Global Economic Growth Falters...Again

Many economists believed economic growth would pick up in 2013 after several challenging years. As the year went on, the developed countries made some improvements, but in developing economies, which powered the global economy out of recession, growth flagged. Although global economic growth decelerated for the third consecutive year, the outlook for the world economy in 2014 is cautiously optimistic.

Toward the end of 2013, the world economy again failed to meet the optimistic expectations that prevailed in the beginning of the year. Just as in 2012, forecasters revised down their outlook as the year progressed. Data through the third quarter of 2013 indicate that instead of the hoped-for acceleration, global economic growth is likely to have been slower than in 2012.

Global growth remained subpar while its underlying dynamics shifted. Advanced economies, which were the laggards of the post-2009 recovery, gathered some momentum, and expansion in a number of previously fast-growing developing economies, such as China, India, and Russia, disappointed. Also, certain risks that were looming at the start of the year—such as a potentially ruinous flare-up of the European debt crisis—abated, and a few new risks sprang up. In particular, investors and policymakers worldwide became increasingly concerned about the impact of U.S. monetary policy tightening on developing countries and the broader global economy.

Still, many forecasters, including the International Monetary Fund (IMF), expect global growth to strengthen in 2014, as major advanced economies expand simultaneously for the first time in several years and growth picks up in developing economies (see chart 1 on page 22).
Among the developed countries, 2013 proved something of a watershed for the economies of the euro zone, Japan, and, in certain respects, the United States.

After six consecutive quarters of contracting, the euro zone returned to growth in the second quarter of 2013, with Germany and France accounting for most of this growth. Even more encouragingly, some of the fiscally troubled European countries (sometimes referred to as “peripheral Europe”) began to show signs of economic stabilization. Portugal was a positive surprise in the second quarter—on the heels of 10 consecutive quarters of negative growth, the country’s economy grew at the fastest pace in the region.

All the countries in peripheral Europe—Greece, Ireland, Italy, Portugal, and Spain—made progress toward reaching their fiscal targets as they implemented difficult austerity measures and some structural reforms. Investor confidence has been slowly returning to the region. Still, economic recovery in those countries will likely be unimpressive because tight financial conditions continue to restrain economic growth. Moreover, austerity fatigue has been setting in, so the risks of backtracking on fiscal adjustment and structural changes remain acute.

Japan’s economic prospects improved notably, as growth strengthened and deflation began to abate in 2013. The improvement was fueled to a large extent by the confidence-boosting policy measures undertaken by the government of Prime Minister Shinzo Abe. His policy agenda, popularly dubbed “Abenomics,” consists of three main components—fiscal stimulus, open-ended monetary loosening, and structural reforms. On the monetary side, the Bank of Japan announced in April that it would switch its policy framework from targeting interest rates to targeting the monetary base. As part of the newly implemented Quantitative and Qualitative Monetary Easing program, Japan’s central bank committed to doubling the monetary base in two years. Growth in 2014 may moderate as the country faces an increase in its consumption tax—a measure that aims to lighten Japan’s heavy public debt burden.

The U.S. economy has not seen a growth turnaround in 2013 similar to Europe’s or Japan’s, but U.S. investors began to face the challenge of preparing for expected tightening of monetary policy. Over the summer, after Fed Chairman Ben Bernanke discussed in May and June a possible change in the Federal Reserve’s course of bond buying, interest rates rose sharply in the United States and other parts of the world, and capital began to flow rapidly out of developing countries.

The investors’ retreat from emerging markets in response to higher interest rates in the United States was not unexpected. The speed and the extent of the capital outflows, however,
were a surprise to many. Although the Federal Reserve left its bond-buying program unchanged in September and the capital outflows abated, the summer turbulence exposed the vulnerability of some key developing countries to capital flight and shed light on a new important risk to the global economy—the loss of developing economies’ economic and financial strength in the face of monetary policy tightening in the United States.

Developing economies’ growth slows
It was mostly the developing economies that carried the global economy out of the 2009 recession. Those countries also showed impressive resilience during the depths of the European debt crisis a few years ago. However, a protracted period of very weak postrecession growth in the developed world has taken a toll on expansion of their economies. Domestic demand in many countries held up relatively well, but their overall growth began to decelerate around 2011 (see chart 2 on page 22). Sluggish demand from the developed world for developing economies’ exports increasingly dragged on economic growth.

The weak growth in the developed world is not the only factor that negatively affected developing economies in the past few years. Another important reason for their slowdown was China’s moderating expansion. Worried about a potential buildup in financial and economic imbalances, Chinese authorities have struggled to rein in credit expansion, in the process putting a brake on the economy. Slower growth in China lessened demand for commodities and raw materials and brought down their prices, thus dampening economic expansion in commodity-exporting countries, many of which are in Latin America.

Domestic policies in emerging markets also played a role in slowing their economic growth. Back in 2010 and 2011, many countries in the developing world were expanding rapidly and began to outgrow their capacity to expand. Capacity constraints, including low unemployment, were pushing up inflation, so central banks stepped in and tightened monetary policy, which also contributed to the recent deceleration.

The latest slowdown in growth and this summer’s capital flight and currency depreciations exposed a number of vulnerabilities in some key developing countries—including Brazil, India, Indonesia, Turkey, and South Africa—and heightened the urgency to implement much-needed structural reforms. An implementation by policymakers of effective measures would strengthen the growth potential of these increasingly important players in the global economy.

The future outlook
Having taken into account the economic slowdown and financial turbulence in emerging markets, the IMF has revised down its forecast for global growth in 2013 and 2014 several times since the spring. Despite the downward revisions, the IMF still expects global growth to strengthen from 2.9 percent in 2013 to 3.6 percent in 2014. Growth is forecast to increase in both advanced and developing economies. Emerging markets will continue to outpace the developed world and account for most of the global economic growth.

The euro zone’s economy should stay on a slow recovery path as the fiscal drag diminishes. Although many peripheral countries remain in belt-tightening mode, austerity measures required to achieve fiscal targets will be less severe. Renewed positive growth in the euro zone is likely to spill over to its major trading partners—the United Kingdom and Eastern and Central Europe. Emerging Asia should reap the benefits of China’s continued, albeit slowed, growth, as well as the recent improvements in Japan’s economic performance. Growth is also expected to pick up in Latin America. The region’s two largest economies—Brazil and Mexico—are likely to expand more rapidly next year. Brazil should benefit from a ramp-up in infrastructure investment and the depreciation of its currency. Mexico’s economy should receive a boost from some strengthening in U.S. demand.

Overall, the outlook for the global economy for 2014 is positive, if still highly uncertain. The world will be watching the Federal Reserve closely as the central bank prepares to reduce monetary stimulus.

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