ECONOMIC SITUATION AND STRATEGY

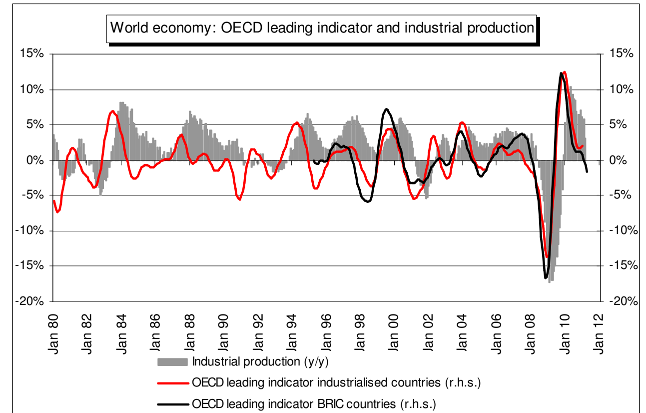
OECD leading indicators: Warning sign for the world economy

The decline of many important leading indicators has continued in the past days. In particular, there seems to be no end of bad news in the United States at the moment. It is not surprising that so much attention is focused on the US economy considering the still huge importance of the United States for the entire world economy. The country accounts for almost one-fourth of global net product. If America is not doing well economically, the rest of the world has a problem – at least when growth is slowing in other countries, too. And that is exactly the impression conveyed by the latest leading indicators from the OECD countries and most important emerging markets.

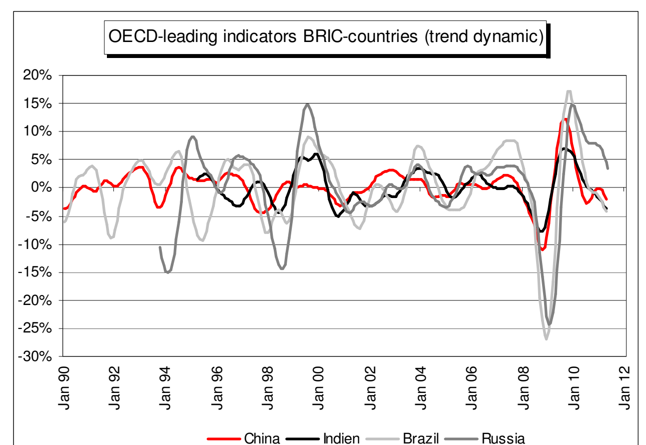
Ranking of world's largest economies

Ranking	Country	Nominal GDP 2010 un US$
	Word	62.242
	EU-16	15.125
1	USA	14.723
2	China	5.878
3	Japan	5.462
4	Germany	3.317
5	France	2.606
6	UK	2.251
7	Italy	2.070
8	Brasil	2.029
9	India	1.645
10	Russia	1.465
11	Canada	1.560
12	Spain	1.420

We previously believed the slowdown that started last year would end in the beginning of 2011 and leading indicators would then turn up again. And at first, it looked exactly as if that scenario would come about. The 6-month rate of change in the OECD leading indicator for the industrialized countries, which has given very reliable and timely signals of past economic turning points, first reached its low in autumn 2010 and then started increasing again slightly. But unfortunately, this trend has not continued. Data released for April show that, contrary to our expectations, the growth rate has not stabilized further. In fact, the opposite has happened. Partly due to revisions of originally reported time series, everything now points to a continued weakening of basic economic momentum. Of the 40 or so OECD leading indicators that we watch and regularly evaluate, only seven now show positive trend momentum. Those are the indictors for Australia, Spain, South Korea, Mexico, New Zealand, South Africa, and Great Britain. However, the improvement for Spain, Mexico, and Great Britain are marginal.



The OECD leading indicator for the United States was still at a level in April that was satisfactory considered by itself. However, the national leading indicators published for May and partly for June have shown that the US economy's momentum has decreased significantly since then. Moreover, data from the world's second-largest national economy, China, is also not very encouraging. The OECD leading indicator worsened in April, and the originally positive development reported for the past months has been revised to a negative one. There is thus much evidence that strong growth impetus for the world economy is not coming from China now, either. Nevertheless, the situation there may still be judged as positive compared with India or Brazil, since those two emerging markets appear headed for a much more pronounced slowdown. That may be gathered already from the development of industrial production. While output is still up by more than 13% on last year's level in China, growth in India has already slowed to 6%, while manufacturers in Brazil are now actually producing less than they did a year ago.

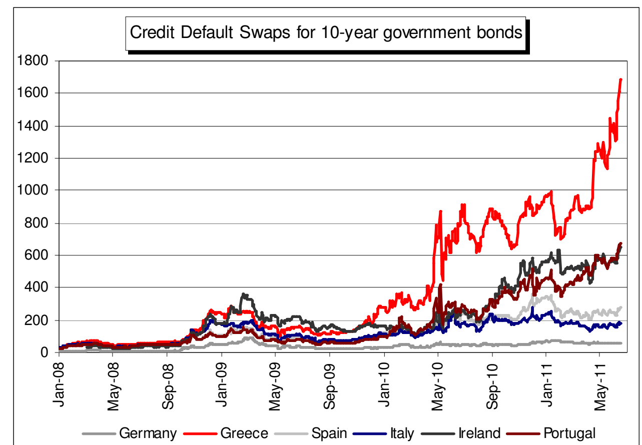


It therefore appears that the world economy is now in a phase of synchronous slowing. We still believe China is capable of initiating changes in the global economic cycle, but there is no sign of that at present. The more synchronously the economic cycle proceeds, the more likely it is that the amplitude of the change will be greater. As gratifying as this is in an upswing because the boom might then turn out that much stronger, the risk is also greater that a

downswing will lead into recession. Although we do not now believe a new global recession is likely, the current state of the world economy suggests that the IMF's 4.4% growth forecast for this year, which we previously considered very plausible, will be difficult to achieve. Instead, the global growth rate this year will probably be between 3.5% and 4% and thus in line with the long-term average.

Given the current weakness of the global economy, we believe it is even more important that policymakers make no critical mistakes in efforts to solve the European debt crisis. Considering the wrangling over further aid to Greece, one is automatically reminded of the year 2008 and the financial crisis that began then. In March 2008, US investment bank Bear Stearns was saved from bankruptcy just in time with assistance from the Fed, but Lehman Brothers, a significantly larger competitor, went bankrupt six months later, and that triggered an upheaval on the financial markets. Before the Lehman bankruptcy, the US government had prevented the collapse of the two mortgage finance companies Fannie Mae and Freddie, for which it had to put up billions of dollars. The political will to rescue another bank at the expense of taxpayers was then no longer there. The consequences of the insolvency were disastrous. Confidence in banks was lost, the financial system was on the verge of collapse, and the world economy entered a severe recession. Further bank collapses could only be prevented because governments issued extensive guarantees, and the economy quickly got back on its feet thanks to huge impetus from monetary and fiscal policy.

The costs of the last economic and financial crisis are all too obvious if one looks at the debt ratios of industrialized countries. Although the Greek debt ratio is at a record high of about 150% of GDP (in Japan, the ratio is 200%), practically all countries may be said to have a debt problem. Many European policymakers are telling Greece "waste not, want not," but few are or have been following that old maxim themselves. In Germany, too, one would like to forget that the Maastricht criterion limiting deficits to 3% was exceeded every year between 2002 and 2005 and consequently official sanction proceedings were initiated. And although Germany is now relatively better off from a fiscal policy standpoint than many other countries (in Europe), that has not always been the case, nor need always be in the future. At any rate, it may be said in criticism that in two years of "super growth" (the economy grew by 3.6% in 2010, and a similar increase is expected in 2011), Germany has not even managed at least to balance its public budget. The budget deficit amounted to just over EUR 80 billion in 2010, and a shortfall of just over EUR 50 billion is expected this year. Somewhat polemically, one could ask who finds it surprising that Greece, whose economy shrank by more than 4% in 2010 and whose GDP will probably decline again by more than 4% in 2011, then runs a deficit of EUR 20 billion.



In the current fragile economic situation, policymakers may easily make mistakes that would have far-reaching consequences. Greece may make the mistake of not continuing the reforms it has begun and making demands that are untenable from the standpoint of European donor countries. In that case, one could expect that Europe would not make further aid payments to Greece and the country would go bankrupt. Or the European donor countries might not agree on a common approach and on how Greece should continue to be supported. This also concerns the German demand that private creditors be involved in further aid to Greece. The argument is that taxpayers should not be made to pay the whole bill by themselves – as they were in the case of the bank rescue. So far, so good, but the idea does not go far enough. For, if private creditors do not participate "voluntarily," any kind of debt restructuring would be viewed as a default by the rating agencies and hence as a national bankruptcy. If that happens, Greek banks will be bankrupt, but then all other owners of Greek government bonds – including other European and international commercial banks, insurance companies, and pension funds – will also have a problem. For, most of the over EUR 300 billion in outstanding debt is still in private hands. And the ECB would also have a big problem because it holds a presumably considerable (though not publicly known) quantity of Greek bonds. If Greek bonds become worthless or have to be largely written off, that will tear deep holes in all bank balance sheets, in those of both private banks and the ECB. If private banks or the ECB have to be recapitalized, i.e., supplied with fresh capital, taxpayers will automatically be back on board.

Moreover, the Lehman bankruptcy has shown that the markets do not differentiate much in such a situation, but rather quickly seek the next potential victim. Portugal and Ireland would probably be the next candidates, and at the latest when market participants started to home in on Spain and/or Italy, the entire monetary union would be in jeopardy. But perhaps it will not be all that bad, and domino effects can be avoided. That could happen in efficient markets, but when panic prevails, markets are usually no longer efficient. Who would actually like to risk this experiment to see how the markets react to a bankruptcy of Greece? Market purists would object that one cannot permanently prop up the weak elements without the entire system eventually

collapsing. Right. So, further support only makes sense if Greece believably continues the reform process it has begun. But the country will not get back on its feet through austerity alone. If one only raises taxes, reduces social outlays, and cuts jobs, that will undermine any growth. The crisis can only be mastered with the help of growth, as the following debt arithmetic shows.

Equilibrium levels of GDP-growth and inflation in order keep the debt to GDP-ratio constant

Debt to GDP-ratio	GDP growth	Inflation	Budget Deficit
150%	2%	2%	6,0%
100%	2%	2%	4,0%
80%	2%	2%	3,2%
60%	2%	2%	2,4%
150%	1%	2%	4,5%
100%	1%	2%	3,0%
80%	1%	2%	2,4%
60%	1%	2%	1,8%
150%	1%	1%	3,0%
100%	1%	1%	2,0%
80%	1%	1%	1,6%
60%	1%	1%	1,2%
150%	3%	3%	9,0%
100%	3%	3%	6,0%
80%	3%	3%	4,8%
60%	3%	3%	3,6%

Only if Greece manages to grow again can the debt ratio of 150% even be kept stable. If it achieves real growth of 2% with an inflation rate of 2%, a budget deficit of 6% could be allowed in order to stabilize the debt ratio. That would be a first, small success. The markets will probably not be convinced, however, that a rehabilitation of Greek state finances could succeed until the debt ratio falls. The table shows possible combinations of (nominal) growth and budget deficits that lead to a sustained debt ratio of 100%. If it achieves only 1% real growth, the country can afford a deficit of 3% with inflation at 2%. On real growth of 2%, the deficit may amount to at most 4%, and on real growth and an inflation rate of 3%, a deficit of 6% is even possible. Any lower deficit would have the result that the debt ratio would settle in at less than 100%. The question is just whether and how the Greeks can manage to limit their budget deficit so much. That would presumably only work if the country did not have to obtain financing via the capital market, but rather received loans from European parties subsidized with a low interest rate – but not just for one or two years, but for significantly longer. Or the countries of the European Monetary Union could guarantee to bear the Greek budget deficit for the next few years. In 2010, Greece made new debt of about EUR 20 billion. If one takes the first rescue program of EUR 100 billion and supplements it with a second tranche in the same order of magnitude, one could thus stabilize Greece for about ten years. That would be enough time not only to initiate reforms, but also to allow their effects to be felt. For, if experience shows anything, it is that rehabilitation of state finances cannot be accomplished in one or two years, but rather takes five, ten, or even fifteen years. However, it is also clear that any manner of such support will entail considerable risks and the success of such measures is by no means assured. In particular, the problem of lacking or even false incentives could be an obstacle to long-term success.

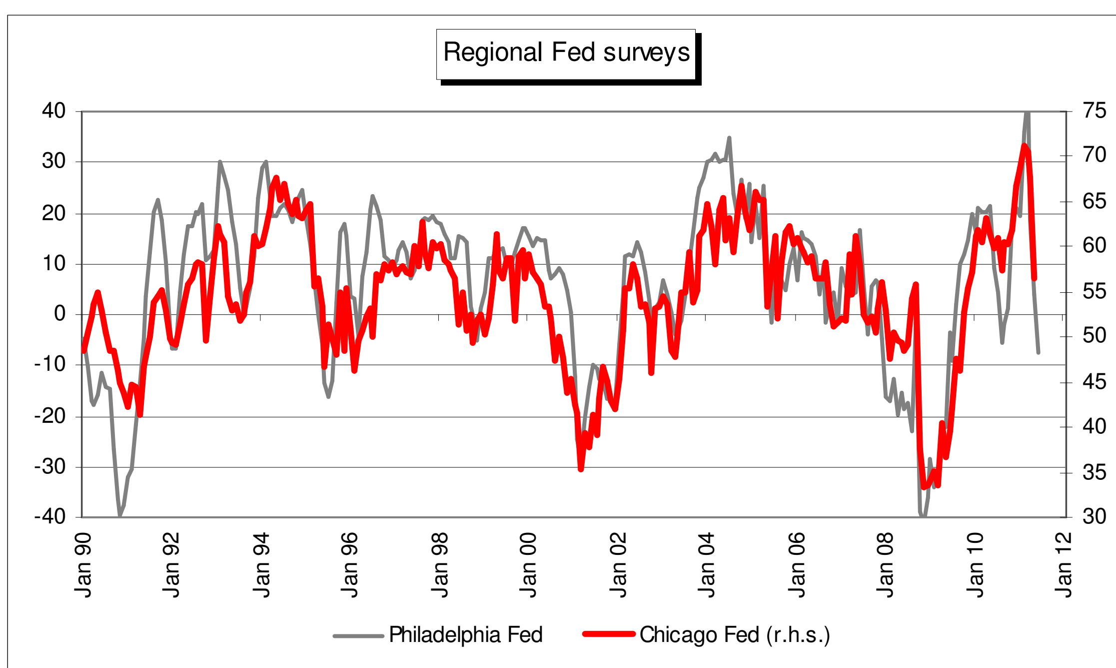
But should one for that reason not even make the attempt? After all, there are many who would like to have the good, old D-mark back. But this debate perhaps overlooks the fact that the euro and the Monetary Union not only cost Germany money, but Germany has also been one of the beneficiaries of the Monetary Union in recent years. Germany is benefiting more than proportionately even from the crisis, because the interest rate level is lower in the euro area and the euro is weaker than would have been the case without the crisis. With the countries of the euro area alone, Germany achieved a trade surplus of EUR 85 billion last year, of which Portugal accounted for EUR 3.7 billion, Greece for about EUR 5 billion (unfortunately, the Bundesbank stopped the time series in October 2010), Spain for EUR 12 billion, and Italy for almost EUR 15 billion. If one looks at the development of the past five years, the surplus in trade with the euro area amounts to almost EUR 500 billion, of which EUR 95 billion is attributable to Spain, EUR 81 billion to Italy, and about EUR 25 billion to Greece. A return to the D-mark would presumably result in a strong revaluation of the German currency on the order of 20-25%. That alone could depress German exports by 10% or more in a year, which would by itself constitute a loss for the German economy of almost EUR 100 billion. This shows that a return to the D-mark would pose considerable economic risks for Germany. However one twists and turns it, there are no simple solutions to the Greek question – for anyone.

Weekly outlook for the period of June 20-24, 2011

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: Producer prices, m/m	1.2%	0.7%	0.4%	1.0%	0.2%		June 20
DE: Producer prices, y/y	5.7%	6.4%	6.2%	6.4%	6.3%		June 20
DE: ZEW economic expectations	15.4	15.7	14.1	7.6	3.1	-8	June 21
DE: Import prices, m/m	1.5%	1.1%	1.1%	0.3%	0.1%		from June 23
DE: Import prices, y/y	11.8%	11.9%	11.3%	9.4%	8.9%		from June 23
DE: PMI, manufacturing	60.5	62.7	60.9	62.0	57.7	55.9	June 23
DE: PMI, services	60.3	58.6	60.1	56.8	56.1	55.5	June 23
DE: Ifo business climate index	113.9	115.4	115.0	114.2	114.2	112.6	June 24
EUR17: New orders, m/m	1.1%	0.5%	-1.6%	1.3%			June 22
EUR17: New orders, y/y	22.7%	21.4%	12.3%	14.4%			June 22
EUR17: PMI, manufacturing	57.3	59.0	57.5	58.0	54.6	52.9	June 23
EUR17: PMI, services	55.9	56.8	57.2	56.7	56.0	55.0	June 23

MMWB estimates in red.

Chart of the week: Haircut priced in by Greek government bonds



After the New York Fed's Empire State Manufacturing Survey had already turned out weak, the release of the significantly more important Philadelphia Fed Index unfortunately was unable to spread new hope. Contrary to expectations, both the assessment of current conditions and the expectation component in this index also worsened appreciably versus the preceding month. It thus joins the ranks of many economically relevant time series that have declined significantly in recent weeks, especially in the United States. In addition to the overall index, numerous subcomponents of the Philadelphia Fed Index are also pointed down and, together with the worsening of many other indicators, suggest that US economic growth will slow in the months ahead. It is thus not surprising that consensus growth estimates for US GDP growth have been lowered in the last few weeks from 3.3% to 2.5%. One good piece of news, at any rate, may be gathered from the current Philly Fed Index, i.e., that the decline of the price-paid component implies that inflation pressure will diminish somewhat in the coming months. That is good news for consumers, whose spending propensity has been bridled somewhat in recent months by elevated inflation rates. Nevertheless, given the current data situation, the possibility exists that a temporary growth dip could develop into a more severe slowdown. However, that is not our main scenario yet. For that, it is still not sufficiently clear what role the Japanese earthquake is actually playing as a trigger of the current weakness of growth.

Financial markets at a glance

	As of	Change versus			
	16.06.2011	10.06.2011	16.05.2011	16.03.2011	31.12.2010
Stock markets		-1 week	-1 month	-3 months	YTD
Dow Jones	11.962	0,1%	-4,7%	3,0%	3,3%
S&P 500	1.268	-0,3%	-4,7%	0,9%	0,8%
Nasdaq	2.624	-0,8%	-5,7%	0,3%	-1,1%
Wilshire 5000	13.364	-0,3%	-4,8%	0,6%	0,6%
DAX	7.110	0,6%	-3,8%	9,2%	2,8%
MDAX	10.558	-0,1%	-2,2%	10,4%	4,2%
TecDAX	875	-0,6%	-5,4%	2,3%	2,8%
EuroStoxx 50	2.731	-0,1%	-5,2%	0,3%	-2,2%
Stoxx 50	2.508	0,0%	-4,3%	1,7%	-3,0%
Nikkei 225	9.411	-1,1%	-1,5%	3,5%	-8,0%
Topix	812	-0,6%	-2,1%	-0,6%	-9,6%
Bond markets					
3 months Euribor	1,49	2	7	32	49
3 months Treasury Bill	0,05	0	1	-5	-7
10 year US Treasuries	2,91	-6	-21	-31	-40
10 year Bunds	2,92	-6	-14	-19	4
10 year JGB	1,12	-1	-1	-10	0
US mortgage rate	4,49	0	-14	-39	-37
IBOXX AAA, €	3,68	-2	-22	-13	10
IBOXX BBB, €	5,03	9	18	0	8
ML US High Yield	7,62	11	43	11	-12
JPM EMBI+, Index	573	-0,3%	0,7%	3,6%	3,9%
Convertible Bonds, Exane 25	5.036	0,0%	-2,7%	0,6%	0,6%
Commodities					
CRB Index	638,80	-2,9%	1,2%	0,6%	1,5%
MG Base Metal Index	414,50	-1,8%	-1,3%	-3,9%	-3,9%
Crude oil Brent	117,20	-1,1%	3,1%	6,8%	25,4%
Gold	1528,34	-0,4%	1,8%	9,1%	7,8%
Freight rates Baltic Dry Index	1.424	0,4%	10,3%	-7,4%	-19,7%
Currencies					
EUR/ USD	1,4088	-2,7%	-0,4%	1,0%	5,4%
EUR/ GBP	0,8772	-0,9%	0,0%	1,0%	2,4%
EUR/ JPY	113,63	-2,0%	-0,6%	1,1%	4,6%
EUR/ CHF	1,1958	-1,9%	-4,7%	-6,2%	-4,4%
USD/JPY	80,62	0,4%	-0,2%	3,2%	-0,7%

Source: Thomson Financial

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