Box 2.3

Medium and long-term growth outlook of major economies

The recovery in major advanced economies have been slow and unstable in the past five years, reflecting the profound legacies of high unemployment levels, excess capacity and weighty debt burdens left by the financial meltdown of 2008. Despite the improved outlook for 2014, activity in many advanced economies further down the road will likely be constrained if these issues are not addressed by fundamental reforms promptly. Besides, the new challenges arising from US monetary policy shifts and slower trend growth of emerging market economies have also surfaced. Coupled with the global population ageing headwinds in the longer term, there are concerns that the more volatile and less growth-supportive external landscape post-financial-tsunami would become a new norm.

The journey of recovery in the euro area is still fraught with difficulties, as fiscal retrenchment will likely continue for a few years given that the public debt loads of many member states still exceed targets and as the weak credit dynamics could pose further obstacles to the private demand recovery. Consumers in the region may also stay frugal unless the labour market recuperation accelerates. Further ahead, the labour market rigidity and other structural problems could add friction to the recovery, while the much-needed reforms to rebuild fundamentals could confront notable political resistance amid growth sluggishness. Although the policy initiatives taken by the EU leaders to resolve the debt problems in the past few years are steps in the right direction, the eurozone is still not totally out of the woods, and there is still a long way to go to establish a robust monetary union to avoid renewed financial distress in future. Hence, the EU Commission, the IMF and most private analysts forecast the real GDP to grow by around 1.5% per year between 2015 and 2018, which is lower than the average rate in the decade before 2008 (***Chart 1a***).

By comparison, the US economic recovery has stronger support deriving from improving fundamentals in the housing market, quick adjustments of financial institutions' balance sheets, and growing benefits from the shale gas revolution. However, the optimism has to be qualified by the still-slow job recovery featured by fits and starts, the possibility of further deleveraging by households and the absence of a medium-term fiscal consolidation plan. Apart from these problems, the US growth potential in the longer term will likely fall due to slower increases in labour force and productivity amidst population ageing, a common formidable challenge to many economies in the next decade. As such, the IMF, the Congressional Budget Office, the Federal Open Market Committee (FOMC) participants and most private analysts generally forecast a further acceleration of US economic growth in the coming two to three years, followed by a gradual convergence to a lower longer-term potential growth rate (***Chart 1b***).

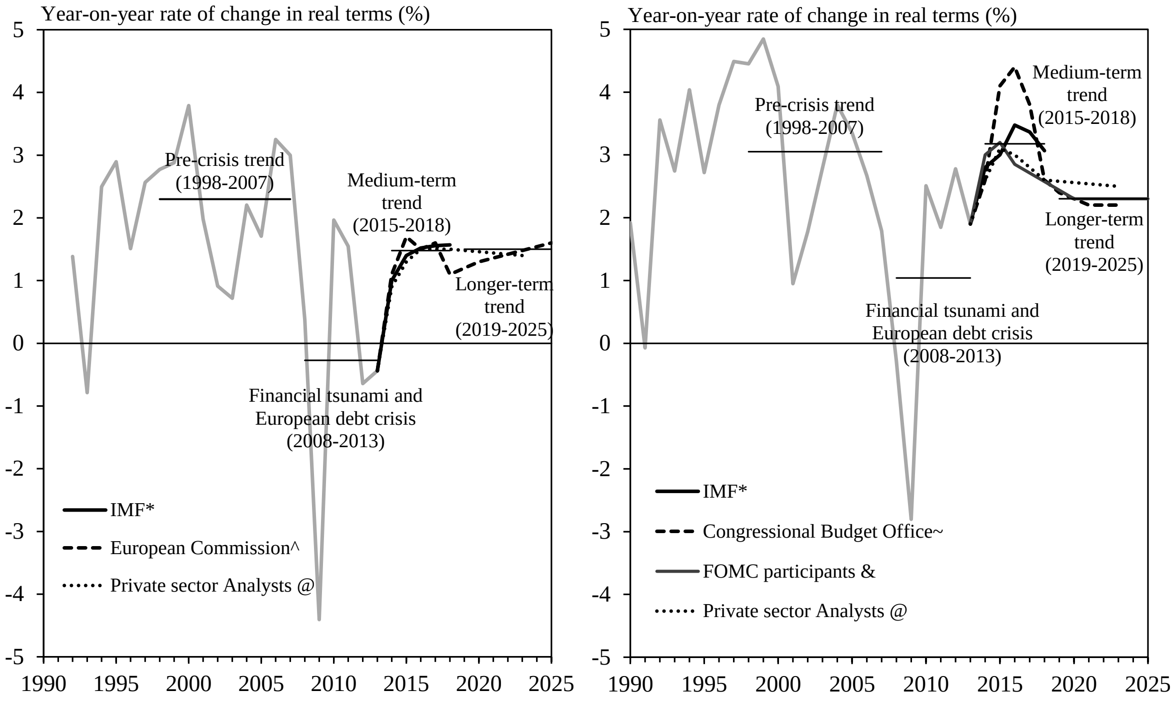
Moreover, the expected acceleration of US economic growth in the near term aforementioned is a mixed blessing, as it would be accompanied by a narrowing output gap and thereby growing risks of monetary stimulus exit and the initiation of the interest rate hikes. At this stage, the Fed seemingly prefers gradualism, but the ultimate exit strategy will actually be contingent on US economic performance as well as price stability. The impacts on global financial conditions and real activity in the coming years over the course of the Fed's monetary policy normalisation are still uncertain, depending on the speed of the Fed's exit and the clarity of its communication, the cyclical positions of other economies, and the capability of the emerging markets in contending with capital flow volatility and rising interest rates.

Box 2.3 (Cont'd)

Chart 1 : Longer-term GDP growth projections for the US and euro area

(a) Euro-area growth on balance is expected to stay below the pre-crisis level

(b) US growth is expected to accelerate first before converging to a lower trend growth



Source: (*) World Economic Outlook October 2013 and January 2014 Update; (^) European Commission 2012 Fiscal Sustainability Report and Autumn 2013 European Economic Forecast; (~) Congressional Budget Office Economic Baseline Projections, February 2013; (@) Consensus Economics October 2013 and February 2014; and (&) FOMC projection materials, December 2013 meeting

As the recipients of massive excess liquidity, emerging market economies are exposed to the risks of capital flow reversals, tighter financial conditions and slowdown in real activity during the Fed's exit to its unconventional monetary easing, with economies having lax financial supervision and large external imbalances being more vulnerable. Apart from global monetary risks, the performance of export-oriented emerging economies, including those in Asia, may still be constrained by the sub-par recovery of many advanced markets. With a more volatile capital flow environment, a less buoyant external demand, compounded by supply-side bottlenecks in individual countries, the trend growth of emerging markets as a group is likely to moderate in the coming years, according to the IMF, to around 5.4% per year between 2015 and 2018, which should still outpace their developed peers and remain the world's growth pillar.

The Mainland should continue to be an important anchor for the world economy. Economic reforms in a wide range of areas will be deepened, aiming at rebalancing the economy towards an intensive growth model propelled by productivity gains. Decisive reform results in important fields are expected to be achieved by 2020, through which the nation's long-term growth sustainability would be enhanced. Given the strong underlying fundamentals, and the anticipation of new potential unleashed by reforms, the IMF envisaged that the Mainland will grow by around 7 percent per year between 2015 and 2018. Such a solid and robust growth, though lower than the double-digit pace in the past decade, would still be among the highest in the global league, making it a vital stabilising force to the global economy in the medium to longer term.