



# ECONOMIC REPORT

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## MAPI Quarterly Forecast of U.S. Exports, Global Growth, and the Dollar: Second Quarter 2009 Through Fourth Quarter 2010

Signs of Bottoming in the United States Foreshadow a Weak Recovery in Global Activity Beginning in the Fourth Quarter of 2009

Currency Activity Will Remain Volatile as Markets Adjust to Monetary and Fiscal Policy Changes

U.S. Export Contraction During 2009 Will Be the Steepest in More Than 50 Years

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## MAPI Quarterly Forecast of U.S. Exports, Global Growth, and the Dollar: Q2 2009 Through Q4 2010

### Introduction: An Historic World Slump

In a world economy plagued by deep recessions, sharp slowdowns, and double-digit declines in manufacturing output, recent U.S. data provide some hope that, just maybe, the worst of the collapse is over. While signs of firmer demand are modest and potentially explainable by one-time factors, several data series in sectors ranging from housing and consumer spending to business investment suggest that an aggressive and innovative monetary policy might be starting to stabilize credit-sensitive areas. And, while even more tenuous, a range of financial data further bolster the case for a U.S. economic recovery later this year. The recent numbers, for example, from a widely followed quarterly Federal Reserve (Fed) survey of lending institutions suggest that the spreading of tighter lending standards throughout the American banking system may be slowing—not anything that is yet going to support a significant economic recovery, but a welcome sign of future improvement.

Unfortunately, apart from hints of a bottom in the United Kingdom housing decline and mixed evidence suggesting that the slowing Chinese economy may not suffer the feared “hard landing,” the improved U.S. data appear to be the only meaningfully positive signals from a grim world landscape. The broad global picture remains troubled. Forecasters remain compelled to rapidly write down their expectations for the near-term growth of gross domestic product (GDP) in many major countries and to deal with the implications of the virtual collapse in manufacturing in the advanced and many developing economies largely brought about by sharply declining global trade activity.

Fiscal and monetary policies throughout the world continue to adjust to the most difficult global economic crisis of the post-depression era. Significant monetary accommodation, in particular, has been a worldwide phenomenon. Major central banks in advanced and developing nations have been engaged in aggressive cutting of policy interest rates. Fiscal policy has been more diffuse and regional in nature, largely influenced by the remarkably diverse domestic politics of major global players. But even more important, given the financial underpinnings of this world slump, have been the

initiation of efforts in the United States, the Eurozone, and the United Kingdom to repair badly broken banking systems and normalize the flow of credit, without which the impact of monetary and fiscal policies will be muted at best. Global equity markets clearly approve of the aggressive advancement of policy in recent weeks. But investors, along with government officials and economists, will be watching incoming data carefully to see if the vague signs of stability in the U.S. economy truly herald a bottom in a virulent global slide.

MAPI expects a slow, grudging recovery in global output to begin later in 2009. As shown in Figure 51 (page 37), we predict that aggregate non-U.S. industrialized country output will decline by 3 percent during the second quarter of 2009 and then by 1 percent during the third quarter. We expect growth to resume during the fourth quarter of 2009 but to be at or below 2 percent through the fourth quarter of 2010. Aggregate developing country growth is expected to be a sluggish 2.0 percent during the second quarter of 2009 but to accelerate gradually to 2.5 percent during the third quarter, 3.0 percent during the fourth quarter of 2009 and first quarter of 2010, followed by a gradual acceleration to 3.7 percent by the fourth quarter of 2010.

MAPI's current dollar forecast is shown in Figure 46 (page 34). In spite of the decline of recent weeks, we expect a bit more upside to the dollar versus the currencies of the industrialized nations as the contractions in the Eurozone and Japan become increasingly deep with little or no evidence of an imminent bottom, reinforcing the “flight-to-safety” instinct that has created such a large flow of funds into U.S. Treasury bonds. As shown, we expect the dollar to appreciate by 4.5 percent against the currencies of the industrialized countries during the second quarter of 2009 (on a compound annual basis) and then be flat for the balance of the year as global central banks race the Fed down to near-zero policy interest rates and as the financial crisis hopefully begins to ease, creating a bit more visibility for global growth as whole. Global current account balances will emerge once again as a trading theme in the currency market, but weak and uncertain growth in the United States and around the world will create a lack of conviction regarding the dollar—and all other major currencies—among traders. Consequently, we expect a flat performance for the

dollar during 2010, down modestly during the first half of the year and up modestly during the second half of the year.

We expect the dollar to gradually return to its pre-crisis position against the currencies of the developing economies as most East Asian currencies resume an upward path in the wake of easing financial fears and slowing capital flight particularly from South Korea and Indonesia, whose currencies have suffered a virtual crash against the dollar during the past year. MAPI expects the dollar to fall by 2 percent against the currencies of the developing economy bloc during the second quarter of 2009, by 5 percent during the third quarter and by 8 percent during the fourth quarter. During 2010, we expect a 5 percent decline during the first quarter, an 8 percent decline during the second and third quarters and a 12 percent decline during the fourth quarter.

The strong dollar and the near-collapse of global demand is expected to result in an 8.3 percent contraction in the growth of total U.S. goods and services exports during 2009 (shown in Figure 52 on page 37). This would be the deepest annual export contraction since 1958. A very modest rebound of 1.2 percent is expected during 2010, reflective of our expectation that the path ahead for the global economy will be difficult and uncertain as financial systems repair, and as shattered confidence is rebuilt.

This report considers activity in key regions as well as in global markets to support our forecast of world growth, the near-term path of the dollar, and the outlook for U.S. export demand. In the next section, I review the global picture and consider the implications of recent U.S. data. This is followed by an overview of the continually troubled path of industrialized country output. Subsequent sections consider recent data from China and India, the broader East Asian region, and key Latin American economies. In the final sections, I consider the outlook for the dollar, the possibility of global deflation, and the outlook for world growth and U.S. export demand.

### **Do Signs of Life in the United States Foreshadow A Bottom for the Global Recession?**

The difficult global outlook is well illustrated in Figure 1. During 2009, forecasters expect sharp contractions throughout the industrialized world, followed by 2010 recoveries that are expected to be modest, at best. Near-zero growth is expected for the developing and transition economies with relatively modest recoveries expected for 2010 that very much depend on improvement in the advanced countries. In recent weeks, major international

organizations including the International Monetary Fund (IMF) and the World Bank have forecasted that total global growth will actually shrink during 2009, with the expected contraction ranging from 0.5 to 1.0 percent, the first actual contraction in global activity since World War II.

The current slump has been characterized by relentless financial and currency turmoil. Partially as a result, global trade activity has experienced a remarkably sharp decline, exacerbated to some degree by tight conditions for merchandise trade financing. As shown in Figure 2, the annualized decline in export activity in the United States and the Euro area during the fourth quarter of 2008 was well in excess of 20 percent, when measured on a quarter-over-quarter basis. The export-dependent developing economies have also experienced an alarming fall off in external demand. China's year-over-year export growth declined to 4.3 percent during the fourth quarter from more than 23 percent on an annualized basis during the third quarter. And recent monthly data point to a deepening contraction in Chinese external demand. Year-over-year export demand in Brazil, a country whose presence in global markets has grown impressively in recent years, fell by 7 percent.

Unsurprisingly, world unemployment has begun to rise. The total unemployment rate in the 30 OECD countries rose to 6.9 percent in January, up from 6.2 percent in August 2008.<sup>1</sup> Given the lagging nature of unemployment, more pain is certain, pressuring already financially strapped governments to expand unemployment and retraining programs and creating a surplus of global labor, the implications of which will be discussed in future MAPI global reports.

The worldwide economic and financial storm has created a risk-averse mentality among international investors, precipitating a large inflow of funds into U.S. treasury markets which, in spite of U.S. economic troubles, is still thought to be the benchmark of "riskless" investing. As shown in Figure 3, large capital inflows have pushed the yield on three-year Treasury notes to near zero. And, the yield on 10-year Treasury notes has fallen below 3 percent, skirting with levels not seen since the early 1950s. Significant risk-aversion behavior has created funding strains for a wide swath of critical sectors. Figure 4 shows historically large risk spreads in corporate funding markets.

Some improvement in financing conditions has emerged as of late. A widely followed Federal Reserve survey of senior loan officers in 60 large domestic banks and 24 U.S. branches of foreign

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<sup>1</sup> The Organization for Economic Cooperation and Development (OECD) represents 30 industrialized and developing nations.

banks shows that fewer lending institutions have continued on a path of tightening, especially in the mortgage credit area. The most recent run of this quarterly survey, conducted during January 2009, revealed that a net 47 percent of respondents tightened credit for prime mortgage borrowers during the prior three months, down measurably from a net 69 percent and a net 74 percent during the prior two surveys conducted in October 2008 and July 2008, respectively.

The survey data are somewhat less encouraging for consumer and business credit. A net 58 percent of respondents to the Fed survey were revealed to have tightened credit on consumer loans other than credit cards during the January 2009 survey, down only modestly from 64 percent during the October survey but significantly higher than the net 32 percent who tightened lending standards in the three months prior to the January 2008 survey. Further, a net 64 percent of lending institutions tightened standards for large and medium commercial and industrial borrowers during the three months prior to the survey, down somewhat from the net 74 percent who tightened in the three months prior to the October 2008 survey.

Given that the U.S. housing collapse has been the prime catalyst for banking and general financial turmoil, recent signs of modestly improved sales and construction activity are even more significant for the broader economy than would normally be the case. During February sales of existing homes, by far the largest component of the private single-family housing market, increased by 5 percent from January levels, with all major regions showing positive activity, including a 15.6 percent increase in the Northeast. Sales of new single-family homes experienced a nearly similar 4.7 percent gain, albeit less widespread, with gains in the South and the West and continued declines in the Northeast and Midwest. Figure 5 places these recent data in context. The welcome gains in new home sales do not yet look meaningful when considered against a more than 41 percent decline between February 2008 and February 2009. Existing home sales do appear to be forming more of a persuasive bottom, likely due to foreclosure sales along with Fed programs to bring mortgage rates down to historic lows.

A truly significant turnaround in housing demand would begin to clear 20-year highs in inventories. Recent data are mixed. Inventories of existing homes have fallen to 9.7 months (at the current sales pace) in January and February, the lowest since February 2008. Inventories of new homes remain more stubbornly high, falling to 12.2 months supply in February from 12.9 in January, still markedly above the 11.7 average for the fourth quarter of 2008, evidence that the price decline may still have a ways

to go to create enough demand to rebalance the market. The decline in housing starts certainly shows the needed activity from the supply side. In spite of a more than 22 percent gain in February, much of it in apartments and condominiums, starts are down more than 47 percent on a year-over-year basis. If the recent improvement in sales heralds a turn in demand, housing prices, shown in Figure 6, might begin to stabilize, supporting efforts to fix the banking system and providing some support for the recession-weary consumer.

Housing and financial stability are needed for a meaningful recovery from what will likely end up to be the deepest U.S. recession since the early 1980s or longer. As shown in Figure 7, U.S. GDP growth declined at an annualized rate of 6.3 percent during the fourth quarter of 2008, comparable to the first quarter 1982 decline of 6.4 percent. While GDP growth for much of the prior four quarters was weak and volatile, the presence of still strong global demand prevented a major contraction. But as financial turmoil spread beyond U.S. borders, growth in key trading partner economies quickly slowed or contracted and export demand rapidly deteriorated. As shown in Figure 8, exports of goods in general and capital goods, excluding automobiles, declined by more than 30 percent during the fourth quarter on an annualized basis. Imports also declined sharply as U.S. consumer spending fell and trade was essentially neutral for GDP during the fourth quarter, neither contributing nor detracting from growth. But this was down significantly from a one percentage point contribution to GDP growth during the third quarter of 2008 and a nearly three percentage point contribution during the second quarter.

The rapid deterioration of the U.S. labor market has added to a sense of public emergency regarding the depth and duration of the downturn. As shown in Figure 9, the unemployment rate, which normally lags changes in GDP, reached 8.5 percent in March, appearing on track to at least approach the levels of the early 1980s, when unemployment exceeded 10 percent between September 1982 and June 1983, before quickly falling to 7.2 percent during June 1984. Remarkably, in the wake of rapidly rising unemployment and widespread job losses that have averaged 684,000 between December 2008 and March 2009, consumer spending appears to have stabilized—somewhat. Significant discounting in the wake of a poor Christmas shopping season could partially explain the better tone to consumer data. And while Figure 10 shows that total consumer spending turned positive in January, with only a modest retracement in February, the difficult circumstances surrounding household demand make it risky to call a turn with a great deal of confidence,

particularly since, as shown in Figure 11, consumer confidence entered the new year at historic lows.

But even if consumer demand is stabilizing, the path of business spending could provide more than enough with which to be concerned. As shown in Figure 12, equipment and software expenditures declined at a startling 28 percent annual rate during the fourth quarter of 2008, a quarter or so earlier than many would expect due to the normally lagging nature of capital spending. While the decline was certainly influenced by a 70 percent plunge in the growth of volatile transportation equipment demand, other key categories experienced deep contractions. As shown in Figure 13, information processing equipment demand growth declined by nearly 23 percent and industrial equipment demand growth, victimized by a global plunge in manufacturing output, declined by nearly 15 percent.

The broad-based if modest rise in durable goods demand in February, with some indication of an improvement in equipment spending, is encouraging but must be evaluated in the context of the global uncertainties facing the U.S. manufacturing sector and the many questions surrounding the path of financial repair in the United States and much of the industrialized world. Further, the continually negative profits picture will, at least for a while, be an impediment to a resumption of sustainable capital spending. On a year-over-year basis, domestic non-financial profits declined by nearly 9 percent during the fourth quarter of 2008, more than twice the rate of decline during the third quarter, but somewhat improved from the double-digit declines of the first half of 2008.

Manufacturing activity in the United States, as for much of the world, has been badly hurt by significant contractions in its two principal demand drivers—exports and business investment. As shown in Figure 14, manufacturing output growth (both including and excluding the normally rapidly growing computers, communications, and semiconductor industries) declined by more than 15 percent at an annual rate during the fourth quarter of 2008 with subsequent monthly data suggesting a similar or worse decline for the first quarter of 2009.

Encouragingly, a widely followed leading indicator presents somewhat persuasive evidence that the fourth quarter 2008 and first quarter 2009 factory output contractions may be the worst of the current downturn. As shown in Figure 15, a composite leading indicator of U.S. manufacturing activity produced by the Institute for Supply Management declined sharply after August 2008 but has since been relatively stable at a low level. This indicates continued contraction, but not an acceleration of the rate of decline. And while the contraction of new orders appears to have slowed markedly in March,

the pace of inventory liquidation appears to have accelerated, painting a picture of a bottoming process.

A rapid disinflation in the United States, shown in Figure 16, brought about by falling demand, plummeting oil and non-fuel commodity prices, a weak labor market, and record low capacity utilization in manufacturing has raised fears over the prospects of deflation, a period of falling prices which can feed on itself by further discouraging spending, investing, and lending. With the economy in such a weakened state, an actual fall in the average price level remains at least a modest risk. But expansionary monetary policy along with some firming of beaten-down global commodity prices and hints of consumer spending stabilization suggest that the risk of a sustained and pernicious deflation, which plagued the U.S. economy during the 1930s, is receding.

Both the boldness of U.S. monetary policy and the current financial quagmire are illustrated in Figure 17, which shows a dramatic surge in both the monetary base as a result of the Fed's efforts of the past year and excess bank reserves accumulated in the wake of unusual lending tightness as risk averse financial institutions hoard cash to repair their balance sheets and ride out the economic storm. While monetary and fiscal policy efforts in the United States have been considerable, a fix for the banking system is an essential ingredient for full economic recovery.

MAPI's short-term outlook for the U.S. economy calls for a deep recession followed by a sub-par recovery during 2010. We expect annual GDP growth to decline by 2.1 percent during 2009, the steepest annual decline since 1946. Recent hints of demand stabilization support our contention that some stability will come into the growth picture during the second half of 2009 and that annual GDP growth will be a modest 2.2 percent during 2010. We expect total consumer spending growth to fall by 0.8 percent during 2009, the first annual consumer spending decline since 1980. Equipment and software demand growth is expected to decline by 13.5 percent during 2009 and then grow by 7.0 percent during 2010. MAPI expects manufacturing growth to decline by a very steep 9.1 percent during 2009, more than twice the 4.1 percent decline experienced during 2001, the trough year for the prior manufacturing downturn. Modest growth of 2.5 percent is expected for U.S. manufacturing output during 2010.

An expected bottoming of oil and commodity prices enters into our forecast that consumer prices will fall by 1.7 percent during 2009 and then rise by 1.9 percent during 2010. The broader price trend is expected to be more stable and we do not anticipate a wide, damaging deflation. Consumer price

inflation, excluding food and energy, is expected to be 1.1 percent during 2009 and 1.2 percent during 2010.

The strong dollar may well position the world to benefit from even modestly improved U.S. demand through a more rapid translation to improved export activity in external demand-oriented regions, such as the Eurozone and Japan. But given the plunge in many U.S. trading partner economies, the strong dollar can only be a supplement, not a substitute, for policies that will stimulate domestic demand throughout the troubled industrialized nations. Moreover, political realities in the United States suggest that our export-oriented trading partners should not count on continuing huge deficits in the U.S. trade account.

### **The Industrialized Economies Bank on Strong Policy Stimulus and a More Stable U.S. Economy**

Outside of the United States, two forces have created deep recessions in major countries and regions—a credit crunch and a deep contraction in the export activity that many major economies still rely on, and indeed some say over-rely on, for growth. The Eurozone countries have been impacted by both problems. As shown in Figure 18, the credit freeze quickly spread beyond U.S. borders and remains a significant issue for the Eurozone outlook. In the latest data for February, the average spread for the yield on 10-year government bonds in the four countries shown over the 10-year German government bond reached a period high of 1.9 percentage points in February 2009, slightly above 1.82 percentage points seen in January and more than a full percentage point above the average for October 2008.

Credit market tightness, along with a rapid deterioration of global demand has created, by some parameters, a more difficult downturn than in the United States. As shown in Figure 19, the average GDP contraction for the three largest Eurozone economies during the fourth quarter of 2008 was 6.8 percent, following on the heels of 1.3 percent and 1.9 percent average declines in the prior two quarters. Forecasters expect Eurozone growth to contract by a sharp 2.6 percent during 2009, a notable deterioration in the outlook from just three months ago when growth was expected to decline by just 0.9 percent.<sup>2</sup> And perhaps more disconcertingly, tepid growth of just 0.5 percent is expected for 2010,

clearly insufficient to reverse what will likely be a multi-year escalation of unemployment.

Figure 20 illustrates a dire situation for Eurozone manufacturing activity. November and December saw significant declines of nearly 15 percent and 12 percent respectively in average manufacturing output growth for the four largest Eurozone economies. And while January data are only available for France and Spain, the contraction, if anything, appears to have deepened significantly into the early days of the new year. Forecasters are taking the latest manufacturing woes to heart by predicting an 8.4 percent plunge in Eurozone industrial production growth during 2009, with only modest 1.0 percent growth expected for 2010.

In support of these dire forecasts, signs of deep economic and manufacturing stress abound in the large Eurozone nations. German export growth plunged by more than 26 percent on an annual basis during the fourth quarter of 2008, a startling development for the world's largest exporter. *Suveys* report that German business confidence fell to a record low in February. Export growth plunged by 14 percent during the fourth quarter of 2008 in France, although consumer spending stayed positive, which will likely be threatened by rising joblessness. Italy's longer term economic troubles have been magnified by the global crisis. Gross fixed capital formation contracted by 25 percent during the fourth quarter of 2008, the fourth consecutive decline in capital formation growth, a clear sign of a complete lack of confidence in the near-term prospects for the Italian economy. And, as shown in Figure 21, export growth plunged by more than 25 percent. If external demand continues to erode, it may reignite debates about the benefits of the euro for long-term economic prospects in Italy.

Figure 22 shows that Spain has joined the United States, the United Kingdom, Ireland, and other countries in confronting a downturn that was at least partially precipitated by a housing bust. Starts and permits data indicate that the residential bust has been as or more dramatic than in the United States. As shown, the Spanish housing market has experienced 7 consecutive quarters of double-digit declines in permit activity, normally thought to be a good leading indicator of the residential construction outlook. The magnitude of the decline has been startling. For the four quarters of 2008, the year-over-year fall in permit activity averaged nearly 60 percent, the type of bust that will likely require a protracted period for recovery both in the housing market and in the broad economy. As a result, Spain is the only one of the four largest Eurozone economies that is not expected to experience any recovery at all during 2010. Spanish GDP growth is

<sup>2</sup> All country forecasts outside of the United States are taken from *Consensus Forecasts*, a publication of Consensus Economics, London, United Kingdom.

expected to decline by 2.5 percent during 2009 and then fall further by a slim 0.1 percent during 2010.

U.S. and Eurozone economic troubles have magnified an already difficult, domestically generated situation in the United Kingdom brought about by much the same housing and credit difficulties that the United States confronts. As shown in Figure 23, the U.K. GDP contraction escalated from 2.6 percent at an annual rate during the third quarter of 2008 to nearly 6 percent during the fourth quarter. There are a few glimmers of light. The steep fall in housing demand does seem to have stabilized, albeit at a low level. Even the modest jump in consumer inflation from 3.0 percent during January to 3.2 percent in February, after a sharp and persistent decline since August 2008, might be taken as something of a stabilizing sign and an indication that an increasingly accommodative monetary policy will eventually work. Nonetheless, for now, analysts have actually downgraded their gloomy expectations for the U.K. economy motivated by increasingly alarming manufacturing data and continued declines in housing prices. The same pattern of deep recession and tepid recovery is expected for the United Kingdom as for much of the industrialized world. GDP is expected to contract by 3.0 percent during 2009, with only 0.5 percent growth anticipated for 2010. And U.K. manufacturing production is expected to contract by 8.5 percent during 2009, well within the anticipated ranges of contraction for the factory sectors in the United States and large Eurozone economies. Slightly less than 1 percent growth is expected for U.K. manufacturing during 2010.

Partially due to a relatively unscathed banking system, the recession in Canada can thus far be characterized as less severe, but only by comparison to Canada's beleaguered advanced country trading partners. As shown in Figure 24, Canadian GDP contracted by 3.4 percent on an annualized basis during the fourth quarter of 2008, somewhat more than half of the 6.3 percent decline in the United States. Canada's chief economic threat has come not from housing and banks but from persistent manufacturing weakness made worse by the plunge in global commodity prices and the sharp decline in global trade. Figure 25 shows that the lengthy downturn in Canadian manufacturing, which began in earnest during December 2007, looked to be at least stabilizing in the May 2008 through July 2008 period. But since July the contraction deepened significantly.

For a while, the broad Canadian economy managed to at least hold its own in the face of persistent industrial weakness. But the dramatic contraction in machinery and equipment investment during the fourth quarter of 2008, shown in Figure 26, illustrates how rapidly that has changed. Like the

United States, Canada had a deep and atypically early dive in business investment growth during the fourth quarter of 2008 as domestic demand weakened and as the export decline, which has been continuous since the third quarter of 2007, progressed from bad to worse.

While the outlook is certainly darkening, forecasters still expect a somewhat shallower downturn in Canada than in other advanced economies. As shown in Figure 27, economists predict a 1.8 percent decline in Canadian GDP during 2009 to be followed by moderate 2.3 percent growth during 2010, a somewhat shallower recession and stronger rebound than MAPI is currently expecting for the U.S. economy. Similarly, Canadian manufacturing output is expected to contract by 6.6 percent during 2009, a less dire forecast than the 9 percent decline expected for U.S. factory output growth as well as being a shallower decline than that expected for the United Kingdom and the four largest Eurozone economies. Canadian industrial production is expected to recover during 2009, with modest 1.7 percent growth expected by global forecasters.

If the Canadian economy appears to be the least impacted of the major industrialized nations by the global crisis, Japan is arguably the biggest victim. By many measures, the Japanese economy was still recovering from the structural demand deficiencies and price instability brought about by its domestic economic crisis of the 1990s when now it is being forced to contend with another enormous challenge. Figure 28 is illustrative of the deep plunge in Japan's economic output. As shown, real GDP contracted by 12 percent on an annualized basis during the fourth quarter, the third consecutive quarter of negative growth. A startling 45 percent contraction in exports, shown in Figure 29 was the primary contributor to sharp GDP contraction. After the economic malaise of the 1990s, Japan restructured its large corporations to create an even greater reliance on exports, a model arguably replicated by Germany. In recent months everything that could go wrong for Japanese exports has. Plummeting global demand particularly from key markets in the United States and China has hurt. And the spike in the yen, which was kept artificially low by the international arbitrage opportunities afforded by near zero policy interest rates, will contribute to a very grim export picture for at least the balance of 2009 and likely into 2010.

In export-oriented economies, a crisis in external demand quickly impacts business investment. Since the beginning of 2008 Japan has experienced an increasingly deep downturn in capital spending. A 13 percent annualized decline in plant and equipment spending during the third quarter of 2008 was followed by a 20 percent decline during the fourth quarter. Alarming for the capital spending outlook,

a 22 percent decline in corporate current profits during the third quarter of 2008 was followed by a staggering 64 percent decline during the fourth quarter.

Figure 30 shows that plummeting exports and business investment have more than taken their toll on manufacturing growth. The acceleration of the decline is as noteworthy as the depth. As shown, monthly manufacturing data reveal a remarkably rapid deterioration from relatively modest declines in August and September 2008 to a year-over-year contraction of nearly 23 percent shown by the latest figure for January 2009.

Forecasters have downgraded their expectations for the Japanese economy at a faster rate than for any major country. Analysts expect GDP growth to contract by 5.8 percent during 2009 with a tepid growth rebound of 0.7 percent during 2010. And, motivated by recent data, they expect a bewildering 27 percent decline in industrial production growth during 2009, much more than twice the 11 percent decline that was experienced during 1975, to date the worst Japanese industrial sector decline of the modern era.

Talk of fiscal stimulus might help the dire outlook in months to come. But for now, the speed and depth of the economic contraction has been so severe that there is simply no way to logically incorporate even a large stimulus into the near-term outlook. Japan has pulled itself out of economic decline before and will certainly do so again. But it is clearly the biggest current risk in the industrialized country picture, one that could have negative implications for U.S., East Asian, and Eurozone recovery prospects through trade and financial channels and by the simple fact that such a deep plunge in a large economy will make it all the more difficult for shattered global confidence to recover.

### **The Chinese and Indian Economies: Hoping To Avoid the Worst**

Fortunately for global prospects, the threat coming from the plunge in the Japanese economy and manufacturing sector is somewhat neutralized by the Chinese situation. Amidst a world of economic pain along with financial and currency chaos, there has been an interesting diversity of opinion regarding the short-term outlook for China. Some observers hold out hope that the Chinese economy, while certainly slowing and at risk, might avoid the much feared hard landing. Domestic demand, in part due to secular developmental forces, appears to be holding up better than in many countries even as exports begin to contract at an increasingly rapid rate. And China's banks appear to be functioning, with the pace of lending seemingly unaffected by the

credit crisis that has stymied much of the industrialized world and some developing areas.

This is not to say that the Chinese outlook, like everything else, is not worrisome. Figure 31 shows that year-over-year GDP growth slowed from a recent peak of 12.6 percent during the second quarter of 2007 to 6.8 percent during the fourth quarter of 2008. Growth below 8 percent is of concern to the Chinese government as it is widely believed that 8 percent growth is the minimum needed to absorb new entrants into the workforce. Given that forecasters believe that annual growth will slow from 9 percent during 2008 to 7 percent during 2009, it is not surprising that the stability-conscious Chinese government put forth a large fiscal stimulus plan which is generally expected to add one percentage point to GDP growth in both 2009 and 2010, although plan details, particularly regarding the disbursal of funds and the intersection with previously enacted spending programs remain sketchy.<sup>3</sup>

Both nominal fixed-asset investment and consumer demand do appear to be slowing but not as much as one would fear if the slowdown were to be severe.<sup>4</sup> Investment is being supported by development efforts in the rural inland areas. And, as shown in Figure 32, year-over-year growth in nominal retail sales fell from a recent peak of 23.3 percent in July 2008 to 11.6 percent for the latest reading in February. Much of this can be accounted for, however, by a disinflation that has recently lapsed into deflation. For the long-term picture the potentially strengthening Chinese consumer is becoming a hot topic of conversation.

But domestic strength aside, there are two factors which raise the risk of a hard landing, with growth below 7 percent and rapidly rising unemployment. The price picture is itself a concern which could have a significant negative impact on investment and consumer spending if deflation were to become deep and prolonged. This is not yet the case. For the latest data in February, total consumer prices fell by 1.6 percent on a year-over-year basis, the first actual price decline of this period of slowing economic growth. An apparent property price bust is of particular concern. Figure 33 shows the emergence of a deflation in residential property prices in China. Many analysts, however, in allaying fears of a housing bust that leads to a consumer

<sup>3</sup> For a recent discussion of China's stimulus package see Yingying Xu, "China's Stimulus Package, A Catalyst That Will Boost Short-Term Growth But Likely Not Lead to Decisive Rebalancing," Manufacturers Alliance/MAPI, Issues in Brief, E-505, February 2009

<sup>4</sup> Fixed-asset investment is a comprehensive indicator that covers the deployment of fixed assets from business investment, residential investment, and government.

downturn, point to the more stable financial position of Chinese households as well as a more conservative mortgage financing system as mitigating factors.

The recent path of exports, shown in Figure 34, presents an even more substantial short-term risk for the Chinese economy than declining prices. The latest data for March show that year-over-year exports fell by 17 percent, the third consecutive month of double-digit declines. While the fall in imports has been even more dramatic, leaving the large trade surplus well intact, the plunge in external demand has raised unemployment among rural migrants who have moved to the urban areas to seek employment in export-oriented industries. If the export decline were to deepen and be prolonged, certainly not inconceivable under current circumstances, it would put manufacturing output, which has stabilized as of late, at risk. And a continued sharp export decline could impact the component of investment that is tied to export industries.

With the Chinese outlook finely balanced between domestic demand resilience, potential deflationary pressures, and growing external weakness, policy might save the day. In addition to the stimulus package, a sharp reversal of monetary policy has boosted money supply growth, an indication that bank lending is supportive of economic growth and could prevent the modest emergence of deflation from being deep and prolonged.

While the near term path of Chinese economic activity could modestly beat expectations, the other Asian emerging market giant, India, appears to be surprising forecasters on the downside. Indian GDP growth, as shown in Figure 35, slowed rather dramatically to 4.5 percent during the fourth quarter of 2008 from an average of 8.3 percent growth during the first three quarters of 2008. As shown, growth had been slowing modestly since the first quarter of 2007 but had, up until third quarter of 2008, stayed above 8 percent.

Consensus Economics (March 2009 Asia Pacific Edition) reports that the fourth quarter 2008 slowdown was primarily the result of a 2.2 percent year-over-year contraction in agricultural output. Manufacturing output, as shown in Figure 36, has been a growing cause for concern. It has been slowing rapidly and was just slightly negative during the fourth quarter. While the Indian economy relies more on domestic demand than exports, the recent path of manufacturing shows that this economy, up until recently a fairly closed one, cannot escape the global maelstrom. In spite of a continuous decline in the rupee since early 2008, sources report that Indian exports were down by nearly 16 percent in January, although imports fell by more than 18 percent.

Clearly, India's industrial sector, which accounts for about 30 percent of GDP, is being pummeled by the same global headwinds that are hitting the manufacturing sector in almost every other major country. While consumer price inflation has been a source of concern in recent years, catalyzed by a boom in global commodity prices, rapidly rising rents and poorly managed monetary policy, experts now believe that inflation has peaked, giving the central bank increased latitude to confront emerging weakness.

But, while monetary policy will certainly be supportive, economists have suggested that India needs to enact further fiscal stimulus, beyond that which was implemented in December 2008. This might be difficult. Apart from the political considerations raised by an impending election, a ballooning fiscal deficit is a problem. Partially as a result, forecasters expect Indian GDP growth to slow from an estimated 6.4 percent during Fiscal Year 2008 to 5.2 percent during Fiscal 2009, considerably slower than the 6.3 percent Fiscal 2009 growth rate prediction put forth three months ago.<sup>5</sup> And industrial production growth, which is estimated to have slowed from 8.5 percent during Fiscal Year 2007 to 3.4 percent during Fiscal 2008, is now expected to stay at 3.4 percent during Fiscal 2009, considerably more sluggish than the 5.1 percent manufacturing growth rate prediction for Fiscal 2009—published three months ago.

### **Developing East Asia Beyond China and India: Slowdowns Yield to Contraction**

Economists, who believed that many of the major developing and newly industrialized nations in East Asia would weather the global storm, are growing more pessimistic by the day. As shown in Figure 37, manufacturing production in three major East Asian nations turned considerably negative during the treacherous fourth quarter of 2008. Economic growth faltered in many of these countries, with Thailand and South Korea registering contractions of 4.3 percent and 3.6 percent, respectively.

Forecasters have significantly downgraded 2009 expectations for these countries in spite of a range of monetary and fiscal policy stimulus efforts. For example, in December, economists expected South Korean growth to be 1.6 percent but now project a contraction of 3 percent. Current expectations that Thai GDP growth will contract by 1.6 percent during

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<sup>5</sup> It should be noted that Indian annual forecasts are reported for an April to March fiscal year.

2009 contrast sharply with the forecast put forth in December that Thai GDP would grow by 2.3 percent.

These highly export-oriented economies simply have not been able to withstand the plunge in global trade activity and the path of their emerging weakness is growing increasingly uncertain. Figure 38 illustrates a dramatic shift in currency market sentiment for the East Asian region, as international investors have fled, likely putting at-risk investment capital in the U.S. Treasury market. South Korea and Indonesia have experienced especially harsh plunges in their currency in recent months against the dollar. During March 2009 the South Korean won was 32 percent below year-ago levels, while the Indonesian rupiah was trading 23 percent below March 2008 levels.

But, while a negative indication at the moment, the dramatic reversal of regional currencies could set the stage for a sharp export increase when the global storm passes and global demand regains its footing—even if external demand is somewhat lower than the average of the years leading up to the current crisis. As shown in Figure 39, forecasters expect South Korean industrial production growth to decline by a sharp 9.2 percent during 2009 but to subsequently enjoy a relatively strong 5.7 percent recovery during 2010. A somewhat similar pattern is expected for Malaysia and Thailand, although Malaysian manufacturing is expected to have a weaker recovery of 3.9 percent during 2010. Indonesian manufacturing production growth is expected to remain positive during 2009, although the outlook is dimming rapidly. Analysts currently expect 1.0 percent growth, one third of the rate that was expected just one month ago.

### **Mexico and Brazil: Global Headwinds and Local Issues**

From an economic standpoint, the escalating visibility of drug-related violence on the Mexico/U.S. border could not have come at a more inopportune time. Even apart from the border town situation, Mexico's close association and dependence on U.S. manufacturing growth, particularly in the auto sector, was sooner or later going to catch up with its relatively impressive performance of recent years and the resilience shown during the first three quarters of 2008. But when domestic problems mix with a global crisis the results are often worse than the sum of the parts as the impact of one catalyzes the negative reach of the other. As shown in Figure 40, GDP contracted by 1.6 percent during the fourth quarter of 2008. While far shallower than the GDP contractions in the United States and Canada, global investors have become increasingly concerned about Mexico's

economic and political stability and the peso has fallen by a bit less than one-third since July 2008.

Global turmoil has severely impacted Mexico's exports and manufacturing growth. Recent data suggest that the recession may deepen considerably. As shown in Figure 41, Mexico's manufacturing contraction has taken a turn for the worse since August 2008. During January 2009, year-over-year manufacturing production fell by nearly 15 percent, approximating the U.S. manufacturing decline for the fourth quarter of 2008. Figure 42 shows the severe export contraction that underlies the manufacturing recession. As shown, year-over-year export demand declined by nearly one-third during January 2009.

As external demand and industrial output tumble and as global investors flee, economists' short-term outlook for Mexico has darkened. GDP is now expected to contract by 2.8 percent during 2009, by contrast to an expectation of essentially zero growth three months ago. Manufacturing output is expected to decline by 5.7 percent. While a modest rebound is expected for 2010 to 2.0 percent growth for GDP and 1.5 percent growth for manufacturing output, if the U.S. recession is indeed reaching a bottom, Mexican prospects might brighten sooner.

Brazil might be able to withstand the global downturn more favorably than Mexico since its domestic situation is growth enhancing rather than detracting. An improvement in public finances, an investment in innovation capacity, and increasing productivity have allowed it to reach the status of a strong global player, with greater than 5 percent growth during 2007 and 2008. But, as is the case with such countries as Germany, its stronger presence in global markets will be a short-term negative. As illustrated in Figure 43, global financial turmoil, collapsing global trade, and the fall in global commodity prices have slowed GDP growth dramatically during the fourth quarter of 2008 to 1.3 percent, on the heels of four consecutive quarters during which growth exceeded 6 percent. In a pronounced statement of diminished expectations, gross fixed capital formation growth slowed to 3.8 percent during the fourth quarter of 2008 on the heels of six quarters during which growth averaged 16 percent, with remarkably little variation.

Brazil's increasingly strong trade ties with China, could, by itself, explain the 7 percent decline in exports during the fourth quarter, certainly a ramification of sharply declining Chinese import demand. Faltering export demand has taken a quick toll on manufacturing growth. As shown in Figure 44, the latest data for January 2009 reveal that year-over-year manufacturing production declined by 17 percent.

While the short-term outlook is darkening, economists do not expect much of an actual recession in Brazil. GDP is expected to decline by a slight 0.1 percent during 2009 and then rebound with modest 2.9 percent growth during 2010. Industrial production is expected to contract by 2.7 percent during 2009 and then experience reasonably solid 3.9 percent growth during 2010.

### **The U.S. Dollar: Strength Amidst Chaos**

The dollar's volatile ride of recent months, shown in Figure 45, reflects two conflicting issues in global currency markets. As mentioned, investors have been pouring capital into U.S. treasury bonds in a flight-to-safety instinct, amidst a world of financial turmoil and recession. But, by contrast, investors have not only had to face the prospect of a deeper-than-expected U.S. recession but an unprecedented monetary policy that forced policy interest rates to near zero, which, along with market-based and liquidity-enhancing programs, have resulted in a surge of the monetary base. Not only has this raised concerns that the central bank is now completely out of ammunition, but investors fear that the Fed is laying the groundwork for a difficult inflation in a post-crisis economy.

Prior to the decline of recent weeks, the dollar has had a strong period of appreciation as the "flight-to-safety" argument clearly won the day. In March the average level of the broad, trade-weighted dollar was 17 percent above the average level for July 2008. The dollar's post-July 2008 appreciation was reflected by a fall in most major currencies with the notable exception of the Japanese yen, which had a 21 percent spike between August 2008 and January 2009, as the aforementioned arbitrage opportunity afforded by near zero domestic interest rates unwound amidst world financial turmoil.

MAPI's current dollar forecast is shown in Figure 46. Despite the decline of recent weeks, we expect a bit more upside to the dollar versus the currencies of the industrialized nations as the contractions in the Eurozone and Japan become increasingly deep, with little or no evidence of an imminent bottom, reinforcing the "flight-to-safety" instinct that has created such a large flow of funds into U.S. Treasury bonds. As shown, we expect the dollar to appreciate by 4.5 percent against the currencies of the industrialized countries during the second quarter of 2009 (on a compound annual basis) and then be flat for the balance of the year as global central banks race the Fed down to near-zero policy interest rates and as the financial crisis hopefully begins to ease, creating a bit more visibility for global growth as a whole. Global current account balances will emerge once again as a

trading theme in the currency market, but weak and uncertain growth in the United States and around the world will create a lack of conviction regarding the dollar—and all other major currencies—among traders. Consequently, we expect a flat performance for the dollar during 2010, down modestly during the first half of the year and up modestly during the second half of the year.

We see the dollar gradually returning to its pre-crisis position against the currencies of the developing economies, as most East Asian currencies resume an upward path against the dollar in the wake of easing financial fears and slowing capital flight particularly from the Korean won and Indonesian rupiah. MAPI expects the dollar to fall by 2 percent against the currencies of the developing economy bloc during the second quarter of 2009, by 5 percent during the third quarter, and by 8 percent during the fourth quarter. During 2010, we expect a 5 percent decline during the first quarter, an 8 percent decline during the second and third quarters, and a 12 percent decline during the fourth quarter.

### **Will Deflation Plague the Global Economy?**

The global price dynamic has been impacted by the boom and bust cycle of input prices during recent years. The wild ride of the oil price, shown in Figure 47, from a peak of more than \$145 per barrel during July 2008 to a recent low of \$30 per barrel in late December of 2008 has had an even more dramatic impact on inflation and inflation expectations in many countries than the dollar, given that the influence of currency fluctuations on domestic price pressures has been shown to be weakening. For the time being, the oil price decline seems to have reached an ostensible bottom with the price recently rising above \$50 per barrel for the first time since late November 2008. And, as shown in Figure 48, non-fuel input prices also appear to have formed a temporary bottom, which appears most pronounced in industrial metals, whose index value has been more than cut in half since April 2008.<sup>6</sup>

The dramatic decline in oil and non-fuel commodity prices, along with steep economic contractions in many major economies, has given rise to fears of a deflationary spiral on a global level that would prolong and deepen the slump. The data in Figure 49 do not do much to either confirm or allay these fears. Clearly, the rapid and steep decline in oil prices has precipitated a massive disinflation in total consumer prices on a global level, and weakening

<sup>6</sup> The "Spot" Index is a measure of the price movements of 22 basic commodities that are presumed to be sensitive to changing economic conditions.

economies has given rise to a tamer disinflation in core prices. As long as the global economy remains in the current difficult and precarious state, deflation will remain a risk. But the data do not yet suggest that a worldwide deflation is imminent and a global move to historically low interest rates, particularly in the industrialized economies, should at least dictate against a protracted and pernicious deflation should one arise at all.

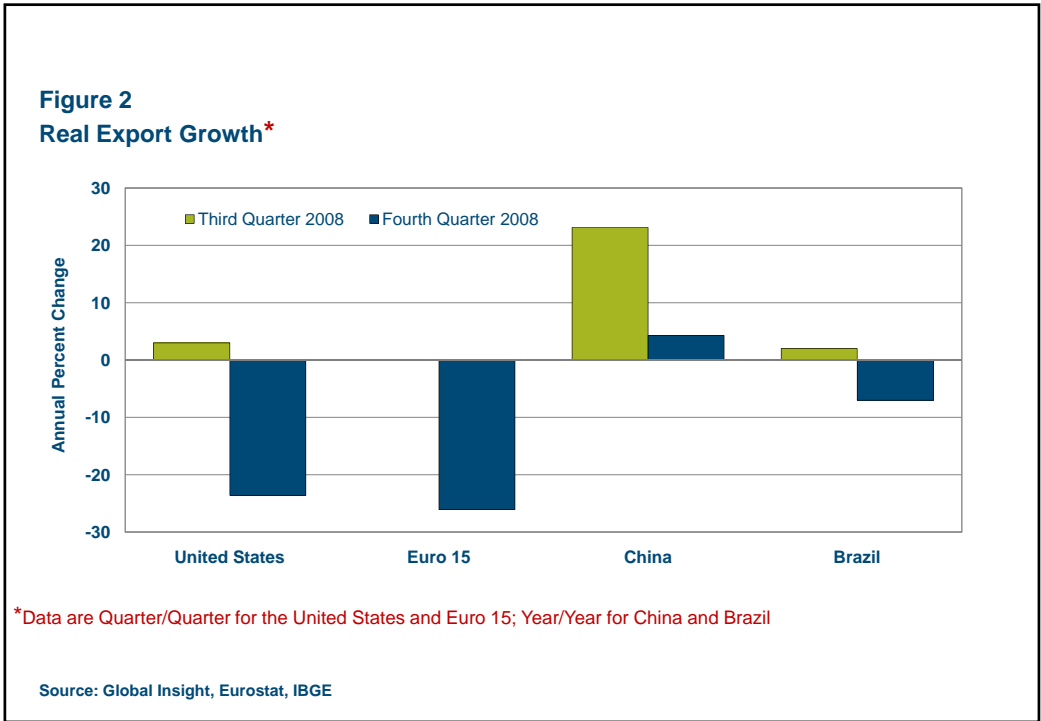
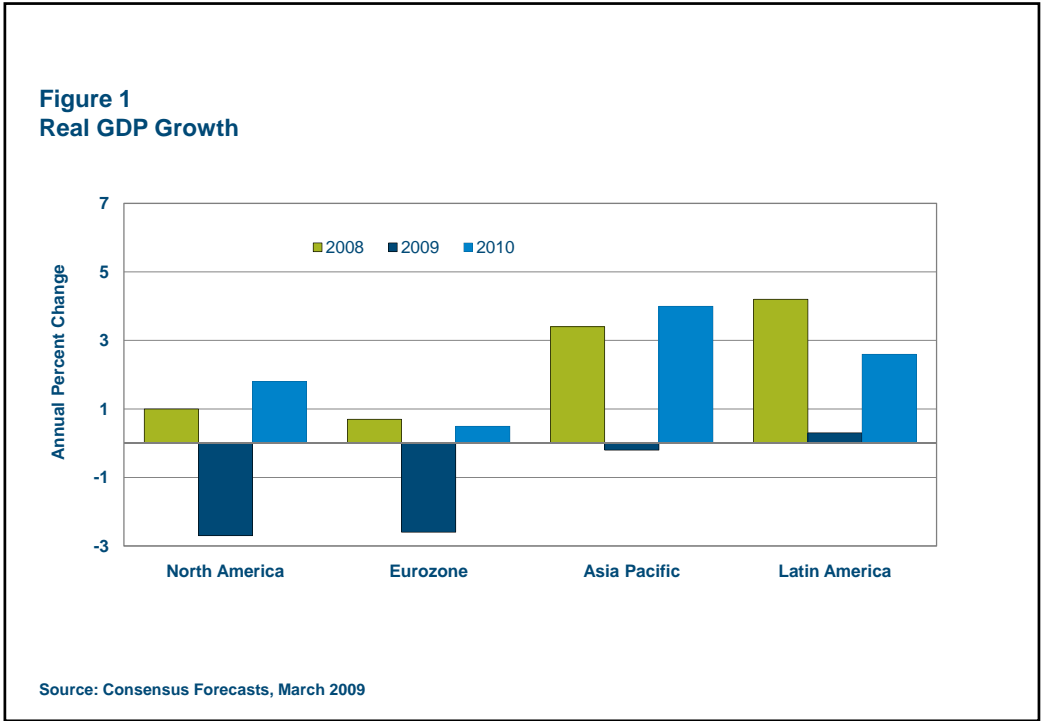
### **U.S. Export Demand: The Worst Contraction Since 1958**

Predicting global growth prospects amidst the bleakest environment of the modern era requires some thinking about the impact of relatively rapid-fire policy efforts in the United States and around the world. As shown in Figure 50, key central banks are pushing their policy interest rates down very quickly, in some cases to historic lows. The Bank of England's key policy rate now stands at its lowest level in the more than 300 year history of the Bank. Added to monetary policy efforts are fiscal policy programs of different sizes, relatively large ones in the United States and China, smaller ones in the Eurozone nations and Japan. Plans for fixing broken banking systems, necessary for key domestic economies and the global economy to realize the full impact of monetary and fiscal policies, are being implemented in the United States, the United Kingdom, and the Eurozone.

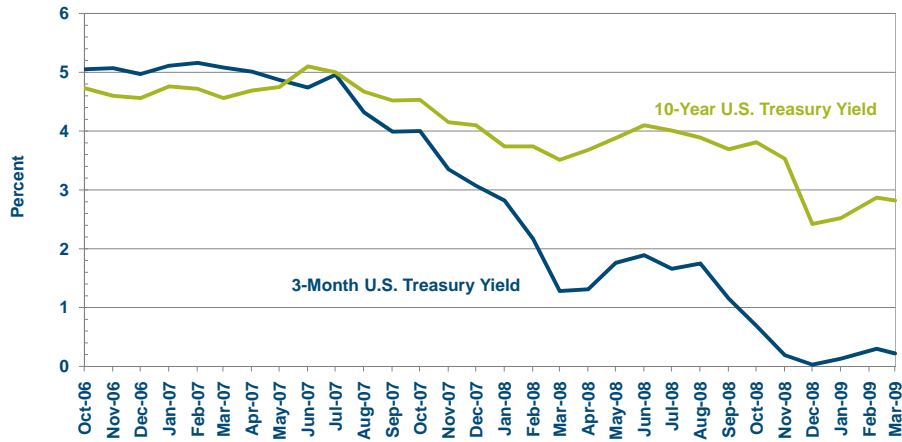
While the rare financial underpinnings of the current global crisis make it more difficult than ever to assess the impact of policy, it is difficult to believe that rock-bottom prices for fuel and commodities, the lowest interest rates in a generation, and a growing attack on bank balance sheet problems would eventually not be sufficient enough to restore at least weakly positive activity. Consequently, MAPI expects a slow, grudging recovery in global output. As shown in Figure 51, we predict aggregate non-U.S. industrialized country output to decline by 3 percent during the second quarter of 2009 and 1 percent during the third quarter. We expect growth to resume during the fourth quarter of 2009 but to be at or below 2 percent through the fourth quarter of 2010.

Aggregate developing country growth is expected to be a sluggish 2.0 percent during the second quarter of 2009 but to accelerate gradually to 2.5 percent during the third quarter, 3.0 percent during the fourth quarter of 2009 and first quarter of 2010, followed by a gradual acceleration to 3.7 percent during the fourth quarter of 2010.

As shown in Figure 52, the strong dollar and near-collapse of global demand is expected to result in an 8.3 percent contraction in the growth of total U.S. goods and services exports during 2009, the deepest annual export contraction since 1958. A very modest rebound of 1.2 percent is expected during 2010, reflective of our expectation that the path ahead for the global economy will be difficult and uncertain as financial systems repair, and as shattered confidence is rebuilt.

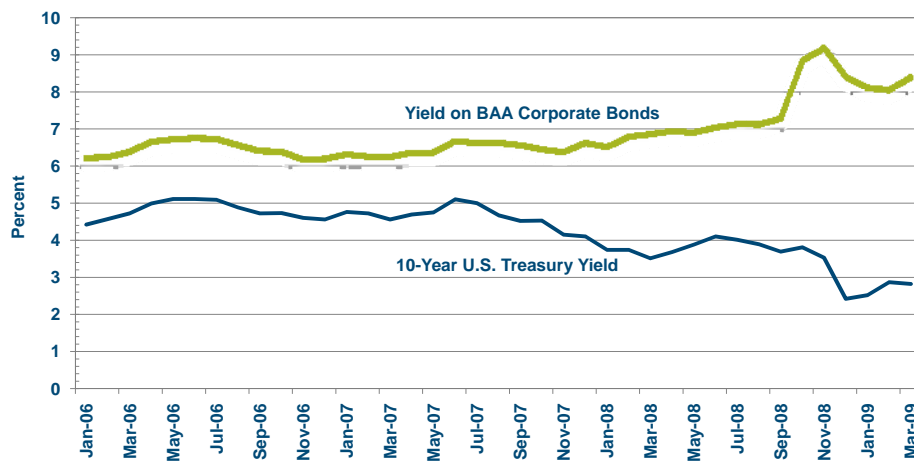


**Figure 3**  
**U.S. Treasury Yields**



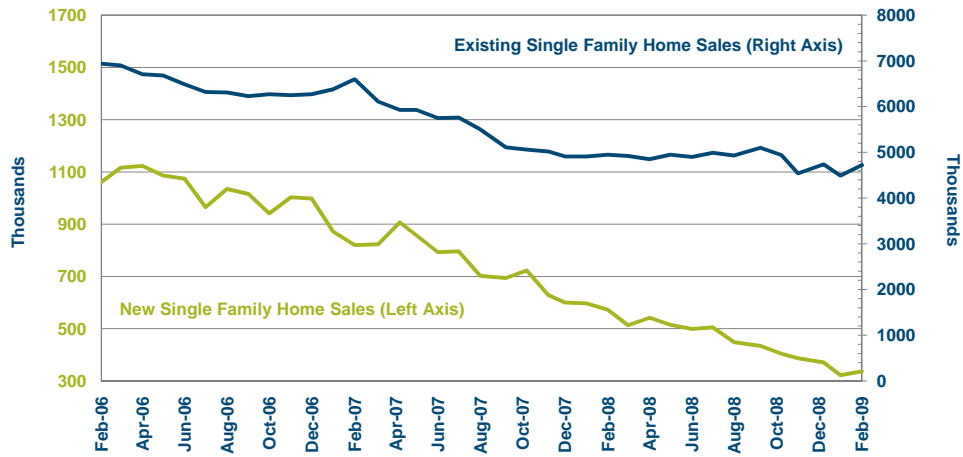
Source: Federal Reserve, Board of Governors

**Figure 4**  
**Treasury and Corporate Bond Yields**



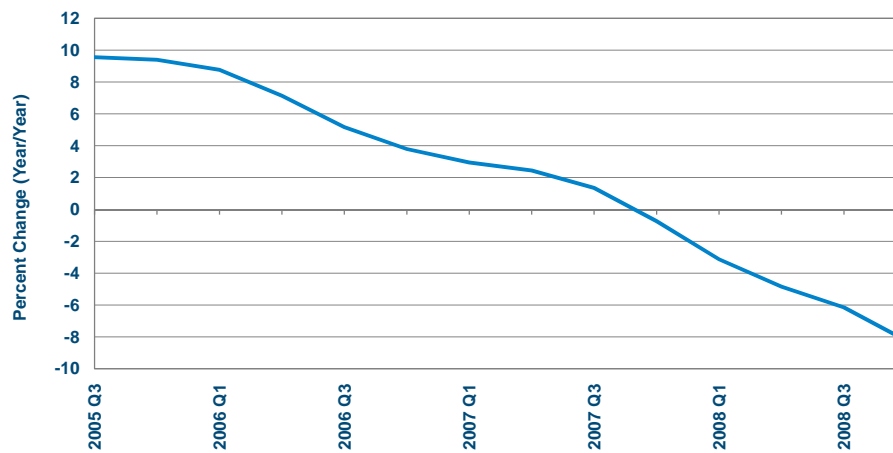
Source: Federal Reserve, Board of Governors

**Figure 5**  
Housing Sales, Seasonally Adjusted Annual Rate

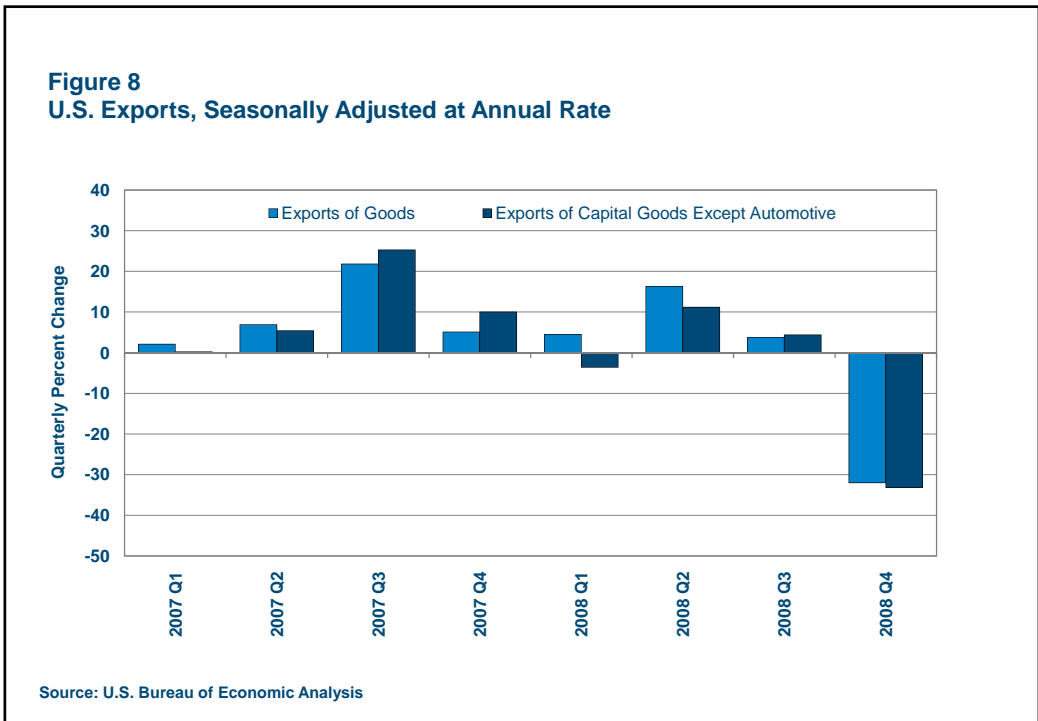
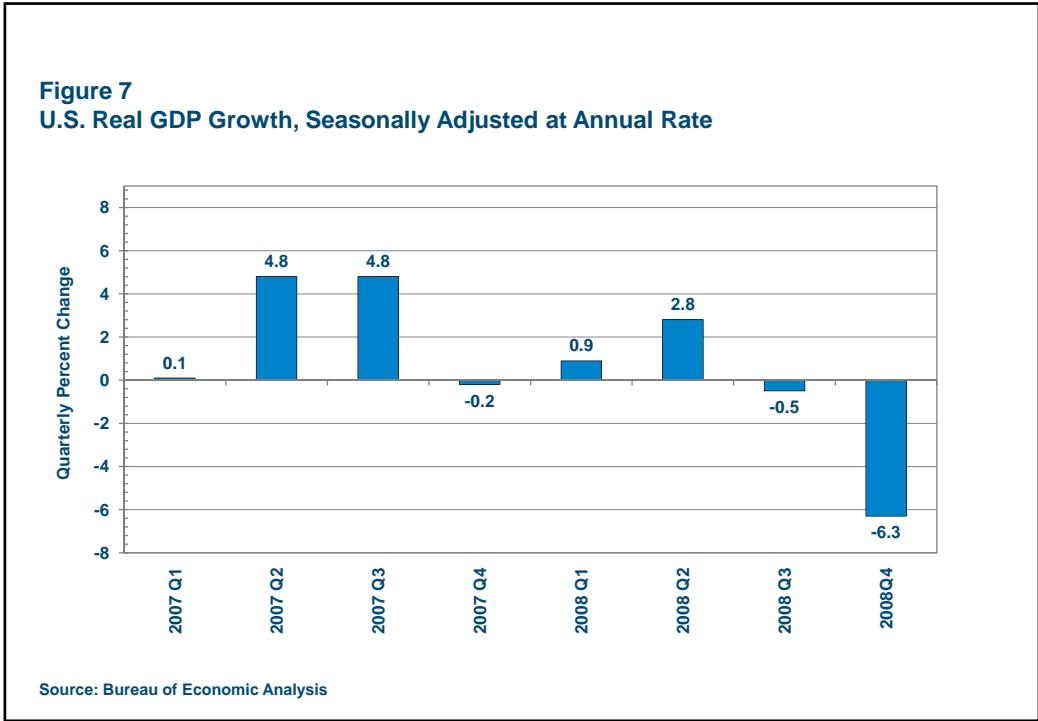


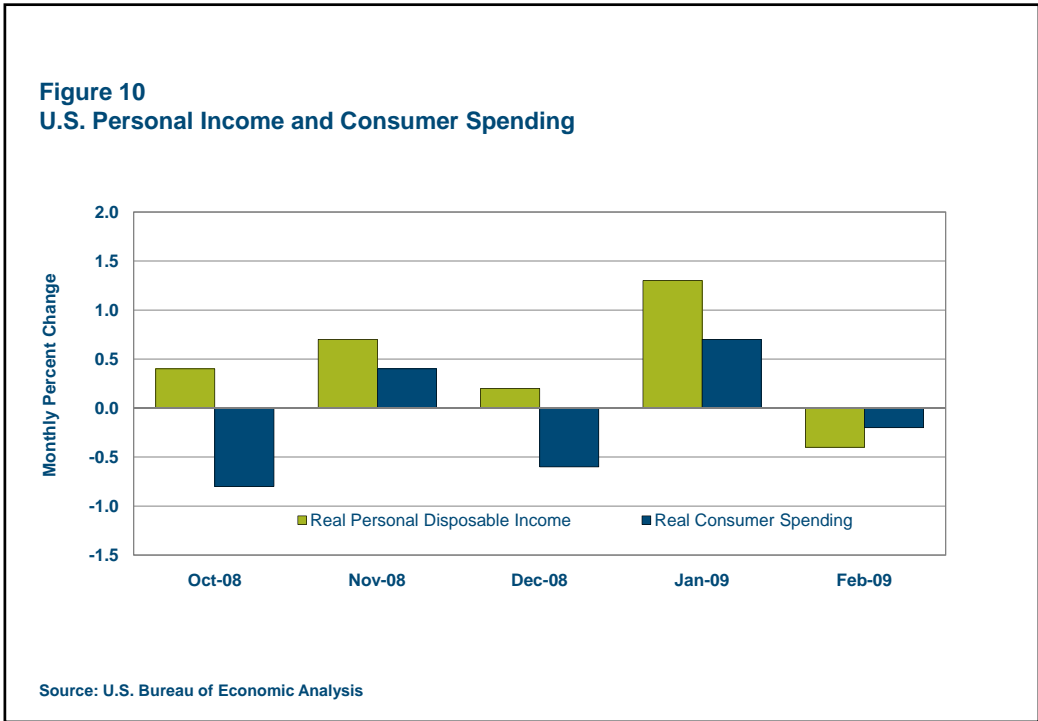
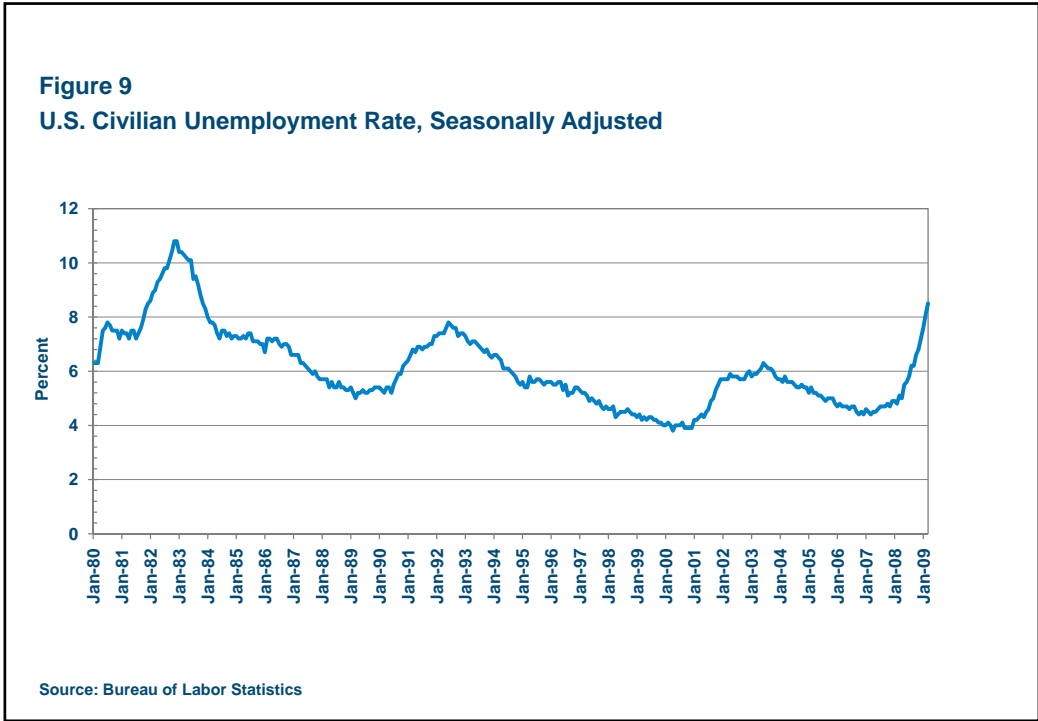
Source: Bureau of the Census and the National Association of Realtors

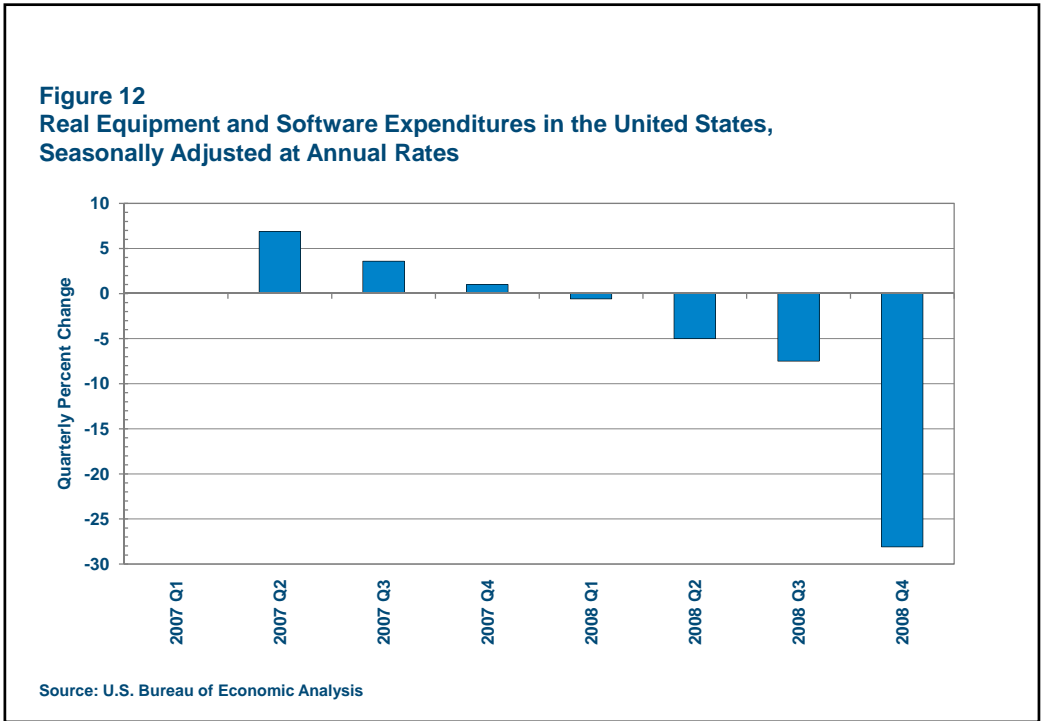
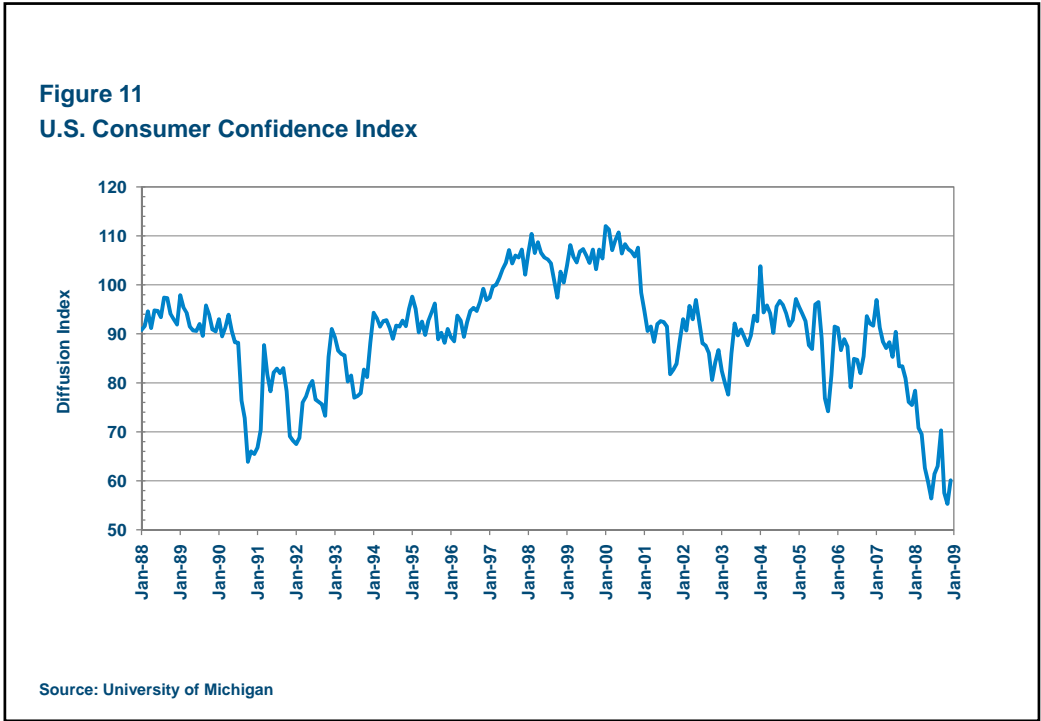
**Figure 6**  
National House Price Appreciation



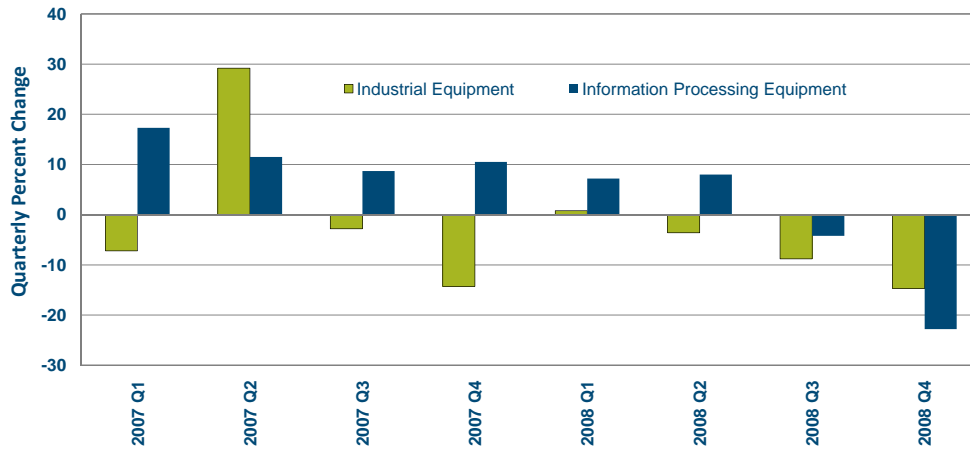
Source: Office of Federal Housing Enterprise Oversight





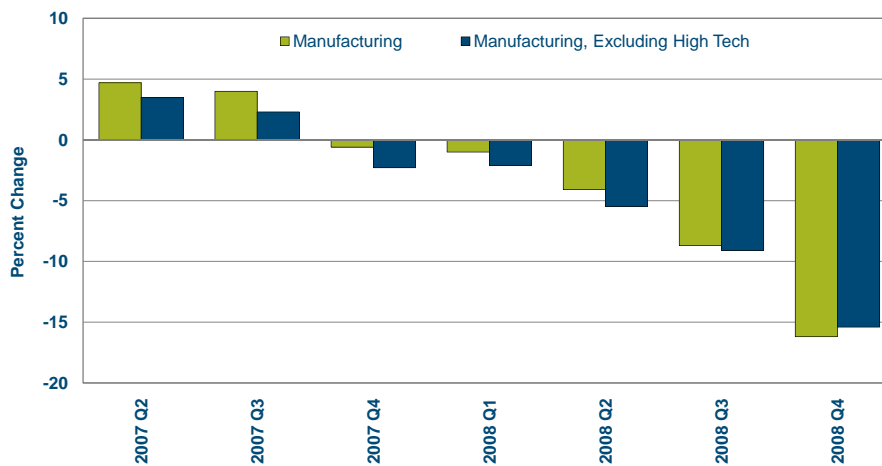


**Figure 13**  
**Key Components of U.S. Equipment and Software Demand, Seasonally Adjusted at Annual Rates**

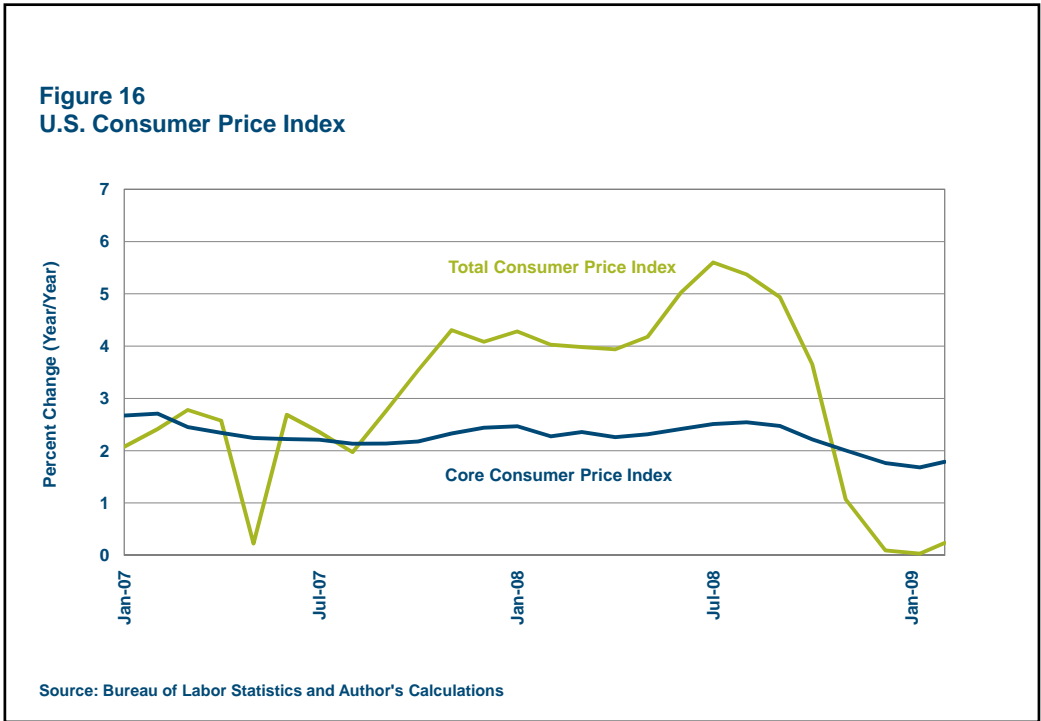
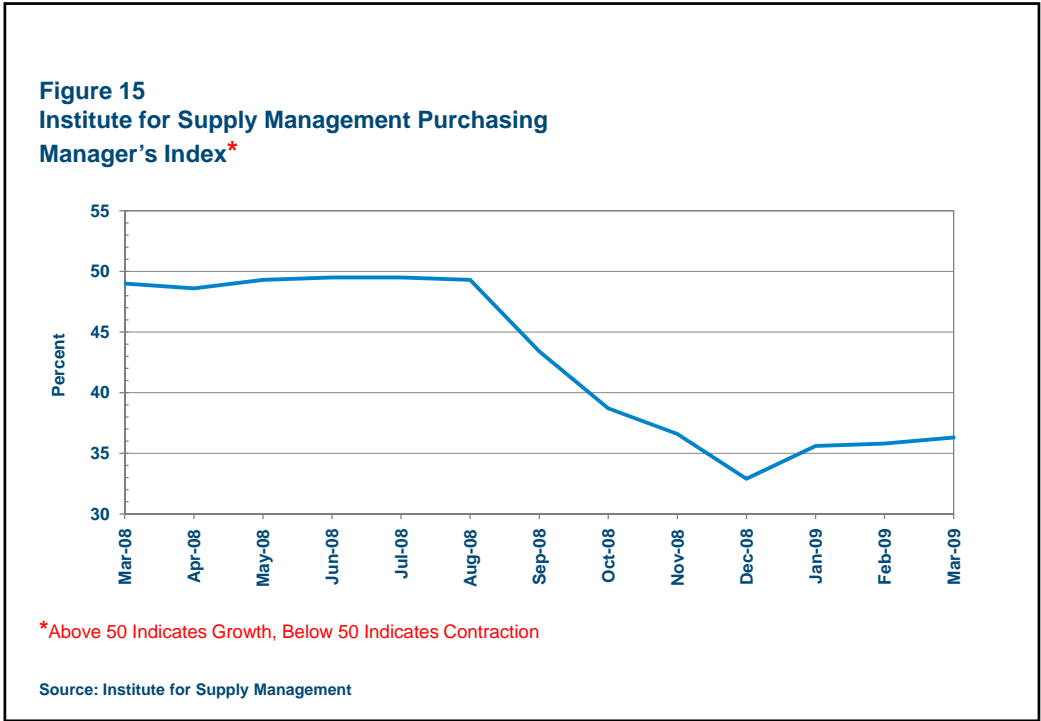


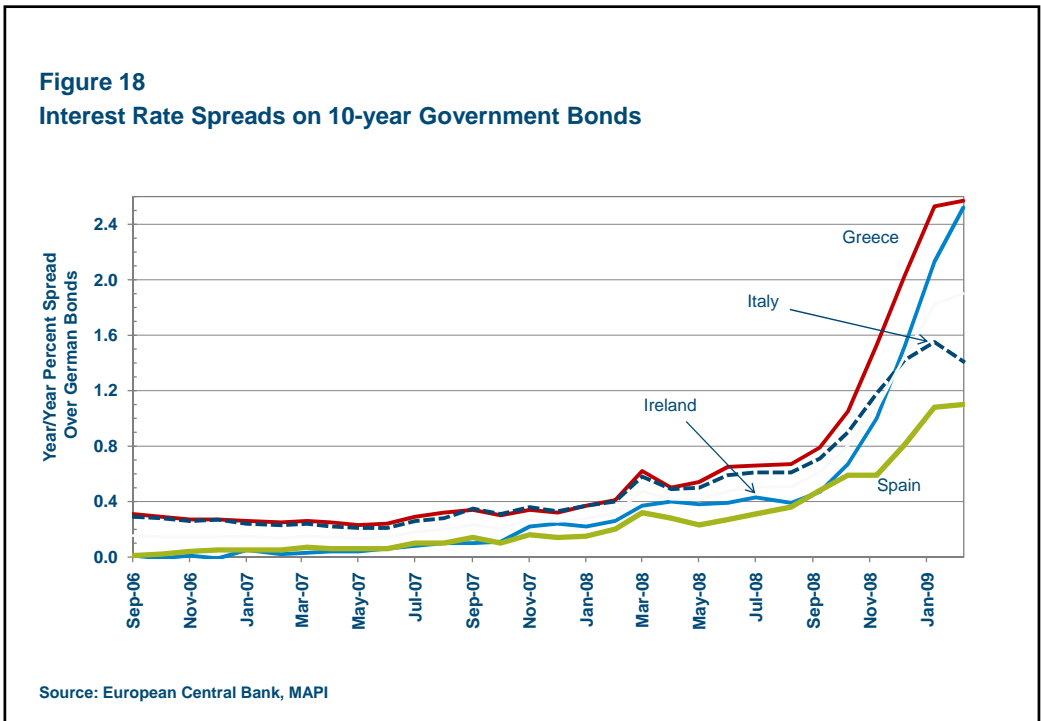
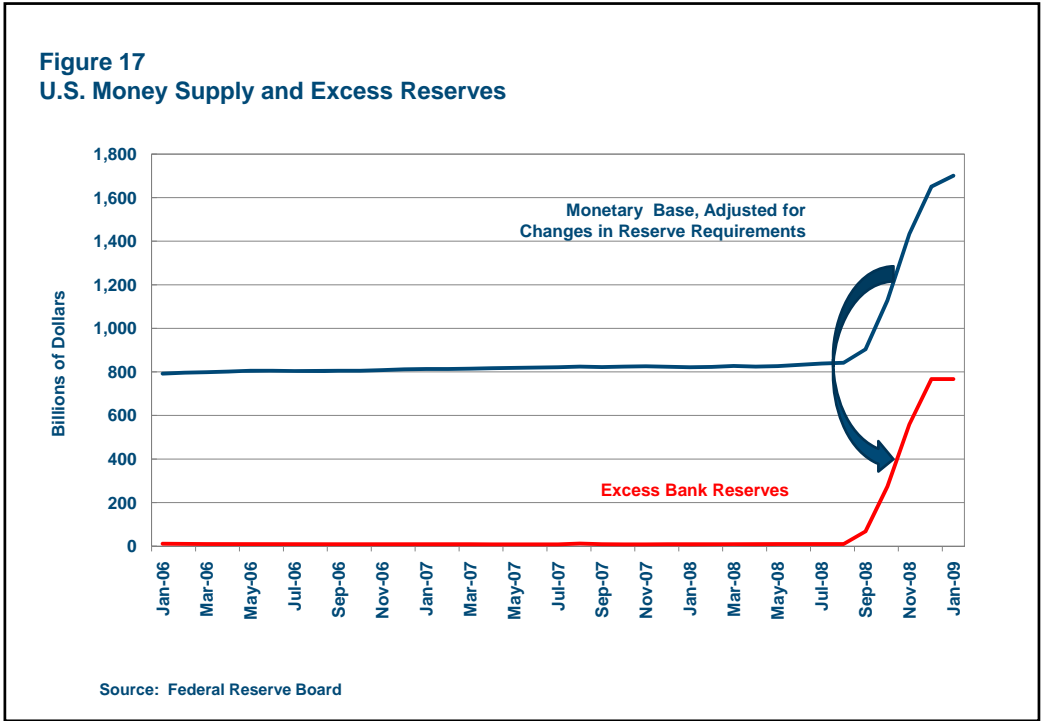
Source: U.S. Bureau of Economic Analysis

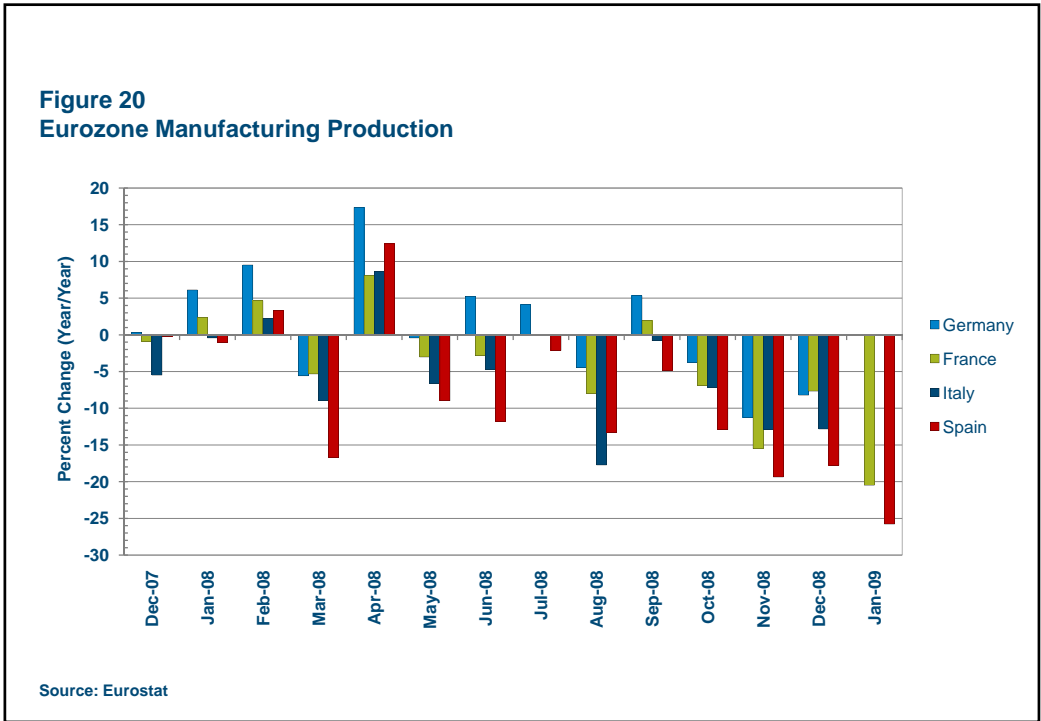
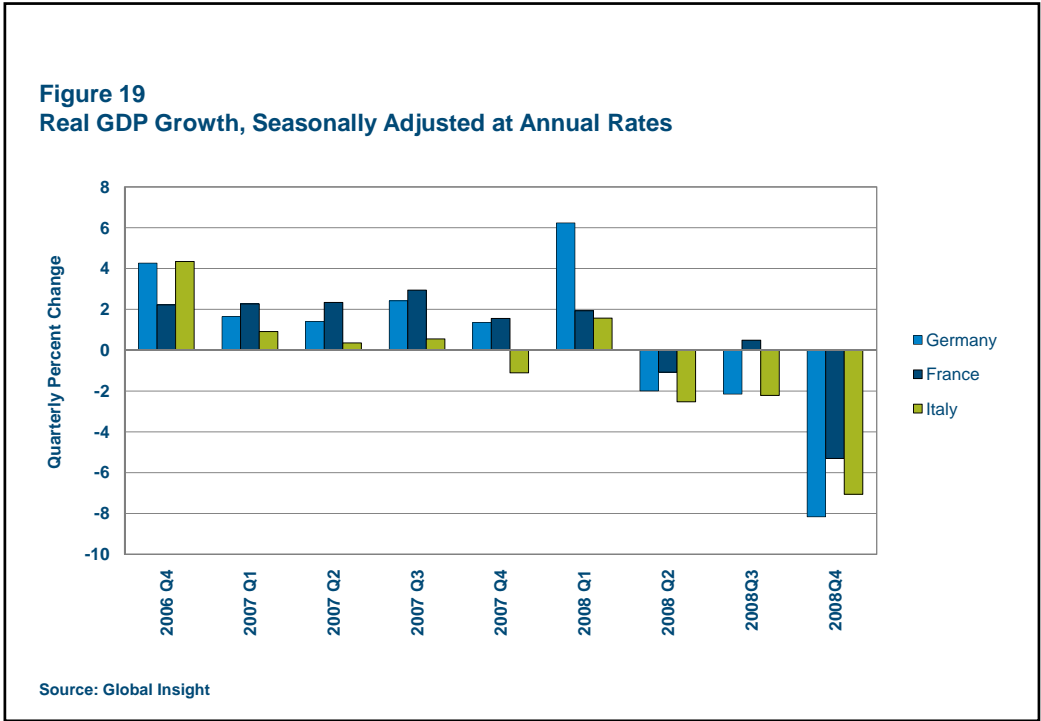
**Figure 14**  
**Growth in U.S. Manufacturing Output, Annualized Rate**

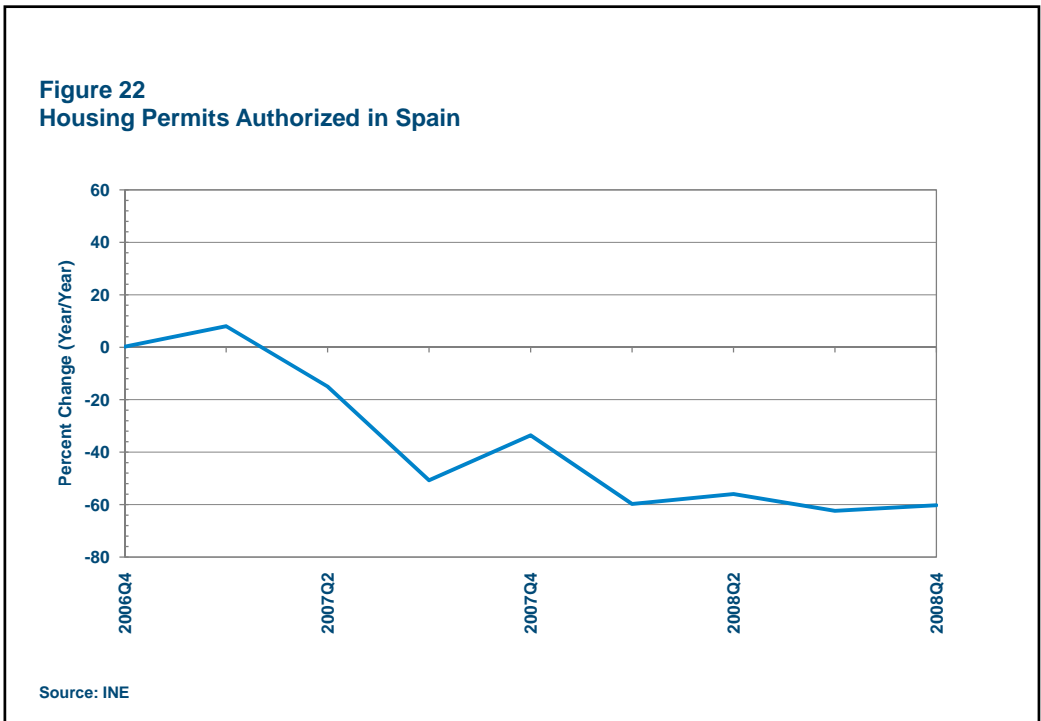
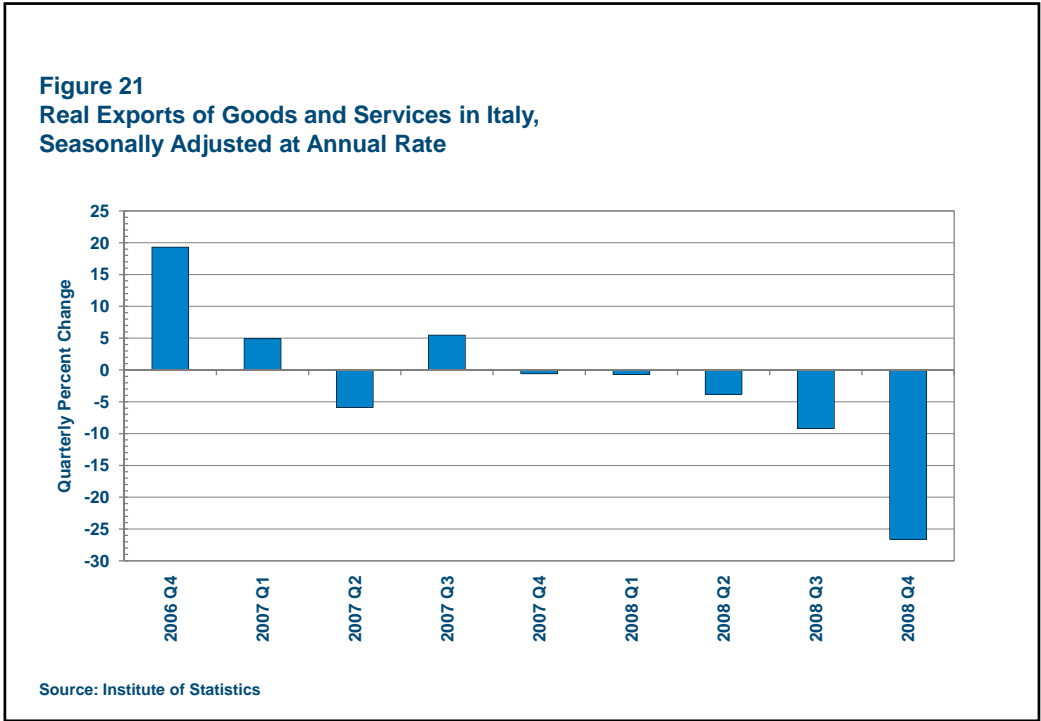


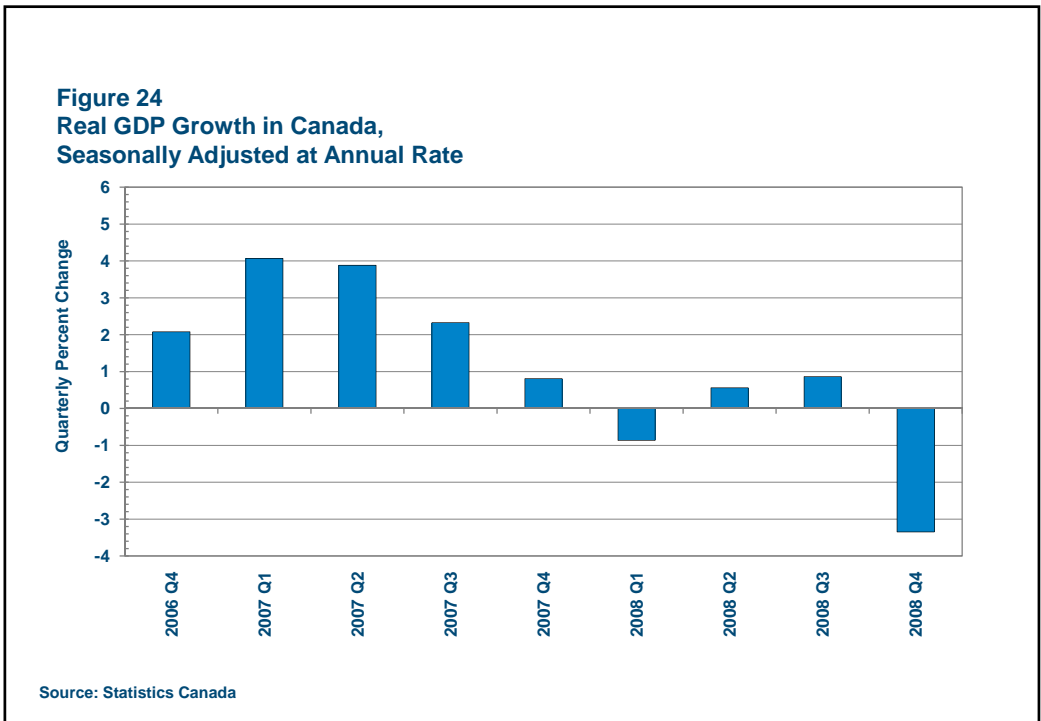
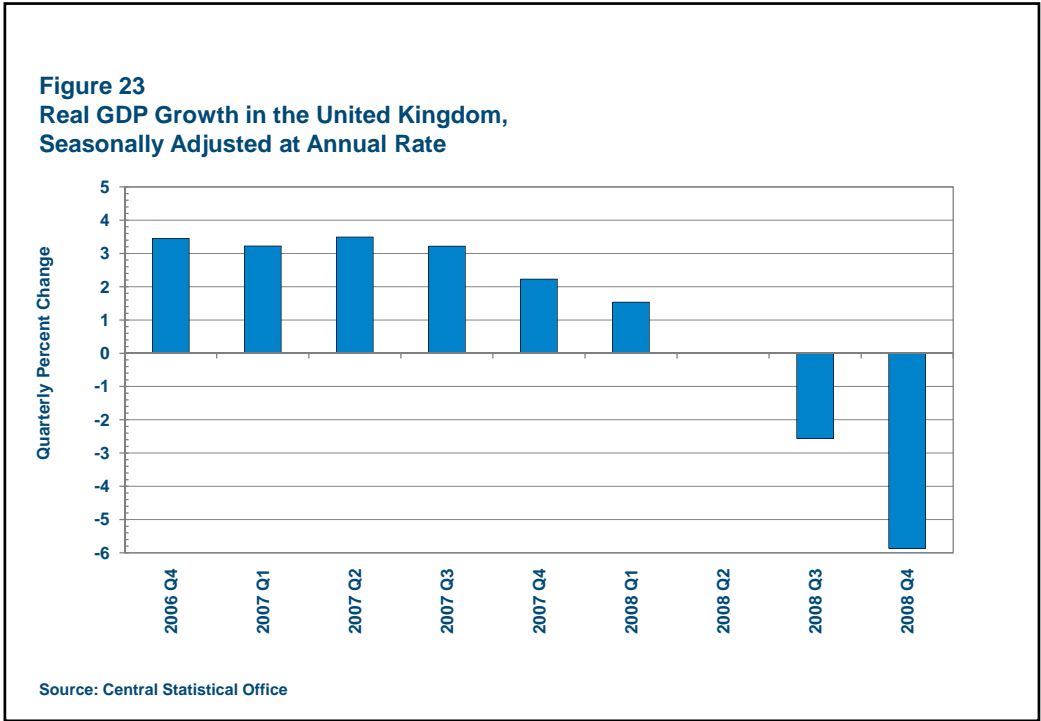
Source: Federal Reserve Board

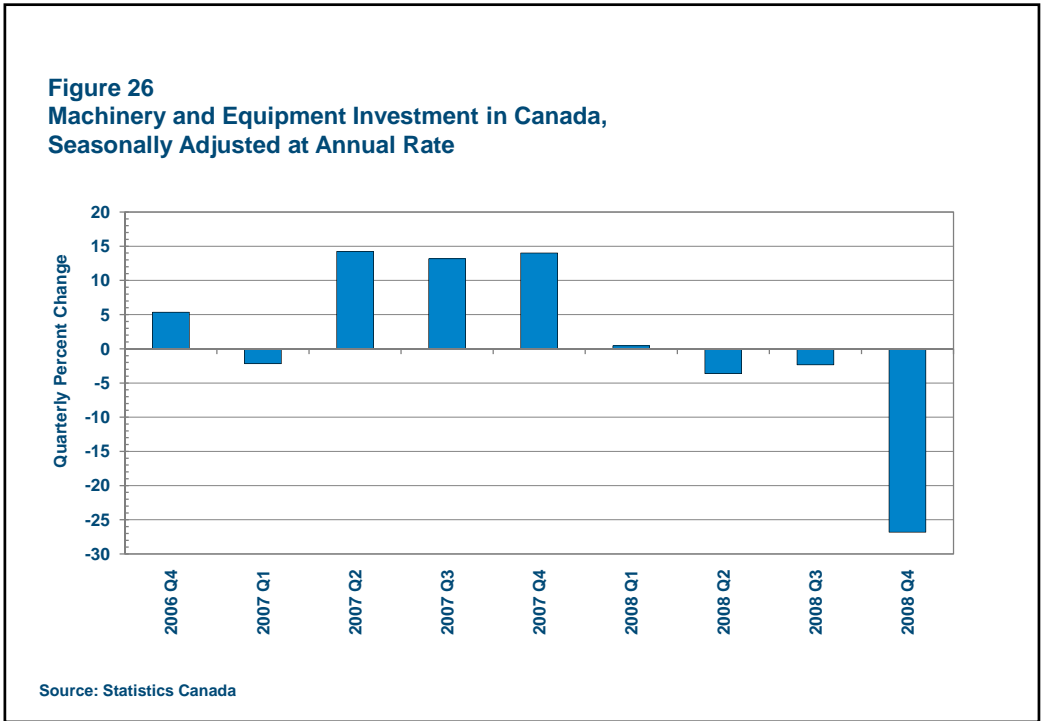
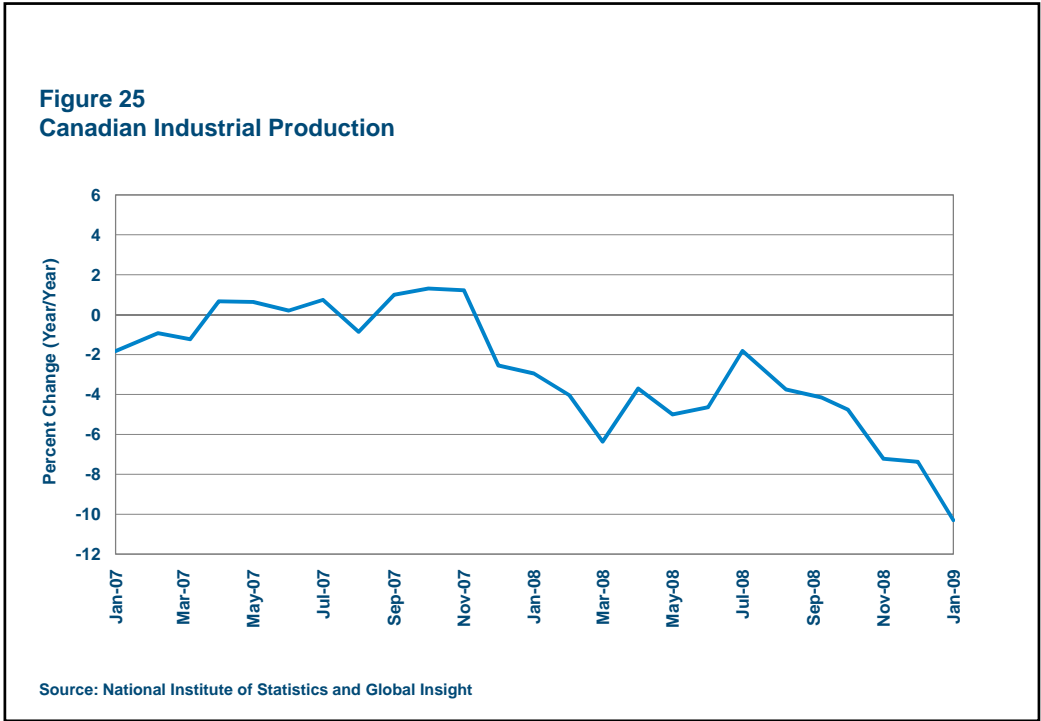


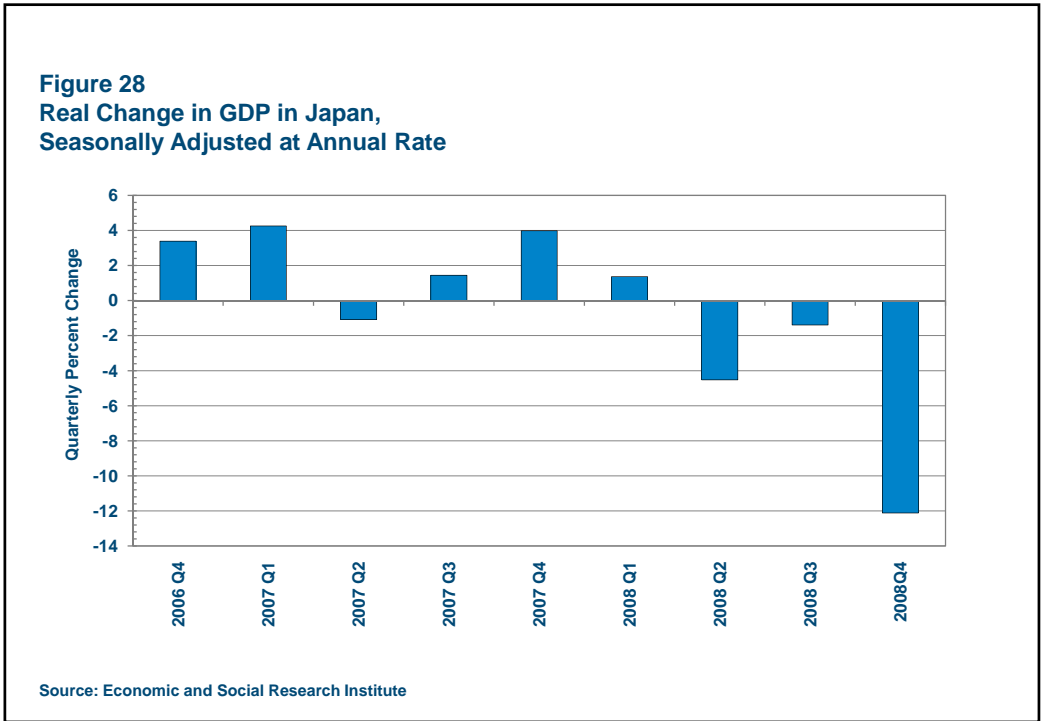
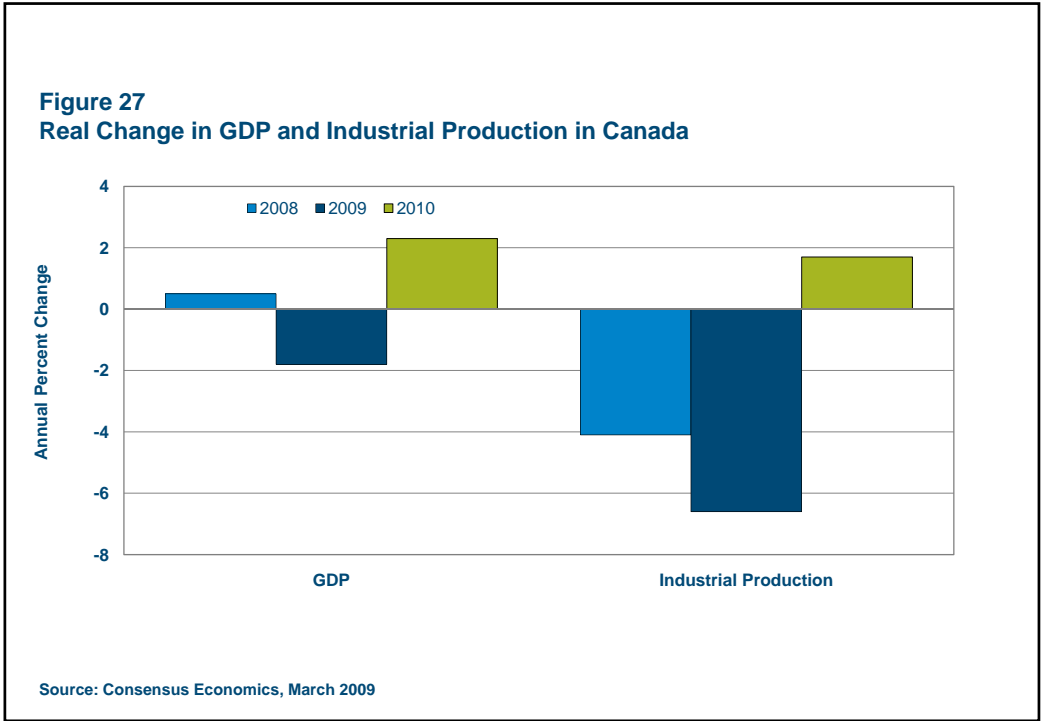




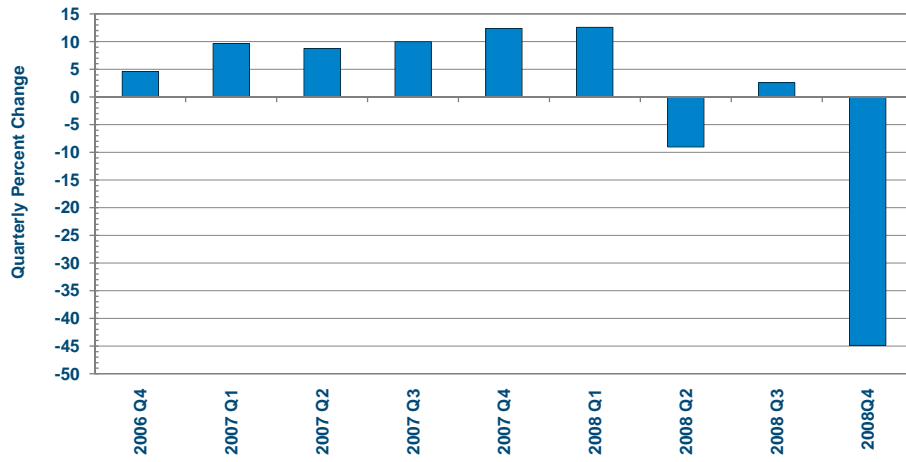






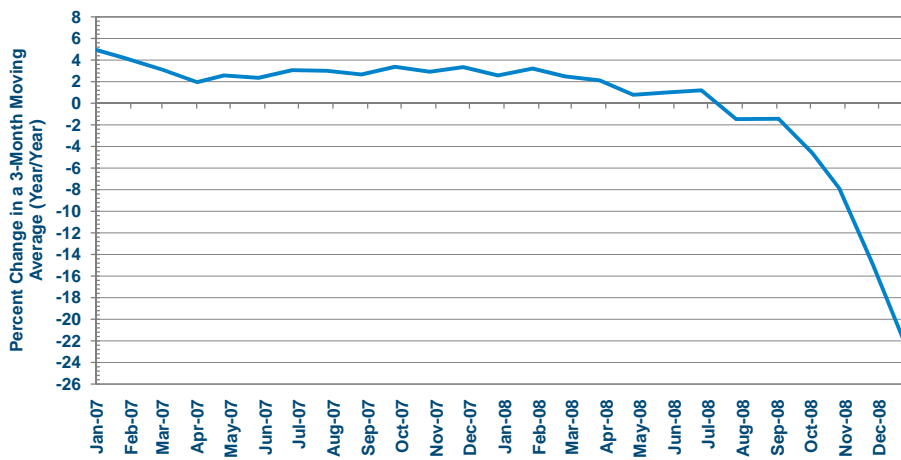


**Figure 29**  
**Real Change in Exports in Japan,**  
**Seasonally Adjusted at Annual Rate**

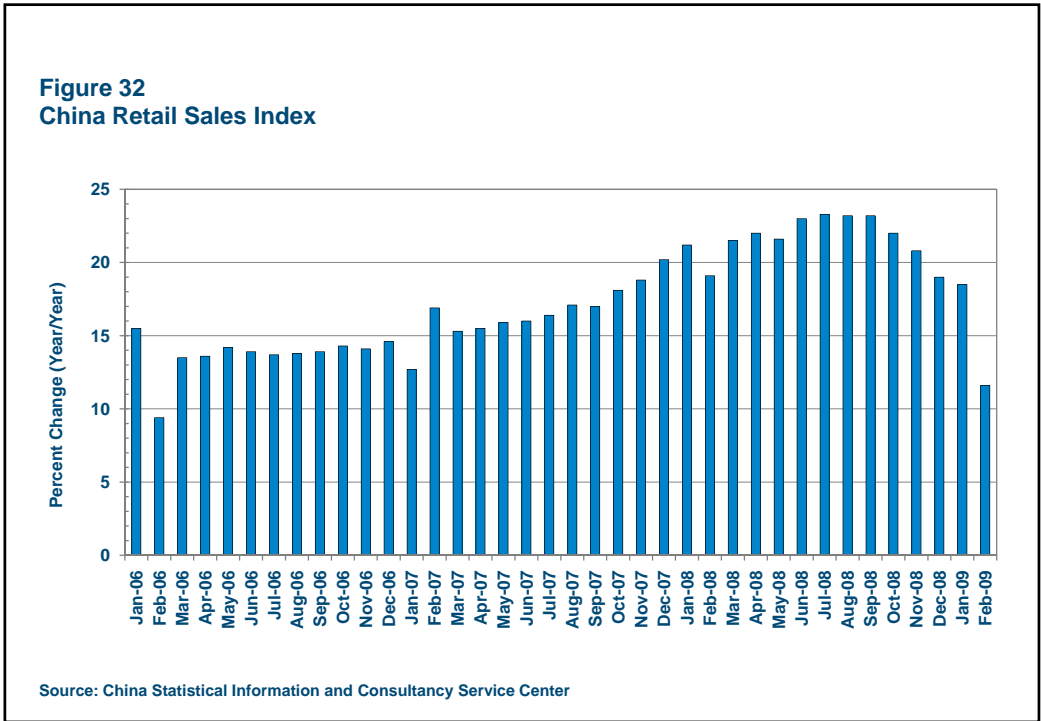
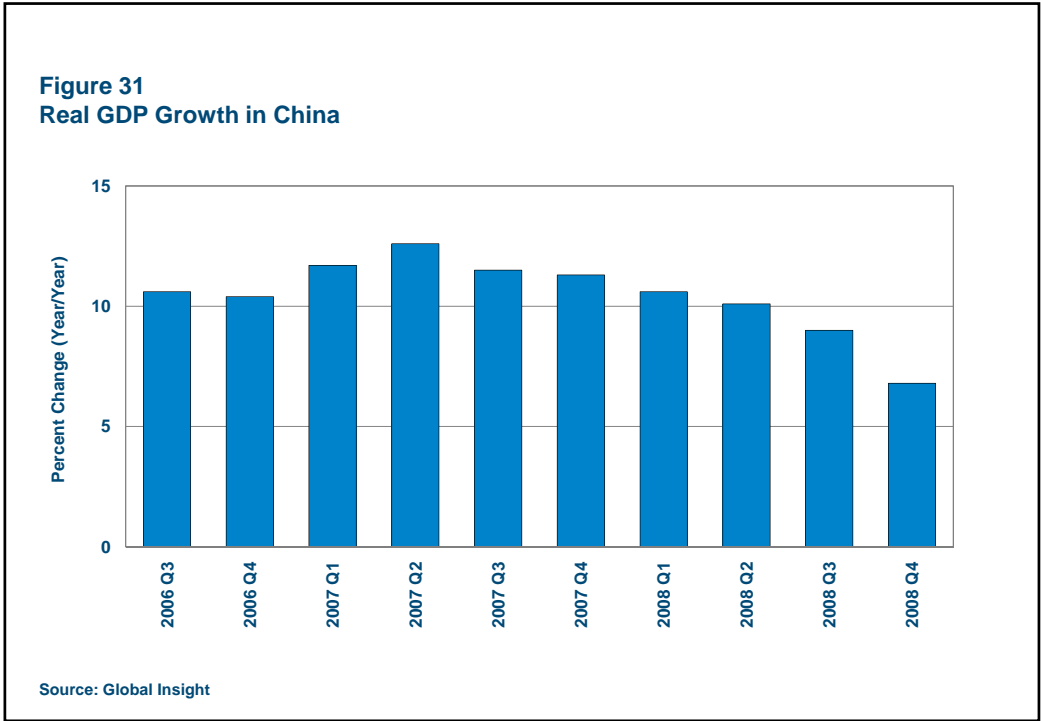


Source: Economic and Social Research Institute

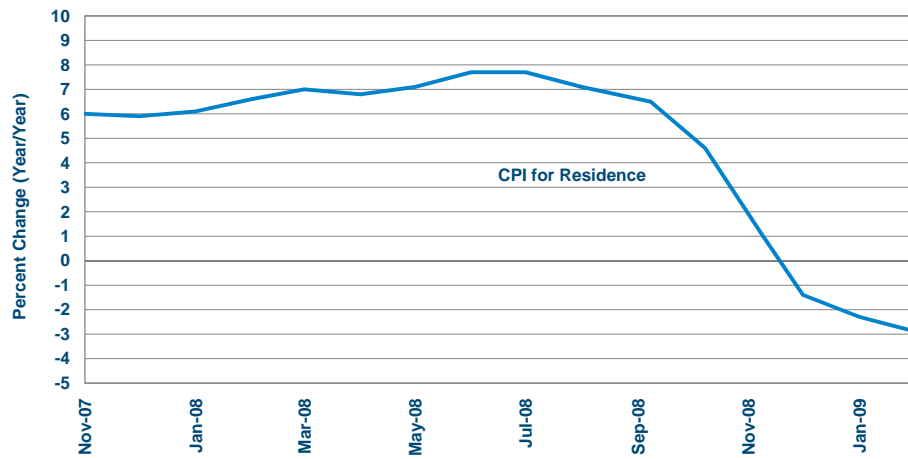
**Figure 30**  
**Japanese Manufacturing Growth**



Source: Department of Trade and Industry

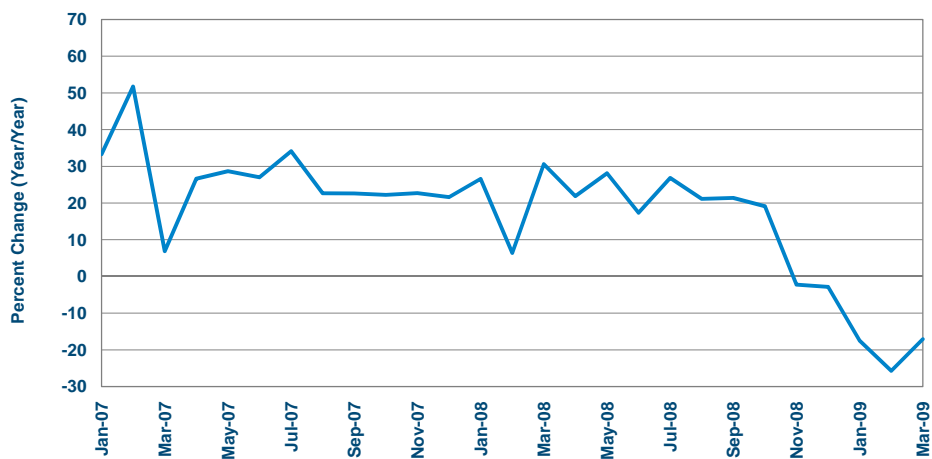


**Figure 33**  
Price Change for Private Housing in China

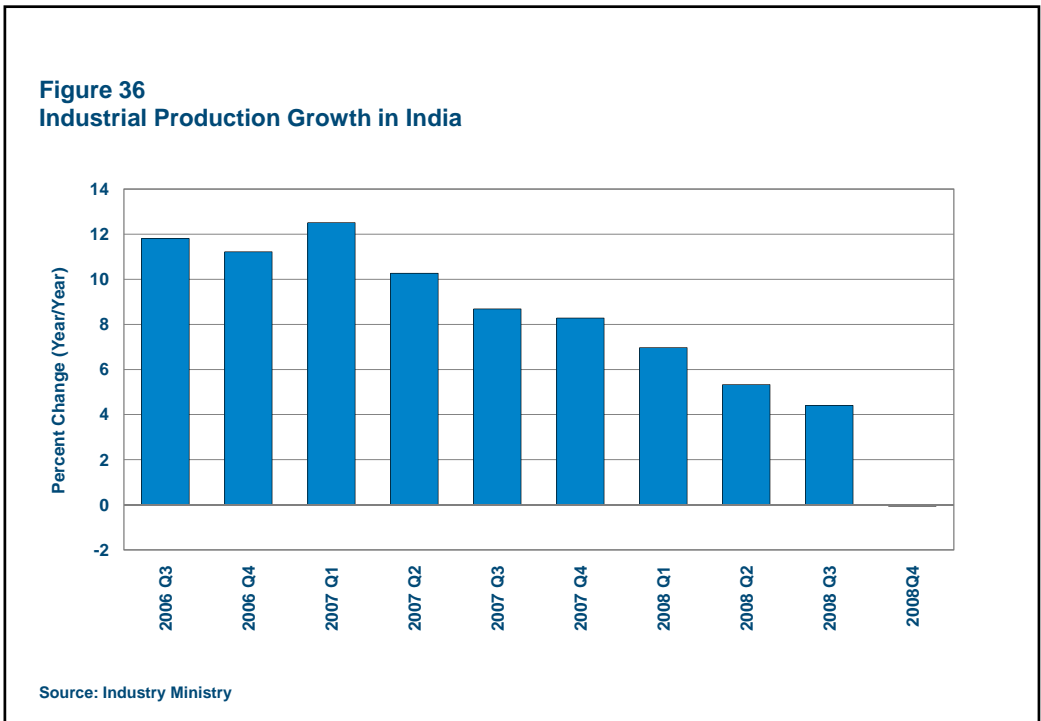
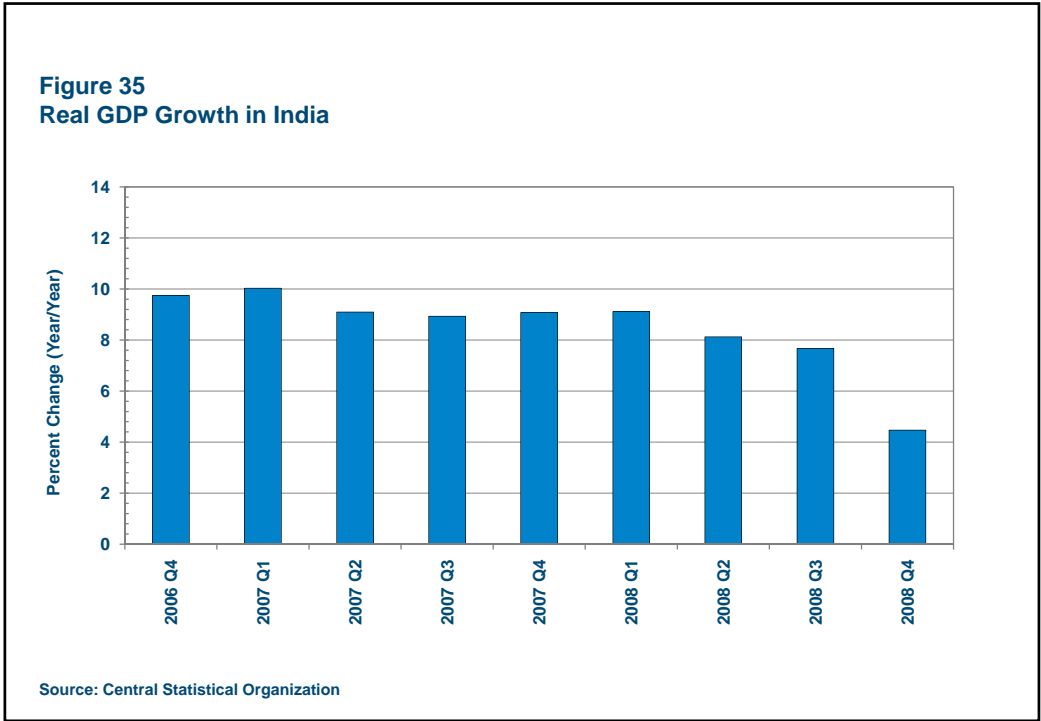


Source: China Statistical Information and Consultancy Service Center

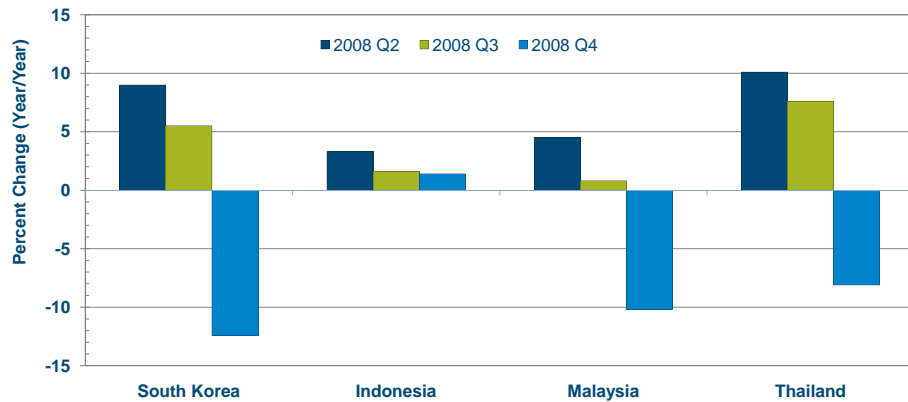
**Figure 34**  
Year-Over-Year Change in Total Chinese Exports



Source: China Statistical Information and Consultancy Service Center

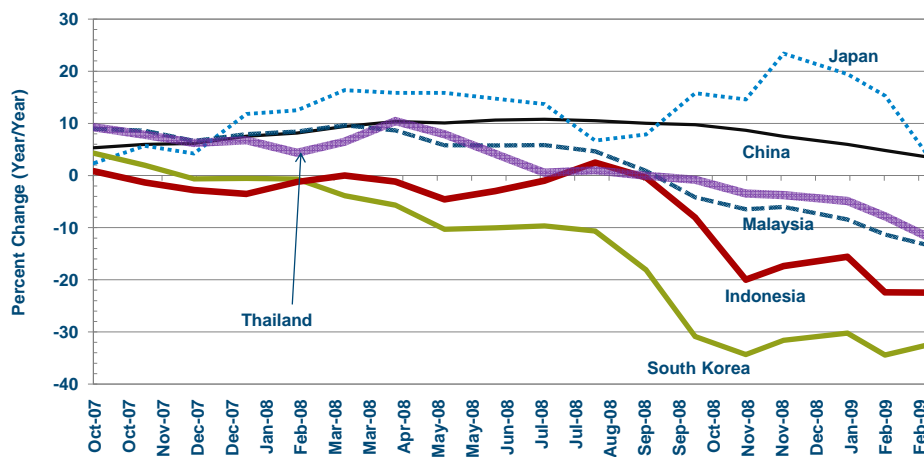


**Figure 37**  
**Quarterly Manufacturing/Industrial Production Growth**  
**in Key East Asian Countries**



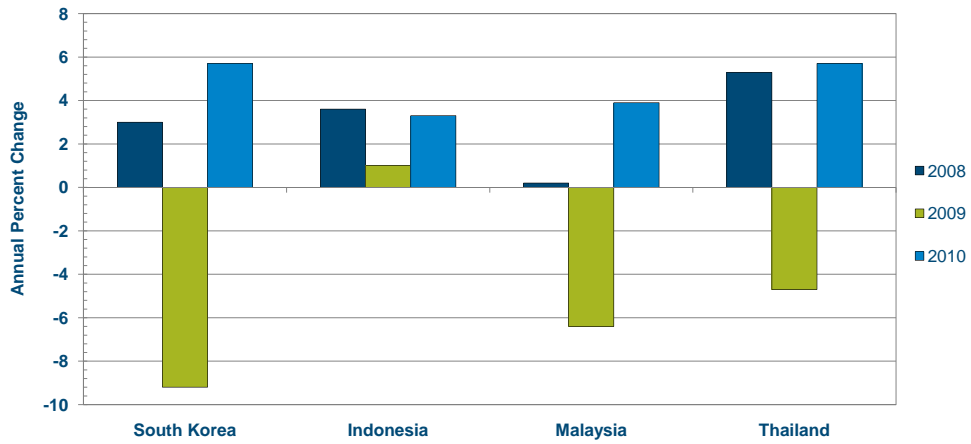
Source: Global Insight and MAPI Calculations

**Figure 38**  
**U.S. Dollars Per Local Currency**



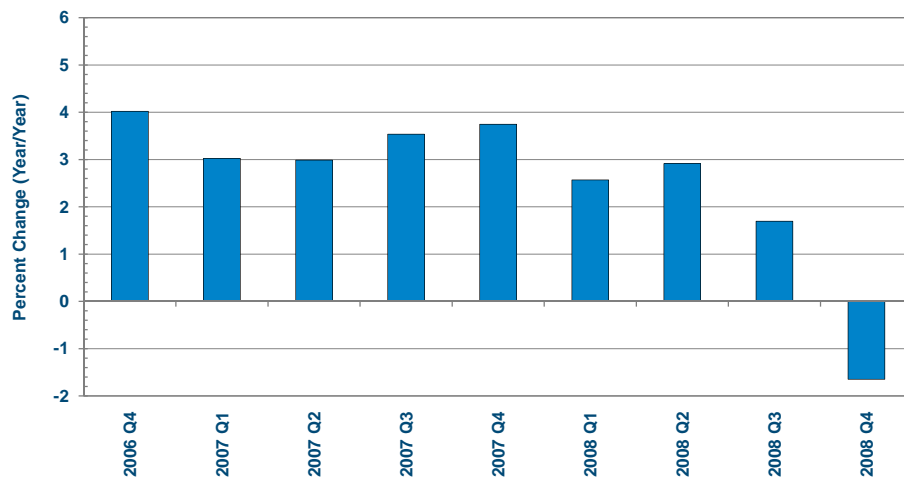
Source: IMF, IFS, Financial Markets, and Global Insight

**Figure 39**  
**Manufacturing/Industrial Production Growth**  
**in East Asian Economies**

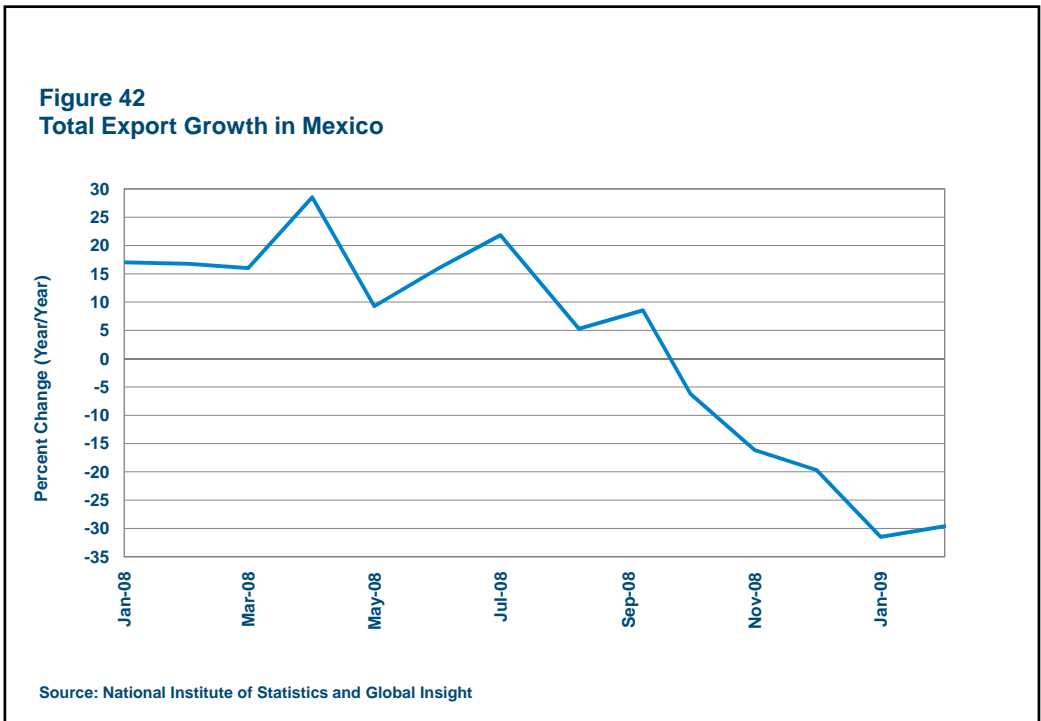
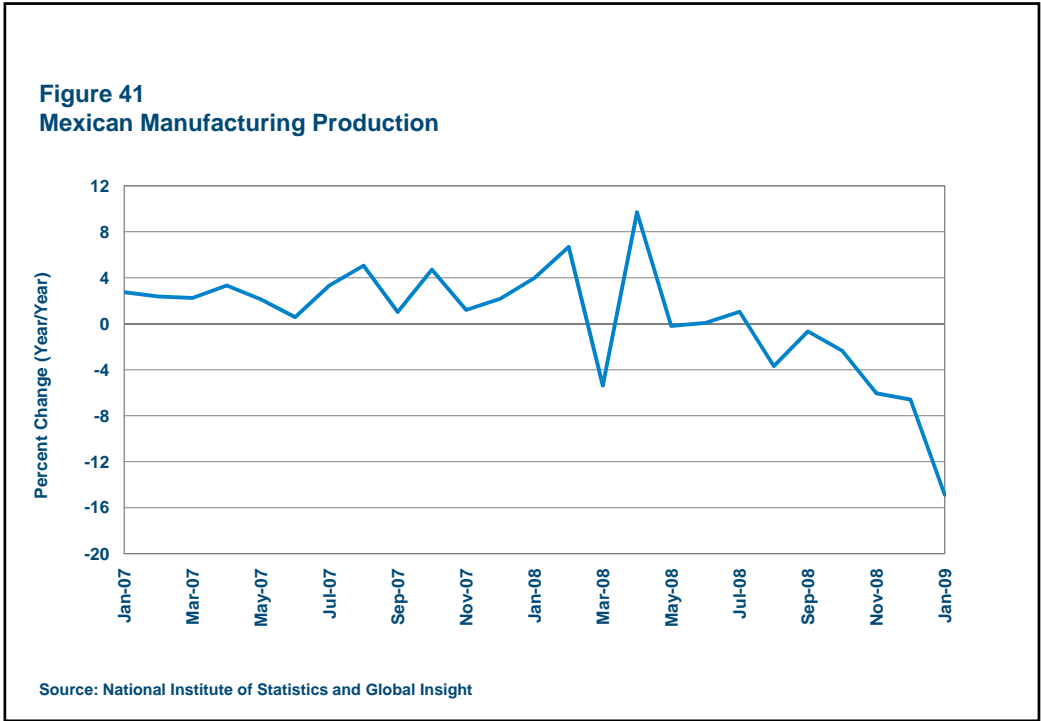


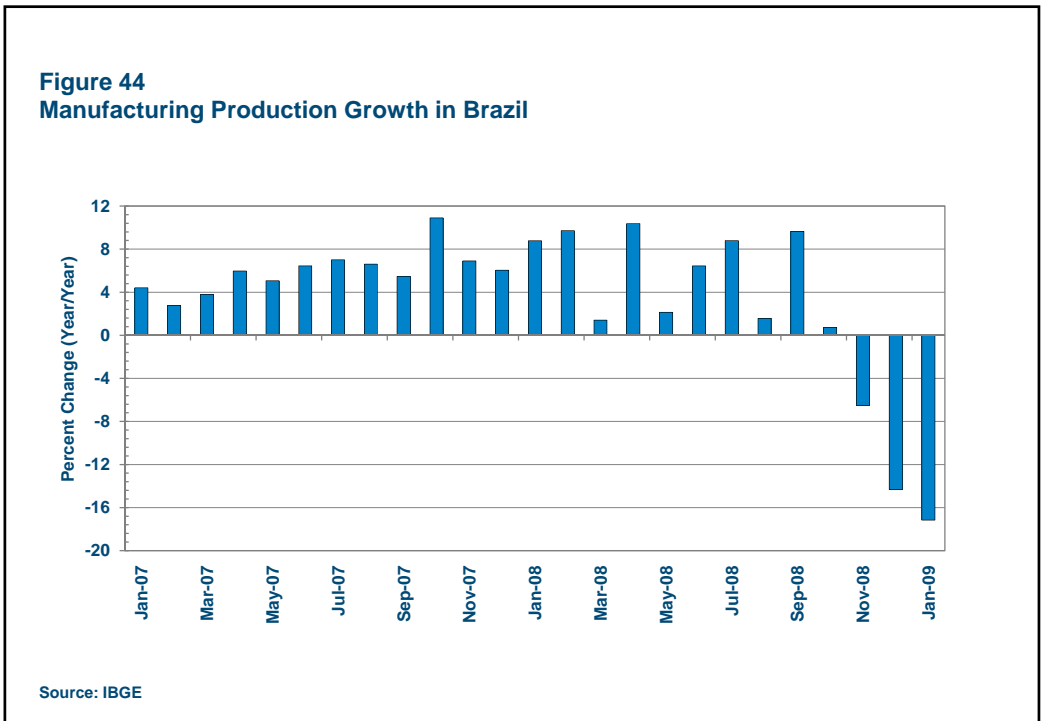
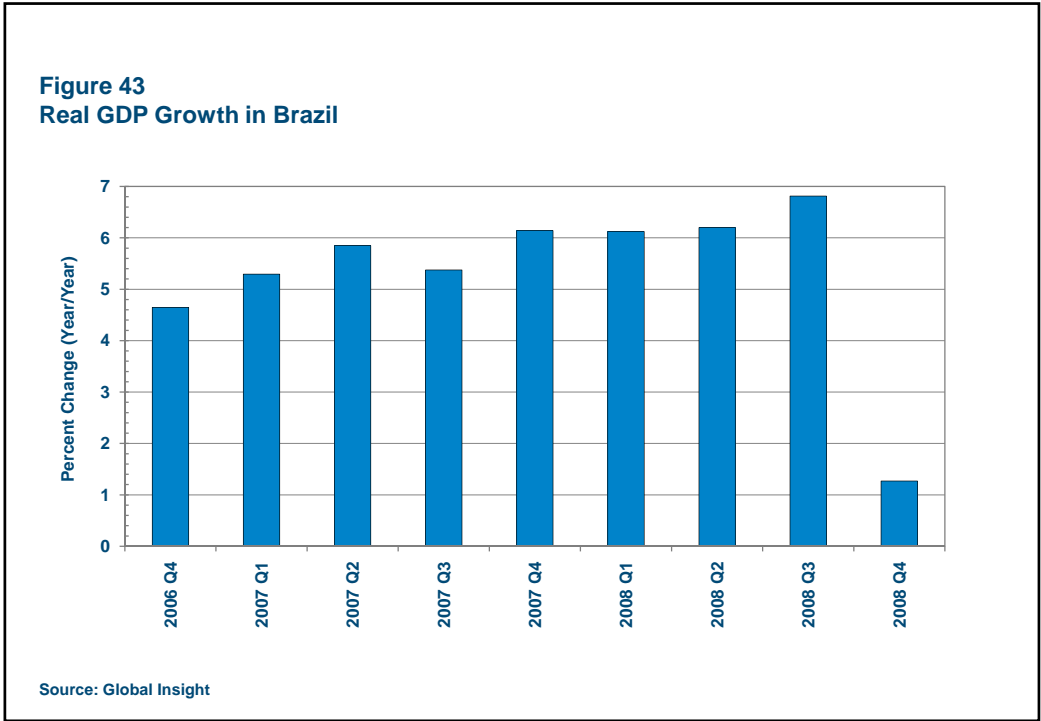
Source: Consensus Economics, March 2009

**Figure 40**  
**Real GDP Growth in Mexico**

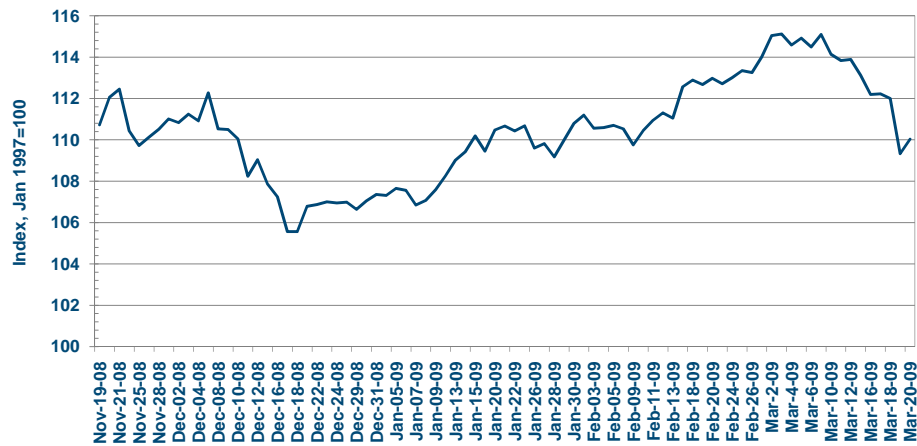


Source: INEGI



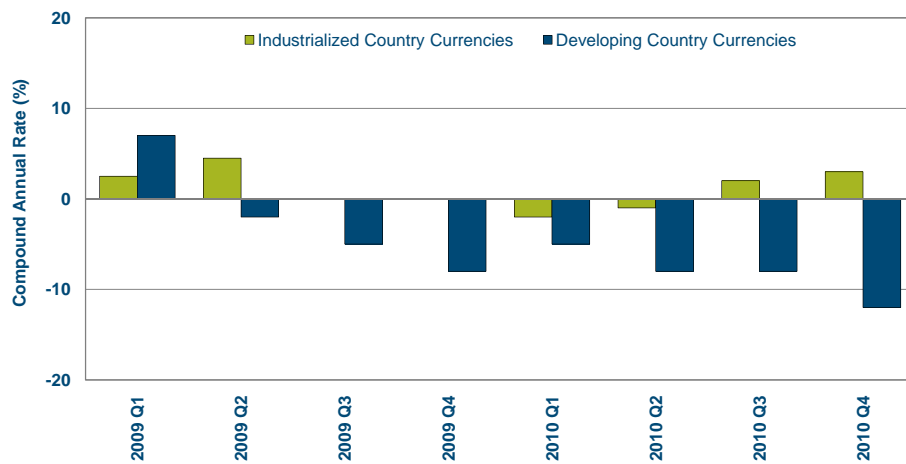


**Figure 45**  
**Nominal Broad Dollar Index**



Source: Federal Reserve, Board of Governors

**Figure 46**  
**MAPI Dollar Forecast**



Source: MAPI Forecast

