

Global Growth to Worsen

The global economy is in a deepening downturn from which the U.S. cannot easily decouple.

The Decoupling Delusion Economic growth is slowing in all 20 economies monitored by ECRI, and is set to decline further in the coming months. Around the world, every major developed country is either in recession or in serious danger of sliding into one. Yet

there is a growing consensus that the U.S. economy will decouple from those economies and begin to accelerate instead.

The decoupling delusion dies hard. Recall that, because the subprime crisis originated in America, it was a common belief until the summer of 2008 that the Eurozone would sidestep any U.S. downturn. This overconfidence culminated in a July 2008 rate hike by the European Central Bank (ECB), months after the Eurozone had already entered recession. Yet, as we had pointed out in this publication much earlier ([↗ Vol. XII, No. II, November 2007](#)), even a U.S. slowdown, let alone recession, was "enough to significantly damage growth in European exports to the U.S."

In truth, as we discuss later ([↗ pages 5 to 10](#)), the likelihood of cyclical decoupling between any pair of economies depends on the kind of economic cycle being considered. We are most likely to see such decoupling between classical business cycle recessions in two economies, especially if one of them has a much higher trend rate of growth. For instance, with China having seen no recessions at all since the late 1980s, its business cycles have been decoupled for decades from those in the U.S.

Such decoupling is more difficult to find when we examine periods of simultaneous below-trend economic growth in a pair of economies. Thus, even China saw economic growth drop well below trend during the 2008-09 global financial crisis, and was certainly not decoupled from the U.S. downturn in that sense.

Decoupling is most unlikely when we refer to concerted cyclical downturns in economic growth in a pair of economies. Today, almost every significant economy is experiencing such a growth rate cycle downturn. The overwhelming majority of economies, including almost every economy monitored by ECRI, is also witnessing a period of below-trend growth, either being in recession already or headed for one. Please note that, the deeper the declines in economic growth, the more likely they are to be synchronized in

Divergent Outlooks

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

FOCUS: Decoupling from Downturns

terms of deviation cycle downturns – and even business cycle contractions.

The real question, then, is whether the U.S. economy can avoid an outright recession in the face of a Eurozone contraction. After all, based on the "positive economic surprises" shaping popular perceptions in recent months, most have concluded that the U.S. is already seeing a revival in growth.

It is little wonder, then, that a CNBC reporter, surprised by the Fed's declaration this week that it intends to keep interest rates exceptionally low at least until late 2014, asked Chairman Bernanke: "We've had several months of economic data that's been stronger than most forecasters expected... but there seems to be very little mention of this recent strength in this statement. Do you and the Committee ... harbor doubts about the recent strength in the economy?" The Fed Chairman's response was notable in the face of near-universal agreement among economists that U.S. economic growth is picking up: "I don't think we are ready to declare that we have entered a new, stronger phase at this point."

As we note later ([pages 5 to 10](#)), "enhanced global interdependence has helped increase the synchronization of cyclical downturns in the major economies." Specifically, the export dependence of most economies has risen dramatically over the last two decades, while global supply chain networks have proliferated, given that trade in intermediate goods now dominates international trade. This exacerbates the Bullwhip Effect, which amplifies fluctuations in end-user demand up the supply chain.

Meanwhile, as we discussed in this publication last month ([Vol. XVI, No. 12, December 2011](#)), cyclical volatility is now near multi-decade highs in every G7 economy, while trend growth in GDP and jobs has been unusually weak in the latest expansion, especially in the U.S., the U.K., France, Italy and Japan. Such conditions virtually dictate more frequent recessions, the risk of which is especially elevated during deeper growth rate cycle downturns.

What the Fed acknowledged this week is the downshift in long-term trend growth in the U.S. that ECRI has long highlighted ([U.S. Cyclical Outlook, Vol. XIII, No. 8, August 2008](#)). Under such circumstances, the only way to "muddle through" without a recession – as the plan appears to be – is to somehow tamp down already-heightened cyclical volatility and avoid shocks. It is a forlorn hope, with the U.S. economy remaining in a recessionary window of vulnerability.

Of course, the Fed's efforts to provide liquidity support for the global financial system in conjunction with other central banks, announced last month, and the ECB's Long-Term Refinancing Operation (LTRO), designed to provide massive liquidity support to Eurozone banks, are intended to head off the clear and present danger of a breakdown in the international financial system. While the ECB's policy of lending cheap money to banks without asking inconvenient questions has been a spectacular success, neither fiscal austerity nor the LTRO can save Southern Europe from deepening recessions. Here again, the plan seems to be to "muddle through" while hoping nothing bad happens along the way.

In the face of recession, injecting liquidity into the system can certainly boost the prices of certain assets. Three months after the Great Recession began, a plunge in the Fed funds rate was followed by double-digit percentage gains in stock prices in the spring of 2008, along with soaring commodity prices. Yet, these steps were unable to forestall the Great Recession.

With the velocity of money plummeting to a new record low, it is becoming increasingly difficult for U.S. monetary policy to boost economic growth.

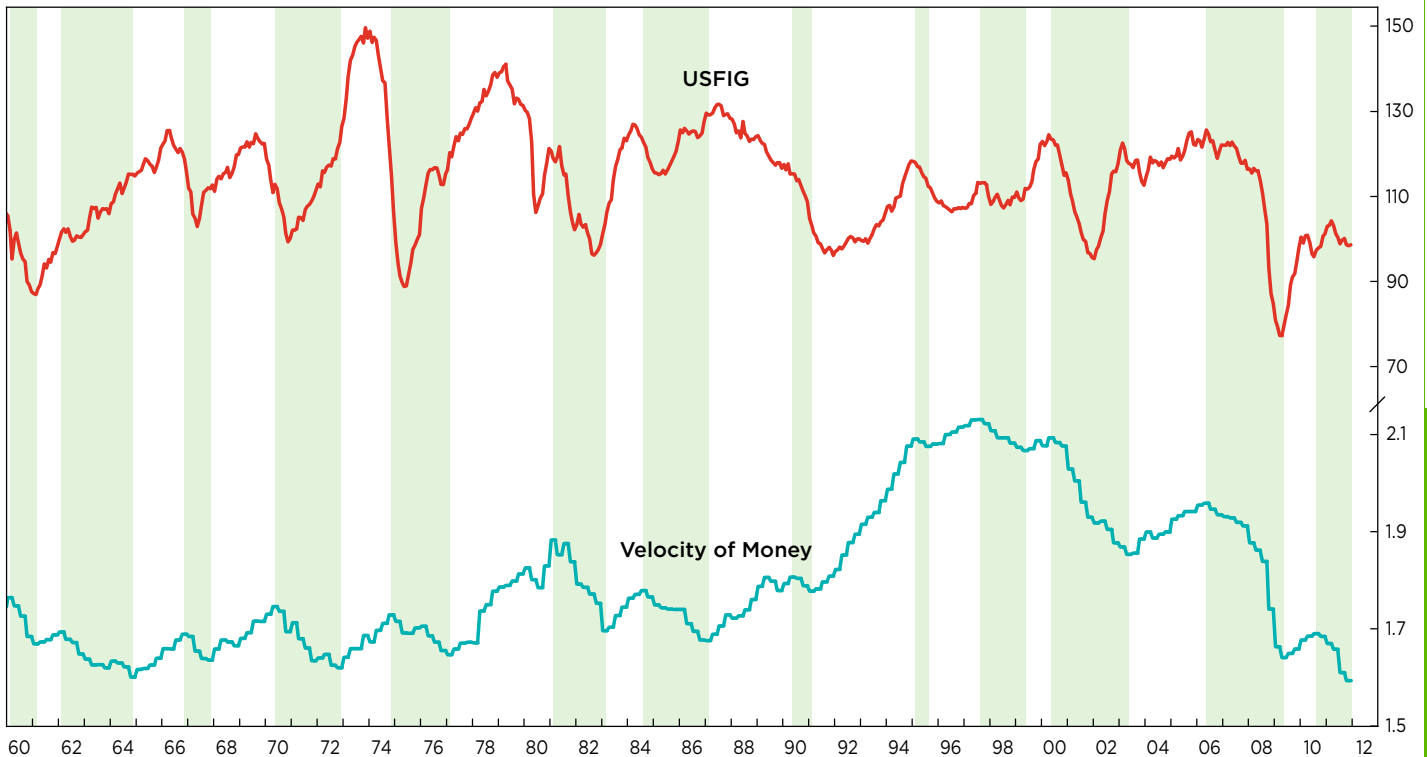
Vanishing Velocity The velocity of money indicates the speed with which it changes hands. If velocity is high, for instance, monetary stimulus will be more effective than if velocity is low.

As we showed in this publication last June ([Vol. XVI, No. 6](#)), the velocity of money has changed substantially over time. However, we noted that its cyclical turning points were fairly predictable, with ECRI's U.S. Future Inflation Gauge (USFIG, Chart 1a, top line) leading the velocity of money (bottom line) at 86% of cyclical turns, with a median lead of six months.

The velocity of money surged between the late 1980s and late 1990s, especially during the longest expansion in U.S. history, but it has since dropped dramatically, and has just plunged to a new record low. Moreover, the downturn in the USFIG suggests that velocity will fall even further in the months ahead.

What this tells us is that, even with the Fed's best efforts at monetary easing, money is changing hands less and less often, and is increasingly sitting idle. In fact, the prospect of disinflation and, even more so, the threat of deflation, is likely to make it more attractive to hold liquid assets. With the USFIG in a cyclical

Chart 1a: U.S. Future Inflation Gauge and Velocity of Money



Shaded areas represent cyclical downturns in the U.S. velocity of money.

downturn, disinflation is the most likely outcome in the months ahead, and a recession would bring with it the potential for deflation, given current conditions. The point is that, while monetary easing can influence asset prices, it may be less effective in boosting economic growth when the velocity of money is plummeting to record lows.

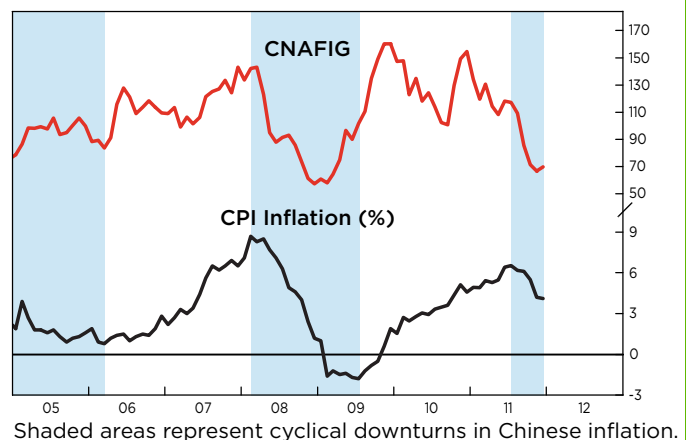
Nor is the increasing impotence of monetary policy confined to the U.S. For all the ECB's monetary policy moves, the velocity of money in the Eurozone has also dropped to almost a new record low, consistent with the downturn in ECRI's Eurozone Future Inflation Gauge (not shown). It does not do the central bank much good to print vast amounts of money, so to speak, if that money is not going to be circulated within the economy.

Unfortunately, the decline in the velocity of money is not just a Western phenomenon. ECRI's calculations show that, even in China, it has now dropped to a new record low (not shown), following the downturn in ECRI's Chinese Alternative Future Inflation Gauge (CNAFIG), which has a median lead of about half a year over Chinese money velocity. Under the circumstances, Chinese efforts to ease monetary policy in the months ahead may turn out to be less effective than generally hoped.

A Tricky Transition Seven months ago in this publication ([Vol. XVI, No. 6, June 2011](#)), based on a cyclical downturn in the CNAFIG, we predicted that "Chinese inflation is likely to start easing in the next few months." As Chart 1b shows, that is precisely what has transpired. In fact, with the CNAFIG still in a cyclical downswing (top line), Chinese CPI inflation (bottom line) is poised to fall further, as is the velocity of money (not shown).

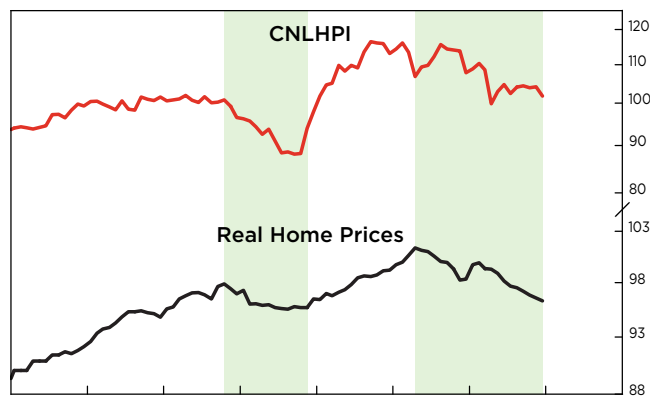
Furthermore, the growth rate of ECRI's Chinese Leading Industrial Production Index (CNLIPI)

Chart 1b: Indicators of Chinese Inflation



Shaded areas represent cyclical downturns in Chinese inflation.

Chart 1c: Chinese Leading Home Price Index and Real Home Prices



Shaded areas represent cyclical downturns in Chinese real home prices.

remains in a clear cyclical downturn, suggesting that Chinese industrial growth, which has already dropped decisively to a 26-month low, will fall further (↗*Chart 26, page 34*). This is a downturn that is not likely to be reversed soon, notwithstanding Chinese policymakers' recent efforts to "fine tune" economic growth.

In fact, as Chart 1c shows, not only are Chinese real home prices falling rapidly (bottom line), but also ECRI's Chinese Leading Home Price Index has not turned up yet (top line). This is a clear warning of further declines ahead for home prices. In other words, with policymakers not in a position to stabilize home prices in the near term, there is still the danger of a disorderly decline in home prices, making for a potentially tricky transition.

As we discuss later (↗*page 18*), CNLIPI growth is a leading indicator of German export growth. Thus, the continued cyclical downswing in CNLIPI growth "does not bode well for a near-term [German] export growth revival." More broadly, growth in the German Leading Exports Index remains in an ongoing downturn (not shown), underscoring the worsening growth prospects for the overall German economy, and highlighting the international trade linkages that make it so difficult to decouple from the economies of important trading partners.

In the same vein, we showed earlier in this publication (↗*Vol. XVI, No. 7, July 2011*) that CNLIPI growth has a median lead of half a year over Brazilian export growth. Thus, the continued downswing in CNLIPI growth threatens to deepen the Brazilian recession.

Thanks to trade linkages, the global downturn is also bad news for the export growth prospects of both

the U.S. and Japan. As we discuss later (↗*page 32*), the Japanese Leading Exports Index is pointing to pessimistic prospects for Japanese exports. Meanwhile, the continued cyclical downswing in the growth rate of the U.S. Leading Exports Index (↗*page 11*) suggests poor prospects for not only U.S. export growth, but also U.S. export price growth, neither of which is likely to be supportive of the U.S. economy, which had been boosted until recently by exports.

The inescapable point is that the world economy is inextricably interlinked. Under the circumstances, it is very difficult for the U.S. economy to decouple from downturns in the rest of the world.

As for the "recent strength in the economy" touted by the CNBC reporter, it looks like much of that strength may be a result of distorted seasonal factors. Specifically, as we explained last week (↗*U.S. Cyclical Outlook, Vol. XVII, No. 1, January 2012*), "the unusually deep contraction in late 2008 and early 2009 is probably being translated by standard seasonal adjustment programs as a lasting change in the seasonal pattern itself rather than being an unrepresentative anomaly. Consequently, the new 'normal' seasonal pattern during the fall and winter months expects the data to be so weak that, in comparison, even moderately weak data are interpreted as being fairly strong."

Because analogous, if not identical, seasonal adjustment procedures are used around the world, it is probable that international economic indicators, including ECRI's own international long leading and coincident indexes, are being biased upward at this time. If so, the economic outlook may be even worse for key Eurozone economies than our indexes currently suggest. The same holds true for economies like Australia, Taiwan and Brazil.

In sum, the global economy is in a deepening downturn from which the U.S. cannot easily delink, making the notion of "decoupling" unrealistic. In the Eurozone, near-term prospects may be worse than many popular indicators suggest, while, in the longer term, very low trend growth is likely to keep much of the region dipping in and out of recession, making the fiscal situation increasingly untenable.

Meanwhile, with Brazil sliding into recession and growth in China and India set to slow for now, the developing countries are in no position to come to the rescue of the West. The only silver lining is the continued indication from ECRI's leading indexes that global industrial growth is still likely to bottom sometime in the first half of 2012. ■