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Financial Market Outlook

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Dr. Michael Heise

After the financial crisis and recession: Subdued growth against more stable backdrop

Allianz

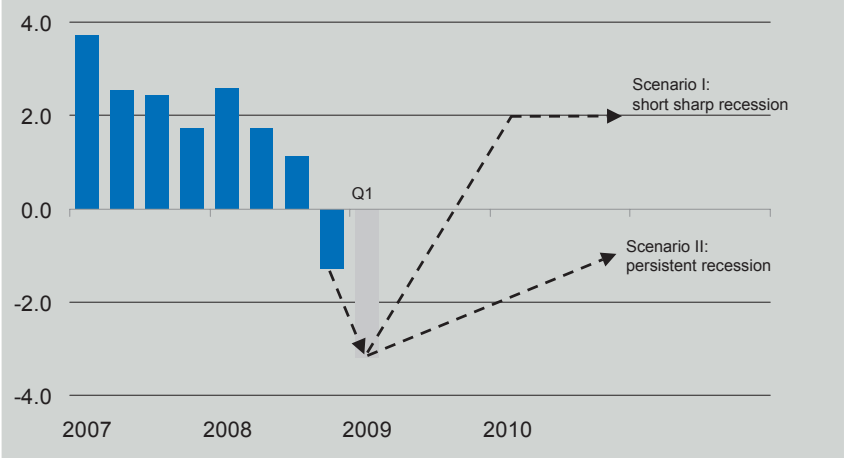
AFTER THE FINANCIAL CRISIS AND RECESSION: SUBDUED GROWTH AGAINST MORE STABLE BACKDROP

From prominent quarters we are being told that the current economic crisis is not only likely to be very deep but is also likely to persist for many years. Particularly striking is the prediction by Robert Shiller of Yale University: "We could have many years of a very weak economy. Big recessions are followed by years of weakness and typically unemployment keeps rising... We could face a decade of weakness." That would be a depression of sorts or, put less dramatically, an L-shaped development in which a sharp economic downturn is followed merely by stagnation.

The interaction between the weakness of the real economy and the financial crisis is certainly what makes the current economic crisis both special and at the same time threatening. If the economy does not recover it will be very difficult to get banking markets back into full functioning order again. On the other hand, the dislocation of financial markets represents a considerable hurdle to overcoming the economic downturn. This is undoubtedly the case. But it would be fallacious to draw the conclusion that an end to the recession is impossible in the near future – as would be the case in Scenario II depicted in the graph below.

Upturn around the corner?

GDP Germany (percentage change over previous year)

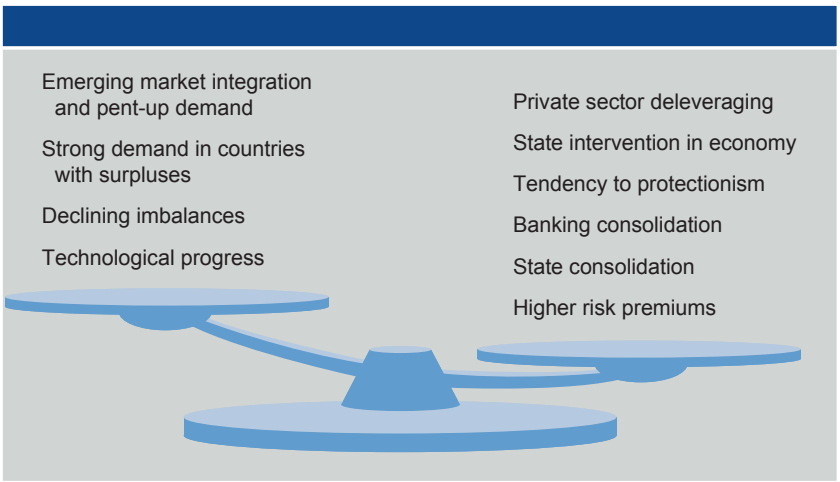


A number of strong mechanisms exist which will get the economy moving again. The most important stabilizing factor is the drop in energy and commodity prices which is boosting the purchasing power of consumers and relieving the burden on company purses. This is joined by an unprecedented combination of monetary and fiscal policy. Interest rates are heading towards zero in many countries and governments worldwide have packaged together programs to stimulate demand worth between USD 1,500 and 2,000bn, i.e. around 3 - 4% of global value added. This is the strongest state boost to the economy ever made in post-war history.

But the important question is what lies in store after the turnaround? Will we slide into stagnation once the state winds down its stimulus packages and interest rates need to be nudged up again? It seems certain that economic growth will be adversely affected by a number of factors in the next five years. These range from the much-needed consolidation of public budgets, which is likely to take many years, to the necessity to reduce debt in the private sector following the boom in lending in many regions, and finally to the negative effects from falling real estate prices in the USA as

well as in many European and Asian countries. Other factors could easily be added to the list of growth-dampening factors, such as reference to greater government intervention in the economic system or the consolidation in the banking sector which is likely to take many years.

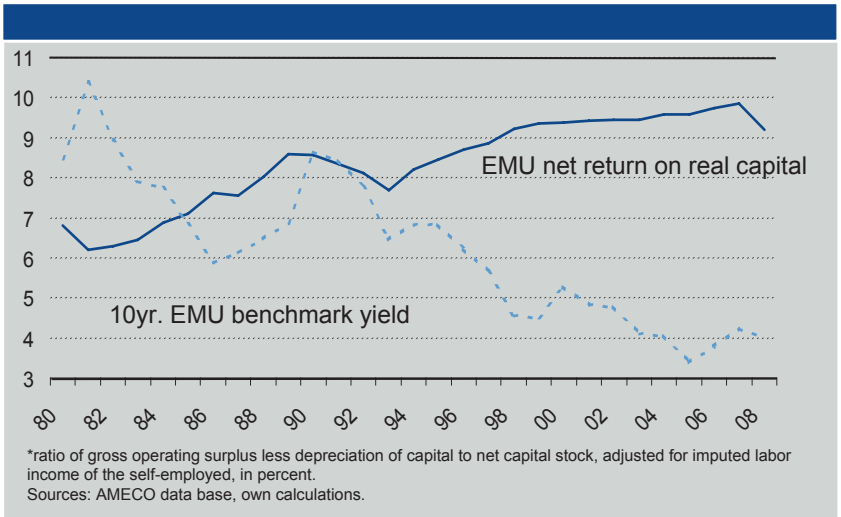
Medium-term growth drivers and brakes



The question is, however, whether these factors are so strong that they will lastingly dominate economic development. Fortunately there are some strong expansionary forces lurking deeply in the global economy. These are, first, the technological progress which has created markets spanning the entire world and helped boost productivity. Secondly, there is the continued integration of emerging markets into the world economy, specifically of the Asian markets which are home to a huge share of the world population. The catching-up process will propel growth for many years to come. In a market economy system, with large swathes of the potential workforce still eager to raise their standard of living and with massive pent-up demand, a return to healthy rates of growth is ensured.

What we are witnessing at the moment is a correction of excesses which have their roots above all in the investments of the boom years. The backdrop is that the return on real capital has distanced itself sharply from the costs of borrowed capital. Around the globe, a huge discrepancy has arisen here in recent years.

Net return on real capital* markedly above return on financial assets



*ratio of gross operating surplus less depreciation of capital to net capital stock, adjusted for imputed labor income of the self-employed, in percent.
Sources: AMECO data base, own calculations.

The return on real capital has rocketed due, among other things, to the success of new locations in central/eastern Europe, Asia and Latin America. Expectations of ever higher profits propelled prices of existing companies – not only on the LBO market – to meteoric heights. There was a massive surge in investment. This boom came about because the cost of capital remained low in spite of an explosion in returns on real capital. And these capital costs remained low because on the one hand monetary policy in the industrialized countries (USA and Japan) was very expansionary and because, on the other, many emerging markets, in an attempt to prevent their currencies from appreciating, emulated this expansive policy and pumped liquidity into the market by building up massive currency reserves. Borrowed capital was also available in abundance because the new securitization methods of the banks created a strong lever. Corrections have to come about here. Less capital will be available and the price will be higher. On the other side, the enormous returns on real capital seen in recent years will not be realizable. The system will correct itself, leading to a lower level of investment. Growth in the capital stock will return to normal, in particular in countries such as China or in some oil and commodity producing countries. This correction process is necessary following the build up of surplus capacities.

The excesses which have built up have to be reduced, in particular in the emerging markets. Share prices have already undergone a correction and real estate prices are currently in the process of correcting. It will take longer for the surplus capacities which have built up in some sectors – steel, automobile, electronics – as a result of an overabundant flow of capital into the emerging markets and excessive investment rates, to contract. Investment activity, which has collapsed globally, is in the throes of a painful correction. Old levels – from 2007 and 2008 – will not be reached again that quickly. The incentive to invest in real capital will no longer be as great as in recent years given the lower spread between the rate of return on real capital over the rate of return on the financial market.

For the world economy as a whole this is not necessarily disadvantageous. Progress can be made on reducing imbalances. The buildup of capacity geared solely to exports will be on a smaller scale. For many years global economic growth will be more moderate than in recent years, but stagnation is not on the cards. The forces of growth stemming from the ongoing catch-up needs of the emerging markets, the ineluctable advance of global economic integration and unrelenting technological progress form a counterweight to the dampening factors and brighten the economic outlook.

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