# Global Economic Outlook

1st Quarter 2009

A Deloitte Research Study

## About Deloitte Research

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**Since our last quarterly report was issued, the global economy has stabilized somewhat — albeit at a low and declining level.** Stability implies a lack of near daily shocks. It does not imply good times. Although there are no longer daily shocks, there are some shocking things happening. These include a nearly synchronous decline in economic growth throughout much of the world, a rapid drop in commodity prices, a rapid decline in a variety of other asset prices, and shrinkage of global trade, in part brought on by failings in the market for trade finance. Yet perhaps the most shocking event is the dramatic change of mindset regarding government policy and the proper role of government in the economy. Much conventional wisdom has been thrown out the window as governments navigate a new landscape, contemplate the unmentionable, and take actions once thought inconceivable. There is almost too much to absorb.

**Dr. Ira Kalish** is Director of Global Economics at Deloitte Research

That is where we come in. In this issue of the quarterly *Global Economic Outlook*, the Deloitte global economists attempt to make sense of what is going on, in addition to providing our usual outlook for the near term future. Here is what to expect in this report:

I begin with an analysis of some of the risks and opportunities stemming from the global crisis. I offer some thoughts on the things that could go wrong (in addition to what has already happened), as well as some good things that might come from all this trouble.

Elisabeth Denison offers some views on how emerging markets are faring in this crisis. She examines the forces influencing the emerging world with particular emphasis on credit, currency, and commodity markets. Should global companies continue to look at emerging markets as a significant source of future growth? Elisabeth answers that question by considering how emerging markets will navigate through this crisis and beyond.

Sunil Rongala looks at how monetary policy is working, or not working, during the current crisis. He examines the experiences of the major central banks and offers his outlook for future action.

Finally, our team of global economists provides their outlooks on nine major countries/regions beginning with Carl Steidtmann's view on the U.S. economic downturn and the efficacy of the policy responses, both past and future. We also look at the economies of the Eurozone, the United Kingdom, Russia, India, China, Japan, Latin America, and the Middle East.

We hope that, although the shelf life of this report is likely to be limited, it provides our readers with some useful insights. As usual, feedback is welcome.

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# Risks and Opportunities of the Response to the Financial Crisis

Dr. Ira Kalish

Now that the global economy is in a crisis of unknown depth and duration, governments the world over are taking unprecedented actions to spur recovery. The question arises as to what other bad things may happen as a consequence of this crisis. In addition, we may very well ask what good might come of all this. In what follows, we offer some thoughts about both questions.

**Dr. Ira Kalish** is Director of Global Economics at Deloitte Research

## Risks

### Innocent bystanders: Who might be hurt by the U.S. rescue package?

In response to the financial crisis, the U.S. government will undertake a massive fiscal stimulus. The goal is to offset the de-leveraging of the private sector by leveraging the public sector and stimulating economic activity. To finance this, the government will issue a massive quantity of government bonds. In normal times, this would not be the best idea. When the government raises money in the bond market, it must compete with private sector borrowers. The end result is an increase in interest rates and a "crowding out" of private investment.

Yet, under current conditions, this is not a concern. Due to heightened risk perception, investors are eager to hold Treasury securities and not much else. The U.S. government will, therefore, not have much trouble selling these bonds and they're not likely to push up U.S. interest rates.

Another worry is that if the government program is financed by the Federal Reserve purchasing many of these new government bonds by printing money, the resulting increase in the money supply could be inflationary. Yet again, these are not normal times. Currently, a greater concern is deflation. Thus, if the Fed prints money to pay for government spending, it could have the positive effect of creating a little inflation and avoiding ruinous deflation.

Given all this, it seems that the U.S. stimulus will be an unambiguously good thing with no negative consequences. Yet as is often the case, things are not so black and white. Unfortunately, the negative consequences of the U.S. fiscal stimulus will be felt outside the United States. The need to absorb a large increase in the quantity of Treasury securities may discourage investors from holding debts issued in emerging markets. In other words, investment in emerging markets may be "crowded out." The result in emerging markets would be higher interest rates, lower levels of investment, and slower economic growth than would otherwise be the case. This will not be the case for those markets that possess vast financial resources such as China. But for countries like Brazil, Mexico, and Russia, the U.S. fiscal stimulus will be a double-edged sword. That is, by boosting U.S. growth, it will help these country's exports. Yet by diverting funds from emerging market bonds, it will have a negative impact on capital accumulation. It could also cause increased volatility in currency markets.

### Unrelated markets: Fallout from credit cards, commercial property, etc.

In the United States, credit card debt is now in excess of one trillion dollars. The biggest issuers of credit cards include the same large banks that have received equity injections from the U.S. government. As the economy weakens, defaults on credit cards are likely to increase further (they have already increased somewhat), forcing those same banks to write down bad debts and, therefore, lose capital once again.

At the same time, retail sales continue to decline, resulting in more retail bankruptcies, liquidations, and at the very least, store closings. For shopping center operators, this is bad news. Indeed the vacancy rate at U.S. shopping centers has increased markedly over the past year. For holders of securities backed by commercial property mortgages, this is bad news as well. Many of these securities have lost value. For banks holding these securities, this means further write-downs and lost capital.

In addition, given credit market conditions, it is unlikely that new securities backed by either credit card debt or commercial retail property can be sold to investors. Therefore, in 2009 we can expect to see the volume of such securities stabilize and possibly decline. This means that consumers will not be able to increase credit card debt. In the United States, this will be problematic for consumer spending growth and for the health of consumer related companies.

Furthermore, existing securities backed by credit card debt and automotive debt are likely to lose value as defaults increase. This not only means bank write-downs, it also suggests the possibility of continued tightness in credit markets. That is because, as in the case of mortgage backed securities, banks will be uncertain about counterparty risk, which is the origin of the financial crisis. Banks become unwilling to lend to one another through the interbank market. This leads banks to seek the safety of liquidity and stop lending to non-bank entities. As long as structured financial products continue to lose value, banks will be highly risk averse. The problem now is that, although governments have re-capitalized banks, further capital losses will continue and, as a consequence, enable continued constriction of credit markets.

### Energy: Low oil prices today presage higher prices in the future

One of the few pieces of good news in developed economies has been the collapse of oil prices. Between the summer of 2008 and the end of the year, oil prices fell by roughly two-thirds. For consumers of energy, this has been one of the few positive aspects of the economic environment. Lower energy costs free up resources that can be spent on other things. For the poorest emerging countries, the collapse of the price of oil is particularly welcome. And, of course, oil exporters will suffer the effects of low prices.

Yet what about the longer run? There are plenty of good reasons to expect higher prices in the future. Once the global economy starts to grow at a rapid pace, and once big emerging markets resume rapid growth, energy demand will rise accordingly. But what about energy supply? It is the confluence of demand and supply that will determine future prices. Yet future supply will depend, in part, on investments made now. The problem is that, with prices so low and with uncertainty about the direction of prices, the current environment will likely discourage new investments in future supply. The end result could be much higher prices in the future.

### Trade: Uncertain letters of credit

About 90 percent of international trade transactions involve some form of credit. Normally, if a company wants to import goods from another company, it obtains a letter of credit from a bank which guarantees that payment will be made to the exporter's bank upon receipt of the goods. Today, given credit market conditions, obtaining trade finance has become either far more expensive or, in some cases, impossible. Failure to address this situation could lead to a dramatic decline in trade flows and, consequently, further downward pressure on global economic activity.

There are two problems. First, banks are charging more to write letters of credit. This reflects their higher cost of capital and their increased concern about counterparty risk. As a result, importers face greater costs in executing transactions. This is particularly onerous for importers in emerging countries who depend more heavily on trade finance than importers in developed markets. The cost of a letter of credit has tripled in China and Brazil in the past year.

The second problem is that some banks are refusing to honor letters of credit as they fear counterparty risk. This means that their exporting clients cannot export. In developed economies, governments have begun to intervene by providing export financing to local companies. The United States and China, for example, recently set up a joint financing facility providing loans, loan guarantees, and insurance for banks that finance trade between the two countries. So much for protectionism. Both countries clearly recognize the huge dislocation that would result from a further drop in trade flows.

Despite efforts by some major governments, trade flows involving many emerging markets are at risk due to financial market conditions. As long as credit remains tight, this situation will endure, possibly putting further downward pressure on economic activity and, as a result, exacerbating the financial market situation.

## Opportunities

### How short-term government spending could have long-term consequences

It is not accepted wisdom these days that government spending could have positive economic effects. The generally greater efficiency of market driven investment is clear for anyone to see. Yet some government investment is necessary when private markets fail to account for what economists call "externalities." That is, some investments have effects beyond their direct effects on economic activity or on particular markets. For example, government-financed pure scientific research has yielded considerable breakthroughs in the treatment of diseases that the market would not have done. The construction of highway networks in many countries resulted in improved transportation efficiency that contributed to the productivity component of economic growth.

Given this, there has been much discussion lately about how large fiscal stimulus plans, aimed at spurring economic recovery in recessionary economies, might also make a longer term contribution to economic well-being. The reality is that, when an economy is in a deep recession, any government spending will suffice to spur economic activity. Recall that the Great Depression in the United States finally ended in 1940 when the U.S. government started massive purchases of weapons to assist Britain in its war with Germany. Such weapons made no contribution to increasing U.S. productivity. Yet the simple (or not so simple) act of producing weapons stimulated employment and ended the Depression.
In the current environment, it is hoped by policymakers that government investments in infrastructure will have a positive impact on productivity.

### Cash is king: How conservative companies will laugh all the way to the bank

During the past decade, investors reacted angrily to companies that kept too much cash on their books. They lauded companies that were highly leveraged at a time of unusually low interest rates. Companies were encouraged to make acquisitions or buy back stock. Today, those same companies appear to have been prescient. In an environment of high risk spreads and poor availability of credit, cash rich companies are well positioned while those that are highly leveraged face difficulties in rolling over their debts.

Meanwhile, many companies are struggling to quickly become more liquid. Capital expenditures have been slashed, divisions closed or scaled back, and strategies have been re-evaluated with cash flow in mind.

When this storm finally rolls back out to sea, the landscape will be strewn with the scattered remains of failed companies. Yet the survivors, particularly those with cash, will be well positioned to gain market share and dominate the business environment.

# Collateral Damage: The Impact of the Financial Crisis Across Emerging Markets

Dr. Elisabeth Denison

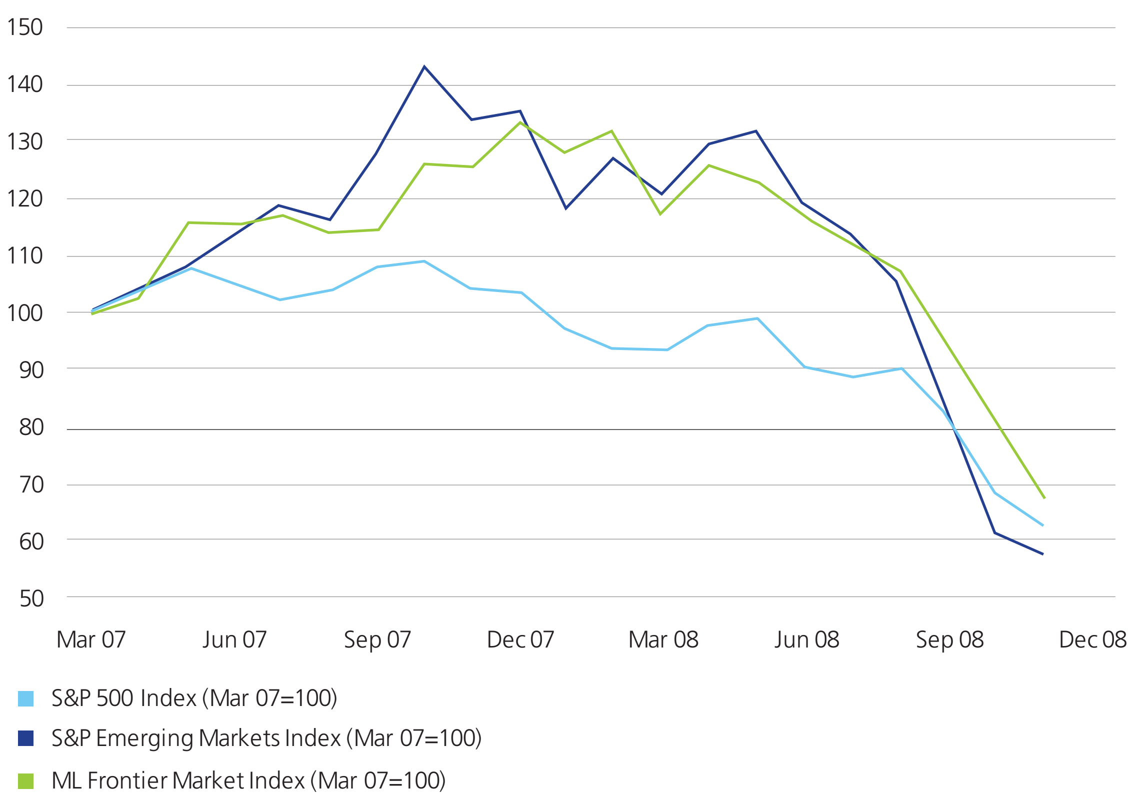
Corporations have greatly expanded their global footprint in recent years, and investors have ventured into new markets to diversify their portfolios. Will this recession mark the end of the rise of emerging markets? Is it still worth pursuing a globalization strategy? Which countries are worst affected? This article tries to shed some light on the forces shaping emerging and developing countries in the aftermath of the financial crisis. Specifically, it examines the effects of three Cs — **credit** availability, **currency** movements, and **commodity** prices — on countries across the emerging market spectrum.

**Dr. Elisabeth Denison** is Senior Economist at Deloitte Research, contributing Eurozone perspectives from Germany

The latest recession undeniably has its origins in the developed world. It is the liability of a decade of unchecked borrowing and the ever-growing complexity of financial instruments that contributed to the global credit crisis. Looking at the destruction of wealth in Western economies now, some might even feel a bit of vindication.

However, the past months have established the fact that the crisis is not stopping here. Frozen credit markets and plummeting currencies have led to a landslide of risk downgrades of former growth champions such as India, Vietnam, and Argentina. Romania became the first EU member whose sovereign credit rating was lowered to "junk" status. Even more worrying, the crisis is cutting-off capital from countries in the developing world, which have made great strides in recent years to raise their living standards and become the "next frontier" for investors.

**Figure 1: Developed and emerging stock markets have re-coupled**




Source: Bloomberg

The re-coupling of the world economy is exemplified in global stock markets. From June 2007 to June 2008, the S&P 500 lost 15 percent of its value. Emerging and frontier market indices, however, held up well, with the S&P Emerging BMI index up four percent and the Merrill Lynch frontier index up one percent in the same period. Then bearishness went global. The S&P 500 index declined another 30 percent between June and November 2008, while emerging market stocks plummeted 50 percent and frontier markets lost 42 percent of their value (see Figure 1).

The economic boom of recent years, fuelled by ample liquidity and easy credit, transformed emerging markets into key players of the global economy. Unfortunately, fast growth helped some countries cover-up underlying structural problems and allowed them to delay necessary reforms. With the spreading of the global crisis, these countries are now hardest hit. If there is any hope for a silver lining, it could be that long-due reforms will now be tackled (in some cases forced by conditions tied to rescue packages).

Meanwhile, for frontier markets, sustained faster growth was seen as essential for reducing poverty and enabling a transition to stable, open-market economies. Slowing global growth will likely prove a setback for development and reform in these nations. The unprecedented extent and the speed of the fall in commodity prices accompanying the current slowdown add another layer of risk. While industrializing nations like India and China naturally welcome the drop in prices, nations rich in natural resources are suffering a severe loss in revenues. Exposure to volatile currency moves adds further pressure to the finances of countries with pegs or tightly managed exchange rate regimes.

Even lower food prices are not necessarily a good thing. The UN Food and Agriculture Organization (FAO) warns that with prices falling so far, so fast, the world may soon face severe food shortages. Under current gloomy prospects for agricultural prices, high input costs and more difficult access to credit, there is little incentive to expand supply. Combined with declining purchasing power due to the economic slowdown, the FAO predicts that episodes of riots and instability in the developing world could again capture the headlines.

## Newly industrialized, emerging, frontier, and low-income countries

Rapid economic expansion over the past decade not only led to vast wealth-creation in the industrialized world, it also greatly enhanced the growth prospects of emerging and developing nations. In fact, the emerging market universe has become increasingly diverse in recent years, which makes it useful to introduce some strategic distinctions.

Economists often classify countries by their per capita income or GDP. However, the IMF notes that especially in the case of low-income countries, it is more useful to look at their pace of development. Another important dimension to consider for investors is market accessibility (including stability, currency convertibility, and political- and geopolitical-risk).

Against this background, some countries like Hong Kong and Singapore, which were commonly lumped into the category of emerging markets, have actually "emerged" and become newly industrialized countries of the developed world. MSCI Barra, the global, equity-market indexing company, is considering a re-classification of Korea and Israel into this category, too.

Brazil, Russia, India and China (BRIC) remain examples of traditional "emerging" markets, together with Taiwan, South Africa, UAE (United Arab Emirates), Poland, Czech Republic, Hungary, Argentina or Pakistan and others. (Emerging markets are marked blue in the world map in Figure 2.)

While there is no strict definition of frontier markets, developing economies with high rates of GDP growth but relatively illiquid markets are often referred to as emerging *emerging* markets. MSCI Barra includes Nigeria, Slovenia, Croatia, Kenya, Romania, Vietnam, Bulgaria, and the Ukraine, among others, in its Frontier Markets Index. (Frontier markets are marked green in Figure 2.)

There are, of course, many more small or low-income countries in the world, of which the IMF notes that about a quarter have seen at least a 50 percent increase in average incomes from 1997 to 2007. Such countries include Chad, Cambodia, Myanmar, Mozambique, Nigeria, Sierra Leone and Tajikistan. Another half have seen some improvement in their living standards (e.g. Bangladesh, Ethiopia, Ghana, Pakistan, Tanzania, Uzbekistan). These emerging, low-income countries are marked light green in Figure 2.

## The credit crisis goes global

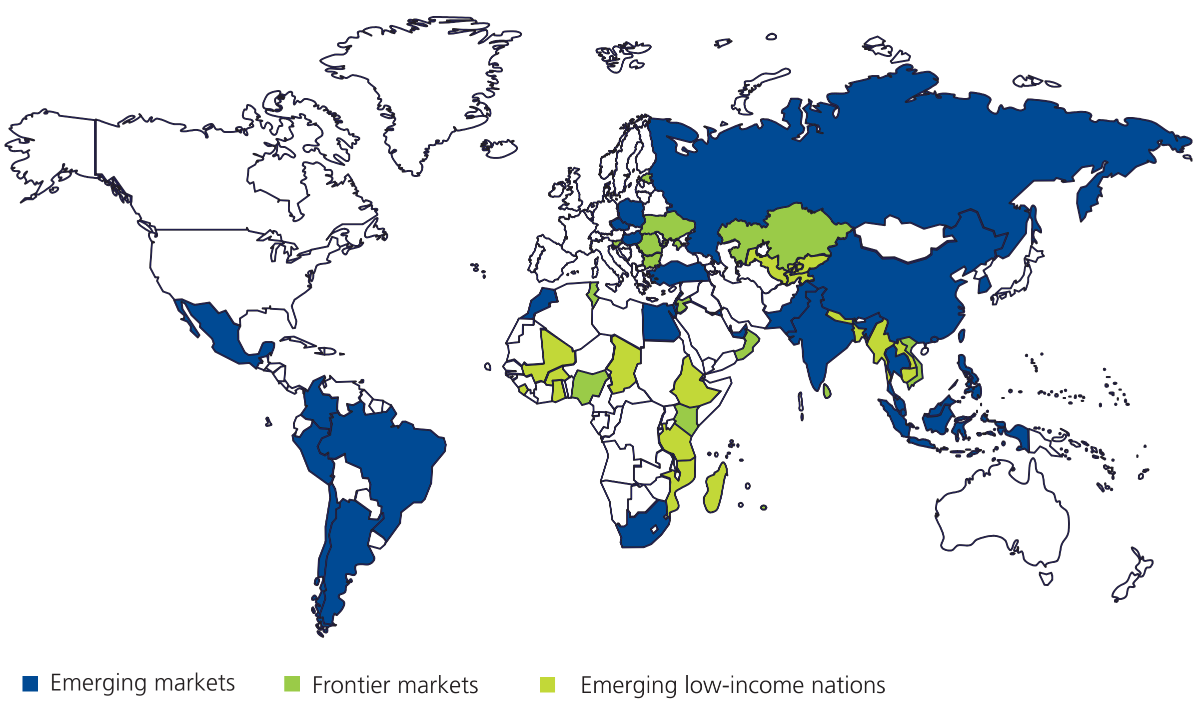
With the recession spreading around the world, nations along the whole emerging market spectrum are being affected through different channels in varying degrees. The financial crisis is also challenging these countries in manifold ways, from liquidity problems and commodity market exposure to the uncovering of structural problems and currency volatility.

The first transmission mechanism of the financial crisis was through the exposure of international banks to U.S. sub-prime mortgages. In this first wave, emerging markets fared relatively well. The fallout was limited to global players among emerging market financial institutions, of which there are relatively few, and oil-money funds in the Middle East, who could probably afford to stomach some losses.

The second shock-wave came with the failure of U.S. Investment Bank Lehman Brothers. The linkages to emerging markets were greater here, especially in emerging countries with relatively well-developed banking sectors.



**Figure 2: Emerging nations of the world**




Source: IMF, MSCI Barra and Deloitte Research

The straw that broke the camel's back, however, was the liquidity crunch that followed the turmoil. As banks become reluctant to lend to each other, money for emerging markets was getting scarce. Risk premiums started to rise across the emerging market continuum. Between October and November 2008, spreads on sovereign debt of emerging markets doubled, with more than a third of the countries in the benchmark JP Morgan Emerging Markets Bond Index Global (EMBIG) trading at spreads above 1,000 basis points (a risk premium of 10 percent above Treasuries).

Against the background of rising borrowing costs, bailout packages — such as Korea's $130 billion package for credit-starved banks and companies — are getting expensive. Other emergency measures, such as state guarantees introduced by some emerging nations to prevent capital outflows to countries perceived to be safer, cannot be credible when a state is already saddled with a heavy debt and the banking system is large. In emerging markets where governments copy Western programs of taking stakes in financial and non-financial institutions with distressed and illiquid assets, there are worries that state participation will not be transitory. In a fragile economic environment, investor confidence is quickly lost.

An additional problem for emerging markets — particularly in Eastern Europe — is the fact that the majority of bank assets are foreign-owned. Problems at Western parent banks quickly translate into tighter credit in local markets. Since most borrowing in these emerging markets is done not by governments, but by companies and individuals, private and business spending is taking a major hit. "Today, it's not the sovereign debt crisis that we saw in the past. It's a potential corporate debt crisis," notes Mansoor Dailami, manager of international finance for the World Bank's development economics division.

For many frontier and low-income countries, the lack of access to credit has dire consequences, too. The IMF warned the donor community at the International Conference on Finance for Development in Doha at the beginning of December 2008 to maintain aid flows and not let the financial crisis derail progress towards achieving the Millennium Development Goals.

## Homegrown problems exposed

Meanwhile, the global de-leveraging process is exposing some home-grown problems in emerging markets, which were covered up by fast growth during the boom years. Countries with large current account deficits financed by private capital inflows find themselves out in the cold (literally, in the case of Iceland). Lax credit standards for mortgages and lending to consumers and small-business are adding to the woes of the banking sector in nations — such as the Baltic States, Romania, and Bulgaria — that financed part of their recent growth with rapid credit expansion.

Nations with a weak fiscal position (e.g. Hungary) are in a particular quagmire, although luckily there are fewer of those now than during the emerging market crisis of 1997. Especially Asian nations seem to have learned their lessons, cleaned their balance sheets and built-up foreign currency reserves over the past decade.

Meanwhile, for some countries in the emerging market universe, there is a danger that the deterioration of the economy will lead to a destabilization of their political situation. Particularly in Eastern Europe, governments got by during the years of rapid growth and falling unemployment.

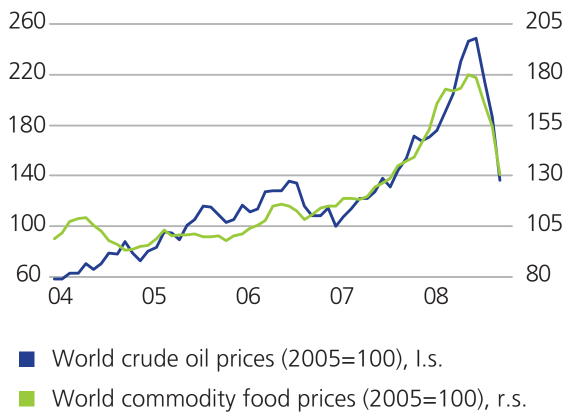
In the group of frontier and low-income nations where political corruption remains widespread, a recession will add to the desolation of populations. A widespread decline in economic fortunes in these countries would likely be a breeding ground for further lawlessness, such as piracy or terrorism.

## Commodity crunch

On top of everything, this global recession comes on the heels of a period of one of the fastest rates of appreciations in commodity prices in history. World food prices rose by over 50 percent between January 2007 and June 2008, while world oil prices surged 150 percent. Several emerging nations are still suffering the delayed effects of these price increases, with high inflation complicating monetary-policy decisions as economic conditions deteriorate.

Over the second half of 2008, however, fears of a global recession have led to a steep decline in commodity prices (see Figure 3). While this benefits industrializing countries like India and China (India spent almost $50 billion on crude oil imports in the five months from April to August 2008), commodity exporting nations are facing an unexpectedly large drop in revenues.

**Figure 3: Roller-coaster ride in commodity markets**




Source: IMF [The Crude Oil Price index, 2005 = 100 is the simple average of three spot prices: Dated Brent, West Texas Intermediate, and the Dubai Fateh. The Commodity Food Price Index, 2005 = 100 includes Cereal, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices]

Russia's government is said to be running a deficit with oil averaging below $70 a barrel. Venezuela's budget for 2009 assumes an average oil price of $95. But the fall in commodity prices has not only hit the government finances of commodity exporting nations, it has been a major drag on their bourses, too. Brazil's commodity exports amount to nine percent of its GDP, according to Lombard Street Research, but its commodity firms — such as the oil giant Petrobras — account for over 40 percent of its stock market.

Beyond the immediate effects on commodity producers, there is a dangerous longer-term implication of the fall in oil prices: lower prices are making new exploration projects unprofitable, so major producers are curtailing investment plans. Royal Dutch Shell Plc, for example, is cutting back plans to develop deposits like the Canadian oil sands. When the world economy — and with it, oil demand — starts to recover, supply shortages might be more severe than ever before. The price of oil could quickly be pushed higher again. Even if it does not look like it now, long-term projections suggest that the days of sustainable low oil prices are over for good. (See also "Crude Realities" in the Global Economic Outlook of Q4 2008.)

For frontier and low-income nations, meanwhile, food prices have an even larger direct effect on purchasing power than oil. Households in these countries typically spend more than half of their income on food, compared to less than 10 percent on fuel.

The problem is that the drop in food prices might not translate into the expected relief for low-income nations. Given the high share of agriculture in many of these countries, the drop in food prices actually reduces prosperity. In addition, the UN Food and Agriculture Organization (FAO) warns that — just like with oil prices — falling food prices will discourage investment in new supply. Scarce credit and high input costs further discourage the development of farmland. Since underlying population dynamics have not changed, underinvestment in supply now could lead to severe food shortages later.

## Currency effects

Connected to the development in commodity markets is another phenomenon that is currently weighing heavily on emerging markets: the downward pressure on their currencies. Even before global credit markets seized-up in September 2008, the currencies of commodity exporters had started to tumble. South Africa has seen its currency fall further than any other in 2008 (except the Icelandic krona). Russia's ruble peaked on July 16 2008, and the Brazilian real began to slip a couple of weeks later.

But it is not just the currencies of commodity exporters that got sucked into the wake of the financial turmoil. As tightening credit conditions unveiled some of the underlying problems in emerging nations, capital started to pull out. The IMF notes that between October and November 2008 alone, emerging equity markets lost about a third of their value in local currency terms and more than 40 percent of their value in U.S. dollar terms because of currency devaluation.

With their exchange rates under pressure, exposure to foreign currency loans adds to the detriment of many emerging markets. Particularly in Central and Eastern Europe, many businesses and households speculated on Euro-convergence of their currencies and took out loans denominated in Euros or Swiss francs at lower interest rates. Serving these loans is getting pricier by the day.

## Opportunities ahead

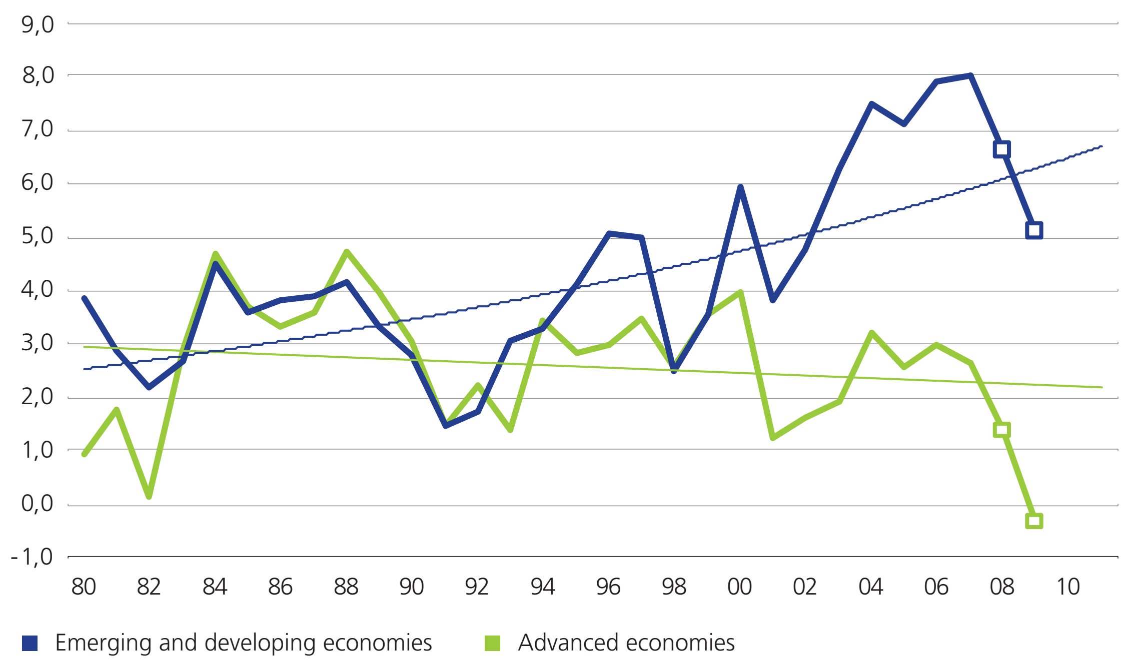
Although the financial crisis originated in the United States, it has become clear over the past year that it affects all actors in the international system. This includes developing countries. Emerging nations can grasp the opportunity for reform and — for those not already saddled with big financing deficits — fiscal stimulus through infrastructure and social investment. In the longer term, this might make them even more attractive investment targets for Western corporations.

Low-income countries have implemented important political and institutional reforms in recent years, but more remains to be done. These nations can only climb the ladder of development if the benefits of growth are shared across the population. To heighten their appeal for foreign investors, frontier markets need to strengthen all aspects of legal, regulatory, and infrastructural development.

This recession will certainly be a setback for growth in emerging nations across the globe. However, the underlying dynamics have not changed. The productive potential of these nations remains great, and there is a significant, unmet need for investment. In 2009, according to IMF forecasts, world growth will be driven entirely by emerging markets while advanced economies contract (see Figure 4). Looking at the underlying long-term trend, companies will likely continue to find attractive opportunities in emerging nations, even if growth there has slowed somewhat.



**Figure 4: Emerging markets remain engines of world growth even in slowdown**




Source: IMF November 2008

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# The Outlook for Monetary Policy

Dr. Sunil Rongala

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Monetary policy — the policy that central banks adopt to govern the cost of money and money supply — has come into the limelight because of the ongoing, global financial crisis. Central banks around the world have been cutting their benchmark interest rates aggressively, hoping that cheaper money, which ironically caused the crisis in the first place, might alleviate some of the pain caused by the crisis. Along with rate cuts, many central banks have been increasing money supply in the economy because of a severe contraction in the velocity of money. The quantity theory of money states that if velocity reduces, money supply in the economy must necessarily rise to prevent a fall in GDP. However, countries such as Brazil and Russia have actually raised their benchmark interest rates.

What really marks this round of monetary easing are the huge cuts that central banks are making. Central banks cut rates by 25–50 basis points, but many have cut rates in one-percent increments. Central bankers typically prefer smaller policy actions to larger ones, but these times are not typical and they have been forced to make larger than usual interest rate cuts. The U.S. Federal Reserve (Fed), on December 16, cut its Fed Funds target rate from 1 percent to a range between 0–0.25 percent, a historic low.

## Recent monetary policy actions



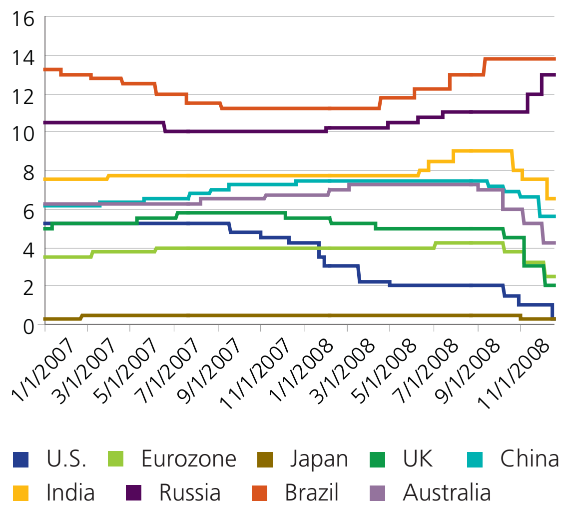
Several central banks have recently enacted expansionary policy actions (see chart below).

While most countries were cutting their interest rates, some countries, notably Brazil and Russia, have been following a tight monetary policy and increasing their benchmark interest rates. Russia briefly reduced interest rates by 50 basis points to 10 percent in June 2007 but resumed its tight policy in January 2008. As of December 1, 2008, the Russian interest rate was 13 percent (the central bank raised rates by 100 basis points). Russia has been raising rates to stem capital flight and the consequent depreciation of the ruble. The Brazilian central bank cut rates throughout 2007 (while most were increasing) and started tightening in April 2008 when they raised rates by 50 basis points to 11.75 percent. As of December 10, 2008, the Selic Rate was 13.75 percent, and the last policy action was a 75-basis point increase on September 11, 2008.

| Country | When their central banks started cutting interest rates | Interest rates before policy action (percent) | Interest rates as of December 16, 2008 (percent) | Date of most recent interest rate change | Size of interest rate cut (basis points) |
|---|---|---|---|---|---|
| United States | September 2007 | 5.75 | 0–0.25 | December 16, 2008 | 75–100 |
| Eurozone | October 2008 | 4.25 | 2.5 | December 4, 2008 | 75 |
| Japan | October 2008 | 0.5 | 0.3 | October 31, 2008 | 30 |
| UK | December 2007 | 5.75 | 2 | December 4, 2008 | 100 (150 basis points cut on November 6) |
| Australia | September 2008 | 7.25 | 4.25 | December 3, 2008 | 100 |
| China | September 2008 | 7.47 | 5.58 | November 27, 2008 | 108 |
| India | October 2008 | 9 | 6.5 | December 8, 2008 | 100 |

## Benchmark interest rates

**Figure 1: Benchmark interest rates**




Source: Bloomberg



## Why the Fed was ahead of the curve: Bernanke and the Great Depression

The central bank that has really stood out when it comes to the monetary easing has been the Fed. The Fed started cutting interest rates in September 2007 — well before any other central bank started following suit. In a series of moves between September 2007 and December 2008, the Fed cut the Federal Funds target rate from 5.25 percent to a target range of 0–0.25 percent. The Fed and especially its Chairman, Ben Bernanke, took a lot of heat for cutting interest rates and elevating inflation levels. In hindsight, it turns out that they were right to cut interest rates. So what was it that the Fed recognized before other central banks?

The current recession is often compared to the Great Depression in the 1930s — there are some similarities, but it is unlikely to be as bad — with Fed Chairman Ben Bernanke considered to be one of the foremost scholars on the Great Depression. The Great Depression has provided many lessons to central bankers on what not to do. One of the primary lessons was not to run a tight money policy when times are bad. Economists Milton Friedman and Anna Schwartz argue in their book, *A Monetary History of the United States*, that the Fed's tight monetary policy was a primary culprit of the deep and protracted nature of the Great Depression. With this hindsight (or foresight), Bernanke not only reduced interest rates aggressively but also gave banks access to liquidity from the discount window and through the Term Auction Facility.

For Bernanke, the safety of the financial sector came first. His reasons are stated in a 1983 paper titled "Nonmonetary Effects of the Financial Crisis in Propagation of the Great Depression." Bernanke wrote: "The two major components of the financial collapse were the loss in confidence in financial institutions, primarily commercial banks, and the widespread insolvency of debtors." In the paper, Bernanke wrote that "the disruption of the financial sector by the banking and debt crises raised the real cost of intermediation between lenders and certain classes of borrowers." The higher intermediation costs, according to Bernanke, led to a decline in aggregate output or GDP.

## The 0–0.25 decision

The Bank of Japan was until now the only central bank to have cut rates to zero; the Fed is the second. The Fed was forced to cut its target rate to a range of 0–0.25 percent for several reasons. They reduced the Fed Funds rate to one percent on October 29, but the effective Fed Funds rate or market rate has been well below the target rate since then — it was 0.52 percent on December 1 and it reduced to 0.15 percent on December 15. Put simply, the Fed was looking to align the target rate with the market rate. Another reason was because the Fed Funds rate was higher than the market rate, many banks chose to park their money with the Fed rather than lend and this cut could likely force banks to lend and hopefully reduce the credit squeeze.

The Fed doesn't want the market rate to go much higher than where it is because of worsening conditions. In the statement announcing the interest rate decision, the Fed said, "Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further."

The fourth reason is that the Fed wants to desperately reduce the interest rates charged to borrowers, which haven't fallen at the same pace — 30 fixed-rate mortgages averaged 5.47 percent for the week ended December 11, 2008 as compared to 6.11 percent a year ago, while adjustable-rate mortgages averaged 5.82 percent as compared to 5.89 percent a year before. To ease this situation, the Fed will buy agency debt and mortgage-backed securities to "provide support to the mortgage and housing markets" and it will increase these purchases if need be.

At 0–0.25 percent, the Fed has all but lost its main monetary policy tool. In what is a novelty, it will now only use its balance sheet as its main tool to "further support credit markets and economic activity."

## The near-term outlook

As far as the United States is concerned, it is very likely that the Fed will keep the Fed Funds target rate at the 0–0.25 percent range in the near- to medium-term because the economy faces dangers on several fronts. The Fed statement said "the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time." The Fed has been taking the lead to reduce interest rates and other central banks followed.

The last cut by the Fed may put pressure on other major central banks to now cut rates. However, the European central bank (ECB) is unlikely to cut interest rates in the near-term unless economic numbers significantly worsen. After the ECB cut rates by a record 75 basis points on December 4, ECB President, Jean-Claude Trichet warned, "We have to beware of being trapped at nominal levels that would be much too low." However, at 2.5 percent, they still have some wriggle room left. As far as the United Kingdom is concerned, median forecasts suggest that the Bank of England (BOE) will cut rates by 50 basis points to 1.5 percent in the near-term. The Bank Rate at two percent is already at its lowest level since 1951. On November 25, BOE Governor Mervyn King discussed the possibility of cutting rates to zero percent to renew the flow of credit to the economy. However, it is unlikely to go there because they, like the ECB, will want to avoid a policy trap.

The Bank of Japan is unlikely to reduce interest rates from the current level of 0.3 percent. It is ever mindful of the policy trap that occurred last time it reduced rates to zero percent. China is likely to cut their rates in the near-term because their macroeconomic numbers have been faltering lately. The People's Bank of China (PBC) posted a statement on their website titled "PBC to Implement Moderately Loose Policy to Boost Growth" after the disappointing third-quarter GDP number came in. The State Council has directed that economic growth have top priority, and the PBC is bound by that directive. The PBC is also likely to cut the reserve of banks in the near-term. Inflation in India is declining, and the Reserve Bank of India (RBI) is likely to continue their expansionary policy. Economic forecasts suggest that economic growth in India will likely slow through next year, and the RBI will cut rates in the near-term to give a boost to the economy. Like the PBC, the RBI will also cut the reserve requirements of banks.

Russian interest rates are likely to remain constant in the near-term or even increase if the capital flight situation gets worse. The prices of Russia's largest export, crude oil, have taken a beating, and recent political problems have scared investors. If the ruble continues its decline, the central bank will have no other option but to increase rates. As far as Brazil is concerned, median forecasts suggest that interest rates will rise to 15 percent in 2009. Brazil has been increasing rates in 2008 because it is "seeking to promote the convergence of inflation to the target trajectory in a timely fashion." November's inflation number came in at 6.39 percent while the central bank's target is six percent for 2008 (the inflation rate for 11 months to November 2008 is 5.6 percent). During their monetary policy meeting on December 11, 2008, policy makers left rates constant but most of them discussed the policy of lowering rates. Given falling commodity prices, it is likely that December's inflation will be low, and that could prompt policy makers to reduce interest rates in January 2009.

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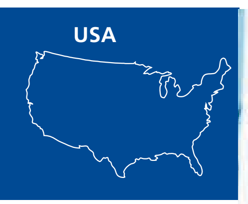
# In Search of the Little Old Ladies on Threadneedle Street

Dr. Carl Steidtmann

Keynes now seems to be all the rage. Everyone is quoting him and even more to the point, everyone is hoping that a little Keynesian magic can be applied to the economy. Funny thing about Keynes, he always seems to show up when the global economy hits a tough patch. FDR was a Keynesian before there was such a thing. Nixon was a Keynesian even as he did away with the very Keynesian Bretton Woods framework. The Japanese were definitely Keynesians in their policy response to the lost decade of the 1990s.

> "You cannot push on a string."
>
> Maynard Keynes
> commenting on monetary policy

contraction of the 1930s. They would make quite a contrast to today's Federal Reserve governors who have steeped themselves in the history of the Great Depression policy errors.







And now, everyone looks to the coming massive spending by the incoming Obama Administration on everything from green energy programs to infrastructure to rescue the economy. Despite all of the interest in Keynes and the possibility of a fiscal solution to the credit crisis, the problem facing the U.S. economy remains decidedly a monetary one. Massive government spending, while loads of fun for politicians, generally comes late to the party in terms of its timing. It is usually done on politically acceptable projects as opposed to economically productive ones and as the Japanese found, doesn't solve the underlying banking system problems.

Keynes was generally dismissive of monetary solutions to the problems posed by severe economic downturns. He was also quite contemptuous of the monetary policy makers. Keynes often referred to the Bank of England governors as the little old ladies on Threadneedle Street, the address of the Bank. In large part, he viewed them as old, conservative, and unwilling to take the drastic measures needed to resolve the severe business

Business spending has held up well as nonfinancial businesses still have strong balance sheets and good prospects outside of the United States.

## Debt Contraction and the Challenge of De-Leveraging

The origins of the recession are often described as the breaking of an asset bubble in housing. A more accurate characterization of the recession's origins would be the deflating of a debt bubble. From housing to cars, from leverage buyouts to structured investment vehicles, the fuel that drove the economy for the past eight years was debt and lots of it. What we have discovered since August 2007 is that much of that debt was lent to borrowers who had no hope of servicing the debt, much less repaying it.

Since the summer of 2007, banks, hedge funds, and insurance companies have been furiously writing off bad debt. While hard to get a precise number, roughly $750 billion in losses have been booked over the past 18 months.

These losses, in turn, reduce shareholder equity, which barring no other changes, results in an increase in financial leverage.

As the banks and other non-banks take these losses, they have to offset them on the asset side of their balance sheets by pulling back on lending. Depending on the degree of balance sheet leverage, every dollar loss of equity requires a 10x to 30x reduction in lending just to maintain the pre-loss degree of leverage. As the banks reduce leverage, the reduction in lending has to be even greater.

Starting in the mortgage market and then spreading to other credit markets, the contraction of credit creation has been abrupt and dramatic.  In the commercial paper market, banks began pulling back in August 2007, refusing to roll over asset backed commercial paper that many banks were using to fund their off balance sheet purchases of mortgage backed securities.  In commercial paper alone, the contraction of credit has been in excess of $800 billion. In the mortgage market, the pull back of credit has been even more severe. After peaking in late 2005 just shy of $1.4 trillion, new mortgage debt creation has almost completely disappeared. All told, credit creation has contracted by more than $2 trillion.

The contraction of credit is in many ways a destruction of money supply. And with the destruction of money has come a dramatic fall in asset prices and a growing problem with deflation. Since the summer, commodity prices have plummeted. Asset prices are down around the world.  Deflation is beginning to show up in both consumer and producer prices.

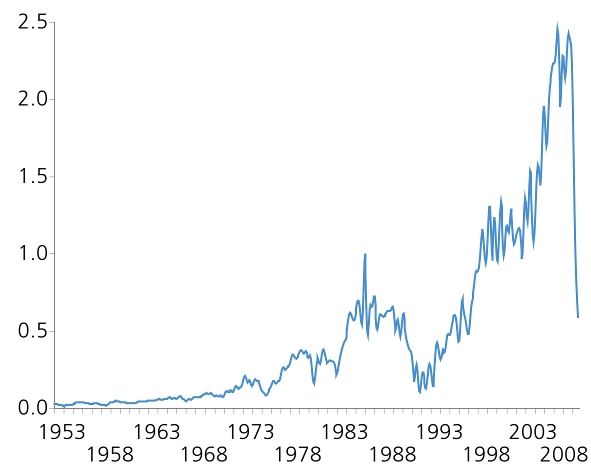
In a heavily indebted world, deflation is particularly destructive as it means debts have to be paid off in money that is gaining in value. For consumers, deflation creates an incentive to delay purchases. For investors, deflation means that holding risk free assets like money now has a positive return.

## Pushing on Keynes' String

From the beginning of the credit crisis, the U.S. Federal Reserve made the bet that the deflationary effects of a credit contraction were of much greater concern than the inflationary effects that might come from preemptive easing. In August 2007, the Fed began to ease in the face of rising energy prices and a falling dollar. It was a gamble at the time, which now looks prescient. After soaring for a year, energy prices peaked during the summer and have fallen sharply while the dollar has turned in a modest rally in its own right. And yet, despite the Fed's aggressive policy stance, the economy has fallen into a deepening recession.

The source of Keynes' distrust of monetary policy in times of economic distress was that the rush for safety and the loss of what he referred to as "animal spirits" would prevent both risk taking and investment, regardless of the prevailing interest rate. In a Keynesian slump, monetary policy simply became ineffective because the demand for liquidity was unlimited. Monetary policy easing got lost in a liquidity trap. In a deflationary environment, investor concerns about their return *of* investment override their desire for a return *on* investment.

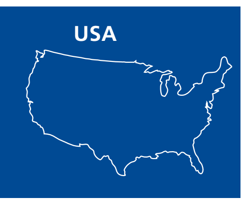
**Figure 1: Private sector debt creation**
(In trillions of $, seasonally adjusted annualized rates)




Source:  Federal Reserve Board

Today we can see signs of this liquidity trap in the market for Treasury Bills. Rates in the short term T-bill market have fallen to zero and there have been cases recently when rates actually went negative. In mid-December, the U.S. Treasury sold $30 billion in three month T-bills at a yield of 0.005 percent. Much like the Japanese government during the lost decade of the 1990s, the U.S. government can borrow unlimited amounts of money for essentially nothing.

USA





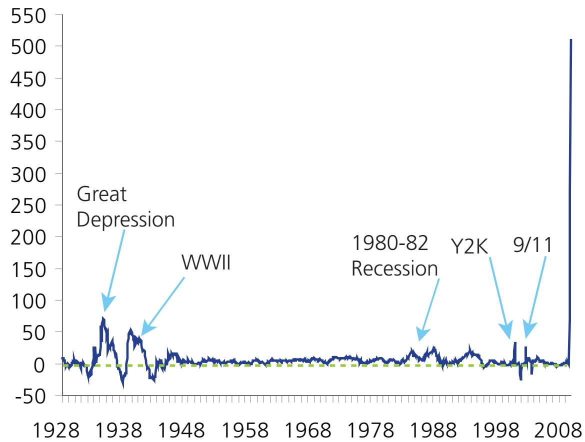

Breaking the liquidity trap has two prerequisites, first, a lot of liquidity and second, a banking system that is solvent. The Fed has aggressively pursued the first prerequisite with an alphabet soup of credit facilities for the banks. The Treasury has aggressively pursued the second with the Troubled Assets Recovery Program (TARP).

## The Monetary Response: No Little Old Ladies Need Apply

The monetary response to this crisis has been one that would have made the Threadneedle ladies blush. The actions by the U.S. Federal Reserve, the U.S. Treasury, the FDIC and the FHA have been massive, coordinated, and relentless.  The Federal Reserve has done everything it can to expand bank reserves by aggressively expanding its own balance sheet even as the balance sheets of private sector financial institutions shrink.

In November 2008, adjusted bank reserves were up 510 percent from a year ago. The Fed sparked the 1930s recovery from the Great Depression with a 70 percent increase in adjusted reserves and was able to help finance the build up for World War II with a more modest 50 percent increase. More recent disruptions like Y2K and 9/11 were handled with temporary boosts in reserves of 33 percent and 25 percent respectively.  The banks are awash in liquidity. The Feds challenge in the not so distant future will be draining these reserves from the system when the economy begins to pick up.

**Figure 3: St. Louis adjusted reserves**
(In Billions $)



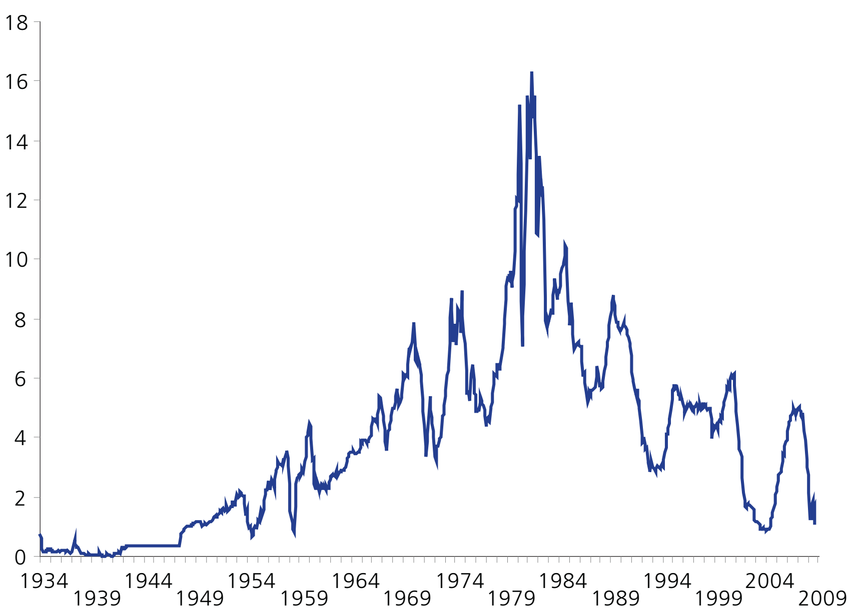

Source: St. Louis Federal Reserve

In addition to lending money to commercial and investment banks through special credit facilities, the Fed has become an active player in the commercial paper market. In the fourth quarter of 2008, the Fed purchased more than $250 billion in commercial paper, giving a strong boost to that market and relieving the cash management problems of both financial and non-financial firms.

The Fed is not alone in its efforts to fight deflation and the systemic threats to the banking system. The FDIC has expanded its deposit insurance to cover deposits up to $250,000 and extended that insurance to include money market deposits. In addition, the FDIC has extended the option of debt insurance on the debt of all of its member banks for a fee.

In addition to the $159 billion spring stimulus package, the Treasury has already allocated the first $350 billion tranche of the $700 billion TARP. The majority of those funds have been used to recapitalize the banking system as a way of reducing the severity of the bank de-leveraging. A total of 88 banks have received funding from the TARP, making the U.S. Treasury the largest bank mutual fund on the face of the planet.

**Figure 2: Three month Treasury Bill rates**




Source: St. Louis Federal Reserve

And finally, the Federal Housing Administration has the Hope for Homeowners program that has $300 billion, helping homeowners at risk of default remain in their homes through refinancing their loans on more manageable terms. Taken together, the FHA, the Federal Reserve, the U.S. Treasury, and the FDIC have extended nearly $9 trillion in loans, expenditures, debt, and deposit insurance.

## Keynes Lives

Despite all of the monetary stimulus that has been put into the financial system, the incoming Obama Administration is not content to wait and see if these past efforts will work.  While initial estimates put the Obama stimulus plan at $500–700 billion, it has more recently been raised to $1 trillion and possibly more over a two year period. The package is expected to include an initial middle class tax cut in addition to a massive infusion of funds for roads, bridges, water systems, school repair, spreading broadband access, promoting health-care information technology, improving energy efficiency in buildings, and renewable-energy projects.  With many states facing severe budget crises of their own, additional finds will be made available to struggling state and local governments.

## Last Thoughts

The Great Depression of the 1930s did not start off as a depression, great or otherwise. The Great Depression became a great disaster as a direct result of not-so-great economic policies. The Hoover Administration raised taxes to balance its budget. The balanced budget orthodoxy was so strong that Roosevelt ran on a balanced budget platform in 1932. With massive new spending plans in the works and a trillion dollar deficit on the horizons, there is little chance of repeating that mistake.

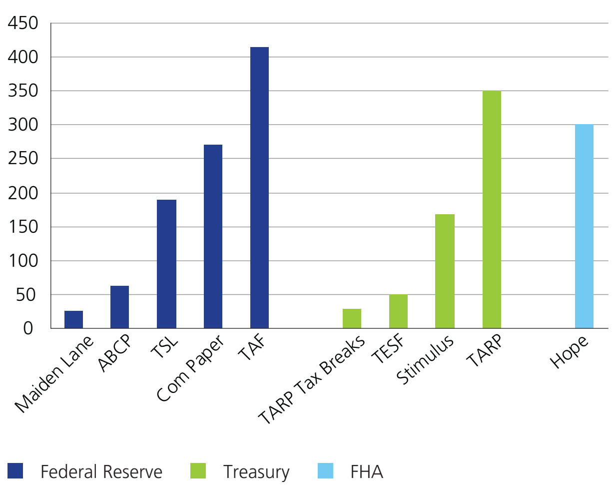
The United States turned protectionist in the early 1930s, passing the Smoot-Hawley Tariff. While protectionist rhetoric was ratcheted up during the presidential campaign, the likelihood of a swing to protectionism also seems remote. And finally, the Federal Reserve of the 1930s did little to stop the run on the financial system, allowing thousands of banks to fail and their depositors to be wiped out. With trillions of dollars in credit facilities, deposit guarantees,

> “We are all Keynesians now.”
>
> Richard Nixon after destroying the Keynesian-built Bretton Woods System

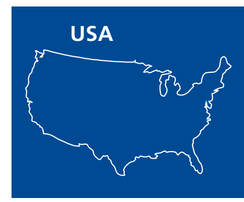
and bailouts, the Federal Reserve of 2008 has shown that it is willing to bear any burden and pay any price to maintain the integrity of the banking system.

The government efforts of the past year mean that we are in the midst of a great transformation of the U.S. economy. As was the case in the 1930s, the economic crisis of our day is increasing government control of the economy. The great trade and spending imbalances of the past decade are in the process of being reversed. Consumer spending as a share of the economy is going to shrink, reducing U.S. imports and putting new pressures on Asian exports and Middle Eastern oil producers to look elsewhere for growth. While it is easy to despair in this season of economic discontent, it is hard not to see that with the effects of nearly $10 trillion in various shades of stimulus that a reasonably strong economic recovery should arrive sometime before the end of 2009.

**Figure 4: Federal government expenditures or outlays by program**
(In Billions of $)




Source: Bloomberg



# Eurozone Economic Outlook

Dr. Elisabeth Denison

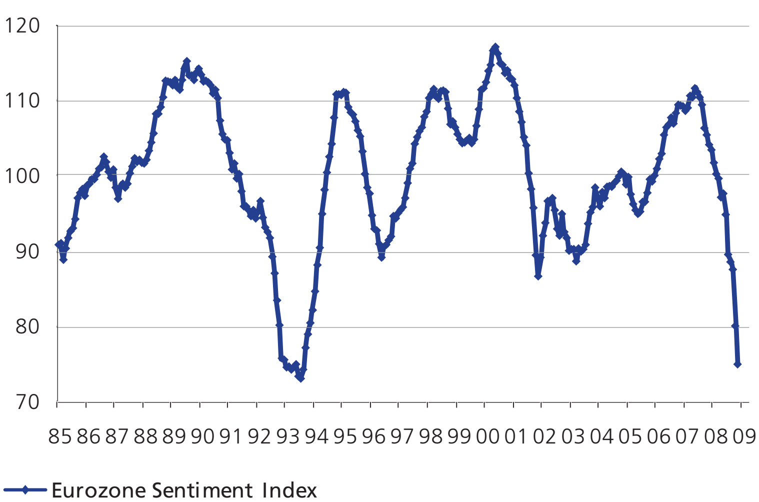
There was a time when it looked like the Eurozone could escape the worst of this crisis and avoid a recession. After all, in most of its member nations, the participation in the asset-price bubble of past years was limited, governments relied less on foreign borrowing, and households had a much higher savings rate. With the unraveling of the world economy, however, it has become clear that the Eurozone will not be spared.

The degree of pessimism in Europe is worrying. The European Commission sentiment index for the Eurozone has dropped by a third from its peak in May 2007 and stands at a 15-year low (see Figure 1). Both industrial and consumer components are down sharply.

Much of the pessimism in Europe seems to be based on the expectation of worse things to come. Official forecasts have been ratcheted down in recent months. Even European Central Bank (ECB) President Jean-Claude Trichet admitted in December: "In the view of the Governing Council, the economic outlook remains surrounded by an exceptionally high degree of uncertainty. Risks to economic growth lie on the downside."




**Figure 1: Pessimism regins in Europe**




Source: European Commission

## Slowing exports and declining investment spending

The Eurozone — and especially its largest economy, Germany — have become increasingly reliant on foreign growth over the past few years while domestic demand languished. The current account surplus for the currency union amounted to +0.3 percent of GDP in 2007, which stands in contrast to a deficit of -5.3 percent in the United States. Germany ran a surplus of -190 billion in 2007, equivalent to 7.7 percent of GDP. While America is paying the price for being overly reliant on foreign capital, some nations in Europe are now paying the price for being too heavily dependent on foreign growth. Declining demand in both industrialized and emerging nations is hitting its manufacturers. In Germany, new orders for industrial goods are down over 20 percent from their peak in 2007 (see Figure 2).

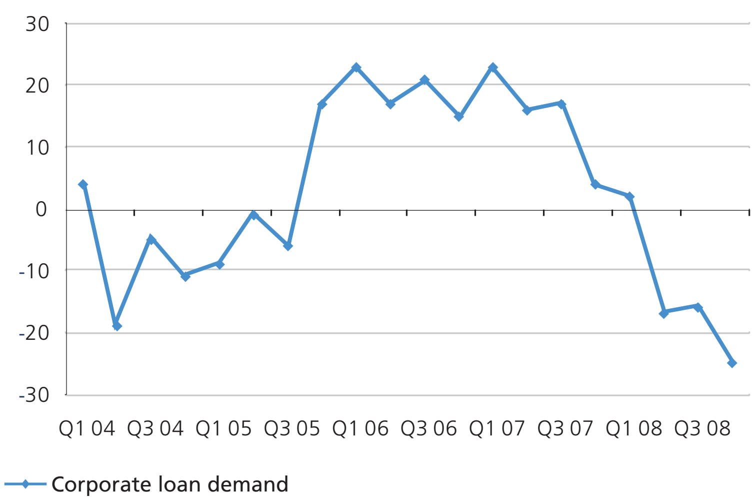
The manufacturing purchasing manager index for the Eurozone fell to a new record-low in 2008, indicating that industrial production will likely continue to contract. With declining capacity utilization, investment spending is being put on hold. Business investment spending in the Eurozone declined 1.5 percent between March and October 2008. In the ECB lending officer survey, banks reported that net demand for loans to enterprises continued to contract in the third quarter of 2008 (see Figure 3). The development was said to be driven primarily by a decline in the need for financing fixed investment.

**Figure 2: New orders are breaking away in Germany**


Source: Destatis (German Statistical Office)




**Figure 3: Business demand for loans continues to decline**




Source: ECB lending officer survey

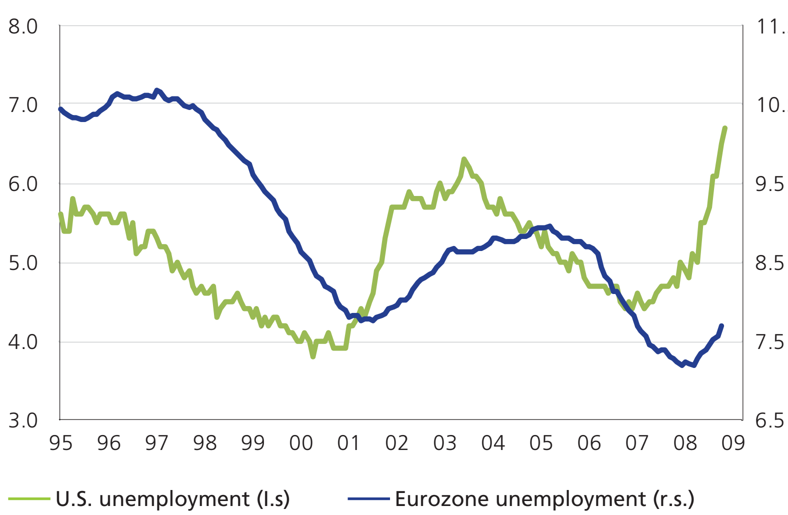



## Reluctant consumers

Unfortunately, consumer spending will not be much of an offset to growth. In theory, continental European consumers should be less affected by the recession than their peers in the United States. They have higher savings and were less exposed to equity and housing market bubbles because stock and homeownership rates are lower than in the United States. Unemployment is only slowly edging up in comparison to the United States (see Figure 4).

Yet, retail sales are dropping just as fast in Europe as in the United States. Over the three months from July to October 2008 on average, deflated non-food retail sales were down -1.5 percent year-on-year in the Euro area, compared to -2.4 percent in the United States. The slowdown in consumer spending in Europe is happening even though the expansion never matched that of the United States. In the five years leading up to 2008, real retail sales were rising an average 1.6 percent per year in Europe, compared to 4.5 percent in America (see Figure 5).

**Figure 4: Following America's lead? Unemployment in United States and Europe**




## Governments to the rescue

What is left if both businesses and consumers are retrenching? To not much surprise, Keynesian solutions are back in vogue. However, in contrast to the United States, whose new president seems set on throwing all he has (and everything he has not) at ending the recession, European stimulus plans have been more guarded. France and Germany announced measures the equivalent of 1.0–1.5 percent of GDP. The European commission is pushing for a joint stimulus package, but there are obvious nationalistic tendencies in the individual rescue packages. French President Sarkozy made it clear that "there will be no help without the commitment not to relocate abroad and to build new engines in France." Chancellor Merkel of Germany, meanwhile, said the country would not "join in a multibillion race simply to create the impression we have done something."

Eurozone politicians have shown that they are capable of cooperation in recent months, but some nations are clearly facing tougher choices than others. Between January and October 2008, unemployment in Spain rose by almost four percent, while it declined 0.5 percent in Germany. Fiscal positions in the region also vastly differ. The "exceptional circumstances" clause of the Maastricht treaty has been invoked to permit states to breach the limit of three percent of GDP on budget deficits up to a point, creating leeway for Italy, France, and other countries pressing up against the barrier.

Financing that debt, however, will get expensive. Government spreads within the union have widened as risk premiums for Italy and other weak EU economies like Greece increased. Countries with more solid financials believe that after years of prudence at home, supporting their spendthrift neighbors is uncalled for. At the meeting of Europe's finance ministers in Brussels in December, Germany is said to have refused a call by Italy for its partners in the Eurozone to help finance Italy's mountain of national debt (the world's third highest at over 100 percent of GDP).

## The monetary union and the role of the ECB

Against the background of diverging national fortunes, questions about the viability of the common currency area naturally arise. However, the increase in yield differentials in Europe does not justify speculation about a breakup of the monetary union by itself. Considering the volatility in global currency markets and the risk premiums attached to some emerging-market debt, the affected countries would probably be even worse off without the Euro. Indeed, some EU member states, which were unwilling to commit to a specific Economic and Monetary Union (EMU) perspective before, are now reconsidering their stance, but they are unlikely to meet the necessary stability criteria.

The European Central Bank surely has its work cut out. However, its independence has served it well so far. It has assumed important crisis management functions in providing liquidity and acted as an international mediator for coordinated action (with 15 central banks that would have been logistically challenging, to say the least). It has lived up to its responsibility and surprised some with a more forceful monetary action than expected. Even the possibility of "quantitative easing" has not been ruled out. "We are supplying liquidity on an unlimited basis. We will continue to look very carefully at the situation of the market and if needed we will take new decisions," said ECB President Trichet when asked about future policy options in December.

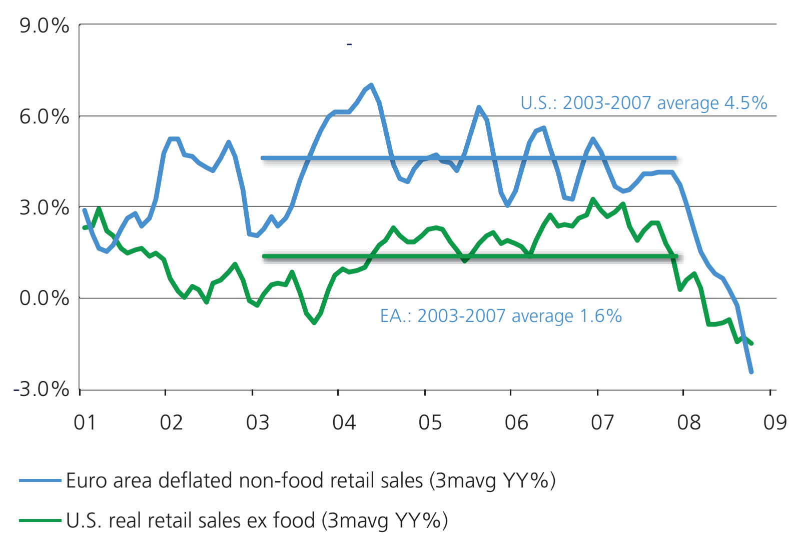
## A chance for Europe

It is hard to imagine right now, but there is a chance that Europe might come out of this recession stronger than before. With the Euro having passed this fire-test, confidence in the currency union will be greatly improved. There are likely to be more than 15 countries in the Euro area before long. Some nations — both within the Eurozone and within the larger EU community — will have been forced to clean up their accounts and commit to long-overdue structural reforms.

Consolidation in Europe's still-fragmented banking system is bound to continue — with or without government support. Corporate rescue packages, if any, will likely focus on preserving the continent's innovative edge — be it in automotive, environmental, or other high technology.

Mastering the challenges of this recession will not be easy for anyone. The psychological contagion has become much greater in an increasingly interconnected world. However, both business- and consumer-sentiment will eventually refocus on fundamentals, and thanks to a hefty dose of monetary and fiscal stimulus, there is hope that they will look better before long.

**Figure 5: Consumers are snapping their wallets shut**




Source: BEA, Eurostat

# China: A Surprising Descent

Dr. Ira Kalish

In recent years, China has been the world's factory, exporting massive quantities of goods to high consumption economies like that of the United States. At the same time, China has come to be seen as an engine of global growth, absorbing commodity imports especially from other rising emerging markets. Yet as of now, China is playing neither role. Instead, the world's most populous nation is experiencing a sudden deceleration in economic activity that has shocked most observers.



In November 2008, China's exports actually declined 2.2 percent from the previous year as demand in the United States and the European Union collapsed. In addition, the lagged effects of currency appreciation kicked in, hurting the profitability of many marginal manufacturers. China's imports dropped 17.9 percent over the prior year as the need for commodities quickly fell. Moreover, the drop in demand caused a collapse in commodity prices, which, in turn, caused a further decline in the value of Chinese imports. Finally, China's industrial production shrank to its lowest level in seven years.

The end result has been a slowdown in Chinese economic growth. Yet the external world is not the sole cause of China's troubles. The country has seen a massive investment boom in recent years, much of which was focused on property. This boom fueled inflationary pressures and caused considerable concern among policymakers. Although the best solution to inflation would have been a large currency appreciation, the government was reluctant to undertake such drastic action as they worried about the consequences for the country's manufacturing sector. Instead, they imposed credit controls that caused a sudden drop in property investment. This has played a role in China's slowdown as well.

The good news for China is that, unlike many other emerging markets, it has not borrowed heavily in global capital markets. Thus, China is not at risk from financial contagion. Indeed, China has been a global lender. Consequently, China is in a good position to self-finance any measures aimed at restoring economic growth. Indeed, this is precisely what the government has done. It has announced a massive fiscal stimulus aimed at boosting domestic demand in order to offset the drop in external demand. While the true size of the stimulus package is smaller than announced (much of the money was already in the pipeline and, thus, does not represent incremental spending), it is nevertheless significant.

This stimulus is important as China has been excessively dependent on exports and investment for economic growth. Consumer spending, on the other hand, has been abnormally low, reflecting a high personal savings rate as well as a low level of wages relative to GDP. In the future, this will have to change if China is to wean itself from dependence on external forces. For now, however, it is critical to maintain a minimal level of growth in order to maintain social cohesion. China is in the midst of a massive migration of people from rural to urban areas. To absorb this migration, the economy must grow rapidly. Yet literally tens of thousands of factories have already closed their doors, resulting in a large increase in unemployment. For now, migration from rural areas is decelerating. Still, the possibility of social unrest is surely one of the factors driving quick government action to boost economic activity. In addition, the government has put currency appreciation on hold lest more factories succumb.

The bottom line is that, in 2009, China will experience slower GDP growth than it has seen in many years. On the positive side, inflation is already abating, both due to the lagged effects of currency appreciation and to the slowdown in demand.

# Japan

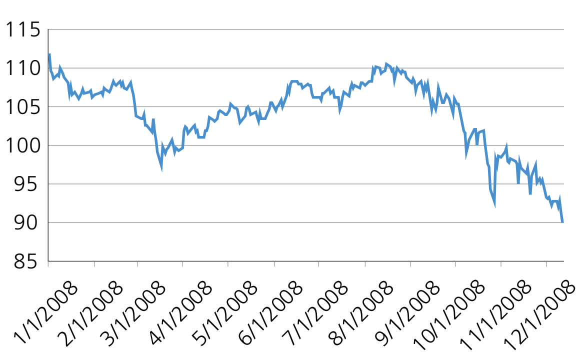
Dr. Sunil Rongala

Perhaps the years of U.S. consumers living well beyond their means made the current recession inevitable. Japan's slowdown, on the other hand, is a profoundly different story. They have diligently run current account surpluses and managed to get themselves out of the mess they were in for a decade. It now seems that thrift hasn't saved them from a slowdown. The Japanese government says that recession has officially set into Japan. GDP in the third quarter of 2008 fell by 0.5 percent on a YoY basis. GDP growth in the first two quarters was not anywhere close to good either. It grew at 1.4 percent in the first quarter and 0.7 percent in the second. Other macro indicators are not looking good either.

JAPAN

Industrial production fell by 7.1 percent in October and grew marginally by 0.2 percent the month before. The average industrial production growth for the first 10 months of 2008 was slightly below zero. One of the leading causes for industrial production to fall was the 6.8 percent drop in automobile production in October. While auto production grew by 4.2 percent in September, it fell by 10.9 percent in August. Retail sales have been very anemic, falling by 0.7 percent in October and 0.3 percent in the previous month. The average growth for the first ten months of the year is less than one percent. Nationwide department store sales have fared even worse. They fell by 6.7 percent in October and 4.7 percent in September while the average growth for the year fell by 3.3 percent. Declining sales can be explained by falling consumer confidence numbers. The consumer confidence index has fallen from 37.9 in January 2008 to 28.7 in November, the lowest in over 25 years. Many companies are now cutting their profit forecasts by substantial numbers because of the bad news.

**Figure 1: Japanese yen to the U.S. dollar**




Source: Bloomberg

The currency has appreciated by nearly 20 percent between the start of the year and the second week of December 2008. This appreciation has its roots in the unwinding of the yen-carry trade, which involves Japanese investors who borrow yen and invest that money elsewhere for a high net return. The currency appreciation has led to a 7.8 percent fall in exports in October. Export growth in 2008 has been weak compared to 2007. It hasn't helped that China, Japan's largest customer, is also experiencing a slowdown and that the yuan has been near constant since July.

Core inflation (inflation less food and energy) grew at just 0.2 percent in October compared to zero percent in August. The average core inflation has been just 0.02 for the first 10 months of 2008. Headline inflation also came in fairly low at just 1.7 percent in October. The Economy Watchers survey index is showing a decline; it fell from 31.8 in January 2008 to 21 in November. Machinery orders, an indicator of capital spending in the next three to six months, have been falling continuously in the past few months. Machinery orders tumbled by 15.5 percent in October compared to -4.2 percent in September and -13 percent in August.

Bank lending in November increased at its slowest pace in 16 years because banks are hoarding cash and pushing-up money-market rates and thus preventing companies from issuing fresh debt. The commercial paper market has also frozen for smaller companies because of falling confidence in them and also because the larger companies are crowding them out. This is despite the Bank of Japan (BOJ) cutting its benchmark interest rate, the over-night call rate, to 0.30 percent in late October. To unfreeze the credit markets, the BOJ has announced that they will start accepting BBB rated corporate debt or higher as collateral (it used to be A- or higher) and that they would start a new lending facility for commercial banks in January 2009. 2008 also saw 30 bankruptcies among publicly traded firms — the most since World War II.

It is very likely that Japan will go through fairly severe tumult in the coming quarters. The macroeconomic leading index is accelerating its downward trend. It was 85 in October compared to 94.8 in January 2008. The OECD estimates that Japan will grow by just 0.1 percent in 2009. This estimate was made before the government upped a $51 billion stimulus package to $110 billion. However, it is unclear how this package will work because a stimulus can only provide a kick-start to the economy and not much more. If consumers refuse to spend, it's unlikely that the stimulus will work, and this will probably happen in Japan. It is also unclear how the government will pay for it. The $51 billion package was announced in October and has yet to be presented in Parliament as of December 15, 2008.

It is very likely that industrial production will decline in Japan. The Tankan Survey for large manufacturers forecasted a major fall in sentiment. Between September and December 2008, the forecast for business conditions index fell from -4 to -24, the largest fall in 34 years. The index, which includes all industries (manufacturing and non-manufacturing), fell from to -24 in December from -19 in September. The BOJ forecasts that the index for large manufacturers will fall to -36 in March 2009 and to -38 for all industries. Another indicator for poor industrial production numbers is the manufacturing purchasing manager's index, which is reaching new lows. It fell to 36.7 in November, the lowest on record, compared to 42.2 in October. Falling exports are also going to hit the profitability of companies.

This means that companies will likely freeze their spending plans — falling machinery orders, which indicate capital spending in the coming three to six months, is falling quite rapidly. This is also likely to affect the job market, which is already quite bad. It also means that a vicious cycle is going to start in the economy where workers who lack job-security are going to spend less and hurt the income statements of companies very badly, which in turn will lay-off more workers and send the economy into a deeper recession. Companies have already been hurt by the high cost of money and further hits could send bankruptcy numbers soaring. A potentially frightening number in the Tankan Survey for companies is the index for "domestic demand and supply conditions for products and services." The BOJ forecasts that the index for large enterprises will be at -39 in March 2009 (means supply is greater than demand) compared to -34 in December 2008. For small enterprises, the index is forecast to be at -50 in March 2009 compared to -41 in December 2008. The one bright spot for companies will be if the BOJ manages to reduce money market rates.

Deflation is very likely to deepen in 2009. The index for output prices for large enterprises fell to -4 in December 2008 compared to 11 in September 2008. The BOJ forecasts that this will fall sharply to -18 in March 2009. For small enterprises, the BOJ forecasts that output prices will fall to -22 in March 2009 compared to -5 in December 2008. Given this, core inflation growth is highly likely to go below zero soon. With falling energy prices, headline inflation will also come down dramatically. The BOJ, which cut its benchmark rate in October by 20 basis points to 0.30 percent, is unlikely to cut rates in the near-term. The only meaningful cut they can do is to bring interest rates down to zero percent, but that means they lose their main tool for policy making — something the Japanese central bank is unlikely to part with but may not have any option. The Japanese yen is likely to maintain current levels (90.25 to the U.S. dollar as of December 12, 2008). Six-month currency forwards on December 12 indicate the yen slightly appreciating to 89.71 to the dollar, further denting exports. This pace is likely to be kept as Japanese investors unwind their foreign investments.

**Ian Stewart** is a Director of Deloitte Research

# The United Kingdom: Into the Storm

Ian Stewart

The financial crisis that began in the United States in 2007 entered a new, virulent phase in September 2008 with the failure of Lehman. The outlook for the UK economy has deteriorated markedly in the face of what the Bank of England has described as the severest disruption to financial markets since the outbreak of the First World War. The United Kingdom entered a recession in the third quarter of 2008 and growth is likely to contract by over one percent in 2009, making the United Kingdom one of the weakest economies in the industrialized world. The precipitate fall in




sterling, which has declined by some 20 percent in the last year, could be seen in part, as a gloomy international verdict on the UK outlook. Given the deeply disrupted state of the financial sector, a return to the trend levels of output growth is unlikely until 2011 or later.

Elevated levels of volatility, risk aversion, and illiquidity have been present across financial markets for over a year, but in the last six months have dramatically impacted the real economy. A process of debt reduction by banks has fed through to a marked reduction in credit growth, with the annual rate dropping from 15 percent in early 2007 to 5.2 percent in the third quarter of 2008. The breakdown of securitization markets in the United Kingdom has left a "funding gap" in credit creation, estimated by the Bank of England at some £700 billion or over 60 percent of GDP. Tighter credit conditions have manifested themselves in rising fees and spreads and tougher collateral requirements and loan covenants. The Deloitte CFO Survey shows that in the fourth quarter 99 percent of major UK corporates rated credit as "hard to obtain," up from just 55 percent a year earlier.

Despite sharp reductions in central bank interest rates, the cost of credit remains at elevated levels. The so-called monetary transmission mechanism is broken. The government has tried to cajole banks into reducing borrowing costs and increasing lending. But with corporate defaults and households mortgage arrears set to mount, so too will pressure on banks' balance sheets. The risks, for now, are that UK credit conditions and credit supply will deteriorate still further.

Consumers have been hit by a crushing combination of declining real incomes, reduced credit availability, and falling housing prices. UK households are highly geared both by international standards and relative to recent history. Household debt has risen from 20 percent of GDP in 1978 to 60 percent in 1998 to almost 90 percent today. House prices fell by 13.9 percent in the year to November, weakening consumer balance sheets in a country where home ownership stands at 70 percent and the savings ratio at less than one percent. The fallout from an increasingly pressured household sector has been seen in the failure of an iconic retail chain and aggressive pre-Christmas discounting by retailers.

With consumer confidence close to a 30-year low and incomes under pressure from higher unemployment, consumption is likely to contract sharply in 2009. Meanwhile, investment, especially in real estate and buildings, has fallen sharply as firms pare back plans for expansion. The Deloitte CFO Survey shows that in December some 77 percent of major UK corporates said they planned to cut capital spending over the coming year.

A crisis that started in the financial sector has spread to the consumer and housing and now to the rest of the economy. Thus a liquidity and solvency crisis for the financial sector has become a liquidity and solvency crisis for parts of the economy far removed from finance. Sectors such as utilities and manufacturing are suffering from weaker demand and a shortage of credit. The non-financial corporate sector is increasingly emulating financials by cutting dividends, reducing debt levels, and laying off staff.

A sharp fall in sterling will offer some respite for exporters. However, with the World Bank forecasting that international trade will contract in 2009 for the first time since the early 1980s, the outlook for UK exports is hardly buoyant. Survey measures of manufacturing export demand peaked in early 2008 and turned down markedly in the closing months of the year.

The United Kingdom has entered a very different recession from those seen in the 1980s and 1990s. These recessions were caused by a deliberate government action to squeeze inflation out of the system through tight monetary policy. The current recession has been caused by the ending of a debt boom and the resulting crisis in the financial system. With the failure of Lehman in September, and the failure of global credit markets, it became apparent that the burden of solving the financial crisis had passed from the private sector to government.

The UK authorities have acted increasingly aggressively to stimulate the economy and aid the recapitalization of the banking system. The Bank of England cut the base rate by an unprecedented 250 basis points in November and December, taking the official rate to just 2 percent. On October 8, the UK government announced a new and extensive package of measures to recapitalize and provide liquidity to the financial system. In its efforts to recapitalize the banks, the Bank of England is expanding its balance sheet and changing its composition to holding riskier and less liquid assets. Like governments elsewhere, the UK authorities have also announced a major fiscal stimulus. The package is worth 0.6 percent of GDP in 2008–2009 and 1.1 percent of GDP in 2009–2010 with much of the stimulus focused on a reduction in the VAT rate.

These measures should help reduce the severity and duration of the downturn. But the adjustment in debt levels and asset prices, which is already underway, has further to run. A financial crisis requires a financial solution. In this case that means the rebuilding of banks' balance sheets, the disclosure of losses, and the restoration of confidence in the financial system. Consumers, too, have stretched balance sheets, with historically low levels of savings and high levels of indebtedness. In a world of scarcer credit and lower real estate prices, consumers need to save more and spend less. This process of rebalancing will take time. Lower central bank interest rates and the provision of liquidity and capital to the banks should stabilize the banking system, but are unlikely to lead to a marked improvement in credit supply in the near term. The evidence from the Japanese, Norwegian, and Swedish banking crises of the 1990s is that deep financial crises tend to be accompanied by prolonged periods of reduced credit supply. In the meantime, the UK economy is likely to see a significant squeeze on activity that lasts well into 2010. Perhaps the best news that 2009 can realistically hope to deliver is gathering evidence that the financial system is on the mend.




## India

Dr. Sunil Rongala

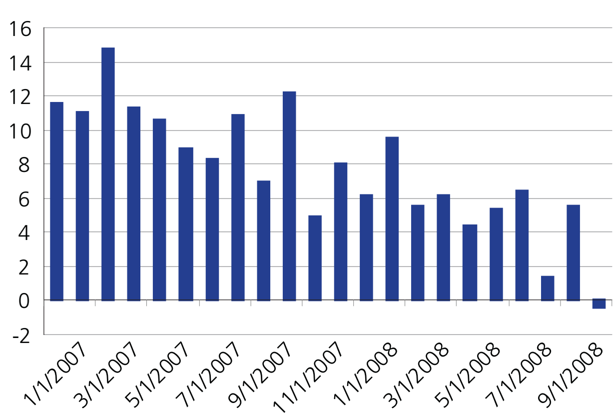
After many quarters of strong economic growth, India's explosive economy is beginning to slow down. GDP growth in the second-quarter of FY09 (India's financial year runs from April–March) was 7.6 percent, slightly down from the previous quarter's 7.9 percent because of slowdowns in some sectors. While most of the world's economies would consider this an exceedingly healthy growth rate, it indicates as plainly as numbers can that India's emergence is anything but infinite. This economic slowdown is now gathering pace. Industrial production (IP) in October 2008 fell by 0.4 percent compared to growth of 5.5 percent in the previous month. IP numbers have been on a downward trend for the past few months compared to 2007 when it averaged close to 10 percent. One of the major reasons for IP to fall was the growth of the manufacturing sector, which accounts for 80 percent of IP. Manufacturing fell by 1.2 percent, something not seen in a very long time. Like IP, manufacturing also had a stellar year in 2007 and has been declining ever since. The auto sector, which contributed to good manufacturing numbers, is now putting the brakes on economic progress.

Consumption in India is also slowing down. GDP growth numbers show that consumption grew at 5.5 percent in the second-quarter compared to 7.9 percent in the first. IP numbers indicate that consumer goods production was down 2.3 percent in October compared to a growth of 14.6 in September. Retail rentals seem to indicate a slowdown in consumption. Newspaper reports indicate that rents have fallen by as much as 35 percent. The Indian rupee lost close to 20 percent of its value against the U.S. dollar in 2008. However, the cheaper rupee has not given any boost to exports, which have been falling in absolute terms. In October, they amounted to $12.82 billion compared to $13.74 billion in the previous month and $16 billion in August. Inflation in India, along with most countries, is on its way down, and it's not a surprise, given falling commodity costs.

The slowdown in the economy has led the Reserve Bank of India (RBI) to cut rates aggressively. Between the middle of October 2008 and the second week of December, the RBI reduced its benchmark interest rate, the repo rate, from 9 percent to 6.5 percent.




**Figure 1: Industrial production growth (percent YoY)**




Source: Bloomberg

Clearly, declining inflation numbers helped, but the slowing economy forced their hand. The Reserve Bank of India, after cutting rates by 100 basis points on December 9, 2008, displayed a shadow of its former optimism:

> "The outlook for India going forward is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008/09. Industrial activity, particularly in the manufacturing and infrastructure sectors, is decelerating. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms in October. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence."

Along with the repo cut, the RBI also decreased the reverse repo rate (liquidity absorption rate) to five percent to discourage banks from parking their excess liquidity. In addition to that, the RBI also eased rules for commercial banks to lend to the real estate sector, a sector that is also experiencing a slowdown. In addition, they have extended the credit period for exporters from six months to nine. Along with the RBI, the government also introduced a whole host of fiscal measures. The government plans to spend INR 200 billion ($4 billion) as well as reduce sales tax by four percent for most goods. The government will also provide incentives to exporters as well as small and medium enterprises and infrastructure companies.

In a conference held on November 21, 2008, the Prime Minister, Manmohan Singh said:

> "No instrument of public policy will be spared, whether it is fiscal policy, monetary policy, exchange-rate policy, public investment policy, all will be deployed to ensure an environment conducive to the growth of enterprise. You have my assurance that despite adverse international environment, we have the capacity and ability to sustain the growth rate of about 8 percent."

It is unlikely that the economy will grow at eight percent in either FY09 or FY10.

In the near-term, it is unlikely that the stimulus and the interest rate cuts will prevent the economy from slowing down. The fiscal stimulus is a fairly small one — very small compared to China. Interest rate cuts have long impact lags (between 12 and 18 months), and the rate cuts that started in October 2008 are unlikely to have an effect until sometime toward the end of 2009. In fact, the effect that the economy may feel in the near-term are the interest rate hikes that the RBI made from 2007 till the latter half of 2008. The small fiscal stimulus could also mean that the government would prefer to rely on monetary measures because it frankly does not have the money to do a large stimulus package. Another reason why the spending may not boost growth is because investment spending, a major driver of economic growth in previous years, is down. It has been estimated that nearly 40 percent of investment spending came from foreign borrowing and the sale of new shares. With the foreign credit market in a major freeze and local stock markets at very low levels, it is unlikely that companies can raise the amount of money they did in previous years. To this end, the RBI, which initially forecasted a growth rate of 7.5 percent for 2008–09 is now widely expected to revise the number downward in their next meeting on January 27, 2009.


# Brazil: Innocent Bystander

Dr. Ira Kalish

Having experienced strong economic growth for the past several years, Brazil is now experiencing a slowdown that will endure throughout 2009. The country has been hit from several directions: weaker demand in the United States and China for Brazil's exports, lower prices of commodities, and significant contagion from the global credit crunch. Let's consider each of these.

First, export growth is slowing due to weak demand in the United States and China. China, in particular, has been an important market for Brazil's commodity exports. Now that China's manufacturing sector is experiencing a sharp slowdown, demand for commodity inputs has diminished. This, in turn, has caused a sharp drop in global commodity prices. For Brazil, this is important as commodities make up roughly 50 percent of export revenue. On the other hand, exports make up only about 15 percent of GDP, so Brazil does not have an onerous dependence on exports.

BRAZIL





Second, the global financial crisis has come to Brazil. Although Brazilian banks were not exposed to the troubled market for U.S.-based asset backed securities, they were exposed to currency market derivatives that have suddenly and unexpectedly moved in a new direction. Many Brazilian companies hedged against the risk of currency appreciation. These exporters wanted to remain competitive even if the Brazilian currency rose in value. Banks were happy to sell these contracts. Yet in recent months, the Brazilian real has depreciated, causing major losses for the banks.

Why did the currency depreciate? There were several reasons. First, declining export revenue put downward pressure on the currency. Second, foreign investors sold assets in Brazil in order to cover their losses at home. This capital outflow also put downward pressure on the currency as well as on Brazilian equity prices. The result was that Brazilian banks have suffered losses and, at the same time, have had difficulty obtaining credit from overseas. The result has been a minor credit crunch in Brazil.

The volatility in Brazil's currency market has forced the Central Bank to intervene to stabilize the situation. The U.S. Federal Reserve set up a swap facility so that several emerging market central banks (including that of Brazil) could fund currency market operations without a sizable loss of currency reserves.

In the coming year, it is likely that Brazil's central bank will focus more on reviving the financial markets and offsetting poor economic growth rather than worrying about the inflationary effects of a weaker currency. Actually, the weaker currency will be good for non-commodity exports once the global economy starts to recover. Although a weaker currency is often inflationary, other factors are likely to prevail. These include weak credit market conditions, weak overseas demand, and lower commodity prices. The end result is that inflation is likely to abate in the coming year. For Brazil, although the risk of inflation seems to have abated, the risk of recession has increased. While a recession in the coming year is unlikely, the economy will experience GDP growth roughly half of what it was in 2008. In particular, there will be a slowdown in growth of exports and business investment.

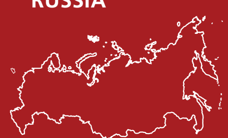
# Russia

Dr. Sunil Rongala

After severe economic problems in 1998, Russia clawed its way back into the black; the growth was largely funded by high crude oil prices. As a result, Russia became the darling of international investors. Now that the price of crude is down to sub-$50 levels, fissures seem to be appearing on a once rock-solid economy. The World Bank had this to say about Russia:

> "After a decade of high growth, the Russian economy is experiencing a slowdown in the wake of the global financial crisis. While Russia's strong short-term macroeconomic fundamentals make it better prepared than many emerging economies to deal with the crisis, its underlying structural weaknesses and high dependence on the price of a single commodity make its impact more pronounced than otherwise."

RUSSIA





GDP grew at 6.2 percent in the third-quarter compared to 7.5 percent in the previous quarter and 8.5 percent in the first quarter. Slower growth in the manufacturing, construction, wholesale and retail, transport and financial sectors was responsible for the economic slowdown. Industrial production fell by 8.7 percent in November. Industrial production in September grew at an anemic 1.7 percent. Retail sales in October were reasonably healthy at 12.3 percent, but it was down from the 15.08 percent average growth recorded in the previous nine months. Exports in October were $38.42 billion compared to 43.55 billion in the month before and $47.39 billion in July because Russia's main export blend of crude, the Urals Crude, has fallen by almost 70 percent between July and December 2008.

There has been significant capital flight from Russia. The total capital outflow between August and early December was an estimated $211 billion; many blame the Georgia war, the collapse of commodities and the freezing of global credit markets. The outflows were also caused by foreign institutional investors exiting the stock market. Between mid May 2008 and early December 2008, the benchmark MICEX index fell by almost 69 percent. As a result of this capital outflow, the ruble has depreciated 20 percent against the U.S. dollar between July 2008 and December 2008. The ruble would have certainly depreciated more had it not been for the Bank of Russia (BOR), Russia's central bank, stepping in to "lean against the wind." Foreign reserves have fallen 25 percent between August and December ($598.1 billion on August 8 to $475.4 billion) and a good part of it has been used to defend the ruble. Exacerbating the problem are ordinary Russians who withdrew six percent of their savings from their accounts in October while foreign currency deposits increased by 11 percent.

Inflation levels are running at uncomfortably high levels — November's headline inflation came in at 13.8 percent — but this is slightly less than the 14.2 percent number recorded in October and 15 percent in September. Worryingly, core inflation is on an upward trend. November's number came in at 12.7 percent compared to 11.5 in October and 1.1 percent in January 2006. As a result, the BOR has been aggressively raising its benchmark interest rate, and the refinancing rate increased from 10.75 in July to 13 percent in December. Another reason for raising rates is to stem the depreciation of the currency.

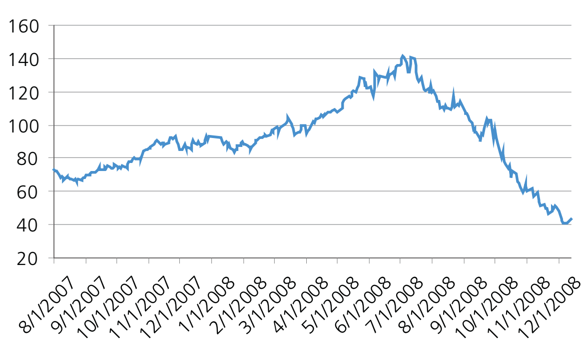
The near-term outlook for Russia is not bright. Consensus forecasts indicate a slowdown in the coming quarters. Deputy economy minister Andrei Klepach, asserted on December 12 that Russia is already in a recession. He said, "The recession has already begun and, I'm afraid, it won't end in two quarters." However, fears of recession may be a bit premature. Klepach went on to say that the economy would grow less than the forecast of 6.8 percent in 2008 (GDP grew by 8.1 percent in 2007) and industrial growth will be 1.9 percent in 2008. As for 2009, the Economist Intelligence Unit forecasts growth to be three percent in 2009 while the European Bank for Reconstruction and Development forecasts growth to be three percent in 2009 if Brent crude averages $75 — an unlikely prospect according to some analysts.

There is a good chance that the Russian government may have to run a budget deficit in 2009 if oil prices remain low because the Russian budget assumes the oil price to be around $70 a barrel. The government may find it tough to raise funds after Standard & Poor (S&P) cut Russia's long-term sovereign credit rating to BBB, the second-lowest investment grade, from BBB+ because of the rapid depletion of foreign reserves. Along with the ratings cut, S&P expects the economy to decline "sharply" in 2009. Though Russian bonds are still investment grade, it has been reported that they are being traded like they are junk bonds. This is not good news. The high credit default swap (CDS) spread also indicates bad news. As of December 11, the CDS spread for five-year Russian sovereign debt denominated in U.S. dollars was 738 though it was down from the 1100 plus spread in September. A spread of 738 for five-year Russian debt indicates that default insurance for $10 million would cost $738,000.

The currency is likely to depreciate from current levels, and the BOR seems to acknowledge that. On December 11, the ruble, which tracks a currency basket consisting of the U.S. dollar (55 percent) and the euro (45 percent), was allowed to decline against a target exchange rate to 7.7 percent from 6.7 percent. On December 15, the BOR widened the band against the target exchange rate without specifying the amount. This was the sixth such move in a month's time. Currency forwards also seem to indicate a depreciation of the ruble. As of December 12, the six-month forward for the ruble against the U.S. dollar stood at 32.11. The central bank is unlikely to waste more reserves in a losing battle to defend the currency because it is thought the ruble may be over-valued at 27–28 levels. A problem with having an overvalued currency is that they are targets for speculative attacks. The government has pledged $200 billion in tax cuts, loans, and other measures in a bid to boost the economy. However, liquidity injections into banks have been limited to the big ones. The inter-bank lending market is very weak. It will probably remain so in the near-term, and this could affect the banking sector quite badly. As part of the tax cuts, the government has announced that they will cut the corporate tax rate by four percentage points to 20 percent in January 2009. Russia may also cut the crude oil export duty from $192.10 to around $117.

Inflation will probably continue to be a problem for Russia. Consensus forecasts suggest that inflation will be over 10 percent in the next year. This high inflation could lead to further downward pressure on the ruble. A weaker currency combined with low oil prices could result in a Russian current account deficit. Because of the high inflation risk and currency depreciation, BOR is likely to keep interest rates at current levels, but it will likely increase if the capital flight situation worsens. The good news, however, is that this crisis is unlikely to even remotely resemble the 1998 financial crisis.

**Figure 1: Urals Crude ($ per barrel)**




Source: Bloomberg



# Middle East: Still Dependent on Oil

Dr. Ira Kalish

In the 1970s when the price of oil was high, the oil exporting economies of the Middle East grew rapidly. Yet they spent much of their largesse on consumption and, consequently, when the price of oil fell, they experienced a sizable drop in living standards. In the past few years when oil prices reached historically high levels, these same economies grew rapidly again. Yet this time, rather than simply expand consumption, they also increased their level of investment, particularly investments in non-oil industries. As such, investment spending accounted for roughly half of the economic growth of the region and enabled the creation of a more diverse economy. Such industries as tourism, agriculture, financial services, and trade expanded rapidly.

Despite the diversification, the Middle Eastern economy remains highly dependent on the price of oil. As of this writing, the price of oil is down nearly two-thirds since mid 2008. The result will be much slower economic growth for the oil exporting economies of the region in 2009. How much lower will depend on where the price of oil settles — something clearly difficult to forecast. For non-oil exporting economies such as Jordan, Morocco, and Lebanon, the lower price of oil will remove an obstacle to growth (high import bills) while adding a new obstacle (lower remittances from workers in the Gulf).

MIDDLE EAST



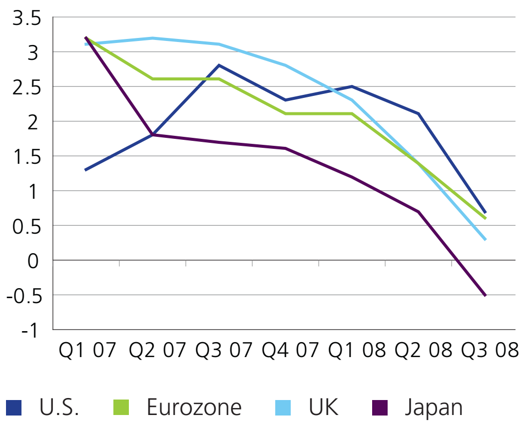
Now that the price of oil has come down, the oil exporting countries are experiencing declining current account surpluses, reduced availability of funds for internal investment, and slower accumulation of foreign currency assets. Still, vast assets remain, a fact that will help to temper the impact of lower oil prices. In addition, these assets will enable the region to stave off the impact on financing from the global credit crunch. Yet the rapid accumulation of financial assets in the past few years did encourage businesses in the region to borrow heavily. Today, given global conditions, regional banks are acting more cautiously leading to slower growth of credit.

On the other hand, the global slowdown and credit crunch will have a serious negative effect on non-oil related industries in the region, especially tourism. In addition, the slowdown in oil revenue and investments in non-oil industries is already reducing the demand for migrant workers. Such workers account for the majority of the population in the U.A.E., for example. Thus, expect to see large numbers of such migrants return home to places like Pakistan, the Philippines, and Egypt. The slowdown in remittance income for these countries will be onerous.

One interesting effect of the decline in the price of oil is on inflation and currency movements. While the price of oil was high, Gulf countries accumulated vast surpluses which placed upward pressure on their currencies. For a variety of reasons, these countries mostly chose to maintain a fixed exchange rate against the dollar (the exception is Kuwait). To do this, they purchased dollars, printed money, and created serious inflation. Now that the surpluses are declining, there is less necessity to intervene in currency markets and, consequently, inflation is likely to abate.

Finally, a word about Dubai is warranted. This city-state within the U.A.E. has attracted the world's attention with astounding investments in property and leisure. While the world shrugs its shoulders and accepts this as the result of oil revenue, the reality is different. Dubai has little oil. Instead, its lavish growth has been funded by borrowing. Yet now, property prices in Dubai are falling and the mortgage market is stalled. This is creating problems for local banks. The government has intervened with increased liquidity and capital injections for the banks. Yet the outlook remains uncertain. It is not clear the degree to which Dubai's problems are the result of a global slowdown or the end product of a property bubble. Perhaps the answer is both.

**GDP Growth Rates (YoY %)**




Source: Bloomberg

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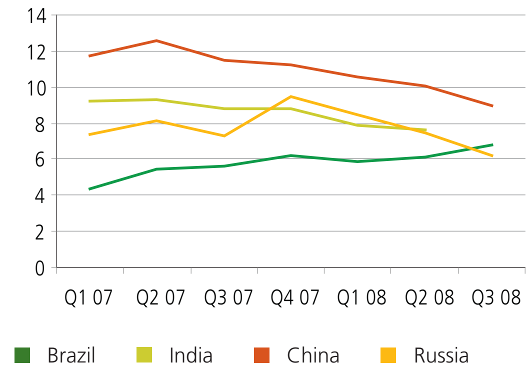
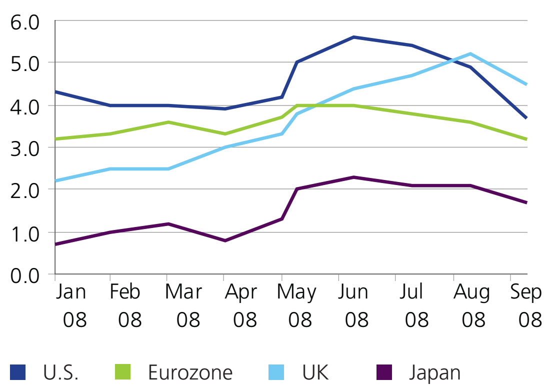


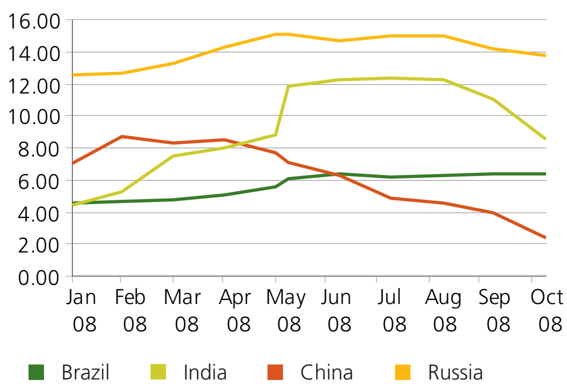

Source: Bloomberg

**Inflation Rates (YoY %)**



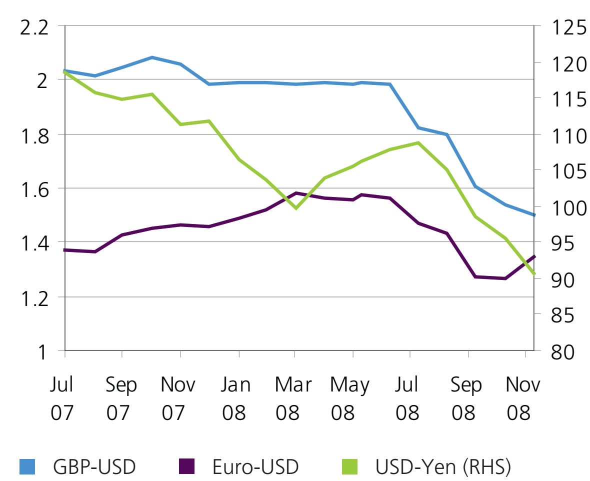

Source: Bloomberg

**Inflation Rates (YoY %)**



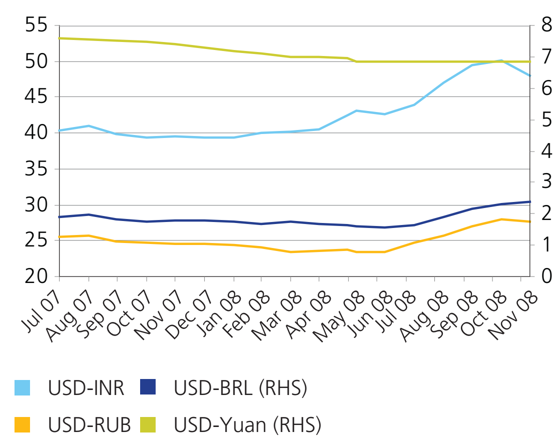

Source: Bloomberg

**Major Currencies vs. the U.S. Dollar (as of December 15, 2008 - YoY %)**




Source: Bloomberg

**Major Currencies vs. the U.S. Dollar (as of December 15, 2008 - YoY %)**




Source: Bloomberg

**Yield Curves (as of December 15, 2008)**

| | U.S. Treasury Bonds & Notes | UK Gifts | Eurozone Sovereign Benchmark | Japan Sovereign |
|---|---|---|---|---|
| 3 Months | 0.02 | 0.52 | 1.76 | 0.47 |
| 1 Year | 0.48 | 1.00 | 2.12 | 0.51 |
| 5 Years | 1.52 | 3.14 | 2.98 | 0.86 |
| 10 Years | 2.57 | 3.75 | 3.46 | 1.38 |

Source: Bloomberg

**Yield Curves (as of December 15, 2008)**

| | Brazil Govt. Benchmark | China Sovereign | India Govt. Actives | Russia Sovereign |
|---|---|---|---|---|
| 3 Months | 14.94 | 1.23 | 5.47 | 10.73 |
| 1 Year | 13.12 | 1.33 | 5.33 | 11.26 |
| 5 Years | 15.01 | 1.94 | 6.18 | 10.51 |
| 10 Years | 15.37 (8 years) | 2.90 | 6.16 | 9.78 |

Source: Bloomberg



**Composite Currency Forecasts (as of December 15, 2008)**

| | Q1 09 | Q2 09 | Q3 09 | Q4 09 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| GBP-USD | 1.45 | 1.47 | 1.5 | 1.52 | 1.58 | 1.74 | 1.8 | 1.79 |
| Euro-USD | 1.23 | 1.22 | 1.23 | 1.25 | 1.28 | 1.28 | 1.3 | 1.28 |
| USD-Yen | 94 | 95 | 100 | 100 | 108 | 108 | 96 | 95 |
| USD-Brazilian Real | 2.4 | 2.35 | 2.29 | 2.25 | 2.28 | NA | NA | NA |
| USD-Chinese Yuan | 6.83 | 6.82 | 6.8 | 6.75 | 6.6 | 6.32 | NA | NA |
| USD-Indian Rupee | 49.5 | 49.25 | 48.75 | 48 | 46.3 | 44.85 | NA | NA |
| USD-Russian Ruble | 29.61 | 30.6 | 31.31 | 31.1 | 30.22 | NA | NA | NA |

Source: Bloomberg

**GDP Forecasts**

| | U.S. | UK | Eurozone | Japan | Brazil | China | India | Russia |
|---|---|---|---|---|---|---|---|---|
| 2008 | 1.3 | 0.8 | 1 | 0.3 | 5.2 | 9.85 | 6.8 | 4.2 |
| 2009 | -0.8 | -1.05 | -0.35 | -0.45 | 2.9 | 8.25 | 5.5 | 2.95 |

Source: Bloomberg, Citigroup
Note: India's financial year is April-March

**OECD Composite Leading Indicators**

| | U.S. | UK | Euro Area | Japan | Brazil | China | India | Russian Federation |
|---|---|---|---|---|---|---|---|---|
| January-08 | 99.33 | 99.82 | 98.12 | 96.77 | 105.80 | 102.26 | 103.49 | 101.06 |
| February-08 | 99.02 | 99.71 | 97.66 | 96.48 | 104.98 | 102.38 | 102.44 | 101.11 |
| March-08 | 98.38 | 98.96 | 97.09 | 95.91 | 103.60 | 102.72 | 101.95 | 100.60 |
| April-08 | 98.25 | 98.55 | 96.58 | 95.76 | 103.71 | 103.73 | 101.34 | 101.71 |
| May-08 | 98.21 | 98.04 | 95.91 | 96.02 | 104.15 | 104.69 | 100.25 | 102.51 |
| June-08 | 98.10 | 97.19 | 95.13 | 95.84 | 106.23 | 103.93 | 98.74 | 104.30 |
| July-08 | 97.85 | 96.28 | 93.97 | 95.37 | 107.58 | 102.67 | 97.69 | 101.06 |
| August-08 | 96.52 | 97.75 | 97.09 | 96.90 | 104.07 | 96.79 | 96.96 | 99.09 |
| September-08 | 95.43 | 96.85 | 96.19 | 96.10 | 103.93 | 95.11 | 95.89 | 96.39 |
| October-08 | 94.18 | 95.97 | 95.26 | 95.17 | 103.64 | 93.38 | 94.79 | 92.43 |

Source: OECD
Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100.

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