International Economics Monthly

October 2015

How worrying are prospects for the world economy?

Main message: *This month we look to a range of indicators to assess whether financial-market volatility over the summer points to a renewed slowing in the world economy driven by weakness in EMEs and China. Emerging market growth surprised to the downside in Q2, and recent capital outflows suggest prospects may have deteriorated further. While the most recent falls in commodity prices appear to reflect weaker demand prospects to a large extent, consistent with moderate spillovers to the world outlook, falls in equity prices appear to be accounted for by a rise in risk premia. Moreover, a range of top-down indicators, though mixed, suggest little evidence that the pace of global growth declined substantially during Q3. Indeed, the sharp contraction in global trade in 2015 H1 looks to be at least partially reversing. A box discusses data developments this month.*

Introduction

Developments over the summer have led to worries that slowing in China and other EMEs may be spilling over to a more generalised weakening in global growth prospects. Major advanced-economy equity indices are down around 10% since the August *IR* (**Chart 1**) prompted by developments in China. This is consistent with market participants putting weight on developments there spilling over to more widespread global-activity weakness. But EMEs have been slowing for several years now (**Chart 2**) while advanced economy growth has, if anything started to pick up gradually. Thus a key question is whether the most recent weakness in EME growth is spreading to AEs. Information from forward-looking asset prices and timelier higher-frequency data can provide a steer on the world activity prospects. So this month's IEM discusses what those indicators are telling us about the outlook.

Chart 1: cumulative changes in global equity prices in 2015

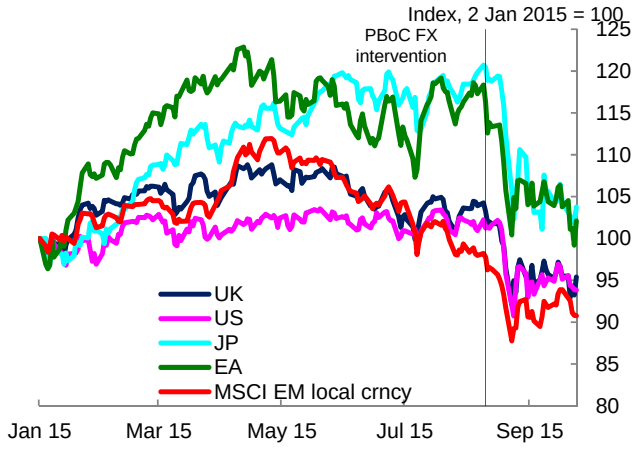
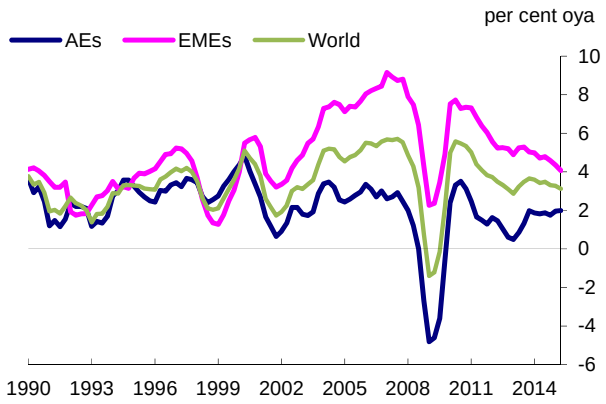


Chart 2: Advanced economy, EME and world GDP growth (PPP-weighted)



The recent weakness in world activity in Q2

The global economy maintained a plodding pace of growth in Q2, with PPP-weighted growth coming in at 0.7% for the third consecutive quarter. While this was disappointing relative to the August *IR*, it was not broad-based with the majority of downside news accounted for by non-China EMEs (**Chart 3**), particularly Brazil and Russia which contributed just over half of the total surprise. Indeed, EME growth fell from 1% oqa, to 0.8% in Q2. Taken together with weakening PMIs (**Chart 4**), prospects for these countries does appear to have deteriorated further. Moreover, further falls in commodity prices (**Chart 5**), though positive for commodity importers, will hurt commodity producers. This, in addition to renewed capital outflow pressure (**Chart 6**), suggests this deterioration

may prove persistent. The next section considers whether the information in equity and commodity prices can help us assess the extent to which EME weakness will spill over to overall global growth prospects.

Chart 3: Contributions to news in PPP-weighted world GDP

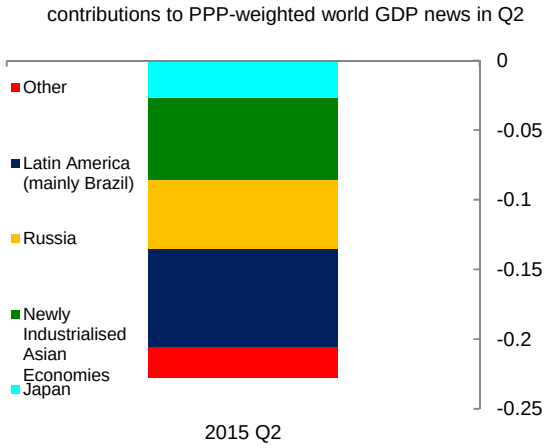


Chart 4: Global composite PMIs

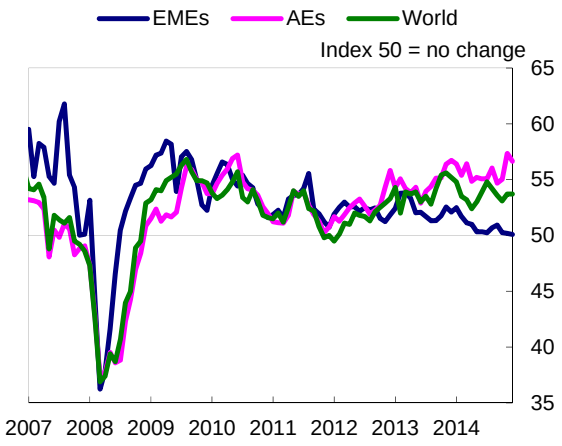


Chart 5: cumulative changes in commodity prices in 2015

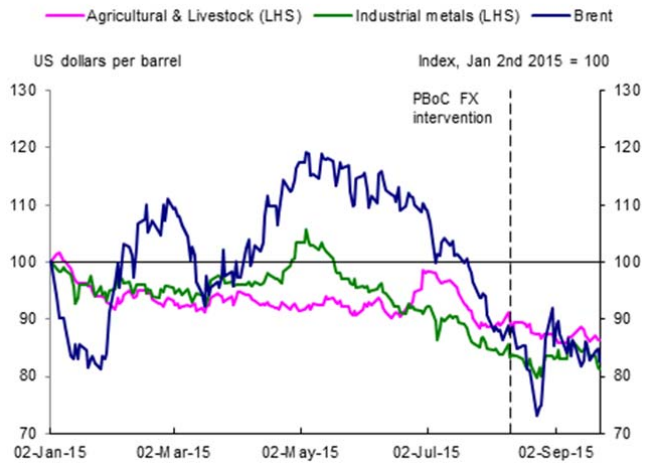
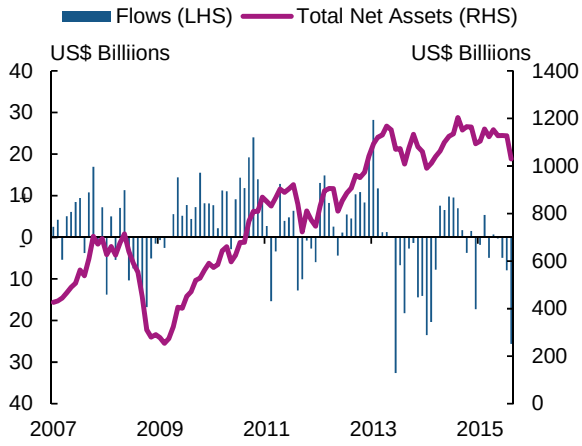


Chart 6: Capital outflows from EME funds (EPFR)



The steer from equities and commodities

Taken at face value, large falls in commodity and other asset prices could signal much weaker prospects for world activity. But such a signal is complicated by other factors driving prices, not least changes in investors' attitude to risk, and the impact of supply shocks in commodity markets.

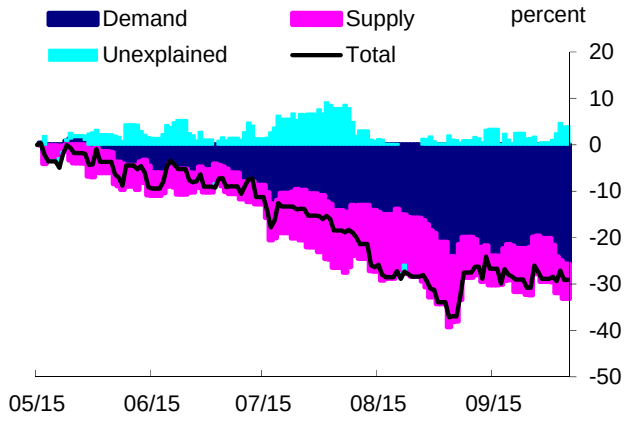
The recent falls in AE equity prices appear to be driven by movements in the equity risk premium. AE equity prices started falling sharply following the devaluation of the renminbi by the PBoC in August (**Chart 1**). MFAD's DDM decomposition is one way of disentangling different drivers of equity prices. **Table 1** shows that, for major AE equity markets, dividend forecasts and risk-free rates have remained relatively unchanged, suggesting that the fall can be accounted for by a rise in the equity risk premium. These results should be taken with a pinch of salt, however, as analysts' expectations of future dividend growth may be revised down further as they digest the implications of recent moves. Even if falls in equity prices are largely accounted for by rises in risk premia, these are consistent with greater uncertainty about the risks to global growth prospects, and, in any case, will tighten financial conditions, providing an additional headwind to growth.

Table 1: DDM decomposition of changes equity prices since Aug IR*

	Change in index since Aug *IR*	Of which accounted for by:		
		Risk-free rate	Actual and expected dividends	Equity risk premium (residual)
FTSE all share	-7.1%	1.5%	-2.2%	-7.5%
S&P 500	-8.4%	1.3%	0.9%	-11.1%
Euro stoxx	-11.6%	-0.1%	-1.1%	-11.6%

* Components may not sum to total due to approximation error.

Chart 7: Asset-price decomposition of oil price changes since May



Sources: Datastream and Bank's calculation.

Meanwhile oil prices have fallen 30% since their 2015 peak in May to around $47pb (**Chart 5**). Unlike the previous fall in oil prices between June 2014 and January 2015, which we have considered to be mostly supply driven, model-based estimates and information from market contacts suggests that the fall since May has been driven by a larger demand component (**Chart 7**). Indeed, information from market contacts suggests that the negative demand factor is likely to reflect fears of a slowdown in Chinese growth triggered by equity market volatility and perhaps concerns over weakness in other EMEs such as Brazil and Russia (together accounting for nearly 10% of global crude consumption).

The most recent demand-led falls may signal weaker growth expectations, but it is also important to put them in context. The latest falls in oil prices takes them back to its previous trough, seen at the start of the year (**Chart 5**). And both our asset-price based decomposition and the decomposition using our SVAR model suggest that around half of the fall in oil prices since the summer of 2014 has been driven by supply.[1]

Taken at face value, however, the demand driven fall in oil prices since August would point to chunky mark down to world GDP. Brent has fallen around 10% since the IR data cut off. That is roughly consistent with market participants marking down expectations of PPP-weighted world GDP by around 1%.[2]

The steer from top-down global indicators for Q3

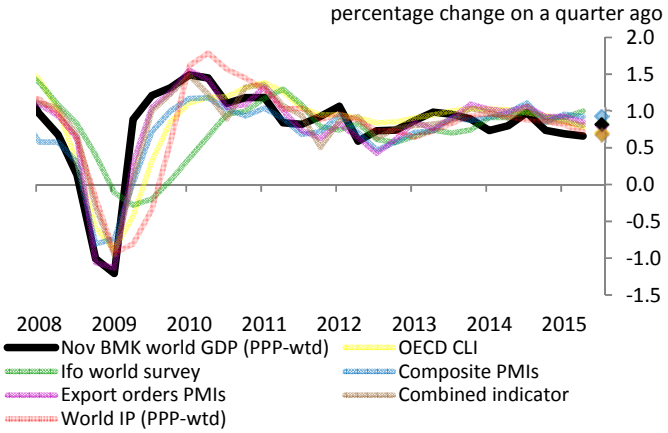
An alternative way to gauge whether spillovers from recent EME weakness are affecting the near-term outlook is to look at high-frequency indicators. The August *IR* forecast embodied a slight pickup in PPP-weighted world GDP growth to 0.8%oqa in Q3, which is in the middle of a range of top-down world activity indicators (**Chart 8**). However, some top-down indicators have edged down this quarter and are now weaker than our forecast, including the OECD composite leading indicator, IP and our own combined-indicator model, which all point to growth remaining at 0.7% in Q3. On the other hand, JP Morgan composite output and world export orders PMIs, and the Ifo world survey all point to a small pickup in growth to around 0.8-9% in line with the August *IR* forecast. Of these indicators, the JP Morgan composite PMI and export orders PMI tend to have the highest correlation with global output.[3]

However, *all* indicators have tended to over-predict global output in recent quarters. In the past, the accuracy of these indicators has fallen when world economic growth stabilises within a small band as it has done in recent years. On the other-hand, high-frequency global activity indicators tend to predict world economic activity relatively better when there are large changes in world economic activity.[4] So we may take comfort from the fact

[1] See "Oil is not as it seems: Expectations of future oil supply key to explaining drop in price", Bank Underground
[2] Based on an income-elasticity of 0.1, which is standard in the literature.

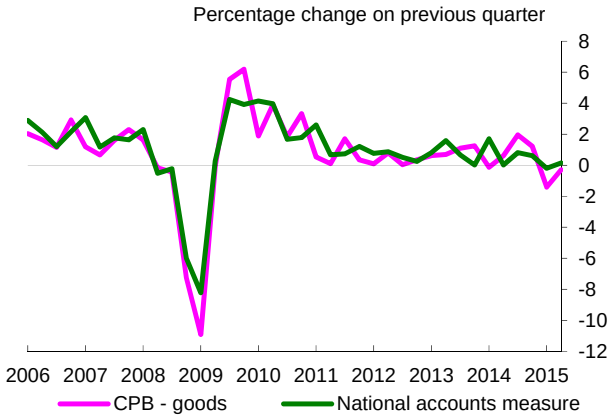
that, despite some indicators ticking down a touch, overall, they are still pointing to relatively stable growth. This picture of continuing near-term moderate growth is supported by bottom up indicators – see Box.

Chart 8: Global top-down indicators – Q3 nowcast*



*August data is available for: Ifo, Composite PMIs and export-orders PMI.

Chart 9: Measures of world trade



The recent weakness in world trade

While a range of top-down indicators do not suggest a marked slowing in near-term global growth, data on world trade have been more worrying. World goods trade volumes show a sharp contraction in H1 2015, with much of the weakness occurring in Asia. According to the CPB, world trade volumes fell by 1.5% in Q1 (**Chart 9**), the largest fall since the crisis, although still significantly smaller in magnitude.

There are several reasons to be cautious about taking an overly negative signal from the contraction in trade, however. First, the CPB series is inherently volatile and has declined by more than other measures of trade this year, including our own in-house measure. Our in-house measure, which includes trade in services, has tended to follow the same growth rate as the CPB series (**Chart 9**), albeit with less volatility, but it has not displayed the same degree of weakness in the recent data. This suggests the recent CPB outturns may prove erratic. Second, there are tentative signs that trade is slowly recovering, with more timely monthly data on Asia trade suggesting a pickup. CPB measured trade contracted in Q2 by 0.5%oqa. But three-month on three-month growth of CPB goods trade in July became positive (0.2%) for the first time since January. And monthly data from national sources to August in Asia, where much of the weakness was based in H1, looks to have continued to recover, particularly in China. Third, trade growth has not been a good predictor of world GDP growth in the past.[5] And fourth, much of the post-crisis weakness in trade relative to global output appears to reflect the growing contribution of EMEs to growth, where imports tend to grow more slowly relative to GDP.[6]

Conclusion

Financial market volatility over the summer has prompted worries that a weaker outlook for China and other EMEs may spill over to a more generalised weakening in global growth prospects. While demand-driven falls in the oil prices since the August *IR* are consistent with around 1% of additional weakness in PPP-weighted world GDP, surveys of dividend growth expectations do not suggest that falls in equities have been driven by market participants becoming gloomier about the central case for global growth. Nonetheless, even if falls in equity prices are largely accounted for by rises in risk premia, these are suggestive of greater uncertainty about global growth prospects, providing an additional headwind to growth. Timelier indicators of global growth in Q3 are mixed, but provide little evidence of a material decline in the pace of growth. And while trade indicators have been more worrying, there are some signs of a turnaround in trade performance through Q3 and some signs structural factors have been at work.

[5] Granger causality tests on the relationship between trade and GDP support this. Using quarterly data from 1990 to 2015Q1 for both UK weighted and MER weighted measures, we find that world trade does not Granger cause world GDP, but world GDP does Granger cause world trade.

Assessment of data and policy news on the mont

Region	Judgement on the month	GDP growth forecasts*		Oct MPC	Sept MPC
Euro area	*Q2 GDP growth was revised up to 0.4%, the same as in the August IR. Q1 was revised up to 0.5%, 0.1pp stronger than the August IR. Recent indicators are still consistent with our Q3 nowcast of 0.4%.*	**EA**	Q1	0.5%	0.4%
			Q2	0.4%	0.3%
			Q3	0.4%	0.4%
US	*The FOMC kept rates unchanged at the 16-17 September meeting, acknowledging recent global concerns and market turbulence. Most FOMC participants still anticipate a rate rise by year-end, making December the most likely date for lift-off.*	**US**	Q1	0.2%	0.2%
			Q2	1.0%	0.9%
			Q3	0.6%	0.7%
RoW	*In China, measures of activity point to slightly stronger growth in Q3, even taking into account a likely drag from the bursting of the stock market. This likely reflects continued policy easing, but such steps (eg the rate cuts) are adding to capital outflow pressures.*	**China**	Q1	1.6%	1.5%
			Q2	1.7%	1.6%
			Q3	1.7%	1.6%
Commodities	*Oil prices have fallen around 1% since pre-MPC to $46pb. It has been trading around $46-$50pb for the past two weeks. The oil futures curve is in contango reflecting historically high world oil inventories due to supply/demand imbalance and the expectation that the imbalance will reduce over time as oil prices rise.*				
World activity	*The JPM global output PMI for August posted 53.7, unchanged since July, consistent with PPP-wtd world GDP growth of 0.8% in Q3. World trade was 0.2% (3m-on3m) in July, the first positive growth rate since January. Other global indicators, such as OECD CLI and CPB world industrial production, suggest a slight slowdown in world growth in 2015 Q3.*				

Euro area

Growth in both Q1 and Q2 was revised up by 0.1pts to 0.5% and 0.4% respectively. Domestic demand was robust in H1 and net trade surprised to the upside in Q2, contributing 0.3pp to quarterly growth where we had expected 0.1pp. The composite PMI index fell modestly in September (-0.4pts), as did the Commission's consumer confidence index (-0.2pts), but Q3 nowcast remains at 0.4%. The second release of HICP inflation in August was 0.1%, down from 0.2% in July and down 0.1% from the flash estimate. We now expect HICP inflation to fall back slightly to 0.0% in September before rising in October and November. The result of the Greek general election reduces the risk of near-term political paralysis, but does not materially change our assessment of medium-term risks. The ECB revised down its forecasts for EA growth and inflation on concerns about EME growth and associated spill overs to asset prices, particularly appreciation of the euro. The tone of President Draghi's press conference was dovish.

US

The FOMC kept rates unchanged at the 16-17 September meeting[1], acknowledging recent global concerns and market turbulence. Chair Yellen noted in the press conference that "[recent global economic and financial] developments may also restrain US economic activity somewhat but have not led at this point to a significant change in the Committee's outlook for the US economy". While the path for FFR was revised downwards, most FOMC participants still anticipate a rate rise by year-end, making December the most likely date for lift-off.

The final release of Q2 US GDP was revised up slightly by 0.1pp to 1.0% qoq. Most of the upside came from stronger spending on services. The updated GDP figure is consistent with our view that solid consumption continues to be a main driver of US economic growth.

The labour market data were mixed in August. August NFPs were softer than previous months, increasing by just 173k (against an average of 206k since 2011). However, this was set against a combined upward revision of 44k in June and July to 245k each. The unemployment rate fell by 0.2pp to 5.1%. August headline PCE inflation remained unchanged at 0.3% while core PCE inflation increased by 0.1pp to 1.3%.

RoW

In China, measures of consumer spending and industrial production point to robust growth in Q3, even taking into account a likely drag from the bursting of the stock market. Retail sales growth rose 0.3pp in August to 10.8% oya, continuing its rising trend. And after some notable weakness in H1, most indicators of industrial activity have bounced back. The official industrial production statistic rose by 0.1 pp in August to 6.1% oya, in-line with the six month average. The firmer indicators of activity likely reflect past policy (e.g. benchmark lending rates are now 50bp lower than in mid-June). However, lower rates, and expectations of further cuts, are likely contributing to capital outflow pressures: official figures show FX reserves declined by $94bn between July and August. The Q3 Nowcast is 1.7%, 0.1pp higher than the Aug IR forecast.

Two other countries released Q2 GDP data: Turkey (1.3% qoq) and Brazil. Partly due to the weak growth outlook and partly due to political deadlock around fiscal consolidation, S&P downgraded Brazil to junk status.

Commodities

Brent oil is now trading in in the range of $46-$50pb. Spot Brent prices remained roughly unchanged since August pre-MPC, with the futures curve being 1% lower. The fall in prices reflects a mix of factors, including continued evidence of a global supply glut (e.g. OECD inventories reached a record high in July). There are also concerns about Chinese growth prospects, which have recently played a role in falling oil prices.

[1] 18/09