Section 3 Risk factors

As has been described so far, the economies of advanced economies have been on a recovery trend after the global economic crisis and the European debt crisis, and the United States has started tapering its quantitative easing program. On the other hand, there is the risk that capital inflow from advanced economies that has supported emerging economies' high economic growth may decline, and this risk could result in a further economic slowdown in emerging economies whose fundamentals are weak. Below, we will look at risk factors faced by the world economy.

1. Turmoil in financial markets due to the tapering of the U.S. quantitative easing program

As shown by the sequence of events related to the tapering of the U.S. quantitative easing program, financial markets in emerging economies have strengthened their resilience against risks but still remain vulnerable to the volatility of the monetary environment. If interest rates rise rapidly during the process of the tapering of the quantitative easing program due to factors such as a better-than-expected condition of the U.S. economy, changes in the market's anticipations and the acceleration of the tapering, that may cause significant changes in the monetary environment in other countries. If such changes increase concern over the vulnerability of some emerging economies' fundamentals, the flows of securities investments may be reversed and loans may be withdrawn rapidly. Such a situation not only would cause major changes such as rapid falls in currencies and stock prices of the relevant emerging economies but also could destabilize financial markets on a larger scale by associating concern over other emerging economies as well.

2. Further economic slowdown of emerging economies

Investors have become increasingly concerned over emerging economies because the medium-term outlooks for their economies are lower than expected. In some emerging economies, the monetary environment has tightened, and investments and durable goods consumption have slowed down more than expected as a result of the rising fund-raising costs for companies. If monetary tightening, acceleration of the FRB's quantitative easing program, and investors' increasing risk-aversion add to these factors, that could throw financial markets into turmoil and trigger capital outflow, bringing a situation to which emerging economies may find difficulties to adjust their markets. If such a situation spreads and the financial stress increases, that could pose a downside risk for economic growth.

3. Slowdown of the Chinese economy

The Chinese government is reducing investments in order to promote structural reform, but there is the risk that this will put further downward pressure on the economy. In addition, amid growing concerns over the financial stability in China, the central government is restricting credit expansion and borrowings by regional governments. While these measures may reduce the vulnerability of financial markets, China's economic growth could be curbed more than is now projected if the financial tightening proceeds more quickly than expected. In that case, there is the risk that the recovery of the world economy will be further delayed.

4. Low inflation mainly in advanced economies

In many advanced economies, the inflation rate is lower than their targets, so there is the risk that their economies may fall into deflation if such shocks that could damage their economies arise in the future.

In addition, if the inflation rates are stuck in the levels below the targets, long-term inflation expectations may decline. Moreover, as policy interest rates have already fallen close to zero in major advanced economies, the room for further monetary easing is limited. As a result, there is the risk that a rise in real interest rates will increase the real debt burden and impede economic activities. In euro-area countries and other advanced economies, there is the risk that economic growth will remain sluggish resulting from such factors as low wages, restrained consumption behavior and a slowdown in corporate earnings growth due to low inflation.

5. Geopolitical risks related to Ukraine

The conflict between Russia and the Western countries has become serious as a result of the turmoil that occurred on the Crimean Peninsula In February 2014. There are concerns over retaliatory measures that may be taken by Russia, such as the suspension of natural gas pipelines extending to Europe, in response to the imposition of sanctions imposed by the Western countries. In addition, concerns grew over the risk that Ukraine would be bankrupted by its huge amount of foreign debts, raising expectations of financial market turmoil and heightening tensions on a global scale. In response to this situation, there are concerns that the economic growth of Russia and Ukraine may slow down and that the impact may spread to the CIS. If the turmoil deepens in the future, or if sanctions and retaliatory measures are implemented on the trade and financial fronts, global financial markets could face new risks and the economies not only of neighboring trade partners but also of other countries could be depressed. There are also concerns over the impact on production and transportation of natural gas, crude oil, corn and wheat.