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Atradius Group

Economic Outlook
November 2013

Editorial

'This Time is Different'. This statement, the title of a much cited study on financial crises by Reinhart and Rogoff, also arguably best describes the current phase of the global economy. It is different in the sense that the US has moved centre stage again in the global economy as the Eurozone's woes diminish.

Two recent events have shaped this shift in focus. Firstly, the announcement by Federal Reserve (Fed) chairman Ben Bernanke on 22 May, that the US will 'taper' its expansionary monetary policy, sent a shockwave through the global financial system. US government bond yields went up, as did those of Germany, while the exchange rates of the currencies of a number of emerging economies - notably India, Indonesia and Turkey - depreciated considerably as capital moved back to advance economies. Although the turmoil has now receded, this episode served as a wake up call for emerging economies to address structural weaknesses if they are to maintain their current growth levels. And it warned the US that its monetary policy needs to be scaled back at some point as the economy continues on its path to recovery.

Secondly, political deadlock in the US between the Republicans and Democrats continued to weigh on fiscal policy and the economy. In early 2013, an agreement was struck on automatic spending cuts: this has limited economic growth by about one percent this year. In October the government was temporarily shut down, again harming the economy. In the same month a threatened default on US treasury bonds which would have had major global implications, was narrowly avoided by 'kicking the can' down the road towards early 2014.

Meanwhile in the Eurozone, as calmness in the financial markets continued to reign, on the back of the implicit European Central Bank (ECB) guarantee not to allow a break up, politicians were able to make significant progress towards a European banking union in June. The mood has clearly changed, as demonstrated by much improved confidence indicators. Even better, the economy has now turned a corner by growing in the second quarter: at least one quarter ahead of expectations. Although much remains to be done on the policy front and the recovery is still fragile, there is a feeling that the Eurozone crisis is fading.

This different picture is reflected in our forecasts for 2014, which have changed since those we made in our May Economic Outlook. Global growth for 2014 will be almost unchanged at 3.1%, as will the modest Eurozone growth of 0.9% and, despite the fiscal woes, a healthy 2.6% growth in the US. But for the emerging economies forecasts are lower: at 4.7% for Asia Pacific and 3.3% for Latin America. The gap in growth between advanced and emerging economies is no longer widening – that too is different.

While the global economic picture is still muted, and unlikely to significantly reduce the high level of insolvencies in many markets in 2014, at least the outlook is brighter in that, across the board, the situation is no longer worsening. Indeed, with quite favourable growth, the insolvency environment in the US is expected to improve. And in the Eurozone only some peripheral countries are expected to see insolvencies rise, while levels in most member states remain about the same. For real improvement, growth levels higher than those expected in 2014 would be necessary.

I would like to thank the Atradius Economic Research team for their contributions to this Economic Outlook. Daan Willebrands diligently took care of the advanced economies, helped by Daniel Bosgraaf. Marijn Kastelein, Paul Burger and Afke Zeilstra together produced the emerging economies chapter. Niklas Nordman drafted the chapter on insolvencies in his usual concise manner. That, at least, was not different this time.

John Lorié, Chief Economist Atradius

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Executive summary

The global economy has stabilised over the past six months and we expect an increase in economic growth in 2014. This is the result of the moderate economic recovery in the United States and waning of the crisis in the Eurozone. Economic growth in emerging markets has moderated but remains relatively strong.

Key points

- Global economic growth is forecast to accelerate from 2.4% in 2013 to 3.1% in 2014, thanks to improving conditions in advanced markets.
- The Eurozone is expected to grow 0.9% in 2014, ending two years of contraction. The United States economy is projected to expand 2.6%. Asia and Latin America still show high growth rates but slightly slower momentum.
- Although risks to the global economy have eased, they have not disappeared. Growth in emerging markets may slow further, the gridlock in US politics could damage the economic recovery and much needed progress towards a European banking union may not meet expectations: all of which could hinder the fragile recovery.
- We forecast that the general insolvency environment will improve slightly in 2014. Whereas many countries saw an increase in insolvencies in 2013, most can now anticipate stable, or marginally improving, conditions.

The global economy is forecast to grow 3.1% in 2014, up from just 2.4% in 2013. This will bring global growth closer to its long-term potential, but the pace is still relatively modest. Most improvements have been seen in advanced markets, where the pace of fiscal consolidation is slowing. Monetary conditions may, on the other hand, tighten as a result of changing policy at the US Central Bank.

Global trade growth is also expected to improve. Trade grew only marginally: 1.9% in the first eight months of 2013, the same rate as in 2012, as a result of weak global growth and an increase in protectionist measures across the world. But, as global economic growth is forecast to increase in 2014, global trade growth is also expected to accelerate, to 4.5%.

Economic conditions in advanced markets have stabilised and are set to improve further. The recession in the Eurozone ended in the second quarter of 2013, aided by easing fears of an impending euro crisis. Consumers and businesses have slowly regained confidence, while governments reduce their pace of fiscal consolidation. Nevertheless, the banking sector remains vulnerable and some member countries may need further financial assistance. The recovery of the United States economy is forecast to accelerate in 2014 as domestic conditions improve. But political disagreement over the fiscal budget and debt ceiling could seriously undermine the otherwise stable economy.

The economic situation in several emerging markets has weakened over the past year. This is both a cyclical and a structural effect. It may not be possible for emerging economies like China and India to maintain their growth figures at the heady pace of recent years. Tighter global financial conditions have also led to an outflow of fund from emerging markets such as Turkey and Brazil. But in general most emerging markets have improved their financial position over the past decade and should be able to weather tighter monetary conditions in the period ahead. Emerging Asia is forecast to grow 6.3% in 2014, compared to growth of 3.3% in Latin America and 3.1% in Eastern Europe.

In line with the better economic conditions across developed markets, we forecast an improving insolvency environment. The United States, United Kingdom and the Nordic region can anticipate a drop in insolvencies in 2014. Although stabilising, insolvencies are forecast to rise 6.8% in the Eurozone in 2013. However, in 2014 an increase of only 0.9% is expected. The Eurozone periphery shows the largest increase in insolvencies with 11.1% growth in 2013 and a further 2.5% increase in 2014. These forecasts are conditional on the stability of the economic and political situation across the Eurozone. In general, credit risk remains elevated but conditions are slowly improving.

1. The global macroeconomic environment

Weak growth as crisis fades

In our May Economic Outlook, we described the deterioration in the global economic environment, but pointed out that the consensus growth in the Eurozone was expected to resume in the second half of 2013. That was the light at the end of the tunnel - however faint - that we could offer our readers. Now, some six months later, we can report that this light has appeared – though still faint, earlier than expected. As the crisis faded, the Eurozone hesitantly came out of recession in the second quarter and this muted recovery is expected to last and strengthen throughout the rest of 2013 and 2014.

Meanwhile the US economy has progressed, to the extent that, in May, US Fed chairman Ben Bernanke announced that the expansionary monetary policy will have to end: the much discussed 'tapering'. That message - and we stress that it was only a message - created unrest in the financial markets and caused a wave of depreciation of emerging market currencies. Financial markets realised that the result of 'tapering', i.e. higher US interest rates, makes investments in emerging economies less attractive.

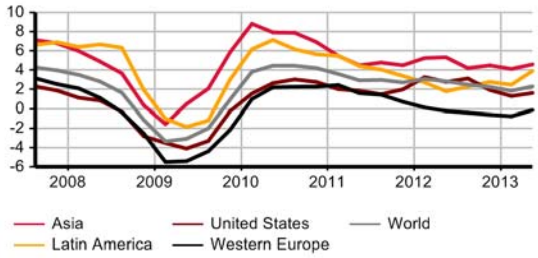
The upshot was lower capital flows and growth in the emerging economies. Compounded by slower growth in emerging economies, resulting from fundamental factors, and somewhat higher growth in advanced economies, we saw a lessening of the growth differentials in the world economy. While the result is an overall increase in global growth, that growth remains relatively muted.

Improving global growth

Global growth rates started to decline during the second half of 2011, after the escalation of the Eurozone crisis (see Chart 1.1), but the indications are that this slide has now bottomed out. While the global growth rate stood at 1.5% in the fourth quarter of 2012, it gradually climbed to 2.8% in the second quarter of 2013. This acceleration in growth was supported by the advanced economies: increasing to 0.8% and 1.1% in the first and second quarter of 2013 respectively. The Eurozone crisis has faded. Growth in emerging markets has improved only slightly, to 4.7% in the second quarter.

Chart 1.1 Real GDP growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

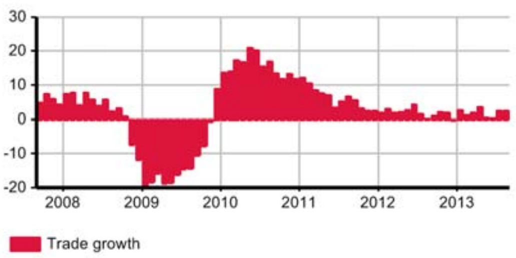
This development suggests that the growth gap between the advance economies and emerging markets is no longer widening. This is predominantly attributable to the Eurozone, where economic decline has finally halted: while the economy shrank in the last quarter of 2012, it bounced back to a neutral stance in the second quarter of 2013. And US growth continues to be positive: roughly unchanged since the fourth quarter of 2012, at 1.3%. Growth in Latin America increased from 2.3% in the fourth quarter of 2012 to 3.5% in the second quarter of 2013. Asia too is seeing higher growth rates, finishing the second quarter of 2013 at 5.2%.

Global trade growth remains muted

Meanwhile, global trade remains under pressure. It grew 1.9% in the first eight months of 2013, as it did for the whole of 2012 (see Chart 1.2). As a comparison, the five year average annual growth rate stands at 5.4%.

Chart 1.2 World trade growth

(Annual percentage change in global trade volumes)



Source: IHS Global Insight

The main factor underlying this muted trade growth is the subdued global economic growth. Protectionism is also thriving: in the twelve months to May 2013, 154 new restrictions were recorded. While the imposition of such restrictions is diminishing, the measures themselves are increasingly disruptive: such as those directly applied at the border in the form of import tariff hikes.[1] Moreover, the measures stick: almost none of the 700 trade restrictions introduced since the start of the crisis have been abolished. Developments in the banking sector have not helped either, with European banks in particular scaling back international lending and trade finance.

Slowing pace of fiscal consolidation

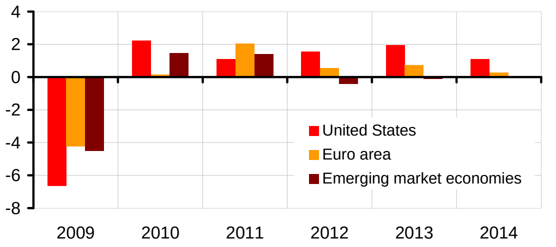
Our May Economic Outlook reported that fiscal policy was not expected to provide any relief for the global economy. In the aftermath of the 2008 crisis, 'fiscal consolidation' was the buzz phrase as the large stimulus that helped avert a global meltdown needed to be wound down to avoid unsustainable levels of government debt. Fiscal consolidation dominated the advanced economies until 2010, and even emerging markets did not shy away from it. This line of policy was expected to hold well into 2013 and 2014, but recent indications are that countries in the Eurozone have reduced their fiscal consolidation efforts.

The pace of fiscal consolidation has a negative impact on GDP growth. Indeed, looking at fiscal policy from this angle, the pace of fiscal consolidation declines and almost disappears, if not in 2013, then at least in 2014.

[1] Argentina, Brazil, Russia and Ukraine are the countries that have introduced the heaviest tariff increases. Brazil was singled out as it accounted for more than one third of the restrictions related to government procurement and shielding of domestic industries. See the EU Report on Potentially Trade-Restrictive Measures, European Commission, 2013.

Chart 1.3 Fiscal consolidation

(Change in budget balance as percent of GDP)



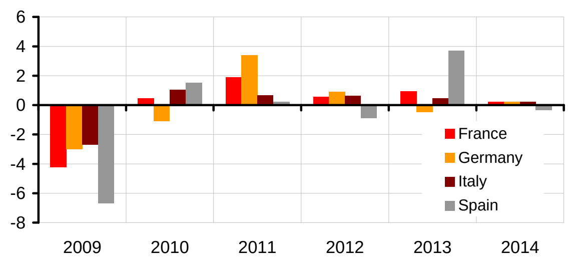
Source: IHS Global Insight

Firstly, the United States has been faced with the greatest task of consolidation. In the crisis year of 2009, its fiscal stimulus amounted to 6.7% (see Chart 1.3). In 2013 it averted the 'fiscal cliff', a series of automatic spending cuts and tax rises that would have resulted in a mild recession. But it still consolidated at 1.9% of GDP in 2013, after 1.1% and 1.6% in 2011 and 2012 respectively. In 2014 fiscal consolidation is projected to again be 1.1%: not inconsiderable but declining.

Secondly, the Eurozone provided less fiscal stimulus in 2009 - 4.2% - and undertook the bulk of its fiscal consolidation earlier, in 2011, at more than 2%. After that, its efforts at consolidation were reduced: 0.6% in 2012, 0.7% in 2013 and a projected 0.3% in 2014. These figures mask large differences between individual countries - in particular in 2013 (see Chart 1.4). This year, France is consolidating at 0.9%, Italy at 0.5% and Spain as much as 3.7% while Germany is providing a fiscal stimulus of 0.5%. In 2014 the declining trend in fiscal consolidation will culminate in an almost neutral stance of 0.2%, whilst Spain will inject a small stimulus.

Chart 1.4 Fiscal cosolidation, Eurozone

(Change in budget balance as percent of GDP)



Source: IHS Global Insight

Thirdly, the fiscal stimulus provided by emerging economies in 2009, at 4.5% of GDP, was slightly higher than the Eurozone, and has since been consolidated. In 2012 there was a move back to stimulus but that has faded to an almost neutral stance in 2013 and 2014. As with the Eurozone, there are large differences between emerging countries. In the case of the BRIC nations, while China and India are maintaining a neutral stance in 2013 and 2014, Brazil is consolidating at 1.5% in 2013 and 0.5% in 2014. Meanwhile, Russia is providing a fiscal stimulus of 0.9% in 2013 and 0.8% in 2014.

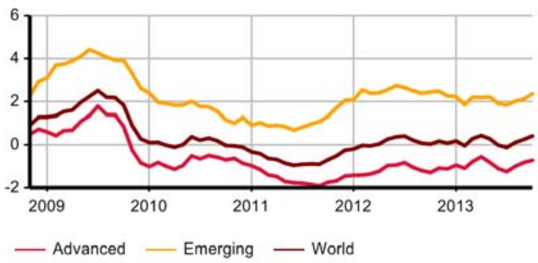
Overall, the dominance of fiscal consolidation is clearly fading, at least for 2014. That is good news for global growth, especially as it is inevitable that the policy instrument still in its most expansionary mode - i.e. monetary policy - will need to be reduced (or 'tapered') as well. Shadows of those events have already been cast ahead.

Tightening monetary policy ahead

Monetary authorities continue to pursue a very loose monetary policy: low interest rates and ample liquidity provision prevail. That has not changed since our last Economic Outlook. Low real interest rates hold for the advanced economies, where the rate is about 1%. In emerging economies the real rate is considerably higher, but at slightly above 2% is still accommodative (see Chart 1.5).

Chart 1.5 Real short-term interest rates

(Short-term rates adjusted for inflation, percentage points)

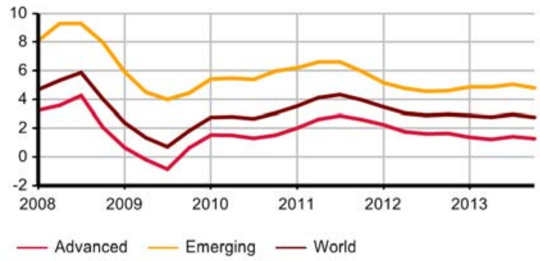


Source: IHS Global Insight

Inflation has not been an issue, at least not at the global level, at 2.7% in the first half of 2013. In advanced economies, inflation has been low, at 1.7%, and in emerging economies relatively modest at 4.5% (see Chart 1.6). In the more diverse group of emerging markets, however, differences are fairly large: e.g. Indonesia 8.4% and Russia 6.5%, while China remains at 1.4%.

Chart 1.6 Consumer price inflation

(Annual percentage change)

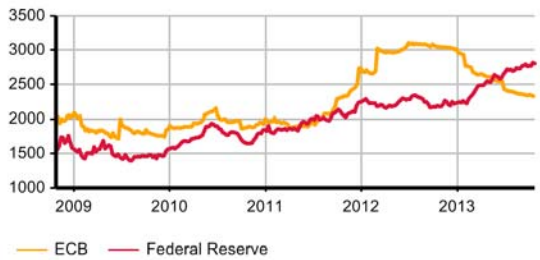


Source: IHS Global Insight

As to liquidity, central banks remain vigilant, providing ample liquidity to the banking system as demonstrated by the growth of their balance sheets (see Chart 1.7).

Chart 1.7 Balance sheet ECB and FED

(Billion of euro)



Source: IHS Global Insight; ECB, FED

The Fed is most expansionary with its use of asset purchases, seeking to reduce unemployment to 6.5%. Its most prominent programme is currently the so-called 'quantitative easing', or QE3, under which it purchases an amount of USD 85 billion in long term assets each month, and provides an equal amount of money to the economy. The ECB is arguably more accommodative, or perhaps reactive, as it seeks to provide liquidity to the banking system if and when needed.[2]

Under its Long Term Refinancing Operation (LTRO) of about EUR 1 trillion that gathered pace in early 2012, the ECB saw its balance sheet drained in late 2011. However, since the peak in 2012, around EUR 300 billion has been repaid, primarily by Spanish banks. The size of the Fed's balance sheet now

[2] Differences in approach which indeed could be attributed to the differences in mandate: the Fed having a bifocal mandate to look after price stability and economic growth, whereas the ECB has only price stability to anchor its actions.

exceeds that of the ECB, marking the difference in monetary policy approach. In that sense, the ECB, following the needs of the banking system, is already on a path towards a more normal monetary policy. At some point the Fed will have to follow, as analysts have long attempted to stress.[3]

A bout of financial market unrest

That message seemed to have fallen on deaf ears until 22 May this year. That was when the Fed announced its intention to start phasing out QE3 asset purchases and subsequently raise interest rates. This came to be known as 'tapering'. While no clear policy action was taken or even announced - this was simply a communication of an intention - the financial markets suddenly woke up to the realisation that the 'easy money' policy would not last forever. A substantial sell-off of US government securities followed, pushing up the 10 year bond yield by almost 1.3 percentage points from March to a peak of 3.0% in July (see Chart 1.8).

Chart 1.8 Long-term government bond yields

(10-year maturity, percentage points)

Source: IHS Global Insight

At the same time the two year yield rose from 0.3% to 0.5%, creating a sizeable difference from the Eurozone equivalent, the German bond yield (see Chart 1.9). Notably, the latter's yield also went up, especially in the two year segment, and spurred the ECB to make the unprecedented statement that it would keep interest rates at or below current levels for an extended period.

Chart 1.9 Short-term government bond yields

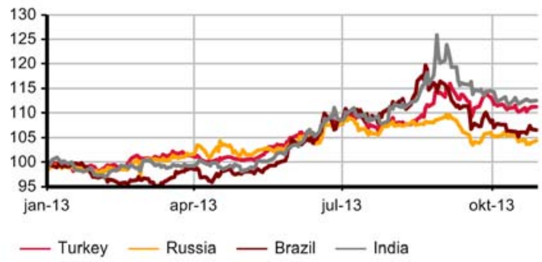
(2-year maturity, percentage points)

Source: IHS Global Insight

The impact was felt in the emerging economies as well, with the 10 year bond yields of Turkey (+3%points), Indonesia (+2.3%), India (+1%), Brazil (+0.8%) and Russia (+0.6%) rising remarkably. This confirms the pattern of a positive correlation between US and emerging market sovereign bonds that has developed since the 2008 crisis.[4]

Chart 1.10 Exchange rates against the USD

(Indexed cross-rates, 1 January 2013 = 100)



Source: IHS Global Insight

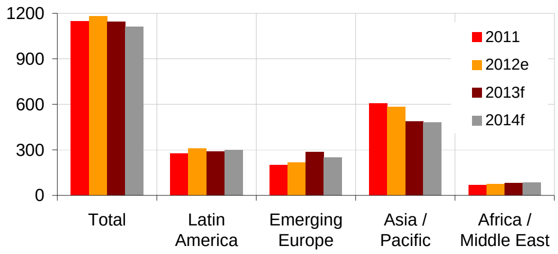
Foreign exchange markets were also impacted, although unevenly (see Chart 1.10). Since 22 May Brazil has seen its currency depreciate by more than 10% against the USD, and India by around 6%, similar to the Indonesian rupiah, while the Russian rouble has weathered events quite comfortably. The sell-off was also clearly visible in the reversal of capital flows to emerging economies. From May to August, USD 66 billion was withdrawn from the equity and bond markets, such that the expected capital flows to emerging economies in 2013 will be USD 30 billion lower than in 2012, at USD 1.1 trillion.[5] This trend is expected to continue in 2014 (see Chart 1.11).

[3] See for example IIF 2013, January Capital Flows to Emerging Markets.

[4] IIF Global Economic Monitor July/August 2013.

[5] IIF 2013, Capital Flows to Emerging Market Economies, June.

Chart 1.11 Capital flows to EMs
(In billion USD)



Source: IIF

The situation has caused Brazil (+1%), Indonesia (+0.75%) and India (+0.5%) to raise their central bank interest rates. Central bank interventions amounted to USD 80 billion: excluding China, that constitutes 2% of the total amount of the emerging markets' official reserves.

Meanwhile, the turmoil has largely settled down, with bond yields and exchange rates recovering, at least to some extent. However, the Fed still has yet to take the decision to start 'tapering' and that possibility looms over the market. Without clear guidance, uncertainty and volatility will prevail.

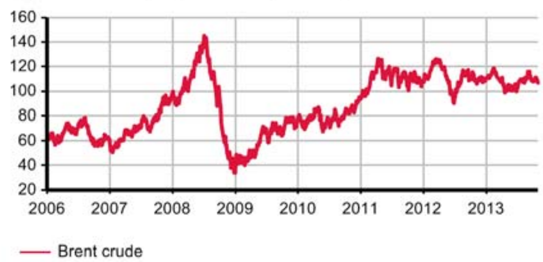
In perspective, the situation is not comparable to a real crisis, such as that of Asia in 1997-1998. Then, the IMF stepped in with a USD 40 billion programme to stabilise the Thai, Indonesian and South Korean economies. Now there is no currency peg, unlike in 1997-1998 when (Asian) currencies were mostly pegged to the USD. Countries will therefore let currencies depreciate and only stem large fluctuations through intervention. This policy is possible because, unlike in 1997-1998, there is no large scale currency mismatch in external borrowing.

Moreover, whereas in 1997-1998 countries could see the bottom of their foreign reserve chests, these are now fairly comfortable: the ratio of short term debt to foreign reserves for India (27%) and Indonesia (39%) are far below the danger zone of above 50%. Exceptional transparency issues with respect to foreign reserves, such as in Thailand in 1997-1998, are less likely to occur while the banking sector is subject to a higher level of supervision. In all, the emerging economies are in much better shape. The 2013 summer turmoil was not a crisis, and is not likely to become one.

Stable oil price developments

Since our May Outlook, oil prices have broadly remained within the band of USD 100 to USD 120 per barrel (see Chart 1.12). Previous speculation, that oil prices could increase to around USD 150 per barrel, has not materialised. Nevertheless, oil prices - and developments on the oil market more generally - warrant continuous monitoring and reporting.

Chart 1.12 Oil price
(Brent crude oil, spot price in USD per barrel)



Source: IHS Global Insight

The price of oil hit a low of USD 99 per barrel in April: just below the USD 100 per barrel that OPEC seems willing to defend.[6] After that, prices started to climb, reaching USD 117 in August, as a result of increasing political tensions about the Syrian conflict. In addition, other more fundamental factors dominate the current price: the supply disruptions in Libya and shortfalls in Nigeria and Iraq, which have reduced supply by around 1.7 million barrels per day. These factors have kept prices relatively high, even though what now seems a diplomatic solution to the threat of a military strike against Syria has relieved upward pressure on prices (estimated at USD 6-7 per barrel Brent).

Such relief is also being provided by the United States, where the continued surge in tight oil production raised output to 7.6 million barrels per day for the 10 months up to August 2013, compared to 6.9 million barrels per day in the same period in 2012. Saudi Arabia is reported to have increased its production to a 32 year high, living up to its status of 'swing producer'. Finally, relief came from the fact that demand has continued to remain weak as a result of lower economic activity. The

[6] That was signalled during their bi-annual Vienna meeting in May. This level is in line with our reasoning in the May Economic Outlook, referring to the level of government expenditure needed to dampen the impact of the Arab Spring.

largest consumers of oil, the United States and China, have muted and lower than expected growth figures respectively, whereas the Eurozone is only just reaching positive growth.

This weak demand, especially in the United States and the Eurozone, will gradually change over the remainder of 2013 and in 2014, although demand for oil is expected to increase only slightly. On the supply side, the United States is expected to continue to add to global supply through its tight oil production, whilst OPEC seems to be content to continue its output of 30 million barrels per day well into 2014. Supply increases in the United States will further alleviate upward pressure on the oil price.

The oil price (Brent) is therefore expected to continue fluctuating around USD 110 per barrel for the foreseeable future These fluctuations will most likely occur within the USD 100-USD 120 per barrel Brent band: anything below USD 100 is likely to trigger OPEC action. Our view on the long-term lower boundary of around USD 85-90 per barrel Brent remains intact: at that level tight oil production will no longer be economical.[7]

Outlook for economic growth improves

Our previous Outlook reported the downward adjustment of the 2013 forecast since early 2012. Until March 2013, growth expectations were adjusted downwards by 0.7 percentage points. The Eurozone was worst affected with a 1.3 percentage point downward adjustment. Since May 2013 another 0.2 percentage points have been shaved off from global growth, but notably without any Eurozone adjustment. This downward adjustment stemmed from Latin America (-0.7%), the United States (-0.5%) and Asia Pacific (-0.2%).

This time, as for the 2014 forecast, the situation is different. Firstly, the adjustment for global growth is only 0.1 percentage points from April until October: i.e. almost stable. Secondly, we have not seen any adjustment to Eurozone or US growth since April. The downward adjustments in the growth forecast are for Latin America (down 0.5 percentage points) and Asia Pacific (down 0.2 percentage points). This reflects the changing growth patterns in the global economy: the emerging markets are still leading the pack but the growth difference between advanced and emerging economies is shrinking – and that marks a real change.

Table 1.1 Real GDP growth - Major regions

	2010	2011	2012	2013f	2014f
Western Europe	1.9	1.5	-0.3	0.0	1.3
United States	3.0	1.8	2.8	1.6	2.6
Eurozone	1.8	1.5	-0.6	-0.3	0.9
Asia Pacific	7.1	4.6	4.8	4.6	4.7
Latin America	6.3	4.2	2.8	2.6	3.1
Total	4.3	3.1	2.7	2.4	3.1

Source: Consensus Forecasts (October 2013)

Growth forecasts for 2014 are therefore comparable to those reported in May. They reflect a higher, though still relatively muted, level of global economic activity. The Eurozone is expected to return to growth of 0.9% while the United States can anticipate 2.7% growth as the recovery gathers pace after the drag of the 'fiscal cliff' is phased out (see Table 1.1). Those were precisely the figures we reported in May as faint rays of light. Those rays are now less faint, especially for the Eurozone, where the bottoming out of the recession, forecast for the second half of the year, has already manifested itself.

However, for the emerging economies growth forecasts are lower: 4.7% for Asia Pacic and 3.3% for Latin America. This reflects the expected impact of the 'tapering' on the emerging economies mentioned earlier - in particular lower capital flows. Moreover, it has become increasingly clear that it may not be possible for emerging economies like China and India to maintain their growth figures of recent years. That will be discussed in more detail in Chapter 3.

Higher global economic activity acts as a spur to a growth in trade. The WTO expects global trade to grow 4.5% in 2014, up from 2.5% in 2013, although this is markedly lower than the past five-year annual average. Ongoing issues with protectionism, already alluded to, constrain trade growth and subsequently global growth of economic activity.

Risks to the outlook

This leaves us with the risks, and in particular the downside risks, that we see in relation to the forecast. The first candidate is the one that we have repeatedly discussed in previous Economic

[7] For a more detailed discussion see Atradius Oil Market Outlook April 2013.

Outlooks: a Eurozone crisis re-escalation. The Eurozone is now finally showing some signs of more robust development. 'Robust' in the sense that financial calmness continues to reign as a result of the ECB's assurance that it will not let the Eurozone break down and the progress that is being made - admittedly with the usual political struggles - towards a European banking union. With the economy finally improving, the risk of a Eurozone break-up (which we never actually believed would happen) is fading. Still, there are too many issues - such as the Italian political situation, the weak banking system and the agreement on the Single Resolution Mechanism - to be complacent and completely discard the risk of re-escalation.

The second candidate is that of a significant slowdown in emerging economies. We can see, in a mild form, the impact that this would have, in the current growth figures, which are being revised downwards. The current slowdown is arguably attributable to the 'tapering' of the Fed's expansionary monetary policy, due to start shortly.

But would this lead to a crisis, like the one in the early years of the millennium? Most likely not: emerging economies are now much better equipped to face such events as we have argued above.

The third risk to the global economic outlook comes from the US's economic policy. The political fight over the yearly fiscal budget and the uplift of the debt ceiling have already undermined economic growth. With the postponement of deadlines to the beginning of 2014 there is a serious risk of a re-escalation of the gridlock. Although the chances of the Republicans and Democrats failing to reach any agreement are small, the impact would be dramatic for the US and for the global economy.

These risk factors are all outside our main scenario. In the forecast period we see smaller downside risks to our forecasts than in earlier periods. This view is also held by the IMF, as published in its October World Economic Outlook. Given the calmness that now reigns, expectations of economic activity in 2014 should remain relatively stable.

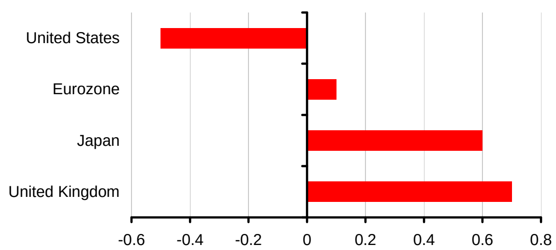
2. Prospects and risks in advanced economies

Improving outlook in advanced economies

Economic conditions have stabilised across advanced markets and are expected to improve further in 2014. The stabilisation marks an end to the strong negative momentum in economic conditions over the past two years and paves the way for a solid, if slow, recovery.

Economic growth in 2013 remains muted. The Eurozone is expected to contract 0.4% over the year, but this is less than the contraction anticipated six months ago. The 2013 growth forecast has been adjusted upwards by 0.1% over the period (see Chart 2.1). The outlook for the UK has also improved, with the economy now forecast to grow 1.3%, compared to just 0.7% expected back in May. In contrast, the US is expected to grow 1.6% this year, down from an earlier forecast of 2.1%.

Chart 2.1 Change in 2013 forecast
(Percentage point change between Apr. and Oct. 2013)



Source: Consensus Economics

The outlook for growth in 2014 has hardly changed from the projections reported in our May Outlook, but this is positive news. In 2011 and 2012, forecasts for growth in the ensuing year were revised steeply downwards during the year as a result of deteriorating conditions. This year, conditions are stable and the long predicted recovery seems to be taking hold this time. The Eurozone is forecast to grow 0.9% in 2014 (see Table 2.1). The UK is expected to expand 2.1% and the US 2.7%.

Table 2.1 Real GDP growth - Major markets

	2010	2011	2012	2013f	2014f
Eurozone	1.9	1.5	-0.6	-0.3	0.9
United States	2.4	1.8	2.8	1.6	2.6
United Kingdom	1.8	1.0	0.1	1.4	2.2
Japan	4.7	-0.5	2.0	1.9	1.7

Source: Consensus Forecasts (October 2013)

However, there is still considerable uncertainty surrounding these projections. In the Eurozone the crisis has remained quiet over the past six months, but the fundamental vulnerabilities remain in place. In the US the fear of a fiscal cliff, or fiscal sequestration, proved unfounded, but new fears over the impact of a change in monetary policy and debt ceiling negotiations have taken hold.

Eurozone: the end of a long recession

The Eurozone has climbed out of recession and is looking forward to modest economic growth. That should further ease the pressure on individual countries and push the euro crisis into the background. But fundamental vulnerabilities remain, such as a weak banking sector, slow progress towards EU integration, and some programme countries possibly needing further financial assistance.

The outlook for the Eurozone has improved over the past six months. The official recession in the Eurozone ended in the second quarter of 2013 when the economy expanded by 0.3%, putting an end to six consecutive quarters of economic contraction. The return to growth appears to be solid with most indicators pointing to further growth in the third quarter. For the full year the economy is expected to contract 0.4%.

The outlook for next year is, however, positive, with the economy forecast to grow 0.9%. The current forecast is slightly lower than the 1.1% growth forecast of six months ago, but clearly marks a turn in the cycle. Nevertheless, the rate of growth is well below the pre-crisis average of 2.2%.

The aggregate also hides larges differences between Eurozone members.

Bottoming out

In general, the bottom may have been reached in the second quarter, but the rate of growth in 2013 is very diverse. The strongest performers are Austria and Germany (see Table 2.2): Austria is forecast to grow 0.4% and Germany can also look forward to a modest expansion of 0.5% due to its positive labour market dynamics, solid government finances and strong export sector. These countries can also look forward to modest economic expansion in 2014.

Table 2.2: Real GDP growth - Major markets

	2010	2011	2012	2013f	2014f
Austria	1.8	2.8	0.9	0.4	1.6
Belgium	2.4	1.9	-0.3	0.0	0.9
France	1.4	1.7	0.0	0.1	0.8
Germany	3.6	3.0	0.7	0.5	1.7
Greece	-4.9	-7.1	-6.4	-4.0	-0.6
Ireland	-1.1	2.2	0.2	0.0	1.9
Italy	1.4	0.6	-2.6	-1.7	0.5
Netherlands	1.6	1.1	-1.3	-1.2	0.4
Portugal	1.9	-1.3	-3.2	-1.9	0.1
Spain	-0.1	0.4	-1.6	-1.3	0.5
Eurozone	1.9	1.5	-0.6	-0.3	0.9

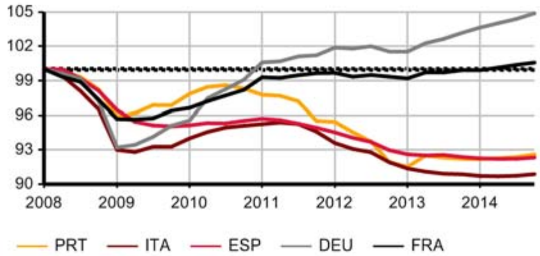
Source: Consensus Forecasts October 2013

Other markets have contracted sharply in 2013. The Greek economy is expected to lose another 4.0% on top of the more than 20% contraction in earlier years. Its economy is heavily impacted by the government policies. Spain, Italy and Portugal are also forecast to contract markedly, as is the Netherlands where the weak housing market comes on top of the government's austerity measures. Although these markets will also see growth in 2014, the level of growth will be very low, or may even threaten a further modest contraction.

The diverging growth in 2013 and outlook for 2014 further exacerbate the differences in output that have been apparent since 2008. The German economy quickly regained what had been lost during the crisis, and by 2011 the size of its economy had surpassed its 2008 peak (see Chart 2.2). For most other Eurozone members, it will be years before their economies return to pre-crisis peaks. Indeed, some are looking at a lost decade. At the end of 2013 the Italian economy will be almost 10% smaller than it was six years ago. Add to this its poor 2014 growth outlook and it is unlikely that the Italian economy will regain its pre-crisis level before 2018. The same is true for Portugal, while Greece is even further away from its peak: as much as 20% smaller than in 2008.

Chart 2.2 Real GDP, Eurozone

(Level index, 2008Q1 = 100: forecast for 2013)



Sources: IHS Global Insight; OECD

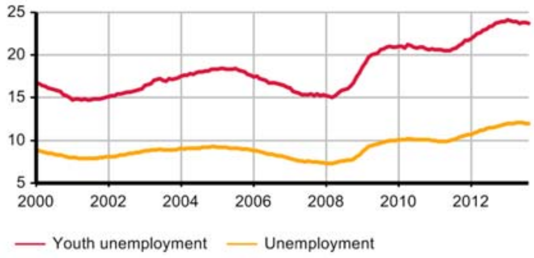
Unemployment may have peaked

The level of unemployment in the Eurozone has increased sharply since the second half of 2011, but may finally be recovering. It increased rapidly during the financial crisis: from 7.3% at the beginning of 2008 to more than 10% in 2010. In 2011 the economy deteriorated again and unemployment increased further. The rate of unemployment stood at 12.0% in August 2013, and had been more or less stable at that level over the previous six months. If economic growth picks up in the second half of 2013 and improves further in 2014, the unemployment rate should soon begin to fall.

The stabilising conditions in the labour market are not only visible in countries that show economic growth, but also in, for example, Spain and Portugal. Unemployment fell in Spain from 26.5% in April to 26.2% in August. This is a small, but notable, improvement and marks a clear deviation from trend. Unemployment dropped even further in Portugal, from 17.0% in May to 16.5% in August.

Chart 2.3 Unemployment, Eurozone

(standardised, seasonally adjusted, percentage)



Source: IHS Global Insight

Youth unemployment has increased considerably over recent years but also shows signs of improvement (see Chart 2.3). Overall in the Eurozone, youth unemployment increased from 15% in 2008 to 23.7% in August 2013; however this hides stark differences between countries.

In Spain youth unemployment is above 50% and in Italy around 40%. The fast rise was a concern for politicians, as unemployment early in a career reduces income for the rest of one's working life. In July, EU politicians therefore agreed to create a EUR 8 billion fund for employment creation and training. But this is too little to make a real change: the only thing that really helps is an expansion of economic activity.

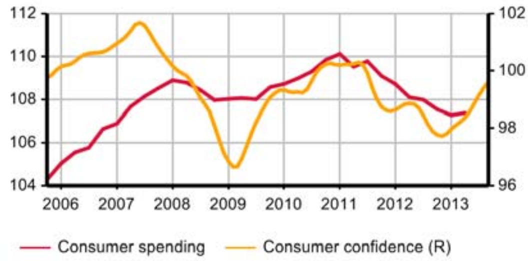
Consumers regain confidence

Consumer confidence has improved substantially since November 2012, as fears of a euro break-up have abated. This confidence was boosted further in the first six months of 2013, but remains below its long-term average (see Chart 2.4).

Consumer spending has also begun to improve. The quarterly increase in the second quarter of this year was the first increase since the beginning of 2011. Consumer spending contributed 0.1% to economic growth in the second quarter. The improvements in the labour market and maintained financial stability should further spur consumption – and this should also benefit businesses.

Chart 2.4 Consumption and confidence

(Confidence index 100 = neutral; Spending index jan 2003 = 100)



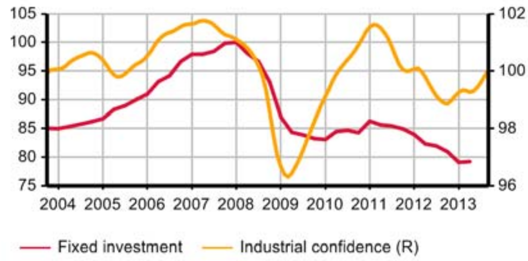
Source: IHS Global Insight; Eurostat

Businesses dare to invest again

Similarly, industrial confidence has improved greatly since the end of 2012 (see Chart 2.5) and is currently close to its long-term, neutral, level. In line with this improving confidence, investment by firms has also increased: investment has been contracting since the beginning of 2011 but saw a small rise for the first time in the second quarter of 2013. The improvement is expected to continue for the rest of this year and in 2014.

Chart 2.5 Investment and confidence

(Confidence index 100 = neutral; Investment index jan 2003 = 100)



Source: IHS Global Insight

This is confirmed by the purchasing managers' index compiled by Markit. The September reading of the Eurozone total index was the highest in 27 months and clearly signals an expansion of economic activity. The positive momentum also suggests an even brighter outlook for the fourth quarter of this year, with visible improvements in both the manufacturing and services sectors. Indeed, there are positive signs in all major economies. Italy and France may see an expansion of activity in the third quarter, while Spain can expect further contraction albeit at a much lower rate than in the first quarter of 2013.

Retail trade in particular has recovered since the beginning of 2013, with real turnover in the sector increasing almost 2.0% between January and August. Recent data shows strong growth in Spain and Portugal. The construction sector has also regained some of its lost ground over the past few months. Production in the sector rose 0.6% between January and August, driven partly by the booming construction sector in Germany, where house prices are rising fast.

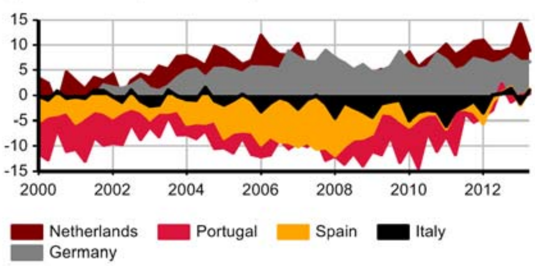
Industrial production, on the other hand, has lost in July what it had gained in the months before. The level of industrial production has now returned to its November 2012 level, when it reached its lowest point since 2010. The drop is visible in almost all countries, including Germany.

Rebalancing Eurozone trade patterns

One of the underlying problems in the Eurozone has been the divergence in international competitiveness between Northern and Southern member states. However, since 2010 there has been a clear improvement in the competitiveness of most countries, owing to government reforms and lower wages. This has translated into improving current account balances which for Portugal, Spain and Italy turned positive at the end of 2012 and have continued to be so in 2013 (see Chart 2.6) - in stark contrast to these countries' huge current account deficits of previous years.

Chart 2.6 Current account balances

(Current account, percent of GDP)



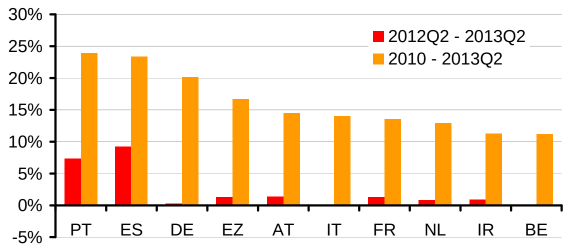
Source: IHS Global Insight

The improvement has not come at a cost to Northern competitiveness. In fact the Dutch and German current account surpluses have remained largely unchanged over the past year. This is the result of stronger exports to countries outside of the Eurozone. For Germany, China has grown hugely in importance as an export market, and the German current account with China has turned positive in 2013. Overall, the Eurozone current account surplus with the rest of the world has increased to EUR 52 billion in the second quarter of 2013, compared to EUR 18 billion in the same period of 2012.

The improvement in the current account balance can't be attributed just to lower imports by Southern European countries but is the result of genuine export growth. Portugal and Spain have seen the largest increase in exports over the past three and a half years, rising by 23.9% and 23.3% respectively (see Chart 2.7). In the past year alone, Portuguese exports have grown by 7% and Spanish exports by 9%, demonstrating a fundamental improvement in the international competitiveness of the Eurozone periphery.

Chart 2.7 Export growth

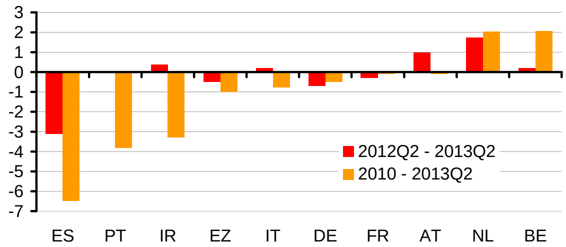
(Change in real export volumes)



Source: Eurostat

The underlying cause of the improvement is lower wages. More specifically, the unit labour cost - the cost to produce a specific amount of output - has dropped significantly in all Southern European countries. Spain and Portugal again show the largest improvement over the past three and a half years, but Ireland and even Italy show progress (see Chart 2.8). Conversely, unit labour costs have risen in the Netherlands and Belgium, while they have improved marginally in Germany. Improvements in Southern European countries - current account, export growth and unit labour costs - suggest that the changes are structural and will significantly improve their stability within the Eurozone.

Chart 2.8 Change in Unit Labour Costs
(Percentage change in level index)

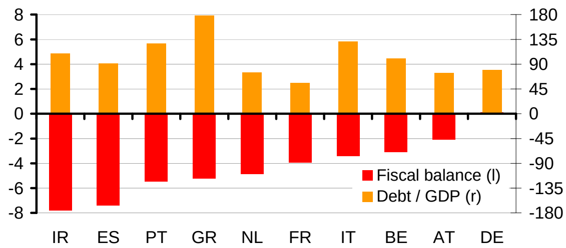


Source: Eurostat

Fiscal consolidation slows

Efforts continue across the Eurozone to improve the fiscal position of governments and stop the increase in public debt. The Southern European countries and Ireland have seen the largest increase in public debt levels and budget deficits as a result of the fallout of the 2009 financial crisis. Tax income fell, welfare costs increased and bank bailouts financed by the government weighed heavily on public finances. Improvements have been made over the past few years by governments to cut spending and boost taxes, but weak economic growth has made it very difficult for countries to reach their deficit targets. The European Commission has therefore eased considerably its demands for deficit reduction, and instead now focuses more on the structural deficit.

Chart 2.9 Fiscal balance and debt 2013
(Percent of GDP)



Source: IHS Global Insight

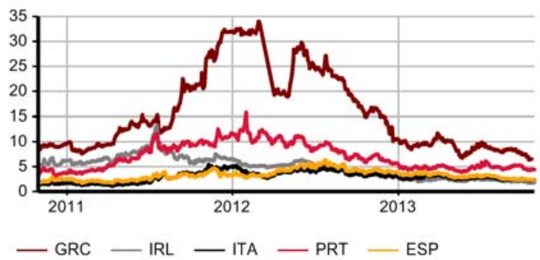
Despite major efforts by some countries, the fiscal position of their governments remains poor. Both Ireland and Spain are expected to have a budget deficit in excess of 7% in 2013 (see Chart 2.9) while Portugal, Greece and the Netherlands also face substantial deficits. This of course pushes up public debt levels. Greece, Italy, Portugal, Ireland and Belgium all carry debt larger than 100% of GDP. This undermines their long run fiscal sustainability and could lead to a loss of confidence by international investors. Currently the situation is calm and the return of positive economic growth in 2014 should make it easier for countries to improve their fiscal position and reduce their debt levels. Portugal and Greece may, however, need additional financial support from the EU before they can return to the financial markets for their funding.

Sovereign bond market stability

Financial markets have been relatively calm over the past six months, boosting consumer and business confidence. The previous Economic Outlook reported that the commitment by ECB president Draghi in August 2012 'To do whatever it takes' to keep the Eurozone together has effectively eliminated, or at least significantly reduced, the risk of a Eurozone break-up. Consequently, spreads of 10 year government bonds, particularly those of peripheral countries, against the German bund have narrowed (see Chart 2.10).

Chart 2.10 Bond spreads within the Eurozone

(10-year bond yields over the German bund, percentage points)



Source: IHS Global Insight

To be more precise, since the beginning of the year Spain (-1 percentage point), Italy (-0.6), Ireland (-0.6), Portugal (-1) and Greece (-3.5) have seen their yield difference from the Eurozone benchmark bond decline. This situation is mirrored in an increase, although minor, in the yield difference for the core Eurozone countries, arguably reflecting a healthy correction of the previous crisis situation, when investors fled to core countries. The increase ranges from Belgium (+0.1 percentage points) to the Netherlands (+0.6) - both small but noticeable.

The yield differences within the core show some impact from the turmoil as a result of the Fed's 'tapering' announcement of 22 May. It is unclear to what extend a tighter US monetary policy will impact the Eurozone. Higher interest rates on government bonds may also push up interest rates in the Eurozone. This may force the ECB to offset these increases by easing its monetary policy. It is for now unclear how this will play out.

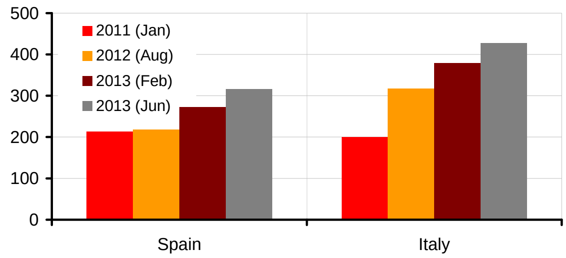
The financial system remains fragile

Despite the improvement in economic conditions, fundamental problems in the banking sector have not improved. The policy measures so far taken by the EU are only a first step in the right direction (see Box 1).

The biggest problem is the financial fragmentation of the banking sector within the Eurozone. This means that banks do not lend to other foreign banks and that a bank's credit worthiness depends on the country in which it is based. This fragmentation is caused by the negative feedback loop between the sovereign and the bank. For example, Spanish and Italian sovereign bond holdings have increased greatly. Spanish banks have taken up more than EUR 100 billion since January 2011; Italian banks more than EUR 200 billion (see Chart 2.11).

And here the sovereign/bank feedback loop comes into the picture: a confidence problem for either of them may trigger a vicious circle of threatened default. This circle can only be broken by mutual Eurozone rescue action, as in the case of Cyprus last spring. With the Banking Union in place, and in particular the ESM lending directly to banks, this loop can be averted: a failed bank would not create a problem for the government and the vicious circle would not be put in motion.

Chart 2.11 Sovereign bond holdings
(Spanish and Italian banks, EUR billion)



Source: BIS

Financial fragmentation hardly reduced

The financial sector in the Eurozone remains fragmented, as is evident from the still significant ECB borrowing by Spanish and Italian banks, needed because other banks will not lend to them. Another sign of this fragmentation is the need for peripheral banks to purchase bonds from their sovereigns as other investors in the Eurozone are apparently shunning these assets.

Box 1: Policy progress

Some progress has been made on the policy front. In our May Economic Outlook we argued that breaking the negative feedback loop between banks and sovereigns in the Eurozone is critical to resolving the crisis and preventing new crises with similar characteristics. With that in mind, two important factors would be the creation of a European Banking Union and the ability of the European Stability Mechanism (ESM) to provide help such as capital injections to ailing banks. In the case of the Banking Union, the European Commission has come up with a proposal for the Single Resolution Mechanism (SRM). Addressing the moral hazard issue in banking, it entails a mechanism to bail-in investors, except insured depositors, as a means of recapitalising banks. If their contribution to recapitalising a bank in a member state - capped to 8% of total liabilities - is insufficient, national banks in the member state should contribute, up to 5%. Only if that 13% is insufficient will tax payers come into the equation, via the ESM, for a maximum amount of EUR 60 billion.

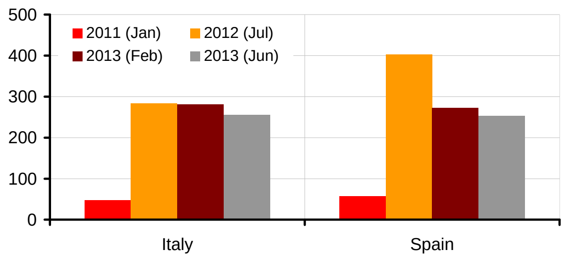
This part of the SRM has been agreed by EU members, but decisions still need to be made as to the creation of a single resolution body, which touches on member states sovereignty, and legal issues.

Meanwhile progress is being made towards the Single Supervisory Mechanism (SSM), for which the European Parliament has now given its vote. The ECB has accepted the role of supervisor of around 130 banks, totalling 80-85% of the Eurozone banks' total assets and will start conducting tests of those banks' robustness in early 2014: the so-called 'Asset Quality Reviews' (AQR). The overall picture is that progress, albeit slow, has been made with the European Banking Union. However, to get the first two stages of the Banking Union - the SSM and SRM - up and running sometime in 2014, the pace of decision making needs to quicken. Moreover, discussions have yet to begin on the third stage of the Banking Union: a Single Depository System.

Before the sovereign debt crisis escalated in mid-2011, Spanish and Italian banks borrowed limited amounts from the ECB: a situation that drastically changed when interbank funding dried up during the autumn of that year. The ECB's late 2011 LTRO programme provided relief, and Spanish and Italian ECB borrowing shot up to more than EUR 400 billion and EUR 280 billion respectively. This is now gradually being paid down, at least by Spanish banks that have repaid EUR 150 billion since July 2012. Italian banks, however, have hardly reduced their reliance on ECB funding (see Chart 2.12).

This lower, but still significant, ECB funding need of Spanish and Italian banks shows that there is still a lack of confidence. In normal times the Eurozone banking system itself would provide such funding through interbank lending.

Chart 2.12 ECB funding, Italy and Spain
(Bank funding, EUR billion)



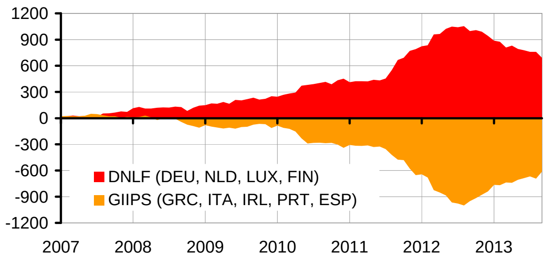
Source: ECB

And that phenomenon remains important, although the positive developments that we signalled in our May Economic Outlook have strengthened. To substantiate this, we again look at two indicators.

Firstly, we consider the so called 'Target2' balances in the Eurozone. As we mentioned in May's Outlook, those imbalances largely reflect the lack of (inter)bank funding and can therefore arguably be seen as a measure for financial fragmentation.

Whereas in January 2013 the aggregate claim from central banks from the Netherlands, Finland, Germany, and Luxembourg stood at EUR 888 billion (mirrored by a liability from those from Spain, Portugal, Italy, Greece and Ireland), by the end of August the figure had further receded, to EUR 693 billion (see Chart 2.13). This means that fragmentation, as measured in this manner, has been reduced by 35% since its peak in August 2012.

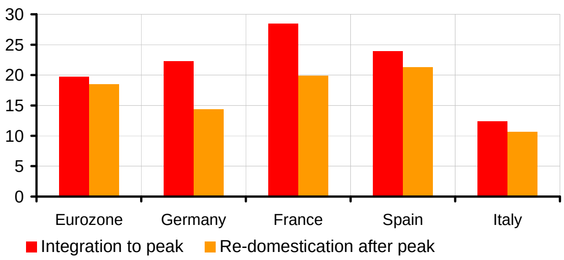
Chart 2.13 Net balance with Eurosystem
(In EUR billion)



Source: Euro Crisis Monitor

Secondly, we can consider the level of bank holdings of cross border bonds, issued by companies and governments. Banks started this process at the inception of the Eurozone with bond holdings peaking somewhere before 2008. At that time, the level of cross border holdings of banks had increased by 19.7% for the Eurozone as a whole, with France at the top with a 28.5% increase. That gain in financial integration has now all but evaporated: in the Eurozone the figure has reduced by 18.5%, leaving just 1.2% (see Chart 2.14). France and Germany have contributed to the reduction, although at a below average level, while Spain and Italy seem to have reversed almost all earlier integration steps. The reversal process, however, has now stopped, at least for the Eurozone as a whole.

Chart 2.14 Change in foreign holdings
(Eurozone banks, percent)



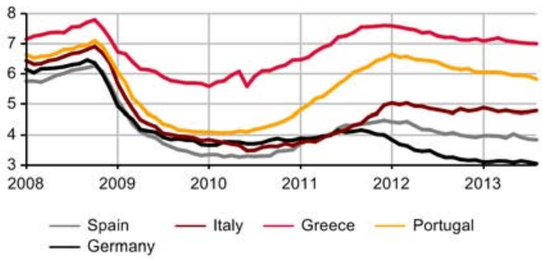
Source: Financial Times

Credit conditions tighten further

Financial fragmentation is reflected in different lending rates across the Eurozone. Indeed, short-term loans to corporate clients in Spain and Italy cost 1% and 1.5% more than in Germany, while such difference was far smaller before the escalation of the Eurozone crisis in 2011 (see Chart 2.15).

Chart 2.15 Interest rates on corporate loans

(Loans of up to 1 year)



Source: IHS Global Insight

The weakness of the banking sector is also reflected in lending growth figures. These are still in negative territory in the Eurozone: for non-financial corporations in June down 3.7% compared to June 2012. This is in sharp contrast to the US, where lending continues to expand, although the pace seems to have abated somewhat. This is both a demand and supply problem. Bank lending surveys by the ECB and the Fed clearly show that lending conditions have continued to tighten in the Eurozone in 2013, while the US has seen an easing of conditions beginning in 2010 (see Chart 2.16). The rate of tightening has, however, slowed in the Eurozone and is close to balance.

Chart 2.16 Conditions for loan supply

(Net percentage balance of tightening versus easing conditions)

Source: IHS Global Insight; ECB, FED

Two issues are of particular note in this bleak picture. Firstly, anecdotal evidence suggests that corporations are increasingly seeking funding outside the banking sector. Secondly, lending usually lags behind economic activity by two to three months as firms seek to finance their initial investments from cash flows. As economic conditions improve, banks may ease their lending conditions as they can anticipate a lower risk of non-repayment of loans. Yet such growth will be limited as long as financial fragmentation dominates the Eurozone.

All in all, there is no cause for complacency regarding the banking sector. Financial fragmentation, though reduced, is still significant. The European Banking Union that should further help reduce this is on its way but a number of agreements still need to be struck. Before that, the banking sector will continue to slow economic recovery in the Eurozone.

United States: political challenges

Economic growth in the US continues to improve, but the recovery remains weak. Consumer spending, business investment and exports are driving the recovery. But political deadlock is not helping to bring stability and reduce the long term fiscal problems. Meanwhile, the Fed is trying to find a balance between monetary easing and tightening.

The US economy grew by an annualised 2.5% in the second quarter of 2013, up from 1.1% in the first quarter. Overall the economy is forecast to expand 1.6% in 2013 and see further growth of 2.7% in 2014.

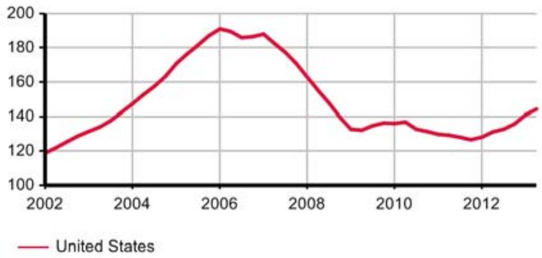
Consumers remain positive

The improvement in consumer confidence noted in our previous Economic Outlook has continued. It increased strongly in the first six months of 2013 before stabilising. The September figure was still slightly below the long-term average, or neutral, confidence level. Thus there is room for further improvement in consumer confidence.

Consumer wealth has been boosted by increasing house prices. The collapse in house prices was one of the causes, if not *the* cause, of the 2008 financial crisis. Prices dropped for three years in a row before stabilising in 2009 (see Chart 2.17). The recovery in prices did not start until 2012, but has now taken hold. House sales benefit from the still low prices in many areas as well as low mortgage rates. Mortgage rates rose at the end of the summer by about 100 basis points as a result of anticipation of a change in monetary policy, but the rate is still low historically.

Chart 2.17 House prices

(Case-Shiller index, 2000=100)



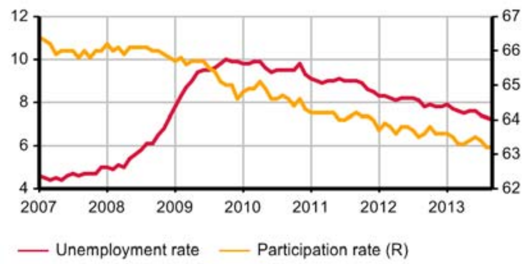
Source: IHS Global Insight; Case-Shiller

Households have continued to improve their finances, with consumers reducing their debt and improving their debt-to-income ratio over the past year. Net wealth is also much better, thanks to both lower debt and higher asset values, such as housing and the stock market. This provides a solid foundation for further improvements in consumer spending, which already increased 1.1% in the first five months of 2013.

The labour market shows more cause for concern. The unemployment rate increased from around 5% before the financial crisis to 10% in 2010. Since then it has slowly but steadily moved downwards, reaching 7.6% in September 2013. More worrying is that the drop is caused by people leaving the labour market, instead of a growth in the number of jobs. The share of the potential work force that has a job - the participation rate - has actually decreased (see chart 2.18). The labour market therefore remains a fundamental weakness in the recovery of consumer confidence and spending.

Chart 2.18 Unemployment and participation

(Percentage points)



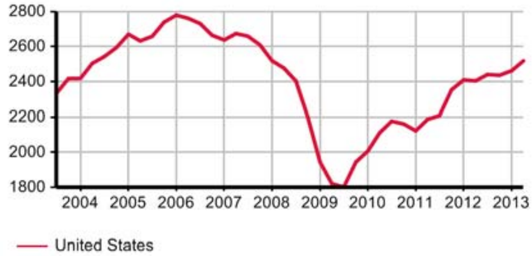
Source: IHS Global Insight

Business investment increases

Industrial confidence improved markedly between April and September 2013. In June the index exceeded the 100 points line, indicating that businesses are more optimistic than the long-term historical average. This optimism is accompanied by higher levels of investment which saw a 1.1% increase in the first quarter of this year and a 2.3% increase in the second quarter (see Chart 2.19).

Chart 2.19 Domestic investment

(Real gross domestic investment in billion USD)



Source: IHS Global Insight

The Markit purchasing managers' indices also point to continued expansion in activity. The manufacturing index reached 52.8 points in September, signalling improving business conditions. But the rate of improvement is slightly lower than in August and July. New orders increased, but at a modest rate. Partly as a result of weaker export demand. Production levels have increased in response to the rise in new orders. The strongest increase in output was seen in the manufacture of consumer goods. Overall the figures point to a stable if modest expansion.

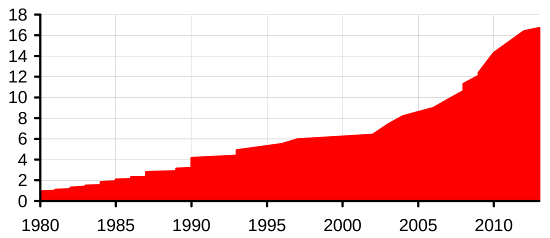
Political deadlock

The risks to the economic recovery still stem from politics. Bickering between Republicans and Democrats over government policy and the fiscal budget has hurt confidence and economic growth.

The latest clash between Republicans and Democrats led to a temporary shutdown of the government. The fiscal year ended on 30 September, with no agreement reached on the fiscal budget for the following year. As a result, about 800,000 non-essential government personnel were sent home and government agencies were closed. Everything from national parks to the space agency NASA was shut down – for the first time since 1996, under Bill Clinton. The debacle may have cut economic growth in the fourth quarter by between 0.2% and 0.5% but this is expected to be redressed by higher growth in the first quarter of 2014.

The shutdown ended on 17 October when a new budget was agreed in the face of the much more severe breaching of the debt-ceiling. On that date, the US government had reached the maximum amount it could borrow. Without raising the ceiling the government would have been forced to live within its means. That ceiling has been raised 47 times since 1980 (see Chart 2.20) but, since the government was in October running a budget deficit of around 3.5% of GDP, it would have been unable to pay all its bills - or worse, unable to fulfil its debt obligations. The former would have led to a deep recession, while the latter would constitute an official default by the government. The final agreement increased the debt ceiling to 7 February and the provided funding for the government until 15 January. This means that the political turmoil and resulting uncertainty may start all over again at the beginning of 2014.

Chart 2.20 US Debt ceiling
(USD trillion)



Source: The White House

The deadlock was caused by the Republicans trying to derail the implementation of 'Obamacare'. Part of the Obamacare programme would have started on the 1 October but the Republicans demanded that it be delayed by a year in return for a debt ceiling increase and the approval of the fiscal budget. The health insurance reform is, however, one of the biggest achievements of the Obama period and the Democrats were unwilling to give in to the Republican demands. In addition to Obamacare, the parties also had to agree on the level of tax and spending.

The government will continue to cut spending. As discussed in the previous Economic Outlook, the government narrowly avoided the 'fiscal cliff' at the beginning of 2013 and in a last-minute deal agreed on a sequestration of automatic spending cuts over a number of years. This led to a strong fiscal consolidation in 2013, but spending will be cut further in 2014 and beyond. The government deficit dropped from 7.0% in 2012 to 3.5% in 2013. The reductions are not targeted but are applied across the board, which reduces economic activity more than necessary. The spending cuts may have reduced economic growth by almost 1% in 2013 and will also weigh on growth in 2014.

Towards tighter monetary policy

The US's monetary policy stance is expected to change. The Fed currently buys USD 85 billion bonds per month in order to reduce interest rates. In May 2013 the Fed indicated for the first time that it was planning a reduction in bond buying. In June chairman Ben Bernanke further clarified the stance by announcing that the Fed would indeed start to 'taper' its programme if the economy continued to perform reasonably. Bernanke expected the programme to end completely by mid-2014. Most analysts expected the Fed to make a first move in September, but that was delayed as a result of the hike in interest rates in anticipation of the policy change and the uncertainty over fiscal policy.

Given the uncertainty caused by the debt ceiling and fiscal negotiations, most analysts now expect that the tapering will remain on hold until the end of 2013, or even later. In addition, Janet Yellen, currently vice-chairperson of the Fed, will replace Bernanke in January 2014. She is generally seen as experienced and is expected to bring stability. The new chairperson is also perceived as relatively 'dovish', which means that she will be very cautious about reducing the current monetary stimulus.

The US economy looks set for moderate economic growth, based on improving consumer and business conditions, but is held back by political uncertainty and fiscal consolidation. The weak growth makes the recovery vulnerable to setbacks. Improving the government fiscal position in times of recovery is actually a lot less damaging to the economy than doing so in times of recession, as many countries in the Eurozone have done. It is mostly the way in which US politicians have agreed on and designed the consolidation that deserves the strongest criticism. The long-term fiscal outlook is also still poor as a result of a large expected increase in government spending via the Medicare and Medicaid programmes. As we've already noted, the debt ceiling has been raised, but this will only provide temporary relief. The ceiling will be reached again at the beginning of 2014 and politicians will once again need to come to an agreement.

United Kingdom: A bright spot

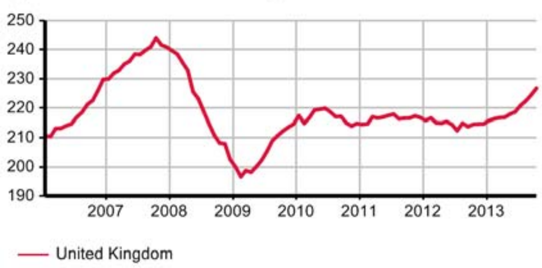
The UK economy is performing relatively well and growth forecasts for 2013 have been revised upwards since our previous Economic Outlook. The economy is expected to expand 1.3% in 2013 and another 2.1% in 2014, driven by consumer spending, investment and trade.

Consumers regain confidence

Consumer confidence has improved substantially over the past six months and in September reached its highest level since 2005. This is due partly to improvements in the housing market as it boosts household wealth. House prices have been rising since the end of 2012 (see Chart 2.21). Some analysts are already talking of a new bubble, but the rise is not yet that broad based and steep. Consumer spending should continue to pick up and stimulate growth into 2014.

Chart 2.21 House prices

(National level index, 2000 Q1=100)



Source: IHS Global Insight

Perhaps surprisingly in view of the rise in consumer confidence, the labour market has yet to recover. The unemployment rate has been flat since November 2012 and remains stuck at 7.7%: well above its pre-crisis level of 5%.

The Bank of England expects the unemployment rate to improve slowly over the coming year, reaching just 7.0% in 2016. Surveys show that job security has increased over recent months, reducing the fear of job loss. The number of people claiming unemployment benefits has also fallen to its lowest level since 2009.

Businesses see orders rise again

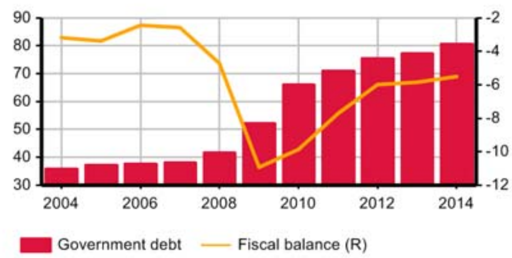
Business activity has improved greatly since the beginning of 2013. According to the purchasing managers' index compiled by Markit, activity in the service sector increased in the third quarter to its highest level since 1997. Incoming new business and confidence are both buoyant. The manufacturing sector also had an encouraging third quarter, with higher production and inflow of new orders. Manufacturing exports have also been growing since the beginning of the year. The construction sector is buoyed by the rise in house prices and the resulting recovery of demand for both residential and commercial construction.

Fiscal and monetary policy: push and pull

The UK government has eased it rate of fiscal consolidation and higher economic growth should make it easier for it to reduce its budget deficit. The government injected a substantial fiscal stimulus during the 2009 recession and has since tried to bring the budget deficit under control. Last year the deficit came in at 6.0% and for 2013 is expected to increase to 6.4% (see Chart 2.22). Public debt continues to slowly increase as a result: rising from less than 40% of GDP before the crisis to its current 80%, as a result of both fiscal easing and the bail-out of the financial sector.

Chart 2.22 Public debt and budget balance

(Government debt and budget balance in percent of GDP)



Source: IHS Global Insight

The Bank of England maintains a very loose monetary policy despite high inflation. Inflation has been above 2% since the end of 2009 and has been stable at around 2.8% over the past year. The Bank is content with this rate, in view of the need for monetary stimulus of the economy, and has indicated that it will keep interest rates at 0.5% until unemployment drops to 7%. In addition to the low interest rate, the Bank has devised a number of schemes to stimulate lending for housing and small businesses. It is expected to continue with its loose monetary policy in the coming year.

Japan: drastic measures

Japan's economy has been improving with positive GDP growth, falling unemployment and expected positive inflation after years of deflation. Prime Minister Shinzo Abe has launched a large scale stimulus package to resolve Japan's macroeconomic problems, popularly labelled 'Abenomics'. This package, consisting of three pillars - or arrows - was announced in December 2012. The three arrows consist of aggressive monetary easing, fiscal policy measures and structural reforms. The main goals of the policies are to achieve a 2% annual inflation rate, a drastically depreciated Yen and lower interest rates to encourage investment. In addition, fiscal spending will increase by 2% of GDP, in 2013. To obtain sustainable public balances, however, a bill was passed to increase the consumption tax rate to 8% in April 2014 and to 10% in 2015.

Strong measures, slow improvement

The positive response to the economic policy discussed in the previous Economic Outlook has since then gained ground. By October, the Nikkei Index had risen about 80% since September 2012. The depreciation of the Yen (17% in real terms) has positively affected export-oriented stocks. The first quarter of 2013 saw a 4.1% annual growth rate after a disappointing second half of 2012. Prices have been rising over the last three years in line with long-term expectations. An improvement in the capital account as a result of sizeable depreciation of the Yen could be expected. However, large energy imports, as a result of the Fukushima nuclear disaster in 2011, have countered this effect.

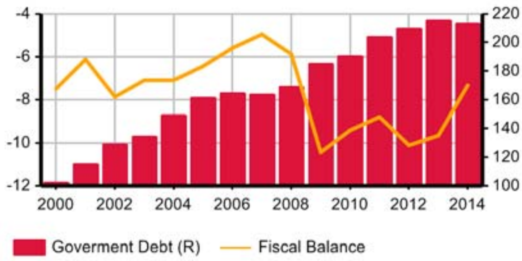
External demand is strengthening (helped by the sharp Yen depreciation), business conditions have improved and a frontloading of consumption and investment ahead of the tax increases next year and in 2015 are supporting the recovery. Economic growth in 2013 is expected to be 2.0%, slowing to 1.2% in 2014 as the consumption tax increase bites and construction investment decreases. As a result of that tax increase, in 2013 inflation is expected to reach 2.9% (with underlying inflation of 1.75%). Unemployment is forecast to drop to 4.1% in 2013 and to stay that way in 2014.

An abundance of challenges

Increasing growth is a real challenge in light of the rapidly ageing labour force. In addition, Japan needs to maintain confidence in the sustainability of its public finances and can therefore not commit to major spending plans without increasing taxes. The debt level will reach 215% of GDP in 2013 while the fiscal deficit runs in the order of 10% of GDP (see Chart 2.23).

Chart 2.23 Fiscal balance and debt

(Government debt and budget balance in percent of GDP)



Source: IHS Global Insight

The slow global recovery and volatility of financial markets are added complications. Furthermore, a slowdown in emerging markets, especially China, could severely hinder developments if exports fall. Furthermore, a start to the tapering announced by the US Fed may result in higher interest rates but also in a stronger Yen, directly affecting Japan's exports, while an outflow of capital from emerging markets may depress external demand.

Finally, a delay in the implementation of structural reforms to achieve financial and fiscal stability may alarm financial markets. As mentioned, Japan's unorthodox stimulus package has started to benefit its economy. Timing, however, is everything in Japan's case, as structural reforms made too early may bring Japan's development to a standstill while leaving it too late may be disastrous for Japan's budget deficit, government debt and investor confidence.

3. Prospects and risks in emerging economies

Economic growth moderates

Since the financial crisis most emerging markets have performed pretty well, while the developed economies have been in dire straits. This suggested that the 'decoupling' theory was, at least to some extent, accurate. Now, when it seems like the economies in the West have the worst part of the crisis behind them and show signs of recovery, it is notable that the economic situation in several emerging markets has weakened somewhat.

The anticipated change in US monetary policy recently triggered sell offs of financial assets in emerging markets. This resulted in stock exchange corrections and currency depreciations in several markets like India, Brazil, Indonesia and South Africa. Why were these markets hit and others not? Does the blame lie wholly with the whims of financial markets or also with the economic or political fundamentals of these countries? It seems that the countries mentioned should, at least partly, blame themselves. Large external financing requirements and a lack of structural economic reforms (resulting in lower than expected growth) are likely causes of the worries of international investors.

Nevertheless, it should be stressed that the overwhelming majority of emerging markets have much stronger economic fundamentals than a decade ago. Many emerging markets are now characterised by low external debt, ample liquidity, low inflation, high economic growth and increased political stability. This means that the risk of a balance of payment crisis or external debt crisis remains low.

It should also be emphasised that exchange rate depreciations are not necessarily all bad. For firms that are dependent on (commodity) imports or foreign financing it definitely poses a risk, but for exporting firms a depreciated currency may prove a blessing. Moreover, many developing market currencies have appreciated in real terms over the years: in many cases resulting in overvalued exchange rates. The liquidity situation in many emerging markets is now comfortable, allowing the central banks to intervene in the currency markets and smooth the depreciation process.

Another important issue is the drop in prices of several commodities. Many developing countries had experienced ever-increasing demand (and thus increasing prices) for commodities, mainly stemming from China. But with the current deceleration of economic growth in China, prices of many commodities are under downward pressure, affecting the economic performance of commodity exporters.

Table 3.1 Real GDP growth - Regional aggregates

	2012	2013f	2014f
Asia (excluding Japan)	6.1	6.0	6.2
Eastern Europe	2.4	2.0	2.9
Latin America	2.8	2.6	3.0
Middle East & North Africa	3.6	2.9	3.7

Source: Consensus Forecasts, IHS Global Insight (October 2013)

Asia: slower momentum

Countries in Asia face decelerating economic growth this year. The announcement by the Fed that it would start 'tapering', as discussed in Chapter 1, took investors by surprise and led to capital outflows and depreciating currencies in several Asian countries. Some were hit more severely than others, depending on external financing requirements and the existence of structural weaknesses in the economy. At the time of publishing this Outlook, most currencies in this region have recovered. Nonetheless, some remain vulnerable to changes in investor sentiment and external shocks. For the region as a whole, economic growth is estimated at 6.3% for 2014, compared to 6.1% in 2013.

Table 3.2 Real GDP growth - Asia

	2011	2012	2013f	2014f
China	9.2	7.7	7.6	7.4
Hong Kong	5.0	1.5	3.0	3.6
India	6.8	5.0	4.6	5.7
Indonesia	6.5	6.2	5.6	5.5
Singapore	4.9	1.3	2.9	3.6
Taiwan	4.0	1.3	2.4	3.6

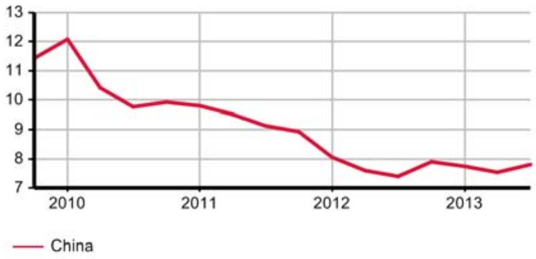
Source: Consensus Forecasts (October 2013)

China: shifting to a lower gear

There was a pick-up in economic activity in the second quarter of 2013 (see Chart 3.1), although it might be short lived. In the third quarter economic growth was 7.8%, following 7.5% growth in the second quarter and 7.7% in the first quarter. The pick-up in economic growth was driven by high credit growth at the beginning of the year and some government stimulus resulting in an increase in investments in infrastructure and housing. Total social financing, which is China's most broad definition of credit, was up by 52% in the first five months of 2013.

Chart 3.1 Economic growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

Fiscal stimulus measures included tax deductions and more investment in railways. The government has stated that rebalancing the economy from an overdependence on investments and exports to a more sustainable growth model based on consumption is necessary. But it seems to be hard for the government to give up its easy solution to support growth, which may aggravate the problems in the economy. Debt is rising and some sectors (steel and aluminium) are confronted by overcapacity. The government has indicated that there is room for investment, for example in municipal subways, rail networks and social housing.

Although private consumption has grown in importance for economic growth, more needs to be done by the government. One of the key instruments already announced by the government to achieve this is urbanisation. Therefore the government has to change the rigid household registration system: the hukou system. Currently, migration rules are very restrictive and residency is heavily regulated, resulting in weak labour mobility and barring millions of rural people from settling in the cities and benefiting from urban welfare and services.

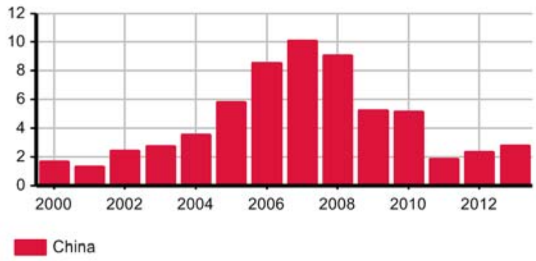
Those living in cities have higher incomes, more access to education and services and spend more on non-basic items. At the time of writing, the government is expected to clarify its reform strategy, which will probably be directed at the fiscal level and at the financial sector. To boost consumption-led economic growth, the government should also introduce reforms to modernise the economy and promote an improved market mechanism. Reforming state-owned enterprises and land ownership could tackle vested interests and contribute to development of the services sector, which is currently inefficient and uncompetitive.

Overall, economic growth is expected to decelerate from 7.7% in 2012 to 7.6% in 2013 and 7.4% in 2014. Lower investment growth and less growth in public spending are the main reasons for China's slower economic growth. The main support is coming from private consumption, fostered by higher wages. After a drop in January and February retail sales of consumer goods have returned to their upward trend. In August, retail sales were up 13.4% and for the first eight months of 2013 were up 12.8% on last year. Inflation is moderate with an expected 2.7% for 2013.

The surplus on the current account is diminishing due to increasing private consumption (see Chart 3.2). This year a surplus of 2.1% of GDP is expected, compared to 2.3% in 2012. As a consequence of this declining surplus, the accumulation of international reserves is slowing. In June this year the interbank rates rose sharply, indicating that the central bank was not willing to provide a never-ending supply of low cost funds to banks to expand their credit, especially through shadow banking (the provision of credit by bodies other than banks, and thus unregulated).

Chart 3.2 Current account balance

(Current account as percentage of GDP)



Source: IHS Global Insight

In March this year the new President Xi Jingping and premier Li Keqiang were appointed. A change of economic policy is unlikely as policy has been broadly captured by the 12th Five-Year Plan for 2011-2016. Sustainable economic growth is a priority of the government, which has indicated that it will tolerate lower economic growth, but at a sustainable level. Maintaining economic growth around 7.5% is also a priority and the government has emphasised the importance of addressing rising income-inequality and corruption by government authorities.

An opaque financial sector

In the past, developments in the banking sector were characterised by high credit growth. Shadow banking activities in particular increased sharply and spurred lending, with informal network lending, wealth management products and securitisation being examples of these off-balance activities. There is little precise data on these shadow banking activities, but Fitch has estimated that total credit (including the off-balance sheet credit) in the economy is around 198% of GDP, compared to 125% in 2008. This rapid credit growth poses a risk to financial stability. The level of non-performing loans is low, at just 1%, but this number is mainly driven by high lending growth. Besides, many loans have been rolled over rather than repaid. Eventually the rapid credit growth will lead to deterioration in asset quality.

Among the main beneficiaries of these shadow banking activities are local governments. They face strict controls on borrowing under their own name, but increasingly borrowing has been done through financing vehicles linked to local governments. A major part of this borrowing has been channelled through the off-balance activities of the banking sector. This makes it opaque and thus difficult to assess the risks. Based on public sources, Fitch estimates that local government debt is around 25% of GDP. Central government finances are good: the budget deficit was just 1.6% of GDP in 2012 and will increase slightly to 2.1% of GDP this year due to increasing spending on social welfare. Central government debt was around 16.7% of GDP in 2012.

Challenges remain

Risks for the Chinese economy in the coming years are problems in the real estate sector, which will have consequences for local governments, and the Chinese banking sector. These risks pose a contingent liability for the central government. We assume that the likelihood of a hard landing is small as the government will step-in to smooth the negative impact on the economy. Keeping in mind the government's low external debt and large foreign exchange reserves, it has ample room to support the economy in the event of a shock. However, it is important for the government to introduce structural reforms and not only rely on increasing investments, as this growth model is losing its radiance. Overall, we can conclude that double digit economic growth figures are history for China.

Hong Kong: property prices soar

In 2013 economic growth is expected to accelerate to 2.6% from 1.5% in 2012. Support comes mainly from private consumption, which is itself supported by the tight labour market, resulting in rising wages. After years of rapid expansion, investments will contract this year. The external balance contributes negatively to economic growth as strong domestic demand leads to higher growth in imports than in exports.

Inflation is quite high in Hong Kong: in 2013 inflation of 4.1% is expected. High rents, which constitute a large part of consumers' price basket, are the main reason for this high inflation. Rental costs follow property prices, which have risen sharply in Hong Kong in recent years: doubling since 2008 and reaching an all time high, exceeding the peak of 1997 before the housing price bubble burst. A limited supply of new houses, strong demand from local and non-local purchasers and the low interest rates imported from the US have boosted house prices.

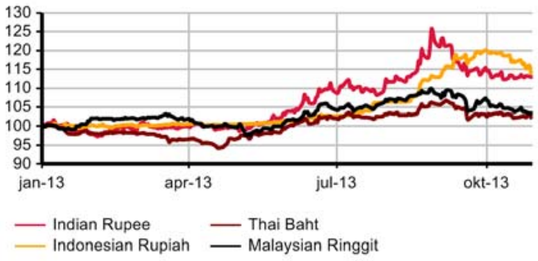
Macro prudential measures taken by the government and the Hong Kong Monetary Authority have cooled the market somewhat this year. The banking sector is well capitalised and regulated and should be able to cope with declining house prices. An uncertainty for the financial sector is the increased lending to mainland China. Credit exposure to China has more then doubled since 2009 and represents the largest exposure (26.4% of banking assets at the end of June 2012). As a small and open economy Hong Kong is vulnerable to external shocks: particularly from China due to the increasingly integrated trade and financial channels.

India: a downward revision

India was one of the emerging markets hit recently by the reaction of international investors to the changing stance of the US Fed. India has a significant external financing requirement, mainly as a result of its large current account deficit. A reversal of foreign capital flows has resulted in a sharp depreciation of the Indian rupee: it depreciated 27% against the dollar between May and the end of August. The Reserve Bank of India has taken measures to counter capital outflow (e.g. import restrictions on gold and a hike in short-term interest rates). Since then the rupee has recovered sharply, although not fully (see Chart 3.3).

Chart 3.3 Exchange rates to the USD

(Indexed cross-rates, 1 Jan 2013 = 100)

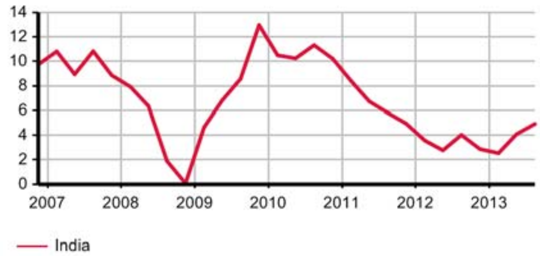


Source: IHS Global Insight

Even if the Indian rupee does not recover further (or again loses some of its value), a balance of payment crisis or debt crisis is unlikely. India remains an interesting long-term destination for foreign direct investment and its total external debt remains manageable, even after the upwards effect of the depreciation. Nevertheless, the unfavourable economic developments in India should not be played down completely. The macro-economic figures have deteriorated gradually over the past couple of years. Real economic growth is far below potential: only 5.0% in 2012, 4.6% in 2013 and an expected 5.7% in 2014 (see Chart 3.4). Inflation remains high at 9.6%. The current account has performed poorly since 2012, showing deficits of 4.9% of GDP in 2012 and a similar figure this year. Fiscal discipline in India is traditionally poor, which has led to high (but largely domestically financed) public debt.

Chart 3.4 Economic growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

The elections scheduled for May 2014 will have a negative effect on fiscal consolidation. The Indian government spends a great deal of money on subsidies and this system needs to be scaled back to make public finance sustainable. Cutting back subsidies on food, fuel and fertilizers would be a highly sensitive issue and it is unlikely that changes will be made before the next elections. Nevertheless, the central government's fiscal deficit is shrinking: from 5.7% of GDP in fiscal year 2012 to 4.9% of GDP in the fiscal year 2013.

Economic growth has been disappointing for several years, largely because of India's poor track record on structural economic reform. Poor infrastructure, poor education, cumbersome 'red tape' and an ineffective legal system are some of the factors that conspire to create the country's poor business environment. Nevertheless, India will remain an important market for many multinationals. With a middle class population of around 70 to 100 million and counting, this remains a market that many international companies cannot afford to ignore. This suggests that foreign capital inflows, largely in the form of FDI, will recover in the medium term. Moreover, the recent financial turmoil may remind the Indian authorities that the confidence of foreign investors should not be taken for granted and may therefore encourage India to accelerate its economic reform. India scores rather low in an international ranking of doing business, at position of 132 out of 189 (see Table 3.3).

Table 3.3: Doing Business Index ranking

	2013	2012
Singapore	1	1
Malaysia	12	14
Thailand	18	17
South Africa	39	41
Mexico	48	53
Turkey	71	68
China	91	91
Russia	112	118
Indonesia	128	130
Brazil	130	128
India	132	132

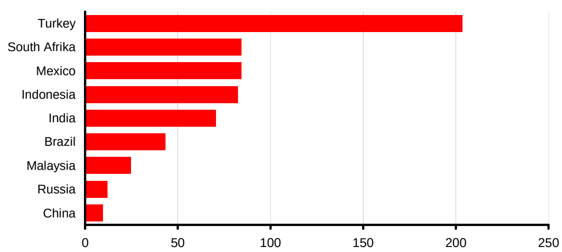
Source: World Bank (2013)

Indonesia: vulnerable to sentiment

Indonesia also faced a large currency depreciation and a steep fall of the Jakarta Stock Exchange index in the summer of 2013 but, after the recent recovery, the stock index is back at the level of early January. This is not the case for the Indonesian rupiah, which has lost 15% of its value against the US dollar (see Chart 3.3). The Indonesian economy continues to show healthy fundamentals: persistent and stable high economic growth, manageable foreign debt and a current account that shows only small deficits. Inflation is under control and government budget deficits are small.

The explanation of Indonesia's apparent vulnerability to changes in market sentiment lies in its significant external financing requirement, overvalued stocks, low real interest rate and a couple of economic policy missteps (see Chart 3.5).

Chart 3.5 External vulnerability
(External financing requirement as percentage of reserves)



Source: EIU

Presidential elections will be held in July 2014, and until then the outlook for structural economic reform looks bleak. President Yudhoyono's powers have been eroded during the course of his second term. The current coalition, consisting of the president's Democratic Party, Golkar and the Islamic PKS (and three smaller coalition partners), has been tarnished by corruption scandals which have severely eroded the government's popularity while the main opposition party PDI-P - the party of former president Megawati Soekarnoputri and the current governor of Jakarta, Joko Widodo - leads in the polls. It is almost certain, however, that, as now, a new government will consist of a multi-party coalition.

The Indonesian government cut fuel subsidies in June but fuel prices remain below the global market price. Indonesian policies were recently characterised as 'resource nationalism': all mines have to be at least 51% owned by Indonesians after 10 years of operation, exports of mineral ores will be prohibited from 2014 and the royalty rate of foreign mining firms will be increased. The government has also imposed import restrictions on several agricultural products. These measures will undoubtedly discourage foreign investment and will most likely be counterproductive and unsustainable.

The reduction of fuel subsidies has resulted in a government saving of USD 5 to USD 6 billion but it has also pushed up inflation to an expected 8.8% (year-on-year) last month. Bank Indonesia has reacted with a 125 basis point hike in the interest rate since July. Indonesia's export portfolio is vulnerable: dominated by commodities and by Chinese demand while slower economic growth in China has affected Indonesia's export performance. The value of goods exported will fall by 6.6% this year compared to two years ago. The disappointing export performance, monetary contraction and the changing attitude of international investors has led to lower economic growth at 5.7% this year.

Malaysia: popular among investors

Malaysia has also experienced capital outflows and associated currency depreciation, although to a lesser extent than India and Indonesia (see Chart 3.3). Malaysia remains one of the most developed markets in Asia with strong solvency indicators, ample liquidity, a strong current account based on commodity and electronics export, low inflation and, moreover, a strong business environment (see Table 3.3).

Economic growth slowed this year to 4.5% from 5.6% in 2012, largely due to a number of major investment projects that were started last year (and the associated large initial capital outlay) and the ongoing weak demand for electronics. Malaysia is traditionally vulnerable to the behaviour of international investors, since 33% of Malaysian bonds and shares are in foreign hands.

Thailand: resilient to shocks

The fourth Asian country to be affected by the sudden outflow of foreign capital is Thailand. The baht lost almost 14% of its value against the dollar between the end of April and the beginning of September and has only regained a little of its value since then. The Thai stock index is back at the level of early January.

Thailand's real economy also sputtered, as the country slipped into recession in the second quarter. Economic growth is, however, expected to recover in the second half of 2013 and reach 3.5% growth for the full year. Prime Minister Yingluck Shinawatra's term has been remarkably stable, considering the country's structurally volatile political scene. The royalist and pro-establishment People's Alliance for Democracy, also known as the Yellow Shirts, has recently announced its departure from the political arena, but political tensions will persist.

Yingluck's expansive (populist) fiscal policies have resulted in somewhat higher, but still manageable, budget deficits: 4.4% of GDP in 2012 and an expected 2.9% in 2013. In particular the programme to subsidise rice production has proved to be a costly affair - and a waste of public money. After mass protests and road blocks, the government has decided to expand the subsidies to the rubber sector too: spending another USD 680 million.

The government has increased the minimum wage considerably and, while the impact on inflation remains very limited, some companies heavily dependent on low skilled labour might feel the effect most. Although showing a worsening trend, the current account is largely balanced and foreign exchange reserves are adequate, making Thailand less vulnerable to the volatility associated with changing foreign capital flows.

Singapore: best in class

As the main trade, transport and financial hub of the region, Singapore is reputedly vulnerable to economic developments in the rest in the world - in particular in Asia. This is, however, not reflected in the current economic figures.

After a moderate recovery in the first and second quarters of this year, following the economic contraction in the fourth quarter of 2012, the Singapore economy has regained traction in the third quarter and this trend is expected to continue. For the year as a whole a growth figure of 2.3% is expected, driven by public investment in infrastructure and private consumption.

Singapore continues to be one of the strongest countries in the world in terms of sovereign risk and macro economics fundamentals. Therefore, and due to the ample foreign exchange reserves and adequate monetary management of the Singapore Monetary Authority, the exchange rate is unlikely to be affected by changing patterns of international investment.

Latin America: a weak business cycle

In the last few months, economic forecasts for 2013 and 2014 for Latin America have been scaled back: in June real GDP growth was expected by Consensus to be 3% (2013) and 3.7% (2014), while the October forecast points to just only 2.6% and 3.0%. The main markets are confronted with less buoyant world trade and lower mineral prices than expected at the beginning of the year. With export revenues weaker than previously anticipated, the current account balance will result in a higher deficit in a period where capital imports to the continent has taken a turn for the worse. It is therefore no wonder that currencies have been subject to downward pressure.

Table 3.4 Real GDP growth, Latin America

	2011	2012	2013f	2014f
Argentina	8.9	1.9	3.5	2.2
Brazil	2.7	0.9	2.4	2.4
Chile	5.9	5.6	4.3	4.2
Colombia	6.6	4.2	3.9	4.5
Mexico	4.0	3.8	1.4	3.4
Peru	6.9	6.3	5.3	5.7
Venezuela	4.2	5.6	1.0	1.6

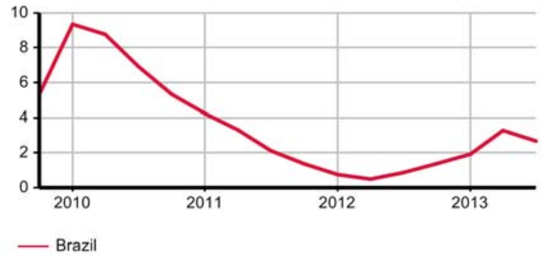
Source: Consensus Forecasts (October 2013)

Brazil: experiencing challenges

Brazil has had one of Latin America's most disappointing business cycles in 2013 and 2014, despite the upturn in the second quarter.

Chart 3.6 Economic growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

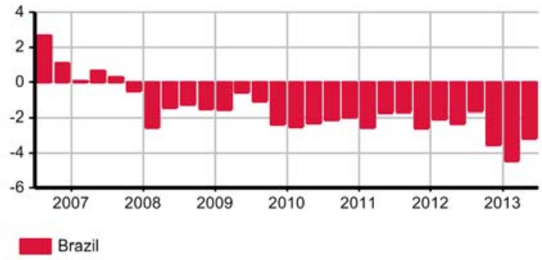
Tight monetary conditions, to fight inflation and to prevent further weakening of the exchange rate, have taken their toll on business confidence, investment growth and consumer spending. After the poor economic record in 2012 - as reflected by meagre GDP growth of 0.9% - economic recovery is apparantly less robust and sustained than previously expected (see Chart 3.6). A restrictive monetary policy is only part of the explanation of this setback: another is the social unrest that erupted in the middle of 2013 as a protest against high prices and poor service in the public sector. A growing middle class, who profited from the better real economic conditions of the last decade, is growing increasingly assertive.

But the protests were also directed against one of Brazil's structural problems: the stubbornly high rate of inflation. For three consecutive years inflation has approached 6% per annum, giving the monetary authority an awkward dilemma: either lower the Selic-interest rate to support economic activity or raise it to curb high consumer prices. Compounding this problem even more is the position of the exchange rate of the real. The mere rumour of 'tapering' by the Fed has already led nervous investors to leave Brazil as a destination for short-term capital inflow that has until now profited from the high interest rate.

A stronger than anticipated depreciation of the real (9.4% against the USD in the second quarter) was the ultimate result of efforts to keep international reserves stable as capital flew out of the country. However, the weakening of the real has helped to restore Brazil's international competitiveness. This will help to counter a deteriorating current account balance in the coming years as imports surge due to major investment projects (see Chart 3.7). Brazil is therefore expected to continue to maintain its investment grade status from the rating agencies.

Chart 3.7 Current account balance

(Balance as percentage of GDP)



Source: IHS Global Insight

President Rousseff is facing new elections in October 2014. Deep seated reform focused on curtailing public sector spending is therefore not expected, although these are urgent if the government is to bring its outlays onto a more sustainable footing. An overhaul of the complex tax system that still deters (foreign) investors is also imminent and hopefully Brazil will mirror itself on Mexico, where reforms have been implemented.

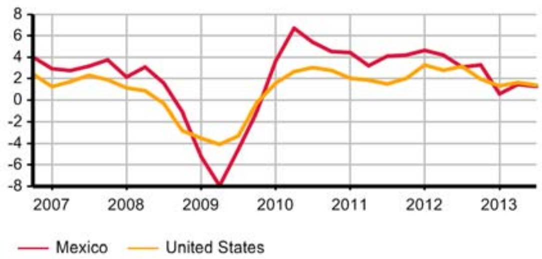
Mexico: tracking the US

The newly elected Mexican president has so far been able to get a majority in Congress to support his plans for restructuring the economy. Most important among these is a reform of the energy sector, such that the state oil producer Pemex may face competition from foreign oil producers. However, Pemex cannot be privatised and so will continue to be state owned, albeit restructured and more efficient.

The GDP forecast for 2013 has been downgraded significantly: the prediction of 3.6% at the beginning of 2013 dropped to 1.4% in October. It might be even less when the full impact of two disastrous hurricanes in September is included. The damage is so far calculated at USD 6 billion and this may add to a budget deficit already reaching 3% of GDP in 2014. On the other hand, extra budgetary outlays for reparation work may boost economic activity in the (re)construction sector. Because Mexico has been affected less by outflowing portfolio capital, Banco de Mexico was quick to lower the official interest rate in an effort to boost activity.

Chart 3.8 Economic growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

With exports mainly going to the United States, the Mexican economy is heavily dependent on the US business cycle (see Chart 3.8). As the conditions north of the border improve only very slowly, the positive impact on the domestic economy in Mexico will also be limited: another explanation for a disappointing business cycle.

It will be 2014 before Mexico can begin to profit from the economic reforms designed to attract more foreign investment. If expectations materialise, real GDP growth may then reach 3.4%. The deficits on the current account of the balance of payments will remain manageable, as incoming (portfolio / investment) capital is sufficient to cover the finance gaps. Mexico will continue to be awarded with solid investment grade ratings by the rating agencies.

Other Latin American markets

The main commodity producers in Latin America are also achieving lower economic growth than expected. **Chile, Colombia, Peru** and **Bolivia** are all very dependent on mineral exports for their export revenues and ultimately for their economic growth.

The same holds true for **Venezuela**, one of the world's largest oil producers. After the heavy election-spending of last year, resulting in remarkably high economic growth of 5.6%, economic conditions are set to worsen. Although the oil exports guarantee Venezuela ample surpluses on its current account, much of the revenue disappears into the coffers of the state or debt-ridden, inefficient state firms like PdVSA.

Venezuela badly needs economic reforms, but so far the new president seems determined to continue the erratic economic policy of the late president Hugo Chavez.

Argentina has to wait for the result of its mid-term Congressional elections. While a bad result for the ruling president Fernandez may hinder her ambition for a third term, this could prove a boost to the economy. So far, economic policy has become so complex and disadvantageous that a change in policy can only contribute to an urgent restructuring to more market orientation and less state intervention.

Argentina's economic performance continues to depend largely on the harvest - which has been very good this year. The official forecast of economic growth of more than 6% in 2014 seems far too high: but then, economic figures in Argentina tend to be very unreliable. The consensus view is only 2.2% growth in 2014. Capital and currency controls continue to hinder the simplification of foreign trade with Argentina: the arbitrary risk of investing in and trading with the country is indeed high.

Central and Eastern Europe: improving

The outlook for economic growth across Eastern Europe has improved slightly, in line with the easing conditions in the Eurozone. Export generally increased and credit conditions improved a little. Countries that are less integrated with Western Europe, such as **Russia** and **Turkey**, have benefited less from the changing conditions: Russia faces its own dynamics while Turkey is exposed to the changing sentiment in international financial markets. Overall the region is forecast to grow 2.1% in 2013, slightly below 2012's 2.4% growth. For 2014 the region is expected to expand 2.9%. Despite improving conditions, economic growth is still well below potential in all countries in the region.

Most Eastern European markets are closely linked to the Western European economy and consequently were less impacted by the Fed announcement of a reduction in US monetary easing: indeed, the financial and exchanges rate markets of most Eastern European countries were hardly affected. A notable exception is Turkey, which has seen a sizeable outflow of foreign funds.

Table 3.5 Real GDP growth, CEE

	2011	2012	2013f	2014f
Czech Rep.	1.7	-1.2	-1.0	1.8
Hungary	1.7	-1.7	0.4	1.5
Poland	4.3	1.9	1.2	2.7
Romania	2.5	0.7	2.3	2.5
Russia	4.3	3.4	1.8	2.7
Turkey	8.3	2.2	3.5	3.8
Ukraine	5.2	0.2	-0.3	1.4

Source: Consensus Forecasts (October 2013)

Turkey: vulnerable to capital outflows

In the last decade Turkey has made impressive economic progress. Thanks to its political stability since 2002, when the AK Party came to power, the country has experienced GDP growth exceeding the European average, while real income per capita has increased substantially. A fast growing population of 75 million and rising prosperity have turned Turkey into one of the most promising markets on the continent.

However, one of the main bottlenecks of the Turkish economy has not been sufficiently addressed, as became apparent this year: the relatively low savings ratio, as reflected by high current account deficits on the balance of payments. Therefore, the country remains very dependent on external funds to bridge its large savings gap, to keep reserves intact and to underpin the lira exchange rate. In 2012 this flaw intensified as easy and cheap access to external funds in financial markets dried up. Short-term capital even started to flow out of the country and the Central Bank had no alternative but to raise the official interest rate to stave off erosion of reserves.

Table 3.6 Economic Figures Turkey

	2012	2013f	2014f
Real GDP growth	2.2	3.5	3.8
Inflation	8.9	7.5	6.8
Current account (% GDP)	-6.1	-6.6	-7.3
Foreign debt (% GDP)	43	43	44

Source: Consensus Forecasts, EIU (October 2013)

By doing so the economy lost further steam in a situation where economic growth had already slowed because of declining exports to European markets and more subdued domestic demand. For the time being, Turkey remains very reliant on financial markets to cover its large finance gaps that originate from its current account deficits and high debt service on foreign debt.

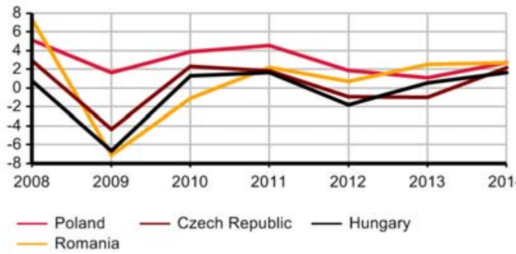
Despite the Taksim Square protest that escalated into national unrest, a fundamental change in the political situation is not expected in the short term. However, this sign of popular dissatisfaction with the rather autocratic rule of the administration has to be addressed more seriously in a society that is heading for diverse democracy and religious tolerance. If realised, Turkey can look forward to an even more promising future and set an example for the region.

Poland: improving conditions

Economic growth disappointed in 2013, but is forecast to increase in 2014 (see Chart 3.9). Sluggish domestic demand and low investment held the economy back in 2013 but next year the domestic economy is expected to pick up again, boosting economic growth. The economy is forecast to grow 1.1% in 2013 and expand 2.6% in 2014.

Chart 3.9 Economic growth

(Forecast 2013 and 2014)



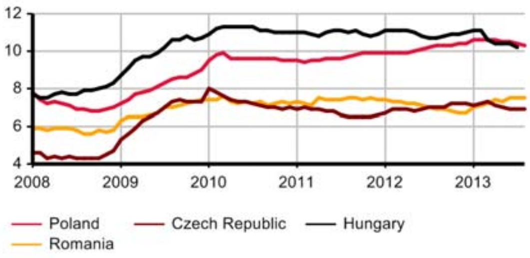
Source: IHS Global Insight

The Polish economy grew 0.4% in the second quarter of 2013: 0.8% compared to the same period in 2012. This was the result of a marginal increase in consumption and a contraction in fixed investment, with healthy exports contributing most to the positive growth figure. The Polish economy benefits from the improving conditions in the Eurozone – particularly in Germany. With export orders increasing strongly, exports are forecast to contribute significantly to economic growth and to a further contraction in the current account deficit in 2014.

Domestic demand is expected to pick up again and consumers can anticipate a rise in real wages as inflation remains low. In addition, the unemployment rate has been falling slowly since the beginning of 2013 (see Chart 3.10). Higher wages and lower unemployment should both boost consumer spending. The improving conditions have also translated into higher consumer confidence and this is expected to translate into higher spending in 2014.

Chart 3.10 Unemployment

(Standardised ILO, seasonally adjusted)



Source: IHS Global Insight

The political situation is stable but fragile, as the ruling government has only a small majority in parliament. The poor economic performance over the past year has increased dissatisfaction among voters and the government of the ruling PO party is deeply unpopular. Better economic conditions may add to stability, but bouts of unrest could occur.

Romania: showing progress

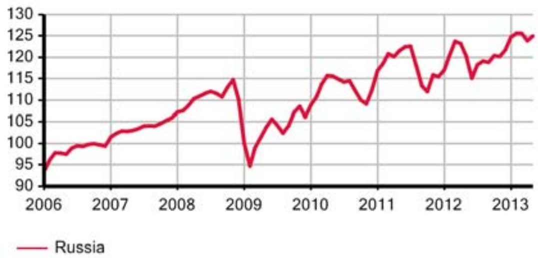
Economic growth in Romania has picked up in 2013 and is forecast to improve further. The economy grew by just 0.7% in 2012 but is expected to expand 2.3% this year. In the first half of 2013 the economy grew 1.8% on the back of strong export demand but domestic consumption and investment was still poor. A good harvest and continuation of robust exports in the third quarter suggest that the economy may see better results in the second half of 2013. The central bank cut the interest rate to 4.25% on 1 October, continuing to pursue monetary easing. The government also reached an agreement with the IMF in September on a new stand-by agreement worth EUR 2 billion. The outlook for 2014 is positive, with 2.5% growth forecast.

Russia: reforms postponed

In our May Economic Outlook we indicated that the oil and gas dominated Russian economy is operating at full potential (5.4% unemployment) with a temporary slowdown due to depressed demand. Lower than expected internal demand and the erosion of competitiveness due to the relatively strong rouble are compounding the ongoing weakness of investments due to the dismal business climate. Russia scores very poorly on the international 'doing business' index: placed 112 out of 189 (see Table 3.3).

Chart 3.11 Real effective exchange rate

(Real trade-weighted exchange rate, index Jan 2009 = 100)



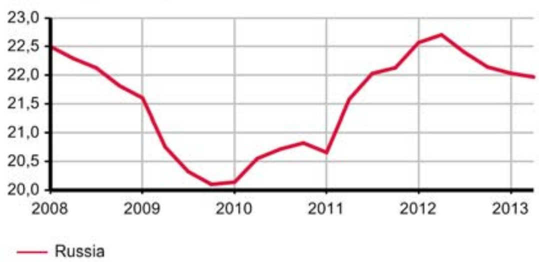
Source: IHS Global Insight

Russian growth came under pressure from a number of factors in the first half of 2013. Export growth slowed due to lower demand for oil and gas and a loss of competitiveness as wages rose. This was reflected in an appreciating real exchange rate (see Chart 3.11) but the trend was partly mitigated by the nominal rouble depreciation of roughly 5% since early 2013.

Fixed investment shrank by 1.4% in the first half of the year, as company profits slumped by 27%. This is adding to the downward trend in investments as a percentage of GDP that has been visible since early 2012 (see Chart 3.12). Retail sales also slowed at roughly half the pace seen last year. Economic growth is expected to pick up in the second half of 2013 and reach 1.8% for the full year. For 2014 an increase to 2.7% is anticipated.

Chart 3.12 Fixed investment

(Percentage of GDP)



Source: IHS Global Insight

Public finances are not a primary concern, but do not allow a lot of room for expansion. The fiscal deficit is estimated to be 0.4% in 2013. These figures are dominated by oil and gas revenue: excluding these revenues the deficit was more than 10% in 2012. To reduce this dependency on oil, Russia has adopted a three year budgetary framework to achieve a balanced budget by 2015. This calls for fiscal tightening in the order of 2% of GDP in 2013, as estimated by the Institute of International Finance (IIF).

Inflation stood at 6.5% in July: down from a peak of 7.4% in May. Inflation was pushed up somewhat by the weaker rouble, but mostly by the wage increase: up by a nominal 13% in the first half of 2013. The informal band of the central bank is to keep the monetary policy rate around 5% to 6%. As the inflation rate is trending downward and approaching the target range, there is currently speculation about a forthcoming interest rate cut: the current policy rate is 5.5%. The impact on the economy of a lower policy rate is questionable: the real inflation rate is already low, indicating monetary expansion.

With fiscal policy and monetary policy constrained by inflation, there is little scope for policy stimulus. This underlines the fact that reforms are urgently needed. Privatisation reforms and efforts to improve the business climate are on the political agenda. President Putin has so far not shown a strong tendency towards reform and there are vested interests in maintaining the status quo. The reform process is therefore likely to remain slow. Privatisation targets for 2014 to 2016 have already been scaled down by a third: indeed,for 2014 the target has been halved.

Oil dependent

The underlying oil price for the budgetary balance is USD 110 per barrel (Brent). An oil price in the range of USD 91 and USD 96 per barrel is supposed to keep the budget in balance. Based on this break-even oil price range, the government's fiscal deficit is not allowed to exceed 1% of GDP. Revenues based on a higher oil price are used to fill two wealth funds, the National Reserve Fund (NRF) and National Wealth Fund (NWF). The assets in the NRF cannot be used for government spending unless they amount to 7% of GDP (currently the NRF amounts to 4.2% and the NWF to 4.3%). The government recently announced that USD 14 billion would be spent from the NWF for infrastructural investments to spur economic growth.
Only a significant drop in the oil price can accelerate the reform process. A sensitivity analysis made by the IIF shows that the oil price would have to decline to around USD 85 per barrel before reform action would be triggered.[8] Such a low oil price is estimated to cause an economic decline in the order of 1%, forcing the government deficit to 3.2%. These are not unmanageable levels but, at USD 70 per barrel, the economy could possibly shrink by 5% and the government deficit could deteriorate to 5.8%.

However, as reported in the Atradius Oil Market Outlook[9], the likelihood of an oil price below USD 80-83 per barrel is relatively low. This is because the Saudi Arabian government budget break-even price is USD 83 per barrel and a lower price will trigger production adjustments by the world's swing producer. Moreover US tight oil production becomes unprofitable below USD 80 per barrel. For this reason, an acceleration in the pace of reform is unlikely – and this also reduces the economic growth potential of Russia. The country therefore seems stuck with a low growth rate.

Middle East and North Africa (MENA)

Recent developments in the Middle East and North Africa indicate a highly polarised region with divided societies, at both a regional and country level. Tribalism and religious differences are the main characteristics of this region.

Table 6: Real GDP growth - MENA

	2010	2011	2012	2013f	2014f
Egypt	5.1	1.8	2.2	2.1	3.2
Morocco	3.6	5.0	2.7	4.5	4.7
Qatar	16.7	13.0	6.2	4.9	4.8
Saudi Arabia	7.4	8.6	5.1	4.2	4.5
Tunisia	3.1	-1.9	3.6	3.1	4.3
UAE	1.7	3.9	4.4	3.7	3.4

Source: IHS Global Insight (October 2013)

Political transition is still ongoing in North Africa, but, as is very evident, the process is difficult – for some countries more than others. The transition in **Tunisia** looks most promising. Different groups are sitting together and seem to be able to make concessions. The prospect of improvement in **Syria** on the other hand is bleak. Political risk in the MENA region as a whole has deteriorated significiantly since the eruption of the Arab spring in December 2011.

[8] IIF, Russia: Weak Growth Likely To Persist Over The Medium Term, August 2013.
[9] See Atradius Oil Market Outlook, April 2013

The situation in **Egypt** is highly uncertain. The military coup at the beginning of July fuelled protests by followers of the Muslim Brotherhood and resulted in violent clashes with the army. It is expected that these protests will continue in the short term. The Egyptian army has announced that a new constitution will be written and that new parliamentary and presidential elections will be held in six months: a quite ambitious schedule. Uncertainty will remain and this will have a negative effect on foreign direct investments and tourism revenues – and thus on economic growth. Plentiful financial support from Saudi Arabia and the United Arab Emirates will prevent a balance of payments crisis, at least in the short term. However, government finances are very weak and the budget deficit unsustainable.

Sub Saharan Africa: commodity based

Economic growth in Sub Saharan Africa is largely driven by commodity exports and the spillovers to private consumption, mainly reflected in the expansion in telecommunications, transport and financial services. Another driver of growth is investment in infrastructure, largely financed by development aid and concessionary loans.

Table 3.7 Real GDP growth, Sub Saharan Africa

	2010	2011	2012	2013f	2014f
Ghana	8.0	15.0	7.9	7.5	7.1
Kenya	5.8	4.4	4.3	4.9	5.3
Nigeria	7.8	7.4	6.5	6.9	6.8
South Africa	3.1	3.5	2.5	2.2	3.3

Source: IHS Global Insight (October 2013)

Sub Saharan Africa is, with the exception of South Africa, not very integrated in the global economy. As a result, the region is largely shielded from international investor sentiment. However, an increasing number of African countries have issued (or are planning to issue) international sovereign bonds, although this may prove more difficult (or at least more expensive) than previously anticipated due to the changing risk appetite of international investors. Another pressing issue is the ongoing reduction in commodity prices, due mainly to lower demand from China.

South Africa: modest recovery

As already mentioned, the South African economy is far more integrated with the rest of the world but, under the current economic circumstances, this is more a liability than an asset. South Africa was among the countries affected by the reversal of international capital flows, with the rand taking a large blow after 1 May from which it has recovered only slightly. That the country was affected is hardly surprising: it is running large double deficits, has considerable external financing requirements and economic growth is low.

Since the Marikana massacre in August 2012, labour market relations have been tense. Not only has the mining sector been plagued by wildcat strikes, but the labour unrest has also affected the automobile sector. The mining sector also has to deal with the drop in demand caused by slowing Chinese growth. Furthermore, all industries are feeling the effect of continuous power shortages due to the insufficient capacity of national electricity producer Eskom.

The next six months will see preparations for the general elections scheduled for spring 2014. Although the governing ANC will almost certainly gain an absolute majority in parliament, it is expected that the opposition Democratic Alliance will continue to increase its share of the vote. Despite the ongoing fiscal stimulus, economic growth remains relatively slow due to problems in the mining and manufacturing sectors. In 2013 growth is estimated at 2.2%, rising to 3.3% in 2014.

Commodity developments

Emerging markets play a central role in today's commodity market, either as a consumer or a producer. On the demand side, it is China that plays an overwhelmingly important role; on the supply side the players are more diverse. Depending on the type of commodity, the Gulf region, Sub Saharan Africa, Russia and Australia are the major producers (see Table 3.8).

Table 3.8 Commodity production in Africa

Botswana, Namibia, Sierra Leone	Diamonds
Angola, Cameroon, Equatorial Guinea, Nigeria, Sudan	Oil
Mali, South Africa, Tanzania, Zimbabwe	Gold
Mozambique	Aluminium
Congo (Kinshasa), Zambia	Copper & Cobalt
Ethiopia	Coffee
Kenya	Tea
Cote d'Ivoire	Cocoa

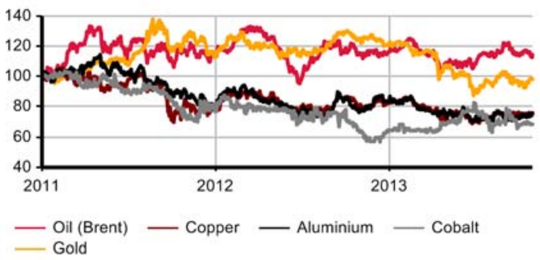
Source: Economic Research Department

The oil price, and therefore the price of natural gas, has developed quite stably since 2011. This was despite decelerating energy demand growth from China, which itself was offset by political instability in the Middle East.

The gold price is traditionally not determined by supply and demand but by the behaviour of financial speculators. It has followed a downward trend since late 2012 due to less turbulence on global financial markets (see Chart 3.13). Unless there is a sudden return to financial turmoil, it is unlikely that the gold price will return to its 2011 peak: a continuation of the downward trend appears more likely.

Chart 3.13 Commodity developments

(Price indices, 1 Jan 2011 = 100)



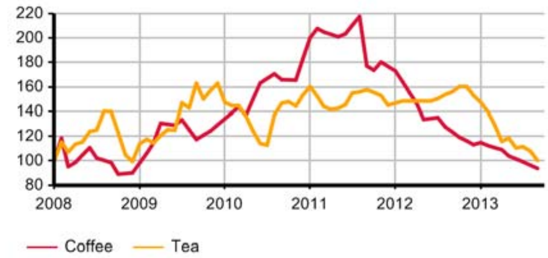
Source: London Metal Exchange, IHS Global Insight

Commodities used in the construction sector or in production of capital goods (for example steel, copper and aluminium) tend to be cyclical. After a fall in the copper price throughout 2011 and 2012, its development has been quite stable since the beginning of 2013. In the short-term, the course of Chinese growth will be an important determinant. Another factor is the export performance of the newly opened Oyu Tolgai copper mine in Mongolia. Aluminium is used mostly in the manufacturing of transport vehicles, a sector that has also proved very sensitive to the business cycle. Recent developments in the price of aluminium have therefore been unfavourable.

The price of agricultural commodities is determined mainly by the weather and its effect on production, and on demand. Since 2011 the price of coffee has dipped sharply. The anticipated bumper harvest in major producer countries such as Brazil and Colombia, and large existing stockpiles, are likely to further undermine the coffee price (see Chart 3.14).

Chart 3.14 Agricultural commodity prices

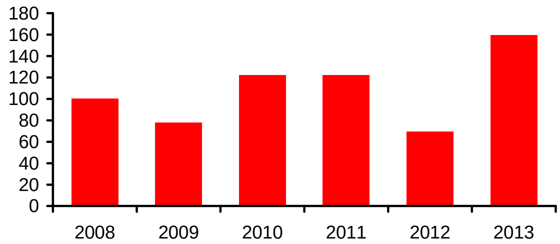
(Price indices by commodity class, index Jan 2008 = 100)



Source: IHS Global Insight

The story for cocoa is very different, as major producing countries are currently plagued by unfavourable weather conditions. Production volumes are also affected by farmers switching their production from cocoa to more lucrative palm oil. In addition to this supply shortage, demand is expected to increase as a result of the recovery of the European economy and the rapidly growing demand for chocolate in Russia and China. The outlook for cocoa is therefore bullish.

Chart 3.15 Diamond price
(Index, 2008 = 100)



Source: Bain

Diamonds are used in equal measure for jewellery and industrial applications. The diamond market is characterised by a limited number of suppliers that largely control the global production volume. Final demand is dominated by the jewellery industry in the US, Japan and China. As a luxury good, this is obviously sensitive to the business cycle: the diamond price decreased significantly in 2009 (see Chart 3.15) but since then has recovered. This increasing trend is expected to continue due to the recovery of the US and the Japanese economies and ongoing growth of the middle class in China.

4. Implications for the insolvency environment

Slightly improving insolvency environment

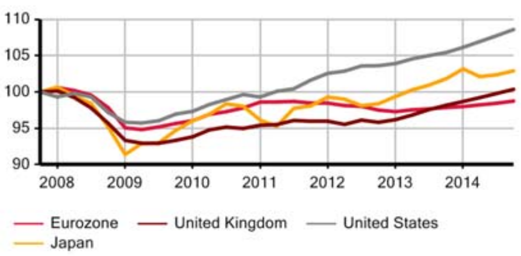
The economic conditions described in the previous chapters ultimately have implications for solvency conditions and payment behaviour among firms. As our report concludes, the outlook for economic activity in the period ahead has brightened somewhat. We also stress however that this expected improvement takes as its starting point a rather low level of activity. Our anticipation of the insolvency environment for 2014 is in many respects a mirror image of this assessment: a small improvement in broad terms but from a rather high level of insolvencies.

Economic output remains suppressed

To put the current insolvency conditions into perspective, let us first briefly revisit how the macroeconomic situation has developed over the past five years. The deep slump in the business cycle that followed the financial turmoil of 2008/09 affected most developed countries. The subsequent economic development has been slow – so slow that it has taken several years to close the output gap from before the crisis. In the United States, GDP returned to its 2007 level in the first half of 2011 (see Chart 4.1). In Japan, which was also severely impacted by the tsunami in 2011, economic activity did not reach its 2007 level until the first half of this year.

Chart 4.1 Real GDP, regions

(Level index, 2007Q4 = 100: forecast for 2013 and 2014)



Source: IHS Global Insight

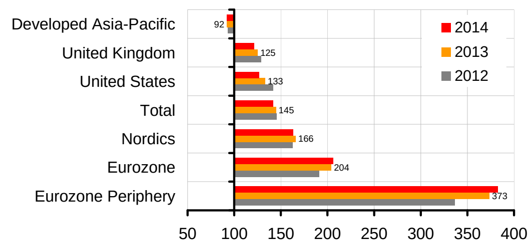
In Europe, economic activity is still recouping lost ground. After five years, real GDP in the UK is still 2% lower. The same is true of the Eurozone, which is not expected to return to its pre-crisis GDP level before 2015. For individual member countries such as Italy and Portugal, on current growth expectations, it will take more than a decade to return to the level of economic activity seen in 2007.

Insolvency levels are high

Against this background of low economic activity, it is not surprising that the years since the financial crisis have been characterised by a high number of insolvencies. The weak growth environment, combined with restricted access to credit, has created a challanging environment for business. At the aggregate level across developed countries, the number of business failures is currently 45% higher than in 2007 (see Chart 4.2). This represents a slight improvement on 2012 and we expect insolvencies to decrease somewhat in 2014.

Chart 4.2 Regional insolvency levels

(Index, 2007 = 100)



Source: Atradius Economic Research

Behind this aggregate picture there is substantial variation in regional performance. The developed part of Asia-Pacific is the only region where the level of insolvencies is currently lower (-8%) than in 2007. In this region the insolvency outlook for 2014 is stable. In the US the level of insolvencies have continued to decrease throughout the year and the outlook is positive, but insolvencies are still 33% higher than in 2007.

The insolvency developments across different parts of Europe display wide variation. While the level of insolvencies in the UK continued to decrease in 2013, it is still 25% higher than before the crisis. In the Nordic region, which has experienced a rise in insolvencies in the first three quarters of this year, the number is now a massive 66% higher than in 2007. Both these regional clusters are expected to show some improvement in 2014.

In aggregate, the Eurozone continues to perform poorly: consistent with the difficult economic climate in recent years, insolvency risk continued to rise across the Eurozone in 2013. Currently the level of insolvencies is twice as high as in 2007 (+204%). This is mainly driven by the worsening conditions in the Eurozone periphery: in this regional cluster the level of business failures stands roughly four times (+373%) higher than before the crisis. And given the economic outlook for the countries directly at the centre of the sovereign debt crisis, this negative insolvency trend is set to continue. We expect the insolvency index for the Eurozone periphery to reach 383 in 2014.

Insolvency forecasts by country

The updated insolvency forecasts for a selection of large countries (generated by our insolvency assessment framework as outlined in Box 4.1) are presented in Table 4.1. These forecasts, underlying the insolvency indices discussed in the previous chapter, show that we expect zero insolvency growth in most countries, and for the remaining countries the expected changes are small relative to the most recent insolvency growth figures.

Since the current situation is of a relatively poor insolvency environment, the degree of forecast improvement is marginal: with the aggregate index improving, from 145 in 2013 to 142 in 2014.

Table 4.1: Insolvency growth (% per annum)

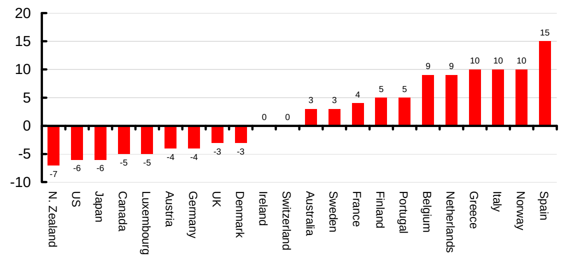
f=forecast	2011	2012	2013f	2014f
Australia	5	1	3	0
Austria	-8	3	-4	0
Belgium	7	4	9	0
Canada	-11	-12	-5	0
Denmark	-15	0	-3	-5
Finland	3	0	5	-2
France	-1	3	4	0
Germany	-6	-6	-4	0
Japan	-4	-5	-6	0
Netherlands	-1	21	9	0
New Zealand	-12	-8	-7	0
Norway	-2	-12	10	-2
Spain	14	38	15	2
Sweden	-4	7	3	0
Switzerland	7	3	0	0
United Kingdom	5	-4	-3	-3
United States	-15	-16	-6	-5

Source: National bureaus, Atradius Economic Research

Countries showing a worsening trend

Chart 4.3 shows projected insolvency developments by country in 2013, sorted by magnitude of insolvency growth (from best to worst). We have witnessed an increase in the number of insolvencies in eleven countries this year compared to last year. Apart from countries in the south of the Eurozone (i.e. Greece, Italy, Portugal and Spain), Belgium, the Netherlands and Norway are also among the worst performing markets.

Chart 4.3 Change in insolvencies 2013
(Insolvency growth expressed in %, October forecast)



Source: Atradius Economic Research

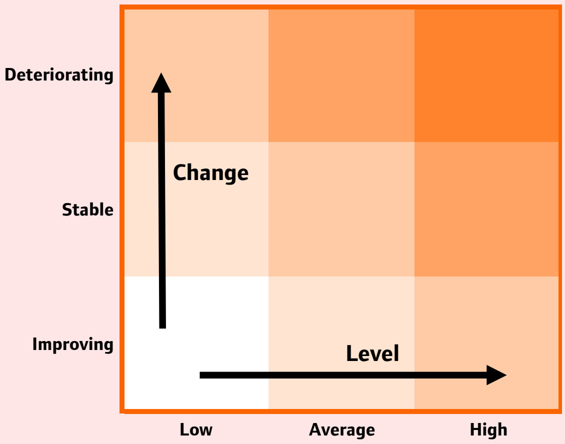
Australia, Sweden, France, Finland and Portugal have also experienced an increase in insolvencies. This worsening situation takes as its starting point already high insolvency levels. Putting the dynamics into perspective, once again using 2007 as a comparison benchmark, makes this very evident (see Chart 4.4). In both Finland and Norway the number of insolvencies is about 60% higher, and in France 20% higher. These markets have experienced a massive increase in defaults since the previous downturn and, given the protracted recessionary conditions, insolvencies are expected to rise further.

Box 4.1: Insolvency assessment methodology

Our insolvency forecast framework delivers expectations of insolvency conditions by market, given the current Economic Outlook. We focus on countries where we have access to sufficient statistics. Two dimensions are important when describing insolvency conditions: the expected change in the number of insolvent firms over the coming period (i.e. the insolvency growth forecast) and the current level of defaults (i.e. the proportion of defaulting firms among the total number of enterprises).

The level gives information on what type of market a particular country represents in terms of default dynamics, and indicates the general likelihood of firms going bankrupt. The insolvency growth forecast reflects our expectation of how the default level will develop (i.e. it shows whether the level of risk is likely to stay the same or change).

Figure 1: Risk Matrix



The countries included in our insolvency assessment framework are classified according to their level and expected change (see Figure 1). The vertical axis depicts the expected change in the default level in 2013 (i.e. whether the insolvency growth forecast is positive, neutral or negative). As such, all countries expected to see deterioration in their insolvency environment this year are to be found in the top segment.

The horizontal axis depicts the absolute level of defaults (i.e. whether the frequency of defaults in a country is assessed as low, average or high). As such, all countries that are perceived as markets characterised with comparatively high default frequencies are to be found in the right-hand segment. This classification provides a high-level overview of underwriting risks across our most important markets for short-term credit insurance.

Our insolvency assessments are based on analysis of historical insolvency statistics for each market. We use these insolvency statistics to produce a corporate failure growth proxy, assuming that the observed insolvency counts are proportional to the total number of (partly unobserved) business failures. The default level assessment is an indication of the relative frequency of insolvencies within a country over time and has been designed to aid comparability across countries.

On average, insolvency growth dynamics tend to respond more or less instantaneously to changing macroeconomic conditions. Although the empirical relationship varies in strength, insolvency growth displays a certain degree of co-movement with the business cycle across most markets: when economic growth in a country accelerates above its trend, this is usually associated with falling insolvency numbers; and conversely, when economic growth slows, it is usually accompanied by rising insolvency numbers.

As our ultimate aim is to link current expectations of macroeconomic performance in the year ahead to implied insolvency movements, we use up-to-date country-specific forecasts of macroeconomic performance to estimate an insolvency response. Based on country-specific information on the trend in actual insolvency developments, this mechanical response is adjusted by expert judgement in a second step. Structural conditions and other country-specific features are also taken into account when determining the insolvency forecasts.

Chart 4.4 Insolvency developments

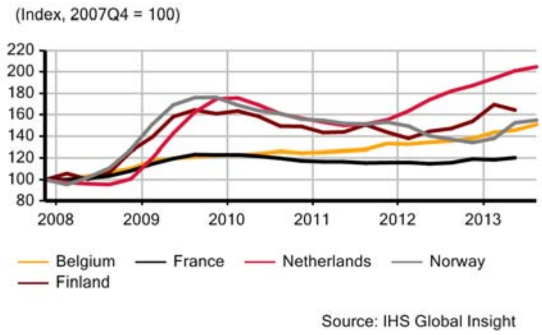
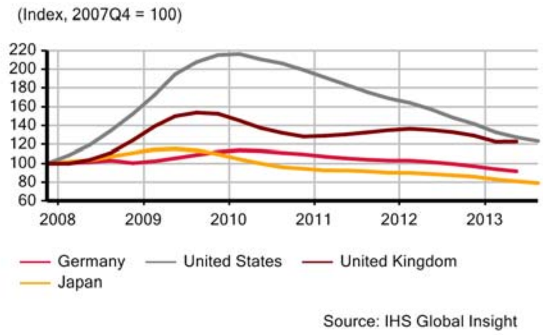


Chart 4.5 Insolvency developments



In Belgium and the Netherlands insolvencies have trended to record readings. Both countries have suffered steep insolvency increases in response to the recessionary conditions in 2012 and the beginning of 2013. The number of insolvencies in the Netherlands is currently more than twice as high as before the crisis.

Countries showing improving conditions

But, as shown in Chart 4.5, there are also several countries in which insolvency conditions have improved over 2013. Apart from Switzerland and Ireland, where the insolvency environment has remained unchanged since last year, nine countries have experienced negative insolvency growth: Austria, Canada, Denmark, Germany, Japan, Luxembourg, New Zealand, the United Kingdom and the United States.

In contrast to most other Eurozone countries, the number of German insolvencies has declined in a stable fashion throughout recent years (see Chart 4.5). Compared to 2007 the level of insolvencies in Germany stands 5% lower, representing quite benign default conditions. The corresponding index figure for Japan is roughly 20% lower. Insolvencies in the US have continued to decrease this year and, in light of the relatively favourable business cycle performance, insolvencies are expected to decrease by 6% in 2013. Although the level of insolvencies is about 20% higher than in 2007, the developments over the past three years bear witness to substantial improvement.

There are also countries where default rates are perceived as high but are expected to improve somewhat as their economies slowly recover in 2013. Even if the number of insolvencies is decreasing slightly in Denmark, it should be stressed that the level of business failures is still very high. Danish insolvencies are now three times higher than before the crisis. Almost half the countries included in our insolvency framework are currently classified as 'high' insolvency markets.

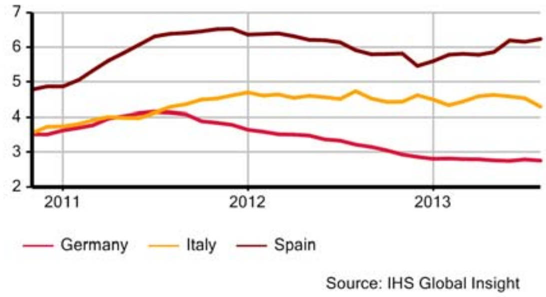
Solvency determinants

Broad-based insolvency dynamics, applying to small as well as large firms, are not only determined by GDP growth performance: these dynamics are also influenced by the prevailing credit conditions and firms' access to financing. As argued in Chapter 2 of this report, lending conditions are still strained, especially in the Eurozone, adding to the vulnerability of highly leveraged firms.

This is an important factor behind our assessment of continued poor insolvency dynamics in countries in the European periphery. While German firms (enjoying more favourable domestic demand conditions) face decreasing lending rates, their Spanish and Italian counterparts are facing high - and in Spain even increasing – lending rates (see Chart 4.6).

Chart 4.6 Lending rates to non-financial firms

(Average lending rates of 5-year maturity, percent)



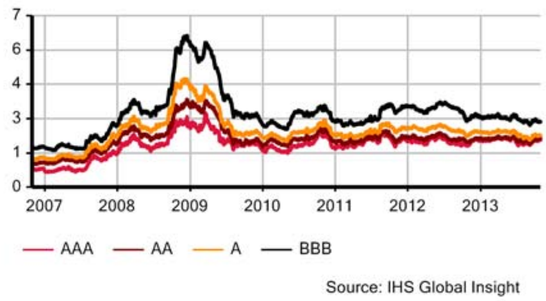
Other credit risk indicators

Consistent with the persistently elevated insolvency levels outlined above, a similar pattern of general default risk is also visible in other metrics of corporate credit risk. The pool of large firms in the listed corporate universe is associated with significantly higher default risk than five years ago.

Corporate bond spreads, a useful external benchmark for the degree of perceived credit risk, have also been stuck at a relatively high level since 2010. Some reduction in the spreads has taken place over the past year, but the current level indicates that the perception of corporate credit risk remains relatively high (see Chart 4.7).

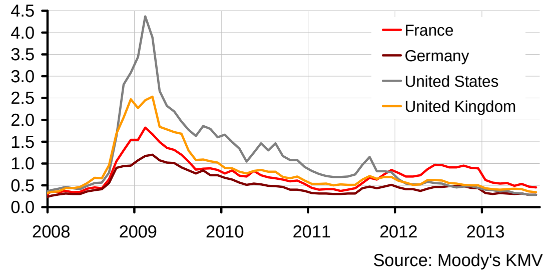
Chart 4.7 US corporate bond spreads

(Yield spread by rating category, percentage points)



We have experienced a general improvement in default expectations across large firms throughout 2013. The median **Expected Default Frequency** (EDF) in the pool of US firms has fallen further: below 0.3%, implying a level similar to the one seen in 2007.[10] The general stock market uplift and the relatively low volatility environment during the past six months lies behind these developments. The EDFs have also broadly declined since the middle of last year across European countries (see Chart 4.8).

Chart 4.8 Median EDF
(Default risk 12 months ahead, percent)



Comparing the EDF developments with the insolvency index it can be seen that the current risk level is still higher than its pre-crisis reading. Across the Eurozone markets directly affected by the Eurozone debt crisis, the risk still lingers at historically high levels, in spite of recent improvements. The Greek median default expectation is still in excess of 7%. The corresponding figure for Portugal is just below 2% and in Italy the median EDF stands at roughly 1%.

In terms of companies **credit rating developments**, as reflected in the actions of rating agencies, the trend of general deterioration in credit quality has continued in 2013. Negative rating actions (from the three major rating agencies) are continuing to dominate positive ones across advanced markets.

But the situation in Western Europe is definitely worse than in North America: consistent with an expected poor business climate there are currently about two downgrades for each upgrade taking place. In North America, the ratio between upgrades and downgrades is close to one-to-one, with an improving trend over the past three quarters: at least in this region credit ratings are finally showing faint signs of improvement.

Brighter expectations, but tail risks remain

The current scenario for economic performance in 2014 implies another challenging year for businesses, particularly in Europe. Although an

[10] The Expected Default Frequency (EDF) tracks default risk among stock listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year default forecast.

The median EDF, as referred to in the charts below, represents the 50th percentile in the total country aggregate of firms.

improvement is expected for 2014 as discussed in this report, performance is still representative of sluggish economic conditions. And there are downside risks to this already stretched scenario throughout the forecast horizon. Additional years of slow economic growth contribute to upward pressure on business failures in markets already characterised by high default rates.

Even if growth in real GDP represents the most central variable in our aggregate insolvency framework, other factors influence the likely path of insolvencies. The restrictive financing conditions, for example, have a more negative impact on the default environment within the corporate sector when the level of leverage is relatively high, as alluded to earlier in this report.

Constrained lending behaviour across the European Union continued in the third quarter of 2013. Looking forward, it is plausible that credit conditions will tighten further in Europe throughout 2013. Against the background of the current growth outlook and financial sector vulnerabilities we are faced with an unbalanced risk assessment around our insolvency forecasts: the likelihood of seeing a general increase in insolvencies is therefore greater than the chance of seeing a substantial improvement in 2014.

Appendix I: Forecast tables

Table A1: Macroeconomic headline figures - Developed markets

	GDP growth (%)			Inflation (%)			Budget balance (% of GDP)			Current account (% of GDP)			Export growth (%)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Australia	3.6	2.4	2.4	1.8	2.1	2.5	-2.7	-1.4	-1.2	-3.7	-2.5	-2.8	6.0	5.8	3.1
Austria	0.6	0.5	1.8	2.5	1.9	1.9	-2.5	-2.1	-1.6	1.8	2.5	2.8	1.7	1.8	4.2
Belgium	-0.3	0.1	1.3	2.8	1.2	1.6	-3.9	-3.1	-2.9	-1.9	-0.6	-0.2	0.7	0.4	4.7
Canada	1.7	1.7	2.5	1.5	1.0	1.6	-3.4	-2.7	-1.4	-3.4	-2.9	-2.1	1.5	1.3	4.0
Denmark	-0.4	0.3	1.6	2.4	0.8	1.5	-4.0	-2.2	-2.4	5.6	5.0	5.4	0.2	1.3	4.9
Finland	-0.8	-0.7	1.2	2.8	1.8	2.1	-1.9	-2.5	-2.5	-1.8	-1.5	-1.3	-0.4	-1.5	2.7
France	0.0	0.2	0.6	2.0	1.0	1.6	-4.8	-4.0	-2.9	-2.2	-1.9	-1.8	2.5	0.8	1.4
Germany	0.9	0.6	1.8	2.0	1.6	1.6	0.1	0.1	0.0	7.0	6.6	6.0	3.8	1.4	5.5
Greece	-6.4	-4.0	-1.0	1.5	-0.5	-0.1	-10.0	-5.2	-4.1	-3.4	-1.7	-0.7	-2.4	0.1	1.6
Ireland	0.1	-0.2	1.8	1.7	0.8	2.1	-7.5	-7.8	-5.5	4.4	3.1	3.2	1.6	0.8	3.2
Italy	-2.6	-1.9	-0.3	3.0	1.3	1.5	-3.0	-3.4	-3.1	-0.5	0.9	1.2	2.2	-0.4	1.1
Japan	2.0	1.9	2.0	0.0	0.2	2.7	-10.1	-9.7	-7.3	1.1	1.3	0.8	-0.1	3.7	10.4
Luxembourg	0.3	0.5	2.1	2.7	1.8	2.2	-0.8	-1.1	-0.5	5.7	4.9	6.6	-2.7	3.2	5.2
Netherlands	-1.3	-1.1	0.7	2.5	2.6	1.9	-4.9	-4.9	-3.9	10.1	9.5	9.3	3.2	2.5	3.7
New Zealand	3.2	2.1	2.8	1.1	1.0	2.1	-4.1	-3.9	-2.0	-5.0	-5.8	-6.6	2.6	-0.1	1.7
Norway	3.0	0.7	1.5	0.7	2.1	1.9	13.9	12.5	11.7	14.2	12.2	12.2	1.8	-2.8	1.0
Portugal	-3.2	-1.9	0.2	2.8	0.4	0.8	-6.4	-5.5	-4.3	-1.5	0.1	1.0	3.2	6.3	3.0
Spain	-1.6	-1.4	-0.3	2.4	1.5	1.3	-10.6	-7.4	-6.3	-1.1	1.0	1.2	2.1	4.7	3.2
Sweden	1.3	0.7	1.9	0.9	0.1	1.4	-0.5	-1.3	-0.7	6.9	6.8	7.0	1.1	-1.6	1.5
Switzerland	1.0	1.9	1.9	-0.7	-0.2	0.5	0.4	0.2	0.4	13.6	12.3	11.7	2.5	2.5	3.6
United Kingdom	0.1	1.4	2.4	2.8	2.7	2.5	-6.0	-5.8	-5.5	-3.8	-3.5	-2.7	1.0	1.2	3.3
United States	2.8	1.5	2.5	2.1	1.5	1.6	-8.1	-5.1	-5.2	-2.7	-2.5	-2.4	3.5	2.2	4.8
Eurozone	-0.6	-0.5	0.8	2.3	1.4	1.6	-3.7	-3.1	-2.6	1.9	2.4	2.4	2.6	1.5	3.7
European Union	-0.4	0.0	1.2	2.5	1.5	1.7	-3.9	-3.4	-2.9	1.0	1.5	1.5	2.4	1.6	3.6

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2013 Q2). Date of forecast, 15 October 2013. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

Table A2: Macroeconomic indicators - Developed markets

	Private cons. (%)			Fixed inv. (%)			Gov. cons. (%)			Retail sales (%)			Industrial prod. (%)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Australia	3.3	2.0	2.6	8.7	-1.1	2.2	3.1	0.7	0.3	1.3	0.4	1.2	3.8	2.3	2.4
Austria	0.3	-0.1	1.2	1.7	-2.3	2.8	0.0	0.9	1.0	-0.7	-0.2	0.1	1.9	0.8	3.6
Belgium	-0.3	0.5	0.8	-0.6	-2.7	0.4	0.4	0.3	0.5	0.4	1.1	0.9	-3.2	0.8	1.6
Canada	1.9	2.2	2.5	4.4	0.8	2.7	1.1	1.4	1.7	1.0	1.6	2.8	0.9	0.9	2.4
Denmark	0.5	0.1	0.5	-0.1	-0.2	1.0	0.7	-0.6	0.7	-2.2	-1.5	0.0	-0.7	1.3	0.9
Finland	0.2	0.0	1.0	-1.0	-2.4	2.3	0.6	0.6	0.3	-1.7	-1.7	0.3	-1.5	-2.3	2.6
France	-0.3	0.2	0.2	-1.2	-2.3	0.7	1.4	1.4	0.8	-1.3	-0.2	0.2	-2.5	-0.6	1.2
Germany	0.7	1.2	1.8	-1.3	-0.5	5.4	1.0	1.0	1.4	-0.1	0.7	1.0	-0.4	0.8	5.7
Greece	-9.1	-5.7	-2.3	-19.2	-8.3	-2.4	-4.2	-5.8	-2.1	-12.3	-8.0	-2.1	-3.4	-2.6	-0.3
Ireland	-0.3	-0.4	2.6	-0.7	-7.5	5.8	-3.8	-1.4	0.6	-2.7	-0.2	-0.7	-1.5	-0.5	2.1
Italy	-4.3	-2.5	-0.3	-8.0	-5.5	-0.9	-2.9	-0.3	-0.6	-4.7	-3.5	-1.8	-6.3	-3.7	-0.8
Japan	2.4	1.9	2.0	4.3	3.3	3.3	2.4	0.8	0.1	1.8	0.3	0.6	0.2	-0.7	6.1
Luxembourg	1.7	0.9	2.8	7.1	0.3	6.0	4.9	2.8	2.2	21.1	16.8	4.4	-5.5	-2.2	6.3
Netherlands	-1.6	-1.9	0.3	-4.0	-8.0	1.3	-0.7	-0.8	0.9	-3.5	-3.6	-1.6	-0.4	0.5	1.0
New Zealand	2.4	3.4	2.6	6.4	8.0	9.6	0.5	-0.1	0.6	2.6	2.8	2.3	0.6	1.8	2.7
Norway	3.1	2.3	1.1	8.1	6.1	2.4	1.7	2.5	2.4	2.8	0.1	0.4	2.8	-3.8	1.9
Portugal	-5.4	-2.5	-0.3	-14.3	-8.2	0.0	-4.8	-2.5	-0.5	-8.2	-2.3	0.2	-5.0	0.5	1.0
Spain	-2.8	-2.7	-0.4	-7.0	-6.3	-1.4	-4.8	-1.4	-1.2	-6.4	-4.4	-0.9	-6.0	-2.1	0.1
Sweden	1.7	1.7	1.6	3.6	-3.2	2.3	1.1	1.3	1.4	1.0	1.7	1.1	-1.1	-3.6	2.1
Switzerland	2.4	2.5	1.8	-0.4	1.3	4.1	3.2	1.6	0.9	1.9	1.1	2.4	2.4	1.9	5.2
United Kingdom	1.2	1.9	2.3	0.9	-1.8	6.6	1.7	0.0	-0.5	-0.4	0.3	1.2	-2.4	-0.4	2.3
United States	2.2	1.9	2.5	5.5	2.7	5.8	-0.2	-1.8	0.2	3.1	2.8	2.2	3.6	2.4	3.1
Eurozone	-1.4	-0.7	0.5	-3.7	-3.4	1.7	-0.6	0.2	0.5	-	-	-	-2.7	-0.8	2.2
European Union	-0.8	0.0	1.0	-2.6	-3.0	2.3	-0.1	0.3	0.4	-	-	-	-2.3	-0.6	2.3

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2013 Q2). Date of forecast, 15 October 2013. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

Table A3: Macroeconomic headline figures - Emerging markets

	GDP growth (%)			Inflation (%)			Current account (% of GDP)			Private cons. (%)			Export growth (%)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Asia Pacific*	6.7	5.7	5.8	5.7	3.7	3.5	1.3	1.2	1.9	6.5	5.6	5.3	7.6	2.8	4.2
ASEAN	5.5	4.8	4.7	3.9	4.5	4.5	2.6	2.5	2.5	5.6	4.5	4.9	2.1	2.7	4.8
China	7.7	7.8	8.0	2.7	2.4	2.8	2.3	3.0	2.7	8.2	8.3	8.4	3.3	3.9	5.7
Hong Kong	1.5	3.1	4.0	4.1	4.3	3.9	1.3	2.2	3.1	3.0	4.8	4.6	1.9	5.9	6.5
Taiwan	1.3	2.6	3.8	1.9	0.8	1.3	10.5	10.9	10.3	1.5	1.7	2.7	0.1	4.1	5.1
India	3.2	4.4	5.6	9.7	9.6	8.1	-4.8	-4.2	-4.1	4.0	3.9	4.0	3.0	5.7	8.8
Singapore	1.3	2.8	3.6	4.5	2.5	3.1	18.6	21.7	19.7	2.2	2.6	4.1	0.3	2.9	4.0
Latin America	2.4	3.1	3.4	6.6	8.1	7.5	-1.7	-2.5	-2.4	4.0	3.0	3.4	1.0	2.6	5.1
Argentina	1.9	4.3	1.8	10.0	11.7	15.5	0.0	0.2	0.1	4.4	5.1	2.1	-6.6	-2.1	3.9
Brazil	0.9	2.4	3.1	5.4	6.1	5.5	-2.4	-3.3	-3.1	3.1	2.0	3.3	0.5	2.0	6.3
Mexico	3.8	1.4	3.3	4.1	4.6	3.9	-1.0	-0.8	-0.7	4.6	2.6	3.3	4.2	2.6	5.5
CIS	3.6	2.5	3.6	5.8	6.5	5.9	2.6	1.7	1.7	7.8	5.6	4.1	0.4	0.3	2.3
Czech republic	-0.9	-1.0	2.2	3.3	1.4	1.5	-2.4	-1.4	-1.5	-2.1	0.3	1.7	4.7	0.8	4.4
Hungary	-1.8	0.5	1.6	5.7	1.9	2.9	1.0	1.8	2.4	-1.9	0.1	1.3	2.0	3.3	1.8
Poland	1.9	1.1	2.7	3.7	1.1	2.4	-3.7	-1.9	-2.2	0.8	0.8	2.5	2.7	4.3	4.5
Russia	3.4	2.1	3.3	5.1	6.7	5.5	3.5	2.1	1.6	6.8	4.5	4.4	1.4	0.6	0.8
Turkey	2.2	3.0	3.7	8.9	7.3	6.9	-6.1	-7.5	-7.8	0.3	3.9	3.3	16.7	2.8	4.0
Africa	5.8	3.5	5.1	8.6	7.1	7.4	-1.2	-3.2	-3.1	4.9	4.2	2.9	9.1	3.2	5.6
South Africa	2.5	2.0	3.0	5.6	6.0	6.0	-6.2	-6.3	-6.8	3.5	2.4	2.7	0.1	5.4	5.6
MENA	4.2	2.5	4.0	7.4	7.8	6.2	13.1	9.9	7.4	3.0	3.6	3.2	4.9	0.5	3.6
BRIC	5.3	5.7	6.4	4.4	4.5	4.2	0.8	1.1	1.0	6.0	5.5	6.0	2.7	3.4	5.4
World	2.6	2.4	3.3	3.2	2.9	3.1	-	-	-	2.4	2.4	2.9	2.7	2.4	4.7

Source: IHS Global Insight

Note: * Excluding Japan

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2013 Q2). Date of forecast, 15 October 2013. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

Appendix II: Country risk

Country risk

Companies that do business internationally rely on the stability of the business environment in the foreign country. Profits and investments are vulnerable to adverse developments in this environment. These risks are broadly termed 'country risk'. The level and change in country risk is therefore an important strategic and operational indicator for international companies.

Country risk covers a wide range of factors such as political developments, the risk of (armed) conflict and sovereign financial situation. These factors relate, for example, to regulatory changes, the risk of confiscation, civil unrest, war, currency controls and devaluations. Country risk takes into account a sovereign's willingness and ability to pay and the impact of this on the ability of public or private entities to meet their cross-border payment obligations. Under its political risk contract, Atradius provides cover against a subset of events that are labelled 'country risk'. This protection allows for companies to safely make transactions across borders.

The STAR rating

STAR is Atradius' in-house political risk rating. STAR stands for Sovereign Transfer and Arbitrary Risk and represents a rating system for assessing country risk. The STAR rating is designed as a summary measure of political risk relevant under the Atradius insurance contract and explicitly targets the impact on public or private entities with cross-border payment obligations.

The STAR rating runs on a scale from 1 to 10, where 1 represents the lowest risk and 10 the highest risk. In addition to the 10-point scale, there are rating modifiers associated with scale steps: 'POSITIVE', 'STABLE', and 'NEGATIVE'. These rating modifiers are referred to as 'notches' and allow further granularity and differentiate more finely between countries in terms of risk.

Table A4 The STAR rating scale

Credit type	Grade	STAR rating	Sovereign type
'Investment grade'	High quality	1	AAA
		2 POSITIVE	AA+
		2 STABLE	AA
		2 NEGATIVE	AA-
	Good	3 POSITIVE	A+
		3 STABLE	A
		3 NEGATIVE	A-
		4 POSITIVE	BBB+
		4 STABLE	BBB
		4 NEGATIVE	BBB-
'Speculative grade'	Adequate	5 POSITIVE	BB+
		5 STABLE	BB
		5 NEGATIVE	BB-
	Impaired	6 POSITIVE	B+
		6 STABLE	B
		6 NEGATIVE	B-
		7 POSITIVE	CCC+
		7 STABLE	CCC
		7 NEGATIVE	CCC-
	Prohibitive conditions	8	CC / C
		9	SD / D
	Off cover	10	

The principal features of the STAR rating scale are demonstrated in Table A4. The 10 rating steps are aggregated into five broad categories to allow their interpretation in terms of credit quality. Starting from the most benign part of the quality spectrum, these categories range from 'High Quality', 'Good', 'Adequate', 'Impaired' to 'Prohibitive Conditions', with a separate grade reserved for 'Off Cover'.

Recent developments

On the next page we summarise country risk conditions across the globe as measured through the STAR rating. Exhibit 1: Overview in the shape of a risk map; Exhibit 2: STAR rating changes taking place between 2013Q1 and 2013Q3.

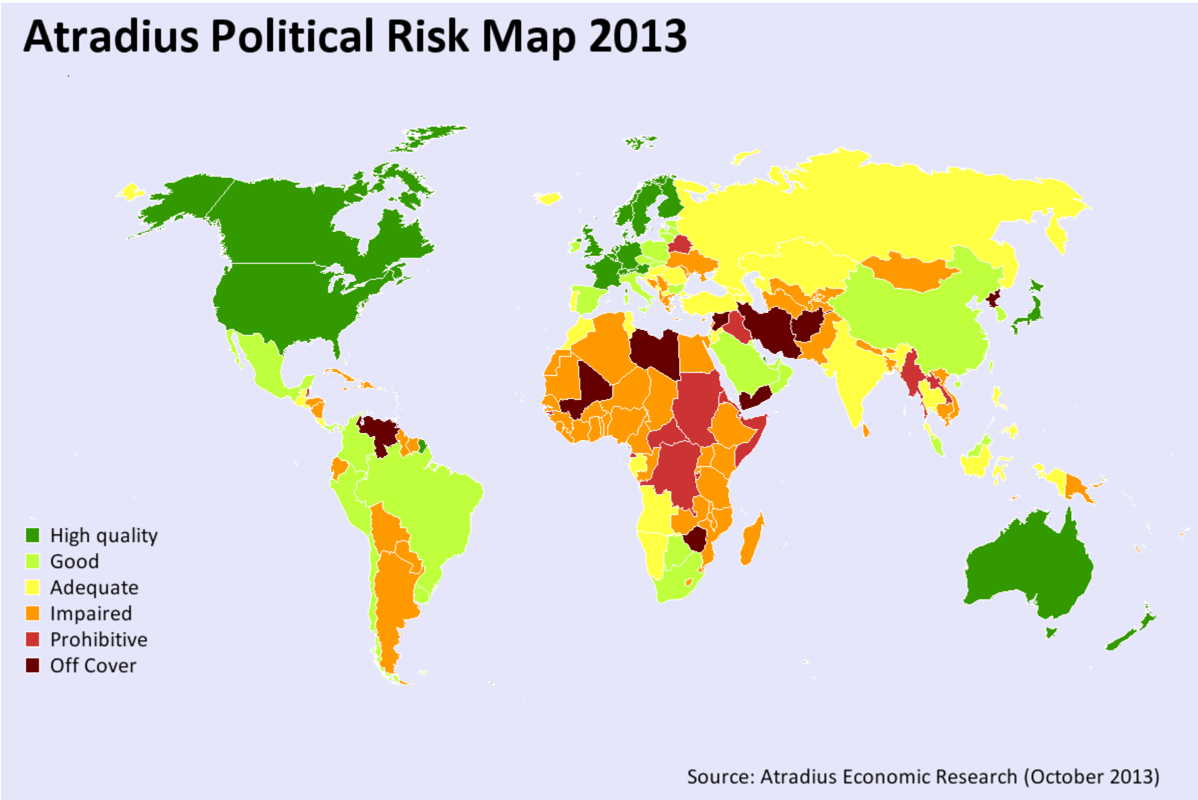
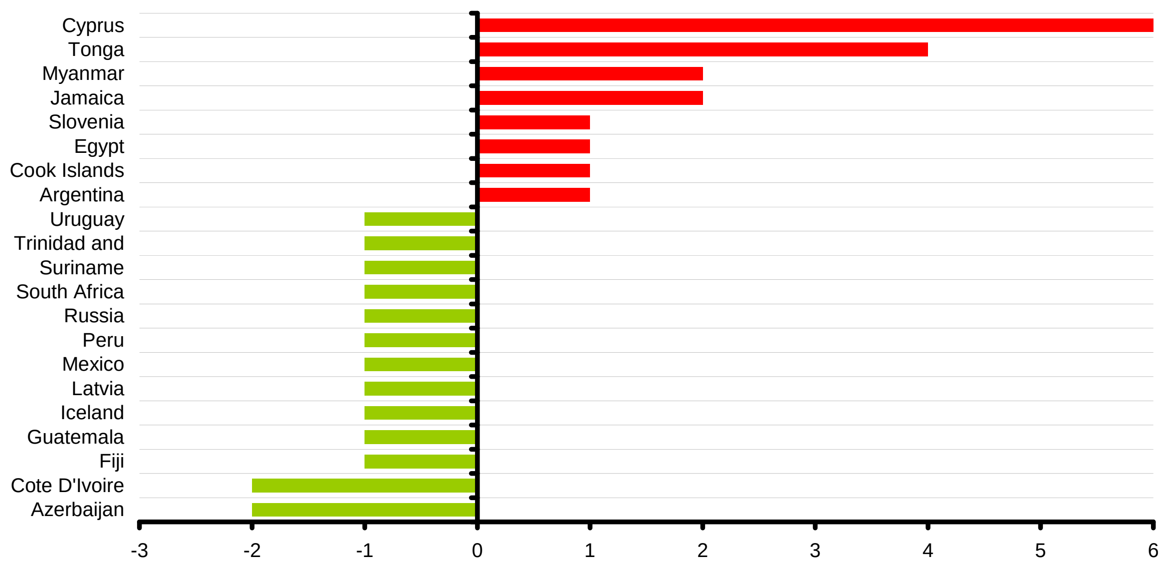


Chart A1 STAR rating changes (2013 Q1 - 2013 Q3)
(Notch movement: Upgrade '-', Downgrade '+')



Source: Atradius Economic Research

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