Cautious optimism is warranted?

The global economy is performing better than most feared a couple of months ago. But there are still many headwinds that can choke the recovery. The good news is that the downside risks may be mitigated by adequate fiscal and monetary policy measures, especially in the emerging countries.

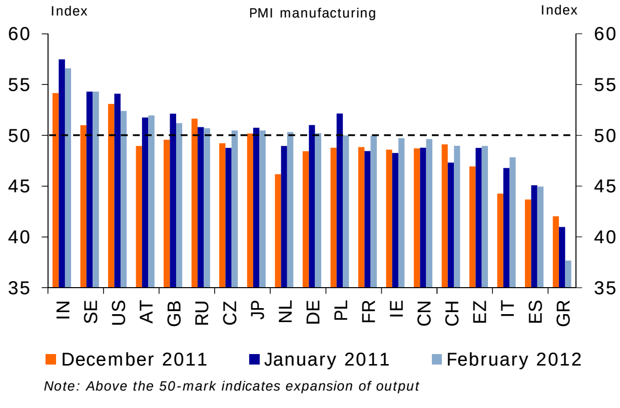
Since the summer of 2011, investors started fearing that the global economy is falling back into another 'lehman-esque' recession. Consumer and producer sentiment data were deteriorating at an eye-watering speed and, as a result, economic growth forecasts were being revised lower by most international institutions. However, the recent improvement in the incoming economic data suggest that the global economy is nowhere close to collapsing as it did in late 2008. Most notably, the manufacturing PMI figures show that purchasing managers in many countries are becoming significantly more upbeat concerning the economic outlook when compared to a few months ago (see figure 1).

Economic activity gaining momentum

At a broader level, we can gauge the pace of global economic activity by looking at the composite leading indicators (CLIs) created by the OECD. Figure 2 shows that the economies of the US and Japan have already turned the corner while the economies of the UK and the eurozone together with the emerging markets (EMs) seem to be stabilising at the data edge. Indeed, the star performer amongst the major advanced economies is the US. The country has thus far managed to shrug off the crisis in the eurozone by growing 0.7% q-o-q in 11Q4, up from 0.5% in the previous quarter. This has resulted in better than expected labour market dynamics. Going forward, we expect GDP growth to remain in the black throughout 2012 but it is likely to stay unimpressive amid the ongoing deleveraging process.

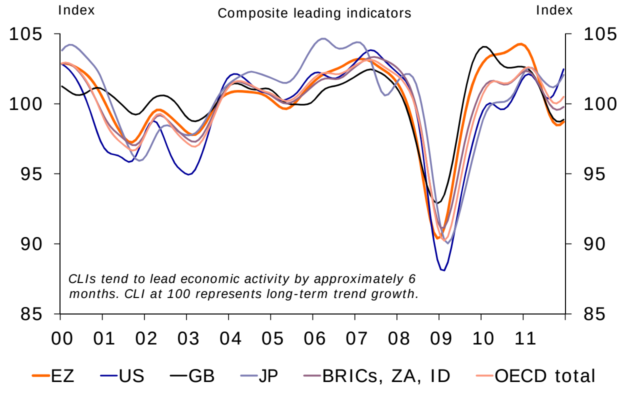
Economic performance has been far less exciting in Europe. The Eurozone

Figure 1: Industrial activity picking up



Bron: Reuters EcoWin

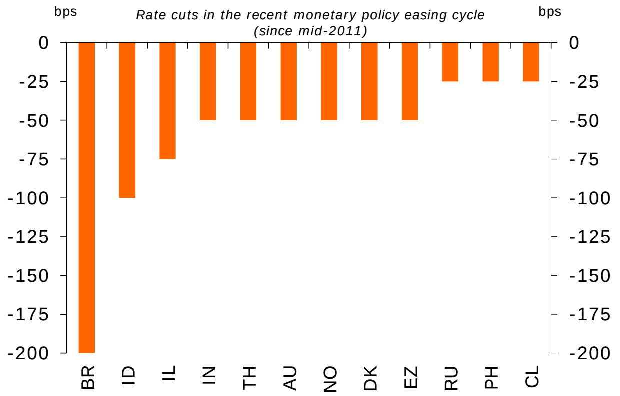
Figure 2: Composite leading indicators (CLIs)



Bron: OECD

economy contracted by 0.3% q-o-q in 11Q4 and we expect another quarterly GDP contraction in the current quarter. Meanwhile, UK's GDP dropped by 0.2% q-o-q in 11Q4. And if leading indicators are anything to go by, the country may just about manage to avoid a recession altogether. Moving further to the East, we note that the Japanese economy contracted by 0.6% q-o-q in 11Q4 owing to weaker external demand and supply disruptions related to the Thai floods. On a positive note, Japan is already showing signs of recovery buoyed by reconstruction efforts.

Figure 3: Policy rates are being lowered



Bron: Reuters EcoWin, Rabobank

Turning towards the emerging markets, we observed a period of slower growth in 2011 amid tighter macroeconomic policy. The good news is that a stabilisation in the pace of economic activity is seen there as well. Note that China's economy is still slowing but with policy being eased gradually (reserve requirements were recently lowered by 50bps for the second time in the current cycle) it should stabilise fairly soon. For that matter, the country is unlikely to experience a hard-landing as some doom-mongers have lately suggested.

Have we turned the corner?

So far, so good. Yet the question one needs to ask is whether we can claim that the worst is truly over? There are reasons to be hopeful! Part of the improvement in the macroeconomic data can be due to the fact that the depressing influence of higher food prices and the disruptions caused by the Japanese earthquake have faded. The swing into positive 'animal spirits' following the imposition of technocratic governments on Greece and Italy and actions taken by central banks have also helped support the recovery. As regards the latter, the 50bp rate cut by the ECB since November in conjunction with its aggressive liquidity operations, the announcement of 'Operation Twist' by the Federal Reserve in late September and the Bank of England's move to increase the size of its asset purchase programme by GBP 75bn in October (it was expanded by GBP 50bn in February 2012) have all resulted in a broad-based easing in financial conditions.

The policy flexibility shown by central banks in the emerging world should not be discounted either. As inflation fears subsided in the second half of 2011 and growth fears came to the fore, monetary authorities there responded by loosening monetary policy (see figure 3). Indeed, inflation has passed its peak in most major economies and only four countries (Hungary, Czech Rep., Mexico and Turkey) are experiencing a rise in inflation rates.

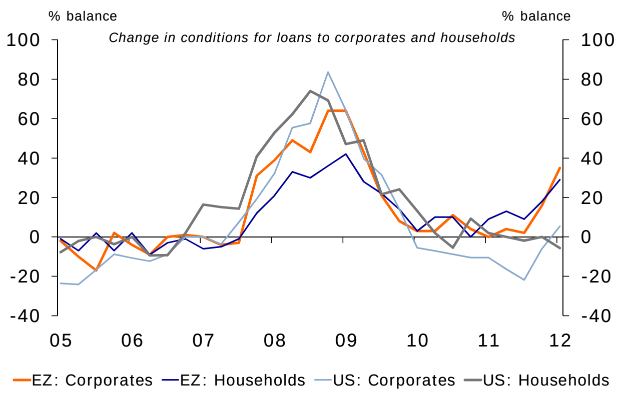
Downside risks should not be ignored

The positive developments notwithstanding, there are still many downside risks that can derail the global recovery. The most immediate risk is intensification of the adverse feedback loops between sovereign and bank (non ECB) funding pressures in the eurozone, resulting in much larger and more protracted bank deleveraging and sizable contractions in credit and output. We should note that bank lending conditions have already tightened (or eased less) in the eurozone and the US during 11Q4 (see figure 4). Similarly, the emerging markets lending survey conducted by the Institute of International Finance (IIF) in the same period signaled a sharp deterioration in emerging market banking conditions in all major regions, specifically in emerging Europe.

Another worry stems from the effect of the harsh austerity measures carried out simultaneously in the peripheral countries of the eurozone. Past and present experience shows that severely front-loaded fiscal consolidation can become partly self-defeating if the economy goes into a tailspin. Implementing further budget cuts to try to stick to deficit targets will in that case push down economic activity even further. If this pessimistic scenario pans out, we will see more social upheaval in the periphery combined with a rise in financial market stress, which can potentially spoil the party.

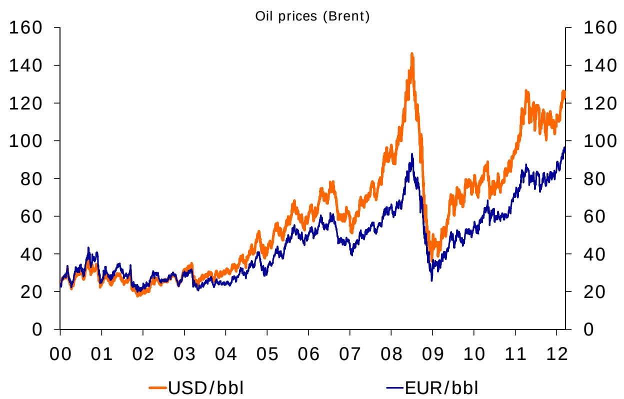
Finally, the recent rise in oil prices (see figure 5) following the intensifying confrontation between Iran and the West remains a worrying supply-side shock. Currently, brent crude futures in dollars remain below the peak reached in 2011 (triggered by the Arab Spring) and are some way off the record-highs reached in mid-2008. That said, prices denominated in euros have passed its peak given the recent weakness of the euro. This means the euro members are hit extra hard! Should oil prices rise more, we can expect it to weigh on global economic activity in the coming quarters.

Figure 4: Credit conditions are tightening



Bron: Federal Reserve, European Central Bank

Figure 5: Oil prices (Brent)



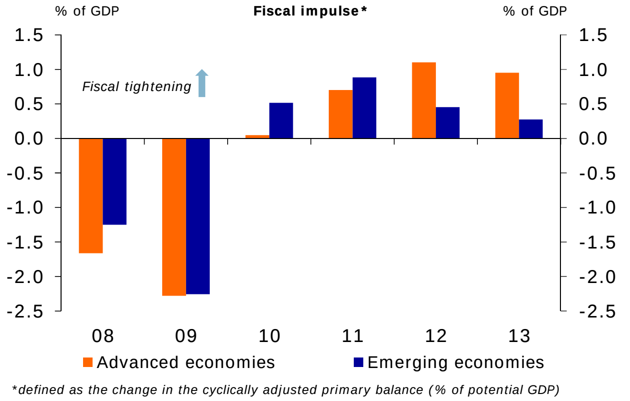
Bron: Reuters EcoWin

Policymakers can make a difference

Thankfully, there are some policy measures that can be taken to mitigate the downside risks to the global outlook. For one, the upcoming fiscal drag at the global level (see figure 6) is perhaps too severe given the state of the world economy. As the IMF recently noted, this does not need to be the case. The Fund claimed that fiscal adjustment is necessary "*but should ideally occur at a pace that supports adequate growth in output and employment*". We completely back this view and argue that countries with enough fiscal space, including some in the eurozone such as Germany and the Netherlands, should reconsider the pace of near-term adjustment, or at least not strive to put new austerity packages on top of the old ones. This will not only bolster growth in the country itself, but also prove beneficial for the peripheral countries that need some breathing space to carry out their own austerity measures. The emerging countries can also play a part given their stronger public sector balance sheets (see figure 7). Governments in the Philippines, Malaysia and Thailand have already started to loosen fiscal policy.

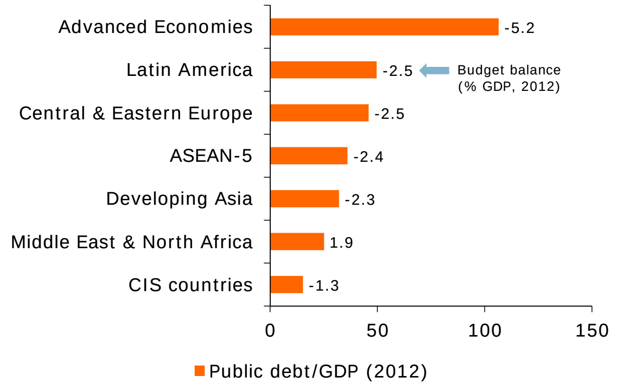
Monetary authorities can step up to the plate as well. Although most rich countries have little or no room to cut interest rates, they can continue to experiment with unconventional policies if growth disappoints. These include further asset purchases (in the US and the UK), further liquidity-boosting operations (in the eurozone) and changes to the way future monetary policy decisions is communicated (in the US). Of course, the risks of these unconventional policies (e.g. higher inflation) must be weighed against the potential rewards. We must admit that the effect of these measures remain highly uncertain and may not materially alter the economic outlook. The good news is that many emerging markets still have lots of conventional monetary firepower at their disposal (see figure 8) to respond to weaker aggregate demand.

Figure 6: Fiscal drag set to intensify



Bron: IMF

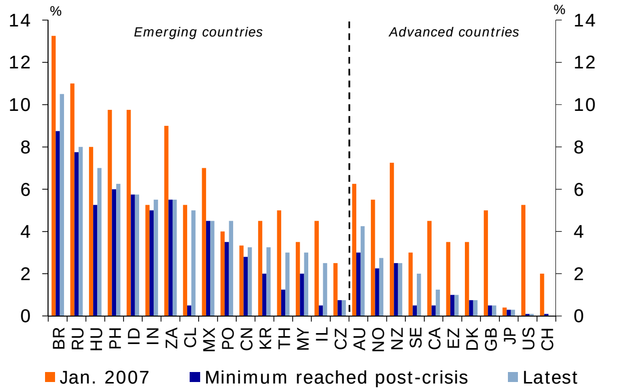
Figure 7: Public finances



Bron: IMF

And finally we have to reiterate once again that collective action can help set the global economy on a more robust growth trajectory by fostering global economic rebalancing. More concretely, countries running huge current account surpluses must eliminate distortions that weigh on their domestic demand. Depending on the precise challenges facing these economies, actions could focus on building more market-oriented exchange systems, stronger social safety nets and pension provisions, better health care and education systems, and removing distortions in certain sectors of the economy.

Figure 8: Monetary policy rates



Bron: Reuters EcoWin, Rabobank

Conclusion

To conclude, the global economy is faring better than most anticipated a few months ago. The US economy is still going relatively strong and for those economies that are expected to go through a recession, we believe it to be neither a deep nor a protracted one. There are still a number of downside risks that can stifle the recovery but we maintain the view that policymakers can contribute to a more resilient recovery by (i) easing fiscal policy and monetary policy wherever possible and (iii) rebalancing global demand. First and foremost, of course, a comprehensive solution to the eurozone debt crisis must be presented to address financial market tensions.

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