The world after 2010

Global economic update: December 2010

By Kevin Lings and Laura Jones, STANLIB economists

With governments pouring money into the system, growth returns but not for developed countries

A combination of extensive fiscal stimulus packages and expansionary monetary policies helped most economies to achieve positive growth in late 2009 and early 2010. The International Monetary Fund (IMF) forecasts global growth to reach 4.2% by the end of 2010, up 0.3% on their January forecast.

Alongside growth, global trade has also shown upward momentum, and so have capital flows. There is no doubt that financial market conditions have improved during 2010.

Economic growth: A mixed bag

These good global numbers are however disguising a more complex reality. We are seeing a moderate recovery in many of the advanced economies and a much stronger recovery in most emerging and developing economies. The very slow growth in the advanced economies is just not enough to make up for the ground lost during the financial crisis. Output for these countries is now 7% below its pre-crisis trend, and this “output gap” is expected to remain large for many years to come.

Consumers of developed nations cut back

The main factor behind this weak performance and prolonged output gap is weak private sector demand. In the United States, consumers, who were the drivers of the economy before the crisis, are being more prudent. In Europe, where banks play a central role in financial mediation, the weak banking sector limits credit supply. In Japan, deflation has reappeared, leading to higher real interest rates, and putting an already fragile recovery in danger.

Growth in emerging markets sustainable

By contrast, growth is expected to be much stronger in emerging economies this year at 6.3%. Developing Asia is in the lead, with a forecast of 8.7% for 2010. Growth appears not only strong now but also sustainable. While fiscal policy often played a central role in supporting economic activity in 2009, private demand is strengthening in these economies and can sustain future growth.

Government debt could explode

In advanced countries, the main challenge this year has been fiscal consolidation. A year ago, the risk was that private demand would collapse, leading to another Great Depression. The priority was therefore to implement fiscal stimulus programmes to avoid a catastrophic depression. This has been partly achieved: demand did not collapse completely and has indeed started to grow, albeit slowly. One year later, however, the risk has shifted direction. The loss in revenues associated with the loss in output threatens to cause a government debt explosion if it can’t be contained.

Emerging markets face a bubble

Emerging economies are facing a different set of challenges. Higher growth prospects and higher interest rates are attracting large capital inflows. These inflows, especially when driven by growth prospects, are fundamentally good, but we have learned from experience that they can also lead to booms and busts. Therefore, the main policy issues facing emerging economies are: how to best accommodate these flows, how much to let the currency appreciate, how to use macroeconomic policy, and how to use macro-prudential tools, reserves and capital controls, to best avoid excesses and maintain stable growth.

Using exchange rates to boost growth

Interestingly, the solutions to the challenges facing advanced and emerging countries are fairly closely linked. In advanced economies, fiscal consolidation is needed but is likely to have an adverse effect on demand and then on growth. To offset these adverse effects and maintain growth, advanced countries may need to depreciate their currencies so as to increase their net exports.

This, in turn, implies that emerging countries will do the reverse, namely let their currencies appreciate and reduce net exports. This may be just what emerging economies need to sustain growth, and by implication, strong growth in the rest of the world. In many countries, it is also clearly in their own, direct best interest to do this.

In China for example, there is a shift away from exports towards domestic consumption, a shift that requires both structural measures to decrease savings, and an appreciation of the currency, which is highly desirable.

Challenges for 2011

In conclusion, we find ourselves at an important new stage of the crisis. A global depression has been averted. The world economy is recovering, and recovering better than we had previously thought. This is certainly welcome news. However, new and no less formidable challenges have presented themselves. Achieving strong, sustained and balanced growth will not be easy in 2011. It will require yet more work, namely fiscal consolidation, exchange rate adjustments and a rebalancing of demand across the world.