

International

Global Economic Growth Acceleration Tempered by Deflation Risks

January 31, 2014

The global economy is expected to post increased growth in 2014 after expanding at 3.0 percent in 2013 (Chart 1). The International Monetary Fund (IMF) raised its October forecasts for 2014 world output growth from 3.6 percent to 3.7 percent, citing strengthening global activity in the second half of 2013. Expected growth for 2014 in advanced economies was revised up from 2.0 percent to 2.2 percent. The 2014 forecast for emerging economies remains the same at 5.1 percent. Downside risks stem from possible deflation in some advanced economies and capital outflows from emerging economies.

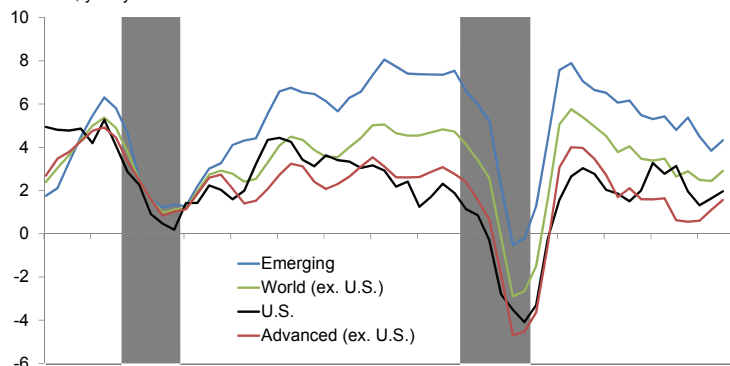
Advanced Economies Seeing Higher Growth, Lower Inflation

Many advanced economies are expected to see a boost to their output growth this year, after sub-par growth in 2013. Japan's economy is finally experiencing signs of a revival after Prime Minister Shinzo Abe's aggressive measures to kick-start growth, dubbed "Abenomics." However, in an effort to scale back debt, a sales tax increase from 5 to 8 percent will go into effect in April. Japan will likely see a healthy first quarter of 2014 as people rush to make purchases before the sales tax hike kicks in. Growth in the second quarter may dip from the increased taxes. At 1.2 percent, headline inflation (which excludes fresh food) is at its highest level in five years, and the central bank is getting closer to meeting its 2 percent inflation target (Chart 2). Japan exports have benefited from a depreciating yen, but rising energy imports after the tsunami and earthquake in 2011 are contributing to a growing trade deficit.

The U.K.'s economic growth of 1.9 percent in 2013 was the most robust since 2007. GDP is now only 1.3 percent below its 2008 peak and could return to pre-recession levels in 2014. The unemployment rate also fell to 7.1 percent, close to the 7 percent threshold at which the Bank of England said it would consider a

Chart 1
World Real GDP Growth Picks Up

Percent, year/year

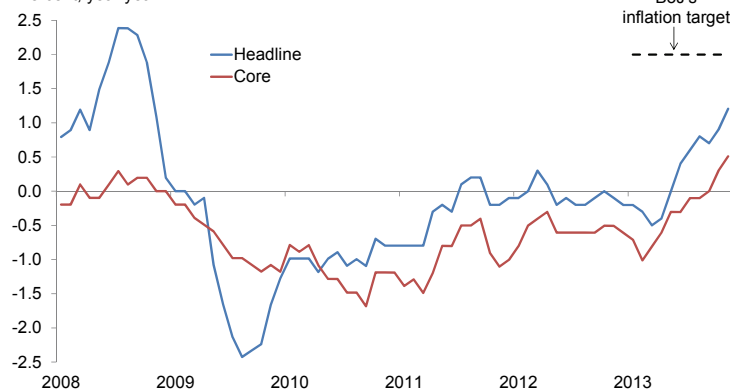


NOTES: Calculations are based on a representative sample of 40 countries. Shaded bars indicate global recessions.

SOURCES: Haver Analytics; author's calculations.

Chart 2
Consumer Price Index Inflation Rising in Japan

Percent, year/year



NOTES: The headline series excludes fresh food. The Bank of Japan (BoJ) implemented an inflation target of 2 percent in January 2013.

SOURCE: Haver Analytics.

rate rise. Governor Mark Carney has signaled a change in the central bank's policy of forward guidance and suggested the bank will not raise its policy rate immediately once the jobless rate reaches 7 percent.

Euro-area indicators are mixed, but overall growth is expected to be positive for 2014 after turning the corner in 2013. Driven by strong private-sector activity in Germany, the euro-area flash manufacturing Purchasing Managers Index (PMI) estimate rose to 53.9, its highest level

since May 2011. However, unemployment rates remain elevated in many countries, with the overall euro-area rate at 12.1 percent since April 2013.

One of the main risks in the euro area right now stems from very low inflation. Headline consumer price inflation in the euro area came in at 0.8 percent in December (Chart 3). Low inflation, or even deflation, could encourage consumers to delay spending due to expectations of future lower prices and could enlarge already significant real debt burdens. Inflation is expected to stay below the European Central Bank's (ECB) target of "below, but close to, 2 percent" in the medium term. After inflation fell to 0.7 percent, the ECB lowered interest rates from 0.5 percent to 0.25 percent in November. Further conventional accommodative monetary policy options are limited, but ECB President Mario Draghi said the ECB stands ready to deploy additional stimulus measures if inflation sinks further.

Emerging Economies Tightening Policy Rates, Implementing Structural Reforms

Some emerging economies are in a much different scenario. Facing an inflation rate of 5.9 percent year over year in December, Brazil's central bank decided to increase its policy rate from 10.0 percent to 10.5 percent on Jan. 15. This is the seventh straight increase in rates, totaling 325 basis points since April 2013. The increase comes at the same time Brazil is experiencing lackluster growth, and higher interest rates could increase the cost of Brazil's large public debt.

The Reserve Bank of India increased its policy rate unexpectedly on Jan. 28 from 7.75 percent to 8.0 percent. Inflation remains high, at 9.9 percent year over year in December, while the country is struggling to revive output growth. Central banks in several emerging economies have recently increased their policy rates in reaction to heightened inflation worries and selloffs in local currencies that sent stocks tumbling (Chart 4).

Investors apprehensive about emerging markets are also paying attention to slowing growth in China. Official figures show that China's 2013 economic growth matched 2012's 7.7 percent increase, exceeding the government's official 7.5 percent target for 2013 (Chart 5). However, the IMF expects China's GDP growth to slow to 7.5 percent in 2014, as China seeks to implement structural economic reforms to limit government intervention and support domestic consumption. The flash manufacturing PMI declined to 49.6 in January,

Chart 3
Low Euro-Area Consumer Price Index Inflation a Concern for 2014

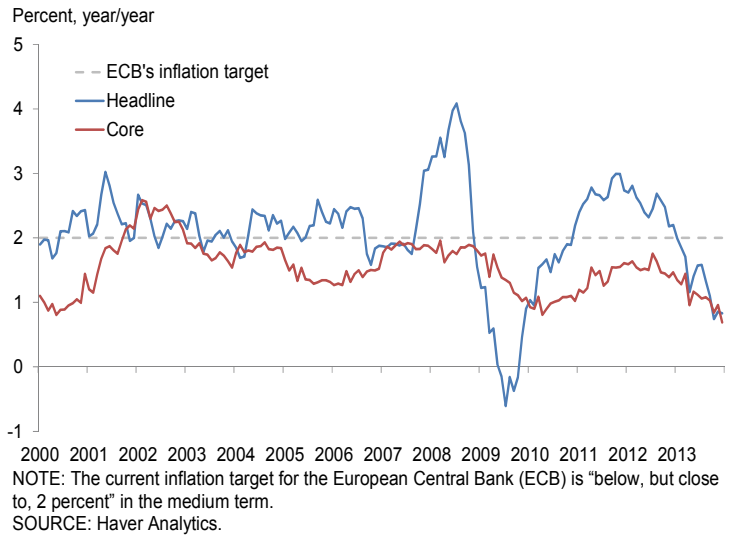


Chart 4
Emerging-Economy Currencies Weaken in January

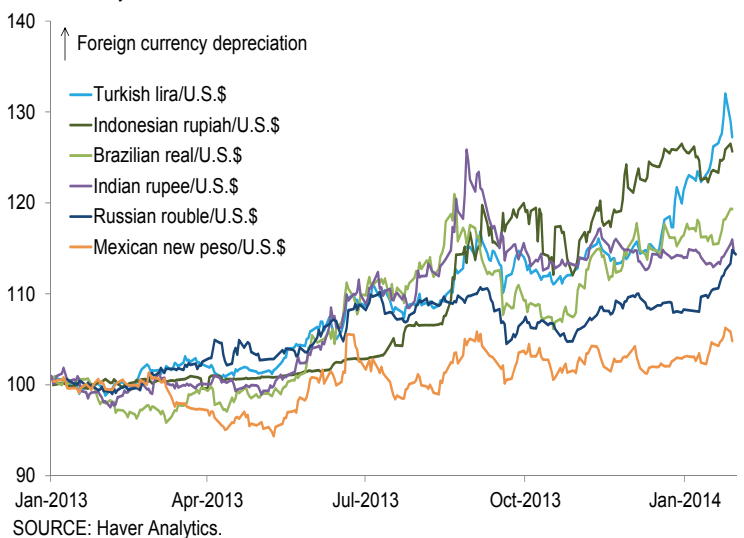


Chart 5
China GDP Growth Meets Target in 2013

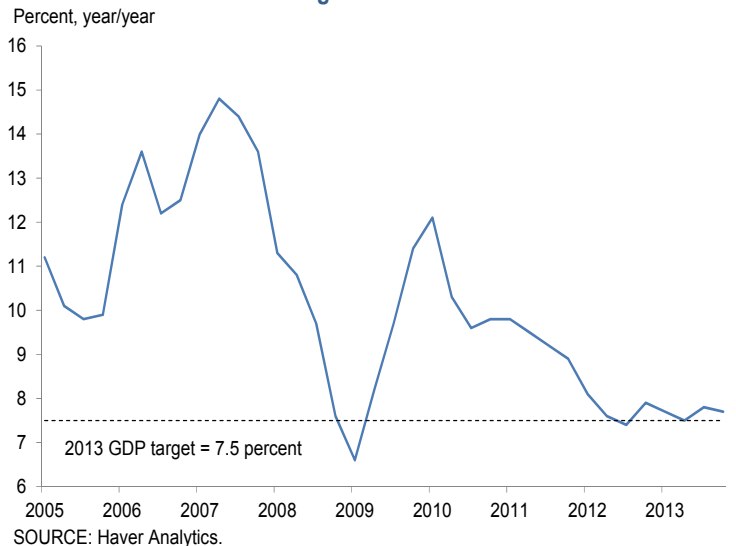
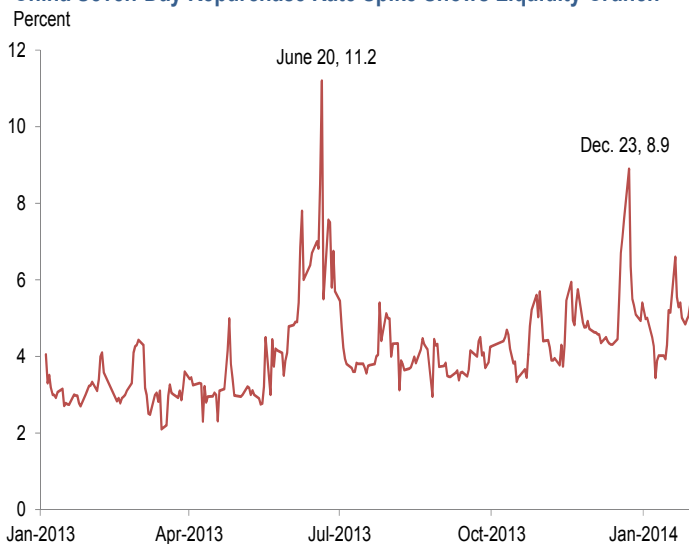


Chart 6
China Seven-Day Repurchase Rate Spike Shows Liquidity Crunch



SOURCE: Bloomberg.

the first reading below 50 in six months, continuing the mild slowdown that occurred at the end of 2013. Further uncertainty stems from China’s shadow lending market—on Dec. 23, the seven-day repurchase agreement (repo) interest rate rose abruptly to 8.9 percent, spiking for the second time in 2013 (Chart 6). The People’s Bank of China eventually intervened to help stabilize the rates and ease the liquidity crunch.

Growth Ahead Amid Obstacles

Global financial uncertainty finally appears to be receding as advanced economies contribute more positive growth, but structural issues in emerging economies remain downside risks. Emerging economies will still contribute positively to world growth, but they must navigate structural reforms and the risks from possible capital outflows.

—Valerie Grossman

About the Author

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