



Economic update

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There are some signs of slowdown in developed economies, although quarterly volatility in growth rates is fairly typical in any economic recovery period. Growth in emerging economies, which now account for around 50% of global GDP, remains robust and there is much greater scope for policy stimulus here if needed. China remains a key support for global growth. US data has weakened, but the picture is certainly not all gloomy: unemployment benefit claims have been falling in recent weeks, employment levels are still rising and although the monthly ISM indicators (the US version of PMIs) for the manufacturing and services sectors have fallen, both remain at levels consistent with economic growth. The recent US corporate reporting season has seen upside surprises to profit expectations.

There have been two major double dip recessions in US history – the first was caused by a severe fiscal squeeze in 1937 and the second by the Fed raising interest rates aggressively from October 1980 to June 1981, in order to tackle inflation. Although the US faces a period of fiscal retrenchment, this is unlikely to be as draconian as the 1937 experience. The Fed is very unlikely to tighten policy any time soon; indeed further stimulus is possible.

The key risk remains a second Lehman-type event, leading to severe stress in money markets. While the prolonged nature of the current European debt crisis has increased the probability of this outcome, we are still some way off a meltdown scenario in money markets. The ECB must play its role in eliminating contagion risk to Spain and Italy, where the issue is still more about liquidity rather than solvency. A considerable burden also rests on governments to tackle the core problem of the sovereign debt crisis and introduce policies aimed at stabilising public debt levels. However, any durable solution to the problem may lie well beyond Europe and the operations of the EFSF. This is a crisis which should be sounding alarm bells in Washington, Beijing and the OPEC states.

Source: rlam as at 5th August 2011 unless otherwise stated.

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