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Uncertainty Lies Ahead for the World Economy

Federal Reserve Chairman Ben Bernanke put it best when describing the prospects for economic recovery in 2011: "unusually uncertain." Uneven recovery among world economies and the possibility of diverging trade and monetary policies combine to make 2011 rife with uncertainty.

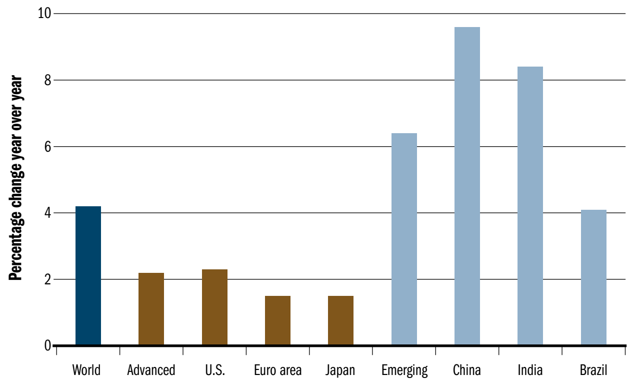
Economies around the world are struggling to emerge from the most severe global recession since the Great Depression. Following the recession of 2007–09, the International Monetary Fund (IMF) projected global output to rise 4.8 percent in 2010 and then 4.2 percent in 2011 (see chart 1). While 2010 saw growth higher than many analysts expected, and the forecast for 4.2 percent growth in 2011 is surely a welcome one, the key question is whether this growth is sustainable.

There are several factors that pose downside risks to the forecast. For one, the recovery is uneven—emerging and developing economies' growth is strong, but the outlook for most developed economies is sluggish. Other concerns are the ongoing risk of diverging economic policies in response to countries being at different stages of recovery. These diverging policies relate to issues such as trade protectionism and exchange rate manipulation or a repeat of the spring 2010 European scare, whereby fiscal strain in one country morphs into a broader financial market contagion, for example. The road to recovery for the global economy looks like an uneven one in 2011.

Not all recoveries are created equal

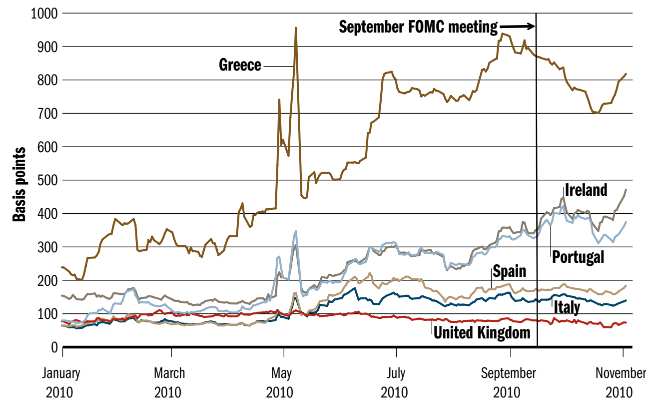
The frequently cited research of Carmen Reinhart and Kenneth Rogoff, found in their book *This Time Is Different*, makes the case that economic expansions following recessions induced by a financial crisis are more painfully slow compared to "normal" postrecession growth. The slower growth is caused by the deleveraging of households, companies, and (sometimes) governments. (*Deleveraging* is the paying down of debt.) In the two decades following such a recession, they estimate that growth is

Chart 1
Growth Forecasts for 2011



Source: International Monetary Fund

Chart 2
European Bond Spreads



Note: Data represent a 10-year bond spread over German bonds.
Source: Bloomberg

1.5 percentage points lower than it would be otherwise.

As a stark representation of this growth differential, chart 1 shows the IMF projected 2011 growth rates of the advanced and emerging economies. Advanced economies are forecast to grow by 2.2 percent and emerging economies should soar ahead with 6.4 percent growth. Among the advanced economies, the euro area and Japan are currently the most sluggish, with growth rates forecast at 1.7 percent and 1.5 percent, respectively. Among the world's large economies, China's expected 2011 growth leads the way at 9.6 percent, but India is not far behind at 8.4 percent. Brazil, after a very strong recovery in 2010 of over 7 percent, should moderate to just over 4 percent.

These estimates of faster growth in emerging economies are not surprising for two reasons. First, emerging economies tend to have higher trend growth rates, given the greater marginal returns on investment and the "catch-up" phenomenon of importing technology from advanced economies. Their lower domestic wages also allow them to more readily attract capital. Second, the recent financial crash originated in the advanced economies—particularly the United States, United Kingdom, and the euro area—and then grew into a global recession with heightened risk aversion, decreased world trade, and the subsequent collapse of demand. These hard-hit Western countries are now particularly burdened with weakened financial systems. Their financial systems were most exposed to the now-soured securities that precipitated the freezing of credit markets and failure, or near-failure, of several systemically important institutions.

But aside from these reasons, the growth differential between advanced and emerging economies going forward is still worrisome. While the nature of an imbalanced recovery is no surprise, it is the degree of asymmetry in growth rates that poses a problem for global economic policymaking.

Greece spillover a slippery problem

One of the underlying causes for the asymmetry of growth is, as previously mentioned, the debt overhang in advanced economies following the financial crisis. Arguably the most significant event that altered the global outlook this past year was the fiscal crisis in Europe. Just as news of the Greek financial crisis began to fade, news came out in November that Ireland requested support from the European Union and the IMF.

The crisis began in late 2009 with scrutiny over the budget reporting by the Greek government. Greece's deficit problem was much more dire than investors in Greek debt had been led to believe, and the outlook for Greece's ability to grow out of its debt burden was becoming more unlikely. After the early stages of the crisis centered on the fiscal scenario in Greece, market stress eventually spread to all the so-called PIIGS (Portugal, Ireland, Italy, Greece, and Spain) and even appeared to threaten the wider euro zone. Following an assortment of unprecedented interventions—highlighted by the 750 billion euro (approximately $1.05 trillion) rescue package from the European Union (through the European Financial Stability Facility) and support from the IMF—market confidence slowly grew, and since June 2010, various measures of financial market functioning have stabilized. See chart 2 for a time plot of European debt spreads; these spreads represent how much more investors demand to be compensated for holding a given country's debt over that of Germany's debt.

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Trade Seeks Traction in 2011

Export growth has become an important national priority. President Obama's national export initiative has set a policy goal of doubling U.S. exports by 2015, an increase that would come as good news to southeastern ports. The recent performance of international trade, however, will make reaching this goal particularly challenging.

The nation's and the region's trade gap grew in late 2010, suggesting that net exports could be a drag on economic growth next year. During most of 2010, the growth in the value of imported merchandise expanded faster than the pace of exports for both U.S. and southeastern ports, increasing the trade gap. By September 2010, the nation's trade gap surged to $59 billion, up from $50 billion a year earlier (see the chart). Likewise, the region's trade imbalances jumped to $8 billion, up from $5 billion in September 2009.

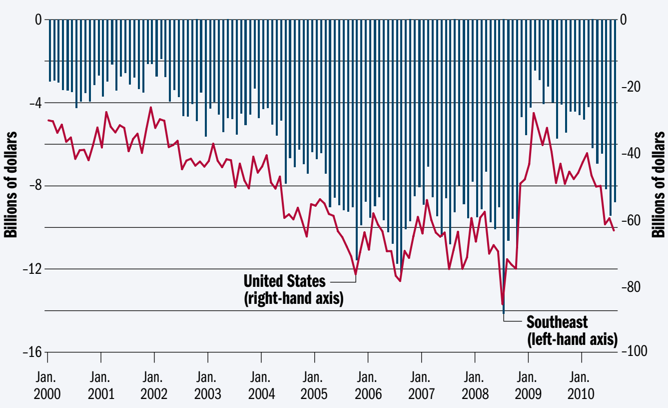
The continued national economic recovery will probably support import demand for consumer, capital, and intermediate goods across regional ports. Depending on the market price of petroleum and related fuels, petroleum's share of imports, now accounting for about one-fifth of all imports, could further set the direction of the nation's trade gap. On the export side, industries located in the region will continue to benefit from a more competitive U.S. dollar that makes U.S. goods more attractive to overseas consumers and businesses.

Port districts such as Miami, New Orleans, and Savannah have seen a rise in global demand for regional products, such as chemicals, agriculture, and transportation equipment. Growth in these exports, however, typically has only limited impact on job creation. The challenge ahead, with the goal of doubling future export values in mind, will be to expand high-value manufacturing shipments like automobiles, high tech, and other goods. ▮

This sidebar was written by Gustavo A. Uceda, an analyst in the Atlanta Fed's research department.

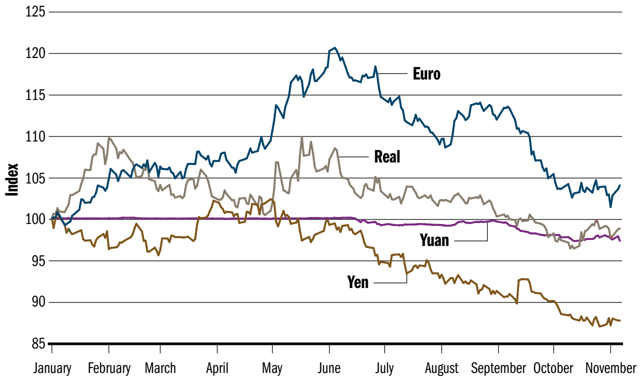
Like a number of regional ports, the port at New Orleans (shown above) has benefited from increased overseas demand for some U.S. products. Part of the challenge lies in translating the growing demand for exports into increased employment.

U.S. and Southeastern Ports' Trade Gaps



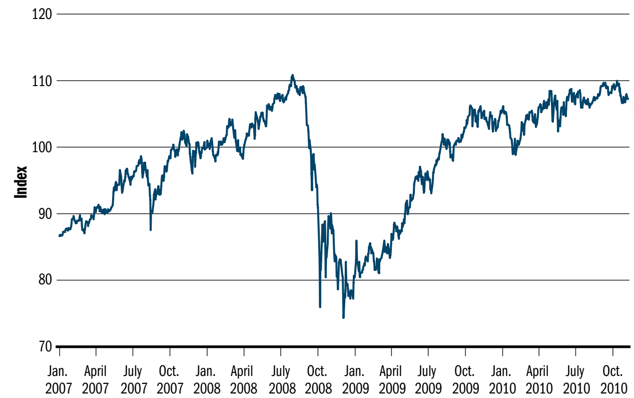
Source: U.S. Department of Commerce, U.S. Census Bureau

Chart 3
Currency Movements Against the U.S. Dollar in 2010



Notes: Movements indicate daily activity and are indexed so that Jan. 4, 2010 = 100. Data are through November 9.
Source: U.S. Bureau of Economic Analysis

Chart 4
Brazil's Real Exchange Rate



Notes: Data represent the daily nominal board effective exchange rate. The year 2000 = 100.
Source: U.S. Bureau of Economic Analysis

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From the summer through October, news of European fiscal deficits, financial market stresses, potential sovereign debt defaults, and even a breakup of the euro zone faded into the background. The focal points of global economic policy have shifted to the sluggish recovery in developed countries and potential for further unconventional monetary stimulus. But the threat of overly indebted advanced economies lacking the ability to fulfill their debt obligations remains a significant threat to the global economic recovery. As chart 2 shows, the cost of financing for Greece, Ireland, and Portugal remains quite high, and the successful implementation of various economic reforms across Europe has yet to occur.

The (ongoing) currency disputes

Another headwind facing the global recovery is the ongoing, contentious issue of currencies. The problem is complex but can be simplified into two interrelated disputes. The first problem is China's currency, the renminbi. By the renminbi's being artificially undervalued, Chinese exports are cheaper and imports into China more expensive than would otherwise be the case if the renminbi were allowed to float freely and appreciate. (Economist Fred Bergsten of the Peterson Institute for International Economics estimates that the renminbi would appreciate from 25 percent to 40 percent if allowed to trade freely.)

It is well documented that Chinese authorities, through the country's central bank, intervene in currency markets by selling their own currency and buying foreign assets to prevent this appreciation. The primary foreign currency they purchase is the U.S. dollar. As a by-product of these interventions, China has amassed around $2 trillion in foreign currency reserves; of that amount, just under $1 trillion are U.S. Treasuries. By preventing the renminbi from appreciating and thus sustaining a de facto peg against the U.S. dollar, China is subsidizing its export industries to maintain domestic economic growth rates of around 10 percent.

Although the renminbi is the name of China's currency, the denomination of bills (or the unit by which prices are measured) is called the yuan. The strength of the yuan was nearly constant against the U.S. dollar until June (see chart 3), which is when Chinese authorities announced they would allow it to appreciate some. Since then, it has appreciated nearly 3 percent against the dollar.

Why does this appreciation pose potential problems? When the yuan is pegged to the U.S. dollar, U.S. exports to China become more expensive and thus work to limit Chinese demand for U.S. goods, preventing a source of postrecession growth. Faced with sluggish growth, U.S. leaders have increasingly fewer feasible options to speed up the recovery. The Federal Reserve is increasingly using whatever tools at its disposal. A new political climate may prevent further government fiscal stimulus. Thus, one possible avenue is a yuan-dollar adjust-

Tension over some countries' varying approaches to budget discipline and fiscal austerity simmered at November's G20 meeting, which brought together the heads of the world's major economies.

ment to spur growth in U.S. export industries. One way to do this is through diplomatic pressure on China from the U.S. government in such forums as the G20 summit meeting. Also, in September the U.S. House of Representatives passed legislation (with a large bipartisan majority) giving the Obama Administration the option to impose tariffs on Chinese imports.

Aside from the de-pegging of the Chinese renminbi from the U.S. dollar, other emerging economies are focused on a second, broader issue: the excessive appreciation of their currency against a basket of currencies. Brazil's currency, for example, has appreciated nearly 50 percent on a trade-weighted basis since December 2008 (see chart 4). This trend hammers Brazilian export competitiveness and in September led the Brazilian finance minister, Guido Mantega, to warn of a potential currency war. While competitive devaluation has not been sufficiently widespread to earn the currency-war label, tensions remain evident in nations seeing their currencies appreciate strongly.

This problem is broader than that of an undervalued Chinese renminbi and reflects the difficulty of managing large capital inflows without damaging economic competitiveness. As mentioned above, there are stark growth rate differentials between advanced and emerging economies. These emerging countries, awash with high-yielding investment opportunities, are facing massive influxes of foreign capital. For example, U.S. investors seeking the growth potential in the Brazilian mining industry are sending their capital into Brazilian markets, causing the real—Brazil's currency—to appreciate. One controversial response to this blessing in disguise is capital controls, through which the government regulates foreign investment. Brazil instituted a tax on foreign investments earlier this year to try to curb just this problem.

Looking ahead to 2011

On November 11–12 in South Korea, the group of advanced economies known as the G20 met in an attempt to reach compromise on a range of issues. Regarding the fiscal problem, tensions are bubbling among G20 members on the issue of implementing austerity measures. Many European nations, particularly the United Kingdom and Germany, want to see an agreement to reduce deficits in the short term, while others, primarily the United States, want to focus less on immediate deficit reduction and more on spurring growth.

As for the matter of global imbalances and currency adjustments, several ideas are on the table, but the makings of any international agreement remain unclear. The United States, through Treasury Secretary Timothy Geithner, proposed a current account surplus/deficit target of around 4 percent of gross domestic product. But that idea was quickly taken off the table following protests by Germany and China. Meanwhile, at its November 2010 meeting the Federal Reserve announced plans to purchase $600 billion in Treasury bonds, and the dollar subsequently depreciated further. So while the United States continues its criticism of the undervalued renminbi, other nations are criticizing the latest efforts of the Fed because of its impact on the dollar exchange rate.

While measures of global output, trade, and employment have recovered from the depths seen during the recent financial crisis and recession, fragilities remain. Whether that fragility is best represented by a fiscal crisis in an overly indebted advanced economy or a failure to reach compromise on global imbalances and currency valuations, several downside risks to the global economy lurk in 2011. ∎

This article was written by Andrew Flowers, an economic analyst at the Atlanta Fed.