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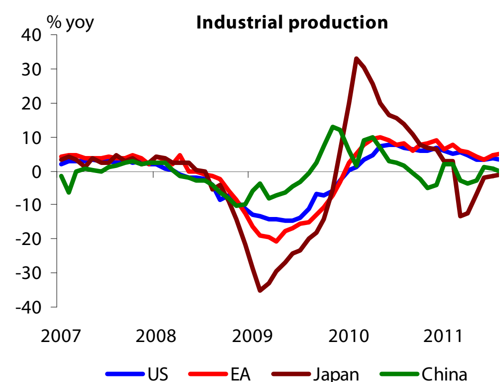
Global growth to muddle through the heightened fiscal and financial uncertainty, albeit at a sub-trend pace

- Leading indicators suggest that what was initially thought of as a soft patch of the global economy due to temporary factors turns out as a persistent slowdown.
- Absent a severe deterioration in the European sovereign crisis, the global slowdown should be a controlled mid-cycle descent, mainly supported by solid demand growth in EMs and additional monetary easing.
- Our estimates suggest a deceleration of global growth from 5.1% in 2010 to about 3.8% in 2011 and 3.8% in 2012, with the largest downside risk being the European sovereign debt crisis.
- Negative factors for global economic activity will also be fiscal consolidation, combined with reduced credit, the erosion of household net worth and subdued personal outlays owing to persistently high unemployment and continued deleveraging.

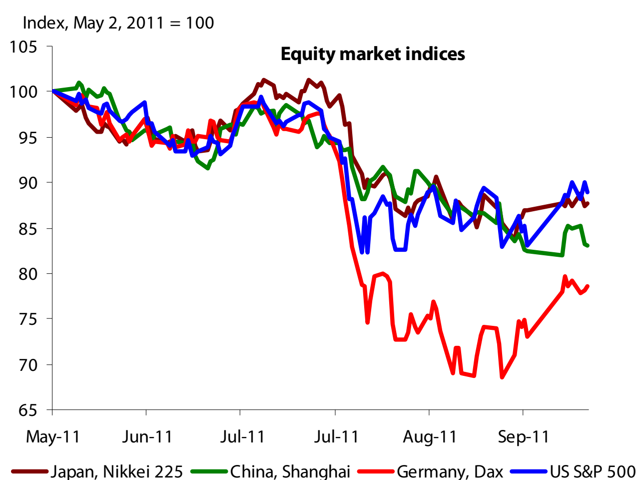
Global economic activity has slowed remarkably over the summer, owing to a lower growth trajectory in most advanced economies, as well as fiscal and financial uncertainty that skyrocketed since August. Surging oil prices and the impact of the events in Japan have led the global industrial sector to a mid-cycle slowdown (Figure 1), a rather temporary effect on global growth that is currently beginning to fade. As mentioned in the latest IMF's World Economic Outlook report, various estimates suggest that these two temporary factors may have reduced output in advanced economies by about 0.5%, concentrated mainly on the second quarter of 2011. In addition, uncertainty over the European debt crisis, the US debt sustainability and the debt ceiling debacle led to a sharp plunge of investors' confidence. Thus, risk aversion has increased significantly and global financial conditions deteriorated sharply in recent months, with global stock markets falling by about 18% from their peak in early May (Figure 2).

Figure 1



Source: US Federal Reserve, Eurostat, Ministry of Economy, Trade and Industry (METI, Japan), National Bureau of Statistics of China

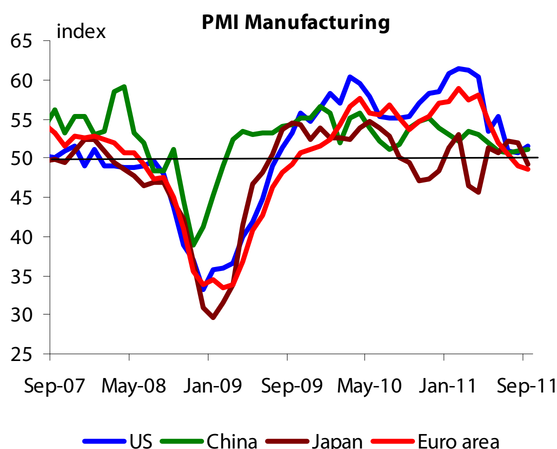
Figure 2



Source: Bloomberg

Leading indicators suggest that what was initially thought of as a soft patch of the global economy due to soaring energy prices and the events in Japan turns out as a persistent slowdown. The unwinding of temporary shocks in the first half of the year has not given its way to a restoration of confidence or a stabilization of economic conditions. Consumer and business confidence indicators in advanced economies continue to hover near levels historically associated with recession, as uncertainty about the Greek debt sustainability and its repercussions to systemic euro area member countries have recently prevailed. The manufacturing PMI reports point to poor momentum in the global manufacturing sector in the near term, with the forward-looking new orders component in many countries falling below the threshold of 50 that distinguishes expansion from contraction (Figure 3).

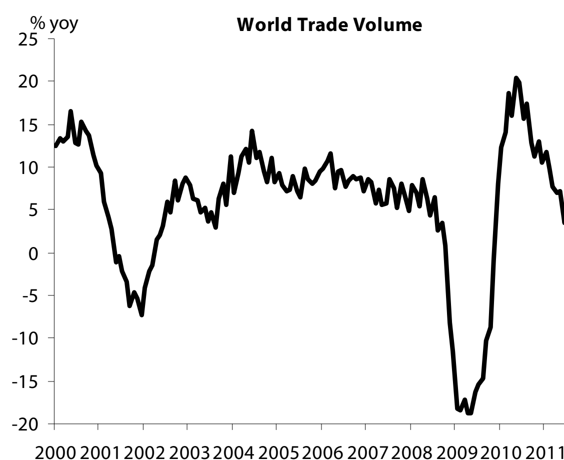
Figure 3



Source: Bloomberg

However, absent a severe deterioration in the European sovereign crisis, the global slowdown should be a controlled mid-cycle descent rather than a recession, mainly supported by solid demand growth in emerging economies and additional monetary easing, as well as a sharp recovery in Japan and favorable capex fundamentals in both advanced and emerging market economies. Our estimates suggest a deceleration of global growth from 5.1% in 2010 to about 3.8% in 2011 and 3.8% in 2012, with Q4 2011 and Q1 2012 likely to be the weakest quarters in a number of economies. The largest risk is the European sovereign debt crisis, which affects global growth through direct trade linkages (Figure 4), or indirectly through financial market conditions. Negative factors for global economic activity will be consolidation measures in several economies, combined with reduced availability of credit, the erosion of household net worth and subdued personal outlays owing to persistently high unemployment and continued deleveraging. While many advanced economies in the euro area are expected to flirt with recession, emerging and developing economies are expected to remain the locomotive of global growth. Growth in emerging economies will probably be moderating to more sustainable rates over the next few years[1], however it still remains fairly robust and essentially stronger than growth in advanced economies. Meanwhile, the share of emerging and developing economies in global GDP has increased substantially over time -from 37% in 2000 to 48% in 2010- and is expected to surpass the advanced economies' share (52% in 2010 versus 63% in 2000) over the next two years[2].

Figure 4



Source: CPB Netherlands Bureau for Economic Policy Analysis

[1] *According to the latest IMF forecasts (World Economic Outlook, September 2011), growth in emerging and developing economies is expected to moderate from 7.3% in 2010 to 6.4% in 2011 and 6.1% in 2012.*

[2] *IMF estimates, World Economic Outlook, September 2011.*

The euro area economy will probably post the weakest growth readings in the next few quarters, with a technical recession, i.e. two consecutive quarters of negative growth, being a likely scenario around the end of the year. In such a case, the recession will most likely be shallow, resembling a stagnation of growth rather than an outright recession. Growth divergence between core and periphery will continue, although it is expected to fade to some extent, as core euro area members have been also affected by financial turmoil. According to our estimates, real GDP growth is expected to decelerate to a below trend average of 0.8% in 2012 from 1.5% in 2011, mainly due to frontloaded fiscal consolidation measures and tensions in Eurozone financial markets.

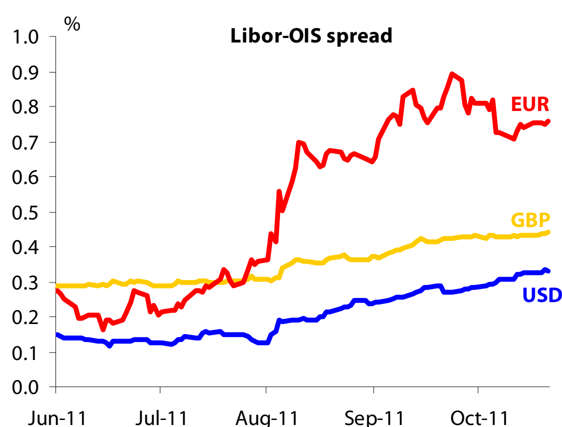
In the US, we see a lower growth trajectory in the medium-term, but reduced risks of near-term recession on the back of a pick-up in personal consumption and favorable fundamentals for equipment and software spending. However, an escalation of the Euro area sovereign debt crisis could affect the US economy through weaker exports, tighter financial conditions and constrained bank credit, leading to a shallow and short-lived recession. Our baseline estimates suggest a below-trend growth of 2.0% in 2012 from 1.7% in 2011, as weak employment growth and persistent economic slack continue to weigh on personal income. The $447bn fiscal stimulus proposed by the Obama administration represents a short-term removal of scheduled fiscal tightening. Thus, fiscal policy in the US will probably boost real GDP growth only modestly by about 0.2% in 2012, should the proposed stimulus plan is finally enacted in its entirety.

European sovereign debt crisis: the largest downside risk for global growth

The global environment is largely determined by developments in the euro area crisis front. The shockwaves of the debt crisis have spread around the globe, as is evident by the sharp deterioration in global business sentiment and rising tensions in money markets (Figure 5). As the crisis has recently engulfed more systemic members, namely Spain and Italy, euro area policymakers should move fast to get to grips with the sovereign crisis. At the moment three risk factors prevent markets from calming down and require urgent action i) bank recapitalization, ii) dealing with Greece's sovereign debt dynamics and iii) ring-fencing solvent but illiquid countries, most notably Spain and Italy, from adverse developments in Greece.

Disputes have been going on about how to use EFSF's resources to deal with the aforementioned risks. While in the July 21 summit, the size of the EFSF was expanded to €440bn, this amount seems to be quite low to insulate banks and sovereigns from the Greek oversized debt and appease markets concerns. €145bn has already been allocated to the program countries, (Portugal, Ireland and Greece), thus reducing the EFSF's firing power to about €295bn. At the same time, Spain's and Italy's refinancing needs until Q2 2013, when the ESM takes over, are about €690bn. Yet, up-scaling the EFSF is unlikely, as this would challenge the AAA rating of the EFSF itself, as well as the rating of contributor countries, most notably France. In addition, it would require a new round of parliamentary approvals. Besides, transformation of the EFSF into a bank and liquidity provision by the ECB is strongly opposed by the latter, as this would be considered monetization of government debt with likely corrosive effects on ECB's credibility.

Figure 5



Source: Bloomberg

Increasing the size of the EFSF through leveraging seems to be the preferred option, yet a complicated task, as it needs to attain full market confidence. The idea that seems to have gained traction is using the EFSF resources to guarantee investors' capital in new sovereign bond issuances. For example, a 20% principal protection on Italian bonds implies that every €1 of EFSF funds can cover €5 of Italian debt. Insurance will possibly come with some form of conditionality. On the positive side, this plan does not need pre-funding. The EFSF only issues guarantees and, if all ends up well, no money will be spent. On the negative side, while such a plan could lower debt servicing costs, it does not fully remove default risk. Hence, Italian and Spanish spreads are likely to remain vulnerable to possible negative turns of the debt crisis. As a result, backstopping intervention from the ECB through its Securities Market Program may remain crucial.

Greece's sovereign debt dynamics remain at the epicenter of the debt crisis. Deeper recession and lack of progress on structural reforms and privatizations result in larger funding gaps, corroborating markets disbelief about the country's debt sustainability. The PSI deal has reopened, as higher loss incurred by private holders is deemed necessary, most notably by Germany, to improve Greece's debt dynamics. However, agreement on the NPV loss seems to be a thorny issue, as banks

and the ECB resist a significantly higher haircut. The new PSI deal has to preserve the voluntary participation status, as already strained financial conditions don't leave much room to accommodate a CDS triggering event. EFSF insurance could be used in the deal as a sweetener, though it would further reduce its power to insulate Spain and Italy.

With respect to bank recapitalization, in a recently published proposal, the European Commission recommends that banks which need to strengthen their capital base should first seek private funds and, if that does not prove fruitful, sovereigns should step in and inject money to the banking sector. The plan leaves taping EFSF as the solution of last resort. This is in line with the German and ECB stance on the bank recapitalization issue, whereas France, whose banks seem to be more vulnerable to sovereign debt exposure, favors a greater contribution from the EFSF. The IMF estimates that sovereign credit strain has had a direct impact of about €200 billion on banks in the EU, while other analysts raise the impact even higher. A new round of stricter stress tests, imposing higher core Tier 1 thresholds (around 8%) and taking into account public debt retained on both banking and trading books, would raise recapitalization needs even more. This implies that state support to banks would further strain public finances, especially France's ability to retain top credit rating. On the other hand, if the EFSF is extensively used to strengthen banks, its resources to contain rising costs of sovereign debt will be reduced.

Overall, political and technical hurdles should be overcome before final details of the anti-contagion mechanisms are spelled out. President Sarkozy and Chancellor Merkel have promised a comprehensive package by November 3, when the G-20 meeting will be held. That said, progress towards a permanent solution may remain slow, while further muddling through is likely. Obstacles in the way of parliamentary ratification of the EFSF enhancement, including Finish requirements for guarantees and Slovakia's no-vote, dramatize how slow and cumbersome political developments in the euro area are. However, market pressure will remain severe, especially felt on Italy and Spain, forcing policymakers to intervene decisively.

Monetary policy to remain supportive for global growth

The policy concern in many advanced and emerging economies in late 2010 and in H1 2011 has been rising inflation, with many of them tightening monetary policy. However, easing inflationary pressures and a broad-based slowdown in global growth has led to an easing bias across the board. While expanding its liquidity operations and reactivating its Securities Market Program, the ECB is expected to fully reverse its tightening cycle in order to boost growth amid strict fiscal austerity. In addition, after committing to keep rates at exceptionally low levels at least until mid-2013, the Federal Reserve announced a Maturity Extension Program for the next nine months in order to put downward pressure on long-term interest rates, create more accommodative financial conditions and support the mortgage market. Should economic and financial market conditions weaken further towards the end of the year, the Fed could announce a third round of quantitative easing (QE3) so as to expand further its balance sheet and, therefore, monetize its debt. Thus, given that growth in advanced economies will likely remain subdued over the next few years, monetary authorities should maintain monetary policy loose, even if that means tolerating inflation persistently above their previous target. Meanwhile, the emerging markets policy tightening cycle has already reached its peak, causing a number of countries to either hold interest rates or even ease. It seems that even policymakers in emerging economies are showing growing tolerance for higher inflation, turning their attention from fighting inflation to supporting growth.

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