DALLASFED Economic Update
International

Global Growth Prospects Lower on Continued Euro-Area Uncertainty

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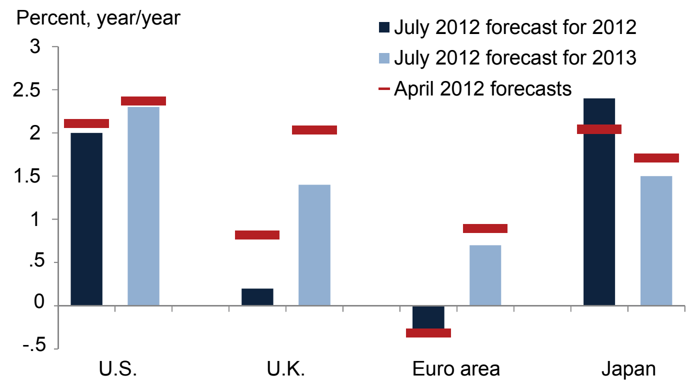
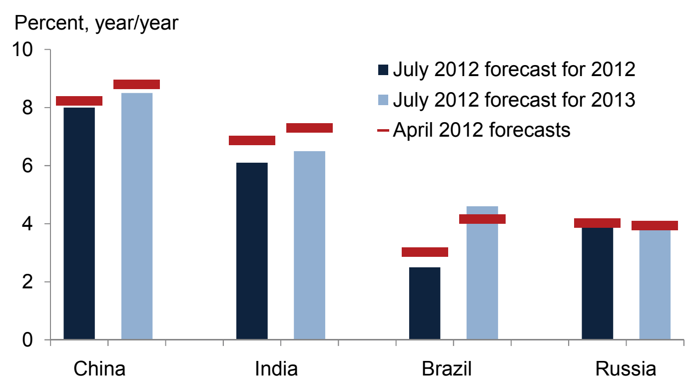
Near-term forecasts for global gross domestic product (GDP) growth have been revised downward in most advanced and emerging economies, with uncertainty surrounding the euro area continuing to restrain growth prospects (*Chart 1*).

With Spain's and Italy's financial stability in question and China's second-quarter growth rates lower than expected, central banks in advanced and emerging economies have lowered benchmark policy rates to stimulate flagging midyear output and employment growth numbers. While the United States is experiencing a positive, albeit moderate, recovery from the global financial crisis, the threat of sovereign debt contagion in the euro area is tempering growth and feeding uncertainty.

Chart 1
GDP Growth Forecasts Revised Downward
A. Slowdown Seen in Advanced Economies ...



B. ... as Well as Emerging Economies



SOURCE: International Monetary Fund.

Euro-Area Uncertainty Persists

Financial imbalances, structural impediments to growth and policy uncertainty continue to contribute to a negative outlook for the euro area. The 17 euro-area states have widely varying financial situations. An examination of balances in the region's TARGET cross-border central bank payment system provides evidence that periphery economies such as Spain and Italy are relying on the European Central Bank and core members such as Germany for bank liquidity (*Chart 2*). This reliance has created large payment deficits between debtor and creditor countries, exacerbating political tensions and revealing the need for structural reform.

Core countries have not escaped the threat of sovereign debt contagion, however: Moody's has lowered its outlook for Germany from stable to negative amid concerns that Greece may leave the euro area and that Germany may be charged with the responsibility of providing more funds to the euro-area periphery.

After reaching a yield of 7.18 percent on June 18, rates for Spain's 10-year government bond hovered slightly below the 7 percent mark for much of June and July, rose to a record high of 7.63 percent on July 24 and then fell back under 7 percent. Italy has also experienced rising borrowing costs. The spreads on 10-year Spanish and Italian bonds over the 10-year German bond have likewise been increasing (Chart 3). The rise in yields has drawn attention to these two countries' financial situations. European finance ministers agreed to a bailout for the Spanish government of up to €100 billion, but several regional governments, unable to pay civil-service wages or service debt payments, are now asking for assistance from Madrid as well. The size of Spain's and Italy's debt markets in comparison to those in Greece and Portugal suggests a higher capacity to absorb increased debt servicing costs and avoid default.

Adding to the global uncertainty stemming from the euro area are recent allegations that major investment banks manipulated the benchmark London Interbank Offered Rate, or LIBOR, to misrepresent their risk portfolios. The LIBOR is the most commonly used benchmark for short-term interest rates, serving as the base rate for $800 trillion in mortgages, loans and investments. Doubts concerning the accuracy of benchmark rates could serve as an additional drag on investor confidence in the region.

Monetary Policy Eases with Global Inflation Pressures

With inflationary pressures mostly low across advanced and emerging economies, monetary authorities in many countries are responding to the recent growth slowdown by lowering benchmark policy rates (*Chart 4*). The Bank of England, which already has a record low rate of 0.5 percent, has little room to enact rate changes. The bank left its rate unchanged and instead pledged a round of quantitative easing on July 5, adding £50 billion to an asset-purchase program that now totals £375 billion. The European Central Bank followed suit, lowering its main lending rate 25 basis points to 0.75 percent and its deposit rate to zero.

Emerging economies also tried to stave off spillover effects from the euro-area crisis by easing monetary policy. On July 5, China unexpectedly lowered its lending rate 31 basis points to 6 percent and its deposit rate 25 basis points to 3 percent following a rate cut in June. Brazil cut its policy rate to a record low of 8 percent on July 11; South Africa unexpectedly lowered its policy rate 50 basis points to a record low of 5 percent on July 19.

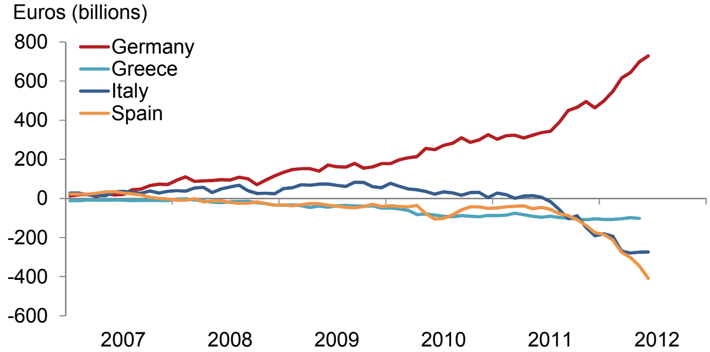
Major Emerging Economies Still Feel Chill from Euro Area

A closer examination of the impetus for China's policy rate cuts reveals that the pace of economic growth in China is slowing. China's manufacturing purchasing managers index, though up to 49.5 from 48.2 in June, still lies in contractionary territory. Moreover, in the second quarter, China's year-over-year GDP growth rate dropped to 7.6 percent, a pace last seen in 2009 (*Chart 5*). The International Monetary Fund (IMF) forecasts real GDP growth rates slightly above 8 percent for China through 2017.

With declining inflationary pressures accompanying softer GDP growth, investors remain uncertain as to whether China's slowdown is indicative of a soft landing or a more pronounced trend. China isn't the only emerging-market economy experiencing slowing growth. While emerging economies are seeing stronger growth than advanced economies, economic activity has decelerated, and the IMF revised its 2012 and 2013 growth forecasts downward for the BRIC economies (Brazil, Russia, India and China) in July.

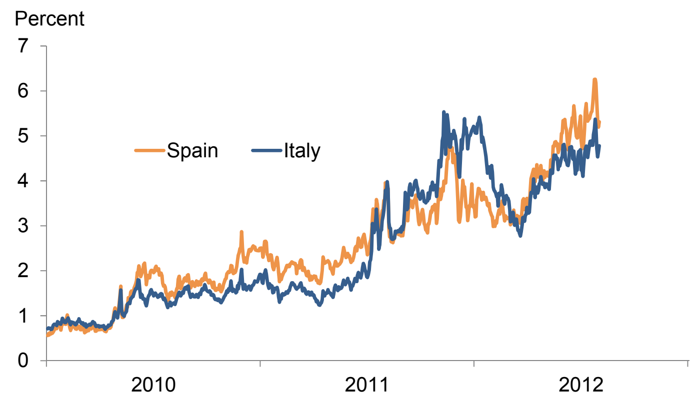
Global Problem Depends on European Solution

Chart 2
TARGET Balance Gaps Widen



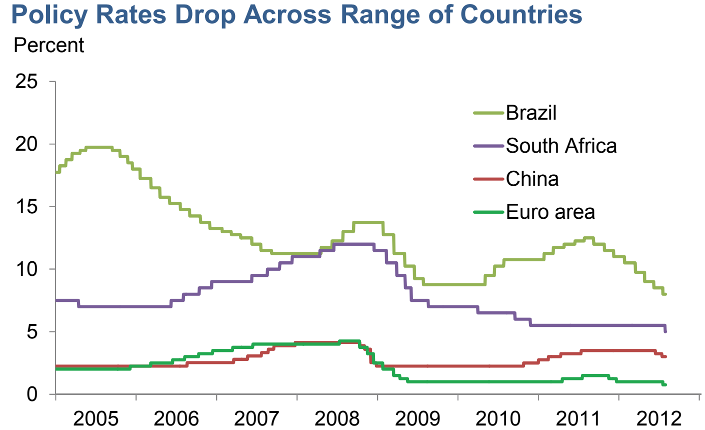
NOTE: TARGET is the cross-border interbank payment system within the euro area. When balances are above zero, nations show a surplus with the European Central Bank; when balances are below zero, nations are in a deficit position within the system.
SOURCES: Institute of Empirical Economic Research, Universität Osnabrück; national central banks; Haver Analytics.

Chart 3
Spanish 10-year Bond Spread Reaches New High; Italy Not Far Behind



NOTE: The chart plots the bond spread, or difference, between 10-year sovereign bonds for Spain and Italy and the 10-year German bond. A higher spread corresponds to higher risk.
SOURCE: Haver Analytics.

Chart 4
Policy Rates Drop Across Range of Countries



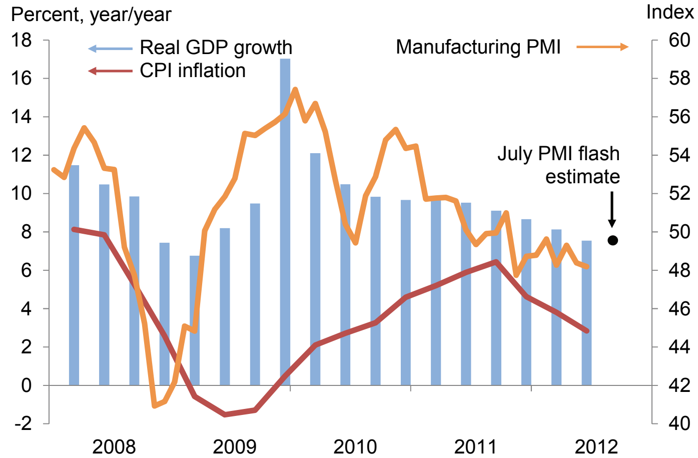
NOTE: The chart plots the overnight SELIC target rate in Brazil, the average repo rate in South Africa, the one-year deposit rate in China and the main refinancing rate in the euro area.
SOURCE: Haver Analytics.

The wide-reaching effects of the euro-area crisis are evident through trade and financial linkages across the globe, and GDP growth forecasts have been lowered in response to continued uncertainty in the region. Resolution of the region's most pressing problems is riding on credible fiscal and structural reform commitments in the euro area, and a renewed pace of growth appears unlikely without momentum from cooperative commitments between the area's member governments. In the second half of the year, both advanced and emerging economies are expected to see continued modest growth, accompanied by low and stable inflationary pressures.

—Payton Odom and Valerie Grossman

Odom is a research analyst and Grossman is a research assistant in the Globalization and Monetary Policy Institute at the Federal Reserve Bank of Dallas.

Chart 5
Manufacturing, GDP and Inflation Readings Point to Slowing Growth in China



NOTES: The manufacturing purchasing managers index (PMI) is a diffusion index, with values above 50 indicating expansion and values below 50 indicating contraction. Flash estimates are early indicators based on incomplete survey returns.
SOURCE: Haver Analytics.