



### Growth Momentum Stalls as Euro-Area Uncertainty Persists

June 27, 2012

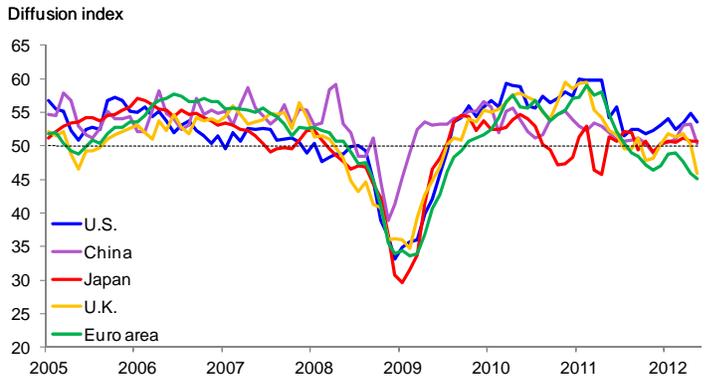
Global gross domestic product (GDP) growth forecasts have moderated in the second quarter, with industrial production and purchasing manager indexes reflecting restrained activity in advanced and emerging economies. Uncertainty regarding near-term stability of the euro area, which appears to be in recession, remains the most important determinant of expansion. While large emerging economies such as Brazil, Russia, India and China have led growth following the global financial crisis, their expansion has cooled to reflect slowing trade activity with advanced-economy partners as well as internal adjustments. Inflationary pressures and commodity prices have moderated.

#### Amid Greek Crisis, Euro Area Lacks Stability

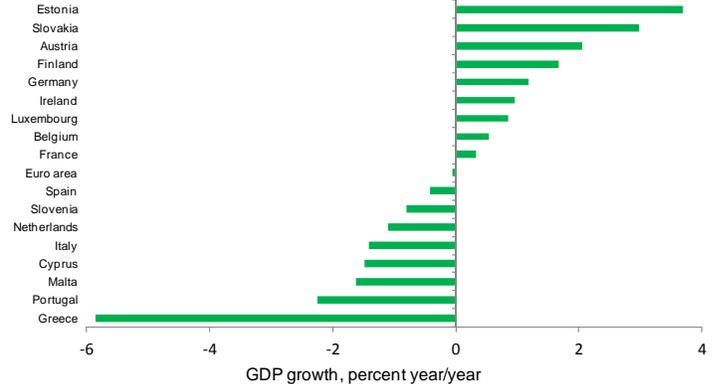
A “risk-off” sentiment—when fearful investors shun risk—is evident in purchasing manager indexes for June, which show declining growth or contraction in most major economies (*Chart 1A*). This reading supplants an upturn in industrial activity and prospects for growth during fourth quarter 2011 and first quarter 2012. GDP contracted in eight euro-area countries during the first quarter (*Chart 1B*). Policymakers fundamentally disagree on the structure of a solution to the region’s sovereign debt and banking crises. This indecisiveness has produced a series of stopgap measures to prevent bank runs and sudden sovereign-debt default while failing to fully bolster investor confidence.

The yield on Spain’s 10-year bonds on June 18 surpassed 7 percent, the threshold at which bailout assistance is commonly thought to be necessary. One of Spain’s largest banks, Bankia SA, requested a €19 billion recapitalization package from the Spanish government on May 25, and third-party stress tests on the entire Spanish banking system, completed on June 21, revealed recapitalization needs of between €51 billion and €62 billion. These developments prompted investor concern that the euro-area debt and banking crisis is reaching a scale that challenges the combined capacities of the European Central Bank (ECB), European Union (EU) and International Monetary Fund. Not all periphery countries face the same uncertainty, however. Ireland affirmed the terms of its bailout package via referendum on May 31 and beat 2011 fiscal deficit targets by a full percentage point.

**Chart 1**  
Euro Crisis Affects Global Growth Prospects  
A. Manufacturing PMIs Turn South in Major Economies



B. Euro-Area Countries See Sluggish or Negative GDP Growth



NOTE: A value above 50 signals expansion in manufacturing activity, while a value below 50 signals contraction. 2011:Q4 values are used for Ireland and Luxembourg. SOURCE: Haver Analytics.

While the ECB shored up member financial institutions, lending them more than €1 trillion, no consensus has emerged within the euro area for closer fiscal and political ties between member countries to address broader issues. The source of this ambiguity resides in conflicts between national interests and the need for cooperation across the region. For example, Greece recently formed a coalition government that is expected to endorse the existing fiscal adjustment program, but only after a second round of elections on June 17, the eve of a scheduled aid disbursement. Such lack of clarity has roiled consumer and industrial sentiment throughout the currency union, including Germany, considered the region’s economic powerhouse (*Chart 2*).

The potential contagion effects from the euro area to other

economies are difficult to assess. On one hand, banks in advanced economies, especially outside the euro area, have reduced their exposure to the euro-area periphery. On the other hand, a sovereign or large bank default would affect over-the-counter financial activity, such as derivatives trading, credit commitments and guarantees. For the U.S., these additional connections suggest higher exposure to the euro area than direct foreign claims alone illustrate (*Chart 3*).

### Emerging Economies Feel Chill

Since advanced-economy GDP bottomed out in 2009 amid the global downturn, emerging economies have been the primary driver of growth, paced by rapid infrastructure development, attractive equity yields and increased consumer spending by a growing middle class. Recent data suggest that large emerging economies' growth prospects declined as advanced-economy import demand languished. Export growth to Europe—the EU is China's largest trading partner—has weakened in recent months (*Chart 4*).

Additionally, large emerging economies face their own challenges: an ongoing real estate adjustment in China, sluggish investment and consumer demand amid policy gridlock in India, and falling commodity demand in Brazil. As a result, monetary authorities have either embarked on an easing cycle or held benchmark rates steady (*Chart 5*). The People's Bank of China cut one-year deposit rates on June 7, the first such action since October 2008. Brazil instituted a 50-basis-point reduction in its target rate to 8.5 percent on May 31 and rolled back taxes on foreign capital inflows. India surprised forecasters by holding off rate increases despite persistent inflation pressures.

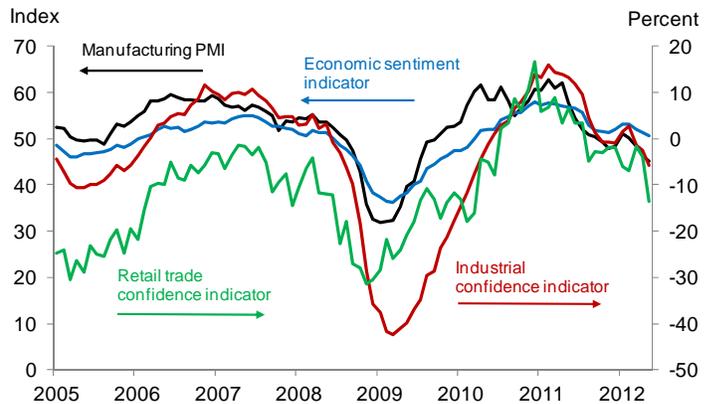
### Inflation and Commodity Prices Retreat

Demand for food and oil provided inflation momentum in emerging economies during the last three years, while advanced economies faced the specter of deflation in the aftermath of the global financial crisis. Since the start of the year, inflationary pressures have abated for most advanced and emerging economies (*Chart 6*). Forecasts indicate continued moderation for the remainder of the year. In April, the U.K. fell within the Bank of England's inflation target range of 1 to 3 percent for the first time since January 2010. Core inflation, a measure of price pressures absent movements in volatile food and energy categories, remains stable across major advanced and emerging economies.

### Continuing Recovery Depends on Credible Euro-Area Solution

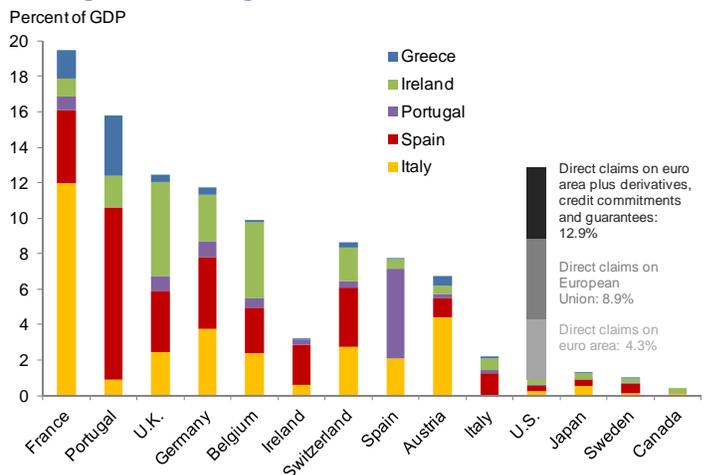
The outlook for global GDP growth for the remainder of 2012 remains positive, albeit significantly more modest than first-quarter forecasts. What is needed is a tenable, medium-term solution to the euro-area crisis, which is

**Chart 2**  
Growth Prospects in Germany Fall



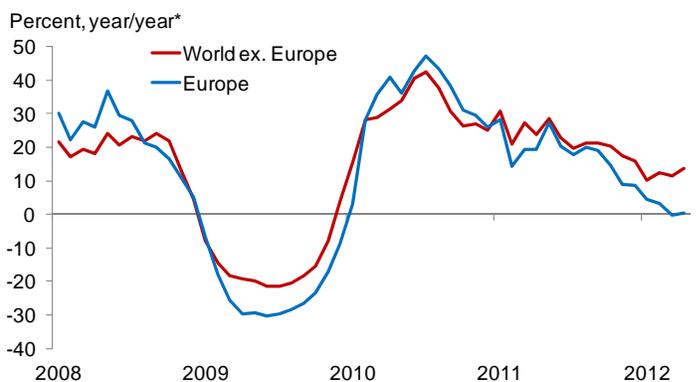
NOTES: The manufacturing PMI is a diffusion index, with values above 50 indicating expansion and values below 50 indicating contraction. The economic sentiment indicator is an index, with values above 50 signaling above-average sentiment and values below 50 signaling below-average sentiment. Industrial and retail trade confidence indicators are percent balances, with positive values reflecting a net-positive sentiment and negative values reflecting a net-negative sentiment.  
SOURCES: Markit; European Commission; Haver Analytics.

**Chart 3**  
U.S. Exposure to Euro-area Periphery Small, but Contagion Risk Larger



NOTES: The chart plots each reference country's direct bank exposure to the peripheral euro-area countries as a share of its 2011 nominal GDP. For the U.S., direct foreign claims on the entire euro area and the European Union are shown, as well as a measure of indirect exposure, measured by derivatives, credit commitments and guarantees extended to euro-area banks.  
SOURCES: Bank for International Settlements; Haver Analytics.

**Chart 4**  
China Export Growth Down to Europe but Robust Elsewhere



\*Three-month moving average.  
SOURCES: China Customs Bureau; Haver Analytics.

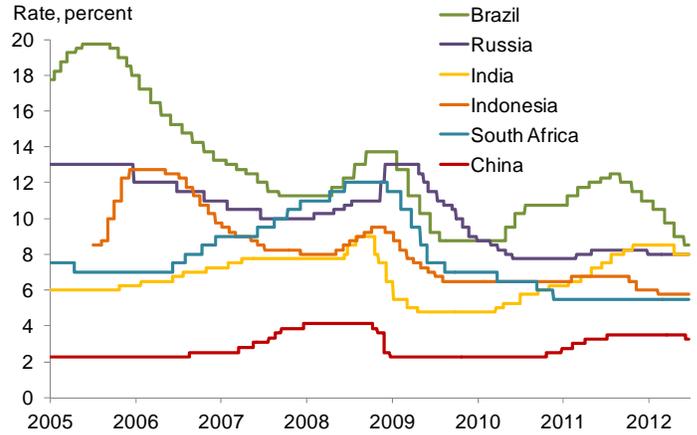
affecting financial markets and real economic output beyond its borders. Such a solution—addressing the threat of contagion and restoring competitiveness and growth prospects for member economies—is the linchpin of resolving global uncertainty, improving investor confidence and reigniting more-robust growth momentum.

—Payton Odom

**About the Author**

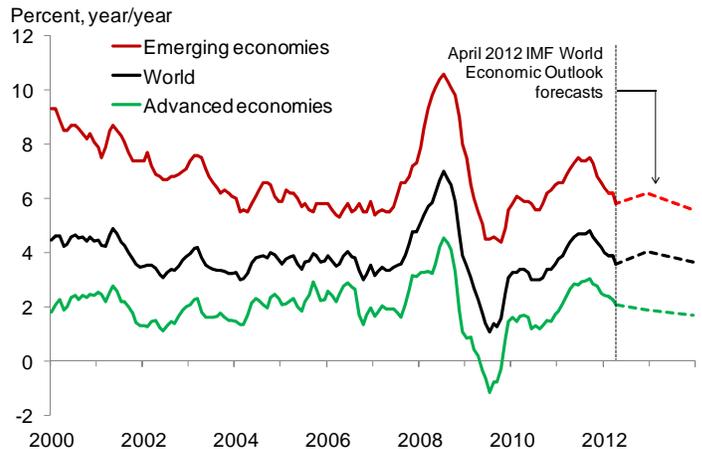
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**Chart 5  
Emerging-Economy Central Banks Hold Off Rate Hikes Amid Slowing Growth**



NOTES: The chart plots the SELIC overnight target rate for Brazil, the refinancing rate for Russia, the Bank of Indonesia (BI) rate for Indonesia, the repo rate for India, the one-year deposit rate for China and the average repo rate for South Africa.  
SOURCES: National central banks; Haver Analytics.

**Chart 6  
Global Inflation Pressures Ease**



SOURCES: Organization for Economic Cooperation and Development; International Monetary Fund (IMF); Haver Analytics.