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The Global Economy 2009: Forecasts Still Falling

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Summary

Forecasts continue to be downgraded each month – the bottom has yet to be reached as further cuts are on the way, chiefly across emerging markets:

- Recent figures from the more developed NE Asian exporters show global manufacturing industries falling at a shocking rate, indicating possible double-digit declines in GDP in 2009.
- There have been worse than expected results in South America, with Brazil likely to see a fall of 3-5% in GDP. Mexico's results could be much worse.
- The economic and financial situation in Eastern Europe and Central Asia is deteriorating rapidly and dangerously.
- News from the US and Europe has also been poor but policy efforts may just about succeed in stabilizing these economies by mid-2009.
- Against this background, analysts are no longer talking about imminent recovery but 'second order derivatives' and 'counterfactuals' – but does this mean and how positive is it?
- Effectively, the optimists hope that the global economy will shrink less rapidly in coming months (the second order derivative turns from positive, foot down on the accelerator, to neutral, foot off).
- 'Counterfactual' means judging a policy's success or failure not by actual economic performance but performance relative to what it might have been without the policy in place: the US will hear more about this as the fiscal package will not lead to growth picking up but it has prevented a further collapse in the US economy.

From a UK perspective, even the pessimists have to concede that recent news points to the UK economy not being the worst affected by the crisis after all. However, this is little comfort as it simply means the recession in other countries will be much deeper than previously expected.

Nevertheless, relative resilience in the UK could be an important indicator of the way in which service-based economies with flexible labour practices might withstand the impact of cycles better than more traditional manufacturing economies. It is too early to judge but this aspect of the recession should be watched carefully as the year unfolds.

Introduction

Getting to grips with the full implications of this extraordinary recession has been extraordinarily difficult. Forecasts have been steadily downgraded each month as the prospect of widespread, substantial declines in GDP and a massive fall in world trade and investment has unfolded. However, the pace of change is starting to slow. As economies are approaching what will probably be the nadir of the downturn, forecasts are converging towards more realistic assessments of the losses in GDP in 2009. Policies are likewise becoming more realistic, as well as being pursued with more urgency, in order to reduce the risk of a further downward spiral – the global economy has already seen dangerous second (if not third) round impacts emerge and domino effects have to be brought to a halt fast.

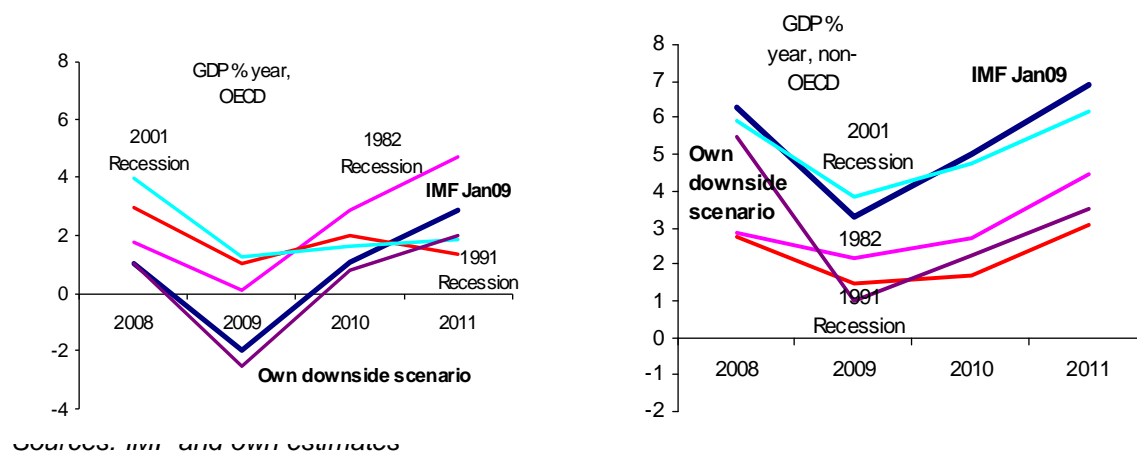
Hopes are now pinned on the US and Europe doing enough to stabilise their economies over the next six months. If this happens, then other countries stand some chance of tackling adjustment problems and resolving issues such as balance of payments crises and emergency funding. If efforts fail, then not only the forecast numbers but the structure of the world economic order could change radically, for the worse, prolonging the impact of this recession for many years to come.

Forecasts Still Falling

A fall in GDP of as much as 2-3% has been widely expected in the US and UK for some time but other major European economies have now accepted this view as well. Indeed, Germany may see an even worse performance in early 2009, which explains the recent rush to boost its proposed fiscal package. Although Spain's economy has been weakening for some time, the situation is still deteriorating. The ECB appears to be inching towards joining the US and Japan in a zero interest rate policy.

By now, IMF and consensus forecasts are close to painting an accurate picture for the OECD, although adjustment is still needed for a few countries; for example, Japan where GDP is now seen falling by at least 3-4% but possibly as much as 10%. So, despite many commentators encouraging the view that the UK will be the most affected of the major developed economies, it may not be the worst case after all.

Figure 1: Forecasts for OECD and non-OECD growth vs. historic recessions point to severity of crisis (January 2009)



But Emerging Market Economies Still Need Further Scrutiny

For emerging markets, official forecasts are further behind the curve. There have been considerable delays in recognizing the inescapable negative impacts from the extreme contraction in global capital flows and credit, exports, commodity prices, industrial production and investment. Even if there are no 'bad banks' in the emerging-market economies and their consumers are relatively immune to the immediate impacts of the global crisis (*both big ifs*), there has been a loss of confidence around the world. This is partly, and logically, because many people foresee the knock-on effects that will put their economies and livelihoods at risk. Forecasts have not only been lagging events and news but they have also shown little differentiation, with reluctance to discriminate between those countries facing a poor year (GDP falling by up to 3%) and those in serious trouble (at risk of 5-10% fall in GDP).

The most obvious casualties are those already in the IMF queue for assistance: they are the countries most immediately affected by the freezing up of global capital flows and credit because of existing external deficits and debt. The casualty list is notably dominated by Eastern Europe where the credit crunch, together with a heavy burden of foreign debt (including hard currency mortgages and consumer credit) are causing a severe financial crisis. Turbulent reactions in currency markets indicate expectations of a slump in this region and also in neighbouring Central Asia, exacerbated in some cases by weak commodity markets.

Some countries have clearly been very aware of the risks and realistic about the damage: notably Turkey quickly began negotiations with the IMF for

standby funding, being well aware of the need for this agreement, whereas other countries have been delaying this decision. The IMF is examining ways of boosting its finances to cope with further demands and the World Bank will also provide help for the poorer developing countries.

Figure 2: Eastern Europe dominates list of crisis-related IMF loans

Country	Date	Amount (\$ bn)
Turkey	2009 (?)	\$20-40
Ukraine	Oct-2008	\$16.4
Hungary	Nov-2008	\$15.7
Pakistan	Nov-2008	\$7.6
Belarus	Dec-2008	\$2.5
Latvia	Dec-2008	\$2.4
Iceland	Oct-2008	\$2.1

Source: IMF

Asia has generally been well ahead in its own forecast assessments: for example, Singapore recently revised its forecast to predict a 5% decline in GDP in 2009, far worse than in 1998 or 2001, an admission which is brutally realistic and honest. China is often criticised for not revealing what others claim to be the true economic facts (claims that have not necessarily been based on reliable analysis) but in this case a drop in growth to just below 7% has been reported for the end of 2008. The government was also ahead of Europe in admitting that it will be hard to fight off the slowdown that is submerging world growth and trade in spite of rapidly relaxing monetary policy and a massive fiscal boost that has been rushed through to support the Chinese economy.

Although around half of Asian trade is now internal to the region, exporters are still highly dependent on US and EU demand, rapidly seeing the repercussions of the economic crisis. While sizeable losses were expected, falls of 30-40% in exports, as reported by countries such as Korea and Taiwan as well as Japan since November, have been jaw-droppingly bad. These have led to further downgrades in economic forecasts and the possibility of double-digit declines in GDP in 2009. While emerging Asia is still expected to grow in 2009, a predicted rate of 2-3% is even lower than the average in 1998. This forecast is heavily reliant on relatively robust estimates for China and, to some extent, India – if these fail, it is possible that Asia's average growth rate may be close to zero. Given the size of Asia and its

imports, such a decline would create further negative impacts on the rest of the world including commodity markets.

The energy economies, primarily the Middle East and Russia, are also seeing growth cut back to close to zero (less for Russia, probably slightly better for the GCC region) owing to the impact of export revenues tumbling to less than half last year's level. Meanwhile Latin America is feeling the negative effects of falling commodity markets, cutting output and prices in metals and minerals as well as demand for manufactures and even food products. In Brazil, industrial production will be down by around 15% year-on-year in early 2009, similar to the falls seen in the big recessions of 1981 and 1990. This suggests that economic growth will be negative in 2009, with the level of GDP falling by 3-5%, far worse than during 1998-2001. In fact, Brazil saw a series of dips in GDP in the early 1980s global recession and again in 1988-1993: there was difficulty in stabilizing the economy in part because of fragile finances and a tendency to devaluation and inflationary spirals. Having reduced these risks, Brazil is now believed to be far better placed to weather this recession and recover strongly. Chile is in a similar position and, to some extent, the same is true of other South American economies while Central America could be harder hit by the impacts from the US. Given its substantial trade and labour links to the US, Mexico will inevitably see a deep recession in 2009, with losses in oil revenues adding further pressure – peso devaluation points to expectations of financial distress.

Africa has also seen a reduction in growth expectations and will be lucky to achieve 2-3% in 2009 – versus 5-6% in recent years. Low-income countries are likely to see recent positive results in terms of poverty alleviation compromised due to continuing shocks from the food/fuel-price crisis and now the global economic downturn. For these countries, the impact of the crisis has manifested itself through reduced demand for exports, falling commodity prices, difficulty in accessing international capital markets and, particularly important for such poor developing countries, decreased remittances from abroad. Both the IMF and the World Bank have urged donor countries to live up to their promises of increased development assistance even though there are severe effects of the financial crisis on their own budgets.

The consequences of the crisis for the world's poorest people are not limited to Africa, and it is estimated that up to 90 million people globally may be pushed into extreme poverty due to the recession.

Figure 3a: Current consensus forecasts point to a weak OECD recovery along with a substantial bounce in the emergers

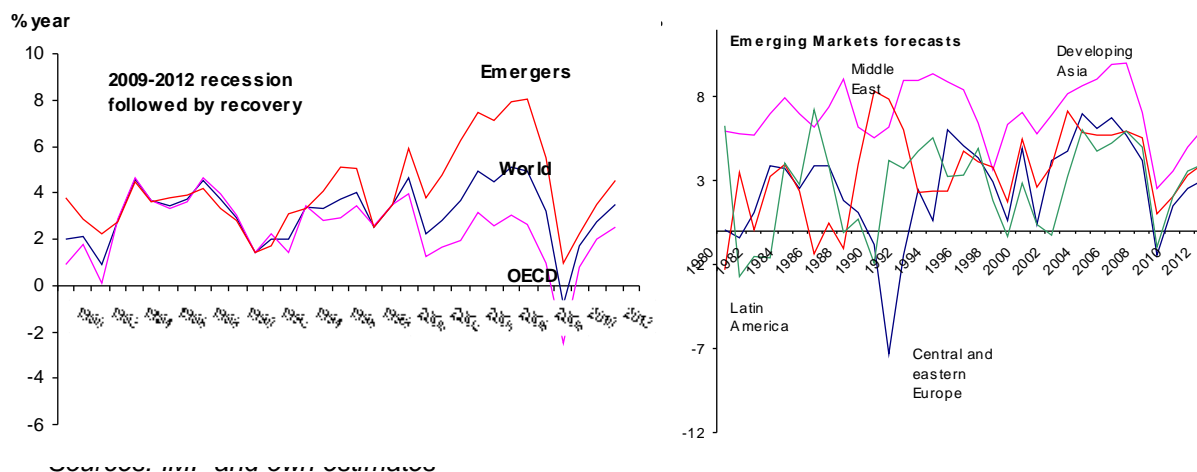
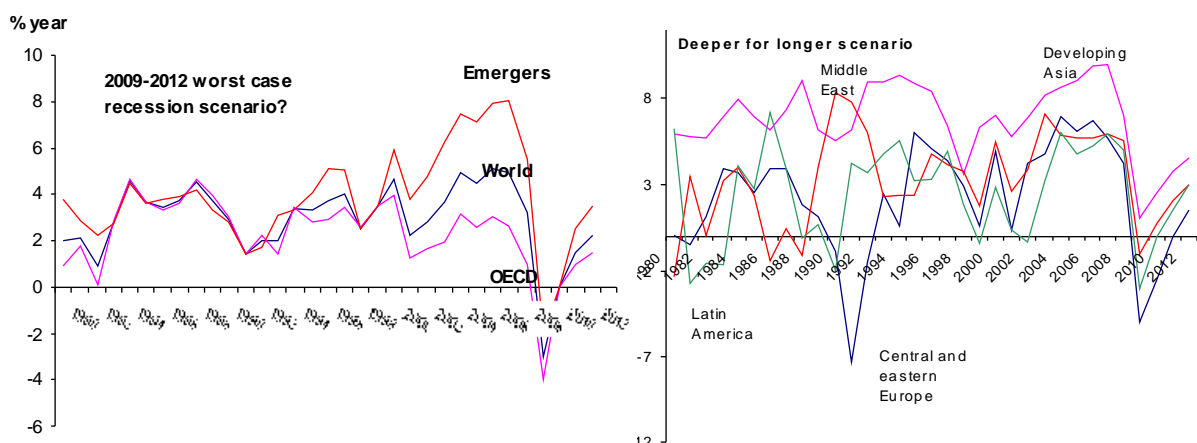


Figure 3b: A plausible downside scenario would leave world GDP around 10% below the consensus forecast in 2012.



Domino effects, causing activity to spiral down, are a serious threat that could both deepen the recession and prolong recovery. And after such a massive lurch in the global cycle, instability may well persist, so the recovery may be very uneven indeed.

Fear of the Minus Sign had to be Overcome

Why were forecasts so slow to catch up with events and the scale of the downturn? Perhaps a key factor was lack of experience of such a deep, synchronized recession: there was no 'template' for guidance. It was hard to put so many minus signs into forecast tables and even harder to understand how much damage there would be not just to GDP but also to world trade and investment, which could fall by as much as 10-20% in 2009.

Such changes in forecasts cannot be based on incremental adjustments but need a radical reassessment of the outlook. It is also important to recognize that when financial systems fail, causality is inverted and forecasts and models have to be operated in a way that reflects this inversion, not as demand-driven but cash flow-driven systems. The world turns upside down and this backs up arguments in favour of meeting the challenge with equally unorthodox policies.

Global capital flows have not simply eased back, they have been snuffed out by the impact of the credit crunch. US and European banks, faced with collapsing balance sheets, have hoarded any capital they could in order to survive. Carry trade has come to an abrupt halt, creating yen appreciation as capital drew back to Japan. The very widespread impact this has had on currencies illustrates the indiscriminate sell-off, with many countries seeing large devaluations of 20-30% or more against the dollar over the last year, including the popular Brazilian real as well as East European currencies with far weaker fundamentals.

In the stampede to bring money back to base, there was no discrimination. However, as these initial impacts from capital flow reversals ease off, there will be more time to reflect on underlying strengths and weaknesses across global markets and economies. Some countries are clearly more vulnerable than others, and the shortage of global capital is imposing particularly tough adjustments on those with unsustainable balance of payments deficits. Robustness is now a considerable advantage for hard-pressed economies. Which economies are best placed to survive and recover?

The Shape of Recovery – What does this Imply?

The most widely discussed and contrasted scenarios for the “shape” of the recession and recovery are the ‘V’, ‘L’ and ‘W’. The implications of these scenarios are also important, not just the shape:

- The deep ‘V’: the 2009 plunge will be severe, so any bounce-back in 2010-2011 will look impressive even if growth is actually mediocre. This scenario implies that policies to promote stability and recovery gain traction but only after a very sharp loss in GDP in the first half of 2009. Most assessments of monetary policy impacts suggest these will take 6-12 months to materialise while fiscal policy efforts are only just beginning to gear up in the first quarter of 2009: it is therefore

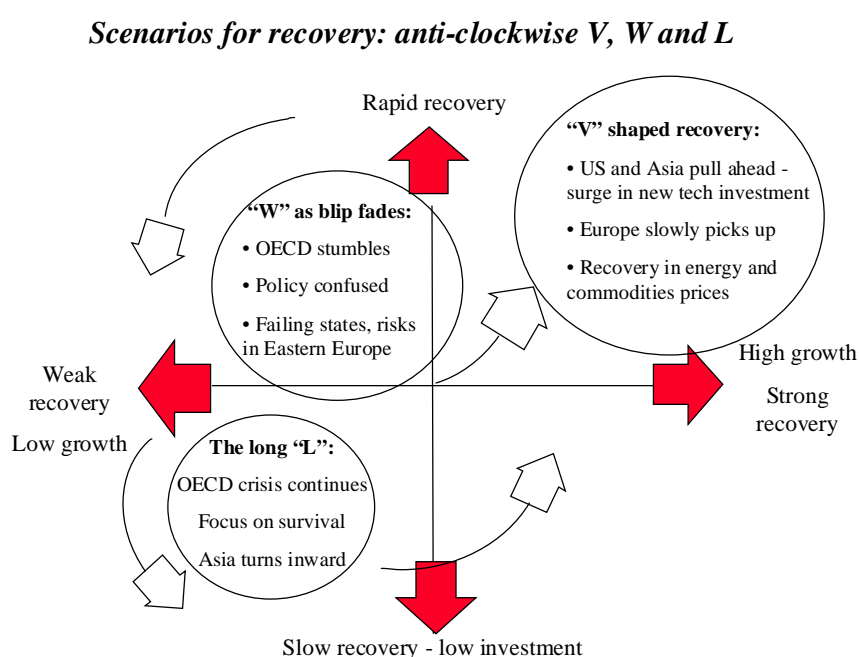
quite plausible that a significant stimulus will kick in by late 2009. But policies have to improve confidence quickly and begin to influence events, otherwise the downward spiral of cut backs and negative feedbacks will continue to drag more economies under, increasing the risk of the 'L' and 'W' scenarios.

- The long 'L': after the steep drop in GDP in 2009, policy is ineffective in lifting confidence and heading off second, third and more rounds of impacts, which keep up the downward pressure on economic activity into 2010-11. Countries that suffered limited impacts in the early stages would feel the pinch and start to weaken, while countries in crisis would begin to question the effectiveness of policy measures and demand alternative action. This could instigate political as well as economic instabilities and herald a retreat to various forms of overt or covert barriers and 'own back yard' protectionism, with nationalism and bilateral relationships replacing the trend towards globalization and free trade. Even East Asia could begin to turn inwards, looking to a more regional solution to reviving growth. The 'L' could threaten to splinter the western coalition and curtail both US and EU influence in global governance.
- Continued volatility and confusion in the 'W' option: after many years of trying to damp the natural cycle in the global economy, moderation has just been blown up by the explosives stored up in the financial sector. Rather than dying down, the rollercoaster cycle from the 2001-02 trough via the peaks of 2005-07 to the slump of 2009 could leave economies vulnerable to continuing violent cycles, making it hard to achieve real headway. A pick-up in 2010 following the 2009 recession might look like the beginnings of recovery, encouraging policymakers to relax their vigilance and scale back efforts, but the blip could abruptly reverse: this happened in Japan in 1996-98. The risk of a 'W' scenario is exacerbated by credible concerns over how long it will take for property market excesses to work out and consumers to scale back high debt levels. There is also the threat that food and end-user energy prices could start to pick up again for a variety of reasons, adding to volatility and uncertainty.

An overview of how the various scenarios may play out in 2010-12 is illustrated in Figure 4. In the coming year we will not be sure which way the world is moving: further contraction may look like an L but the recovery may simply be delayed while a rapid pick up could be highly misleading, turning into a 'W' rather than a convincing 'V'.

Regions will see varying exposure to the stresses highlighted – the weak, primarily in Eastern Europe, Turkey and Pakistan, are already looking for IMF bailouts and the next tier (including more countries from Eastern Europe) will join the queue if recovery is weak and prolonged, pulling yet more economies down with them, possibly including a few from Asia as well as Latin America in the worst case ‘L’ scenario.

Figure 4: The shape of recovery will dictate developments over next decade – high probability of ‘V’ but cannot dismiss risk of ‘W’ or even ‘L’ in spite of history being against it

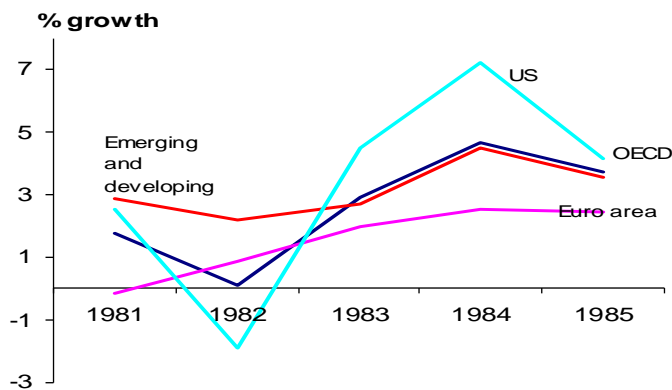


Only the most robust economies will have the autonomy to steer their own course to recovery – and only the large can impact on the rest of the world. The leaders have to be the US and China – both have large home markets and a considerable degree of economic and financial autonomy, helped by dollar hegemony on one side and high levels of savings on the other. But financial strength is not the only reason; these two large single markets can effectively act to sustain their internal growth even against a relatively weak world background. While it is clear that exports are a small part of the US economy, China is generally seen as highly dependent on export growth. Yet this is not exactly the case, especially if those imports associated with export production are netted out. The much more important factor for China is investment while rapid consumption growth has also boosted domestic demand’s contribution to growth. Although some dispute the figures for 1998-

99, China has been able to ride out global cycles before thanks to the waves of investment projects that have kept the country employed in achieving high growth. It has the resources and potential for development to repeat this effort, helped by both massive fiscal and monetary boosts.

Two of the world's largest economies, a big debtor and major creditor, both committed to growth targets, will strive and thrive. They have the necessary robustness and will to engineer recovery. Even so, it is highly unlikely that the US will be able to create a rebound on the scale of that seen following the early 1980s recession (Figure 5), while China is clearly signalling that it will consider itself very fortunate indeed if it can hold growth in the 7-8% range in the face of severe global headwinds in 2009-10.

Figure 5: Big rebound in US growth post 1982 recession – no such bounce expected in 2010 but US consumer still the key to recovery



Other countries lack either the scale and robustness or the determination to lead the recovery - although they will follow once a revival in the US and China starts to emerge. After the early 1980s recession, Europe struggled along behind the US and it is likely to do so again, in part hobbled by some EU members being in crisis themselves. However, there is an important difference versus the 1980s as the declining population and labour force may make it easier to avoid a large and sustained rise in unemployment. Across the OECD, it will also be important to watch how 'post industrial' knowledge-based economies, with more flexible labour and considerable self-stabilizing mechanisms cope with a major global recession. In spite of current pessimism, some economies may see some upside surprises after all, helping to boost sentiment.

However, too much reliance on the US and China's self-sufficiency with little support elsewhere would fail to encourage an open world with well-balanced governance. This could pose serious risks for the future. The shape of the recovery will impact on the development of the global economy for the next decade. Europe, in particular, needs to pay careful attention to the implications of its short-term economic performance and policy decisions throughout the present crisis.