

Looking Forward, to 2007 and Beyond

As 2006 draws to a close, we assess the prospects for the world economy in 2007 and offer our first thoughts on the outlook for 2008. Taking a very long-term perspective, we also offer our initial views on the economic impact of global warming.

'Happy Slowdown' Unfolds, Amid Rising Trend Growth

We expect that the world will experience a 'happy slowdown' in 2007. US growth is set to remain well below trend over the next year, but the impact of this should be offset by healthy growth elsewhere, including Europe, the BRICs and Japan.

The US slowdown is clearly underway, with a falling housing market, lukewarm consumer spending and broad-based industrial weakness. The labour market thus far has held up remarkably well, but we expect that housing weakness will soon hurt employment in the construction sector, pushing up the unemployment rate.

Historically, it has only taken a modest increase in unemployment for the Fed to begin cutting rates. We expect that the Fed will act in the spring and will cut rates by a total of 125bp, to 4.0%, by the end of 2007. We expect GDP growth to fall from 3.3% this year to just 2.1% in 2007.

In contrast, Europe's recovery appears solid. Euroland growth is set to come in well above trend this year, at 2.7%, and to remain roughly at trend next year, at 2.1%. Extensive corporate restructuring in Germany is at last paying off, with business confidence at its highest level since 1991 and unemployment falling sharply. This should support domestic consumption, which has been the weak link in the recovery. Business confidence in Euroland as a whole is at its highest level since early 2001, and final domestic demand continues to grow at a healthy pace across the region.

Strong growth and sticky inflation mean that we still expect the ECB to 'normalise' interest rates—despite the recent strength of the Euro. We forecast that rates will rise to 4.0% by mid-2007.

The biggest challenge to our 'decoupling' view comes from Japan. A string of weak data has cast a cloud on our expectations of a domestic demand-led recovery. The news is not all bad, however, and we see the recent

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GDP Growth: GS vs Consensus					
% yoy	2006		2007		2008
	GS	Consensus	GS	Consensus	GS
US	3.3	3.3	2.1	2.5	2.5
Japan	2.9	2.7	2.2	2.0	2.8
Euroland	2.7	2.6	2.1	1.9	2.4
UK	2.6	2.6	2.8	2.4	2.7
Europe	3.0	2.7	2.5	2.2	2.6
China	10.5	10.5	9.8	9.3	10.0
India	8.2	8.1	8.0	7.5	7.8
BRICs	8.9	8.9	8.5	8.1	8.5
Advanced Economies	3.2	3.1	2.4	2.4	2.7
World	4.8	4.5	4.1	3.9	4.3

Inflation: GS vs Consensus					
% yoy	2006		2007		2008
	GS	Consensus	GS	Consensus	GS
US	3.2	3.4	1.9	2.3	2.0
Japan	0.1	0.2	0.4	0.4	0.8
Euroland	2.2	2.2	2.0	2.1	1.7
UK	2.3	2.3	2.0	2.2	2.0
Europe	2.2	2.1	2.1	2.1	1.9
China	1.4	1.5	2.2	2.1	2.0
India	5.2	5.6	5.1	5.0	5.0
BRICs	3.3	3.3	3.5	3.5	3.4
Advanced Economies	2.3	2.4	1.8	2.0	1.8
World	3.2	3.2	2.7	2.7	2.7

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disappointments as a ‘soft patch’ rather than an end to the recovery. We expect growth to reaccelerate in mid-2007, with the full year coming in at 2.2% after 2.9% in 2006. We expect the Bank of Japan to raise rates in the first part of 2007.

With support from the emerging markets, world growth should experience only a shallow dip, from 4.8% in 2006 to 4.1% in 2007. This suggests that the rest of the world has managed to ‘decouple’ from the US to a greater extent than in the past.

The slowdown is also ‘happy’ in the sense that a rebalancing of global growth away from the US would help to reduce some of the existing global imbalances and would put the world economy as a whole on a stronger footing.

Our First Look at 2008

Extending our forecasts to 2008 for the first time, we expect the world to

be in even better shape. US growth should recover somewhat, rising to 2.5%, while Europe and Japan both look likely to reaccelerate, Europe to 2.4% and Japan to 2.8%. This will push global growth up to 4.3%.

Our forecasts also suggest that the trend growth rate—the rate at which an economy can grow without generating inflation—is on the rise in many parts of Europe (especially Germany and the UK), as well as in significant parts of Asia (particularly China and India). The efficiency of growth is increasing in China, helped by improved profitability, as well as in many parts of Europe, which is also benefiting from higher immigration.

Across the world, we see few signs that strong economic growth is generating higher inflation. Evidence of decoupling in growth and limited inflation points to a very benign outlook for many financial markets, including the major stock markets as well as emerging market debt and equities. Moreover, we see no

significant evidence of an asset price ‘bubble’. Equity prices are underpinned by relatively high equity risk premia and modest valuations, and while debt spreads are tight, the changing dynamics of the world economy and the strong fundamentals suggest that markets are not being too cavalier.

The two major risks to our forecast seem to be first, the chance that inflation will surprise on the upside; and second, the ongoing threat of protectionism in developed countries, which would be particularly important for the BRICs.

BRICs Five Years On

This week marks the five-year anniversary of our introduction of the BRICs concept, in which we highlighted the enormous growth potential of Brazil, Russia, India and China. Five years on, initial scepticism has given way to widespread focus on economic opportunities in the BRICs and their impact on asset markets. Notably:

- Our best estimate is that the BRICs’ share of world GDP in the world is now 11%, up from slightly less than 8% in 2000.
- China has already become the world’s fourth-largest economy and seems highly likely to surpass Germany before 2010. In fact China’s GDP has more than doubled since 2000, meaning that it has effectively created another France, two Canadas or a few Indias.
- BRICs has not been just about China. The BRICs’ aggregate contribution to global growth has been in the vicinity of 30% since 2000, and both India and Russia have made significant contributions.

Size of the Economy : 2000 vs 2006

	2000		2006	
	GDP (current US\$ bn)	Share of World GDP (%)	GDP (current US\$ bn)	Share of World GDP (%)
US	9,817	31.0	13,234	27.7
Japan	4,762	15.0	4,589	9.6
Germany	1,956	6.2	2,824	5.9
China	1,198	3.8	2,590	5.4
UK	1,476	4.7	2,266	4.7
France	1,368	4.3	2,174	4.6
Canada	732	2.3	1,244	2.6
Brazil	602	1.9	955	2.0
Russia	260	0.8	938	2.0
India	423	1.3	774	1.6
Netherlands	375	1.2	648	1.4
BRICs	2,484	7.8	5,256	11.0

Source: IMF, GS

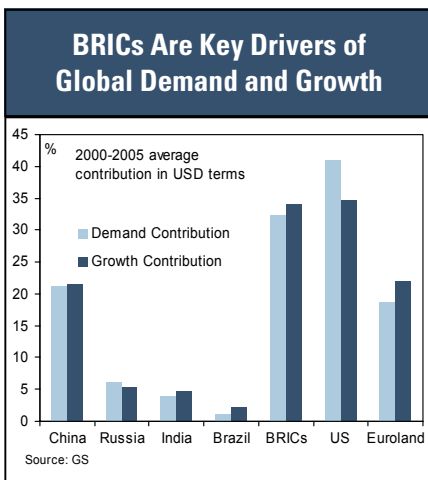
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In fact, the increase in India's GDP is equivalent to the size of the Netherlands in 2000.

- The BRICs growth has greatly influenced—and in some cases dominated—financial markets. Commodity markets remain



mesmerised by the demands from China and India and by energy supply from Russia. Foreign exchange markets are justifiably obsessed with the Chinese Yuan, and the Brazilian Real has appreciated sharply in the past two years.

- BRICs exchange rates have appreciated in real terms in all cases and, in the case of China and Brazil, in nominal terms as well.
- Less than 10 years after the Russian crisis, its FX reserves are around US\$280bn—bigger than those of the Eurozone combined. China's FX reserves are in the vicinity of \$1trillion.

Strong BRICs growth is key to our positive outlook, given that we expect the BRICs' contribution to global growth to exceed that of the US in both 2007 and 2008.

What About Global Warming?

Our BRICs growth projections potentially pose major challenges to the environment by placing challenges on resource utilisation, especially during the period up to 2020. However, the picture is not all gloom and doom—not least because this creates exciting opportunities in the sustainable energy space.

There is little evidence that energy resources are likely to run out, as many natural resource producers recognise. The key issue is not supply but price. Economic theory dictates that the price mechanism works to balance supply and demand. One might argue that the large rise in the relative prices of energy, especially oil and gas, is encouraging both the development of alternative energy sources and more efficient ways of using energy.

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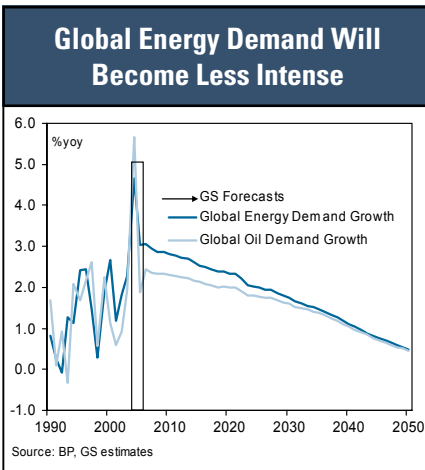
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It is also not obvious that energy demand will rise persistently—a fact that pessimists often overlook. Chinese energy demands will probably become less intense after 2020, due to both its rising wealth and its aging population.

Indeed, one might even argue that the strong demand for energy driven by China and India has been necessary to force policymakers to take the issue of global warming seriously.

A 'Greenspan-esque' Move to Reduce Emissions

The recent Stern Report highlighted the role that governments need to play in introducing policies to reduce greenhouse gas emissions—if we are to avoid a catastrophic outcome for the world economy and society in the second half of the century. Stern suggested that the pursuit of such policies would probably cost about 1% of annual world GDP by 2050. As many sceptics have noted, the uncertainties surrounding the Stern projections are significant.

Nonetheless, the risk/reward trade-off seems considerably attractive. Just as

The Stern Review and Global Warming

'Climate change represents a unique challenge for economics: it is the greatest and widest-ranging market failure ever seen.'

The Stern Review on Climate Change has pushed the issue of global warming to the forefront in many countries, particularly in Europe. This independent study examines the science behind climate change and analyses what it describes as the potentially catastrophic and irreversible economic and social harm that climate change could wreak—if not addressed now.

Unchecked, the concentration of greenhouse gases will, according to the Review, reach twice its pre-industrial level as early as 2035. Stern finds a 75% chance that this would raise average global temperatures by 2°C (from the 1750-1850 average). By 2100, there is a 50% chance that temperatures could rise by more than 5°C—as much as they have done from the last ice age to today.

While acknowledging that forecasting on this scale 'requires caution and humility', the Review estimates that the economic impact of global warming could cost at least 5% of global GDP each year, forever. At the high end, it could run to 20% of GDP or more. Poor countries that have contributed the least to the problem would likely suffer the most.

Taking a risk/return perspective, Stern argues that the costs of mitigation can be held to 1% of annual global GDP by 2050. This would require cutting greenhouse gas emissions by more than 80% from current levels. By 2050, emissions per unit of GDP might need to be just one-quarter of current levels, given global economic growth. Stern stresses that the critical period for action is the next 10-20 years; delay would entail higher risks and higher costs.

Drastic reductions of the scale will obviously require concerted and coordinated government policies to reduce emissions and to encourage the development of cleaner forms of energy. These include carbon pricing; policies to encourage low-carbon and high-efficiency technology; and regulatory and informational steps to change consumer behavior.

These measures will take time to have a meaningful impact, so Stern calls for greater 'adaptation', particularly in developing countries, to cushion the economic and social effects that are sure to occur in the next few decades.

US monetary policy under Alan Greenspan for much of the past 20 years had been geared towards reducing the chance of an unfavourable outcome despite the uncertainties, surely the same applies to policies to reduce the risks of a catastrophic outcome to global warming. But it is important to note that popular awareness of global warming has not, as yet, been matched by a widespread willingness to sacrifice in order to prevent it.