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
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

[Graph showing new orders for capital goods from 1998 to 2012]
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
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
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
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
European economy

– What to do?
  • ECB acts to prevent collapse
  • Bond yields fall
  • Probability of collapse collapses
Eurozone Crisis

– Three possible scenarios for the future:
  • Nothing changes
  • Europe integrates
  • Eurozone collapses
## Eurozone Crisis

–What integration would look like

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

## Eurozone Crisis

–How Germany and Europe disagree

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

Exits by destination
US$, % chg year over year
Chinese economy

– Longer term issues
  • Next stage of growth more difficult:
  • Excessive and wasteful investment
  • Unfavorable demographics will slow growth