FROM THE CAPITAL

IMF: 2015 growth risks drop

General assumptions about future metal usage rates based on historical outcomes need rethinking

John Robertson

The latest International Monetary Fund (IMF) half-yearly World Economic Outlook report was unusual. In a heartening move for the mining industry, the IMF did not cut back its forecast for global output growth in the year ahead.

Resource-sector investment strategy is a constant search for variations in output growth momentum that can make the difference between stronger raw-material demand and slumping market optimism. The analysis produced by the IMF about the sources and composition of growth is of particular interest in tracking what is happening.

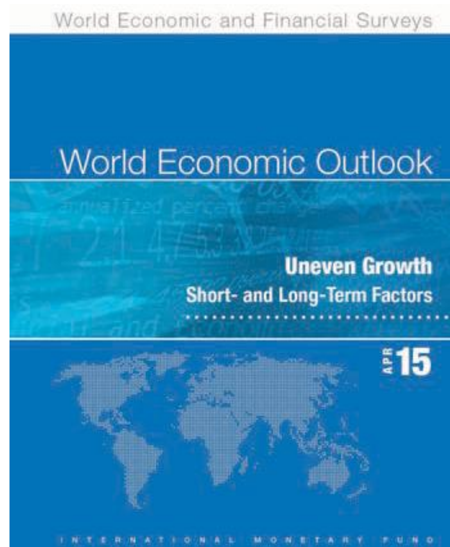
Over the past several years the IMF has typically been starting with a forecast of at least 4% growth in global output for the year ahead before paring it back as the risks to growth have loomed larger. In this, they have been little different to others trying to adapt their views to changes in the cycle.

The investment significance of these changes rests not only on the expected rate of growth itself but on the direction of the revisions as a sign of cyclical evolution. As long as forecasts are being pulled back, investment market confidence is likely to be low or falling. If forecasts are on the rise as the strength of the global economy is being underestimated, confidence about the outlook should be building.

The latest numbers indicate a transition between falling confidence about the future and rising optimism. The magnitude of the change is not yet enough to create genuine excitement, but is indicative of some progress through the cycle.

Within the IMF forecasts, there were some important divergences. Among the advanced economies, upward revisions for growth in Europe and Japan have been offset by lower expected outcomes elsewhere. Among emerging markets, positive revisions for India are offset by cuts to forecasts for Russia – which the IMF sees in a lengthy recession – Latin America and Africa.

The world continues to grapple with some of the economic legacy issues arising from 2008 and 2009, but two developments have contributed to the relative optimism now evident. One is lower oil prices. The head of research at the IMF described the drop in prices in his press briefing as "a very good thing", although the gains are not unqualified as the outlook for Russia, among other oil exporters, attests.



The other factor contributing positively to the outlook has been US dollar appreciation resulting in improved competitiveness for Europe, Japan and many developing economies. Here, too, there are winners and losers. The USA and China are among the losers. As the IMF points out, however, these two are probably the most able of all the national economies to adapt to change.

Within Europe, borrowing costs have come down for financial institutions, but the beneficial effect of cheaper capital on the real economy is still in the pipeline. Having contracted in 2013, European output expanded by an estimated 0.9% in 2014, which the Fund expects to accelerate to 1.5% and 1.6% growth in 2015 and 2016, respectively. These expected growth outcomes are up to 0.3 percentage points higher than forecasts made a year ago and indicative of rising confidence about the outlook.

This more optimistic view about Europe is shared. Among the most bullish are the staff economists at the European Central Bank. They are forecasting that an expansion of 1.5% in 2015 will increase to 1.9% and 2.1% in the following two years. As recently as December, they had been expecting 1% in 2015 and 1.5% in 2016.

Having been consistently too optimistic about the outlook, the IMF's starting point for growth in the upcoming calendar year is lower than for any recent year since 2010, with very modest future accelerations by historical standards. This might prove an overly pessimistic reaction to recent forecasting disappointments, but the IMF has been influenced by a detailed analysis of future potential growth also published in the past week.

On the IMF's reckoning, global potential growth, primarily driven by a combination of demographic factors dictating the size of the labour force and productivity, is now lower in both advanced and developing economies compared to what could have been expected prior to the 2008 financial crisis.

The slowdown in potential growth in advanced economies began earlier than 2008, but both economic groupings are now suffering the same fate, according to the IMF's study.

Its conclusion about future growth potential comes with some important qualifications but, if the IMF is right, assumptions about future growth trends based on past experience would need reappraising. There is an implied warning in this analysis for the mining industry against simplistically extrapolating metal usage rates.

The increasing share of relatively metal intensive investment spending in emerging economy GDP, which drove raw material usage rates in the 2000s, already appears to have ended. A compensating lift in the share of advanced economy investment spending will rely more heavily on private-sector discretionary spending than the development-driven outcomes that gained momentum through 2003-08 in emerging economies. Hard to foresee fiscal flexibility will also be needed if government spending is to contribute.

There will be important variations from commodity to commodity, but, in general, these conclusions are a warning to the industry that assumptions about future metal usage based on historical outcomes need rethinking.

The iron-ore miners are real-time evidence of what can happen when forecasting frameworks do not take proper account of the macro drivers for an industry. Their unrealistic – and ultimately counterproductive – assumption that the investment intensity of China's economy would keep rising despite analysis to the contrary, for example, has landed them in a grim commercial place.

The onus should be on companies soliciting investments to take account of the best available analysis available on the subject or show reasons why it does not apply to them. The IMF has provided a cogently argued piece of analysis that challenges the industry to adjust its thinking to accommodate a different operating framework over the coming years. ▼

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