GLOBAL ECONOMIC OUTLOOK – OCTOBER

2011

Monetary and Statistics Department
External Economic Relations Division

CZECH NATIONAL BANK

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I. SUMMARY

The October issue of the Global Economic Outlook presents recent and expected developments in selected countries from the point of view of standard indicators such as GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices. The regular detailed analysis (section VII *Focus*) looks back at the autumn meeting of the Institute of International Finance (IIF) which was held on 23–25 September in Washington and dealt with issues such as the future of housing financing, financial stability and the role of rating agencies in the financial system, and the changing face of the Middle East. Systemic stability and the role of global financial firms, and fiscal management in mature economies were also discussed. As usual, IIF economists also presented their Global Economic and Financial Outlook.

Financial, equity and commodity markets have recently responded with sharp swings to the results of the frequent meetings of European politicians, who are trying – so far not very successfully – to resolve the Greek debt crisis and to find a viable systemic solution that will calm investors and stop the debt crisis spreading to large euro area countries. However, the austerity measures taken by governments across Europe to reduce their debts are having a negative impact on economic growth. This, in turn, is reducing the effectiveness of the austerity measures and increasing social tensions in many countries. Moreover, the situation is being complicated by rating agencies, which expect the austerity measures to produce a slowdown in economic growth in problem countries rather than to generate benefits, and are expressing their concerns about the future financing of these countries' government debts by downgrading their ratings. Central banks in advanced countries are trying to stimulate their domestic economies by lowering interest rates (despite rising inflation) and are taking often highly non-standard measures to further (quantitatively) ease the monetary conditions. The reduced demand in advanced countries is affecting export-oriented emerging economies, whose economic growth is starting to weaken. Their central banks are therefore likely to soon end the period of interest rate increases, which they have so far used to combat the overheating of the economy and elevated inflation.

The above developments have resulted in a further decline in the economic growth outlook, especially in the euro area and Germany in 2012. There is also a growing risk of recession, particularly in the countries of the southern periphery of the euro area. The lower outlook for economic growth should cause inflation to decline from its current elevated levels next year. Commodity prices should also cause inflation to fall if their decline is sustained. The October leading indicators signal a worsening economic outlook in the euro area, including Germany. By contrast, the PMI edged up in China and the USA, which, moreover, showed an improvement in consumer confidence.

Interbank market rates in the euro area remained flat; their falling outlook is currently in line with the October CF forecast that the ECB will lower its main refinancing rate by 0.25 p.p. before the end of the year and again in early 2012. By contrast, LIBOR dollar rates have been rising since the start of August and their outlook is upward. Yields on both German and US ten-year government bonds bottomed out around mid-September and edged up above 2% in October.

The US dollar responded as usual to the increased uncertainty and investors' risk aversion by appreciating, this time exceptionally strongly. The dollar-euro exchange rate thus reached an eight-month high at the start of October.

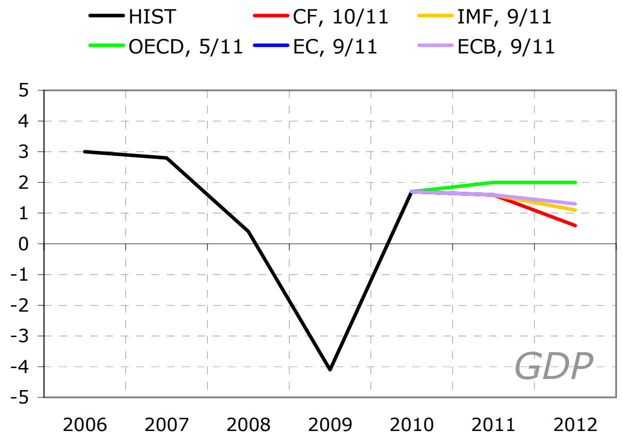
While the resultant decline in energy commodity prices in the previous month was only moderate (despite a strong wobble), prices of industrial metals continued to fall as a result of the deteriorating economic outlook. Even more surprising, however, is the strong across-the-board decline in prices of food commodities, which occurred mainly in September.

II.1 GDP

The global economic slowdown is continuing and the risk of recession is rising. The new outlooks (CF and BOFIT) suggest lower growth in all the economies monitored by the GEO in 2011 than in 2010. While the advanced economies are suffering the consequences of debt and financial problems, economic growth in China is being dampened mainly by monetary policy tightening. Economic growth in the euro area will decline to 1.6% in 2011, pulled down by less-than-1% growth or even stagnation in the countries of the southern periphery (Greece, Italy, Portugal and Spain). GDP growth in Germany will be 2.9% in 2011, while the USA will record a 0.1 p.p. higher growth. According to CF and BOFIT, China will grow by 9.0–9.1% this year.

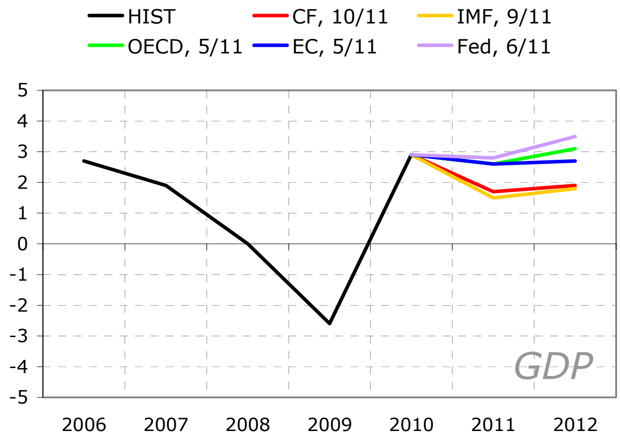
Growth is expected to slow further in 2012 (0.6% in the euro area, 1.0% in Germany and 8.0–8.5% in China). The exception is the USA, where the economy will grow by 1.9% next year.

EURO AREA



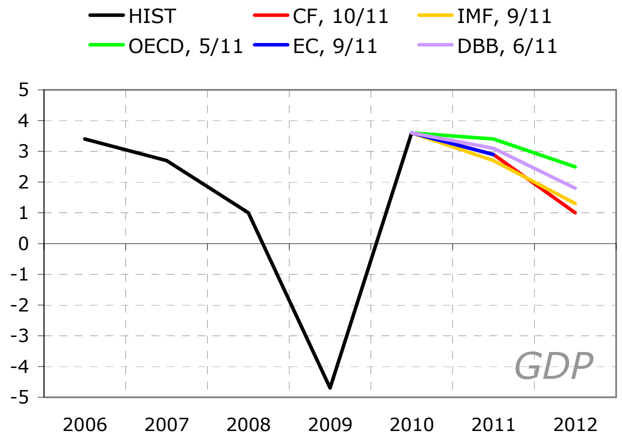
	HIST	CF	IMF	OECD	EC	ECB
2010	1.7					
2011		1.6	1.6	2.0	1.6	1.6
2012		0.6	1.1	2.0		1.3

USA



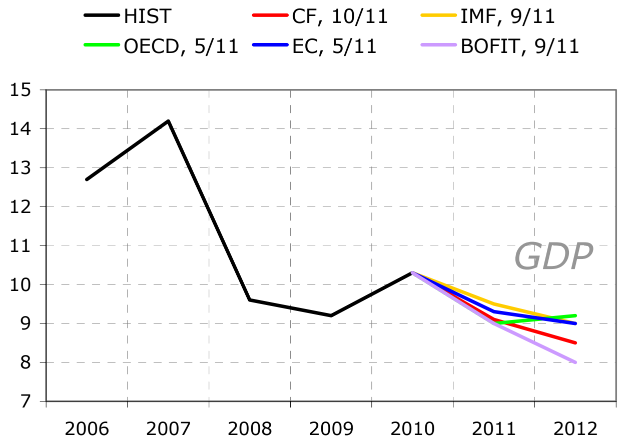
	HIST	CF	IMF	OECD	EC	Fed
2010	2.9					
2011		1.7	1.5	2.6	2.6	2.8
2012		1.9	1.8	3.1	2.7	3.5

GERMANY



	HIST	CF	IMF	OECD	EC	DBB
2010	3.6					
2011		2.9	2.7	3.4	2.9	3.1
2012		1.0	1.3	2.5		1.8

CHINA



	HIST	CF	IMF	OECD	EC	BOFIT
2010	10.3					
2011		9.1	9.5	9.0	9.3	9.0
2012		8.5	9.0	9.2	9.0	8.0

Note: Legend shows latest forecast data in format “Source, month/year of forecast publication”. HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 14 October 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

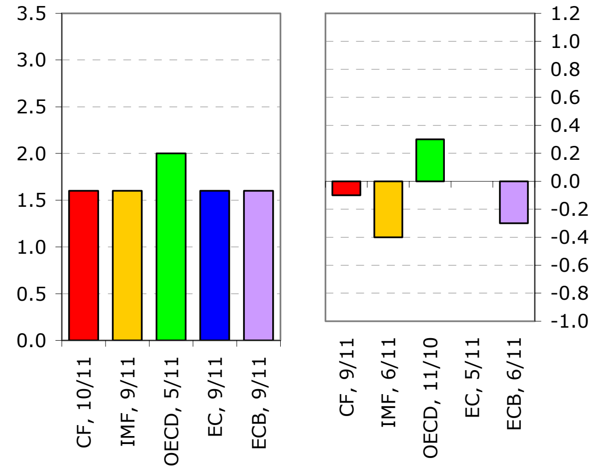
II.2 Current GDP forecast and change from the previous forecast

For the third consecutive month, Consensus Forecasts (CF) reduced its estimate for euro area economic growth in 2011 and now expects it to be 0.1 p.p. lower than its September estimate (see the chart below). On the other hand, the outlook for the USA is 0.1 p.p. higher than previously forecasted. The outlooks for Germany and China for 2011 remained unchanged; BOFIT also left its September outlook for China's economic growth unchanged.

According to CF, the euro area and Germany will have more moderate growth in 2012 compared to the September outlook, by 0.4 p.p. and 0.3 p.p. respectively. The economic growth outlook for the USA in 2012 was unchanged in the October CF. CF expects GDP growth in China in 2012 to be 0.1 p.p. lower than the previous outlook. BOFIT left its 2012 outlook unchanged.

EURO AREA

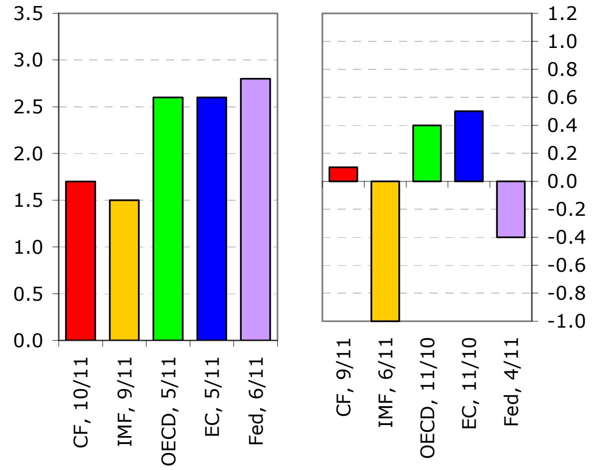
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	ECB
Forecast	1.7	1.6	1.6	2.0	1.6	1.6
Change		-0.1	-0.4	0.3	0.0	-0.3

USA

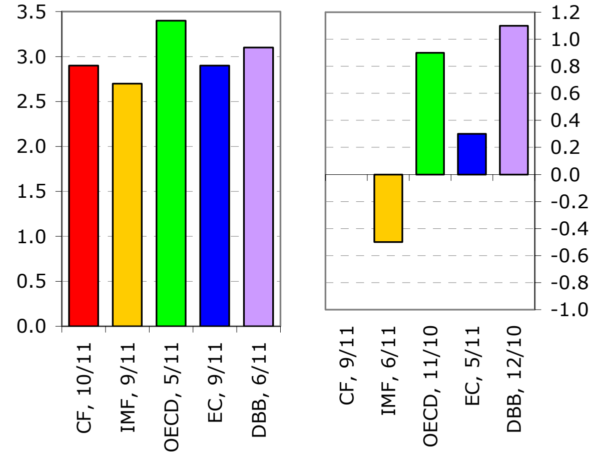
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	Fed
Forecast	2.9	1.7	1.5	2.6	2.6	2.8
Change		0.1	-1.0	0.4	0.5	-0.4

GERMANY

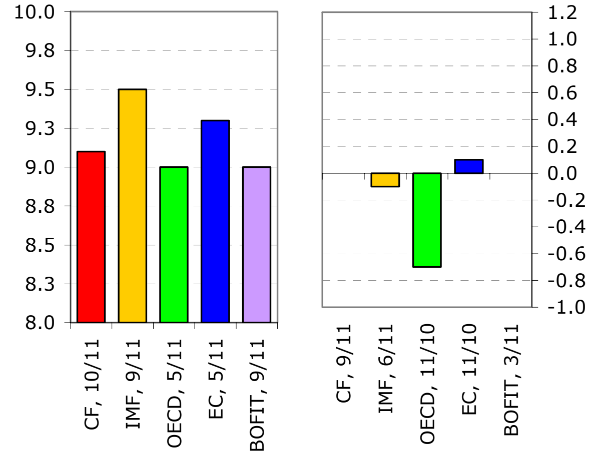
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	DBB
Forecast	3.6	2.9	2.7	3.4	2.9	3.1
Change		0.0	-0.5	0.9	0.3	1.1

CHINA

Forecast forecast for 2011 | Change from previous forecast



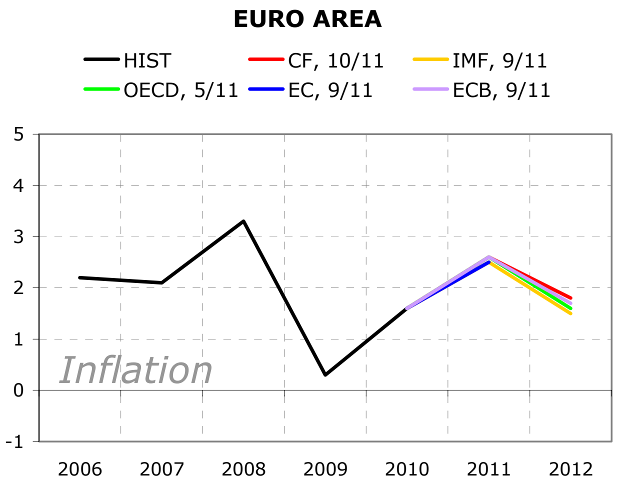
	2010	CF	IMF	OECD	EC	BOFIT
Forecast	10.3	9.1	9.5	9.0	9.3	9.0
Change		0.0	-0.1	-0.7	0.1	0.0

Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 14 October 2011]
Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

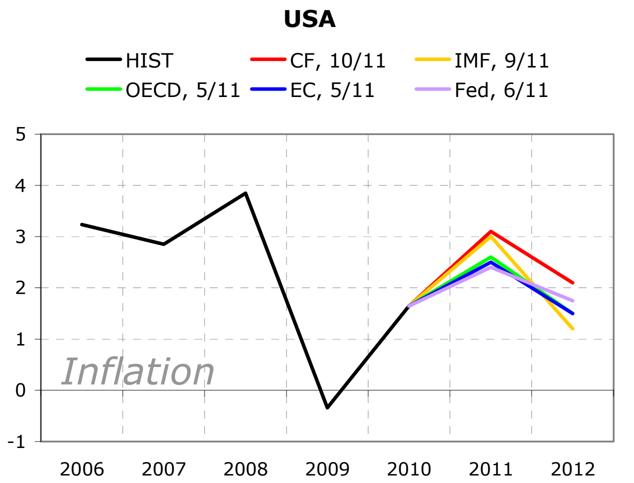
II.3 Inflation

Inflation in the euro area and Germany will remain well above 2% this year: inflation is expected to be 2.6% in the monetary union as a whole and 2.3% in Germany. Inflation in the USA will increase to 3.1%, while prices in China will grow at 5.4% despite the monetary policy tightening.

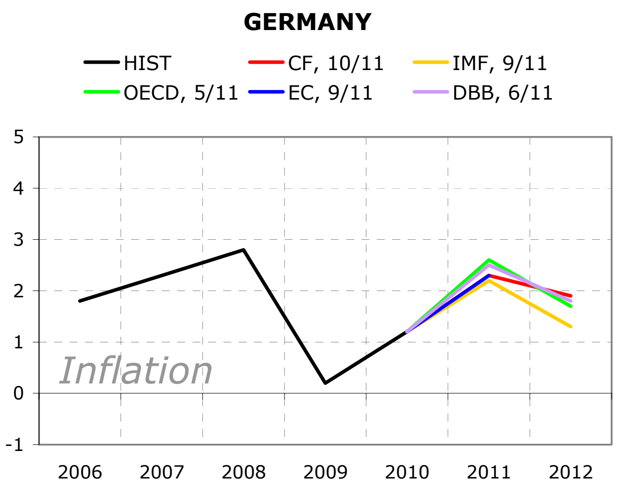
Having surged this year, inflation is expected to slow next year. Inflation is expected to be 1.9% in Germany and 1.8% in the euro area in 2012. Inflation in the USA will slow to 2.1%, while price growth in China is not expected to exceed 4%.



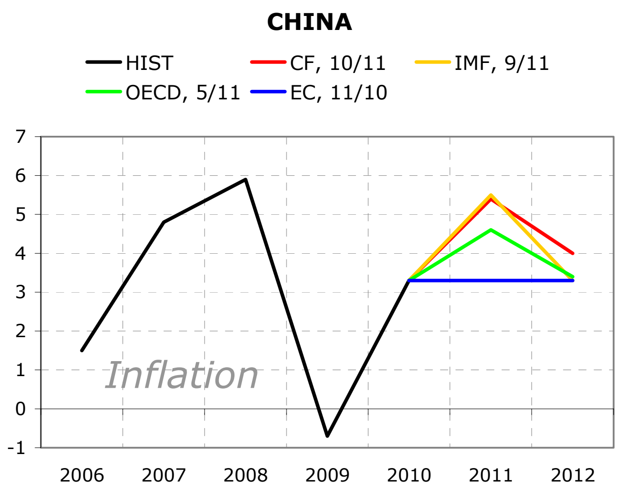
	HIST	CF	IMF	OECD	EC	ECB
2010	1.6					
2011		2.6	2.5	2.6	2.5	2.6
2012		1.8	1.5	1.6		1.7



	HIST	CF	IMF	OECD	EC	Fed
2010	1.6					
2011		3.1	3.0	2.6	2.5	2.4
2012		2.1	1.2	1.5	1.5	1.8



	HIST	CF	IMF	OECD	EC	DBB
2010	1.2					
2011		2.3	2.2	2.6	2.3	2.5
2012		1.9	1.3	1.7		1.8



	HIST	CF	IMF	OECD	EC
2010	3.3				
2011		5.4	5.5	4.6	3.3
2012		4.0	3.3	3.4	3.3

Note: Legend shows latest forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 14 October 2011]

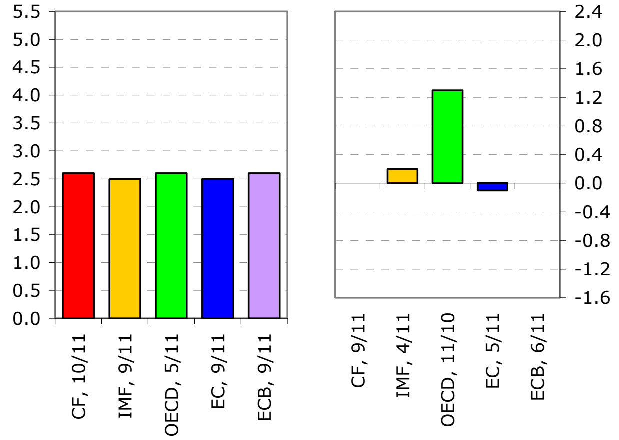
Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.4 Inflation forecast and change from the previous forecast

The October issue of CF left the outlook for inflation in the advanced economies monitored by the GEO unchanged both this year (see the chart) and the next year. Inflation in China in 2011 and 2012 has been revised upwards by 0.1 p.p. by the October CF.

EURO AREA

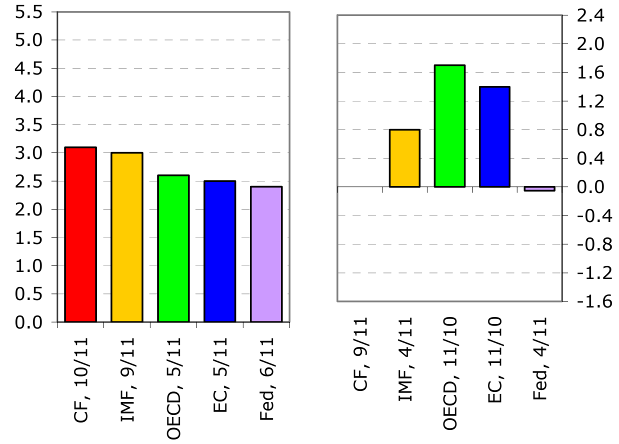
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	ECB
Forecast	1.6	2.6	2.5	2.6	2.5	2.6
Change		0.0	0.2	1.3	-0.1	0.0

USA

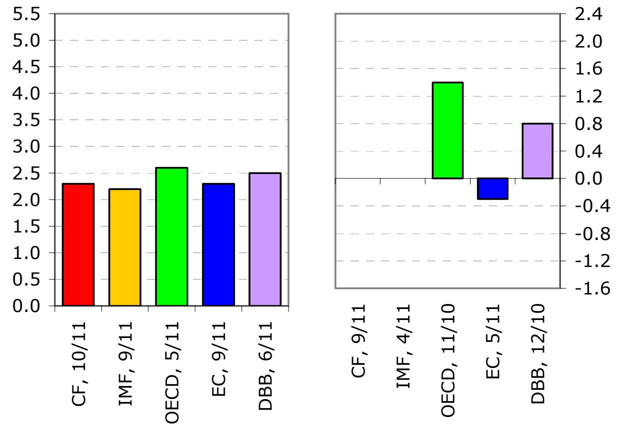
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	Fed
Forecast	1.6	3.1	3.0	2.6	2.5	2.4
Change		0.0	0.8	1.7	1.4	-0.1

GERMANY

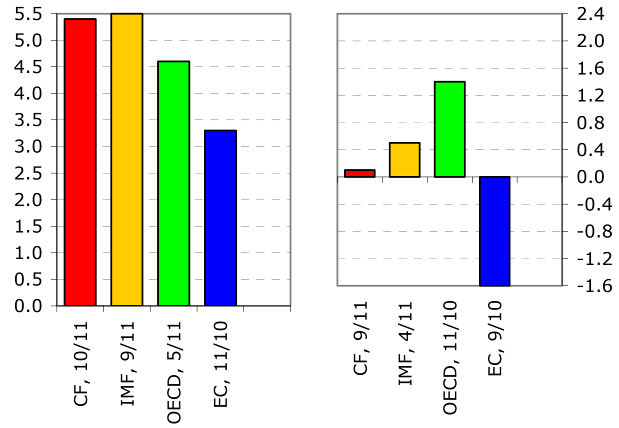
Forecast forecast for 2011 | Change from previous forecast



	2010	CF	IMF	OECD	EC	DBB
Forecast	1.2	2.3	2.2	2.6	2.3	2.5
Change		0.0	0.0	1.4	-0.3	0.8

CHINA

Forecast forecast for 2011 | Change from previous forecast



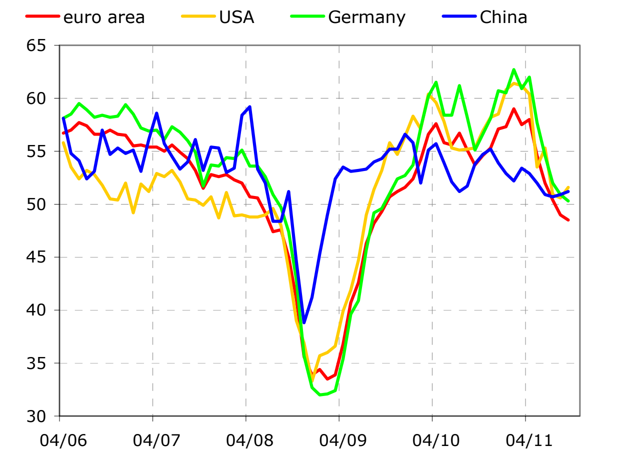
	2010	CF	IMF	OECD	EC
Forecast	3.3	5.4	5.5	4.6	3.3
Change		0.1	0.5	1.4	-1.6

Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 14 October 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

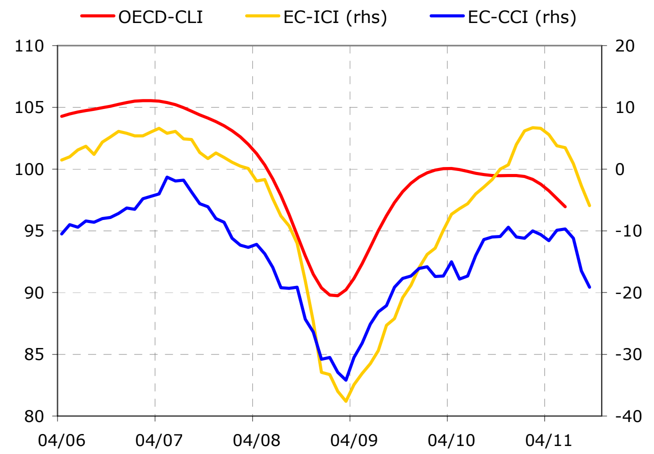
Based on leading indicators, the economic outlook for the euro area including Germany deteriorated further in October, while economic growth expectations for the USA and China improved slightly. A similar estimate applies to future industrial production; the PMI (Purchasing Managers' Index) increased in the USA and China, while deteriorating further in the euro area and Germany. In addition to a higher prediction for industrial production, consumer confidence indicators improved in the USA. In the euro area, along with the PMI in industry (which fell to 48.5 points and stayed below 50 points for the second consecutive month), all the other monitored leading indicators – business and consumer confidence indicators – deteriorated. Similarly, in addition to the PMI in industry, all the other indicators declined in Germany, confirming the overall deterioration in expected economic developments.

PMI IN MANUFACTURING



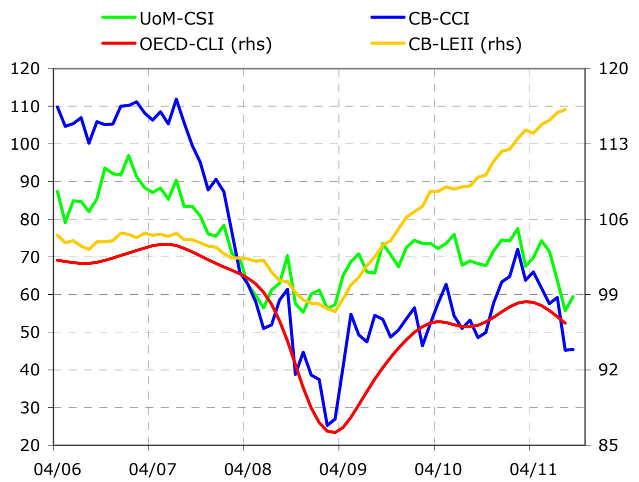
	EA	US	DE	CN
7/11	50.4	50.9	52.0	50.7
8/11	49.0	50.6	50.9	50.9
9/11	48.5	51.6	50.3	51.2

EURO AREA



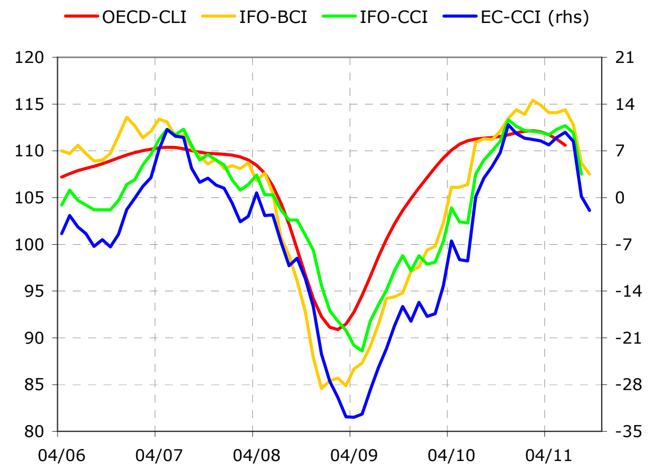
	OECD-CLI	EC-ICI	EC-CCI
7/11		0.9	-11.2
8/11		-2.7	-16.5
9/11		-5.9	-19.1

USA



	OECD-CLI	CB-LEII	UoM-CSI	CB-CCI
7/11	96.9	115.9	63.7	59.2
8/11	96.3	116.2	55.7	45.2
9/11			59.4	45.4

GERMANY



	OECD-CLI	IFO-BCI	IFO-CCI	EC-CCI
7/11		112.8	111.9	8.4
8/11		108.7	107.5	0.2
9/11		107.5	0.0	-1.9

Note: OECD-CLI stands for OECD Composite Leading Indicator, EC-ICI (right-hand scale) for European Commission Industrial Confidence Indicator, EC-CCI (right-hand scale) for EC Consumer Confidence Indicator, CB-LEII for Conference Board Leading Economic Indicator Index, CB-CCI for CB Consumer Confidence Index, UoM-CSI for University of Michigan Consumer Sentiment Index, IFO-BCI for Institute for Economic Research – Business Climate Index, and IFO-CCI for IFO Consumer Confidence Index. [Cut-off date for data: 14 October 2011]

Source: CNB calculation using OECD, EC, IFO and UoM databases.

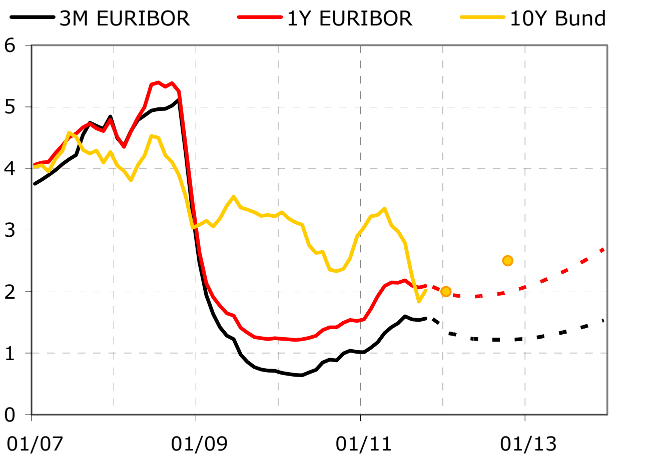
IV.1 Outlook for short-term and long-term interest rates: Euro area

The ECB left its interest rates unchanged at its October meeting. Its refinancing rate is thus still 1.5%. The ECB responded to the escalating debt crisis by supplying additional long-term liquidity using refinancing operations with 12M and 13M maturities. It also decided to purchase up to EUR 40 billion of loans (covered by bonds). No future reduction of the refinancing rate (in response to the deteriorating outlook for economic activity) was mentioned.

The 3M EURIBOR remained flat in September and the first half of October just above the ECB's main refinancing rate. However, the expected fall slowed compared to the previous month's forecast and copies the expected values of the ECB rate, which CF10 expects to be lowered by 0.25 p.p. before the end of 2011 and further in 2012 Q1. Renewed growth is expected in 2013. A similar path (at higher levels) is expected for the 1Y EURIBOR.

The ten-year German government bond reached a historical low on 22 September, when its yield dropped below 1.7%. Although it has corrected somewhat since, CF10 has considerably reduced its outlook again. The yield is expected to remain roughly at the current 2.0% at the 3M horizon and to edge up only to 2.5% at the 1Y horizon.

EURO AREA



	09/11	10/11	06/12	12/12	06/13	12/13
3M EURIBOR	1.54	1.56	1.23	1.23	1.34	1.53
1Y EURIBOR	2.07	2.09	1.93	2.05	2.32	2.69
	09/11	**10/11**	**01/12**	**10/12**		
10Y Bund	1.84	2.02	2.00	2.50		

Note: Forecast for EURIBOR rates is based on rates implied by interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizon). Forecast for German government bond yield (10Y Bund) is derived from CF forecast. Dashed lines and points represent outlook. [Cut-off date for data: 12 October 2011]

Sources: Thomson Reuters (Datastream), Bloomberg, CNB calculations.

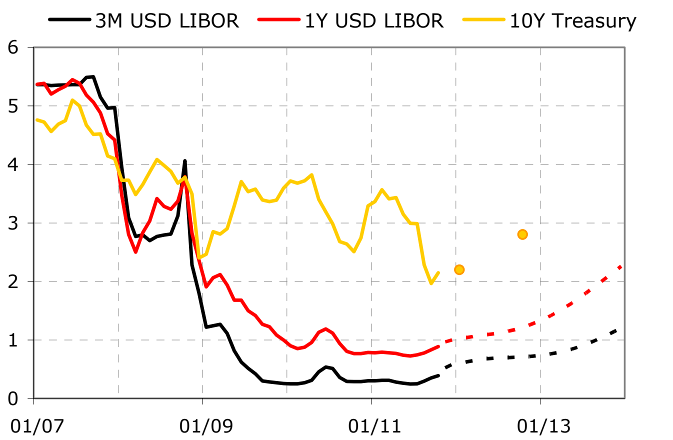
IV.2 Outlook for short-term and long-term interest rates: USA

Besides its August commitment to hold rates low at least until mid-2013, the Fed decided in September to change its portfolio time structure due to "significant downside risks to the economic outlook". Operation Twist involves the purchase of USD 400 billion of bonds with 6Y–30Y maturities and the sale of an equal amount of bonds with up to 3Y maturity. The operation should have the same impact as a 0.5 p.p. monetary policy rate cut.

Despite this, dollar LIBOR rates have been rising since early August and their outlook has been revised upwards from the previous forecast. The rise is expected to accelerate further, especially from 2013 onwards.

The 10Y government bond yield followed a similar path as the German bund. CF10 greatly reduced its forecast here as well.

USA



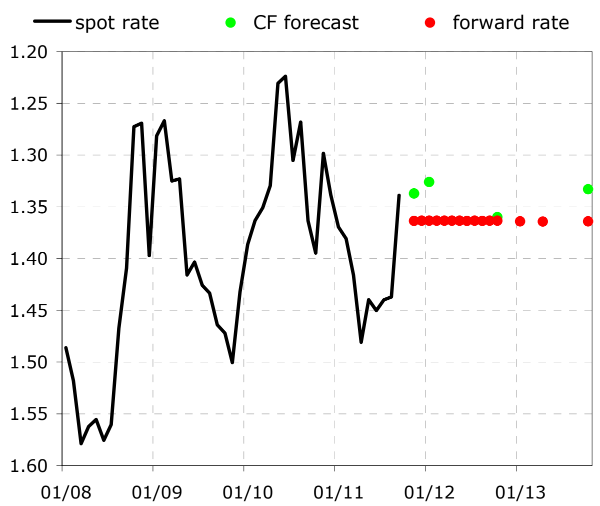
	09/11	10/11	06/12	12/12	06/13	12/13
3M USD LIBOR	0.35	0.39	0.69	0.73	0.88	1.20
1Y USD LIBOR	0.83	0.89	1.11	1.30	1.71	2.26
	09/11	**10/11**	**01/12**	**10/12**		
10Y Treasury	1.96	2.15	2.20	2.80		

Note: Forecast for 3M and 1Y USD LIBOR rates is based on rates implied by London interbank market yield curve (USD LIBOR rates are used up to 3M, 3M FRA rates up to 15M, and adjusted IRS rates for longer horizon). Forecast for US government bond yield (10Y Treasury) is derived from CF forecast. Dashed lines and points represent outlook. [Cut-off date for data: 12 October 2011]

Sources: Thomson Reuters (Datastream), Bloomberg, CNB calculations.

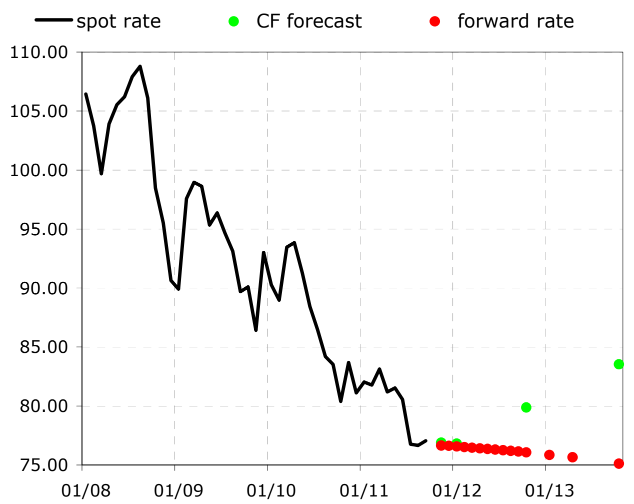
The US$ per euro rate has been appreciating since early September, reaching an 8-month high, due to higher risk aversion and the persisting debt crisis in the euro area. The dollar was also supported by the Fed's decision to finance the purchase of longer-term bonds by selling shorter-term bonds without need to increase the money supply. The current situation was also reflected in the outlook for the exchange rate, which is projected to be stable at USD 1.33/EUR at the 1Y horizon. Investors' renewed interest in the dollar was also due to the introduction of a cap on the Swfr per US$ rate. Since then, the franc has been just below this limit, although interventions were necessary just a few days after the cap was introduced. The cap thus seems to be credible and the new CF also expects the rate to be stable below CHF 1.2/EUR at the 1Y horizon. A further round of quantitative easing in response to a worse outlook for UK economic growth resulted in a significant depreciation of the pound against the dollar. According to CF, this trend will last until the end of 2011. The outlook for the yen showed no major changes.

US$ per Euro



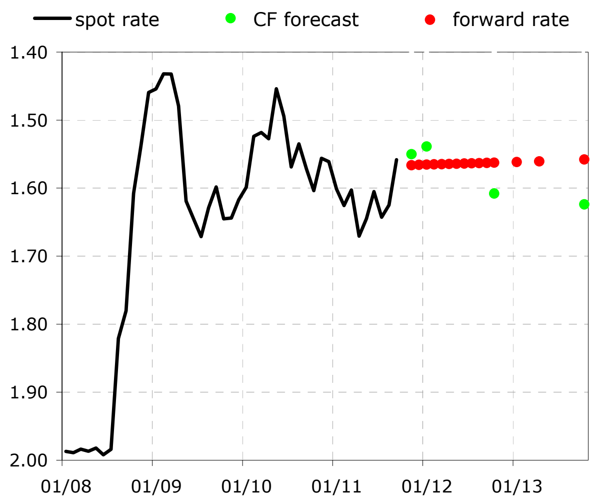
	10/10/11	11/11	01/12	10/12	10/13
spot rate	1.364				
CF forecast		1.337	1.326	1.360	1.333
forward rate		1.364	1.363	1.363	1.364

Yen per US$



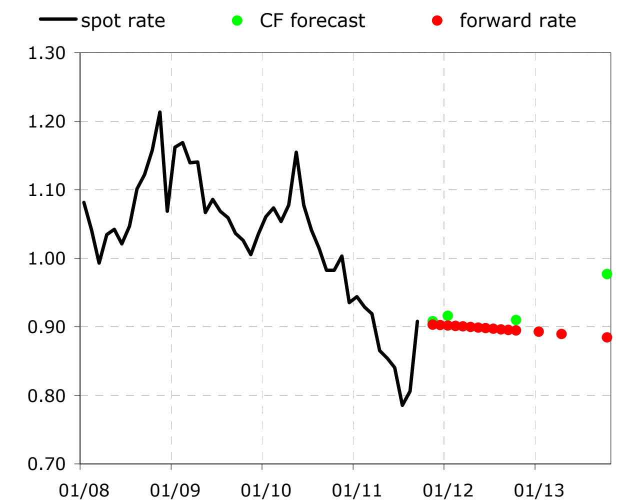
	10/10/11	11/11	01/12	10/12	10/13
spot rate	76.68				
CF forecast		76.89	76.80	79.86	83.53
forward rate		76.65	76.56	76.07	75.11

US$ per UK£



	10/10/11	11/11	01/12	10/12	10/13
spot rate	1.567				
CF forecast		1.550	1.539	1.608	1.624
forward rate		1.566	1.565	1.563	1.558

Swfr per US$



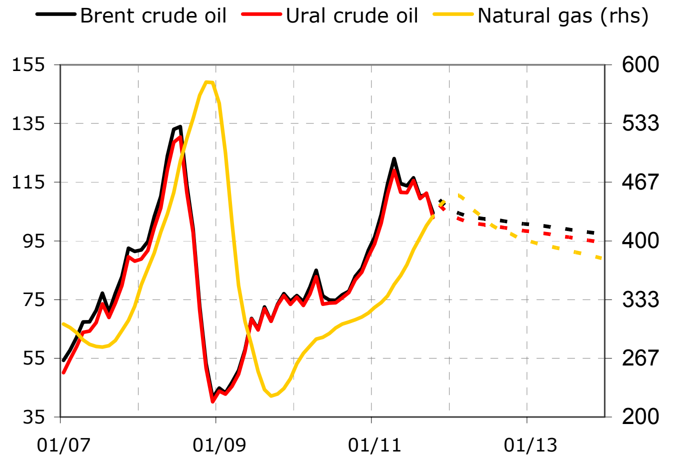
	10/10/11	11/11	01/12	10/12	10/13
spot rate	0.904				
CF forecast		0.908	0.916	0.910	0.977
forward rate		0.903	0.902	0.895	0.884

Note: Increase in currency pair represents appreciation of US dollar; data as of the last day of the month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibilities for securing future exchange rate. [Cut-off date for data: 15 October 2011] Source: CNB calculation using Bloomberg and Consensus Forecasts databases.

VI.1 Oil and natural gas

The Brent crude oil price has been fluctuating around a gently falling trend since about April 2011. Periods of relative stability or modest growth have been alternating with sharp falls. In the first half of September the Brent oil price moved within a horizontal band of USD 110–115 a barrel. A relatively strong decline followed in the rest of the month, and on 4 October the price dropped below USD 100 a barrel again for the first time since February 2011. As in the previous three cases, however, a fast upward correction followed, and the Brent price was again above USD 110 a barrel in mid-October. The futures-based forecast remains down sloping, but has shifted downwards by around USD 4 a barrel over the entire horizon compared to the previous month's levels. The market is therefore not expecting any future problems with supply and expects it to grow thanks to the gradual renewal of supplies of Libyan oil.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS



	10/11	06/12	12/12	06/13	12/13
Brent crude oil	104.5	102.5	100.8	99.2	97.3
Ural crude oil	103.0	100.5	98.4	96.6	94.5
Natural gas	428.0	425.0	401.3	390.4	380.2

Note: Oil prices in USD/barrel are taken from listings on London-based ICE Futures Europe international exchange. Prices of Russian natural gas at border with Germany in USD/1000 cubic m are calculated using IMF data. Future oil prices are derived from oil futures. Dashed line represents outlook. [Cut-off date for data: 12 October 2011].

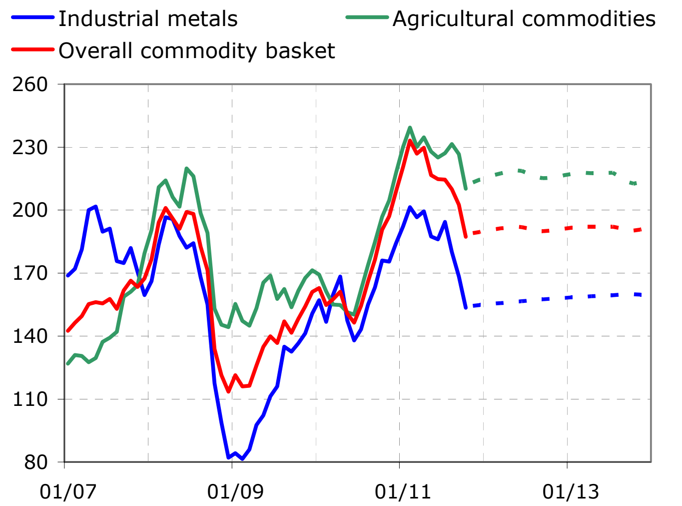
Source: Bloomberg, IMF, CNB calculations.

VI.2 Other commodities

Energy commodity prices (including coal prices) recorded only a slight decline in September, but the price fall across other commodities was significant. Prices of wheat, maize, rice, soy and sugar fell by around 20% and the price of coffee by a full quarter. Only meat prices showed the opposite trend, remaining close to their historical highs (beef in particular). As for non-food agricultural commodities, the price of rubber fell (by 17%), while the price of cotton has been flat since mid-July (having fallen sharply in Q2). Prices of industrial metals also fell sharply in September – aluminium by only 10% (still with an upward outlook), but copper by 25% (with a flat outlook). Lead, nickel, platinum and zinc prices fell significantly, while prices of steel and iron ore were little changed.

The average monthly index of non-energy commodity prices was thus 20% lower in the first half of October compared to its February high. The food commodity sub-index recorded a smaller decline (12%), while industrial commodities fell by 28% (of which industrial metals by 24%).

OUTLOOK FOR OTHER COMMODITY PRICES



	10/11	06/12	12/12	06/13	12/13
Industrial metals	153.5	156.6	158.2	159.3	159.6
Agricultural commodities	210.1	218.6	216.6	217.6	214.2
Overall commodity basket	187.3	191.9	191.1	192.0	191.2

Note: Chart shows indices, year 2005 = 100. Dashed line represents outlook. [Cut-off date for data: 12 October 2011].

Source: Bloomberg, outlooks based on futures.

A LOOK BACK AT THE IIF ANNUAL MEMBERSHIP MEETING[1]

The annual membership meeting of the Institute of International Finance (IIF)[2] was held on 23–25 September in Washington, D.C., simultaneously, as usual, with the annual meeting of the International Monetary Fund and the World Bank. The first day of the meeting began with a session on the future of housing finance, followed by sessions on financial stability and the role of ratings and rating agencies in the financial system. As usual, the second day of the meeting was given over first to presentations by IIF economists on the economic and financial outlook for mature and emerging economies. The programme then included a special session on the changing face of the Middle East, followed by a discussion forum consisting mainly of central bankers addressing the current turbulent macroeconomic outlook. The evening programme featured a tribute to the outgoing ECB President Jean-Claude Trichet, including a special address by the former Fed Chairman Paul Volcker. Discussion forums on systemic stability and the role of global financial firms and on fiscal management in mature economies were held on the final day of the meeting.

1. The future of housing finance

The reason for having this opening session, according to Hung Q. Tran (IIF), was the significant role of the US mortgage market and its crucial role in the financial crisis which started in 2007. The discussion focused primarily on the situation in the United States (Shaun Donovan, US Secretary for Housing and Urban Development; Peter Wallison, Arthur F. Burns; and John Walsh, Office of the Comptroller of the Currency), which was then contrasted with the (according to all the evidence) functioning German mortgage market (Matthias Metz, Bausparkasse Schwabisch Hall AG).

Mr Donovan focused on the mortgage market situation after the collapse of Lehman Brothers, which consisted in stabilising Fannie Mae and Freddie Mac,[3] including the Federal Housing Administration. He emphasised in this context that the aim of his agency is to help stabilise home prices and eliminate significant home price volatility. Four important steps should contribute to this: (i) keeping existing home-owners in their homes and reducing the level of foreclosures; (ii) increasing the liquidity of properties and the property market; (iii) reducing the number of properties for which mortgages are higher than their current market price; and (iv) reducing difficulties with access to home-financing credit, which would be aided by a decline in unemployment. Mr Donovan concluded by declaring the Obama administration's goal (White Paper) of reducing the excessively high percentage of guaranteed mortgages and suppressing the roles of Fannie Mae and Freddie Mac on the US mortgage market and creating a functioning regulatory framework for all mortgage market agents (including consolidation of the existing regulatory institutions).

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[1] Written by Luboš Komárek (Lubos.Komarek@cnb.cz). The opinions expressed in this issue are those of the author and do not necessarily reflect the official position of the Czech National Bank.

[2] The IIF (www.iif.com) is a global association of financial institutions (mainly large ones) created in 1983 in response to the international debt crisis. Members include most of the world's largest commercial banks and investment banks, insurance companies and investment management firms.

[3] The Federal National Mortgage Association, commonly called Fannie Mae, was established in 1939 during the Great Depression as part of President Roosevelt's New Deal. The Federal Home Loan Mortgage Corporations, known as Freddie Mac, was set up in the 1970s to compete with Fannie Mae and to create a robust and efficient secondary mortgage market.

John Walsh's presentation focused on explaining the activities of banks – as mortgage providers supervised by his Office – aimed at the regeneration of the US mortgage market. Mr Walsh mentioned the Office's efforts to discuss foreclosures retrospectively in cooperation with banks and to find solutions to such foreclosures. Ultimately, both banks and existing home-owners should profit from this process.

In contrast to the above speakers, Peter Wallison pressed strongly for sweeping changes to the operation of the US mortgage market. Generally speaking, he said, the role of the US government on the mortgage market should be reduced and this room should be left to the market. Referring to the White Paper mentioned by Mr Donovan, he suggested three possible approaches to the reform of the US mortgage market: (i) a fully private system; (ii) a private system with a backstop role for the government in the event of financial crisis; (iii) a government-guaranteed system similar to the existing one, using agencies similar to Fannie Mae and Freddie Mac (which had generated enormous losses, i.e. costs for taxpayers). Mr Wallison mentioned that Republican lawmakers would prefer a more radical switch from the current system to a more private one and a downscaling of the activities of Fannie Mae and Freddie Mac.

The final presentation was given by Matthias Metz, who pointed to the functioning and time-tested viability of the German mortgage market, which has stable prices as well as a very low mortgage default ratio. The German system is based on three pillars: a deliberate legal and regulatory framework, a prudent financing culture, and a stable funding base of (Bauspar) savings, covered by bonds. According to Mr Metz, there are three reasons why the German model is successful: (i) there is a mandatory down payment; (ii) you cannot walk away from your mortgage (underwater borrowers are still liable for it); (iii) there is a long-term relationship between the client and the bank.

2. The role of ratings and rating agencies in the financial system

Another interesting, and quite lively, debate was the session on rating agencies. They were represented by Richard Cantor (Moody's) and Paul Coughlin (Standard & Poor's). Peter Kerstens (Delegation of the EU to the USA) and especially Soledad Núñez Ramos (Ministry of Economy and Finance, Spain) acted as natural opponents.

Mr Cantor dealt with two key questions: *What is the real role of ratings?* and *What is the correct role of rating agencies in the financial system?* The answers to the first question were that (i) ratings should be treated by market participants just like any other independent information; (ii) no institution should have a monopoly on credit opinions; (iii) a rating represents the overview of one of many independent institutions; (iv) an investor should have the option of consulting the rating results with the agency and of being supported by research and previous results in the area, i.e. ratings should foster, not terminate, market dialogue. He then presented the role of ratings from the perspective of imperfect information (the principal-agent relationship), which gives rise to information asymmetry, leading to the problems of adverse selection and moral hazard. Regulatory authorities have been working with ratings in a mechanistic (not prudential) sense, with the regulator acting as the principal and the securities-purchasing financial institution as the agent. Mr Cantor sees the latter question as being more complex, especially as regards rating agencies' impact on financial markets. One camp is calling for the influence of the current major rating agencies[4] to be reduced. Three recommendations might help achieve this: (i) a reduced role of ratings in the regulatory framework; (ii) constraints on publishing ratings; (iii) the establishment of a

[4] Standard & Poors, Moody's Investor Service and Fitch Ratings

government agency providing an alternative view of credit risk. The other, probably less strong camp is calling for rating agencies to have a greater influence and highlighting their independent opinion of rated firms.

In the next presentation, Paul Coughlin started by adding that ratings express relative opinions about the creditworthiness of an issuer or credit quality of its debt. At the same time, ratings cannot be treated as absolute measures of default probability. Mr Coughlin then dealt with Standard & Poor's key rating criteria, namely comparability, transparency, harmonisation and simplification. He demonstrated these criteria on the creation of sovereign ratings, which consist of five key areas – political, economic, external, fiscal and monetary scores.[5] The following part of his presentation dealt with sovereign rating migration and distribution. Here, the best performer is the Asian-Pacific region, with the highest number of rating and outlook upgrades. Looking back at the ratings issued in Europe, he noted that Standard & Poor's had downgraded the rating for Greece from A+ to A in 2004. The market premium between Greece and Germany had nonetheless been very low at the time. Mr Coughlin then tried to answer the question of whether rating actions lead to market destabilisation. That the evidence does not confirm this he demonstrated by comparing Standard & Poor's ratings with the implicit ratings (CDS Market Indicators) and CDS spreads for Greece, Ireland, Italy and Portugal, as well as for the United Kingdom, for which the indicators do not currently signal a change in rating. Standard & Poor's has also adopted new bank-rating criteria which enable transparent identification of whether a potential change in rating is due to a change in the business, capital and earnings, risk or liquidity position. Mr Coughlin concluded by saying that the rating agencies had not caused the market over-reaction during the crisis and had fulfilled their role well.

A contrasting view was presented by Ms Ramos, who began by agreeing with Mr Cantor and Mr Coughlin that rating agencies play an important role in the globalised modern world. Rating agencies had lost some of their reputation (by insufficiently revealing the problems of rated entities and assets) and were trying to get it back. Ms Ramos based her criticism of the functioning of rating agencies on the procyclicality argument. Procyclicality, she said, is a result of excessive consideration of markets' perceptions rather than fundamental analysis, and also of inappropriate timing of rating actions. In this context, Ms Ramos proposed a rule that rating agencies should make decisions on Thursdays and announce ratings on Fridays C.O.B. This rule would prevent strategic games aimed at influencing markets and would allow a rated entity to publish its opinion before the markets open again. Ms Ramos concluded her presentation by illustrating the inappropriateness of rating actions on the example of the Spanish economy.

3. The IIF Global Economic Outlook

According to IIF economists, the global economy faces four challenges arising from the effects of: (i) the Arab Spring (higher oil prices[6] and weaker growth in MENA[7] countries, (ii) the Japanese earthquake (a strong effect on global industry), (iii) fiscal tightening in mature economies, and (iv) monetary tightening in emerging economies. The Global

[5] In this context Mr Coughlin illustrated that the recent downgrading of the USA's rating was due to the political score.

[6] The IIF prediction expects the gap between the prices of WTI and Brent oil to narrow again after 2013. This gap emerged at the start of this year owing to a large decrease in the WTI oil price. We will deal with this topic in more detail in the November issue of the Global Economic Outlook.

[7] MENA stands for Middle East and North Africa.

Economic Outlook was then presented by IIF Chief Economist Phillip Suttle (see the table).

Table: Outlook for global economic activity and inflation

Country	Real GDP growth (% y/y)			Inflation (% y/y)		
	2011	2012	2013	2011	2012	2013
Developed Economies	1.4	1.8	2.1	2.2	1.3	1.7
United States	1.6	1.8	2.4	3.0	1.0	2.0
Euro Area	1.7	1.3	1.7	2.0	2.0	2.0
Japan	-0.3	2.8	1.9	-0.3	-0.1	0.0
Emerging Markets	6.3	6.0	--	6.3	5.7	--
Latin America	4.2	3.7	--	8.3	8.5	--
Emerging Europe	4.5	3.7	--	6.4	6.2	--
Emerging Asia	8.0	7.9	--	5.4	4.2	--
Africa/Middle East	4.6	4.1	--	6.2	6.2	--
World total	3.4	3.6	--	3.9	3.2	--

Mr Suttle then asked why monetary policy is not working as it should. In his opinion, the main reason is a deterioration in the functioning of the transmission mechanism, in particular the credit channel. This is evidenced both by persisting very low credit demand and by low credit supply. According to Mr Suttle, this situation is due to commercial banks focusing too much on trading in new central bank instruments in quantitative easing programmes instead of on classical credit business.

He went on to present six macro realities facing commercial banks: (i) The euro crisis, which means that banks, especially systemically important ones, face a tough choice: protect themselves or protect the financial system, where they play a significant role? The ongoing effort to reform the regulatory framework adds to the challenges faced by commercial banks. (ii) It’s tough for banks to live in a near-zero interest rate world, as demonstrated by the poor profits of Japanese banks and increased asset price volatility (a possible consequence of very low rates). (iii) Policymakers are keen to deflect attention away from their own failings; rescue proposals are subject to frequent changes and remain in unfinished form. (iv) The spread of financial protectionism, which is especially prevalent in Europe. Some hope is pinned on Basel III.[8] (v) Equity investors now view banks as low return and high risk. This will result in very expensive equity financing for banks. (vi) It’s a two-speed world, as reflected in a dilemma in commercial banks’ strategy: whether to concentrate on emerging regions with a view to sharing in their stronger economic growth, or to focus on stagnant local markets.

Mr Suttle ended his presentation of the IIF Global Economic Outlook with the following slogan: “*The Global Economy Will Be Airborne Momentarily*”. This can be interpreted differently in British and US English,[9] and it is up to each individual to decide which is the more likely option. The remaining presentations in this session focused on the economic situation on individual continents and on the fact that the current crisis is a “balance sheet crisis”.[10] However, voices were heard at the IIF meeting warning that the current situation in the advanced economies may be worse than at the time of the Lehman Brothers collapse.

[8] The first four points relate mainly to mature economies.

[9] “Airborne momentarily” can mean “for a minute” in British English and “in a minute” in US English.

[10] Financial institutions’ balance sheets are contaminated by less or more toxic assets.

BOFIT	Bank of Finland Institute for Economies in Transition
CB-CCI	Conference Board Consumer Confidence Index
CB-LEII	Conference Board Leading Economic Indicator Index
CBOT	Chicago Board of Trade
CF	Consensus Forecasts
CN	China
CNB	Czech National Bank
DBB	Deutsche Bundesbank
DE	Germany
EA	euro area
EC	European Commission
ECB	European Central Bank
EC-CCI	European Commission Consumer Confidence Indicator
EC-ICI	European Commission Industrial Confidence Indicator
EIU	The Economist Intelligence Unit database
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserve System (the US central bank)
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
CHF	Swiss franc
IFO	Institute for Economic Research
IFO-BCI	IFO – Business Climate Index
IFO-CCI	IFO – Consumer Confidence Index
IMF	International Monetary Fund
IRS	Interest rate swap
JPY	Japanese yen
LIBOR	London Interbank Offered Rate
N/A	not available
OECD	Organisation for Economic Co-operation and Development
OECD-CLI	OECD Composite Leading Indicator
UoM	University of Michigan
UoM-CSI	University of Michigan Consumer Sentiment Index
US	United States
USD	US dollar

	Issue
International integration of the Chinese stock market (Jan Babecký, Luboš Komárek and Zlatuše Komárková)	2011-1
The link between the Brent crude oil price and the US dollar exchange rate (Filip Novotný)	2011-2
A look back at the IIF spring membership meeting (Jan Hošek)	2011-3
Monetary policy of the People’s Bank of China (Soňa Benecká)	2011-4
Winners and losers of the economic crisis in the eyes of European investors (Alexis Derviz)	2011-5
How have global imbalances changed during the crisis? (Vladimír Žďárský)	2011-6
Assessment of the forecasts monitored in the GEO (Filip Novotný)	2011-7
Eurodollar markets (Narcisa Kadlčáková)	2011-8
Increased uncertainty in euro area financial markets (Tomáš Adam and Soňa Benecká)	2011-8
Monetary policy of the central bank of the Russian Federation (Oxana Babecká)	2011-9
Where to look for a safe haven currency (Soňa Benecká)	2011-9
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