

Schroders

Global Economic Outlook

A truly global crisis



In summary:

- **Output and employment figures plunge around the world**
- **Unlike previous downturns, this crisis appears to be truly global: all regions are affected**
- **US interest rate cuts and falling energy prices are starting to benefit the consumer**
- **We believe further government intervention will be necessary to shore up the UK banking system**

By Keith Wade, Chief Economist

The past month has brought a raft of gloomy economic news with output and employment plunging around the world. Exports have been falling with Asia experiencing some of the sharpest declines. It was also reported that China, the powerhouse of the region, recorded its weakest GDP growth for seven years in the final quarter of last year. Over the next month, we expect all the major economies to record falls in output for the final quarter of 2008, confirming that this downturn is truly synchronised.

Unlike some previous economic downturns, this crisis appears to be global. In the past, economies have been assisted in their recovery by strong demand from the rest of the world. However, with the Americas, Europe and Asia all affected, it is difficult to see where that support will come from. Hope that China will pick up the slack may, we believe, be disappointed in a world where that economy has been, and remains, a major producing nation rather than a consumer.

Some good news...

There has, however, been some good news this month as there is now evidence that, after three months of very sharp interest rate cuts by the US central bank, the Federal Reserve, borrowers are beginning to see some benefit in terms of lower interest payments. The decline in the oil price is also bringing some relief to stretched household incomes. In effect, lower energy prices will act like a tax cut for households and is worth 1.5% of disposable income (approximately \$160 billion) to US households.

...but some bad news in the UK...

The bad news is that, despite a brief respite in December and early January, the banking crisis is back. Towards the end of January, the S&P financials index experienced one of its sharpest ever falls as it crashed to a 14-year low. In the UK, the shares of Royal Bank of Scotland (RBS) are down some 98% from their peak and, with the British government likely to own 70% of the company, is on the verge of nationalisation. The original rescue package launched in October last year has not succeeded in saving the banks, and perhaps even more significantly, has failed to kick start lending again.

The problem for the banks, not just in the UK, but across the US and Europe too, remains one of damaged balance sheets with the full cost of the sub-prime debacle still being accounted for. Given the scale of the capital required and the lack of appetite in the private sector for financing banks, we believe the UK



government will be left with little option but to intervene further. This is likely to take the form of nationalisation of RBS and possibly Lloyds, combined with the creation of a 'bad bank' to take so-called toxic assets off the balance sheets of the remaining banks, primarily Barclays. Such an outcome could well prove to be the turning point in the crisis by providing the foundations for a resumption in lending.

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