DALLASFED Economic Update
International

Global Recovery Still at Risk

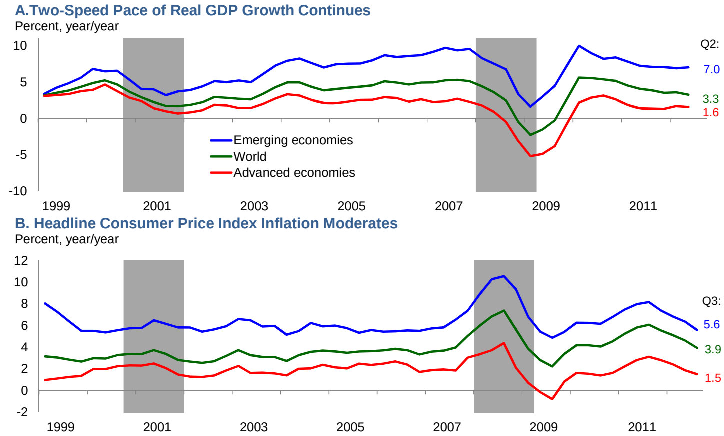
November 7, 2012

The global outlook remains uneven, with emerging economies outperforming advanced economies in terms of growth while registering higher inflation rates (*Chart 1A, B*).[1] Overall, inflation continues to moderate as commodity prices retreat, although the weak recovery also may be a restraining force.

Indicators of global economic activity—particularly in manufacturing—are raising the prospect of a further slowdown. The Federal Reserve Bank of Dallas' weighted purchasing managers index (PMI) measures show that manufacturing has staggered since the second half of 2011 in both advanced and emerging economies (*Chart 2A*). Despite that, the global service sector PMI remains in expansion.

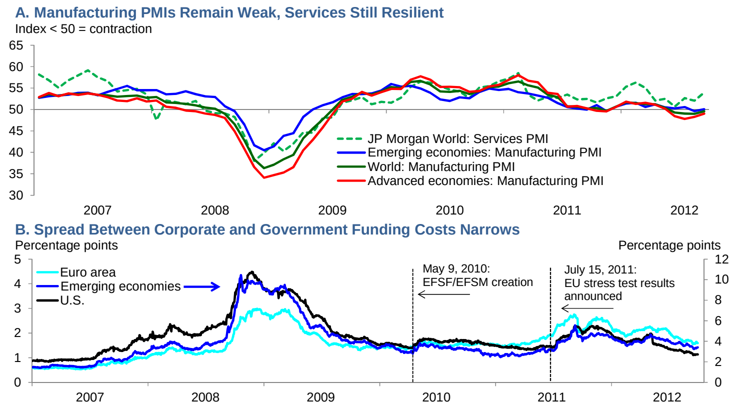
Financial conditions have returned to 2010–11 levels after substantial monetary support and intervention, as evidenced by declining spreads between corporate and government bonds (*Chart 2B*). However, credit is not equally accessible across countries due to the strained banking systems of some advanced economies.

Chart 1
Global Economic Outlook



NOTE: Shaded areas indicate global recession.
SOURCES: Haver Analytics; authors' calculations.

Chart 2
Real and Financial Indicators



NOTES: The emerging economies spread is the Corporate Emerging Market Bond Index by J.P. Morgan, which tracks dollar-denominated long-term debt rated Baa2/BBB that is issued by emerging-market corporations. Spreads for the euro area and U.S. are calculated as the difference between 10-year corporate bond yields, rated A, and 10-year government bond yields. EFSF and EFSM are European temporary lending facilities.
SOURCES: Haver Analytics; Markit; Bloomberg; authors' calculations.

Delayed External Adjustments

Current accounts—like the two sides of a coin—describe an economy's trade balance, plus net income and transfers from abroad, and also its net external borrowing/lending (domestic savings minus investment). If imports exceed exports, external funds must be borrowed to cover the resulting deficit. The growing current-account deficits among advanced economies (the U.S. and a number of European countries) prior to the global recession were a counterpart to the large surpluses accumulated mainly by emerging economies.

Growth in economies with large current-account deficits was based on high domestic absorption stimulated by the wealth illusion of a boom in real asset prices (particularly real estate); domestic demand in the aftermath of the 2008–09 downturn was supported by large public dissaving and expansionary, unconventional monetary policy. In economies with large current-account surpluses, domestic savings tends to be high and growth remains largely dependent on foreign demand and policy support. The policy response to the global recession has, in effect, delayed the structural adjustment of current-account balances and, by extension, the rebalancing of growth toward domestic demand in current-account-surplus countries and foreign demand in deficit countries. As the external adjustment lags, global risks increase due to policy uncertainty and the consequences of fiscal restraint—especially for countries with severely strained public finances.

Exchange-rate realignments can help to unwind the current account and rebalance global growth. A real depreciation—at least in the short run—increases the relative price of tradables over nontradables (such as housing), encouraging resources to relocate to the tradable sector. It makes imports more expensive, supporting a demand shift toward domestic products. Exchange rates can also affect the domestic demand by altering the relative value of national wealth and the external debt.

A policy of managed exchange rates to protect exporters (de facto or de jure) that interferes with the current-account adjustment has had some notable adherents in Latin America and Asia. However, this policy appears neither as broad-based nor as sustained as feared during the 2008–09 global downturn (*Chart 3A*). Emerging economies in particular are increasingly less willing or less able to import U.S. monetary policy to maintain their exchange rates. After an initial appreciation in 2008, the real value of the dollar largely continues to depreciate against a basket of emerging currencies while it moves sideways with the advanced currencies.

Exchange rates partly reflect differences in monetary policy between advanced and emerging economies. Chart 3B illustrates the relative stance of international monetary policy using the U.S. as a benchmark. A stance is deemed accommodative if the U.S. would have employed tighter policy in the same situation, while aiming to keep inflation under control and output close to potential. By this metric, emerging economies' monetary policy has followed closely that of the advanced economies since 2003. By 2008, central banks (mainly in advanced economies) with policy rates near the zero bound started to use the size and composition of their balance sheets to reverse involuntary tightening. Emerging economies began to slowly adjust for the overly accommodative monetary policy in the middle of 2011. Now, only advanced economies display signs of accommodative monetary policy. It's uncertain how this divergence in monetary policy stance will affect exchange rates and the speed of adjustment.

Euro-Area Crisis

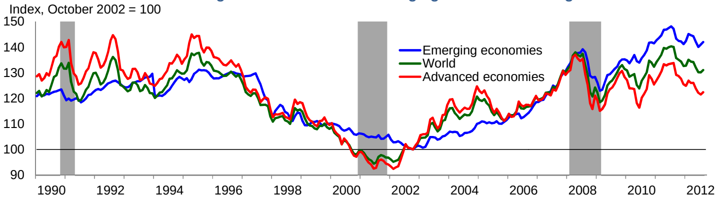
The ongoing euro crisis is reminiscent of the 1992–93 crisis of the European Monetary System, but back then, the crisis' resolution was facilitated by the U.K. withdrawal from the peg and the devaluation of the currencies of Italy, Spain, Portugal and Ireland. Nonetheless, European policymakers came to reaffirm their commitment to give up the exchange rate as a stabilization policy tool—judging from the 1992–93 experience that semifixed exchange rates were vulnerable because they were neither truly binding nor fully credible. The limited economic integration and real convergence attained during the 1990s did not constitute a major impediment to the creation of the euro in 1999.

The convergence of borrowing rates was deemed key in the perceived success of the first decade of the euro, in

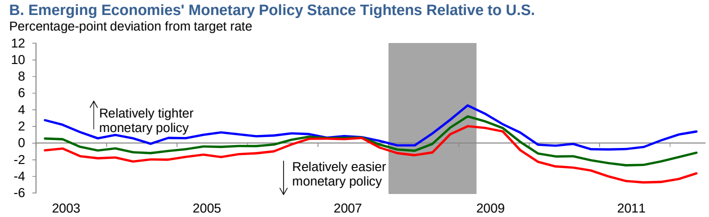
Chart 3

International Monetary Developments

A. Real Value of U.S. Dollar Against Advanced and Emerging Economies Diverges



B. Emerging Economies' Monetary Policy Stance Tightens Relative to U.S.

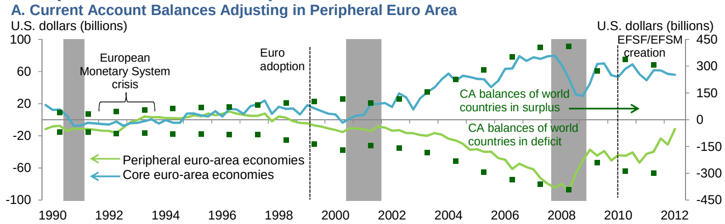


NOTE: Shaded areas indicate global recession. An increase in the consumer price index-based real exchange rate means a real depreciation.
SOURCES: Haver Analytics; authors' calculations.

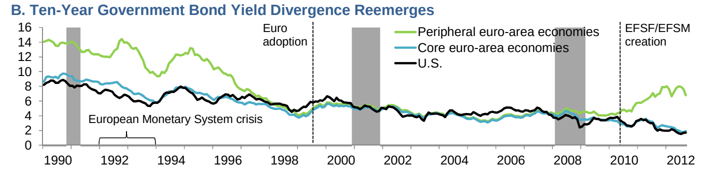
Chart 4

European Financial Developments

A. Current Account Balances Adjusting in Peripheral Euro Area



B. Ten-Year Government Bond Yield Divergence Reemerges



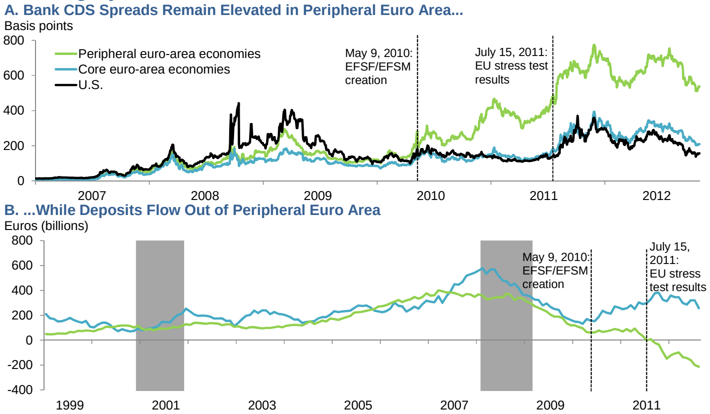
NOTES: Shaded areas indicate global recession. Peripheral euro-area economies are Ireland, Greece, Portugal, Spain, Italy and Slovenia. Data for Malta and Cyprus are excluded. Current account (CA) balances for world countries in surplus and deficit (represented with green blocks) based on annual International Monetary Fund (IMF) data, divided by 4. EFSF and EFSM are European temporary lending facilities.
SOURCES: Organization for Economic Cooperation and Development; IMF; Haver Analytics; authors' calculations.

spite of the buildup of current account deficits and surpluses in peripheral and core euro-area economies, respectively—a significant fraction of the world's total for both deficits and surpluses (*Chart 4A*). Low interest rates and access to external borrowed funds spurred a large increase in private (and public) indebtedness and also fueled asset price booms in many peripheral euro-area economies (*Chart 4B*). In the aftermath of the global recession, current-account balances have declined significantly for the peripheral euro-area economies, and the divergence in long-term yields has reemerged, revealing a significant disparity in fundamentals within the euro area.

The response to the global downturn was based on expansionary fiscal policies at the country level and accommodative monetary policy. This supported domestic demand to some extent but also crowded out private investment and delayed the external adjustment.

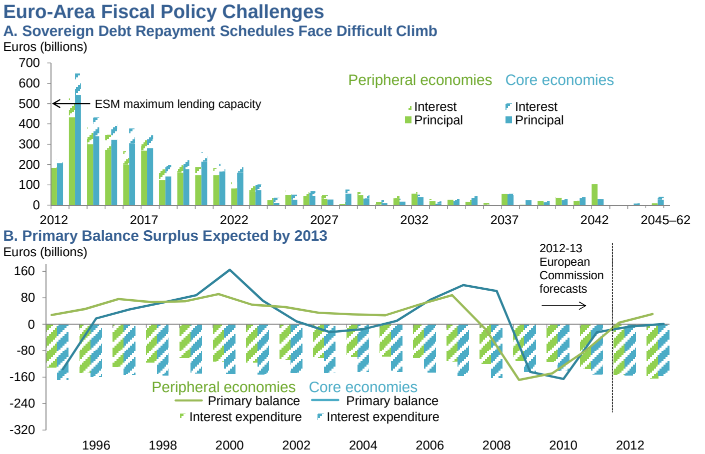
When an external devaluation (through the exchange rate) is not possible and fiscal policy runs its course, putting at risk the sustainability of public finances, countries with

Chart 5
Banking System Conditions



NOTE: Shaded areas indicate global recessions. Peripheral euro-area economies are Ireland, Greece, Portugal, Spain, Italy, Slovenia and Cyprus. Bank CDS (credit default swap) spreads are weighted by 2005 bank assets. Twelve-month cumulated deposit flows are from households and private nonfinancial corporations. EFSF and EFSM are European temporary lending facilities.
SOURCES: Bloomberg; *The Banker*; ECB; authors' calculations.

Chart 6
Euro-Area Fiscal Policy Challenges



NOTES: Peripheral euro-area economies are Ireland, Greece, Portugal, Spain, Italy, Slovenia and Cyprus. ESM is the European Stability Mechanism.
SOURCES: Bloomberg; Haver Analytics; authors' calculations.

large current-account deficits resort to some combination of structural reforms and internal devaluation to restore their competitiveness. Labor market reform, wage cuts and cuts in taxes on labor (partly offset by the increase of other taxes) have been implemented with that aim. Without growth resumption, debt restructuring for financially distressed countries such as Greece and even the abandonment of the euro currency have become part of the policy debate as well.

The ailing banking system and worsening public finances in the peripheral euro-area economies are presently the most pressing challenges. Problems of chronic low productivity in the peripheral economies were partly masked by strong domestic demand sustained by borrowing. This borrowing funded large increases in government expenditures and high public debt and, in other cases, increases in private sector debt and large run-ups in real estate and land prices. Domestic banks intermediated much of the debt buildup by borrowing cheaply from abroad, thereby facilitating the accumulation of current-account deficits.

As the external funds that once flowed freely toward these peripheral euro-area economies dried up, their banks became increasingly stressed (*Chart 5A*) and dependent upon European Central Bank (ECB) support. Adding to worries due to the strained interbank lending, the peripheral economies were hit by a sizeable decline in deposits, which were partly relocated to stronger euro-area economies (*Chart 5B*). The decline did not start in earnest until after the deterioration of public finances and the extent of bank exposures became more apparent to the public in 2011.

Euro-area governments responded to the distress of peripheral euro-area sovereigns with the creation of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). The European Stability Mechanism (ESM) was established on Sept. 27, 2012, to replace the temporary lending facilities of the EFSF/EFSM. The pledges to nations so far include €198 billion to Greece, €52 billion to Ireland and €45 billion to Portugal, plus €100 billion to Spanish banks. The ESM's maximum lending capacity of €500 billion covers only a fraction of the gross funding needs of the peripheral economies through 2013 (Chart 6A) and does not necessarily guarantee the sustainability of their debt obligations.

Whenever the nominal GDP growth of an economy is below its government's funding costs, a surplus on the primary balance (the difference between government revenues and expenses, excluding interest on debt) is required to stabilize the debt as a fraction of GDP. So, unless sustained growth, lower funding costs or both can be attained, the primary-balance surplus that is expected by 2013 will be important to take back control over public finances (*Chart 6B*). Economies that default do so primarily as a result of high interest expenditures, and those remain a heavy burden for peripheral euro-area economies. However, debt restructuring does not avoid the need for a significant fiscal consolidation because a defaulting country is likely shut out of borrowing and therefore needs to run a primary-balance surplus to service its restructured debt (and any debt not affected by restructuring).

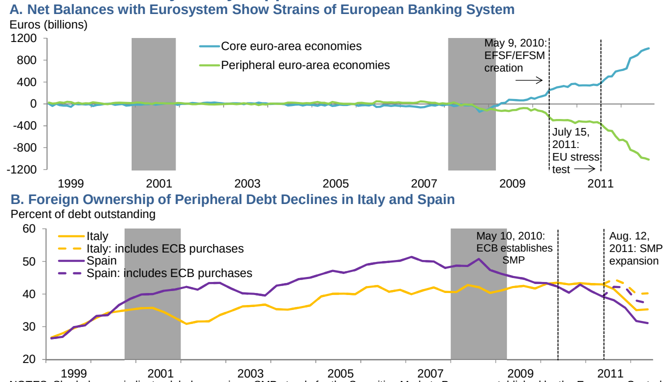
After borrowing and lending dried up in the interbank market in 2009, peripheral euro-area banks' funding needs were increasingly supported through the Eurosystem (*Chart 7A*). Banks in core euro-area economies that would have loaned funds to peripheral banks directly four years ago now prefer to park those funds at their central banks, which assume the risks. The Securities Markets Program (SMP) initiated by the central banks of the Eurosystem on May 10, 2010, allowed the ECB to purchase distressed government bonds. Spain and Italy have seen a decline in the share of government debt owned by foreigners and an increase in their borrowing costs, partly offset by SMP purchases since August 2011 (*Chart 7B*).

At its meeting on Sept. 6, the ECB upped its support further with the Outright Monetary Transactions program. Governments must agree to strict ESM conditions before ECB bond-buying operations in the secondary market are triggered. Enforcement rests on the threat that bond purchases will be suspended if conditions imposed under the terms of the bailout are not met.

Even if the sovereign and banking crises can be contained in the near term, any resolution to the European problems that preserves the integrity of the common currency must confront a number of long-term structural issues. A currency area must rely on a policy framework and policy tools that minimize the emergence of imbalances and foster their adjustment when they occur, but progress has been slow and the global downturn has tended to magnify preexisting policy disagreements. Europe also has to deal with other long-term issues. Aside from demographic factors stemming from a low fertility rate and an aging population, those concerns notably include the productivity gap between the peripheral and core economies. The gap has been rising since the adoption of the euro, and even core European economies have had a hard time catching up to U.S. productivity.

—Valerie Grossman, Adrienne Mack and Enrique Martínez-García

Chart 7
Euro-Area Monetary Policy Support



NOTES: Shaded areas indicate global recessions. SMP stands for the Securities Markets Program established by the European Central Bank (ECB), which was extended to include Spanish and Italian bonds in August 2011. Purchases are assumed to be one-third of Spanish bonds and two-thirds of Italian bonds. EFSF and EFSM are European temporary lending facilities. Peripheral euro-area economies are Ireland, Greece, Portugal, Spain, Italy, Slovenia and Cyprus.
SOURCES: University of Osnabrück; Bank of Italy; Bank of Spain; Bloomberg; authors' calculations.

Note

1. Advanced economies include all countries whose gross domestic product (GDP) per capita in purchasing power parity (PPP) was—on average in 2003–07—at least three times higher than the median of all countries in the world, excluding oil producers. Emerging economies include all other countries. Each aggregate uses all available data according to this classification, with annual purchasing power parity-adjusted GDP weights from the International Monetary Fund (IMF), except real exchange rates, where trade weights are computed with IMF data on imports plus exports in U.S. dollars. Turning points of the global cycle are determined by the size of the economies' simultaneously contracting industrial production reaching 60 percent of global output.

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About the Authors

Grossman is a research assistant, Mack is a research analyst and Martínez-García is a senior research economist in the Globalization and Monetary Policy Institute at the Federal Reserve Bank of Dallas.