

1. The Global Economy: What a difference a (turbulent market) day makes

Financial markets have experienced a turbulent month, but there are conflicting views about the consequences for the global economy. As always in hectic times, there is so much noise in current data that it is easy to lose sight of the bigger picture. The fundamentals for a robust expansion of the global economy are still in place. True, the soft patch in the US may have become a bit mushier, and this is reflected in widespread downward revisions for 2007. But the expansions in Europe and Japan continue to be healthy, while growth in emerging markets is expected to slow, but from high levels. The only cloud in this picture relates to stubborn inflation pressure. Although low by the unacceptable standards of the seventies, they warrant close monitoring and – particularly in Europe, but possibly also in the US – further monetary tightening.

In the **US**, the 64,000 \$ question is whether the **bursting** of the **sub-prime mortgage bubble** will lead to “the great unraveling.” A contraction of credit supply could indeed throw a monkey wrench, and it is easy to create scenarios wherein heightened risk aversion spreads from one sector to the next and eventually undermines the confidence on which leveraged economies are built. In its recent policy statement the Fed acknowledged that the balance of risks has shifted. Although it eased its tightening bias, it continued to be concerned about “elevated inflation.” Hence, the Fed has become data dependent and appears to have fallen back to the reactive stance of the Greenspan period.

Coincidentally, it was also Alan Greenspan who rocked the markets when he said the probability of a recession was 30%. At first blush he seemed to have understated the risk. A simple probit model based on the shape of the yield curve spits out a probability of 40%. This seems to be too close for comfort to the 49% seen at the end of 2000, which accurately foresaw the recession of 2001. But such calculations have to be taken with a grain of salt. Adjusting for the current, still favorable financing conditions yields a recession probability of 5%. It compares favorably with an equally adjusted probability of nearly 100% at the end of 2000. While downside risks have increased, the odds for a systemic credit crunch continue to be small. But the present may deliver an acid test for the claim that financial markets are more sophisticated and make our economies less crisis-prone (see box next page).

While the US engine appears to sputter, **Japan and Euroland** continue their expansions. In both regions private consumption is flanked by strong capital expenditures, making the expansions more sustainable. However, strong growth and unabated inflation pressure will force the ECB to tighten further, which is likely to dampen the cycle in 2008. In contrast, recent steps by the Bank of England are showing an impact on activity in the **United Kingdom**. Nevertheless, further tightening cannot be ruled out. While the growth rate in **Switzerland** is expected to decline from the surprisingly high level of 2007, economic activity will easily exceed the abysmal record of the nineties.

Emerging markets continue to provide stimulus to the global economy. Encouraging is the fact that the growth momentum is shifting from exports to domestic demand. In light of accelerating inflation the central banks of **India** and **China** have continued their tightening course, but growth in both countries is likely to remain in the range of 8% to 10%. Similarly, the outlook for **Latin America** is robust, with growth of 4.5% in the current year after close to 5% in 2006. Fiscal consolidation (particularly in **Brazil**, which will bring up the rear in 2007) and strong demand for commodities contribute to the region’s positive outlook. While **Argentina** will eventually be hobbled by inter-

ventionism, the recovery from the deep recession experienced at the beginning of the decade is unlikely to lose steam in the near term. However, a retreat from market reforms initiated in the 1990s could dampen long-term growth prospects across the whole region.

Financial innovation and downside risks

The breathtaking speed of financial innovations seen in the last two decades has raised the concern whether they have amplified the credit cycle. The argument supposes that excessive lending in calm times must unavoidably be followed by greater financial market volatility, a disproportional credit contraction and a high risk of systemic financial crisis, which could lead to a severe economic contraction. Clearly, an unappealing sequence by anybody's standard. Hence, the question is whether financial innovations have created downside risks and whether current market turbulences are forecasting a recession.

There is indeed the risk that a sharp rise in asset price volatility – as observed in recent weeks – can lead to a sharp decline in confidence, which could have an excessive impact on credit markets. Regulators are also concerned that market infrastructures have not kept pace with developments (Alan Greenspan talked about 19th century methods of dealing with 21st century financial instruments). Moreover, the sheer number of contracts that would have to be unwound in times of distress goes beyond our imagination; it has been compared to the impossible endeavor of “unscrambling the eggs.”

However, in an economist's perspective, the arguments for financial innovation are compelling. By slicing and dicing risk more finely and spreading it more broadly, markets should have become more efficient and more resistant. Innovations help allocating capital to the highest return and make our economies and the financial system more resilient in times of stress, thereby promoting growth and future prosperity.

These expectations are borne out by technical models. We find that financial innovation, coupled with greater macroeconomic stability, has indeed reduced the risk of systemic crises in advanced economies. However, innovations also seem to be making crises potentially more severe, a finding that presents formidable challenges for prudential regulation and supervision.

In support of the positive expectations one can refer to the ease with which the US financial system absorbed the substantial scale of corporate defaults in the wake of the bursting of the dot-com bubble. Credit market innovations do not appear to have increased leverage in the corporate sector. To the contrary, non-financial corporate leverage is low by historical standards. At the same time, credit risks have been spread more broadly. US financial institutions now hold only about 15% of total credit outstanding as opposed to more than double this level two decades ago.

For the time being, the arguments for financial innovation are winning the day. US regulators appear not to be overly concerned by the bursting of the sub-prime mortgage bubble. After a spurt of innovation, they see the financial system as different but not inherently less stable.

Similarly, the market volatility observed in recent weeks appears to have little to no predictive implication for the business cycle. One of the salient characteristics of the last two decades is the enduring decline in the volatility of output and inflation (economists speak of the “Great Moderation”). At the same time, asset prices continued to be volatile. In fact, the volatility of stock and bond prices increased at the beginning of the decade. Hence, current financial market turbulences do not appear to predict an unstable business cycle or an upcoming recession.

Despite financial market turbulences the outlook for robust global growth remains intact, although the US economy is bound to slow appreciably in the current year and is unlikely to recover as quickly in 2008 as most forecasters expect. Unchanged is also the specter of persistent inflation. But central banks

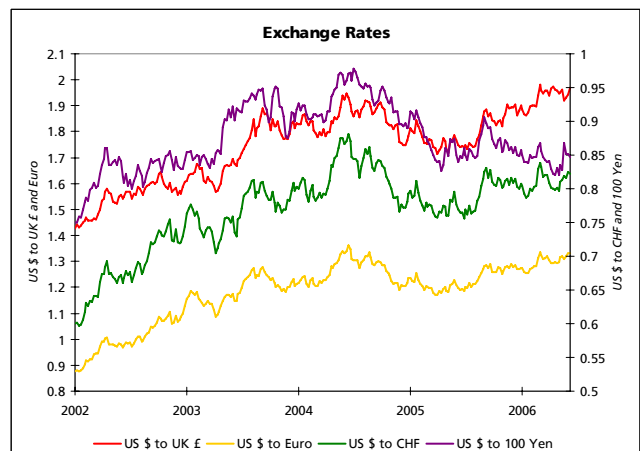
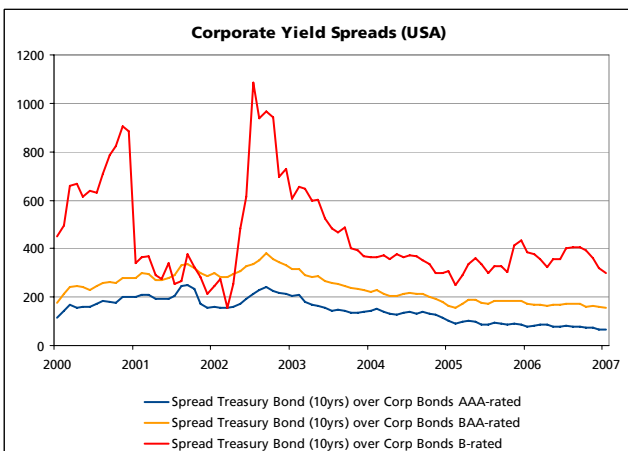
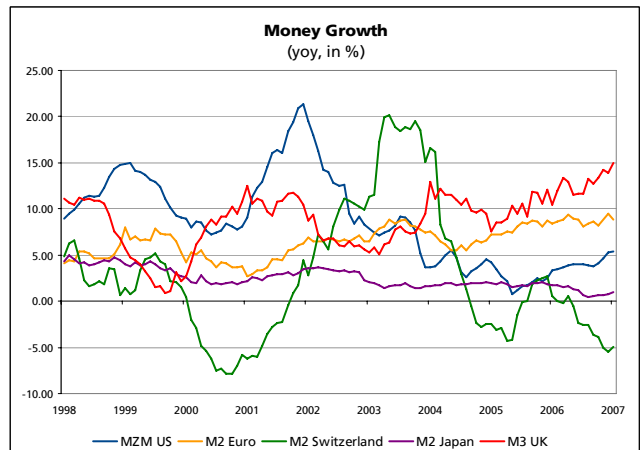
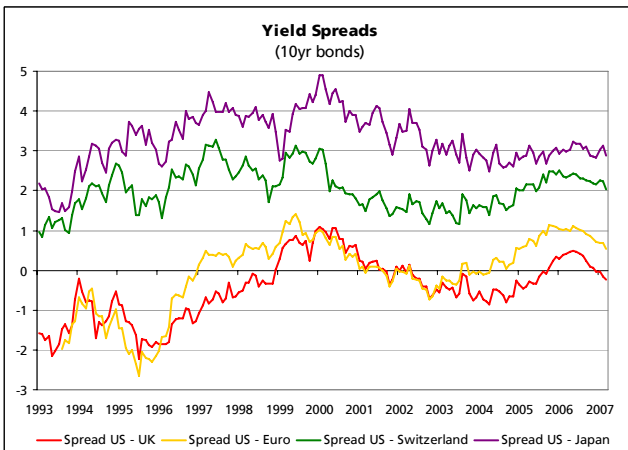
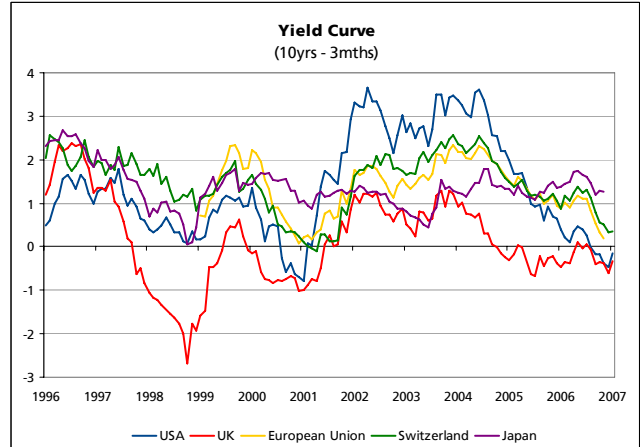
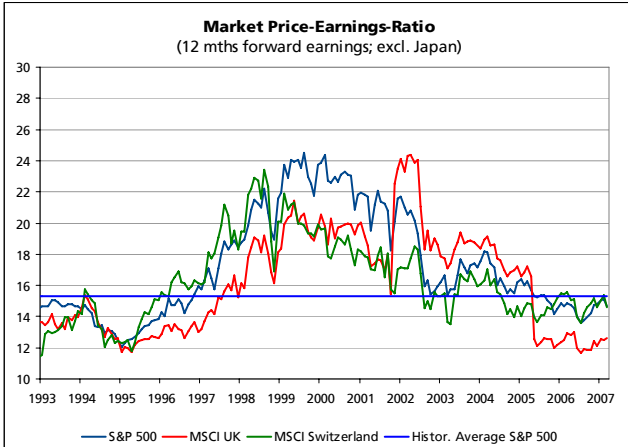
appear to be rising to the challenge. And despite market turbulences, risk premia have barely budged. Volatility measures derived from implicit option prices are nearly back to where they were before February 25.

Thus, risks continue to be priced for perfection. The **lack of fear** and the concomitant **misperception of risk** should continue to be of concern, and a correction of risk premia to more appropriate levels cannot be ruled out. Such a correction could engender a confidence crisis about the strength of the US economy and its attractiveness to foreign investors. In the worst case, foreign lending would dry up, forcing higher long-term interest rates and a declining dollar, an unpalatable situation indeed. But for the time being, market turbulences do not appear to foreshadow either a systemic financial crisis or a protracted economic contraction.

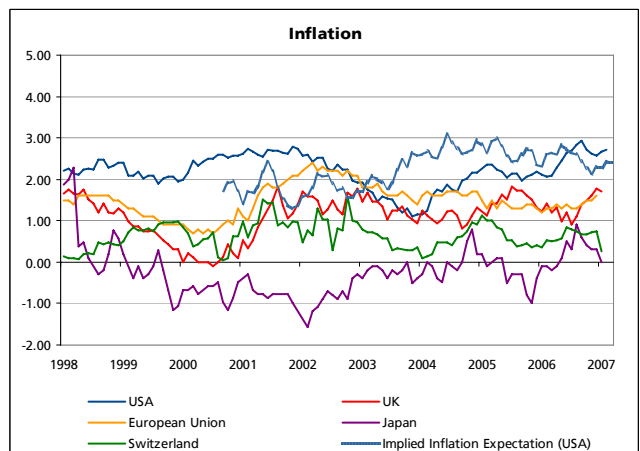
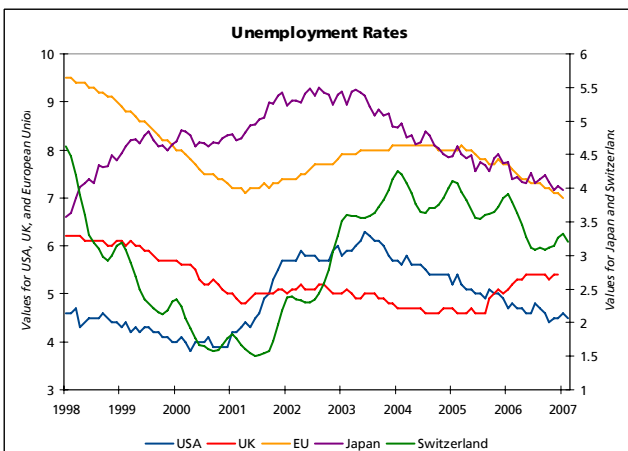
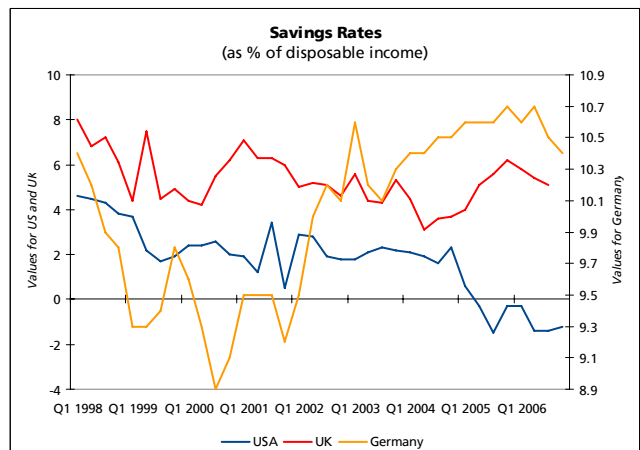
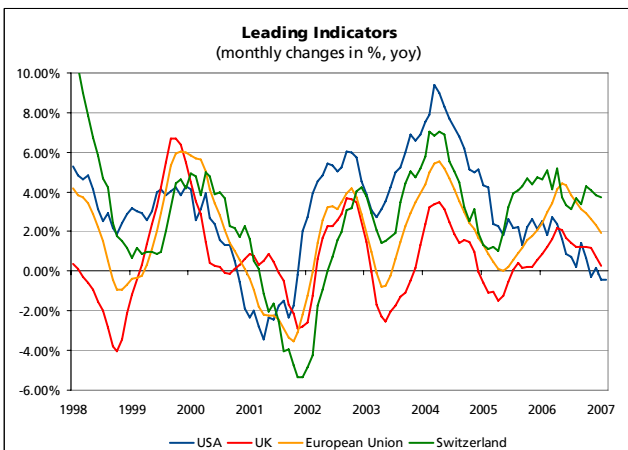
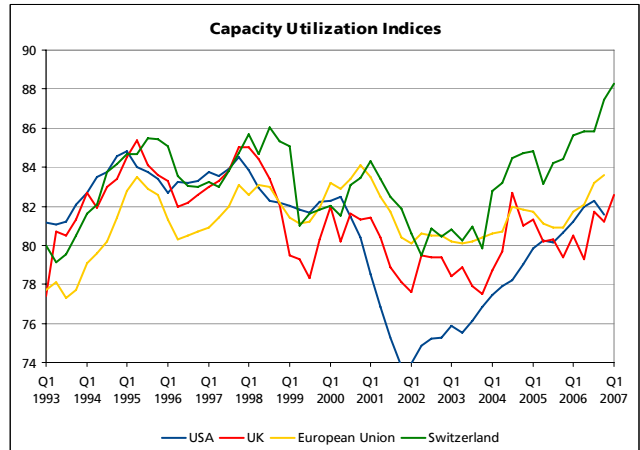
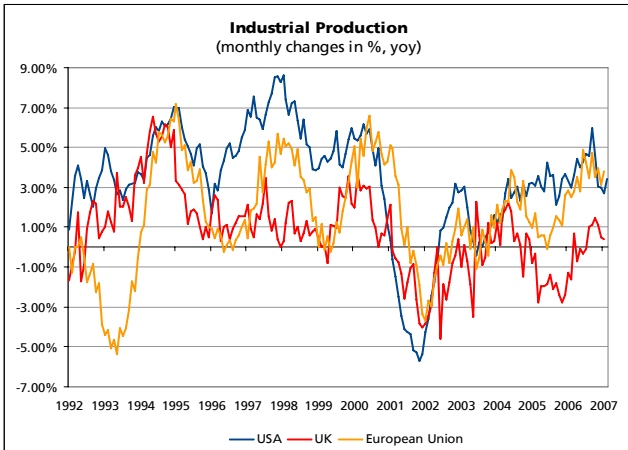
Outlook for Main Regions (Δ in %)												
	GDP, real			Inflation (CPI or HPCI)			Interest Rates					
	06	07	08	06	07	08	3 month libor			10-year bond		
	E	F	F	E	F	F	Actual	3mF	12mF	Actual	3mF	12mF
USA	3.3	2.7	2.5	3.2	3.0	2.5	4.91	5.00	5.00	4.61	4.80	5.30
Euroland	2.7	2.0	2.2	2.2	2.4	2.2	3.90	4.20	4.20	4.06	4.10	4.20
Japan	2.2	2.2	2.2	0.4	0.6	0.6	0.71	0.70	0.70	1.60	1.80	1.80
UK	2.7	2.7	2.3	2.3	2.4	2.1	5.47	5.75	5.75	4.61	4.80	5.00
CH	2.8	2.3	2.0	1.1	0.8	0.8	2.29	2.40	2.40	2.65	2.80	2.80
China	10.5	9.5	9.5	1.9	2.5	3.0	<i>E</i> = Estimate <i>F</i> = Forecast					
India	9.0	8.5	8.0	5.7	5.5	5.5						
Latin America	5.0	4.5	4.5	5.6	5.1	4.9						
CEE	5.8	5.5	5.5	6.7	6.3	5.5						

Sources: Kiel Institute, IIF, IMF, Zurich

2. Financial sector data



3. Real Sector Data



Source: Datastream

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