NIRA Policy Review
No.50 Jan. 2011

Global recovery still in the shadow of the crisis

Paul Sheard
Global Chief Economist and Head of Economic Research, Nomura Securities

After the global economy experienced its worst financial crisis and recession since the Great Depression, it recovered nicely in 2010, likely growing by about 4.9% (aggregated according to Purchasing Power Parity weights; the same below). This recovery can be attributed to two key factors. There is a natural tendency for economies to stabilize and then recover after a sharp fall in output, but more important in this episode, governments and central banks around the world responded to the crisis with aggressive monetary, fiscal and financial stabilization measures. These policy measures helped prevent a collapse of the global financial system and a second Great Depression, and helped put the economy on a recovery path. We expect the recovery to continue, forecasting the global economy to grow by 4.4% in 2011, contributed to by growth in emerging market economies of 6.6% and developed world economies of 2.4%.

However, just two years after the crisis pitched the global economy into recession, the global economy remains in a precarious situation as the excesses that built up during the boom/bubble and the aftermath of the crisis continue to weigh on economies. As Japan well knows from its own experience, a once- or twice-in-a-century crisis like this one casts a long shadow. Policymakers and economic agents need to work through the aftermath of the crisis with the necessary policy response – notably by restoring damaged or distorted financial, household, government and central bank balance sheets to health and normalcy – and correct the macro, structural and regulatory deficiencies that helped cause the crisis in the first place. It is a tall order and there is plenty that can go wrong.

There was no single cause of the global financial crisis, but an important aspect was that large and unsustainable current account imbalances were built. The current account balance of a country at a given period represents its total savings, in both the private (household and corporate sectors) and public sectors, net of investment; or equivalently, the increase in its net financial claims on (in the case of a surplus), or indebtedness to (in the case of a deficit), foreigners. At the center of the global imbalances were a current account surplus that was getting too large in China and a current account deficit that was getting too large in the United States. Put simply, China was lending too much money to the US to finance excessive consumption, partly of the goods China was exporting, and rising house prices in the US and a strong dollar (helped by China's pegging its currency to the dollar) provided the asset price signals to US households to feel comfortable living beyond their means.

US facing headwinds from household deleveraging

In the US, households still have very high levels of mainly mortgage-related debt, relative to historical norms, which they need to gradually reduce. Prior to the housing and credit bubble, the ratio of household debt to disposable income was about 0.9x, but in the bubble it rose to about 1.35x. It is now about 1.2x, suggesting that at this rate it will take another 4-5 years before it is back to its historic norm. If households are intent on bringing down their debt levels, they are less likely to borrow to finance new housing investment or consumption, so monetary policy (interest rate cuts) provides much less stimulus than it normally would. We see this household debt deleveraging continuing to crimp growth in 2011 and beyond. This is because of the weak consumption profile it implies and also because corporations – even though they have strong balance sheets, lots of cash and capital markets are generally open for business – are unlikely to splurge on investment expenditure while the outlook for consumer demand remains weak.

However, a double-dip recession in the US looks unlikely. The Federal Reserve has acted very aggressively during and after the crisis to provide monetary stimulus to the economy and it is likely to continue to do "whatever it takes" to ensure the economy does not bleed slowly into deflation. Precisely because the Fed understands that monetary policy in a post-bubble deleveraging environment imparts less stimulus than normal, it has calibrated its policy response accordingly, quickly cutting the federal funds rate to close to zero and aggressively buying longer-term securities, expanding the size of its balance sheet by 163% since the end of August 2008 (to show aggressive this is, the Bank of Japan increased its balance sheet by only about 35% when it conducted quantitative easing in the March 2001-March 2006 period). With a two-year extension of the Bush-era tax cuts and other tax measures, fiscal policy is likely to remain supportive of a recovery too. Levels of housing and consumer durable demand are very low relative to historic norms, suggesting that there is little downside from here. For instance, while there is still an overhang of housing from the bubble, housing investment as a share of nominal GDP is at an unprecedently low level, of just 2.2%, compared to the long-term average of about 4.5% and the bubble peak of 6.3%.

We expect the US economy to expand by 3.0% in 2011, after likely growing by 2.9% in 2010, but this modestly above-potential growth rate will likely do little to bring the unemployment rate down, which we see still at 9.0% in Q4 2011. Nor, given the slack in the economy, do we expect any inflationary pressures; rather, given the likely success of the Fed's so-called "QE2" we expect a welcome gradual and mild abatement of disinflationary pressures.

Europe struggling with fiscal crisis

Europe faces stiff headwinds to growth as it struggles to cope with the fiscal aftermath of the 2008 financial crisis. The fiscal crisis that broke out in the euro area in early 2010 revealed the uncomfortable fact (for European policymakers) that a monetary union in Europe without more elements of a fiscal union is not sustainable.

Since the euro was adopted as a single currency in 1999, Germany, in particular, has gained in competitiveness relative to the periphery countries, many of which clocked up too much public or private sector debt. A country like Greece, which finds itself uncompetitive vis-à-vis the euro zone as a whole and with too much government debt, cannot depreciate its currency or cut its policy interest rate because it has ceded both instruments to the euro area as a whole. To restore competitiveness and market confidence in its fiscal finances, it has to implement severe austerity measures, but in the short term, fiscal austerity hits growth, casting doubt on fiscal sustainability. Unable to depreciate its currency or cut its policy interest, a country like Greece can only implement such deflationary austerity measures and avoid skeptical markets forcing it into default if it receives strong official financing support from the euro area governments and from the IMF.

Determined not to let the euro break up, or any member state to default, European policymakers, by putting in place a €110bn financial rescue package for Greece and by contributing €500bn to a financial stability facility – a prelude to a permanent European Monetary Fund – are moving the euro zone further in the direction of de facto fiscal union. They are doing this with reluctance and via a messy political process, but the alternative is the less palatable one of risking an escalating fiscal and financial crisis that could ultimately lead to the break-up of the euro.

We expect Germany, its competitiveness enhanced, to continue to recover smartly as it benefits from lower bund interest rates, a weaker euro and a recovery in export demand. But the euro area periphery, facing a burst housing bubble in parts and fiscal austerity headwinds, will likely continue to struggle. We expect the euro area as a whole to grow by just 1.9% in 2011, too slow to make much dint in its double-digit unemployment rate. We expect European policymakers to continue to do whatever it takes to keep a lid on the fiscal crisis, but the fiscal crisis escalating and even spreading outside the region is probably the biggest downside risk to the global economy in 2011.

Japan mired in deflation

Japan’s GDP fell by an astounding 10.1% in the recession as exports fell by 37%. Japan’s GDP has bounced back quite sharply but, even so, the level of real GDP still stands 3.4% below its pre-crisis peak. We forecast Japan’s GDP to grow just 1.1% in 2011 after likely growing by about 4.4% in 2010. Growth in 2010 benefited from a big contribution from net exports and from fiscal measures supporting household consumption.

Recently Japan’s recovery has been losing steam as the overseas recovery has slowed and the yen has strengthened. We expect growth to be negative in Q4 2010, as a fiscal- and hot weather-supported surge in household consumption in Q3 is partly reversed. We expect the pace of recovery to slow sharply through H1 2011, with growing risks on the downside. However, the recovery should find its footing again from around mid-2011, supported by fiscal and monetary policy, as well as a renewed acceleration in overseas economies, particularly in Asia.

Japan's problem is that the economy never really emerged from the deflation that it fell into in the 1990s after the bursting of its own asset price bubble; the recent crisis and recession has worsened Japan's deflation. The GDP deflator in Japan peaked in Q2 1994 and has fallen by a cumulative 15% since then. In contrast, the GDP deflator in the same period has risen by a cumulative 39% in the US and by 46% in the UK. The Japanese CPI, excluding food and energy, has increased in year-on-year terms in only five months in the entire past decade. Deflation appears to be hard-wired into the Japanese economy.

It is unlikely that Japan will simply grow out of deflation. Most economists regard it as the job of the central bank to achieve and maintain operational price stability, and this principle is enshrined in central banking laws and operating frameworks all around the world. The modern theory of inflation puts a lot of emphasis on the role of the public's inflation expectations as a determinant of longer-term inflation outcomes and of the role of the central bank in anchoring those expectations at a desirable level. To do so, the central bank needs to be seen as credible – that is, having the tools to achieve its desired inflation rate and being determined to use them to achieve it.

When the economy is in, or is threatened by, deflation, the central bank still has a way to ease monetary conditions after cutting the policy interest rate to zero. This is to expand the size and alter the composition of its balance sheet, by acquiring assets from the private sector and financing those purchases by creating excess reserves. In principle, there is no limit to the capacity of the central bank to increase the size of its balance sheet and therefore to try to ease monetary conditions and influence inflation expectations and inflation outcomes using this tool.

The Bank of Japan pioneered this so-called "quantitative easing" policy, but in this crisis, unlike the Fed, it has been curiously reluctant to use it. The BOJ has increased the size of its balance sheet by just 18% since the crisis erupted, compared with the Fed's 163%. However, the BOJ did announce a new "comprehensive easing" policy in October, including the bold step of buying ETFs and REITs in order to attract risk money into the equity and real estate markets as part of a ¥35trn asset purchase fund. This is an important step in the right direction but it is important that the BOJ now work with the government to use this new policy tool-kit aggressively, increasing the size of the asset purchases as much as needed, with the aim of overcoming deflation once and for all.

China's investment juggernaut

We remain very bullish on the Chinese economy, which is experiencing dramatic domestic demand-led growth along a relentless development path. We expect China to grow by 9.8% in 2011, after likely growing by 10.2% in

2010, in line with its 30-year average growth rate.

China responded to the financial crisis and global recession by stepping up domestic investment in infrastructure, particularly in the central and western regions. Rapid credit-fuelled investment growth allowed China to continue to grow strongly (by 9.1% in 2009) despite most of the world going into recession and global output shrinking by 0.7%. Household consumption has also been strong as rural incomes rise and China develops an urban middle class. We expect retail sales (in nominal terms) in 2011 to grow by 20%. China has used the financial crisis to give it a further spur to rapid economic development.

With the investment share of GDP approaching 50%, however, the Chinese economy has put itself on an investment treadmill. China needs to keep investment growing rapidly because a significant slowdown in the rate of investment growth (let alone it turning negative), would pull down the overall economic growth rate sharply. If investment growth were to slow to zero, for instance, there would still be a massive amount of investment being undertaken but China's growth rate would roughly be cut in half. A slowdown in China would have a big impact on global growth as China contributes about one-third of global growth, far more than any other economy. The impact on the Asian economy, including Japan, would be particularly acute.

By aggressively stimulating domestic demand in the way it has, China is doing its bit to correct global imbalances. China's current account surplus, which was 9.8% of GDP in 2008, looks set to be fall to about 5% in 2010 and we forecast it to decline further to 4.1% in 2011. The US current account deficit has also fallen from a peak of 6.5% of GDP in Q4 2005, at the height of the housing boom, to 3.5% in the latest quarter.

Global rebalancing, that is, bringing current account balances back to more normal sustainable levels, requires a combination of "internal" (changing domestic consumption, savings and investment behavior) and "external" (involving the realignment of exchange rates) rebalancing.

While aggressively pursuing internal rebalancing, China has been less willing to embrace external rebalancing. Rather, it continues to manage its exchange rate in what amounts to a quasi-peg against the US dollar. After re-pegging its exchange rate to the dollar in July 2008, China announced in June this year that it was moving back to a more flexible exchange rate regime and it has allowed the renminbi to appreciate against the dollar by about 2.5% since then. But China continues to heavily intervene in the currency market, accumulating a large amount of foreign exchange reserves, which is de facto evidence that the currency is undervalued.

The problem with this approach is that, with capital flowing more freely, it is impossible for China to target the exchange rate and operate a domestic monetary policy aimed at controlling inflation at the same time. If China continues to target its exchange rate, it risks triggering domestic inflation. As a rapidly growing economy with rising income levels, China's real exchange rate needs to rise over time. If this real exchange rate appreciation is not allowed to occur via appreciation of the nominal exchange rate, while maintaining domestic price stability, it is likely that it will occur via domestic inflation. This would require various tightening measures, which indeed China's policymakers have already started. A risk here is that, trying to juggle one ball too many, the tightening measures lead to a pull-back in investment, with the adverse consequences for growth discussed above.

This phenomenon is not limited to China. With emerging market economies growing strongly and developed world economies facing strong headwinds and likely to have low interest rates for a long time, money is flowing into emerging market economies on a large scale. This is putting upward pressure on exchange rates, which policymakers are resisting with foreign exchange intervention and increasingly by using capital controls and macro-prudential measures. Such policies run the risk of leading to domestic overheating and inflation, which in turn sets the stage for policy tightening and a possible overshoot on the downside.

Onus on Japan

The risks that lurk in the global economy as it continues to cope with the aftermath of the financial crisis and the challenges of global rebalancing are all the more reason for Japanese policymakers to focus on getting those things that are under their control – domestic policies – right. Structural reforms are important, but the most striking aspect of the Japanese economy is its long-term debilitating deflation. Fighting deflation is first and foremost a task for the central bank. Getting the economy out of its nominal stagnation – nominal GDP is at the same level as it was in Q2 1993 (it is up 123% in the US in the same period) – would make all kinds of structural reforms that much easier to carry out.

Notes

Data employed in this paper were obtained from the following sources:

Global Weekly Economic Monitor, NOMURA

Federal Reserve, US Bureau of Economic Analysis, UK Office for National Statistics, Bank of Japan, Japanese Cabinet Office, Japanese Ministry of Internal Affairs and Communications, China Economic Information Network, Bloomberg BGN

About the Author:

Paul Sheard

Paul Sheard has been Global Chief Economist and Head of Economic Research for Nomura Securities since November 2008, and is based in New York.

Mr. Sheard formerly held the same position at Lehman Brothers (2006-08), and prior to this was Chief Economist Asia at Lehman Brothers (2000-2006).

Born in Australia in 1954, Mr. Sheard holds a BA (Hons) from Monash University and PhD and Masters of Economics degrees from the Australian National University. He has lived in Japan for a total of 17 years, most recently from 1993 to 2006.

Mr. Sheard has held faculty positions at Osaka University and the Australian National University, and visiting positions at Stanford University and the Bank of Japan.

He has published two books in Japanese, one of which was awarded the Suntory Gakugeisho (メインバンク資本主義の危機、東洋経済新報社1997).

Mr. Sheard has also served on various Japanese government advisory bodies, including

subcommittees of the Economic Council in the Hashimoto and Obuchi administrations.

This paper was written for *NIRA Seisaku Rebyu* (NIRA Policy Review) No. 50 (January2011), entitled “*2011-nen no keizai o yomu* (Reading the Economic Situation in 2011).”