

GLOBAL ECONOMIC OUTLOOK



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The Global Cycle Takes Another Leg Down

ACROSS THE DEVELOPED WORLD, the range of available policy options is dwindling after decades of deficit spending and several years of unorthodox monetary-easing measures. Speculative attacks on institutions in the eurozone have intensified amid sluggish responses to Europe's debt crisis from the region's policymakers. Meanwhile, the balance sheets of US consumers are under renewed pressure from falling house and equity prices, and many emerging markets are tightening in order to curb persistent inflationary pressures.

Consequently, activity is slowing across all regions and leading indicators point to more economic pain ahead (**Figure 1**). Eventually, policy in the developed world will have to become more aggressive, while policy in emerging countries can become more accommodative once inflationary pressures ease. We are hopeful that the deterioration in global economic momentum can be halted over the next six months, setting the stage for stronger growth in the latter part of 2012.

Deleveraging Takes Years, Not Quarters

The 2008 crisis and consequent ramp-up of developed-country government indebtedness has cast a shadow over the world's medium-term growth prospects. **Figure 2** shows the aggregate debt stock in major developed economies. Japan stands out in terms of overall leverage. Amazingly, even after a decade of private-sector deleveraging that nation's overall stock of debt has increased amid a public-sector spending

binge. Spain appears to be following in Japan's footsteps. The US and Germany are still at the lower end of this spectrum, though the rise in US government debt is quite alarming.

KEY POINTS

- ▶ Policy in the developed world will have to become more aggressive, while policy in emerging countries can turn more accommodative once inflationary pressures ease. We are hopeful that the deterioration in global economic momentum can be halted over the next six months, setting the stage for stronger growth in the latter part of 2012.
- ▶ A Japan-style balance-sheet recession appears to be in the cards for Europe.
- ▶ We expect China to be a global "shock absorber" in this crisis, as it was in the last. In the near term, however, the Chinese economy is expected to slow in tandem with the global economy.

A historical analysis of prior financial and economic crises reveals that deleveraging processes typically last 5 – 7 years. **Figure 3** takes a closer look at the private-sector deleveraging process and contrasts current conditions with previous milestone economic and financial crises. This graph reveals that Ireland, Latvia, the UK, and the US are further along in the deleveraging process than southern Europe. Despite the tremendous economic pain that Spain, Greece, Italy, and Portugal have already experienced, these countries still have a long way to go in making this adjustment. For example, when we compare rates of contraction in the housing sector across the globe, we find that housing is quite likely to stabilize during 2012. But in Spain, and in Ireland to a lesser extent, much of the adjustment in prices has yet to play out.

Europe’s “Balance-Sheet Recession”

Richard Koo of Nomura coined this phrase in describing Japan’s lost decades (the 1990s and 2000s) of stagnation. The country’s experience over this period seems to impart the lesson that when the private sector is rapidly deleveraging, an economy can only keep expanding if the government pursues offsetting, robustly expansionary fiscal policy. But if fiscal

policy must also be contractionary — if bond markets won’t accept the continued run-up of debt by a government without extracting extortionate spreads — its economy must contract.

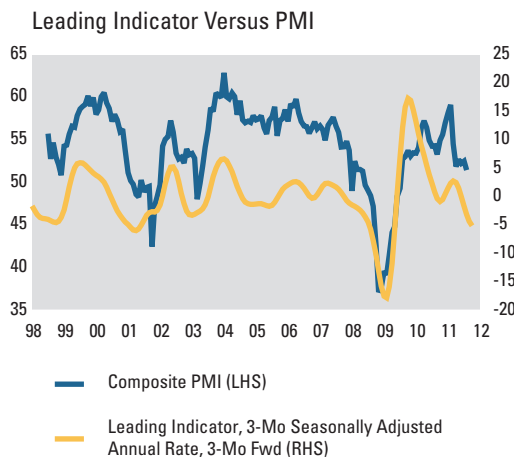
That is exactly Europe’s problem. The planned expansion of Europe’s stability fund, the European Financial Stability Facility (EFSF), to €440 billion will not be enough to meet the funding needs of distressed banks and governments. It will take years for greater fiscal integration of the eurozone to be implemented, so the European Central Bank (ECB) has to be the final backstop in the current crisis. The ECB will insist on severe fiscal cutbacks before it aggressively increases its balance sheet by purchasing the bonds of embattled member countries. A Japan-style balance-sheet recession appears to be in the cards for this region.

Will a European Crisis Tip the US into Recession?

The very modest expansion of the US economy will not be able to withstand significant external shocks, and indeed faces its own headwinds. Although the US economy is much better positioned than Europe’s, at least over the next year or so, a very bearish European outcome would likely tip the US into recession as well.

Figure 1

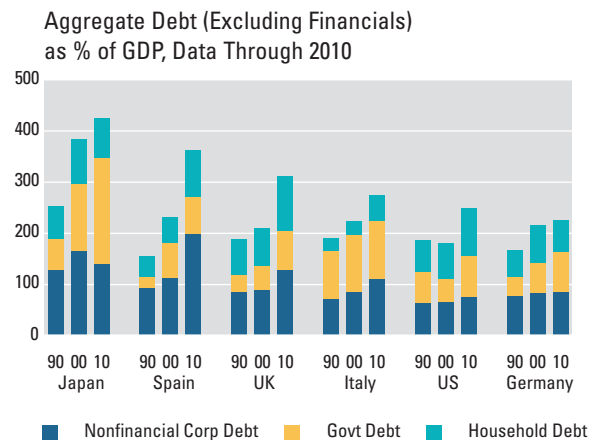
Global Leading Indicators Suggest More Pain Lies Ahead



Sources: JPMorgan, Organisation for Economic Co-operation and Development (OECD)

Figure 2

Debt Has Risen Across the Developed World



*Italy data begins in 1995
 Sources: International Monetary Fund, Federal Reserve, Bank of Japan, Bank of Spain, UK Office of National Statistics, Bundesbank, National Statistical Institute of Italy

The recent performance of the US economy has been disappointing. Putting things into historical perspective, the current expansion has been as fragile as the 2000 – 2005 upturn (Figure 4). In the immediate aftermath of the dot-com bust in the early 2000s, US credit markets shut down. The contractionary role played back then by corporate balance-sheet adjustments is today filled by deleveraging households and financial institutions.

Stretched household balance sheets imply that consumption is highly dependent on the health of housing and equity markets, the level of commodity prices, and the availability of credit and associated financing costs. Oil and agricultural prices have trended down recently, but not fast enough to offset the downward pull of sagging housing and equity markets. The credit dimension is similarly mixed: While financing costs have come down sharply, credit standards have tightened significantly. Overall, we are still hopeful that consumption will record modest growth in coming quarters.

Compared to Europe, the US is delaying necessary fiscal adjustments. Currently the US fiscal deficit hovers around 10% of GDP. Based on current statutory commitments, that is scheduled to drop by around 2% of GDP in 2012, and by another 3% in 2013. But the fact that 2012 is a presidential

election year makes it less likely that these fiscal cut-backs will actually be implemented. In 2013, though, the administration and Congress will finally begin to tackle the nation's long-term deficit dilemma, guaranteeing a weaker growth outlook in the process.

Can Emerging Markets Offset Weakness in the Developed World?

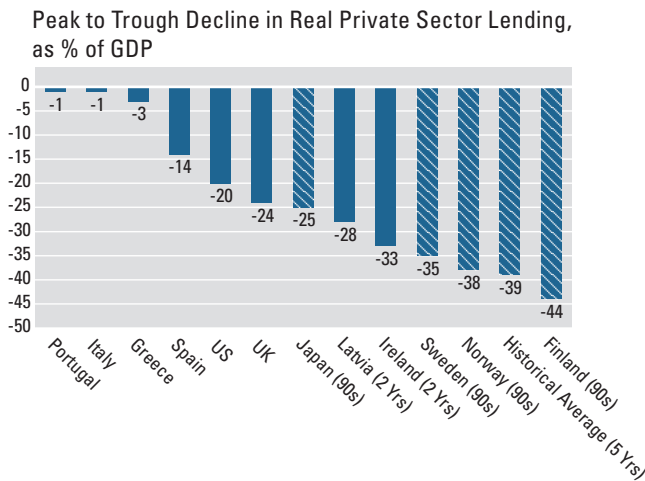
Not really. It is not that the emerging markets are too small to carry their own weight. The problem is that they are too integrated into the global economy to be immune from the upcoming trade shock as developed-world demand for their exports falters. In addition, many emerging countries have been fighting domestic inflation by tightening policy. The combined impact of weaker trade and policy tightening will trigger a pronounced slowdown for many emerging nations. Among the largest economies, Brazil and India will slow the most. South Korea, China, South Africa, Russia, and Indonesia are somewhat better positioned.

Chinese Policy to the Rescue?

Policymakers in China have come to realize that they were too aggressive in the 2008 financial crisis, jump-starting mas-

Figure 3

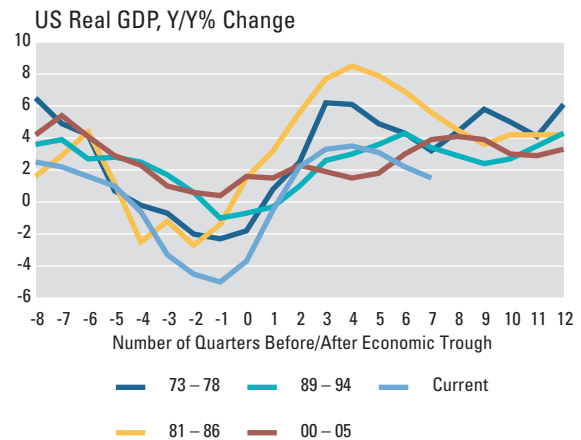
Sectoral Deleveraging Has a Long Way to Go in Southern Europe



Bars denote historical data, as of 2011, unless otherwise specified. Striped bars highlight previous crises. Sources: Bank for International Settlements, International Monetary Fund, Wellington Management

Figure 4

Will a European Crisis Tip the US into Recession?

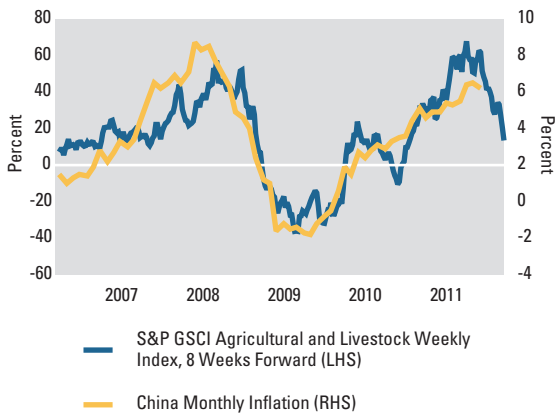


Source: Bureau of Economic Analysis

sive infrastructure programs to offset the global slump. Credit surged and spiraled out of control, while bad debt accumulated in the banking sector and local governments. This time around, China’s policy response will be more measured, but still meaningful. The government has managed to cool the overheating housing sector, and inflation is set to slow decisively over the next six months (Figure 5). We expect China to be a global “shock absorber” in this crisis as it was in the last, though its economy is expected to slow in tandem with the global economy in the near term.

Figure 5

Chinese Inflation Has Peaked



Sources: Standard and Poor's, China National Bureau of Statistics

Summary and Conclusions

Europe continues to be the center of global financial and economic woes, but other regions show signs of diminishing momentum as well. Policy has been slow to come to the rescue. In Europe, it will take time to rebuild strained fiscal and political institutions, while US policymakers are increasingly out of options for additional stimulus. Emerging economies can and will ease policy, but their need to tamp down domestic inflationary pressures will make this a less-than-straight-forward process. We expect the global economic cycle to take another leg down before policy comes to the rescue. Yet we are hopeful that lower inflation over the next six months will set the stage for a resumption in policy stimulus and improving activity later in 2012.

About the Author

Robert Scherfke, PhD, is a senior member of Wellington Management’s Global Macroanalysis Research Group. He leads the firm’s thinking on global macro activity, conducting cyclical research to identify important inflection points and well-positioned equity markets, which he communicates firmwide in his strategy publication *The Macro Wheel of Fortune*. For our clients, he authors the *Global Economic Outlook* and *Global Macro Insights*, as well as providing regular video updates in the series called *Watch the World*.

Global Economic Forecast

	Real GDP			Inflation			Stock Market Earnings ²		
	2010 ¹	2011	2012	2010 ¹	2011	2012	2010	2011	2012
US	2.9%	1.6%	2.0%	1.6%	3.0%	3.0%	39%	28%	14%
Euro Area	1.7	1.0	0.0	1.6	2.6	1.9	44	20	11
UK	1.3	0.9	0.0	4.7	4.0	2.0	33	20	11
Japan ¹	3.9	-0.5	2.4	-0.7	-0.2	-0.2	153	23	20
China	10.3	8.9	7.0	3.3	5.8	4.0			
World	4.0	3.0	2.8	2.6	4.1	3.4			

¹Consensus Economics

²Based on FactSet

Sources: Wellington Management, Consensus Economics



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