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Global economic outlook, winter 2010: the first snowdrops are blooming

This study was prepared under the authority of the Directorate General of the Treasury (DG Trésor) and does not necessarily reflect the position of the Ministry for the Economy, Industry and Employment.

- After the great recession of 2008-2009, global activity stabilized in the spring of 2009 and picked up in the summer, when most economies emerged from recession. But the recovery is fragile: in Q4 2009, when the rebound was confirmed in the United States and Japan, activity faltered in most European countries.

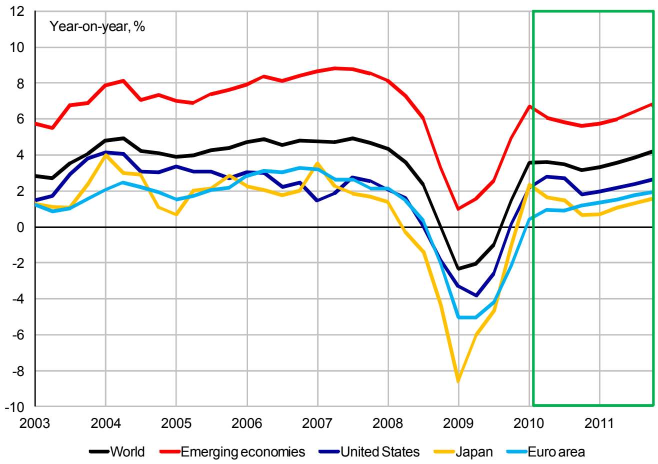
- The economic rebound has been so far driven by stimulus plans and the inversion of the inventory cycle. But conditions now favour the emergence of a gradual recovery led by world trade, which benefits from vigorous demand in emerging countries. Inflation is contained, except in Japan where it is expected to remain negative.

- Domestic imbalances, however, are a constraint to the recovery in the medium term. Since 2000, economic growth in the U.S., the U.K. and Spain has been based on a strong expansion of credit to households, primarily mortgage loans. Also, European firms often financed their investments with excessive debt leverage. Most governments turned to borrowing, piling public debt on top of private debt. Absorbing these imbalances will take considerable time, as households cope with unemployment and negative real-estate wealth effects, and firms are burdened by large unutilized capacities and modest demand-which fail to create an incentive to invest despite higher margin rates.

- A lower-than-expected saving rate and a stronger rebound on financial markets could fuel a sharper pickup. On the other hand, deepening global imbalances or greater deflationary pressures would increase the downside risk to the economy.

- 2009 saw a great recession, but also the start of the recovery: global GDP fell 1.0% in 2009, and should now rise by 3.4% in 2010 and 3.7% in 2011.

International environment: GDP growth



Sources: National accounts, OECD, DG Trésor forecasts

MINISTÈRE DE L'ÉCONOMIE
DE L'INDUSTRIE ET DE L'EMPLOI

1. A break in the clouds

1.1 The second half of 2009 witnessed a ray of hope for the international economy

The major developed economies emerged from recession in the second half of 2009. Only Spain, which is suffering from major imbalances, is still mired in recession, as GDP fell for the sixth straight quarter in Q4 2009. And Italy has not fully moved ahead with recovery, as the satisfactory third quarter was followed by a slight contraction in GDP in Q4.[1] In the United Kingdom, after six straight quarters of falling GDP, the economy stabilized in the last quarter of 2009. Germany and France had exited recession earlier, in Q2. Activity remained strong through the end of the year in France, but the economy marked time in Germany. National trajectories in the EU are thus seen to be heterogeneous, fragile and bumpy. The same holds for Japan, where the economy, after a sluggish Q3, picked up in Q4. The U.S. is currently the only exception to the rule, as the Q3 rebound in activity was confirmed in Q4.

Table 1: Recent changes in GDP (volume, %)

	Q1 2009	Q2 2009	Q3 2009	Q4 2009	2009	2010 (carry-over)
Euro area	−2.5	−0.1	0.4	0.1	−4.0	0.3
Germany	−3.5	0.4	0.7	0.0	−4.9	0.5
France	−1.4	0.3	0.2	0.6	−2.2	0.6
Italy	−2.7	−0.5	0.6	−0.2	−4.9	0.0
Spain	−1.7	−1.0	−0.3	−0.1	−3.6	−0.5
Belgium	−1.7	−0.1	0.7	0.3	−3.0	0.6
Netherlands	−2.3	−1.1	0.5	0.3	−4.0	0.2
Greece	−1.0	−0.3	−0.5	−0.8	−2.0	−0.9
Ireland	−2.1	−0.6	0.4		−6.8	0.0
Portugal	−2.0	0.5	0.7	0.0	−2.8	0.5
United States	−1.6	−0.2	0.6	1.4	−2.4	1.3
Japan	−3.2	1.3	0.0	1.1	−5.1	1.2
United Kingdom	−2.5	−0.7	−0.2	0.1	−4.8	−0.2

Sources: National accounts, OECD, DG Trésor forecasts

1.2 Improvement factors are, for the time being, temporary

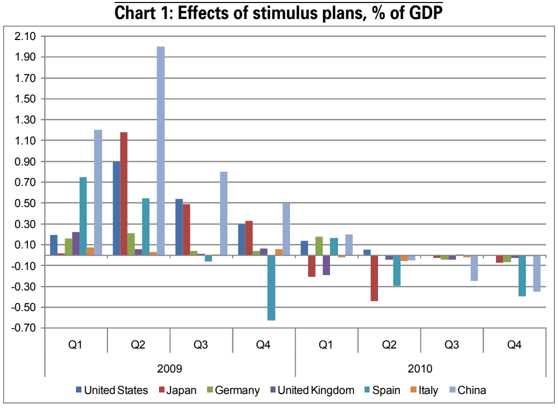
The current improvement is attributable first to governments' implementation of fiscal stimulus packages, which aimed to limit the size of the recession, and then to foster the emergence of a recovery (Box 1). Since mid-2009, further measures have been announced to consolidate the first encouraging signs that appeared in early summer; these measures include the extension of unemployment insurance benefits and tax credits for first-time homebuyers in the United States; an extension of unemployment benefit, reduction in company tax rate, and a lower VAT rate on hotel rooms in Germany; the extension of unemployment benefit and a public investment fund allocated to municipalities in Spain; and the vote on a fifth stimulus package in Japan. The stimulus plans appear to have particularly boosted activity in Q2 and Q3 2009. The measures are temporary, and their withdrawal, even if gradual, should have negative repercussions on growth in the main Western economies and Asia starting in Q1 2010.

Box 1: **Effects of stimulus plans[a]**

The effectiveness of stimulus plans depends less on the amounts committed than on their content. The impact of a stimulus package will differ depending on whether it targets consumption or public investment, through direct transfers to households or support for business investment, as the multipliers associated with the outlays differ. What's more, the multipliers are very sensitive to the elasticity of domestic demand for imports: stimulus increases domestic demand, part of which can be supplied by additional imports; the higher the elasticity, the higher the ensuing import leakage effects (i.e., reduction in the multipliers).

Both in terms of the amounts announced and relative to GDP, China's plan appears to be the largest, exceeding those in U.S., Germany and Japan. The effectiveness of Germany's plan is impaired by high import leakage. This would make the Chinese, American and Japanese plans the most efficient in terms of activity: because they focus more on public investment and public consumption, domestic demand is stimulated more strongly and import leakages are reduced.

Chart 1: Effects of stimulus plans, % of GDP



Source: DG Trésor calculations

The effects of the stimulus plans are concentrated in the second and third quarters of 2009 (and also in Q1 2009 for China's stimulus plan). Pullback effects, as the stimulus is withdrawn, are therefore expected to affect activity as early as 2010, particularly in Spain, as well as the UK, and to a lesser extent Italy.

a. These estimates are revised from those published in Trésor-Economics No. 66, October 2009. The method is unchanged.

(1) These data, however, are expected to be revised considerably.

Improvement is also based on a pickup in world trade. The contraction in world trade in the winter of 2009 amplified the recession, particularly in export-oriented Germany and Japan, and symmetrically, the pickup lent support to the recovery, as exports rebounded markedly in all areas in Q3 2009. The recovery in world trade began to a large extent in China, where the ramping up of the stimulus plan led to a pronounced rebound in domestic demand, which then stimulated imports. But the situation could be temporary, as China's authorities tightened credit policy in early 2010.

Another factor contributing to good GDP performance in H2 2009 is the turnaround in the inventory cycle. In the depths of the crisis, manufacturers often postponed production plans and decided to draw down inventories. The move was intensified by their funding difficulties, in an unprecedented environment of tighter borrowing standards. The massive inventory reductions weighed on growth until the start of summer 2009. With the upturn in demand, manufacturers slowed the pace of destocking; this boosted growth starting in Q3 in all the advanced economies (Table 2). In the United States, inventory change is estimated to have contributed to over half of GDP growth in Q4 2009. With euro area manufacturers reporting fairly low finished-product inventories in the business surveys, inventory change is expected to continue to support growth in the developed countries, at least in the short term.

Table 2: Contribution from changes in inventories

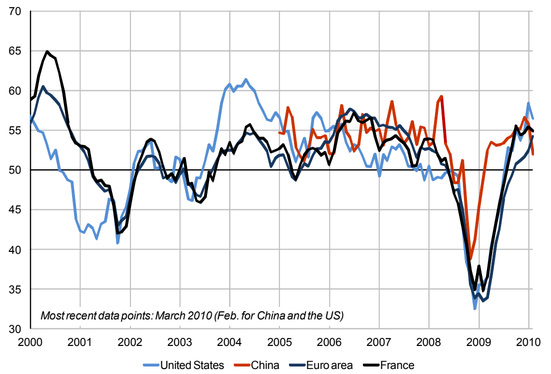
	2008			2009				2010
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	carry-over
United States	−0.3	0.1	−0.1	−0.6	−0.2	0.2	0.8	**0.6**
Japan	−0.1	0.1	1.0	−0.6	−0.6	−0.1	0.1	**−0.1**
United Kingdom	−0.5	−0.3	−1.4	−0.2	0.4	−0.3	−0.1	**−0.1**
Germany	−0.5	0.8	0.2	−0.3	−2.0	1.5	−1.2	**−0.7**
Italy	−0.4	0.0	0.4	−0.4	−0.3	0.1	0.1	**0.0**
Spain	0.0	0.0	0.0	0.0	0.0	0.0	0.1	**0.1**

Sources: National accounts

1.3 A hesitant recovery seems to be at work

The most recent economic indicators have made sluggish progress, particularly in the euro area where the slowdown in the recovery in the business climate in industry, which has been perceptible since November, was confirmed at the very start of 2010 (see chart 2). But the March indicators have picked up encouragingly. In the United States, the industrial confidence indicator followed a saw-toothed path in the second half of 2009. China is virtually alone in showing a continuous improvement in manufacturers' confidence since the trough in November 2008. Nevertheless, in all the countries considered, these indicators remain above the 50-point level that separates expansion from contraction. The industrial production figures confirm the qualitative signals from the surveys. In every country, industrial production grew at a slower pace in the last quarter of 2009 than in the previous quarter.

Chart 2: Business surveys - PMI manufacturing



Sources: Reuters, BEA, Markit, National Bureau of Statistics (China)

2. Factors restraining economic recovery

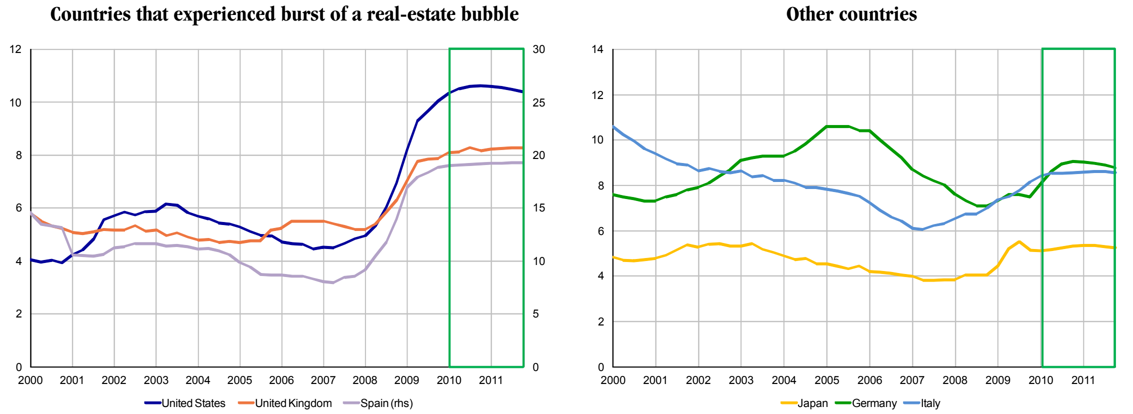
2.1 Labour market adjustments

Job destruction started earliest in countries that had undergone a domestic real-estate crisis before the financial crisis (see below). These are countries where the unemployment rate rose rapidly, reaching record levels in three years' time: between 2007 and 2009, the U.S. unemployment rate rose from 5% to 10%; in Spain, where the construction sector accounted for 10% of economic activity in 2009, it rose from less than 5% to over 19%; and finally, in the United Kingdom, it rose from 6% to 7.8% (see charts 3a and 3b).

In other countries, the adjustment began later and has been smaller relatively to the size of the shock on activity. In Japan, where the labour market usually adjusts through changes in wages, the financial crisis has seen employment levels become more of a variable of adjustment, largely due to the structural increase in the number of non-regular workers.[2]

(2) Note however that changes in the participation, i.e., the propensity of workers to join or leave the labour force depending on the economy situation is particularly strong in Japan, which makes it difficult to analyze changes in the official unemployment rate.

Chart 3: Unemployment rate, as % of labour force



Sources: National accounts, DG Trésor forecasts

Box 2: **The link between activity and employment**

The difference in employment responses from one country to the next depends on the nature of the shock incurred, the level of employee protection, and most importantly the presence of temporary measures to support employment. Short-time work and similar measures implemented in several euro area countries and Japan can counter an increase in long-term unemployment and allow greater flexibility in adjusting the level of employment during the ensuing recovery, as the workforce remains on standby and employers can skip the hiring and training phases. While these measures have preserved a higher level of employment, particularly in Germany, they may have only delayed much-needed structural changes.

The transition from this temporary regime should weigh on the recovery of jobs, because firms can be expected to call upon these workers before they consider hiring new staff.

The charts below depict, for the extreme cases of Germany and the U.S., the responses of activity (on the horizontal axis) and employment (on the vertical axis) during the current crisis (blue) and earlier crises. The charts also indicate changes in apparent labour productivity: the closer the curve approaches the 45° line (dashed purple), the better productivity will have been preserved during the crisis. That is the case in the U.S., but far less in Germany, where short-time working arrangements were widely used.

Chart 4: United States

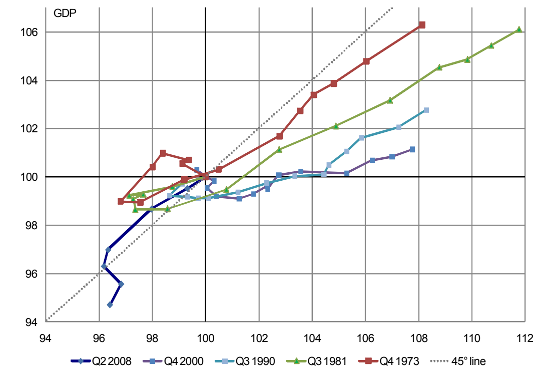
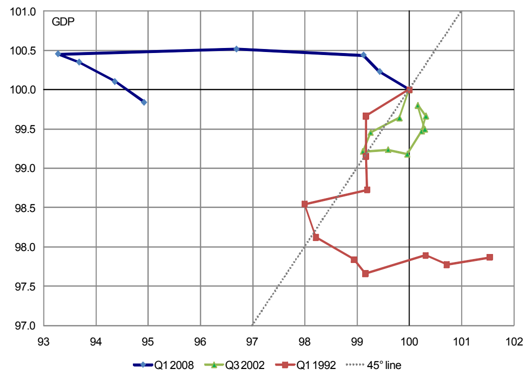


Chart 5: Germany



Sources: National accounts

2.2 Corrections in real estate markets

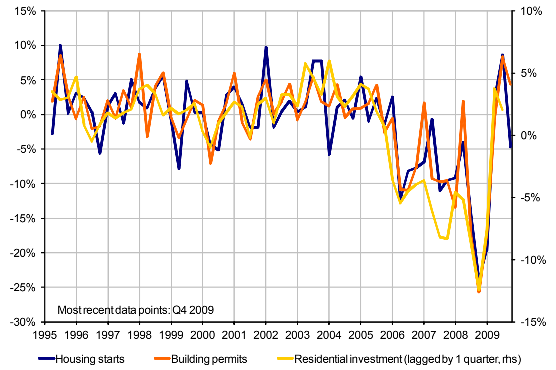
In the United States, mortgage foreclosure and default rates are still on a negative trend and should continue to weigh on the real estate market. Combined with still-high inventories of unsold homes, continuing foreclosures through the end of 2010 should exacerbate the excess supply observed since 2008. Oversupply should continue to drive nominal property prices lower, despite the sharp pickup in residential investment (see chart 6).[3] In Spain as well, property prices should continue to fall, even if lending conditions are somewhat normalising.

The adjustment in construction investment should be completed in early 2011, and at the end of 2011 residential investment should be back to the pre-bubble level of 1998.

The situation in the U.K. is more ambiguous, given that strong constraints to the supply of homes have already reversed the fall in housing prices. With further stimulus from easier lending terms, housing prices should rise further in 2010 and 2011, even if the earlier reduction in household income constrains residential investment through the end of 2010.

(3) Residential investment, however, should remain well below pre-crisis levels.

Chart 6: United States residential investment



Sources: Census, BEA

2.3 Private agents face financing difficulties

Access to funds has improved since the start of 2009. In addition to fiscal stimulus, the measures to support the financial sector (credit extension measures, expansion of deposit insurance, and liquidity injections) combined with the monetary policy measures (rate cuts and unconventional intervention) put in place in 2008 and early 2009, and maintained to a large extent since them, contributed to reducing tensions on the markets and ending the recession. Interbank spreads have returned to their early-2007 levels, signalling normalization of the money market. Still, corporate spreads are having trouble reverting to their long-term levels, and surveys of banks continue to indicate more-restrictive lending standards.

2.4 Large domestic imbalances in certain countries

In some countries, households are seeking to reduce debt and build precautionary saving. Since 2000, economic growth in the United States, the United Kingdom and Spain had been predicated on a strong increase in credit (primarily mortgage), and household debt ratios rose continuously. The collapse of the bubble aggravated the situation, making a radical change in household finances inevitable. In addition, job destructions and the substantial deepening of public deficits promote more cautious behaviour, generating greater saving:[4] in Spain, for instance, the gross savings rate[5] is forecasted to rise from 10% at the start of 2008 to 19% in 2011.

European firms had financed their investments primarily by debt, and were already fairly heavily leveraged when the recession began. This made them all the more vulnerable when access to credit tightened. And while the debt burden may have been eased by the reduction in the ECB's key rate, a degree of deleveraging is expected in the medium term.

3. Recovery in the developed countries is driven mainly by trade

3.1 The restoration of global trade, in association with vigorous demand in emerging economies, is expected to fuel of recovery in the 2011 time horizon

The year 2009 was marked by a historic decline in world trade, which fell 12.8%, after 1.7% growth in 2008 and average annual growth of 6.6% over the past ten years. But 2009 also saw initial signs of a trade recovery, with global trade expected to pick up by 7.9% in 2010. But as the effects of public stimulus wear off, China's GDP could decelerate in 2011, causing growth in world trade to also slow slightly (with 7.3% growth forecast for 2011).

3.2 Business investment is gradually picking up

Firms have proved fairly resilient to the crisis; using employment levels as a variable of adjustment[6] enabled them to limit the decline in margin rates in 2009[7] (see below). In the U.S. in particular, companies' productivity performance appears to have been affected very little by the recession, probably because of the adjustment through employment levels. Margin rates are expected to be restored over the next two years. More widely, firms mainly maintain the same trend in wages per head, to the detriment of employment levels-except in Germany, where employers impose severe wage moderation.

Investment in developed countries should be slow to pick up (see chart 7) because of low capacity utilization, deleveraging in the euro area, and the lack of full normalization of risk premiums. Stronger growth in private investment should be deferred to 2011.

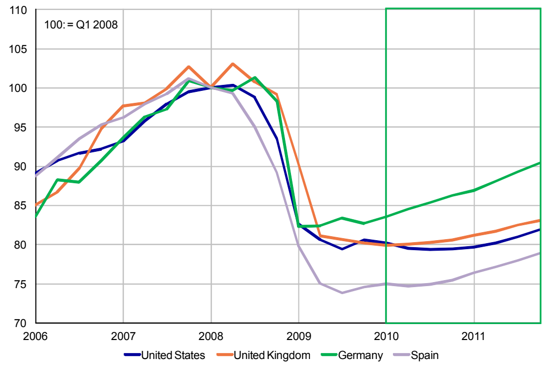
(4) Except in Japan, where population aging and the stimulus packages are expected to have a negative impact on savings. However, it could be argued that the high level of Japanese savings would make additional saving unnecessary.

(5) The difference between gross savings and net savings is due to interest payments between households and current-account transfers to the rest of the world. The difference is particularly high in the U.S., where net savings and gross savings in 2009 came to 4.7% and 7.8%, respectively.

(6) Japan is a special case: whereas traditionally in recessions firms preserve employment levels at the expense of wages-primarily because of the preponderant position of the unions-this time they seem to have adjusted both variables, as a result of the recent increase in the number of less-protected agency workers. Average wages per head should thus fall through the end of 2011, as employment falls in 2010 and then stagnates in 2011.

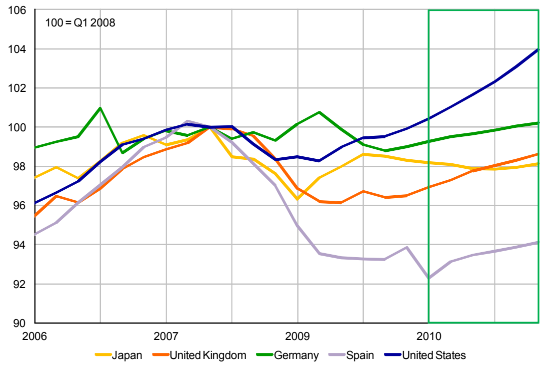
(7) This apparent resilience in the margin rates of nonfinancial firms could probably also be attributed to the elimination due to the crisis of the least profitable firms.

Chart 7: Business investment



Sources: National accounts, DG Trésor forecasts

Chart 8: Household consumption



Sources: National accounts, DG Trésor forecasts

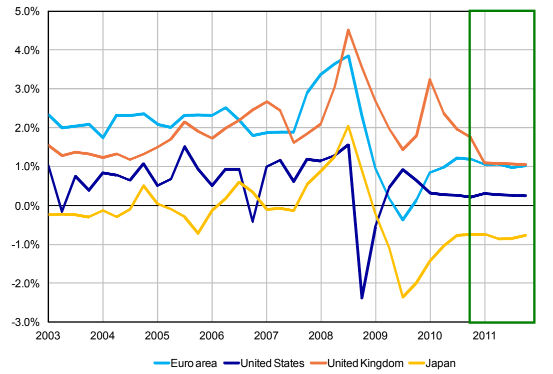
3.3 In all developed economies except the United States, private consumption should undergoes a modest pickup before accelerating in 2011, in a low-inflation environment

In most developed countries, the outlook for consumption in 2010 is largely unfavourable. Income from employment is constrained by the higher unemployment rate and the adjustment in wages. Further, **wealth effects are considerably weakened** by lower financial and real-estate wealth; the build-up of precautionary savings also weighs on U.S. consumer demand. These cyclical effects, however, are offset to a degree by the stimulus plans that should boost household consumption into 2010.

Starting in 2011, the rebound in gross disposable income and the turnaround in the unemployment rate create conditions for a sustained consumption recovery despite the continuing cleaning-up of household balance sheets. Gross disposable income starts moving higher again on both sides of the Atlantic. Japan is the exception, with both employment and wages moving lower.

Consumption is not negatively impacted by price-level changes (see chart 9), as inflation is contained in the euro area and the United States; and inflation continues to be negative in Japan in 2010 and 2011, notably due to the fall in wages and the earlier appreciation of the yen.

Chart 9: World inflation



Sources: National accounts, DG Trésor forecasts

4. Balanced uncertainties

4.1 Deflationary pressures or the effects of needed fiscal consolidations could be more pronounced; global imbalances could intensify again

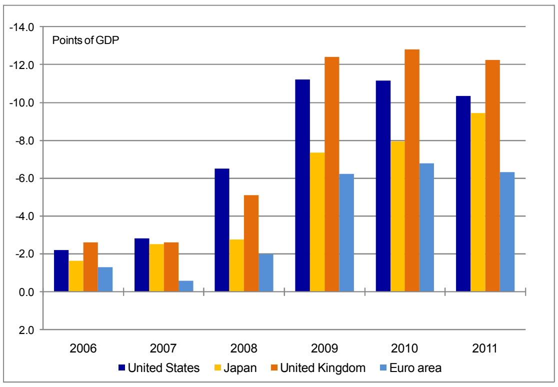
The crisis will have reduced world trade imbalances, but probably only temporarily (Box 3). The sudden contraction in world trade has forced traditional exporting countries to find alternative sources of demand, and countries that typically ran large trade deficits have trimmed imports. But as current economic indicators show, recovery will likely see a reversion to previous patterns of trade balances reflecting a mismatch between domestic saving and domestic investment.

The large gaps between potential and actual output could heighten deflationary pressures. Even if the current environment makes it more challenging than usual to estimate the potential growth rates of the large advanced economies,[8] the output gaps point to a deep cyclical trough. While inflation is contained, in our forecast it remains clearly positive except in Japan.

(8) Some capital stock may now be obsolete and improperly taken into account in estimating potential output. Another question relates to the impact of the crisis on total factor productivity, which may have been influenced positively if the lowest-productivity ones were forced out of business; on the other hand, extended restructuring and lower R&D expenditure can reduce productivity gains.

In response to the crisis, most governments in developed economies put in place enormous stimulus packages that have limited the recession. These countercyclical policies, which were considered necessary in the short term,[9] considerably widened public deficits (see chart 10). Most have therefore committed to fiscal consolidation-for the EU member states, under the framework of the stability and growth pact-by reducing outlays or increasing receipts. This is already the case in Spain with the increase in the VAT rate in 2010.

Chart 10: Public deficits



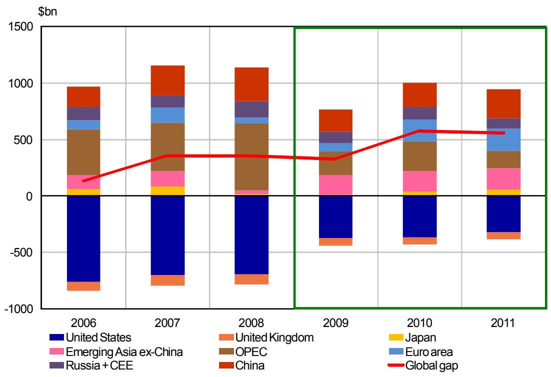
Sources: National accounts, DG Trésor forecasts

Box 3: **Measurement difficulties and effects of the recession on global imbalances**

Global current account imbalances were reduced during the recession (see chart 11), with the U.S. balance of goods and services cut by over half, and a reduction in the trade surpluses of OPEC members and China. But there is unlikely to be any significant continuation of the rebalancing because the U.S. public deficit remains high, despite the stabilization of the U.S. saving rate at a higher level, and because a sustained increase in China's domestic demand would require, inter alia, that the government improve social services-something that would take time.

Any analysis of these global imbalances must be cautious, because the world trade figures suffer from a statistical bias. The trade gap between regions in surplus and regions in deficit was relatively small in 2000, and has widened considerably since 2006, from an average of about USD 40 billion in 2000-2005 to over USD 320 billion in 2006-2008. It is difficult to determine specifically whether the large and rapid increase in the gap is attributable to overstatement of some countries' surpluses, understatement of deficits, or a combination of the two.

Chart 11: Current account imbalances



Sources: IMF ; DG Trésor forecasts

However, a disaggregated analysis of the dynamics of the balances of goods and services for the principal trading areas reveals a correlation between the increase in this statistical bias and the increase in the global balance of services exports. The latter could be linked to an overstatement of exports by the principal exporters of "market services," particularly financial services and to a lesser extent IT services.

4.2 A lower than expected savings rate and a sharper rebound in the financial markets could lead to a more pronounced economic recovery

If savings rates were to increase less than forecasted, the automatic effect would be to raise consumption and thus activity.

The assumptions for changes in financial markets are relatively neutral, e.g., freezing prices at the average of the previous thirty days. However, if because of the significant loss in value of assets during the crisis, these assumptions were to prove overly pessimistic, that would have a positive impact on investment, by facilitating access to funds for nonfinancial firms, and on household consumption, via wealth effects.

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(9) This is the principle of Keynesian stimulus, which encourages governments to let their current-account balance deteriorate, at least in the short term, in order to kick-start the economy.

Table 3: Summary of growth forecasts

Annual averages in %	2008	Forecasts					
		2009		2010		2011	
		Jan. 2010	March 2010	Jan. 2010	March 2010	Jan. 2010	March 2010
GDP							
World	2.5	−1.0	*−1.0*	3.4	*3.4*	3.7	*3.7*
United States	0.4	−2.4	*−2.5*	2.3	*2.3*	2.3	*2.3*
Japan	−1.2	−5.0	*−5.2*	1.5	*1.1*	1.1	*1.1*
China	9.6	8.7	*8.1*	10.0	*10.2*	9.0	*9.0*
Euro area	0.6	−4.0	*−4.0*	1.0	*1.1*	1.6	*1.5*
Germany	1.0	−4.9	*−4.8*	1.4	*1.8*	1.8	*1.6*
Spain	0.9	−3.6	*−3.5*	−0.3	*−0.2*	0.9	*1.0*
Italy	−1.0	−4.9	*−4.8*	0.6	*0.7*	1.2	*1.2*
United Kingdom	0.5	−4.8	*−4.8*	0.4	*0.4*	1.6	*1.6*
World trade	2.1	−12.8	*−12.8*	7.9	*7.9*	7.2	*7.3*
World demand for French goods and services	1.8	−13.1	*−13.0*	5.3	*5.5*	6.2	*6.2*
Inflation							
United States	3.8	−0.3	*−0.4*	1.9	*1.6*	1.1	*1.1*
Japan	1.3	−1.4	*−1.5*	−1.0	*−1.0*	−0.8	*−0.8*
Euro area	3.3	0.2	*0.2*	1.4	*1.1*	1.2	*1.0*

Sources: National accounts, DG Trésor forecasts

Note: These forecasts are based on information available as of 19 February 2010. The January 2010 scenario was based on information in the French Supplementary Budget Bill (*Projet de Loi de Finances Rectificative*) and the Stability Programme. After revision in March 2010, growth forecasts for 2010 have been revised downward for Germany and the United Kingdom, upward for Japan and the United States, without any impact on France.

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