A delicate balance
Chris Giles

For those who do not follow every twist and turn in the global economic data, the past week has come as quite a shock.

Such has been the extent of the bad news for every large advanced economy that none now seems insulated from the ravages of the North Atlantic credit crisis. Instead, all appear on the brink of recession, with risks rapidly becoming realities.

The week started badly with the obscure-sounding Senior Loan Officers' report from the Federal Reserve in the US. This survey of banks' willingness to extend credit is eagerly awaited by central bankers as a gauge of the health of the financial sector. In every category of lending to companies and households, US banks were making loans more expensive and difficult to come by. Demand from borrowers was also weak, boding ill for the US economy in the quarters to come.

A plethora of woes in the UK also dominated the first half of the week. In a letter to business leaders, Richard Lambert, director-general of the CBI, conceded that the employers' organisation has been "consistently overopti-mistic about the economic outlook over the past 12 months".

His admission was followed on Wednesday by similar, if less candid, comments from the Bank of England. Mervyn King, Bank governor, said inflation was likely to top 5 per cent in coming months, more than twice the inflation target. "It's bound to be the case," he added, "that there is a possibility of a quarter or two of negative growth". As far as economists found it possible to tell from the Bank's graphs, it thinks there is a 50-50 chance that the UK economy will be smaller in a year's time than it is today. That, in anyone's book, would be a recession.

The troubles are by no means confined to Anglo-Saxon economies. In the second quarter, Japan's economy shrank by 0.6 per cent, its worst quarterly performance for seven years. On Thursday, the eurozone posted a second-quarter contraction of 0.2 per cent, its first since the launch of the single currency in 1999, with falling national income in Germany, France and Italy.

Concern in Spain, where growth has slumped but just remained positive at 0.1 per cent, was so great that ministers returned from their holidays for an emergency mid-August cabinet meeting, which agreed on an economic stimulus package. The third quarter looks just as bad for the eurozone, with sentiment and purchasing indicators for July particularly weak.

Finally, attention shifted back to the US for some shockingly bad inflation figures. Consumer prices were 5.6 per cent higher in July than a year earlier, the worst rise in the cost of living since 1991.

Stuart Green, of HSBC, who does look at the figures daily, says the surprise has not been the bad news as such but its timing. Having expected troubles in the US to spread to other econo-mies, "it hadn't come though until the past month and then it all came through in the past few weeks", he says.

His surprise is widely shared. Most big European economies and Japan had appeared resilient until recently. Now, across the developed world, inflation is uncomfortably high, households are being squeezed and economies are flirting with recession.

The big fear is that the current downturn becomes a vicious cycle in which economic weak-ness hits an already-fragile financial system, leading to even tighter restrictions on lending and another economic lurch.

For many, what appears certain is the veracity of the old adage that when America sneezes, the rest of the world catches a cold. All the talk of decoupling - the ability of economies to remain resilient in the face of US weakness - has been proved bogus and it is time to hunker down.

Rarely someone to be outbid on gloomy predictions, Professor Nouriel Roubini of New York University's Stern School argued this week that "literally every single Group of Seven economy is now headed towards a recessionary hard landing".

He cites the financial crisis, the credit and liquidity crunch, the bursting of housing bubbles, falling stock markets, the burden of high oil and commodity prices, trade linkages to the US, the strong euro and the inability of policymakers to respond for fear of stoking inflation as the toxic mix that will push "the global economy - not just the US -[into] a serious and protracted recession".

Furthermore, he insists, this disaster for the developed world will end the run of the "Brics" Brazil, Russia, India and China, which up to now have continued to grow strongly without a care for the pain in the G7.

He argues that China and emerging Asia will be hit by reduced exports to the G7, that India and other emerging economies with trade deficits will suffer a "sudden stop of capital", while commodity exporters will be hit by falling prices for their raw materials. Evidence of the plausibility of this scenario came this week from India, where the prime minister's economic advisory council forecast that growth would slow from 9 per cent last year to 7.7 per cent this year.

But for all the gloomy figures and forecasts, there are silver linings. It is easy to lump the similar weak recent outcomes in each advanced economy to the same cause and come up with the spurious conclusion that economies are linked rather more than they are. This interpretation, says Julian Jessop of Capital Economics, "ignores significant differences in the relative importance of the factors driving the downturns in the respective regions".

First, some of the seemingly dire second-quarter figures are more accurately reported as corrections from an unusually strong first quarter. In Germany, the economy shrank 0.5 per cent in the second quarter after growing 1.3 per cent in the first. Gross domestic product is still estimated as 1.7 per cent higher than a year ago, which is not a bad figure for Europe's largest economy. The same applies to Japan, where the 0.6 per cent contraction was almost matched in the same quarter of 2007, so the year-on-year growth rate declined only slightly from 1.2 per cent in the first quarter to 1 per cent in the second.

A second reason for optimism is that the causes of underlying weakness are different among the large advanced economies. While high commodity prices have hit households across the world, the withdrawal of credit, falling asset prices and high consumer debt appear to be taking a toll only on countries with particularly over-extended housing markets - the US, Ireland, Spain and potentially the UK.

Most importantly, there are signs that the commodity boom is going into reverse. Not even the fighting in Georgia, a country with an important pipeline to the Black Sea, could stem falls in the oil price this week, something that a month ago would certainly have sent crude soaring higher.

David Mackie, of JPMorgan, says the fall in commodity prices will be a cushion against the downturn: "With oil at $145 a barrel, the euro area is in recession; with oil at $115 the region will stagnate for a while."

The change in the commodity markets is a sign that there are some automatic stabilisers in the modern world economy. Prices rose rapidly as demand continued to grow and supply was

disappointing, but with better news this week on oil output and signs that harvests are improving alongside weaker demand, prices have plummeted with boosts to household incomes in prospect.

What is more, the decoupling thesis - in the sense of parts of Europe and Japan being relatively immune from specific US problems - retains its force. The story was never that any economy, rich or poor, could decouple from a global phenomenon such as a marked increase in vital input prices.

But danger lurks around every corner, even for those countries praising themselves for high savings rates, low levels of debt and strong banking sectors. The past year has not been a good time for the consensus economic forecasts, nor for official predictions.

So the advanced world is at a precarious juncture. The data are clearly getting worse and this threatens to have its own dynamic. Survey evidence shows European companies think retrenchment is the best answer to current problems. Meanwhile, the US nervously awaits the end of the year, when the boost to* incomes from tax rebates dissipates. It is difficult to envisage an outcome without a painful period in the US, the UK, Spain and Ireland.

Although the falling oll price, now down more than 20 per cent from its recent high, will reduce the contractionary and inflationary forces worldwide, there are still very real risks that households and companies begin to think that higher inflation is normal, leading to a wage-price spiral. Even if it does not materialise, the threat of persistently sticky inflation will constrain the actions of central banks in boosting demand at a troubled time.

So for now, the global policy is wait and see - and hope. The twin shocks of high commodity prices and financial crisis could fade away over the coming year as the world economy finds a new equilibrium, not as dynamic as the past five years, but still quite pleasant.

It is a perfectly possible scenario, but the gyrations of the past year, let alone the past few months, suggest that it is not probable. There are good reasons to believe that the path ahead in most advanced economies is brighter than some doom-laden predictions. But it is still likely to be a bumpy ride.

Fonte: Financial Times, London, August 16 / August 17 2008. Primeiro Caderno. p. 8.