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Economic Outlook

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The Year Ahead

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We can expect 2010 to be a volatile year. This likelihood is underscored by looking back at 2008 and 2009. Two thousand eight was a highly volatile year leading up to the collapse of Lehman Brothers in September, which was followed by the risk of a total systemic meltdown. That sharp and obvious risk spike prompted massive policy responses that were simply the largest that central banks, with rate cuts and liquidity provision, and governments, with tax cuts and spending increases, could manage. The result—beginning in March 2009—was a linear rise in the prices of risky assets, the result of massive relief once the slip into a global depression had been averted and the acute phase of the crisis in the financial sector had passed.

The real economy also responded to the massive stimulus but remained heavily dependent on it. In the United States, growth during the second half of 2009 probably averaged about 3 percent. Absent temporary fiscal stimulus and inventory rebuilding, which taken together added about 4 percentage points to U.S. growth, the economy would have contracted at about a 1 percent annual rate during the second half of 2009.

As we move from 2009 to 2010, we are not likely to see a continuation of the improving financial and economic trends that characterized the last three quarters of 2009. The intensity of the stimulus applied cannot be repeated. Recall that central banks pushed interest rates to zero and undertook massive liquidity injections into the banking system while governments simultaneously and aggressively boosted spending—pushing up deficits and debt. Yet it is far from clear whether many of the world's economies can sustain growth without the massive stimulus or, in the case of China, avoid inflation without its withdrawal.

The need to modulate stimulative policies somehow during 2010 makes for a highly uncertain outlook. Policy errors are likely. For better or worse, policy adjustments in four key countries or areas will determine the path of the global economy in 2010: China, Japan, the United States, and Europe.

China: Inflationary Pressure

China's reaction to the negative shocks following the September 2008 collapse of Lehman Brothers was the largest and most rapid among all major economies. By November, the Chinese had announced a huge fiscal stimulus claimed to be equal to 14 percent of Chinese gross domestic product (GDP), to be applied over a period of about two years with substantial frontloading. In the United States, 14 percent of GDP would be equivalent to a $2 trillion stimulus or about triple the size of the substantial U.S. stimulus plan announced early in 2009. Beyond that, China's centrally planned policy apparatus implemented the stimulus considerably more rapidly than governments in other market economies carried out theirs.

China's policymakers accompanied the surge of stimulative fiscal policy with sharply accelerated money and credit growth. By November, the year-over-year growth rate of loans in China had reached 34 percent. Over the course of the year, the focus of lending shifted from the corporate sector to the household sector. By November, 80 percent of loan growth was directed to households. That statistic strongly suggests that Chinese

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policymakers may have seen some inventory accumulation as a result of production surges earlier in the year and so, subsequently, have redirected rapid credit growth to support elevated purchases of goods and services by households.

Rapid growth of government spending and credit in China has begun to push up prices. During the three months ending in November, China's annualized consumer inflation rate rose to 3.8 percent, up sharply from negative readings several months ago.

The leading edge of higher Chinese inflation is always a rise in food prices. In fact, food prices account for the bulk of the movement in the Chinese consumer inflation index. By the first week in December, the food price index, compiled by China Reality Research, had reached 19.2 percent year-over-year—a sharp acceleration from the negative readings at the end of the summer. Along with rising food prices, rapidly increasing prices for property, water, and electricity have boosted inflation concerns. By November, 80 percent of survey respondents indicated that they expected a rise in prices over the next six months—up sharply from a mere 22 percent in April 2009.

The annual growth rate of loans and credit in China has averaged about 15 percent, with one jump above a 20 percent growth rate between June 2003 and June 2004 that was followed by a sharp run-up in inflation. Given the spike in money and credit growth to well over 30 percent, accompanied by the powerful fiscal stimulus being applied, a steep increase in food prices and a broader inflation are virtually assured in China.

Inflationary pressure is being intensified by inflows of funds into China driven by its undervalued currency. China's cap on the renminbi is creating heavy strains in the global economy while increasing the risk of inflation problems inside China. Since China's currency is pegged to the dollar, the dollar's weakness means China gains a substantial currency advantage over its competitors in Asia and other emerging markets. The rush of capital into Brazil, the other emerging-market star, is boosting its currency (the real) against the dollar and the renminbi, thereby eroding Brazil's ability to compete against Chinese producers. Brazil has already put controls on capital inflows in order to attempt to control the pressure for its currency to rise against the dollar and the renminbi but without much success. More restrictive measures may follow in Brazil and elsewhere as negative pressure on exports intensifies in a world of excess production capacity and misaligned currencies.

As 2010 unfolds, China will be under increasing pressure to allow a currency adjustment that will alleviate the inflationary pressure inside its borders and the deflationary pressure that its currency undervaluation is exporting, not just to Brazil, but to the economies of major countries in Europe and to the United States and Japan.

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Japan: Shrinking Nominal GDP

An important victim of China's undervalued currency is Japan, currently one of the weakest spots in the global economy. Japan presented a dismaying economic picture in 2009 without much promise for improvement in 2010. About four weeks after a sharp increase in growth to a 4.8 percent annual rate was initially reported for the third quarter, the same number was revised down sharply to 1.3 percent. As is so often the case in Japan, the headline "real" numbers were substantially inflated by the assumption of falling prices. In the initial report, the assumption of a –5.1 percent GDP deflator turned a –0.3 percent nominal growth rate in the third quarter into a positive 4.8 percent real rate. Once the revisions were completed, the nominal, annualized growth rate in the third quarter was reported to be –3.4 percent, as the deflator was adjusted to a 4.7 percent annual rate. Falling nominal GDP is deflationary because it shrinks the total money value of activity, thereby forcing producers to cut prices even further to try to capture a larger share of an overall shrinking demand pie.

The blunt truth is that Japan is slipping into a deflationary crisis, with interest rates set effectively at zero, a budget deficit at over 8 percent of GDP, and government debt heading for 200 percent of GDP—far above the rising G7 average of about 90 percent.

The most disconcerting aspect about the path of inflation and nominal GDP growth in Japan is that it is considerably weaker than the worst levels reached during Japan's "lost decade" of the 1990s. Japan's year-over-year nominal GDP growth has recovered slightly from the –8 percent level reached earlier in 2009, but the downward revision, the result of a sharp drop in estimates of third-quarter capital spending, is a clear sign of falling

momentum and rising excess capacity tied to weak domestic demand and falling net exports. The latter reflects an overvalued currency problem that could get worse as deflation boosts real yields inside Japan and thereby boosts repatriation of capital.

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Japan's monetary and fiscal policy responses to the deflationary crisis have been tepid. Early in December, the Bank of Japan reversed its decision to let quantitative easing measures expire at the end of the year and instead decided to provide an additional $10 trillion in loans to financial institutions at a 0.1 percent interest rate per annum to renew stimulus. These measures are modest at best and unlikely to reverse Japan's deflation pressures.

The new Democratic Party of Japan (DPJ) government has pursued a stop-and-go policy on fiscal stimulus. After cutting back sharply on the public works projects included in the stimulus package of its predecessor as ruling party, the Liberal Democratic Party (LDP), the DPJ reversed itself and restored the funds early in December when it announced a ¥7.2 trillion stimulus package. Of the ¥7.2 trillion, ¥3.2 trillion is simply a replacement of funds that had already been in stream. Of the remaining ¥4 trillion, about half is an extension of existing loan guarantees, leaving a net ¥2 trillion of stimulus that will boost GDP 0.4 percent at most. Neither the fiscal nor monetary measures take effect immediately.

Japan's dilemma clearly demonstrates the corrosive effects of persistent deflation. The negative shock to the global economy occasioned by the bursting of the real estate bubble, coupled with China's currency peg, which enhances China's competitive position in Asia and globally to the detriment of exporters like Japan, has placed Japan in danger of a severe deflationary crisis that policymakers have little means to combat. As already noted, although it is somewhat counterintuitive, Japan's currency may continue to strengthen despite the weakness of the economy as intensifying deflation raises real yields on Japanese government bonds. Such real yields are already substantially higher than those available in the United States and Europe at all maturities, thanks to the increase occasioned by accelerating deflation.

If there were ever a case for a powerful central bank commitment to outright money creation that would arrest deflation pressures, Japan in 2010 fills the bill. Such steps would require a sharp intensification of the level of concern displayed by the Bank of Japan about the deflation. There was a hopeful sign from the Bank of Japan after its December 18 policy meeting, when it declared that it will not tolerate a negative year-over-year consumer price index (CPI). Given the fact that Japan's year-over-year CPI is currently falling at a 2.5 percent rate, the Bank of Japan had better be planning a radical move toward quantitative easing. If history is any guide, however, the odds of such a step are slim.

United States: Sustainable Demand Growth?

The headline U.S. data during the second half of 2009 provided a pleasant surprise: as already noted, substantial support from fiscal stimulus, coupled with inventory rebuilding, boosted real GDP growth in the second half of the year to an estimated 3 percent annual rate. Without fiscal stimulus and inventory building, however, growth would have remained negative—an ominous fact because the fiscal stimulus will fade rapidly by mid-2010. As for monetary stimulus, the Federal Reserve has indicated an intention to maintain a highly aggressive stance, with a zero fed funds rate for an extended period. Moreover, the jump in the unemployment rate above 10 percent in October prompted talk of additional fiscal stimulus of about $100 billion at an annual rate, notwithstanding a modest drop in the unemployment rate from 10.2 to 10 percent during November. If enacted promptly and applied aggressively during 2010, fiscal stimulus on that scale could add about two-thirds of a percentage point to growth.

It is probably fair to say that the U.S. postbubble experience has resembled, in many ways, the experience of Japan after the collapse of its equity-market bubble in 1990. While ample stimulus has been applied, the U.S. banking system remains passive as a financial intermediary, and consequently banks are creating relatively little credit. Meanwhile, about one-quarter of all mortgaged homes are worth less than the value of the mortgage, thereby sharply curtailing the financial flexibility and mobility of American households. Additionally, about one in six American workers are experiencing either outright unemployment or employment below desired levels. The weakness in the American job market exacerbates problems of labor mobility and confidence that

are tied to a high level of distress in the residential real estate sector. Stresses in the $3 trillion market for commercial real estate are rising with the prospect of substantial dislocations still on the horizon for 2010.

The ongoing strain on the American economy, a widely alleged end to the recession at midyear in 2009 notwithstanding, is underscored by continued weakness in year-over-year nominal data. Year-over-year nominal GDP has been contracting all year—falling at a 1.4 percent rate in the first quarter, a 2.4 percent rate in the second quarter, and a 1.9 percent rate in the third quarter. The drop in nominal GDP probably continued into the fourth quarter, with some relief possible in early 2010, should real growth pick up substantially. A likely continuation of disinflation, however, will prevent a sharp recovery in year-over-year nominal GDP growth. This is problematic because much of the improvement in profitability that has helped to support equity prices is tied to cost-containment measures. Cost reductions can go only so far to improve the profit picture when the total nominal value of output is shrinking. The pressure to hold market share in a shrinking pool of nominal aggregate demand may result in more deflation or disinflation pressures, just as it has done in Japan.

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Sustainable growth during 2010—even growth at a level of about 2 percent—will require persistent growth of domestic demand. Third-quarter final sales were stimulated by the "cash-for-clunkers" program, which caused households to accelerate outlays on automobiles and depressed the savings rate. Spending has held up in the fourth quarter, thanks to aggressive price cutting that has prompted a substantial response from American consumers, enough to boost estimated consumption in the fourth quarter to a 2 percent annual growth rate. The strain on disposable income from the jump in consumption during the second half of the year is perhaps best captured by the October data on personal income and consumption, the latest available at the time of this writing. During the three months ending in October, real consumer spending rose at a 2.6 percent annual rate while real disposable income rose at a 0.6 percent annual rate. Whether spending can continue to grow substantially in excess of income growth, and therefore draw down savings, remains one of the major uncertainties overhanging the U.S. economy as we move into 2010.

Europe: Currency Area Problems

The postbubble strains on Europe are taking the form of pressure on the European currency area. Among the countries that use the euro are Greece, Ireland, Spain, and Portugal—all countries experiencing substantial postbubble stresses. Greece is perhaps the most notable example of an economy inside the euro area that is being punished by an overvalued currency. The Greek government and Greek households have engaged in heavy borrowing in order to sustain outlays in the face of the drag on the economy from an overvalued currency. Greece adopted the euro in large part to enjoy the benefits of lower interest rates afforded by the euro denomination of its borrowing. The Greek government has sharply increased its deficit from 3.6 percent of GDP in 2007 to 12.7 percent of GDP in 2009. Private-sector borrowing has jumped as well to about 275 percent of GDP in 2009—up sharply from below 150 percent in 2001.

The sharp increase in Greek borrowing is inconsistent with the criteria of strict budgetary constraints purportedly applied to members of the European Economic and Monetary Union (EMU). Budget deficits are not supposed to exceed 3 percent of GDP in states within the EMU. Had Greece not been a member of the EMU, higher inflation and a sharp increase in borrowing in that country would have pushed down the currency and put a cap on borrowing while forcing tighter monetary policy. Failing that, the currency would have depreciated. Greece is by no means alone as an EMU economy with a budget deficit sharply above the 3 percent criterion, but it has the most rapidly deteriorating fiscal picture at a time of rapidly rising budget deficits.

Greece's tenuous position in the EMU is reflected in the premium on its borrowing rate versus that of Germany. At the end of November, yields on Greek five-year debt instruments were about 170 basis points above yields on five-year German instruments. By mid-December, that spread had reached 225 basis points.

While the EMU will probably survive postbubble strains in Greece as well as in Spain, Portugal, and Ireland, it will require help from either the International Monetary Fund or the core countries in the currency union—Germany and France. The basic problem for the countries under pressure is that reducing the strains

requires substantially tighter monetary and fiscal policy at a moment when global growth is not robust.

Overall, the rising tensions in the EMU may depress the euro relative to other currencies, an outcome not entirely unwelcome, especially to Germany's exporters but also to manufacturers in France. Homegrown stresses in Spain, however, where the property bubble was at least as extreme as that in the United States, will probably rise as interest rates are boosted in response to rising strains on the euro system. Beyond that, European banks, heavily burdened with loans tied to the real estate bubble and the general excesses of the rapid run-up in activity prior to 2008, will probably continue to be reluctant to extend credit, like their American counterparts. The ominous failure of an Austrian bank early in December adds to concerns in Europe's banking sector—recalling the failure of the Viennese bank Credit Anstalt in 1931.

Overview

The postbubble stresses that will emerge around the globe in 2010 will produce substantially more market volatility than was seen in 2009. Beyond that, the policy environment will become considerably more complex. External and internal pressures for revaluation of the renminbi will grow exponentially alongside rising inflation pressures inside China. If China's policymakers wait too long, either to allow the currency to adjust or to rein in inflationary pressures, requisite abrupt policy adjustments could produce substantial instability in Chinese equity and real estate markets. Japan's struggle with deflation stands as a warning to avoid the risk of increasing deflationary momentum and as a prod for the Bank of Japan to contemplate far more aggressive reflationary measures. America is probably on track for moderate, if uneven, growth of 2 to 2.5 percent during 2010. The continuing pressures on employment and prolonged household distress attached to sharply lower home values increase the risk of further policy mistakes. The risk of protectionism rises as well. In Europe, it will become increasingly obvious that the existing EMU is not an optimal currency area, and there will be pressure for reflationary measures that will run sharply counter to the European Central Bank's determination to maintain low and stable inflation. Taken all together, these underlying conditions suggest that the possibility of policy error is high. One only hopes that policymakers remain humble and alert enough to move quickly to correct errors as evidence warrants.

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