Global Economic Insight

Euro-Crisis: the Single Most Worrying Problem for the Global Economy

John Greenwood, Chief Economist, Invesco Ltd
Quarterly Economic Outlook – Q3 2012

INTRODUCTION

The crisis in the Eurozone is no nearer resolution. Without a fiscal union the monetary union will collapse either as a result of accelerating bank runs in the periphery, or as a result of elections that bring radical leaders to power. Either set of events could cause moderate leaders in the core to lose control of events, resulting in an exit for one or more of the crisis economies. Unfortunately for the monetary union, euro-area leaders are as reluctant as ever to embark on a far-reaching fiscal union because a federal Eurozone Treasury with powers to tax, control spending and issue bonds would be incompatible with the retention of national sovereignty.

The EU represents about one fifth of global GDP. Consequently the crisis in the Eurozone is not only generating a recession in the region, but is severely hampering global trade, undermining growth in the UK, eastern Europe, North America as well as growth in export-dependent Asia. Further global economic weakness is unavoidable until a credible, sustainable resolution to the euro-crisis is within sight.

In the US, which had been enjoying a better recovery than the UK or Europe, real GDP growth appears to be losing momentum again. The current policy impasse has shifted attention to the possibility of a “fiscal cliff” in early 2013 – i.e. the risk of a sharp cutback in government spending and a simultaneous rise in taxes together creating a hit to GDP of between -3% and -5%. Meantime monetary policy has limited ability to induce households or firms with debt-impaired balance sheets to spend more vigorously. Private investment is slowing – possibly in anticipation of the withdrawal of fiscal stimulus -and consumer confidence has been falling.

In China, the economy has avoided a hard landing but it is clearly still slowing under the pressure of both domestic as well as external factors. On the domestic side the policy-makers are still trying to bring shadow bank lending and property prices under control, while on the external side there are numerous signs of exports slowing further.

Invesco Forecast in blue brackets

<table>
<thead>
<tr>
<th>2011 Actual</th>
<th>2012 Consensus Forecast</th>
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<tbody>
<tr>
<td>US</td>
<td>Real GDP</td>
</tr>
<tr>
<td>US</td>
<td>1.7%</td>
</tr>
<tr>
<td>EU-17</td>
<td>1.5%</td>
</tr>
<tr>
<td>UK</td>
<td>0.7%</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.7%</td>
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<tr>
<td>Australia</td>
<td>2.0%</td>
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<tr>
<td>Canada</td>
<td>2.5%</td>
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<tr>
<td>China</td>
<td>9.2%</td>
</tr>
<tr>
<td>India*</td>
<td>6.7%</td>
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</tbody>
</table>

Source: Consensus Economics, 14 May 2012

* Fiscal year data (ie. FY11 = Apr 11 to March 12)

In view of the global economic weakness, central bank policy rates in the developed world are likely to remain close to the “zero bound” for an extended period, with policy-makers periodically resorting to central bank balance sheet expansion via asset purchases. In this situation it is expected that investors will remain in a search-for-yield mode. This will in turn cause quality assets that generate safe and sustainable yields to be bid to a premium relative to assets generating lower income streams.

One corollary is that despite efforts at quantitative easing (QE) by different central banks there is unlikely to be any upsurge in asset prices as there would have been in the past following traditional liquidity boosts. A second is that inflation is likely to fall more than expected in the second half of the year. A third is that commodity prices are likely to weaken further during the rest of the year.

UNITED STATES

Following a series of relatively favourable economic data releases in January and February, most of the economic data points released in the second quarter have again been disappointing and below expectations (see fig 3). This applies to housing, the labour market, investment, retail sales and consumer confidence. In addition, investors have become much more keenly aware of the possibility of an adverse fiscal shock that is likely to knock back real GDP growth by as much as 3% in the early months of 2013 if Congress does not act to mitigate the consequences of the impending fiscal contraction.

The pace of US recovery in this cycle has been notably weaker than in the average of past recoveries since 1970. Two theories have emerged to explain this sub-par performance. One theory argues that the US economy has been permanently damaged by the severity of the preceding recession of 2008-09, and as a result the engine of growth will not be as strong going forward. This helps to explain why the unemployment rate has remained stubbornly high, why companies have been reluctant to invest despite having

Fig 1: Inflation and Growth Forecasts

Fig 2: The Euro has weakened at last
ample cash resources, and why excess capacity remains a feature of the post-recession economy.

An alternative explanation - which I prefer - is that the bubble and the recession caused serious damage to the balance sheets of the household and financial sectors, with both taking on excessive debt, and that it simply takes many years for individuals (who cannot raise capital and who are reluctant to sell their homes to raise the cash needed to repay debt) and financial institutions to repair their balance sheets. During this period of extended recuperation real GDP growth is adversely affected because households are either cutting back consumption in order to increase savings and pay down debt, and/or investment is reduced because some of those savings are being used to repay debt rather than used for new investments.

One reason I prefer the latter theory is that it helps to explain why monetary and fiscal policy have been unsuccessful in generating a normal recovery on this occasion. The Fed, for example, has engaged twice in large-scale QE operations, and since September 2011 it has been buying $400 billion long-dated US Treasuries and selling short-dated Treasuries in "operation twist", recently announcing an extension of this to December with an additional $267 billion of purchases and sales. But whether it has expanded its balance sheet or flattened the yield curve, the impact on asset markets has been short-lived, and the effect on real GDP growth has been limited. The problem is that both sets of operations are designed to boost spending – something indebted households and firms are reluctant to do – and neither operation significantly accelerates the process of balance sheet repair for households or financial institutions.

The risks to the US economy from the fiscal cliff after the Presidential election in November arise from expiring tax legislation and the automatic application of certain “sequestrations” or spending reductions. Specifically, eliminating the Bush tax cuts that have already been extended for two years since 2010 would increase personal taxation by some $140 bn; the payroll tax cut if reversed would add roughly $95 bn to employment costs; scrapping the Alternative Minimum Tax (AMT) would cost middle income households another $90 bn; and the removal of other tax cuts would cost $100 bn for a grand total of $425 bn in increased taxes. On the spending side unemployment insurance is set to be reduced by $26 bn, while sequestration applies to $52 bn of defence spending and $13 bn of health care annually, for a total of $91 bn p.a. If implemented together, tax increases of $425 bn and spending cuts of $91 bn amount to a net contraction in the federal deficit of over $515 bn, or nearly 3.5% of GDP, a drastic change by past standards.

Of course nobody knows what will happen. It is possible that the lame duck Congress will be able to pass amending or extending legislation, but it is equally possible that gridlock will prevail. What does seem certain is that uncertainty will rise towards year end, lowering planned business investment and consumer spending.

Looking forward, I expect real GDP growth to average 2.3% in 2012 -well below the normal 3-4% that is typical of the early stages of a recovery. Nevertheless, while I expect growth to remain moderate, in my view the current economic upswing will be sustained. However, inflation should fall significantly in the second half of 2012 with headline CPI inflation declining to 1.6% by year end or 2.2% for the year as a whole.

**THE EUROZONE**

As this Outlook was being written the euro-area leaders of 27 nations were gathering in Brussels on June 28-29 for the nineteenth summit in a long series of meetings that have attempted to craft a solution to the continuing debt crisis in the Eurozone. On the agenda for consideration was a plan drawn up by EU President Van Rompuy, EU Commission President Barosso, Euro Finance group President Juncker, and ECB President Draghi. This proposed “developing a vision for theEMU” around four building blocks consisting of an integrated financial sector; integrated budgetary and integrated economic policy frameworks, together with ensuring “democratic legitimacy and accountability” to be achieved over the next decade.

Concretely the proposed financial framework only calls for “single European banking supervision and a common deposit insurance and resolution framework,” while in the budgetary arena the plan only calls for “a qualitative move towards a fiscal union”. In the medium term it says that “the issuance of common debt could be explored,” and “steps towards the introduction of joint and several sovereign liabilities could be considered as long as a robust framework for budgetary discipline and competitiveness is in place to avoid moral hazard and foster responsibility and compliance.” A more detailed interim plan is proposed for October, with a final report in December.

These ideas still fall a long way short of what is required to ensure that the European monetary union is genuinely robust and sustainable. The proposal to create a “single European banking supervisor and a common deposit insurance and resolution framework” may be fine for containing or addressing the next crisis, but as far as the current crisis is concerned, the horse has already bolted. In essence these elements are a sideshow, and will not stop the current banking and debt crisis from escalating.
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On Friday June 29th it was announced that the euro-zone leaders had agreed to permit the EFSF/ESM rescue funds to be used to recapitalise banks directly without first being loaned to governments, but only once an overall euro-banking supervisor has been set up. This should help to weaken the toxic link between sovereigns and banks, but it does not put the solvency of euro-area banks beyond doubt, and it does not resolve the problem of the sovereign debt markets given that the total rescue funds (EUR 500 bn) are only 20% of total Spanish and Italian government debt (EUR 2,400 bn). It was also agreed that loans by the rescue funds for bank recapitalisation would not rank senior to private creditors, an important condition for ensuring continued private sector buying support for peripheral sovereign debt. These are small steps in the right direction, but a long way from a comprehensive solution.

To see what is needed to solve the euro-debt crisis once and for all it is helpful to ask not “What else can be integrated?” or “How many banking or other unions can be created?” but what protection can a depositor expect when placing funds with euro-area banks? Banks are leveraged institutions and therefore potentially very vulnerable to losses or deposit withdrawals. Normally, in a sound monetary system, there would be typically several layers of protection available to worried depositors. The problem is that the Eurozone fails in the vital, final or ultimate layer of protection, namely government protection (see below table).

Yet almost all of the member states are resolutely opposed to giving up their national sovereignty in favour of a federal euro-zone Treasury with full powers to tax, spend and borrow on behalf of all members. The refusal to correct this fundamental flaw in the architecture of the euro-zone risks is tearing the edifice apart. But consumers are instinctively aware of the problem, and are seeking to protect their funds by deposit withdrawals. In the face of this crisis it is to be hoped that the euro-zone authorities can act with speed and firmness. However, it is sadly probable that the euro-area institutions are too complex, too bureaucratic and too legalistic to be able to respond promptly.

The best hope for the Euro-zone as a whole is that the ECB provides additional 3-year LTROs, fuelling a strong recovery in Germany and other core economies. This should have favourable spill-over effects on the struggling peripheral economies, encouraging southern Euro-zone exporters and raising relative prices in the core. In practice, however, the recessions in seven euro-zone economies – mainly in the periphery -are starting to drag down the economies of the core. In Germany, for example, retail sales have fallen for the past two months (April and May) while the IFO business climate survey also weakened in May. For the year 2012 across the Euro-zone as a whole I expect -0.3% real GDP growth and 2.8% CPI inflation.

UNIFIED KINGDOM

Real GDP growth in 2012 Q1 was reported at -0.3% following -0.4% in 2011 Q4, putting the UK economy back in recession according to the common yardstick of two successive quarters of negative real GDP growth. The other significant development in the quarter was the surprise decline in the CPI inflation measure to 2.8% year-on-year in May. In my view both of these developments are consistent with the abnormally low rates of monetary growth since the second half of 2009. The combination of low money growth and rising import prices had been squeezing households’ purchasing power and the economy is showing the symptoms in the form of weaker nominal and real spending growth.

High inflation, disappointing growth figures and an unexpected slippage in the government’s fiscal performance (see Fig. 5) have made the past six months tough ones for the coalition’s strategy. The persistently high inflation of the past year eroded consumers’ real purchasing power at a time when nominal wage growth was very weak anyway. Over the year to April wage earnings in the public and private sector together increased by only 1.3% year-on-year in nominal terms, implying a real decline of 1.2% or 1.5% depending on the price index used. However, this is a considerable improvement over the 3-4% declines in real terms being experienced last autumn.

This is the fundamental reason why fiscal unions must precede monetary unions, and why fiscal unions must be contiguous with monetary unions. In modern economies with fiat money systems the ultimate guarantor of people’s money is the state, but if the state is already over-indebted – as in Europe’s peripheral member states - and cannot act to rescue the banks, then the crisis could easily be exacerbated by deposit withdrawals or bank losses. Already in the euro-zone today there are silent bank runs occurring in Greece, Spain, Portugal and Ireland. There is now a serious risk that these runs could intensify, tightening the financial squeeze and deepening the recessions.

<table>
<thead>
<tr>
<th>LAYERS OF PROTECTION AVAILABLE TO EURO-AREA DEPOSITORS</th>
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<tbody>
<tr>
<td>1. Conversion of deposits to cash - available.</td>
</tr>
<tr>
<td>2. Bank capital - available, but clearly such capital is now “at risk” or inadequate in several parts of the euro-zone.</td>
</tr>
<tr>
<td>3. Deposit insurance – available for most for retail deposits up to EUR 100,000.</td>
</tr>
<tr>
<td>4. Central bank liquidity – but the ECB has generally been a reluctant supplier of liquidity.</td>
</tr>
<tr>
<td>5. Government protection or guarantee of bank liabilities – as offered by the US Treasury and HM Treasury in the UK during the 2008-09 crisis.</td>
</tr>
</tbody>
</table>

However, the euro-zone has no federal government to provide this backstop and therefore depositors must rely on already indebted national governments. Clearly the lack of a final backstop is going to be viewed as inadequate protection by many bank customers, prompting bank runs and the transfer of funds abroad.

Fig 4:

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On the fiscal front revenues and expenditures have both been falling on a 12-month moving total basis since January, and until May the net public sector borrowing requirement was narrowing rapidly. Undoubtedly the weakness of the economy has restricted the growth of tax revenues, but the government’s persistence on expenditure cuts was starting to pay off with a narrowing deficit until the May data were released. Going forward there will be a delicate balance between the effects of a weaker economy on tax revenues and the effect of the on-going fiscal contraction on expenditures.

In the monetary policy arena the Bank of England’s Monetary Policy Committee has kept Base Rate at 0.5% since March 2009, and on June 7th at their last meeting the members narrowly decided by 5-4 not to expand asset purchases beyond the prevailing £325 billion. Nevertheless, with the emergence of further weak data since the meeting, the decline in the inflation rate, and the intensification of the downturn in the euro-zone it is widely expected that the MPC will increase asset purchases by £50 billion at their next allotment to provide 6-month sterling loans at a small Extended Collateral Term Repos (ECTRs) in £5 billion by loans to the “real economy”, and activation of the Bank’s financing to banks for a period of several years, collateralised schemes: “funding for lending” which will provide subsidised loans. In both cases, as with QE, the effectiveness of the new schemes will be determined by the extent to which they are offset by loan repayments or de-leveraging elsewhere in the system. After all, as Osborne himself has said, you don’t solve a debt problem with more debt.

The main reason for the UK economy’s weak performance last year was the erosion of personal incomes in real terms by high inflation. The outlook for inflation will therefore be crucial to the restoration of economic growth over the next two years. In this respect the surprise decline of CPI inflation in May to 2.8% was a positive development, and I expect it to fall to 2% by year end (2.8% for the year as a whole). However, real GDP growth for the year will remain in my view very weak at 0.4%, adversely affected both by the Eurozone crisis and by the effects of high inflation in the first half of the year.

CHINA

China is facing two types of economic slowdown: a self-imposed domestic slowdown following the panic measures of credit expansion in 2008-09, and an involuntary downturn in exports to its major markets – Europe and the US. Neither slowdown looks likely to be turned around quickly.

The domestic slowdown is necessary on account of the overheating generated by the excessive surge in money and credit associated with the stimulus policies of 2008-09. From October 2010 the authorities took their foot off the accelerator and started tapping on the brakes, reducing loan quotas, raising interest rates, and discouraging second mortgages. However, the damage had been done as property prices soared and consumer prices started rising. The priority of the leadership since then has been to contain the overheating and bring down inflation. In large measure this has been achieved, but shadow bank lending continues to grow very rapidly with credit to non-bank financial institutions up 40.8% year-on-year in April. These loans to trust management vehicles are a favoured mechanism for depositors to escape the interest rate ceilings on regulated lending. Consequently although the Chinese authorities have cut reserve requirements twice and lowered official interest rates once, they have not eased up on loan quotas – their main tool for easing policy. It is probable that with the leadership change imminent in the autumn there will not be any drastic policy move over the next few months.

The external slowdown is more problematic for China. Employment in the export-related sectors is huge, and much of the economy’s enormous investment programme is tied to exports. There is evidence of growing inventories of raw materials as overseas demand slows, and Chinese firms have yet to cut back orders in areas such as long-term contracts for imported iron ore and coking coal. In the three months March-May Chinese exports had slowed to single digit growth rates, while re-export data from Hong Kong suggests even lower growth of exports of Chinese origin to final destinations. Another clear sign of on-going concern by policy-makers about the outlook is that the authorities have frozen the appreciation of the Chinese currency against the US dollar, exactly as they did between July 2008 and June 2010. In fact they have even allowed some depreciation, with the yuan weakening from 6.30 to 6.36 per US dollar.

For 2012 as a whole I expect 8.0% real GDP growth and 3.5% CPI inflation.

JAPAN

The economic recovery from the disastrous tsunami of March 2011 and the subsequent electricity supply problems has
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shown two quarters of strength in 2011 Q3 and 2012 Q1 when real GDP grew 7.8% and 4.7% annualised respectively, but is not expected to maintain this pace. For example the Bank of Japan’s Tankan (Short-term Outlook) survey has been negative over the past two quarters, and industrial production fell sharply (-3.3% month-on-month) in May, although some of this was due to the timing of holiday dates. Overall Japanese economic output remains in a gradual uptrend that is expected to continue during June and July according to METI’s survey.

On the fiscal front landmark legislation was initiated at the end of June by Japan’s Lower House to raise the 5% consumption tax to 8% in April 2014 and 10% in October 2015. This was achieved thanks to cooperation of the opposition Liberal Democratic Party (LDP) and New Komeito Party (NKP), but 57 members of the ruling Democratic Party of Japan (DPJ) voted against the bill (and 15 abstained), a development that could result in a re-shaping of the political landscape, even if it does not prevent passage through the Upper House. Assuming the bill becomes law, this would mark the first really significant effort to tackle the budget deficit since the days of PM Hashimoto (1997-98) or PM Koizumi (2001-06).

One of the main lasting financial results of the damage from the Great Tohoku Earthquake and Tsunami has been the marked deterioration in Japan’s balance of trade and current accounts data, both of which have weakened significantly from their traditional persistent surpluses. Recent monthly data have shown regular deficits on trade account and intermittent deficits on current account. Nevertheless, despite a temporary decline in February and March, the Japanese yen has held up well thanks to lesser capital outflows than in the past, and the role of Japan as a relative safe haven from the euro-zone crisis. Looking ahead, the ageing of the population and the decline in the labour force imply a lower household savings ratio which in turn would tend to weaken Japan’s long term external position.

Despite turning marginally positive during the past year or so Japan’s price indices are gradually reverting to deflation again. They had benefited from commodity price increases and a temporarily weaker yen, but the underlying drag from very slow money and credit growth – unaffected so far by the Bank of Japan’s small moves towards quantitative easing – and the weakness of domestic demand has essentially ruled out any sustained increase in prices. Japan’s GDP deflator and the CPI ex-food and energy, for example, are both still falling on a year-on-year basis. For the year as a whole I expect 2.7% real GDP growth (largely due to favourable base effects) and 0.6% headline CPI inflation.

NON-JAPAN ASIA
Most East Asian economies have experienced some further weakening in growth in the opening months of 2012, especially as their exports have slowed (see Fig 6). Exports of Taiwan and Korea, for example, both fell in year-on-year terms in May, the third successive month of decline. The data from these two economies is significant because both economies are heavily industrialised and therefore their export performance is closely related to the strength of consumer demand in the developed economies of Europe and North America, and because both economies succeed in producing their trade data reports within a few days of the month-end so they act as lead indicators for other economies in the region.

Inflation across the region will benefit from weaker commodity prices during 2012 as food and energy prices constitute between 20% and 35% of CPI indices in the region. Against this background most of the central banks in the region mostly kept their key policy rates unchanged during the quarter (e.g. Indonesia, Malaysia, Taiwan, Thailand etc), but we could see further cuts later in the year as economic growth slows. While the export downturn continues, currencies have again been somewhat weaker across the region. The June consensus forecasts for real GDP and inflation put Asia ex-Japan’s real GDP and CPI inflation in 2012 at 6.4% and 3.9% respectively.

COMMODITIES
Having rallied between early October 2011 and late February of this year as economic growth in the US and elsewhere took a temporary upswing, commodity prices have subsequently sold off. Taking two broad dollar-based indices of commodity prices, the GSCI Spot Index (which includes oil and energy prices) has now declined 11.5% since the start of the year, while the Reuters-CRB index (which does not include oil products) has declined 7.8%. As the differing composition of these indices makes clear, the decline in oil prices since March has been steep and striking. Buoyed up as they were at the start of the year by expectations of a conflict in the Straits of Hormuz, Brent crude prices fell from $124 to $90, while West Texas Intermediate prices declined from $109 to below $80 per barrel (Figure 7).
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Metal prices have generally followed crude oil prices downward with a short lag since peaking in February or March, but have not yet fallen as far. Agricultural and food prices have been more mixed with wheat and coffee prices falling but soybean prices rising. In broad terms commodity prices have been weakening in the cold light of disillusion about a global recovery or rising inflation. My view is that, except in the event of a shock such as conflict with Iran, commodity prices are likely to weaken further in 2012, reducing headline inflation rates in most economies.

**CONCLUSION**

The seemingly unending euro-zone debt crisis is the single most worrying problem for the global economy, but unfortunately the June 28-29 summit meeting of euro-zone leaders will not put an end to the fundamental flaws in the architecture of the single currency. The US meanwhile is expected to continue to grow at a moderate rate, well below its potential, as balance sheets in the household and financial sectors are repaired. The UK is following in the track of the US in terms of balance sheet repair, but starts from a worse position due to the greater leverage of its banks and households going into the downturn, and the larger size of its government sector, but also due to its proximity to and export-dependence upon the euro-zone. Elsewhere major exporting economies of the emerging world such as China, the other East Asian tigers, and Brazil are also expected to continue to be caught in the euro-zone downdraft.

John Greenwood
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June 29, 2012.

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