Global Economic Outlook

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Global slowdown or false alarm?

Deficits
Deal with them now or later?

Eurozone
Balancing short- and long-term needs

China
Finding the right balance

Deloitte.

Global Economic Outlook Q3 2010

The state of the global economy remains a mystery for many corporate executives. Uncertainty about the near future may be inhibiting investments in new capacity and new products. The degree to which companies spend depends on the solidity of expectations about the future. In the latest issue of Deloitte's Global Economic Outlook, our economists survey the global landscape and offer a roadmap. While residual problems linger following the worst economic crisis of the last 60 years, the bottom line appears to be moderate growth with almost no inflation. In the world's leading markets economic recovery continues. While slower in the United States than previously anticipated, and while slowing a bit in China, growth is surprisingly robust in Japan and Europe. Overall, the outlook suggests that businesses have something to cheer and reason to expand.

The global economy continues to grow but uncertainty has gripped observers about the sustainability of growth in the world's three biggest markets: the United States, Europe, and China. In the United States, growth has been disappointing and the job market appears to be going nowhere. In Europe, the sovereign debt crisis and the policy response have conspired to alarm markets. Finally, China's tightening of monetary policy and efforts to cool an overheated property market have raised fears that growth will slow.

In this issue of the quarterly Global Economic Outlook, our economists peruse the economic environment and place these events in perspective.

In our topical article, I highlight the differences in opinion about the role of fiscal policy amidst economic recovery. While Europeans argue for quickly reducing deficits lest financial markets react negatively to government debt, American policymakers suggest that deficit reduction can wait a little while longer. I offer some rules of thumb as to when deficit reduction works and when it does not.

Elisabeth Denison begins her quarterly outlook on the Eurozone by stating that "the recovery in Europe is on track." Given the recent turmoil in Europe's financial markets, this is a welcome point of view. But it needn't be surprising. The reality, as Elisabeth points out, is that many indicators are demonstrating a robust recovery. While some analysts fear that Europe's fiscal tightening will hurt growth, Elisabeth states that "this is the right thing to do." She makes the case that fiscal consolidation will better position Europe for sustainable growth.

In my analysis of the U.S. economy, I point to a number of reasons why the economic recovery has so far been disappointing. I also point to reasons why the recovery will likely be sustained, although at a slower pace than previously thought. Furthermore, I tackle the issue of inflation, specifically why inflation is much less of an issue for the U.S. economy than previously expected.

While fears abound about growth in the United States and Europe, the third largest advanced economy is now growing faster than anticipated. In his outlook on Japan, Ian Stewart says that growth in 2010 will be better than expected but that it will slow down somewhat in 2011. Yet Ian also highlights Japan's continuing dependence on exports. The lack of improvement in domestic demand means that growth at current levels can probably not be sustained.

In my analysis of China, I discuss several issues that have raised questions about the sustainability of growth. These include consumer price inflation, property prices, labor unrest, and exchange rate policy. Although China is clearly growing rapidly, each of these issues and how they unfold will have an impact on future growth.

In this issue, we welcome Siddharth Ramalingam as a contributor to the report. In his outlook on the Indian economy, he demonstrates that India's large agricultural sector and its dependence on the monsoon will play a role in determining the sustainability of India's strong recovery. The monsoon influences food prices and, therefore, inflation. Thus, while policy appears to be supportive of non-inflationary growth, the weather could be the ultimate determinant.

In his article on the United Kingdom, Ian Stewart suggests that despite strong growth in the first quarter, the outlook remains weak. Ian says that the fiscal retrenchment proposed by the new government is expected to cause economic slowdown, at least in the short term. In addition, external factors are not now supportive of growth either. On the other hand, the new fiscal policy is expected to eliminate any risk of a Greek-style debt crisis.

Next, Elisabeth Denison offers an outlook on Russia. She says that after a deep recession, a strong recovery is under way. It is fueled mainly by external demand for Russia's commodity exports. Moreover, consumer demand has been strong. On the other hand, business investment is declining. Elisabeth notes that this situation is not sustainable and that Russia requires reforms in order to wean itself off oil and gas.

Finally, I offer an optimistic assessment of Brazil. Growth is currently strong enough to fuel rising inflation. The policy response could create difficulties in the form of higher interest rates and a higher-valued currency. Longer term, Brazil's prospects will depend on a mix of good policy, a strong global economy, and continued optimism on the part of foreign investors.

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9 **United States: Conflicting signs** Is the U.S. economy sputtering? Much evidence suggests so. The weak job and housing markets point to a disappointing economic recovery so far, but some positive signs do remain. Leading indicators suggest that an upturn in the job market is imminent, consumer confidence is on the rise, and inflation is much less of an issue than previously thought. At this point in time, it appears likely that the U.S. economy will continue to grow and avoid a double-dip.

13 **Japan: 2010 Rebound, 2011 slowdown** Japan's upturn in economic activity proved better than expected. Exports and industrial production have bounced back strongly, leading economists to substantially revise up their forecast for Japanese growth this year. However, the lack of improvement in domestic demand and a continuing dependence on exports means that growth at current levels can probably not be sustained.

17 **China: Finding the right balance** Two of the biggest issues facing China at the moment involve prices. Specifically, there is concern about consumer prices and home prices. The first is in danger of accelerating and the second is in danger of collapsing. Either event, or more likely the policy response thereof, could derail the economic recovery.

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21 **India: Testy rains, testing times** Higher than anticipated growth in the manufacturing, mining, and agricultural sectors heightened the euphoria around India's resilience against the global economic downturn. But much of India's near-term economic fortunes will depend on the monsoons. If the rain gods should play truant, runaway food inflation, widespread outcry against the government's recent decision to decontrol petrol prices, and a large fiscal deficit will most likely dampen the country's economic prospects ahead.

25 **United Kingdom: Confidence dips** Business confidence has dipped as worries about a renewed weak patch in the U.K. recovery have mounted. Fiscal tightening looms as the United Kingdom switches from a period of growth driven by government and the consumer to one led by exports, capital spending, and industrial output. It is unlikely to be an easy or smooth transition. The most likely outlook remains for a sluggish, erratic but continuing recovery.

29 **Russia: Rebound gains momentum** The overall picture of a rather muted recovery in Russia is in need of an update. Real economic activity has picked up in recent months, fueled by external demand for commodity exports and a recovery in domestic demand. But even if fundamentals are looking up, all will not be smooth sailing in the coming months. Russia's reliance on the energy sector remains a key macroeconomic risk, weighing on the country's long-term growth prospects.

33 **Brazil: How fast can the country grow?** Is Brazil overheating? The country is experiencing strong consumer-led economic growth while inflation is a bit higher than desired. A change in monetary policy seems the most likely option to cool off the economy, but this could lead to difficulties in the form of higher interest rates and a higher-valued currency. In the long term, Brazil's fortunes will depend on a mix of good policy and a strong global economy.

35 **Appendix**

Charts for developed countries GDP growth rates; inflation rates; major currencies vs. the U.S. dollar; yield curves; composite median GDP forecasts; composite median currency forecasts; OECD composite leading indicators.

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"Give me chastity and continence, but not yet."

- Saint Augustine

Deficits: Deal with them now or later?

In many countries across Western Europe there is currently a rush to drastically cut big budget deficits. Significant pain is being imposed in the hope that this will impress financial markets and improve economic performance. In the United States, however, there is no such urgency. Indeed, the Obama administration has proposed temporarily increasing the deficit in order to stimulate economic activity and has advised Germany to do the same. Deficit cutting, it is argued, can wait until later. Who is right? Should large budget deficits be cut now or later? As usual, the answer depends on circumstances.

First, consider the situation. Deficits have exploded during the past two years. There were three major causes. First, when economic activity declined, tax revenue declined. Moreover, recessions usually lead to an automatic increase in government expenditures such as unemployment benefits. Thus, the recession contributed substantially to increased deficits. Second, many governments enacted discretionary increases in spending and cut taxes in order to stimulate economic activity. Third, many governments spent heavily to re-capitalize troubled financial institutions. The good news is that all three of these factors are in the process of being reversed. As economic recovery unfolds, tax revenue expands and spending declines. In addition, the expenditures on stimulus and bank re-capitalization were one-off events that will not necessarily be repeated. Thus, deficits should already be on a path to improvement as long as economic recovery continues.

The problem is that deficits will remain very high this year and next, so much so that the stock of government debt is increasing rapidly. This means that future budgets will balloon as a result of increased interest payments. In addition, the aging population in most developed economies is leading to increased expenditures on pension and medical benefits for the elderly. Thus, many countries face a structural budget deficit unrelated to the recent recession.

A deficit that leaves the debt to GDP ratio unchanged or declining is widely considered a good definition of sustainability. No one disputes the fact that difficult actions will be required to bring deficits down to sustainable levels. The dispute rests solely on the timing of this action.

The argument for quick action

Some government ministers and economists argue that quick action is needed. They say that big deficits are causing a crisis of confidence within the private sector. They say that the fear of the consequences of deficits is causing uncertainty and, therefore, reducing business investment and consumer spending. They believe that strong anti-deficit action will stimulate the private sector to spend. These arguments are made by the new leaders of the British government as well as the leadership of Germany's government.

The argument for waiting

Others, however, state that deficit reduction prior to full recovery will be harmful. They say that the real harm from deficits takes place when an economy is operating at full capacity. That is, when government borrowing competes with the private sector and reduces business investment. They believe that deficits are useful when the economy is operating below capacity and when the private sector is in the process of de-leveraging. Government leveraging is seen as offsetting the negative impact of private sector de-leveraging.

Who is right?

It is safe to say that both sides have strong arguments. Yet the decision as to which argument to buy depends on circumstance. The question, then, is under what circumstances would early deficit cutting work? Also, are those circumstances present today?

If a policy of cutting deficits is to succeed now, certain conditions must be met:

- Successful deficit cutting requires an offsetting improvement in net exports and/or private sector spending. In other words, there should be reason to expect that public sector cutbacks will be more than met by private sector increases in spending. Normally, this happens when the economy is at full capacity. Yet the British government argues that it will happen now because of the impact on business confidence. They argue that the prospect of huge deficits is so unnerving to the private sector as to quell investment. That being said, it might not be a good idea to cut the deficit when the private sector is still in the process of de-leveraging as is the case today.
- Cutting the deficit might not be effective if interest rates are already close to zero. Normally, cutting deficits reduces the demand for credit and puts downward pressure on interest rates – thereby helping to boost private sector spending. Yet when interest rates are so low that they cannot go any lower, this clearly cannot be the case.

- It probably makes sense for small economies (i.e. Greece, Portugal) that have no control over monetary policy (due to their membership in the Eurozone) and that need to convince financial markets that they're solvent, to cut deficits. This can reduce the local cost of capital and improve the solvency of local banks. Indeed, this is what is happening and it is not controversial. The controversy rests on whether large economies such as the United Kingdom, Germany, and the United States should follow a similar policy.

- The success or failure of deficit reduction depends strongly on what the central bank does. Normally, a fiscal tightening that is offset by monetary expansion can have a positive impact on the economy. However, if interest rates are already close to zero, then fiscal tightening might not work. Or, under such unusual circumstances, monetary policy might only work if it involves "quantitative easing." That is, it might work if central banks essentially print money. In the case of the European Central Bank (ECB), choosing the right policy is difficult given the divergent fiscal policies and growth rates of several member nations.

The micro side of things

There is a microeconomic argument to be made for rapid deficit reduction. When the public sector passes a critical share of GDP, it becomes onerous in that it saps resources from the private sector, ultimately requires confiscatory tax rates, and places the government in the position of providing services that could otherwise be undertaken privately. This thereby promotes inefficiency in the economy and reduces productivity growth and thus economic growth. The argument, then, is that rapid deficit reduction is necessary to quickly reduce the role of the public sector in the economy.

This is, in part, the argument of the British government. Prior to the recent election, the British government had already put in place a plan for deficit reduction. The new government accelerated the plan with the goal of convincing financial markets that the public sector will significantly shrink from its current elevated level. The other factor was a desire to avert any contagion from the sovereign debt crisis engulfing the Eurozone.

There is a counter-argument. It is that, while the microeconomic reasons for reducing the size of the public sector are correct, reducing the deficit quickly is unrelated to the question of the size of the public realm. Rather, rapid deficit reduction still poses risk to economic recovery as long as the economy remains under-utilized. Instead, it is suggested that a credible plan for future deficit reduction is all that is required to please the financial markets.

Imbalances and deficits

One of the factors that contributed to the massive economic crisis of the past two years was the substantial imbalance in the global economy. There were debtor countries (United States, United Kingdom, and Spain, to name a few) that consumed more than they produced and borrowed heavily from other countries to make up the difference. Then there were countries (Germany, China, and Japan) that provided the funds that debtor nations required to live beyond their means. Policy contributed to these imbalances. In the debtor countries, budget deficits and incentives for consumer borrowing played a role. In surplus countries, currency intervention enabled funds to be loaned cheaply to debtor nations, thereby stimulating their asset price bubbles and excessive borrowing. Going forward, it will be helpful if countries reverse these imbalances. Thus, debtor countries should reign in their budget deficits while surplus countries should be less austere. The latter should stimulate domestic consumption so as not to depend on exports for growth.

What does this mean for deficit reduction? It suggests that the United Kingdom and United States should cut their budget deficits more aggressively than, say, Germany. On the other hand, it does not necessarily suggest quick action for the United Kingdom and United States. Rather, it suggests credible action. For Germany, on the other hand, it suggests that austerity might not be the right policy at all.

What does experience tell us?

Unfortunately, there are examples of both success and failure in tightening fiscal policy. The most successful application of this policy came in 1993. The U.S. economy was in recovery but was still operating below full capacity.

The Clinton administration proposed a policy of fiscal tightening involving both tax increases and spending cuts. The argument was that if financial markets are convinced that government finances are sound, they will not anticipate having to absorb large amounts of debt. This will keep interest rates low and stimulate private sector spending. The argument also included the expectation that the U.S. Federal Reserve would loosen policy in response to fiscal tightening. This did indeed happen. The result was strong economic growth throughout the 1990s.

Yet such a policy has also resulted in disappointment. While the United States grew in the 1990s, Japan stagnated. With many idle resources and prices declining, the Japanese government maintained a relatively tight fiscal policy. Although deficits were high, this was the result of weak economic performance, not a policy of stimulus. The result was very slow economic growth. There were two problems in Japan. First, the private sector was in the process of massive de-leveraging, the result of a banking crisis. Tight fiscal policy failed to offset this and, as a result, credit did not expand. Second, monetary policy remained relatively tight. Although interest rates were close to zero, the central bank did nothing to expand the money supply. Hence, Japan's economy failed to grow.

Is there a rule of thumb?

Is there a rule of thumb as to when to institute fiscal consolidation? If one believes that the market is the best determinant of resource allocation, then financial markets should provide guidance to policy makers. If the interest rate on government bonds rises to an elevated level, then one can argue that the markets are offering a warning. It suggests that deficits are unsustainable and are in danger of crowding out private sector spending. This is surely the case with the small countries of Europe today. This, also, was the argument made for fiscal consolidation in the United States in the early 1990s.

Yet, today, bond market rates in the United States, Japan, and the United Kingdom remain unusually low even while deficits are unusually high. What are the markets saying? On the one hand, they could be saying that current deficits pose no danger given the shallow private sector demand for credit. They could be saying that an economy with substantial idle assets can absorb large deficits. On the other hand, one could argue that markets are not always efficient and that they are providing incorrect signals. The existence of asset price bubbles and wild asset price swings suggests that, at the least, markets are not always efficient. If so, then today's low interest rates provide no signal at all to policy makers. Thus, officials must judge the situation for themselves.

The reality is that there is no good rule of thumb. Only time will tell which of the current policy choices was the right one.

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Eurozone: Balancing short- and long-term needs

by Dr. Elisabeth Denison

The recovery in Europe is on track.
Economic activity has rebounded faster than expected, spurred on by a weaker currency and fast-growing external demand. However, the Damocles sword of a debt crisis continues to hang over the continent. Banks are heavily exposed to sovereigns with worrying fundamentals and the risk remains that another financial upset snips the real recovery at its bud. Against international pressure to continue stimulating domestic demand, politicians in Europe are on a mission to bring spending under control. For the long-term prospects of the Eurozone, this is the right thing to do.

Between debt and desire

Nothing highlights cultural and structural differences more than a crisis. When money stops flowing, diverging philosophies are exposed. Not surprisingly, the approaches to combat recessions in past decades have differed markedly between nations. In that sense, the financial crisis marked a sea change. Governments worldwide acted in unprecedented synchronicity, orchestrating financial rescue packages and passing sizable fiscal stimulus. However, this show of unity was partly involuntary. The hands of politicians were forced by the increasingly interconnected nature of the global economic and financial system.

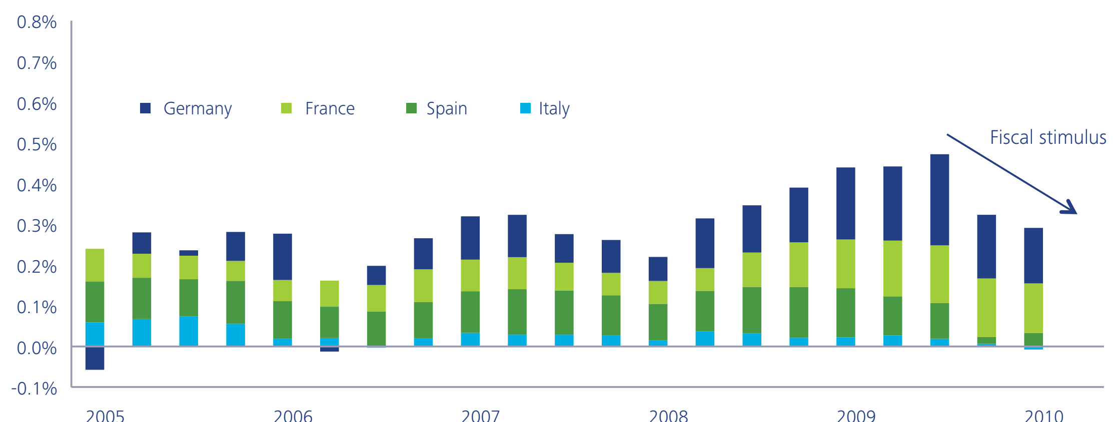
Now that the worst has been avoided, differences reemerge. Countries with inherent Keynesian philosophies (mostly characterized by large deficits before the crisis) are once again pitted against surplus states who wish to refocus on austerity. The echoes of this discussion are being heard in transatlantic relations but also within Europe. Facing the risk of a debt and currency crisis in the Eurozone, leaders are trying to draft credible strategies to cut debts and boost cross-border coordination and control.

One can of course argue that this push for austerity is endangering the recovery in Europe. Government spending has certainly helped ease the pain of the recession in the past two years. The biggest economies – Germany, France, Spain and Italy – alone contributed about 1 percent to Eurozone growth in 2008 and 2009 (see figure 1).

By now, however, most governments in Europe have passed fiscal austerity packages. In Germany, chancellor Merkel announced savings measures amounting to €80 billion (about 3 percent of GDP) from next year until 2014. Italy has passed a €25 billion package, in Spain the efforts sum up to €15 billion. In France – although a coordinated package has not been produced – the government announced a reform of its pension system, gradually raising the retirement age from 60 to 62 by 2018. The savings measures will certainly weigh on Eurozone growth over the next few years, but there is a belief in Europe that the measures will not significantly impact global growth. That contrasts with views expressed by President Obama in a letter to world leaders ahead of the G20 meeting in June, in which he was "concerned by weak private sector demand and continued heavy reliance on exports by some countries with already large external surpluses."

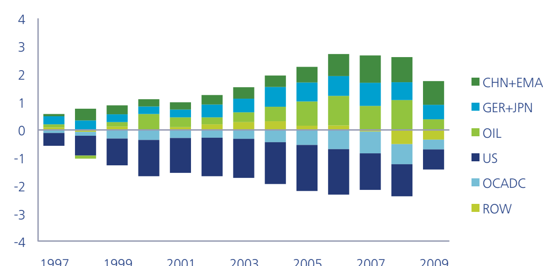
Undoubtedly, the imbalances in global current accounts reached before the crisis were unsustainable (see figure 2). However, the argument which, on the one hand, pits Germany or Japan in the same context as China and other emerging markets, against deficit nations on the other, is flawed in an important aspect: demographics.

Figure 1: Government spending
(Gov. spending contribution to Eurozone GDP growth, 4qtr avg)



Source: Eurostat

Figure 2: Current account balance in percent of world GDP



Source: IMF, with CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Taiwan Province of China, Thailand; OIL: Oil exporters; OCADC: Other current-account-deficit countries; ROW: Rest of the World

Europe – and in particular the big industrial nations at its core – is aging fast. Expansive fiscal policies to stimulate domestic demand cannot be sustained against a demographic environment in which a third of the population will be in retirement within the next 20-30 years. The outcome of such policies can be seen in Japan with its combined debt of over 400 percent of GDP – half of which belongs to the business sector, a third to the government and the rest to households. Against this debt burden, the outlook is rather bleak for future generations.

Europe might be hurting short-term growth prospects with its austerity measures, but the long-term benefits of sound fiscal policies should be clear: "Reducing deficits and debt and generally improving the quality of budgets would enable Member States to free the necessary resources to encourage innovation, investment, education and employment which, in turn, would allow them to face more confidently the challenges posed by globalization and an aging population," said Joaquín Almunia, Commissioner for Economic and Monetary Affairs, in presenting the annual Public Finances in EMU report in June.

Ludwig von Mises, a classical liberal and one of the leaders of the Austrian school of economics put it in a more general way fifty years ago: "…there is need to emphasize the truism that the government can spend or invest only what it takes away from its citizens and that its additional spending and investment curtails the citizens' spending and investment to the full extent of its quantity."[1]

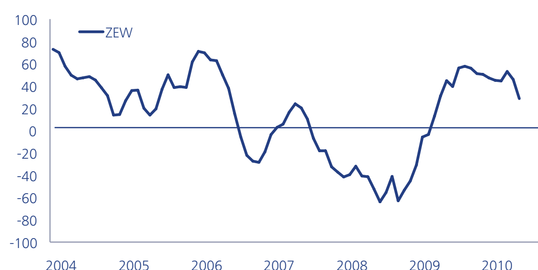
Financial woes versus real strength

The biggest risk to global growth currently is the debt burden accumulated over the past decade. Its ownership has in parts shifted from the private to the public sector during the crisis, but the fundamental implication remains the same: Borrowing to sustain a desired level of spending can only be successful if lenders are confident in the ability of the borrower to repay the loans. For some nations, that confidence is waning fast. The prospect of sovereign default brings with it concerns about a banking crisis. Some banks in Europe in particular might have become too dependent on the unlimited liquidity the ECB has pumped into the market and their ability to use low-rated sovereign debt as collateral at the central bank.

Recently completed stress tests of European banks have sought to boost confidence in financial markets. Nonetheless, the German investor confidence index took a dive in June, indicating a high level of uncertainty in the investment community. The forward-looking financial sector indicator compiled by the ZEW research institute lost 17.1 points over the past month, falling to 28.7 in June (see figure 3). "Economic sentiment is weakened by the uncertainty about the future developments of the debt crisis and the perspective of necessary cuts in public expenditure in EU-member countries," the ZEW statement said.

Meanwhile, the real economy continues to surprise to the upside. The depreciation of the euro, together with

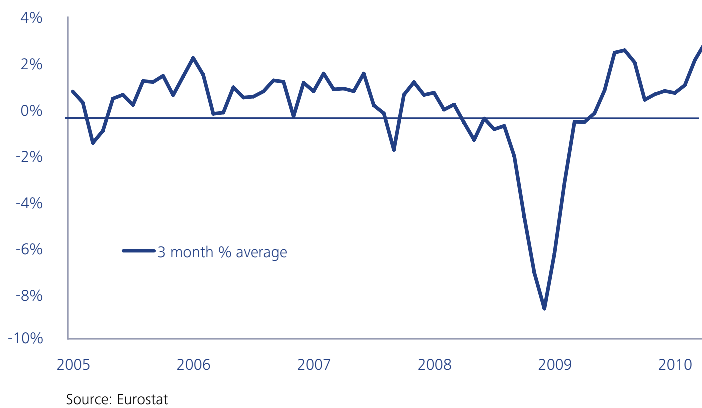
Figure 3: German investor confidence



Source: Center for European Economic Research

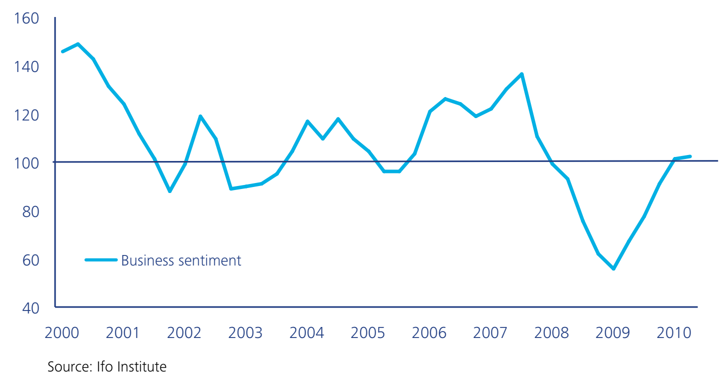
[1] Ludwig von Mises, Human Action: A Treatise on Economics, 3rd revised edition, (Chicago: Henry Regnery, 1966), pp.744.

Figure 4: Eurozone new industry orders



Source: Eurostat

Figure 5: Ifo Survey Eurozone



Source: Ifo Institute

a stronger than expected rebound in global trade, is spurring the recovery. New industry orders in the Eurozone are up over 20 percent from a year ago (see figure 4). Business confidence has returned to pre-crisis levels, reflecting an unexpected rise in boardroom optimism. In the second quarter of 2010, the Ifo business sentiment index for the Eurozone was up over 50 percent from a year ago and higher than at any time in the past two years (see figure 5).

In Germany, 33 percent of 22,000 companies polled by the DIHK trade and industry federation in June were confident of continued economic growth. "For the first time in two years, more companies want to create jobs than cut them," a DIHK statement said.

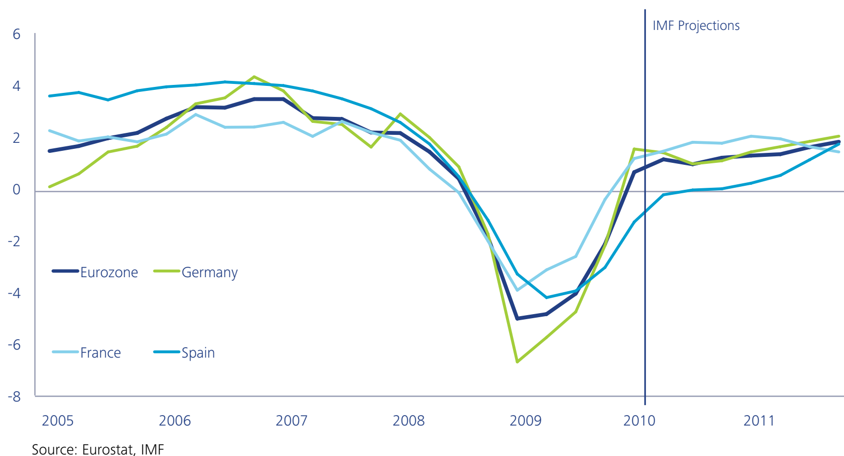
GDP projections for the Eurozone have been revised upwards in recent months, with some forecasters expecting growth of up to 2 percent for 2011.

The IMF is predicting 1.2 percent and 1.8 percent growth for 2010 and 2011 respectively, with Germany and France being the main drivers of the rebound (see figure 6).

Conclusion

The Eurozone has emerged from recession and the recovery is on track - even if the risk of another financial sector upset remains. While austerity packages will weigh on growth in the medium term, fiscal consolidation in the Eurozone is fundamentally the right course to take against the background of structural and demographic challenges. If done right, the consolidation efforts in the region can bolster competitiveness and help secure Europe’s growth for the future.

Figure 6: Real GDP growth (YoY%)



Source: Eurostat, IMF

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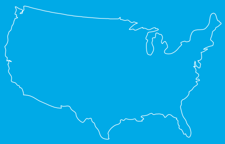

USA

United States: Conflicting signs

by Dr. Ira Kalish

Is the U.S. economy sputtering? Much evidence suggests so.

First quarter GDP growth has been revised downward twice and now stands at an annualized rate of 2.7 percent. The job market is weak – employment is growing slowly and the labor force is shrinking as discouraged workers stop seeking jobs. The housing market, after stabilizing during the past year, is worsening following the end of government subsidies. Credit market conditions are improving as evidenced by low-risk spreads, but demand for credit continues to contract. In addition, consumer price inflation appears to be easing rather than worsening. This suggests considerable slack in the economy even after massive government stimulus. Consumer spending is not growing after taking account of specific government subsidies for autos and housing. Finally, although the manufacturing sector is growing, there is evidence of deceleration. Among the indicators that are down are new orders and shipments of durable goods, both of which had been rising earlier in the year.

On the other hand, some positive signs remain. Although the job market is weak, that is to be expected at this stage of economic recovery. The recent decline in payroll employment was mainly due to the dismissal of temporary census workers. Private sector payrolls increased, albeit modestly. Moreover, there are some leading indicators suggesting that job recovery is imminent. These include continued increases in temporary employment as well as gains in productivity, both of which tend to lead to increases in permanent employment. In addition, industrial production is up 7.6 percent over the previous year.

Still, the preponderance of recent economic news suggests a slowdown in growth. But why might this be happening? There are a number of possibilities. Some observers suggest that the crisis in the Eurozone has had a negative impact on the willingness of businesses to invest. The serious drop in U.S. equity prices, seen as being influenced by events in Europe, could have had a psychological effect on both consumers and business.

...some would argue that too much government involvement in the economy is stifling private sector spending. Observers point to health reform legislation, financial reform legislation, and impending large deficits...

Another possibility is that evidence of slowing growth in China has also hurt U.S. equity prices and U.S. business investment plans. The problems in Europe and China together could be the perfect storm that harms the economic recovery in the United States.

Still another possibility is that U.S. economic policy is starting to shift from being supportive of growth toward neutrality. Last year's fiscal stimulus spending is already starting to wind down. That is why the U.S. administration is calling for accelerated spending. In addition, monetary policy has begun the long journey toward normalcy as the Federal Reserve reverses its acquisition of mortgage-backed securities. While not contractionary, such a policy represents an end to aggressive monetary expansion.

Alternatively, some would argue that too much government involvement in the economy is stifling private sector spending. Observers point to health reform legislation, financial reform legislation, and impending large deficits as having a negative effect on private sector willingness to take risk.

On the other hand, the end of several government programs supportive of growth could be having a negative impact. These include the Term Asset-Backed Securities Loan Facility (TALF) program which subsidized private purchases of securitized assets, the first-time homebuyer credit, and the cash for clunker program for automobiles. The impact of ending the TALF scheme might only be psychological as the program was not utilized to a large degree.

What about those worries about inflation?

In 2009 as the U.S. economy reeled, some economists looking toward the then future recovery worried about inflation. Their concern was driven by the aggressive

stance of the Federal Reserve's monetary policy. They feared that once bank lending returned to normal, the money supply would increase dramatically thereby laying the foundations of inflation. In addition, they had other worries. These included large budget deficits which could be financed by printing money, a declining dollar and the inflationary effect on import prices, rising commodity prices, and increased government support for organized labor.

Today, such worries appear to have been premature. Inflation has declined rather than increased and one could be forgiven for fearing deflation at this point in time. Consider the factors that influence the rate of inflation. First, the money supply is not rising rapidly. Bank lending remains weak and credit growth is constrained by the severe weakness in the market for securitized assets. This means that banks are not in a position to sell bundled loans to investors, thereby freeing assets for the creation of more loans.

Second, the budget deficit, while big, has not been an issue. The government has had no difficulty in selling bonds to finance the deficit. This suggests that the markets are not yet concerned about the inflationary or other effects of government borrowing.

Third, the dollar has lately risen in value due to the weakness of the euro. As such, imported inflation looks to be a non-issue for now. Finally, commodity prices have gone nowhere lately. The price of oil has been relatively steady and is expected to remain so. Consequently, commodity inflation is not expected to create inflationary problems for the U.S. economy.

What about the consumer?

At more than 70 percent of GDP, consumer spending will play a critical role in the strength of the recovery. While no one is expecting the kind of rapid spending growth characteristic of the past decade (much of which was financed with debt), a modest improvement will be important. So far, this has not been the case. While spending rose moderately from January through April, it fell in seriously May.

Yet the picture for May changes when taking several factors into account. By excluding gasoline (which fell due to a drop in prices), autos (which fell due to the expiration of government subsidies), and building materials (which fell when the incentive for home buying expired), sales were flat on a year-over-year basis. Such core sales were also flat in April. In other words, consumer spending, having been boosted by the government, is now going nowhere.

Yet there are some indicators that suggest potential strength for the consumer. Measures of consumer confidence are rising, although they remain below historic averages. Consumer cash flow has dramatically improved after two years of paying down debts and increasing savings. Finally, there is clearly significant pent-up demand for consumer goods after a period of modest spending. So what is holding back the consumer?

Several factors are hurting the growth of spending. These include declining equity prices, weakness in the job market, poorer consumer credit conditions, and general uncertainty about the economy.

What next for the U.S. economy?

At this point in time, it appears likely that the U.S. economy will continue to grow and avoid a double-dip. But it also seems likely that growth will be somewhat slower than previously expected – at least for the remainder of 2010.

Beyond 2010, much will depend on the stance of policy and the impact of overseas events. As for policy, the low level of inflation provides room for the Fed to maintain a more aggressive stance. Fiscal policy is not likely to change much given the difficulty of passing new legislation. Overseas, Europe appears to be growing nicely despite the sovereign debt crisis. This means that U.S. exports to Europe should not be hurt. As for China, where growth might slow from very rapid to merely rapid, the impact of China's economy on the United States should not be negative.

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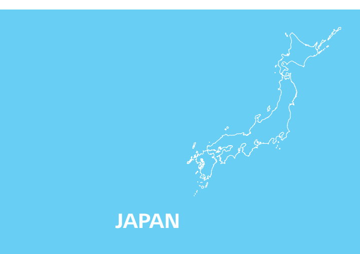


Japan: 2010 Rebound, 2011 slowdown

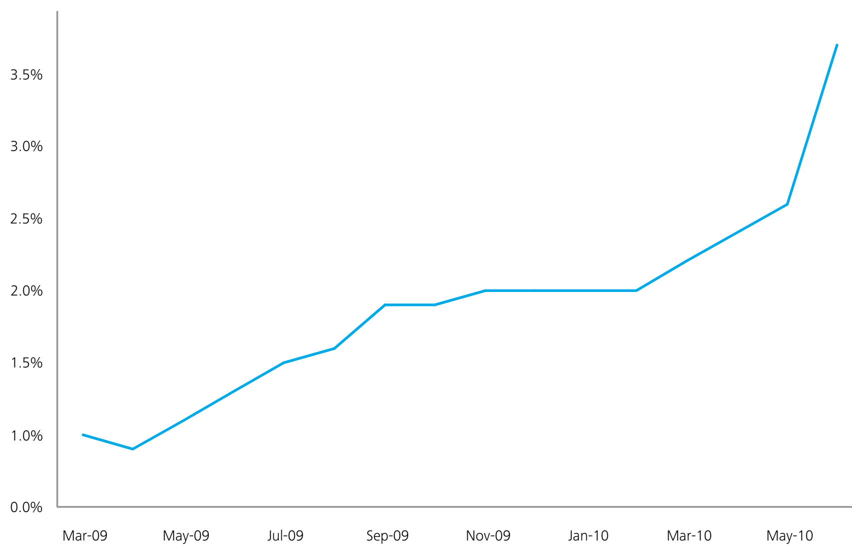
by Ian Stewart

- The outlook for Japanese growth has improved markedly in the last three months
- The recovery is being driven by

Japan is seeing a strong inventory- and export-led rebound in activity, with this performance driven by an upturn in the global cycle. Just as Japan's slowdown in 2008-2009 surprised in its intensity, so has the upturn proved stronger than expected.

exports and industrial output • After a strong rebound in growth in 2010, activity is likely to slow through 2011

Figure 1: Japanese GDP growth consensus forecasts for 2010



Source: The Economist and Consensus Economics

Exports and industrial production have bounced back strongly, leading economists to substantially revise up their forecast for Japanese growth this year (see figure 1). Consensus forecasts for 2010 GDP growth have almost tripled since the start of this year and now stand at 3.2 percent. If correct, this will be the fastest rate of growth Japan has experienced in 19 years. In addition, it will make Japan one of the world's fastest-growing economies this year, with a growth rate similar to the United States or Canada.

The impetus for Japan's rebound has come from a recovery in the global economy and, in particular, from improving demand in its principle export markets like the United States, China, South Korea, and Taiwan. Japanese exports rose by over 40 percent in the year to April, giving a strong impetus to industrial output.

So far the fallout from the Euro debt crisis and from increasing concerns about global growth have had little impact on the Japanese economy. Financial conditions have continued to ease: the overnight call rate remains at very low levels and firms' funding costs have fallen somewhat. Issuing conditions for commercial paper and corporate bonds remain good and even those for low-rated corporate bonds have improved. The Bank of Japan's benchmark Tankan survey of business confidence has continued to move upwards and in June reached the highest level in two years (figure 2).

While financial markets have focused on sovereign debt problems in Europe, Japan has one of the highest structural budget deficits in the world and an exceptionally high level of public debt to GDP.

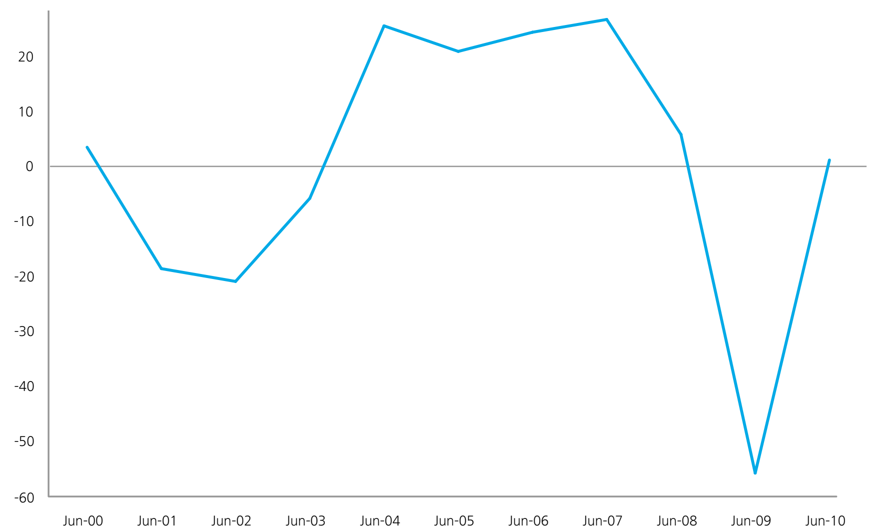
The key question remains whether Japan's recovery will spread out from the export sector to the domestic economy. Like its recession, Japan's recovery so far has reflected its dependence on exports. The strength of the rebound in industrial output and exports partly reflects the very depressed starting point. Last year Japanese industrial output hit a 25 year low and a rebound from these levels is bound to generate impressive rates of growth. With the trade-weighted Yen up almost 40 percent from its 2006 lows (figure 3), and growth in many of Japan's key markets likely to slow next year, the impetus to grow from exports will likely fade in 2011.

The news on domestic demand is mixed. Investment does seem to be picking up after last year's 19 percent contraction. But any recovery here is likely to be constrained for some time by the relatively high degree of slack in the economy. Private consumption is also recovering and this is reflected in recent improvements in retail sales and in consumer confidence. Employment and income growth have come under strong pressure in the last year although the squeeze here shows signs of abating.

Yet recent growth in consumer spending has been boosted by temporary spending subsidies. With these subsidies set to come to an end, and with unemployment above 5 percent (a high level by Japanese standards, see figure 4), growth in consumer spending is likely to slow into 2011.

While financial markets have focused on sovereign debt problems in Europe, Japan has one of the highest structural budget deficits in the world and an exceptionally high level of public debt to GDP. Europe's debt crisis has so far

Figure 2: Tankan business confidence index

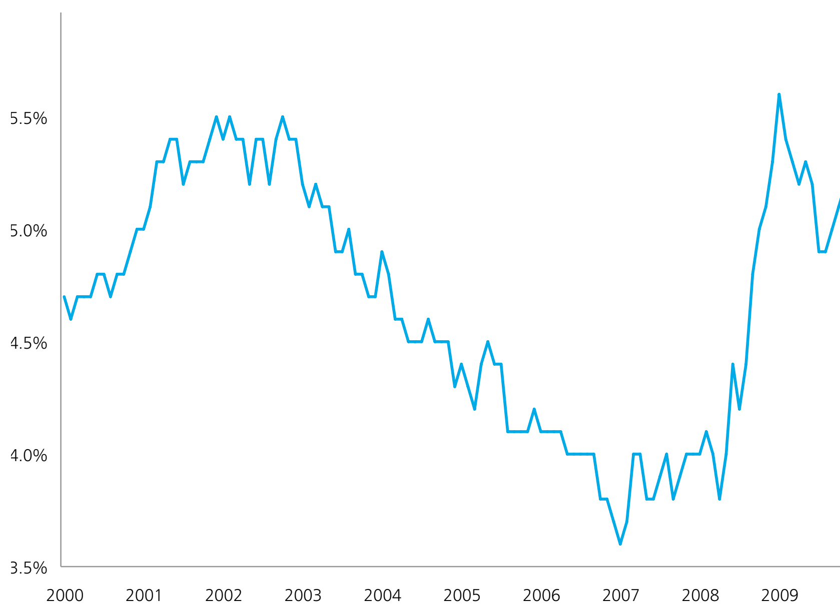


Source: Bank of Japan

Figure 3: Trade weighted Yen

Source: Datastream

Figure 4: Japanese unemployment rate, %



Source: Datastream

boosted the safe-haven appeal of Japanese bonds but the new government, under Mr. Naoto Kan, has signalled for more aggressive fiscal consolidation. Reflecting the scale of the challenge facing the authorities, the new government's target is to restore a primary budget balance by 2020/21 – in 10 years time.

With fiscal policy starting to tighten, the yen continuing to strengthen and interest rates near zero, the scope for conventional macroeconomic policy to provide much new stimulus to the economy is limited. But rather than launch a new wave of quantitative easing, through the purchase of corporate bonds or stocks, the Bank of Japan in June announced plans to make available $32 billion to commercial banks to lend to various industrial sectors.

Japan is likely to see a very strong recovery in 2010, with the economy expanding by over 3 percent. But with policy constrained and domestic demand likely to remain sluggish, we expect growth to slow to around half this rate in 2011.

CHINA

China: Finding the right balance

by Dr. Ira Kalish

Prices and property

Two of the biggest issues facing China at the moment involve prices. Specifically, there is concern about consumer prices and home prices. The first is in danger of accelerating and the second is in danger of collapsing. Either event, or more likely the policy response thereof, could derail the economic recovery. Let's consider the facts. First, inflation remains modest in China, with consumer prices up 3.1 percent in May over the previous year (although this is up from 2.2 percent in March). Yet the broad money supply was up almost 30 percent. Given that money supply influences inflation with an expected lag of about six to nine months, this bodes poorly for inflation later this year and early next. Moreover, the economy is clearly growing at or near the point of overheating. In May, exports were up 48.5 percent, the fastest pace in six years. At the same time, property prices are 12.4 percent over the previous year.

The authorities are clearly in a difficult situation. Tightening monetary policy risks bursting the property price bubble and dampening domestic demand. Lower property prices could also lead to increased bank losses. Yet failure to act adequately risks allowing inflation to get out of hand. In that case, more severe tightening and a consequent recession could be necessary by next year. In addition, excessively high property prices are making it difficult for ordinary Chinese to find affordable housing in China's big cities.

The Chinese authorities have begun to modestly tighten monetary policy. But is it enough? Some observers suggest that the easing of government stimulus will cause the economy to slow down. If this happens, it would point to less risk of inflation. Yet the strength of retail sales (up 18.5 percent in April) as well as the surprisingly strong export numbers suggest otherwise.

Wages and workers

The recent unrest at Chinese factories is not unprecedented. What is new about it is the degree to which the Chinese authorities are allowing such unrest to be publicized within China. The unrest itself clearly reflects the rising power of labor in a period of labor shortage. Most of the workers who were dismissed during the economic slowdown have been re-employed. Yet factories are not able to match labor supply with their rising demand. The result is that factories are raising wages, regional governments are requiring higher minimum wages, and many workers are expressing their frustration about compensation and work conditions through unrest and even suicide.

This situation actually represents a return to the conditions that existed just prior to the economic crisis. As recently as 2007, labor was in short supply at Chinese factories as the rising demand for labor outstripped the increasing supply. Then the economic crisis came, 20 million workers lost their jobs, and many returned to their ancestral homes in the interior of China. Now, many are choosing to stay put rather than returning to the coastal factories. Hence the shortage of labor in the factory towns of coastal China has arisen.

China's leaders are now worried about the implications for export revenue given that roughly 20 percent of China's exports go to the European Union.

During the boom years prior to 2008, wages were held down to some extent by the continuing and massive influx of rural workers into the big cities. This massive migration, perhaps the biggest in human history, provided an endless supply of cheap labor to the growing factory towns. During that period, however, the central government invested massively in infrastructure in China's interior with the hope of stimulating economic development. The result is that, today, decent jobs are far more plentiful in the interior and workers needn't move to the coast to find work.

What happens next? Wages are likely to rise considerably in the coastal cities. Low value-added production will become less profitable in such locations. Some such capacity will shift toward the interior (this is already happening) and some will shift to lower-wage countries such as India, Vietnam, and Indonesia among others. Meanwhile China's coastal cities will shift toward higher value-added output, taking advantage of the increasing supply of skilled and educated workers. This process will not be smooth. Hence, the unrest recently experienced may become more intense.

One question that arises is whether the rise in wages will significantly increase export prices. The answer is probably not. Labor costs represent a small share of the total cost of electronics products. While labor is a higher share of the cost of apparel and textiles, much of this capacity is already moving to lower wage locations.

Exchange rate concerns

China was probably on the verge of significant revaluation of its currency until the Eurozone crisis emerged. When the U.S. dollar appreciated significantly against the euro, it took the renminbi along as well given China's policy of fixing the renminbi-dollar exchange rate. China's leaders are now worried about the implications for export revenue given that roughly 20 percent of China's exports go to the European Union.

On the other hand, the fixed exchange rate policy is creating significant costs for China. These include increased political opposition in the United States and inflationary pressures at home. Consequently, China announced on June 19 (a Saturday) that it is adopting a more flexible exchange rate policy. Yet the following day China announced that the exchange rate will remain "basically stable." Hence, it is unclear as to how flexible the policy will be, if at all. It is entirely possible that China will not significantly revalue the renminbi against the dollar as this would push the renminbi to new and dangerous heights against the euro. The concern is that, after a significant drop in export revenue from Europe already, China cannot afford to be priced out of the European market.

The big question now is whether the new caution about the exchange rate is a temporary blip or a sustained policy shift. If it is the latter, then the chances that China will reduce its dependence on exports and shift toward

domestically driven growth are much lower. On the other hand, there is increasing talk in the U.S. Congress about imposing trade restrictions if China fails to revalue. Hence the Chinese authorities are in a difficult position regardless of what they choose to do.

The interesting thing, however, is that China's modest move initially caused excitement across Asia. The first response by other Asian countries was to allow their currencies to rise quickly against the dollar. Then, more sober analysis prevailed and markets calmed down. Yet China's action did create an expectation that, eventually, the Chinese currency will rise in value to a significant degree. For other Asian countries, this creates an opportunity to revalue their currencies against the dollar with impunity. The result would be disinflationary pressures, more stimulus to domestic demand, and continued competitiveness for exports sent to China.

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India: Testy rains, testing times

by Siddharth Ramalingam

In essence, if India must march on, inflation must fall. And if inflation must fall, the rains must fall.

Much of India's near-term economic fortunes will depend on the monsoons. If the rain gods should play truant, runaway food inflation, widespread outcry against the government's recent decision to decontrol petrol prices, and a large fiscal deficit will most likely dampen the euphoria around India's resilience against the global economic downturn.

Last year's good news

Prompting a celebration of the Indian economy in the past few months has been the upward revision of the 2009-2010 GDP growth estimate by the Central Statistical Organization from 7.2 to 7.4 percent. The improvement in the economy was largely driven by a surge in manufacturing and mining activity during the last two quarters of the 2009-2010 fiscal year. Early indications are that manufacturing is continuing to grow, and exports are beginning to pick up as well, lending credence to the view that there is truly a strong underlying growth story. Higher than anticipated growth was also seen in the agricultural sector, but the 0.2 percent increase is still sluggish and a continued lackluster performance on the agricultural front can significantly undermine the country's growth.

The monsoon effect

The agricultural sector accounts for about 15 percent of India's national income and is dependent primarily on the monsoon for irrigation. A successful monsoon is a must if the economy is to grow at the forecast rate of over 8 percent. Thus far, rainfall has been 16-24 percent below average. The meteorological department has, however, forecasted normal rainfall over the full course of the monsoon season. If the monsoons should fail, we can expect a downward revision of economic forecasts. Since the sector's forward economic linkages are significant, a failed monsoon will likely lead to the ballooning of already high inflation.

Inflation and policy ramifications

Driven largely by skyrocketing food prices, rising inflation has threatened to derail both government reform and the economic stimulus program. Food price inflation has been heading northwards at an alarming pace due to supply bottlenecks. The wholesale price index touched 10.6 percent in May and retail food price inflation was 16.9 percent in the second week of June. The uncertainty around the monsoon is only stoking the price rise. While it

is plausible that inflation may fall in the short term as a result of the government's announcement that the monsoon will likely yield normal rainfall, what will transpire between now and the end of the monsoon is anyone's call.

In February, the government announced a target deficit of 5.5 percent of GDP for the current fiscal year. The government, as in the past, has announced a policy of privatization to generate revenue to bridge the fiscal gap. Proceeds from privatization will not in itself help the government bridge the fiscal deficit. That being said, a major windfall has come the government's way through the auction of 3G and Broadband telecom spectrums. While the roughly INR 1 billion will go a long way toward reducing the fiscal deficit, the efficacy of collecting and accounting for the proceeds of the sale in one year is suspect.

In a bold move to correct long-term fiscal imbalances, the government decontrolled petrol prices in the last week of June, paving the way for the market to determine the price for petrol. It raised prices of cooking gas, petroleum, and diesel as well. This unprecedented move will most likely save the government significant amounts it would otherwise have spent on subsidizing petrol prices, and will also help improve energy efficiency. That the government is committed to reducing the fiscal deficit is clear given that it is holding fast on its decision to decontrol petrol prices despite rancorous protests by opposition parties.

There are downsides to the government's move to free prices though. The government has decontrolled only the price of petrol. It will still have to provide significant subsidies on diesel, kerosene, and cooking gas. And if petroleum prices were to increase to 2009 highs, the government will likely step in to control petrol prices. More importantly, the freeing of petroleum prices will, at current price levels, add to the already burgeoning inflation. So, the decontrolling is partial at best, and possibly poorly timed.

With the freeing of petrol prices expected to drive inflation up by as much as 100 basis points, and opposition parties snapping at the heels of the ruling government and policy makers, the Reserve Bank of India was compelled to act. The central bank increased interest rates by 25 basis points in the first week of July, taking the total rate increase this year to 75 basis points.

Why the rains must fall

Just days before the central bank announced its rate increase, the country's largest public sector bank ushered in a new lending rate regime known as the base rate system; the bank will not lend to any customer below this rate. Within days, 80 banks migrated to the new system, with the range for base rates registering at 7 to 8.75 percent across banks. Retail customers' cost of funds is the same under the new regime. However, the increase in rates by the central bank and the prospect of a further increase at the bank's policy review will likely lead to an upward revision of base rates. This will result in an increase in the cost of funds for consumers. And if inflation continues to be high, it is not inconceivable that the central bank will further increase rates, leading to upward revisions in base rates. Household sector final consumption and investment expenditure could fall as a result.

With preferential rates out of the question under the base rate regime, businesses will no longer enjoy a low cost of funds, and will also be forced to go to the commercial paper market for short-term funds. And any future increase in the base rate will only progressively increase the cost of funds for businesses. With money markets currently short on liquidity, a lot depends on the business sector, especially the manufacturing sector's resilience in the medium-term.

In essence, if India must march on, inflation must fall. And if inflation must fall, the rains must fall.

United Kingdom: Confidence dips

by Ian Stewart

- **U.K. business confidence has dipped as worries about a renewed weak patch in the recovery have mounted**
- **The new government's Emergency Budget has outlined a more aggressive program of fiscal retrenchment and has reduced the already low probability of a Greek-style debt crisis**
- **The most likely outlook remains for a sluggish, erratic but continuing recovery**

In the last edition of the *Global Economic Outlook* we observed that "doubts persist about the pace and sustainability" of the U.K. recovery. Despite solid and broad-based growth in output in the first quarter, those doubts have mounted in recent months. CFO optimism as recorded by the Deloitte CFO Survey* dropped sharply in the second quarter, declining to the lowest level in a year (Figure 1). Meanwhile, U.K. CFOs have edged up the probability they assign to a double-dip in growth from 33 percent in the first quarter to 38 percent today.

A series of factors are weighing on sentiment in the United Kingdom.

Fiscal tightening at home, the most severe since the 1920s, is widely expected to slow the recovery. Two-thirds of U.K. CFOs expect tighter fiscal policy to have negative effects on their company in the short term, particularly relating to concerns about reduced consumer spending and job losses in the public sector.

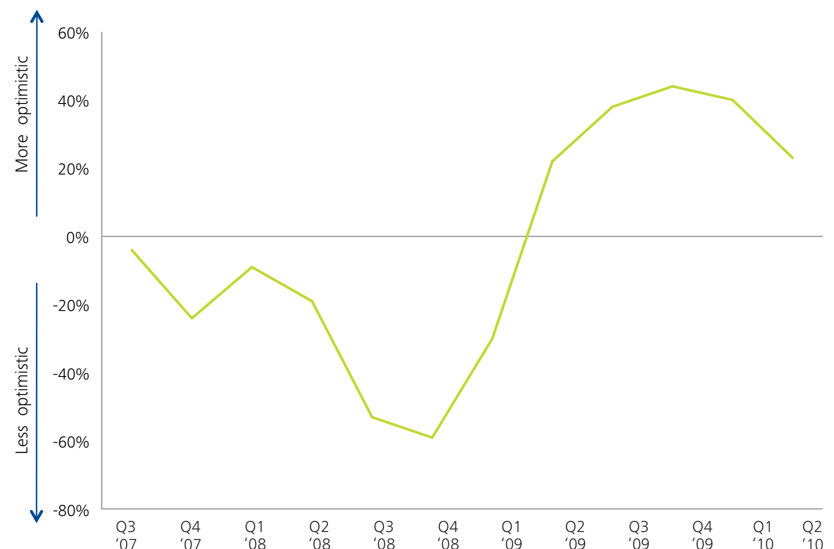
Meanwhile, the global outlook remains uncertain. The Eurozone debt crisis has led to renewed fears about the resilience of the Euro area banks. An anaemic Eurozone recovery threatens U.K. exports to the region and this is widely seen as one of the main channels for the U.K. recovery. Given the high degree of correlation between national financial markets, weakness and volatility in Euro area markets has also been swiftly transmitted to U.K. financial markets.

Signs of a slowdown in China's economy and worries that the global inventory cycle has peaked have also prompted fears that the United Kingdom may be heading for a double-dip.

Yet the news from the United Kingdom is not uniformly bad. The outlook for growth in the periphery of the Euro area is poor, but growth in Northern Europe is better and prospects outside of Europe have improved in recent months. Consensus or average forecasts for global growth have risen between April and June from 3.9 to 4.2 percent.

Figure 1: Financial prospects

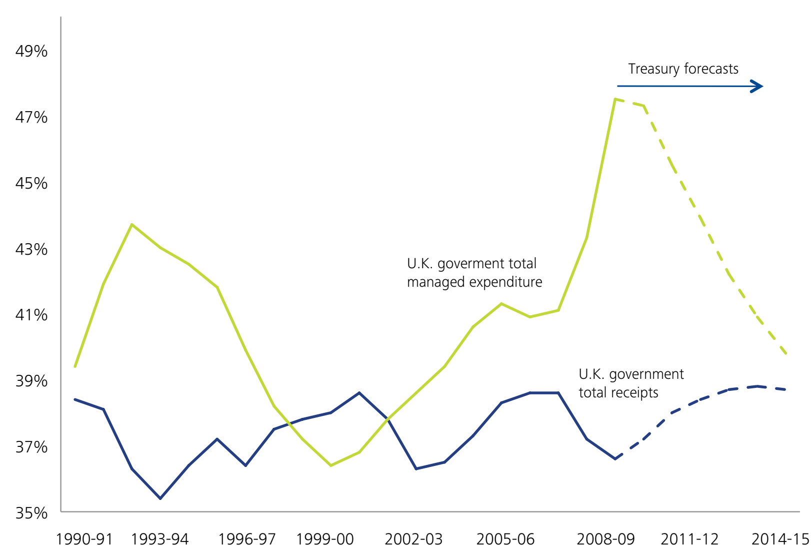
Net % of CFOs who are more optimistic about financial prospects for their company now than three months ago



*Source: Deloitte U.K. CFO Survey

*The Deloitte CFO Survey was conducted by Deloitte LLP, the U.K. member firm of DTT

Figure 2: Fiscal squeeze
U.K. public expenditure/receipts as a % of GDP



Source: Emergency Budget forecasts, HM Treasury

Fiscal tightening looms, but a new, more aggressive plan for fiscal consolidation (figure 2) has boosted the United Kingdom's credibility with bond investors and the ratings agencies. In doing so, it has helped depress U.K. government bond yields and reduced the already low probability of the United Kingdom suffering a Greek-style crisis. Despite the barrage of bad news on the U.K.'s public finances, the borrowing numbers have come in on the low side of expectations in recent months. Economists have revised down their forecasts for borrowing in 2010/11 by 18 percent in the last year. Shrinking the deficit will be a huge task, but from now on there are likely to be fewer nasty fiscal surprises.

Of course the central issue is whether the new Budget measures will derail the recovery.

The classic Keynesian view is that fiscal consolidation takes spending power out of the economy and hits growth. In this view, lower public spending and higher taxes means a weaker economy.

The actual numbers involved in the Emergency Budget do not look large enough to transform the growth picture. Extra fiscal tightening announced this year – £8.1 billion in 2010/11 – is equal to about 0.6 percent of GDP. The extra planned tightening for next year is equal to 1.1 percent of GDP, but by then the United Kingdom is likely to be growing at a rather stronger rate.

More fundamentally, there is an alternative view to that held by Keynsians. This emphasizes the importance of private sector expectations. A fiscal squeeze that is seen by the private sector as representing a permanent shrinkage of government leads consumers and corporates to reduce their estimate of the future tax burden. The resulting rise in expected future income enables people and businesses to raise spending now and in the future. Counterintuitively, this theory says that a fiscal contraction can boost growth.

This can happen. Looking at Denmark's success in cutting its budget deficit and boosting growth in the 1980s, one study noted, "The Danish experience shows that cuts in government spending can be associated with increases in consumption...even in the presence of a substantial increase in current taxes."[1]

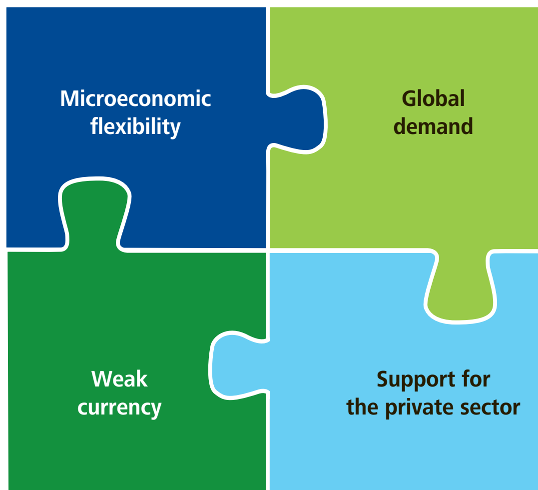
The authors conclude that the most plausible reason for the strength of the surge in Danish private sector spending was the belief that government and taxes were shrinking for good. As a result Danish consumers and corporates started spending their higher future incomes even as government spending was falling.

This holds an important lesson for politicians today. The key to keeping growth going during a period of fiscal austerity is to grow the private sector. The United Kingdom's new government seems to have taken this lesson to heart. In rhetoric and measures the Emergency Budget was pro-business, with a modest shift in the burden of tax from corporates to consumers. Overall, the government estimates that 77 percent of the planned fiscal adjustment will come from cuts in spending and 23 percent from tax rises.

Economies such as Denmark, Sweden, or Canada, which have successfully shrunk public deficits and maintained

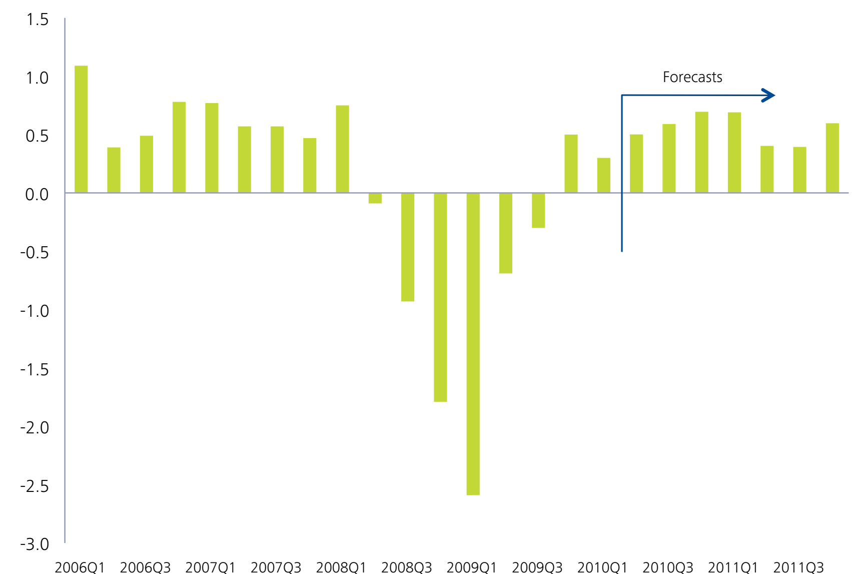
[1]Francesco Giavazzi, Marco Pagano, *Can Severe Fiscal Contractions be Expansionary? Tales of Two Small European Countries*, NBER Working Paper No. 3372, May 1990

Figure 3: Factors supporting growth during fiscal consolidation



Source: Economics & Markets, Deloitte Research, London

Figure 4: OBR forecast
U.K. GDP growth YoY



Source: ONS, Office for Budget Responsibility and Deloitte calculations

growth, generally have a number of important characteristics (figure 3). They are flexible economies and have governments that sought to bolster the private sector, often with tax cuts. A weak currency and strong overseas demand were also important in helping offset shrinking public expenditure. The United Kingdom scores reasonably well on these sorts of criteria, something which offers hope that fiscal austerity can be combined with economic growth.

The independent Office of Budget Responsibility (OBR) provides us with the most credible estimate of the effect of the budget on activity. The OBR has cut its 2010 GDP forecast from 1.3 to 1.2 percent and its 2011 forecast from 2.6 to 2.3 percent in the wake of the budget (figure 4). The market consensus is that this will be a sluggish but sustained U.K. recovery - the budget is unlikely to change that view.

The Bank of England, however, is likely to see the scale of the coming squeeze as justifying a prolonged period of very low interest rates. In the last three months, financial markets have significantly pushed back their estimate of the magnitude and timing of U.K. rate hikes. Futures markets now expect three-month interbank interest rates to stay below 3 percent for the next three years – a remarkably long period of ultra-low interest rates.

A slow process of financial repair is continuing. Credit conditions for corporates and consumers have improved significantly in the last year. Indeed, CFO sentiment about the availability of credit is now more positive than at any time since the Deloitte CFO Survey* started in the third quarter of 2007. Remarkably, bank borrowing has regained its pre-recession appeal as a source of funding for CFOs.

Corporates remain firmly focussed on controlling costs, but, in a sign that the liquidity crisis for corporates is continuing to abate, boosting cash flow has dropped down CFOs' priority list for the next year. Crucially, growth strategies, including capital spending, expanding into new markets, and launching new products and services, have shifted up the list of CFOs' priorities since the start of the year.

The United Kingdom is switching from a period of growth driven by government and the consumer to one led by exports, capital spending, and industrial output. It is unlikely to be an easy or smooth transition. The most likely outlook remains for a sluggish, erratic but continuing recovery.

*The Deloitte CFO Survey was conducted by Deloitte LLP, the U.K. member firm of DTT

Russia: Rebound gains momentum

by Dr. Elisabeth Denison

The Russian economy suffered a sharp contraction in 2009. After a bumpy start to 2010, the recovery gained momentum in the second quarter. Economic activity is underpinned by rising external demand and the delayed impact of the government's stimulus package and lower interest rates. The budget has benefited from higher oil prices, but fiscal consolidation remains important in the medium term. In the longer term, the government is challenged to introduce exchange rate flexibility and more openness in trade to diversify its economy away from natural resources for sustainable growth.

Industrial production on the rebound

The Russian economy was hit by the global financial crisis and lower oil prices in 2009, with output contracting by 7.9 percent. While the first quarter of 2010 disappointed with a relatively lackluster performance, recent statistics display much more positive dynamics. Manufacturing is taking the lead, with industrial production expanding by 12.6 percent year-on-year in May, following a 10.4 percent gain in April (see figure 1). Even though year-on-year growth is exaggerated somewhat by a weak base in 2009, month-on-month production rose by 1.4 percent after edging up 0.6 percent in April (seasonally-adjusted).

The manufacturing rebound is driven, in part, by a pickup in exports. However, the Russian export base is still not diversified enough to fully benefit from growth in other parts of the world – particularly other BRIC nations and emerging Asia. Its main exports remain products and services related to natural resources.

President Medvedev is aware of the necessity to change Russia's role in the global economy if it wants to avoid the fate of countries like Saudi Arabia, which is having difficulty diversifying its economy away from oil and gas. "Medvedev knows Russia will become an even less competitive country unless it diversifies and modernizes," says Robert Service, senior fellow at the Hoover Institute.

Finally joining the World Trade Organization (WTO) will help that transformation along and analysts think that President Obama's recent pledge to help Russia complete its 17-year mission may be just enough to get the deal done. On that point, President Medvedev appears to have won a power struggle with Prime Minister Putin, whose previous comments suggested he had cooled over the prospect of joining the WTO.

Recovery in domestic demand

Next to exports, domestic demand is becoming another pillar of support for the Russian economy. With rising real wages and incomes, household consumption has begun to contribute to the recovery. Retail trade was up 4.2 percent in April from a year ago, while the transport and communication sectors reported an increase of 14.8 percent. Even the construction sector, depressed for almost two years, shows signs of recovery. The construction of residential housing is up 16.2 percent year-on-year.

Figure 1: Recovery of the Russian industrial sector
Industrial production, YoY%

Source: Bloomberg

Business spending, however, remains depressed. Fixed capital investment fell another 4.7 percent in the first quarter of 2010 compared with the same period a year ago. The decline from an already low base indicates that the majority of companies have not returned to an active investment strategy. Instead, most enterprises seem instead to be focused on increasing the utilization of existing capacity and restocking inventories to meet potential further increases in demand.

However, there is hope that with strengthening consumer demand and rising exports, business spending will start to pick up soon as well. Russia is one of the least indebted industrialized nations and national savings are relatively high at nearly 29 percent of GDP. The drop in public savings last year was offset to some extent by an increase in private sector savings. With falling inflation, higher real returns and a stable ruble, there is a better chance for these savings to be re-invested in the economy.

Monetary policy

In terms of monetary policy, the Russian Central Bank (RCB) has been acting against the global trend. When the global financial crisis began in September 2008 and global central banks slashed their rates at an accelerated schedule, the RCB had to raise its rates to 13 percent to limit capital flight and support the ruble. The easing cycle started in April 2009 and continued through the start of June 2010, when the refinancing rate was cut for the 14th straight time to 7.75 percent - despite the fact that a number of central banks around the world have started to tighten.

With the apparent recovery of the economy, however, the RCB decided to keep rates on hold in early July. It indicated that it has provided enough monetary stimulus for the time being and inflation remains a concern. While no longer in double-digits, inflation has stopped declining and remains elevated at over 4 percent.

The RCB has expressed an interest in moving towards a floating exchange rate regime over the next 12-18 months, which would imply a greater monetary policy focus on reducing inflation. However, such a decision will require support from the government, which is concerned that too great an appreciation of the ruble will damage competitiveness.

Conclusion

The overall picture of a rather muted recovery in Russia earlier in the year is in need of an update. Real economic

activity has picked up in recent months and leading indicators point to further improvement in dynamics ahead. Most forecasters expect growth of between 3.5 and 4.5 percent for 2010. The OECD recently raised its prediction to 5.5 percent.

But even if fundamentals are looking up, all will not be smooth sailing in coming months. As 2008 made clear, the globalized economy has become too interdependent for a country like Russia to remain untouched by a possible deterioration in prospects in advanced economies or another financial market upset.

Meanwhile, the government still has important homework to do. First it needs to rein in its budget: It is now spending an additional $100 billion a year of its oil and gas export revenue than before the crisis. Secondly – and importantly – it needs to continue on its path to liberalization and diversification. Russia's reliance on the energy sector remains a key macroeconomic risk, weighing on the country's long-term growth prospects.

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Brazil: How fast can the country grow?

by Dr. Ira Kalish

Is Brazil overheating? The country is experiencing strong consumer-led economic growth while inflation is a bit higher than desired. In the first quarter of 2010, economic growth was over 9 percent on an annualized basis. Conventional wisdom is that the country can grow at a rate of roughly 5 to 6 percent before starting to fuel inflation. Many forecasters are now expecting economic growth in 2010 to be in the range of 6 to 7 percent. Meanwhile inflation is running above 5 percent while the central bank's target is 4.5 percent. Thus, an unsustainable situation appears to be developing.

Although there has been very modest fiscal tightening, nothing significant is likely to happen prior to the presidential election set for October. Instead, monetary policy will be the principal tool for cooling off the economy. Already, the independent central bank has increased the base rate twice this year. Yet tighter monetary policy creates the risk of pushing the already elevated currency even higher. Moreover, interest rates in the neighborhood of 10 percent reduce business investment. The fact that the economy is being led by consumer spending raises a question as to the sustainability of the recovery. Finally, a higher currency hurts the competitiveness of non-commodity exports and further stimulates consumer spending. On the other hand, the country has a large stock of foreign currency reserves which will be helpful in the event that a high-valued currency damages the trade balance. The good thing about currency appreciation is that it tends to suppress inflationary pressures.

The policy mix

Going forward, reliance on monetary policy alone will be detrimental to long-term growth. If Brazil is to keep inflation low without onerous interest rates and exchange rates, fiscal policy will have to be tighter. The issue, then, is whether the next administration will enact more stringent fiscal consolidation. If it does, reduced government borrowing will allow for lower interest rates. The negative effects of fiscal consolidation on economic growth could then be offset by a loosening of monetary policy. Another issue is the composition of government spending. Recently, there has been faster growth of spending on payrolls than on investment, while the opposite would be preferable. One area of weakness for Brazil is infrastructure and further investment here would help long-term growth.

For now, the government appears to be achieving its modest fiscal policy goals. While spending has been moderately restrained, tax revenue has been substantially boosted by economic recovery. The result is a primary surplus close to target and a debt to GDP ratio of 60 percent, modest by the standards of many rich nations. The debt to GDP ratio is even expected to decline in the next several years. As such, Brazil is in a reasonably good fiscal position.

Given the current mix of policies, it is expected that the breakneck pace of growth will decline and that economic growth in 2011 will be lower than in 2010.

What about the longer-term?

Today, there is considerable optimism both in and out of Brazil about the country's long-term prospects. This is due to several factors such as the consistency of government policy, the sustained reduction in inflation (unusual compared to Brazil's long history), political and social stability, a rising middle class, and the prospect of becoming an oil exporter. In addition, the euphoria that often greets great events – in this case the upcoming Olympics and FIFA World Cup games that will take place in Brazil in the coming years – further advances the country's prospects.

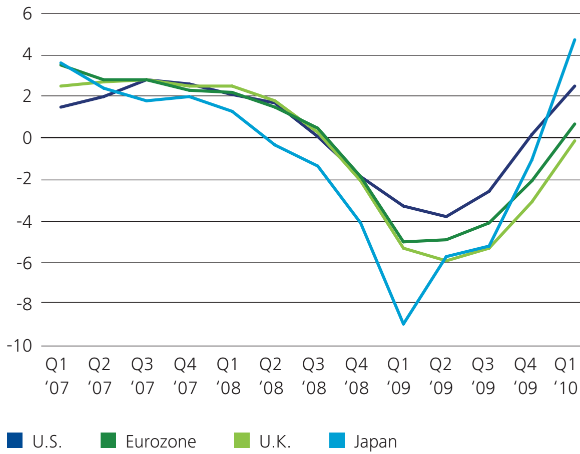
Is the optimism justified? Often, optimism itself can create the conditions about which people are optimistic. For example, optimism has fueled a large amount of direct investment into Brazil. In the coming years, that investment will yield stronger gains in industrial output, productivity, and exports.

In addition, the rise of China has had a positive impact on Brazil. China's propensity to import has fueled Brazilian commodity and manufactured exports. In addition, China's move up the value chains is making Brazil an increasingly attractive location for lower value-added exports of manufactures. Finally, China's rise has boosted the prices of the commodities that Brazil has in abundance.

On the other hand, there is concern in the business community that the next government will take a more statist approach to economic development and that this would be harmful to productivity growth. Thus, it appears that Brazil's longer term fortunes will be determined by a mix of policy, foreign events, and business sentiment.

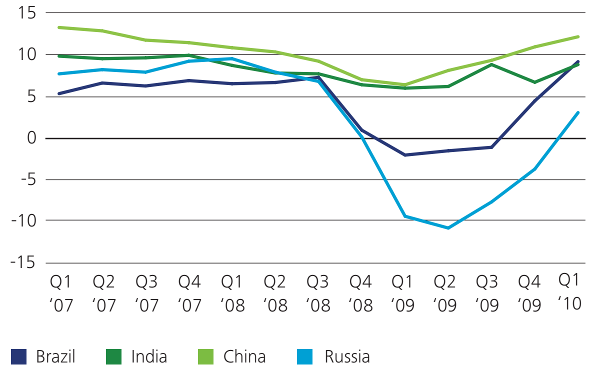
Appendix

GDP growth rates (YoY%)



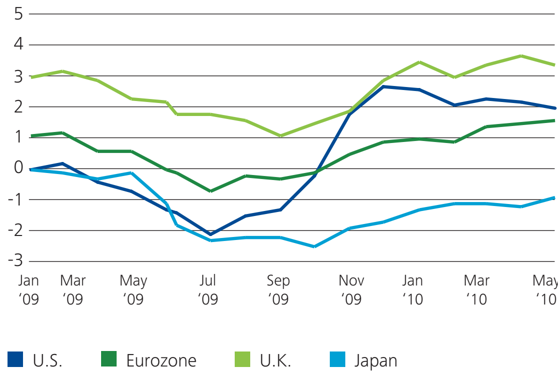
Source: Bloomberg

GDP growth rates (YoY%)



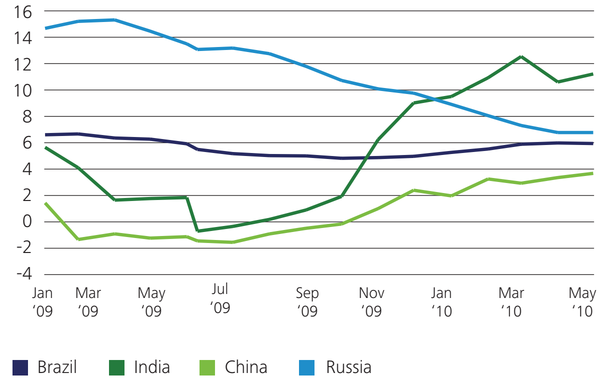
Note: India's fiscal year is April – March
Source: Bloomberg

Inflation rates (YoY%)



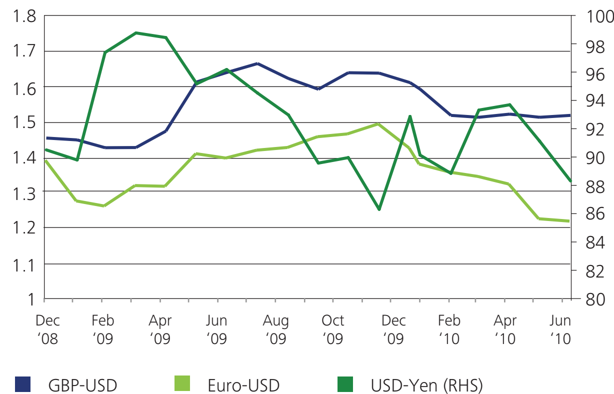
Source: Bloomberg

Inflation rates (YoY%)



Source: Bloomberg

Major currencies vs. the U.S. dollar



Source: Bloomberg

Yield curves (as of July 08, 2010)*

	U.S. Treasury Bonds & Notes	U.K. Gifts	Eurozone Govt. Benchmark	Japan Sovereign	Brazil Govt. Benchmark	China Sovereign	India Govt. Actives	Russia
3 Months	0.16	0.59	0.28	0.12	10.96	1.80	5.33	
1 Year	0.29	0.59	0.65	1.14	11.72	1.94	5.76	2.25
5 Years	1.79	2.06	1.53	0.36	12.156 (4 years)	2.62	7.36	
10 Years	2.99	3.36	2.61	1.15	12.169 (7 years)	3.29	7.59	6.347 (9 years)

Composite median GDP Forecasts (as of July 08, 2010)*†

	U.S.	U.K.	Eurozone	Japan	Brazil	China	Russia
2010	3.2	1.2	1.05	3.2	6.55	10.1	4.05
2011	2.9	2	1.3	1.7	4.5	9.25	4.2
2012	3.05	2.45	1.6		4.5		4.5

Composite median currency forecasts (as of July 08, 2010)*

	Q3 10	Q4 10	Q1 11	Q2 11	2011	2012
GBP-USD	1.44	1.44	1.47	1.48	1.52	1.53
Euro-USD	1.2	1.19	1.19	1.2	1.21	1.3
USD-Yen	94	96	100	102	105	107.5
USD-Brazilian Real	1.82	1.8	1.79	1.73	1.8	1.85
USD-Chinese Yuan	6.75	6.7	6.63	6.55	6.5	6.41
USD-Indian Rupee	45.5	44.41	43.95	43.45	43	41.5
USD-Russian Ruble	30.89	30.73	30.62	30.42	30	30.14

OECD Composite leading indicators (amplitude adjusted)

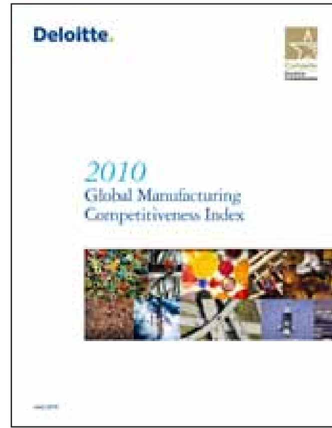
	U.S.	U.K.	Euro area	Japan	Brazil	China	India	Russia
June 2008	100.50	98.60	99.00	101.80	106.10	97.00	100.30	105.10
July 2008	99.60	97.70	97.90	101.10	103.10	96.10	99.50	103.00
August 2008	98.30	96.60	96.70	100.10	99.40	95.10	98.50	100.20
September 2008	96.60	95.60	95.30	98.70	95.30	94.20	97.40	96.80
October 2008	94.80	94.70	94.00	97.10	91.10	93.60	96.20	93.10
November 2008	92.90	93.90	92.80	95.30	87.60	93.40	95.10	89.90
December 2008	91.40	93.50	92.00	93.70	85.30	93.70	94.30	87.60
January 2009	90.30	93.30	91.70	92.30	84.40	94.60	94.00	86.50
February 2009	89.90	93.40	91.80	91.40	84.70	96.00	94.20	86.30
March 2009	90.00	93.80	92.50	91.10	86.10	97.50	94.70	86.90
April 2009	90.80	94.70	93.50	91.50	88.20	98.90	95.50	88.00
May 2009	91.90	95.70	94.90	92.20	90.50	100.10	96.40	89.70
June 2009	93.20	97.00	96.30	93.20	92.80	101.10	97.20	91.80
July 2009	94.60	98.40	97.80	94.40	94.80	101.90	97.80	93.90
August 2009	95.90	99.80	99.20	95.60	96.40	102.40	98.20	95.90
September 2009	97.10	101.20	100.40	96.90	97.60	102.80	98.60	97.60
October 2009	98.30	102.30	101.40	98.10	98.60	103.00	99.00	98.80
November 2009	99.30	103.10	102.30	99.30	99.20	103.00	99.50	99.80
December 2009	100.40	103.70	103.00	100.50	99.70	102.90	100.00	100.50
January 2010	101.30	104.20	103.60	101.60	100.10	102.70	100.40	101.10
February 2010	102.20	104.50	104.00	102.40	100.40	102.40	100.80	101.60
March 2010	103.00	104.70	104.40	103.10	100.50	102.00	101.10	102.10
April 2010	103.60	104.80	104.70	103.70	100.60	101.60	101.40	102.70

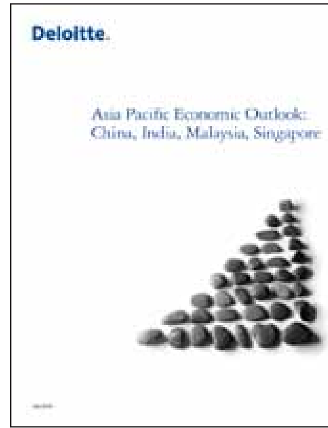
Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100.

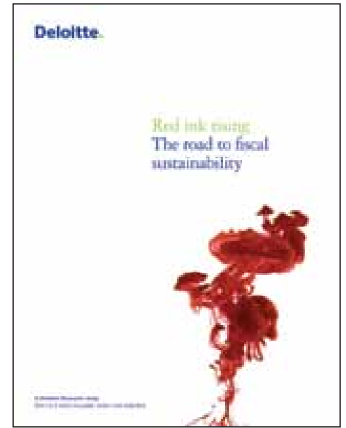
Source: OECD

*Source: Bloomberg †No data for India in Bloomberg

Additional resources







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