8. International Environment

The global economic recovery is slow, since it is affected by two negative factors. First, private demand in developed countries is growing at a slower pace than expected, so the recovery is not yet self-sustaining, and second, fiscal and financial risks increased over the summer. A mix of these two factors can have a very significant impact on the global economy. Unless euro area governments proceed to prevent the escalation of the crisis, a global recession may be looming. The stabilization of oil and food prices is expected, and consequently an inflation slowdown in the next year. Since inflation is decelerating, many central banks have decreased their reference rate to stimulate growth. Unlike monetary policy, fiscal policy is mainly restrictive, especially in developed countries and the euro area.

The growth of the global economy has weakened, accompanied by growing risks of short-term or long-term recession. The euro area countries and the U.S. are facing the problem of high public debt. In both cases, the lack of consensus among political factors is an obstacle to an adequate solution. Currently, the euro area crisis poses the biggest risk for the continuation of global recovery. Unless the euro area leaders reach an agreement on future steps leading to a "tighter" fiscal union, the euro area will cease to exist in its present form, which will have highly adverse consequences for the global economy, likely to push it back into recession. The euro area crisis is at its peak and its resolution is expected by the year's end.

In the circumstances of dominant political factors, the usual macroeconomic models are not a precise method for anticipating future growth rates. The political processes that will decide on institutional restructuring of the European Union and the euro area are of key importance for the short-term and medium-term perspective of their economies. Hence, under such circumstances forecasts based on usual models lack standard reliability.

Personal consumption is not recovering fast enough to compensate for the adverse effects that fiscal consolidation has on growth in developed countries. A growth slowdown in developed countries negatively impacts exports of developing countries. For this reason, the IMF made downward adjustments in the growth forecasts in its latest report[1]; the global growth rate should amount to 4% and has been decreased by 0.3 percentage points relative to the previous forecast. The euro area crisis is spreading towards the countries "in the heart" of the euro area, prompting banks to cut back lending activities and keep their solvency at a high level, which hampers growth. Lower growth decreases future tax revenues thus increasing the insolvency risk of countries, and not only those on the outskirts of the euro area. This vicious circle can only be broken by the agreement of the euro area leaders on a "firmer" fiscal union. If such an agreement is reached, it will most likely be accompanied by a joint action of the European Central Bank (ECB) and the International Monetary Fund (IMF) that might be supported by the central banks of major non-European economies (the U.S., China, Japan etc.).

The global economic growth continues at a slower pace, accompanied by the growing risks of recession relapse in case the euro area crisis escalates.

According to IMF projections, in 2011 developed countries should achieve a of 1.6 growth rate, which is by 0.8 percentage points less than the projection published in the previous *QM* edition. The growth of euro area economies is still slow: in Q3, preliminary annual estimates show that annual growth in Q3 totaled 1.4%, i.e. below the growth figures in Q2 (1.6%). At a quarterly level, the growth remained unchanged in Q3 relative to Q2. The surveys and other hard data indicate that industrial production contributed to the growth more than in Q2. Also, retail data say that personal consumption grew in Q3 as well. The most recent IMF report anticipates a 1.1% growth of the euro area in 2012. As we already pointed out, the growth rates projected by the IMF should be taken with caution. Many economists foresee a euro area recession and negative growth in the next year, due to the unfavorable results of the latest polls and production data. For example, JP Morgan anticipates negative GDP growth of -0.7% in the euro area in 2012.

1 *World Economic Outlook*, IMF September 2011. In the meantime, the latest economic data are below expectations, indicating an even worse scenario than the one presented in the IMF September report.

Among euro area countries, the strongest growth was recorded in Germany, as expected, due to the rise in personal consumption and exports. However, both Germany and France, which are presently seen as the euro area economy "engine", are facing the consequences of the crisis in the European sovereign bond market. Polls conducted among businessmen and consumers show an economic downturn due to reduced demand, while financial conditions impacting the rise in lending activities – are growing increasingly unfavorable.

Table T8-1. The World: Economic Growth and Inflation, 2009-2012[1)]

	Real GDP								Inflation		
	Real growth (%)				Real growth, (%)[3)]				Consumer prices (%)[4)]		
	2009	2010	2011[2)]	2012[2)]	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q1 2011	Q2 2011	Q3 2011
U.S.	-3.5	3.0	1.5	1.8	3.1	2.2	1.6	1.5	2.1	3.4	3.8
Japan	-6.3	4.0	-0.5	2.3	2.5	-0.6	-1	-0.2	-0.5	-0.4	0.1
China	9.2	10.3	9.5	9.0	10.4	9.7	9.6	9.4	5.1	5.7	6.3
Eurozone	-4.3	1.8	1.6	1.1	1.9	2.4	1.6	1.4	2.5	2.7	2.7
Germany	-5.1	3.6	2.7	1.3	3.8	4.6	2.9	2.6	2.1	2.3	2.5
France	-2.6	1.4	1.7	1.4	1.4	2.2	1.6	1.6	1.8	2.1	2.1
United Kingdom	-4.9	1.4	1.1	1.6	1.3	1.6	0.6	0.5	4.1	4.4	4.7
Italy	-5.2	1.3	0.6	0.3	1.5	1.0	0.8…		2.3	2.7	2.8
The Russian Federation	-7.8	4.0	4.3	4.1	4.4	3.8	3.4…		9.5	9.5	8.1

1) Source: IMF, Eurostat, OECD, National Bureau of Statistics of Kina, Russian Federal State Statistics Service
2) Annual growth rates for 2011 and 2012 are projections of the IMF. In January, downward corrections are expected by the IMF
3) The growth rates of GDP are interannual
4) In comparison to the same period last year.

Both Germany and France, currently seen as the euro area economy "engine", are affected by the crisis in the European sovereign bond market.

According to IMF projections, economic growth in the United States should reach 1.5% in 2011. Annual GDP growth in Q2 and Q3 totaled 1.6% and 1.5%, respectively. Public consumption throughout the entire year has not been conducive to growth, and this trend will most likely continue due to the consolidation of the national and local deficit. Since the onset of crisis, over a million public sector employees have lost their jobs. In circumstances of reduced available income due to a weak labor market demand and high commodity prices, personal consumption cannot rise significantly. Growth was mainly stimulated by business investments and exports.

The projected growth rate for developing countries for 2011 has also been reduced from 6.6% to 6.4%, whereas for 2012 it went down by 0.3 percentage points to 6.1%. Reduced demand in the Western countries adversely impacted production in Asia, which had already been under pressure since the Japan earthquake. The economic activity has been reduced in the Arabic part of the world due to the riots and war in Libya. Central and Eastern European countries experienced a sound recovery in the first half of the year, but will have to cope with reduced external demand due to their proximity to the euro area. A mix of global factors has led to a global downturn. The IMF reduced the growth rates for all emerging countries, as well as for China, India and Russia.

The IMF reduced growth rates for all emerging countries, as well as for China, India and Russia.

Based on the latest trends, the IMF made downwards adjustments of the forecasts for some Central and East European countries relative to the data published in the September report. The projected GDP growth rate for Serbia in 2012 now amounts to 1.5% instead of 3%, for Romania it should be within the 1.75%-2.25% range instead of 3.5%, and for Bosnia and Herzegovina it should amount to 0.7% instead of 3%, while for Bulgaria, Croatia, Hungary and Macedonia the adjustments have not been published yet.

According to the IMF projections, consumer prices in developed countries will rise to 2.6% in 2001 and 1.4% in the following year. In the euro area, consumer prices are expected to register a 2.5% growth, which is somewhat lower than in the U.S. (3%). The countries of Central and Eastern Europe should see an average rise in consumer prices of 5.2% this year and 4.5% the following year. A global inflation slowdown is expected owing to the stabilization of oil and food prices. Oil prices are currently almost at the level registered before the Arab spring.

Table T8-2. Chosen Indicators for Countries in the Region1)

	Real growth (%)						Consumer prices (%)		Current account, % of GDP		Fiscal deficit, % of GDP	
	2010	Q1 2011 2)	Q2 2011 2)	Q3 2011 2)	2011 3)	2012 3)	2011 4)	2012 4)	2011 3)	2012 3)	2011 3)	2012 3)
Bulgaria	0.2	3.3	2.0	1.3	2.5	3.0	3.8	2.9	1.6	0.6	-2.5	-2.2
Romania	-1.3	0.8	0.8	4.5	1.5	1.8-2.3 5)	6.4	4.3	-4.5	-4.6	-4.4	-2.8
Hungary	1.2	1.9	1.7	1.5	1.8	1.7	3.7	3.0	2.0	1.5	-2.0	-3.6
Croatia	-1.2	-0.8	0.8	0.6	0.8	1.8	3.2	3.4	-1.8	-2.7	-5.7	-5.1
Macedonia	1.8	5.1	5.3	..	3.0	3.7	4.4	2.0	-5.5	-6.6	-2.5	-2.2
Bosnia and Herzegovina	0.7	..	..	..	1.7 5)	0.7 5)	4.0	2.5	-6.2	-5.6	-3.0	-1.6
Serbia (QM)	*1.0*	*3.7*	*2.4*	*0.7*	*2.0*	*1.5*	*11.2*	*4.5*	*-7.7*	*-8.9*	*-4.5*	*-4.3*

1) Source: Eurostat,WEO September 2011, IMF
2) Year on year quarterly growth rate, source: Eurostat, IMF, QM for Serbia
3) IMF estimates, QM for Serbia
4) Inflation (average), source: IMF, SORS and QM for Serbia
5) The latest estimates from IMF Pin / Staff Report. For other countries downward corrections are also expected, given that new estimates are not published, we use data from the WEO, September 2011 IMF.

The Food Price Index[2] is about 5% lower than the high level reached in February this year, but still 19% higher compared to the figures recorded in September 2010. The projected consumer price growth rate for Serbia amounts to 11.3% in 2011, undoubtedly the highest rate in the region of Central and Eastern European, but is expected to see a slowdown to the rate of 4.3% in the next year. Given the fact that inflation has slowed down, many central banks decreased their reference rates in order to stimulate growth. A further decrease in reference rates is expected, due to the high likelihood of recession in the euro area.

Global inflation is expected to slow down owing to the stabilization of oil and food prices.

The price of gold reached its historic maximum of USD 1,923 per ounce at the beginning of September, due to uncertain economic growth in the U.S. and problems in the euro area. Only twenty days later, gold lost almost 20% of its value, when several stock exchanges increased the minimum capital amount for investors whose portfolio includes this metal. It is hard to find historical examples that correspond to the current global economic and political situation, thus making forecasts on future trends of the gold price uncertain.

At the last ECB Board meeting in November, the reference rate was reduced by 25 basis points to 1.25%, making a turn in that way towards expansive monetary policy. Jean-Claude Trichet left the position of ECB president and Italian Mario Draghi took his office. Economists did not believe that the ECB would reduce the interest rate at the beginning of the new presidency, since it could spark fears that the new governor has a “softer” approach towards inflation. However, the new President Draghi, pressured by deteriorating data on the euro area economic activity evidently could not wait until December. Nevertheless, financial markets reacted positively to the decision of the new President, and a further decrease in the reference rate is anticipated.

By the end of October, all euro area leaders agreed on several further measures addressing the crisis. Greek debt sustainability and reducing uncertainty in the banking sector were the main issues. Greece was granted another financial package totaling EUR 100 billion (in May 2010 it totaled EUR 110 billion). This should be sufficient to cover Greece’s financial needs until end of 2014, as well as funds for recapitalization of country’s banking system. The IMF financially supported this package, just like the previous one.

EBA[3], the regulatory agency of the European Union’s banking system, estimates that about EUR 100 billion of additional capital is required for major European banks to meet safety criteria, once the values of European bonds are registered at real prices in their portfolio. The EBA requires banks to meet these criteria by June 30, 2012, and submit plans for their implementation by the end of 2011. This has to be performed in a manner that will not put credit channels to economy under jeopardy in case the recession hits the euro area.

Euro area leaders considered increasing the EFSF[4] leverage, in order to have enough capacity to buffer financial market blows. Two methods of leverage increase are possible: credit growth or establishment of a special investment fund. According to the first solution, countries would issue

2 World Bank global food price index.
3 European Banking Authority.
4 European Financial Stabilization Fund.

bonds guaranteed by EFSF-issued securities. In this way, financial strength of the Fund could be boosted even four times. For now, it is still unknown how specifically the EFSF's strength will be boosted, but most probably apart from this body, both the ECB and the IMF will take part in resolution of this crisis.

Monetary policy is becoming a complicated issue for U.S. economists, given the fact that incentives have so far failed to yield expected results.

Monetary policy is becoming a complicated issue for U.S. economists, given the fact that incentives have so far failed to yield expected results. After the second phase of quantitative easing, the so-called "Operation Twist" was launched in September. The implementation of this measure entails the sale of bonds with maturity of less than three years, and purchase of bonds with a longer maturity period (6 to 30 years), in order to "straighten" the American yield curve and stimulate economy without increasing FED assets which could spark further inflationary pressures. It is hard to forecast the effects of "Operation Twist" now, but most probably they are weaker than expected. The reference rate is near zero, its further decrease is not possible, so new monetary measures are taken into consideration in order to further stimulate the economy. Three suggestions are taken under advisement: 1. targeting nominal GDP, 2. aiming the core inflation level and 3. maintaining a low reference rate until unemployment drops to a level ranging from 7% to 7.5% or inflation permanently exceeds 3%. Academic circles are debating about the most adequate method for the current situation, and it remains to be seen how monetary policy will be changed.

As inflationary pressures are reduced, central banks in developing countries have the opportunity to stimulate the economy by reducing reference rates. Since August, due to the adverse impact of the euro area crisis, the central banks of Brazil, Romania, Serbia, Indonesia, Pakistan and Georgia have reduced their reference rates. The reduction of reference rates is expected in other countries as well.

Many economists are of the opinion that savings measures throughout the euro area have contributed to intensifying the crisis and slowing down growth, also having failed to achieve their goal – putting the bond market under control. At the same time, restrictive fiscal policy hampered growth in several countries, and now the solvency of the countries in the "heart" of the euro area and on its outskirts alike is being reviewed. France might lose its credit rating. The lack of demand in a German government-bond auction caused the increase of their interest rate by 20 basis points on the very same day.

The euro area crisis can be stabilized by stronger fiscal centralization of the European Union. Financing countries on the outskirts of the euro area through ECB interventions and without changing the Lisbon Treaty is not a long-term solution. The ECB purchases bonds of countries at risk on the secondary market, in order to decrease pressure on their interest rates. Without stronger fiscal integration, the purchased bonds will remain in ECB's possession, which is a transfer of fiscal costs. In the case of such a scenario, Germany would most likely leave the euro area. Germany will not agree to finance debts of other countries without any control of their fiscal deficits, because it is an example of the *free rider* problem. This is the reason why the Lisbon Treaty needs to be amended, so as to allow the European Union to control the budget deficit level of member states.

The euro area crisis can be stabilized by stronger fiscal centralization of the European Union.

Just like the euro area, the U.S. also has problems related to fiscal policy. For now, Democrats and Republicans have not been able to find a compromise solution with regard to the budget. Democrats call for higher taxes on the wealthy, while Republicans advocate cutting public spending. As in the euro area, political consensus is missing here as well. There are solutions but these are not implemented due to the "unbending" positions that both parties took. If they fail to reach an agreement – automatic measures that include discontinuing unemployment benefits and tax incentives to middle class will ensue next year. According to some estimates, the discontinuation of such measures could reduce GDP growth in the U.S. by more than one percentage point during the next year. Absence of a compromise between Republicans and Democrats that would ensure sustainable public spending in the U.S., can lead to the problem escalation on the bond market, much like in the euro area.

So far, Republicans and Democrats have not been able to reach a compromise solution on the future pursuit of fiscal policy in the U.S.

By August this year, bond markets in Central and Eastern Europe resisted the impacts of the euro area crisis. Before that, bond interest rates in the countries of the region were rising in the periods when investors were globally reducing risk propensity, and their growth did not highly correlate with the interest rate growth in the euro area. Namely, by the end of this summer the situation changed – the danger of direct risk transfer from the euro area to Central and Eastern Europe increased. The crisis can be transferred in two ways: through financial channels in case the European capital is withdrawn from the region, and by reducing exports to the euro area in case of recession. In order to prevent negative spill-over effects, the IMF advises focusing macroeconomic policy on fiscal consolidation and solving the problem of non-performing loans.

The risk of a direct spill-over of the crisis from the euro area to Central and Eastern Europe has increased.

Public debt relative to GDP ratio and success of measures aimed at decreasing budget deficits and increasing fiscal discipline are different in the countries of the region. Despite the measures, considerable fiscal risks are still present in many countries. Fiscal deficit exceeds 4% of GDP in Croatia, Latvia, Lithuania, Poland, Romania and Serbia, while public debt exceeds 50% of GDP in Albania, Hungary and Poland. To determine insolvency risk, apart from these classical indicators, it is also advisable to analyze sovereign short-term debts, as well as the level of public debt in foreign currency.

If, prior to the crisis in 2008, countries had set aside a portion of tax revenues to use it in periods of economic downturn, fiscal risks would have been much lower in the region. Instead, surpluses were used to stimulate consumption. For the purpose of implementing a disciplined fiscal policy and reducing such mistakes in the future, the IMF recommends the application of fiscal provisions (that are usually enforced upon adoption of the law on fiscal provisions). Surveys indicate that fiscal provisions positively affect fiscal discipline. In the absence of strong institutions, fiscal provisions can be circumvented, namely, by means of different creative accounting and off-budget items. Although they are not *panacea,* fiscal provisions still introduce some kind of a spending ceiling during the expansion phase, even when not fully followed.

Another problem that should be the focus of economic policy is non-performing loans. According to the latest data, in Lithuania, Latvia, Montenegro, Serbia and Ukraine the level of non-performing loans exceeds 15% of the total loan level. In most countries non-performing loans peaked in mid-2011, while a slow decline was registered in Poland, Russia and the Baltic states. This percentage is usually high in countries that have had sharp cycles and experienced sharp credit growth and rise in real estate prices during expansion. Fluctuation of the national currency exchange rate affects the amount of non-performing loans as well, as retail and corporate clients have difficulties with repayment of foreign currency denominated loans when the exchange rate falters. Out of all countries in Central and Eastern Europe, Serbia has reached the highest non-performing loans to total loans ratio – as much as 18.6%, but this does not mean that the financial risk is also above-average, since it has one of the best capital adequacy ratios in the region, amounting to 19.7%[5]. Regardless of a high level of non-performing loans, the banking sector in the region is solidly capitalized, and currently financial stability is not seriously threatened. However, the IMF advises regulatory bodies to actively control banking operations, since a bank in Russia and another one in Latvia went bankrupt last summer and in November, respectively. Currently, non-performing loans pose a bigger obstacle to GDP growth than they are a threat to financial stability. For this reason, a drop in the number of non-performing loans is desirable. Thus, the IMF recommends: removal of obstacles in tax legislation relating to debt restructuring, strengthening institutions and amending laws in order to improve efficiency of debt recovery and settlement.

Austrian banks are very active on the Central and Eastern European market: the amount of investments into Central and Eastern Europe by three banks exceeds the Austrian GDP. If a bank is threatened by insolvency due to a loss on that market, Austria will have to recapitalize it in order to stabilize financial system, what will place burden on public finances. This possibility may prompt credit agencies to reduce Austria's credit rating, so its financial authorities have decided to take preventive measures. Banks were instructed to limit future lending to Central and Eastern

5 IMF data for June 2011

European countries up to the amount of local deposits. Beside the measure for limiting credit growth in the region, banks will have to meet Basel III criteria before the schedule, and hold additional reserves for possible losses. Such decision of Austrian government is a reversal with respect to the Vienna initiative – it reduces loans availability in Central and Eastern Europe, and has a procyclical effect in the period of growth slowdown. This is an example of how the euro area crisis can adversely impact economies in Central and Eastern European countries through the financial channel.

Austrian banks were instructed to limit future lending to the Central and Eastern European countries up to the amount of local deposits.

Adverse impact through the financial channel may be realized if the euro area banks, due to insolvency reasons, start withdrawing their capital from Central and Eastern Europe, or stop revolving old loans. The biggest insolvency risk is incurred by banks whose head office is in the GIIPS countries (Greece, Italy, Ireland, Portugal and Spain). The bigger the investment share of the banks from GIIPS countries into some Central and Eastern European country, the higher the possibility of negative impact through financial channels. The table shows that investments of banks that have head offices in the GIIPS countries compared to the total investments of foreign banks are higher only in Bulgaria and Croatia than in Serbia.

Table T8-3. Investments of foreign banks into Central and Eastern European countries[1)] (share of foreign ownership of bank assets expressed in percentages of the country's total banking assets)

	Bulgaria	Croatia	Czech Republic	Hungary	Latvia	Lithuania	Macedonia	Poland	Romania	Serbia
Austria	8.9	36.4	26.7	20.7	...	...	1.2	4.3	31.5	17.9
Belgium	2.5	...	21.1	11.5	...	...	...	3.8	...	1.2
Denmark	...	...	...	...	1.4	6.4	...	...	...	...
France	4.1	6.8	16.7	...	...	...	6.3	4.2	13.7	8.3
Germany	6.1	...	1.8	10.4	...	...	4.1	9.8	0.1	2.8
Greece	25.0	...	...	...	...	...	24.7	0.6	15.8	17.3
Hungary	11.6	3.3	...	...	...	...	...	...	1.1	...
Italy	15.4	47.7	6.7	14.4	...	...	...	11.6	7.1	21.5
Netherlands	...	...	...	...	...	...	...	8.7	3.5	...
Norway	...	...	...	...	8.5	13.5	...	0.8	...	...
Portugal	...	...	...	...	...	...	...	4.1	0.6	...
Slovenia	...	...	...	...	...	...	20.5	...	...	...
Spain	...	...	...	...	...	...	...	6.0	...	...
Sweden	...	...	...	...	41.4	60.8	...	2.2	...	...
Turkey	...	...	...	...	...	...	2.6	...	...	...
USA	...	...	3.3	3.2	0.9	...	...	6.5	...	...
Total GIIPS[2)]	40.3	47.7	6.7	14.4	0.0	0.0	24.7	22.3	23.6	38.8
Total Eurozone	62.0	90.9	73.0	56.9	0.0	0.0	56.9	53.1	72.4	69.0
Total foreign ownership	84.0	90.9	97.0	85.6	60.0	84.0	92.9	72.3	87.4	74.0
The largest share	25.0	47.7	26.7	20.7	41.4	60.8	24.7	11.6	31.5	21.5
The largest share origin	Greece	Italy	Austria	Austria	Sweden	Sweden	Greece	Italy	Austria	Italy

1) Source: Fitch Agency
2) Abbreviation for the group of countries most affected by the crisis in the Eurozone - Greece, Italy, Ireland, Portugal and Spain

Hungary requested financial aid from the IMF.

Hungary requested financial aid from the IMF and the European Union, which is a sharp reversal of the official policy of the right-oriented government of *Viktor Orbán*. More than a year ago, the Hungarian government suspended a credit-line arrangement with the IMF, and continued its controversial economic policy. Hungary is registering a low economic growth, and the public debt to GDP ratio has risen due to weakening of the Forint. Hungary has the highest ratio of domestic loans expressed in Swiss francs to GDP in the region. As the Forint weakened and the Swiss Franc strengthened, the number of non-performing loans went up. Short-term public debt to GDP ratio exceeds 10%. Interest rates on government bonds recorded a rise due to the euro area crisis, so the government changed its policy course in order to prevent a downgrade of Hungary's rating. However, the change in the attitude towards the IMF was ill timed, as only several days later, Moody's credit rating agency still reduced Hungary's rating. It remains to be seen whether other agencies will make the same decision, or will the cooperation with the IMF convince them that Hungary will implement efficient reforms.