

1. The global economy

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Summary

- Global growth prospects are heavily influenced by the financial crisis in the Eurozone, with the UK especially sensitive to Eurozone developments due to close trade and financial links.
- Eurozone GDP is expected to contract in 2012 as financial strains spill over to the real economy. However, our baseline forecast assumes that the Eurozone stays in its current shape, in particular thanks to further intervention by the European Central Bank.
- Emerging market growth is expected to slow in 2012, limiting prospects for export-led growth in the rest of the world.
- Meanwhile, a moderate recovery is expected to continue in the US, assuming only a limited drag from tighter fiscal policy.
- World growth is forecast at 2.5% in 2012 and 3.5% in 2013 (at market exchange rates). Risks to this forecast are skewed to the downside, with an escalation of the Eurozone crisis and a China hard landing perceived to be key sources of risk. In particular, refinancing very large amounts of government debt in the Eurozone this year perhaps represents the largest single threat to global growth.

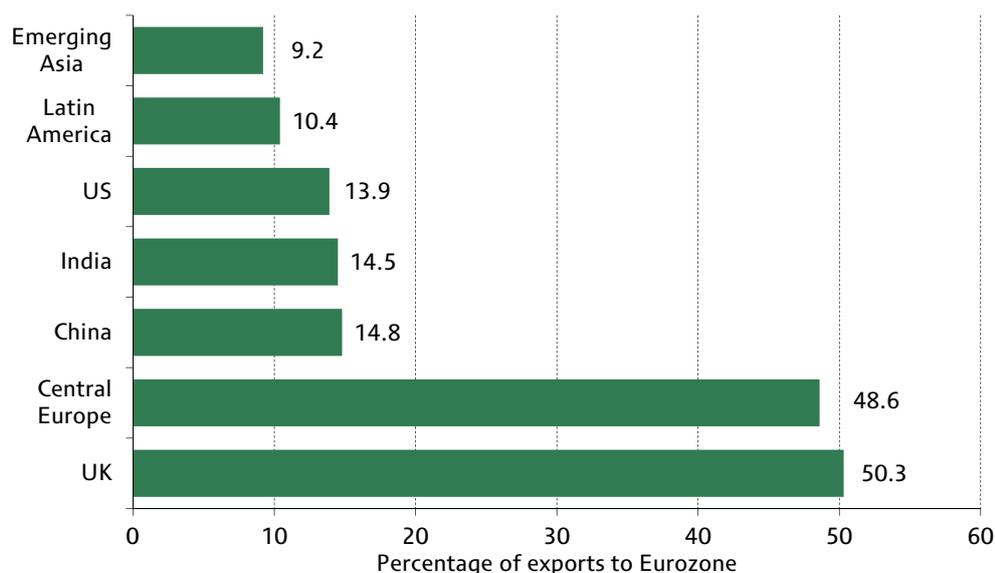
1.1 Introduction

Over the past twenty years, the UK economy has become particularly unbalanced, becoming overly reliant on domestic demand, and in particular consumer spending, to drive economic growth. However, the need for households to deleverage means that consumers no longer look as likely a source of growth as they were before. The sharp depreciation in the value of the pound in the aftermath of the financial crisis raised hopes that exports would fill the void left by the consumer, and the signs were promising in the early stages of the recovery.

However, the global economic outlook darkened in the final months of 2011, in large part due to the deteriorating financial and economic picture in the Eurozone. Economic prospects for 2012 will also be heavily influenced by developments in the Eurozone given its status as a large export market (see Figure 1.1), and the potential for the financial crisis there to generate significant financial shockwaves will affect all the major economies.

The UK is especially at risk from Eurozone developments given its close economic and financial links with the Eurozone. The Eurozone accounts for a large fraction of UK exports, and while UK banks' exposure to the sovereign debt of the troubled 'peripheral' Eurozone states such as Greece is modest, the indirect exposure of UK banks to the Eurozone via loans to the private sector and financial institutions is substantial.

Figure 1.1. Exposure to Eurozone



Source: Haver Analytics, Oxford Economics.

Our forecast for the global economy is set out in Section 1.2, while Section 1.3 describes the key risks to this forecast. Section 1.4 concludes.

1.2 Global outlook

Eurozone

The Eurozone financial crisis continued to intensify over the second half of 2011, despite a number of attempts by EU leaders to stem it. Investor concerns about Greece mounted through the year as Greece's economy continued to shrink rapidly, undermining attempts to rein in the budget deficit. Greece, Portugal and Ireland were all shut out of private bond markets and became dependent on official financial assistance. And most dangerously of all, the crisis spread to the bond markets of larger countries such as Spain and Italy, which between them have around €3 trillion of sovereign debt outstanding.

In October 2011, Eurozone leaders outlined generous new official financing deals for Greece, Ireland and Portugal and also proposed that Greece's private sector bondholders should agree a 'voluntary' 50% write-down of their debt holdings.¹ Plans were also announced to 'leverage up' the Eurozone's bailout fund, the European Financial Stability Facility (EFSF), to provide support for Spain and Italy. These announcements failed to restore market confidence, however, with investors doubtful that the debt relief granted to Greece was sufficient to restore long-term solvency and sceptical about the effectiveness of the new EFSF mechanism. Indeed, the EFSF struggled to raise relatively modest sums at an acceptable cost in the final months of 2011.²

¹ This was announced by José Manuel Durão Barroso, President of the European Commission, in a speech on 27 October 2011 (<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/714&format=HTML&aged=0&language=EN&quiLanguage=en>).

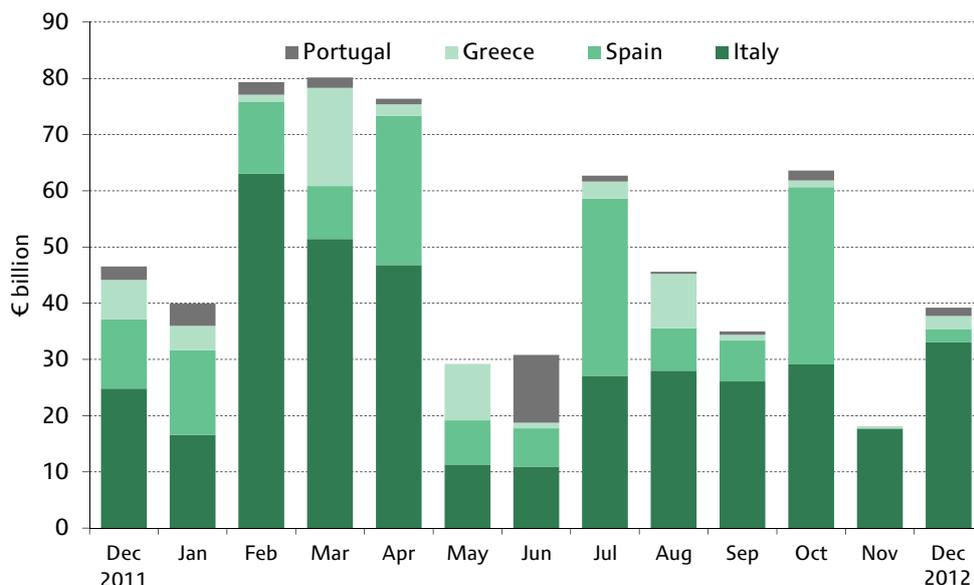
² For example, in early November, the EFSF was only able to sell a €3 billion 10-year bond in support of Ireland by using some of its own funds to cover the shortfall (<http://www.telegraph.co.uk/finance/financialcrisis/8886380/Eurozone-bail-out-fund-has-to-resort-to-buying-its-own-debt.html>).

As the crisis continued to worsen, EU leaders met again on 8–9 December 2011 with the aim of framing a ‘grand bargain’ to restore confidence. Once again, however, their proposals were insufficient to turn around market sentiment. The proposed ‘fiscal compact’ was not the fiscal union many observers were hoping for, and may well prove unworkable. And investors still see the Eurozone’s bailout fund as lacking sufficient firepower to form an effective ‘firewall’ against financial contagion.

As 2012 began, further difficulties arose. Talks between Greece and its creditors to hammer out the terms of the debt swap agreed in October 2011 ran into problems, with some participants arguing for deeper write-downs of debt holdings while creditors resisted this. With large bond maturities due in March, this raised the spectre of a disorderly default by Greece. Meanwhile, the capacity of the Eurozone bailout fund to shore up sovereign bond markets was further damaged by France and Austria losing their AAA credit rating with Standard & Poors, leading to a downgrade of the EFSF itself.

This latter development was especially worrying given the large upcoming debt maturities in Italy and Spain. These two countries need to refinance around €210 billion of government debt between February and April 2012 (see Figure 1.2), which will be very difficult unless market conditions improve substantially. The consequences of a failure to roll over this debt would be dramatic – in our view, this ‘rollover risk’ now poses the single most serious threat to global financial stability.

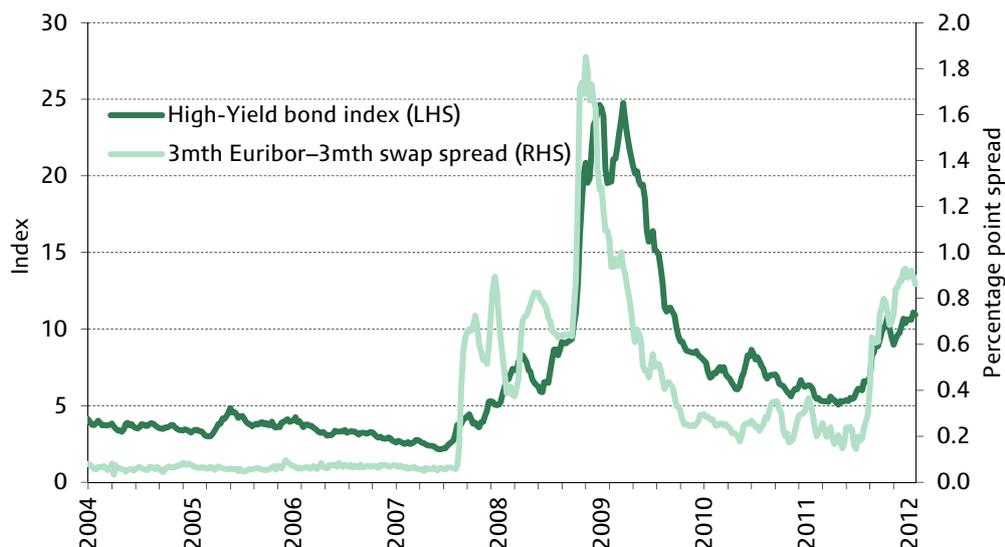
Figure 1.2. Eurozone maturing government debt



Source: Bloomberg.

The distress in sovereign bond markets in the Eurozone has also now spread to broader financial markets, with financial stress levels rising (Figure 1.3). Funding pressures have become acute for Eurozone banks, with many struggling to access unsecured markets at a reasonable cost and growing reliance for funding on European Central Bank (ECB) loans. In addition, in an ill-timed decision, banks are required to raise capital ratios by June 2012. Banks have begun to tighten credit conditions again in response to their own very tight funding environment, threatening damage to the real economy. In some of the ‘peripheral’ Eurozone countries, the situation is graver still, with accelerating outflows of bank deposits in recent months which threaten to undermine banking systems.

Figure 1.3. Eurozone risk spreads



Notes: The High-Yield bond index is compiled by Merrill Lynch and is a commonly-used benchmark index for high-yield corporate bonds. Euribor is short for Euro Interbank Offered Rate. The Euribor rates are based on the average interest rates at which a panel of more than 50 European banks borrow funds from one another. The spread of this rate over the Overnight Indexed Swap (OIS) rate is a good proxy for the degree of financial stress – higher spreads indicate elevated levels of stress.

Source: Haver Analytics, Merrill Lynch.

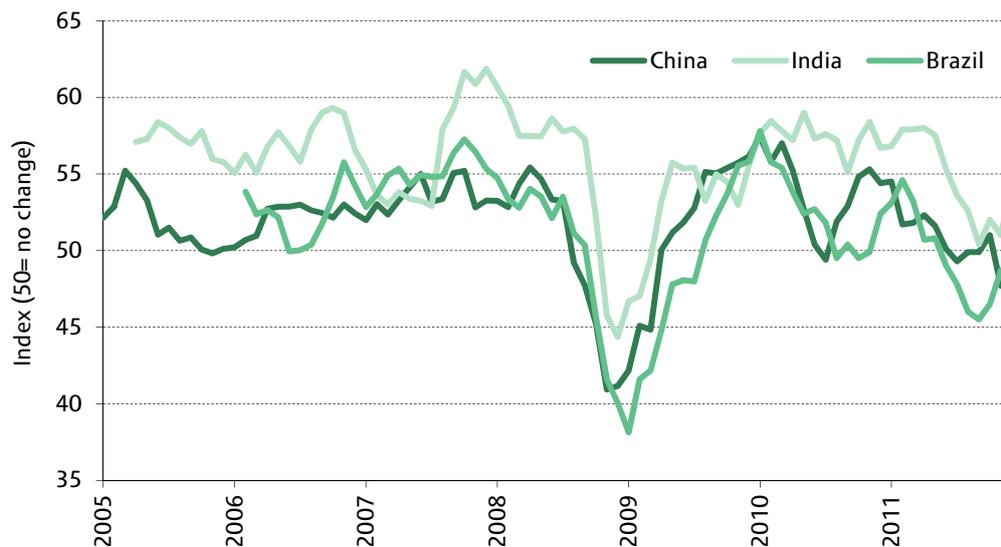
The financial crisis in the Eurozone has also spilled over into the real economy. Gross domestic product (GDP) growth across the whole of the Eurozone ground to a halt in the second half of 2011, even in the previously robust ‘core’ Eurozone economies such as Germany and France. Indicators such as the Purchasing Managers’ Index (PMI) surveys have pointed to contracting output for several months now, and we estimate that the Eurozone re-entered recession in 2011Q4, with a small decline in GDP forecast for 2012 as a whole. This represents a significant blow to UK export prospects in the short term, given that around 50% of UK exports go to the Eurozone.

Emerging economies

The prospects of exports buoying growth in Europe and elsewhere have also been set back by a weakening picture in the emerging markets. The PMI surveys for China were disappointing in the final months of 2011 (Figure 1.4), both in manufacturing and services. The latter development implies that economic weakness might be spreading from the export-dependent sectors to what has until now been a very robust domestic market. We forecast that Chinese GDP growth will slow to around 8% in 2012 from 9% in 2011 and over 10% in 2010.

Elsewhere in the emerging world, Q3 GDP data for Brazil showed zero growth and we now forecast GDP growth in 2012 at 3.1% only. India, meanwhile, has seen a sharp slowdown in industrial output and investment. The latter trend is especially worrying given the importance of investment in fuelling India’s economic ‘take-off’ in recent years. We expect Indian GDP growth at 6.5% in 2012, below 7% for the first time since 2002.

Figure 1.4. BRICs: manufacturing Purchasing Managers' Index



Notes: The Purchasing Managers' Index is an indicator produced by Markit Group by polling private sector companies. The chart shows results for activity in the manufacturing sector, with a reading above 50 indicating that activity is increasing.

Source: PMI / Markit / China NBS.

Though some progress has been made in recent years, the UK's record of exporting to these countries is poor, with only around 5% of exports going to the BRIC³ countries. Therefore, even though our forecasts for these countries remain considerably stronger than those for advanced economies, the UK is unlikely to derive significant benefit.

Japan

Japan suffered a difficult 2011 with natural disasters in March disrupting the energy sector and hitting growth hard for several months. In the third quarter of 2011, the country showed strong signs of recovery with GDP rising by 1.4%, but this rebound started to run out of steam in the final months of the year, with GDP likely to have contracted in 2011Q4 and fallen by around 1% in 2011 as a whole.

Prospects for 2012 also look subdued. The industrial sector is struggling with the effects of a strong currency – a side effect of global financial conditions which have created strong 'safe haven' flows into yen assets – and weakening export demand due to the global and regional economic slowdown. In addition, consumer demand is set to grow at a subdued pace given low growth in real household incomes. We forecast that this will lead to GDP growth being constrained to just 1.4% in 2012.

US

A brighter spot in the global economy at present is the US, where recent data releases have generally outperformed expectations. The Institute for Supply Management (ISM) surveys have continued to point to positive, if moderate, growth and the labour market improved in late 2011 with unemployment falling back and a healthier rate of employment growth in December. Consumer confidence also rebounded strongly in

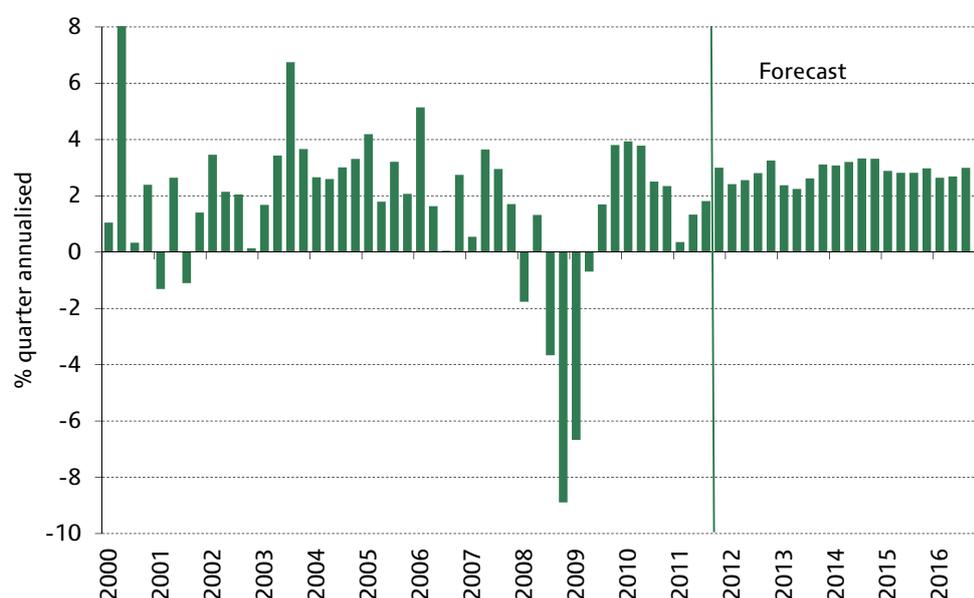
³ BRIC countries are Brazil, Russia, India and China.

November and December 2011, and there were some tentative signs of recovery in some housing indicators.

There is also some evidence that the Federal Reserve's loose monetary policy may be feeding through to the economy more effectively than that of other major central banks. Both the broad money supply and credit indicators are showing reasonable rates of growth and there are few signs as yet of the crisis in the Eurozone spilling over into a tightening in credit conditions in the US.

Many US indicators nevertheless remain at relatively low levels, including housing starts and home sales, consumer confidence and employment. Structural problems in the housing sector remain severe and will restrain recovery there, while an overhang of household debt will continue to hold back the consumer recovery. As a result, the current and forecast pace of the US recovery is modest. We estimate GDP grew by just 1.7% in 2011 and forecast growth of only 2.5% for 2012 (Figure 1.5).

Figure 1.5. US GDP growth



Source: Oxford Economics.

The US remains at risk from a further deterioration in global financial conditions. Some potential risk factors are already visible, including the rise in US dollar LIBOR⁴ in recent months. Another significant area of risk relates to US fiscal policy. This is set to be a drag on growth from 2012 but the scale of the drag is uncertain and dependent upon political factors such as whether the administration and Congress can agree on extending the payroll tax holiday and related measures and on a further rise in the debt ceiling.

The US remains a key export destination for the UK, second only to the Eurozone in terms of importance. But it also plays a key role in shaping global developments, as seen by the impact of the mid-2011 US slowdown on global growth and sentiment.

⁴ LIBOR stands for London Interbank Offered Rate.

Global outlook

As 2012 begins, the global economy is at a dangerous juncture. We forecast world GDP growth at 2.5% for this year (Table 1.1), rising to 3.5% in 2013 (at market exchange rates) but there are substantial downside risks to this forecast, especially those relating to the Eurozone financial crisis. Radical changes in policy look necessary to preserve the Eurozone, including a much-expanded effort by the ECB. Without this, non-Eurozone economies may have to consider major policy shifts themselves to ease the economic fallout.

Table 1.1. Summary of international forecasts

Real GDP	2010	2011	2012	2013	2014	2015
North America						
United States	3.0	1.7	2.5	2.7	3.0	3.0
Canada	3.2	2.4	2.1	2.6	2.7	2.7
Europe						
Eurozone	1.8	1.6	-0.2	1.2	1.8	2.0
Germany	3.6	3.0	0.6	1.7	2.1	2.0
France	1.4	1.6	-0.2	1.4	2.0	2.0
Italy	1.4	0.4	-1.0	0.0	0.8	1.4
UK	2.1	0.9	0.3	1.9	2.8	2.8
EU27	1.9	1.6	0.0	1.6	2.4	2.5
Asia						
Japan	4.5	-1.0	1.4	3.1	2.2	1.4
China	10.4	9.0	8.2	9.1	8.8	8.3
India	8.7	7.1	6.5	8.7	9.2	8.6
World	3.9	2.8	2.5	3.5	3.8	3.7

Source: Oxford Economics.

Such measures would include an extension of the expansionary monetary policy approaches seen since 2009. But a shift towards more unorthodox approaches is also possible, involving policies such as heavy foreign exchange market intervention and – more damagingly – the use of protectionism and perhaps exchange controls.

This weak short-term global forecast has significant implications for UK export prospects, particularly given that the weakness is concentrated on the Eurozone, the UK's most important export market. We expect growth in world trade, weighted by UK export shares, to be just 3.7% in 2012, only half its long-term average.

1.3 Risks to the global economy

The scale of global economic risks is such that an outcome similar to that shown in our central forecast has a probability of just 45%. There are a number of possible alternative scenarios, in which global growth could diverge significantly from our baseline. We cover the key scenarios for the global economy below and move on to assess their possible implications for the UK economy in Chapter 2.

Disorderly defaults in the Eurozone

The first set of alternative scenarios relates to the possibility that the Eurozone financial crisis concludes in a disorderly manner. A range of possible scenarios exist under this heading, including a large-scale and disorderly default in Greece, multiple sovereign defaults across the Eurozone, a Greek exit from the Eurozone and a wider Eurozone break-up. We see a probability of 30% to a disorderly default in Greece, while a broad Eurozone break-up we see having a probability of around 10%.

The impact of these different scenarios would vary greatly, with a disorderly default in only Greece likely to be less severe than a scenario where the defaults are more widespread and result in exit from the euro. For the purposes of the Green Budget, we study the most extreme scenario, that of a wider Eurozone break-up.

A broad Eurozone break-up could result from the failure of the authorities to agree a credible and permanent solution to the crisis, leading financial and business confidence to collapse. Italy and Spain would be unable to refinance debt maturing in early 2012, triggering a series of disorderly defaults. With the peripheral economies unwilling to accept even greater austerity measures, the Eurozone would then break apart. In this scenario, the most likely outcome would be that five economies – Greece, Portugal, Ireland, Italy and Spain – would leave the euro and establish new national currencies.

The exiting countries have suffered a substantial loss of competitiveness over the past decade and, as such, we would expect the new national currencies to depreciate sharply. In addition, euro-exiting countries would almost certainly see large-scale capital outflows initially, leading their exchange rates to ‘overshoot’ fair value. At the same time, the residual euro is likely to strengthen significantly, given the greater focus on the stronger northern European economies.

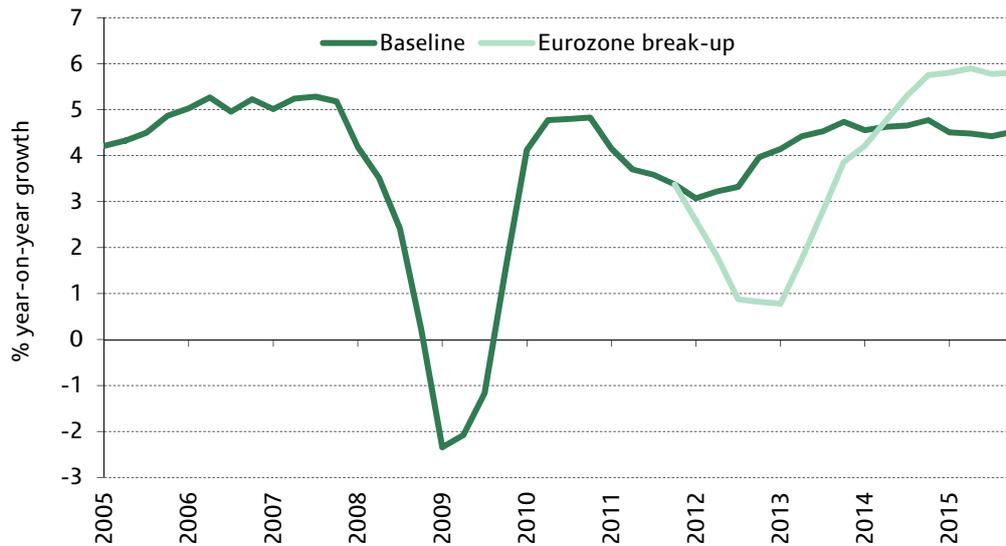
There would also be substantial costs related to the redenomination of contracts from euros into the new currencies, including legal costs. Though euro-exiting countries would increase nominal interest rates following a surge in inflation, it is unlikely that they would raise rates to levels that would be needed to keep inflation down, given the need to support their fragile economies.

The series of defaults would also have a significant impact on banks’ balance sheets across the world, causing interbank markets to freeze up in a similar way seen in the aftermath of the Lehman Brothers failure, leading to a severe credit crunch.

Outside of the Eurozone, heightened uncertainty would send stock markets down sharply. Business confidence would be dampened by the weaker outlook and increased uncertainty, which would have a negative impact on investment in all countries. Furthermore, trade linkages with the Eurozone would depress demand for countries’ exports, particularly in countries such as the UK.

In this scenario, the five exiting countries could see double-digit initial drops in GDP with steep falls also in the ‘core’ Eurozone countries. US GDP growth would slow below 1% by 2013, with a weaker dollar mitigating the effects of weaker global growth, while the UK would suffer a more severe downturn because of its closer trade and financial links with the Eurozone, with GDP about 5% below baseline by end-2013. Growth in China would slow to about 6½% a year in 2012 and 2013. The global economy would only avoid outright recession thanks to policy support in emerging markets (Figure 1.6).

Figure 1.6. World GDP under Eurozone break-up



Source: Oxford Economics.

China hard landing

Another significant downside risk to the global economy is that of a 'hard landing' in China stemming from financial imbalances and an over-inflated property sector. The scale of the credit stimulus the Chinese government pursued in 2009 and early 2010 to help China through the global financial crisis has raised concerns about the robustness of the banking sector and, in particular, about contingent liabilities to local government investment vehicles.

These concerns would be aggravated if exports slowed sharply or poor returns to infrastructure investment at the local level threatened local government finances and the profitability of the industrial sector. This could lead to a sharp increase in non-performing loans (NPLs). A surge in NPLs and a deterioration in banks' balance sheets in China would freeze the amount of credit available to the banking system for investment. In addition, the risk premium in China would rise, pushing up the cost of borrowing. As a consequence, investment would fall sharply, hitting GDP growth and leading to lower employment, which would subsequently weigh down on consumption.

Another trigger for banking sector stress is the property market. Over-capacity in the commercial property market could lead to a sharp correction, and the resulting increase in perceived risk could lead to a more generalised fall in asset prices. The property sector accounts for a significant portion of total investment flows in China and a sharp correction in this sector would reduce investment, resulting in lower employment and growth.

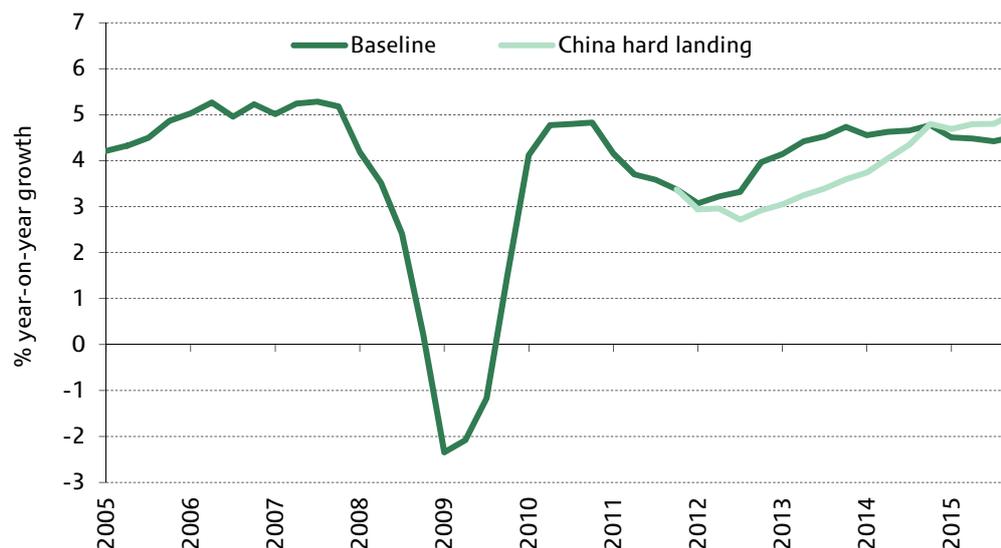
Knock-on effects onto business and consumer confidence from a collapse in the property sector would likely further depress demand, leading to a hard landing for GDP growth. In this scenario, Chinese GDP growth would fall to around 6.5% in 2012 and to below 5.5% in 2013.

We see a probability of this scenario of 15%. This probability is reduced by the fact that the Chinese authorities have scope to respond more aggressively to slowing growth with policy stimulus. Already, the central bank has cut reserve requirements for Chinese banks to ease credit conditions in the slowing economy. However, it is of course possible that

the authorities act too slowly to preserve growth, or that they make errors which exacerbate the downturn.

The impact of a Chinese hard landing on the rest of the world would be noticeable through trade linkages and financial contagion, although the inevitable sharp drop in commodity prices would mitigate some of the impact (Figure 1.7). In this scenario, we would expect the US to grow by around 2% in 2012 and 1.8% in 2013 and Eurozone GDP would fall by around 0.3% in 2012 and grow by just 0.8% in 2013.

Figure 1.7. World GDP under China hard landing



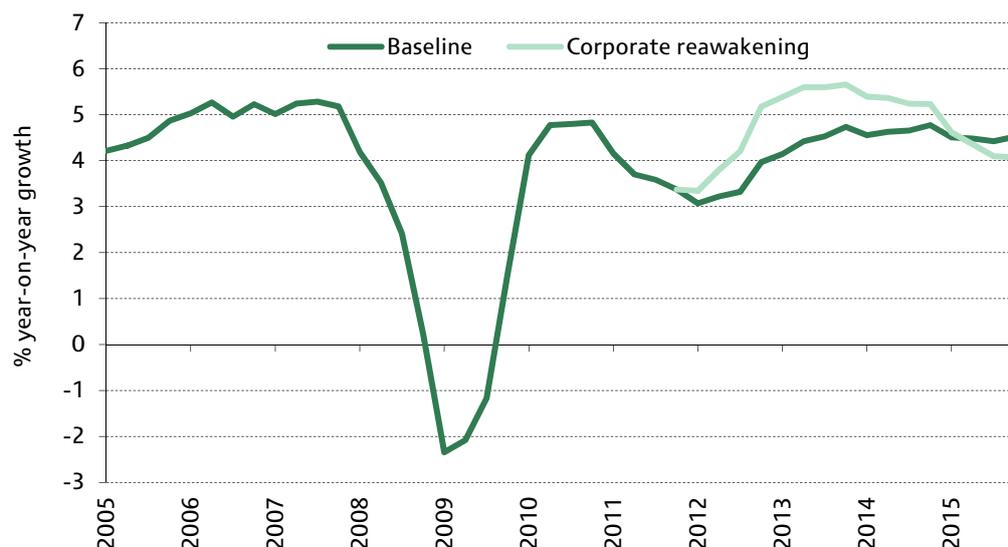
Source: Oxford Economics.

Corporate reawakening

As well as the downside scenarios outlined above, there are also possible upside risks to our central forecast. One possible upside scenario might be generated by the development of credible plans to deal with fiscal problems and the financial crisis in the Eurozone and an easing of tensions in the Middle East which led to oil prices falling back. This would encourage the corporate sector to invest and boost its workforce, as well as easing pressure on the purchasing power of households. Industrialised countries would lead the way, with beneficial spillover effects on emerging markets.

In developed countries, the corporate sector has built up large financial surpluses and, in this scenario, the restructuring of the global financial system and stability brought about by fiscal consolidation would lead business to spend these funds quicker than in the baseline rather than paying down debt. This would enhance confidence in the industrialised economies, leading to a quick recovery in demand (Figure 1.8). In this scenario, US GDP would grow by over 3% in 2012 and accelerate to 4.0% in 2013, whereas in the Eurozone economic activity would expand by around 0.6% in 2012 and 2.2% in 2013. We see a relatively low probability of 10% to this scenario.

Figure 1.8. World GDP under corporate reawakening



Source: Oxford Economics.

1.4 Conclusions

The global economic outlook is of particular importance to the UK, given the goal of rebalancing the UK economy towards exports and investment. The external risks to UK growth prospects are greater still due to close trade and financial links with the Eurozone, where the financial crisis has escalated over recent months and spilled over to the real economy. Eurozone GDP is forecast to contract slightly in 2012, with the risk of a rather deeper recession should the financial crisis culminate in a disorderly manner.

In addition, global growth is being held back by a slowdown in growth in the emerging markets and by a relatively modest pace of recovery in Japan and to a lesser extent in the US. Some of the emerging countries have scope to loosen policy to boost growth but there is also the risk that China will suffer a 'hard landing', which would be a significant blow to regional and global growth prospects. The US economy also remains vulnerable to further financial shocks, with the consumer rebound still relatively muted.

There are also upside risks to world growth, including the possibility that credible steps to ease global financial tensions plus lower oil prices spark a faster recovery of consumer and investment spending. However, currently downside risks dominate, especially those connected to the Eurozone.