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The Global Economy: Who Gets Out of the Gate First?

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Executive Summary

The global economy fell off a cliff late last year as the credit crunch brought economic activity to a standstill, and most major economies appear to have contracted at a sharp rate in the first quarter as well. Although recent data suggest that the bottom has probably not been reached yet, rates of decline may be starting to slow. Eventually, however, the global economy will begin to recover. Will major economies rise from the ashes at the same time and pace, or will certain economies lead others?

In our view, China will probably be the first major economy out of the gate. China did not have many of the problems that plagued other major economies, and Chinese policymakers were quick to enact expansionary macroeconomic policies. The U.S. economy faces some formidable challenges, but it should be one of the first economies to post positive growth numbers again due to the unprecedented stimulus that has been applied. The U.K. economy, which in many respects resembles its American counterpart, should start to turn the corner as well later this year. In contrast, the Euro-zone will likely lag the United States and Great Britain due to the tepid policy response to date in continental Europe. Japan should also be one of the last major economies to emerge from the current downturn.

Our views regarding near-term trajectories of the world's major economies influence our foreign exchange rate forecasts. Specifically, we project that the U.S. dollar will strengthen versus most major currencies over the next few quarters as the United States shows signs of emerging from the downturn before most other major economies.

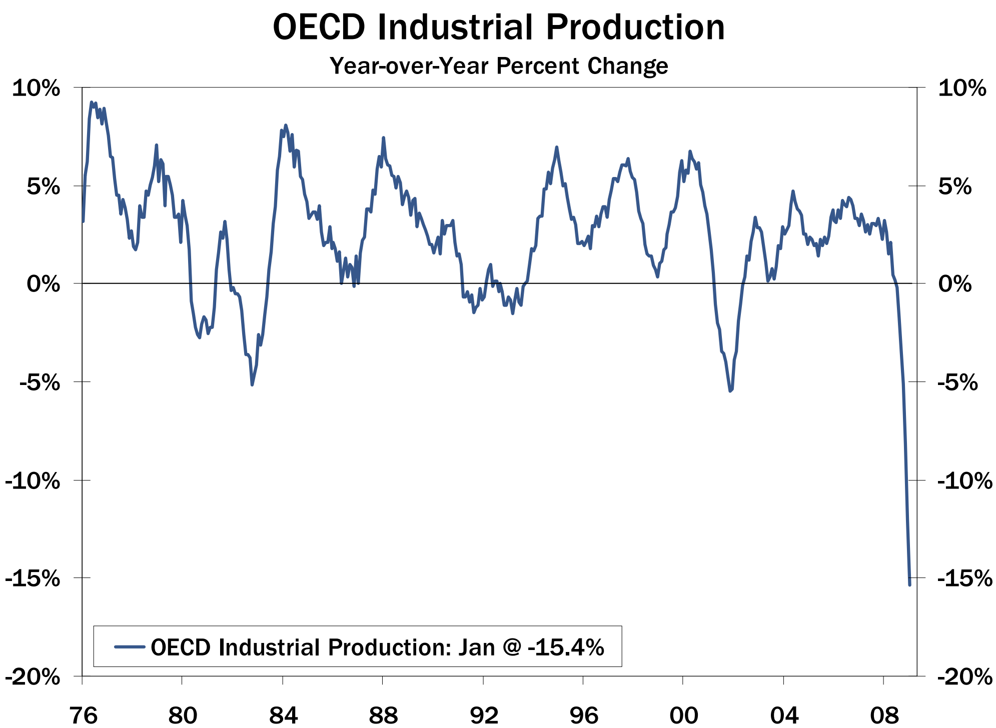
Is Global Recovery Around the Corner?

The global economy is in the midst of its deepest recession in decades.

It is now well documented that the global economy is in the midst of its deepest recession in decades. As shown in Exhibit 1, industrial production in the 30 countries that comprise the Organization for Economic Cooperation and Development (OECD) plunged 15 percent in January relative to the same month in 2008.[1] Moreover, the downturns of the early 1980s and 2001 pale in comparison to the current nosedive. With grim news on production in individual countries in February and March it is very likely that the OECD composite has slumped even further.

[1] The thirty members of the OECD are generally the 30 most advanced economies in the world.

Exhibit 1



Source: Organization for Economic Cooperation and Development and Wachovia

Is the outlook starting to brighten?

With many economies in deep recessions at present, it may seem a bit premature to discuss recovery. However, many stock markets have posted impressive gains over the past few weeks as economic data have generally not been as bad as earlier this year. In a recent interview, Fed Chairman Bernanke went so far as to claim that there are some "green shoots" of recovery in the U.S. economy that are starting to appear. Is the outlook starting to brighten? If so, will the major economies of the world, which simultaneously fell off a cliff last autumn, experience synchronous recoveries? Or will certain economies come out of the gate before others?

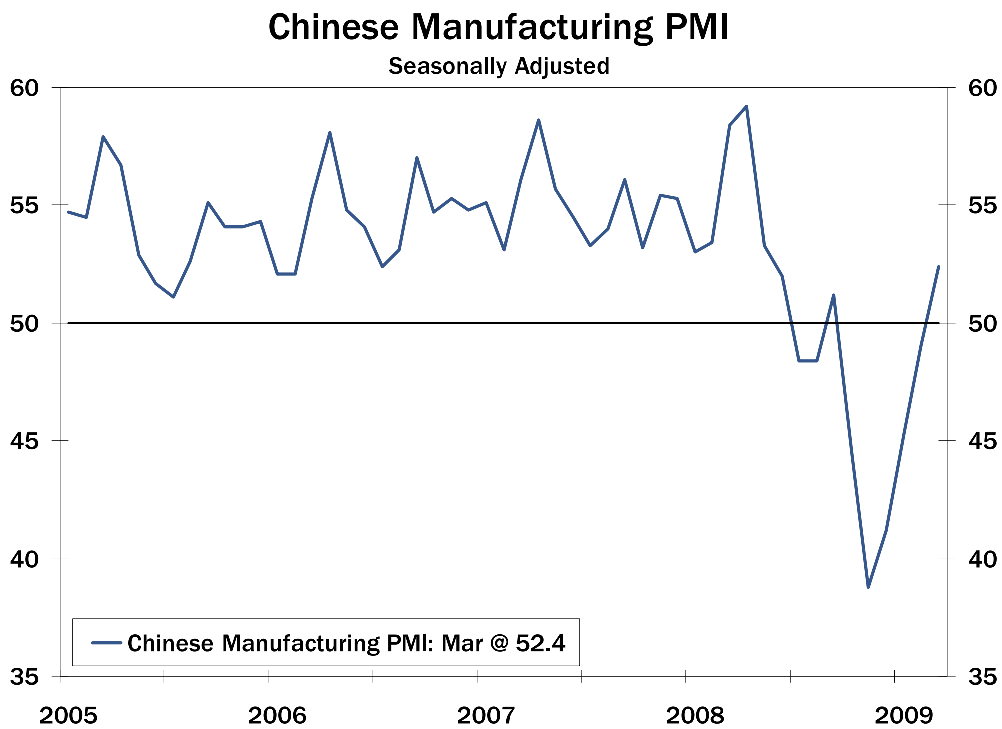
The deepening of trade and capital flows has made business cycles across major economies more synchronous than they were in the past. Although stronger economic activity in one major economy will likely have spillover effects on other economies, cycles are not perfectly synchronized and we expect major economies to emerge from the current downturn at varying speeds and at different times. In the pages that follow, we outline our expectations for the world's major economies over the next year or so.

The Recovery in China May Already Be Under Way

The Chinese economy appears to have strengthened at the end of the first quarter.

In our view, China will be the first large economy to recover. Arguably, the Chinese economy may already be emerging from its brief slump. Although the year-over-year real GDP growth rate declined from 6.8 percent in the fourth quarter of 2008 to 6.1 percent in the first quarter of this year, monthly data suggest that the economy picked up at the end of the quarter. As shown in Exhibit 2, the purchasing managers' index for the manufacturing sector crossed the demarcation line that separates expansion from contraction in March, and "hard" data subsequently corroborated that industrial production strengthened during the month. Although retail sales have decelerated somewhat over the past few months, the 15 percent year-over-year growth rate that was registered in the first quarter of 2009 is still very respectable.

Exhibit 2



Source: Bloomberg LP and Wachovia

Chinese economic growth slowed throughout 2008 in response to tighter macroeconomic policies the government implemented last year when inflation was seen as the biggest economic problem the country faced. The slowdown in China was exacerbated last autumn as most major economies fell off a cliff in the wake of Lehman Brothers' implosion. Chinese exports, which had been growing at a double-digit pace throughout much of 2008, were down 20 percent on a year-over-year basis in the first quarter of 2009.

China did not have many of the problems that plagued other major economies.

However, China did not have many of the problems that plagued other major economies that will be discussed in more detail below. The four large state-owned Chinese banks, which account for the majority of deposits and loans in the economy, never had much exposure to the U.S. housing market. There have been some losses within the Chinese banking system, but nothing close to the write-downs that many Western banks have posted.[2] Consequently, growth in bank lending remained strong, and it has picked up even further—the year-over-year growth rate in bank lending jumped up to 27 percent in March—now that the government has relaxed credit restrictions that were put in place last year when inflation was raging. In

[2] Write-downs at the Bank of China and the Industrial and Commercial Bank of China (ICBC) have totaled \$5.9 billion and \$2.3 billion, respectively, a drop in the bucket compared to the \$1.3 trillion worth of losses that have been realized worldwide since the third quarter of 2007.

addition, the government has supported economic growth via acceleration in infrastructure spending that was planned for the next few years.

Most Asian economies should rebound relatively quickly from the current global malaise.

The recent strengthening of Chinese economic activity is good news for many small open economies in Asia, many of which have extensive trade ties with China. Industrial production (IP) in Taiwan bounced eight percent in February relative to the previous month, and Korean IP has risen for two consecutive months. As with China, most other Asian banking systems were not highly exposed to the U.S. mortgage markets, so banks in the region generally remain in good health. Therefore, most Asian economies should rebound relatively quickly from the current global malaise.

United States: Formidable Challenges versus Aggressive Policy Response

The United States has been the epicenter of the global financial turmoil that has transpired since the summer of 2007. Not only did the crisis begin here, but American financial institutions have accounted for the lion's share of the $1.3 trillion in write-downs to date. More than 5 million jobs have been lost since the economy entered recession in December 2007, and the unemployment rate, which currently stands at a 26-year high of 8.5 percent, is bound to rise even higher. Further softness in the labor market will lead to higher rates of delinquencies on residential and consumer loans that will continue to pressure banks for the foreseeable future.

The U.S. economy should be one of the first major economies to experience positive GDP growth again.

Despite the formidable economic and financial challenges that the United States faces, the U.S. economy should be one of the first major economies (other than China) to experience positive GDP growth again. For starters, there has been an unprecedented liquidation of inventories in recent months (Exhibit 3). The drag on the economy will start to fade as the rate of inventory liquidation become less extreme. Speaking of drag, recent data suggest that the sharp downturn in residential construction, which has weighed on U.S. economic growth for three years, may be starting to flatten. Moreover, U.S. policymakers, both monetary and fiscal, have taken extraordinary steps to shore up the financial system and stimulate the economy.[3] The effects of policy stimulus in conjunction with a slower pace of destocking should turn GDP growth positive later this year.[4] That said, the recovery that we project for 2010 likely will be very sluggish, at least initially, as consumers continue to increase savings rates and reduce leverage.

Macroeconomic policy in Canada has turned very expansionary.

Both the Canadian and Mexican economies weakened markedly last autumn after the U.S. economy went into a tailspin. Therefore, both countries, which have very extensive trade ties with the United States, should benefit from stronger economic growth in their large North American neighbor. Moreover, macroeconomic policy in Canada has turned very expansionary, which will also help the economy to recover. The Bank of Canada has cut its policy rate to only 0.25 percent, and it has committed to keep it there until the middle of next year. In addition, the Canadian government has implemented a fiscal stimulus package, including spending increases and tax cuts that will take effect over the next two years, which is worth about four percent of GDP. The Bank of Mexico has eased rates by 225 bps since late November, and the Mexican government has announced a small fiscal stimulus package.

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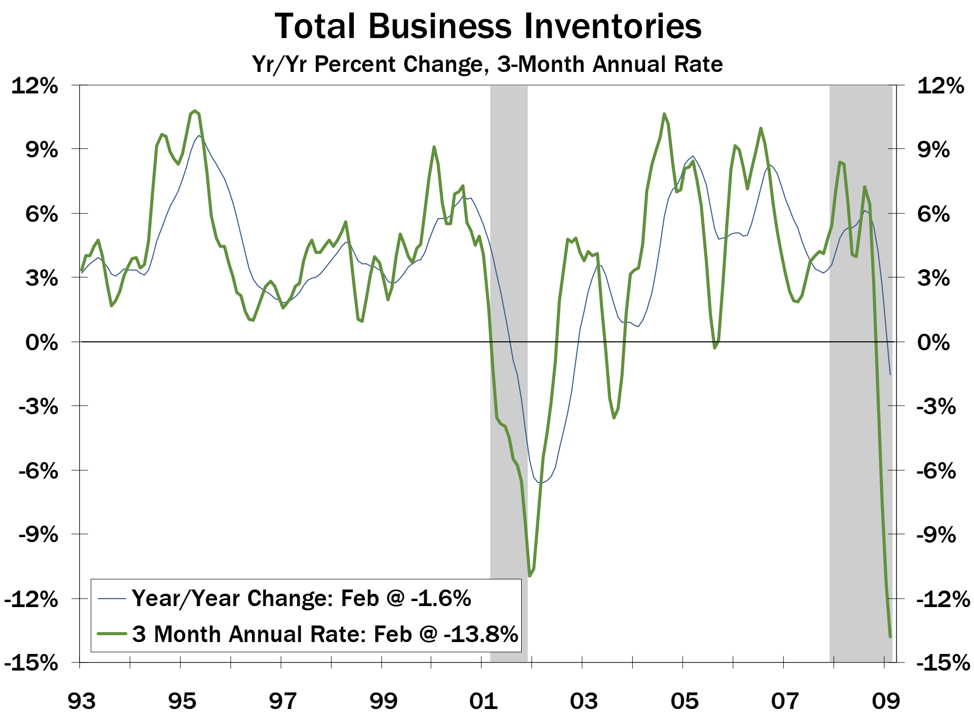
[3] The stimulus package that Congress passed and President Obama signed in February is equivalent to 5.6 percent of U.S. GDP. The effects will be spread out over the next two years.

[4] See the *Monthly Economic Outlook*, which is posted at www.wachovia.com/economics, for our forecast details.

Exhibit 3



Source: Department of Commerce and Wachovia

The United Kingdom Looks and Smells Like the United States

In many respects the U.K. economy is the U.S. economy on steroids. For starters, house prices in Great Britain generally rose more than in America. A widely followed index of U.K. house prices more than trebled between 1997 and 2007, but it has subsequently dropped about 20 percent from its peak (Exhibit 4). Many British consumers are highly geared. The ratio of liabilities to nominal disposable income in the United Kingdom exceeds 180 percent, well above the comparable ratio in the United States (140 percent). The British banking system is in shambles with some of the largest banks in the country effectively nationalized. Real GDP tumbled at an annualized rate of 6.1 percent in the fourth quarter of 2008 relative to the previous quarter, the sharpest rate of contraction since 1980, and another sharp decline appears to have occurred in the first quarter as well.

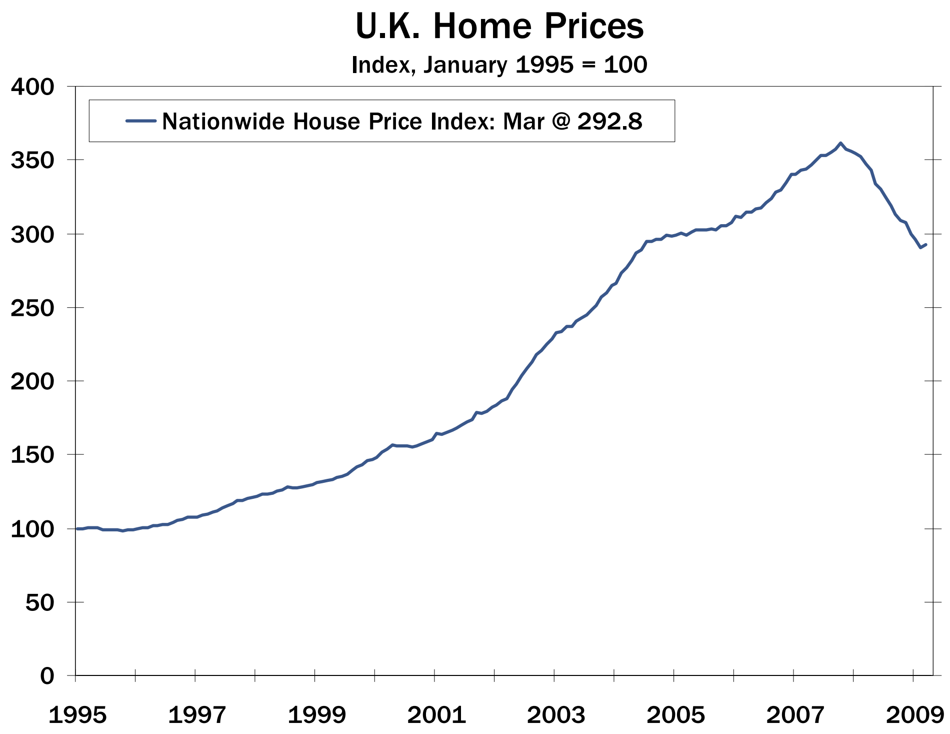
Another sharp decline in British real GDP appears to have occurred in the first quarter.

However, British policymakers have responded to the crisis in an aggressive fashion. The Bank of England has reduced its main policy rate from 5.75 percent in December 2007 to only 0.50 percent at present, and it has a program in place that will buy £75 billion of private sector debt securities from the banking system. The bank is also purchasing £75 billion of British government bonds in an attempt to pull down long-term interest rates. The government has implemented a fiscal stimulus package, which includes both infrastructure spending and a cut in the VAT rate that is worth approximately one percent of GDP.

British policymakers have responded to the crisis in an aggressive fashion.

The stimulus measures appear to be bearing some fruit as available monthly indicators suggest that the rate of contraction in the British economy probably slowed at the end of the first quarter. As noted above, however, the British economy faces a host of domestic economic and financial challenges that will limit the vigor of any upturn. In addition, nearly 60 percent of British exports are destined for other countries in the European Union, and the weakness in the Euro-zone economy that we project for the remainder of the year will constrain growth in British exports. In our view, however, the U.K. economy will probably emerge from recession before the Euro-zone due in part to the aggressive policy response undertaken by British authorities.

Exhibit 4



Source: Nationwide Building Society and Wachovia

Euro-zone Recovery Constrained by Lackluster Policy Response

The Euro-zone economy, which slipped into a mild recession in the middle of last year, experienced a record rate of decline in the fourth quarter. Unfortunately, available indicators from the first quarter suggest that the economy continued to contract at a very rapid rate. For example, the purchasing managers' indices for both the manufacturing and the service sectors remain in territory that is consistent with deep recession (Exhibit 5).

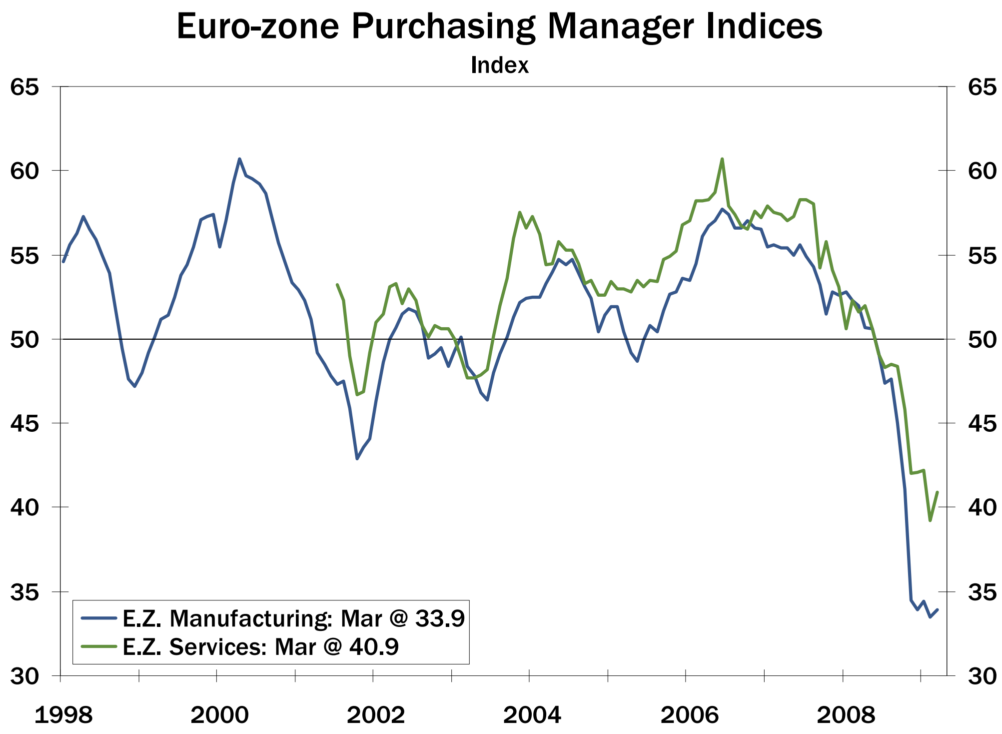
In our view, the response of continental policymakers has not been very aggressive.

In our view, the response of continental policymakers has not been very aggressive. Yes, the European Central Bank has cut its main policy rate by 300 bps since early October. However, at 1.25 percent the ECB's policy rate is high relative to the Bank of Japan (0.10 percent), the Federal Reserve and the Bank of Canada (0.25 percent each), and the Bank of England (0.50 percent).

The ECB has also been slow to implement "unconventional" policy steps (e.g., large purchases of private sector debt securities from the banking system and outright purchases of government bonds) that the Fed and the Bank of England have already undertaken. Because the legislation that created the ECB limits its ability to take on credit risk, perhaps our criticism should be directed at European politicians.

However, the point that European policymakers writ large have been relatively slow to respond to the global credit crisis still stands. Speaking of governments, the German government has enacted a fairly large fiscal stimulus package that is worth about three percent of GDP. However, the French package is rather small (0.6 percent of GDP), and the Italian program is essentially nonexistent.

Exhibit 5



Source: Bloomberg L.P. and Wachovia

The Euro-zone also suffers from a number of problems that will hold back individual economies to different degrees.

The overall Euro-zone also suffers from a number of problems that will hold back individual economies to different degrees. Spain clearly had a housing market bubble that has subsequently burst, and house prices in France doubled in a relatively short period of time (i.e., between early 2001 and late 2007). Germany never had a housing bubble, but it has extensive trade ties with eastern Europe and the countries of the former Soviet Union. Many of these countries have fallen into deep recessions, which will constrain growth in German exports for some time. Lack of structural reform has caused Italy to lag behind France and Germany over the past few years, and it is unlikely that Italy will turn into an engine of growth anytime soon.[5]

In our view, the tepid policy response likely will cause the Euro-zone to lag behind the American, British and Chinese economies. Any recovery that begins in the Euro-zone likely will not begin until late this year/early next year, and it probably will be driven by exports, at least initially. Because growth in other major economies likely

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[5] For a pessimistic view on growth prospects in Greece, Italy and Spain see "The Long Road Ahead for 'Club Med' Countries" (March 18, 2009), which is posted on our website or which is available from the author upon request.

will remain below trend next year, the Euro-zone economy will probably experience a subpar year of growth in 2010 as well.

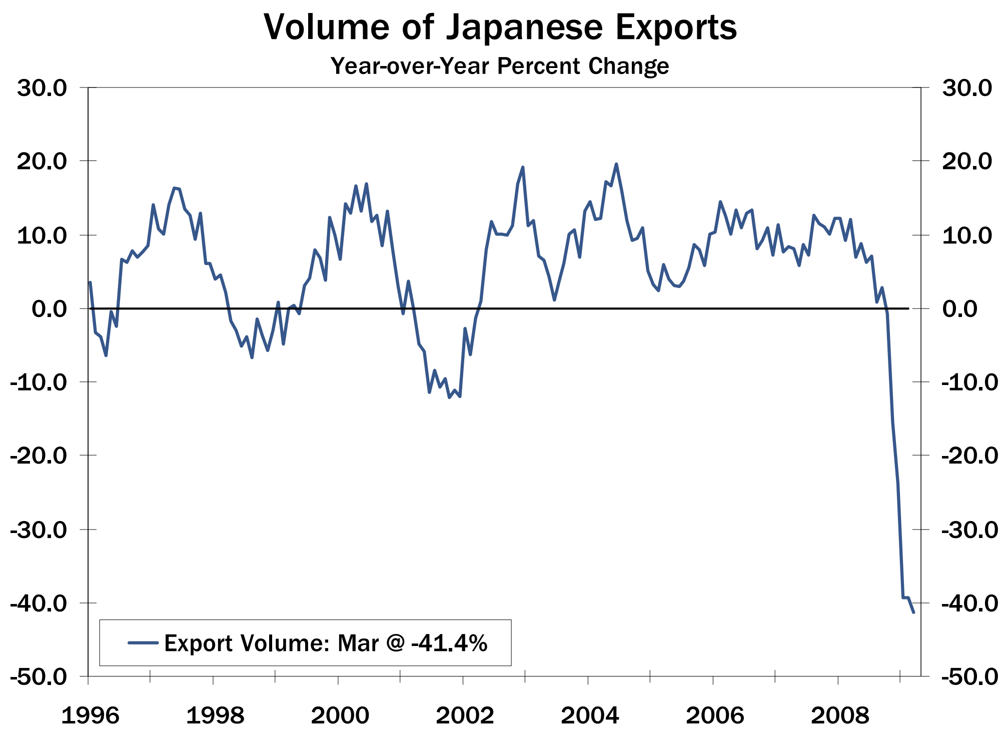
Japan Probably Will Be a Laggard as Well

Japan appears to be in the midst of its deepest recession since the country emerged from the utter destruction of World War II. The economy has contracted for three consecutive quarters, and the 12.1 percent annualized plunge in real GDP in the fourth quarter appears to be the sharpest rate of contraction in about 35 years. Real GDP may very well have dropped at a double-digit rate again in the first quarter.

Until exports and capital spending stabilize, the Japanese economy is likely to contract further.

Net exports have been a primary driver of growth for the Japanese economy over the past few years, and the collapse in trade volumes last autumn hit Japan especially hard (Exhibit 6). Capital spending, which is cyclically sensitive, has also been an important source of growth since 2002. The sharp downturn in the export sector has caused capital spending to fall off sharply as well. Consumer spending is more stable, but has underperformed. Personal consumption expenditures account for nearly 60 percent of Japanese GDP, but its contribution to growth has been far less than its GDP share over the past few years. Until exports and capital spending stabilize, the Japanese economy is likely to contract further.

Exhibit 6



Source: Global Insight and Wachovia

The policy rate of the Bank of Japan (BoJ) stood at only 0.50 percent before the crisis, so BoJ policymakers only had limited room to maneuver. The BoJ has reduced its policy rate to 0.10 percent, but 40 bps of rate cuts will only have a limited effect on the economy. The fiscal policy response has a better chance of providing some much needed stimulus to the economy. The Japanese government has already primed the fiscal pump with a package of spending increases, and a new plan could bring the total package to an impressive three percent of GDP this year. Although fiscal spending should help to bring the double-digit decline in GDP to an end, a self-sustaining recovery will need the twin drivers of exports and capital spending to kick in again. Exports should stabilize in the months ahead as the freefall in economic activity in some of the world's major economies levels out. However, capital spending likely won't begin to accelerate until next year, at the earliest. Indeed, the recently released Tankan report showed that Japanese businesses plan to cut capex by 11 percent in the fiscal year that began on April 1. In our view, the Japanese economy will probably continue to contract, albeit not as sharply as in the past two quarters, throughout 2009.

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Conclusion

Most major economies fell off a cliff late last year as the global credit crunch, which was exacerbated by Lehman Brothers' failure, brought the global economy to a standstill. Most major economies appear to have contracted at a sharp rate in the first quarter as well, but recent data suggest that rates of decline may be starting to slow. Chinese policymakers were quick to turn to expansionary macroeconomic policies, and recent data suggest that China may be starting to emerge from its brief downturn. The U.S. economy has not hit bottom yet, but the unprecedented rate of inventory liquidation in conjunction with aggressive policy easing should cause GDP growth to turn positive later this year. The U.K. economy has many of the same problems as its American counterpart, but British authorities have also been quick to ease policy. Consequently, the British economy should also hit bottom later this year. In our view, the Euro-zone will lag most other economies due to the relatively tepid policy response. Exports and capital spending have been important drivers of economic growth in Japan over the past few years. Therefore, Japan is likely to lag other major economies as well.

Our views on the near-term trajectories of the world's major economies have implications for our exchange rates forecasts. Because we project that the United States will exhibit incipient signs of recovery before most other economies, we forecast that the U.S. dollar will trend higher vis-à-vis most currencies over the next few quarters.[6] Further out—sometime early next year perhaps—the greenback could flatten and even depreciate somewhat if the U.S. economic recovery proves to be quite sluggish. That said, we maintain our view that the dollar, which has strengthened versus most currencies since last July, will continue to trend higher for the foreseeable future.

We forecast that the U.S. dollar will trend higher vis-à-vis most currencies over the next few quarters.

[6] The specifics of our foreign exchange forecast are contained in our *Monthly Economic Outlook*.

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