

World Economy: Continued Expansion amid Increased Uncertainties

Klaus-Jürgen Gern, Salomon Fiedler, Philipp Hauber, Stefan Kooths, Galina Potjagailo and Ulrich Stolzenburg

The world economy has gained traction in the course of 2016 despite elevated policy uncertainty and seems to have picked up further in the beginning of 2017. The change in the US government apparently has led to expectations of substantial policy stimulus, while a competitive valuation of currencies supports growth in Europe and Japan. In the emerging countries, the trend towards weakening economies has been arrested in the course of last year and the outlook is for a gradual acceleration of growth. Growth in global output – at PPP – should increase to 3.5 percent and 3.6 percent in 2017 and 2018, respectively, up from 3.1 percent last year and unchanged from our December forecast. Risks to the forecast are, however, prominent, partly related to the fact that the new US government has heralded sweeping policy changes but so far not been sufficiently concrete with its plans.

➤ **Winter 2017 has seen the world economy accelerate despite new political uncertainties.**

After a weak start, the world economy in 2016 gradually gained momentum and grew at a quarterly rate of 0.9 percent per quarter in the second half of the year, roughly the average pace of growth since the end of the global financial crisis in 2009 (Graph). The IfW-Indicator for World Economic Activity has increased further in the first quarter of 2017 to the highest level since the beginning of 2011. The robust growth is remarkable given that political uncertainties have increased following the Brexit decision, the outcome of the US presidential election and rising probabilities of politically problematic results in the upcoming key elections in a number of EU member states.

➤ **Stock markets have rallied following the US presidential election, while measures of political uncertainty have increased especially outside the US.**

Statements in the campaign and in the months after the election suggest sweeping changes in a number of policy areas, however, without specific details being available for the time being. Judged by the reaction of financial markets, the proposed policies seem to be perceived as business friendly on aggregate. At the same time, media-based indices of political uncertainty suggest an increase in political uncertainty which is potentially damaging for economic activity.

➤ **Policy plans indicate a strongly expansive US fiscal policy, which could lead to swiftly rising inflationary pressures, given that economic slack is limited.** The new US administration has announced substantial increases infrastructure expenditures and military spending. In addition, large-scale tax cuts have been proposed stemming from a reduction in income taxes and a fundamental reform of corporate taxes along the lines of the GOP plan. While such a reform has the potential to significantly stimulate economic



activity, it raises concerns inside and outside of the US that the result would be heavy distortions in cross-border trade (see the box on the proposed Cash Flow Tax with Border Adjustment (in German), [IfW-Box 2017.1](#)). Apart from this, there is the question to what extent the US economy is able to accommodate additional demand (see the box (in German) on the evolution of the US potential labor supply). Core consumer price inflation is already at 2.3 percent, and a significant further rise in inflation would probably lead to an accelerated tightening of monetary policy or a stronger appreciation of the dollar (or both) putting a lid on growth.

- **Protectionism is a risk for growth in the short and medium run, but a trade war is not the most likely scenario.** The critical attitude of the new US government towards free trade and the ambition to aggressively use tariffs and subsidies as a policy tool in international economic relations has raised concerns among its trading partners. If trade retaliation were to follow, the global economy could be severely impaired. The probability of a trade war is, however, reduced by the fact that in the case of the United States, protectionist measures hurting foreign economic activity would also hit the US economy substantially due to the large volume of capital invested abroad (see the box on the threat of protectionism in the transatlantic economic area, [IfW-Box 2017.3](#)).
- **Monetary policy in the advanced economies is drifting further apart.** The Fed has raised interest rates for the second time in this tightening cycle and indicated that a further step is imminent. We expect a further gradual increase bringing the lower bound of the target for the fed funds rate to 1.5 percent by the end of next year. By contrast, central banks in Japan and the euro area will keep policy rates at zero over the forecast horizon given that underlying inflation is likely to remain substantially below target for some time to come.
- **Global growth will gradually strengthen, but remain moderate this year and next.** Global GDP at PPP is expected to rise to 3.5 percent and 3.6 percent, respectively, from an estimated 3.1 percent last year. Weighted at market exchange rates growth rates will be $\frac{3}{4}$ percentage points lower (Table 1). Growth in world trade will accelerate to 3 percent from the low rate of 1.8 percent registered last year.
- **Growth in the advanced economies is picking up further.** This is mainly due to an acceleration of growth in the US to 2.5 and 2.7 percent this year and next, respectively, from 1.6 percent in 2016. Japanese growth will rise to 1.3 percent this year on the back of the recent devaluation of the Yen, but fall back to 1.0 percent in 2018. In the European Union GDP will continue to increase at moderate rates of 1.9 and 1.8 percent in 2017 and 2018, respectively, restrained by elevated policy uncertainty.
- **Emerging economies will gradually gain momentum, but structural impediments remain in place.** On aggregate, growth in the emerging economies will gradually strengthen. The Chinese government is expected to keep GDP growth above 6 percent for the time being. In Latin America, the upturn in commodity prices has brightened up the outlook and in the course of this year Brazil is expected to finally emerge from recession. In Russia the recovery is forecast to continue, albeit slowly due to continued institutional deficiencies.
- **Risks to the outlook are manifold.** Most of the risks are to the downside, but there is also an upside, including a larger than anticipated fiscal impulse in the United States to US growth or deregulation releasing more economic momentum than expected. Downward risks emanate from a possible rollback in global trade relations, from results in the European elections that increase political uncertainties in Europe further, or the unresolved issue of Brexit. Also the risk remains that financial market developments weigh on growth, e.g. in the context of US monetary tightening or further dollar appreciation which could negatively affect emerging economies with high external debt.

Real GDP and consumer prices in selected countries and regions, 2016–2018

| | Gross domestic product | | | Consumer prices | | |
|--|------------------------|------|------|-----------------|------|------|
| | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| United States | 1.6 | 2.5 | 2.7 | 1.3 | 2.5 | 2.8 |
| Japan | 1.0 | 1.3 | 1.0 | -0.1 | 0.6 | 0.6 |
| Euro Area | 1.7 | 1.8 | 1.7 | 0.0 | 1.5 | 1.4 |
| United Kingdom | 1.8 | 1.8 | 1.5 | 0.7 | 2.7 | 2.5 |
| Advanced economies total | 1.7 | 2.1 | 2.1 | 0.7 | 1.8 | 1.9 |
| China | 6.7 | 6.4 | 5.9 | 2.0 | 2.2 | 2.2 |
| Latin America | -1.3 | 0.7 | 2.0 | 8.4 | 6.6 | 5.6 |
| India | 7.1 | 6.8 | 7.2 | 5.3 | 4.0 | 5.0 |
| East Asia | 4.8 | 4.7 | 4.9 | 3.0 | 3.3 | 3.8 |
| Russia | -0.2 | 1.1 | 1.5 | 7.0 | 4.8 | 5.0 |
| World economy total | 3.1 | 3.5 | 3.6 | 3.0 | 3.2 | 3.4 |
| <i>Addendum: World trade volume</i> | 1.8 | 3.0 | 3.0 | . | . | . |
| Oil price (Brent in US-\$) | 44.7 | 56.6 | 55.9 | . | . | . |
| World economy total (weighted according to GDP at market exchange rates) | 2.4 | 2.9 | 3.0 | 2.4 | 2.8 | 3.0 |

Weighted according to GDP at PPP rates. — East Asia: Emerging Asia excluding China and India. — Shaded: IfW forecast.

Source: Forecast of the Kiel Institute for the World Economy.

Contact:

Prof. Dr. Stefan Kooths

Tel.: +49 (0) 30-2067-9664 (Office Berlin)

Tel.: +49 (0) 431-8814-579 (Office Kiel)

stefan.kooths@ifw-kiel.de

Dr. Klaus-Jürgen Gern

Tel.: +49 (0) 431-8814-262

klaus-juergen.gern@ifw-kiel.de