DALLASFED Economic Update
International

U.S. Shines Despite Dim Global Outlook

February 3, 2015

Weakness in the euro area, Japan and some emerging economies (especially oil-exporting countries) has dimmed the global outlook. The International Monetary Fund (IMF) lowered growth expectations further in its World Economic Outlook (WEO) update of January 2015, following a substantial downward revision in the October 2014 WEO. The IMF projects 3.5 percent annual growth in 2015 and 3.7 in 2016, down 0.3 percentage points in both years. The World Bank has revised down its forecasts by 0.4 and 0.2 percentage points to 3.0 percent in 2015 and 3.3 percent in 2016, respec-tively. The bright spot remains the U.S., for which the IMF and the World Bank have revised up their GDP projections by 0.5 and 0.2 percentage points, respectively, for 2015.

Exports and industrial activity are showing signs of weakness (*Chart 1*). Inflation concerns loom for major advanced economies. The IMF has revised downward its inflation forecasts by 0.8 and 0.4 percentage points for 2015 and 2016, respectively, for advanced economies but has raised its forecasts for some emerging countries.

Four main developments have tilted the global outlook to the downside since the summer of 2014.

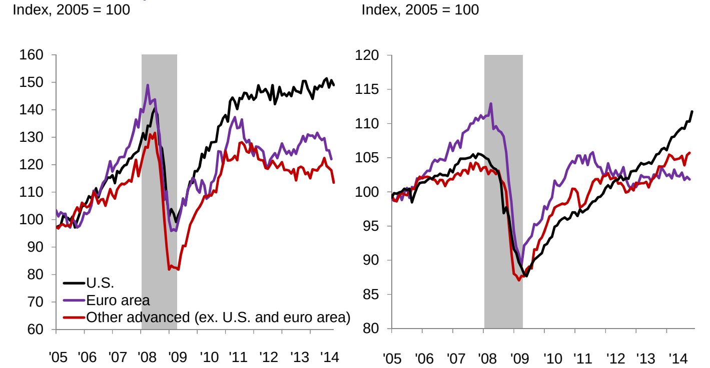
Low Inflation in Advanced Economies

The euro-area headline Harmonized Index of Consumer Prices (HICP) came down to –0.2 percent in December 2014. In an effort to prevent low long-term inflation expectations from getting entrenched, the European Central Bank (ECB) announced a balance sheet target following its Sept. 14, 2014, meeting. In its Jan. 22, 2015, meeting, the ECB decided to expand its purchases to €60 billion a month from March 2015 until September 2016. Their commitment is open-ended, or until a "sustained adjustment to the path of inflation" is achieved.

On Oct. 31, the Bank of Japan (BoJ) opted to accelerate its purchases of government bonds in light of declining inflation expectations for the medium term. Governor Haruhiko Kuroda stated that "today's step shows our (the BoJ's) unwavering determination to end deflation."

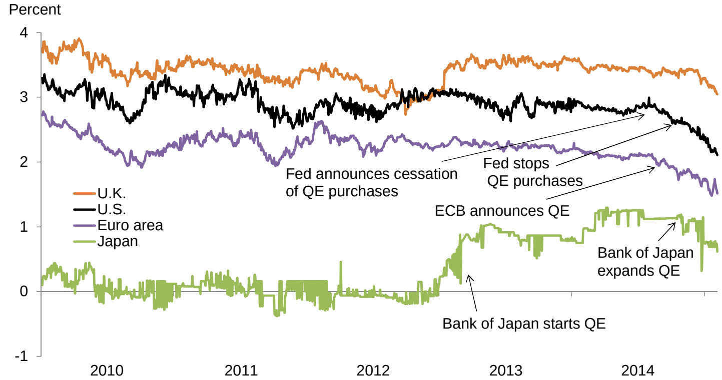
Chart 2 illustrates inflation-linked swap rates at the five-years-forward-five-years-ahead horizon, a conventional measure of long-term inflation expectations. It indicates what financial investors expect inflation to be over the next five years starting five years from now. Current low oil prices are likely not the cause of the decline in medium-term inflation expectations seen since mid-2014. An inflation rate persistently below the central bank's medium-term target increases the real value of both public and private debt and, at near-zero rates, may result in higher real interest rates (and tighter financial conditions).[1] The fear is that if inflation lingers below expectations, monetary policy's ability to anchor inflation expectations may be questioned. Long-term inflation expectations may further slide if this goes unchecked, perhaps leading to a Japanese-style deflationary trap.[2]

Chart 1
Exports and Industrial Production Have Largely Stagnated Since 2011



NOTES: Aggregated using U.S. trade weights. Shaded bars indicate global recessions (methodology for dating global cycles from "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," by V. Grossman, A. Mack and E. Martínez-García, Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute Working Paper no. 169, January 2014.).
SOURCES: Database of Global Economic Indicators; Haver Analytics; Consensus Forecasts; IMF; authors' calculations.

Chart 2
Long-Term Inflation Expectations Drift Steadily Downward Since Second Half of 2014



NOTE: Japan also had quantitative easing in 2001. Plotted is 5-year, 5-year forward U.S. dollar inflation swap rates.
SOURCE: Bloomberg.

Low Long-Term Interest Rates in Most Advanced Economies

The Euribor entered negative territory in early January. Similarly, sovereign bond yields in a number of advanced economies have turned negative even at two- to five-year maturities (*Chart 3*). Spain, Italy, Greece, Portugal and Ireland are now borrowing at lower yields than the U.S., even factoring in higher risk premiums (*Chart 4*). Switzerland's 10-year rates fell below zero after its central bank penalized deposits on Dec. 18, 2014, eventually scrapping its ceiling of 1.20 Swiss francs against the euro on Jan. 15, 2015.

The worsening global outlook may imply a longer period of near-zero policy rates, which would become incorporated into lower long-term rates—especially in the euro area and Japan. For some advanced economies, the decline in long-term interest rates started before economic strains appeared in 2014. This perhaps indicates that either inflation expectations declined or that real rates diminished as concerns about secular stagnation grew.[3] The U.S. has seen recent declines in long-term rates, but its greater stability and the appreciation of the U.S. dollar suggest that the U.S. economy is still improving.

Increased Short-Term Volatility

Oil prices fell from $105.8/barrel in June 2014 to below $50/barrel, reflecting some moderation in global growth expectations, but mostly a response to supply-side factors. OPEC decided against a cut in production on Nov. 27, 2014. The price of oil has continued to fall, while volatility in energy markets has increased further since (*Chart 5*).[4] Higher volatility may increase the option value of waiting and lead to delaying of investments, possibly curtailing medium-term production and putting upward pressure on medium-term oil prices.

Despite higher uncertainty, lower oil prices resulting from supply-side factors are generally considered positive for global growth. Lower oil prices increase disposable income for households and reduce costs to firms, which boosts consumption. This demand boost is expected to offset the negative effects on oil-exporting countries. Depending on medium-term oil prices, the U.S. may benefit modestly, while the euro area, Japan and emerging Asia could get more sizable gains. Oil-exporting economies stand to lose the most.

Low oil prices restrain headline inflation, although the appreciation of the U.S. dollar may have dampened the pass-through effect into local prices for some countries.[5] In emerging economies, low oil prices have justified recent policy rate cuts by the central banks in India, Turkey, Peru, Egypt and Romania (Brazil, in turn, tightened rates).

Declining Medium-Term Growth Prospects

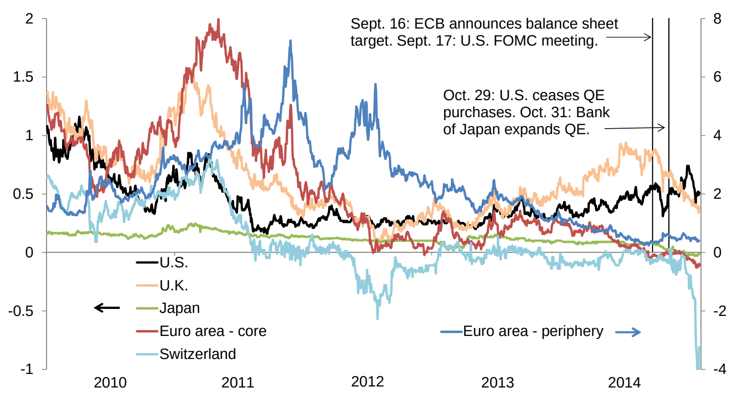
For some advanced economies, the 2008 global recession and its aftermath further depressed their long-term prospects, contributing to low inflation, weak growth and underutilized resources.[6] In emerging economies, the weaker-than-expected growth is largely seen as reflecting ongoing adjustment to lower medium-term growth than previously expected.

China's gradual reforms, with an emphasis on financial liberalization, aim to curtail rapid credit growth and more efficiently allocate resources to investment. However, short-term indicators suggest that China continues to slow down (*Chart 6*). There are growing concerns about China's "tolerance" for lower growth and how Chinese authorities may react. Assuming a limited response to this moderation, the IMF now expects annual growth rates of 6.8 and 6.3 percent for 2015 and 2016, respectively, with negative regional spillovers and effects on commodities markets.

Conclusion

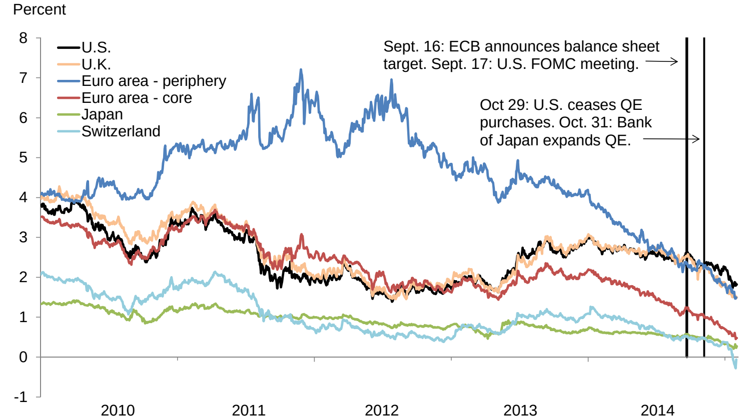
Rising geopolitical tensions, such as the unresolved Russia–Ukraine conflict, will remain a headwind for the global outlook in 2015. The euro-area crisis continues to test the limits of the European institutional framework. The ramifications of Greece's recent political shake-up may depend partly on whether it triggers a domino effect on the political landscape of other European Union countries. This

Chart 3
2-Year Sovereign Bond Yields Turn Negative in Most Advanced Economies



NOTES: Euro area–core comprises Austria, Belgium, Finland, France, Germany and the Netherlands. Euro area–periphery comprises Italy, Ireland and Spain.
SOURCE: Reuters.

Chart 4
10-Year Sovereign Bond Yields Declining in Most Advanced Economies



NOTES: Euro area–core comprises Austria, Belgium, Finland, France, Germany and the Netherlands. Euro area–periphery comprises Italy, Ireland and Spain.
SOURCE: Reuters.

poses the risk of further paralysis and acrimony, which may inhibit progress toward structural reforms in the euro area.

The potential boost to global growth from low oil prices may therefore be offset by risks to the global outlook in Japan, the euro area and some emerging economies. Interim volatility may also increase while commodity markets find a "new normal." The global economy finds itself—once again—at an important crossroad heading into 2015.

—Enrique Martínez-García and Bradley Graves

Notes

1. "Debt-Deflation: Theory and Evidence," by Mervyn King, *European Economic Review*, vol. 38, no. 3–4, 1994, pp. 419–45.
2. "It's Baaack: Japan's Slump and the Return of the Liquidity Trap," by Paul R. Krugman, Brookings Papers on Economic Activity, vol. 2, 1998, pp. 137–87; "An IS-LM Analysis of the Zero-Bound Problem," by Evan F. Koenig, Federal Reserve Bank of Dallas *Staff Papers*, no. 13, 2011.
3. Secular stagnation refers to no significant growth in economic activity over the medium to long run.

4. Short-term volatility in energy is partly attributed to oil markets operating without the price backstop of OPEC (Saudi Arabia) and unexpected increases in production elsewhere (Iraq).

5. The correlation between commodity prices and the exchange rate of commodity exporters has been suggested as a possible reason for the strengthening of the U.S. dollar observed since mid-2014. Other factors include the safe-haven status of the U.S. and the increased volatility in other parts of the world (flight to quality).

6. The worsening prospects may come from hysteresis in the labor market, reduced investment (particularly in research and development), and the brain drain from a prolonged contraction in economic activity.

About the Authors

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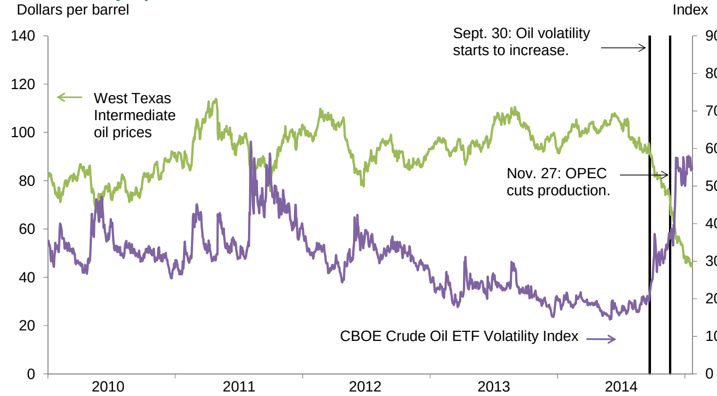
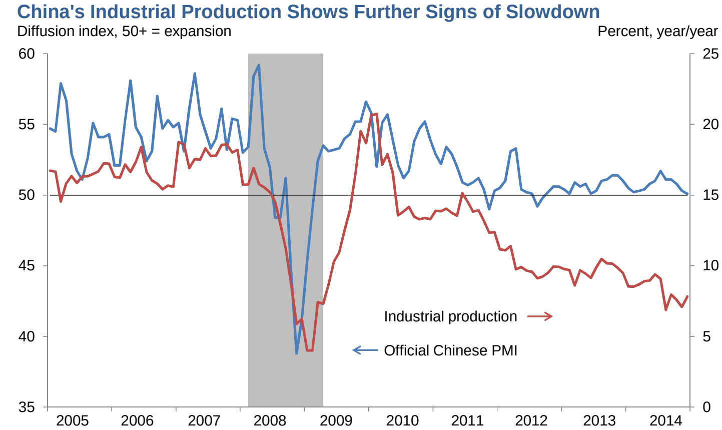
Chart 5
Oil Volatility Spikes as Prices Continue to Search for a Bottom



NOTE: The Crude Oil Volatility Index measures the market's expectation of 30-day volatility of crude oil prices using the VIX methodology.
SOURCES: Bloomberg; Chicago Board Options Exchange.

Chart 6
China's Industrial Production Shows Further Signs of Slowdown



NOTE: Shaded bar indicates global recession (Grossman et al. 2014).
SOURCES: China National Bureau of Statistics; China Federation of Logistics & Purchasing.