Global Economic Outlook

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2015 Outlook Conference
Ohio Wesleyan University

November 12, 2014

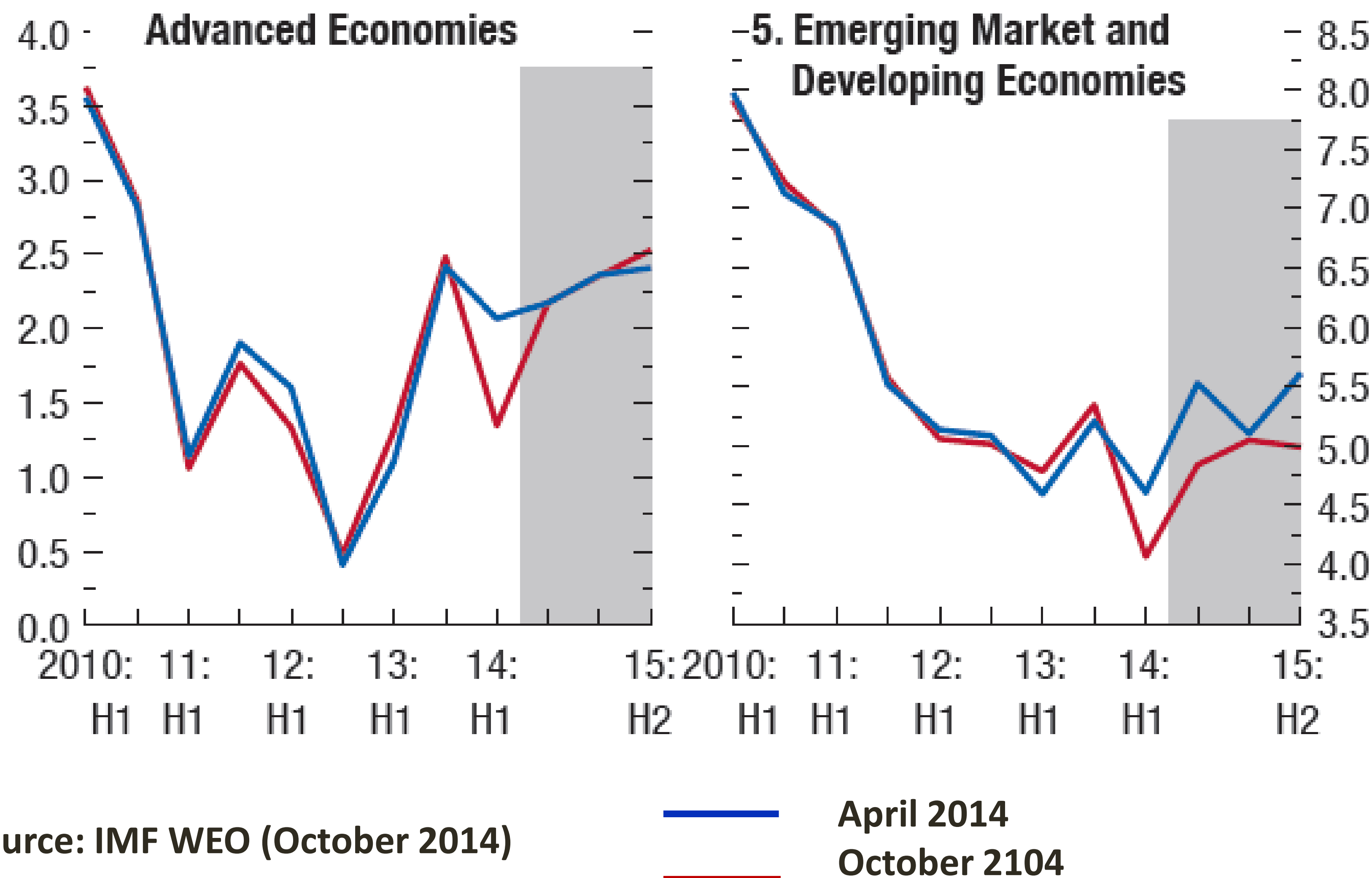
THE OHIO STATE UNIVERSITY

Global Economic Growth

- World output forecast to grow by 3.8% in 2015
- Growth expected to strengthen across advanced economies
- Pace of recovery different across regions: stronger in US, weak in euro area, modest in Japan, and solid in UK and Canada
- Growth in emerging and developing economies projected to show modest increase - stronger domestic demand and recovery in external demand

Economic Growth Breakdown

GDP Growth (Annualized semiannual % change)



Source: IMF WEO (October 2014)

Growth Dynamics

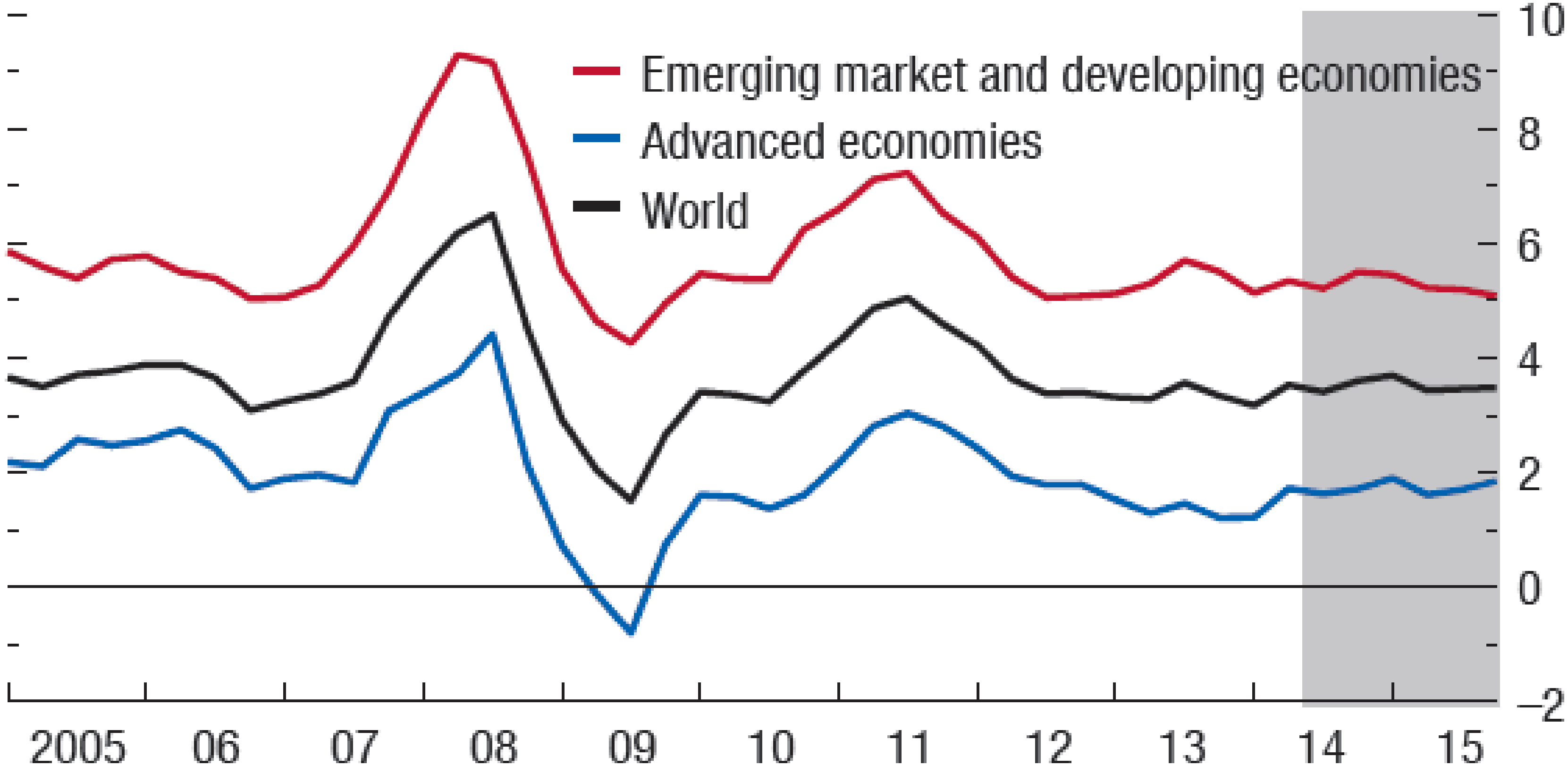
- US (3.1%) - rebound due to monetary policy, strengthened household balance sheets, and healthier housing market
- Japan (0.8%) - stable even with fiscal adjustment
- Euro area (1.3%) - prospects uneven across countries
- China (7.1%) - slowdown in residential investment
- In Latin America (2.2%) - deteriorating terms of trade and idiosyncratic domestic constraints

Inflation Forecasts

- Inflation low in advanced economies:
  - Large output-gaps
  - Deflation continues to be a concern
- Inflation rates in major economies:
  - US – 2.1%
  - Euro area – 0.9%
  - Japan – 2.0%
  - Emerging/developing economies – 5.6%

Global Inflation

Headline Inflation



Source: IMF WEO (October 2014)

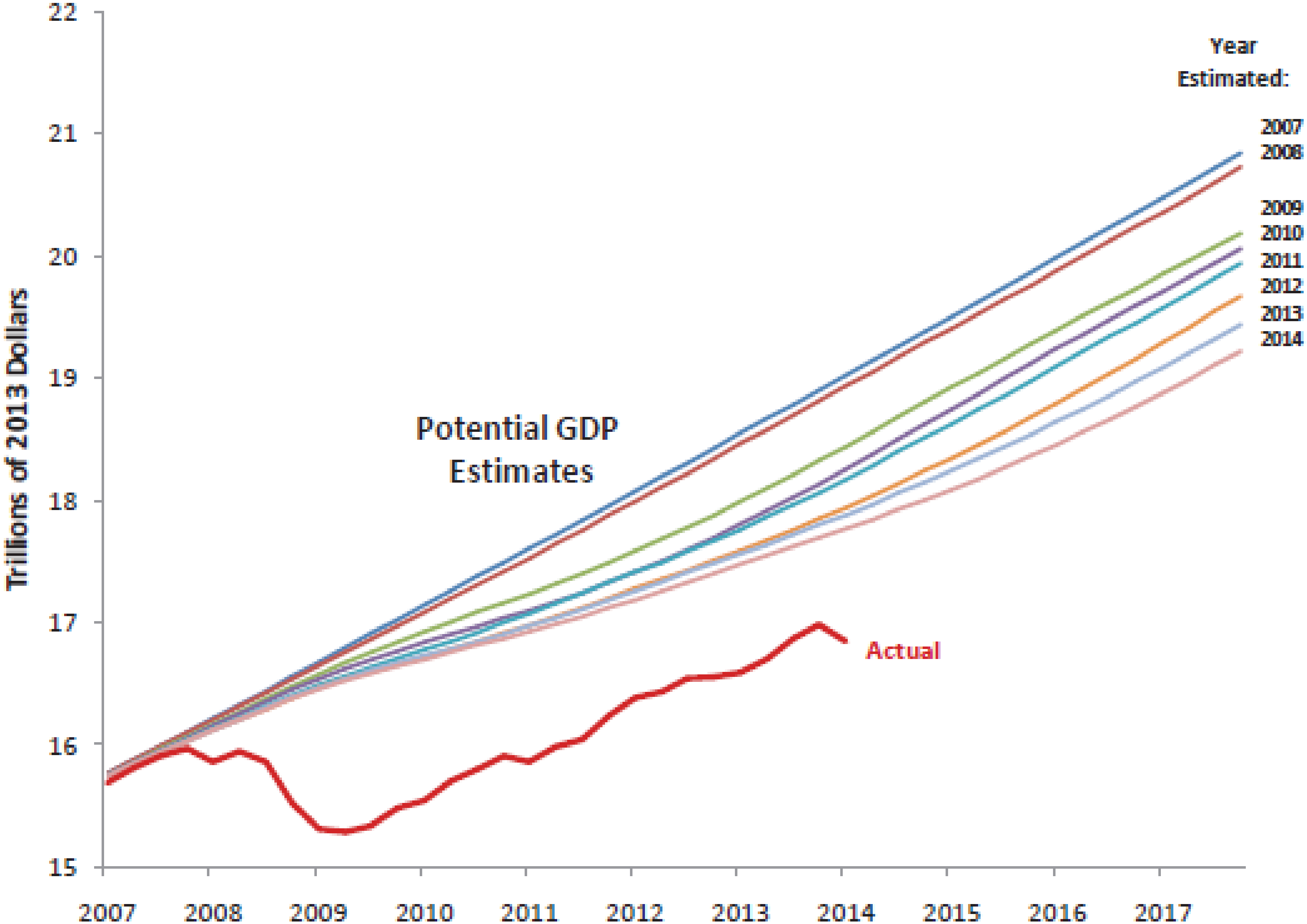
Increase in Downside Risks

- Short-term risks:
  - geopolitical
  - monetary policy normalization in US
  - deflation in euro zone
- Medium-term risks:
  - low growth potential and possibility of “secular stagnation” in advanced economies
  - hard landing in China if it does not rebalance

“Secular Stagnation”?

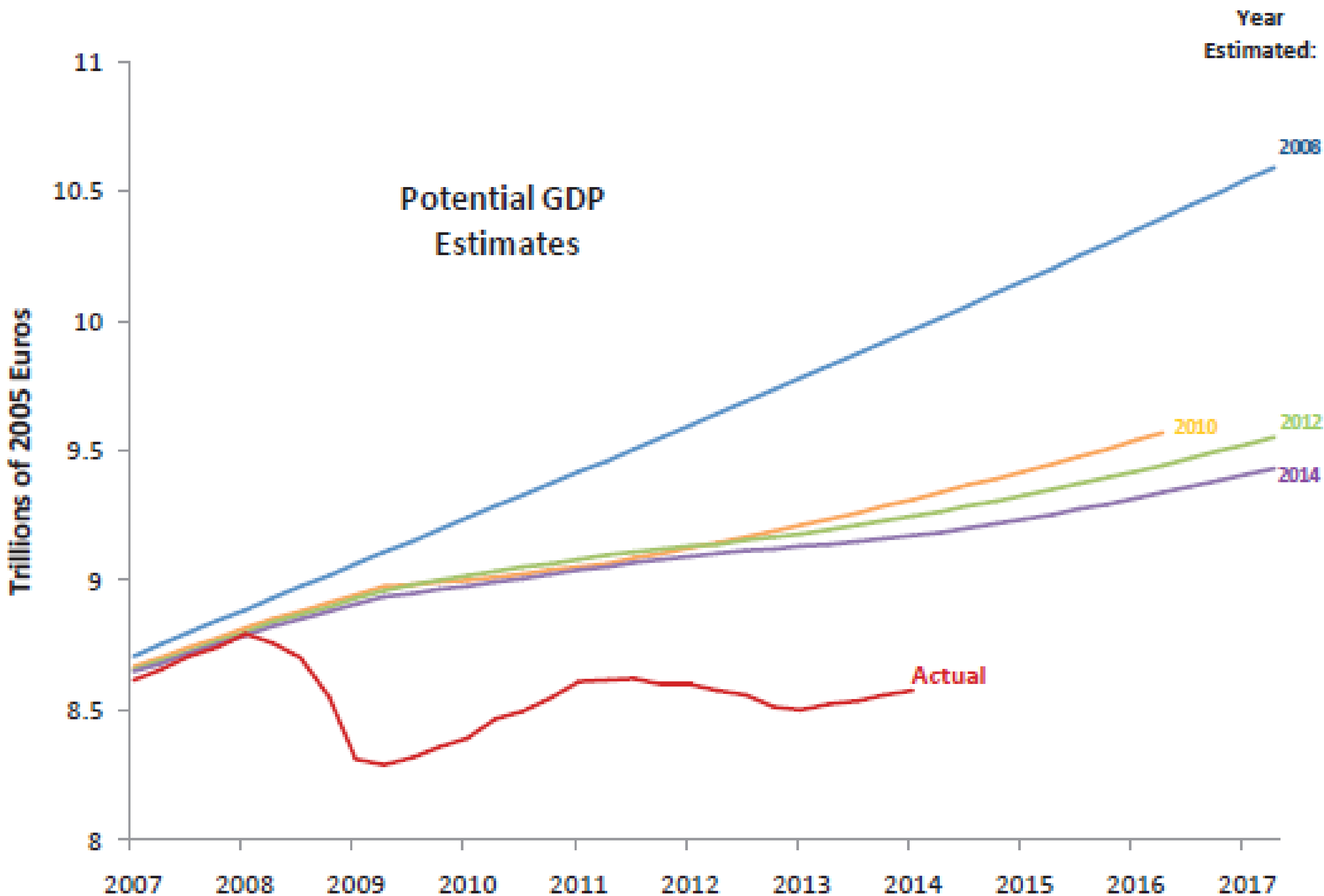
- **Why have advanced economies not returned to pre-crisis growth rates despite near-zero interest rates?**
  - **Potential long-run growth rate may have fallen – slowdown in growth of productive inputs and technological progress (Gordon, 2014)**
  - **Persistent output gaps - weak private demand (Summers, 2014; Krugman, 2014)**
  - **Damage to potential output – unemployment has resulted in depreciation of human capital and “loss of talent” (Glaeser, 2014)**

US Output Gap



Source: CBO and BEA

Eurozone Output Gap



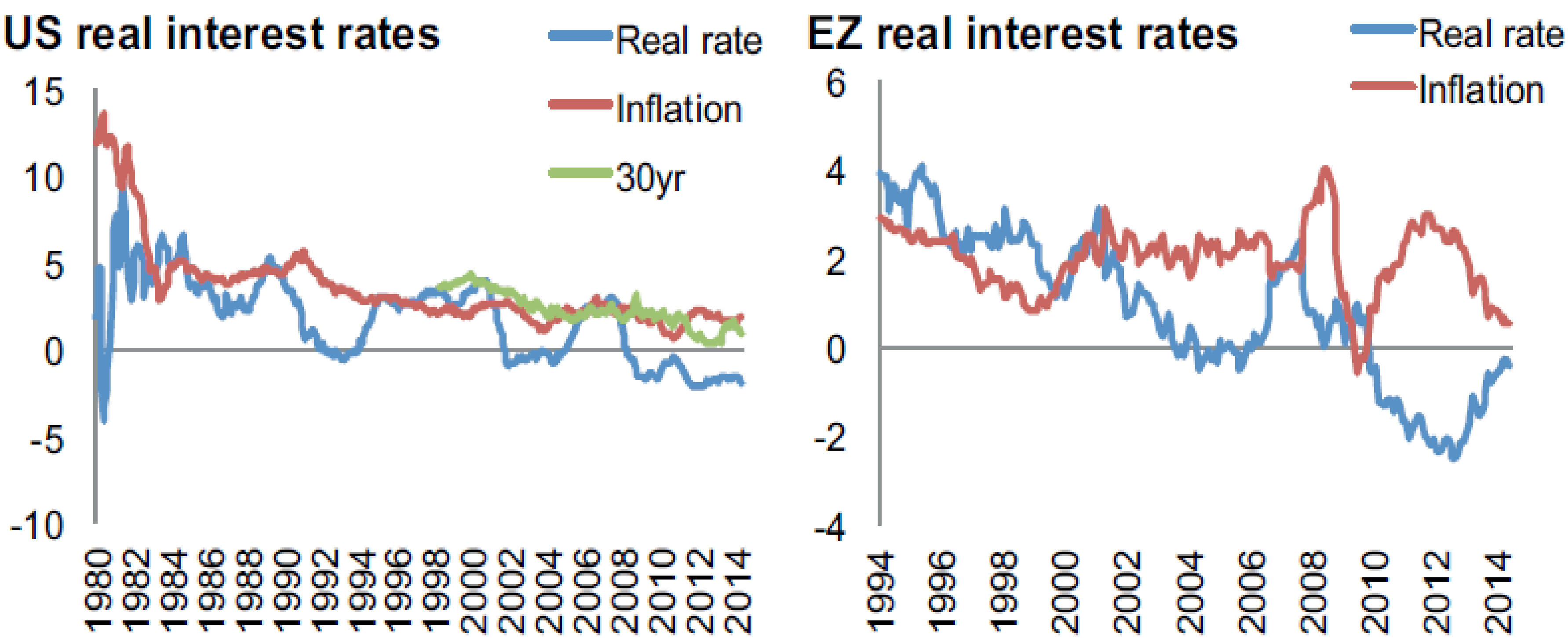
Source: IMF, Bloomberg

Implications of "Secular Stagnation"

- Negative real interest rates may be needed to equate savings and investment with full employment - boost investment and discourages saving
- Harder to achieve full employment with low inflation and zero lower bound on policy interest rates
- If there is deflation, negative real rate of interest is arithmetically impossible
- May be difficult to achieve full employment, satisfactory growth and financial stability through conventional monetary policy

What about Real Interest Rates?

Real Interest Rates in US and Eurozone



Source: ECB, Bloomberg

Do Low Real Interest Rates Matter?

- If real rates are low in normal times, adverse shocks more likely to require negative real rates in order to restore full employment investment-savings balance
- Low real interest rates undermine financial stability:
  - increase risk taking as investors seek yield
  - promote irresponsible lending as coupon payments are low and easy to meet
  - make Ponzi schemes attractive
- Real interest rate required to restore full employment inconsistent with financial stability

“Just Resting” or Really Sick?

- If US has steady-state growth of 2%/annum not obvious it will suffer permanent shortfall in demand or require permanent negative real interest rate
- “Secular stagnation” may be much more real for Europe (Crafts, 2014):
  - less favorable demographics
  - lower productivity growth than US
  - burden of fiscal consolidation
  - ECB’s strict focus on low inflation

What are the Policy Choices?

- Challenge to recent macroeconomic policy consensus
- Central bank(s) could operate with a higher target inflation rate(s) – thereby lowering real interest rate(s)
- Increase investment and reduce saving:
  - invest in physical infrastructure
  - simplify procedures for business start-up
  - maintain social safety net to maintain spending
  - redistribute income to those with higher propensity to spend