

Will L-U-V stand test of time?

Once the governments start withdrawing stimuli, part of which is non-recurring, the pace of recovery is likely to slow down



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IT'S the silly season again, with much of the financial commentariat spewing out predictions for the New Year. Based at least in part on the impressive price action of the stock markets of late, research analysts are calling for the good times to roll on next year. Well, we are all indeed entitled to our opinions, but not to our own facts. So, before succumbing to the folly of forecasting, it would be worthwhile to get the facts right on the key issue of global growth as that is the most important factor in making a projections.

There is no consensus on the shape of the global economic recovery so far. Most of us are still lost in the alphabet soup of whether it is an L-, U- or V-shaped recovery. Despite the return of growth in almost every country, the pattern of the global rebound is very uneven.

For the US, a U-shaped recovery is a charitable description. The economy grew at an annualised pace of 2.8% in the third quarter of 2009 and is on track to expand at roughly the same pace in the current quarter. This is the weakest rebound on record; in the first year of a recovery, the economy's growth rate has typically been twice the size of the decline in the downturn. The US economy contracted by 3.8% on a peak-to-trough basis during the recession that began in late 2007. By historical standards, the US economy should now be printing GDP growth numbers of more than 7% to recoup lost output.

A recovery-to-loss ratio of barely one is a disappointing outcome and explains why large unemployment, huge excess capacity and terrible government finances still plague the country. After a sharp downturn, a growth rate of 3% is just not enough to lift the employment rate and businesses are still shedding their workforce. Instead, five months after the end of a recession, the US should be generating over 2,00,000 jobs a month.

The story is grimmer in other parts of the developed world. The recovery in countries such as Japan and the UK is more L-shaped with a gentle upward slope. Although both those economies are on course to register growth rates of 2% on an annualised basis in the current quarter, the recovery-to-loss ratio is still well below one. The Japanese economy shrank by a staggering 7.7% during the recession while the UK contracted by 5.6%. A run rate of 2% growth implies that even two years from now, these economies will be operating at a lower level of output than at the peak in early 2008.

The picture for much of continental Europe is only slightly better. While countries from Germany to Sweden are on track to grow at a somewhat faster pace of 3%, it would still leave them with a recovery-to-loss ratio of less than one as the Euro-area contracted by 4.7% on a peak-to-trough basis through the downturn. The tepid recovery in the developed world — ranging between U- and L-shaped — explains why economic sentiment remains moribund in many parts of the world even in the face of all the headlines about the end of the Great Recession and monster stock market rallies.

The handful of countries in the V-shaped camp are all from the developing world. China leads the pack: the economy experienced just a single quarter of negative growth at the end of 2008 and is on course to expand this year by 9% — in

line its trend growth rate. India and Indonesia have followed a similar path though the rebound is far less spectacular than that of China.

Brazil and South Korea too are witnessing a V-shaped comeback; with a recovery-to-loss ratio of greater than one, their economies will have regained the near-5% loss in output by the middle of 2010. Poland and the Philippines have impressed more with their resilience through the downturn than by the ensuing rebound. Both economies held up well despite the expected negative repercussions from falling remittances and trade exposure to their respective regions.

But in many other emerging markets, the recovery is rather U-shaped. It could take at least two more years before real GDP returns to pre-crisis levels in Russia, Mexico, Turkey and Taiwan. These economies contracted by anywhere between 9% and 13% during the downturn and they are presently not even growing at half that rate.

In a few developing countries where domestic finances are in a complete mess and dependence on external financing is high, the recovery is turning out to be merely L-shaped. Ukraine, Hungary, Bulgaria and Romania are all struggling

port, in the form of fiscal and monetary stimuli, has ensured the Great Recession did not morph into Great Depression 2.0.

The question now is whether the current pace of expansion will sustain through the course of next year. The effects of massive government spending will begin to fade and the private sector will have to pick up the slack. While the impact of government spending in reviving growth in the US is well-documented, its significance in boosting emerging market growth this year is probably underestimated.

The consumer in places such as China, India and Brazil has undoubtedly been relatively resilient but an increase in both government consumption and investment have also played a major role in shoring up growth in these countries. According to JP Morgan Research, stimulus spending added 2.8% to emerging market growth this year. Such a powerful impulse will be missing in 2010 as some of the spending is non-recurring and policymakers have little scope for offering a fresh stimulus given their high debt burden.

Policymakers will also be under pressure to focus more on initiatives that foster greater stability in the financial system rather than

THE WEAKEST REBOUND?

Even if the US economy grows at the current consensus rate of 3% in the first year of the rebound, it would constitute the weakest recovery on record based on the historical recovery-loss ratio

US real GDP in contractions and recoveries

	DECLINE FROM PEAK TO TROUGH	GAIN ONE YEAR POST-TROUGH	RECOVERY-TO-LOSS RATIO
1948-49	-1.7%	7.4%	4.4
1953-54	-2.6%	6.3%	2.4
1957-58	-3.7%	7.5%	2.0
1960-61	-1.6%	6.3%	3.9
1970	-1.1%	4.5%	4.1
1973-75	-3.2%	6.2%	1.9
1980	-2.2%	4.4%	2.0
1981-82	-2.9%	7.7%	2.7
1990-91	-1.4%	2.6%	1.9
2001	-0.3%	2.3%	7.7
2008-10 (F)	-3.8%	3.0%	0.8

(F): Consensus forecast for one year ending 2Q2010

Recovery-to-loss ratio: Gain in the first year of recovery in real GDP/peak-to-trough loss during the recession

Source: United States Bureau of Economic Analysis & Morgan Stanley Investment Management



to return to positive growth territory while the three Baltic states of Estonia, Latvia and Lithuania will likely register another decline in GDP growth in 2010, albeit a much smaller shrinkage of 2-3% following an incredible 15-20% drop in 2009. Meanwhile, growth in the United Arab Emirates could be close to zero next year following the ongoing debt crisis.

In sum, it appears that after the deepest and longest economic downturn the global economy has faced in its post-World War-II history, the recovery is turning out to be sub-par. Conventional wisdom that the further the economy dips under water the stronger it will pop back up is not playing out. This is because lot of the excesses in the system, from the high leverage on the US consumer's balance-sheet to overcapacity in global manufacturing, have not been washed out. Consumers and businesses across the globe including in many emerging markets are also still in a state of shock after the near-miss from last year's financial cataclysm.

Of course, the fact that there is any revival underway, regardless of shape and size, is a miracle, especially when contrasted with the dire outlook a year ago. The enormous policy sup-

port, in the form of fiscal and monetary stimuli, has ensured the Great Recession did not morph into Great Depression 2.0. The question now is whether the current pace of expansion will sustain through the course of next year. The effects of massive government spending will begin to fade and the private sector will have to pick up the slack. While the impact of government spending in reviving growth in the US is well-documented, its significance in boosting emerging market growth this year is probably underestimated.

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Despite an economic revival in almost every country during the current quarter, the pattern of the global rebound is very uneven. Government spending has propped up growth everywhere and the recovery in many countries is still the weakest on record.