

The Outlook for the World Economy: It Will Get Much Worse Before It Gets Better

Nariman Behravesh

Chief Economist, IHS Global Insight

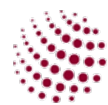
10 December 2008



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Crisis Update



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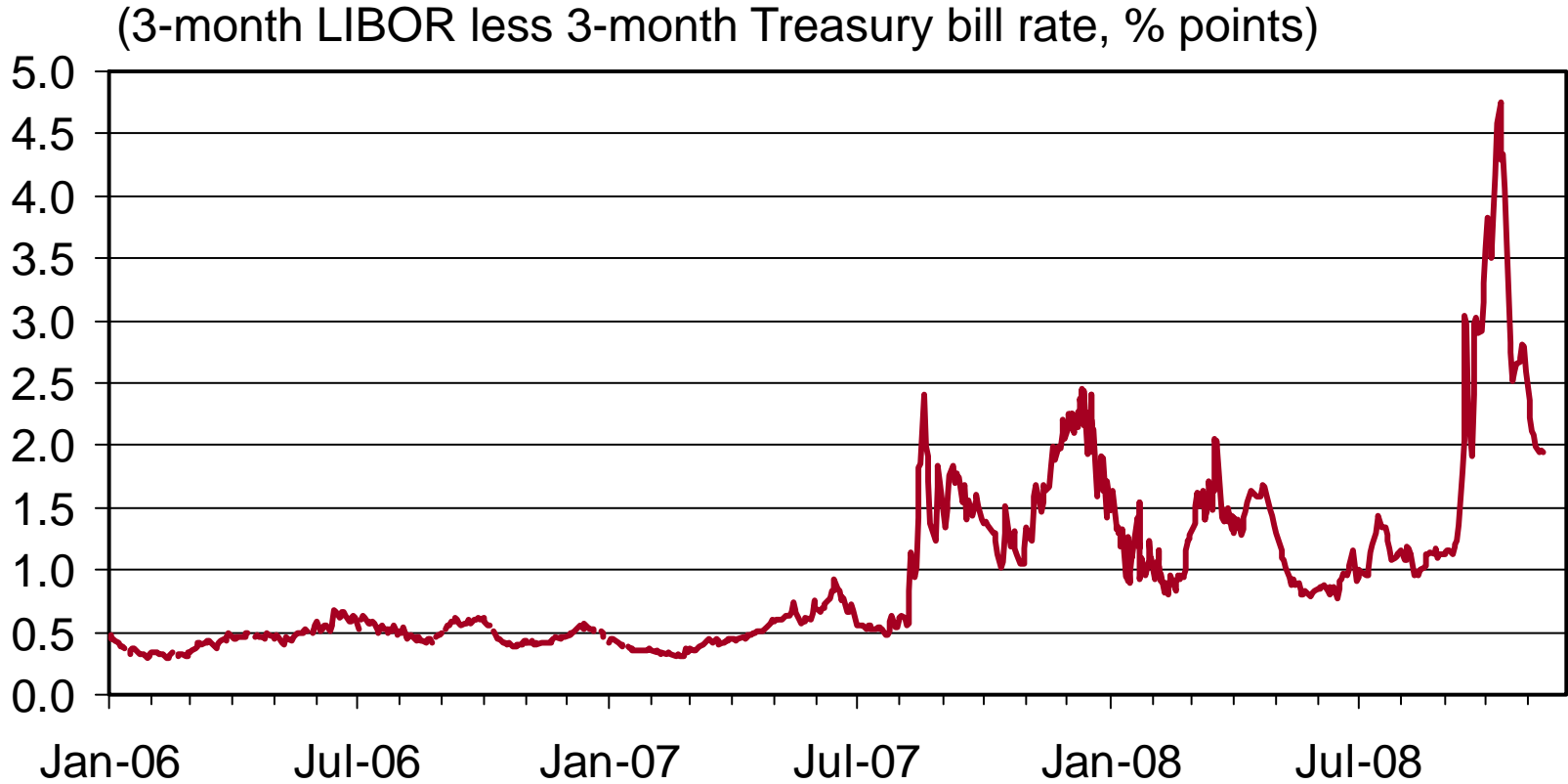
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Big, Bad, and Broad-based

- By some measures the biggest **global** housing and credit bubble in history
- Not just Made in U.S.A.
- Credit growth was strong everywhere
- Bank loan/deposit ratios were much higher in Europe
- Subprime crisis was the first symptom
- Bubbles in commodity, equity, foreign exchange and real estate markets are bursting in many parts of the world
- No region will be unscathed — the only question is how badly will they be hurt



A Key Sign of Extreme Risk Aversion

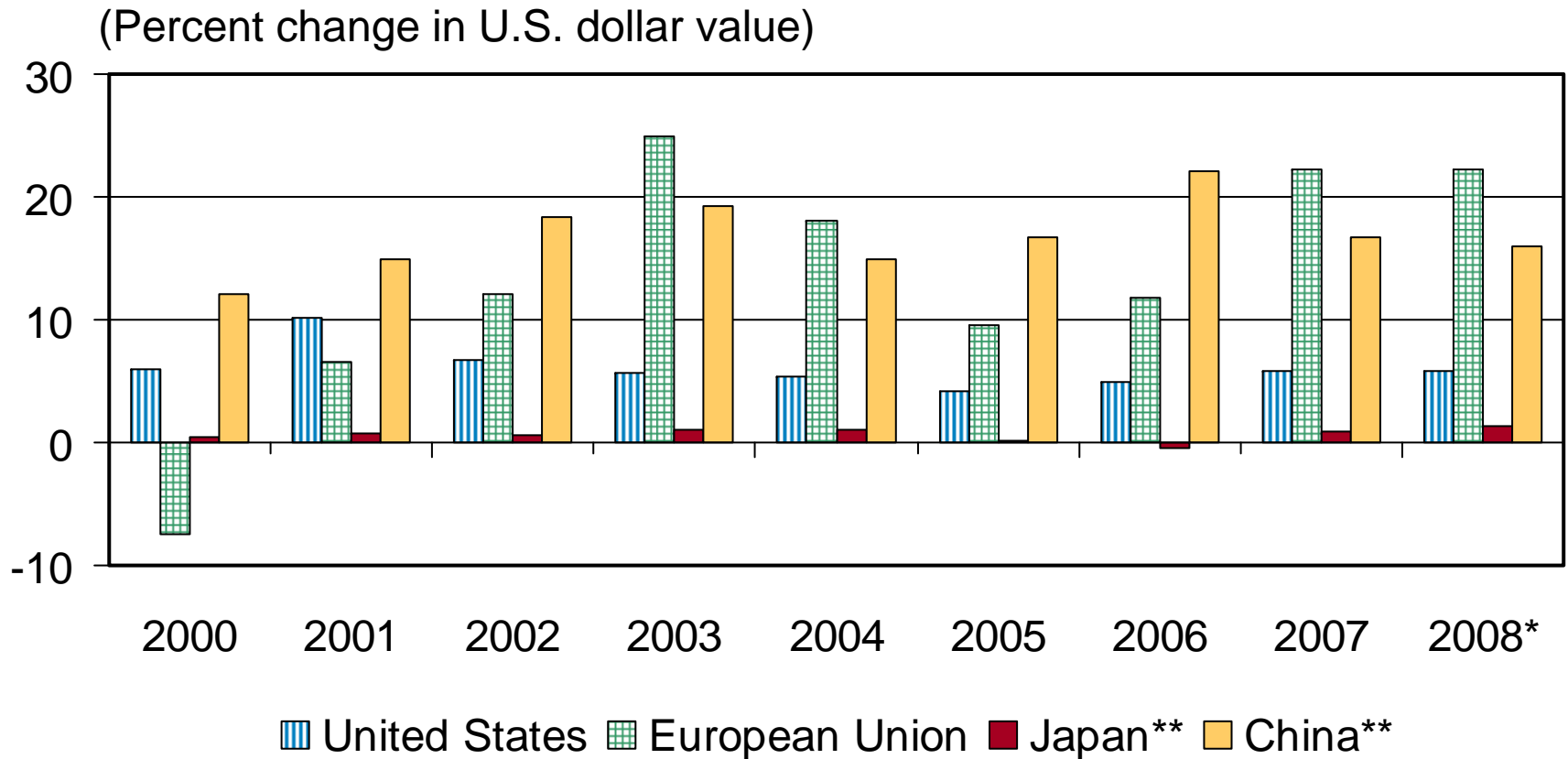


How Did We Get Here?

- **Classic hangover after a binge**
- **Driving forces: deregulation, financial innovation, and the globalization of capital?**
- **Major culprit: loose monetary policies everywhere...**
- **...Although the savings “glut” may have only played a secondary role, interest rates have been falling for decades**
- **Another major culprit: government incentives to take on debt — e.g., not everyone should own a home**
- **Modern finance has done a lot of good, but it has not reduced volatility, speculation or leverage**

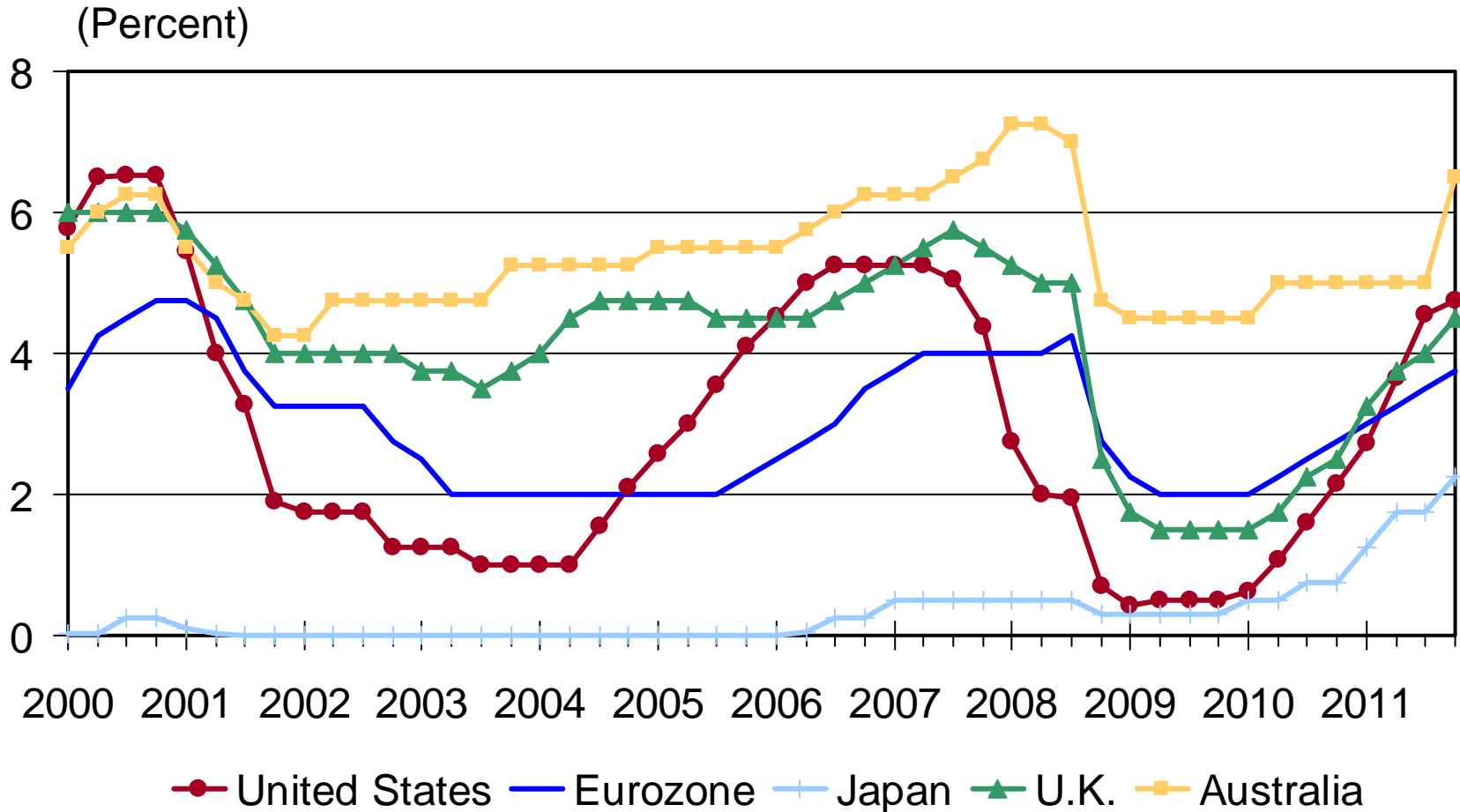


Money Supply Growth

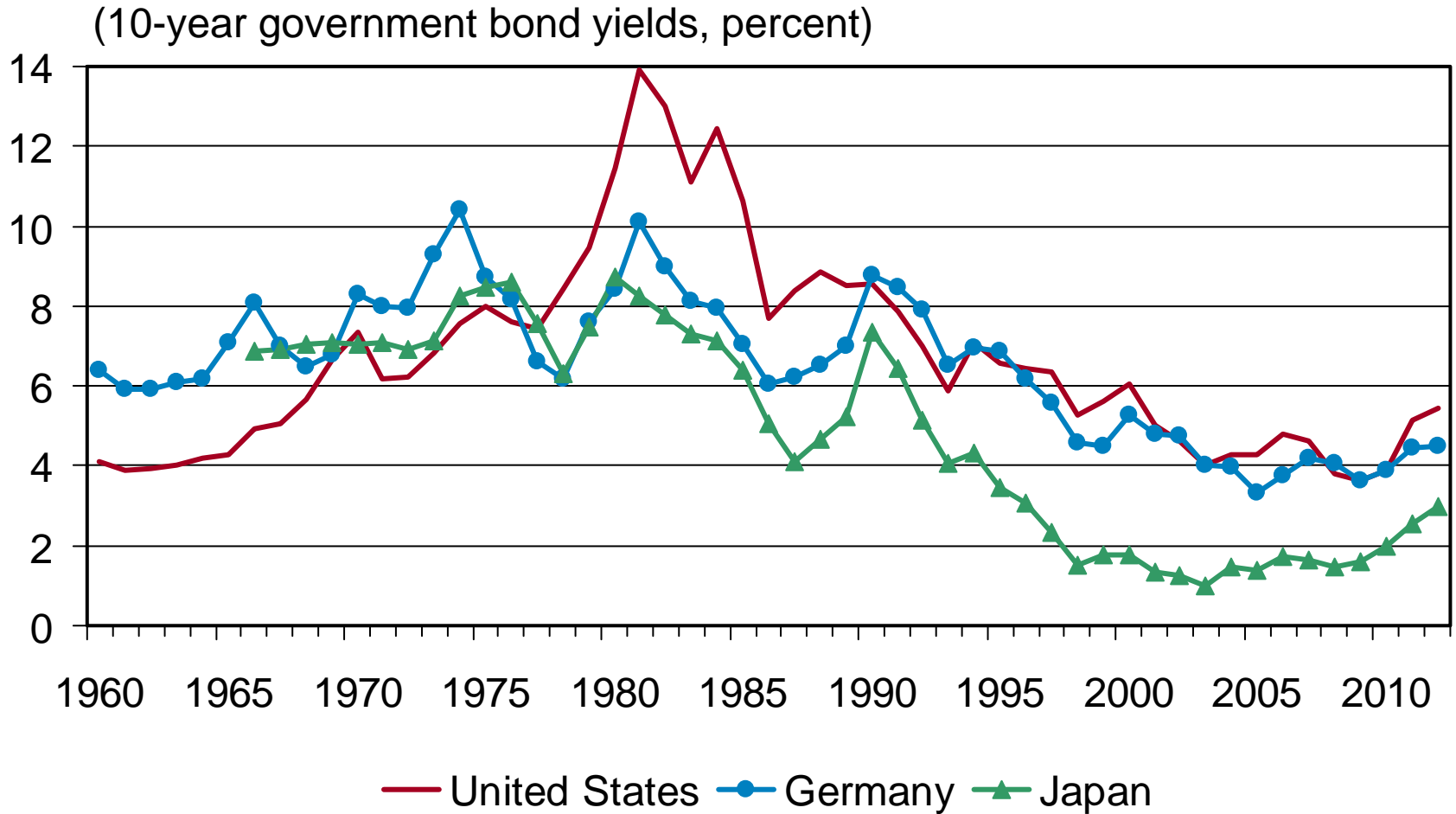


* Through August 2008; ** Percent change calculated in local currency units

Policy Interest Rates: Mostly Moving Down



Long-term Interest Rates

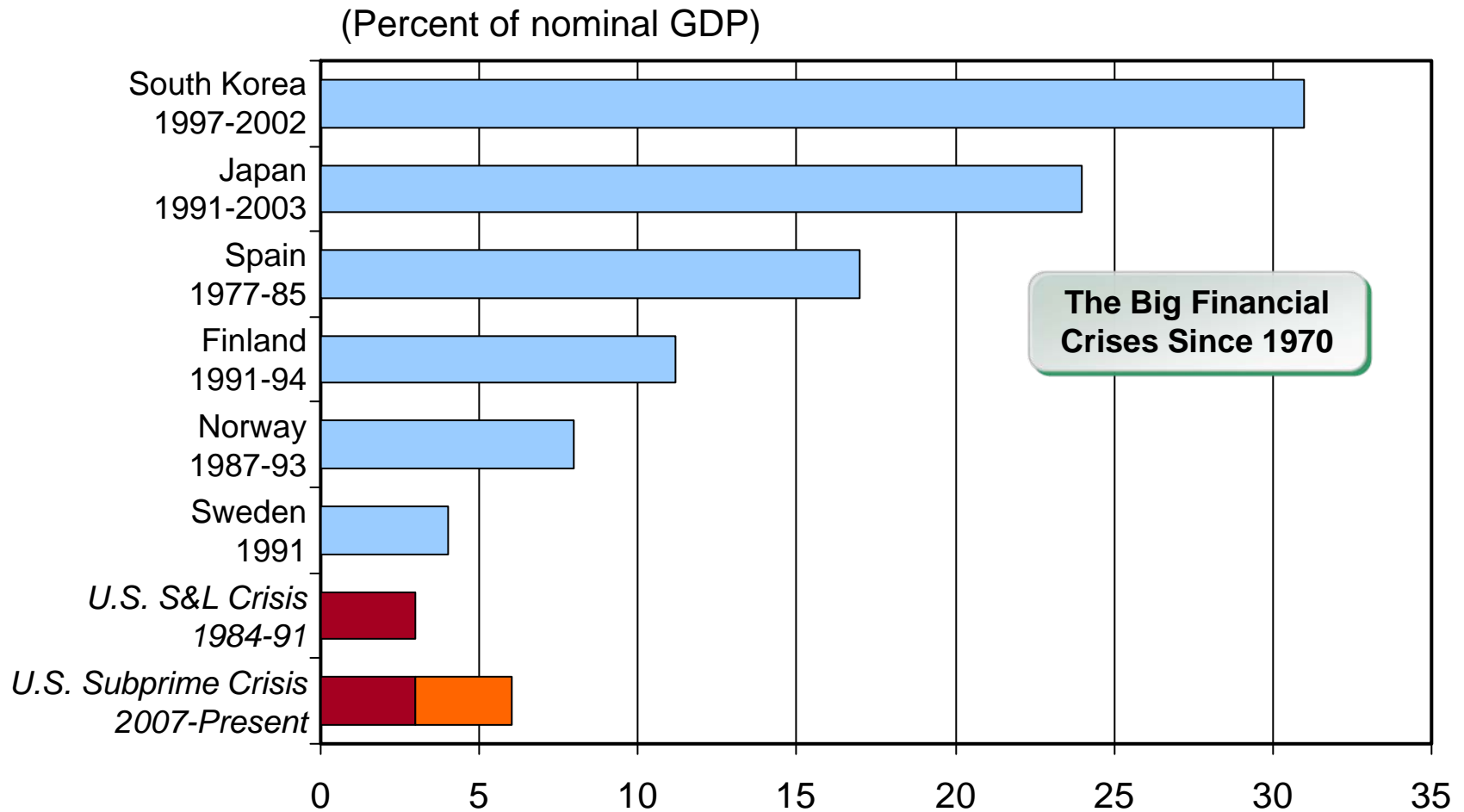


Lessons From Past Crises

- **We've been here before — many times**
- **Finance is speculation — but it has played a hugely beneficial role throughout history**
- **Wall Street R.I.P? Don't bet on it**
- **The worst financial crises in recent decades have occurred in heavily regulated and bank-dominated financial systems (e.g., Japan and South Korea)**
- **Lesson: deflation is a bigger threat than inflation (Fed versus ECB)**
- **Lesson: beggar-thy-neighbor policies are a disaster**
- **Lesson: bold swift action is needed (Japan versus Sweden)**



Fiscal Costs of Post-War Banking Crises



Source: OECD, IMF, Global Insight



Lessons from Past Crises II

- **Lesson: there are limits to crisis management — sooner rather than later systemic solutions are needed**
- **Lesson: dealing with illiquidity without dealing with insolvency is ineffective**
- **Lesson: key ingredients of a successful “fix” include: lots of liquidity, capital infusions, debt guarantees, deposit insurance, and fiscal stimulus — plus help for homeowners**
- **Good news: after bumbling around for a while, the G7 got their act together in a matter of months not years**
- **Bad news: the average downturn after a big banking crisis has lasted four years — although it may not be as bad this time around**



World Recession Alert



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Commodities: What Goes Up Must Come Down

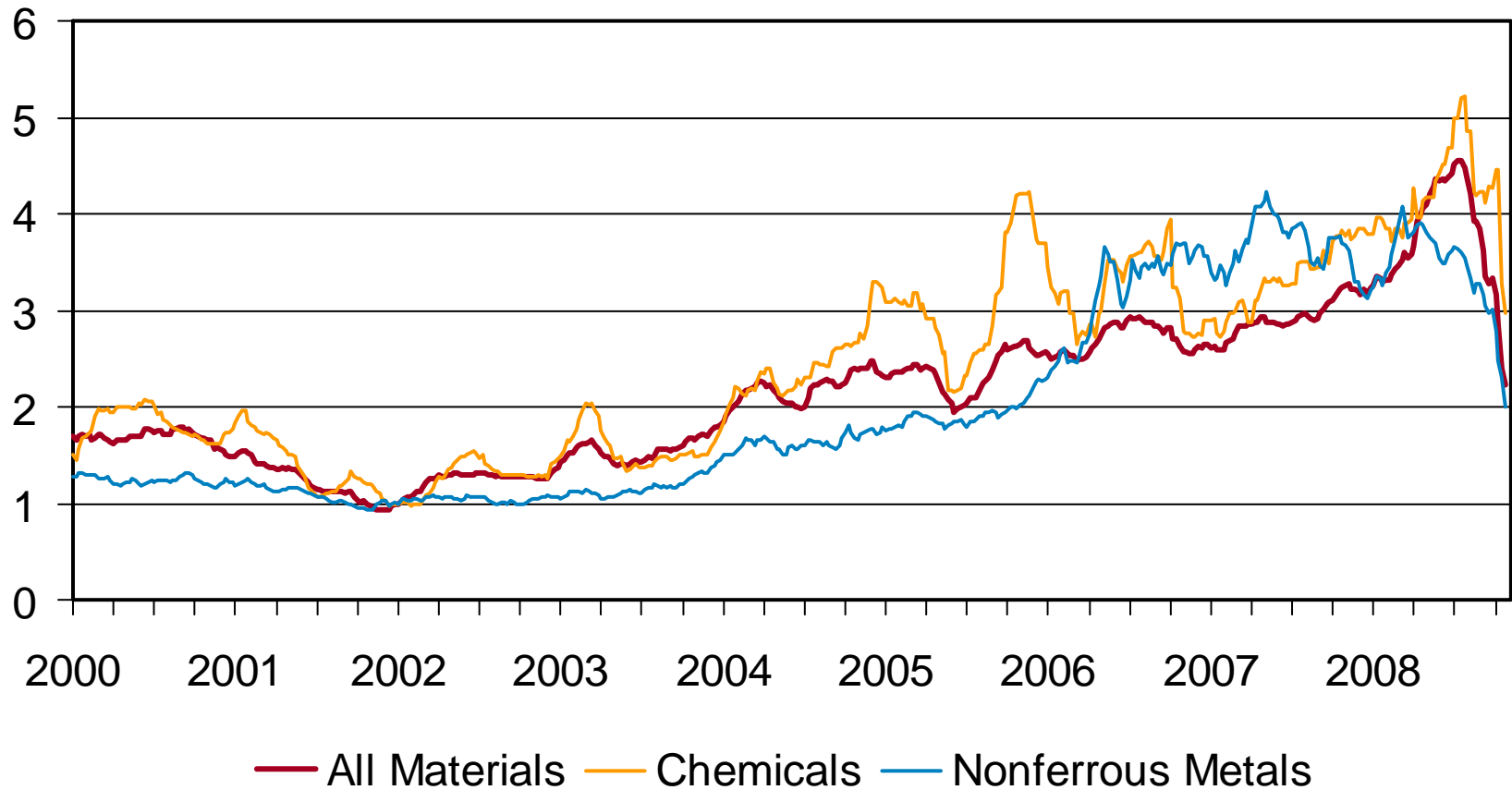
- **Commodities were very much a part of the bubble**
- **Stimulative monetary policies were a key factor in demand growth**
- **Over the past couple of years a weak dollar and investment flows (speculation?) also contributed — but their role should not be exaggerated**
- **The worsening credit crunch and expectations of a global recession have triggered 50% to 60% drops in a matter of a few weeks**
- **Worst case scenario: commodity prices could fall another 20% to 30% from current levels**



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Industrial Materials Prices Plunge from Peaks

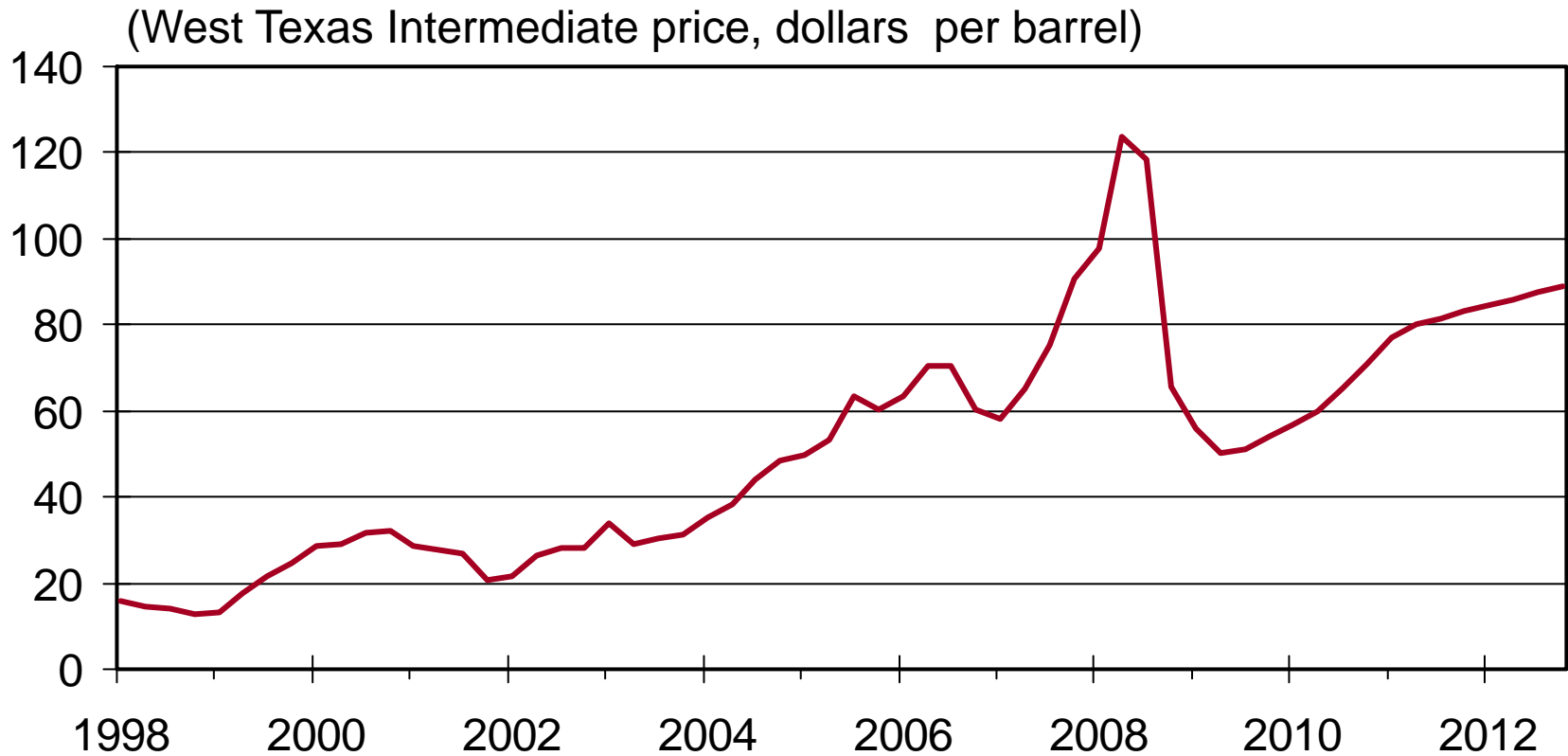
(Global Insight Indexes, 2002:1=1.0)



— All Materials — Chemicals — Nonferrous Metals



Relief from High Crude Oil Prices



Why Is the Dollar So Strong?

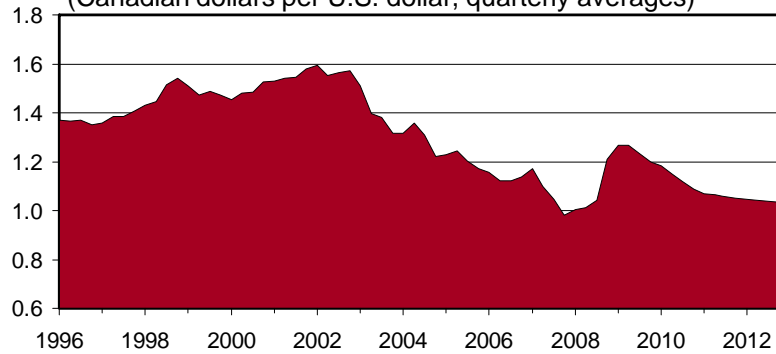
- **“Best looking horse in the glue factory”**
- **Even though the U.S. is one of the hardest hit economies, the safe-haven/principal-reserve-currency status of the dollar has trumped other fears**
- **So far, many currencies have born the brunt of this attempt to seek safety — including the euro**
- **Real effective exchange rates tell a very different story than bilateral nominal exchange rates: the euro is not that strong and the dollar is not that weak, but the yen is still quite weak and the renminbi is quite strong**
- **Ten-year anniversary of the euro: a mixed record**



U.S. Dollar Exchange Rates

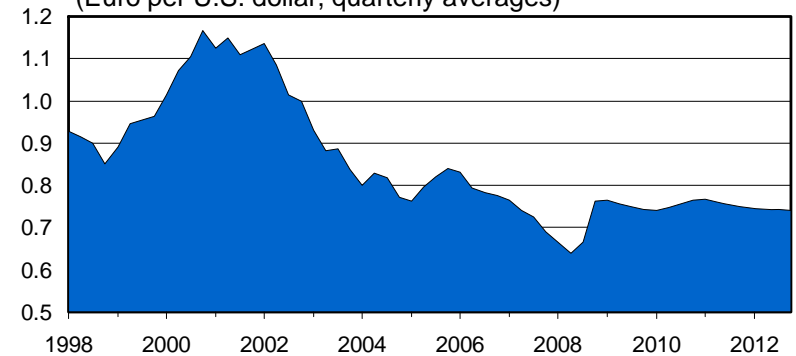
Near Parity with the Canadian Dollar

(Canadian dollars per U.S. dollar, quarterly averages)



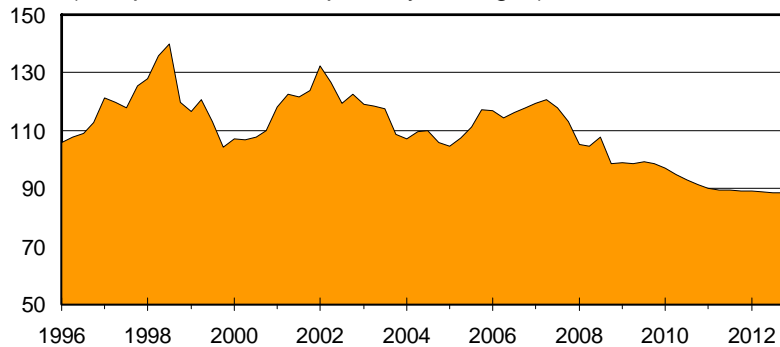
Limited Recovery Against the Euro

(Euro per U.S. dollar, quarterly averages)



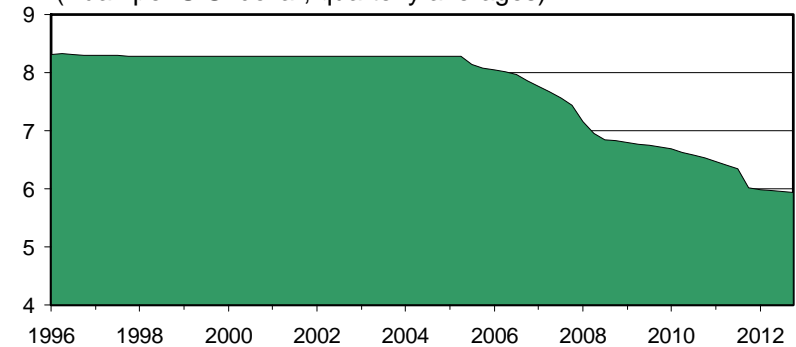
Depreciation Against Japanese Yen

(Yen per U.S. dollar, quarterly averages)



Falling Against China's Renminbi

(Yuan per U.S. dollar, quarterly averages)

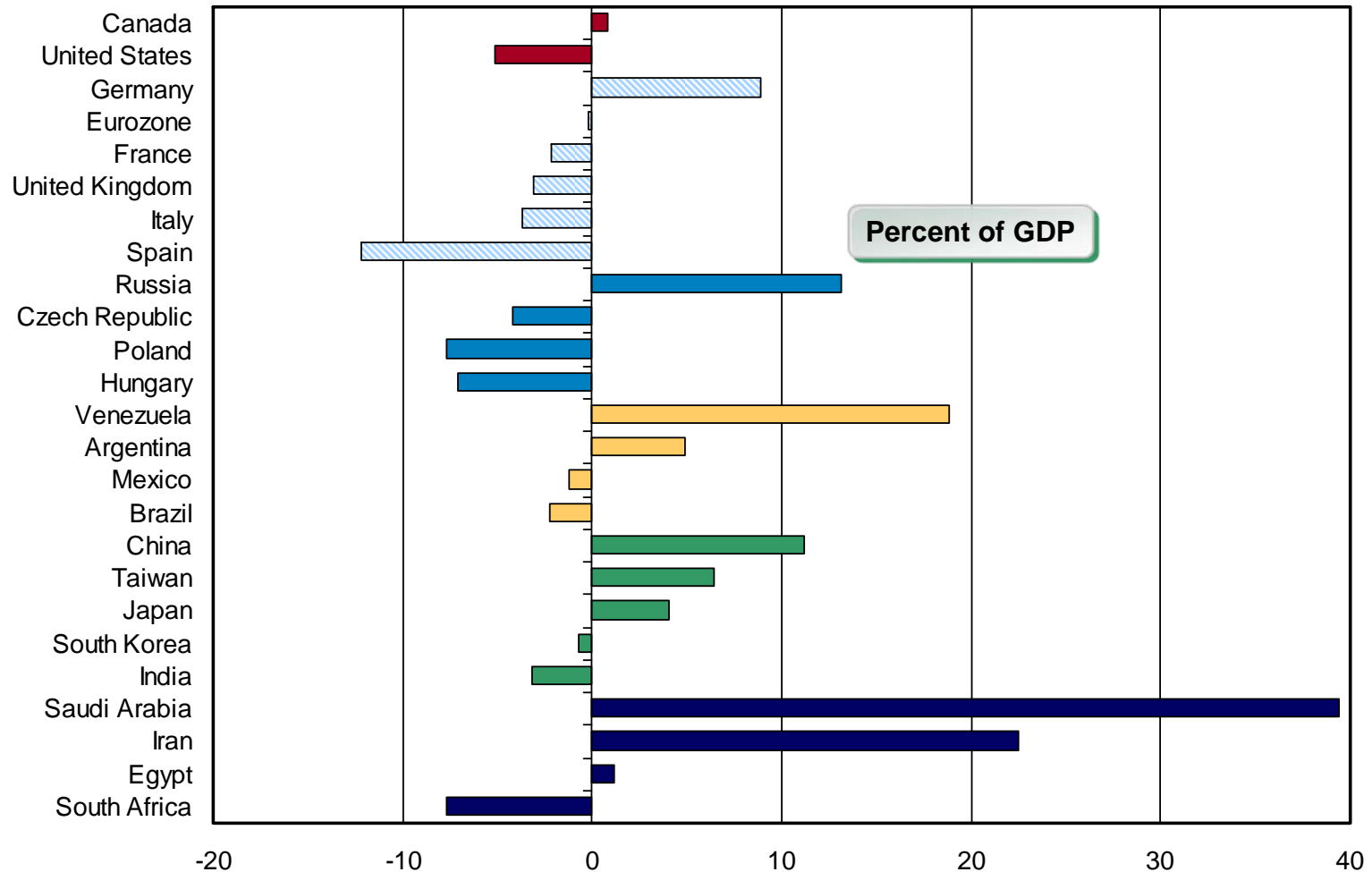


Who Is Most Vulnerable?

- **Already we have seen emerging markets equity prices fall around 60% since fall of 2007**
- **At the same time, emerging markets risk spreads have surged to around 800bp...**
- **...And many currencies have seen large drops**
- **It's clear that capital flows into even the strongest emerging markets (e.g., China) have fallen**
- **Because of its export dependence, Asia is particularly vulnerable to a downside scenario**
- **Countries with large current account deficits are at risk**



Current Account Deficits, 2008



Bottom Line: World Recession in 2009 ...

- **The U.S., Europe, and Japan will suffer through recessions that will probably be “more than mild”**
- **No regions will be immune from a significant deceleration — some will be particularly hard hit (e.g., Emerging Europe)**
- **Large reserves will help Asia and the Middle East — but for how long?**
- **A repeat of either the Great Depression or a Japan-style lost decade seems like a remote possibility**
- **Forecast of our forecast: there will most likely be further downward revisions**



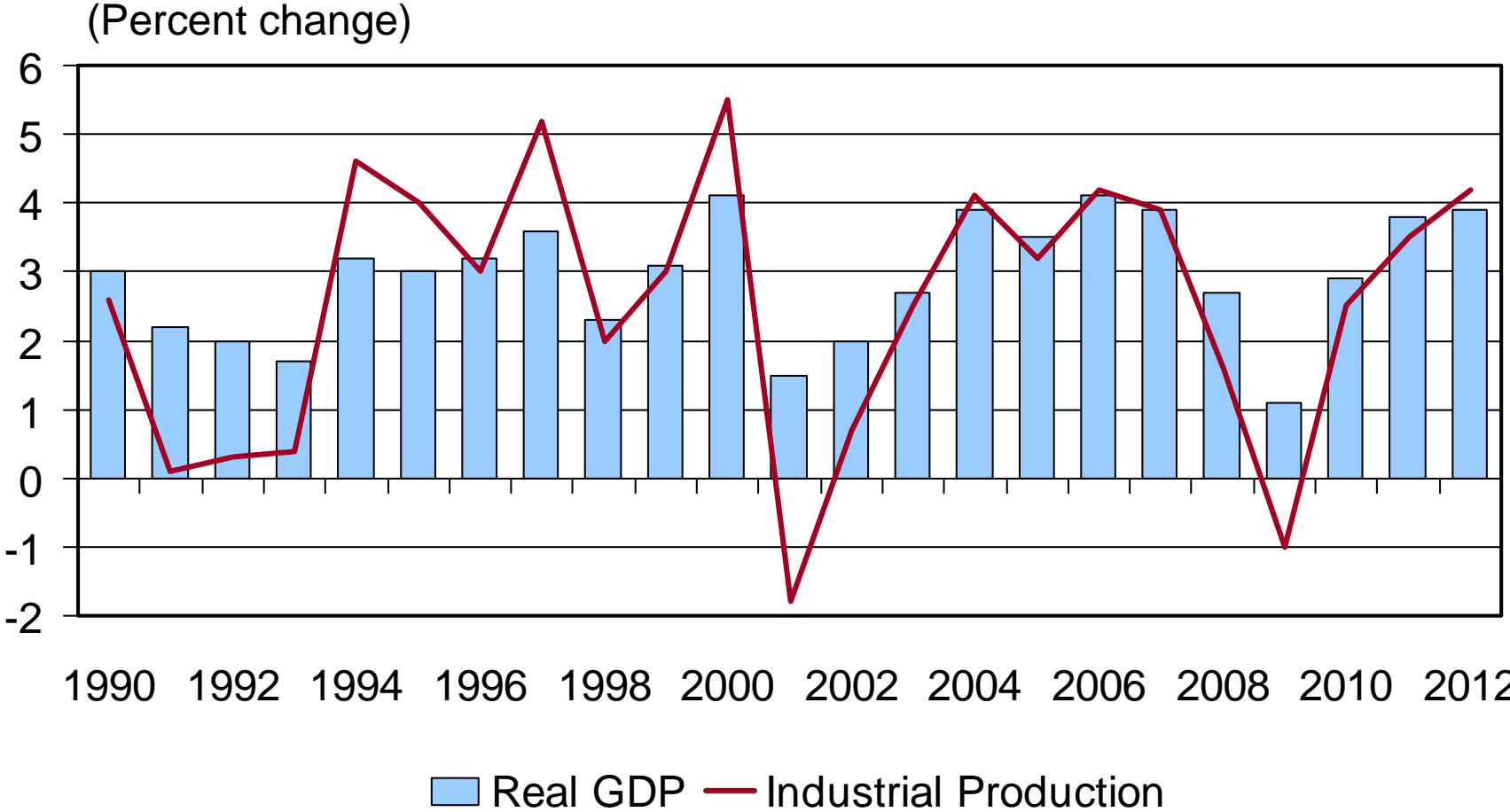
... But Also a Relatively Strong Rebound

- **The collapse of commodity prices will help consumers and businesses**
- **The financial rescue packages will help — they already are**
- **Existing and expected monetary stimulus will make the adjustments easier**
- **More fiscal stimulus in the pipeline in many countries**
- **Bottom line: deep recession in 2009, modest recovery in 2010, and a sharper rebound in 2011**



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The World Economy: No Recovery Until 2010



World Roundup

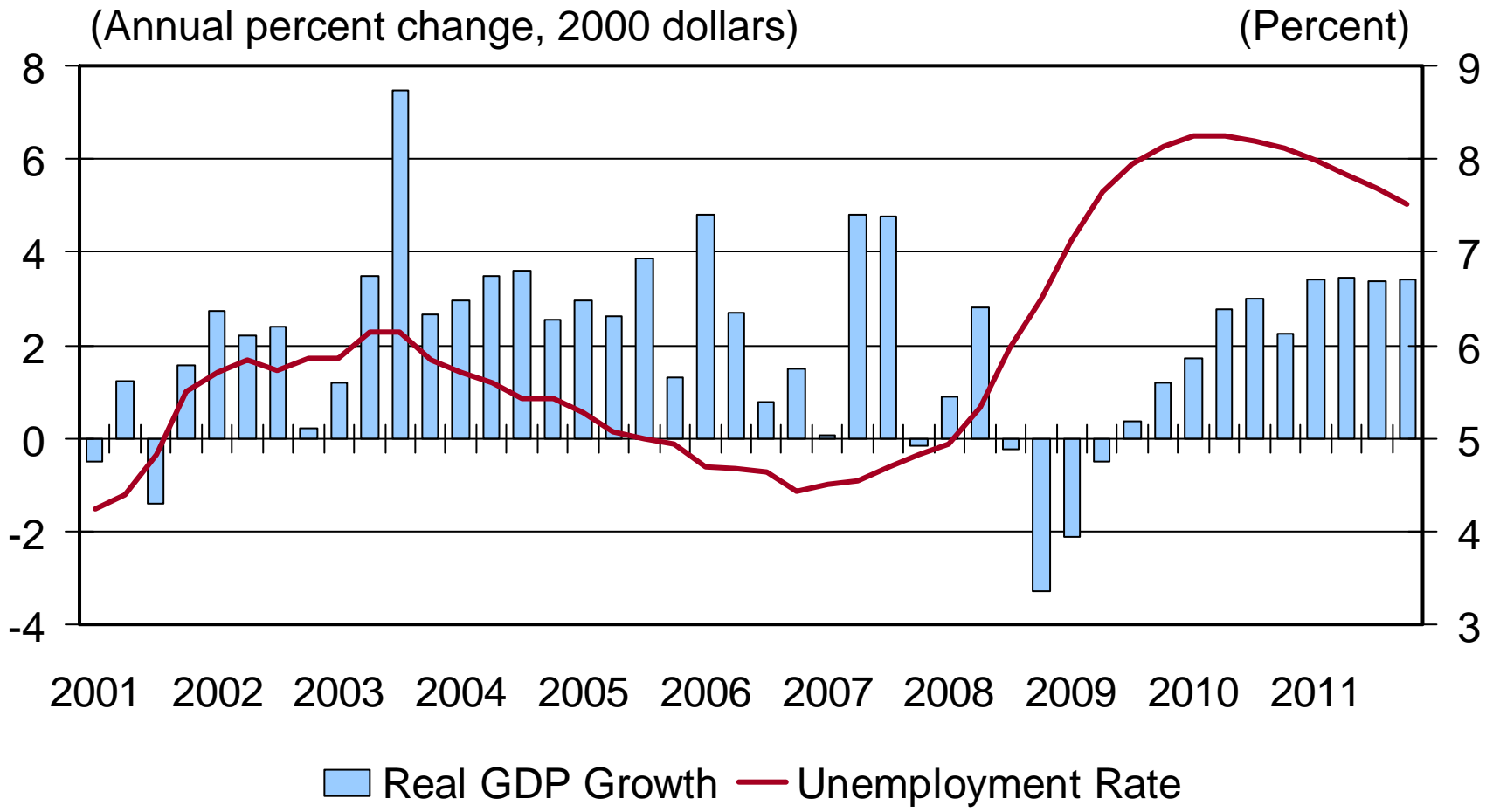


North America: Deeper Recession

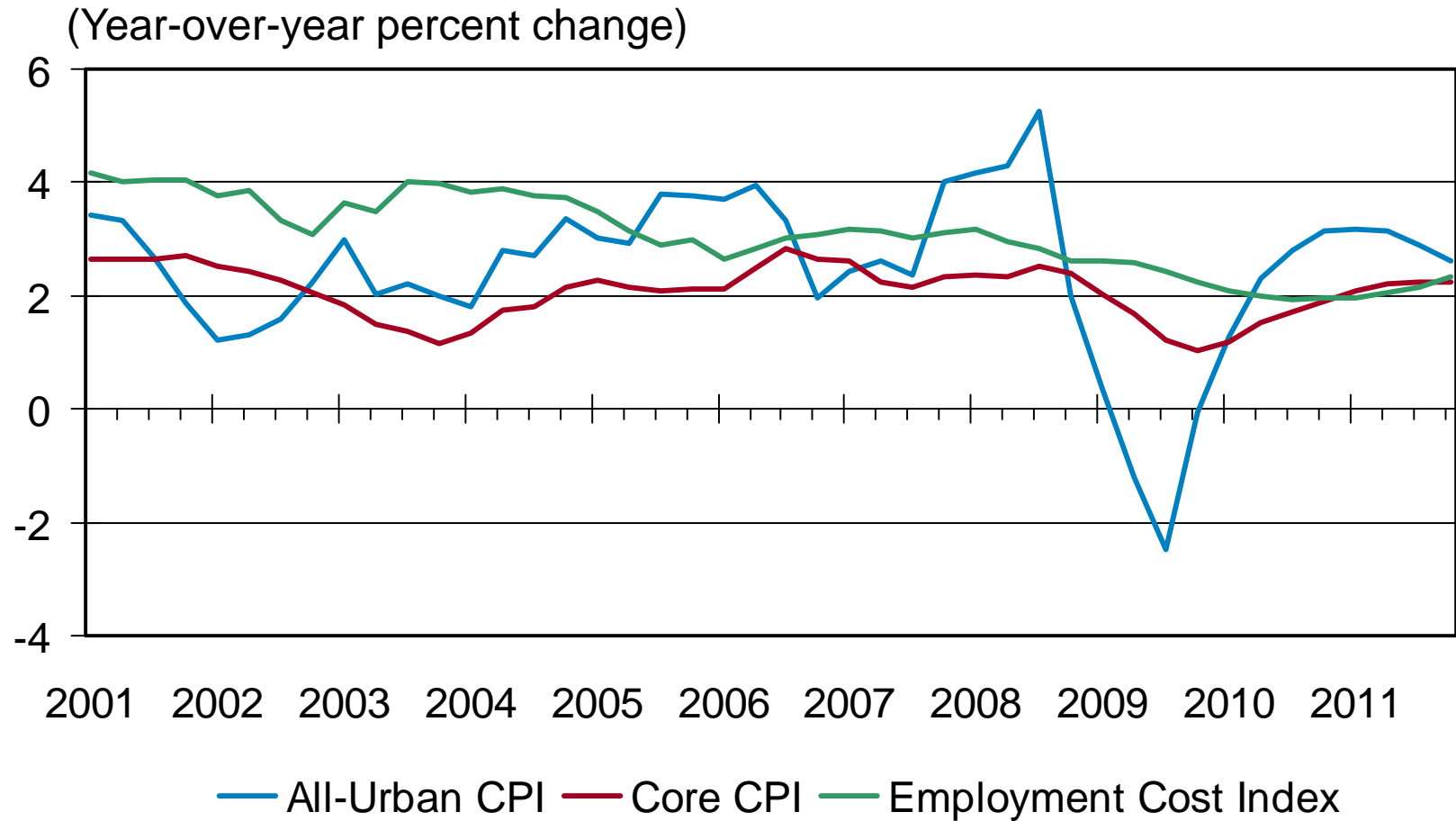
- **The only debate now is how deep will the recession be**
- **The rescue efforts seem to be bearing fruit, although it is too early to tell**
- **More fiscal stimulus is in the cards — the incoming Obama administration will probably push for a package of \$500 billion to \$700 in tax cuts and spending increases**
- **The Fed will cut at least another 50bp**
- **Worsening prospects in the rest of the world will hurt U.S. exports**
- **Canada and Mexico will not be able to avoid being badly hurt**



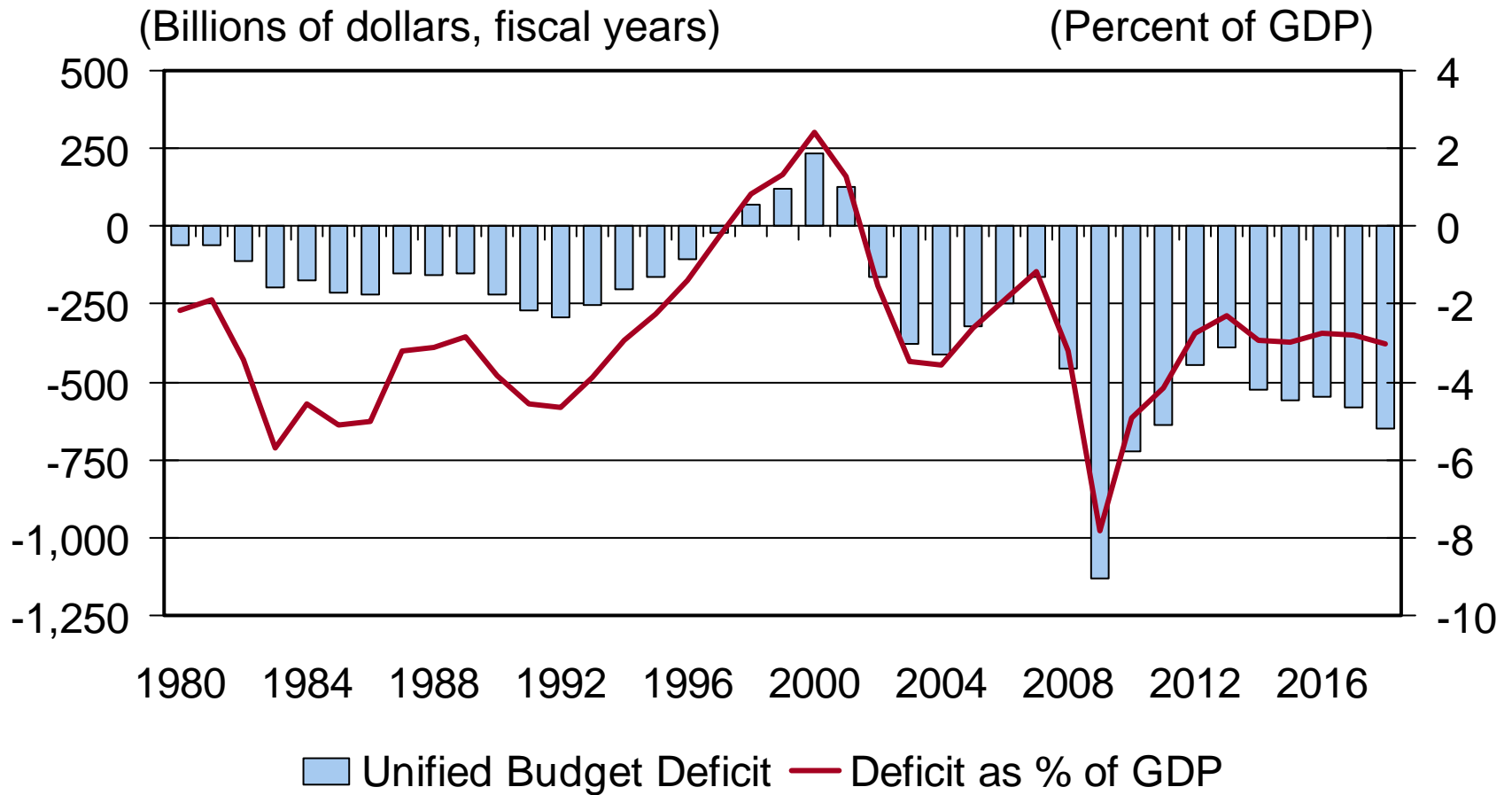
As U.S. Economic Growth Falls Below Potential, the Unemployment Rate Rises



Food and Energy Prices Caused a Spike in Consumer Price Inflation



The Federal Budget Deficit Widens Again



Elements of an Obama Fiscal Package

- **“Permanent” tax cuts**
- **Infrastructure spending**
- **Revenue sharing with state and local governments (e.g., some of it focused on Medicaid)**
- **More unemployment benefits**
- **Some relief for homeowners**
- **Bailout for Detroit?**

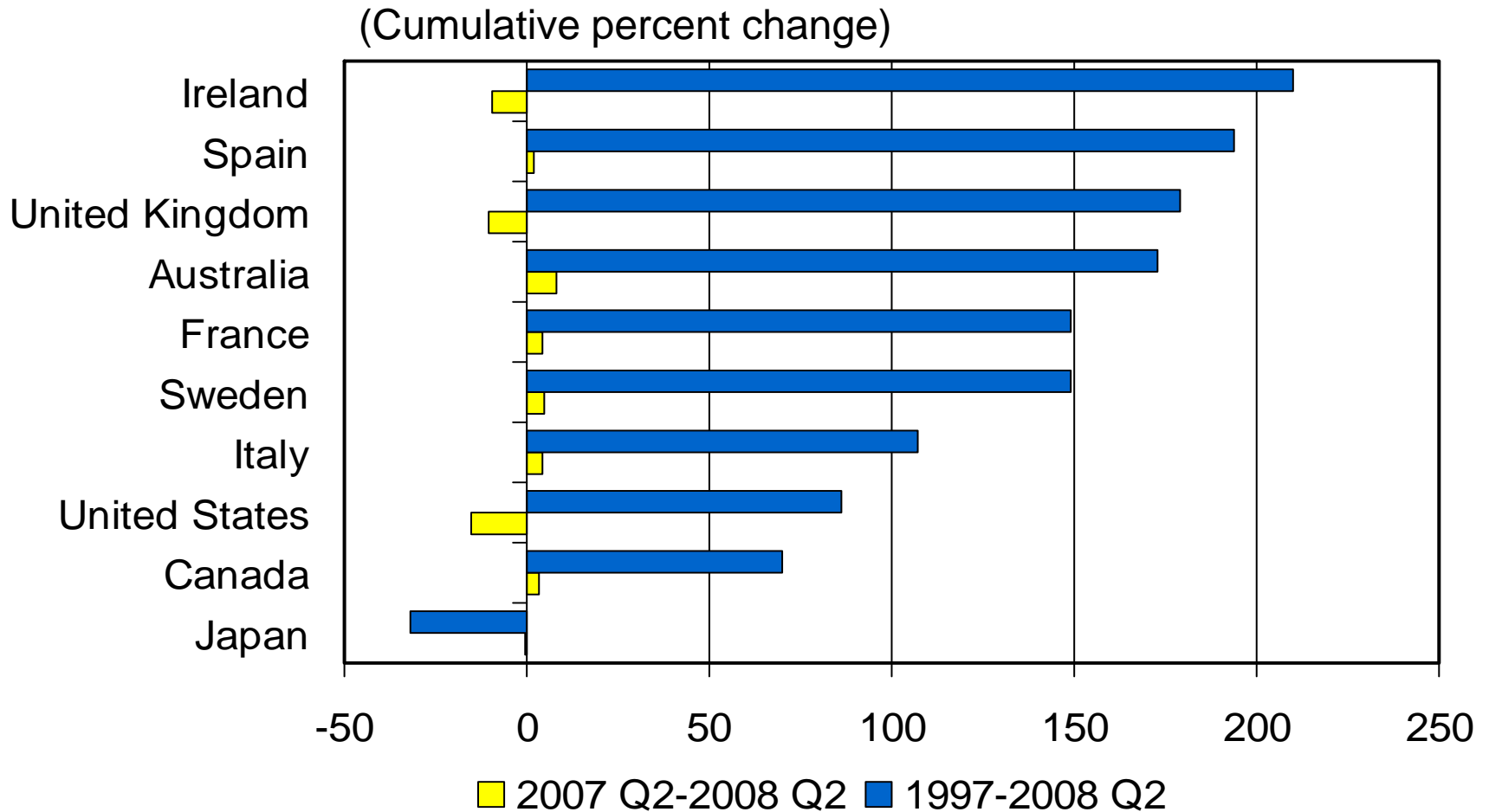


Western Europe: No Avoiding Recession

- **No de-coupling here**
- **After some hesitation, Europe has shown leadership on the resolution of the financial crisis...**
- **...Nevertheless, high leverage, exposure to the subprime mess, a strong euro, and a world recession will drag down the key economies**
- **Housing crashes will also inflict a lot of damage**
- **A weaker euro and lower oil prices are the only positive developments**
- **Many countries are in or on the brink of recession**



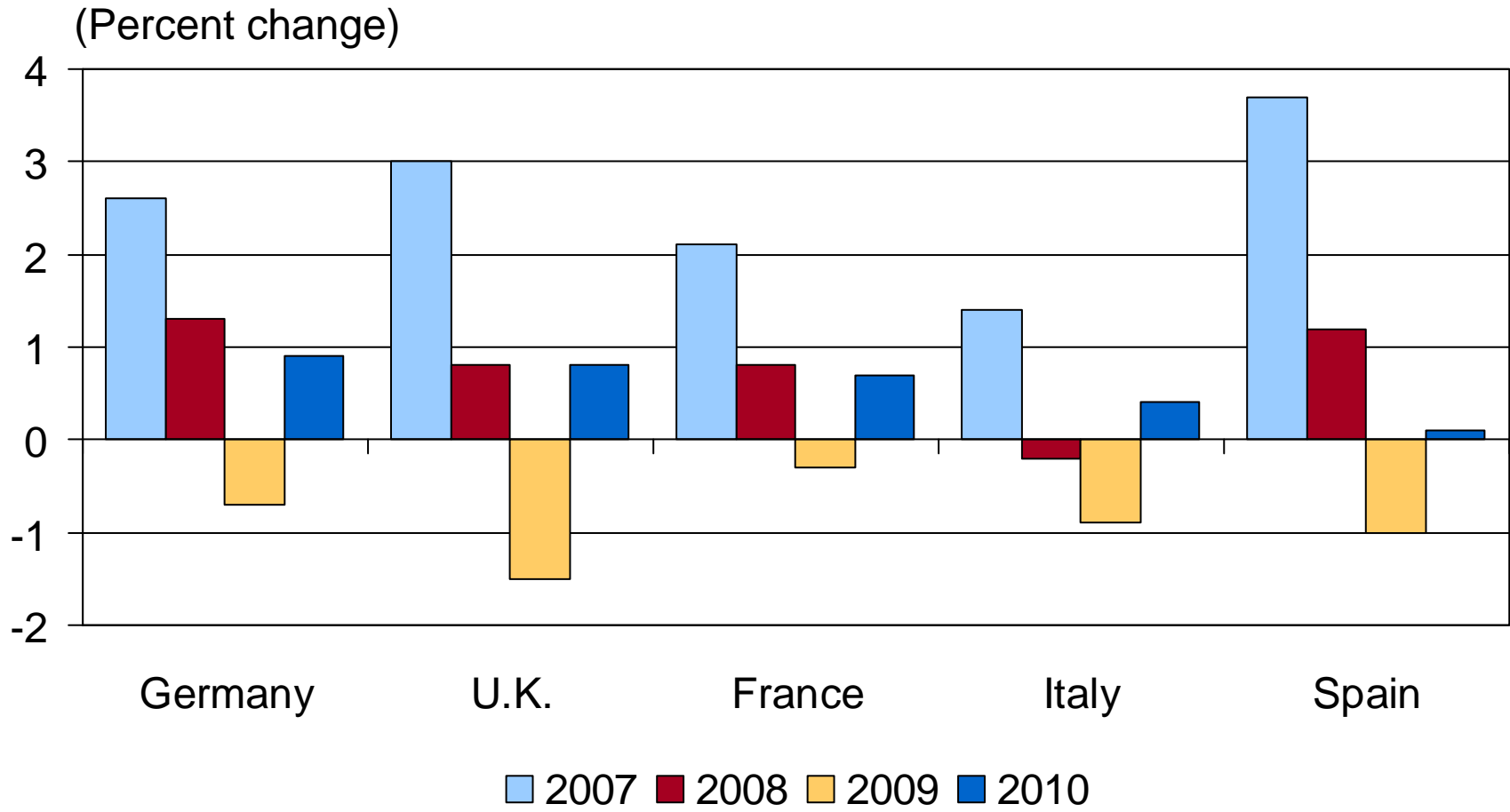
House Prices Soared in Many Countries



Source: *The Economist*, September 13, 2008



Real GDP Growth Rates Vary Across Europe



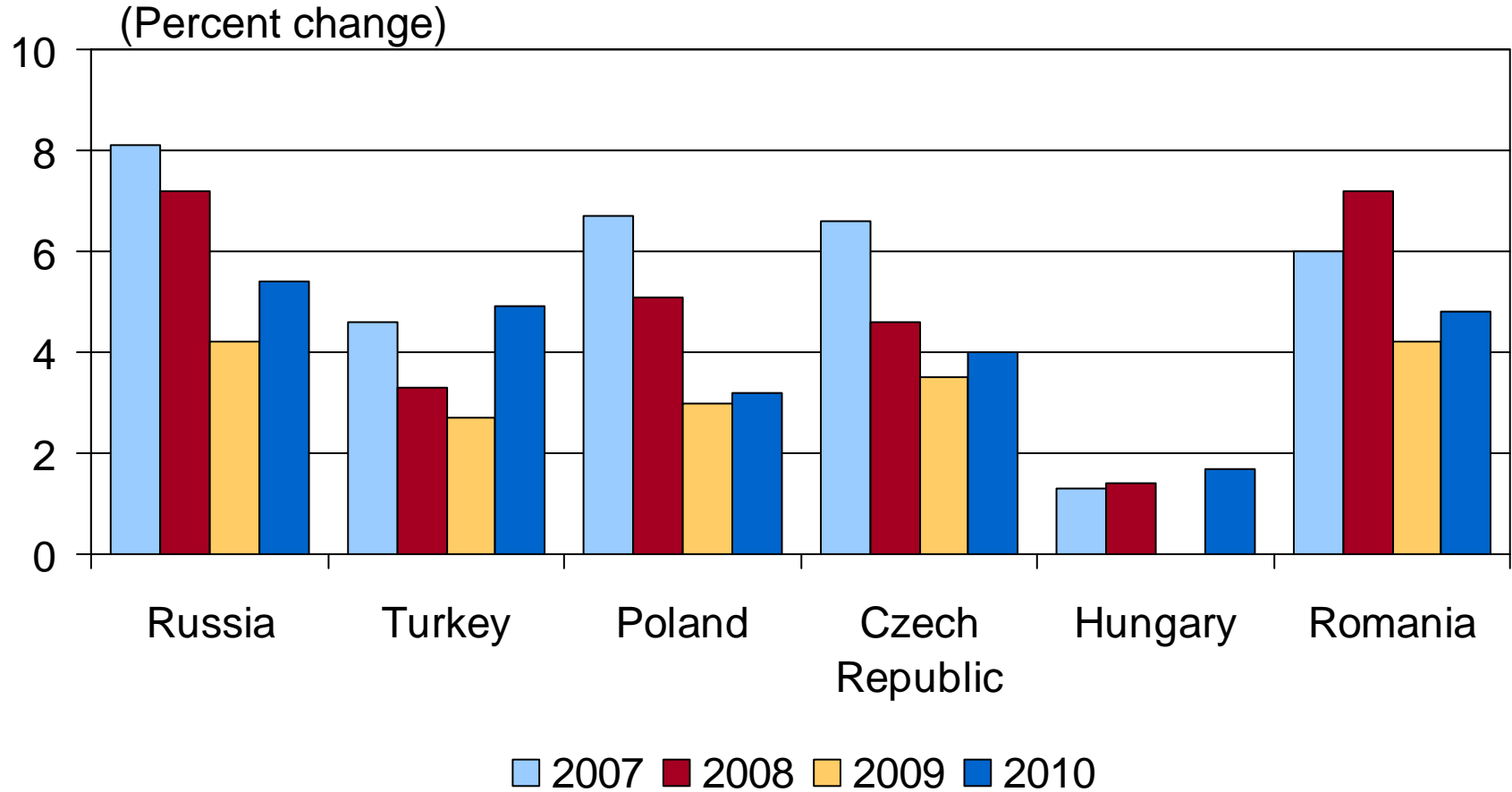
Emerging Europe: Very Vulnerable

- **Because of large current account deficits many countries in this region are particularly vulnerable to the credit crunch and rising risk premia**
- **The countries at the periphery of Europe (Iceland, the Baltics, Bulgaria, etc.) are in deep trouble**
- **Russia's recent financial turmoil suggests that the boom is not only over, but there is more downside to growth**
- **Lower oil prices and recessions in the U.S. and the EU will inflict even more pain on the Russian economy**



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Real GDP Growth in Emerging Europe

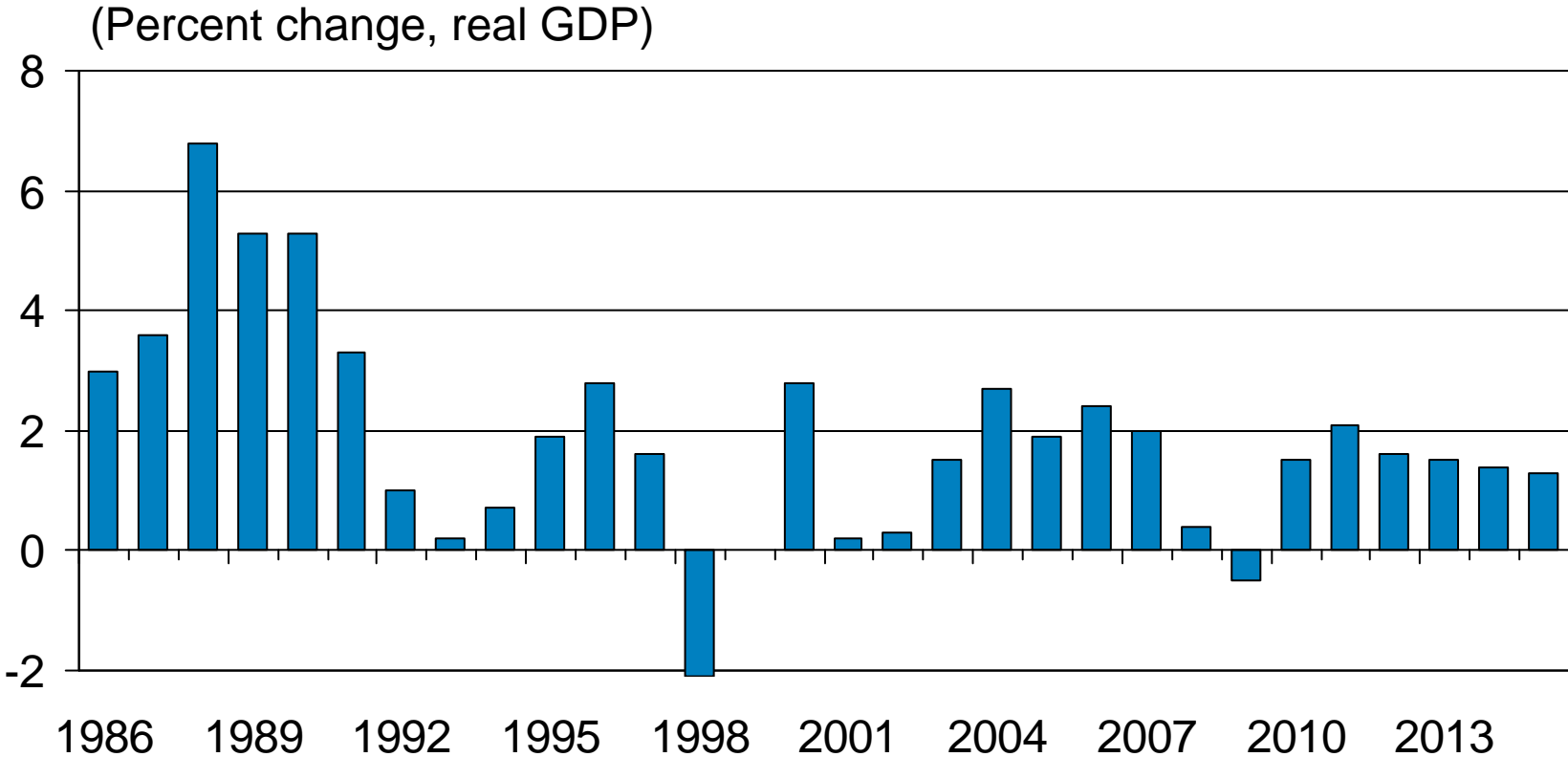


Asia: Better Off than Most?

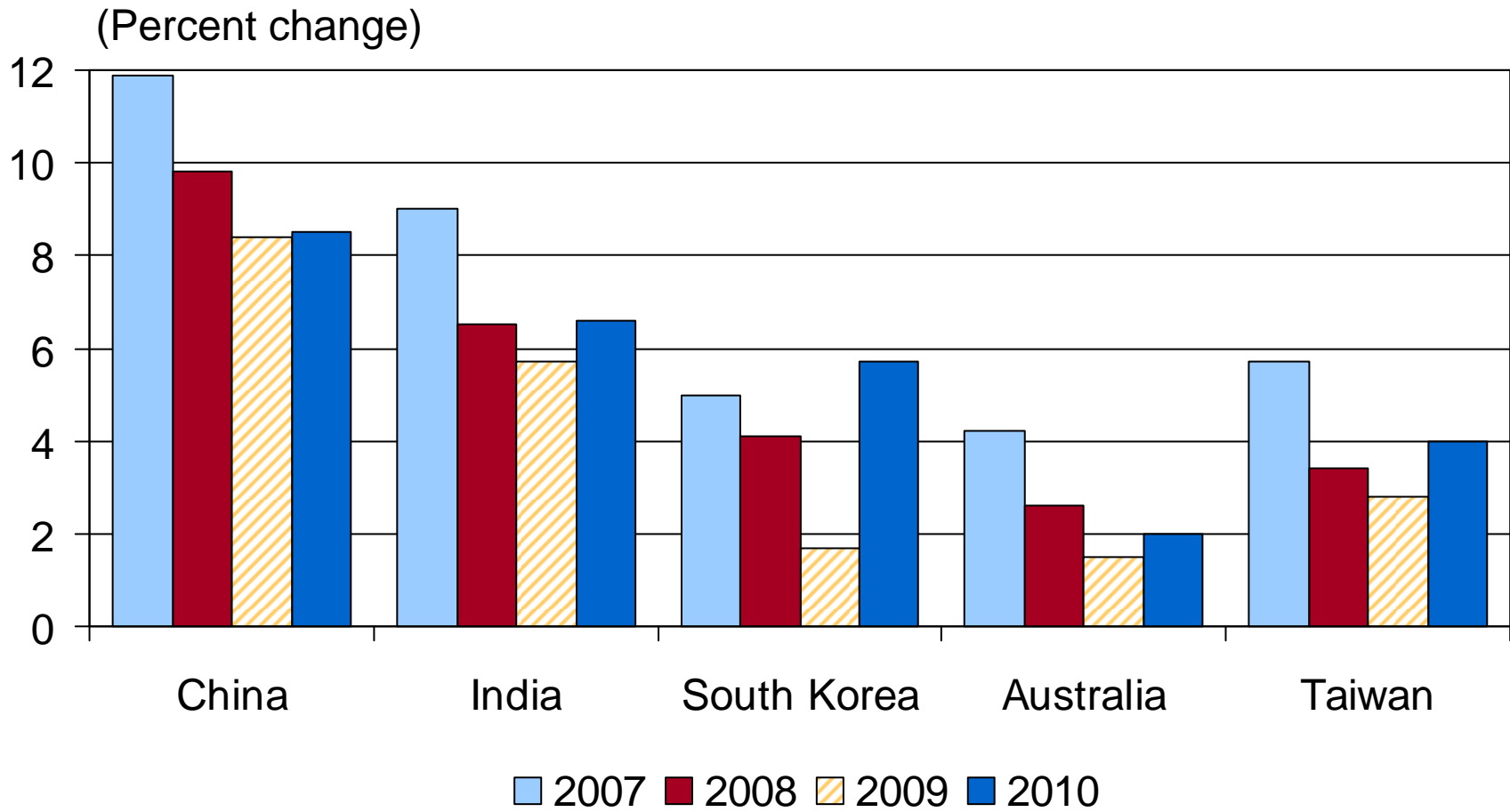
- **While the exposure to the subprime crisis is limited and finances are strong, export dependence is a big vulnerability**
- **Can domestic demand compensate for the worsening external environment? Only up to a point**
- **Capital inflows are diminishing, hurting investment prospects**
- **Australia and South Korea are particularly vulnerable — as are Pakistan, Thailand and Vietnam**
- **China has suffered (the collapse in the stock market), but may be able to weather the crisis better than most**



Japan's Economy Has Limited Growth Potential



Real GDP Growth in Asia/Pacific Economies

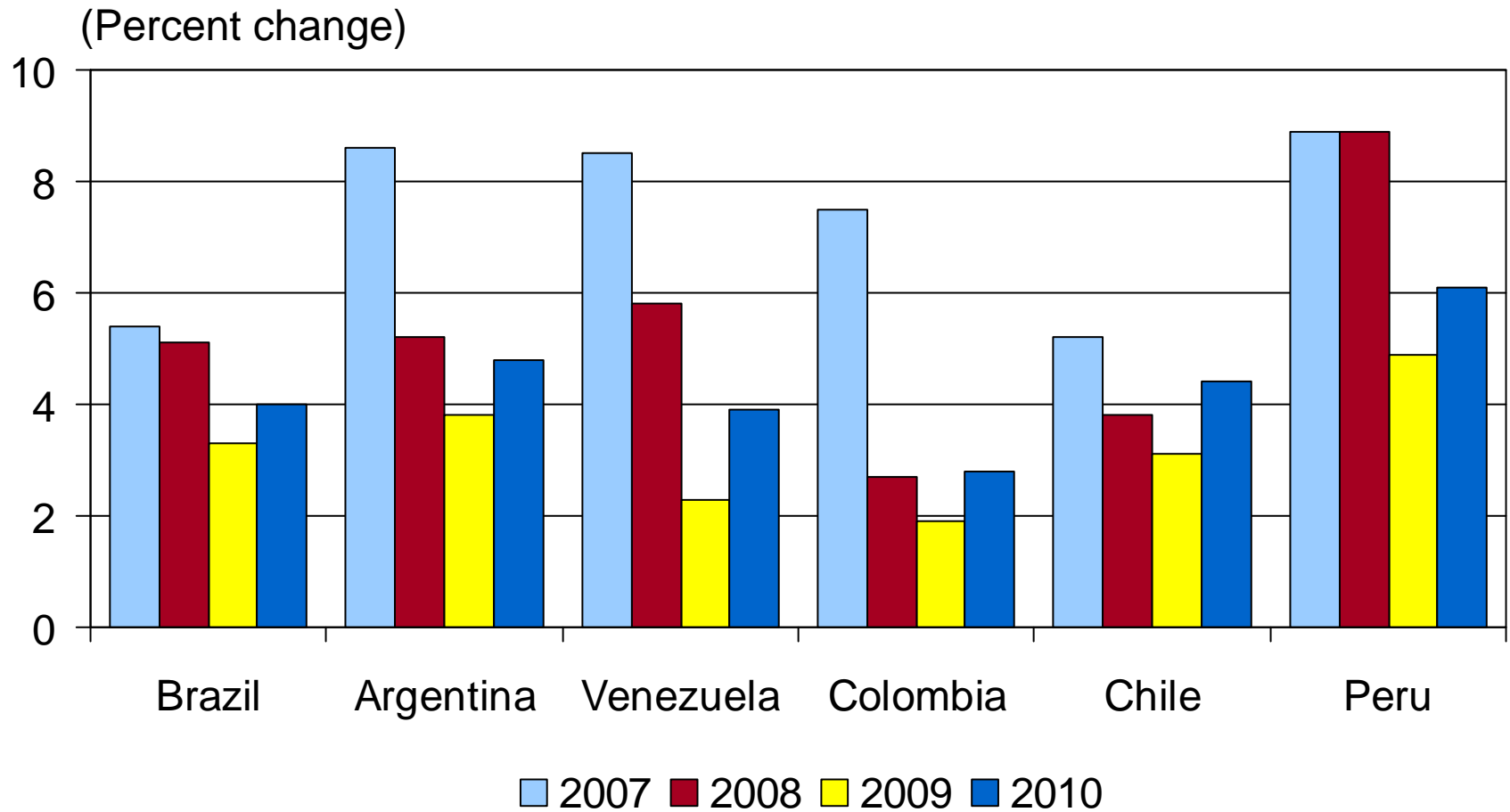


Latin America: Mostly Bad News

- **Collapsing commodity prices, a slump in world trade and recessions in key markets will pull down growth across the region**
- **Mexico will be dragged down by a U.S. recession**
- **Argentina: a mini banking crisis earlier this year, still high financing needs, a mismanaged economy, and a bleaker commodity outlook have limited options for growth**
- **Brazil: strong growth will likely be cut with the credit squeeze, falling stock prices and huge downward pressure on the real**
- **Venezuela: collapsing oil prices will hurt the government's ability to fund its social programs ahead of the elections, and a falling currency will exacerbate inflationary pressures — caused by terrible policies**



Real GDP Growth in Latin America

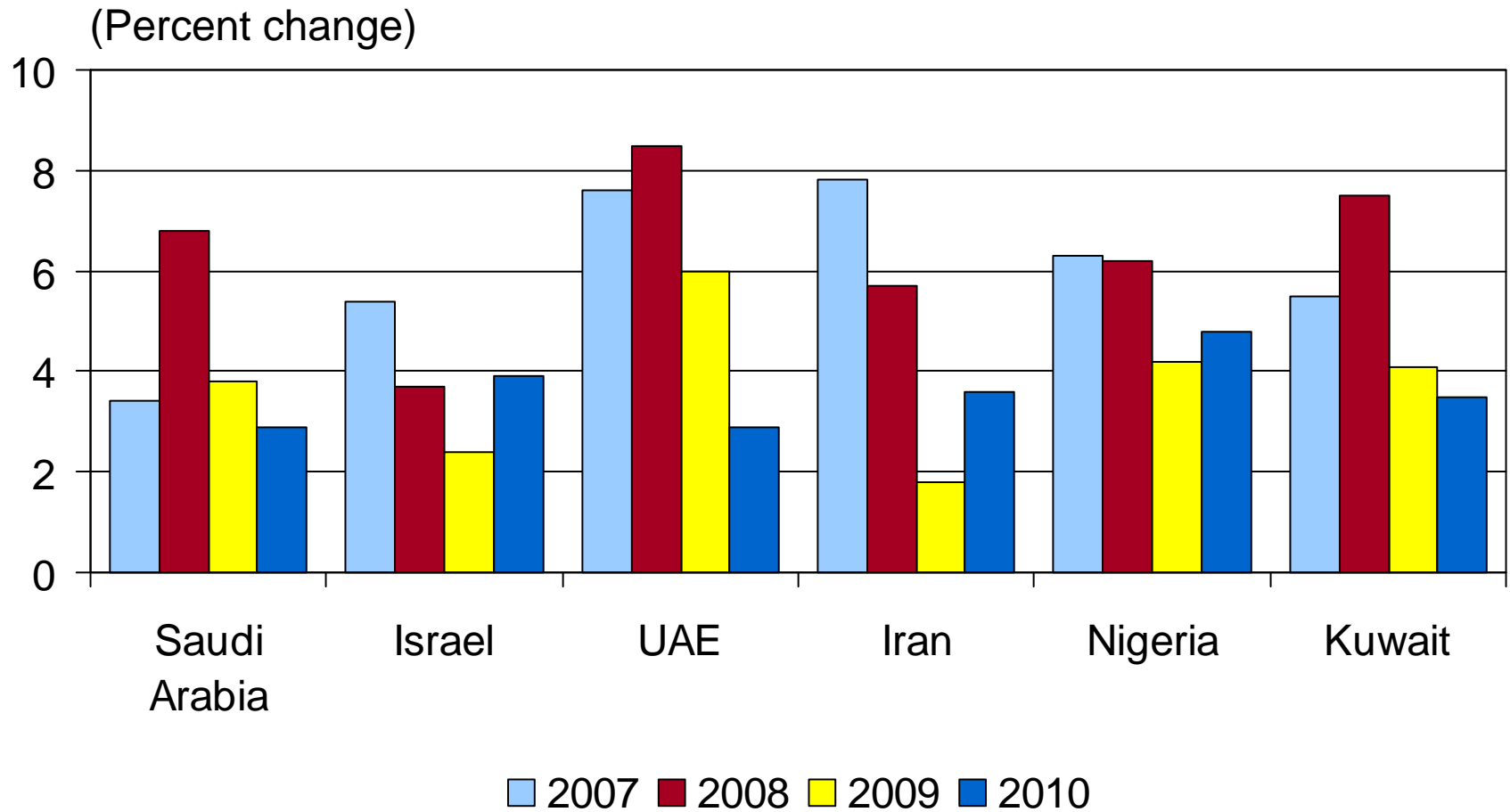


Middle East and Africa: The Party's Over

- **Volatility in the price of oil and other commodities is nothing but bad news**
- **Large current account surpluses in oil exporting countries will help to cushion the blow...**
- **...But the global liquidity squeeze is hurting investment projects throughout the region**
- **Keep an eye on South Africa — there may be trouble ahead**
- **If the price of oil stays at \$60 or goes lower, it will cut growth by a lot**



Real GDP Growth in the Middle East and Africa



Bottom Line

- **A world recession is inevitable — the only debate is about how deep and how long**
- **If the financial crisis dissipates, then a modest rebound in 2010 is possible, if not...**
- **De-leveraging in the worst-hit countries could take many years**
- **Falling commodity prices will “re-balance” growth and change the terms of trade**
- **Don’t get too carried away with the doom and gloom — the rebound (when it starts) is likely to be strong**
- **U.S. economic resilience and Asian dynamism will likely reassert themselves once the crisis has blown over**



Thank you!

Nariman Behravesh
Chief Economist, IHS Global Insight
nariman.behravesh@globalinsight.com



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