



Global economic outlook

What to expect in 2013 and beyond

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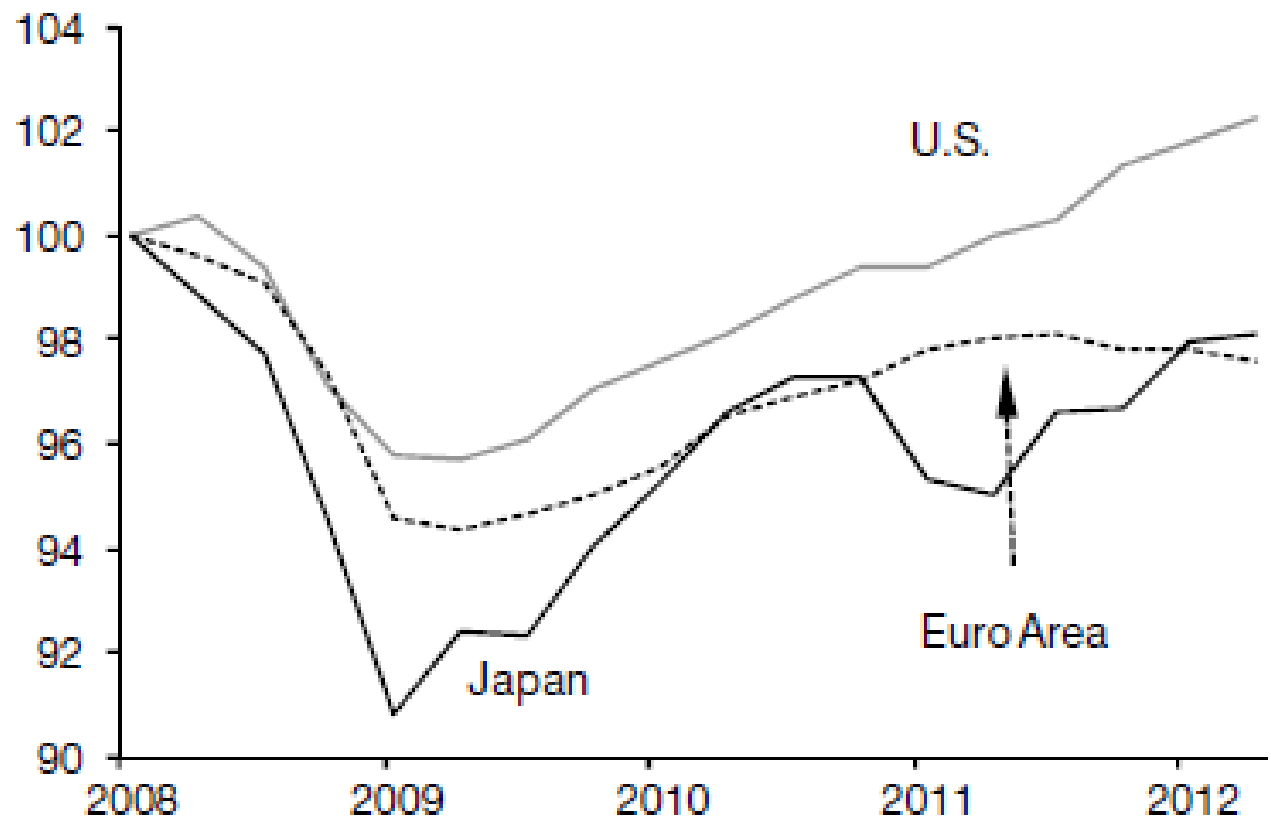
The global economy

–Growth

- US is the star performer among developed countries

G3: Real GDP Levels

Index, 2008Q1=100



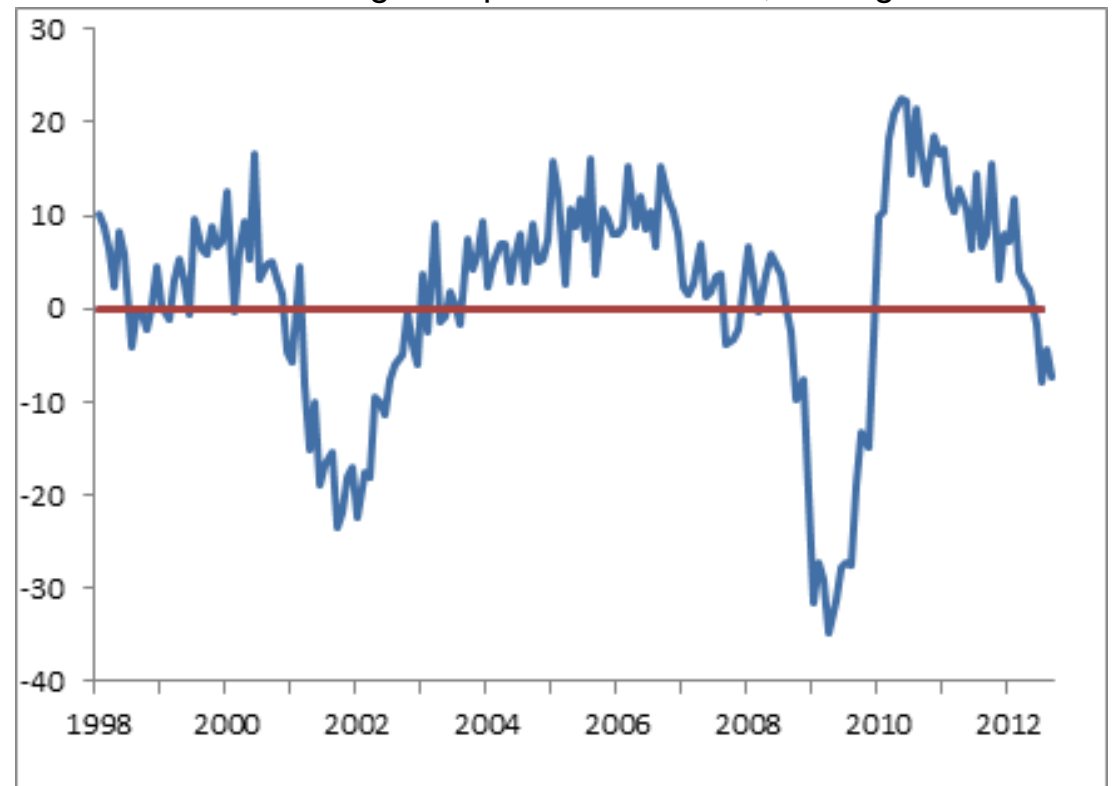
US economy

–Headwinds from Europe

- Exports decline
- Capital spending declines
- Leads to slowdown in manufacturing sector
- Some signs of stabilization

New orders for capital goods

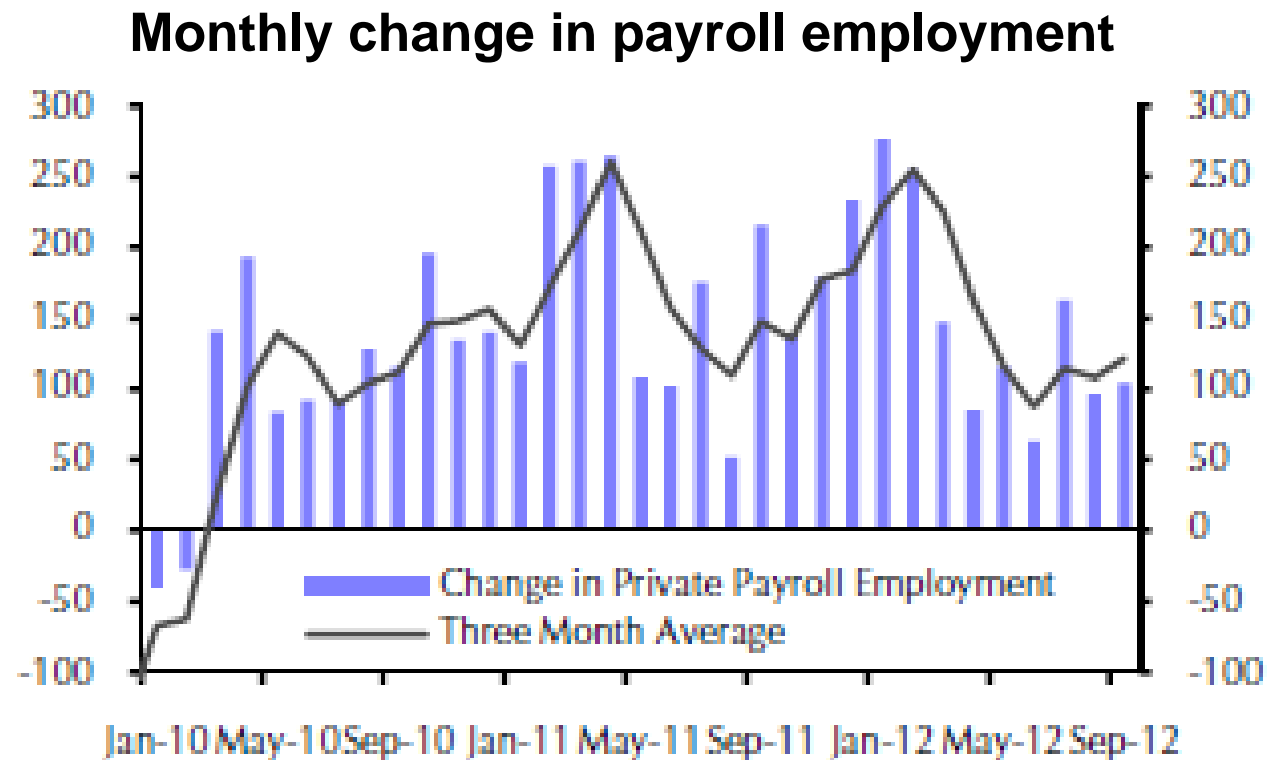
Excluding transport and defense, % Chg



US economy

–Headwinds from Europe

- Job growth anemic, but continuing
- Some signs of improvement in recent months

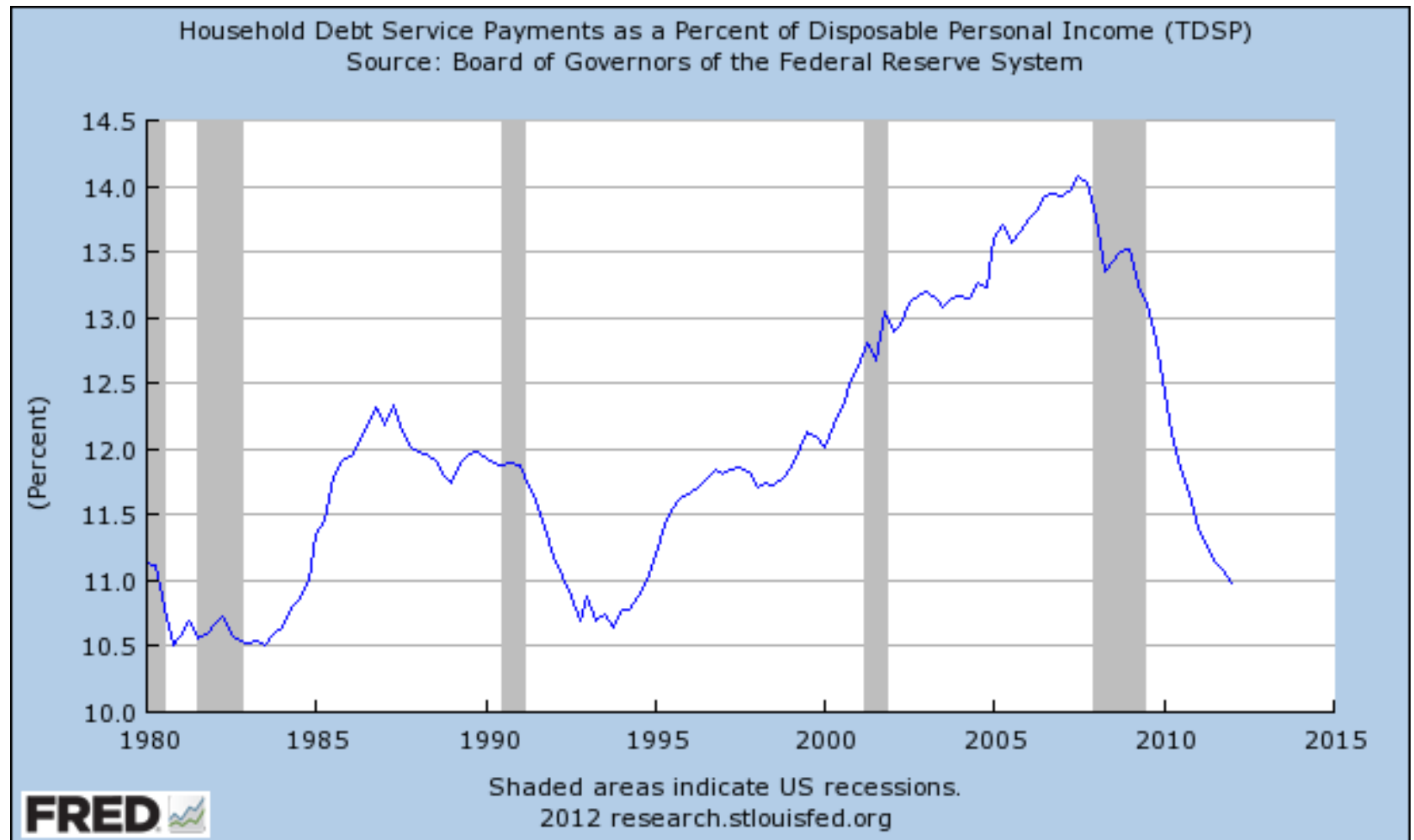


Source: Capital Economics

US economy

–Some positive signs

- Consumer cash flow improves

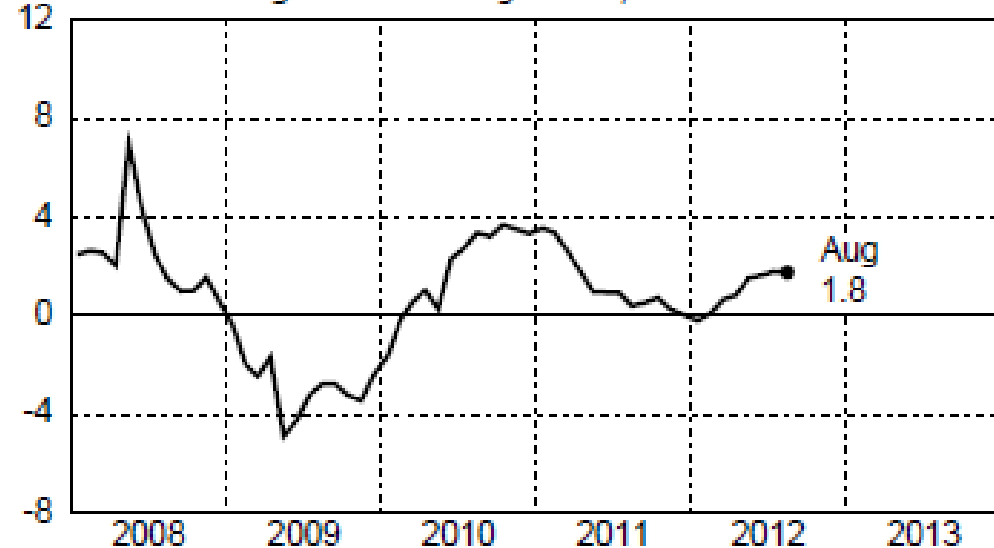


US economy

–Some positive signs

- Consumer spending continues to grow
- Poor income growth offset by wealth, cash flow, and confidence

Real Personal Disposable Income
Percent Change Over Year-Ago Level, Chained 2005 Dollars



Real Personal Consumption Expenditures
Percent Change Over Year-Ago Level

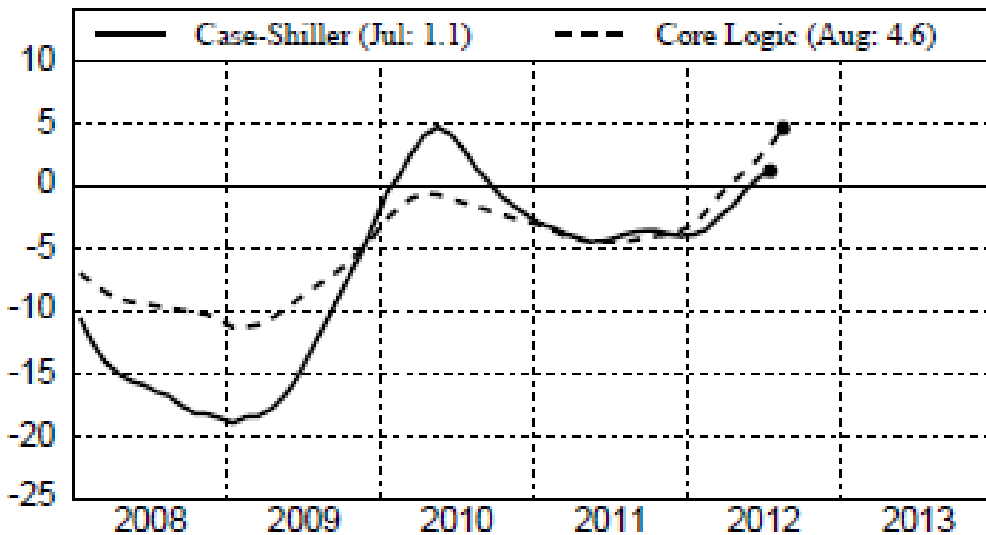


US economy

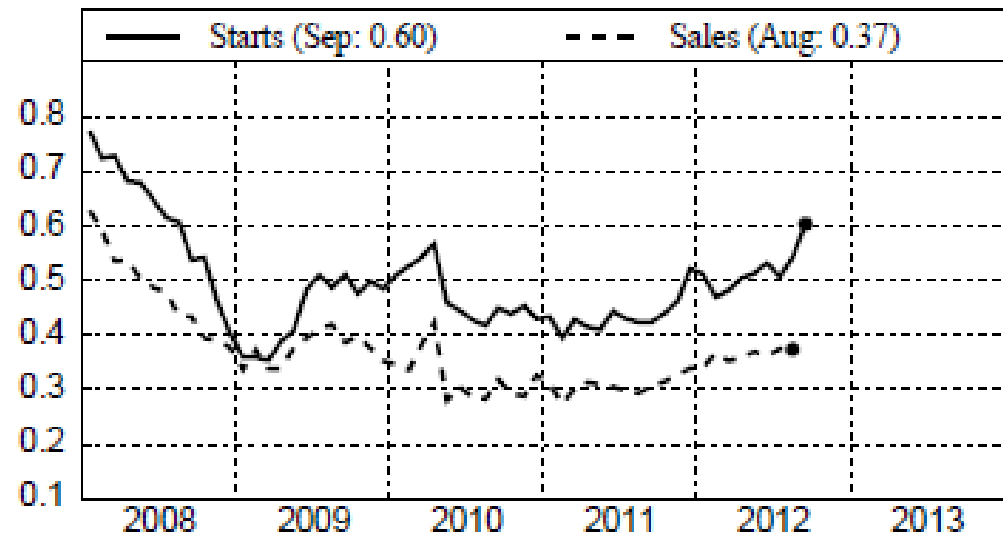
–Some positive signs

- Housing market in modest recovery
- Prices rise, activity increases, starts at highest since 2008
- Low mortgage rates are having a positive impact

Prices
Percent Change Over Year-Ago Level



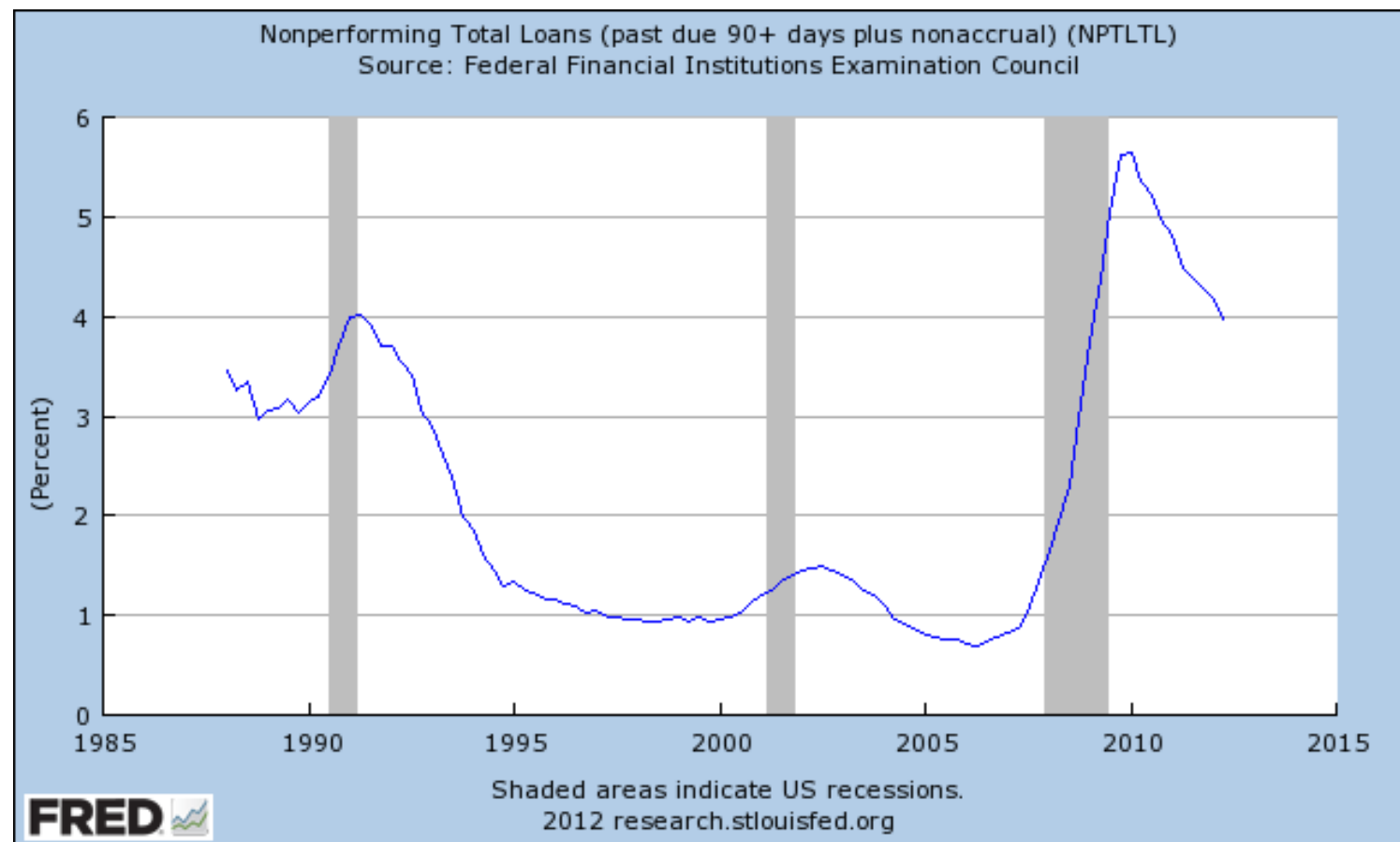
New Single Family Housing
Millions of Units



US economy

–Some positive signs

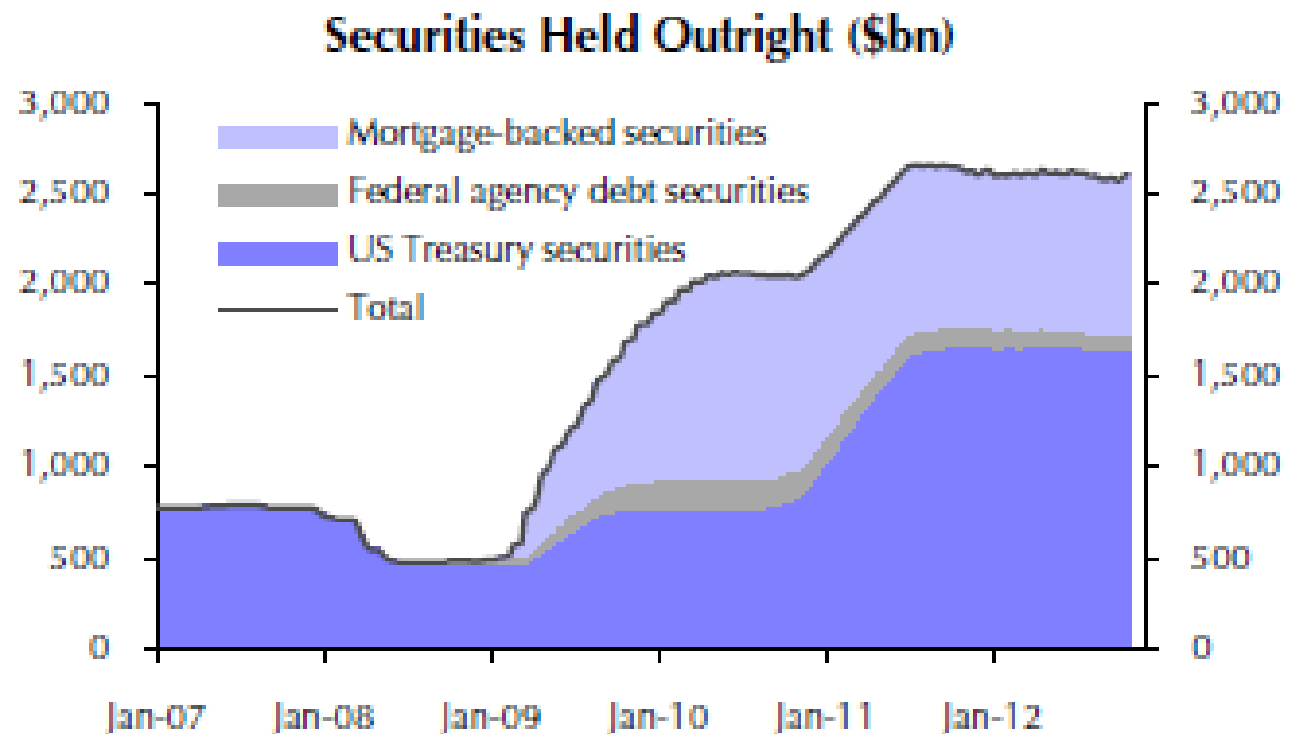
- Credit markets have improved – but we're not there yet



US economy

–Fed takes action

- QE3 will cut long term rates, boost liquidity
- Purchases of MBS should help to unlock housing market
- Risks:
 - Future inflation?
 - Takes pressure off Congress

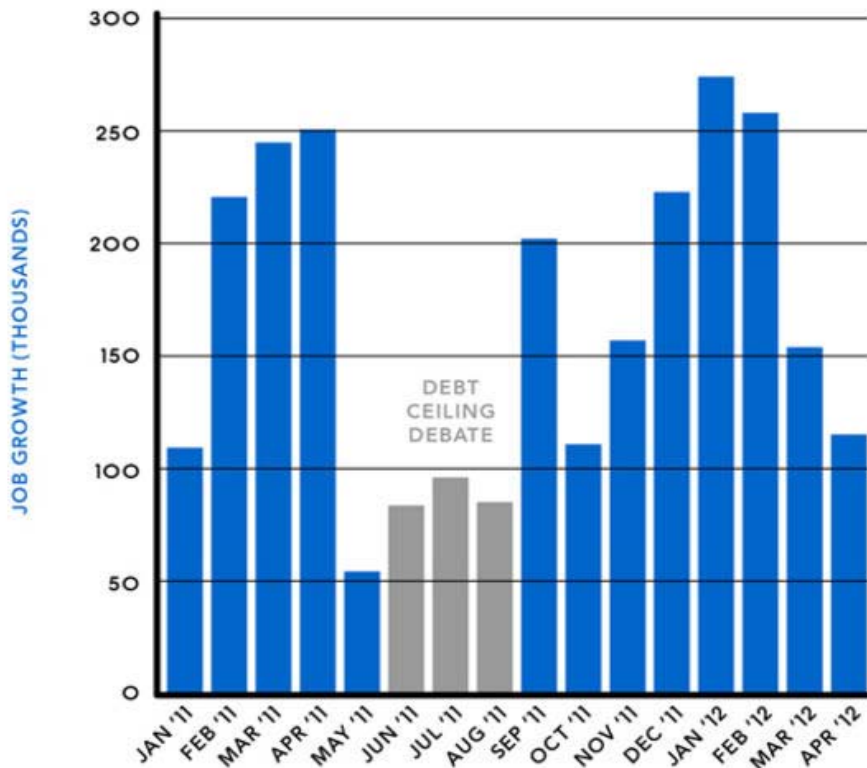


US economy

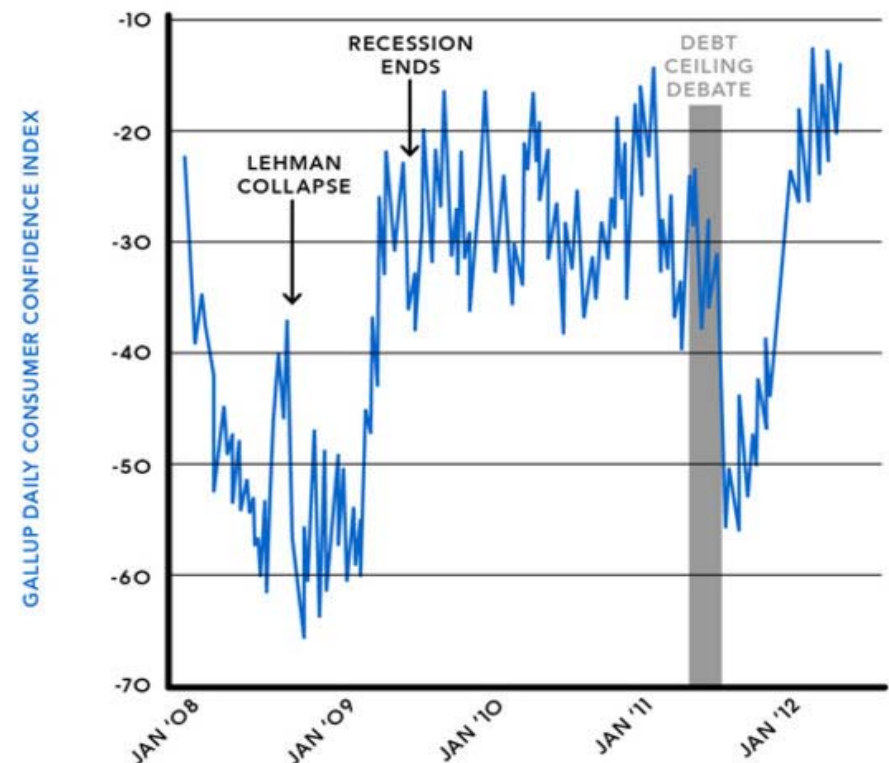
–The fiscal cliff

- Taxes rise, spending drops in Jan 2012 by \$600 billion in one year
- Failure to act actually solves deficit problem – but at a huge cost
- Republicans may be amenable to new revenue
- Obama amenable to new ways to generate revenue
- Uncertainty could hurt economic activity

MONTHLY GROWTH IN NON-FARM PAYROLLS



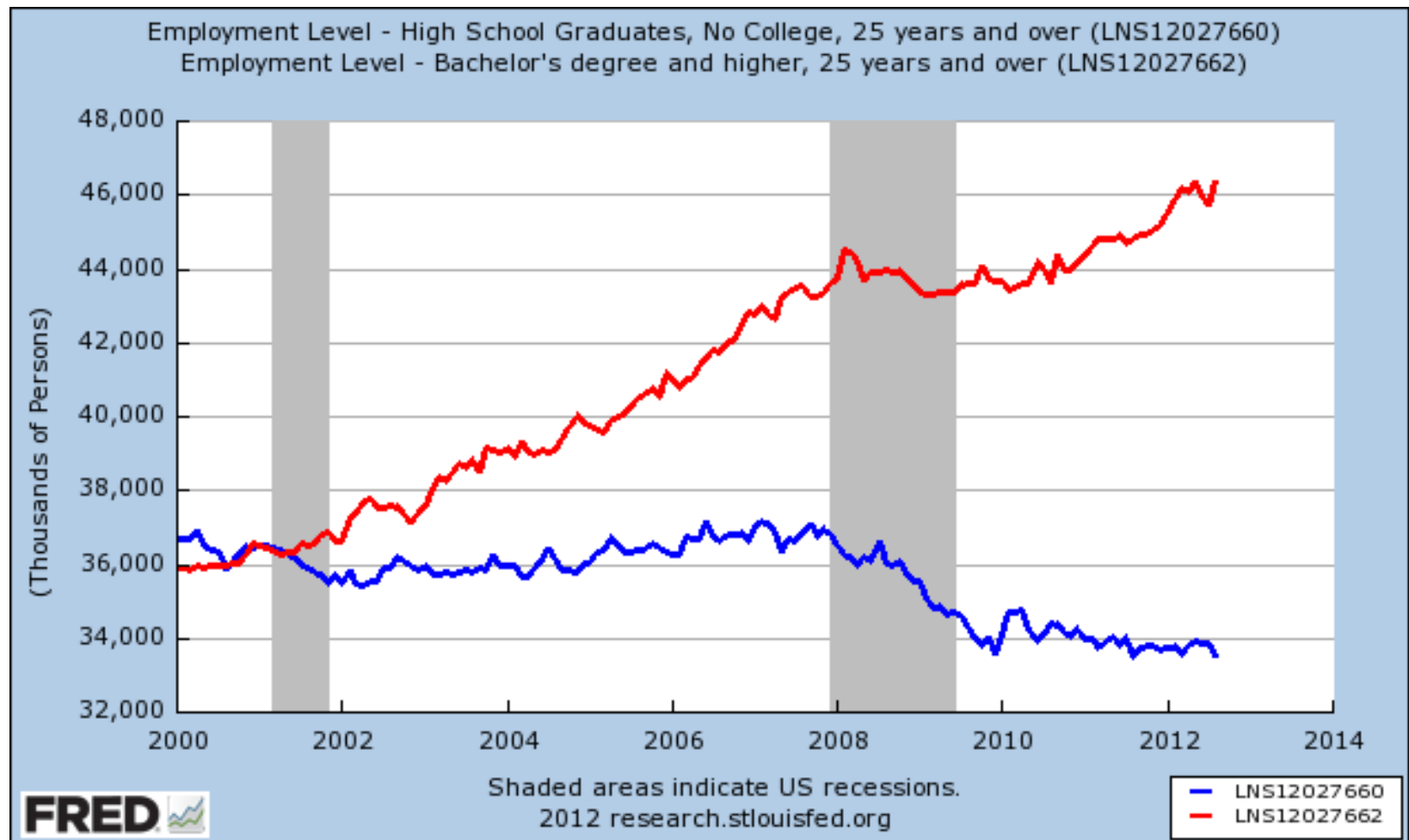
CONSUMER CONFIDENCE



US economy

–Longer term issues

- Labor market troubled by skills mismatch
 - Contributes to income disparity



US economy

–Longer term issues

- Future growth from exports, investment



European economy

–Eurozone in recession

- Fiscal tightening in every country
- Perceived currency risk boosts spreads
- Monetary policy neutral
- Uncertainty hurts business
- Weak euro helping exports



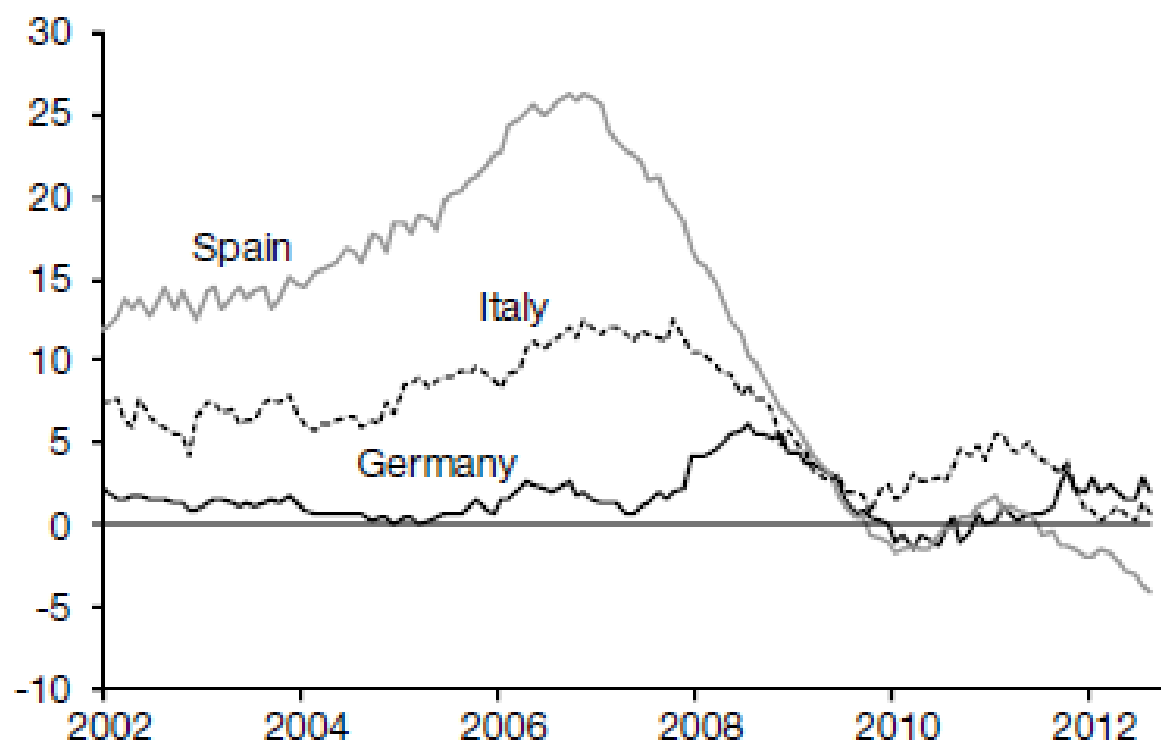
European economy

–Credit markets failing

- Banks compelled to recapitalize
- Banks stuck with bad assets in Spain, Ireland, Portugal
- Banks hoard government bonds, shed other assets
- Capital flight from south to north

Euro Area: Credit to Private Sector

percent change over a year ago



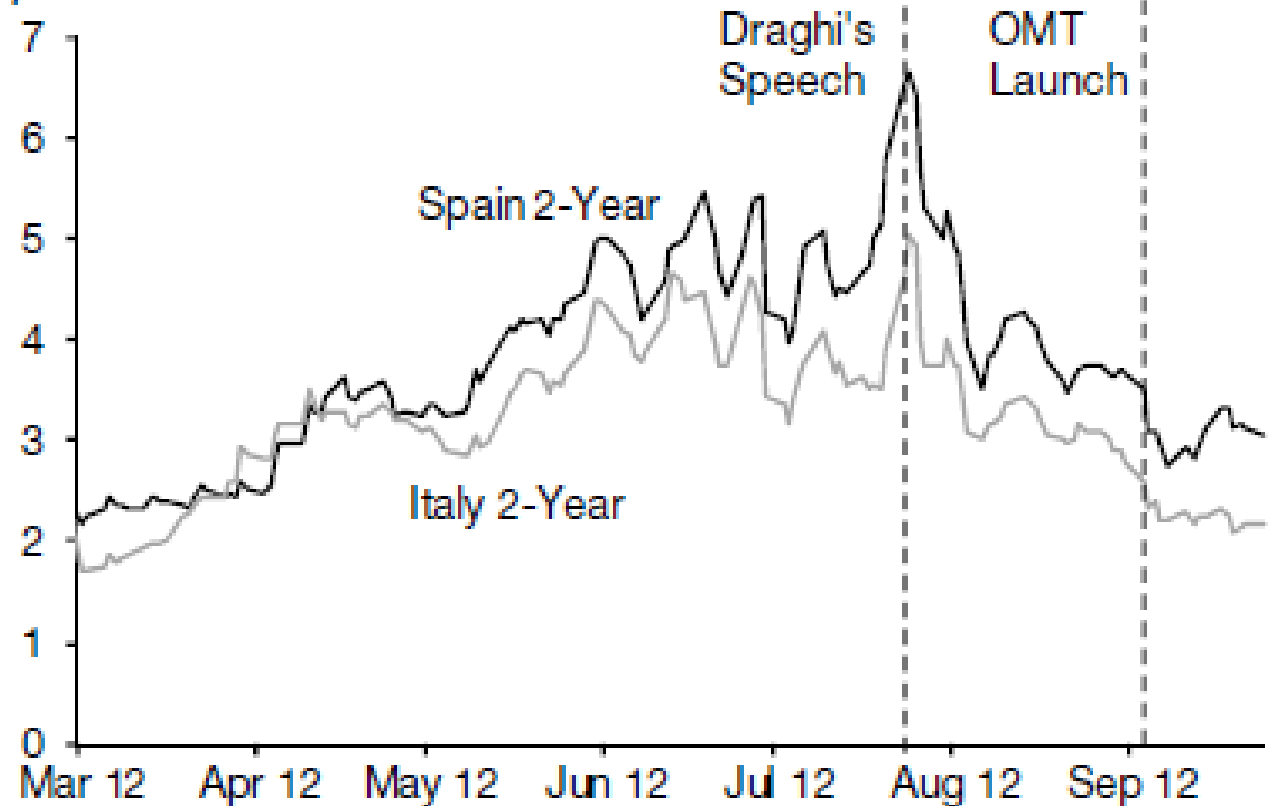
European economy

–What to do?

- ECB acts to prevent collapse
- Bond yields fall
- Probability of collapse collapses

Spain and Italy: Sovereign Bond Yields

percent



Eurozone Crisis

–Three possible scenarios for the future:

- Nothing changes
- Europe integrates
- Eurozone collapses



Eurozone Crisis

–What integration would look like

Proposed reform	What the critics say
Pooling of debt	Without fiscal discipline, this would be a bottomless pit.
EU-wide bank supervision and recapitalization	Requires joint funding. Where would the money come from?
EU-wide deposit insurance	Must include bank supervision.
Fiscal union with transfers	Without fiscal discipline and reform, this would be a bottomless pit

Eurozone Crisis

–How Germany and Europe disagree

What Merkel says	What the critics say
<p>Fiscal and financial integration must wait for political union.</p> <p>This include reforms of labor markets plus fiscal discipline</p>	<p>This assumes that banks have time. They do not.</p> <p>Banks must be quickly be recapitalized and governments must have access to credit soon.</p>
<p>While we want the Eurozone intact, the cost of supporting the peripheral countries is too big, and not fair to Germany.</p>	<p>What is the alternative? It is collapse, which would severely hurt Germany.</p>

Eurozone Crisis

–What failure might look like

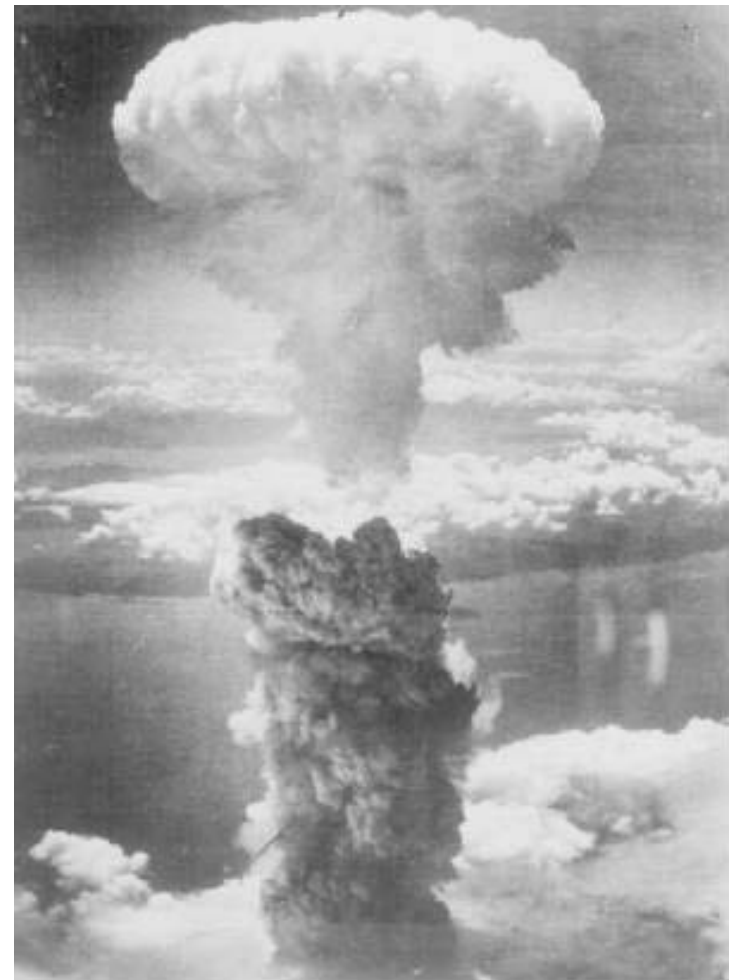
- First, Greece falls:

- Greece runs out of cash, prints drachmas
- Banks lose access to ECB and they collapse
- Border controls
- No access to external credit
- Real GDP drops rapidly
- Coup or civil war possible



Eurozone Crisis

- What failure might look like
 - Then contagion engulfs Europe:
 - Spain and Italy cannot obtain credit
 - Bailout funds exhausted, defaults begin
 - Massive capital flight
 - EU imposes capital controls
 - Banks collapse, credit halts
 - Countries start printing money
 - Euro rises, hurts German exports
 - Sharp drop in economic activity
 - Global contagion



Chinese economy

–Soft landing

- Exports hurt by European situation
- Manufacturing in decline
- Government implements stimulus
- Monetary policy eased
- Unclear whether economy has turned the corner



Chinese economy

–Longer term issues

- Next stage of growth more difficult:
- Excessive and wasteful investment
- Unfavorable demographics will slow growth



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