to companies whose repayment capacity is doubtful.

The ECB (2016a) identifies concerns on the sustainability of public and private debt as a risk. The persistent low nominal growth and the associated slower reduction of debt-to-GDP ratio is likely to rekindle the debate on fiscal sustainability. On the other hand, the low interest rates have markedly improved the fiscal sustainability of public debt in many countries and increased their fiscal policy space. Already in the run-up to the Italian referendum on 4 December 2016 the spread of Italian government bonds increased in comparison to German ten-year bonds. A similar trend was seen in numerous other countries, though to a lesser extent, with the exception of Japan. The latest available data indicates that the debate on public debt sustainability remains squarely on the table.

German economy facing shaky impetus

Due to its strong orientation towards exports, the German economy should benefit from a pick-up in global trade and a weaker euro in the course of 2017. The transatlantic economic and interest rate divide will support net exports particularly, which would otherwise have been negatively affected by the restrained investment and muted trade with the United Kingdom. A moderate increase in capital investment in equipment by business is likely to be a part of this scenario. Overall, the German economy should grow in real terms by 1.5 percent (adjusted for working days) or 1.8 percent, thus steadily gathering upwind.

Of course, it remains to be seen just how and when the change in course in US tax legislation and individual expenditure programmes will occur and precisely how this will impact on foreign companies and on external economic relations. Alongside the United States, the euro area, South America and the Asia-Pacific region should all perform better and provide small impulses for growth.

The unilateralist U.S. foreign economic policy bears grave risiks. The expressly aggressive pursuit of national trade policy objectives is not a novelty in US foreign economic policy. Such phases were already seen under President Reagan and President Clinton. Trump's election campaign pledges were not directed at European countries. Nonetheless Europe could be both directly and indirectly economically affected by second-round effects of trade disputes between the US and China or between the US and its North American partners in NAFTA. The significant presence of production in Mexico is worth noting in this context.

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