ASSOCIATION D'INSTITUTS EUROPEENS DE CONJONCTURE ECONOMIQUE

ASSOCIATION OF EUROPEAN CONJUNCTURE INSTITUTES

AIECE GENERAL REPORT

Report submitted at the AIECE Autumn General Meeting

Brussels, 28-29 October 2010

Part I

Final version

Closing date of the Report: 19 October 2010

This report has been written by Janusz Chojna, Małgorzata Jagiełło, Juliusz Kotyński, Krzysztof Marczewski, Jan Przystupa and Janusz Sawicki at IBRKK. Excellent research assistance was provided by Łukasz Ambroziak and Daniel Koć. Special thanks to Stella Balfoussias, who prepared a box for the Report.

Instytut Badań Rynku, Konsumpcji i Koniunktur

Al. Jerozolimskie 87, 02-001 Warszawa, Poland

phone: 48(22) 813-46-50, 813-51-86, fax: 48(22) 628-24-79

e-mail: ibrkk@ibrkk.pl

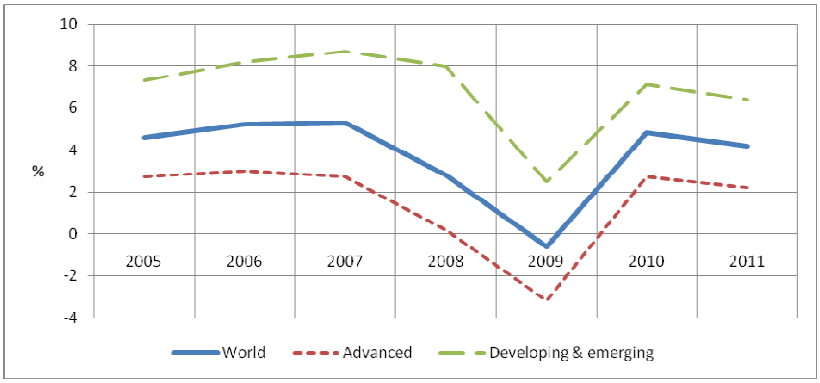
http://www.ibrkk.pl

Contents

1. The world economic environment

The recovery of the global economy is proceeding in two speeds; the growth trajectories of key advanced countries and developing and emerging economies are situated on different levels of the long-term growth map (Fig. 1.1). The growth rate gap between the two major country groups that appeared in the last decade rose dramatically during the global recession. It is likely to widen and to consolidate in the coming decade, for structural reasons. The output share of the developing and emerging economies (notably of Asia), inhabited by almost 85% of the global population, grows systematically. It reached 46% of the global product in 2009 (in PPP terms) and in a couple of years is likely to exceed a half of the world's GDP. Hence, as the President of the World Bank Group stated, the notion of the "Third World" has lost its significance[1]*. That became evident during the last deep recession.*

Figure 1.1. Similar growth paths, various pace. Annual GDP growth rates (%), by main country groups, 2005-2011[a].



[a] IMF projections, October 2010.

Source: IMF, World Economic Outlook: Recovery, Risk, and Rebalancing, October 2010.

Table 1.1. GDP changes of the main country groups, 2005-2011[a]

Country groups	GDP (*PPP*) shares, %	Real GDP, annual changes, %						
	2009	2005	2006	2007	2008	2009	2010[a]	2011[a]
World	100.0	4.6	5.2	5.3	2.8	-0.6	4.8	4.2
Advanced	53.8	2.7	3.0	2.7	0.2	-3.2	2.7	2.2
Developing & emerging	46.2	7.3	8.2	8.7	8.0	2.5	7.1	6.4

[a] IMF projections.

Source: IMF, as in Figure 1.1.

[1] R. B. Zoellick, The End of the Third World? Modernizing Multilateralism for a Multipolar World, Woodrow Wilson Center for International Scholars, April 14, 2010.

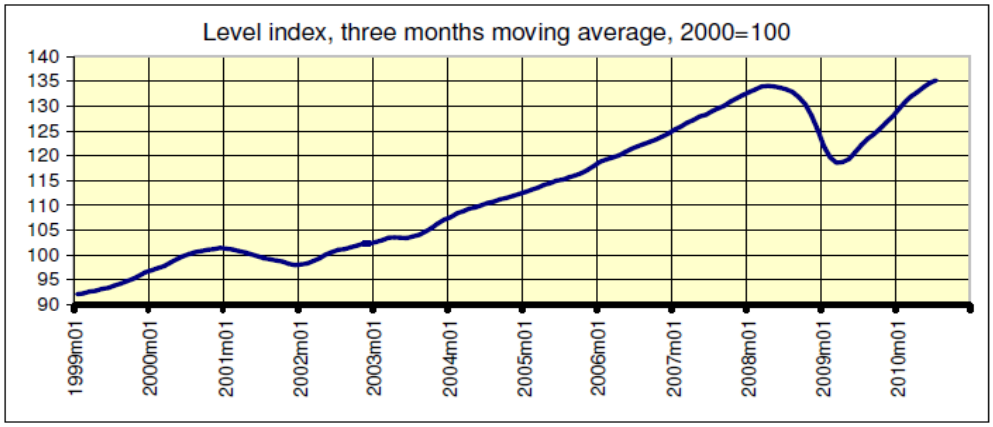
1.1. The global economy

The continuing global economic rebound seems relatively firm but not necessarily long lasting and widespread, as the systemic roots of the deep global recession have not been eliminated. There is still a downside risk of a fragile recovery or a protracted stagnation, particularly in some advanced or emerging areas and countries that face a dilemma of prompt application of resolute exit strategies and painful structural reforms or continuation of their activist economic policies, increasing fiscal deficits and debt levels and endangering financial stability of their economies. On the other hand, a sudden and general abandonment of state stimulus measures, notably by major economies, could set off a new recession and a global financial crisis. Improper policy responses, as well as unexpected external shocks, may possibly provoke financial turbulences, spilling over to the real economy. In a medium term, the social and political aversion to costly reforms could result in a fall of investors' confidence and financial destabilisation or even defaults of some countries. In these circumstances, the economic growth in many advanced economies, notably in Europe, is likely to remain rather constrained over the next quinquennium.

The real sphere

After a historic fall of the global product by 0.6% in 2009, for the first time since 1946 - due to an absolute GDP decrease by 3.2% in advanced economies and a decline of the annual growth rate, from 8.0 to 2.5%, in developing and emerging economies - the world output is expected to rise by 4.8% in 2010 and 4.2% in 2011, being largely driven by a strong growth in the latter group of countries (forecast by IMF at 7.1% and 6.4%, respectively).

Figure 1.2. World industrial production growth, levels

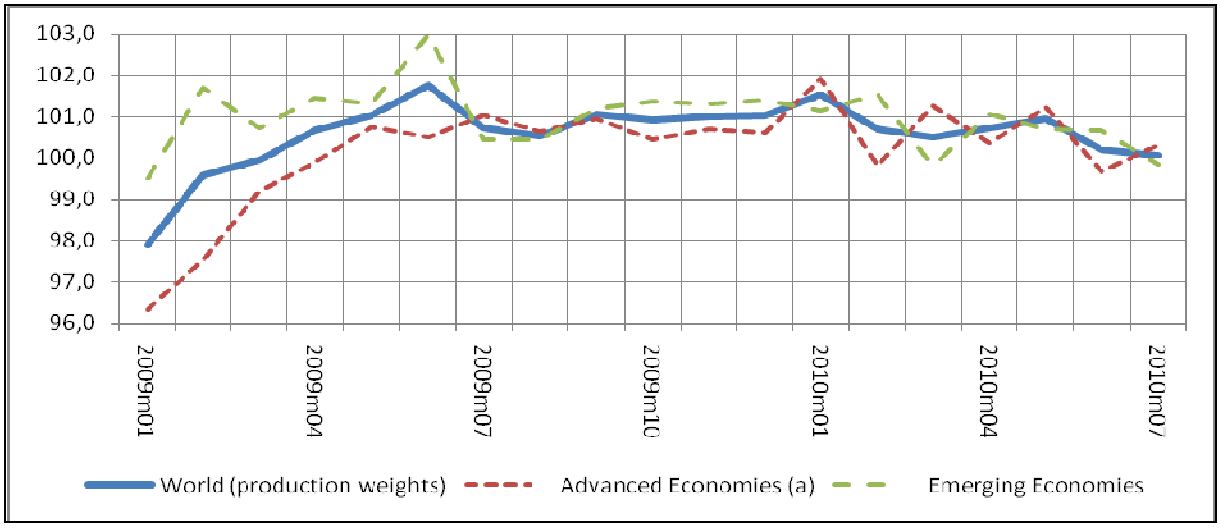


Source: CPB, World Trade Monitor, July 2010.

In mid-2010, the volume of world industrial output surpassed the pre-crisis level of Q1 2008, and the growth curve over the year of recovery occurred steeper than the trend line for 2002-2008 (Fig.1.2).

The monthly growth rates (m/m) of the world industrial output reached their peak for 2009-2010 in June 2009, at least in advanced economies, and levelled off afterwards, showing a fluctuating, declining trend in H1 2010 (generally with positive values, i.e. indices surpassing or approaching 100.0) - Fig. 1.3.

Figure 1.3. World industrial production 2009m01-2010m07– volume indices s.a. (previous month=100)

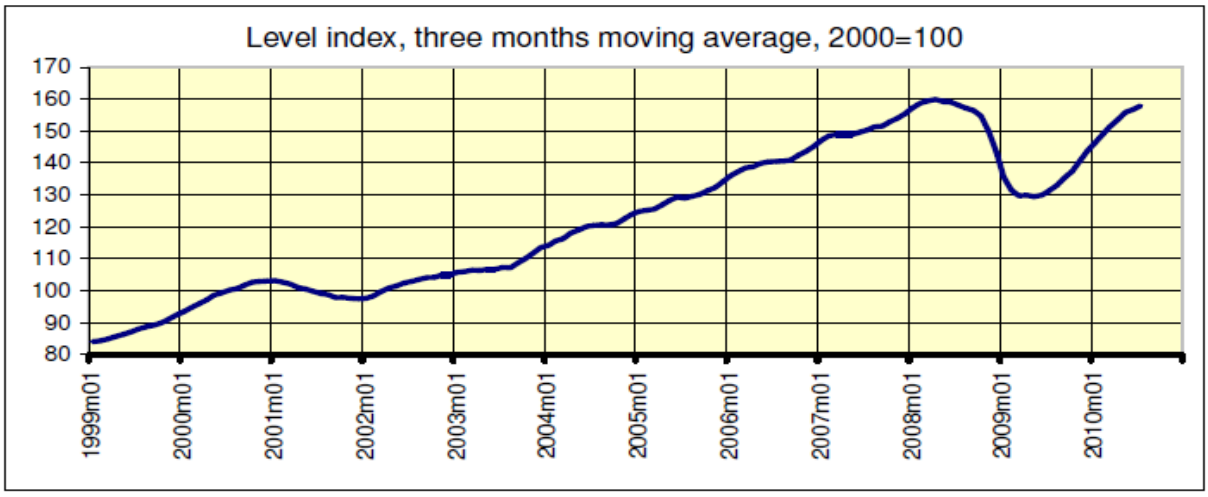


(a) OECD excluding Turkey, Mexico, Korea and Central European countries.
Source: CPB, World Trade Monitor, July 2010.

The world trade

The fluctuations of world trade have been much deeper in recent years than those of the GDP and of the industrial production. The volume of world trade in goods and services that fell sharply in 2009 (by 11.0%) is going to regain possibly its pre-crisis level in 2010, after an annual growth of 11.4%, expected for this year by the IMF (WEO, October). The expansion of world trade is forecast to continue in 2011, with a slower but respectable pace of 7% (IMF). The world trade in goods declined more steeply (by 12%) in 2009, to the level of 2005, but its recovery could also be steeper in 2010 (12.5%), despite a possible moderation of growth in H2 of this year (Fig. 1.4).

Figure 1.4. Volume of world merchandise trade, 1999-2010, monthly data (moving average), s.a.



Source: CPB, World Trade Monitor, July 2010.

The past and projected by IMF changes in volumes of external trade in goods of both main country groups and in the world trade in 2008-2011 are presented in Table 1.2.

Table 1.2. Annual volume changes in the world trade in goods, by main country groups, 2008-2011[a]

	2008	2009	2010[a]	2011[a]
World	2.7	-12.0	12.	7
Advanced economies				
Exports	1.8	-13.8	12.4	5.9
Imports	0.3	-13.6	11.3	5.3
Developing and emerging economies				
Exports	4.3	-8.5	12.3	8.9
Imports	8.4	-9.3	14.9	10.2

[a] IMF projections.

Source: IMF, October 2010, as in Figure 1.1.

A stronger surge in the world trade (exports) flows - by 13.5% - has been envisaged for 2010 by WTO experts, in their forecast of 20 September (WTO, PRESS/616), revised upward from 10% expected by WTO in March 2010.

This was commented upon rather optimistically by WTO Director-General Pascal Lamy, as follows: “This surge in trade flows provides the means to climb out of this painful economic recession and can help put people back to work. It underscores, as well, the wisdom governments have shown in rejecting protectionism.”

The 2010 forecast difference with IMF stems mostly from much higher growth of merchandise exports volume of developing economies (16.5%) predicted by WTO (Table 1.3), although it should be born in mind that the IMF and WTO series are not fully comparable.

Table 1.3. Volume of merchandise exports by region, 2008-2010[a]

Annual % change	2008	2009	2010[a]
World	2.2	-12.2	13.5
Developed economies	0.8	-15.3	11.5
Developing economies and CIS	3.8	-7.8	16.5

[a] WTO projections.

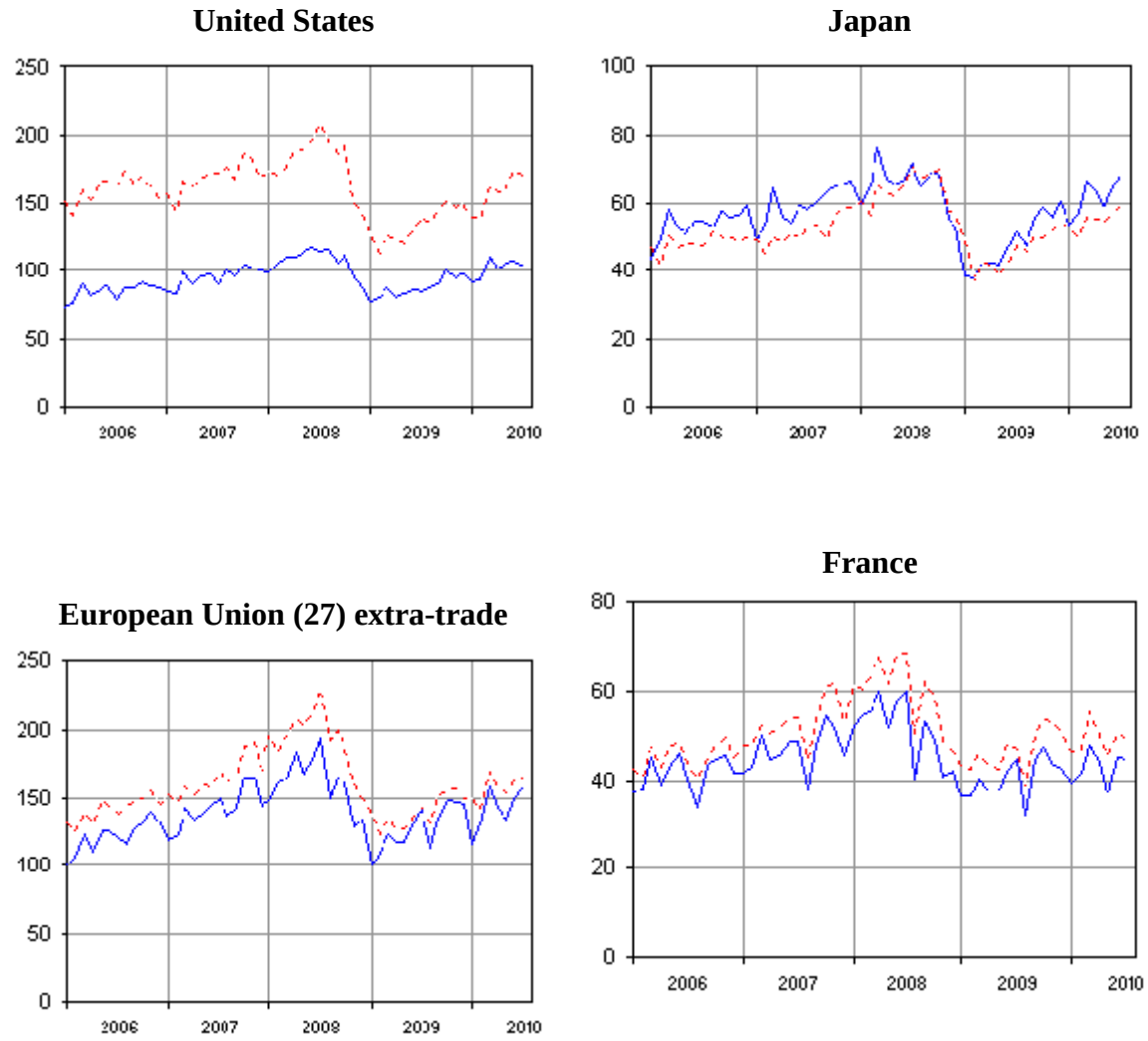
Source: WTO, 2010 Press Releases, PRESS/616, 20 September 2010.

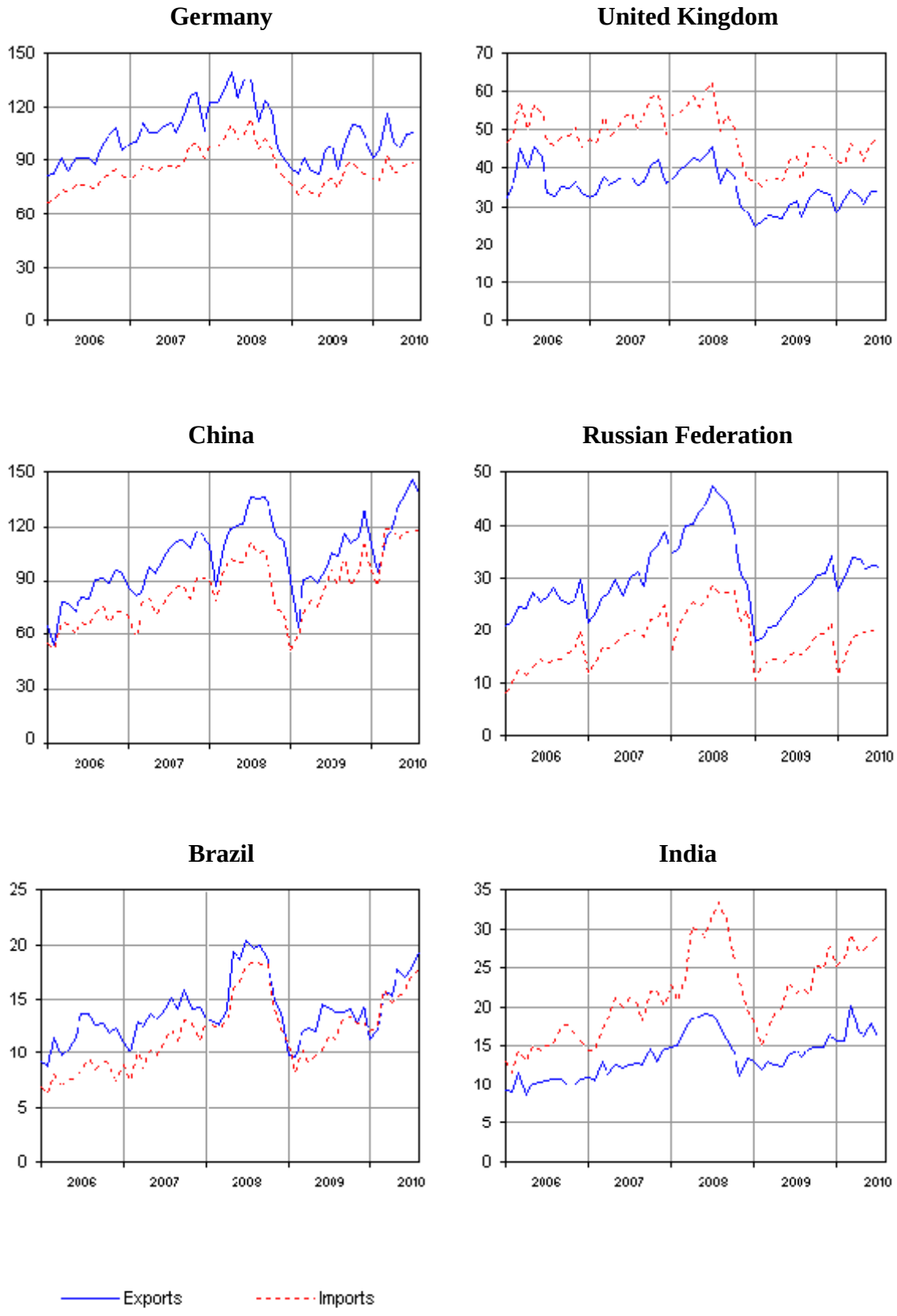
WTO Press report stressed also that: “This would be the fastest year-on-year expansion of trade ever recorded in a data series going back to 1950. But such a large growth rate should be understood in the context of a severely depressed level of trade in 2009, when world exports

plunged by 12.2%. The next fastest year-on-year growth was 11.8% in 1976, one year after the then unprecedented decline of 7.3% in 1975."

Monthly profiles of trade levels of selected economies in January 2006-August 2010, derived from the WTO Press Release, are shown in Figure 1.5.

Figure 1.5. Monthly merchandise exports and imports of selected economies, January 2006 – August 2010 (billion dollars)





Sources: WTO 2010 Press Releases, PRESS/616, 20 September 2010.

Upward revisions dominate in GDP and trade forecasts for 2010

Most institutions have revised upwards their spring global and regional projections of output and trade in summer (interim forecasts) and in autumn 2010, in particular for the US and the emerging economies, but also for the EU (notably under evidence of a stronger growth of the German economy than envisaged earlier).

The IMF brought up its forecast of the world output growth in 2010 from 4.2% (WEO April) to 4.8% (October), including the upward revisions of the GDP in advanced economies from 2.3% to 2.7%, and that for developing and emerging economies from 6.3% to 7.1%.

The world trade growth (goods and services) forecast of IMF has been raised from 7.0% to 11.4%, similarly as the WTO projections (see above).

Moderation and caution prevailing in forecasts of output, investment and employment for 2011, with downward risks pending; "*Heating Up in the South, Cooler in the North*"[2]

The profile of most global and regional forecasts for 2010-2011 has changed somewhat, in comparison with those published in spring 2010. Then a gradual recovery, with a rising pace in 2011, was rather envisaged. Now, in autumn, better than expected results noted in H1 2010 and the revised upwards forecasts for this year have been accompanied by a relatively slower pace of recovery predicted for 2011.

In absolute terms, however, the growth rates of output and trade projected for the next year are not necessarily lower than those presented in earlier forecasts. Actually, the GDP growth in advanced economies projected for 2011 in October by the IMF was by 0.2 percentage point lower than in the April projections, but the 2011 forecasts for developing and emerging economies, and for the world, were only by 0.1 p.p. lower in the WEO of October. They have been revised recently upwards by IMF experts, notably for the emerging Asia: up to 9.4% in 2010 and 8.1% in 2011[3].

Growth of major advanced economies is possibly approaching its normal, sustainable level, despite some pending downward risks, notably those associated with fragility of the financial system, volatility of exchange rates ("The War of Currencies"?) and with high structural fiscal deficits and public debts in many economies.

A moderation or a slight slowdown of growth rates, notably in advanced economies, is, however, possible in Q3 2010 and Q1 2011, as suggested by the OECD Composite Leading Indicators or other indices, including Ifo World Economic Climate indicators (Figure 1.6).

The conclusions of the Ifo World Economic Survey (III/2010) for Q3 2010, concerning the world economic climate, were rather mixed:

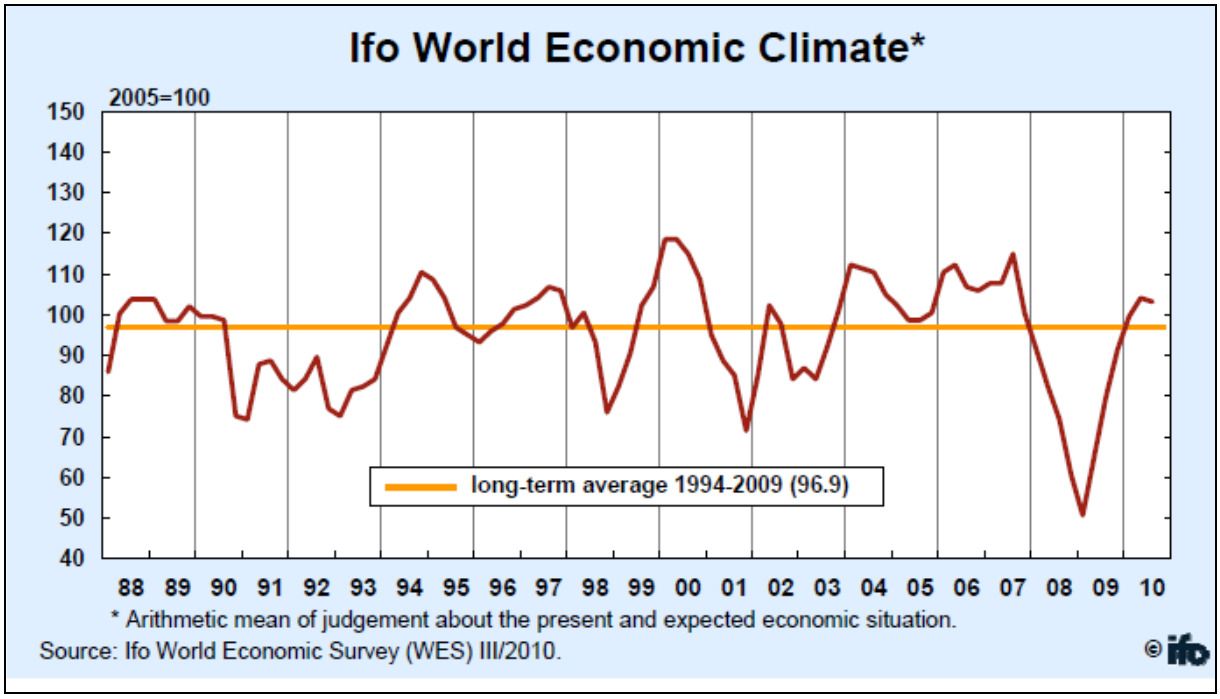
"The Ifo World Economic Climate clouded over slightly in the third quarter of 2010. Although the surveyed experts have given better assessments of the current economic

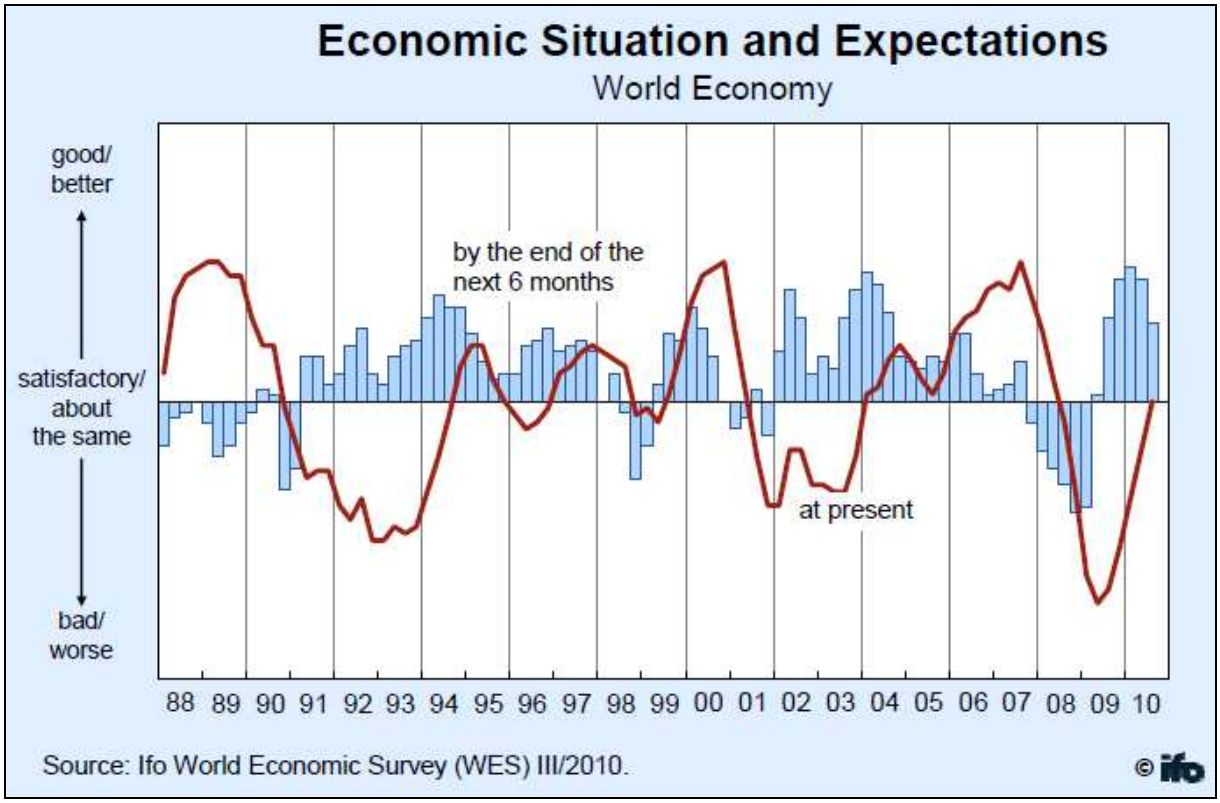
[2] IMF, Regional Economic Outlook: Western Hemisphere. Heating Up in the South, Cooler in the North, October 2010.

[3] IMF, Regional Economic Outlook: Asia and Pacific. Consolidating the Recovery and Building Sustainable Growth, October 2010, Table1.1, p. 24.

situation than in the first half of 2010, the economic expectations for the coming six months have been revised downwards. The results indicate that the recovery of world economic activity will continue at a slower pace in the second half of the year".

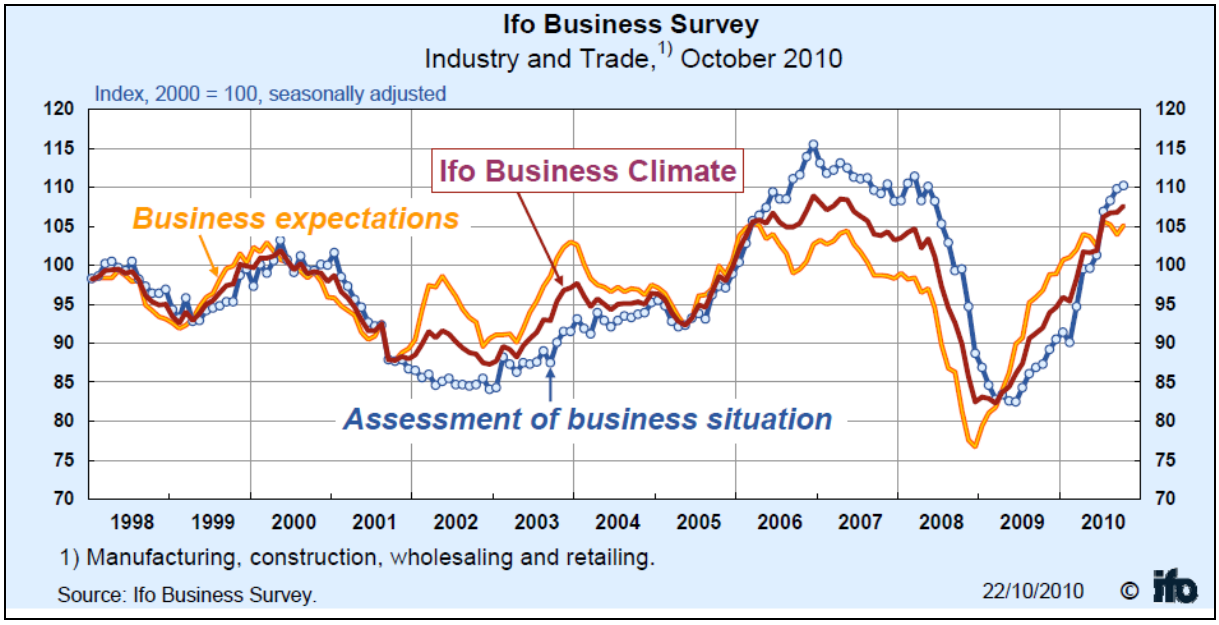
Figure 1.6. World economy climate in view of Ifo indicators (August 2010)





The latest results of the Ifo Business Survey for German economy (22 October 2010) have shown, however, that the assessments of the business situation and expectations in industry and trade appear rather good and improving (Figure 1.7).

Figure 1.7. Indices of Business Climate in German Industry and Trade (2000=100, s.a.) presented in Ifo Business Survey, October 2010



That is an essential signal not only for Germany, but also for the whole euro area and the EU.

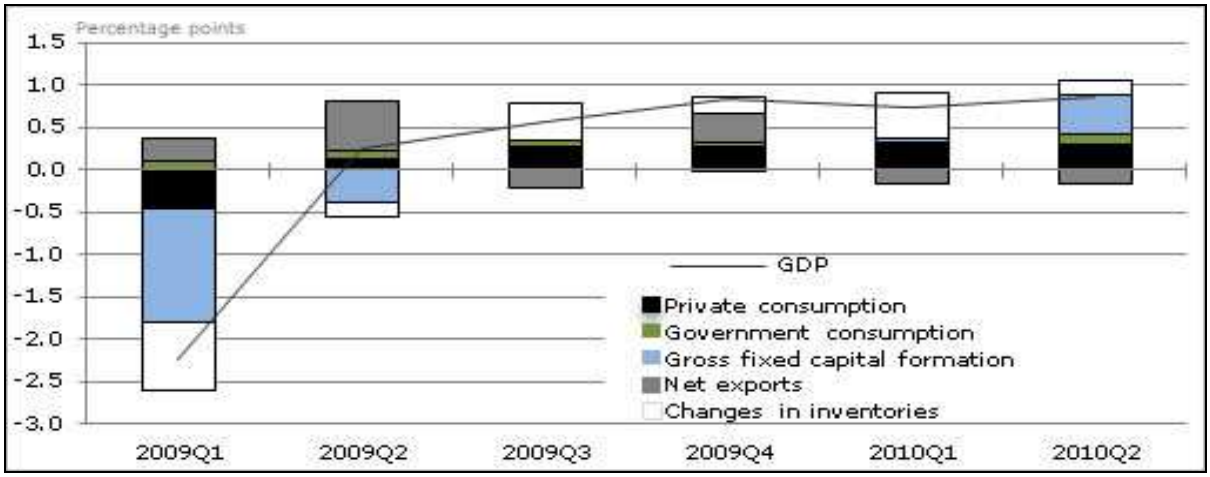
Rather positive business expectations might be associated, *inter alia*, with a marked recovery of investment in the US and other economies. According to the OECD:

"Real GDP in the OECD area increased by 0.9% in the second quarter of 2010 from the previous quarter, a stronger pace than previously estimated (0.7%).

Gross fixed investment was the main contributor to the GDP increase, adding 0.4 percentage point to overall growth. The rise in investment was the first since early 2008, and the pace was the fastest since the first quarter of 2000"[4] (Figure 1.8).

[4] OECD, Press Release, Quarterly National Accounts - Contributions to GDP growth - Second Quarter 2010, OECD: Investment rebound supports OECD GDP growth in the second quarter of 2010, 06/10/2010.

Figure 1.8. Contributions to OECD real GDP growth



Source: OECD, Press Release, Quarterly National Accounts: Quarterly growth rates of real GDP. 06/10/2010.

Projections and views of the AIECE Institutes

The AIECE Institutes have generally augmented their economic projections for 2010, while the figures given for GDP growth in 2011 remained lower than those for 2010 - for the world and its main regions, including the US, Euro area and Asia.

A risk of a "second dip" is perceived by the institutes rather as insignificant. Nevertheless, a slowdown of recovery in advanced economies is assessed as quite probable, notably if the fast economic expansion of the emerging Asia, pulling imports from other regions, were hindered by overheating, financial disorder or structural imbalances; or if the financial deleveraging in advanced economies were too hasty; or the plans for a gradual improvement of their public finances occurred unfeasible.

The economic and financial linkages and interdependencies between the main world regions are, however, mutual. Any new financial collapse or a rise of trade protectionism in the economically advanced countries would imply a serious blow to growth prospects of the emerging economies.

Questions for discussion on the global economic environment:

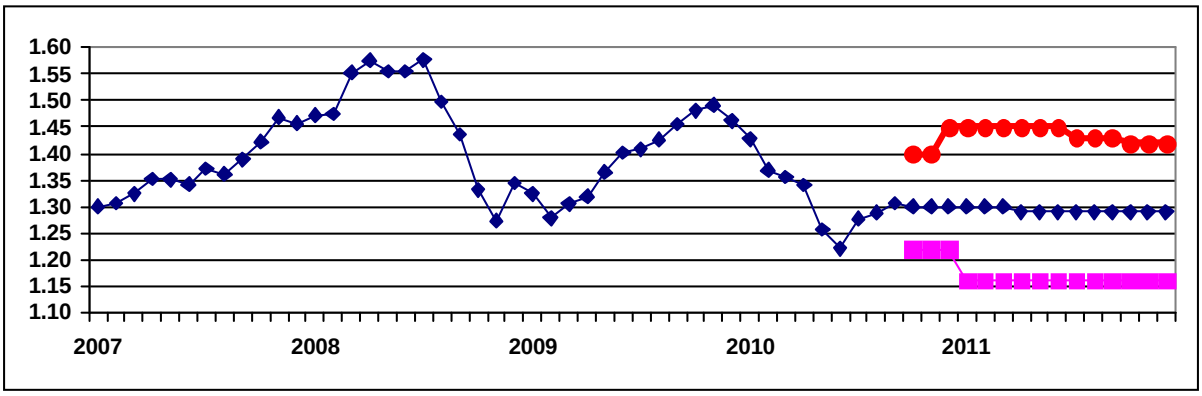
- **Is the "two-speed growth" only the feature of the present recovery, or rather a structural attribute of the future global growth in the coming decade?**
- **What are the main downside risks facing the global recovery in 2011?**
- **Is "The War of Currencies" a real international economic policy problem, to be solved by new institutions or regulations?**

1.2. Exchange rates

Financial turmoil and uncertain outlook of the world economy induce high exchange rate volatility. According to many AIECE Institutes, it is to persist in the forecast period. There are risks on the ground of economic fundamentals practically for all exchange rates (KOPINT). Nervousness in the markets will disappear only when the industrialised economies clearly move out of the crisis and embark on a more dynamic growth path (BIPE).

The Greek crisis triggered a strong appreciation of the dollar against the euro - from 1.49 USD/EUR in November 2009 to 1.22 USD/EUR in June 2010. Afterwards the trend reversed as the crisis was solved and improved outlook of the European economy was accompanied by gloomy performance in the US. The dollar depreciated to 1.31 per euro in September 2010 and to 1.39, according to the recent quotations (as of 22nd October).

Figure 1.9. USD/EUR exchange rate



Source: ECB (actual January 2007 - September 2010),
The AIECE Institutes (forecast: 2010Q4 - 2011Q4; mean, min and max scenarios).

Mean of the AIECE Institutes' projections put the USD/EUR exchange rate on a stable path of 1.30 on average both in 2010 and 2011, though with important differences between individual projections. For 2010, they vary from 1.25 to 1.38 USD/EUR, and for 2011, they represent even a wider band, from 1.16 to 1.42 USD/EUR.

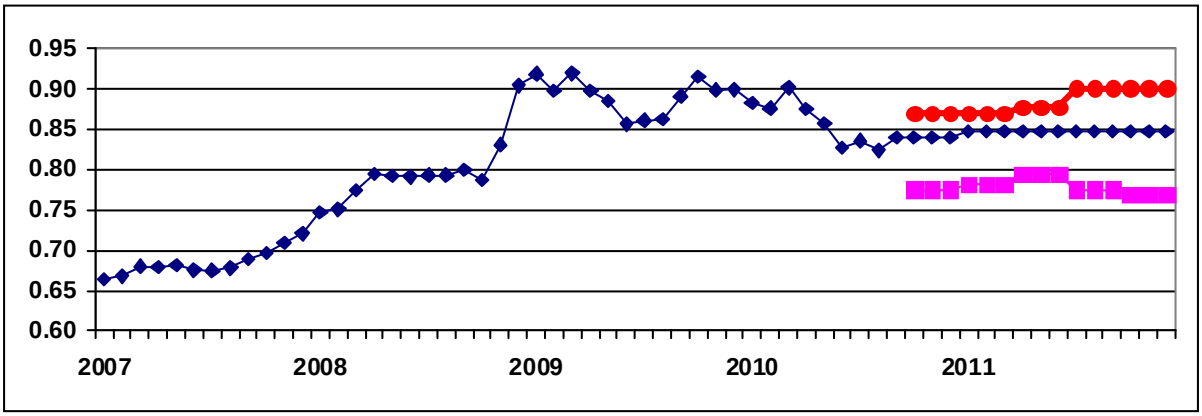
The views of the AIECE Institutes can be aggregated into three groups:

- The USD/EUR exchange rate would remain quite stable in the forecast period, which is based on technical assumption of its random walk in the short run (CPB) or on the assessment that the economic situation as well as short- and long-term interest rates on both sides of the Atlantic would follow the same pattern in the coming months (IRES).
- The dollar depreciation against the euro would continue into 2011 because of the narrowing of the growth differentials (WIFO), quantitative easing implementation by the Federal Reserve (FPB), an increased focus on the US debt problems (CSE) or in order to structurally adjust the US current balance, i.e. to reach and maintain a deficit around 2.5-3 per cent of the GDP (Prometeia).

- The trend would reverse again and the dollar would start to appreciate against the euro. The arguments for such option are as follows: uncertainty about Eurozone growth prospects will arise in the second half of 2011 (ISAE) and a fall of the European growth rate below the one in the US can be expected (COE), fiscal turmoil in Europe should outweigh deficit worries in the US (KOF), the rise in the US long-term interest rates would be stronger than that in Europe (COE). Besides, there is mentioned a risk that in the view of still fragile financial situation of some European countries as Greek, Ireland, Spain and Portugal, new pressures on the euro cannot be excluded.

The pound strongly lost against the euro during the financial crisis, but from the beginning of 2009 the exchange rate stabilised within a band of 0.82 - 0.92 GBP/EUR. The mean of the AIECE Institutes' forecasts indicates quite a stable path of 0.85 GBP/EUR till the end of 2011.

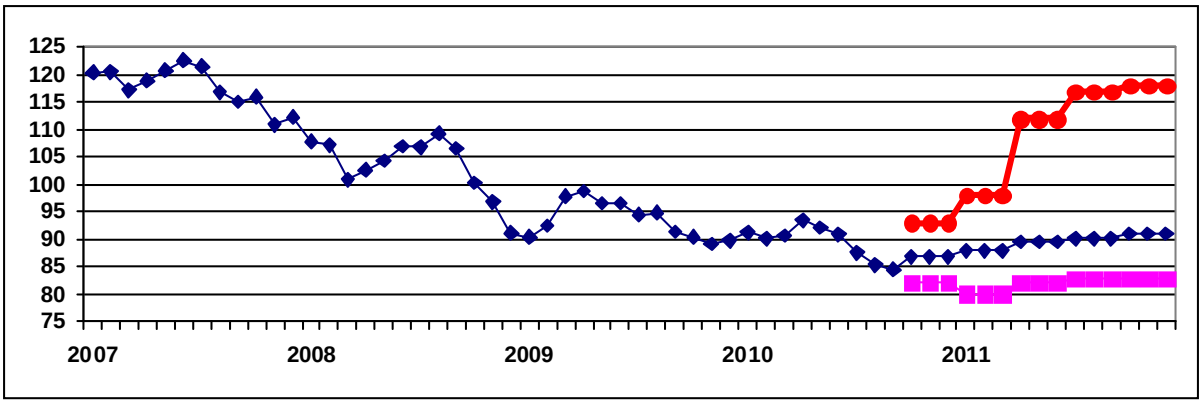
Figure 1.10. GBP/EUR exchange rate



Source: ECB (actual January 2007 - September 2010),
The AIECE Institutes (forecast: 2010Q4 - 2011Q4; mean, min and max scenarios).

Since the mid-2007 to September 2010, the yen strongly appreciated against the dollar and the euro – from 122.6 to 84.4 and from 164.6 to 110.3 respectively.

Figure 1.11. YEN/USD exchange rate



Source: ECB (actual January 2007 - September 2010),
The AIECE Institutes (forecast: 2010Q4 - 2011Q4; mean, min and max scenarios).

The AIECE Institutes believe that the yen would cease to appreciate against the dollar as a result of the intervention of the Japanese central bank (CCSF) or expected changes in interest rates' differentials in favour of the US ones (COE). The mean of the institutes' forecasts indicates a gradual depreciation of the yen from 86.8 JPY/USD in 2010Q4 to 91 JPY/USD in 2011Q4, though with wide differences between individual projections (from 82.8 to 118 at the end of the period). The yen/euro yearly average is placed at 117.1 in 2010 and 115.6 in 2011 (mean) as compared with 130.3 in 2009.

The Chinese yuan has remained pegged to the dollar, hence against the euro it followed the USD/EUR path, i.e. a gradual appreciation in the period from November 2009 (10.2 CNY/EUR) to June 2010 (8.32 CNY/EUR), followed by a slight depreciation, to 8.81 CNY/EUR, in September. Renewed pressures on the Chinese authorities for appreciation of the undervalued yuan reappear both from Europe and the US.

Table 1.4. Balance on current account, per cent of GDP

	2007	2010	2011
Advanced economies	-0.9	-0.3	-0.1
USA	-5.1	-3.2	-2.6
Euro area	0.4	0.2	0.5
Japan	4.8	3.1	2.3
United Kingdom	-2.6	-2.2	-2.0
Central and Eastern Europe	-8.0	-3.7	-4.0
Russia	5.9	4.7	3.7
China	10.6	4.7	5.1
Brazil	0.1	-2.6	-3.0

Source: IMF.

Under the impact of the crisis, the global imbalances have been reduced and the IMF projects their further reduction in 2011, though with some important exceptions (e.g. Euro area, Central and Eastern Europe, China, Brazil). However, the outlook could change if the danger of "currency war" with major economies' monetary authorities playing for devaluation of their currencies materialises.

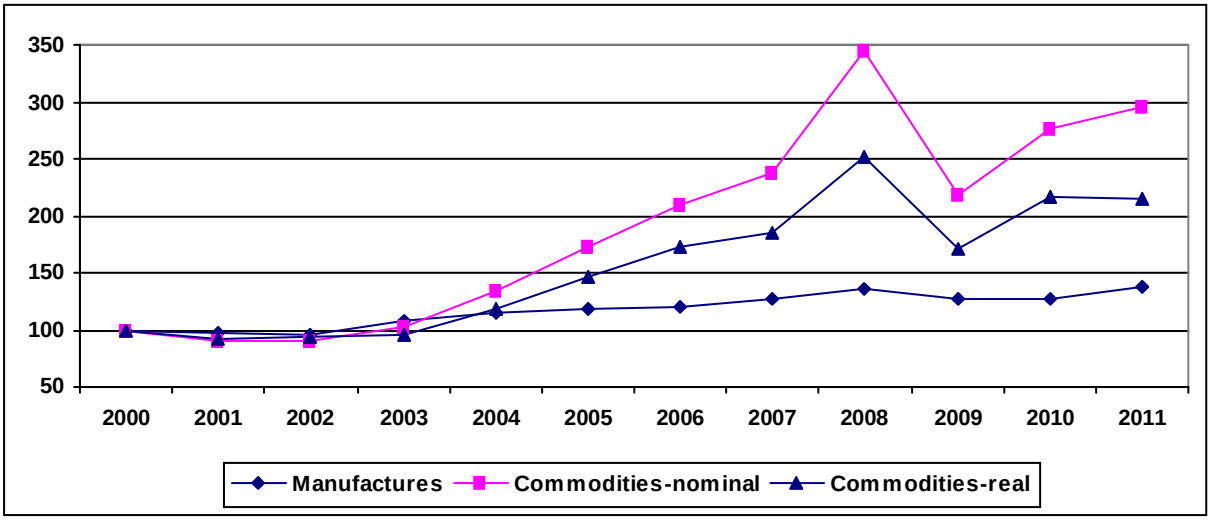
Questions for discussion:

- **Which arguments of the AIECE Institutes – for further depreciation of the dollar against the euro, for its renewed appreciation or for stabilisation of the exchange rate – do you find the most convincing?**
- **Do you believe in the Chinese yuan revaluation?**

1.3. Oil and commodity prices

The outlook for oil and raw materials prices reflects a fragile world economic recovery. Though "all commodities" HWWI price index is to increase by as much as 29 per cent in USD terms this year, the rise would stem mainly from the carry-over effect as growth rates in successive quarters of 2011 proved quite modest – by 4 per cent both in the 1st and the 2nd quarters followed by stagnation in the 3rd quarter. In view of economic slowdown in the USA, China and Japan, accompanied by ample commodity stocks, supplies have been more than sufficient to cover weakening demand, thus easing the pressure for major price raises. The market balance and hence the price trends would not much change also in 2011 as the recent commodity forecasts indicate. The IMF WEO projects only 3.3 per cent rise in oil price next year together with 2 per cent fall in non-fuel commodities price index. Slightly higher is the projection of the AIECE Commodity Group that includes 7 per cent rise in yearly average oil price level and 8 per cent price rise for commodities excluding energy.

Figure 1.12. Nominal and real commodity prices, USD terms, 2010=100



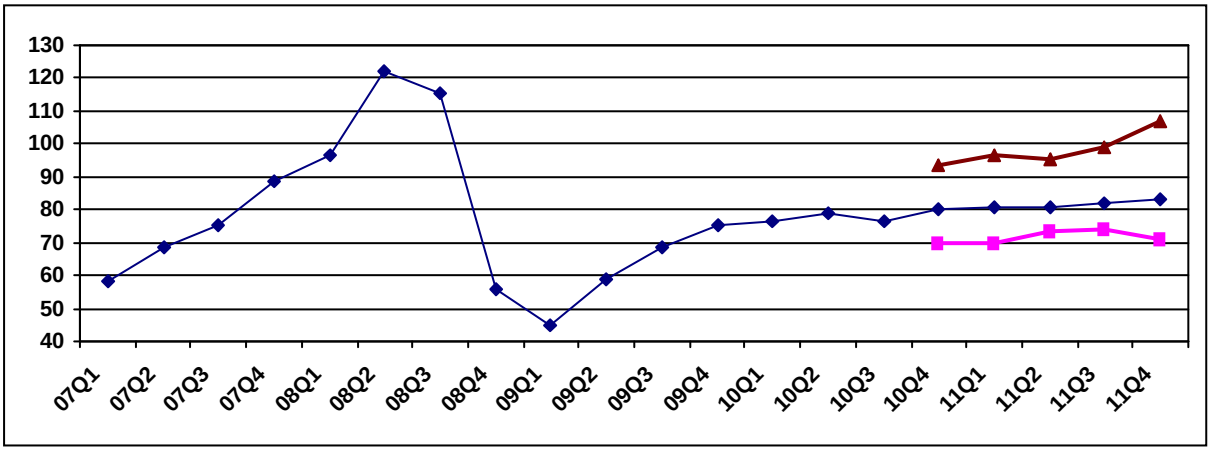
Source: AIECE Commodity Group, IMF WEO, IBRKK calculations

Even under a relatively higher scenario of the Commodity Group, one could expect a fall in real commodity prices (i.e. nominal prices deflated with export unit value of manufactures) as well as in commodity price index in euro terms next year provided that the recent depreciation of the US dollar persists. Nevertheless, raw materials would remain quite expensive by historical standards with their nominal and real price levels as projected for this and next year lower only to their 2008 peak.

In the last four quarters (from 2009Q4 to 2010Q3), oil price (Brent) fluctuated in a narrow band of USD 75-79/bbl showing only recently a modest rise to USD 85/bbl in mid-October under the impact of weaker dollar. The strong upward price trend that prevailed in 2009Q1-3 has been hampered by rising oil production (especially in non-OPEC countries, including the USA, Russia and Brazil), accompanied by higher (as compared with mid-term average) commercial oil inventories in OECD countries, OPEC spare capacities rebuilt to normal levels and the signs of economic slowdown in some major oil consuming countries, including China.

Though the recent oil price rise could be supported in near term by the seasonal factor (as demand usually strengthens in winter months), the projections for 2011 show still quite a stable price level with only limited support to its significant rise. According to the International Energy Agency, the global oil demand yearly growth would decline from the expected 2.1 mbd in 2010 to 1.2 mbd in 2011 (and if GDP growth were a third lower, demand growth would only reach 0.4 mbd next year). Diminishing increment in the world oil consumption (from 1.7 mbd in 2010 to 1.4 mbd in 2011) is also projected by the US Energy Information Administration (EIA). Although the EIA expects a gradual reduction in OECD oil inventories as well as lower non-OPEC supply (due to declining North Sea, North American and Russian deliveries), rising OPEC production should keep the price from increasing dramatically. A major downside risk can be connected with a possible double-dip scenario, while on the upside with sustained, stronger than expected USD depreciation.

Figure 1.13. Oil prices, Brent, USD/bbl



Source: World Bank (actual: 2007Q1 - 2010Q3), the AIECE Institutes (forecast: 2010Q4 - 2011Q4; mean, min and max scenarios).

The AIECE Institutes views

The scenario of relatively stable oil price is supported by the AIECE Institutes. Mean of forecasted quarterly profile indicates end-of-the-quarter price close to USD 80/bbl in 2010Q4, USD 81/bbl in 2011Q1-2, USD 82/bbl in 2011Q3 and USD 83/bbl in 2011Q4, with projections at the end of the forecast period ranging from USD 71/bbl to USD 107/bbl. Next year's average would reach USD 81.5/bbl, i.e. only 4.6 per cent up the price expected in 2010 (USD 77.9/bbl).

As determinants of oil price path in the forecast period, the AIECE Institutes usually regard such factors as: oil demand growth (though with divergent opinions on what would prevail as price determinant – global slowdown or still strong demand from emerging economies), surplus production capacities and OPEC's ability to control supplies. Some Institutes also discuss the possible impact of exchange rates, speculative investments and spillover effects of the fires in Russia this summer or link the price with general inflation in the US.

- A possible decrease of oil price is seen as the combined effect of global slowdown and increasing supply of oil (GKI).

- There is some slight upside pressure due to increasing demand. However, capacity usage remains low and price increases are contained (DIW). Supply can quickly respond to a possible demand growth, thus keeping prices relatively stable (SKEP). Moreover, the deceleration of growth in advanced countries and, to a lesser extent, in developing areas, in the second half of 2010 and in the first part of 2011 would contribute to keep oil price rather stable (ISAE). The price would rise at an accelerated pace from 2011Q3 (OFCE, CEPREDE).

- The huge amount of liquidity in the market could feed speculative investments in the commodity markets, increasing volatility of the prices and with possible short-term hikes in oil price (Prometeia), though investors prefer gold or silver (KOPINT).
- Risks for large changes in both directions are quite substantial. China is a key as has been in recent years (ETLA). In view of OPEC's ability to control the market, we could reject the hypothesis of sustained oil price below USD 70/bbl, while we could not exclude the hypothesis of its sustained rise over USD 80-85/bbl, though we do not regard it as the most probable scenario (COE).

In the non-energy segment of commodity markets, this year's summer months saw a dramatic rise in the prices of cereals. Wheat price increased by 60 per cent between June and September, triggered by reduced global production forecasts (mainly due to drought and wildfires in the CIS as well as flooding in Pakistan), which was accompanied by the USD depreciation and speculative buying. Though the AIECE Commodity Group expects cereals price growth to expire next year, the recent surge would translate into a substantial, 27 per cent rise on yearly basis in 2011. Quite a strong yearly average price increase next year is also projected for oilseeds and vegetable oils (by 17 per cent) and for ferrous raw materials (by 14 per cent), while the price level is to decrease in the case of wood products (by 8 per cent) as well as tropical beverages and sugar (by 1 per cent). Non-ferrous metals would note a modest, 7 per cent price rise.

Another phenomenon that deserves attention concerns soaring prices of precious metals (that are not included into the group of base commodities). Gold prices were recently (on 20th October 2010) trading at USD 1341/ounce, over 40 per cent higher as compared with the last year's average. Beside the strong jewellery demand in India and the Middle East, the price rise was fuelled by gold perception as a low risk asset – an important factor in the period of financial turbulences and overall economic uncertainty.

Questions for discussion:

- **Do you believe in "no-hike" oil and commodity price scenario? How do you assess the major upside and downside risk factors (e.g. demand growth, possible disruptions to supplies for geopolitical reasons, speculative buying, future exchange rates developments)?**
- **What would be the impact of slower commodity price growth on inflation expectations and current account/trade balance in your country? Do you regard it as a significant support for economic recovery?**

1.4. Monetary and financial markets

The situation in monetary and financial markets in 2010 as well as probably in the year 2011 will be shaped by the following events:

- ways, in which central banks decide to unwind extraordinary measures applied to combat crisis,
- decisions taken by governments to temper world internal and external imbalances,
- means and ways of rearrangement of the financial system.

As central banks play an important role in supporting the existing financial systems, their job now is to unwind the measures they have been putting into operation to master excess liquidity, which has been used to keep financial systems alive. Consequently, as for today, we observe the following in the developed world: a weak (although positive) economic activity, lasting world imbalances, high unemployment and not confirmed stability of financial systems. That state of affairs, if continued, will sooner or later affect the financial situation of emerging and developing markets.

If the liquidity trap confirms its existence, and central governments are not able to increase their outlays due to excessive general government sector debt, the "zero interest rate policy" won't bring major players back on the growth track (and reduce output gap). The development of the balance sheets of the most important money players has demonstrated so far that the year 2010 is an episode of "reflection" interrupted by unexpected events. The central banks face the vital decisions concerning further actions, which are still ahead of them.

In 2011, we shall see how the indebtedness problem will unfold in some regions and the world economy will further respond to the crisis. If we face jobless recovery or sluggish and erratic growth, the central banks will long be considering when and how to tighten their policies. FED and other CBs will not want to share the blame for sluggish internal activity of non-financial enterprises and falling private consumption (as well as erratic capital markets). How that will influence the export-oriented policy in the situation where everybody wants to diminish output gap thorough net exports is another matter.

Financial markets are still fragile and they overreact to the development of different scenarios as, for instance, the development of sovereign debt problems in the euro area. As a consequence, spreads in the markets stay under the influence of the indebtedness problems and still existing world imbalances. One can presume that when economy starts to accelerate, the existing world's imbalances - external and internal (kind of cross twin deficits) - will tend to widen, which could further increase volatility of interest rates, exchange rates and assets prices.

Short- and medium-term prospects for both high-income and developing countries seem to be complicated, especially if the financial sector is not suitably reorganised. For high-income countries, weak financial sectors will make it even more difficult to curb public outlays and set public finances on a sustainable growth path. The IMF (2010) estimates that high-income countries will need to cut government spending (or raise revenues) by 8.8 percent of GDP for a 20-year period in order to bring debt levels down to 60 percent of GDP by 2030. And that is not only the DC concern as, for instance, India and other EMs must fight their public sector debt problems.

In these circumstances, the economic climate or, better to say, confidence felt by the major players seems to play an especially important role in diminishing the uncertainty, volatility in

the markets. More than ever, the financial system is under the influence of biased information, herd-like decision, and different, often contradictory, opinions. The Japanese experience of previous years proved that unless within the financial sector decision makers are not sure that the system is resilient and safe, we will not see stabilised banking relations. All formulated by BIS proposals to augment capital and liquidity as well as stress tests undertaken so far seem to calm the climate, but in November we will witness how universally the banking regulations could eventually be agreed upon, when they are implemented, what will stay outside the regulators supervision.

Central banks policies

Potential downside of economy of DCs, combined with the strains in interbank and sovereign markets, complicated exits from the extraordinary fiscal and monetary policies initiated some months ago. For the major CBs markets now anticipate a lengthening of the "extended period" of very accommodative monetary policy. In fact, the ECB has not only reinstated some of its extraordinary operations for liquidity provision, but has also announced a program to purchase sovereign debt. Despite that J. C. Trichet repeats its dedication to unwind the measures used by the Bank. Others, like FED, Bank of Japan and Bank of England do not hesitate and have already announced further QE policy.

FED

The U.S. administration proposed recently a package of $180 billion in business tax breaks and infrastructure outlays to boost spending and job growth. Having helped corporations with over $1 trillion package, FED is now turning its attention to consumers' balance sheets. The U.S. government's total outstanding debt is about $13.5 trillion. Even after the stimulus measure and other government actions, the U.S. unemployment rate stays at 9.6 percent. In the USA, unemployment is an important target for FED and the most important target for politicians. In these circumstances, we can expect FED to pump more money into the economy and keep overnight interest rate unchanged near zero (0.25 percent) - as FED decision makers said: to spur growth and support prices. According to announcements, FED will buy more Treasuries as inflation measures are at levels "somewhat below" the central bank's mandate to achieve stable prices and full employment. As long as jobless recovery threatens economy, we should not foresee FED to tighten monetary policy. On 21st September, the Federal Open Market Committee declared that it "will maintain the target range for the federal funds rate at 0 to 1/4 percent and …. are likely to warrant exceptionally low levels for the federal funds rate for an extended period". The Committee will maintain also its existing policy of reinvesting principal payments from its securities holdings in longer-term Treasure securities.

Bank of England

The Bank of England's policy makers are moving closer to adding more stimuli to the economy after they held the key rate at 0.5 percent and their bond-purchase plan at 200 billion pounds ($317 billion). Bank is joining Fed in contemplating further bond purchases (to do more quantitative easing) to bolster the recovery. Small changes of the level of the lowest since 300 years official bank rate are possible when inflation begins to build up problems to the Bank.

ECB

Despite the surplus liquidity environment (due to the main refinancing operations, one-year longer term refinancing operation and other activities), the redistribution of interbank liquidity has been far from normal. Ongoing concerns about counterpart credit risk and the increased intermediation role of the Eurosystem continued to hamper interbank lending activity. Ongoing turbulence reached a peak in early May 2010 when liquidity in several euro area government bond markets almost vanished amid concerns about tail and contagion risks.

In view of these developments, on 9 May 2010, the Governing Council of the ECB decided to conduct interventions in the euro area secondary markets for public and private debt securities in the context of Securities Markets Programme and to reactivate some of the non-standard monetary policy measures that had been phased out shortly before - to ensure depth and liquidity in those market segments that were dysfunctional. In addition, temporary liquidity swap lines with the Federal Reserve System were reactivated in coordination with other central banks. The ECB starts to buy Greek, Irish and Portuguese bonds, and exit from the Securities Markets Programme in the months ahead seems to be very unlikely, especially if some Eurozone countries will be dependent on support for some time.

Developments in euro area government bond markets varied significantly across countries. Concerns about fiscal deficits in several euro area countries were the main driver of abrupt changes in sovereign credit default swap (CDS) and intra-euro area government bond yield spreads. We assume that if no systemic crisis happens in the months to come (in 2011) banks start to compete with other banks to obtain longer-term funding from the ECB and the interbank market. That could place upward pressure on money market rates, and thus increase the funding pressures for some banks. We think that up to the end of 2010, the ECB won't change its policy. Further steps depend on the development of the debt situation and the resilience of the financial sector of the euro area (reliability of conducted stress tests). Some economists warn the ECB of prolonged QE policy. On the other hand, in October, EONIA jumped 6 months high against the dollar and further interest climb could eventually force the ECB to lower policy rate below present 1 percent. It is interesting to see how the ECB will react to ongoing euro appreciation.

Bank of Japan

After the outbreak of the recent financial crisis, Bank implemented various measures, such as ample liquidity provision to financial markets, provision of complementary lending through a standing facility or U.S. dollar funds-supplying operations. Nevertheless, the bank is now discussing more steps to ease monetary policy and continue to provide ample liquidity to the financial markets. Now as Bank is increasingly occupied with the currency development progressing yen appreciation forced MOF to sell $20 billion of yen securities (first time since 2004). As Japan recovery depends on export, further steps could also be envisaged. Bank was recently facing a mounting pressure to increase monthly purchases of government papers, and politicians flag the possibility of amending the Bank of Japan Law, which guarantees the central bank's independence from the government. To beat deflation in Japan and keep exports growing one cannot exclude that the central bank and the government can work closer (monetize the debt). As a public sector debt is almost entirely "home made", that option is not impossible. If the pressure on further yen appreciation continues (exercising pressure on export and deflation expectations), the bank can increase policy rate and supply of broad money (which rises during 2010 at the modest constant level). For the time being to stop yen to appreciate BofJ lowered its benchmark rate to zero and decided to extend $360 billion loan to banks as well $60 billion of QE (part for public debt).

It is worth to mention that as for now a handful of high-income countries (including Australia, Canada and Norway, Israel, Korea, New Zealand, Sweden) have raised short-term policy rates.

In all developed countries, central banks closely observe how their banks cope with risks to the economy and how sovereign indebtedness develops. The important problem is now to what extent CB's can inflate their balance sheets and how fast they will be able to hammer out the real exit strategy.

Interest rates

Interest rates in the last part of this year and in the period 2011- 2012 will be influenced by the banks refinancing needs. Banks internationally face a substantial refinancing challenge over the coming years, as private sector funding matures and extraordinary public support is withdrawn. Globally, banks are estimated to have at least USD5 trillion of medium to long-term funding maturing over the next three years. It implies that interest rates will stay under pressure between funding demands and repayments strain - the rollover problem, which in May raised Euribor. On top of that, banks run into the very high government deficits and debt levels in several high-income countries (notably, Greece, Ireland, Italy, Portugal and Spain). Debt problems already have provoked a great deal of volatility in international financial (and even commodity) markets and a realignment of global currencies as the euro has depreciated against the dollar (now is appreciating again). Although there was a sharp increase in risk premium yet there are only limited indications of contagion. Following the announcement of nearly $1 trillion aid package by the European Union, IMF and ECB, the initial sharp increase in the price of credit default swaps (CDSs over 100 bps) on the sovereign debt of some European countries receded before rebounding partially in the following weeks. LIBOR-OIS spreads have increased to 32 basis points. Commercial banks were obviously concerned that the ability of counterparts to repay even short loans might be affected by a default or restructuring of high-income sovereign debt. Concerns about banks' sovereign debt exposures contributed to a marked tightening in funding market conditions. Risk appetite measured by Credit Swiss and Bank of England was only 50% lower than in the middle of the crisis.

The following drawings present changes of TED and OIS spread:

Figure 1.14. TED and OIS changes

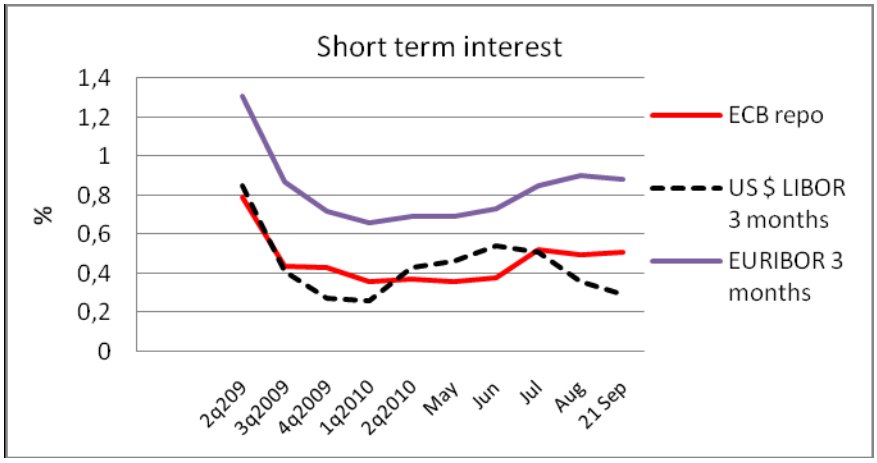
Source: Bloomberg

Nevertheless, LIBOR-OIS spreads remain well below the values observed during the initial phases of the sub-prime crisis, which implies that for the moment (at the end of September), markets are not excessively concerned.

Increased counterpart concerns have caused longer-term LIBOR-overnight index swap (OIS) spreads to widen again. To alleviate these funding strains, the ECB and the U.S. Federal Reserve reintroduced anew flexibility into their liquidity operations. The ECB suspended its collateral requirements on Greek sovereign debt and reactivated some of its long-term operations, while the Federal Reserve reinstated its foreign exchange swap lines. Despite these efforts to improve the functioning of the interbank market, euro area banks are still hoarding liquidity and putting those funds in the ECB's deposit facility.

Likewise U.S. LIBOR eased on expectations of continued loose policy on part of the FED.

Figure 1.15



It is worth to mention that financial institutions for some time have been pricing in increases in both short-term and long-term interest rates, as well as flattening of the yield curve. If medium and long-term interest rates eventually rise more than envisaged, the financial sector find itself anew under serious pressure (the case constituted one of few hypotheses in bank stress test in Europe). That could be also one of the reasons for CB's to stick to zero percent policy rates.

Large interest-rate differentials between developing and high-income countries are likely to remain or widen, increasing carry-trade opportunities. As monetary policy starts to tighten in developing countries, incentives to undertake carry-trades may intensify.

Summing up, one can support the OECD guess about the increase of $ LIBOR from 0.82% at the end of 2010 to 1.25% in 2011 and ELIBOR from 1.02% to 1.15% in 2011. A similar guess one can find in the Bank of England analysis.

Bond yields

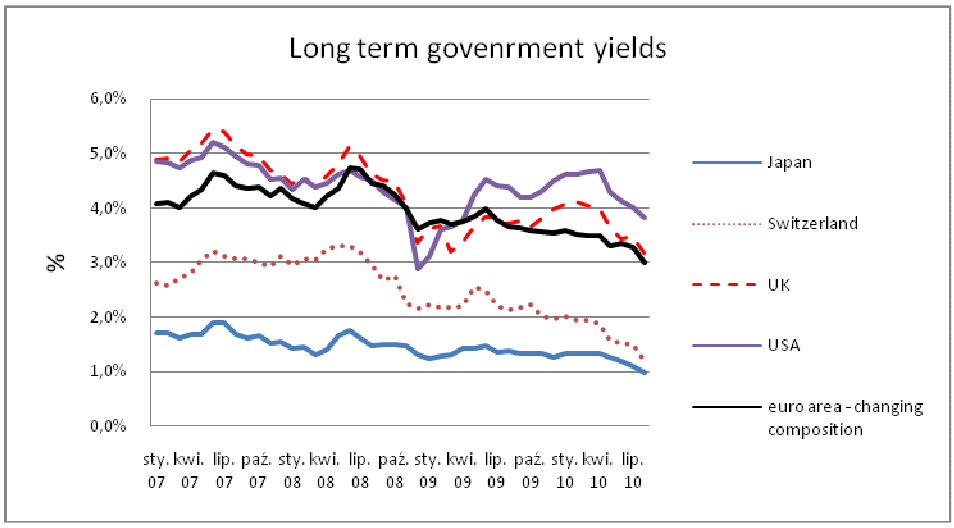
Developments in bond markets were driven by renewed market concerns about the near-term economic outlook for the global economy, and particularly for the United States (worries about the labour market). On top of that, excessive public deficits and rising debt-to-GDP ratios may pose upside risks for sovereign and corporate bond yields in the euro area. Spreads for Ireland, Greece and Portugal began to increase in early August, widening as much as 237 basis points. Despite the watershed events of the European Financial Stability Facility (EFSF) and the European bank stress test, concerns about long-term risks continued to over-hang many of these countries. Ireland came under a particular scrutiny as bank funding pressures

resurfaced, leading to a fresh high in Irish CDS spreads in mid-September. But the recent bond issues from Ireland, Greece and Spain have helped to ease tensions in the European debt markets – at least for the moment. More recently, some differentiation in sovereign credit has also emerged between Germany, which has benefited from safe haven flows, and Belgium, Austria and France.

Against this background, market sentiment worsened and the rebound of risk aversion triggered significant flows away from risky assets. As a result, AAA-rated long-term government bond yields declined markedly in both the euro area and the United States. Nonetheless, the average level of 10-year bonds yields remained above the level suggested by nominal GDP growth determining the long-term equilibrium level for nominal bond yields - from the public sector deficit point of view. That will not alleviate concerns about the credibility of the medium-term fiscal consolidation plans of euro area countries with the largest fiscal imbalances.

Moreover, in the euro area, as well as in the United States, government bond yield curves remained very steep, spurring interest among market participants in carry trades, which involve funding longer-term investments with short-term financing. The ratio between the interest rate differential and its implied volatility – a gauge of the risk-return trade-off in such carry trades – has been increasing since late 2008 and, despite a recent decline, still remained high in mid-September 2010. The build-up of such trades has contributed to raising the risk of their abrupt unwinding, which, if it were to occur, would most likely raise the risk of higher interest rate volatility in the period ahead. Fly from more risky assets to AAA could help to flatten the yield curve (as it was in September). Since May, long government bonds have fallen in EA, USA and Japan. It is difficult to predict for how long that trend will continue, as the prospects for Federal Reserve and Bank of England to expand asset purchases boosted demand for government securities. The Japanese CB also recently decided to buy more government bonds and the whole Japanese banking system is now a dominant buyer of JGB's.

Figure 1.16



In the third and fourth quarters of this year, the rollover financial needs of high-developed countries are at the level above $4 trillion. Most of the credit needs will be taken by developed countries banks, which, at the same time, will be confronted by significant funding pressures coming from maturing bonds in the next few years, especially in the euro area.

Around 50% of the stock of long-term debt securities issued by euro area governments is held by euro area banks. OECD estimates that government borrowing is projected to rise to $19 trillion next year among OECD members, nearly twice that of 2007.

Short- and long-term interest rates and the forecast for the coming 18 months are presented in the table below:

Table 1.5. Long-term interest rate per cent per annum - 10 yr government bond yields

	2006	2007	2008	2009	2010	2011
Switzerland	2.52	2.93	2.90	2.20	2.29	3.39
United Kingdom	4.50	5.01	4.59	3.65	4.19	5.27
United States	4.79	4.63	3.67	3.26	4.10	5.35
Japan	1.74	1.67	1.47	1.33	1.48	2.23
Euro area	3.84	4.32	4.30	3.79	3.75	4.74
Short-term interest rate per cent per annum, three months	2006	2007	2008	2009	2010	2011
Switzerland	1.56	2.57	2.48	0.36	0.31	1.12
United Kingdom	4.80	5.95	5.49	1.20	0.76	2.52
United States	5.17	5.28	3.20	0.94	0.46	2.43
Japan	0.2	0.7	0.7	0.3	0.2	0.2
Euro area	3.08	4.28	4.63	1.23	0.72	1.93

Source: OECD

Good news is that due to stabilisation of the foreign and public sector debt situation in emerging markets European sovereign debt problems exerted little reaction on these countries' financial conditions (except for CEE and CIS countries).

Differences between European spreads and the spreads in other regions are presented by the following table.

Table 1.6. Difference in spreads between Europe and other regions

	2007	2008	2q209	3q2009	4q2009	1q2010	2q2010	May	Jun.	Jul	Aug.	21 Sep
US Corporate (high yield bonds)	-146	-545	-640	-434	-349	-287	-276	-265	-309	-303	-322	-299
JP Morgan Emerging markets	-39	-36	-36	-15	-49	-64	-52	-51	-49	-47	-45	-48
Asia	-3	15	71	70	25	4	34	40	48	57	70	75
Latin America	-50	-56	-81	-47	-95	-119	-110	-110	-108	-105	-103	-111
Middle East	-318	-215	-151	-101	-130	-83	-78	-70	-65	-96	-124	-115
Africa	-130	-82	-22	62	16	11	-1	24	-51	-58	-57	-51

Debt problems

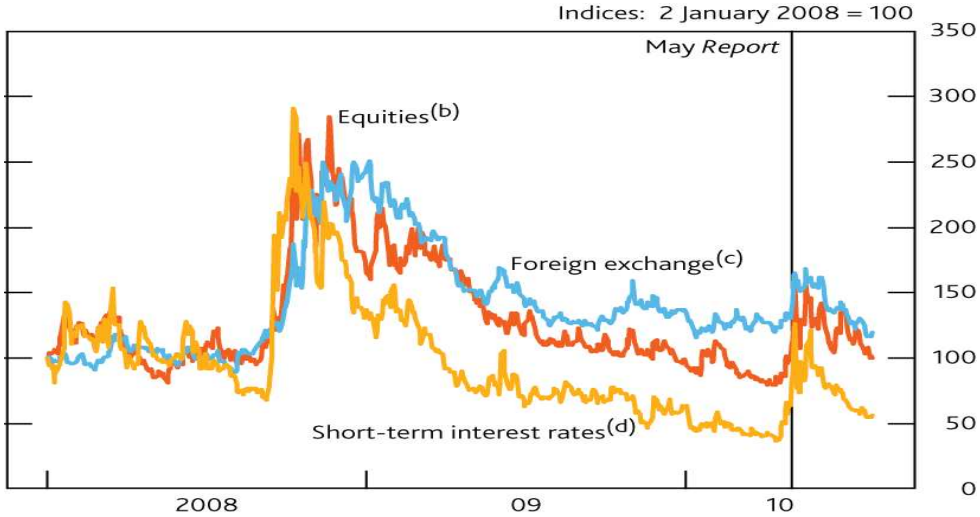
There are several channels, through which the risks may spread from sovereign debt markets

into the financial system. First, deteriorating fiscal positions on account of rising public debt imply higher financing needs by sovereigns, and thus increase the risk of a crowding-out of financing for financial and non-financial firms.

Second, excessive fiscal deficits increase risks for inflation and inflation expectations, which could potentially lead to an increase in risk premium and long-term interest rates, resulting in higher funding costs. In addition, some structural asset-pricing models of credit spreads predict higher credit spreads after periods of lower interest rates.

Third, corporate bonds and credit default swap (CDS) contracts are priced using a “risk-free” rate as a benchmark, and this “risk-free” rate is typically derived from a sovereign debt security with a corresponding maturity. Results of individual country regressions suggest that a widening of intra-euro area sovereign spreads by 100 basis points could lead to a further increase of, on average, about 10-20 basis points in corporate bond yields in the euro area as a whole, while estimates for countries that are potentially more prone to higher increases in sovereign bond yields lie well above that range. Overall market reaction to sovereign debt problems we observed recently is shown in the figure made by Bank of England.

Figure 1.17. Market reaction to sovereign debt problems (a)



(a) Three-month option-implied volatilities.
(b) Average of FTSE 100, S&P 500 and Euro Stoxx 50.
(c) Average of sterling-US dollar, euro-US dollar and sterling-euro exchange rates.
(d) Average of three-month short sterling, euro-dollar and Euribor.

Where and how fast the debt problem (seen only through central government debt) has developed is shown in the following table where we present for the last 11 years central government debt as percent of GDP - when it was recorded over the 50% threshold:

Table 1.7. Central government debt

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Czech Republic											
France					1,9%	2,6%	3,3%	2,1%	2,1%	4,2%	10,8%
Germany											
Greece	53,6%	58,9%	59,7%	59,2%	55,8%	58,3%	60,3%	57,5%	55,8%	59,6%	75,7%
Hungary	9,1%	4,1%	0,5%	3,6%	6,3%	5,7%	8,1%	11,9%	11,3%	18,2%	22,7%
Iceland											37,2%
Ireland											
Italy	56,7%	53,6%	52,7%	49,5%	46,8%	46,2%	47,5%	46,7%	45,2%	48,0%	56,6%
Japan	47,0%	56,1%	73,5%	87,6%	90,9%	106,7%	114,3%	111,4%	114,2%	128,0%	-1,3%
Korea											
Poland											
Portugal	5,1%	4,1%	6,0%	8,7%	10,2%	13,0%	18,2%	19,8%	19,2%	21,2%	31,1%
Spain	2,3%										
Switzerland											
Turkey			24,1%	19,2%	12,2%	6,6%	1,1%				
United Kingdom										11,3%	25,1%
United States											3,1%

Some of the countries, which have high debt/GDP ratio, hold also high external funding - measured as ratio of government debt held abroad divided by GDP (Greece, Italy, Portugal, Ireland and France). Many advanced economies will face growing public debt funding needs, as primary balances remain in deficit and shorter-term debt issued during the financial crisis matures over the next year and a half. As the average deficit for advanced economies is projected to fall from 9 percent of GDP in 2009 to 8.25 percent of GDP in 2010 (according to IMF), the debt GDP ratio must rise, because of the structure of budget deficits (high primary deficit).

The debt situation will influence the financial markets through measures announced by Government in several countries, which include: pension and tax system reforms, freezes in public sector pay, cuts in public investment, and reduction of welfare programmes such as subsidies to parents. All these actions should decrease public spending and influence growth. If GDP growth slows and governments nonetheless choose to stop developing the Ponzi scheme, then the real interest rates bill should be lower than the real GDP raise. That implies that the present monetary policy shouldn't be changed.

Table 1.8

Planned budget cuts in Europe (%GDP) in 2010-2015

Country	Budget cuts
Austria	0.90%
Belgium	5.30%
France	4.50%
Germany	3.00%
Greece	10.70%
Hungary	1.60%
Ireland	3.20%
Italy	1.60%
Netherlands	2.10%
Portugal	6.60%
Spain	8.20%

Source: CESIFO

It is worth to stress that that USA deficit ended this year at the level of $1.47 trillion and will only become stabilised in 2011 as "economic conditions provide little scope for reducing deficits significantly further over the next year or two". Although it was the FED chairman statement that could be seen as a political declaration.

Another difficult problem for the time being unsolved is the world foreign indebtedness structure, which was perceived as one of the reasons for the last crisis. The October IMF World Economic Outlook gives the forecast for balances of current account, which confirms that before the crisis tendencies could be rebuilt (Table below). Two rebalancing acts as IMW call it will not happen in the nearest future.

Table 1.9. Current account balances

bln USD	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2015
Advanced economy	-216.3	-218.4	-219.9	-409.7	-453.0	-342.5	-492.6	-122.6	-110.1	-28.6	-274.4
USA	-458.1	-520.7	-630.5	747.6	-802.6	-718.1	-668.9	-378.4	-466.5	-400.4	-601.7
Emerging and developing	79.9	145.4	219.6	444.5	662.8	654.3	703.4	339.1	312.3	325.2	763.8
East and Central Europe	-21.1	-33.3	-53.4	-59.8	-87.4	-132.9	-153.0	-40.2	-64.7	-73.8	-112.3
Latin and America	-16.2	9.2	21.4	36.7	49.8	15.1	-28.9	-21.9	-56.6	-80.2	-109
Sub Saharan	-12.4	-12.2	-8.0	-2.8	30.8	9.7	-1.5	-15.1	-11.3	-21.4	-24.9
Reserves											
Emerging and developing economies	1 032.5	1 363.1	1 814.3	2 309.2	3 078.6	4 374.7	4 957.0	5 518.3	6 194.4	6 776.3	

Source: IMF.

Equity performance

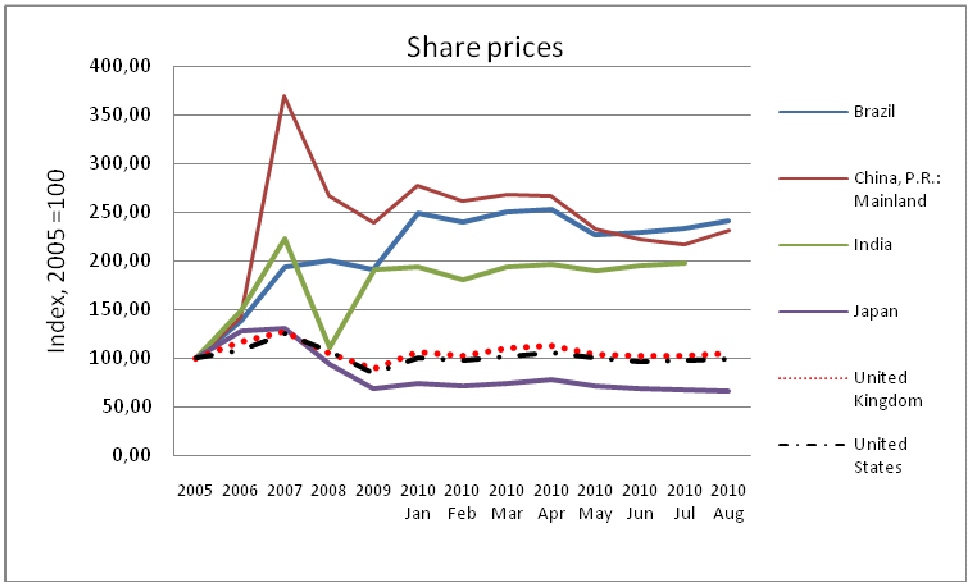
Amid higher uncertainty about the macroeconomic outlook, episodes of intense volatility of euro area equity prices were observed after around mid-January and again in early May 2010. In the near term, the main risk for euro area stock markets seems to be the possibility that a delayed or slower than currently expected economic recovery might hit growth-sensitive earnings of listed firms and put downward pressure on euro area stock prices. Emerging markets are being affected by the increased risks in the euro area due to the reduction in broad risk appetite, which has led to tighter financing conditions. Portfolio flows to emerging markets have partially reversed, after a significant run-up for almost a year between March 2009 and April 2010, and asset price valuations have declined.

Figure 1.18.

Since the bottom of the recent global crisis, equities in emerging markets have significantly outperformed those in developed markets due to robust domestic conditions and stronger fundamentals. The performance in EM markets has been driven by such sectors as telecom, health, and care and consumer staples in countries like Argentina, Chile, Mexico, Indonesia, Malaysia, Thailand and Turkey. EM shares stop to be cheap relative to DM while measuring

their valuation by P/E, P/Sales or dividend yield. Cumulative net foreign share purchases of EM equities were in the third quarter at a new high since 1999. Medium cap valuations also look expensive, as well as some cyclical sectors. Volatilities tend to come down in bull markets, however, this time the trend for EM and foreign exchange volatility has been clearly upward. Another cause of concern for EM, as the Word Bank is pointing to, has been equity correlations, which have refused to come down even after the crisis. Such high correlations imply a risk of EM reacting to a negative shock in a more pronounced fashion than in the past. There is significant risk of equities moving down together in sync, if growth slows. There are high correlations, especially in big countries like the BIRC with respect to the S&P. From this perspective, countries like Malaysia, Thailand and LAC countries such as Peru, Colombia, Chile and Argentina look attractive due to their recently low or negative correlation. In the third quarter, investors have been encouraged to move back into riskier assets recently by signs that China's economy is still able to drive world trade and easing concerns about the stability of the world financial system. The VIX volatility index has been falling almost steadily since May, but stays in October at the August level.

Figure 1.19



For the whole 2010, the stock market is erratic and responds for any bad information like economic outlook in USA, sovereign debt situation in Europe, better situation in China, wide bank stress tests or the revised proposals for financial regulation. Despite of all the bad news the outlook for earnings expectations over the next twelve months, while moderating slightly since May, remained comfortably at robust levels above 20% for both US and euro area companies, some analysts declared in summer. But in October, for the first time in more than a year, analysts cut their forecasts index earnings for S&P 500. Analysts cut 2011 profit estimates for benchmark stock indices in 20 of the world's 24 developed markets. Estimates show S&P 500 earnings may raise 15 percent in 2011, down from a forecast of 20 percent growth in March.

Banking regulations

Let us remember that on the eve of crisis we had come to be in a situation where for instance the capital of UK banks, relative to their assets, was around half the level that was typical fifty years earlier and probably around one third of the level that was usual one hundred years ago. In the US, the decline in bank capital over the past one hundred years is quite probably even larger. Furthermore, in recent years, the quality of banks' capital deteriorated as banks exploited the availability of new hybrid capital instruments, which often had the tax advantages of debt. In practice, hybrid capital did not absorb banks' losses despite being treated for regulatory purposes as if it was like equity. At the same time, banking assets, relative to the size of the economy, had grown very sharply. Relative to GDP, they had roughly doubled in the 10 years up to 2007. Despite Basel I and II, many banks instead of 8% of hard capital backing risks typically held 2%. And if we consider that regulatory adjustments, such as goodwill, are deducted from Tier 1 or Tier 2 capital, then it was possible for banks to have even lower levels of tangible common equity. We should also remember that the effects of the crisis became manifested in 2007 and built-up prior to the implementation of Basel II. Many countries that have adopted Basel II did so in 2008 or later. But, as Japanese authorities pointed to, some financial institutions were forced to fail not only because of poor capital endowment but because liquidity became tight despite the fact that they maintained a sufficient regulatory capital adequacy ratio. In these circumstances, the core of bank reforms should be not only stronger capital and liquidity regulation but also, what is even more difficult to achieve, the extension of regulation to the shadow banking system, and the reinforcement of the derivatives market infrastructure. Tougher capital requirements for trading and the introduction of financial leverage is also an important problem. The stress test undertaken in USA and Europe had to be a supplementary measure to regulatory reforms decided upon at the G20 Leaders summit last year in Pittsburgh. Although the stress test was favourable, the key test is still on the funding side, with European banks having to refinance Euro 6 trn by 2012. (5-year CDS spreads for the banking sector drop after the release of Europe bank stress results). In total, aggregate impairment and trading losses under the adverse scenario and additional sovereign shock would amount to €566 billion. The results of the 2010 survey reinforce the conclusion of the earlier FSI surveys that Basel II should be implemented widely around the world. The FED chief advocates tougher capital and liquidity standards for financial institutions and rules that require more derivatives to "be standardized and traded on exchanges rather than over the counter." "The excessive dependence of some financial firms on unstable short-term funding led to runs on key institutions, with highly adverse implications for the functioning of the system as a whole," Bernanke said. In particular, there seems to be a generally ample room for improvement in liquidity risk management of financial institutions such as securities firms that do not have a stable funding source as deposits. The set of capital rules governing trading book exposures was another regulatory deficiency. Many banks relied excessively on wholesale funding to finance securitised, illiquid assets. In addition, there were poor incentives and poor governance at the firm level along with a lack of transparency, which made it nearly impossible to understand a bank's exposures or the quality of the capital backing them. For regulators, trading books, off balance sheet vehicles, complex securitisation up to now are still an uncharted area. The new definition of capital and the inclusion of off-balance-sheet items in the calculation of the leverage ratio are also important factors. The global liquidity standard does not currently exist. The Liquidity Coverage Ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. This is complemented by the Net Stable Funding Ratio (NSFR), which is a longer-term structural ratio designed to address liquidity mismatches.

In August, the Committee and the FSB published a report on the macroeconomic implications of the proposed higher regulatory standards during the transition to these new rules. This report concluded that the transition to stronger capital and liquidity standards is likely to have only a modest impact on economic growth.

Together with the introduction of global liquidity standards, the new capital standards deliver the core of the global financial reform agenda, and will be presented to the Seoul G20 Leaders Summit in November. An extended transition to this new regime should, according to the authors, enable banks to build resilience through a greater retention of earnings, while sustaining lending.

The changes BIS has envisaged are vast and complicated. They do not simplify – on the contrary, they try to regulate all what has been devised so far. And the real problem lays elsewhere and boils down to the question, how the new standards will keep pace with financial innovation to come. Despite the fact that transition period is proposed to be long and universality of the rules not necessarily given.

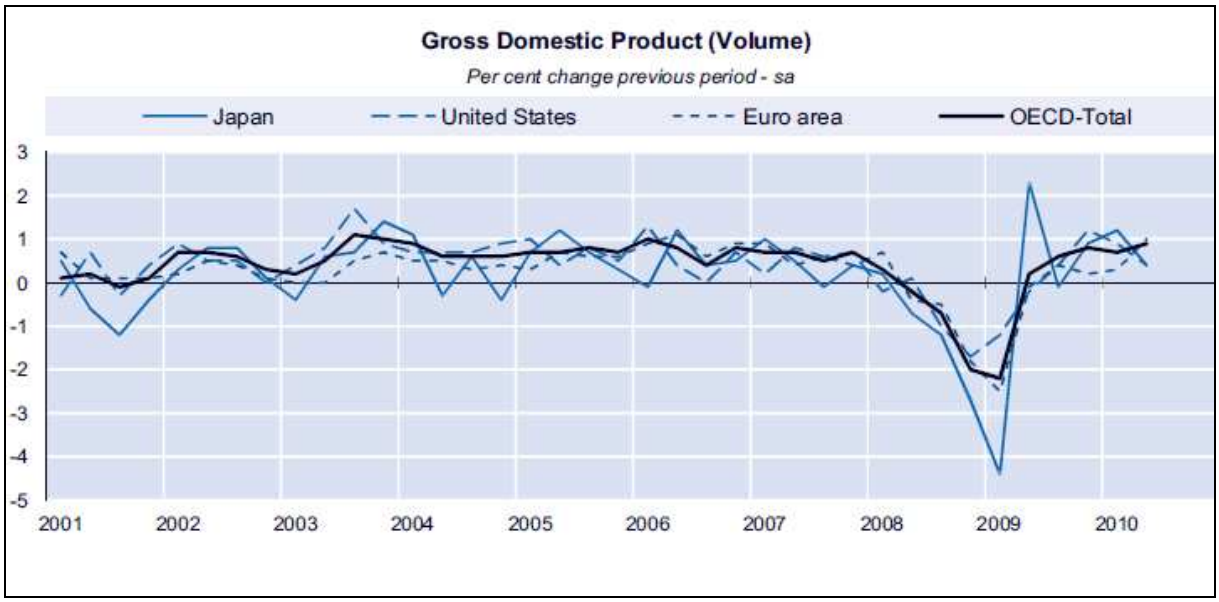
Questions for discussion

- **Can we expect major DC central banks to orchestrate their way to unwind the extra measures, which have been applied?**
- **What Europe will do if sovereign debt restructuring turns to be the only way out of financial torment for some countries in 2011?**
- **In which direction world imbalances will develop?**
- **Will the November decisions of G-20 change the world regulatory landscape?**

2. The international economic outlook

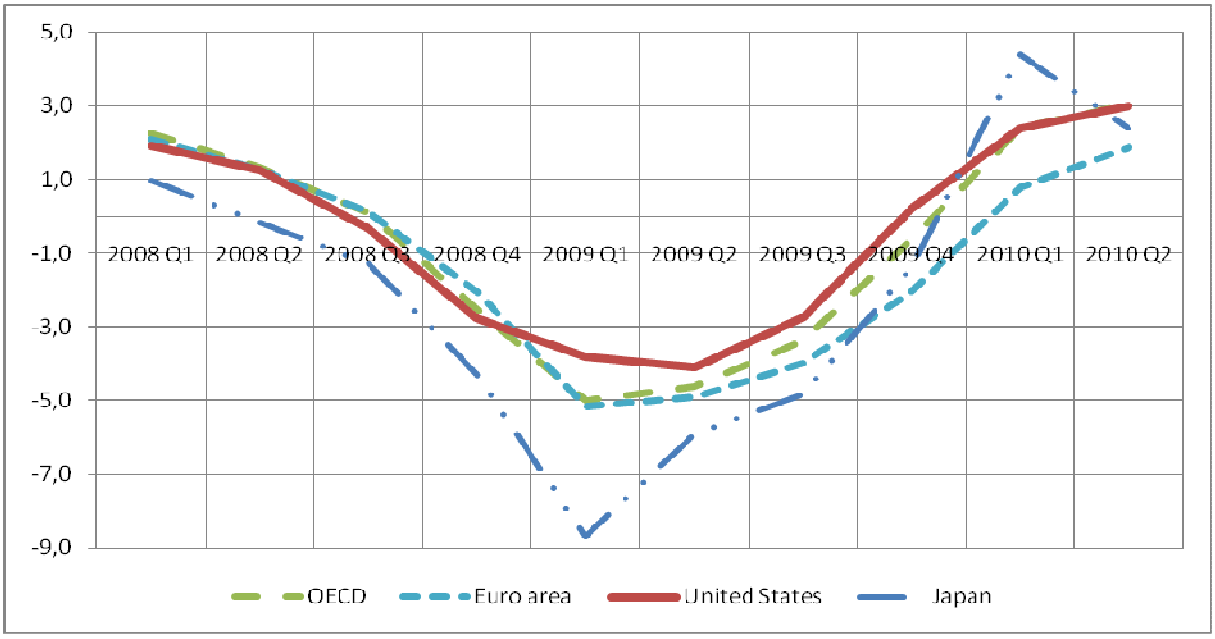
In 2010, both main groups of economies of the world – emerging and advanced ones – followed a path of fragile but noticeable recovery. Within the group of OECD member countries, the quarterly growth rate fluctuations gradually flattened, converging at a level of 0.5-1.0% (q/q) or 1.5-3.0% (y/y) in mid-2010 (Figures 2.1-2.2, Table 2.1).

Figure 2.1. GDP changes (q/q) for major advanced economies, 2001-2010



Source: OECD, Main Economic Indicators, 10/2010.

Figure 2.2. Quarterly GDP changes (y/y) for OECD[a], US, Japan and Euro area, 2008-2010 (%)



[a] Excluding Chile, Israel and Slovenia.

Source: OECD, Quarterly National Accounts, OECD National Accounts Statistics (database).

Table 2.1. Quarterly GDP changes for major advanced economies (y/y), 2008-2010 (%)

	2008				2009				2010	
	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2
USA	1.9	1.2	-0.3	-2.8	-3.8	-4.1	-2.7	0.2	2.4	3.0
Japan	1.0	-0.2	-1.3	-4.3	-8.7	-5.9	-4.8	-1.4	4.4	2.4
EU	2.2	1.5	0.3	-2.1	-5.1	-5.1	-4.3	-2.2	0.7	1.9
Euro area	2.1	1.3	0.1	-2.1	-5.2	-4.9	-4.0	-2.0	0.8	1.9
UK	1.9	1.0	-0.4	-2.7	-5.5	-6.0	-5.4	-3.0	-0.3	1.7
Major 7	1.7	0.9	-0.4	-2.8	-5.1	-4.7	-3.6	-0.8	2.2	2.7
OECD[a]	2.2	1.3	0.1	-2.5	-5.0	-4.6	-3.4	-0.6	2.4	3.1

[a] Excluding Chile, Israel and Slovenia.

Source: OECD, Quarterly National Accounts, OECD National Accounts Statistics (database).

2.1. The United States

Since June 2009, the United States' economy has been recovering from the deepest post-World War II recession (Figures 2.1 - 2.6).

It was just in June 2009 when the trough of the recession in the business activity was apparently reached, as established distinguished members of the Business Cycle Dating Committee of the NBER on 20 September 2010:

"*The trough marks the end of the recession that began in December 2007 and the beginning of an expansion. The recession lasted 18 months, which makes it the longest of any recession since World War II.*

Previously the longest post-war recessions were those of 1973-75 and 1981-82, both of which lasted 16 months.

In determining that a trough occurred in June 2009, the committee did not conclude that economic conditions since that month have been favourable or that the economy has returned to operating at normal capacity.

Rather, the committee determined only that the recession ended and a recovery began in that month.

A recession is a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

The trough marks the end of the declining phase and the start of the rising phase of the business cycle.

Economic activity is typically below normal in the early stages of an expansion, and it sometimes remains so well into the expansion.

The committee decided that any future downturn of the economy would be a new recession and not a continuation of the recession that began in December 2007.

The basis for this decision was the length and strength of the recovery to date."

NBER, Cambridge, MA, September 20, 2010

According to the latest data released on 30 September 2010 by the Bureau of Economic Analysis, the US real gross domestic product increased 1.7 percent in the second quarter of 2010 after increasing 3.7 percent in the first quarter (y/y). Real gross domestic purchases rose 5.1 percent in the second quarter, compared with 3.9 percent in the first quarter (Table 2.2).

Table 2.2. Real GDP. Percent change from the preceding period. Seasonally adjusted at annual rates, 2009-2010

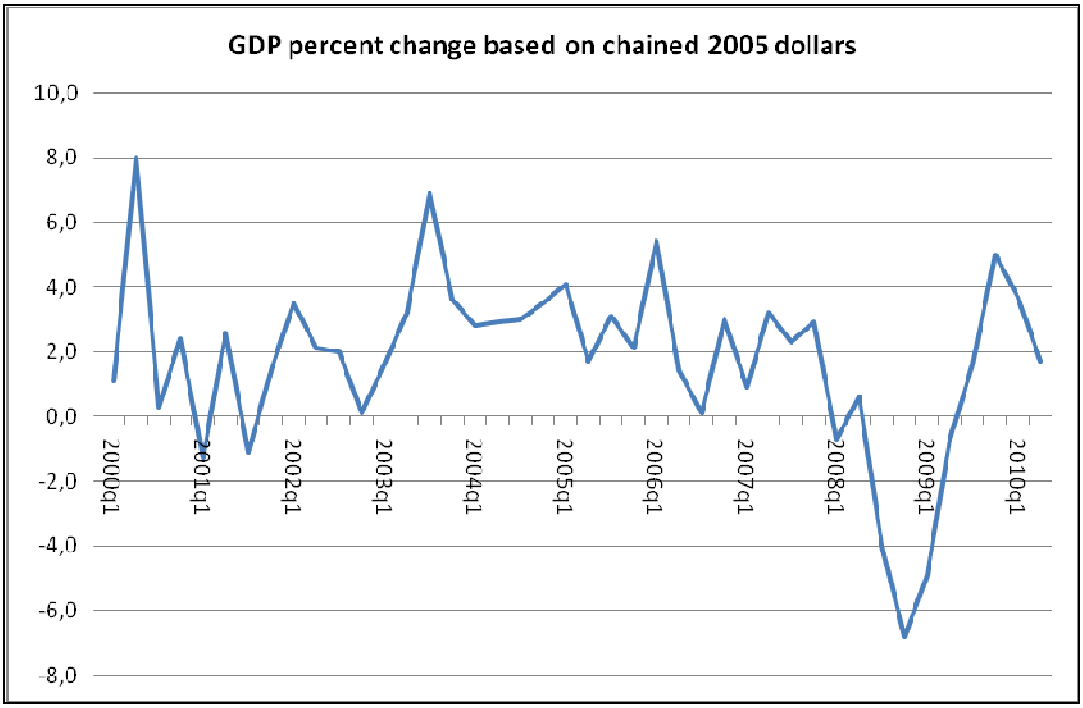
Line		2009 I	2009 II	2009 III	2009 IV	2010 I	2010 II
1	**Gross domestic product**	**-4.9**	**-0.7**	**1.6**	**5.0**	**3.7**	**1.7**
2	**Personal consumption expenditures**	**-0.5**	**-1.6**	**2.0**	**0.9**	**1.9**	**2.2**
3	Goods	1.8	-1.5	7.2	1.7	5.7	3.4
4	Durable goods	4.8	-3.1	20.1	-1.1	8.8	6.8
5	Nondurable goods	0.4	-0.7	1.7	3.1	4.2	1.9
6	Services	-1.6	-1.7	-0.5	0.5	0.1	1.6
7	**Gross private domestic investment**	**-42.2**	**-18.5**	**11.8**	**26.7**	**29.1**	**26.2**
8	Fixed investment	-35.4	-10.1	0.7	-1.3	3.3	18.9
9	Nonresidential	-35.2	-7.5	-1.7	-1.4	7.8	17.2
10	Structures	-41.0	-20.2	-12.4	-29.2	-17.8	-0.5
11	Equipment and software	-31.6	0.2	4.2	14.6	20.4	24.8
12	Residential	-36.2	-19.7	10.6	-0.8	-12.3	25.7
13	Change in private inventories	---	---	---	---	---	---
14	**Net exports of goods and services**	---	---	---	---	---	---
15	Exports	-27.8	-1.0	12.2	24.4	11.4	9.1
16	Goods	-34.1	-3.7	18.7	31.7	14.0	11.5
17	Services	-12.3	4.7	0.1	10.2	5.8	3.9
18	Imports	-35.3	-10.6	21.9	4.9	11.2	33.5
19	Goods	-38.9	-10.6	27.4	6.2	12.0	40.5
20	Services	-16.8	-10.9	1.5	-0.5	7.8	4.3
21	**Government consumption expenditures and gross investment**	**-3.0**	**6.1**	**1.6**	**-1.4**	**-1.6**	**3.9**
22	Federal	-5.0	14.9	5.7	0.0	1.8	9.1
23	National defense	-8.4	16.8	9.0	-2.5	0.4	7.4
24	Nondefense	2.6	10.9	-0.9	5.6	5.0	12.8
25	State and local	-1.7	1.0	-1.0	-2.3	-3.8	0.6
	Addendum:						
26	Gross domestic product, current dollars	-3.9	-0.4	2.3	4.7	4.8	3.7

Source: BEA.

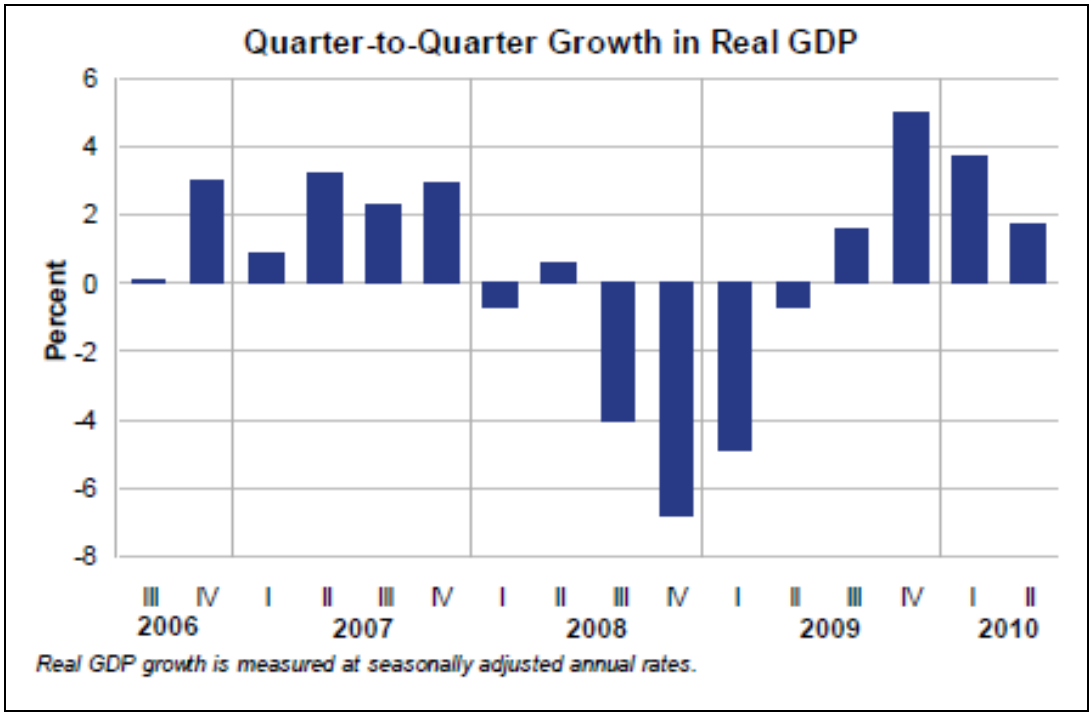
Some deceleration in real GDP growth in 2010 Q2 primarily reflected a pick-up in the purchases supplied by imports (by 33.5% y/y, of which imports of goods jumped by 40.5%) and a slowdown in inventory investment. The growth of exports volume (9.1%) was much more modest than those of imports and slightly lower than in Q1. However, the bound of imports could also be interpreted as a positive sign of growing internal demand and the business activity. These contributions to the slowdown in GDP growth were partly offset by an upturn in residential investment, acceleration in business fixed investment and in federal government expenditures, as well as an upturn in state and local government spending. Besides, a strong effective depreciation of the US dollar may contribute to a stronger growth of exports and weakening of imports in 2011.

Figure 2.3. GDP, quarterly. Change from preceding period, %. Seasonally adjusted annual rates

2000-2010



2006-2010



Source: BEA, GDP Growth Slows in the Second Quarter. "Third" Estimate of GDP, 30 September 2010.

The stepping up expansion of gross private investment in the successive last four quarters (2009 Q3-2010 Q2), after deep investment falls in the preceding periods, associated with an upward move in residential construction in 2010 Q2, was particularly important and perceived (e.g. by the OECD experts[5]) as a sign of continuing, relatively firm but losing its impetus, recovery.

On the positive side, there was also a steady (since the beginning of 2009) though decelerating quarterly growth of corporate profits (Figure 2.4).

Figure 2.4. Quarterly changes in corporate profits, q/q (%), 2006-2010

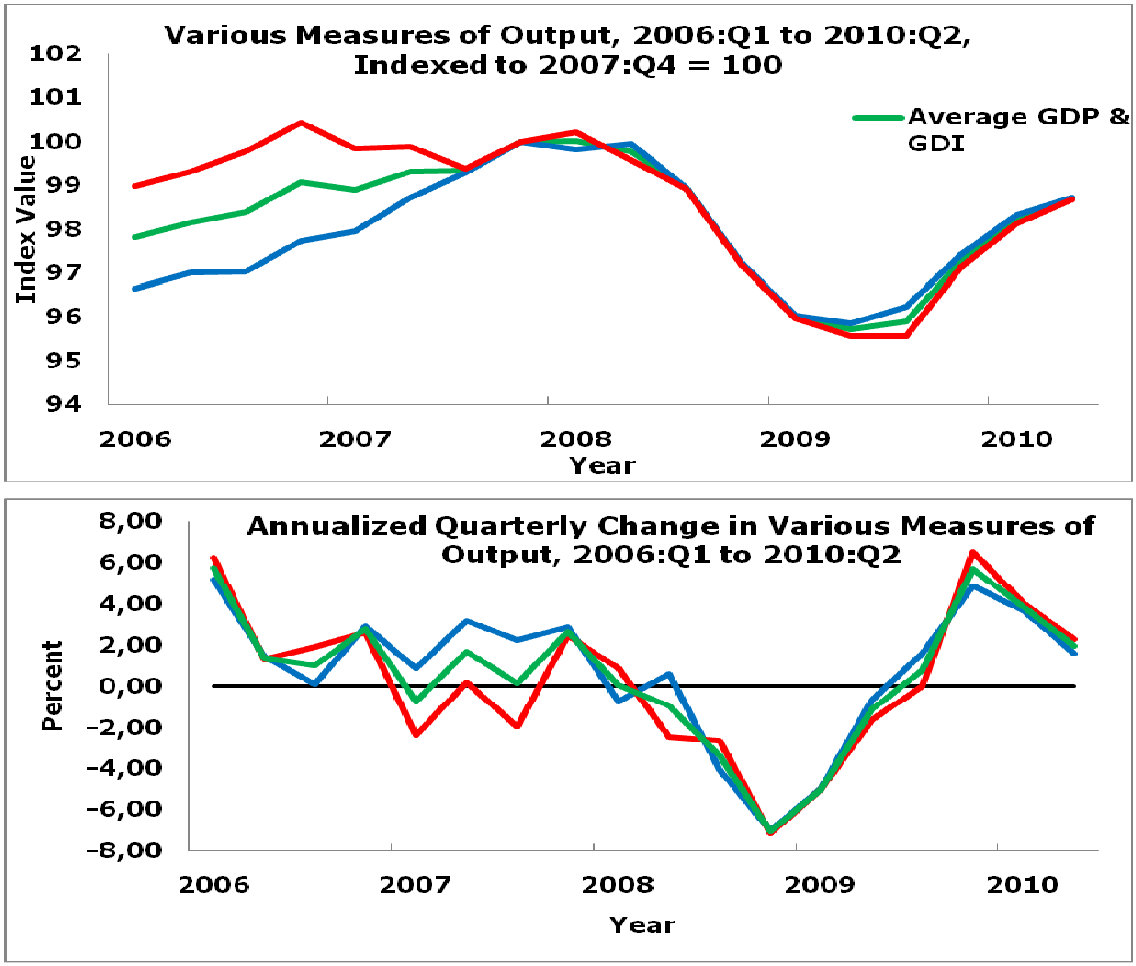
Source: BEA.

Despite a relatively steep recovery of output (since June 2009), measured by GDP, GNI and gross value added by sectors, the pre-crisis levels of production and investment have not been yet attained, as demonstrate the charts derived from the BEA studies (Figures 2.5-2.6).

The sharpest decline, since January 2008 till June 2009, and the steepest recovery, have shown the monthly indices of industrial output (Figure 2.6).

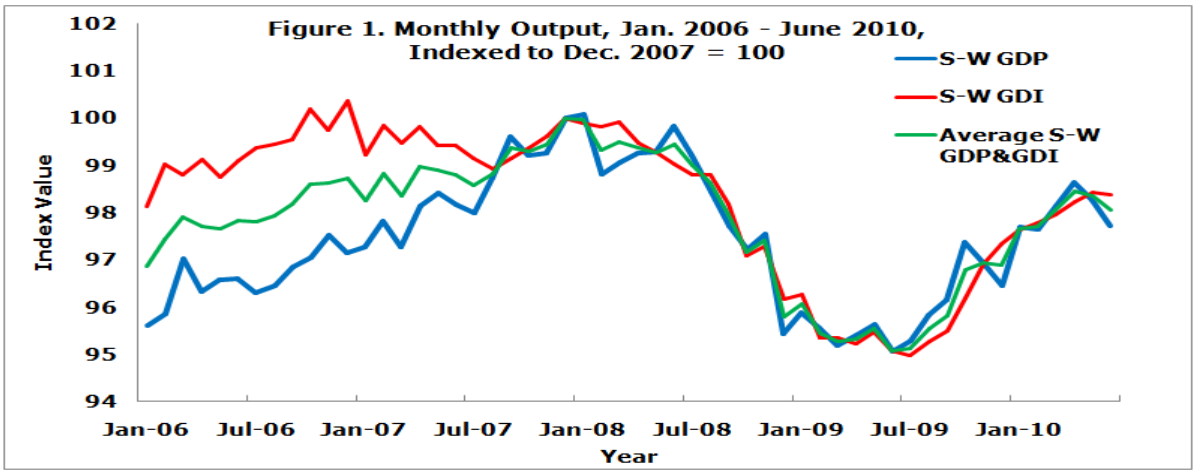
[5] OECD, Investment rebound supports OECD GDP growth in the second quarter of 2010, 06/10/2010, op.cit.

Figure 2.5. Quarterly indices of various measures of output, 2006-2010 (2007 Q4 = 100)



Source: BEA.

Figure 2.6. Monthly indices of output, 2006-2010. December 2007 = 100



S-W GDP = New Stock-Watson index of monthly GDP, http://www.princeton.edu/~mwatson/mgdp_gdi.html

S-W GDI = New Stock-Watson index of monthly GDI, http://www.princeton.edu/~mwatson/mgdp_gdi.html

All data series incorporate the latest revisions as of 18 September 2010.

The outlook for 2010-2011

The US economic recovery is largely policy-driven, and modest by historical standards. This is the view expressed in the last issues of the IMF WEO and Regional Economic Outlook: Western Hemisphere (October 2010): "*Capital injections in major financial institutions, emergency lending, stress tests, and guarantees stabilized financial conditions and broke the adverse macro financial spiral*. [...] *Unlike the usual "V-shaped" episodes that characterized past U.S. business cycles, the ongoing recovery has been tame, with consumer spending particularly lacklustre.*[6]"

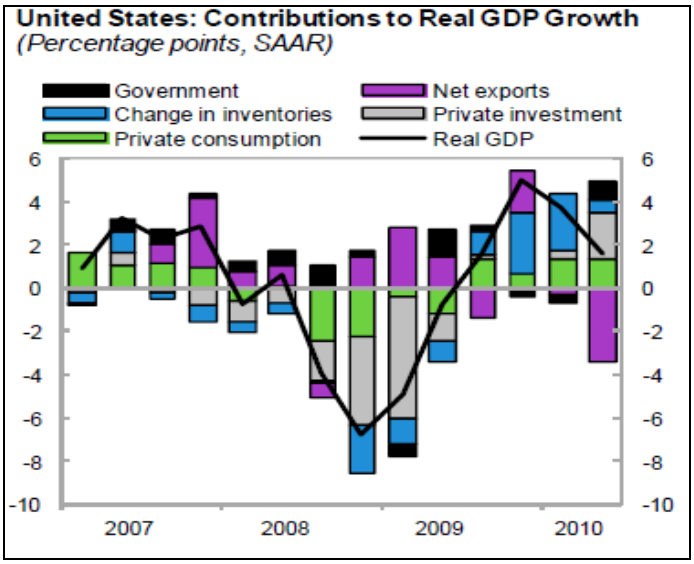
Table 2.3. The United States: Main economic indicators, 2007-2011[a]

	2007	2008	2009	2010[a]	2011[a]
GDP growth, %	1.9	0.0	-2.6	2.6	2.3
Inflation[b], %	4.1	0.7	1.9	0.5	1.2
Current account balance, % of GDP	-5.1	-4.7	-2.7	-3.2	-2.6
Public sector balance, % of GDP	-2.7	-6.7	-12.9	-11.1	-9.7
Public sector gross debt, % of GDP	62.1	71.1	84.3	92.7	99.3
Unemployment rate, %	4.6	5.8	9.3	9.7	8.9

[a] IMF projections. For unemployment: OECD projections.
[b] End of period.

Source: IMF, Regional Economic Outlook: Western Hemisphere. Heating Up in the South, Cooler in the North, October 2010; World Economic Outlook. Recovery, Risk, and Rebalancing, October 2010; OECD, Economic Outlook, 87 (June 2010).

Figure 2.7. According to IMF, "The US recovery is losing strength, with the unwinding of the inventory cycle and weakness of private consumption"



Source: IMF, Regional Economic Outlook: Western Hemisphere…, October 2010, p. 4.

[6] IMF, Regional Economic Outlook: Western Hemisphere…, p. 4.

Projections and views of the AIECE Institutes

The AIECE Institutes forecast the US GDP to rise by 2.7% in 2010 (alike as in May 2010) and by 2.3% in 2011 (against 2.4% foreseen half a year ago).

- It is pointed out for instance that: "*The recovery in the US is slowing substantially. Consumption demand is weak due to persistent unemployment and high indebtedness of households. Investment in structures did not yet pass the trough. With the fading of fiscal stimulus and the contribution from inventory restocking, growth will further slow over the coming quarters*" (DIW).
- This view is supported by some other institutes, e.g.: "*US economic situation is on the edge of a net slowdown. The main engines for recovery till now, the inventory build up and the stimulus package, would lose momentum in the coming months. With the expiration of most stimulus measures, the households' disposable income should fall sharply. In the wake of slowing household demand, companies would not increase the pace of restocking while more uncertain outlook would weigh on business investment growth*" (INSEE).
- Some institutes offer, however, higher GDP growth forecasts for 2010 and 2011, and point out that: "*The downward revision to growth in the second quarter of 2010 was largely a reflection of stronger import growth than previously estimated. This has a positive spillover effect on the rest of the world*" (NIESR).
- Others observe that: "*The risks* [for the global and US economy] *are both upside and downside. Upside risks include a faster recovery in the US than we presently expect. The past resilience of the US economy has not shown yet in this phase of recovery, but indicators are blurred and trends difficult to read. Faster US growth would reassure markets and companies, and could prompt increases in confidence and willingness to take risks*" (BIPE).
- Among the downside risks for coming years there are possible implications of the fiscal tightening that "*will restrain the recovery in 2011 and 2012. Policy is expected to be tightened by about ½ per cent of GDP in the 2011 calendar year and a further 2% in 2012*" (NIESR).
- High and persistent unemployment in the US might also be negatively affected by a prompt implementation of the "exit strategy". "*Labour markets are characterized by high unemployment and even ever growing long term unemployment, even though the number of discouraged workers is high and hours worked have fallen as much in the US as in Europe during the crisis*" (BIPE).
- There are also fears of the potential effects on the US and global economy of the high and rising "*US debt, dependent on China's willingness to continue financing it, when at the same time it is under pressure to revalue the yuan (why buy $ bonds if the $ is going to fall against the yuan?), and the potentially underestimated leftovers of the subprime crisis*" (BIPE).
- Another structural, persistent problem of the US economy, which was among the roots of the recent crises, relates to the situation of residential construction and of the housing market. "*Housing markets remain totally depressed: whereas many analysts expected them to recover faster thanks to fast demographic growth, implying that the excess stock of existing houses could be absorbed in one or two years given the construction trend, the reality is very different. Houses prices remain 15% to 20% below the pre-crisis peak,*

so that households are "encouraged" to default on their loans and move back to a more modest house. Until housing markets really recover, the default rates will continue to increase, threatening the banking sector". However, "*Housing sector should improve gradually as of next year. Once it will be clear that the double dip has been avoided and once labour markets start strengthening, one will expect housing prices to start moving up, triggering further interest for housing investment.*" (BIPE).

Questions for discussion

- **A stronger investment increase in the US (encompassing also the residential component) is envisaged for 2011, according to the OECD forecast. The growth of private consumption may also accelerate in 2011. Then, is a consolidation of recovery of the domestic demand likely?**
- **The US foreign trade in goods and services, after a deep decline in 2009, almost recovered in 2010. Is the fast expansion of trade (mostly imports) going to continue in 2011 and how the effective depreciation of the dollar is going to influence US production costs, output and exports?**
- **What is the outlook for inflation and employment in 2011?**
- **Is the recovery of the housing market going to strengthen?**
- **According to the OECD report[7], the U.S. fiscal stimulus saved some 2.5 to 3.5 million additional jobs from being lost by raising aggregate demand and supporting employment. Is there a real threat of another crash on the financial market and of a new recession if support policies are going to fade?**

2.2. Japan

Japan experienced the adverse effects of the global slowdown earlier than other major industrialised countries, and the recession proved relatively deep. The GDP volume started to shrink already in 2008Q2. The negative GDP growth lasted for four consecutive quarters with year-on-year fall reaching 8.9 per cent in 2009Q1. However, the Japanese economy was also among the first to emerge from the crisis. Growth resumed already in 2009Q2 (1.5 per cent quarter-on-quarter) and, after a break in 2009Q3 (-0.1 per cent), again in 2009Q4 and 2010Q1 (0.9 per cent and 1.2 per cent respectively). The recovery was mainly based on a strong rebound in exports, and supported by private consumption and private non-residential investment that also started to bottom out.

The economy lost momentum in 2010Q2 as quarter-on-quarter GDP growth slowed down to 0.4 per cent. Similar quarterly rates are to be maintained till the end of 2011 with possible minor fall in 2010Q1 and slight acceleration in the second half of the next year (Consensus Forecasts), though some experts do not exclude even the risk of a double-dip recession.

Under conditions of Japan's strong reliance on external demand, the slowdown largely reflected deceleration in the world trade growth and weakening Asian demand, accompanied

[7] OECD Economic Surveys: United States, September 2010.

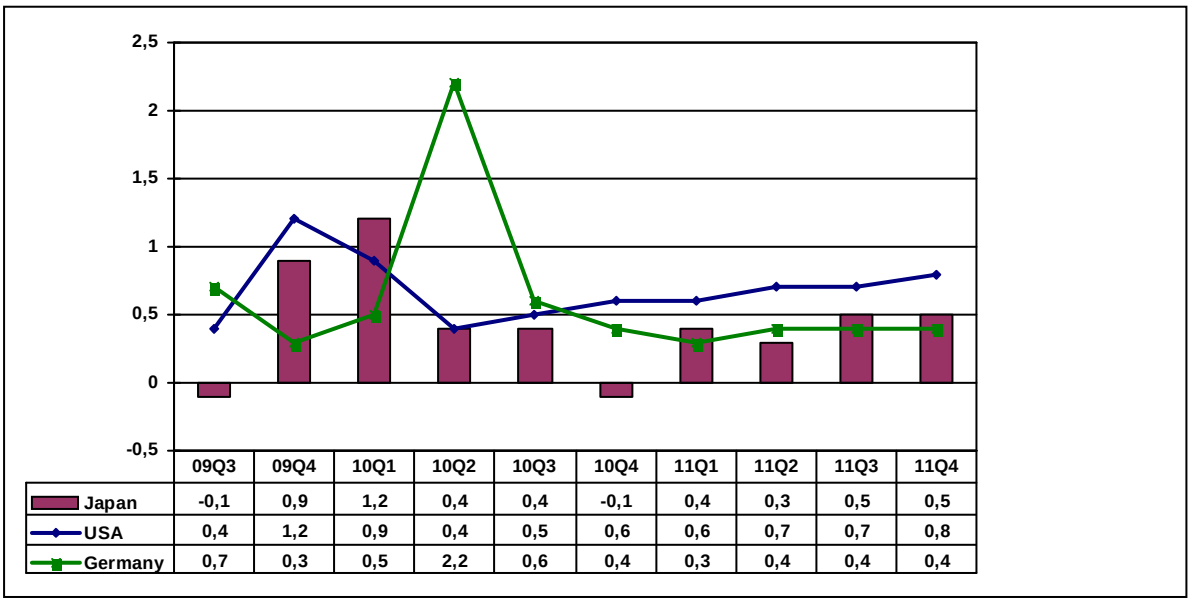
by the proceeding appreciation of the yen, which has risen 22 per cent against the euro and 27 per cent against the dollar since mid-2007. The exports growth slowed for the sixth straight month in August this year, to 15.8 per cent on yearly basis, from a peak of 45.3 per cent in February (exports to Asia were up by 18.6 per cent, while to the US by 8.8 per cent only). In September, the Bank of Japan intervened in the currency markets for the first time since 2004 as the yen had reached a 15-year high against the dollar, but so far with no evident success.

Domestic demand is also slackening. The data for 2010Q2 show flat private consumption and only modest rise of business investment (0.5 per cent quarter-on-quarter). The outcome can be attributed to a number of factors including vanishing effects of recessionary fiscal stimulus, the economy's sliding into deep deflation (core inflation fell a record 2.4 per cent in September) and still a high (by the Japanese standards) unemployment rate of 5 per cent. Though job losses in Japan during the recession were relatively small by comparison to those in most other OECD countries (only 0.8 per cent fall as compared with 1.7 per cent decline in the OECD on average) due to Japanese employers attempts to preserve jobs despite sharp deterioration of business conditions, the current unemployment rate exceeds its level prior the global crisis (4 per cent in 2007), while the "labour hoarding" translated into substantial losses in hourly productivity (4.8 per cent fall during the recession, one of the largest among OECD countries).

Japanese business confidence, as measured by the BoJ Tankan survey, increased from the record low of –58 in early 2009 to a marginally positive 1 in June 2010 and 8 in September. However, manufacturers expect the index to fall back into negative by the end of the year (to –1 in December) due to the strong yen and downward correction in company investment plans.

In view of the BoJ interest rate reduced to below 0.1 per cent in October this year and huge public debt (gross debt can reach 225.9 per cent of the GDP this year according to IMF WEO), a room for manoeuvre both in monetary and fiscal policies seems limited. However, the Bank of Japan announced 3 trillion yen (USD 35bn) lending programme in August, followed by a quantitative easing scheme, while the government has recently approved a USD 60bn stimulus package to boost jobs, spending and growth.

Figure 2.8. Quarterly GDP growth rate in Japan against the US and Germany (per cent change over the previous quarter)

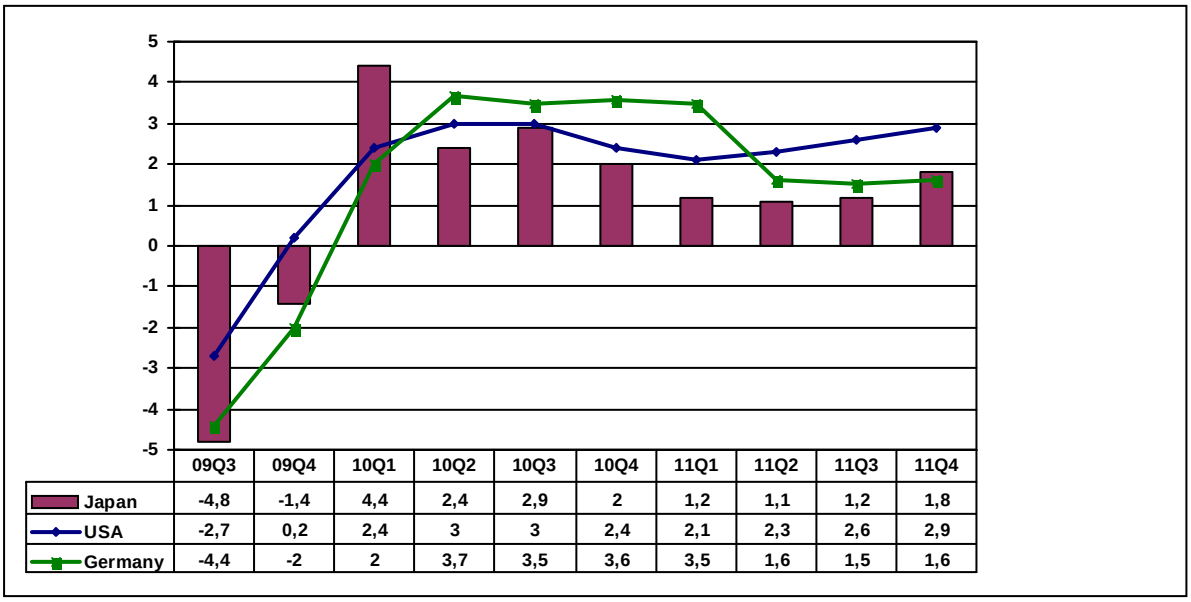


	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	11Q1	11Q2	11Q3	11Q4
Japan	-0,1	0,9	1,2	0,4	0,4	-0,1	0,4	0,3	0,5	0,5
USA	0,4	1,2	0,9	0,4	0,5	0,6	0,6	0,7	0,7	0,8
Germany	0,7	0,3	0,5	2,2	0,6	0,4	0,3	0,4	0,4	0,4

Note: 2009Q2-2010Q2 – actual, 2010Q2-2011Q4 – forecast.

Source: Consensus Forecasts.

Figure 2.9. Quarterly GDP growth rate in Japan against the US and Germany (per cent change over the previous year)



	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	11Q1	11Q2	11Q3	11Q4
Japan	-4,8	-1,4	4,4	2,4	2,9	2	1,2	1,1	1,2	1,8
USA	-2,7	0,2	2,4	3	3	2,4	2,1	2,3	2,6	2,9
Germany	-4,4	-2	2	3,7	3,5	3,6	3,5	1,6	1,5	1,6

Note: 2009Q2-2010Q2 – actual, 2010Q2-2011Q4 – forecast.

Source: Consensus Forecasts.

The AIECE Institutes views

Economic growth in Japan is seen fragile, and the chance for a sustained recovery is usually described as low. High dependency on external markets, weakness of domestic demand and the importance of structural problems including ageing population, huge indebtedness and limited efficiency of traditional policies are often emphasized.

Table 2.4. Japan's GDP growth rate projections (per cent change on the previous year)

	2010	2011
AIECE, autumn 2010	2.8	1.5
AIECE, spring 2010	1.7	1.4
WEO, October 2010	2.8	1.5
Consensus Forecasts, October 2010	3.0	1.2

Note: The AIECE Institutes' and Consensus forecasts are mean of individual projections.

Source: The AIECE Institutes, IMF, Consensus Forecasts.

According to the AIECE Institutes mean forecast, the GDP growth rate in Japan would decline from 2.8 per cent expected in 2010 to 1.5 per cent in 2011 (with projections ranging from 0.9 per cent to 2.2 per cent). As compared with the spring forecast it implies a substantial upward correction for 2010 (+1.1 p.p.) and a slight upward correction for 2011 (+0.1 p.p.). The AIECE autumn forecast is identical as the recently presented by the IMF (in October WEO) and close to the Consensus Forecast.

Within the policy discussion, the AIECE Institutes suggest the following measures to sustain recovery:

- Both fiscal and monetary policy has become ineffective. If Japan is to return to sustained growth, structural reforms are needed, aimed at domestic demand strengthening (CBP). The latest stimulus programme is seen by some institutes as the only means to sustain recovery (CCSF), while other perceive it as tiny and unable to replace the disappearing previous stimulus (IfW). However, given the massive public debt levels, room for fiscal stimulus is extremely limited (DIW). Moreover, past experiences show a low impact of expansionary fiscal policies (Prometeia).

- A fiscal correction seems appropriate in the next years (REF). The fiscal policy should be contractive due to the high general government deficit. Structural changes regarding outlays and taxes should be implemented, and also there should be more deregulations in some areas (NIER).

- Containing deflation by means of continued quantitative easing and avoiding large negative fiscal impulses will be appropriate in the short run. As the financing of the large public debt by the domestic population largely acts like a tax, it would be more appropriate to increase VAT directly in the medium term (KOF).

- With no further margins to stimulate the economy by direct spending, a lot can be done in improving competition via reduction in regulation in the service sector and in

the labour market. These zero-cost measures could improve productivity, which could produce a rise in wages, an increase in consumer spending and, hence, growth (ISAE).

- Huge excess production capacities in industry should be written down, thereby with the disappearance of huge depreciation sums corporate profitability would improve with a positive impact on output and growth (GKI).

- Maintaining a restrictive public policy stance and doing its best to avoid appreciating the yen (BIPE) or unconventional monetary policy with the target of inflating the economy and depreciating the yen (Prometeia) seem appropriate policies. On the other hand, the intervention of the BoJ in foreign exchange markets to weaken the yen is seen as counterproductive. If it is successful, it tends to exacerbate global imbalances by enhancing Japan's current account surplus (GKI).

Questions for discussion:

- **What is your opinion on the possible efficiency of policy measures recently applied in Japan (the BoJ intervention to weaken the yen, new stimulus packages)?**

- **What do you think about policy proposals by the AIECE Institutes aimed at sustaining the economic growth in Japan?**

2.3. Emerging Asia

According to the recent report of the Asian Development Bank, "*Developing Asia is rebounding solidly from the global economic downturn. Growth is expected to reach 8.2% in 2010 and 7.7% in 2011, underpinned by a rapid turnaround in exports, healthy private demand, and the lingering effects of expansionary fiscal and monetary policy measures*"[8].

The GDP growth of the five countries of East Asia is, however, forecast to slow down to 7.7% in 2011, against 8.6% expected by ADB in 2010, due to phasing out economic stimulus policies, more restrained growth of the world trade, and to the end of the low-base effect.

China grew at a double-digit rate in the first half of 2010. This pace is expected to decelerate in the second half of the year. ADB forecasts of the GDP growth for China are 9.6% and 9.1% for 2010 and 2011 respectively, while India is expected to grow by 8.5% and 8.7%, correspondingly. These ADB forecasts may be judged rather conservative, though generally an optimistic mood prevails in Asia.

According to the ECB, "*The remarkable economic performance of emerging Asia that started in the second quarter of 2009 was initially mainly driven by fiscal and monetary stimuli, and subsequently by the rebound in world demand, but also increasingly by domestic private demand. More recently, the gradual withdrawal of policy support and the moderation of*

[8] Asian Development Bank, Asian Development Outlook 2010 Update. The Future of Growth in Asia, September 2010, p. 1-4.

external demand have led to some (limited) cooling down of economic activity and are expected to result in somewhat slower growth in the second half of 2010".[9]

Somewhat higher projections were presented by the OECD in September and by the IMF in October 2010, albeit they were also lower for 2011 than for 2010 (Table 2.11 and Figure 2.10).

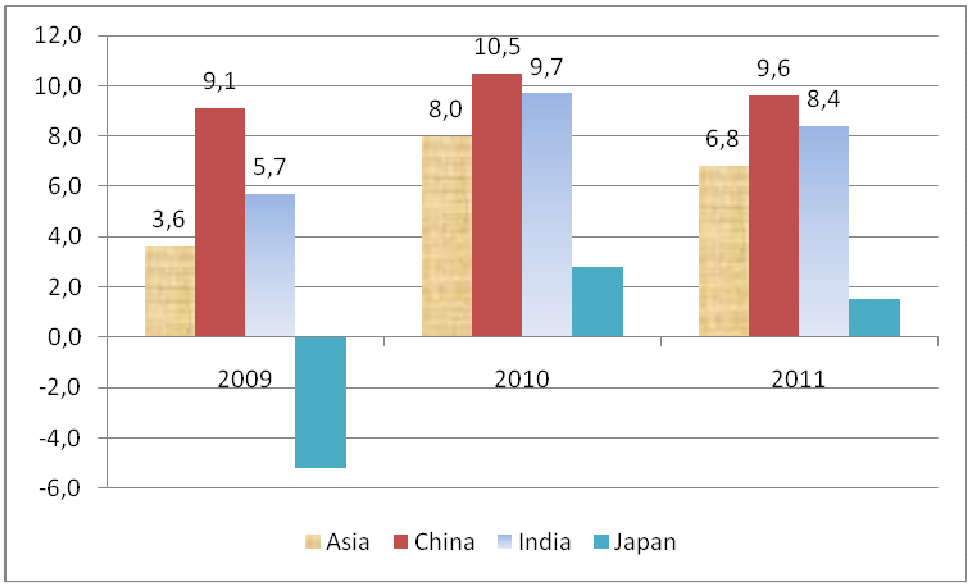
Table 2.11. Asia: Real GDP growth, y/y (%)

	2009	2010[a]	2011[a]
Asia	3.6	8.0	6.8
Emerging Asia	5.8	9.4	8.1
China	9.1	10.5	9.6
India	5.7	9.7	8.4
Emerging Asia excl. China and India	0.4	7.2	4.9
Japan	-5.2	2.8	1.5

[a] IMF projections.

Source: IMF, Regional Economic Outlook. Asia and Pacific, Consolidating the Recovery and Building Sustainable Growth, October 2010.

Figure 2.10. GDP annual growth rates, 2009-2011[a] (%)



[a] IMF projections.

Source: IMF, as in Table 2.11.

[9] ECB, Monthly Bulletin, September 2010.

Experts of the IMF, in the latest issue of the Regional Economic Outlook for Asia and Pacific (October 2010), stated that "*Asia has entered the second year of the global economic expansion still firmly in the lead of the recovery. Growth in the first half of 2010 proceeded well above trend in almost all regional economies, as global manufacturing continued to rebound and fuelled exports and investment in the region. Private consumption also remained strong, as labour conditions continued to improve and confidence remained high despite greater market volatility as a result of global financial turbulence. During the second half of 2010, economic activity has moderated toward a more sustainable pace, although it remains robust. In particular, industrial production and export growth rates have started to moderate. This in part reflects the maturing of the global and regional inventory cycle, particularly for the information technology products that are important for production and exports in many Asian economies.* […] *GDP growth for Asia as a whole is projected to rise to about 8 percent in 2010 before moderating to a more sustainable rate of about 7 percent 2011. The projections represent an upward revision of nearly 1 percentage point for 2010 compared with the April 2010 Asia and Pacific Regional Economic Outlook, mainly reflecting the much stronger-than-expected outturns across the region so far in 2010, and a slight reduction for 2011*". [10]

The ECB, following the IMF staff study[11], concluded: "*Regarding economic links with advanced economies, the recent global crisis has confirmed that developments in emerging economies continue to depend significantly on advanced economies. Indeed, even though the shock stemmed from the advanced world, the median emerging economy suffered about as large a decline in output as the median advanced economy*"[12].

It is expected that growth remains particularly strong in the large, domestic-demand-driven economies of China, India, and Indonesia.

"*A gradual pace of withdrawal of policy stimulus, sustained improvements in labour market conditions, and still accommodative financial conditions are expected to sustain private domestic demand. Ample global liquidity on the one hand, and the relatively robust growth and low public debt in Asia on the other hand, should continue to fuel capital flows to the region. Reflecting the slowing of export growth and strong domestic demand, Asia's current account surplus is projected to decrease to about 3 percent of regional GDP in 2010 and 2011, from about 5 percent in 2007, making a modest contribution to the narrowing of global imbalances* […] *The main risk to the outlook is the external environment. … While global financial conditions have improved since June 2010, underlying sovereign and banking vulnerabilities in advanced economies remain a significant challenge, and concerns linger over the strength of the global recovery. Despite Asia's strong economic and policy fundamentals, important trade and financial linkages with advanced economies suggest that a further deterioration in global financial conditions and a slowing of the global recovery would have important repercussions for the region*"[13].

---

[10] IMF, Regional Economic Outlook. Asia and Pacific. Consolidating the Recovery and Building Sustainable Growth, October 2010.

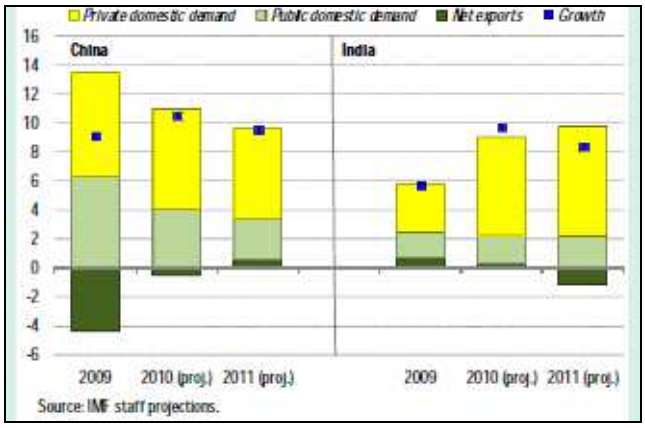
[11] How Did Emerging Markets Cope in the Crisis?, IMF, 2010.

[12] ECB, Monthly Bulletin, October 2010, p. 11.

[13] IMF, Regional Economic Outlook. Asia and Pacific, October 2010, op. cit.

For the two main emerging economies of the region, and of the world, China and India, the profiles and determinants of the rapid economic growth are somewhat different, and the excess of the China GDP growth rate over that of India appears diminishing (Figures 2.10, 2.11).

Figure 2.11. China and India. Contributions to growth, percentage points, y/y



Source: IMF, Regional Economic Outlook. Asia and Pacific. Consolidating the Recovery and Building Sustainable Growth, October 2010.

As stems from the IMF forecasts, a part of all other specificities, the projected growth rates of India in 2010 (9.7%) and that of China in 2011 (9.6%) are likely to be similar and descending.

The expansion of India's economy in 2009-2011 appears to be largely driven by increasing private domestic demand (up to some 7 percentage points forecast for 2011), supported by a substantial – but almost constant in relation to GDP (about 2 p.p.) – contribution of the public domestic demand, with a relatively small and decreasing input of net exports (to become probably negative in 2011).

In China, the contribution of the private domestic demand has also been the main one, but practically steady in relation to the GDP (around 7 percentage points). Another major input to growth consisted of the public domestic demand which was however declining during the recovery period, from more than 6 p.p. in 2009 to some 3 p.p. projected for 2011. The net exports contribution to GDP - that became substantially negative in 2009 (some -4 p.p.) - has been recovering afterwards, and is likely to become positive again in 2011.

Projections and views of the AIECE Institutes

The projections and comments on the outlook of emerging Asian economies and its potential impact on the global economy comply in general with the analysed above opinions and forecasts of international institutions.

- According to some institutes, principal risks for the global economic situation, rather on a downward side, are linked with a possible evolution of the Chinese economy in the short and medium term, notably in the area of residential investment, as it is stressed by COE: *"Le risque principal tient aux évolutions de l'économie chinoise (short-term factors). Nous retenons le scénario d'un ralentissement sans heurts (avec une croissance du PIB de 9.5 % en 2010 puis de 8.5 % en 2011) où la consommation chinoise resterait soutenue. L'inconnue principale réside dans l'évolution de l'investissement immobilier. Il s'essouffle sous l'effet de mesures d'endiguement de la*

distribution du crédit mais sur fond d'un probable excès de construction dont l'ampleur reste délicate à apprécier."

- Also ETLA points out that: "*China is already cooling its economy… Recent tightening of economic policies is well justified. The latest move came on the 29th of September in addition to measures set in last April to cool the housing markets. In addition to other measures like raising the interest rates, the housing market should cool and inflation to come back in control.*"
- In this context, it is indicated that "*Asia has led the recovery and world economy is sensitive to a slowdown in Asia.*" In the area of the exchange rates prospects, it is expected that: "*The appreciation of the RMB is expected to continue on a very moderate path and therefore it will not reverse imbalances rapidly*" (KEPE).
- It is also stressed that the global impact of the evolution in China is going to depend on the future stance of its trade policy, external economic developments and China responses to neo-protective measures pondered by some advanced economies: "*The government took measures in order to avoid an overheating of the Chinese economy. Exports recovered and due to lively domestic demand imports grew at a dynamic pace. In the coming month the trade surplus of China may drop as US demand will most likely fall, and rising wages and lively investment activity may encourage imports. However, we think that even with a fall, the trade surplus of China will remain substantial. According to the government in the future more flexibility can be expected in the development of the RMB. Market protection measures possibly be introduced by the US, may lead to a new stance on behalf of China*" (Kopint-Tárki).
- "*The administrative measures aimed at containing the housing bubbles prove to be effective, with the possible and undesired effect on the local government balance sheet whose revenues come mostly from the taxes on the house and land transactions. The RMB appreciation so far is very small but we expect some more next years.* We expect *a modest decline of Chinese trade surplus within 2011*" (PROMETEIA).
- "*India is still growing at a rapid pace despite high unemployment and inflation. With domestic demand as the main engine of growth, the current account deficit has been rising substantially. Given strong consumption and investment, we are optimistic with regard to India's short- and medium term outlook. However, we expect a slowdown of growth rates due to further monetary tightening – despite a deceleration of inflation rates as a result of favourable base effects of raw material and food prices. Fiscal policy is expected to be more restrictive as subsidies will be reduced and the inefficient government sector is likely to see intensified reforms*" (KOF Swiss Economic Institute).
- Also PROMETEIA is of the opinion that for India "*The outlook sounds good. The fiscal tightening is a necessary choice in order to keep under control and reduce the public sector deficit. Inflation rate is very high and it largely depends on food and fuel prices. This means that tight monetary policy will hardly affect it*".

The AIECE Institutes views on interrelations between Asian and the US/European growth

The most popular is the opinion that economic recovery in Asia and in the US/Europe depend on one another (47 per cent of responses), but only slightly lower percentage of responding institutes (40 per cent) indicates as the leading pattern of growth interrelation that the US and European economic rebound is conditioned by the strength of Asian economies. The opposite view that Asian pick-up is dependent on the strength of the US and European recovery is supported far less often (13 per cent of respondents). The arguments can be summarised as follows:

- Both recoveries depend on each other (FPB). In neither of these two groups of countries external factors may be regarded as irrelevant (CCSF). However, the Asian economies are becoming more and more important for the world economy as their middle classes and, hence, the Asian domestic demand are gaining importance (FPB). Consequently, Asia is in a key role as it has taken a role of locomotive from the US (ETLA).
- Asian growth is self-sustained, the US, Europe and Latin America benefit from it much and no change in this pattern is expected in the near future (GKI). The Asian domestic demand is definitely less constrained than the one in the US and in Europe (WIFO). The recovery in advanced economies has been greatly helped by the quick recovery of demand in Asia, particularly in China, which has acted decisively when the crisis hit (CPB). The strength of the recovery in the USA and in Europe is to a large extent dependent on the ability of their business community to link on to the robust economic growth of the BICs and of other Asian NICs (CCSF). Asia is leading the global business cycle (KOF).
- Yet Asia as a whole is still highly dependent on the US and European consumption. While strong growth in Asia has supported the recovery in advanced economies, the overall contribution of Asia to growth in the US and Europe is still very limited (KOF). The Asian business cycle is still dependent on advanced economies recovery. Major Asian economies are still dependent on external demand, and advanced countries still represent an important destination market for exports. A change toward a more balanced growth through a major role of Asian domestic demand is not a short-term pattern (ISAE).

Questions for discussion on Emerging Asia

- **What would be the consequences of a more flexible exchange rate policy in China – for the economic prospects, inflation, imports and consumption in this country and for the global rebalancing?**
- **In case of a rise of protectionism in Western advanced economies, is the intra-regional Asian trade and progressing regional economic integration a valid alternative for global linkages of China and India?**
- **What are the main determinants of rising inflation in China and India? Is it going to become a real impediment to sustainable growth of these economies?**
- **Is India's economic growth likely to overcome that of China in coming years?**

2.4. Central and Eastern Europe

1. Russia: Slower growth expected in Q3, 2010

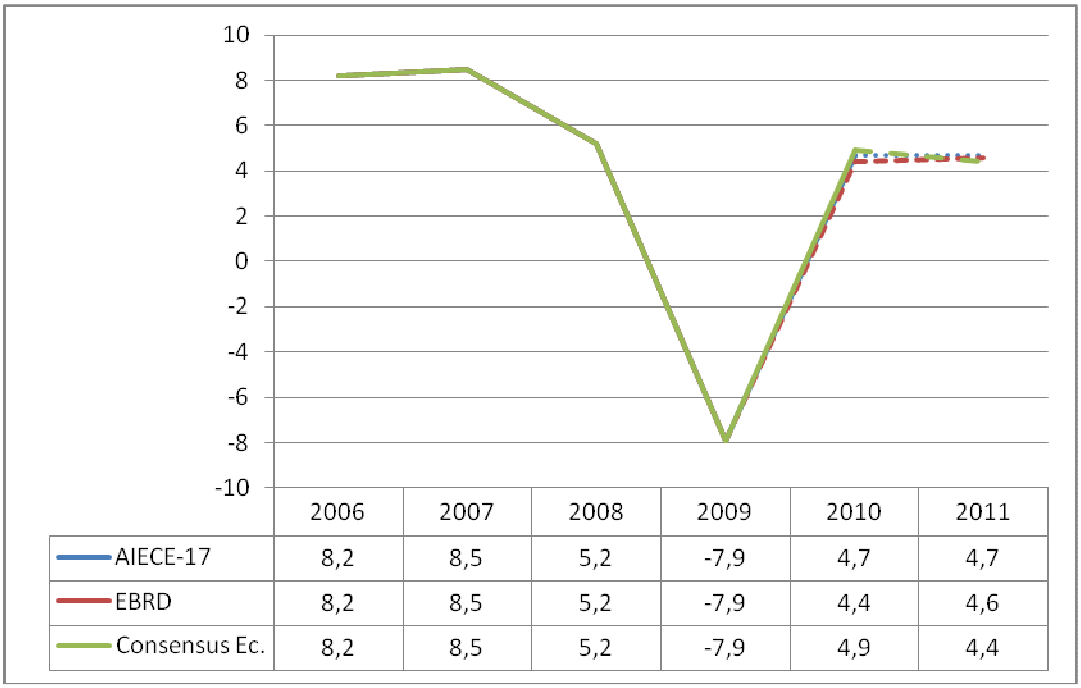
Russian economy has been on a steep recovery path since the end of 2009, on the back of higher oil prices, large-scale fiscal stimulus packages and banking-system support. The outlook for growth and exchange rate stability in the country remains highly dependent on the outlook for commodity prices, especially oil, and also on the global sentiment in capital flows to emerging markets. It is the consumer demand (supported by the Russian government) that is the main growth factor in 2010. After GDP growth by 3.1% in Q1 and by 5.2% in Q2, 2010, GDP growth in H1 remains at similar 4% achieved in the first six months of the relevant period of the previous year.

Positive trends of the economic recovery in H1, 2010 may not sustain in H2. The main obstacles for the accelerated economic recovery are the unstable dynamics in demand and low investment activity. While in Q2 the growth was observed to accelerate for the majority of macroeconomic indices, in July abnormally hot weather resulted not only in the decrease in agriculture production, but also in the sharp deceleration of the investment activity. The influence of the agriculture on the GDP growth comes from its position in the structure of the Russian national economy. The agriculture accounts for 4.0% of the GDP, 9.8% of the average number of the employed in the economy and 4.5% of the investments in fixed assets.

Inflation expectations have jumped in recent months, reflecting the summer drought and a drop in crop yields. The reduction in wheat harvests has been so severe that the temporary export ban on grain may last until next year. CPI inflation rose from 5.5% (y-o-y) in July to more than 6% in August and is expected to move up further in the coming months.

In January-July 2010, investments in fixed assets went up by 1.3%; however, it should be taken into account that the contraction of the investment demand in the corresponding period of the previous year reached 20.4%. Throughout the current year the dynamics of investments proved to be highly unstable, which testified that the impact of factors formed during the acute phase of the crisis at the end of 2008 and the first half of 2009 sustained. The unfavourable climatic situation acted as a factor intensifying the decrease in investment activity. For now, the forecasts for growth in Russia for both 2010 and 2011 report 4.4 percent and 4.6 percent respectively (Fig. 1).

Fig. 1. The Russian GDP growth and forecast (% of annual change).



	2006	2007	2008	2009	2010	2011
AIECE-17	8,2	8,5	5,2	-7,9	4,7	4,7
EBRD	8,2	8,5	5,2	-7,9	4,4	4,6
Consensus Ec.	8,2	8,5	5,2	-7,9	4,9	4,4

Source: EBRD, Consensus Economics Inc., AIECE Institutes.

The AIECE Institutes views

Most of the Institutes point out that Russia remains highly dependent on external demand for oil and other raw materials and that "a fiscal stimulus as well as a rebound in oil prices from the lows in the winter 2008/9 supported the recovery". However, there is no consensus on the Russian growth profile for 2010 and 2011. Some AIECE Institutes revised downward their forecasts after Russia's disappointing H1, 2010 growth and a slight acceleration of the growth next year is expected by them. The others believe that the Russian GDP will continue to grow at the higher rates in H2 than in H1, 2010 and forecast the deceleration of the GDP dynamics not earlier than the next year.

Some main ideas may be summarised as below:

1) *Coe-Rexecode: "We expect Russia's recovery to be weak and fragile. Despite recent signs of strength, a weak banking sector burdened with non-performing loans, relatively high unemployment and substantial under-employment will keep domestic demand moderate and dampen some of the impact of higher oil prices and fiscal stimulus."*

2) *KOF: "Situation and prospects in Russia have stabilised given recovering revenues from oil exports. However, structural problems are severe. In particular, private consumption, which has been the main driver of growth in the pre-crisis years, will expand at a considerably slower pace. With fiscal deleveraging, a weak financial system, strong government involvement in the economy and large corporate debt, the medium-term outlook for Russia is weaker as compared with other emerging market countries."*

3) *Confindustria: "The abnormally hot weather could hurt agricultural production and export revenues in 3Q, the impact of which could deduct 1pp or more from 2010 GDP growth forecast. For the rest, growth will be alimented from oil and gas revenues."*

4) *ISAE: "Net export, along with consumption, will become less supportive over the course of the year, while investment remains sluggish. A gradual improvement in credit growth will support consumption in 2011, along with Asian energy demand, which improves the growth prospects for 2011 for which we forecasts 5% growth."*

2. Baltic States: rebalancing in an uncertain environment

The Baltic economies experienced a sharp contraction in 2009 (Fig. 2); however, they will experience an almost V-shaped recovery, with growth rebounding in 2010 and 2011.

Fig. 2. The GDP growth in the Baltic States (annual % change)

Source: ECFIN, Consensus Economics Inc.

Outcomes and prospects for the Baltic States differ considerably due to different policy frameworks in place. All these countries continue to rebalance their economies in an uncertain environment. The situation was the most critical in Latvia, but after the government extensive measures undertaken in line with the programme agreed with international institutions to rein in its budget deficit, the Latvian credit rating outlook was upgraded to "stable" by Fitch in early September.

The financial consequences of the crisis were less severe for Estonia, which is currently a candidate to join the euro area in 2011. The Estonian economy grew in q-o-q terms for the past three quarters. The expansion was driven predominantly by external demand as domestic consumption has been undermined by high unemployment and cutbacks in government expenditure.

In Lithuania, after a strong performance in Q2, the forecast for this country shows a "zero" rate of growth in 2010. Private consumption remains a drag on output; however, exports surged in Q2, bolstering industrial production and the 2011 outlook for gross fixed investment.

Resuming, in the coming years, the main challenge for the Baltic States is to re-launch their potential for growth while completing the rebalancing of their economies.

3. Central Europe: Domestic demand still struggling or recovering

A revival in import demand from Germany and the euro zone has been the main driver of economic output in many Central European countries. Sentiment, of course, varies from country to country, but growth appears unlikely to match pre-crisis levels (Fig. 3), amid tighter credit conditions and a focus on debt. Poland is, in a certain sense, an exception of this development since its economic activity continued to be strong in the second quarter of 2010. The largest contributor to the Polish economy growth was an uptick in domestic demand, which increased on the back of rebuilding inventories and accelerating private consumption, fuelled by improving confidence to the stronger recovery. However, private investment continued to suffer from uncertainties regarding the global recovery and low capacity utilisation levels.

Fig. 3. The GDP growth in the Central European countries (CECs)

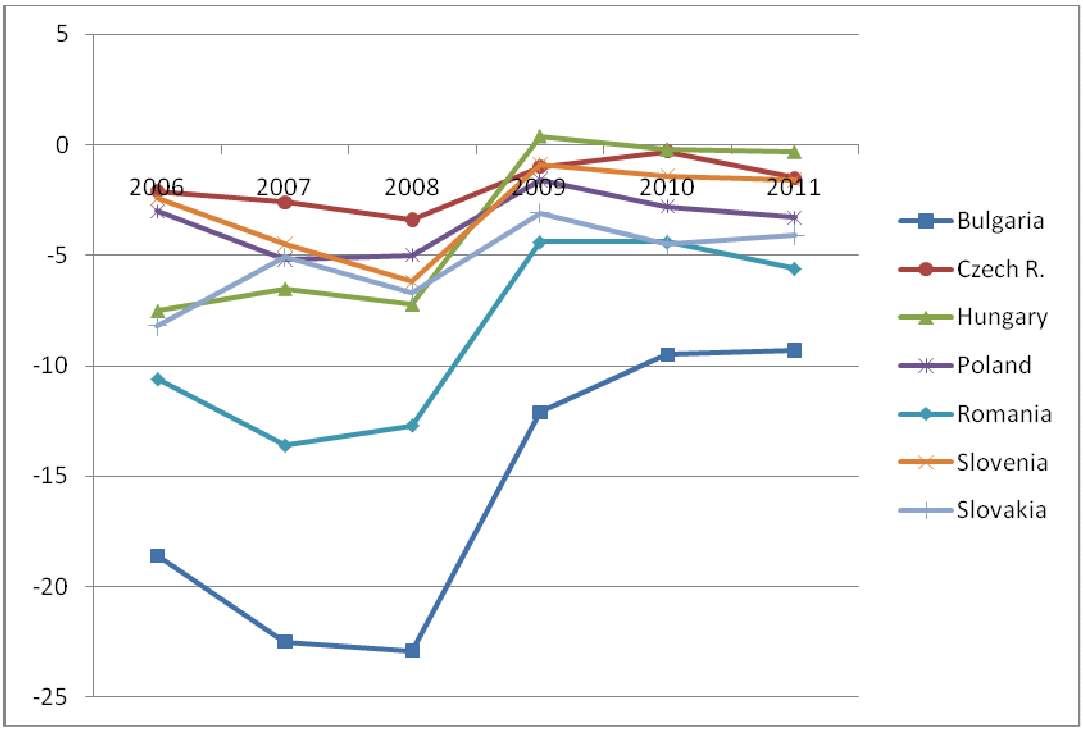
Source: ECFIN, AIECE Institutes.

The AIECE Institutes views

The AIECE Institutes views on the economic outlook for the Central Europe can be divided into two groups. One group records that the outlook is in line with the external and internal risks and still remains shrouded in uncertainty. The other group looks more optimistic and links chances for growth in these countries to the Western Europe economic recovery. However all the institutes agree that the spending cuts in governmental budgets can curb consumption and imports. It is stressed that: "persistent unemployment and jobless growth is one of the major risks for Central Europe, especially if the labour migration to old member states would be limited due to subdued recovery" (SKEP). Other views differ from: "The persistence of an unusually high (in some cases even double-digit) unemployment rate in Central and Eastern European countries we regard not as a risk, but as a certainty" (CCS&F) to: "Unemployment rates are still very high, in most of the countries, but the situation may not last in the long run. In line with economic recovery, employment should recover" (Coe-Rexecode). The deflationary pressures are rather not recognized by the Institutes as a main risk in the region.

For now, the CECs performances are set to lag, reflecting a relative weakness in domestic demand and changes in financial imbalances (Fig. 4). In 2009, the sizeable current-account deficits improved as a per cent of GDP, due to a contraction in domestic demand and a decline in external demand for CECs goods. The deficits are expected to stabilise gradually in many countries of the region in 2010 and 2011, on one side reflecting the rebound in domestic demand and on the other the lagged effects of appreciating national currencies in some countries in the region (Hungary, Poland; Table 1).

Fig. 4. The current account balances (as % of GDP)



Source: European Commission, AIECE Institutes.

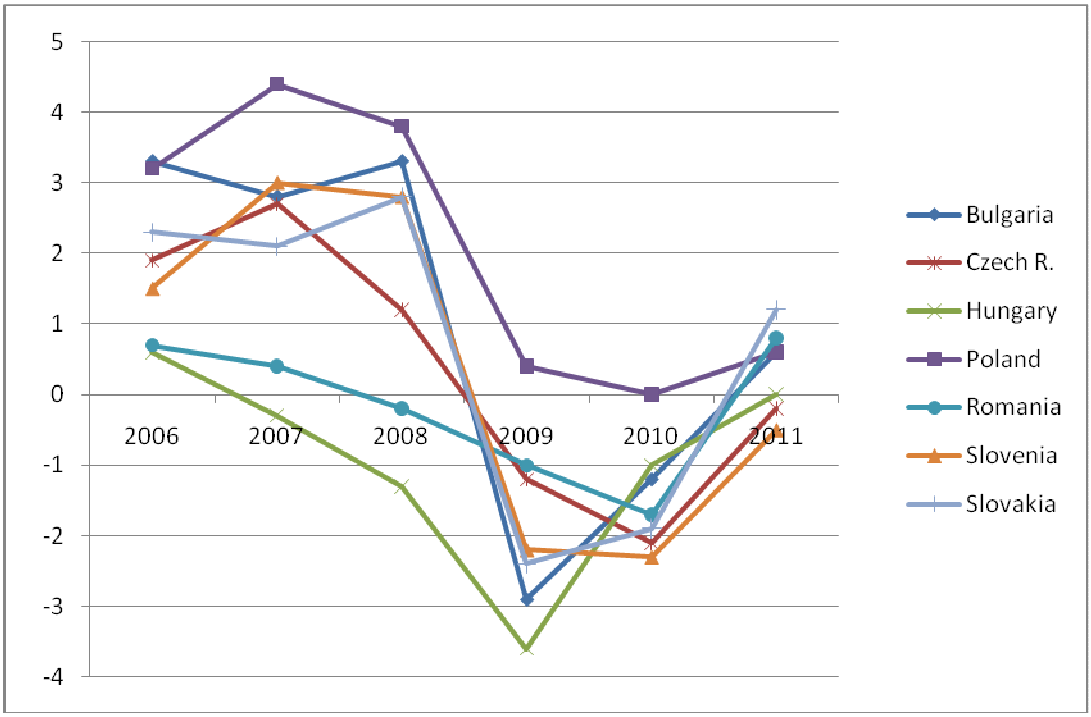
Table 1. Exchange rates against the euro (at the end of the year)

	2006	2007	2008	2009	Spot rate 20 Sept. 2010
Bulgaria	1.956	1.956	1.956	1.956	1.956
Czech R.	27.50	26.59	26.85	26.41	24.66
Hungary	252.4	252.8	265.9	270.2	280.6
Poland	3.833	3.596	4.119	4.106	3.940
Romania	3.385	3.613	4.033	4.236	4.263

Source: Consensus Economics Inc.

The global uncertainty and large fiscal imbalances continue to depress gross fixed investment in the region, which are set to contract in 2010. Confidence in the 2011 outlook is eroded by uncertainty about the global investment climate, as well as planned cutbacks in government expenditure to slash budget deficits. The employment decreased dramatically in the region (Fig. 5) and the unemployment rates are much higher than in 2009. However, it is not rather expected that they may rich double-digit levels in 2011, with exception of Hungary, where the risk is relatively higher, and Slovakia, where it is already done (Fig. 6).

Fig. 5. Employment in the Central European countries (% change)



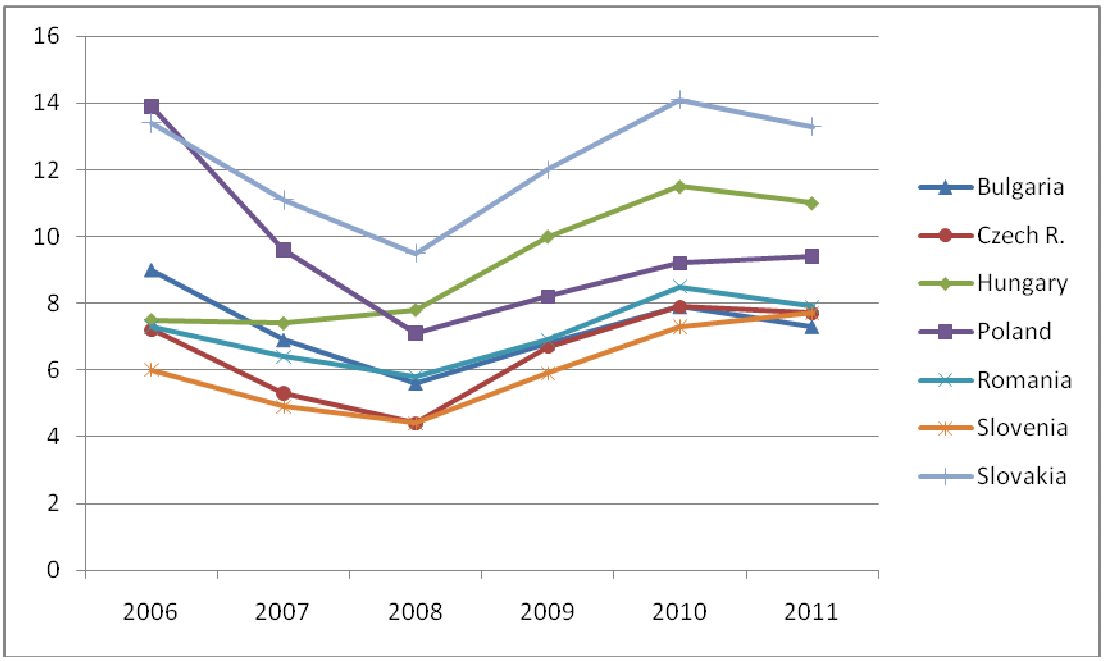
Source: European Commission, AIECE Institutes.

The AIECE Institutes views

Considering the opening of German and Austrian labour markets for citizens of the Central Europe NMS (except for Bulgaria and Romania) on the 1st of May 2011, some countries do not expect any significant impact on their own labour market (CSE, SKEP, CPB) or project

that there will be no major flows in 2010 and 2011. GKI is expecting "the increase of commuting" in the case of Hungary and points that "nevertheless, commuting exists even nowadays, a partial impact could be the legalization of the present practice". On the other hand, CCS&F assumes, that "the opening of the German and Austrian labour market to citizens of CEECs, together with cuts in salaries of employees of the public sector which are envisaged in the Czech republic, will increase the lack of highly qualified labour already perceived (especially the lack of personnel in health care)". WIFO adds, that the effects expected on the Austrian labour markets are "pretty small" and underlines that "among higher qualifications, the opening of the labour market has effectively taken place in recent years. Some further effects may be visible among lower qualifications; however, as recent experiences have shown, immigration also depends on labour demand".

Fig. 6. Unemployment rate in the Central European countries (%, Eurostat definition)



Source: European Commission, AIECE Institutes.

4. Prospects for the financial sector in the region

The situation in the financial sector differs strongly from country to country and remains fragile, but it is not a major downward risk to the outlook. However, fiscal adjustments policies adopted in some countries (e.g. Hungary, Poland) may influence the economic activity and postpone the adoption of euro. Recent experiences convinced individual CECs that becoming members of the EMU has also some disadvantages.

The AIECE Institutes views

The Institutes do not expect any "turbulences" in the financial sector of CEECs, but they notice the vulnerability of this sector. The main aspects mentioned by the Institutes can be summarised as below:

1) *CCS&F: "In most of CEECs, the financial sector was never "out of control" and even in those countries, where such a situation temporarily developed, it was rapidly "put by" thanks to the involvement of the IMF and drastic austerity measures having been*

introduced by their governments. Large foreign-currency denominated debts are still outstanding. Especially with the rise of the Swiss franc, housing sectors mortgages pose a large risk for banks' balance sheets."

2) *Coe-Rexecode: "While still fragile, we do not believe the financial situation in CEECs to be a major downward risk to the outlook. Despite challenging fiscal situations in some countries (Hungary for example), they may not default. Fiscal adjustment policies adopted by some of those countries have already shown results, even if the public debt reduction will be gradual and though the Stability Growth Pact limits may not be reached in time. Moreover, fiscal adjustment policies may weigh on economic growth and this is another factor that may delay EMU entry for some countries."*

3) *GKI: "The financial sector is sound; risks are related to the banks with foreign stake. There are risks that in case of financial turbulence mother banks reject or reduce the financing of their Central and Eastern European affiliates".*

4) *CPB: "Like in other European countries, the financial sector remains vulnerable."*

5) *SKEP: "Financial sector in CEECs remains vulnerable due to high presence of the foreign banks and their subsidiaries. Although the worse times might have already passed we are not yet safe."*

6) *KOF: "Large foreign-currency denominated debts are still outstanding. Especially with the rise of the Swiss Franc, housing sectors mortgages pose a large risk for banks' balance sheets."*

Questions for discussion:

1. **At the end of summer 2010, stagnation of economic activity and inflation upsurge were dominating among the economic trends in Russia. How long and to what extent are they dependent on climate anomalies and will be the major issues this autumn?**

2. **Is the domestic demand still struggling or recovering in the Central European Countries? How to make it more vigorous?**

3. **Hungarian Institute GKI is very optimistic about the foreign capital flows into the economy. What is the Hungarian strategy to attract the foreign investments in time of unfavourable global investment climate?**

4. **Estonia is a candidate to join the euro area in 2011. What are the prospects of euro adoption by other New Member States?**

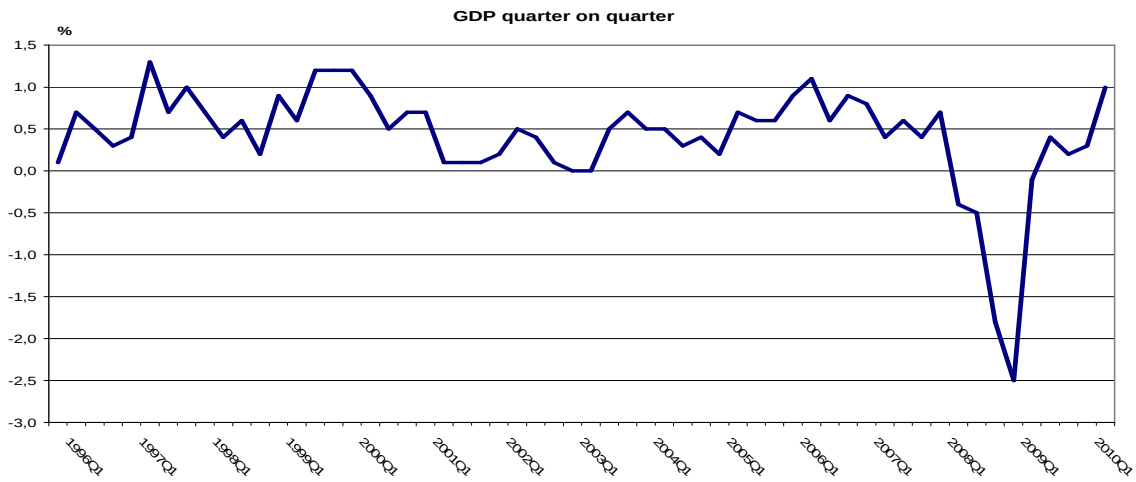
5. **Considering the situation in the financial sector in the CE countries, will the current developments in the region change the importance of foreign-owned banks?**

6. **Considering the opening of German and Austrian labour markets for citizens of Central Europe on the 1st of May 2011(except for Bulgaria and Romania), AIECE Institutes, in general, do not expect any significant impact on their own labour markets. Does it mean that no major flows of labour forces are projected in 2010 and 2011?**

3. The euro area

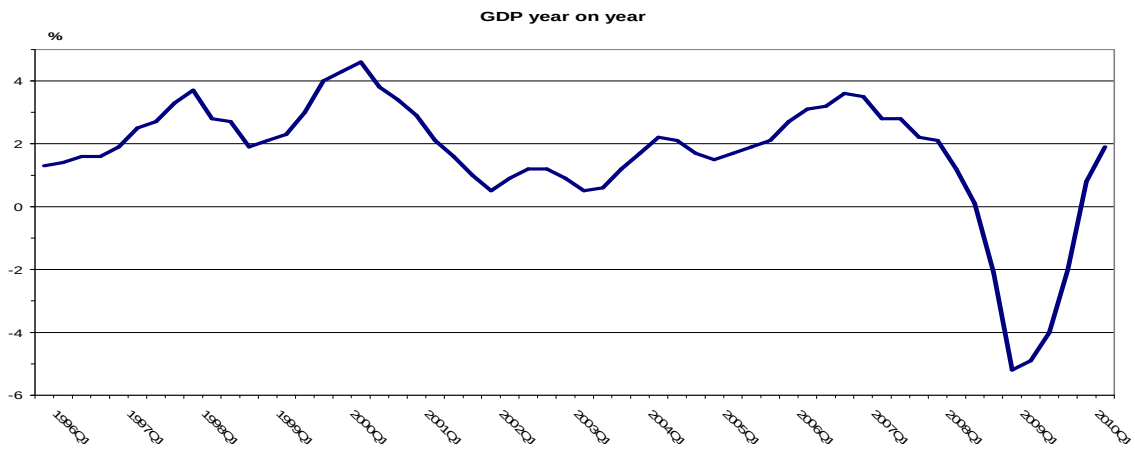
In the second quarter of 2010, the quarterly GDP in the euro area increased for the fourth time in a row reaching encouraging 1% rate. This recovery follows the five quarter-long periods of recession. In yearly terms, the GDP growth reached 1.9%.

Figure 3.1



Source: Eurostat

Figure 3.2

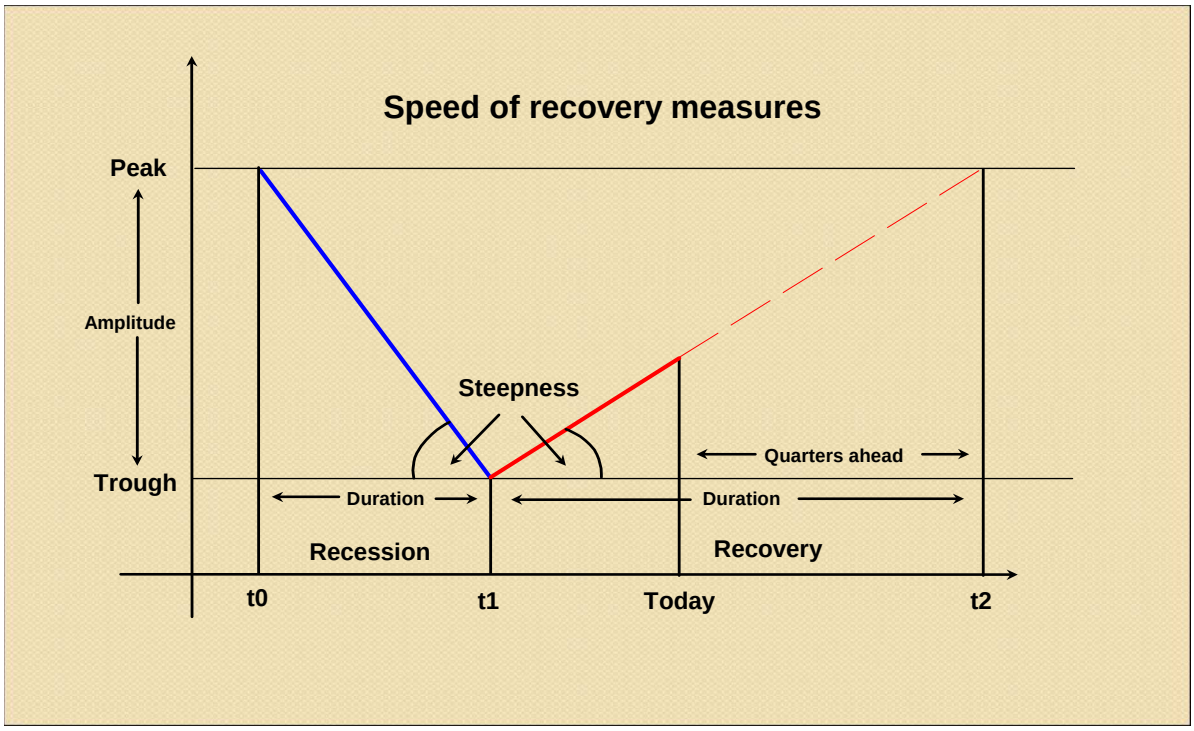


Source: Eurostat

Sluggish recovery

However, the speed of recovery is rather meagre (Table 3.1). For the euro area as a whole, the number of quarters ahead before a recuperation of the level of previous peak exceeds seven. In several countries, the recovery is so fresh and weak that it would take a two-digit number of quarters to approach the level of the previous peak subject to the up-to-date recorded average quarterly growth rate. Figure 3.3 explains the recovery measures used for calculations shown in Table 3.1.

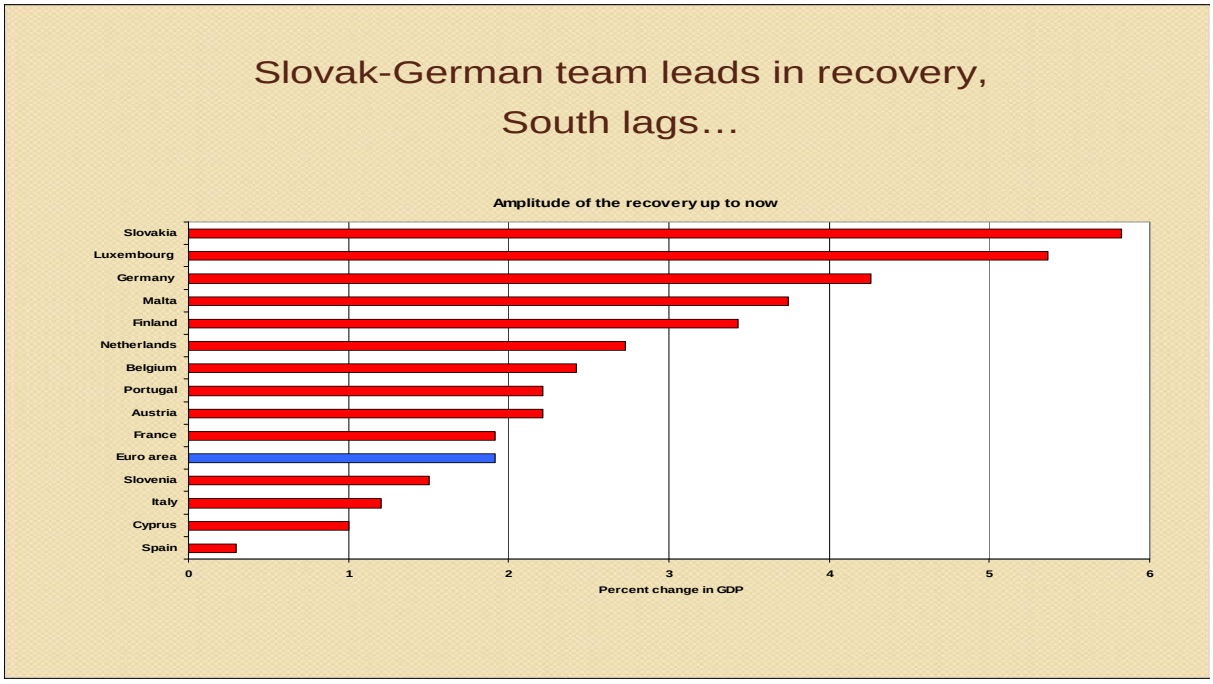
Figure 3.3



Source: IBRKK

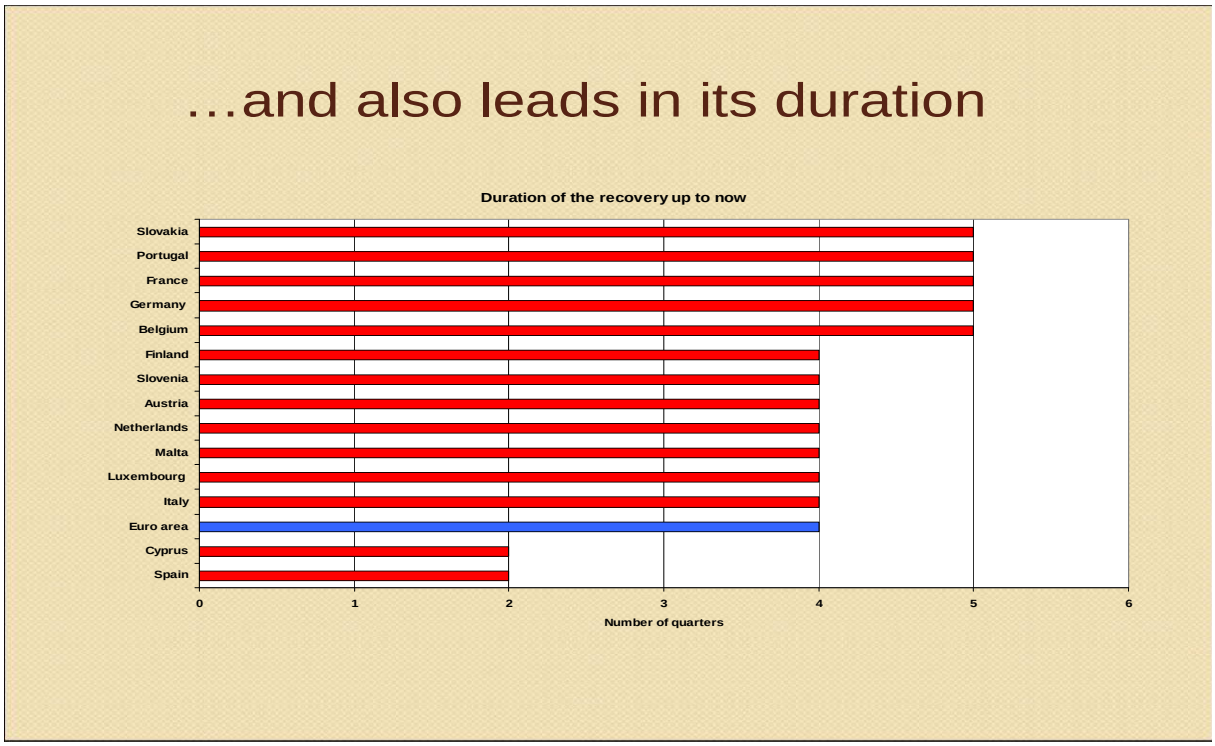
In some countries, the recovery has not materialised yet. Though duration of the recent recession was in line with an average of former episodes, its amplitude and steepness was greater. Contrary to the former ones, the current recovery is extraordinary flat (see Fig. 3.4-3.6).

Figure 3.4



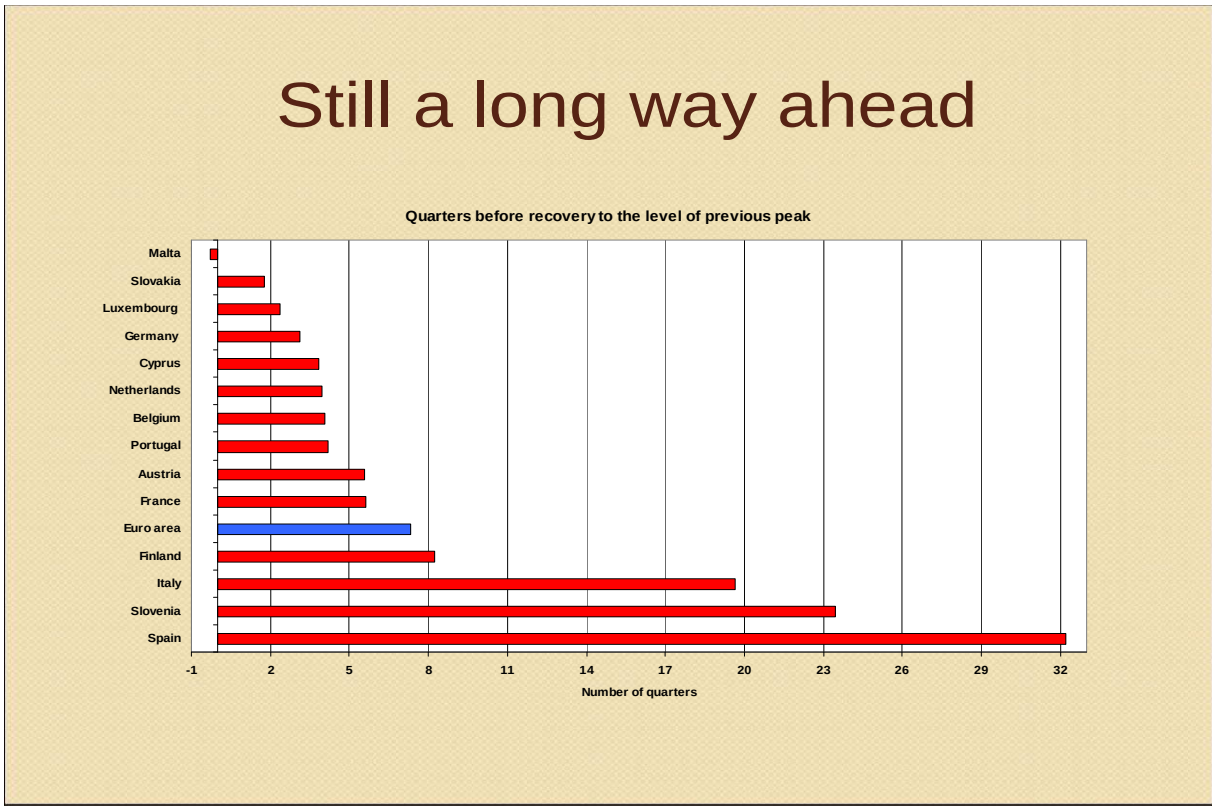
Source: Eurostat

Figure 3.5



Source: Eurostat

Figure 3.6



Source: IBRKK

Differentials in quarterly growth rates among countries have again increased after a mitigation in last years' final quarter and this year's first, with Germany (2.2%) and Finland (1.9%) on the one side, and Greece (-1.8%) and Ireland (-1.2%) on the other side. Euro area growth potential proves to be quite heterogeneous.

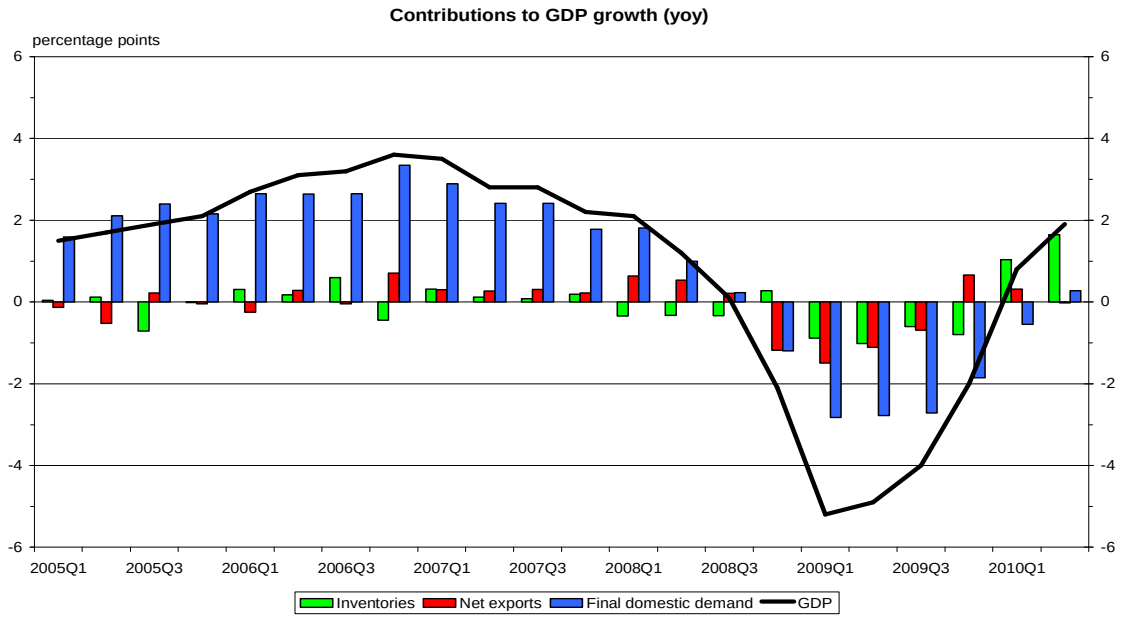
Table 3.1. **Summary statistics on current business cycle in the euro area**

	Recession		**Current recovery**		**Number of quarters ahead before recovery to the level of previous peak**
	Duration*	**Amplitude ****	**Duration***	**Amplitude ****	
European Union	5	-5.40	4	1.91	7.73
Euro area	5	-5.21	4	1.91	7.30
Belgium	3	-4.25	5	2.42	4.08
Germany	4	-6.56	5	4.26	3.14
Ireland	10	-13.38			
Greece	7	-5.76			
Spain	6	-5.00	2	0.30	32.22
France	4	-3.95	5	1.91	5.62
Italy	5	-6.83	4	1.20	19.63
Cyprus	5	-2.87	2	1.00	3.84
Luxembourg	4	-7.99	4	5.37	2.37
Malta	3	-3.37	4	3.75	-0.27
Netherlands	5	-5.20	4	2.73	3.94
Austria	4	-5.11	4	2.21	5.58
Portugal	4	-3.95	5	2.22	4.19
Slovenia	3	-9.74	4	1.50	23.46
Slovakia	1	-7.40	5	5.83	1.79
Finland	4	-9.81	4	3.43	8.23
United Kingdom	6	-6.53	3	2.01	7.18
Norway	4	-2.09	4	0.80	6.56
Switzerland	4	-3.36	4	3.34	0.16
United States	6	-4.14	4	2.93	1.86
Japan	4	-8.74	5	4.77	4.81

* Number of quarters
**Percent change in real GDP
Source: IBRKK.

In the first quarter of the year, the recovery was mainly driven by a marked acceleration of stock building with a weak support coming from domestic demand. In the second quarter, with a continuation of stock building, a revival of final domestic demand added about 0.5 p.p. to the GDP growth. In the y-o-y terms, inventories were the key growth factor (see Fig. 3.7).

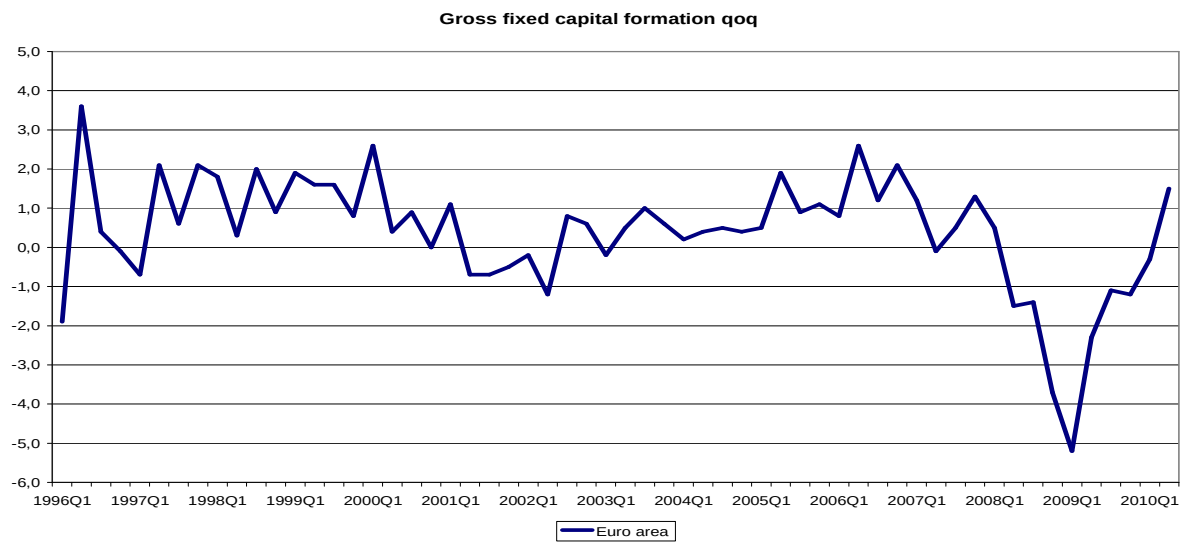
Figure 3.7



Source: Eurostat

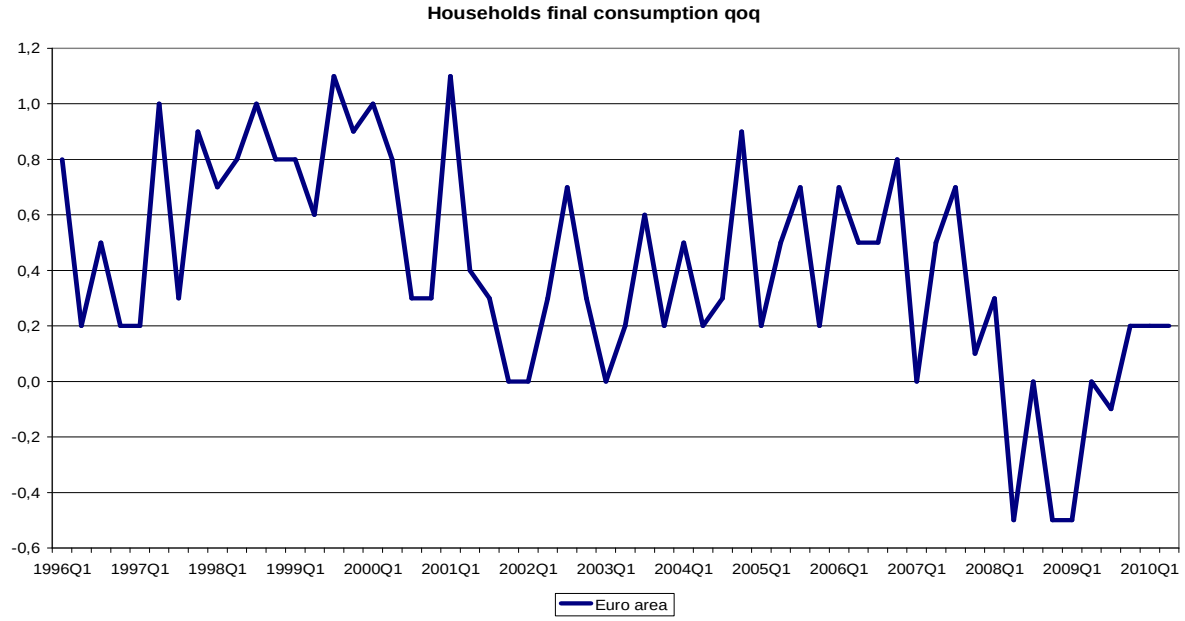
The revival of final domestic demand was primarily due to a dynamic swing back into growth of gross fixed capital formation (1.5% q-o-q), mainly in Germany. Excluding Germany, investment demand was still weak (0.2%). The rate of capacity utilisation has been improving since the fourth quarter of 2009 to reach 77.4% according to the survey data collected in October, still fairly below the long-term average (81.6). Consumption expenditures remained flat (0.2%), fuelled only by cuts in savings with real disposable income shrinking. A stronger domestic demand accelerated imports but exports benefited even more, with net exports contribution to the second quarter GDP growth equal to 0.1 p.p.

Figure 3.8



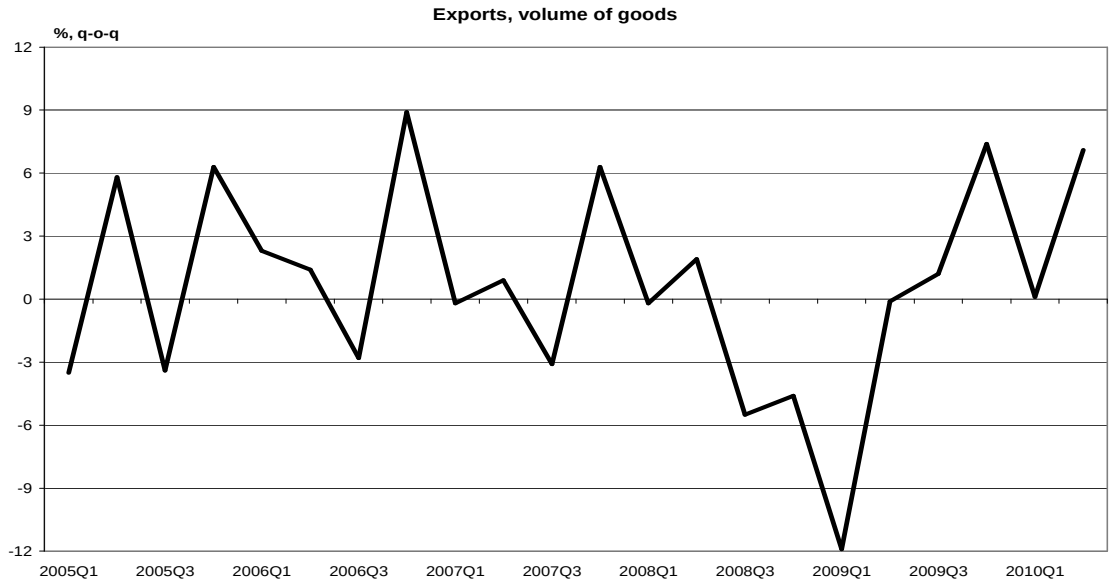
Source: Eurostat

Figure 3.9



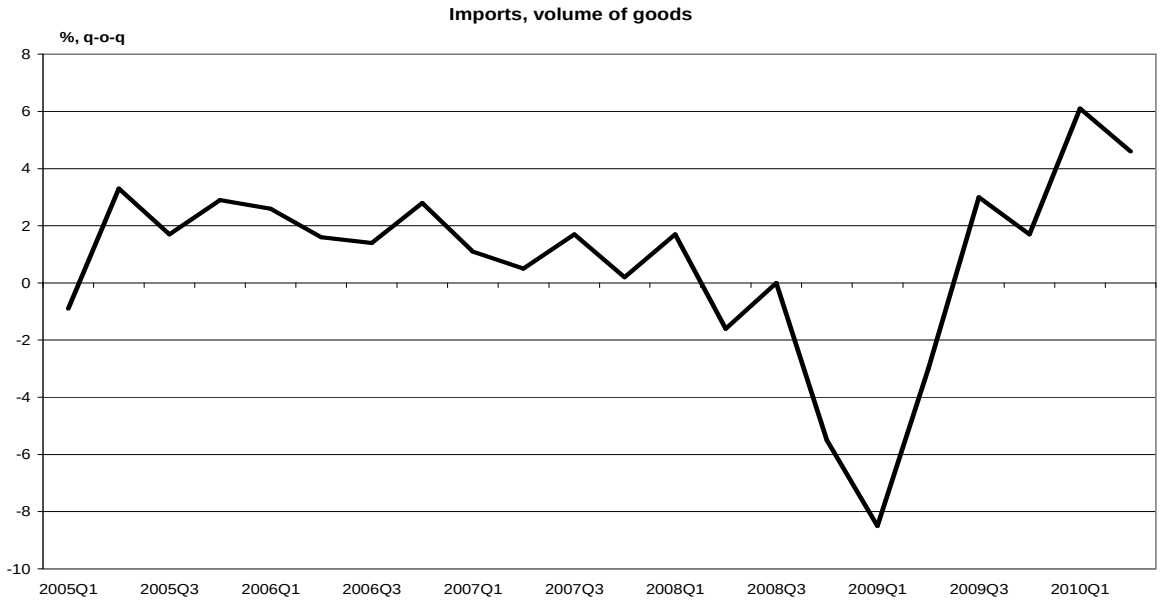
Source: Eurostat

Figure 3.10



Source: Eurostat

Figure 3.11



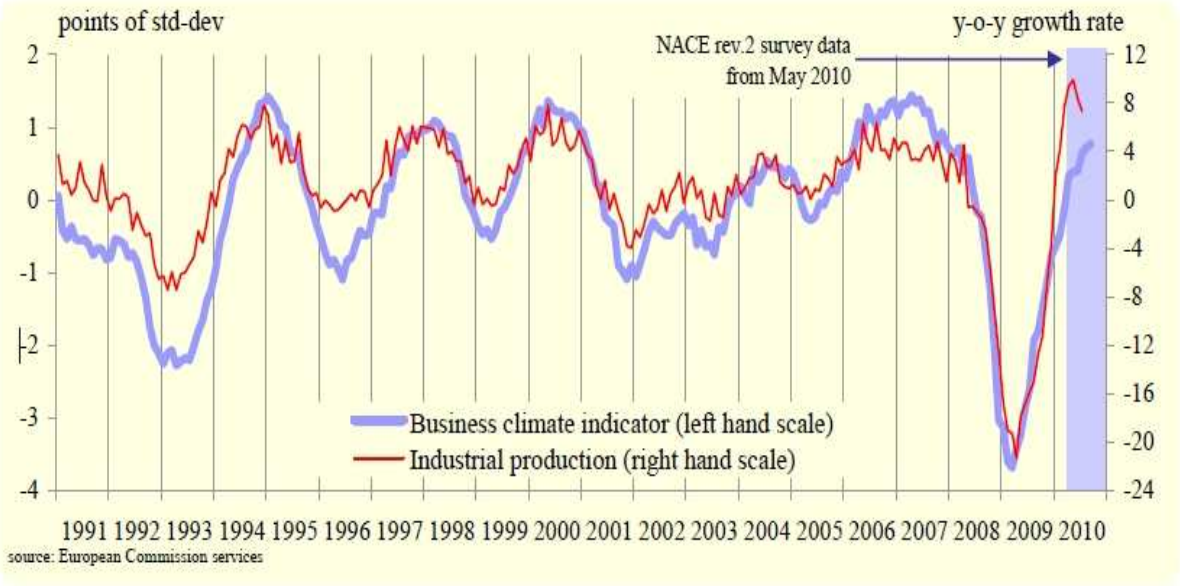
Source: Eurostat

Industrial production was up by 9% y-o-y in the second quarter, but the July-August data (7.2% and 7.9% respectively) showed some signs of exhaustion of former dynamics. In September, sentiment in industry improved by 1 point, mainly due to a slight improvement of order books and production expectations.

Figure 3.12

Source: Eurostat

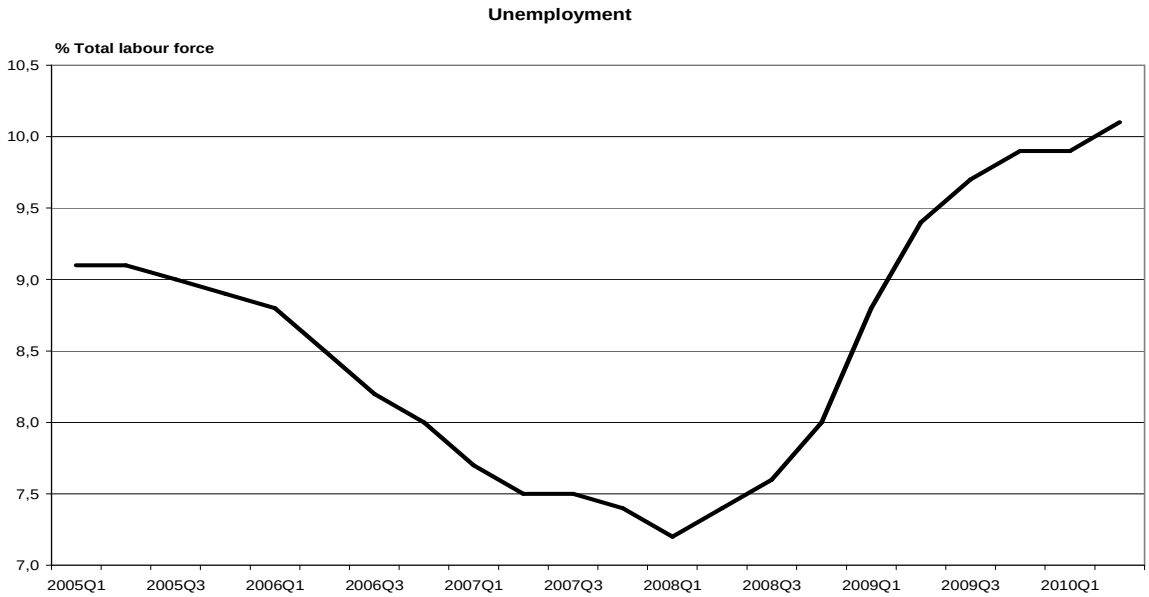
Figure 3.13



Unemployment stabilises

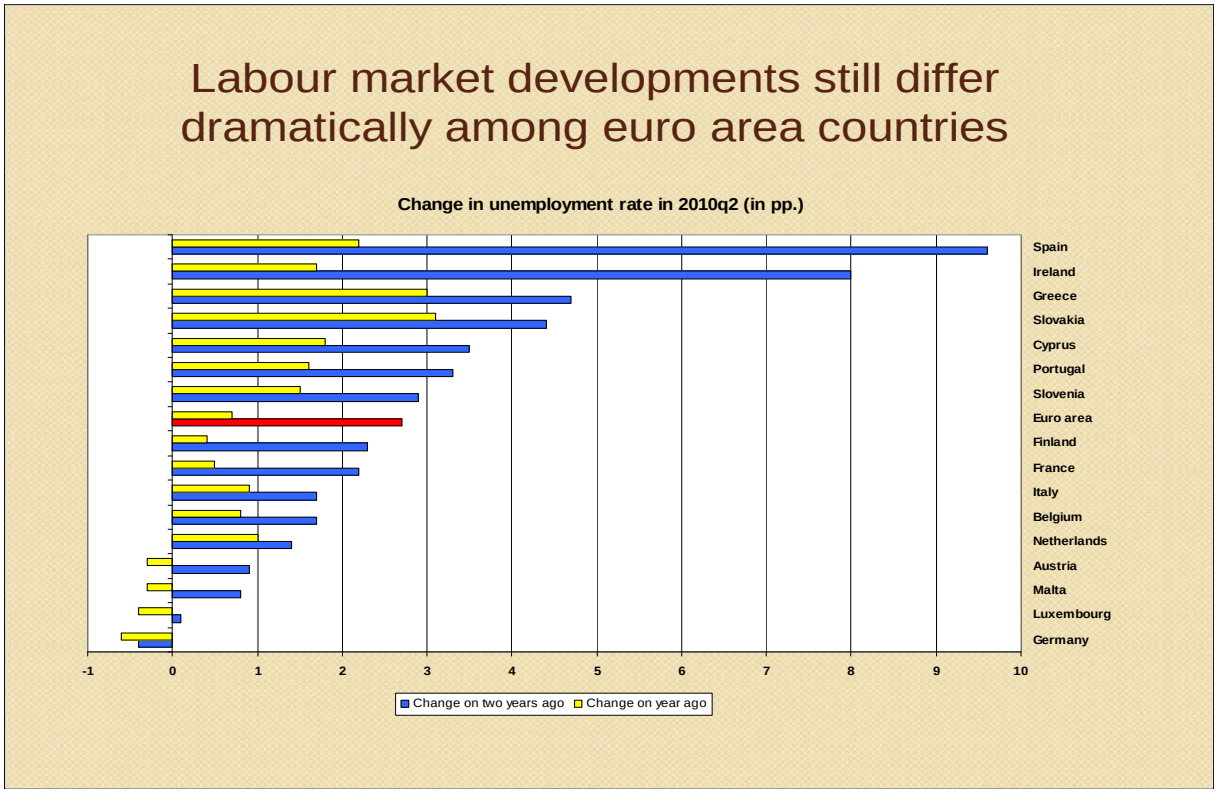
In summer, the unemployment rate remained unchanged, fixing at the 10.1% level of the second quarter, 0.7 p.p. and 2.5 p.p. higher than, respectively, 2009 and 2008 averages. However, this aggregate hides extremely wide differences among the member countries. Between 08Q2 and 10Q2, the unemployment rate increased by 2.7 p.p. in the euro area, ranging from the 0.4 p.p. drop in Germany to the 9.6 p.p. hike in Spain, reflecting great diversities in employment policies ranging from labour hoarding to labour shedding.

Figure 3.14



Source: Eurostat

Figure 3.15



Source: Eurostat

Table 3.2

Recession 08q1-09q1

	Compensation	Employment	GDP	ULC
Euro area	**2,2**	**-1,2**	**-5,2**	**6,3**
Belgium	4,2	-0,7	-3,7	7,2
Germany	1,1	0,5	-6,6	8,1
Ireland	0,3	-8,6	-9,2	0,9
Greece	5,5	-0,6	-1,0	5,9
Spain	4,6	-6,4	-3,5	1,7
France	1,0	-0,4	-3,9	4,5
Italy	1,5	-0,9	-6,5	7,1
Luxembourg	-3,9	8,0	-5,3	9,4
Netherlands	1,2	1,7	-4,0	7,0
Austria	1,5	0,1	-3,9	5,5
Slovenia	5,9	-0,9	-8,4	13,3
Slovakia	7,9	0,0	-4,5	12,4
Finland	2,9	-1,1	-8,8	10,7

Source: IBRKK calculations based on Eurostat data

Table 3.3

Recovery 09q1-10q1

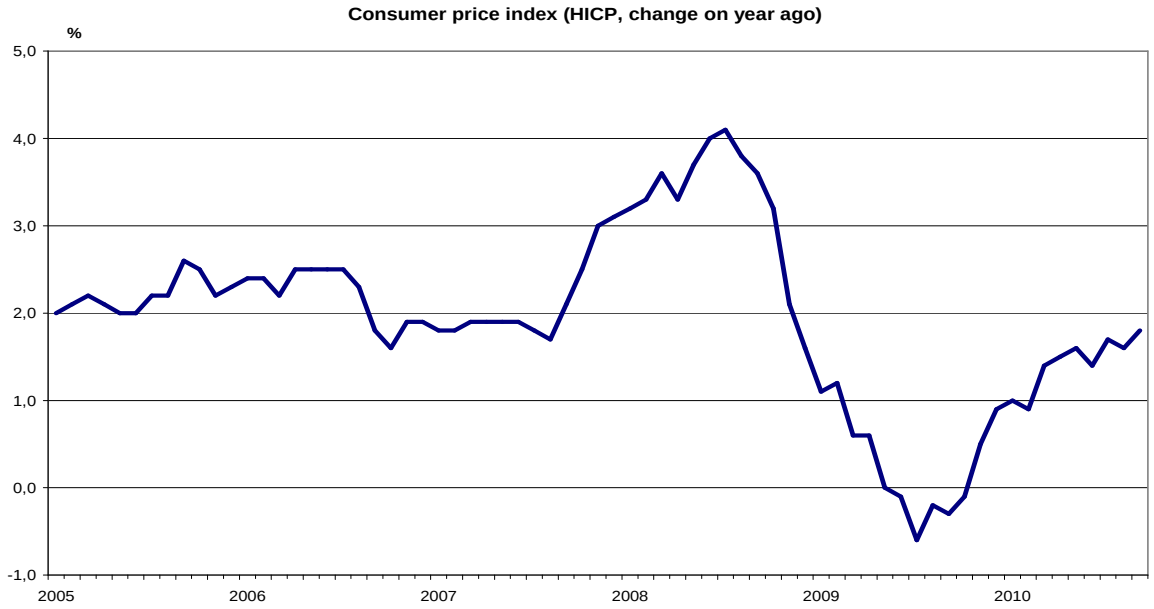
	Compensation	Employment	GDP	ULC
Euro area	**1,2**	**-1,0**	**0,8**	**-0,6**
Belgium	-1,2	1,2	1,6	-1,6
Germany	1,3	0,4	2,0	-0,4
Ireland	-1,0	-5,7	-0,7	-6,0
Greece	-2,8	-1,3	-2,3	-1,8
Spain	1,7	-3,6	-1,3	-0,6
France	2,2	-0,2	1,2	0,8
Italy	-0,2	-0,9	0,5	-1,6
Luxembourg	-0,1	2,2	2,9	-0,8
Netherlands	1,6	-2,2	0,5	-1,0
Austria	1,4	0,0	0,2	1,2
Slovenia	-0,3	0,3	-0,1	0,1
Slovakia	4,2	-4,5	4,6	-4,9
Finland	1,7	-2,4	0,6	-1,4

Source: IBRKK calculations based on Eurostat data

Inflation threats very low

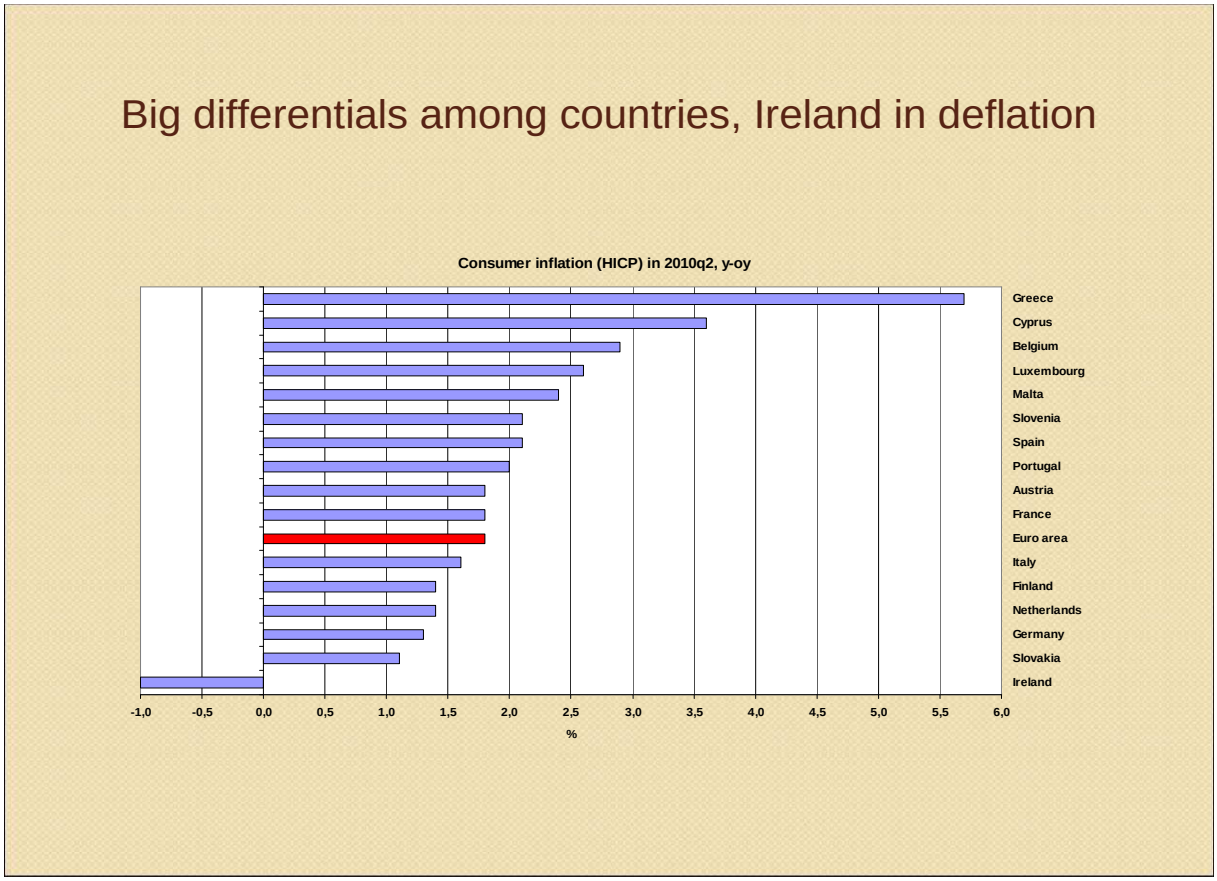
In September 2010, the euro area annual inflation rate reached 1.8%, due to a rise in food prices and, to a lesser extent, in energy prices. This is a marked increase as compared to the March 2010 figure (1.4%), but the core inflation rate is practically unchanged (0.9%-1.0%). Balance of consumer inflation expectations showed even a downturn tendency in the August-September period. There is a consensus among the AIECE Institutes to predict HICP inflation at 1.4%-1.5% both in 2010 and 2011. A typical opinion is that: *the revival of inflation is not a real risk for the time being. With tight income and fiscal policies as well as the appreciation of the euro against major currencies and the drop of oil price a deflationary pressure is more probable than the revival of inflation in 2011.* Reasoning in these lines some institutes expect a decline of the annual inflation rate to 1.1%-1.2% in 2011.

Figure 3.16



Source: Eurostat

Figure 3.17



Source: Eurostat

Monetary policy will remain expansionary

Discussing in the light of recent GDP and inflation developments, the majority of institutes do not see the ECB to increase interest rates over the projection horizon. Some of them see small upside risks to this scenario just in the last quarter of 2011, if growth proves more robust than it currently appears.

Except low inflation expectations another reason for the expansionary monetary policy is that fiscal policy has to be tightened more than is motivated by cyclical considerations in many countries. The optimal policy-mix then requires still low interest rates.

Short-term interest rates have bottomed out in the past months and are constantly rising but the progressive ending of quantitative easing in the euro zone should bring back the Euribor 3-month rate near to the main refinancing rate. (see Fig. 3.18). As FPB concludes: t*here is no need to hurry monetary tightening as there is substantial slack in the economy and as economic growth will slow in the second half of 2010, especially with core inflation stuck at 1%. Moreover, for the moment the ECB is even hampered to take away its extra-ordinary measures taken in the wake of the financial crisis as it is still provisioning unlimited liquidity demands to banks in the euro area (albeit for a maximum period of 3 months instead of 1 year before). For banks in Portugal, Ireland, Greece and Spain have become very dependent on ECB lending (61% of overall lending while these countries account for only 18% of the euro area's GDP) as these countries' banks access to money markets is largely cut off.*

Figure 3.18. Euribor 3-month

Source: ECB

Main risks for the euro area

Assessment of risk made by the AIECE Institutes is strongly skewed towards the negative side.

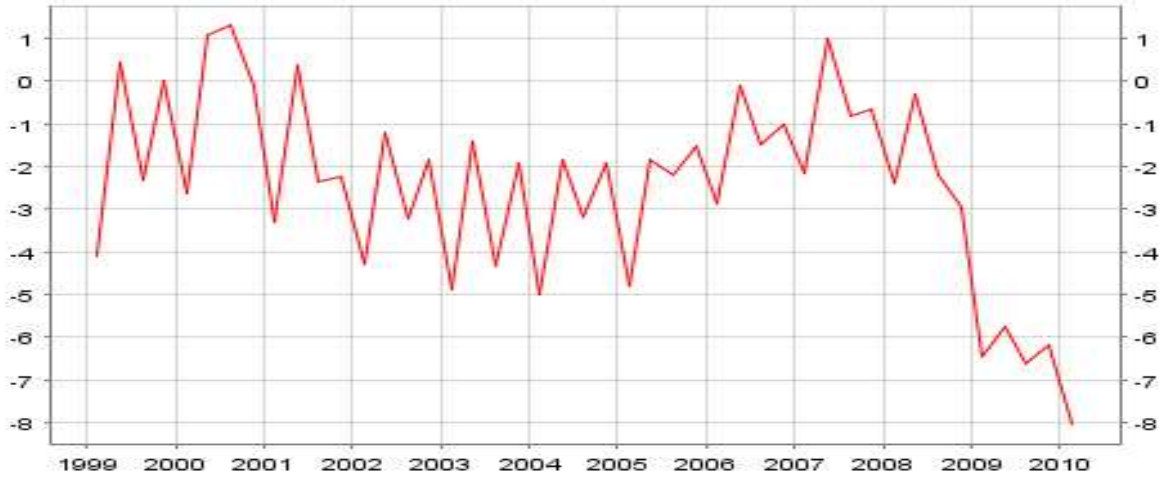
Public finances as a major downside risk factor

With general government deficit exceeding bottoming to 8% of GDP and debt-to-GDP ratio approaching 80% gloomy picture of public finances takes first rank in the list of downside risks (see Fig. 3.19-3.20 and Table 3.4).

As NIER states: a *more general downside risk relates to the fact that many euro area countries are currently very vulnerable to any economic disturbance as government fiscal balances are very weak and monetary policy is already very expansionary. A situation where fiscal consolidation in euro area countries loses credibility could spark another round of financial market turbulence. A lengthy period of such turbulence would hamper economic growth. Unsustainability in government fiscal balances could also force large countries (not only in Europe) to undertake much more marked fiscal consolidations than would be optimal from a cyclical point of view. This could jeopardize the current economic recovery.*

But, on the other hand: *The implementation of drastic fiscal restrictions in order to contain public deficits and debts could also represent a major drag on the Euro area economy (Confindustria).*

Figure 3.19. Government deficit (-) / surplus (+) as a % of GDP



Source: ECB

Figure 3.20. Government debt as a % of GDP

Source: ECB

Table 3.4

MEMBER STATES FISCAL POSITION IN 2009

	Government balance (% of GDP)	Government debt (% of GDP)
Greece	-15,6	115,4
Ireland	-14,4	65,5
Spain	-11,1	53,2
Portugal	-9,3	76,1
Slovakia	-7,9	35,4
France	-7,5	78,1
Cyprus	-6,3	78,6
Belgium	-6,0	96,2
Cyprus	-6,0	58,0
Slovenia	-5,8	35,4
Netherlands	-5,4	60,8
Italy	-5,3	116,0
Malta	-3,8	68,6
Austria	-3,5	67,5
Germany	-3,0	73,4
Finland	-2,5	43,8
Luxembourg	-0,7	14,5

Source: EDP notification

Among other downside risks, the following were the most frequently mentioned:

- The appreciation trend of the euro/dollar rate. This could cool down the export recovery,
- The size of deceleration in the US,
- The calendar of corporate destocking,
- GDP growth in emerging economies will decelerate significantly,
- Longer times to adjust the banking sector,
- Continued households' and firms' deleveraging,
- Further decline in house prices.

Upside risks: recovery rescue in China or Germany or both

The upside risks list is rather short and contains:

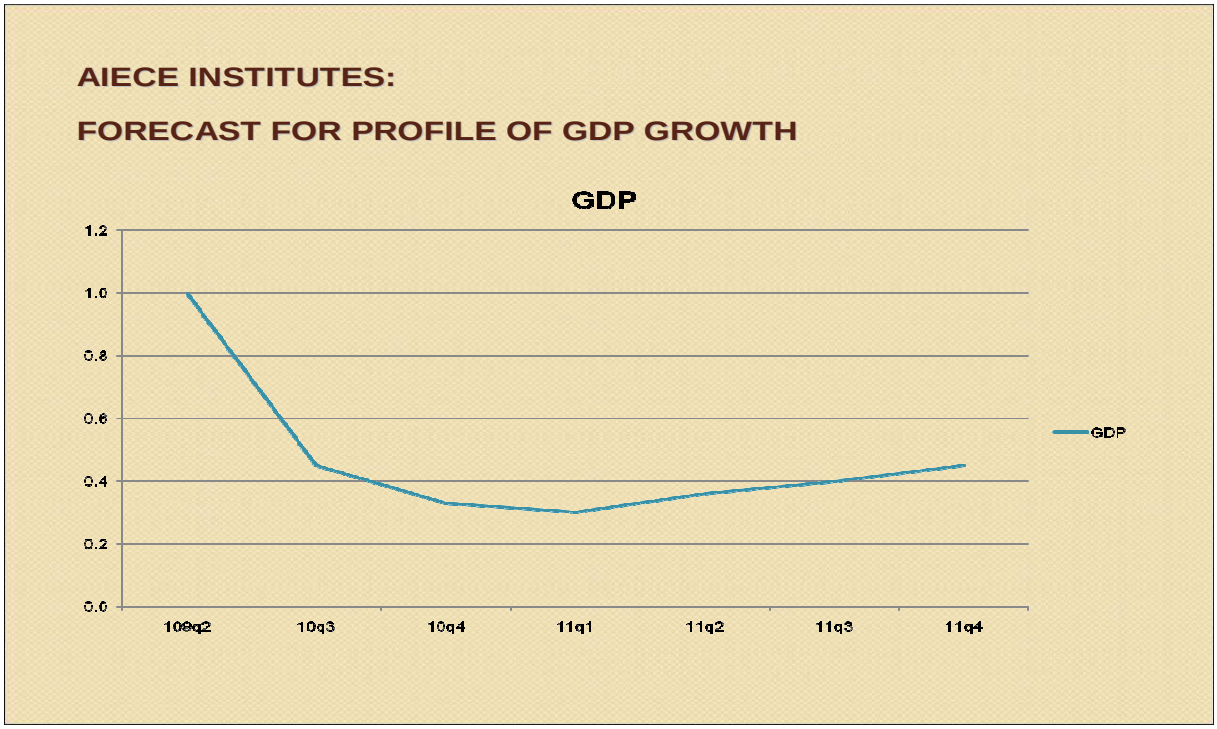
- Stronger than expected foreign demand, in particular in China,
- Domestic demand in 'healthy' euro area countries, in particular in Germany, accelerates more than anticipated,
- Faster than expected normalisation of financial markets,
- Short run impact of monetary policy on asset prices and domestic demand,
- Stronger than expected revival of households' and firms' expenditures in advanced economies.

AIECE forecast for GDP 2011

On average, the AIECE Institutes forecast that the euro area GDP will grow by 1.6% in 2010 and 1.5% in 2011, which is for the current year a strong upward correction of 0.6 p.p. (primarily due to a German factor) and nil correction for the next year as compared with

figures in the Spring 2010 General Report. Institutes providing quarterly profile predict a temporary growth weakening in 10q3-11q2.

Figure 3.21



Source: AIECE Institutes

Table 3.5

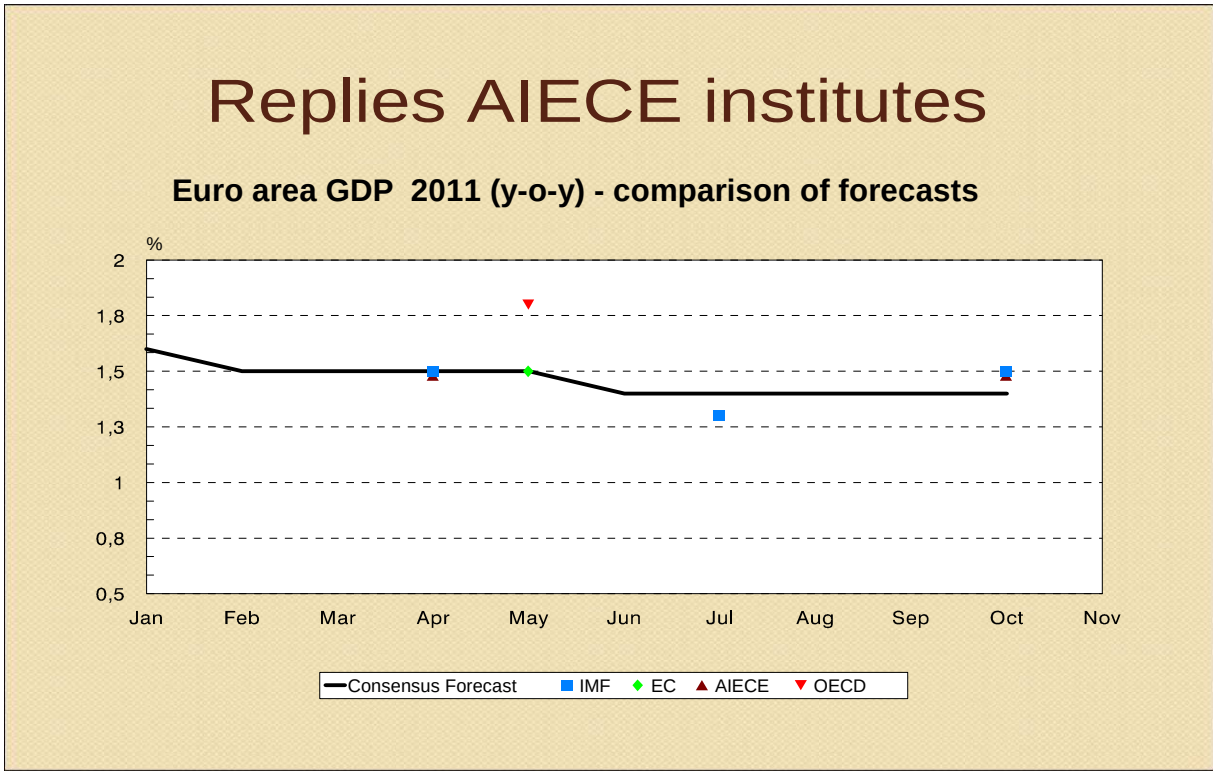
AIECE INSTITUTES:

FORECASTS FOR EURO AREA KEY FIGURES

	2010	2011
GDP	1,6	1,5
Government consumption	1,1	0,8
Private consumption	0,8	1,0
GFCF	-0,7	2,8
CPI	1,5	1,5
Unemployment rate	10,0	10,0

Source: AIECE Institutes

Figure 3.22



Source: AIECE Institutes, IMF, OECD, European Commission, Consensus Forecast

Questions for discussion

- **Double dip recession possibility in the euro area is rather ruled out, but what are reasons for the expected growth weakening on turn of 2010 and 2011?**
- **What are fundamentals of the forecast of nearly 3% GFCF growth in 2011?**
- **Is the prevailing macroeconomic divergence in the euro area an obstacle or rather a chance to accelerate the recovery?**
- **Is a decline in the cost competitiveness due to rigidities in labour markets and the euro appreciation a serious threat to the recovery in the projection horizon?**
- **Majority of the euro area countries are currently under voluntary or involuntary process of fiscal consolidation. What effects of the process will weigh more in the projection horizon – positive or negative?**
- **How likely is that the recovery will be unable to recuperate the employment level of the previous peak in majority of countries?**

Greece: Not yet fiscal discipline but a good start.

A promising progress in structural reform

by Stella Balfoussias, Center of Planning and Economic Research, Athens

Greece's budgetary problems owe much to the rapid growth of public sector employment the high age-related spending and the poor tax administration. These weaknesses have been compounded by the growing loss in competitiveness due to higher rates of inflation than the euro area.

A fiscal adjustment programme was introduced in order to cope with the fiscal crisis, in the context of the EU and IMF support package. The programme for fiscal consolidation is based on a combination of measures drawing on both the expenditure and the revenue side. So far the government has shown considerable resolve in following through on its commitments. The timetable of implementation of the various fiscal contraction measures (increase in the indirect and direct tax burden, income and spending cuts) has been followed accurately. As a result according to available data, budget execution, up to now, has been on target with regards to expenditure, while the revenue targets have been missed by a non-negligible margin.

Because of the increases in indirect taxation inflation has accelerated. These inflationary effects are expected to be offset partly as the fall in demand becomes much more pronounced in the course of the year and as labour cost (ULC) growth in the business sector slows down. Nevertheless, the high rate of headline inflation should not have a significant adverse impact on competitiveness because the taxation component of domestic prices is only partially transferred to export prices.

Greece's debt burden is, nevertheless, very high and many analysts doubt that the Greek consolidation effort will succeed in bringing down the public debt burden and restoring fiscal sustainability, even if all the promised fiscal tightening is implemented. A lot depends on the growth outlook and the progress with structural reform

Thus far, progress with structural reforms has been considerable, with the relevant legislation in three areas of high priority having already been approved.

Pension Reform

In July 2010 the Parliament approved a far-reaching pension reform aimed at ensuring the long-run sustainability of the retirement system. The key elements of the reform included (i) the calculation of pensionable earnings on the basis of the full earnings history, instead of the top 5 of the last 10 years of earnings (ii) the introduction of a minimum retirement age of 60 for all workers (men and women) by 2015, with a requirement of 40 years of contributions to receive full benefits and a reduction of benefits by 6% a year for those who claim before the age 65 without having 40 years of contributions (iii) the introduction of uniform accrual rates

for all workers, bringing these down from 2%-3% a year to a much lower range of 0.8%-1.5% a year, depending on the years of service (iv) the indexation of pensions with inflation, instead of wage growth (v) the equalisation of benefit formulas and retirement ages across all funds, with six pension funds remaining and a separation of these funds from the health insurance component, and (vi) the revision of the arduous professions list in 2011, so as to restrict the arduous classification to less than 10% of the working population, instead of about a third of the labour force.

Labour Market Reform

As part of the process of implementation of a comprehensive labour market reform, legislation was adopted in July 2010 to address institutional rigidities and facilitate labour market entry. Key elements of this legislation included (i) the introduction of a sub-minimum wage for newly-hired employees younger than 25 (84% of the minimum wage level), with payment of their social security contributions by the Manpower Services Organization, (ii) the substantial reduction of severance costs for white-collar workers, through a shortening of the notification period.

Further reforms in labour legislation aimed at increasing wage flexibility, most importantly the reform of the arbitration procedure will be implemented by presidential decree before the end of the year.

Road Freight Reform

In the framework of the efforts to increase competition and remove restrictions, the Parliament approved in September 2010 a major reform of freight transport regulations. The main elements of this reform included (i) the elimination of quantitative licensing restrictions, with licenses granted automatically upon meeting a series of objective criteria set by the law, and (ii) the abolition of administratively set prices for general cargo, with the exception of oil fuel, where the administration can still set maximum prices.

The above reforms have important implications for the inflation and competitiveness outlook as well as for the long-term growth prospects.

An important recent development in the wake of labour market reform has been the 3-year-long national general collective wage agreement signed by the social partners, which provides for zero increases in minimum wages during 2010 and up to mid-2011 and increases equal to average 2010 euro area inflation as of 1 July 2011. The agreement is important because it signals the social partners' realisation of the gravity of the situation, as well as their broad acceptance of current economic policy goals. In real terms it results in a significant wage cut. One cannot predict with any certainty whether these increases in minimum wages will serve as an upper bound for private sector increase. However, given, the adverse situation in the labour market, which will certainly persist in 2011 one might risk the projection that average contractual increases in the private sector will be approximately equal to those in the present agreement.

Taking into account the recent legislative provisions and the new policies on arbitration decisions and on collective agreements signed on the basis of a mediator's proposal we

tentatively and conservatively projected that unit labour cost growth in the total economy will actually turn negative in 2010 (from an average growth rate of 4.4% in the period 2000-08 and 3.2% in 2009).

These projections reflect an expected fall of 12.8% in average earnings of government employees and zero new contractual wage increases of employees in the rest of the business sector. Thus, according to very conservative projections, in the business sector compensation per employee will increase by only 0.3% and ULC growth will slow down significantly. Further downward pressure on wage developments in the business sector is expected from a "demonstration effect" of the wage policy implemented in the public sector and from adverse demand and labour market conditions. Therefore, in the end, it is probable that in the business sector average earnings will decrease and ULC growth will be close to zero or even negative in 2010.

Beyond 2010, according to tentative projections, compensation per employee in the total economy will decline by 0.2% in 2011 and ULC in the total economy may also fall (by 0.5% to 0.7%), exhibiting zero to 0.5% growth in the business sector. Again, these projections are conservative, since they do not take into account fully the fact that labour and product market reforms which may lead to stronger productivity growth.

Greek labour market variables
Long-term developments and projections
Annual rates of change

	2000-08	2009	2010	2011
Total economy				
Compensation per employee	5.9	2.3	-2.9	-0.2
Labour Productivity (VA per employee)	1.4	-0.9	-1.0	0.2
Number of employees	1.5	-0.7	-2.9	-3.0
ULC	4.4	3.2	-1.9	-0.5
Government Sector				
Compensation per employee	8.2	5.2	-12.8	-1.7
Number of employees	2.3	1.0	-2.8	-3.5
Business sector				
Compensation per employee	5.0	3.7	0.35	0.25
Labour Productivity (VA per employee)	1.7	0.8		
Number of employees	2.3	-1.3	-2.9	-3.0
ULC	3.2	3.7	1.3	0.2

Given the complexity of the political economy of labour market reform and fiscal tightening, the above developments give some signs for optimism.

4. Other West European countries

The United Kingdom

The current situation

Since the last quarter of 2009, a moderate recovery has been observed in the UK. The GDP growth rate amounted to 1.2% (yoy) in the first quarter 2010 and to 1.7% in the second quarter. Economic growth was supported by the positive contribution of stock changes, government spending and private consumption. Net exports lowered the GDP growth by 1.3 p.p. in the first and by 1.0 p.p. in the second quarter. The unemployment rate remains below 8% (7.8% in the second quarter of 2010), i.e. 2.47 million jobless. Consumer price (as measured by HICP) increased by 3.1% in September 2010 and, at the same time, inflation expectations grew up to 3.4%. This is much higher than 2% inflation target of the BoE.

The economic policy

Despite the risk of inflation, enhanced by 2.5 p.p. VAT raise announced by the government, probably the BoE policy will not change over the coming year and, according to the NIESR, "*given the weak recovery the stance* (of the BoE) *is appropriate. With fiscal policy constraining growth substantially over the next few years, it is appropriate for interest rates to remain close to zero and the Bank of England to maintain the scale of quantitative easing at around 15 per cent of GDP. QE would have been more effective if corporate paper had been purchased in a larger scale, as was the case in the US. Even so estimates by NIESR suggest that QE raised the level of GDP by 1 per cent in 2009 and 2010"*.

On the other hand, the UK's fiscal stimulus finished at the start of this year. The last year ended with 11.4% deficit on the general government balance. The *Emergency Budget* was regressive: since January 2011, VAT will be raised by 2.5 p.p. and all working age benefits are going to be reformed. Spending cuts equivalent to around ½ of GDP would be introduced in the second half of this year. On the fiscal consolidation plan, the NIESR said the scale of the adjustment is dramatic: "*The government has announced for a cumulative £120 billion fiscal retrenchment over the period 2010-11 to 2014-15. … Cuts to government departments are expected to lead to ½ million public sector job losses (fifth of the public sector employment) alone. Tax and spending plans in the Emergency Budget will reduce the economic growth rate by 0.4 per cent in 2011"*.

The outlook

The very restrictive Emergency Budget, combined with the increasing risk of inflation, has induced the professional forecasters to change their opinions on the economy prospects for the coming years. All forecasters remark that the restrictive policy can negatively affect the domestic demand (especially the government spending), i.e. the factors, which positively contribute to the (weak) GDP growth in the first half of 2010. However, they cut their figures by 0.2-0.4 p.p. only. The forecasts of September/October 2010 have been shown in the table below.

Table 4.1. The UK. Forecasts 2010-2011

	2010			2011		
	GDP	**HICP**	**BoE rate**	**GDP**	**HICP**	**BoE rate**
Consensus	1.5	3.1	x	2.1	2.6	x
Median of bank forecasters	1.6	2.7	0.50	2.0	2.4	1.3
The Economist	1.5	3.0	x	1.9	x	x
NIESR	1.6	3.1	0.50	1.6	2.8	0.60

Source: *Foreign Exchange Consensus Forecasts*, 13 September 2010; *The Economist*, September 2010; *Forecasts for the UK economy*, HM Treasury September 2010, No. 281; NIESR, October 2010.

The NIESR forecast for 2011 GDP growth is 1.6% and the Morgan Stanley Bank shows the lower one (1.3%). However, all forecasters follow the ideas indicated by NIESR: "*From next year the contribution of consumer spending will be less than in the decade before the recession. Per capita consumer spending will not recover its prerecession peak until 2015. Growth will be more dependent on the contribution of net trade, while public spending will pose a drag on economic growth for longer than had previously been expected. Public sector spending cuts will subtract from economic growth in every year from 2011 to 2015*".

The Scandinavian countries (Denmark, Norway, Sweden) and Switzerland

The sound economy is the common feature of these diverse countries. All of them were affected by the global crisis; however, it rather looks like the cyclical slowdown and hit mainly the real sphere. The fiscal policy has been expansionary or very expansionary in 2010, and it will turn to neutral or expansionary in the next year. Despite of such fiscal policy, the public sector fiscal balance in 2010 varies between -0.6% in Sweden and slightly over 4% in Denmark and Norway. In 2011, the respective figures are: -0.8% in Sweden, through 0.9% in Denmark and Switzerland, to slightly over 3% in Norway. Hence, the possible tightening of the fiscal policy is of a symbolic character and it does not harm the economic situation of households.

In this context, the outlook for all four countries seems to be positive:

- for Denmark (DEC opinion): "*Fiscal policy was very supportive for the economic activity in 2009 and 2010. The effect on growth in 2009 is estimated at around 1½ per cent. Fiscal policy contributed by another 1 per cent to growth in 2010 – lifting the level of GDP by almost 3 per cent in 2010…The main elements was a strong increase of public consumption, higher public investments and a tax reform, that was significantly underfinanced in the short run… GDP is expected to grow by 2¼ per cent in 2010, 1-1¼ per cent in 2011 and 1¾-2 in 2012. These growth rates will bring the output gap down from around -4 per cent in 2010 to around -2½ per cent in 2012*";
- for Norway (Statistics Norway): "*The monetary and fiscal policy impetus will wane gradually over the next few quarters. The interest rate has bottomed out, and fiscal policy will be tightened somewhat. It appears reasonable to assume that policy will be approximately cyclically neutral…We estimate mainland GDP growth at approximately 1.5 per cent in 2010. From next year, growth in the mainland economy*

could almost double and hence rise to just over trend. In 2013, we expect the Norwegian economy to be in a pronounced cyclical upturn, so that we approach a cyclically neutral situation towards the end of the year. In the event, the coming cyclical upturn will be moderate compared with the upturn from 2003 to 2005 when the Norwegian economy last moved from".

- for Sweden (CSE and NIER): *"The Swedish economy has rebounded and is displaying a strong recovery. This year's GDP growth will reach 3.5-4 percent, boosted by private consumption, investments in stock and exports. Signs of the strength of the recovery are that the labour market is already showing positive growth and that company investments are rising. (*CSE*)…The upturn is due primarily to highly expansionary economic policies in Sweden and elsewhere. With the rapid upturn in world trade, Swedish exports have recovered quickly so far in 2010. (*NIER*)… The stable public finances with a government budget turning positive during 2011 give the politicians the opportunity to implement reforms that would increase Swedish competitiveness. (*CSE*)…The recovery of the Swedish economy will continue in 2011 and 2012, albeit at a somewhat slower rate than in 2010. In 2011 and 2012, GDP will grow by 3.4 percent per year… Exports have been a significant driving force in the recovery thus far and will remain so for the next few years. In comparison with previous recoveries, however, domestic demand will play a more important part this time. Swedish household saving is at a historic high.... Monetary policy is highly expansionary, and strong general government finances will permit an expansionary fiscal policy in 2011 as well. (*NIER*)"*;
- for Switzerland (KOF): "*Gross debt is at around 40% of GDP, and the cyclical deficits will not go beyond 1.0% of GDP (1.3% including the social insurances, particularly, unemployment insurance), having been preceded by considerable surpluses. There is thus little need for austerity measures…Fiscal policy has supported aggregate demand in 2009 and 2010, though to a comparatively modest extent. Given the soundness of state finances, more support would have been appropriate. …in 2010, GDP will therefore grow at a gratifying 2.7 per cent. In 2011, however, economic growth will be somewhat weaker, at 1.8 per cent. The slow-down of the world economy and the strong Swiss franc will put a damper on the upturn".*

Questions:

- **The UK's gross debt amounting to 68.2 per cent of GDP in 2009 and despite the austerity measures it will probably hit 82 per cent in 2011 with the fiscal deficit slightly less than 10 per cent of the GDP. How do you assess contents, size and consequences of consolidation plan of the Emergency Budget?**
- **The Scandinavian governments have sound fiscal accounts. Are they enough sound to support recovery and to continue combining economic efficiency with high social ambitions?**

5. Special topic: Exit strategies

Expanding government deficits and public debt have led to concerns about the long-run sustainability of public finances. There are many calls for an early exit from the fiscal stimulation packages, but fears about GDP costs of too early fiscal consolidation are also very common. Some European countries are already in the process of consolidation, others are preparing the policy change. We asked questions concerning timing, scope and expected effects of the consolidation efforts and assessment of the recent EU Council proposals for a greater fiscal policy coordination in the EU.

Q 1. How do you assess necessity and a desired time profile of implementation of the exit strategy in fiscal policy in your country?

Answers:

1) There is definitely a necessity and a good time to start exit strategy (WIFO, IfW, DIW, SKEP, NIESR and CCSF, CPB, CEPREDE, with some reservations concerning its pace and shape)

IfW: *As the output gap is narrowing in the course of next year, the government is well advised to implement the exit strategy measures now.*

CCSF: *The implementation of a rational exist strategy we regard to be necessary.*

But its implementation should be strictly in tune with the speed and scope of the ongoing recovery.

2) Fiscal stimulation package was small enough, so there is no problem with its withdrawal (FPB, KOF)

FPB: *Belgium fiscal stimulus during the crisis was very limited. As we have a very open economy, the better thing for us to do was to take advantage of the stimulus measures taken in our neighbouring countries (e.g. the Belgian car sector benefited from the scrap premium in Germany).*

3) Fiscal policy has been already very restrictive (KEPE, GKI, KOPINT)

GKI: *The exit strategy started already in 2007 with the reduction of the general government deficit. Hungary has been under excessive deficit procedure since 2004. In 2011 it has to reduce its general government deficit to less than 3 per cent of GDP.*

4) Implementation of exit should have been postponed (Prometeia, REF)

Prometeia: *Even considering the high level of the Italian public debt, the still unsatisfactory recovery would have required a growth oriented fiscal policy and the exit strategy should have been postponed till 2012.*

5) There is no need for any exit policy (Swedish institutes)

CSE: *Fiscal policy in Sweden has not been as influenced by the financial crisis as policies in many other countries.*

Q 2. Do you think the austerity measures already undertaken or announced by fiscal authorities are well tailored and sufficient to restore public finance position in your country? Please comment.

a) Are they sufficient?

Answers:

In short run yes, in a longer perspective no (ETLA, WIFO, Kopint, CEPREDE, Prometeia)

CEPREDE: *We think the austerity measures taken by fiscal authorities are sufficient to restore public finance position in Spain in the medium term, but for the future there are going to be necessary new measures of incomes reactivation, in the sense that it is indispensable to promote the flexible hiring and recover the wages.*

ETLA: The Finnish public debt is relatively low, which makes restoring public finance position less challenging than in most other EU countries in the short term. In longer term, Finland has larger than average sustainability gap in finances due to e.g. aging of the population. This stresses the importance of the exit.

No, they are not sufficient (IfW, DIW, BIPE, REF) or possibly insufficient (KEPE)

DIW: *No. There is need (and room in terms of growth) for a substantially stronger consolidation of fiscal policy.*

REF: Our forecasts suggest that Italy will need some further fiscal correction to bring the public finances on a sustainable position.

BIPE**:** *The measures remain timid in view of what is needed to reverse the past trend in the deficit share of GDP (i.e., permanent increase…)*

b) Are they well tailored?

Answers:

Shifted mainly to expenditures cuts without tackling structural issues (WIFO, ETLA)

WIFO: *As to current plans, we would like to see the efforts more shifted towards expenditure cuts (e.g. subsidies). We also think that the current measures, which are done with some urgency, should be complemented with tackling structural issues such as a reform of public administration, pensions and the like asap.*

Affecting mainly low-income groups (CCSF, IBRKK)

CCSF: Austerity measures announced by the fiscal authorities of the Czech Republic will certainly improve the position of its public finances. Criticized is the fact that they are applied even before the recovery of its economy has fully developed and that they are making mainly low-income groups of the population carry the burden (the consequences) of the slump.

Too high cuts in investment expenditures (SKEP)

SKEP: *We believe that budgetary cuts in investment expenditures have been too high. We would expect more strictness of other public expenditures (public sector wages, more efficient public institutions and agencies...)*

IFW – Germany: *So far, the major part of the consolidation measures focus on tax increases. A more substantial cut in subsidies and government spending would be more favourable to the domestic development. Also, there is a substantial risk that additional consolidation measures will further reduce the level of public investment spending that is already on a downward trend.*

More tax rises is evitable (NIESR)

NIESR: *The public finances will slowly be put back in order, with more tax raises being inevitable. Spending based consolidations, which we plan, have more effect on output in the short term than do tax based consolidations*

Q 3. Is there a significant risk that the fiscal consolidation will considerably affect speed of recovery in your country?

Answers:

Yes (CCSF, KEPE, IBRKK, Prometeia, REF, CPB, Kopint, CEPREDE)

Prometeia: *We estimate the effect of restrictive fiscal policy approved by the Government to be of 0.2 p.p. of GDP next year and 0.3 p.p. in 2012 (the Government estimate 0.3 and 0.5 p.p. respectively).*

No (WIFO, FPB, KOF, BIPE, DIW, SKEP)

WIFO: *We think that the risk is contained. Household savings are high and there is enough room for lowering the household saving rate. Further, the employment outlook is reasonably good, hence we predict a slight decline in unemployment despite fiscal consolidation.*

No, only a danger of negative spillover from export markets due to fiscal consolidation in other countries (ETLA, CSE, NIER)

CSE: *Not the fiscal consolidation in Sweden. The fiscal consolidation in the rest of the western world may influence Sweden.*

No, lower interest rates may help growth (GKI)

GKI: This must not necessarily be the case. The tight and disciplined fiscal policy may result in the decrease of country risk spreads and lower interest rates with lower interest payments that may contribute to more dynamic GDP growth.

Q 4. How do you assess impact of recently endorsed by the EU Council proposals for greater economic policy coordination in the EU and introduction of a stricter policy guidance under the European Semester as of January 2011 on your country fiscal policy future shape?

Answers:

The proposals are welcome (CCSF, ETLA, KEPE, SKEP, GKI, Kopint), but their impact on policy is hard to assess (CPB, FPB, BIPE)

ETLA: *ETLA welcomes strict rules and automatic procedures to guarantee sustainable public finances. The rules should depend on the health of the economy. The countries with small problems in public finances suffer the bad development in crisis countries.*

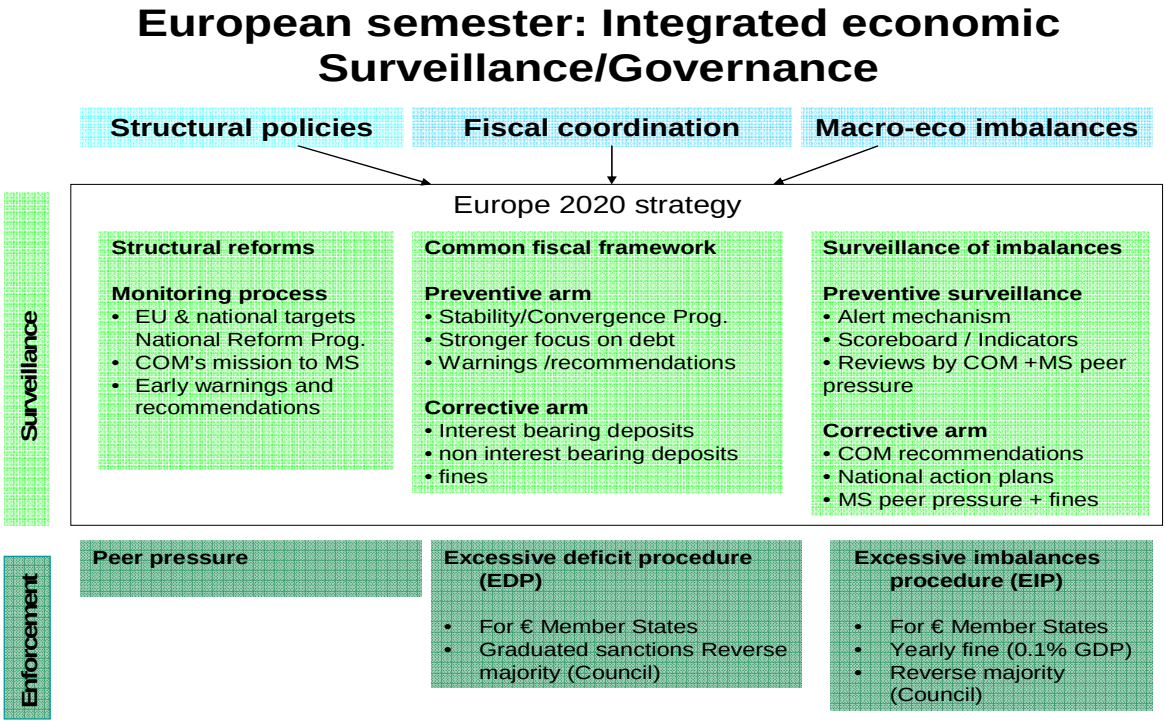
CPB: *Policy coordination is to be assessed positively. However, the impact of policy coordination on policy is hard to assess. Is coordination really leading to a different policy stance? The European semester is a step in the right direction. It makes policy discussion in ECOFIN more forward looking.*

These obligations will have costs (CEPREDE)

CEPREDE: *These proposals are one of the greatest opportunities to promote the European construction process, because it imply the obligation to correct the budgets problems, while ensuring not to incur new macroeconomic imbalances in the future. However, these obligations are going to commit the natural recovery of the coastal economies (Spain, Italy,*

Greece and Ireland), because the coordination will stop the encouragement of these economies based on increased public spending.

Figure 5.1



Source: European Commission

A credible no-bailout clause would be much more effective (IfW)

IfW: *Any form of economic policy coordination bears the risk that coordination takes place at the central level that is not suitable for specific member states. Instead, a re-establishment of a credible no-bailout clause would be much more effective. As Germany already agreed upon a fiscal sustainability clause within its constitution, an additional European guidance would probably not have a substantial effect on the future financial policy stance.*

- **How do you assess contents of fiscal consolidation packages in your countries? Could social tensions involved be less?**
- **Stricter policy guidance under the European Semester introduces a budget expenditure rule in the SGP preventive arm and regular monitoring of macroeconomic imbalances of MS (including CABs). How do you assess effectiveness of these proposals and possible interferences with national fiscal policy objectives?**
- **Would really a credible no-bail-out clause be much more effective measure to ensure reinforcement of economic governance in the EU and euro area?**