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Economic Growth: Is the glass a third full or two thirds empty?

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Weak growth

Real global economic growth was weak in Q1. Estimates put economic growth at an annualised 1.5% (q/q). Thus the long-term trend of downward revisions is intact, which keeps the fears of global economy possibly heading for persistent stagnation alive.

Growth dent?

In terms of sectors, this development was broadly based. Retail sales, industrial production, exports, and company investments have been weak. As far as countries are concerned, the economies standing out are the USA (stagnation), China (drastic weakening) as well as Russia and Brazil (shrinking). Interestingly, the Eurozone, Eastern Europe, and Japan recorded accelerating growth rates. These countries account for almost a third of global GDP. Was the weak global economic growth in Q1 short-lived? Is the glass one-third full or two-thirds empty?

The new stars

At real growth of 1.6% and 2.4%, respectively, the Eurozone and Japan recorded accelerating growth rates over the previous quarter. Here are two exemplary, positive developments: first, the lending volume of banks to other countries within the Eurozone has started to grow. This suggests a decline in the fragmentation of the financial market in the Eurozone. Second, the deflator in Japan is rising and has reached 3.4% in Q1 (y/y). The average since 1955 is -0.8%.

Weak signals

The signals of an increased growth rate in Q2 are few and far between, with economic indicators such as industrial production and exports in April suggesting no improvement on a net basis. The important leading indicators of the OECD, too, are on a decline. And lastly, the data surprises have also been largely negative. On the upside, the initial estimate for the global purchasing managers index in May has increased slightly. That being said, this indicator had failed to predict the decline in GDP growth in Q1.

Assumptions

For global economic growth to accelerate in Q2 towards its potential (about 2.5%), at least three assumptions have to be made. Firstly, some factors that are responsible for the stagnation in the USA (bad weather, strikes) are only temporary. Secondly, the loosening measures in the Chinese economy are effective enough to generate increased growth. Thirdly, the weak global economy hardly affects the cyclical upswing in Japan and the Eurozone.

High noon with Greece

The impending default of Greece is one of the risk factors for the markets. The time of a decision in favour or against defaulting is approaching. The conflict of the various institutions with Greece illustrates that the institutional framework necessary for the functioning of the Eurozone that would effectively coordinate the fiscal and economic policy does not exist (yet). If a country faces a debt overload, there are basically only three ways to handle the situation, with neither one of them looking particularly enticing:

1. Credits and transfer payments to the country in question. Without structural reforms in the receiving country, these measures are unpopular in the paying countries. Since saving and the reduction of unit labour costs trigger recessions and high unemployment, said reforms are unpopular in the receiving countries. If both parties act rationally, a compromise is the most likely solution.
2. Exit from the Eurozone and devaluation. If the devaluation of the currency does not go hand in hand with structural reforms, the ensuing chaos in the devaluing country is not only short-lived. N.B. the monetary zone is apparently not linked by inseparable ties.
3. If the central bank provided money directly to finance the budget deficit, it erodes the currency.

Killjoy Fed

The US Fed members have suggested the launch of a cycle of Fed funds rate hikes this year. In doing so, they mentioned an important condition: the economy had to improve as expected by the Fed. This means that if it turns out that the stagnation in Q1 was really only a dent, the Fed Funds rate is likely to be raised in September or a bit later.

Conclusion

The combination of weak economic growth and a loose monetary policy supports many asset classes, even if bond yields and earnings prospects are subdued. In this environment the markets may experience strong movements if the market participants change their expectations even just by a moderate degree – either positively, such as in the case of the Eurozone, or negatively, if Greece defaults of the Fed increases rates excessively.

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