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Economic Views

Global

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View from the top

The recovery from the worst recession since the great depression has been slow and jumpy in the developed world. Recessions triggered by financial crises typically take longer to bounce back from and the recession of 2008-09 is no exception. Two years after the nadir of the recession, the world's largest economy, the US, is still spluttering along, the eurozone is trying to avert a sovereign debt crisis and Japan has lapsed back into recession after a devastating natural disaster.

The slowdown in some key developed markets and the tightening of monetary policy in emerging markets has impacted negatively on global trade and industrial production volumes. We expect this is evidence of a temporary blip and not a permanent dip – volumes will recover, but with an ever increasing focus on emerging markets as customers and not just producers. Tensions over currencies have been off the front pages in the first half of 2011, but there is potential for another flare up in the near term, as the underlying causes of the contention have yet to be resolved.

The world economy is set to slow down in 2011, as government and central bank policies are tightened and key developed markets go through a deleveraging process. The following year should see global growth bounce back, as trade rebounds, consumer spending picks up and the economic uncertainty surrounding current events such as US debt negotiations, the Greek debt crisis, and the Japanese earthquake and Arab spring subsides.

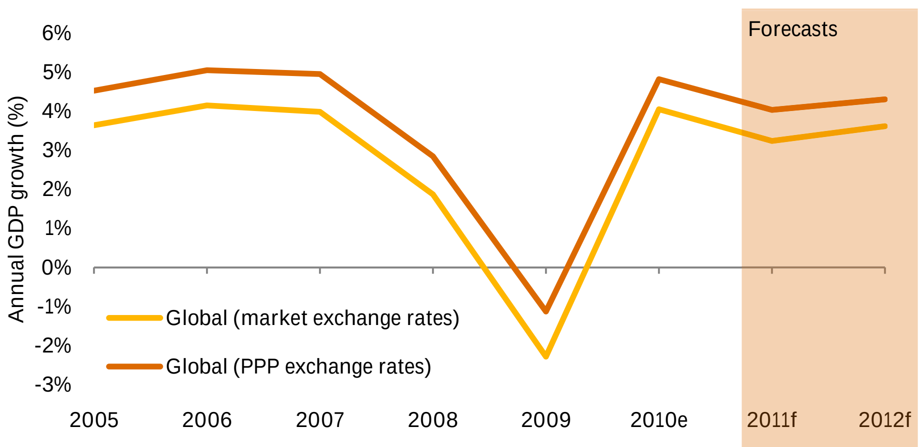
Key opportunities

- Reconstruction phase in Japan
- Continued expansion of global trade
- High end manufacturing in developed markets
- Emerging market consumers

Key threats

- Supply chain disruption from natural disasters in Japan
- Fiscal consolidation and monetary tightening
- Developed market consumers
- Currency tensions returning to the surface

GDP growth: recent history and forecasts



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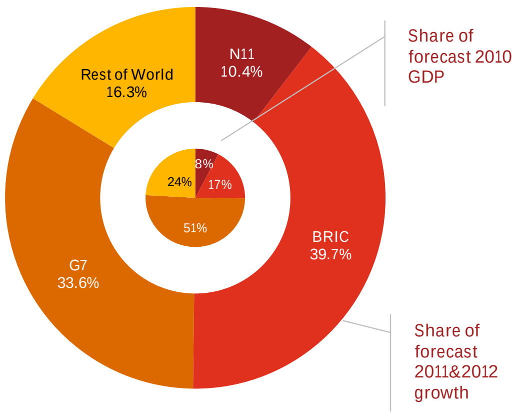
Source: PricewaterhouseCoopers forecasts (f)

Forecasts are updated regularly online at economics.pwc.com

Outlook has worsened in key developed markets

The years that preceded the crisis saw booms in Europe and the United States that fuelled growth in emerging markets. China achieved staggering growth rates as it exported cheap manufactured goods to Western markets. Now the tables have turned and consumers in developed markets can no longer afford to prop up world expansion – deleveraging, uncertainty, unemployment and austerity will not allow it. Companies in the Western world are increasingly looking to the emerging markets to fill this void and the rising middle classes in countries like China are more than happy to oblige. Chart 1 below shows that the fast growing BRIC economies (Brazil, Russia, India and China) made up just 17% of global GDP in 2010, but are expected to account for 40% of world GDP growth over 2011 and 2012.

Chart 1: World GDP and forecast GDP growth by region



Source: IMF; PwC forecasts

The G7 economies will contribute less to world GDP growth in the next two years than the BRIC economies, even though their economies are collectively three times the size. Downwards pressure on consumer spending is expected to drag on GDP across many of the large developed markets in the next two years, for a number of reasons; unemployment and pressure on disposable incomes in the US, austerity and uncertainty in the eurozone and a lack of consumer confidence in Japan.

A country that has defied this trend is Germany, which has helped to bolster eurozone growth at a time when the peripheral economies are struggling. Germany has in part been able to achieve such impressive growth due to its export focused economy. The country's traditional export markets are still on the ropes, but exports to emerging markets, especially China, have helped to fill that gap.

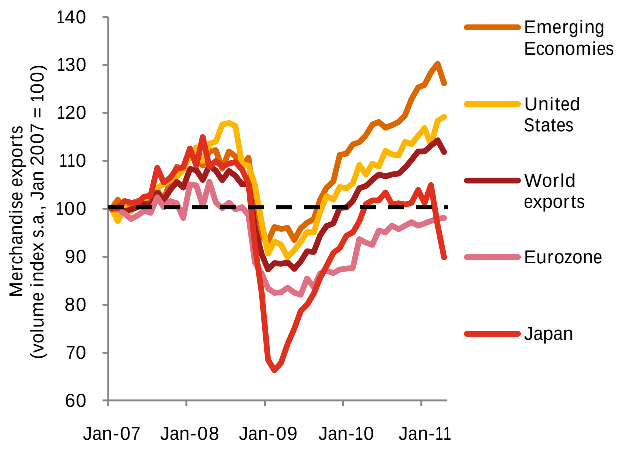
A host of developed country governments are now embarking on periods of austerity, necessitated by profligacy during the boom years and the cost of saving the financial system from imploding during the recent crisis. This will necessarily cut back on government spending, but will also reduce the disposable incomes of households, through tax rises and welfare cuts. In the short term, these two effects will make it hard for businesses to grow through concentrating on their local markets alone. Hence, those companies that can take advantage of the rapidly expanding business and consumer demand from emerging economies may be best placed to prosper. South Korea and Germany have shown this approach to bear significant fruit – other developed economies could follow suit.

World trade contracts – a temporary blip or the start of a more permanent dip?

There has been a substantial bounce back in global trade in the last two years (see Chart 2 below). However, exports have yet to reach their pre-recession levels in both the eurozone and Japan. Most of the countries in the eurozone do the majority of their trading with other eurozone countries. The weakness of a number of these economies has meant exports have recovered less strongly in the eurozone than other parts of the world economy.

World exports have come under pressure in recent months, due to the tightening of interest rates in emerging markets and the disruption to production experienced as a result of the Japanese earthquake. The disaster disrupted supply chains within Japan and internationally, particularly in the automotive sector.

Chart 2: World merchandise export volumes



Source: CPB World Trade Monitor; PwC analysis

We expect this will be a temporary blip, as opposed to a more permanent dip. Globalisation is expected to continue to increase world trade volumes relative to GDP in the medium term. The patterns of this trade are expected to evolve however. No longer will emerging markets simply be the world's production shed. Consumers and businesses from these economies are expected to increasingly drive global demand. This has started to happen already, imports to emerging markets have grown by over 20% since 2007, vastly outstripping the growth in developed markets.

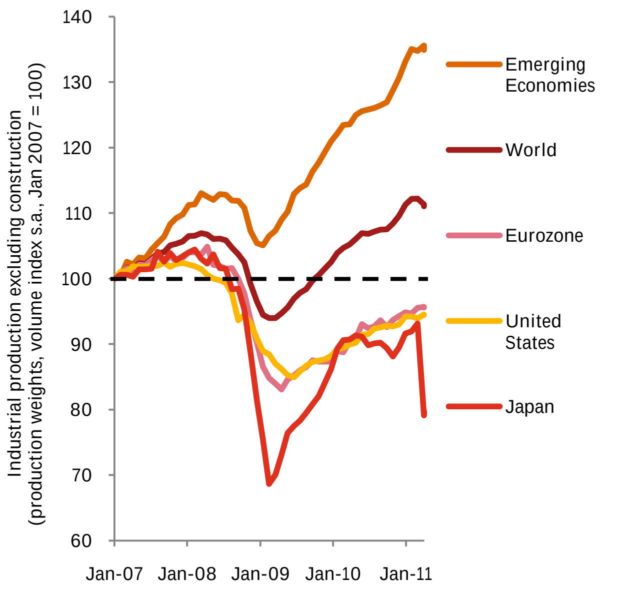
Manufacturing has underpinned much of the recovery, but can it continue to do so?

Manufacturing is typically one of the more cyclical sectors, which means it suffers more in recession, but often bounces back more strongly than other sectors. Hence unsurprisingly during the recovery phase, manufacturing has made a significant contribution to economic growth globally.

Chart 3 (below) highlights the path of industrial production (excluding construction) across a selection of countries and regions of the world economy. The first point to note – industrial production is still below its 2007 level in the US, the eurozone and Japan. Industrial production in the emerging economies on the other hand has expanded by around 35% since 2007. This growth has been overwhelmingly concentrated in Asia.

World industrial production contracted in April, but as with exports, this was heavily driven by Japan. Japan's production is expected to rebound and we have already seen signs of this recently.

Chart 3: World industrial production



Source: CPB World Trade Monitor; PwC analysis

The most interesting question is can manufacturing continue to support economic expansion in the developed economies?

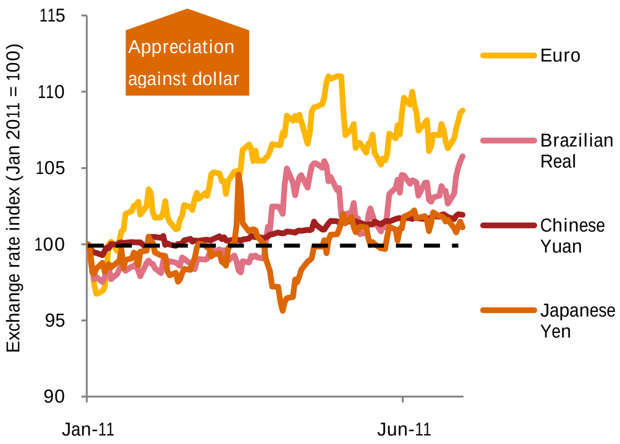
The Japanese disaster disrupted the supply chains of companies throughout the developed world, but this should be a temporary effect. In the short term, the recent weakness experienced in the developed world is expected to weigh on industrial production and we might see its contribution to growth fall. In the medium term, manufacturing still has some way to climb until it reaches its pre-recession levels, with spare capacity, a recovery of consumer demand in domestic markets and opportunities in emerging markets still leave room for additional expansion. In the long run, manufacturing in developed markets will need to adapt to survive – taking advantage of the comparative advantages manufacturers still possess, such as technology and human capital. This niche approach has worked well in Germany and South Korea.

Currency tensions still lurk below the surface

The US dollar has weakened to varying extents against many of the major global currencies since the start of the year (see Chart 4 below). It has particularly lost ground to the euro, which has been buoyed by the strength of its two largest economies, Germany and France. The European Central Bank also chose to tighten interest rates in April and again in early July, policy decision which is not expected to happen in the US for some time. The periods where the euro has weakened in the last couple of months have largely coincided with fears of messy end to the Greek sovereign debt crisis.

The Brazilian Real has appreciated against the dollar as well, driven by substantially higher interest rates and buoyant commodity markets. The Japanese Yen was very volatile immediately following the earthquake, but ended June at roughly the same level as it entered 2011. The weakness of the US economy has also contributed to the weak dollar, with disappointing Q1 GDP growth figures and a string of poor data from the housing and labour markets putting downwards pressure on the dollar.

Chart 4: World currencies against the US dollar



Source: Thompson DataStream

The Chinese currency, the Renminbi, has not moved much against the dollar, due to the Chinese government's management of the exchange rate. An appreciation of 2% since the start of the year would have been larger without their intervention. The Chinese managed float has kept down the prices of their exports, particularly to the US. This is one factor that has contributed the build up of a large trade surplus between China and the US over the last ten years.

With US domestic demand struggling, the external competiveness of the economy could become more of an issue for US policymakers. However, the current weakness of the dollar is likely to slightly dampen the urgency of the need for the US to take action. Currency tensions are perhaps more of an immediate concern in emerging markets with high interest rates and floating exchange rates, such as Brazil, where interest rates are currently 12.25%. The Real currently sits at around 12 year highs against the US dollar, which has lead to concerns over the effects it could have on the competitiveness of domestic industry.

China's exchange rate policy effectively gives it a competitive advantage in export markets over emerging economies which are experiencing rapidly appreciating exchange rates. This has led to some emerging economies, such as Brazil, start to intervene to stop their currencies appreciating so fast, which could set a dangerous precedent; if more emerging economies follow suit, this is likely to see global currency tensions flare up once again.

Currency tensions have not disappeared from the global economy and if anything the economic environment is even more conducive to a currency war now than it was a year ago. The front line of the currency war has been quiet for some time, but don't expect this sleeping monster to stay dormant for too much longer.

World GDP growth outlook deteriorates slightly in 2011, but 2012 forecast unchanged

The rate of GDP growth is projected to slow to 3.2% for the world economy in 2011 due to tighter monetary policy in emerging markets, fiscal consolidation in the developed world and the end of the restocking cycle. Since our last report, there has also been a down rating of the growth prospects for two of the world largest economies; Japan and the US. The extent of the economic damage caused by the Japanese earthquake took some time to become apparent. The scale of the disruption caused to the supply chains of manufacturing firms was larger than expected (particularly in the automotive sector), which plunged the economy back into recession in the first quarter of 2011. The US economy has also experienced a slowdown in recent months, with the economy expanding well below trend in Q1 2011, and there has been soft data emerging from the US labour and housing markets and the manufacturing sector since the start of the year.

The main body of the reconstruction phase of the response to the recent Japanese earthquake will help boost world GDP growth to 3.6% in 2012. The general upswing in growth in 2012 is expected to be driven by improved growth performance in some of the G7 economies such as Japan, US, UK, and the Central and Eastern European countries like Russia, Poland, and Bulgaria. These countries are expected to be boosted by increased global trade, recovering consumer spending and lower levels of uncertainty surrounding global economic prospects.

GDP growth: Recent data and forecasts

	Share of world GDP in 2010	2009	Annual % change 2010	2011f	2012f
Global economy		-2.3	4.0	3.2	3.6
Major developed economies					
United States	23.3%	-3.2	2.9	2.6	2.9
Eurozone	19.4%	-3.6	1.7	2.0	1.7
Japan	8.7%	-6.3	4.0	-0.5	3.0
Germany	5.3%	-4.7	3.5	3.5	2.2
United Kingdom	3.6%	-4.9	1.3	1.4	2.2
France	4.1%	-2.5	1.5	2.2	2.0
Italy	3.3%	-5.1	1.2	0.8	1.0
Canada	2.5%	-2.5	3.1	2.7	2.6
Major emerging economies					
China	9.3%	9.1	10.3	9.5	9.1
Russia	2.3%	-7.9	4.0	4.2	4.5
Brazil	3.3%	-0.7	7.5	4.4	4.6
India	2.4%	7.0	8.6	8.0	8.2

Source: IMF; PricewaterhouseCoopers forecasts (f)

Inflation: Recent data and forecasts

	Share of world GDP in 2010	2009	Annual % change 2010	2011f	2012f
Global economy		0.8	2.4	3.4	2.7
Major developed economies					
United States	23.3%	-0.3	1.7	2.8	2.3
Eurozone	19.4%	0.3	1.6	2.6	2.0
Japan	8.7%	-1.3	-0.7	0.1	0.2
Germany	5.3%	0.2	1.2	2.7	2.3
United Kingdom	3.6%	2.2	3.3	4.5	2.8
France	4.1%	0.1	1.7	2.2	1.8
Italy	3.3%	0.8	1.6	2.5	1.9
Canada	2.5%	0.3	1.8	2.7	2.1
Major emerging economies					
China	9.3%	-0.7	3.3	4.9	3.5
Russia	2.3%	11.7	6.9	8.9	6.2
Brazil	3.3%	4.9	5.0	5.9	4.9
India	2.4%	2.2	9.6	8.3	6.8

Source: IMF; PricewaterhouseCoopers forecasts (f)

PwC Macro Consulting Services

Economic Views reports are produced by PwC's Macro Consulting team. The team maintains in-house models of over 40 economies which together account for 90% of global GDP. This provides us with the essential understanding of the economic outlook around the world. To this we add systematic and in-depth exploration and analysis of prevailing and emerging trends – economic and otherwise.

The team works with businesses and governments to identify and assess strategic opportunities and external risks. The team's consulting services combine strategic analysis of macro trends with strong quantitative techniques across four broad categories outlined below:

Economy Vision Design

We work with cities, regions and countries to create or update their economic vision blueprints and strategies. Our analysis takes into consideration our worldwide macro views and leverages our proprietary data on demand and supply trends in different regions and sectors. Using a mix of primary and secondary research, modelling, forecasting, benchmarking and gap analysis, we answer the following questions for our clients:

- What economic goals are realistic?
- Who are our main competitors?
- How we compare against the competition?
- What should we do to improve our global standing?

Geographical market selection

We assist growing multinational companies to assess opportunities in new geographical markets. This is done through bespoke econometric analysis using in-house models that project demand and supply dynamics. Typically we forecast demand in potential new markets as measured by revenue. To this we can add projections of costs and other risks that affect market attractiveness.

Business scenario analysis

We use our knowledge of macro trends and our econometric toolkit to help companies understand the risks and opportunities in their business through the following techniques:

- Revenue forecasting, using econometric models that link our economic forecasts and industry indicators to revenue;
- Stress-testing key business metrics by creating and applying upside and downside macroeconomic risk scenarios; and
- Price elasticity analysis, pointing at a product's optimal price in a given market and estimating its impact on key business metrics.

Economic impact analysis

We assist clients in demonstrating the value they bring to their host economies in the context of wider economic trends. Our findings are typically used for media profile-raising as well as to support government relations, and comprise estimates of a company or industry's impact on GDP, employment and long-term productivity growth, as well as other wider socio-economic benefits.

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