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From the Desk of...

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World economy: lifting the curtain on what worries the EIU about for 2008. Robin Bew, Editorial Director and Chief Economist at the Economist Intelligence Unit, provides a fascinating insight into the debate on risks we face for emerging markets

Feburary 2008: At this time of year, economists and other crystal ball gazers turn their attention to the year ahead. The Economist Group is no exception: our *World in 2008* publication has just arrived at the news stands, edited by Daniel Franklin, a fellow speaker who is part of The Insight Bureau. The Economist Intelligence Unit also joins the party, with its *Country by Country* look at the economic and political outlook for every nation on earth. And most other publishing and research houses are also peering into the future. But despite the multitude of forecast offerings there is often a sense that the really interesting deliberations are the ones going on *inside* the research houses, which never quite make it into print. So in this issue of *From the desk of* I aim to lift the curtain on the discussion inside the Economist Intelligence Unit and shed a little light (though not too much) on the debates within.

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Most forecasters, including ourselves, are predicting a rocky ride for the developed world in 2008. However, there is a general consensus that the picture for the emerging world is brighter. Forecasts differ in degree, of course. We are pessimistic on the US economy - compared to many of our peers. And forecasters also differ in the extent to which they feel the emerging world has decoupled from the developed countries. But there is a remarkable consensus around the broad global economic outlook next year.

But discussion within the Economist Intelligence Unit is focused not on the central scenario, but on the risks. So below I set out five areas where debate still rages:

Five key risks: US dollar collapse, de-leveraging and asset deflation, developed world policy constraints, emerging market decoupling and emerging market policy shifts

I. Dollar collapse: The US dollar has been declining against the Euro for several years, and is also weak against the yen and most other currencies which are allowed to float freely. In large part, this reflects the huge trade deficit the US runs with the rest of the world. However, in recent months this soft dollar, combined with weakening US domestic demand, has started to feed through into an improved trade performance. As a result, most forecasters hope that the dollar is nearing its floor against the Euro, and is set to regain ground against higher yielding currencies such as sterling.

But there is a risk that such optimism is premature. With the short-term US economic outlook darkening by the day, and revelations about the poor health of the financial system likely to continue, there is a chance that existing holders of US dollar assets will decide to diversify their holdings. The long-term economic picture reinforces this concern -- expectations of trend growth in the US have been cut as productivity weakens, suggesting that the growth gap between the US and EU in the years ahead will be smaller than in previous decades. Weaker productivity suggests that US investment returns will be more modest than in the past. This may encourage

central banks in Asia (and investment managers in the Middle East) to direct a greater proportion of their investments towards Europe or even the emerging markets. If this occurred, the dollar could finish 2008 far weaker than in our central scenario.

II. De-leveraging and asset price deflation: It is already clear that the financial sector will have a rocky ride in 2008. But there is a risk that the interplay between balance sheets and asset prices results in a fully fledged banking crisis which could depress the economy for several years. Over recent months financial institutions have announced a series of write-downs, as they account for the depressed value of some assets on their balance sheets (mainly sub-prime mortgages). But with investors reassessing the worth of an ever greater pool of financial instruments, it seems likely that a wider set of assets will come under downwards pressure in the months ahead.

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This risks sparking a vicious downwards spiral in assets prices and the health of financial institutions. As asset prices fall, leveraged investors such as hedge funds need to meet margin calls to their creditors. To make those payments they sell assets, which create further downwards price pressure and potentially start a self reinforcing spiral which, at its extreme, ends in collapse. Banks are affected slightly differently, but a downwards spiral in asset prices would force ever greater write-downs, damaging profitability and thereby limiting their ability to lend. Credit availability to healthy borrowers would be affected, damaging prospects in areas of the economy far removed from the sub-prime sector or the financial services industry. Ultimately, banking solvency could be threatened. Extreme though this scenario sounds, it is similar to that which occurred in Japan during the 1990s. And the consequences would be severe--that onetime powerhouse of the developed world has yet to recover fully from its own financial disaster.

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III. Developed world policy constraints: When economies slow, investors and businessmen look to monetary policy for support. Expectations of swinging interest rate cuts have been increased as the economic clouds darken. In the 2001 recession, the Fed rode to the rescue with a monetary policy easing so great that the economy rebound far faster than expected. However, policy makers are far more constrained in setting interest rates than they have been for years. In early January the Bank of England refused to cut interest rates despite a weakening economy, because inflationary pressures remained too high. In the US, investors continue to believe that Ben Bernanke will cut rates sharply. But consumer price inflation is running at 4.3%, and producer prices are up 7.7%. How much room for manoeuvre does the Fed have to cut rates with abandon? There is a risk that financial market participants could be disappointed.

IV. Emerging market decoupling: The idea that emerging markets can weather the downturn in the US is instrumental in forecasts that world growth will remain reasonable this year. The key to this prediction is not only that domestic demand will expand rapidly in the emerging world, but also that consumption and investment spending is far higher, in cash terms, than in 2001 (the last US recession, when emerging markets were hit hard).

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However, there are three risks to keep in mind.

- First, if globalisation was central to the rise of emerging markets (including China) over the last decade, it seems counter-intuitive to suggest they can ride out a dramatic slowdown in the US economy and hence US import demand
- Secondly, many fast growing emerging market economies have built their success on the back of high commodity prices, which have boosted incomes. But the US accounts for a quarter of all demand in the global economy, so there must be a risk that commodity demand takes a hit in the months ahead and that prices and emerging world incomes fall
- And finally, some emerging market economies still rely on financial flows from the developed world in order to keep afloat. As investors become more cautious, there is a risk that funds to countries like Turkey, Hungary or Romania dry up, with serious economic consequences

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V. Emerging market policy shifts: One of the mechanisms many emerging markets have used in recent years to foster strong economic growth is exchange rate manipulation. Many countries, notably China, have intervened in currency markets to hold their currencies down. Not only has this supported exports, it has also resulted in domestic economies which are flooded with liquidity, allowing rampant credit creation, and soaring investment and (in some countries) consumer spending. But one common theme across emerging markets in 2008 is accelerating inflation. Years of low interest rates, cheap currencies and soaring liquidity, coupled with record rises in commodity prices, have finally started to drive up consumer prices. It is unclear how policy makers propose to respond, but there is a risk that 2008 could be marked by rapid currency appreciation in the emerging markets, or sharply higher interest rates, or both. The health of the domestic demand boom of recent years may, as a result, be in doubt.

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Hopefully, the risks above will remain just that--risks, to be discussed at the water cooler, not facts to be written into business plans. And readers will be pleased to know that most of the hair-raising scenarios discussed at the Economist Intelligence Unit every month never make it into our official forecast and never occur in real life. But, just occasionally, the worst does happen and if it does in 2008, remember that you read about it here first!

About Robin Bew

Robin Bew is one of the Economist Intelligence Unit's sharpest minds and leads its global editorial team. He is recognised for his commentary and interpretation of economic developments. He is an engaging presenter who helps business executives make sense of these developments. He draws from over a decade of experience presenting his views -- and defending them -- to media and business audiences, to Board members and to regional management teams. He also shares his perspectives in public forums, major business summits and private client gatherings alike.

Robin Bew has over 14 years' experience observing, analysing and forecasting global economic developments. The Economist Intelligence Unit is globally recognised as the leader in country analysis and forecasting. Robin has overall responsibility for Economist Intelligence Unit's editorial operations throughout the organisation leads its internal intellectual debate. His particular expertise is on risk, global economy, world business environment and the financial services industry. He oversees all Economist Intelligence Unit content generation, including subscription services such as the *Country Reports*, *Country Forecasts*, daily wire services, custom or sponsored research and Corporate Network programmes. He is the editor of Global Risk, an Economist Intelligence Unit monthly publication and is a regular contributor to *The Economist* newspaper and to the annual *The World in* magazine, as well as numerous Economist Intelligence Unit country reports and forecasts.

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