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IN THIS ISSUE

- Output slowdown in the US and recent pressure on financial markets may signal a change in speed for the world economy.
- According to some analysts, the unwinding of global imbalances could trigger disorderly corrections to trade and output growth, with some emerging markets suffering from weak economic fundamentals particularly at risk.
- In our view, these risks are, however, mitigated by increasing resilience of emerging market economies compared to the mid-1990s and by sizeable international reserve build-up.
- We suggest more risk differentiation in this context of uncertainty and slower global growth.
- As a result, inflation risks should remain the prevailing source of concern for policymakers, especially in emerging markets.

Half Full Or Half Empty: How Is the Glass Of Global Growth?

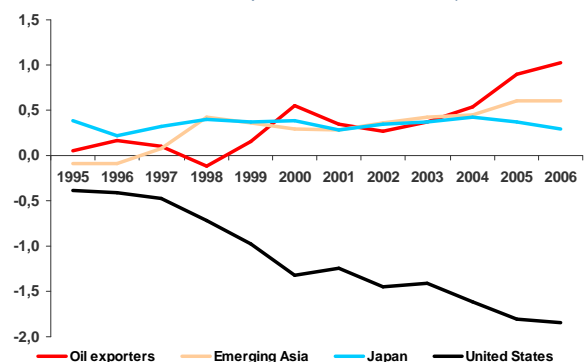
International growth outlook: who is wrong?

Two alternative views have confronted themselves in recent months on the medium-term outlook of the world economy, in light of recent economic developments in advanced and emerging markets. According to the pessimistic view, global imbalances—resulting among other factors from the property bubble in the United States (US)—have started to unwind in a disorderly way and could trigger a dramatic fall in

US private consumption. This, in turn, would affect the economic performance of exporting emerging markets and thereby lead to a sharp contraction in world output growth and international trade. The “half-full glass” version of the debate leads to opposite conclusions: the US economy will experience a soft (as opposed to hard) landing from unsustainable consumption-led growth patterns. This will help bring in check rising price pressures, housing market overvaluation, and the exploding current account deficit, contributing to a gradual solution to global imbalances. *We support this latter view, but highlight the need to differentiate country risk more than markets currently do. We also suggest that inflation should be considered the number-one enemy in emerging markets with weak fundamentals. We explain why in the following sections.*

Global imbalances have widened

(current account balances, percent of world GDP)



Source: SACE calculations on IMF data.

So far so good. World economic growth has been strong in recent years. Real output growth averaged over 4% in the 2002-05 period, led by sustained international trade flows. This growth level is comparable to other spells of high world growth (e.g, growth was above 4% on average also in 1976-79 and in the mid-90s) and has been achieved in a context of rising commodity prices

and geopolitical instability. More importantly, economic growth has also been more evenly spread worldwide, with poorer countries, including in Africa, participating to global economic development unlike previous world high-growth periods: a fact neglected in most analyses.

Capital flows to emerging markets have been intensive. This is a blessing for these economies, but requires good economic management. Favourable global economic conditions and extraordinary access to market financing at inexpensive conditions have generated large capital inflows towards emerging market economies. Capitals have been attracted by fast-growing markets, led by China and the rest of emerging Asia; by the strong performance of post-crisis Latin American countries; and the oil-related growth of resource-rich regions. At the same time, capital flows have also been boosted by strong international remittances: in itself an effect of market integration and globalization. These positive developments are also reflected in the continuous reduction in emerging market risk as measured by EMBI spreads, which fell by about 700 bps since the end of the Argentinean crisis.

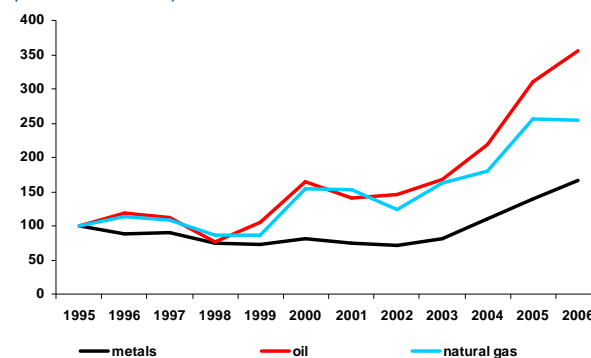
However, global vulnerabilities have increased. Global imbalances have expanded with the US current account balance exceeding 6% of GDP. Trade surpluses in emerging markets and resource-rich countries have reached record highs and have led to the accumulation of sizeable international reserves (e.g., China is about to pass the US\$ 1,000 billion threshold). These imbalances put strong pressure on the dollar that so far has been supported by massive purchases of US government securities by reserve-accumulating countries. A slowdown in the US demand may trigger a dramatic change in the direction of capital flows and lead to a sharp depreciation of the dollar according to the pessimistic views. However, this would operate in the direction of narrowing the US trade balance gap, although at a cost.

Commodity price levels remain high. Sustained by expanding demand from China and increased worldwide consumption, commodity prices increased sharply in recent years. Prices of metals, oil and gas, copper and other basic commodities have edged up at a rapid pace. Oil price upward trends were also affected by global geo-political factors (e.g., instability in Iraq and Afghanistan, political tensions between the US and Venezuela, violence in Nigeria, and conflicts in the Middle East). Despite oil prices passed the US\$ 70 per barrel psychological threshold, they remain lower in real terms than during previous oil shocks. They are now back to below US\$ 65 per barrel. Also, the latest spell of oil price increase has been more gradual than in the past. This is

the consequence of increasing oil demand being the key underlying factor for oil price inflation rather than supply constraints, unlike the oil crises of the 1970s. This means that high oil prices may remain high for a long period, notwithstanding the increase in world's energy efficiency over the last decade as estimated by the IMF (more so in the advanced markets than in China).

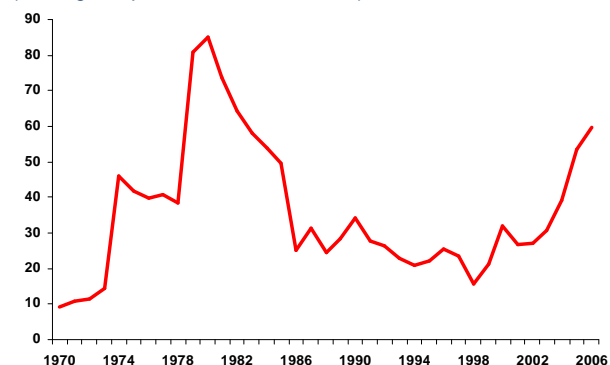
Commodity prices up...

(index 1995=100)



... but oil prices still below peak periods in real terms

(Average oil price in 2005 US dollars)

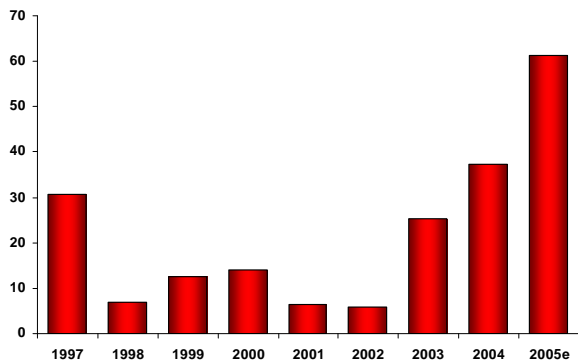


Source: SACE calculations on IMF data.

Too much liquidity? Excess liquid assets owned by emerging market economies may represent another source of vulnerability for global stability. This factor is often cited by pessimists to support their views. Portfolio investment has in fact increased since 2002 and exceeded US\$ 60 billion in 2005: twice the size of the pre-Asian crisis level in 1997. Flows remain concentrated in absolute terms: two thirds are directed to China, India and South Africa. However, they are more evenly spread geographically when calculated as a ratio to destination countries' GDP. Portfolio flows have positive impacts on recipient economies as they provide capitals for economic activity and contribute to deepen and stabilize financial markets. They do not necessarily come without risks. Given its short-term nature, portfolio investment may rapidly change destination as market sentiment changes, thereby affecting regional financial stability. This is particularly evident in the case of derivative trade. Short-term capital inflows have also been accompanied by a

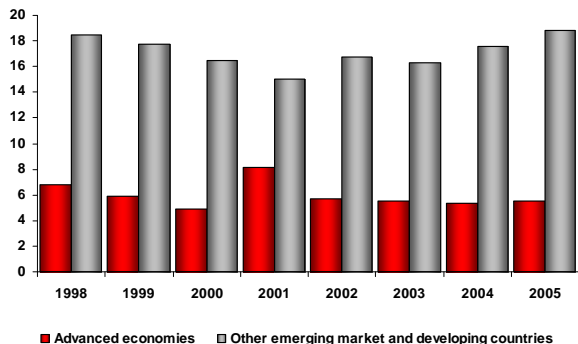
sharp increase in the rate of growth of monetary aggregates worldwide, owing to favourable financing access conditions (e.g., low real interest rates in most countries) but these trends have been accompanied by deeper and more efficient financial systems, including in emerging economies.

Portfolio inflows on the rise...
(flows, billions of US dollars)



Source: IIF.

... and still a lot of liquidity
(M1 aggregate, annual percent change)



Source: IMF.

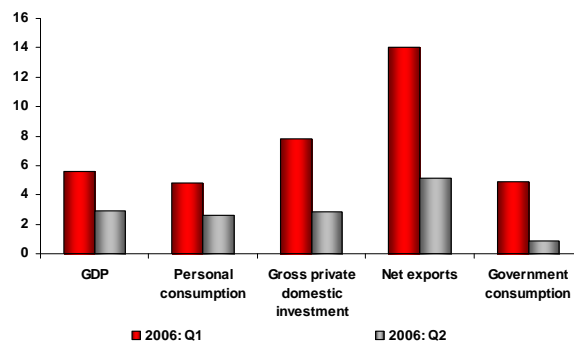
Real estate prices may have reached a peak.

Housing prices reached staggering levels in some industrial countries such as the United Kingdom (where they started to slow down lately) and the US (where they may have finally peaked). Home prices surged mostly as a result of favourable global financing conditions. There are two risks that stem from these trends: the property bubble could burst and lead to significant negative wealth effects in industrial countries, thereby contributing to reduce permanent income. This would have a depressive impact on private consumption first and private investment at a later stage. Besides this direct effect there could also be an indirect effect of housing market developments on private consumption. In the US, property wealth withdrawals were a significant factor contributing to household consumption growth. A slowdown, or even a more marked fall, in the construction sector would also hit domestic demand via lower employment growth.

Is the recent slowdown in US growth a sign that pessimists were right?

Revised data for the second quarter report a not-so-sluggish 2.9% GDP growth year-on-year. This is not much below potential output growth, but it is half the speed of GDP increase in the first quarter of 2006. The reduction in US growth originates from lower construction investment and less rapid private consumption growth. Home sales have been down by more than 10% year-on-year based on recent monthly data, while inflation exceeded 4% annual growth (with core inflation at 2%) and wage costs have drifted up reducing company profits and increasing unit labour costs. Net export growth was also below Q1 data, but this result also reflected one-off sectoral developments (e.g., a slowdown in aircraft export).

US output growth slowdown
(annualized qoq percent changes)



Source: US Bureau of Economic Analysis.

We view the US economy as cooling down, but not freezing.

Productivity growth has been the main factor underlying non-inflationary output growth performance in the past quarters, but this may have come to a halt. As wage pressure start to build up, unit labour costs erode profit margins and competitiveness. The US treasury yield curve remains flat: this may be a result of abundant savings worldwide, but it also shows that markets are factoring in a slowdown in the US economy. Nonetheless, at almost 3% yearly, growth is still well above the euro area output speed: no sign of a hard landing yet!

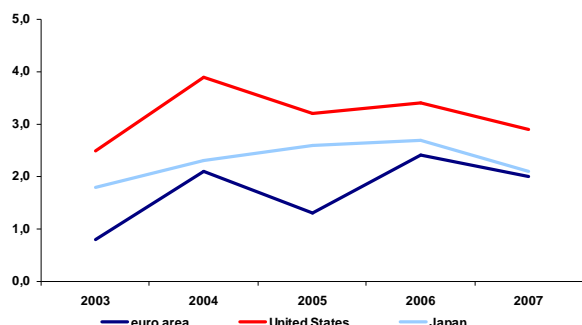
Growth "redirection" is another mitigating factor.

The US economic slowdown comes at a time when the euro area outlook is positive and GDP growth has exceeded 2% per year, led by strong economic performances in Germany and France. Data for Q2 were also very positive in countries such as Italy that have traditionally reported lower growth. Beyond Europe, growth remains sustained in emerging Asia, with China showing no sign of major deceleration and India following closely. Japan is now firmly back on a moderate but positive growth path and exporting Latin America is doing well despite populist policies in some countries. With oil and other

commodity prices remaining strong, resource-rich Middle-East and Russia are poised to continue to benefit from a favourable economic outlook.

Regional rebalance of growth

(Real GDP, annual percent change)



Source: IMF.

More importantly, we see emerging markets more resilient than in the past. Comparing current data for emerging market economies with the situation before the Asian crisis, we can observe a sharp reduction in external and fiscal vulnerabilities experienced in the post-crisis years. These countries have now stronger balance-of-payment positions, sit on a much higher pile of international reserves, have in general consolidated their fiscal positions and reduced inflation thanks to institutional reforms that made monetary policy management more independent.

Emerging markets learned their lesson

(in percent)

	1996	2005
GDP growth	7.5	5.2
Inflation	23.5	5.9
Current Account/GDP	-1.8	1.7
Total External Debt/GDP	32.2	28.8
Reserves/short-term debt	145.9	400.1
Fiscal Balance/GDP	-3.1	-2.4

Source: SACE calculations on IMF data.

Over the medium term, emerging economies can add significantly to world demand.

Consumer markets in these countries are largely untapped. Investment- and export-intensive growth in Asia and other emerging market regions could over time experience a "rotation" in domestic factors contributing to output growth, with a more significant role of domestic private consumption. This creates opportunities to rebalance global trade flows and the corresponding exchange rate parities in a gradual way. China trades heavily (both for export and import) with other emerging markets, particularly in Asia, not just with traditional industrial countries. This means that China may not only insulates better its economy from the US economic cycle up and downs, but it also keeps

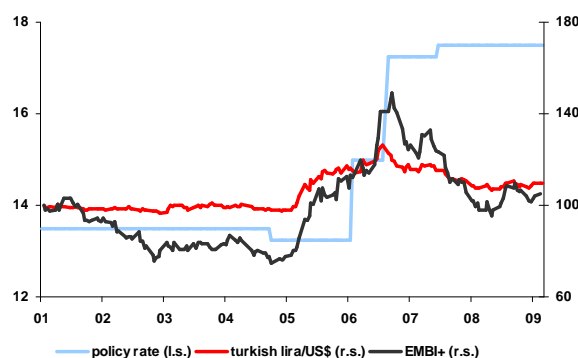
demanding goods and services from other emerging markets. This reduces the extent of a potential "contagion" originating from a slower US economic growth by better regional market integration.

Is the glass half full or half empty? Our answer is: there is more than one glass.

Not all emerging market countries look alike. The resilience of emerging markets to future shocks depends on fundamentals and policy responses. During the recent May-June episode of change in market sentiment that hit Turkey, Hungary and South Africa, although with a delay the authorities of these countries were able to react and gain back market confidence. These episodes also tell some interesting lessons: first, in a context of higher uncertainties it is countries with weaker fundamentals (e.g., fiscal problems, current account imbalances) that risk more. Second, political and institutional instability are increasingly seen by markets as important elements of country risk: delayed policy responses to market signals can be paid dearly. Third, countries with stronger transparency and better institutions are more able to deal with the likely increase in market selectivity towards emerging economies. Finally, inflation (not growth) is still the main investors' concern. Countries postponing painful adjustments out of concerns for growth may find themselves under attack if their fundamentals are problematic.

Market tensions contained by policy responses

(EMBI+ and exchange rate: index 2 jan=100)



Source: SACE calculations on Central Bank of Turkey, UIC and JPMorgan Chase data.

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