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German Industry

GLOBAL GROWTH OUTLOOK

Loss of momentum.

Global economy drifting sideways

June 2016

- **The global economy is drifting sideways. Real growth this year is likely to draw level with last year's figure at around three percent.** Latin America and the CIS countries are experiencing regional recessions, while growth in sub-Saharan Africa is weak.

- **Industrial production, global trade and global FDI are all set to increase very little this year. Industrial production is unlikely to recover from its low level this year (2015: 1.9 percent), and is on track to underperform economic output.** Global trade could grow by as much as three percent in terms of volume. Foreign direct investment in 2015 was driven by acquisitions, displaying little signs of a shift towards real investments in new capacities.

- **The financial risks to the global economy have increased substantially in the last two years.** Global financial stability is especially at risk from heavily indebted companies in emerging economies. The drastic expansion and sustained stimulation of lending in China over the last few years harbours considerable mid-term financial risks and is endangering the chances of a successful structural transformation of the Chinese economy.

- **Regarding economic policy, more emphasis needs to be placed on structural reform, fiscal policy needs to develop more impetus and monetary policy needs to stay on track.** China, Japan and the euro countries need to implement further structural reform, while no reforms can be expected from the United States in 2016. Momentum from trade and investment liberalisation is also urgently required both in Asia and in the transatlantic region.

Content

Listless start to the new year 3

Regional economic development a mixed bag 6

Exchange rates have adjusted 7

China's economic stabilisation efforts working but harbour risks 8

U.S. economy continues moderate growth 10

Europe's economy continues to recover 10

Global industrial production barely growing 11

Global trade exhibiting weak growth 12

Foreign direct investment (FDI) dominated by takeovers 13

Capital flowing out of emerging economies 14

Inflation and other major trends in monetary policy 14

International financial stability 16

Germany's fortune in a weak world? 17

Sources 18

Imprint 19

Listless start to the new year

The global economy lost its footing slightly in the second half of 2015. The increase in production of only 2.8 percent was its lowest level for some time. Prospects for global economic growth for this year have slipped by around half a percentage point since last autumn. Global production is unlikely to gather momentum in 2016 but rather stay level with last year's growth of just over three percent (see chart below). Growth should pick up to between 3.25 and 3.5 percent in 2017, especially if Brazil and Russia manage to pull out of their recessions. With 4.1 percent, the IMF forecasts that developing and emerging economies will continue to grow twice as fast as advanced economies (1.9 percent). Financial market risks have meanwhile increased considerably, particularly due to the very heavy indebtedness of companies in many developing countries.

Forecast summary: Growth in real GDP 2016/17

	2015	2016			2017		
	IS	IMF[1]	OECD[2]	EU-COM[3]	IMF	OECD	EU-COM
World	3.0	3.1	3.0[4]	3.1	3.5	3.3[4]	3.4
USA	2.4	2.4	1.8	2.3	2.5	2.2	2.2
China	6.9	6.5	6.5	6.5	6.2	6.2	6.2
Japan	0.5	0.5	0.7	0.8	-0.1	0.4	0.4
EU	2.0			1.8			1.9
Euro area	1.7	1.5	1.6	1.6	1.6	1.7	1.8
Germany	1.7	1.5	1.3	1.6	1.7	1.7	1.6
France	1.2	1.1	1.4	1.3	1.3	1.5	1.7
Italy	0.8	1.0	1.0	1.1	1.1	1.4	1.3
Spain	3.2	2.6	2.8	2.6	2.3	2.3	2.5
UK	2.3	1.9	1.7	1.8	2.2	2.0	1.9
India	7.3	7.5[5]	7.4	7.4	7.5[5]	7.5	7.4
Brazil	-3.8	-3.8	-4.3	-3.7	0.0	-1.7	0.3
Russia	-3.7	-1.8	-1.7	-1.9	0.8	0.5	0.5

1: IMF (April 2016)
2: OECD (June 2016)
3: European Commission (May 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

Overall, the most recent slowdown that started in autumn 2015 took the capital markets somewhat by surprise. The markets needed a full two months at the beginning of 2016 to price in the gloomier outlook. Alongside the usual adjustments on the equity markets, this resulted in very low capital inflows paired with rising outflows for the developing and emerging market countries (IMF 2016b). The financing conditions have subsequently become more difficult in many developing countries. A look at the expenditure side of national economic output shows that private consumption has trended upwards across the globe while investment activity has faltered in all major regions. Foreign trade hardly provided for any momentum, and global trade may even drop below production with international organisations forecasting growth of less than three percent. The volume of imported goods and services, adjusted for the European Union, only nudged up 0.5 percent. The European Commission is expecting the volume of imports to recover slightly and grow 2.1 percent (European Commission 2016).

Among the major national economies, the **United States** slowed down slightly towards the end of 2015, but still managed real growth of 2.4 percent compared to 2014. The U.S. administration is anticipating 2.7 percent growth this year (White House 2016), as is the OECD, while the IMF's forecast is slightly more modest at 2.4 percent. In 2015, household consumption spending grew by 3.1 percent in real terms, public consumption by a meagre 0.7 percent, while gross fixed capital formation increased by a healthy 4.9 percent. Imports grew by 4.9 percent, outperforming exports, which were up by only 1.1 percent. Private consumption contributed 2.1 percentage points to growth, public consumption another 0.1 points and investments 0.8 points, while net exports pulled growth down by 0.6 percentage points. This general pattern is likely to continue throughout 2016. The U.S. economy recorded annualised growth of 0.8 percent in the first quarter.

China, on the other hand, should be able to grow by 6.75 percent, buoyed by a series of economic policy measures which, on the downside, will increase risks to financial stability. The **European Union** should achieve real growth of 1.8 percent and the euro area 1.6 percent (European Commission 2016). **Japan**, on account of its interdependence with China and the strong yen, is set to experience another very weak year with growth of only 0.5 percent despite continuing its very expansive monetary policy course. The Japanese economy nonetheless started off the first quarter of the year with growth of 0.4 percent (although the preliminary estimates of the statistical authorities here are notoriously unreliable).

China's structural transformation a dominant factor in global slowdown

China's economic structural transformation is the biggest contributing factor to the current downturn. The shift of the economy towards more private consumption and services initiated in 2011 has since resulted in a continuous slowdown of investment and trade activity. The resulting knock-on effects have dampened economic momentum throughout Asia, ushered in the end of the commodity super-cycle (China's share in 2014 was still at 40 percent of global demand for metal), slowed down global industrial activity (China's share: 25 percent!), decelerated global investment activity (share: 25 percent!) and taken the steam out of global trade (share: ten percent).

Low oil prices bring little impetus

The modest outlook for demand coupled with temporary surplus supply on the oil market has pushed oil prices down, the barrel price of Brent crude oil falling at times to below 30 dollars. Prices fell over 30 percent between summer 2015 and this February, since recovering to around 50 U.S. dollars a barrel. The short-term outlook for prices for this year is stable. Prices for coal and gas on the global markets also fell.

The oil price slump has dramatically decreased disposable income in some oil-producing countries, forcing them to stringently readjust their fiscal policy, foreign trade and investment activity. The slump has also accentuated the recessions in Russia, Venezuela and Brazil. The end of the oil cycle has also cut investment activity in this sector back by one-quarter, dragging down overall global growth by around a quarter of a percentage point. The profits of many oil and mining companies have been squeezed and the level of bad loans in this sector is on the rise, meaning that some exposed banks will have to make write-offs sooner or later.

On the other hand, the low oil prices have buoyed private consumption spending, above all in the industrialised countries of East Asia and somewhat in Europe and North America. The overall momentum is positive, though much weaker than previously. The situation on the oil markets will only start balancing out in the course of next year, especially considering that attempts by the OPEC to cap production so far, most recently in mid-April at the OPEC meeting in Doha, have failed due to conflicting interests, particularly of Iran and Saudi Arabia.

Monetary and fiscal policy providing limited support

Global economic development will only be marginally impacted by the fiscal policy direction of the major economies. The slightly expansive fiscal policy taken in 2016 by the United States, China and parts of Europe (Germany and Italy) is set against the slightly restrictive policy of Japan and other parts of Europe (Spain, United Kingdom) and many developing countries. The continuing high levels of debt in the three largest economies are restricting their policy space (IMF 2016b). Consolidating public finances is still on the agenda in many countries and has become even more pressing in many developing countries, particularly the oil-exporting countries. Growth-oriented shifts in existing budgets are almost non-existent but would be necessary to support structural reform and strengthen public investment and the viability of public budgets.

The monetary policies of the major central banks are still widely divergent. While the Fed and the Bank of England are beginning to tighten the monetary reins, the ECB and the Japanese and Chinese central banks have only recently substantially increased their expansive measures. The central banks of all the major economies have had to take action to counter the dampening impact of China and the oil prices on general price levels, which will make monetary policy goals more difficult to attain. Compensating for deflationary demand shocks when nominal interest rates are already close to zero is becoming increasingly difficult, calling forth unusual measures to bring real interest rates down to a reasonable level. This has also changed the expectations put on monetary policy. The Fed is still currently expected to hike up interest rates once or twice this year, while hardly any changes are priced in for China, Japan and the euro area (Projektgruppe Gemeinschaftsdiagnose 2016).

Structural policy falling short

In the last three years, the pace of structural reform in the major economies has been much slower than required. Particularly little progress has been made recently in the United States, with any move in structural policy blocked the political impasse. In Japan the overall impact of the various smaller reform packages of the Abe administration, while all basically positive, has fallen short of the mark. In China progress has been made in reforming communal finances and liberalising interest rates, but larger-scale political decisions on structural reform announced in late 2013 have still not been reached nor implemented. In the euro area only a few countries have tackled reforms recently that could help lift potential growth in the medium term, particularly in Italy and to a lesser extent in France. At least work has started on implementing the European Agenda to deepen the single market and promote investment, but a positive impact can only be expected to unfold in the medium term. Brazil, India and Russia have also hardly made any progress with reforms. International trade liberalisation is also stalling, with impetus in the short term only likely in the trans-Pacific region. Given that monetary policy has nothing left to offer and the limitations of financial policy space, it is hardly surprising that the G20 and IMF have recently called for reforms to stimulate momentum – though only from their respective partners!

Risks remain high, margin for error small

Boosting growth potential and actual growth in the global economy is a top priority in almost all major economies. The risks of economic downturn emanating from the commodity cycle, diverging monetary policies, volatile capital flows, over-indebted companies in emerging economies, security conflicts, the risk of a British exit from the European Union and the Chinese structural transformation make it all the more important to practice great caution and invest more effort in economic policy. Reforms on the labour and product markets, improved environments for investment and technological progress, and innovation policies all need to be pursued more vigorously than has been the case so far. Some countries also need to do more to increase the stability of their banking sector by further shaking out and strengthening banks' balance sheets. The ideal mix is different for each country, but all the big countries have more than enough on their plate (see e.g. OECD 2015 and IMF 2016a).

The British referendum: a special factor

The outcome of the British referendum on staying in the European Union on 23 June poses a special risk. Many studies, most recently from the British Treasury (HM Treasury 2016), have shown the longer-term disadvantages of an exit. In the short term, the United Kingdom would have to withstand the macroeconomic shock of a “no” vote, with possibly more volatile bond yields, exchange rates, current account financing and production. The upcoming referendum has already curbed investment and economic activity. A “no” vote is anticipated to reduce economic output by half a percentage point of GDP in 2017 and 2018, followed by a one-off larger-scale shock of at least 1.5 percentage points in 2019 (OECD 2016). The UK government has also calculated that UK economic output, which has grown by between 3.4 percent and 9.5 percent in the last 15 years, will be lower in the case of an exit, depending on what agreement is then made between the United Kingdom and the European Union. In view of the various difficulties in estimating the consequences, these figures are likely to be on the lower scale of the possible damage.

Regional economic development a mixed bag

The economic prospects for the developing and emerging economies in 2016 are still widely disparate. An average here is meaningless, with very rosy prospects for growth in India at seven percent worlds apart from the deep recession in Brazil with economic output expected to shrink by another three to four percent. The prospects for **Brazil** with its new government are still unclear. The country is in a very strained economic position with a budget deficit of over ten percent of GDP, inflation at around the same level, the government debt ratio rising due to the recession and the budget deficit, a double-digit key interest rate, real interest rates at a full eight percent, lending pointing downwards and the currency depreciating considerably against the U.S. dollar. Brazil's interim president Temer and new central bank president Goldfajn have their work cut out for them to stabilise the situation, although they do enjoy a large majority in the parliamentary chambers and could thus manage to pass reforms and budget measures that will help Brazil climb out of recession in the course of 2017. Brazil’s recession is likely to turn overall growth in **Latin America** negative (minus two percent), with Argentina, Ecuador and Venezuela also in recessionary territory. At least Bolivia, Columbia, Paraguay and Peru should be able to pull up the overall result with over two percent growth. Key interest rates are high throughout South America. Bond yields are as much as ten percent in Latin America, while equity markets are trading at 40 percent below 2007 levels. Within **North America**, Mexico is on track for normal growth with just over 2.5 percent and a dynamic rise in lending. Canada is not set to grow much this year, with estimates at 1.5 percent.

Russia and the Caucasus and Central Asian countries comprise the second sluggish region currently suffering heavily from the end of the commodity cycle. Production is expected to trend downwards in Russia, Belarus and Azerbaijan. The other energy exporters in the region (Kazakhstan, Uzbekistan and Turkmenistan) will have to get used to falling momentum. Net importers could manage to record positive growth all in all due to the improved situation in the Ukraine, although at a low level all round.

The oil-exporting countries of the **Middle East and North Africa** will experience a tangible increase in production of over three percent, particularly Iran and Iraq. Saudi Arabia and the Emirates, on the other hand, may still have to face negative growth rates. Saudi Arabia, Algeria and Iraq will all have to deal with very high current account deficits. Growth in the region’s oil-importing countries, at around 3.5 percent, will be slightly lower on average than in the previous year.

For **sub-Saharan Africa** growth prospects for this year are also weak, weighed down by commodity prices and unfavourable financing conditions. The region should nonetheless grow by around three percent. For South Africa, in contrast, the IMF is forecasting growth of only slightly over 0.5 percent, with just over two percent for Nigeria and Angola. Eastern Africa is the only part of the continent where infrastructure investments and buoyant consumer demand will be pushing growth rates up to over five percent.

Regional economic outlook for 2016	
South America	-2.0
Central America	4.3
Caribbean	3.5
Asia-Pacific, Advanced economies[1]	1.3
Asia-Pacific, Developing economies[2]	6.4
CIS States[3]	-1.1
Middle East, North Africa, Afghanistan, Pakistan	3.1
Israel	2.8
Sub-Sahara Africa	3.0

[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

Source: IMF (2016a)

The **developing Asian and Pacific countries** are still heading for continued economic growth of around six percent, and the ASEAN countries for average growth of around five percent.

The smaller advanced economies such as South Korea, Taiwan, Hong Kong and Singapore are set to reach their potential with growth rates of between 1.5 and three percent. The developing Asian and Pacific countries are in a good overall position in macroeconomic terms, despite the Chinese slowdown. With an average key interest rate of around six percent (excluding China), bond yields of around seven percent and real interest rates at around two percent, it is hardly surprising that the equity markets have performed so well since 2007. Equity prices in the region are about 50 percent higher than in 2007. **India's** economy is displaying very dynamic growth at over 7.5 percent, fuelled by private consumption and rising investments. Inflation remains under control at around five percent with trade balances (current account deficit of 1.5 percent) showing no signs of any larger-scale problems.

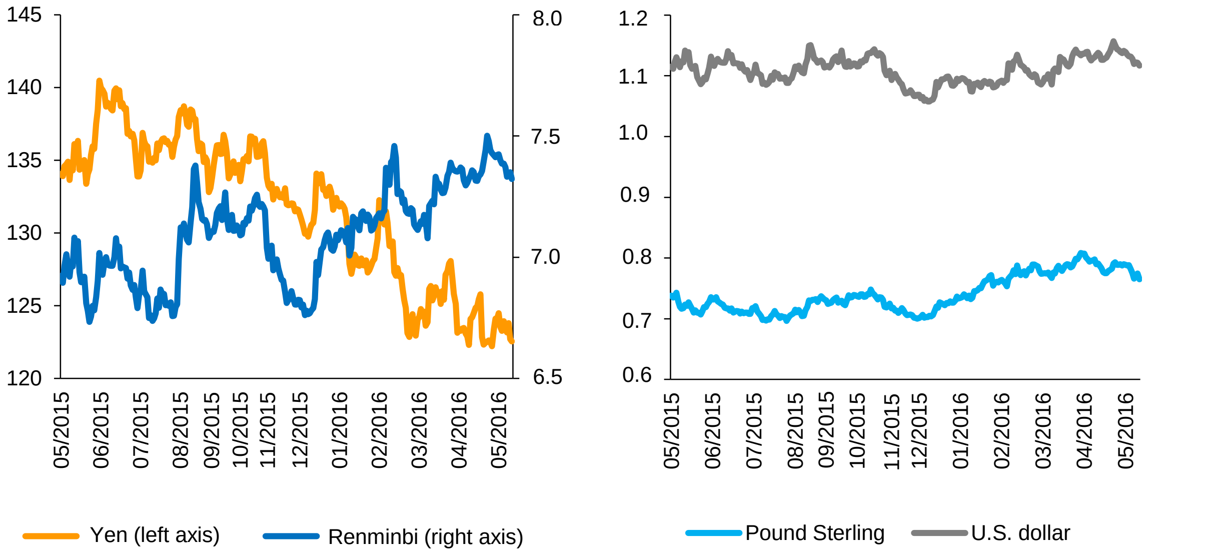
Exchange rates have adjusted

Over the last three quarters, the exchange rates of the major currency areas made clear adjustments to the changed circumstances. Around half of the adjustments were attributable to the weaker outlook for growth and global trade and the developments on the oil market. Policy mistakes in individual countries that led to volatile capital movements accounted for further adjustments.

In real and trade-adjusted terms, the yen has appreciated around ten percent since last summer; the U.S. dollar initially appreciated three percent, but then dipped back down to 1.5 percent; the euro appreciated only marginally with one percent; while the pound sterling depreciated seven percent and the renminbi two percent. The currencies of South Africa, Mexico, Russia and Columbia were all under great pressure, also due to commodity trends.

The imbalances in foreign trade have, in contrast, dropped considerably in the last few years. Nonetheless, the oil-producing countries did have to endure hefty corrections. Overall, the imbalances themselves are not currently posing any large risks. This is also because there are no virulent macroeconomic imbalances in the major national economies, although there are risks on the horizon.

Development of the exchange rate to the Euro



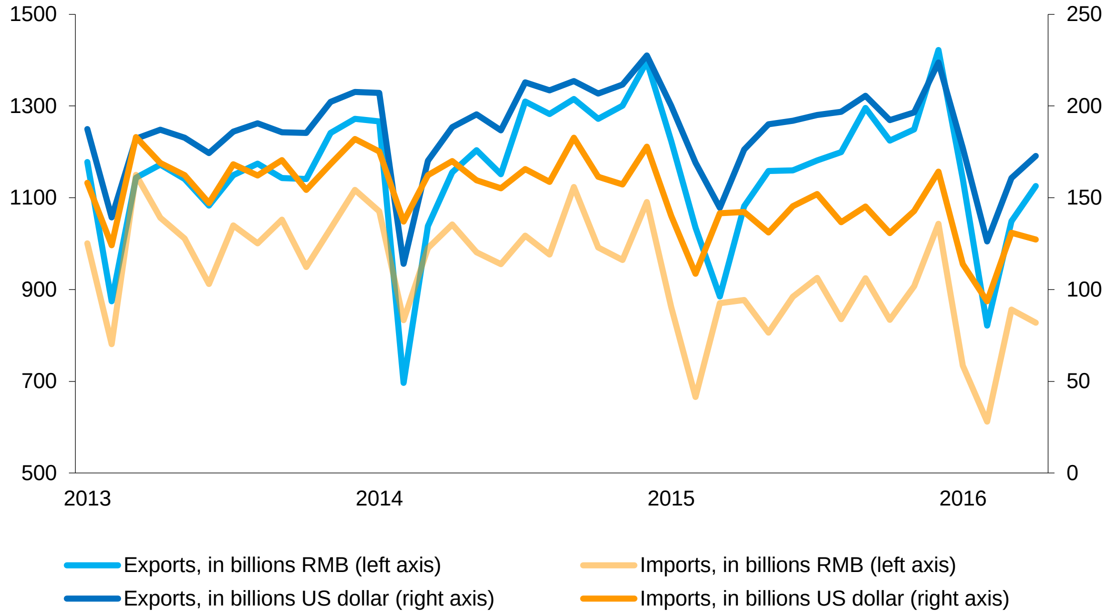
Source: Eurostat

China’s economic stabilisation efforts working but harbour risks

With China’s G20 presidency this year, there are clear incentives for the Chinese leadership to attain their growth objectives of 6.5 to seven percent. Following the worrying developments in August 2015 and in January and February of this year, the Chinese government has pulled out all the stops to mitigate the slowdown of the economy, including implementing monetary and fiscal policy stimuli and relaxing the lending practices of the state-owned banks, in an effort to conjure up the necessary economic warmth in the run-up to the meeting of the G20 heads of state and government this September. But, at the same time, the leadership is currently shying away from implementing any larger-scale structural reform (see Müller and Deutsch 2015 for an extensive analysis). It remains to be seen whether the supply-oriented structural reform propagated by the Chinese government since the beginning of the year will be able to inject new impetus into its reform efforts.

The Chinese central bank has cut benchmark interest rates five times by a total of 1.25 percentage points since the start of its loosening policy and, most recently, cut the reserve ratio of banks (by a total of three percentage points down to 17 percent), bringing about an influx into the banking system of around 100 billion dollars. The government has also initiated stimulus packages of a similar scale in fiscal policy of around one percent of GDP (transport routes, infrastructure, environmental protection) and has indicated increasing net lending from just over two percent to three percent of GDP this year. The growth of money supply (M2), which should have been brought down to well below ten percent for consolidation reasons, was at 14 and 13 percent in the latest figures (January and February respectively). The overall funding of the economy experienced strong growth in early 2016, with property investments in particular flourishing from robust demand in office property and strong sales of owner-occupied apartments since December 2015 (Zhiwei and Li 2016). The government is also trying to pave the way for a bank balance sheet shakeout by turning bad loans into equity, even though the volume here is still very low.

Development of Chinese foreign trade*



* goods and services

Source: CEIC

Industry and foreign trade currently being stimulated

Despite some efforts to reduce industrial surplus capacities in steel and cement in particular, the most recent figures for industrial production show growth once again at over six percent year-on-year. The same goes for the Purchasing Managers' Index that was once again in the positive. The change in equipment spending has also got out of the red again. Following the very weak figures for foreign trade in January and February this year, the results are good for March. Exports, down eleven percent (calculated in U.S. dollars; in renminbi: down seven percent) from previous year's level in January and 25 percent in February (in renminbi: down 21 percent), then recovered to exceed previous year's level in March by twelve percent (in renminbi: up 19 percent), then dipped down again in April by 1.8 percent (in renminbi: up four percent). Imports, down 19 percent from previous year's level in January and down 14 percent in February (in renminbi: down 14 percent and eight percent respectively), were only down eight percent in March (in renminbi: down two percent), but then 10.9 percent in April (in renminbi: down six percent). After seasonal adjustment, exports performed somewhat better (April: stable in U.S. dollars and up six percent in renminbi), with imports only decreasing by seven percent (or two percent in renminbi) year-on-year. The negative trend is largely cancelled out by the seasonal adjustment but it remains to be seen whether this stabilisation will continue throughout the rest of the year.

The capital outflow from China has also slowed down. The rapid settlement of dollar payables by Chinese companies and official and informal divestments in portfolio assets and the property market were the main drivers between summer 2015 and February 2016, but the central bank dropped reserves to 3.2 trillion U.S. dollars and clearly signalised that the currency should not depreciate substantially. The markets have also become more confident that the new basket orientation is now a reality, which has done much to stabilise the situation.

Short-term outlook encouraging

The continued rapid growth of the service sector and the labour market is underpinning growth. In the first quarter, the Chinese economy grew by 6.7 percent. Growth of over seven percent is looking likely for the second quarter, followed by more moderate growth in the second half of the year. The upwardly adjusted estimates of the IMF and the OECD for this year (6.5 percent) are probably around a quarter of a percentage point too pessimistic.

U.S. economy continues moderate growth

The U.S. economy recorded annualised growth of 1.4 percent in the fourth quarter of 2015, according to U.S. Bureau of Economic Analysis (BEA) figures. Overall GDP-growth in 2015 was level with growth in 2014 at 2.4 percent. On 28 May the BEA published its second estimate for the first quarter of 2016, which put annualised growth for the U.S. economy in that quarter at only 0.8 percent. This was the U.S. economy’s worst performance since the first quarter of 2015, caused primarily by declining private investment, decreasing exports and stagnant federal-level public spending. Foreign trade is under pressure from the strong dollar. Between the fourth quarter of 2015 and the first quarter of 2016, exports (goods and services) dropped by around 13 billion, from 544 billion to 531 billion U.S. dollars. Imports dipped slightly in the same period, from 678 billion U.S. dollars to 664 billion U.S. dollars.

Sentiment in manufacturing is subdued. Concerns about share prices sliding in reaction to the Chinese stock market correction, the possibility of currency depreciations around the world and the continued fall of energy prices are clearly curbing the propensity to invest. In the fourth quarter of 2015, the rate of investment (i.e. the share of private investment in GDP) dropped slightly for the third consecutive time. After reaching a temporary record high of 17 percent in the first quarter of 2015, the investment ratio dropped throughout the year down to 16.7 percent in the fourth quarter, according to BEA figures. The BEA’s second estimate shows that the investment ratio continued to fall in the first quarter of 2016, going down to 16.5 percent. Investments are nonetheless likely to pick up in the medium term, on the back of robust consumption and high profit margins. The economic situation in China is cause for particular uncertainty.

However, low GDP growth in the first quarter should not be given too much weight. The value of the dollar has recently dropped slightly and oil prices have stabilised somewhat. Both these factors should have a positive impact on the second quarter. According to its April 2016 estimate, the IMF is expecting a relatively constant rate of growth of 2.4 percent in 2016, with a slight acceleration to 2.5 percent in 2017. The situation on the labour market is also positive. At the beginning of the year the unemployment rate dropped to 4.9 percent, which is its lowest level since February 2008. While unemployment did nudge up again to five percent in March and April, it is still much lower than last year’s figures of 5.5 and 5.4 percent respectively. In the long-term, the high public debt level (101.8 percent of GDP at the end of fiscal year 2015) will put a strain on the U.S. economy and the budget.

Europe’s economy continues to recover

The moderate recovery in the European Union and the euro area is continuing, despite being curbed by the faltering global economy. The spring forecast of the European Commission (2016) anticipates growth of 1.8 percent in the EU and 1.6 percent for the euro area this year. The estimates in its winter forecast in February 2016 had each been 0.1 percentage points higher. The main factor driving growth in the EU is still private consumption, contributing around 1.2 percentage points. Investments are gradually picking up speed and should contribute around 0.6 percentage points to the GDP increase. Growth here is still being fuelled by the low oil prices and the expansive monetary policy of the ECB. Inflation should remain low at around 0.1 percent in 2016 (ECB 2016a). The situation on the labour market is continuing to ease up, with the European Commission forecasting unemployment rates of 8.9 percent in the EU and 10.3 percent in the euro area. The EU and the euro area are set to remain net exporters in 2016 with current account surpluses of 2.2 percent (EU) and 3.7 percent (euro area). Imports are, however, likely to grow faster than exports in comparison to 2015.

Stimulating investment activity and structural reform are currently the top priorities for European economic policy. With the Investment Plan for Europe and the European Fund for Strategic Investment decided on in June 2015, the Juncker Commission is trying to inject some momentum into investment. The willingness to reform has recently deteriorated in many EU member states, with sluggish implementation of major reforms in goods, services and labour markets. As seen in Spain and Ireland, however, it is precisely these reforms that are capable of greatly increasing productivity and growth. More extensive presentations of the EU economy are available in the current BDI report Growth Outlook Europe (Eichert and Jäger 2016).

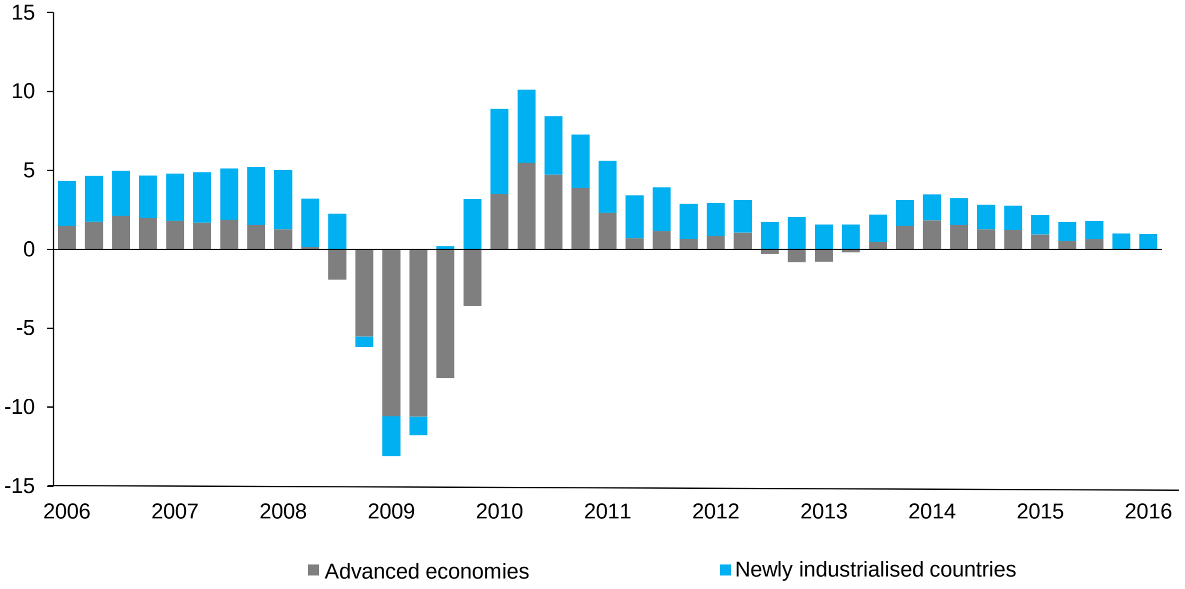
Global industrial production barely growing

In the fourth quarter 2015, global industrial production only increased 0.3 percent over the previous quarter after seasonal and working-day adjustments. Growth was also very modest year-on-year with an increase of 1.3 percent. For 2015, global industrial production only increased 1.9 percent over the previous year. This is the lowest rate of growth recorded since 2009.

After seasonal and calendar adjustments, the **advanced economies**, which account for just under two-thirds of global industry, increased production by 0.9 percent in 2015. The euro area and the United States both registered above-average growth. Japan's industry recorded a decline in production of around one percent. The increase in production in the remaining industrialised countries averaged just under 0.5 percent.

Industrial production has also lost steam in the **emerging economies**. Production here only expanded three percent last year. Apart from the crisis year of 2009 in which production decreased slightly, this is the weakest performance seen since 1999 and 2002 when the Asia crisis and the dotcom bubble burst respectively triggered global recessions. The main factor causing the current weak growth in emerging economies is probably China's weak economic development. Broken down to the individual regions, industrial production in Asia's emerging economies still increased by just below five percent. In the Middle East and Africa industrial production increased following two years of decline. There was very little change in Central and Eastern Europe, while in Latin America industrial production decreased for the second year in a row.

Development of industrial production* in advanced and newly industrialised countries



*production index, quarter-on-quarter change in percent

Source: Netherlands Bureau for Economic Policy Analysis

Production momentum currently weak

The two-month comparison of February/March 2016 shows an increase in global industrial production of 0.9 percent year-on-year after seasonal and calendar adjustments. The emerging economies were able to increase production by 2.7 percent, largely on account of the Asian countries. Latin America was the only region to register declining production. All other emerging economies slightly increased their industrial production. In the advanced economies, the two-month comparison of February/March 2016 shows an overall drop in industrial production of one percent overall caused by the weak economic growth in the United States and Japan. The euro area and the remaining advanced economies recorded a slight increase in production. The Global Manufacturing Purchasing Managers' Index dropped 0.5 percentage points in April, down to 50.1, just managing to remain on the expansion side.

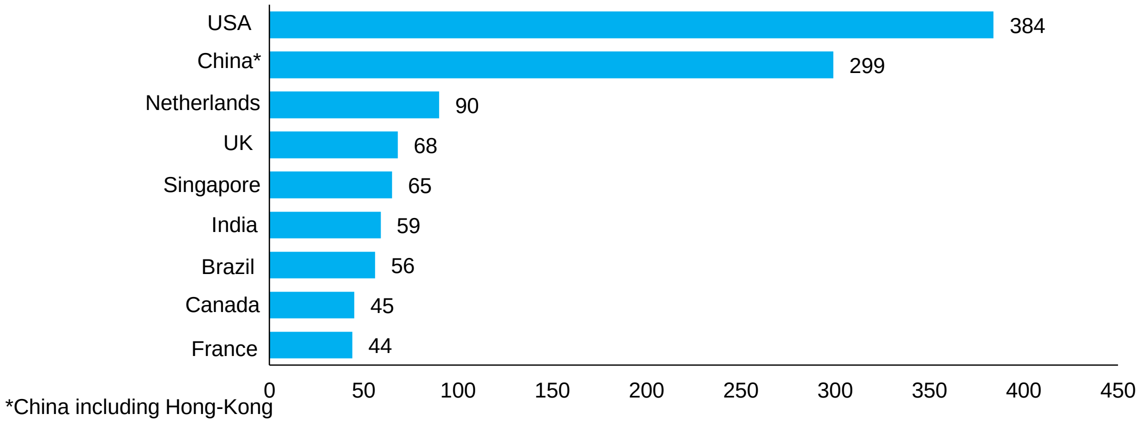
Global trade exhibiting weak growth

According to preliminary growth estimates from the Netherlands Bureau for Economic Analysis (CPB), global trade in the first quarter 2016 decreased by 1.7 percent over the previous quarter. Thus, the downward trend continues (Q3 2015: 1.4 percent; Q4 2015: 0.7 percent). The main reason for the decrease in early 2016 was the slump in demand from emerging economies (down 4.8 percent). Demand from industrialised countries actually increased by a slight 0.3 percent compared with the previous quarter. Regarding exports, emerging economies were particularly hit by the decrease in demand (down 2.1 percent), with exports from industrialised countries only falling by one percent in the first quarter. During that period the decrease was particularly pronounced in January (down three percent over the previous month), with only a slight dip in March (down 0.5 percent). As the figures for the individual months are so volatile and therefore not a good basis for identifying trends, the CPB also calculates the momentum of growth in terms of the growth in the last three months in comparison to growth in the three previous months. In March, this momentum was at minus 1.7 percent (February: minus 0.5 percent), which shows that global trade is still pointing down. The RWI/ISL Container Throughput Index, which estimates the development of global trade according to figures from 81 international ports (most recently for April 2016), also indicates a stagnation of global trade. In 2015 overall, global trade grew by 2.8 percent according to International Monetary Fund (IMF) figures. For the current year, the IMF is anticipating growth of 3.1 percent and 3.8 percent for 2017. Whether these levels of growth can really be achieved is questionable given the current weak development.

Foreign direct investment (FDI) dominated by takeovers

Preliminary figures from UNCTAD show an increase in global investment flows in 2015 of 36.5 percent compared with 2014. At a volume of 1.7 trillion U.S. dollars, this is the highest figure since the global financial crisis. The main driver fuelling this rapid growth was mergers and acquisitions, which increased by around 61.5 percent. Greenfield investments, in contrast, remained almost level with only 0.9 percent growth. The sharp global increase in FDI is therefore not going hand in hand with a global expansion of worldwide production capacities.

Investments in 2015: US a magnet for investors
Global FDI inflow in 2015 (in billion USdollar)



*China including Hong-Kong

Source: UNCTAD

A key contributor to the increase was the rise of FDI in industrialised countries of 89.9 percent, up to 936 billion U.S. dollars. A total of 55 percent of investment flows in 2015 went into the industrialised countries. A particularly popular investment destination for global investors in 2015 was the United States. In 2014, FDI flows stood at a relatively low level with 107 billion U.S. dollars compared with the previous years. In 2015 they have approximately quadrupled, increasing to 384 billion U.S. dollars. The increase of FDI in the United States matches the results of a survey conducted in late 2015 according to which the United States was rated the most popular investment destination in the next twelve months for the 151 CFOs from large German corporations surveyed (Deloitte 2015). The United States is therefore still the top destination for FDI worldwide.

Investments in the European Union rose steeply in 2015, going up 67.6 percent to 426 billion U.S. dollars after decreasing three years in a row. The increase in the EU was also largely due to mergers and acquisitions. However, greenfield investments also increased by 14.2 percent, meaning that production capacities were also increased.

Investments in developing and emerging economies increased by 5.3 percent in 2015. In the emerging economies of Asia, they increased by 15.5 percent. Investments in China, the second most popular investment destination worldwide, increased by six percent to 163 billion U.S. dollars – which is the highest ever figure for China. However, investments in China's production capacities did decline though, while investments in the service sector increased. Investments in Africa in 2015 decreased by 31.4 percent to 38 billion U.S. dollars, with a particularly pronounced drop in sub-Saharan Africa. FDI flows to South Africa even dropped by as much as 74 percent.

For the current year, UNCTAD is not expecting the growth of global FDI to match that of 2015. In view of the fragile state of the global economy, the volatility on the financial markets and the increased geopolitical risks, FDI is actually expected to decrease.

Capital flowing out of emerging economies

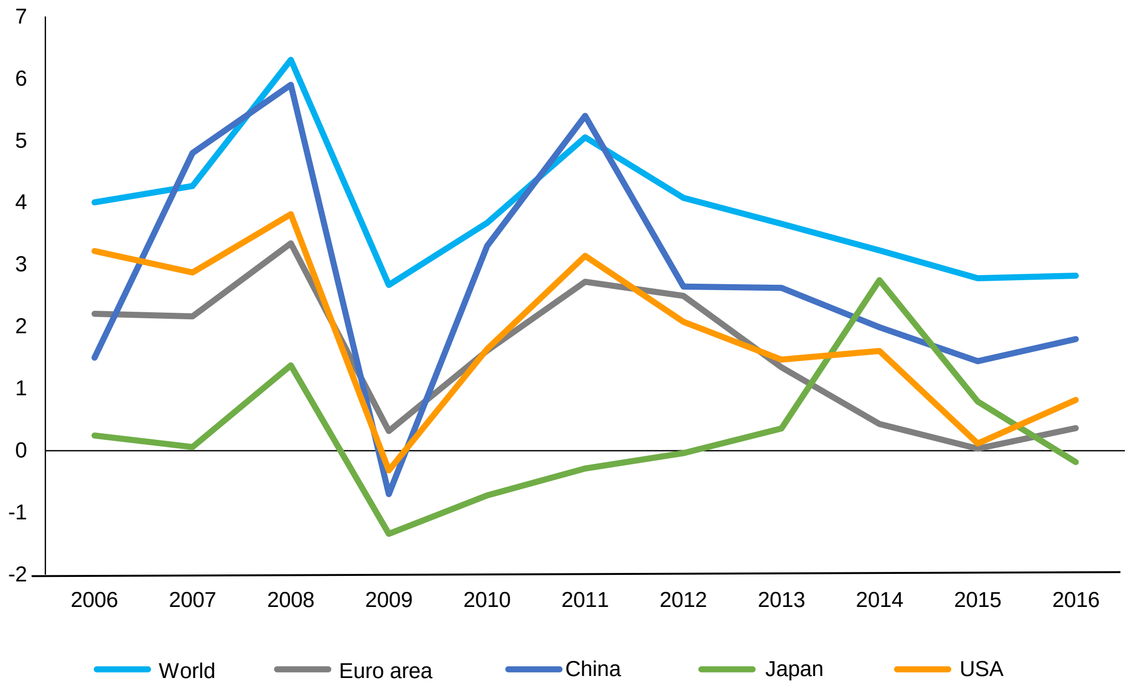
The net capital flows in emerging economies have decreased noticeably since 2010. A similar phase in the cycle of investment flows was last seen in the 1980s and 1990s. This trend is attributable in part to the catching-up process and the declining growth rates in emerging economies, but also to the normalisation of monetary policy in the United States. The liberalisation of the financial markets in the emerging economies has caused capital outflows to increase more rapidly than before (IMF 2016a). According to IMF calculations, net capital flows in the emerging economies were around 1.1 trillion U.S. dollars lower in 2015 than in 2010. This corresponds to close to five percent of GDP of this group of 45 countries. In regional terms, the decreases in China and Russia in particular are driving this trend. Around three quarters of the 45 countries have also recorded slumps in their net capital flows, including both commodity-exporting and commodity-importing countries. Countries with flexible exchange rates, low government debt levels and high foreign currency reserves have lower net capital flows than others. A look at the individual categories of capital outflows (direct investment, portfolio, debt and other investments including bank loans) shows a slump in all four types of capital flows. Hardest hit are direct investment and other investments.

The IMF (2016a) largely attributes the dropping net capital flows to the low growth prospects of emerging economies. Capital flows are therefore not expected to increase anytime soon. This trend will pose challenges for the emerging economies particularly in terms of economic policy. Responsible fiscal policy, particularly in view of a possible deterioration of debt financing conditions, and macro-prudential monitoring, particularly for exchange rate imbalances and the build-up of foreign currency reserves, are thus all the more important.

Inflation and other major trends in monetary policy

Most economic regions of the world recorded falling inflation rates between 2011 and 2015. The global price increase dropped from five percent to below three percent. In both the United States and the euro area, inflation decreased from around three percent to close to zero. The weak upward trend of prices is due, on the one hand, to declining prices for oil and other commodities and, on the other, the gloomy overall prospects for global economic growth. For 2016, the ECB (2016b), the European Commission (2016) and the OECD (2016a) are anticipating a turnaround in inflation.

Global inflation, in percent



Source: IMF 2016a

The European Central Bank further expanded its policy of quantitative easing in March 2016. The bond purchase scheme was stocked up from 60 billion euros a month to 80 billion euros and can now include corporate bonds as well as government bonds. The key interest rate in the euro area was reduced to zero percent, and the deposit rate to minus 0.4 percent. Further measures included setting up a package of refinancing operations (TLTRO II) with attractive refinancing conditions for banks for loans granted to the real economy. ECB President Draghi rightly emphasised that monetary policy alone will not be sufficient for a turnaround. It is structural reform in the member states of the economic and monetary union that is required above all to sustainably revive the economy and increase prices.

The U.S. Federal Reserve already initiated a turnaround in interest rates in December 2015 by increasing the benchmark interest rates from zero to 0.25 percent to 0.25 to 0.5 percent. Further incremental increases were planned for 2016. Deutsche Bank Research (2016a) anticipated that these incremental hikes would take key interest rates to just over two percent by 2017. The decision to increase interest rates was based primarily on the robust economic figures of the United States at the end of 2015, although these deteriorated in the first quarter of 2016. No further increases in the key interest rates have therefore taken place as yet this year.

Inflation in Japan is expected to reverse into deflation in 2016 following a period of rising prices from 2013 to 2015. The Bank of Japan started an ambitious quantitative easing programme in 2013, however, as in the euro area, structural reforms to stabilise economic and price development for the long term are missing.

International financial stability

The stability of global financial markets has deteriorated according to the latest figures. Share prices went down across the globe by around ten percent at the beginning of the year. The majority of this decrease has since been compensated for but volatility remains high. Risk aversion is on the up and credit spreads have increased. The stability of European banks has increased thanks to the Banking Union although many banks are still facing major problems and need to adjust their business models. The earnings situation of EU banks is worse than that of their U.S. counterparts and balance sheet adjustment is taking longer. While in the United States there are only around 0.7 percent of non-performing loans in the balance sheets, in the EU they make up more than two percent. And this figure is much higher in individual countries (Italy: 11.2 percent) and individual banks. The share prices of European banks have recently dropped significantly. Overall, the IMF (2016b) sees excess capacities in the EU banking sector.

The significance of emerging economies for global financial stability has increased considerably throughout the last decade. Risks in China and other markets have an increasingly large impact on German and European foreign trade. On the one hand, the share of emerging economies in global GDP has increased to a substantial 38 percent. On the other hand, the foreign trade between emerging economies and advanced economies has intensified, and the integration of the global financial markets has progressed rapidly since the beginning of the century. Consequently, around one third of the volatility on the equity markets in the advanced economies is attributable to emerging economies. The turbulences on the Chinese stock market on 6 January 2016 thus significantly increased the volatility of global share prices.

International financial stability is particularly at risk from the increasing indebtedness of emerging economies. Private debt measured as share of GDP in emerging economies is currently at around 130 percent. While this figure is below the equivalent for advanced economies (160 percent), it has risen constantly throughout the last ten years. The indebtedness of the corporate sector in emerging economies has almost doubled in the last ten years, rising from 55 percent to over 100 percent of GDP, according to the Bank for International Settlements (2016). In parallel to the growing rate of indebtedness, the profitability of companies is dropping. In the same ten-year period, return on equity in the emerging economies has shrunk from 18 to 8.5 percent and the trend is still pointing downwards. This casts doubt on the repayment of many loans. Rising debt and falling earnings are indications that capital and resources are being misallocated in many emerging economies. We therefore anticipate long-winded and painful restructuring processes that will impact on global trade flows.

Making the situation even more difficult is the fact that a large part of the debts are listed in U.S. dollars, with corporate bonds to the tune of 1.6 billion U.S. dollars in circulation in the emerging economies. And these are not just companies that generate their revenues in dollars. Exchange rate fluctuations therefore pose an additional risk. The nominal trade-weighted U.S. dollar exchange rate has increased by around 25 percent since 2011. The Fed’s interest policy could make this trend even more pronounced.

Risks have increased not just in the corporate sector but also in the public sector. The spreads on government bonds have increased in many emerging economies. The reasons for this are mostly specific to the individual countries. While in Brazil the main reason is the weak economic performance, for oil-exporting countries it is the fallen commodity prices. Public budgets and the corporate sector are not cleanly separated in many emerging economies. Many public companies are facing huge challenges, particularly in the commodity sector. There are risks of contamination in both directions. Losses of state-owned companies are a considerable strain on public budgets. Vice versa, strained public budgets restrict the financing available to state-owned companies.

Germany’s fortune in a weak world?

The global economy is likely to trend sideways this year. In very general terms, demand in Africa, the Americas, Asia and Eurasia is faltering slightly, picking up only in the core countries of Europe. The negative momentum coming from developments in partner regions is noticeable in the flat foreign trade trends.

Furthermore, financial risks in the international system have again increased in the last two years. The risks posed by a no vote in the UK referendum on staying in the European Union are also rather substantial and could even push the country into recession (HM Treasury 2016b). The margins for error for the international economy and international economic policy have got slimmer.

In our most recent quarterly report for Germany we investigate whether the German economy can maintain its robust growth in this environment. The risks coming from the rest of the world should definitely not be underestimated.

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