Uncertainty Still Hangs Over the Global Economy

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The global outlook has rebounded from a low point in January but remains weak due to volatile financial markets and low commodity prices. In a speech to the National Association for Business Economics, International Monetary Fund (IMF) First Deputy Director David Lipsky said, "The IMF's latest reading of the global economy shows once again a weakening baseline Moreover, risks have increased further, with volatile financial markets and low commodity prices creating fresh concerns about the health of the global economy."

Global Output Slumps

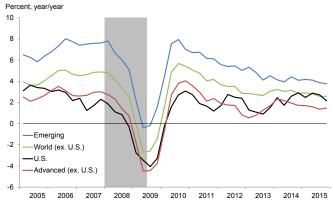
Global growth is slowing (Chart 1). Fourth-quarter real gross domestic product (GDP) growth in emerging markets was below 4 percent, its lowest level since 2003, except for during the 2009 recession. Advanced foreign economies slowed as well; consequently, global GDP growth is at its lowest since 2009. This global slowdown made U.S. exports to emerging markets decline considerably, while exports to advanced economies grew slightly.

Dropping Energy Prices Create Downward Pressure on Prices

Excess oil supply has driven prices to levels not seen in more than a decade. Consequently, headline inflation fell in all major country aggregates starting in late 2014 (Chart 2). Although there has been a recent pickup in headline inflation, it still remains low due to falling commodity prices. In contrast, inflation in Venezuela is very high and nearing hyperinflation.

Whereas the falling price of energy has led to a sharp drop in headline consumer price index (CPI) inflation globally, core CPI inflation, which excludes the volatile food and energy prices, has remained fairly steady (Chart 3). The fall in energy prices is impacting U.S. import price inflation, resulting in a 6 percent per year decline in import prices. The Organization of Economic Cooperation Development (OECD) predicts U.S. import price inflation will remain negative through the end of 2017.

Chart 1 Global Growth Slows



NOTES: Aggregated using U.S. trade weights. Shaded bar indicates global recession. SOURCES: Database of Global Economic Indicators; Haver Analytics; author's calculations.

Chart 2 Headline Inflation Ticks Up



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Differing Monetary Policies Create Currency Valuation Movements

Since the beginning of the year, the dollar has slightly depreciated against other advanced and emerging economies' currencies due to improving optimism about the global economy. Most advanced economies will likely continue their quantitative easing programs as the Federal Reserve normalizes policy, strengthening the dollar against their currencies.

Emerging Economies Combat Declining Capital Inflows

Capital inflows into emerging economies turned negative in late 2014 and picked up steam in late 2015 with the Fed's decision to raise rates. Emerging economies have four options to combat this loss of capital inflows: spend reserves to cover the balance of payments shortfall, allow the balance of payments deficit to depreciate the currency, raise interest rates or tighten capital controls.

Countries with the weakest balance of payment positions and lowest foreign reserves are likely to raise interest rates (Chart 4). Since late January, South Africa, Mexico and Colombia have each raised rates by 50 basis points and Peru by 25 basis points. China on the other hand, has an enormous stockpile of foreign exchange reserves, which it is using to counterbalance the downward pressure from declining capital inflows. Chinese foreign reserves have fallen from \$4 trillion in June 2014 to \$3.2 trillion currently. In the three months leading up to January 2016, Chinese reserves fell by \$100 billion per month. In February, China went through \$30 billion more. At this pace, China needs between \$1.6 trillion and \$2.7 trillion to curb currency pressures from capital outflows and will be able sustain its actions for approximately the next year to year and a half.

Global Slowdown Affecting the Renminbi

Sharp declines in capital inflows to China combined with low commodity prices have put significant pressure on the renminbi (RMB). However, allowing its currency to depreciate so soon after it was included in the IMF's Special Drawing Right is as much a political decision as an economic one.

Given that China does not have a lot of foreign currency-denominated debt, which allows the RMB to depreciate, is not as damaging for China as it would be for other emerging economies. China is instead battling the pressures by selling foreign currency reserves. Falling reserves shrink the People's Bank of China's (PBoC's) balance sheet, indicating monetary tightening. However, at the same time, China has engaged in monetary easing and, since November 2014, has cut rates six times.

Conclusion

The global economy seems to be dancing on thin ice. The divergence of monetary policy is creating uncertainty, while the global slowdown is causing turmoil among emerging economies and their currencies.

-Arthur Hinojosa

Chart 3
Global Core Inflation Steady, While U.S. Picks Up

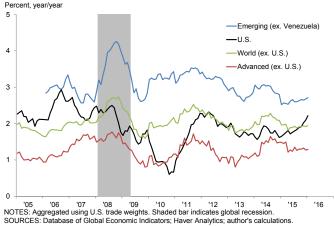
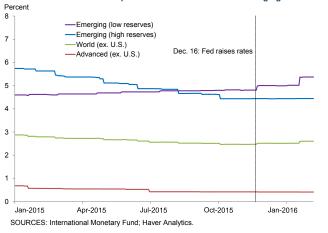


Chart 4
Federal Reserve Rate Hike Spurs Rate Increases in Some Emerging Markets



About the Author

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