DALLASFED Economic Update International

Global Growth Remains Restrained, Policy Uncertainty Heightens

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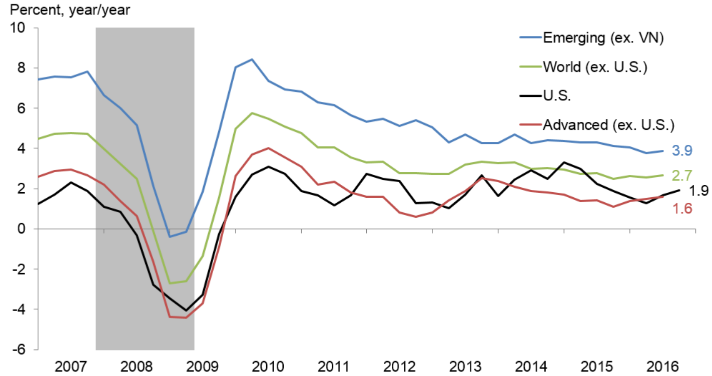
Global growth remains tame amid shifting policy priorities and related policy uncertainty. Downward risks to the outlook center on: The policy shift expected under the new U.S. administration, the possibility of a less-gradual normalization of U.S. monetary policy, China's fiscal space (and credit deepening) to continue providing stimulus to its economy and global spillovers from these developments.[1] Protectionist pressures in some advanced economies are also cited as a key concern.

Straddling the Fence

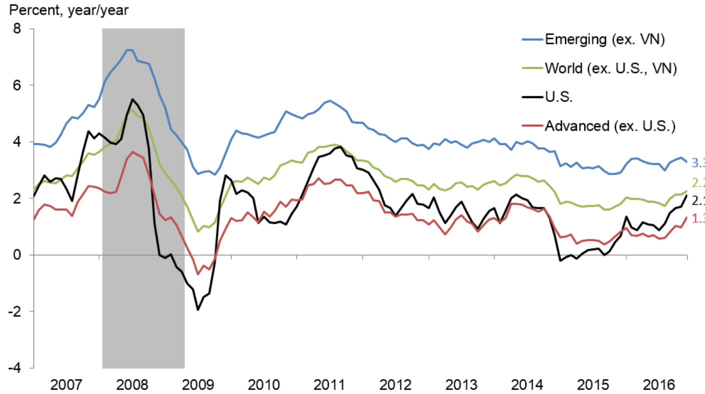
World (ex. U.S.) gross domestic product (GDP) growth for the third quarter was slightly revised up to 2.7 percent year over year *(Chart 1)*.[2] Fourth-quarter data for China came in at 6.8 percent year over year, higher than the 6.7 percent posted in the third quarter. Headline Consumer Price Index inflation among advanced economies (ex. U.S.) has ticked up to 1.3 percent year over year in December 2016 from 1.0 percent in November *(Chart 2)*. Headline inflation among emerging economies (ex. Venezuela) was 3.3 percent, down from 3.4 percent.

Chart 1
Global Growth Remains Relatively Unchanged in Third Quarter 2016



NOTES: VN stands for Venezuela. Most recent data for the U.S. is for fourth quarter 2016 and third quarter 2016 for all others. Calculations are based on a representative sample of 40 countries aggregated using U.S. trade weights. Shaded bars indicate global recessions.
SOURCES: Database of Global Economic Indicators; Haver Analytics; authors' calculations.

Chart 2
Headline Inflation Picks Up in Advanced Economies in December 2016



NOTES: VN stands for Venezuela. Calculations are based on a representative sample of 40 countries aggregated using U.S. trade weights. Venezuela is excluded for lack of data. Shaded bars indicate global recessions.
SOURCES: Database of Global Economic Indicators; Haver Analytics; authors' calculations.

The latest projections from the International Monetary Fund (IMF) for 2017–18 remain unchanged relative to October 2016, implying only a modest strengthening in global GDP growth over the medium term after what the IMF calls "a lackluster outturn in 2016." The global outlook remains uneven. There is some near-term improvement among advanced economies, such as firming up in Japan, slight abatement of risks in Europe and the U.K. (Brexit) and the expectation of fiscal stimulus in the U.S. Meanwhile, significant downward revisions to GDP growth in some major emerging economies—most notably Mexico, Brazil and India—have largely outweighed China's better-than-expected growth. Mexico faces "tighter financial conditions and increased headwinds from U.S.-related uncertainty," according to the latest IMF projections report.

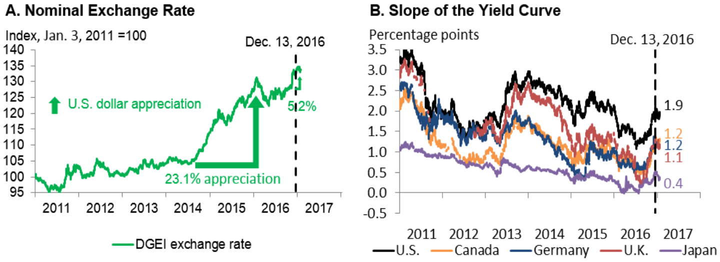
What Lies Behind the Aggregate Numbers?

The appreciation of the U.S. dollar *(Chart 3A)* and the steepening of the yield curve around the Nov. 8 election *(Chart 3B)* are cited by the IMF as consistent with "some near-term fiscal stimulus and a less gradual normalization of monetary policy" in the U.S. Those patterns appear to have receded somewhat since December 2016. The dollar gains seen in November are largely due to a weakening Mexican peso and to a lesser extent the euro, yen and renminbi.

Renminbi's slide against the dollar has reversed somewhat. China's currency has been largely steady against the China Foreign Exchange Trade System (CFETS) trade-weighted basket of currencies since mid-2016 *(Chart 4A)*, while reserve losses have resumed *(Chart 4B)*. Starting Jan. 1, 2017, the number of currencies in the CFETS currency basket has increased to 24 from 13.[3] Capital outflows continue, despite capital controls and regulations. China faces other policy challenges—the large fiscal and credit expansion supporting official growth objectives in recent years raises concern about China's growing debt.

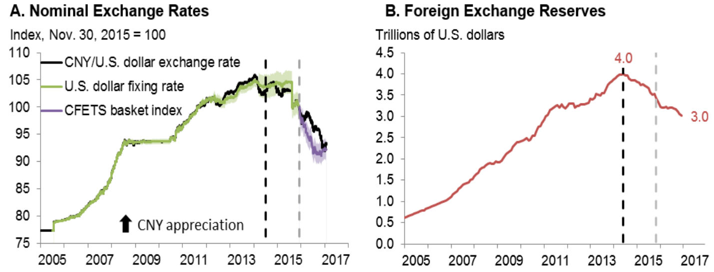
Volatility among emerging economies remains subdued following the December 2016 rate hike by the Federal Reserve, with limited signs of contagion so far. The perils associated with unanchored inflation expectations leading to deflation appear to have receded as well.[4] Long-term inflation expectations among major advanced economies have either stabilized at levels consistent with a conventional inflation target or continue to improve *(Chart 5)*—partly aided by monetary accommodation in the euro area and Japan.[5] The European Central Bank announced at its December 2016 meeting an extension of quantitative easing until December 2017 but at a decreased rate of €60 billion (down from €80 billion) per month from March.

Chart 3
Dollar Appreciation, Steepening of the Yield Curve Appear to Have Halted



NOTES: A. Nominal trade-weighted value of the U.S. dollar is aggregated using the currencies and weights of the Database of Global Economic Indicators (DGEI). The green arrows show the appreciation of the U.S. dollar from July 1, 2014, to Jan. 20, 2016, and from Nov. 8, 2016, to Jan. 16, 2017. B. The lines plotted to illustrate the slope of the yield curve are calculated as the difference between the 10-year yield and the three-month yield.
SOURCES: Database of Global Economic Indicators; Haver Analytics; Bloomberg.

Chart 4
Renminbi Regains Some Ground, Foreign Exchange Reserves Dwindle



NOTES: A trading band for the onshore (CNY) renminbi at ±0.3 percent against the dollar replaced the dollar peg on July 21, 2005. The band was extended to ±0.5 percent on May 19, 2007, ±1.0 percent on April 16, 2012, and ±2.0 percent on March 17, 2014. The basis of the band was changed to a basket of currencies on Nov. 30, 2015.
SOURCES: Bloomberg; China Foreign Exchange Trade System; People's Bank of China; authors' calculations.

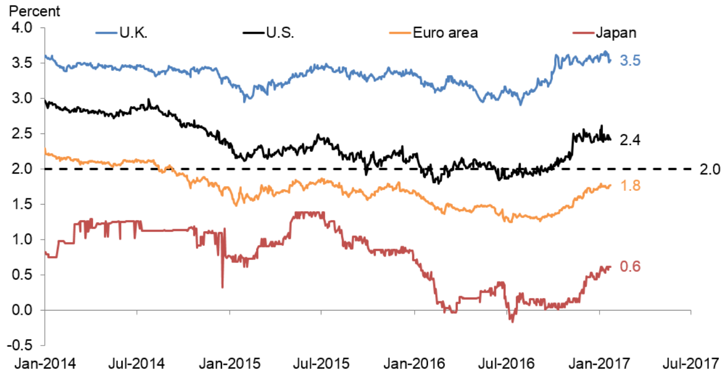
Policy Shift Looms Large Over the Outlook

Destabilizing financial volatility and capital outflows among vulnerable emerging economies, triggered by rising borrowing costs during the ongoing U.S. tightening cycle, have yet to materialize. Well-anchored long-term inflation expectations have reduced the perceived risks of low inflation over the medium term among advanced economies. However, risks to the global outlook are tilted downward.

There is growing uncertainty about policy in China and the U.S.—particularly from the expected shift in fiscal policy stance and trade relationships under the new U.S. administration. Monetary policy divergence between the U.S. and other advanced economies is expected to further strengthen the U.S. dollar. Protectionism and populism in some advanced economies, the "competitiveness" gap within the European Union and the perception that political strife may slow necessary structural reforms further cast a dim light over the global outlook.

–Enrique Martínez-García and Kelvinder Virdi

Chart 5
Long-Term Inflation Expectations Rebound After Mid-2016



NOTES: Inflation expectations are derived from inflation-linked swap rates at the five-years-forward-five-years-ahead horizon and indicate what markets think the next five years of inflation will be like starting five years from now. Horizontal dashed line at 2.0 percent is included as a reference.
SOURCE: Bloomberg.

Notes

1. These risks are expounded, among others, by the International Monetary Fund Jan. 16, 2017, update to World Economic Outlook projections. See "A Shifting Global Economic Landscape," *World Economic Outlook Update*, January 2017.
2. World (ex. U.S.), advanced (ex. U.S.) and emerging aggregates come from a representative sample of 40 of the largest economies, ranked and weighted by their importance as U.S. trading partners. See "A New Database of Global Economic Indicators," by Valerie Grossman, Adrienne Mack and Enrique Martínez-García, *Journal of Economic and Social Measurement*, vol. 39, no. 3, 2014, pp. 163–97. Also "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," by Grossman, Mack and Martínez-García, *Journal of Macroeconomics*, vol. 46, 2015, pp. 170–85.
3. On Nov. 30, 2015, China introduced the currency basket, retooling its exchange rate policy. For background, see "Subdued Emerging Economy Growth Prospects, Uncertainty Loom Large," by Valerie Grossman and Enrique Martínez-García, Federal Reserve Bank of Dallas *International Economic Update*, Feb. 2, 2016; China Foreign Exchange Trade System: "Calculation Methodology of RMB Indices v1.0", Dec. 11, 2015; and "Calculation Methodology of RMB Indices v1.1," Dec. 29, 2016.
4. On the anchoring of inflation expectations, see "U.S. Shines Despite Dim Global Outlook," by Enrique Martínez-García and Bradley Graves, Federal Reserve Bank of Dallas *International Economic Update*, Feb. 3, 2015.
5. Chart 5 illustrates inflation-linked swap rates at the five-years-forward-five-years-ahead horizon. They indicate what markets think the next five years of inflation will be like starting five years from now.

About the Authors

Martínez-García is a senior research economist and advisor and Virdi is a research analyst in the Globalization and Monetary Policy Institute at the Federal Reserve Bank of Dallas.