International Outlook for 2011

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The world economy is slowing again and is expected to grow at 4.2 percent in 2011. There are no doubts that the advanced economies are facing the greatest economic challenge since the Great Depression. Mounting tensions between the advanced economies and the emerging economies (particularly China) are further complicating things, as the pace of recovery is very uneven (2.2 percent for the developing countries and 7 percent for the emerging countries). The advanced economies are unoptimistic because the sluggish growth has yet to create jobs, particularly in the United States, Europe and Japan.

In the western world, the effects of the massive fiscal and monetary stimulus packages are dissipating while unemployment rates are still historically high a year after most of those economies have been technically out of recession. What are the immediate options of the developed-economy governments: austerity measures, more stimulus, protectionism or global collaboration? Further questions that remain to be answered include the following: Is it possible to ensure fiscal sustainability without dampening the recovery? How do we make sure that recovery efforts create jobs? And does sustainable recovery need global collaboration and rebalancing of the world economies?

Reflecting on recent financial meltdowns, such as the run on Northern Rock Bank in the United Kingdom in September 2007, the bankruptcy of Lehman Brothers in the U.S. in September 2008, and the Euro crisis of 2010, it is clear that we operate in a highly intertwined global financial market where what happens in one country affects the standing of financial institutions in other countries. This implies that the answers to the above questions cannot come from one country's perspective.

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This year's global forecast may further mark the start in the shift of global economic weights as most of the developing economies will grow faster than the United States and their richer peers. Economists tracking advanced economies as a whole worry that without faster internal growth the world's rich economies will be stuck in unprecedented high unemployment rates and idle capacity. The remainder of this paper will emphasize the divide between the advanced and the developing economies, focusing on the challenges each group is facing, the solutions formulated by their respective governments, and my take on what is coming next.

Advanced Economies

The sluggish growth in the advanced economies comes from two sources: weak consumption and weak investment. On one front, households are rebuilding their damaged balance sheets and are saving instead of consuming; on the other front, the financial system is still tightly rationing credit to businesses. The downside risks for a slower recovery in 2011 relative to 2010 are real as the different stimulus package initiatives are wearing off. However, at the same time, there exists a real need to stabilize the budgets of these countries in the medium term as most of them have been aggressively running over-accommodating fiscal policies in the past two-and-a-half years. How can a country service their public debt with millions of workers unemployed and the demographic shift to an aging population? In countries where access to the global capital market has been restrained or entirely shut down (such as Ireland, Greece and Spain), the policy option is clear: consolidate the debt and proceed to very painful reforms of public sector spending.

In the United States, the market for sovereign debt is not closed and the country can borrow at zero percent short term and around 2 percent in the long term, so there is an option for us to continue to stimulate the economy. The danger for the United States would be to hamper its economy's potential by keeping its labor force idle too long. An exaggerated time of idle labor can significantly lower the potential labor force as disillusioned workers will give up and their skills will become obsolete, particularly in highly skilled tech industries.

The problem for most of the developed world is that the population is aging, people retire too early (from a pension perspective), productivity has weakened, and immigration is controlled. Without a stimulus, demand remains weak and the damage could be great. This is the view of President Obama's economic team. Their policy recommendation is to not front-load the deficit reduction while keeping an eye on the consolidation of the long-term debt. Without a clear formulation of how we will rebalance our budget we are going to deviate from the appropriate long-term path of output production. France is proceeding more credibly by making future deficit cuts with their gradual reform of the retirement age, and so could the U.S. by enacting explicit future budget cuts and tax changes. The U.K., on the other hand, has decided to slash their government spending, betting on the theory that a leaner government would stimulate investment and consumption. For the British, reducing the massive government debt would lift private confidence, consumers would stop saving their disposable income, and entrepreneurs would feel confident to spend as their fear of higher taxes to repay the debt would be eliminated.

The bottom line is that economists are deeply divided about what is the best policy to adopt. IMF economists studied the difference between a country's current level of public debt and its debt limit and suggested that the ratio of public debt to GDP of 52 percent for the U.S. and 68 percent for the U.K. allowed them some flexibility. However, economists at the Brookings Institution warn about the adverse effect of such uncontrollable spending on innovation and private investment.

Emerging Markets

The emphasis is on the Asian emerging markets where growth is strong and is leading the global recovery. Nevertheless, those economies face important challenges and downside risks to their growth forecast in the medium term. One of the biggest challenges facing those countries is to create and sustain a private domestic demand so that they do not depend so heavily on their exports to the more advanced economies; this is what is referred to as rebalancing growth. The other challenge is to manage the high inflow of investments in smaller Asian countries and build the domestic infrastructure necessary to continue to develop economically. In general, the Asian economies are capital-abundant and it is time now to improve productivity by getting rid of all the structural rigidities in the labor market in particular. The inflow of capital is further expected to increase as the U.S. Federal Reserve is preparing for a second round of monetary stimulus that will push investors to higher earnings in the Asian markets. All this can end in asset bubbles and is putting an upward pressure on prices and the value of domestic currency in the emerging economies. Countries with flexible rates have witnessed significant appreciation of their currency.

For others, like China, the upward pressure on the domestic currency has been counteracted by the extraordinary accumulation of foreign assets, especially U.S. treasury bonds. The Chinese Central Bank exchanges the inflows of dollars for renminbi at a fixed exchange rate, thereby keeping the value of the renminbi artificially high, and then uses the dollars to buy U.S. T-bonds. According to the U.S. Treasury, China held $46.7 billion of its treasury bills as of July 2010, making it the largest holder of the bills. This influx of renminbi further threatens the Chinese economy with inflationary pressures, but through the sterilization process—the Central Bank of China forcing their financial institutions to buy Chinese bonds—the government has dampened the pressure on prices. By building foreign reserves and creating a current account surplus, China provides foreign investors the necessary collateral for the capital they invest in the country. Therefore, the fixed exchange rate regime and sterilization policies can serve as a nice development strategy, but China's use of its capital surplus to invest in incredibly low-yielding U.S. treasuries certainly diminishes its medium term prospects. Furthermore, China's dollar dependency is a consequence of this policy, and a devaluation of the greenback would adversely affect the world's biggest stockpile of foreign exchange reserves.

Conclusion

The outlook for the global economy is highly uncertain in the medium term. A lot of instability is caused in part by the monetary policy of the Federal Reserve System. This flood of liquidity in the market is putting downward pressure on the U.S. currency with the hope that it will boost U.S. exports and stimulate the U.S. stock market. The Fed has good intentions in creating all this liquidity as it hopes to stimulate the U.S. economy, but the unintended consequence is that it may cause chaos for the rest of the world as a devaluation of the U.S. currency, and eventual revaluation of the renminbi, will do very little to correct the trade imbalances. Americans may buy fewer Chinese goods, but will they increase their savings or just divert to other trade partners? And above all, will the U.S. government start saving? The world is at a crossroads and countries are trying to find a domestic solution to a global problem.