

# Heading for the rocks

Will financial turmoil sink the world economy?

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ownership of CDOs, this led to a widespread loss of confidence in counterparty risk in the financial system.

Corporate borrowing costs soared, mergers and acquisitions dried up and stock prices fell. Hedge funds, which borrow heavily to supercharge their returns, faced margin calls from lenders, which forced them to sell good assets to raise cash. Even the biggest institutions became reluctant to lend to each other in the interbank market, where the wheels of finance are greased. With the global financial system shuddering, central banks in the US, Europe and Asia injected funds into their economies to keep them functioning. The search for higher returns that had tempted investors to ignore risk and buy equities in Russia, bonds in Egypt and currencies in Iceland was reversing as risk was repriced.

**Has dispersing risk really made the world safer?**

Events of the past month have shown that while risk can be disintermediated by banks, it cannot be eliminated. Arguably, it migrates to elements of the financial system, such as hedge funds, insurers and pension funds, which are less qualified to manage it. And banks, which had been thought to have become safer as a result of the disintermediation of risk, now face increased risk exposure. Some are being forced to assume responsibility for the liabilities of off-balance-sheet vehicles which cannot be refinanced. Others have been left holding large loans for leveraged buy-outs which they underwrote but cannot syndicate in current market conditions.

## Global outlook: The good, the bad and the ugly

### *The main risk to the world economy is a deflationary spiral in asset prices*

The tremors in financial markets have gone far beyond their beginnings in the US subprime mortgage sector, and indeed far beyond the borders of the US. The full impact on the markets, and the repercussions on the global economy, remains unclear, but we can sketch out three broad scenarios:

- Scenario 1. The Economist Intelligence Unit's central forecast, to which we attach a probability of 60%, sees the impact being contained by timely monetary policy action, with only a modest effect on the global economy.
- Scenario 2. Our main risk scenario, with a 30% probability, envisages the US falling into recession, with substantial fallout in the rest of the world.
- Scenario 3. Should the US enter recession, another, darker scenario arises: that corrective action fails, and severe economic repercussions cascade from the US into the world economy with devastating effect. We attach only a 10% probability to this outcome, but the potential impact is so severe that it warrants careful consideration.

Since scenario 1 informs our regular output and scenario 3 has a low probability, the bulk of this report focuses on scenario 2.

### **Subprime failures, liquidity shortages and deleveraging**

Broadly speaking, there are three main routes through which market turmoil could have its impact. The first is the direct effect on holders of subprime-related assets. The second is the liquidity crunch that is occurring in response to uncertainty over who holds the dubious assets and the extent of their exposure. The third is the repricing of risky assets in response to the subprime crisis, and, as a corollary, the reduction of leverage in the global financial system.

The three mechanisms carry different levels of threat. The US subprime crisis will have a direct impact on all those holding subprime-linked assets, including those subprime mortgage lenders who are still in business. This is a relatively small asset class, so losses should be contained. The Federal Reserve (US central bank) estimates the total losses at US\$50bn-100bn, compared with total debt in the US non-financial sector of US\$29.3trn at the end of March 2007. Although the Federal Reserve's estimate may be too low and mortgage-related losses may widen beyond the subprime sector, total losses should be manageable.

The liquidity issue is more worrying. Because it is difficult for lenders to assess other financial institutions' exposure to subprime losses, their willingness to lend even to each other has been curtailed. As a consequence, the supply of funds in money markets has been squeezed, restricting the supply of short-term financing for financial institutions and threatening a systemic liquidity crisis. However, modern central banks have an impressive arsenal against such a crisis, and the biggest have been quick to act, providing massive cash injections to the money markets. The Federal Reserve has also cut its discount rate (the rate at which it lends to banks if they need emergency cash).

**Deleveraging is the most serious risk of all**

The third issue is the most serious of all—a repricing of risky assets and deleveraging by investors. As investors and financial institutions reappraise the risks associated with different assets, prices of all sorts of instruments (equities, corporate and government bonds, commodities and even works of art) will adjust to new (generally lower) levels. For any given level of risk, financing will be more expensive and will be rationed. Private equity's heyday has passed. Acquisition targets will be smaller and the leverage applied to deals less extreme. Assets under management by hedge funds will fall. Casualties of the recent turmoil will close. Survivors will find it harder to attract fresh capital as pension funds and other mainstream investors rethink the wisdom of their allocations into alternative assets. Banks, still the centre of the financial universe notwithstanding the growth of derivatives, will have to deleverage in order to offset liabilities which they are forced to bring onto their balance sheets. This downward pressure on asset prices and paying off of debt have the potential to crimp the broad global economy, extending far beyond the original subprime area.

Subprime losses, a drying-up of liquidity, and a generalised repricing of risk and deleveraging will be concerns under all three of our forecast scenarios. The difference between the three economic outlooks hinges on the severity of their effects. Subprime losses will be significant under all scenarios, even our central forecast that serious economic fallout is avoided. Liquidity concerns will vary between the scenarios, depending on the speed with which market participants identify which institutions are nursing big losses and the ability of central banks to keep the money markets operating. But it is in the issue of deleveraging where the main differences between the three risk scenarios lie. In our central forecast (scenario 1) it occurs in a gradual, orderly fashion. In our main risk scenario (scenario 2) recession in the US leads to wider payment difficulties with mortgages and to corporate bankruptcies. This leads to a more aggressive rationing of credit on the part of banks, with adverse feedback effects into the real economy. Our worst-case scenario (scenario 3) encompasses a systemic financial crisis, including bank failures, declining asset prices and widespread insolvency problems.

Monetary policy will play a key roll in determining which scenario comes to pass. Many want central banks to cut interest rates aggressively, and quickly. But, although the authorities have learnt their lessons from the great depression (when the Federal Reserve kept monetary policy tight), they face difficult policy choices. They do not want to encourage moral hazard by being seen to bail out investors and speculators who have made risky bets. Memories are still fresh of 1998 when interest rate cuts in response to the failure of a hedge fund, Long Term Capital Management, contributed to the stockmarket bubble of the late 1990s.

But if liquidity injections are insufficient to restore money markets to normal, or deleveraging starts to occur at a rapid pace, the crisis will cease to be a purely financial one and will start to have clear economic consequences. In such circumstances, central banks will feel that they have little alternative other than to cut their policy rates. There are questions about how effective cuts in policy rates will be in improving financing conditions if—as is likely—

there is a general tightening of lending standards following the excesses of the past few years. In our central forecast, we assume that monetary easing does work and helps the US to avoid recession. But it is easy to see how a worse outcome could occur.



In trying to identify which of our three scenarios will come to pass, it is interesting to consider how the world economy came to be in this situation. The subprime problem is symptomatic of a broader cycle of an increase in indebtedness, associated with asset price appreciation and a mispricing of risk. Recent years have seen a sharp decline in the volatility of asset prices, luring many investors towards riskier assets. The associated price gains have made these assets appear even more attractive, as have the poor returns available on low-risk instruments such as the government bonds of the main industrialised countries. Seeing what looked like a one-way bet, many investors borrowed heavily to invest. Consequently, equities, real estate, emerging markets, commodities, even works of art and, of course, subprime mortgages, all appreciated dramatically in value. The recent market disruption has led to a substantial decline in prices for some risky assets, and the potential for further losses is high. Under our central forecast, measures including effective intervention by central banks will mitigate these problems, allowing markets to rebalance in an orderly fashion without undue repercussions for the wider economy.

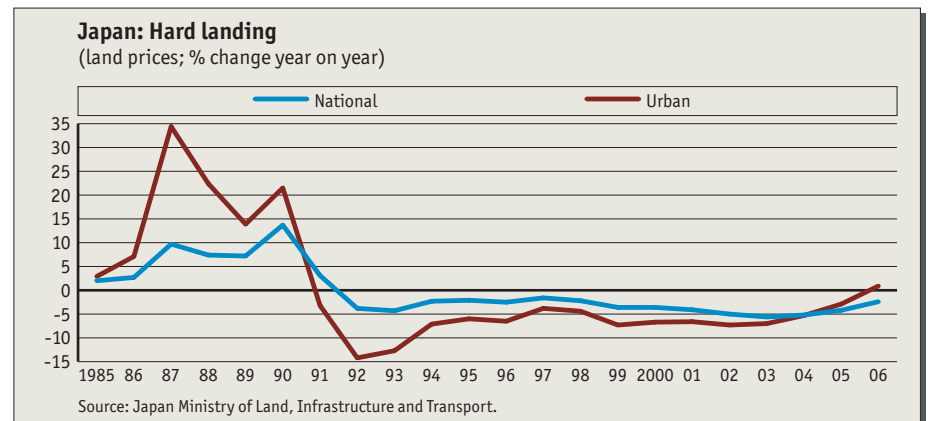
### **The likely economic outcome under our main risk scenario**

However, under our main risk scenario interventions would only be partly effective and the depth and duration of turmoil on the markets would be extended, with implications not just for financial markets but for the "real" economy too. With investor confidence waning, a steady fall from the recent peak in risk asset prices would begin. The damage would not be confined to the US—across the developed and emerging world, risk asset prices are already under downward pressure. To take equity markets as one example, a 20% peak-to-trough fall seems plausible, given movements in recent weeks.

As risk asset prices fall further, banks—under pressure to improve their balance sheets—will force investors to liquidate even their good investments to meet margin requirements. As this process expands, more assets will be sold, triggering further price declines and margin calls. At its worst, this self-

reinforcing trend could see prices chasing each other down across asset classes in a debt deflation spiral.

Housing prices in the US, in particular, have further to fall, but property valuations are also high relative to rents in other industrialised countries (see box—**Housing markets: Living in a bubble**). According to the OECD, inflation-adjusted house prices in major economies (excluding Japan and Germany) rose by 6.4% in 2000-05, up from 4.2% in the previous five-year period. Average growth rates had never before risen above 3.1% for any five-year interval since 1975, and this surge suggests a global housing bubble.



Japan provides a dire example of how bursting asset bubbles can play out. Japanese stock prices rose by 200% between the end of 1985 and the end of 1989, before falling by 60% by the end of 1992, and house prices followed a similar trend. Largely because of this, Japan’s economy was essentially stagnant for the next ten years, plagued by deflation and debt. The surge in Japanese asset prices, admittedly, was faster than it has been in the US of late—there was talk of the Imperial palace in Tokyo being worth more than the entire US state of California—but the effects of falling asset prices in the US would be serious nonetheless.

**A US recession would cause a cascade of damage**

The US would be most directly affected by the financial downturn envisaged in our main risk scenario. We would expect growth to slow to 0.2% in 2008, compared with a 2.3% projection in our central forecast. US households would face major losses on equity and real estate investments. US companies, which have relied heavily on consumer spending for their profits, will cut back on investment as demand falls and financial conditions tighten.

The effect on the rest of the world would come through two channels: deteriorating global financial conditions and weakening demand from the US. Higher risk premiums would have an immediate fallout for companies. At present, corporate leverage in the non-financial sector globally is modest. Companies have worked hard to improve balance sheets after rampant borrowing and investment during the dotcom bubble in the late 1990s. As profits have soared, companies have relied on their earnings to finance investment plans. But profits will fall under our main risk scenario, reducing opportunities for businesses to self-fund investments. Beyond that, companies in many countries still rely heavily on banks and financial markets for funding,

both of which will be hit by tightening credit. More importantly, the slump in US private consumption will cause many export-oriented companies worldwide to reassess investment plans, since demand is a bigger factor in investment planning than the cost of capital.

### **Decoupling from the US?**

The growing size and influence of European and Asian economies means that the US has less influence on global growth than it did a decade ago. Indeed, minor fluctuations in US demand do not have a noticeable effect on growth in the rest of the world. But the sharp slowdown in the US envisaged in our main risk scenario would seriously affect global growth because no other economy is large enough and dynamic enough to pick up the slack. Although the euro area has performed well of late, this followed several years of buoyant global demand that strengthened employment growth and investment in western Europe. A withdrawal of US demand would cause Europe's recovery to falter. Nor is Europe, with its relatively high savings rate and concern over pension security, likely to replace the US as the "consumer of last resort".

Neither is Japan in a position to pick up the economic mantle from the US. Growth in Japan over the last five years averaged 1.7%, of which more than one-third came directly from exports. Consequently, a downturn in export demand from a languishing US economy will, under our risk scenario, undermine the Japanese expansion. Japan has limited room for a policy response, since short-term interest rates are already at 0.5% and the country boasts the worst fiscal position of the developed world. As in the euro area, Japan's prospects will be undermined by a sharp appreciation of the yen, which will be boosted in our main risk scenario by a massive unwinding of so-called carry trades (see box—**The carry trade: Cashing in?**).

During the first half of 2007, China's contribution to global GDP growth surpassed that of the US for the first time. But if it is wrong to say that the euro area and Japan have decoupled from the US, it is even more dubious to make this claim for China and emerging Asia generally. Intra-Asian trade has surged in recent years, but this largely reflects the increasing integration of supply chains across Asia. According to the Asian Development Bank, 70% of trade within Asia (including China but excluding Japan and Taiwan) consists of intermediate goods used in manufacturing processes, and a large share of goods still ultimately end up in rich, developed countries. Consequently, the sharp US slowdown envisioned in our main risk scenario will cause real pain for many Asian economies, although the full effect may only hit the region (and other emerging markets) with a delay. Many governments, including China's, will also try to dampen the impact of a US downturn by intervening to keep their exchange rates relatively steady against the US dollar. But US politicians will rail against what they see as unfair currency policies, targeting China in particular and leading to a rise in trade tensions.

In our main risk scenario, Latin America will be hit harder than other emerging markets because it depends more than most on the US market, and because of still-elevated debt levels that need to be financed from abroad (despite considerable progress on this front recently). Eastern Europe will suffer from slower growth in the euro area. Several of the more highly leveraged countries, such as Turkey, will be hurt by tightening financial conditions, increasing the

risk of a crisis. The Middle East and many African economies will suffer from a fall in commodity prices. Yet even in our main risk scenario, crude oil prices will still be high by historical measures, averaging US\$42/barrel in 2008. As many oil exporters have been unable to absorb surging energy receipts domestically, the impact of the deteriorating terms of trade on them will be only moderate.

The cascade of repercussions around the globe is the subject of the remainder of this report, which focuses on the implications region by region.

### Forecasts and risks

Under our central forecast (scenario 1), the global economy will grow by 5.1% in 2007 (calculated using purchasing power parity exchange rates) and by 4.8% in 2008. If our main risk scenario (scenario 2) comes to pass, world GDP growth will slow to 4.8% in 2007 and 3.7% in 2008. The growth rate next year would still surpass the 2.4% and 2.9% rates in 2001 and 2002 respectively, and would still be above the threshold that most economists set for a global recession (around 3%).

Why is this only a risk and not our central forecast? We believe central banks have learned important lessons from past asset price bubbles, and will not hesitate to pump funds into the economy to cushion a slowdown in growth. In our main risk scenario, we expect the Federal Reserve to look past inflationary pressures (which would evaporate quickly in a slowdown) and cut its benchmark lending rate from 5.25% to 3.75% by the end of 2008. The European Central Bank will also cut its reference rate, and the Bank of Japan will slow the pace at which it raises rates (from an extremely low level).

At the same time, our main risk scenario is by no means the worst case. There is a possibility that monetary policy stimulus may have less traction than it did during previous downturns (possibly because of financial innovation itself). There is also a risk that central banks will withhold interest rate cuts for fear of creating a "moral hazard" that would encourage another round of overinvestment and another asset bubble.

Many policymakers, including the IMF, play down the risk of a severe global slowdown, emphasising the economy's "strong fundamentals". This is true only in the narrow sense that global growth has been very strong in recent years. But the global expansion stands on a fragile base, driven by unsustainable consumer demand in the US. Many commentators, including the Economist Intelligence Unit, believe that the repricing of risk is a good thing because it will put the global economy on a sounder footing. But this is true only in the longer term. For the next 12 to 18 months, a significant reassessment of risk could lead to huge capital flows into and out of economies, volatile currency swings, big fluctuations in stock and bond prices, and rising alarm among investors. This is a recipe for slower growth in much of the world, and brings the risk of a recession that much closer.

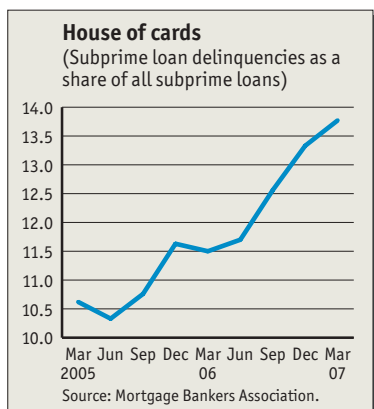
**World summary: Main risk scenario**

(central forecast in brackets)

	2006		2007		2008		2009	
<b>Real GDP growth (PPP exchange rates)</b>								
<b>World</b>	<b>5.3</b>	<b>(5.3)</b>	<b>4.8</b>	<b>(5.1)</b>	<b>3.7</b>	<b>(4.8)</b>	<b>3.9</b>	<b>(4.5)</b>
OECD	3.0	(3.0)	2.3	(2.6)	1.2	(2.5)	2.1	(2.6)
Non-OECD	8.3	(8.3)	7.8	(8.2)	6.6	(7.5)	5.8	(6.7)
<b>Real GDP growth (market exchange rates)</b>								
<b>World</b>	<b>4.0</b>	<b>(4.0)</b>	<b>3.2</b>	<b>(3.6)</b>	<b>2.0</b>	<b>(3.5)</b>	<b>2.9</b>	<b>(3.4)</b>
United States	2.9	(2.9)	1.5	(1.9)	0.2	(2.3)	1.8	(2.7)
Western Europe	2.9	(2.9)	2.4	(2.7)	1.4	(2.3)	2.0	(2.2)
Eastern Europe	6.8	(6.8)	6.1	(6.5)	4.4	(5.8)	5.0	(5.2)
Asia & Australasia	5.4	(5.4)	5.2	(5.6)	3.7	(5.2)	4.2	(4.6)
Latin America	5.3	(5.3)	4.3	(4.6)	3.2	(4.1)	3.5	(3.7)
Middle East & North Africa	5.7	(5.7)	4.8	(5.1)	4.2	(5.6)	5.0	(5.4)
Sub-Saharan Africa	5.7	(5.7)	5.2	(5.6)	4.0	(5.9)	4.8	(5.7)
<b>Trade in goods</b>								
<b>World</b>	<b>10.2</b>	<b>(10.2)</b>	<b>6.5</b>	<b>(7.1)</b>	<b>5.3</b>	<b>(8.0)</b>	<b>7.0</b>	<b>(8.0)</b>

## United States: How much slower?

***Our central forecast is for the US to come through the turbulence relatively unscathed, but the risk of a recession is rising***



The principal challenge facing the US economy is not the dislocation in financial markets but the consequences of the housing fallout. Even before the financial turbulence, the Economist Intelligence Unit had expected the economy to slow during the remainder of 2007 and in early 2008. The housing slump shows few signs of easing; the stock of unsold homes was at a record in June, and monthly figures show that the median price of existing homes is still falling. Delinquencies on subprime mortgages will continue to rise; many of these loans had low introductory rates that reset at significantly higher levels after two or three years. Mortgages granted in 2005, at the height of the housing bubble, have only just begun to reset, suggesting that the delinquency rate—nearly 14% in the first quarter—will move higher. This will sap consumer confidence and weigh on spending. The labour market—which is only now feeling the effects of the housing slump—will also be a source of strain. The unemployment rate in July ticked up one-tenth of a percentage point, to 4.6%, but we expect it to approach 5% in coming months.

### Central scenario—60%

Despite the recent financial market crisis, we expect a gradual recovery in consumer and business spending in 2008. There remain many positive signs—not least the strong level of corporate profitability and robust corporate balance sheets, which gives some confidence that the non-financial sector can ride out the storm. With limited easing by the Federal Reserve (the central bank), and absent any nasty surprises emerging in the banking sector, our central forecast of GDP growth averaging 1.9% in 2007 and 2.3% in 2008 seems reasonable (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### Risk scenario—30%

The current market disruptions have, however, clearly raised the risks of a worse outcome for the economy over the next 18-24 months. Although these do not constitute our baseline scenario, their potential impact means that they must be given careful consideration.

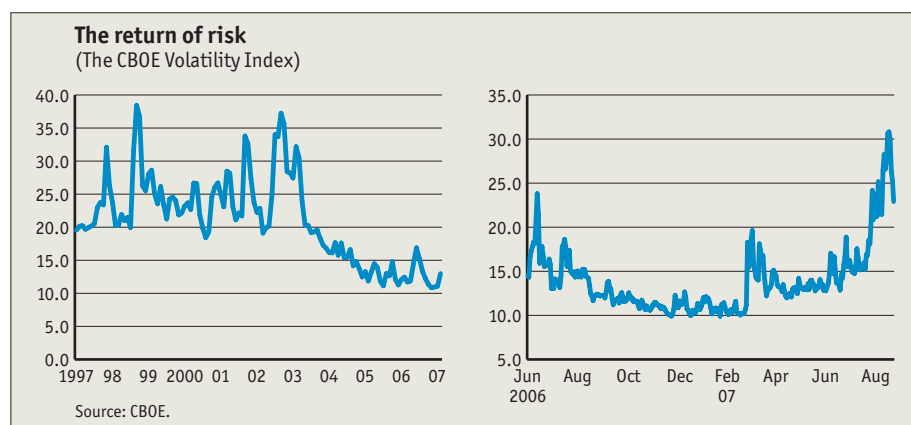
**Falling consumption, investment and exports would add up to a recession**

In our risk scenario, renewed market turbulence and yet tighter credit conditions are sufficiently destabilising to push the US economy into a recession in 2008, with output declining for two consecutive quarters. Problems in the broader financial sector would start to appear, as the downward pressure on financial asset prices exerts pressure on firms with only limited exposure to subprime mortgages. The Federal Reserve would respond, but a broad-based seizure in financial markets would nonetheless exact a heavy price on growth. GDP growth for 2008 overall would average just 0.2%. The transmission process

from financial sector turbulence to economic growth would occur in three ways: through reductions in consumer spending, business investment and exports.

When the Internet tech bubble burst in 2001, many economists predicted a long and crunching recession for the US as households cut back their spending to reflect the losses sustained on their equity portfolios. The downturn, however, was far milder than feared, in large part because aggressive interest rate cuts by the Federal Reserve kick-started a housing boom, which did much to offset the fall in equity prices on consumers' overall wealth. The situation this time round, however, is much less favourable. House prices in the US have been declining since mid-2006, limiting the ability of consumers to borrow against the equity in their homes and spend on consumer durables. Softer house prices also encourage consumers to save more, as their total wealth declines. But these negative effects have been mitigated, to some extent, by gains in other areas of households' portfolios. Surging equity markets have allowed some consumers to overlook their housing woes. Indeed, the Standard & Poor's 500 equity index rose by around 10% this year before the financial crunch.

In this risk scenario, in which both housing and equity prices are declining, we assume that downward price pressure in these markets continues for at least the remainder of 2007. Housing markets are plagued by oversupply and a sudden removal of credit from low-income borrowers, while equity markets have been stimulated by liquidity-fuelled merger and acquisition activity (which in our risk scenario would not continue). This would almost certainly lead to a significant pullback in consumer spending. Housing and equity prices falling together for a sustained period would prompt a jump in the personal savings rate, which, at less than 1% of disposable income, is currently very low. More savings would mean less personal spending, which makes up 70% of GDP. The effect on economic growth would be swift and substantial.



Business investment is also vulnerable. In the debt markets, spreads on corporate bonds surged in the days after the crisis broke, and investors remain wary of all but the safest debt—US Treasury notes. In mid-August contracts on the CDX North American Investment Grade Index (a benchmark for the cost of protecting corporate bonds against default) soared. In our central forecast (scenario 1), we expect business investment to continue growing this year and

next. But in our risk scenario, with a further tightening of credit conditions in the corporate paper market and an expected consumer demand crunch, business investment would be likely to decline. Profits, which have been exceptionally strong in recent years, would slump, while confidence waned. This would further erode economic growth. In such an environment, companies would begin reducing staff and would cut back on hiring. We would expect the unemployment rate in this scenario to rise gradually but steadily over the next two years, peaking at around 6% in mid-2009.

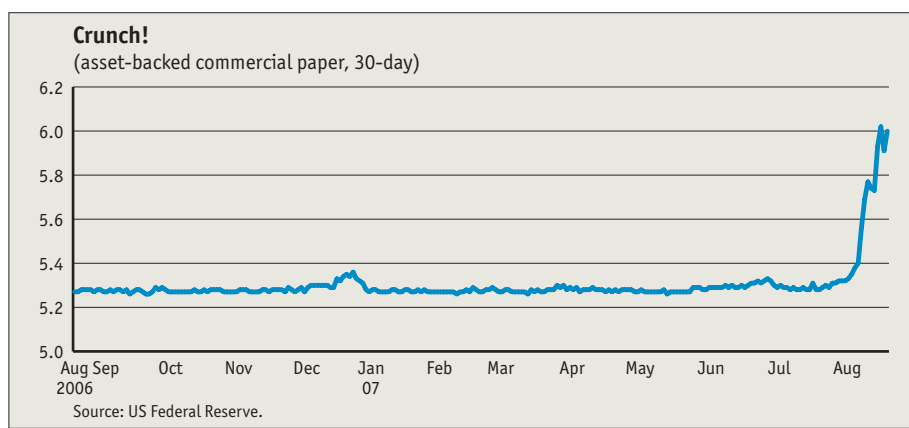
Exports, a bright spot for the US economy in 2007, would also falter if a global repricing of risk drained liquidity from the economies of key US trading partners. US exports have been rising at a rate of more than 10% a year since 2005, and strong growth in foreign markets was expected to sustain and strengthen that pace in 2008. But the reinforcing effects of the global crisis would curb that trend: a slumping US economy would buy less from other countries, which in turn would have less cash to purchase US goods. An outflow of investment from emerging markets as investors' reassessed risk would also slow their demand for US goods.

**Federal Reserve intervention  
would ease any liquidity  
problems**

The Federal Reserve would not remain idle as the economy slowed. We would expect the central bank to lower interest rates by about 150 basis points between 2007 and 2008. Indeed, this policy response is an essential component of our forecast—without it, a darker outlook would beckon. Rate cuts would add liquidity to the economy, limiting the depth of the recession and, over time, helping to stimulate a gradual recovery. But even with timely policy action, severe market turmoil spilling over into the real economy would exact a serious toll on economic growth, which would remain below trend in 2009, at only about 1.8%.

**A number of things could send  
markets tumbling again**

There are several potential triggers for a renewed tightening of equity and credit markets—and, hence, the onset of a recession. The first is the possibility of the collapse of an important financial institution or market participant. Already, two hedge funds run by Bear Stearns, an investment bank, have lost virtually all of their assets, and at least 90 mortgage companies have either closed down or sought buyers since the beginning of the year. So far, there has been no evidence that any of the major banks are in financial trouble, but the opaque nature of their derivatives investments suggests that regulators and markets do not have a clear idea of where the stresses lie. Four large US banks borrowed money from the Federal Reserve on August 22nd, and, while this was a symbolic act—to remove the taint normally associated with borrowing from the central bank—it suggested that other, more needy institutions may come next. Indeed, pressures in the banking pipeline are building: according to the Federal Deposit Insurance Corporation, a banking regulator, in late August, late loan payments in the second quarter at US banks and thrifts rose by 36% on the year-earlier period, the largest 12-month jump in 16 years.



Miscommunication between the Federal Reserve and financial market participants also poses a significant risk to the economy, and to a renewal of turbulence. At its scheduled August 7th policy meeting, the central bank barely acknowledged pressures in financial markets, stressing its goal of reducing inflation. Three days later, as markets unravelled, the Federal Reserve injected liquidity into the financial system, and a week later cut by half a percentage point the rate at which it lends to banks—the so-called discount rate. This helped, but left financial markets counting heavily on cuts in the more important federal funds rate—which sets the standard for short-term interest rates nationally.

The Federal Reserve finds itself in a difficult position: it is keen to retain its inflation-fighting credentials and is therefore reluctant to cut interest rates, which may create a “moral hazard” by bailing out investors and encouraging them to take on too much risk again in future. Yet the Federal Reserve has said it “is prepared to act as needed” to aid the financial system, suggesting that a rate cut cannot be ruled out. This juggling act will be a difficult one for the Federal Reserve to maintain, and any slip could unnerve markets.

### **Worst-case scenario—10%**

The risk scenario outlined above sounds alarming, particularly in the context of an economy that has performed so well in recent years. But it is by no means the most negative plausible outcome. The financial pressures outlined above, resulting in a sharp curtailment of credit across the economy overall, would have a much more serious impact if the Federal Reserve failed to respond sufficiently, and in a sufficiently timely manner. While it is unlikely that the Federal Reserve would make such a policy mistake, this scenario cannot be ruled out. The downside economic risks are uncertain, yet inflationary pressures persist and are a source of concern for policymakers. When it comes to interest rate cuts, “too little, too late” is all too easy to imagine. But if a combination of falling equity prices, declining home prices and rising unemployment catch the Federal Reserve unawares, causing a substantial pullback in consumer and corporate spending and a desire to shed debt rather than spend, a Japanese-type slump is a frightening and yet plausible result. Fortunately, we put the chances of such a policy mistake at just 10%.

## Asia: Trading down

### *Asia is far better placed to withstand financial shock waves now than it was in 1997, but the trade channel is a different story*

From safety scares over Chinese goods in US stores to the role of Japan in the carry trade, there is no shortage of evidence of Asia's entrenched, and in many cases increasing, integration into the world economy. Unsurprisingly, therefore, the widening financial market turmoil resulting from the US subprime mortgage crisis has raised questions over the extent and nature of any possible contagion threat to Asia.

The precise impact will depend on the severity of any global economic downturn or credit squeeze. Clearly there are implications both for the financial sector and the real economy in Asia. However, while the fallout from the US subprime sector remains largely a financial story for now—and its consequences for Asian stockmarkets, currencies, interest rates and lending should not be ignored—the key risk for the region is the possibility of a slowdown in US import demand, which would hurt Asian export growth.

### Central scenario—60%

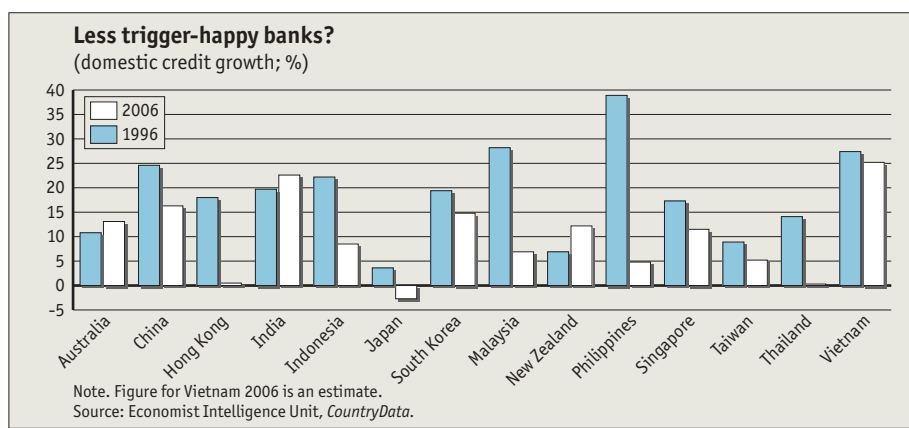
The Economist Intelligence Unit's baseline forecast remains benign, with the US managing to avoid a recession and GDP growth in Asia remaining relatively robust at 5.6% this year and 5.2% in 2008. Under this scenario, despite slowing US growth, the Chinese economy would continue to power along at 10-11% a year in 2007 and 2008, helping to support exports from other Asian countries (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### Risk scenario—30%

However, under our main risk scenario, and in particular given the potential for severe consumer retrenchment in the US, the consequences for Asia's trade-dependent economies would be far more severe. A sharp US slowdown could exacerbate whatever financial difficulties the subprime crisis creates for Asia, and indirectly expose financial-sector weaknesses that have been hidden until now as a result of strong economic growth and buoyant asset prices in the region.

#### Assessing the knock-on effect

So what would be the implications for Asia of a deep global credit crunch, a generalised repricing of assets and a US recession? Asia's financial sector is in much better shape to withstand disruption than it was when the regional financial crisis struck in 1997-98. At the same time, the region is now structurally more vulnerable through the trade channel. China, for instance, is now more entrenched in global supply chains following its entry to the World Trade Organisation in 2001. In particular, we do not believe that Asia has significantly "decoupled" from the US economy, despite some appearances to the contrary, making it vulnerable to a slowdown in US import demand.



Unlike in the run-up to the 1997-98 crisis, many Asian economies now have large foreign reserves, stronger current-account positions and more flexible exchange-rate regimes (although in some cases still heavily managed). Extensive regulatory reforms and consolidation have improved the health of the banking sector in a number of countries, most notably South Korea. Recent lending growth in most Asian economies—although still rapid in some cases—has not been as excessive as it was a decade ago. Commercial banks' net foreign asset positions are also generally much healthier. There remains, of course, the caveat that the kinds of stresses that financial contagion or a US recession would create would undoubtedly cause more balance sheet problems to emerge, which could be reflected in higher non-performing loan (NPL) ratios.

Asia's direct exposure to the US subprime sector appears to be limited so far. This does not negate the possibility that bigger problems could yet emerge, especially as one of the key reasons for the recent turmoil has been the opacity and dispersal of risk, making it impossible in most cases to know where the exposure lies. On August 23rd, for example, two of China's "Big Five" state-owned commercial banks—Bank of China and the Industrial and Commercial Bank of China—announced subprime-related exposure totalling almost US\$11bn. However, of all Asia's major economies China is perhaps the least susceptible to financial contagion because of its largely closed financial system—despite moves under way to ease restrictions on outward investment.

Elsewhere in the region, a further unravelling of the carry trade could create unforeseen problems for Japanese banks owed large sums by investors who have borrowed yen to invest in higher-yielding currencies elsewhere (see box—**The carry trade: Cashing in?**). But the fact that at the time of writing no signs of such distress have been reported suggests that the risk is not extreme, given that there has already been a substantial unwinding of the carry trade.

#### **The carry trade: Cashing in?**

The proof of how linked financial markets have become is evident in the yen's 6% upward lurch against the US dollar between early and mid-August. The trigger for this movement was the outward ripple of the turmoil in the US subprime mortgage market, which in turn persuaded many investors to unwind hitherto profitable carry-trade positions.

Such trades, which involve borrowing funds in countries where interest rates are low, such as Japan and Switzerland, and investing in assets in countries where interest rates are high, such as New Zealand, Turkey and South Africa, have been a feature of financial markets for around a decade now and have helped to add extra froth to global asset-price inflation. Measuring their size is, however, notoriously difficult: not only is there no way of knowing which foreign-exchange trades involve carry trades, but the common practice of conducting high-volume carry trades through derivatives further blurs the picture.

Recent market turbulence and a renewed awareness of risk on the part of investors suggest that the carry trade's days may be numbered. This may be no bad thing over the long term if, for instance, an end to the trade helps to reduce global imbalances. "Beneficiaries" of the trade such as New Zealand and Turkey have seen their current-account positions worsen partly as a result of their strengthening currencies, and until August the yen languished at 20-year lows in real effective terms, thus boosting Japan's already generous external position.

However, a disorderly unwinding of carry-trade positions could also lower growth in beneficiary countries as private consumption and domestic asset prices moved downwards. Particularly vulnerable in the latter regard are the myriad hedge funds that have grown fat on the carry trade. But also noteworthy is "Mrs Watanabe", the generic Japanese household investor, who, hungry for better yields on her large stock of savings than are available in low-interest-rate Japan, has turned herself into a key currency-market player. Japanese newspaper reports suggest that in just three days at the height of the mid-August turmoil Japanese households lost a hefty ¥3.6trn (US\$3bn).

Central and east European borrowers may also be hit. Many borrowers in this region have taken advantage of low interest rates in Switzerland to take out Swiss-franc-denominated mortgages. This makes these borrowers vulnerable to the large and sustained depreciation of their own currencies that would arise from further carry-trade unwinding.

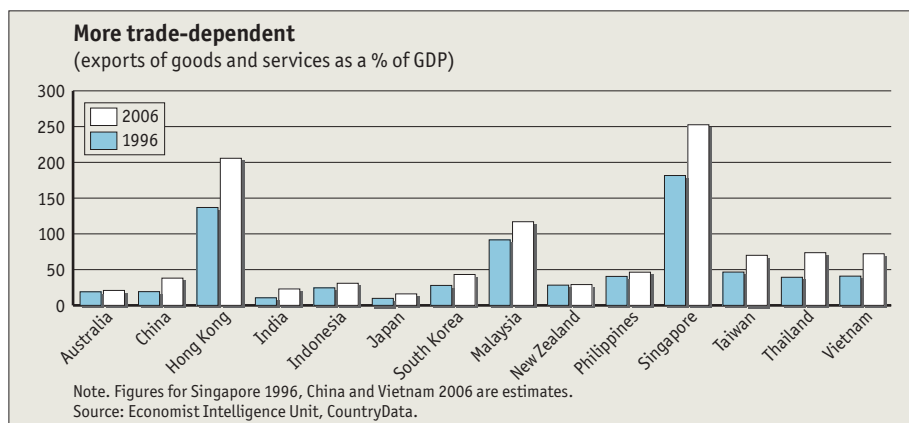
### **India would be hit by a sharp tightening of credit**

Asia's third big player, India, could face problems in the case of wide-scale deleveraging and a generalised repricing of risk. The country has been the recipient of large capital inflows recently, including portfolio investment, foreign direct investment and the receipts from external borrowings by aggressively expansion-minded domestic firms. In the event of a dramatic tightening of credit, some of these sources of capital could dry up. Portfolio inflows by foreign institutional investors could reverse rapidly in the event of a flight to safety, exerting downward pressure on share prices and making it more difficult for Indian companies to raise money through other channels.

The enormous amounts that Indian firms have borrowed overseas recently could also create cashflow problems if borrowers are unable to roll over or restructure their debt. All this could deal a blow to Indian companies' ambitions to expand domestically or make foreign acquisitions. A potential mitigating factor for capital inflows is the importance of non-resident Indians (NRIs) as a source of capital; inflows from NRIs would be less likely to dry up, in part because of NRIs' emotional attachment to their country of origin and in part because of the high interest rates available in India.

## Demand for exports is the key to Asia's outlook

Whatever the financial sector problems that Asia may face, we believe that they would be eclipsed by the effects of a US recession on demand for Asian exports. Our central forecast, which predicts US GDP growth of 1.9% this year and 2.3% in 2008, would not unduly upset Asian export growth (although a number of countries in the region are due for an export slowdown, following rapid export growth in 2004-06). However, our main risk scenario (scenario 2) would pose greater challenges. Although there has been much talk of Asia decoupling from the global economy, we believe that a full-blown US recession would hit Asian exports hard. Assuming US growth of just 1.5% this year and 0.2% in 2008, our projections suggest a modest slowdown in Asian GDP growth in 2007 (to 5.2%), but followed by a sharp slowdown to 3.7% in 2008.



**Why no decoupling?** Without exception, the important economies in Asia have become more reliant on exports over the last decade; in some cases that reliance continues to increase. Exports of goods and services accounted for 38% of Chinese GDP in 2006, double the share a decade earlier. For India, once largely closed to the global economy, exports of goods and services have risen from 11% of GDP to 23%. For other big players—Japan (16% in 2006, up from 10% a decade earlier), South Korea (43%, from 28%) and Taiwan (a robust 70%, from 47%)—it is a similar story. The countries in the Association of South-East Asian Nations (ASEAN) are among the most trade-dependent of all, and thus especially vulnerable to an external slowdown. Singapore and Hong Kong, as open economies in which exports account for over 200% of GDP, would also suffer in the event of a trade slowdown, although both are also generally quick to rebound.

The main argument for decoupling is that China has become a much more important trading partner for its Asian neighbours. Indeed, the rise in intra-regional trade has played a key role in boosting the share of exports as a percentage of GDP in Asian countries. China's growing involvement as a trader has appeared to insulate other Asian exporting countries, albeit to a limited degree, from the vagaries of demand in OECD markets. However, most Asian countries still send a substantial share (typically 13-20%) of their exports to the US. Just as importantly, many of the exports that Asia sends to China are ultimately destined for the US as well, and therefore again dependent on US

demand. As a result, our risk scenario includes an assumption that the region's export performance is seriously cramped by the recession in the US.

### **Worst-case scenario—10%**

Should our worst-case scenario come to pass, with the US entering a much deeper and protracted recession than even assumed under our risk scenario, the impact on Asia would look much more alarming. The implications for China specifically would be central to the rest of the regional outlook, given the huge contribution the country makes to regional (and global) growth and the strong linkages with the US.

Given that a deep US recession would go hand in hand with a sharp contraction in import demand, Chinese exports would be seriously affected. Slower export growth could force Chinese manufacturers to dump goods originally destined for the US onto the domestic market (although some of these goods might also be dumped on third markets such as the EU and the rest of Asia). This would exacerbate already fierce price competition in China and reduce corporate profits. A combination of falling profits and overcapacity would, in turn, cause more bad loans to appear, increasing the risk of a banking crisis. Although China's NPL ratio was just 7.5% at end-2006, compared with almost 30% in 2001, according to a recent IMF report, the dubious quality of Chinese credit-risk assessment means that the true number could be much higher. In any event, a banking crisis would increase the pressure on lenders and borrowers alike, leading to the emergence of new NPLs. This would weaken banks' ability to fund the investment growth that, along with exports, has underpinned China's economic boom. At the same time, excess capacity would undermine the overall rationale for investment.

However, the Chinese government would still have considerable room for fiscal manoeuvre should it need to stimulate growth. It would almost certainly be determined to take such action, if necessary, in order to keep the economy afloat and maintain political stability as the Beijing Olympics approach. Nonetheless, offsetting a steep US downturn would be all but impossible. Other Asian economies, especially those in ASEAN that are highly trade-dependent, would thus face the prospect not only of weaker demand from the US, but also of weaker demand from China.



some 13% of employment. France, Denmark, Sweden and Ireland are vulnerable too. History shows that house price corrections have frequently been associated with severe downturns or recessions.

A bursting of the housing bubble would depress consumer spending, especially in the UK, Spain and Ireland, and to a lesser extent in France. Rising asset prices have enabled borrowers to remortgage properties in order to finance consumer goods purchases. A housing correction would not only reduce their capacity to maintain consumer borrowing secured against ever-rising asset values, but would trigger a downward spiral of insolvencies, higher unemployment and further falls in house prices. Although debt and asset prices in France have not been as extreme as elsewhere, economic growth has become heavily reliant on consumer spending, so the impact could be severe there too.

### **Housing markets: Living in a bubble**

The past decade has seen a housing boom across much of the developed and emerging world. The total value of residential property in developed economies rose by around three-quarters between 2000 and 2006, to almost US\$75trn. This was equivalent to more than these economies' national income over the period.

As property transactions are typically financed by a large amount of debt relative to equity, gains are magnified by leverage. In this sense, what happened in housing was representative of a broader trend of debt-financed asset price appreciation. The boom was driven by cheap money and a relaxation of lending standards, sometimes by the growth of mortgage securitisation. It has left property looking overvalued on metrics such as rental yields and prices as a multiple of household income.

Japan provides a warning of what can happen when a boom turns to bust and the leverage effect goes into reverse. Japanese property prices dropped every year from 1991 to 2005, declining by 40% from their peak.

Many countries are vulnerable but the UK, Spain and Australia are among the most at risk of following the US into a housing slump. The UK housing market is supported by a scarcity of supply. But problems of affordability are increasing among householders with self-certificated mortgages, the UK equivalent of subprime. This has been the most dynamic market segment in recent years, growing annually by around 25%, although it probably still represents less than 5% of total mortgages outstanding, compared with 15% for subprime in the US.

More than 125,000 UK households are behind with their mortgage payments, 1% of the total. And lenders foreclosed on 14,000 properties in the first six months of 2007, an increase of 30% year on year. In absolute terms, these numbers are still well below those reached in the housing market crash of the early 1990s, but the trend gives cause for concern. And more households will face payment difficulties if banks ration credit and raise interest charges on adjustable-rate mortgages as part of a process of repricing of risk and deleveraging. The high end of the UK market is also vulnerable in the event of a downturn in the City, an important driver of property prices in the capital.

In Spain, a decade-long boom has seen the share of construction rise to 18.5% of GDP, twice the European average. This year the supply of 800,000 houses is estimated to exceed demand by some 200,000. A decline in prices will be needed to clear the overhang, a process that is likely to be painful and drawn-out. Most mortgages are at adjustable rates. But even if the ECB cuts its policy rate, banks are likely to increase mortgage rates. Spanish banks could be among the most affected by a process of

deleveraging and repricing of risk because of their aggressive expansion during the boom. There are likely to be casualties among Spain's real estate and construction groups, which have borrowed heavily on the strength of overvalued assets to finance acquisitions.

In Australia, non-documented mortgages account for at most 2% of total loans. The overall quality of the mortgage book will provide some support to Australia's market. But affordability could become strained for all house owners as a result of high interest charges. Interest rates, which are already among the highest in the world at 6.5%, may rise if an unwinding of the carry trade exerts renewed downward pressure on the Australian dollar. A favoured vehicle for the carry trade, the Australian dollar was driven to multi-year highs in July before a sharp sell-off.

Some consumers will weather the fallout better than others. Germans not only carry low levels of debt, but their household consumption has long been a relatively weak component of GDP growth. The historically low level of home ownership, coupled with limited household borrowing, will leave the German consumer insulated from a general re-rating of risk within the EU and globally. Ironically, it may have been the tepid spending habits of German consumers that sent local banks into the precarious world of subprime debts in search of higher yields in the first place.

Rising corporate profits on the back of strong export growth and overseas earnings by German companies have only recently begun to filter through to slightly higher wages (or at least higher wage demands). But this process, which in a benign scenario might have boosted the economy, will impede growth if corporate profits are dampened by a weaker export environment in the US plus weaker demand for investment goods from emerging markets. German banks show few signs of loosening their stringent lending conditions even to high-saving households.

**It is unlikely that the EU would follow the US into recession**

Under this risk scenario, EU growth would weaken in response to US and financial sector difficulties. But even a tighter consumer spending outlook, coupled with weaker exports, would be unlikely to plunge the euro zone into recession. We would also expect the ECB to respond by cutting its main policy rate by 1 percentage point to 3.25%, before gradually raising it again to 4% in 2009 as a recovery took hold. This would ease mortgage-financing worries and boost consumer spending, so even under the risk scenario we would expect euro zone growth to slow to only 1.3% in 2008 and pick up to 1.9% in 2009. However, Spain, which already faces a serious construction downturn, would suffer particularly badly, while France, whose external sector has been a net drag on GDP growth, would find it even tougher to generate exports to compensate for weaker consumer spending.

Outside the euro zone, the Bank of England, which is probably at the top of its interest rate cycle, would almost certainly cut rates in response to action by the Federal Reserve, from 5.75% this year to 5.25% in 2008 and 5% in 2009. This would be designed to shore up spending and try to avert a harsher housing market correction, and would be in line with a moderating inflation outlook.

The economic impact of further US dollar depreciation would be contained. The EU as a large, self-contained trading area is less dependent on exports.

Although the US accounts for some 23% of EU exports beyond the bloc, the figure is small in relation to GDP. Ireland (which sends 18% of its total exports to the US) would be the worst affected, but of the larger EU economies only the UK, which sends 13% of its total exports to the US, would be seriously harmed (although this would also be partly mitigated by cheaper dollar-denominated imports).

A lower US dollar might also give European firms an edge in acquiring indebted US firms. But corporate finance is likely not only to move down a gear but also to shift emphasis drastically away from leveraged private equity deals towards "blue chip" companies with strong balance sheets or the ability to make attractive all-share offers.

### **Worst-case scenario—10%**

While our main risk scenario suggests that western Europe would suffer economic and financial damage from a US recession and financial market problems, an outright European recession should be easily avoided. However, a worst-case scenario would rebound on EU growth more significantly. Exports, of course, would be hit much harder as US import demand growth went into reverse. But the greatest risks lie in the financial transmission channels. Substantial downward pressure on risk asset prices (such as equities, corporate bonds and emerging-market debt instruments) would drive a need on the part of financial institutions to deleverage. Firms in Europe tend to rely on bank finance more than their US counterparts, but events in the past few weeks have underscored that European financial institutions are by no means immune to solvency or liquidity problems emanating from declines in financial asset prices, and credit availability to the corporate and personal sector would be greatly impaired. House price declines would be steeper and more protracted than even in our risk scenario. The ECB has demonstrated a willingness to act aggressively to head off financial sector difficulties by injecting liquidity into the financial system, and would certainly cut rates substantially in this environment. But fiscal policy flexibility is limited, and a severe US downturn, combined with a global repricing of risk and concurrent deleveraging, would be likely to slow the main west European economies to a crawl.

## Eastern Europe: Catching a cold?

### *The knock-on effects of a US recession could cut 2008 GDP growth by up to 2 percentage points*

Eastern Europe has performed strongly in recent years, fuelled by high commodity prices, strong demand from western Europe, and robust domestic demand. But the region is not immune to developments overseas, and if the global downturn caused by a worsening of financial market conditions continues to deepen, economic performance will be negatively affected.

### Central scenario—60%

Under the Economist Intelligence Unit's central forecast, the economic impact on central and eastern Europe of the recent financial turmoil is likely to be marginal. Economic growth in the region is expected to slow in 2008-09 for more prosaic reasons: monetary policy is tightening because of rising inflationary pressures, and many commercial banks are less eager to lend given concerns about the rapid growth of credit, especially for real estate. Higher wages and stronger currencies are also set to take some of the shine off the recent impressive export performance. Overall, our central forecast is that real GDP growth in eastern Europe will slow from an estimated 6.5% in 2007 to 5.8% in 2008 and 5.2% in 2009 (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### Risk scenario—30%

#### **A global credit crunch would hurt countries reliant on foreign borrowing**

Under our main risk scenario, where a severe global credit crunch would drag down growth rates in the US and western Europe, access to external finance for eastern Europe would become harder, with strong implications for those countries currently reliant on foreign borrowing. West European demand for the region's exports would decline, too, and falling commodity prices—especially for oil—would hit Russia and other gas and oil producers in the region (and, indirectly, affect their trading partners).

A sharp increase in risk premiums and increased difficulties in accessing external finance would force a much sharper adjustment of external imbalances in countries—primarily the Baltic states, Hungary, Romania and Bulgaria—that have become heavily dependent on external finance to cover large balance-of-payments deficits. Although much of this finance has been in the form of foreign direct investment (FDI), which should continue to flow barring a much more serious slowdown in western Europe than we are anticipating even in our risk scenario, an increasing proportion of these funds has been provided by the banks, often in the form of loans from foreign banks to their local subsidiaries.

A sudden reassessment of the risks attached to such lending would make it more difficult to take out new borrowing or to roll over existing foreign loans.

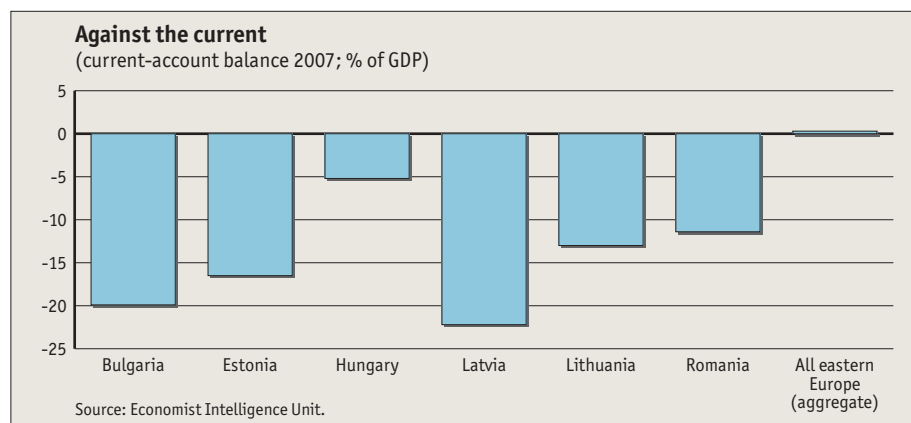
This would force a rapid slowdown in domestic credit growth, leading to much slower expansion in consumer spending and corporate investment than previously expected.

In particular, the property market, which has been booming in most countries of the region, would be hit hard, raising the spectre of bankruptcies among developers and a rise in bad debts in the domestic banking system. The banks' strong financial positions (bank profitability is currently very high across the region) should allow them to absorb these losses, but an increase in bad debts would further constrain their willingness to lend in the future, prolonging the slowdown. Moreover, in the Baltic states and Bulgaria, the fixed exchange-rate link to the euro means that there is little room for policy to counter any downturn. Under our risk scenario, these economies could see their growth rates (which were already expected to slow in 2008-09) reduced by a further 1.5-2 percentage points over the next couple of years.

The slowdown would be still more severe if it turned out that any of the foreign banks active in the region had been left exposed by large losses in the US or other major markets. The Baltic states, where the banking sectors are dominated by a small number of Scandinavian banks, would be particularly vulnerable if one of these parent banks were to run into serious financial problems. In such an extreme situation, the exchange-rate link to the euro could come under severe pressure, and the real economy would probably fall into recession. In most of the other countries of the region, banking systems are less concentrated and foreign ownership in the financial sector is more diversified, making them much less vulnerable to problems in one parent bank.

**In more self-reliant countries, the “real” economy will be key**

Other central and east European countries are less dependent on external finance for investment. In these countries, unless a severe loss of confidence caused the holders of financial assets to dump their holdings, changes in the availability of foreign financing would be less likely to affect the economic outlook than would real factors. Among the latter, the most important would be slower growth in western Europe, which would have a noticeable effect on the growth prospects of central and eastern Europe (excluding the Commonwealth of Independent States–CIS). For these countries, exports to the EU15 average around one-third of GDP, with Germany by far the most important market.



However, some of the central and east European states have seen the share of their exports going to the EU15 fall as they have redirected trade to faster-growing markets, so that there has probably been some “delinking” between western Europe and some of the east European economies in the past few years. In addition, in those countries that run an autonomous monetary policy, there would be scope to cut interest rates to counter the deflationary effects of a fall in external demand.

Overall, we expect that the economic impact of a slowdown in euro zone growth of a little less than 1 percentage point in 2008, as envisaged in our main risk scenario, would be around 0.5 percentage points off GDP growth in central and eastern Europe (excluding the CIS) in 2008. The dampening effect on growth would be likely to persist into 2009 as weakness spread from the export sector to the rest of the economy.

**Russia and other energy producers will look to oil prices**

By contrast, changes in oil prices will play the leading role in Russia and other energy suppliers. Under the risk scenario, slower growth in global economic activity could lead to oil prices of around US\$40/barrel in 2008, some US\$30/b lower than previously forecast. A fall in oil prices of this size would have a direct impact on GDP growth in Russia and the other oil producers in the region, knocking perhaps 1-1.5 percentage points off forecast growth next year. Lower oil prices would reduce some of the present upward pressure on the rouble, but would also hit Russian state budget revenue at a time when fiscal policy was already being loosened ahead of the 2008 presidential election.

Slower growth in Russia would in turn lead to lower demand for imports from Russia's trading partners, so affecting countries such as Ukraine. In addition, any significant slowdown in Russia would lead to a fall in the employment of foreign workers and, hence, to a drop in remittance flows. This would increase the exposure of countries such as Armenia and Moldova, which are heavily dependent on remittances to fund their external imbalances.

### **Worst-case scenario—10%**

Most countries in the region have relied heavily on foreign capital inflows in recent years. The more dramatic curtailment of external finance envisaged under our worst-case scenario would thus undoubtedly severely test those countries. Countries with fixed currency regimes would come under particular pressure. Not only would portfolio investment be negatively affected, but the severe impact on the corporate sector in western Europe would be likely to lead to a major decline in inflows of FDI, which has been central to the success of many of the region's economies. The financing difficulties would be compounded by the drop in import demand in western Europe. Eastern Europe has become less exposed to fluctuations in west European demand over the past decade, but it would not be immune to an import recession in the west.

For Russia and other energy exporters in the CIS, the impact on commodity prices would exact the biggest toll. A fall in oil prices to a level of well below US\$40/b, that persisted for several years, would put the onus for sustaining growth in these countries onto the non-energy-related sectors of the Russian

economy and those of other energy exporters in the CIS. Given the lack of diversification in these economies and the well-known weaknesses of the business environment, this would be recipe for a sharp economic slowdown that could have political as well as economic ramifications.

### **Commodity prices: Turn of the tide**

Strong global economic growth in recent years has been accompanied by soaring commodities prices. In our central forecast, continued robust growth will keep oil prices close to US\$70/b in 2007-08. Although prices will ease slightly as new capacity comes on stream in 2009, they will not fall much below US\$60/b.

Prices for hard commodities have fluctuated strongly in response to recent financial market turmoil, but our central forecast sees them reverting to previous trends as calm returns. The industrial raw materials (IRM) index will fall by around 15% in 2008-09 as increased investment in metals capacity kicks in—but this is fairly insignificant compared with an increase of more than 150% in the past six years. Soft commodity prices will continue to rise, with our food, feedstuffs and beverages (FFB) index rising by 16% in 2007 and an annual average of 1.6% in 2008-09.

### **The main risk scenario**

Under our main risk scenario oil prices would fall sharply, for three main reasons:

- First, weakening growth would reduce expansion of oil demand. Although emerging markets, notably China and the Middle East, have been responsible for most of the growth of oil demand in recent years, North America accounts for some 30% of total demand, compared with 18% for Asia and 8% for the Middle East.
- Second, as the supply-demand imbalance narrows and prices began to fall, OPEC's commitment to limiting supply might waver, with members cheating on quotas in an attempt to maintain revenue.
- Finally, a liquidity crisis in financial markets would affect commodity markets too. Speculation in commodities futures—driven by many of the same factors that have underlain increased risk appetite more broadly—has accentuated the bull trend in oil prices over the past four years. A liquidity crisis would reverse this, compounding the fall in prices brought about by shifting fundamentals.

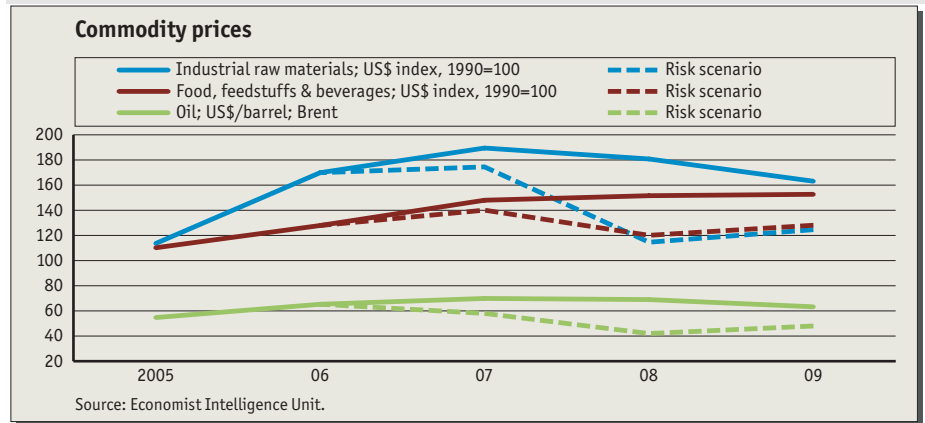
In such a scenario, oil prices could be expected to weaken to below US\$60/b in 2007 as the US slowdown began and towards US\$40/b in 2008. Even this, though, would only take oil prices back to just above the levels of 2004—given the lack of any major prospects for increased production, outside Saudi Arabia, and the threat of geopolitical tensions in key oil-producing areas, a return to US\$20/b oil remains highly unlikely, even in our worst-case scenario.

Hard commodities look vulnerable to a correction even in the baseline scenario, as prices have risen to what look like unsustainably high levels—appreciably higher than marginal costs. In our main risk scenario weakening demand would dampen the rise in the IRM index in 2007 to around 3%. In 2008 the increase of supply already expected as expansions in mining and refining capacity take effect would coincide with a weakening of demand, to produce a sharp fall in prices of around one-third, followed by a modest recovery, of less than 9%, in 2009 as demand picked up again.

Soft commodities look less exposed to a downturn. The main factors in current high prices are surging biofuel demand and declining stocks—the latter owing to

unfavourable weather conditions and reduced plantings (often because of competition for acreage from more lucrative crops) leading to smaller harvests. Both these factors would hold in our worst-case scenario (investment in biofuels would still be high, as long-term worries over energy-security would remain), and prices would therefore be more resilient than for hard commodities, with the FFB index falling by some 14% in 2008 before beginning to recover in 2009.

Our worst-case scenario would see sharper falls in prices for both hard and soft commodities, as global demand collapsed. Moreover, prices would be unlikely to rebound much even into the medium term, as the global economy struggled to recover.



## Middle East and North Africa: It's the oil, stupid

### *While other regions scramble to cover the risks arising from global financial turmoil, some in the Middle East may be rubbing their hands*

The economies of the Middle East and North Africa (MENA) are more sensitive to changes in the oil markets than to global financial trends, and as such they have felt little impact so far of the turmoil on world markets. But their vulnerability to commodity price movements is high—if financial turmoil crimps economic growth in the US, Europe and China, energy demand would suffer and the Middle East would quickly feel the impact.

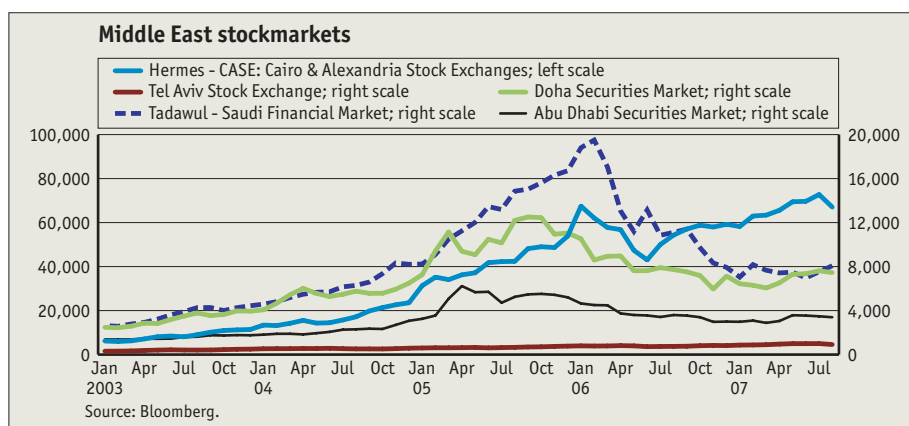
### Central scenario—60%

The Economist Intelligence Unit's central forecast, in which the US, Europe and the rest of the world avoid serious fallout from the current financial market turmoil, sees oil prices staying very high in the medium term. This, in turn, will sustain government consumption, consumer confidence, and overall domestic demand in the region. As a result, contagion from the current turmoil will be limited, and economic growth is expected to average 5.1% this year, rising to 5.6% in 2008 as continued high oil prices support ongoing regional investment (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### Risk scenario—30%

If the US fell into recession, as envisaged by our main risk scenario, oil demand would be hit and, consequently, oil prices would slide. Although many Gulf Arab states could survive even a sharp fall in prices, there would be some knock-on effect on the region's spending and consumption levels. This is the case even in the non-oil-exporting Arab states (Egypt, Jordan, Lebanon, Morocco and Tunisia), which have benefited from a surge in foreign direct investment (FDI) from the Gulf Arab states in particular.

Israel's stockmarket is perhaps the most vulnerable in the region to the negative sentiment surrounding the banking sectors in the US and the EU (its main export markets), and the Tel Aviv Stock Exchange has fallen back sharply in recent weeks. Several of the Middle East's stockmarkets have also witnessed small dips this month, but most remain above their levels at the start of the year, and, in any case, the MENA equity markets, especially in the Gulf Arab states, already witnessed a steep downward correction in 2006 that did little to check the region's economic boom. Indeed, the region's investment funds could in fact be well placed in the short term to benefit from the financial travails in the US and the EU.



The current global stockmarket problems, tightening of bank lending practices and, potentially, large-scale asset sell-offs in the future could pose a massive "shopping opportunity" for the cash-rich Gulf investment funds. Although this raises concerns over the possible political fallout in the West—most likely to manifest itself in calls for increased economic protectionism—on the whole the present climate should be relatively conducive for such acquisition activity. Western private equity funds are likely to remain hindered by a credit squeeze, and the price and quality of the assets available should become increasingly attractive if many institutions choose to deleverage.

Already the activities of the Gulf investment funds have attracted significant scrutiny in the West, but this has yet to check their lofty ambitions to any great degree. In part this reflects the massive sums they have to invest: although precise data are unavailable, economic analysts Roubini Global Economics Monitor conservatively estimate that the investment funds of the Gulf Co-operation Council (GCC—Saudi Arabia, Bahrain, Qatar, Oman, Kuwait and the UAE) had assets totalling some US\$845bn at end-2006.

#### Gulf investment funds, end-2006

(US\$ bn; estimates)

Abu Dhabi Investment Authority	600
Kuwait Investment Authority	200
Qatar Investment Authority	40
Dubai International Capital	5
<b>Total</b>	<b>845</b>

<sup>a</sup> Saudi Arabia does not have an official sovereign wealth fund, but is thought to have around US\$300bn in assets among various state-owned agencies and corporations.

Sources: RGE Monitor; Economist Intelligence Unit.

However, if the present financial turmoil persists, then the MENA region cannot remain aloof for ever. For instance, some of the Gulf Arab funds could be hit because of their global exposure—Dubai's Emaar Properties, for instance, is vulnerable because of its purchase of a US property developer, John Laing Homes, in 2006. In addition, any tightening of lending practices by the world's major banks could have a big impact on the region's ambitious development plans—most notably in the downstream energy sector and in infrastructure.

According to Moody's Investors Service, a US-based credit rating agency, demand for project finance in the GCC will reach some US\$50bn this year, and Qatar alone is seeking finance for projects worth some US\$130bn over the next six years. The MENA states are expecting a significant portion of this project finance to be provided by large global financial institutions, and, should this fail to materialise, they will have to rein in their plans. At the same time, the governments might choose to compensate by redirecting more of their surplus oil revenue back home, which in turn would cause a commensurate decline in FDI into the non-oil-exporting states.

## Worst-case scenario—10%

### The worst-case scenario would hit non-oil producers hardest

The horror stories only arise if one assumes the worst case; our high-impact scenario (to which we attach a 10% probability), with a deeper and more prolonged slowdown in the US depressing global growth, would have serious ramifications for those non-oil exporters most reliant on the US market (such as Jordan and Israel), as well as for the North African states that depend heavily on sales to the EU. In addition, at a time of a global slowdown, sourcing sufficient demand for the massive number of luxury apartments and villas, as well as lavish tourist projects, that are currently being built and planned could prove tricky. This could potentially leave a number of property "white elephants" across the region, and their (admittedly wealthy) sponsors nursing losses.

### Sovereign wealth funds: Buying opportunity?

Sovereign wealth funds (SWFs), state-owned funds that invest countries' excess foreign-exchange reserves, have emerged as major financial players. Some 25 countries either operate or are set to create SWFs; most are oil exporters (notably Russia and Middle Eastern states) and Asian states with large current-account surpluses (including China). SWFs already control some US\$1.5trn-2trn in assets worldwide—more than is managed by hedge funds—and on some estimates this figure could swell to US\$12trn by 2015.

The slowing growth and financial turmoil of our risk scenario would present risks for SWFs—but also opportunities. A slowdown in the OECD would reduce Asian states' exports and current-account surpluses, and so curb the build-up of their foreign-exchange reserves, and a lower oil price would reduce inflows into oil exporters' SWFs. Nevertheless, with Asian countries still running current-account surpluses (albeit smaller), and oil prices unlikely to fall below US\$40/barrel for any sustained period, SWFs would still have plenty of cash to draw on. Much would then depend on their strategy.

SWFs are often seen as a potential source of liquidity for markets as risk-aversion rises among financial investors. However, in our worst-case scenario, as markets fell sharply greater conservatism could be expected from SWF operators as well.

The main rationale behind SWFs was to try to boost returns on countries' foreign-exchange reserves (which have swollen well beyond what is needed for prudential management) by diversifying away from US Treasuries, the traditional "risk-free" asset, and into higher-yielding assets—equities, emerging-market Treasuries, real estate and commodities.

This strategy will look less attractive if turbulence on financial markets persists and deepens. China's new wealth fund has already faced criticism domestically after its US\$3bn investment in the private equity firm Blackstone was followed by a drop in the US company's share price in the recent market turbulence. Diversification away from US Treasuries would therefore be slower and more cautious.

At the same time, however, the falling share prices of Western corporations would present some alluring bargains for SWFs—especially in so far as they are looking to gain a strategic foothold in sectors such as energy, or to acquire firms that offer access to technology and intellectual property that cannot easily be developed domestically. There would be concern in the West at the prospect of widespread takeovers by non-democratic states, particularly in the case of assets perceived as strategic. Controversies over attempted acquisitions similar to the failed attempt by China's CNOOC to take over Unocal (US) could be expected with growing frequency if the impact of financial turmoil on world economic activity were to be mild. This would still be the case in a downturn, but they could then be expected to elicit a tougher response.

There have already been some calls in the West for, in effect, financial protectionism. In a context of reeling global markets and a hard-hitting slowdown in the OECD, such calls would have a greater chance of a receptive hearing from policymakers.

The potential impact on international oil prices and the US dollar pose greater concerns still. Should economic growth in the US decline sharply in 2008, the impact on its main trading partners, notably those in Asia, would crimp oil demand worldwide and could cause oil prices to fall steeply. This would undermine the fiscal position of the oil exporters, pushing some, such as Bahrain and Saudi Arabia, into the red, and others, most notably Iran, Syria and Yemen, into alarmingly wide deficits.

In addition, under our worst-case scenario, the US dollar would depreciate more steeply than presently envisaged, which, given the fact that oil is denominated in US dollars, would also hit the purchasing power of the oil-exporting countries. Those states with US dollar pegs (namely most of the GCC countries, as well as Jordan and Lebanon) would at the same time experience rising import price inflation from their non-US suppliers—a particularly live issue at present, given the climate of rising inflation across the region.

A sharp decline in oil earnings would force governments to rein in fiscal expenditure and, in many cases, postpone or cancel a variety of infrastructure and industrial projects. This would not only hit GDP growth but, should wealth levels drop precipitously, might also cause substantial public discontent in an already volatile region.

## Latin America: Buffeted, but afloat

### *Many countries have used the good years to fatten up, but they remain vulnerable to a sharp slowdown*

In the past Latin America has suffered from adverse swings in international conditions, but in recent years fundamentals have improved markedly. Although not immune to global financial turmoil or a US slowdown, the region should fare better than many expect.

### Central scenario—60%

Most countries are relatively well placed to withstand deterioration in global economic and financial conditions, and will be largely unscathed if events develop as in the Economist Intelligence Unit's central forecast. Improved current-account balances and reduced fiscal deficits have greatly lessened the reliance on foreign capital, so the chances of a financial crisis, as experienced across the region in the 1990s, are low. And, in our central forecast, commodity prices are set to remain buoyant and import demand in major markets reasonable. As a result, we expect growth to average 4.6% in 2007, slowing slightly to 4.1% in 2008 (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### Risk scenario—30%

Even the sharp adjustment in US growth rates envisaged under our main risk scenario would cut just 1 percentage point or so off Latin American GDP growth in 2008, a modest outcome. With a few notable exceptions such as Ecuador, Venezuela and Argentina, the region has adopted flexible policy frameworks, enhancing confidence in macroeconomic stability. Fiscal policy is more disciplined and solvency ratios have improved. Policymakers mostly used the good years to reduce external vulnerabilities, switching external debt into domestic debt. International reserves have risen markedly. A gradual deepening of local capital markets has made the region less reliant on foreign savings to finance growth, and domestic demand has been picking up, providing momentum.

### **A drying up of international bank credit lines would halt credit booms**

But it would be wrong to be complacent. The region has weathered the August storm in the financial markets relatively well, but would suffer more if volatility persists. Latin currencies and asset markets have taken a hit, and there has been a hiatus in sovereign and corporate debt issuance. If the credit crunch deepens, international bank credit lines will face some disruption, and this would have some impact on the real economy. During the recent credit upswing, banks in Mexico, Central America, the Caribbean and some Andean countries have borrowed from US banks to lend on to consumers and corporates, fuelling a mini-credit boom. In these countries, US, Spanish and UK banks have considerable market share, so further direct fallout from the US subprime crisis

involving these banks would also have ramifications for their activities in the region. Banks in Brazil, Argentina and Chile are less exposed in this sense, as they have relied more on domestic sources to fund the credit expansion.

The region would also be hit by trade effects. Exports have played an important role in the strong economic performance of recent years (although with imports also surging, the contribution of net trade has been increasingly negative). High prices for the region's agricultural and mineral commodity exports have boosted economic growth, fiscal performance and the external accounts. Thus a sharp fall in US and global demand (and commodity prices) would take the wind out of Latin America's sails.

However, a recession in the US would hit not only exports, but remittances and foreign direct investment (FDI) flows to the region. Mexico would be first in the firing line, given its increasingly close links to the US economy—remittances have already been slowing as the US housing boom unravels. A sharp fall in oil prices would also hit the public finances, since typically one-third of revenue is oil-related. Smaller open economies, such as those in Central America and the Caribbean, would suffer too. With external sources of growth (exports, remittances and FDI, international bank lines) potentially drying up, these countries would be more reliant on local sources of demand, but these are weak. Although a sharp fall in oil prices would provide some relief for heavy oil importers in Central America and the Caribbean, they would find it more problematic to raise the finance to cover their external financing requirements (which will widen as export growth tails off), forcing adjustments in imports.

A US recession would also negatively affect exports from South American countries. Although some of the main commodity exporters, such as Brazil, Argentina, Chile and Peru, have diversified their export markets to Asia, they would also suffer as Asian growth weakened.

#### **A measured response by policymakers**

In view of the region's sounder economic fundamentals, the policy response would be likely to be measured. In the past, Latin American policymakers would typically have had to respond to the kind of currency pressures observed in recent weeks by tightening monetary policy, intervening in currency markets, or scrambling to get a contingency credit line from the IMF. This time, downward pressure on currencies comes after an appreciation in recent years, making the adjustments less alarming.

Moreover, with prices better anchored by inflation-targeting regimes, currency weakness now has less of a feed-through to inflation. Reductions in the US's Federal funds rate would in any case widen the interest differential between US and Latin American rates, providing currencies with some support.

However, a sharp fall in commodity prices would bring currencies under greater pressure by eroding the region's narrow current-account surplus. Monetary policy would hence be guided more by inflation risks than currency movements, although ultimately sustained pressure on Latin American currencies would force some policy action.

**Solvency not under threat, yet** In a more risk-averse environment investors might be expected to pay greater attention to Latin America's fiscal performance. Commodity windfalls and above-trend GDP growth have boosted the public finances. Public debt/GDP ratios have come down from the record highs of the late 1990s and early 2000s, increasing confidence in public solvency. However, primary spending was already becoming expansionary before the market turmoil began, as governments in several countries loosened their belts.

Across the region, fiscal revenue stands to suffer should GDP growth underperform; the pain would be felt more acutely among oil and commodity exporters with falling prices (Venezuela and Ecuador would be particularly vulnerable in this respect).

Chile would be less affected by falls in copper prices, as it has saved much of the windfall, has minimal public debt and is one of the only countries in the region that can pursue counter-cyclical fiscal policies without endangering public solvency.

Regionally, there would be a need for some belt-tightening, which would be most likely to fall on public investment. Debt-servicing costs would rise again, adding to fiscal pressures. Access to external voluntary financing would become more difficult and the terms more onerous; nevertheless, provided that financial markets function adequately, Latin America's sovereigns and corporates would still be able to access external finance on terms that would not unduly heighten liquidity or solvency risks.

Although responding to the global deterioration would occupy the bulk of policymakers' attention, it would serve to provide a timely reminder to the region's political class of the need to enact growth-enhancing and solvency-strengthening reforms, the momentum for which has faded as the region enjoyed above-trend growth in 2004-06.

### **Worst-case scenario—10%**

The tighter credit conditions under our high-impact scenario could lead to problems in countries that have been enjoying a consumer-fuelled credit boom. Although policy rates are likely to be relatively steady, commercial interest rates could well rise in line with global risk-aversion and tighter credit markets. It is important to remember that spreads between Latin American and OECD interest rates, despite widening in recent weeks, remain extraordinarily low. In an environment where investors fundamentally reassessed their exposures, the potential for interest rates to spike would be high.

In this scenario indicators of financial soundness would deteriorate, although most banking systems should be able to withstand this. However, in many cases regulation and supervision remain below international best-practice; nasty surprises, with weaknesses that went unnoticed during the consumer credit boom, could come to the fore, particularly in smaller countries where connected lending remains prevalent.

### **Emerging markets: Reverse contagion**

Emerging markets have traditionally exaggerated trends in global growth, outperforming during booms, underperforming during downturns. They have followed form during the current upswing, averaging growth 4 percentage points higher than their developed counterparts. But what about when the cycle turns?

Bulls argue that emerging markets are now able to grow on the basis of sustainable domestic demand. They cite stronger external balance sheets, improved macroeconomic policymaking, and structural changes such as the development of consumer credit and mortgage markets. This argument has merit, and we are upbeat about emerging markets' long-term growth prospects. But we are sceptical that they would decouple from a serious downturn in the US.

Some cite the US slowdown in the first half of 2007 as validation of the decoupling thesis, but this is premature. So far the slowdown has been restricted to the housing sector, which has a small weighting in imports. If the resilient US consumer were finally to buckle in the rest of 2007-08, emerging markets would feel the draught.

The US accounts for one-fifth of global consumption and is the most important single market for China's exports. And it is China's export machine that drives a good deal of Asia's intra-regional trade. As globalisation increases linkages between countries, economic cycles are likely to become more—rather than less—synchronous.

#### **Less vulnerable?**

In the past emerging markets were often vulnerable to defaults and maxi-devaluations when the global economy stalled. Would it be any different today?

In aggregate, emerging markets have been running a large current-account surplus, as they have become the chief source of financing for the huge US current-account deficit. This has been reflected in a strengthening of emerging markets' external balance sheets.

Foreign-exchange reserves have soared while external debt has either fallen or stabilised, making many emerging markets net external creditors.

Consequently, there is little risk of a rerun of the external liquidity crises that devastated emerging markets in the late 1990s. This is reflected in our sovereign risk ratings, which are at their best level ever.

Nevertheless, we believe that many emerging-market assets are richly valued and that investors are not being adequately compensated for risk. This is still the case now that the spread on the emerging-market bond index has widened to 255 basis points over US Treasuries, from a record low of 160 basis points earlier in 2007.

Among emerging-market assets we would expect foreign-currency sovereign bonds to outperform during a process of deleveraging, whereas riskier assets such as emerging-market corporate bonds, equities and local-currency bonds would be vulnerable to sharper corrections.

## Africa: From boom to bust?

### ***Weak links to the global economy insulate the region from financial market problems, but a global slump would be a different matter***

Sub-Saharan Africa has been performing well of late, as high commodity prices boost export earnings and also promote foreign direct investment (FDI) into the region, and particularly into resource-rich countries. Indeed, in recent years economic growth has outperformed (albeit from a very low base) some other emerging-market groupings. But can the region continue this strong performance in the face of global headwinds?

### **Central scenario—60%**

In the Economist Intelligence Unit's central forecast, financial market turmoil will be contained and the US, although slowed by housing market woes, will escape recession. Meanwhile, the rest of the global economy will continue to perform strongly. This is a framework in which world trade in general, and demand for commodities in particular, will remain robust. Oil prices—important to many countries in the region—are expected to remain close to US\$70/barrel for dated Brent Blend. This is easily high enough to support strong growth in the major oil producers. Continued robust demand for industrial raw materials will help other countries in the region, as will strong soft commodity prices (driven in part by demand for biofuels). As a result, we expect GDP growth in the region to average just under 6% over the next two years (for more details, see the Economist Intelligence Unit's *Global Outlook* report).

### **Risk scenario—30%**

Although Sub-Saharan Africa is only weakly integrated into the global economy, our main risk scenario, which sees a marked drop in commodity prices combined with a slowdown in world trade, would trigger a sharp deceleration in the region's economies, many of which remain heavily dependent on commodity exports. The impact would be most apparent in 2008: weaker commodity prices, notably of crude oil (meaning a particularly difficult year for regional oil exporters), as well as cocoa, coffee, tea, copper, gold and platinum, would push South Africa and Nigeria towards economic contraction or even recession. As these are Sub-Saharan Africa's dominant economies, downturns here would have knock-on effects on the rest of the region. Meanwhile, some states, particularly post-conflict countries with no natural resources, poor economic policies and high cost structures, would continue to stagnate, and increase their dependency on donor support.

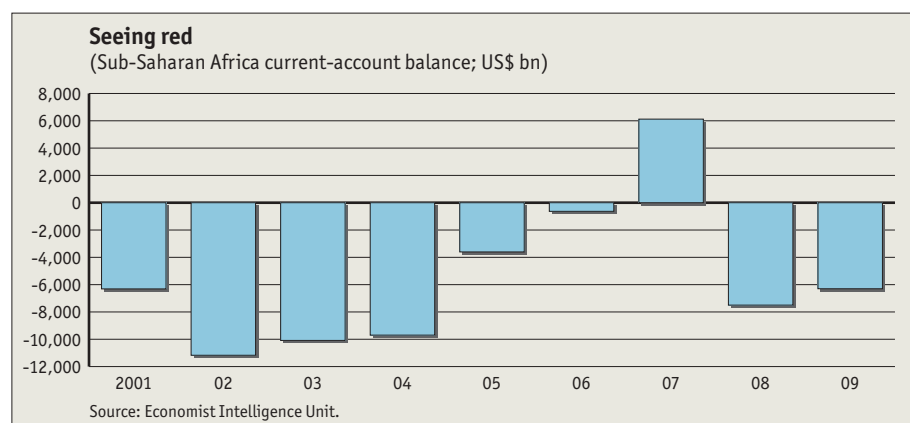
The region's fiscal and external accounts would come under pressure, and probably return to deficit. Globalisation, and in particular increasing trade with Asia, has played a role in the region's strong growth in recent years, and a slowdown in China would have an impact on the region. Asia now accounts for about one-quarter of Africa's exports, with exports to China alone growing

by 30% a year since 2000; indeed, China accounts for about one-fifth of the region's export expansion over the past six years. Nevertheless, more than 70% of the region's exports went to the EU and the US in 2006, and although this was well below the 1990 figure of 88%, it is clear that industrialised-country destinations still dominate. However, growth in these areas is also projected to slow more markedly than under our central forecast, meaning that African exports would come under pressure in all of the continent's main markets.



The pipeline of investment in hydrocarbons projects and cheap lending, from China particularly, might provide some cushion against setbacks in the global economy, but a further substantial downturn in key trading partners and low investor confidence would have repercussions for the regional economies.

A stagnating South African economy would have a knock-on effect on other regional economies, notably Botswana, Namibia and Mozambique. The unwinding of carry trades would hit South Africa through the financial channel. A dramatic fall in property prices (mortgage advances accounted for 47% of private credit in 2006) and a major downturn in the stockmarket would undermine profitability. With household debt as a percentage of disposable income rising to a record high of 73.8% at the end of 2006, a marked increase in interest rates would reduce households' debt-servicing capacity and affect banks' asset quality. Monetary and exchange-rate policies would have to be sufficiently flexible to respond to volatile movements in capital.



For Nigeria, the region's other major economy, a slump in prices on world markets and membership of OPEC would have the largest impact on the economy: the cartel would increase its efforts to reduce supply at a time of depressed demand. In these circumstances oil-related GDP would shrink in 2008, and the performance of the non-oil economy, constrained by lack of credit, poor infrastructure and considerably weaker domestic demand, would only partly mitigate this fall.

Overall, therefore, regional growth, on a weighted basis, would be likely to slow notably in 2008 under our risk scenario. It would post slightly higher growth in 2009 as commodity prices recovered, but expansion would remain well below the rate of population growth, meaning that incomes per head would shrink.

## **Worst-case scenario—10%**

Our worst-case scenario, based on a much deeper and more pronounced global slowdown, would clearly work against Africa. A prolonged recession in the US, particularly Asia and EU, compounded with weak global trade, would deepen the region's economic downturn. A number of African states would be forced to resume the structural adjustment programmes designed by international financial institutions such as the World Bank and the IMF—particularly those undergoing severe fiscal and current-account crunches or exchange-rate crises as a result of falling export receipts brought about by extremely low commodity prices.

The downward trend in the region's stock of external debt, which has been apparent since 2005, would be quickly reversed as many countries were forced to embark on a new round of borrowing to cover their shortfalls. African stockmarkets and foreign investment would also struggle, reflecting the deepening problems in other emerging markets around the world. This would not only hit the region's growth and efforts to reduce poverty, but any serious or sustained downturn in the global economy would once again make Africa appear more peripheral.

**Global assumptions: Main risk scenario**

(central forecast in brackets)

	2006		2007		2008		2009	
<b>Real GDP growth (%)</b>								
<b>World (market exchange rates)</b>	<b>4.0</b>	<b>(4.0)</b>	<b>3.2</b>	<b>(3.6)</b>	<b>2.0</b>	<b>(3.5)</b>	<b>2.9</b>	<b>(3.4)</b>
US	2.9	(2.9)	1.5	(1.9)	0.2	(2.3)	1.8	(2.7)
Japan	2.2	(2.2)	2.1	(2.5)	1.0	(2.1)	1.2	(1.6)
Euro area	2.8	(2.7)	2.4	(2.5)	1.3	(2.2)	1.9	(2.1)
China	11.1	(11.1)	10.8	(11.4)	9.0	(10.1)	7.0	(8.4)
<b>World (PPP exchange rates)</b>	<b>5.3</b>	<b>(5.3)</b>	<b>4.8</b>	<b>(5.1)</b>	<b>3.7</b>	<b>(4.8)</b>	<b>3.9</b>	<b>(4.5)</b>
OECD	3.0	(3.0)	2.3	(2.6)	1.2	(2.5)	2.1	(2.6)
Non-OECD	8.3	(8.3)	7.8	(8.2)	6.6	(7.5)	5.8	(6.7)
<b>World trade growth (%)</b>								
Goods	10.2	(10.2)	6.5	(7.1)	5.3	(8.0)	7.0	(8.0)
<b>Commodity prices</b>								
Oil (US\$/barrel; Brent)	65.28	(65.28)	58.00	(69.91)	42.00	(69.00)	48.00	(63.25)
% change	19.3	(19.3)	-11.2	(7.1)	-27.6	(-1.3)	14.3	(-8.3)
World non-oil commodity prices (US\$)	31.2	(31.2)	6.2	(13.6)	-24.3	(-1.1)	7.5	(-4.4)
Food, feedstuffs & beverages	16.1	(16.1)	9.5	(15.7)	-14.3	(2.5)	6.7	(0.7)
Industrial raw materials	49.6	(49.6)	3.0	(11.6)	-34.3	(-4.6)	8.7	(-9.8)
<b>Main policy interest rates (%; end-period)</b>								
Federal Reserve	5.25	(5.25)	4.50	(4.75)	3.75	(4.75)	5.00	(5.00)
Bank of Japan	0.25	(0.25)	0.25	(0.75)	0.50	(1.25)	1.50	(2.00)
European Central Bank	3.50	(3.50)	3.25	(4.25)	3.50	(4.25)	4.00	(4.00)
<b>Exchange rates (av)</b>								
¥:US\$	116	(116)	115	(117)	103	(106)	96	(97)
US\$:€	1.26	(1.26)	1.38	(1.36)	1.41	(1.38)	1.34	(1.32)
<b>Exchange rates (end-period)</b>								
¥:US\$	119	(119)	108	(112)	99	(101)	94	(95)
US\$:€	1.32	(1.32)	1.30	(1.39)	1.40	(1.35)	1.30	(1.30)