

## Subdued Emerging Economy Growth Prospects, Uncertainty Loom Large

February 2, 2016

Emerging economies' slowdown weighed on the modest recovery in advanced economies in 2015 (*Chart 1*), weakening the 2016–17 global growth outlook somewhat.<sup>1</sup> The International Monetary Fund lowered its global growth forecasts for both 2016 and 2017 by 0.2 percentage points in its January World Economic Outlook update. Global risks are tilted to the downside due to low inflation in advanced economies, financial volatility in China, and diminished growth prospects and policy uncertainty in key emerging economies.

### Advanced Economies Grappling with Low Inflation

Improved financial conditions and lower oil prices have aided the cyclical recovery among advanced economies—the latter contributing to low headline inflation as well. Price dynamics are weak as core inflation (without food and energy) remains persistently low in major advanced economies (*Chart 2*). The cyclical recovery is unlikely to create inflationary pressures soon given the remaining economic slack in the euro area and lower-than-target long-term inflation expectations in Japan.

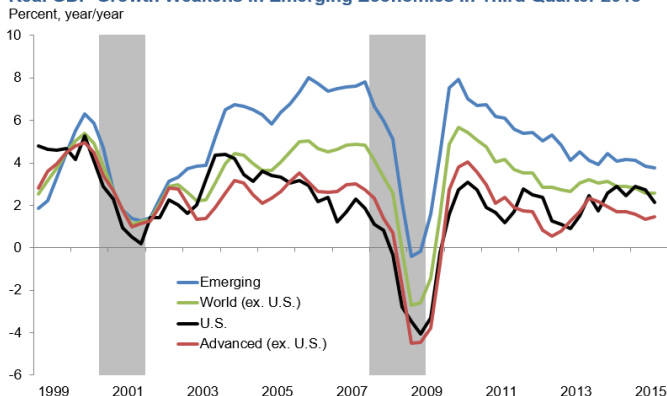
On Jan. 29, the Bank of Japan (BoJ) introduced a negative interest rate policy—lowering rates to -0.1 percent on selected current account deposits—in an effort to ward off deflation and provide further support for the economy. The European Central Bank (ECB) left rates unchanged at its Jan. 21 policy meeting. More easing is a possibility if low inflation appears to become entrenched, pushing long-term inflation expectations down. Monetary policy divergence arising between the Federal Reserve and the BoJ and ECB is expected to strengthen the dollar and, therefore, benefit Japanese and European exporters. Still, the weakness in emerging economies may dampen external demand, offsetting the current tailwinds that are aiding the cyclical recovery in advanced economies.

### China's Slowdown Poses Challenges

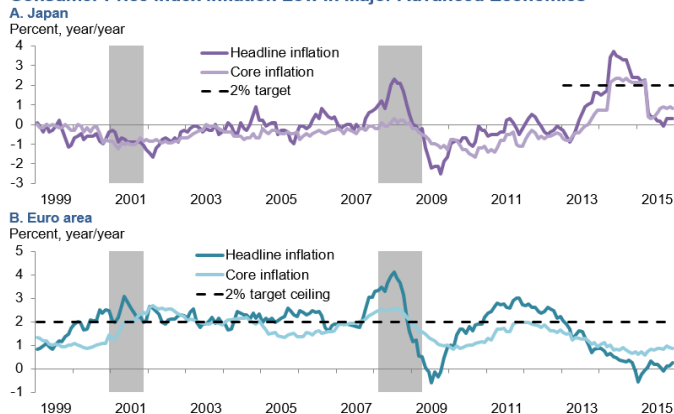
The People's Bank of China (PBoC) is engaged in an easing cycle and in exchange rate management aimed at supporting the government's growth target—which is expected to be adjusted downward in 2016 from the target of "around 7 percent" set for 2015. Ahead of the Lunar New Year, the PBoC typically injects extra liquidity to avoid a holiday-induced funding squeeze. This year, the PBoC extended more liquidity than in previous years, offering over 1.5 trillion yuan in gross short- and medium-term lending to banks. However, the aggressive move by the PBoC also accentuates its accommodative policy stance at a time of rising capital flight and large stock market losses.

Chinese equity markets' large fall at the beginning of 2016—echoing the nosedive in mid-2015—has the authorities balancing competing goals: stabilizing the financial system and letting the market correct itself toward its long-run anchor.<sup>2</sup> Large foreign reserve losses—amounting to 16.5 percent of total reserves over the past 18 months—suggest China has acted to curb currency pressures from capital outflows (*Chart 3*). Even with the stricter capital controls enforced over the past two years, this proved insufficient to sustain the renminbi. China's exchange rate against the U.S. dollar has depreciated a further 2.5 percent since its Au-

**Chart 1**  
Real GDP Growth Weakens in Emerging Economies in Third Quarter 2015



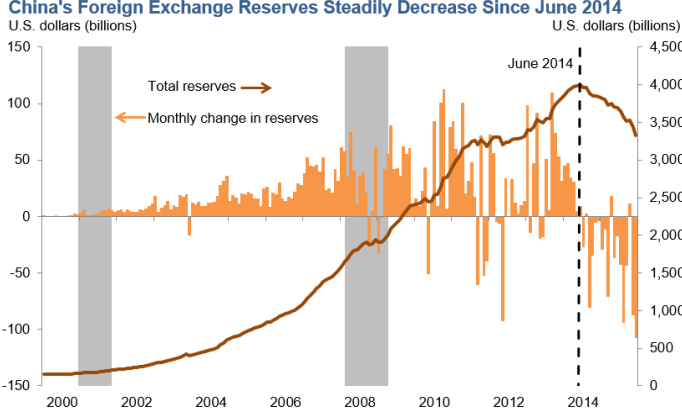
**Chart 2**  
Consumer Price Index Inflation Low in Major Advanced Economies



gust low (*Chart 4*), albeit providing additional relief to the export sector.<sup>3</sup>

China's annual growth of 6.9 percent for 2015 was the slowest in 25 years as its economy continued to rebalance from export-driven to consumption-driven (services-oriented) growth. Growth in the secondary (manufacturing) sector fell to a record low of 0.2 percent year over year in nominal terms in third quarter 2015 (*Chart 5*), while real growth slid to 5.7 percent year over year. The growth discrepancy arises from sizable price declines that are partly related to overcapacity in certain industries and the fall in commodity prices. Policy uncertainty and further signs of manufacturing weakness together have contributed to heightened concerns about the depth of China's economic slowdown.

**Chart 3**  
China's Foreign Exchange Reserves Steadily Decrease Since June 2014



NOTES: Shaded bars indicate global recessions.  
SOURCES: People's Bank of China; Haver Analytics.

### Diminished Prospects, Volatility Clouding Recovery

The economic situation in other emerging economies is uneven. Countries like India have seen their growth prospects reinvigorated in recent years. Still, many other emerging economies are hurt by diminished prospects—particularly commodity exporters, countries with large imbalances and those exposed to political uncertainty. Brazil has seen one of the most dramatic turnarounds in fortune. Its gross domestic product growth fell to -4.5 percent year over year in third quarter 2015 and is thought to have declined further in the fourth quarter. Brazil's recession is aggravated by political paralysis and public mistrust resulting from major corruption allegations (Operation Car Wash).<sup>4</sup> Brazil's central bank, confronted with above-target inflation (10.7 percent year over year in December), cited increasing economic uncertainties in deciding to keep its overnight rate (known as the SELIC rate) unchanged at 14.25 percent at its Jan. 20 policy meeting.

Political risks are a concern among key advanced economies as well. The severity of the 2008 recession in the European Union (EU) has led to a much more polarized electorate and greater intra-European discord on policy. The large inflow of migrants and refugees—more than 1 million in 2015—has overwhelmed European governments (Chart 6). Lacking a common immigration policy, countries have begun to reinstate border controls. The crisis poses a test to Europe's passport-free travel arrangements (Schengen).

### Emerging Economies, Uncertainty Remain Headwinds

Risks to the global outlook are tilted downward. Key downward risks come from a further slowdown in China, weakness among commodity exporters and potential spillovers. Low oil prices and policy uncertainty are other major downside risks, while unrealized gains from declining oil prices for importers remain an upside risk. Concern over destabilizing financial volatility and capital outflows among vulnerable emerging economies, triggered by rising borrowing costs during the U.S. tightening cycle, has yet to materialize.

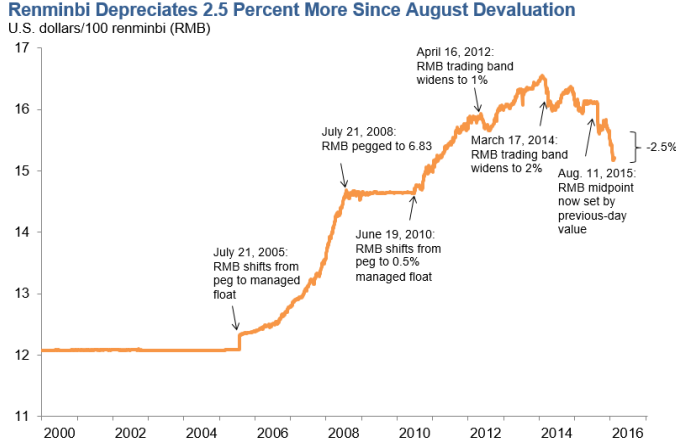
—Valerie Grossman and Enrique Martínez-García

### Notes

1. Aggregate numbers for world (ex. U.S.), advanced (ex. U.S.) and emerging come from a representative sample of 40 of the largest economies, ranked and weighted by their importance as U.S. trading partners. See "A New Database of Global Economic Indicators," by Valerie Grossman, Adrienne Mack and Enrique Martínez-García, *Journal of Economic and Social Measurement*, vol. 39, no. 3, 2014, pp. 163–97. For the methodology used for dating global cycles, see "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," also by Grossman, Mack and Martínez-García, *Journal of Macroeconomics*, vol. 46, 2015, pp. 170–85.

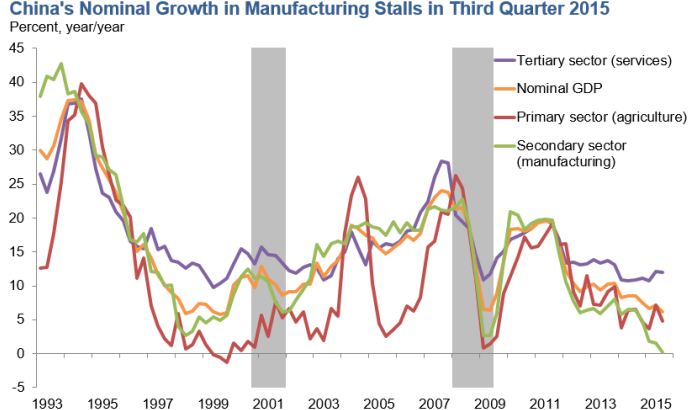
2. For an overview of China's financial volatility in mid-2015, see "Financial Markets React to Chinese Interventions," by Valerie Grossman, *International Economic Update*, Sept. 18, 2015.

**Chart 4**  
Renminbi Depreciates 2.5 Percent More Since August Devaluation



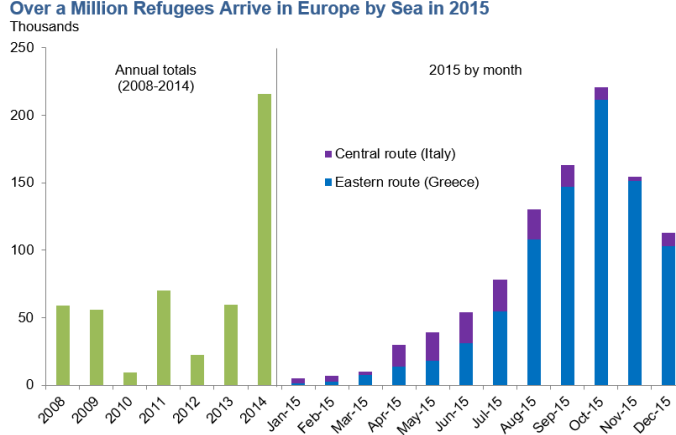
SOURCES: Wall Street Journal; Haver Analytics.

**Chart 5**  
China's Nominal Growth in Manufacturing Stalls in Third Quarter 2015



NOTES: Shaded bars indicate global recessions.  
SOURCES: China's National Bureau of Statistics; Haver Analytics.

**Chart 6**  
Over a Million Refugees Arrive in Europe by Sea in 2015



SOURCE: United Nations High Commissioner for Refugees.

- The recent depreciation could also signal a policy shift toward exchange rate management of a basket of currencies.
- Operation Car Wash refers to an investigation started in March 2014 on allegations of large-scale corruption and money laundering at the state-controlled oil company Petrobras.

### About the Authors

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