

1. The Global Economy: The (perfect) storm brewing

The repricing of risk has begun, and the consequences are ugly. After nearly five years of unprecedented rapid global growth with low interest rates, compressed risk premia, and low inflation, financial markets have turned a corner. Liquidity has dried up, volatility has increased, and credit markets are tense. While this was not entirely unexpected, the timing and source of shocks and the subsequent chain of events took most by surprise. The burning question now is: “how long and how deep?” But there are no easy answers. Undisputed is only that the US will suffer a severe slowdown. It is prudent to assume that the US contraction and the global credit crunch emerging now will lead to a global slowdown that may last into 2009. One straw to hold on is the fact that the financial headwinds are blowing against a global economy that in many parts is driven by strong domestic factors (above all in emerging Asia) and that most businesses have strong balance sheets.

The US economy is in the center of the storm. In a worst-case scenario subprime losses could exceed USD 400 billion, of which up to USD 130 billion may have to be absorbed by the US banking system alone. This may lead to a credit contraction in a magnitude of USD 1.3 to 2.0 trillion, or 6% to 9% of the current household and business debt. That would be more than a stiff headwind, and it seems unlikely that the real economy will be resilient enough to recover quickly from such a shock. Hence, forecasts that US growth will trough in the current quarter appear to be optimistic. More likely is a protracted slowdown extending into 2009. Whether it will be a “growth recession,” with quarterly growth rates below 2% for some time, or a full-blown recession for parts of 2008, depends on the success of monetary policy and the global economy’s reaction to the US shock. Until now, the change in US net exports has been strong enough to compensate for the decline in the housing sector. But a slowdown in the rest of the world, high energy prices, and potentially the need to lean against inflation at an inopportune time in the cycle may push the economy over the brink.

Europe looks vulnerable, although concurrent indicators continue to be strong. The transmission is likely to come through the credit channel as continental European businesses are more dependent on bank borrowing than their American competitors. This is also true for the **UK economy** where the adjustments to falling house prices and widening credit spreads will take their toll. At current reading, the UK growth rate may decline from roughly 3% in the current year to less than 2% in 2008. Similarly, **Euroland** will have to cope with the combined impact of the credit crunch and the strong euro which is likely to depress the real growth rate to also less than 2%. Finally, it remains to be seen for how much longer **Switzerland** can maintain its blistering (by historic standards) growth. While leading indicators point to continued strength, the share of its banking sector is one of the largest in advanced economies. It seems unlikely that Swiss banks can weather the storm completely unscathed, which too would have a dampening impact on the real economy.

Developments in Asia are still dominated by China and India. Growth in these countries is firmly driven by domestic demand. Even a significant export slowdown would only shave off about 2%-points from growth rates of more than 11% in China and roughly 9% in India, but not derail growth. An issue for both countries may turn out to be inflation. It is at an 11-year high in China (although at a seemingly manageable level of 7%), and it continues to increase in India. The story is entirely different in **Japan**, where the domestic economy has been losing steam since mid-year and tightening by the Bank of Japan, originally expected for February, looks likely to be shelved. On the positive side, Japan continues to benefit from strong growth in neighboring East Asia and the corporate sector appears to be in reasonable good health to cope with adverse headwinds.

Inflation has captured the news in recent weeks. The reason for attention is an increase in headline inflation to 3% (yr/yr) and higher in both the US and Euroland due to high commodity and energy prices. But this is not inflation; it merely reflects changes in relative prices. As long as there is no monetary accommodation, these changes will not feed into inflation. But several factors should be of concern. First, trend productivity growth has slowed in recent years, and unit labor costs in the US, for example, are no longer compatible with an implicit inflation target of 2%. Second, the dollar has weakened substantially over the last year. This puts pressure on central banks in Europe and Asia. In order to fend off an undesired strength of their home currencies, they maintain an easier monetary policy than they would have chosen autonomously. In other words, the weak dollar tends to spread inflation through the world. In the past, it has done so with a lag of about two years. Should history repeat itself, the world's central banks may have to fight ensuing inflation pressures in the course of 2008 and at a time when cyclical considerations would call for easing rather than tightening.

Will a US contraction spill over to the rest of the world?

In light of the talk about how much our world has become interconnected in the age of globalization, business cycles should be highly correlated across borders. Indeed, over the last 20 years, co-movements between G-7 equity markets have significantly increased, and the demise of Northern Rock, IKB, and Sachsen LB (just to mention a few cases) attest to tight financial linkages. In the past, if the US sneezed, the rest of the world would catch a cold. And the US has been sneezing loudly in recent months. Does it still bode ill for the rest of us?

Not necessarily. Contrary to common perceptions, G-3 production cycles have decoupled over the last 20 years. And today, global rebalancing is underway. Since 2001, incomes and demand outside the United States have grown faster, while US expansions have become less import intensive. One reason for the desirable rebalancing may be the period of low inflation. Prior to 1990, the common battle against inflation subjected all countries to common shocks, which led to correlated cycles. Now, local trends appear to be more prominent, and some degree of decoupling could be a reality.

In fact, decoupling has been observed also in the past. A short period after 1988 was characterized by a rotation in US growth from domestic demand toward external demand. At the same time, Japan and Germany began growing faster than the US; Germany thanks to unification; Japan in reaction to monetary expansion engineered to fight yen appreciation. Unfortunately, the expansions were allowed to get out of hand. In both countries they were followed by a correction, which was particularly painful and protracted in the case of Japan.

The benign interpretation of the prospects for rebalancing hinges on two important qualifications. First, NAFTA has made Canada and Mexico more strongly coupled to the US, and over the last decade the dependency of the four largest East Asian economies (China, Japan, Korea, and Taiwan) on the US cycle has increased. Hence, these two regions should be more affected by a US demand shock than the rest of the world. Second, rebalancing and decoupling are contingent on the severity of the US slowdown. A full-blown and protracted US recession would undoubtedly impact adversely the global economy and decoupling would become elusive.

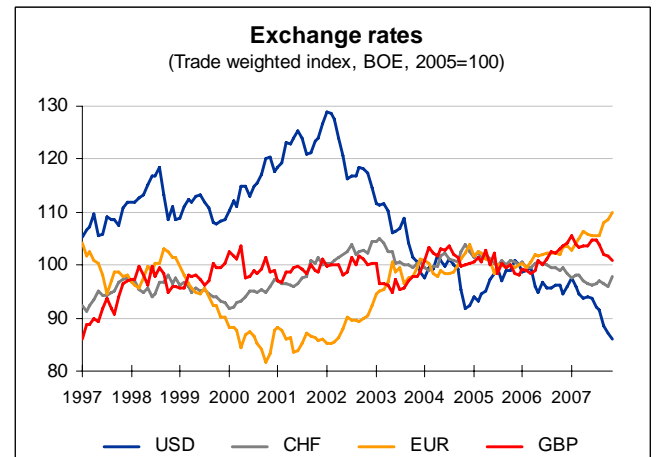
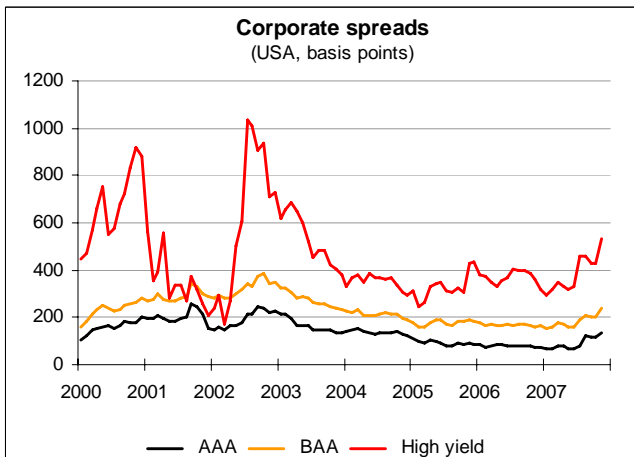
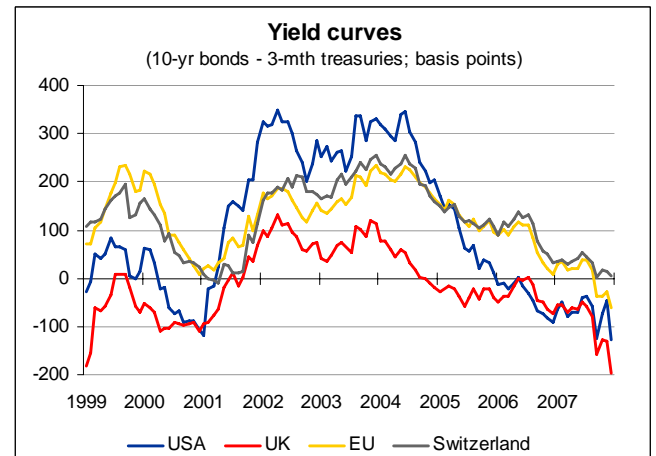
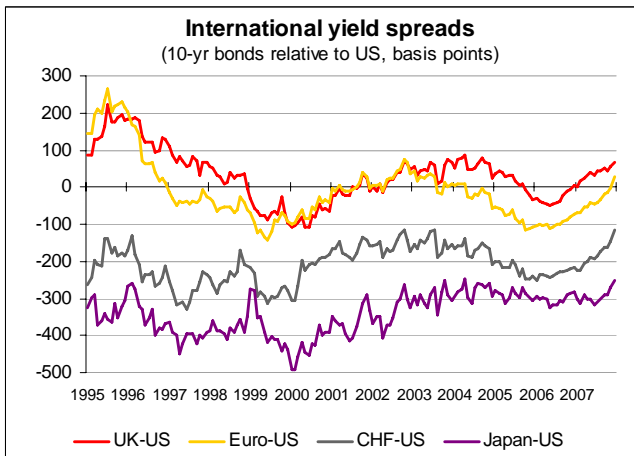
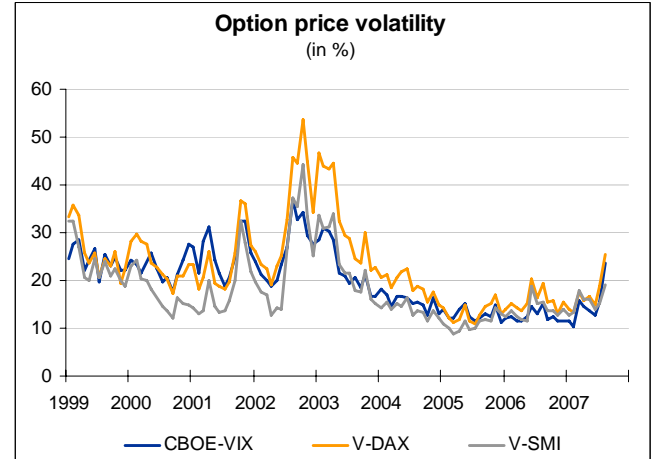
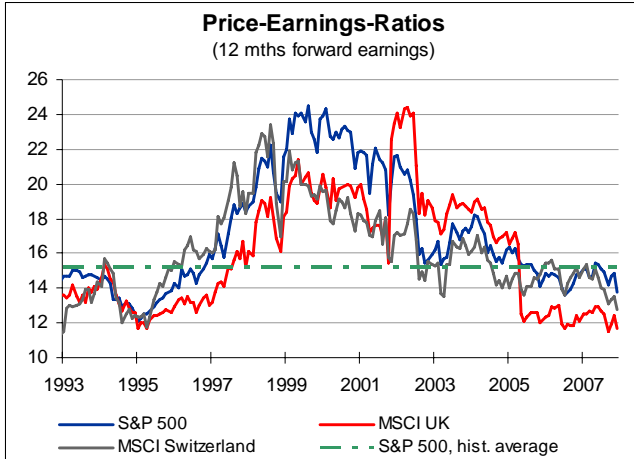
We may take some comfort from current data that a US recession appears not yet to be in the cards. But the experiences of Japan and Germany in the 1990s highlight that today's seemingly benign development – a possible decoupling from the US business cycle – may carry the seeds of an unwelcome correction in the future.

The implications for insurance of financial market turbulences and a potentially severe economic contraction are difficult to gauge. Risk aversion has increased. This is certainly true in the financial markets, but if we accept that markets are connected, it must also be true for insurance. Hence, demand for insurance products (particularly in the corporate segment) should increase and, holding everything else constant, the market should harden. Of course, this has to be seen in the context of a market softening across a broad spectrum of lines. Thus it might be more appropriate to say that the softening will become less pronounced as market conditions change. To the extent that some insurers have to absorb subprime-related losses (worst case estimates range up to USD 100 billion) and that investment returns may be compressed for some time, we expect global insurance capacity to be constrained, at least at the margin. Again, this would contribute to a hardening of the insurance market. A hardening should also be expected in lines of business that are impacted particularly strongly by current events. This appears to be true for D&O, where losses in the US alone are likely to exceed USD 3 billion. On the other hand we should expect softening in cycle-sensitive lines, such as construction, where the decline has been particularly pronounced in the US, but also in auto and homeowner's insurance. On balance, the softening due to a marked economic slowdown may be stronger than the hardening that may be attributed to increased risk aversion and financial market turbulences.

Outlook for Main Regions (Δ in %)												
	GDP, real			Inflation (CPI or HPCI)			Interest Rates					
	07	08	09	07	08	09	3 month euro rates			10-year bond yields		
	E	F	F	E	F	F	Actual	3mF	12mF	Actual	3mF	12mF
USA	2.1	1.2	2.0	2.9	2.7	2.5	5.15	4.25	4.40	4.02	4.1	4.5
Euroland	2.6	1.6	1.9	2.0	2.0	2.0	4.74	4.50	4.20	4.23	4.2	4.2
Japan	1.8	1.2	1.6	0.1	0.6	0.6	.85	0.9	0.9	1.48	1.6	1.6
UK	3.0	1.6	1.9	2.3	2.2	2.0	6.57	6.0	5.5	4.67	4.2	4.5
CH	2.4	1.2	1.6	0.7	1.2	1.2	2.75	2.4	2.6	2.87	2.8	3.0
China	11.5	10.0	10.0	4.8	5.5	5.0	<i>E</i> = Estimate <i>F</i> = Forecast					
India	8.6	7.5	8.0	4.5	4.5	4.5						
Latin America	5.0	4.0	4.4	5.1	5.2	5.2						
CEE	6.2	5.4	5.7	4.2	4.6	4.2						

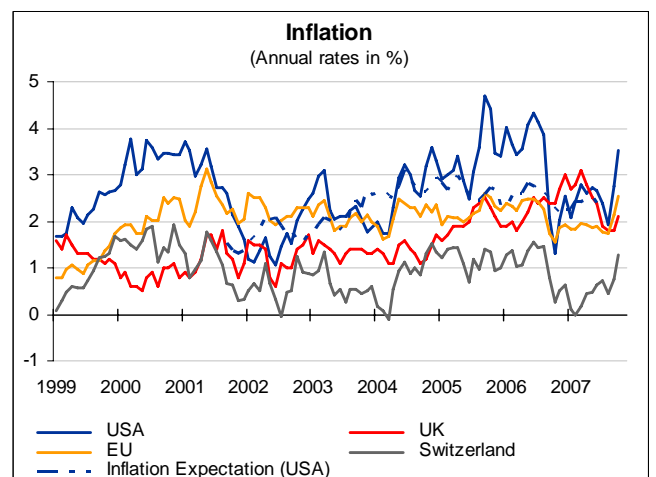
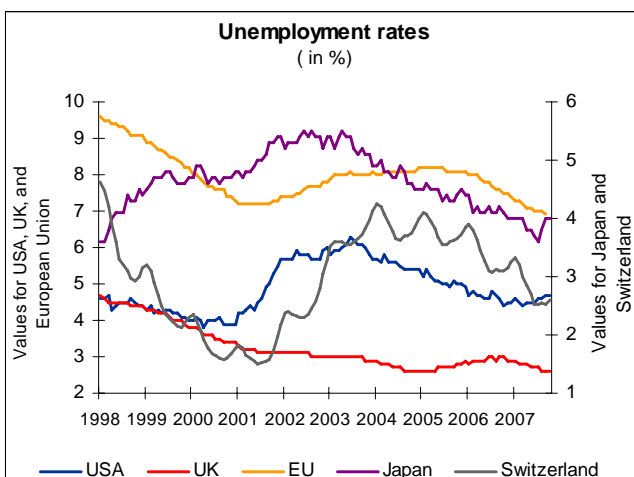
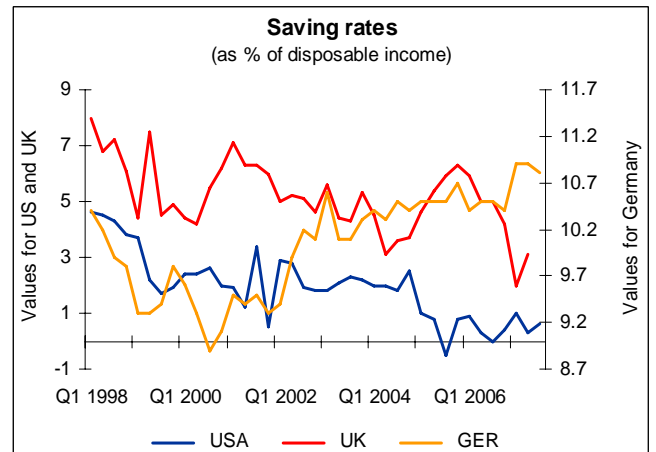
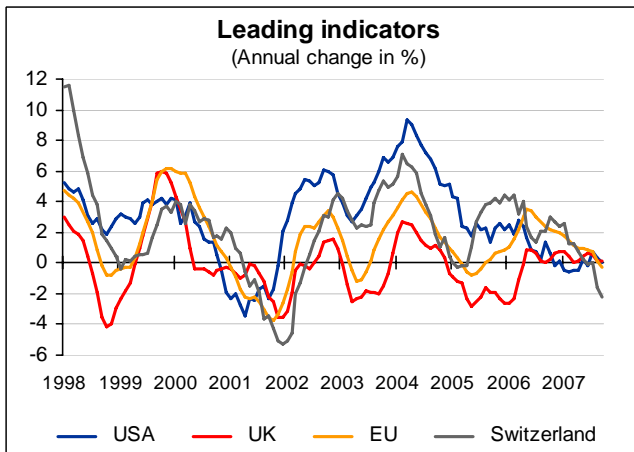
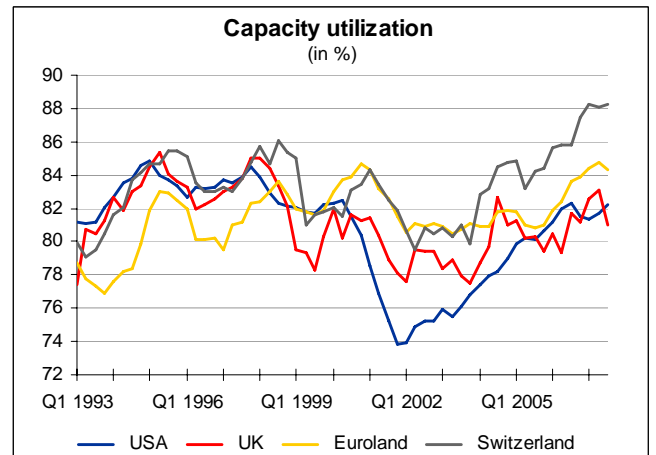
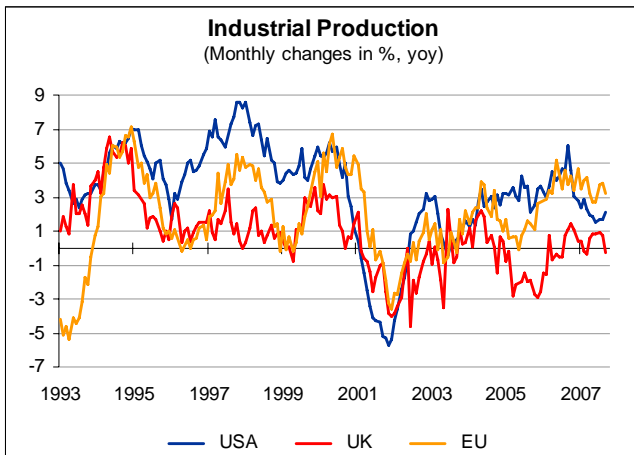
Sources: OECD, IIF, Zurich

2. Financial sector data



Source: DataStream

3. Real Sector Data



Source: DataStream

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