Beacon Economics

Global Forecast

by Lynn Reaser

Key Chapter Findings

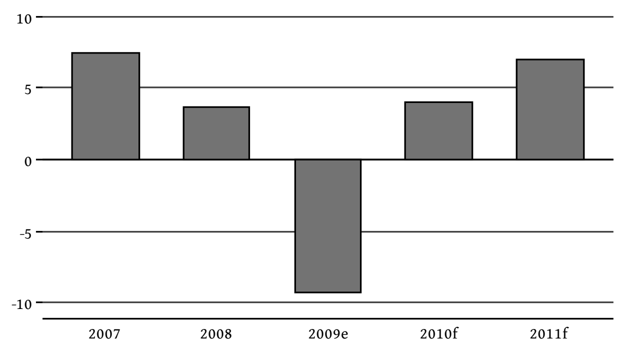
- Look for world trade to recover in 2010 with a gain of about 4%, following this year's estimated plunge of around 9%. Expect a further advance of around 7% in 2011.
- California's exporters should participate in the recovery, supported by a weaker dollar and at least modest growth in most countries.
- In addition to agricultural products, California should see considerable demand for computer and electronics products, machinery, transportation equipment, and chemicals.
- China and South Korea present the most potential growth for California firms selling abroad during the coming two years. Hong Kong, Singapore, and Canada should also offer significant opportunities. Among the state's ten largest export markets, Japan and the U.K. are likely to show the slowest growth.

Setting the Course for World Trade

The world economy has suffered a cruel, synchronized recession, with no safe harbor. Housing boom-and-bust episodes have pummeled countries such as the United Kingdom, Spain, Australia, and New Zealand, along with the United States. Financial problems have engulfed banks in nations ranging from Iceland and Latvia to Germany and Ireland. A pullback in consumer and business spending became a universal trend, while cutbacks in trade finance aggravated the downward spiral. The numbers speak to the damage: the volume of world trade will probably show a plunge between 9.0% and 9.5% for 2009 as a whole.

Fortunately, the worst of the downturn appears to be over. Although not coordinated, the simultaneous efforts of countries throughout the world to resuscitate their economies via aggressive fiscal and monetary policies appear to be achieving some success. Even though loan losses will continue to plague the banking system, financial markets are again functioning well enough to probably support 4.0% world trade growth during 2010, with a further 7.0% advance in 2011. Placing these figures in perspective, trade expanded 7.5% in 2007.

World Trade Dives, Recovers
Real Volumes, Annual Percent Change



e = estimate, f = forecast
Sources: International Monetary Fund and PLNU

Decoupling – Myth or Reality?

As 2008 unfolded and the optimists became less confident that a serious U.S. recession could be avoided, there was some hope that a worldwide downturn could still be averted. For example, growing household incomes and spending might provide a buffer for such countries as China, South Korea, and Vietnam. Many emerging markets, including Brazil and Mexico, had managed their economies more prudently, becoming less dependent on short-term "hot" money flows. Indeed, banking crises did not flare up everywhere – Canada's banks sidestepped the assumption of many of the toxic assets crippling markets elsewhere. Housing bubbles were not universal – Germany avoided the upswings and downswings seen elsewhere in the eurozone. Still, the falloff in demand, the cutbacks by risk-averse investors, and the drop in remittances by workers abroad ultimately quashed most proponents of "decoupling."

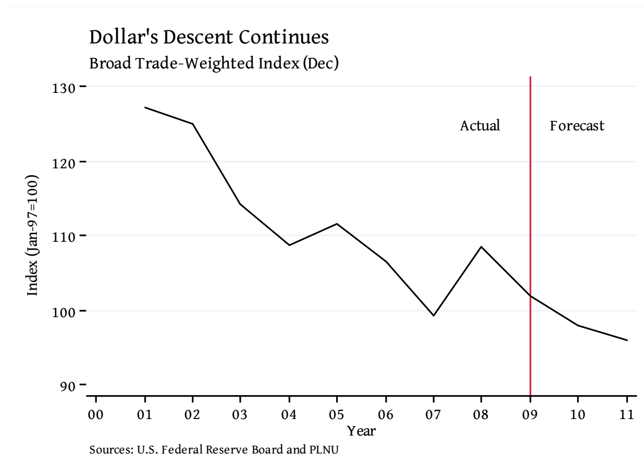
China's success in restarting its economic engine, which sparked a revival in commodity prices and trade throughout Asia, did rejuvenate a few advocates of decoupling. The recent experience would suggest that the emergence of consumer markets in various countries can drive some independence of performance, but the linkages of financial markets and trade will limit the extent and impact of decoupling in the near term.

Risks to Global Trade – What Could Capsize the Boat?

What could drown the prospects for a recovery in world trade during the next couple of years? Three forces likely pose the greatest risk. First, a failure of U.S. consumer spending to show at least a modest expansion would bring an early end to the improving signs we have recently seen. Second, another tidal wave of bank credit losses, such as losses from commercial real estate loans, consumer credit, or loans made to finance corporate buyouts, could ravage stock and bond markets along with financing. Third, an early upswing in inflation could provoke a round of monetary policy tightening around the world, stifling prospects for growth. While none of these risks appears high, they are not negligible and merit a close monitoring.

Prospects for the Dollar – Moving Downstream

From its peak early in 2002 until mid-2008, the greenback shed 26% versus a broad-based index of the countries accounting for the bulk of U.S. trade. This decline was reasonably orderly and, as theory would suggest, helped to reduce a burgeoning trade deficit by making U.S. exports more competitive and imports more expensive. The overall current account deficit peaked at $804 billion in 2006 and fell to $706 billion in 2008.

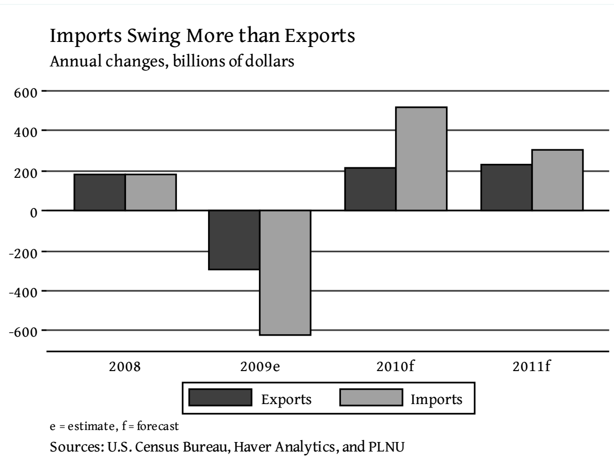


The dollar reversed course last year as investors sought a safe haven, opting for the "mattress" of short-term Treasury bills. The greenback's value rose 9% in 2008. This year has witnessed the unwinding of that strategy, as investors have moved back into stocks and bonds and invested in higher-yielding currencies, such as those found in Canada and Australia.

Look for risk tolerance to play a diminishing role in dictating the dollar's course during the coming year as other factors move to the forefront. The U.S. trade deficit is likely to widen again in 2010 as the rebuilding of business inventories causes imports to rise faster than exports. The federal deficit is on target to equal around $1.6 trillion in fiscal 2009 and could sum to a cumulative $10 trillion over the next ten years. A weaker dollar may be required to coax the necessary funds to our shores. International investors now own more than half of all privately held Treasury securities. Any fears about future U.S. inflation, even if unfounded, could also pressure the dollar. No massive dollar sell-off is likely, but a decline of approximately 4% on a trade-weighted basis is likely in 2010 and a decline of 2% is likely in 2011, following an estimated 6% decrease in 2009.

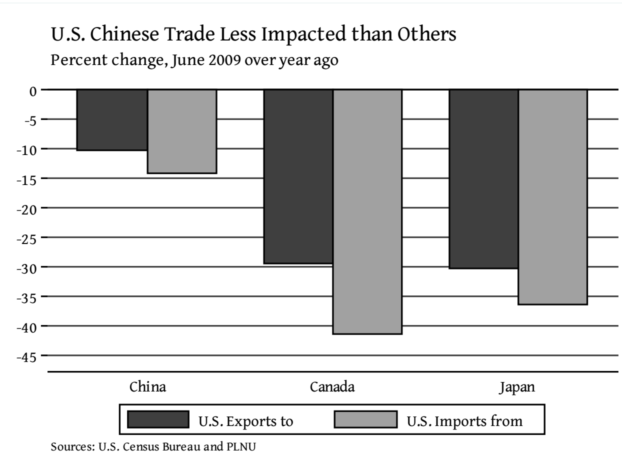
A Shrinking Trade Deficit, but How Sustainable?

The U.S. trade deficit has shrunk dramatically over the past three years after cresting in 2006. Total trade expanded on both sides of the ledger in 2007 and 2008, but export growth outpaced that of imports during both years. The story has changed radically in 2009. The recession has slashed both exports and imports, but the drop in imports has been twice that of exports. As U.S. manufacturing has migrated overseas, other countries have borne more of the swings in American demand. They have benefited more from booms in U.S. demand but have also suffered more from the severe declines.

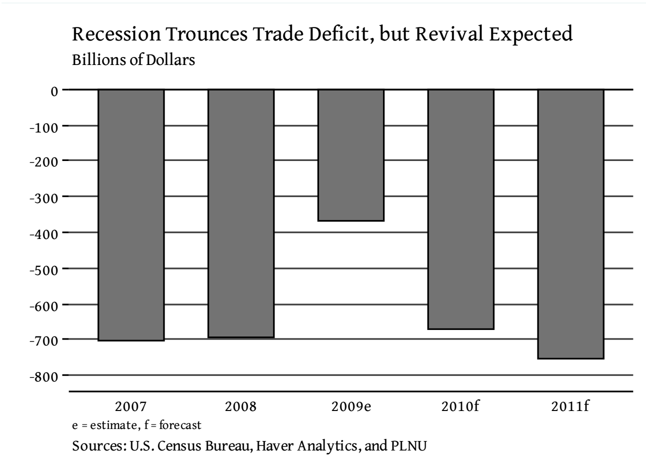


The experience among America's major trade partners has differed significantly. For example, in June 2008, the U.S. had its largest trade deficits with China, Canada, and Japan. A year, later, the trade deficit had diminished significantly with all three countries as imports fell more than exports in all three cases.

The import decline from Canada has been particularly stark, with a plunge of about 40%, reflecting in part lower prices for energy and some other commodities. Exports fell nearly 30% to Canada. Similar large declines have been witnessed with Japan. In contrast, exports to China decreased about 10% over the year, while imports fell 14%. The more moderate drop in China-bound exports mirrors the greater relative strength of demand in the Asian nation. The more moderate fall in U.S. imports from China reflects the continued appetite for Chinese-made consumer goods, especially as budget-conscious American consumers have shifted to lower-cost products.

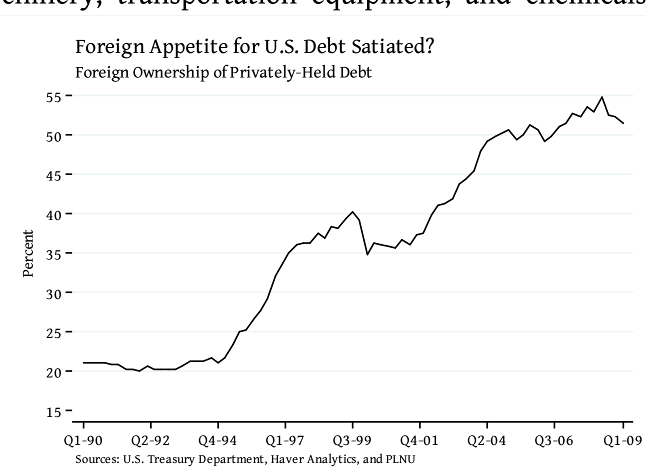


The striking reduction in the U.S. trade deficit is likely to be temporary. A revival in U.S. consumer and business spending, even if only moderate, will draw in more imports. The rebuilding of business inventories will amplify the return of imported products. As a result, although both exports and imports are likely to expand in 2010 and 2011, a larger rise in imports is likely to drive the trade deficit higher again. Still, the total expected two years from now is likely to be less than the 2006 peak.



California's Export Markets – Assessing the Currents

The value of goods produced in California for export reached $145 billion in 2008. This represented a gain of 8% over 2007, with average growth over the five years since 2003 at 9%. Exports have fallen this year, but we expect them to rise in 2010, with further momentum in 2011. In addition to agricultural goods, California's leading exports include computer and electronics products (including components for manufacture and re-export), machinery, transportation equipment, and chemicals.



How will California's top ten export markets perform? The following section rates each of them based on expected sales potential during the 2010-2011 timeframe, the risk to that forecast, and the impact of expected currency changes on California's competitive position. Grades of "A" (highest) to "F" (lowest) are assigned.

Mexico – Looking North

The steep downturn in the United States has pummeled the Mexican economy in the past year as exports dried up, incomes from jobs across the border evaporated, oil prices dropped, and an outbreak of the swine flu caused businesses to be shut during early May. Real GDP plunged at an annualized rate of over 20% from the prior quarter in this year's first three months and another 4% in the quarter ending in June. Some of the negatives are now beginning to unwind. Although the sharp drop in U.S. jobs will continue to weigh on remittances, exports and oil prices are recovering. Some American companies, assessing the cost of transit from Asia, are refocusing on the benefits of maquiladoras. Investors are likely to include Mexico as they return to emerging markets, and tourism should pick up over the coming year.

Still, the challenges facing our southern neighbor loom large. Disruptions to cross-border trade and tourism from tighter security measures have added to the problems of Mexico's drug cartels and wars. President Felipe Calderón has also not been able to implement reforms in energy (still primarily a government monopoly), education, and taxes t¬o boost the economy's growth potential.

Look for Mexico to achieve modest growth during the next two years, with swings in oil prices probably causing the major risk to that forecast. Anticipate some recovery in the value of the peso, which will give some help to the competitive posture of California's exports. On balance, a "C" grade appears appropriate for the Mexican market.

Canada – Looking South

Despite the success of Canadian banks in avoiding the financial meltdown experienced by their American counterparts, the falloff in industrial demand pummeled the country's commodity and high-tech economic base. Interest rate cuts by the Bank of Canada, combined with tax cuts and a step-up in government spending, have produced some recent improvement in sales to consumers and factory orders.

The rebound in Chinese demand for raw materials and investors' renewed interest in commodities have spawned a revival in energy and metals prices. Some pickup in U.S. consumer and business spending should help the nation's growth prospects. The success of the U.S. "cash for clunkers" campaign has prompted some rise in auto production, although much of the increase may be in facilities in areas outside the border area.

The lack of major imbalances in Canada's economy should promote a resumption of general economic growth, although the tight linkages to the United States will limit its potential if American growth is sluggish. The currency's further expected appreciation is likely to give California exports some edge. Overall, a "B" rating for Canada as a potential export market seems warranted.

California's Leading Export Markets

Country	Volume 2008 ($ Billions)	Avg. Annual Growth (2003-08, %)
Mexico	20.5	6.6
Canada	17.7	9.6
Japan	13.1	2.2
China	11.0	15.2
South Korea	7.7	9.9
Germany	5.8	10.1
Hong Kong	5.7	6.4
United Kingdom	5.5	4.9
Taiwan	5.1	3.0
Singapore	4.1	4.0
TOTAL	144.8	9.0

Sources: Wiser, Haver Analytics, and PLNU

Japan – Avoiding Another "Lost Decade"

After a year of steep decline, Japan staged a 3.7% annualized growth in real GDP during the second quarter. A rebound in exports to China, a government stimulus plan (including incentives for the purchase of ecological products), and less inventory liquidation drove output higher. Yet, Japan's failure to mount a sustained recovery during the 1990s because of troubled bank balance sheets and premature fiscal tightening give reason for caution.

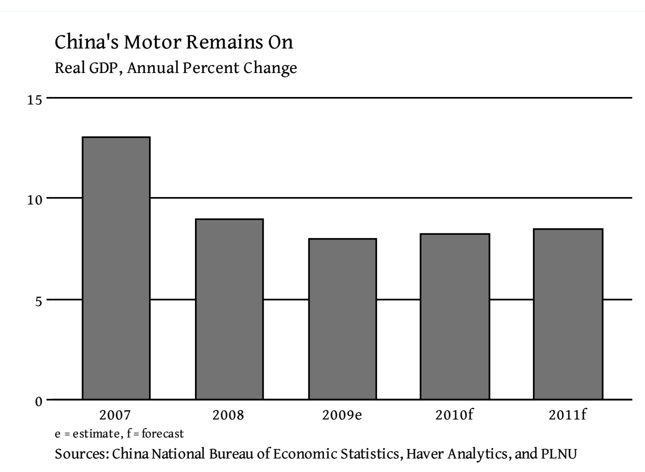
The decision of Japanese voters to oust the Liberal Democratic Party (LDP) after more than a century of dominance brings new uncertainty into the mix. Expect the newly elected Democratic Party of Japan (DPJ) to follow a more populist strategy aimed at households. Increases in the minimum wage, tax credits for new parents, reductions in gasoline taxes, and education subsidies are all on the table. The nation's debt, now equal to about 170% of GDP – versus around 58% in the U.S. ratio – could cause larger Japanese corporations to bear some of the resulting increase in costs. Business investment and hiring could accordingly suffer, stifling the recovery.

Japan's auto industry also is losing its competitive edge and its ability to boost the economy. Korea has made impressive strides with its lineup, the Europeans continue to challenge Japan's luxury models, and China and India are eventually set to challenge the lower end of the market. Even new models from General Motors might represent some competitive threat to Japanese firms.

Although Japan's economy is likely to grow in both 2010 and 2011, gains are expected to be modest and risks are significant. The dollar should be at an attractive level for U.S. exports, although the yen's further appreciation is likely to be limited in light of investors' uncertainty about the Japanese economy and the desire of Japan's government to maintain a competitive currency. As a result, we give the country a "D" in terms of its export potential.

China – Managing Growth

While many analysts thought that the United States would lead the world out of recession, China appears to be at the forefront. Confronted by rising unemployment and the prospect of social unrest, the Chinese government launched a $585 billion stimulus package in late 2008. Although vestiges of China's command and control economy are inefficient, and its financial markets are underdeveloped, the Chinese government was highly effective in quickly reviving economic activity. Banks, instructed by the government to step up lending, injected $1.1 trillion of new loans into the economy during the first half of 2009, a threefold increase over the prior year. Combined with heavy investment in various infrastructure projects and consumer rebates for purchases of home appliances, computers, mobile phones, and cars, this flood of new money helped drive real GDP sharply higher in the second quarter.



China now faces the challenge of guiding the economy back to a channel of sustainable growth. The risk of a bubble in stock and property prices, along with a rash of ill-advised loans, is palpable. Fortunately, the government has already taken steps to slow down lending and infrastructure spending, but its success in fine-tuning the economy remains in question.

Look for China to see real GDP growth in the range of 7.5% to 9.0% starting this year through 2011, making it potentially one of the most rapidly expanding markets for California exports. China's demand for high-tech products and machinery as it builds out its infrastructure and boosts productivity will benefit California firms. Rising incomes in the country and a voracious demand for raw materials should further raise prospects for the state's exporters. There is some risk to the downside should the government have to take stark measures to curb overheating. The Chinese government is also likely to allow its currency to appreciate only modestly to protect its exporters. Despite these latter two factors, the growth prospects argue for an "A" rating for China for California exporters.

South Korea – Swimming to the Surface

South Korea has joined its Asia neighbors in staging a sizable recovery in the second quarter. Real GDP bounced higher at an annualized rate close to 10% in the three-month period ending in June, even as the pace of inventory liquidation accelerated. Rising internal investment and consumer spending combined with expanding exports to drive output higher. Home prices have started to rise.

Inflation has cooled from a 13-year high of around 5% last year to around 3% in 2009, with higher unemployment pushing wages lower. Banks and non-financial firms, which rely on foreign sources, have seen their access to dollars improve markedly in contrast to the paucity of funding earlier this year.

Look for South Korea's economy to show sizable growth during the next two years. The central bank has warned of the risk of overheating, but consumer caution is likely to help keep the brakes on growth. As investor concerns about the country's current account balance and growth prospects have eased, the currency has appreciated, with further gains anticipated to levels that should be more competitive for U.S. exporters. Although security risks with North Korea are likely to persist, the country rates an "A" rating as an export destination.

Germany – Jumping the Waves, but Can It Last?

While the eurozone seemed destined to lag any revival in world economic growth, Germany managed a boost in second quarter output, with real GDP posting a small 1% annualized gain. In contrast, first quarter numbers revealed a harsh 13% annualized drop. Albeit delayed, the European Central Bank's steps to pump sizable amounts of liquidity into the system, combined with various fiscal stimulus measures, including government spending and a German "cash for clunkers" program (modeled after the concept first launched in France in December 2008), helped stabilize the economy.

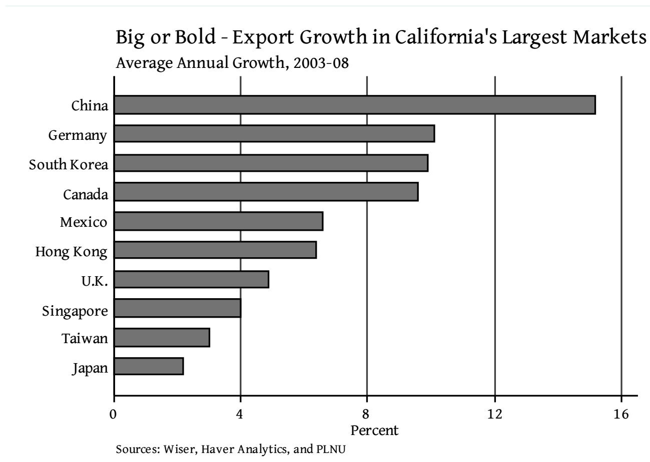
Prospects going forward are more circumspect. Do not expect any additional easing from the European Central Bank as monetary policymakers in the region generally believe they can only effectively control inflation and should not engage in fine-tuning economic growth. The German government's commitment to reducing the deficit is likely to stem further fiscal stimulus.

On balance, look for Germany's economy to post moderate growth over the next two years, with considerable risk. For California exporters, expected further gains in the euro, as international investors diversify their investments into non-dollar assets, will help the state's firms compete more effectively in Germany. Still, the expected fall of the dollar versus the euro is likely to provide only a partial offset to growth prospects and the attendant risks. Germany's export market grade is a "C."

The United Kingdom – Trying to Right the Ship

The U.K. has paralleled the U.S. experience of the past two years more closely than any other nation. A traumatic housing cycle, an implosion of bank balance sheets, and a crumbling of business and consumer confidence enveloped the nation. A vigorous policy response was launched, including steep interest rate cuts, intervention to assist crippled banks, and fiscal stimulus, including Britain's version of a "cash for clunkers" program. Although real GDP continued to fall in the second quarter, business surveys suggest that output is bottoming out.

Still, the recovery remains fragile. Regulation and taxes are eroding London's leadership as a major financial center, although in the near term there may not be a dominant alternative. In recognition of the economy's vulnerability, the Bank of England left its key interest rate unchanged at 0.5% in early August and opted to expand its purchase of government and corporate securities to enhance its program of "quantitative easing." The magnitude of the budget deficit may prevent further fiscal stimulus.



Look for Britain's economy to gradually improve over the course of the coming year. As in the United States, a number of risks surround this forecast, including further write-downs on bank balance sheets, a hesitant consumer, and a fledgling bottom in housing. While the pound's recent rally makes U.S. goods more competitive¸ the nation's challenges could limit the size of further gains. The combination of growth, risk, and expected currency movements suggest a "D" as the appropriate grade.

Hong Kong – Investors Throw a Life Raft

Supported by its largest export market, China, Hong Kong bounced back last quarter. Real GDP, which had suffered an annualized plunge of around 16% in the first quarter, staged a 16% annualized gain last quarter. Fiscal stimulus, particularly in construction, has helped, and the stock market's sharp rebound has been pivotal in the upswing. A revival in Hong Kong's Initial Private Offering (IPO) market has attracted large amounts of foreign capital.

The recovery is still in its early stages, with rising unemployment checking consumer spending. Concerns about swine flu are still curbing critical tourism from China. The success or failure of China in guiding its economy will largely dictate Hong Kong's future.

On balance, expect Hong Kong to show relatively rapid growth over the coming two years, although the risk of overheating/rapid cooling in the tightly linked Chinese-Hong Kong market exists. Hong Kong's maintenance of a tight peg to the dollar will continue to constrain the competitive position of California exports. Despite the risks to growth and the disadvantage in terms of currency values, Hong Kong's growth prospects award it a "B" as an export market.

Taiwan – Dependent on World Tides

Riding the same currents flowing throughout Asia, Taiwan has recently seen better economic news, even though Typhoon Morakot exacted a serious toll on lives and property on the island in early August. Real GDP soared at an annualized rate of 19% from the prior quarter in the April-June period. China's rebates on home appliance purchases spurred a pickup in demand for Taiwanese electronics products. Demand for liquid crystal display (LCD) panels for televisions has also improved considerably. Still, internal demand from consumers and businesses remains soft. Rising unemployment and weak income gains are hampering consumer spending, while uncertainty and tight credit is constraining business investment.

Look for Taiwan's economy to be driven by prospects in China, the United States, Europe, and the rest of the world. Growth is likely to be moderate, with considerable risk. The government will probably allow only limited appreciation of its currency, which will constrain the competitiveness of California products. Overall, a "C" rating appears appropriate.

Singapore – Open Waters

As one of the most open and export-dependent economies in the world, Singapore's economy is at the mercy of swings in world trade.

Not surprisingly, the harsh downturn of the past year sent waves crashing down on the city-state's economy. As witnessed in most of Asia, improvement did surface in the second quarter. Rising exports, inventory restocking by electronics manufacturers, and government infrastructure

Report Card
California's Export Potential 2010-11*

China	A
South Korea	A
Hong Kong	B
Canada	B
Singapore	B
Taiwan	C
Germany	C
Mexico	C
Japan	D
U.K.	D

*Ratings based on assessment of growth, risk, and exchange rates
Source: PLNU

spending drove real
GDP up at a 22% annualized clip. A strong upturn in biomedical manufacturing also contributed, although this sector remains highly volatile.

The expected upturn in world trade during the coming two years should push Singapore's economy forward, but any risk to U.S. or Chinese growth represents sizable risk. In the meantime, slack income gains will limit consumer spending while business investment is likely to wait for more tangible signs of a durable recovery. Singapore's currency can be expected to appreciate further vis-à-vis the dollar, which will help the competitive posture of California exports. We rate the country's export potential as a "B."

Keys to Surviving Foreign Waters

These trends and expectations suggest certain strategies to manage international business lines during the next two years.

First, recognize that currencies represent one of the most difficult economic variables to forecast. Forces driving exchange rates change over time and can encompass risk aptitude, interest-rate differentials, political perception, and comparative growth rates. Changes in investors' views about currencies can be sudden and dramatic. As a result, companies would be well served to consider hedging against currency risk so they can concentrate on their core products and marketing plans.

Second, elections and other political developments merit close monitoring. Political actions can include investment restrictions, credit controls, and expropriation of foreign-owned assets. Political backlashes could be substantial during the next two years as electorates voice displeasure if economic prospects fail to materially improve. Preemptive actions by businesses to safeguard against such possibilities could be vital.

Third, evaluate on a periodic basis the costs and benefits of foreign versus more localized sourcing. Rising energy prices may make the cost of shipping goods from Asia uneconomic relative to the costs of producing in the United States or Mexico. The benefits of shorter shipping times to inventory management, better quality control, and tighter linkages between designers and manufacturers may also outweigh labor-cost savings.

Fourth, importers should expect more requirements from the federal and state governments, consumers, and retailers for verification that foreign plants meet certain safety, health, worker, and environmental standards. These requirements suggest that companies desiring to maintain foreign firms as part of their supply chain will need extensive systems and resources dedicated to reporting and compliance.

Overall, California firms are well positioned to benefit from the expected recovery in global trade during the coming two years. While export markets carry particular challenges, many firms will find them to be a vital part of their business and growth strategies.