

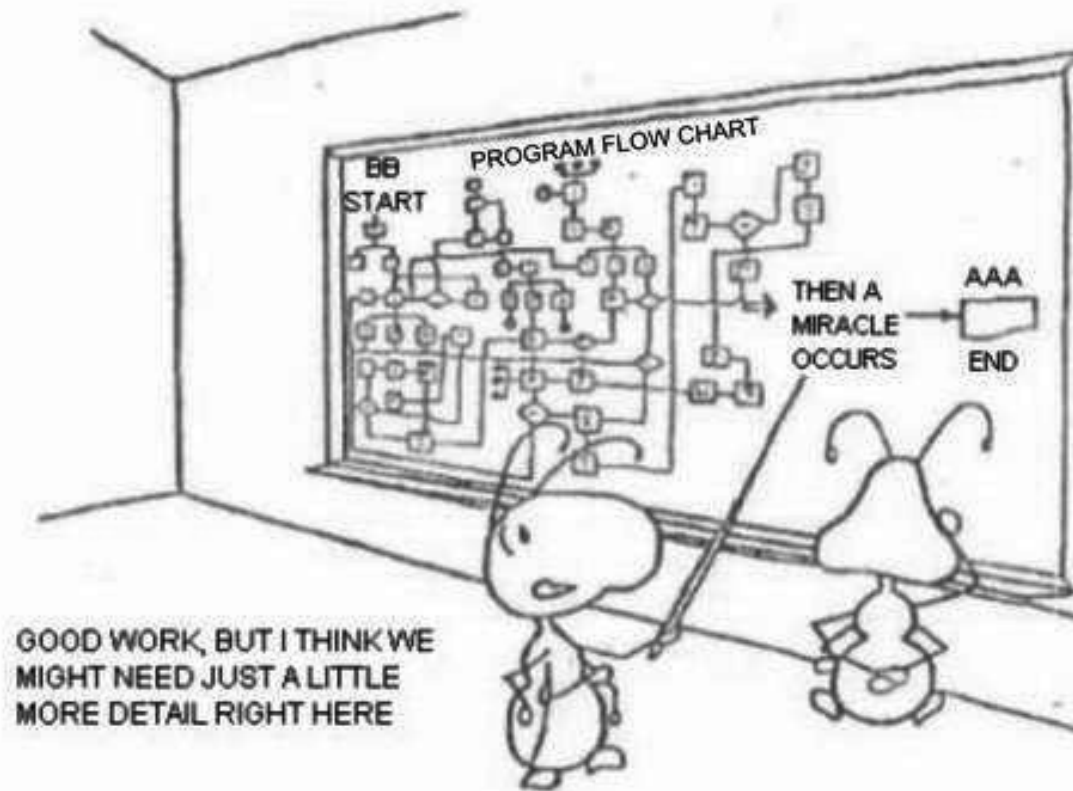
Desperately seeking stability

Charting a course
for the global
economy

Robin Bew
Editorial Director
March 2011



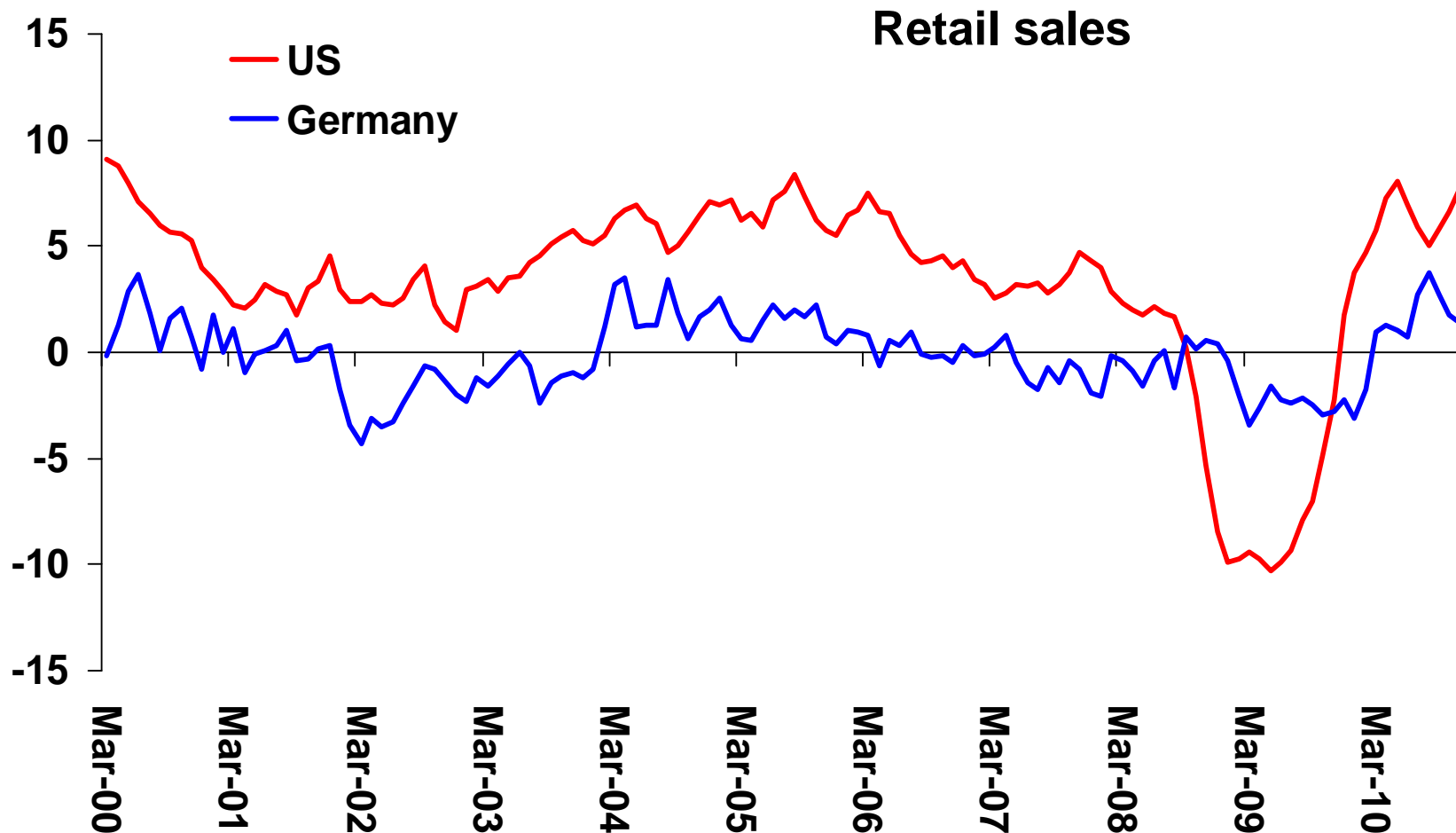
THE RATING PROCESS. ????



Where's the growth?

How the world is recovering

Rich-world consumers are showing signs of life...



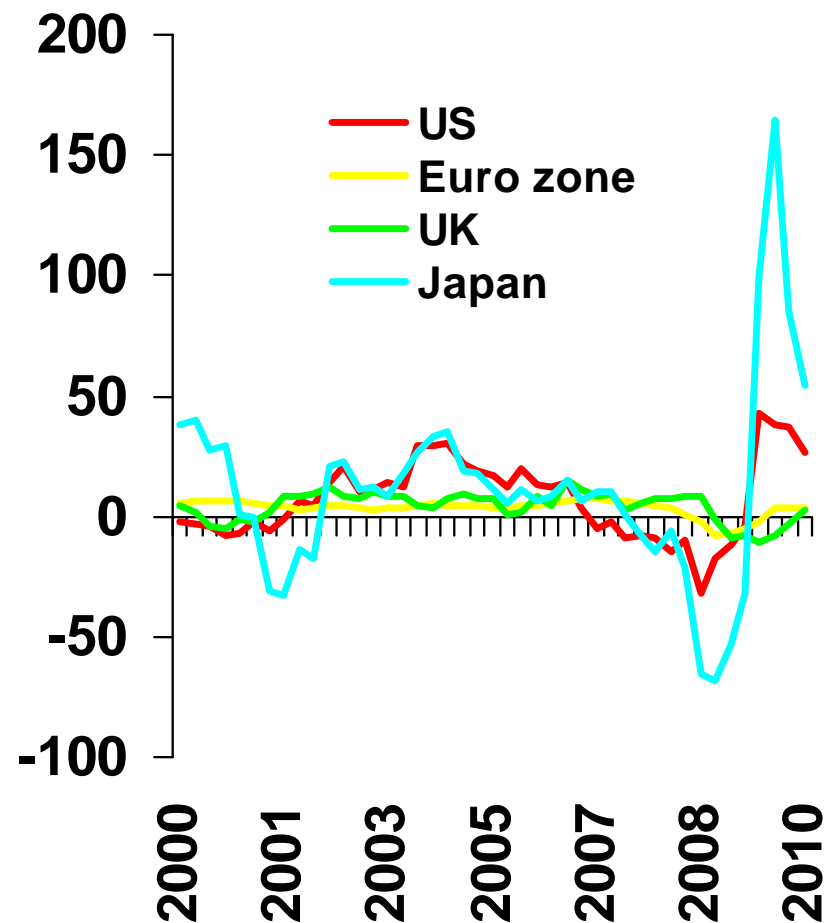
Retail sales: % change year on year; 3-month moving average.
Source: National governments; Haver

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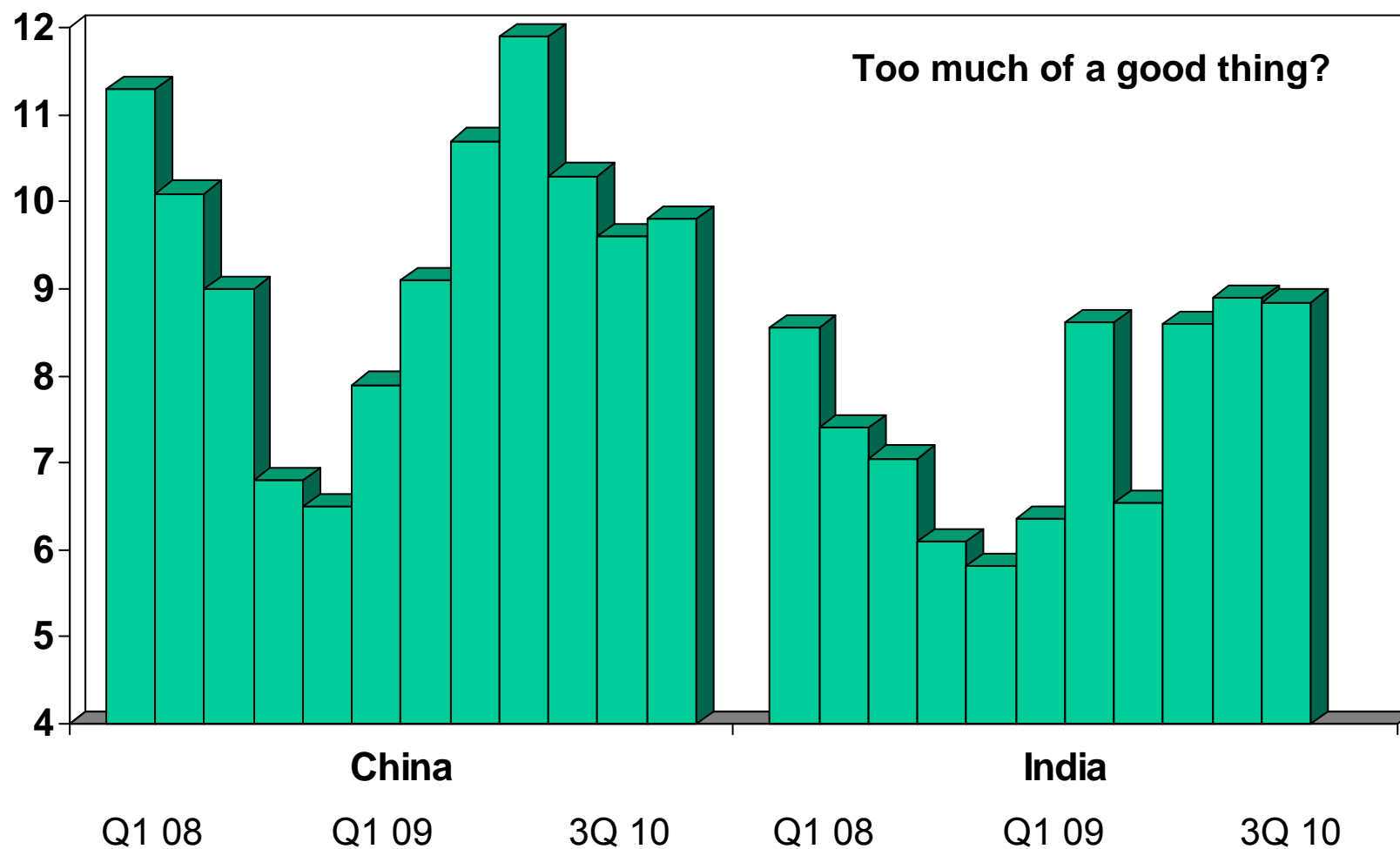
...as the corporate sector rebounds

- Banks and companies look in much better health
 - Banks have rebuilt balance sheets
 - Often via bailouts
 - ▶ In UK, Germany, US
 - ▶ Not Ireland, Portugal, Spain!!
 - Companies were generally more prudent in boom
 - Key difference from Japan
- Profits have rebounded
 - Have money to invest
 - But where?
 - ▶ Demand in the rich countries will be sluggish for some years



% change in corporate and bank profits.
National sources.

Growth bounces back impressively in China, India



Real GDP growth, % change year on year. Source: National governments, Haver

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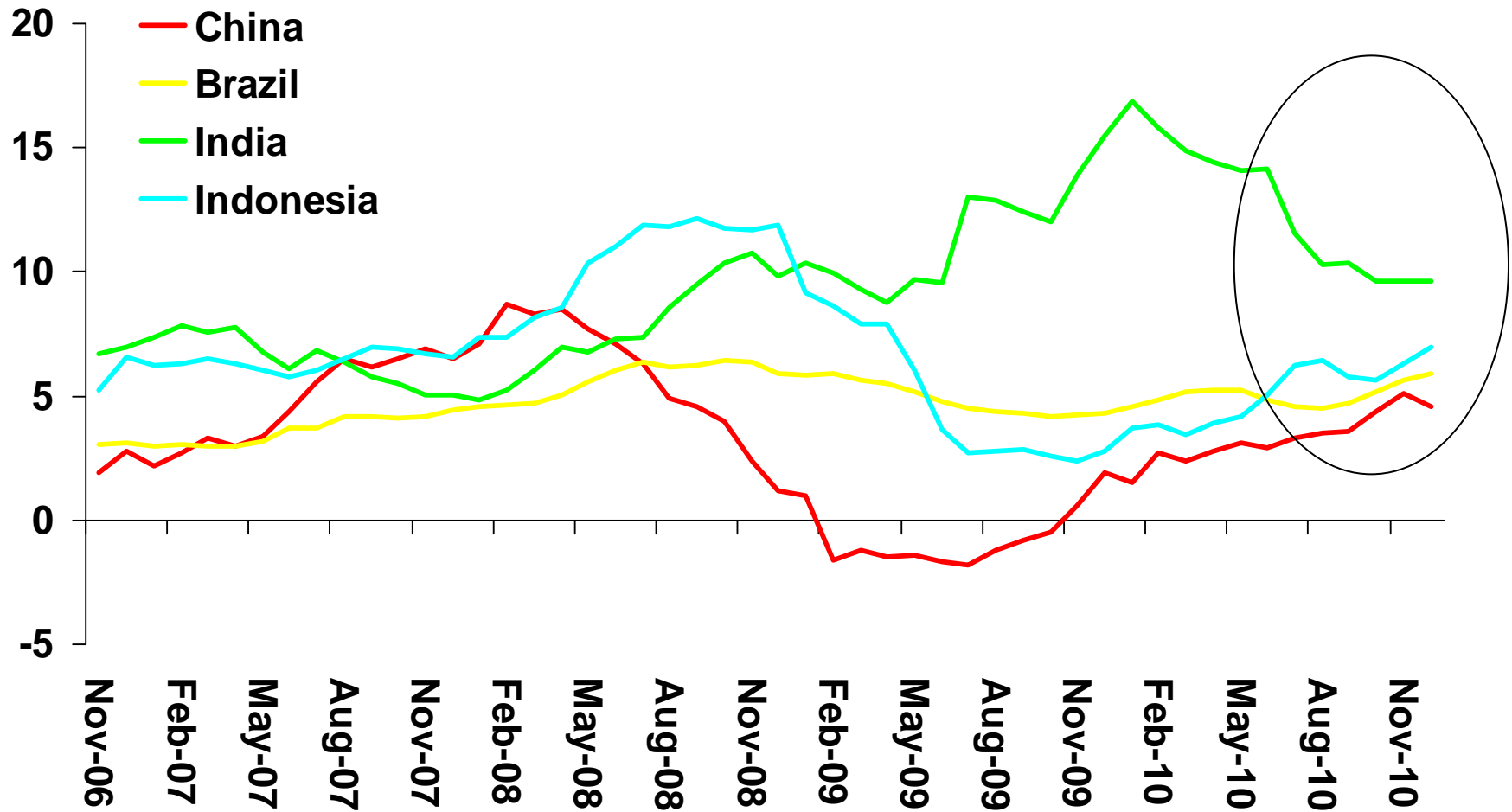
**So there's nothing to worry
about, right?**

WRONG



Worry 1: Inflation

Inflation is accelerating in emerging markets ...



Consumer prices indices; % change, Y o Y. Source: Haver, Bloomberg

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... posing a dilemma for central bankers

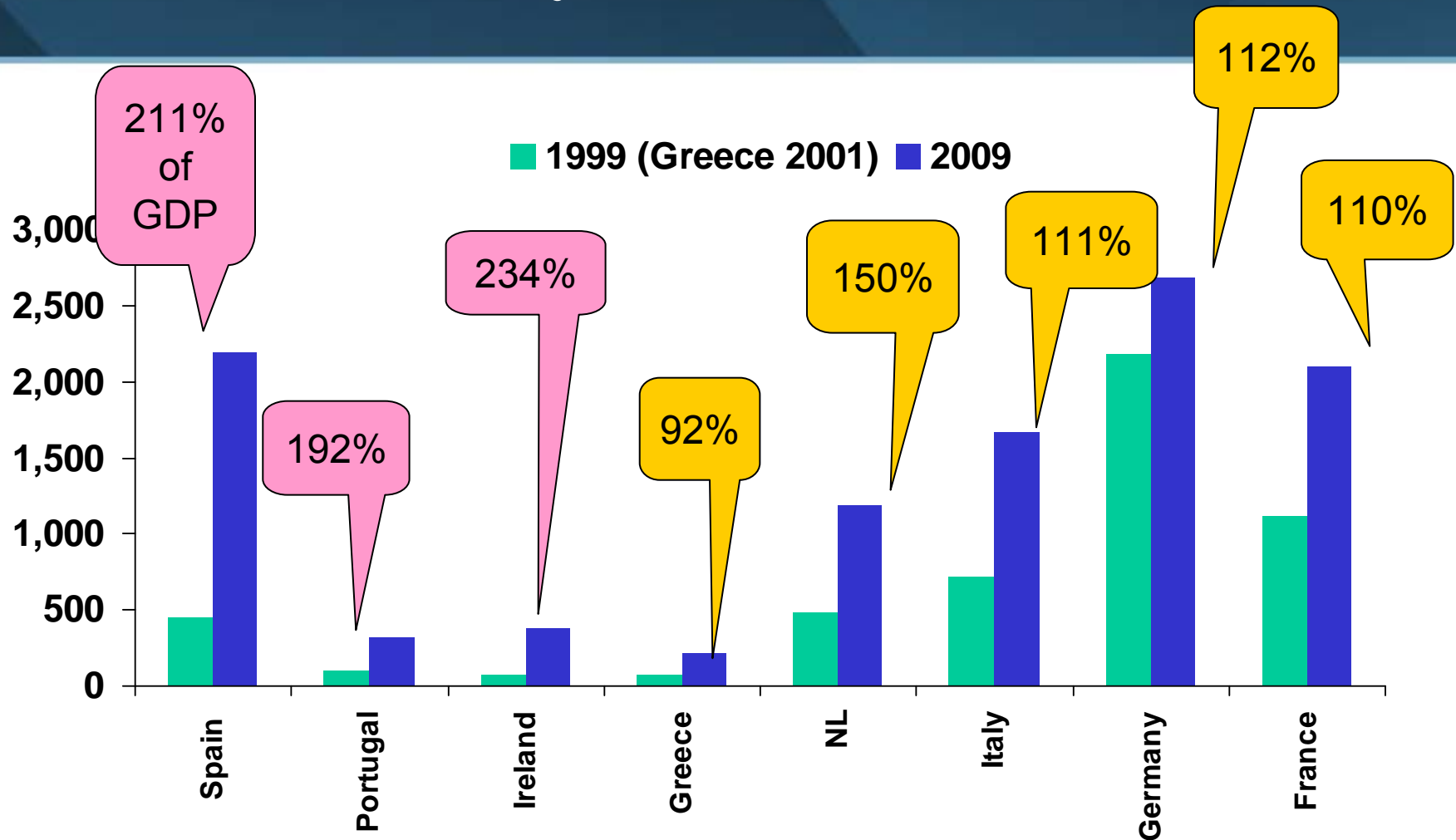
- Much of the rise in inflation is coming from higher food prices
 - But it's more than that
 - Wider capacity constraints are evident as emerging markets soar
- Higher prices feed into higher wage demands
 - Correlation strong in China; risks upward cycle
- Emerging market central banks face a dilemma
 - Need to tighten monetary policy to cool demand, restrain prices
 - But higher interest rates attract more foreign capital
 - Pushes up exchange rate, erodes export competitiveness





Worry 2: Insolvency

The Euro zone solvency crisis will continue...



Bank claims on private sector, € bn. (UK bank lending at 213% of GDP in 2009, £3trn.)

Sources: IMF, *International Financial Statistics*; EIU, CountryData.

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...as financial problems loom large...

Financial fragility

- Crisis was about banks and private sector
 - Big lenders, big borrowers, big bankruptcies
- Governments have (rightly) stepped in
 - Huge bailouts, public spending, tax cuts
- But substantial balance-sheet stresses remain
 - For household sector
 - Need to save, not spend
 - For public sector
 - Governments can go bust too
- Will hold growth back for a long time
 - And could do a lot worse than that



...meaning euro collapse is a real (albeit small) possibility

- Wipe-out of exiting country's banking sector, households default on euro debt
- Collateral damage to foreign banks, particularly in the euro zone, and companies and households
- Contagion—markets pick off weaker countries following exit, triggering further turmoil
- Euro collapse would trigger depression for the euro zone?
- Leaving the euro would be a political decision, not an economic one

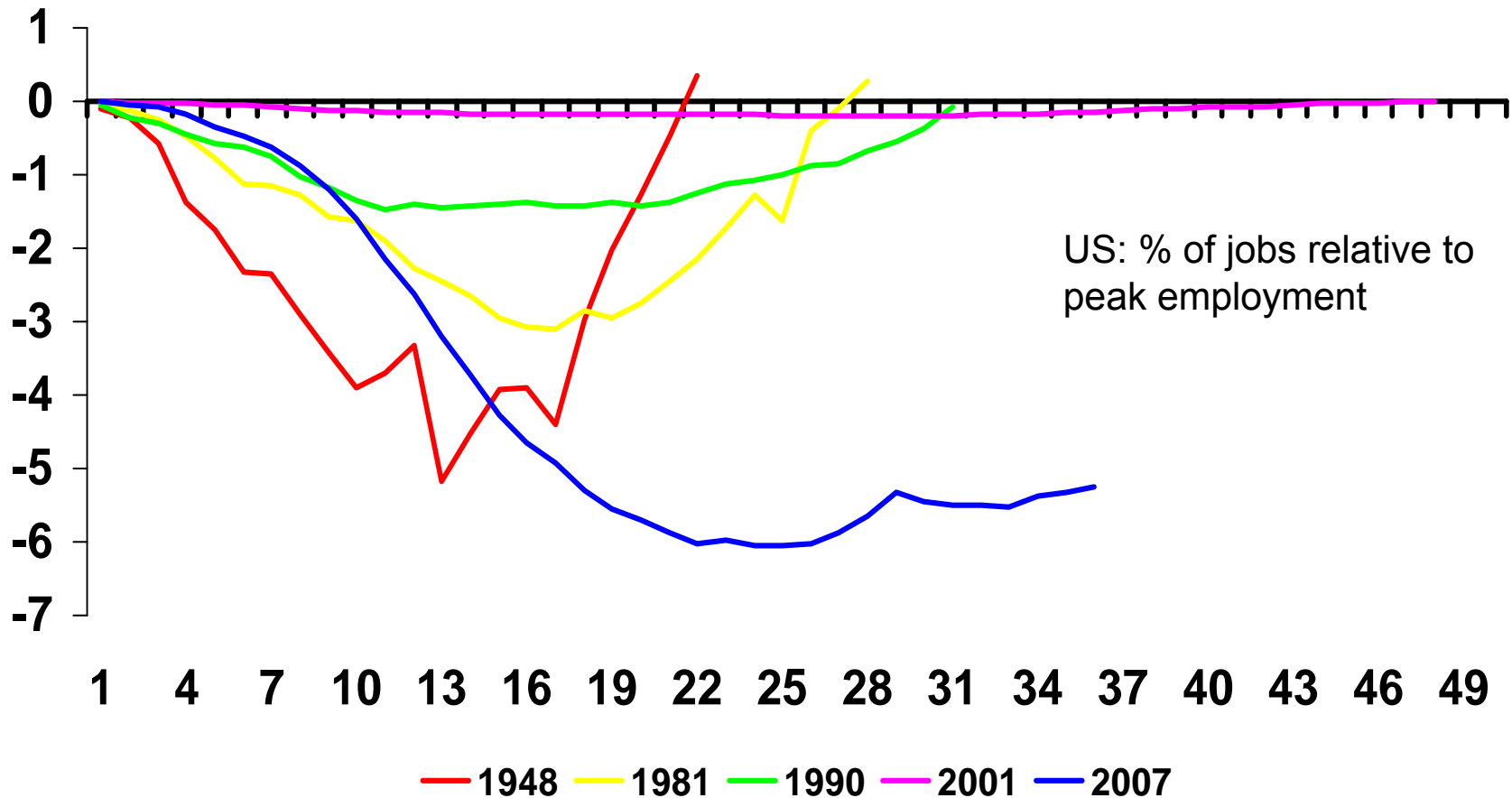




Worry 3:

Idleness

A US recovery? So where are the jobs?



Months from peak employment. Sources: Bureau of Labour Statistics; EIU.

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Worry 4:

Instability

Political tensions are rising—and it's no surprise

“The decades-long global trend in democratisation has come to a halt. Democracy is in retreat. The dominant pattern in all regions over the past two years has been backsliding on previously attained progress.”

Democracy index 2010

“Democracy in retreat,” EIU



Egypt ranks 138 out of 167 countries in the Economist Intelligence Unit's "Democracy Index" for 2010. Its score, on a scale of 1 to 10, fell to 3.07 last year from 3.89 in 2008, among the largest declines of any country.



So what lies ahead?

What to expect in the next two years

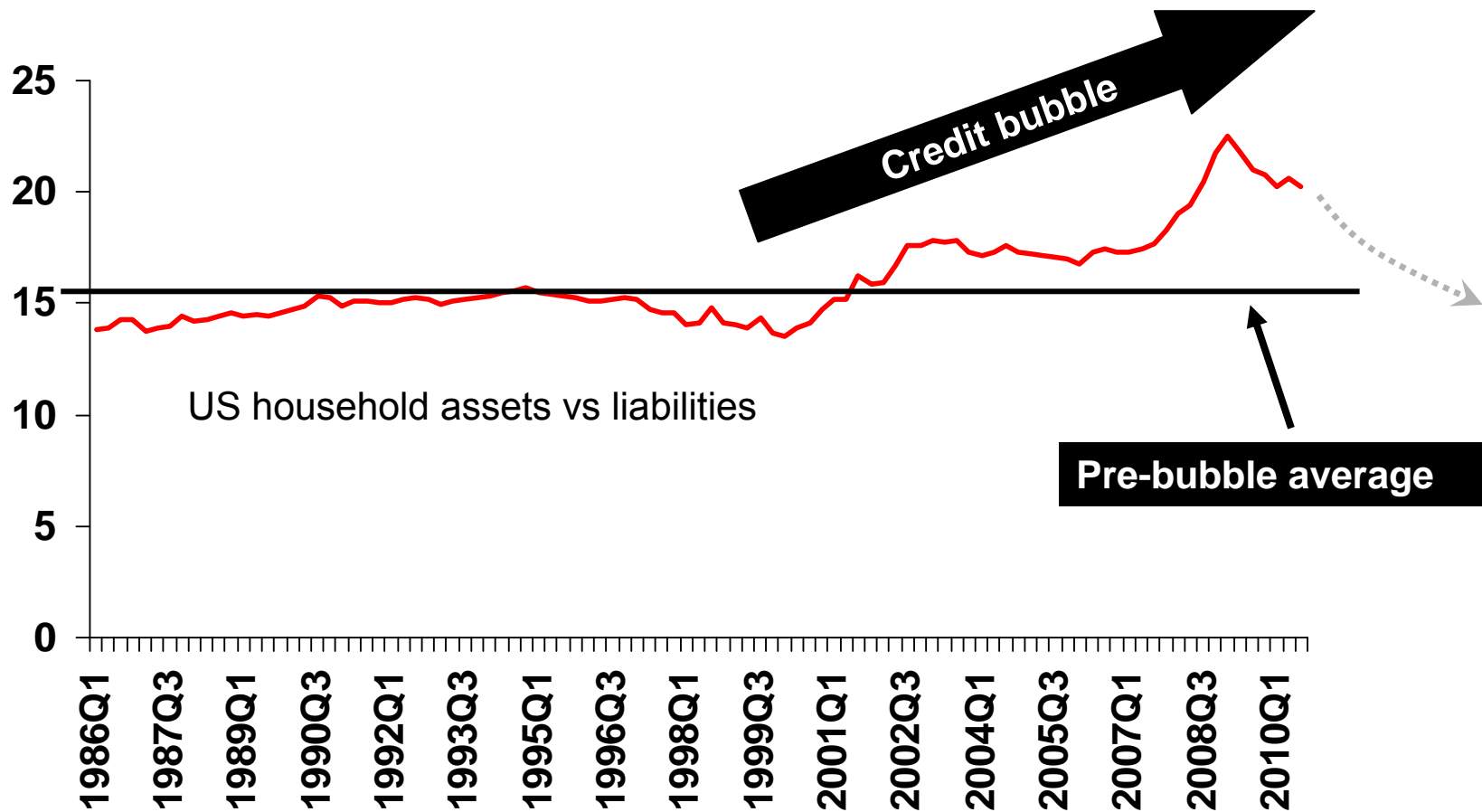
- A weaker west
- More and less Europe
- Emerging nations come off the boil
- Political instability becomes the norm

Austerity bites....

- Fiscal stimulus turns to austerity
 - Already happening in Europe
 - Greece, Ireland, Portugal, UK taking severe measures
 - More limited measures elsewhere
 - Necessity in the US by 2012
 - Happening at the State level now
- Monetary policy can't compensate
 - QE helps support bond markets
 - Allows weak governments to borrow
 - Not clear that it's having a broader economic impact
 - ▶ Credit growth sluggish
 - Credibility issues



...and household debt reduction has hardly started



More and less Europe

- More Europe
 - What happened to “no bailout”?
 - Now a push for euro zone economic government
 - Debt breaks?
 - Punishments?
 - Harmonisation of pensions ages etc?
 - A Eurobond??
- Less Europe
 - Pain in the periphery is awful
 - Exit is not in anyone’s interest today
 - But that may change

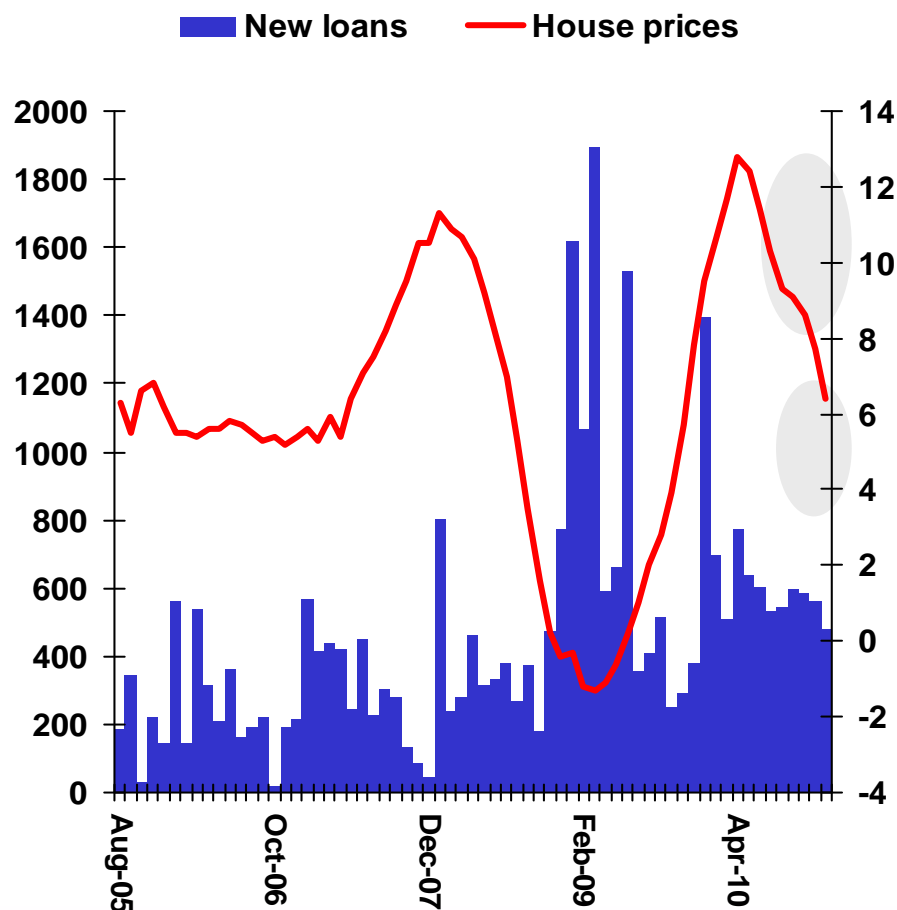


Schiller’s Ode to Joy (sung at the euro’s launch)

*Oh friends, no more of these sad tones!
Let us rather raise our voices together
In more pleasant and joyful tones.
Joy!*

Emerging nations come off the boil

China puts on the brakes!



Why worry?

- Inflation causing social ills
- Inflationary asset price bubble
 - US-style property crisis
 - Government-inspired crash
- Poor allocation of capital

Governments have reacted

- Capital controls
- Higher interest rates
- Reserve requirements
- Currency intervention

What sort of slowdown?

- Hard landing possible but unlikely
- Still expected to outpace developed world by some margin

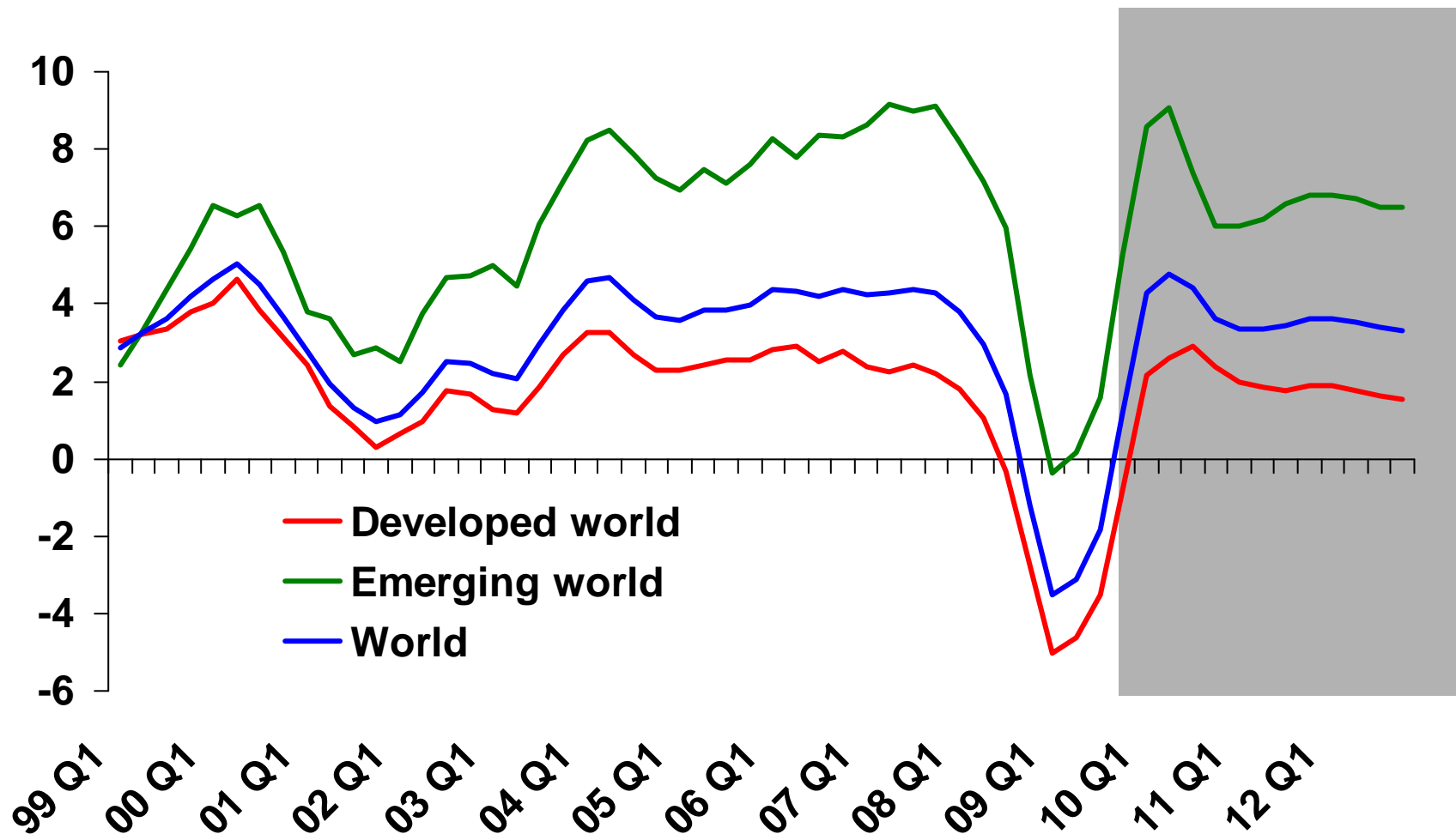
New loans, m RMB; House prices, % change YoY. Source China Economic Info Net, Natl Reform and Development Commission

Political instability

- Our latest democracy index shows “democracy in retreat”
 - Democratic freedoms eroded in 91 out of 167 countries we assess
 - Usually minor changes, but some more significant
 - Reaction to economic crisis?
 - Economic crisis can foment unrest
 - Backlash against economic hardship, austerity
 - ▶ Including inflation
 - Backlash against government clampdown
 - Can lead to democratic breakthrough or repression
 - But instability and disorder is always present

What does it mean for you?

Global outlook: Diverging trends



GDP growth, % year on year

Source: EIU estimates

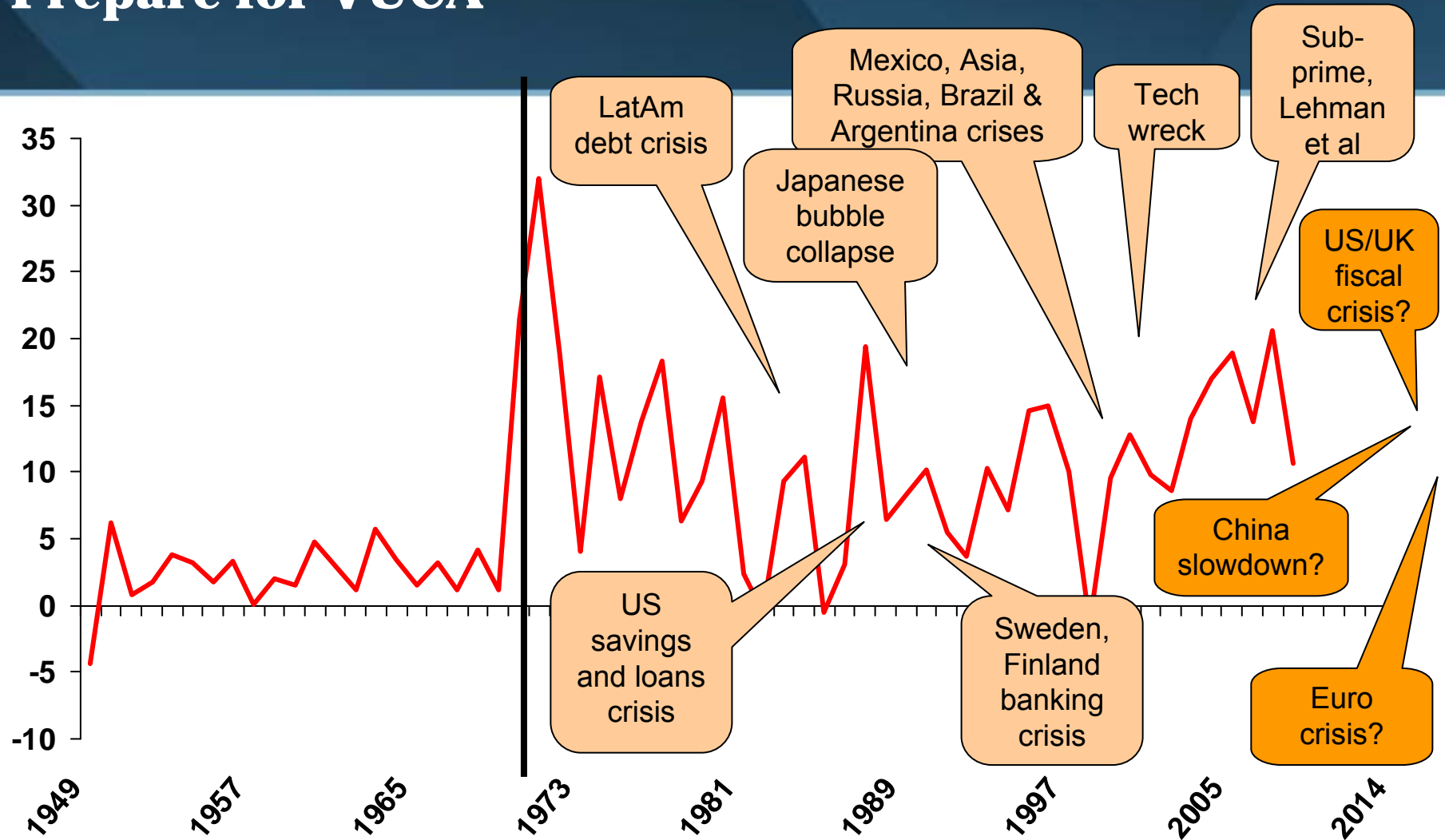
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Making sense of it all

- **Growth has resumed**
 - But centre of gravity is shifting
 - China / India are the true emerging giants
- **Cycles and structures**
 - Harsh economic cycle in the west
 - But aging, indebtedness are structural issues
 - Will hold back demand for a decade or more
- **Hyper-globalisation**
 - It's been good for us, but now it will be good for them
 - The rise of the emerging MNC
- **Who will win the battle of ideas?**
 - West vs East?
 - Young vs old?

Prepare for VUCA



Global foreign-exchange reserves. % change, year on year.
Source: IMF.