TD Economics
Special Report
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GLOBAL SYNCHRONICITY

As of mid-February, consensus forecasts (via Bloomberg) are pegging world real output growth for 2009 at +0.6%, very close to the +0.5% growth rate the IMF changed their forecast to just a few weeks ago. TD Economics has for some time been more pessimistic and has stuck with our +0.5% forecast for global growth since last October. However, as the figures roll in around the world for the fourth quarter of 2008, it appears that even the TD Economics forecast is too high. World output appears heading towards an outright contraction this year of at least -0.5%. This would be the first contraction in the post-war period. And, as we discuss below, even this may yet need to be revised lower.

The emerging picture of economic activity is clearly showing the synchronization of the cycle in almost every corner of the world. Nowhere is this more readily seen than in the ongoing deleveraging in international trade flows. The level of nominal exports (in US$ terms) is back to 2003 levels in Taiwan (through January) and back to 2001 levels in the Philippines (through December). If the Philippines January figures follow some of the other regional economies, they will be back down to 1997/98 levels. In fact, with figures still coming in, the apparent decline in global trade over the last four months (Oct-Jan) is uncomfortably close to the decline seen over three years of the Great Depression.

But this synchronicity is not unique to Asian emerging markets (EMs). We have seen similar movements across advanced economies, as well as EMs in Latin America and Central and Eastern Europe (CEE). In fact, as the chart on the bottom of page two shows, the changes in trade flows across EM regions remain highly correlated with each other. EMs remain part of a global system, and at its heart, that system is still driven by consumer demand.

HIGHLIGHTS

- Recent consensus forecasts peg global economic growth for 2009 at just +0.6%.
- While TD Economics has been much more pessimistic than consensus for some time, even our forecasts appear to have been too optimistic.
- As a result, we now expect the global economy to contract in 2009 by -0.5%.
- This would be the first contraction of the global economy in the post-war era.
- With the feedback from contractions in global trade flows into domestic demand and the ongoing financial risks in Eastern Europe, we still see large downside risks for the global economy.
emanating from advanced nations. For example, due to their much higher level of income, U.S. consumers still spend six times more than Chinese consumers, in spite of being outnumbered almost 5:1. EM economies continue to grow in importance, but they still lack the heft to carry the world on their shoulders.

And the links do not end there, because EM exports also tend to move closely with local industrial production, which itself tends to drive real GDP growth. Using statistical tests for causality, we have found that nominal U.S. retail sales, the trade-weighted U.S. dollar, and Asian industrial production appear to hold a primacy in the global economy, leading many of the economic developments seen around the world. Changes in U.S. retail sales, as well as

Asian industrial production, tend to lead changes in EM exports from Asia, Latin America, and Russia. Moreover, changes in the trade-weighted U.S. dollar tend to exert an additional leading influence on Asian exports, as well as lead changes in industrial production in Latin American and CEE EMs. After these initial impulses, the feedback effect appears to take over, spreading through trade and production trends around the world.

**Preliminary Global Assessment**

First estimates of the European GDP figures showed annualized Q4 contractions of -8.2% (Germany), -7.1% (Italy), -5.9% (U.K.), and -4.6% (France). Meanwhile, the Japanese economy contracted at a 12.7% annualized pace in the fourth quarter and may see another double digit contraction in the first quarter of 2009. Suddenly, the U.S. 3.9% contraction in the fourth quarter, even after its likely revision to a -5% handle, doesn’t look so bad. And, while the Canadian economy is likely to show a sizeable contraction in the final quarter of last year as well, it has a decent chance of turning out to be “the best of the worst.”
Across the G-7, the early evidence suggests that economic performance did not deteriorate much more in the early months of 2009, but nor did it get much better.

In emerging markets, we have seen an increased concern in the last week over the fate of CEE economies and the potential for their problems to infect Western European economies. This risk is real. In recent years, Western European banks lending to CEE clients was very significant. With the much sharper than anticipated contraction in Western Europe, this has led to a sudden deterioration in the growth prospects for eastern economies. The issue for the CEE economies is exacerbated by the practice of some of these loans and residential mortgages being taken out in foreign currencies. So as the CEE currencies have depreciated to reflect the deteriorated sentiment, this has led to the increasing cost of servicing these debts, which in turn leads to significant problems for those banks that made the loans.

While many of the smaller Asian EMs have been some of the worst hit to date, India and China remain remarkable in their resiliency. Industrial production in India has continued to decelerate, but at a rate that is almost unchanged since early 2007. In China, there has been a sense of stabilization since December. It would appear that the Chinese stimulus plan has been able to make its presence felt on the economy much faster than elsewhere. In part, the relative small size of private consumer spending in China may be helping them. In 2008, Chinese investment spending was nearly the same size (in nominal U.S. dollar terms) as investment spending in the U.S., and was slightly larger in magnitude than all of Chinese consumer spending last year. Because of the importance of investment spending to the Chinese economy, infrastructure and government spending plans have shown early signs of success.

While we were never one to believe in the global decoupling myth, we did not expect the sudden and dramatic retrenchment in global trade flows that we have seen. U.S. consumer spending, exacerbated by the disinflationary trends, collapsed late in 2008. This meant demand for EM exports took a major hit. At the same time, while the appreciation of the U.S. dollar – and requisite depreciation of partner currencies – means that many EMs should be able to gain some market share in the medium-term, the near-term impact was a sudden and sharp depreciation of the value of their exports. This must yet be distributed into lower corporate profits, investment spending, and employment in these economies.

And, while our forecast is now noticeably below consensus, it still incorporates an expectation for a global recovery in the second half of the year. This is premised on the expectation U.S. consumer spending will be driven by both monetary and fiscal measures, as well as the ongoing stimulative impact of low gas prices. Moreover, the sharp global shifts have masked some other important positive developments we think have gone under-noticed. One would be the fact that the U.S. is now running a trade surplus once we exclude their net trade deficits in petroleum products and with China. These two areas make up a sizeable 25% of U.S. total trade flows, but this does mean...
that for the first time in over a decade, the U.S. is running a trade surplus on the remaining 75% of their trade flows.

With the risk that this recovery might prove more distant than we expect, the front-loaded nature of the global contraction, and the fact that we must continue to discern the full extent of the global contagion underway, we feel the risks to this new forecast still remain to the downside. We could even see a further downgrade when we release our next full Quarterly Economic Forecast in mid-March once some more pieces of the puzzle become known.

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