

Global Economic Outlook

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Policymakers confront reality

The future of the euro – Part II
Getting it right this time

QE – What's in a name?

China
Tradeoffs continue

Turkey
More positive than negative





Global Economic Outlook Q3 2011

In recent months, the major areas of uncertainty for the global economy have revolved around the crisis in the Eurozone, the future path of monetary and fiscal policy in the United States, and the fight against inflation in emerging markets. As such, our report this quarter offers some thoughts on these topics.

We begin with Elisabeth Denison on the future of the euro. She offers a brief history of the development of the Eurozone and talks about factors related to the current crisis. According to Elisabeth, no solution will be enduring unless it considers long-term and structural changes to put impacted European economies back on the path to sustainable growth.

We then turn to the mix of policy in the United States, with specific focus on what the Federal Reserve might do now that the second round of quantitative easing has ended. Pralhad Burli and Siddharth Ramalingam offer a brief explanation of the mechanics and impact of quantitative easing (QE), a discussion of the first two rounds of QE, and a point of view on whether and when another round might be necessary. They also discuss alternatives to QE that might have the effect of boosting liquidity and adding to credit growth.

Our final topical article concerns the issue of how best to measure economic well-being. Satish Raghavendran and Neha Jain discuss whether or not GDP is an adequate measure of a country's economic output. After all, there are countries with seemingly high levels of per capita GDP yet with high levels of environmental degradation and poor measures of public health. They discuss the various limitations of using GDP and offer alternative measures. They conclude that, despite the problems with GDP, the many alternatives still leave much to be desired.

We then move to our outlooks for various countries and regions. In his quarterly point of view on the U.S. economy, Carl Steidtmann looks at the recent slowdown in economic activity. He explores the debate over whether the United States is headed for a double-dip or simply a soft landing. After examining the data, Carl concludes that the case for growth is "more compelling."

Next, I offer my view on the outlook for China. I discuss how, in the short term, China's authorities continue to struggle with restraining inflationary growth while maintaining export competitiveness. I then turn to some of the longer term obstacles to rapid growth, specifically the challenges presented by over-investment. I suggest that the transition to a more normal economy is fraught with dangers and could lead to a substantial decline in growth.

Elisabeth Denison then returns with her quarterly outlook for the Eurozone economy. She suggests that Europe faces a “rather worrying combination of ingredients.” These include a two-track recovery in which the north and south grow at very different rates, a tightening of monetary policy by the central bank, tighter fiscal policy everywhere and slower growth in key export markets. She concludes that the outlook is for moderate growth at best.

Ian Stewart then provides his outlook for the UK economy. He believes that the recent weakness in growth is not, as many analysts suggest, solely due to tighter fiscal policy. He believes that another important contributor is the surprisingly high level of inflation and its impact on the real spending power of consumers. He hopes that, with inflation likely to fall next year, the UK recovery would gain a firmer footing.

Next, I offer my view on the Japanese economy. I discuss how the earthquake and tsunami have rendered an even worse economic decline than initially expected. However, I offer hope that reconstruction spending will provide a boost to growth in the coming months. In addition, I discuss the impact of various ways of financing reconstruction.

On Brazil, I discuss the two key and intertwined issues of exchange rates and inflation. I analyze the choices faced by Brazil’s authorities. I also discuss some of the longer obstacles to continued rapid economic growth, with special focus on Brazil’s inadequate level of investment.

Next, I offer my view on the outlook for Russia’ economy. I discuss how Russia is fighting high inflation and what impact oil prices might have on Russian economic policy decisions. I also attempt to explain why Russia’s growth rate has not been as strong as that of the other BRIC economies.

Next, Siddharth Ramalingam provides his quarterly view on India. He discusses the monetary and fiscal policy choices faced by the authorities, as well as how the monsoon might affect inflation and policy in the months ahead. He opines that maintaining strong growth while limiting inflation will be a difficult challenge.

Finally, Pralhad Burli offers a point of view on Turkey. He notes that, of late, Turkey’s growth has been spectacular. This has been driven by reforms designed to prepare Turkey for EU entry. Yet, despite the good news, Turkey faces a number of challenges including a burgeoning external deficit and uncomfortably high inflation.



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The future of the euro – Part II: Getting it right this time

by Dr. Elisabeth Denison

The story of European integration is a long one, but solving its first serious debt crisis should not have been. The second quarter 2010 edition of the Global Economic Outlook featured an article called “The future of the euro,” describing the pros and cons of different options for dealing with the emerging debt crisis of fringe nations. Unfortunately, instead of fundamental reform, the year that followed introduced more stopgap measures while the crisis deepened. Finally, on July 21, European leaders agreed on far-reaching measures that will change the structure of the monetary union. As an immediate effect, the rescue of Greece will help calm nerves and ease the pressure which has been building in the European bond market. But the real test will be in the execution of the agreements reached on economic alignment and fiscal discipline. If it succeeds, it will lift European integration to the next level.

A short review

When the euro was created, the 11 founding nations agreed under the Growth and Stability Pact that government debt may not exceed 60 percent of GDP and government spending may not be above 3 percent of GDP. The Maastricht treaty also set “convergence” criteria, such as low and stable inflation and long-term interest rates, to check whether countries were economically fit enough to join the single currency. One problem was that even Germany and France were in violation of treaty and ran “excessive” deficits under the pact’s definition for some years – so the rules were eased in 2005. There was no agreement on consistent criteria to govern the reporting by member countries, and the Economic and Monetary Union (EMU) did not include an enforcement mechanism. A monetary union without fiscal integration relies on individual governments to take the actions necessary to comply with the rules of the union.

With global growth flourishing and the financial system awash with liquidity, none of this mattered during the

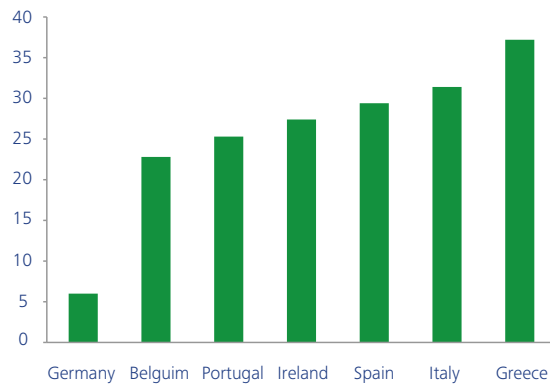
first few years of the monetary union. While growth in Germany was still sluggish for most of the past decade, fringe nations benefitted from low interest rates and ample credit availability due to the elimination of exchange-rate risks. Credit markets overlooked large current account deficits, rising real estate prices and the public finance practices of peripheral nations.

Structural and financial problems exposed

Weaknesses were exposed when the crisis struck. What determines the success of an economy in a monetary union is its flexibility in both labor and product markets, since it can no longer rely on currency depreciation to realign its costs. High levels of liquidity obscured the fact that the peripheral economies had declined steadily after the introduction of the euro. While core nations stuck to a strict reform process of holding labor costs in check, wages in countries like Spain, Italy and Portugal rose faster than productivity, thereby eroding competitiveness. Greek unit labor costs rose 37 percent over the last 10 years against an increase of just 5 percent in Germany (see figure 1).



Figure 1 : Unit labor costs in select Eurozone countries
Average 2000-2010 (%)



Source: Eurostat

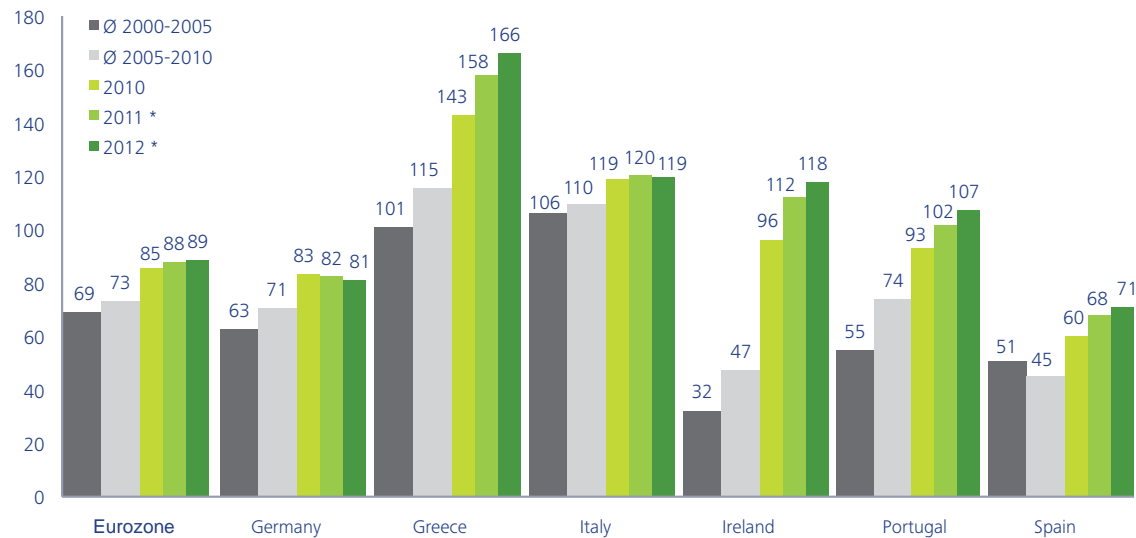
would require a prolonged and challenging reduction in Greek wages.

A public-debt-to-GDP ratio of 127 percent and a budget deficit of 15.4 percent of GDP were factors which led to markets raising questions about the risk associated with Greece’s sovereign debt. Ireland had low public debt going into the crisis, but the state was hit by declining tax revenues and the cost of its banking sector bailout after the housing bubble burst. As of May, the European Commission predicted public debt above 100 percent of GDP for both Ireland and Portugal by the end of this year. Greece will likely cross the 160 percent threshold soon (see figure 2).

What to do?

As declining confidence led to rising risk premiums in the European government bond market in May 2010, country

Figure 2: Government debt % GDP



Source: EU Commission

For Greece in particular, this impact on competitiveness aggravated its starting point relative to the rest of the group. With the lowest exports-to-GDP ratio in the Euro area, membership to the Eurozone presented more advantages in terms of access to inexpensive imports rather than a path to higher productivity. Trying to focus on exports to get the economy back on a sustainable growth track

leaders came together and constructed a €750 billion rescue package. It consisted of the European Financial Stability Facility (EFSF) plus additional guarantees by the International Monetary Fund (IMF). Greece received a bail-out worth €110 billion (\$158 billion), which was supposed to put the nation back to borrowing from the private capital market within three years. That expectation has not held. Furthermore, Portugal and Ireland also had



As of May, the European Commission predicts public debt above 100 percent of GDP for both Ireland and Portugal by the end of this year. Greece will likely cross the 160 percent threshold soon.

to receive rescue funds and it became clear that Greece will be in need of a second rescue package of roughly the same magnitude as the first, and soon.

How would the rescue package be paid for? The answer hinged on how far private creditors would “participate” – something Germany in particular had been pushing for as the negotiations dragged on. The ECB was at first opposed to any form of “reprofiling” of debt amid worries about the impact on its own portfolio if the restructuring was deemed a “credit event” by rating agencies.

Meanwhile, reforms set out by European leaders in March 2011 fell short of a comprehensive long-term solution. The “Pact for the euro” aimed to strengthen cohesion in the single-currency area through economic measures – for example, greater wage flexibility – and the introduction of

binding fiscal rules to fix public finances. The temporary rescue fund will be turned into a permanent “European Stability Mechanism” (ESM) with an effective lending capacity of €500 billion by 2013.

Markets were not convinced of the long-term success of these measures (or worried their implementation will take too long to avoid an imminent default of Greece). Credit rating agency Standard & Poor’s has downgraded Greek government debt to CCC in June, making it the lowest-rated sovereign debt in the world. The insurance premiums for Greece and other affected nations – including the ones rescued – were higher in May 2011 than they were in May 2010. The level of interest rates on Greek debt meant that the government would have had to make interest payments equivalent to around 12 percent of GDP this year.

The options

So what were the options for stabilizing fringe nations of the monetary union, first and foremost Greece? European leaders seemed to have recognized that another short-term stop-gap measure will not be good enough for markets (and more importantly, the electorates). Another rescue package without a long-term plan is just prolonging the uncertainty. Breaking up the monetary union would not have been a workable solution. The expulsion of Greece (or any other member state) whether from the EU or from EMU would be so challenging on multiple levels that its likelihood is close to zero (see *Global Economic Outlook Q2 2010*).

A voluntary exit of a Eurozone member might be possible – but what would be gained? A return to the nation's old legal tender would severely hurt confidence; interest rates would rise even higher, increasing the fiscal deficit even further and making solvency even less likely. In addition, forcing one country of the common currency out would have serious contagion effects. Markets would immediately price in similar scenarios for other endangered nations. Forming a “strong euro” area would in addition hurt core nations' growth prospects. Germany, for example, is sending over 60 percent of exports to Eurozone neighbors – with suddenly depreciated currencies, they won't be able to afford as much of them.

The new deal

Finding a long-term solution meant tackling two issues (1) providing immediate relief for indebted fringe nations and convincing markets that a working system is in place to deal with any emerging debt crisis and (2) agreeing on a common understanding of fiscal discipline and creating the structures for enforcing it. At a crucial summit on July 21, heads of the state of the euro area and European Union institutions, together with the IMF, agreed on measures to deal with both points:

(1) Immediate relief for Greece, private sector involvement and stabilization tools

Restructuring: The total official financing will amount to an estimated €109 billion, with the refinancing profile of Greece improved through lower interest rates (reduced in the Eurozone's portion from about 5.5 percent to 3.5

percent) and extended maturities (from 7.5 years to a minimum of 15 years and up to 30 years with a grace period of 10 years). The IMF will continue to contribute to the financing and the EFSF will be used as a financing vehicle. Recapitalization of Greek banks will be provided if needed.

The restructuring of Greece debt – both in terms of interest to be paid as well as maturities – is not much different in nature from a Bradybond-style rescue operation, in which Greek government bonds would have been swapped for debt issued jointly by euro-region members (ideally EFSF bonds). (Brady bonds, named after then-U.S. Treasury Secretary Nicholas Brady, enabled 17 countries in Latin America, Africa, Asia and Eastern Europe to swap bad loans for new debt starting in 1989, some of which was backed by zero-coupon U.S. Treasuries.)

Private Sector Involvement (“PSI”): About a third of the €109 billion cost of the package (€37 billion) will be absorbed by the private sector through write-downs between now and 2014. In addition, a debt buyback program is expected contribute another €12.6 billion, bringing the total to €50 billion. For the period 2011-2019, the total net contribution of the private sector has been communicated at €106 billion – but there is still some uncertainty surrounding that figure. Importantly, the statement stresses that “As far as our general approach to private sector involvement in the Euro area is concerned, we would like to make it clear that Greece requires an exceptional and unique solution.” The EFSF lending rates and maturities agreed upon for Greece, however, will also be applied to Portugal and Ireland.

Stabilization Tools: To improve the effectiveness of the EFSF and of the ESM and address contagion in the long-term, the leaders decided that the new financial stability facility would be made more flexible to intervene in secondary markets and provide recapitalization of financial institutions if necessary. And the agreement states that the community is “determined to continue to provide support to countries under programs until they have regained market access, provided they successfully implement those programs.” Combined, these announcements are intended to address the markets most immediate fears and lead to easing pressure in Eurozone bond markets.



(2) Fiscal integration of the monetary union and economic governance

For the longer term, a commitment has finally been reached to take the integration of the Eurozone to the next level. Paragraphs 10 to 16 of the statement detail the plans for fiscal alignment and economic governance. Public deficits in all countries (except those under a program) will be brought below 3 percent by 2013 at the latest. Leaders commit to implementing the national fiscal frameworks foreseen in the fiscal directive by the end of 2012.

In conclusion, then, stakeholders realized that any immediate financial solution to the European debt crisis

had to come with fundamental reform. Having taken the leap, the future of Europe has got decidedly brighter. It will not be an easy road, and fringe nations still need much help in putting their economies back on a sustainable growth path. Part of the deal reached on July 21 was a kind of “revival package” for Greece, pledging support from EU structural aid funds and technical assistance in implementing reforms. But importantly, leaders have come together and communicated a firm commitment to the Euro area, along with their willingness to act in the interest of the whole within a clear structure and abide by the rules of enforcement. If that can be put into practice, it will prove an old saying right: “Never waste the opportunities offered by a good crisis.”

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QE – What’s in a name?

by Siddharth Ramalingam and Pralhad Burli





Did quantitative easing (QE) succeed in kick-starting the economy? The jury is still out on whether QE1 and QE2 were a success. There is no certainty of a QE3 when the \$600 billion QE2 program ends at the end of June; well, at least not immediately. If the U.S. economy deteriorates in the coming months, policymakers may well implement another round of monetary measures that aim to inject momentum into the still nascent recovery.

QE – a brief history

The first round of quantitative easing, QE1, focused primarily on adding liquidity to the banking system. The Federal Reserve purchased agency securities and mortgage-backed securities from troubled financial institutions and accumulated assets that were not conventionally part of its balance sheet. Purchases by the Fed increased the price of assets and lowered yields. As a result, private individuals either substituted their asset holding or exited the market altogether. As private holdings in these assets declined, liquidity improved in the private sector. Without this easing, the United States, and the global economy, could have slipped into a longer and deeper recession.

The second round of quantitative easing, QE2, was significantly different from the first. The Fed aimed to bring down real long-term interest rates by buying long-term treasuries, thereby raising prices and reducing yields.

Increased liquidity would in turn push equity prices higher and stimulate the economy by creating a wealth effect and also banish fears of deflation. Furthermore, the lower interest rates and the expectation that short-term interest rates will be held at a low level were expected to weaken the value of the dollar, thereby making U.S. exports more competitive. However, QE2 is viewed as having had only limited success in accelerating the economic recovery.

What next?

The U.S. economy has hit a soft patch. GDP growth slipped to 1.8 percent in early 2011 and is expected at close to zero percent in second quarter. As of this writing, it is unclear whether the dip in GDP growth is temporary or if the recent weakness foretells more serious consequences. Unemployment remains at stubbornly high levels and continues to rise, low real interest rates have not stimulated the economy and much of the cash that has been infused into the economy is sitting idle in bank vaults. Everything is not well with the economy. So, will there be a QE3?

While it seemed unthinkable until recently, the possibility of another round of stimulus, namely QE3, cannot be ruled out. Some experts believe the Fed may be compelled to intervene and provide the economy with another stimulus. Others think that, until there are clear signs of another



recession, the Fed is unlikely to intervene. The Fed's current stance is equivocal. While it has ruled out another round of quantitative easing immediately, it has retained some flexibility in responding to the turn of events in coming months. In other words, policymakers are unsure about the future of the economy and, if the economy veers toward another recession, QE3 might emerge as a distinct possibility.

At this point, the Fed has indicated that it will continue to reinvest maturing assets, marking what could be a QE2 redux. In a similar move to the QE-lite program that followed the initial QE, the Fed will reinvest run-off of about \$300 billion to purchase treasuries. The reinvestment program will likely take the effective spending under QE2 to about \$900 billion.

ifs and buts

QE3, whether right at the heels of QE2 or months away, could have adverse consequences. Belief in the U.S. economy's ability to recover fully may wane, treasuries may start to be viewed as risky assets and bond yields may increase. It is unlikely that the Fed will rein in liquidity either and may find it difficult to offload assets. Specifically,

it will be challenging to offload Government Sponsored Enterprise debt and Mortgage Backed Securities from its \$2.8 trillion balance sheet. Moreover, weak growth, high unemployment, and state and municipal sector challenges loom large. And most of the factors that caused the financial crisis have not yet been addressed.

Another challenge that the Fed might have to face in coming months is the federal deficit. Prior to QE2, a significant amount of U.S. debt was bought by foreigners. Under QE2, the Fed took over as the majority buyer of debt. Once the \$600 billion under QE2 runs out, the QE2 redux will likely kick in. But, the funds available under the QE2 redux are far fewer than those available under QE2. However, it is important to note that the government may not actually take on as much debt as it has in the last year; and much will depend on negotiations on the debt ceiling. Still, if domestic buyers and foreign buyers, and funds under the QE2 redux cannot together mop up government debt, the Fed will be compelled to step in with additional measures.

International pressure to coordinate monetary responses to the current crisis could weigh on whether the Fed goes for another round of quantitative easing as well. The



Bank of England Monetary Policy Committee in its June meeting extensively discussed the possibility of increasing the size of its asset purchase program. While eight of nine members on the committee voted against the proposal, the importance attached to the asset purchase proposition underscores the severity of current economic challenges. If inflation falls below the medium-term target of the central bank, further asset purchases may be warranted. Likewise, Eurozone countries agreed to enhance the lending capacity of the European Financial Stability Facility (the proposal is yet to be ratified). The move will likely allow for a swift recapitalization of the banking system. While the EFSF does not amount to quantitative easing, it may also help inject liquidity, provide stability and potentially stave-off a sovereign debt-crisis. Furthermore, the ECB has undertaken QE and is likely to continue to do so, albeit, in less transparent ways. Similar actions in other parts of the world could create economic conditions that increase the need to for further measures to increase liquidity in the United States.

An alternative measure the Federal Reserve may use to increase liquidity is the reduction of interest paid by the Fed on its reserves. U.S. banks hold nearly \$1 trillion in

excess reserves with the Fed. Reducing the interest rate paid below the current 0.25 percent will likely prompt banks to lend more and boost credit growth. Alternatively, the Fed could uphold its interest rate ceiling and promise to maintain a near zero interest rate for a prolonged period. Market forces could then move interest rates to the desired level. Such measures will also not hurt the Fed's balance sheet. Policymakers do have non-monetary options as well. For example, releasing oil stocks from strategic reserves will help in bringing down energy price inflation. This will, in turn, improve both producer and consumer sentiments, and possibly inject some momentum into the economy.

If increasing liquidity is the Fed's main concern, another round of quantitative easing is not the only option at the Fed's disposal. QE may be helpful if the demand for money rises and the economy faces a liquidity trap. Otherwise, an incessant reliance on QE could backfire and result in significantly higher inflation, even stagflation. While the QE2 redux runs its course, the Fed may utilize a bevy of other measures to increase liquidity. It need not even label its policy actions as quantitative easing. After all, what's in a name?



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GDP metric – Time for a makeover?

by Dr. Satish Raghavendran and Neha Jain

Gross domestic product, or GDP, has long been regarded as the principal measure of economic activity. Conceptually, GDP measures the value of goods and services produced in the economy. The change in GDP over time is used as an indicator of economic growth. Since economic performance is directly linked to consumption and employment, the GDP of a country is often regarded as a proxy indicator of human development and the well-being of its citizens. However, given substantive changes in the structure of the economy, the question remains – is GDP still an adequate measure of economic welfare?



This issue becomes even more relevant because the GDP metric is one of the main indicators used by policymakers to design and measure the performance of national policies. Inaccuracies and oversight in measurement can lead to misdirected efforts. The issue of distorted polices is amplified as the world economy is currently recovering from an extraordinary economic contraction. Prominent economists (Stiglitz et al) have even attributed the failure of our growth-centric measurement system to give warning signals as one of the causes of the recent economic crisis. It is believed that misplaced faith in the GDP and related statistical indicators resulted in overlooking asset bubbles that were developing in the economy. During 2004-2007, GDP numbers painted a rosy picture of the world economy and failed to deliver a warning against the economic crisis that ensued. Perhaps it's time for policymakers to readdress the fundamental assumptions which typically guide policies.

What is the GDP metric lacking?

GDP measures the economic value of goods and services produced within an economy thereby overlooking the contribution of non-market activities, that is, activities that do not have a market price. Hence, to a large extent, actual output is underestimated. Moreover, since GDP is an aggregate measure, it does not capture income disparities which are an important indicator of the well-being of citizens. In our performance-oriented world, GDP estimates have often been used by stakeholders to highlight economic expansion, while not necessarily focusing on the real developments or lack thereof in the quality of life of its citizens. Many argue that the output measured by GDP will eventually have trickle down effects on the quality of life of citizens, but this is an indirect measure. A more specific indicator can more accurately assess the quality of life and may be used to better direct remedial measures.

Esponsing a historical perspective on the evolution of this metric can provide meaningful insights. The concept of national production was initially introduced by Adam Smith in his book *Wealth of Nations* and later used by Simon Kuznets to estimate economic output for the U.S. Commerce Department. In its initial form, Gross National Product (GNP) measured the value of goods and services produced by a country's enterprises whether located within the country or abroad. The GNP estimate then

gained importance as a war-planning tool during World War II as it enabled countries to identify underutilized capacity and boost production to support their war-ridden economies.

During wartime, there was an excessive emphasis on the production of goods without much attention toward the externalities that they generate, especially the negative effects. This statistic failed to recognize negative externalities caused by environmental degradation and resource depletion. For instance, even in modern day economies, industrial production activities that have an environmental impact will boost the GDP of a country in terms of the value of goods that it produces. However, the impact these activities might have on the environment and the health of citizens eventually affects their quality of life and could ultimately influence productivity and well-being. This makes a compelling case for the inclusion of the impact of externalities in the computation of GDP, or at the very least that they be considered while designing economic policies.

Aside from the valuation of externalities, the issue of sustainability has long challenged development economists. It is important for policymakers to look beyond GDP when assessing the health of their economies, especially those that rely excessively on natural resources. There is not only a need to measure the value added by a country's natural resources but also be mindful of the sustainability of the output derived from these resources.

A solution to this challenge is found in the **Green GDP** metric. The concept of Green GDP gained popularity in the 1990s as a way of assigning economic costs to environmental impacts and resource depletion. Green GDP is calculated by adjusting the economic value of environment impacts and resource depletion from the traditional GDP estimate. In fact, when the Chinese government published its Green GDP statistics in 2004, it was found that 'Green GDP' took away almost 3 percent from the conventional GDP estimate. Despite caveats in the methodology used, Green GDP reinforces the need to adjust for environmental/ecological costs when calculating national output. This approach can enable policymakers to strike the optimal tradeoff between growth and sustainability.

Another alternative measure of GDP is the **Genuine**

As a novel experiment, the Bhutanese government launched the Gross National Happiness (GNH) index as an alternative to GDP in 2008.

Progress Indicator which has a much broader coverage than traditional GDP. Its measurement is similar to conventional GDP but deviates to include factors such as unpaid labor, wealth distributions, social breakdown (crime, divorce, etc.), loss of leisure, foreign borrowing and environmental damages. The composite indicator thus differentiates between factors that add to well-being and those that diminish it. This can be especially useful for policymakers to perform a cost-benefit analysis of such non-market activities and allocate development spending accordingly.

The World Bank's **Genuine Savings** is yet another indicator that specifically addresses the sustainability issue. Genuine Savings or Adjusted Net Savings measures the true rate of savings in an economy after taking into account investments in human capital, depletion of natural resources, and damage caused by pollution. The indicator is expressed as a percentage of Gross National Income and a persistently negative figure indicates that the country's total wealth is declining – that is, current development is not sustainable in the future. Genuine Savings serves as a forward-looking tool for policymakers to formulate their monetary and fiscal policies while keeping social and environmental factors in mind.

Changing with the times

In the last couple of decades, a number of countries have transitioned from industrial economies to service-oriented economies. Although GDP includes the value added by services, it fails to adequately account for quality improvements. For instance, upgrading the quality of healthcare and education can greatly enhance the well-being of people without actually increasing economic output as estimated by the traditional GDP metric. In fact, improvements in the quality of goods such as computers, etc., can improve productivity but remain unaccounted for in

national income estimates. The nature of our society has undergone a paradigm shift from a production-oriented society to one that lays a greater emphasis on the quality of life. Rapid technological advancements and the advent of digitalization have also made citizens more aware and quality conscious. Moreover, NGO's have gained prominence in today's society but their actual contribution toward the betterment of society cannot be adequately quantified, and hence goes largely unnoticed. Therefore it is apparent that the measurement of national income must evolve to meet the realities of the 21st century society.

The **United Nation's Human Development Index (HDI)**, which measures the socio-economic progress of a nation, offers a powerful alternative to conventional GDP. It is a composite indicator that reflects life expectancy, literacy, education, and standards of living in countries worldwide. HDI is an effective indicator of the quality of life enjoyed by the country's citizens and is reflective of overall well-being. It is widely used to classify economies as "developed," "developing" or "under-developed" and thus offers a yardstick for overall national progress and international comparison.

As a novel experiment, the Bhutanese government launched the **Gross National Happiness (GNH)** index as an alternative to GDP in 2008. The country aims to preserve its environment, culture, and community cohesion by maximizing its GNH. Although the universal applications of this model are limited, it has nevertheless spurred discussion on the broader concept of well-being and happiness. Since then, a number of organizations have developed indices to incorporate the social aspect of development.

The **Happy Planet Index (HPI)** developed by the New Economics Foundation (NEF) is one such alterna-

tive. HPI seeks to measure the environmental efficiency of supporting well-being in a country. In other words, it measures the relative efficiency with which a country converts its natural resources into long and happy lives for its citizens. HPI calculations include three separate indicators: life-satisfaction, life expectancy, and an ecological footprint based on data gathered from the World Bank, UNDP and WWF. The index does not report how “happy” a country is but it broadly indicates the well-being delivered per unit of environmental impact. NEF has also put forward a radical proposal in the form of the **National Accounts of Well-being**. This is envisioned as a composite indicator that covers dual aspects of well-being: personal and social. The initial framework is based on surveys conducted across Europe and has succeeded in attracting attention as a comprehensive measure of well-being.

The indicators discussed above are either arrived at through adjustments to the traditional GDP metric or stand alone as comprehensive substitutes to the metric itself. However, a third approach of supplementing the current system of national accounts with **Environmental Accounts** is gaining traction, especially in Europe. In recently proposed revisions to the System of National Accounts, the UN’s *Handbook of National Accounting* could widen the scope of national accounts by incorporating data on environmental and social aspects as well. It suggested that countries across the world switch to the **System of Integrated Environment and Economic Accounting (SEEA)** by publishing additional accounts as supplements to conventional GDP accounts.

Measure to manage

While the limitations of GDP as a measure of national income have gained a critical mass of awareness, there appears no perfect alternative which can be universally

adopted. The collection of metrics is intimately linked to the phenomenon of interest. Information affects behavior; the kind of data collected is both an indication of intent as well as outcome. For instance, a collection of data related to environmental impact shows intent on the part of policymakers who will ultimately use this data to design their policies to protect the environment. Hence it has become imperative to prioritize and design the right indicators to better manage desired outcomes. While these alternatives address specific lacunae in conventional measures, they cannot adequately fill the current gap, so the issue of their mass adoption still remains. Perhaps an international organization can take the initiative in standardizing the reporting of alternative measures.

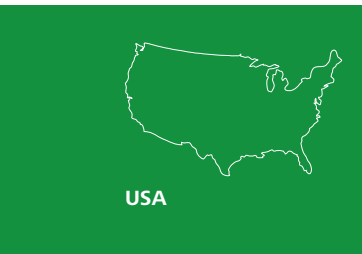
As governments and policymakers rebalance their development objectives to include social aspects, the policies that they choose will have repercussions on the living standards in a country, which will directly impact corporate strategies. Using alternative and balanced measures of output could better enable governments to develop policies which would be responsive to their pressing social issues, and could better support their goal of improving their socially-conscious national output. For example, if Green GDP were to become a yardstick for policymakers, they could devise policies to minimize the environmental impact and resource depletion in a cost-effective way. This could have a direct impact on the supply chains of firms using inputs that are harmful to the environment. The firms would then have a greater incentive to “green” their supply chain to drive environmentally sustainable production. Therefore adopting more comprehensive metrics can drive the appropriate behavior and socially beneficial outcomes for the citizenry and country alike.

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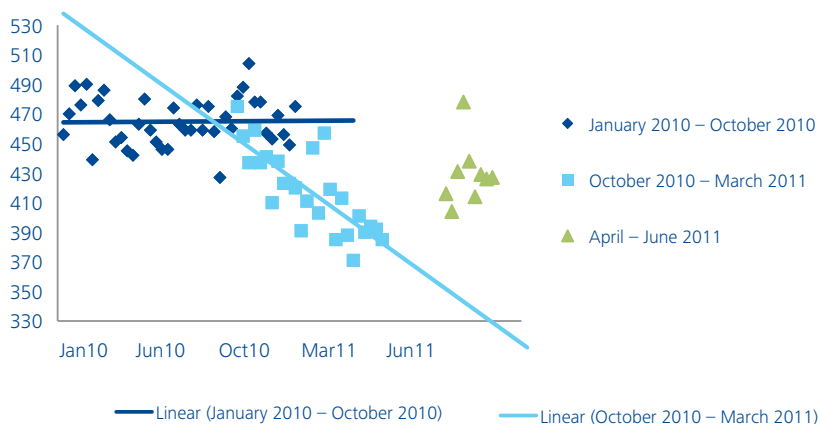
United States: Soft patch or double-dip

by Dr. Carl Steidtmann

At some point in every recovery, the economy slows from its initial rebound pace. In the last three business expansions, a slowdown about 18 months into the recovery prompted a debate about the possibility of a double-dip. In 1986, it was due to banking problems and falling energy prices in the oil patch. In 1994, rising interest and tax rates slowed the momentum. In 2002-2003, uncertainty over the confrontation with Iraq created a period of below-trend growth.

As the U.S. economy moves into its third year of recovery, a number of leading indicators are giving off less than encouraging news. Initial jobless claims have ticked up and employment growth has slowed. Regional production indices published by the Federal Reserve have turned down. The debate has been joined over whether this weakness represents a soft patch in the economy due to temporary headwinds or something more systemic that could lead to a second downturn.

Figure 1: Initial jobless claims
(Thousands)



Source: U.S. Department of Labor

The case for a double-dip

Worries about the strength of the recovery began to emerge in early April. Initial jobless claims, which had been declining, broke off in April 2011 and have been hovering at 50,000 or more above the trend seen in the previous six months.

The decline in claims from October through March was aided by the creation of 1.15 million private sector jobs, the largest such gain since April 2006. Recent readings, however, have been more than three standard deviations from the mean trend line that was started back in October 2010. To be on-trend, these readings would need to be in the 370,000 to 390,000 range. While one such event could be claimed as an outlier, the probability of nearly two months of such events being outliers is quite remote. A reversal of fortunes here produced a gain of just 54,000 jobs in May and puts the current recovery on shaky grounds.

Banking profitability and recessions

Economic downturns are often driven by challenges in the banking sector. The profit performance of this sector

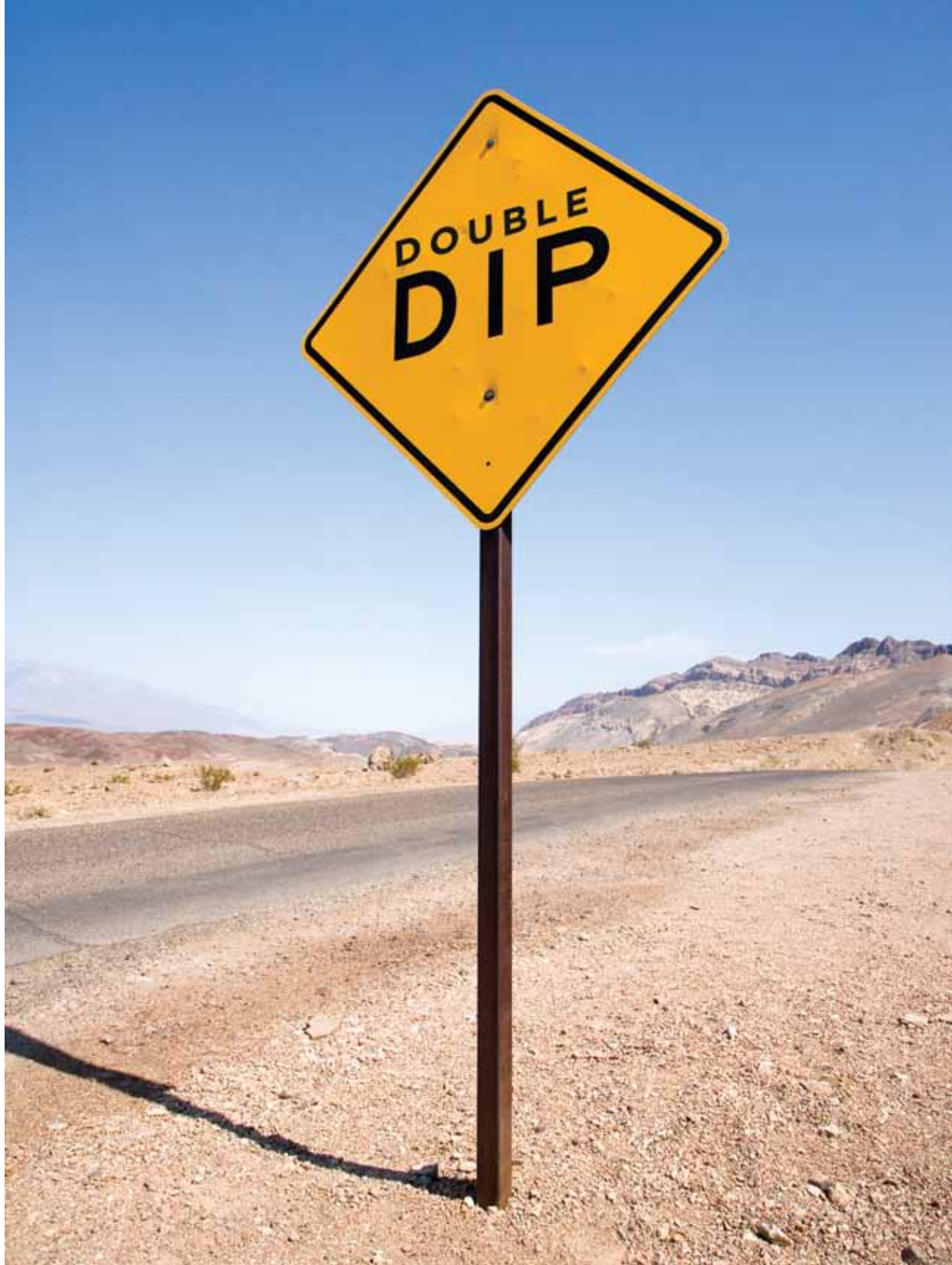
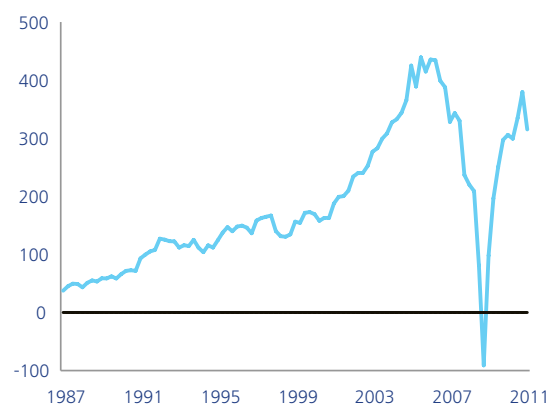


Figure 2: Financial sector profitability
(In billions of \$, seasonally adjusted annualized rates)



Source: U.S. Bureau of Economic Analysis

in the first quarter of 2011 was a result of several factors, including the fact that some of the issues that created the 2007-2009 recession continue to linger. These challenges, coupled with broad and still uncertain new regulations, are impacting the performance of banks.

Housing market decline and U.S. banks

Bank profits are being hurt, in part, by the state of the housing market. Falling home prices translate into increasing bank losses as banks work through their backlog of foreclosures. The pipeline of foreclosed-upon houses means that home prices will probably continue to fall and bank losses will likely continue to increase.

In March, the Case-Shiller Home Price index fell 3.6 percent from a year ago. The decline in home prices represents a significant threat to bank balance sheets and profitability. By maintaining a steep yield curve, the Federal Reserve is hoping to support the financial health of the banking system by providing liquidity and enabling them to maintain their margins. The fall in home prices lengthens the time for that cure.

While the pipeline of mortgages that are in default is slowly declining, the number of mortgages that are in foreclosure continues to rise. As a result, FDIC insured banks' inventory of real estate owned (REO) properties remains very high despite the fact that bank sales make up more than 30 percent of all existing home sales.

The risk to banks is that they are holding assets that are declining in value, reducing their recovery value and adding to bank losses. In addition to these future capital write-downs, another \$500 billion in mortgages are current but underwater and at risk of default, so the banks face an on-going threat to the capital structure of their balance sheets. It was this set of problems that contributed to the sharp decline in bank profitability in the first quarter.

Risk based capital requirements

Current bank woes could become even more challenging over the next couple of years due to an imminent change in bank capital requirements. In a speech in early June, Fed governor Daniel Tarullo laid out possible increased capital requirements for systemically important financial institutions, a task assigned to the Fed by last year's Dodd-Frank banking reform act. The enhanced capital requirements being contemplated by the Fed would go well beyond those required in Basel III and would be based on both the size of an institution and the riskiness of the assets it is holding.

By increasing capital requirements with the size of an institution, the new regulations could neutralize any economies of scale that might come from size. It might force some banks to raise capital; other banks may look to divestiture as a way of meeting the new requirements. The downside risks of increasing reserve requirements should be considered in setting enhanced capital requirements.

Sovereign debt and U.S. banks

There may be some impact to the U.S. banking system from the ongoing debate over who will shoulder the burden of Greek debt restructuring.

Moreover, questions have arisen as to whether or not Ireland, Portugal or some other country will face challenges similar to those of Greece. The current Greek debt crisis poses some risk for European and, to a lesser extent, U.S. banks.

The argument in Europe is over who is going to shoulder the burden of any Greek debt default. While there is significant disagreement between the current German government and the European Central Bank over how to resolve the crisis, eventually some of it could fall to the

Table 1: U.S. bank exposure

In billions \$	Greece	Ireland	Portugal	Total
Direct	7.3	51.0	5.3	63.6
Credit Default Swaps	34.1	54.0	41.2	129.3
Total	41.4	105.0	46.5	192.9

Source: Bank of International Settlements, as of Q4 2010

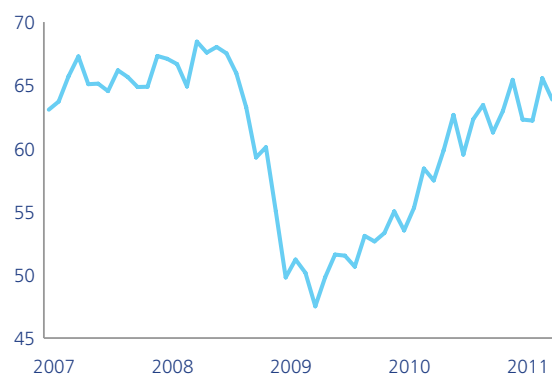
banks, impacting their balance sheets and possibly limiting future credit creation. U.S. banks have \$192.9 billion in exposure to Greece, Ireland and Portugal sovereign debt, most of it through credit default swaps.

The July 21 European Council agreement is a step toward trying to resolve these issues. In expanding the role of the European Financial Stability Facility (EFSF), the banks now have a lower cost mechanism to reduce their exposure to higher risk sovereign debt. In the short run this may reduce the risk of both default and contagion. In the longer run, the success of this program will depend on whether the different indebted countries can effectively address their fiscal imbalances. The patience of the Eurozone general public to fund these efforts will also be tested.

Additional challenges

Looking beyond the banking system, there are several additional reasons to believe that a second downturn is in the making. First, the federal government deficit debate

Figure 3: New orders for non-defense capital goods – excluding aircraft (In billions of \$)



Source: U.S. Census Bureau

in the United States is heading toward more austerity and portends slower growth. Budgetary concerns at the state level simply compound this challenge.

Second, rising oil prices weigh heavily on consumer purchasing power. Energy pushes up the price of everything – particularly food, which is very energy-intensive. As a result, real disposable income was flat in April. Rising energy prices also take a toll on corporate margins.

Third, business uncertainty over financial service, health-care and energy reform is prompting caution on new investment – there was a decline in April orders for durable goods. Capital investment should be soaring given the added incentives that were part of last year's tax compromise.

The recent weakness in Chinese manufacturing shows that the Chinese economic juggernaut is slowing. Overinvestment by China is beginning to catch up with reality. The lack of return on investment on many of these projects could eventually hurt their banking system, reducing their ability to fund deficits in both Europe and the United States.

The double-dip case concludes by arguing that the Federal Reserve could be forced into another round of quantitative easing (QE) to keep the banking system liquid. The risk in a third round of QE is that the Fed could lose credibility with the markets and risks even greater inflation in the future.

The case for a soft landing

A combination of one-time events has slowed growth. The earthquake and tsunami in Japan is hurting exports and disrupting auto production in the United States. A rash of harsh weather has left devastation throughout much of the South and Midwest. These events disturb the normal flow

of economic activity. But as they pass, rebuilding adds back some of the lost growth. Employment trends in the first half of the year suggest that the underlying fundamentals of the economy remain intact and it is those fundamentals coupled with additional stimulus from rebuilding that will give the economy a boost in the second half.

What is lacking in the case for a double-dip is the financial crisis that sets it off. The financial crisis of 2008 was preceded by a series of market indicators that screamed

distress. At the present time, most of those indicators are pointing to continued growth.

Risk spreads

Spreads between Baa corporate debt and the U.S. Treasury 10-year note reached 612 basis points at the height of the financial crisis in the fall of 2008. In June 2011, the spread was around 260 basis points. Over the past 40 years this spread has averaged 220 basis points. Risk spreads, while slightly elevated, in no way suggest that an economic downturn is pending.

Figure 4: Risk curve
(Baa corporate bond yield less 10-year U.S. Treasury yield)



Source: Federal Reserve Board

Financial crises are first and foremost liquidity events. One measure of short-term bank liquidity is the TED spread, the difference between the three-month London Interbank Offered Rate (LIBOR) and the three-month U.S. Treasury bill rate. The spread is a reflection of risk in short-term lending to banks. In normal times, the TED spread fluctuates between 10 and 50 basis points. During the financial crisis of 2008, the TED spread hit a high of 468 basis points.

During the early phases of the Greek debt crisis in June 2010, the TED spread briefly spiked up to 51 basis points. Since the first of the year, the TED spread has averaged 22 basis points. While the trend has been up slightly, the overall level of the TED spread reflects no sign of banking system stress.

Figure 5: TED spread
(In basis points)



Source: Federal Reserve Board

Commercial paper

In the run up to the financial crisis of 2008, commercial paper outstanding went into a steep decline. Traditionally, commercial paper is used by high quality debtors to fund short term cash flow needs. In the last decade, many hedge funds that invested in mortgage backed securities used commercial paper to increase their leverage. When fears over the quality of the collateral for many of these hedge funds began to rise, their access to the commercial paper markets was closed.

The severity of the decline in commercial paper forced the Federal Reserve to purchase commercial paper in the fall of 2008 as part of their first round of quantitative easing. As the Fed exited the market in 2009, commercial paper outstanding continued to decline as businesses cut inventories and headcounts as a more direct way of generating short-term working capital. Since the first of the year, the



commercial paper market has posted a solid recovery off of a depressed level. Commercial paper outstanding has risen by 30 percent since early January. A rise in commercial paper outstanding is a reflection of a growing willingness of businesses to hire more and hold more inventory.

The treasury yield curve

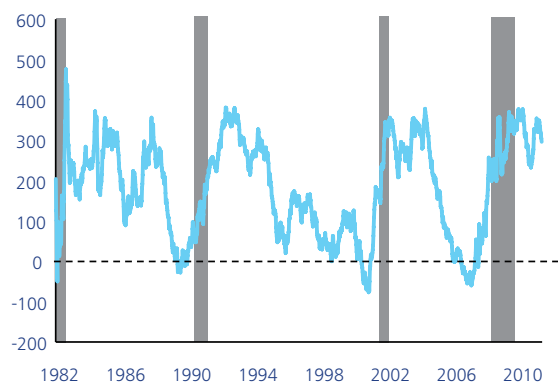
The yield curve in the U.S. Treasury market is the difference between 3-month and 10-year Treasury yields. Over

Figure 6: Commercial paper outstanding
(In trillions of dollars)



Source: Federal Reserve Board

Figure 7: Treasury yield curve
(10 year Treasury yield less three month T-bill yield)
Gray areas indicate recessions



Source: Federal Reserve Board

the past 60 years, it has been the single most reliable financial leading indicator of recessions, having successfully anticipated every recession, while only posting two false recession readings.

The Treasury yield curve is a proxy for bank margins. When the spread is large, bank margins are generally robust. Wide margins give banks an incentive to lend, which in turn grows the economy. When the yield curve inverts with short-term rates rising above long-term rates, bank margins are poor and lending tends to contract. Prior to the 2007-2009 recession, the Treasury yield curve inverted as it has prior to every post-World War II recession

At 294 basis points, the Treasury yield curve is a long way from inverting and is providing a favorable lending environment for bank profitability. While the changing regulatory environment presents uncertainty for banks, Federal Reserve policy is creating both liquidity and supporting favorable margins for the financial sector.

Conclusions and observations

Every recovery hits a soft patch and every soft patch generates a debate about the risk of a double-dip recession. In some cases those soft patches develop into full blown recessions. The case for a second downturn rests on the expectation that another debt crisis will likely bring down the banking system much as it did in 2008. While the problems in the housing market and with sovereign debt in Europe are real, they don't represent the potential for multi-trillion dollar losses that prompted the 2008 crisis.

The case for growth seems, at the moment, to be more compelling. The accepted indicators of financial distress – the risk curve, commercial paper outstanding and the TED spread – show no signs of credit market fear. At the same time, the slope of the yield curve in the Treasury market is pointing to continued growth. If the reasons for the recent weakness in growth are due to the earthquake and tsunami in Japan and the destructive weather in the United States, then those causes will pass. The economy may be at a tipping point but the case for continued growth still seems to be the stronger one.





CHINA

China: Tradeoffs continue

by Dr. Ira Kalish

Short term situation

The key short-term issues facing China continue to revolve around inflation and exchange rates. Actually, the main concern is the tradeoff between dealing with inflation and maintaining the competitiveness of exports. Chinese authorities continue to tighten monetary policy in order to suppress inflation. Yet this has the effect of putting upward pressure on their currency. But, as they continue to hold the lid on the value of their currency, they create inflationary conditions. The bottom line is that policymakers cannot simultaneously fight inflation and suppress the currency. Something has to give.

One thing that has very recently changed in this tug of war is currency policy. The authorities have lately allowed the currency to appreciate at a slightly faster pace than previously. This suggests that the fight against inflation may be taking precedence over exchange rate concerns. Perhaps the fact that inflation reached a peak of 6.4 percent in June influenced authorities to shift the emphasis of policy. Perhaps it was the fact that non-food inflation neared 3 percent. In any event, inflation itself is helping to move the true value of the currency. As prices in China increase faster than prices in the major industrial countries, the real (inflation adjusted) value of the currency rises. For example, with rising prices and wages in China, export prices rise faster than local prices in overseas markets. The eventual result could be a slowdown in export growth. As the real value of the currency rises, it removes some of the need for the government to relax exchange rate policy.

Inflation

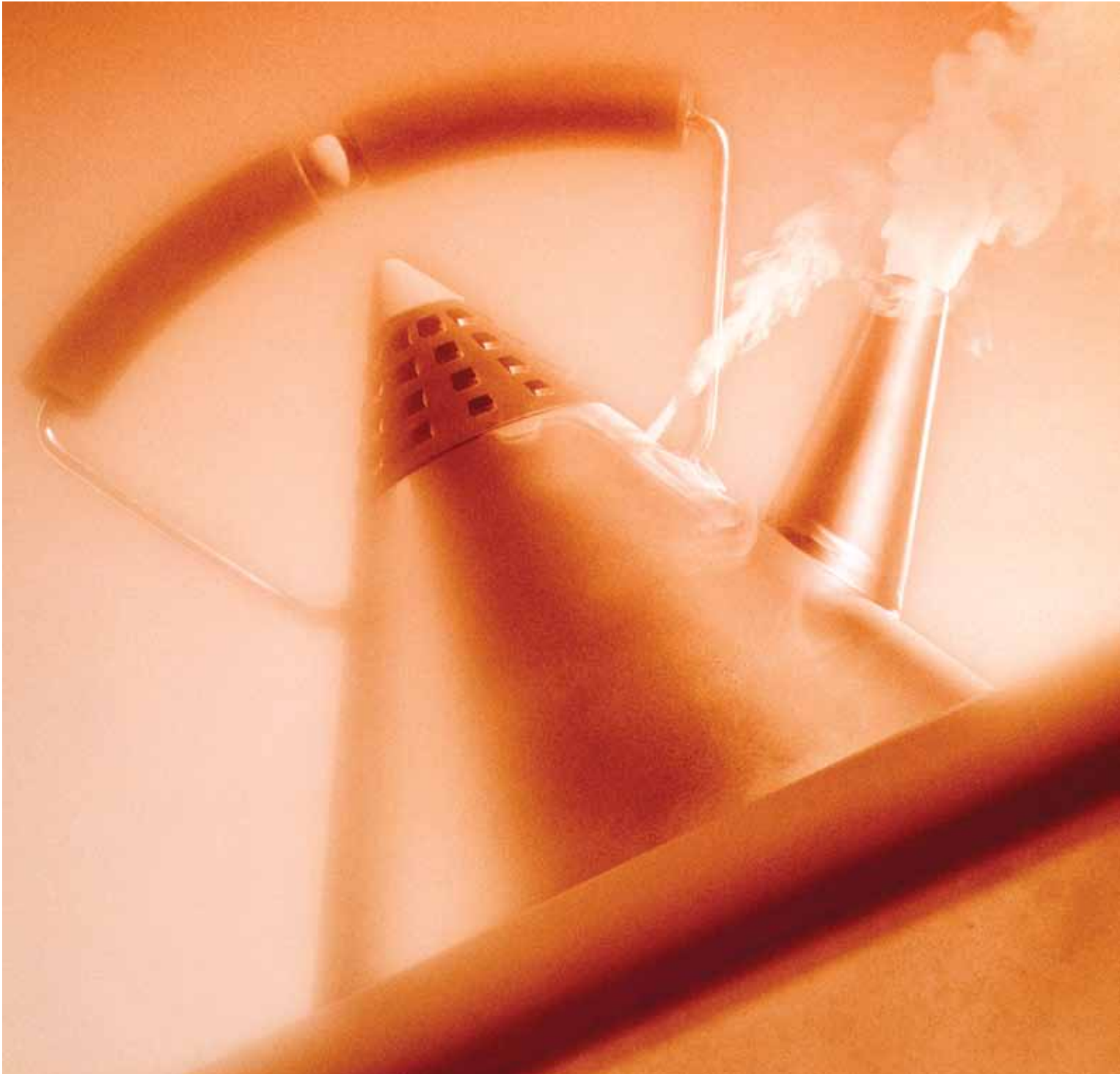
Meanwhile, the fight against inflation continues. However, although interest rates have risen, they remain roughly

similar to the rate of inflation. Thus, real rates are close to zero. This raises questions regarding the effectiveness of this approach if the goal of policy is to suppress credit expansion. Instead, authorities are using tools other than interest rates to suppress credit growth. For example, the required reserve ratio (RRR) that the authorities impose on banks has increased gradually over the past year. This has the effect of reducing the availability of credit. It also threatens to hurt businesses that have borrowed excessively. For example, there has been huge activity in the property market. If the tightening of monetary policy leads to lower values for property, developers may face trouble servicing their debts, resulting in potential bank solvency issues further down the road.

Why has inflation risen so rapidly in China? There are several factors at play. First, the lagged effect of relaxed monetary policy has been a major contributing factor. And although monetary policy has been tightened, we have not yet seen a dramatic deceleration of credit creation.

Second, as the economy grew rapidly, and as internal migration slowed, labor became in short supply. Paychecks rose rapidly, leading to a wage price increase that continues. In other words, China has developed an inflationary psychology. More restrictive policies may be needed to address such sentiment.

Third, rising global commodity prices (which are due, in part, to rapidly-growing Chinese demand) have fed into the costs of doing business in China. In particular, rising global food prices have had an impact on Chinese food prices, the biggest contributor to overall inflation. Included in this is the impact of rising global energy prices on food





production costs. It is therefore notable that China recently participated in a global effort to cut energy prices by selling oil reserves.

Finally, the decision by China to not allow more currency appreciation previously made it more difficult to control inflation. A more rapidly rising currency would have led to declining import prices and, consequently, downward pressure on domestic prices. The fact that China is now allowing a more rapid appreciation of the currency could have beneficial consequences going forward.

Impact of fiscal policy

One of the things that kept China from falling into recession during the global financial crisis was a massive fiscal stimulus largely aimed at infrastructure spending. Now much of that spending is set to decline as the stimulus wears off and the government shifts toward a tighter fiscal policy. This decline in spending will likely be helpful in taming an overheated economy. Longer term, however, the government is starting to shift the focus on spending away from infrastructure toward services designed to build a "harmonious society." This includes spending on pensions, education and healthcare (the latter part of an effort to provide universal insurance by the end of the decade). The goal of this kind of spending is, in part, to reduce consumer saving and thereby increase

consumer spending. The government clearly wants consumer demand to drive economic growth. In addition, this spending is aimed at reversing the rising income inequality in China.

Although China's central government deficit is only about 2 percent of GDP, provincial and local governments have amassed large debts in order to finance the stimulus spending of the past three years. As interest rates increase, rising interest payments on this debt could create problems for local governments. That could either mean cutbacks in local government spending and/or increased central government subsidies to local governments.

Unbalanced, uncoordinated, and ultimately unsustainable

An observer recently said that China's economy is "unstable, unbalanced, uncoordinated and ultimately unsustainable." We might not have repeated these words but for the fact that they were uttered by China's Prime Minister, Wen Jiabao. He addressed an issue that is of critical importance for China's longer term economic health. That is, recent economic growth has exhibited patterns that cannot be sustained without causing serious harm.



The bottom line is that policymakers cannot simultaneously fight inflation and suppress the currency. Something has to give.

In recent years, the share of national income devoted to investment in fixed assets has risen dramatically. Why? The supply of national savings increased dramatically as well, providing cheap funding for excessive investment. Why did the nation's savings increase? Households increased their savings relative to income. More importantly, household income declined as a share of national income as enterprise income rose dramatically. This was due to the high profitability of state-owned businesses that are protected from competition. Hence, enterprise profits as a share of GDP rose rapidly (a form of savings), providing the funding for massive investment.

What challenges does such massive investment present? The answer is that it is not providing a positive return and, therefore, is not contributing to future increases in consumption. Investment is only worthwhile if, in delaying current consumption, a society is building the capacity to consume more in the future. Yet, beyond a certain point, the value of such investment becomes questionable. At its current level, China's investment spending is largely boosting current GDP by keeping people employed. A significant challenge for China will be to make the transition to a new, more typical economic structure. The goal will be to suppress investment and boost consumer spending. Getting there without major disruption will be challenging.

One way to change China's economic structure is to subsidize consumer pensions and healthcare in order to reduce the need to save. This process is already beginning. Another way is to reduce subsidies for state-owned enterprises, open them to competition, and ultimately fully privatize them. This would substantially reduce enterprise saving and reduce the impetus for excessive investment. Finally, a rapid appreciation of the currency would increase domestic consumption (by lowering import costs), reduce investment in export industries, and stop the process of hot money flowing into China. The latter fact would enable higher interest rates that could suppress investment.

The drawback is that any one of these actions could create temporary dislocation. Investment could be suppressed quickly, but it might take a long time to stimulate consumer spending to make up for the difference. In the interim, there could be a sharp slowdown in economic growth. Such a scenario has happened elsewhere in the past. It will be interesting to see how China's authorities navigate such dangerous waters.



Eurozone: Economic recovery starts to falter

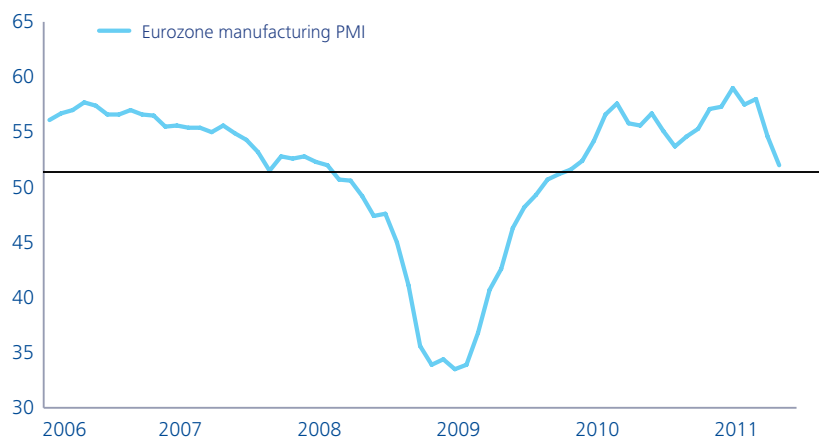
by Dr. Elisabeth Denison

Discussions of the Eurozone these days can't help but dwell on the debt crisis. This is for good reason. Finding a long-term solution to deal with high levels of government debt and formulating a coherent strategy for a working European bond market are key ingredients for a successful future of the common currency area. These issues are a focal point in a separate article in this publication called "The future of the Euro II." Whatever the solution to the debt crisis, fiscal tightening will be on the agenda in Europe. Private sector spending also seems to be losing steam after an unusually strong start to the year. There is still a deep divide between relatively strong-growing core nations and those at the periphery which are not exhibiting strong growth, but overall, the momentum is slowing along with the global economy. Unfortunately, inflation still remains above the ECB's comfort zone, explaining its tightening stance. All in all, this is a rather challenging combination of ingredients for the Eurozone economy.

Eurozone manufacturing loses steam

Growth in the Eurozone's manufacturing sector is slowing. After an average level of 58 in the first quarter, the Eurozone purchasing managers index (PMI) fell to 52.0 in June from 54.6 in May, its lowest reading since December 2009. The index is still holding above its 50 break-even level overall; Germany and France are outpacing the rest of the Eurozone, but some of the region's weaker economies even appear to be slipping back into recession. Italy's manufacturing sector shrank for the first time in 20 months, Spain's contracted for the second month running, and Ireland's PMI fell below the break-even level for the first time in nine months.

Figure 1: Eurozone manufacturing slows



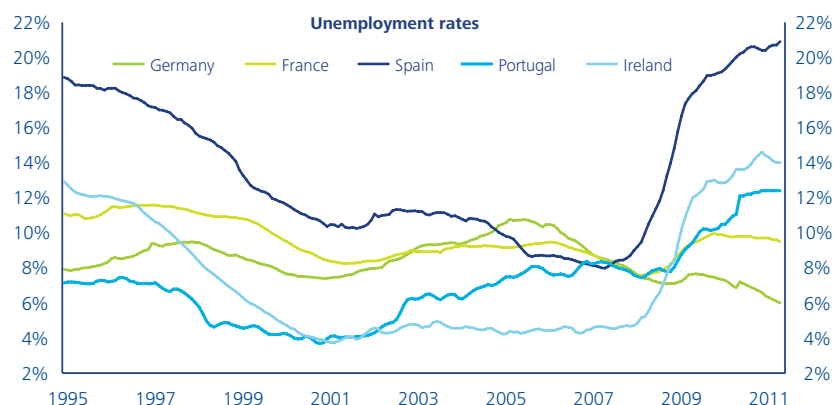
Source: Eurostat

The slowdown in Europe is echoing a reduced pace of activity worldwide. Britain's manufacturing sector expanded at its slowest pace in nearly two years in June, and the Russian manufacturing index fell to its weakest level since March last year. China's main index of activity dropped to a low of 50.9 in June, with forecasters predicting a contraction next month if the trend continues. The United States was the only bright spot; the ISM manufacturing index in the United States rose to 55.3 from 53.5 the previous month.

Labor market recovery remains uneven

The unemployment rate in the Eurozone stood at 9.9 percent in May, unchanged from April. It is down from



Figure 2: Eurozone diverging labor market trends

Source: Eurostat

10.2 percent a year ago, but the pace of recovery is slow and uneven. Germany and France posted falls in their jobless rates in May, with unemployment now standing at 6 percent and 9.5 percent, respectively. Netherlands recorded the lowest unemployment rate with 4.2 percent. The highest rate is still seen in Spain, standing at 20.9 percent in May. The jobless rate also remains stuck at double-digit levels in Ireland and Portugal, which have also been engulfed by the debt crisis (see figure 2).

Economic sentiment

Along with slowing activity, economic sentiment in the Eurozone also fell in June. The European Commission said weakening confidence in industry had depressed economic sentiment, but the fall was partly compensated for by gains in services and construction. Consumer and retail confidence remained broadly unchanged. "The current level of the indicator remains very high, but the consecutive drops observed may suggest that Euro area industry has entered a phase of growth moderation," the Commission said.

At 105.1 in June, the economic sentiment index (ESI) still stands above its long-term average of 100, but it is no longer on a strong expansionary path. A look at the business-cycle tracer confirms that the upswing is

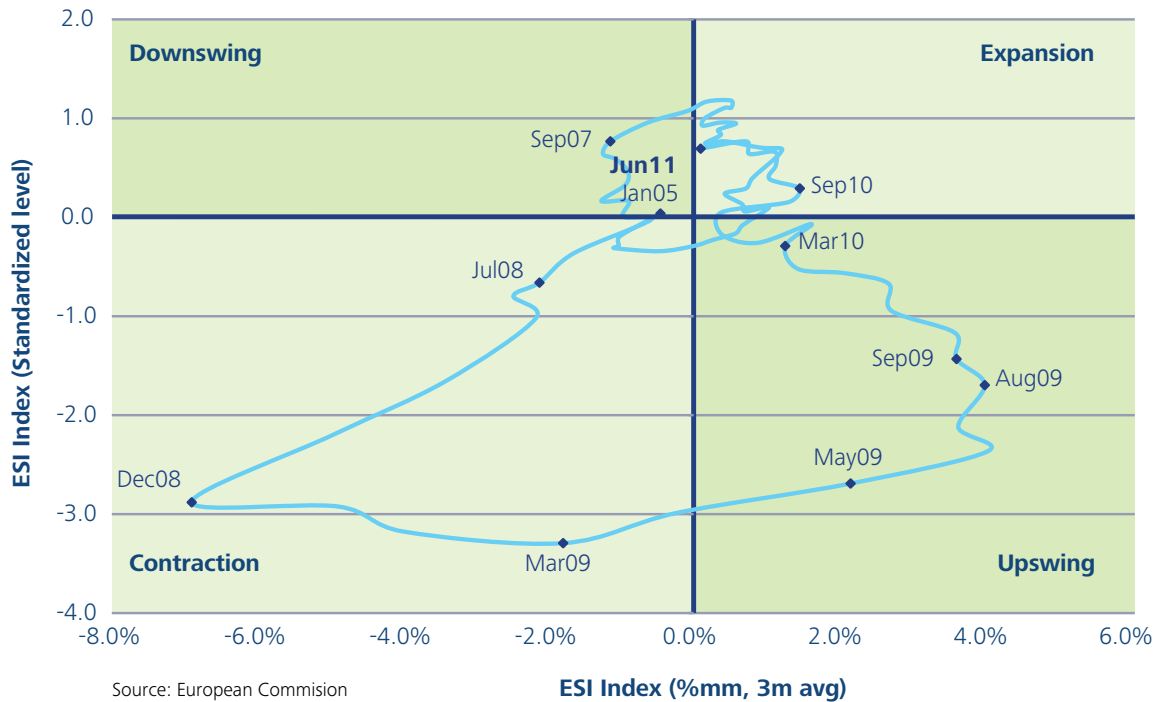
losing steam. The indicator graphs the level of economic sentiment (standardized index) on the vertical axis and its change (growth momentum) on the horizontal axis. It shows the start of the upswing in early 2009 and the start of the expansion in early 2010. Its reading in June 2011 – although still in expansionary territory – suggests that the pace of recovery is slowing (see figure 3).

What's in store for the rest of 2011?

The economic recovery of the Eurozone over the past year has been driven mainly by industrial nations in its core, especially Germany and France. Germany has been particularly dynamic, benefitting from export demand, a confident consumer base, and declining unemployment, which has fallen below pre-crisis levels. France's economic performance has not quite matched Germany's, but it can safely be grouped in the Eurozone's core with accelerating growth and minimal debt worries.

Looking ahead, the performance of core nations will remain crucial to the overall recovery of the Eurozone. Slowing global demand could weigh on exports to the Far East and the Americas, and if the ECB sticks to its tightening stance, it will likely further slow the spending power of fringe nations in Europe, too. Since Germany sends about 60 percent of its exports to neighboring countries

Figure 3: Eurozone sentiment



France's economic performance has not quite matched Germany's, but it can safely be grouped in the Eurozone's core with accelerating growth and minimal debt worries.

in Europe, the effects will be felt in its economy. In June, both Germany and France reported weaker than expected manufacturing activity; the price gauge of the survey also eased. If the trend continues, it will take some pressure off the ECB. With consumer price inflation approaching 3 percent in the Eurozone, it is hard for the ECB not to be talking about vigilance, but softening real economic data could convince them to slow the pace. That will be good news for debt-ridden peripheral nations. It will also make it easier to find a permanent solution to the debt crisis, which remains a crucial ingredient for the sustainable recovery of the Eurozone.

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United Kingdom: Inflation headwinds

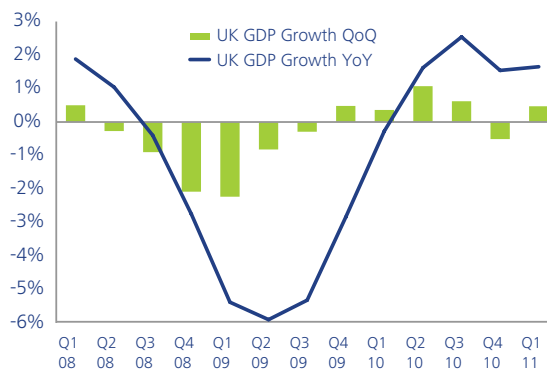
by Ian Stewart

- UK activity is running at sub trend rates
- High inflation has hit consumer spending power hard
- Private sector hiring remains strong

The UK economy has hit a soft patch in recent months. After an unexpected 0.5 percent contraction in GDP in the fourth quarter of 2010, activity bounced back by the same amount in the first quarter of 2011, leaving the level of GDP flat over a six month period. UK GDP growth forecasts have edged lower since the start of the year.

The softness in the UK economy could be seen as part of a global phenomenon. Prospects for growth in Japan, the world's third largest economy, have slumped in the wake of the tsunami and nuclear crisis. The effects have rippled far; supply chain disruptions have hit manufacturers around the world, including the United Kingdom. At the same time, the Indian and Chinese economies have shown signs of cooling in response to past monetary tightening. Meanwhile the Euro area debt crisis has unsettled markets.

Figure 1: UK GDP growth (YoY%)



Source: Datastream

Yet these factors would not explain the particularly disappointing performance of the United Kingdom, especially when growth prospects for the Euro area have improved since the start of the year. (While southern and peripheral Europe remains weak, growth forecasts for what might be called Northern Europe – Germany, France, Austria, Belgium, the Netherlands, and Finland - have risen over the last six months).

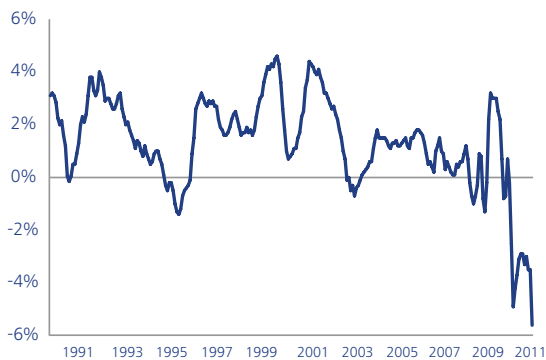
There are two competing explanations for the recent weakness of the UK economy.

Some commentators and politicians have emphasized the role of fiscal policy, arguing that cuts in public spending have weighed disproportionately on sentiment and

activity. The government's program of fiscal austerity has certainly started to bite. The public sector is shedding jobs at an accelerating rate, with 143,000 jobs cut in the last year. Pay has been frozen for much of the public sector and the government is also seeking to significantly reduce the future cost of public sector pensions.

Yet our sense is that fiscal austerity is a contributory factor, but not the main cause for the sluggishness of UK growth. Tax rises and weakness in public sector pay have played a part in depressing incomes. But high levels of inflation, through their depressant effect on real incomes, seem to be a greater problem. The interaction of unexpectedly high inflation with weak wage growth has caused a massive squeeze on consumer spending power.

Figure 2: UK post-tax real earnings growth (YoY%)



Source: Datastream

The scale of the inflation shock which has afflicted the United Kingdom is striking: a year ago the Bank of England's central view was that inflation today would be around 1.0 percent. In actuality, CPI inflation is running at 4.5 percent. In the last 5 years, UK inflation has been above its 2.0 percent target for 83 percent of the time. What marks the United Kingdom out from other industrialized nations is the strength of inflation, which, even stripping out food and energy, is running at more than twice the rates seen in the United States and Eurozone.

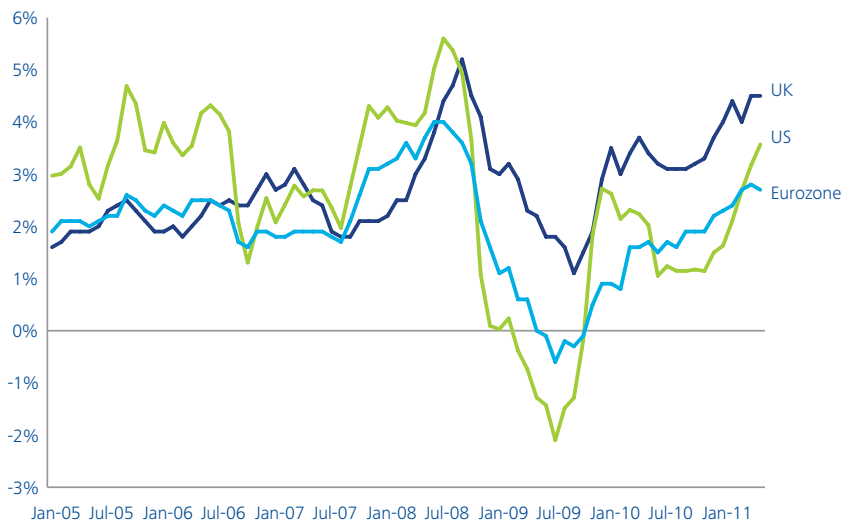
High inflation and slow earnings growth have delivered what seems likely to become the longest squeeze on UK consumer spending power since the 1920s.



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Figure 3: CPI inflation



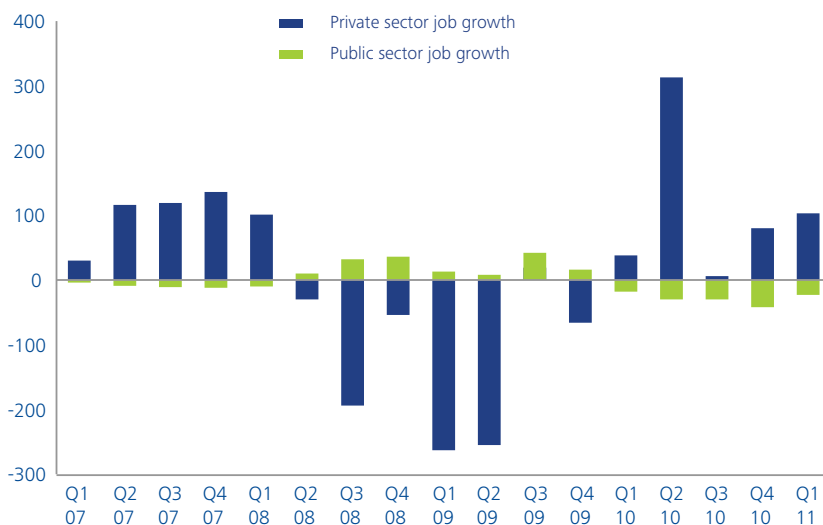
Source: Datastream

This year, growth in consumer spending in the United Kingdom is forecast at just 0.1 percent, weaker than in any other major industrialized country – and weaker even than in Spain, which is undergoing a more severe program of fiscal austerity than the United Kingdom.

Two related factors have exacerbated the weakness of the UK consumer sector. Credit supply is constrained, especially for consumers with little collateral, high borrowing requirements, or poor credit histories. And UK housing still does not look cheap. *The Economist*, for instance, estimates that UK house prices are overvalued by 30 percent relative to rents.

The idea that fiscal austerity is behind the United Kingdom’s sub-par performance does not sit easily with the willingness of private sector employers to take on new staff. Over the last year, the UK private sector has created 520,000 new jobs, an increase of 2.3 percent, easily eclipsing the 143,000 jobs shed in the public sector. Against a backdrop of erratic and sluggish growth, the private sector is actually creating new jobs at the fastest rate in 11 years.

Figure 4: UK private and public sector job growth (In thousands)



Source: Datastream

Perhaps surprisingly, employment in the retail and wholesale sector, and the finance and insurance sector, has risen sharply in the last year. The information and communication sector has also generated strong growth in jobs over the last year. Elsewhere, professional services – including law, management consultancy and accountancy – have proved virtually recession-proof. Employment in this sector climbed through the recession and has continued to rise since the economy returned to growth.

The big hope for the UK consumer is that inflation falls away sharply next year as the impact of past tax, commodity and food price increases fall out of the CPI numbers. Lower inflation and steadily rising average earnings should mean that next year, real earnings could switch from being negative to mildly positive. This would not be remotely sufficient to deliver a strong recovery in consumption. But lower inflation, as well as being a huge relief to the Bank of England, should bolster consumer spirits and lend some modest support to Britain’s recovery in 2012.



Japan: Finding a silver lining

by Dr. Ira Kalish





Japan faces a big, twofold question: how quickly will it recover from the Tohoku earthquake, and how will it finance its reconstruction? On a positive note, industrial production is on the mend. After falling 15.5 percent in March and stabilizing in April, industrial production rose 5.7 percent in May, the second biggest jump ever recorded. Automotive output was up a staggering 59.5 percent. Still, industrial output remains lower than a year ago. Moreover, recent reductions in nuclear generating capacity could limit the recovery of the industrial economy. Shutdowns could certainly lead to increased blackouts in the summer months, so Japan is not yet completely out of the woods.

Nevertheless, the second half of 2011 could be much better. If Japan's capacity for generating electricity does not decline any further, sizable increases in industrial output could continue for the remainder of 2011. The two big uncertainties regarding growth in the second half will be the degree to which Japan's capacity for generating electricity recovers and the amount of money the government quickly spends on reconstruction. Still, for all of 2011, GDP is likely to be down from the previous year.

Reconstruction spending

There are many questions about the pace, cost, and financing of reconstruction. The answers to these questions will determine the medium-term growth for Japan as well as longer-term developments for Japan's economy.

The Parliament has already allocated 6 trillion yen (US\$75 billion) in two tranches for immediate spending on reconstruction. This is but a modest down payment. Within the next few months, the Parliament is expected to allocate an additional 8 to 10 trillion yen for reconstruction. This would bring the total to no more than 16 trillion yen



(US\$200 billion), probably about two-thirds of the eventual total cost. Therefore, more funding will probably be required in 2012 and beyond. The money allocated so far will not make a significant difference in Japan's economic growth. The next tranche, expected to be legislated by the end of the summer, will play a bigger role in boosting growth.

Reconstruction finance

Paying for this vast spending is another critical issue. There are three possibilities: taxes could be increased, the government could issue bonds to the public, or the Bank of Japan (BoJ) could purchase those bonds, essentially engaging in a form of quantitative easing to finance reconstruction.

The initial funding has been financed by bond sales, some of which may have been purchased by the BoJ. The central bank has been unusually aggressive with monetary policy since the earthquake, engaging in quantitative easing aimed at providing the economy with sufficient liquidity. In addition, further funding for reconstruction from bond sales could lead to an increase in bond yields because financial markets may become alarmed at such a sudden and massive increase in the already-large stock of Japanese government debt. If yields were to rise too quickly, it is likely that the BoJ would step in with a new round of quantitative easing.

What about raising taxes to support reconstruction? It is notable that a recent poll by Nikkei found that 69 percent of Japanese people believe that taxes should be

What about raising taxes to support reconstruction?

It is notable that a recent poll by Nikkei found that 69 percent of Japanese people believe that taxes should be raised to pay for some or all of the cost of reconstruction.

raised to pay for some or all of the cost of reconstruction. Yet, voters only support a temporary tax increase, not a permanent one. The government has indicated that it would like to increase the consumption tax from 5 percent to 8 percent in order to fund reconstruction, but it is not clear that this will happen. Debate continues to rage in the Parliament about this critical issue.

Of the three forms of finance, a tax-funded increase in spending would have the most modest impact on economic activity. Many analysts prefer tax-funded reconstruction because of concerns about Japan's large sovereign debt. One can argue, however, that such concerns are overblown. Japan's domestic saving is so large that it funds domestic investment and government borrowing, and there is still money left to transfer overseas. That amount is Japan's current account surplus. Hence, unless national savings declines precipitously, it is likely that interest rates will remain relatively low.

Risks to the outlook

For now, it seems likely that Japan's growth will be strong during the second half of 2011 and be moderately strong in 2012. Yet, there are two factors that could throw sand in the wheels of economic activity.

First, there is the issue of generating electricity, especially the renewal or replacement of nuclear power. Failure to get the system back to normal will retard economic recovery.

Second, Japan remains heavily dependent on exports for economic expansion. While reconstruction will aid domestic demand, Japan's longer term recovery will depend on exporting industrial products to the world. But two factors could retard exports: the continuing strength of the Japanese yen and slower economic growth in other countries such as China.

Longer term issues

How Japan spends reconstruction money could have significant implications for its economic future. Will Japanese companies try to restore their heavy industrial base, or will heavy industry move offshore? Will the automotive industry accelerate the trend toward factories in lower-wage countries? To a certain extent, such a change would make sense. Japan is a high-wage, high value-added country with a declining, aging population. In the long term, it will be a venue for performing high-value processes. It will also make sense to continue accumulating overseas assets that will enable Japan to earn income from overseas, especially as the trade surplus eventually declines.



Brazil: Rise in the real

by Dr. Ira Kalish

The biggest economic issues in Brazil at the moment, and the biggest risks to the outlook, involve the country's currency value and the path of its fiscal policy. Notably, the two issues are related.

Issue one

First, consider the currency. Since early 2009, the value of the Brazilian real has risen by nearly 50 percent against the U.S. dollar. It has returned to roughly the same level it reached just prior to the global crisis of 2008. Moreover, the pace of appreciation accelerated in the past year, coinciding with the implementation of a second round of quantitative easing by the U.S. Federal Reserve. Indeed, many commentators blame U.S. monetary policy for the rise in the real. They point to increased U.S. liquidity and a big interest rate differential between the United States and Brazil. Yet there are other important reasons for the rise in the real. These include Brazil's currently strong performance and solid growth prospects. This makes the country an attractive destination for global capital. In addition, the global rise in commodity prices has boosted Brazil's earnings, thereby putting upward pressure on the currency. This has also boosted interest in investing in Brazil's commodity sector.

Whatever the reason for the rise in the real, the government is clearly concerned. In 2010, the economy grew at a rate of 7.5 percent, very high by recent standards and clearly high enough to stir up worrisome inflation. Hence, a tighter monetary policy was warranted and interest rates have been repeatedly increased. The authorities are concerned that further monetary tightening will drive even more capital into Brazil, boosting the currency yet again. A higher valued real increases export prices and hurts the competitiveness of Brazil's non-commodity exports. Moreover, the prospect of boosting manufactured exports is seen as one of the principal drivers for future growth in Brazil. Thus, the value of the currency is of critical importance. On the other hand, a higher-valued currency is somewhat disinflationary as it tends to lower import prices. Thus, there may be a silver lining.

What to do?

The government has already taken several actions aimed at stemming the inflow of capital that is putting upward pressure on the currency. Taxes have been imposed on foreign purchases of some classes of Brazilian assets. In addition, banks have been required to hold higher reserves relative to assets. Banks also have been subject to a higher tax on short-term lending. Observers expect that the government will impose barriers on the ability of Brazilian banks to borrow overseas. Yet, these actions have competed with high interest rates and rising commodity prices, and the latter appears to be winning.

What else can the government do? Aside from loosening monetary policy (which is not likely to happen), perhaps the better solution is a tightening of fiscal policy.

Issue two

Fiscal policy essentially boils down to how much of government spending should be financed through taxation versus borrowing. The more a country's government borrows, the more it competes with the private sector for scarce funds and, therefore, boosts interest rates. Thus, one way to deal with the currency would be to tighten fiscal policy (less borrowing). This would have the likely effect of reducing interest rates and, therefore, reducing capital inflows which boost the currency.

The good news is that Brazil's fiscal deficit appears to be declining on its own. The strong economic growth of the past year has boosted tax revenue and reduced the government's borrowing requirement below what had otherwise been expected. Will this be sufficient? Many analysts believe not. They point to a number of areas in which spending is expected to grow rapidly in the coming years. These include costs related to the World Cup and the Olympics, rising pension costs, rising public employment costs, and the desire of the current government to spend more on social issues. Absent tax increases, these spending increases will cause the deficit to widen rather than decline. The government has indicated that it plans to reduce the deficit, but questions remain as to whether this will happen.



Longer term issue

Not only is fiscal discipline important in order to deal with the rising currency, it is also important from the perspective of promoting long-term economic growth. Any deficit necessarily subtracts from a country's saving, thereby reducing resources available for investment. Currently, domestic saving in Brazil, at roughly 16 percent of GDP, is very low compared to other fast-growing economies. In China, domestic saving is in excess of 50 percent of GDP. In other countries, the figure is in the range of 30 to 40 percent. As a result, investment in Brazil is relatively low at roughly 19 percent of GDP. This stifles the ability of the economy to grow as investment creates the capital necessary to boost future consumption. Yet, with investment in excess of domestic saving, the country must borrow from overseas.

Boosting investment will require either borrowing more from overseas or saving more domestically. The latter can be helped by reducing government borrowing. As for borrowing from overseas, this is not necessarily a bad thing. Yet, the recent surge of capital flowing in from overseas has had the negative effect of boosting the value of the currency. Brazil surely doesn't need more of this. Rather, a reduction in the budget deficit is the more effective way to free resources for investment and, therefore, boost future economic growth.



RUSSIA



Russia: The BRIC outlier

by Dr. Ira Kalish

For Russia, the big issues involve the fight against relatively high inflation, the impact of the price of oil, and the longer term prospects for growth.

Inflation

Russian inflation, which was 5.5 percent in July 2010, accelerated to 9.6 percent in January 2011. This was, in part, the lagged result of an aggressive monetary policy implemented during the worst of the economic crisis. Since January, inflation has hovered in the range of 9.4 to 9.6 percent and was at 9.4 percent in June 2011, the most recent month. Clearly the central bank's tightening of monetary policy during the past year has been successful in stopping the acceleration of prices. The question now is whether inflation will decline to a more tolerable level. The general expectation is that inflation will gradually ease in the coming year.

Several factors will make a difference. First, the lagged effects of tighter monetary policy will continue to have an impact on prices. Second, the appreciation of the ruble will put downward pressure on import prices, thereby reducing inflationary pressures. The question, then, is how much further the currency will appreciate. Third, the price of oil will both directly and indirectly influence inflation. As for the indirect impact, oil prices will influence the path of the ruble which, in turn, will influence inflation. If oil prices rise, the ruble will rise, thereby reversing some of the direct effects of higher energy prices on production costs. If the price of oil falls, it could weaken the ruble which would be inflationary. On the other hand, lower energy prices would directly result in lower input costs, which would temper inflation.

Oil price impact

Not only will changes in oil prices influence Russian inflation and exchange rates, they have other important implications as well. First, higher oil prices would boost government revenue, thereby reducing the budget deficit and reducing the necessity of painful fiscal measures. Given the government's likely aggressive spending plans for 2012 (an election year), an oil windfall would enable the government to meet its goals without raising taxes or facing a larger deficit. Second, higher oil prices would boost Russia's export revenue, contributing both to

economic growth as well as improvements in the country's external accounts. Third, higher oil prices would likely fuel more investment in the energy sector, contributing to current and future growth. This depends, of course, on the climate for investment. Proposed changes in the regulatory environment could improve the investment climate.

The question, then, is what direction will oil prices go? The recent intervention in the global oil market by major governments did put downward pressure on the price of oil. The coordinated sale of oil reserves suggests that, if the price goes up again, major governments may choose to repeat their action. Hence, to a certain extent, there is a ceiling on the price of oil. On the other hand, oil remains far more expensive than a year ago, reflecting the uncertainties brought on by turmoil in the Middle East. A reasonable expectation, then, is that oil is not going anywhere anytime soon.

Economic growth

Russia's economy has not grown very rapidly compared to the other BRICs. What is wrong? After all, Russia has benefitted from an increase in the price of oil, a sensible combination of monetary and fiscal policy, and a government increasingly committed to reform and transparency. Moreover, following a steep drop in GDP during the global crisis, it might be expected that growth would be strong as the economy catches up. Yet, in the past year, growth has been modest at about 4.5 percent.

One problem is that investment has not grown as fast as in other countries. Currently, fixed asset investment is about 22 percent of GDP, more than in Brazil but far less than in China. Moreover, it can be argued that much investment is unproductive given restrictions on foreign involvement in the economy, the existence of corruption, and the failure of capital markets to stimulate entrepreneurship. The transparency the government seeks would certainly improve investment efficiency, but it has not happened yet.

The big uncertainty regarding the implementation of reforms involves the outcome of next year's election. How the political environment unfolds will provide signals about the likelihood and nature of changes in economic policy.





India: It takes two hands to clap

by Siddharth Ramalingam

It is time to pray to the rain gods in India. If the monsoons fail, both government officials and central bank authorities could worry. Already-high inflation could worsen very quickly, forcing officials to engage in aggressive monetary tightening, which could even have a political impact. High oil prices and government expenditure are likely to keep the fiscal deficit high through the year. Rain or no rain, it will take delicate monetary policy and fiscal action to make sure the economy is not knocked off its growth path.

Inflation: The same old story

Inflation continues to stymie India's growth ambitions. So far, inflation has been sticky in 2011; headline inflation hovered around 9 percent from January through June. Core inflation continues to be high, coming in at 7.3 percent in May. This indicates that it is not only oil and food prices that are driving prices upward; inflation is more broad-based. That being said, food inflation, which rose from about 7 percent in early May to above 9 percent in mid-June, continues to worry policymakers. With the onset of the monsoon, significant attention is being paid to what the meteorological department is saying. If evidence of a below-par monsoon strengthens, it is likely that food inflation will rise sharply. A good monsoon, on the other hand, will help stifle food inflation. However, a good monsoon will not guarantee significantly lower food prices because of lingering supply-side bottlenecks in the agriculture sector.

The central bank stressed that its primary concern is price stability and that it is willing to sacrifice growth in order to rein in inflation. The bank raised the interest rate once again in June. The 25 basis point increase, the tenth increase since March 2010, now takes the interest rate to 7.5 percent. The central bank expects inflation to be around 9 percent in the first half of the fiscal year, and

it aims to bring inflation down to 6 percent by the end of the current fiscal year. However, consumers are not so optimistic. A recent survey conducted by the central bank shows that households expect inflation to rise to 12 percent in the current quarter and reach 13 percent next year. A reason for this apparent disconnect could be the fact that the central bank tracks the wholesale price index, which is more in sync with international commodity prices and less with what consumers purchase.

A new growth trajectory

Interest rate hikes are finally taking their toll on growth. GDP growth for the first three months of 2011 came in at 7.8 percent, compared to 9.4 percent in the corresponding quarter in 2010. Much of the slowdown was due to a decline in manufacturing and mining output. For the last fiscal year, GDP growth was 8.5 percent, which is just a shade off the central bank's 8.6 percent forecast. India's manufacturing sector continued to ease in May as new orders slowed down and input prices continued to rise. The purchasing managers index (PMI) crept lower to 57.5 from 58 in April. Still, overall sentiment continues to be positive. A recent survey shows that companies expect profits to rise by 20 percent in the quarter ending in June. Advance tax collected during the first quarter of the current fiscal has risen by 45 percent, providing clear evidence that all is still quite well.

The central bank is unlikely to take a positive view of the corporate sector's unbridled optimism. Increasing interest rates have thus far only managed to impact growth in specific sectors. The auto sector, for example, experienced a drop in sales as consumer credit became increasingly expensive, and the banking sector is experiencing a slowdown in credit growth. The current effects of increasing interest rates are far from being broad-based. It



is likely that the central bank will further increase interest rates this year in order to rein in both growth and inflation. Costlier credit could also lead to a drop in investment activity through the year. Consequently, GDP growth for the current fiscal year could be as low as 7 percent.

The external sector

India's exports rose sharply in May due to an increase in shipments of engineering and electronic products. Exports

surged 56.9 percent year-on-year to \$25.9 billion; the total for the first two months of the fiscal year registered at \$49.8 billion. The government set a target of \$300 billion in exports for the current fiscal year. Imports rose 54.1 percent to \$40.9 billion, reaching the highest level in four years and leading to a trade deficit that was at \$15 billion in May, the widest since August 2008. The sharp rise in the trade deficit is a cause for concern and needs to be monitored closely in the coming months.



Foreign direct investment (FDI) in India has fallen sharply in recent times. During the 11 month period from April 2010 until February 2011, FDI fell 25 percent to \$18.3 billion. The finance minister is optimistic that FDI will pick up in the second half of 2011. Recent efforts to change the FDI policy could help ensure that funds flow into the country. In the first week of April, the government scrapped a controversial rule that prohibited foreign companies from establishing wholly-owned subsidiaries in a field of business in which they were already jointly operating with a local partner without the said partner's permission. The Department of Industrial Policy and Promotion (DIPP) prepared a draft framework for 51 percent FDI in the multi-brand retail segment. The draft, if approved, could herald the entry of multinational retailers like Walmart and Carrefour in the Indian market. FDI in the retail sector is likely to improve distribution networks and supply chain efficiencies and over time, help reduce food inflation.

Burgeoning fiscal deficit

The Indian government ran a fiscal deficit of 5.1 percent of the GDP last year due to high subsidies and unexpectedly high state spending. Although the government has vowed to reduce the deficit to 4.6 percent this year, recent developments could lead to the deficit touching 5.8 percent by the end of the year.

High oil prices are hurting the country's finances. The Indian government subsidizes the losses of state-owned petroleum companies, and this is estimated to cost the country more than one trillion rupees a year. In order to reduce the subsidy burden, petrol prices were deregulated last year. However, diesel, cooking gas and kerosene prices were left unchanged. Prices were finally revised upward in June to better reflect international oil prices. The government also decided to reduce customs and excise duties on petroleum and refined oil products in order to provide

The Department of Industrial Policy and Promotion (DIPP) prepared a draft framework for 51 percent FDI in the multi-brand retail segment. The draft, if approved, could herald the entry of multinational retailers like Walmart and Carrefour in the Indian market.

state-owned petroleum companies relief from the losses they incur due to price regulation. Despite these measures, the government is likely to shoulder an oil subsidy of 1.2 trillion rupees and also suffer a loss in customs and excise duties to the tune of 490 billion rupees this year. To compound matters, the rise in the price of diesel, kerosene and cooking gas is likely to stoke inflation.

The government plans to raise about \$93 billion in debt this year, 60 percent of which is likely to be raised in the first half of the fiscal year. This gives the government ample room to raise more money than budgeted in order to meet its target of 4.6 percent. However, if the government does so, there could be a liquidity shortage in the capital markets, forcing the central bank to buy government bonds in the open market. A shortage of liquidity is a threat to growth, while an infusion of liquidity in the market runs the risk of fuelling inflation.

The course ahead

Inflation is unlikely to subside in the near term, and the central bank will probably continue raising interest rates until inflation stabilizes around 6 percent. However, the effectiveness of monetary policy is limited by fiscal policy. Unless India's fiscal situation improves, it is unlikely that its economic challenges will be alleviated in the coming year. After all, it takes two hands to clap.



Turkey: More positive than negative

by Pralhad Burli

Turkey's story is remarkable against the backdrop of the economic crisis. Prior to the recession, the country's growth rate was among the highest in the OECD world. Its aspiration to join the European Union led to several structural reforms that helped strengthen the country's macro-economic framework, including the financial and banking sectors. Consequently, Turkey weathered the recession much better than some of its peers. While the economy did not escape the crisis unscathed, Turkey staged a strong comeback. In 2010, Turkey's growth not only outpaced its peers but was higher than a majority of the emerging market economies. While Turkey seems to have everything going for it, some downside risks loom large. The country's economic future depends on how well policymakers manage the challenges stemming from a widening current account deficit and rising inflation.

Growth begets growth

Turkey ended 2010 on a positive note. During the 4th quarter of 2010, GDP expanded by 9.2 percent. The economy surprised on the upside, after experiencing a brief slowdown during third quarter. As a result, GDP growth for 2010 reached an astounding 8.9 percent. While part of the growth is attributed to base effects, domestic demand emerged as the key driver in 2010. Private consumption, which constitutes nearly 70 percent of aggregate demand, grew by 6.6 percent. Gross fixed capital formation expanded 44 percent after contracting nearly 20 percent in 2009. Furthermore, labor market

developments, credit expansion and overall confidence in the economy supported growth.

Prospects for 2011 look promising. The year began on a strong note as GDP grew by 11 percent during the first quarter of 2011. Private consumption was strong and will likely continue to be the mainstay of the economy. In addition, public sector consumption propped up by election spending could further add to growth. Consumer credit expansion and business lending are on an upward trajectory and point toward growth in consumption and investment. Furthermore, capacity utilization rates have been high and the economy is probably operating near potential. As a result, the favorable employment scenario will likely boost disposable income and thereby increase purchasing power.

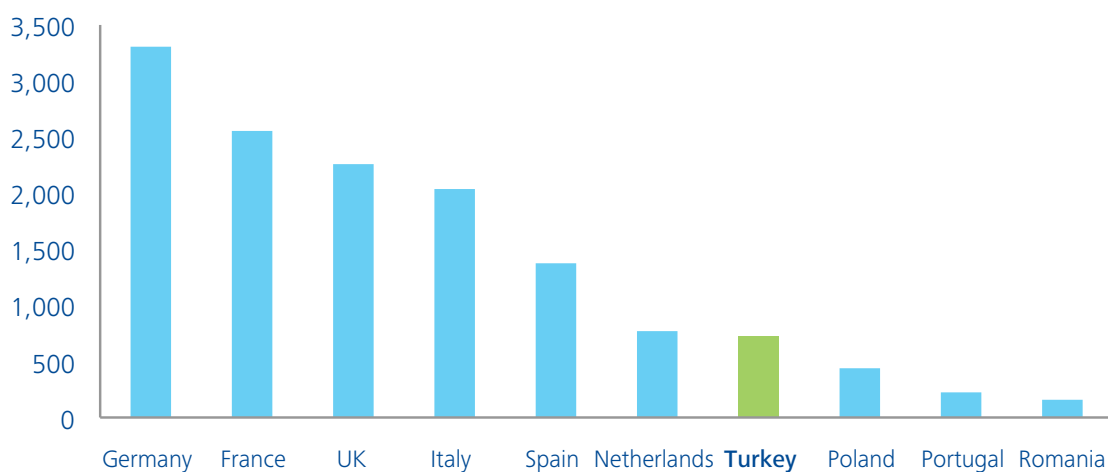
Likewise, industrial output recorded double-digit increases during the first few months of the year. While April data indicated a slight decline over March, industrial output remains healthy. A similar pattern of healthy but moderating growth is likely in the other sectors of the economy during the remainder of the year. The strong start, however, will probably enable Turkey to achieve a GDP growth rate near 6 percent in 2011. Furthermore, as per OECD forecasts, Turkey is expected to be the fastest-growing economy among OECD members during 2011-2017, with annual growth anticipated to average 6.7 percent.





Figure 1: Ranked by GDP, Turkey places 7th in Europe

GDP in billion (US \$)



Source: International Monetary Fund, World Economic Outlook Database, October 2010

A growing deficit

Despite Turkey's glowing performance, all is not well. Persistent current account deficits have been a feature of the Turkish economy for a while. Over the past decade, Turkey has managed a current account surplus only once – in 2001. Accelerated growth in the current account deficit is a reason for concern. Since 2002, the country's deficit has increased every year barring 2008 and 2009. In 2009, the recession led to a contraction in both exports and imports and the current account deficit as a percentage of GDP dipped to 2.3 percent. However, as the economy recovered, exports grew and imports grew even faster. As a result, Turkey's current account deficit in 2010 reached 6.6 percent, its highest level ever. Looking ahead, the current account deficit will likely widen to between 7.8 and 8 percent in 2011.

Turkey's chronic current account deficit stems from the structure of its manufacturing and export sectors. A majority of Turkey's imports are re-exported so imports and exports usually grow in tandem. Thus, export growth will not necessarily lead to a narrower deficit. Also, the country's reliance on energy imports has worsened its trade balance, particularly due to higher commodity prices. The current account deficit more than doubled to US\$22.1

billion in first quarter, compared to US\$10 billion in early 2010. Riding on energy imports, import growth was a staggering 46 percent compared to last year. In comparison, exports grew a mere 18.6 percent.

Turkey's historically low savings rate also renders the economy dependent on external financing to close the investment gap. Of late, the economy has witnessed a sharp increase in portfolio investment. In 2010, Turkey received over US\$19.6 billion in foreign portfolio investment of which nearly 82 percent was in debt securities. At the same time, foreign direct investments (FDI) dwindled to just over US\$9 billion after reaching a peak of US\$22 billion in 2007. This marks a shift from long-term FDI investments to short-term inflows. Capital flows are rising despite low interest rates and attempts by the central bank to keep the currency from appreciating, which raise questions about the sustainability of such flows. The short-term nature of portfolio investments exposes the economy to the risk of capital flight. Given the fragile economic environment in the Euro area, a reversal in investor sentiment can potentially lead to a volatile macroeconomic environment that could prove to be detrimental to Turkey's economic stability.







To compound matters, the ratio of FDI to gross fixed investment has declined sharply. Foreign capital flows have instead found their way to Turkey's property market. At the moment, property prices are high and a correction in real estate prices is possible in the medium term. There are no immediate solutions to Turkey's swelling current account deficit. However, policy measures to boost savings and reduce the country's reliance on foreign funds could augur well in the long run.

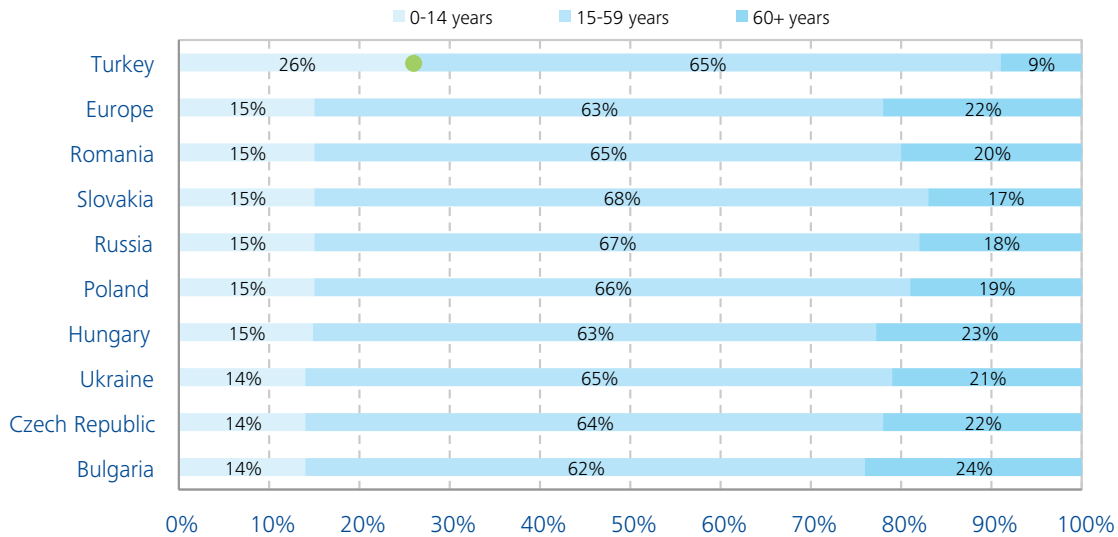
Monetary policy conundrum

Inflation has intensified and inflation expectations have risen too. Both core and headline inflation witnessed a steep increase in 2010. Consumer prices were up nearly 2.5 percent in May 2011 and year-over-year CPI rose beyond 7 percent. Escalating oil prices continue to push inflation upward. Furthermore, the pass-through of higher oil prices to other energy items is expected to persist during the second half of the year. By the end of the year, inflation may average between 6.5 and 7 percent, well above the central bank's target of 5.5 percent

Given Turkey's macroeconomic environment, overseeing its monetary policy is a complex task. While a tighter monetary policy seems desirable to rein in inflation, higher interest rates could negatively affect Turkey's recovery prospects. An interest rate hike could potentially aggravate the current account deficit. If short-term capital inflows increase rapidly following a rate hike, Turkey's currency will strengthen, thereby widening the current account deficit further. In light of the volatile global recovery, higher interest rates could also have an adverse effect on Turkey's employment numbers.

The central bank recently chose to raise reserve requirements to curb credit expansion. Despite these actions, credit growth experienced only a marginal slowdown. However, the effects of monetary tightening on credit growth will probably become more visible over the next few months. At present, the central bank's reluctance to increase interest rates seems reasonable. However, if inflation rises further, the central bank could hike interest rates up to 75 basis points during the second half of the year.

Figure 2: Turkey has the youngest population in Europe – Average age is 28.3 years



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2010 Revision

AKP’s landslide victory

As expected, the incumbent Justice and Development Party (AKP) won the parliamentary elections held in June. While the ruling party won nearly 50 percent of the total vote, it fell short of securing the 330 seats necessary to propose a referendum to change the constitution.

Financial markets reacted positively to the outcome. The AKP has been credited with pursuing responsible economic policies. A third term for the AKP will likely result in policy continuity. On the plus side, this could spur capital inflows into the economy. On the other hand, several challenges remain, particularly from rising inflation, currency appreciation, and a widening current account deficit.

Turkey and the Eurozone

Despite its rising impact on Europe, Turkey’s accession into the Eurozone seems unlikely in the near future. Turkey has transitioned from being predominantly agrarian into a market-driven economy that is open to international trade and financial services. It also aspires to be a major financial center in Eastern Europe. Turkey holds the potential to serve as a link between Europe and Asia for trade and strategic oil and gas pipelines. Since Europe

faces a demographic disadvantage due to its dwindling working population, Turkey’s young population could be an important source of labor. On the other hand, Europe’s continuing sovereign debt crisis may further delay Turkey’s accession to the EU. Furthermore, the uncertainty of stability in the Eurozone could possibly deter Turkey. Policymakers may prefer to have an independent monetary policy in case an economic downturn in Europe becomes inevitable. Finally, Turkey may also benefit by having control over its exchange rate in order to protect its competitiveness against other European nations.

Conclusion

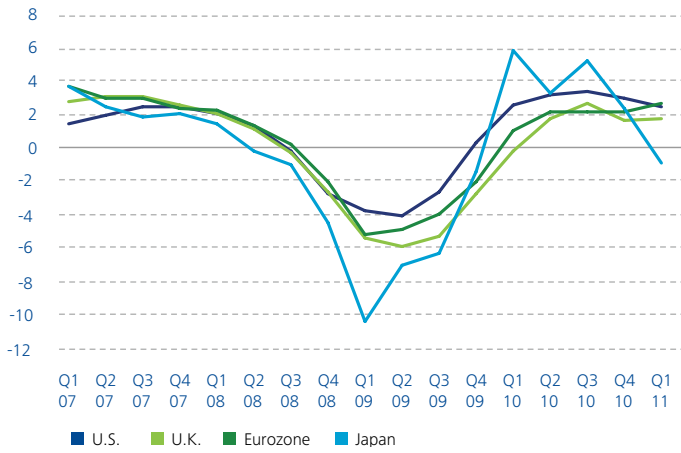
In the short run, the high current account deficit is a reason for concern. Inflationary pressures may intensify if oil prices remain elevated. A favorable employment scenario in Turkey will likely support income growth and benefit overall domestic demand. If external demand improves, the Turkish export sector will be boosted. Furthermore, a stable political environment instills confidence. The momentum of 2010 is expected to gradually fade away, yet the economy will probably still grow at a healthy rate. Turkey is poised to achieve above-average growth in 2011.

Since Europe faces a demographic disadvantage due to its dwindling working population, Turkey's young population could be an important source of labor.

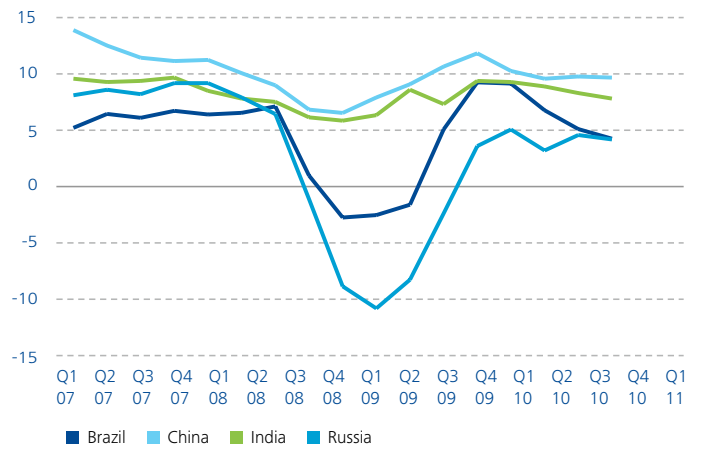


Appendix

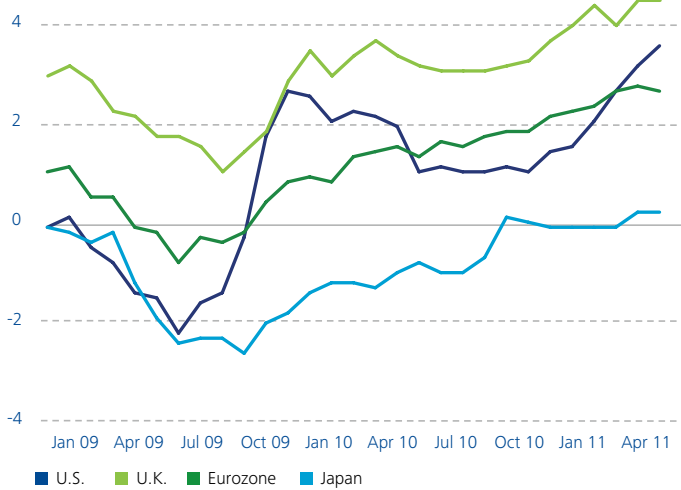
GDP Growth Rates (YoY %)*



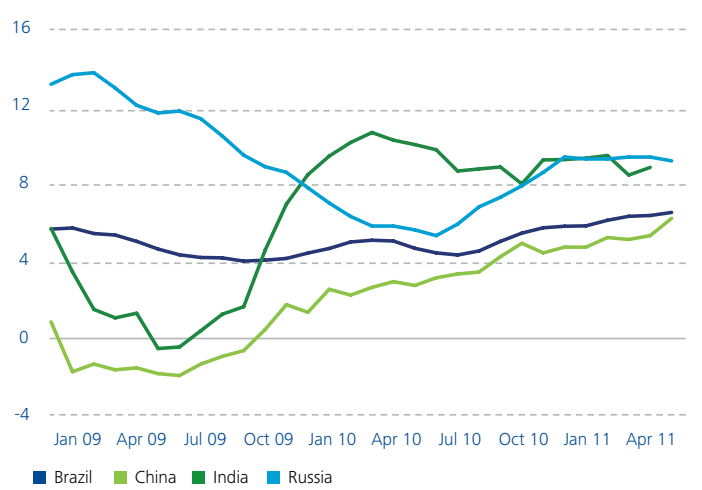
GDP Growth Rates (YoY %) *†



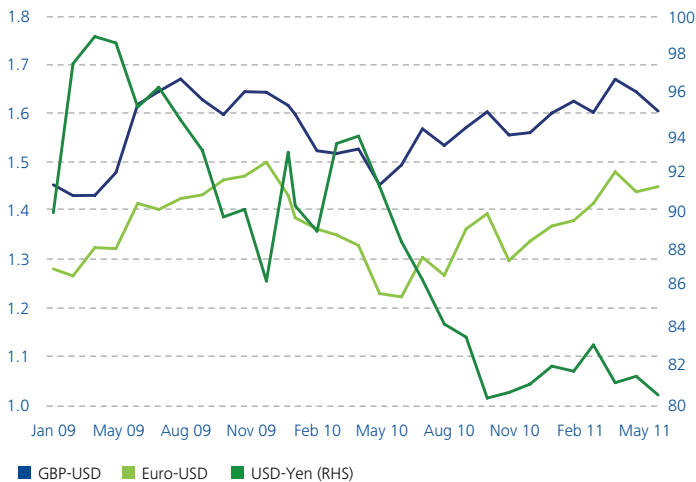
Inflation Rates (YoY %)*



Inflation Rates (YoY %)*‡



Major Currencies vs. the US Dollar*



Source: *Bloomberg †India's fiscal year is April-March ‡Inflation data for India is based on the WPI

Yield curves (as on July 11, 2011)*

	U.S. Treasury Bonds & Notes	UK Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Brazil Govt. Benchmark	China Sovereign	India Govt. Actives	Russia‡
3 Months	0.02	0.54	1.13	0.10	12.40	3.50	8.13	3.83
1 Year	0.16	0.54	1.43	0.13	12.72	3.37	8.10	4.66
5 Years	1.58	1.88	1.88	0.45	12.633 (4 year)	3.56	8.38	7.48
10 Years	3.03	3.19	3.19	1.18	12.41	3.91	8.35	8.26

Composite median GDP forecasts (as on July 11, 2011)*†

	U.S.	UK	Eurozone	Japan	Brazil	China	India†	Russia
2011	2.5	1.4	2	-0.6	4	9.5	7.9	4.6
2012	2.9	2	1.7	2.9	4.1			4.4
2013	3.2	2.35	1.95		4.5			4.15

Composite median currency forecasts (as on July 11, 2011)*

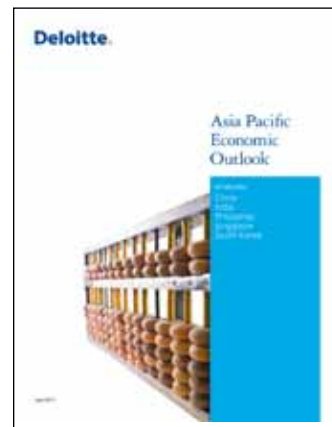
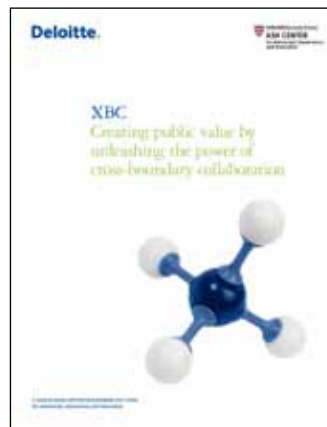
	Q2 11	Q3 11	Q4 11	Q1 12	2011	2012	2013
GBP-USD	1.63	1.63	1.63	1.62	1.63	1.65	1.65
Euro-USD	1.44	1.41	1.42	1.4	1.41	1.39	1.36
USD-Yen	83	85	87	88	85	90	92
USD-Brazilian Real	1.6	1.6	1.62	1.61	1.6	1.65	1.75
USD-Chinese Yuan	6.39	6.3	6.24	6.2	6.3	6.02	6.1
USD-Indian Rupee*	45.5	44.7	44		44.7		
USD-Russian Ruble	28	28	28.5	28.5	28	28.75	28.62

OECD Composite leading indicators (Amplitude adjusted)

	U.S.	UK	Eurozone	Japan	Brazil	China	India	Russia
Jul 09	92.9	98	96.5	93.3	96.2	101.7	99.4	92
Aug 09	94.2	99.4	97.9	94.3	97.7	102.5	100	93.7
Sep 09	95.4	100.7	99.1	95.4	98.9	103	100.4	95.1
Oct 09	96.5	101.9	100.2	96.5	99.8	103.3	100.9	96.1
Nov 09	97.5	102.7	101	97.6	100.5	103.5	101.4	96.8
Dec 09	98.4	103.3	101.6	98.6	100.9	103.4	101.9	97.3
Jan 10	99.2	103.6	102.1	99.5	101.3	103.2	102.2	97.7
Feb 10	99.9	103.8	102.5	100.1	101.6	102.8	102.3	98.1
Mar 10	100.3	103.7	102.8	100.5	101.6	102.4	102.2	98.6
Apr 10	100.6	103.5	102.9	100.7	101.6	102	102	99.2
May 10	100.6	103.1	102.9	100.8	101.4	101.6	101.8	99.8
Jun 10	100.4	102.7	102.9	100.8	101	101.2	101.7	100.4
Jul 10	100.4	102.3	102.9	100.9	100.7	101	101.6	101.1
Aug 10	100.4	102.1	102.9	101.1	100.5	101	101.5	101.8
Sep 10	100.6	102	103	101.4	100.4	101.3	101.4	102.5
Oct 10	101	101.9	103	101.8	100.5	101.6	101.2	103.1
Nov 10	101.5	101.9	103.2	102.5	100.5	101.8	101	103.6
Dec 10	102.1	101.8	103.3	103.2	100.4	101.9	100.7	104
Jan 11	102.6	101.8	103.3	103.8	100.1	101.8	100.3	104.2
Feb 11	103	101.7	103.2	104.2	99.5	101.5	99.7	104.2
Mar 11	103.3	101.6	102.9	104.4	99	101.1	98.9	104.2
Apr 11	103.4	101.4	102.5	104.1	98.3	100.6	98.1	104
May 11	103.4	101.3	102.1	103.7	97.6	100.2	97.4	103.9

Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100. Source: OECD

Additional resources



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