Pathfinder Economic Alert

Global Economic Outlook: The Weak (and Strong) get Weaker…..

The Pathfinder Foundation (PF) presents herewith a summary of the report published by McKinsey & Company, the leading management consultancy. This summary provides a comprehensive look at macroeconomic, financial market, and sovereign and public policy indicators in 6 key geographies as end of 2Q 2012; the United States, Eurozone, China, India, Brazil and Russia. For Sri Lankan policy-makers as well as the business community dealing with international markets the findings and trends herein will undoubtedly be useful in formulating their policies and strategies.

Developed Economies Heading Towards a Recession

The global economy started off the second half of 2012 with a whimper as the latest data confirm that growth is faltering across all regions. Europe is clearly in the midst of an intensifying contraction, US consumers and businesses are pulling back in the face of increasing uncertainty, and a marked slowdown in emerging markets is testing their vitality. Last month, the question remained whether the slowdown was merely a soft patch or the onset of a more generalized "powering down" of the global economy. The accumulating evidence indicates that the developed economies are heading towards a recession (although some may still manage to eke out modest growth.

The Patient Getting Weaker but antidotes in Short supply.

Back in 2008/2009, authorities had a rich arsenal of fiscal and monetary policy tools to deploy in response to the economic crisis. But today, interest rates in advanced economies are near zero and budget deficit/debt spirals are limiting the options for fiscal stimulus. Not only is the patient getting weaker and more susceptible to shocks, but the necessary antidotes are also in short supply.

Gloomy Outlook

In this setting, the rapid pace of developments in the global economy is forcing businesses and governments to brace for a wide range of potential outcomes, including an expanded crisis in the Eurozone, an uncertainty-induced slowdown in the US, and a significant and protracted downshift in high-growth markets. According to the most recent McKinsey Quarterly survey, only 10 percent of executives think current conditions in the global economy are better now than six months ago, and just 20 percent expect conditions to improve over the next six months. At the same time, some 46 percent of respondents expect to see a recession in the Eurozone within this timeframe.

Market Developments

- **Consumers and households — taking a back seat.** In the US, the pace of retail sales fell for the third straight month as consumers cut back on purchases of autos, furniture, and appliances. Retail sales in the Eurozone, while very weak, surprised on the upside with only a modest 0.7% year-on-year decline in May (compared with 2.8% decline in April). Meanwhile, retail sales gains were off slightly in China despite government measures to stimulate spending, but retreated sharply in Brazil to just 6.8% year-on-year (down from 8.8% in April and 11% in May 2011). Consumer confidence fell in the Eurozone, Brazil, the US and China.

- **Business activity — global contraction.** The global manufacturing Purchasing Managers Index (PMI), a leading indicator of economic growth, moved into the contraction zone (48.9) in June for the first time since November 2011. The US manufacturing PMI also fell to below 50 (49.7) for the first time since July 2009. The Eurozone remained the main source of weakness (at 45.1), led by steep declines in Italy and Spain. The BRICs were not immune to the general malaise, with contractions in both Brazil and China. The global services PMI stood at 50.6 in June (down from 52 in April), reflecting particularly weak activity in the Eurozone and slowdowns in the US and China.

- **Commodities and prices — mostly sideways.** Diminishing expectations for global growth have kept a lid on a wide range of commodity prices, with most categories remaining essentially unchanged for the month. The exceptions were agriculture and energy prices (Brent crude crossed the $100 per barrel mark), which were driven up by the perception of increasing supply disruption risks. Consumer price inflation was also largely unchanged in advanced economies and eased somewhat in Brazil and China.

- **Capital markets — chronic concern over the Eurozone.** Uncertainty over the Eurozone drove 10-year yields higher in Spain (above 7%) and Italy, and to historic lows in the US and Germany. The prospect that Spain’s regional governments will ask for financial rescue has heightened fears of an imminent bailout. Equity markets, however, regained some lost territory in June amid expectations of monetary easing. Market volatility, rose on fears that Greeks would vote in an anti-austerity government, then fell back upon election of a pro-austerity coalition.

- **Government/policy — a diminished arsenal for stimulus.** Given the prevailing softness in both advanced and emerging economies, central banks have lowered interest rates in an effort to stimulate growth. The ECB cut the Eurozone interest rate by 0.25 percentage point to a historic low of 0.75%; the People's Bank of China reduced its rate for the second time in less than two months, to 6%; and the Bank of Brazil took 50 basis points off the benchmark Selic rate, setting a new low of 8%. While Brazil and China have also put modest fiscal stimulus measures in place, most advanced economies no longer have this option in the face of existing austerity measures and deficit concerns.

Regional Roundup

Eurozone: Still the weakest link. The latest data confirm that pressures are mounting. Unemployment in the region reached yet another high of 11.1%, retail sales fell, and manufacturing PMI and services PMI contracted in June for the 11^{th} and 9^{th} consecutive month, respectively. Even as bond yields soared, Spanish authorities introduced EUR 65 bn in additional austerity measures that will only add to the drag on growth. Unemployment in Spain hit 24.7% last month and the outlook for manufacturing and services activity is bleak. Despite a series of summits, Eurozone authorities have failed to deliver a resolution package that can decisively soothe market nerves. As a result, the crisis continues to escalate threatening the ability of the entire Eurozone to stay afloat. At a minimum, economists increasingly assert that Greece's exit from the Euro is inevitable.

United States: The outlook dims. This month's news suggests that weakness is spreading. New jobs creation was disappointingly modest for the third month in a row. With consumer confidence slipping for the fourth consecutive month, retail sales were also unexpectedly sluggish. Most concerning is that the manufacturing PMI moved into the contraction zone for the first time since 2009. On the positive side, housing prices appear to be staging a recovery. In addition, the household debt service ratio fell to its lowest level (under 11%) since 1994, suggesting that Americans are continuing to deleverage.

China: Continued slowdown or a pause? GDP growth cooled to 7.6% in Q2 as industrial output and investment spending slowed. On the consumer side, confidence fell in June and retail sales were essentially flat. On the manufacturing front, the official and HSBC PMIs dropped (with new orders showing the largest drop in three years) while the trade surplus widened as imports weakened, echoing soft domestic demand. Pressures on consumer and producer prices continued to ease. Chinese authorities have been uncharacteristically aggressive in responding to the slowdown, announcing an initial interest-rate cut on June 8 (to 6.31%) and a second cut (to 6.00%) barely a month later.

India: Slow growth amid relatively high inflation. As reported last month, Q1 growth came in at just 5.3% year-on-year, the lowest quarterly increase in nine years—the result of severe cutbacks in industrial production and business fixed investment. Most recent data confirm that the slowdown continues as business confidence dipped to its lowest point in 12 quarters and the current account deficit climbed to a record high of 4.5% of GDP. With wholesale inflation easing slightly but food prices inching up, the central bank is left in a quandary about how to stimulate the economy without fueling further inflation.

Brazil: Deteriorating prospects. Business activity continued to deteriorate as industrial production in May contracted 5.6% year-on-year and the manufacturing PMI again fell. Retail sales, along with consumer confidence, remained more subdued than expected. The Bank of Brazil lowered the benchmark Selic rate by 50 basis points in June to an all-time low of 8%, indicating that additional cuts may be in the offing. As consumer price inflation retreats well within the central bank's target range, opportunities to ease monetary policy are improving.

This is the Thirty Fourth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

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