DALLASFED Economic Update
International

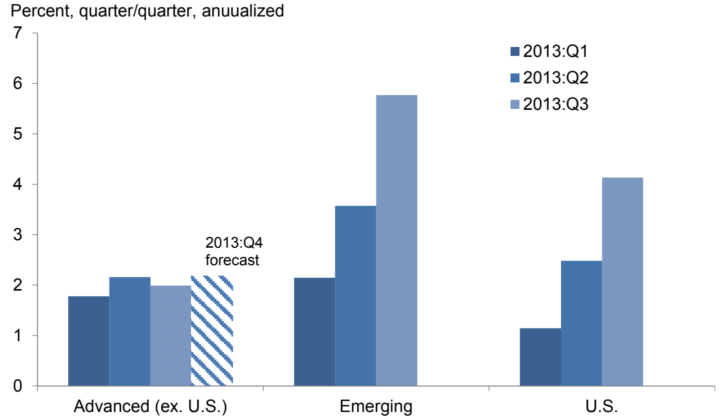
Global Economy Poised for Growth Acceleration in 2014

December 24, 2013

Global growth showed broad-based improvement in third quarter 2013. Real gross domestic product (GDP) expansion accelerated in emerging economies. While advanced economies (excluding the U.S.) fell short of their second-quarter pace, they are expected to regain momentum by the end of the year (*Chart 1*).

The global economy seems to have reached an inflection point: Whether an upward trajectory can be achieved in 2014 depends on a sustained recovery in advanced economies and financial stability in emerging economies. Structural reform in China will be needed to avoid a downgrade in long-term global growth potential.

Chart 1
Q3 Real GDP Growth Indicates Stabilization in Advanced Economies
Percent, quarter/quarter, anuualized



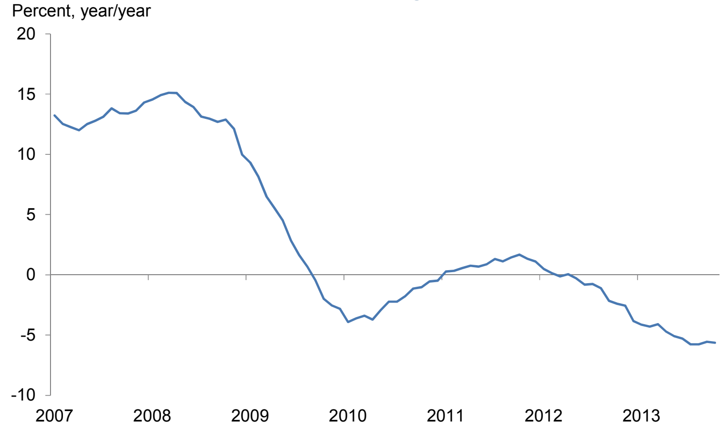
NOTE: Calculations are based on a representative sample of 40 countries.
SOURCES: Haver Analytics; Consensus Economics; author's calculations.

Weak Demand Threatens Recovery in Advanced Economies

Although the euro-area economy continued to expand in the third quarter, the pace of recovery has slowed: Real GDP grew at an annualized 0.3 percent (quarter over quarter), down from 1.2 percent in the second quarter. A contraction in net exports contributed to slower growth. A pickup in construction investment was able to offset the decline. However, a revival of domestic demand will be necessary to maintain positive growth.

Alongside high unemployment and fiscal consolidation, domestic demand remains weak. Improved employment conditions will require a boost in business investment. Low levels of business investment are a result of tight credit conditions. Credit to the private sector continues to decline (*Chart 2*).

Chart 2
Credit to Private Sector Continues to Tighten in the Euro Area
Percent, year/year



NOTE: Private sector consists of nonfinancial corporations.
SOURCE: Haver Analytics.

Prolonged weak aggregate demand has created a deflationary environment in some periphery economies. On Nov. 17, the European Central Bank responded by lowering its policy rate from 0.5 percent to 0.25 percent. With the policy rate moving closer to the zero bound, future rate cuts become more difficult.

Faced with persistent deflationary pressures, weak aggregate demand and a policy rate near zero, the Bank of Japan began increasing its monetary base through large-scale asset purchases. The plan has successfully driven up prices, but nominal wages have not yet caught up to increases in consumer prices. This is weighing on private consumption. Much of the increase in GDP growth stems from government investment (*Chart 3*). With plans to increase fiscal consolidation in April 2014, private demand must be restored in order to sustain positive growth.

Asset Prices in Emerging Economies Driven by International Investment

Low growth prospects and quantitative easing have limited investment gains in advanced economies. This has caused an increase in capital flows from advanced to emerging economies. Capital inflows can be beneficial for an emerging economy by creating additional funding for domestic investment. However, if the economy has become dependent on international capital to finance domestic investment, a slowdown or sudden reversal in capital inflows could downgrade long-run growth prospects. Economies producing a current account deficit are more vulnerable to capital flow reversals.

In particular, Brazil, India and Indonesia have accumulated large stocks of international investment from the U.S. (*Chart 4*). Since these economies have also been running a current account deficit, they were the most affected by speculation over the timing of the Fed's tapering decision.

However, the composition of capital stock from the U.S. reveals that foreign direct investment (FDI) represents only a small percentage of total investment capital. The majority of capital stock is concentrated in portfolio and other investment, which is not used to directly finance domestic investment. The portion of non-FDI inflows being used to fund domestic investment can be measured by the difference between net capital inflows and the change in foreign currency reserves (*Chart 5*).

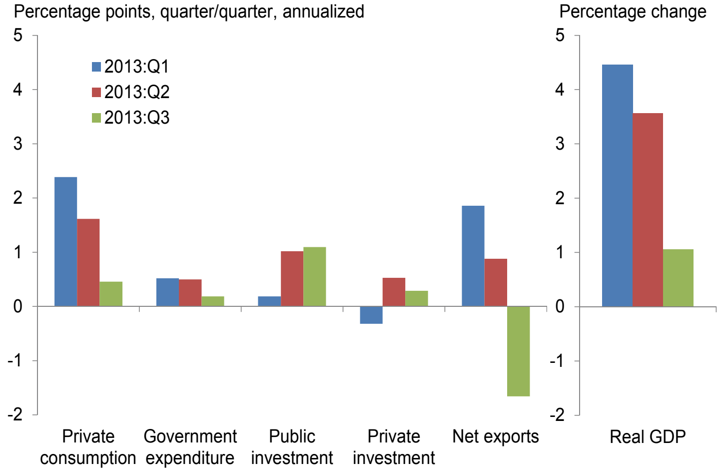
This reveals that the majority of capital inflows remain allocated in asset markets, causing an overvaluation of asset prices. A reversal of flows is necessary to correct price distortions and prevent asset bubbles from developing, but a rapid devaluation could threaten the financial stability of emerging economies.

China Announces Reforms to Adopt Market-Driven Economy

China's economy continues to lose momentum. Although the economy rebounded in the third quarter, expanding 9.3 percent (quarter over quarter, annualized), expected annual 2013 growth of 7.5 percent represents its slowest pace of growth in over a decade. Structural barriers have downgraded the economy's growth potential. Government regulations restricting labor mobility and limiting financial market access to the private sector have created an inefficient allocation of resources.

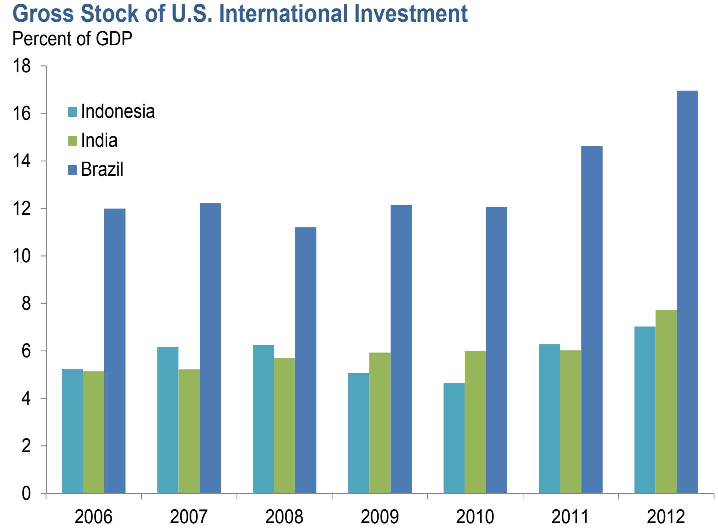
In November, Chinese President Xi Jinping unveiled broad-based reforms designed to create a more-market

Chart 3
Growth Contribution of Private Demand Weakens in Japan



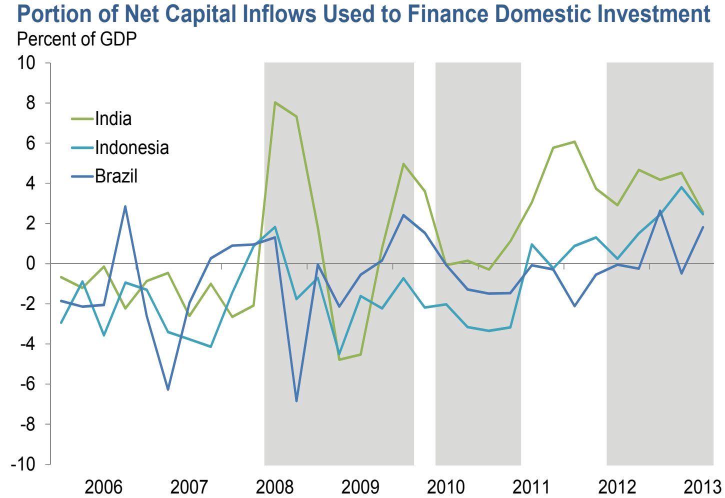
SOURCE: Haver Analytics.

Chart 4
Gross Stock of U.S. International Investment



SOURCES: Haver Analytics; U.S. Treasury.

Chart 5
Portion of Net Capital Inflows Used to Finance Domestic Investment



NOTES: Portion to fund investment measured by net capital inflows of non-FDI investment minus the change in foreign currency reserves. Shaded bars indicate periods of quantitative easing by the Federal Reserve.
SOURCES: Haver Analytics; U.S. Treasury.

-oriented economy. Included are plans to facilitate rural -to-urban migration and allow private banks to operate in financial markets. As rural workers transition out of the agricultural sector, their wages will rise, boosting private consumption. As non-state-owned businesses gain access to funding, market competition will improve, increasing corporate profits.

These reforms will facilitate the transition of China's current export-oriented growth strategy toward a domestically driven economy.

Broad-Based Risks Accompany Improved Global Outlook

While global growth for 2013 has been modest, acceleration is possible in 2014. A sustainable recovery in the euro area will require stronger private demand. If the creation of the euro-area banking union can restore credibility to the banking sector, investment should return, improving labor market conditions. Although emerging markets are vulnerable to a sharp decline in asset prices, with policy rates at high levels and a large holding of reserves, financial instability should stay contained. It is necessary for China to adopt a more market-oriented economy in order to preserve long-term growth, but it is unclear how and when structural reforms will be implemented.

—Adrienne Mack

About the Author

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