Global Economic Outlook

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Emerging markets lead recovery

World Economic Forum 2011:
Changing stakes

Sub-Saharan Africa:
Cashing in on commodities

China:
Balancing act

USA:
The case for cautious pessimism

Deloitte.

Global Economic Outlook Q1 2011

While economists focus on the short-term transition out of the crisis and into sustainable recovery, one cannot help but feel that a bigger and longer term transition is under way. Of course, things have been changing for some time. For the past thirty years, the big emerging markets have gradually increased their share of the global pie following two centuries of relative decline. But now, the process of catching up appears to be accelerating, and with dramatic consequences. This is most noticeable in the aftermath of the global recession. As developed markets struggle to recover, big emerging countries are racing ahead – not only boosting their own living standards, but stimulating growth in the rest of the world. With much more rapid growth than the developed world, these countries have become significant players in the global economy. For the first time, their policies are of critical importance to everyone else. Moreover, as they grow, their middle classes are rising in importance and attracting the lion's share of attention from many of the world's biggest companies. For the developed economies, this means managing a process of relative decline.

The rapid advancement of emerging nations is but one of the many new realities that global companies face. Indeed, "new realities" is the theme of this year's World Economic Forum meeting in Davos, Switzerland. In this issue of Deloitte's quarterly *Global Economic Outlook*, we begin with Elisabeth Denison examining the new realities of the global economy and their implications for global business. She looks at the changing dynamics of East versus West, private sector versus public sector, energy demand versus sustainability, and youth versus aging, among others.

Next, Carl Steidtmann provides his view on the US economic outlook. As the title of his article suggests, Carl is cautiously pessimistic. While he acknowledges that 2010 ended with a number of signs pointing to growth (including stimulatory policies), problems that could retard the recovery still linger. Among the obstacles to growth are troubled state and local finances, structural problems in the job market, rising energy costs and declining home prices.

In my analysis of China's economy, I discuss the balancing act that Chinese authorities face in trying to suppress inflation without harming export competitiveness and economic growth. I also examine the question as to whether China has a real inflation problem or merely a problem of rising food prices. Finally, I look at the longer term effects of an economy that is excessively dependent on investment for growth.

Next, Elisabeth Denison examines the outlook for the Eurozone. She says that overall prospects are improving, but notes that a North-South divide persists. In addition, she looks at how the crisis of the past year sets the stage for potentially radical changes to the structure of the Eurozone. The details of such changes will have an important impact on the size and nature of growth for the Eurozone's member nations.

In my outlook for the Japanese economy, I discuss the prospects for two sectors that have boosted growth recently: consumer spending and exports. Unfortunately, both face strong headwinds in the coming year. In addition, the newly expansive monetary policy might not be sufficient to offset these negative factors. Thus, the outlook for Japan in 2011 is for a considerable slowdown in growth.

In his outlook for India, Siddharth Ramalingam takes a relatively optimistic view of growth in 2011. He notes that the manufacturing sector is doing especially well on the back of both domestic demand and export strength. However, inflation is a persistent problem with which the central bank will have to contend. As is the case in the other BRICs, this will require a careful balancing act. Finally, Siddharth examines the policy options available to the government that could help to boost future growth.

Next, Ian Stewart focuses on the outlook for the UK economy. He discusses the surprisingly strong growth emanating from the United Kingdom. Fueling the momentum is expansive monetary policy, strong export demand, a weak pound and increased business investment. The big question, then, is whether the private sector will pick up the slack when government fiscal tightening kicks in. Ian suggests that the United Kingdom will likely be successful in shifting away from growth led by consumers and government toward growth based on exports and investment.

In my outlook on Brazil, I discuss how relatively high inflation is creating a conundrum for policymakers. On the one hand, they want to suppress inflation. On the other hand, they are wont to allow further increases in the currency lest export competitiveness is harmed. I also discuss how Brazil's longer term outlook is clouded by uncertainty about the policies that the new government will pursue.

Next, I examine the outlook for Russia. While higher energy prices will have a positive impact on growth, several other factors could restrain economic expansion. Hence, the outlook for 2011 is modest at best. Longer term, much will depend on the degree to which reforms that can stimulate investment in non-commodity industries are enacted.

Finally, Pralhad Burli offers some thoughts on the outlook for Sub-Saharan Africa. This region, which lagged the rest of the world for much of the past several decades, is attracting considerable attention of late. Growth has accelerated in many major Sub-Saharan countries and the rise of big emerging markets has stimulated demand for commodities that are in abundance in Africa. Pralhad addresses the question of whether Africa's good fortune will be sustained.

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World Economic Forum 2011: Changing stakes

Dr. Elisabeth Denison

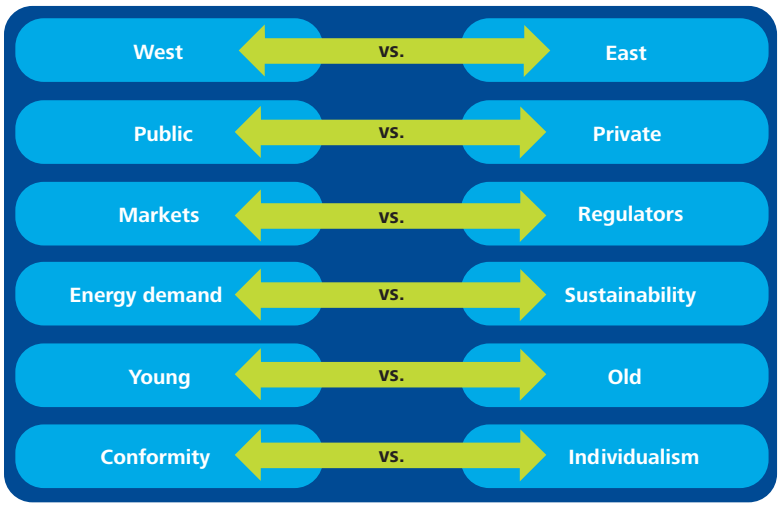
As the New Year begins, leaders from around the world are convening for the annual gathering in Davos, Switzerland, to discuss current issues and long-term concerns. The theme of this year's World Economic Forum, "The New Reality", is defined by several fundamental shifts shaping the global economy and these developments will likely have a profound impact on the way we live and work. Thus, in the first quarter edition of Deloitte's *Global Economic Outlook*, in addition to our customary perspective on worldwide economic trends, we also want to share some insights on the shifting global landscape (figure 1).

(1) West to East

It seemed like a perfect symbiosis: Over the past decade, a "consuming" group of nations in the West (led by the United States and United Kingdom, but also other smaller nations relying heavily on debt to finance growth) fuelled exports in a "producing" group of countries mainly encompassing economies in East Asia, as well as Germany, Japan and oil producing nations. Figure 2 shows the clear division between these surplus countries on the one hand and deficit nations like the United Kingdom and the United States on the other. However, the accumulation of huge current account imbalances could not go on forever.

The financial crisis was the catalyst for the process of global rebalancing, but the underlying demographic and economic trends which are fuelling this development have been in place for some time. With the maturing of emerging nations, financial power and consumption is increasingly shifting from West to East – or more accurately from aging industrial nations to emerging industrial powers in Asia, South America and Africa. These economies are morphing from being the world's workbench to being its sales booth. In China and India alone, about two billion new middle-income consumers are expected to join the consumer base in the next 20 years (see figure 3).

Figure 1: A World Transformed



In 2010, China passed Japan to become the world's second-largest economy behind the United States. The OECD estimates that

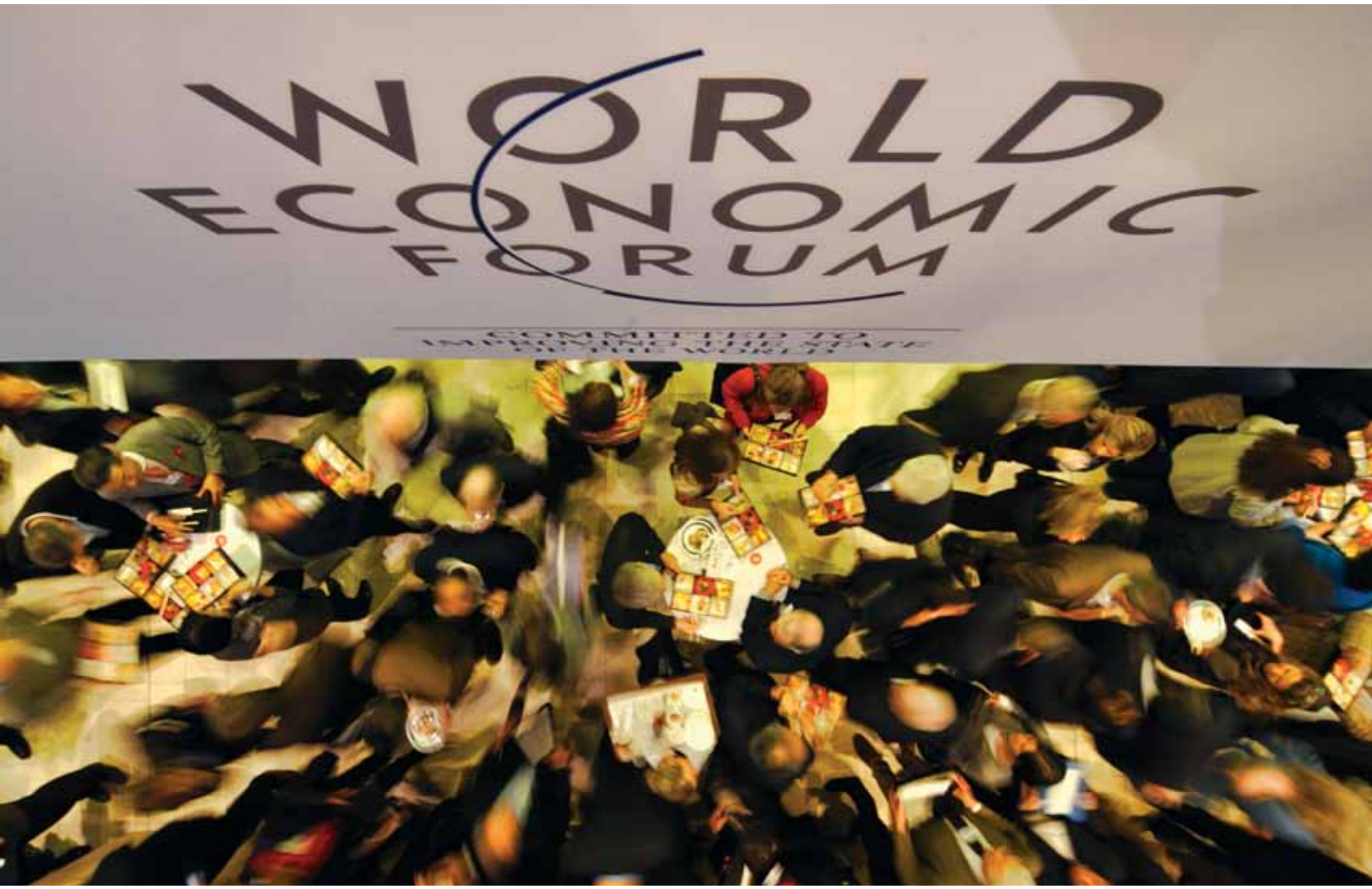
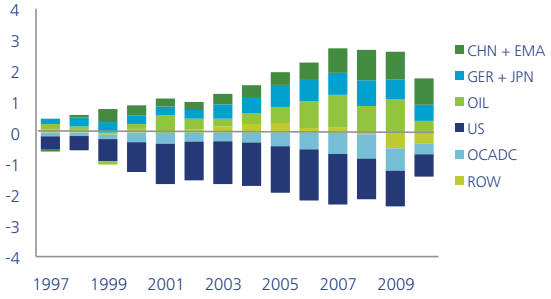
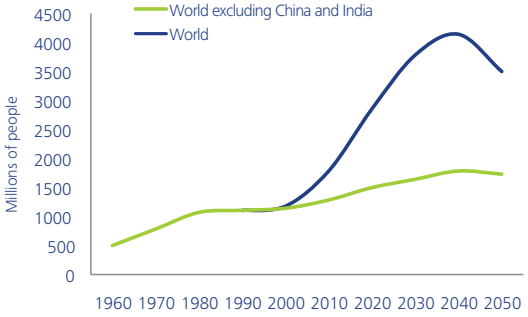


Figure 2: Global Imbalances (Current account balance in percent of world GDP)



Source: IMF; CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Taiwan Province of China, Thailand. OIL: Oil exporters. OCADC: Other current-account-deficit countries. ROW: Rest of the World

Figure 3: Asia's Expanding Middle Class



Source: Goldman Sachs analysis (incomes between $6K and $30K in 2007 PPP)

by 2030 China will overtake the United States and account for almost a quarter of world GDP. With a per capita income similar to that of Western Europe in 1990, China is still lagging behind the wealth of the United States but it will play a significant role in the world economy. It is expected to share this power with the rest of the BRIC nations, which trend analysis predicts will by then have displaced the United Kingdom, France and Germany from the top ranks of the world's biggest economies.

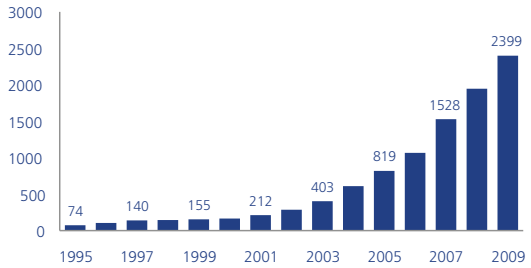
The transition will most likely not be smooth; it will be (and already is) accompanied by increasing protectionism and arguments over the appropriate level of exchange rates. Japan recently reinstated a zero interest rate policy in a bid to ward off deflation; China is artificially holding its currency weak in order to support exports and Western central banks continue to flood the world with cheap money to help pull their economies out of the post-recessionary slump. At the summit in Korea in November 2010, G20 leaders coined the phrase "currency war" to describe rising tensions in foreign exchange markets; the arguments are likely to continue for some time.

(2) Public versus Private

The shift of global economic power to nations with strong state influence has also renewed the debate about the role of government in a free market economy. During the financial crisis, western nations were compelled to abandon their laissez-faire approach to capitalism and – with systemic contagion threatening – take stakes in private companies ranging from banks to car producers. In addition to billions spent on direct investments, governments set up funds of unprecedented magnitude to secure loans and guarantee bad debt – be it of banks, corporations and individuals (US Troubled Asset Relief Program, TARP) or governments (European Financial Stability Facility, EFSF). Governments are by now eager to exit from these involuntary involvements – a development accelerated by the pressing need for fiscal consolidation. However, finding the right arrangement is not always easy.

On the other side of the world, a different kind of transition is taking place. China continues to morph from state communism to a kind of "state capitalism", nurturing home-grown multinational champions that are shooting up the Fortune Global 500 list. And the Chinese government can be generous: with its centrally-planned economy, export success and managed exchange rate system, China has filled its coffers in recent years. The country's foreign exchange reserves have tripled since 2005 and the latest count stands close to $2.5 trillion (see figure 4).

Figure 4: The Financial Power of China
FX Reserves China ($bn)



Source: State Administration of Foreign Exchange, China

Western governments are now finding themselves faced with eager bidders from China, Russia, India, Brazil and other emerging nations as they plan the exit from their private sector engagements. "Being eaten by the dragon," headlines *The Economist* with its briefing on Chinese takeovers in the November edition; it concludes that, in order to address other countries' concerns about political control, China may have to loosen its hold on state-owned companies and yield power to a new generation of Chinese executives with international education and experience. Change is approaching, and Western governments and corporations are adjusting their strategies to respond to this new competitive reality. Bilateral and multilateral ties are being strengthened at official levels and the private sector continues to explore options for cooperation and joint ventures.

(3) Markets versus Regulators

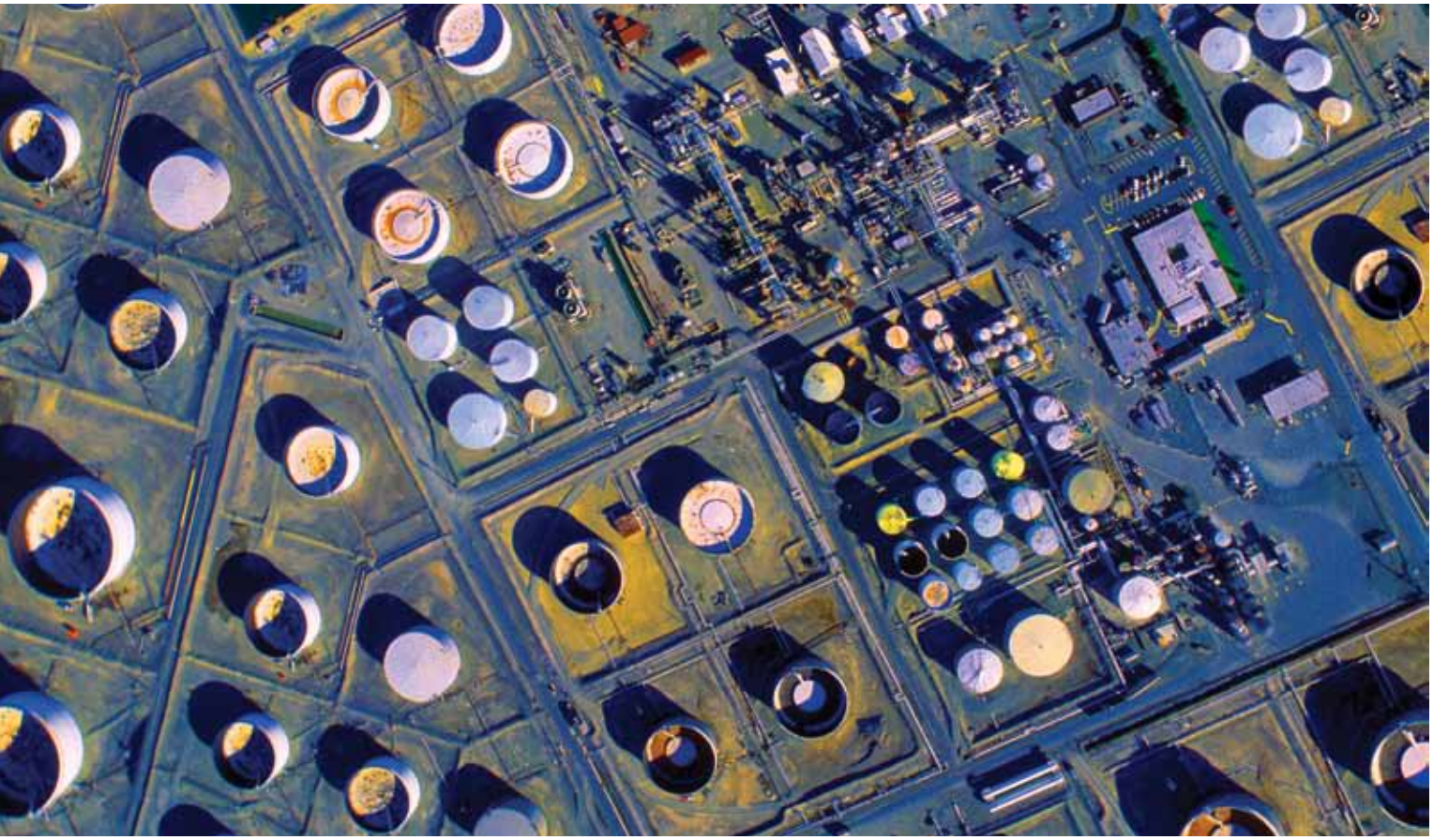
Related to the debate on state control over assets is the question of government involvement in regulating the markets themselves. Not surprisingly, the crisis has put the spotlight back onto what constitutes the minimum standard and appropriate level of regulation for global financial markets. But the debate has extended beyond off-balance sheet conduits and complex derivatives to fundamental issues of international accounting standards, capital require-

ments for banks and insurance companies, as well as the role of national and supra-national agencies as enforcers. Governments are rethinking their role as guardians of transparency and compliance for private entities.

In the European Union, the drive toward more regulation is in full swing. However, there is a danger that politicians could get carried away and overcompensate in their urge for safety. As Edmund Stoiber, former minister-president of Bavaria and now chairman of the EU High Level Group of Independent Stakeholders on Administrative Burdens, put it: "Politicians have a tendency not to be satisfied with the use of a strong belt; better to also fasten suspenders and, just in case, rely on a couple of safety pins in addition." Faced with the increasing complexity of a globalized world, regulators have to weigh their national agendas against the need for international coordination. In some cases, cross-border cooperation in the establishment of international standards is necessary; other issues – such as the enforcement structure and role of national agencies – will need to be solved on a country-by-country basis against the backdrop of different legal frameworks.

(4) Energy demand and Sustainability

Energy policy is one field where many see government regulation and multilateral agreements as a necessary tool to push markets in the right direction. Rapid industrialization and rising standards of living in the developing world are likely to put enormous strains on natural resources in coming years: Roughly 60,000 km of expressways have been built in China over the past decade and current plans envisage a network of 85,000 km by 2020, exceeding America's 75,000 km of Interstate roads. With over 13 million new cars sold annually, China has become the



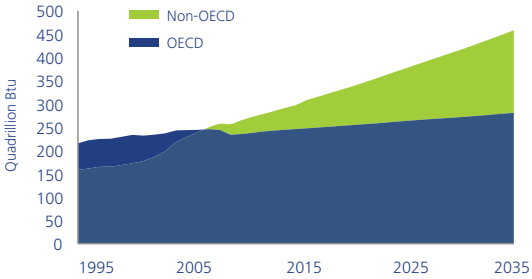
world's leading automotive market. In just 10 years, China has gone from being the world's 20th largest oil consumer to being its 2nd largest.

According to current predictions by the US Energy Information Administration, global energy consumption will rise by more than 50 percent over the next 20 years, driven mainly by the rapid industrialization of the developing world. Global CO_2 emissions are predicted to rise along with energy use or even faster, since most of the growth in usage will come from countries with low energy efficiency and a lag in the development of clean technologies.

While the Kyoto protocol was a first step in the direction of a coordinated response to rising emissions and global climate change, progress since has been mixed.

Nevertheless, the transition to a low-carbon society has started and looking at the underlying fundamentals, it is clear that much more lies ahead. To make room for an extra 2 billion consumers by 2050, the global society will

Figure 5: Global Energy Consumption



Source: EIA International Energy Outlook 2010

have to adapt to a more sustainable way of life; carbon resources are limited and energy efficiency is currently not high enough to sustain the passage.

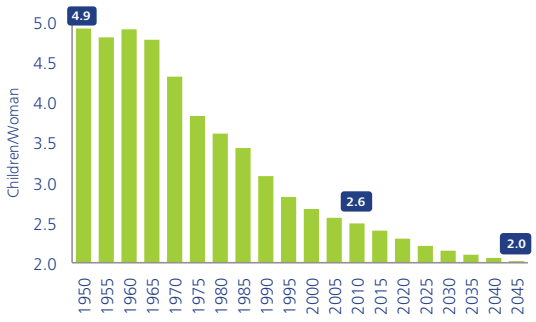
To ensure energy security against targeted growth, governments have various policy instruments at their disposal, ranging from an acquisition strategy of natural resource deposits to encouraging the development of alternative energy sources through incentives (clean development mechanism), penalties (carbon tax) or the introduction of new laws. Whatever the mix, the result will most likely be rising energy costs over the next decades. Companies have to prepare for this reality in the context of differing national approaches, which in some cases can lead to competitive distortion.

(5) Young versus Old

Some might argue that resource and environmental problems will solve themselves over time, albeit a very long time of 50 to 100 years. That is because, historically, when living standards have risen (as they are now doing in the developing world), population growth tends to decelerate. The global fertility rate has already dropped by half in the past 50 years – the average of 5 children per woman fell to 2.6 in 2009 and is projected to dip below the so-called "replacement level" of 2.1 by mid-century (see figure 6).

In some ways, a falling fertility rate in developing nations is a welcome development – population growth levels off and per capita income rises. Unfortunately for taxpayers, people also tend to live longer when they grow richer. After the so-called "golden generations" with young, but no longer unduly fast-growing populations as currently experienced by emerging powers like India, the next phase is a reversal of the population pyramid: Societies will age. In the industrial world, this is already happening.

Figure 6: Global Fertility Rate



Source: UN population projections

Germany, one of the most affected nations, is expected to lose one-third of its workforce – approximately 15 million workers – over the next 30 years; by 2050, a third of its population could be over 65 years of age. This kind of change can be discussed in theory, but no one has lived through anything like it in practice. It will fundamentally change the way we work and live – and it will be wise to prepare for this new reality soon. Governments will have to consider raising taxes and limiting spending on non-retirement programs, or allow for a gradual increase in the retirement age and more immigration; companies need to focus on keeping older workers attached to their workforce and being able to leverage a global talent pool. Whatever the actions taken, demographics over the next couple of decades will favor nations with young and growing populations like India, the Middle East and Africa.

(6) Conformity versus Individualism

Finally, a trend worth highlighting because it transcends all the developments above: the move towards a data-based, connected and transparent society. As economic and socio-political shifts combine with the use of transformational technology, we are experiencing an exponential rise in the power of information. Billions and billions of bytes worth of data – Mega (10^6), Giga (10^9), Tera (10^{12}), Peta (10^{15}), Exa (10^{18}), Zeta (10^{21}) and the alphabet game continues – are collected worldwide and processed to find every possible correlation.

In Germany, the Leibniz Supercomputing Center is being built to provide services to the scientific and academic communities in Europe; but even with its processing capacity of over 3 petaFLOPs (one petaFLOP is the equivalent of a quadrillion operations per second), the supercomputer will likely not make it to the world's top spot when it goes online in 2012. Two US laboratories are currently working on developing 20 petaFLOP versions. This highlights the incredible speed with which information processing capacity is evolving – it was only in October 2010 that China's Tianhe-1A (Milky Way) computer took the top spot with 2.5 petaFLOPs.

> "A company's brand is not what the company says it is, but what Google says it is. [...] Word of mouth is now a public conversation. [...] The ants have megaphones."
>
> — Chris Anderson

The race towards more processing capacity also relates to the above-mentioned topic of energy consumption. With its rapid development of server capacity, IT is emerging as one of the fastest-growing energy consumers and energy efficiency gains from the use of green IT are opening new service industries. The Supercomputing Center in Munich, for example, uses the heat generated by the servers to warm the rooms of neighboring buildings and the specially developed cooling system can lower energy costs by over 50 percent.

In this age of transformational technology, the rise in processing power and capacity is leading to more data being stored – including information about customer preferences and purchases, to web searches and phone calls. This has some important implications: First, the volume of information, its speed and reach, is raising levels of public awareness across the globe and is leading to greater demands for transparency. Companies (and governments) should be prepared to not only accept, but also anticipate and participate in this trend. As Chris Anderson put it, "A company's brand is not what the company says it is, but what Google says it is. [...] Word of mouth is now a public conversation. [...] The ants have megaphones."

At the same time, the data deluge is also forcing companies and individuals to deal with an ever-increasing flood of information, so those with the analytical skills (and technologies) to extract the important bits and pieces are at a clear advantage.

Conclusion

As governments, businesses and individuals deal with these global transformations in coming decades, finding a common ground and workable solutions will require close cooperation and international coordination. Or – as the

World Economic Forum puts it – "Key to navigating the new reality will be shared norms that not only transcend differences across generations, stakeholder groups and geographies in a multi-polar world, but also enable inclusive growth."

Politicians will likely be compelled to expand their thinking far beyond their election terms in order to master the rebalancing of budgets, and the unwinding of stimulus and private sector engagements. They will need to plan for demographic changes in pension and health care, and foster international collaboration and cooperation in a changing geo-political environment. Redesigning the regulatory framework, enhancing transparency and ensuring energy security while driving sustainability are just a few of the challenges ahead.

Businesses will likely continue to restructure in order to improve their cost position and intensify their focus on corporate governance. Between strategic outsourcing and off-shoring, supply chains, alliances, partnerships, and other growth arrangements, the definition of the enterprise has changed, resulting in considerable business portfolio upheaval. In a changing world, the challenge will be to keep pace with the markets of the future and leverage a global workforce to promote greater cultural diversity and nurture future leaders.

It is a tall agenda, but it offers plenty of opportunities for leaders with foresight.

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USA

United States: The case for cautious pessimism

by Dr. Carl Steidtmann

The year 2010 closed on a note of economic optimism as President Obama and Congressional Republicans agreed to a tax compromise bill that will keep current tax rates unchanged while giving businesses a few extra incentives for investment in 2011. A temporary reduction in the Social Security tax on wages will give consumers a little more spending money as well. The real economy is showing some signs of life: Jobless claims are coming down; holiday consumer spending was strong; manufacturing continues to post solid growth and corporate profits are at record levels.

At the same time, leading financial indicators point to stronger growth as well. The yield curve in the US Treasury market, which has a solid forecasting record, has steepened in recent months. A steeper yield curve is a proxy for bank margins. As bank margins widen, bank lending tends to increase. As credit creation picks up, that usually drives an improvement in growth. The US stock market, while not always a perfect leading indicator, is also pointing to stronger growth. The S&P 500 posted a 6.5 percent gain in the fourth quarter of 2010 and a gain of 13 percent for the year, driven in part by the strong growth in corporate profits.

A little good news was welcome after a year of sluggish growth and high unemployment. That good news has led to the highest level of bullish stock market sentiment since the summer of 2004. It has also prompted most Wall Street economists to raise their forecasts for 2011 and to estimate that the economy will more likely outperform their raised forecasts. This kind of consensual group think is almost always wrong.

While many reasons have been given for the subprime nature of the recovery, the role of uncertainty has been a central theme. With tax rates set for at least the next two years and the likelihood of any major sweeping reform remote, it would be easy to conclude that uncertainty is no longer an issue. That conclusion would also be wrong.

While fiscal and monetary policies remain stoutly stimulatory, a number of fundamental challenges remain. The biggest source of uncertainty in the coming year surrounds state and local government finances, job creation, energy prices and the state of the housing market. In each instance, there is a strong case for pessimism.

State and local government finances are dismal

Much has been made out of the fiscal problems of state and local governments. To address these problems, voters have sent 27 new governors to their respective state capitals, bringing with them new staff and new ideas on how to address these issues.

Since the recession started in the fourth quarter of 2007, state and local governments have spent roughly $500 billion more than they have received in tax revenue. The shortfall was made up by $160 billion in subsidies from the federal government that was part of the 2009 stimulus bill. The balance of $344 billion has been borrowed. In many cases, borrowing has been done to cover unfunded pension and health care liabilities. While such liabilities have been treated as long-term capital requirements, they are really operational expenses that many states were able to delay paying as a way of balancing their budgets, putting another liability on their balance sheets and putting off the day of reckoning… which has now arrived.

The state of Illinois covered its pension obligations this year by issuing $4.1 billion in pension obligation bonds. As a result, many capital projects are being put on hold or cancelled in order to keep the overall level of borrowing down. That is what New Jersey was recently forced to do with the project to build a second rail tunnel under the Hudson.

Over the next year, the borrowing needs of states will remain high as federal government support is removed. On the plus side, tax receipts have rebounded over the past year. An improving economy will continue that trend. At the same time, state and local governments have already started the hard process of cutting costs. Since peaking in 2008, local employment has dropped by 380,000. The states have actually made small additions to employment.

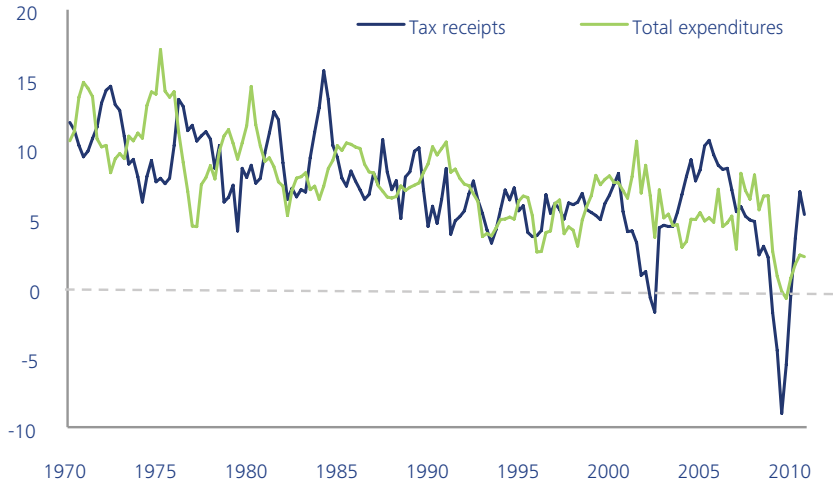
As a result of these changes, state and local governments ran a $26 billion surplus in their current accounts over the course of the past year. With more cuts expected, the reduction in costs coupled with the rise in tax revenues will reduce the deficit gap for most state and local governments in the short run – as has been the case in every recovery over the past 40 years with the notable exception of the 1990/91 recession, other things being equal.

Unfortunately for the states, not everything will be equal in 2011. In order to receive part of the $160 billion handed out by the federal government in 2009, states had to agree to maintenance of eligibility requirements that will make it difficult for them to cut back on Medicaid spending going forward. Even before health care reform was passed, Medicaid made up 21 percent of all state spending. The federal government actuary for Medicare and Medicaid has estimated that Medicaid spending by the states will increase by 41 percent between 2010 and 2011 as a result of health care reform. By pushing Medicaid up to 30 percent of all state spending, last year's health care reform act will make Medicaid the states' top spending priority, exceeding even education.

While the short-term fiscal problems of state and local governments are challenging, the longer term fiscal problems are much more serious. Numerous studies of state and local finances have come out over the past year. While there is a wide variance among the different studies as to how deep the fiscal problems of the states are, there is wide agreement that the problems are deep, structural and tied to underfunded pension and health care liabilities. Given the recent shift in power in the federal government, it is unlikely that we will see the kind of federal subsidies that helped the states through the recent recession.

In a study published in 2010, the Pew Center on the States found that unfunded health care and other non-pension benefit liabilities for state and local governments was $587 billion as of 2008. Unfunded pension liabilities were $1 trillion. The researchers who developed this analysis estimated that

Figure 1: State and Local Government Tax Receipts and Expenditures
Annual % change



Source: Bureau of Economic Analysis

the shortfalls are even greater today, given the losses these funds took during the recession.

A second study, done by the Private Enterprise Research Center at Texas A&M University using a lower discount rate than the one used by Pew, concluded that unfunded liabilities from state and local government health care and pension promises amounts to $3.1 trillion. That comes to roughly $27,500 for every household in the United States.

Whether the shortfall is $1.6 or $3.1 trillion, it represents an unprecedented fiscal and legal challenge. In most states, these shortfalls are contractual liabilities that have been written into union contracts. In some cases, like California, the pension obligations carry the weight of a state constitutional guarantee.

While short-term finances will improve in aggregate with the economy, that improvement will come with painful reductions in spending and headcounts. In past recoveries, government spending and hiring gave a lift to the private sector. In this recovery, due to the structural problems that state and local governments face, this sector will be a drag on future growth.

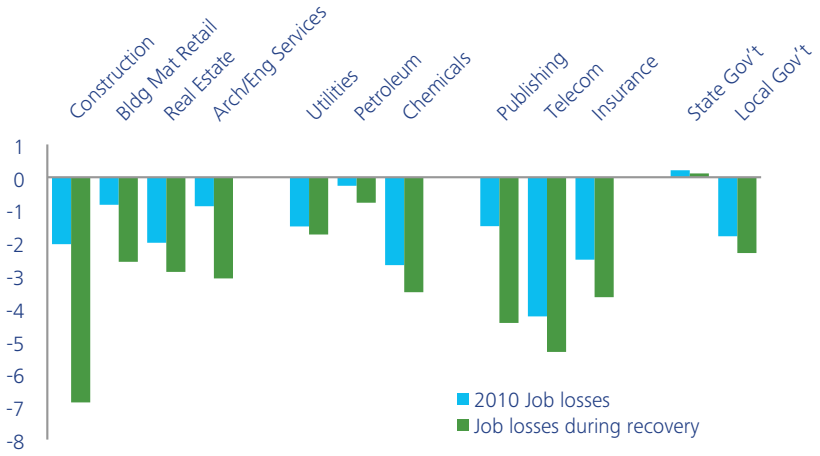
Job creation will continue to lag

The labor market is traditionally a lagging indicator of the economy and that has certainly been the case in this recovery. Despite nearly 18 months of economic growth, non-farm payroll employment has grown by a very modest 951,000 since hitting bottom in December 2009 and has actually lost 101,000 jobs since the recovery started in June 2009. Were the economy to add 200,000 jobs a month, it would take until the year 2020 to get the unemployment rate back below 6 percent. Even that pace of job growth is not likely any time soon.

In addition to state and local governments, there are several other key sectors of the economy where employment is still falling and will continue to do so in the coming year. Together, these industries employ roughly 35 million workers, slightly more than 25 percent of the entire labor market. These industries are:

- Construction
- Building materials retailing
- Real estate
- Architects and engineering services
- Utilities
- Petroleum
- Chemicals
- Publishing
- Telecommunications
- Insurance

Figure 2: Job Losses by Industry (YoY %)



Source: U.S. Department of Labor

Collectively, these contracting segments of the economy shed 565,000 jobs in 2010 and have given up 1,061,000 jobs since the recovery started in June 2009. With some of these sectors like construction and state government poised to accelerate their job losses in 2011, a strong case can be made that total employment growth is going to continue to be weak in the coming year and the unemployment rate is likely to rise.

The US economy lost 8.3 million jobs during the 2007-2009 recession. Since the beginning of 2010, the economy has added back 951,000 jobs. At the current pace of recovery, total employment will be back to its December 2007 peak by late 2018 and, even then, the unemployment rate will be higher than it was in December 2007 due to growth in the labor force. Lacking sufficient

Were the economy to add 200,000 jobs a month, it would take until the year 2020 to get the unemployment rate back below 6 percent. Even that pace of job growth is not likely any time soon.

job growth to produce a falling unemployment rate, the economy will not have the means to make the recovery self-reinforcing.

Energy prices

Rising energy prices have brought more than one US recovery to a halt. While the financial crisis was the focus of attention in the last recession, oil prices spiking to $147 a barrel in the summer of 2008 were an important if overlooked contributing factor.

After falling to $39 a barrel, oil prices have climbed back above $90. Rising oil prices act like a tax on both businesses and consumer spending. Recent changes in ethanol regulation coupled with further restrictions on off-shore drilling will increase the cost and reduce the

Figure 3: Total Petroleum Costs
As a % of GDP

Source: St Louis Federal Reserve, Bureau of Economic Analysis, and Energy Information Agency

supply of petroleum-based energy in the United States. A weaker dollar coupled with continued solid growth in the developing world points to a healthy growth in demand. The combination of higher domestic costs and stronger foreign demand points to higher prices for oil. There are a different set of constraints working outside of the United States. In many energy-rich markets like Venezuela, Nigeria and Iran, investment in the petroleum industry is severely lacking due to political instability. As a result, we could see further declines in oil supply from these exporting regions of the world.

The tipping point for rising oil prices has historically been when the total cost of petroleum exceeds 4 percent of GDP. The recessions of 1973-1974, 1980-1982 and 2007-2009 all saw oil price spikes that took petroleum's share of GDP above 4 percent and contributed to recession. When the total petroleum cost fell from 8.9 percent of GDP in 1980 to 4.5 percent in early 1983, it provided additional support for the recovery. The second leg down in 1985 to 1.9 percent helped to extend the recovery. The steady decline in oil expenditures throughout the 1990s contributed to the strength and longevity of that recovery. With oil prices at $90 a barrel and the GDP share going to petroleum hovering at 4 percent, the economy is at risk for an energy shock in 2011.

The housing market's second leg down

Housing was at the heart of the 2007-2009 recession. Lax lending practices were justified on the grounds that home prices could never fall on a nationwide basis. When prices did fall, it led to a wave of mortgage defaults and widespread bank losses. Over the past year, home prices have stabilized as efforts to revive the housing market through home buyer tax incentives have brought a significant amount of future housing demand into the present.

At the same time, problems with the foreclosure process have kept some of the supply of bank-owned real estate off the market. As both of these developments reverse, supply is going to increase while demand will lag. As a result, the housing market faces the risk of a second leg down.

Figure 4: Home Prices in Major Metro Areas
(YoY % change, October 2010

Source: Standard and Poor's

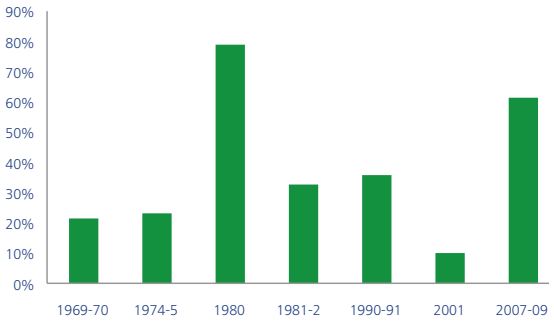
Over the past year, home prices have fallen in 16 of 20 major metropolitan markets as measured by the Case-Shiller Home Price index. The pace of the price decline has also accelerated in recent months.

The negative effects of declining home prices are broadly felt throughout the economy. Declining home prices reduce household wealth and have a dampening effect on consumer spending. By putting more mortgages under-water, declining home prices increase the risk of more home mortgage defaults. Falling home prices hurt the value of the bank-owned inventory, resulting in greater losses to the banks. By creating the fear of future capital loss, declining home prices have a perversely negative effect on home purchases as potential buyers wait until prices stop falling.

The inventory buildup is over

Every recovery gets a boost from inventory building. The business cycle is a reflection of the inventory cycle in many ways. As a recession takes hold, businesses stop production and sell off inventory. In the last recession, the

Figure 5: Inventory Rebuilding as a Share of GDP Growth
First five quarters of recovery



Source: Bureau of Economic Analysis

reduction in inventory added to the length and the severity of the downturn. When recovery does come, businesses have to rebuild inventories, adding to the strength of the rebound.

Over the first five quarters of recovery, just over 60 percent of GDP growth has come from a rebuilding of inventories. This is the second highest contribution to a recovery by inventories in the past forty years. Only the rebound from the short-lived 1980 recovery saw a greater contribution.

Businesses do not have to start cutting inventories for this component of GDP to begin to have a negative effect on the economy. They simply have to slow down their pace of inventory accumulation. Slower growth in inventory accumulation will have a drag on top line GDP growth in 2011. As a result, one of the sources of strength in the recent recovery will, in 2011, turn into a drag on growth.

Conclusions and observations

We enter the new year on a note of much needed optimism. Fiscal policy at the federal level remains very stimulatory. At the same time, the Federal Reserve's policy of quantitative easing is putting more money and stimulus into the banking system. The stock market has turned in a strong performance and the slope of the yield curve in the US Treasury market is very steep. All are good reasons for optimism about 2011.

And yet, there are real reasons for concern that the coming year may not turn out as well as many are hoping. The finances of state and local governments face multiple challenges. Health care reform will add to the states' Medicaid obligations. Unfunded benefit obligations will make the states' longer term fiscal challenges seem daunting. The loss of federal government subsidies will add to their fiscal imbalances.

While job growth has returned, a significant portion of the labor market faces challenges that are likely to keep overall employment growth muted, making it difficult for the recovery to become self-reinforcing. Lacking employment growth, the unemployment rate is likely to rise over the year, putting a damper on consumer confidence and spending. Rising energy prices will add to the problems faced by consumers, reducing the growth of consumer spending.

Given the increase in the supply of foreclosed houses, the scarcity of home mortgage financing and the weakness in demand, home prices are set to fall in 2011. Declining home prices will hurt both bank and household balance sheets. Inventory rebuilding gave a significant boost to the recovery in its first five quarters. Over the next year, that important source of stimulus will be very much lacking. Without it, real GDP growth will suffer.

Any one of these challenges would not be enough to derail a recovery. However, taken together, they represent enough of a challenge to the US economy to make an objective observer cautiously pessimistic about the outlook for 2011.

CHINA

China: Balancing Act

by Dr. Ira Kalish

China, as always, is at a crossroads. On the one hand, inflation is becoming a problem and the government is taking measures to restrain price increases. On the other hand, the government is attempting to protect the competitiveness of exporters by restraining the appreciating currency. Yet in doing so, it exacerbates the problem of inflation. The government therefore faces a difficult balancing act. The way that China handles this will, in part, determine the country's economic path in the coming year.

Inflation rising

The Hyperlink Research Consumer Sentiment Survey dropped precipitously in November to levels not seen since the global financial crisis. A rising expectation of inflation was the principal reason given for the decline. Separately, the People's Bank of China reported that its survey of households in the fourth quarter indicated the worst level of price satisfaction since 1999. Clearly, China's consumers are concerned about where their economy is heading, with particular focus on the stability of prices.

Are consumer concerns warranted? The answer is that there has indeed been a dramatic change in the inflationary environment. A year ago, China was experiencing deflation. Now things are different. Consumer price inflation in China was 5.1 percent in November on a year-over-year basis. The main culprit was food inflation which was 11.7 percent, while non-food inflation was a very modest 1.9 percent. Producer price inflation was 6.1 percent in November.

Interestingly, the food price increases represent a transfer of wealth from urban to rural China. For the country's roughly 600 million rural residents, food price inflation is equivalent to a pay increase that serves to reduce the country's grievous income inequality, one of the government's goals. Indeed, in the first three quarters of 2010, household incomes in rural China grew more rapidly than in urban areas. On the other hand, urban wages are nonetheless rising rapidly, owing in part to a labor shortage created by inadequate migration from rural areas. Also, every provincial government in China has increased the minimum wage with the largest gain taking place in Beijing. Thus, many urban workers are able to absorb the food price increases without reducing other forms of spending. In addition, despite higher growth in rural China, urban household incomes remain roughly three times higher than rural incomes. Thus, there is a long way to go to correct the inequality.

As for inflation, it is seen as the lagged result of rapid money supply growth over the past two years. In response to the global financial crisis, China engaged in massive monetary and fiscal stimulus. This was successful in moderating the drop in growth, yet it did lead to rises in consumer prices and even more onerous hikes in property prices.

The policy response

In light of concerns about rising inflation, the central bank increased the base interest rate in October and then again in December. It also raised the required reserve ratio (RRR) six times in 2010, including three hikes in the last thirty days of the year. By year-end, the RRR stood at 18.5 percent. In addition, the year-over-year growth of the broad money supply had dropped from 29 percent in October 2009 to 19 percent in October 2010 (still fairly high).

As wages increase in China's coastal cities and as the currency rises in value, many exporters are shifting production toward the interior of China where wages are substantially lower. This is especially true for low-value-added products such as textiles, apparel, footwear and toys.

Yet as China's trade surplus has grown, the desire to hold down the value of the currency means that the central bank has to issue currency in order to purchase dollar-denominated assets. This increases liquidity, offsetting the impact of a tightened monetary policy. In addition, the higher interest rates that resulted from the PBC's rate increase in October are attracting hot money from overseas. This is forcing further reserve purchases by the central bank in order to prevent the currency from rising in value. This means that unless the government allows the currency to rise in value, it will have difficulty reigning in liquidity expansion and, therefore, inflation. The question, now, is whether the government will choose to accelerate currency appreciation rather than accept the inflationary consequences of the current policy. Doing so would entail harming the profitability of many exporters.

Furthermore, although interest rates have been increased, the relatively high rate of inflation means that real interest rates remain in negative territory. Restraining credit growth will probably require positive real interest rates. So in effect, further rate hikes on the part of the central bank are likely in 2011.

One problem for policymakers, however, is that it is not clear that a serious inflation problem even exists. The inflation predicament is fueled primarily by food prices, which account for about one-third of the overall price index. It could be that, rather than facing a problem of overall inflation, China faces a shift in relative prices due to changing supply and demand conditions in the market for food commodities. If that is the case, then tightening monetary policy could be for naught.

Moreover, it could also be that the monetary tightening already undertaken in 2010 will be sufficient to cause a slowdown in inflation during 2011. After all, monetary policy always acts with a lag. Thus, monetary policy must be made with imperfect information and foresight.

Notably, GDP growth has been slowing. In the first quarter of 2010, GDP was up 11.5 percent over the previous year. By the third quarter, GDP growth had dropped to 9.6 percent. Such restraint on growth will remove bottlenecks, reduce excess demand and help temper inflation. In addition, the fiscal stimulus that was enacted during the financial crisis expired at the end of 2010. Thus, China faces a decline in public investment that will also reduce GDP growth. Notably, investment (including the public component) probably accounted for about half of the growth of GDP in 2010.

Another piece of evidence supporting the view that monetary policy is already working is the fact that property price inflation has subsided since early 2010. Given that property prices in China have tended to move ahead of consumer prices, this suggests that consumer price inflation could start to head down sometime in 2011 – even if monetary policy is not tightened further. On the other hand, a continued policy of holding down the currency could create more inflationary pressures.

Changing role of exports

Given China's reluctance to allow faster appreciation of the currency, it is worthwhile to examine the current state of China's export competitiveness. Although exports continue to grow at a rapid pace, the source of growth is quickly changing. In the first three quarters of 2010, while exports to Europe, the United States and Japan grew 35 percent, 31 percent and 24 percent respectively, exports to Brazil, Russia and India grew 90 percent, 75 percent and 40 percent respectively. While the latter three accounted for only 6 percent of China's trade, such rapid growth will ultimately render these countries important export destinations. Thus, China is moving toward more trade with other emerging economies.

Other aspects of China's exporting are changing as well. As wages increase in China's coastal cities and as the currency

rises in value, many exporters are shifting production toward the interior of China where wages are substantially lower. This is especially true for low-value-added products such as textiles, apparel, footwear and toys. Yet as this process unfolds, it is putting upward pressure on wages in the interior regions. As costs rise, it is likely that such production will start to shift out of China to lower-wage countries such as Vietnam and India. Meanwhile, China is expected to move up the value chain, producing higher-value-added products, more wares for the domestic market and more services rather than goods. Indeed, China's manufacturing industry is seeing a steady overall decline in employment as the economy becomes more service oriented – similar to the recent experience of more affluent economies.

Another aspect of the changing nature of China's economy is the continuing strength of the consumer sector. For example, inflation-adjusted retail sales have been increasing at a double-digit pace for the past year. However, as monetary tightening takes effect, especially affecting property values and property market activity, inflation-adjusted retail sales have decelerated slightly as increased inflation offset steady nominal sales growth. Still, at 12.9 percent real growth, the retailing industry continues to do quite well.

Debating the longer term future

While China's growth in recent years has been amazing, a consensus is developing that the type of growth China experienced cannot be sustained indefinitely. In recent years, consumer spending has shrunk from about half of GDP to about a third. Meanwhile, investment has grown disproportionately, accounting for nearly half of GDP. For example, in the first nine months of 2010, real GDP rose 10.6 percent while investment rose 24 percent.

The continuation of this situation could set the stage for a crisis in the future. Excessive investment in factories, office buildings and luxury apartments could lead to excess capacity, declining asset values and financial troubles for banks. When investment ultimately declines, it is not clear that consumer spending will step in and make up the difference. If not, China could face a serious decline in growth. This situation is not unlike what Japan experienced a generation ago when investment growth slowed. That led to a long-term decline in economic growth. This is not merely an academic issue. Instead, it has led to a public debate involving public officials. China's Premier recently said that "there is a lack of balance, coordination and sustainability in economic development."

Eurozone: United they stand, divided they fall

by Dr. Elisabeth Denison

Economic prospects of the Eurozone are improving. GDP projections range between 1 and 2 percent for 2011, driven in large part by exports and strengthening consumer and investment spending in core nations. But writing about the future of the Eurozone is by now as much a lesson in history and politics as in economics. The crisis of the past year laid open fundamental weaknesses in the structure of the union and authorities have not been idle. Over the past year, European politicians have taken steps that could radically alter the Eurozone's architecture and its future.

The North-South divide

There has been much talk recently about a break-up of the Eurozone. Scenarios range from an exit of one or more peripheral nations to a division into northern and southern Euro-states, to a complete disintegration with the re-introduction of national currencies. The latter idea can probably be discounted and exits of individual member states might be possible but seem unlikely (the legal and practical implications of this scenario were discussed in the *Global Economic Outlook* 2nd quarter 2010 edition, "The future of the euro: The case for coming out stronger").

But what about the North-South divide? A recent research paper by the American Enterprise Institute argues that strong countries might at some point refuse to rescue the weak and weak countries would start to rebel against austerity: "It would seem unreasonable to expect that voters in the Eurozone's north, and especially in Germany, will indefinitely acquiesce to the transfer of large amounts of bailout money to the Eurozone's south in an effort to keep those countries afloat. And it would seem even more unreasonable to expect voters in the south to indefinitely endure the severe economic and social pain associated with austerity measures attached to the financing they receive from the north."

The northern and southern Euro-states idea has been widely discussed in the media recently not least because the former president of the German Association of Industry, Hans-Olaf Henkel, is promoting the idea in his just published book. There are a couple of variations of the theme. Some would have Germany partner with Austria, the Benelux States and Finland for the northern Euro league, while France leads a southern Euro coalition including the Mediterranean States. Others suggest that the industrial nations at the core, led by Germany and France, form a currency union separate from weaker fringe nations which include the so-called PIIGS states (Portugal, Ireland, Italy, Greece and Spain).

Proponents of the North-South Euro idea argue that, in the absence of a domestic currency to replace, there could be no speculation (as has been the experience with dollarization in some cases) and weaker states would get the opportunity to devalue and gain in competitiveness relative to their stronger neighbors in the north. There are flaws in this structure, however. Countries with the softer currency (and weaker sovereign rating) would see their interest rate burden increase and face even more difficult financing conditions. Also, the South Euro would combine countries in a currency union which have little in common; their trade and economic links are mainly geared towards the north. Furthermore, if the exchange rate loss of the currency conversion is forced upon private debt holders, this is in effect nothing more than a hair-cut which could equally be negotiated as part of an official debt restructuring under the euro (it just needs the introduction of an official mechanism).

... without a federal government, there has been no framework for coordination of tax policy or budget processes. The crisis has exposed the cracks in the EMU's foundation.

More important than economic considerations are the political implications of a division. The euro's history is closely tied to the development of European unity in general. After a century of political tension between Germany and France, negotiations between the two countries resulted in the European Coal and Steel Community (ECSC) being established in 1950, only five years after the end of the war. The ECSC, which would create a common market for coal and steel, was Europe's first supranational agreement and was signed by France, Germany, Italy, Belgium, Luxembourg and the Netherlands. In the decades that followed, the drive towards economic integration continued. In 1985, the Schengen agreement eliminated many border controls and established the free movement of goods around the EU.

The creation of a single currency – launched with the signing of the Maastricht Treaty in 1992 – was the logical next step in securing the stability of the European marketplace. While the euro did not fulfill all criteria of an optimum currency area, the problem seems not so much its logic but the way it was implemented. The process, which was largely delegated to the European Commission, is seen by many as complicated and opaque. The structures created were compromises against the background of differing ideas about the necessary degree of fiscal coordination; without a federal government, there has been no framework for coordination of tax policy or budget processes. The crisis has exposed the cracks in the EMU's foundation.

Which way forward?

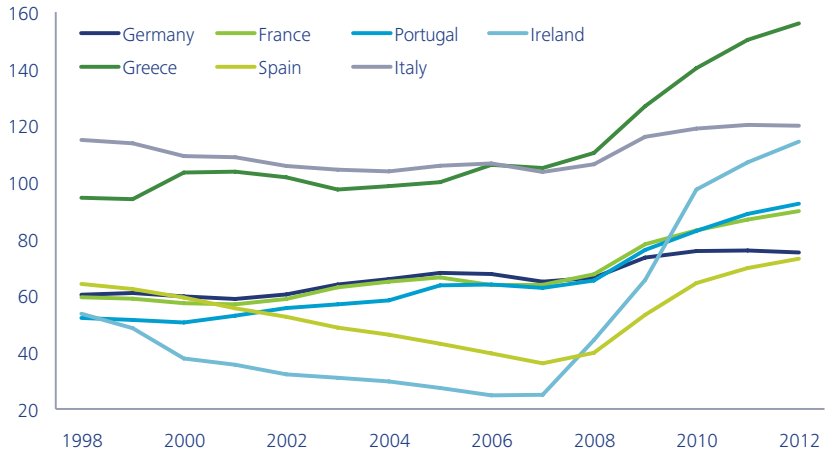
After the stop-gap measures and ad-hoc rescues of Greece and Ireland, it is clear that fundamental changes are needed in Europe. But ideas about what that should encompass differ. On one side, Germany and other net-savers are calling for policy adjustments in the periphery, aided by official financing arrangements as necessary, while others are arguing for various forms of fiscal federalism.

In the discussion of European integration, France has long pushed for a greater political union. At the EU summit in Brussels in December, French President Nicholas Sarkozy said "it is now necessary to go further and to make clear in the Eurozone the need for the convergence of economic policies." His finance minister, Christine Lagarde, told a German newspaper that "an economic government means seeking the approval of other states" before taking action. Her remarks were rejected by German minister of economics, Rainer Brüderle, who described the idea of a federal fiscal transfer union as "not a good plan," calling instead for a permanent protection mechanism for the single currency and sanctions against Eurozone members who fail to exercise budget restraint.

Such a protection mechanism could take the form of a permanent rescue fund for troubled euro nations or a common Eurozone bond that would allow financially weak members to pool their credit rating with stronger nations. Both options were discussed at the recent EU summit. However, the idea of a Eurobond was rejected by both Germany and France amid worries about the implied borrowing costs. Instead, a broad agreement was reached at the summit to establish a permanent rescue system (European Stability Mechanism, ESM) when the current $975 billion emergency fund runs out in 2013. Under the new system, as is the case with the current arrangement, financial assistance will be tied to the adoption of budgetary measures drafted by the EU's executive commission and the IMF. New strategies under the ESM include the envisaged participation of the private sector. Private investor contributions would depend on the seriousness of the crisis and range from an encouragement to hold on to investments in a liquidity squeeze to a rescheduling of debt payments in a restructuring if a government was deemed insolvent. The possibility that the private sector will be called on to bear some of the costs of financial rescues after the emergency net expires in 2013 has led to a rise in sovereign credit spreads; although most observers see it as the right step. "The way it was presented created confusion," said EIB president Philippe Maystadt.

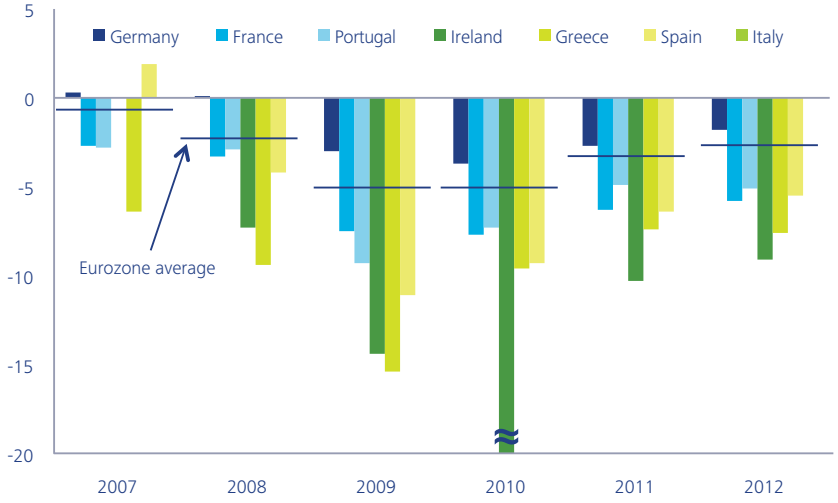
Whatever structural changes are implemented in Europe, peripheral countries will not be able to escape the need to carry out domestic reform. This will have to include regulatory efforts as well as budgetary consolidation. In Ireland and Spain, governments bore the cost of bailing out banks with insufficient funds after the real estate sector meltdown. Banking supervision and financial sector

Figure 1: Eurozone Government Debt
(Government debt % GDP)



Source: Eurostat and European Commission Autumn 2010 forecast

Figure 2: Eurozone Budget Outlook
(Government budget balance % GDP)



Source: Eurostat and European Commission Autumn 2010 forecast

oversight will have to be addressed there in addition to debt consolidation efforts. Other countries like Greece and Portugal borrowed excessively to fund their expansionary policies, prompting the need for a new approach to fiscal discipline. The latest European Commission (EC) forecast projects government debt of over 100 percent of GDP and a budget balance well over the Eurozone's average in several PIIGS nations (see figures 1 and 2).

The institutionalization of an official framework will help peripheral nations deal with accumulated debt, prevent the accumulation of such imbalances in the future and strengthen the cohesion of the Eurozone overall. In late October, a special EC Task Force outlined the strategy for more effective economic governance in the EU and the Euro area along five pillars:

(1) **Fiscal discipline**, notably through a stronger Stability and Growth Pact and a higher degree of rules-based decision-making for the adoption of enforcement measures;
(2) Broadening **economic surveillance** to encompass macro imbalances and competitiveness;
(3) Deeper and **broader coordination** with the introduction of a so-called "European semester" to allow a simultaneous assessment of both budgetary measures and structural reforms;
(4) A robust **framework for crisis management**;
(5) **Stronger institutions** and more effective rules-based decision-making.

The implementation of many of these recommendations will require the adoption of new legislation; policymakers will need to "fast track" this process if they want to ensure that necessary governance measures flank any new structures created (such as the ESM).

The implementation of changes will be helped by improving economic prospects for the Eurozone. Rising consumer spending – supported by the lagged effects of policy stimulus put in place during the crisis – is setting the scene for a gradual but sustained pick-up in activity. Growth projections for Germany have been ratcheted up in recent months as strong economic activity surprised analysts in the face of the fiscal crisis. The Ifo measure of sentiment hit a fresh record-high in December with the business climate index rising to 109.9 – the highest level

since reunification. Germany's economy will likely grow 3.5 percent in 2010, about twice as fast as the Eurozone as a whole.

However, the recovery of the Eurozone remains a story of two-speed growth. Peripheral countries continue to struggle. "There is an unexploited productivity potential in Europe if structural reforms happen," OECD chief economist, Pier Carlo Padoan, noted at the presentation of the organization's Euro area survey in December. "But, like any reforms, that requires political capital and it takes time."

Also, the health of the banking sector remains a concern. According to the ECB's recent Financial Stability Review, Eurozone banks will need more than 1 trillion euros in the next two years to cover maturing bonds, so capital markets will be crowded. "The volatility of European financial markets increased the uncertainty of the Eurozone economy," said Jean-Claude Trichet, president of the ECB.

The foundation for a sustained recovery in Europe will be laid with reforms and structural changes currently in the pipeline; they include consolidation of public finances after the deterioration of fiscal positions over the past three years, stronger enforcement of the stability and growth pact and a framework that sets out a pre-determined course to deal with any possible future crisis. Only with a stable structure will the common marketplace of Europe retain its economic voice in a tri-polar world between the Americas and Asia.

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Japan: Strong numbers may not last

by Dr. Ira Kalish

Japanese economic growth was surprisingly impressive recently. In the third quarter of 2010, the economy grew by 4.5 percent compared to a year ago, while year-over-year growth was 5.0 percent. The biggest contributors to growth were consumer spending followed by exports. Yet, prospects for quarter four and beyond are worrisome.

Japan's consumers

First, consider consumer spending. For most of 2010, nominal retail spending was growing at a rate of about 4 percent, boosted primarily by government incentives. Yet by October 2010, year-over-year growth was -0.5 percent, suggesting that fourth quarter consumer spending figures will turn out to be poor. The underlying reason is that government incentives for consumer spending expired at the end of 2010 and, as of this writing, will not be renewed in 2011.

What about consumer income? One of the big problems for Japan is that nominal wages have been declining for over a decade. In November 2010, for example, monthly wages were down 8.4 percent from one year earlier. In real terms, this represented a substantial drop. This partly explains the decline in the savings rate as consumers struggle to maintain spending by increasing the share of income consumed.

Another interesting aspect of declining wages is the fact that unemployment remains high. Free market enthusiasts have long argued that the solution to unemployment is wage flexibility rather than government intervention. In any market, an excess supply suggests that the price is too high. Yet as Japanese wages have declined, unemployment has remained stubbornly high since the start of the global crisis in 2008. As of October, the rate was 5.1 percent – relatively high by Japanese standards. Thus, a combination of high unemployment and declining wages bodes poorly for a boost to consumer spending, especially in the absence of government incentives.

Exports

Second, consider Japan's export market. More than half of Japan's exports are now capital goods rather than consumer goods. Many such products are exported to China, thus taking advantage of China's gargantuan investment spending. Yet China's government is currently tightening monetary policy with the aim of slowing economic growth, especially the growth of investment. Naturally, a slowdown in Chinese growth is likely to hurt Japan.

As for Japan's non-capital goods exports, a disproportionate share consists of electronic products – especially consumer electronics. Weak demand in developed

economies combined with increasing competition from Korean, Taiwanese and Chinese producers will probably hurt the growth of Japan's exports in the coming year.

Moreover, the Japanese yen is currently considered overvalued, having increased in value since 2007. This has a deleterious effect on export prices as it tends to make exports more expensive. For those exporters who choose not to raise prices, the high-valued currency has a negative impact on profit margins. Either way, exports are hurt by the currency's value. This is not likely to change unless monetary policy becomes more aggressive or unless Japan starts to have inflation. Although the Bank of Japan intervened in September to suppress the value of the yen, only a major shift in monetary policy is likely to have a lasting impact on the yen. One problem with deflation is that, even with very low interest rates, the Japanese yen is attractive since it preserves its value. A small amount of inflation could lead to currency depreciation.

Thus, the two mainstays of recent Japanese growth, consumer spending and exports, face serious headwinds. Consequently, the relatively strong level of business investment that took place in 2010 is not likely to be sustained in 2011. Business sentiment, as evidenced by the Tankan Survey, is ebbing as companies expect consumer and export growth to be curtailed in 2011. Industrial production is, consequently, already decelerating.

The role of policy

Given Japan's challenges, is it possible that economic policy will help to boost growth? First, consider monetary policy. Although the central bank is now in an aggressive stance (having implemented a new dose of quantitative easing), the interest rate on 10-year government bonds remains above 1 percent and has risen lately. Hence, the real interest rate is in positive territory at a time when it would be helpful for it to be low or negative. The modest size of the quantitative easing has not yet produced the kind of liquidity increase needed to boost the economy. A successful policy of QE would likely result in higher inflation, higher asset prices, a lower currency value and more rapid money supply growth. Almost none of this has happened – at least not yet.

On the positive side, however, deflation is abating. For the past two years, prices were declining. Yet as of October 2010, prices were up 0.2 percent year-over-year. Moreover, this shift in inflation could lead to expectations of higher inflation. That would be a plus as it could mean lower real interest rates (nominal rates minus expected inflation).

Hence, the jury remains out as to whether monetary policy will significantly boost economic activity.

As for fiscal policy, Japan already has the highest level of government debt as a share of GDP among major developed nations. It is now roughly 200 percent. The imperative of restraining the buildup of debt reduces the scope for stimulatory measures. That being said, the Parliament did pass a supplementary budget of US$60 billion in 2010 that will likely have some positive impact on growth in the first half of 2011. Still, $60 billion is a relatively small share of GDP. Moreover, fiscal policy going forward is likely to be more conservative, thus having a negative impact on growth. In addition, if consumers expect future tax increases in order to close the budget gap, this could have a negative impact on spending.

Conclusion

It now appears that Japan's economic growth in 2011 will be markedly slower than the strong performance of 2010. While deflation may abate somewhat, it does not appear likely that Japan will experience the level of inflation required to boost spending, push down the yen and increase credit demand.

Siddharth Ramalingam is a Senior Analyst at Deloitte Research, India

India: Old wine, new bottle?

by Siddharth Ramalingam

A new year, but a familiar story – India's economy continues to pitch ahead, albeit with several hurdles on the horizon. Inflation will likely continue to challenge central bank authorities as they struggle with setting the optimum interest rate that will push back inflation and at the same time not stifle growth. Domestic demand is expected to continue to hold the key to broad-based growth. Policy implementations in the first half of 2011 could go a long way in strengthening the manufacturing and export sectors, and boost growth prospects in the long term.

Blame it on the onions and the middle class

Food price inflation has been at the center of Indian policy decisions in the last year. In mid-2010, much hope was placed on the monsoons to bring soaring food prices down. A successful monsoon, for a moment, promised to rein in inflation. However, supply-side bottlenecks and untimely rains in the last quarter of the year have threatened to launch inflation into orbit once again. In October, inflation began to wane from the 13 percent level, only to climb back up to 14 percent in December. The latest rise in consumer prices has been ascribed to the rise in the cost of onions; unseasonal rains have led to massive crop failures. The finance minister has also linked food inflation to the rise in demand for cereals and pulses brought on by the rising incomes of India's vast middle class.

Food price inflation aside, fuel inflation and elevated commodity prices have begun to exert upward pressure on inflation and will likely continue to do so in the coming months. Petrol prices, which were de-regulated in June 2010, increased in December 2010, taking fuel inflation to 11.2 percent in December from 10.3 percent in November. Petrol prices were further hiked in January 2011; this will undoubtedly lead to a further increase in inflation.

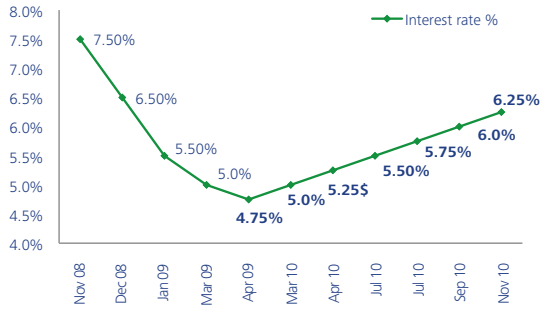
Headline inflation came in at 8.3 percent in December and is expected to be higher for January. Rising prices led the ruling government to constitute an inter-ministerial group

The latest rise in inflation has been ascribed to the rise in the cost of onions; untimely rains have led to massive crop failures. The finance minister has also linked food inflation to the rise in demand for cereals and pulses brought on by the rising incomes of India's vast middle class.

(IMG) under the aegis of the Chief Economic Adviser in January. The IMG has been charged with the responsibility to read warning signals and prevent future price spikes. Short-term measures announced by the government include the sale of onions at prices below the current market level by select government agencies, and the purchase and allocation of essential commodities through government distribution systems. The government will also regularly review the import and export of all essential commodities, and tweak policies on an on-going basis to keep prices from getting out of control. Long-term measures announced were largely related to removing supply-side bottlenecks that plague the agricultural sector.

The central bank, committed to controlling inflation, will very likely increase its interest rate in a calibrated manner during 2011. The central bank increased its interest rate six times in 2010 (figure 1).

Figure 1: Rising Interest Rates



Source: www.global-rates.com

Paving the way for a rate hike

With money being mopped up from the economy, largely due to a government auction of telecom wireless spectra and record sales of shares during the year, the Indian economy has been faced with a liquidity crunch for some time now. In its quarterly review of monetary policy in December, the central bank pledged to infuse liquidity into the economy. It reduced the SLR (statutory liquidity ratio) by 1 percent, releasing funds into the banking system in order to spur the growth of credit. The bank also unveiled plans to buy back about $10.6 billion worth of government bonds through open market operations. This infusion of liquidity in the economy paves the way for rate increases in the near future.

The road ahead for manufacturing

The manufacturing sector lurched back into double-digit growth in October as output at factories and mines rose 10.8 percent compared to 4.4 percent in September. Much of the surge was accounted for by consumer durables. This upswing reflects, to some degree, the seasonal increase in domestic expenditure on account of major Indian festivals. Although the purchasing managers index (PMI) for manufacturing fell to 56.7 in December from 58.4 in November, the manufacturing sector will likely continue to expand on the back of domestic demand and improving exports. However, the rising cost of capital and raw materials could adversely influence output in the coming months.

India's exports rose 27 percent to $18.89 billion in November while imports increased by 11 percent to $27.79 billion. This helped narrow the trade deficit for the month to $8.9 billion, but the escalating current account deficit remains a concern. The cumulative value of exports for the period April-November 2010 grew nearly 30 percent to $140.29 billion from $110.69 billion during the corresponding period a year ago.

While it is not possible to be unequivocal about near-term prospects for both manufacturing and exports, 2011 will likely herald policies that will be designed to improve India's export competitiveness and further develop manufacturing in the long term. The commerce ministry is

currently reviewing export performance across sectors and is likely to announce incentives for struggling divisions. Sectors hit hard in 2010, like garments, handicrafts and tea, may get a much needed respite. The commerce minister is of the view that the incentives already given for market diversification have yielded encouraging results. Government and industry bodies are bullish about exports crossing the $200 billion target for this fiscal year.

The next year will also likely bear witness to several trade pacts with other Asia Pacific countries and global players. In the first half of 2011, India stands to benefit from the Comprehensive Economic Partnership Agreements with Malaysia and Japan; negotiations are underway with New Zealand and Canada as well. A broad-based Bilateral Trade and Investment Agreement with the European Union is also being discussed. Furthermore, the National Manufacturing Policy, which is expected to lay the foundation to increase manufacturing's contribution to GDP from around 17 percent to 25 percent by 2022, will also likely be rolled out in early 2011. Although the effects of these measures will unlikely come to fruition in the short term, these developments will probably give a fillip to waning confidence in the manufacturing and export sectors. The coming year could also see some key decisions reached on foreign direct investment (FDI) in the retail and defense sectors. The proposed Goods and Services Tax, which aims to dismantle the complexities and non-transparency in the current tax regime, could boost prospects longer term, but is unlikely to come into effect before 2012.

A tricky road ahead

For the Indian economy to surge ahead, the central bank and government authorities will need to perform a delicate balancing act between multiple demands in the coming year. Inflation will unlikely abate in the near term and the central bank's target headline rate of around 6 percent looks difficult to achieve by the end of the current fiscal. Systemic inflation probably won't be held down by interest rate increases in the long run. Fuel inflation could well come to haunt the government in 2011. If crude prices continue to rise, the government could be compelled to step in and subsidize prices, adding to its burgeoning fiscal deficit. The government has also shown no signs of deceleration in raising debt; it is likely that it will raise about $98 billion by the end of the current fiscal.

The current account deficit is cause for concern. The deficit widened to $15.8 billion in the quarter ended September 2010 compared to $9.2 billion for the same period a year earlier. Although foreign institutional investment (FII) inflows have helped keep the deficit in check, these inflows are fickle; they have been used to buy assets and are therefore quickly reversible. Domestic demand is a significant driver of growth, but the rising cost of capital and falling FDI could have a negative impact on domestic capacity expansion. This could either lead to an increase in imports, or inflation, or both, compromising growth in the long term.

The economy is on cue to achieve a growth rate of 8.5 percent in the current fiscal year. However, if growth is to be sustained in the years to come, there will need to be a significant correction of structural imbalances. The policies that will likely come into play during the first quarter of 2011 are steps in this direction.

Ian Stewart is Chief Economist at Deloitte Research in the United Kingdom

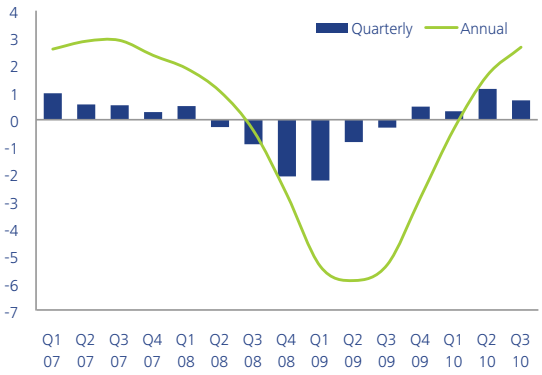
United Kingdom: Counting on the corporate sector

by Ian Stewart

- UK corporates are shifting to more expansionary strategies
- Growth seems to be gradually rebalancing away from consumption
- The United Kingdom is likely to see a continuing, if bumpy recovery

The United Kingdom continued to recover from the deep recession with surprisingly strong growth in recent quarters. The economy expanded by above-trend rates of 1.1 percent in the second quarter and 0.7 percent in the third quarter (figure 1). The recovery will likely continue, bolstered by expansionary monetary policy, a growing global economy and a marked decline in the exchange rate. The central question for the United Kingdom is how effectively private sector demand can pick up the slack created by weaker government spending and a slower pace of stock building.

Figure 1: UK GDP Growth %



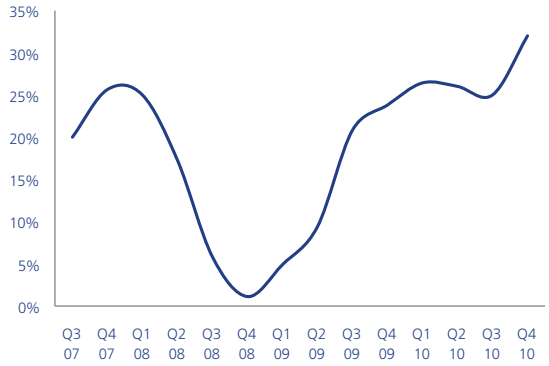
Source: Deloitte Research

Recent news suggests that the private sector is stirring. Third quarter GDP growth was driven by final demand, rather than stock building. Manufacturing output has risen sharply and, according to figures from the purchasing managers index (PMI), grew in December at the fastest rate in 16 years. There are also tentative signs that the United Kingdom's trade position is slowly starting to improve. For the first time in over a year, net trade made

a positive contribution to growth in the third quarter of 2010. The private sector has also created jobs through 2010, easily outweighing the effect of job losses in the public sector.

Underlying such data is a corporate sector which is increasingly confident and enjoys generally sound balance sheets. Deloitte's latest survey of Chief Financial Officers*, which was carried out in December, sheds light on the priorities and plans of major UK corporates as they enter 2011. The picture is positive. CFO confidence rebounded in the fourth quarter of 2010, regaining much of the ground lost in the second and third quarters. CFO fears of a "double-dip" have abated. And corporate risk appetite has risen sharply, reaching the highest level since the survey started in third quarter 2007 (figure 2). Growing appetite for risk is leading to a willingness to embrace more expansionary balance sheet strategies.

Figure 2: Corporate Risk Appetite
(% of UK CFOs who think now is a good time to take greater risk onto their company's balance sheet)



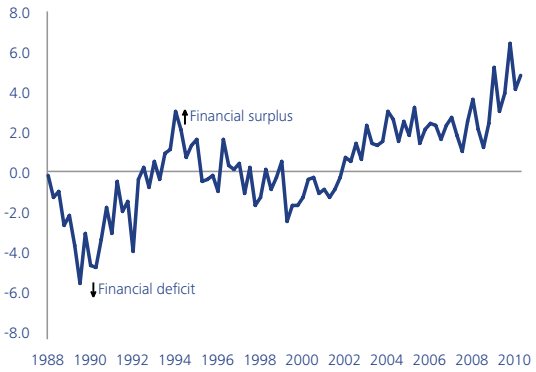
Source: Deloitte UK CFO Survey, Q4 2010

For many corporates, 2010 was dominated by the need to continue cost cuts against a backdrop of slow growth in revenues. But cost control has dropped from first priority for CFOs a year ago to third priority today. The top priority for CFOs is introducing new products and services or expanding into new markets. As they enter 2011, CFOs are increasingly positive on the outlook for revenues, hiring and capital spending.

Improving credit conditions are also likely to have contributed to rising corporate optimism and risk appetite. Debt finance fell out of favor with CFOs during the recession. But improving credit availability and lower interest rates have led to a marked change in attitudes. In the fourth quarter of 2010, bank borrowing and bond issuance were as popular with CFOs as they were before the credit crunch started in 2007. And after a period of aggressive corporate debt reduction, CFOs are of the view that the UK corporate sector is no longer over-leveraged.

Against a backdrop of constrained credit supply and weak top-line growth, the focus for UK corporates over the last two years has been on strengthening balance sheets and cutting costs. Those strategies have worked: profitability has risen sharply, debt levels have declined and companies have generated big increases in cash flow. Official data show that UK corporates are running a substantial financial surplus and are major providers of

Figure 3: Financial Balance of UK Corporates as a % of GDP



Source: Bank of England

*Deloitte UK CFO Survey, 4th Quarter 2010

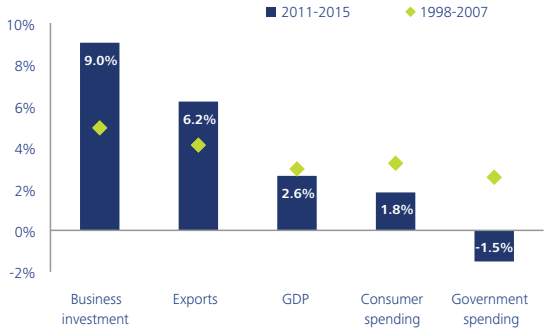
The Deloitte CFO Survey was conducted by Deloitte LLP, the UK member firm of DTT

capital to the rest of the economy (figure 3). The indication from this quarter's CFO Survey is that from this position of strength, corporates are increasingly planning for growth in 2011.

A new emphasis on expansion by large UK companies lends support to the idea that the recovery is likely to broaden out through 2011, aided by growth in private sector hiring and capital spending. If 2010 was the year of balance sheet rebuilding and cost cutting, 2011 looks set to be the year in which corporates start spending again.

The balance sheet and policy backdrop suggests that the private sector is likely to be the engine of growth in the economy. Loose monetary policy favors the private sector while tight fiscal policy will hit government spending. Meanwhile, consumer and government balance sheets look stretched compared to corporates' balance sheets.

Figure 4: Composition of Future Growth in the UK
(Forecast growth in the next 5 years vs growth before the recession, annualized)



Source: ONS & OBR forecasts

This conjunction points to a radical change in the composition of growth in the United Kingdom. The independent Office for Budget Responsibility forecasts that business investment and exports are likely to be significantly stronger than in recent years, while consumer and government spending is likely to be significantly weaker (figure 4).

Numerous uncertainties persist. UK consumers remain under pressure, with real incomes declining under the weight of high inflation, sluggish earnings growth and rising taxes. A secular change in the pricing and availability of credit means that many households and corporates face problems accessing credit. Fiscal tightening will really start to bite in 2011 and some analysts fear this will derail the recovery. Meanwhile, the fiscal tribulations of Ireland and other smaller Euro area countries pose a threat to the demand for UK exports and to UK banks with exposure to these countries.

Yet not all the risks to the UK outlook lie on the downside. A particularly loose monetary policy, a robust corporate sector and an evolving global recovery represent powerful tailwinds to the UK recovery. The path of the UK's recovery will not likely be smooth – and will probably not be as strong as the growth rates seen in the second and third quarters of 2010 – but it *is* likely to be continuing.

Brazil: Will inflation be tamed?

by Dr. Ira Kalish

As with the other BRIC economies, inflation is the key issue facing Brazil. In November, consumer prices were up 5.6 percent from the previous year. This exceeds the central bank's target inflation rate of 4.5 percent. The troubling inflation is the result of several factors.

First, the economy is growing very rapidly with GDP up 6.7 percent year-over-year in the third quarter. This unusually rapid pace of growth is probably faster than Brazil can reasonably achieve without creating inflationary bottlenecks. Indeed, the labor market is already very tight with the unemployment rate at 6.1 percent in October, the lowest figure ever recorded. The result is upward pressure on wages.

Second, global commodity prices have been rising rapidly. This is especially true of food prices. This has a direct effect on inflation in Brazil, as food accounts for a big chunk of consumer spending and, therefore, forms a large share of the consumer price index.

Third, Brazil is experiencing the lagged impact of the loose monetary and fiscal policies that were introduced during the global economic crisis. Although monetary policy has been tightened during 2010, it will take time for this to work its way through the economy, weaken demand and cause disinflation. Notably, the tightening of monetary policy in 2010 led to higher interest rates. This had the effect of attracting portfolio investments from overseas. The result was upward pressure on the value of the Brazilian real. While currency appreciation is disinflationary, it can also be damaging to export competitiveness.

Meanwhile, the central bank has stated that the inflation outlook is "far less favorable" than previously believed. Hence, it is expected that the central bank will further increase interest rates early in 2011. The question, then, is how far the central bank will go, whether its policy will seriously hurt economic growth and to what extent exchange rate considerations will restrain monetary tightening.

Fiscal policy

In December 2010, Brazil's Congress approved a small increase in the minimum wage for government workers. At less than half the increase sought by unions, this represents a modest shift toward fiscal tightening. It has been seen as a signal that the new government, consistent with its stated goals, will pursue a policy of deficit reduction. Doing so is expected to reduce long-term interest rates, which remain among the highest in Latin America. Moreover, expectations about fiscal policy matter almost as much as the actual policy. If markets are convinced that government largesse and borrowing will decline (and this is a source of heated debate), it could have a salutary effect on interest rates. However, a combination of monetary and fiscal tightening in 2011 will surely cause a slowdown in economic growth. While this is desirable given the unacceptably high rate of inflation, too much tightening could be damaging to economic growth and employment. A serious slowdown would lead to a widening of the budget deficit.

The outlook

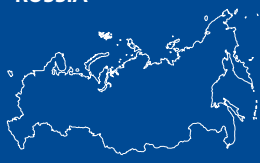
Given the current and expected mix of policy, it is likely that Brazil's economic growth will decelerate in 2011 toward the range of 4 to 5 percent. In addition, inflation should moderate by year-end 2011.

Longer term, the big question is whether Brazil can sustain the high rates of growth seen in recent years. For any country, long-term growth depends on an increase in the labor force as well as a rise in productivity. The latter depends on the amount of investment in new capital as well as improvements in the efficiency with which that capital is used. For now, Brazil's investment rate is relatively low at less than 20 percent of GDP. Brazil's external deficit reflects the fact that some of that investment is funded by foreigners, offsetting the low rate of domestic saving. Therefore, one way to increase growth would be to increase the domestic savings available for investment. And one way to do that would be to cut government borrowing. This would also have the positive effect of cutting interest rates and putting downward pressure on the value of the currency. Thus, long-term fiscal consolidation will be critical to ensuring rapid growth as well as boosting investment and exports.

As for the efficiency of capital, that will depend on the degree to which markets are permitted to function freely, thus ensuring the most effective allocation of capital. Deregulation and freer trade will be critical in this regard.

With a new government taking office at the start of 2011, there remains considerable uncertainty about the long-term direction of policy. While there are indications of short-term fiscal consolidation, it is not clear whether this will be sustained into the future. The surge in spending in 2010 raised some eyebrows. However, it is often the case that, in democracies, spending rises in anticipation of an election and then declines afterward. This may have been the case. It is also not clear whether, in the coming years, the mix of spending will shift away from subsidies and toward public investment. This would have the effect of boosting productivity. Nor is it clear whether there will be deregulation, more statist policies, or some combination of the two. By the end of 2011, there should be greater clarity on these issues.

RUSSIA



Are higher energy prices enough?

by Dr. Ira Kalish

It is likely that the high [oil and gas] prices seen at the beginning of 2011 will be sustained and could go higher.

Economic growth registered at 2.7 percent in the third quarter of 2010, a slight change from the good performance during the first half of the year when growth topped out at 5.2 percent in the second quarter, specifically. The slowdown in the third quarter was due to slower export growth and the effects of the summer drought. Going forward, economic momentum in 2011 is expected to be moderate. On the one hand, Russia will benefit from high global prices of oil and natural gas. It is likely that the high prices seen at the beginning of 2011 will be sustained and could go higher. On the other hand, Russia's energy production is not going to increase in 2011 as there has been insufficient investment in recent years. In addition, Russia's non-commodity exports will be hurt by the slow growth of demand in Western Europe.

The impact of policy

The government has put in place a fiscal policy of spending reductions designed to cut the budget deficit over the coming two years. While the spending cuts will have a direct negative impact on economic activity, the reduction in the deficit could have a positive impact on credit markets and business confidence. Deficit reduction, if credible, could suppress interest rates. It could also help to hold down the value of the ruble. Hence, the net effect of deficit reduction is hard to judge. In part, it will depend on what the monetary authorities do.

Monetary policy is, as usual, caught between a rock and a hard place. Inflation remains higher than desirable. After falling early in 2010, inflation accelerated in the second half of the year. This was due to the impact of higher food prices (stemming, in part, from the drought), rising real wages (the result of shortages of skilled labor), and the lagged effect of fiscal and monetary stimulus.

While the central bank clearly wants to create conditions for disinflation, it is not clear what the best approach would be to bring this about. Raising interest rates – the usual route to lower inflation – might attract hot money from overseas and boost the value of the ruble. This would have a negative impact on export competitiveness at a time when the government wants to move Russia away from excessive dependence on oil and natural gas exports. Yet currency market intervention to suppress the value of the ruble would have the effect of boosting the money supply. This, of course, would be inflationary. Russia is in a similar position to several other emerging nations like China, for example.

For now, the ruble remains relatively weak, especially against the euro. While good for export competitiveness, it probably reflects low confidence in the Russian economy given its modest growth and dependence on commodities.

Longer term issues

President Medvedev has announced that the state will sell stakes in about 900 companies over the next five years, raising about US$60 billion. This appears to be principally designed to reduce the budget deficit without having to directly cut spending as much as otherwise. It is not clear, however, whether this plan represents a shift toward more

market orientation of policy. There are conflicting signs in this regard. On the one hand, Russian accession to the World Trade Organization (WTO) appears to be imminent following agreement with the United States on the terms of entry. Moreover, the president has spoken of the need for modernization and increased investment in non-resource industries in order to diversify the economy and take advantage of a highly-skilled labor force. On the other hand, there has not yet been any significant movement away from protectionism and state control of the resource sector.

The big question is whether Russia can successfully move away from dependence on natural resource exports. Many obstacles exist. Among them are the high regulatory costs of doing business, corruption, poor infrastructure and high costs of capital. On the other hand, Russia has an abundance of highly-skilled labor that could be utilized in information technology, life sciences and other high-value-added industries if sufficient investment were to take place. Barring a shift toward such investment, the only other factor that could significantly boost long-term growth would be more investment in energy production capacity.

President Medvedev has announced that the state will sell stakes in about 900 companies over the next five years, raising about US$60 billion. This appears to be principally designed to reduce the budget deficit without having to directly cut spending as much as otherwise.

Jürg Vollmer/maiakinfo

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Sub-Saharan Africa: Cashing in on commodities

by Pralhad Burli

The global economic crisis may have muted Africa's growth story, but Sub-Saharan Africa is poised to experience another decade of robust growth beginning in 2011. Several economies in the region have recovered well, with overall growth expected at nearly 5 percent in 2010. Since economies in Sub-Saharan Africa are relatively less integrated with the global financial system, many observers believed that the financial crisis would have a negligible impact on economies in the region. However, the region did not escape the negative effects of the global economic recession. While the banking system was relatively stable, the contraction in trade and lower commodity exports dampened GDP growth during and soon after the economic crisis.

Looking ahead, the strength of the domestic economy coupled with a steady rise in the middle class will likely support GDP growth in 2011. Regional trade within Africa has the potential to emerge as an engine of growth and may spur domestic demand. Commodity exporting economies are likely to benefit from higher commodity prices. However, fragility in the global economic recovery poses downside risks arising from limited external demand. In 2011, Sub-Saharan Africa will likely record GDP growth between 5 and 5.5 percent.

Over the past decade, successive governments in several countries have ushered in policy reforms that have benefitted economies across the region. Prior to the global economic crisis, growth in Sub-Saharan Africa averaged more than 5 percent a year during the 2002 to 2008 period, compared to less than 2.5 percent during the 1990s. Growth-oriented policies and credible political intent increased the profitability of firms operating in Africa. Energy and metal prices have spurred growth in resource-rich nations. As a result, foreign direct investment (FDI) flows continue to grow. Even in the crisis years of 2008-2009, foreign investment grew at 22 and 16 percent respectively. Furthermore, economic growth and improved service delivery has accelerated progress towards achieving the Millennium Development goals.

A combination of factors including economic policy, structural changes and trade has resulted in steady growth in Sub-Saharan Africa. Countries that were more reform-oriented grew faster. Will the region be able to consolidate the gains, control communal conflicts and maintain an environment conducive for future growth? Furthermore, if governments stay committed to policy reform, a strong domestic economy riding on higher incomes, low unemployment, healthy consumption and increased regional trade will probably result in accelerated growth throughout the region.

South Africa

While several nations in Sub-Saharan Africa weathered the crisis and are now headed onto a path of sustainable recovery, South Africa – the region's largest economy – experienced slow growth during the second half of 2010. The mining industry, accounting for nearly 30 percent of South Africa's exports, contracted sharply and derailed growth momentum. As inventory restocking decelerates and domestic demand fails to catch up, South Africa's momentum will probably not match the growth rates of most economies in the region. GDP growth is projected at 3 percent in 2010 and slightly higher at 3.5 percent in 2011.

Other concerns for South Africa stem from high levels of unemployment and turmoil in the labor market. These two factors are likely to have a significant influence on the recovery of the South African economy by affecting both manufacturing productivity and domestic demand. Furthermore, income inequality, corruption, crime and a high incidence of HIV/AIDS remain critical challenges impeding South Africa's growth.

However, there are a few positives in the country's outlook. In the aftermath of the financial crisis, hosting the World Cup provided a stimulus to South Africa's economy and the country has benefitted from increased tourism and foreign investment. With a population of nearly 50 million, South Africa attracts the attention of the world's leading retailers and multinational companies. Walmart's recent foray into the South African market may change

the retail environment dramatically. Consumer goods companies and firms in the services sector view South Africa's diverse demography as a tremendous opportunity and are expanding their presence in the region. With a rising middle class, consumer spending has grown rapidly in recent years – a trend that is expected to continue. Improved standards of education will likely reduce the demand/supply gap for skilled labor. Wages may also rise gradually thereby increasing the spending potential of individuals. Given its size and economic ties with other African countries, South Africa's economic performance will probably have a major influence on the overall performance of the region in 2011.

Nigeria

Resource-rich Nigeria performed better than its peers in 2010. Growth in the agricultural sector, supported by investments in horticulture and cash crops, likely boosted GDP growth in 2010. Although oil production and exports have been lackluster, growth in the non-oil sector pushed the economy forward. In 2011, oil prices are likely to increase and, if global demand for oil picks up and sufficient investment takes place, growth prospects for Nigeria will probably improve. However, dependence on oil exports makes Nigeria's economy vulnerable to global commodity prices and fluctuations in the demand for oil. Slower growth in China and anemic demand from Europe may dampen oil revenues. Nigeria will likely achieve nearly 7 percent GDP growth in 2010 and in all likelihood will carry this solid momentum into 2011.

While the banking sector in Sub-Saharan Africa was relatively insulated from the global financial meltdown, Nigeria experienced a crisis in its banking sector in 2009. Driven by inherent weaknesses in the country's banking system, Nigeria's crisis was exacerbated by global macroeconomic conditions and a collapse in oil prices. Macroeconomic instability resulting from volatile capital inflows, banks being overexposed to local asset markets leading to inadequate diversification and poor risk management resulted in a fragile financial system. In fact, quite a few banks were found to be severely undercapitalized. Liquidity constraints, maturity mismatches on deposits and accumulated losses lowered shareholder capital. The setting up of asset management companies to take over impaired assets, backed by firm policy responses from the central

bank, set the stage for a bounceback of Nigeria's financial sector. While regulation and supervision by the central bank mitigated some weakness, there could be a need for further intervention. Under this scenario, credit expansion may be restricted and growth may be muted.

Managing inflationary pressures is paramount to maintaining macroeconomic stability in Nigeria. Over the past two years inflation has been steep and will likely continue to hover in the 13 to 14 percent range during 2011. Taming inflation may require large-scale monetary measures. While the central bank left its benchmark interest rate unchanged, tighter monetary policy may be forthcoming. However, it is unclear whether the policy likely to be adopted by the central bank will serve to reduce inflation significantly.

In addition, deficiencies in basic infrastructure (like electricity supply) continue to pose downside risks to meaningful economic growth. Despite the good performance of the economy, violence in the Niger Delta and widespread corruption are also factors behind the mixed outlook for Nigeria's economy in 2011.

Ghana

Strong demand for cocoa and gold propped up GDP growth in Ghana during 2010. The country's recent venture into oil production will most likely further boost GDP and exports, narrowing the current account deficit in 2011. IMF programs reduced financing pressures significantly and aid from multilateral donors supported domestic consumption until recently. However, Ghana's recent transition to a middle-income nation will prevent it from receiving concessional loans from the International Development Association (IDA) in the future. Overall, growth prospects for Ghana remain positive in 2011 but several risks remain. Poverty, fiscal mismanagement, lack of institutional frameworks and infrastructure are critical bottlenecks constraining growth.

Kenya

A revival in tourism and solid growth in the agriculture, construction and telecomm sectors boosted Kenya's economy in 2010. However, Europe's weak recovery may undermine growth and employment in the agriculture and manufacturing sectors. Insufficient electricity supply, governance issues and shortages of skilled labor will likely stifle growth. Despite these constraints, Kenya will likely register growth in excess of 5 percent in 2011.

Other countries

Higher prices for copper and an upsurge in FDI inflows will likely boost Zambia's economy in 2011. Extended tax holidays in the country's first multi-facility economic zone is attracting investors. The government's fiscal policy is expected to be expansionary in 2011, supporting large-scale investments in the infrastructure sector.

Meanwhile, market-oriented policies made Rwanda one of the region's top performers in terms of structural reforms.

GDP growth in 2011 will ride on growth in the services and manufacturing sectors. Post-electoral violence in the Ivory Coast may lead to instability in the region and could also drive up global cocoa prices. Meanwhile, inflation has slowed down in Zimbabwe but the economic recovery is expected to be slow and grueling.

Risk

Will Africa fall prey to the "Dutch Disease"? While a majority of Africa's economies depend heavily on commodity exports, Africa's growth potential transcends commodity exports. Some Asian economies such as Malaysia and Indonesia have been able to strike a balance between resources and manufacturing exports. However, whether Africa can emulate similar success is still unclear. Several hurdles, including but not limited to the lack of skilled labor and inadequate infrastructure, could constrain Africa's emergence as a hub for outsourcing and manufacturing industries.

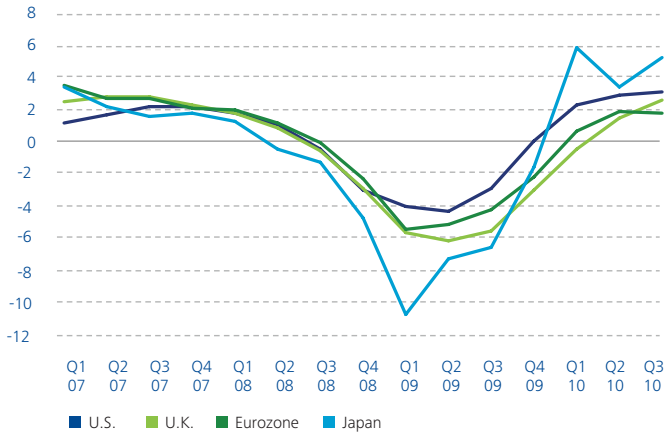
Conclusion

Improved macroeconomic fundamentals and structural changes in governance and policy have spurred growth throughout the region. At the same time, soaring prices of oil, precious metals, diamonds and minerals have helped lift Africa's GDP since the early 2000s to 2007. However, poverty, malnutrition, access to clean drinking water, HIV/AIDS and malaria pose real challenges, leaving successive governments to grapple with these issues.

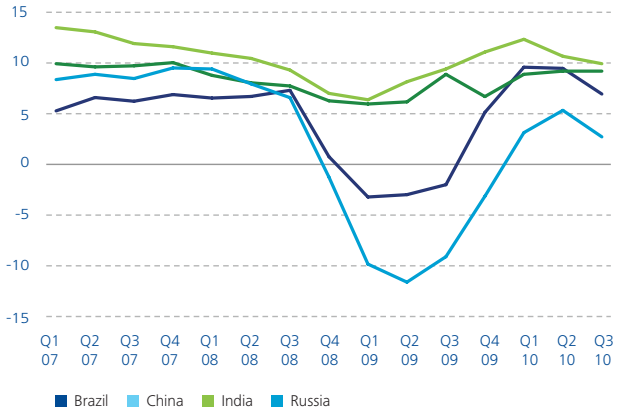
In 2011, Sub-Saharan Africa is poised to achieve robust growth. The size of the population makes the region an attractive destination for the services industry and consumer goods companies. The euphoria around Africa's growth potential will likely attract large-scale foreign investments in 2011. This may help bridge deficiencies in Africa's infrastructure and energy sectors. On the other hand, violence, corruption and unstable governments are deterrents for foreign investors. Furthermore, the lack of adequate infrastructure and high levels of unemployment impair growth prospects. Impending elections in Kenya, Nigeria, Uganda, Zambia and nearly 13 other nations will, in part, determine the future of the region. If governments adopt populist measures during elections, fiscal and monetary measures that supported Africa's growth momentum may be weakened. Nevertheless domestic demand, regional trade and exports place Sub-Saharan Africa on a sustainable growth path. Commodity exporters are likely to grow and economies with diversified export portfolios will probably grow more.

Appendix

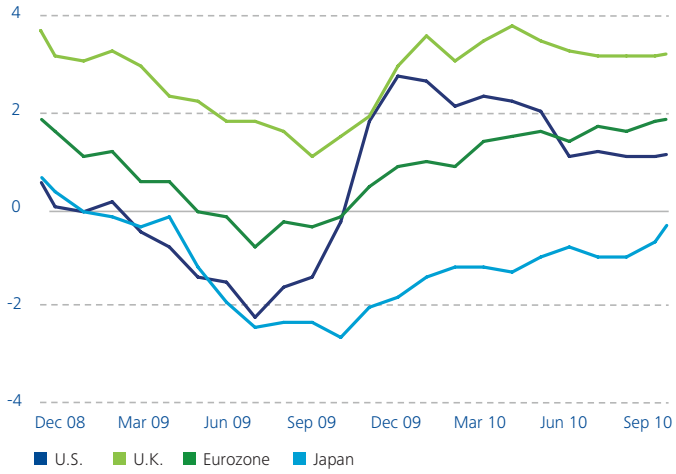
GDP Growth Rates (YoY %)*



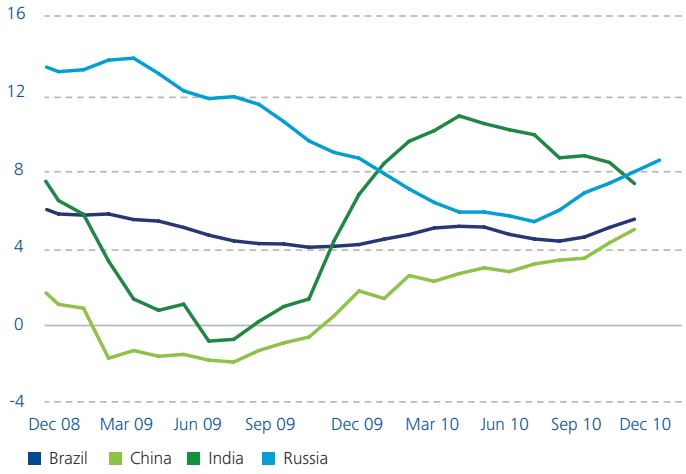
GDP Growth Rates (YoY %) *†



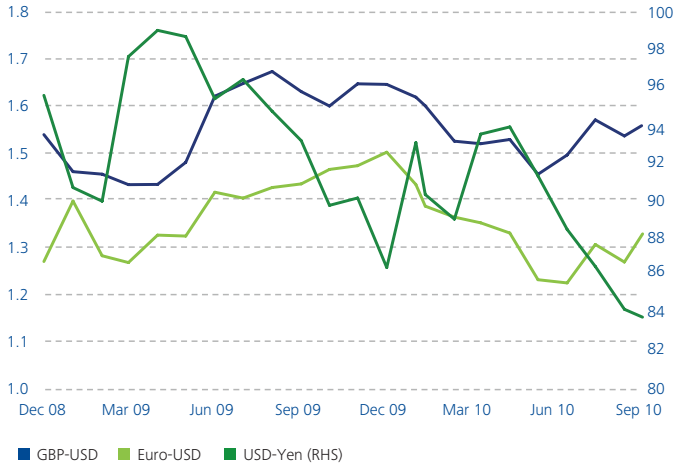
Inflation Rates (YoY %)*



Inflation Rates (YoY %)*‡



Major Currencies vs. the US Dollar*



Source: *Bloomberg †India's fiscal year is April-March ‡Inflation data for India is based on the WPI

Yield curves (as on January 05, 2011)*

	U.S. Treasury Bonds & Notes	U.K. Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Brazil Govt. Benchmark	China Sovereign	India Govt. Actives	Russia‡
3 Months	0.13	0.59	0.36	0.12	11.18	2.99	7.10	4.23
1 Year	0.28	0.70	0.75	0.14	12.12	3.21	7.46	5.00
5 Years	2.14	2.32	1.86	0.43	12.138 (4 year)	3.46	7.86	7.48
10 Years	3.47	3.55	2.94	1.16	12.06	3.86	8.06	8.36

Composite median GDP forecasts (as on January 05, 2011)*†

	U.S.	U.K.	Eurozone	Japan	Brazil	China	India†	Russia
2010	2.8	1.8	1.7	4.3	7.5	10.7	8.3	4
2011	2.6	2	1.5	1.3	4.45	9.01	8.5	4.2
2012	3.2	2.1	1.8	2	4.5			4.1

Composite median currency forecasts (as on January 05, 2011)*

	Q1 11	Q2 11	Q3 11	Q4 11	2011	2012
GBP-USD	1.55	1.56	1.58	1.59	1.59	1.61
Euro-USD	1.3	1.32	1.33	1.32	1.32	1.3
USD-Yen	85	86	89	90	90	95
USD-Brazilian Real	1.7	1.69	1.67	1.7	1.7	1.8
USD-Chinese Yuan	6.52	6.43	6.36	6.28	6.28	6.18
USD-Indian Rupee	44.12	44.13	44.2	43	43	42.98
USD-Russian Ruble	30.75	30.8	31	30.48	30.48	29.5

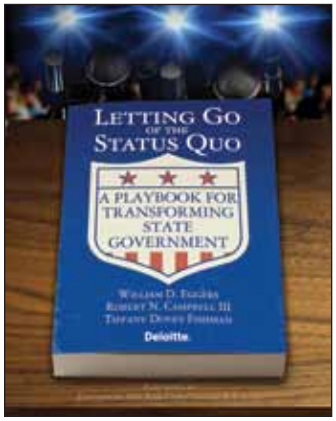
OECD Composite leading indicators (Amplitude adjusted)

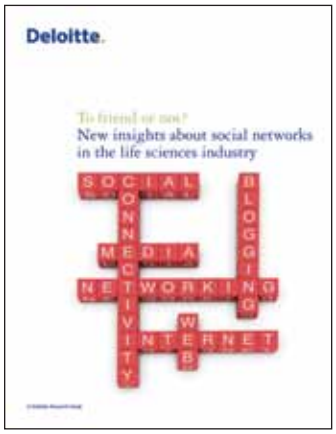
	U.S.	U.K.	Japan	Brazil	China	India	Russia
Jan 09	89.8	93	91.7	84.3	94.4	94.8	86.3
Feb 09	89.3	93.1	90.8	84.7	95.7	95.5	86
Mar 09	89.5	93.5	90.5	86.2	97	96.3	86.5
Apr 09	90.2	94.3	90.8	88.3	98.3	97.3	87.5
May 09	91.3	95.4	91.5	90.6	99.6	98.2	89
Jun 09	92.6	96.6	92.5	92.9	100.7	98.9	90.7
Jul 09	93.9	98	93.6	94.9	101.7	99.5	92.6
Aug 09	95.2	99.4	94.7	96.5	102.4	99.8	94.3
Sep 09	96.4	100.7	95.9	97.8	102.9	100.1	95.7
Oct 09	97.5	101.8	97.1	98.7	103.3	100.3	96.8
Nov 09	98.5	102.6	98.3	99.5	103.6	100.5	97.5
Dec 09	99.5	103.1	99.3	100	103.8	100.7	98.1
Jan 10	100.4	103.5	100.3	100.4	103.8	100.9	98.6
Feb 10	101	103.6	100.9	100.7	103.7	100.9	99.1
Mar 10	101.5	103.6	101.4	100.9	103.4	100.9	99.7
Apr 10	101.8	103.4	101.7	100.9	103.1	100.9	100.3
May 10	101.8	103.1	101.8	100.7	102.5	100.9	100.9
Jun 10	101.7	102.8	102	100.3	101.7	100.9	101.6
Jul 10	101.6	102.5	102.1	99.9	100.9	100.9	102.3
Aug 10	101.6	102.3	102.4	99.5	100.6	101	103
Sep 10	101.8	102.2	102.6	99.2	100.7	101.1	103.7
Oct 10	102.2	102.2	103	99	101	101.1	104.5
Nov 10	102.7	102.2	103.4	98.6	101.3	101.1	105.3

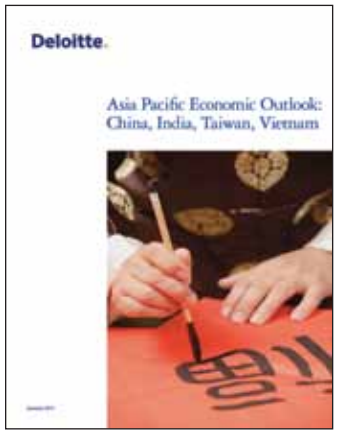
Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100. Source: OECD

Source: *Bloomberg ‡MICEX rates †JP Morgan

Additional resources







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