**Sujet:** La vision macro est toujours dominée par les défis fiscaux / Big picture still dominated by fiscal challenges.

**Source:** Capital Economics

**Date: 26-5-2010**

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# GLOBAL ECONOMICS UPDATE

26th May 2010

CAPITAL ECONOMICS

## Big picture still dominated by fiscal challenges

- **Despite the turmoil in financial markets, the near-term outlook for the world economy is brighter than a few months ago.** Nonetheless, a seemingly impressive rebound in 2010 is likely to give way to renewed weakness from 2011 as the reversal of fiscal stimulus again exposes the underlying fragilities left by the recession. For those thinking beyond the next few quarters, this is still the big issue.
- In many countries, the mood in the markets is much gloomier than the latest economic data and surveys of business and consumer confidence would suggest. Earlier this month we raised our GDP forecasts for the US and Japan. As a result of these and other changes **we now expect global GDP to grow by around 4.5% this year** (using PPP weights), compared to a previous estimate of 4.0%.
- But recent developments in Europe illustrate two good reasons to expect global growth to slow again in 2011. For a start, **the fiscal squeeze now starting in the euro-zone and UK shows how the global banking crisis has only been partially resolved by transferring the problem to the public finances.** Indeed, the stronger recoveries in the US and Japan have been flattered by the relatively large fiscal stimulus there. (See Chart 1.) It is not necessary for policy to be tightened for the boost to growth to fade. Instead it is enough that the previous stimulus is not repeated. (This point applies to emerging economies too, notably China where the quarter-on-quarter data suggest growth and inflation are already cooling.)
- In fact, **while the degree and timing will vary from country to country, fiscal policy will soon turn restrictive at the global level**. As Chart 2 shows, the fiscal stance will still be stimulatory in the advanced economies this year, but much less so than before, and it will be progressively tightened in 2011 and beyond. (Note however that the tightening will be smaller and shorter-lived in emerging economies. This supports our view that the prospects for Emerging Asia in particular remain relatively bright, although countries in Emerging Europe relying on foreign capital and those in Latin America depending on commodity exports, as well as Russia, are more likely to struggle.)
- Secondly, the crisis in the financial sector has not gone away. Casualties from the recession are still emerging, as the latest problems in the Spanish banking sector have shown. The regulatory backlash is also building. Germany may have broken ranks with its assault on short-selling, but there is more pain to come almost everywhere in the form of higher banking taxes, stricter capital requirements, and so on. * **The financial sector as whole is in much better shape now than it was eighteen months ago. But it will not be able to contribute as much to sustaining the economic recovery as it would normally do.**
- We therefore continue to expect global GDP growth to slow next year, probably to around 3.5%. In contrast, the consensus sees the recovery holding strong. (For example the OECD's just-published forecasts are 4.6% for 2010 and 4.5% for 2011.) What's more, 3.5% would fall well short of the average of nearly 5.0% between 2004 and 2007. ~~**The upshot is that there is still plenty of scope for disappointment in those markets –**~~ **notably commodities – where many seem to assume that the world economy can sail back to pre-crisis growth rates as if nothing has happened in the meantime.**

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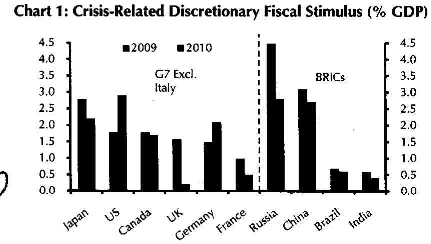
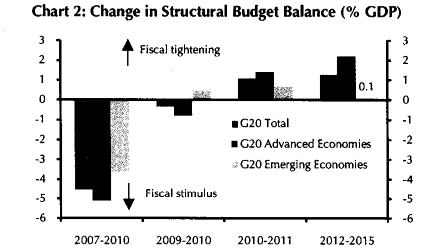
**Chart 1: Crisis-Related Discretionary Fiscal Stimulus (% GDP)**




Source – IMF. Italy excluded as net stimulus negligible in both years.

**Chart 2: Change in Structural Budget Balance (% GDP)**




Source – IMF. Structural balance = cyclically-adjusted primary balance.

commodities prices don't reflect world GDP of 4-5% in the future. If so, oil would be $125 ppb and copper $400