BDI
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German Industry

GLOBAL GROWTH OUTLOOK

Asia and Europe driving world economy

August 2017

- **World economy showing unexpectedly strong momentum since start of year.** Real economic output expected to increase worldwide by 3.6 percent, driven mainly by China, Japan and the euro area.

- **Robust rise in global trade and industrial production.** Exports growing substantially in Asia, North America, Western Europe and commodity countries. Industrial production pointing up in euro area and Japan.

- **Markets defying protectionist risks so far.** Brexit presents a threat for foreign trade in Europe. US trade policy still vague and risk of further trade disputes remains high.

- **Fiscal policy impetus from US no longer expected for this year.** No clear strategy in financial policy to align draft budget with tax plans. We expect 2.1 percent growth.

- **Weaker US dollar supports Chinese economy and many emerging countries.** Euro appreciation bearable and keeping oil costs down. Commodity prices moving sideways.

- **Regional differences with highs and lows.** South America and Russia gather pace while the Middle East and Sub-Saharan Africa record economic slowdowns.

- **Accelerating global trade positive for German economy.** Unexpectedly strong upwind in exports and investments anticipated in further course of year.

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Political tension affecting global markets

Six months ago we were still anticipating a noticeable upswing in the US economy on the back of the extremely aggressive fiscal policy plans of the newly elected US administration and Congress. After all, it is rare to have one-party control in Washington. The global markets initially stormed into a phase of anticipated pro-business but potentially anti-trade policy changes in the US, but as of spring adjusted to a continuation of the status quo at least until the end of the year. These fluctuating expectations particularly affected the financial markets, including foreign exchange markets. Since then, surprising data has come not from the US but from Beijing, Tokyo, Paris, Berlin and Frankfurt. While economic prospects have dipped in the United States, they have brightened considerably in many other regions of the world despite continuing concerns about the threats of protectionism.

Over the last decades, we have rarely seen such a strong divergence between positive economic developments and rising political risks for the international division of labour. Although the new US administration, Brexit and security issues in Asia have considerably raised political uncertainty regarding the global economic order in the last six months, the global markets are on a surprisingly positive trajectory.

Upswing in the first half year

For 2017 we are expecting real global production to increase by 3.6 percent over the previous year. The spring forecasts of the international economic organisations of around 3.5 percent growth are probably still underestimating the revival in economic activity, with hard data for the second quarter surpassing expectations in some cases. Although there are some indications that not all major economies will perform as vigorously in the second half year as they did in the first, the upward revisions of most economic analysts are still lagging behind the good data. The latest IMF forecast suggests that given the current political and economic situation the pace of growth could be maintained next year as well (3.6 percent).

Moreover, while growth in real production of around 3.6 percent is still below the pre-crisis 20-year average of four percent (1987-2007) the economy is gathering further momentum. We are expecting growth in real GDP this year of two percent for industrialised countries and 4.6 percent for emerging and developing countries. Industrial production is also on the rise worldwide, with purchasing managers indices at a high level in the first half year and pointing to expansion almost across the board. The economic upturn is emanating above all from Asia and Europe. China is also growing slightly faster than expected. Brazil and Russia have managed to stop their nosedive in production and rebound to growth. Growth expectations for India, in contrast, have been downwardly revised by all analysts by a good half a point to around seven percent.

World trade picking up again while oil prices remain moderate

The biggest difference to last year is likely to be the revival of world trade, which is forecast to grow by four percent this year (IMF 2017b). The main factors driving this development are stronger demand for capital goods in Asia and among commodity exporters, above all in oil-producing countries, as well as an improved investment climate in North America and Western Europe. While oil prices remained moderate at around 55 US dollars per barrel of Brent in the first quarter of 2017, they dropped in the second quarter to around 45 euros by the end of June due to several supply-side factors. Based on oil futures, the prices should recover slightly again in the medium term to around 50 and 60 US dollars.

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

	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	3.2	3.0[4]	3.0	3.5	3.5[4]	3.4	3.6	3.6	3.6
USA	1.6	1.6	1.6	2.1	2.1	2.2	2.1	2.4	2.3
China	6.7	6.7	6.7	6.7	6.6	6.6	6.4	6.4	6.3
Japan	1.0	1.0	1.0	1.3	1.4	1.2	0.6	1.0	0.6
EU			1.8			1.7			1.8
Euro area	1.8	1.7	1.9	1.9	1.8	1.9	1.7	1.8	1.9
Germany	1.8	1.8	1.9	1.8	2.0	1.6	1.6	2.0	1.9
France	1.2	1.1	1.2	1.5	1.3	1.4	1.7	1.5	1.7
Italy	0.9	1.0	0.9	1.3	1.0	0.9	1.0	0.8	1.1
Spain	3.2	3.2	3.2	3.1	2.8	2.8	2.4	2.4	2.4
UK	1.8	1.8	1.8	1.7	1.6	1.8	1.5	1.0	1.3
India	7.1[5]	7.1	7.1	7.2[5]	7.3	7.2	7.7	7.7	7.5
Brazil	-3.6	-3.6	-3.6	0.3	0.7	0.5	1.3	1.6	1.8
Russia	-0.2	-0.2	-0.2	1.4	1.4	1.2	1.4	1.6	1.4

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

Price acceleration remains low

Prices around the world are showing little dynamics. In industrialised countries, they are expected to increase by an average of two percent in 2017, with the IMF forecasting 1.9 percent (IMF 2017f); this applies to both the inflation rate overall and the core rates (OECD 2017). While inflation has stayed below the targets set by the central banks in Japan and the euro area, the core rate (without energy and foods) in the United States is currently hovering at just over two percent. The United Kingdom has recorded higher inflation rates of above two percent, driven mainly by the temporary devaluation of the pound sterling. The OECD is forecasting inflation of 2.8 percent for this year, with just under five percent in the developing and emerging countries. The core rate of 3.5 percent recorded in the first quarter has provided no cause for alarm. During spring, expected inflation (over ten years) increased to just over 1.7 percent in industrialised countries, while emerging countries are anticipating prices to stabilise further to just over three percent.

The outlook for prices is muted for many reasons. Producer prices in Asia have moved out of negative territory back to dynamic growth rates of just under ten percent over last year thanks to the recovery of the Chinese investment climate. However the general upward momentum in wages in industrialised countries is falling short of expectations. In some countries, factors curbing wages are high unemployment levels coupled with restrained expansion in lending as both public and private balance sheets are being downsized. In other countries, structural factors on the labour market and in the tariff system (such as a low level of collective bargaining coverage and trade union organisation) are pressing down on wages. As a result, real wages are lagging behind the upward trajectory in economic fundamentals across the euro area, Japan and the US. This calls for explanation particularly in the US and Japan where the labour markets are already at full employment (and, in Japan, even slightly above that).

Productivity too low worldwide

The feeble increase in real wages is mainly due to insufficient developments in total factor productivity across the globe. Inadequate investment activity, a levelling off of the positive effects created by the deployment of information and communication technologies in the last decade, the aging populations in the OECD area and in many Asian countries (IMF 2017b), several years of decreasing trade integration, slow progress in education and the design of more pro-growth tax systems, decreasing competition on product markets and a weakened mechanism for diffusing technical progress between world market leaders and the many small and medium-sized enterprises have all been stifling productivity and real wage growth for several years now (see also OECD 2017). In some crisis countries, a misallocation of capital and the persistent over-indebtedness of the non-financial corporate sector in conjunction with balance sheet problems in the banking sector have curbed investment activity to such an extent that technical progress has suffered on a massive scale (IMF 2017).

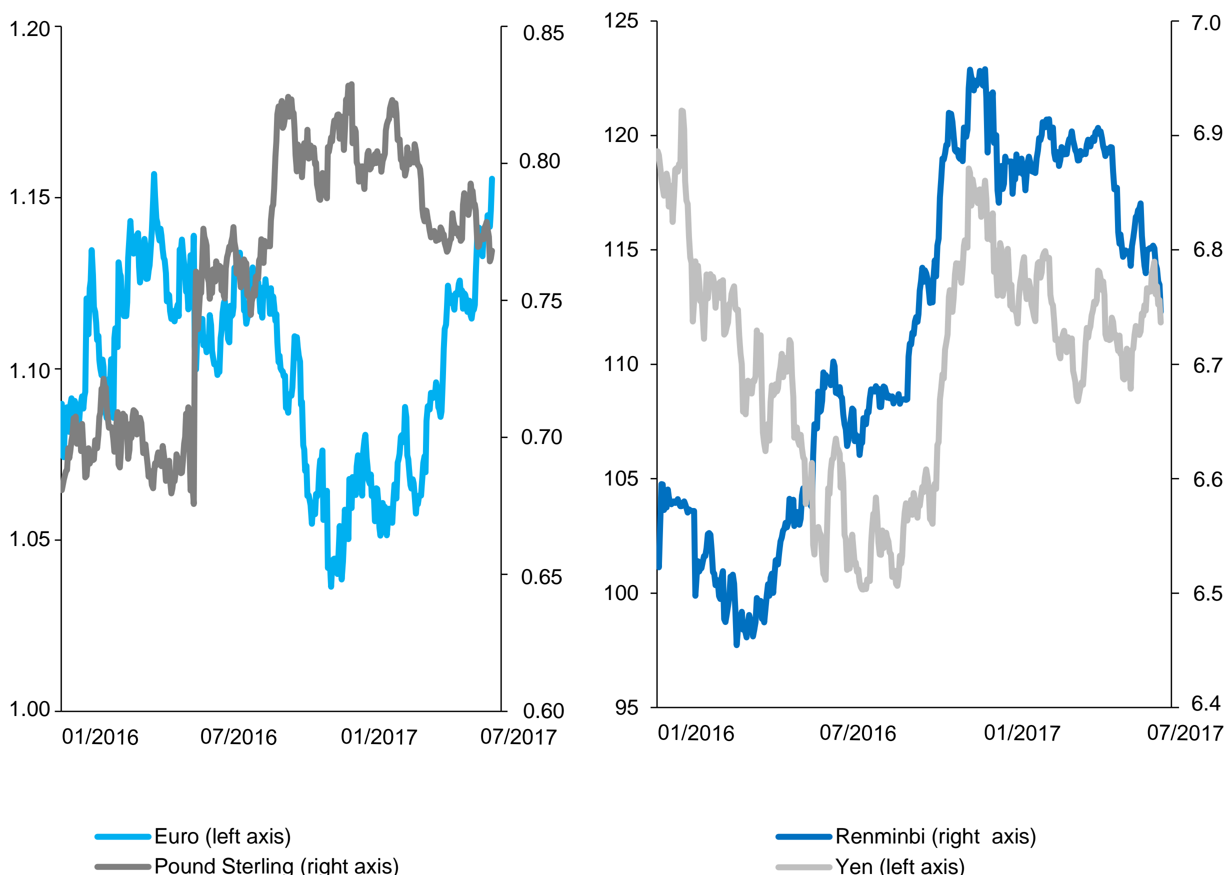
Productivity has left the rock-bottom rates seen in 2008/09 to achieve a slight increase of 0.3 percent on average year on year between 2011 and 2016 (IMF 2017). With investment activity picking up, productivity growth should be able to recover further and is projected to rise to 0.7 percent on average per year between 2017 and 2022 (weighted according to economic output measured at purchasing power parity). This level of growth is still considerably lower than the average recorded in the fifteen years before the crisis (average growth from 2000 to 2007 was one percent). The trends in productivity in the developing and emerging countries are very similar. While these countries registered productivity gains of 2.8 percent per year on average, growth in productivity dropped to an annual average of only 1.3 percent between 2011 and 2016. By 2022, however growth could get back to 1.9 percent.

Marginal adjustments in exchange rates

The trends in the external value of key currencies have been somewhat mixed in the last six months. The external value of the US dollar was initially buoyed by the election of Donald Trump as president, but by spring it was pointing down following the delays in the political decision-making process on the planned US tax reform. The US dollar thus rose substantially in the first quarter before the downward adjustment in spring. On a real trade-weighted basis, the US dollar has depreciated by 3.5 percent since March. The euro, on the other hand, depreciated slightly in the first quarter before appreciating by 3.5 percent since March, also on a real trade-weighted basis. In the second quarter the yen appreciated considerably against the US dollar. The pound sterling regained its footing and has risen in value in the first six months of the year. The Korean won and the new Taiwan dollar also experienced strong upward pressure. Among the currencies of the emerging countries, the Turkish lira came under particular pressure in the first quarter, plummeting by more than ten percent while the Russian ruble soared up by over 15 percent. The Brazilian real first appreciated slightly, buoyed by the improved economic prospects before dropping again in June due to the corruption problems. Real interest rates are still very high in Russia and Brazil at five and seven percent respectively.

Overall in the first six months of the year, the currencies of developing and emerging countries appreciated by four percent against the US dollar and depreciated by three percent against the euro. This trend is unlikely to continue into the second half of the year (Deutsche Bank 2017).

Exchange rates against the US dollar



Source: Macrobond

Net impact of fiscal policy still neutral

The global mix of economic policy in the first half of the year continues to be marked by an imbalance in the various fields of economic policy. While monetary policy remains accommodative, fiscal policy has been neutral in sum. Structural policy has had virtually no positive effects on growth and employment, except in Japan and individual European countries. Overall, the economic focus of fiscal policy remains neutral worldwide, even though many countries including Germany and Canada have planned a slight expansion in their fiscal policy in 2017. Other countries such as France and Italy, for example, are planning to step on the brakes. Japan will be moving more or less sideways in 2017 but is planning to carry out the postponed hike in value-added tax in 2018. The direction of US policy is not yet clear but is likely to be slightly expansive even without any tax reforms. If things continue as they are, the budget deficits of industrialised countries will hardly improve from their current level of around three percent of economic output. The emerging countries, in contrast, should manage to consolidate their budgets slightly down to around three percent over the next five years.

With monetary stimuli being reduced at different rates in different regions, fiscal policy will have to play a stronger part in supporting economic recovery and stimulating growth through structural measures that are more conducive to growth. 2017 has so far only seen a few cases of fiscal policy reforms with a stronger focus on achieving growth, for example in the restructuring of tax systems or a more growth-oriented public budget weighted towards education, innovation, investment and infrastructure (OECD 2017). Several governments, including the United States, France and the United Kingdom are planning corporate tax cuts this year or next.

At least progress is being made in fiscal consolidation, above all in Europe, as is reflected particularly by the simpler indicators such as net borrowing in relation to economic output or the debt ratio (European Commission 2017). The economic upswing and the reduction in unemployment are having a positive impact as is lower public debt servicing thanks to the low interest rates. China, Japan and the United States, on the other hand, are not following a clear path towards either growth or consolidation in their fiscal policy. China is stimulating the economy with infrastructure expenditure on the one hand while stepping up discipline through a direct control of borrowing by regulating banks.

Capital market yields increase slightly, though from a very low level

In the current environment, however, the unambitious fiscal policy adopted by the major economies is not being punished by the markets. In view of the low structural growth momentum across the board and the current lack of other stimuli, bond yields even recently dipped slightly once again in some countries. The longer-term trend is nonetheless positive with yields gradually picking up. Yields in the US have increased for three years in a row now, with ten-year government bonds well above the two percent mark. Furthermore, although the introduction of normalisation of monetary policy was greeted with nervousness on the market (“taper tantrum” 2013) in the US, it has so far not caused any real crisis phenomena or shock adjustments. This process is set to continue in the US in particular. The OECD, for example, is expecting yields to recover to just over four percent by the end of 2018 (OECD 2017).

In contrast, government benchmark bonds are still negative in many countries in Europe and in Japan, including 75 percent of outstanding German government bonds (OECD 2017: 39), which puts Germany at the top of the table here. Average yields in the euro area are only just over 50 basis points, at around one percent in the United Kingdom and at almost zero percent (most recently at five basis points) in Japan. In Europe, the yields should rise to well over two percent in the next 18 months, while in Japan yields are set to remain low for several years to come.

Monetary policy still accommodative

This is of course largely due to the continued expansionary path of monetary policy in Europe and in Japan, which stimulates the economy with quantitative measures but consequently has to tolerate abnormal developments in asset prices. Monetary policy is set to remain expansive in Japan and the euro area. The ECB recently assessed the situation as having a symmetrical risk and indicated that monetary policy will remain expansive. Instruments such as forward guidance, purchasing programmes and key interest rates should only be adjusted on a step-by-step basis.

In view of the prospects for the economy and inflation in the US, the FED will continue to increase interest rates. The FED board is currently expecting interest rates to reach 2.25 percent (projection’s middle variant) by the end of next year and to push ahead with a phase-out of QE measures.

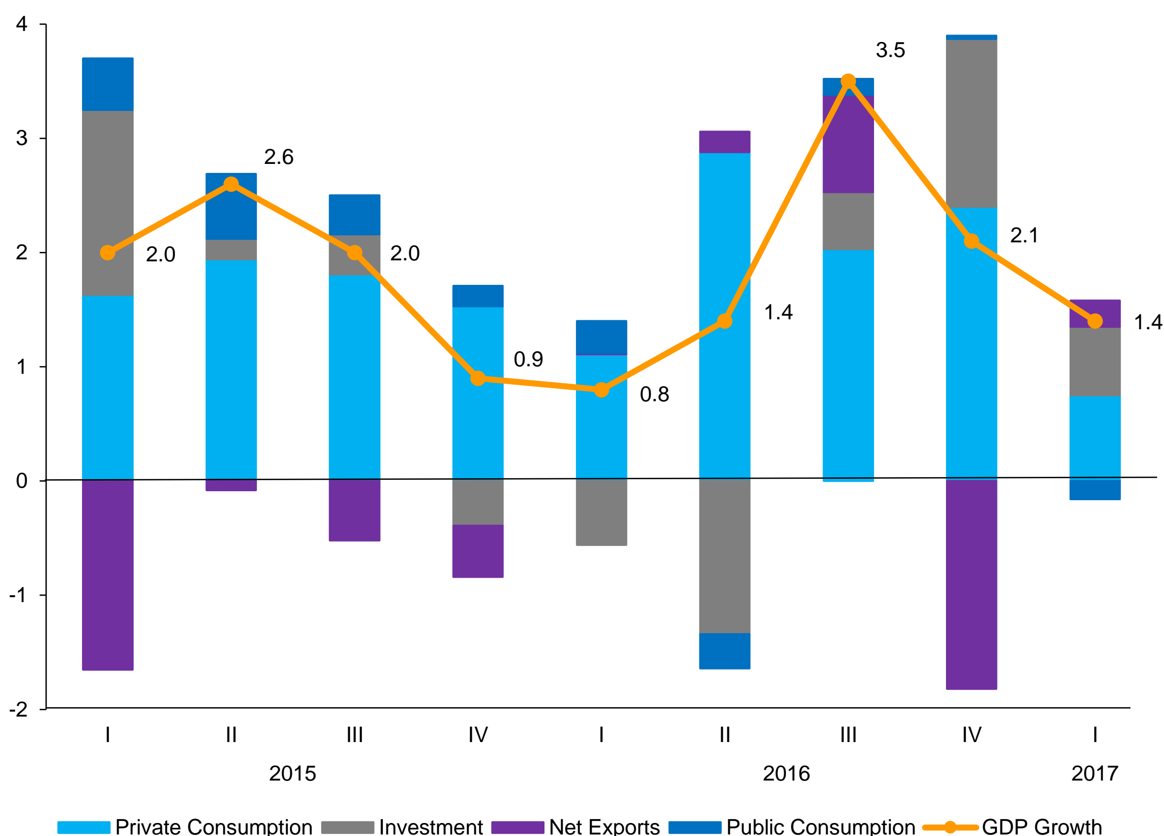
United States: Improved prospects for 2017 following weak start to the year

US economy slowly recovering from low oil prices and strong dollar

In 2016 the US economy only grew by 1.6 percent overall, curbed in particular by weak investments and low energy prices. GDP growth likely to pick up in 2017, despite the modest start to the year. According to the third estimate of the US Bureau of Economic Analysis (BEA), the US economy grew by an annualised rate of 1.4 percent in the first quarter of 2017 (according to the European convention: 0.35 percent over the previous quarter). The lion's share of growth was generated by private consumption spending and investments in, with a slight positive contribution from net exports. Stifling growth on the other hand were lower private inventory investments and lower public spending at both the state and local level.

The US economy is currently recovering from the stronger US dollar and the low oil prices. International trade and investment in the energy sector should pick up further as a result. The investment ratio, measured in the share of private investment in relation to GDP, already increased from 16.4 percent in the fourth quarter 2016 to 16.6 percent in the first quarter 2017. Sentiment in private households and companies remains good so that we expect private consumption to remain a driver of GDP growth and the investment activity of companies to stay lively.

USA: Growth contributions to GDP in percentage points



*annualised quarterly figures

Source: U.S. Bureau for Economic Analysis

In 2017 the US economy is expected to grow overall by around 2.1 percent. The IMF, which had slightly cut its forecast in June, concurs with this figure. But this will only be achieved if the US administration implements a more expansive fiscal policy. Trump's economic policy agenda with comprehensive tax cuts and infrastructure investment first has to be approved by Congress. The tax reform will not be adopted before the second half of 2017 at the earliest. Restrictions in international trade, a turnaround in financial market regulations and a too rapid increase in interest rates in the US could, on the other hand, jeopardise growth not just in the US but also in the world economy.

Labour market sending out mixed signals, with full employment approaching

Unemployment has continued to fall steadily, reaching 4.3 percent in May 2017. This is the lowest it has been for 16 years, lower even than in the pre-crisis year of 2007. The number of long-term unemployed, defined as those who have been unemployed for at least 27 weeks, has dropped slightly in the course of the year so far, going down to 1.66 million in May. One year previously, in May 2016, it was 1.89 million. The long-term unemployed accounted for 24 percent of all unemployed persons in May 2017. The average period of unemployment was 24.7 weeks. One year previously the average period was 25.7 weeks.

The fact that the US economy is reaching full employment also has a downside. Further growth can increasingly only be achieved by raising productivity. Moreover, the good data can be somewhat misleading. Economic analysts had previously expected a higher increase in jobs for May. A particular problem is the fact that a large proportion of the US population does not participate on the labour market at all. Only those who actively register as seeking work are classified as unemployed. The labour force participation rate, which is the proportion of the population that have a job or are actively seeking work, had reached 63 percent in February and March, but dropped down again in April (62.9 percent) and May (62.7 percent). The participation rate is low in general and well below the pre-crisis levels of around 66 percent (2007). Furthermore, wages are only rising very gradually despite the continued expansion of the US economy.

Fed continues more restrictive course

Over the last twelve months (June 2016 to May 2017) living costs in the US have increased by only 1.9 percent. Inflation, which rose in the second half of 2016, recently stagnated before dropping slightly in May (down 0.1 percent). In February, inflation was still at 2.7 percent. The most recent drop in inflation was triggered by falling energy prices, while food prices, on the other hand, have risen. In December 2016 the Fed had signalised its intention to increase interest rates three times in 2017 provided that the labour market remains stable and inflation draws close to the two percent target. After increasing rates by 0.25 percentage points in December 2016 and two further hikes of 0.25 percentage points each in March and June 2017 interest rates are now within a range of one to 1.25 percent. The Fed decided to raise the base rate again in June despite the mixed signals coming from the labour market.

Tax reform good for the economic activity but problematic for government deficit and debt levels

The tax reforms announced by the Trump administration would stimulate US economic growth, but so far Congress has not been able to agree on the necessary legislation. An agreement with a tax bill passed by both chambers is expected by the end of the current year at the earliest. The economic impact of the reforms will thus start to be felt during the course of next year at the earliest. The OECD is only expecting tax breaks to stimulate private consumption and investment from 2018 on. These effects, however, will also be accompanied by the negative impact that tax cuts could have on the already strained budget. Further stimulus could be provided by investments in infrastructure which, in turn could additionally burden the federal budget. Such investments were announced during Donald Trump's election campaign. Since then, no concrete plans have been presented to implement them.

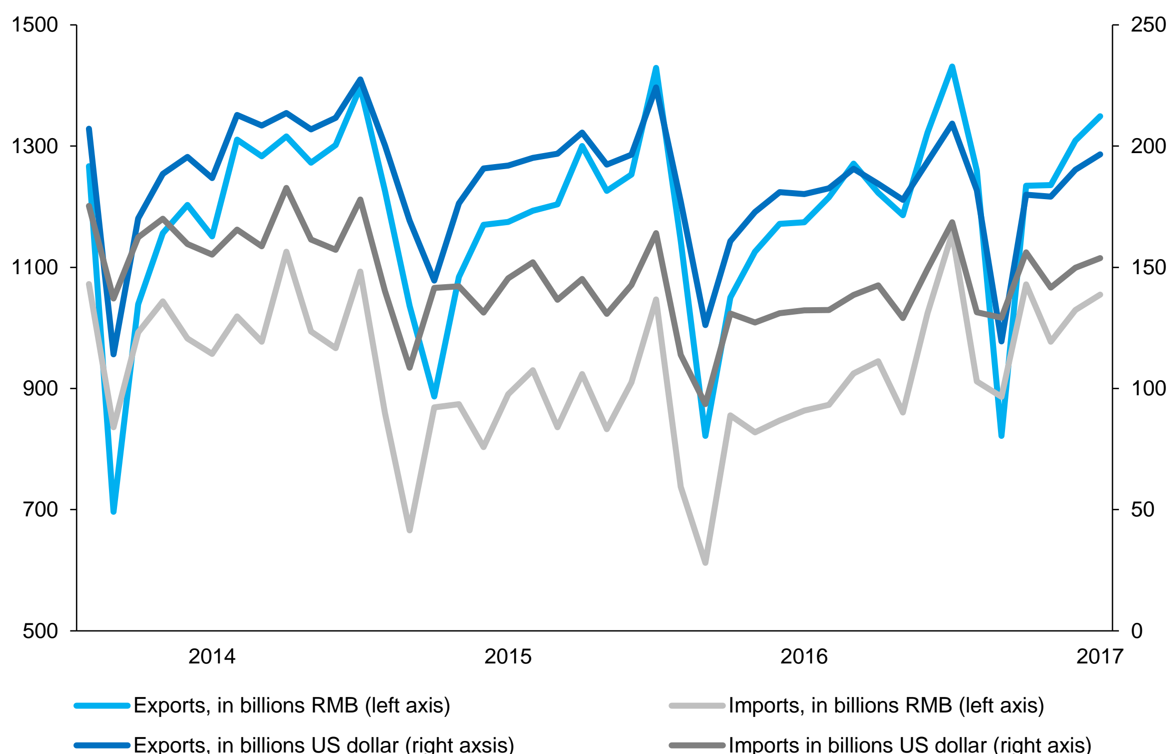
China continues to grow

Buoyed by monetary and fiscal stimulus measures, economic growth in China in 2017 and 2018 is expected to maintain its current level. In real terms, economic output is expected to grow by a good 6.75 percent in 2017 with slight upward potential. At present it is not possible to foresee whether growth will really tail off slightly in 2018. The cyclical recovery in Asia is strengthening net exports. Growth of just under 6.5 percent from 2018 to 2020 would still be compatible with the targets set by the leadership.

Strong first half year 2017

In the first six months of the year, China generated an economic output equivalent to 4,916 billion euros. The level of growth and most indicators are surprisingly positive. Consumer prices rose by a moderate 1.4 percent, with producer prices rising by a robust 6.6 percent, fuelled by increasing commodity prices and increasing wages. State sector investments rose by twelve percent. The private sector, which accounts for over 60 percent of investment, grew by an impressive 7.2 percent. Spurred by the stimulus measures, infrastructure investment soared up 21.5 percent. Investments in high-tech were boosted by the “Made in China 2025” campaign, going up 20 percent. The momentum in real estate is slowly cooling down as regulatory measures gradually take effect and interest rates for lending remain high. Construction investment grew by 8.5 percent compared to the previous year. Foreign trade, in domestic currency terms, remain a strong driver of growth, with exports increasing by 15 percent and imports increasing by no less than 25.7 percent in the first half of the year.

Development of Chinese foreign trade*



*goods and services

Source: Macrobond

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Sluggish implementation of planned reforms

Since the emergence of the “new normal” of more moderate growth rates, China has turned once more to an expansive monetary policy with debt-financed investments and infrastructure projects. The current stimulus programme for infrastructure will continue until 2018. The Belt and Road Initiative is designed to gradually transfer this model to the surrounding countries and open up new export markets. This could generate further impetus for growth. In the medium term, however, only more extensive reforms will improve stability and minimise the risks involved in the structural transformation towards increased domestic consumption and more services. A proactive policy approach that gives market forces more leeway and reduces debt in the non-financial sector would have a broad positive impact (IWF 2017g and Lam, Rodlauer, Schipke 2017). Under the slogan “supply-side structural reform”, efforts are being made to reduce overcapacity, surplus residential housing and excessive corporate debt. The objective is to make production more efficient overall and increase its focus on complex supplier parts and high-end products. Progress in the reform of state-owned companies is slow due to the possible social consequences and overcapacity is so far not being tackled at a fundamental level.

Debt increasing but at a slower pace

New borrowing in the last few years has increased public and corporate debt. At present, total public debt amounts to approximately 260 percent of GDP and corporate debt to around 170 percent. Corporate liabilities are mainly nominated in renminbi. In extreme cases this could facilitate debt relief as the state has wide-ranging options for intervention. Snowball effects from non-performing loans could pose a risk for the system and negatively impact on foreign economic and financial flows. China’s high foreign currency and gold reserves remain a positive factor.

Party congress in autumn will map out China’s course

The National Congress of the Communist Party of China scheduled to take place this autumn will decide on top-level government reshuffles and the future course of the country’s economic policy. The big question here is whether the party will commit to market economy elements, as it already indicated once in 2013 but did not then implement, or whether it will continue to focus on centrally planned state interventions as in the last five-year plan. We should therefore not expect to see any major reforms before the autumn, as the course will rather be targeted towards stability and steady growth.

Japanese economy continues to gather pace

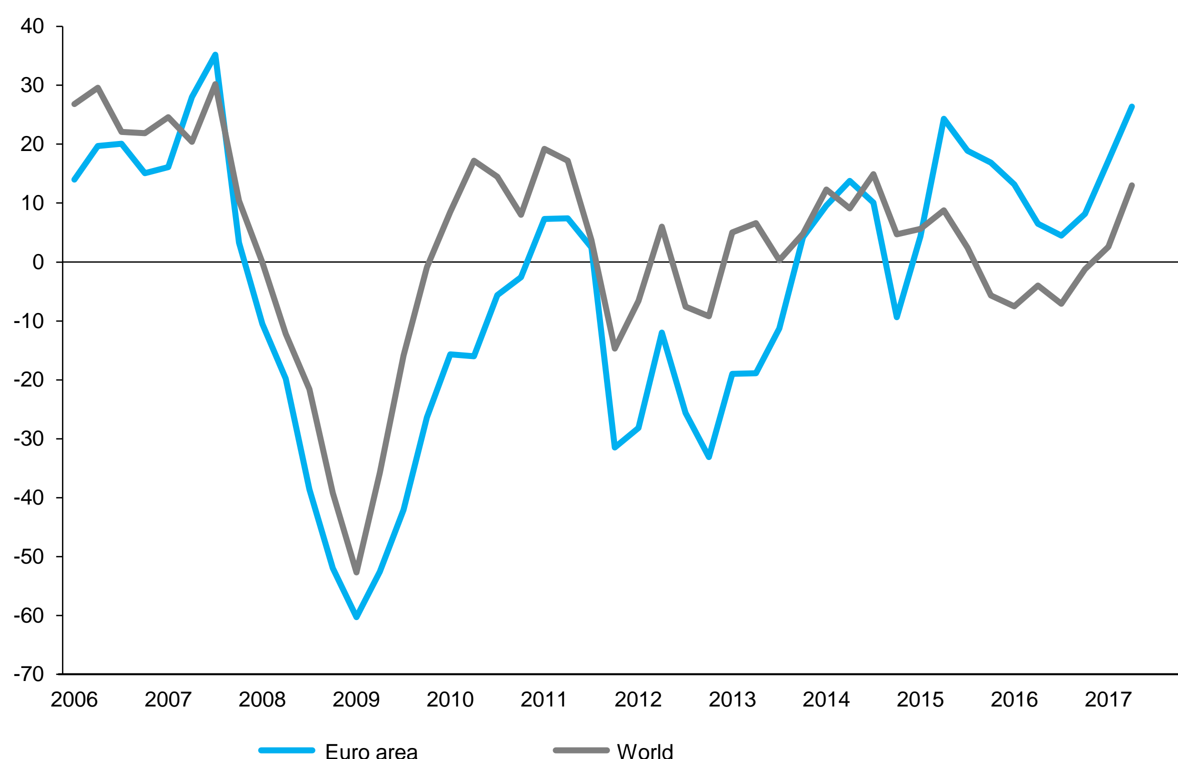
Japan is also benefiting from the economic recovery across Asia. Most analysts have upwardly revised their expectations for economic growth to well above one percent. The OECD most recently predicted growth of 1.4 percent and the IMF 1.3 percent. Net exports in particular are rising and should contribute a noticeable half a percentage point of growth. The fiscal stimulus measures of the last few years are additionally supporting growth. While the manufacturing sector is driving the upturn, services are also expanding moderately. Companies are making good profits and employment is set to increase further in the next two years even though the labour supply is tighter now than it has been for the last 40 years (OECD 2017b). Investments in buildings and equipment are also likely to experience a robust upswing, while private consumption is only set to rise slightly. Construction investments will also continue to benefit from infrastructure investments ahead of the 2020 Olympic Games. In 2018, we can expect to see growth drop down slightly to around one percent growth as imports start to pick up, investment momentum diminishes and tax policy becomes more restrictive. Financial policy will not be able to provide much support at all going forward as the primary deficit of around 2.5 percent in 2017 is already 1.5 percentage points above the target set by the government and net borrowing is running at excessive pace at five percent of GDP. The country still lacks a medium-term fiscal policy strategy to stabilise the debt ratio. Further necessary measures include structural reforms to reduce the dual labour market, more deeply integrate small and medium-sized enterprises in world trade, and to make Japanese society more open to the employment of

women and foreign workers. All these points are on the agenda of the Abe government.
After a dip at the start of the year, the rate of inflation should rise somewhat, though not very strongly as wages are only increasing sluggishly despite full employment. At the same time, the weaker yen and increasing energy prices (compared to last year) are providing a slight upwind in prices and will likely bring the inflation rate up to a good one percent by the end of the year. The Bank of Japan is still driving an extremely aggressive expansionary course and is sticking to its strategy of directly influencing yield curves, keeping yields for ten-year government bonds at close to zero percent, and expanding the monetary base until inflation reaches the target of two percent.

Unexpected performance of Europe in first half year

The upturn in Europe is continuing with unexpected vigour. Both the EU and the euro area grew 0.6 percent over the previous quarter in the first quarter of 2017, clearly outperforming the US, which only registered 0.3 percent growth. For 2017 overall the European Commission and the OECD are forecasting GDP in the euro area to grow by between 1.7 and 1.8 percent. The ECB (2017a) and the IMF (2017f) are even more optimistic, predicting growth of 1.9 percent in their most recent projections. The latest sentiment indicators underline this upward trend. The ifo Business Climate Index for the euro area is at its highest level since 2008 at 26.4 points. Since 2015 expectations for the euro area have trended above the global average.

ifo Business Climate Index as balance in percent



Source: Macrobond

The major driver of growth in the euro area is still private consumption though momentum is expected to tail off slightly this year due to gradually rising inflation. Investments should increase in 2017 in line with the cyclical development and exports also outperformed expectations in the first half of the year. The upturn has further reduced the rate of unemployment, which is likely to average out at 9.4 percent for 2017 overall. There are still

considerable differences between the individual countries. While some member states are already facing labour shortages in some sectors, unemployment remains high in peripheral countries, with more than 20 percent in Greece and more than 17 percent in Spain (BusinessEurope 2017).

No turnaround in monetary and interest rate policy

A major factor supporting the upturn in the real economy is the unconventional monetary policy of the ECB. The ECB's bond purchasing programme of over 60 billion euros per month is scheduled to continue until the end of the year and probably beyond, though on a smaller scale. In public statements issued in June 2017, ECB President Mario Draghi for the first time signalised a gradual reduction of the expansionary measures in the future. However, the monetary stance should not be tightened too quickly. The production gap is starting to close but price acceleration remains reserved. The ECB is forecasting inflation to increase from 0.2 percent in 2016 to 1.5 percent this year and then to drop back down to 1.3 percent in 2018. Although the expansionary course has so far had a positive impact on GDP, the transmission mechanism from production to inflation has been weaker since the crisis. There is probably much more potential on the labour market than is currently reflected by the unemployment figures. The upward pressure on wages is still marginal despite improved conditions on the labour market. Low productivity growth on account of overdue structural reforms is one of the reasons here. Even if the upturn continues, monetary policy thus still needs to play a supporting role to avoid endangering the target for inflation of close to, but under, two percent. In view of this, interest rates are likely to remain low for several years to come.

Political uncertainty fades, confidence in the upturn rises

The political uncertainty caused by the unexpected outcome of the referendum in the United Kingdom and the French presidential elections has subsided. The Bundestag elections in Germany this autumn will be the last major political event of the years 2016 and 2017. In general, no fundamental changes are expected in the political course of Germany, irrespective of how the mandates are ultimately distributed, so the uncertainty here is limited. The situation in Italy remains unclear, with new elections potentially on the horizon following the failed constitutional referendum. The situation in Greece is just as complicated but we no longer expect another crisis with spillover effects.

This is the first time since 2008 that the economic and political environment in Europe has become more stable and this opportunity must be used for urgently needed reforms. These include not only national efforts to increase productivity and reduce risks, but, in particular, measures to stabilise the Economic and Monetary Union. The window of opportunity to implement these reforms lies between the German elections in 2017 and the European Parliament elections in 2019 and is thus very narrow indeed.

Global financial system is stabilising though risks remain

International financial stability has further improved in the last few months. Increased growth in most economic regions and the expansionary monetary policy adopted by many economies has helped further stabilise the global equity and bond markets and other asset classes (IMF 2017b). Higher commodity prices have improved the financial situation of exporting developing countries and accelerated debt reduction in the private sector. Exchange rate effects remain a risk for these countries, especially those with US dollar debt. The uncertainty regarding the economic policy of the new US administration remains high. Tax policy and regulation issues in particular remain unclear.

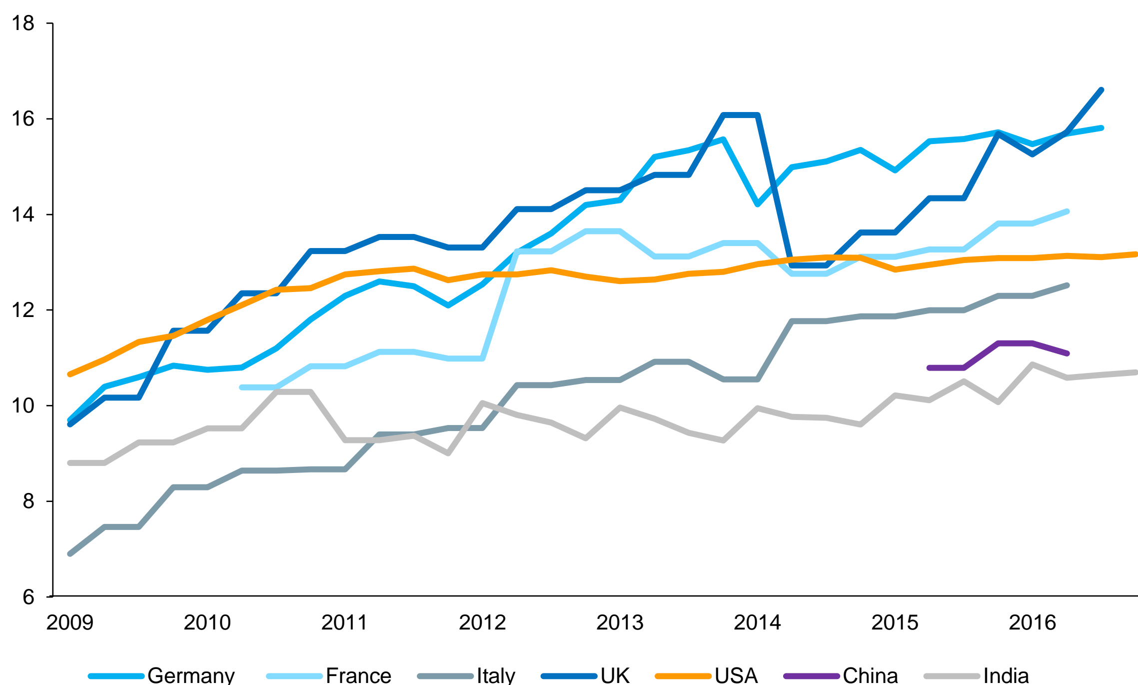
In Europe, the financial system continues to suffer from structural problems. Low profitability and non-performing loans are obstructing the healing process of the banking system and the capital markets are underdeveloped in comparison to the US. There are still considerable dormant risks in the balance sheets of state-owned enter-

prises and banks in China that are barely visible in international statistics. Overall, however, the slightly improved global growth prospects in combination with low interest rates have raised the risk-taking appetite of investors. The price increases recorded in some markets, such as residential property, are already approaching the early warning values (ECB 2017b).

Banks slow to build up equity and resolve structural problems

The equity position of banks has risen since 2009 and now provides a bigger risk buffer. However, the predominantly low level of profitability and persistently high level of non-performing loans are curbing the further expansion of the equity base. This is particularly true in Europe where a consolidation of the fragmented banking system is urgently required. The Banco Popular Español was successfully resolved in June without involving taxpayers by applying the Single Resolution Mechanism (SRM) of the European Banking Union. On the other hand, the case of the Banca Monte dei Paschi di Siena and two other Italian financial institutions showed that a resolution procedure is not always possible without public funds. The measures for the two Venetian banks were implemented in line with Banking Union regulations that permit the application of Italian insolvency legislation for smaller institutions. The problem caused by the link between ailing banks and public finances has therefore not been finally resolved and still has a negative impact on the level of stability expected of the financial system. The regulations need to be strengthened further to complete the Banking Union. Tax incentives for private investors to acquire bank bonds should also be eliminated.

Risk-weighted equity ratio of banks in percent

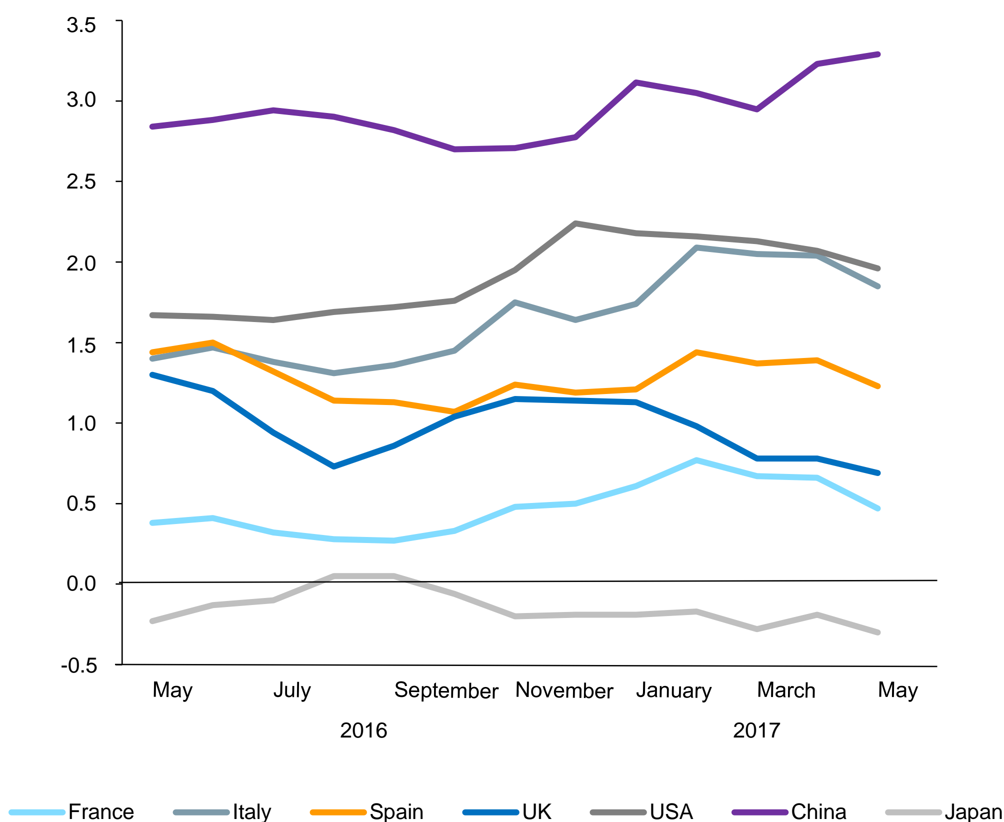


Source: Macrobond

Risk premiums on government bonds down slightly again

In late 2016, the spreads of ten-year government bonds of various economies compared with ten-year German government bonds had increased. This trend has reversed again with the exception of Chinese bonds, mainly as a result of the upwardly revised global economic prospects. Interest rate turnarounds by central banks pose a risk for some countries, as these could lead to debt sustainability problems. The interest rates in the US have spillover effects on Europe and Asia and can lead to major price impacts on the markets for government bonds and also, in part, for private sector assets. A consistent orientation towards growth and investment is urgently required to build confidence in public budgets and to prepare for the interest rate turnaround.

Spreads of selected government bonds* in percent



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

Source: Macrobond

Regional developments

The global economic recovery also picked up speed in the majority of developing and emerging countries in the first half of the year. The **Asian-Pacific countries** benefited in particular. Several forces are driving the economic upswing in Asia (Deutsche Bank 2017): some countries have profited considerably from the upwind in foreign trade in the region, including Indonesia, Hong Kong, Malaysia, the Philippines, South Korea, Thailand and Vietnam. Currency devaluations provided additional support in some cases. Several countries are running substantial public investment programmes that have increased demand (Malaysia, Taiwan, Thailand with South Korea soon to follow). Private investments have also increased strongly in some countries (India, Indonesia). India is set to grow with slightly less momentum at around seven percent (IWF 2017f: 7.2 percent) as the currency reform has caused some losses. In view of the largely appropriate monetary and fiscal policy and structural improvements including in sales tax, the situation should start to improve again before long. Although Modi announced in his election campaign that he would take comprehensive steps towards liberalising the prevailing planned-economy elements in the Indian economy, these have not been implemented so far (Economist 2017). Overall, however, the growth prospects for the **Asian-Pacific region** have brightened. The developing countries of the Asian-Pacific region should grow by over 6.5 percent this year, while high-income countries in the region are set to experience moderate growth of over two percent (Australia and New Zealand both 3.1 percent, Hong Kong: 2.4 percent, Singapore: 2.2 percent, South Korea: 2.7 percent, see IMF (2017b)).

Regional economic outlook* 2017	
South America	0.6
Central America	3.9
Caribbean	3.6
Asia-Pacific, Advanced economies[1]	1.9
Asia-Pacific, Developing economies[2]	6.5
CIS-States[3]	1.7
Middle East, North Africa, Afghanistan, Pakistan	2.6
Israel	2.9
Sub-Sahara Africa	2.7

[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

*Growth of real GDP over previous year in percent

Source: IMF (April and July 2017)

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In **South America, Central America and the Caribbean**, it is above all Argentina and Brazil that have found their way back to growth. In 2016 the region recorded its third-worst performance in the last thirty years with a decrease in production of one percent (IMF 2017d). The end of the commodity boom, the terms-of-trade shock and the necessary adjustments were all weighing heavily on commodity exporters in particular. Brazil, Argentina, Ecuador and Venezuela went through a deep recession with Central America and the Pacific countries performing much better overall. But things are looking up again, **and the region as a whole** should achieve growth of around one percent of GDP this year and two percent next year. **South America** is largely treading water, while **Central America** and the **Caribbean** can expect growth rates similar to last year of between 3.5 and four percent. **Argentina** should be able to finish off the year with growth of more than two percent as it sees improvement on a broad front. Public investment is going up, private consumption and wages are rising, exports are growing steeply following a good harvest season and progress is being made both in budget consolidation and in combating inflation. **Brazil** will hopefully manage to grow by half a percent (IMF 2017: 0.3 percent; OECD 2017a: 0.7 percent). Private consumption and investments are continuing to point down, with increasing inventories being the only factor keeping domestic demand halfway stable. Foreign trade should increase by around five percent although net exports are set to remain neutral (OECD 2017a). Progress in budget consolidation, the reform of social security systems and combating inflation (now at around six percent) has provided leeway for monetary easing. Structural reforms in provincial budgets, on labour and product markets and in the private sector are still urgently needed. The latest political uncertainties surrounding the administration are also having a dampening effect on the economy. Economic growth in **Chile, Columbia and Peru** meanwhile is somewhat slower than expected.

The same is true of **Mexico** (classified as part of North America), which is growing at an unusually weak pace of under two percent (IMF: 1.9 percent). Here, tighter financing conditions for the private sector and uncertainties surrounding trade with the US, labour market mobility between Mexico and the US, and the future remittances of Mexican migrants are all casting a cloud on investment activity and private consumption. Furthermore, the Bank of Mexico had to combat inflation that was somewhat too high at over five percent (target: three percent), while the peso has appreciated since the start of the year. **Canada**, in contrast, has experienced two years of economic upturn. The economy is set to grow by at least 2.5 percent, buoyed by a moderately expansionary monetary and fiscal policy.

The prospects for the region of the **Middle East, North Africa, Afghanistan and Pakist**an are weaker. The region is likely to increase economic output by a mere 2.6 percent this year. Turkey is the exception here with significant growth driven mainly by expansionary monetary and fiscal measures and public investment in infrastructure. The countries of **Sub-Saharan Africa** are more than a quarter-point under the previous year's level and are declining at the same rate, while South Africa's economy is stagnating. The prospects are rosier for the former **CIS States. Russia**, in particular, is gathering pace and is now expected to grow by just under one and a half percent (IMF: 1.4 percent) on the back of rising oil prices, lower financing costs for private enterprise, increasing wages and falling unemployment. Although exports are still being curbed by sanctions, domestic demand is now finally picking up following two very tough years with a cumulative double-digit drop (down 9.5 percent in 2015 alone). **Kazakhstan** should grow substantially faster than anticipated one year ago and reach 2.5 percent. The region overall should manage growth of 1.7 percent.

Global trade should see robust growth this year

Global trade grew by 2.2 percent in 2016 over last year according to International Monetary Fund estimates. In the first quarter of the current year, global trade grew by 1.8 percent over the final quarter 2016 according to preliminary estimates from the Netherlands Bureau for Economic Policy Analysis. The primary factor driving trade was the comparatively high demand from emerging countries whose imports increased over the previous quarter by 3.3 percent. Imports of industrialised countries rose by a comparatively low 0.8 percent. Exporters from emerging countries benefited from an increased demand for goods, increasing their exports by 2.8 percent in the first quarter. The RWI/ISL Container Throughput Index, which measures global trade developments based on

capacity utilisation of the world's major container ports, indicates that global trade is set to continue expanding noticeably. The index reached its highest level yet in May. It is likely that global trade will grow more strongly this year than last. The International Monetary Fund is anticipating a four percent increase in world trade.

Foreign direct investment

Global cross-border direct investment flows suffered a setback in 2016 after strong growth in 2015. UNCTAD figures show a drop of two percent in investment flows down to 1.8 billion US dollars in response to the slow-down in economic momentum and increasing global risks. Investment flows into emerging countries were particularly affected, going down 14 percent. Foreign direct investment into industrialised countries, on the other hand was up five percent. This brought the proportion of global investment flows into industrialised countries back up slightly, to currently 59 percent, thus somewhat curbing the several-year trend of investment flows towards emerging countries. Cross-border direct investment should pick up in the course of this year. Rising global trade and economic growth will invigorate investment activity particularly in emerging countries if commodity prices continue to increase. The UNCTAD is anticipating global direct investment flows to increase by five percent in 2017.

Clear increase in global industrial production at start of year

In 2016 global industrial production increased by 1.9 percent over the previous year on the back of a strong second half to the year. The growth rate slightly exceeded the previous year's 1.7 percent. Emerging countries exhibited the strongest growth. Production here increased by 3.5 percent over 2016 following an increase of three percent the year before. In the developed countries, industrial production increased by only 0.2 percent following on from 0.4 percent growth in 2015.

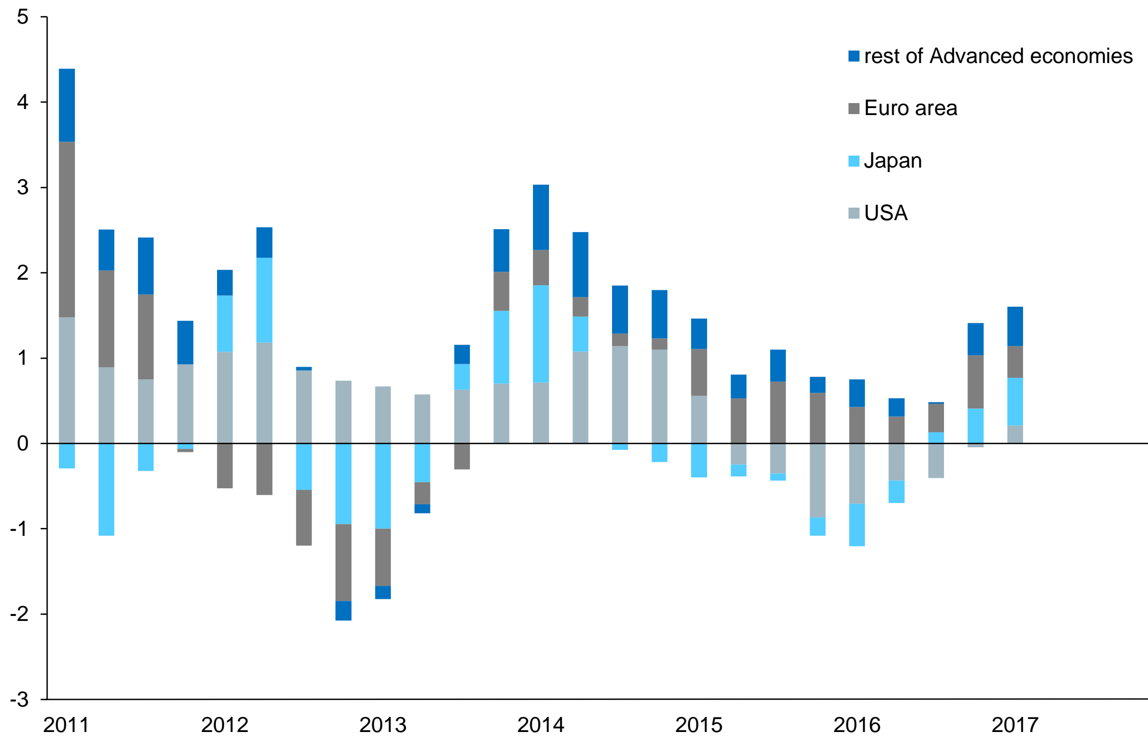
According to the latest data released by the Netherlands Bureau for Economic Policy Analysis (CPB), global industrial production in the first quarter of the current year increased by 2.9 percent year on year. At 4.1 percent, growth in emerging countries was considerably higher than in developed economies, which only managed to grow by 1.6 percent. The latest figures point to a continuation of the current upward trend. In April 2017 global industrial production increased by 3.3 percent compared to April 2016. While the pace of growth has increased slightly in the advanced economies (up 2.8 percent following up 2.2 percent in March) momentum in emerging countries has dropped slightly (up 3.8 percent following up 4.3 percent in March).

Broad-based upturn in advanced economies

The advanced economies, where just under 53 percent of industrial value added is produced, are set to experience a broad-based upturn. Industrial production has been rising in all major developed economic regions for the last two quarters. Industrial production in the US (which accounts for 17.2 percent of global industrial production) increased in the first quarter of 2017 for the first time following six successive decreases.

Japan, where just over eight percent of global industrial production takes place, registered production expansions of 2.6 percent in the fourth quarter of 2016 and 3.7 percent in the first quarter 2017.

Industry production* in Advanced economies



*Chnage over previous year in percent

Source: Netherlands Bureau for Economic Policy Analysis

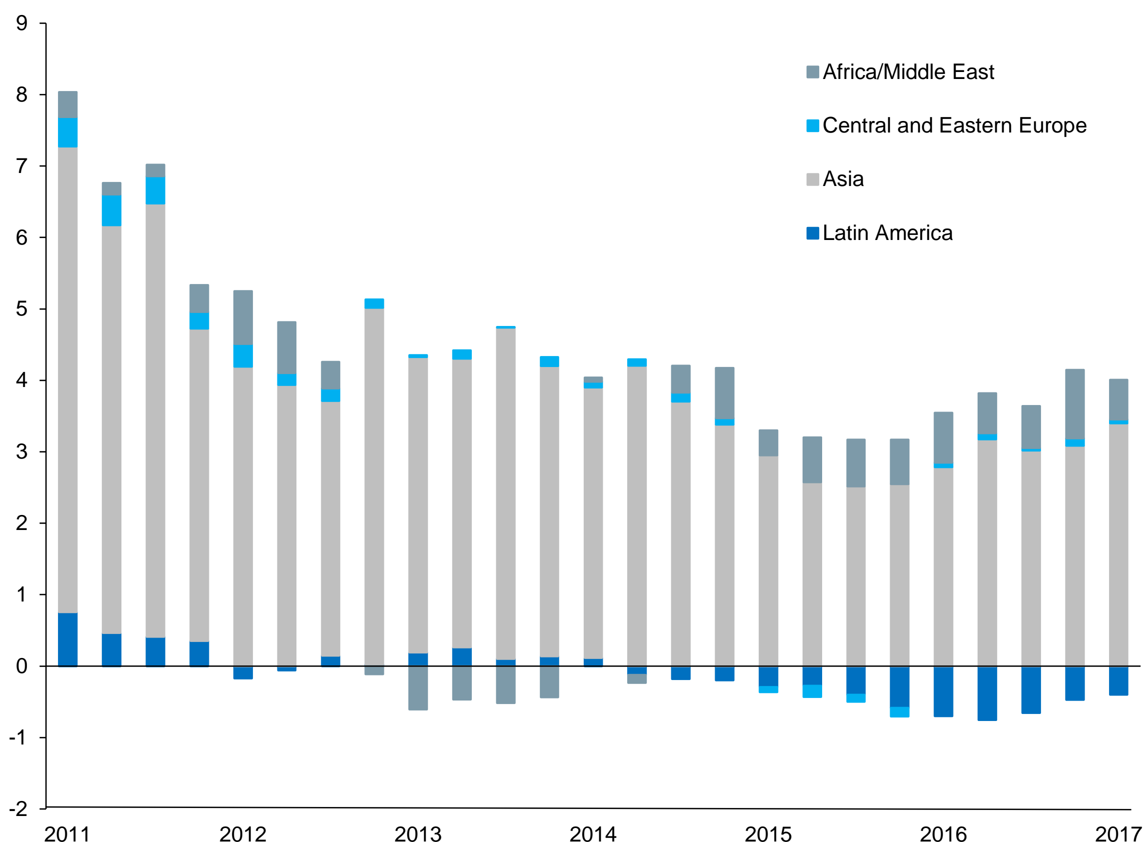
In the euro area, industry has been expanding constantly since the fourth quarter 2013. The above-average growth in production in this region of 2.6 percent in the fourth quarter 2016 was followed by an increase of 1.4 percent in the first quarter of the current year. Somewhat over 15 percent of worldwide industrial production takes place in the euro area. The other advanced economies (which account for 11.9 percent of global industrial production) have been growing for 15 quarters now without interruption. Following a production increase of 1.7 percent in the fourth quarter 2016, industrial production rose more than average in the first quarter 2017 by 2.2 percent.

Emerging countries: Asia booming, Latin America in long-term recession

Asian emerging countries (incl. China), where 26.7 percent of worldwide industrial value is produced, are a key driver of momentum in industrial production. Following an increase of 5.4 percent in the fourth quarter 2016, industrial production showed a stronger expansion in the first quarter of 2017 than in the last two years, going up by six percent. Production also grew in Africa and the Middle East (proportion of global industrial production: 9.1 percent) increasing year on year in the last two quarters by five percent and 2.9 percent respectively. In Central and Eastern Europe (proportion of global production: 3.3 percent) industrial production has increased steadily for slightly over one year with growth rates of around one percent. The trend in Latin America, on the other hand, is troubling. Industrial production in this region has been declining continuously since the second quarter 2014.

In the first quarter 2017 the decrease over the previous year was still a substantial 2.1 percent. The region, which accounts for slightly over 17 percent of the industrial production of emerging countries, pulled down production growth in emerging countries by just under 0.4 percentage points in the first quarter.

Industry production* in Emerging markets



*Change over previous year in percent

Source: Netherlands Bureau for Economic Policy Analysis

Consequences for the German economy

The German economy has grown at an unexpectedly strong pace in the first quarter. Since then, many indicators have also been substantially more positive than anticipated at the start of the year. The stronger economy in the euro area and Asia and the rising demand for capital goods has benefited incoming orders and production in Germany. The business climate has also brightened noticeably once again in 2017. This suggests that the perspectives for foreign trade, investment activity and employment in manufacturing will continue to improve.

The revival of global trade and the economy in most major countries will have a positive impact on net exports. Domestic demand is so far developing largely in line with projections, with a buoyant construction sector, increasing investment in equipment and a consistent though moderate rise in private consumption. Net exports may deliver a positive surprise in the further course of the year – provided, of course, that none of the major political risks to the global economy materialise.

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