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International Economic Update

Amid Risks, Global Growth Outlook Positive

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Recent gross domestic product (GDP) growth forecasts suggest that the advanced economies' rebound from the global financial crisis is on solid ground and that emerging economies continue to lead the recovery by a substantial margin.

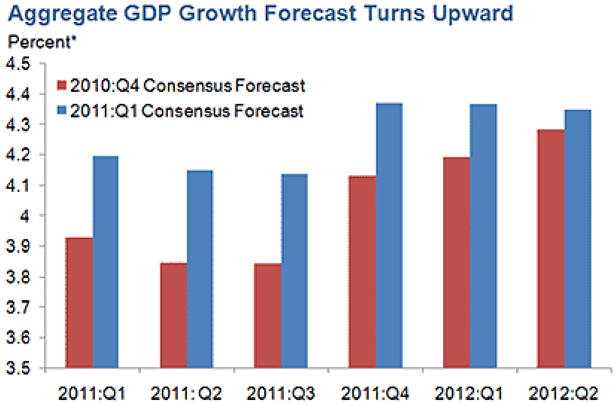
Business activity indexes signal expansion, and March unemployment data provide hope that stubbornly high advanced-economy rates are turning lower. At the same time, inflation has picked up. As nations meet or surpass central bank headline inflation targets, monetary authorities in both advanced and emerging economies have implemented benchmark rate hikes to blunt price pressures.

Though the outlook is robust, the Japanese earthquake and nuclear calamities, persistently high commodity prices and continuing fears of sovereign debt default in peripheral euro-area economies may impede the pace and scope of growth.

First-Quarter Developments Positive

Strengthening consumer demand and trade flows from emerging economies prompted an upturn in an aggregate global GDP growth forecast, which now indicates annual growth of 4.2 percent in 2011 and 4.3 percent in 2012 (*Chart 1*).[1] Emerging economies are outperforming advanced economies and surpassing forecasts; for example, first-quarter GDP in China grew a surprising 9.7 percent year-over-year.

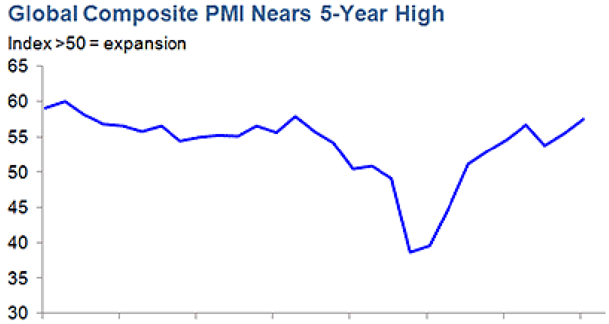
Chart 1
Aggregate GDP Growth Forecast Turns Upward



*Year-over-year annualized rates.
SOURCE: Consensus Economics.

The global composite purchasing manager index (PMI) reading in April suggests continued economic expansion. As a result of the Tohoku earthquake March 11 and subsequent nuclear accident, Japan's composite PMI dropped 15 points, lowering March's global index by almost 3 points.[2] Despite this slowdown, the data are encouraging, with the global composite index reaching its highest value, on a quarterly basis, since 2007 (*Chart 2*).

Chart 2
Global Composite PMI Nears 5-Year High



NOTE: Monthly data are aggregated to quarterly frequencies.
SOURCES: J.P. Morgan; Bloomberg.

Unemployment in advanced economies remains stubbornly high, but incremental decreases in some advanced economies hint at a broader turnaround. U.S. unemployment fell to 8.8 percent in March from 8.9 percent the month before. The rate fell in the euro area to 9.9 percent in March from 10 percent in February, while ticking down in Canada to 7.7 percent from 7.8 percent.

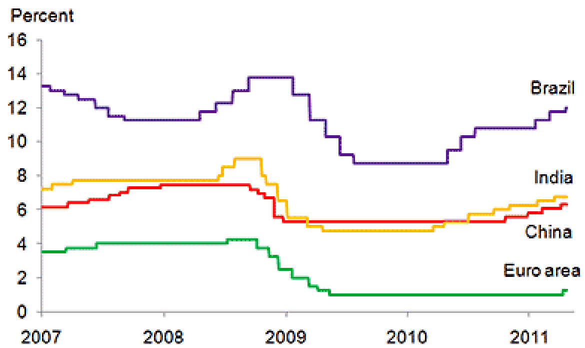
Inflationary Pressures Prompt Response

High rates of headline inflation and fears of unsustainable expansion, or overheating, have accompanied surging capital inflows, rising commodity prices and rapid GDP growth in emerging economies such as Brazil, India and China. Authorities have implemented capital controls and raised policy rates to stem credit expansion and price increases.

The People's Bank of China raised its one-year lending rate 0.25 percentage points to 6.31 percent on April 6. Two weeks later, it boosted the reserve-requirement ratio—the share of deposits banks must hold in reserve—for the fourth time in 2011. The ratio was raised to 20.5 percent as headline inflation reached 5.4 percent on a year-over-year basis in March. The Central Bank of Brazil followed suit on April 21, increasing its benchmark rate 0.25 percentage points to 12 percent. In addition, Indonesia and India raised rates in the first quarter of the year.

On April 13, the European Central Bank raised its main policy rate 0.25 percentage points to 1.25 percent, the first increase since July 2008 (*Chart 3*). The U.K.'s rate remains at 0.5 percent, though headline inflation ran at a 4 percent annual rate in March, well above the Bank of England's target range of 1 to 3 percent. Average benchmark rates remain low in the U.S. (0.125 percent) as well as in Japan (0.05 percent).

Chart 3
Euro Area Joins Emerging Economies in Lifting Rates



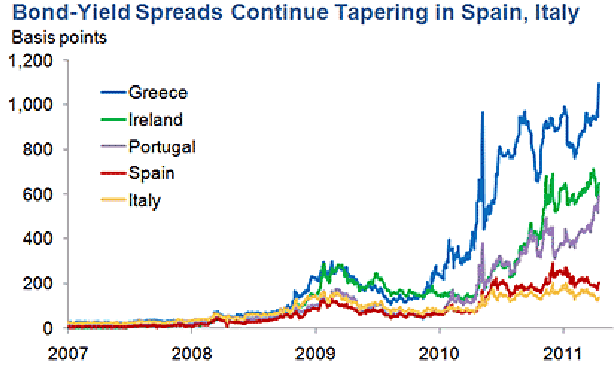
NOTE: The chart plots the SELIC overnight target rate for Brazil, the repurchase agreement (repo) rate for India, the one-year lending rate for China and the main refinancing operation rate for the euro area.
SOURCES: Central banks; Haver Analytics.

Euro-Area Sovereign Debt Troubles Continue

Heavily indebted euro-area economies continue to experience fiscal woes. Portugal submitted a $114 billion bailout request to the European Commission on April 7. Irish banks underwent a second round of stress tests on March 31, revealing the need for an additional $34 billion of capital. In response, Moody's cut Ireland's sovereign rating by two levels to Baa3, just above "junk" grade.

Ten-year government bond-yield spreads over German bonds, considered a safe investment, continue to rise in Greece, Ireland and Portugal; by contrast, spreads have decreased 0.5 percentage points in both Spain and Italy since the beginning of the year, though the possibility of contagion remains (*Chart 4*).

Chart 4
Bond-Yield Spreads Continue Tapering in Spain, Italy



NOTE: The chart shows the spread, or difference, in interest rates between

10-year government bonds for various countries and German 10-year government bonds. One-hundred basis points equals 1 percentage point.
SOURCES: Reuters; Haver Analytics.

Risks Remain, but Growth Should Continue

Advanced and emerging economies have expanded in 2011, albeit at different rates. While emerging economies have returned to or exceeded prerecession GDP growth rates, it remains to be seen whether advanced economies will soon attain levels experienced before the global downturn. Commodity and energy prices, the calamities in Japan and discouraging euro-area sovereign debt news pose obstacles to a continuing recovery. Still, moderate global growth appears sustainable in the near term.

—Payton Odom

1. The aggregate measure covers eight economies: Canada, China, the euro area, India, Japan, Mexico, the U.K. and the U.S. Together, they comprise 65 percent of world gross domestic product.
2. Purchasing managers indexes are published by Markit. If the Japanese composite index had stayed at its February level, the March global composite index would have read 57.3. An index reading greater than 50 indicates expansion.

About the Author

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