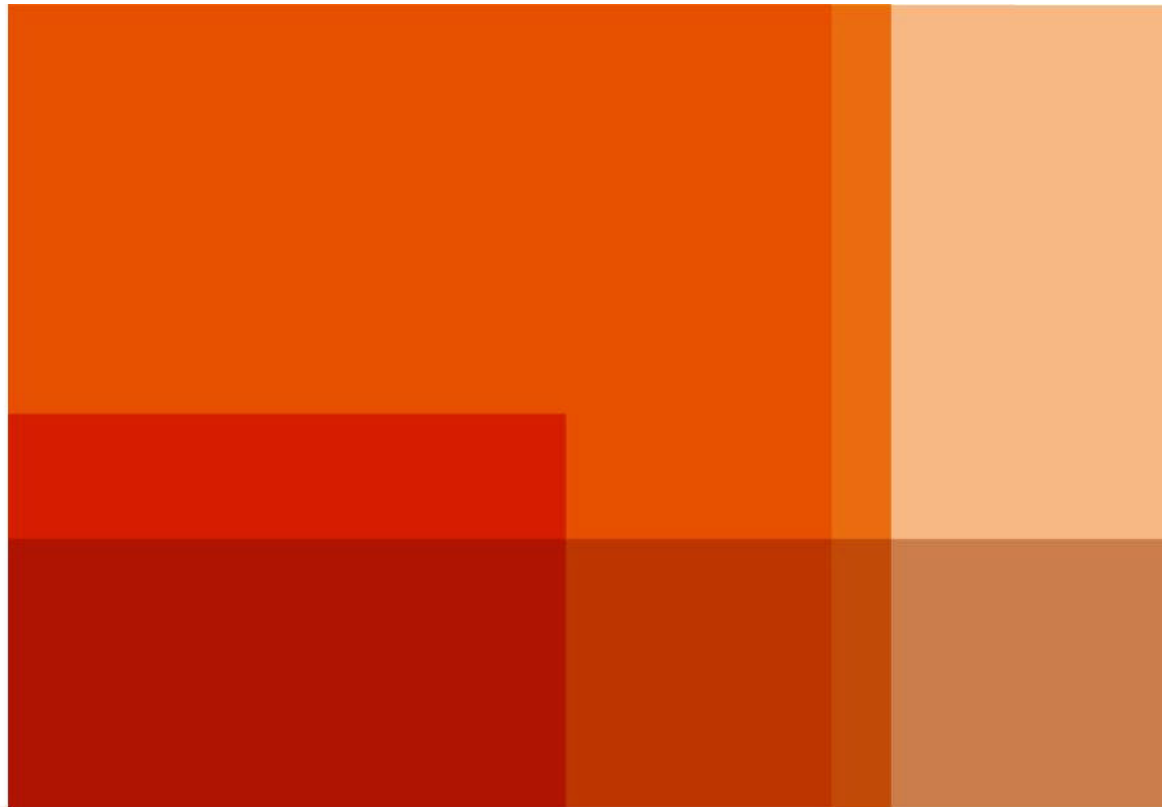


Economic Views Global

December 2011



View from the top

Three years after the onset of the global financial crisis the anticipated economic recovery in 2011-12 has been put on hold in most advanced economies. At the same time, developing economies have taken the lead in driving forward global economic growth. In this edition of Global Economic Views we set out five key themes that we believe will dominate the economic outlook for 2012 and will have implications for the wider business community.

Five key trends to look out for in 2012

- Next year is likely to see the continuation of uncertainty which will breed market volatility and exert pressure on the currencies of ‘weak’ emerging economies.
- The lack of a holistic plan to deal with the Eurozone crisis means that the ‘unthinkable’ – a Eurozone break-up – remains a possibility.
- A vacuum in global leadership is appearing at a time when it is needed most, casting a shadow on the timing of the recovery.
- On the brighter side, there will be significant business and trade opportunities arising in emerging markets.
- The combination of relative Middle East stability, low global economic growth and a weak dollar is likely to exert a downward pressure on oil prices in 2012.

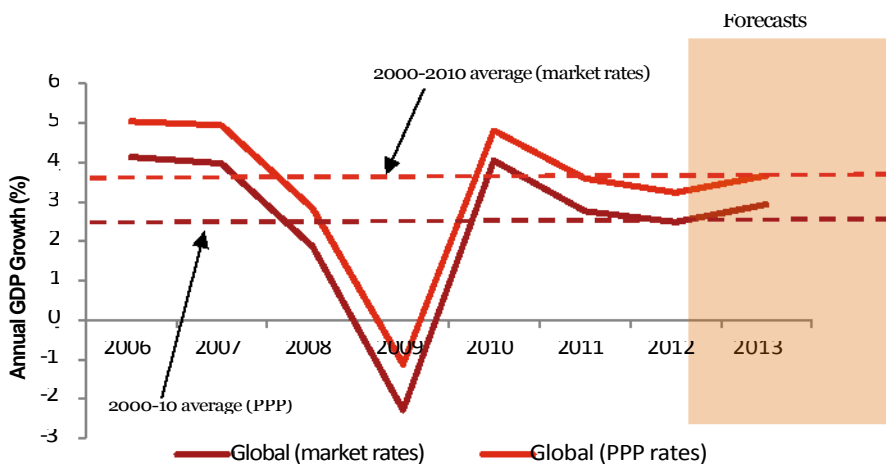
Key opportunities

- **Emerging market economic growth**
- **Affluent consumers in developing economies**
- **Stable oil prices**
- **Trade opportunities in China, India, South Korea and other stable emerging economies**

Key threats

- A Eurozone break-up
- Heightened market volatility
- Policy uncertainty
- Capital outflow from risky emerging economies and vulnerable European countries

GDP growth: recent history and forecasts



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1. Introduction

The past three years have seen the global economy bounce back from a financial crisis. The co-ordinated global response in 2009 is credited with helping to stabilise the economy at that time. However, the escalating eurozone crisis and the continued weak growth in advanced economies has cast doubts on the extent of the recovery in 2012. We now expect the US economy to grow at 2% next year, below its trend rate, while the Eurozone is flirting with a double-dip recession. Policy inaction in the US and Eurozone has characterised 2011. We expect this theme to continue into 2012 for the US, which could now be in a lame duck period, but Eurozone leaders may be forced to act decisively.

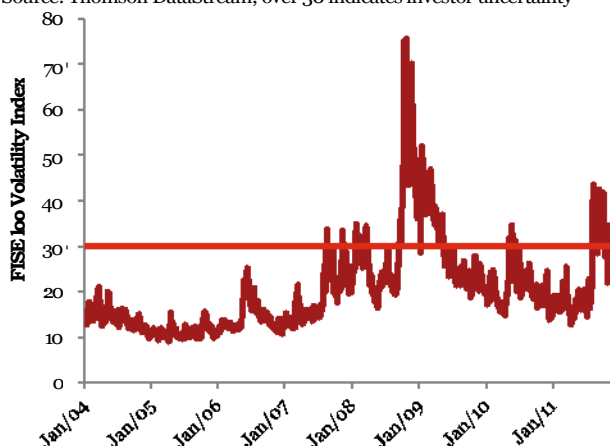
We anticipate developing economies, particularly those with an increasingly affluent consumer base and unencumbered by a high debt burden, will contribute around three-quarters of global economic growth in 2012. Significant opportunities are expected to arise for businesses exporting to China, which will continue to grow in importance as the Renminbi appreciates, and India through the further opening up of its vast internal markets.

Nevertheless, we expect a slowing of global economic growth in 2012, followed by a slight pick-up in 2013. A gradual return in confidence, a pick up of private sector activity in advanced economies, and a steady easing of credit conditions will drive growth in 2013.

2. Uncertainty and volatility

Uncertain political and economic outcomes drive volatility in markets; both are bad for business planning and both are increasingly present in the global economy today.

Figure 1: Volatility Index for FTSE 100
 Source: Thomson DataStream; over 30 indicates investor uncertainty



Uncertainty about global economic events, particularly in the developed world, has emerged as an issue in 2011. This is being fuelled by a lack of decisive action by policymakers

and economic data that is performing below expectations. In the Eurozone, it remains unclear how policymakers will respond to the current crisis so it is unclear where the economy is heading.

In other advanced countries, expansionary monetary policy is being undertaken on a scale which has never been tried before, leaving the medium-term impacts of these policies unknown.

Uncertainty is undesirable for a number of reasons. Firstly, it breeds volatility in the markets. Secondly, households and businesses delay investment and consumption decisions until they are more certain about the future. This drags down economic growth.

Figure 1 shows the implied volatility present in the FTSE 100 stock market which, due to its international composition, also reflects to some degree global volatility. According to the data provider a value higher than 30 indicates investor uncertainty. The index has been above this threshold for roughly half the trading days post-June 2011, although, at present it is below this threshold.

One consequence of market volatility is that investors opt for perceived safe-haven assets such as US and UK gilts; recently yields in these two countries have been pushed to record lows.

What does this mean for 2012?

We expect to see further market volatility in 2012 and an intensification of these capital flows. This will help sustain low interest rates in the receiving countries and should also cause their currencies to appreciate relative to the countries from which the capital is exiting.

As in 2008, this will create winners and losers. The difference this time around is that we think that investors will differentiate between 'risky' and 'stable' emerging economies more than they did in 2008.

Emerging economies with large stocks of foreign currency reserves or countries which have built investor confidence will fare better than the rest. These countries could include Brazil, China, Russia and South Korea. We expect these countries to maintain a stable environment for business and investment activities next year and maintain flat or marginally appreciating exchange rates.

The outlook for other emerging economies is more uncertain. The Turkish Lira, for example, has lost around one quarter of its value in the past six months partly because of capital outflows and fears about its large current account deficit. This has led to higher inflation and reduced economic growth – we have almost halved the growth projection for Turkey for next year. Businesses operating in emerging economies perceived as 'risky' by investors will

face upward pressure on their input costs from import-led inflation.

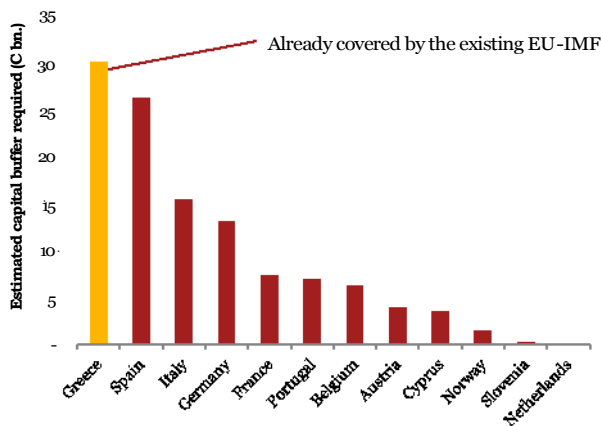
3. Think the unthinkable in the Eurozone

The Eurozone crisis has developed from a problem in a few peripheral countries to a full blown financial and sovereign debt crisis engulfing core European economies like Italy. We expect that the Eurozone that re-emerges next year will be very different to the one we know today. The implications for businesses within and outside this region are enormous.

The current combination of policy measures are not helping:

- A tightening of fiscal policy in a number of Eurozone economies in 2012, at a time of weak private sector activity.
- The European Central Bank (ECB) not loosening monetary policy further, even for solvent economies; and
- Enhanced capital rules coming into force by June 2012 which the European Banking Authority (EBA) estimates will cost the banking industry €114 billion - see Figure 2. In the absence of investor appetite to invest further in banks, or mitigating actions to retain earnings or reduce compensation, this will lead to lending cuts and a further tightening of credit conditions in 2012.

Figure 2: Additional capital European banks will need to raise to meet required European Banking Authority enhanced capital rules



Source: European Banking Authority, December 2011. Greece figures based on October 2011 estimate

The big concern for 2012 is that the Eurozone falls into a deep recession or worse. Growing market pressure and significant tranches of sovereign debt due for refinancing by early Spring point at a likely resolution to the current phase of the crisis in the first quarter of 2012, if not sooner.

What does this mean for 2012?

The events of the past few weeks have indicated that businesses should think the unthinkable in the Eurozone. Some commentators are suggesting that the probability of a break-up is as high as 50%. While we do not go this far we do see it as a possibility alongside other less radical scenarios. Our recent special focus paper *What next for the Eurozone*¹ outlines four potential scenarios for 2012 to help businesses make plans in these uncertain times.

In our best case scenario, which assumes an aggressive policy of monetary expansion, we expect the Eurozone to avoid recession in 2012, but this will come at a cost of high inflation in the short term and lower potential growth in the medium term. In our worst-case scenario, which would be triggered by a further round of sovereign debt restructuring, we expect that Eurozone GDP will contract by around 5% in a recession lasting two to three years.

On balance, we expect a small contraction in the Eurozone next year and we would expect the euro to depreciate against other major currencies in 2012. This is detrimental for the global economy as the Eurozone will not contribute to global growth, and is particularly adverse for countries that export to the Eurozone.

4. A lack of global leadership

Policymakers on both sides of the Atlantic appear unable to tackle problems in their economies. In Europe, leaders appear unable to manoeuvre out of the crisis, whilst in the US Congress still has not come up with a plan for dealing with the fiscal deficit. At a global level, the G20 has not played a central role in events this year, with its key meeting in November overshadowed by events in Greece.

In the US, the bipartisan ‘budget supercommittee’ assigned with coming up with a credible deficit reduction plan failed to reach an agreement. A second smaller proposal, the Americans Jobs Act, aiming to deal with a record high unemployment rate, has suffered a similar fate.

The Eurozone is suffering from a policy deadlock. The past few months have seen multiple formal and informal meetings between key players in an effort to build consensus. Policy initiatives from these meetings have tended to fall down under scrutiny. For example, while the December Summit of European leaders made progress on a more disciplined fiscal policy, equally important areas such as increasing the amount of funds available to support

¹ *What next for the Eurozone? Possible scenarios for 2012, Dec. 2012*

vulnerable countries and reforms to return vulnerable countries to a sustainable growth path remain elusive.

What does this mean for 2012?

The question for 2012 is whether there is sufficient consensus at the national and supra-national level to undertake the radical action needed, and provide markets with the confidence that ‘someone is in charge’, to avert escalation of events.

Unfortunately we do not see where this leadership will come from. The US is already in ‘election mode’ diverting policymakers’ attention from global events, and from taking tough decisions on the deficit at home. European policymakers have yet to prove, firstly, that they can agree on a way out of the crisis in the Eurozone, and secondly, that they can focus on economic objectives further afield. Finally, none of the emerging market economies appear ready to take on a global leadership role.

The G20 may be the only credible supra-national body that can step into the role. It did not have a good 2011. A key decision that the G20 will need to make next year will be whether to boost the resources of the International Monetary Fund (IMF) so that it can play an even stronger role in supporting the Eurozone economy through the crisis and protect other economies from the fallout. Getting agreement on this will be tough under Mexico’s chairmanship, which has limited experience of dealing with global economic issues.

5. Opportunities in emerging markets

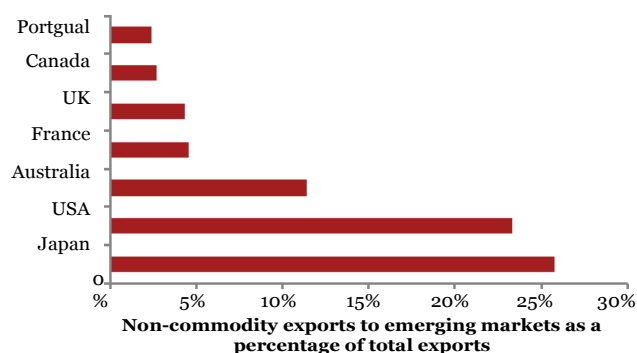
We expect that the economic crisis will accelerate the shift of economic activity from advanced to emerging economies. As part of this transition we expect consumers to play a larger role in emerging economies. This is one of the few bright spots for businesses to exploit in 2012.

Our recent report² looking at the future of global trade flows over the next 20 years, points out how this trend is expected to develop, particularly in the high-end manufacturing and service sector. In an often cited example, China is predicted to account for nearly 20% of global demand for luxuries by

2020³. The question right now however is: how well-placed are advanced economies to exploit this opportunity to cushion weak domestic demand at home?

The answer will largely depend on the existing trade and commercial networks that are in place with the BRIC and other emerging economies. Figure 4 indicates that US and Japanese businesses have already taken advantage of this opportunity, partly because of their geography. European businesses, however, are lagging behind.

Figure 4: Trade linkages with emerging markets



Source: UNCTAD, 2010 figures

Movements in exchange rates will also play a role. In theory, an economy with a depreciating exchange rate is associated with an improving net-export performance. However in practice, some countries manage their exchange rate which prevents this adjustment.

China for example, has appreciated its currency by 4% this year under international pressure, but this may need to be much higher given their trade balance.

We have also seen signs of a reform momentum appearing in India with respect to opening up its retail, airline and insurance sectors to foreign investors. Opportunities in India are important to businesses because of the sheer size of its markets and its potential for growth.

What does this mean for 2012?

In 2012, if the Chinese are persuaded to continue to appreciate the renminbi, there will be an excellent opportunity for businesses to exploit existing trade linkages to increase their exports in this growing economy. In India

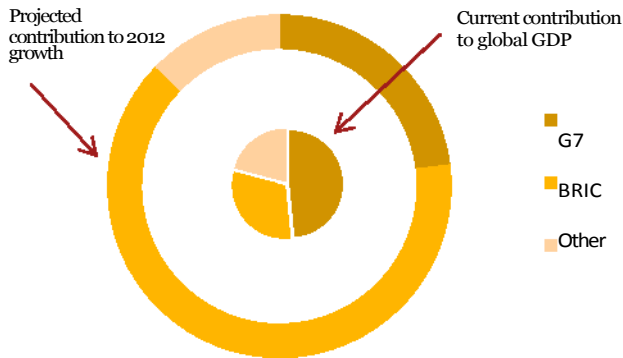
² Future of world trade. Top 25 sea and airfreight routes in 2030, Mar 2011

³ CLSA Asia-Pacific Markets, Dipped in Gold: Luxury Lifestyles in China and Hong Kong, Feb 2011

key opportunities will exist for the country to capture a bigger proportion of global FDI flows.

Domestic firms in emerging economies should benefit from the transfer of skills and know-how whilst those investing could benefit from a more diversified portfolio.

Figure 6: Composition of global GDP and contribution to 2012 projected growth



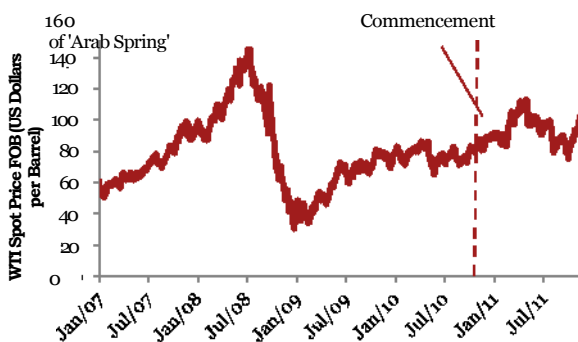
Source: IMF, PwC analysis

Our forecasts suggest that more than 75% of global growth will come from these economies even though they make up only around half of global GDP.

6. Stable oil prices

Unrest in the Middle East and North Africa (MENA) region, which began a year ago, risked destabilizing oil markets as this region produces 61% of global oil supply. The major development in the ‘Arab Spring’ countries was the establishment of interim administrations in Libya and Tunisia as well as the completion of elections in Egypt. Despite these developments, oil prices over the last year have fallen from a peak of \$113 per barrel in April 2011 and have been relative stable since.

Figure 7: Oil prices



Source: US Energy Information Administration

What does this mean for 2012?

Despite continued instability in Syria and other isolated pockets of turmoil, we do not envisage that events in the MENA region will play a decisive role in oil prices next year. Instead, we think that oil demand and the US dollar exchange rate will be the principal determinants of oil prices in 2012.

The combination of slowing global growth and upward pressure on the US dollar exchange rate should prevent oil prices rising further in 2012 and, in fact, it is more likely that they will fall.

GDP growth: Recent data and forecasts

	Share of world GDP in 2010	Annual	% change		
		2010	2011 ^e	2012 ^f	2013 ^f
Global economy		4.0	2.7	2.5	3.0
Major developed economies					
United States	23.3%	2.9	1.6	2.0	2.5
Eurozone*	19.4%	1.7	1.5	-0.2	1.0
Japan	8.7%	4.0	-0.5	2.1	1.3
Germany	5.3%	3.5	2.6	0.9	1.5
United Kingdom	3.6%	1.3	1.0	1.0	2.1
France	4.1%	1.5	1.7	-0.4	1.5
Italy	3.3%	1.2	0.6	-1.4	-0.6
Canada	2.5%	3.1	2.2	2.0	2.3
Major emerging economies					
China	9.3%	10.3	9.3	8.4	8.6
Russia	2.3%	4.0	4.4	3.4	3.7
Brazil	3.3%	7.5	3.5	3.7	4.2
India	2.4%	8.6	7.4	7.7	7.8

Source: IMF; PricewaterhouseCoopers estimate (e) and forecasts (f)

Inflation: Recent data and forecasts

	Share of world GDP in 2010	Annual	% change		
		2010	2011 ^e	2012 ^f	2013 ^f
Global economy		2.4	3.5	2.7	2.5
Major developed economies					
United States	23.3%	1.7	2.9	2.0	1.9
Eurozone*	19.4%	1.6	2.5	2.2	2.0
Japan	8.7%	-0.7	0.0	-0.1	0.2
Germany	5.3%	1.2	2.3	3.0	2.5
United Kingdom	3.6%	3.3	4.8	2.5	2.1
France	4.1%	1.7	2.2	1.8	1.6
Italy	3.3%	1.6	2.7	0.8	1.5
Canada	2.5%	1.8	2.8	2.1	2.0
Major emerging economies					
China	9.3%	3.3	5.6	3.9	3.6
Russia	2.3%	6.9	8.3	6.5	6.4
Brazil	3.3%	5.0	6.4	5.6	5.2
India	2.4%	9.6	9.0	7.3	6.6

Source: IMF; PricewaterhouseCoopers estimate (e) and forecasts (f)

* Projections are derived from a probability-weighted outlook for our different scenarios described in the *What next for the Eurozone? Possible scenarios for 2012 (Dec. 2012)* report.

PwC Macro Consulting

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.

Geographical market selection

We assist growing multinational companies to assess opportunities in new geographical markets.

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.

Economic impact analysis

We assist clients in demonstrating the value they bring to their host economies in the context of wider economic trends.

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