World economy in choppy waters
by Michael Heise

Concerns about the strength and sustainability of the global economic recovery have increased. Are we heading for a renewed downturn?

Fears of a setback in the Chinese economy in the wake of measures aimed at curbing buoyant activity, particularly in the real estate sector, seem overdone. In view of the successes notched up in past years, for instance during the Asian crisis, the ability of Chinese policymakers to achieve a soft landing should not be underestimated this time either. In the USA the sharp swings in some economic indicators certainly make an assessment of the underlying trend in activity difficult. A relapse of the US economy into recession after only a brief rebound would be a rare event, last seen in recent economic history only in the early 1980s in conjunction with a drastic tightening of monetary policy.

The euro area is dogged by the debt crisis, with its impact on the direction of fiscal policy. The austerity packages agreed in the eurozone since the end of last year add up to a good 0.5% of GDP in 2010 and a good 1% of GDP in 2011. Compared with a scenario without this consolidation, eurozone gross domestic product in 2011 is likely to be ¾ - 1 percent lower. This is not sufficient to justify the forecast of a recession. Moreover, the austerity packages must be seen alongside the positive effects from a lower euro. In the first half of 2010 the effective exchange rate of the euro – as measured against the currencies of against 21 trading partners – fell by around 10%. This boosts export demand. Of course, higher import prices push up consumer prices, eating into purchasing power. But, on balance, our estimates show positive effects from a sustained 10% real euro depreciation of 0.8-0.9% of GDP after two years.

Consequently, the negative demand effects of the austerity packages and the positive effects of the euro depreciation could balance each other out, at least if the lower valuation of the euro persists. It should also not be underestimated that the prospect of an improvement in the public-sector finances in the future could help to stabilize private sector spending behavior.

All told, continued, albeit moderate, growth is on the cards. On the markets for risky assets, this lays the foundation for a fundamentally positive trend. But with the economic indicators patchy, investors will probably take some time yet pondering where the pace of growth in the
world economy is going to pan out. A linear upward trend is therefore unlikely, temporary setbacks and a good deal of jitters remain the order of the day.