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Global Economic Outlook 2008

A Deloitte Research Study

Table of Contents

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Global Economic Outlook 2008

The medium-term direction of the global economy will be set largely by two countries: China and the US. Together, these behemoths account for a sizable share of global economic growth, and especially import growth – thereby stimulating exports and economic growth in the rest of the world. Hence, how they perform matters. Moreover, the financial imbalance between these two countries has already had serious consequences for growth, exchange rates, and interest rate. More may follow. Currently, the global economy is undergoing a transition from one era of economic expansion to another. The transition itself was brought on by the bursting of a bubble in the US housing market. Yet bubbles don't emerge at random. They usually have a cause in the form of an economic event. In this case, the event was the huge flow of liquidity from China to the US. And, of course, bubbles always eventually burst.

In what follows, we will examine how the economic imbalance between the US and China contributed to the housing bubble in the US. The bursting of that bubble is having important consequences for the global economy. More importantly, we will offer our view on how the continuation and eventual unwinding of global imbalances will affect the future direction and structure of the global economy. The future direction of China and the US will also be examined, along with the implications for the rest of the world. Finally, the economic outlook for other major economic players will be examined.

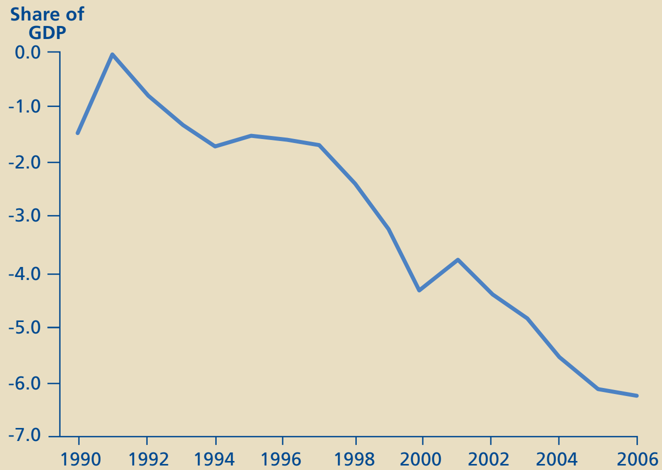
Setting the stage

In the past decade, there has been a massive flow of funds from China to the US. Why? The answer is that China and other Asian nations save a larger share of their output than they invest, while the US invests more than it saves. The result is that Asia, principally China, sends it excess savings to the US. For many years this has been a win-win situation for both countries.[1] For China, funding America's external deficit has enabled the US to cheaply import Chinese exports. This, in turn, has kept millions of Chinese workers employed producing exportable goods.

For the US, importing China's savings has enabled the country to enjoy a high level of borrowing without high borrowing costs. This is party due to the fact that China's government has directly funded the US external deficit through currency intervention. That is, in order to hold down the value of the Chinese currency and keep exports cheap, the Chinese government has purchased dollars and held them in the form of US Treasury securities. This intervention, along with similar intervention by other countries with large surpluses, has funded a large share of the US external deficit. The result is that China's government has amassed a huge stock of foreign currency reserves – now in excess of US$1.4 trillion. For the US government, being able to fund budget deficits by selling bonds to a foreign government has held down long-term interest rates.

Yet there is no such thing as a free lunch. The US now has a very large external deficit that may not be sustainable in the long-term. Unwinding that imbalance could ultimately be painful. China, in the course of purchasing dollars by printing its own money, has caused a rapid expansion of its money supply with resulting increases in inflation. Indeed the inflation rate has risen from less than zero four years ago to more than 6% today.

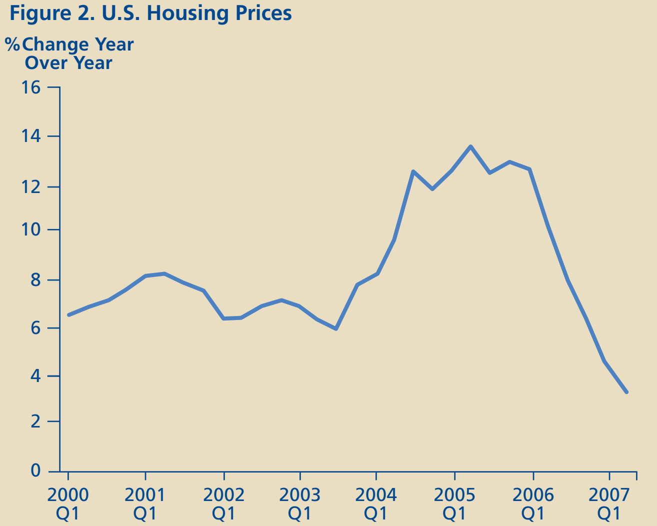
Figure 1. U.S. Current Account Balance



Source: IMF

Moreover, the massive flow of capital from China to the US has had some unanticipated effects as well. That flow, by contributing to low US interest rates and excess liquidity, caused US investors to seek new outlets in order to achieve higher returns. In the past few years, equity markets were not as attractive as in the past due to the aftermath of scandals, new regulations, and the unwinding of the technology stock bubble. Instead, investors looked to property. In a growing economy with low interest rates, it is reasonable to expect that home prices would rise. And indeed they rose. Yet something more happened. As home prices rose, people started to expect prices to rise further. They started to pay prices unrelated to the expected return from renting out the homes. Instead, people paid prices related to their expectation that prices would rise further. A speculative bubble took hold. It is a bubble because, like a soapy bubble, it cannot last forever. Eventually, like a ponzi scheme, it must end.

Figure 2. U.S. Housing Prices



Source: Freddie Mac, Fannie Mae

This particular bubble was no aberration. There have been many property price bubbles in the past, all ending in tears. In this case, the rise in short-term interest rates in the period 2004-06 augured the end of the bubble. The US Federal Reserve, wary of rising inflation expectations, increased rates in order to cool the economy and avert inflation.

For the property market, this turned out to be a problem. In 2005-06, mortgage lenders dramatically increased their origination of sub-prime mortgages – those offered to consumers with low incomes and poor credit histories. Banks sold these mortgages to other institutions that repackaged them into securities that were then sold to investors, the latter being enticed by the high potential return on such securities. Often, consumers were enticed to take on such mortgages with low, teaser rates for the first few months. Then the mortgage would revert to a market interest rate[2]. While rates were low and home prices were rising, this was not a problem. Yet when interest rates rose and home prices stalled, holders of sub-prime mortgages started to default in large numbers.

In the past, when homeowners ran into trouble, the banks that originated their mortgages wound up in trouble. Indeed as recently as 1980 only 10% of US mortgages were securitized compared to 56% in 2006. Today, we face a situation where many of those sub-prime mortgages have been re-packaged, securitized, and sold to the secondary market where they have quickly disappeared – only to reappear in unexpected places when trouble developed. And that is how the credit crunch began.

Credit crunch

In the era before the Great Depression of the 1930s, economic downturns were usually called "panics." Why? The reason is that economic downturns usually resulted from sudden changes in financial market sentiment. People literally panicked when something went wrong such as a failure by a borrower to meet its obligations. The result was that people withdrew money from banks, banks failed to lend, and real economic activity declined.

Starting in the autumn of 2007, the world found itself in the midst of a panic of sorts emanating from problems in the US sub-prime mortgage market. The good news is that, unlike in the past, there are clever and powerful central banks that have the capacity to add liquidity to the financial system. Still, even when they inject liquidity, they cannot erase losses nor can they erase risk. Thus, there can still be consequences from financial failure. Such consequences are being experienced today and will probably persist for a while.

In the past, problems in the credit market were reflected in the solvency of banks. In the last two decades, however, securitization was supposed to reduce the likelihood of problems in financial markets by dispersing risk. And while risk was dispersed, it was not reduced. Instead, a new kind of risk has been created. That is, there is some uncertainty as to the location of risky assets. This lack of information, or lack of transparency has contributed to the seizing up of credit markets. Moreover, much of the risk turns out to reside with banks, often through off balance sheet vehicles. The difference now is that we often don't know where that risk resides until trouble emerges.

Several aspects of the financial environment contributed to this crisis. First, some mortgage originators did not undertake careful due diligence. Second, they had a strong incentive to lend to risky borrowers as investors, seeking high returns, were eager to purchase securities backed by sub-prime mortgages. Third, securitization has taken on new dimensions with the development of exotic derivative financial instruments for which there is not a substantial liquid market. The lack of liquidity meant that, when trouble emerged, these assets could not easily be dumped. Nor could they be easily priced.

What happens next?

As of this writing (November 2007), there is a high degree of uncertainty about the length and depth of the credit crunch. Thus, it is difficult to offer a short-term forecast. Instead, this publication will focus on the medium term outlook. The important question is how global growth will be affected by the turmoil in financial markets.

First, since the turmoil began, there has been a substantial re-pricing of risk. This is probably a good thing as markets had likely become sanguine about risk. Still, you can have too much of a good thing, and that is certainly the case now. Spreads on asset backed securities have widened and the markets for commercial paper, high yield bonds, and inter-bank lending have been dramatically squeezed. Major banks have written off sizable losses thereby adding to a constriction of credit. While the asset market that started this crisis was located in the United States, the impact has been trans-Atlantic. This is true, in part, because the assets in question were sold into a global market, mostly into Europe. Banks in Europe have experienced losses and credit conditions there have been negatively affected.

At the very least, the crisis will probably have a negative impact on US and, to a lesser extent, European growth during 2008. While numerous scenarios can be suggested, the most likely in our view is for either a moderate slowdown or mild recession in the US, moderate slowdown in Europe, and not much impact in Asia. Some countries that depend heavily on exports to the US will suffer accordingly. Latin America, in particular, falls into this category.

What are some alternative scenarios?

The possibility exists that the crisis could become larger or more prolonged due to economic contagion. That is, asset markets unrelated to the market for mortgage backed securities could suffer a loss of liquidity as credit markets seize up and as investors shun risk and seek safety. There is a long history of such contagion – although not all contagions have led to economic slowdowns. Contagion is not necessarily a result of rational assessment of risk, but it happens nonetheless and can have serious consequences.

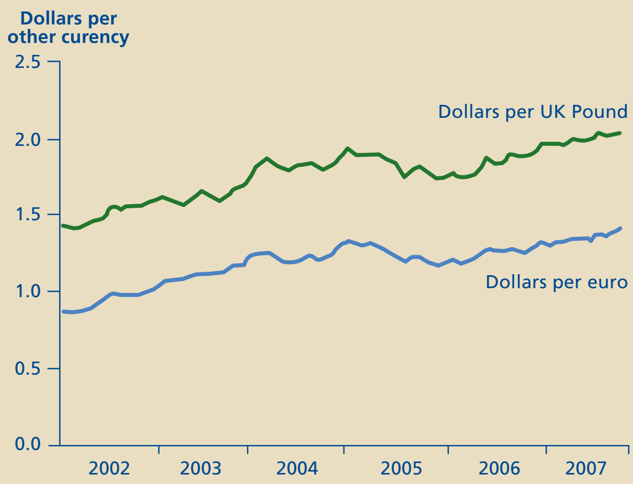
Another possibility is that the crisis will be prolonged by a failure to restore transparency, liquidity, and credibility to financial markets. This happened in Japan following the bursting of its financial bubble in 1990. The Japanese central bank failed to provide adequate liquidity and the Japanese government failed to adequately assist banks in cleaning up their balance sheets. The result was an unusually long period of stagnant growth and deflation. This scenario seems unlikely given the quick early responses by various central banks to the current crisis.

Finally, there remains the possibility that the current turmoil will not have much of an impact on the global economy at all. There is historical precedence for this. Recall the US equity market crash in 1987. The US Federal Reserve immediately pumped liquidity into the system and the economy probably grew faster than would otherwise have been the case. Now, following the credit crunch that began in August 2007, the Fed has reversed course by increasing liquidity and lowering interest rates – something that might not otherwise have happened so soon. The end result could actually be no change in growth with only the financial sector taking a hit.

Dollar movement

Meanwhile, as of this writing, the US dollar continues to fall in value. From 2002 until late 2007, the dollar fell 38% against the euro, 30% against the British pound, and 39% against the Canadian dollar. However on a trade-weighted basis, the dollar fell only 24% during this period. Why the difference? The answer is that many emerging countries with which the US trades have intervened in currency markets to keep their currencies from appreciating. Most notable, of course, is China. Yet China has been gradually revaluing its currency for the past two years and may accelerate that process.

Figure 3. U.S. Dollar Versus Major Currencies



Source: U.S. Federal Reserve

It was to be expected that, with a large US current account deficit, the dollar would fall. When financial market participants believed that, at a given exchange rate, the deficit was unsustainable, they removed support for the dollar. As the dollar falls, it causes import prices to rise and export prices to decline, thereby leading to an improvement in the current account deficit. This process should continue until financial market participants are convinced that the dollar is sufficiently low to bring the deficit to a sustainable level.

So far, the decline in the value of the dollar appears to have had a positive impact. Real imports have declined and real export growth has accelerated. Moreover, the current account deficit has begun to improve. Yet the dollar will probably fall further. A decline in the value of the dollar acts with a lag. Financial market participants, however, tend to push the dollar down until they are convinced that the dollar level is sustainable – and they probably don't think it is at this point in time.

In addition, there are other factors that are putting downward pressure on the dollar. Interest rates in the US which are lower than in Europe tend to put downward pressure on the dollar. In addition, the fact that many central banks are known to be rebalancing their foreign currency portfolios away from dollars is also having a negative effect on the dollar.

The biggest concern about a falling dollar is that it could be inflationary in the US if it causes a sizable increase in import prices. This hasn't happened yet, but could as the dollar falls further. Until now, many importers have absorbed the exchange rate movement by allowing for lower profit margins. Yet this cannot go on forever, and ultimately import prices will have to rise. When that happens, it could inhibit the flexibility of the Federal Reserve to lower interest rates. This is important given the continuing problems in credit markets.

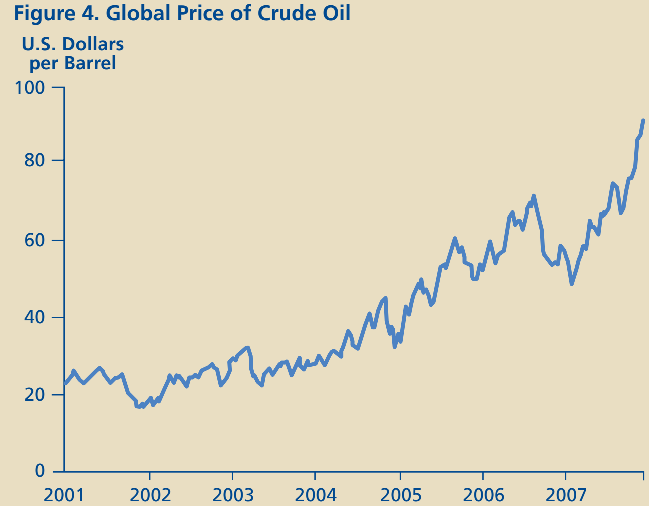
On the other hand, a declining dollar means a rising euro, pound, and yen. For Europe, Britain, and Japan, this means deflationary pressure and, therefore, more flexibility for these country's central banks to lower interest rates without sparking inflation.

Finally, a rapid decline in the value of the dollar remains a possibility. Financial markets have been known to become volatile when investors panic. Given the uncertainty in credit markets, currency market volatility could become a problem. A rapid drop in the dollar could be destabilizing to financial markets and might require currency intervention by major central banks in order to restore stability.

The price of oil

Why has the price of oil jumped five-fold in the past five years? And why has the global economy done so well despite this rise? The answers to both questions are related. The price of oil rose, in large part, due to the strength of the global economy and its impact on the demand for oil. In fact, the global economy in this decade has grown faster than at any other time in recorded history[3]. A significant portion of this growth was attributable to the rise of China and India. Notably, both countries subsidize the cost of energy, thereby encouraging highly inefficient use of energy. Thus, it should be no surprise that so much of the world's increased demand for oil came from these two countries. This is quite different from oil price spikes of the past, many of which were due to a drop in supply rather than an increase in demand.

Figure 4. Global Price of Crude Oil



Source: Energy Information Agency

The price of oil has also risen because the capacity to produce oil has not kept pace with rising demand. Why not? After all, a rising price should encourage producers to explore for more oil and develop new productive capacity. Yet it takes time for new investments to bear fruit. Moreover, when the price of oil started to rise earlier this decade, many producers were not convinced that the increased price would be sustained. Consequently, they were reluctant to take on new investments that might not be profitable should the price reverse. Finally, much potential new capacity exists in countries where governments, rather than private investors, decide whether to undertake new investments. In many countries, the high price has enabled governments to accumulate cash, pay off debts, and flex political muscles. New investments, which would have siphoned off much of that cash, were not considered a high priority – especially when the payoff was seen as far off in the future. The result has been very slow development of new capacity.

There are other factors influencing the price of oil. Political risk surely plays a role. An increased threat of war in an oil producing country always leads to a higher price. Political or social turmoil in an oil producing country often reduces both investment and current output. Consider Iraq, or Nigeria. Finally, the declining value of the US dollar tends to have a positive impact on the dollar price of oil.

Where do we go from here? There is no easy answer to this question. The good news is that the world has collectively managed to absorb a huge price increase without much economic cost. That is partly due to the fact that, following the oil shocks of the 1970s, there was a massive investment in improved energy efficiency. Today, the world can better absorb higher energy prices than in the past. Still, there are limits. It is probably safe to say that further substantial increases beyond the current price ($97 as of early November 2007) could be onerous, both for economic growth and inflation.

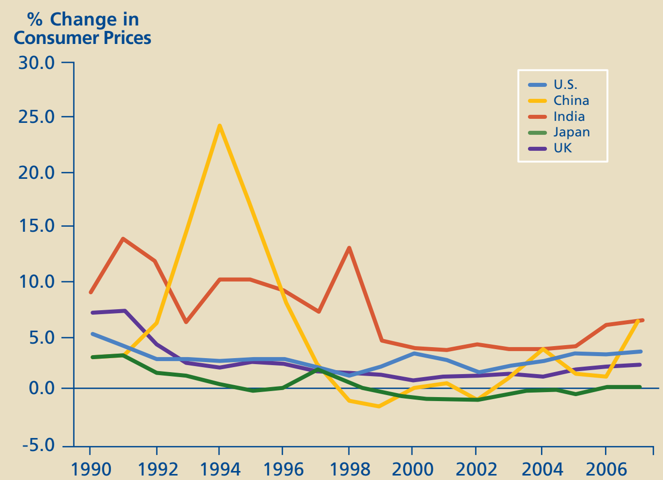
The future direction of the price of oil will be the result of several factors. First, consider demand. If the US economy slows down in 2008, the price of oil would probably fall. Second, exchange rates matter. If the US dollar continues to fall in value (which is likely), there will be pressure on the price of oil. Finally, much will depend on the political situation in several oil rich countries or their neighbors.

One school of thought[4] holds that, with the rapid growth of China and India, we're now in an era similar to what transpired in the immediate post-war era in the 1940s and 1950s. Then, the rapid growth of the global economy spurred very rapid growth in the demand for energy – far higher, in fact, then what we've experienced since the late 1960s. At that time, however, oil supplies were in abundance and demand was met without high prices. It would be expected, however, that higher prices would constrain demand. Indeed, this may happen – especially in developed countries. Yet the strong economic growth in emerging countries will probably overwhelm the effect of rising prices on demand. Given today's supply constraints we may be entering an era of relatively high oil prices.

Is inflation coming back?

One of the sterling economic accomplishments of the past generation was the end of serious inflation in most major countries. Yet in 2006-07, inflation began to rear its ugly head in many major countries. Inflation accelerated in the US, the European Union, China, and India. Are we in danger of a new era of inflation? And, if so, what would this do to economic growth?

Figure 5. Inflation in Selected Countries



Source: U.S. Bureau of Labor Statistics and IMF

First, let's consider why inflation went away. There were four major reasons:

First, monetary policy got better. Independent central banks in both developed and emerging nations consistently kept money supply growth under control so that inflationary expectations were reduced. This is critical. After all, if expectations for inflation are low, workers and businesses will be less aggressive in seeking higher wages and prices respectively.

Second, globalization has had a salutary effect on inflation. The massive increase in the global labor force and in global productive capacity put downward pressure on prices.

Third, money supply growth influenced asset prices rather than goods prices. Goods inflation takes place when too much money is chasing too few goods. In this case, that money chased assets such as equities and property.

Fourth, the accelerated improvements in information technology in the past two decades contributed to rapid productivity growth. This enabled stronger economic growth without creating inflationary pressures.

So why is inflation now on the rebound? There are several reasons:

First, the global economy has been growing at an exceptional pace, thereby putting upward pressure on commodity prices – including oil.

Second, in many countries there has been very rapid growth of the money supply. In China, for example, rapid money supply growth stemmed from central bank currency intervention aimed at suppressing the value of the Chinese currency. As discussed above, much of that money supply growth fueled asset prices. Yet it appears that it is finally having an impact on goods prices as labor and product markets have become tight.

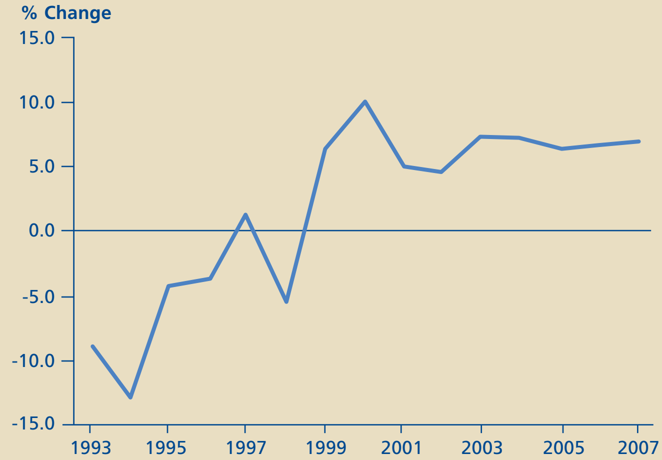
Finally, the declining value of the dollar is likely to be inflationary in the US as well as in those countries that tie the value of their currencies to the US dollar. This includes many emerging nations.

What happens next? As Alan Greenspan suggested in his recent memoirs[5], central banks may soon face a more challenging environment in which to control inflation. The favorable impact of globalization on inflation has been a temporary phenomenon that will eventually end. The entry of China and India into the global economy, by adding huge numbers of low wage workers to the global pool of labor, put downward pressure on wages and prices. Yet the process of integrating these giant countries into the global economy will not last forever. Once largely completed, that particular restraint on global inflation will be removed and central banks will face a somewhat worse environment. Figuring out the timing of that transition will be difficult.

Russia

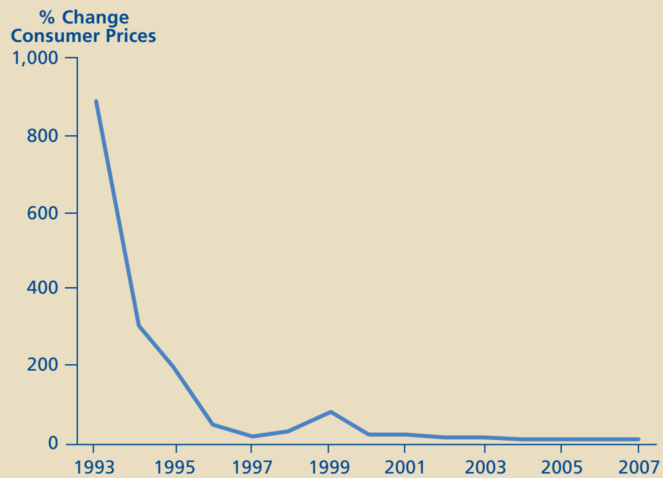
Russia's economy has grown exceptionally fast in recent years. In 2007, growth will probably come in above 7%. As a result, Russians are wealthier and are spending money, the government is flush with cash and is investing in much needed infrastructure, and foreign investors are eager to participate in an apparent boom. Yet the question arises as to the sustainability of Russia's sudden success. Is it simply a result of high oil prices, or has there been a structural change in Russia's economy that warrants high growth regardless of the price of oil?

Figure 6. Russia Real GDP



Source: IMF

Figure 7. Russian Inflation



Source: IMF

The answer is that oil has probably played the dominant role. Still, the high price of oil has given Russia much needed breathing room to get its house in order. So in that sense, there have been some structural changes. The high price of oil has enabled the government to dramatically improve its fiscal position, reduce external debt, improve its credit rating, and accumulate a vast reservoir of foreign currency reserves, thereby reducing the risk of default or sharp currency fluctuation. In addition, the government has instituted a tax system that has attracted global attention. The rise in incomes has stimulated the consumer sector and made Russia an attractive market for foreign companies interested in selling to Russian consumers and businesses.

On the other hand, the government is gradually re-nationalizing the energy sector, intimidating foreign companies and domestic entrepreneurs through prosecutions, and acting in a heavy-handed manner with respect to its Western energy customers. The business environment is not conducive to the kind of investment that would enable the economy to grow absent high energy prices. Therefore, the economy appears to be at risk if energy prices fall.

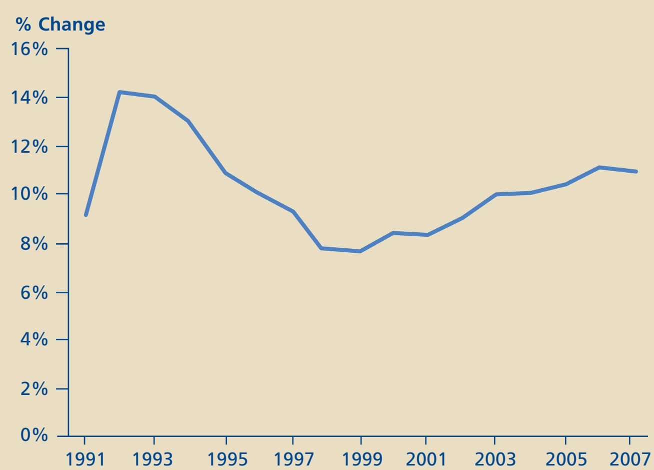
As Russia is highly dependent on natural resource exports, it is starting to suffer from what is known as the "Dutch disease." That is, a vast injection of foreign currency has put upward pressure on the currency, thereby hurting the competitiveness of non-oil exports. In addition, high inflation (relative to other countries) is causing an inflation adjusted appreciation in the value of the ruble, thereby hurting export competitiveness as well. The World Bank recently reported[6] that Russia's unit labor costs in manufacturing have risen considerably, thereby harming non-oil export competitiveness. Thus it should not be surprising that fixed investment in Russia remains an unusually low share of GDP compared to other emerging countries. Moreover, investment in the energy sector has been weak. This means that output is not likely to expand much in the near future.

The bottom line for Russia is that, although growth is currently strong, the economy remains vulnerable on a number of fronts. The price of oil, the rising value of the currency, and relatively high inflation all put the economy at risk. Efforts to control inflation could stymie growth. Therefore even if the price of oil remains elevated, there is a risk that growth could slow down.

China

China's economy is finally showing signs of overheating. In October 2007, consumer prices were up 6.5% over the previous year, a considerable change from the deflation that was prevalent in the early part of this decade. This figure probably understates the extent of inflationary pressure as China's government controls many domestic prices. A very disproportionate share of the current inflation is due to food prices. Of course a very high share of consumer spending is on food, so this matters a great deal.

Figure 8. China Real GDP

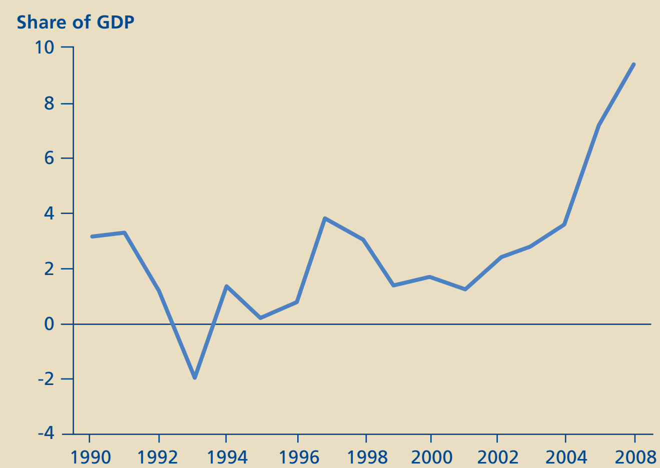


Source: IMF

Relative food prices have been buttressed by several factors: global commodity price increases, shifts in land usage away from farming in China, environmental damage to agricultural land, and failure to allow farmers full property rights, thereby reducing the amount they are willing to invest in their land. Instead, China is importing food on a large scale, especially from neighboring Asian countries. This increased demand for their exports is contributing to increased global commodity prices.

Why is inflation on the rise? The economy is growing very rapidly, putting upward pressure on wages in a tight labor market. This strong growth is due, in part, to rapid money supply growth. The latter is principally due to the fact that the government has intervened to hold down the value of the currency (renminbi) and has failed to fully sterilize the monetary impact of currency intervention. Sterilization takes place when the government issues new bonds in order to absorb the money created when it purchases foreign currency. The problem has been that, in order to find a market for such bonds, the government must keep offering a higher return. As interest rates in China have thus increased, more speculative money has flowed into China in order to take advantage of higher rates. Investors are also speculating that China will ultimately be forced to substantially revalue the currency. Yet the government must purchase this inflow of money in order to hold down the currency. A vicious cycle is thus created. Moreover, it cannot go on indefinitely. Sooner or later, the government will have to substantially revalue its currency in order to quell rising inflation. This is of critical importance because inflation is, and has been, an important cause of social unrest – both in China and elsewhere. Reducing inflationary pressures is likely to be a significant goal of Chinese economic policy.

Figure 9. China Current Account Balance



Source: IMF

What happens next? If China revalues its currency further, inflationary pressures will be abated. Exports, however, will probably not suffer much. Some export capacity will shift toward China's interior where wages are lower. In addition, the shift toward higher value added exports will continue. Such exports are better able to absorb the impact of a higher valued currency as they have a smaller labor component.

Currency revaluation will make imports cheaper. This will stimulate domestic demand and help China in its transition away from excessive dependence on exports. Still, exports will remain an important component in China's growth arsenal. What happens, then, if the US economy slows down? For China, the good news is that there has been some decoupling from the US economy. In recent years, an increasing share of exports has gone to Europe rather than to the US. So a US slowdown will be less detrimental to China than would have been true in the past. Nevertheless, it will have some negative impact.

China's relationship with Europe, however, is becoming troubled. As the US dollar has fallen in value against the euro and the pound, and as China's currency has remained relatively fixed against the dollar, the result is that the renminbi has fallen in value against Europe's currencies. This has hurt European exports to China and has caused an increase in protectionist sentiment in Europe aimed principally against China. Thus, if China does substantially revalue the renminbi, it will stimulate the flow of European goods to China.

Aside from the currency issue, China has a number of challenges that it must navigate if it is to maintain high growth and stability. Most importantly, China must continue the process of privatization of state owned enterprises in order to encourage more efficient use of capital. This will relieve China's banks from the necessity of supporting state owned companies and will improve the efficiency of the capital markets. Of concern, however, is the fact that investors have shown what might be considered irrational exuberance about privatization. New share issues have attracted so much demand that some observers are worried about yet another financial bubble.

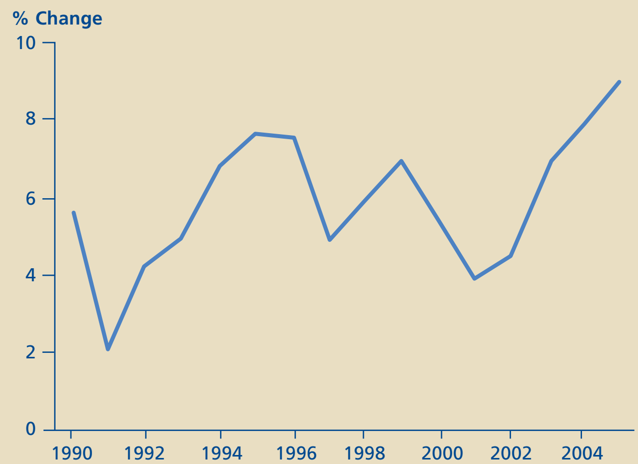
In the longer-term, China's economy will face some daunting challenges. These include environmental degradation and the associated public health costs, maintaining adequate supplies of skilled labor in an increasingly sophisticated economy, rising protectionism in the US and Europe, and the rising cost of raw materials.

Finally, it should be noted that, despite all the hype about China's importance in the global economy, China remains a very poor nation. A recent survey conducted by the Asian Development Bank found that, when utilizing improved measurement techniques, China's economy is found to be about 40% smaller than previously estimated. The number of poor people is actually considerably higher than previously thought. This does not take anything away from the incredible progress that China has made. Yet it does indicate that China has a long way to go before it reaches the dizzying heights often predicted by analysts.

India

India is gripped by euphoria – and not surprisingly. After all, the country has been growing faster than ever in the past few years. Since 2003, growth has consistently averaged above 8%. Growth was roughly half that figure during the prior four years. Indian conglomerates are flush with cash and are starting to cast a shadow on the global stage. India's vast army of university graduates, no longer departing the country in large numbers, is now sought after by global and local companies eager to export thoughtware by satellite. Foreign investors are eagerly injecting money into India, betting that the strong growth will continue apace. So is there any reason to worry?

Figure 10. India Real GDP



Source: IMF

Unfortunately, yes. There are some causes for concern. For example, the vast majority of foreign investment is in the form of portfolio investment rather than direct investment. Much of it is going into the equity markets, helping to drive equity and property prices to dizzying heights. This form of investment is worrisome as money can flow out just as easily as it can flow in. This sets the stage for potential financial market turmoil if and when the emerging market equity bubble bursts.

Another problem is that India's government continues to run a large budget deficit (roughly 4% of GDP). Thus the government is eating up a portion of domestic savings, thereby increasing the cost of capital. This subtracts from potential investment in productive capacity.

Consequently, India's business investment and investment in human capital remain weak relative to the needs of a rapidly growing economy. This imbalance cannot endure. In addition, inefficiencies in India's labor and product markets, the result of excessive regulation, also inhibit long-term growth. Failure to enact reforms, improve fiscal discipline, and invest sufficiently in human capital and infrastructure, could ultimately result in slower growth.

On the positive side, India's strong economic growth appears to be the result of two important sectors. First, and not surprisingly, the service sector – notably financial and business services but also trade, hotels, and restaurants – has contributed significantly to India's growth acceleration. The only thing likely to hold this back is the supply constraint on human capital. Secondly, and a bit at odds with conventional wisdom, the manufacturing sector has accelerated significantly. This is particular welcome as India probably cannot maintain breakneck growth based on business services alone. Manufacturing will be critical to improving the lot of the relatively uneducated masses.

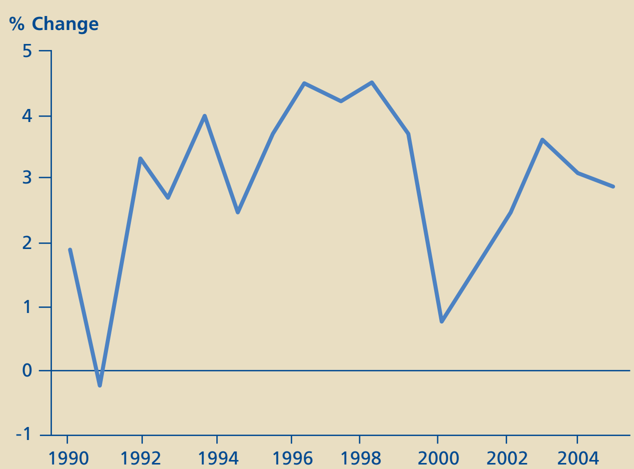
Interestingly, the preponderance of manufacturing growth is due to domestic demand rather than export demand. The former has been fueled by the strong liquidity that has also fueled the growth of the financial sector. That liquidity is, in part, the result of large capital inflows from overseas. Unfortunately, the net effect of this has been to cause a currency appreciation which will damage the competitiveness of exports.

The government thus faces a delicate balancing act in the near term. It must avoid inflation while at the same time avoiding excessive constriction of credit. The latter could burst the property price bubble and thereby crimp domestic demand. That would do damage to the nascent expansion of the manufacturing sector.

USA

The big question regarding the US economy is whether there will be a slump or simply a slog. The answer depends largely on what the consumer does in response to the housing market debacle. As of this writing, the economy has not slowed down yet despite trouble in the housing market. Residential investment has dropped sharply but consumer spending, other than on home-related products, has not. Moreover, export growth has accelerated.

Figure 11. U.S. Real GDP



Source: U.S. Bureau of Economic Analysis

Is this situation sustainable? The answer depends on the degree to which the wealth effect of housing is important. In recent years, it has been very important. As home prices rose, millions of homeowners were able to liquidate the extra equity in their homes by refinancing their mortgages. This accounted for a sizable share of the growth of consumer spending. Now that interest rates are higher and home prices are falling, the opportunity for consumers to acquire extra cash is considerably reduced. Yet they keep spending. Rather than borrow against their homes, they're simply borrowing with credit cards. Much like a college student intent on staying out until dawn, consumers are seemingly unable to accept that the party is over. If the negative wealth effect of the housing situation kicks in, growth will slow. This seems to be a very likely scenario. After all, as of November 2007 there is a large inventory of unsold homes. This implies that prices will have to fall further in order to restore equilibrium to the market.

There are, of course, other factors that will influence the path of the US economy. The credit crunch will have a temporary negative impact on bank lending for business investment as well as mergers and acquisitions. Consequently, investment growth could be constrained. The high price of oil is already having a negative impact on spending by relatively lower income consumers. And the continuing drop in the value of the dollar will restrict the ability of the Federal Reserve to lower interest rates without stimulating inflationary pressures.

The housing market itself, other than the wealth effect of declining home prices, will be important. As of this writing, housing starts are already down 47% from their peak. This has had an impact on construction employment. In addition, declining sales of new and existing homes has a negative impact on consumer spending on home related products. The high rate of defaults on sub-prime mortgages is already influencing lending standards by banks leading to a more constricted market for consumer credit. Finally, throughout early 2008 there will be a high number of resets of adjustable rate mortgages (ARMs). At the least this will reduce consumer cash flow. Worse, it could lead to more mortgage defaults and further problems in the market for mortgage backed securities.

In sum, the US economy is likely to slow significantly in 2008 and there remains a strong possibility of a recession. On the other hand, if US economy does take a temporary detour from strong growth, it is likely that a downturn will be mild and short-lived. The lower dollar is already helping to restore a positive impact from net exports. In addition, the economy has become far less volatile in the past. This is due to a greater reliance on services rather than goods. It is also due to far better inventory management than in the past.

On the other hand, the potentially inflationary impact of a declining dollar may restrain the Federal Reserve from aggressively lowering interest rates. In this case, the economic recovery, when it comes, could be muted. In fact, the Federal Reserve recently issued a report suggesting that the rate at which the US economy can grow without sparking inflation is lower than previously thought. Therefore, it might be expected that the Fed will be especially cautious in the near future.

Western Europe

The good news from Europe is that the continent is less dependent on stimulus from the US than in the past. This "decoupling" means that, in the event the US economy slows significantly, the impact on Europe will be somewhat limited. The other good news is that, with strong currencies (euro, pound), Europe's central banks will have some leeway to lower interest rates without concern about inflation. This could be important as the strong currencies are hurting export growth. Thus it will be important to stimulate domestic demand.

There is, however, some bad news. First, some European countries are at risk from inflated housing prices. Of particular concern are the UK, Spain, and Ireland. Property price bubbles have probably supported consumer spending growth as well as construction related employment growth. A reversal of such bubbles could have negative consequences for economic growth.

Second, although Europe is less vulnerable to US demand than in the past, it remains quite vulnerable to contagion from US credit market conditions. Some financial institutions in Europe have already experienced sizable losses and others may follow. This results from their holding of securities backed by US sub-prime mortgages. How this plays out is hard to predict. Equally important, a collapse of housing prices in any of the inflated European markets could create financial losses for European banks and lead to a constriction of credit.

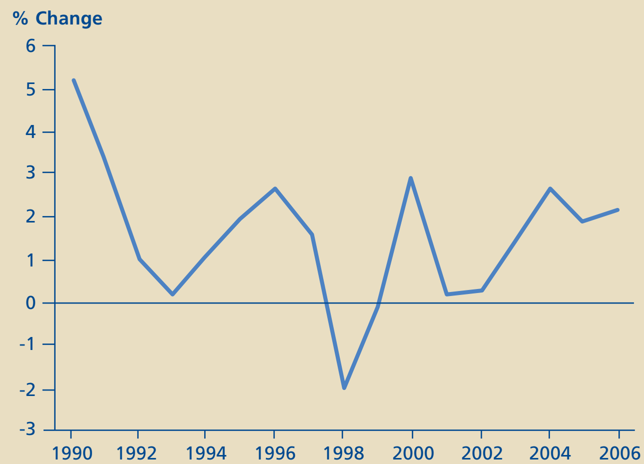
Third, the rising euro is already having a negative impact on export growth. While forecasting exchange rates is an almost useless exercise, the reality of an elevated euro is particularly challenging for manufacturers based on the European continent. Some are already struggling to cut costs in order to offset the exchange rate impact. A shifting of capacity outside of Western Europe could take place as well.

Longer term, Europe's economic performance will be determined by structural factors. These include regulation of the labor market, taxation policy, competitive policy, subsidies, and the degree of trade restrictions. In each of these areas, there appears to be a general consensus among political leaders that policy should move in the direction of liberalization. Yet action has been politically difficult and the outlook must be considered uncertain. In Germany there is concern that, due to high tax revenues and a balanced budget, the government might squander opportunities for reform. For example, there is talk about extending the length of unemployment benefits.

Japan

Japan continues to muddle along. After a few years of moderately healthy economic growth, Japan appears to be slowing. Consumer spending and investment have slowed, leaving exports as the primary driver of the economy. Exports to China, Europe, and the US have been strong, especially as the yen has remained relatively weak for the past three years – although it has begun to rise against the US dollar this year. Still, the yen's weakness, especially against the euro, has been an important factor in export growth. Now, with the prospect of a slowdown in the US in 2008, export growth could weaken. On the other hand, Japan, like China, has decoupled somewhat from the US. Given the strength of exports to China and Europe, a slowdown in the US will not have as severe an impact on Japan as would have been the case in the past.

Figure 12. Japan Real GDP



Source: U.S. Bureau of Economic Analysis

Looking ahead, it seems likely that the yen will rise in value. In part this will be due to the unraveling of the yen carry trade[7]. As investors expect the yen to rise, they will unwind their carry trade positions, thereby actually putting upward pressure on the yen. This appreciation will dampen export growth and contribute to Japan's continuing deflation. The latter is worrisome as the Bank of Japan has actually tightened monetary policy during the past two years, despite declining prices. Deflation hurts the financial sector and inhibits new business investment. Whether this policy will be reversed is hard to say.

On the positive side, Japan appears to be relatively immune to the impact of higher energy prices. That is because Japan is much less dependent on oil than in the past. Japan now has better energy efficiency, less use of fossil fuels (more nuclear), and less use of oil compared to other fossil fuels (LNG, coal) than in the past. The result is that higher energy prices are not having a serious impact on growth.

Surplus countries invest rather than hold bonds

One of the most notable economic events recently has been the rapid growth of so-called sovereign wealth funds. These funds, the result of massive surpluses, are likely to continue growing, especially in emerging countries like China, Russia, and the Middle East.

The growing size of sovereign wealth funds is indicative of excess currency reserves accumulating in the coffers of central banks of several countries. This development is a direct result of a surge in export revenues in the last five years of resource abundant countries (Persian Gulf, Russia) and countries that have been export powerhouses (China).

Traditionally emerging countries' central banks have invested their excess reserves in US Treasury bills. However, investments in corporate bonds and equities through professional fund managers offer governments an opportunity to earn higher returns on their burgeoning reserves. For example, Norway's 'Government Pension Fund-Global' has generated an annual nominal return of 6.5% since 1997. Many governments are following Norway's footsteps and choosing wealth funds as vehicles for their investments abroad.

With $1.4 trillion in reserves, China has the largest pool of currency reserves to invest. China has announced plans to infuse US$200 billion in a new sovereign wealth fund under the aegis of China Investment Corporation.

According to research done by Standard Chartered and Oxford Analytica, the top twenty known sovereign wealth funds have over US$2 trillion to invest. The top seven such funds within this group, with more than US$100 billion each, belong to Abu Dhabi (part of the UAE), Singapore, Norway, Kuwait, China, and Russia. The Abu Dhabi Investment Authority (ADIA) and the Government of Singapore Investment Corporation control two of the largest funds with estimated assets of US$875 billion and US$330 billion respectively.

The future of sovereign wealth funds

There are numerous estimates as to where this situation is likely to go. Deutsche Bank Research estimates that sovereign wealth funds could be managing assets of over US$5 trillion within the next five years and more than US$10 trillion within the next ten years. Morgan Stanley predicts that these funds could grow from the present level of US$2.5 trillion to US$12 trillion by 2015 and could exceed the total pool of official reserves held by the world's central banks by 2011. Standard Chartered Bank predicts that these funds, estimated at US$2.2 trillion at present, could be managing US$13.4 trillion worth of assets a decade from now. Finally, Merrill Lynch Global Research says that such assets could grow from US$1.9 trillion in 2007 to US$7.9 trillion by 2011.

Do these predictions make sense? That depends on the assumptions on which they are based. Most such predictions are based on three essential assumptions. First, it is assumed that oil prices will remain relatively high. Consequently, oil exporters will continue to accumulate surpluses. Second, it is assumed that China will continue to be an exporting powerhouse and that the US will continue to run a large current account deficit. As such, China is expected to accumulate surpluses as well. Finally, it is assumed that the already large pool of funds in the hands of governments will obtain good returns. Thus, even absent continuing surpluses, the size of these funds is expected to grow.

Evaluating these assumptions is difficult. First, a sustained high oil price, while not out of the question, would certainly be a deviation from past experience. Second, the US current account deficit is likely to decline. Indeed, this is already happening. Moreover, China's surplus will probably decline as will the surpluses of other emerging countries. This should slow the growth of the pool of sovereign wealth funds. Thus, while these funds are indeed likely to grow, there is reason to expect that such growth will slow down.

On the other hand, these funds are already large and significant. They are becoming more aggressive investors and are likely to be important contributors to hedge funds, private equity funds, and will even be important as direct participants in merger and acquisition activity. This is not much different from the role already played by government run pension funds in developed economies. The pension funds of some US state and local governments are already huge investors.

What is different here is that the funds in question are mostly coming from emerging countries. There is a fear that there will be a political component to investment decisions. There is also a fear that hostile governments could seek to take control of assets considered to be of strategic importance to certain countries. Whether or not these fears are warranted, they could have an impact on the degree to which countries are open to foreign investment. New limitations on such investments could have a negative impact on global merger and acquisition activity.

More likely, however, sovereign wealth funds will simply become significant players in global financial markets. Most will probably be managed in a professional manner, much like the already well respected funds of Norway and Singapore.

What might be the impact on global financial markets? Sovereign wealth funds are taking over the management of assets that used to be classified as foreign currency reserves of central banks. Most such funds have been invested in US Treasury securities. As funds rapidly move away from central banks to be invested, this could entail downward pressure on the value of US government bonds, downward pressure on the value of the US dollar, and upward pressure on equity prices.

One of the good things about sovereign wealth funds is that, unlike private sector funds, they are not highly leveraged. They are not likely to face a necessity of liquidating positions in the event of higher interest rates, capital losses, or regulatory changes. Moreover, they are mostly likely to be long-term investors and, therefore, are unlikely to roil financial markets by short-term trading. On the negative side, many of the existing funds lack the kind of transparency ordinarily characteristic of private sector funds. This lack of information could cause financial market volatility during periods of financial market stress. One possibility is that Western governments will ban sovereign wealth funds from taking controlling stakes in companies in certain key industries such as aerospace, energy, or high technology. Another possibility is that such funds will be required to be independently managed with a high degree of transparency before being able to participate in certain financial markets.

Thinking about the long-term

There is a tendency to become panicked over short-term economic volatility. The current turmoil in financial markets is particularly worrisome to those without a memory of past downturns. Yet in developed markets, long-term GDP growth rates have tended to be fairly steady over long periods of time. Hence, although a short-term drop in growth will have a short-term negative effect on employment and business profitability it does not necessarily imply that longer-term growth rates have changed. Thus, long-term planning need not take undue account of short-term circumstances. It should, instead, be based on expectations of long-term growth.

On the other hand, long-term rates of growth can change for a variety of reasons. The most notable example is the long stagnation experienced by Japan following the collapse of the "bubble economy" in 1990. This was followed by a succession of poor policy responses that resulted in unusually slow growth until quite recently. Another example would be the major economies of continental Europe. Starting in the late 1970s, they adopted policies that rigidified their labor markets, protected companies from competition, and placed regulatory restrictions on companies. The result was that, starting in the 1980s, growth was significantly slower than before.

Today, there is fear that, after a period of unusually strong global growth, the recent financial problems could augur a new era of slower growth. Is this possible? Yes. Is it likely? No. Barring radical changes in policies, it is reasonable to expect that long-term global growth will not change radically either. On the other hand, long-term growth could change in some countries. Consider the following possibilities:

China

Due to a slower birth rate over the past two decades, the labor force will grow more slowly in coming years. Absent acceleration in the growth of productivity, this could lead to a slowdown in economic growth. On the other hand, privatization of the financial system will lead to more productive business investments. A better return on investment could lead to accelerated growth.

USA

A new era of rising commodity prices combined with a declining dollar could drive the Federal Reserve to maintain tighter monetary policy in order to restrain inflation. This could mean somewhat slower long-term growth.

European Union

Reforms that liberalize the labor market in major countries could lead to expanded employment as well as more efficient deployment of labor. The result could be a temporary acceleration in economic growth.

Endnotes

[1] For a thorough analysis of the global imbalance, see Deloitte's Global Economic Outlook 2007, published in October 2006.

[2] According to Nouriel Roubini, in 2005-2006 roughly 50% of *all* mortgage originations involved such incentives as no down-payments, interest rate only mortgages, negative amortization, and low teaser rates. See Roubini, Nouriel, The First Crisis of Financial Globalization and Securitization, Oct 22, 2007, www.rgemonitor,com.

[3] The size of the global economy is measured using PPP (purchasing power parity) exchange rates. The goal here is to accurately reflect the true purchasing power of each country's currency.

[4] See Verleger, Philip, *The Coming Triple Digit Oil Price*, The International Economy, Fall 2007

[5] Greenspan, Alan, The Age of Turbulence, Penguin Press, 2007

[6] Russian Economic Report, World Bank, Nov 2007. Unit labor costs are the labor costs of producing an additional unit of output.

[7] The yen carry trade involves investors borrowing yen at a low interest rate and purchasing high yield securities in other countries (such as New Zealand). The investment pays off as long as the yen fails to appreciate significantly during the life of the investment.

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Ira Kalish is Director, Global Economics and Consumer Business at Deloitte Research. He specializes in global economic issues as well as the effects of economic, demographic, and social trends on the global retailing and consumer products industries. Mr. Kalish conducts research on global economic issues and has authored in-depth reports on economic and consumer issues in many of the world's major countries. In addition, Mr. Kalish has been widely quoted in the news media. His remarks have been published by The Wall Street Journal, Business Week, The Economist, The Financial Times, and USA Today to name a few. Mr. Kalish holds a bachelor's degree in economics from Vassar College and a Ph.D. in international economics from Johns Hopkins University.

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