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Global Economic Outlook 2006

Global risks, regional opportunities



A Deloitte Research Study

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Global Economic Outlook 2006

Global risks, regional opportunities

The world economy is performing reasonably well. Growth in the US, China, Russia, and India is strong. Inflation in most major countries remains low by historical standards and long-term interest rates are unusually and surprisingly low. Even long-suffering Japan has seen relatively good performance lately, the result of strong demand from neighboring China. And although some of the biggest countries of the European continent are stagnating, others are doing quite nicely. Finally, although the price of oil has risen substantially, oil consuming nations seem to have absorbed this shock reasonably well. Meanwhile, oil exporting nations are seeing their first major windfall in a generation.

Yet a variety of risks cast a darkening shadow across the global economic landscape. Among these risks are the effects of the increase in the price of oil as well as instability in some oil-exporting countries, protectionist sentiment in much of the developed world, and the huge financial imbalance between the US and the rest of the world. Each of these factors is a reality, not merely a risk. The only question is how the effects of these realities will unfold over time. The risk is that they will unfold in a disorderly and ultimately de-stabilizing manner. The hope, of course, is that policymakers will take the necessary steps to ensure a smooth transition to the next stage of global growth.

This report examines the various risks to the global economy and offers a point of view as to their future direction. It suggests possible scenarios and the future direction of interest rates, exchange rates, and commodity prices. The goal is to offer some useful planning premises for global companies that are exposed to global risks.

This report also looks at the world's major economies and the issues they face. Of special interest are today's most discussed economies: China and India. The question arises as to the staying power of their extraordinary growth.

Table 1. GDP Growth in Selected Economies

	US	Eurozone	Japan	UK
1997	4.5	2.6	1.8	3.2
1998	4.2	2.8	-1.0	3.2
1999	4.4	2.7	-0.1	3.0
2000	3.7	3.8	2.4	4.0
2001	0.8	1.7	0.2	2.2
2002	1.6	0.9	-0.3	2.0
2003	2.7	0.7	1.4	2.5
2004	4.2	2.0	2.7	3.2
2005 Est	3.5	1.2	2.0	1.9

Source: IMF

Energy economics

The spectacular rise in the price of oil over the past few years has not had a spectacular impact on the global economy – at least not yet. Why is this?

There are a number of explanations. First, the impact of oil on the global economy is less than used to be the case simply because energy is used more efficiently. Today in the US, for example, only half as much oil is used per dollar of real GDP as was used in the mid-1970s. So a given increase in the price of oil has half the impact on the US economy than in the 1970s. The same is true in the other major industrial nations.

Second, although the price of oil has risen substantially, as of October 2005 it remains below the highs reached in the late 1970s – when adjusting for inflation. Thus the rise in the price of oil is not as onerous as what happened 25 years ago.

Third, due to the decline in the value of the dollar over the past two years, the price that Europeans pay for oil has not risen nearly as much as the dollar price of oil. Thus Europe, an important consumer of oil, has not experienced the same rise in the price of oil that the US has experienced.

Fourth, until recently consumers in industrial nations acted as if the rise in the price of oil would be temporary. In other words, they failed to adjust their behavior accordingly. That fact, however, has changed in recent months. Indeed, consumer spending in the US has slowed and the mix of automobiles purchased has shifted.

Finally, the reason the price of oil rose has much to do with its impact. In the past, oil price shocks were largely supply driven. Yet, Katrina aside, the rise in the price over the past two years was largely due to increased demand. The strength of the economies of China and India, for example, played a significant role in pushing up the price of oil. A demand shock is different than a supply shock in that it reflects economic strength. When, in the 1970s, supply was cut due to political events, the increased price was the mechanism by which a smaller quantity was rationed among consuming nations. Today, the increased price is a mechanism for constraining the demands of an overheated global economy. In a sense the price of oil is playing the role that interest rates often play when an economy overheats. Thus a rising price of oil is not necessarily cause for anguish. On the other hand, as in any overheating situation, it is cause for concern about inflation.

The impact of oil

So, the oil shock hasn't been as onerous as could be the case. That is not to say, however, that an increased price has no consequences. Indeed the world is already feeling the impact. First, rising prices can be and have been inflationary. By late 2005 inflation in the G7 countries had reached its highest level since the early 1990s. That is one reason why the US Federal Reserve has been increasing short-term interest rates and will probably continue to do so long after this report is published.

In addition, the rise in the price of oil is similar to an increased tax imposed by foreigners. It must be paid, and doing so requires spending less on something else. Thus economic growth is slowing due to this increased transfer of resources to oil producing countries. Growth will also slow due to the effects of higher interest rates as central banks attempt to offset the inflationary impact of higher prices.

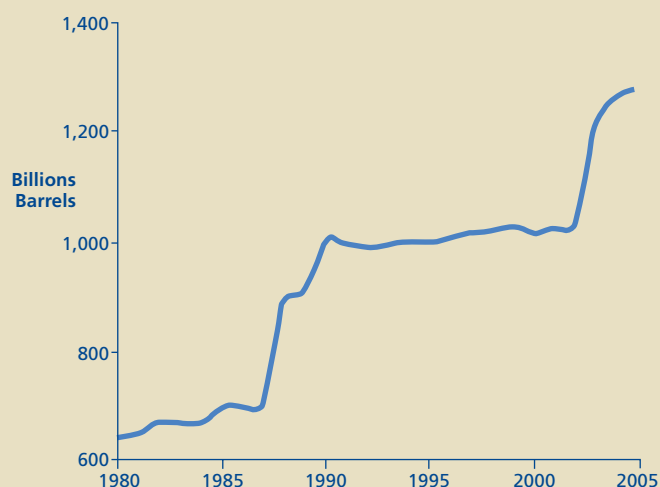
A sufficient slowdown in economic growth would have a dampening effect on the price of oil. Thus, although the price of oil was pushed up by recent hurricanes, it could easily drop below \$60 per barrel in 2006 if growth in the US and China slow. On the other hand, this could be offset by a steep drop in the value of the dollar. A declining dollar would put upward pressure on the price of oil. Thus, forecasting the price of oil is as difficult as forecasting exchange rates and interest rates. Perhaps it is sufficient to say that oil prices could become more volatile. Moreover, the longer-term path of the price of oil will depend not just on demand conditions, but on supply as well.

The supply side

What about oil production? Capacity has not increased significantly due to a relatively limited level of exploration in recent years. Like consumers, oil companies were not convinced of the durability of higher prices and, thus, invested accordingly. Moreover, many places with potential exploration opportunities are wracked either by political instability, terrorism, or governments that limit foreign investment. Countries such as Saudi Arabia, Iran, Iraq, Nigeria, Venezuela, Russia, and Indonesia are, consequently, investing less than optimally in exploration and recovery. The situation in Russia is particularly onerous. There, massive opportunity exists, but foreign companies are being shunned at a time when the domestic industry lacks sufficient capital and technology to do the job. Whether this will change anytime soon is hard to say.

Finally, many analysts believe that there are simply not sufficient exploration opportunities to meet growing demand. As a result, these proponents of the "peak oil" theory believe that, for the first time in generations, a significant and sustained increase in oil prices will take place over the next few years. They believe that we have finally reached the limits of oil output. Others, however, point to the fact that proven reserves have doubled in the past 25 years even as demand has grown and vast quantities of oil have been consumed. They believe that the peak is not at hand and that sufficient exploration will yield results that will, once again, drive down the real price of oil. The correct view on this debate will determine the future path of oil prices.

Figure 1. Global Proved Crude Oil Reserves



Source: U.S. Department of Energy

Another issue is downstream investment. Refinery capacity has not increased much in the past two decades and new investments take considerable time to come on line. Thus, even if the supply of crude were to increase substantially, there would not be sufficient capacity to refine that crude – especially in the US. Absent a drop in demand, US prices of refined products could remain historically high for quite a while. The effect could be a continued dampening of non-oil related economic activity in the world’s largest economy.

The US and an unbalanced global economy

A current account imbalance is the difference between what a country saves and invests. When the current account is in deficit, it means that domestic saving is insufficient to finance investment. The difference is made up by borrowing from foreigners or selling assets to foreigners. Such an imbalance is not necessarily a bad thing. After all, a country that borrows from foreigners to finance an increase in investment is,

effectively, investing for the future. Conventional wisdom holds that rich countries will run current account surpluses, funneling excess savings into poorer countries with strong investment opportunities. Yet today, the US has an enormous current account deficit and the biggest surpluses belong to poorer emerging countries such as China. Why is this?

The US current account deficit is due to a collapse in US net saving rather than an increase in investment. Household savings in the US fell throughout the 1990s due to strong returns on financial assets and remained low during this decade due to the effect of increased home prices on consumer perception of wealth. Moreover it is not simply private savings that has collapsed but government savings as well. The federal government’s increased budget deficit represents a decline in national savings.

The surplus in China is due to the fact that saving in China has risen even faster than investment – which itself has risen rapidly. In part that increase in saving is due to the Chinese government’s mercantilist choice to hold down the value of its currency by accumulating foreign currency reserves. In addition, savings of enterprises have increased as the private sector has grown and become profitable and as state-owned enterprises have improved their efficiency. Finally, personal saving in China has risen as the safety net offered by state-owned companies has gradually been removed through privatization.

In addition, many countries other than China are now running current account surpluses that have risen in recent years. For example, oil exporters have experienced increased current account surpluses due to the rapid increase in the price of oil. The combined current account surplus of Middle Eastern countries rose from \$30 billion in 2002 to a likely \$218 billion in 2005. Unlike during past increases in the price of oil, petroleum producing countries have chosen to conserve rather than spend their windfalls. Even less affluent oil exporters such as Russia have experienced an increased surplus.

Table 2. Current Account Balances of Key Economies
\$US Billions

	US	Eurozone	Japan	Other OECD Economies	China	Russia	Middle East	Combined Non-US
1999	-300.1	31.7	114.5	44.1	15.7	22.2	11.9	240.1
1998	-214.1	57.7	119.1	62.8	31.6	-2.1	-25.2	243.9
1999	-300.1	31.7	114.5	44.1	15.7	22.2	11.9	240.1
2000	-416.0	-37.0	119.6	71.4	20.5	44.6	69.8	288.9
2001	-389.5	7.0	87.8	83.9	17.4	33.4	39.3	268.8
2002	-475.2	48.5	112.6	91.6	35.4	30.9	30.0	349.0
2003	-519.7	26.7	136.2	137.2	45.9	35.4	57.3	438.7
2004	-668.1	46.7	172.1	135.3	68.7	59.9	102.8	585.5
2005 Est	-759.0	23.7	153.1	131.1	115.6	101.8	217.6	742.9

Source: IMF

The middle income nations of Southeast Asia have also experienced an increased surplus due to a downturn in investment since the financial crisis of 1997-98. This substantial decline in investment spending took place in order to pay down debts accumulated during the boom years of the early 1990s. Investment remains relatively low as manufacturing capacity in the region now shifts to China. Hence, countries such as Thailand and Malaysia have surpluses that are, in part, financing the US external deficit.

So what happens next?

Left alone, the US current account deficit will grow, both absolutely and as a share of US GDP. As that deficit grows, the net interest payments Americans must make will grow as well. Will foreigners be happy to finance this largesse? The answer is that they will not if they believe it is unsustainable. After all, if it is unsustainable, then the dollar must fall in order to boost US exports and reduce imports. So, foreigners will not want to hold an increasing share of their own portfolios in the form of dollar-denominated assets if they believe that the dollar will lose value in the future. In other words, if investors believe that the dollar must fall, then the dollar will fall. Or to put it another way, if investors believe that other investors believe the dollar must fall, they will avoid the dollar thus causing the dollar to fall. Indeed, this has already happened. The dollar has fallen during the past few years, thus rendering dollar assets a smaller share of foreigners' portfolios.

Before the reader gets too much of a headache from this, consider that the real issue is not whether the dollar will fall, but when and by how much. That, in turn, will depend on the actions of policymakers. For example, if the US government were to reduce its long-term budget deficit, this would represent an increase in US savings – thus reducing the need to borrow from foreigners. The US external deficit would decline without the need for a large further drop in the value of the dollar. Failure by the US to reduce the budget deficit, however, would mean that reducing the external deficit would require a large drop in the dollar.

Another example concerns the actions of China's central bank. If it undertakes a substantial revaluation of the Chinese currency, then the dollar will have fallen a good deal on a trade-weighted basis. Yet in such a circumstance the dollar need not fall as much against the euro and pound.

Finally there is the example of Europe. If the European Central Bank (ECB) stimulates Europe's economy through interest rate reductions, European demand for US exports would increase. The result would be less downward pressure on the dollar.

Why must the dollar fall?

In any event, the dollar will fall further. Yet the question arises as to why it must fall at all? After all, it has fallen quite a bit already. Hasn't this been sufficient? The answer is no, and the dollar must fall further. There are several reasons for this.

First, despite a considerable decline in the dollar already, US import prices have not moved much. Importers have taken a hit to their margins rather than increase prices. Naturally, this cannot go on forever. A further decline in the value of the dollar will probably lead to higher import prices. The result will be that consumers will begin to switch from imports to domestically produced goods – thereby helping to reduce the current account deficit.

Second, although the dollar has fallen considerably against the euro and pound over the past two years, it has fallen much less on a trade-weighted basis. This is because many Asian countries, following the lead of China, have maintained a fixed exchange rate with respect to the dollar.

The US current account deficit has been exacerbated by higher oil prices and could be enlarged by higher long-term interest rates. The latter would be due to the impact of interest rates on net interest payments. On the other hand, higher interest rates will slow the US economy, resulting in lower demand for imports. In addition, a lower dollar will ultimately have the same effect.

For the rest of the world, a lower dollar will reduce export demand and force economies to seek growth from domestic demand or exports to non-US markets. The good news is that a weaker dollar will be dis-inflationary for the US's trading partners. This will allow other countries to lower their short-term interest rates and stimulate domestic demand. The bottom line is that a weaker dollar will ultimately allow a shift in the structure of global growth. In the US, this shift will entail slower growth of domestic demand and more rapid growth of exports. In the rest of the world, it will mean the opposite: stronger domestic demand and weaker export growth. The process and speed by which this transition occurs will determine how painful it will be.

What about interest rates

An important issue is the effect of the global imbalance on interest rates. One of the surprising aspects of the current economic environment has been the relatively low level of long-term interest rates – both in the US and the rest of the world.

Consider the US. Given that foreigners have become increasingly averse to holding dollar denominated assets, it would be expected that they would demand a higher return on US assets. Moreover, the increasing supply of US government debt would also suggest higher interest rates. Yet these rates have remained low. The best explanation is the fact that Asian central banks have been accumulating US Treasury securities. The result is that the private sector has not had to absorb much of this debt.

Table 3. Holdings of US Treasury Securities by Foreign Governments
\$US Billions

Country	March of 2000	October of 2004	Change
China	76.9	188.9	112.0
Japan	178.0	419.5	241.5
Taiwan	25.4	33.7	8.3
Hong Kong	22.9	29.2	6.4
Korea	14.0	38.2	24.3
Other	318.4	415.0	96.6
Total held by govts	635.6	1,124.7	489.1

Source: CESifo Forum

If Asian central banks stop or reduce their accumulation of US Treasury securities, it is reasonable to expect that US rates will rise – possibly substantially. Will this happen? Yes, China is likely to allow its currency to appreciate in the next two years. The result will be less Chinese accumulation of reserves. Absent a reduction in the US budget deficit, this would mean that the US government would have to sell more bonds to private investors. They, in turn, would require a higher return in order to absorb this increase.

What would be the effect of higher long-term interest rates? Clearly higher rates would tend to slow economic activity. This would happen just at a time when short-term rates are being increased in order to quash inflationary pressures – the latter the result of higher oil prices.

China's next step

China has become one of the prime influences in the global economy. As discussed above, China's exchange rate policy will influence trade flows, interest rates, and economic growth in the rest of the world. In addition, China's import growth has strongly influenced the economic recovery in Japan.

Yet increasingly the economic path of China itself is of considerable importance to the world's global companies. That is because the Chinese market is now very large. Just how large? When using current exchange rates, China's economy is now among the world's top ten. Yet when using an exchange rate that measures the true purchasing power of the currency (better known as a purchasing power parity exchange rate, or PPP rate) China's economy is the world's second largest. Another way to measure China's importance is to consider oil consumption. China is now the world's second largest consumer of petroleum after the US. So, by any measure, China's market is huge. Therefore, the question of China's future economic path is critical.

Exchange rate

China is likely to revalue its currency further. Continued maintenance of a relatively low valued currency necessarily entails rapid money supply growth in order to purchase the excess dollars entering China. This has not yet caused high inflation (in part due to domestic price controls, declining tariffs, and excess capacity). Yet it will have onerous effects on China's economy if it continues. Already this excessive money supply growth has led to a property price bubble and will eventually lead to general inflation.

Revaluation will help China to shift toward domestically generated growth, rather than relying on more volatile exports. Exports have been a critical component in China's growth, having increased 140-fold since 1970 (world exports rose 20-fold). Yet domestic demand would make for more stable longer-term growth with less vulnerability to external events beyond China's control. Finally, China's leaders will recognize that China can adjust to a higher valued currency without creating significant unemployment. That is because much of China's recent export growth involved high valued added products that are less labor intensive. Hence, a revaluation will not necessarily lead to sizable increases in export prices.

What will a higher valued currency mean for global companies? For companies exporting from China, it will mean higher export prices. The degree to which prices rise depends on the labor input of the product. Labor intensive products such as apparel and textiles could see significant pass-through. Yet capacity for producing such products can be shifted toward the Chinese interior where wages are substantially lower. Moreover, liberalized trade will lower export prices as well. Capacity can also be shifted to lower wage countries such as India. For higher value-added products with substantial imported components, export prices will not increase much. So the principal impact of revaluation might not be a big shift in export growth. Instead, there may be a bigger impact on imports.

For companies selling into the Chinese market, a higher valued currency will mean lower prices of imported components and imported final goods. This will mean greater effective purchasing power on the part of Chinese consumers and businesses. Finally, Chinese companies will face greater competition from imports. This will force them to become more efficient and price competitive.

China's growth

China's growth has been very strong compared to most other countries. Yet it has not been as strong as could be the case under the right circumstances. Although China's growth could temporarily slow down in the near term, it could actually accelerate in the longer term if the reform process is not interrupted.

First, how is it possible that China's growth has not been sufficient? The answer is that, in the past, other Asian countries actually grew faster at similar stages of economic development. Specifically, Japan and South Korea grew faster with less investment in the 1950s and 1960s. China's level of investment has been massive. Yet the return on this investment in terms of economic growth has been poor due to the inefficient nature of much of that investment. China invested heavily in loss-making state-run enterprises. Most of the efficient, growth-enhancing investment of the last two decades has come from foreign capital. So although China's growth has been strong, it should have been stronger given the level of investment that took place. In other words, much of that investment was wasted.

Table 4. Growth from take-off
Real GDP growth 24 years after economy took off

Japan	(1950-1974)	495%
Korea	(1965-1989)	488%
China	(1978-2002)	266%

Source: IMF

Why might China's growth slow in the short term? The answer is that revaluation of the currency, which necessarily entails a slowdown in the growth of the money supply, should remove some of the overheating of China's economy. Revaluation will slow export growth by raising some export prices. Slower money supply growth will remove stimulus to excess bank lending for construction and other forms of investment. A slowdown right now would probably be a good thing as it would remove inflationary pressures by bringing growth into line with capacity. Moreover, it would remove some of the inflationary pressure in global commodity markets.

Can China grow faster in the future? Yes, provided that reforms take place which improve the efficiency of investment decisions. Specifically, further privatization of state-owned companies will remove the incentive for politically motivated bank lending. Privatization of banks combined with foreign participation in banking will stimulate lending based on creditworthiness rather than politics. All of this will mean investments that are more likely to have a positive return and, therefore, likely to lead to economic growth.

Will reforms take place? They are already under way. The government clearly knows what needs to be done. The problem is that the process of reform necessarily entails some short-term costs. For example, privatization of inefficient state-owned companies often involves dismissal of workers. Increased unemployment could lead to social unrest. The challenge for the Chinese government is to maintain reasonably rapid growth in order to absorb dismissed workers into the market economy. That way the process of reform can continue without onerous social consequences.

Another problem is that China uses resources inefficiently. Specifically, energy efficiency is far lower in China than in the developed world. One reason is that the government subsidizes energy costs. When global energy prices rose, the prices paid by Chinese consumers and businesses rose by only a fraction of the global increase. The result was a lack of incentive to improve efficiency and conserve. Ironically, China's failure to properly price energy, and the consequently huge increase in energy consumption, has contributed to the increased global price of energy.

Outlook for China

China is likely to experience a brief, moderate slowdown in growth in 2006. In the longer-term, China's growth is likely to accelerate as the process of economic reform unfolds. As this growth takes place, China will move up the value chain with a disproportionate share of growth coming from higher value added goods and services. Today, China's investment in education is considerable, with a large output of university graduates. This fact, combined with greater and more efficient investment, will drive productivity growth and enable a sizable increase in the purchasing power of ordinary Chinese.

India: the next big thing?

India has been described as the next big thing. Its strong growth in recent years, combined with its emergence as a hub for off-shoring of service functions, has created a considerable buzz in the business world. Is this justified? Will India be the next China?

To answer these questions, let us first consider the facts. On the positive side, India has experienced relatively strong economic growth following the economic reforms first enacted in the early 1990s. Such reforms included deregulation of many domestic sectors, greater openness to foreign investment in most sectors, more sensible monetary and fiscal policies, and trade liberalization. As for the latter, India's average tariff fell from 56% in 1990 to 28% in 2004. Still, this leaves India less open than China. By comparison, China's tariff dropped from 32% to 6% over the same period.

In addition, the IT and telecommunications revolutions allowed India to take advantage of its vast supply of highly educated, English speaking professionals – many with degrees in technology related subjects. These people became the vanguard for India's emergence as a major exporter of IT related services. Consequently, India's IT industry revenue rose from US\$8.2 billion in 1999 to US\$28.2 billion in 2004. It is expected that this industry will grow rapidly in the coming years.

Moreover foreign business interest in investing in India is quite high. A survey by the United Nations Commission for Trade and Development (UNCTAD) indicated that India is second only to China as an attractive destination for foreign direct investment (FDI). Yet this interest has not translated into a commensurate level of transactions. While FDI has increased since the early 1990s, it remains low compared to other big emerging markets. For example, India's FDI was less than 1%

Table 5. Growth of IT and ITES in India

	Industry Revenue US\$ Bill	Share of GDP (%)	Industry Exports US\$ Bill
1997-98	5.0	1.2	
1998-99	6.0	1.5	
1999-00	8.2	1.9	4.0
2000-01	12.1	2.7	6.2
2001-02	13.4	2.9	7.5
2002-03	16.1	3.2	9.9
2003-04	21.5	3.5	13.3
2004-05E	28.2	4.1	17.9

Source: NASSCOM (National Association of Software and Service Companies) www.nasscom.org

of GDP in 2002 compared to 3.7% of GDP in China. In the past the problem was restrictions on FDI. That is no longer a serious concern as the government has substantially liberalized the FDI regime. Instead, the problem is the overall business environment including high and distorting taxes, regulation (especially labor market restrictions), poor physical infrastructure, and corruption.

Unfortunately, India's business sector remains hampered by regulations that add cost and delay innovation. For example, the World Bank reports that it takes 89 days to start a business in India versus 41 days in China. On the other hand, custom clearance in India is faster – seven days versus 10 days in China. Still, on most measures of business efficiency, India fails compared to China and Southeast Asia. The IMF estimates that the paucity of FDI in India is directly related to these failings.

Table 6. Regional Comparison of Key Business Indicators

	India	China	Korea	Malaysia	Thailand
Infrastructure					
Electric power consumption, kwh per capita, 2001	364.7	893.4	5,288.4	2,731.0	1,508.4
Internet users per 1,000 people, 2003	15.9	46.0	551.9	319.7	77.6
Paved roads as % of total roads, 1999	45.7	91.0	74.5	75.8	97.5
Overall infrastructure quality (rank out of 102 countries)	70	55	21	12	29
Bureaucracy and red tape					
Startup procedures to register a business, 2004	11	12	12	9	8
Days to start a business, 2004	89	41	22	30	33
Time (in days) to enforce a contract, 2004	425	241	75	300	390
Efficiency of legal framework (rank out of 102)	35	50	41	19	32
Burden of regulation (rank out of 102)	67	21	23	16	25

Sources: World Bank, various publications

The future of reform

India's future depends in large part on the degree to which the government can enact further reforms. Yet it faces conflicting demands. It must cut the budget deficit in order to improve the health of the financial system, but it must increase spending on infrastructure and caring for the needs of the poor.

The Common Minimum Program (CMP) is the manifesto of the ruling coalition. It has been billed as "reforms with a human face." The idea is to continue the process of economic liberalization championed by the former government, but also add aspects designed to spread the benefits more equitably – especially toward the rural population. The liberalization agenda includes further privatization, labor market reform, fiscal probity, and reductions in subsidies. The "human face" aspects include increased spending on infrastructure and social programs aimed at reducing poverty. There are some obvious conflicts: fiscal conservatism versus increased social spending, subsidy reduction versus support for the poor, privatization versus employment growth. These conflicts basically reflect short versus long term planning and must be reconciled. One way the government intends to meet the requirements of this agenda is to offset increased social spending (education, health, etc) with reductions in subsidies.

So far, the government has taken a number of steps. These include shifting to a defined contribution pension plan for the government, reducing trade tariffs, liberalizing flows of foreign capital, reducing the number of industries that are regulated and protected, and accelerating privatization.

Perhaps the most innovative step taken by the government is the effort to establish special economic zones (SEZs). The idea is to replicate the enormous success of such zones in China. Legislation creating the SEZs was passed in May 2005. It did not go as far as the government wanted in that it failed to liberalize the labor market in the SEZs. The principal effect of the legislation is to provide substantial tax benefits to companies that invest in the zones. In addition, the legislation provides that exports and imports move quickly and avoid red tape. However, it does not lower trade barriers.

The government is also keen to stimulate rapid growth in the manufacturing sector. Although India's overall growth has been strong lately, the government is concerned that the disproportionate contribution of services, especially IT-enabled services as well as business process outsourcing (BPO), means that growth will not adequately affect India's vast number of poor. The services sector has improved the lives of India's educated class. Yet in order to stimulate employment and income growth among the poor and working class, a big push in manufacturing will be required. Yet the goods producing sector remains hampered by poor infrastructure, especially in transportation and power generation.

One thing holding back the manufacturing industry is the existence of restrictive labor market regulations, similar to those in Western Europe. These rules stymie job growth because they make it difficult and costly to dismiss workers. Hence, companies will only hire new workers if they are confident that the demand for their products will remain steady.

Another problem is that the government continues to run a large budget deficit which eats up a sizable portion of the country's savings. In 2004, the combined deficit of the central and state governments was 8.7% of GDP. This raises the cost of capital and starves many entrepreneurial businesses of capital. Moreover, the deficit impedes the government's ability to fund needed infrastructure programs.

India's next step

A reasonable scenario for India will be continued strong growth, but growth below that of China. In other words, India does not seem likely to catch up with China anytime soon. On the other hand, India is poised to attract more investment not only in IT services but in low wage manufacturing. The degree to which this happens depends on investment in infrastructure and labor market reform. If India attracts a sizable amount of manufacturing activity, this will help to absorb many underemployed workers into the market economy.

India will benefit, of course, from China's likely currency revaluation. When China finally undertakes a major revaluation, some low wage manufacturing capacity will shift out of China and into India and other low wage locations.

Europe: can the sickness be cured?

Europe's largest economies have suffered relatively high unemployment and low growth for quite a long time. This used to be known as "Eurosclerosis." The solution, according to most economists, has always been to deregulate these economies, especially their sclerotic labor markets. Yet not much has happened. Now, Europe is at something of a crossroads. Its two leading economies, Germany and France, are struggling with a conflict between the comfortable yet slow growth that comes from doing nothing and the social costs involved in generating the potentially stronger growth that could come from reform.

This conflict was at the forefront of the recent elections in Germany. There, the voters split virtually down the middle, reflecting no clear consensus on how to approach new economic realities. In France, a new government includes leaders on both sides of the debate about the extent of economic reform.

Table 7. Productivity Growth in Selected Economies, %

	US	Eurozone	Japan	UK
1997	3.6	3.4	5.0	1.5
1998	4.8	3.6	-3.6	4.5
1999	3.5	5.4	3.3	4.4
2000	4.6	6.5	6.8	6.3
2001	2.3	2.2	-3.0	3.4
2002	7.5	1.6	3.7	1.5
2003	5.2	1.1	5.3	5.1
2004	5.2	3.0	5.3	5.8
2005	4.4	1.5	1.8	0.3
Avg 1997-06	4.4	3.0	2.6	3.4

Source: IMF

Europe faces several long-term issues with which it must grapple soon:

Onerous demographics

Europeans are living longer, retiring earlier, and having fewer children than in the past. The result of this is that, soon, the labor force will decline while the number of retirees increases. Absent a substantial boost to productivity growth, this implies declining economic growth – if any. This is not a politically or socially sustainable situation. The best solution would be to expand the share of the population that works. This means people retiring later.

It also means removing some of the safety net that makes unemployment a viable alternative to labor market participation. Doing either of these will be politically challenging to say the least. Another solution, already under way to some extent, is immigration. This boosts the ratio of workers to retirees and provides a low cost solution to the necessity of low value-added jobs. Yet immigration can be socially destabilizing.

Excessive safety net

Europe's high level of unemployment and low growth are, in part, the result of excessive protection and subsidization. When some politicians refer to Europe's "social model," they often mean the vast array of subsidies available to those not working. Unlike in the US or many emerging countries, the unemployed in Europe will likely not suffer materially. Thus, the incentive to find work is less. Moreover, the cost of such subsidies is, in part, responsible for a relatively high level of taxation.

Excessive regulation

Europe's high unemployment is largely the result of rules that discourage the creation of new jobs. Rules that make the dismissal of workers difficult and costly encourage companies to seek ways to increase output without increasing labor input. This is one of the reasons why France, for example, has a very high level of worker productivity – but a high level of unemployment as well. Efforts to deregulate labor markets have been politically contentious.

Table 8. Productivity versus GDP per capita (US=100)

Country	GDP per capita		Output per hour	
	1995	2003	1995	2003
US	100	100	100	100
Eurozone	72	70	95	89
Germany	77	70	97	90
France	75	74	108	107
Japan	81	74	71	69
UK	72	77	81	83

Source: BIS

Excessive protection

Many European governments, as well as the European Union, protect various industries from the vicissitudes of competition. Farmers, for example, receive subsidies and protection that keep them in business. The consequence, however, is that domestic food prices are higher than would otherwise be the case. In addition, many countries restrict efficient operations in the retail sector. The result is that retail productivity is considerably lower than in the US, retail prices higher than would otherwise be the case, and retail employment lower as well.

What to do with the EU

The European Union has ambitiously expanded, both by deepening its impact on member countries and by expanding eastward through new membership. Yet the EU is having difficulty figuring out its appropriate role. It has gone far beyond being a customs union. With the creation of the euro, the hope existed that being part of a monetary union would force member states to focus more on making the regulatory environment more conducive to investment. This has not happened. Instead, countries have continued their high level of regulation, often seeking protection in the form of EU regulations.

Moreover, the eurozone has created difficulties for those countries with relatively low rates of inflation such as Germany. These countries need lower interest rates, yet the ECB has been careful to maintain interest rates with the higher inflation member countries in mind. Perhaps as the anti-inflation credentials of the ECB are developed, there will be a greater willingness to maintain lower interest rates – especially in an environment of an appreciating currency and high unemployment.

What will happen next in Europe?

Absent major reforms to labor and product markets, and absent major changes in monetary policy, much of Europe seems destined for relatively slow growth and high unemployment. The UK is a notable exception, given its independent monetary policy, lower level of regulation, and high level of immigration.

The euro and pound are likely to rise in value against the dollar. This will be deflationary and could provide a basis for lower interest rates. If that happens, then Europe's economy could grow faster, with greater emphasis on domestic demand and less on exports. For Germany in particular, this would be a challenging transition – not one that would be helped by current domestic economic policies.

Japan: Is the sun rising again?

Japan may be on the verge of a gradual economic renewal, following roughly 15 years of stagnant growth and deflation. A number of factors point in this direction, not the least of which is strong political support for a government committed to reform. Sustained recovery will require not simply an ephemeral boost in exports (this has happened before), but strength in the domestic economy. It will require increased investment by Japanese business and increased spending by Japanese consumers.

Of course the recent situation does not necessarily offer much promise. In 2004, strong GDP growth of 2.7% was largely fueled by exports (up 14.4%), mostly to China, while consumer spending rose a more timid 1.5%. Still, the future may be different.

Investment spending, for example, might be ready for a recovery. Japan's companies have spent much of the past 15 years cleaning up their messy balance sheets while the country's banks have substantially reduced their portfolios of non-performing loans. The result is that companies are now in a better position to invest rather than pay down debts. Banks are in a better position to lend on the basis of business opportunity rather than simply rolling over bad loans. On the other hand, Japanese companies must anticipate strong domestic demand before they are willing to expand investment.

Good news

There are already some positive signs with respect to the consumer. For example, wages and employment are now rising at a significant pace for the first time in many years. Consumers have reduced their personal savings substantially, from 15% of income in the 1980s to roughly 6% today. Yet consumer spending could accelerate as job and wage growth start to improve. Indeed, retail sales are rising faster than GDP. Moreover, further reform of Japan's financial sector, combined with improved equity market performance, may compel Japanese to part with their savings if the return they receive is more robust.

Another positive sign is that inflation is now expected to reappear in 2006. In an economy laden with bad debts, the presence of deflation for the past 15 years has been onerous indeed. A little inflation could go a long way toward reducing the real value of debts and improving the financial position of companies and banks.

The role of exports

Finally, although Japan's economic salvation will mainly entail strength in the domestic economy, exports will still play a role. In that arena, Japan is fairly well positioned, having been very adept at developing the Chinese market for Japanese capital goods. Still, the rise of China and other Asian economies as centers for the manufacture of sophisticated goods means that Japan's manufacturing sector will necessarily face limits. Instead, Japan's growth will be fueled by services and higher value added processes within the manufacturing arena.

Unfortunately, in order to create the conditions for more robust domestic growth, Japan will have to go through a further process of economic reforms. This process could temporarily slow growth. That is because it will involve removing protections for poor performing companies and their employees.

Issues for the US

As discussed earlier, the biggest issue facing the US economy is the huge current account deficit, the resolution of which will affect exchange rates, interest rates, inflation, and growth for the next few years. Still, there are other US economic issues of concern to global companies. These include the political obstacles to dealing with the budget deficit, the looming public pension crisis, the crisis in private pensions, and the issue of immigration and visas. Let us consider the latter two issues in-depth:

Private pensions and healthcare

In the late 1990s, many US companies with defined benefit pension schemes stopped contributing to their plans as the rise in equity prices ensured that the plans were properly funded. This fact allowed companies to spend more on investments or provide better returns to shareholders in the form of higher profits or share buybacks. The positive effect of this on share prices added to the strong state of the pensions.

Then at the beginning of this decade, the market took a turn. The result was that many pension schemes were suddenly under-funded. This required that contributions be increased. The result was less money available for investment or shareholder returns. Today, many companies in mature industries are burdened with excessive pension obligations. Many are also burdened with promises of healthcare for retirees and their dependents at a time when health costs are rising rapidly. The result is poor share price performance and inadequate funds for investment, just at a time of increasing competition from abroad. In addition, this pension and healthcare problem applies as well to state and local governments.

The current problem is due to a number of factors. The most important is demographics. People are simply living longer than had been expected when many promises were made. Another problem is that, in the 1970s and 1980s, many companies bought labor peace and moderate wages by making promiscuous promises about the future. Now those companies face competitive challenges that they never anticipated.

The resolution of this problem will not come quickly, and may require government intervention in the form of new pension rules and a new role for government in healthcare provision or pricing. In the interim, investment in mature industries could be held back. Employment in these industries will surely decline.

Immigration and visas

Since the terrorist attack on Sep 11, 2001, the US government has been more restrictive in issuing visas to foreign visitors. While well-intentioned, this action has had negative consequences for the US economy in several ways.

First, the government is issuing far fewer work visas for skilled employees in the technology sector. IT industry executives have loudly complained that this is undermining their ability to conduct research. Rather than bringing Indians to America, many technology companies are now shifting research facilities to India. India and China are producing more engineers and scientists than the US. It appears that they are willing to work in the US at wages that do not attract sufficient numbers of Americans to those professions. For the US to continue developing leading edge technology, it will need to import skilled workers from Asia. Although the US government recently increased the number of visas issued, the number is still below the level prior to 2001.

Second, the US government is also being restrictive in issuing visas to visitors from emerging countries. The result is that many business executives from China, India, and other important countries are having problems entering the US in a timely manner. Some Chinese businesses, rather than send purchasing missions to the US, are sending them to Japan instead in order to obtain important capital goods. This fact is hurting US export development. In a larger sense, it is harming the ability of US companies to participate in the global business environment.

On the positive side

Despite these and other problems, the US economy continues to grow faster than most developed nations. Not only is the labor force growing more rapidly than in Europe and Japan, productivity continues to rise rapidly. Productivity growth is strong in Japan and the UK as well, but in the eurozone productivity growth lags. The strength of US productivity growth has enabled the economy to generate higher labor costs without fueling inflation. Thus, until the recent oil price shock, unit labor costs in the US were rising slowly. Even with accelerated growth of unit labor costs recently, competition from overseas is likely to keep a lid on non-oil inflation. Thus the US economy seems capable of strong non-inflationary growth.

Why is productivity growth continuing to rise rapidly? In part, the answer is that US industry is reaping the benefits of considerable investment in information technology. Moreover, not only has there been an increase in the stock of technology-based capital, but companies have radically changed the way they do things in order to take advantage of new technologies. In other words, business processes have improved as a result of technology. This process continues as industry adapts even newer technologies, especially as the cost of information technology continues to fall.

Concluding thoughts

There are a number of serious risks facing the global economy. These include large-scale terrorism, a possible pandemic involving avian flu, military conflict in key places such as the Middle East, and dramatic changes in the political climate in key countries. And there are more predictable risks such as the eventual unwinding of the huge US current account deficit and the impact on asset prices, big movements in the price of oil, and the manner by which major countries deal with the demographic changes unfolding.

For global companies navigating this business environment, the challenge will be to minimize the risk from uncontrollable events while still taking appropriate business risks. Not all risks can be hedged. Therefore, companies must make some educated bets. At the same time, they must diversify risk by taking several bets, often contradictory ones.

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