Boxes

1 The recent evolution of global risks – an assessment

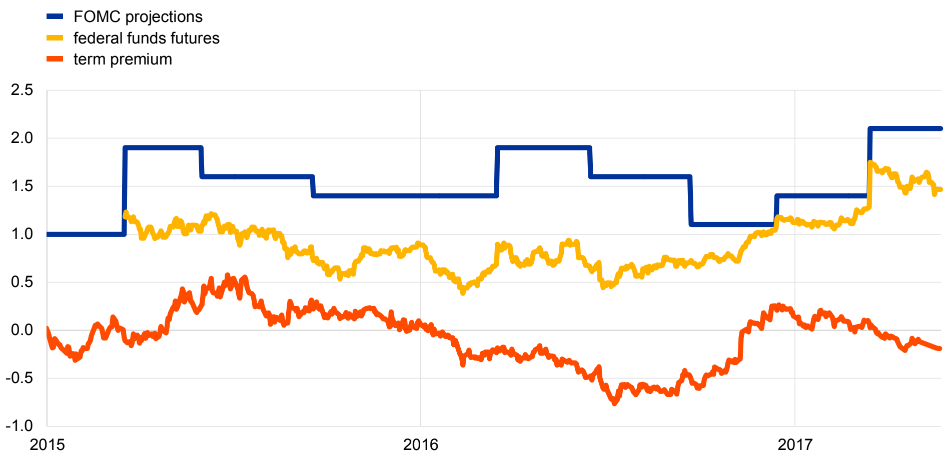
This box provides a qualitative assessment of how key global risks have evolved since early 2016.

Risks of an abrupt shift in global financial conditions appear to have eased but not disappeared. Since the "taper tantrum" episode in 2013, when expectations regarding US monetary policy shifted abruptly, a combination of careful communication and a very gradual approach to monetary tightening by the US Federal Reserve System appears to have mitigated such risks somewhat. In particular, the gap between market expectations and Federal Open Market Committee (FOMC) projections regarding interest rates has narrowed (see Chart A), suggesting that the prospect of monetary policy surprises has diminished. However, uncertainty about the tightening cycle in the United States remains and, despite the modest rebound in the term premium since mid-2016, longer-term interest rates remain very low.

Chart A

US federal funds rates compared with FOMC projections

(projections for the end of the next calendar year; percentages)



Source: ECB staff calculations based on data from Bloomberg and the Federal Reserve Board.
Notes: The latest observation is for 23 May 2017 for federal funds futures and 15 March 2017 for FOMC projections. The term premium is the Federal Reserve Bank of New York's estimate based on ten-year Treasury yields.

At the same time major emerging market economies (EMEs) seem better placed than some years ago to weather tighter external financing conditions. In recent years vulnerabilities and external imbalances in several EMEs have declined, with real interest rates increasing, inflation falling, credit growth slowing and current account imbalances declining. This should make them more resilient to adverse external financing shocks. Nonetheless, some EMEs – particularly those with large external debts – remain exposed to an abrupt tightening of global financial conditions. Accordingly, an abrupt reversal in global financial market sentiment weighing on global activity, and particularly EME activity, continues to be a risk to the global outlook.

Policy support for growth has mitigated concerns about the short-term outlook for China. From mid-2015 concerns about the outlook for China were prominent amid fears over the sharp slowdown in activity, capital outflows and the depreciation of the renminbi, compounded by rising policy uncertainty. A robust policy response – including substantial fiscal support, infrastructure spending, looser financial conditions and tightened capital controls – alleviated such worries. By underscoring the authorities' determination to maintain growth close to targets, it may have helped to allay concerns about the near-term outlook. However, the policy response came with significant costs, including a further increase in leverage and increased resource misallocation (with stimulus again being concentrated on the state-owned sector). Tighter capital controls also helped to fuel a housing market boom, as funds were channelled towards domestic assets.

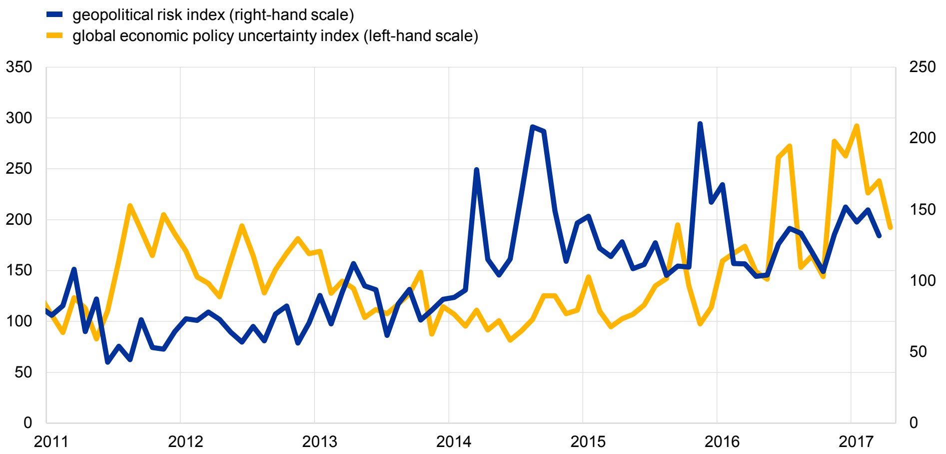
Policy uncertainty has increased at the global level, with concerns about more inward-looking policies, while geopolitical tensions remain elevated. Geopolitical tensions have been a key downside risk to growth in recent years, although their intensity and location have varied over time, ranging from the conflict in the Middle East and tensions with North Korea and in the South China Sea, to political tension between Turkey and the EU, and their impact on refugee flows towards the EU. Some of these risks are more local or regional in nature, while others have a more global dimension, and their probabilities and impacts are difficult to estimate. An index of geopolitical tensions, which captures incidents of war, political tension and terrorist attacks, shows a broadly stable level between early 2016 and the start of 2017.[8] Moreover, since the US election pressures for more inward-looking policies have risen. Overall, global policy uncertainty has trended upwards in recent years (see Chart B).

8 Caldara, Dario and Iacoviello, Matteo, "Measuring Geopolitical Risk", Working Paper, Board of Governors of the Federal Reserve System, 2016.

Chart B

Global economic policy uncertainty and measures of geopolitical tension

(indices)



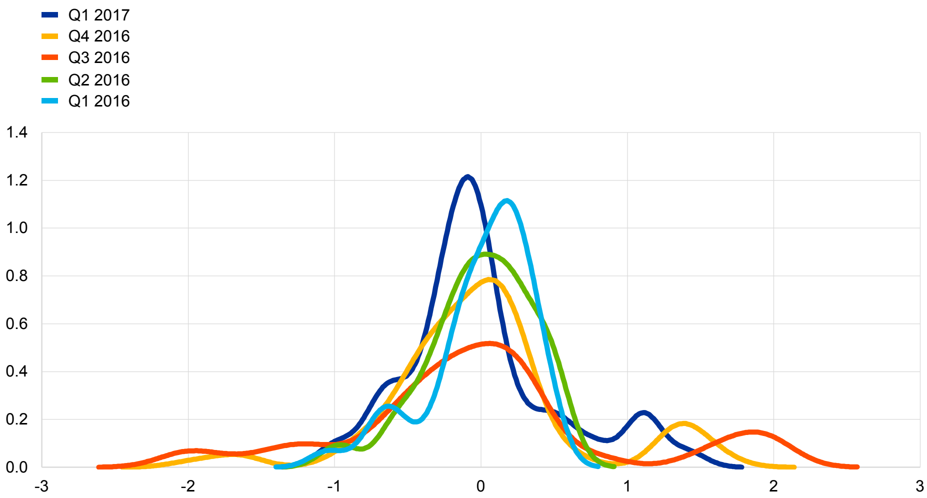
Sources: Haver, Federal Reserve Board and ECB staff calculations.
Notes: The global economic policy uncertainty index is a GDP-weighted average for 17 countries. The geopolitical risk index measures the incidence of wars, geopolitical tensions and terrorist attacks. The latest observation is for March 2017 for geopolitical risk and April 2017 for global economic policy uncertainty.

The medium-term risks of an adverse fall-out from Brexit persist. The immediate impact of the UK referendum on EU membership has been more benign than initially expected. Activity in the United Kingdom was relatively robust in 2016, although it moderated early this year as inflation rose following the pound sterling's depreciation. The dispersion of forecasts compiled by Consensus Economics has narrowed (see Chart C), although it remains wider than in the pre-referendum period. Nonetheless, medium-term risks persist, particularly related to the outcome of the negotiations on the conditions for leaving the EU and future trade.

Chart C

Dispersion of UK growth forecasts

(kernel densities of demeaned one-year ahead growth)



Sources: Consensus Economics and ECB staff calculations.

In sum, the analysis suggests that existing downside risks to global growth may have declined over the past year, but have not disappeared. Moreover, new risks have emerged. On the one hand, careful communication by the Federal Reserve System, coupled with a very gradual course of monetary policy tightening and the decline in vulnerabilities in major EMEs, appears to have eased the risk of a disorderly tightening of global financial conditions. On the other hand, although policy actions to support activity have helped allay concerns about the near-term prospects for China, medium-term vulnerabilities remain elevated, given further increases in leverage. In addition, geopolitical tensions remain high. At the same time, new sources of risk have emerged – in particular, there is significant policy uncertainty surrounding the intentions of the new US Administration regarding fiscal and, especially, trade policies, the latter entailing potentially significant negative effects on the global economy. Moreover, the expected gradual recovery of the world economy is contingent on a number of important assumptions about policy, and it remains heavily reliant on ongoing monetary and fiscal policy support. Overall, therefore, although some risks appear to have diminished, the balance of risks to the global outlook remains tilted to the downside.