

POLICY BRIEF


GLOBAL POLITICAL TRENDS CENTER (GPoT)

PROSPECTS FOR GLOBAL GROWTH IN 2012

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ABSTRACT The current concern among many is that what we are faced today is not a usual crisis that is part of the economic cycle, but an era of great stagnation with low growth and high unemployment, not witnessed since the Great Depression of the 1930's. One wonders which country will drive global growth while major actors such as the European Union are now financial casinos, the United States is continuously losing its dynamism, Japan is struggling under demographical problems, and the emerging markets are still too small and volatile. Once again, policy makers acknowledge that the problems of growth are global and systematic; such that if one faces an issue, all of them get contaminated. However, they still seek for solutions in mercantilist national policies.

It has been five years since the financial crisis erupted in 2007, yet the world economy has still not seen signs of definite recovery. From the controversial downgrading of U.S. debt by Standard & Poor's to the worsening of the crisis in continental Europe, popular Wall Street protests, and the angry Greeks in the streets of Athens, problems faced by the West – especially Europe – are out in the open.

The current concern is that what is faced today is not a usual crisis that is a part of the economic cycle, but an era of great stagnation with low growth and high unemployment, not witnessed since the

Great Depression of the 1930's. The effects are lucid among the developed economies of Europe, the United States, and Japan, and the emerging economies are also not immune to the same issues. Only few economists believe that the rapid growth of emerging markets – most notably China – is sustainable, considering the numerous issues that surfaced in Western financial markets.

Reflecting the deterioration in Europe and the slowdown in emerging markets, the International Monetary Fund (IMF) marked down its global growth forecast for 2012 from 4.0% to 3.3%. To make things worse, the increasing Iranian threat

at the Strait of Hormuz started to pose a risk for global energy prices, which could further damage this year's global growth. Under these circumstances, the World Bank and the IMF estimates are able to list only recovering countries such as Libya, Iraq, Angola and Niger as 2012's booming economies.

Europe: The Center of the Cause

As stated by David Calleo, a political economist based at Johns Hopkins School of Advanced International Studies, Europe was already struggling under a socio-economic crisis by the 1970's, where sectors expanded inexorably, fiscal conditions deteriorated, stagflation grew endemic, labor was too expensive and inflexible, and an excess of taxation and regulation stifled entrepreneurship (Calleo, 2003, p. 166). The ongoing Cold War and the post-war assistance by the United States, however, let Europe decline and other economic blocs rise as alternatives. It was this old world order that created an optimistic way of thinking in Europe where people began to believe that opportunities would be permanent in the West and life would only keep getting better. President of France Charles de Gaulle once defined Europeans with this understanding as "people spoiled by prosperity".

However, the age of optimism that was built upon post-war economic restructuring started to erode by the end of the Cold War as the global outlook began to change. In effect, economic globalization put Europe in an increasingly unfavorable position. By the early 1990's, Europe's unemployment levels had reached a scale unobserved since the

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Depression. The end of the Cold War also diminished the significance of the strategic partnership between Europe and the United States as the U.S. turned its focus to the emerging Asia. Europe was becoming increasingly irrelevant, a problem to which Europe responded with greater integration and a common currency with a hope to advantageously position Europe within the newly shaping post-1989 order.

However, the monetary union soon started to become the basis of Europe's problems. The existence of a European Central Bank permitted less developed countries like Greece, Ireland and Portugal to borrow at will without the existence of any centralized accountability mechanisms or regulatory institutions. These poorer periphery countries did not have any choice but to borrow, since the stronger Euro rendered their once cheap service economies uncompetitive. Indeed, an absolute cultural, political and economic integration that does not exist in Europe is vital for an efficient monetary union similar to the one in the United States since it is difficult to balance the fiscal needs of countries that are at different production levels.

Even though problems had been visible for a long time, European policy makers were not able to come up with timely solutions for these gradually emerging issues as they were occupied with other issues that needed immediate handling such as immigration and extreme right politics. Once financial crisis hit, after had built up for a long time, Europe's initial response was to spend more money. Through deficit spending, they intended to stabilize the banking sector and hence prevent economic stagnation. However, this has brought deficits up to unprecedented



levels, raising concerns regarding their sustainability in the long run.

Given the prices of government debt, resources that are needed to lift up the economy further are no longer there. Europe is situated at the center of world's financial problems. Borrowing costs for European Union's weaker economies such as Greece, Ireland, Portugal, Spain and Italy have reached record highs, and richer countries like Germany do not seem committed to coming to their rescue unless Europe manages to make common decisions and stay together. The World Bank also recently cut its 2012 forecasts for the 17 countries that use the Euro currency from an expansion of 1.8% to a contraction of 0.3%.

Yet the decline of the Euro is not only a problem for Europe. Europe is the largest trade partner of both the U.S. and China. If wealthy European consumers stop buying, this will largely affect the growth prospects of the emerging Asian and Latin American economies. There are also nations that hold Euro as their reserve currency, although the number of such nations is small compared to those holding U.S. dollars. Central Banks in Asia and Latin America have already started to diversify their Euro holdings by acquiring U.S. dollars and Gold. The common feeling amongst them is that the situation in Europe is going from bad to worse without any effective policy actions being implemented.

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United States: Weak Expansion

In spite of not being as tragic as in continental Europe, prospects are also not looking very bright on the other side of the Atlantic. Although latest numbers for the fourth quarter of 2011 have shown a gradual recovery in the United States, it is also realized by American policy makers that the Great Recession has caused an economic decline, and that a further fiscal stimulus would be more costly than it has ever been. Without further fiscal stimulus, The Federal Reserve Bank will have to turn to its printing presses for a third or fourth round, which will push back the U.S. dollar.

However, due to the position that the United States and its currency hold, investors are still holding onto U.S. Treasuries. Moreover, the troubles in Europe leave the U.S. dollar as the only safe reserve currency to invest in. Although U.S.'s addiction to debt raises eyebrows, the Chinese Central Bank still prefers investing in the dollar rather than in the Euro, pound, or in any other emerging market currency, none of which are as large or as stable.

It is quite an irony that it was the same day that Standard and Poor's raised its famous warnings, markets revealed their confidence in the American financial sector once again by lowering the borrowing cost for the United States, causing the dollar to gain value against the Euro. This is because there is simply no alternative to the U.S. dollar at this point in time. Monetary policies are likely to support growth in the U.S. in 2012. Despite a deficit that is as high as 10% of GDP and a total debt that constitutes 70% of GDP, the U.S. is still expected to be the



fastest growing nation among advanced economies, and global growth still mostly relies on the limited U.S. expansion.

Fifty years ago, the U.S. produced half of world's goods and services. This ratio is now down to 25%. This was not only caused by the slowing down of the U.S. economy – in fact exports were up from \$1 trillion in 2009 to \$1.2 trillion in 2010. However, there are new actors on the scene that are expanding more aggressively. The United States is still a major player in the global economy, but its importance is declining.

Moreover, the United States is already feeling the effects of Europe's financial problems. According to the data from the U.S. Department of Commerce, exports to Europe fell by 6% in November 2011. The World Bank cut this year's growth forecasts for the United States from 2.9% to 2.2% and from 2.7% to 2.4% for 2013, due to the slowdown in the global economy and the ongoing brawl in Washington over spending and taxes. The IMF points out that there might be potential spillover effects to U.S. banks from the crisis in the Euro area. To this end, the United States might turn to austerity budgeting sooner than expected for a gradual decline of the deficit, further decreasing the prospects for growth. We should also note that unemployment levels have reached 9% and the level of growth is not sufficient to make up for the increase in this percentage.

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Japan: An engine of Growth No More

Meanwhile, Japan has been suffering from low growth and deflation for years. Once an engine of growth, the Japanese economy is now stagnating. It has had six prime ministers in five years, a crushingly high national debt and a Yen touching post-war highs and making it harder for Japanese exporters to earn profits. Since the beginning of 2006, the yen appreciated by 34% against the U.S. dollar. Yen has also appreciated by 16% against the Euro since May 2011, which further decreased Japanese competitiveness. Last year, Bank of Japan implemented a policy in order to depreciate the Yen, however the effects were short-lived.

Together with the weak export demand amid the European crisis and floods in Thailand, where more than 1300 Japanese companies are based, the economy shrank by 2.3% during the fourth quarter of 2011. The outlook for the world's third largest economy remains unclear,

as the exporters are not able to determine the extent of the European crisis. Major Japanese manufacturers like Sony and Honda have already shifted their operations overseas due to high production costs in Japan. According to J.P. Morgan, a global consulting firm, 76% of Japanese automobile production will soon be based overseas, up from 49% in 2003.

As it is the case for China today, during the 1980's and 1990's, Japan's huge trade surplus was a target for American and European mercantilists. However, this is no more the case today, reflecting the broader changes that took place in the Japanese economy. In December 2011,



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Moreover, Prime Minister Yoshihiko Noda is struggling with the world's largest public debt. According to the IMF, Japan's debt to GDP ratio was more than 130% in 2011 – the second highest in the world after Greece. Despite low bond yields due to the country's current account surplus, financing the debt is becoming more complicated with the broader changes taking place in the economy. The Bank of Japan announced its intention to issue 10 trillion Yens of public debt in order hit the near term inflation target of 1%. The change in the trade balance suggests that foreigners will need to finance the increasing Japanese public debt in the future, which could lead to higher bond yields.

Given the elongated periods of imbalance, what is happening in Japan was expected. High saving Japanese consumers are not spending enough to produce a domestic demand that is sufficient to generate growth. Moreover, once productive Japanese population is now ageing and retiring citizens have started to withdraw their assets. Japanese savings rate has fallen from 14% of disposable income in the early 1990's to only 2% in the past couple of years (Economist, 2012). With private savings shrinking and the government borrowing heavily, Japan's current account position could soon move towards a deficit. Under these conditions,

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once a growth engine, the Japanese economy is no longer able to contribute to global growth, as it is suffering under demographical and structural problems.

Emerging Asia and Latin America: Slowing Down

With the recognition of the downfall of Europe, the U.S. and Japan, increased expectations arose of the emerging economies as tomorrow's drivers for global growth. However, despite their rapid emergence, they are still not equivalent alternatives. Commonly referred to as BRIC countries, Brazil, Russia, China and India currently control no more than 15% of the world trade – in comparison to the roughly 50% share that the E.U. and the U.S. hold in total. For

example, India, with its estimated population of 1.17 billion, only forms around 2% of world markets. On the other hand, markets of second tier emerging countries such as Turkey, Mexico, and South Africa, are still too limited to have a larger impact on global growth despite having certain regional influences. Moreover, emerging markets still lack political and economic cohesion amongst themselves.

Investors are hoping that emerging markets will drive the world economy, yet after a strong rebound in the immediate aftermath of the global crisis, the pace of economic activity has slowed down in many emerging markets. This was mostly due to the crisis in Europe that has led to a reduction in export orders and financial services. Among emerging market economies, the Central and Eastern Europe (CEE) is the region that bears the highest



risk with its direct trade and financial linkages to the Eurozone. The IMF has lowered the region's growth outlook for 2012 from 1.6% to 1.1%.

Furthermore, European banks provide about 30% of trade and project financing in the emerging Asia, which would mean that increasing pressure on European banks might result in a loss of parent bank support for local lending. In fact, reflecting the negative outlook for the global economy, investors have cut investments in developing countries by 45% in the second half of 2011 compared to the previous year.

The IMF also warned about the increasing risk in emerging markets due to the loosening of domestic real estate and credit markets. For example, China's investment spending is running at close to 50% and the Chinese economy is facing a growing threat of over-accumulation, which could inevitably lead to a deflationary pressure, hence slower growth. The government's investment stimulus encourages massive state bank lending that triggers a speculative boom – mostly concentrated on the real estate sector that is now amounting to roughly 13% of China's GDP. The value of the unsold Chinese real estate inventories amounted to \$50 billion in August 2011. This is an increase of 46% compared to the previous year (Foster & McChesney, 2012, p. 7).

Emerging markets also need to cope with inflationary pressures, which is a result of their increasing domestic consumption. In fact, China, India, South Africa, Russia and Turkey have chosen to cool rapid growth and inflation in 2012 through interest rate hikes and other similar measures. Yet, as

Europe weakens, developing countries could find that their slowing down might be larger than necessary to cope with inflationary pressures. The IMF estimates that developing economies will expand by 6% in 2012.

Iran and Energy Prices

Certain unresolved political conflicts also exist that could potentially contribute to the slowdown of the global economy. Suspicions over Iran's nuclear program are increasing the tensions in the Middle East. The European Union has previously announced that it would embargo Iranian oil imports, which are about 500,000 barrels a day. Iran has announced in response that it would stop trading with major E.U. buyers such as France and England, stressing out that it could find other demand for its oil if necessary.

Meanwhile, there are speculations of an Israeli air strike on Iran and an Iranian threat to blockade the Strait of Hormuz. Iran and the U.S. have already deployed their battleships to the Strait, which is a transit way for 17 million barrels of crude oil a day –

one fifth of global consumption.

Although the slowing down of Europe and the United States, and increasing energy efficiency have decreased the demand for oil, the dependence on the global oil supply chain persists. Tensions with Iran have increased oil prices to their highest in the last 8 months – as high as \$120 a barrel. Any potential speculations could increase the price of crude oil to the levels of \$150 a barrel, which would translate

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into higher global inflation and slower growth.

With its 150 billion barrels of reserves, Iran holds the world's third largest reserves. It exports 2.5 million barrels of oil a day, ranking Iran as the world's third largest oil exporter. If the sanctions on Iran were to be implemented effectively and Iran was taken out of the global supply chain, the world's energy demand could be partially satisfied by Saudi Arabia's spare production of 2 million barrels a day. Yet, this is still less than the amount of Iranian exports, and more importantly, the spare production has not previously been tested. Without Iranian crude exports, it seems that oil prices will keep increasing, and this constitutes a major risk for global growth in 2012.

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billion in 2010 to \$60 billion in 2011, as it increased its oil production.

All aforementioned financial troubles aside, it is encouraging to see that income disparities between the world's poorest nations and the rest of the world are becoming less critical. In fact, the amount of trade between Africa and rest of the world increased by 200% since 2000, foreign debts declined by a quarter and budget deficits have decreased by two thirds. However, Africa still provides only 2.5% of world output, and none of the African countries will be able to compete with China, India, Mexico or Turkey in terms of impacting global growth in the near future.

One wonders which country will drive global growth while major actors such as the European Union are now financial casinos, the United States is continuously losing its dynamism, Japan is struggling under demographical problems, and the emerging markets are still too small and volatile. Once again, policy makers acknowledge that the problems of growth are global and systematic; such that if one faces an issue, all of them get contaminated. However, they still seek for solutions in mercantilist national policies.

Recovery States, Income Gap and Conclusion

The projections for 2012 bring forward unexpected nations as the world's booming economies, such as Libya growing at 23%, Niger at 15.4%, Iraq at 12% and Angola at 10.5%. These are all recovering states that have recently started from the bottom and therefore are in the first and fastest stages of growth, also thanks to increasing commodity prices in 2012. The former Portuguese colony Angola, for example, is now Africa's second largest oil producer. Since last year, Portugal has been lobbying for Angola to invest its petrodollars in Portugal since the European country is now struggling with the terms of the \$99 billion financial rescue package. War torn Iraq, on the other hand, has managed to expand its reserve holdings from \$50

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