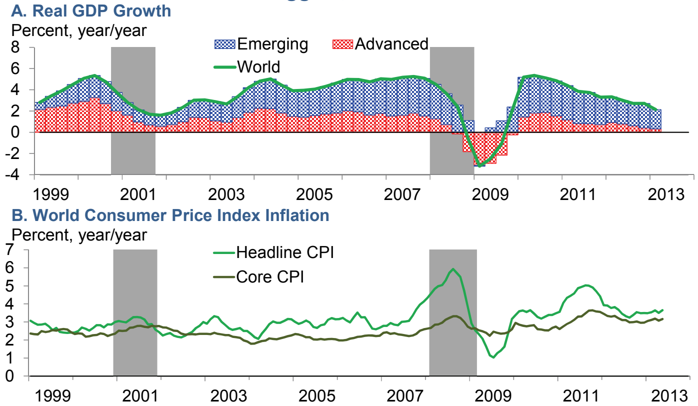
DALLASFED Economic Update
International

The Challenge That Lies Ahead: Sluggish Global Growth

August 8, 2013

Over the past three years, global growth has almost continuously decelerated as the slowdown has reached the emerging-market economies, Japan has struggled to bounce back and the recession in the euro area has become more protracted. Short-term indicators in recent months have contributed to the perception of lower-than-expected growth, but global inflation remains largely contained (*Chart 1*).

Chart 1
Global Growth Remains Sluggish, Global Inflation Subdued



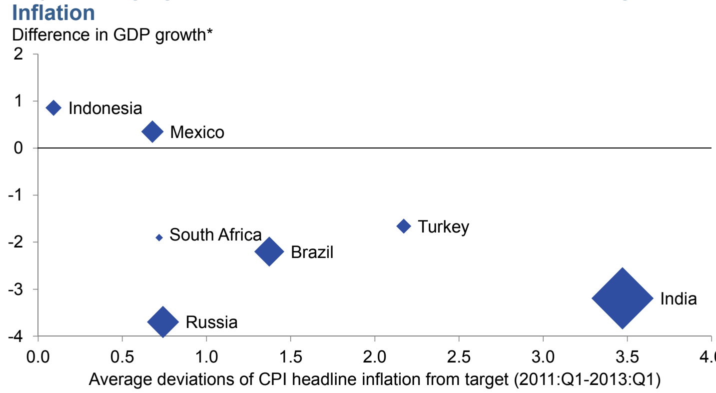
NOTES: Calculations are based on a representative sample of 40 countries. Shaded areas indicate global recessions.
SOURCES: Haver Analytics; authors' calculations.

The Deceleration of Emerging Economies

A number of emerging economies are showing signs of straining against capacity constraints and above-target inflation. Political risks and social unrest have reemerged in some areas as well. Capital flow volatility and foreign exchange market pressures have receded somewhat since May but highlight some external vulnerabilities. While these developments suggest lower growth and greater uncertainty in 2013, concern has risen about the long-term growth prospects of key emerging economies.

Short-term indicators: [1]China's GDP growth stayed barely above 7.5 percent in the second quarter. China's exports fell 3.2 percent in June, the most since October 2009, while imports barely grew at 0.2 percent. India's first-quarter growth was 2.8 percent after posting an average of 8.6 percent during 2003–07. Indonesia's exports continued their 15-month slide, with a June decline of 4.4 percent. Retail sales, industrial production and Purchasing Managers Indexes (PMIs) came on the soft side for Brazil and Mexico. For South Africa the signs were mixed, with June exports declining 7.0 percent but July PMI reaching a five-month high of 52.2. Turkey's manufacturing PMI dipped below the 50 threshold in July to 49.8. The prospect of social unrest flared up with protests erupting in Turkey in late May and then in Brazil. Strikes in South Africa's mines and the removal of President Morsi in Egypt are fueling political uncertainty.

Chart 2
Major Emerging Economies Face Lower Growth, Above-Target Inflation

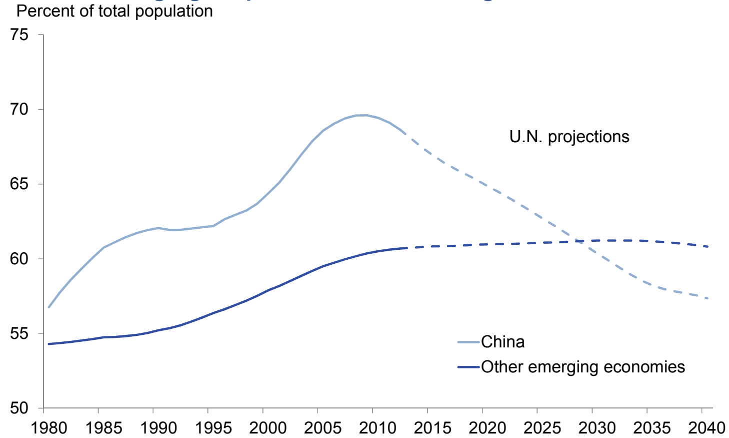


*Average growth 2003:Q1-2007:Q4 minus average growth 2011:Q1-2013:Q1 in percentage points
NOTES: Calculations use consumer price index (CPI) for all countries except India, which uses wholesale price index (WPI). Size of diamond represents share of world GDP.
SOURCES: Haver Analytics; authors' calculations.

External imbalances: Since mid-2011, capital inflows into emerging economies have moderated, largely as a result of declining cross-border bank flows (mainly from European banks after the euro-area crisis dip in 2011–12). The broader revaluation of emerging markets in early May in light of expectations of a possible shift in U.S. monetary policy brought higher volatility and declines in portfolio flows. The currencies of major emerging economies with larger current account deficits—South Africa, India, Indonesia, Turkey and Brazil—depreciated the most. Most of them consequently have been tightening monetary policy with an eye to curtailing inflation and halting the depreciation of their currencies. This has raised questions about how emerging economies—especially with de facto nominal anchor to the U.S. dollar—might respond when U.S. monetary policy becomes tighter. Moderate external debt burdens and the cushion of accumulated international reserves should allow most emerging economies to withstand short-term capital outflows.

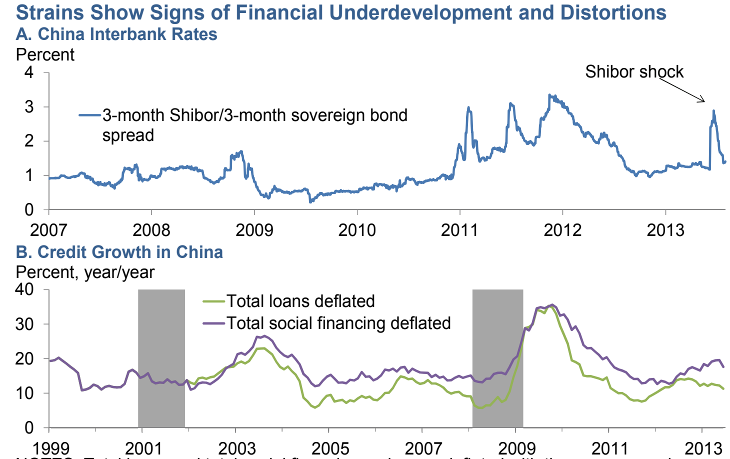
Long-term trends: Major emerging economies' growth is moderating due in part to slower external demand from mature markets (Japan, euro area) not offset with domestic demand. Capacity constraints become binding when the economy grows above potential—the output level that can be sustained when the factors of production (labor and capital) are fully utilized. Growing above potential can be sustained only temporarily and generally comes with signs of overheating and accelerating inflation. The evidence that growth has been generally lower than in the half-decade prior to the recession, with inflation remaining above target, suggests that the fundamentals of a number of major emerging economies may not support the same pace of rapid growth as they did before (*Chart 2*). Monetary policy is on a tightening trajectory in a number of these countries.[2]

Chart 3
China Working-Age Population Share Declining



SOURCES: U.N. Population Division; Haver Analytics; authors' calculations.

Chart 4
Strains Show Signs of Financial Underdevelopment and Distortions



NOTES: Total loans and total social financing series are deflated with the consumer price index of China. Shaded areas indicate global recessions.
SOURCES: Bloomberg; Haver Analytics; authors' calculations.

China at a Crossroad

China's external balance is still in surplus and its currency continues to appreciate, unlike the currencies of other major emerging economies. But China is increasingly confronted with the limits to its export- and investment-driven growth model of the past. Long-term projections anticipate a slowdown toward 7 percent by 2016–20 (China's growth target under its current Five Year Plan is 7.5 percent) and down to 5 percent by 2026–30, "assuming steady reforms and no major shocks."[3] The real test of China's reform drive will come if the slowdown is more abrupt and steep than these projections indicate.

The demographic factor and urbanization: China's working-age population share (15–59) has peaked, and its size shrank for the first time in 2012 (*Chart 3*).[4] Its dependency ratio is projected to rise as well. Labor market mobility is constrained by the *hukou* (household registration) system, which could amplify the negative impact of Chinese demographics. Local governments resist the expansion of social services under the *hukou* system to rural migrant workers because of the impact this may have on their finances. Under the current system, local governments increasingly have had to rely on off-budget land sales or borrowing with land as collateral to cover their revenue shortfall, contributing to the buildup of debt at the local level and to excesses in public infrastructure and land development.

Constraints to productivity: A slowdown can occur when rising wages erode competitiveness but domestic productivity gains do not materialize to offset them. Significant financial strains could also emerge with underdeveloped financial markets, leading in many cases to financial crisis and ultimately a steep decline in growth. The way to avoid this pattern is to maintain the robust productivity gains of the previous decades. However, productivity gains from reallocation of resources from agriculture to manufacturing are narrowing as human capital becomes key to moving up the technological ladder. China has come to dominate the global markets for low-tech manufactures and cannot grow much more through gaining market share in those industries. China has moved closer to the technological frontier, so productivity growth depends more on China's ability to innovate and less on foreign-technology adoption. Financial sector repression distorts the pricing of capital, creating the incentives behind the rapid increase in shadow financing. State-owned enterprises (SOEs) crowd out credit to the private sector, notably the more innovative new firms. The SOEs' protected position undermines competitiveness and productivity growth.

Reform agenda: On June 20, China's repurchase agreement (repo) interest rate spreads abruptly soared—the Shanghai interbank offered rate (Shibor) spreads spiked similarly (*Chart 4A*). China's central bank eventually intervened, helping stabilize interbank rates. Chinese authorities continue to press for slower credit growth both from bank and nonbank financing sources through tighter interbank liquidity (*Chart 4B*).[5] Moreover, China continued its gradual efforts toward financial reform unabated—on July 20, the central bank removed the lending rate floor, previously set at 30 percent below the 6 percent benchmark lending rate.

The offshore renminbi market development continued in 2013 with a cross-border program allowing qualified Hong Kong banks to lend renminbi to selected Chinese companies at lower offshore rates. Taiwan initiated renminbi clearing and settlement operations, to be followed by Singapore. A bilateral swap arrangement was announced in March with Brazil for an amount of 188 billion renminbi. The Chinese authorities have reiterated their intention of "making the renminbi basically convertible by 2015."

Japan's New Policies

Second-quarter growth was stronger than expected in Japan, driven by consumption and net exports—helped by a 19.9 percent depreciation of the yen (in real effective terms) since September 2012. Prime Minister Abe's reformist policies include proposals to increase labor force participation, introduce more competition and deregulate the rigid Japanese labor market (reducing duality, making hiring/firing easier and introducing wage flexibility) and open the door to immigration reform. The exact details are still being worked out.

The Protracted Euro-Area Recession

The euro area's flash composite output PMI rose to 50.4 in July, an 18-month high, but its sluggish growth remains a major drag on the global outlook. Without the exchange rate to facilitate the external adjustment as during the 1991–92 recession, euro-area countries had limited macro policy options to spur growth. Internal devaluation was pursued to reduce the costs of labor—through wage cuts and reform of the labor market and of labor taxation—in order to improve the external competitiveness of the economy and promote growth through exports.

The downside of internal devaluation is that it may depress domestic demand. Household savings as a share of GDP has significantly declined since 2009 in the financially distressed euro-area countries (*Chart 5*), and their households' income per capita has seen a large decline in the current recession (*Chart 6*). Households have supported private consumption to some degree by saving less, but the prospects for consumption to pick up have been weakened. Personal consumption expenditure may remain severely restrained in the peripheral euro-area countries. The contribution of exports and the reversal of the current account deficits of the past have not been enough to compensate for the low domestic demand and weak balance sheets, so investment keeps falling and growth remains elusive.[6]

Financial tensions have eased temporarily in the euro area since the spike of sovereign and banking risk in 2011–12. Financial reform keeps advancing slowly. The ECB relaxed its collateral framework, increasing ratings eligibility for asset-backed securities, among other changes. Reforms on the path toward a banking union and a unified labor market continue to lag behind pending the resumption of growth—and there is no appetite at this juncture for fiscal union.

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About the Authors
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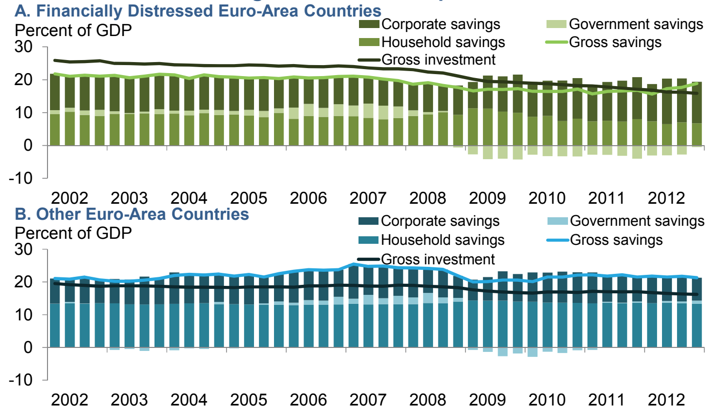
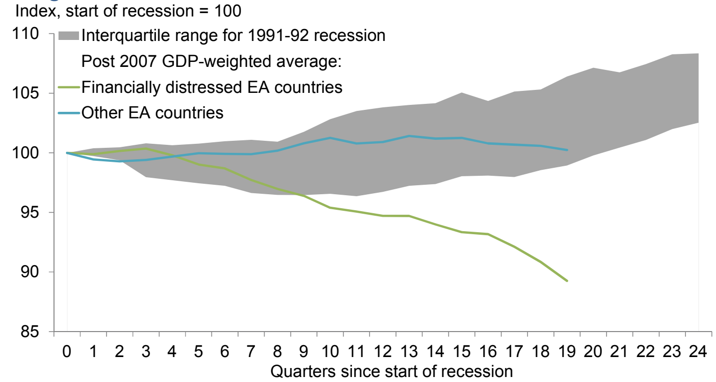
Chart 5
Gross Household Savings Declines in Peripheral Euro-Area Countries



NOTE: Excluding Slovenia, Cyprus and Greece among the financially distressed and Estonia, Luxembourg, Malta, Slovakia and Austria among the other euro-area countries for lack of data.
SOURCES: Dallas Fed's International House Price Database; Haver Analytics; authors' calculations.

Chart 6
Household Income Falling in Peripheral Euro-Area Countries, Stagnant in Core Countries



NOTE: Excluding Slovenia, Cyprus and Greece among the financially distressed and Estonia, Luxembourg, Malta, Slovakia and Austria among the other euro-area countries for lack of data.
SOURCES: Dallas Fed's International House Price Database; Haver Analytics, author's calculations.

Notes

1. Unless otherwise noted, all indicators are reported seasonally adjusted and all growth rates are expressed in year-over-year terms.

2. Most other emerging economies are experiencing low inflation and are keeping policy on hold, with a few of them loosening it (mostly in Eastern Europe).

3. World Bank (2013): "China 2030: Building a Modern, Harmonious, and Creative High-Income Society," using projections from the Development Research Center of the State Council of China (Table O.1).

4. The retirement age in China currently is 60 for men, 55 for female civil servants and 50 for female workers.

5. Total social financing encompasses traditional bank financing (loans) as well as other forms of nonbank financing that have been permitted in China since 2002 (e.g., corporate bonds, trust loans, entrust loans and bank acceptances).

6. Up to a statistical discrepancy, national gross saving (S) equals private gross investment (I) plus the current account (CA).