ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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The dramatic downturn in the world economy has spawned a host of horrific scenarios. With global orders for electronics, machinery and automobiles plummeting 20 to 50% on a year earlier and evidence of a severe slowdown in world trade, even experienced and hard-nosed people like Paul Volcker are drawing comparisons with the Great Depression of the years 1929 to 1933. Among the variations of the depression scenario under discussion are the collapse of eastern European economies, government defaults of formerly solid states like Austria and the breakup of the eurozone, with all this culminating in the tears of inflation.

What is the probability of such horrific scenarios? The answer depends on the very basic analysis of the present situation: Is the economic crisis mainly due to the "expectation shock" of the financial crisis that has suddenly and abruptly dealt a blow to private sector demand? Or is the severe recession first and foremost a reflection of fundamental problems in the world economy such as towering private debt, a negative housing cycle or international current account imbalances? In the first case, the business cycle may quickly improve once we finally get the financial crisis under control. In the second case, the problems will be more stubborn, the recession more prolonged.

Of course, there can be no doubt that the correction of credit bubbles, excessive house price inflation and international imbalances is exacerbating the downturn and will take some time to be completed. But do these observations justify a sudden sharp retraction of demand for many manufactured products and services by 20 to 30%? Are we heading for an L-curve, with a sharp drop and no subsequent recovery? The answer is no. There is no fundamental long-term lack of demand on global markets. For one, emerging markets still have enormous pent-up demand. And secondly, not all industrialized developed countries are plagued by mountains of private household debt, obliging them to switch into deleveraging mode. Surplus countries like Japan and Germany have a large potential, as do those emerging markets with high savings ratios in Asia or the Middle East. In a global view, we cannot all be borrowers.

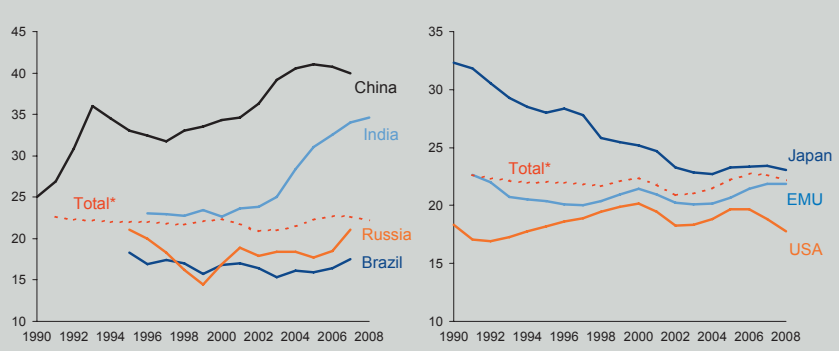
Another argument put forward for years of economic weakness is the purported existence of large amounts of excess supply in the world economy. While there is evidence of overcapacities in certain sectors, e.g. the automobile sector and possibly in commodity production following the mega boom, there is no indication that we are suffering from a large global over-investment cycle. Looking at the investment ratios of recent years, we see strong increases in emerging markets such as China, India and others. But at the same time, investment ratios in the developed world have not risen but in some cases even trended downward (see chart on next page). These trends are interrelated, as there has been a strong build-up of capacity by western firms in emerging markets.

Given moderate capacity growth in the developed countries in recent years, we need to ask whether the capacity build-up in emerging markets can be sustainable? Many people would doubt this. But actually, it is not clear-cut. Many emerging markets like China are actually experiencing a so-called knife-edge problem (in economic theory attributed to Harrod-Domar) where investment to build up capacity generates employment and incomes, which eventually create the demand needed to utilize the new capacities. When an economy tips off the knife-edge because demand growth

drops below capacity growth, more investment can actually help as it has a strong accelerator effect on demand. The balancing act is difficult, but not impossible.

Investment ratio

Machinery & eqpt investment as % of GDP, nominal



* USA, Japan, EMU and BRIC countries (1991 - 94 without India, Russia and Brazil, 1995 without India, 2008 estimate).

The overall conclusion is that the world economy will not be constrained for many years by insufficient demand and excess supply. Nonetheless, the challenges facing economic policy are daunting. It has to prevent a cyclical crisis from becoming structural. The hurdles are manifold. With unemployment soaring, there is a risk of dequalification and demotivation in the workforce, effects that tend to linger. Furthermore, a sudden downward shift in demand leads to under-utilization and the accumulation of inventories, prompting companies to trim their medium-term investment and growth plans.

To prevent cyclical problems from becoming structural, fiscal stimulus packages and massive attempts to curb the financial crisis are certainly appropriate. But these policies in turn create structural problems for public budgets. So the boost the economies are currently getting from government action will at some stage transmute into a dampening factor once consolidation of government spending and possible tax increases become the order of the day.

Pivotal to igniting a strong turnaround of the cycle is the restoration of confidence in the stability of the financial system. Government support for ailing financial institutions is certainly necessary, but it alone cannot do the job. Most importantly, the adjustments in the financial sector have to work through: higher capital provisioning, reduced risks on balance sheets, lower trading exposures, closure of non-profit activities, cost-cutting and downsizing. Although this is actually taking place at quite a swift pace, it is not yet becoming clearly visible in capital ratios or risk-weighted assets as our regulations concerning mark-to-market valuation of assets and rating-dependent capital requirements are highly pro-cyclical in nature and suggest that a further deterioration of the situation is lurking in the pipeline. Unfortunately, progress on overhauling these regulations, although widely demanded by policymakers, is too slow.

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