GLOBAL ECONOMIC OUTLOOK – JUNE

2011

Monetary and Statistics Department
External Economic Relations Division

CNB CZECH NATIONAL BANK

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In addition to the standard outlooks for GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices, the June issue of the Global Economic Outlook also presents an ad hoc analysis on: "HOW HAVE GLOBAL IMBALANCES CHANGED DURING THE CRISIS?" It contains an evaluation of the developing imbalances in the four economically most important countries (territories) representing more than one half of the world economy, i.e. the United States, the euro area, China and Japan.

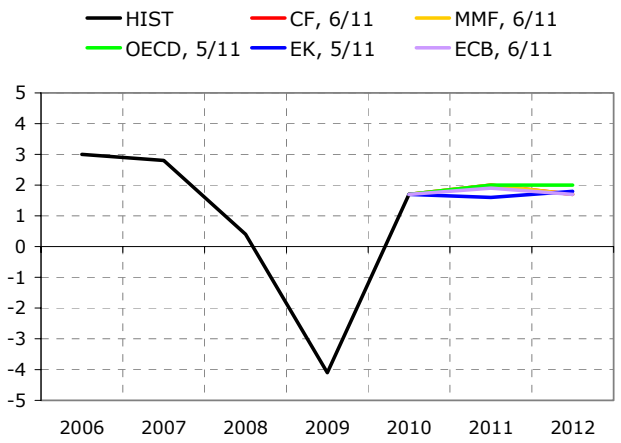
The current figures from the monitored territories still show – from the point of view of the recently ended financial crisis – solid levels. Although the data for the euro area and in particular Germany improved in June, the opposite corrections have been made for the United States and China. The observed leading indicators and other information from the world economy suggest a slight deterioration in future outlooks. Moreover, aggregate macroeconomic data conceal substantial imbalances within the monetary union; their impact on performance and especially the reputation of the euro area as a whole may be crucial. Ongoing negotiations among the European authorities and the IMF have not found a satisfactory solution to financing the Greek government debt. In addition, the "star pupil" of the euro area (Germany) is expected to show a more pronounced slowdown in economic activity than expected just a few months ago. The performance of the United States should remain at its current robust levels. A postponement in the introduction of budgetary moderation in the United States does represent a risk. Global economic growth will continue to be driven by emerging economies, especially China and India.

Prices of oil as well as several other commodities and energies still have an inflationary effect in all the monitored countries and regions. However, their impact on consumer prices is gradually declining as growth in oil prices to around USD 115 a barrel and subsequently remaining around this level should result in their gradual unwinding from future inflation. Of course, there is a real risk that oil prices can grow above USD 120 a barrel, which would reinforce inflation pressures. As regards changes in interest rates, it is expected that the cycle of the Fed's monetary policy tightening will be postponed for the last quarter of this year, while an increase in ECB's interest rates is assumed at one of the next meetings.

II.1 GDP

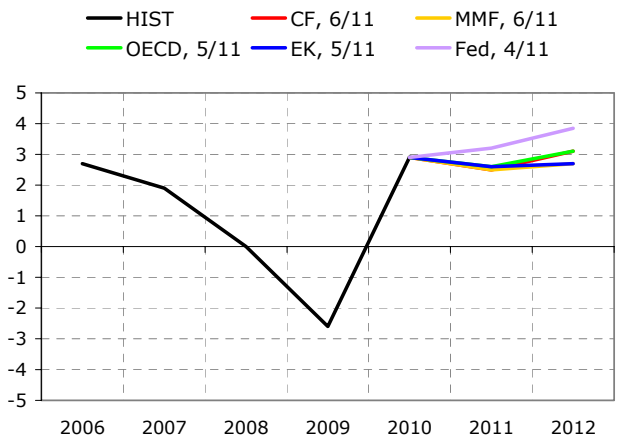
The economic outlooks of the euro area have been stable thus far; the euro area should grow at around 2% until the end of 2012. Domestic demand should be a source of growth in the euro area, while net exports should decline. Persisting imbalances within the monetary union and German economic growth represent a risk to growth in the EU. German GDP will stand between 3.1% and 3.4% this year due to foreign trade growth, investment and private consumption. Nevertheless, the outlooks for German performance are declining; it should be around 2% at the end of 2012. Despite a slight slowdown in 2011, the US economy should record robust growth about 1 percentage point above that in the euro area. The reasons for the slowdown in 2011 include persisting high commodity prices, lower trade intensity with Japan, higher unemployment and further weakening in the housing market. The Fed is the most optimistic in this regard, forecasting U.S. GDP growth at almost 4% at the end of 2012. Economic growth in China is expected to be between 9.0% and 9.6% this year, but its outlook is also declining.

EURO AREA



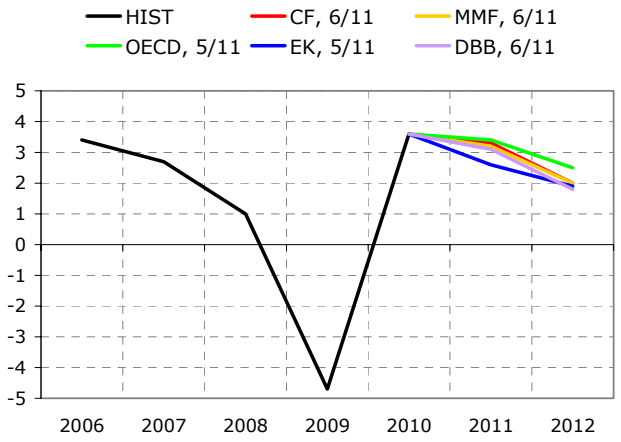
	HIST	CF	MMF	OECD	EK	ECB
2010	1.7					
2011		2.0	2.0	2.0	1.6	1.9
2012		1.7	1.7	2.0	1.8	1.7

USA



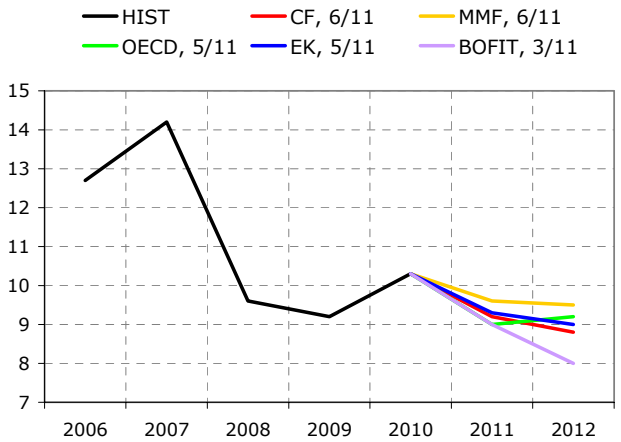
	HIST	CF	IMF	OECD	EC	Fed
2010	2.9					
2011		2.5	2.5	2.6	2.6	3.2
2012		3.1	2.7	3.1	2.7	3.9

GERMANY



	HIST	CF	MMF	OECD	EK	DBB
2010	3.6					
2011		3.3	3.2	3.4	2.6	3.1
2012		2.0	2.0	2.5	1.9	1.8

CHINA



	HIST	CF	MMF	OECD	EK	BOFIT
2010	10.3					
2011		9.2	9.6	9.0	9.3	9.0
2012		8.8	9.5	9.2	9.0	8.0

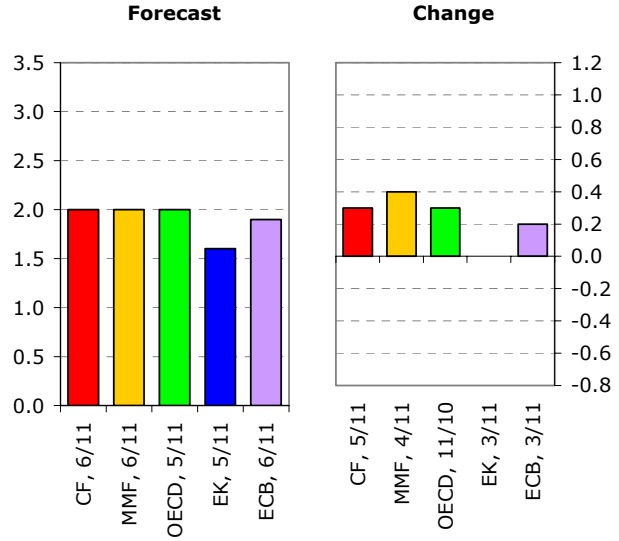
Note: Legend shows latest forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 17 June 2011]

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

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

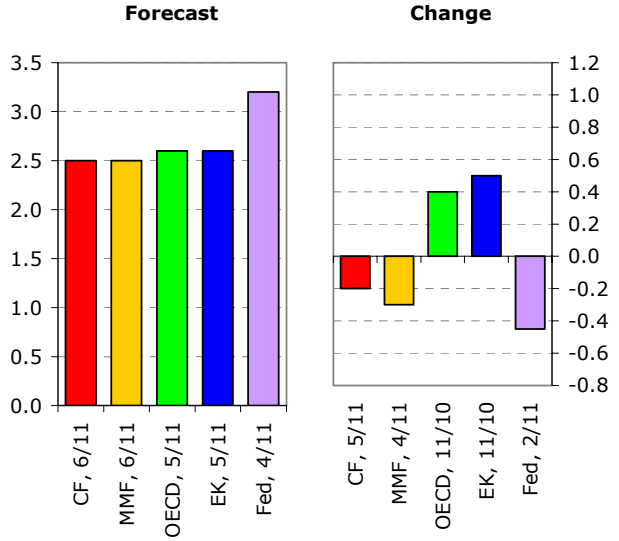
In May and the first half of June, a major upward revision to economic growth in the euro area and Germany was made in the forecasts of all monitored institutions. GDP growth in the euro area is expected to be 0.2-0.4% higher in 2011, with Germany growing by 0.5-1.1% more than in previous outlooks by the CF, IMF, OECD, ECB and DBB. The June CF and World Economic Outlook assume a more moderate (than the previous forecast) economic recovery in the United States and China. The OECD also suggests a slower rate of GDP growth in China. Changes for the United States go in both directions; the June CF shifted the estimate 0.2 percentage point lower, as did the April estimate by the IMF. Similar corrections for China (CF, IMF) are rather minor.

EURO AREA



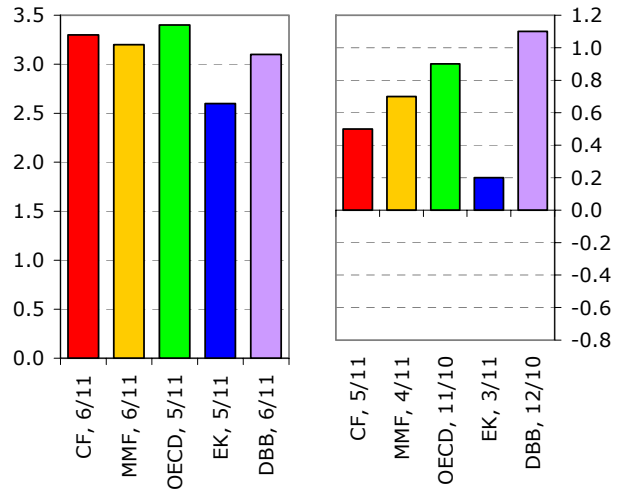
	2010	CF	MMF	OECD	EK	ECB
Forecast	1.7	2.0	2.0	2.0	1.6	1.9
Change		0.3	0.4	0.3	0.0	0.2

USA



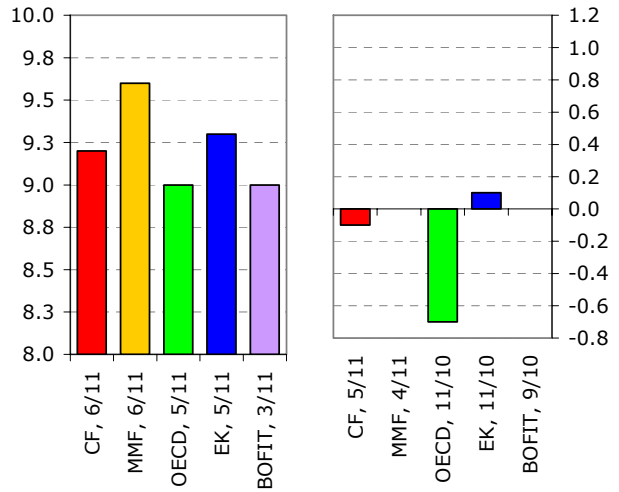
	2010	CF	MMF	OECD	EK	Fed
Forecast	2.9	2.5	2.5	2.6	2.6	3.2
Change		-0.2	-0.3	0.4	0.5	-0.5

GERMANY



	2010	CF	MMF	OECD	EK	DBB
Forecast	3.6	3.3	3.2	3.4	2.6	3.1
Change		0.5	0.7	0.9	0.2	1.1

CHINA



	2010	CF	MMF	OECD	EK	BOFIT
Forecast	10.3	9.2	9.6	9.0	9.3	9.0
Change		-0.1	0.0	-0.7	0.1	0.0

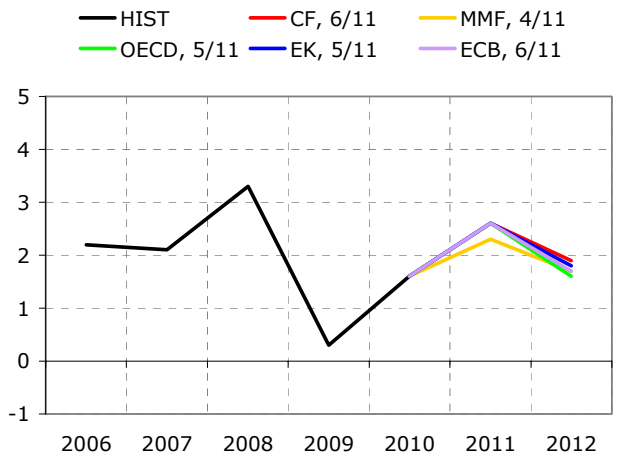
Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 17 June 2011]

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

II.3 Inflation

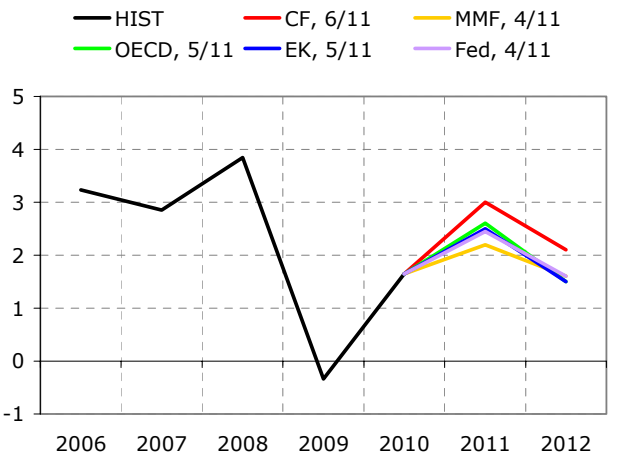
In 2011, inflation will reach the highest levels in all the monitored territories chiefly due to the inflationary effect of oil and several other commodity prices. Furthermore, inflation may be fostered by higher capacity utilisation, especially in the euro area and Germany, where inflation is expected to be between 2.2% and 2.6% this year. The expected tightening of monetary policy will have an anti-inflationary effect. Price growth in the United States will rise to 2.2%-3.0% this year. The inflation rate will return to 2% or below in the monitored advanced economies next year. Inflation in China will drop from almost 5% in 2011 to 2.5%-3.8% in 2012, mainly due to monetary policy tightening, the expected decline in demand and halt in import price growth.

EURO AREA



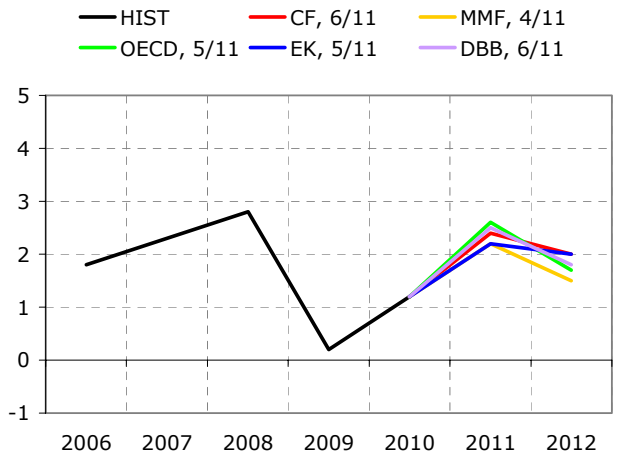
	HIST	CF	MMF	OECD	EK	ECB
2010	1.6					
2011		2.6	2.3	2.6	2.6	2.6
2012		1.9	1.7	1.6	1.8	1.7

USA



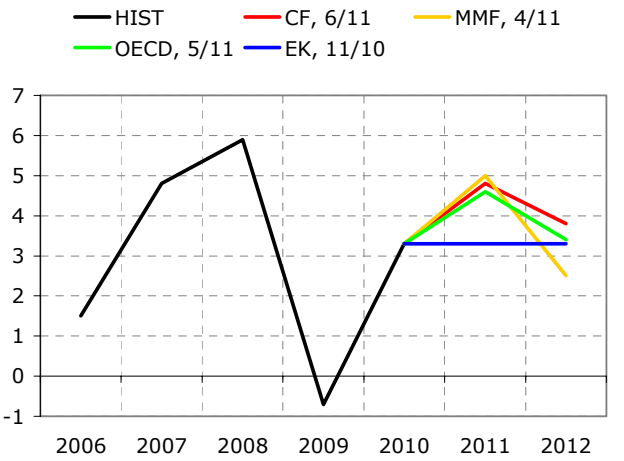
	HIST	CF	MMF	OECD	EK	Fed
2010	1.6					
2011		3.0	2.2	2.6	2.5	2.5
2012		2.1	1.6	1.5	1.5	1.6

GERMANY



	HIST	CF	MMF	OECD	EK	DBB
2010	1.2					
2011		2.4	2.2	2.6	2.2	2.5
2012		2.0	1.5	1.7	2.0	1.8

CHINA



	HIST	CF	MMF	OECD	EK
2010	3.3				
2011		4.8	5.0	4.6	3.3
2012		3.8	2.5	3.4	3.3

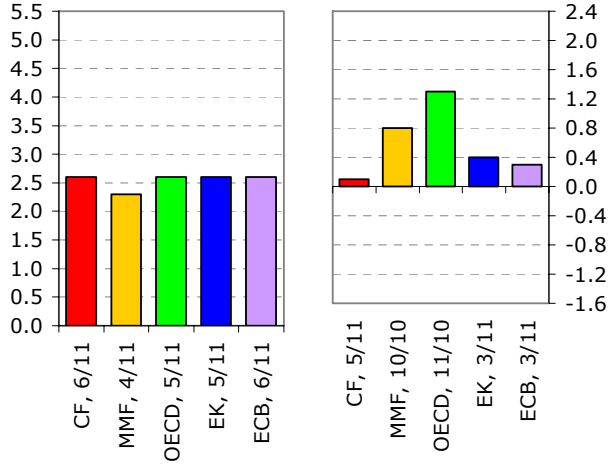
Note: Legend shows latest forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 17 June 2011]

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

II.4 Inflation forecast comparison and change from the previous forecast

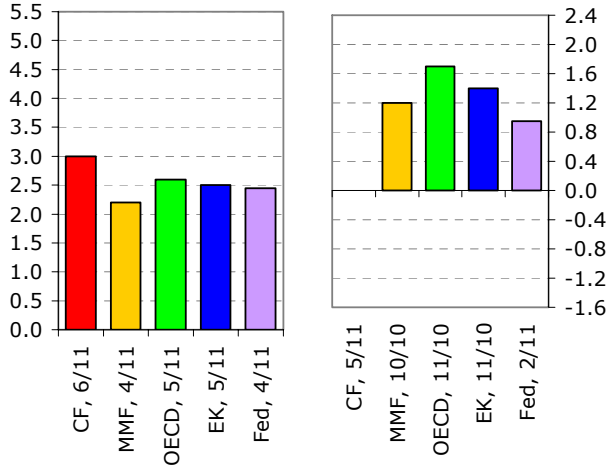
New forecasts (CF, DBB, ECB, IMF and OECD) expect higher inflation in all the monitored countries and regions than the previous forecast. Since the inflation forecast is still being revised upwards, the change is mostly greater in outlooks that are not published as frequently.

EURO AREA



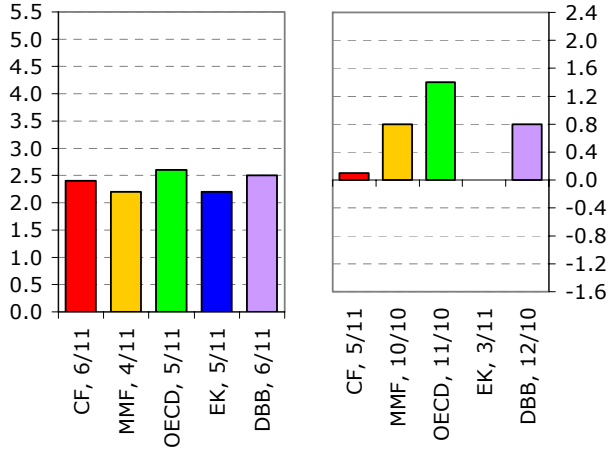
	2010	CF	MMF	OECD	EK	ECB
Forecast	1.6	2.6	2.3	2.6	2.6	2.6
Change		0.1	0.8	1.3	0.4	0.3

USA



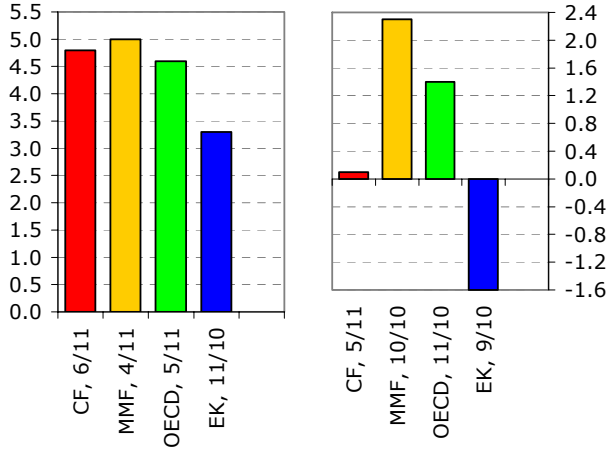
	2010	CF	MMF	OECD	EK	Fed
Forecast	1.6443	3.0	2.2	2.6	2.5	2.5
Change		0.0	1.2	1.7	1.4	1.0

GERMANY



	2010	CF	MMF	OECD	EK	DBB
Forecast	1.2	2.4	2.2	2.6	2.2	2.5
Change		0.1	0.8	1.4	0.0	0.8

CHINA



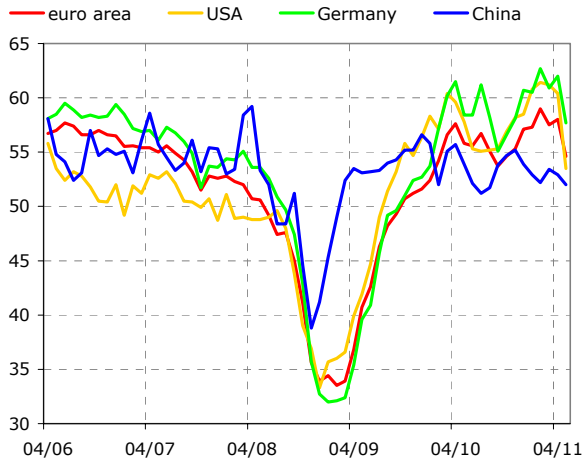
	2010	CF	MMF	OECD	EK
Forecast	3.3	4.8	5.0	4.6	3.3
Change		0.1	2.3	1.4	-1.6

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: 17 June 2011]

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

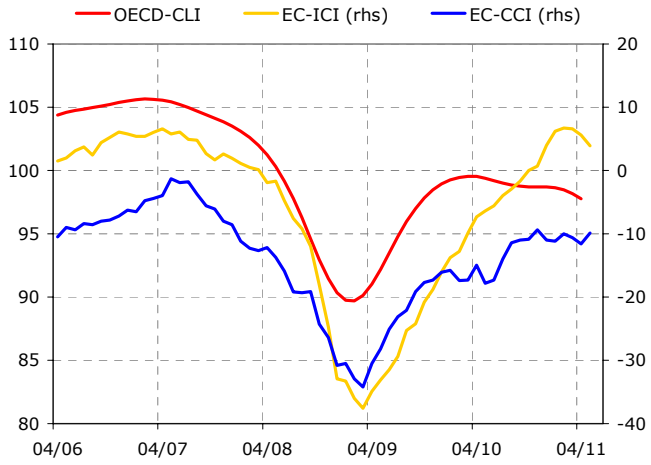
The global economic outlook deteriorated in June. The PMI (Purchasing Managers' Index) in industry decreased for all countries and regions under review, suggesting a decline in global economic growth in the period ahead. The United States saw decreases also in other leading indicators except Michigan University's consumer confidence index. This also indicates a slowdown in GDP growth. In the euro area, in addition to the PMI there were also declines in the other leading indicators (except the consumer confidence indicator). The most favourable economic outlook can be seen for Germany, where the other leading indicators except the PMI fell only marginally and consumer confidence indicators increased.

PMI IN MANUFACTURING



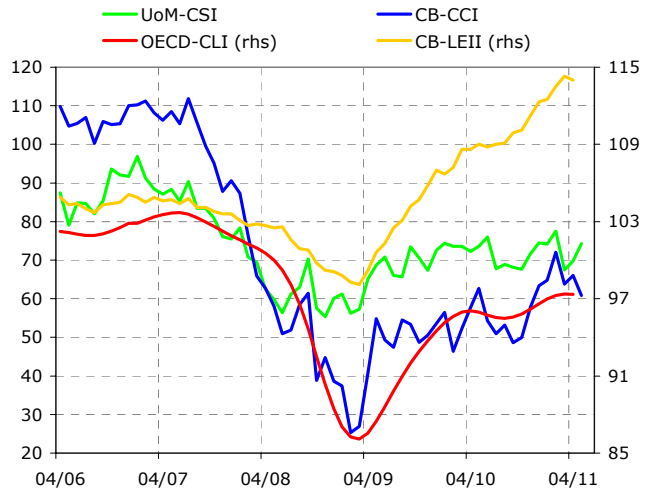
	EA	US	DE	CN
3/11	57.5	61.2	60.9	53.4
4/11	58.0	60.4	62.0	52.9
5/11	54.6	53.5	57.7	52.0

EURO AREA



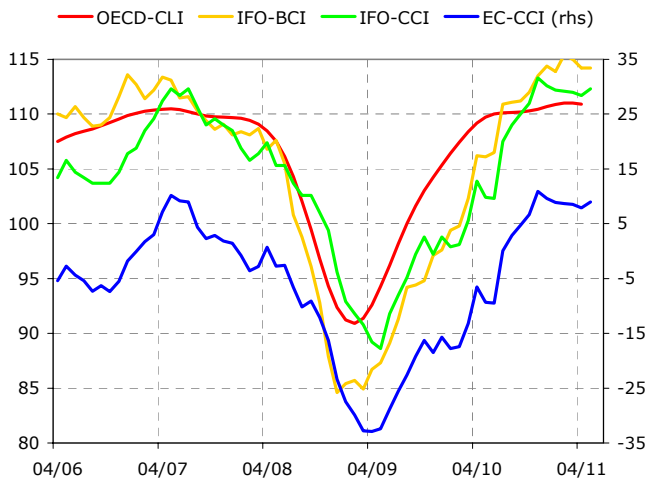
	OECD-CLI	EC-ICI	EC-CCI
3/11	98.2	6.6	-10.6
4/11	97.8	5.6	-11.6
5/11		3.9	-9.9

USA



	OECD-CLI	CB-LEII	UoM-CSI	CB-CCI
3/11	97.4	114.3	67.5	63.8
4/11	97.3	114.0	69.8	66.0
5/11			74.3	60.8

GERMANY



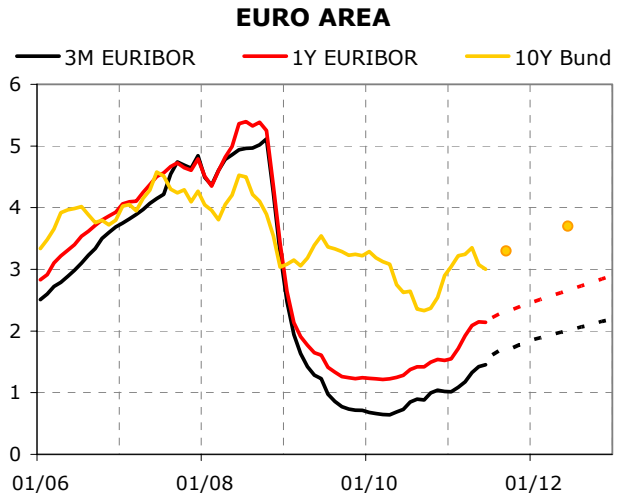
	OECD-CLI	IFO-BCI	IFO-CCI	EC-CCI
3/11	111.0	115.0	112.0	8.5
4/11	110.9	114.2	111.7	7.9
5/11		114.2	112.3	9.0

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: 16 June 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 Governing Council meeting in May and the subsequent communication brought the growth trend in 3M and 1Y EURIBOR rates to a halt. The one-year rate has been flat at about 2.15% since then. The three-month rate was close to 1.43% in May, but at present it is again showing modest growth. The outlook based on implied rates was revised downwards in June (as in May). The expected 3M rate decreased by another 0.4 percentage points to 2.2% at the end of 2012; the forecast for the 1Y rate fell by the same amount to 2.9%. The 10Y German government bond yield has been decreasing since April and the outlook based on the June Consensus Forecasts has thus been revised downwards as well. The expected value at the three-month horizon fell from 3.4% to 3.3%; the forecast at the twelve-month horizon remained at 3.7%.



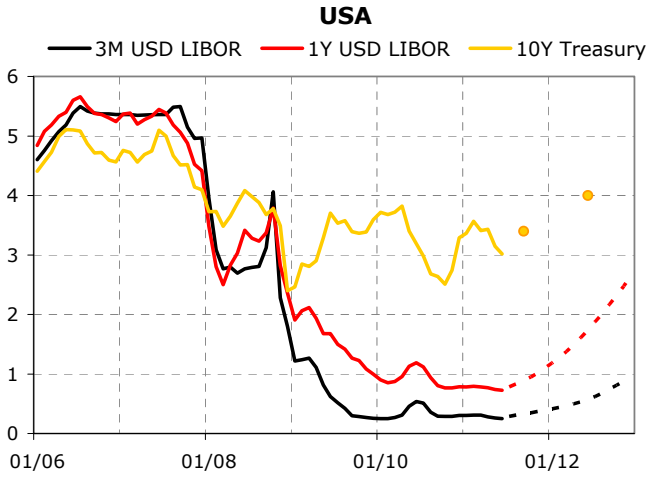
	05/11	06/11	12/11	06/12	12/12
3M EURIBOR	1.43	1.45	1.82	2.01	2.18
1Y EURIBOR	2.15	2.14	2.44	2.66	2.88
	05/11	**06/11**	**09/11**	**06/12**	
10Y Bund	3.08	3.00	3.30	3.70	

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 line represents outlook. [Cut-off date for data: 13 June 2011]

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

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

After a long period of stagnation and although markets have been expecting growth for some time, dollar LIBOR rates have declined slightly since April. The forecast continued rising in June, but the expected growth rate fell significantly. The end-2012 outlook shifted downward by 0.4 percentage points for the 3M rate, to 1.0%. The change was much more significant for the 1Y rate, which is expected to decrease from 3.7% to 2.6%. In the United States, as in the euro area, the 10-year government bond yield continued to decline. This resulted in a 0.2 percentage point decrease in the forecast based on the June CF at both the three-month and one-year horizons to 3.4% and 4.0%, respectively.



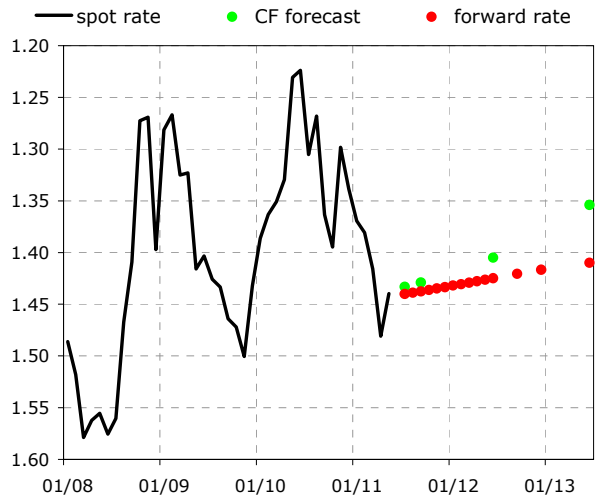
	05/11	06/11	12/11	06/12	12/12
3M USD LIBOR	0.26	0.25	0.40	0.57	0.95
1Y USD LIBOR	0.74	0.72	1.10	1.74	2.63
	05/11	**06/11**	**09/11**	**06/12**	
10Y Treasury	3.15	3.02	3.40	4.00	

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 line represents outlook. [Cut-off date for data: 13 June 2011]

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

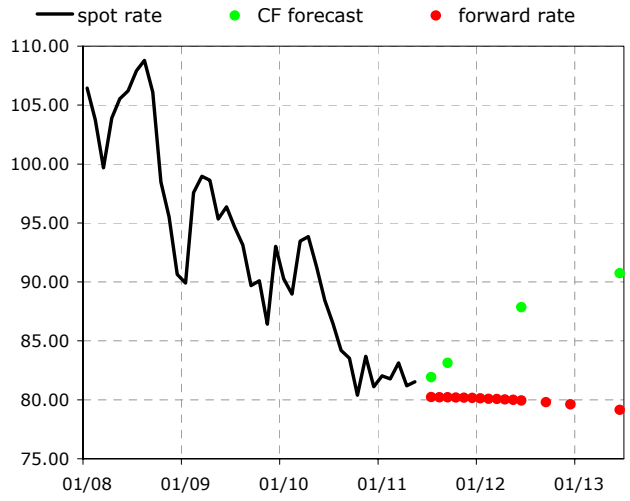
The dollar has depreciated against the euro since the start of 2011 to USD 1.49/EUR. After the ECB interest rate decision and amid the deepening debt crisis in Greece in early May, the dollar grew strongly, but the ECB plan to raise its key rate in July is preventing the dollar from appreciating further against the euro. The euro area and Germany are reporting higher-than-expected GDP growth, as new outlooks for the United States (CF, Fed) have deteriorated; inflation in the euro area compared to the United States should have a neutral impact on the exchange rate. As risks also exist in the United States (in consumption, employment and Fed policies), the new outlook for the exchange rate is the same as a month earlier. The dollar should still appreciate slowly, to USD 1.35/EUR. The Swiss franc is benefiting from the uncertainty, growing against the dollar in May and June to CHF 0.83/USD as its short-term outlook rose. Forecasts for other currencies were unchanged. The USD-GBP rate should stay at around USD 1.65/GBP at the two-year horizon. The dollar should grow over 10% against the yen.

US$ per Euro



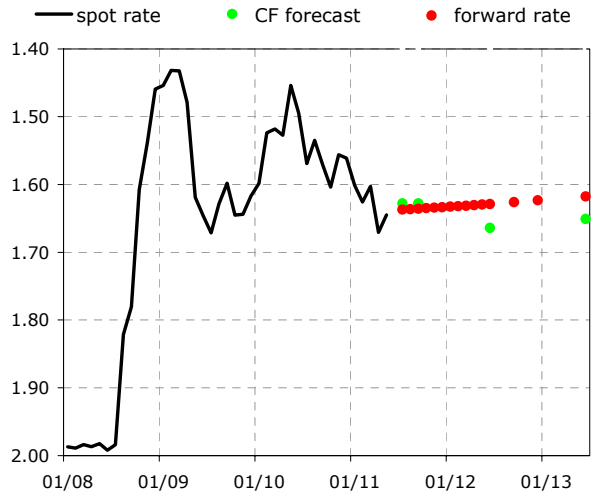
	13/6/11	07/11	09/11	06/12	06/13
spot rate	1.441				
CF forecast		1.433	1.429	1.405	1.354
forward rate		1.440	1.438	1.425	1.410

Yen per US$



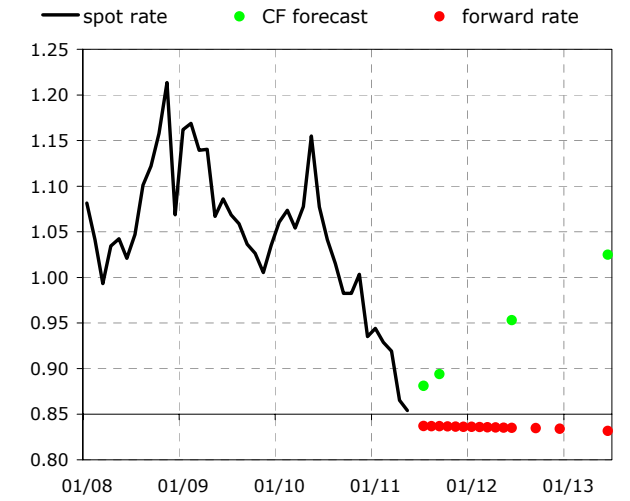
	13/6/11	07/11	09/11	06/12	06/13
spot rate	80.24				
CF forecast		81.93	83.14	87.85	90.75
forward rate		80.23	80.20	79.94	79.14

US$ per UK£



	13/6/11	07/11	09/11	06/12	06/13
spot rate	1.638				
CF forecast		1.628	1.628	1.664	1.651
forward rate		1.637	1.636	1.629	1.618

Swfr per US$



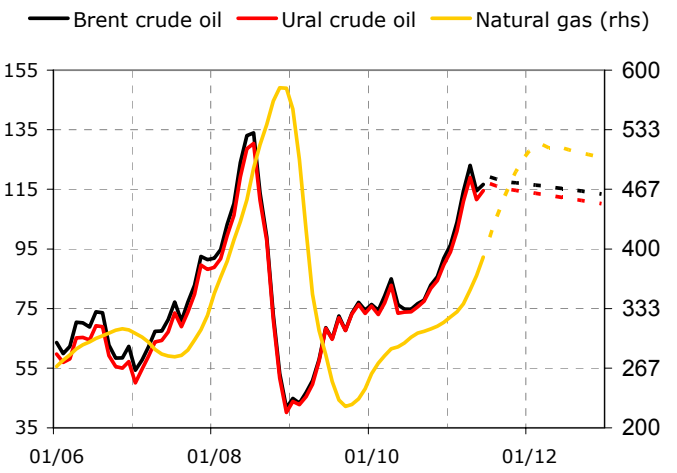
	13/6/11	07/11	09/11	06/12	06/13
spot rate	0.837				
CF forecast		0.881	0.894	0.953	1.025
forward rate		0.837	0.837	0.835	0.832

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: 17 June 2011] Source: CNB calculation using Bloomberg and Consensus Forecasts databases.

VI.1 Oil and natural gas

After the strong fall in early May due to the dollar's sharp appreciation, the Brent oil price fluctuated around the horizontal trend for three weeks and then turned upwards. Oil prices are currently affected more by changing sentiment than by economic fundamentals. OPEC representatives did not agree at their meeting on a change in extraction quotas, although some of them had indicated in advance that the quotas will rise. As the previous forecast had been created immediately after the May decline, the June path shifted upwards by about USD 4/barrel, but is still falling. By contrast, the forecasts of most major agencies monitoring the oil market expect Brent oil prices to rise further. The natural gas price reflects the oil market with a lag of roughly six months.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS



	06/11	12/11	06/12	12/12
Brent crude oil	116.7	116.9	115.3	113.4
Ural crude oil	114.6	114.3	112.3	110.2
Natural gas	390.9	499.3	512.8	502.1

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: 13 June 2011].

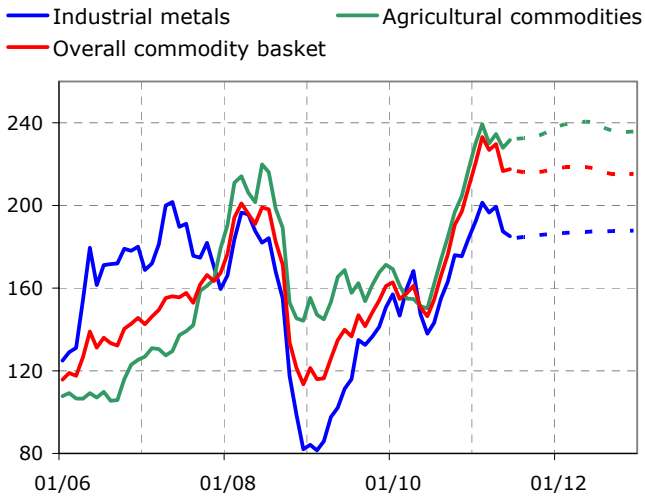
Source: Bloomberg, IMF, CNB calculations.

VI.2 Other commodities

Unlike oil prices, the total non-energy commodity price index did not see renewed growth after the May decline. The forecast grew just slightly compared to May owing to expected somewhat higher food commodity prices and lower prices of industrial metals.

Turning to individual commodities, prices are expected to rise for wheat (due to extremely dry weather and falling stocks) and rice. By contrast, there should be a decline in the price of corn (from the present record values) and sugar. However, corn is an important commodity for the production of bioethanol and its price will thus also depend on oil price developments. As regards industrial commodities, the price of cotton should decrease further and that of aluminium should increase. However, industrial commodity prices will to a large extent depend on the economic situation in China, which is the main consumer of these commodities.

OUTLOOK FOR OTHER COMMODITY PRICES



	06/11	12/11	06/12	12/12
Industrial metals	185.2	186.2	187.4	187.9
Agricultural commodities	231.7	236.7	240.3	235.8
Overall commodity basket	217.6	217.4	218.2	215.4

Note: Chart shows indices, year 2005 = 100. Dashed line represents outlook. [Cut-off date for data: 13 June 2011].

Source: Bloomberg, outlooks based on futures.

HOW HAVE GLOBAL IMBALANCES CHANGED DURING THE CRISIS?[1]

The global economic and financial crisis, which started in 2007 in the United States and hit the rest of the world the following year, was just the culmination of earlier unbalanced developments in numerous countries. Owing to the demographic trend in advanced countries and the gradual shift of economic activities away from advanced countries and particularly toward East, South and South-East Asia, the economic potential in many countries started decreasing, or at least did not grow at a rate corresponding to the rise in consumption. Insufficient export capacities and relatively high domestic consumption led to deeper imbalances on some countries' current accounts that were beyond sustainable limits. The workforce also started to gradually redirect away from industry and tradable services to sectors where there is no or only very limited international competition, including the public sector. The growing role of the state in maintaining the living standard of the population, demographic trends and the decline in corporate revenues due to their relocation to more cost and tax friendly destinations resulted in rising public finance deficits in some countries. Economic growth was often maintained artificially[2] or accelerated by credit-driven growth in private consumption. The unbalanced development in some advanced countries was even amplified by excessive growth in real estate development activities which were largely financed by bank loans. The burst of the real estate bubble together with the failure of extremely risky operations by US investment banks caused the crisis in the United States in 2007. The imbalances that precipitated the previous crises and obviously also the recent one are also an indicator of future crises. This article therefore sets out to map the changes that have occurred since the crisis started, and whether the processes it had started resulted in removing or mitigating the imbalances, or whether these persist and the risk of their painful removal should be expected in the near or more distant future.

To simplify the picture of the evolution of global imbalances, the article monitors only the imbalances in the four economically most important countries (territories) representing more than half of the world economy (the United States, euro area, China and Japan). As the large-scale imbalances concentrated in the household or business sectors usually reflect in unbalanced developments in the banking sector, which is then rescued by the state as the last resort, and as partial imbalances as a rule pass through to external imbalances[3], this article chiefly focuses on external imbalances and public finance imbalances. When assessing euro area imbalances, we should take into account its specific position as an association of countries with a single currency, but with a very limited common fiscal policy. Turning to external imbalances, the situation is – due to the existence of a single currency – the same as for other countries under review, whereas in the area of fiscal imbalance the overall view on the euro area is rather misleading, as the very limited common budget (slightly above 1% of GDP) does not allow the reallocation of funds across the individual countries which is possible in the United States and in both Asian countries.

Certain signs of long-term unbalanced developments were visible already at the end of the last century. At the start of the new millennium, however, global imbalances were not too high or did

[1] The opinions expressed in this article are those of the author and do not necessarily reflect the official position of the Czech National Bank.

[2] Despite this, the share of advanced countries in the global GDP decreased by about 10 percentage points in the last ten years.

[3] This does not apply to all cases. For example, the high fiscal imbalance in Japan (the biggest public debt in the world currently exceeding the country's two annual gross domestic products) is largely offset by the population's high propensity to save and is in no way reflected in the external imbalance.

not reach risk values.[4] They manifested themselves mainly in rising public budget deficits and public debt in Japan (mostly internal debt) and in the gradually increasing external imbalance in the United States. The relatively high debt of euro area countries showed no upward trend. Current account surpluses in China also were in no way extreme.

Table 1: Basic characteristics of public finances and external balances of major world economies in the 1990s

(as a percentage of GDP)

	1990	1995	2000
	Public budgets balance		
USA	-3.8	-2.2	2.4
Euro area	-3.0	-7.5	0.0
Japan	2.0	-4.7	-7.6
China	-	-0.9	-2.5
	Public debt		
USA*	42.1	49.1	34.7
Euro area	-	70.9	69.5
Japan	63.9	86.2	135.4
China	6.2	7.1	12.3
	Current account balance		
USA	-1.4	-1.5	-4.2
Euro area	0.5	0.6	-0.6
Japan	1.4	2.1	2.6
China	3.0	0.2	1.7
	Goods and services balance		
USA	-1.4	-1.3	-3.8
Euro area	1.0	1.7	0.6
Japan	0.9	1.4	1.5
China	2.6	1.6	2.4

Note: * state debt

Source: Economist Intelligence Unit

The unbalanced development of major world economies picked up significantly at the start of the new millennium. Whereas public budgets – except that of Japan – showed no dramatic trends, there were signs of a worsening US position in terms of the external balance. The external imbalance in the United States as measured by the current account gradually amounted to 6% of GDP, thereby exceeding the general "safe" level[5]. US economic growth was primarily driven by private consumption which made extreme use of loans. By contrast, the Chinese current account surplus of over 9% of GDP signalled a one-sided, export-oriented economy that would be unsustainable in the long run[6]. The euro area and Japan were still balanced economies (as regards external balance).

To sum up, the main problem of the last ten years was the accumulation of imbalances in the United States consisting in excessive household and local government debt combined with relatively low external competitiveness and the moderate debt of the federal government. The total gross debt in the United States[7] was three times higher than its GDP. Deposits with US banks covered only about three-quarters of lending. The high indebtedness of all entities thus made the US economy strongly dependent on external resources. The "normal" functioning of the

[4] A current account deficit exceeding 5% of GDP and public debt exceeding 80% of GDP are as a rule considered risk values. Nonetheless, these values can be regarded as tentative as much depends on the country's credibility and the existence of specific factors that can modify these tentative values.

[5] In the case of the United States, however, it should be taken into account that the dollar still plays the role of the main global reserve currency and a deficit slightly exceeding the commonly stated safe limit is not in itself extremely dangerous, even over the medium term.

[6] However, an imbalance in the form of a surplus does not render an economy as vulnerable as in the case of a deficit.

[7] Households, business, banking and public sectors.

United States required capital imports of about USD 800 billion per year. The proportion of mortgages secured by property on the asset side of banks was too large (potential problems with both liquidity and prices)[8]. At the same time, the United States had managed to sell a large part of these low liquidity, overpriced assets abroad before the crisis started, mostly to Europe (worth USD 500 billion).

The crisis broke out in the United States in 2007 and took the form of financial crisis, while the rest of the advanced world was hit only in 2008 in the form of declining demand. In addition, Europe was strongly hit by the financial crisis owing to European banks' exposure primarily in financial operations with US CDOs and CDSs, which were largely linked with subprime mortgages.

The financial and economic crisis caused the imbalances to diminish, especially in the US household sector (the saving ratio rose from 1.4% in 2005 to 5.8% in 2010) and banking sector (chiefly thanks to government intervention); the external imbalance was much lower as well. On the other hand, the public finance imbalance grew sharply – the public debt-to-GDP ratio increased by about 30 percentage points and was close to the annual GDP. Fiscal developments in the euro area were also affected by rising public finance deficits. As a result, the public debt increased by almost 20 percentage points during the crisis, mostly due to assistance provided to the banking sector and efforts to keep budget expenditures high amid relatively strong falls in revenues. A relatively pronounced deterioration of public finances was observed also in Japan and China (the debts rose by about 25 percentage points and 10 percentage points, respectively). The Chinese current account surplus fell almost by half.

Table 2: Fiscal deficit and public debt changes compared to the pre-crisis level

(as a percentage of GDP)

	2006		2010	
USA	-1.9	36.5*	-8.9	62.3*
Euro area	-1.4	68.5	-6.2	86.0
Japan	-1.6	172.1	-7.7	197.5
China	-0.7	12.4	-1.6	22.9**

Note: * state debt. Public debt is currently about 30 percentage points higher. ** 2009 data

Source: Economist Intelligence Unit

Table 3: Change in the external (im)balance during the crisis

	2006		2010	
	CA/GDP	**GSB/GDP**	**CA/GDP**	**GSB/GDP**
USA	-6.0	-5.7	-3.2	-3.4
Euro area	0.4	1.3	0.3	1.7
Japan	3.9	1.4	3.6	1.4
China	9.1	7.5	5.2	3.9

Source: Economist Intelligence Unit

To sum up, external imbalances moderated during the crisis (the Chinese current account surplus and the US deficit decreased significantly and a modest surplus in Japan and approximate balance in the euro area were maintained)[9]. It is also obvious that there was a certain moderation in US household and banking sector imbalances, but this came at the expense of rising public debts in the United States and in Europe. Public debts and fiscal deficits of the

[8] Following the decline in property prices in the United States, almost one-fourth of all outstanding debts were higher than the value of the property.

[9] The structure of US economic growth is, however, strongly deviated in favour of public consumption to the detriment of private consumption, which can affect the total import intensity of GDP. It is therefore not clear, how the current account deficit (goods and services balance) will develop once private consumption growth is renewed.

entities under review have deepened significantly and currently represent the biggest risk of a "relapse" of the crisis (except China). It can be said that for the most part, painful economic restructuring did not occur (except in some smaller European economies), balances were renewed only to a limited extent and imbalances tended to just shift to the public sector. If 80% of GDP is considered the critical value for the public debt, Japan exceeds this figure 2.5 times, the United States by one-quarter and the euro area by about 10%, whereas the Chinese deficit is about one-fourth of the critical level. From this very simple statistical perspective, Japan is a greatly endangered country, the situation in the United States is also quite bad and the euro area is on the borderline. The real evaluation is much more complicated, however.

While the development of US public finances is not sustainable in the long run, the government probably has several years to stop the unfavourable trend and – unlike EU countries – also has space for raising tax revenues. The high share of external financing – which can be considered much less stable than domestic financing – increases the risk, but the United States can still benefit from its position as the number one economic power and from the dollar's role as the most important world currency. Moreover, it is "assisted" by the much bigger problems of some euro area countries which partly took the markets' focus away from the US problems.

The huge Japanese deficit should also be regarded as a certain form of the population's pension security amid the limited role of public finances in providing for elderly citizens. Owing to the very limited external financing of the fiscal deficit and very low interest rates related to its financing over the long term, it can be assumed that the deficit is sustainable in the mid-term. The ageing population is probably the biggest risk facing Japan, as Japan has so far used immigration to stabilise its population only to a very limited extent. The still very good external competitiveness of the country gives rise to some optimism.

The assessment of the euro area is much more difficult, as in the case of imbalances – except external imbalance, where the overall position does not currently pose any problem – the assessment is based mainly on national characteristics. The overall fiscal position of the euro area is more favourable than that of the United States or Japan (both the public finance deficit and public debt are lower), but the situation of the individual euro area countries is quite different. Some euro area countries are not able to finance themselves on the financial markets (the relative public finance deficits in Greece and Ireland are higher than in the United States and the deficit in Portugal is lower). The problem is that the low external competitiveness of Greece and Portugal (current account deficits at around 10% of GDP) does not create conditions for the repayment of the public debt in the future. Some countries' defaults may even amplify the problems of the banking sector, above all in "old" EU countries. The volume of bonds of the PIGS[10] countries held by banks from EU countries exceeds EUR 1,000 billion (especially Germany, France and the United Kingdom; however, the much lower holdings of bonds of problematic countries may be relatively dangerous for the banking sectors of Spain and Cyprus). Some countries (Ireland, Spain, the United Kingdom) have not yet resolved the problems of the banking sector, mainly as regards mortgages.

Based on information available to date, it seems likely that the painful measures directed at removing imbalances are still awaiting us as problems have rather been postponed[11]. The vast majority of countries did not start the "painful" structural reforms and only (to a large extent) tried to maintain a living standard at the expense of steep increases in the public debt. The United States and Japan will probably have more time to resolve their problems than the euro area, where the process of forced balance renewal started much earlier in the weakest countries (some form of long-term, essentially non-refundable assistance by other euro area or EU countries as an alternative). The situation will be all the more difficult as the extent of the banking sector's problems may be greater than in 2008 and the euro area public debts have increased substantially since then. This means that the ability of most countries to take over bank debts without threatening their credibility has decreased.

[10] Portugal, Ireland, Greece and Spain.

[11] Except for several non-euro area countries, where living on debt has really been reduced by a decrease in consumption (e.g. Latvia, Hungary).

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

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