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# Towards a Post-Crisis Global Economy: G20 Need Last Push to Support Real Recovery

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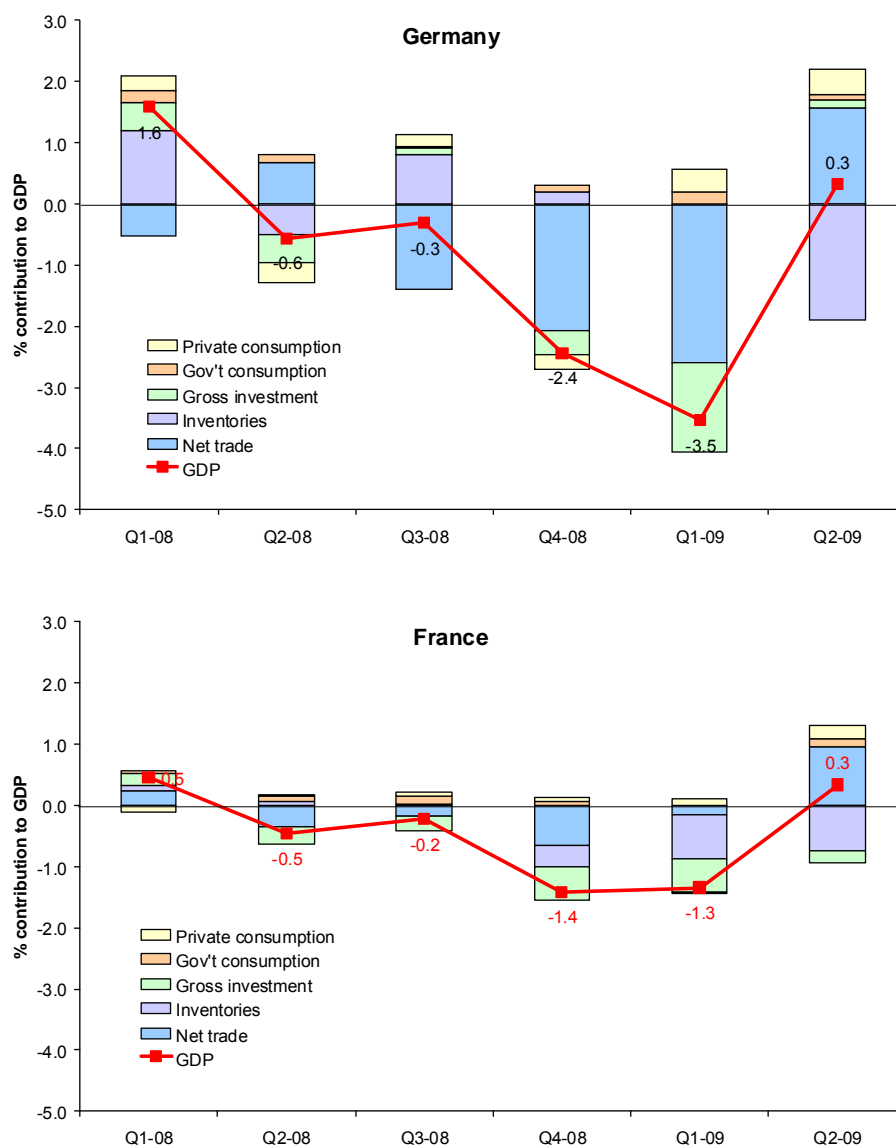
## Key Points

- The latest data point to a modest pick up in economic conditions albeit activity levels are still dangerously weak versus pre-crisis peaks. Following confirmation of a bounce back in growth for Asia (including Japan) in the second quarter, there was much greater surprise at the announcement in mid-August of a small pick up in GDP for France and Germany, spelling the end of recession for these two leading EU economies.
- Less fortunately, there was little critical appraisal of what the figures actually portrayed for the European economy as a whole. In particular, a further drop in imports in both France and Germany, on which the gain in GDP depended, was downplayed. This pointed to still weak business confidence and destocking as well as the failure to provide positive support for trade partners. Indeed, the rise in GDP could be called a “beggar-thy-neighbour” rebound rather than a true recovery.
- There was little mention of the 1% drop in GDP and falling exports seen in the Netherlands, an EU bellwether for trade. Spain and Italy also saw GDP decline further and the overall figure for the Euro area fell 0.1%, with EU GDP down 0.2%. The region is not out of recession yet.
- In spite of these caveats, the third quarter should see a more generalised pick up in demand and GDP across the major economies. Easy monetary and fiscal policy, improving sentiment and bargain prices are encouraging a rise in consumer demand, with incentives including car scrappage rebates that have been one of the most successful policy cloning operations across the major economies. But companies and thus business investment remain under pressure due to the reduced level of domestic and global demand as well as the fiercely competitive environment.
- Policymakers must now turn their attention to the problem of regenerating business optimism and investment plans, which depend on confidence in future growth. G20 need to provide a last push to complete the job of launching a convincing recovery by 2010 before setting to work on credible exit strategies.

## Import-lite End to Recession in Germany and France

The unexpected declaration that Germany and France were out of recession was one of the most prominent news items in mid-August. It was clearly important that they could jointly announce a pick up in GDP for the second quarter. Considerable political mileage as well as news coverage was gained from this event.

**Figure 1: Contributions to German and French GDP**



Sources: DeStatis and INSEE

However, the effect is somewhat spoiled on more careful examination of the data, including the drop in GDP registered in other economies such as Italy, Spain and, more notably, the Netherlands, the latter serving as a key indicator of weak European trade, which Germany and France failed to support as their imports continued to fall.

The initial analysis was also confused by lack of complete data. While France's national statistics office (INSEE) released a full set of figures for GDP components along with the GDP data in mid-August, Germany only issued a flash estimate for GDP while awaiting a full data release at the end of August. The analysis from INSEE confirmed previous trends that pointed to a relatively stable performance for the French economy (including exports) but the data also showed a large drop in imports, a key indicator of still weak business expectations and a negative result for France's trade partners. Release of full data confirmed that Germany saw a larger fall in imports than exports, which boosted GDP by improving net trade.

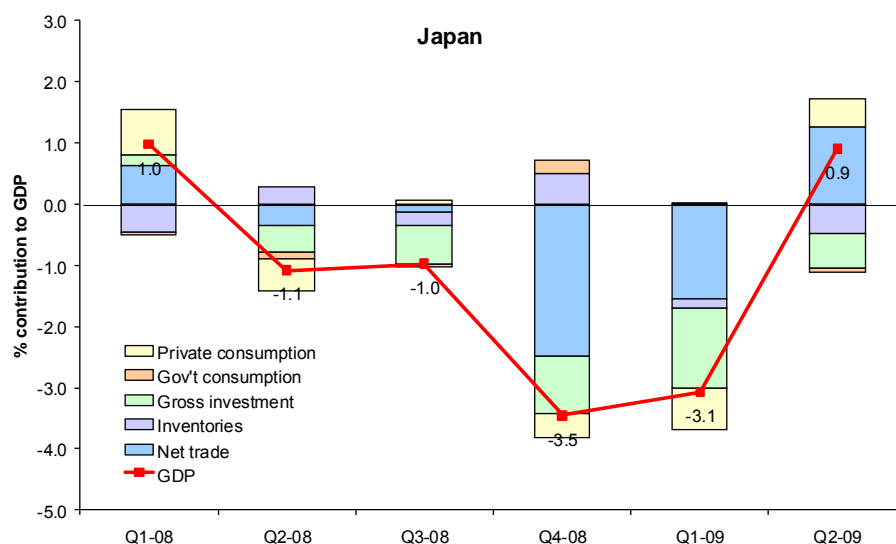
The much praised end to recession in France and Germany might therefore be dubbed a "beggar-thy-neighbour" rebound rather than a true recovery. Although private consumption and government expenditure contributed positively in Q2 to GDP in both countries, this only partly compensated for the large decline in inventories, thus it was the drop in imports that pushed GDP growth into positive territory.

Other EU member states and external trade partners have suffered from this drop in imports in the Eurozone's two largest markets. Under particular pressure are countries such as the Netherlands, heavily dependent on EU trade and reliant on the Franco-German markets. Weakened domestic demand and the inability to count on an export-led recovery mean that a return to growth for the EU as a whole has been delayed.

Japan was the third OECD economy to declare the end of recession thanks to a fairly strong rebound from a poor first quarter. Japan's slump was similar to Germany's in that both were hit by massive export losses in late 2008, leading to appalling contractions in GDP during Q4 08 and Q1 09 (even exceeding 3% on a quarter-on-quarter basis). However, in the second quarter, Japan's GDP picked up even more strongly than its Franco-German equivalents, showing growth of 0.9% versus Q1 (nearly 4% annualized). This was also largely due to a positive net trade contribution, including a drop in imports. However, unlike Germany and France, it was a rise in exports that pushed GDP up the most in Japan. Given the fact that Japan's major trade

partners are in Asia, where a number of countries saw a good rebound in demand in Q2, the evidence points to a fairly credible regional recovery, unlike the situation in Europe.

**Figure 2: Contributions to Japanese GDP**



Source: Ministry of Finance

The Q2 rebound in these three leading economies contrasts with the continued contraction in what had previously been thought of as the leading candidates for recovery among advanced economies: the US and UK. The UK outlook appears most worrisome given the surprisingly poor Q2 data and the downward revision in the latest forecasts from the European Commission and - more radically - the OECD (which admittedly has a history of pessimistic UK assessments). These forecasts contrast with upward revisions to Germany and Japan's projections.

**Table 1: Change in European Commission forecasts for 2009**

%	GDP 2009 May 09	GDP 2009 Sep 09	Difference Jun-Sep
Germany	-5.4	-5.1	▲ 0.3
France	-3.0	-2.1	▲ 0.9
UK	-3.8	-4.3	▼ 0.5
Euro area	-4.0	-4.0	0.0

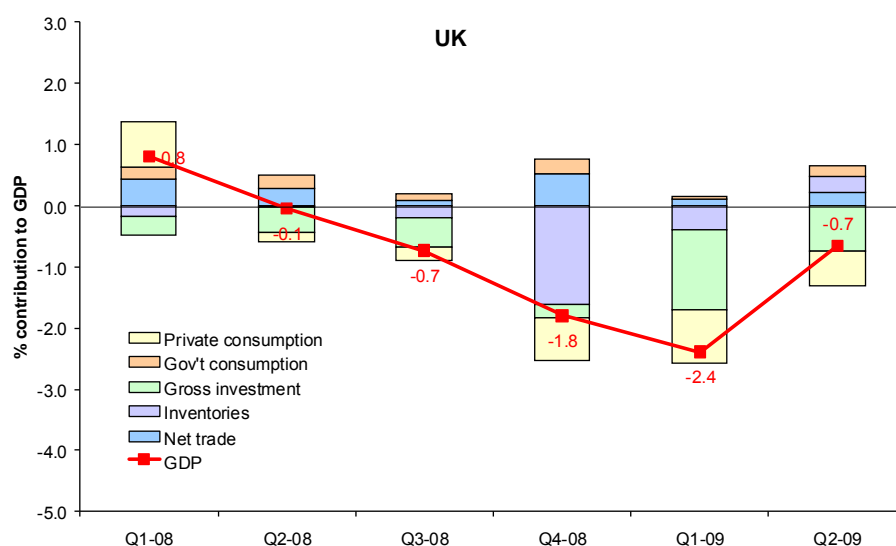
Source: European Commission

**Table 2: Change in OECD forecasts for 2009**

%	GDP 2009 Dec 08	GDP 2009 Mar 09	GDP 2009 Jun 09	GDP 2009 Sep 09	Difference Jun-Sep
Germany	-0.8	-5.3	-6.1	-4.8	▲ 1.3
France	-0.4	-3.3	-3.0	-2.1	▲ 0.9
UK	-1.1	-3.7	-4.3	-4.7	▼ 0.4
US	-0.9	-4.0	-2.8	-2.8	0.0
Japan	-0.1	-6.6	-6.8	-5.6	▲ 1.2
Euro area	-0.6	-4.1	-4.8	-3.9	▲ 0.9

Source: OECD

The main reason for disappointing UK growth was the unexpectedly poor performance of private consumption compared with surprisingly firm figures from Germany and France. This had been considered the UK's strongest card based on initially encouraging retail sales figures and a strengthening service sector performance. Late adoption of car scrappage schemes in the UK (compared with France and Germany) may have made a difference. However, in spite of flat retail sales, signs for Q3 are more positive with car sales gaining and industrial production up sharply, encouraging forecasters to predict a healthy gain in GDP. This may lead to more optimistic revisions to forecasts for the UK in coming months.

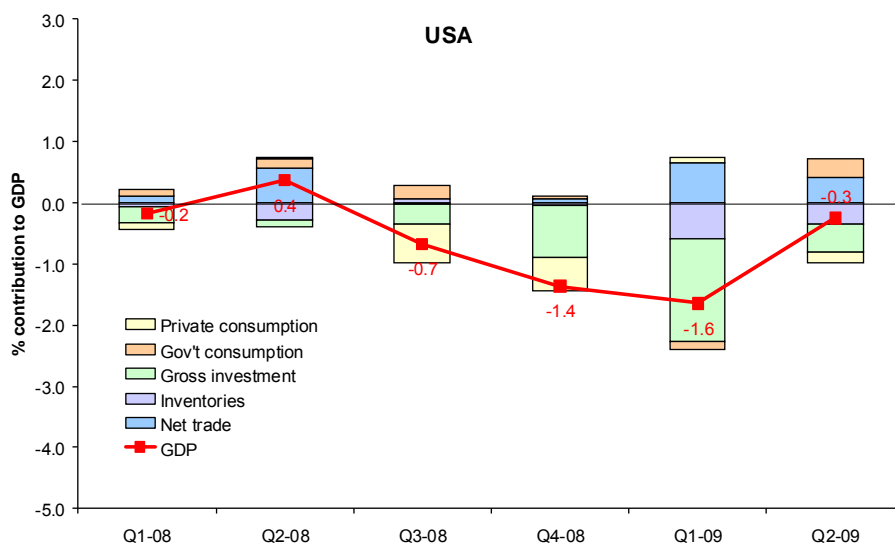
**Figure 3: Contributions to UK GDP**

Source: Office of National Statistics

Nevertheless, given the OECD's downbeat assessment and widespread concerns over the prospective rise in UK public sector debt (an issue that has turned into a political battle, previewing a debate that may determine next year's election), markets are now increasingly uncertain regarding the state of the UK economy. Sterling has lost its previous upward momentum. Notably, the poor GDP news followed the announcement in early August of a further £50 billion monetary injection as part of the Bank of England's policy of quantitative easing, a move which indicated that weakness in the economy remained the Bank's key concern.

US GDP also weakened in Q2 although growth is widely expected to resume in Q3, with consumption gaining from the "cash for clunkers" scheme boosting car sales. There may even be a small rise in imports (a boost for trade partners) as businesses rebuild inventories to feed into a pick up in demand. Like the UK, private consumption remained depressed in Q2 despite optimism over 'green shoots' and the stabilization of the housing market. Apart from impacts due to the credit crunch and need to rebuild savings, rising unemployment has another reason for households holding back spending, indeed unemployment rate hit a high of 9.7% in August. But monthly job losses are now sharply down from their peak (216,000 in August after surging to over 700,000 in March), suggesting that losses could bottom out over the next few months.

**Figure 4: Contributions to US GDP**



Source: BEA

Regarding adjustment in the labour market, the US contrasts with the EU where employment protection measures have limited the rise in unemployment. However, this means that EU unemployment could see a sharp rise this autumn unless companies can be persuaded that activity will quickly recover to past peaks by 2010-2011.

In summary, after the slide into deep recession, the second quarter data for the major economies point to an "import-lite" stabilization in economic activity at a lower level of demand. G20 governments need to maintain their confidence building exercises and must focus increasingly on boosting the outlook for business and investment. But what do the higher frequency data suggest looking ahead?

### **Monthly Data Point to Gains Across OECD in Q3**

What is currently happening to domestic demand and trade across the EU and the US and do these data also point to improving trends going into the second half of the year? Although we argue above that the second quarter figures were less favourable than portrayed for the Euro area, higher frequency data are pointing to improvements in underlying fundamentals in H2 and a pick up in imports should also begin to emerge as domestic demand conditions recover.

The consumer outlook for both the US and EU is strengthening, with the car sector one of the key drivers. As mentioned above, car scrappage schemes have been one of the major success stories of fiscal stimulus plans, first in the Euro area (starting in France in late 2008), then the UK (from May) and now in the US where such a plan was launched, with some delay, in July.

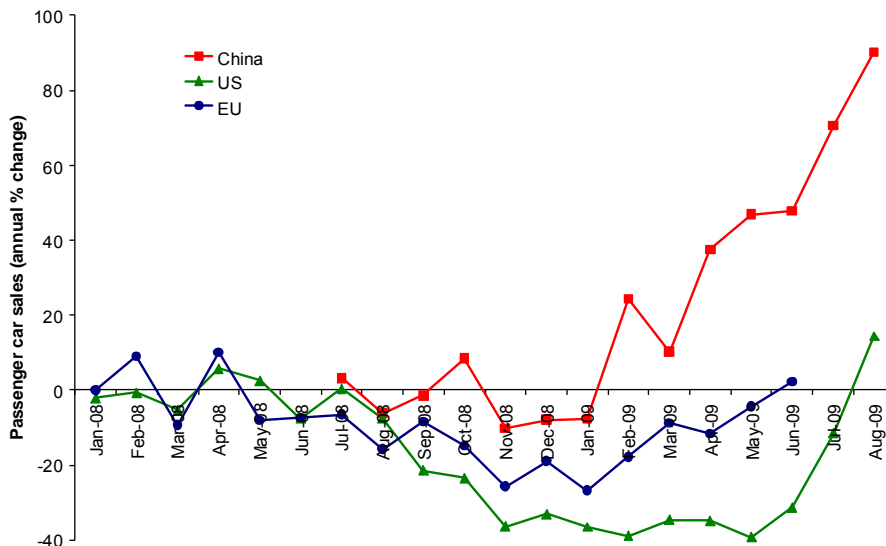
For Europe, these schemes helped prevent a deeper deterioration of the auto industry and consumer spending, contrasting with poor figures in the US. But the American car market has recently made an even more dramatic resurgence, recovering to its pre-crisis monthly sales rate in the two months since the 'cash for clunkers' deal came into effect. This means that the US has reprised its position (lost to China earlier in the year) as the world's largest market. In fact, the initial \$1 billion of funding for the US 'cash for clunkers' plan was doubled due to high demand.

Momentum in sales may initially flag as government subsidies end but should strengthen again as consumer conditions improve. Dealers will continue to offer incentives and the outlook for the car industry now looks more stable,



especially in the US where uncertainty over its survival was a serious disincentive for potential purchasers prior to agreements on restructuring.

**Figure 5: Passenger car sales in major global markets**



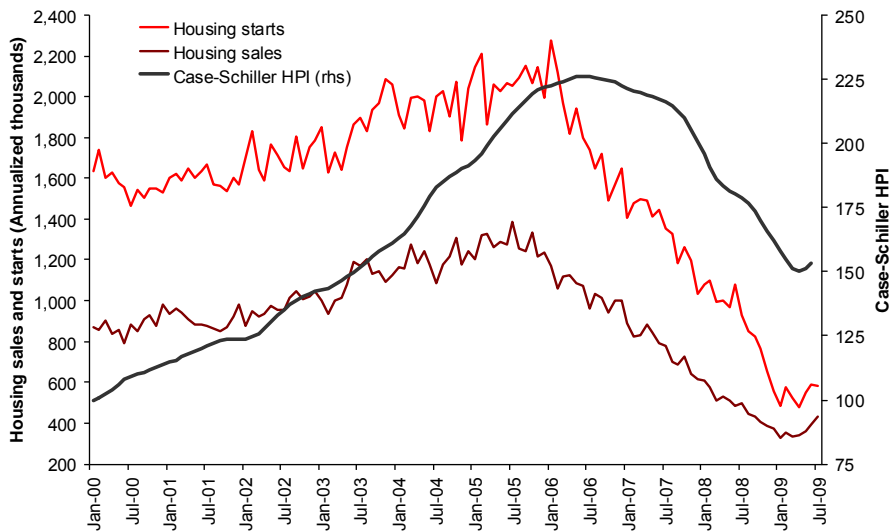
Sources: BEA, ACEA, CAAM

Household sentiment and purchasing power are also being boosted by the recovery in financial markets, which has reduced the previously heavy losses in the value of pension funds and savings. This is particularly true in the US, where households typically keep more than half their financial wealth in equity funds but it also influences wealthier households in Europe and elsewhere. Fear of further financial turmoil has died down although it would be unwise to assume that the global financial system has fully adjusted and adapted to the post-crisis reality. For example, substantial write downs of bad debts are still expected in the Euro area and some banks also remain highly leveraged.

Another boost for household confidence and residential investment is the improvement in housing markets emerging in the US and UK. The US housing market was the first to show strains as early as 2006 when prices began falling from their record peaks. Latest indicators show that housing sales and prices are stabilizing following several months of mild improvement. This upswing could fizzle out, however, if the market is hit with a further round of foreclosures and delinquencies due to increases in unemployment. For example, recent data has shown that fixed-rate prime mortgages now

represent an increasing share of foreclosures,<sup>1</sup> a reflection of householders facing greater payment difficulties.

**Figure 6: US Housing market**



Source: US Census Bureau, Standard & Poor's

Overall, OECD consumers seem to be lifting spending a little, undoubtedly helped by the easy policy stance, low inflation and bargain hunting, which is also emerging in some property markets. A new build up of inventories after massive destocking over the last year is also expected to boost production and import demand. This encourages the view that OECD GDP and trade will pick up over the second half of 2009.

### Rest of the World: Asia Boosts Growth and Trade

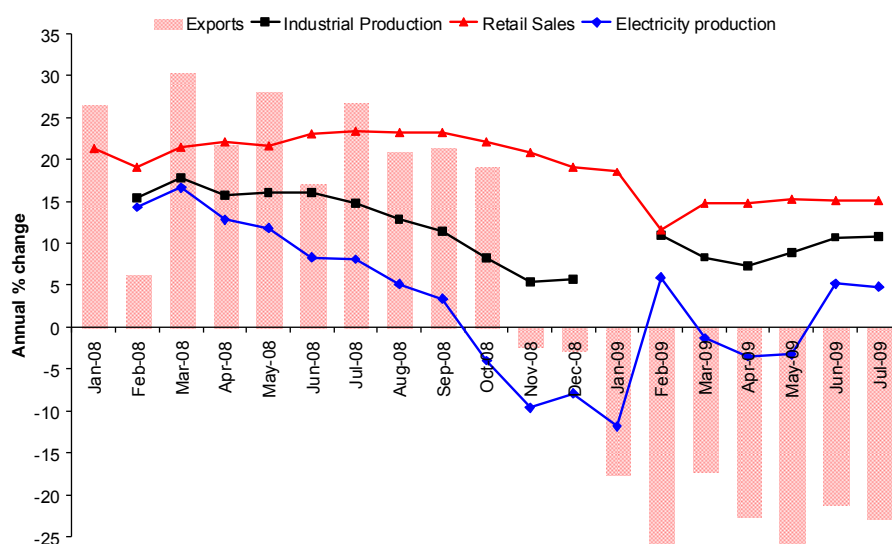
Across the developing world, a fairly rapid recovery is already underway, helped by improving global financial markets and sentiment. However, growth is heavily concentrated in Asia, especially boosted by China and India.

After a strong pick up in growth from 6% in Q1 to nearly 8% in Q2, the outlook for China remains positive. This is in spite of worries over the effect of credit

<sup>1</sup> Mortgage Bankers Association (2009), "Delinquencies continue to Rise, Foreclosures Flat in Latest MBA National Delinquency Survey", 20 August 2009

conditions being tightened, which may impact more on the stock market than the real economy. Retail sales and industrial production are buoyant but investment and the car market may also be affected by reduced credit growth after the huge surge in the first half of the year.

**Figure 7: China's real economy indicators**



Sources: EIU, China Data Online

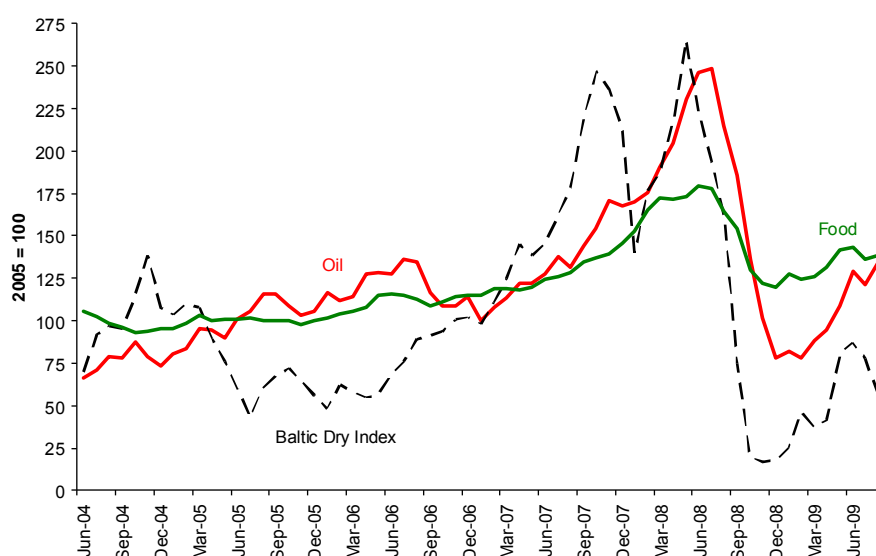
While exports have remained weak so far, the modest recovery now emerging in the US and EU should provide some hope of gains for China and the Asian region. In particular, ICT exports to the US and Europe could see a fairly swift and substantial rebound, brightening prospects for key Asian suppliers. In turn, a stronger Asia will revive trade and boost sentiment in other regions.

Latin America is also beginning to move out of recession (Brazil growing again in Q2) although estimates of the aggregate regional outlook for 2009 have worsened due to the severe contraction experienced in Mexico. Low dependency on bank financing has made Latin American corporates more resilient to credit shocks while healthy public balance sheets have provided a buffer against capital flight, weakened exports and lower commodity prices. In contrast, Eastern Europe, Central Asia and most of the Middle East remain weak and risk prone due to impacts from ongoing deleveraging in the global financial system and the collapse in investment.

Reducing the risks to a global recovery, inflation looks set to remain low, at least in the next year, with wage increases weak and reduced pressure in commodity markets compared with 2008. The recovery in oil prices seems to have stabilized, helped by relatively flat energy demand and perhaps also the reported new capacity in Saudi Arabia.

Nevertheless, there is an on-going risk to poorer consumers in developing countries from persistent volatility in food prices, reflecting the tight conditions in some markets and vulnerability to weather and other shocks.

**Figure 8: Oil, food and shipping prices<sup>2</sup>**



Sources: IMF, Bloomberg

## Policy Must Remain Pro-Growth

With Q2 confirming that the downturn has stabilized and monthly data now pointing to a prospective improvement in H2, the final question will be whether such an improvement in global demand can be turned into steady growth in 2010 and beyond. Given the problems exposed by the recession and the need to consider policy tightening at some stage, in order to curb the costs of recession-busting policies, the world economy will remain in a precarious position on the cliff face for some time to come (see the

<sup>2</sup> The Baltic is a daily index of international shipping prices of dry bulk cargo. By measuring shipping demand it serves as a proxy for world trade. Recent moves towards time charters rather than spot pricing may, however, have eroded its usefulness as a short-term trade indicator.

complementary Chatham House programme paper on the long-term economic outlook). A smooth, sustainable recovery is not assured.

Of most immediate concern is the prospective re-intensification of risk this autumn as companies reassess their business plans and the implications of below-peak demand conditions prevailing for some time to come. At the moment, business indicators in leading economies point to a promising resurgence in confidence. In part this may be due to the recognition of the emerging gains in consumer spending along with efficiency effects from restructuring after layoffs and cutbacks rather than a reflection of expectations for future market conditions. Certainly the level of activity is still much weaker than the past peak, even if conditions are improving, and this risks provoking a new round of corporate retrenchment, with deeper cut backs in production and also jobs. As one example, Toyota has already announced intentions to cut capacity for car production in 2010.

Business investment is therefore set to be the last component of GDP to recover. Gains in consumption may jump-start economic growth, but without a similar revival of investment the recovery in trade and GDP will remain feeble.

Reappraisals of the growth outlook will lead to policy changes as governments examine the implications of recent stimulus packages for government debt profiles (this issue is also examined in the complementary programme paper on the long term outlook). However, the message must remain firm: the world economy is not out of the woods yet and policy makers must keep their foot on the accelerator for a while longer – not switch abruptly to the brake – or they will risk destabilising economies into a double dip recession.

G20 discussions recognise this risk and the need to remain vigilant in engineering a recovery. Sustaining an upturn in the OECD economies through 2010 must be a key short term aim for policymakers.