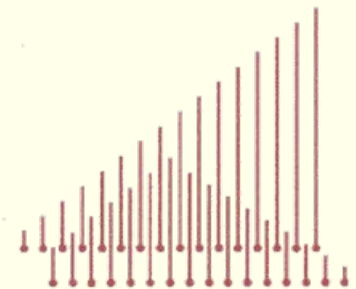


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Prospects for the World Economy

Dawn Holland

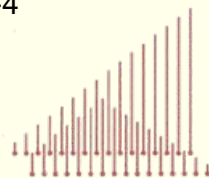
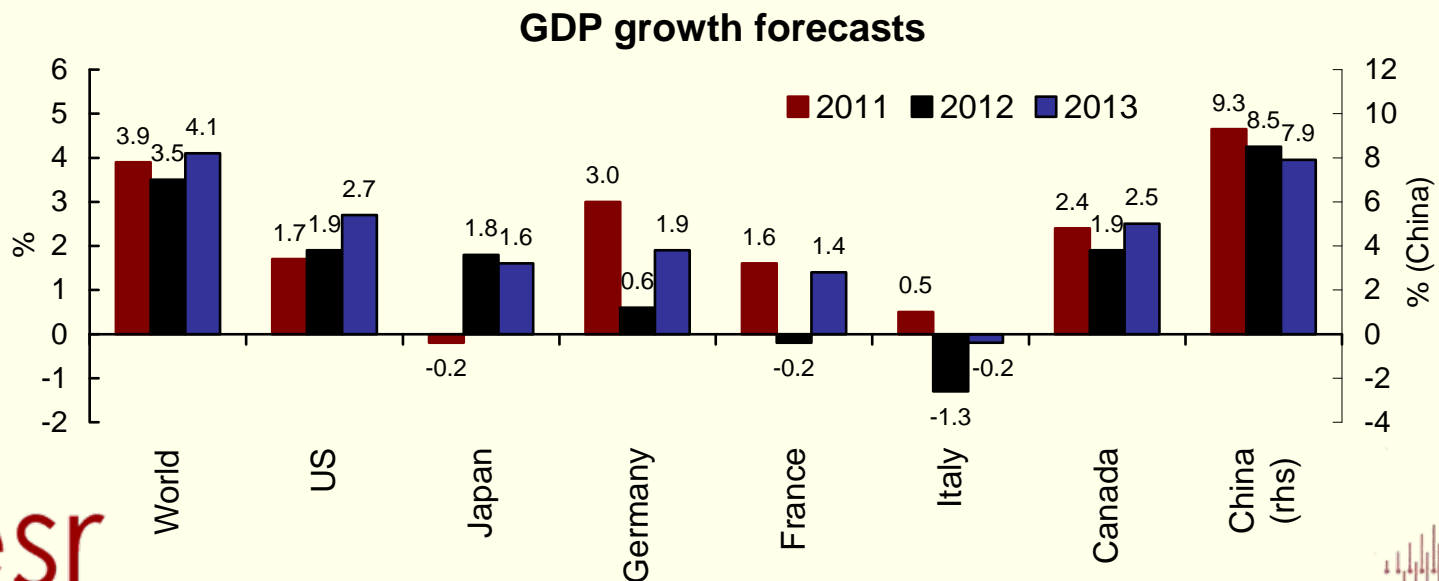
National Institute Economic Review No. 219
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National Institute
of Economic and
Social Research

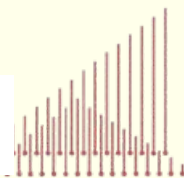
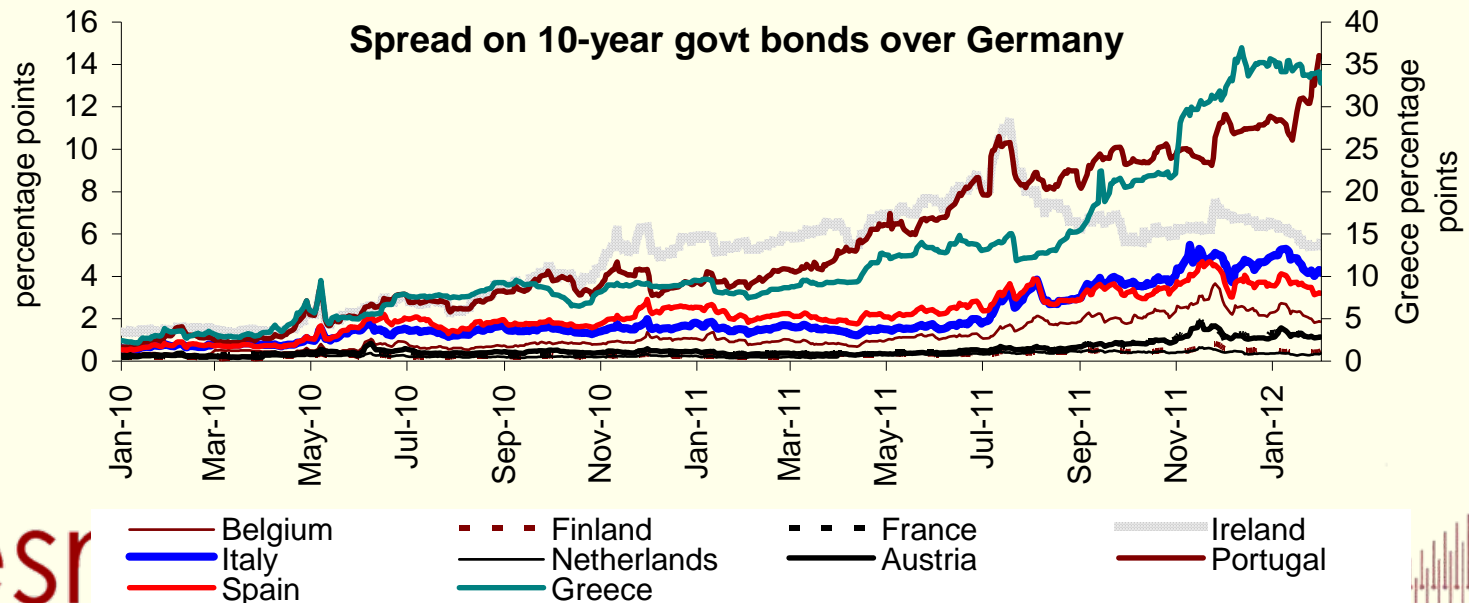
World overview

- **World growth to slow to 3½% in 2012**
 - Forecast is broadly in line with “muddling through” scenario from October
 - Forecast mild recession in the Euro Area and the UK this year
 - Prospects in US and Canada are stronger, while Japan is supported by reconstruction activity
 - China moderating, but sharp slowdown should be avoided
 - A key assumptions underlying forecast – decisive resolution to Euro Area crisis in second half of 2012



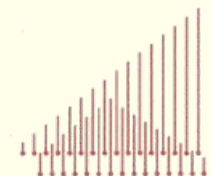
Sovereign spreads remain high in Europe

- Policy actions to date have brought little relief
 - ECB has boosted liquidity in the banking sector
 - New fiscal compact and balanced budget rule
 - New governments in Italy, Greece, Portugal, Ireland, Spain have pressed fiscal consolidation
 - Greek debt restructuring still under debate
- Move towards fiscal union ... or euro break-up?



Fiscal policy is tight

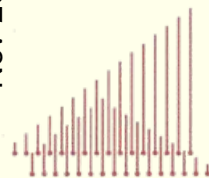
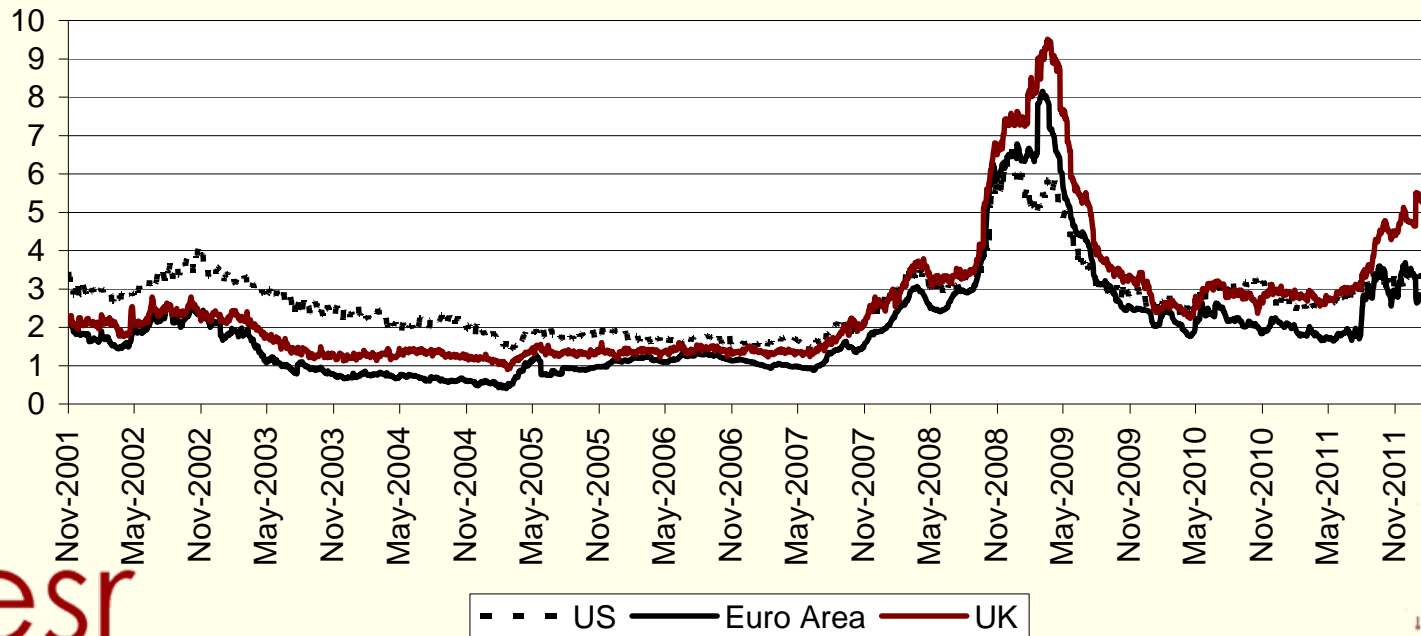
- **Deeper austerity in Europe is not the answer**
 - According to Euroframe (2012), fiscal measures introduced this year reduce GDP growth in the Euro Area by 0.8-1.3 percentage points
 - Austerity brought in to...
 - ... reduce borrowing requirement under relatively high interest rates
 - ... demonstrate commitment to sustainable finances and push government bond yields down
 - Some studies suggest 1% of GDP fiscal improvement would reduce bond yields by 0.2 percentage points
- **US fiscal policy tightened by 1½% of GDP this year**
 - Assume temporary payroll tax cuts extended to end of financial year
 - Failure of “Super Committee” means automatic spending cuts in 2013
 - At least \$20 billion (0.5% GDP) per annum over 10 years
- **Japan’s policy is expansionary, but tax rises planned 2013**



Bank lending conditions are tight in Europe

- High bond yields and sovereign downgrades
- Recapitalisation requirements imposed by EBA (June 2012)
 - Euro Area Bank Lending Survey suggests even tighter
 - Affects all EU banking systems through interbank linkages
- Does not appear to have spread to US

BAA corporate vs long rate on government bonds



Monetary policy is loose

- **ECB**

- Reversed interest rate rises of last year
- Injecting liquidity into banking system
 - Not yet clear if this is reinvested in vulnerable sovereign debt
- Very limited investment in government debt in the secondary market
 - Large-scale investment (LOLR to governments) would push bond yields down
 - Issuance of Eurobonds – guaranteed by stronger states – would push bond yields down

- **Federal Reserve**

- “Exceptionally low interest rates until at least late 2014”
- Explicit inflation target (2%) and unemployment target (5.2-6%)
- Under our current forecast, QE3 will not be necessary in the US

- **Bank of Japan**

- Committed to near zero interest rates
- QE since crisis has included corporate securities

