SITUATION OF AND OUTLOOK FOR THE GLOBAL ECONOMY AT THE START OF 2015

This article was written by the Associate Directorate General International Affairs.

Introduction

The expectations prevailing in early 2014 about a pick-up in the global economy were thwarted, to some extent, as the year unfolded. As analysed in detail in the second section of this report, the sluggishness of activity was across several regions (the euro area, Japan and Latin America), and even China slowed marginally, although it continued to grow at a rate of over 7%. By contrast, other areas performed more favourably (the United States, the United Kingdom and emerging Europe). This differentiated behaviour of activity came about against a background of accommodative monetary policies and less stringent fiscal policies. The decline in commodities prices (and of oil in particular) had a downward impact on what were already very low rates of inflation, which tended to settle at a lower-than-expected level in many advanced economies.

The world economy in 2014 was marked by a series of events that will have far-reaching repercussions into 2015. These events included most notably the aforementioned fall in oil prices, which steepened sharply in the second half of the year and which has only come to a halt in early 2015. While the impact of this shock is, overall, positive for global growth (and, in particular, for oil-importing countries), adverse effects on oil-exporting countries are proving most notable. Further, as indicated, the decline in oil prices has a downward bearing (temporarily, in principle) on inflation rates that are already very low in the advanced economies, lessening central banks' room for manoeuvre in the face of potential adverse shocks. Compounding this is the intensification of the cyclical differences between the main advanced economies, which has strengthened expectations of divergences in their respective monetary policy stances, with potential repercussions for international capital markets and financing flows. Other, longer-term trends are also influencing capital markets, the outcome of banking disintermediation and of regulatory changes, which affect economies' financing patterns and, therefore, their growth possibilities. And, ultimately, this is a further factor shaping the outlook for the emerging economies. In some cases, such as Latin America, the disappearance of the favourable external conditions which enabled them to grow in the past poses a significant challenge to the sustainability of their growth, while in other cases, such as China, a re-gearing of the growth strategy towards a more balanced pattern can be seen. These issues, to which geopolitical risks may be added, are addressed in the third section of this article.

Broadly, the forecasts for 2015, included in the fourth section, suggest global growth will stabilise at moderate rates (of around 3%-4%). This will be the outcome of greater dynamism in the advanced economies and of a further slowdown in the emerging ones. Risks appear to be balanced overall, given that the favourable effects of the fall in oil prices and of more expansionary economic policies will be counterbalanced by the vulnerabilities associated with low inflation, the potentially adverse impact on markets of monetary policy divergences in the advanced economies, the possible over-pricing of certain financial assets and geopolitical risks.

The global economy in 2014

In 2014, the world economy grew by 3.3%, a rate similar to that for 2013 (see Table 1) but once again below that expected at the start of the year (3.7%). This was due to the weakness shown by many emerging economies and by certain advanced countries (see top left-hand panel of Chart 1), despite the support provided by economic policies. Global

MAIN MACROECONOMIC INDICATORS (a)

TABLE 1

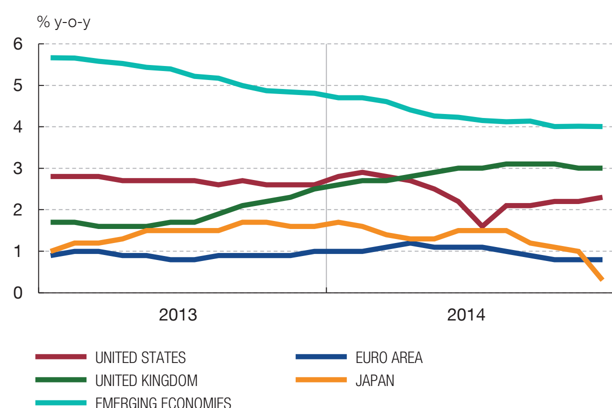
	2011	2012	2013	2014	2013				2014			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
United States												
Gross domestic product	1.6	2.3	2.2	2.4	1.7	1.8	2.3	3.1	1.9	2.6	2.7	2.4
Consumer price index (b)	3.2	2.1	1.5	1.6	1.7	1.4	1.6	1.2	1.4	2.1	1.8	1.2
Current account balance	-3.0	-2.9	-2.4	0.0	-2.6	-2.6	-2.4	-2.0	-2.4	-2.3	-2.3	0.0
General government balance	-9.4	-8.1	-5.2	-4.6	-5.8	-4.7	-5.8	-4.5	-4.7	-4.8	-4.7	-4.4
Gross public debt (c)	124.6	127.5	125.6	126.1	127.7	126.7	126.1	125.6	126.8	124.9	125.4	126.1
Unemployment rate	8.5	7.9	6.7	5.6	7.5	7.5	7.2	6.7	6.6	6.1	5.9	5.6
Euro area												
Gross domestic product	1.8	-0.8	-0.4	1.1	-1.2	-0.6	-0.3	0.4	1.3	1.0	1.0	1.1
Consumer price index (b)	2.7	2.5	1.4	0.4	1.9	1.4	1.4	0.8	0.7	0.6	0.4	0.2
Current account balance	-0.1	1.5	2.2	2.3	1.2	2.0	2.1	3.4	1.4	1.7	2.9	3.4
General government balance	-4.2	-3.6	-2.9	—								
Gross public debt	88.3	92.9	95.2	—								
Unemployment rate	10.7	11.9	11.9	11.3	12.0	12.0	12.0	11.9	11.7	11.6	11.5	11.3
United Kingdom												
Gross domestic product	1.6	0.7	1.7	2.6	0.9	1.7	1.6	2.4	2.5	2.6	2.5	2.7
Consumer price index (b)	4.5	2.8	2.6	1.5	2.8	2.7	2.7	2.1	1.7	1.7	1.4	0.9
Current account balance	-1.7	-3.7	-4.5	—	-3.9	-2.3	-6.0	-5.6	-5.1	-5.4	-6.0	—
General government balance	-7.6	-8.3	-5.7	-5.6	-7.6	-6.1	-6.0	-5.7	-5.8	-6.2	-6.1	-5.6
Gross public debt	75.3	88.6	94.2	91.5	85.4	86.6	86.5	87.3	87.8	88.6	88.0	89.6
Unemployment rate	8.4	7.8	7.2	5.7	7.8	7.8	7.6	7.2	6.8	6.3	6.0	5.7
Japan												
Gross domestic product	-0.5	1.8	1.6	0.0	0.5	1.4	2.2	2.3	2.4	-0.3	-1.4	-0.8
Consumer price index (b)	-0.3	0.0	0.4	2.7	-0.6	-0.3	0.9	1.4	1.5	3.6	3.3	2.5
Current account balance	2.1	1.0	0.7	0.6	1.0	1.0	1.0	0.8	0.4	0.0	-0.1	0.2
General government balance	-7.7	-8.6	-7.2	—	-7.8	-7.5	-7.3	-7.2	-6.8	-5.9	-5.7	—
Gross public debt	209.5	216.5	224.2	230.0	218.8	220.8	222.5	224.2	225.7	227.1	228.8	230.0
Unemployment rate	4.5	4.3	3.7	3.4	4.1	3.9	4.0	3.7	3.6	3.7	3.6	3.4
China												
Gross domestic product	9.5	7.7	7.7	7.4	7.8	7.5	7.9	7.6	7.4	7.5	7.3	7.3
Consumer price index (b)	5.4	2.7	2.6	2.0	2.4	2.4	2.8	2.9	2.3	2.2	2.0	1.5
Current account balance	1.9	2.6	1.9	—	2.2	2.3	2.7	2.6	1.5	1.7	2.0	—
General government balance	-1.8	-1.5	-1.8	—	-2.2	-2.2	-2.8	-1.5	-1.8	-2.3	-2.4	—
Gross public debt	36.5	37.4	39.4	40.7								
Emerging Asia (excluding China) (d)												
Gross domestic product	2.3	2.5	5.4	5.4	4.3	5.8	6.0	5.5	4.7	5.5	5.7	5.7
Consumer price index (b)	2.3	6.4	6.7	5.4	6.8	6.2	6.8	7.2	6.2	6.1	5.3	4.1
Current account balance	1.9	-1.7	-0.2	—	-1.5	-1.6	-1.1	-0.3	0.3	0.9	0.8	—
General government balance	-0.1	-3.1	-3.1	—	-2.6	-3.0	-3.0	-3.0	-2.6	-2.7	-2.6	—
Gross public debt	51.1	51.6	49.6	49.3								
Latin America (e)												
Gross domestic product	4.5	2.8	2.6	—	1.9	3.4	2.7	2.3	1.9	0.3	0.7	—
Consumer price index (b)	4.9	4.5	4.6	5.0	4.6	5.0	4.5	4.4	4.7	4.9	5.1	5.2
Current account balance	-1.0	-1.6	-2.7	—	-2.1	-2.3	-2.6	-2.6	-2.7	-2.7	-2.6	—
General government balance	-0.6	-0.6	-1.1	—	0.3	-0.9	-1.0	-1.1	-1.0	-1.2	-1.7	—
Gross public debt	50.2	51.5	52.5	—								
Eastern Europe (f)												
Gross domestic product	3.2	0.6	1.4	2.8	0.1	0.5	2.1	2.9	3.1	2.8	2.9	2.5
Consumer price index (b)	3.9	3.8	1.5	0.3	2.3	1.6	1.3	0.7	0.5	0.3	0.3	0.0
Current account balance	-3.6	-3.1	-1.1	—	-2.0	-1.3	-0.7	-0.3	0.0	-0.3	-0.2	—
General government balance	-3.6	-3.4	-3.2	-0.2								
Gross public debt	50.2	51.5	52.5	—								
Memorandum item: GDP growth (a) (g)												
Global	4.1	3.4	3.3	3.3	2.8	3.3	3.6	3.8	3.5	3.2	3.3	—
Advanced economies	1.7	1.2	1.3	1.9	0.7	1.1	1.5	2.2	1.9	1.8	1.7	—
Emerging economies	6.2	5.1	4.7	4.5	4.9	5.5	5.7	5.4	5.1	4.7	4.9	—
Memorandum item: inflation (a) (g)												
Global	5.2	4.2	3.9	3.8	3.3	3.2	3.4	3.4	3.1	3.4	3.1	—
Advanced economies	2.7	2.0	1.4	1.4	1.5	1.3	1.5	1.2	1.2	1.7	1.5	1.0
Emerging economies	7.3	6.1	5.9	5.5	5.2	5.1	5.5	5.7	5.0	5.2	4.9	—

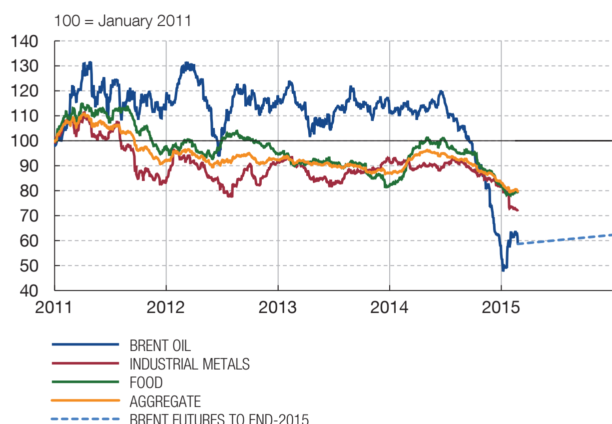
SOURCES: IMF, Banco de España, Eurostat and national statistics.

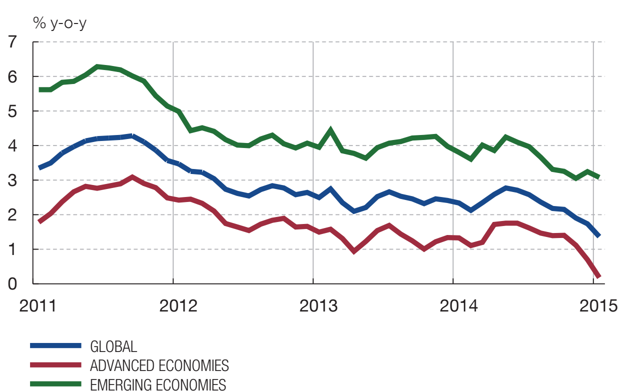
a GDP and inflation are expressed as a year-on-year percentage change; current account balance, general government balance and gross public debt are expressed as a percentage of GDP.
b The quarterly CPI is the average for the quarter.
c Federal government, state and local government liabilities, including pension payment commitments to public sector employees. Obtained from the financial accounts published by the Federal Reserve.
d Emerging Asia includes: China, India, South Korea, Indonesia, Thailand, Malaysia, Philippines, Hong Kong and Singapore.
e Latin America: Brazil, Mexico, Argentina, Colombia, Venezuela, Peru and Chile. Excluding Argentina and Venezuela for the CPI aggregate, and Venezuela for the aggregate of the general government balance.
f Eastern Europe: Poland, Czech Republic, Romania, Hungary, Bulgaria and Croatia.
g Annual data show the latest IMF forecasts publicly available when this report went to press. Quarterly data calculated using a sample of 41 economies (17 advanced and 24 emerging) representing almost 90 % of global GDP, weighted in PPP terms. All economies referred to in notes b, c and d are included in the sample.

THE GLOBAL ECONOMY IN 2014. OVERVIEW

CHART 1







SOURCES: CPB World Trade Monitor, Consensus Forecast, ICIS Pricing, Datastream-Thomson Reuters, Commodity Research Bureau and national statistics.

trade grew by only 3.1% (against 3.4% in 2013 and the figure of 4.5% expected at the start of the year), meaning that the apparent elasticity of trade to global GDP was once again below that derived from the historical relationship between both variables (see top right-hand panel of Chart 1). This reflects both temporary factors – such as the weak behaviour of investment, a component with a high import content – and more structural issues (see Box 1).

Turning to prices, global inflation held at low levels in the first half of the year, resuming a declining path subsequently as it was dragged down by the fall in commodities prices. It ended the year below 2% (see bottom right-hand panel of Chart 1). The price of Brent oil, which held stable until June at around $110 per barrel, collapsed as from July to $45 per barrel as at mid-January 2015, marking a 50% decline in 2014 (see bottom left-hand panel of Chart 1). As the following section analyses in greater detail, this heavy fall has been due both to demand- and supply-side factors. The prices of other commodities posted a 12% decline overall during the year.

The financial markets continued to be characterised by high liquidity in 2014, although there were two clearly differentiated phases during the year. In the first half, expectations of an orderly normalisation of monetary policy in the United States and the United Kingdom were conducive to an appetite for risk, yield search and low volatility. This environment

World trade has traditionally grown more rapidly than GDP; in fact, in the 1990s it posted a record gap, exceeding the latter by 2.1 times. However, in recent years the growth of world trade has tended to approach that of GDP, to the point that it has been only 1.4 times higher on average over the past decade (see Panel 1); in 2014 it even grew less than GDP.

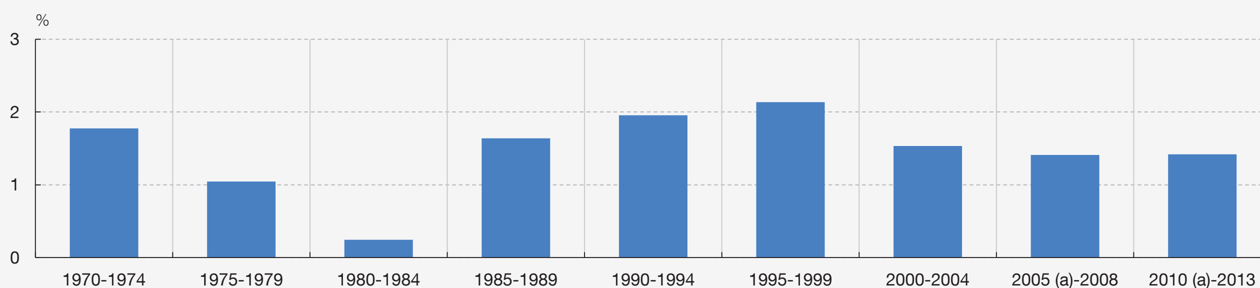
Three main explanations have been proposed for this fall in the trade-GDP growth ratio. First, lesser international fragmentation of the value chain (or even relocation processes possibly reversing the previous trend towards globalisation), which might give rise to less trade-intensive production processes or, tantamount to this, a fall in the volume of cross-border transactions per unit of value added. Second, changes in agents' spending patterns, which have raised the relative weight of less-traded products, such as services and public expenditure, and lowered the importance of investment goods or consumer durables. Finally, the third explanation commonly posited is a resurgence of protectionism (e.g. through an increase in non-tariff barriers, such as quality standards or health regulations) or, in a similar vein, slower headway in liberalisation and trade integration processes. There are, however, alternative explanations, such as changes in relative prices and productivities between tradeable and non-tradeable goods and the consequences that these changes have on the distribution of spending, the statistical effects which hinder proper measurement of trade (such as distorted transfer prices or accurate quantification of the value added incorporated into services trade) or the exhaustion of technological innovations that boosted trade (e.g. containerisation).

Using disaggregated annual data for 33 OECD countries, a statistical model is estimated for the period 1950-2013 in which global imports depend on world GDP and which distinguishes the short- and long-term effects.[1] This approximation allows global elasticity to be decomposed into a weighted average of the elasticity of each country and, within that country, of each product. In general, the elasticity of manufactured goods trade to GDP is observed to have decreased substantially from 2000, while that of commodities has increased. In particular, imports of commodities in the United States have an elasticity of 4.

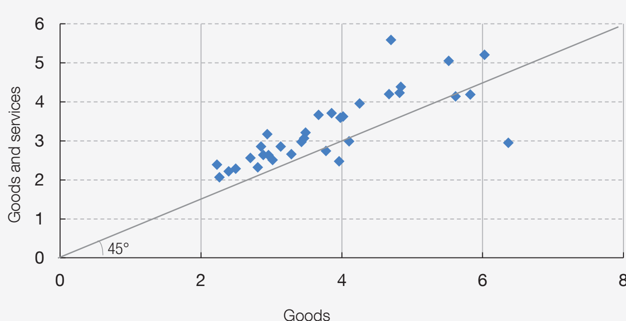
1 See Constantinescu, Mattoo and Ruta (2015).

ELASTICITY OF WORLD TRADE TO GDP

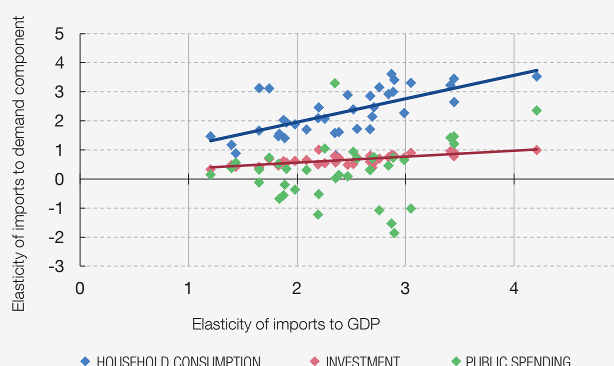
1 APPARENT ELASTICITY OF IMPORTS TO GDP (5-YEAR AVERAGE)



2 ELASTICITY OF TRADE TO GLOBAL GDP BY COUNTRY



3 ELASTICITY OF TRADE TO GLOBAL GDP BY COUNTRY AND DEMAND COMPONENT



SOURCES: IMF, OECD and Banco de España.

a 4-year average.

The results suggest that the decrease in the sensitivity of trade to GDP at the global level is a fairly persistent phenomenon, since the estimated long-term elasticity is 1.3, similar to that obtained for the 1970s and much lower than that for the period before China jointed the WTO, when elasticity averaged 2.1. From the standpoint of traded products, the increase in importance of services would be consistent with a lower elasticity of world trade to GDP, since trade in these products is less sensitive to activity (see Panel 2). The performance of government consumption is similar. By contrast, the fall in investment accounts for a very small percentage of the observed decrease in elasticity (see Panel 3).

was consistent with some correction of the overpricing of certain segments with high credit risk, such as high-yield corporate debt. As from August, markets worsened and risk-aversion increased, owing to a combination of several factors. Adding to doubts over the strength of global growth were the heightening of geopolitical risks (notably Ukraine and the Middle East) and the sharpness of the collapse in oil prices, denting the optimism prevailing in the previous period. This translated into abrupt increases in volatility (especially in exchange rates and interest rates) and into greater sensitivity to adverse news, which affected stock market performance. In 2015 to date, concern over these factors appears to have diminished, in a more favourable environment, spurred by the launch of the Eurosystem's asset purchase programmes and by the stabilising of oil prices.

In addition to high volatility, another characteristic feature of market behaviour in 2014 was the strong appreciation of the dollar against other currencies (see top panel of Chart 2), in a setting in which the different cyclical positions of the main advanced economies (United States and the United Kingdom, set against the euro area and Japan) continued to support a differentiated stance for their monetary policies. However, long-term bond yields in these economies tended to fall overall from the summer (even turning negative in some cases), in a movement which reflects the search for safe-haven assets and the flight to quality.

In the case of the financial markets in the emerging economies, the vulnerability shown by them since mid-2013 was exacerbated by the successive scaling back of growth prospects, which bore down on stock market performance. In addition, the depreciation of the dollar lessened the attractiveness of carry trade in the emerging markets, which posted capital outflows in some segments and a significant depreciation of their currencies. From October onwards, these unfavourable trends became more accentuated (markedly so in Latin America and in Eastern Europe) and the risk premia of some of these countries marked their highest levels since 2009. The downturn not only affected some countries considered vulnerable, but also those which in previous episodes had stood out owing to their strength, but for which oil is the main export commodity and source of public revenue.

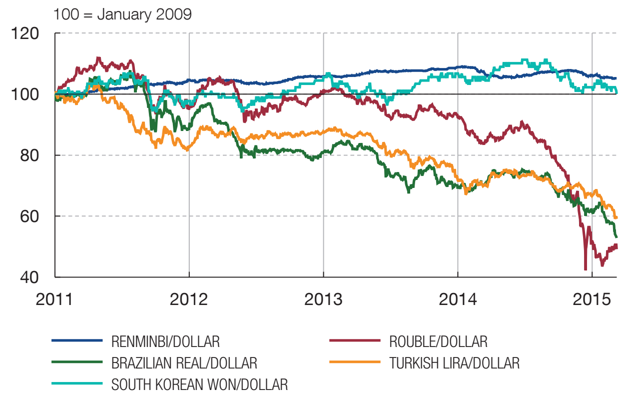
Activity in the advanced economies in 2014 was more dynamic than the previous year, though below expectations (1.8% against 2.2%). As can be seen in the top panel of Chart 3, these developments mask a divergence between the greater strength of the recovery in the United States (where growth was 2.4%, despite the bad weather in Q1) and the United Kingdom (2.6%), and that in the euro area (0.8%) and Japan (0%). In the first two countries, growth was underpinned by domestic demand, strengthened by the correction of their imbalances (debt, etc.), favourable monetary and financial conditions,

FINANCIAL MARKETS

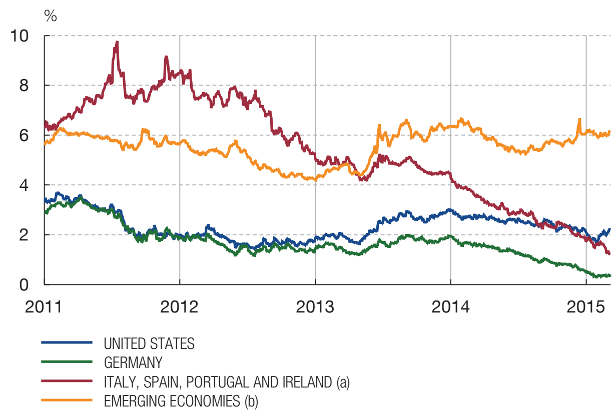
CHART 2

EXCHANGE RATES. DEVELOPED ECONOMIES

EXCHANGE RATES. EMERGING ECONOMIES

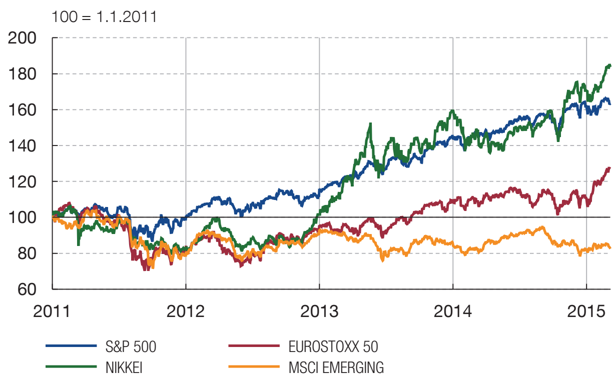


10-YEAR YIELDS

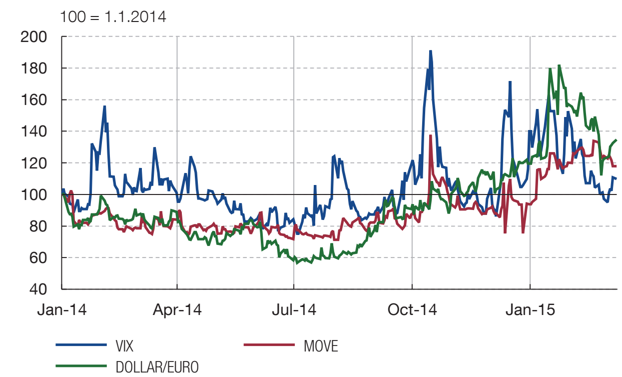


SOVEREIGN SPREADS (c)

STOCK MARKETS



VOLATILITY INDICES



SOURCE: Datastream-Thomson Reuters.

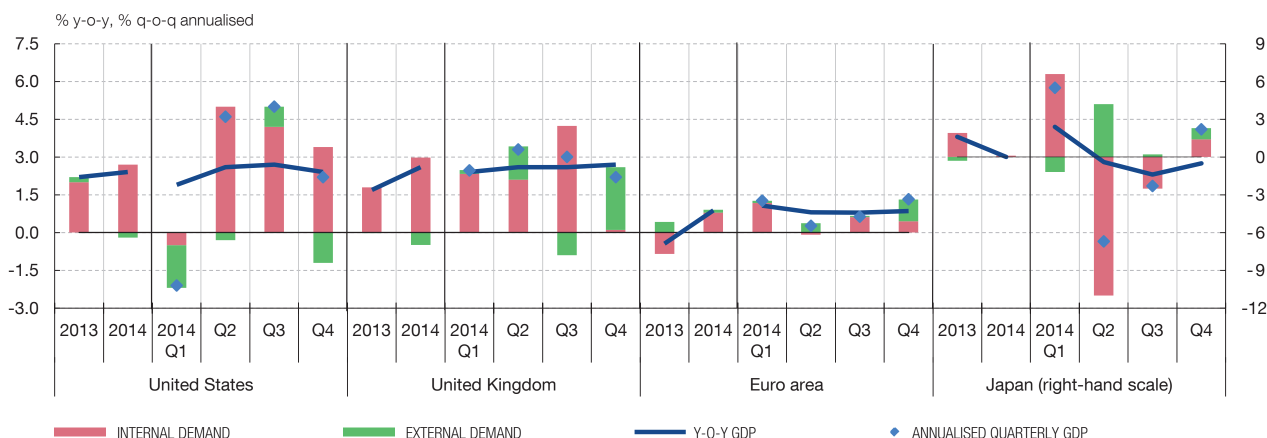
a Simple average of the countries.
b Emerging economies is calculated adding EMBI differential + Composite to the US yield.
c Spreads, in basis points, of sovereign bond yields against the dollar.

and a substantial labour market improvement, since the unemployment rate fell from 6.7% to 5.6% in the United States, and from 7.1% to 5.8% in the United Kingdom (see bottom left-hand panel of Chart 3). In the case of Japan, growth as from Q1 was lower than expected, since the effects of the rise in tax on consumption, in April, were more severe than anticipated and led the economy to move once more into recession, since GDP fell

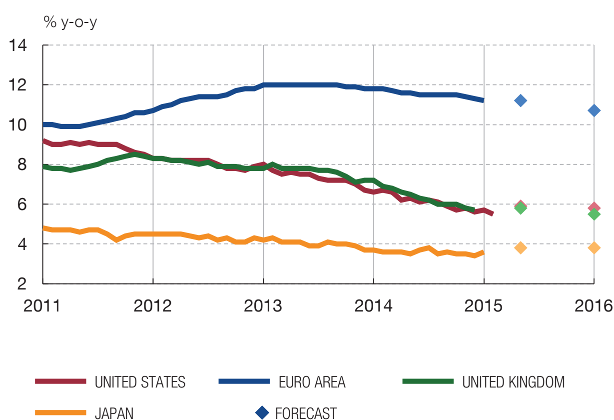
MACROECONOMIC DEVELOPMENTS IN ADVANCED ECONOMIES

CHART 3

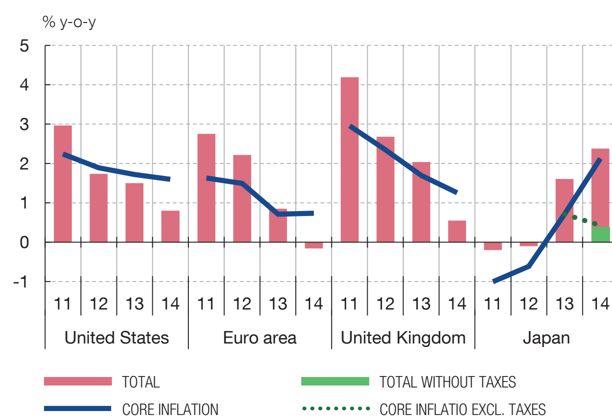
CONTRIBUTION TO GDP GROWTH IN THE ADVANCED ECONOMIES



UNEMPLOYMENT RATE



CONSUMER PRICES



SOURCES: IMF, national statistics, Consensus Forecast, Barclays Live and Datastream-Thomson Reuters.

forcefully in Q2 and Q3. There was something of a rise in Q4 both in Japan and in the euro area, supported by the favourable effects of lower energy prices. In the United States and the United Kingdom, growth remained robust, but lower than in the previous quarters.

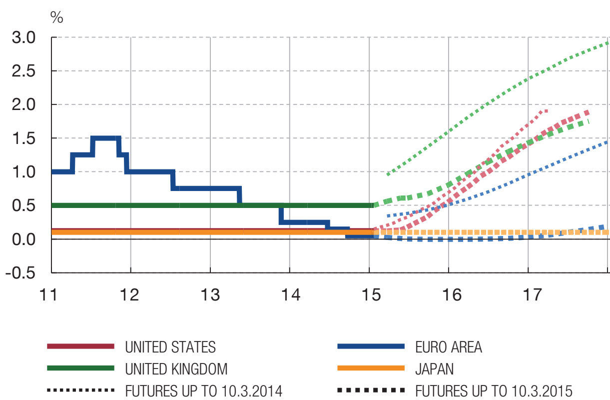
Inflation rates in the advanced economies, which were already at low levels (and far below central bank targets in the euro area and in Japan), fell sharply from mid-year, dragged down by oil prices (see bottom right-hand panel of Chart 3). US inflation ended the year at 0.8%, and at 0.5% in the United Kingdom, against a background of moderate wage growth and exchange rate appreciation. In the euro area, inflation was in negative territory (-0.2%) in December 2014, and there have been further declines in the opening months of 2015. In Japan the inflation rate ended the year at 2.4%, although stripping out the effect of tax rises it held at far below the target of 2% and ended the year at 0.4%. Core inflation rates were more stable, but also declined somewhat in the second half of the year, and in the case of the euro area they remained far off the 2% reference; inflation expectations derived from financial instruments also fell, while those arising from surveys proved more stable.

Against this backdrop, monetary policies retained a highly accommodative but differentiated stance, in keeping with the different cyclical positions of the economies (see top panels of Chart 4). New expansionary measures were introduced in Japan and in the euro area, while

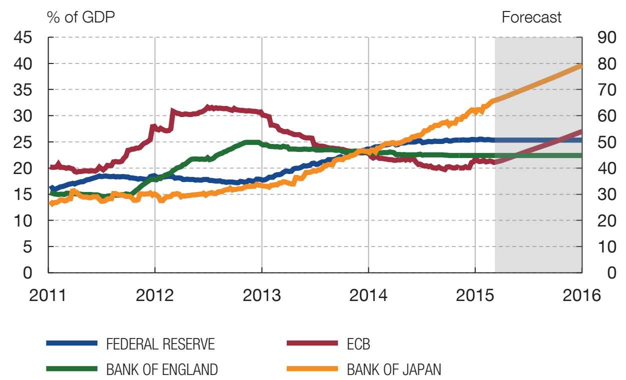
MACROECONOMIC POLICIES IN ADVANCED ECONOMIES

CHART 4

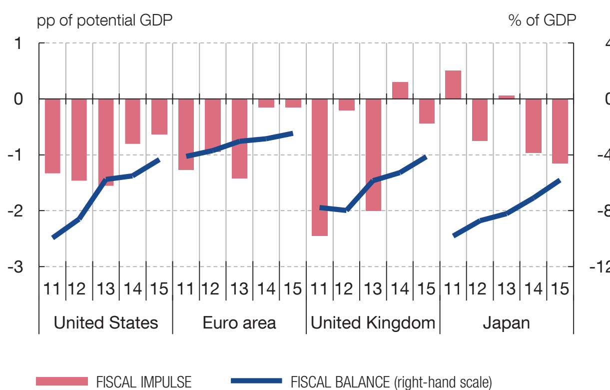
OFFICIAL INTEREST RATES AND INTEREST RATE EXPECTATIONS



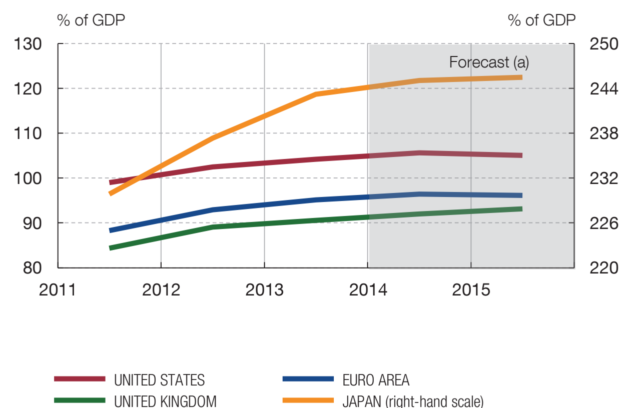
CENTRAL BANK BALANCE SHEETS: TOTAL ASSETS



BALANCE AND FISCAL IMPULSE (2011-2015)



PUBLIC DEBT



SOURCES: Federal Reserve, ECB, Bank of England, Bank of Japan, Datastream-Thomson Reuters and IMF.

a The forecast for Japan start in 2013.

the US Federal Reserve gradually withdrew its financial asset purchases, winding them up in October, and eliminated the quantitative references to the unemployment rate in its forward guidance policy, shifting to a more qualitative formulation. The Bank of England held its official rate at 0.5% and maintained the volume of its asset purchase programme, further adopting restrictive macroprudential measures aimed at reducing the risks arising for indebted households from the increase in house prices. Moreover, at end-2014 it extended its *Funding for Lending Scheme* for another year, solely for loans to SMEs. In late October the Bank of Japan expanded its asset purchase programme indefinitely, stepping up the annual rate of purchases from ¥60-70 billion to ¥80 billion, and it extended its financing-supporting measures. Faced with the fall in inflation and the attendant slippage in medium-term expectations, the ECB adopted new monetary easing decisions in the June-September 2014 period: it cut its official rates and committed itself to holding them at low levels over a prolonged period, and it introduced a new longer-term financing facility, linked to the granting of loans, and two private debt purchase programmes, which have been extended in January 2015 to purchases of government securities.

Among the central banks of other advanced economies, those in Sweden, Canada, Australia and Norway cut their official interest rates in the second half of the year in order to tackle the slowdown in their economies and low inflation. The Bank of Sweden placed

its official rate in negative territory in early 2015 and announced a public debt purchase programme. The Danish and Swiss central banks had to react to the expansionary measures of the ECB in order to contain the pressures on their exchange rates: in Denmark's case, with large-scale foreign exchange interventions and making its deposit rates negative; and in Switzerland's case, by abandoning the Swiss franc's foreign exchange ceiling against the euro, which it had maintained since 2011, given the difficulty of defending this ceiling and the large size of its central bank balance sheet.

Fiscal policies held on a path of consolidation in the advanced economies, albeit at a lesser pace than in the preceding years, except in Japan (see bottom left-hand panel of Chart 4). The average deficit declined by 0.5 pp to 3.9% of GDP, although public debt ratios continued increasing and rose to 106.5% of GDP (see bottom right-hand panel of Chart 4). In particular, the US budget deficit stood at 5.5% of GDP, 0.3 pp down on the previous year; the UK deficit was 5.3%, 0.4 pp below the previous year's figure; and in the euro area it is estimated at 2.6%, 0.3 pp less than in 2013. In Japan, following the rise in the tax rate on consumption in April, adverse developments in the economy led Prime Minister Abe to introduce a new fiscal stimulus package and to postpone the second increase in the tax on consumption until 2017. Notwithstanding these measures, the deficit dipped from 7.2% of GDP in 2013 to 5.7% in the period from October 2013 to September 2014.

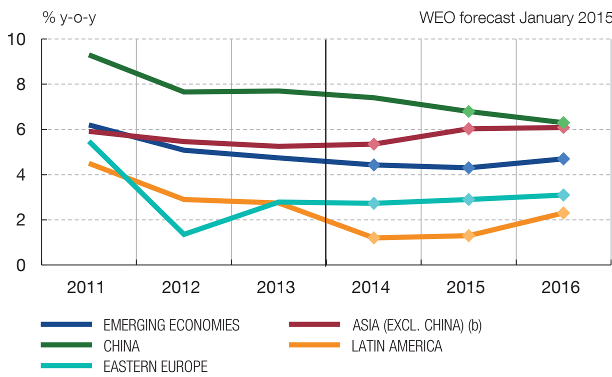
In short, the correction of domestic imbalances in the advanced economies continued in 2014, more clearly so in the United States and the United Kingdom. Along with the reduction in high unemployment rates and headway in the process of fiscal consolidation, as earlier mentioned, the deleveraging of the private sector and the recovery in the real estate market moved ahead. Thus, non-financial private sector debt fell in the United States and the United Kingdom by 26 pp and 35 pp of GDP, respectively, to 147% and 162%, from the peaks reached during the crisis. The correction of the private debt ratios has been more modest in the euro area as a whole, although in those cases where the imbalances built up were greatest, the adjustment has been sharper. On the real estate markets, the recovery has remained relatively slow in the United States and somewhat more dynamic in the United Kingdom, although in this latter case supply-side constraints have led to higher growth in house prices.

Turning to the emerging economies, their growth rate fell for the fourth year running from 4.7% in 2013 to 4.4% (see Table 1 and top left-hand panel of Chart 5), 0.5 pp below the projections at the start of the year. The moderation was partly the outcome of the slowdown in China (7.4%, against 7.7% in 2013), but Latin America and Russia were the regions that showed most weakness. The marked decline in commodities prices and, in the case of Russia, trade and financial sanctions, were key to explaining these developments.

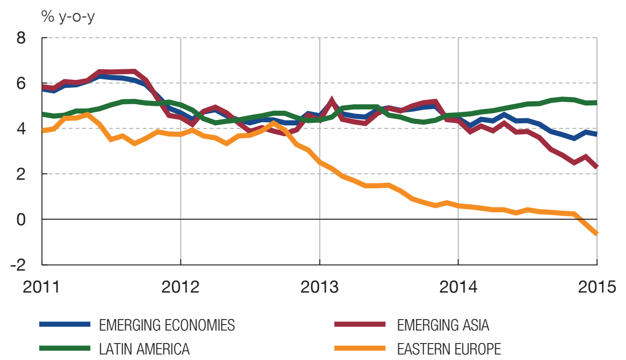
The slowdown in China ran in parallel to the gradual easing in inflation. This downtrend in price growth became more accentuated in early 2015, strongly influenced by the fall in oil prices, and it was likewise perceptible in core inflation, which stood at a year-on-year rate of 1.1%. However, these developments do not appear to jeopardise the ongoing re-balancing of demand, as there is a significant inflation differential in favour of non-tradable goods and services. Against a backdrop of economic slowdown and declining inflation such as that described, macroeconomic policy has tended to be supportive of growth, initially in a selective fashion, with measures in the fiscal and monetary realms, and subsequently with more general measures, such as interest rate cuts aimed at preventing greater rises in the cost of financing. In the rest of emerging Asia, growth was slightly lower than in 2013 (except in India), standing around 4.6%. Inflation eased appreciably, especially in the second half of the year, as a result

MACROECONOMIC DEVELOPMENTS IN EMERGING ECONOMIES (a) CHART 5

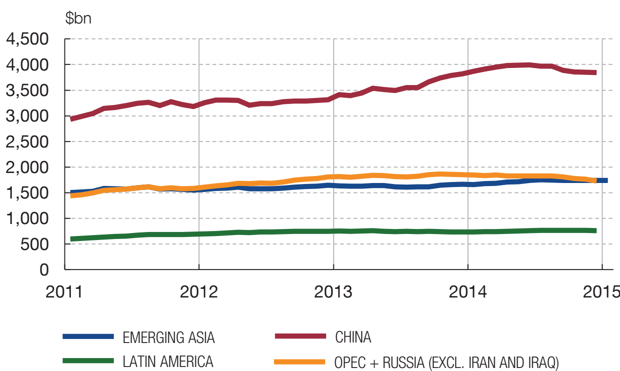
ANNUAL GROWTH RATES



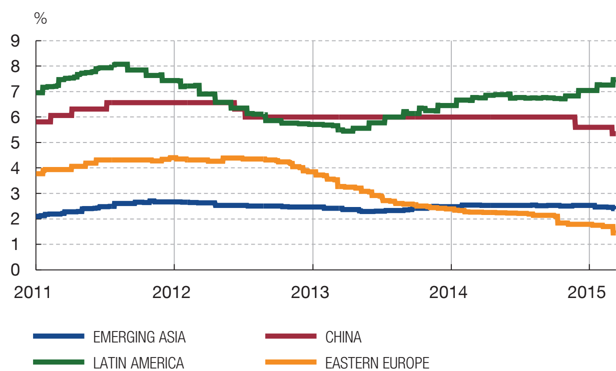
INFLATION RATES



INTERNATIONAL RESERVES



OFFICIAL INTEREST RATES



SOURCES: IMF, Datastream-Thomson Reuters, Bloomberg and national statistics.

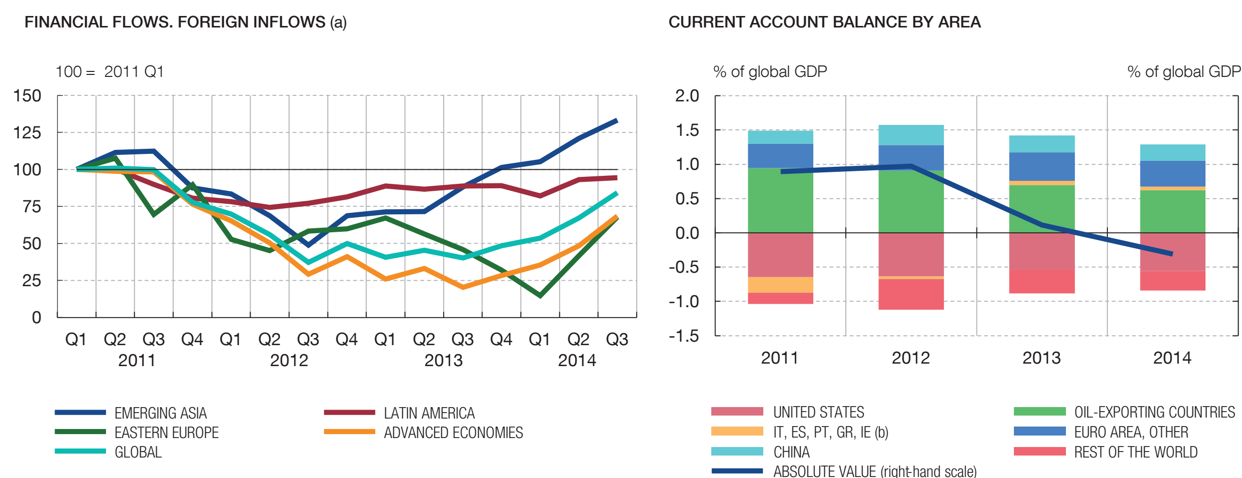
a For the composition of the country aggregates, see footnotes to Table 1.
b Forecasts refer to WEO, October 2014.

of the decline in energy prices, although the depreciation of exchange rates softened the impact. That provides some room to implement more expansionary monetary policies, while adopting macroprudential measures to limit risks (see top right-hand panel of Chart 5).

The slackness in activity observed since the second half of 2013 continued in Latin America, making for GDP growth of 1.2% in 2014, 2 pp less than expected. Activity ground to a halt more markedly in those countries with less economic policy headroom, such as Argentina and Venezuela, which are both in recession and with very high inflation rates. Brazil also slowed considerably, partly owing to the uncertainty over elections. The commodities-exporting economies more exposed to China, such as Chile and Peru, saw a small increase in activity. Colombia, in contrast, maintained sound growth, although in the second half of the year it was affected by the collapse in oil prices, oil being its main commodity export. Mexico decoupled from these trends owing to its trade integration with the United States, although its recovery was also weaker than expected. Despite the sluggishness of growth, consumer prices surprised analysts by rising in several countries (see top right-hand panel of Chart 5). In Argentina and Venezuela, inflation was spurred by the monetary financing of the budget deficit and the depreciation of the exchange rate, and stood at very high rates. In the five countries with inflation targets – namely Mexico, Colombia, Peru, Chile and Brazil – inflation ran at 4.9% on average, 0.5 pp up on 2013 and above-target (in some cases even above the upper limit of the target band), impacted by the feed-through of exchange rate depreciations and pressures in the services sectors.

CAPITAL FLOWS AND GLOBAL IMBALANCES

CHART 6



SOURCES: IMF, World Bank, national statistics, Bloomberg, Datastream-Thomsom Reuters and EPFR Global.

a For the composition of the country aggregates, see footnotes to Table 1.
b Italy, Spain, Portugal, Greece and Ireland.

Economic policies in Latin America diverged significantly. Both Brazil and Colombia tightened their monetary and fiscal policies, Brazil procyclically so, sharpening the adjustment of its economy in the short term. Chile and Peru, by contrast, harnessed the room for manoeuvre provided by the soundness of their economic fundamentals to relax monetary policy and announce fiscal stimulus to counter the slowdown in activity. Mexico eased its monetary policy, against a background of low inflation and gradually firmer growth, but it announced a fiscal adjustment in early 2015 warranted by expectations of lower oil prices in the future. One key aspect is the greater attention being afforded to structural reforms as a means of raising potential growth. Mexico has taken the lead on this matter, with a broad raft of reforms in recent years, and there has also been progress in Chile in this respect.

Finally, growth in Eastern Europe became more buoyant, standing slightly below 3% (1.4% in 2013), chiefly on the basis of the resilience of domestic demand. In a setting of very low inflation, weakness in the euro area and repercussions from the conflict between Ukraine and Russia, several central banks in the region further eased their monetary policies.

Capital flows trended favourably in the first half of the year, but with some cross-regional differences: those targeted on emerging Asia increased sharply, and those on the advanced economies somewhat less so, while Latin American and Eastern European flows held stable (see left-hand panel of Chart 6). In 2014, current account imbalances lessened slightly (see right-hand panel of Chart 6), chiefly owing to the moderation of the surplus of the oil-exporting countries. The reduction in oil prices should contribute to a greater adjustment of global imbalances, although the persistence of low prices may lead to changes in the direction of some capital flows, the implications of which have yet to be analysed. Conversely, in terms of stocks, the imbalances of the net international investment position have increased.

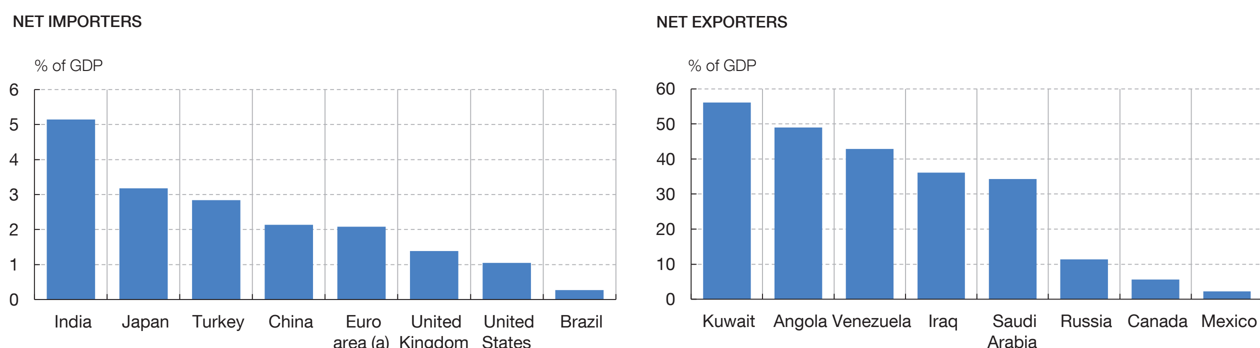
Factors of relevance for the world economy in 2015

THE REDUCTION IN OIL PRICES: CONSEQUENCES AND OUTLOOK

As discussed in the previous section, the marked fall in oil prices in the second half of 2014 is attributable both to demand-side factors (owing to the lower growth of the emerging and of some of the developed economies) and supply-side factors. In this respect, in addition to rising output in non-conventional oil (in particular shale oil) in the United States in recent years, this year has seen the partial recovery in the output of certain OPEC members subject to geopolitical tensions (such as Libya and Iraq). But the key factor has been the

FOREIGN TRADE IN OIL AND OIL PRODUCTS

CHART 7



SOURCE: JODI-Oil World Database.

a Aggregate constructed from data for Germany, France and Italy.

change in attitude in Saudi Arabia, which has shifted from regulating its output to stabilise crude oil prices to defending its market share.

Like any favourable supply-side shock, the reduction in oil prices entails an increase in real income and a fall in prices at the global level. However, it also involves a strong redistribution of income between net oil exporting and importing countries. The countries benefiting most are the main net importers, owing to the improvement in the terms of trade (see left-hand panel of Chart 7 in the case of the G 20 countries). In this group, the case of the United States may be highlighted; despite being the biggest global producer, it is also the biggest consumer and a net importer. Accordingly, the impact of the fall in prices is also expected to benefit the US economy. Conversely, those most harmed are the net exporting countries, which face strong contractions in the value of their output (see right-hand panel of Chart 7). Indeed, for most of these countries the redistributive effects predominate in the total effect, whereby their expected growth has been revised significantly downwards and they have faced greater turbulence on the financial markets. Moreover, the very intensity of the decline in prices may have had an additional unfavourable effect, by increasing uncertainty at the global level.

There are other effects of the reduction in oil prices that should be highlighted. First, heightened downward pressures on prices in countries with already-very-low inflation rates and interest rates close to zero, such as in Europe and Japan. In such an environment, there is a risk that the fall in goods and services prices – the outcome of the direct impact of lower fuel prices – will feed through to a persistent reduction in inflation expectations, affecting wages and potentially deriving in a downward price spiral that is difficult to curb owing to the scant leeway available to monetary policy. This poses a challenge for central bank communication policy, since part of the beneficial effects for importing countries, associated with the improvement in their net exports, might be partially mitigated by the unfavourable effects of any future deflation on demand. Further, in addition to the fall in non-energy imports by the oil-exporting countries (and the subsequent ensuing adverse impact on world trade), it should be borne in mind that many of these countries have accumulated a portion of their fiscal revenues of the past decade in sovereign wealth funds (SWFs), which are typically invested in real or financial assets in the developed economies. The fall in prices may force these funds to reduce their investment (and even to disinvest), which would prompt downward pressures on asset prices and upward pressures on interest rates.

After touching bottom in late January 2015, with a barrel of Brent below $50, prices have since rebounded towards $60. It is difficult to gauge their course in the medium term, which will depend on the behaviour of supply and demand. On the supply side, there are three notable factors that may alter the current situation. Firstly, the decline in prices might prompt a contraction in the US shale oil industry, which is made up of many medium-sized producers which, in some cases, are highly indebted. This contraction would reduce expected crude oil output, or it would at least lessen its growth rate; indeed, a recent rise in well closures in the United States appears to be discernible. Secondly, the fall in revenue – and the associated social tensions – might give rise to instability in some of the main producers, which would also lead to lower output. Thirdly, Saudi Arabia might resume its traditional strategy of regulating supply in an attempt to stabilise prices at a level higher than at present, which seems unlikely in light of the declarations by its authorities. Probably, current price levels would deter investment in new extraction capacity and in the exploration of reserves, thus reducing the growth rate of supply in the medium term. Generally, investment might become more volatile, as could prices. On the demand side, current prices should stimulate growth, raising the demand for crude oil in the medium term. It will be the interaction of all these factors that determines the path of prices over the coming year.

DETERMINANTS AND CONSEQUENCES OF LOW INFLATION IN THE ADVANCED ECONOMIES

As earlier mentioned, the fall in oil prices is one of the factors behind the generalised reduction in inflation rates, especially in the second half of 2014. Nonetheless, the low inflation figures in the advanced economies date back some time. Since mid-2011, inflation has been on a declining trend, owing chiefly to the lesser contribution of the energy component and of food prices. Core inflation (which excludes fresh food and energy) has held more stable, although in some cases – as in the euro area and Japan – it has also fallen significantly, departing from official inflation targets. In 2015, if the path of slightly rising oil prices shown by the futures markets holds, the contribution of the energy component to the OECD countries' inflation rates will be negative, especially in the first half of the year, correcting itself subsequently up to November, since November 2014 was the time of the biggest slump (see left-hand panel of Chart 8).

This setting of very low inflation rates in the advanced economies, against a background of economic recovery and strong monetary stimuli, prompts a two-sided debate. On one hand, as to whether the determinants of inflation have changed, since during the crisis the opposite occurred: inflation rates held above what such a contractionary episode would suggest. On the other, as to whether the maintenance of very low inflation rates may have adverse economic effects, especially if they are prolonged over time and feed through to long-term inflation expectations.

Regarding the determinants of inflation, the standard Phillips curve models consider the degree of slack in the economy – measured via the business cycle or cyclical unemployment – and agents' inflation expectations, along with other elements (commodities prices, the exchange rate, etc.). Various studies have shown how, in recent decades, the sensitivity of inflation to the degree of slack in the economy has diminished (see right-hand panel of Chart 8).[1] That could be due to factors such as the credibility gained by central banks in attaining inflation targets – which would result in a greater anchoring of long-term inflation

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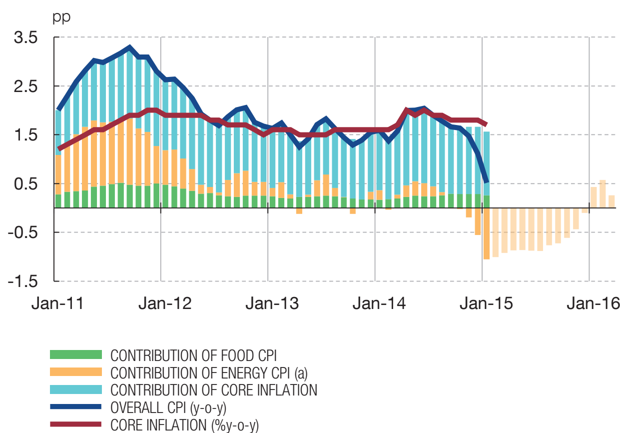
1 See IMF (2013), "The Dog That Didn't Bark: Has Inflation Been Muzzled or Was It Just Sleeping?", Chapter 3 of the *World Economic Outlook,* April 2013, or BIS (2014), "Growth and inflation: drivers and prospects", Chapter 4 of the BIS *Annual Report* 2014. The lesser sensitivity of inflation to the degree of slack in the economy is not, however, general. See, for example, Álvarez and Urtasun (2013), "Variation in the cyclical sensitivity of Spanish inflation: an initial approach", *Economic Bulletin*, July-August, Banco de España.

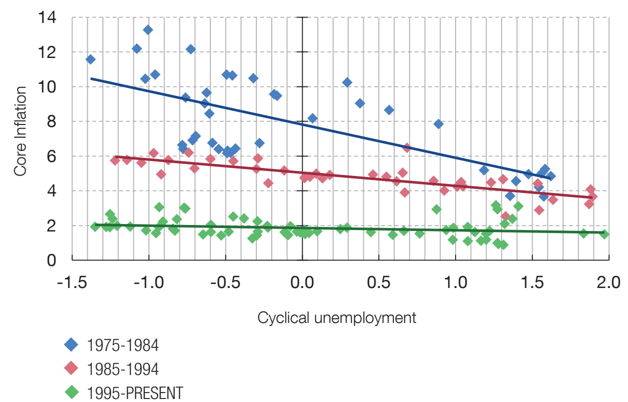
INFLATION DETERMINANTS IN ADVANCED ECONOMIES

CHART 8

INFLATION BREAKDOWN IN OECD COUNTRIES



FLATTENING OF THE PHILLIPS CURVE (b)



SOURCES: Datastream-Thomson Reuters, OECD, IMF and Banco de España.

a Forecasts of energy component contribution to the CPI taking oil price futures as a reference.
b Each point represents the quarterly average of core inflation and cyclical unemployent in advanced economies.

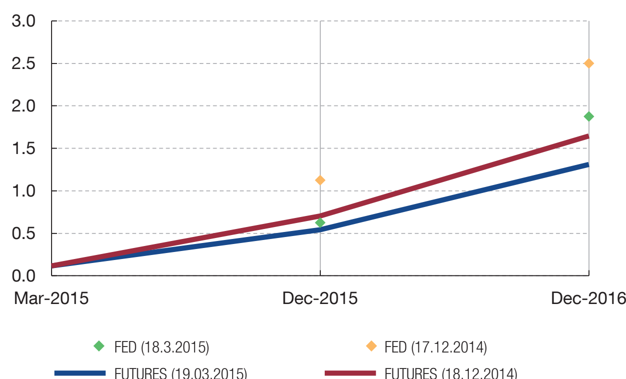
expectations around monetary policy objectives and in a higher coefficient of inflation expectations in the Phillips curve – or to the effects of globalisation, since there is evidence of global factors accounting for more in determining inflation than the cyclical position of each economy. These factors would explain why inflation did not fall to lower levels during the crisis, when output gaps were very negative, and why at present inflation rates are holding at low levels despite the reduction in the degree of economic slack. In addition, factors linked to each country's specific circumstances might be contributing to holding inflation rates down, such as the appreciation of exchange rates and wage moderation in the United States and the United Kingdom. In the United States, pent-up wage deflation would account for inflation moderation, whereas the sluggishness of productivity would be the operative factor in the United Kingdom.

As regards the effects of continuing very low inflation rates over a prolonged period, it should first be said that they contribute to raising real interest rates, acting as a drag on agents' spending decisions and generating more unemployment.[2] Further, against a background of high debt of the national sectors, a very low inflation rate hampers the deleveraging process and increases the debt burden. Also, within a monetary union such as the euro area, very low inflation rates across the region make the adjustment of relative prices that economies with competitiveness problems have to make more costly in terms of unemployment. Finally, the most harmful effects would arise if inflation expectations became unanchored, posing deflationary risks. In this respect, it is important to be watchful concerning the observed decline in inflation expectations in the main advanced economies, a decline which, to date, has been more marked in the short-term segment, but which is also discernible in certain measures of long-term inflation expectations. This is one of the challenges that must be tackled by monetary policy in the advanced economies, in a setting characterised by growing cyclical divergences, as discussed in the following section.

2 The harmful effects of an inflation rate below central bank targets over a prolonged period, even keeping inflation expectations well anchored, have been highlighted in the literature. See, for example, Svensson (2015), "The Possible Unemployment Cost of Average Inflation below a Credible Target", *American Economic Journal: Macroeconomics*, 7 (1), pp. 258-296.

MONETARY POLICY AND CYCLICAL DIVERGENCES

CHART 9



SOURCES: Datastream-Thomson Reuters and Federal Reserve.

MONETARY POLICY DECISIONS IN THE ADVANCED ECONOMIES IN A SETTING OF CYCLICAL DIVERGENCES

After finalising its asset purchases in 2014, the Federal Reserve has signalled that the process of normalisation of US monetary policy will begin in 2015. This intention reflects the soundness of the recovery in the labour market (in respect of job creation and of the reduction in the unemployment rate, which is drawing closer to its equilibrium level) and confidence that the current decline in inflation will be a temporary phenomenon and that it will return eventually to its 2% target. As part of this process of normalisation, the first step will be the raising of the official interest rate (the federal funds target rate) from the low at which it has stood (0 %-0.25 %) since December 2008, while the volume of assets on the Fed balance sheet will hold constant, with proceeds from maturing assets being reinvested. The normalisation of the central bank's balance sheet, in terms of the reduction of its size and the move to a shorter-dated asset structure, will take place in a second stage. It is sought by these announcements on future monetary policy decisions to minimise the distortions this process may entail for the normal functioning of financial markets, avoiding experiences such as that in May 2013 when the mere announcement that the Fed was considering reducing the volume of asset purchases under its quantitative easing programme (QE3) led to a sharp reaction by the financial markets.

Compared with the situation in the United States, and with the exception of the Bank of England, a large number of the advanced economies' central banks have opted in recent months to add greater measures of monetary expansion, set against the downward revisions of their growth forecasts and, mainly, downside pressures on prices and inflation expectations (see left-hand panel of Chart 9). Hence the period of convergent (and non-standard) monetary policies in the developed economies, which prevailed from end-2008, appears to have concluded. Since the outlook for 2015-2016 assumes an increase in the cyclical divergences between these countries, the differences in their monetary policy stances might become greater.

These differences in monetary policy decisions have been manifest in exchange rate developments, with the dollar appreciating by more than 15% in nominal effective terms since mid-2014 (see top left-hand panel of Chart 2), but not in the same manner in the yield spreads on longer-dated debt (see top right-hand panel of Chart 2), since yields have also fallen in the United States, dragged down by the international environment (see Box 2).

In 2014, debt yields in the main developed economies held on a declining trend, which was more pronounced from the summer (see Panel 1). This was in contrast to the divergent stance of monetary policies in the main developed economies. While these differences have already translated into a strengthening of the dollar against the leading currencies, government debt yields, which should accompany the expectation of official interest rate rises, have only very recently reacted. This Box analyses the possible determinants of the low level of yields in the United States.

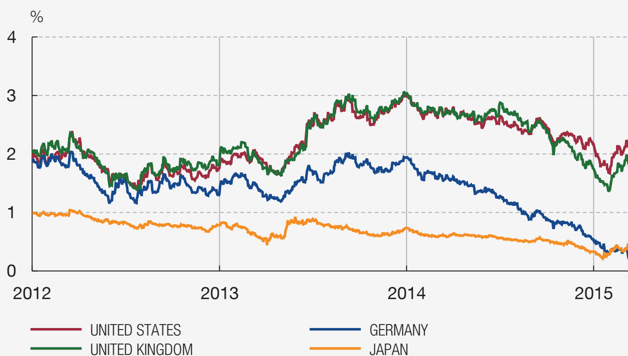
Although the reduction in US 10-year yields has coincided with lower long-term inflation expectations (see Panel 2), their decline appears to be related to a greater extent to the reduction in the term premium. This variable, which in theory is associated with the uncertainty of predicting the possible path of short-term interest rates, showed abnormally low values during the periods in which the Federal Reserve was actively purchasing fixed-income securities. In May 2013, with the start of discussions about tapering, the term premium increased and held at levels closer to its historical average. However, during 2014 this variable showed a further decline, even turning negative (see Panel 3).

Several factors may lie behind these developments in the term premium. First, there may be a precautionary motive, with flight-to-quality movements prompted by a more volatile environment. Such a consideration may have been more significant from August last year, when a combination of several factors prompted an increase in uncertainty on markets. Among these factors are the bleaker outlook for global growth, fears of deflation in the developed economies, growing geopolitical risk and the collapse in crude oil prices. This setting triggered flight-to-quality movements, as suggested by the increase in yields on high-risk assets, and it might also have exerted an influence in the opposite direction on long-term US debt yields, given their safe-haven status.

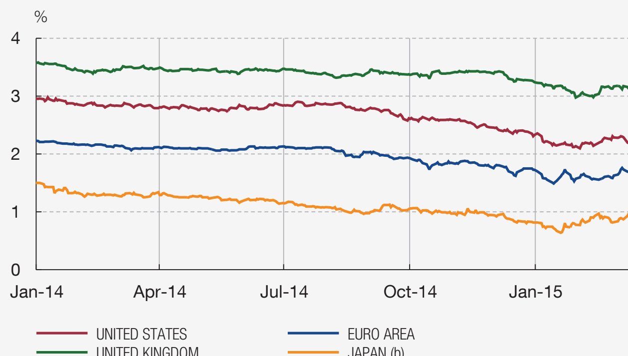
Second, the convergence of long-term rates in the developed economies might also reflect a shortage of assets considered as

INTEREST RATES AND INFLATION EXPECTATIONS

1 10-YEAR GOVERNMENT BOND YIELDS

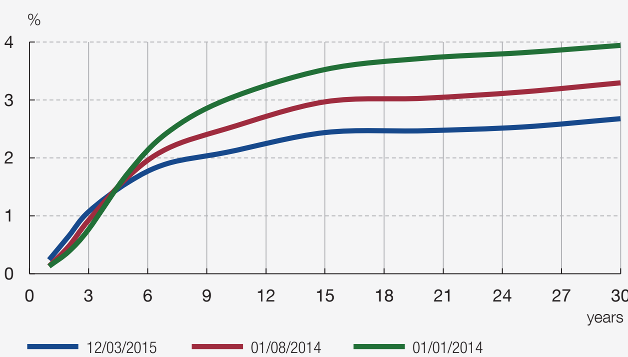


2 INFLATION EXPECTATIONS (a)



3 UNITED STATES: 10-YEAR BOND YIELD AND TERM PREMIUM

4 US TREASURY BOND YIELD CURVE



SOURCES: Datastream, Federal Reserve and Barclays Capital.

a Forward Inflation swaps. 5-year interest rate in 5 years time.
b Forward swap.

safe, in a setting in which, on one hand, no increase in annual public debt issuance by these countries is foreseen and, on the other, where the more expansionary nature of the accommodative policies of the ECB and the Bank of Japan reduces the amount of such assets available for investors. This setting might explain why certain European and Japanese institutional investors, that need to invest a significant portion of their portfolio in long-term securities, should prefer to assume or cover the foreign exchange risk associated with purchasing US debt before acquiring securities in their own currencies with negative yields.

Both factors might persist in the medium term. For one thing, as monetary conditions normalise, the period of abnormally low volatility of the past year will foreseeably conclude, which might trigger flight-to-quality movements in the event of sharp rises. For another, the supply of safe assets would not seem likely to expand in a context of public finances consolidation in the main developed countries. Accordingly, a scenario cannot be ruled out in which the 10-year yield does not react once the rise in official rates has started, which would pose a major challenge to the Federal Reserve in terms of the degree of tightening it may consider necessary, given the situation of the economy. In this respect, recent yield curve developments, where the shorter-dated segments have reacted to expectations of rises while the curve has declined in the longer-dated segments, suggest the possibility that the conundrum of the previous contractionary cycle may be revived (see Panel 4). But nor is it possible to rule out a scenario of greater volatility on financial markets as a result of wider differences between monetary policies, especially between the United States and the euro area and Japan, with significant increases in long-term interest rates globally.

As regards the process of normalisation to be pursued by the Federal Open Market Committee (FOMC), the markets are currently discounting a 100-125 bp increase in the federal funds target rate to end-2016, which marks a slightly gentler and more gradual rising path than that envisaged by the FOMC members themselves (see right-hand panel of Chart 9). The difference may reflect a differing assessment of the reaction function of the FOMC, or of the degree of recovery in the US economy and/or of the inflation outlook, which may be summarised overall in the slack existing in the labour market. Hence, although the unemployment rate is already close to the NAIRU (the estimate for which was revised downwards in March 2015), other indicators – such as wage trends – are still far removed from what would be a normalised labour market situation. Moreover, both the expansionary effect of the decline in long-term bond yields on the US economy and the restrictive effect of the dollar's appreciation (through the trade channel and incomes, owing to their impact on corporate profits) may hamper the process of monetary policy normalisation. In sum, this process poses a notable challenge as it must unfold in a setting of cyclical and monetary policy divergence, with low inflation, and it may give rise to episodes of volatility on financial markets.

TOWARDS A CHANGE IN FINANCING PATTERNS IN THE ADVANCED ECONOMIES?

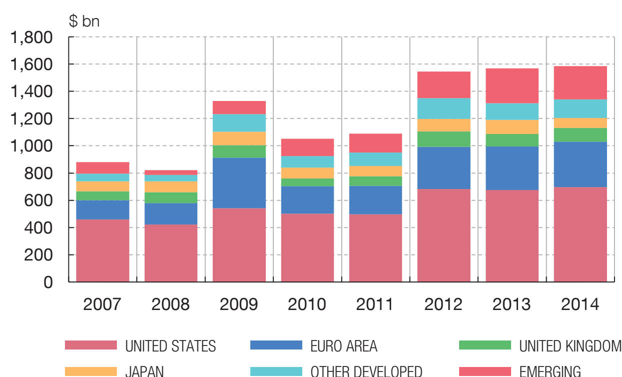
Major headway was made in 2014 in the regulatory reform of the banking sector. The FSB's proposal for a new requirement to equip global systemic banks with sufficient total loss-absorbing capacity (TLAC) to ensure their orderly resolution, avoiding the use of public funds and guaranteeing the continuity of their critical functions, marked the completion of the new regulatory framework for banks following the financial crisis. Thus, while there are still aspects and details to be ironed out in the coming years, last year saw a significant reduction in the regulatory uncertainty facing credit institutions when deciding on their future business strategies.

The new regulatory arrangements frame a setting conducive to a lesser role for bank intermediation and to a more important one for the capital markets in the financing of certain sectors, such as large corporations and infrastructure projects (see left-hand panel of Chart 10). Indeed, disintermediation has progressively stepped up in recent years, as

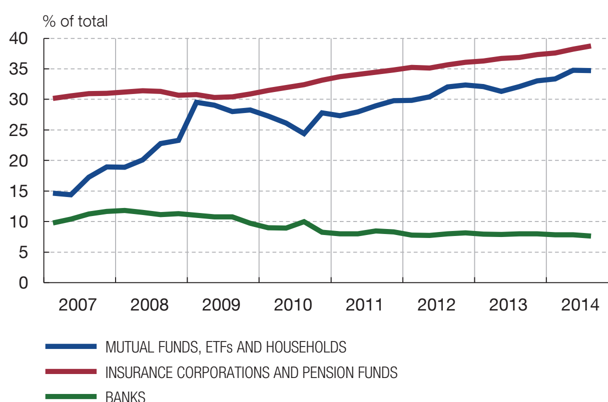
NON-FINANCIAL CORPORATIONS' BOND ISSUES AND BOND HOLDINGS IN THE UNITED STATES

CHART 10

GROSS CORPORATE BOND ISSUES BY COUNTRY/REGION



UNITED STATES: HOLDING OF CORPORATE AND FOREIGN BONDS BY SECTOR



SOURCES: Dealogic and Federal Reserve.

the banking sector has adapted to new requirements, in keeping with the transition phases laid down by regulators. This trend coincides, moreover, with a change in the type of participants on capital markets, where the role of institutional investors has taken on greater importance at the expense of banks (see right-hand panel of Chart 10).

Overall, a framework has been set in place in which the financial position of the banking sector comes out stronger, as both the risks banks incur and the consequences following a potential bankruptcy and the likelihood of using taxpayers' funds in the ensuing bailout have diminished. At the same time, other agents – such as pension and investment funds, and insurers – assume a greater role in the process of financial intermediation, in segments in which they were previously not present. This more diversified and resilient environment than was the case before the crisis is not, however, free from risks. In this respect, regulators and supervisors are beginning to pay greater attention to issues such as the behaviour of institutional investors when faced with bouts of tension, the effects investment by these agents in less liquid assets may have or the difficulties certain firms may encounter in re-financing their issues, especially against the background of an appreciating dollar. At the same time, there is also monitoring of the developing and growing activity of agents which, lying outside the banking regulation perimeter, perform intermediation services very similar to those of credit institutions.

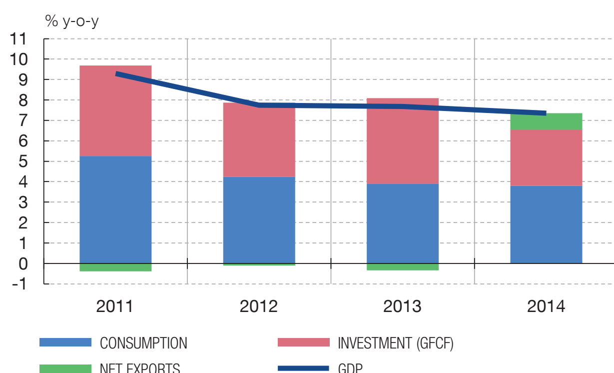
Ahead in 2015, a scenario is taking shape in which banking intermediation will continue to be moderate – given the steps banks still have to take in order to meet the new requirements – and in which financing via the markets may be influenced by the likely tightening of monetary policy in the United States. This scenario should affect to a greater extent those agents with greater dependence on dollar market funds, as is the case of the emerging countries (and in particular of Latin America), although the consequences for each economy will depend on the responsiveness of national banks or on the possibility of companies funding themselves in other currencies.

EMERGING ECONOMIES: SHOCKS AND ADJUSTMENT

The easing of growth in the emerging economies is proving to be one of the most significant facets of global economic developments. These economies have been operating against a backdrop of lacklustre and uneven recovery in the developed economies, which has been compounded – sequentially and to differing degrees of significance – by three types of shocks. The first has been the slowdown in the Chinese economy, in train since 2011,

ADJUSTMENT IN EMERGING ECONOMIES

CHART 11



SOURCES: National Bureau of Statistics of China and Datastream-Thomson Reuters.

with major consequences for the commodities prices and external demand of its main trading partners in Asia and Latin America. In the past four years, Chinese growth has declined by 4 pp from close to 11% in 2010 to little over 7% in 2014, partly as a result of the decision by its authorities, endorsed following the change in government in 2012, to attain a more balanced and sustainable growth pattern. The other two shocks are more recent: on one hand, the tightening of external financing conditions, which has come about, in recurrent episodes, since debate ensued in mid-2013 on the start of tapering in the United States, and which might intensify when the Federal Reserve initiates the process of normalisation of interest rates in 2015; and on the other, the decline in oil prices in the second half of 2014.

During 2014, the signs of a re-balancing of the Chinese economy became more patent (see left-hand panel of Chart 11). From the expenditure standpoint, the weight of private consumption increased by 3 pp of GDP compared with 2013, to stand at 52%, in parallel with a decline in the investment ratio. As to the sectors of activity, services continued to increase their share in GDP, rising to 48% at the expense of industry (36%) and the primary sector (6%). The measures adopted by the authorities cover various realms, ranging from the financial and the environmental to the fiscal. Since 2013, and especially the first half of 2014, limits have been placed on the growth of non-bank credit in the highest-risk segments of the financial system. The spending capacity of local governments has also been curbed and financing conditions have been tightened for second-home purchases. This has all made for a marked moderation in investment, adding to the ongoing adjustment of the sectors with idle capacity, chiefly in manufacturing and heavy industry. At the same time, the cumulative increase in household per capita income, arising from improved wages in the public and private sectors alike, has underpinned higher growth in private consumption, which was also boosted over the past year by an improvement in income distribution. Also in 2014, external and domestic financial liberalisation stepped up, with significant progress in making the exchange rate and interest rates more flexible, and the announcement of the forthcoming establishment of a deposit guarantee scheme, all of which will promote the mobilisation of saving. In these circumstances, activity in China continued to slow in 2014.

From a broader standpoint, the recent slowdown in China is largely the result of the implementation of a series of economic policy measures geared to moderating excesses in the financial system, the real estate sector and public spending. In parallel, the re-

balancing of the economy towards a more sustainable model of development continued, with a greater contribution by consumption and a lesser contribution by investment being posted in respect of GDP growth. However, the downtrend in inflation, sharper since the second half of 2014, has required greater support from monetary policy.

The significance of China in world trade means that its lower growth will have substantial repercussions, especially in the emerging economies. In the case of Latin America, China has two main channels of influence: external demand and commodities prices. China has become the leading or second trade partner for most South American countries (10-20% of their total exports) in just a decade, which has tended to increase the correlation between their business cycles. Some estimates associate a 1 pp fall in the growth of the Chinese economy with a 0.6 pp reduction, on average, in Latin American growth. Moreover, lower Chinese demand for commodities contributes to reducing the prices of these products on international markets, where their cumulative decline since 2011, measured by an overall index, stands at over 45%. Just as the continuous increase in the terms of trade underpinned economic dynamism in Latin America over the past decade, their correction in recent years is symmetrically prompting a decline in income and lower growth. In emerging Asia, weaker Chinese growth has led to a slowdown in exports from other countries in the region to China, although this easing might more broadly reflect the sluggishness of global demand, through its impact on value chains.

As to the financing conditions of emerging economies on international markets, a pick-up in capital inflows towards these economies was observed up until 2014 Q2 (see right-hand panel of Chart 6), which probably reversed in the second half of the year, judging by the across-the-board depreciation in exchange rates during that period, more markedly so in the case of the oil-exporting economies. Thus, on the data available to the first half of 2014, the recovery in capital inflows could be seen to be particularly intense in emerging Asia, including China. Capital inflows were seen to stabilise in Latin America at levels somewhat higher than those of 2013, as was the case in Eastern Europe, where they had most fallen previously. Even so, both in Latin America and in Eastern Europe, capital inflows continue to be lower than those received in 2011. In Latin America, lower capital inflows and lower economic activity also translated into a significant slowdown in domestic lending to the private sector. And this without the expected increase in US interest rates having yet materialised. Both the downward revision of growth forecasts in a good number of emerging economies and the rising trend of the dollar appear to presage the continuing moderation of capital flows towards these economies, especially if the change in monetary cycle in the United States is confirmed.

So far, the impact of the third shock – the fall in oil prices – is perceptible above all in lower inflation rates in Asia. In Latin America, pressures on services prices and the pass-through of the depreciation of exchange rates have tended to keep inflation rates relatively high, even in the countries with inflation targeting regimes. Foreseeably, the effects on activity will be noted to a greater extent in 2015 and will prove clearly positive for most of Asia, but differentiated in their impact on Latin American countries. Some Latin American countries are particularly vulnerable: the fall in oil prices is especially detrimental to those economies whose productive, exporting and revenue-raising specialisation has been geared to oil, such as Venezuela, where 96% of exports and 50% of public revenues depend on oil. Moreover, Venezuela has a low level of reserves and does not have access to external financing markets. For other economies, such as Colombia (where oil accounts for slightly over half its exports) or Mexico (where the tax revenue associated with oil exceeds 30% of the total and where, moreover, an energy reform has been launched to attract investment

and foreign technology to oil production), this is also a major shock. Both countries have the scope to withstand this shock, with a high level of international reserves, healthy public finances and advanced fiscal rules. In emerging Asia, lower oil prices are exerting a favourable impact on most countries' trade balances (especially in India's case); the exception is Malaysia, the area's sole net exporter.

The outlook for 2015

The year 2015 has begun with fresh downward revisions to world growth forecasts. However, the net positive effects of the reduction in costs stemming from lower oil prices will foreseeably be perceived with greater clarity once the intensity of the adjustment has been overcome and even though the permanence of these lower levels may be subject to uncertainty. Economic policies will continue to be accommodative, even though cyclical differences persist among the main advanced economies along with divergences in monetary policy stance, thereby influencing financing conditions at the global level, inter-regional capital flows and exchange rates. Finally, world trade remains subject to notable sluggishness, although a somewhat more favourable tempo can be detected in the advanced economies.

Against this background, the baseline scenario for 2015 includes growth in the world economy slightly above that for 2014, at around 3.5% (3.3% in 2014). That would be the result of the strengthening of the recovery in the advanced economies – whose average growth would be close to 2.5%, around 0.5 pp up on 2014 – and of stabilisation in the emerging economies, whereby their average increase would stand marginally below 4.5%.

A widespread strengthening of activity is expected in the advanced economies, albeit at differing paces. It will foreseeably be more intense in those economies, such as the United States and the United Kingdom, that have made most headway in adjusting their imbalances (private-sector balance sheets, fiscal consolidation, unemployment and the real estate sector). In other areas, such as the euro area and Japan, the increase in activity will be more moderate. In any event, the recovery will be broadly assisted by the low levels of oil prices (with the exception of those economies such as Norway and Canada that are net oil exporters), the accommodative stance of monetary policies (even in those economies further along the monetary cycle) and the gradual slowdown in the pace of fiscal consolidation.

In recent years the main emerging economies have recurrently posted lower-than-projected growth rates, which have fed through to a significant downward revision in their potential growth. In some areas this has been associated with the scant structural reforms made during the boom period. However, even bearing in mind this lower long-term growth, in the baseline scenario for 2015 the emerging economies are not expected to reach their potential, owing to various factors. For these economies as a whole, the increase in external demand from the advanced economies and the favourable effect of low oil prices on the oil-importing economies will foreseeably be more than offset by the slowdown in China (where policy management will perhaps be more focused on mitigating vulnerabilities than on stimulating growth), the long-expected normalisation of US monetary policy (and the subsequent tightening of global financial conditions and the re-directing of capital flows towards the United States) and the adverse impact of the price of oil (and other commodities) on exporting economies. This latter factor will particularly affect Russia, bearing down on an economy that was already slowing and which, moreover, was subject to various sanctions imposed by certain advanced economies. Nor is the outlook particularly favourable for the Latin American economies, which are especially sensitive to the change in cycle in commodities prices and to the eventual normalisation of global financial conditions.

Inflation is generally expected to remain very low (and even post negative levels for much of 2015 in many of the advanced economies). This forecast largely resides on the fact that a substantial reversal of the decline in commodities prices is not expected and, in the case of the advanced economies, on the fact that inflation will continue to evidence limited sensitivity to the degree of slack that has been observed in economies in recent years.

Regarding risks of a global scope, recent developments in the oil market (in particular the uncertainty over the factors underlying such risks) amplify the risks, in both directions, associated with the course of oil prices and with their potential impact; in particular, a greater positive impact on global growth cannot be ruled out. Moreover, a substantial group of countries (with the significant exceptions of the United States and the United Kingdom) are adopting or are ready to adopt more expansionary economic policy measures, especially in the monetary policy realm.

Among the downside risks, divergences in the monetary policy stance in the main advanced economies – the result of the marked differences in their cyclical position – pose a risk to financial stability. This is because a widening of such differences may prompt bouts of turbulence, with sharp adjustments in exchange rates and in other asset prices (especially high-yield assets and those of emerging economies) and the sudden relocation of capital flows. Further, the persistence of very low inflation rates over a prolonged period may check the recovery, insofar as this may raise the real cost of financing and, moreover, hamper the debt-reduction process. Also, a sharper slowdown in a systemic emerging economy (especially if in China there were to be a disorderly re-balancing of the economy, significantly affecting growth) would have an adverse bearing on global growth. Finally, geopolitical risks are still very significant, the hotspots being the territorial conflict in Ukraine and the spread of terrorism in the Middle East.

On international financial markets, the prevailing setting of high liquidity has been conducive to a build-up of certain significant risks. Thus, although some segments that were recently overpriced – such as US high-yield bonds – have been corrected, other causes for concern exist, such as the greater credit and liquidity risk arising from the high holdings of corporate debt in institutional investors' portfolios. In parallel, some recent structural changes – such as the lesser weight of bank financing and the greater weight of financing-providers outside the regulatory perimeter – pose some doubts over the access to financing of certain segments such as SMEs, which have traditionally been more dependent on bank intermediation.

Among the specific risks of the advanced economies, the marked decline in inflation in the euro area, in other European economies and in Japan (if the impact of the tax rise is discounted) increases the possibility of a disanchoring of inflation expectations. Over the longer term, in the euro area and Japan the prolonged weakness of demand and the scant headway in redressing certain imbalances – mainly the high levels of public and private debt – may ultimately entrench a low growth scenario.

Finally, the emerging economies may be particularly sensitive to bouts of instability on the international financial markets, prompted not only by global shocks but also by events in specific regions or economies (linked, for example, to problems in oil exporting countries), which ultimately translate into a broad change in investor sentiment towards them. Moreover, the persistent weakness of growth figures in some cases may suggest that the long-term growth capacity of these economies is still overestimated.

In sum, the world economy continues to move on a modest growth path which, while clearly below its pre-crisis trajectory, may be boosted in the short term by the firming of the recovery of the advanced economies, as a result of the continuing low oil price levels and the accommodative monetary policy stance. These foreseeably temporary factors may prove conducive to more resolute progress in correcting these economies' imbalances, contributing to supporting growth in the emerging economies in a setting which, owing to various factors (the expected tightening of global funding conditions, the ongoing slowdown in the Chinese economy and the end of the commodities bullish cycle), is particularly adverse for some of them.

19.3.2015.