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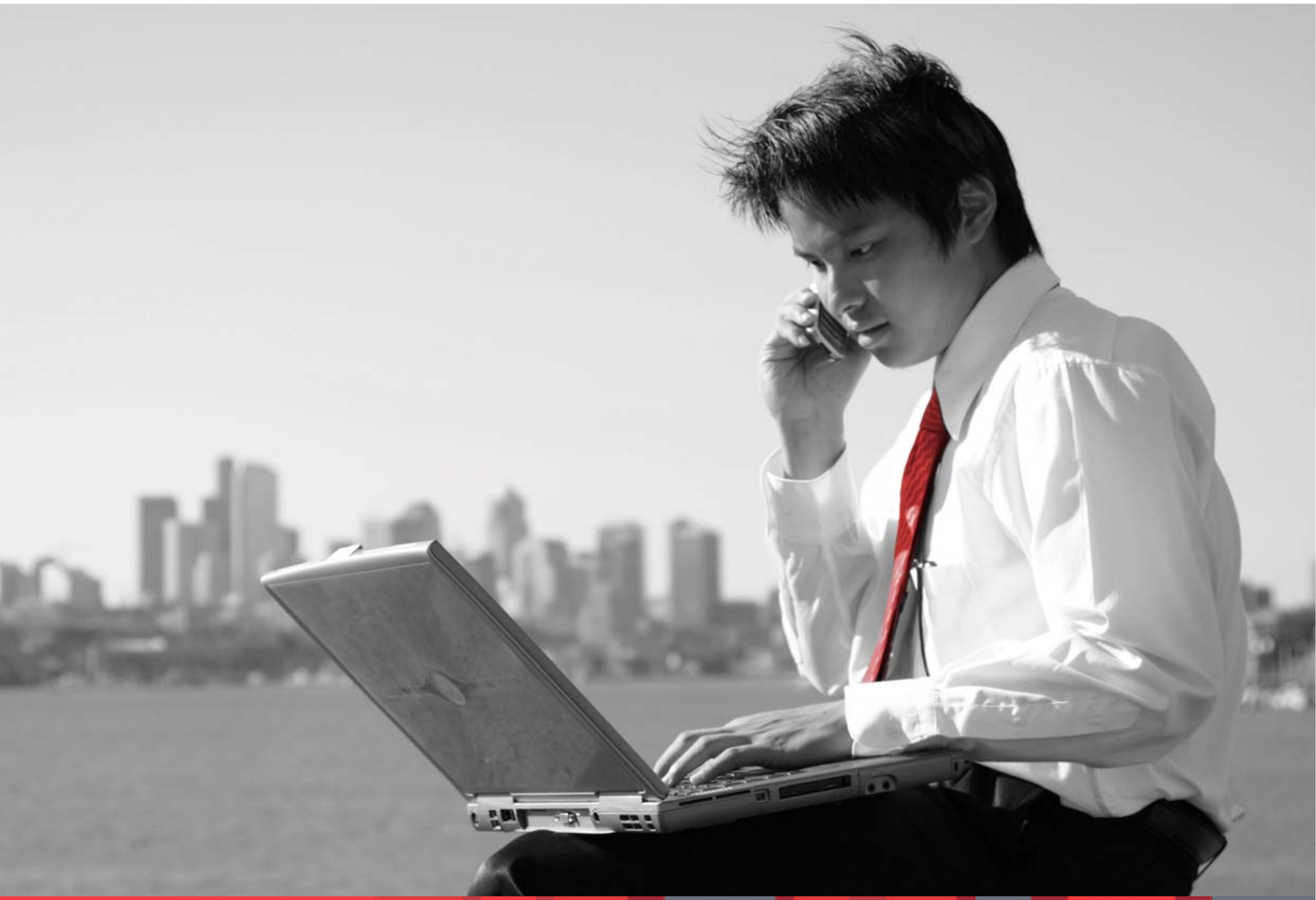

Economic Outlook
May 2013

Editorial

In last November's Economic Outlook we argued that we had moved away from the abyss of another economic crisis. That position was founded on the encouraging policy steps in the Eurozone that had been taken in June 2012. Steps, indeed, that had calmed the financial markets: in particular, European Central Bank (ECB) president Draghi's commitment '…to do whatever it takes...'. But at the same time we were seeing a continuation of the significant slide in global economic growth that had begun earlier in the year. The question was whether this slide would stop.

It didn't. 2012 ended with just 2.6% global growth and a 0.5% contraction in the Eurozone. So hopes then turned to 2013: hopes that the crisis would end, pulling the Eurozone out of recession over the course of this year and spurring global growth. On that assumption, back in November 2012 our expectations were for (still muted) global growth of 2.8%. Now, in May 2013, it has become increasingly clear that the Eurozone will again contract this year – probably by 0.4% - and global growth forecasts for 2013 have been gradually scaled back to 2.6%: a level supported by Asia (4.8% growth), Latin America (3.4%) and, to a lesser extent, the United States. For 2014 a similar picture is by and large expected to emerge, except that the Eurozone will at last show some recovery (0.9% growth), boosting global growth to 3.2%.

Financial market recovery in the Eurozone has not been sufficient to generate a recovery in the real economy. The question then naturally arises 'What do we need financial markets to do to make real progress?' A few, perhaps familiar, answers present themselves.

Firstly, the financial markets can and should be calmed by the resolute implementation of the policy steps towards a banking union that have already been announced. This is critical, as it breaks the dangerous feedback loop between sovereigns and banks in parts of the Eurozone.

Secondly, and perhaps even more importantly at this stage, the monetary transmission mechanism should be restored. Despite ample liquidity, banks are still reluctant to lend - especially to smaller firms, which are an important source of (potential) growth.

Thirdly, another dangerous feedback loop - the one between fiscal consolidation and growth - needs to be firmly addressed. The IMF has been calling for a scaling back, or at least mitigation, of fiscal consolidation for the past couple of months and European countries seem increasingly inclined to this course. But care should be taken to avoid a further increase in debt levels. This is critical because it is precisely the correction of debt levels, public and private, that largely explains the current underlying contraction in advanced economies. Running up debt levels would simply delay that deleveraging process and therefore the return to growth.

With the rather weak state of the global economy in mind, it comes as no surprise that the insolvency environment for 2013 remains unfavourable in many markets, and even deteriorates in quite a number of them. We qualify that situation as stabilisation at a high level, although with marginal improvements. Reflecting the pattern of global growth, the trend in insolvencies has improved in the emerging economies and the US, but deteriorated in the Eurozone. Indeed, the growing importance of the emerging economies is reflected in the focus that we place on them in this report.

My thanks go to my colleagues Paul Burger, Marijn Kastelein and Afke Zeilstra for their contributions to the section on emerging economies, to Daan Willebrands for elucidating the major issues for advanced economies, to Niklas Nordman for his work on the insolvency section of the report, and to Daniel Bosgraaf, the latest addition to our team, for his support throughout.

John Lorié, Chief Economist Atradius Group

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Executive summary

The global economic environment has weakened over the past six months and we expect only modest economic growth in 2013. Global growth is projected to improve at the end of the year due to a better economic performance in the United States and stabilisation of the Eurozone economy. However, there is a high risk that economic growth will be even slower than pictured in this outlook.

Key points

- Global economic growth is expected to stabilise at 2.6% this year as growth in advanced markets remains sluggish and emerging markets continue their strong performance.
- Eurozone GDP is expected to shrink further in 2013, at a rate of -0.4%. Growth in the United States is stable at 2.1%. Asia and Latin America show strong and slightly improving growth rates.
- Risks to the global outlook are high: the Eurozone crisis could intensify, fiscal consolidation may derail the economic recovery in the United States and growth in emerging markets may slow.
- While the overall insolvency environment stabilises, we forecast rising insolvencies in 10 out of the 22 markets that we track. Eurozone countries in particular will see a further increase due to the ongoing weak economic conditions.

Global growth is expected to reach 2.6% in 2013, more or less the same rate as last year. The global economy is forecast to gain speed at the end of the year and improve in 2014 to 3.2%. However, for this acceleration in growth to take place, a number of conditions need to be met. Firstly, the Eurozone should continue implementing banking union and make progress on fiscal and political integration. Secondly, the United States should reduce its front-loaded austerity. Thirdly, emerging markets have to maintain their rapid expansion. These assumptions are far from certain and therefore the downside risks to the outlook remain high.

Global trade grew by just 2.5% in 2012: well below the long-term average of 5.4%. We now expect slow trade growth in 2013 due to the weak global environment, credit constraints and increased protectionism. Trade between emerging markets is however expected to continue growing rapidly.

Advanced markets are characterised by a combination of fiscal consolidation and loose monetary policy. Despite the latter, bank lending conditions for both firms and households are still tough. The Eurozone will contract again this year, but may resume positive growth in 2014. Financial market conditions have improved significantly over the past six months, but this has yet to translate into better economic conditions. Unemployment in Europe has reached a record level and consumers remain pessimistic. Economic growth in the United States of 2.1% in 2013 and 2.7% in 2014 marks a relatively weak but steady recovery.

Emerging markets remain the driving force of global growth. Asia, excluding Japan, is expected to grow 6.6% this year, largely thanks to China, whose growth is projected to reach 8.2%. Latin America will benefit from this strong growth in Asia, increasing its growth to 3.4%, up from a moderate 2.7% last year. Eastern Europe is heavily influenced by the weak economic conditions in the Eurozone, but growth may pick up to reflect a better Eurozone performance in 2014. Emerging markets face risks associated with large capital inflows, as the expansionary monetary policy regimes in advanced markets seek profitable investment opportunities.

The weak global outlook is however consistent with a stabilisation of the insolvency environment in many markets, with the aggregate insolvency frequency even improving marginally in 2013. The Eurozone shows a moderate increase in the already high level of insolvencies, while the Eurozone periphery will see a more significant increase. Conditions improve in the Asia-Pacific region and the United States because of their relatively better economic conditions. In general terms, credit risk is elevated and will remain so throughout the forecast horizon.

1. The global macroeconomic environment

Light at the end of the tunnel remains faint

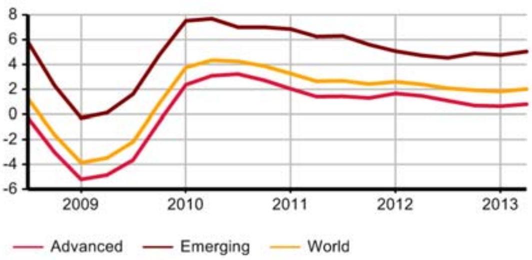
The global economic environment has deteriorated over the past six months and 2013 is not expected to be much better than 2012, although the consensus is that, in the second half of 2013, muted growth will resume in the Eurozone. That will raise global growth levels, which now rely on emerging economies and, to a lesser extent, the US. However, for this to happen, the Eurozone must stick resolutely to its path of policy change to improve the architecture of the monetary union. This is an issue fraught with risks - as recent events, such as those in Cyprus, show. Light at the end of the tunnel therefore remains faint.

Continued weakening of global growth…

Global growth slid further in 2012 as the impact of the Eurozone crisis began to spread to the world economy (see Chart 1.1). Growth was weak in the first three quarters (2.3% on average year-on-year compared to 2.6% in the same period of 2011), followed by a dismal fourth quarter (1.7% year-on-year compared again to 2.6% in 2011).

Chart 1.1 Real GDP growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

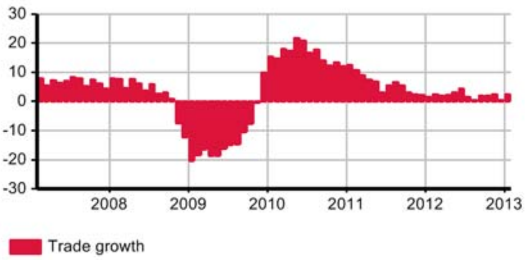
Global growth was dragged down by the advanced economies, whose average quarterly growth was just 1% in the first three quarters of 2012, compared to 1.4% in 2011. Indeed, especially in the fourth quarter, growth was minimal at 0.5% year-on-year (1.7% in 2011). Emerging markets too were affected: in particular, the average quarterly growth in the first three quarters of 2012 was 4.8% year-on-year compared to 6% in 2011, while the fourth quarter did not deviate much from the first three quarters' average of 4.8% (5% in 2011).

…and trade growth under pressure

Global trade continued to grow in 2012, albeit at a low rate (see Chart 1.2). With an outcome of 2.5%, trade growth was significantly down on 2011's 5% and well below the 5.4% long-term average.

Chart 1.2 World trade growth

(Annual percentage change in global trade volumes)



Source: IHS Global Insight

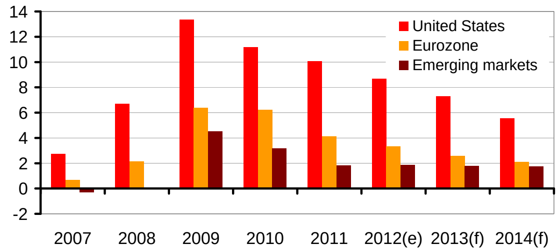
Indeed, this reflected developments in global economic activity, particularly in the advanced economies, as well as ongoing trade finance constraints and protectionism. [1] Imports in the advanced economies grew in 2012 by just 0.4% (down from 2.9% in 2011), and export growth slumped to 1.5% (from 4.6%). While the advanced economies trailed behind the 2.5% global figure, emerging economies' trade grew more prominently: with imports up by 5.4% and exports by 3.5%. Nevertheless, even these economies could not escape the impact of sliding global growth: falling from 2011's comparable figures of 8.3% and 5.3% respectively.

[1] The WTO reports a slowdown in the imposition of new trade-restrictive measures taken by countries and notes that a minimal majority of all measures are facilitating trade. But this hardly contributes to the downsizing of the stock of trade restrictions and distortions put in place since 2008.

No relief from fiscal policy…

Slow global growth calls for expansionary government policy, first and foremost in the Eurozone, but that is precisely what we are not seeing from the developments in the government deficit. In 2012 the Eurozone deficit was 3.3% lower than in 2011 (4.1%). This pattern is visible for the US and the emerging economies too. Fiscal consolidation is a global phenomenon and will continue to be so in 2013 and 2014. No relief, or at least very little, can be expected from fiscal policy – and it is worth investigating the reason why this is the case. Therefore, we will consider the various economic blocks separately (see Chart 1.3).

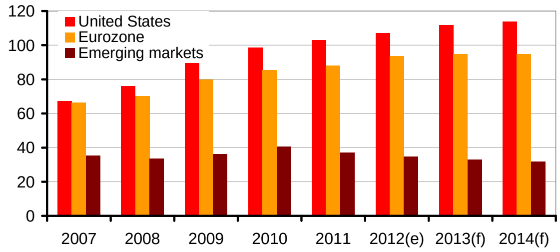
Chart 1.3 Government deficit
(Government budget balance as percentage of GDP)



Source: IMF

Firstly, looking at the US, its fiscal deficit has been reduced rapidly from 13.3% in 2009, although the expected deficit level for 2014 - at 5.6% - is still sizeable. The very high debt-to-GDP ratio of more than 100% can still be easily financed due to the depth of the US financial markets and the reserve currency role of the dollar (see Chart 1.4). Still, it is not thought to be sustainable and has to be contained. At the moment this is done by the automatic spending cuts that we will describe in more detail in Section 2 of this report, on the advanced economies, a process that will erode this year's growth by 0.7%. While the size of the consolidation seems indisputable, the mix of policy measures can be improved.

Chart 1.4 Government debt
(Government debt as percentage of GDP)



Source: IMF

Secondly, the Eurozone deficit - 3.3% in 2012 - is considerably lower than that of the US's 8.7%. That signals much more fiscal consolidation in the Eurozone than in the US which, in combination with its lower debt-to-GDP level compared to the US, suggests some fiscal leeway for the Eurozone. And arguably the Eurozone needs it, because it is currently in recession. However, fiscal stimulus is a politically sensitive issue and currently not on the cards. Deficits will be further reduced in 2013 and 2014: to 2.6% and 2.1% respectively. Nevertheless, building on the IMF warning to be careful with fiscal consolidation in a recession, the pace of consolidation in countries such as Greece, Portugal and even Spain is somewhat mitigated.

Thirdly, the emerging economies have kept their government deficits at roughly the same percentage of GDP and are expected to continue to do so in 2013 and 2014 (1.7% and 1.8%).[2] With quite low levels of debt-to-GDP, they are well placed to inject fiscal stimulus but will be reluctant to do so.[3] Strong growth in emerging markets means that inflation now looms large: in India inflation stood at 9.3% in 2012 and in Russia at 5.1%. Moreover, access to financial markets to finance government spending is a different matter for emerging economies than for advanced economies.

In summary, no relief can be expected from fiscal policy. There is very limited scope for fiscal stimulus in the advanced economies as deleveraging is needed to bring debt to GDP ratios back to pre Lehman levels. The emerging economies have a much better position but are constrained by

[2] At the current economic growth levels this implies a significant increase of government spending.
[3] China in particular has shown that it does not hesitate to increase government spending if needed. This was evident when an infrastructure programme worth USD 158 billion was announced in 2011, following the threat of a soft landing of growth.

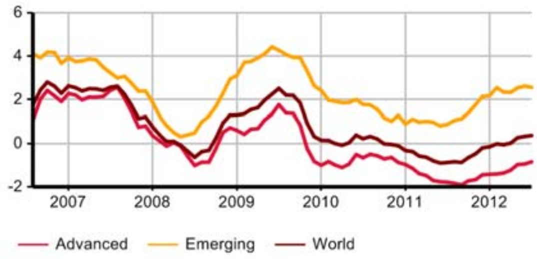
inflation and financial market access. Relief should come from monetary policy, which continues to be loose, but is largely ineffective at pushing the global economy to a higher growth path.

…but monetary policy loosening continues

While fiscal policy is constrained and no relief can be expected to accelerate the global economy, monetary authorities in the advanced economies continue to support demand - or at least attempt to do so. They do this by keeping the official interest rates low and providing ample liquidity to the banks: the latter policy has actually accelerated since our November 2012 Economic Outlook.

Chart 1.5 Real short-term interest rates

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



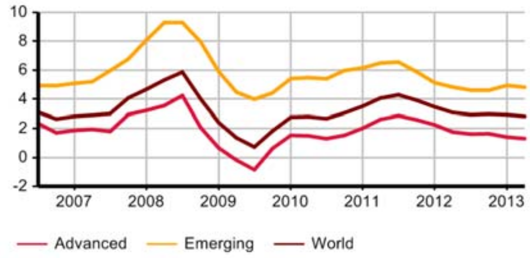
Source: IHS Global Insight

Real short-term interest rates - our price measure of monetary easing (or tightening) - have been globally flat since November, with official interest rates and inflation rates hardly moving (see Chart 1.5). And, at around zero percent, monetary easing is still in full swing, in line with what the global economy needs. However, this hides a notable convergence in real interest rates between advanced economies and emerging economies.

In the advanced economies, the official rates have remained low, at 0.125% in the US, 0.5% in the Eurozone and 0.5% in the UK. However, because of the slightly receding (and low) inflation rates in the advanced economies resulting from weaker demand (see Chart 1.6), the short-term real interest rate has risen and, indeed, this indicates some tightening of a still (very) loose montary policy.

Chart 1.6 Consumer price inflation

(Annual percentage change)



Source: IHS Global Insight

In the emerging economies we see the opposite. Official rates are quite high - Brazil 7.25%, China 6%, India 7% and Russia 5.25% - but have generally fallen since the late summer of 2012: even to the extent that monetary easing can be detected for the emerging economies. Monetary policy is loosening somewhat in the emerging economies, and this is somewhat puzzling in view of their rather high growth rates and relatively high inflation. We should therefore look at the second weapon in the Central Bank arsenal - liquidity provisioning - for an explanation.

Liquidity provisioning has continued to be plentiful in the advanced economies, and has arguably accelerated as reflected in the balance sheets of the Central Banks (see Chart 1.7). In December 2012 the US's Federal Reserve System (FED) announced that it would step up its quantitative easing programme from the USD 40 billion per month announced in September to USD 85 billion, by purchasing long treasuries following the expiration of its maturity extension programme. Moreover, the programme was firmed-up by the announcement that it would continue as long as the unemployment rate stayed below 6.5% (and inflation - and inflation expectations - remain within boundaries). If, as the Institute of International Finance (IIF) expects,[4] the programme will continue well into 2014, the FED's balance sheet will be expanded by another USD 1.6 trillion.

[4] IIF Global Economic Monitor, December 2012, p. 15.

Chart 1.7 Balance sheet ECB and FED

(Billion of euro)

Source: IHS Global Insight; ECB, FED

In a bid to pull the Japanese economy out of its deflationary spiral, in April the Bank of Japan (BoJ) announced a doubling of the amount of money in circulation. [5] Meanwhile, and notably, the ECB balance sheet has shrunk, as the relative calmness in the financial markets since August 2012 has allowed a number of banks to replace Central Bank funding by other means, such as bond issues. This does not reflect retrenchment from monetary easing, but simply reflects the reduction in the use of the long-term refinancing operation (LTRO) programme of EUR 1 trillion[6] launched early in 2012 to counter serious problems in the interbank funding market, and bank funding more generally. Banks have simply found other means to finance their operations. ECB monetary liquidity provisioning remains adequate and the global picture is one of monetary easing through liquidity provisioning.

This policy - and here we make the link with monetary loosening in the emerging economies - has some side effects. In particular, it poses a threat to monetary stability in the emerging economies as money seeks a way into the global financial system. To the extent that such a threat is realistic, authorities react with lower official rates.

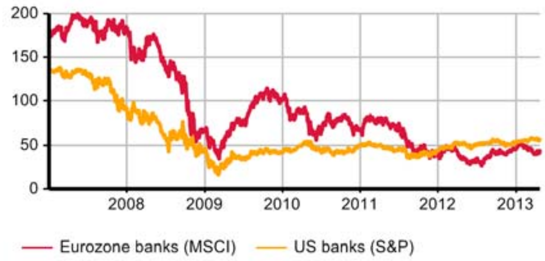
Indeed, the rate cut of 1.25% by the Brazilian Central Bank should be considered from this perspective: it relieves upward pressure on the exchange rate and thus the erosion of competitiveness. Monetary policy, originated in the advanced economies, therefore has a global impact.[7]

Tensions in the banking system ease…

In our previous Economic Outlook we stated that credit conditions in the advanced economies were tight despite the massive monetary loosening taking place, particularly in the US. We also pointed at the difference between the situation in the US and the Eurozone where, in the latter, conditions were significantly worse. However, in neither region was monetary transmission working as it should be. Now we will take stock of the current situation and argue that, despite some positive developments in the Eurozone, the overall picture of the effectiveness of monetary policy in the advanced economies remains bleak.

Chart 1.8 Share index US and Eurozone banks

(Index, January 1998 = 100)

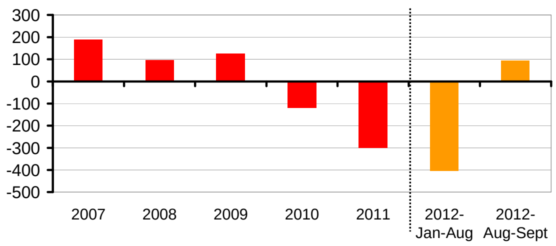


Source: IHS Global Insight

This is reflected in the share prices of banks over the past half year: prices for US and Eurozone banks remain historically low compared to pre-crisis levels (see Chart 1.8). But, crucially, a positive development can be seen, particularly in the Eurozone. The index is 60% higher than its low point in mid 2012.[8] This is the result of the ECB announcement of an Open Market Programme that we discuss below. In essence, the ECB has said that it will do everything to prevent the Eurozone falling apart. It had, and still has, a significant impact: financial market confidence is cautiously returning to the Eurozone.

[5] This is a dramatic policy change: the balance sheet of the Bank of Japan (BoJ) will increase by 1.1% per month in 2014, which compares to 0.54% of US GDP. Financial Times, April 5, 2013.
[6] As at April, EUR 225 billion of the programme, which originally generated EUR 500 billion extra liquidity, has been paid back.
[7] Exchange rate volatility has occurred over the past month as a result of increased monetary activity: in particular from the FED and BoJ. This has revived the discussion on currency wars. The threat is that other countries (like Brazil) will start to address any negative impact on competitiveness. If conducted on a large scale, a currency war can arise. At this stage, with the ECB and FED focusing on domestic monetary targets, and therefore not foreign competitiveness, such a development seems less probable: a G20 agreement announced in February 2013 also confirms this position.
[8] The Standard &Poor's index for US banks is 12% higher.

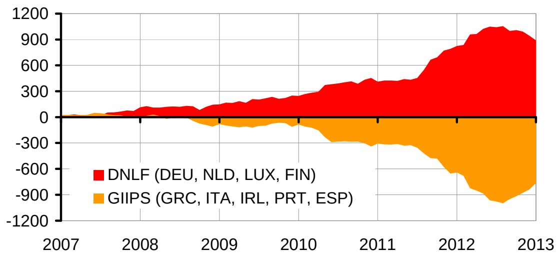
Chart 1.9 Private flows to the perifery
(in Euro billion)



Source: Financial Times, ING

Let's look at some indicators to support this. Firstly, private money flows to the peripheral[9] countries have started to return (see Chart 1.9). Since August 2012, around EUR 93 billion has flown into these countries. While this is still far below the amount of EUR 824 billion that has flown out of these countries at an accelerating pace since 2010, it demonstrates a turning point: money is coming back.

Chart 1.10 Net balance with Eurosystem
(in Euro billion)



Source: ECB

Secondly, the so-called 'Target2' balances in the Eurozone banking system have started to improve, especially since Autumn last year (see Chart 1.10). The imbalances largely reflect the lack of (inter)bank funding for peripheral countries that we had already noted in last November's Economic Outlook.[10] By mid January 2013, Central Banks from Germany, The Netherlands, Finland and Luxembourg had a claim of EUR 888 billion on the ECB, while the Central Banks of Spain, Italy, Greece, Portugal and Ireland were due a similar amount. This EUR 888 billion is down from EUR 1,055 billion in August. While the imbalance is still high, efforts to reduce it have been made: peripheral (inter)bank funding has improved. Thirdly, US money market funds are returning. November 2012 figures show that US money funds had raised their holdings for the fifth consecutive month: by 8% to French banks and 26% to German banks. Again, the allocation is still 60% below the peak of May 2011 when 30.6% of holdings were in European banks.

While tensions in the banking system have eased and confidence cautiously returns, the system still seems vulnerable. In this context we should point at the holdings of government bonds issued by pheriperal countries that we reported on in last November's Economic Outlook. The pattern that we detected at that time - of declining but still sizeable portfolios held by French and German banks and increasing and large portfolios held by Spanish and Italian banks (of their local governments) - indicated a risk of a so-called 'negative feedback loop'.

Such risk has not receded since November. On the contrary, while French and German banks have indeed further reduced their peripheral government holdings, this reduction has been outweighed by the higher purchase by Spanish and Italian banks: with 24% and 42% respectively added since November. This development poses an increased risk. Firstly, the holding of peripheral government bonds by the (still vulnerable) banking sector as a whole seems to have risen. Secondly, the holdings now weigh more heavily on the weaker part of the Eurozone banking sector: the peripheral one.

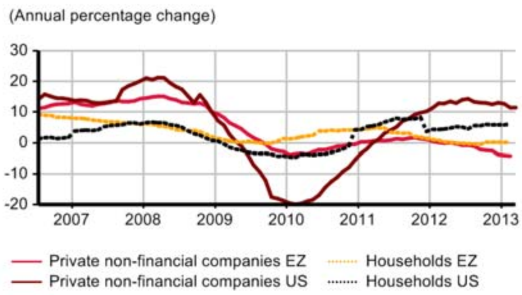
...but monetary transmission still hampered

Although some confidence has returned, the Eurozone banking system is still vulnerable. There is as yet no visible improvement in the monetary transmission mechanism, measured by growth in bank lending. Indeed, lending to companies in the Eurozone shrank in 2012, while lending to households remained neutral. That clearly reflects the slow growth of economic activity – but is also a cause of it as the lack of credit restrains economic growth. This is confirmed by the continued tightening of loan supply conditions in the Eurozone - for firms as well as households. We describe this in more detail in Part 4 of this report. Banks are simply very reluctant with their lending in the periphery and also in other countries. The US does a lot better in this respect, with an increase in lending to both firms and households (see Chart 1.11). This reflects a higher level of economic activity – and more besides, as loan supply conditions are also softening. The banking system

[9] The Eurozone periphery is here defined as; Spain, Italy, Ireland, Greece, and Portugal.
[10] See Cechetti, S., McCauley, R.N. and McGuire, P.M., Interpreting Target2 Balances, BIS working paper no. 393, December 2012.

in the US is in better shape following interventions since the 2008 crisis that have allowed the system, at least partly, to transmit the various doses of monetary stimuli provided by the FED.

Chart 1.11 Lending growth



Source: IHS Global Insight

Policy steps in the Eurozone: some progress

In last November's Economic Outlook we referred to the policy steps that in our view were important in helping contain last summer's escalation of the Eurozone[11], therefore avoiding the recurrence of a Lehman type event. These policy steps were identified as the Fiscal Compact, the European Stability Mechanism (ESM) configuration, the European Banking Union and the ECB purchase of government bonds. At the time we pointed out that these were indeed important steps to strengthen the configuration of the Economic and Monetary Union (EMU), but that much still needed to be done and the implementation risk of these measures was high. Given the importance of these steps and the risk that is still linked to a re-escalation of the Eurozone crisis, we will now provide a brief update of progress on this issue.

- **Fiscal Compact Treaty.** The Fiscal Compact is meant to enhance budgetary discipline in the European Union (EU) - or rather, in the EMU. It does so by enshrining budgetary discipline in national law, including a self-correcting mechanism, with the European Commission having a policing role. The Compact was to take effect on 1 January 2013 if at least 12 EU members had ratified it and indeed this has happened, with 17 member states, including 15 EMU members, having ratified the Treaty.[12]

- **European Stability Mechanism (ESM).** The ESM was established in September 2012 to succeed two existing rescue funds. It has a lending capacity of EUR 500 billion available to countries subject to an IMF programme. In addition, it was agreed in October 2012 that the fund could be used to recapitalise banks (without government involvement, thus breaking the loop between banks and governments). However, this is subject to a banking supervisory mechanism being in place - presumably sometime during 2013. A decision is still pending on the question of whether direct bank recapitalisation will be allowed for cases discovered before 2013.

- **European Banking Union.** The steps for creating a banking union involve a supervision mechanism, a mechanism for bank resolution and a deposit insurance scheme, all at EU level. The ECB has agreed to take on a supervisory role for around 150-200 of the EU-wide 6000 banks, to become effective by March 2014 at the earliest. The mechanisms for bank resolution and deposit insurance are yet to be arranged, with a proposal for the former to be drafted by the European Commission in the first half of 2013. So far, there has been little appetite to push forward the deposit insurance scheme.

- **ECB purchase of government bonds.** As a follow-up of the ECB president Draghi statement 'To do whatever it takes'. Open Market Transactions (OMT) were announced, under which the ECB will purchase an unlimited amount of government bonds, conditional upon the country involved being subject to an IMF programme. The announcement has so far not led to any action by the ECB but has taken the premium for an EMU break-up out of the government bond yields.

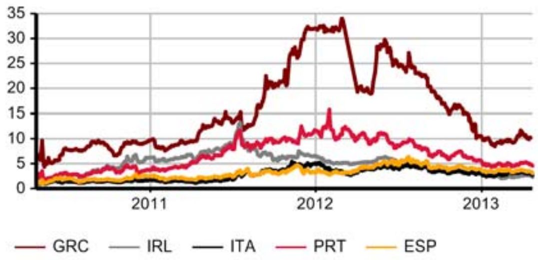
On the basis of this overview it can be argued that the Eurozone has indeed made progress and that the implementation risk is lower than at the time the measures were announced. The Fiscal Compact is in place, as is the ESM. The ECB has made an important statement with the announcement regarding the use of OMT as a backstop. It has provided (relative) calmness to the financial markets as shown above (see also Chart 1.12).

[11] See Economic Outlook, November 2012, p. 11.

[12] Early in March 2013 the Treaty ratification was still in process in Belgium and The Netherlands.

Chart 1.12 Bond spreads within the Eurozone

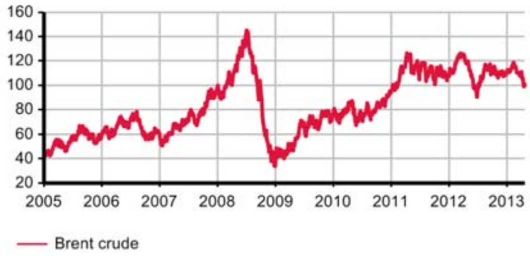
(10-year bond yields over the German bund, percentage points)



Source: IHS Global Insight

Chart 1.13 Oil price

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



Source: IHS Global Insight

Despite this, the most important, if not critical, step, involving the break of the vicious loop between banks and government finance, via the creation of a European Banking Union and direct bank recapitalisation by the ESM, still needs to be finalised. Therefore, there is still a significant amount of implementation risk surrounding these policy measures - and uncertainty (whether or not visible in yields) remains.

The threat of an oil price spike drifts away

Large swings in oil prices are a threat to the stability of the world economy and therefore pose a risk that warrants continued monitoring. Since our last Economic Outlook the oil price has been moving in a band between USD 100 and 120 per barrel for Brent (see Chart 1.13). This relatively stable situation comes at a time when the geopolitical threat of Iran and more broadly unrest in the Middle East has clearly not abated. Talks between Iran and the so-called 'P5+1' (US, UK, France, China, Russia and Germany) are taking place, but Iran continues on a course potentially leading to the production of a nuclear weapon.

In March 2012, Middle East political tensions had caused a spike in the oil price of USD 128 per barrel out of fear for a production cut. Such a spike looks less likely now. The global economy is expected to grow at a much slower pace than envisaged at that time (see below), depressing demand for oil. The level of USD 150 per barrel that the IMF fears will dent growth by 1-1.5% in many parts of the world therefore seems some way off: indeed, even further away than in November, when we already signalled an easing of the upward oil price pressure.

Despite this current reassuring calmness over the oil price, volatility is never far away. Tensions in the Middle East and uncertainty over global economic developments remain. Therefore, moves outside the current USD 100-120 per barrel band, especially downwards, are still possible. Oil producers in the Middle East have attempted to dampen the impact of the Arab Spring by pushing up government expenditure on, amongst other things, social programmes.

As a consequence, an oil price of around USD 85-90 per barrel would now hurt these countries and probably prompt Saudi Arabia, in its role as a swing producer, to prevent the oil price falling below that level. Indeed, there is nothing that may stop the oil price from rising above that level, at least in the short run. In the longer term we may see, in a scenario of relatively high prices, further increases in production from previously uneconomical sources, reducing price pressure. As we argue in our Oil Market Outlook[13] of April this year, current price levels have already boosted supply from tar sands and light tight oil, particularly in the US. But another such revolution, as well as substitution to other energy means, takes time.

Downward adjustment of growth forecasts

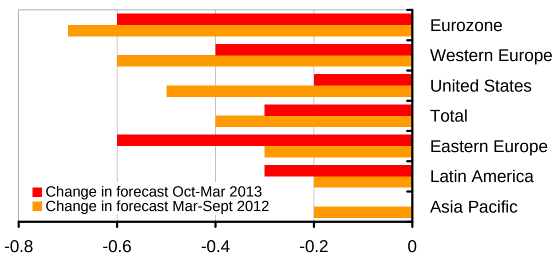
The continuation of the slide in global GDP during 2012 has had a significant impact on the forecast for growth levels in 2013. In last November's Economic Outlook we had warned of a significant lowering of growth projections for 2013. Already, during the period from March to September 2012, expectations for global growth in 2013 had been cut by 0.4 percentage points. This figure was dominated by the Eurozone adjustment of 0.7%, reflecting the Eurozone crisis peak during the summer of 2012,

[13]See Economic Research 'Oil Market Outlook', 2013.

with other major regions also seeing downward adjustments.

With the relative calmness in the financial markets, we might reasonably expect to see a positive direction in growth forecasts. However, on the contrary, the slide in global growth forecasts has persisted from October 2012 to March 2013: down by another 0.3 percentage points, one percentage point below the forecast slide in the previous period (see Chart 1.14). Again, the Eurozone adjustment still dominates the scene (0.6 percentage point decline), with other major regions following at a slower pace and showing a more diverse picture. The revised forecast for the US is only -0.2 percentage points, and for Asia there has been no recent adjustment.

Chart 1.14 Change in GDP forecast, 2013
(Forecast differences in percentage points)



Source: Consensus Forecasts

These dynamics leave us with a global growth forecast for 2013 of a rather muted 2.6% (see Table 1.1). Asia continues to be the growth engine of the world economy, with projected growth of 4.8% (4.7% in 2012). Support is coming from Latin America where 3.4% is projected (up from 2.7% in 2012). The US's forecast for 2013 stands at 2.1%, while the Eurozone's continuing problems are reflected in a forecast contraction of 0.4% (0.5% in 2012).

Table 1.1 Real GDP growth - Major regions

	2010	2011	2012	2013f	2014f
Western Europe	1.9	1.5	-0.3	0.0	1.2
United States	3.0	1.8	2.2	2.1	2.7
Eurozone	1.8	1.5	-0.5	-0.4	0.9
Asia Pacific	7.1	4.6	4.7	4.8	4.9
Latin America	6.3	4.2	2.7	3.4	3.8
Total	4.3	3.1	2.5	2.6	3.2

Source: Consensus Forecasts (April 2013)

The faint rays of light in advanced economies, as we have outlined above, will not become visible until 2014, when the Eurozone is expected to return to growth - albeit by a very modest 0.9% - and US growth is expected to strengthen to 2.7%. For this to happen, the turning points for GDP growth will have to become visible in the second half of 2013. We will elaborate on this in the next chapter of this report.

These forecasts are based on the presumption that the Eurozone will indeed remain on the path of reinforcing the EMU architecture by resolutely implementing the policy measures discussed above. Indeed, muddling through the crisis, by relying on the ECB's promise not to let the Eurozone fall apart, will not be enough. If the necessary implementation happens, the Eurozone may indeed start to show growth in the second half of 2013 and continue its upward path in 2014 with some slight growth.

This highlights the most significant downside risk to the forecast: that of a Eurozone 'muddle through' scenario without any further convincing steps to reinforce the EMU. Without those steps, events like the Italian elections and the Cypriot bail-out (or bail-in for that matter) will continue to weigh heavily on real economic growth, despite the calmness in the financial markets. If that happens, the 1% 2014 forecast for the Eurozone will be too optimistic and global growth lower than currently projected. That is the most significant risk to the current forecast and more likely than a Eurozone break up: as we have repeatedly pointed out, we expect the Eurozone to stay together.[14]

Our conviction in this respect is founded not so much on the soundness of the current EMU configuration but rather the necessity for members to avoid the huge economic (and potentially social and political) cost of leaving. Therefore, the chances of a Eurozone break up are limited over the current time horizon of our Outlook.

[14] See our publication 'Sticking Together; the Future of the Eurozone'.

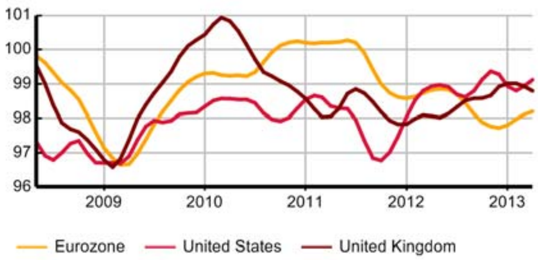
2. Prospects and risks in advanced economies

A weak outlook across advanced economies

The already bleak outlook for 2013 presented in our November 2012 Economic Outlook has worsened. Economic growth was disappointing in the fourth quarter of 2012 and expectations for growth in 2013 have been revised downwards across all advanced economies. The main theme driving the forecast revisions is the negative cycle between government austerity and the resulting damage to the real economy. Both consumers and producers face higher taxes, lower subsidies and policy uncertainty.

Chart 2.1 Consumer climate indicators

(Index 100 = Neutral)



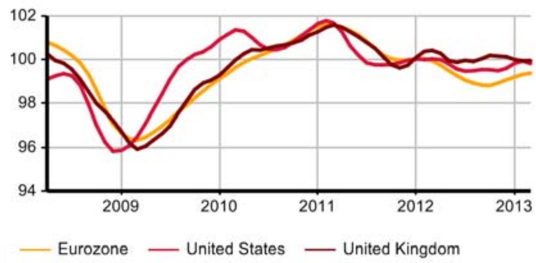
Source: IHS Global Insight; OECD

In the US, consumer confidence has fallen over the past six months as consumers feared the 'fiscal cliff' at the end of the year. In the event, the cliff was avoided and was replaced by a slower 'sequester' of government spending cuts (see Chart 2.1). In contrast, Eurozone consumers took confidence in the eased pressure on the monetary union. However, confidence remains low as unemployment has increased and benefits have been cut.

Producer confidence shows a similar pattern, with the US deteriorating and the Eurozone improving (see Chart 2.2). Output in the US grew by a meagre 0.1% in the fourth quarter of 2012 compared to the previous quarter, as companies postponed investments in anticipation of the fiscal cliff. The Eurozone actually contracted 0.6% over the same period, although producers seemed to become less pessimistic.

Chart 2.2 Industrial confidence

(Manufacturing confidence index 100 = neutral)



Source: IHS Global Insight; OECD

The US is forecast to grow 2.1% this year, down from 2.2% in 2012 (see Table 2.1). The Eurozone is expected to contract by 0.4% after shrinking 0.5% in 2012. The UK is however expected to improve from 0.3% in 2012 to 0.7% in 2013. Growth in Japan is projected to moderate from 2.0% in 2012 to 1.3% in 2013.

Table 2.1 Real GDP growth - Major markets

	2010	2011	2012	2013f	2014f
Eurozone	1.9	1.5	-0.5	-0.4	0.9
United States	2.4	1.8	2.2	2.1	2.7
United Kingdom	1.8	1.0	0.3	0.7	1.6
Japan	4.7	-0.5	2.0	1.3	1.3

Source: Consensus Forecasts (April 2013)

Eurozone: another year in recession

The Eurozone crisis is not over yet, as evidenced by the messy bail-out of Cyprus. Tensions in financial markets have eased considerably since the second half of 2012 on the new commitments by the ECB, but the real economy shows no sign of improvement. Domestic demand is sluggish as consumer spending contracted in 2012. Governments also continue their strategy of fiscal consolidation and businesses are unwilling to invest. Current forecasts show an improvement at the end of 2013 and modest growth in 2014, but these expectations are highly vulnerable to downside risk.

In terms of the Eurozone's economic performance there are broadly two groups. The Southern European countries of Italy, Spain, Portugal and Greece all contracted sharply in 2012 and are also expected to shrink in 2013 (see Table 2.2). Then, there are countries that show modest growth or stagnation such as Germany, France, Ireland and Austria.

Table 2.2 Real GDP growth - Major markets

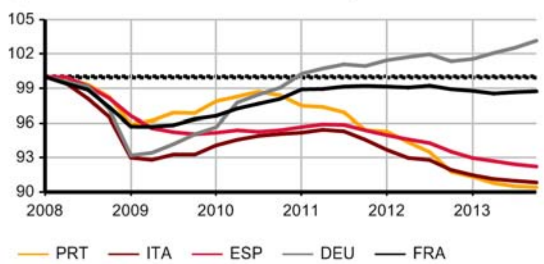
	2010	2011	2012	2013f	2014f
Austria	2.3	2.7	0.7	0.6	1.5
Belgium	2.4	1.8	-0.2	0.1	1.1
France	1.4	1.7	0.0	-0.1	0.7
Germany	3.6	3.0	0.7	0.7	1.7
Greece	-4.9	-7.1	-6.4	-4.9	-1.4
Ireland	-0.8	1.4	0.9	0.9	1.9
Italy	1.4	0.6	-2.4	-1.4	0.5
Netherlands	1.6	1.1	-1.0	-0.8	0.8
Portugal	1.9	-1.6	-3.2	-2.6	0.0
Spain	-0.1	0.4	-1.4	-1.6	0.2
Eurozone	1.9	1.5	-0.5	-0.4	0.9

Source: Consensus Forecasts (April 2013)

This division is also visible in the change in the size of the economy since 2008. Germany had already grown beyond its pre-crisis size by the beginning of 2011 and is expanding further (see Chart 2.3). However, the economies of Spain, Portugal and Italy are still almost 10% smaller than they were at the end of 2007. The Greek economy has shrunk by a massive 25% over the past five years: one of the worst performances in modern history.

Chart 2.3 Real GDP - Eurozone

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



Sources: IHS Global Insight; OECD

The return of growth to the Eurozone is uncertain. The pick up in growth has to come from increased exports to non-Eurozone markets and the transmission of better financial market conditions to the real economy. But financial markets can be easily disrupted, as the bail-out of Cyprus has shown. In the event, the bail-out did not cause widespread concern of contagion, but it could have easily ended differently: the Cypriot government is said to have seriously considered leaving the euro. Uncertainty over the political situation in Italy, the federal election in Germany in September or new bail-out requests could reignite fear on the financial markets and depress economic growth.

A difficult business environment

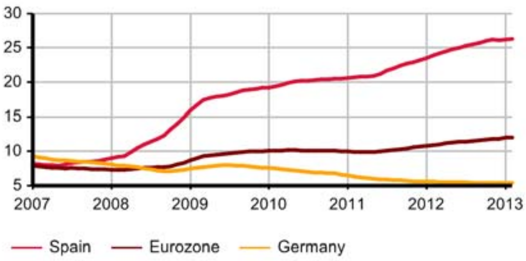
All Eurozone countries face a difficult business environment. The latest output indicators, based on purchasing managers information by Markit, show continued contraction across most markets in the first quarter of 2013. The Eurozone aggregate index reached 46.5 points, indicating a modest contraction. France in particular is facing a steep deterioration in its economic performance, with the possibility of a larger contraction in the first quarter than in Spain or Italy. Even Germany, which so far had been able to show modest growth, appears close to stagnation.

Principally, those industries dependent on domestic demand will feel the pinch. Overall, retail trade was down 1.4% year-on-year in February. The drop was almost 10% in Spain, while retail trade increased in Ireland (1.1%) and Germany (2.1%). The construction sector too was under pressure, with a 9.1% yearly reduction in production seen in January. Spain did relatively well, despite its housing 'bust', with a contraction of just 1% compared to a drop of almost 10% in France and 14% in the Netherlands.

The difficult environment for companies translates into ongoing upward unemployment levels across the Eurozone. The unemployment rate climbed above 12% in March: the highest level since the introduction of the single currency in 1999 (see Chart 2.4). France stands out with a steep increase in unemployment levels to 11% over recent months. Unemployment remains low in Germany (5.4%) and Austria (4.8%). On average, youth unemployment is at 23.9%, but is above 50% in Spain and Greece.

Chart 2.4 Unemployment

(percentage of workforce)

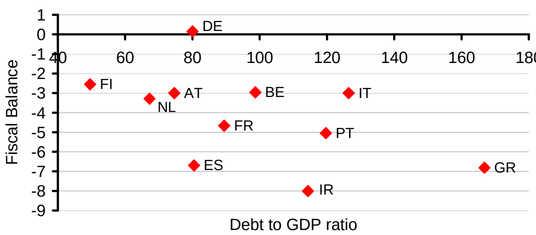


Source: IHS Global Insight

The case for fiscal reform

As mentioned in Part 1, governments still face large budget deficits. During the financial crisis of 2008, governments across the Eurozone saw a serious deterioration in their fiscal balances as a result of lower tax income and increased expenditure on social benefits. Bank bail-outs added to government deficits and debt levels and the sustainability of government debt has come under severe pressure as a result of these forces. Chart 2.5 shows the fiscal balance and debt to GDP ratio in a number of Eurozone markets, clearly indicating that Greece, Ireland and Portugal are facing pressure, with very high debt levels and large fiscal imbalances. They are closely followed by Spain, Italy and France, where a loss of market confidence would push up finance rates making it more expensive - or impossible - for these governments to finance their deficits and roll over their existing debt.

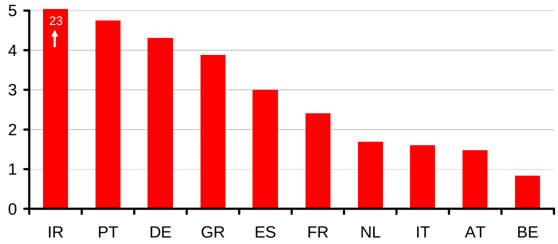
Chart 2.5 Fiscal sustainability
(Percentage of GDP, 2012 values)



Source: IHS Global Insight

Government austerity measures have reduced fiscal deficits substantially since 2009. Eurozone governments cut spending and increased taxes in an effort to improve their budget balances. As a result, the deficit dropped significantly over 2011 and 2012 in all markets (see Chart 2.6). The programme countries - Ireland, Portugal and Greece - saw the biggest improvement and Spain was also able to reduce its deficit by 3 percentage points in just two years. The improvement in Germany was supported by positive economic growth, which automatically reduces government spending on social benefits and increases tax returns. Fiscal consolidation efforts are likely to continue for some years.

Chart 2.6 Change in fiscal balance 2011-'12
(Percentage point change)

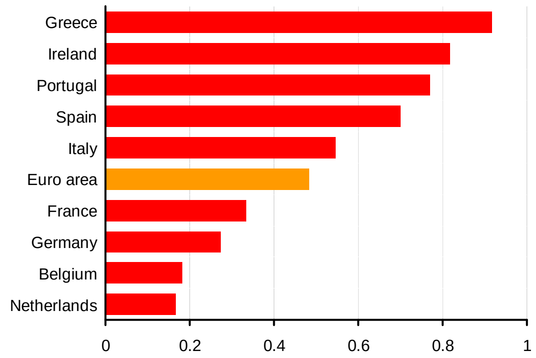


Source: IHS Global Insight

Fiscal consolidation by means of austerity measures limits growth, because such measures deter consumer spending and business investment. The large-scale consolidation across Southern European markets partly explains their poor economic performance. As a result, the European Commission is taking a softer stance on the budget target, replacing the 3% deficit target by the more flexible structural deficit target. This year Portugal, Spain, the Netherlands and France are once more allowed to overshoot their 3% target, while Spain and Portugal are likely to miss their 3% targets again in 2014.

The European Commission would like to see more focus on structural reform instead of austerity. Structural reforms are designed to boost productivity and stimulate growth. Austerity alone cannot improve the medium and long-term debt sustainability: that also requires economic growth. According to the OECD, the countries with a bail-out package have introduced substantial reform over the past years, with Greece, Ireland and Portugal making notable progress in this respect (see Chart 2.7). Of the Southern European countries, Italy has demonstrated the least reform, feeding worries about its medium-term economic development. It remains uncertain whether the new government sworn in on 28 April will be able to push through the measures needed to reform the economy and improve Italy's sluggish long-term growth rate.

Chart 2.7 Reform efforts across Europe
(OECD responsiveness index 2011-2012)

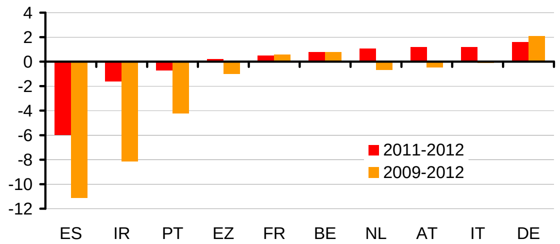


Source: OECD (2013)

Exports to drive growth

Another way to stimulate growth is to increase international competitiveness and boost exports. This can be achieved by an improvement in productivity or by lowering labour costs. Unit labour costs have indeed come down significantly in a number of reform countries (see Chart 2.8). Spain has improved its position considerably since 2010 and made large gains in 2012. However, the real effective exchange rate has improved more modestly because of a relatively high inflation rate caused by an increase in VAT. Ireland and Portugal have also lowered their labour costs, but not so in Italy, where the labour costs rose in 2012, undoing the gains from earlier years.

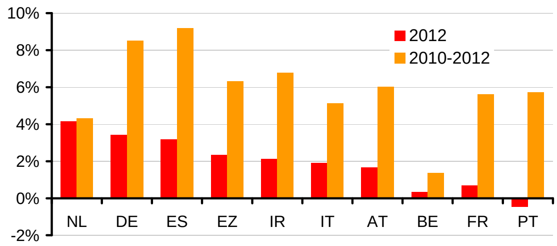
Chart 2.8 Change in Unit Labour Costs
(Percentage change in level index)



Source: Eurostat

Exports are indeed growing - and not only in the countries that have implemented reforms. Exports increased in all markets in 2012 except for Portugal where they stayed more or less unchanged. The strongest growth was seen in the Netherlands, Germany and Spain (see Chart 2.9). In recent years, Spain has been the best performing market in this respect, with export growing more than 9% since 2010: slightly faster than its pre-crisis average growth of 2.8% per year. Growth was greatest in exports to emerging markets, but very limited in exports to other Eurozone countries. The Spanish experience suggests that it is indeed possible for Eurozone markets to improve their exports by reducing labour costs.

Chart 2.9 Export growth
(Percentage change)



Source: Eurostat

A long way to go

It will take many years before the Eurozone economy returns to its pre-crisis average growth rate. The reforms and consolidation efforts by governments across the Eurozone are medium to long-term projects. Moreover, the recovery of the labour market, business environment and banking sector all take time. The modest growth projected for 2014 could make the adjustment process easier for all parties involved but risks to the fragile outlook abound: the implementation of the banking union should continue, future bail-outs should be resolved more decidedly and governments must put structural reforms ahead of austerity measures.

United States: opposing forces

Investors seem optimistic about the US economy, as the Dow Jones index reached a new record high in February 2013. However, the economic recovery could still be crushed by large scale fiscal adjustment. Optimists point to high company profits, increasing consumer wealth and falling unemployment to vindicate high asset prices, and assume that the economy is strong enough to handle the government's 'fiscal sequester' of spending cuts. The budget cuts began in March this year and spending could drop by 1.9% of gross domestic product in 2013 if the government is unable to reach a new agreement.[15] That would reduce growth significantly, risking derailment of the economic recovery.

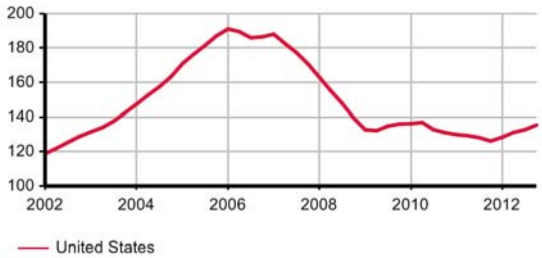
[15] The Economist, 2 March 2013

The upside: a strong recovery

Despite the weak 0.1% quarterly growth in the last quarter of 2012, the US economy is showing signs of strong recovery. According to Markit, the manufacturing sector is expected to expand at a robust quarterly rate of around 2% in the first quarter of 2013. Markit's index of manufacturing production, based on purchasing managers, has shown great improvements since November 2012: reaching 54.3 points and indicating solid expansion. Output has also improved: in February achieving its best growth since March 2012, thanks to an increase in new orders.

Chart 2.10 House prices

(Case-Shiller index, 2000=100)



Source: IHS Global Insight; Case-Shiller

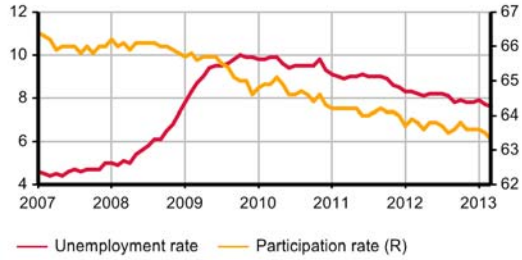
Investment in the construction sector has also recovered markedly since 2010, as a result of the stabilisation of the housing market. Investment in residential and non-residential construction increased 7% in 2012, while housing starts were up 37%. The recovery is based on rising house prices. House prices bottomed out in the second half of 2011 after contracting by almost 60% (see Chart 2.10). Prices rose slowly throughout 2012 and are likely to continue to improve in 2013. As a result, delinquency rates have stabilised, but remain well above their pre-crisis level.

The industry has received a further boost from the oil and shale gas revolution, which has reduced prices and increased income for domestic energy producers. Gas production increased by almost 30% between 2005 and 2011 and oil production rose by more than 10%. Production levels are expected to continue to rise in the coming years. Both oil and gas prices in the US are below world prices, creating an advantage for energy-heavy industries over their foreign competitors.

Eventually the US may become energy independent and already the drop in energy imports has led to a substantial improvement in the current account balance, reducing the US's dependence on foreign financing.

Chart 2.11 Unemployment and participation

(Percentage points)



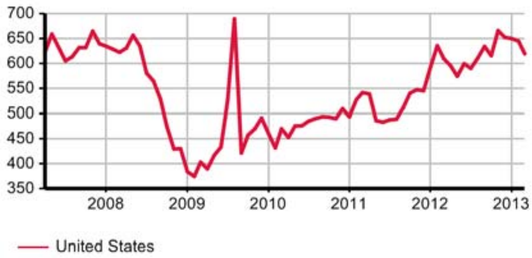
Source: IHS Global Insight

Better business conditions are also benefiting consumers as the labour market picks up: the unemployment rate decreased from 10.0% in 2009 to 7.7% in February 2013 (see Chart 2.11). However, as we said in last November's Economic Outlook, the improvement in the employment figures is taking longer than in previous economic recoveries. Data on the participation rate – the proportion of people actually employed - reveals a deeper problem: that the rate has dropped significantly over recent years and was just stable throughout 2012. This suggests that the reduction in unemployment is mostly the result of people dropping out of the labour force – i.e. simply stopping looking for work. Recent figures on job creation may indicate a more positive development, with 236,000 jobs added in February this year, while the number of claims for unemployment insurance has also reached a new low.

Consumer wealth received a boost from improving household balance sheets, thanks to higher house prices and increased stock market values. Total household asset value increased by 7.4% in 2012: growing by 22% since its lowest point in 2009. By the end of 2012, households had also reduced their debt levels to an average of USD 47,000 per capita: down 1.6% on 2011. The ratio of financial obligations to disposable income is even better and is now at its lowest level for thirty years.

Chart 2.12 Car sales

(Passenger car registration seasonally adjusted, in thousands)



Source: IHS Global Insight

Increased net wealth and slightly better employment conditions are encouraging households to spend and, as a result, consumer spending increased by almost 2.0% in 2012. While this is still slightly below the 2.9% average growth in spending between 2001 and 2007, it still indicates a positive trend. Car sales also rebounded in February - to 644,500 - back to their pre-crisis level (see Chart 2.12). Nevertheless, consumer confidence remains subdued by uncertainty over spending and taxing policies from Washington.

Downside: the fiscal sequester

The government deficit came down to 7.0% in 2012, but remains unsustainable in the medium term. There are two reasons;

- Actions to combat the deep financial crisis pushed down revenues and increased public spending. The deficit increased to 10% in the wake of the financial crisis and has reduced only modestly since then;
- Government spending on Medicare and Medicaid is expected to increase rapidly over the next decade. The Congressional Budget Office estimates that government spending on health insurance for the elderly, disabled and poor will double over the next decade from USD 717 billion in 2012 to USD 1,475 billion in 2023.

The government avoided the fiscal cliff (i.e. the abrupt introduction of large scale spending cuts and tax increases) at New Year, but was unable to stop the subsequent 'sequestration' of USD 1.2 trillion in automatic spending cuts over the next decade that began on 1 March.

The sequestration was part of the 2011 Budget Control Act intended to force Republicans and Democrats to agree on a more sensible way to reduce the deficit by USD 1.2 to 1.5 trillion. They failed to reach an agreement. A last-minute political deal pushed the implementation of the sequestration from 1 January to 1 March and reduced the level of the spending cuts to about around USD 64 billion in 2013.

If the spending reductions are implemented in full, they will lower economic growth by 0.7% in 2013, according to estimates by Roubini Global Economics [16] . Unemployment will also suffer, reducing far less than previously anticipated. Defence will be hit hard by cuts of around 8% while non-defence spending will be cut by 5%. The harsh potential effects of the measures mean that politicians continue to try to reach a new agreement.

The Democrats need the support of the Republicans to get any agreement past the Senate, and this is proving extremely difficult. President Obama wants to increase tax revenue over the next decade to cover part of the budget reduction. Republicans argue that the increase in tax revenues of around USD 650 billion over the next decade, part of the smaller fiscal cliff deal proposed by Obama in December, is sufficient and that the rest of the reduction should come from cuts in spending. Any deal would only partly reduce the total amount of sequestration; large scale budget reform is inevitable.

Overall, the US economy is gaining in strength, but growth remains muted by federal spending cuts. The outlook for the medium term is positive as the fiscal rebalancing is most effective during 2013. As a result growth is expected to improve to 2.7% in 2014.

United Kingdom: a weak recovery

The UK barely avoided a recession last year, but growth is currently expected to gain some traction in 2013 and 2014. The economy grew by 0.3% in 2012, while output fell by 0.3%, quarter-on-quarter, in the final quarter. Growth is projected to increase to 0.7% in 2013 and to 1.6% in 2014, in line with slowly improving conditions across Europe.

The UK lost its sovereign triple-A rating from credit agency Moody's and Fitch on 22 February and 19 April respectively, because of its ongoing economic

[16] RGE, 'Self-inflicted Wounds: Sequestration Hits the U.S.', 28 February 2013

problems. According to Moody's, three factors increase the degree of sovereign risk:

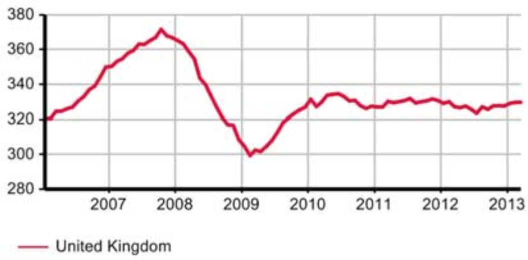
- the medium-term growth outlook continues to be weak;
- this weak growth makes it more difficult for the government to balance its books; and
- high and rising government debt means there is little room to absorb new shocks.

The rating change reduced the government's creditworthiness, but has not had any effect on financing conditions and the real economy.

Not all sectors are in bad shape. Business volumes in the service sector have been improving for months, according to Markit's purchasing managers' index. Payroll numbers have also increased and confidence in the outlook has improved to its highest level in ten months. However, the index for output in the construction sector indicates contraction and, in March, new orders received by construction companies fell for the tenth consecutive month. The manufacturing sector is also expected to show a modest contraction in the first quarter of 2013, with manufacturers reporting falls in both new orders and production in March.

Chart 2.13 House prices

(National level index, 1993 Q1=100)

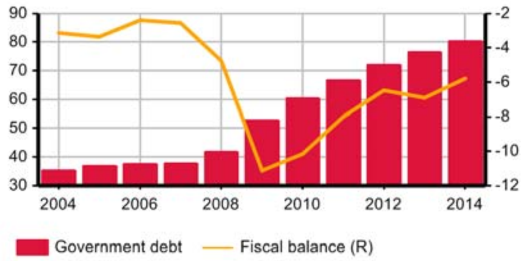


Source: IHS Global Insight

Consumer confidence improved substantially throughout 2012, but has remained stagnant since November. Better conditions on the labour market stimulate confidence. The unemployment rate dropped from a peak of 8.4% at the end of 2011 to 7.8% in December last year, but still has some way to go regain 2007's rate of 5%. Consumer confidence was further stimulated by stabilising house prices (see Chart 2.13). Prices have actually been increasing since the second half of 2012, boosting household wealth and spending power.

Chart 2.14 Public debt and budget balance, UK

(Government debt and budget balance in percent of GDP)



Source: IHS Global Insight

The government is implementing a harsh austerity programme to reduce the large budget deficit. The deficit widened from 2.5% in 2007 to 11% in 2009 as the financial crisis hit (see Chart 2.14). Adjustments have since reduced the deficit to 6.5% in 2012. However, the austerity measures have taken their toll on both consumer demand and business investment, lowering economic growth.

Subject to the government remaining in power after the next election, its plans are likely to continue beyond 2020. Record low interest rates and large scale intervention by the Central Bank are stimulating the economy (the Bank of England has expanded the monetary base four times since 2009). The positive outlook for higher economic growth in 2013 could be countered by the more negative impact of government measures on growth or weaker than expected economic performance across mainland Europe.

Japan: massive quantitative easing

The Japanese economy may benefit from the new government's drastic changes being designed to pull the country out of its decade-long period of deflation. Consumer prices are forecast to grow 0.1% in 2013 and 1.9% in 2014. Business investment and industrial production are also forecast to grow robustly in 2014 (by 3.4% and 3.6% respectively). Overall, economic activity is expected to increase 1.3% in both 2013 and 2014. This is slightly lower than the 2.0% recorded in 2012, as the economy recovered from the 2011 earthquake and tsunami.

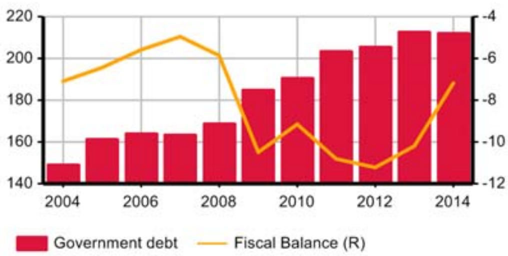
At the beginning of this year, the new government of Prime Minister Shinzo Abe focused on improving the economy. The general course of action outlined by the government is threefold:

- push the Bank of Japan towards a loose monetary policy;
- employ a flexible fiscal policy combining measures for short and mid term stimulus; and
- initiate a programme to stimulate potential growth.

On 23 January the Japanese government declared that it will commit to a new fiscal stimulus package of 23 trillion yen. The government has already announced that it will spend 10.3 trillion yen of this package on post-quake reconstruction, stimulus for investment and welfare measures. An immediate drawback is that the government deficit is likely to exceed 11% of GDP in 2013 (see Chart 2.15) and this could prove detrimental to Japan's already record debt-to-GDP ratio.

Chart 2.15 Public debt and budget balance, JP

(Government debt and budget balance in percent of GDP)



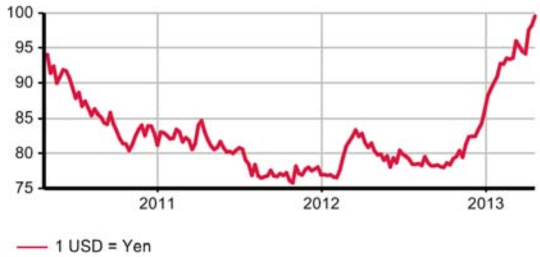
Source: IHS Global Insight

The goal of loose monetary policy is to simultaneously achieve depreciation of the yen (see chart 2.16) and avoid further deflation. The new Bank of Japan governor Haruhiko Kuroda, appointed in March this year, supports the Prime Minister's policy.

Following his appointment, Kuroda declared that the Bank of Japan will abandon interest rates as a target and focus instead on the monetary base. Indeed, the Japanese Central Bank is aiming to almost double the monetary base by the end of 2014. Subsequently, on 4 April, Kuroda announced that the monetary base will be substantially expanded and that the Bank of Japan is committed to bringing inflation up to 2%, seamlessly aligning the goals of the Bank of Japan with those of the government.

Chart 2.16 Japanese Yen per US Dollar

(Exchange rate, spot price)



Source: IHS Global Insight

At the same time, the Prime Minister is hoping this radical course will help him to win back the upper house this summer. Since household expectations about unemployment have improved, the economic situation is regarded more positively, business sentiment among manufacturers is soaring and the yen is steadily depreciating, the Prime Minister has every reason to be optimistic.

However, there is concern about the lack of structural reform: overcapacity, high public debt and an ageing and shrinking population will continue to depress growth. Furthermore, even though the yen is steadily depreciating, there are no conclusive signs of increased demand for Japanese exports. Japan will have to carefully assess its debt position as it maintains the world's highest debt-to-GDP ratio and the second largest public debt, second only to the US.

3. Prospects and risks in emerging economies

Strong and stable growth

Economic growth in the emerging economies has slowed in recent years due to the stagnation in the Eurozone and the US, but remains significantly higher than in the advanced economies. Compared to advanced countries, emerging markets have more room to manoeuvre in the event of an economic slowdown. However, looking in more detail we conclude that there is quite some difference between various less developed markets. All have their own internal problems, which should be addressed to sustain high economic growth. In the short term we will not see a return to the high growth figures of before the financial crisis.

Table 3.1 Real GDP growth - Regional aggregates

	2012	2013f	2014f
Asia (excluding Japan)	6.1	6.6	6.7
Eastern Europe	2.4	2.7	3.6
Latin America	2.7	3.4	3.8
Middle East & North Africa	3.6	2.5	3.8

Source: Consensus, IHS Global Insight (April 2013)

Asia: the persistent economic driving force

Asia remains the driving force of the world economy. For the region as a whole, economic growth is estimated at 4.8%, more or less the same as last year (4.7%).

Table 3.2 Real GDP growth - Asia

	2010	2011	2012	2013f	2014f
China	10.4	9.2	7.8	8.2	8.0
Hong Kong	7.0	5.0	1.4	3.5	4.1
India	8.5	6.8	5.1	6.1	6.8
Indonesia	6.1	6.5	6.2	6.3	6.3
Singapore	14.8	4.9	1.3	2.5	3.8
Taiwan	10.7	4.0	1.3	3.6	4.0

Source: Consensus Forecasts (April 2013)

Most countries in the region are export-oriented and benefit from increasing demand from China. For countries exporting technology products and commodities, China is one of the main export destinations.

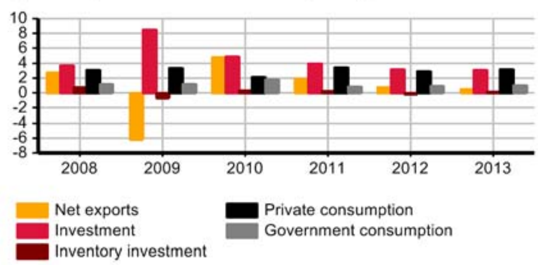
China: still going strong

China's economic growth has decelerated since mid 2011 because of weak demand for its exports and a slowdown in property investment growth. However, the economy regained momentum in the last quarter of 2012, thanks to the government's stimulus programme, loose monetary policy and an improvement in external demand. The stimulus programme included investment in public infrastructure such as railways and, although much smaller than 2008's programme, it proved to be an easy way to spur economic growth.

Overall economic growth decelerated last year to 7.8% - the lowest figure for 13 years - from 9.2% in 2011. Economic growth is expected to accelerate to 8.2% this year as the increase in public infrastructure projects and real estate development support investment growth. Exports will benefit from increasing external demand while private consumption will continue to rise in line with increasing incomes.

Chart 3.1 Contributions to GDP growth, China

(Chain-weighted basis; forecast data edge 2012)



Source: IHS Global Insight

Reasonable solid fundamentals

Maintaining economic growth of around 7.5% is a priority and, as in earlier years, this will be the focus of government policies. Although the government has emphasised that rebalancing economic growth is important, until now the measures taken have only aggravated the imbalances. Therefore, this policy is unsustainable and reforms are needed to reduce China's over-dependence on investment-led growth.

Some analysts have pointed to the rather unreliable Chinese statistics and assume that the share of consumption in GDP is larger than the current figures show. The downside risks for the Chinese economy come from its over-heated real estate sector, which will have consequences for both local governments and the Chinese banking sector.

The transition of leadership last November was followed by a change in government in March this year. For the next ten years, Xi Jingping will be the new President and Li Keqiang the premier, dealing with the day-to-day running of the country. A change of economic policy is not expected as policy has been broadly encompassed by the 12th Five-Year Plan for 2011-2016. Premier Li Keqiang has reiterated that sustainable economic growth is a priority, emphasising in one of his first speeches that increasing income inequality and corruption by government authorities must also be addressed.

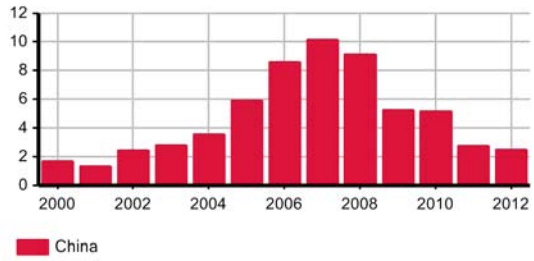
The Chinese premier's statements on the importance of urbanisation for the future are expected to lead to the issuing of new guidelines regarding China's rigid household registration system: the so-called 'Hukou' system. Rules on migration are currently very restrictive and residency is heavily regulated, causing a clear split between the urban and rural population, so that millions of the latter are not allowed to settle in the cities nor benefit from welfare and services available to city dwellers. Changing these rules could help rebalance the economy: urbanisation boosts private consumption as city dwellers have higher incomes, more access to education and services, and spend more on non-basic items.

As labour is not as abundant as in past years, there will be continued upward pressure on labour costs. According to UN statistics, the ratio of working age population to total population will peak in two years time. If rising labour costs are accompanied by productivity gains, the negative impact could be limited. Some industries have relocated to the interior provinces, where wages are lower, but lqbour costs will still continue to rise because of the government's decision to increase minimum wages to support consumption. Nevertheless, labour-intensive companies will continue to outsource their production and China will climb into the higher value production chain: already, low-cost manufacturing has moved to other countries such as Vietnam and Bangladesh.

The surplus on China's current account is diminishing (see Chart 3.2). This year a surplus of 1.8% of GDP is expected, compared to last year's 2.6%. Import and export growth go 'hand in hand' as Chinese imports consist largely of components that are assembled in Chinese factories and then shipped overseas. However, an increasing number of imports will in future be for consumption in the domestic market. As the current account surplus is declining, the accumulation of international reserves is slowing. The liberalisation of the capital account will progress slowly.

Chart 3.2 Current account balance

(Current account as percentage of GDP)



Source: IHS Global Insight

Inflationary pressures mean that the Central Bank will probably end its accommodative policy stance this year. Inflation is expected to increase from 2.6% in 2012 to 4.3% this year, due mainly to increased demand.

Structural issues

The Chinese banking sector is quite weak and dominated by large state banks which prefer to channel money to state companies and projects rather than to privately owned businesses. Its contribution to GDP is considerable compared to other emerging economies: according to Fitch, bank credit is around 128% of GDP and, if off-balance sheet credit is included, 190% of GDP (compared to 128% in 2008). Low or even negative deposit returns have spurred off-balance activities in the banking sector. This shadow banking includes, for example, securitisation, wealth management products and informal network lending. Precise data is not available and therefore the risks to the economy are difficult to assess. However, most of the activity is linked to the real estate sector. Although the non-performing loans portfolio is low - just 1% at the end of September 2012 - rapid credit growth will eventually lead to a deterioration in asset quality. In the past year many loans have been rolled over instead of being repaid.

Another weakness in the Chinese economy is the financial status of local governments. No clear data is available, but it is widely assumed that local authorities' finances have deteriorated. In 2009-2010 local government borrowed heavily, resulting in local government debt rising to 26.5% of GDP at the end of 2010 from 17.7% of GDP at the end of 2008 – and in 2011 many local government loans were rolled over. Spending by local governments is financed mostly by earnings from land sales and, if the property sector experiences a correction, this could lead to financing difficulties.

Central government finances are healthy. The budget deficit was just 1.6% of GDP in 2012 and will rise only slightly - to 2.0% of GDP - this year as spending increases. Central government debt was around 16.7% of GDP in 2012 and we can therefore assume that the government has room to support the economy in the event of an internal or external shock.

Challenges in the period ahead

China faces some challenges in the coming years, not just in its economic development but also as a consequence of its years of focusing only on high economic growth. Recent problems with air quality in Beijing, protests over corruption and water pollution are indicative of what is in store. To preserve high economic growth in the medium term and to steer the economy away from its overdependence on investments and exports towards consumption, government reforms to stimulate private consumption are vital. Government spending on health services, education and pensions will increase.

In addition, the government will introduce tax reforms, support substantial pay increases and reform the household registration system. Financial liberalisation - such as a more flexible exchange rate, freeing interest rates and opening up the capital account - are also underway. State owned companies and private companies should be restructured, but progress will be slow due to vested interests.

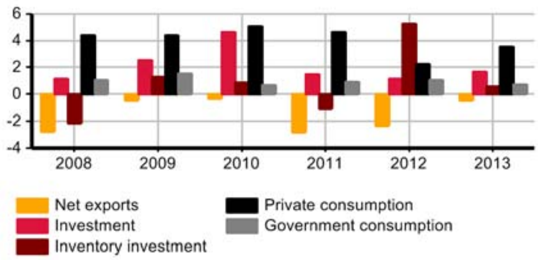
If economic growth decelerates sharply this will affect the world economy. As in the past decade, increasing demand from China for commodities and other products was one of the driving forces behind the world's economic growth. The impact of a Chinese downturn will vary from country to country, depending on their level of exports to China as a percentage of their total exports or GDP and on how well diversified their exports are. However, in the short term, a downturn in the Chinese economy is unlikely.

India: performing below potential

The fragmented political landscape in India has become even more disjointed since the ruling United Progressive Alliance lost its majority in parliament in late 2012, after the withdrawal of the small Trinamool Congress. Although the ruling coalition is not expected to collapse, its decisiveness will be weak for the remainder of its term, which ends in May 2014. The Indian economy has not returned to the very high growth rates we saw up to 2011. In fact, economic growth has decelerated to 5.5% this year, with all the main components of the GDP aggregate showing a similar slowing trend (see Chart 3.3).

Chart 3.3 Contributions to GDP growth, India

(Chain-weighted basis; forecast data edge 2012)

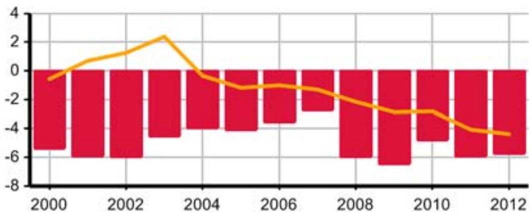


Source: IHS Global Insight

India is also running a double deficit: both the government budget balance and the current account show negative signs (see Chart 3.4). Fortunately the public deficits can be financed quite easily domestically, so that India can keep its external debt at a relatively low and manageable level. Since the current account deficit has to be offset by the capital account, it is essential that India attracts foreign capital.

Chart 3.4 Fiscal and CA balance, India

(Fiscal balance and current account as percentage of GDP)



Source: IHS Global Insight

For that reason, a more welcoming approach to foreign capital is recommended. India's total public debt (domestic and foreign) is high (66% of GDP) but is decreasing as a proportion of GDP. Inflation has levelled off and is expected to remain in single digits for the next few years (8.2% in 2013) but is still high enough to prevent the Reserve Bank of India from significant monetary expansion.

Structural economic reforms are needed to allow a return to the high growth path of 9% per annum that many analyst consider feasible in the medium term if more structural reforms are implemented. The most urgent reforms include investment in physical infrastructure, education, achieving a more flexible labour market and cutting red tape. However, vested interests and government capacity constraints are likely to continue preventing these reforms, at least in the short term.

Nevertheless, the Indian government has taken a few steps in the right direction, such as the liberalisation of the multi-brand retail (supermarket) and aviation sectors and the reduction of fuel subsidies. These are important steps, since inefficient food retail is believed to be an important cause of India's high inflation, while the subsidies on fuel (food and fertilisers) are seen as the main causes of the persistent fiscal deficits.

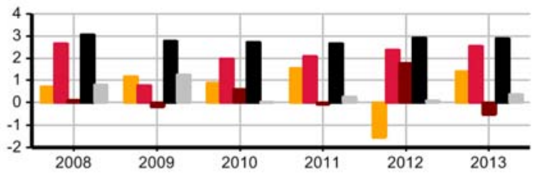
India's banking sector is conservatively managed and traditionally focused on granting credit to the corporate sector. A recent trend is the supply of credit to consumers: in particular mortgages and auto loans. The Indian banking sector is well capitalised and credit quality is considered to be robust. India's sovereign and country risk will remain good, but economic growth (although still significant) may continue to disappoint.

South East Asia: diverse but rising

Indonesia remains the star performer of South East Asia. Economic growth has been above 6% per annum since 2010 and, for 2013, 6.5% is forecast: with private consumption, investment and net exports the main growth drivers (see Chart 3.5). Indonesia is able to achieve this impressive growth while simultaneously keeping inflation and the government budget balance under control. The current account showed a small deficit in 2012 after years of surpluses.

Chart 3.5 Contribution to GDP, Indonesia

(Chain-weighted basis; forecast data edge 2012)



Source: IHS Global Insight

Like India, Indonesia struggles with necessary structural economic reforms. Infrastructure and the business environment need to be improved, corruption combatted, fuel subsidies reduced and the labour market made more flexible. None of these issues is likely to be tackled in the short term. As a result, Indonesia's growth rate is likely to be below its potential but nevertheless the current high growth rate is considered sustainable. As a large and relatively closed economy, Indonesia is not vulnerable to negative developments in the Eurozone. Indonesia's exports are dominated by commodities: mainly towards China. Its sovereign payment capacity, businesses and banking sector are generally in good health.

Vietnam is slowly recovering from a difficult period. Decelerating economic growth, high inflation, a large double deficit, decreasing foreign investment, a weak banking sector and problems at a number of state-owned enterprises dragged the Vietnamese economy into dire straits. However, it now seems to be over the worst. The current account has improved, foreign exchange reserves are rising (albeit from a very low level), inflation has fallen and economic growth has proved to be relatively resilient. Vietnam's foreign debt level remains manageable but the country is still reliant on foreign capital and has little buffers in case of renewed trouble.

After years of political unrest, the government led by Yingluck Shinawatra has restored stability in **Thailand**. The premiership of Yingluck, the sister of the controversial former prime minister Thaksin, has resulted in a return of *Thaksonomics*: the populist policies which include an expansionary fiscal policy, the introduction of a minimum wage and investment in infrastructure and rural areas. These policies will result in healthy economic growth of 4.4% this year but also in a fiscal deficit of similar size. In spite of the government's budget deficit, Thailand's external debt will fall as a percentage of GDP.

Malaysia remains one of the most developed and economically stable countries in the region. It is characterised by strong macroeconomic fundamentals, sound economic policies and a healthy financial sector. Economic growth is consistently high and projected to be 5% this year, driven by private consumption and investment in the oil and gas sector and in infrastructure, while inflation can be kept at a very low 2.2%. The economy is highly dependent on its oil and gas industry which allows Malaysia to run structural surpluses on its budget balance and current account. Private consumption is buoyed by a robust labour market and government transfers.

Myanmar is regarded as the last big frontier market in the region. The country has been a political and economic pariah state for decades, but recently the ruling military junta has become more serious about political reform and rapprochement to Paris Club creditors: a debt restructuring was achieved in January. Myanmar has extensive economic potential: the country is fertile, with natural gas reserves, and offers opportunities for both tourism and labour intensive industry. Its location between China and India is favourable for trade and transport. Economic growth is forecast to be 6.3% for 2013. However, it remains to be seen how serious the military junta is about political and badly needed economic reforms.

Advanced Asian markets

Improved external demand will support the South **Korean** economy. This year, acceleration of economic growth is expected: to 2.8% from last year's 2.1%. The main driver of economic growth is private consumption, encouraged by low unemployment and low interest rates. Inflation in 2012 was 2.2%: below the Central Bank's target. Last year a new president, Park Guen-Hye, was elected. She will continue the pro-business approach but faces the challenge posed by the threat from North Korea. So far, in response to the joint military exercise by the US and South Korea, North Korea has used only harsh rhetoric. Most analysts believe that it will stay a verbal threat and that military action is unlikely.

Taiwan's export-oriented economy benefited from the acceleration of economic growth in China at the end of 2012. Economic growth was 1.3% in 2012 and is expected to increase to 3.5% this year. Private consumption is one of the main drivers as unemployment and interest rates are both low while real wages are increasing. As inflation is moderate, the Central Bank can keep its interest rate at the already low level. The government will tighten its fiscal stance from the loose fiscal policy it has followed in recent years to support economic growth.

Singapore is the main financial and transport hub of the region and therefore the most connected to other parts of the world. This makes its economy vulnerable to the crisis in Europe and to disappointing growth in the US, and this will have an impact on Singapore's exports. Nevertheless, ongoing economic growth in China and the more recent boom in South East Asia has partially offset the effects of the depressed economic situation in the West. Singapore narrowly avoided a recession in the last quarter of 2012 but is expected to generate significant economic growth (2.9%) in 2013, driven by investment in public infrastructure and by private consumption. The city state's dependence on cyclical sectors such as financial services and electronics is somewhat cushioned by the increasing importance of the pharmaceutical industry.

Latin America: uncertain recovery

After the economic moderation of last year, real gross domestic product in Latin America is set to increase: from 2.7% in 2012 to 3.3%. But the pace of the recovery is far from certain. First of all, it is dependent on developments in the industrialised countries of the US and Europe: both important markets for Latin American products. However, as the emphasis of world trade shifts towards the emerging markets, GDP growth there has become equally relevant to the Latin American countries. With economic growth in Asia buoyant again, Latin America's economic activity will receive a boost this year as the continent is an important supplier of commodities, industrial products and goods to Asian markets.

Table 3.3 Real GDP growth - Latin America

	2010	2011	2012	2013f	2014f
Argentina	9.2	8.9	1.9	2.7	2.4
Brazil	7.5	2.7	0.9	3.1	3.7
Colombia	4.3	5.8	4.0	4.1	4.6
Chile	5.2	6.0	5.6	5.1	4.8
Mexico	5.5	3.9	3.9	3.4	4.0
Peru	8.8	6.9	6.3	6.1	6.2
Venezuela	-1.5	4.2	5.6	1.5	2.3

Source: Consensus Forecasts (April 2013)

Brazil: a disappointing performance

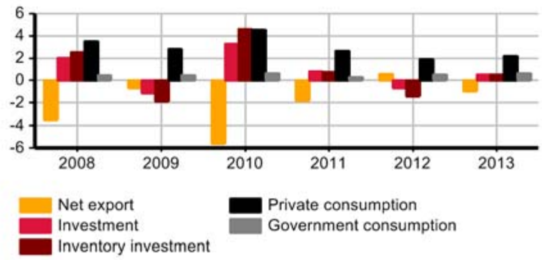
Recent economic developments in Brazil have not been as positive as expected at the end of 2012, when a mild recovery to fuel a broad-based domestic upswing in 2013 was anticipated.

However, the outcome is still rather subdued. First quarter GDP figures were not particularly promising, especially as real domestic demand did not show a marked rebound. In the boom year of 2010, Brazilian consumers accumulated debts so heavily that they are still paying off their debts. And, despite the fact that interest rates have come down significantly, consumers still show little appetite to increase their spending (see Chart 3.6).

At least 2012's recession in Brazil's industrial sector, which cut real output by 2.6%, seems to have come to an end, and this year manufacturing production will rise moderately - by 3% - thanks mainly to exports.

Chart 3.6 Contributions to GDP growth, Brazil

(Chain-weighted basis; forecast data edge 2012)



Source: IHS Global Insight

Although the official Selic interest rate has been left unchanged in the early months of 2013, a monetary tightening in the course of the year cannot be ruled out despite the fragility of the economic upswing. The monetary authorities may have to opt for higher rates in the fight against inflation - stubbornly high at more than 5% annually. In fact, in February the annual rate climbed to 6.3%: not far short of the Central Bank's target ceiling of 6.5%. Higher interest rates may deter a rebound in domestic demand, in which case exports will become an even more important driver of the economic upswing this year.

A rebound is also influenced by the exchange rate of the Real. Foreign investors seeking to profit from high domestic interest rates are driving up the Real exchange rate and ultimately undermining the competitiveness of Brazilian exports. That has already been happening since 2009: surpluses on the capital account have far exceeded deficits on the current account of the balance of payments. In 2011 capital imports totalled USD 112 billion and the deficit on the current account remained at USD 52 billion, causing upward pressure on the Real exchange rate and, after intervention by the Central Bank, an accumulation of reserves.

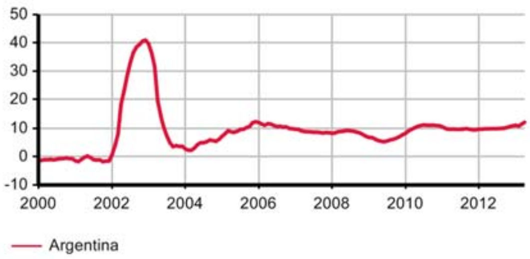
Regional snapshots: a mixed bag

Mexico's new administration has unfolded long-awaited measures ('Pact for Mexico') to restructure an economy that has for decades been characterised by a lack of competition in product and labour markets. President Enrique Peña Nieto, who won last December's elections with a convincing majority, has taken the first steps to reforming certain sectors and enhancing more (foreign) competition. Still uncertain though are his plans for opening up the 'hermetically sealed' energy sector and the state-run oil company Pemex. Such a reform is needed to stop the falling domestic oil production of the last few years.

Meanwhile, the Mexican economy seems destined to continue its moderate but still positive growth rate of 3.5% in 2013. The final outcome will depend largely on developments in its northern neighbour, the USA: recipient of more than 80% of Mexican exports. The success of these exports also depends on the peso exchange rate which is feeling constant upward pressure from the influence of global monetary policies and the subsequent capital imports. The strength of the peso against the US dollar has already prompted the Central Bank to cut the interest rate to 4% in March this year. Mexico's rate of inflation is still fairly moderate (3.6% per annum in February) but remains structurally above that of the US.

Chart 3.7 Consumer price inflation

(Annual percentage change in CPI)



Source: IHS Global Insight

Although **Argentina** is recovering from the low growth of 1.9% in 2012, real GDP growth will remain under pressure in 2013: 2.8% at best. Moreover, statistics in Argentina are unreliable so the final outcome will be even more uncertain. The controls implemented in 2012 to save foreign exchange will hurt business activities this year, as will the social unrest that emerged in 2012 and which will remain a negative factor in any eventual economic recovery. The protests are directed at the fast pace of inflation, which is set to be much higher than the officially reported 10.8% in 2012 (see Chart 3.7). Consensus' estimate, made in February this year, is for an annual rate of more than 25%.

Argentina's weakened international liquidity position, as reflected by a declining level of foreign exchange, will force the monetary authorities to continue to impose import restrictions and currency controls in 2013. These measures will complicate foreign trade, and contribute to payment delays by Argentine importers and to even more capital flight. A devaluation of the peso seems unavoidable.

The death of **Venezuela**'s long-serving leader Hugo Chavez will not change its economic policy in the short term. Vice president Maduro sought to profit from Chavez' popularity in April's elections, but in the event won by just a narrow, and currently contested, margin. He will continue his predecessor's erratic policy that proved a barrier to free market economic activities, created supply shortages, deterred foreign investors and frustrated real economic growth that could raise the living standards of the population. Inflation in Venezuela is high (above 20% in 2012) and there is a continuing risk that the Bolivar exchange rate will be devalued for a second time this year.

The other markets in Latin America have shown sustained GDP growth rates so far in 2013. Colombia, Peru and Chile are main exporters of minerals and commodities and therefore highly reliant on developments in Asia. As those developments continue to be positive, these three countries can expect healthy external finance and economic growth rates this year.

MENA: political uncertainty

Economic growth in the countries of North Africa is affected by internal political uncertainty and the problems in the Eurozone as, for most of them, Europe is the main export market and the main source of tourism and remittances. Vulnerability to external shocks has increased as high oil prices and disappointing export revenue have led to higher deficits on the government budget and current account.

While **Tunisia** has recently accepted an IMF programme, **Egypt** is still delaying the decision to accept one. It is not that Egypt doesn't need such a programme, but the authorities are reluctant as some measures in the IMF programme would be painful for the population. To reduce the large deficits on the government balance, the subsidy system should be reformed, but such reforms would be an unpopular move.

Table 3.4 Real GDP growth - MENA

	2010	2011	2012	2013f	2014f
Egypt	5.1	1.8	2.2	2.7	4.2
Morocco	3.6	5.0	2.5	3.9	4.6
Qatar	16.7	14.8	4.6	4.2	4.8
Saudi Arabia	5.1	7.1	6.8	3.5	4.4
Tunisia	3.5	-1.5	2.5	3.1	4.3
UAE	1.3	4.2	4.2	2.7	3.3

Source: IHS Global Insight (April 2013)

To prevent a balance of payments crisis Egypt needs IMF funding. Its small current account deficit is accompanied by large capital outflows, resulting in a deficit on the balance of payments and a sharp drop in its international reserves. However, the recent inflow of foreign aid from Qatar, Turkey and Libya has eased concerns of a balance of payments crisis in the short term. Economic growth in Egypt is supported by private consumption and government spending, but political uncertainty is constraining growth.

Sub Saharan Africa: high growth

Sub Sahara is continuing its decade-long economic advance. Assisted by structurally high commodity prices (stemming largely from Asian demand) and also by increased political and macroeconomic stability, the continent has achieved economic growth of around 6% per annum since the early 2000s, in spite of unfavourable economic developments in Europe.

Table 3.5 Real GDP growth - Sub-Saharan Africa

	2010	2011	2012	2013f	2014f
Ghana	8.0	14.4	8.4	7.7	7.5
Kenya	5.8	4.4	3.6	4.2	5.3
Nigeria	7.2	7.9	6.7	6.4	6.1
South Africa	3.1	3.5	2.5	2.9	3.5

Source: IHS Global Insight (April 2013)

Africa's largest and most developed economy, **South Africa**, is the odd one out. South Africa's economy was hit badly by the financial crisis and the recovery has been disappointing. Social instability came to the surface last year when miners at the Marikana platinum mine organised wildcat strikes that were violently oppressed by the police. The unrest in the mining sector is likely to persist during 2013.

Economic growth is forecast to be 2.8% this year, due mainly to the government's ongoing fiscal stimulus. This has led to persistent government budget deficits, but these can be financed largely domestically and therefore South Africa's solvency remains solid.

As already mentioned, the situation in the rest of Sub Saharan Africa is much rosier, and political developments in Kenya are particularly interesting. The recent parliamentary and presidential elections went without significant civil unrest, in sharp contrast to the 2007 elections which degenerated into large scale tribal violence. The outcome of the presidential elections – the choice of Uhuru Kenyatta as the new president - will complicate international relations, since Kenyatta has been summoned to attend the International Criminal Court in The Hague. Nevertheless, the quiet course of the elections gave a boost for East Africa's most dynamic economy and growth is expected to accelerate to 4.8% this year.

Angola's economy is driven by oil. Besides its lack of diversification, Angola has to deal with challenges stemming from weak institutional capacity, corruption and poor social indicators. However, it is making progress in tackling these shortcomings and economic policy is strengthened. Oil production will increase in the coming years, and the oil price is currently high. Economic growth has received a further boost from the LNG production which has begun at the Soyo plant: growth is projected to reach an impressive 8.3%.

The CEE region: Eurozone contagion

An economic upswing in the countries of Central and Eastern Europe (the CEE region) will be modest and uncertain. After the 2.4% real GDP growth last year, 2013 will probably end only a little better: at 2.7%. Analysed by sub-regions, economic performance differs markedly. With 3.4% economic growth, the Comonwealth of Independent States (the CIS countries) headed by Russia will register the same business conditions as last year. The countries in south east Europe may be able to shrug of the recession of 2012 (-0.3%) and return to moderate real growth of 1.2%. The weakest performance is to be expected in the countries closest to the Eurozone: Poland, the Czech Republic, Slovakia, Hungary and Slovenia will together realise just 0.8% real GDP growth - little better than last year's 0.6%. Broadly speaking, it is obvious that the nearer the countries are to the borders of the

Eurozone, the poorer the economic results will be. Moreover, the prospect for those economies is rather uncertain, depending on a far from assured recovery in the Eurozone.

Table 3.6 Real GDP growth - CEE

	2010	2011	2012	2013f	2014f
Czech Rep.	2.2	1.7	-1.3	-0.1	1.7
Hungary	1.2	1.7	-1.7	-0.1	1.3
Poland	3.9	4.3	2.0	1.4	2.8
Romania	-1.3	2.5	0.5	1.7	2.6
Russia	4.0	4.3	3.4	3.2	3.8
Turkey	9.0	8.3	2.2	3.9	4.8
Ukraine	4.2	5.2	0.2	0.9	3.5

Source: Consensus Forecasts (April 2013)

In addition to the real economic contagion from the Eurozone crisis, there is a financial impact through the channel of the banking system. Many banks in the CEE region are subsidiaries of banks in the Eurozone. If the parent institutions have financial problems, their subsidiaries in the CEE have to reconsider their portfolios (i.e. deleverage) with a consequent impact on their ability to provide finance in those markets - and thus on real economic activity there.

So far the **Polish** economy has been able to escape the Eurozone turmoil, as evidenced by its fairly reasonable growth rates up to 2012. However, last year both private consumers and investors began to be more reluctant to spend, contributing to a much weaker domestic market. This less upbeat sentiment was only partially mitigated by a more positive export performance, ultimately leading to real GDP growth of just 2%, compared to 4.3% in 2011. Already we can see that 2013 will be hardly any better. Monetary easing by the Central Bank, made possible by the sustained moderation of the inflation rate, may contribute to more impetus to domestic spending in the course of the year but, with the unemployment rate reaching 14% and a government aiming for the 3% GDP criteria needed to apply for Eurozone entry, economic prospects in Poland have become even more subdued.

The social protests in **Bulgaria** and **Romania** against more austerity gained ground in 2012, resulting in the collapse of the governments in Sofia and Bucharest. After the deep recession of 2009, real GDP growth in Bulgaria had remained disappointing because of poor domestic demand and a rather weak export performance due to the crises in the Eurozone and Greece.

The pegging of the lev against the euro gives the monetary authorities little room to implement an independent policy and propel the economy.

The Romanian currency, the leu, is floating against the euro and will come under pressure in the event of more political volatility in the country, as was evidenced last year. Like its southern neighbour, Romania has not been able to recoup 2009's big GDP loss. Economic performance has been quite poor until now, with many households still reluctant to spend and exports within the CEE and to the Eurozone hardly flourishing. The economy narrowly escaped another recession in the second half of 2012.

The economy of **Ukraine** was precarious in 2012, and will remain so this year. The low price of steel, the country's main export, has curbed export growth and contributed to a sustained fall in international reserves. Large current account deficits, high foreign debt service obligations and a lack of IMF-funded financial support mean that the situation will remain fragile throughout 2013. A recovery in the steel market depends on a more pronounced global recovery and is therefore unlikely in the short term. Moreover, the political climate in Ukraine is proving a deterrant to western investors.

Its impressive growth rates since the 2009 recession warrant the question whether **Turkey** has earned the title 'new tiger of the Bosphorus'. After real economic growth of 9% per annum in 2010/11, last year saw a marked cooling of the economy, although this may be only temporary. A new surge in consumer and investor spending is on the cards, together with a sustained growth in Turkish exports. However, some factors threaten to spoil the party:

- the unsettled political situation in the region (Syria, Iraq);
- the high rate of inflation and the deficits on the current account of the balance of payments that rise as the domestic economy grows; And
- Turkey's high dependence on imports of oil and other commodities to satisfy its (energy) needs, a constant burden on its external accounts.

Russia: no reforms but reasonable growth

In our November 2012 Outlook we highlighted the impact of the re-election of Vladimir Putin as Russian president. In brief, it comes with political stability, but also with increased repression[17] and ambitious economic reform plans such as those related to the business environment.

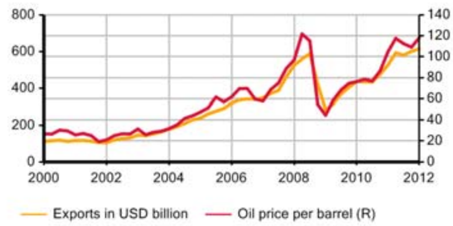
Russia is 112th in the World Bank's 'Doing Business' survey, scoring especially poorly on starting a business, construction permits and cross border trade – and its bureaucracy is notoriously cumbersome. However, far reaching economic reforms, badly needed to address the business environment and to diversify the economy away from the dominant oil and gas sector, are unlikely. That expectation is based on president Putin's record in power and the vested interests of his supporters. Indeed, the current privatisation programme does not look ambitious enough, given that the Russian state controls 50% of the economy. Minority stakes in VTB Bank, Alrosa (mining), Sibir Airlines and TGK-5, a regional electricity producer, are to be sold in 2013, followed by planned sales of, among others, stakes in Aeroflot and Rosneft in 2016.

The government has voiced its opposition to corruption, but any sweeping plan of action has yet to materialise. The one positive note - Russia's entry into the World Trade Organisation (WTO) - is expected to have an economic impact in the longer term. Oil and gas exports (50% of export revenue) are subject to hardly any tariffs in the importing countries. Average tariffs will fall from 13.2% to 10.8%, and that of manufactured goods from 9.5% to 7.3%. More sensitive reductions - on cars, pork and aircraft - will not take effect until 2019/20. The importance of oil to the Russian economy is illustrated by its export dynamics (see Chart 3.8).

[17] In our earlier reports we have noted a rising tendency of repression. One example is the so called 'Pussy Riot' affair, which ended in jail sentences for the band's mocking of the president. A new wave of inspections of NGOs has also been initiated as part of an attempt to crack down on civil society (often referred to as the 'third sector' in society after government and business).

Chart 3.8 Exports and oil price, Russia

(Nominal NIA exports and world oil price expressed in USD)



Source: IHS Global Insight

The economy continues to perform at near to full capacity, with potential and current growth almost overlapping at 3.4% in 2012 as the crucial oil price level remained quite benign. But growth fell from 4.3% in 2011 and was lower than expected because of the political uncertainty in early 2012 and poor global growth. This slower growth trend has continued into 2013 as domestic demand softens: retail sales in January and February saw growth of 2.5% and 3.5% year-on-year. Inflation, a drop in sentiment and the deceleration of credit expansion have all taken their toll.

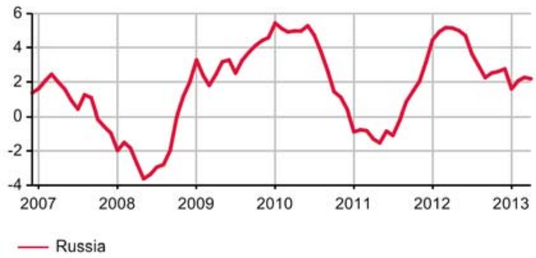
For the forecast period, little change is expected. Assuming an oil price above USD 100 per barrel, we expect 3.3% GDP growth in 2013 and 3.8% in 2014. Higher growth cannot be expected, as an increase in oil production is hampered by oil firms struggling with depleted oil fields and more difficult extraction. Moreover, investment remains relatively low, reflecting the dismal Russian business climate. Macro indicators show a more upbeat picture.

The fiscal balance for 2012 stood at a 0.1% deficit: compared to a 0.8% surplus in 2011. Excluding oil and gas revenues, the deficit would have been 10.6%, also worse than 2011's 9.5%. However, the budget for 2013 signals budgetary tightening as real spending growth will be neutral throughout 2013-2015. A deficit of 0.8% is envisaged in 2013, 0.2% in 2014 and a balanced budget in 2015. These figures assume real GDP growth of 3.6% and an oil price of USD 97 per barrel, which seems realistic. Government debt stood at 7.8% in 2012, and is expected to hover around that level in 2013 and 2014: 8.1% and 8% respectively. Moreover, the Fiscal Rule[18] should help increase the buffer in the Reserve Fund from USD 87 billion in 2013 (4.7% of GDP) to USD 150 billion in 2015 (5.7% of GDP).

[18] The 'Fiscal Rule of 2012' introduces decoupling of government spending from oil price movements and lowering of the break-even oil price: for 2013 estimated at USD 105 per barrel.

Chart 3.9 Real short-term interest rate

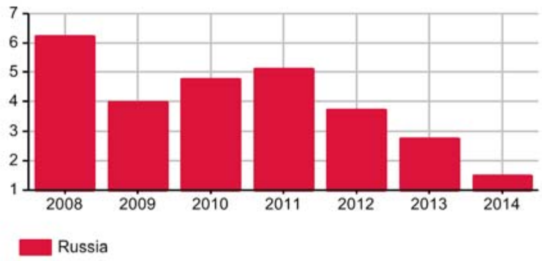
(Percentage, short-term yield adjusted for inflation)



Source: IHS Global Insight

Chart 3.10 Current account balance

(Current account balance as percentage of GDP)



Source: IHS Global Insight

Inflation rose during the second half of 2012 due to a poor harvest, increases in utility prices, temporary monetary easing and a weaker rouble. But the overall figure of 5.1% was considerably lower than 2011's 8.4%. In early 2013 the underlying trend of falling inflation resurfaced, with the figure dropping to 7% year-on-year in March from 7.3% in February. The Russian Central Bank is aiming for 5%-6% inflation for 2013 and 4-5% for 2014. At these inflation rates and with an official rate of 8.25%, the real interest rate is relatively low, indicating a case for further monetary tightening (see Chart 3.9).

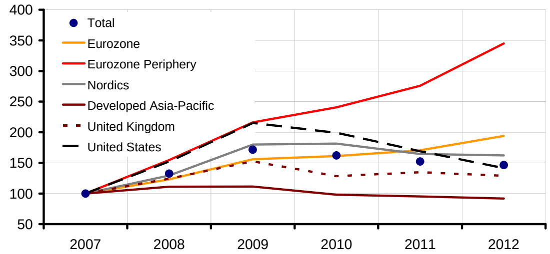
At the current rather benign oil price levels, Russia's oil dominated exports are keeping the current account in healthy territory, at a 4% of GDP surplus in 2012: but lower than the 5.2% in 2011 (see Chart 3.10). Even the capital account improved as Russian banks were able to massively tap the international financial markets: resulting in record capital inflows of USD 23.6 billion. However, this masks Russia's ongoing and increasing underlying problem with capital outflows in the non-financial sector. Indeed, the outflows recorded in that sector reached a record USD 80.4 billion: up from USD 5.4 billion in 2011. Again, this is arguably the result of the lack of investment opportunities in Russia and underscores the need for reforms. For 2013 and onwards, the current account surplus is expected to shrink on the back of increased internal demand and an appreciating real exchange rate. This will inevitably have an impact on capital outflows.

4. Implications for the insolvency environment

Insolvencies at a high level in 2012

Globally, the number of business failures continued to decrease slightly in 2012, mainly as a result of an improved insolvency environment in the Asia-Pacific region and North America. Europe presented a mixed picture. On the one hand the UK and the Nordic countries experienced quite stable insolvency dynamics while, on the other, insolvency risk continued to rise across the Eurozone, driven by the sharply deteriorating economic conditions in the Eurozone periphery.

Chart 4.1 Insolvency developments
(Index, 2007 = 100)



Source: Economic Research

Despite this slight improvement in insolvency risk, the general frequency of default is still high. This can be seen in our insolvency index[19], which shows that a mere stabilisation in the total insolvency level took place (see Chart 4.1). In GDP-weighted terms, we estimate the aggregate insolvency level to be roughly 50% higher than in 2007, i.e. before the onset of the crisis.

Insolvency trends across various regional aggregates show marked differences. In developed Asia-Pacific, the insolvency index is even lower than in 2007. However, this is an exception. In the UK the default level is 30% higher than in 2007 and in the US the corresponding figure is slightly above 40%. In the Nordic region the insolvency index stands at 162, i.e. roughly 60% higher than before the downturn. The common denominator across the regions mentioned above is that the insolvency environment has improved, at least marginally, since 2010.

This is not the case for the Eurozone as a whole, which has continued to deteriorate in every post-crisis year: the estimated default frequency in 2012 is almost twice that of 2007. Not surprisingly, the deterioration has been most accentuated in the countries at the centre of the sovereign debt crisis. In 2012, roughly 3.5 times as many defaults took place in the Eurozone periphery compared to 2007.

It is against this background that we must view the insolvency projections for the period ahead: there is still a long way to go to return to pre-crisis default levels.

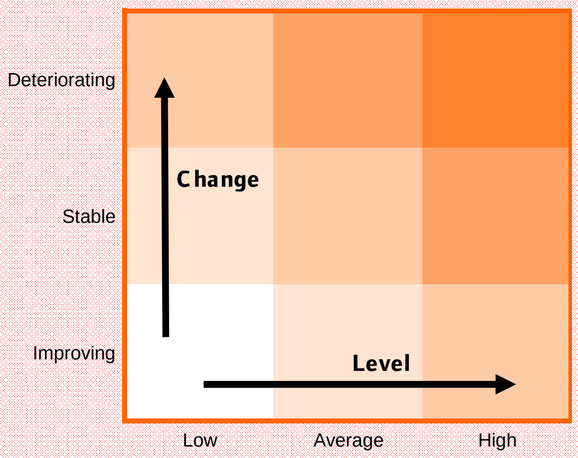
[19] The insolvency index is based on the estimated number of business failures measured within calendar years. The regional averages have been calculated as GDP-weighted (at current exchange rates) country indices: Developed Asia-Pacific (Australia, Japan and New Zealand); Nordics (Denmark, Finland, Norway and Sweden); Eurozone Periphery (Portugal, Ireland, Italy, Greece and Spain); Total represents all 22 markets.

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 a selection of 22 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 of defaults 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 4.1 Risk Matrix



Presented in a 'matrix', the countries included in our insolvency assessment framework are classified according to their level and expected change (see Figure 4.1). 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 row of the matrix.

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 by 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 facilitate 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.

The level, however, influences the insolvency growth dynamics. A country that already experiences an elevated insolvency level is less likely to respond as strongly to cyclical movements as a market that shows a low insolvency level. 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, this mechanical response is adjusted, in a second step, by expert judgement. Structural conditions and other country-specific features are manually taken into account when determining the insolvency forecasts.

2013: a year of stabilising conditions

Applying our insolvency assessment framework (as outlined in Box 4.1), we expect the number of insolvencies to remain more or less stable across major markets in 2013. The aggregate insolvency frequency improves marginally, by less than 2%, in 2013. Since 2012 saw a relatively poor insolvency environment across advanced economies, the degree of forecast improvement is small. In regional terms, the insolvency situation in 2013 is anticipated to closely resemble the conditions of the previous year.

Table 4.1 Insolvency growth (% per annum)[20]

	2010	2011	2012*	2013f
Australia	-1	5	1	3
Austria	-8	-8	3	2
Belgium	2	7	4	6
Canada	-20	-11	-12	-5
Denmark	13	-15	0	-2
Finland	-13	3	0	-2
France	-5	-1	3	4
Germany	-2	-6	-6	-4
Greece	30	33	30	10
Ireland	10	-7	0	-5
Italy	21	17	15	10
Japan	-14	-4	-5	-2
Luxembourg	33	5	8	-5
Netherlands	-10	-1	21	4
New Zealand	-6	-12	-8	-3
Norway	-12	-2	-12	-2
Portugal	16	17	20	5
Spain	2	14	38	5
Sweden	-4	-4	7	3
Switzerland	20	7	3	-2
United Kingdom	-16	5	-4	-3
United States	-7	-15	-16	-6

Source: National bureaus, Atradius Economic Research

The insolvency environment continues to improve marginally in the Asia-Pacific region, with Japan and New Zealand seeing insolvencies drop by 2% and 3%, respectively (see Table 4.1). Similarly, the Nordic region is expected to improve slightly: Denmark, Finland and Norway are all anticipated to see the number of insolvencies drop by 2% this year. Conversely, insolvency risk is forecast to continue to rise across the Eurozone: while the overall insolvency level climbs moderately, the Eurozone periphery increases more significantly. Our anticipation of shrinking economic activity in 2013 for a number of countries is broadly consistent with deteriorating insolvency conditions. Except for Finland, Germany, Ireland and Luxembourg, we expect insolvencies to increase this year. The mixed default outlook for the Eurozone reflects the large and growing differences in economic performance between the core and the periphery.

Some countries show deterioration…

The top-right field of the insolvency matrix holds the countries where insolvencies are at a high level and expected to climb further (see Figure 4.2). In addition to the countries in the south of the Eurozone (i.e. Greece, Italy, Portugal and Spain), Belgium and France also belong to this cluster.

Figure 4.2 Insolvency matrix for 2013

	Low	Average	High
Deteriorating	Sweden	Australia, Netherlands	Belgium, France, Greece, Italy, Portugal, Spain
Stable	Finland, Japan, Norway	Austria, Switzerland	Denmark
Improving	Canada, Germany, New Zealand	United States	Ireland, Luxembourg, United Kingdom

While Belgium and France are expected to stagnate in 2013 (as reported in the second part of this outlook), economic growth is expected to be negative for a third consecutive year in the periphery. These markets have experienced a massive deterioration in their default environment since the previous downturn and, given the protracted recessionary conditions, the insolvency situation is set to deteriorate further.

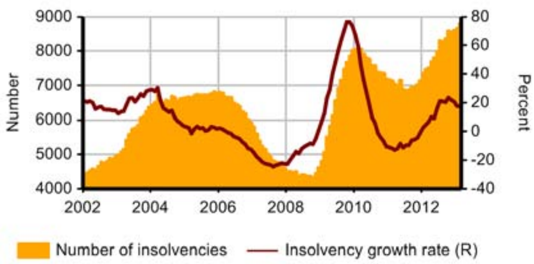
The remaining two fields in the top-row of Figure 4.2 contain countries where insolvencies are at a relatively lower level, but expected to climb in the period ahead. The Netherlands suffered a second sharp insolvency increase in response to the

[20] Note: *) Final figures for all countries except Greece, Ireland, Italy and Portugal. f) Forecast.

economic contraction in 2012: insolvencies increased 21%, reaching an all-time high (see Chart 4.2). As the Dutch economy shrinks in 2013, insolvencies are expected to increase further this year. Although the default level has increased considerably since the previous crisis, the Netherlands still represents an average default market. Australia belongs to the same default type as the Netherlands and is expected to see insolvency growth of 3% in 2013.

Chart 4.2 Insolvency trends, The Netherlands

(1-year trailing sum of insolvency counts based on monthly data)



Source: IHS Global Insight; CBS

The insolvency rate has remained comparatively low in Sweden since the crisis. In line with the sharp moderation in economic activity, insolvencies grew 7% in 2012. Given that the negative insolvency trend persisted in the first quarter, a slight rate of deterioration is also expected for 2013.

…and some remain stable…

As mentioned earlier, the forecast insolvency growth figures for 2013 are small by comparative measures: the expected growth rates range from -6% to +10%. Since many countries have experienced insolvency growth in excess of 25% for several consecutive years recently, the forecast movements are almost marginal. Markets that fall in the range of -2% to +2% we label 'stable'. Japan, together with Finland and Norway, are all low-default countries expected to see marginal improvements.

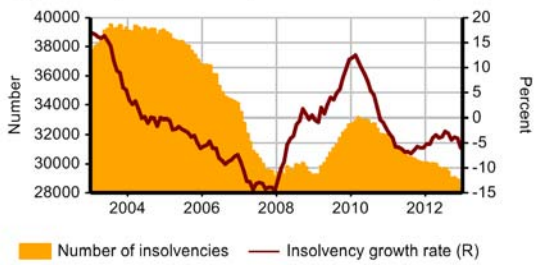
The same goes for Switzerland, which belongs to the average level default category. In Austria, however, we expect to see a marginal increase of 2% in insolvencies. In Denmark insolvencies are at a very high level, but are expected to decrease slightly in 2013. This is in contrast to its Nordic neighbours, which all belong to the low default segment in Figure 4.2. The anticipated 2% improvement in Danish insolvencies is reflective of a gradual adjustment back towards a long-run default level rather than a sign of underlying economic strength.

…while we also see room for improvement

The bottom-left field of the risk matrix shows countries where default conditions in terms of frequency risk are most favourable (i.e. those that display a low level of insolvencies and are likely to see further improvement). Here for example, we find Canada, which has performed better than its peers in terms of economic growth over the last period. Its declining insolvency trend is expected to continue in 2013. New Zealand too remained a low default market throughout the previous crisis. As the insolvency trend is benign and economic conditions are expected to develop in line with potential, we foresee a slight reduction in the number of insolvencies in 2013.

Chart 4.3 Insolvency trends, Germany

(1-year trailing sum of insolvency counts based on monthly data)

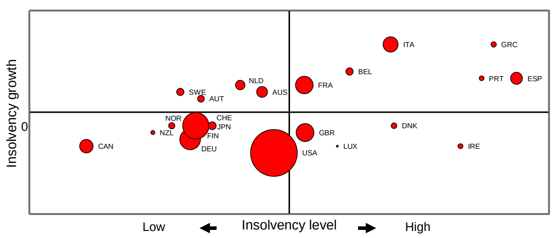


Source: IHS Global Insight

Despite the deep rate of economic contraction in 2009 – and the rather sharp moderation in economic growth in 2011 – German insolvencies have developed in a stable way throughout the past years and the default environment has remained relatively benign (see Chart 4.3). Although economic growth in Germany is expected to be slow in 2013, it represents unchanged conditions. Given the current positive default trend, the insolvency situation is expected to improve somewhat in 2013. Insolvencies in the US continued to decrease in 2012 and, in view of the relatively favourable business cycle performance, insolvencies are expected to decrease by another 6% in 2013. Although the level of insolvencies is still high by historical standards, the US is again regarded as an 'average' default market.

Almost half the countries included in our insolvency framework are currently classified as 'high' insolvency markets, i.e. situated in the right half of Chart 4.4. There are also a number of countries where default rates are perceived as high but are expected to improve as their economies slowly recover in 2013. Ireland, Luxembourg and the UK all display these characteristics. Broad-based insolvency dynamics, applying to both small and large firms, are not only determined by economic growth performance: these dynamics are also influenced by the prevailing credit conditions and the ability of firms to finance themselves. And lending conditions are strained at present, adding to the vulnerability of firms that are highly leveraged. This is an important factor behind insolvency dynamics at the moment, in particular across countries in the European periphery.

Chart 4.4 Insolvency overview 2013
(Insolvency frequency proportional to GDP)



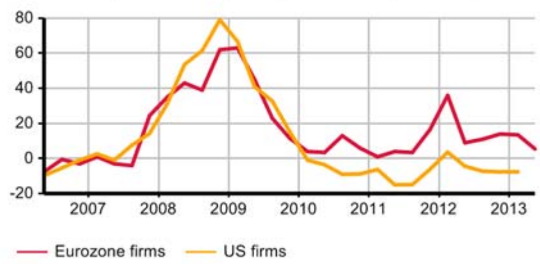
Source: Atradius Economic Research

Tight bank lending behaviour in Europe

In recent years the stuttering banking system has been a dominant factor of economic developments in Europe. As negative news has been abundant, it is of importance to monitor changing conditions in that part of the economy. For European developments, the quarterly bank lending officer survey published by the ECB offers a good yardstick. Constrained lending behaviour across the EU continued in the first quarter of 2013 (see Chart 4.5). About 15% of the banks stated that they had tightened their credit standards as applied to the approval of loans or credit lines to enterprises: the tightening was more profound in long-term lending and lending to large enterprises than for small and medium eterprises (SMEs).

Chart 4.5 Conditions for loan supply

(Net percentage balance of tightening versus easing conditions)



Source: IHS Global Insight; ECB, FED

In addition to stricter loan approval conditions, the terms of credit have also tightened considerably. More than a quarter of banks stated a price increase on loans of all risk classes, with other factors being a reduction in the size of loans and higher collateral requirements. At the same time, only 1% of banks indicated that they have eased their credit standards. The result is a continuation of the tightening credit environment that has been ongoing since the second half of 2007.

Even though the trend in credit supply did not change much, we see a fundamentally different picture in the driving factors behind the tightening. As detailed in previous editions of our Economic Outlook, banks have struggled with balance sheet constraints and the negative impact of the sovereign debt crisis in Europe. However, these factors seem to be of less importance today: more than 93% of the banks state that the sovereign debt crisis no longer affects their lending behaviour and funding conditions. The driving force behind the tightening in 2013, as stated by the bank officials, is instead a generally pessimistic outlook for economic activity in the period ahead.

Against the background of weak future growth prospects it is not surprising that firms' demand for credit has also declined. In net terms, more than a quarter of banks reported falling demand in the first quarter of this year. The importance of falling credit demand cannot be ignored, especially as reductions in fixed investments are the most commonly stated reason. Besides indicating falling business confidence about earnings capacity in the next few years, reductions in fixed investment across Europe are eroding the future economic potential.

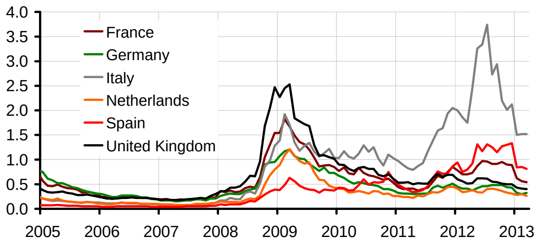
In addition to developments already mentioned, new regulatory requirements are affecting

European banks. In an effort to strengthen their capital positions, banks are decreasing their risky asset positions and demanding higher prices for risks. Both have a negative effect on the real economy as credit supply is further constrained. Looking forward, it is reasonable to assume that credit conditions will tighten further in Europe throughout 2013. Against the background of our economic outlook, as presented in the second section of this report, it is difficult to see a substantial improvement in credit conditions in Europe taking place before 2014.

Large firms: not so different from small

Consistent with the persistently elevated insolvency levels outlined above, the market perception of risk across large firms has remained relatively high since 2010. Nevertheless, we have recently experienced a general improvement in default expectations in large European firms. Expected Default Frequencies (EDFs) have broadly declined since the middle of last year across European countries (see Chart 4.6).[21]

Chart 4.6 Median EDF, Europe
(Default risk 12 months ahead, percent)



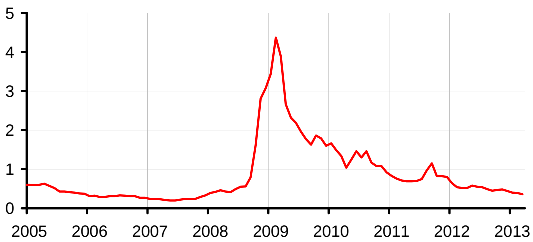
Source: Moody's KMV

The general stock market uplift and low volatility environment during the past six months lies behind these developments. Just as in the case of the insolvency index, it should be stressed that the current risk level still is considerably higher than pre-crisis. In spite of the recent improvements, the EDF evolution across Eurozone markets directly affected by the Eurozone debt crisis implies that risk still hovers at very high levels.

[21] 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.

Suppressed equity valuations combined with high debt levels on corporate balance sheets have resulted in a Greek median default expectation in excess of 8%. The corresponding figure for Portugal is just below 4% and in Italy the median EDF stands at roughly 1.5%. In North America the EDFs have continued to fall, which is in line with its significantly better economic performance. The median EDF in the pool of US firms has fallen further below 0.4%, implying a level similar to the one that prevailed in the fourth quarter of 2005 (see Chart 4.7).

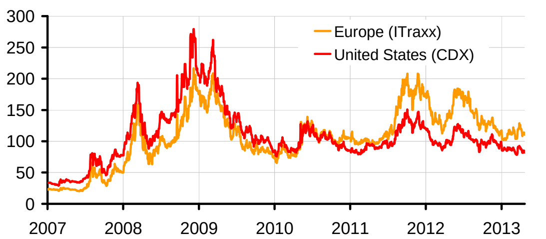
Chart 4.7 Median EDF, United States
(Default risk 12 months ahead, percent)



Source: Moody's KMV

A similar pattern of general default risk is also visible in other metrics of corporate credit risk. Credit Default Swap (CDS) spreads, a useful external benchmark for the price of credit risk, have also been stuck at a relatively high level since 2010. Some reduction in risk has taken place over the past six months, but the current level indicates that the perception of corporate credit risk remains high (see Chart 4.8). The pool of large firms in the listed corporate universe is associated with significantly higher default risk than five years ago.

Chart 4.8 Credit Default Swap spreads
(5-year segement, basis points)



Source: Bloomberg

As reflected in the actions of rating agencies, the trend of general deterioration in credit quality has continued over the same period. Negative rating actions (from the three major rating agencies) are continuing to dominate positive ones in both Western Europe and North America. But the situation in Europe is definitely worse: consistent with an expected poor business climate in the period ahead, there were about five downgrades for each upgrade in the first quarter. In North America, the ratio between upgrades and downgrades is still below one, but with an improving trend over recent quarters: in the US at least, credit ratings are finally showing faint signs of improvement.

An uncertain environment: downside risk

The current scenario for economic performance in 2013 implies another challenging year for businesses, particularly in Europe. Although, as noted in this report, a global economic improvement is expected in 2014, the outlined situation is still representative of rather bleak conditions. And there are significant downside risks to this already stretched scenario throughout the forecast horizon. Further economic contraction ahead contributes to upward pressure on business failures in markets already characterised by high default rates.

In view of the expectations of a weak and protracted Eurozone recovery in 2014 and beyond, demand conditions will remain sluggish over the medium term. Financing conditions for firms are already very tight, hampering the possibilities of making productive investments. Moreover, we anticipate further tightening of lending conditions in Europe throughout 2013.

Although several important political steps have been taken to address the problems in the Eurozone, the debt crisis remains critical and is pulling the real economy further into recession.

Uncertainty around the current outlook for global economic activity is unusually high, with a multitude of risk factors suggesting a fairly large likelihood of weaker developments. In other words, the current outlook is associated with substantial downside risk.

The most recent developments in Cyprus underline the extreme challenges facing European crisis management. Through financial and trade linkages, governments and firms across the globe are vulnerable to an escalation of the Eurozone crisis, which therefore still represents a large risk factor to the global outlook. As discussed in the first part of this report, we expect the Eurozone to remain intact, but the risk of the sovereign debt crisis eventually leading to an exit of one or more member states is not negligible.

A global recession, or double-dip, could materialise as a result of the compounded effects of multiple adverse developments (e.g. if the Eurozone debt crisis worsens again, US politicians fail to tackle the medium-term solutions to the large fiscal deficit, or growth in several major emerging market economies decelerates). In addition to this, there is also growing geopolitical instability. The heightened risk that the dispute between North and South Korea may escalate into military clashes emphasises other latent conflicts and power struggles in the region.

Appendix: 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	2.5	2.9	1.8	2.5	2.5	-2.7	-0.3	0.2	-3.7	-3.5	-3.7	6.3	4.8	2.7
Austria	0.8	0.9	1.5	2.5	1.9	1.9	-2.5	-2.0	-1.5	2.1	2.6	2.7	1.8	1.2	2.8
Belgium	-0.2	-0.4	0.3	2.8	1.4	1.7	-3.9	-3.1	-2.6	-1.4	-1.0	-0.6	0.4	-1.5	0.7
Canada	1.8	1.6	2.5	1.5	1.5	2.0	-3.2	-2.3	-1.4	-3.7	-2.7	-2.1	1.6	1.5	4.5
Denmark	-0.5	0.0	0.3	2.4	1.1	1.6	-4.0	-3.0	-2.6	5.8	5.7	5.2	0.9	-0.8	0.6
Finland	-0.2	0.1	1.6	2.8	2.3	1.9	-1.9	-1.7	-0.8	-1.9	-0.2	0.8	-1.4	1.0	3.0
France	0.0	-0.4	0.4	2.0	1.0	1.7	-4.8	-3.9	-3.0	-1.8	-1.7	-1.4	2.5	0.1	1.3
Germany	0.9	0.7	1.4	2.0	1.4	1.5	0.2	-0.1	-0.3	6.3	6.2	5.9	4.3	2.1	4.0
Greece	-6.4	-5.2	-6.6	1.5	-0.3	16.2	-6.8	-5.1	-0.6	-2.9	-0.9	1.3	-2.4	-1.0	-1.0
Ireland	0.9	0.9	1.5	1.7	1.5	2.0	-8.1	-7.4	-4.9	1.4	1.7	2.4	2.9	1.9	2.1
Italy	-2.4	-1.9	-0.5	3.0	1.7	1.7	-3.0	-3.2	-2.5	-1.1	-0.6	0.0	2.2	1.5	0.6
Japan	2.0	0.8	1.8	0.0	-0.5	1.3	-11.2	-10.2	-7.2	1.0	0.9	0.8	-0.2	0.9	15.0
Luxembourg	0.3	1.3	2.0	2.7	2.0	2.1	-0.8	-1.0	-0.5	6.1	6.8	6.6	-2.5	3.3	5.3
Netherlands	-1.0	-0.7	0.7	2.5	2.5	1.9	-3.3	-3.1	-2.8	8.6	7.4	7.6	3.3	1.9	3.3
New Zealand	3.0	2.7	2.8	1.1	1.4	2.3	-4.1	-4.3	-1.9	-5.0	-5.5	-6.5	2.1	2.6	1.5
Norway	3.0	1.1	1.4	0.7	1.5	1.8	14.0	12.5	11.8	15.5	15.1	14.2	2.2	-2.2	1.1
Portugal	-3.2	-3.2	-0.2	2.8	-0.2	0.9	-6.4	-5.8	-4.1	-2.9	-1.8	-1.3	3.3	-0.1	1.5
Spain	-1.4	-1.9	-0.7	2.4	2.0	1.9	-7.0	-6.2	-4.8	-0.8	1.3	1.2	3.1	2.5	0.4
Sweden	1.2	1.2	1.9	0.9	0.3	1.3	-0.3	-0.6	0.2	6.5	6.7	6.6	1.3	1.0	1.0
Switzerland	1.0	1.4	1.7	-0.7	-0.4	0.4	0.6	0.1	0.2	13.6	12.9	11.8	1.1	3.0	2.3
United Kingdom	0.3	0.7	1.4	2.8	2.9	2.4	-6.5	-6.9	-5.8	-3.7	-3.0	-2.5	-0.2	1.1	2.5
United States	2.2	2.0	2.8	2.1	1.4	1.6	-7.6	-5.6	-4.5	-3.0	-2.7	-2.4	3.4	2.6	5.1
Eurozone	-0.5	-0.6	0.4	2.3	1.5	1.9	-3.2	-2.9	-2.2	1.6	2.0	2.1	2.9	1.4	2.4
European Union	-0.3	-0.2	0.7	2.4	1.7	2.0	-3.5	-3.3	-2.7	0.8	1.2	1.3	2.4	1.2	2.5

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2012 Q4). Date of forecast, 15 April 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	3.2	2.0	2.7	8.4	4.0	4.7	3.2	-1.4	0.5	1.4	1.3	1.2	4.0	2.7	1.8
Austria	0.4	0.6	1.3	1.8	1.1	2.0	0.4	0.6	1.0	-0.7	-0.2	0.1	3.0	1.5	2.3
Belgium	-0.6	0.1	0.1	-0.5	-2.7	0.2	0.1	0.5	0.7	0.7	-0.2	0.0	-3.0	-0.1	0.6
Canada	1.9	2.1	2.4	3.2	1.0	2.6	0.4	1.5	1.6	0.9	0.3	2.2	0.4	-0.2	2.6
Denmark	0.6	-0.2	0.3	2.2	0.4	0.2	0.2	1.7	0.6	-2.2	-0.7	-0.7	-0.7	0.3	0.6
Finland	1.6	0.5	1.3	-2.9	-1.3	2.8	0.8	0.4	0.6	-1.6	-0.8	0.5	-1.6	0.7	2.5
France	-0.1	-0.4	0.3	0.0	-1.3	0.5	1.4	0.7	0.9	-0.6	0.0	0.1	-2.6	-1.3	1.1
Germany	0.6	1.1	1.3	-1.9	1.0	3.5	1.4	1.4	1.3	-0.2	1.9	0.5	-0.4	1.0	4.0
Greece	-9.1	-4.4	-6.2	-19.2	-6.1	-8.9	-4.2	-3.8	-8.4	-12.3	-6.3	-7.3	-3.3	-2.0	-10.7
Ireland	-0.9	1.1	0.7	1.1	-1.5	3.9	-3.8	-1.7	0.7	-2.6	-1.1	-0.7	-1.9	0.4	1.3
Italy	-4.3	-2.7	-0.9	-8.0	-3.8	-1.2	-2.9	-1.5	-0.7	-4.6	-3.6	-1.9	-6.3	-2.8	-0.4
Japan	2.4	0.4	0.6	4.4	3.0	4.3	2.7	0.8	-3.0	1.8	-0.1	0.3	-1.0	-1.4	6.3
Luxembourg	1.7	1.7	2.4	7.0	-1.0	5.4	4.9	2.8	2.1	6.6	4.3	1.4	-5.3	0.5	4.2
Netherlands	-1.4	-1.1	0.6	-4.6	-2.4	0.8	0.0	0.6	1.1	-3.5	-3.1	-1.6	-0.4	-0.5	0.9
New Zealand	2.1	2.8	2.7	6.6	9.6	8.9	0.3	-1.0	0.0	2.7	2.3	2.1	0.0	2.4	2.6
Norway	3.0	1.9	1.1	8.3	4.4	1.5	1.9	2.2	2.3	2.8	0.6	-0.2	2.8	-0.2	1.2
Portugal	-5.6	-3.2	-0.4	-14.5	-8.3	-1.1	-4.4	-3.7	-0.3	-8.2	-3.2	-0.4	-5.0	-1.1	0.8
Spain	-2.1	-3.1	-0.5	-9.1	-5.6	-0.9	-3.7	-2.7	-0.7	-6.4	-5.1	-1.9	-6.0	-3.1	-0.3
Sweden	1.7	1.2	1.4	4.0	1.5	3.5	1.2	1.7	1.5	1.1	1.5	1.2	-1.1	0.1	2.1
Switzerland	2.5	2.0	1.4	0.1	1.6	3.6	0.7	1.7	0.9	1.9	2.0	1.1	2.6	1.5	2.0
United Kingdom	1.2	1.3	1.6	1.5	1.6	3.5	2.2	-0.4	-0.6	-0.5	0.0	1.2	-2.4	-0.8	1.6
United States	1.9	2.2	2.5	6.1	5.0	7.4	-1.3	-2.4	0.1	2.9	2.2	1.1	3.6	3.2	3.0
Eurozone	-1.3	-0.8	0.2	-3.8	-1.8	1.0	-0.3	0.0	0.5	-	-	-	-2.7	-0.8	1.4
European Union	-0.7	-0.3	0.7	-2.6	-1.0	1.6	0.1	0.0	0.4	-	-	-	-2.3	-0.6	1.6

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2012 Q4). Date of forecast, 15 April 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	5.8	6.2	5.6	3.7	3.6	1.7	1.4	1.7	6.6	5.7	5.7	8.9	2.9	4.9
ASEAN	5.5	5.1	5.5	3.9	4.2	4.3	2.8	2.5	2.6	6.1	4.4	4.8	1.9	4.6	7.0
China	7.8	8.1	8.3	2.7	2.5	3.5	2.6	3.2	3.1	8.2	8.9	9.0	4.2	5.1	7.6
Hong Kong	1.4	3.7	4.6	4.1	3.8	3.5	3.0	3.9	4.2	4.0	4.5	4.7	1.3	5.0	6.6
Taiwan	1.3	3.6	4.4	1.9	1.6	1.8	9.9	9.6	9.1	1.5	2.5	3.4	0.1	5.0	6.1
India	4.2	6.0	6.9	9.3	9.5	7.2	-4.4	-3.5	-3.3	3.8	5.5	5.9	0.5	7.6	11.4
Singapore	1.3	2.4	4.2	4.5	3.8	3.0	16.2	15.1	16.7	1.7	1.8	3.2	0.3	2.9	8.0
Latin America	2.5	3.4	4.1	6.6	7.5	7.1	-1.7	-1.8	-1.7	3.9	3.6	4.3	0.9	2.9	4.6
Argentina	1.9	1.8	2.8	10.0	12.0	12.2	0.5	0.6	0.6	4.4	1.8	2.8	-6.6	0.3	3.1
Brazil	1.0	2.9	4.2	5.4	6.3	5.4	-2.4	-2.4	-2.2	2.9	3.3	4.9	0.4	2.3	6.3
Mexico	3.9	3.6	5.0	4.3	3.9	3.8	-0.5	-0.5	-0.4	3.5	3.5	4.4	4.5	5.4	7.9
CIS	3.5	3.1	4.1	5.8	6.6	5.8	3.2	2.8	2.0	8.3	4.1	5.2	1.3	3.1	2.4
Czech republic	-1.2	-0.1	2.0	3.3	1.9	1.9	-2.4	-2.4	-2.3	-3.5	-0.1	1.6	4.1	-0.5	3.6
Hungary	-1.8	-0.2	0.9	5.7	3.5	3.7	1.6	1.5	2.0	-2.0	-0.2	0.9	2.0	-0.5	1.1
Poland	2.0	1.1	2.8	3.7	1.4	2.7	-3.5	-3.2	-3.5	0.5	0.4	2.9	2.3	2.9	3.1
Russia	3.4	3.0	3.9	5.1	6.3	5.2	3.7	2.8	1.5	6.8	3.6	5.8	1.4	1.4	0.8
Turkey	2.2	3.8	4.2	8.9	6.5	5.5	-6.0	-6.3	-6.1	0.1	3.0	3.7	17.2	5.0	3.9
Africa	5.0	4.3	4.8	8.5	7.2	7.1	1.1	0.5	-0.1	4.8	4.7	4.0	7.9	4.1	4.9
South Africa	2.5	2.9	3.5	5.6	5.8	6.0	-6.2	-6.7	-6.8	3.5	3.2	3.4	0.1	3.9	5.7
MENA	3.6	2.5	3.6	8.2	8.3	6.8	12.0	9.4	6.5	2.8	3.4	3.8	7.3	-0.2	3.0
BRIC	5.5	6.3	6.9	4.3	4.5	4.5	1.0	1.4	1.3	5.9	6.2	7.1	2.9	4.6	6.9
World	2.6	2.6	3.5	3.2	2.9	3.2	-	-	-	2.3	2.3	3.0	2.9	2.6	5.0

Source: IHS Global Insight

Note: * Excluding Japan

Note: IHS Global Insight forecasts for 2013 and 2014 (Data edge 2012 Q4). Date of forecast, 15 April 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.

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