Economic Update INTERNATIONAL
Federal Reserve Bank of Dallas

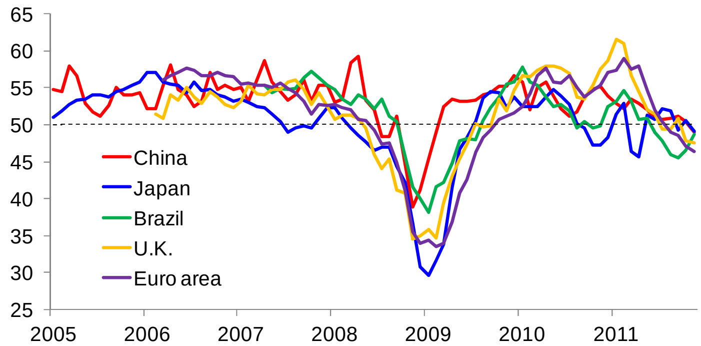
Global Growth at an Inflection Point

December 15, 2011

At the end of 2010, the global recovery from financial crisis appeared to be gaining self-sustaining momentum for both advanced and emerging economies; in 2011, the pace of recovery stalled, particularly in the first half of the year. While partly due to supply chain disruptions from calamities in Japan and Thailand and oil price spikes from political unrest in the Middle East, this slowdown was exacerbated by uncertainty regarding fiscal consolidation commitments in the U.S. and the threat of sovereign debt default contagion for euro-area economies, which looks to be the most substantial risk to the global recovery in the near term.

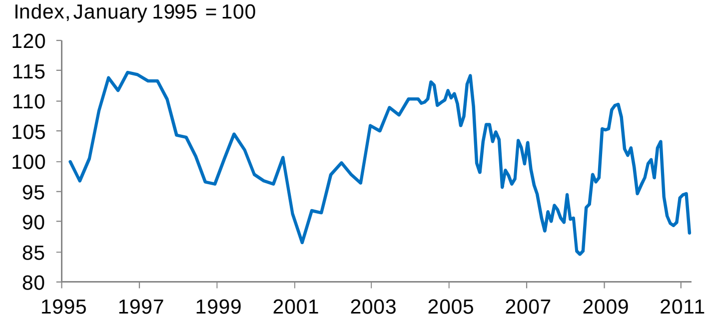
Additionally, emerging economies will likely see slowdowns in export and capital inflow growth from advanced economies in the coming year. They also face the challenge of stemming unsustainable credit expansion while maintaining growth momentum. These developments have given way to steady downgrades to 2012 global gross domestic product (GDP) growth forecasts throughout the year, though positive growth is still anticipated. With lower growth, commodity prices and inflation should retreat from peaks reached earlier this year.

Chart 1
Manufacturing PMIs Signal Contraction in Large Economies



NOTE: A value above 50 signals expansion in manufacturing activity, while a value below 50 signals contraction.
SOURCES: Haver Analytics; Bloomberg.

Chart 2
Consumer Confidence Nears Recessionary Trough



NOTE: The consumer confidence aggregate is a GDP-weighted average of consumer confidence indexes in the U.S., Germany, euro area and Japan.
SOURCE: Bloomberg.

Material Slowdown in Manufacturing Activity

Industrial production data and Purchasing Managers Index (PMI) surveys indicate that global manufacturing activity has slowed in the fourth quarter of this year and will likely stagnate or dip further in the near term.[1] In September, industrial production in advanced economies grew by just over 2 percent, the most sluggish pace seen since December 2009. November PMI surveys came in at 49.1 for Japan, 49 for China, 48.7 for Brazil, 47.6 for the U.K. and 46.4 for the euro area, all signaling contraction (*Chart 1*).

Manufacturing activity suffered from a temporary shutdown in global production networks due to natural disasters in Japan and Thailand. More trenchant is low demand from businesses and consumers, who lack certainty regarding the level of coordination and effectiveness of major policy decisions facing the world's largest economies. This uncertainty, fomented by persistently high unemployment levels and an unclear path toward debt sustainability in the medium term, is reflected in consumer confidence indicators for various major economies, which have reached lows historically seen in a recession (*Chart 2*).

Spillover Effects and Growth Tradeoffs in Emerging Economies

Having fared comparably well in the global financial crisis and subsequent recovery, emerging economies will likely feel the effects of stalled growth from advanced economies as well as face challenges of their own: Unprecedented lending levels financed through robust export demand growth and high commodity prices have the potential to cause asset bubbles, especially since capital inflows to these economies are volatile. Moreover, output growth in major emerging economies like China and Brazil is export-driven; thus, a drop in export demand would leave these economies particularly vulnerable to growth slowdowns.

Due to both contractionary policy moves from monetary authorities and lower food and energy prices, headline inflation levels in emerging economies have abated. In November, consumer prices increased by 6.7 percent in Russia, 6.6 percent in Brazil and 4.2 percent in China from a year ago, continuing a downward trend from the past four months (*Chart 3*). Emerging-economy central banks face a delicate balance of stemming unsustainable credit expansion that can fuel asset bubbles on one hand and keeping benchmark rates low enough to maintain growth momentum on the other. In 2012, inflation will likely depend on demand from advanced economies and the manner in which policymakers respond to new developments.

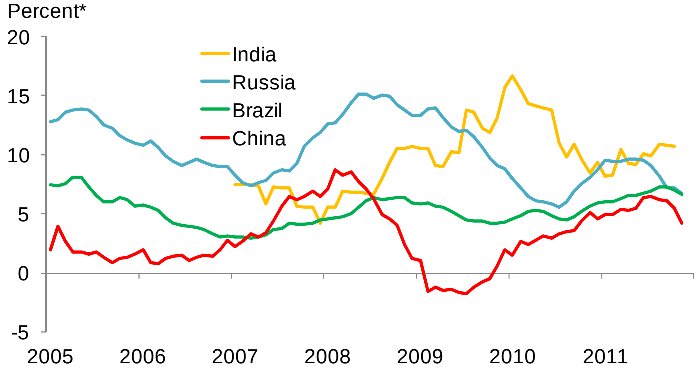
All Eyes on Watch for Euro-Area Debt Resolution

The lack of clarity on how peripheral euro-area economies will fulfill their sovereign debt obligations while avoiding at least partial default has enveloped the region, now threatened with recession. Though recent talks between German Chancellor Angela Merkel and French President Nicolas Sarkozy have revealed progress in charting out a plan for jointly supporting debt-ridden peripheral economies and stopping momentum from reaching the core European banking system, eliciting stronger fiscal commitments from member economies has proven difficult.

When a country controls its own currency, the penalty for over-indebtedness is devaluation against other currencies, which affects domestic activity through trade and finance channels. In the euro area, nations retain sovereignty while ceding control of their currencies to the European Central Bank, and punitive borrowing rates on government debt substitute for currency devaluation. However, if a country were to become unable to raise sufficient funds to pay its creditors, all members of the currency union would suffer, and creditors would rapidly shift debt holdings and demand payment in a perceivably more reliable currency. The effects of a default would reach far beyond Europe, since banks in other countries are significantly exposed to euro-denominated debt (*Chart 4*). This interconnectedness is the source of the possibility for contagion.

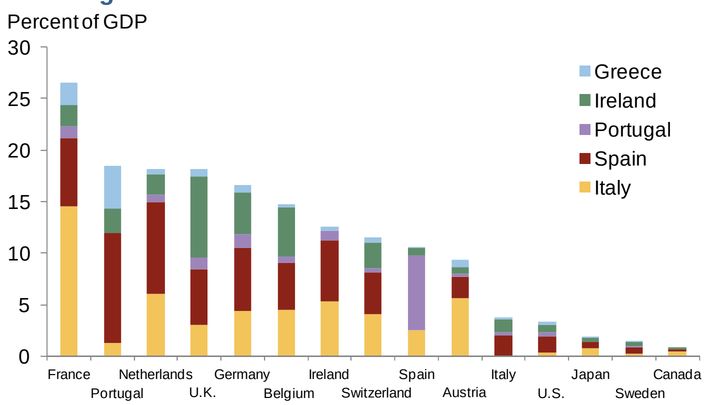
The European Financial Stability Facility was established

Chart 3
Inflation Pressures Easing in Emerging Economies



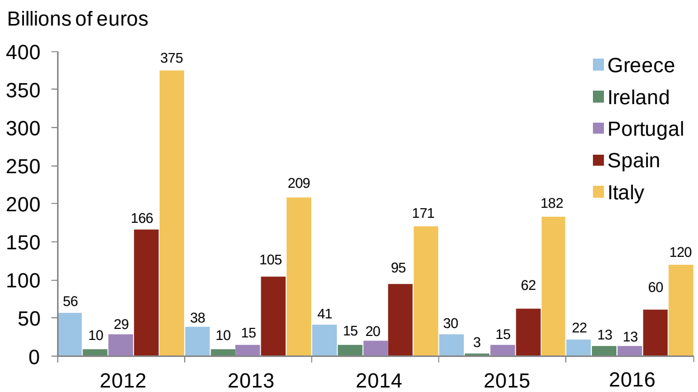
*Year/year.
SOURCE: National statistical offices.

Chart 4
Select Economies' Banking Exposure to High-Risk Sovereign Debt



NOTES: The chart plots the total claims that banks in each country have, as a share of its estimated 2011 GDP, on sovereign debt in Greece, Ireland, Portugal, Spain and Italy. All values are nominal.
SOURCE: Bank for International Settlements.

Chart 5
Sovereign Debt Repayment Schedule for Select Euro-Area Economies



NOTES: Repayment amounts include both principal and accrued interest. All values are nominal.
SOURCE: Bloomberg.

in May 2010 to serve as a stopgap for countries in need of emergency lending, but the fund is not large enough to cover a default scenario from Spain or Italy, whose sovereign debt obligations in 2012 together exceed 540 billion euros (*Chart 5*).

Conclusion

Growth in advanced economies stalled in 2011 due to unforeseeable manufacturing setbacks, deep uncertainty concerning appropriate fiscal support for the recovery and persistent weakness in consumer demand. Arriving at a solution for indebted euro-area economies has become the major determinant of the direction of the recovery in the coming year. Emerging economies have avoided the deceleration of their advanced-economy counterparts but will likely confront the effects of lower exports and volatile capital flows. Though positive global output growth is forecasted for 2012, it is expected to be weak and subject to significant downside risk.

—Payton Odom

About the Author

Odom is a research assistant in the Research Department of the Federal Reserve Bank of Dallas.

Notes

PMI measures are indicators based on surveys of firms' assessment of whether economic conditions are expanding or contracting. They are published monthly by Markit Economics.