Global Slowdown to Persist

Dashing hopes of a quick rebound, the global industrial slowdown will last at least through year-end.

"An Awful Lot of Uncertainty" Until recently, the Federal Reserve had been fairly sanguine about the trajectory of U.S. economic growth. Indeed, in his press conference two months ago, Chairman Bernanke spoke of the Fed's "outlook for above-trend growth," with "the economic recovery ... proceeding at a moderate pace."

At last week's press conference, Mr. Bernanke's tone was noticeably different, as he admitted that the economic recovery was unfolding "somewhat more slowly than the [Fed] had expected." Yet, he conceded, "[w]e don't have a precise read on why this slower pace of growth is persisting." Moreover, he acknowledged, "we have an awful lot of uncertainty right now about how much of the slowdown is temporary, how much is permanent."

But the economic weakness came as no surprise to ECRI's leading indexes, on the basis of which, in May, we reconfirmed our earlier forecasts –– that "[i]ndustrial growth will slow around the world, as will overall economic growth in the U.S. and most of Europe" *(↗International Cyclical Outlook, Vol. XVI, No. 5, May 2011)*. Today, ECRI's leading indexes still point to a continued slowdown rather than a quick bounce out of a "temporary soft patch."

Undoubtedly, global growth took a temporary hit from the Japanese earthquake that should soon be reversed, especially in industries such as the automobile industry that involve supply chains passing through Japan. But many are making the mistake of attributing the weakness entirely to such temporary shocks, with the expectation that the economy will therefore return quickly to a rising growth trajectory. Rather, according to ECRI's leading indexes, it is the bounce that will prove to be temporary, and give way to a cyclical slowdown.

Fed economists may be starting to suspect that the economic recovery is not sticking to the "temporary soft patch" script, hence the "awful lot of uncertainty" about the persistence of the slowdown. However, with the second round of quantitative easing about to end and a third round likely to meet strong resistance in the current political climate, the Fed is largely powerless to provide a further monetary policy boost at this juncture. Under the circumstances, despite his apparent confusion, Mr. Bernanke may prefer to stick to the party line that the economy will experience "greater growth going forward," even though this is not evident from good leading indicators. Such touching faith is even more abundant across the pond.

Implausible Denial More than a year ago in this publication *(↗Vol. XV, No. 4, April 2010)*, we concluded that the "two alternatives to default or at least restructuring of Greek debt" – highly draconian fiscal

Divergent Outlooks

	Current Growth	Consensus Growth Outlook	ECRI Growth Outlook
↗U.S.	Slow/Average	Slow/Average	Slow/Average
↗Canada	Slow/Average	Average	Average
↗Mexico	Average	Average	Average
↗Germany	Average	Average	Slow/Average
↗France	Average	Average	Slow/Average
↗U.K.	Slow	Slow	Slow
↗Italy	Slow	Slow/Average	Slow
↗Spain	Recessionary/Slow	Slow/Average	Recessionary/Slow
↗Switzerland	Slow/Average	Average	Slow
↗Sweden	Average	Average	Average
↗Austria	Average	Average	Slow/Average
↗Japan	Recessionary	Recessionary	Recessionary
↗China	Slow/Average	Average	Average
↗India	Average	Average	Average
↗Korea	Slow/Average	Average	Average
↗Australia	Slow/Average	Average	Slow/Average
↗Taiwan	Average	Average	Average
↗New Zealand	Recessionary	Recessionary	Recessionary
↗South Africa	Slow/Average	Average	Slow

FOCUS: German Outlook

policy changes in Greece or its exit from the Eurozone – were both politically untenable. However, since a Greek default was – and continues to be – unacceptable to a number of powerful stakeholders, the official policy became, and still remains, one of implausible denial about Greece's solvency.

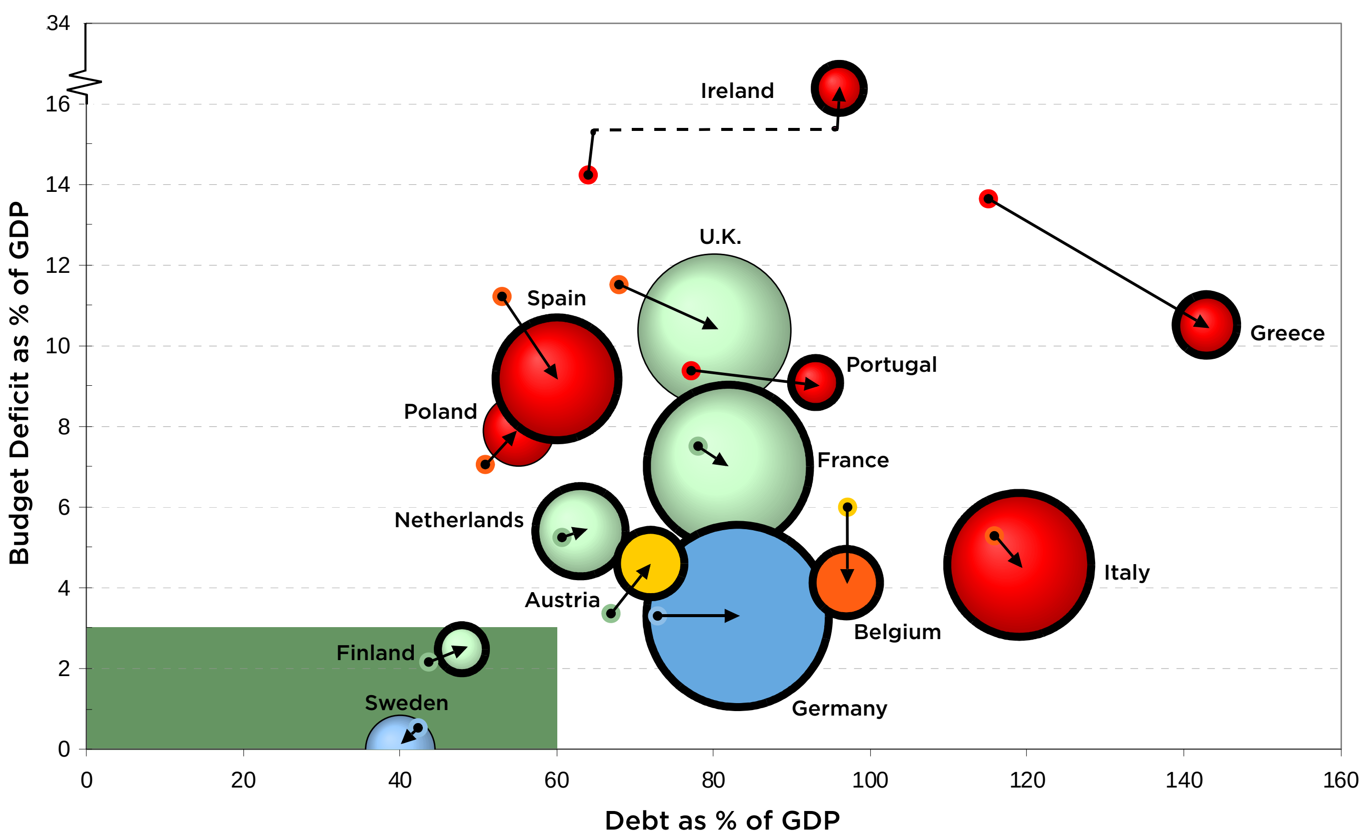
That pretense will become even harder to maintain in the coming months. As we discuss in detail later *(↗pages 5 to 7)*, German economic growth is set to slow more than most expect. This slowdown will make it more painful for the German electorate to support their Southern European compatriots, further complicating European policymaking. But growth prospects are not worsening for Germany alone; they are dimming across Europe, and ominously, darkening again in Southern Europe.

As luck would have it, in the year or so since the European sovereign debt crisis burst on the economic scene, Europe has enjoyed a sustained stretch of above-trend economic growth, making it much easier to paper over the cracks in the system. But what the business cycle gives, it can also take away. Unfortunately, European economic growth is poised to slow in the coming months. In fact, European retail sales growth, which has already turned down, is set to sustain a cyclical downswing *(↗page 14)*.

Just over a year ago in this publication *(↗Vol. XV, No. 5, May 2010)*, we examined the debt profiles of a range of European economies. A newly updated version of the chart we had highlighted at the time (Chart 1a) shows the debt profiles of 11 Eurozone economies (thick borders) and three other European economies (thin borders) in the form of circles, whose coordinates on the chart represent their sovereign debt as a percentage of GDP (horizontal scale) and annual budget deficit as a percentage of GDP (vertical scale).

The circles are sized such that their areas are proportionate to their GDP, and colored based on their recent interest rate spreads compared with Germany's borrowing rates. The red circles represent the widest spreads – over 200 basis points; the orange circle represents a spread between 100 and 199 basis points; the yellow circle represents a spread between 50 and 99 basis points; the green circles represent spreads under 50 basis points but above zero; and the blue circles represent spreads at or near zero. Finally, the black dots at the tails of the arrows represent the circle locations when we displayed them last year, with the colors

Chart 1a: Fiscal Profiles of European Economies



surrounding the dots indicating the interest rate spreads in May 2010.

This chart makes it evident that the fiscal austerity imposed in many European economies has generally succeeded in reducing the budget deficit as a percentage of GDP. The dramatic exception is Ireland, which, with its budget deficit skyrocketing to a third of its GDP, is practically off the chart. Other, more minor, exceptions to this pattern, where the budget deficit has risen as a percentage of GDP, are Poland, which is not part of the Eurozone, and Finland, Austria and the Netherlands, where the percentages are still in the low to mid-single digits. In the case of Germany, the percentage is virtually unchanged.

Yet, it is remarkable that, despite a cyclical phase of above-trend economic growth over the past year or so, along with painful fiscal austerity in most of these economies, debt as a percentage of GDP has actually risen almost everywhere. The only true exception (other than Belgium, where that percentage stayed the same) is Sweden, which has seen exceptionally strong economic growth over the past year. Of course, the biggest increases in the debt-to-GDP ratios were seen in Ireland, Greece and Portugal, all of which are mired in deep recessions.

Research has shown that a rise in public debt as a percentage of GDP above the 90% threshold is generally associated with lower economic growth. As Chart 1a shows, Ireland and Portugal are now above that mark, while Belgium had a larger debt load to begin with. Of course, the percentages were well above 100% for Greece and Italy, and continue to rise.

Notably, despite the combination of significant efforts to impose austerity and a relatively favorable phase of the business cycle, the percentages of debt to GDP have now risen to 80% or more for Germany, France and the U.K. – Europe's three largest economies. These figures are no longer that far from the aforementioned 90% threshold. None of the Eurozone economies except Finland (and tiny Luxembourg, which is not shown) lie within the green rectangular area at the bottom left of the chart that marks the debt and deficit levels permitted by the 1997 Stability and Growth Pact. Indeed, nearly all of them, including Germany, are moving in the wrong direction.

Of course, many of these economies are export-oriented so their growth prospects depend in part on their export prospects. This is especially true for Germany, where the cyclical outlook for global industrial growth in general and Chinese industrial growth in particular does not bode well at all *(↗pages 5 to 7)*. A critical issue in this context is the caging of the Chinese "inflation tiger."

Caging the Tiger Chinese consumer price inflation has already risen to a 34-month high of 5.5% – well above the official targets of 3% for 2010 and 4% for 2011. Some analysts expect it to surge as high as 6% in the near future. Yet Premier Wen Jiabao, in a recent newspaper article, claims to be "confident price rises will be firmly under control this year." Is his confidence well-founded?

In fact, Chinese economic growth has slowed significantly, according to ECRI's Chinese Coincident Index growth rate *(↗Chart 26b, page 31)*. Chinese industrial production growth has also moderated, and is likely to ease further *(↗Chart 27, page 32)*. It is not surprising, in this context, that ECRI's Chinese Alternative Future Inflation Gauge (CNAFIG) is now in a cyclical downturn (Chart 1b, top line).

Under the circumstances, while it is possible for CPI inflation (bottom line) to rise further in the near term, it is likely to start easing in the coming months. In that sense, the CNAFIG lends support to Mr. Wen's view. Still, with food price inflation hitting 11.7% in May and likely to stay high due to disruptions caused by the recent floods in southern China, the Chinese authorities will remain under pressure to curb price increases.

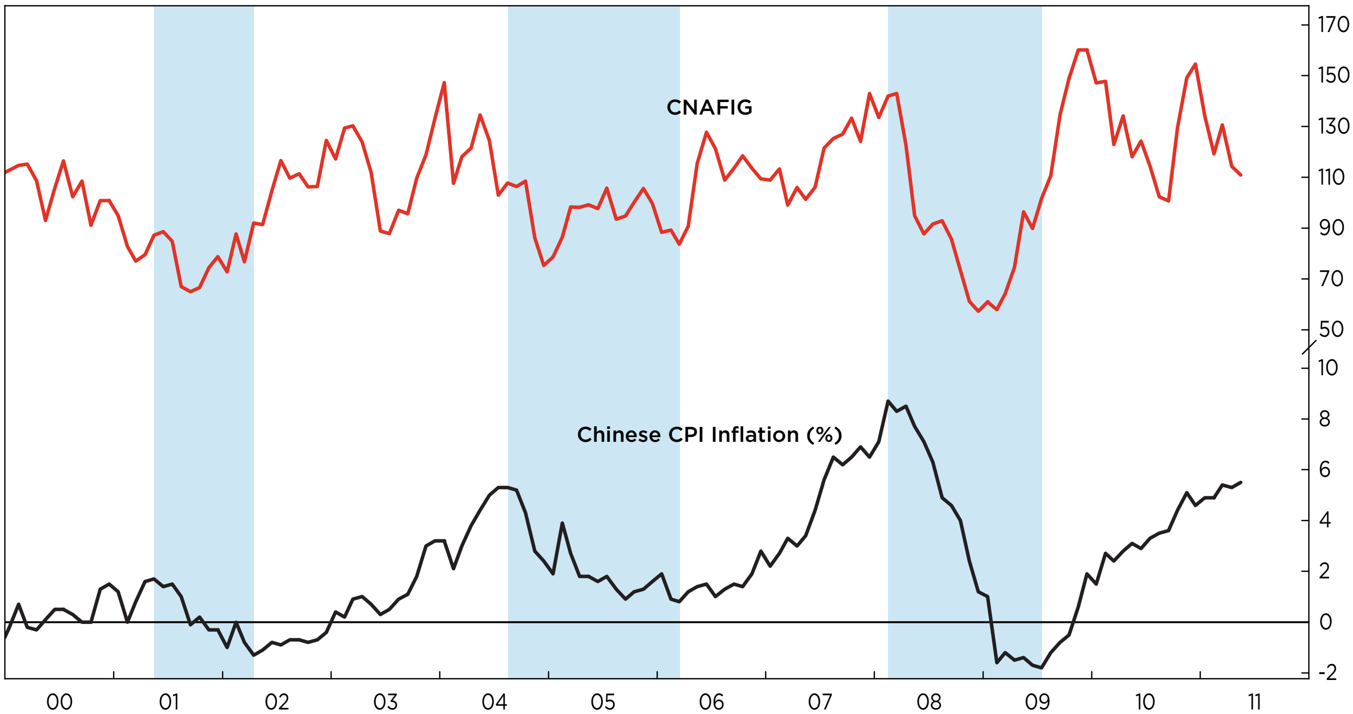
Chinese inflation is likely to start easing in the next few months.

The point is that, Mr. Wen's apparent certitude about inflation notwithstanding, Chinese officials could very well take further steps in the foreseeable future to cool economic growth. That would be bad news for economies that depend on exports to China.

Apart from Germany, this includes Australia, where economic growth has already dropped to the worst readings since its last recession in 1990-91. Because the Queensland floods are being widely blamed for the slowdown, many expect growth to rebound soon.

Unfortunately, given the downturn in the growth rate of the Australian Long Leading Index, which began long before the floods *(↗Chart 32b, page 37)*, Australian growth prospects are decidedly downbeat. Significantly, Australian consumer and business expectations have both dropped to around two-year

Chart 1b: Indicators of Chinese Inflation



Shaded areas represent cyclical downturns in Chinese inflation.

lows (*page 28*). Meanwhile, ECRI's Australian Future Inflation Gauge is in a clear cyclical downturn (*Chart 31, page 36*), suggesting that inflation will ebb in the coming quarters. Against this backdrop, and given ECRI's forecast of a sustained slowdown in global industrial growth, Australian rate hike expectations may well be overdone.

A key justification for our global industrial slowdown forecast, which we initially announced in this publication in January 2011 (*Vol. XVI, No. 1*), was the downturn in ECRI's Financial Related Diffusion Index (FRDI), which is a long leading indicator of global industrial growth. In April, the FRDI fell to a 31-year low before registering a one-month uptick. Because its median lead over global industrial growth is almost a year, a cyclical revival in global industrial growth is unlikely to begin before early 2012.

While China has become a much more important driver of global growth in recent years, exports to China represent a significant percentage of GDP only for Germany and China's neighbors in the Asia-Pacific region (*International Cyclical Outlook, Vol. XIV, No.11, November 2009*). At the end of the day, the U.S. is still the indispensable export market. Thus, the main driver of global growth remains the U.S. economy.

In order for stimulative monetary policy to be effective, it is not enough to increase the money supply if the velocity of money is low. Unfortunately, money velocity has plunged in the U.S. in the wake of the Great Recession. While such longer-term structural changes in velocity are more difficult to anticipate, we note that ECRI's U.S. Future Inflation Gauge (USFIG) has a median lead of half a year over cyclical turning points in the velocity of money (*page 8*). As such, with the USFIG falling to a seven-month low, consistent with the slowdown in economic growth, the velocity of money appears unlikely to turn up this year. On this score, U.S. monetary policy will probably be relatively ineffective for the time being.

In sum, there is little likelihood of a sustainable snap-back in U.S. economic growth any time soon. Rather, global growth is set to slow further in the coming months. This is an ominous prospect, especially in the context of the European debt crisis. ■

