



Perspectives by Ruth Lea

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Global recovery? Too soon to pop champagne corks

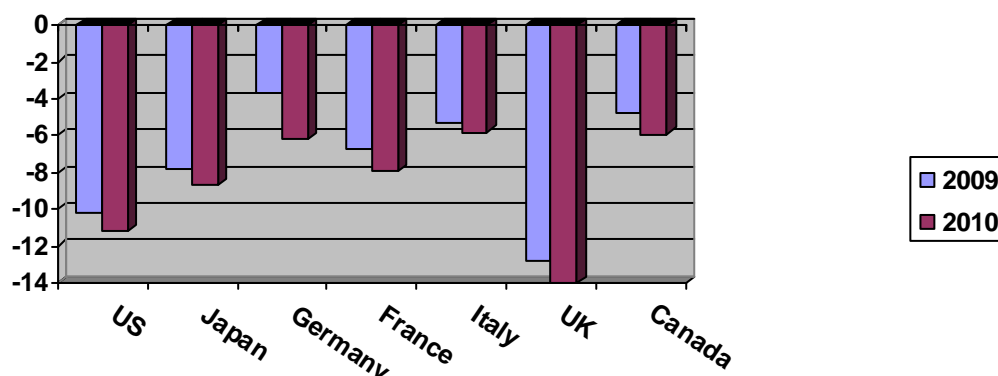
Introduction

The coverage of last week's G20 meeting of finance ministers in London was dominated by the debate on restricting bankers' bonuses and the potential clash between France and Germany on one side and the US and possibly the UK on the other. (There seemed to be some ambiguity on the British part.) By the end of the meeting there was, however, some agreement on matters including disclosure and structuring bonuses to relate to the long-term fortunes of the business. The Financial Stability Board¹ was tasked with the job of devising detailed rules over bonus structures in time for the next G20 meeting of heads of state later this month (24-25 September) in Pittsburgh.

On the global economy there was a palpable feeling of relief that economic meltdown had been averted and a Great Depression avoided. The mood was altogether more optimistic than in April and the debate moved on from the need for stimulus measures to the development of "exit strategies". But there was still caution. Some economies may have already returned to growth, and China for example is growing strongly sustained by public investment, but it was generally agreed that for most economies it was far too early to start withdrawing the vigorous monetary and fiscal stimulus packages implemented over the past year.

There was also talk about developing "cooperative and coordinated" exit strategies, to be advised by the IMF. But to what degree such strategies are coordinated remains to be seen. There was precious little international coordination going into the economic crisis, even within the EU, and it is highly probable there will be just as little if not less coordination during the global recovery. But this should not be seen as a major problem. The world's major economies vary in many fundamental ways and they require differing policy responses. For example they vary in the general health of the government finances, as can be seen in chart 1 below. And they will require individually tailored exit strategies.

Chart 1 G7: OECD projections for General Government financial balances, % of GDP



Sources: OECD, *Economic Outlook*, June 2009, no 85.

This chart shows that the UK and the US are clearly running the largest government deficits as a % of GDP of the G7, with the pressure especially intense on the UK for severe fiscal retrenchment over the next 9-12 months. France's and Germany's deficits are more manageable whilst Italy's have been constrained by restricted fiscal expansion policies reflecting the already large debt-GDP ratio and Canada's have been contained by the benign hangover of the prudent fiscal retrenchment in the 1990s. Canada cut spending by 20% over three years in the mid-1990s.

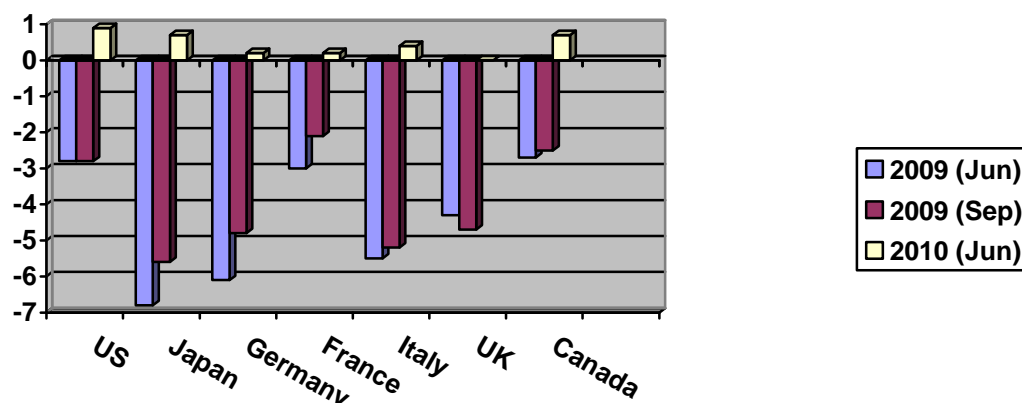
Inevitably, national policies will be geared to national circumstances. Any "coordination" of policies can only be tangential and subordinate to the necessity for individual governments and central banks to make the decisions they consider appropriate for their economies, given their policy objectives.

Signs of economic recovery

There are signs that the major economies are improving. Much attention is paid to business surveys which are showing greater optimism. But such surveys should always come with a health warning as they are subjective snapshots of business opinion and cannot give a remotely accurate indication of quantitative changes in economic activity.² Official GDP data are showing improvements too. They show that the rate of decline is slowing, as in the case of the US and the UK, or there has already been a quicker-than-expected turnaround to positive growth, as in the case of Japan, France and Germany. Recovery not only seems to be occurring but it seems to be occurring sooner than widely expected.

The OECD recently released revised GDP forecasts for the G7 countries and, with the exception of Britain (where the 2nd quarter was worse than expected) and the US, the figures for 2009 looked more optimistic. This is shown in chart 2 below.

Chart 2 G7: OECD projections for annual GDP changes (%): June (2009, 2010) and September (2009)



Sources: (i) OECD, *Economic Outlook*, June 2009, no 85. (ii) OECD, "What is the economic outlook for OECD countries? An interim assessment", 3 September 2009, www.oecd.org

The OECD still expects the US economy to decline by 2.8% in 2009, as it did in June. The British economy is now forecast to contract by 4.7% compared with 4.3% in June. The improvements in Germany and Japan, heavily export-oriented countries that have been disproportionately affected by the fall in world trade volumes, saw the biggest beneficial revisions.

The IMF has also been revising its forecasts along similar, though not identical, lines to the OECD.³ Compared with their July forecast, the IMF expects the US as well as the UK to do worse overall in 2009, whilst Germany should show the biggest improvement. World GDP is expected to fall 1.3% in 2009, marginally better than July's forecast decline of 1.4% whilst growth is now projected to be 2.9% next year compared with July's projection of 2.5%.

Reasons for caution

Even though there are more hopeful signs there is no shortage of voices urging caution. In addition to the G20 finance ministers already mentioned, IMF Managing Director Dominique Strauss-Kahn recently urged caution and said that stimulus policies should remain in place.⁴ A danger hanging over recovery is the assumption that a robust and sustainable recovery is already on track and that, as a consequence, supportive monetary and fiscal policies will be prematurely withdrawn. There have to be doubts.

In the US, even though housing prices appear to have stabilised and housing construction may be nearing the bottom, US consumer spending (excluding cars) remains very weak, with income barely growing amid continuing job losses (albeit at a decelerating rate) and weak wage growth. Auto spending has been supported by the finite \$3bn "cash for clunkers" scheme. Japan's GDP increased by 0.9% in the 2nd helped by higher exports to China and other recovering markets, but much of the GDP rise was due to a huge government stimulus package and it is unclear whether the momentum will be sustained when this is concluded. The UK's problems have been well rehearsed in previous Perspectives.^{5,6}

And even though France and Germany posted 0.3% quarterly increases in the 2nd quarter, again helped by higher exports and, temporary, car scrappage schemes, doubts are expressed about the strength of their recoveries. (Note too that Germany's GDP fell by hefty 3.5% in the first quarter so there is considerable leeway to be made up.)

Firstly, the persistent strength of the euro against the pound and the dollar hurts the exporting capacity of France and Germany - and all of the eurozone of course. Secondly, the state in both countries has so far cushioned consumption indirectly by stemming job losses. In France make-work schemes in the public sector have kept the jobless rate from rising too far. In Germany, the accord between industry and government to keep short-time workers on payrolls has had a similar effect.⁷ Employment, consequently, has not been slashed in line with production as in the US and the UK. Unemployment therefore will almost certainly stabilise later in France and Germany than in the UK and the US and act as a more persistent drag on growth.

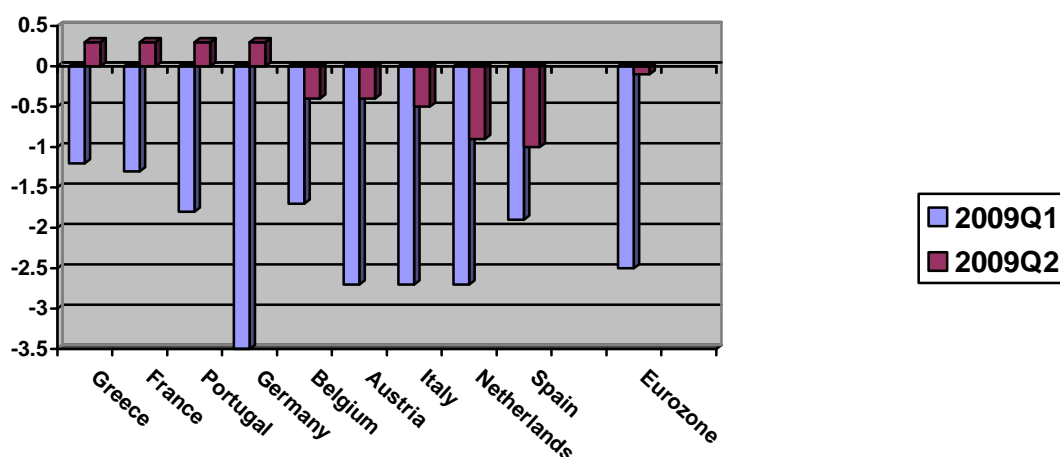
Thirdly, and perhaps most importantly, the main export markets for France and especially Germany – the US, the UK, eastern Europe and southern Europe – will probably remain depressed. The EU market is especially important and will not, and cannot, be offset by buoyant growth in the Far East. China and Hong Kong account for just 5% of German exports, compared with 63% for the rest of the EU.⁸

All in all, these factors cast doubt on the sustainability of the rebound in the French and German economies and could result in another downward leg of the recession before finally recovering – a “W” shaped recovery.

A “two-speed eurozone”

The economic weakness in the rest of the EU will, therefore, act as another drag on growth for France and Germany. Leaving aside the UK and eastern Europe, the sluggish performance of fellow eurozone members Italy and Spain is notable. Even as France and Germany announced a return to growth, Italy and Spain announced continuing recession with Italy posting a 0.5% fall in GDP in the 2nd quarter and Spain a full 1.0% decline. These figures are shown in chart 3 below. The economies of both Italy and Spain are hampered by a loss of competitiveness following a long period in which unit wage costs have risen, exacerbated by a rising exchange rate. This is particularly relevant to Italy and its ability to export. Spain, on the other hand, suffers more from domestic travails – not least the fall-out from the property “boom and bust”.

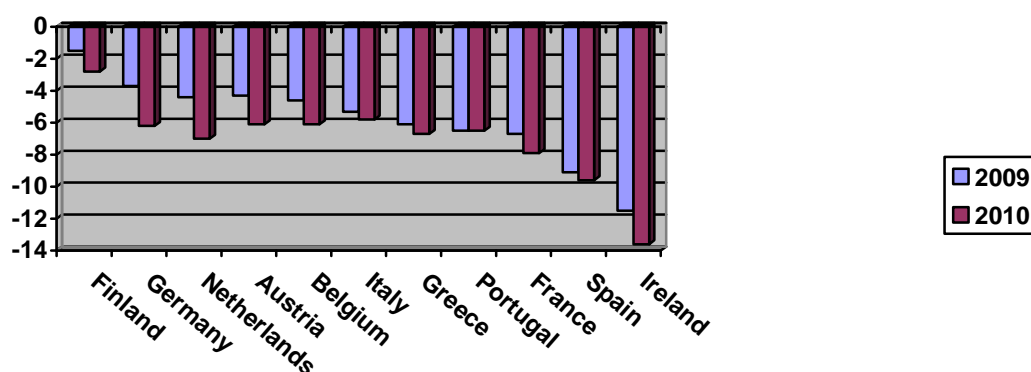
Chart 3 Eurozone countries, GDP quarterly change (%), for the 1st and 2nd quarters of 2009 (%)



Main source: Eurostat, “Euro area GDP down by 0.1% and EU27 GDP down by 0.3%; -4.6% and -4.8% respectively compared with the 2nd of 2008”, 13 August 2009. The 2nd quarter data are not yet available for Ireland and Finland. The other omitted eurozone members are: Luxembourg, Slovenia, Slovakia, Malta and Cyprus.

Spain’s predicament is especially severe and has resulted in a sharp deterioration in the public finances – with a general government financial deficit projected to be nearly 10% of GDP in 2010, as shown in chart 4 below. Even so, this is not as bad as Ireland’s, which is expected to approach 14% of GDP in 2010, or Britain’s, which is expected to reach 14% of GDP (see chart 1 above for Britain).

Chart 4 OECD projections for General Government financial balances, as a % GDP, selected eurozone countries



Sources: OECD, *Economic Outlook*, June 2009, no 85.

A cautious ECB

Despite the better numbers posted for France and Germany for the 2nd quarter, it is unsurprising that Jean-Claude Trichet, President of the European Central Bank, was very cautious at last week’s ECB press conference at which there was the announcement of “no change” in interest rates. Trichet warned that a “bumpy road” could lie ahead for the 16-country region. And even though strategies for unwinding emergency measures could be discussed, “it is no time to exit”. The ECB, under Trichet’s presidency, is forecasting only a “very gradual recovery” and has hinted that growth could even be thrown into reverse.^{9,10}

These warnings should be heeded. Talk of rapid recovery in the eurozone is vastly overdone and premature. Meanwhile the US and the UK have yet to show any positive growth. It really is too early to get out the champagne.

References

1. The Financial Stability Board, the re-established Financial Stability Forum, was set up in April 2009 after the London G20 summit of heads of state to “develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.” The FSB’s secretariat is housed at the Bank for International Settlements in Basel.
2. Ruth Lea, “Summer recovery will turn to cold winter”, *The Times*, 26 August 2009.
3. Reuters newswire, “IMF revises up 2010 world GDP forecast”, 4 September 2009. The forecast is due for official release in October.
4. IMF, “IMF Managing Director Dominique Strauss-Kahn sees renewed stability but remains cautious about global recovery, notes need for continued policy actions”, 4 September 2009, www.imf.org.
5. Ruth Lea, “Continuing problems in the banking sector will curb recovery”, Arbuthnot Banking Group, 3 August 2009.
6. See also, Ruth Lea, “Summer recovery will turn to cold winter”, *The Times*, 26 August 2009.
7. Economist, “Growing apart?”, *Economist*, 22 August 2009.
8. Anatole Kaletsky, “No cause for celebrations across Europe just yet”, *The Times*, 24 August 2009.
9. Ralph Atkins and Daniel Schaefer, “Cautious ECB leaves rates on hold and warns of ‘bumpy ride’ ahead”, *Financial Times*, 4 September 2009
10. Note also the next set of interim forecasts from the European Commission for the EU is due on 14 September 2009. The last full EC forecast was in May 2009 (spring).

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