Global Economic Prospects as of April 4, 2011: Continued Growth Despite the Turmoil

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Paper presented at the nineteenth semiannual meeting on Global Economic Prospects
April 4, 2011.

Overview

Political turmoil has raged across much of North Africa and the Middle East in the early months of this year, contributing to an upsurge in world oil prices that is part of a broader upturn in most commodity prices and in overall consumer price inflation. Meanwhile, a historic earthquake and tsunami have devastated parts of northern Honshu and crippled a major nuclear power plant. A powerful earthquake has also hit the southern island of New Zealand, and Queensland in Australia has suffered an enormous flood.

All of these developments, which could not have been anticipated six months ago, will have negative impacts on global economic growth during at least the first half of 2011 and suggest an increase in the downside risks looking farther forward. Nevertheless, my global growth forecast for 2011 and 2012 is essentially unchanged from six months ago. As reported in table 1, using purchasing power parity (PPP) exchange rate weights, world real GDP growth on a year-over-year basis is projected to be 4.3 percent this year and 4.5 percent next year (compared with forecasts of 4.3 and 4.4 percent, respectively, as of last September).

The explanation of this forecast stability is that economic developments through mid-February, before most of the recent turmoil, pointed to an upward revision of global growth forecasts. Indeed, somewhat stronger than anticipated growth in the second half of 2010 for several (but not all) important economies, has led to an upward revision, from 4.6 to 4.9 percent, for estimated world growth in 2010. This has positive carry-over effects for growth in 2011. In addition, leading indicators such as purchasing managers indexes pointed to strong growth in early 2011.

These reasons for increased optimism have now been reversed by recent events. However, the downward revision of global growth prospects from early this year could hardly be characterized as a “double dip.” Instead, it is now clear from the results and projections summarized in table 1 that the world economy has more than fulfilled my forecast of early 2009 that by mid-2009, the world economy would begin a stronger than expected, “V-shaped” recovery from the great global recession. Also, to an even greater extent than I had anticipated two years ago, the great global recovery has featured much stronger performance by the emerging-market and developing economies than by the advanced economies. This pattern is expected to persist at least through 2011 and 2012.

Inflation is clearly rising on a worldwide basis, led by surging food and energy costs. Broad indexes of consumer prices have risen significantly in recent months in most countries. A world index computed by the International Monetary Fund (using PPP weights) shows that three-month moving average inflation rate is up from barely 2 percent last summer to over 5 percent early this year. While some of this recent rise in inflation may well prove temporary, increases in longer-term expectations of inflation reasonably reflect the likely reality going forward.

Table 1 Real GDP growth: Results for 2008–10 and forecast for 2011–12
(percent)

Region or country	**2008**	**2009**	**2010**	**2011**	**2012**
World (PPP weights)	2.8	–0.6	4.9	4.3	4.5
Advanced economies	0.2	–3.4	3.0	2.7	2.9
United States	Nil	–2.6	2.9	3.3	3.2
Japan	–1.2	–6.3	3.9	1.0	3.5
Canada	0.5	–2.5	3.1	3.1	2.9
Western Europe	0.3	–4.1	1.8	2.1	2.2
United Kingdom	–0.1	–4.9	1.3	2.0	2.5
Other non–Euro Area	0.3	–3.0	3.2	3.0	2.8
Euro Area	0.3	–4.0	1.7	2.0	2.1
Germany	1.0	–4.7	3.6	2.9	2.2
France	0.1	–2.5	1.5	2.0	2.1
Italy	–1.3	–5.0	1.1	1.3	1.4
Other Euro Area	0.7	–3.9	0.7	1.6	2.3
Other advanced non-Europe	2.2	0.2	6.5	4.3	4.6
Emerging-market and developing economies	6.0	2.6	7.1	6.1	6.3
Asia	7.7	7.0	9.2	8.4	8.1
China	9.6	9.2	10.3	9.2	8.8
India	6.4	5.7	9.2	8.8	8.5
Other Asia	4.0	2.8	6.2	5.8	5.5
Latin America	4.3	–1.8	6.0	5.0	4.7
Brazil	5.2	–0.6	7.5	5.5	5.0
Mexico	1.5	–6.1	5.5	4.5	4.0
Other Latin America	5.0	–0.1	5.0	4.7	4.7
Central and Eastern Europe	3.0	–3.6	4.0	4.2	4.5
Commonwealth of Independent States	5.3	–6.5	4.5	4.8	4.8
Russia	5.2	–7.9	4.0	4.5	4.5
Middle East and North Africa	5.5	1.8	4.0	1.0	4.0
Sub-Saharan Africa	5.5	2.8	5.0	4.8	5.2

PPP = purchasing power parity

The monetary authorities in most key emerging-market economies (where economic growth has generally been robust) have responded to these inflation developments with significant (but not excessive) policy tightening. Most smaller advanced economies with independent monetary policies have followed suit. The European Central Bank (ECB) and (perhaps) the Bank of England appear likely to join in soon. This will leave the Bank of Japan and the US Federal Reserve as the only important central banks that have not moved, even modestly, to begin to reverse policies of extraordinary monetary ease.

Rising inflation and the monetary policies that will be used to combat it raise important concerns about global growth prospects. In view of the usual lags in the effects of monetary policy (and the fact that policies generally remain accommodative despite recent tightening), these concerns apply primarily to growth projected for next year rather than for this year. If increasing inflation pressures prove more virulent than now anticipated, or if policy is either tightened too much too soon or too little to be effective, the result could be a sharp slowdown in growth by 2012.

For the advanced economies, these dangers are probably somewhat farther off, but the maintenance of too easy policies for too long could set the stage for growth problems by 2013.

Apart from their impact on inflation and on monetary policy, recent sharp increases in the (relative) prices of food and energy create more direct concerns for economic growth through their effect on the real value of consumer incomes and, in some countries, by fomenting social turmoil. The risk of further sharp increases in commodity prices is probably greatest in the energy area because of the deepening turmoil in key oil-producing countries. For the baseline economic forecast, however, the downside risk to growth from the possibility of sharply higher energy prices is counterbalanced by the possibility that world energy prices could drop significantly if worries about further supply disruptions prove exaggerated. For food prices the risk of a further upsurge is more limited, but the increases already in place seem likely to be more durable.

As always, there are many other sources of risk for the economic outlook. The sovereign debt problems of some West European countries remain troublesome and continue to raise concerns about the stability of some financial institutions. Following the lead of most other countries, the United States needs shift from fiscal expansion to fiscal consolidation and do so at a pace that is neither so rapid that it undermines recovery nor so sluggish that it undermines confidence. Over the same time span, the Federal Reserve will need to move away from its policy of extraordinary ease to a policy that will assure reasonable price stability in the longer term. Other major central banks, including the ECB, the Bank of England, and (ultimately) the Bank of Japan, will need to manage carefully similar policy transitions. Many emerging-market economies will face the unusual challenge of managing their economic policies (and exchange rates) in circumstances where they are leading the global expansion and their advanced-economy trading partners are continuing to face substantial margins of slack.

In assessing the risks to global growth, one often tends to view things from the dark side, and recent developments undoubtedly add to the perception of significant downside risks. However, it is a mistake to believe the risks are heavily weighted to the downside. There are upside risks as well. The global economic recovery that began less than two years ago still has considerable room to run, especially in the advanced economies where margins of slack remain unusually large. The potential growth rate for the world economy is probably about 4 percent, with potential growth of somewhat more than 6 percent for emerging-market and developing countries and a little over 2 percent for the advanced economies (including the newly advanced economies in Asia). My economic forecast reasonably envisions that emerging-market and developing countries will, on average, achieve their potential growth rates this year and next. The advanced economies are projected to make rather modest progress in reducing large margins of slack. Clearly, they could do worse, but they also could do better.

Emerging-Market and Developing Economies

The projected slowdown of growth for this broad group of countries from 7.1 percent in 2010 to 6.1 percent in 2011 reflects primarily the slowing of rapid growth in a number of key countries after the initial bounce-back from the global recession. In addition, it is clear that the Middle East and North Africa region will suffer a sharp slowdown in growth this year, with the hope that growth will recover in 2012.

Among the emerging-market and developing economies, the Asian region accounts for half of total real GDP and has been the most rapidly growing region for many years. China alone accounts for over one-half of the Asian region's GDP (excluding the advanced Asian economies), for over one-quarter of the GDP for all emerging-market and developing countries, and for one-eighth of world real GDP (second only to the United States with a one-fifth share in world GDP). Taking account of the measures that the Chinese authorities have implemented to combat rising consumer inflation and real estate speculation, it is reasonable to forecast that China's growth will fall from over 10 percent last year to barely more than 9 percent this year and slightly less in 2012.

My colleague Nicholas Lardy will explore why, despite the doubts expressed by some analysts, growth rates in the range of these projections appear sustainable for the Chinese economy over the next decade.

India enjoyed better than 9 percent growth in (calendar year) 2010, but data for the fourth quarter indicate a significant slowdown. For fiscal year 2010, which just ended in March, growth will probably come in a little below 9 percent. Inflation has become a significant problem and the size of the fiscal deficit is worrying. Measures to deal with these concerns will keep real growth below 9 percent this year and next. In the rest of emerging Asia, growth is projected to moderate from over 6 percent last year to slightly below that rate this year and next.

In Latin America, Brazil is the largest economy, accounting for more than one-third of the region's output. With 7.5 percent growth in 2010, Brazil's economy recorded its strongest performance in a generation. For 2011 and 2012, I expect that growth to continue at a solid but less spectacular rate of 5 percent or a little higher. For Mexico, the second largest economy in Latin America, growth turned out somewhat better than generally expected last year, with a 5.5 percent increase in real GDP. I expect that growth will be a little less buoyant this year and next. Elsewhere in the region, growth should be sustained at nearly 5 percent, with most countries doing reasonably well by the standards of the past 20 years. [Notably, Chile is forecast to show a 1 percent increase in growth on a year-over-year basis for 2011. This reflects the fact that the GDP decline in the first quarter of 2010 associated with the earthquake in southern Chile pulled down GDP growth for 2010 as a whole. The rapid rebound from this disaster in later quarters of last year has a positive carry-over effect for annual growth in 2011.]

Turkey and Poland are the largest economies in Central and Eastern Europe. Turkey rebounded from nearly a 5 percent output decline in 2009 to almost 8 percent real growth last year. For 2011 and 2012, it is reasonable to expect about 5 percent real growth, which would appear to be roughly in line with Turkey's potential growth rate. Poland survived the great global recession with only a slowdown of growth to about 1.5 percent in 2009. Last year saw a rebound to almost 4 percent real growth, and growth both this year and next should slightly exceed that figure. Most of the economies of Central and Eastern Europe suffered significant output declines in 2009, ranging from 4 percent in the Czech Republic to 8 percent in Slovenia and exceeding 12 percent in the three small Baltic countries. Most of the region returned to positive but sub-par growth last year, with modest output declines in Croatia, Latvia, and Romania. This year should see a return to more normal positive growth rates in most of these countries. This will counterbalance the projected decline in Turkey's growth rate, leaving projected growth for the region at somewhat above 4 percent.

With the resurgence of world energy prices, the Russian economy snapped back from almost an 8 percent output decline in 2009 to record 4 percent real GDP gain in 2010. Recent increases in world energy prices should help propel the Russian economy to moderately stronger growth this year and next. The Ukraine suffered a 15 percent real output loss in 2009 due to both domestic political turmoil and the global recession. Last year saw a rebound to 4 percent positive growth, and growth of 5 percent or so is a reasonable prospect for 2011 and 2012. Elsewhere in the Commonwealth of Independent States the economic weight lies with the energy-exporting countries, led by Kazakhstan. These countries generally did not see output declines during the global recession, and growth subsequently and looking forward is likely to be in the 6 to 8 percent range.

Somewhat surprisingly, Sub-Saharan Africa came through the global recession with growth of better than 2 percent, and last year saw growth rise to 5 percent. Continued strong performance of the Nigerian economy, aided by higher oil prices, together with some increase of growth in South Africa suggest a moderate upgrading of the forecast for Africa's growth this year and next. Unfortunately, the deepening crisis in Ivory Coast and possibility of a messy separation of southern Sudan from the rest of the country blunt such optimism. These concerns suggest a modest reduction in the growth forecast for Africa at least for 2011.

The Middle East and North Africa region saw only a slowdown of growth (to about 2 percent) during the great global recession. Aided by rising world energy prices, the region's growth strengthened to about 4 percent last year. Until recently, growth appeared likely to strengthen further this year and next. Clearly, this prospect has been changed by recent developments. Egypt is one of the three largest economies of the region, and after suffering only a modest economic slowdown during the global recession appeared on course to achieve growth of 5 percent or better. The disruption leading up to the resignation of President Hosni Mubarak almost surely pushed output down in the first quarter of this year. A rapid bounce back is possible but by no means assured.

Similar concerns apply for Tunisia, Bahrain, Yemen, and now Syria—all of which have economies much smaller than Egypt's. The situation in Libya is far worse and a significant drop in GDP will occur this year even if oil production is rapidly restored to near normal levels and military conflict rapidly subsides. So far, the major oil-exporting countries in the Persian Gulf, including Saudi Arabia, have been little affected by the political turmoil in the region, and growth in these economies may benefit both from higher oil prices and from increased government expenditures and transfer payments to help forestall social unrest. Iran continues to labor under intensified sanctions directed against its nuclear program. Prospects for economic growth continue to be muted, but so far there is little indication of major and sustained political turbulence.

Obviously, uncertainties about economic growth for the Middle East and North Africa region have become very great. For the present, it seems prudent to write down the forecast for 2011 from the 4.5 percent indicated last September to no more than 1 percent. A return to significantly positive growth in the region will occur eventually and is possible for 2012. However, unlike natural disasters, which usually are followed by rapid economic recoveries, episodes of political turmoil and social unrest may take extended periods to resolve sufficiently to allow a resumption of reasonably rapid economic growth.

Other Advanced Economies

Before turning to the United States and the advanced economies of Western Europe, it is useful to review growth prospects in the diverse group of other advanced economies around the world. This group includes Japan, Canada, Australia, New Zealand, Israel, and the newly advanced economies in Asia (Hong Kong, Singapore, South Korea, and Taiwan). Altogether, these advanced economies account for 13 percent of world real GDP (on a PPP exchange rate weighting), with Japan at 6 percent, Canada at 1.8 percent, Australia at 1.4 percent, and the newly advanced Asian economies at 3.5 percent.

Although it was neither the source nor the destination of much of the financial turbulence that hit the world economy in 2008–09, Japan suffered a particularly deep recession. Output dropped more than in any other G-7 country: down 6.3 percent in 2009 after a 1.2 percent decline in 2008. Recovery was anticipated to be very sluggish, with my forecast of 2.7 percent growth in 2010 being well above the average forecast of a year ago. Performance significantly exceeded these meager expectations with growth reaching almost 4 percent last year. However, this still left output 4 percent below its pre-recession level by the end of last year.

After turning slightly negative in the fourth quarter of last year, the Japanese economy appeared to be rebounding early this year—before the earthquake/tsunami/nuclear accident. The economic disruption from these combined disasters clearly depressed economic activity in March and will probably push first quarter GDP growth negative. Output will likely continue to be depressed in April, and even with a fairly vigorous recovery beginning later in the spring, GDP growth for the first half to 2011 is not likely to be much above zero. Strong recovery in the second half, as is consistent with the usual pattern following natural disasters, suggests that real GDP may still show a small year-on-year rise. My judgment at this time is to cut the forecast for Japanese economic growth this year to 1 percent from what would have been an upwardly revised forecast of

2.7 percent before the disaster. For 2012, I am revising up the forecast to 3.5 percent from an earlier tentative forecast of 2.0 percent.

There has been much discussion of the adverse impact of Japan's disaster on output in other countries through disruptions in the supplies of key inputs. Undoubtedly, there is some effect in this direction, but my assessment is that it will turn out to be essentially trivial measured against the scale of world GDP. While there will be some short-term adverse economic effect on other countries from the disaster in Japan, I expect that the increase in Japanese import demand associated with reconstruction will soon overwhelm these adverse effects, leaving a small positive effect on growth of real GDP in the rest of the world for this year and next.

Of course, it seems inconsiderate, perhaps even cruel, to suggest that a human tragedy of immense proportions that we have just seen in Japan would have, on balance, positive economic consequences for other countries. But compassion should not cloud analysis. After the terrorist attack of September 11, 2001, it was widely feared that the US economy (which was already in mild recession) would suffer severe economic consequences. For most of the rest of the world, which was also entering recession, it was also feared that there would be significant, although less severe, adverse consequences.

The facts belie this. US real GDP recorded a small decline (1.1 percent at an annual rate) in the third quarter of 2001. The terrorist attack that occurred late in the quarter contributed something to this result, but economic data from before the attack suggested that the outcome for the quarter would have been modestly negative anyway. The fourth quarter saw a rebound to slightly positive (1.4 percent at an annual rate) real GDP growth, and in the first half of 2002, growth strengthened to a 2.6 percent annual rate. Undoubtedly there were economic losses from disruptions of transportation and travel arising out of increased concerns about terrorism amounting to billions of dollars, but the effect is small relative to global GDP of about $40 trillion at the time. Whatever their importance in other respects, the notion of substantial damage to US or world economic growth from the September 11 attacks is a myth.

The Australian economy came through the global recession with a moderate slowdown in growth and rebounded to nearly 3 percent growth in 2010, with signs of acceleration late in the year. With margins of slack remaining low and inflationary pressures beginning to increase, the Reserve Bank has tightened monetary policy to effectively a neutral stance consistent with economic expansion at Australia's potential growth rate of about 3 percent.

The floods in Australia this January will likely depress Australia's real GDP in the first half of this year. Recovery efforts should begin to have a positive effect by the second half and will carry over into 2012. The net impact is a downward revision of projected growth by half a percentage point to 2.6 percent for 2011 and an upward adjustment of the projection for 2012 to 3.6 percent.

New Zealand was hit harder than Australia by the global recession, and the rebound last year was anemic. Economic growth appeared to be picking up somewhat early this year, but the Christchurch earthquake in February is a setback that is likely to keep growth this year to no more than about 1 percent. The Reserve Bank has responded by easing policy back to the stance at the depth of the global financial crisis. With recovery from the earthquake under way later this year and next, year-on-year economic growth for 2012 is likely to rise to at least 3.5 percent.

Thanks to the solidity of its financial system and the benefits of being an important commodity exporter, Canada suffered the smallest output decline of any of the G-7countries during the great recession. Recovery, aided by rising export prices and export volumes, has been the strongest of the G-7 countries. Indeed, Canada is the only major industrial country where real GDP at the end of 2010 was measurably above (by about 1 percentage point) its pre-recession level. [The United States barely regained its 2007Q4 level of real GDP by 2010Q4, and the other five G-7 countries (including Germany) were all below their pre-recession levels of real GDP.] The recovery is even more impressive in terms of domestic demand, which is up more than 7 percent from its recession low and more than 3 percent from its pre-recession peak.

The unemployment rate in Canada is now down 0.7 percentage points from its recession peak of 8.5 percent but is still meaningfully above its multi-decade low of 6.0 percent before the recession. This suggests that there remains a moderate margin of slack outside of the hot commodity-producing sectors of the Canadian economy. Headline inflation has recently picked up to over 4 percent (on a three-month basis), but core inflation remains subdued. The Bank of Canada began to retighten monetary policy last year raising the bank rate cumulatively by 75 basis points to 1.25 percent. More tightening is coming this year and next, but the Bank of Canada rightly does not feel great urgency to tighten substantially.

Boosted by further gains from export earnings, the real incomes of Canadian households are likely to continue to rise relatively rapidly, adding impetus to domestic demand growth. With some slack still available, with Canadian economic policies not in restrictive mode, and with the US economy doing moderately well, Canada should be expected to enjoy somewhat better than potential growth this year with only a modest fall-off in 2012.

Israel weathered the great recession without an outright output decline. Growth last year strengthened to nearly 5 percent. The Israeli economy is feeling relatively little from the political and economic turbulence elsewhere in the Middle East, while continuing to enjoy expanding trade with Western Europe and the United States. Inflation appears to be under adequate control without any need for severe monetary tightening. Growth of 4 percent or better this year and next is a reasonable prospect.

The four newly advanced Asian economies were all hit hard by the collapse of world trade during the great recession. Recovery in these economies has varied between strong and spectacular, with real GDP growth last year of just over 6 percent in South Korea, almost 7 percent in Hong Kong, nearly 11 percent in Taiwan, and better than 14 percent in Singapore. Growth rates must now be expected to moderate after the first phase of cyclical recovery (and spectacular recovery of world trade) has passed. For the group, growth this year and next should probably be 4.5 to 5 percent after better than 8 percent growth in 2010.

Western Europe

The share of all of the (advanced) economies of Western Europe in world GDP (on a PPP exchange rate basis) is the same as that of the United States, just over 20 percent. The countries of the Euro Area account for three-quarters of the share of Western Europe or 15 percent of world GDP. The United Kingdom accounts for 3 percent of world GDP, and four smaller (but not tiny) countries, Denmark, Norway, Sweden, and Switzerland, jointly account for about 2 percent of world GDP.

Looking first at the United Kingdom, the 18 years from 1991 through 2007 was a remarkable period of sustained economic growth with low inflation. But significant economic and financial excesses and imbalances that built up over this period ultimately led to the deepest recession of the postwar era. UK real GDP fell by 6 percentage points during the six quarters from 2008Q2 through 2009Q3. The recovery beginning in the autumn of 2009 has been tepid with real GDP rising cumulatively by just under 2 percent through the end of 2010.

Indeed, the final quarter of last year saw a modest decline in real GDP as the ambitious fiscal austerity program of the new coalition government began to take hold. This austerity program sensibly includes both significant revenue increases and important expenditure restraints. Over four years it should improve the government's structural budget position by about 6 percentage points of GDP, with further significant improvement in the budget balance through the normal cyclical recovery of revenues and decline in expenditure (the automatic stabilizers).

Notably, forecasts of UK real GDP growth for both this year and next (in the *Economist* poll and the *Consensus Forecasts*) are distinctly positive. This is so not only for the average among forecasts but also for the entire range of forecasts. Specifically, for the *Economist* poll in March, forecasts for 2011 range between 1.1 and 2.4 percent with an average of 1.6 percent; and forecast for 2012 range between 1.6 and 2.7 percent with an average of 2.0 percent. For the March

Consensus Forecasts, the range for 2011 is between 1.3 and 3.1 percent with an average of 1.9 percent, and the range for 2012 is between 2.0 and 3.0 percent with an average of 2.1 percent. My forecast for the UK economic growth is near the middle range: 2.0 percent for 2011 and 2.5 percent for 2012.

The depreciation of sterling since 2007 by more than 20 percent in real effective terms undoubtedly contributes to positive assessments of UK growth prospects, as does the continuation of very easy monetary policy. In addition, it appears that economic forecasters do not share the prejudices of some unreconstructed Keynesians concerning the overwhelming power of fiscal policy. If they did, forecasts for UK growth this year would average no higher than zero and the range would spread well into negative territory.

On the other hand, serious economic forecasters apparently do not believe the nonsense put forward by some conservative politicians, commentators, and economists that fiscal austerity should normally be expected to have a positive effect on economic growth, even in the relatively short term. If this were the case, then one would surely expect that the UK economy, which has a wide margin of slack, a highly competitive exchange rate, and a very accommodative monetary policy, together with an impressive program of fiscal austerity would enjoy economic growth well above potential—at least 4 percent—this year and next.

Thus, if the outcome for UK growth is within the range now being forecast, this should help dispel and discredit some of the nonsense that one too often hears about the effects of fiscal policy. I have little doubt, however, that those whose views on this issue are informed primarily by their quasi-religious prejudices will not be much persuaded by the facts.

Inflation in the United Kingdom has been running above the Bank of England's target rate of 2 percent for four years, and it appears headed to 4 percent this year before falling back toward (but not necessarily below) 2 percent in 2012. Despite inflation persistently above target, the Bank of England has maintained a highly accommodative monetary policy, with the base rate kept at 50 basis points since early 2009. I believe that this has been the appropriate monetary policy in view of all developments in the UK economy. However, the policy is not consistent with the usual rhetoric of "inflation targeting," where output and employment are relevant for monetary policy not for their own sake but primarily because they are useful in forecasting future inflation.

The Bank of England could have tightened monetary policy sufficiently over the past two years to bring inflation down closer to its target rate and avoid much of the current upturn of inflation. It wisely chose not to do so because, despite the likely consequences for inflation, a highly accommodative monetary policy was needed to forestall further declines in output and employment below potential and to promote economic recovery.

With inflation trending further upward, however, now is not the time to contemplate further monetary easing through large-scale central bank asset purchases—unless the economy falls back into outright recession. Indeed, a small increase in the base rate of, say, 50 basis points would probably have little negative effect on growth and could pay dividends in enhancing central bank's credibility, thereby forestalling increases in inflation expectations that would push up longer-term interest rates.

The four small-to-midsized West European economies outside of the Euro Area (Denmark, Norway, Sweden, and Switzerland) have had somewhat disparate experiences in the great recession and subsequent recovery. Benefiting from its position as an energy exporter, Norway experienced only a modest loss of real GDP during the recession and subsequently has more than regained its pre-recession output level. Growth at about a 3 percent rate is a realistic prospect for this year and next.

In contrast, Denmark suffered a large (about 7 percent) real output loss during the recession, and the recovery has so far restored only about a third of this loss. Without the benefit of sharply rising export prices, growth prospects appear to be in the 2 percent range. Like Denmark, Sweden suffered a large output loss during the recession, but a fairly vigorous subsequent recovery has already restored much of this loss, and growth of 3 to 4 percent over the next two years appears likely to complete the task. Notably, the Swedish krona depreciated substantially against the euro during the recession while the Danish krone essentially maintained its value in euros.

The Swiss economy declined only about 2 percent during the great recession, despite substantial problems for its major banks (primarily in their non-Swiss operations). During 2008 and 2009, the Swiss authorities fought with some success to keep the franc from appreciating further against the euro. This probably helped to limit the recession and restore output to above its pre-recession level before the end of 2010. Recently, however, the Swiss franc has appreciated another 10 percent against the euro and more than that against the US dollar. It will be interesting to see whether the Swiss economy sustains growth of 2 percent or slightly better in the face of this exchange rate appreciation.

Despite the common perception of the United States as the epicenter of the global financial crisis of 2008–09, the Euro Area as a whole suffered a somewhat larger output loss during the great recession than the United States, 5 percent versus 4 percent. Also, while the United States has (barely) recovered its pre-recession level of real GDP, real GDP for the Euro Area remained 2½ percent below its pre-recession peak at the end of 2010.

Within the Euro Area, the depth of the recession varied considerably, and economic performance has become more disparate during the recovery. Among the four largest economies, Germany and Italy saw substantial output declines of more than 6 percent during the recession, while output in France and (somewhat surprisingly) in Spain fell less than 5 percent. In Germany, recovery has surprised on the upside, with real GDP rising 5.5 percent from its recession low by the end of last year. In Italy, with a similar output decline, recovery so far has amounted to barely 2 percent. In France, the recovery has also been anemic, but with a smaller output loss, real GDP was at end 2010 1.5 percent below its pre-recession peak—versus a 1 percent output loss from the pre-recession peak for Germany, which had a steeper output loss during the recession but a more vigorous recovery.

Substantial disparities also exist among the smaller members of the Euro Area. Leaving aside the relatively small recent members, it is fair to say that Austria, Belgium, and the Netherlands are in roughly the same situation as France both concerning the output loss during the recession and the extent of the subsequent recovery. Finland suffered about a 10 percent output loss and has regained about one-third of that loss.

Among the three countries that are at the heart of recent worries about sovereign fiscal sustainability, Portugal has so far absorbed significantly less economic damage than the others. During the general Euro Area recession, Portuguese real GDP fell by less than the average for the area. Subsequently there was a very tepid recovery before the modest output decline feared for this year. Greece also took a relatively modest hit to output during the general recession (through 2009Q2), but subsequent efforts at fiscal consolidation and other difficulties have pushed real GDP about 10 percent below its pre-recession level—with further output losses expected this year. Ireland was very hard hit during the general recession before there were serious concerns about the government's fiscal sustainability (which deteriorated dramatically because of commitments to aid Ireland's overextended banks). The Irish economy has shrunk further since the summer of 2009, with the cumulative output loss since the start of the recession now exceeding 12 percent.

All of this points to key issues that are central to assessing the Euro Area's economic prospects. Before the euro was created, intellectual debates about the virtues and defects of the common currency focused on the issue of how economic policy would handle situations of substantial divergence of economic conditions and policy needs among participants in the common currency—without the flexibility of independent monetary policies or the ability to adjust exchange rates. Discussion also focused on how fiscal policies would be coordinated and on how the fiscal difficulties of individual members would be handled.

Many of the proponents of the euro, however, ignored these issues or simply ruled them out of the debate. Economic convergence before and after the euro was established would assure that disparities in economic performance and policy requirements would not grow very large.

Economic actors would learn to operate within the constraints of invariable exchange rates. Monetary policy would be dedicated single-mindedly to the sacred objective of price stability, with everyone agreeing that profane concerns about output and employment should never be mentioned in the holy contemplation of monetary policy. Fiscal deficits and public debt levels would be rigorously disciplined under the Stability and Growth Pact. Bailouts of national governments, especially by the common central bank, would be forbidden by the basic law of the community. Governments that somehow found themselves in fiscal difficulty, despite all of the safeguards, would have to solve their own problems as best they could. The concept of the central bank as a "lender of last resort" would be banned. Market mechanisms backed by bankruptcy courts would supply all of the necessary financial discipline. Moral hazard would effectively be outlawed in the Euro Area.

Is this an exaggeration? Yes, but only a slight exaggeration. The sad truth is that Euro Area politicians and officials were utterly unprepared to deal with key policy issues that have arisen over the past year or so because they steadfastly refused even to think about these issues before the crisis was upon them. The result has been a series of ad hoc efforts to deal with fiscal crises faced by at least three Euro Area governments. Although reality has been accorded a higher degree of recognition, and there has been considerable progress in structuring and implementing cooperative framework for addressing fiscal sustainability, this framework is neither complete nor entirely coherent.

On monetary policy, I have not heard or seen any serious analysis of how the ECB should and will deal with wide disparities in the economic situations of different members of the Euro Area. There is nothing wrong with a general declaration reaffirming that the ECB will continue to pursue its overriding objective of price stability for the Euro Area. Such a statement, however, is not informative about the difficult choices for ECB monetary policy that will have to be made in dealing with the disparate economic conditions and policy needs of different parts of the Euro Area.

My forecast for the Euro Area is based on the expectation that key policy challenges will continue to be met by the age-old strategy of "muddling through." The Euro Area will not collapse, and no member will be forced or allowed to withdraw. A general European banking crisis will be avoided, and recession will not soon return to most of the Euro Area. Explicit sovereign defaults will not occur, but behind the scenes restructurings will be undertaken. Volumes of official lending to governments facing fiscal difficulties will probably rise, while maturities are extended and interest rates are reduced. Disguised official support through the banking system, with the cooperation of the ECB, will continue and probably expand. In the fiscally challenged countries, consolidation will continue despite moderate negative effects on growth and social protests, but the pace of consolidation will be sensitive to these concerns. It will not be sufficiently rapid to permit Greece and probably Ireland and possibly Portugal to return to private-market financing of their longer-term debt any time soon.

For Euro Area monetary policy, I expect that the ECB will carry through with its signaled intention to raise the official repo rate this month, probably by 25 basis points. I expect another such move by July, and quite possibly another move in the autumn. This is all on the assumption that overall inflation in the Euro Area remains somewhat above 2 percent but is not dramatically accelerating. Modest monetary tightening will have some negative effect on growth, but the effect should be small and will come with a lag. This will not be helpful for countries with fiscal problems or with large margins of slack, but it will hardly be catastrophic.

The crunch for ECB monetary policy will probably come next year when the issue will become whether to push the repo rate above 2 percent. With the unemployment rate in Germany already below its pre-recession low and the lowest in decades, and with the German economy likely to grow somewhat above potential for the next year, it is reasonable to expect that wage inflation will pick up in Germany. For Germans who have a particular phobia of inflation, this will be worrying, and there will be pressure on the ECB to move its policy to something that is not highly accommodative, that is, a repo rate of 3 percent or higher. Aside from Austria and the Netherlands, however, no other country in the Euro Area is in a situation similar to Germany. Margins of slack are significant and unemployment rates are escalated and likely to remain so through next year; and few would appreciate the upward pressure on the euro's exchange rate likely to result from rapid tightening of ECB monetary policy relative to that of other major central banks. Muddling through this dilemma will probably involve greater lip service to concerns about inflation but very limited actions of further monetary tightening, at least until margins of slack are significantly reduced across the Euro Area and/or rising inflation becomes a dire threat.

With this understanding about the likely course of policy in the Euro Area, my forecast is for 2 percent real GDP growth this year and for 2.1 percent growth next year. These forecasts are somewhat above the average but within the range of other forecasts for growth in the Euro Area (1.1 to 2.3 percent for 2011 and 1.4 to 2.3 percent for 2012 in the March *Economist* poll and 1.2 to 2.2 percent for 2011 and 1.5 to 2.2 percent for 2012 in the March *Consensus Forecast*). Similarly, my forecasts for individual Euro Area countries are generally above the average but within the range of other forecasts.

My modest relative optimism reflects the general observation that during economic recoveries when margins of slack are considerable and policies are accommodative, the average growth forecast tends to undershoot actual performance—there is too much pessimism. I also recognize that among the policy strategies that are actually available, a strategy of muddling though may not be too bad; and European policy officials are very experienced muddlers.

The United States

Real GDP growth for the US economy in 2010 is now estimated at 2.9 percent. This is clearly below my previous forecasts of 3.6 percent in April 2009 and 4.0 percent in both September 2009 and April 2010. (My forecast of September 2010 was bang on at 2.9 percent, but accurate forecasting becomes much easier when a year is already three-fourths over.) To assess US economic prospects for this year and next, it is useful to examine what went right and what went wrong with these earlier forecasts.

For this purpose table 2 presents the main elements of the forecast for the US economy made a year ago in April 2010. The forecasts refer to the projected rise in real GDP and its key components during the initial quarters of recovery, beginning in mid-2009 and extending to the end of 2010, all measured in 2005 chained dollars. These forecasts are compared with the actual results as reported through March this year.

The forecast rise in real GDP of $R838 billion was clearly a significant overshoot. Government purchases rose but by less than forecast. I overestimated what the stimulus package would do and underestimated the downward pressure on spending by state and local governments. Real net exports deteriorated slightly more than forecast. Together, however, these modest forecast errors made a net contribution to the total forecast error for real GDP of just $R27 billion.

The overshoot in the forecast of consumer spending of $R106 billion is significant but easily explained. The forecast presumed that households would want to raise their saving rates from under 2 percent in mid-2009 to about 6 percent by end 2010. Accordingly, consumption spending was forecast to rise along with the increase in GDP, but by only half of the increase in GDP (versus an existing consumption share of 70 percent). If the projected changes in the other components of GDP had been correct, the error in the forecast of consumption spending would have been virtually nil.

Thus, the primary source of the error in the forecast is that the likely gain in private investment spending was overestimated. The forecast of the rebound of inventory investment is modest for this usually volatile component. The decline of investment in nonresidential structures is very close to forecast. The rise of investment in equipment and software is moderately larger than forecast. The problem is that the forecast of a strong rebound of residential investment never materialized.

Table 2 Comparison of past forecast and results for US real GDP (changes from 2009Q2 to 2010Q4 in 2005 chained billions of dollars)

Change in real GDP or component	**Forecast of April 2010**	**Result**	**Difference**
Real GDP	838	571	–267
Consumption	411	305	–106
Gross private domestic investment	436	308	–128
Nonresidential structures	–50	–57	–7
Equipment and software	154	200	+46
Residential	106	–8	–114
Inventories	210	178	–32
Net exports	–50	–56	–6
Government purchases	51	30	–21

The failure of residential investment to show a substantial rebound after six quarters of general economic recovery is a special feature of the present recovery. In past US business cycles, especially those involving relatively deep recessions, the preceding boom in residential investment has usually ended before the beginning of the general recession and a large proportionate decline in residential investment has made an important contribution to the decline in overall GDP. In the recovery phase, the usual pattern has been for residential investment to turn sharply upward at the start of the general economic recovery and for gains in such investment to contribute substantially to the initial strength of the recovery.

This usual pattern has not been followed in the present recovery. Real residential investment at the end of last year was essentially unchanged from its highly depressed level at the trough of the recession in the second quarter of 2009, and there is no sign yet that residential investment is staging a comeback. Why has residential investment remained so depressed for so long—in stark contrast to the normal pattern of business cycle recoveries? An answer to this question is important both for understanding why the US recovery has been fairly sluggish up to now and for what the prospects are for the expansion over the next couple of years.

Some, including former Federal Reserve Chairman Alan Greenspan, have suggested that excessive or inappropriate regulation is the answer. I would put the emphasis on two other factors. First, the housing boom that preceded the current housing depression had a key feature that distinguishes it from all of its predecessors (at least for the United States in the postwar era). In addition to a substantial increase in new home building (and therefore in real residential investment), there was an enormous run up in house prices. Between 2000 and the peak in 2006, real house prices (adjusted for general consumer price inflation) essentially doubled on a nationwide basis. Since the peak, house prices have retraced about two-thirds of their earlier gains and for the past two years have been essentially trendless.

This great house price deflation has seriously disrupted the entire housing market. Many homeowners find that the principal due on their mortgage is greater than the now depressed value of their home. If their income drops or otherwise proves inadequate to pay their mortgage, they have little option but to default or negotiate a so-called short sale. In either case the market for existing homes is flooded with more inventory of distressed properties. Also, those who exit home ownership through these means are not good candidates for early return as home purchasers and new mortgage borrowers. Indeed, even many of those who are able to meet their mortgage obligations may be effectively frozen out of the normal housing upgrade cycle where people use the rising equity in their existing home due to its nominal price appreciation to provide the wherewithal for a down payment on a more valuable residence. Regulations requiring unnecessarily high down payments or otherwise unduly restricting the availability of housing finance may exacerbate these problems, but they are not the main cause.

Second, when people need to reduce their spending (because of lower income or the need to increase saving or pay off debt), one of the effective ways of doing this is by reducing the number of separate households. Adult children (unmarried or married) remain living or return to living with their parents. Some of the elderly move in with their adult children, or vice versa. Unrelated individuals combine households. All of these downward adjustments to the number of separate households have been promoted by the high unemployment, very sluggish wage growth, and the need to increase saving in recent years.

The effect on the housing market is substantial. If only 2 percent of separate households decide to recombine (or not separate), the demand for housing units drops by about 2½ million. This offsets two years of normal growth in the net demand for housing units due to rising population. We end up with the situation we have at present: new home building is reduced to the level (about 500,000 units) that is needed to offset old units that are being removed from the housing stock.

These forces tending to depress the housing market and residential investment will gradually dissipate. Population growth will push up the net demand for new houses. Increasing incomes and a rising willingness to spend will promote a higher ratio of separate households to population. With gross new home production no more than that needed to sustain a constant housing stock, the inventory of homes available for occupancy will shrink to the point where higher residential investment is needed.

How long will it take to reach this point. I expect that we will reach it sometime later this year (about two years after I had earlier anticipated). This implies that we should see modest gains in residential investment this year and more substantial gains in 2012 and the years beyond. More specifically, I forecast that real residential investment will rise about 8½ percent this year (16½ percent on a Q4-to-Q4 basis) and 22½ percent next year. This will push the level of real residential investment up to $R465 billion in 2005 chain-linked dollars by the end of 2012—still less than 60 percent of the peak level of residential investment at the end of 2005.

Real investment in nonresidential structures is forecast to expand at a moderate pace this year and next. There are indications that this is already happening. Investment in equipment and software is projected to show continued robust 14 percent growth during 2011 but then fall off considerably to 6.3 percent growth during 2012. This reflects the presumed effect of providing for immediate expensing of most equipment investment for tax purposes during 2011 and then removing this privilege in 2012. Inventory investment is assumed to recover from a temporarily low level in 2010Q4 and then remain essentially flat.

Consumption spending is projected to rise somewhat less rapidly than GDP, as households pursue further modest increases in saving rates and as rising taxes (in 2012) cut more deeply into households' disposable incomes. The year-over-year forecasts are for 3.0 percent real consumption growth this year and 2.7 percent growth next year. The Q4-to-Q4 forecasts are 3.4 and 2.5 percent, respectively.

With a quite competitive exchange rate for the US dollar and with growth in the rest of the world projected to remain reasonably robust, I expect that demand for US exports will continue to expand at nearly a 10 percent annual rate. US demand for imports is projected to grow at a somewhat slower pace, especially in 2011 when we should still be working down some of the import bulge in the middle of last year. Because real imports are now about 25 percent larger than real exports, moderately faster proportional growth of exports than imports leads to a forecast of modest deterioration in US real net exports in 2012 after a small improvement in 2011.

Real government purchases of goods and services are projected to shrink both this year and next for both the federal and state and local governments. Notably, however, these modest declines in real government purchases are a comparatively small part of the fiscal consolidation that is likely this year and especially in 2012. The main actions of fiscal consolidation will be during 2012 in scaling back some existing tax breaks and in reducing government transfer payments, including the extended unemployment benefits and special health care benefits for the unemployed.

All together, my forecast is for US real GDP growth of 3.3 percent in 2011 and 3.2 percent in 2012; on a Q4-to-Q4 basis the forecasts are 3.8 percent this year and 3.0 percent next year. The slowdown apparent in the Q4-to-Q4 forecasts reflects primarily the presumption that substantial fiscal consolidation taking place during 2012 will have a significant but not overwhelming depressive effect on growth next year. A rebound in residential investment (after two years of delay) and continued strong growth of US exports are expected, and will be needed, to offset some of the depressive effect of fiscal consolidation and keep the US economy expanding at a respectable pace.

With economic growth running above the potential growth rate and with businesses having exhausted most of the opportunities to increase labor effort without raising employment, we should expect the unemployment rate to fall further this year and next. By the end of this year, I project an unemployment rate of 8 percent or a little less. By the end of 2012, the unemployment rate should be down to 7.5 percent.

Table 3 US economic forecast, real GDP and its components (percent changes year-over-year and Q4-to-Q4)

Real GDP component (percentage growth rate)	**2011 Year/Year**	**2011 Q4/Q4**	**2012 Year/Year**	**2012 Q4/Q4**
Real GDP	3.3	3.8	3.2	3.0
Consumption	3.0	3.4	2.7	2.5
Gross private domestic investment	11.0	15.3	10.9	10.3
Nonresidential structures	3.4	5.6	6.1	7.4
Equipment and software	12.7	14.1	6.0	6.3
Residential	8.4	16.6	20.8	22.4
Inventories (level change)	–3	44	5	5
Net exports (level change)	12	–22	–25	–30
Exports	9.8	10.0	9.6	9.8
Imports	7.3	6.1	8.9	9.3
Government purchases	–1.3	–2.0	–0.6	–0.4
Federal	–0.9	–2.0	–0.5	–0.4
State and local	–1.5	–2.0	–0.7	–0.4

Monetary policy will remain supportive of economic expansion, even as the Federal Reserve begins to move to a somewhat less accommodative stance over the next two years. Indeed, I explicitly reject the view that seems to suggest that the Federal Reserve needs to become increasingly more accommodative—promising to keep the federal funds rate near zero virtually indefinitely and adding assets to its balance sheet at the pace of $1 trillion per year or higher—in order to give meaningful support to the expansion. Even before the latest move of quantitative easing begun last November (but was effectively signaled in September), Federal Reserve policy was already exceptionally easy.

The additional quantitative easing now under way should probably continue until its announced end in June. This will likely give a modest boost to the economy in the near term. But, it will not remove the key stumbling block to a more vigorous and sustained recovery—the deep problems in the housing sector. There is a limit to what easier monetary policy can usefully accomplish and there are dangers from being too easy for too long. That danger is not only that inflation will be generated if the central bank is tardy in applying monetary restraint. Indeed, the effort to boost the economic expansion through very easy monetary policy from 2002 through 2004 is part of the reason that we got the residential investment and housing price bubble that is now proving so difficult to unwind. For monetary policy as in architecture, sometimes "less is more," and it is well to recall the wisdom of the Beatles, "When I find myself in times of trouble, mother Mary comes to me, speaking words of wisdom—Let It Be."