

Outlook for global economy in 2012

A R Chowdhury, Professor and Chair, Department of Economics, Marquette University and Advisor, Federal Reserve Bank, has made authentic and highly thought-provoking observations on the outlook for global economy in 2012. He writes : We expect 2012 to be a year of slowing global growth, with wide divergences between regions and countries. Overall global growth will slow from about 3% in 2011 to 2.5% in 2012. For 2013, a modest recovery in global growth is likely.

The Euro-zone sovereign debt crisis will escalate, provoking a sufficiently strong policy response from the European Central Bank (ECB) and creditor governments to prevent Euro-zone disintegration and a string of disorderly sovereign debt defaults. Even so, sovereign spreads will remain unusually wide even at end-2012. The euro area already probably is falling back into recession, with negative quarter-over-quarter growth in fourth quarter of 2011 likely to carry over into 2012. Real GDP in the euro area will drop by at least 1% in 2012.

The United Kingdom is likely to be near recession, and we also look for a marked slowdown in Eastern Europe in 2012. By contrast, modest but sustained growth will occur in the United States in 2012 and beyond, and still relatively strong but slowing growth will take place in 2012 in emerging Asia, Latin America, Africa and the Middle East. In all, there will be sluggish growth in the advanced economies (around 1% year — over-year in 2012), with emerging market growth of about 5% for 2012.

As a result, the extent to which global growth is China-dependent will increase. The lagged effect of past domestic tightening and slowing export growth are likely to cool China's growth below 9% in 2012. Nevertheless, China will continue to account for a huge share of global growth.

The specific predictions for 2012 could be summarised as follows. The US will avoid a recession: The US domestic risks have diminished somewhat and growth momentum has picked up modestly. After a fairly miserable first half of the year, the economy grew by 2% in the third quarter and is likely to accelerate to more than 3% growth in the final quarter of 2011. There are a number of signs that recent momentum could carry into next year — job openings are on the rise, the unemployment rate is trending down and corporate profits relative to GDP are at their highest level in over six decades.

Recession in the Euro-zone: The Euro-zone sovereign debt and banking crisis will intensify further in 2012, with sovereign yield spreads vs German Bunds remaining high in many Euro-zone countries, and many countries in the euro-zone in recession. We do not, however, expect the euro area to break up in 2012 or the following years, nor do we expect the disorderly default of an euro-zone country. The risk that either or both of these disaster scenarios materialise is, however, non-negligible at around 25%.

Asian growth will continue: While Asia will not remain immune to a recession in the Euro-zone, growth in the region will continue to be the strongest in the world for a number of reasons. First, Japan's post-earthquake rebound will help to underpin the region's exports, offsetting some of the weakness in sales to Europe. Second, Chinese economic growth will be around 8% and further bolster Asian growth prospects. Third, easing inflation will give all Asian governments much leeway to stimulate, if necessary.

Growth in emerging markets will continue: The Euro-zone crisis will have an adverse impact on emerging European countries as Western Europe is its most important export destination and also

because the region is dominated by subsidiaries of Western European banks — all of which are tightening credit. Latin America and Africa are relatively more vulnerable to the United States and China so, barring a plunge in commodity prices, the growth in these regions should be reasonable.

Inflation will drop worldwide: With soft world growth and drop in commodity prices, inflation is likely to decline worldwide in 2012. The decline will be more pronounced in the developed countries due to the excess capacity in the labour and product markets. The drop in food prices in recent months will also keep inflation under control in the emerging markets.

Monetary policy will be accommodative: Easing inflationary pressures and increasing concerns about the growth outlook will force most central banks to follow an expansionary monetary policy. Some central banks, such as, Reserve Bank of India and Bank of China, that had been following a restrictive policy would soon ease their policy tools.

Of course, there are major risks in the outlook. First, the possibility that the Euro crisis escalates and then is contained and mitigated somewhat by policy responses is subject to considerable risks — most of them on the downside. On the upside, it is possible that the ECB and creditor nations may be willing to commit themselves publicly to provide extraordinarily large assistance early enough to prevent sovereign spreads widening further, although this is rather unlikely.

On the downside, it is possible that there may not be a viable overlap between what the ECB and creditor nations are prepared to offer and what Greece and other periphery countries need to avoid early defaults. The chance of one or more countries leaving the European Monetary union (EMU) in 2012-13 is about 25%. If this happens it would probably be a Greek exit, but there is also a small chance that Germany balks at the costs of sustaining EMU and walks out, probably together with other core countries.

Second, the experience of 2008-09 highlights that bank deleveraging during economic weakness (which is likely in Europe) can cause a large drop in economic activity. Third, emerging Asia may hit a slowdown in exports to Europe compounded by the drag from previous domestic policy tightening. In particular, restrictions on home purchases in China are producing a sharp slowdown in housing activity. If there is a deeper downturn in emerging Asia, this would probably produce sharper loosening in monetary, credit and fiscal policies.

Fourth, there will be a limited decline in imbalances between current account surplus and deficit countries, both globally and in the euro zone. The continuation of such imbalances creates additional downside risks to the outlook. For example, the necessary recycling of excess savings from current account surplus countries may not occur smoothly, and deficit countries may turn to protectionism or disruptive foreign exchange policies to try and regain the growth lost to imports.