

1. The Global Economy: Strong market headwinds

The global economy was in a precarious condition at the end of the first quarter of 2008. Financial market turbulences have again flared up in the wake of the collapse of Bear Stearns. Inflation, fueled by commodity and energy prices, is beginning to bite into household incomes, and growth in industrialized countries is slowing appreciably. In its recently revised forecast the OECD puts quarter-on quarter real GDP growth in the seven largest industrialized countries (G-7) at 0.3% in the first quarter, with an error of margin of +/- 0.4%. Clearly, G-7 growth is close to stall speed. While monetary and fiscal policy reaction – above all in the US – attempts to stem the tide, it remains to be seen whether what's essentially a solvency crisis can be remedied through conventional policy tools alone. Moreover, deep interest rate cuts may create an unpalatable inflation challenge further down the road.

The US economy has been moving sideways at best. A prominent observer such as Martin Feldstein (head of the NBER, which determines the beginning and end of recessions) sees the US already in recession; he fears that it may be the most severe downturn since World War II. According to Goldman Sachs, “tighter credit conditions since mid-2007 could subtract roughly 1-1/4 percentage points from first-quarter growth and 2-1/2 points from second-quarter growth.” But it is important to see that the strong downward forces continue to be concentrated in homebuilding and industries tied to the housing sector. Driven by a weakening dollar, the rest of the economy continues to benefit from growing exports. Moreover, corporate balance sheets in the non-financial sector are healthy; the sector's debt/equity ratio has been falling steadily since 1993. Finally, monetary policy, and in the second half of 2008 also fiscal policy measures, are designed to mitigate the adverse credit market headwinds, although it remains to be seen whether the combined policy impact will be strong enough to effectively stem the tide.

Europe continues to weaken. Growth has fallen below potential in Euroland, and Germany, the dominant economy, appears to heading toward slower growth or even a recession (a forecast supported by a number of leading indicators). But comparatively high inflation keeps tying the hands of the European Central Bank; interest rate cuts are not in the cards before the second half of 2008. Outliers in the somber picture are Switzerland and the United Kingdom at the time being. Switzerland in particular is benefiting from strong exports and growth in employment and real wages, which will support future consumption. Nevertheless, even under these beneficial circumstances, Switzerland's growth is likely to decline from 3.1% to roughly 2% in the current year and to 1.5% in 2009.

Growth has slowed also in Japan, notwithstanding the buoyant environment in neighboring South East Asia. In light of Japan's high foreign investment position the yen appreciation is likely to generate negative wealth effects, which will exacerbate the impact of the recently observed decline in net exports to the United States. In addition, high oil prices will further dampen private consumption.

Emerging countries, and particularly Asian countries, continue to perform strongly. This raises the feasibility of decoupling. Econometric evidence supports the claim that the impact of the North (mainly industrialized OECD countries) on the growth dynamics of the emerging South (but not the developing South) has declined during the period of rapid globalization that began in 1986. Intra-regional trade between emerging countries is now an important source of growth. While China's growth in exports to the US slowed to 5% in the 12 months ending in January, exports to Brazil, India and Russia increased by more than 60%. Roughly half of China's exports now go to other emerging countries, and less than 10% of exports from the BRICs, the four largest emerging countries, have a US destination. In that sense, decoupling has become feasible. The world appears to have moved from dependence to multidimensional interdependence, which is likely to mitigate the impact of the US slowdown at least for the countries of the emerging South.

Fundamental adjustments underway

Conventional wisdom has it that a US recession – if there is one – will be mild and short. This view is supported by forward looking indicators and the aggressive fiscal and monetary policy measures. But this view may be too benign, because it fails to account for fundamental adjustments that are currently underway. There is a distinct risk that the downturn may be more prolonged than currently expected.

First, monetary policy may not be as effective as in previous downturns. Over the last two decades US financial markets, and to a lesser degree the financial system in continental Europe, have experienced a profound structural change from bank-related to financial market-related intermediation. One implication of this change is that the ability to generate liquidity (i.e. extend credit) depends on the valuation of assets underlying the process of securitization. If these asset values are declining securitization stops and credit has to be unwound. This is why US banks and broker-dealers in particular are currently frantically reducing their balance sheets. But central banks acting as **lenders of last resort** are geared toward credit expansion – the last thing the US financial sector has in mind. Hence, the central bank has to become more of a **market maker of last resort**. This is one of the reasons why the Federal Reserve (Fed) is now prepared to accept a broader range of collateral and include also broker-dealers in open market transactions. This is clearly a step in the right direction. But given the uncertainties about the valuation of a vast array of securitized products, it is not yet clear whether the Fed was able to stop the vicious cycle of bad news, write-offs and further declining asset values.

Second, the unraveling of past excesses may take longer than commonly assumed. This is a rather trivial argument based on the observation that it took several years for the housing bubble to develop. While the bubble may implode quickly, the unwinding of the credit pyramid built on it may take a long time. In the last outlook we reported on 18 bank-centered crises induced by the deflation of previous housing booms. The sobering conclusion was that it took at least two years for output growth to return to trend. In light of the severity of the US housing collapse, this time span may have to be extended.

Third, and more fundamentally, the reduction of global savings/investment imbalances has just begun, and this process will also take its time. The current correction must be seen in the context of the macro imbalances that have affected the global economy for more than a decade. Low interest rates, for example, were to a large part the result of excess savings in emerging Asia that financed the US current account deficit within a framework of quasi-fixed exchange rates pegged to the dollar. But the mechanisms that supported an international monetary system, which observers have christened Bretton Woods II, appear now to be unraveling. The US is experiencing a conventional current account crisis with attendant adjustments in surplus countries. Such crises typically include a sharp decline of the home currency and an income contraction that brings domestic absorption more in line with domestic production. These two developments are now observed in the United States. From previous current account crises we know that it takes more than two years for output growth to return to potential, which is another way of saying that it may take time for the US recovery to set in.

Taken together these three factors support a call that the downturn in the United States and its global ramifications will take several years to play out. While the US recession may be shallow, the recovery is likely to be anemic and protracted and lasting well into 2009.

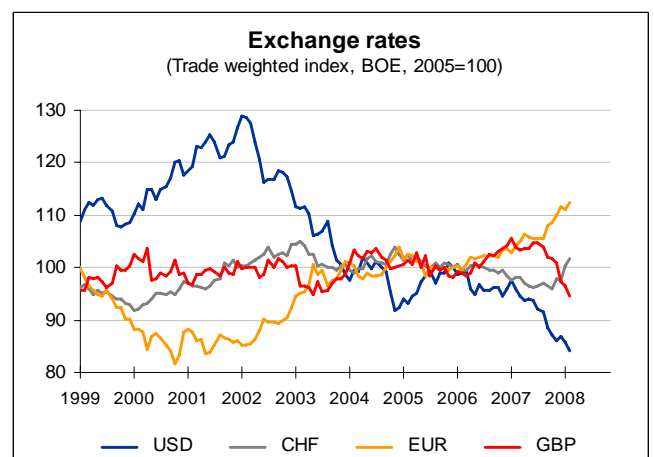
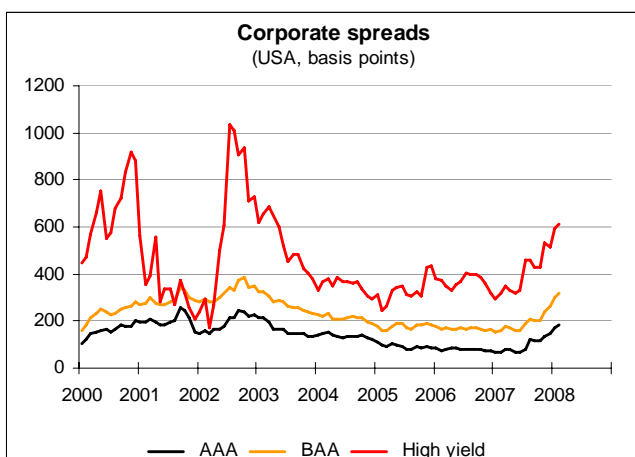
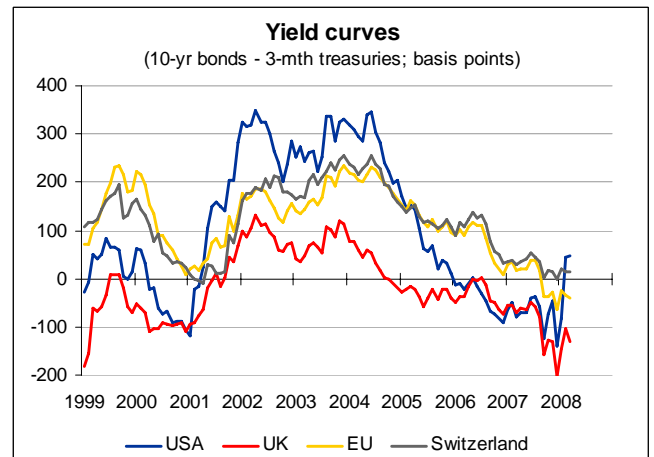
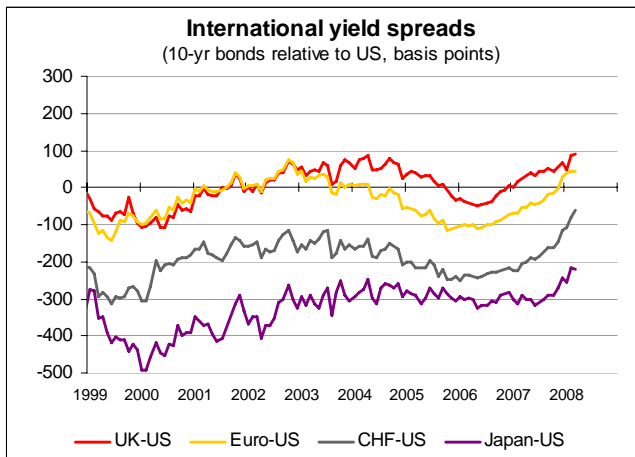
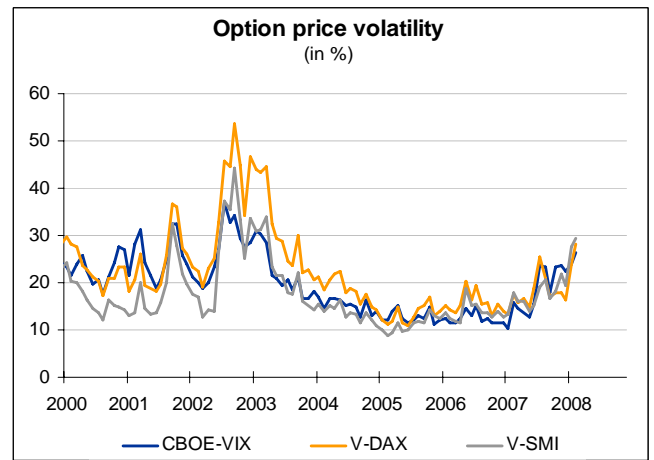
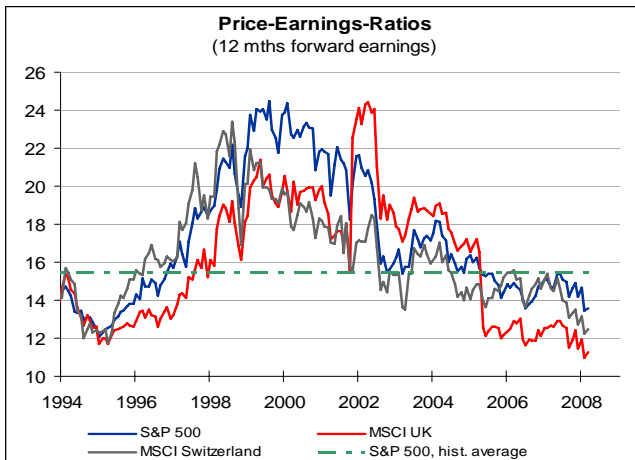
On balance, risks continue to be skewed toward the downside

- The main risk derives from the ongoing **turmoil in financial markets** and an underestimation of the **collateral damage** caused by the US housing slump. Monetary policy channels are murky, particularly at times of financial stress, and the Fed may find itself pushing the proverbial string. Likewise, fiscal policy (tax cuts of USD 150 billion have been agreed) may be less efficient given that the US budget is already in deficit.
- A second set of concerns centers on those **emerging markets** that are heavily dependent on capital flows (Central and Eastern Europe comes to mind, but also a few countries in Latin America). Spreads on emerging market debt have been low in recent years. While they have risen in some places, there still appears to be a bubble waiting to pop in other regions. Furthermore, trade linkages are likely to affect export-dependent Asian countries and reveal that earlier decoupling stories may have been greatly exaggerated.
- The third concern relates to ongoing **global imbalances**. While true that the declining dollar and a slowing economy will reduce the US current account deficit, it is also true that monetary and fiscal policies employed to fight a recession will perpetuate the chronic savings/investment imbalance in the US. Hence, the risk of abrupt current account adjustments with disruptive foreign exchange movements and severe financial market repercussions continues to hang over the global economy.

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	2.2	1.1	1.4	2.9	3.3	2.5	2.55	2.30	2.30	3.46	3.50	3.80
Euroland	2.6	1.3	1.6	2.1	2.5	2.2	4.65	4.40	4.00	3.98	3.90	4.00
Japan	2.1	1.1	1.6	0.1	0.6	0.6	0.86	0.80	0.90	1.31	1.40	1.60
UK	3.1	1.5	1.9	2.3	2.2	2.1	6.00	5.20	4.80	4.36	4.40	4.60
CH	3.1	1.9	1.5	0.7	1.5	1.2	2.82	2.80	2.60	2.81	2.80	3.00
China	11.4	10.0	9.5	4.8	5.5	5.0	<i>E</i> = Estimate <i>F</i> = Forecast					
India	8.7	7.8	8.2	4.5	4.5	4.5						
Latin America	5.7	4.6	4.2	5.1	5.8	5.6						
CEE	5.8	5.0	5.0	4.3	5.0	4.0						

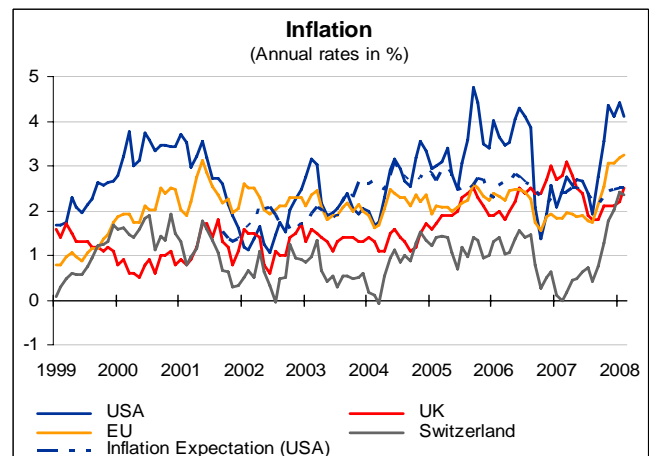
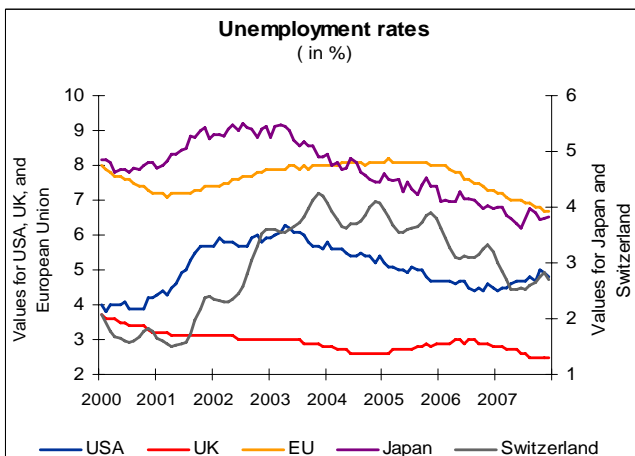
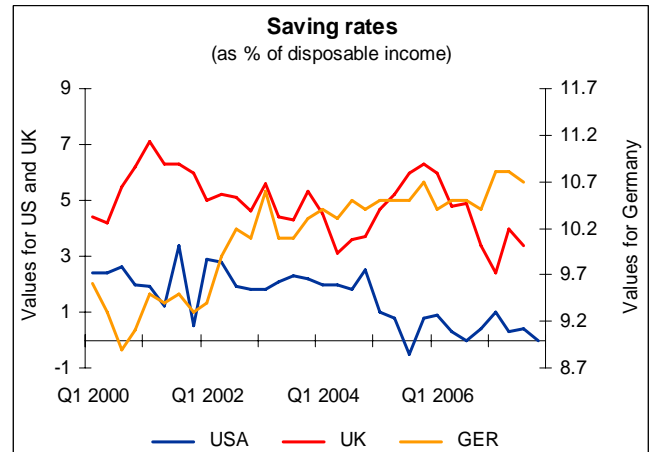
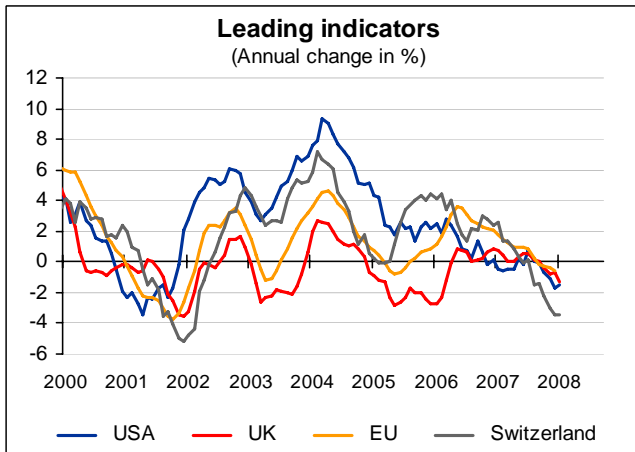
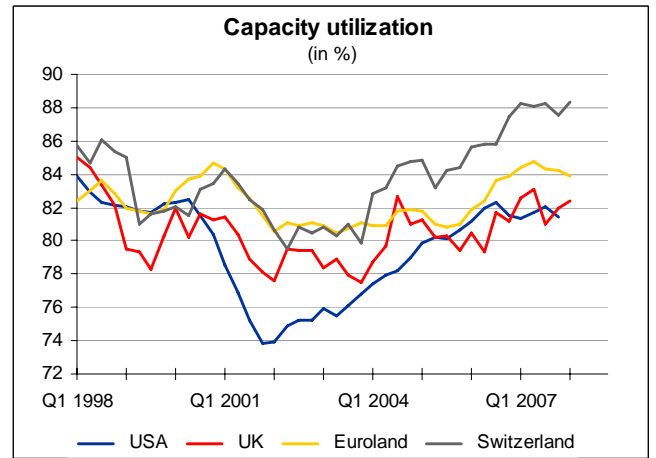
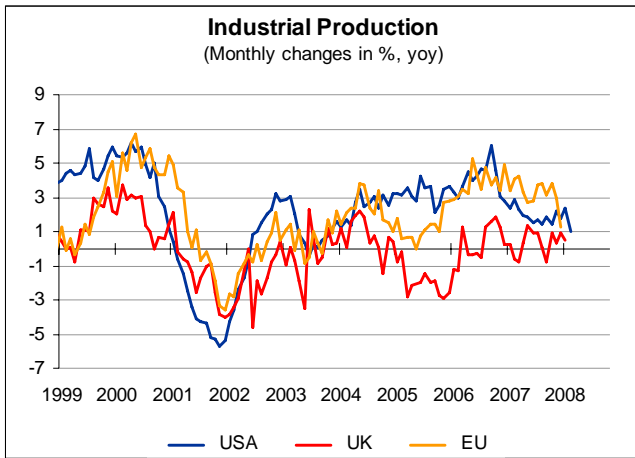
Sources: IIF, Zurich

2. Financial sector data



Source: DataStream

3. Real Sector Data



Source: DataStream

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