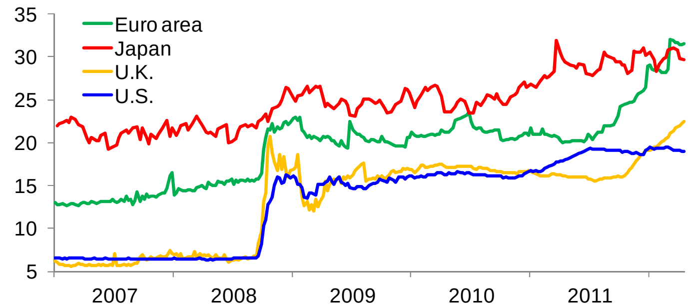
Economic Update INTERNATIONAL
Federal Reserve Bank of Dallas

Sustained Recovery Dependent on Euro-Area Resolution

April 27, 2012

The global economic outlook has improved but remains vulnerable. The upward revision is due to an improvement in the euro-area crisis and a stable U.S. recovery. However, a more comprehensive, long-term resolution in the euro area is necessary for the global outlook to remain positive. Thus, an intensification of the euro crisis remains the biggest threat to current conditions. High oil prices could also impede growth. Even if these risks do not materialize, the global recovery is expected to continue at a slow pace. Monetary policy has remained extremely accommodative to bolster economic activity, but fiscal consolidation is holding back demand.

Chart 1
Central Bank Balance Sheets Reach Record Highs

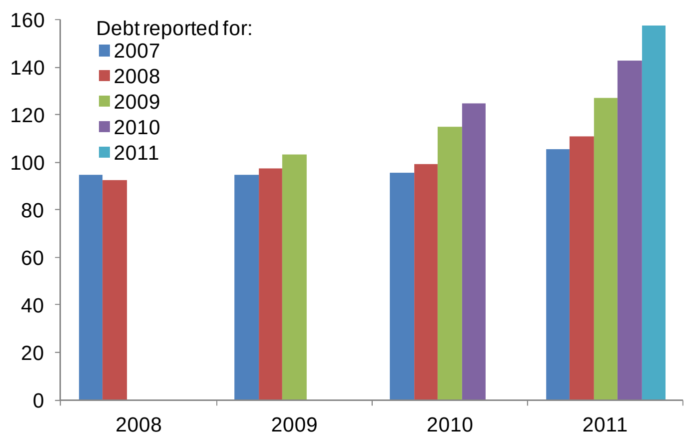


NOTE: 2011 GDP data are used to extend series.
SOURCE: Haver Analytics.

'Monetary Tsunami' Created by Advanced Economies

Weak growth in the advanced economies has warranted persistently low policy rates. In the U.S., the policy rate has remained between 0.25 and zero percent since December 2008. The U.K.'s policy rate has been 0.5 percent since March 2009. The Bank of Japan lowered its policy rate from a long-standing 0.1 percent to 0.05 percent in October 2010. Monetary policy can become constrained when policy rates approach zero, since negative policy rates are not possible. Alternative procedures are now necessary to further ease monetary conditions. Expanding central bank balance sheets display the magnitude of monetary stimulus (*Chart 1*). Large liquidity injections have helped ease constrained economic activity. The European Central Bank (ECB) avoided a credit crunch by holding two auctions, where banks could purchase long-term refinancing. At the second auction settled in March 2012, 530 billion euros were injected into the European banking system, greatly easing constrained credit conditions.

Chart 2
Greek Government Debt Reports Revised Upward



NOTE: Reports are published in the spring of each year, so the last year shown for each report is a forecast.
SOURCE: European Commission Public Finance Reports.

Euro-Area Crisis Contained, For Now

The success of various actions designed to prevent an escalation of the euro area's sovereign and financial crisis has managed—for the time being—to avert the most imminent risk to the global economy. In addition to the ECB liquidity injections, national governments and international organizations have come together to help contain the euro-area crisis. Greece avoided a disorderly default by restructuring its debt obligations. An increase in rescue fund capacity created a financial "firewall" and managed to assuage fears of contagion. These actions produced a short-term solution, but policymakers still must implement structural reforms that address the root causes of the crisis.

Fiscal accountability must be restored through prudent austerity measures, but this will be extremely difficult given current economic conditions. Drastic cuts to fiscal stimulus will derail growth. Unfortunately, economic contraction and high unemployment rates are disproportionate across euro-area countries, and those requiring the most fiscal consolidation are also suffering the most. The unemployment rate in Greece reached 21 percent in December. February rates were 23.6 percent in Spain and 9.3 percent in Italy. In contrast, Germany's unemployment rate was 5.7 percent in February.

Restoring Fiscal Accountability

Over the past decade, fiscal overspending in Greece has manifested into unsustainable levels of government debt. Vague reporting guidelines allowed Greek debt to go underreported, preventing the market from correctly assessing the risk of default (*Chart 2*). Unfortunately, Greece is not the only economy to accumulate excessive levels of government debt (*Chart 3*). Under the Maastricht Treaty, which was established to promote sustainable convergence between the euro-area economies, government debt should not exceed 60 percent of GDP. If this limit is breached, plans for significant debt reduction must be under way. It was necessary to increase government spending in the aftermath of the global recession, using fiscal stimulus to promote economic recovery. However, this exacerbated the already high debt levels, placing the financial institutions that hold government debt as collateral at risk. Given the interconnected nature of the euro-area economy, one disorderly default could trigger a widespread financial crisis. Thus, strongly enforced fiscal austerity is necessary for investor confidence to return.

Emerging Economies Attract Investment

The improved global outlook has increased investors' risk appetite, which, alongside the accommodative monetary policy of advanced economies, has increased the flow of capital into the emerging economies. As capital inflows increase, the currency of an emerging economy appreciates. This is detrimental to the largely export-driven economies. To counteract currency movements, emerging economies can increase their foreign exchange reserves (*Chart 4*).

China is notorious for its currency interventions and is often accused of maintaining a competitive edge on manufacturing exports. Though China's foreign exchange reserves remain at high levels, the rate of accumulation has decreased. The renminbi has appreciated 8 percent against the dollar since June 2010, when the two-year peg that held the renminbi to the dollar was eased (*Chart 5*). China's trade surplus is also diminishing. These developments align with the recently announced downgrade in China's annual growth target. Focus appears to be shifting toward internal demand, which is a good strategy for sustainable growth.

Fragile but Sustainable Recovery

Long-term euro-area reforms are necessary for a sustained global recovery. Specifically, fiscal austerity must be enforced. If long-term austerity measures are implemented, the recovery process for the euro area will be slow and difficult, but investor confidence should return. If weak fiscal discipline is exercised, the euro-area crisis could escalate. Growth in emerging economies has moderated but remains strong. As these economies continue to develop, their demand for oil grows. This increasing demand combined with geopolitical risks and a constrained oil supply could cause oil prices to increase, which would dampen global growth.

—Adrienne Mack

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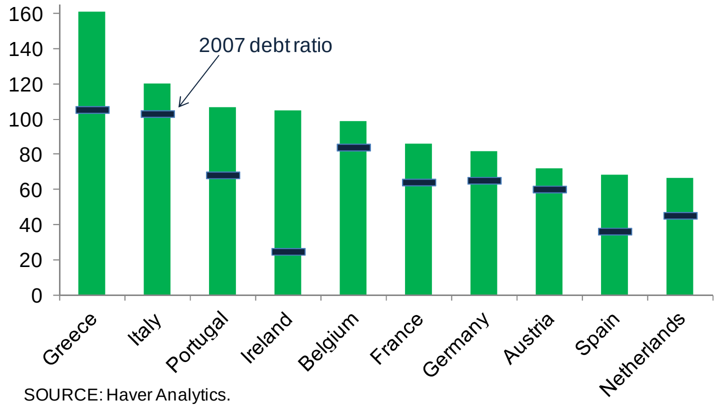
About the Author

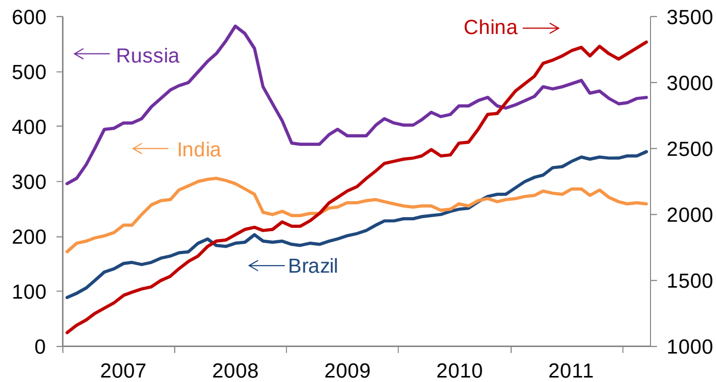
Mack is a research analyst in the Research Department at the Federal Reserve Bank in Dallas.

Chart 3
2011 Gross Government Debt Exceeds 60 Percent Limit



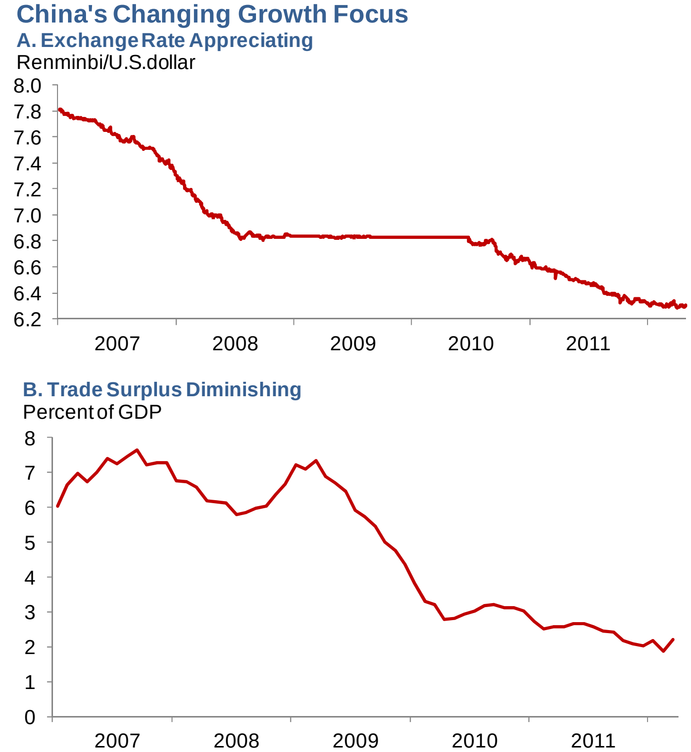
SOURCE: Haver Analytics.

Chart 4
Foreign Exchange Reserves Accumulate



SOURCE: Haver Analytics.

Chart 5
China's Changing Growth Focus



SOURCE: Haver Analytics.