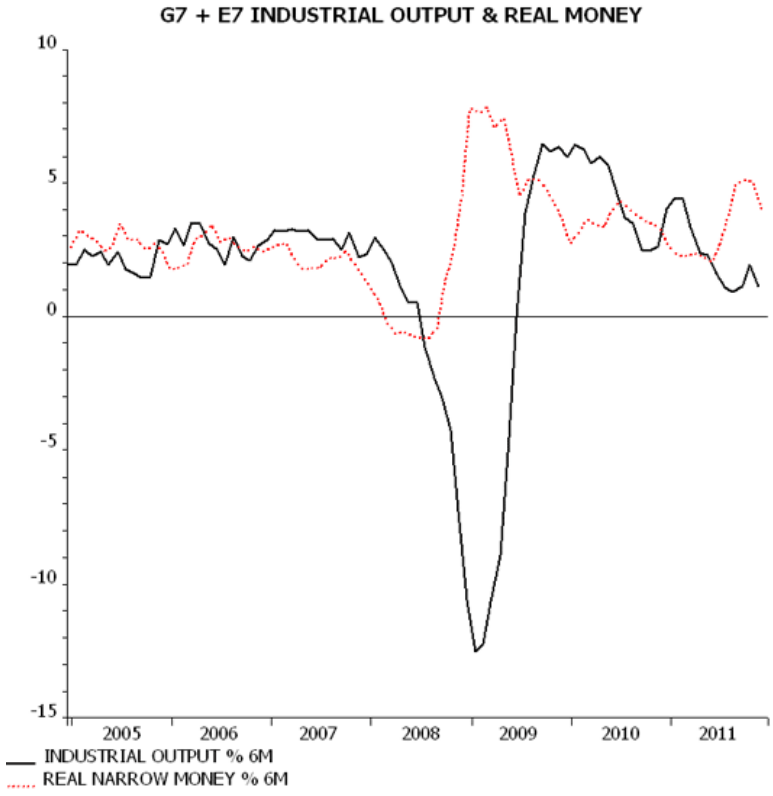
Global Views

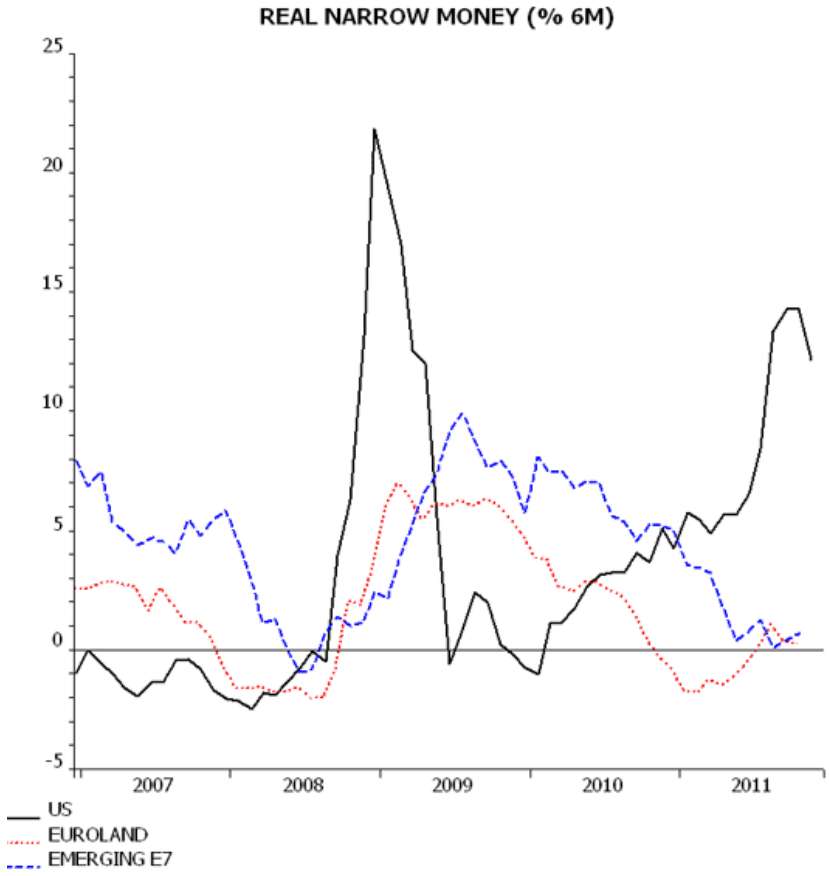
Global outlook: plenty to worry about but monetary backdrop hopeful
by Simon Ward, Chief Economist

The consensus is gloomy about global economic prospects for 2012, as evidenced by the December Merrill Lynch survey of fund managers, showing growth expectations at their lowest level since January 2009. Among the most commonly-cited worries are a disorderly Eurozone break-up, a fiscally-induced US recession and a property bust / "hard landing" in China. The perspective of these notes, however, is more hopeful, based on a recovery in the key forecasting indicator employed here – six-month real narrow money expansion in the G7 and emerging "E7" economies. This indicator warned of economic weakness in early 2011 when most commentators were bullish. It has since returned to an above-average level, suggesting an improving economy from late 2011, allowing for the usual lag – see first chart. Current monetary conditions may be contrasted with those prevailing at the start of the 2008 economic and financial crisis, when G7 plus E7 real narrow money was contracting.



The seemingly-benign aggregate monetary picture, however, conceals significant regional variation that informs the debate about 2012 prospects. Strength in the G7 plus E7 real money measure, until now, has been narrowly focused on the US – see second chart. The implication that the US economy would outperform has been borne out by recent data suggesting fourth-quarter GDP growth of 3-4% annualised. US monetary buoyancy, however, may have reflected the impact of the Fed's "QE2" bond-buying operation so could fade in early 2012, barring renewed stimulus. A further issue is the scale of fiscal tightening in 2012 – the Congress, at the time of writing, had failed to reach agreement on extending important payroll tax and

unemployment benefit concessions. 100% capital allowances scheduled to be phased out at end-2011, moreover, may have given an artificial boost to investment that will unwind in early 2012. A forecast, therefore, that the US economy will continue to outperform in 2012 is conditional on real money expansion being sustained and political agreement being reached to lessen fiscal drag.



Strong US monetary trends have been offset by weakness in the Eurozone and "E7" emerging economies, in both cases partly related to policy tightening. E7 "overheating" in early 2011 warranted such restriction but these economies have since slowed sharply while inflationary pressures are easing, partly reflecting softer food commodity prices. Another precondition, therefore, of an optimistic global outlook is that E7 central banks loosen policies in early 2012 to ensure a significant reacceleration of real narrow money expansion. Recent developments in China – by some distance the largest E7 economy – are hopeful: six-month real narrow money growth firmed in October and November as inflation cooled and the authorities started to reverse course. (The still-hawkish Reserve Bank of India, by contrast, is at risk of monetary overkill.)

In contrast to E7 monetary authorities, the ECB made a bad policy mistake by scaling back its "unconventional" support measures in 2010 before hiking rates in the spring and summer of 2011 despite slowing monetary growth, indicating little medium-term inflation risk. A contraction in real money in early 2011 warned of an oncoming recession but – somewhat surprisingly – the six-month rate of change returned to positive territory during the second half, suggesting that economic contraction will prove modest and temporary. Such a scenario, however, depends on the ECB easing policy further in early 2012, a prospect

clouded by opposition within the Governing Council to the second quarter-point rate cut delivered in December. An optimistic outlook requires not only a recovery in Eurozone-wide real money expansion but also an end to monetary contraction in the periphery, without which a return to economic growth – critical for fiscal consolidation plans – will remain elusive.

Such qualifications notwithstanding, the current constellation of monetary data casts doubt on consensus gloom about economic prospects. Global real money expansion, moreover, is running ahead of industrial output growth, suggesting "excess" liquidity available to flow into markets and push up asset prices. Real money was rising more slowly than output at the start of 2011 – a reason for doubting bullish fund manager forecasts for equities at the time, as recorded in the Merrill Lynch survey. Will monetary analysis again trump the consensus – now mostly bearish – in 2012?

Simplistic forecasting rule suggests trend-like UK growth

In several previous Decembers these notes have assessed the prospects for the UK economy in the coming year using a simplistic forecasting rule-of-thumb based on whether annual broad money supply growth and the level of the stock market are higher or lower in inflation-adjusted terms than a year earlier. GDP growth averaged 3.8% in the 15 years since 1966 when both conditions were positive but only 0.4% in the 10 years following a "dual negative" signal. The average for the remaining 20 years when the two conditions gave conflicting results was 2.2% – close to the 2.3% mean for the full 45 years (i.e. 1966-2010).

In December 2010, the real level of the stock market was higher than a year before but annual real money supply expansion was lower, suggesting that 2011 would be an "average" year for growth. In the event, GDP is on course to have risen by only 0.9%, assuming a flat fourth quarter. This weakness, however, partly reflects a fall in North Sea production – gross value added excluding oil and gas may rise by 1.4%. It should be noted, moreover, that there were two fewer working days in 2011 than 2010 – 251 versus 253, with one of the lost days due to the additional Royal Wedding bank holiday. GDP statistics do not adjust for working days, implicitly assuming that any lost output is recouped within the quarter or year. On an alternative assumption – equally defensible – that only half is recovered, GDP growth in 2011 was depressed by about 0.4 percentage points (i.e. one day as a percentage of 253), implying a "true" rate of expansion of about 1.3%, or 1.8% excluding oil and gas. (The effect turns positive in 2012, when there are 252 working days despite an additional bank holiday to celebrate the Queen’s Diamond Jubilee.)

The real level of equity prices is certain to end 2011 lower than in December 2010 but annual real broad money growth (on the M4ex measure) is currently higher, based on October monetary and November inflation data. The suggestion, therefore, is that 2012 will be an "average" year for the economy, involving trend-like growth. Trend expansion, admittedly, may be lower than in the past but the approach offers hope that current consensus expectations of an increase in GDP of only 0.7% will prove too downbeat.

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Date of issue: 30 December 2011