Global Economy Continues to Grow amid Downside Risks

November 14, 2018

Global economic growth remains solid, although the pace is moderating as significant downside risks remain for both advanced and emerging economies. These include the outstanding trade dispute between the U.S. and China, stalemates in Europe, tightening global financial conditions that are inducing stress in vulnerable emerging economies, and other idiosyncratic factors.

Aggregate GDP Forecasts Remain Unchanged

The Dallas Fed's Database of Global Economic Indicators forecasts that world (excluding U.S.) real gross domestic product (GDP) will grow 3.1 percent in 2018 (*Chart 1*). Advanced economies (ex. U.S.) are expected to grow 2 percent and emerging countries 4.2 percent. These growth rates are slightly above their estimated potential; hence, the pace of GDP growth is expected to slow in subsequent years as output gaps (the difference between actual output and maximum potential output) close.

Inflationary Pressures in Foreign Economies Rise

A strong U.S. dollar and higher energy prices have led to a slow rise in headline inflationary pressures in foreign economies. The 2018 headline Consumer Price Index (CPI) inflation forecast (ex. U.S. and Venezuela) was revised marginally upward to 2.9 percent, while the outlook for next year was unchanged at 2.7 percent. Price pressures remain uneven across economies. In the euro area and Japan, inflation rates remain low, whereas in the U.K. and a number of emerging economies, inflation is above the rate targeted by their individual central banks.

Although growth is still robust (albeit moderating) and inflation is gradually rising, stock prices have experienced a marked decline across the globe except in Brazil, where the market has rallied because of less uncertainty following recent elections (*Table 1*).

Monetary Policy Remains Largely Unchanged

Monetary policy throughout the world remains little changed since late September, with the exception of a few countries.

The Bank of Canada increased its target for the overnight rate by 25 basis points to 1.75 percent at its October meeting. On Oct. 15, the People's Bank of China further reduced the minimum reserve requirements by 1 percentage point to 14.5 percent, freeing up $175 billion. The move reflects policymakers' attempts to carefully support growth in the wake of a trade dispute with the U.S. without relying excessively on additional debt-driven stimulus.

In contrast to China, many emerging economies are in a tightening cycle. Among central banks in smaller emerging economies, the Central Bank of Chile raised its monetary policy rate by 25 basis points to 2.75 percent on Oct. 18, the Central Bank of the Philippines raised its overnight reverse repurchase facility rate by 50 basis points to 4.5 percent on Sept. 28, and Bank Indonesia raised its policy rate by 25 basis points on Sept. 27.

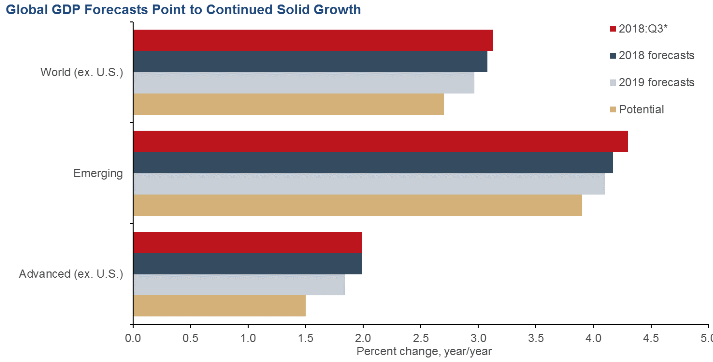
Continuing Risks to Outlook

The trade policy uncertainty remains elevated between the two largest economies in the world, the U.S. and China (representing a third of world GDP in purchasing power parity terms). Further escalation in protectionist measures could derail business sentiment and investment as well as disrupt global supply chains.

In Europe, Brexit (British exit from the European Union) negotiations continue to struggle as disagreements over Ireland's land border with the U.K. remain unresolved.

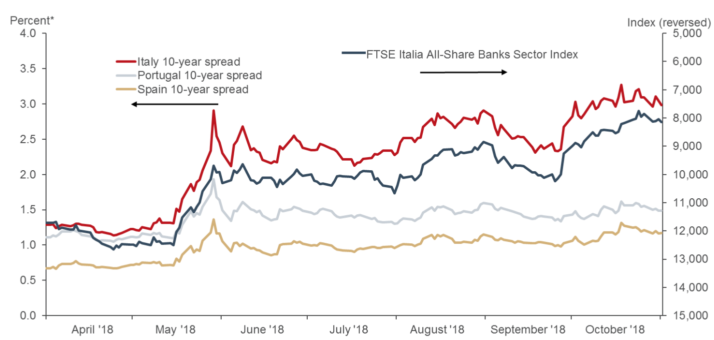
On a positive note, the United States–Mexico–Canada Agreement has alleviated some trade uncertainty.

Chart 1
Global GDP Forecasts Point to Continued Solid Growth



*For countries where third quarter 2018 gross domestic product (GDP) data were unavailable, second quarter 2018 data were used.
NOTE: Calculations are based on a representative sample of 40 countries aggregated using U.S. trade weights.
SOURCES: Database of Global Economic Indicators; Haver Analytics; Consensus Forecasts; International Monetary Fund.

Chart 2
Volatility Rises in Italian Bonds and Bank Stocks



*Spread over the German 10-year bond yield.
NOTE: Last daily data points are Nov. 1, 2018.
SOURCE: Bloomberg.

Uncertainty in Italy

Italy's government is on a collision course with Brussels (the de facto capital of the European Union) over its budget proposal for 2019, creating some volatility in financial markets. The budget proposal includes: a fiscal deficit of 2.4 percent of GDP (three times larger than the target agreed upon by the previous government and the European Union Commission), optimistic projections of 1.5 percent GDP growth in 2019 (well above the International Monetary Fund forecast of 1 percent) and a decrease in the retirement age along with additional welfare benefits for the unemployed (both expected to contribute significantly to the overall deficit).

This proposal has unnerved financial markets, and Italian bond yields and bank stocks have witnessed increased volatility since late September. The yield on 10-year Italian government bonds has increased by 53 basis points to 3.38 percent, representing a sizable 298-basis-point spread over German bonds, while the FTSE Italia All-Share Banks Sector Index has fallen by 18 percent (*Chart 2*). So far, government yields in other euro-area member states have not been much affected.

If the proposed 2019 budget moves ahead as planned, it will increase Italy's sovereign debt, which currently amounts to about 130 percent of GDP. Italy is the third-largest euro-area member, and its large amount of debt poses a vulnerability not only to the Italian economy, but also to the euro area.

—Alexander Chudik and Amro Shohoud

....

About the Authors

Chudik is an economic policy advisor and senior economist and Shohoud is a research assistant in the Globalization Institute at the Federal Reserve Bank of Dallas.

Table 1: Global Stock Markets

	Stock index	Change since September 2018 (%)	Change since October 2017 (%)
Advanced			
Canada	TSX Composite	-6.5	-5.5
Euro area	S&P Europe 350	-4.7	-8.5
Japan	Nikkei 225	-9.1	-3.3
United Kingdom	FTSE 100	-4.6	-5.0
U.S.	S&P 500	-6.1	6.2
Emerging			
China	SSE-SZN 300	-6.8	-20.5
Mexico	IPC	-8.0	-6.0
India	Sensex	-5.2	2.5
Brazil	Bovespa	13.4	19.8
Russia	MICEX	-2.9	13.3
South Africa	FTSE/JSE	-6.3	-10.0

NOTE: Daily data were updated Oct. 30, 2018.

SOURCES: Financial Times; New York Times; Toronto Stock Exchange; Standard & Poor's; Moscow Exchange; Bombay Stock Exchange; Shanghai Stock Exchange; Wall Street Journal; Haver Analytics; national sources.