

The challenges ahead

Global economic update: January 2011

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We start the year with the same question we asked last year – will the global economic recovery be sustained?

The recent economic and financial crisis resulted in the most severe economic downturn and financial distress since the Great Depression. Fortunately, the world economy has started to recover, helped by some very unusual and unprecedented policy responses. But will the recovery be sustained?

No one is spending the money

The key debates for 2011 are likely to focus on the effectiveness of monetary and fiscal policies.

Economic recovery, especially in the richest countries, is being delayed and undermined by persistent problems with the lack of credit flows and consumer spending. The continuing lack of confidence among financial intermediaries, especially banks, has diminished the expected positive effects of low interest rates and quantitative easing by central banks.

Simply put, there is not enough credit flowing around the global economy to sustain a recovery. The stress tests conducted in Europe in June last year were meant to restore confidence in financial institutions and to help return the financial system to a state approaching normality. Yet money and credit is not moving easily around the economy, even with the additional efforts being undertaken by central bankers.

US pain continues

In the United States the recovery is softening more than expected. Household indebtedness and the absence of job growth are inhibiting consumer demand, the key element in the expected recovery. The government and the Federal Reserve will need to cope with high unemployment and a housing market that may take years to recover. These two variables will continue to create problems for their financial system. The process of de-leveraging by US households during 2011, in the absence of robust economic growth, will put even more pressure on the government and the Federal Reserve to engage in yet another round of economic stimulus.

Japan remains in the doldrums

In Japan the economic and financial signals are not good either. The country faces a demographic problem, accentuated by years of economic underperformance, a weak financial sector still reeling from the real estate problems of a generation ago, and an export sector whose superior performance cannot compensate for the problems in other parts of the economy. The pursuit of different policies by different countries in an attempt to address specific national problems does not facilitate a global management of the crisis.

Europe faces its own challenges

In spite of Germany's excellent growth record in 2010, driven in part by its dismal performance in 2009 and by increasing demand from China, European countries will face 2011 with a number of challenges.

Budget deficits will be hard to erase in the absence of growth. Tax increases and cuts in public spending will likely depress growth even further.

Policymakers in most European Union countries will face a hard balancing act between laying the foundations for sustainable growth in the medium to long-term, and addressing the difficult economic and employment outlook in the short-run and the growing rate of structural unemployment.

Members of the eurozone face the additional hurdle that their companies rely on bank credit (as opposed to capital markets) to a greater extent than in the US. Thus, the slow, gradual normalization of credit flows continues to limit the pace of recovery in the real economy and in employment. In 2011, the combined GDP growth of the eurozone is not likely to exceed 1% by much, about the same as in 2010. Under this growth scenario, unemployment will not decrease.

Emerging markets surge ahead

2011 will be tough for the majority of economies, and especially the US, Japan, and the European Union, due to the growing risk aversion among investors in these countries. While the richest economies cope with slow growth, persistently high unemployment and financial volatility, the emerging economies are surging ahead, increasing their share of global production, savings, and consumption. Growth rates in Asia, Latin America, the Middle East, and Africa are poised to easily exceed those in Europe, the United States and Japan in 2011.

Strong growth predicted for Latin America

Latin America is expected to grow by more than 4% in 2011. Brazil has consolidated its position as one of the most relevant participants on the global financial and economic scene. Brazil's outstanding economic policies in recent years helped their economy grow last year by just over 7% and it is expected to grow by about another 4% in 2011. Brazil's range of exports includes raw materials and semi-processed goods, as well as high-tech items like regional jets, automotive components, and sugarcane ethanol.

Emerging economies sell to their own markets

Emerging economies are increasing their exports to other emerging economies, a sign that their economic bonanza may become self-sustaining. In addition, domestic consumption is growing as both governments and households spend on goods and services. For instance, retail sales in the emerging economies have grown by nearly 60% since the beginning of 2007, compared with almost no growth in the advanced economies. The rise of a large middle-class of consumers and savers in countries such as China, India and Brazil will be felt around the world. It goes without saying that companies globally will need to adjust their product designs, production locations, and marketing and distribution strategies to these important new developments.

Stricter financial control

During 2011, new banking regulations will be implemented in many advanced countries, resulting in a focus on stricter risk management systems, more de-leveraging, closer monitoring of corporate borrowers and a smaller propensity to finance the growth projects of non-financial companies.

A new order is needed

As the International Monetary Fund itself has acknowledged, the present crisis has called into question the existing policy tools to address systemic economic and financial turmoil. Global governance will be on the agenda at the meetings of the G20 and other international forums in 2011.

Perhaps the most urgent need is in designing a set of procedures for countries to follow in the event of a new global economic and financial meltdown, one that reduces the risk of contagion and helps affected economies grow out of the problem. Recent experience has shown that the G20 may be a more effective forum for the development of a collaborative approach to policy decisions, and for global economic and financial governance.

Calls for the reduction of global economic and financial imbalances will be made during 2011 as long as economic growth, trade balances, financial reserves and economic well-being continue being as unevenly distributed as they currently are.

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