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Financial Market Outlook

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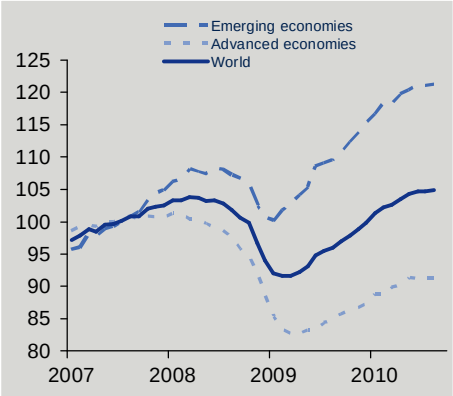
The global economy: Growth slips down a gear, but no relapse into recession

Allianz

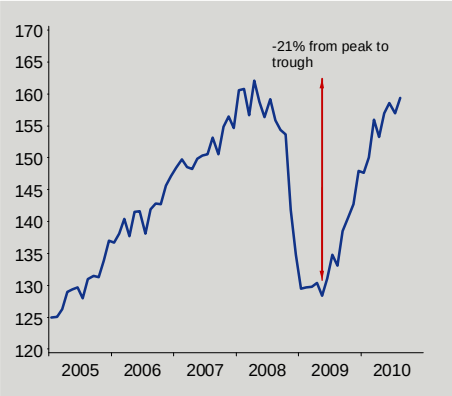
THE GLOBAL ECONOMY: GROWTH SLIPS DOWN A GEAR, BUT NO RELAPSE INTO RECESSION

The global economy has bounced back strongly over the past one-and-a-half years: global trade and industrial production are now roughly back where they were before the financial and economic crisis struck. Industrial production has managed to shrug off a slump of 12%, while global trade has clambered back from a 21% nosedive. To date, the recovery has been very much a two-speed one. In emerging Asia and in parts of Latin America, we have seen a more or less classic V-shaped rebound. By contrast, the recovery in the large industrialized countries has so far been relatively weak, leaving the level of economic activity well below its previous trend and unemployment rates uncomfortably high. Ultimately, the varying pace of the recovery reflects the degree to which the countries were hit by the financial crisis.

Global industrial production (Index, 2007=100)



World trade volume (goods) (Index, 2000=100)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Current economic indicators suggest that economic momentum has passed its peak. While economic recovery continues, it is proceeding at a more measured pace than in recent quarters. There are a number of reasons for this:

- The very strong growth momentum witnessed in many countries over the last few quarters has to be viewed, in part, in the context of the abrupt economic slump (in late 2008) that preceded it. Obviously, this sort of growth momentum is impossible to maintain once the economy has made up for a major part of the losses triggered by the confidence shock. A slowdown has to be expected with respect to inventory demand and the speed of world trade expansion.

- The growth seen in recent quarters was fanned by economic stimulus packages that are now gradually being unwound. So the global economy will have to do without this source of stimulus in the future. And that's not all: the sovereign debt crisis in the euro area has drastically exposed the profound fiscal challenges facing many industrial economies. Fiscal tightening, which in some countries like Greece, Spain, Ireland or the UK is quite drastic, is likely to put a damper on economic growth for some time to come.

- Past experience suggests that recoveries from recessions triggered by financial crises tend to be slower than normal as it takes time for nonfinancial and financial sectors alike to de-leverage and repair their balance sheets.

Progress has, however, already been made on this latter front. Highly indebted households in some industrialized countries have stepped up their savings and slashed housing investment. That creates a financial surplus, which is gradually reducing indebtedness. Upward pressure on saving rates should thus abate.

Moreover, the business sector in the industrialized countries has enacted massive cost cutting and restructuring as a result of the crisis. Profits have rebounded, labor demand and capacity utilization have improved. At the same time, despite some pick-up, business investment as a share of GDP still remains exceptionally low. Since many investment projects were put on hold, or project timescales elongated during the crisis, a considerable investment backlog is likely to have formed. In the euro area, for example, business surveys in the manufacturing sector reveal that equipment shortages have gained importance as a constraining factor for production. Indeed, the proportion of respondents citing equipment shortages has risen to well above the historical average. Given the low base level of investment and higher internal funds, M&E investment is likely to increase solidly.

Monetary policy will likely remain very accommodative for the time being. Stimulative financial conditions should underpin gains in private economic activity.

Last but not least, there is still considerable economic catch-up work left to do on the emerging markets. Although they will certainly not be left unscathed by more moderate growth in advanced economies, the links between the advanced and emerging-market economies have become looser, as the relative importance of the latter has risen in recent years. The robust performance in key Latin American countries such as Brazil is a positive surprise.

All in all, we look set to enter a period with moderate global economic growth. After a 3.7% rise in global output this year, the increase is expected to be slightly weaker next year at 3.3% (country weighting based on current exchange rates). Growth rates are set to ease both in the industrialized countries and in the emerging markets, whereby the slowdown in the industrial economies will be more pronounced. Economies without seriously over-indebted private and public sectors will tend to grow more quickly than countries where consolidation is of the essence. Euro area growth stands to benefit from a robust German economy, which is set to record a considerably above-average performance this year. The positive interplay between rising employment, increasing incomes and higher demand suggests that the German recovery has now developed a momentum of its own.

Despite a fairly strong global recovery, there are of course risks for 2011 and beyond. Apart from rising commodity prices, one major risk is that strong downward pressure on the US dollar could slow down growth not only in Europe, risking a renewed escalation of the sovereign debt crisis, but also in Japan, where the yen has already appreciated markedly, and in strongly appreciating emerging markets in Asia and Latin America. A co-operative solution to the currency tensions is needed. It would entail some appreciation of the Chinese yuan to take pressure from other currencies, some correction of extremely expansionary QE policies in the US and moves by European governments to foster domestic demand, especially investment. This would contribute

to a more balanced, and presumably higher, growth outcome for the world economy. Therefore the odds are not bad that such policies will be pursued, instead of fighting mutually disadvantageous currency and trade wars.

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