ABN·AMRO

Macro Weekly

Divergence everywhere

Group Economics

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The global economy is currently characterised by a significant divergence: advanced economies are doing quite well, but emerging economies are struggling. In an integrated world economy such divergence cannot last for a very long period. An amazing divergence also appears to develop (or perhaps it has existed for some time already) within the policy committee of the US Federal Reserve. This all creates uncertainty. We have lowered our growth forecasts for a number of important emerging economies.

Struggling EMs

Emerging economies are having an increasingly difficult time this year. There are several reasons for this. First and foremost is the cooling in China, or more specifically, the cooling of the industrial sector in China. Many other EMs are highly dependent on industrial activity in China and, as a result, they are all feeling the effects. A second, but related factor, is the weakness of commodity prices, which is causing a serious deterioration in the terms of trade for many EMs, which is a significant headwind. Furthermore, political fragility is affecting a number of EMs as is poor macroeconomic management. Brazil in particular features high on all such lists. Its economy has fallen into recession and it is hard to see what policymakers can do to turn things around. Inflation has risen and the central bank has raised interest rates in response. This is understandable, but not good for short-term growth prospects. In addition, economic weakness has affected public finances and the response here is that action has to be taken to prevent too severe a deterioration. This also is bad for growth. And if this was not bad enough, the political situation complicates matters even more, with the various corruption scandals and the record low popularity of President Dilma Rousseff, who was only elected to her second term last year.

On top of all these factors, EMs are under pressure from a tightening of financial conditions as capital is flowing out of these economies. There is a lot of talk about this tightening of financial conditions, sometimes dubbed quantitative tightening. It is, however, extremely difficult to gauge the magnitude and to assess the effects.

Advanced economies doing well

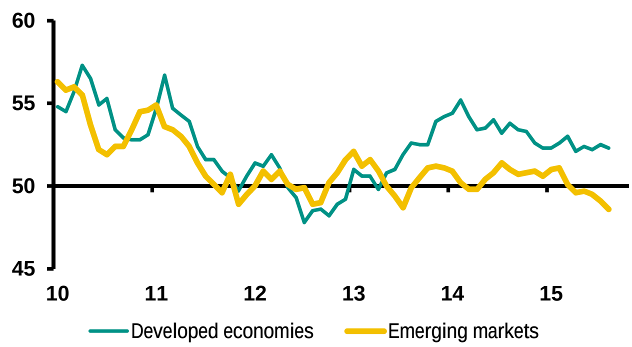
At the other end of the spectrum, advanced economies are doing well. Growth in the US and in the eurozone in particular, while unspectacular, is above the long-term trend in these economies, resulting in falling unemployment rates and improving public finances. The basis for growth in these economies has broadened in recent quarters.

Divergence cannot last very long

The chart on this page shows the PMIs for industrialised countries and for emerging economies. In an integrated world economy one would expect the correlation between the two to be high. And it is. A couple of important points need to be made here. First, PMIs for emerging economies do not have a particularly long record. And one should probably be careful interpreting this series, in particular as regards the level. However, it is clear that the PMI for emerging economies has fallen consistently this year (and has fallen below 50 recently). On the other hand, the PMI for advanced economies has stabilised this year at a level well in excess of 50.

PMI Manufacturing

Index, <50 = negative, >50 = positive



Source: Thomson Reuters Datastream

I would suggest that such a divergence cannot last very long. Either the advanced economies will pull up the EMs or the EMs will drag down the advanced economies. Most likely, it will be somewhere in between. The key questions here appear to be whether or not China will experience a hard landing, how vulnerable advanced economies are to the weakness in EMs and how financial conditions will develop.

On China, we are not too pessimistic. Weakness is concentrated in the industrial sector, which can be volatile. In addition, we continue to think that Chinese policymakers have a strong motive to prevent a hard landing, they also have the means in our view and the past shows they also have the ability. We take comfort from that as well as from the fact that the housing sector appears to have bottomed and the services sector remains relatively strong.

On the vulnerability of advanced economies, we are also not overly pessimistic. The fact that growth in advanced economies has broadened significantly suggests that the vulnerability is not particularly large in the short term.

Finally, on financial conditions, I have already said that they are hard to gauge. Of particular interest here is the path of monetary policy in the US.

Divided FOMC

At their September meeting the FOMC decided to leave interest rates unchanged. Weakness in emerging economies, volatility on financial markets and in particular the effects that all these factors may have on the US prevented the Fed from hiking rates. They left open the possibility of a rate hike any time and one of the FOMC members, Richmond Fed President Jeffrey Lacker wanted to raise rates. Lacker is a well-known hawk. The differences of view within the FOMC are clearly very significant. While Lacker wanted to tighten monetary policy one of the others is now expecting the correct Fed funds rate to lower by the end of the year than it is now. That would bring the key rate in negative territory. As there are only two meetings left before the end of the year, that FOMC member will either have to get his way (which does not seem very likely), change his mind (which he will be reluctant to do as it would imply him saying that he made an error and has realised this within a few weeks) or dissent at at least one of the last two meetings this year. One would love to be a fly on the wall in those FOMC meetings.

The Fed seems to be struggling with three key questions. What is the actual state of the economy, what are they actually trying to achieve and what are the feedback loops between US monetary policy, its effects on EMs and by extension on the global economy, and then back onto the US.

While the member projecting lower rates is obviously a dove on the FOMC, the same way Lacker is a hawk, experience of recent years suggests that the way things evolve tend to make the dovish view more relevant than the hawkish view. This may change, of course, but it is probably fair to say that the Fed will proceed cautiously. We have, for a while, argued that they Fed will hike in December. This has now become a lot less certain, but it still seems reasonable to consider this as the base case.

Our overall assessment

We see all the risks referred to above. Yet, we think China will not experience a hard landing. In addition, we think that advanced economies will not be overly vulnerable, at least in the short term, to weakness in EMs. Finally, we think that the Fed will proceed cautiously. Assuming things will settle down in the global economy over the next couple of months, a Fed rate hike in December is still a good possibility, but chances of a further delay have increased materially.

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Main economic/financial forecasts

GDP growth (%)	2013	2014	2015e	2016e	3M interbank rate	10/09/2015	17/09/2015	+3M	+12M	2015e	2016e
United States	1.5	2.4	2.7	2.9	United States	0.34	0.35	0.6	1.3	0.6	1.6
Eurozone	-0.2	0.9	1.6	2.0	Eurozone	-0.04	-0.04	0.00	0.00	0.00	0.00
Japan	1.6	-0.1	1.0	1.2	Japan	0.17	0.17	0.2	0.2	0.2	0.2
United Kingdom	1.7	3.0	2.8	2.6	United Kingdom	0.59	0.59	0.7	1.5	0.7	1.7
China	7.7	7.3	7.0	6.5							
World	3.1	3.2	3.1	3.5							
Inflation (%)	**2013**	**2014**	**2015e**	**2016e**	**10Y interest rate**	**10/09/2015**	**17/09/2015**	**+3M**	**+12M**	**2015e**	**2016e**
United States	1.5	1.6	0.2	2.1	US Treasury	2.23	2.19	2.3	2.7	2.3	2.7
Eurozone	1.3	0.4	0.2	1.5	German Bund	0.70	0.79	0.5	1.3	0.5	1.4
Japan	0.3	2.8	0.7	1.4	Euro swap rate	1.02	1.04	0.8	1.6	0.8	1.6
United Kingdom	2.6	1.5	1.1	1.9	Japanese gov. bonds	0.33	0.34	0.7	1.0	0.7	1.0
China	2.6	2.0	1.5	2.0	UK gilts	1.86	1.96	2.0	2.6	2.0	2.7
World	4.3	3.9	3.8	3.8							
Key policy rate	**17/09/2015**	**+3M**	**2015e**	**2016e**	**Currencies**	**10/09/2015**	**17/09/2015**	**+3M**	**+12M**	**2015e**	**2016e**
Federal Reserve	0.25	0.50	0.50	1.50	EUR/USD	1.12	1.13	1.00	1.05	1.00	1.10
European Central Bank	0.05	0.05	0.05	0.05	USD/JPY	120.6	120.0	128	135	128	135
Bank of Japan	0.10	0.10	0.10	0.10	GBP/USD	1.54	1.55	1.49	1.50	1.49	1.49
Bank of England	0.50	0.50	0.50	1.50	EUR/GBP	0.73	0.73	0.67	0.70	0.67	0.74
People's Bank of China	4.60	4.35	4.35	4.35	USD/CNY	6.38	6.37	6.55	6.70	6.55	6.75

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

Key Economic Indicators and Events

Day	Date	Time	Country	Key Economic Indicators and Events	Period	Latest outcome	Consensus	ABN AMRO
Monday	21/09/2015	09:00:00	CH	Foreign currency reserves - CHF mln	Aug	531820		
Monday	21/09/2015	15:45:00	EC	ECB announces weekly QE details				
Monday	21/09/2015	16:00:00	US	Existing home sales - % mom	Aug	2.0	-1.2	**-0.8**
Monday	21/09/2015	20:00:00	MX	Policy rate - %	Sep 21	3.0	3.1	
Tuesday	22/09/2015	13:00:00	TR	Repo rate - %	Sep 22	7.5		
Tuesday	22/09/2015	14:00:00	HU	Base rate -%	Sep 22	1.4	1.4	
Tuesday	22/09/2015	15:00:00	US	FHFA house price index - % mom	Jul	0.2	0.5	**0.4**
Wednesday	23/09/2015	03:45:00	CN	PMI manufacturing - index (Caixin) - flash	Sep P	47.3	47.8	
Wednesday	23/09/2015	10:00:00	EC	PMI services - index	Sep P	54.4	54.2	**54.5**
Wednesday	23/09/2015	10:00:00	EC	Composite PMI output	Sep P	54.3	54.1	**54.2**
Wednesday	23/09/2015	10:00:00	EC	PMI manufacturing - index	Sep P	52.3	52.2	**51.8**
Wednesday	23/09/2015	15:45:00	US	Markit - Flash PMI	Sep P	53.0		
Thursday	24/09/2015	06:30:00	NL	Producer confidence manufacturing - index	Sep	3.5		**3.0**
Thursday	24/09/2015	10:00:00	DE	Ifo - business climate - index	Sep	108.3	107.9	**108.1**
Thursday	24/09/2015	10:00:00	NO	Policy rate - %	Sep 24	1.0		
Thursday	24/09/2015	11:10:00	EZ	ECB allotment TLTRO-5 - EUR bn		73.8		
Thursday	24/09/2015	13:00:00	CZ	Repo rate - %	Sep 24	0.1	0.1	
Thursday	24/09/2015	14:30:00	US	New durable goods orders - % mom	Aug	2.2	-2.2	**-2.0**
Thursday	24/09/2015	16:00:00	US	New homes sold - % mom	Aug	5.4	1.5	**1.4**
Friday	25/09/2015	01:30:00	JP	CPI - % yoy	Aug	0.2	0.1	
Friday	25/09/2015	10:00:00	EC	M3 growth - % yoy	Aug	5.3	5.4	**5.5**
Friday	25/09/2015	14:30:00	US	GDP - % qoq annualised	2Q T	3.7	3.7	**3.7**
Friday	25/09/2015	16:00:00	US	Univ. of Michigan cons. confidence - index	Sep F	85.7	87.6	**85.0**

Source: Bloomberg, Reuters, ABN AMRO Group Economics (we provide own forecasts only for selected key variables and events)