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World Outlook *Autumn 2008*

Global Economic Trends and Prospects

ECONOMIC PERFORMANCE AND TRENDS



World Outlook Autumn 2008: Global Economic Trends and Prospects
by *Kip Beckman*

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Preface

The *World Outlook Autumn 2008* was prepared by Kip Beckman, Principal Research Associate, under the general direction of Paul Darby, Deputy Chief Economist.

The report examines the short-term economic outlook for the world's major economies. In addition, the *World Outlook* contains an in-depth analysis of a number of issues that are relevant for understanding economic trends and developments in the world economy.

The *World Outlook* is updated each quarter based on the latest projections available to the Conference Board.

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ISSN 0843-4328
Agreement No. 40063028
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Highlights

- A number of developed countries are close to recession, and below-trend growth is anticipated at least through 2009 given the current state of financial markets.
- With global demand in a slump, inflationary pressures from food and fuel will moderate somewhat.
- The outlook for Europe has deteriorated as more economies there succumb to the global credit crunch.
- After more than a year of global financial turbulence, a number of Asia-Pacific economies have slowed sharply, and some are even close to recessionary conditions.

U.S. Troubles Cast Dark Shadow Over Global Economy

The world economy is buckling under the weight of the worst financial crisis to affect the U.S. economy in the last half-century. (See boxes “Moving to the Dark Side” and “Debt and More Debt.”) A number of developed countries are close to recession, and below-trend growth is anticipated at least through 2009 given the current state of financial markets. The hope is that the U.S. Treasury plan to purchase bad mortgage debt from financial institutions will permit banks to resume lending activity. We expect the world economy to expand by 2.8 per cent this year before growth slumps to 2.4 per cent in 2009. (See Chart 1.)

The period of sluggish global growth could actually represent a blessing in disguise in that it has helped address imbalances in the world economy.

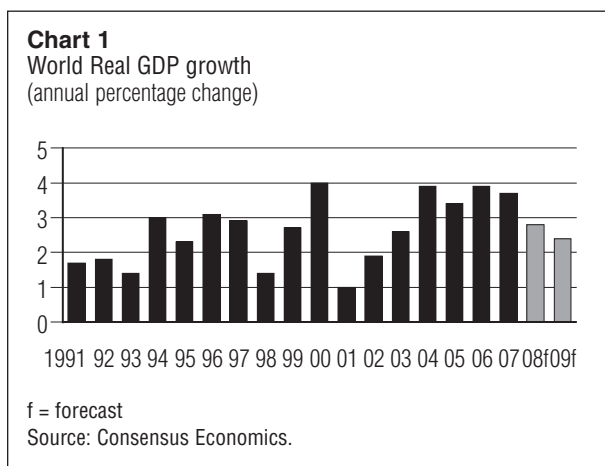
With global demand in a slump, inflationary pressures from food and fuel will moderate somewhat, and it is likely that the recent acceleration in commodity prices has peaked for now. Assuming that there are no dramatic supply-side shocks over the near term, increases in commodity prices should remain subdued through 2009.

The period of sluggish global growth could actually represent a blessing in disguise in that it has helped address some of the imbalances in the world economy.

The tumble in the value of the U.S. dollar has been a key factor in helping to correct the bloated external trade deficit. Since early 2002, the U.S. dollar has dropped by around 25 per cent against the world’s major currencies. Soaring oil prices have helped galvanize public support for greater use of public transportation and energy conservation. These welcome developments could help slow the emission of greenhouse gases. Americans, for instance, are driving around 10 billion fewer miles per month than they were at the start of this year. Japan is constructing quick-recharge power stations and other infrastructure to accommodate a huge production of battery-powered cars.

High oil prices have also forced governments to address the issue of fuel subsidies, especially in developing countries. Subsidies have been lowered in China and India (as well as in other countries in the Asia-Pacific region) because they represent an increasingly unsustainable fiscal burden for government and divert valuable resources from more important needs. The savings from lower fuel subsidies could be re-directed toward health care and education—pressing needs in the developing world.

With GDP growth stalled in the United Kingdom, Germany, and France, the economic outlook for Europe is pessimistic. The U.K. economy has been crippled by a U.S.-style housing crisis, while France and Germany have been hurt by slumping export demand. In the Asia-Pacific region, key economic indicators for South Korea and Japan are heading in the wrong direction. Real consumer spending in Japan likely contracted over the summer months, and exports to the United States have dropped for 11 consecutive months. Consumer sentiment has been tumbling in South Korea. Even China’s three cornerstones of economic growth have lost momentum lately. Industrial production is weakening, export growth has decelerated, and the investment cycle has peaked. While China’s projected GDP growth of 9.5 per cent this year is the envy of most countries, it represents a downturn from the 12 per cent in 2007.



The outlook for Latin America is more optimistic compared with that for other regions in the world thanks to strong domestic demand in Brazil and Argentina. The Mexican economy has also been holding up fairly well despite slower demand from its major trading partner, the United States.

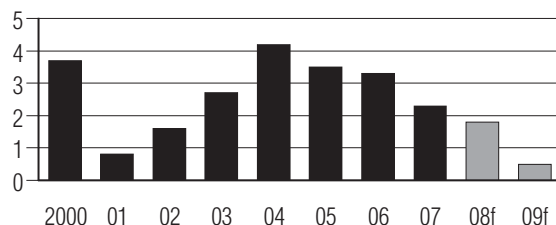
The risks to the current outlook are all on the downside due to the uncertainty surrounding world financial markets. If the U.S. Treasury plan fails to quell the stress in financial markets, the world economy could enter a vicious cycle of weak economic activity leading to greater financial market uncertainty, additional credit tightening, and more job losses. Rising trade protectionism is another major risk to the outlook during times of slumping global activity.

Moving to the Dark Side

The outlook for the U.S. economy has turned decidedly gloomy given the fact that the sub-prime financial shock is continuing unabated with equities at cyclical lows and credit spreads remaining well above historical averages. Borrowing is set to soar to record highs as the Treasury prepares to spend upward of \$700 billion to calm jittery global financial markets. The job market continues to deteriorate. Employment has declined in all the major industries, with the exception of health care and government. To date, the strength in exports has enabled the economy to avoid a technical recession, defined as two quarters of negative growth. However, over the near term, the U.S. economy will slip into recession due to the slump in consumer spending. Despite the pervasive pessimism, there are some tentative signs that the bottom for housing markets might not be far off. The current outlook calls for real GDP growth of 1.8 per cent this year and 0.5 per cent in 2009. (See chart.)

The unrest in financial markets is apparent from the briefness of the feeling of relief that transpired after the federal government's takeover of mortgage finance giants Fannie Mae and Freddie Mac. Investors welcomed the government move. By the next day, however, their attention had returned to other difficulties in the credit markets—and equities tumbled once again. This was then followed by the bankruptcy of the Lehman Brothers investment bank, the takeover of global financial services firm Merrill Lynch by Bank of America for \$50 billion, and the emergency loan to insurance giant AIG. When all these moves failed to calm financial markets, the Treasury Department and the Federal Reserve announced a plan for the government to buy hundreds of billions of dollars in mortgage-related assets. The goal of the plan is to allow financial firms to get these bad assets off their books and thereby enable them to resume lending activities. Government officials subsequently decided to use some of the \$700 billion to directly purchase bank equity.

U.S. Real GDP Growth
(annual percentage change)



f = forecast

Sources: The Conference Board of Canada; Bureau of Economic Analysis (BEA).

The ongoing problems in labour markets were readily apparent from the September employment numbers which showed 159,000 jobs being lost. The economy has been shedding jobs since the beginning of this year (over 700,000 job losses so far) and there are few signs that this trend will end any time soon. Ongoing job reductions have the potential to ignite a vicious cycle in which rising unemployment forces households to lower spending, which in turn causes businesses to reduce investment and payrolls.

The economy is also adjusting to the rapidly fading stimulus provided by this past summer's tax rebate cheques. A total of more than \$100 billion was delivered to households between May and early July, and the extra cash boosted spending somewhat. However, the government was hoping for a better response on the part of households. This failed to transpire because the stimulus cheques arrived just as gasoline and food prices were surging to record highs. Business investment spending is also set to weaken because of declining corporate profits and rising corporate bankruptcies.

All these negative developments will ensure that the economy continues to struggle through at least the first half of 2009. However, there are indications that some of the economy's imbalances are gradually being worked off. The tumble in home prices has resulted in a restoration of housing affordability in some metropolitan areas of the country. Home prices and effective rents are now in line with household incomes in Boston, Chicago, Denver, and even parts of California. The downturn in housing starts, while having a devastating impact on the economy, has finally lowered construction below the depressed level of new-home sales. Inventories of new homes are finally declining, and although it will take until sometime in 2010 before inventories are worked off, construction activity should start to expand in the first half of 2009.

The takeover of Fannie and Freddie is another positive for the economy given that mortgage rates declined below 6 per cent immediately after the announcement was made. Mortgage credit should also be easier to obtain over the near term because the government has provided Fannie and Freddie with more capital, enabling the organizations to provide more and larger mortgage loans to the worst-hit parts of the country, including California, Florida, and New York.

The Treasury's plan to buy toxic mortgage debt and purchase bank equity should eventually help stabilize the housing market and improve credit conditions in the economy, especially over the medium term. However, over the next few months the economy will have to survive a number of challenges that present significant downside risks to the current outlook. Plummeting equity markets will hurt business and consumer confidence. This could lead to weaker spending and more job losses. Also, the loss of wealth attributable to the drop in equities will constrain spending.

HOW WILL TUMBLING COMMODITY PRICES AFFECT LATIN AMERICA?

Real GDP is expected to increase by 4.3 per cent in Latin America this year before growth declines to 3.7 per cent in 2009. Despite strong growth in domestic demand in key countries, it is not possible for Latin America to escape unscathed from the negative tailwinds affecting global financial markets in general and the U.S. econ-

omy in particular, since the U.S. is a key trading partner for many countries in this region. **Argentina's** economy (see Chart 2) will expand by 6.6 per cent this year and 4.2 per cent in 2009 despite high inflation and the lack of any coordinated policies to keep price increases under control. The defeat of a proposed farm tariff bill underscores a growing crisis of confidence in President Cristina Fernandez's government. **Venezuela's** vast oil wealth is not enough to prevent a sharp contraction in

Debt and More Debt

The incredible developments over the past few weeks raise many questions. Two of the more crucial questions are: Can the U.S. government afford to pay for all of these bailouts? And what will happen to the U.S. dollar? The U.S. government has extremely deep pockets. Privately held U.S. debt stood at around \$4.4 trillion at the beginning of 2008—representing about one-third of U.S. GDP. This debt-to-GDP ratio is 50 per cent lower than the debt burden carried by many European countries, and it compares even more favourably with Japan's heavy debt burden. It is possible that the financial crisis has added \$200 billion to \$300 billion to net debt. This estimate takes into account the likely costs of nationalizing Freddie and Fannie, the \$29 billion bailout of Bear Stearns, the potential fallout from the various low-quality collateral that the Fed has had to take on its balance sheets over the past few months, and lastly, the bailout of insurer AIG. It is not immediately clear how the Treasury plan, which will set aside up to \$700 billion to purchase bad mortgage debt from financial institutions, will affect the overall debt load. A case can be made that the federal government could eventually turn a profit if the Treasury can sell the purchased assets for a higher price in a few years when the housing market stabilizes. In any event, the Congressional Budget Office has told Congress that any expected loss on the \$700 billion program would be included when estimating the impact on the federal budget deficit. (See chart.)

If by some chance the credit crisis ended today, the added costs would be manageable since they are estimated to be equal to the cost of another year of U.S. military involvement in Iraq. Unfortunately, the crisis is not over, as evidenced by the large spread between the Libor rate (the interest rate that banks in Europe charge each other for overnight loans) and safe U.S. Treasury bills. Harvard University economics professor Kenneth Rogoff estimates that the government may have to spend five to ten times more than it already has, taking the total costs of containing the crisis to somewhere in excess of \$1 trillion. It is true that the federal government and the Fed have ensured that the private sector will share some of the burden of the bailout. They forced the fourth-largest investment bank, Lehman Brothers, into bankruptcy and Merrill Lynch into a distressed sale to Bank of America. This helped to engineer a much-needed consolidation in the country's financial sector. However, Rogoff contends that it will be difficult to stop the credit crisis from spreading to corporate, consumer, and municipal debt. It will also be challenging for the Fed to resist the demand from politicians to provide even more funding for bailouts—especially if the current volatility in equity markets persists.

If Rogoff's projections turn out to be credible, this type of expansion in the debt could impose huge fiscal costs on the U.S. economy. While Republicans and Democrats are both currently talking about more tax cuts, the party that wins the election will have a tough choice—increase taxes, lower spending, or do both. It may be difficult for the U.S. military to maintain its military dominance in the world given the potential pressure to cut spending over the medium

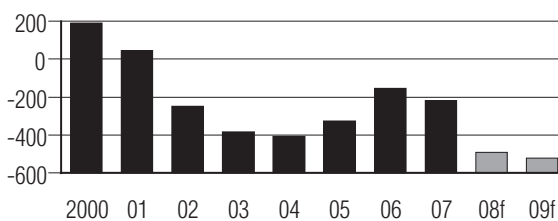
term. The troubled financial system may also make it harder for the Fed to contain inflation (although falling commodity prices at present take away some of the inflation fuel). Monetary authorities could come under pressure to permit inflation to increase so as to enable the economy to deflate the soaring costs of its private and public debts. Inflation will also be difficult to contain if the money supply is ramped up to help finance the numerous bailouts.

Let's also remember that the United States still has a huge current account deficit that requires external financing. To date, central banks in China, Japan, and elsewhere have helped finance the deficit by purchasing U.S. securities. Will they continue to do so if the credit crisis extends well into 2009? The answer to this question may ultimately determine how the crisis plays itself out over the coming months.

With regard to the U.S. dollar, one of the remarkable developments in financial markets has been the increase in the value of the U.S. dollar against most of the world's major currencies in the midst of what some are calling the worst financial crisis since the Great Depression. If the United States were a developing country, its exchange rate would be plummeting and interest rates on its government debt would be skyrocketing. In fact, the opposite has transpired. The dollar actually gained value through September, and rates on three-month Treasury bills reached 54-year lows. With Japan and most of Europe also in trouble, investors have been pouring their money into U.S. government bonds since they are considered to have zero risk.

The interesting question is this: Can the dollar continue to remain immune from the credit crisis and maintain its value? The current outlook calls for the U.S. dollar to remain fairly flat over the short-to-medium term—but there are significant downside risks. When investors finally digest the massive public and private sector borrowing needs required to finance the bailouts and the ongoing requirements to fund the wars in Iraq and Afghanistan, it is possible that the dollar could falter once again.

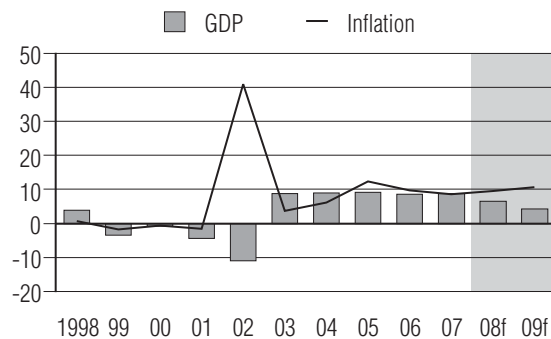
Federal Balance
(NIPA basis, \$ billions)



f = forecast

Sources: The Conference Board of Canada; BEA.

Chart 2
Argentina GDP and Inflation
(annual percentage change)

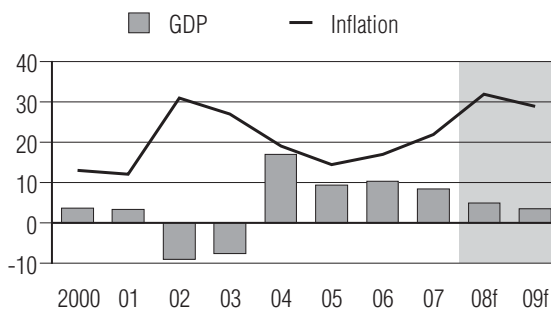


f = forecast
Source: Consensus Economics.

GDP growth (see Chart 3) over the near term. After growing by 8.4 per cent in 2007, it will fall to 4.9 this year and 3.5 per cent in 2009. Inflation running above 30 per cent and government decrees to nationalize more and more industries are hurting growth in consumption and investment spending.

In both **Brazil** and **Chile** (see Charts 4 and 5), interest rates have marched higher as policy makers have continued their efforts to anchor inflation expectations. This past summer, Brazil's central bank quickened the pace of interest rate hikes with a 75-basis-point increase that followed a rise of 50 basis points at each of its two previous meetings. It then boosted the key rate another 75 points in September. The central bank in Chile recently lifted its cost of borrowing to its highest level in almost 10 years after increasing the benchmark interest rate to 8.3 per cent. Chile's economy is expected to expand in

Chart 3
Venezuela's GDP and Inflation
(annual percentage change)



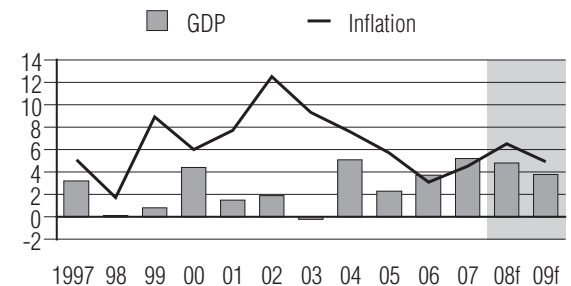
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Source: Consensus Economics.

the 4 per cent range in 2008–09 compared with growth of 5 per cent in 2007. The Brazilian economy will also slow, going from 5.2 per cent growth in 2007 to growth of under 4 per cent in 2009.

The recent decline in commodity prices raises an interesting question concerning the impact on major exporting countries in Latin America. The perception is that Latin America's economic prospects are closely linked to commodity prices. But does the old "banana republic" model accurately describe the current reality in Latin America?

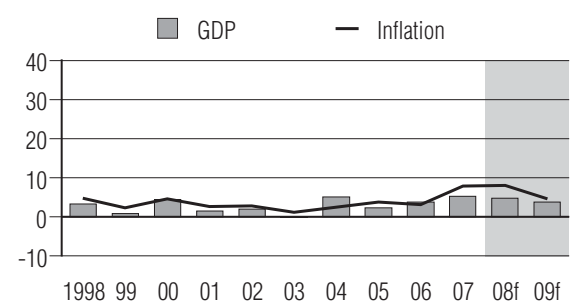
Commodities remain important for many Latin American countries (although their importance varies considerably from country to country within the region). Crude oil accounts for about 15 per cent of Mexico's total export revenue and 80 per cent of Venezuela's. In Chile, copper exports bring in more than 50 per cent of

Chart 4
Brazil GDP and Inflation
(annual percentage change)



f = forecast
Source: Consensus Economics.

Chart 5
Chile GDP and Inflation
(annual percentage change)



f = forecast
Source: Consensus Economics.

total export revenues. Argentina's exports of soy contribute 20 per cent of its total export revenues, while Brazil's exports of iron pulled in 15 per cent of export revenues.

The image of Latin America as being simply a region of "banana republics" is outdated.

For the entire Latin American region, however, exports actually contain a fairly high manufacturing component. This is indicative of the region's ongoing industrialization that came on the heels of structural reforms implemented more than two decades ago. Over the past five years, agriculture, mining, and energy exports brought in around 45 per cent of total Latin American exports. Industrial exports accounted for 55 per cent of the total. The increased importance of manufacturing exports occurred at a time when commodity prices were soaring. As a point of comparison, primary exports were 60 per cent of total export revenue in the early 1990s. This suggests that the image of Latin America as being simply a region of "banana republics" is outdated.

There is little doubt that, as a net exporter, the region will feel the effects of tumbling commodity prices; however, this will not lead to the crisis that some economists are anticipating. Lower commodity prices will lower the region's external revenues, a development that will lead to a reduction in aggregate demand. This will cause growth to moderate, but only to rates more in line with production capacity, thereby avoiding sending the region into the type of economic crisis that has frequently occurred in past decades. The fact that government budgets and economic programs are based on very conservative estimates for commodity prices should help the situation.

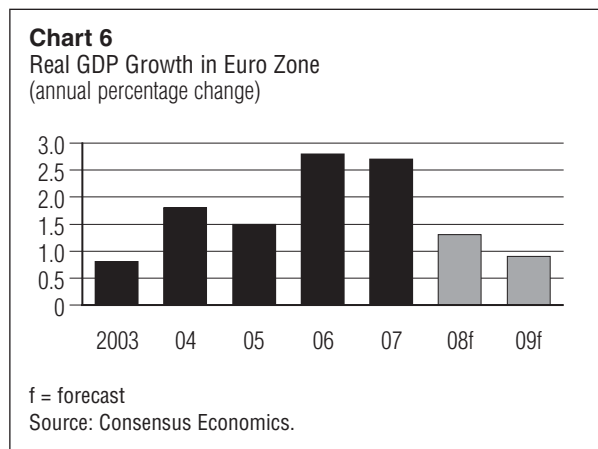
A number of Latin American countries have used the recent run-up in commodity prices to invest in economic development and infrastructure programs. Some governments have put part of their commodity export earnings into international reserves or stabilization funds or, as is the case in Chile and Brazil, the creation of sovereign wealth funds. These developments have enabled governments in the region to implement countercyclical measures and to increase the capital stock, which should expand potential economic growth over the long term.

It would seem that Latin America has learned its lessons from the past when global financial crises resulted in runs on regional currencies leading to sharp currency depreciation and soaring inflation. Most countries have not engaged in extravagant government-funded projects but have instead taken steps to prepare for a time when the commodity export tap runs dry. Consequently, the drop in commodity prices should only make it difficult for the region to attain potential growth estimated to be in the 4.5 per cent range.

OUTLOOK IN EUROPE—GRIMMER BY THE DAY

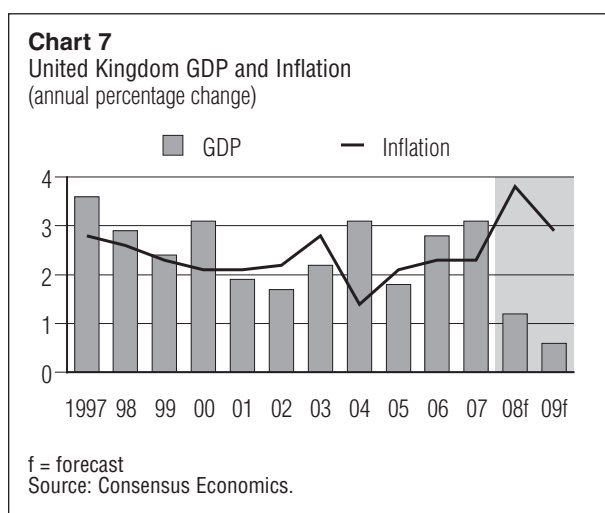
The outlook for Europe has deteriorated since the beginning of 2008 as more economies succumb to the year-long global credit crunch. Many financial firms in Western Europe were involved in purchasing mortgage-backed debt, and as a result, they are feeling the impact of this crisis far more than other regions in the world, such as Asia-Pacific and Latin America. While ongoing injections of liquidity by major central banks have stabilized credit markets somewhat, lending conditions continue to tighten. The difficulty in obtaining credit has forced businesses and households in Europe to lower spending on goods and services as well as investment. The fallout from the credit crisis will result in subdued growth in the real economy over the coming quarters. Real GDP in Western Europe is forecast to expand by only 1.3 per cent this year and 0.9 per cent in 2009. (See Chart 6.)

Among the countries of Europe, the **United Kingdom** is possibly the most exposed to the global credit crisis. This is because of the crucial role the country's business and financial services sector plays in the economy.



Aggressive U.S.-style lending practices during the close-to-decade-long property boom have left financial institutions exposed to the credit turmoil while, at the same time, households are having to cope with a pile of debt. Meanwhile higher borrowing costs, weaker sales, and rising producer prices have hurt business investment. Services, manufacturing, and construction activity have all contracted recently, a development that has led firms to let more and more workers go.

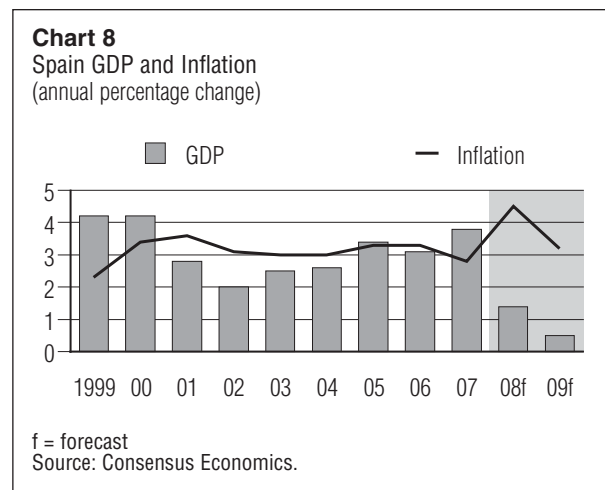
The U.K. economy is in extreme danger of slipping into recession. The most recent forecasts suggest that real GDP declined in the third quarter. Real GDP is expected to increase by only 1.2 per cent this year, and even weaker growth of 0.6 per cent is anticipated in 2009 as the troubled housing market continues to deteriorate. (See Chart 7.)



Ireland's housing market was the first to feel the heat from the stresses imposed by rising mortgage rates and soaring home prices during the boom period in the early-to-mid-2000s. Home prices have been dropping for the better part of a year and are expected to decline by close to 15 per cent in 2008. The downturn is forecast to ease in 2009 due mainly to mortgage rate relief. Real GDP will decline by 0.2 per cent in 2008 before growth picks up slightly to 1.1 per cent in 2009.

Spain is in much the same boat as Ireland and the United Kingdom. A bursting of the housing market bubble in Spain has resulted in tumbling home prices. In the past four to five years, employment and growth in all three countries—but especially in Ireland and Spain—have been driven, in large part, by booming housing markets. The increased dependence on real

estate has left these economies susceptible to the global credit crisis. As a result, the effects of the housing slump quickly spread to other sectors of the economy. Industrial production in Spain and Ireland declined sharply over the past few quarters, especially for consumer durables. Slumping labour markets will also have a negative impact on consumer spending in these two countries. A recovery in GDP growth will not occur (see Chart 8) until the slide in housing prices comes to an end, something that isn't expected to occur until the latter part of 2009.

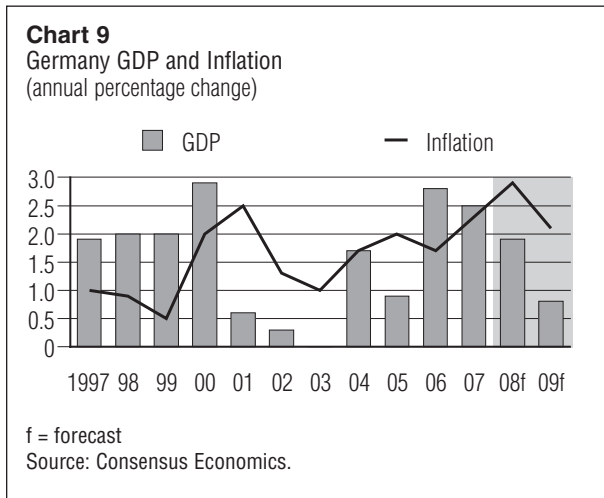


The problems in **Italy's** economy continue to mount—although, for a change, the housing market is not the main culprit. Real GDP is contracting as weak domestic and external demand, combined with rising input costs, have tightened profit margins and made it much more difficult for Italian businesses to obtain credit for investment. The recently elected government of Prime Minister Sylvio Berlusconi has implemented spending cuts in the face of declining value-added tax revenues. Spending cuts will only add to the already anemic growth in real GDP. The most optimistic outlook for Italy's economy over the near term is for meagre growth of less than 1 per cent in both 2008 and 2009. The reality could easily turn out to be negative growth.

The most optimistic outlook for Italy's economy over the near term is for meagre growth.

Germany is in better shape than many other countries in the region thanks to solid gains in machinery and equipment investment. The country's housing market is not in the same dire straits as those in Ireland, Spain, and

the United Kingdom. However, the ongoing credit crisis has started to negatively affect business confidence, and this could lead German firms to pare back expansion plans and hiring initiatives. The German economy is forecast to grow by 1.9 per cent this year and only 0.8 per cent in 2009 (see Chart 9) as sluggish growth in the global economy hurts export growth over the near term.



While the outlook for the German economy has turned decidedly gloomy, it should continue to benefit from recent labour market reforms that have improved the country's productivity and international competitiveness. Germany's diversified product mix and its trade with oil-rich countries such as Russia and the Gulf states should help support economic activity and ensure that the economy avoids a technical recession.

As economic activity in Germany—the region's largest economy—weakens, the country's largest trade partners, including **France, Switzerland, Austria, and Hungary**, will feel the heat. In addition to a looming trade slowdown with Germany, these countries are also experiencing weaker demand from the United Kingdom and the United States. This will hurt export growth and industrial production.

In comparison with countries in Western Europe, those in **Eastern Europe** are still recording fairly solid growth. Business investment, employment growth, and consumer spending all remain on solid ground. Nevertheless, this region still must overcome a number of serious hurdles in order to ensure that the economic expansion continues unabated. The acceleration in both consumer and producer prices since the beginning of 2008 is an important downside risk. Skills shortages

continue to grow as the expansion of the EU has increased the opportunities for skilled East European workers to travel to the West in search of higher-paying jobs. This places upward pressure on wages and could potentially result in secondary inflation effects that force central banks to increase interest rates. At the same time, Eastern Europe's financial markets have been unable to avoid the turmoil in world credit markets as equity markets have tumbled due to risk aversion among investors. This will hurt the region's ability to raise new capital, thereby curtailing expansion plans and hiring.

DECOUPLING IN ASIA-PACIFIC REGION?

The view that most countries in the Asia-Pacific region could somehow decouple from developments in the U.S. economy and continue expanding at a brisk pace has been put to rest by the recent economic developments. After more than a year of global financial turbulence, a number of Asia-Pacific economies have slowed sharply, and some are even close to recessionary conditions. In fact, the more complicated nature of trading relationships that depend on global supply chains suggests that the actual exposure to the U.S. economy may be underestimated. For instance, many of the components and intermediate goods delivered to **China** are used to produce goods for U.S. and European consumption. With China lowering demand for manufacturing inputs in the second half of this year, the rest of Asia will feel the full impact of the global slowdown in economic growth. Real GDP growth is expected to average around 4.5 per cent per year over the short term, down from growth of 6 per cent in 2007.

The view that most countries in the Asia-Pacific region could somehow decouple from developments in the U.S. economy and continue expanding at a brisk pace has been put to rest.

Asia is also interlinked with the global economy via capital flows. Huge capital inflows into Asian equity markets in 2007 resulted in sharp increases in benchmark indices. For instance, the close to 50 per cent increase in **India's** Sensex last year was mainly a result of a net purchase of \$17 billion worth of stocks by foreign investors. However, as global credit conditions deteriorated this year, restricted access to funding resulted in a large repatriation by foreign portfolio

investors. A net outflow of \$7 billion from the Indian stock market so far in 2008 has led to a tumble of its benchmark index. The situation is similar across Asia where most equity markets are on track to record losses of well over 30 per cent in 2008.

In addition to the credit crisis, many Asian countries are also dealing with political challenges that are hurting

business confidence and could therefore impact economic growth. **Japan** continues to face political uncertainty that began in the middle of last year when the opposition won control of the upper house of parliament. The ruling party has encountered difficulties in having its policies implemented. Even worse, the parties were unable for a time to agree on the choice of a new head for the central bank, and they left the post vacant for

Turkey's Economy Heats Up

When an Islamic-leaning party (the AKP) took over the government in Turkey six years ago, few would have predicted that the economy would undergo an unprecedented boom. Many businessmen were leery of a government that favoured headscarves and bans on the sale of alcohol. After all, this is a country where the military has intervened in the past when the government strayed from the secular line favoured by the country's generals.

Yet today, the Turkish economy is in much better shape under an Islamic government than it was under the previous secular governments that were more in tune with the Western-style ways of most Turkish business leaders. Annual average GDP growth since 2002 has been 6.5 per cent, up from 2.5 per cent over the previous six years. (See chart.)

While the majority of Turks are Muslim, Islam and its religious symbols have been banished from the state since 1923 when Mustafa Kemal Ataturk founded the modern Turkish republic. He believed that religion posed a serious obstacle to his vision of Turkey eventually becoming a modern power based on Western principles. Many Islamists in the Arab world have been wary of the secular ways of governments in Turkey, and they are closely watching Turkey's current experiment with an Islamic-style government.

It is interesting that the Islamic religion, in theory, is not opposed to free market ideas. In fact, the prophet Muhammad was once a merchant, and his first wife, Khadijah, was a successful businesswoman. However, over the past century, Islam has been used as a vehicle to attack capitalism and markets. These attacks are not necessarily based on deeply held religious convictions, but are more often a response to the type of corrupt capitalism practiced in countries such as Egypt, Algeria, and Indonesia.

Turkey's ruling AKP has taken the view that the solution to the country's economic difficulties is free trade and the opening up of an economy long dominated by government cronies. Since the AKP gained power at the end of 2002, exports have more than tripled, foreign investment has increased from less than \$1 billion to more than \$20 billion, and the number of tourists visiting the country has more than doubled. The government has also imposed fiscal discipline, accelerated privatization, and cut the size of the bureaucracy. In addition, the AKP has initiated steps required in order to achieve Turkey's long-sought-after goal of joining the EU. These steps include implementing regulatory changes designed to bring Turkey more in line with the European model of government.

It is interesting that the AKP's brand of free market economic policies with an emphasis on conservative, faith-based, personal values has turned more conventional alignments upside down. In many countries, politicians who support free market ideas are generally supported by

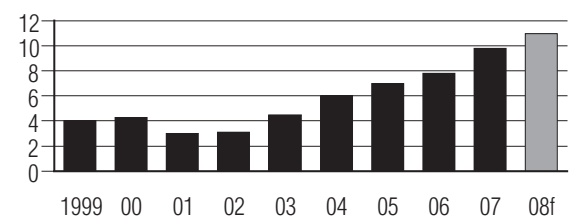
the wealthy business community, while poorer people are far more skeptical. This has certainly been the case in many Latin American countries. It has been just the opposite in Turkey—business people are suspicious of the government's intentions, while those less well off and more religious support the AKP.

The government has generally been able to convince its critics that it does not have a secret agenda to turn Turkey into an Islamic state. An influential association of Turkish industrialists recently came out in support of the government's economic policies. The AKP did, however, run into problems earlier on this year when it attempted to lift the ban on female students covering their hair in class.

To be sure, Turkey's economy continues to face serious economic obstacles. A major concern is the ever widening current account trade deficit, which currently stands at more than US\$43 billion. The deficit has increased mainly because of rising energy prices and the need for the country to import the machinery and equipment required to modernize its economy. Some economists point out that Turkey's current account has generally been on the plus side during bad economic times and that the current deficit is a sign of strength. Nevertheless, the deficit has worried investors, and there are concerns that the global credit squeeze could hurt Turkey's ability to borrow from abroad.

Turkey also must avoid the dramatic swings in economic fortune that have characterized the country over the past few decades. An attempt in the 1980s to open up the economy and try to copy some of the success attained by the so-called "Asian tiger" economies got off to a good start, but the export-led effort soon faded and was quickly followed by a period of chronic inflation and budget deficits. A major constraint on economic growth has been political instability linked to the Kurdish minority's seeking of greater autonomy and the ongoing debate over the type of society that Turkey should be. To succeed, the current government will have to avoid these past pitfalls.

Turkey's Per-Capita GDP (US\$ 000s)



f = forecast
Source: IMF.

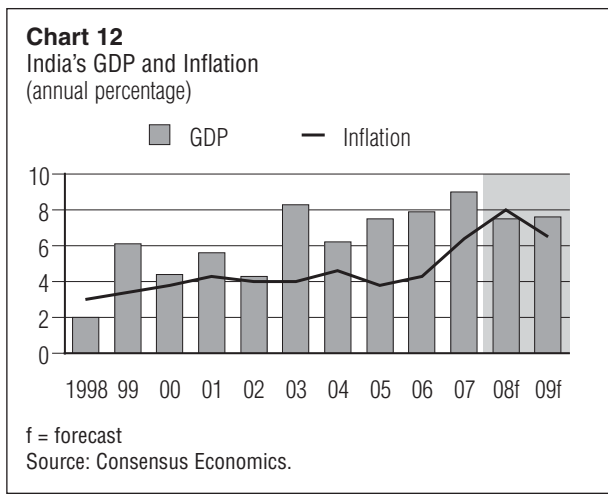
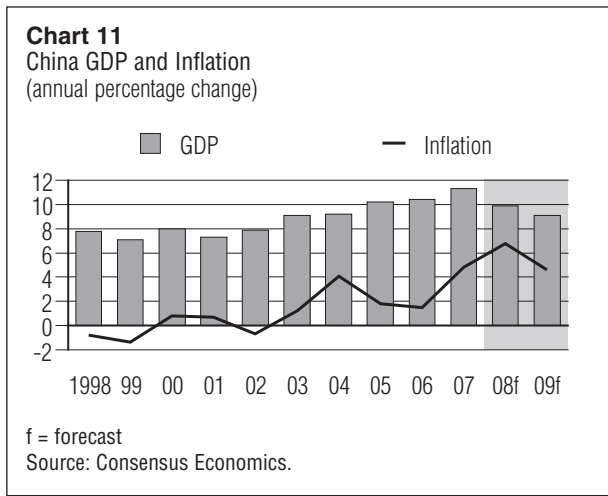
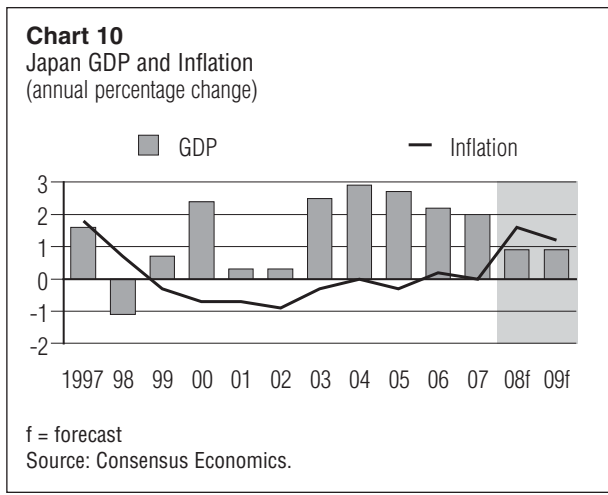
several weeks. The lack of agreement between members of the upper and lower houses of parliament is a major obstacle for the slumping Japanese economy since urgently needed policy changes are required at this time. The government must also contend with huge public debt. (See Chart 10.)

Political difficulties have also become a fact of life in **Thailand**. A state of emergency was declared in the early part of September, a development that will harm tourism and investment. India's general elections must be held by May of next year. The incumbent government's chances of winning are not great, and it is likely that it will introduce more expansionary policies designed to lower poverty and improve infrastructure. This factor should ensure that India's economy expands at a 7–8 per cent clip over the near term as higher government spending enables the country to avoid much of the problems facing other emerging countries.

A contraction in economic growth is inevitable given the region's reliance on exports.

Central bankers across the region are combatting a common problem—sluggish growth and rising inflation. Recently, the response on the part of monetary authorities has differed, depending on the different priorities in each country. Emerging countries, including India, Indonesia, and the Philippines, have sharply increased interest rates in order to contain inflation. Alternatively, Australia, New Zealand, and Singapore have decided to lower interest rates in an attempt to kick-start economic growth. At the same time, Malaysia has kept interest rates on hold despite soaring inflation due to concerns that higher interest rates could harm the economic expansion.

While the outlook for the Asia-Pacific region is far from rosy, with the exception of Japan, most countries should be able to avoid slipping into a technical recession (defined as two consecutive quarters of negative growth). However, a contraction in economic growth is inevitable given the region's reliance on exports in a time of weak global demand. It is also worth noting that, although growth in China and India is slowing, their economic performance will remain the envy of most developed countries. (See charts 11 and 12.)



Is the Free Market Approach Dead?

The turmoil in financial markets and the U.S. decision to spend \$700 billion to purchase bad mortgage debt from financial firms has given valuable ammunition to opponents of U.S. economic leadership and the free market approach that emphasizes deregulation. In South Korea, opponents of the government's plans to liberalize Korean financial markets are pointing to the massive U.S. government intervention in financial markets as evidence of what could happen if the plan goes ahead. German Chancellor Angela Merkel has used the crisis to bolster her defence of a German law that provides the government with a veto over potential takeovers of Volkswagen. The ongoing efforts by the U.S. government to convince the Chinese government to let the yuan float in world currency markets could also be undermined by the spectacle of the U.S. financial turmoil.

In a global economy in which financial market linkages are much more prominent today than they were a few decades ago, the crisis has raised serious concerns regarding the U.S. approach to economic policy. The intention to spend \$700 billion has shaken confidence in the U.S. dollar among foreign investors. They contend that the plan will increase already sky-high debt levels. These worries could hurt the U.S. dollar's status as the number one currency in the world. China, Japan, and other holders of billions of dollars worth of U.S. securities could move assets out of the dollar and into other currencies, such as the euro, over the next few months due to fears about the state of the U.S. economy.

Some economists in China have been urging the government to reduce its role in the economy and to follow a U.S.-style approach. However, considering what has transpired in the United States recently, these efforts may come to naught. Chinese economist Xu Xiaonian of the China Europe International Business School in Shanghai contends that the government's move in September to halt a sell-off in equity markets by purchasing stocks from state-controlled companies—one of the greatest market interventions in years—occurred, in part, based on the U.S. government intervention in its own markets. It could be that Asian governments now view the American free market model as a failure.

The extent of the damage to the U.S. model will depend on the length and severity of the current crisis. If the Treasury plan succeeds in boosting the fortunes of the housing market and the economy recovers quickly, faith in the free market approach could be restored. It is worth noting that the U.S. economy came back quickly from previous financial crises, such as the Savings and Loan fiasco in the late 1980s. There is no doubt, however, that America's difficulties could undermine support for its international goals over the short term. These initiatives include gaining greater access to foreign markets for U.S. financial companies and encouraging greater deregulation in continental Europe.

In Europe over the past few decades, the United States and the United Kingdom have represented what can be thought of as an "Anglo-Saxon" version of capitalism in contrast to the German and French model which allows a more prominent role for unions and greater government intervention in the economy. Until recently, many economists in Europe encouraged governments to adopt the U.S. approach due to higher productivity and GDP growth. However, when Germany chaired the G8 summit in 2007, the German chancellor criticized the U.S. government for resisting stronger regulation of financial markets. Even French President Nicolas Sarkozy, who ran for office on a pro-American platform, called for a more regulated form of capitalism at a speech to the UN in September.

In Latin America, the financial crisis has provided valuable ammunition for politicians who favour greater state control of economies and who claim that free market policies have led to an increase in the region's income inequality. This is particularly true in Venezuela and Bolivia. In a part of the world that has long been wary of U.S.-style capitalism, and where populist rhetoric from leaders like Venezuelan President Hugo Chavez often reigns supreme, it would not take much to tip the balance the other way, even in Brazil and Chile—countries that have implemented free market policies over the past decade or so.

The United States has also opened itself up to charges of hypocrisy, especially regarding the Asian financial crisis of the late 1990s. At the time, U.S. and other western leaders advocated tough, market-oriented solutions to the crisis. The former prime minister of Malaysia, Mahathir Mohamad, remembers how U.S. officials urged him never to bail out failing financial institutions. It is somewhat ironic that the United States has bailed out dozens of failed banks, mortgage corporations, and other firms over the last seven months.

After many years of listening to U.S. officials criticize Moscow for increasing government intervention in the Russian economy, President Dmitry Medvedev wasted little time in highlighting America's about-face on market intervention. Russia is exposed to U.S. mortgage-backed securities in its \$600 billion reserves from oil earnings, much of which is invested in U.S. dollar assets.

There is little doubt that the ongoing crisis in U.S. financial markets has given critics of free market economics and globalization a huge shot in the arm. Yet, it would be wrong to conclude that there will be a sharp move toward re-regulation in light of developments in the United States. The majority of economists in Europe are still of the strong belief that the region needs much greater deregulation, especially in labour markets. Let's also not forget that globalization has lifted millions and millions of people out of poverty in China, India, and parts of Latin America. Yes, it is true that financial markets in the United States will require greater regulation if they are to avoid a repeat of the fiasco that saw people without income or assets receiving mortgages from unscrupulous lenders. But let's not throw out the baby with the bathwater.

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Publication 08-318
E-copy: \$975 • Printed copy: \$1,025

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