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Why the global economy could surprise on the upside in 2017 despite all the uncertainty

Last year, the global economy proved fairly resilient in the face of unexpected shocks. Neither concerns about a slowdown in the Chinese economy nor major political surprises – including the result of the Brexit referendum in June and the outcome of the US presidential elections in November – managed to knock the global economy off its moderate growth path. So does the global economic resilience witnessed in 2016 mean that we can be optimistic about 2017, which presumably has its fair share of political turbulence in store, as well? We think the answer is yes.

The global economy is in relatively good shape and is getting off to a positive start to the new year having picked up speed slightly in the closing quarter of 2016. We are penciling in economic growth of 2.8% for 2017 as a whole, after 2.4% last year.

EMERGING MARKETS BACK ON THE EXPANSION PATH

In the emerging markets, the signs for this year point towards a "moderate economic upturn". This will be fueled primarily by the economic stabilization in the two emerging market heavyweights, Russia and Brazil, as well as by the pickup in commodity-exporting countries.

MORE EXPANSIVE US ECONOMIC POLICY

In the advanced economies, the conditions for growth are fairly favorable on the whole. Although the specifics of US economic policy under President Donald Trump are not sufficiently clear yet, a new policy mix is emerging: monetary policy will provide somewhat less of a boost to economic development, whereas fiscal policy will do more. Although the scale of the measures is not yet clear, Trump will remain true to his pledges to cut taxes and launch investment initiatives. These measures are likely to buoy economic growth in the course of 2017 – despite the dampening effects of rising inflation, slightly higher interest rates and the resulting appreciation of the US dollar.

EUROZONE: DOMESTIC DEMAND CONTINUES TO DRIVE THE ECONOMY

In the eurozone, economic growth is likely to remain just above the potential rate, i.e. the long-term growth trend, for the third year running. The balance sheet recession is finally behind us and domestic demand is likely to continue to deliver positive impetus. Although consumers are likely to be slightly less keen to spend due to rising inflation and the rebound in oil prices, the ongoing

increase in employment is likely to provide a boost. The specter of deflation will presumably disappear completely in 2017. Nevertheless, in contrast to the Fed, the ECB is unlikely to shift down a gear, but will stick to its ultra-loose monetary policy. Given the large monetary policy divergence, the weakness of the euro is likely to persist.

KEY RISKS IN 2017

We have identified four key risks that are creating significant uncertainty and could put a spoke in the economic wheel:

1. **Disruptive protectionism**: Unfortunately, the US is likely to go down the road of implementing individual protectionist measures and making threats in reaction to the rising US trade deficit. Our base scenario does not, however, include the prospect of an extended trade war between the US and China or other key trading partners. An escalation of these trade conflicts would create a major downside risk for the US as well, which is why the country is well advised to avoid them. We put the risk of this sort of scenario at low to moderate, but the impact on the global economy would be all the more devastating. A global trade war could shave around 2 percentage points off global trade growth and around 1 percentage point off global output a year.
2. **Boom/bust:** Excessively expansionary fiscal policy in the US – but also in Europe – alongside ongoing loose monetary policy could cause the economy to overheat if the recovery is more pronounced than expected. A sharp jump in inflation to well above the 2% mark in the industrial countries would prompt central banks to change course abruptly, risking an economic slump in 2018/19. We do not believe that a boom/bust scenario is very likely, as the advanced economies are likely to take timely economic policy measures in response to any signs of overheating. The US Fed, for example, has already signaled a swifter normalization of US monetary policy this year in response to the brighter-than-expected economic backdrop.
3. **Emerging market debt crisis:** In order to counter a slowdown in growth, some emerging markets have been pursuing very expansive economic policies in recent years, fueling an ongoing increase in macroeconomic imbalances, mainly in the form of galloping corporate debt and inflationary real estate prices. This means that the risk of dramatic corrections is mounting steadily. While we believe that the risk of a debt crisis erupting in the emerging markets in 2017 is low, we do believe that it is extremely likely to materialize in the medium term. Global trade and global GDP growth could dip by 2-3 and 1-2 percentage points respectively for a period of two to three years following the outbreak of the crisis.
4. **Disintegration of the EU**: The European Union will once again face major challenges, mainly of a political nature, in 2017. In addition to the Brexit negotiations, the spotlight will be on the parliamentary elections in key eurozone member states, such as the Netherlands, France and Germany. Further political successes by populist forces could sow discord on the search for common solutions and heighten divisions within the EU. This would also erode member states' willingness to push ahead with reforms, which is already fragile enough, both nationally and at European level. It is crucial for the member states to press ahead with their reform policies in order to keep the growth process intact, promote investment appetite, create more jobs and whittle down the debt mountain. Otherwise, the risk of concerns over Europe's future flaring up again will return in the medium to long term. In this sort of scenario, we expect to see a prolonged period of stagnation or a recession on the continent. In the short term, we believe that the break-up of the EU or the eurozone – triggered, for example, by a French exit from the EU in the event of an election victory by Le Pen – is a relatively unlikely scenario. France would have a lot to lose indeed from such a move. And the UK is certainly not a shining example of the advantages associated with breaking ties with the EU.

THE BEGINNING OF THE END OF THE "NEW NORMAL"?

All in all, we expect the global economy to show an improvement in 2017 compared with 2016. Especially because the downside risks are currently being overstated, if anything, for 2017, we believe that the global economy might even surprise on the upside this year. There is no doubt that this does not signal the end of the "new normal", i.e. the environment of sub-par economic growth and low inflation that has prevailed since the economic crisis. The first signs of a tentative turnaround, however, are starting to emerge – with long-term interest rates and inflation now edging up again – and this is expected to continue in 2017.

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