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Global Economic Outlook 2009 Update

Press Release

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EUCLID Global Economic Outlook Webcast

Good afternoon.

Please note that this press briefing is under embargo until February 20th, 2009, noon GMT.

In view of ongoing developments affecting global economics and finance, EUCLID is revising and updating the 2009 Global Economic Outlook report initially presented in October 2008.

Again, the following reflections on the 2009 global outlook are based on current patterns and take into account the recent IMF World Economic Outlook and Global Financial Stability reports. This forecast will in all likelihood be revised and updated by May 1, 2009 as events and trends continue to unfold.

The unwinding of the global credit bubble is continuing to affect the global economy at the macro and micro economic levels in significant ways. This process of deleveraging is rare and at the heart of the current crisis which is **not a typical cyclical recession**.

What we are observing at this time and forecasting for 2009 is **a significant drop in demand**, both from households and businesses. This will result in **a sharp decline in international trade**, along with **persistent deflationary pressures**.

This drop in demand is caused by a number of factors, notably (1) ongoing unavailability of credit connected with the reluctance of financial institutions to approve loans or find qualified borrowers (2) overextended credit burdens requiring a

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noticeable decrease in consumption and (3) a **pessimistic outlook** affecting spending and investment behavior, also known as the 'animal spirits' factor of economic activity.

Social unrest and growing unemployment are also factors affecting recovery in a demand-driven economy.

US AND GLOBAL FINANCIAL SECTORS

In 2008, credit markets were primarily affected by the unraveling of financial instruments – notably mortgage-backed securities - connected with the housing sector. These financial instruments were further leveraged by credit derivatives which were perceived as insurance but were in fact unable to provide adequate risk mitigation. The financial sector remains vulnerable due to the inability to determine an actual market value for these instruments, which is one of the causes of loss of confidence among actors. The so-called "toxic waste tranches" of CDOs is thus an issue that needs to be addressed, which may lead to partial nationalizations or to the externalization of these assets to a separate vehicle or 'bad bank.' As a result, government authorities will be forced to make difficult decisions involving taxpayer-backed bailouts, nationalization, and monetization leading to **subsequent inflation or hyperinflation**.

In 2009, significant risks of deterioration remain, notably in the United States. The first one is that **commercial mortgages** are being affected by the global economic slowdown and severely impact the value of related instruments. This possible collapse in another category of instruments is of great concern. The second is the **insolvency of a number of pension funds in the United States**, which may have a destabilizing influence throughout 2009.

SPECIFIC OUTLOOK

As a result of these factors, the global GDP will contract in 2009, for the first time since the 1930s. However, there will be a certain decoupling between emerging and OECD economies. Our estimate is that the real GDP contraction in the United States may be as high as 5% in spite of low or negative inflation, due to the large part of consumer spending in the US GDP.

In the United States, the United Kingdom and other similar markets, **real estate prices** are likely to decline for another 2 or 3 years if the symmetrical model of bubble deflation is to be followed. However, if affordability and the return to the historical income to median price ratio are perceived as positive elements, this decline in prices may be seen as necessary and foundational for future stability and recovery.

It now seems clear that the **deflationary forces will be prevailing** during the first half of 2009. Nevertheless, it remains EUCLID's forecast that inflation will return in late 2009 or 2010. The resort to **credit and quantitative easing** as policy instruments by central banks seems unavoidable and yet carries a strong risk of subsequent inflation. However, the European Central Bank seems committed to avoid a course of action that would lead to the debasing of the EURO.

Thus, the ability of governments and central banks to stimulate the economy is limited by various constraints. The lowering of interest rates to historical lows may in fact have negative consequences in terms of capital destruction and monetary options. The **EURO zone** will undoubtedly experience **threatening tensions** as some States may be unable or unwilling to remain within the parameters of the Stability and Growth Pact.

It is already apparent that the slowdown affecting OECD economies, most dramatically the United Kingdom and Spain, is also affecting the BRIC and emerging countries. The ability of the Chinese government to transform its society from an export-oriented economy with a high savings rate to a new model will be a decisive factor in 2009.

COMMODITIES / GOLD

This global decline in activity has a noticeable impact on commodities, including oil. Due to a **combination of demand and supply destruction**, it is difficult to predict the evolution of the price of oil in the months to come. It seems unlikely however that oil will remain under $45 per barrel, and EUCLID confirms its forecast of continued and long-term increases in energy prices.

IMPLICATIONS

The unfolding crisis can be considered systemic and foundational. The credibility of the US financial markets has been undermined, as well as investors' sense that government policies and oversight are responsible and can be trusted. Although the **US dollar** is experiencing a rebound, the mid-term outlook, as early as mid-2009, is that of unavoidable weakness and possible loss of status as reference currency. This may in fact result in **a global synergy to devalue** not only the US dollar but paper currencies in general, leading to **a significant rise in the price of gold** and select commodities.

At this juncture, the **debt-based economy** has reached a fork in the road which may require massive write-offs, comprehensive debt relief, and ultimately the **emergence of a new financial order**. Of immediate concern is the need to defuse the negatively reinforcing feedback loop between mortgage defaults, economic contraction, unemployment and access to credit.

Among possible outcomes, the introduction of a global financial authority connected to a restructured IMF is likely. The possibility of **adding gold to the SDR basket in order to develop a global currency mechanism** may also emerge to further enhance currency stability and Central Bank cooperation.

In summary, we are observing ongoing capital destruction, insolvency of the banking sector and unsustainable global imbalances which **need to be addressed at the intergovernmental level** in order to avoid a catastrophic collapse of global output. The temptation to resort to politically acceptable solutions such as monetization and non-productive fiscal stimulus is especially great and will require exceptional leadership at the upcoming G-20 summit.

For further information, please visit www.euclid.int.

Thank you.