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The world economy in the summer of 2012: a fragile recovery

This study was prepared under the authority of the Directorate General of the Treasury (DG Trésor) and does not necessarily reflect the position of the Ministry of Economy and Finance.

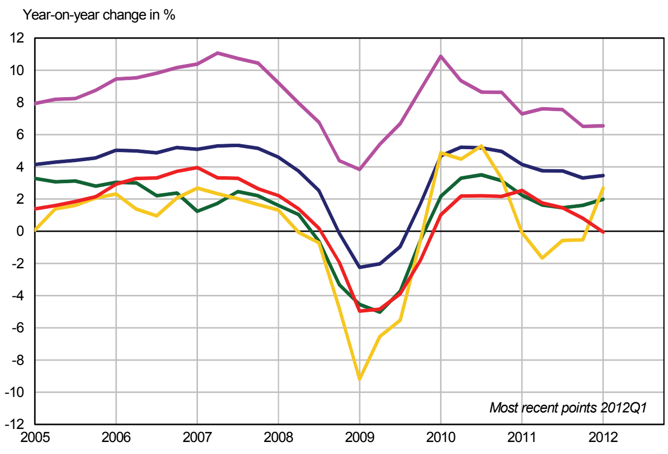
- The world economic outlook in the summer of 2012 hinges on the resolution of the crisis in the euro area. Monetary policy decisions made at the end of 2011 significantly reduced financial tensions and stabilised growth in early 2012. Recent developments in Spain and in Greece, in the run-up to the elections, have revived some fears and weakened the short-term outlook for the euro area, particularly in Southern countries. German growth has remained firm, underpinned by sturdy household consumption and foreign trade driven by exports to countries outside of the euro area. Growth in the United Kingdom slowed, primarily as a result of businesses' adopting a wait-and-see attitude.

- Growth was slightly stronger in other areas of the world. Rapid easing of tensions in the United States enabled the economy to make steady progress over the last few quarters, boosted by strong job growth, although this flagged in recent months. Growth in China slowed, mainly as a result of sluggish world trade, but was still relatively strong. Following Japan's natural catastrophe in March 2011, economic growth was boosted by public-sector and private-sector spending on reconstruction.

- The long-winded process of reducing general government, household and corporate debt will continue to weigh on the outlook for growth in the majority of the advanced economies up until 2013. Weak labour markets in Europe and the United States will also hinder recovery. In the event that the financial situation gradually returns to normal, the euro area's economy will contract slightly in 2012 and then resume moderate growth in 2013. Disparities will continue to widen, with the Southern European countries (Spain and Italy) in recession and Germany still showing growth. The process of consolidating public finances will hinder growth in the United Kingdom. The pace of American economic growth will be slower, as determined by fiscal policy, which is bound to be very restrictive in 2013. Japan's growth profile will depend on the timetable for reconstruction, with stronger growth in 2012 than in 2013. China should continued to enjoy sustained growth.

- Major uncertainty surrounds the economic situation, primarily because of developments in the euro area. Recent events in Spain and Greece have delayed the end of the crisis and underlined the vulnerability of the European economy. The decisions made at the European Council meeting of 28 and 29 June could lead to more rapid easing of tensions and promote growth.

Global GDP growth



Source: DG Trésor calculations.

MINISTÈRE DE L'ÉCONOMIE DES FINANCES ET DE L'INDUSTRIE

1. In early 2012, growth disparities widened on either side of the Atlantic Ocean and between countries in the euro area

1.1 The financial turmoil that started in the third quarter of 2011 quickly subsided in the United States, but intensified in the euro area

Markets were very unstable in the third quarter of 2011, following events that shook investor confidence on both sides of the Atlantic. A stream of bad news out of the United States started in July, with a revision of the national accounts and rising concerns about government debt. However, financial tensions gradually eased and growth remained strong at 0.7% in the fourth quarter (see Table 1), as household consumption remained firm. **In the euro area, market worries were fuelled by fears about the sovereign debt of core economies like Spain and Italy**. Tensions on money and bond markets fed off each other and spiralled in the second half of the year, leading to widening interbank and sovereign spreads, particularly in the South of the euro area. The euro area GDP contracted by 0.3% in the fourth quarter, as financial tensions were transmitted to the wider economy through falls in consumer and producer confidence, negative wealth effects and tighter credit terms. These effects were amplified by the slump in world trade. The United Kingdom's GDP shrank as well, contracting by 0.3% in the fourth quarter, in the wake of a shock to confidence and weaker demand from the euro area.

In Asia, Japan's stagnant growth is primarily a result of the negative impact that flooding in Thailand had on regional trade. In China, growth remained strong, albeit slightly slower at 1.9% in the fourth quarter, following the slump in world trade and a tightening of monetary policy that began in late 2010.

1.2 In early 2012, financial markets temporarily regained their composure, largely as a result of monetary policy decisions

Monetary policy decisions in the euro area at the end of 2011 (see Box 1) were followed by gradual, but ultimately short-lived, easing of tensions. The European Central Bank (ECB) announced two exceptional longer-term refinancing operations on 8 December. These refinancing operations with a maturity of three years represented loans to financial institutions of €489 billion on 21 December and €530 billion on 29 February. These resulted in a significant increase in liquidity. The ECB also made two 25-basis-point cuts to its policy rate in November and December, lowering it to 1.0%. Tension on interbank and sovereign debt markets, particularly in Italy and Spain, eased substantially. The weakening of euro-area growth was halted in the first quarter. However, disparities within the area widened. Italy's GDP contracted sharply again, shrinking by 0.8%, whereas Spain's GDP contracted by 0.3%. France's economy was stagnant, while growth rebounded in Germany (+ 0.5%, beating expectations), Belgium (+ 0.3%) and the Netherlands (+ 0.3%).

Other major economies showed stronger growth in the first quarter, except the United Kingdom, where the economy shrank by a further 0.3%, as business investment and inventory patterns hampered growth and foreign trade slumped. The United States saw relatively dynamic growth of 0.5%, which was once again driven by household consumption. Growth in China slowed, but remained vigorous at 1.8%. In Japan, GDP growth rose from 0.0% to 1.2% on the strength of spending for reconstruction and the rebound following slower growth in the previous quarter as a result of the flooding in Thailand.

Table 1: Quarterly growth of real GDP (seasonally and working-day adjusted, in%)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2009	2010	2011	2012*
United States	0.1	0.3	0.5	0.7	0.5	*–3.5*	*3.0*	*1.7*	*1.3*
China	2.2	2.3	2.4	1.9	1.8	*9.2*	*10.4*	*9.2*	*5.0*
Japan	–2.0	–0.4	1.9	0,0	1.2	*–5.5*	*4.4*	*–0.7*	*2.0*
United Kingdom	0.5	–0.1	0.6	–0.4	–0.3	*–4.0*	*1.8*	*0.8*	*–0.3*
Euro area	**0.7**	**0.1**	**0.1**	**–0.3**	**0.0**	***–4.4***	***2.0***	***1.5***	***–0.1***
Germany	1.3	0.3	0.6	–0.2	0.5	*–5.1*	*3.6*	*3.1*	*0.7*
France	**0.9**	**0.0**	**0.3**	**0.1**	**0.0**	***–3.1***	***1.6***	***1.7***	***0.2***
Italy	0.1	0.3	–0.2	–0.7	–0.8	*–5.5*	*1.8*	*0.4*	*–1.4*
Spain	0.4	0.2	0.0	–0.3	–0.3	*–3.7*	*–0.1*	*0.7*	*–0.5*
Belgium	1.0	0.3	0.0	–0.1	0.3	*–2.7*	*2.2*	*2.0*	*0.3*
Netherlands	0.6	0.0	–0.4	–0.6	0.3	*–3.7*	*1.6*	*1.0*	*–0.4*

* Cumulative at the end of 2012Q1.

Sources: DataInsight and Eurostat; slight discrepancies with the annual accounts are possible because of the working day adjustment.

1.3 Since the end of February, new fears focusing on Spain and Greece revived tensions and uncertainty in the euro area

Tension surrounding Spanish sovereign debt was further exacerbated (see Chart 1) as a streak of bad news aroused investors' fears. At the end of February, Spain announced that its government deficit for 2011 would be larger than previously estimated. Starting in mid-April, worries increased about the Spanish banking sector, which is burdened with large numbers of sour loans, especially after banks reported mixed quarterly earnings. Since the end of May, tension was fuelled further by the problems that Spain's regional governments encountered in obtaining refinancing and the upwards revision of banks' estimated recapitalisation requirements. Consequently, Standard & Poors downgraded Spain's credit rating at the end of April and Fitch followed suit in early June. Even Spain's acceptance of European assistance to recapitalise its banks did not reassure all market analysts.

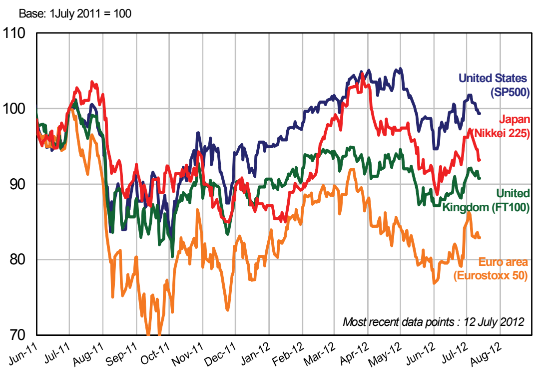
In Greece, worries about the political situation, when no governing coalition could be put together following the general elections in mid-May, amplified concerns about the future of the euro area. The outcome of the 17 June elections, and the formation of a coalition government supporting the continued implementation of the Troika's programme, helped to ease tensions.

At the same time, Italy saw yields on its sovereign debt rise, but to a lesser extent. The resurgence of risk aversion, combined with gloomy economic indicators in the euro area and lower than expected growth indicators in the United States and China, led to a fall in world stock markets.

Chart 1: Sovereign yields in the euro area and leading stock market indices

Sovereign yields (10-year bonds) - Euro area

Leading world stock market indices



Source: DataInsight.

The main economic indicators available for the second quarter of 2012 reveal that the situation is still quite fragile in the euro area. Manufacturing output in the main euro-area economies was down in April and May (see Table 2). In May and June, the purchasing managers' indices (PMI) for the manufacturing and services sector of the main euro-area economies were still at very low levels (see Chart 2), especially in Italy and Spain.

Output was expected to be more resilient in the other leading economies. In the United States, the economy continued to create new jobs, but not nearly as many as at the beginning of the year, and the latest manufacturing output figures point to only moderate growth. Even though growth in China is slowing down, it remains vigorous.

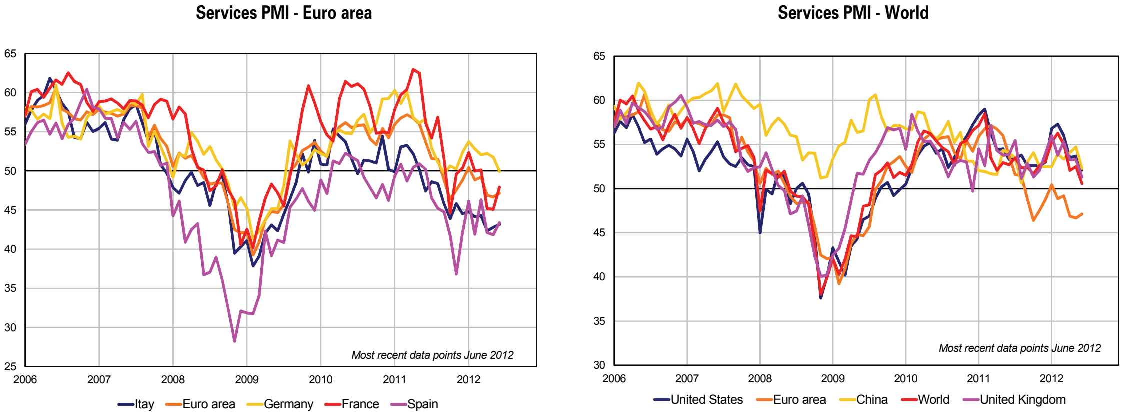
Table 2: Manufacturing output (monthly and quarterly variations)

	January-12	February-12	March-12	April-12	May-12	2011Q4	2012Q1	2012Q2(**)
United States	1.1	0.9	–0.6	0.7	–0.4	1.3	2.4	0.4
China (*)	0.5	0.6	1.2	0.4	0.9	2.6	2.2	2.2
Japan	0.8	–1.5	1.2	–0.2	–3.1	0.5	1.2	–2.0
United Kingdom	–0.4	–1.2	0.9	–0.8	1.2	–1.2	–0.3	0.2
Euro area	–0.3	–0.5	1.1	–2.0	1.0	–1.8	–0.6	–0.7
Germany	0.6	0.3	1.1	–2.3	1.9	–1.8	0.1	–0.3
France	**–0.1**	**–1.0**	**1.4**	**–0.9**	–1.0	**–0.9**	**–0.9**	**–0.9**
Italy	–2.6	–1.1	0.8	–2.2	0.7	–2.4	–2.3	–1.6
Spain (*)	–0.8	–1.3	–1.0	–1.0	0.6	–2.3	–1.4	–1.7

(*) Industrial output (**) Cumulative.

Sources: nationales.

Chart 2: Purchasing Manager Indices - euro area and world



Source: Markit.

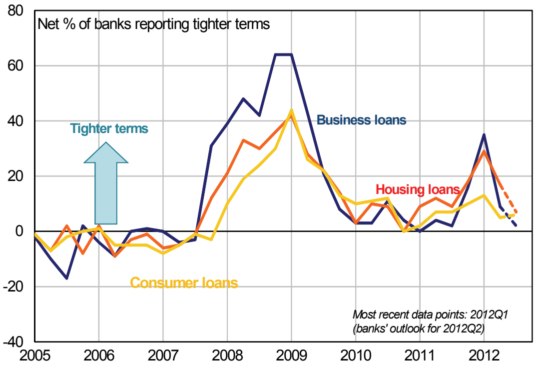
Sources: Markit, ISM.

Box 1: **Financial tension is hindering investment in some economies**

The financial sector's problems will continue to affect the wider economy in the euro-area countries because of their impact on private sector confidence and on credit terms, particularly for business loans and more particularly in Italy.

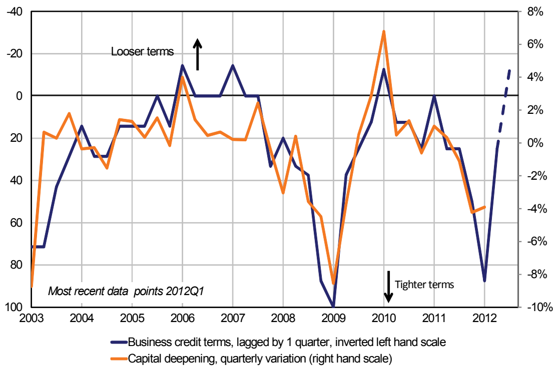
The ECB's bank survey shows that one of the effects of the transmission of financial tension to the real economy in the euro area has been tighter credit terms since the end of 2011. This means that capital spending by businesses, especially in Italy, has been hampered by a financial constraint (credit terms are strongly correlated to capital deepening). In the first quarter of 2012, credit terms eased substantially in the euro area, but the demand for business loans declined further, especially in Italy.

Chart 3: Household and business credit terms survey



Sources: ECB, Bank lending survey.

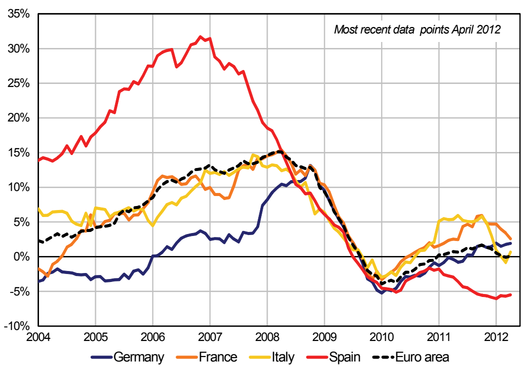
Chart 4: Business credit terms and capital deepening



Sources: Bank of Italy and Istat.

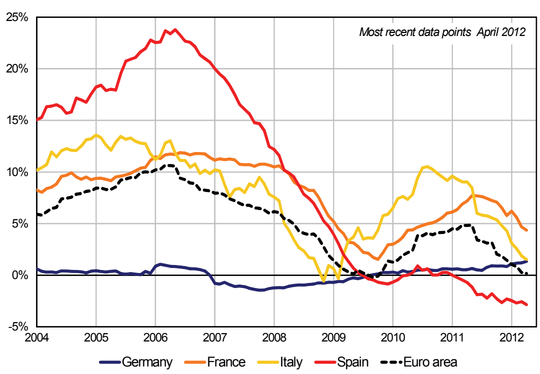
Outstanding loans to non-financial corporations (NFCs), which correspond to the net outcome of credit supply and demand, were lower at the end of 2011, especially in Italy. Outstanding loans to households also declined.

Chart 5: One-year change in outstanding loans to non-financial corporations



Source: ECB.

Chart 6: One-year change in outstanding loans to households



Source: ECB.

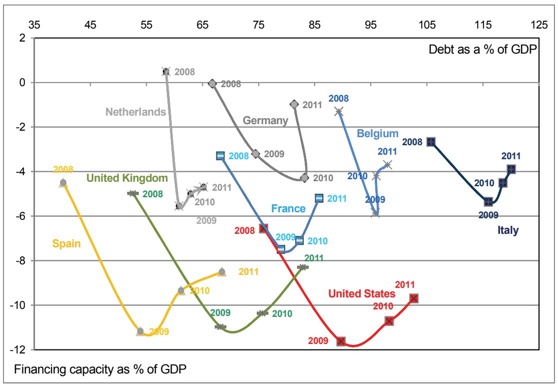
2. Outlook for 2013: many imbalances impede growth

2.1 World growth will still be moderate, restricted by the debt reduction process and weak labour markets in the main advanced economies

Even if tensions ease gradually, global economic growth will still be moderate in 2013. **The process of consolidating public finances that most of the advanced economies have embarked upon** (see Chart 7) should impede growth by dampening public and private demand. Its effects will be amplified through trade. Efforts to reduce fiscal deficits vary from country to country. The measures taken in 2012 and 2013 will be particularly extensive in Southern European countries, substantial in the United States, the United Kingdom, France, Belgium and the Netherlands and, in contrast, very small in Germany. The implementation of various reconstruction plans following the Sendai earthquake means that Japan's budget will continue to expand.

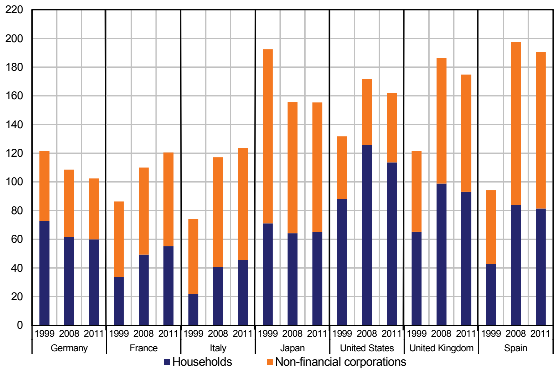
The long-winded process of reducing private-sector debt in the main advanced economies should continue. After seeing strong growth in the first decade of this century, household and business debt has been trending downward since the crisis (see Chart 8). This process should continue in the medium term and will dampen household consumption in the United States, the United Kingdom and Spain by maintaining pressure to raise savings rates. It will also dampen business investment in Spain.

Chart 7: Debt and deficit levels from 2008 to 2011



Sources: OECD; 2011; national statistics institutes and central banks.

Chart 8: Private sector debt at year-end



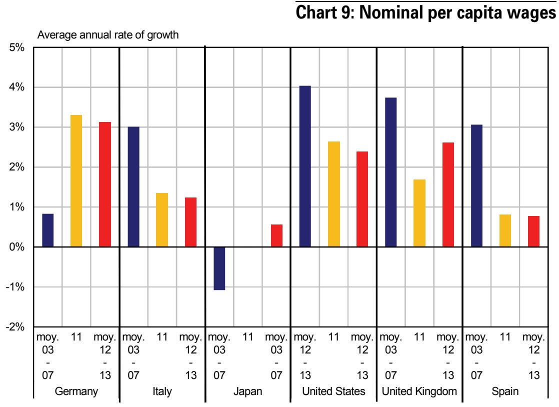
Source: Banque de France.

Ultimately, weak labour markets in the main advanced economies will hamper growth. These countries have seen a significant increase in long-term unemployment, which points to an increase in structural unemployment as a result of the hysteresis effect. The increases were particularly large in Spain and, to a lesser extent, in the United States. In 2011, the proportion of long-term unemployed was still very high in Germany and Italy, at nearly 50%, and in Spain, where it exceeded 40%. Furthermore, massive job losses in some sectors are making redeployment of the labour force especially difficult in some economies, such as Spain and, to a lesser extent, the United States (see Box 2).

These constraints, combined with modest growth, mean that unemployment rates in Europe are unlikely to fall between now and the end of 2013. In the United States, the downwards trend in the unemployment rate that started in mid-2011 is continuing, but to a lesser extent, which means that the rate at the end of 2013 will still be much higher than its pre-crisis level. Spain's jobless rate will remain extremely high. Germany's jobless rate will continue to decline slightly to reach its lowest level since reunification.

The overall weakness of the job market will curb wage growth. Average wage growth will be much slower than before the crisis in Spain and Italy in 2012 and 2013. Wage moderation will continue against the backdrop of a very poor outlook for economic growth and a very weak labour market (see Chart 9). To a lesser extent, wages in the United States will also rise more slowly, as the outlook for growth is relatively poor with regard to American standards and unemployment is much higher. On the other hand, German wage growth will be strong, as indicated by the outcome of the latest round of wage negotiations, where very low unemployment levels increased the bargaining power of labour.

Chart 9: Nominal per capita wages



Sources: National accounts.

Box 2: **Problems with redeployment of the labour force**

The Beveridge Curve is helpful for illustrating the redeployment of the labour force by sector. This curve is the graphical representation of the relationship between unemployment and the job vacancy rate. A higher job vacancy rate will reduce unemployment and vice versa. The efficiency of the labour market is indicated by the angle of the curve. The higher it moves to the right, the less efficiently labour supply is matched to demand.

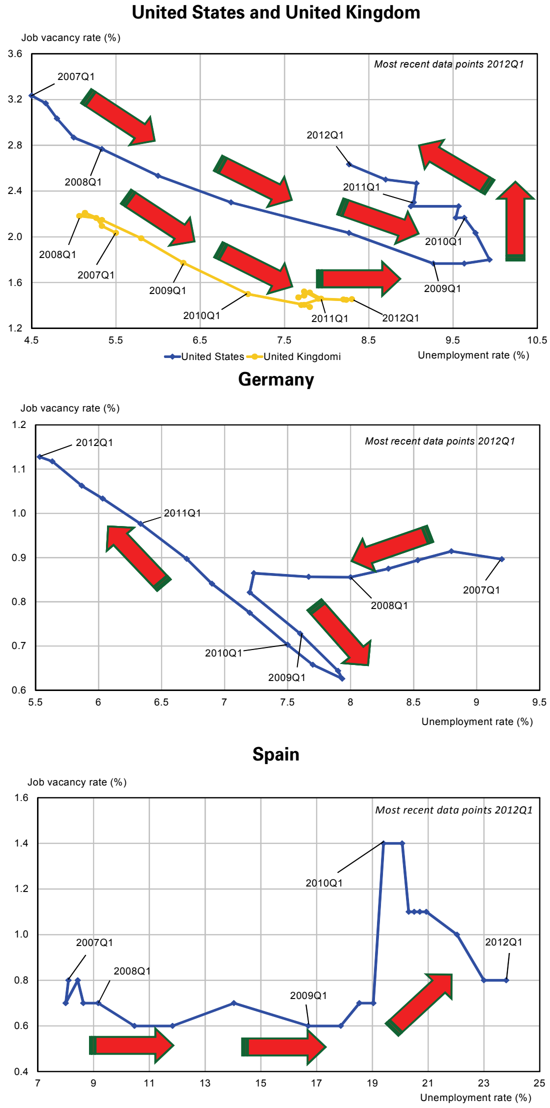
We may distinguish three groups of countries:

In the United Kingdom and the United States, the curve moved towards more unemployment and fewer vacant jobs up until the middle of 2009, which is the classic pattern in a recessionary period in the business cycle. Since 2010, the movement of the curve points to mismatched supply and demand and, consequently, a slight increase in structural unemployment. The cycle seems further along in the United States, where the curve is already rising again. At this point, the curve seems to have shifted to the right, which means that for the same job vacancy rate, the unemployment rate is now some 2.5 percentage points higher than its pre-crisis level.

In Spain, the marked shift to the right of the curve points to a very serious mismatch, which is probably due to problems redeploying the labour force following the collapse of the construction sector and the related services.

The situation in Germany is the reverse of that in Spain, with a overall shift of the curve to the left in the last four years. For the same job vacancy rate, the unemployment rate at the beginning of 2011 was some 2.5 percentage points lower than at the beginning of 2007. This suggests an improvement in the efficiency of the labour market. Germany now faces labour shortages in some sectors, with job vacancy rates that are now higher than their pre-crisis levels.

Chart 10: Beveridge curves



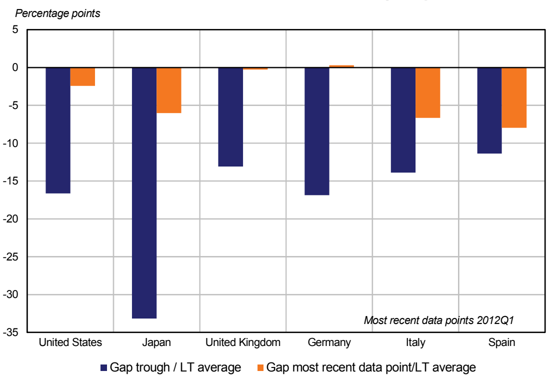
Sources: OECD, Eurostat and Directorate General of the Treasury calculations.

2.2 Some internal factors will, however, sustain world economic growth...

Inflationary pressures will ease with slower unit wage cost growth, persistently wide output gaps and, most importantly, the recent fall in oil prices, when the price of a barrel of Brent dipped below $100 in early June. Weaker inflation, combined with continuing job creation in the United States and strong wage growth in Germany will boost the purchasing power of households in those countries. In Southern Europe, falling inflation will only provide weak support for growth, since it will offset only a small part of the decline in wage and non-wage income.

Investment needs will be greater in some economies (see Chart 11). Capacity utilisation rates have reverted to their long-term mean in Germany and the United Kingdom. On the other hand, they are still far below the mean in Japan, Spain and Italy. Other factors should boost business investment: high profit margins, very accommodative monetary policy, the financial environment and, more specifically, credit terms, which should gradually return to normal, and the gradual recovery of stock markets, which will have a positive impact on the earnings of listed companies (Tobin's q).

Chart 11: Capacity utilisation rates



Sources: national data and Directorate General of the Treasury calculations.

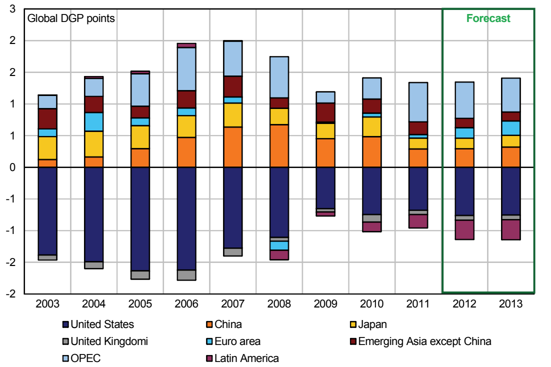
2.3 ... and be amplified by the gradual recovery in world trade

Worldwide economic growth could also be driven by external factors, as trade gradually recovers. Average annual growth of world trade in 2012 will be seriously hampered by the contraction of economic activity in the euro area between 2011 and 2012. However, this effect will be partially offset by sustained trade generated by the United States and the rest of the world. World trade should start to rebound in mid-2012, driven by the gradual recovery expected in the euro area. In 2013, it should return to virtually the same rate of growth seen before the crisis.

2.4 Global imbalances should stabilise

On-going adjustments will only stabilise current account imbalances, which will nonetheless be smaller than before the crisis (see Chart 12). The imbalances were much smaller than before the crisis in 2011. This stemmed from the significant reduction in the United States' trade deficit, as well as the smaller aggregate trade surplus of the Asian economies, including China. In 2012 and 2013, the reduction of global imbalances will not continue and the situation will stabilise. One notable change during this period will be the growing surplus of the euro area, as the economies of Southern Europe and Ireland continue to seek a new balance.

Chart 12: Current account balances - World



Sources: IMF and Directorate General of the Treasury.

3. The outlook for global growth primarily has downsides and major uncertainty persists.

Our economic scenario is surrounded by major uncertainty and primarily downside risks, mainly related to the crisis in the euro area.

The risk of excessive reduction of banks' debt, especially in the euro area, a sharper slowdown in the growth of emerging economies, or else larger than expected efforts to achieve fiscal consolidation in the United States, Japan and the United Kingdom, could also hamper recovery. Implementation of current legislation in the United States would lead to a sharper fiscal contraction that would curb global growth.

On the other hand, more rapid rebalancing of global growth could provide additional stimulus for the international economy. In the specific case of the euro area, the current crisis has eroded the value of the European currency, boosting euro-area exports and attenuating the expected negative effects of the slowdown in global trade.

Oil-price-related risks seem to be in balance. The fall in prices seen since the beginning of May could continue given the current surplus of supply. On the other hand, a more rapid recovery in worldwide growth or rising geopolitical tensions would be likely to cause oil prices to spike.

The decisions made at the European Council meeting of 28 and 29 June could lead to more rapid easing of tensions and promote growth. The Heads of State and Government decided to establish a single banking supervision mechanism that involves the ECB for euro-area banks. The creation of this new authority could make it possible for the European Stability Mechanism (ESM) to recapitalise banks directly. Furthermore, the lack of seniority in the Spanish bank bailout, along with the ECB's involvement in implementing such stabilisation tools as the European Financial Stability Facility (EFSF) and the ESM, are likely to ease tensions. In addition, the agreement on a growth and jobs pact worth €120 billion (1% of European GDP), that provides for additional loans from the EIB and unused EU structural funds, could provide further impetus for growth. Ultimately, the Van Rompuy roadmap outlining was of deepening Economic and Monetary Union provides a vision for meeting long-term challenges. The situation is still fragile and calls for rigorous implementation of these commitments.

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