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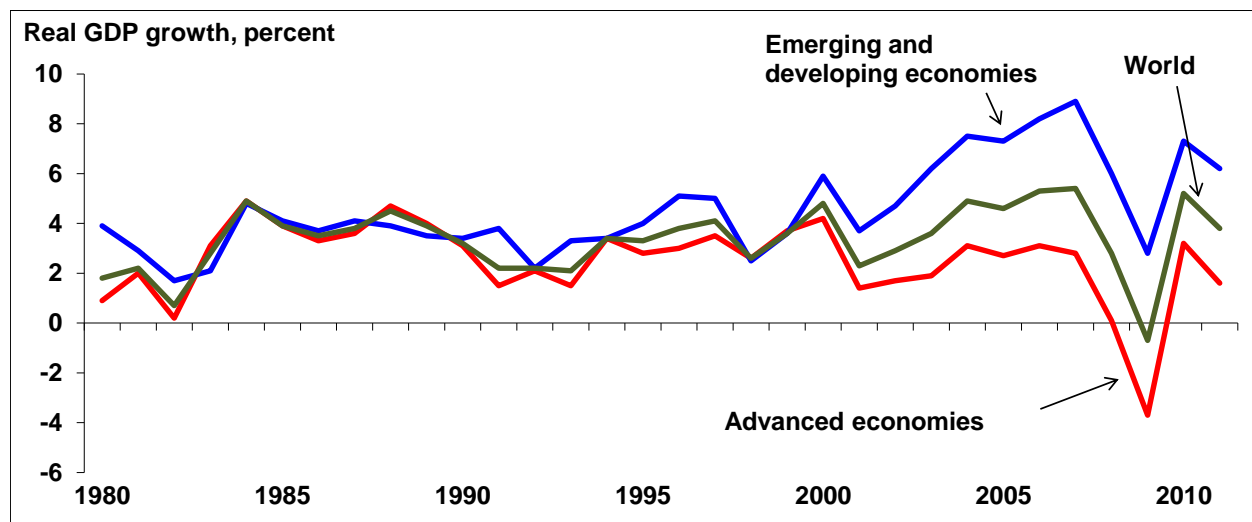
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It's the question on everyone's mind: Can the world avoid a double-dip recession? The short answer is the world can, Europe won't, and the risks remain asymmetric on the downside.

We are living in a two-speed world, where developing and emerging nations are growing more than twice as quickly as advanced economies. A large range of policies including structural economic reforms, opening trade and financial market reforms, and encouraging technological adoption and innovation, have fostered stronger growth in these developing and emerging economies.

But it is a misnomer to claim that developing and emerging economies have decoupled from advanced economies. Just look at the chart below. Since 2000, you can see that while the blue line (emerging and developing economies) is substantially above the red line (advanced economies), the rates of change are highly correlated. The Great Recession has taught us that the world is more interconnected than ever before, not only through trade but also through complex and nuanced financial linkages. Emerging and developing economies saw growth slow throughout 2011, partly because of monetary and credit tightening initiated in late 2010 and early 2011 to combat rising domestic inflationary pressures. Additionally, the financial turmoil in Europe has restricted flows of capital to these markets.

Two-speed recovery: Global growth slowing



Source: IMF.

The U.S. and Europe have had a subdued recovery from the Great Recession for a variety of reasons, and Europe is threatened anew. The Great Recession has been followed by a Rogoff/Reinhart constrained recovery, meaning that necessary deleveraging of financial balance sheets on the part of consumers and businesses, partly through transfer to public balance sheets, limits the potential pace of recovery.

This deleveraging is still in its early stages in most countries. The ratio of total debt to GDP has declined in just three advanced economies since the 2008–09 financial crisis: the U.S., South Korea and Australia. Some deleveraging of consumer and businesses has occurred, but the public-sector balance sheet has become more impaired.

BRIC Slowdown

Slower growth in BRIC countries in 2011 was largely due to monetary and credit tightening aimed at combating rising inflationary pressures. Their growth braked substantially by mid-2011, as reflected in various nations' purchasing managers indices (PMIs), in part because the financial turmoil in Europe spread to developing and high-income countries.

Investors became increasingly risk-averse, and capital flows into developing countries declined. Gross capital flows to developing countries fell to around \$170 billion in the second half of 2011, down 45 percent from \$310 billion in the second half of 2010. Equity issuance plunged by 80 percent to \$25 billion, with China and Brazil accounting for much of the decline. Stock markets fell and their economies suffered from a negative wealth effect. However, the bulk of this slowdown was domestic-led.

Brazil's economy has seen the most rapid deceleration, with growth falling to just 2.2 percent year-over-year in the third quarter of 2011. However, this could have been the low point for Brazil's economy as the PMI appears to have begun to bottom out in November and December. Moderating inflation will aid real income growth in Brazil this year. India's PMI, which never fell below 50 and is improving, and Russia's PMI, which fell in December, both point to a reasonable pace of expansion. Meanwhile, China's PMI ticked up in December.

Euro Zone Recession

The February 21 deal between the so-called Troika (European Union, International Monetary Fund and European Central Bank) on a write-down of Greek sovereign debt held by the banks and other private actors was critical to boosting near-term confidence in the euro zone. The 50 percent-plus private-sector haircut reduces the stock of debt and provides Greece, through austerity and structural reforms, with an opportunity to display that it can manage its debt-servicing burden. Trepidation remains that Greek political leaders might attempt to backtrack after the April elections and not implement all the components of the agreement. Most importantly, the latest Greek debt deal could reduce the threat of further contagion to other GIIPS (Greece, Ireland, Italy, Portugal, and Spain). In my estimation, banks need to be recapitalized by closer to €200 billion, and the size of the European Financial Stability Facility needs to be increased to over €1 trillion.

European banks have become very risk-averse and afraid to lend to each other, prompting the European Central Bank (ECB) to offer its three-year long-term refinancing operation to improve liquidity. This provides an insurance policy in a way because of the risks associated with not being able to refinance the €800 billion of maturing bank debt in 2012. The ECB made €489 billion of three-year loans available to more than 500 European banks on December 21. About €200 billion of liquidity has been injected. It will make another round of loans available by the end of February.

However, counterparty risk and economic uncertainty remain high so that banks may prefer to hoard cash rather than lend it to businesses and households. Nevertheless, a major credit crunch has been avoided and given policymakers time to meaningfully address the sovereign debt and banking problems.

What hasn't been largely addressed is what led to the central government budget deficits and accumulated debt in the euro zone: competitive disparities within the member countries since adopting the euro. It is no coincidence that Greece has seen the largest increase in unit labor costs, or wages adjusted for productivity, and had the poorest economic performance and the largest accumulation of debt since joining the euro zone. Spain and Italy saw their competitiveness deteriorate as well. Both are in the early stages of addressing them. Without a common currency, these nations can't devalue to reclaim competitiveness.

Germany has reaped the benefits of structural reforms of labor and product markets implemented in the late 1990s and 2000s. Germany's unit wage costs have fallen relative to Greece and other European countries—improving its competitiveness. Germany's jobless rate has been falling consistently and has reached 5.6 percent, the lowest in 20 years. However, Germany is discovering how dependent its economy has become on other European nations with 60 percent of exports now destined for them.

U.S.: Good News

I have been a consistent optimist in predicting that the U.S. won't experience a double-dip recession. This wasn't a very popular position when I made the projection last August, but growth did accelerate in late 2011 to nearly 3.0 percent. However, I must acknowledge that the mix of fourth-quarter growth wasn't favorable because much of it came from inventory rebuilding. The risk of U.S. recession has been reduced to approximately 20 percent in my estimation, down from 35 percent last fall.

The job market is displaying signs of improvement, but substantially less than is required to bring the unemployment rate down in a meaningful way. Joblessness declined to 8.3 percent in January, and the establishment survey showed a gain of 243,000. Earlier the establishment survey showed that job growth had ground to a halt over the summer. Subsequent revisions show that gains were greater than previously estimated.

There is room for cautious optimism on the spending intentions of consumers. Despite lingering damage from the debt-ceiling debates, sovereign-debt concerns in Europe, and slow job creation, U.S. households with employed members have cut their debt-servicing burdens, and interest rates are at record lows. Recovering purchases of auto sales—now back to over 14 million at an annual rate—explain much of the overall improvement in consumer spending. Consumers have deferred purchases of big-ticket items such as cars, and significant pent-up demand has been created. The deleveraging of household debt is supporting the recovery in consumer spending. The level of consumer installment debt relative to disposable income has fallen to where it was in 1994, and servicing that debt is less onerous with interest rates at record lows.

There are signs that housing prices are beginning to stabilize. But foreclosures remain elevated, and substantial shadow inventory could still find its way onto the housing market. The fear that housing prices might fall further has kept buyers and lenders on the sidelines. Contract cancellations remain at elevated levels, and existing home sales have improved very modestly. However, gains in employment are helping to support demand. Other indicators such as housing prices relative to income and rent relative to income are below trend—positive signs that the market is close to a bottom.

As opposed to small businesses, non-financial corporate balance sheets are in remarkably good shape. Corporate profits relative to sales are at the highest level in the post- World War II period. When you look at this on a cash-flow basis, profits are even stronger. This will support strong business investment in equipment and software, and there are early signs that investment in structures is recovering. The resurgence in equipment investment, especially in IT and software, is the underreported story of this recovery. Much of the early stage of this recovery was due to pent-up demand from businesses that had deferred IT investments. Purchases of servers, routers, other communications equipment, and the software that runs them are surging.

Exports remain a source of growth for the U.S. economy—rising almost 12 percent vs. a year ago. Much of this export strength is in technology products and services. However, the biggest risk to the U.S. outlook stems from a recession in the euro zone and a decline in U.S. exports to the region. The good news is that the U.S. isn't nearly as reliant on exports to the euro zone as it was several decades ago. Less than 19 percent of U.S. exports of goods and services go to the EU. A 10 percent decline in U.S. exports to the EU would result in a 2 percent decline in total U.S. exports and a 0.2 percent hit to GDP growth. Exports to Canada, Mexico, China, and other parts of Asia should largely offset the decline.

China: A Soft Landing

China has experienced a slowdown in economic growth in response to previous monetary and credit tightening. Weaker capital inflows from the West, partly attributable to financial frailties in Europe, and lower demand for China's exports in the West, have caused GDP growth to diminish from 10.4 percent in 2010 to around 9.0 percent by end of 2011. Another source of the slowdown comes from the housing sector, where speculation was driven by rapidly rising prices. Housing prices have begun to ease, and construction activity has fallen somewhat. China's purchasing managers' index indicates that manufacturing output should be stable. Strong retail sales in November and December suggest that domestic demand remains fairly resilient.

There has been much discussion about the necessity for the U.S. to consume less and export more, and for China to do the opposite, to rebalance the world economy. During the Great Recession, China's exports did decline and import growth slowed, cutting its trade balance in half. Since early 2010, the trade balance has stabilized. China was able to offset somewhat lower exports to the U.S. with rising volumes within Asia. Recently, both exports and imports have fallen, and the trade deficit has plateaued.

Members of Congress and others have demanded that China be designated a currency manipulator, accusing the country of artificially keeping the RMB at a lower exchange rate against the dollar than market forces would dictate. While China certainly monitors its exchange rate vs. the dollar closely—and its foreign exchange reserves of over \$3.0 trillion (roughly \$2.0 trillion of it in U.S. dollars) allow it great flexibility in do so—it can't be stated that China doesn't permit the RMB to appreciate. Since 2005, the real exchange rate has appreciated by around 35 percent. The rising value of the RMB has altered the relative costs of producing in China, and many U.S. manufacturers are choosing to expand operations in the U.S. rather than China.

China flooded its economy with liquidity during the financial crisis in 2009. Domestic credit growth reached 30 percent. It has restrained credit growth since then and has begun to reverse course. With lower inflation and commodity prices easing, along with weakening economic growth, the central bank at the end of November was able to cut banks' reserve requirement ratios for the first time since the end of 2008. Monetary policy is likely to ease further in the next few months, which should lessen downside risks to the outlook.

Japan: Still Important

Although the size of China's economy surpassed Japan's in 2010, Japan is still the third-largest economy in the world and important to understanding the global economy. GDP recovered somewhat in the third quarter after the supply chain and production disruptions caused by the tsunami and nuclear disaster as well as flooding in Thailand. However, Japan's GDP shrunk in the fourth quarter of last year as the recovery from natural disasters began running out of steam.

Industrial activity has been volatile, with contracting orders resulting from slower regional and global growth. Business confidence remains subdued and investment soft. It is important to understand that Japan's population has been declining since 2005, and its population is rapidly aging. The yen has appreciated dramatically over the past few years, in part because it was seen as a safe haven during the 2008-09 financial crisis and recent problems in the euro zone. Because of the loss of competitiveness from the high value of the yen, and the loss of productive capacity from natural disasters, Japan will record only its second trade deficit in the past three decades.

Economic Outlook

The euro zone is in a recession. It should be mild with real GDP declining 0.4 percent in 2012, but the risks are asymmetrical on the downside. Policy errors could lead to a far worse outcome, but a muddling through remains the most likely scenario. German consumers are showing signs of absorbing some of the loss in aggregate demand, limiting downside from fiscal austerity measures and deeper recessions in the southern periphery.

In the U.S., less drag from state and local government, modest improvement in multi-family housing, better consumer balance sheets, modest gains in employment and wages, strong business investment in equipment and software (combined with low interest rates), and export gains will permit U.S. GDP to grow 2.6 percent in 2012 and 2.7 percent in 2013.

Japanese authorities will attempt to hold down the value of the yen through intervention, and exports should recover somewhat, allowing GDP to rise 1.6 percent in 2012 and 2.5 percent in 2013. South Korea will see growth slow to 3.0 percent due to weaker export growth. Canada will grow in the low 2.0 percent range.

3 Greatest Risks to Growth in 2012

- Further deterioration in the euro zone crisis
- A reduction in oil supplies from Iran and higher prices
- A hard landing in China caused by a property bubble bursting

International economic forecast*

GDP, year-over-year percent change

	2010	2011	2012	2013
Global (2005 PPP weights)	4.6	3.7	3.1	3.7
<i>Advanced economies**</i>	2.9	1.6	1.7	2.2
U.S.	3.0	1.8	2.6	2.7
Euro zone	1.8	1.6	-0.4	1.1
U.K.	2.1	1.0	0.4	1.8
Japan	4.5	-0.9	1.6	2.5
South Korea	6.2	3.6	3.0	4.5
Canada	3.2	2.5	2.2	2.5
<i>Developing countries**</i>	7.3	6.0	5.3	6.1
China	10.4	9.3	8.3	8.9
India	8.7	7.3	6.8	8.3
Mexico	5.4	3.9	3.8	4.5
Brazil	7.5	2.9	3.2	4.3
Russia	4.0	4.1	3.7	3.8

* As of January 24, 2012; ** aggregated using 2005 PPP weights.

Sources: Milken Institute, Oxford Economics.

China's growth will diminish to 8.3 percent in 2012, when it will appoint a new group of leaders. India's economic growth will slip to 6.8 percent. Mexico, closely tied to the U.S., will see growth of 3.8 percent. Brazil's growth will pick up again to roughly 3.2 percent in 2012, while high oil prices will help keep the Russian economy stable.

Overall, world GDP growth will ease from 3.7 percent in 2011 to 3.1 percent in 2012. It should recover to 3.7 percent in 2013.