

Global Economic Outlook August 2009

The future trajectory of the global economy will be determined by two factors – how potent the extraordinary policy stimulus ultimately proves to be and whether the growth potential of the major economies has been permanently dented by the global financial crisis. The jury is still out, but the prospects don't look good on either count – we expect it to be a slow grind higher rather than a quick return to form for much of the globe.

Policy - every which way and loose

There's certainly no questioning policymakers' commitment to get things moving again. In fact, on the stimulus front there's never been anything like it, either in scale or scope. Interest rates have been cut towards zero across much of the world. In the UK and the US strenuous efforts have been made to lower longer-term interest rates and to help lower the cost of credit for households and firms through massive asset purchases. Indeed, the Bank of England and the US Federal Reserve are each well on their way to purchasing £175 billion and \$1.5 trillion of assets (equivalent to 12% of their respective economic output in 2008). Record post-war budget deficits hint at the massive support from governments around the world.

But set against this gargantuan effort is the fact that policy stimulus just isn't what it used to be. In part, this is because of the turmoil in the global financial system, which prevents lower policy rates from feeding through as thick and fast to the wider economy. Moreover, in much of the developed world, households and firms have exhausted their appetite for debt – lower interest rates are facilitating balance sheet repair (repaying debt) rather than boosting spending. Many emerging markets have also struggled, as access to global capital markets has been curtailed.

Clouds gathering over the medium-term

Ultimately, economic growth is determined by increases in the size of the working population and productivity growth (how much extra output firms can get out from a stock of inputs). Over the medium to long term the situation looks challenging on both fronts for the world's advanced economies. There are political pressures to limit immigration, while, further out, demographic trends point to a slower rate of natural increase in the labour force. Productivity is notoriously difficult to project, as it relies heavily on the rate of technological change. Nevertheless, there are a number of clear headwinds.

Investment, which affects the size and quality of the capital stock, has been severely curtailed, and will dent productivity for a number of years. Before the crisis, the compensation demanded by investors for taking on risk had been bid down to unusually low levels as benign economic conditions were expected to last indefinitely. The situation has shifted decisively, and as a result, the cost of capital is likely to be permanently higher, acting as an ongoing drag on investment. The damage inflicted on public finances is also a factor. Sharp increases in public debt will increase competition for the pool of global savings. Eventually this will push up long-term interest rates, "crowding out" private investment. The shape of the economy is also likely to shift. Moving resources from one sector to another will dent productivity during the period of transition.

Trending down?

For these reasons, trend rates of growth are probably lower – for example, trend growth in the UK and US is likely to be closer to 2% rather than the 3% we became accustomed to before the global financial crisis struck. Emerging markets face challenges too, but are still expected to outperform their industrialised counterparts. After all, there is still plenty of scope for "catch-up" – especially in China, which will act as an important growth engine for the wider Asian region. Productivity tends to rise much more rapidly, as technological advances are absorbed and labour moves from agriculture to industry/services. The worst is over, but the road to recovery will be long and winding. (RG)

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United Kingdom – (Re) Balancing act

The Bank of England has been amongst the most aggressive of central banks in battling the downturn, slashing rates to 0.5% and purchasing c15% of the stock of UK government bonds in a bid to breathe life back into the economy. This is already the worst downturn in a generation, but the tide may be starting to turn, with signs of stabilisation in the manufacturing and service sectors (chart 1). Nevertheless, it's likely to be a case of "bumping along the bottom" over the next twelve months, rather than a return to the strong rates of growth we experienced pre-crisis. Little progress has been made in repairing finances - this will exert a drag for some time to come.

Chart 1: Activity appears to have stabilised in both manufacturing and service sectors (diffusion index)

Source: Purchasing Managers' Indices, Markit/NTC

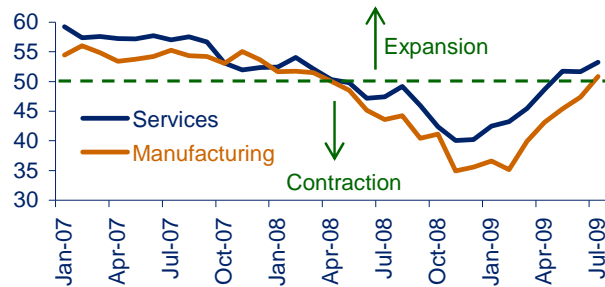
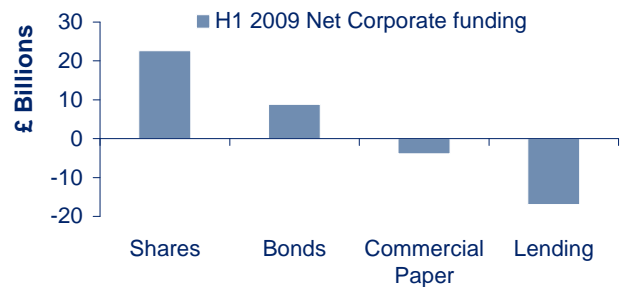


Chart 2: Non financial corporations have made progress restructuring balance sheets

Source: Datastream



All guns blazing

As of June, the UK economy had shrunk by c6% during this recession. In Q1 alone, activity declined by 2.4% - almost as much as during the entire 1990s recession (which lasted fifteen months). Against this backdrop, perhaps it isn't too surprising that the Monetary Policy Committee is taking no chances. It plans to inject £175bn into the financial system - equivalent to 12% of the UK's output in 2008 - by purchasing assets, mainly government bonds. Gauging the success of these measures isn't easy, as we don't know what would have happened without them, but the evidence we have is encouraging.

Tensions in financial markets have eased. The spread between the Bank Rate and the rate at which banks will lend to each other (LIBOR) has narrowed steadily. The BoE's purchases of government bonds have helped to keep longer-term interest rates down - capping the cost of mortgages and longer-term business borrowing. This has also persuaded investors to consider the higher returns offered by corporate bonds, which has improved financing conditions for firms (as evidenced by the narrowing spread between the interest rates on corporate and government bonds).

The easing in financial conditions appears to have helped activity to stabilise. Surveys of output in the manufacturing and service sectors have moved up from the record lows seen at the start of the year. But a lasting recovery requires a sustained improvement in demand - it's not clear that the foundations for this have yet been laid.

Progress on balance sheet repair remains disappointing.

The transition to a more sustainable growth path is likely to require a reduction in the indebtedness of households and firms. In the corporate sector, some headway has been made. Businesses have been raising equity to reduce their dependence on debt finance. Larger firms have been swapping loans for corporate bonds to take advantage of favourable capital market conditions, as reflected in record rates of bond issuance, helping to make up for the gap left by the retreat of foreign lenders.

There are fewer signs of progress in the household sector - a major concern since they account for two thirds of spending in the economy. Households have been paying down credit cards and loans, but mortgage debt, which accounts for over 80% of the total, have continued to rise. Moreover, pressures on consumers look set to grow rather than diminish in the near term. Unemployment, which lags economic output, will probably keep rising until late 2010. Even further out there will be headwinds. More borrowers have moved onto variable rate borrowing, increasing exposure to interest rises when they eventually rise (although we don't think this will happen until late 2010). For example, in Q4 2007, c47% of outstanding mortgages were on variable interest rates - the proportion rose to 56% in Q1 2009. If this pattern remains, in the next rate-hiking cycle a 25bps increase in the Bank Rate may feel like a lot more.

Fixing the public finances will also be high on the list of priorities, acting as another drag, just as the recovery gains momentum. The major credit rating agencies have already flagged up the need for the UK to articulate a convincing strategy for returning the public finances to a more sustainable trajectory. If not, the UK could lose its coveted AAA credit rating. This would put upward pressure on the cost of government borrowing and would have knock-on effects for the wider economy.

(DR)

United States – We don't have lift-off

The economy contracted in Q2, but only slightly, and surveys suggest it may have managed to emerge from recession in Q3. Investors seem convinced, as evidenced by narrowing credit spreads and rallying equity markets. Even house prices have stabilised. This raises the question, are we set for a swift return to economic normality? Probably not. The Q2 performance relied on government spending and trade, while household and investment spending plummeted again. Formidable obstacles remain, suggesting that growth, when it comes, will be anaemic. Firms awash with capacity aren't looking to invest and, with jobs being lost rapidly, the all-important consumer will remain under pressure. The export sector is too small relative to the rest of the economy, and the global economy is too fragile, to deliver a robust, export-led recovery.

Chart 3: ISM surveys suggest economy is stabilising

Source: Datastream

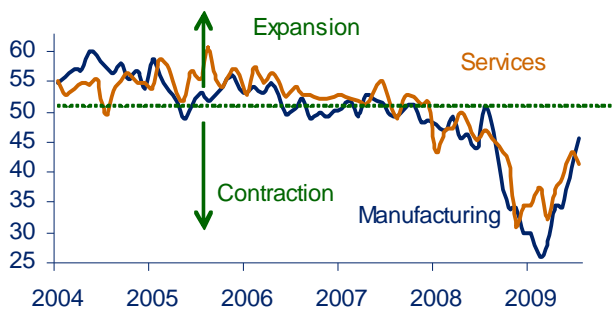


Chart 4: Employment still contracting at a near record rate

Source: Datastream



Recent data point to renewed expansion, but the economy is unlikely to power ahead

It's not hard to understand the more optimistic mood, as 'green shoots' remain in evidence. The closely-watched ISM surveys of activity in the manufacturing and service sectors have recovered strongly (chart 3). These are good leading indicators that suggest that growth could be close at hand. Similarly, in the housing market, the source of many of the economy's problems, there has been progress, with prices rising for the first time in three years on the most reliable measure. But the good news ends there. As inventories remain elevated compared to the level of sales, 'de-stocking', a large drag on output recently, could continue to be a problem unless demand rebounds rapidly - and that looks unlikely.

The pace of job losses remains savage, with over 6.7 million jobs lost since the start of the recession and 3.3 million in the first half of 2009. There were 4.2% fewer workers in July compared to the previous year, a near-record fall (chart 4). Jobs will continue to be lost until *after* the economy returns to trend growth – probably not until late next year. Consequently, consumer spending will stay under pressure. Not only is income falling due to job losses and slower wage growth, but households are having to save more (and hence spend less) to rebuild wealth decimated by falling asset markets. Over the past two years \$14 trillion, \$127k per family, has been wiped off the household sector's balance sheet. This damage will take time to repair. The 30% rise in equity markets from March's lows has helped, but the biggest drag - housing - is likely to remain depressed for a prolonged period. Part of the balance sheet adjustment will come through debt repayment. In the first quarter of 2009, total household debt fell in year-on-year terms for the first time on record. It probably has further to fall.

Business investment also looks set to remain weak. Firms' utilisation of their plant and machinery is at its lowest levels on record. Investment has fallen a massive 26% in response, and won't recover until demand recovers and firms start to run out of spare capacity. Low investment now also bodes poorly for long-term growth post-recession.

Policymakers have welcomed recent improvements, but remain cautious

The net trade position has been improving, but only because imports have been falling even faster than exports. Over the longer term a weaker dollar will help to pull the economy out of recession, but only once global demand recovers. Given this backdrop, it's easy to see why policymakers, while acknowledging improvements, are still cautious, and policy stimulus remains on the agenda. Federal Reserve Chairman Ben Bernanke kicked off the discussion of what the Central Bank's 'exit strategy' from quantitative easing might look like, but was keen to stress that rates will remain low for some time due to the fragility of the economy. Core inflation, stripping out volatile oil and food prices, has been sticky (+1.7% y/y in June), but the weak outlook for demand means that deflation, rather than inflation, remains the worry.

We have revised up our forecasts slightly to reflect recent positive developments. We now expect a 3% contraction in 2009 (3.5% previously) and 1% growth in 2010. Unemployment could peak a touch lower in 2010, at maybe 10.8% rather than 11%, but that's the extent of our increased optimism for the time being. **(GC)**

Euro area – Outlook: clouded

The Eurozone surprised everyone when its two largest economies emerged from recession in the second quarter. This apparent outperformance isn't likely to last. Germany remains dependant on exports for growth – a strategy that is unlikely to be a winner when most of its major export markets outside of Asia continue to struggle. Moreover, many of the peripheral economies that provided the demand momentum within the region are grappling with difficult structural adjustments. Policy support is also less evident. Euro area countries remain fiscally hamstrung by strained public finances. On the monetary side, the ECB has dealt with banks' funding needs, for now, by injecting lots of liquidity. It has belatedly joined the quantitative easing card table, but in a relatively timid fashion.

Chart 5: Output declines have varied significantly across the region (Euro area GDP, peak to Q1, %)

Source: RBS, datastream

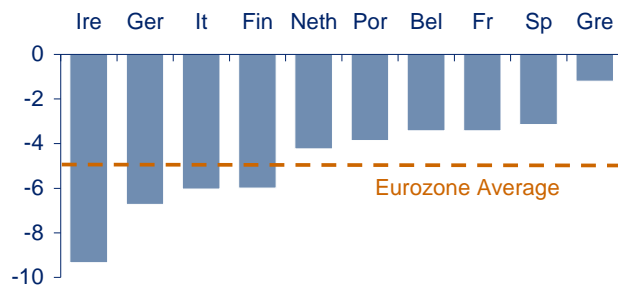
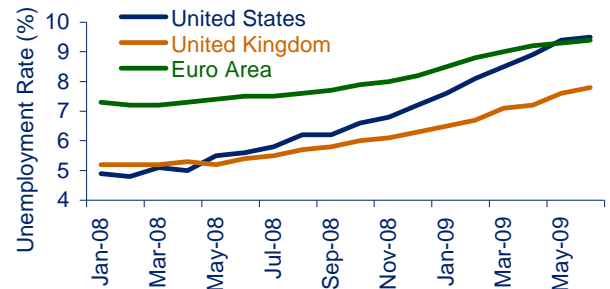


Chart 6: Euro area unemployment has not risen as quickly as elsewhere, but started from a higher base

Source: Datastream



Few signs of European convergence in recession either

The downturn has been severe. By the end of the first quarter, the Eurozone economy had shrunk by almost 5%, though performance varied significantly across the region (chart 5). Germany, the largest economy, was amongst the hardest hit. A modest return to growth in Q2, shared by France, sparked optimism that recession was over, but is unlikely to herald a strong rebound. Germany in particular relies too much on exports. A rebound in demand from major markets like the US and UK is necessary for prolonged growth, but is unlikely in the near term. Healthy demand from Asia won't be enough. In any case, the French and German results were offset by large declines elsewhere (0.5% in Italy, 1.0% in Spain and 0.9% in the Netherlands), so the euro area overall still contracted slightly in Q2. This highlights the difficult adjustments that many euro area countries are grappling with, from deflating housing bubbles to uncompetitive wages.

Unemployment hit 9.5% by May (chart 6) and could reach 12% in 2010, given the lag between the labour market trends and economic activity. That's a problem, because stronger consumer spending could be the euro area's best hope for a sustained upturn. Consumers in the major euro area economies are less leveraged than US and UK counterparts, so there is at least scope for consumer spending-based growth. But not while unemployment surges. Energy price falls are helping to give some respite to households and firms in the region, but the scope for support from falling prices is limited and could ultimately prove counter-productive. Deflation - a sustained period of falling prices across the economy - is the last thing the economy needs. It can lead to a downward spiral, as purchases are deferred because goods are expected to be cheaper in the future.

Monetary policy belatedly cranked up, fiscal policy hamstrung

As the region's plight became increasingly apparent, policymakers did crank up their efforts. Short-term rates were reduced to 1% in May and the European Central Bank (ECB) is belatedly undertaking a form of quantitative easing by purchasing €60bn of 'covered bonds' (private sector debt similar to asset-backed securities). The ECB has also injected a massive slug of liquidity into the banking system, to ease bank funding, and arrest the slowdown in the pace of bank lending. This was viewed with concern, because bank lending is more important than debt or equity funding compared with the US or UK.

The ECB's actions looked a little late and timid vis-à-vis the US and UK, which conducted much larger asset purchases. Indeed, the ECB's efforts to support lending growth may also meet with limited success as demand matters as much as supply, and firms are focused on strengthening balance sheets, which points to more debt repayment. There is a risk that the ECB becomes even more cautious, now that fears of near term deflation have subsided, at least for the time being.

With only a modest monetary stimulus, and a strong upturn in foreign demand unlikely in the near term, the euro area is unlikely to lead the developed world to a sustained recovery. Indeed, a further stimulus may yet be required. If so, the QE program could grow and evolve. There's little scope for fiscal policy to do more. Public finances were in a parlous state even before the recession, with a debt-to-GDP ratio of 66% at its lowest in 2007 (vs. 44% in the UK at the time). This is already expected to rise to 84% by 2010. **(GC)**

Asia – Phoenix from the ashes?

Emerging Asia appears to be emerging from the global downturn. This is in large part due to a rapid and comprehensive policy response. China and India look like they are on course for solid growth this year and next, though it is unlikely they will return to the exceptional rates of expansion witnessed immediately before the international financial crisis. Growth remains reliant on accommodative fiscal and monetary policies. Domestic demand is under pressure from rising unemployment, and international demand is not expected to rebound to support exports for some time. Japan has also bottomed out, but considerable challenges still lie ahead.

China – too much of a good thing

China recorded an impressive 7.9% y/y growth in Q2 and the economy appears on course to achieve its 8% growth target this year and next. The government's fiscal stimulus and accommodative monetary policy are the explanation for the performance. But short-term success may be sowing the seeds of longer term problems. Imbalances are swelling. Growth is being driven by government spending and public investment – underlying domestic demand remains weak, despite policies aimed at boosting consumer spending. Rapid credit growth is fuelling bubbles in equity and other asset markets, and has revived concerns that the economy may overheat: in quarter-on-quarter terms GDP growth is estimated to have been 15% (annualised) in Q2 – for comparison, the US outturn was 1% (annualised) and Japan was a not too shabby 3.7%.

The RMB 4 trillion (\$586bn) stimulus enacted by the Chinese government is eminently affordable - it will cause only a 3% of GDP hole in the budget this year. With national debt below 10% of GDP, this is an enviable situation. However, the package is light on structural measures that would be of long-term benefit. Key policy objectives are to spur domestic demand and to create, or at least maintain jobs, which will be expansionary only in the short term. In the near term monetary policy is likely to remain expansionary. In the absence of clear signs of overheating, like a sharp rise in inflation or wages, the State Council, the body that ultimately decides monetary policy, is unlikely to tighten until the final quarter of the year. There is a risk that monetary policy is left too loose for too long. But an early withdrawal of fiscal and monetary stimuli could reveal a weaker than expected economy, and see growth fall below Beijing's target. For now, the State Council is more likely to be concerned with the potential for social unrest than an over-accommodative monetary policy.

India

The economy faces many challenges, but it appears to be past the worst of the current slowdown. Output growth dropped to 5.8% year-on-year in Q1, down from an average of 9% over the previous five years. But the economy has been doing much better in recent months: industrial production growth rebounded in Q2 (+7.8% y/y in June); accommodative monetary and fiscal policies have supported credit growth and demand; and the Bombay Stock Exchange Index has almost doubled since its mid-March lows. Although a sustained rebound is not assured, India's slowdown has ended and the economy looks set to achieve 5.5% GDP growth in fiscal year 2009/10 (ending March 2010), and 7.5% growth in 2010/11.

In the short term, a poor monsoon threatens to depress agriculture and could delay the recovery. About one-half of the population is dependent on agriculture, and a poor crop would push up food prices, adversely impacting the poor. Fiscal policy is likely to remain supportive until the agricultural weakness subsides and recovery takes hold. But the government budget deficit is large (8% of GDP in 2008/09) and needs to be brought under control in the medium term. Much needed economic reforms would further support growth, these include: making the labour market more flexible; allowing higher foreign participation in the insurance and retail sectors; and reviving the process of government divestment in industry.

Japan

Japan appears to have staged a rebound from the deep downturn that saw the economy contract by almost 10%, and asset prices return to early 1980 levels. A bounce in exports to China, a slowdown in the pace of inventory de-accumulation, and a supportive government stimulus package stood behind a return to positive growth in the second quarter. But a robust growth trajectory is unlikely to be maintained, and mild deflation is likely to persist for several years. Capacity utilisation rates have collapsed, from c100% in the middle of last year (indicating that firms were operating flat out), to 60% in Q2. This suggests that firms have lots of spare capacity and hence will have little appetite for investment for a considerable period. A weakening labour market and falling wages are exacerbating the lack of domestic demand that is the key structural problem for the Japanese economy.

The longer-term situation is little better. Poor prospects for investment and consumer spending will make rebalancing Japanese economic growth away from a dependency on exports particularly challenging. Demographic trends present additional obstacles to the growth outlook. The population will peak in 2010 and the dependency ratio (the proportion of the population of working age to those that aren't) will rise sharply. Against this backdrop, fixing public finances that are characterised by very large budget deficits (c10% of GDP in 2009) and amongst the highest government debt ratios in the developed world (215% of GDP) will be extremely challenging. Japan may be at risk of a second "lost decade". **(DR)**

Oil – Sand in the gears?

Investor sentiment has been a key driver of oil prices, just as it has been for other assets. There's little reason for this pattern to shift, so the global economic outlook will determine where crude prices are headed. We are sceptical of the view that record oil prices helped cause the recession. After all, oil prices rose by a factor of ten between 1999 and 2007 without de-railing global growth. But this doesn't mean that a steep rise couldn't act as a brake on the recovery when it arrives. Households and firms have been under severe pressure, and are therefore likely to be more sensitive to income shocks. Higher prices are a real risk, given the current dearth of investment.

Chart 7: US stocks climb to multi-year highs

Source: Energy Information Administration

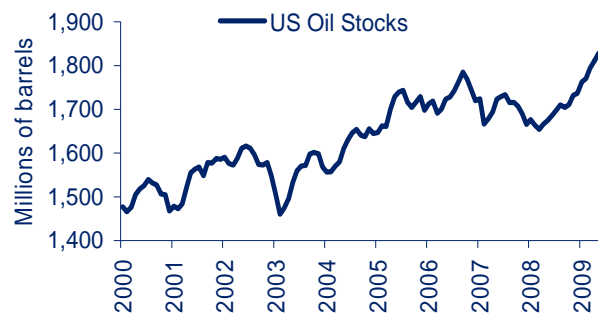


Chart 8: Futures markets anticipate a rebound in prices

Source: New York Mercantile Exchange



Supply has responded, but demand destruction still dominates

In the wake of the global recession, global demand has slumped. Within developed economies, consumption fell by more than 3% between March 2008 and March 2009, the latest period for which data are available. Growth also slowed markedly in emerging markets. Demand destruction will continue until the global recession has run its course. We expect demand to recover first in emerging markets, most notably China, where the rebound in cyclical demand will be reinforced by its ambition to enlarge its strategic stockpiles. The major industrial economies will follow later.

Supply has dropped as well, but less drastically. OPEC has implemented three quarters of the agreed production cuts, but has signalled little appetite for more. Actual production has been on an upward path for several months now, highlighting the difficulties any cartel faces maintaining discipline. Since April, OPEC production has crept up by 400,000 barrels per day as member states seek to generate extra revenues to meet rapidly growing spending needs at home. As Iraq's oil industry is being rebuilt, additional supplies have contributed to the rise. Production has increased by 6% since April and exports have topped two million barrels per day for the first time since the war. Iraq is the only OPEC country not bound by quotas.

As a result of weak demand growth and less than offsetting reductions in supply, inventories have soared and stand at eighteen year highs in the US, for example. Millions of additional barrels of oil are stored on floating tankers around the world, as their owners are waiting for prices to go up. The build up in inventories could cushion price increases once the global economy reverts to growth. During a normal cycle demand growth outpaces the lagged response on the supply side since it takes time to complete new projects. But this time ample inventories will buy some time.

Economic growth and monetary policy are key factors to watch

We expect the pace of the global recovery to be modest with inflation remaining subdued, hence we maintain our baseline forecast for crude oil prices to stay in a \$65 to \$75 range. In the near-term, risks are skewed to the downside, as many regions remain in recession or are at least experiencing sub-par growth. But the balance shifts toward the upside during 2010 when the recovery is expected to become more firmly entrenched. The actions of policymakers will also be important. We don't expect central banks to mop up excess liquidity rapidly and tighten monetary policy sharply. If they do, crude oil will feel the full impact. Monetary tightening will curb physical demand, increase the cost of storage and reduce investor demand by increasing the opportunity costs of investing in commodities. Under this scenario, prices would have a hard time breaking \$75. Conversely, if central banks leave tightening too late, heightened inflation fears and expectations for a strong rebound in demand would support oil prices, which could again reach triple digits under this scenario.

Underinvestment in the past holds risks for the future

Global oil infrastructure is inadequate across the supply chain, from production fields to transportation. Underinvestment at the height of the crunch, when credit was tight and expensive contributed to the problem. The global oil industry remains hobbled by the dominance of state-owned national oil companies, and many barriers to trade and investment mean that investment levels will remain below the level of a competitive industry even after the rebound. In the short term this means increased price volatility as infrastructure constraints limit the market's ability to smooth excess demand or supply. Longer term it holds the potential for price spikes once the economy fully recovers. (TF)

Annex 1: Summary of Forecasts (Annual average and y/y % change unless otherwise stated)

	Average	Forecasts						
	2004-2008	2006	2007	2008	2009	2010	2011	2012
United Kingdom								
Real GDP Growth	2.3	2.9	2.6	0.8	-4.7	0.3	1.7	2.1
Consumption	2.0	1.5	2.1	1.2	-3.1	-1.5	0.8	1.1
Investment	3.8	6.4	7.9	-2.8	-14.4	-5.7	3.0	4.4
Unemployment (%)	5.2	5.5	5.3	5.8	8.3	10.6	9.8	8.4
Inflation (CPI)	2.3	2.3	2.4	3.6	1.6	0.8	1.4	1.9
Policy rate (end period)	....	5.00	5.50	2.00	0.50	0.50	2.50	4.00
United States								
Real GDP Growth	2.4	2.7	2.1	0.5	-3.0	1.0	2.2	2.4
Consumption	2.4	2.9	2.7	-0.2	-1.6	-0.7	1.1	1.7
Investment	2.6	3.7	-2.1	-3.3	-19.0	-2.0	3.7	5.1
Unemployment*	5.1	4.6	4.6	5.8	9.3	10.5	10.4	8.8
Inflation	3.2	3.2	2.9	3.8	-0.5	1.3	1.9	2.0
Policy rate (end period)	....	5.25	4.25	0.25	0.25	0.25	2.50	4.75
Eurozone								
Real GDP Growth	2.0	3.0	2.7	0.5	-4.3	0.5	1.5	2.0
o/w Germany	1.7	3.4	2.6	1.0	-6.3	0.5	1.5	1.7
France	1.8	2.4	2.3	0.3	-2.9	0.6	1.4	1.8
Italy	0.9	2.1	1.5	-1.0	-4.9	0.4	0.9	1.2
Spain	3.1	3.9	3.7	1.2	-3.4	-0.3	1.1	1.8
Inflation	2.4	2.2	2.1	3.3	0.4	1.1	1.6	1.8
Policy rate (end period)	....	3.50	4.00	2.50	1.00	1.00	2.25	3.75
ASIA (GDP Growth)								
Japan	1.6	2.0	2.3	-0.7	-6.3	0.8	1.0	1.2
China	11.2	11.7	13.2	10.0	8.0	8.0	8.0	8.5
India	5.7	5.5	6.3	6.1	6.0	6.5	6.5	7.0
Oil Price (Brent, \$/bbl)								
	66.0	65.2	72.4	96.9	58.7	73.3	77.0	80.0
Exchange Rates								
\$ per £ (end period)	....	1.96	1.99	1.44	1.62	1.58	1.60	1.60
\$ per € (end period)	....	1.32	1.46	1.39	1.36	1.22	1.20	1.20
£ per € (end period)	0.67	0.73	0.95	0.84	0.77	0.75	0.75
¥ per \$ (end period)	119	112	91	95	95	95	95

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