Shocks Unbalance the Global Economy

A number of shocks slowed the global economic recovery in 2011. Emerging economies on the whole fared better than the advanced economies, but the interconnectedness of the global economy and financial markets did not leave them unscathed. Economists are looking to moderate growth in 2012, but their fairly optimistic forecast hinges on the resolution of the European debt crisis and the political fiscal impasse in the United States.

As 2010 drew to an end, economic forecasters were predicting continued robust expansion into 2011 for the global economy. Sizeable macroeconomic stimulus packages in most parts of the world had boosted much of the growth throughout the year, but policymakers were hoping that as fiscal support faded, private demand would strengthen enough to carry the expansion forward. Although economists at the time acknowledged a number of downside risks, such as possible return of financial stresses in fiscally weak countries in the euro area, the baseline scenario was of sustained solid growth in advanced economies and a strong expansion in emerging countries.

But soon after 2011 began, the global economy began to experience a number of shocks, and global expansion slowed. Growth in advanced economies weakened markedly. The emerging economies as a group fared better, but given the interconnectedness of the global economy and financial markets, their growth momentum also waned as economic activity decelerated across the advanced economies.

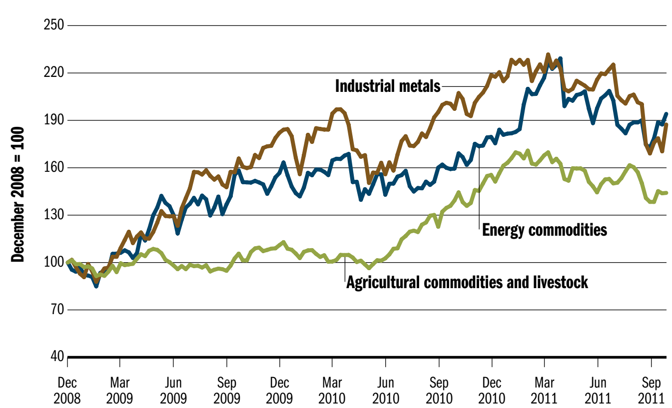
Civil unrest, natural disaster unsettle the world economy

In the early weeks of 2011, civil unrest spread through a number of countries in the Middle East and North Africa—a region that is also a key global supplier of oil. Resulting concerns over oil supplies sent oil prices sharply higher. In addition, prices of many other commodities, including agricultural commodities, had been increasing in tandem with continued economic growth (see chart 1). Both food and gasoline became significantly more expensive, fanning inflationary pressures and reducing consumer spending on more discretionary items.

Then, in March, natural disaster struck Japan. A massive earthquake followed by a tsunami ravaged the northeastern part of the country, leaving human tragedy and vast property damage in their wake. Japan is a major supplier of products and parts to factories the world over, so the disruption in Japan's manufacturing capability caused production around the globe to stutter. Some experts estimate that global automotive production, for example, fell by about 30 percent in the two months following the earthquake. Overall, the interruption in the supply chain may have shaved off as much as half a percentage point from world economic growth in the second quarter.

As the second quarter closed, renewed concerns about sovereign debt in a number of euro zone countries began to roil global financial markets. The sovereign debt crisis first broke out in Greece in 2010, but the response of European policymakers at the time helped limit its impact on the global economy. Economists and other observers assumed that the negative financial and economic effects of the necessary fiscal adjustment would be contained to the so-called "peripheral" European countries—Greece, Ireland, Portugal, Spain, and Italy. However, the sovereign debt problems in Europe proved to be much deeper and more contagious.

Chart 1
Commodity Prices



Note: Data are through October 2011.
Source: Standard and Poor's/Haver Analytics

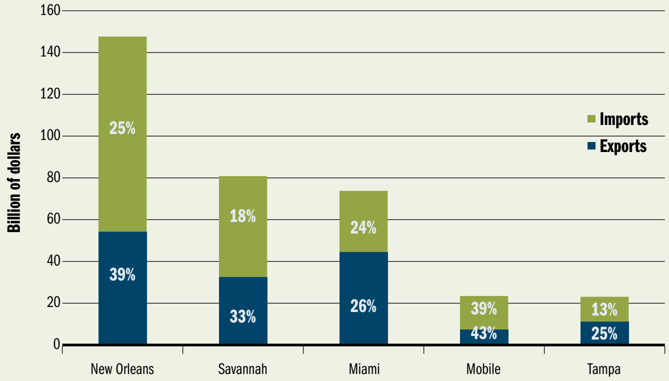
International Trade Shores Up U.S. Economy

Mobile, Alabama's port

International trade continues to play an important part in the U.S. economy. Exports in particular have contributed significantly to the economic recovery. Healthy economic expansion in most of our major trading partners has generated solid foreign demand for U.S. goods and services. U.S. exports to fast-growing emerging economies, such as China, have been particularly strong. In addition, the depreciation of the dollar has made U.S. exporters more competitive in international markets. Capital goods, auto products, industrial supplies, and services have been the largest contributors to recent export growth.

Imports, which fell sharply during the recession, have also increased as consumer spending and business investment recovered in the United States, with capital goods, autos, and auto parts leading overall import growth after the recession. Notably, consumer goods (except autos) accounted for less than one-fifth of the total increase, which is significantly less than in the decade prior to the recession. Overall, the U.S. trade deficit has widened since mid-2009, as our imports continue to exceed exports.

Trade Values by Port District



Note: Data are through August 2011. Percentages indicate growth in 2011 over 2010.
Source: U.S. Census Bureau/Haver Analytics

In the first half of 2011, both exports and imports increased steadily, although trade growth decelerated when the global economy lost some momentum. Data from southeastern ports confirm this growth. Year to date, all port districts in the region saw double-digit increases in both exports and imports by value compared to the same period in 2010 (see the chart). Trade growth was especially robust in the Mobile, Alabama, port district, with increases in the prices and shipments of coal, pulp products, and steel accounting for a big part of that growth. The Mobile port also benefited from rising production and shipments from a major steel manufacturer that moved to the area.

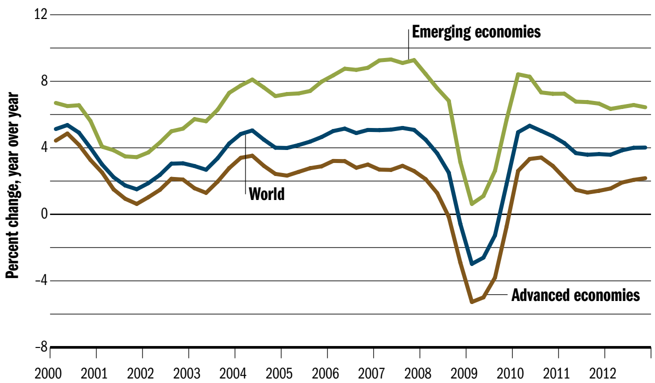
International trade is likely to contribute to U.S. economic growth in 2012. Economic forecasts call for exports to continue increasing, largely because of the continued demand for U.S. products from emerging economies. Meanwhile, import growth will probably remain subdued, in line with expected softness in domestic spending.

Sovereign debt problems persist in peripheral Europe

After Greece's rescue by the European Union and the International Monetary Fund, Ireland and Portugal also asked for international assistance when borrowing in financial markets became cost-prohibitive. All three countries received large financial packages, equal to about 45 percent of their gross domestic products and enough to cover most of their governments' financing needs for three years.

Over this past summer, however, investors became increasingly concerned about the ability of Italy and Spain—the third- and fourth-largest economies in the euro area—to pay their sovereign debts. As worries about the fiscal sustainability of these two countries increased, global financial markets became more volatile and stock prices moved sharply lower. Investor anxiety about sovereign defaults then hit the euro area's banking sector. Markets became more and more concerned about the exposure

Chart 2
2012 Global Outlook



Source: International Monetary Fund, *World Economic Outlook, September 2011: Slowing Growth, Rising Risks*

of European banks, including those in France and Germany, to the peripheral countries' sovereign debt problems. Stock prices of the largest French banks fell to levels not seen since early 2009. European banks began to face acute funding pressures. Given the European economy's reliance on bank lending, escalating problems in the banking sector became a major risk to the region's economic recovery. Significantly, the banking sector is a major channel through which European woes could be transmitted to other parts of the world, including the United States.

European policymakers had to mobilize larger and larger official financial resources to calm the markets, and the European Central Bank (ECB) did its share to support the banking sector. The ECB provided liquidity, bought sovereign debt, and supplied dollar funding to European banks by using a swap line with the Federal Reserve. Without a doubt, much of the financial market volatility was directly linked to investors' perception of the effectiveness of the various measures the policymakers took to arrest the crisis.

Governments in the peripheral countries committed to multiyear austerity plans that include drastically reducing public spending and increasing some taxes to reduce their nations' deficits and bring down debt burdens. They also announced structural reforms, such as pension and labor reforms, to promote long-term growth and fiscal sustainability. All of these countries, which represent a large part of Europe's economy, are facing several years of fiscal and structural adjustments and weakened growth prospects.

The sovereign debt crisis in Europe severely undermined consumer and business confidence and put a brake on economic growth in the region. Even in Germany, which has been the euro area's growth leader since the end of the recession in 2009, economic recovery lost momentum.

Financial markets transmitted European uncertainty to other parts of the world, including the United States, dragging down consumer and business confidence here as well. Furthermore, the lack of political consensus around fiscal adjustment plans in the United States has also weighed on confidence here.

Emerging economies remain resilient

The disruptions of the advanced economies did not affect the emerging economies to the extent that they have in the past. Although the increased global uncertainty caused capital flows to emerging countries to reverse somewhat and also weakened Western demand for their exports, domestic demand in emerging countries was relatively strong (see the sidebar). The emerging economies' resilience is explainable in part by East Asia's rising power. The region's economy is now large and dynamic enough to generate sizable import demand for foreign products. China in particular supported economic growth in Latin America, for

China's appetite for commodities such as oil resulted in growth in exports from resource-rich countries.

example, by importing a wide range of raw materials and other commodities that the region produces. In addition, China is an important investor in many developing countries, especially in Latin America and Africa.

In fact, in contrast to the anemic expansion in advanced economies, economic growth in emerging countries was strong enough in 2011 to generate concerns about potential overheating. Furthermore, emerging countries experienced substantial inflationary pressures from the rising price of food, which in these countries represents a big part of consumer spending. Many parts of the emerging world tightened monetary policy as a result of these pressures. However, as the global environment became more uncertain, central banks in many emerging economies either paused or actually began to reverse earlier rate hikes to support their economies.

The look ahead is uncertain

The global economy is expected to expand in 2012, although the pace of growth is likely to continue to differ substantially across regions. Emerging countries, which now account for about 40 percent of global consumption and two-thirds of global growth, are expected to maintain their strong growth trends. Some deceleration may occur, however, if external demand weakens enough. Eastern Europe, in part because of its trade links to Western Europe, is particularly vulnerable to the downturn in the euro area. Many emerging countries have room to offset declines in external demand with more stimulative macroeconomic policies.

Advanced economies, on the other hand, are facing weak growth and cannot rely solely on fiscal or monetary policies to turn their fortunes around. Policy interest rates are already close to zero in many countries and, with very weak fiscal positions, governments have no more appetite for fiscal stimulus. High unemployment, weak income growth, and still-depressed housing markets in many of those countries—including the United States—are likely to continue to weigh on consumer confidence and willingness to spend. On the positive side, economists expect inflationary pressures to subside as commodity prices level off. In addition, business investment is likely to remain strong, and demand from emerging markets should support the advanced economies' exporters.

The International Monetary Fund's September forecast for 2012 predicted an expansion in the global economy at a 4 percent pace—close to its 2011 growth pace. Emerging countries are expected to grow at about 6 percent, while advanced economies are likely to expand at a much smaller 2 percent (see chart 2 on page 25).

This fairly optimistic outlook is very uncertain and subject to considerable downside risks. The biggest of those risks are the continued severe financial stress in Europe and political impasse over fiscal consolidation in the United States. Continued political stalemate in the United States over the fiscal situation may lead to more loss of consumer and business confidence, which in turn could further undercut economic activity. Other notable risks are potential credit and real estate bubbles in some emerging countries and a possible run-up in world commodity prices because of tight supply-demand balance for a number of major commodities. ∎

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