DALLASFED Economic Update

International

Firmer Global Growth Hinges on Policy Shifts, Political Clarity

March 17, 2017

World output growth (ex. U.S.) ticked up to 2.9 percent year over year in fourth quarter 2016, pushing 2016 annual growth to 2.7 percent *(Chart 1)*.[1] Emerging economies, which have contributed an average 71 percent of world (ex. U.S.) growth since 2010, expanded 4.2 percent year over year in the fourth quarter.

Advanced economies (ex. U.S.) grew 1.9 percent year over year amid expansion in the euro area that exceeded its 2011–15 average. Although inflation concerns abated somewhat, global risks remain mostly unchanged and tilted slightly to the downside, reflecting political concerns and uncertainty.

Euro Area Poised to Surpass Prerecession Peak

There are signs of stronger momentum in the beginning of 2017 among advanced economies (ex. U.S.) after a somewhat lackluster 2015–16, though political challenges and policy risks remain. Several key elections are scheduled in the euro area over the next year that could reshape the continent's politics. The European Union also must contend with the formal start of Brexit negotiations with the U.K., as well as with ongoing debt negotiations with Greece.

The euro-area economy seems to be gaining ground even as the recovery remains uneven. Based on gross domestic product (GDP) per capita, the euro area in 2017 is finally set to exceed its prerecession peak reached during first quarter 2008 *(Chart 2)*. Among southern European countries, Spain has achieved a robust recovery after the euro-area sovereign debt crisis (2011–12), while Italy is little improved. Greece remains in the doldrums, in spite of having met or surpassed its fiscal targets—as revealed in official statistics.

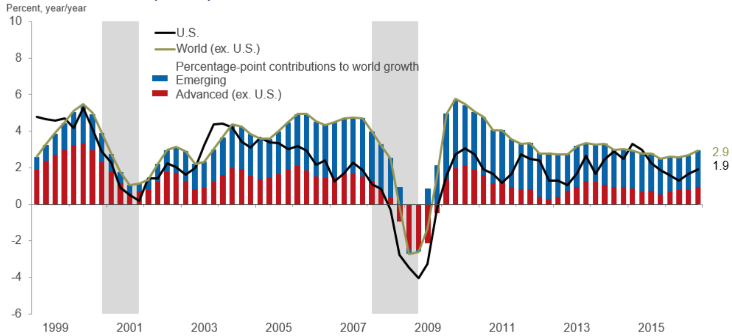
Headline consumer price index (CPI) inflation in the euro area rose 2.0 percent year over year in February, exceeding the European Central Bank (ECB) target of close-to-but-below 2.0 percent inflation for the first time since January 2013. The latest increase was largely due to a 9.3 percent year-over-year rise in energy prices. The ECB left its key interest rates and policy guidance unchanged at its meeting on March 9. U.S. headline CPI inflation also increased, rising to 2.5 percent in January, with an 11.1 percent increase in energy prices.

Net Exports Stifle Fourth Quarter U.S. Growth

Rising oil prices have also led to higher nominal U.S. imports, expanding the U.S. trade deficit to an almost five-year high in January. Throughout most of the recovery (2011–14), net exports (exports minus imports) were a small positive contributor to growth in real (inflation-adjusted) terms *(Chart 3)*.

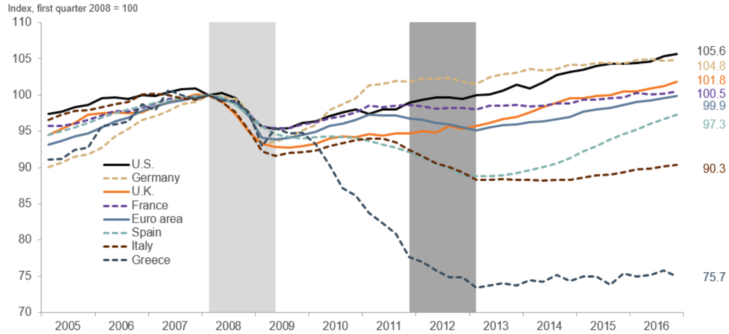
As the dollar strengthened after 2015 (mostly on the back of declining oil prices), net export contributions damped

Chart 1
Emerging Economies' Contribution to World (ex. U.S.) Growth Outweighing That of Advanced Economies (ex. U.S.)



NOTES: Calculations are based on a representative sample of 40 countries aggregated using U.S. trade weights. Shaded areas indicate global recessions (Valerie Grossman, Adrienne Mack and Enrique Martínez-García (2015)): "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," *Journal of Macroeconomics*, vol. 46, pp. 170–85). Last data point is fourth quarter 2016.
SOURCES: Database of Global Economic Indicators; Haver Analytics; authors' calculations.

Chart 2
GDP Per Capita Slowly Recovers in the Euro Area, but Major Differences Emerge Among Southern European Countries



NOTES: Indexed to peak in the euro area. Lighter shaded area indicates global recession (Valerie Grossman, Adrienne Mack and Enrique Martínez-García [2015]): "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," *Journal of Macroeconomics*, vol. 46, pp. 170–85). Darker shaded area indicates sovereign debt crisis. Last data point is fourth quarter 2016.
SOURCES: National statistical offices; Organization for Economic Cooperation and Development; Haver Analytics; authors' calculations.

U.S. growth, accounting for a 1.7 percentage-point drag during fourth quarter 2016.[2] The export and import components of growth can be volatile from quarter to quarter, but recent improvement in net exports' contribution to growth appears to have halted—even when depicted as a four-quarter moving average.

U.S. Dollar Appreciation on Pause

With oil prices falling since mid-2014, currencies of many big net exporters significantly weakened in U.S. dollar terms. Appreciation of the dollar has been significantly influenced by the impact of falling oil prices on those oil-sensitive currencies *(Chart 4)*. Monetary policy divergence between the Fed and other major central banks (ECB, Bank of Japan) is expected to favor a strong dollar going forward. Most dollar appreciation since the first half of 2016 can be attributed to the Mexican peso, in particular. The exchange rate reached 21.95 pesos per dollar in January before falling back below 20.

Mexico Experiencing Uncertainty

The peso depreciated throughout 2016 due to deteriorating domestic conditions, tighter financial conditions at home from policy rate hikes, and more recently, from U.S. spillovers and heightened uncertainty. These exchange rate movements have had some pass-through into higher inflation (expected to accelerate in 2017).

Policymakers at Banco de México took emergency actions in defense of their currency, raising the overnight lending rate 50 basis points to 6.25 percent on Feb. 9. Authorities also announced $20 billion in foreign-exchange hedges on Feb. 21 to support the peso without draining international reserves.

Mexico has also contended with deteriorating oil revenues (particularly since oil prices fell in mid-2014). The pace of reform has been slow, failing to translate into foreign investment and new production. Public investment has declined notably over the years as oil revenues fell and amid some efforts at fiscal consolidation.

Retail sales and private consumption have been mostly resilient. However, consumer and business confidence in Mexico has slipped, reflecting heightened uncertainty regarding relations with the U.S. and domestic elections in 2017–18 *(Chart 5)*.

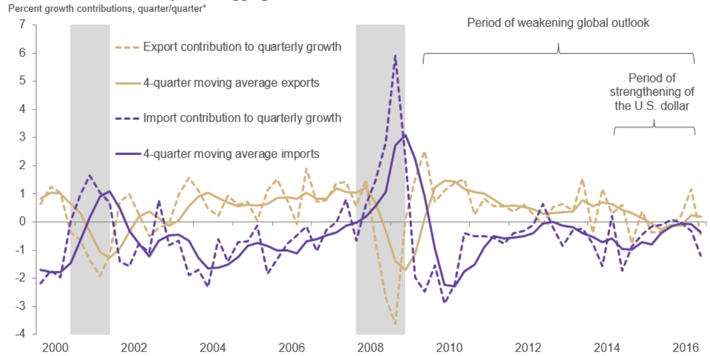
Balance of Risks Still Slightly to the Downside

The balance of risks remains mostly unchanged, tilted over the medium term slightly to the downside. Political uncertainty and elections in several countries could affect some economies (in Europe, Mexico). Headwinds include spillovers from China's continued slowdown (with additional complications from soaring debt, overcapacity, housing market overheating), despite fine-tuning efforts largely endorsed by Chinese authorities in the "two sessions" meetings in March.[3]

On the upside, the risks of contagion from normalization of U.S. monetary policy have not yet materialized (with perhaps the exception of Mexico), possibly signaling limited spillovers. Subdued currency pressures, together with better-than-expected inflation readings, have helped pave the way for somewhat looser monetary policy and financial conditions in some emerging economies (most recently evidenced by the Brazil rate cut in February).

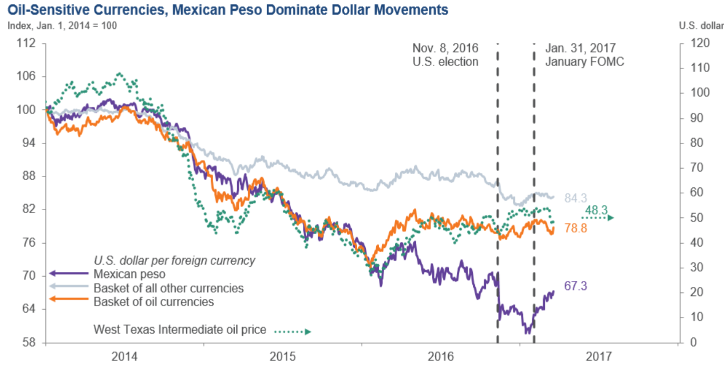
–Enrique Martínez-García and Valerie Grossman

Chart 3
Contribution from Net Exports Dragging Fourth-Quarter Growth



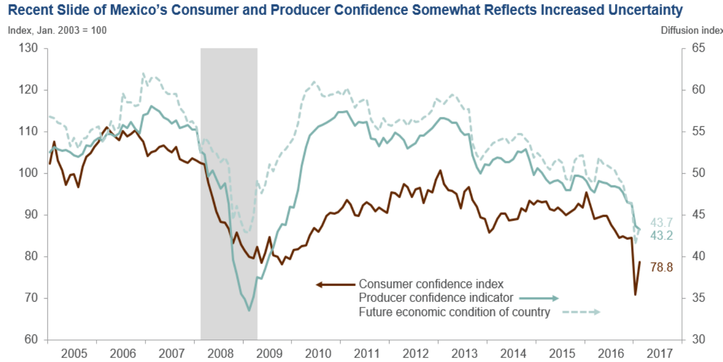
*Seasonally adjusted, annualized rate.
NOTES: Shaded areas indicate global recessions (Valerie Grossman, Adrienne Mack and Enrique Martínez-García (2015): "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," *Journal of Macroeconomics*, vol. 46, pp. 170–85). Last data point is fourth quarter 2016.
SOURCES: Bureau of Economic Analysis; Haver Analytics; authors' calculations.

Chart 4
Oil-Sensitive Currencies, Mexican Peso Dominate Dollar Movements



NOTES: Nominal trade-weighted value of the U.S. dollar (USD) is aggregated using the currencies and weights of the Database of Global Economic Indicators (DGEI). Last data point is March 15, 2017. The oil currencies grouping includes Canada, Brazil, Venezuela, Nigeria and Russia. The other currencies grouping includes the remaining countries in DGEI besides the Mexican peso and those in the oil currencies grouping. Decline in exchange rate means appreciation of the U.S. dollar. FOMC refers to the Federal Open Market Committee meeting.
SOURCES: Database of Global Economic Indicators; Haver Analytics.

Chart 5
Recent Slide of Mexico's Consumer and Producer Confidence Somewhat Reflects Increased Uncertainty



NOTES: Future economic conditions is a component of the producer confidence indicator. Shaded area indicates global recession (Valerie Grossman, Adrienne Mack and Enrique Martínez-García (2015)): "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," *Journal of Macroeconomics*, vol. 46, pp. 170–85). Last data point is February 2017.
SOURCES: Instituto Nacional de Estadística Geografía e Informática (National Institute of Statistics and Geography of Mexico); Haver Analytics.

Notes

1. World (ex. U.S.), advanced (ex. U.S.) and emerging aggregates come from a representative sample of 40 of the largest economies, ranked and weighted by their importance as U.S. trading partners. See, "A New Database of Global Economic Indicators," by Valerie Grossman, Adrienne Mack and Enrique Martínez-García, *Journal of Economic and Social Measurement*, vol. 39, no. 3, 2014, pp. 163–97. Also, "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," by Grossman, Mack and Martínez-García, *Journal of Macroeconomics*, vol. 46, 2015, pp. 170–85.
2. The contributions reported here only provide an account of the direct effects from trade. Trade also has general equilibrium impacts that affect consumption and investment. For a further discussion of standard trade effects over the business cycle, see "Investment and Trade Patterns in a Sticky-Price, Open-Economy Model," by Enrique Martínez-García and Jens Søndergaard in *The Economics of Imperfect Markets. The Effect of Market Imperfections on Economic Decision-Making*, edited by Giorgio Calcagnini and Enrico Saltari, Series: Contributions to Economics. Heidelberg: Springer (Physica-Verlag), 2009; and "Speaking of Trade: Quantifying the Economic Impact of Multilingualism," by Enrique Martínez-García and María Teresa Martínez-García, mimeo, Federal Reserve Bank of Dallas, 2016.
3. The dual sessions of the National Committee of the Chinese People's Political Consultative Conference and the National People's Congress.

About the Authors

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