Towards a Post-Crisis Economy:
Festive Spirit Absent as Recovery Limps into 2010

Vanessa Rossi and Rodrigo Delgado Aguilera
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Key points

- Although Europe and the US are out of recession and look likely to sustain at least a modest pick-up in GDP in 2010, this is a distinctly optimism-lite recovery with a heavy focus on downside risks – in fact the economic mood at the end of the year is more sober than festive.

- Trouble spots, chiefly associated with deteriorating public finances and external debt, are breaking out in Europe where the return to growth is generally blighted by weak domestic demand, the need for further adjustment in the banking sector and the threat of both fiscal and monetary policy tightening – even the agreed tax package from Germany has been overshadowed by concern that small country crises could escalate.

- In the US, the rebound in domestic demand in late 2009 has been far more robust than in Europe and policy looks set to remain easy. But the collapse in the commercial property market is adding to the distress in construction, the real estate and banking sectors, forcing more closures among small banks.

- Although the UK’s overall GDP performance in 2009 was actually little different from that of the Euro area, technically it is one of the few major economies to remain trapped in recession. The surprising drop in GDP in Q3 was due to one-off factors and anomalies, such as unusual discrepancies between consumption, retail sales and service sector growth.

- What could turn this picture around? To improve confidence and ensure a sustained global growth beyond 2010, it is essential that the recovery gathers pace in the US – this would also shore up market sentiment and stabilise the dollar, helping other parts of the world to sustain growth as well.

- While stronger EU internal growth would also add to a more positive outlook, arguably it is as important for Europe to find a convincing solution to the economic and financial crises facing a number of member states. If this is not possible, then talk of EU macro prudential oversight will ring hollow.
Introduction

Why isn't the mood more optimistic? Is economics living up to its description as the “dismal” science? In fact, almost all the major economies are now growing again - a far cry from early in the year when production, investment and trade were in freefall and many feared that recession would continue unrelieved through 2009 and into 2010.

The success in averting a more precipitous collapse was undoubtedly due to the broad array of macro policy measures mustered to avoid a repeat of the 1930s descent into depression: governments kept interest rates low, provided extensive support for the banks, and propped up real economic activity and jobs with fiscal stimulus packages. Despite criticism from opponents of government intervention, by and large these policies succeeded in bringing the dive into recession to a halt.

However, recovery is a far slower, and more uneven, process. And policymakers will increasingly focus on determining exit strategies, adding to the risks ahead. The world economy is still some way from returning to its previous peak let alone where business had expected to be. Compared with a year ago, the mood has changed from panic-stricken to simply sombre but recovery euphoria is distinctly lacking. This reflects the continuing threat of further shock waves from property markets, the financial system and country debt crises as well as the prospect of widespread post-crisis policy tightening – taxpayers are waiting for the inevitable bill for the war on recession. In addition, consumers face a tougher year, with inflation returning and unemployment still rising, while many companies are struggling to reverse the slump in revenues.

Conditions remain extremely fragile in all major advanced economies. Indeed, even the emergers look less than stellar if high fliers such as China and India are stripped out of the pack. That is not to say that all regions were badly hit: most Asian countries managed to bounce back from the post-Lehman trade shock as early as the second quarter while Latin America (excluding troubled Mexico) and the Middle East economies mostly survived with just a mild downturn.

In virtually all cases, governments stepped up to the plate to provide some degree of monetary and (especially) fiscal support during the crisis. But from now on, across the world economy, the next stages of recovery will have to rely on self-sustaining growth in the private sector rather than easy money and public support. The heavy lifting will have to come from the more robust
sectors such as services, which saw only a shallow recession, and ICT, which had a sharp but short slump. In addition, the US is seeking to actively engage business in generating a stronger and broader based rebound in growth during 2010, focusing on new industries, jobs and investment.

In Europe, the tax cut package just passed in Germany might signal the beginning of a new drive to support domestic demand growth – not before time but still good news.\(^1\) However, this has been overshadowed by concern over debt and default risks in the more fragile EU economies: these problems need to be resolved to take the EU forward and boost confidence not only in recovery but also in the potential for meaningful macro prudential oversight in the future.

### Table 1: Quarterly growth and forecasts

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\(*\) Estimated year-on-year growth necessary to attain IMF’s full year forecast for 2009

*Sources: National statistical offices, IMF WEO Oct 09 (forecasts)*

\(^1\) At €8.5 billion, the tax package is equivalent to about 0.5% of GDP - but as much as 10% of Germany’s expected 2010 deficit
European recovery struggling to gain traction: legacy of weak internal demand, excessive reliance on exports

The European recovery is at risk of a relapse if private sector demand fails to improve before governments and central banks begin to withdraw support during 2010. Along with the US, the EU economy exited recession in Q3 but the pick-up in GDP was much lower than that across the Atlantic and it was also worryingly dependent, yet again, on a boost from government and net trade.

In Q2, the Euro area’s two largest economies, France and Germany, appeared to make a surprisingly speedy return to positive GDP growth but this was largely on the back of a fall in imports, while private sector domestic demand (that is, household consumption and business investment) remained fragile. The drop in imports was certainly no help to trade partners such as the Netherlands and Eastern Europe yet three months later, domestic demand remains disappointingly low. In France, it is still in decline after government expenditure is deducted from the equation, while in Germany household consumption fell outright during Q3. In fact, closer scrutiny of the Germany Q3 figures shows that the pickup in GDP was based almost entirely on substantial restocking – however, imports did rise this time around, which should have a positive effect across badly hit trade partners.

Figure 1: Contributions to Euro area GDP

Source: Eurostat
Overall, the figures should trouble policy-makers eager to make a quick exit from fiscal and monetary support. The EU is already starting to examine the possible timetable for fiscal tightening amid concern over rising public-sector debt while the European Central Bank is moving towards exit strategies for monetary policy. It is highly unlikely that member states would have either the scope or the stomach for further coordinated fiscal or monetary stimulus even if the currently fragile economic recovery fails to progress.

As domestic demand remains weak, government withdrawal means that the EU will remain heavily dependent on the global economy to promote export-driven growth in spite of the fact that the recession has illustrated the risks inherent in this model. Germany’s economy, in particular, has been battered by the collapse in global demand for consumer durables (chiefly cars) and investment goods, in which its industry excels. While its exports have soared to nearly 50% of GDP, local demand was virtually static over the last decade. The risks of such dependency on cyclical export industries have been reviewed in detail in a previous Chatham House International Economics Programme Paper, Risk Mitigation Takes on a More Significant Role as Globalization Amplifies the Impact of World Cycles.

However, the crisis may serve to provoke a shift in policy priorities. One sign of change is the successful passage of the tax cut package in Germany: this may begin to restore the balance in Europe’s largest economy. It will be a slow process to address the persistent weakness in the Euro area’s domestic growth but hopefully this may now be underway.

Sources: DeStatis, INSEE

Available at http://www.chathamhouse.org.uk/research/economics/papers/view/-/id/785/
Less fortunately, downside risks are all too prevalent in the short term. They include the possibility that the credit crunch could get worse as European banks remain weak. Estimates suggest that European institutions are lagging behind in writing off bad debts. In addition, although different accounting practices explain some of the discrepancies, European banks generally have higher leverage and lower capital adequacy ratios than their US counterparts, which were much quicker to restructure their balance sheets. As a result, Europe is seen as reluctant to adopt the tougher ratios being proposed by financial market regulators in order to strengthen the global financial system. Such reforms could put European banks at a disadvantage versus US banks, requiring them to hold more capital even against low-risk operations such as retail banking and limiting credit availability.

Analysis of the crisis tends to support the European view in that neither leverage ratios nor capital adequacy accurately measure the health of the banking sector - other factors are also critical in tipping the balance of risk. However, in as much as steps can be taken to reduce future threats, some curbs are likely to be implemented on leverage and banks will be required to make greater capital provisions.

Figure 3: Capital base of US and European banks in mid-2009

Source: Wall Street Journal (RWA = risk weighted assets)

Ultimately, bank risk will always be hard to decipher, in part because it is not always clear where risks lie. Recent problems in Dubai and Greece are just a couple of examples of how the threat of debt defaults can suddenly surface.
with uncertain consequences. This is not the first time in 2009 that European banks have been hit with a potential debt problem: during the first quarter, it was the possible domino effect of Eastern European financial crises that caused concern until timely intervention by the IMF and the EBRD restored confidence. The Greek situation poses a particularly difficult challenge as it will test the ECB’s commitment to shore up the balances of its member states. The Greek budget deficit of 12.7% of GDP is the largest in the Euro area and is clearly out of touch with the established maximum of 3%. Although Greece’s debt is not large in absolute terms (at €300 billion it is less than 5% of total EU debt), a bailout would pose a significant moral hazard while on the other hand, a default could dampen confidence in the EU’s ability and willingness to address the vulnerabilities of its member states.

Figure 4: Expected write-downs in Europe and the US indicate 2010 will be a heavier year in Europe

Source: IMF GFSR Oct 09

In conclusion, the European recovery is at risk due to the sluggish state of domestic demand, the threat of premature policy reversals and a still vulnerable banking system. It is unfortunate that progress in 2010 will depend so heavily on export growth – rest of the world demand – when the Euro area should be capable of driving its own demand growth. But the German tax initiative will be watched closely to see if it can start to turn the tide and reduce the economy’s vulnerability to global cycles.
### The anomaly: why did the UK remain in recession in Q3 despite more promising indicators?

The UK was the only major industrialized country to report a further fall in GDP in Q3 apart from Spain, which is caught in the middle of a housing bust exceeding even that of the US in its severity and impact on unemployment. What has been particularly puzzling for the UK is the fact that numerous leading indicators (such as retail sales and business surveys) pointed to a Q3 recovery, at least in the service sector. Given that services ultimately account for the bulk of output (unlike more industrial economies such as Germany and Japan), this should have virtually guaranteed that the UK's GDP picked up in Q3. Unfortunately, GDP data showed a further contraction even after an upward revision to the initial October estimate.

While there is undoubtedly reason to be concerned about the UK's disappointing Q3 results, closer scrutiny of the reasons why GDP did not grow reveals a picture that is complex but slightly less gloomy. This explanation can reconcile GDP results with other indicators of the state of the economy as well as clarifying the technical reasons for weak GDP.

To begin with, the concept of equating retail sales with service sector performance must be debunked. Using the two synonymously is potentially very misleading since retailing is only one component of services – and a very small one at that. The Office of National Statistics (ONS) methodology assigns only a 7.1% weight to retailing within total services (business services and finance, for example, account for 40.1%). Despite this, retail sales are the most widely quoted monthly indicator for the real economy along with industrial production. The latter, in contrast, does an accurate job of representing the industrial sector (it only excludes construction, which is almost always treated separately).

Why then is it common to use such a small segment of services as representative of the whole? Firstly, only a few countries – the UK being one of them – produce monthly statistics on the service sector as a whole, despite the fact that it represents a larger share of output than any other sector. Secondly, the performance of retail sales and the service sector is actually broadly similar during good times, therefore serving as a useful proxy. But during this particular crisis, when the shock has disproportionately hit business and financial services, as well as the sale of higher-price goods such as cars (which are not included in retail sales) and wholesale distribution (strongly linked to business reactions to the crisis), retail sales can
expected to behave rather differently – in the UK’s case relatively well since mid-2008 compared to other segments of services.

As shown in Figure 5, even what appears to have been a strong performance in retail sales during the third quarter had little effect on the estimate for services overall. But if indicators such as retail sales are unreliable guides, what about business surveys such as the CIPS/Markit Services Purchasing Managers Index (PMI)? These are widely quoted as being reliable monthly indicators on the state of service-sector businesses, incorporating information not on only on output, but also on new orders, stock levels, employment and prices. As such they represent expectations as well as current conditions; useful for forecasting business conditions within the coming months (indeed, a clear lag in trends of approximately three months can be observed in Figure 6). Overlaying the performance of the PMI with the services and retail sales indices, it can be seen that the PMI has surged during 2009, more closely matching the performance of retail sales than total services.

The reasons for this divergence are not clear: perhaps service sector businesses are decidedly more upbeat than their manufacturing counterparts, or perhaps the share of retailers surveyed is much larger, thus biasing the PMI towards retail (an issue which would probably not have been a problem...
during good times). It may also be the case that factors other than output – which is the only factor considered by the service indices – might actually be looking positive to the firms surveyed. Whatever the case, it is evident that the PMI is not telling the same story as the service index in current conditions, especially given the degree of uncertainty.

**Figure 6: Comparison of PMI and service indices**

![Comparison of PMI and service indices](image)

Note: Retail sales using 3-m rolling averages to smoothen year-on-year volatility

*Sources: Markit, ONS*

Clearly the hope of retail sales boosting GDP was misplaced. But what else caused GDP to drop during Q3? The answer seems to be oil and vehicle imports, along with further destocking.

The increase in oil imports has been attributed to increased refinery demand occurring simultaneously with lower domestic production due to summer maintenance on North Sea oil rigs.

In addition, a surge in auto-sector imports has been associated with the car scrappage scheme. Looking back at the service sector figures above, vehicle sales soared during Q3, increasing by 4.3% compared to the previous quarter. Not only was this a very small contribution considering the overall size of service sector GDP but there appears to have been some substitution of expenditure, privileging car sales versus the rest. Overall, this explains why the car scrappage policy did so little to boost the UK’s service sector even if it offered an important life-line for dealerships and other UK companies in auto-
related sectors. However, the car factor was more significant when looking at the effect on UK net trade. When combined with the important oil deficit, the overall result was a decline in net trade which knocked 0.2% off GDP growth.

Figure 7: Contributions to UK GDP by expenditure (25 Nov 09 revision)

Note: A more recent revision on 22 December has improved the Q3 GDP figure to -0.2% although a detailed breakdown of components is not yet available. Own calculations suggest that gross fixed capital formation made a notable positive contribution, offset by a bigger hit in inventories.

Source: ONS

Overall, these details for services and imports can readily explain the way GDP has performed on both the expenditure and output sides of the national accounts. The oil issue is the easiest to illustrate from the data: extractive industries accounted almost entirely for the sector’s poor performance on the output side (a negative contribution of -0.1% according to the 25 November revision). But the fact that overall consumption remained flat despite the surge in car sales suggests that demand was displaced from other sectors into the auto sector. Which sector took the biggest hit? From the data, it looks to have been business services and finance.

On a positive note, the fact that falling stocks and rising imports were the main negative contributors to GDP on the expenditure side – rather than falling domestic demand – could be seen as a plus point: it implies that demand is recovering even if it is partly via the purchase of imported goods (after all, this does boost prospects for the UK’s trade partners). And speeding up the rundown of inventories is also beneficial as it will ultimately
make way for more production and sales in 2010. Furthermore, better than expected figures on business investment and construction have recently been released, helping the latest Q3 GDP revision to improve to -0.2%.

Nevertheless, the fact remains that retail spending remains disturbingly weak and there are no reasons to expect any new stimulus for this in the short term. Indeed, another dismal holiday season (exacerbated by the spell of bad weather) could dampen confidence in recovery given the impending end to some of the fiscal relief measures which helped boost consumption in 2009, primarily the car scrappage scheme and the temporary VAT cut. The end of the VAT cut will also have an impact on the headline inflation figure in the New Year as retailers pass the cost on to consumers.

Figure 8: Headline consumer inflation

![Inflation Rate Chart]

*Source: BLS, Eurostat*

**Strong rebound in the US, but turbulent property markets may sour the recovery**

In contrast to the dubious recovery in the Euro area and the UK’s persisting recession, the US’s results for GDP in Q3 looked considerably more robust. Domestic demand saw a clear rebound, led by household consumption which accounted for the bulk of the upsurge. Overall, this is definitely not an export-led recovery – in fact, net trade was negative. Although the widening trade gap provides a much needed boost to global demand and world trade in the short run, it will undoubtedly raise further concern over long-term global
imbalances if it accelerates in 2010 – G20 finance ministers are already looking in more depth at this issue now that the need for crisis management is fading. Nevertheless, it is financial reform and exit strategies that will continue to dominate the agenda in 2010.

Figure 9: Contributions to US GDP

Despite the solid Q3 results, the US economy is not immune to further turbulence, particularly regarding persistent problems in residential and commercial real estate – and therefore the banking sector. High levels of unemployment have fuelled risks of a new round of delinquencies in mortgage payments along with other factors, such as negative equity and the possible ending of special assistance schemes.

According to the Mortgage Bankers Association, nearly 10% of all outstanding residential mortgages were in delinquency at the end of Q3 and 4.5% were in the process of foreclosure. Both of these were increases compared to the previous quarter and the previous year. Putting this together means that one in every seven housing loans in the US is in some state of distress, and the figure is even more depressing in some of the hardest-hit states. In Florida alone, 25% of mortgages are estimated to be in delinquency and 13% in foreclosure, the highest in the country. Unsurprisingly, the state of the housing sector in terms of prices, sales and starts has remained more or less flat through 2009 – indeed, many fear that there could be a renewed downturn rather than a pick up in 2010.
As if the problems in the residential sector were not enough, the picture emerging in commercial property is even more alarming. Concern over bad debt is mounting as commercial property prices continue to plummet.

Unlike housing, where the initial signs of turbulence were felt in early 2007, the state of the non-financial corporate sector was relatively sound until the Lehman collapse, after which the credit crunch hit the real economy with full force. The subsequent collapse in business investment meant that many projects were frozen or scrapped. Because of the longer time-span of projects in the commercial sector, the pipeline is only just starting to come to an end and construction companies now face difficult conditions, possibly for several years.

The commercial property sector is suffering from similar problems to those which brought down housing: over-exuberance about the economy and growth, questionable lending practices, excessive securitization of loans and a belief that property prices would not fall (in fact, they have fallen more than housing and are still in free-fall). Numerous commercial real estate developers have gone bankrupt during the last year, echoing the collapse of the subprime lenders back in early 2007. And potentially massive toxic debt will weigh heavily on the balance sheets of banks – not just large banks but many smaller, regional banks which have much higher exposure to commercial property investments in their portfolios. This largely explains the
upsurge in US bank failures in 2009: a total of 95 in the first nine months of the year, compared to only 28 in 2007/08 according to the Federal Deposit Insurance Corporation (FDIC). This is the largest number of failures in the US since the savings & loan crisis, which wiped out hundreds of small and medium-sized lenders.

**Figure 11: US housing (HPI) versus commercial property prices (CPPI) indices**

![Graph showing US housing (HPI) versus commercial property prices (CPPI) indices.](image)

*Source: Standard & Poor's, MIT*

The scale of commercial projects and lending means that no banks, big or small, are safe from this crisis. Furthermore, the problem is still far from peaking: in the US alone, as much as $1.4 trillion of commercial debt is due by 2012. Although the figure for Europe is much smaller at nearly $500 billion, this is only a fraction of the total debt outstanding beyond 2012. Around $140 billion in loans are said to be already in default while another $550 are heading in the same direction.³ Save for a miraculous turnaround in the property market, banks will be hard pressed to find ways to roll over or renegotiate the bulk of this debt, at a time when their ability to cover bad debts is already impaired.

³ *BusinessWeek*, 'Why This Real Estate Bust Is Different', 05-11-09 and *Financial Times*, 'Vacant possessions', 07-12-09.
In spite of all these concerns over property and banking, the US economy is still seen having more upside potential in 2010 than the EU. In part, this is due to the momentum and tenacity of domestic consumption and hopes that job losses are coming to an end as productivity growth has surged. There is also scope for a release of pent up business investment, as projects and spending were put on hold during the crisis. Efforts to encourage US corporates to sustain the recovery with a surge in investment in new industries and jobs could begin to show results by mid-2010. And to help these trends along, US policy will probably remain relatively easy.

**Figure 12: Rate of non-current loans**

In spite of all these concerns over property and banking, the US economy is still seen having more upside potential in 2010 than the EU. In part, this is due to the momentum and tenacity of domestic consumption and hopes that job losses are coming to an end as productivity growth has surged. There is also scope for a release of pent up business investment, as projects and spending were put on hold during the crisis. Efforts to encourage US corporates to sustain the recovery with a surge in investment in new industries and jobs could begin to show results by mid-2010. And to help these trends along, US policy will probably remain relatively easy.

**Hard work for the private sector to sustain recovery in 2010**

There are too many problems still to be addressed for 2010 to be seen as anything but a very difficult year: following up on the first rebound in late 2009 will be hard work. Growth will almost certainly be mildly positive (guaranteed by base year effects) but progress may well be rocky rather than smooth. While the real economy in the Euro area, UK and also the US and Japan appears to be making weak but positive progress, there is an increasing need for vigilance in terms of possible impacts from changes in monetary policy and potential financial market turbulence. News about the US commercial
property markets and also financing in Dubai and Greece has rattled markets already but other flashpoints may be the emerging uptick in headline inflation\textsuperscript{4} and interest rate volatility, especially in the Euro area where the ECB may be determined to act even if the US Fed stands pat.

If momentum is to build into sustainable growth in 2011 and beyond, it will have to be on the back of renewed growth in private demand in the leading developed economies – consumption and investment must pick up. Although they have helped lift the world economy in 2009 and can almost certainly keep up momentum in 2010, the emergers will ultimately depend on improving demand in what are still the major markets for many of their exports.

Among the key sectors that will have to do the heavy lifting will probably be services (boosting the US and European domestic economies) and the likes of ICT, where demand is already enjoying a marked recovery and helping Asian exporters. Provided companies in these sectors can keep up growth and create jobs, then the prospects for more troubled cyclical sectors such as investment goods and construction will eventually improve. This is essential to pave the way towards higher productivity growth and innovation for the longer run as well as sustaining the recovery in the short term.

Given the problems besetting both the US and Europe it is unclear which will succeed best in reviving sustainable domestic growth – but the conclusion of this race will undoubtedly have important implications for financial market trends and for the course of the dollar. In this respect, 2010 could be a watershed year. For what one can observe so far, however, it certainly seems the US is poised for a stronger recovery given its greater rebound in production (which also contracted less than in Europe) and the more muted hit on services over the course of 2009.

The EU is clearly struggling with disparate country problems, hoping that individual responses will meet each challenge while Brussels and the ECB impose a tough policy framework to meet their respective public sector debt and monetary stability targets. It is also dangerously dependent on export growths to drive growth and is thus unable to stand the pressure of a strong euro. In contrast, the US is likely to keep central policies as easy as possible to support the worst affected regions and sectors in the country – and in so doing spreads the effect of low cost borrowing around the country and the

\textsuperscript{4} The inflation threat is examined in detail in the Chatham House Programme Paper Inflation – Ghost of the Past or Upcoming Threat? Available at: http://www.chathamhouse.org.uk/research/economics/papers/view/id/807
world. The ultimate aim must be to restore sustainable growth whichever adjustment method is preferred: soft-touch US or EU sanctions-led.

Historically, it has been the US economy that rebounded most strongly from recession – support, while controversial, won the recovery race (e.g. in the early 1980s). And the dollar has typically rebounded with the economy – the domestic driven US could withstand this effect, unlike the Euro area.

Unfortunately, confidence is too low for this to be taken for granted and both the US economy and the dollar must wait to see what 2010 holds in store.

About the Authors

Vanessa Rossi is Senior Research Fellow in International Economics and Rodrigo Delgado Aguilera is Research Assistant with the Royal Institute for International Affairs, Chatham House