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US immune from eurozone contagion so far

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In the second half of 2011, the US economy appeared to buck the impact of the eurozone crisis, with American economic data surprising on the strong side in the final quarter of the year. But, as the new year begins, it seems improbable that economic activity in the US and the eurozone can remain so divergent for much longer.

Will the weakness in the eurozone eventually bring the US economy to its knees? Or will the greater resilience of the US win the day? The answer to these questions will determine whether the global economy will experience a double-dip recession in 2012.

The data released over the holiday period seem to be pointing in a more optimistic direction than markets have recognised. A year of above-trend growth certainly looks like a stretch in the present environment of fiscal tightening and global deleveraging. But the risks of a global double-dip recession appear to be receding, at least for now.

It is never easy for economists to identify major turning points in the global economic cycle as they are happening in real time. Economic data at these stages of the cycle are inevitably noisy, and it is easy to miss major inflection points, even several months in arrears. Yet active investors have little choice but to attempt to take a view on this critical matter. By the time that economic data have clearly confirmed a turning point in global activity, asset prices will already have fully discounted the news.

One way of trying to handle this difficulty is to examine monthly changes in global leading indicators, including business surveys. Regular readers of this blog will know that this method does not always work by any means, but it does often highlight interesting information which should not be ignored. As the first graph shows, these real-time data have traced out a clear turning point in global activity since the middle of last year:

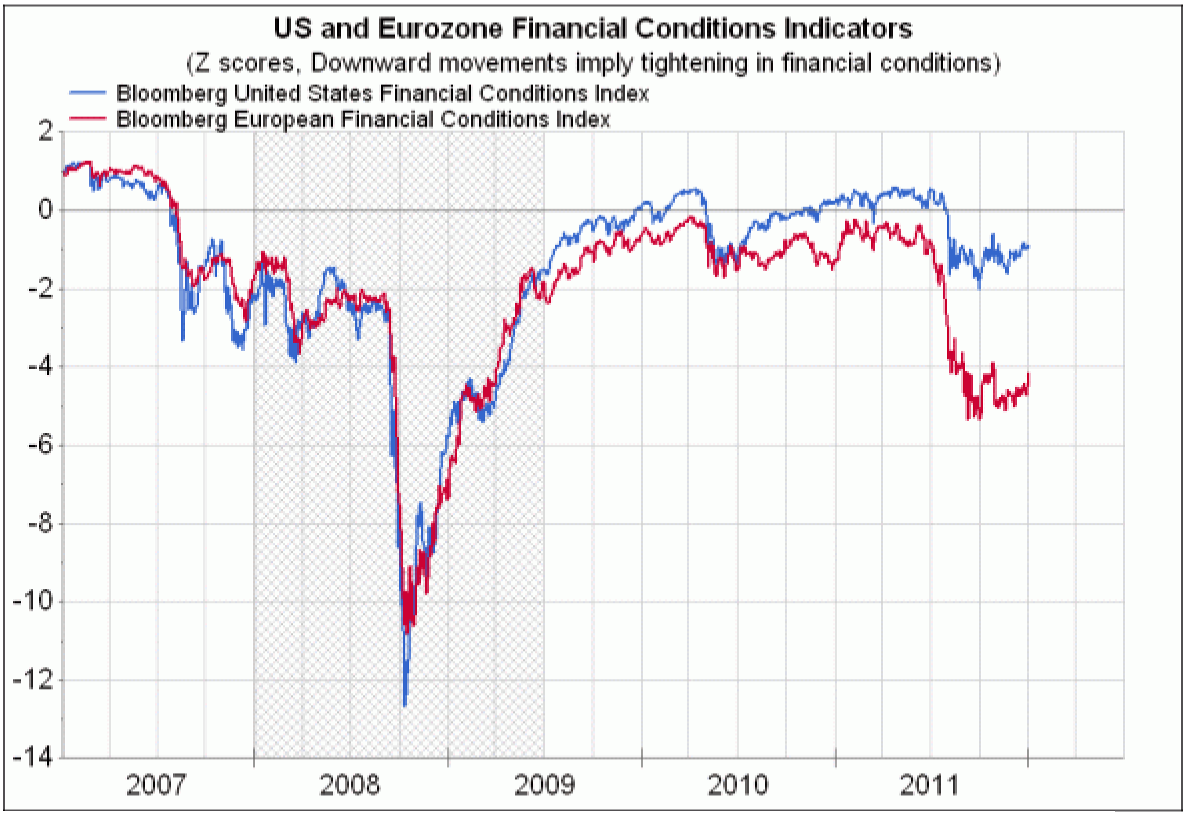
In retrospect, the path for world oil prices probably proved decisive for the mini cycle in global activity in 2011. Leading indicators bottomed in July/August, shortly after oil prices peaked. Global activity improved slightly in September and October, but at that stage only the US proved robust to the increasingly grim economic data emerging from Europe and China. There seemed to be a significant risk that the eurozone crisis would cause a renewed recession not just in Europe, but in the world as a whole. But the economic data which have so far appeared for November and December do not seem to have justified these fears.

These data are clearly inconsistent with the view that the world is tumbling into a recession, still less a repeat of the disaster which occurred at the end of 2008. Furthermore, while the data in the eurozone continued to worsen into November, the business surveys which have just been released for December have shown a slight improvement even there, instead of the further nosedive which was widely feared.

The eurozone is, of course, already in a shallow recession, and this will inevitably worsen markedly in the peripheral economies as fiscal policy tightens by about 2 per cent of GDP this year and banks continue to delever. But the large demand shock which is under way in the crisis economies of the eurozone will, on its own, reduce global GDP by no more than 0.2 per cent this year. Even assuming that the eurozone shock drags the core economies like France and Germany into recession, which is likely but not certain, the impact on global GDP would be only about 0.4 per cent.

This is manageable, given the 3.3 per cent growth rate which the US economy seems to have recorded in 2011 Q4. Admittedly, part of this apparent strength in the US may well be illusory. There are grounds for believing that seasonal distortions have exaggerated the strength of the American economy in recent months. And fiscal policy is scheduled to tighten by about 0.75 per cent of GDP this year, much the same as last year. But in the absence of much greater contagion from the eurozone, recession risk in the US seems much smaller than it was in mid 2011.

So how might trans-Atlantic contagion occur? By far the most worrying channel is via stress in the eurozone banking sector. Consider the following graph, which shows financial conditions indicators in the US and the eurozone, calculated by Michael Rosenberg at
Bloomberg:



The tightening in the eurozone FCI has now been about half as severe as that which hit the European economy at the end of 2008. That is enough to cause a recession, but it would have been far worse if the ECB had not taken enormous steps to support the financial system, and the integrity of the euro (see this earlier blog). In the process, they have come much closer to full-scale quantitative easing, along with bailing out of eurozone governments, than they have been willing to acknowledge in their rhetoric.

Meanwhile, the Fed's continuing preference for extremely easy monetary policy in the US has prevented the financial tightening from crossing the Atlantic. The absence of any tightening in financial conditions in the US during the recent crisis stands in sharp contrast to what happened in 2008.

Many economists (and I include myself in this) are beginning to feel very uneasy about the ability of central bank balance sheets to absorb these shocks in an unlimited manner. This has never been tried before in anything like comparable circumstances. But no-one seems to have a viable alternative to what the central banks are being forced to do. And that is the only reason why the eurozone crisis has not turned into another Lehman shock, along with a renewed global recession.