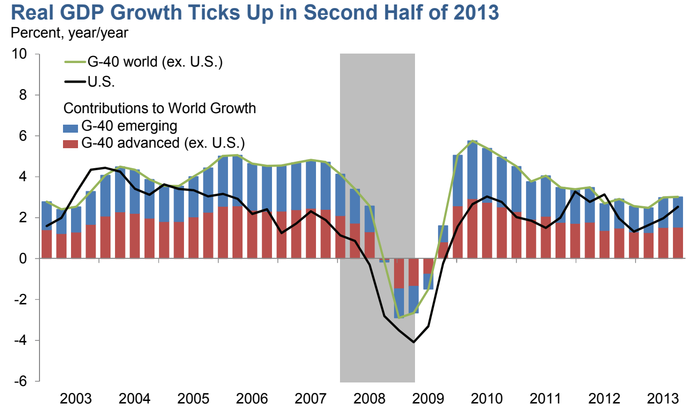
DALLASFED Economic Update
International

Is the Tide Turning Back?

March 25, 2014

Economic activity improved for the world during the second half of 2013 as year-over-year growth ticked up to 3 percent with acceleration in advanced economies. Advanced and emerging economies contributed evenly (*Chart 1).*[1]

Chart 1
Real GDP Growth Ticks Up in Second Half of 2013



NOTES: Aggregated using U.S. trade weights. Shaded bar indicates global recession (Grossman et al. 2014).
SOURCES: Database of Global Economic Indicators; Haver Analytics; authors' calculations.

Headline consumer price index inflation increased to 3.4 percent year over year in January 2014 due to a pickup in emerging economies—a 1.4 percentage-point increase from January 2013 to reach 5.6 percent. Inflation in advanced economies excluding the U.S. remains around 1.3 percent year over year. Downside risks to the outlook for 2014 continue. Data released since January have heightened concern over softer-than-expected growth, and geopolitical developments in Ukraine have also increased macro risks.

Slowing Growth in China May Hinder Structural Reforms

Fiscal problems in China have grown as stimulus has increasingly become dependent on local government investment. China's National Audit Office data indicate that local government debt and guarantees increased to 17.9 trillion yuan as of midyear 2013 from 10.7 trillion at the end of 2010. Total renminbi loan growth (14.2 percent year over year in February) is running well above nominal gross domestic product growth and is possibly contributing to a rise in real estate prices since 2013. Monetary policy has progressively shifted toward moderating credit growth and reducing excessive risk-taking behavior, while gradually removing government controls on the financial system.

The reform agenda laid out in the Third Plenum of the Central Committee of the Communist Party (November 2013) is ambitious in scope (*Table 1*). China has pursued this path incrementally, taking steps to relax the one-child policy and promote rapid internationalization of the renminbi and even proposing the partial privatization of some state-owned enterprises.

Since January, China has expanded its support facilities for the most liquidity-constrained banks in response to recent spikes in interbank rates (Dec. 23 and Jan. 20) and has weakened its implicit guarantee on financial products—even allowing the onshore default of Shanghai Chaori Solar Energy on March 6. Regarding exchange rate policy, China widened the renminbi's intraday trading band against the U.S. dollar to +/-2 percent on March 17, accompanied by a 1.5 percent onshore depreciation since Feb. 17.[2]

Economic performance in China has missed expectations in the first two months of 2014 on industrial production, manufacturing purchasing managers indexes,

Table 1
Key Goals of China's Reform Agenda

Goal	Implementation Measures
Financial reform	Interest rates, capital account, exchange rate liberalization
Fiscal reform	Local government funding and revenue-sharing, reduce government intervention
Socioeconomic reform	Land and pension reforms, household registration ("hukou") system reform, easing one child policy
Public sector reform	Administrative and judicial reform, state-owned enterprise partial privatization, "decisive role" for markets
SOURCE: Authors' assessment based on publicly available reports as of March 17, 2014.	

fixed-asset investment and retail sales. The eye-popping export decline of 18.1 percent in February, while partly seasonal, raised warning flags about the strength of the external sector.

At a press conference following the recent National People's Congress annual meeting on March 13—at which a 7.5 growth target was set for 2014[3]—Premier Li Keqiang admitted that due to weaker-than-expected data, the Chinese economy faces "challenges" in 2014. Questions have arisen about the direction of macro policy for the year and the speed of reform if economic activity continues to show signs of sliding below the official target.

Vulnerabilities Appear Broad Based Among Emerging Economies

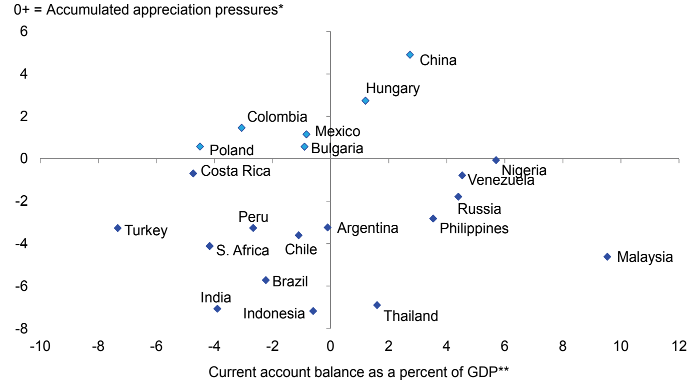
In some emerging economies, currencies appear under pressure and capital outflows have increased since May 2013, coinciding with the announcement of possible Federal Reserve tapering. Currencies under downward pressure either depreciate or require policy intervention to be sustained.

Chart 2 illustrates the magnitude of currency pressure buildup using an indicator that accounts for the actual depreciation of the currency and the impact of policy interventions.[4] Historically, episodes of currency stress are preceded by periods of sustained and unusually large current account deficits—current account reversals and large capital outflows can result in large exchange rate corrections. *Chart 2* (lower right quadrant) shows that downward currency pressures have also affected some emerging economies with current account surpluses.

The combination of external vulnerabilities and broad domestic weakness—such as structural impediments to sustained growth and political uncertainty—in some emerging economies may result in further exchange rate correction to bring about external and internal rebalancing. It could also mean tighter domestic financial conditions if authorities defend their currencies. Financial conditions might be constrained further as advanced economies begin to scale back monetary accommodation, pushing world interest rates upward.

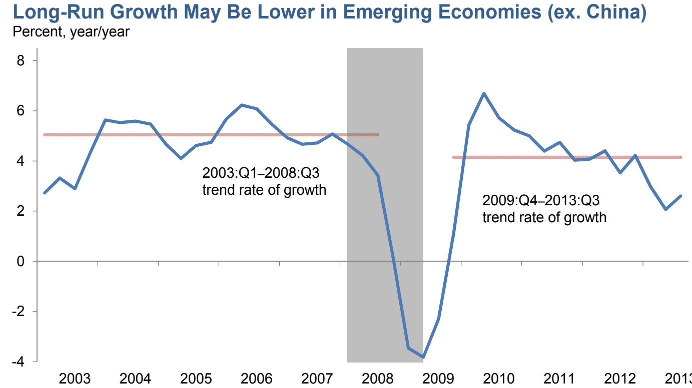
Structural impediments in many of these emerging economies could partly account for their sluggish growth since the last global recession. Based on the growth rates achieved, lower trend growth during the recovery seems increasingly likely (*Chart 3*).

Chart 2
Emerging Economies Experiencing Sustained Currency Pressures



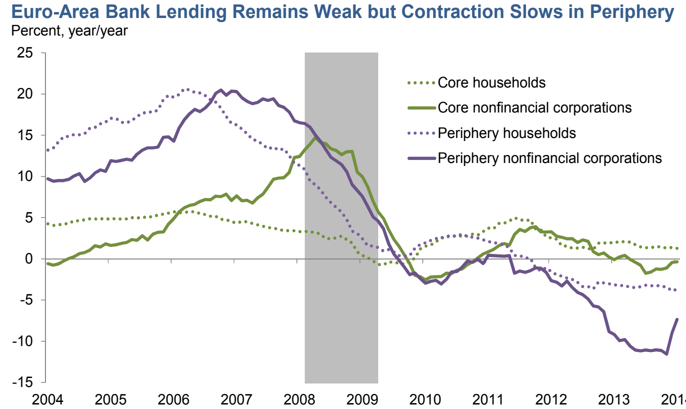
*May 2013–January 2014.
**2010–12 average.
NOTE: The accumulated exchange market pressure index accounts for movements in exchange rates, reserves and policy rates for each country since May 2013.
SOURCES: Haver Analytics; International Monetary Fund; authors' calculations.

Chart 3
Long-Run Growth May Be Lower in Emerging Economies (ex. China)



NOTES: Aggregated using U.S. trade weights. Shaded bar indicates global recession (Grossman et al. 2014). A linear trend with a break (estimated on 2008:Q4) is fitted to the real GDP in levels to obtain the trend rate.
SOURCES: Database of Global Economic Indicators; Haver Analytics; authors' calculations.

Chart 4
Euro-Area Bank Lending Remains Weak but Contraction Slows in Periphery



NOTES: Periphery countries are Cyprus, Greece, Ireland, Italy, Portugal and Spain. Core countries include Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands. Shaded bar indicates global recession (Grossman et al. 2014).
SOURCES: Haver Analytics; European Central Bank; authors' calculations.

This has implications for future growth prospects but also means current projections of economic slack could be overstated, which is consistent with the buildup of inflationary pressures that most of these emerging economies have been experiencing. Increased inflation could further erode their external competitiveness and heighten policy risks as emerging economies pursue multiple, often conflicting objectives (sustaining growth, supporting the currency, restraining inflation).

Financial Conditions in Advanced Economies Remain a Concern

In advanced economies, the monetary policy stance remains accommodative, while fiscal consolidation continues, though at a moderated pace. Downside risks to the outlook in Japan and the euro area come from lower-than-expected inflation. This increases the burden of debt in real terms and raises real interest rates. Japan's bold experiment with monetary easing in 2013 drove the yen down—providing a short-lived economic boost—and helped push up inflation. But concerns remain whether the 2 percent target has been fully incorporated into inflation expectations.

Across the euro area, private sector credit growth remains weak, partly due to the pullback in nonfinancial corporate lending in both the core (-0.4 percent year over year in January 2014) and the periphery (-7.4 percent) (*Chart 4*). This has been a restraining factor on inflation, investment and overall growth.

Bank lending has been stifled in part by increased regulatory burdens (the implementation of Basel III in 2014) that warranted deleveraging to meet capital and liquidity requirements. The rollout of the Single Supervisory Mechanism in the euro area requires a balance-sheet assessment and stress test of banks—the European Central Bank (ECB) comprehensive assessment—prior to the ECB assuming its full supervisory powers in November 2014. Further efforts to reduce risk exposure, raise capital and deleverage are likely still needed, weighing on the availability of credit and the growth and inflation outlook.

Restraints on the Global Economy

Developments in Ukraine may have implications for commodities markets, lead to trade disruption and increase macro uncertainty. Downside risks to the outlook also come from the perceived softness in China's economy, developments in emerging economies (such as currency stress and sluggish growth), policy hurdles and low inflation in addition to new regulatory burdens in advanced economies.

—Adrienne Mack and Enrique Martínez-García

Notes

1. Data reported in this international update for the aggregates—world (ex. U.S.), advanced (ex. U.S.) and emerging—come from a representative sample of 40 of the largest economies ranked by their importance as trading partners of the U.S. (G–40)—see "Database of Global Economic Indicators (DGEI): A Methodological Note," by Valerie Grossman, Adrienne Mack and Enrique Martínez-García, Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute Working Paper no. 166, December 2013. For the methodology used for dating global cycles, see "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," also by Grossman, Mack and Martínez-García, Globalization and Monetary Policy Institute Working Paper no. 169, January 2014.
2. The band was introduced on 2007 at +/-0.5 percent and widened to +/-1 percent in April 2012.
3. Major macroeconomic targets for 2014: 7.5 percent year-over-year real gross domestic product (GDP) growth, 3.5 percent inflation, 13.5 percent growth of M2 (money supply), 2.1 percent of GDP central government deficit and 10 million urban employment growth (increased from 9 million in 2013, while all other targets remain unchanged).
4. The indicator used is the exchange market pressure index (EMPI). See "Contagious Currency Crises: First Tests," by Barry Eichengreen, Andrew Rose and Charles Wyplosz, *Scandinavian Journal of Economics*, vol. 98, no. 4, 1996.

About the Authors

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