Group Economics

RBS Group

World Economy Barometer

Just when we were on a roll

CLASSIFICATION: EXTERNAL

October 2013

- **The Purchasing Managers' Indices (PMI) usually provide a very timely insight of private sector activity. However, this month they may be a victim of rapidly changing circumstances.**
- **The US government shutdown and the uncertainty surrounding the debt ceiling is likely to be exerting a drag on the economy as we write.**
- **So what can we say? Despite a weaker reading in the global composite PMI, the global economy appears in reasonable shape – there's plenty of green on our heatmap (chart 5).**
- **It means that if the troubles in the US can be resolved soon, there's a good chance things can get back on track quickly. But the most glaring risk to the global economy is that the political issues in the US are not resolved, or simply re-emerge in the very near future, and do substantial damage to growth.**

The global economy took its foot off the pedal in September. The composite PMI, covering both manufacturing and services, fell from 55.1 to 53.5. Although this is a three-month low it's still a solid figure. Whether the drop was down to the political impasse in the US or a natural moderation in growth is difficult to disentangle. But given that the US services sector recorded a sharp fall, political deadlock may have damaged private sector confidence. And as October has seen a heightening of debt ceiling fears and the government shutdown drag on, these impacts may have intensified.

US - debt ceiling impacts. Debt ceiling worries affects the US and global economies through three major channels:

- **Households –** the government shutdown has resulted in around 800,000 workers being temporarily laid off. Additionally, a closely-watched index of consumer confidence has fallen to nine-month low, partly on account of the debt ceiling uncertainty, Taken together, it's reasonable to assume consumers may retreat into their shells, even if only temporarily, and for spending to be weaker.
- **Businesses –** the likely main impact on businesses is through weaker consumer demand and a resultant pause on hiring and investment decisions. Separately, the debt ceiling, if it is not raised, has ignited fears that the US Treasury will not have the funds to meet debt payment obligations at some point over the coming month. This is already causing short-term interest rates to rise and straining certain parts of the financial system. Not least the market through which many corporates place, and raise, cash for short-term purposes. So far these issues are manageable. And for the time being longer-term interest rates are generally unmoved.
- **International –** a weaker US consumer and business reticence will likely manifest itself in weaker export orders, damaging trading partners (including the UK) and many export-reliant emerging markets. And it's not just domestic financial systems that will feel the strain. Of the outstanding $16.7 trillion US government debt, $5.6 trillion is held by foreign and international investors. China and Japan each hold over $1 trillion. These are enourmous positions and so maintaining confidence in US Treasuries is of paramount importance to the global financial system. If these countries were to sell substantial positions it would likely cause havoc.

US – indefinite dysfunction? As we write, the US government is inching toward a deal to restart government and agree a rise in the debt ceiling. But the deal may only be very short-term in nature (early 2014 is the current expectation). And given that the political environment will likely remain as challenging as it has been recently, the experience of the past few weeks may simply be repeated. Such an environment doesn't mean an end to the recovery in the US but it's a drag on growth.

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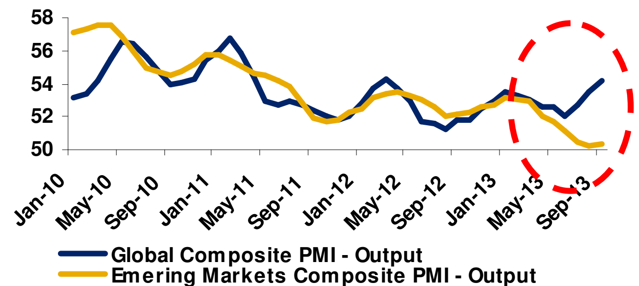
It also makes monetary policy difficult for the central bank. The Fed had been on course to 'taper' its asset-purchase programme before the end of the year but the recent debacle over fiscal policy means early 2014 seems more likely. But the decision may not be any easier at that point if another political stand-off ensues. The Fed will likely want to pause and assess the damage before making a decision on tapering. Predicting a path for US interest rates may have just gotten a lot more difficult. And volatility in rates may increase.

A window of opportunity for emerging markets. The emerging markets index edged up marginally from 50.7 to 50.8. But India continues to be the standout concern with its malaise continuing. And overall emerging markets remain downbeat while the global environment has improved (chart 1).

When the Fed announced its intention to 'taper' its asset purchases in May, emerging market assets were the big losers. Higher interest rate expectations in the US prompted a flight of capital out of many emerging economies. This created pressures for many countries that rely on these flows coming into their countries. India, Indonesia, Turkey and South Africa were some of the most high profile emerging markets to suffer. But the Fed's decision to delay tapering has granted some respite. Emerging markets, particularly India, have a window of opportunity to push ahead with reforms that reduce their reliance on external funding. Unfortunately, India's recent history suggests that opportunity will likely be wasted. As for other emerging markets, they need the global trade cycle to improve. So its encouraging that global new export orders reached their highest level in over two years in September. But whether this has continued into October as the debt ceiling debate has intensified is another question.

Chart 1: Emerging markets have struggled for traction despite the global rebound in recent months

Source: Datastream, Group Economics



UK – another strong month, what might be next? The UK services PMI registered a figure of 60.3 in September, down only marginally from 60.5. It rounded off an exceptionally strong quarter for the UK services sector. Indeed, it was the highest quarterly reading since 1997. It's worth noting that the survey does *not* indicate that the UK services sector grew at its strongest pace in 16 years in Q3. But at the least it suggests that the UK services sector has enjoyed a very healthy few months and there has been a marked pick-up in confidence from earlier in the year.

The other bit of good news is that there may be signs of life in wages at long last. The salaries component of the PMI jobs report is at its highest level since November 2007 (chart 2). Meanwhile, the regional reports point to pay pressures in the North of England, Scotland and London in particular. So although pay growth remains exceptionally weak for now, the next few months may begin to see some sort of improvement. The highly skilled may be the biggest beneficiaries rather than the labour market as a whole. But it will be a start to putting the recovery on a firmer footing.

Going forward, it would be perfectly reasonable for the survey data to soften given how strong it has been. But this shouldn't cause dismay. Lower readings would simply reflect the fact that we remain in the nascent stages of the recovery, with the drag from government budget deficit reduction measures to be with us for years to come. And unemployment has a long way to fall in many regions before the Bank of England's 7% threshold is met (chart 3).

Chart 2: Is anaemic UK pay growth about to change?

Source: Datastream, Group Economics

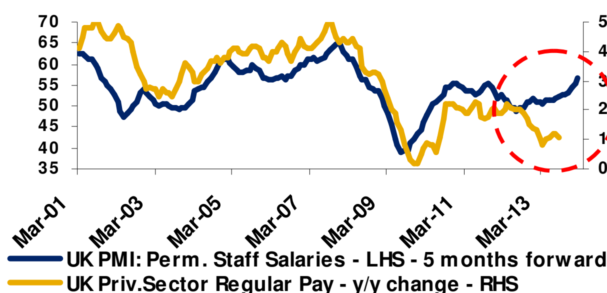


Chart 3: UK Regional Unemployment: Some have a long way to go to reach 7%

Source: Datastream, Group Economics

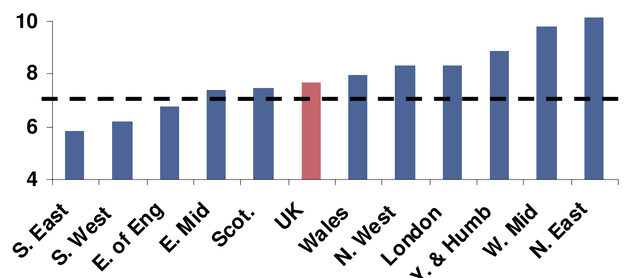


Chart 4: Manuf. PMI – Deviation from long-term trend

Source: Datastream, Group Economics

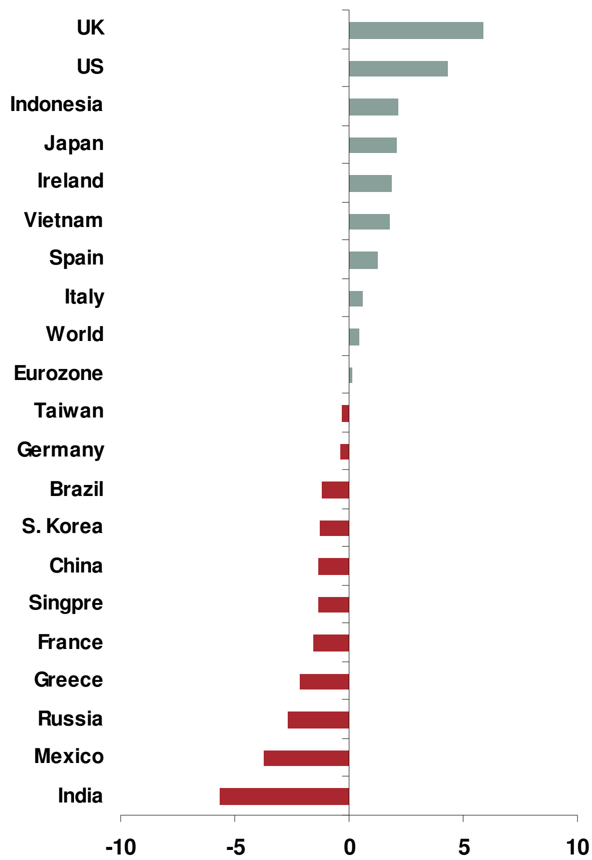


Chart 5: Services PMI – Deviation from long-term trend

Source: Datastream, Group Economics

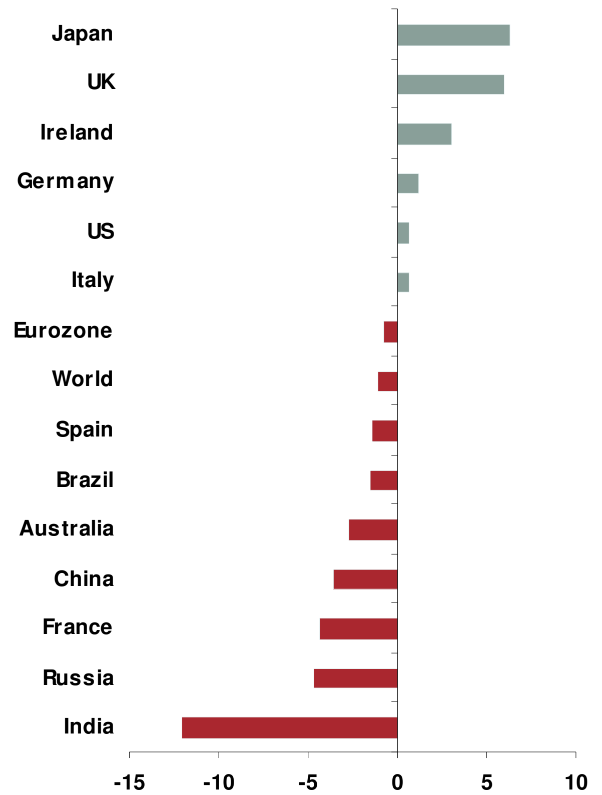
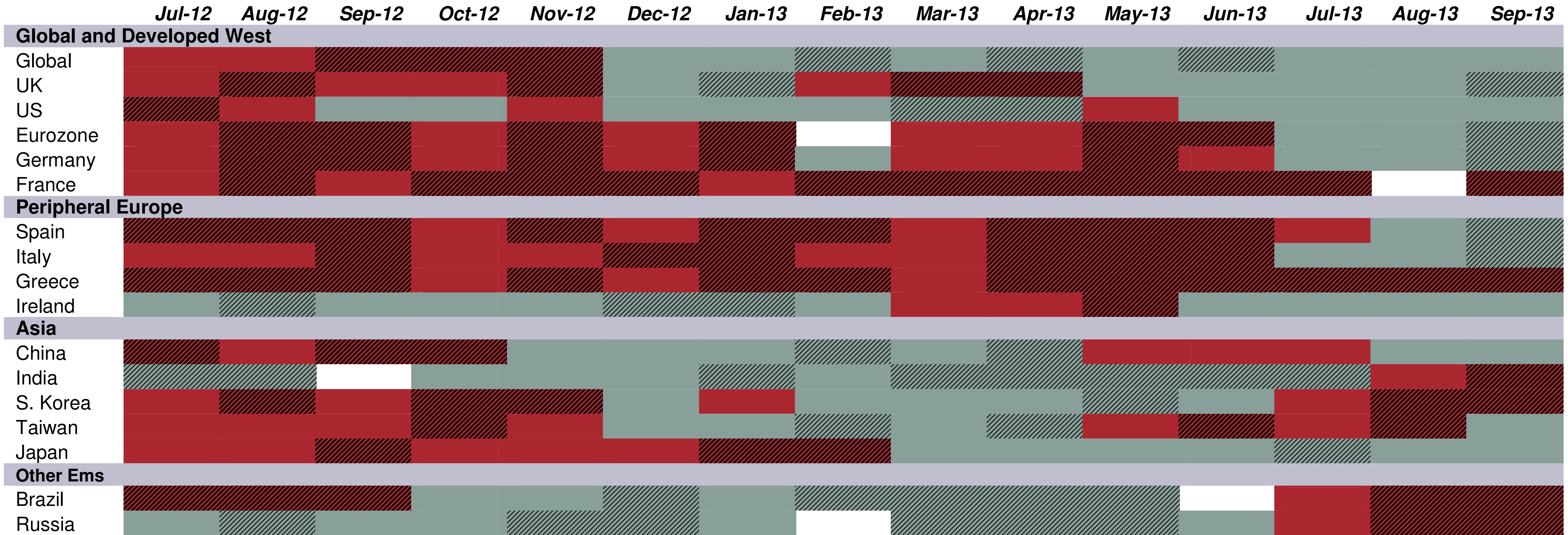


Chart 6: PMI Heatmap – Manufacturing Sector



Key

1 Inside Expansion Territory and Rising
2 Inside Expansion Territory but Falling
3 Inside Contraction Territory and but Rising
4 Inside Contraction Territory and Falling

- *- blank cells denote no change from the previous month*

What are the Purchasing Managers' Indices (PMIs) and why are they important? *The PMIs are a key guage of global private sector activity. Business across the world's major developed and developing economies are surveyed each month and asked to describe activity levels in the context of a number of key variables, including business output, new orders, employment and prices. Both manufacturers and service providers are surveyed (although construction and retail PMIs are provided for some countries). Most countries then produce a composite figure that gives a weighted average reading of all the sectors surveyed. The readings are centred around 50, with a figure above 50 denoting expansion while a reading below 50 signifies contraction. By analysing PMI data we are able to take the temperature of the global economy, assess how different regions and countries are performing and gain advance indication of future activity. Our analysis is issued each month following the release of all the surveys.*

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