

A World Economy in Good Shape

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The world economy remains in good shape. America's growth is steady; China is still powering ahead; the whole of East and South East Asia is also expanding at a healthy clip; relatively firm commodity prices are helping other emerging economies and world trade is surging again. The most encouraging news comes from Europe. Eastern Europe is booming with growth rates of the order of 4 per cent or more expected for this year in the Czech Republic, Poland and Romania. In the West, the UK, though affected by Brexit, remains resilient, while the Eurozone keeps gathering strength.

Some slowdown is likely in China over the coming years. The authorities are very conscious of the breakneck speed with which debt has been accumulated in the corporate sector, a speed reminiscent of what had happened in Japan in the bubble years of the 1980s. Hence a tightening of monetary policy would seem inevitable. This has not really happened so far because the Central Bank does not want to rock the boat before the very important Party Congress scheduled for October and November. Past that date, however, it is highly likely that credit will be tightened. As a consequence, growth is expected to slow down from its present near 7 per cent annual pace to a more sedate (and sustainable) 6 per cent rate. A (mild) deceleration is also expected in the United States. This, however, is not inevitable. Should Trump succeed in launching a sensible programme for reforming and cutting taxation, the economy could strengthen next year.

The European outlook is steadily improving. Virtually all the forward confidence indicators are, at present, pointing upwards. Indeed, both the Eurozone's purchasing managers' index for manufacturing and the overall consumer confidence index have reached levels not seen since the last boom that preceded the collapse of Lehmann Brothers. In addition, the spectre of deflation seems to have been defeated. Prices are rising virtually everywhere at a steady and modest rate. And while higher interest rates seem, more or less, inevitable, the likely increases in the Eurozone (if not in Britain) will be small and drawn out in time.

Eurozone short rates may only return into positive territory in 2020. Permissive monetary policies are matched by relatively accommodating fiscal policies. Gone is the austerity zeal of the first half of the decade. While reducing public debt and deficits remains an aim, faster growth is achieving some of this without a need for hefty tax increases or further expenditure cuts. It is true that euro depreciation, rapid in 2015-16, is giving way to renewed appreciation, but the recent rises in the currency's value vis-à-vis the dollar, the pound or the yuan have hardly been very sharp.

Within Europe, Germany is still powering ahead. Growth of 2 per cent is expected for both this year and next, thanks to strong exports and a revival in consumer demand fed by relatively rapidly rising wages. Indeed, the risks could well be on the upside. Integrating hundreds of thousands of recent immigrants will require large outlays for education and construction in particular. And government spending is also required for investment in infrastructure given the neglect from which this item has suffered for many years. A new coalition government may well use part of the budget surplus which Germany enjoys at present to finance some of these urgent needs, over and above what has already been budgeted. It is true that Germany is close to full employment, but increased demand pressures are unlikely to send inflation much above its present, and hardly Weimar-like, 1¾-2 per cent rate.

Elsewhere in the Eurozone, French confidence and activity have both risen since Macron's election. The same is broadly true for Italy, though the country's outlook is somewhat clouded by the uncertainty surrounding next year's parliamentary elections. Spain too is still growing strongly, at some 3 per cent both this year and next, with, so far at least, few unfavourable effects coming from the Catalan crisis. It is unknown of course, how this crisis will be resolved, but initial market reactions have been surprisingly muted. And relatively robust activity can be seen in several of the Eurozone's smaller economies, such as the Netherlands, Austria, Finland, Portugal and even Greece.

The UK's picture is perhaps a bit less buoyant. Though Brexit clearly did not have the dramatic negative economic effects that

some observers (and, in particular, the Treasury) had predicted, it is having some unfavourable impact now. Two major demand components, in particular, seem to be affected. The favourable consequences for the tradeable sector of the pound's sharp decline appear to have been more than offset by the depreciation's unfavourable consequences for consumer price inflation and, consequently, for the growth of real disposable income and private consumption. In addition, the continuing uncertainty as to the length of any transitional deal with the EU, as well as to the contents of any final agreement are, inevitably, dampening investment. To this must be added the likelihood of an increase in interest rates, possibly before the end of this year. Growth of the order of 1½ per cent in 2017-19 is thus likely, well below the 2 per cent of the 2010-16 years.

As argued in the last note circulated in July, the biggest external risks to this favourable outlook come from China and the United States. Monetary policy is likely to be tightened in both countries by end year. And in both countries this is likely to dampen growth. Lower demand for commodities in China and a stronger dollar in the US could, in turn, have negative effects on the emerging world. In addition, of course, the threat of increased American protectionism still lingers. Within Europe, on the other hand, anti-Euro sentiments seem to have abated and the political risks associated with increasing populism are no longer as present as before.

GDP GROWTH RATES (%)

| | 2015 | 2016 | 2017 | 2018 | 2019 |
|----------------|------|------|------|------|------|
| Eurozone | 1.9 | 1.8 | 2.2 | 1.9 | 1.6 |
| United Kingdom | 2.2 | 1.8 | 1.5 | 1.5 | 1.6 |
| United States | 2.9 | 1.5 | 2.2 | 2.4 | 1.8 |
| China | 6.9 | 6.7 | 6.8 | 6.2 | 5.8 |
| World | 2.8 | 2.4 | 2.9 | 3.0 | 2.8 |

Source: Oxford Economics

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