

Will 2006 Be a Year of Resilience or Complacency?

We expect 2006 to be another robust year for the world economy, with global real GDP growth of 4.2% led by strength from Japan, China, most of the BRICs and, for the first half, the US. A new-year's roundtable looks at the risks to our views and the question of how resilient the world can be in the face of a forecast slowdown in the US in the second half.

Jan Hatzius: The US economy will not be as resilient in 2006. US domestic demand growth had significant support in 2005 from the lagged effects of monetary stimulus, including the strength of the housing market. The saving rate fell significantly further, and that offset—in fact arguably more than offset—the increase in energy prices. But that's likely to change during 2006. We are expecting a fairly significant consumer-led slowdown in the second half. So the resilience that one would hope for will have to come from elsewhere.

Jim O'Neill: Fortunately, for the first time in a long, long time there is some evidence to believe that the world can cope with a moderately softer US economy—better than it has been able to do for most of the last decade.

I see three reasons for that. One is of course the BRICs story. Over the past five years Brazil, Russia, India and China together have contributed 28% of world GDP growth, and this share is probably rising. The recent revision to the level of Chinese GDP is further evidence of the move away from reliance on the US, as is the news that Chinese growth ended last year stronger than we and the consensus had thought. India is growing above consensus forecasts, and growth there looks like it will accelerate. India is also making noise about welcoming FDI, which could be the start of greater global FDI and greater confidence about global investment. It could also prompt a new wave of disinflationary forces.

Secondly, there is evidence, albeit marginal and early, that some European countries, particularly Germany, are showing signs of life in domestic demand. And thirdly, more and more people are starting to accept that Japan is out of its mess and that domestic demand—not exports—is what's driving growth there. If you put these things together, there may be upside risks to the world outlook as well as downside ones.

Peter Oppenheimer: Equity market performance over the last three or four weeks has been consistent with some upward revision to the growth outlook.

Erik Nielsen: I quite agree with what Jim says on Europe. We are already forecasting higher growth this year than in 2005, and the risk is certainly on the upside. Growth is still

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Roundtable Participants

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Jan Hatzius, Chief US Economist

Sun Bae Kim, Co-Director of Asia Economic Research

Erik Nielsen, Chief European Economist

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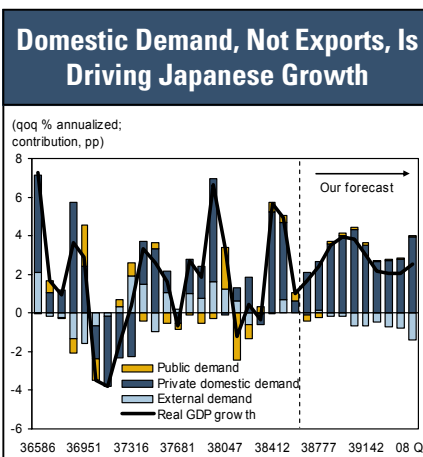
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primarily export-led, but capex is picking up very nicely, and the unemployment numbers are starting to point to higher consumption. We think Germany is very well placed to reap the benefits of globalisation, though things still don't look very good for the corporate sector in Italy, Spain and to some extent France.

One important thing—which we have never before seen in Europe—is that bilateral trade between Europe and the oil exporters (OPEC, Russia and Norway) has not deteriorated in this oil price cycle. One reason may be that the Middle East is channelling money into European consumption and investment. Another important reason is Russia's increasingly prominent role in the global energy market. Russia is rapidly developing a substantial middle class, one that is consuming or buying non-consumer goods out of Europe. This is again a BRICs story.

Sandra Lawson: Will 2006 finally be the year that 'Asia Becomes Confident'?

Sun Bae Kim: 2005 did show gradual signs of Asian domestic demand



improving. But I think the notion of a genuine decoupling from the US economy is still a forecast as opposed to reality.

Thinking about Jim's comment that the rest of the world seems better able to cope in the face of a moderate slowdown in the US, I would put the emphasis on *moderate*. Momentum in Asia has been building gradually, and this does allow for an upside surprise to growth—but only if global trade doesn't collapse abruptly. If it does collapse, then Asia could struggle a bit, given that the export share in Asia's GDP is very large. China's export share of GDP has basically doubled, from less than 20% in the mid- to late-1990s to close to 40% now. So the downside risk would be if the domestic demand slowdown in the US unfolds much more violently than our forecast.

JO'N: Let me play devil's advocate. Obviously a big slowdown in US domestic demand would hurt everyone. But maybe the real story going forward in Asia is that India raises its share of trade in GDP and China deliberately reduces it.

SBK: That would be the ideal situation, and I definitely get the sense that policymakers want to push the economy in that direction. India has been unrolling some fairly persuasive policy packages, very reminiscent of the policy incentives and reforms China implemented starting in the late 1970s.

These models did not emerge in a vacuum or by sheer coincidence; obviously Indian policymakers have taken note of what has brought very visible success in China. And I do detect quite a bit of desire, either explicitly or implicitly, to emulate China's success.

Tetsu Yamakawa: Our forecast for Japan is already fairly close to the top of the market consensus, but any surprise is more likely to be on the upside than on the downside. Despite increasing evidence of the sustainability of Japanese growth, the Bank of Japan is likely to stick with its a zero interest rate policy. So as Japan moves into moderate inflation, real interest rates will be negative, and financial conditions will be easier.

Many people still worry that Japan will face the risk of deceleration in 2006, simply because of the upcoming fiscal consolidation. But easier financial conditions will help to offset the impact of the fiscal contraction. Plus both households and the corporate sector have pretty much discounted the fiscal contraction, so it's unlikely that this will arrive as a surprise to the market.

PO: I see another upside risk to growth, which is the huge cash piles in the corporate sector in virtually every region of the world. In the US alone the corporate sector is going to generate over a trillion dollars of cash flow internally this year.

It's still uncertain whether large chunks of this cash will go back to shareholders—which ultimately would mean money for shareholders to continue consuming—or whether it will go into capital spending and into product markets. But either way, this vast amount of cash should be fairly supportive to growth.

Resilience or Complacency?

Dominic Wilson: I find it unusually difficult to think of good and different downside risks, which is comforting and troubling at the same time. We

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know the US housing risk exists and the US slowdown risk exists, and we can think of conventional risks in a bunch of other places.

But the sort of things that have scared us in the past aren't big worries at the moment. Emerging markets generally are in surplus; their exchange rates aren't massively over-valued; the corporate sector is in pretty good shape; and a significant rise in oil prices hasn't hurt the world as much as we thought it would.

One worry is that the world's leverage to China has clearly increased, and a huge range of asset markets are now levered to performance there in a way that they weren't before. But it feels like the risk of a growth slowdown there is actually a lot smaller than it has been in recent years.

Asset markets generally are pricing risk at very, very low levels in terms of credit spreads and emerging market

debt spreads. The big exception is equities, where there's still a decent risk premium embedded.

EN: The problem, in a sense, is that we all know and acknowledge a range of global imbalances, and we have all implicitly assumed that they will move away, gradually and nicely. They won't be eliminated in 2006, but everything will move nicely towards equilibrium. And that's probably the least likely scenario.

PO: That's actually the point, isn't it? People have been talking about some of these risks for a long time—global imbalances, the US consumer—and when we raise them again, the typical response is that 'most people made the same arguments this time last year, or this time the year before'.

As long as these problems don't actually unravel in the way that people fear, it's like the dog that never bites. And the longer it goes on with people being comfortable about it, the longer people accept that 'the

world has changed' and these events will never actually have an impact.

That in itself is the underlying risk, that people are becoming more and more comfortable with the ability of financial markets to absorb and deal with bankruptcies in the credit market, or imbalances getting bigger, or political turmoil in the Middle East, or whatever.

JO'N: One way we've chosen to address this sort of risk is to recommend buying gold as one of our top ten trades for 2006. A key reason is that we see gold as the 'hedge to have when you're not quite sure what you're hedging against.'

DW: The flipside to Peter's point about complacency is that financial markets have in fact shown a remarkable ability to absorb a diverse array of shocks. If you had said, at the end of 2004, that oil would go to \$70; GM and Ford would be downgraded to junk; the Fed would hike at every

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meeting; a hurricane would put New Orleans underwater; what do you think the major equity markets will do?—most people probably wouldn't have predicted such a benign outcome as we had.

JO'N: Surely it's no coincidence that the US stock market has underperformed many others. Most of the risks have been US-related, and most of the new dynamic edges are outside the US. And the markets have effectively been quite rational in reflecting that.

JH: At least in one of these areas, a long-anticipated shift looks much more likely now. In fact I'm quite a bit more concerned now than I was 12 months ago about the eventual adjustment in the US saving/investment imbalances. Large imbalances existed 12 months ago, but the US economy also had a housing market that was powering ahead throughout 2004 and the first half of 2005.

That has really changed over the last six months. We are now seeing concrete signs of a slowdown in the housing market. This makes me quite

a bit more concerned that the adjustment will finally unfold over the coming year.

The Sleeper Risk: Inflation?

SL: Here's a risk that isn't on the perpetual shortlist: Are we being too rosy about the outlook for inflation?

SBK: In our global forecast, Asia's the only region where we forecast higher inflation for 2006 than in 2005. I find that a bit odd.

EN: In Europe, inflation is the forecast I worry about the least. The growth side is much more likely to be the surprise. The ECB may surprise us by raising rates more than the 25bp we are forecasting for March, but that won't be because inflation is taking off. On the contrary, it will be because they think growth is good enough to allow normalised interest rates. We have been looking and looking for inflationary pressures in Europe, and they just are not there.

PO: Well, at least not in the consumer-facing parts of Europe. In the last three years, margins have basically gone up in every sector and in every part of the world, but last year we started to see margins peaking out at the EBITDA level, and we started to see big differences.

The sectors that are closest to the sources of production are seeing their margins hold up at extraordinarily high levels, but the areas closest to the consumer are actually starting to see operating or EBITDA margins coming down a bit. I suppose that feeds through into the macro picture—the industrial infrastructure-led parts of the world still look strong, but the consumer parts of the world are increasingly vulnerable because of what may happen in the US.

JH: Given what's happening with global supply of goods, it's hard to believe you should be too nervous about inflation from the goods sector. But if the US economy *doesn't* slow, if domestic demand doesn't slow as much as we expect in 2007, then we could see inflationary pressures from the services sector and the labour market.

That's something to keep an eye on, to the extent that the very optimistic growth expectations which now seem to be discounted in the equity markets actually come to pass. If the equity market is right about the strength in GDP growth over the next two years, then it may be adversely surprised by wage acceleration and more inflationary pressures in the domestic US economy.

JO'N: There is clearly an upside risk to inflation given the level of activity in the world, and G3 monetary policy being so far below normal for this level of global growth. However, I think global trend growth is rising, thanks to the BRICs. And there are such big changes in the world economy, driven again by the BRICs. If, as I said earlier, India over the next several years can successfully adopt measures to attract more FDI in industry as well as in services, then we might have another wave of global deflationary pressures—as with China—still ahead.

EN: You don't need to hang it on India alone. Look at Vietnam and Eastern Europe. All of the peripheral countries around the BRICs are benefiting from the BRICs and contributing to the changes in the global economy. ■

Unit Labour Costs a Potential Source of Inflationary Pressure

