Economic Update INTERNATIONAL
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Growth Stalls as Economies Adjust

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Following the moderation in the first quarter of 2011, global growth is expected to continue decelerating throughout the year. Both advanced and emerging economies are seeing economic performance slow.

Mounting government debt is the main contributor to the diminished outlook for the advanced economies, especially in the euro area. The emerging economies continue to fight inflation, with high food prices producing additional price pressures. Monetary authorities have adopted contractionary policies in an attempt to control rising inflation, and these policies have facilitated weaker economic activity.

Evident in this recent economic slowdown is how interconnected economies have become. An optimal strategy for promoting global growth requires the stabilization of both advanced and emerging economies.

Uncertainty Rises With Sovereign Debt Debates

Advanced economies are suffering from high public debt levels. Austerity measures are necessary, but the structures for new budget plans are under much debate. Market uncertainty has heightened as the effectiveness of current and future plans are called into question. Stock markets in the U.S. and euro area have declined substantially as investors seek safer asset options amid falling growth potential.

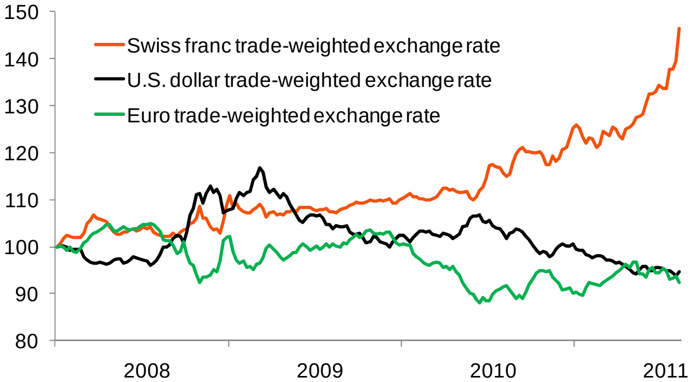
Switzerland has become an attractive destination for investors (*Chart 1*). Exchange rates show investors prefer to hold Swiss francs over the U.S. dollar and the euro. Switzerland serves as a beacon of hope for debt-laden countries; after struggling with high sovereign debt in the 1990s, the nation adopted strict austerity measures to promote a balanced budget, contributing to its stable economy.

Europe Placed in the Spotlight

Sovereign debt issues in the European periphery pose the greatest risk because of the possibility of contagion with other euro-area economies. On July 21, European leaders agreed to extend financial relief measures: Previous loan conditions were eased, and Greece was granted an additional bailout package. Despite this aid, the markets are still cautious. Subsequent movements in 10-year bond-yield spreads suggest uncertainty remains due to fears of a possible default by Spain or Italy (*Chart 2*).

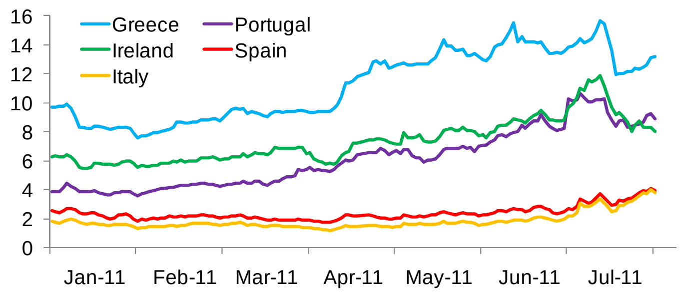
These spreads show differences in bond yields when compared with the German equivalent, which is viewed as a safe investment. A rising spread is indicative of a risky asset. Spreads for Spain and Italy hit record highs. In two weeks, beginning on July 25, spreads rose 19 percent for Spain and 32 percent for Italy. Though Spain and Italy are not at risk for immediate default, some doubt the ability of

Chart 1
Investors Flee to Safety
Index, January 2008 = 100

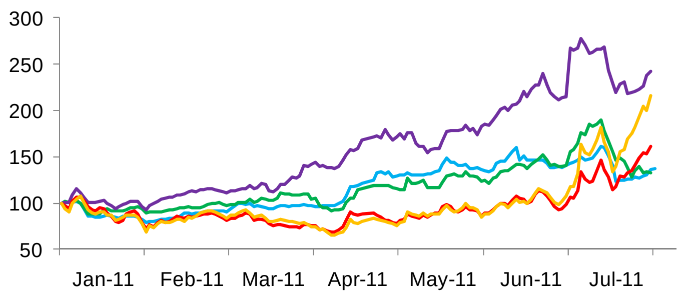


SOURCE: Haver Analytics.

Chart 2
10-Year Bond-Yield Spreads Show Increased Risk
A. Although Italy and Spain Are Low...
Percent



B. ...They Are Rising Rapidly
Index, January 2011 = 100



NOTES: Spreads indicate interest rate differentials between the 10-year government bond for various countries and the German 10-year government bond. Chart 2B shows change in spreads relative to January 2011.
SOURCE: Bloomberg.

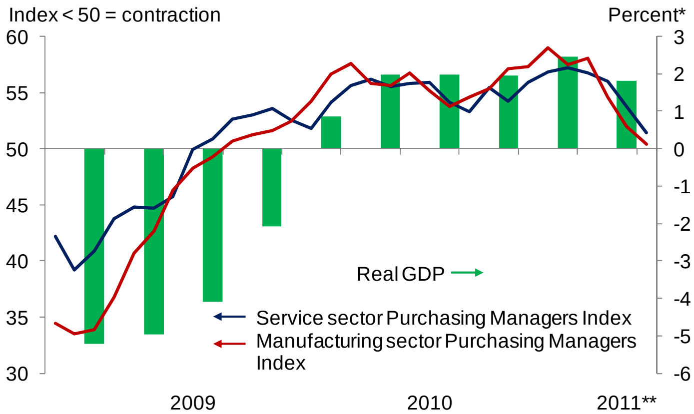
the European Financial Stability Facility (EFSF) to supply adequate funds on a longer-term basis.[1] The debt obligations for those countries in more immediate risk of default surpass the lending capacity of the EFSF. If Italy or Spain were to default as well, the funds would not be available to assuage the situation.

Debt Affects European Economy

The sovereign debt crisis is having a negative impact on the euro area's economic performance (*Chart 3*). The Purchasing Managers Index (PMI) for the euro area indicates both the manufacturing and service sector are dangerously close to contraction levels. PMIs closely follow the economic performance for the overall economy. Thus, gross domestic product (GDP) growth is expected to decline in the second quarter of 2011. The downward trend of the PMIs suggests a further decrease in GDP growth.

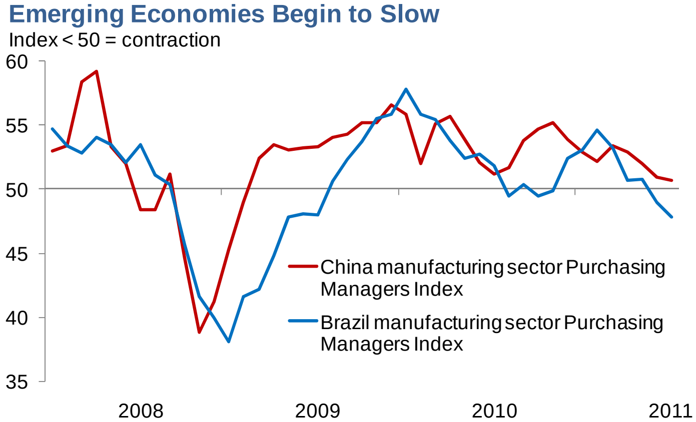
Germany has been a growth leader in the euro area, but the underperformance of other economies has caused a drop in German exports. Exports are a major contributor to German GDP growth; on average, 42 percent of Germany's exports go to the euro area. As GDP growth slows in the euro area, so will Germany's exports. German exports fell 2.6 percent from March to April. The deceleration of emerging economies has also affected the German export sector.

Chart 3
Euro Area Growth Slows



* Year-over-year change.
**2011:Q2 estimate is from June Consensus Forecast.
SOURCES: Bloomberg; Haver Analytics; Consensus Economics.

Chart 4
Emerging Economies Begin to Slow



SOURCE: Bloomberg.

Emerging Economies Slow Amid Inflation Battles

Emerging economies continue to face inflationary pressures due to high capital inflows. Rising food prices have added to these pressures. Changes in the consumer price index (CPI) are used to measure inflation. The CPI tracks prices for a select bundle of goods, which is determined by the consumption habits of an economy. The CPI composition for emerging economies is heavily weighted in food. Thus, high food prices have a disproportionate effect on inflation in the emerging economies. For example, food and beverages comprise 31 percent of the CPI in Brazil and 48 percent in India, compared with 15 percent in the U.S.

Monetary authorities are vigilantly raising policy rates to combat rising inflation. Since the beginning of 2011, Brazil has increased its policy rate five times, with the latest increase occurring in July. China also increased rates in July, the third time this year. India raised rates in June, its fourth increase this year.

The latest PMI data for the manufacturing sectors in Brazil and China indicate these tightening measures have successfully slowed down their economies (*Chart 4).*

China's PMI dropped to 50.7 in July. Brazil's PMI reached contractionary levels in June and dropped even further in July to 47.9. As these economies begin to slow, their inflation rates should fall. This will help moderate capital inflows.

Momentum Expected to Rebound in 2012

The recent economic slowdown highlights the growing effects of globalization. Countries that were regional growth leaders are starting to be affected by the poor performance of other economies through the export sector. High inflation in emerging economies has prompted policy contraction, stalling the main contributors of global growth. However, such policy responses should be viewed as attempts to promote long-term global growth. As interest rate differentials begin to lessen, capital flows will be redirected to advanced economies, and this increased investment will help stimulate economies whose public funds are strained. The efficiency of market stabilization is contributing to higher growth prospects for 2012.

—Adrienne Mack

About the Author

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

Notes

1. The EFSF was created at the onset of the European financial crisis to preserve the monetary union by aiding distressed countries.