



Global Economy Watch

A turnaround for the G7?



Dear readers,

In April, policymakers will gather in Washington D.C. for the World Bank-IMF Spring meeting. Part of their discussions will focus on the recent uptick in economic activity in the leading (G7) advanced economies.

In this edition, we have looked at whether the recent optimism about the G7 is justified and, more importantly, whether it can be sustained.

On the first point, “hard” data indicate a slight acceleration in G7 economic growth to 1.7% year-on-year in the last quarter of 2016 (see Figure 1). However, what is driving the optimism is the broad-based nature of the recovery across the G7, as indicated by less variation in growth rates across countries than at any time in the past 20 years (see Figure 4).

We think three reasons explain this turnaround.

First, the continued highly accommodative monetary stance across the G7 and, in particular, in the Eurozone, despite the gradual rise in US rates from historic lows recently.

Second, governments are starting to spend more, with some putting infrastructure plans in place.

Third, there has been an uptick in demand from the large (E7) emerging markets, partly driven by a fiscal stimulus in China, as well as a turnaround in

economic activity in Brazil. This is corroborated by recent trade data, which show that emerging markets’ import growth continued to grow compared to a year earlier.

So, will this continue in the future?

Most “soft” survey-based data suggest the momentum has carried on through the first quarter of this year. We will not know this for sure until the “hard” data on GDP is released later in this month, starting with the US and UK on April 28th.

Even so, policymakers’ discussions should focus on the key factor which determines long-run standards of living: productivity. Our analysis shows that post-crisis productivity growth in the G7 has been around two thirds slower than its long-run average rate.

Typically, governments take on the task to push through economy-wide reforms. For example, they can help drive large public investment projects or invest more in schooling. They can also help drive a more open trade agenda which, however, seems less likely in the current climate.

But we think that businesses also have an important role to play, particularly from a bottom-up perspective. Best practice management techniques, for example, could have an impact on national productivity rates if implemented across a large number of businesses.

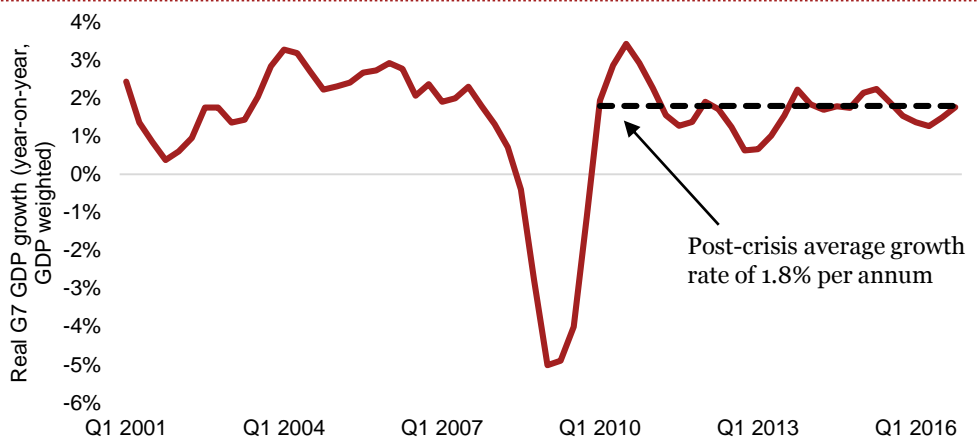


Kind regards,

Barret Kupelian

PwC | Senior Economist

Fig 1: Recently there has been a gradual uptick in G7 economic activity



Sources: PwC analysis, Thomson Datastream

Visit our blog for periodic updates at:

pwc.blogs.com/economics_in_business



Economic update: It's all about productivity

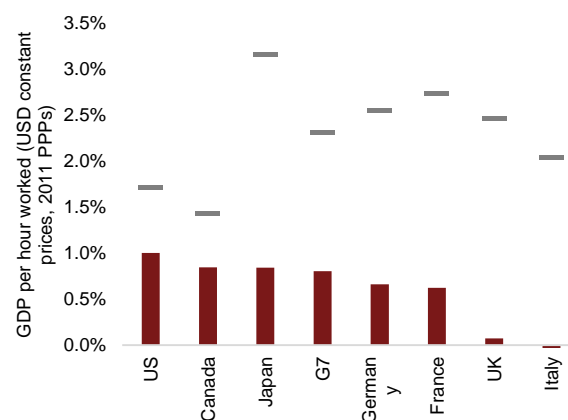
In the long run, economic development is all about sustained productivity growth. But one of the lasting scars of the financial crisis has been that productivity growth — defined as GDP per hour worked — has grown more slowly than its long-term average rate (see Figure 2). Focusing on the G7, our analysis indicates that average productivity levels are now around 10% lower than what they would have been had this grown at its pre-crisis trend rate. So what is holding productivity growth back?

One of the key reasons cited is lack of investment in hard infrastructure (roads, airports, bridges etc). Across the OECD, for example, public investment has dropped by an average of 8% annually since 2010. An obvious policy would be to reverse this trend and so increase the capital stock per worker as well as reap the productivity benefits from any positive knock-on effects from this better infrastructure. However, there are limits to how far some governments can go here, especially if they already carry a relatively high stock of debt.

Furthermore, there are issues that are more specific to the economies in question. In the Eurozone, for example, there is a € 1 trillion stock of non-performing loans, which makes it difficult for banks to channel liquidity to households and businesses. So policies which help facilitate corporate restructuring could potentially help to improve capital allocation and push out lower-productivity firms. This point is particularly relevant for the peripheral Eurozone economies.

In conclusion, G7 productivity growth rates have been around two thirds slower post-crisis compared to their historic trend growth rates. A mixture of bold structural reforms targeted at both the private and public sectors is needed to help bring about faster productivity growth but this will be a long term process.

Fig 2: The G7 post crisis productivity growth rate has been disappointing



Bars show 2008-2015/6 per annum average productivity growth rates. Horizontal lines show 1971-2007 per annum average productivity growth rate. Note: This measure of productivity has been calculated in Purchasing Power Parity (PPP) terms and so is sensitive to exchange rates. As such, it does not take into account of structural differences between economies, such as labour market flexibility. This feature, for example, gives the UK a lower relative figure.

Sources: PwC analysis, OECD

What would be the business impact of a more protectionist US?

During the US Presidential election campaign candidate Trump suggested radical policies to help influence the way the US trades with the rest of the world. His key pledges were based on a mix of policies which included:

- a broad “border tax” which, depending on its final form, could discourage imports;
- tariffs on US imports from specific countries (of the order of 30-40%); and
- renegotiating key trade agreements.

Since then, the new administration has ordered a comprehensive analysis of the \$500 billion trade deficit that the US runs with the rest of the world. The results of this analysis will be reported at the end of June.

So what would be the effect on the global economy if these election pledges were adopted as official US policy?

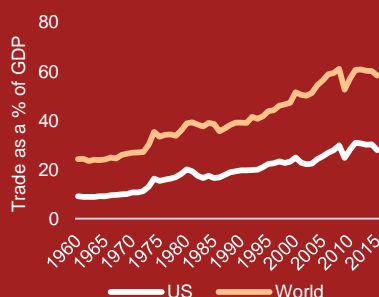
Proponents of these changes highlight the revenue raising features of tariffs for the US government. They also argue that tariffs will lead to a stronger dollar, which would in effect make imports cheaper and so cancel out their impact on US consumers (at least in part).

However, this approach assumes that the value of the US dollar is determined just by trade flows. In reality countless other factors matter including US monetary policy relative to other major countries, uncertainty and future prospects for US growth. It would therefore be difficult to predict, at this stage, how the dollar would behave in reaction to such policies. However, there are other wider considerations to take into account.

At an extreme, these pledges could cause a trade war

A blanket tariff on imports to the US would

Fig 3: In all post-war history, trade openness has been increasing



Sources: World Bank

signal a significant departure from the liberal trade policy which has promoted strong global and US trade growth for many decades, at least prior to the financial crisis (see Figure 3). According to the latest data from the World Bank, the US applied weighted tariff rate on imports is 1.6%. Increasing this by, say, five percentage points would bring US levels of protectionism on to a par with those of low or middle-income countries, some of which tend to impose tariffs to protect domestic industry during earlier stages of economic development, as indeed the US did in the 19th and early 20th centuries.

How would the US's main trading partners respond?

Some of the US's largest trading partners e.g. China, Mexico and Germany, have already stated their intention to take retaliatory action. Assuming this will involve raising tariffs on US products, economic theory — and common sense — suggests that both parties would be worse-off on average (even if some protected

US industries may gain at least in the short to medium term).

Research by the Peterson Institute¹ estimates that a trade war could lead to a decrease of around 3% in US GDP over a two year period. The severity of the shock for the US's trade partners would depend on the size of the bilateral trade flows as well as their capability to substitute US imports at similar cost (whether through domestic production or imports from elsewhere).

What does this mean for businesses?

The biggest effect of a significant increase in US protectionism could be the associated increase in uncertainty for businesses. This could make the business community think twice when deciding whether to undertake large-scale investments related to trade involving the US, which could lead to a short-term slowdown to growth.

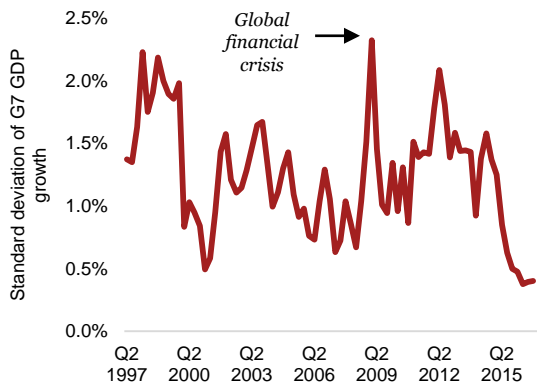
Also, some industries and countries might be disproportionately affected depending on how (or if) these campaign pledges are converted to specific policies. For example, the automobile, machinery and clothing industries in Mexico and China could be disproportionately affected. Businesses may also need to rethink their supply chain models.

Yet, the majority of CEOs do not seem too worried, at least for the moment. For example, in our latest Global and US CEO surveys almost two-thirds of the US respondents said they were very confident about their company's prospects for revenue growth for the next three years. This was higher than the global average of around 51%.

¹ PITE Briefing: “Assessing Trade Agendas in the US Presidential Campaigns”, September 2016

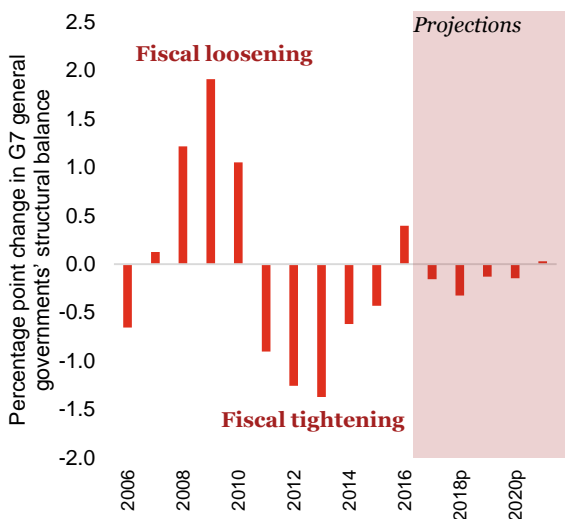
Have the G7 reached escape velocity?

Fig 4: The variability in G7 GDP growth rates is low by historical standards



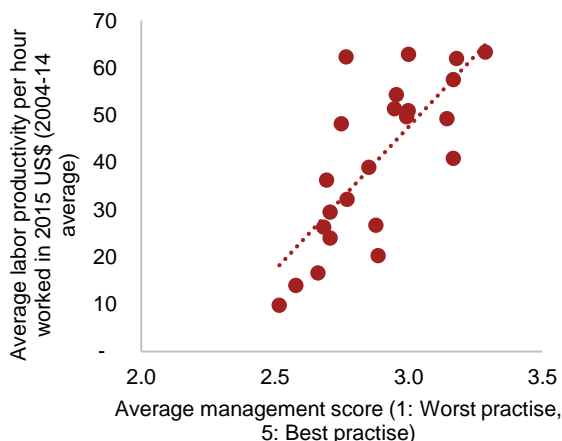
Source: PwC analysis, OECD

Fig 5: Adjusted for the economic cycle governments adopted a more lax fiscal stance in 2016



Sources: PwC analysis, OECD

Fig 6: Practising best practice management is associated with higher national productivity rates



Sources: World Management Survey, PwC analysis

G7 economic activity has picked up and is also now more broadly based

Economic data show that, in the last quarter of 2016, G7 real GDP growth accelerated to a rate of 1.7% year on year, broadly in line with the post-crisis average of 1.8%. This in itself is not remarkable (see Figure 1).

What is, however, driving recent increased economic optimism is not the pace at which the G7 are growing, but the fact that G7 growth is broadly based. In fact, Figure 4 shows that the degree of variability of growth rates across the G7 has reached its lowest point since at least 1997. This leads to a bigger question—have the G7 finally reached escape velocity after years of relatively disappointing growth since the financial crisis of 2008-9?

Policy settings and stronger emerging markets explain G7 growth upswing

To answer this question, we first need to understand what is driving the current upswing in economic activity. We think three reasons explain this:

- **Monetary policy, particularly in Europe:** The Eurozone's extremely accommodative monetary stance since the ECB announced a quantitative easing programme in the first quarter of 2015 has helped to reduce the cost of borrowing and disparities across the Eurozone. In Italy, for example, the cost of finance to business dropped by around 110 basis points to less than 2% compared to the period just before the quantitative easing programme began. Outside the Eurozone, the Bank of England also significantly relaxed UK monetary policy in August 2016 following the Brexit vote.
- **Fiscal policy:** Governments have started to spend again. Figure 5 shows that, controlling for the economic cycle, the G7 fiscal stance was broadly accommodative in 2016 for the first time since 2010. Some of this is because historic policy shifts have reduced deficits so reducing the need for further fiscal tightening (e.g. cutbacks in public spending in the UK, VAT hike in Japan etc.), but also because most of the G7 (Canada, Japan, the UK and Germany) have announced plans to upgrade their infrastructure.
- **Emerging imports:** A more favourable outlook for the large (E7) emerging economies—which receive around 20% of G7 exports—with Brazil's economy starting to turn around and the Chinese authorities stimulating the economy by increasing credit channelled via the so-called policy banks. Our analysis of trade data for the last quarter of 2016 shows that emerging economy imports grew by around 1% relative to a year earlier with Central and Eastern Europe and Emerging Asia growing the fastest.

Have we reached escape velocity?

Most survey data for the first quarter of this year have been relatively upbeat and, in general, this is expected to flow into hard data (e.g. GDP) for the first quarter of the year. But it's also important to point out that the factors mentioned above are changing. On monetary policy, for example, the Federal Reserve continues to tighten policy. On fiscal policy, IMF projections shows that a broadly neutral fiscal stance is expected and so the one-off boost from last year isn't expected to be repeated (see projections in Figure 5). And some of the G7 economies are expected to go through some big changes which come with an element of uncertainty (e.g. Brexit in the UK, potentially uncertainty in the US given the change in the administration; elections in France and Germany also add uncertainty to the mix).

Key to reaching escape velocity is productivity growth

However, the biggest factor that will determine whether the G7 have reached escape velocity is productivity growth. This has been a weak point for most of the G7 as discussed on the previous page (see Figure 2).

Governments are important drivers of the productivity agenda. But they are not the only ones. Increasingly, evidence is emerging that businesses also have a critical role in influencing national productivity levels. For example, data from the World Management Survey in Figure 6 shows that firms with better management practices are associated with higher levels of national productivity. In the UK, in a recent speech by Andy Haldane of the Bank of England pointed out that a one standard deviation improvement in the quality of management raises productivity by, on average, 10% for the firms in question. If this improvement could be spread across most businesses, then the impact on national productivity levels would be sizeable.

In conclusion, the recent synchronised pick-up in activity in the G7 is welcome and is expected to continue at least through the first part of 2017. However, if the G7 want to reach escape velocity on a sustainable basis, then the focus of both governments and businesses needs to be on improving productivity levels.

Projections: April 2017

	Share of 2016 world GDP		Real GDP growth			Inflation		
	PPP	MER	2017p	2018p	2019-2023p	2017p	2018p	2019-2023p
Global (Market Exchange Rates)		100%	2.9	3.0	3.0	2.7	2.7	2.5
Global (PPP rates)	100%		3.4	3.5	3.5	3.1	3.0	2.9
G7	31.5%	46.4%	1.8	1.8	1.9	2.0	2.2	1.8
E7	36.2%	25.9%	5.1	5.1	5.0	3.6	3.9	3.3
United States	15.8%	24.5%	2.2	2.4	2.3	2.3	2.5	2.0
China	17.3%	15.2%	6.5	6.1	5.7	1.8	2.5	2.8
Japan	4.2%	5.6%	0.5	0.7	0.8	1.3	1.5	1.5
United Kingdom	2.4%	3.9%	1.6	1.4	2.0	2.6	2.8	2.3
Eurozone	12.0%	15.8%	1.6	1.5	1.5	1.4	1.5	1.4
France	2.3%	3.3%	1.5	1.4	1.6	1.2	1.3	1.2
Germany	3.4%	4.6%	1.5	1.5	1.4	1.8	1.9	1.7
Greece	0.3%	0.3%	1.6	2.0	1.8	0.5	0.7	1.1
Ireland	0.3%	0.4%	3.8	3.8	2.6	1.0	1.2	1.5
Italy	1.9%	2.5%	1.0	0.9	1.2	1.1	1.2	1.4
Netherlands	0.7%	1.0%	1.6	1.7	1.8	1.5	1.5	1.3
Portugal	0.3%	0.3%	1.1	1.2	1.1	1.0	1.0	1.4
Spain	1.4%	1.6%	2.3	2.1	2.0	1.3	1.5	1.2
Poland	0.9%	0.6%	3.2	3.4	3.5	1.7	1.7	2.4
Russia	3.3%	1.8%	1.1	1.4	1.5	4.7	4.5	4.0
Turkey	1.4%	1.0%	2.8	3.1	3.4	9.2	7.5	7.0
Australia	1.0%	1.7%	2.7	2.8	2.7	2.5	2.2	2.5
India	7.0%	2.8%	7.3	7.4	6.5	5.0	4.9	5.0
Indonesia	2.5%	1.2%	5.1	5.3	5.4	4.5	4.4	5.1
South Korea	1.6%	1.9%	2.6	2.8	3.3	1.6	2.8	3.3
Argentina	0.8%	0.9%	2.3	2.6	2.5	25.0	-	-
Brazil	2.8%	2.4%	0.4	1.5	3.0	5.0	4.5	4.5
Canada	1.4%	2.1%	2.0	2.1	2.2	2.1	2.1	2.0
Mexico	2.0%	1.6%	1.5	2.0	3.0	4.0	3.5	3.0
South Africa	0.6%	0.4%	1.0	1.5	3.0	6.0	5.8	5.5
Nigeria	1.0%	0.7%	0.8	1.8	4.2	15.0	14.0	12.0
Saudi Arabia	1.5%	0.9%	0.8	2.1	3.5	3.5	3.7	2.5

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has recently launched a new CPI measure, which only contains data from April 2016. Therefore we only project inflation for 2017, and will provide 2018 and 2019-2023 projections once a longer series is available. Note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	1.00% (March 2017)	Further gradual tightening over the year	2 – 3 May
European Central Bank	0.00% (March 2016)	No rate rise for the foreseeable future	27 April
Bank of England	0.25% (August 2016)	No change in rates expected in the short-term	11 May



Barret Kupelian

T: + 44 (0) 20 7213 1579
E: barret.g.kupelian@pwc.com



James Loughridge

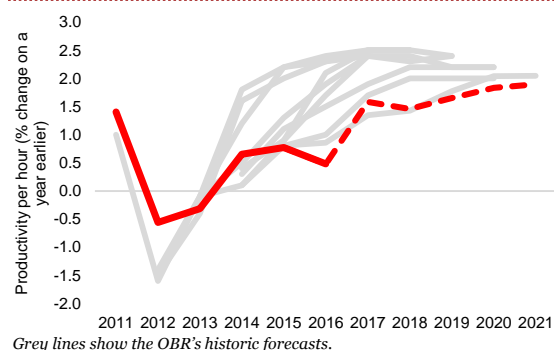
T: +44 780 266 0106
E: james.r.loughridge@pwc.com

Chart of the month

The latest projections of the Office for Budget Responsibility (OBR) in the UK show that it expects labour productivity to gradually increase to its long-term rate over a four projection horizon.

Is this realistic? The chart also shows that historically labour productivity forecasts have failed to materialised.

Productivity rates are difficult to forecast



Sources: PwC analysis, OBR

We help you understand how big economic, demographic, social, and environmental changes affect your organisation by setting out scenarios that identify growth opportunities and risks on a global, regional, national and local level. We help make strategic and tactical operational, pricing and investment decisions to support business value creation. We work together with you to achieve sustainable growth. Do get in contact with one of the team if you would like to discuss any of these topics.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2017 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.