

## 8. International Environment

The global recovery continues but at a slower pace than expected, and in addition there are significant variations across regions and countries. While growth in developing countries and the U.S. slows down, the Eurozone is on the verge of “technical recession” which will likely be exacerbated by the end of the year. The main risks to the global economic recovery is the slowdown and possible recession of the Eurozone’s economy, and lack of agreement among the politicians in the U.S. in terms of fiscal policy. Large developing countries are implementing expansionary monetary policy to stimulate growth. The Fed began the third phase of “quantitative easing”, while the ECB launched a new programme of purchasing bonds. A global decline of the inflation rate is expected by the end of the year due to the relatively low growth, but the highly variable price of oil makes the forecasting difficult. In Eastern and Central European countries political populism is jeopardizing arrangements with the IMF and deterring investors.

### Global trends

Global recovery in the second quarter is weaker than expected. In many developed and developing countries, growth was slightly lower than expected. That is why the IMF cut global growth rate from 3.6% to 3.5% in 2012, and from 4.1% to 3.9% in 2013. As for the rest of the world, the growth rate for developed countries also declined marginally - from 1.5% to 1.4% for 2012, and from 2.1% to 1.9% for 2013. The forecast was primarily reduced due to the lower growth in the Eurozone. Even the rate for developing countries was reduced from 5.7% to 5.6% in 2012, and from 6.1% to 5.9% in 2013. Slowdown also occurred in China, India and Brazil, not only due to the reduction in external demand, but also due to the decline in domestic demand, primarily because of the measures that were taken in 2011, which were aimed at curbing inflationary tendencies. Due to its proximity to the Eurozone, growth in the countries of Central and Eastern Europe (CEE) has suffered a negative impact of reduced demand for trading partners, as well as continued reduction in lending of European banks that have investments in the region. The forecasted growth rates of 1.9% for 2012 and 2.8% for 2013 for CEE are by far the lowest compared to other regions of the developing countries, and it is expected they will again be adjusted downwards.

According to the IMF, there are two main risks to global recovery - a possible recession in the Eurozone and lack of agreement among the U.S. politicians in terms of fiscal policy. Global growth could be jeopardized if the politicians in the European Union do not proceed with the development of a concrete plan that would help the countries on the periphery and establish fiscal discipline, but these measures should not be too restrictive as they could cause a recession. Apart from the Eurozone, the biggest risk to global growth is a complicated situation in the U.S. in terms of fiscal policy, as there is still no compromise on the rate of taxes and budget spending.

IMF supports the latest expansionary monetary measures in the U.S. and the Eurozone, while for other developed countries it advises that the monetary policy be prepared to use unconventional measures in case the growth slows down, and the fiscal consolidation plans be adjusted if there is a serious downturn. This applies to developed countries, and it must be emphasized that in terms of developing countries, such a change in fiscal consolidation plan may be hazardous to financial stability, particularly where the public debt to GDP ratio is at a relatively high level.

The main risk to growth in the developing countries are external factors, so it is likely that the published growth rates will be adjusted downwards. According to the IMF, financial stability can be compromised during this period of recovery in the developing countries, due to low growth and high aversion to risk of the investors. If there is a withdrawal of capital by foreign investors, there are necessary measures to be taken to protect the sharp decline of the exchange rate, especially in small economies. Economic policy should minimize the negative effects of

lower growth, low inflow or sudden capital outflows. As before, the proposed instruments vary depending on the economic situation of the developing country. Where inflation is low and stable, the reference rates can be reduced in order to incite borrowing. If inflation is relatively high, reduction of the reference rate is not a suitable instrument, even if borrowing is declining. In countries where capital inflows after the crisis have been significantly reduced, it is necessary to implement supervision and regulation of the financial system along with appropriate macroeconomic policies in order to attract investors and reduce risk in the financial system.

The price of oil has expressed great variability in the first half of the year. During the second quarter, the oil price declined, primarily due to lower demand because of the slowdown in global economic activity, but also because of the increased production (Saudi Arabia). However, after the situation in the Eurozone improved, the price of oil started to grow again. According to the latest IMF report, global inflation should decline in the following year, in developed countries to 1.6% and in developing countries to 5.6%, and a decline in raw material prices is expected as well. These forecasts may be changed, because the prices of raw materials, energy and gold have increased due to the expansionary monetary measures in the U.S. and the Eurozone.

### Tendencies in the EU

Generally speaking, the economic situation in the Eurozone deteriorated during Q2 - successful countries like Germany slowed down the growth, while the decline in the indebted countries will be higher than previously predicted. On annual basis, after stagnating in Q1, the Eurozone's GDP declined 0.4% in Q2, which is the first annual contraction since Q4 2009. Personal consumption was low due to austerity measures and the uncertainty on the bonds market negatively affected the activity of companies. Due to its strong exports and private consumption, Germany again had the highest growth among the larger Eurozone economies, while in Italy and Spain the recession grew. Austerity measures in these two economies will yield results in the future, but in the meantime, the high interest rates at which these countries are borrowing money are further burdening their economies. A negative growth rate of GDP in the Eurozone is expected in the next quarter as well.

The turning point in the Eurozone was a summit in late June, which indicated that the end of the crisis in the Eurozone is finally near, when it was agreed that the countries on the periphery will have access to the funds from the stabilisation fund. Financial markets reacted positively. There is a possibility that bailout funds intended for banks will be distributed directly and the vicious cycle of aiding the banks through the government, which raised the level of public debt, would be broken. In order to achieve this, a greater financial integration is required, so Germany's condition is establishing a European banking monitoring mechanism, after which the direct assistance to the banks will be possible.

In early July, the ECB reduced the reference rate to 0.75% even though inflation was above the upper limit, but according to the ECB officials, it was certain that the inflation would decline by the end of the year, due to the economic downturn. In addition to the reference rate, the ECB also reduced the reserve requirements on deposits to 0%, which is the new historic low, in order to encourage banks to lend to one another.

ECB launched a new program in early September for purchasing bonds on the secondary market, without specifying the upper limit of funds that would be necessary, nor the time frame. Purchase of bonds would be conditional on completing structural reforms and austerity measures, and it could always be stopped, if the country seeking international aid does not keep its end of the agreement. Purchased bonds will be "sterilized" by selling higher quality bonds of other countries, and their maturity will range from 1 to 3 years. During the summit in June, there was a discussion about whether there will be enough funds to rescue Spain or Italy, and that is why the maximum amount of funds for the intervention was not mentioned, in order to make investors more confident in its efficiency. Also, another difference is that the ECB as a creditor will not have a special status, as was the case during the SMP.

## Tendencies in the U.S.

GDP growth in the U.S. during Q2 on annual level was 2.2%, which represents a slowdown compared to Q1, especially if we look at the growth on a quarterly basis. The slowdown is caused primarily by reduced personal consumption. Government spending is again falling, which was to be expected, since this has been the trend since early 2010, as well as the decline in business investment. Exports grew, but at a slower pace than imports, making the contribution of net exports a negative one.

The main threat to the U.S. economy (and the world's growth), which is already declining, is the lack of agreement between the Republicans and the Democrats on the fiscal policy. If by the end of the year the situation remains unchanged, many of the tax cuts will automatically be abolished, and a portion of budget spending stopped. According to the Congressional Budget Office analysis, this would lead to a reduction of fiscal deficit by 500 billion USD, but also to another recession and rising of unemployment in the coming year. The U.S. presidential elections will be held in November, so most analysts think that an agreement will be reached after the election, but that at the same time the election campaigns are creating an atmosphere in which an agreement is currently impossible to reach.

Following the decision in June to proceed with "Operation Twist" in September, the Fed began the third phase of "quantitative easing". It is planned to purchase monthly mortgage bonds in the amount of 40 billion USD, and the deadline in which the record low reference rate would be held at that level has been extended from the end of 2014 to the first half of 2015. Unconventional measures have increasingly less effect, but in a situation of low growth and high unemployment, they are gaining more and more supporters. There is increasing discussion on the possibility of introducing a new target for monetary policy - the growth of nominal GDP.

## Tendencies in Central and Eastern Europe (CEE)

The biggest risks to the economic growth of the CEE countries are the slowdown of the Eurozone, where the main factors are export markets, as well as the withdrawal of capital by foreign banks that are active in the region. After the completion of the duration of the Vienna Initiative, a reduction in bank lending has lately intensified, especially in periods when the risk to peripheral Eurozone bond markets was increased. The vulnerability of the economies because of it depends on the parent banks. Certainly the banks with the capital from Greece or Italy are more vulnerable than the banks whose parent company is in Germany. Foreign direct investments can reduce the negative impact of the withdrawal of bank capital. Because of the recession in Eurozone, the level of foreign direct investment from that region to the CEE will be stagnant at best, so it is advisable to direct attention to partners from East Asia as well. If a country has access to the EU market, investors from East Asia gladly use the market proximity and low labor costs, and there are already a lot of success stories (Foxconn, Samsung, etc.). In terms of other risks, longer or deeper contraction in the Eurozone, the countries with a more diversified export will be able to better adapt to the reduced demand. Therefore, it is appropriate to increase exports to the markets of developing countries, where the demand is more certain.

Political populism in some CEE countries is jeopardizing the negotiations or arrangements with the IMF. Populism is associated with defects in the political systems of some countries, which hinder the adoption of the necessary consolidation programmes. Depreciation of the exchange rate, reduced demand for government bonds, and subsequent increase of the country's cost of borrowing are all regular consequences of government's refusal to accept IMF's conditions.

Croatia's economy went back into recession and the growth rate of GDP during Q2 was 2.1%. Consumption is low due to rising unemployment, lack of demand for consumer loans, and the negative effects of the VAT increase. Investments are also low, while the government does not plan major investments before 2013. Exports will depend on the situation in Eurozone, while tourism during summer was a success. The required reserve ratio was reduced, but it will not

affect macroeconomic stability – it is expected that the exchange rate will remain stable and the inflation low. The main risk to the Croatian economy is deteriorating situation in the Eurozone and the possible loss of the current credit rating. In early September, the Fitch agency kept the old credit rating of Croatia, but the forecast has been changed from negative to stable, which is good news and confirms that the government is now implementing a successful fiscal consolidation. Croatia has managed to weather the “Great Recession” without an arrangement with IMF, and it is certain that the state will be able to provide funds to finance the deficit, which dropped significantly this year. Taxes were increased immediately after the formation of the government, and by the end of the year, cuts are planned for budget funded wages, as well as a lay-off of public sector employees. Changing the law reduced the influence of trade unions, and a new collective agreement is foreseen that will eliminate many of the benefits of civil servants, while the restructuring of public enterprises with lay-offs has also been announced. A fiscal deficit of 3.8% is planned, but due to low growth there could be some deviation from the plan, although the government should try at all cost to fulfil the fiscal consolidation measures. The government has announced that it plans two privatisations through sale of government’s shares – fertiliser company “Petrochemicals” and “Croatia Insurance”, so their stock prices recorded significant growth.

Negotiations of Hungary with the IMF started in July and it was expected that an agreement would be reached by the end of the year. The bond market reacted positively and reduced the interest rate on government bonds. It seemed that the negative consequences of unorthodox economic policies and controversial change in the law will finally be reduced by agreement with the IMF. However, it is uncertain now whether an agreement will be reached due to Hungarian government suddenly announcing that it does not accept the reduction of pensions, job cuts in the public sector, and abolishing of atypical taxes and reduction of standard taxes. Financial market players were taken by surprise and reacted negatively to the news, immediately weakening the forint by 1.5% against the Euro.

During Q2 Romania has achieved GDP growth of 1.7% annually, a slight acceleration compared to Q1. The contraction in the Eurozone will negatively impact the growth of the Romanian economy, as 50% of exports are placed on this market, and 80% of foreign direct investment comes from there. Drought will have a negative impact on GDP growth, while inflation will increase due to lower supply of agricultural products in the market. In Romania too, the political situation complicates the implementation of economic reforms and deters investors. The European Union strongly criticised government actions, and financial markets have reacted negatively, so leu depreciated 4.5% against the Euro to historically the lowest value, while the central bank had to defend the exchange rate, which reduced the forex reserves. In addition, several auctions where government bonds were offered were unsuccessful because the borrowing costs were too high. Disagreement with the IMF is visible in the planned increase in public sector wages by 7.4% in December, despite the fact that there was a similar increase in June this year. The government insists on it in order to get the votes of public employees in the upcoming elections. The IMF will most likely agree to these terms, but in order to avoid a significant increase in the projected level of the fiscal deficit (3% was agreed), the government will have to withdraw from capital investments. During the negotiations with the IMF, a 5% increase of natural gas prices was agreed, an accelerated privatisation of public enterprises in the energy sector and the chemical industry, as well as settling of debts of public enterprises towards the state.