Economic Update INTERNATIONAL
Federal Reserve Bank of Dallas

The Global Outlook: The Good, the Bad and the Ugly

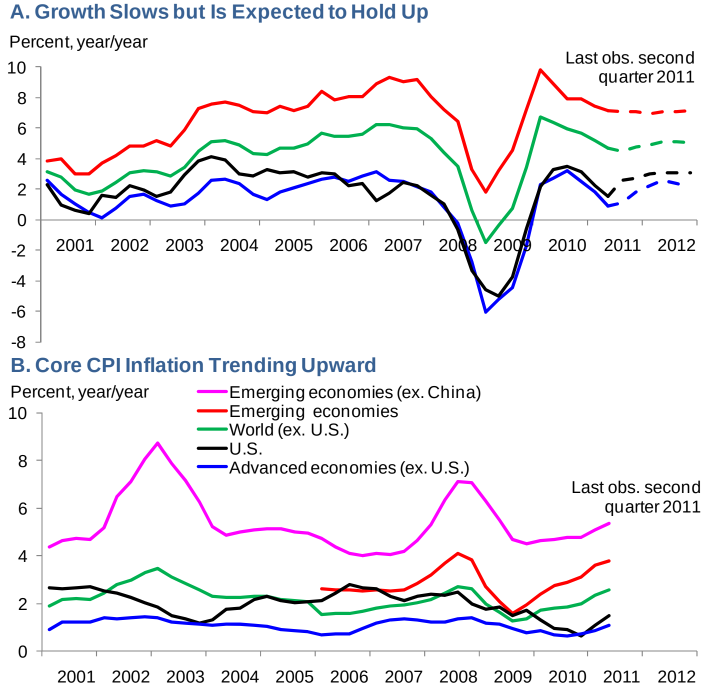
September 22, 2011

The world economy has been slowing gradually since 2010 due to a weakening recovery in advanced economies. The outlook for inflation remains stable, although signs of overheating are creeping up again in emerging economies as core inflation trends upward.

Advanced economies have maintained extremely accommodative monetary policy stances to stimulate growth. As a whole, emerging economies have tightened monetary policy (and even lending) to combat inflation and rapid asset price appreciation; some have also relied on capital controls to manage their exchange rates and promote export-led growth. Expansionary fiscal policies have weakened the state of public finances in most advanced economies. These fiscal challenges have prompted varied efforts to raise taxes and cut spending to curb debt.

While the growth slowdown is expected to be temporary, risks are heightened. Fiscal consolidation, the euro-area sovereign debt crisis and potential spillovers to advanced economies' financial system pose significant downside risks to the global outlook.

Chart 1
Tracking the Global Economy



NOTES: Dashed lines denote forecasted values. World includes 28 of the largest U.S. trading partners. Advanced economies are Australia, Canada, France, Germany, Italy, Ireland, Japan, the Netherlands, Sweden, Switzerland and the U.K. Emerging economies are Argentina, Brazil, Chile, China, Colombia, Hong Kong, India, Indonesia, Israel, Korea, Malaysia, Mexico, Philippines, Saudi Arabia, Singapore, Thailand and Venezuela. Core CPI inflation aggregates have been computed excluding Hong Kong, India and Saudi Arabia for lack of data. Weighting is based on yearly purchasing power parity-adjusted GDP shares.
SOURCES: Haver Analytics; *Consensus Forecasts* published by Consensus Economics; IMF World Economic Outlook; authors' calculations.

The Good: Emerging Economies' Robust Growth, Advanced Economies' Stable Core Inflation

Global growth continues at a dual pace, with emerging economies outperforming advanced economies. For the remainder of 2011 and in 2012, emerging-economy annual gross domestic product (GDP) growth is expected to average 7 percent. Advanced economies are expected to average 2 percent growth over the same period (*Chart 1A*).

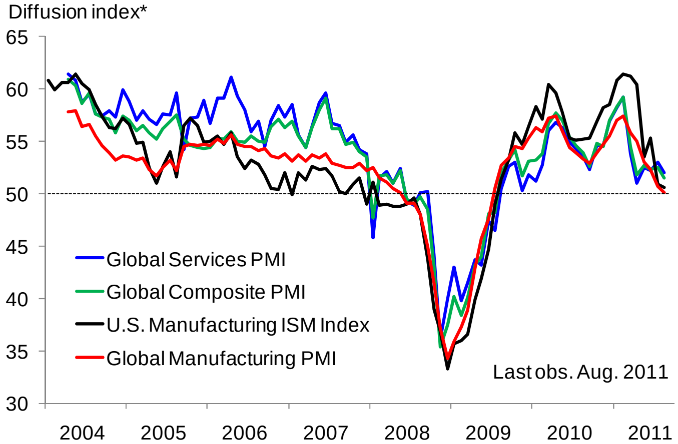
Commodity price booms in 2008 and 2010 have affected headline consumer price index (CPI) inflation in advanced and emerging economies. However, core inflation, a measure of price changes that excludes food and energy due to their volatility, has grown at a stable 1 percent annual rate in advanced economies despite large swings in headline CPI. Monetary policy in these economies has remained largely accommodative. In turn, core CPI inflation appears to be increasing in emerging economies (*Chart 1B*), which has forced their monetary authorities to increase policy rates partly to ward off inflation.

The Bad: Broad Slowdown, Deteriorating Conditions in Advanced Economies

Purchasing Managers Index (PMI) data show that both advanced and emerging economies have lost momentum in the manufacturing and service sectors, suggesting that the recent slowdown is more broadly based than previously thought. The J.P. Morgan Global Composite PMI fell from a peak of 59.2 in February to 51.5 in July. Over the same period, the Global Manufacturing PMI fell from 57.4 to 50.1, just above contractionary territory (*Chart 2*).

Signs of deterioration in the euro area have mounted since July. Money market spreads for the euro have risen above their average prior to the collapse of Lehman Brothers, but this increase has not fed through to other advanced-economy money markets (Chart 3). Stock markets around the world—not just in the euro area—have also reflected the financial stress and have suffered substantial declines. Even the euro–U.S. dollar exchange rate has flagged in the last month. These financial market strains pose a significant risk to the global outlook because declines in financial wealth

Chart 2
Global Manufacturing PMI Falls; Services PMI Softens



*An index value above 50 signals expansion; a value below 50 signals contraction.
SOURCES: Bloomberg; Institute for Supply Management; Haver Analytics.

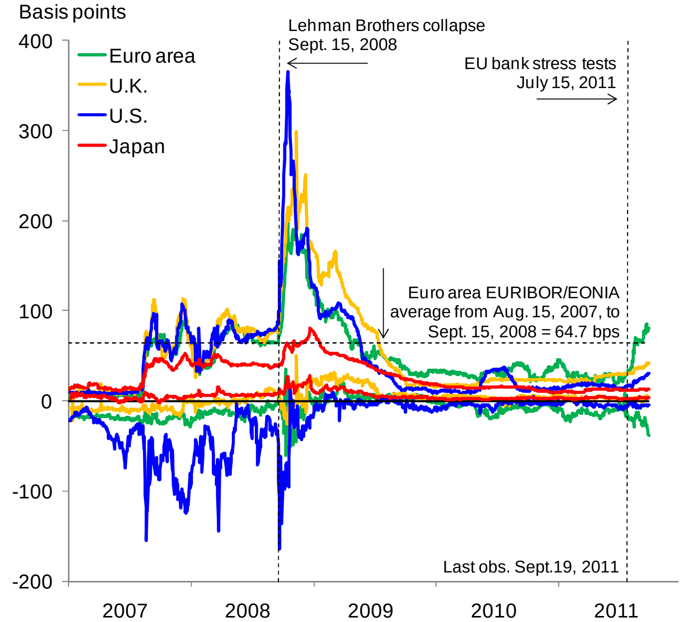
could further restrain private consumption and weaken the demand for U.S. exports abroad, while borrowing cost increases could affect the ability of firms to fund investment and expand the workforce.

The Ugly: Euro-Area Debt and Financial Crises Pose Major Downside Risks

The European Banking Authority released its latest bank stress tests on July 15. Greece's struggle to meet fiscal and structural reform targets prompted the International Monetary Fund, the European Commission and the European Central Bank to suspend the fifth review of the country's fiscal consolidation program on Sept. 2. These developments have acted as bad omens for financial markets, but doubts over the state of the peripheral EU were already pronounced in 2010, as seen in the skyrocketing costs of insuring bank debt and even sovereign debt with credit default swaps (CDS) (*Charts 4A and 4B*). What is new is that bank and sovereign CDS spreads for core EU countries and the U.S. have climbed as information about their exposure to peripheral Europe and the size of potential losses has prompted fears of a financial spillover from the EU periphery to other advanced economies.

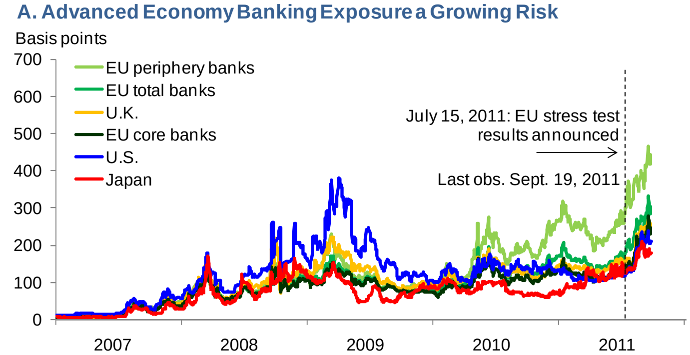
The spillover risk stems in part from the level of interconnectedness of the banking system within Europe and the U.S. (*Chart 5*). While U.S. banks do not directly hold large amounts of foreign claims from the EU periphery (and only small amounts from Greece), they are exposed to assets from France, Germany and the U.K., which, in turn, hold over $1.78 trillion in public and private claims from the EU periphery (in particular from Italy and Spain). Public claims are at most 30 percent of total foreign claims reported (and often less), suggesting that exposure to private-sector claims is of greater material importance for core European, U.K. and U.S. banks than exposure to peripheral EU sovereign debt. Additionally, nonbank financial institutions such as insurance companies and pension and mutual funds hold significant amounts of peripheral EU debt, making the re-

Chart 3
Euro-Area Money Market Spreads Above Pre-Lehman Average

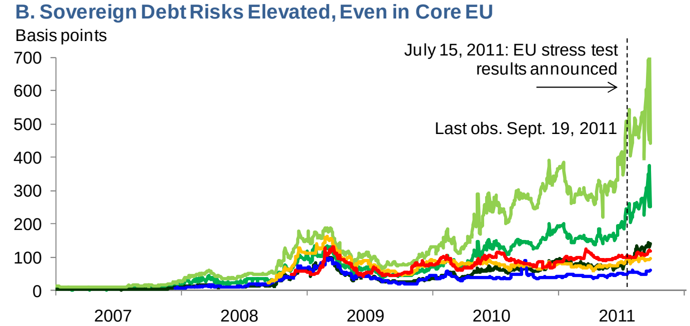


NOTES: The chart plots above the zero-line the spread between the three-month EURIBOR and EONIA for the euro area, the three-month LIBOR dollar rate and OIS for U.S., the three-month LIBOR sterling rate and SONIA for the U.K. and the three-month LIBOR yen rate and TONAR for Japan. The chart plots below the zero-line the spread between the three-month AAA-rated euro-area bond yield and the EONIA, the three-month U.S. T-bill and OIS, the three-month U.K. bond yield and SONIA and the three-month yield on Japanese Treasury discount bills and TONAR, respectively. The difference between the LIBOR/OIS spread and the T-bill/OIS spread is often called a TED spread.
SOURCES: Bloomberg; Haver Analytics.

Chart 4
Markets on Watch for Spillover from Peripheral EU
A. Advanced Economy Banking Exposure a Growing Risk

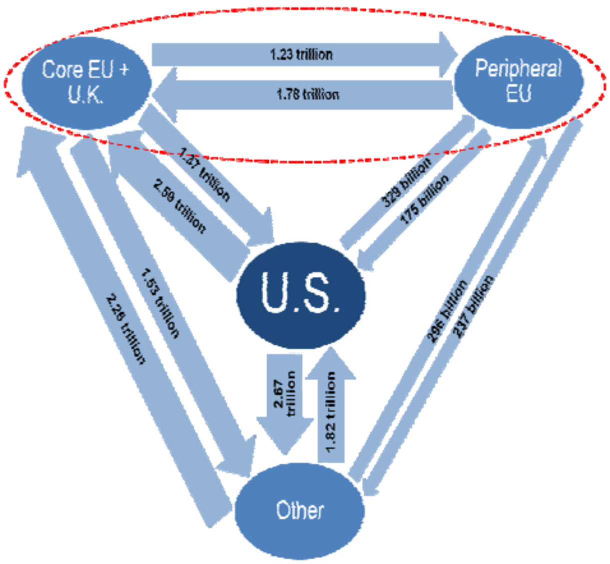


B. Sovereign Debt Risks Elevated, Even in Core EU



NOTES: Banking credit default swap (CDS) quotes are weighted by each bank's share of total assets at the end of 2010. The EU periphery includes leading banks from Spain, Portugal and Italy. The core EU includes banks from Belgium, Denmark, France, Germany, the Netherlands and Sweden. Sovereign CDS quotes are weighted by each country's purchasing power parity-adjusted 2010 GDP shares. Japanese sovereign CDS spreads are quoted in yen, U.S. spreads in euros and all others in U.S. dollars. Core EU includes sovereign CDS spreads from Belgium, France, Germany, the Netherlands and Sweden, while the EU periphery includes those of Greece, Ireland, Italy, Portugal and Spain.
SOURCES: Organization for Economic Cooperation and Development; Bloomberg; authors' calculations.

Chart 5
Core EU and U.K. Banks Most Exposed to Peripheral EU Financial Strains



NOTES: Data reported are outstanding total foreign claims held by domestically owned banks of each country grouping, expressed in U.S. dollars and valued on an ultimate-risk basis. Data correspond to first quarter 2011. Core EU countries are Belgium, France, Germany, the Netherlands and Sweden. Peripheral EU countries are Greece, Ireland, Italy, Portugal and Spain. All other reporting countries (Australia, Austria, Canada, Chile, Taiwan, Denmark, Finland, India, Japan, Norway, Singapore, Switzerland and Turkey) are bundled together and labeled "Other." The chart does not include total foreign claims on nonreporting countries. Arrows point toward the country or group of countries holding the foreign claims.
SOURCES: Bank for International Settlements consolidated banking statistics; authors' calculations.

percussions and scale of default presumably larger and more uncertain.

Growing Risks to the Global Outlook

Available forecasts for global growth suggest the ongoing slowdown will be temporary, but the outlook must be tempered by increasing risks related to fiscal and financial challenges in advanced economies and the worsening euro-area debt crisis. While core inflation remains within the prerecession range for advanced economies, rising headline and core inflation have required monetary authorities in emerging economies to lift policy rates and, in some instances, curb domestic lending and international capital flows. Advanced economies have continued to underperform their emerging counterparts and face stronger headwinds from the EU periphery and from rising public indebtedness. Governments' response to these challenges will likely determine global economic performance in the medium term.

—Enrique Martínez-García and Payton Odom

About the Authors

Martínez-García is a senior research economist and Odom is a research analyst in the Research Department of the Federal Reserve Bank of Dallas.