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Federal Reserve Bank of Dallas

The Global Outlook Is Weakening

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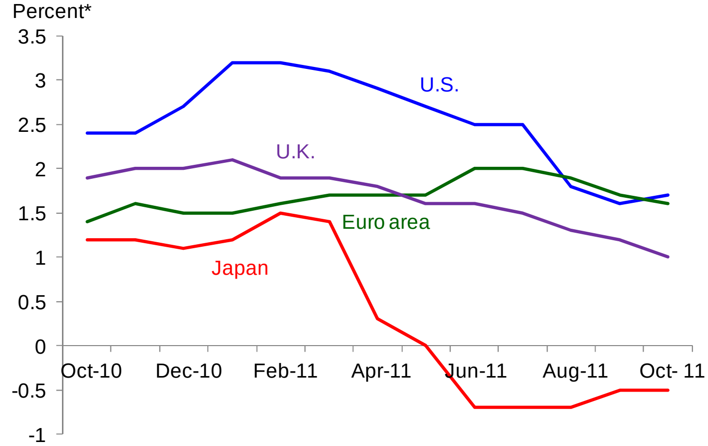
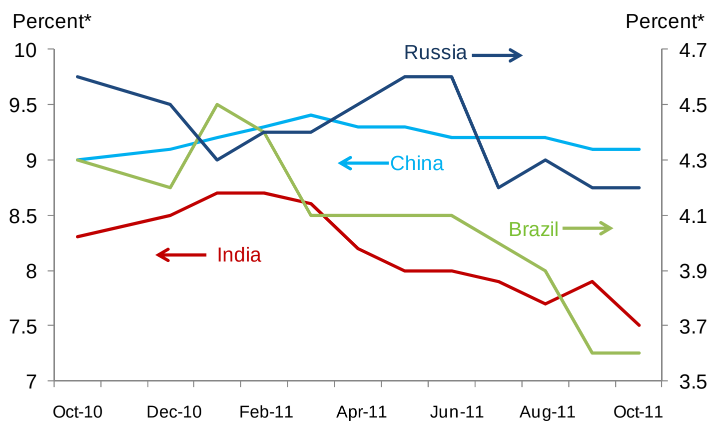
A slowdown in economic activity has materialized at the global level. In October, both advanced and emerging economies faced downward revisions in real gross domestic product (GDP) growth prospects for 2011. Investor uncertainty has heightened, causing increased market volatility. Recent economic activity suggests a more optimistic outlook for the U.S. relative to other advanced economies. The U.S. is benefiting from high labor productivity, which creates positive implications for capital inflows and international trade.

Chart 1
2011 Real GDP Growth Forecasts Predict Advanced Economies will Slow



*Year/year.
SOURCE: Consensus Economics.

Chart 2
2011 Real GDP Growth Prospects Down in Emerging Economies



*Year/year.
SOURCE: Consensus Economics.

Advanced Economies Slow Due to Europe Concerns

Growth prospects for advanced economies in 2011 mirror the decline in economic sentiment. Chart 1 shows the evolution of the 2011 Consensus Forecasts for real GDP growth in four major advanced economies. The October 2011 consensus showed a downgrade in expected real GDP growth for both the Euro area and the U.K. These economies are particularly vulnerable to further adverse spillover effects. Additional Greek debt reforms were introduced at the end of October to ease some of the financial strain that is impeding economic output in European economies. However, this failed to generate confidence among investors regarding future European stability. Government bond yields for the European economies remain at elevated levels. Italy's 10-year government bond yield surpassed 6 percent at the end of October. This is an important threshold; levels above 6 percent indicate unsustainable debt levels. Italy remains a major concern because of the magnitude of debt relief that will be required should the country default.

Emerging Economies Feel Effects of Decreased Global Demand

Once resilient to dampened economic activity, the emerging economies also experienced a decline in real GDP growth prospects for 2011, albeit not as severe (*Chart 2*). Slower economic activity is a result of declining global demand and the contractionary policies implemented in response to rising inflation. The export sector has been a major contributor of real GDP growth for the emerging economies, but poor performance in advanced economies has led to a decline in demand for exports. Another factor causing a decline in exports is the appreciation of emerging-market currency, which drives up export prices. From July to August, nominal exports of goods fell 13.6 percent in India. From August to September, nominal exports fell 3.8 percent in China and 5.6 percent in Brazil.

Slower economic activity in emerging economies is also a result of tightened policy rates, which have succeeded in taming inflation. Brazil, Russia, India and China all experienced a decline in consumer price index (CPI) inflation rates year over year for September. However, slower economic growth is a byproduct of these contractionary policies. The drop in economic performance resulted in Brazil easing policy rates in September and again in October. Though the economies have begun to see a decline in projected output, this slower growth should be seen as a healthier pace of expansion.

Markets Volatile as Investors Face Uncertainty

With economic prospects weakening at the global level, investor uncertainty is playing out in the equity, commodity and currency markets (*Chart 3*).

In response to slower global growth, investors left equity markets in favor of less-risky assets. The world equity index, a global aggregate of stock indexes weighted by market capitalization, declined 14 percent from May to October. The commodities market has also experienced large declines, decreasing 15 percent from May to October. However, the subsequent release of more favorable economic data has shifted investor sentiment back toward equity markets. Both equity and commodity markets reversed their downward paths in October due to better-than-expected economic data; industrial production figures for both advanced and emerging economies indicate the pace of expansion reached in second quarter 2011 should be maintained.

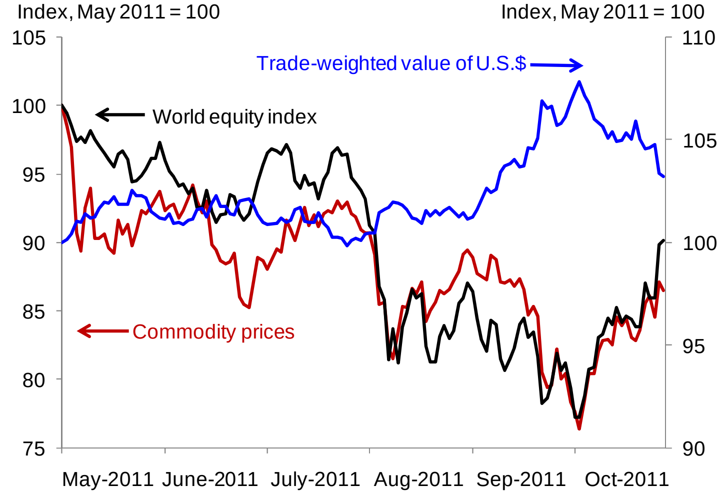
The trade-weighted value of the U.S. dollar is negatively correlated with global equity and commodity markets. As investors fear global growth is stalling, they are more inclined to invest in U.S. assets, which are seen as a safer option. When global activity becomes more robust, the trade-weighted value of the U.S. dollar declines. A positive outcome of a decline in the U.S. dollar is increased trade activity. U.S. exports become more attractive because a falling U.S. dollar pushes down export prices. Higher labor productivity in the U.S. relative to other advance economies also promotes an increase in trade activity.

U.S. Benefits from Labor Productivity

Though the 2011 outlook has weakened for most advanced economies, the 2011 Consensus Forecast for 2011 real GDP growth in the U.S. was revised upward in October. One factor contributing to stronger U.S. economic activity is higher labor productivity, which is measured by real GDP per worker (*Chart 4*).

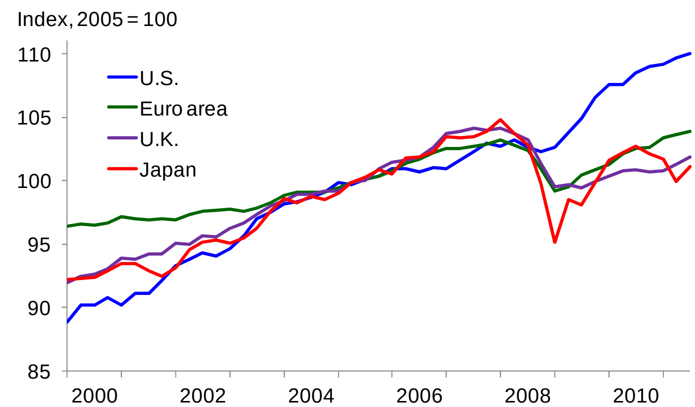
What is remarkable about labor productivity in the U.S. was its continued strength during the 2008 recession. It is common for labor productivity to drop at the onset of a recession, which occurred in the other advanced economies. Labor productivity eventually rebounded in these economies, but the U.S. experienced increases at a much higher rate. The implications of a permanent drop in foreign productivity are mixed. On one hand, it results in weaker global economic activity by generating a drop in global supply and an increase in costs, translating into higher prices. On the other hand, it is favorable for U.S. economic activity because it attracts capital inflows and heightens trade competitiveness. The effects of the labor productivity differentials can be seen by comparing aggregate stock indexes for

Chart 3
Investor Uncertainty Moves Markets



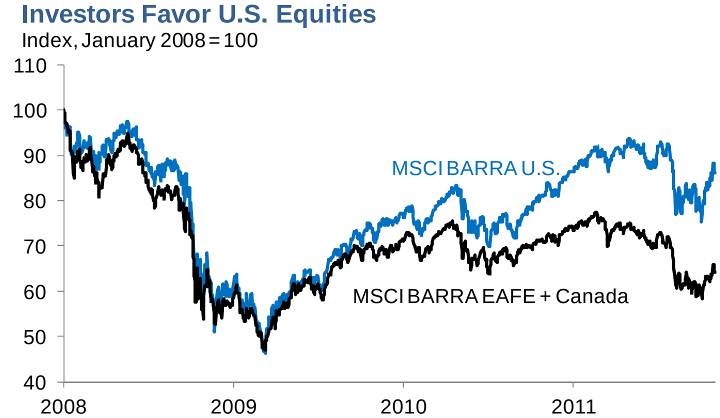
SOURCES: Haver Analytics; Bloomberg.

Chart 4
Labor Productivity Remains Strong in U.S.



SOURCE: Haver Analytics.

Chart 5
Investors Favor U.S. Equities



NOTE: The MSCI BARRA indexes are designed to measure equity performance in advanced economies. Countries included in the EAFE + Canada aggregate are: Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the U.K. It is weighted by market capitalization.
SOURCE: Bloomberg.

the U.S. and other advanced economies (*Chart 5*).

Global Outlook Remains Cloudy

As investors remain uneasy about the outlook for economic conditions, markets will remain volatile. This has fewer consequences for the U.S., which is benefiting from increased capital flows and favorable trade conditions due to high labor productivity. The outlook for European countries rests on the ability of authorities to resolve the burdensome debt problems. The emerging economies will likely see a softening of economic activity due to a decrease in global demand, placing growth levels on a more sustainable path.

—Adrienne Mack

About the Author

Mack is a research analyst in the Research Department of the Federal Reserve Bank of Dallas.