Global Economic Environment

Great Wall, China. Courtesy: http://moodle.cambria.ac.uk/course/view.php?id=522

Introduction

According to the International Monetary Fund (IMF), world GDP growth was 3.1% in 2015, moderately lower than the 3.4% observed in 2014. Global growth has been decelerating since the most recent peak of 4.2% in 2011. The slowing growth is, to a certain extent, attributed to the deceleration in emerging market economies (EMEs), most notably China.

For the past several years, growth in EMEs, particularly China, were the main drivers of global growth. During the first decade of the new millennium, China, currently the world's largest economy, recorded annual average real GDP growth of 10.5%. In contrast, over the past five years, China's economic growth has decelerated to 6.9% in 2015. This slower growth is negatively impacting demand for commodities. On the other hand, the decline in oil prices is boosting consumption, especially in major oil importing countries.

The slowing of economic growth in the EMEs, combined with oversupply, has placed downward pressure on several commodity prices, particularly oil and iron ore. The price of crude oil (Brent) is approximately 70% lower than the level recorded in June 2014. In turn, this has negatively affected most commodity exporters. Russia and Brazil are in the midst of deep recessions. Due to its economic diversity, Canada has remained relatively resilient to the downturn, although not uniformly across provinces.

Monetary policies are now diverging. The Federal Reserve Board in the United States increased its target interest rate (the Federal Funds Rate) by 0.25 percentage points in December 2015 to reduce its monetary stimulus, while the European Central Bank and Bank of Japan remain in full-scale stimulus mode. The Bank of Canada and Bank of England appear reluctant to adjust interest rates until financial and commodity markets become less volatile.

Real GDP Growth (%)

	2014	2015e	2016f	2017f
World	3.4	3.1	3.4	3.6
Brazil	0.1	-3.8	-3.5	0.0
India	7.3	7.3	7.5	7.5
Russia	0.6	-3.7	-1.0	1.0
China	7.3	6.9	6.3	6.0
Canada	2.5	1.2	1.5	2.2
United States	2.4	2.4	2.1	2.4
Japan	0.0	0.6	1.0	0.3
Euro Area	0.9	1.5	1.7	1.7
United Kingdom	2.9	2.2	2.2	2.2
Germany	1.6	1.5	1.7	1.7
France	0.2	1.1	1.3	1.5
Italy	-0.4	0.8	1.3	1.2
Spain	1.4	3.2	2.7	2.3
Greece	0.8	-2.3	-1.3	2.7

e: estimate; f: forecast

Source: Canada - average forecast of major Canadian banks; U.S. - Survey of Professional Forecasters, U.S. Federal Reserve Bank of Philadelphia; all other jurisdictions - International Monetary Fund

The IMF projects a 2016 growth rate in real GDP of 3.4% for the world, 2.1% for advanced economies and 4.3% for EMEs. These forecasts from January have been revised down slightly since the October forecast.

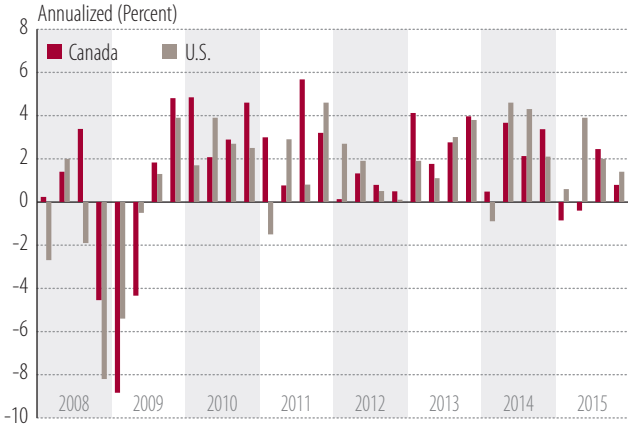
United States

U.S. economic growth has been steady, but moderate, in recent years. Real GDP increased by 2.4% in 2015, the same as 2014. During 2015, quarterly growth peaked at a robust 3.9% (annualized) in the second quarter and then declined throughout the second half of the year to 1.4% in the fourth quarter.

Consumer spending accounts for about two-thirds of U.S. economic activity. Given limited growth in investment (stemming partially from low prices for oil and other commodities) and lower exports (constrained by subdued growth in the world economy and appreciation of the U.S. dollar), con-

sumer spending will continue to be the main driver of growth in the near-term. In 2015, growth in real consumer spending, at 3.1%, outpaced real GDP growth. On a quarterly basis, consumption growth peaked in the second quarter at 3.6% but fell to 2.4% in the fourth quarter. Consumption of durable goods increased by 6.0% in 2015, largely driven by a 5.9% increase in the quantity of vehicles sold.

Canada and US GDP Growth



Source: Statistics Canada; Bureau of Economic Analysis

Non-residential investment increased by 2.8% in 2015. The year started at a subdued pace (1.6% in the first quarter), picked up steam in the second and third quarters but ended with a 2.1% decline in the fourth quarter. Investments have been impacted by a slowdown in the energy sector, due to the falling price of crude oil. Non-residential investment closely follows the industrial capacity utilization rate, and this rate declined throughout 2015.

Residential investment fared better. In 2015, housing starts increased by 10.8%, following a steady upward trend since 2010. However, the number of starts remains lower than the pre-recession average. From 2000 to 2007, annual average housing starts were 1.738 million compared to 1.112 million starts in 2015.

The exports sector was challenged throughout 2015 by the rising value of the U.S. dollar. The trade-weighted U.S. dollar index increased by 12.6% in 2015, due in part to diverging monetary policies between the U.S. and several of its trading partners. Growth in real exports of goods and services started and ended 2015 on quarterly declines, with positive growth in between, for overall growth of 1.1% for the year.

Labour market conditions continued to improve in 2015. The unemployment rate decreased throughout the year, reaching 4.9% in January 2016, the lowest rate since 2008. Employment increased by 1.7%, while the participation rate declined by 0.2 percentage points. In addition to job gains, average hourly earnings increased by 2.1% in 2015.

The decreasing unemployment rate and concerns about future inflation driven by accelerating wage gains led to expectations that the Federal Reserve would begin raising the Federal Funds target rate increase at some point during 2015. An increase occurred in December 2015, when the Federal Open Market Committee decided to increase the target rate by 25 basis points, bringing it between 0.25% and 0.50%. This is the first time the rate had been raised since December 2008. It is expected that the target rate will be progressively increased in the near future, but the pace and timing of those increases will be dependent on economic performance.

The U.S. economy is expected to expand by 2.1% in 2016, down from a growth rate of 2.4% in 2015. Consumer spending and the housing market are expected to drive growth, buoyed by pent-up demand, job gains and increasing incomes. However, the strength of the U.S. dollar and subdued global demand will constrain exports, and capital spending is expected to be restrained by low commodity prices. Real GDP growth is expected to accelerate to 2.4% in 2017.

United Kingdom

Real GDP growth in the United Kingdom slowed in 2015, with growth of 2.2% compared to 2.9% in 2014. Growth stemmed primarily from private consumption as exports were constrained by weak

external demand. Capital expenditures were strong at the beginning of the year, but weakened in the second half, partly due to pullback in the energy sector.

Consumer spending grew by 3.0% in 2015, buoyed by record high employment, real income growth and low energy prices. The unemployment rate for the three months ending January 2016 was 5.1%, the lowest rate in 10 years.

The outlook for 2016 is for growth similar to that recorded in 2015, however, downside risks exist. Following a renegotiation of the current conditions of Britain's membership in the European Union at a summit in Brussels, the UK will hold a referendum on its EU membership on June 23, 2016. Uncertainty regarding the outcome of the referendum and slower growth in emerging markets, especially China, are the two main risks. On the upside, consumer confidence remains high and the labour market remains robust. Overall, the IMF expects the economy to grow by 2.2% in 2016, on par with 2015's growth.

Eurozone

The Eurozone consists of the 19 jurisdictions within the European Union that have adopted the euro as their currency. Collectively, the Eurozone accounted for 12.0% of global GDP in 2015, with the largest economies being those of Germany, France, Italy and Spain. While overall GDP growth in 2015 was a modest 1.5%, it was an improvement from the 0.9% growth recorded the previous year. Low energy prices and reduced financial market volatility generated solid gains in private consumption and capital spending. Exports also posted gains of 5.0%, but total GDP growth was held back by a 5.7% surge in imports.

There were considerable variations in GDP growth, with Spain increasing by 3.2% while Italy posted 0.8%. Germany, considered the main engine of Europe's economy, increased by 1.7%, in line with the Eurozone average. Economic growth reduced the unemployment rate from 11.6% in 2014 to 10.9% last year, but stark differences persist between countries. Unemployment in Germany reached a post-reunification low of 4.6% while much higher rates persisted in periphery countries like Spain where the unemployment rate averaged 22.1% in 2015.

Facing continuing sluggish growth and inflation oscillating around zero, the European Central Bank (ECB) launched its Quantitative Easing (QE) in early 2015 which committed to purchase European bonds worth €60 billion monthly until September 2016. The ECB later extended the plan to continue purchases to March 2017 and just recently announced plans to include corporate bonds and increase purchases to €80 billion monthly starting April 1, 2016.

In addition to its QE program, the ECB has been carrying out a negative interest rate policy since June of 2014 by maintaining a negative interest rate on its overnight deposit facility. The purpose of negative interest rates and QE is to boost overall growth and increase inflation to around 2%. The ECB stated that it intends to conduct its QE policy until reaching this inflation target. Inflation has been muted in the last couple of years with price gains for most products largely offset by falling energy prices.

Significant risks to the economic outlook for the Eurozone persist. Italian banks continue to carry a large number of non-performing loans and serious risks of a banking sector collapse exist in that country. Both the sovereign debt crisis in Greece—which has not been settled and could resurface—and/or a UK vote to leave the European Union in the upcoming referendum could cause significant negative economic and financial market shocks.

Another issue in 2015 that has reverberated throughout the European Union is that of Syrian and Iraqi refugees. Some countries, such as Germany and Sweden, have adopted an "open door"

policy, while some, such as Hungary, have been less enthusiastic. Further divergence could occur as anti-immigration parties may see their support increase, especially following the recent terrorist attacks in Paris and Brussels. This could threaten the free flow of commerce and workers within the EU.

The IMF projects annual real GDP growth in the Eurozone of 1.7% for each of 2016 and 2017, and the most recent ECB Survey of Professional Forecasters predicts the unemployment rate will fall to 10.3% in 2016 and 9.9% in 2017.

Japan

Japan is the world's fourth largest economy, accounting for 4.3% of world GDP on a purchasing power parity basis in 2015. The country has experienced a number of serious economic difficulties over the past two decades with persistently low inflation or deflation, increasingly high levels of government debt and weak private sector growth. Over the past 20 years, Japan's real GDP has increased by an annual average of only 0.7%, and inflation has averaged only 0.1% per year. In addition, due to a rapidly aging population, Japan's public finances are under sustained pressure, particularly for health and long-term care expenditures, which are difficult to constrain.

In 2013, the Government of Japan launched a three-pronged approach for economic recovery through monetary, fiscal, and structural policies. These policies included a large fiscal stimulus program; measures by Bank of Japan to increase the money supply, including the introduction of quantitative and qualitative monetary easing; and structural reforms such as reducing protectionism for selected industries and reducing labour market rigidities. Thus far, these policies have had only limited success.

Weakness in the Japanese economy continued in 2015 with real GDP increasing by only 0.6% relative to 2014. The inflation rate was 0.8% in 2015, well below the Bank of Japan's 2% target rate. On January 29, 2016, the Bank of Japan applied its first negative interest rate (-0.1%) to current accounts that financial institutions hold at the Bank and has indicated that it will reduce this rate further into negative territory if necessary.

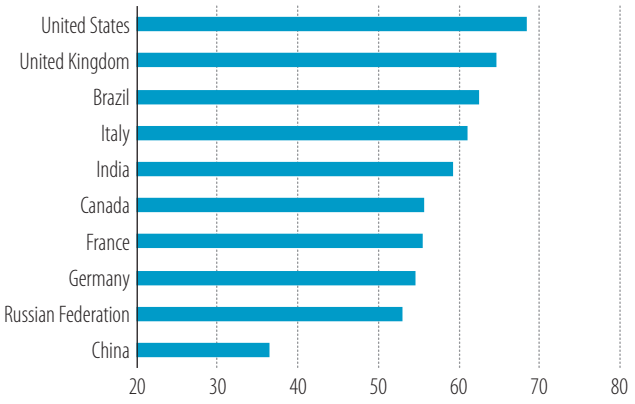
The IMF expects weakness in Japan's economy to continue in 2016 and 2017 with real GDP growth forecasted at 1.0% and 0.3% respectively.

China

The Chinese economy expanded by 6.9% in 2015, slightly less than the 7.3% recorded in 2014. Although it is significantly lower than the annual average rate of 10.4% recorded between 1992 and 2007, it remains significantly above growth rates recorded in advanced economies. Gains in consumption and investment more than offset the first decline in exports since 2009. GDP growth was further aided by a large decline in imports.

The Chinese economy is in the midst of important structural changes, with the government committed to transitioning the drivers of growth from manufacturing and investment to services and consumption. Compared to both developed and developing countries, China's consumption as a share of GDP is unusually small: in 2014 it was just 36.5% in China compared to 68.4% in the U.S. and 59.2% in India (see chart).

Household Final Consumption Expenditure
as a Percent of GDP, 2014



Source: World Bank and U.S. Bureau of Economic Analysis

Despite the stated restructuring goals, in recent years the government has shown a willingness to support the economy via cheap credit, strong investment and a loose monetary policy when economic activity appears to be slowing too quickly. This could potentially slow the rate of restructuring.

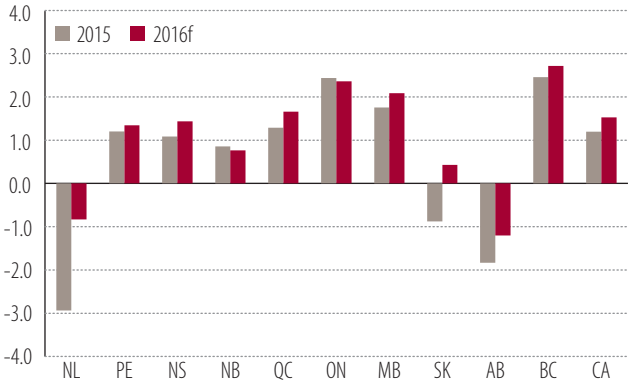
The Chinese government has identified several challenges it will tackle in 2016. In line with the aforementioned structural problems, they will seek to decrease overcapacity, in particular within less efficient state-owned enterprises and in heavy industrial sectors, such as steel, cement and mining. They will also aim at reducing the excess housing inventory, as supply, in terms of new units, has exceeded the demand in the last five years.

The Chinese economy has shown signs of stabilizing early in 2016, with industrial production, investment and house prices all increasing. The IMF expects real GDP growth in China to be 6.3% in 2016 and 6.0% in 2017, due to weaker investment growth as the economy continues to rebalance towards a more consumer based economy.

Canada

During the last decade, economic growth in provinces with a large commodity sector, notably fossil fuels, surpassed the national average. Several other provinces, particularly Ontario and Québec, were left to deal with faltering manufacturing sectors, partly due to increasing global competition and appreciation of the Canadian dollar. The recent collapse of crude oil prices, and consequent Canadian dollar depreciation, led to a reversal of fortunes. Alberta, Newfoundland and Labrador and Saskatchewan are all believed to have recorded negative real GDP growth in 2015 (see chart). On the other hand, British Columbia, Manitoba, Ontario and Québec posted growth at or above the national average. Real GDP growth for Canada is estimated at 1.2% for 2015.

Real GDP Growth by Province



f: forecast
Source: Average of Canadian major banks and the Conference Board of Canada

Canadian retail sales increased by 2.2% in 2015. This is one of the lowest growth rates outside of a recession in recent decades. Household indebtedness has been steadily increasing since the early 1990s and reached a record high last year. Thus far, debt levels have proven to be sustainable due, in part, to a low interest rate environment. The ratio of interest payments to disposable income is currently at a historically low level. However, with interest rates expected to rise soon, interest payments could rise substantially and consumers may not have the freedom to increase expenditures, thus limiting the contribution of consumption to GDP growth.

Real capital investment in Canada fell by 3.3% in 2015, constrained by lower spending in the mining and oil and gas sectors. As well, the depreciation of the Canadian dollar increased the cost of imported machinery and equipment. However, the Bank of Canada's January 2016 Business Outlook Survey indicated increased investment intentions in export-oriented industries not tied to commodities.

The value of exports were hard hit by the decline in oil and mineral prices in 2015, but real exports displayed a strong performance, increasing by 3.0%. The volume of exports increased across most categories aided by additional capacity in the oil industry and increased exports of consumer goods

supported by a low dollar and solid U.S. demand. The low dollar and solid U.S. demand is expected to contribute to further gains on non-energy exports in 2016.

In response to a slowing economy, particularly in commodity dependent provinces, the Bank of Canada started cutting interest rates last year. The Bank of Canada lowered the target overnight bank rate twice in 2015—by 25 basis points on January 21st and by another 25 basis points on July 15th—in an attempt to boost investment and stimulate economic growth. The target overnight rate currently stands at 0.5%.

The Canadian dollar depreciated steadily throughout 2015 declining by 15% from near 85 cents US at the start of the year to near 72 cents at the end. Declining commodity prices in general, and oil prices in particular, was the major factor behind the decline, but increasing interest rates in the US combined with falling rates in Canada also contributed.

Gains in the labour market were subdued in 2015. National employment grew by just 0.8% and the unemployment rate remained unchanged at 6.9%. Average weekly earnings grew by 1.8% nationally and gains were recorded in all provinces.

Economic growth in 2016 is expected to vary across the country. Lower energy prices and solid U.S. demand will continue to help economic performance in manufacturing intensive provinces, such as Québec and Ontario, and other provinces less dependent on oil and mineral exports such as British Columbia and Manitoba. Meanwhile low commodity prices will continue to restrain growth in the more oil and mineral resource-based provinces, such as Newfoundland and Labrador, Saskatchewan and Alberta. The latest consensus of bank forecasts and the Conference Board of Canada expects growth in Canada to average 1.5% in 2016. British Columbia, Manitoba and Ontario are expected to lead the provinces in growth both this year and next.