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GLOBAL ECONOMIC & MARKET OUTLOOK

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- Better management of tail risks in the euro area, slow but solid steps towards a permanent solution to the sovereign debt crisis and monetary easing from major central banks is expected to allow sentiment to improve and the global economy to grow faster in 2013 (3.5%) than in 2012 (3.2%).

- The outlook of the US economy is highly dependent on fiscal policy. We expect a deceleration of real GDP growth to around 1.8% y-o-y in 2013 from 2.2% in 2012, provided that the spending sequestration process is replaced by back-loaded measures and the size of the fiscal restraint amounts to 1-1.5% of GDP.

- In the euro area, the economy is expected to stall due to simultaneous fiscal deleveraging, adverse credit conditions and rising unemployment. Provided policy implementation momentum remains intact, further improvement in economic sentiment may ultimately feed through to the real economy and allow a return to positive GDP growth in the second half of the year. That said, growth will likely be anemic and the economy will remain fragile.

- In emerging markets, improved financial conditions and monetary stimulus suggest a firming of economic activity in 2013. Growth will be mostly driven by domestic demand. Given that a significant share of the current slowdown in EM economies is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade.

- Shortcomings in policy action in the euro area is a major risk to the global economy, as they could reverse the process of recouping economic confidence and fuel financial tensions. In Greece, a fragile political coalition needs to continue its reform program amidst rising social fatigue. In Spain, reform progress might loose pace due to complacency on declining borrowing costs, while the government's reluctance to accept conditionalities may trigger financial jitters if markets push it to ask for help.

- Further muddling through rather than a permanent resolution to the euro area sovereign debt crisis is expected in 2013, due to dissenting views over the right mix of risk sharing and loss of sovereignty. The German elections in the Fall may slow the process of European integration.

- An excessive short-term fiscal adjustment in the U.S. would have a negative impact on economic growth, with significant implications for global demand and trade. The tax increases that were implemented at the beginning of 2013 will probably constitute a significant drag on household income. Therefore, it is of vital importance for policymakers to agree on replacing the across-the-board- spending cuts with a more back-loaded mechanism to reduce spending, so as to restraint the drag from fiscal policy on real economic activity.

- Further monetary policy easing by major central banks is likely. The ECB will likely keep its policy rate unchanged and launch unconventional credit easing measures to respond to fragmented financial markets. The FOMC will probably stay tied to a highly accommodative stance of monetary policy in 2013, in order to support a fragile economy that is being hit by fiscal consolidation, with exceptionally low fed funds rates at 0-0.25% and an open-ended balance sheet expansion.

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Executive Summary

Global economic activity has started to gain momentum in recent months, in line with our prior expectations of an acceleration of the pace of growth globally towards 2013. Continuing unconventional monetary policy and further steps towards the resolution of the European sovereign debt crisis have resulted in an improvement of economic sentiment at the end of 2012. The afore-mentioned factors have also reduced considerably tail risks, allowing financial market tensions to abate significantly and risky assets to rebound since mid-2012 (Figures 1 & 2). Industrial production data of major economies have shown signs of stabilization (Figure 3), while the recent pick up in global manufacturing PMIs suggests that the turn up of the industrial business cycle should become more prominent over the next few months.

On the positive side fro global growth, China seems to have avoided the risk of a hard landing as recent data confirm that growth is improving and that policymakers have been successful in avoiding a significantly lower trend growth. Generally, emerging economies will continue to grow much faster than advanced economies, as their relatively healthier public finances leave them room to accommodate a sudden shock to their economies. On the contrary, fiscal consolidation will be a major drag to economic growth in the euro area and the US in 2013.

While the balance of risks now seems less skewed to the downside than it has been three months ago, global economic environment remains fragile, as the global outlook continues to be largely dependent on developments in the euro area and the US fiscal situation.

Likely policy shortcomings with respect to the handling of the sovereign debt crisis in the euro area constitute a major risk to the global economy. A loss in reform momentum in periphery countries could give rise to a new bout of financial turmoil, reversing achieved progress in markets' confidence. In Greece, a fragile political coalition is called to continue the overhauling of the economy amidst rising social fatigue and high and still climbing unemployment that will test the government's cohesion. In Spain, reform progress might loose pace due to complacency on declining borrowing costs. Meanwhile, the social cost of economic adjustment nurtures euro sceptic political powers. Moreover, given that Spain will be likely pushed to make an official request to the ESM for assistance, reluctance of Spanish authorities to an OMT activation could trigger jitters in financial markets. At the euro area level, further muddling through rather than a permanent resolution to the debt crisis is expected in 2013. While it is evident that some form of mutualisation of risks should be part of the solution, dissenting views over the right mix of risk sharing and loss of sovereignty are likely to keep a permanent solution to the debt crisis distant. Additionally, while we expect further progress in building the four pillars of European integration in the course of 2013, discussions will most likely remain cumbersome and heated. The German elections in fall may slow the process. Not least, calm market conditions may create a complacent feeling among European authorities, which have proven to deliver in a speedier fashion when pressure is intense rather that in calm times.

Furthermore, an excessive short-term fiscal adjustment in the U.S would have a negative impact on economic growth, with significant implications for global demand and trade. The tax increases that were implemented at the beginning of 2013, such as the expiration of the payroll tax cut and the upper income tax cut, will probably constitute a significant drag on household income. The fiscal consolidation measures amount to around $200-230 bn, i.e. 1.5% of GDP, so the expected fiscal restraint should reduce growth by at least 1.0-1.5% in 2013. The fiscal drag would increase even further, should the sequestration process takes effect in full at the beginning of March. If Congress does not act to cancel the sequester, then across-the-board spending cuts will automatically be implemented, totalling about $85bn in FY2013, i.e. 0.5% of GDP. Hence, it is of vital importance for policymakers to agree on replacing the across-the-board- spending cuts with a more back-loaded mechanism to reduce spending so as to restraint the drag from fiscal policy on real economic activity.

I. Global Outlook

Dimitris Malliaropulos, Vasilis Zarkos, Maria Prandeka, Olga Kosma

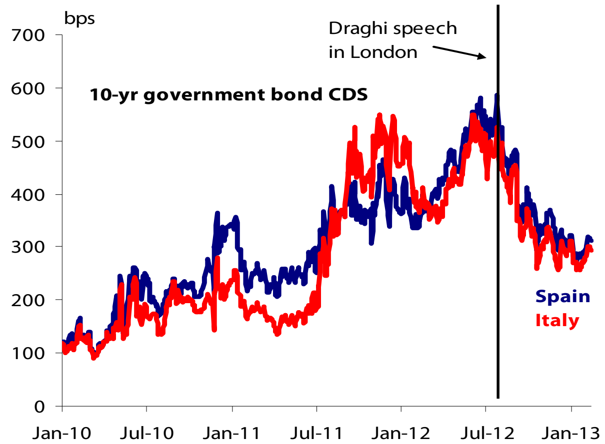
Improving financial conditions and enhanced tools to avoid tail risks should allow global economic growth to pick up in 2013

Global economic activity has started to gain momentum in recent months, in line with our prior expectations of an acceleration of the pace of growth globally towards 2013. Continuing unconventional monetary policy and further steps towards the resolution of the European sovereign debt crisis have resulted in an improvement of economic sentiment at the end of 2012. The afore-mentioned factors have also reduced considerably tail risks, allowing financial market tensions to abate significantly and risky assets to rebound since mid-2012 (Figures 1 & 2). Industrial production data of major economies have shown signs of stabilization (Figure 3), while the recent pick up in global manufacturing PMIs suggests that the upturn of the industrial business cycle should become more prominent over the next few months (Figure 4). Reflecting the improvement in the global economic activity, global trade growth has been increasing gradually since its recent lows over the summer 2012 (Figure 5). Most of the increase in trade growth was driven by the increase in developing countries and US import demand (Figure 6). Euro area imports, which account for about 12% of total merchandise world imports, were still contracting in November 2012, albeit at a slower pace.

Overall, the global outlook continues to be largely dependent on developments in the euro area and the handling of the US fiscal situation. Indeed, the global economic environment remains fragile, as advanced economies continue to face high debt levels and fiscal austerity, uncertainty about a permanent resolution to the crisis in Europe and the US fiscal situation persists and slower growth in emerging markets restrains global growth. The balance of risks, however, is now less skewed to the downside than it has been three months ago. It's worth noting that China avoided the risk of a hard landing, as recent data confirm that growth is improving and that policymakers have been successful in avoiding a significantly lower trend growth. Generally, emerging economies will continue to grow much faster than advanced economies, as their relatively healthier public finances leave them room to accommodate a sudden shock to their economies. On the contrary, fiscal consolidation will be a major drag to economic growth in the euro area and the US in 2013.

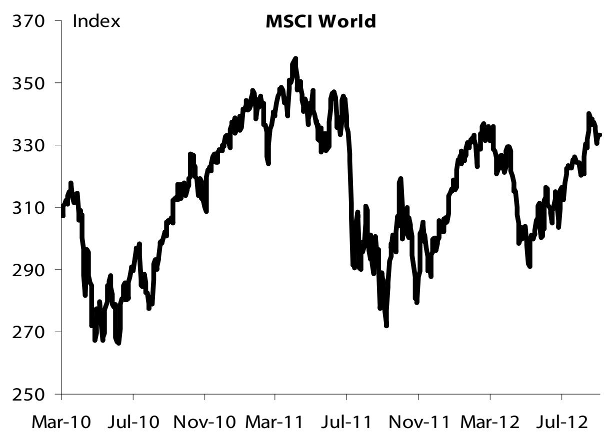
Our global GDP estimates remain intact for 2013, with a slight rebound of real growth from 3.2% in 2012 to 3.5% in 2013 and 4.0% in 2014. Based on our estimates for real GDP growth, we project world trade of goods and services to grow at 5.0% in 2013, up from 3.5% in 2012, and rebound further to 6.0% in 2014, in line with its ten year average of about 6.0%.

Figure 1



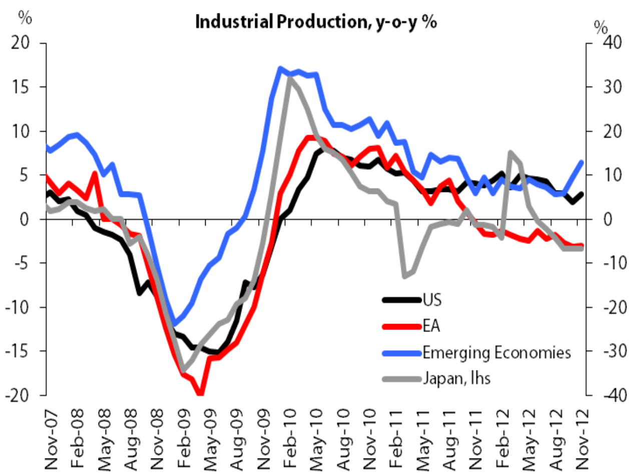
Source: Ecowin

Figure 2



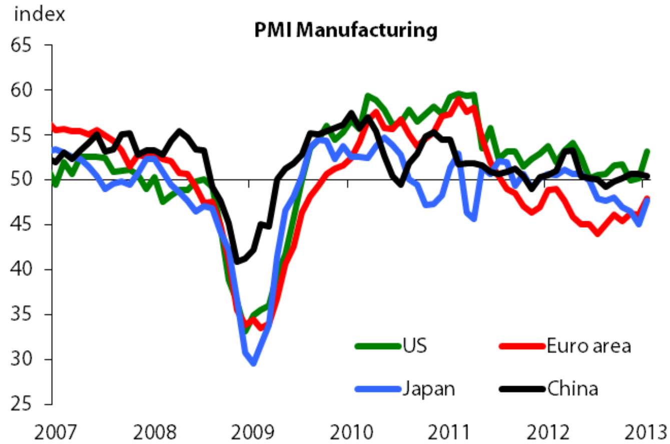
Source: Bloomberg

Figure 3



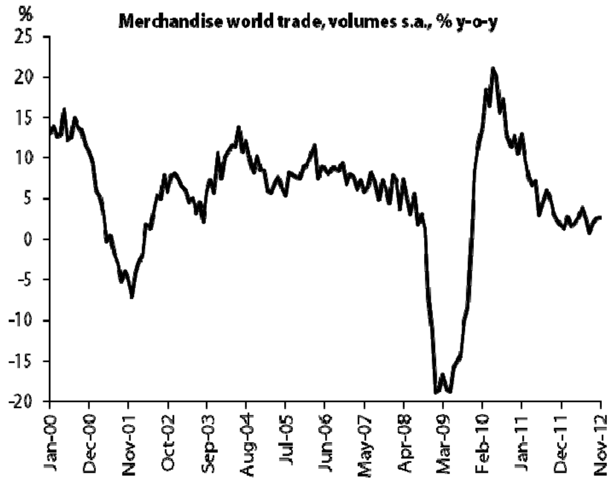
Source: CPB Netherlands Bureau for Economic Policy Analysis

Figure 4



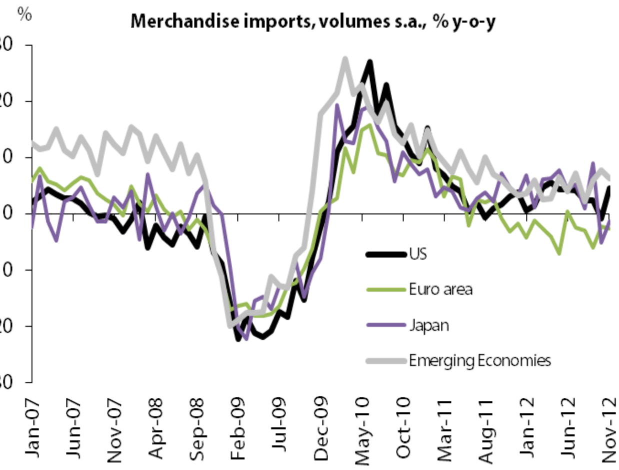
Source: Bloomberg

Figure 5



Source: CPB Netherlands Bureau for Economic Policy Analysis

Figure 6



Source: CPB Netherlands Bureau for Economic Policy Analysis

Policy shortcomings in the euro area and US fiscal policy are the main risks to the global economy

Likely policy shortcomings with respect to the handling of the sovereign debt crisis in the euro area constitute a major risk to the global economy. A loss in reform momentum in periphery countries could give rise to a new bout of financial turmoil, reversing achieved progress in markets' confidence. In Greece, a fragile political coalition is called to continue the overhauling of the economy amidst rising social fatigue and high and still climbing unemployment that will test the government's cohesion. In Spain, reform progress might loose pace due to complacency on declining borrowing costs. Meanwhile, the social cost of economic adjustment nurtures euro sceptic political powers. Moreover, given that Spain will be likely pushed to make an official request to the ESM for assistance, reluctance of Spanish authorities to an OMT activation could trigger jitters in financial markets. At the euro area level, further muddling through rather than a permanent resolution to the debt crisis is expected in 2013. While it is evident that some form of mutualisation of risks should be part of the solution, dissenting views over the right mix of risk sharing and loss of sovereignty are likely to keep a permanent solution to the debt crisis distant. Additionally, while we expect further progress in building the four pillars of European integration in the course of 2013, discussions will most likely remain cumbersome and heated. The German elections in fall may slow the process. Not least, calm market conditions may create a complacent feeling among European authorities, which have proven to deliver in a speedier fashion when pressure is intense rather that in calm times.

A second risk to our global economic outlook is related to an excessive short-term fiscal adjustment in the U.S. that would have a negative impact on economic growth, with significant implications for global demand and trade. The tax increases that were implemented at the beginning of 2013, such as the expiration of the payroll tax cut and the upper income tax cut, will probably constitute a significant drag on household income. The fiscal consolidation measures amount to around $200-230 bn, i.e. 1.5% of GDP, so the expected fiscal restraint should reduce growth by at least 1.0-1.5% in 2013. The fiscal drag would increase even further, should the sequestration process takes effect in full at the beginning of March. If Congress does not act to cancel the sequester, then across-the-board spending cuts will automatically be implemented, totalling about $85bn in FY2013, i.e. 0.5% of GDP. Hence, it is of vital importance for policymakers to agree on replacing the across-the-board- spending cuts with a more back-loaded mechanism to reduce spending so as to restraint the drag from fiscal policy on real economic activity.

Easy monetary conditions are expected to be supportive for global growth

Loose monetary conditions will continue to support global economic growth this year. In the US, the uncertainty surrounding fiscal policy and the slow recovery in labor market conditions has prompted the Fed to replace the "Operation Twist" that was completed at the end of 2012 with purchases of long-term Treasury securities and improve its communication by announcing numerical threshold values for unemployment and inflation to guide the first rate hike. We believe that the FOMC will stay tied to a highly accommodative stance of monetary policy in 2013 in order to support a fragile economy that is being hit by fiscal consolidation, with exceptionally low fed funds rates at 0-0.25% and an open-ended balance sheet expansion. Should economic and labor market conditions improve in H2 2013, then the Fed may diminish the monthly rate of asset purchases by year-end.

In the euro area, the ECB will keep prioritizing the amendment of the monetary transmission channel over rate cuts, given that loose monetary policy is materially hindered from passing through to bank lending rates in peripheral countries. Whereas the OMT program has paid valuable service in stabilizing sovereign bond markets, it may not prove fully effective to re-ignite credit growth, given the adverse economic conditions prevailing in these countries. To complement the OMT effect, the ECB could launch credit easing measures to stimulate bank lending in periphery members. Funding schemes, such as the Bank of England's funding for lending program and/or private asset purchases, could be possible initiatives. A rate cut would become increasingly likely in the case of sustained euro appreciation.

The Bank of Japan is expected to maintain its accommodative policy to contain appreciation pressures on the yen and support its new inflation target of 2%. The succession of current Governor and vice-Governors by more dovish officials is expected to facilitate government plans for super-loose monetary policy.

Against the background of improving EMs growth outlook, most central banks in emerging markets stayed on hold over the last part of 2012. Meanwhile, average headline inflation across major EM economies has started to decline significantly since September 2012, in tandem with a significant fall in world food prices. We expect most emerging markets' central banks to keep interest rates unchanged for most of 2013. Admittedly, with inflation below the targets and a still fragile external backdrop, there will be ample room to ease if growth starts to disappoint again.

Country/regional economic outlook

In the **US**, real GDP reported a modest decline in the final quarter of 2012, due to temporary de-stocking and a sharp decline in defense spending. However, the overall trend in the US economy does not point to a recessionary territory, as private domestic demand actually strengthened. Although the improving financial environment and the recovery in the housing market have helped to improve private sector's balance sheets, the tax increases set to take effect at the beginning of 2013 and uncertainty surrounding US fiscal policy will probably weigh on personal income and, consequently, on private consumption expenditures in the short term. We expect real GDP growth to remain subdued around 1.5-2.0% in H1 2013 and pick up to 2.5% in H2 2013, provided that the fiscal drag diminishes over time. Overall, we expect a deceleration of real GDP growth to around 1.8% y-o-y in 2013 from 2.2% in 2012, assuming that the spending sequestration process is replaced by back-loaded measures and the size of the fiscal restraint amounts to 1-1.5% of GDP. The risks are tilted to the downside, as policymakers may not reverse the spending cuts so that the sequester takes effect in full on March 1. According to our estimates, automatic reductions in spending would reduce real GDP growth by about 0.5 percentage points, lowering our GDP forecast to 1.3% y-o-y in 2013.

The **euro area** GDP growth is likely to return to positive territory in the second half of the year, provided that confidence continues improving. That said, the economy remains fragile and it is expected to lag its peers due to harsh economic conditions and substantial fiscal drag. Risks to the economy remain on the downside, stemming mainly from failure of policymakers to persevere on structural reforms and worsening of the economic situation in periphery countries due to simultaneous fiscal austerity and private deleveraging. Our annual growth projection for 2013 has been revised downwards to 0% from 0.3% a quarter earlier. The ECB is anticipated to remain on hold in the next couple of years, unless the economic situation deteriorates substantially. Emphasis is expected to remain on fixing the monetary transmission mechanism and re-integrating the euro area financial markets. To this end, more unconventional measures are likely.

In **Japan,** GDP growth is expected to return to positive territory in 2013 due to a combination of accommodative fiscal and monetary policy and improving global outlook. An emergency fiscal stimulus plan is expected to boost public investment and partially shield the economy from external shocks. Exit from deflation remains a challenge for the government. To that end, super accommodative monetary policy should be complemented with structural reforms to raise the country's potential growth. Territorial disputes with China pose downside risks to Japanese exports.

Growth in **EM economies** is expected to rebound slightly in 2013. Improved financial conditions and monetary stimulus suggest a firming of economic activity in 2013. Growth will be mostly driven by domestic demand. With fiscal consolidation continuing in most developed markets, however, growth rates of EMs exports will remain relatively modest and below historical standards. Given that a significant share of the current slowdown in EM economies is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade. The outlook is largely dependent on developments in the euro area and the handling of the US fiscal situation. In China, the risk of a hard landing seems to have subsided, as recent data confirm that growth is improving somewhat and that policymakers have been successful in avoiding a significantly lower trend growth. Generally, risks still remain as long as the recovery in the global economy remains fragile and, thus, vulnerable to sudden shocks, all of which could dampen global demand.

II. Global Economic Outlook

1. The US economy

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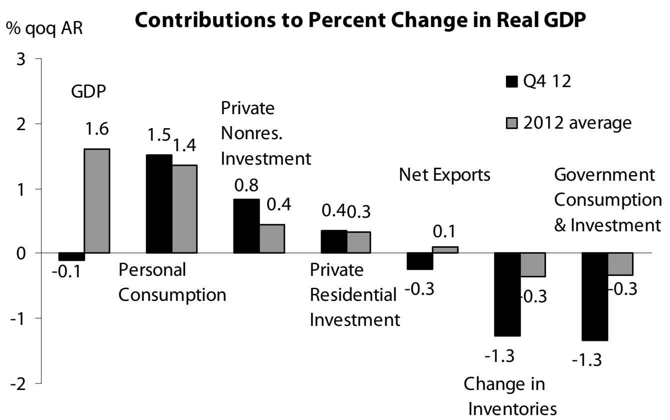
- Real GDP reported a modest decline in the final quarter of 2012, due to temporary de-stocking and a sharp decline in defense spending. This decline does not represent the overall trend in the US economy, as private domestic demand actually strengthened.
- The major risk for the US economic outlook in 2013 stems from the effect of higher taxes and reduced disposable income on private consumption, and the sequestration process that is set to take effect on March 1.
- We expect real GDP growth to remain subdued around 1.5-2.0% in H1 2013 and pick up to 2.5% in H2 2013, provided that the fiscal drag diminishes over time. Overall, we expect a deceleration of real GDP growth to around 1.8% y-o-y in 2013 from 2.2% in 2012, assuming that the spending sequestration process is replaced by back-loaded measures and the size of the fiscal restraint amounts to 1-1.5% of GDP.
- Given the uncertainty surrounding fiscal policy and the slow recovery in labor market conditions, the Fed replaced the "Operation Twist" that was completed at the end of 2012 with purchases of long-term Treasury securities and improved its communication by announcing numerical threshold values for unemployment and inflation to guide the first rate hike.
- The FOMC will stay tied to a highly accommodative stance of monetary policy in 2013 in order to support a fragile economy that is being hit by fiscal consolidation, with exceptionally low fed funds rates at 0-0.25% and an open-ended balance sheet expansion. Should economic and labor market conditions improve in H2 2013, then the Fed may diminish the monthly rate of asset purchases by year-end.

Overview

Real economic activity accelerated modestly to 2.2% in 2012, from 1.8% in 2011, continuing the below-trend growth seen since the recession ended in mid-2009. Although residential investment growth strengthened due to the turnaround in the US housing market, private consumption growth was probably restrained by tepid growth in US households' income. Furthermore, the anticipation of higher taxes and public spending reductions, combined with uncertainty about the magnitude and composition of the expected fiscal tightening, has led consumers and firms to hold back on spending and investment. The US labor market improved modestly in 2012 but still remained relatively weak, with the unemployment rate declining from 8.5% at the end of 2011 to 7.8% in December 2012. The slow labor market recovery has prompted the Fed to launch a third round of quantitative easing, initiating purchases of agency mortgage-backed securities and long-term Treasuries.

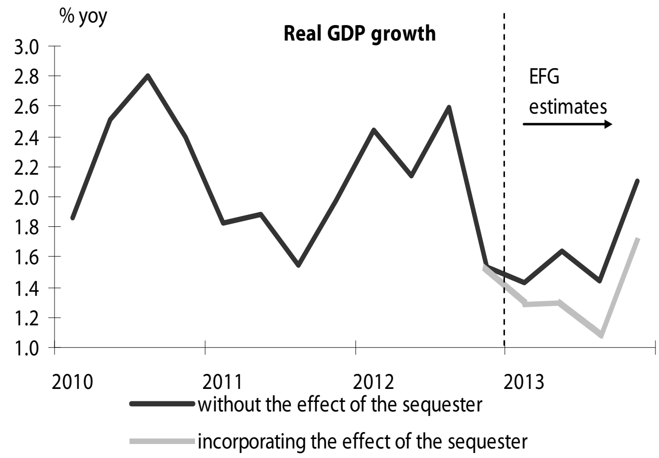
Real GDP reported a modest decline in the final quarter of 2012, due to temporary de-stocking and a sharp decline in defense spending. However, the overall trend in the US economy does not point to a recessionary territory, as private domestic demand actually strengthened (Figure 1.1). Although the improving financial environment and the recovery in the housing market have helped to improve private sector's balance sheets, the tax increases set to take effect at the beginning of 2013 and uncertainty surrounding US fiscal policy will probably weigh on personal income and, consequently, private consumption expenditures in the short term. We expect real GDP growth to remain subdued around 1.5-2.0% in H1 2013 and pick up to 2.5% in H2 2013, provided that the fiscal drag diminishes over time. Overall, we expect a deceleration of real GDP growth to around 1.8% y-o-y in 2013 from 2.2% in 2012, assuming that the spending sequestration process is replaced by back-loaded measures and the size of the fiscal restraint amounts to 1-1.5% of GDP. The risks are tilted to the downside, as policymakers may not reverse the spending cuts so that the sequester takes effect in full on March 1. According to our estimates, automatic reductions in spending would reduce real GDP growth by about 0.5 percentage points, lowering our GDP forecast to 1.3% y-o-y in 2013 (Figure 1.2).

Figure 1.1



Source: US Bureau of Economic Analysis, Eurobank Research estimates

Figure 1.2



Source: US Bureau of Economic Analysis, Eurobank Research estimates

Negative GDP growth, due to defense spending and inventory building

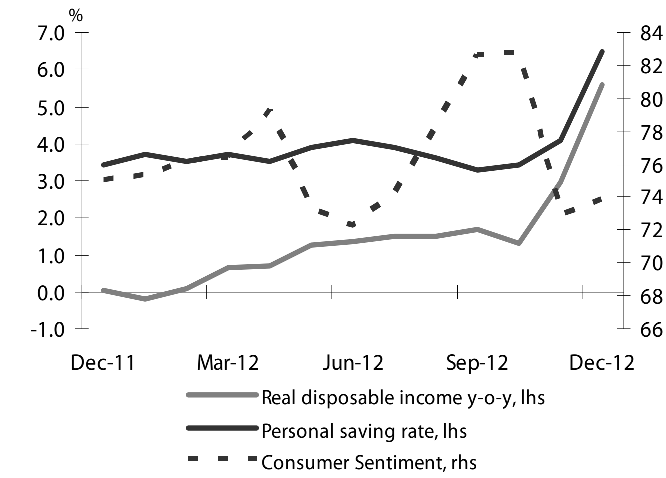
According to the advance estimate of the Bureau of Economic Analysis (BEA), real GDP declined by 0.1% q-o-q saar in Q4 2012, after a 3.1% quarterly growth in the previous quarter. The decline in real GDP -the first reported negative growth since Q2 2009 when the economy was in recession- was centered on inventory investment and government defense outlays, each subtracting 1.3% from real growth (Figure 1.1). The negative contribution from inventories stemmed from declines across the board (retail, wholesale, durable and nondurable manufacturing sectors), as firms allowed their stock levels to shrink after a strong inventory accumulation in Q3. Government defense spending reported the largest negative contribution in four decades, probably reflecting payback for strong positive contribution in the previous quarter, as well as a reduction in public spending in anticipation of the scheduled sequester cut to the defense spending.

The weakness in inventories and defense spending does not reflect the overall trend in the US economy, as final private demand growth added 2.5% to real GDP growth in the final quarter of 2012, following a 1.6% contribution in Q3. Real private consumption growth accelerated to 2.2% q-o-q saar from 1.6% in Q3, contributing 1.5% to real GDP growth. The personal income accounts were particularly strong (Figure 1.3), with real disposable income increasing by roughly 7% q-o-q saar, boosted by special dividends and accelerated bonus payments ahead of the 2013 dividend tax hike. However, we expect disposable income to decline sharply at the beginning of 2013, as these one-off payments have been brought forward at the end of 2012 and it is very likely to have a negative payback in Q1 2013. Besides, the tax increases that are about to take effect in 2013, such as the expiration of the payroll tax cut and the upper income tax cut, will probably constitute a significant drag on household income. The expected plunge in real personal income will likely lead to a much lower saving rate and a much lower private spending growth. Although the exact effect of higher taxes and, consequently, reduced disposable income on consumption is highly uncertain, high-frequency data up to date are consistent with a modest growth of personal outlays. In particular, consumer confidence published by the University of Michigan improved in January (Figure 1.3), light vehicle sales remain above their Q4 2012 average, while ICSC chain store sales index surged in January to their highest level since September 2011. In addition, January retail sales suggest that private spending have help up relatively well since the tax increased took effect on January 1. Overall, real personal consumption growth is expected to decelerate to about 1.0% q-o-q saar in Q1 2013, almost half of its reported growth in Q4 2013.

Real fixed investment growth was the second major contributor to real GDP growth. Although structures reported a small decline (-1.1% q-o-q saar), equipment and software investment growth accelerated to 12.4% q-o-q saar, after a drop of

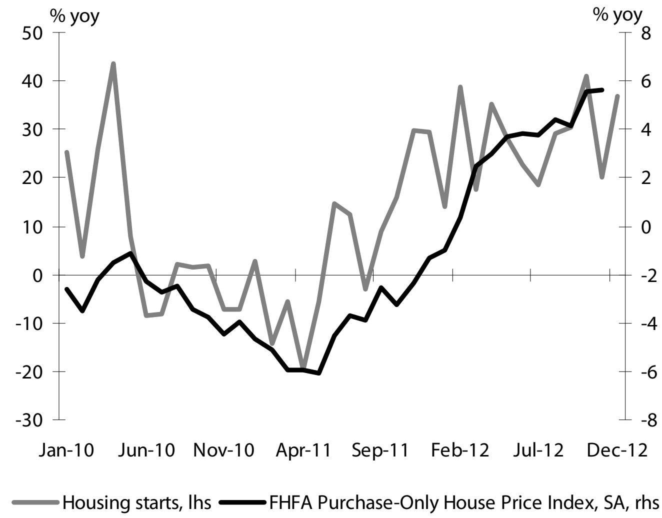
2.6% in the previous quarter. Meanwhile, real residential investment continues its upward trend, contributing roughly 0.7% to real growth in H2 2012. Given the expected deceleration in personal consumption growth amid the sharp decline in personal income in Q1 2013, real fixed investment growth will be very important for the prospects of the US economy this year. We expect the recovery in the US housing market to continue supporting real economic growth, with residential investment maintaining the same upward momentum in 2013 (Figure 1.4).

Figure 1.3



Source: US Bureau of Economic Analysis, Thomson Reuters/ University of Michigan

Figure 1.4



Source: US Census Bureau, OFHEO

Unlike domestic demand, external demand was particularly weak in the final quarter of 2012, subtracting 0.3% from GDP growth. Real exports of goods and services declined by 5.7% q-o-q saar in Q4, almost double the reported decline in real imports (-3.2%). Although net trade contributed an average of 0.2 percentage points to GDP growth in the past three quarters, it was actually a drag for economic activity in Q4 due to the ongoing deceleration of economic growth in US trade partners. Net trade is not expected to be a strong contributor to real economic activity in 2013, as export demand from its main partners will probably remain subdued.

Fiscal policy is a key to US economic outlook

At the beginning of the year, Congress approved a legislation to avoid the automatic spending cuts and the majority of tax increases expected to take effect from January 1. The automatic sequestration process has been delayed for two months until March 1, giving lawmakers the chance to find alternatives to replace the $1.2trn in spending cuts over the next 10 years[1]. The fiscal agreement includes:

(a) the expiration of the 2% payroll tax cut for the first $113.7k of income (workers' payroll tax rate increase from 4.2% in 2012 to 6.2%), resulting in a fiscal drag on disposable income of about $120bn in 2013.

(b) the expiration of upper income tax cut, combined with an increase in the dividend and capital gains tax rate. In particular, the marginal income rate increases from 35% in 2012 to 39.6% for income above $400k for individuals or $450k for married couples. Limits will return on itemized deductions and personal exemptions at $250k for individuals and $300k for married couples. Furthermore, the rate on dividends and capital gains increases from 15% to roughly 20% for households earning more that the above mentioned thresholds. The expected increase in 2013 revenues hovers around the range of $25-$50bn.

[1] 50% of the spending cuts are scheduled for defense spending, 35% for nondefense discretionary, and about 15% for Medicare and other health spending.

(c) the permanent reform of the Alternative Minimum Tax (AMT). According to this measure, the AMT has been permanently indexed to inflation, removing the need to have patches every year or so. The income threshold for being subject to the AMT will rise automatically each year according to changes in prices.

(d) the extension of tax cuts for individuals/married couples earning below upper income tax thresholds ($400k/$450k respectively). If these tax cuts had expired, this would constitute a fiscal drag of about $120-$170bn.

(e) the extension of emergency unemployment insurance benefits and refundable tax credits (for low income households) for one year. If this tax cuts had expired, this would yield about $40bn of additional revenue.

The fiscal consolidation measures amount to around $200-230 bn, i.e. 1.5% of GDP, so the expected fiscal restraint should reduce growth by at least 1.0-1.5% in 2013. The fiscal restraint would increase by a further 0.3-0.5% of GDP in 2013, should the sequestration process takes effect in full at the beginning of March. If Congress does not act to cancel the sequester, then across-the-board spending cuts will automatically be implemented, totalling about $85bn in FY2013, i.e. 0.5% of GDP (Figure 1.2).

Meanwhile, the US federal government is currently operating under temporary spending authority (the so-called continuing resolution) that is set to expire at the end of March. The spending authority was most recently extended in September 2012 for six months until March 27, 2013, and it is not the first time that such an extension happens. When policymakers are unable to agree on full-year spending levels, they agree on temporary ones that have to be extended in a certain period of time. If Congress does not extend temporary spending authority by March 27, then all non-essential government activities funded by congressional appropriations will shut down. Although we do not expect the policymakers to allow a government shutdown to happen, such a partial shutdown would have only a minor effect on 2013 GDP growth, as only 10-15% of federal spending relies on congressional appropriations that are considered as non-essential.

The extension of the debt limit deadline from the beginning of March to around August 2013 leaves the sequestration process on March 1 and the possibility of a partial government shutdown on March 27 as the two remaining weapons for Republicans to win additional spending cuts. House Republicans have expressed their will to replace the sequestration process with other mandatory spending cuts, while congressional Democrats seem prepared to accept further tax increases instead. It is of vital importance for policymakers to agree on replacing the across-the-board- spending cuts with a more back-loaded mechanism to reduce spending so as to restraint the drag from fiscal policy on real economic activity.

Further monetary accommodation to support the fragile US economy

In line with our forecasts in our previous Global edition in October 2012, the Fed decided at its December FOMC meeting to provide further monetary accommodation in order to support a stronger economic recovery. In particular, the FOMC replaced the Operation Twist that was completed at the end of 2012 with purchases of long-term Treasury securities at a rate of $45bn per month. This decision comes on top of its September decision to initiate purchases of agency mortgage-backed securities at a pace of $40bn per month, suggesting that the Fed’s balance sheet will be expanding at a rate of $85bn per months starting in January 2013. The Fed will be buying in the 4-30Y segment and the duration of the purchases is a little shorter that the Operation Twist program (Table 1.1).

Moreover, the Committee decided to keep fed funds rates at a record low of 0-0.25% at least as long as: (1) the unemployment rate remains above 6.5%, (2) inflation one- to two- years ahead is projected to be no more than 2.5%, and (3) longer-term inflation expectations continue to be well anchored. As Chairman Bernanke highlighted, this change to outcome-based forward guidance does not represent an increase in the amount of monetary accommodation, but rather an improvement in communications that is more satisfying than the calendar-based guidance. Besides, according to the latest economic projections of FOMC members (Table 1.2), the unemployment rate is forecasted to range in the area of 6.0-6.6% in 2015, which is consistent with the Fed’s previous calendar guidance that the fed funds rates would stay at exceptionally low levels until mid-2015.

Table 1.1: Moderate shift towards a lower duration of Treasury purchases

Operation Twist		QE3	
Maturity Range	**Allocation**	**Maturity Range**	**Allocation**
		4 – 4.75Y	11%
		4.75 – 5.75Y	12%
6 – 8Y	32%	5.75 – 7Y	16%
8 – 10Y	32%	7 – 10Y	29%
10 – 20Y	4%	10 – 20Y	2%
20 – 30Y	29%	20 – 30Y	27%
TIPS	3%	TIPS	3%

Source: Federal Reserve Bank of New York

Table 1.2: Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, December 2012

	Central Tendency*			
	2013	**2014**	**2015**	**Longer**
Change in real GDP	**2.3 – 3.0**	**3.0 - 3.5**	**3.0 – 3.7**	**2.3 - 2.5**
September forecast	(2.5-3.0)	(3.0-3.8)	(3.0-3.8)	(2.3-2.5)
Unemployment rate	**7.4 – 7.7**	**6.8 – 7.3**	**6.0 - 6.6**	**5.2 - 6.0**
September forecast	(7.6-7.9)	(6.7-7.3)	(6.0-6.8)	(5.2-6.0)
PCE inflation	**1.3- 2.0**	**1.5 - 2.0**	**1.7 - 2.0**	**2.0**
September forecast	(1.6-2.0)	(1.6-2.0)	(1.8-2.0)	(2.0)
Core PCE inflation	**1.6 - 1.9**	**1.6 - 2.0**	**1.8- 2.0**	
September forecast	(1.7-2.0)	(1.8-2.0)	(1.9-2.0)	
Fed Funds Rate	**0.00 - 0.25**	**0.00 – 1.50**	**0.50- 2.50**	**3.75 - 4.25**

*The central tendency excludes the three highest and three lower projections for each variable in each year.

Source: Federal Reserve, Eurobank EFG Research

The FOMC did not alter its views at its January meeting, expecting that "with appropriate policy accommodation, economic growth will proceed at a moderate pace". Given the uncertainty surrounding fiscal policy and the slow recovery in labor market conditions, we expect that the Fed will continue purchasing assets through year-end. The third round of quantitative easing is actually an open-ended purchase program, in the sense that the overall amount and duration of asset purchases will be dependent on economic and financial developments in the following months. Should economic and labor market conditions improve in the second half of the year, then the Fed may diminish the monthly rate of asset purchases by year-end.

2. The Euro area economy

Dimitris Malliaropulos, Vasilis Zarkos

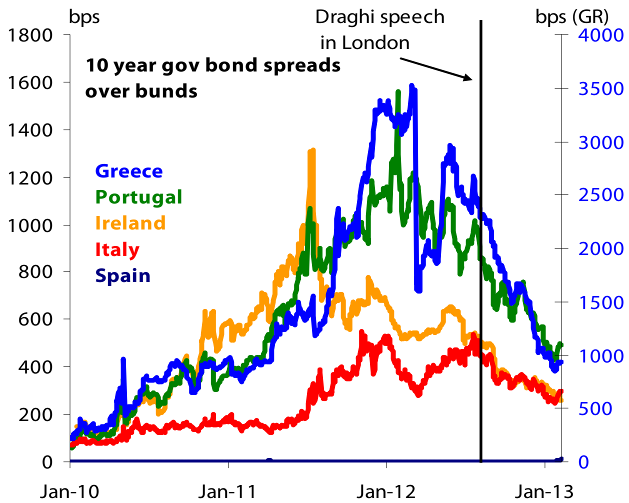
- Euro area GDP growth is likely to return to positive territory in the second half of the year, provided that confidence continues to improve. That said, the economy remains fragile and it is expected to lag its peers due to harsh economic conditions and substantial fiscal drag.
- Risks to the economy remain on the downside, stemming mainly from failure of policymakers to persevere on structural reforms and worsening of the economic situation in periphery countries due to simultaneous fiscal austerity and private deleveraging.
- Provided that reform momentum remains intact in the course of this year, an economic rebound may materialize in 2014 on the backdrop of restored confidence feeding through to the real economy, abating headwinds from fiscal consolidation and gradual improvement of credit conditions.
- The ECB is anticipated to remain on hold in the next couple of years, unless the economic situation deteriorates substantially. Emphasis is expected to remain on fixing the monetary transmission mechanism and re-integrating the euro area financial markets. To this end, more unconventional measures are likely.

Positive GDP growth in H2 likely due to restoration of confidence

Stabilizing political and financial conditions have led to a recoup of economic confidence, which, if continued, may feed through to the real economy, allowing euro area real GDP to show first signs of positive growth on a quarterly basis later in the year. Several factors have contributed to an abatement of uncertainty, after reaching a climax in the second half of last year. In Greece, a government committed to the reform program has been formed. Moreover, the announcement of the OMT program by the ECB has removed tail risks over a monetary break-up, providing the euro area with enhanced ammunition to contain contagion effects of the sovereign debt crisis and avert extreme outcomes. A third reason is progress made by policymakers in institutional building, aiming at addressing structural weaknesses of the European Union. Reduced uncertainty has allowed private investors to return to Spain and Italy and deposits in periphery countries to rise. Government bond spreads have narrowed substantially relative to the levels observed last summer (Figure 2.1).

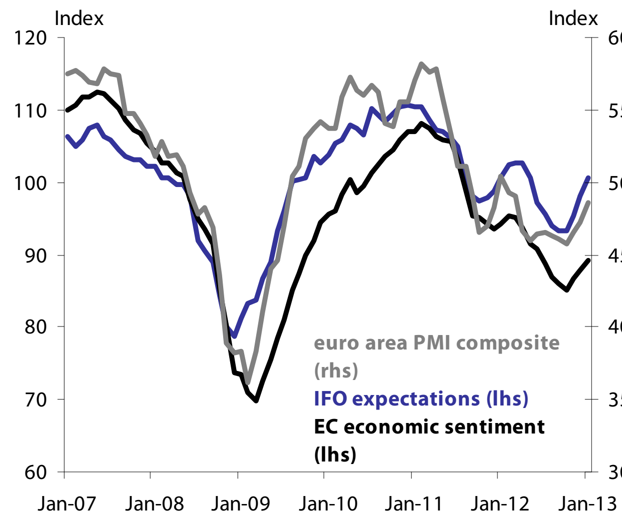
In line with easier financial tensions, a series of leading indicators have revealed signs of a tentative re-building of confidence (Figure 2.2). Recent stabilisation in PMI surveys and the European Commission's indices, as well as the improvement in the IFO, Insee and Banque de France surveys imply that economic activity may have finally bottomed in Q4. However, the PMI indices continue pointing to economic contraction, implying that easier conditions in financial markets have not reached the real economy, yet. Indeed, business confidence remains low and downside risks will likely deter firms from increasing investment or adjusting their hiring plans. Moreover, record high unemployment and uncertainty over future income will keep household personal expenditures subdued. Overall, we expect the euro area economy to continue lagging its developed peers on the backdrop of fiscal consolidation and private de-leveraging. In particular, GDP is forecasted to continue contracting in the first two quarters and start improving only gradually in the second half of the year. Our forecast for annual GDP growth in 2013 has been downgraded to 0.0% from 0.3%, three months earlier.

Figure 2.1



Note: For Ireland, spreads of 8-yr bonds are shown
Source: Bloomberg

Figure 2.2



Source: Bloomberg

Looking further ahead, the euro area economy is likely to experience a rebound in 2014 (projected annual GDP growth of 1%) on the backdrop of improved confidence feeding through to the real economy, abatement of fiscal headwinds, easier credit standards, further progress in institution formation, substantial unwinding of fiscal and external imbalances and a positive contribution to overall euro area growth from periphery countries.

The divergent growth pattern of euro area countries is expected to continue in 2013. Peripheral economies are expected to post another year of significant contraction. On the other hand, Germany is expected to return to positive growth at the beginning of 2013, after most likely experiencing a soft patch in Q4 2012. A pick up in global economic growth will likely support German exports. In addition, German economic conditions are favourable of an increase in domestic demand. Unemployment is low, wage increases are the highest in the last decades, financial conditions are benign and wealth effects from a buoyant housing sector are also supportive. Absent of negative shocks, the rebuilding of confidence should propel investment and inventory rebuilding, which have been a drag to the German economy in 2012. A rise in German domestic demand would assist the adjustment process in periphery members, which need a symmetric response from surplus countries to unwind their external imbalances.

Risks are to the downside and the road ahead will remain bumpy

While the outlook for 2013 looks less unsettled and our central scenario points to a continuing improvement of financial and economic conditions, the economy is not out of the woods. Headwinds to an already fragile economy remain strong and risks are tilted to the downside.

For the economic sentiment to continue improving, policymakers should remain committed to addressing fiscal sustainability concerns and pushing through structural reforms that will increase potential growth and assist the orientation of resources towards tradable sectors. Accomplishing the reform agenda is critical for periphery countries to convince over their ability to service their debts and allure private investors to restart financing their economies. Political stability and continuation of policy reform may allow accommodative monetary policy and improving financial conditions reach the real economy, setting indeed in motion a cycle of positive contagion.

In this context, policy action is the main risk to the euro area economy. A loss in reform momentum in periphery countries could give rise to a new bout of financial turmoil reversing achieved progress in markets' confidence. In Greece, a fragile political coalition is called to continue the overhauling of the economy amidst rising social fatigue and high and still climbing unemployment that will test the government's cohesion. In Spain, the reform progress might loose pace due to complacency on declining borrowing costs. Meanwhile, the social cost of economic adjustment nurtures euro sceptic political powers. Moreover, given that Spain will likely be pushed to make an official request to the ESM for assistance, reluctance of Spanish authorities to an OMT activation could trigger jitters in financial markets. At the euro area level, further muddling through rather than a permanent resolution to the debt crisis is expected in 2013. While it is evident that some form of mutualisation of risks should be part of the solution, dissenting views over the right mix of risk sharing and loss of sovereignty are likely to keep a permanent solution to the debt crisis distant. Additionally, while we expect further progress in building the four pillars of European integration in the course of 2013, discussions will most likely remain cumbersome and heated. The German elections in fall may also slow the process. Not least, calm market conditions may create a complacent feeling among European authorities which have proven to deliver in a speedier fashion when pressure is intense rather that in calm weather. In all, complacency and political hesitance may cause new bouts of financial volatility.

The fiscal headwind is expected to remain a major drag for the euro area economy in 2013. According to the OECD data, the fiscal consolidation on a cyclically adjusted basis will remain substantial (Table 2.1). The recent debate on the size of fiscal multipliers accentuates the uncertainty over the magnitude of the adverse effect of austerity measures on growth. Of particular importance is that fiscal consolidation is projected to remain severe in Spain, one of the most vulnerable countries. This raises the risk of significant worsening of the economic situation in Spain, which would affect adversely its ailing banking sector and could throw the country into a bad equilibrium once again. On the positive side for the prospects of the euro area economy, as countries have made substantial progress in unwinding fiscal excesses, it seems that we stand passed the harshest point and the headwind from the fiscal retrenchment is set to abate next year.

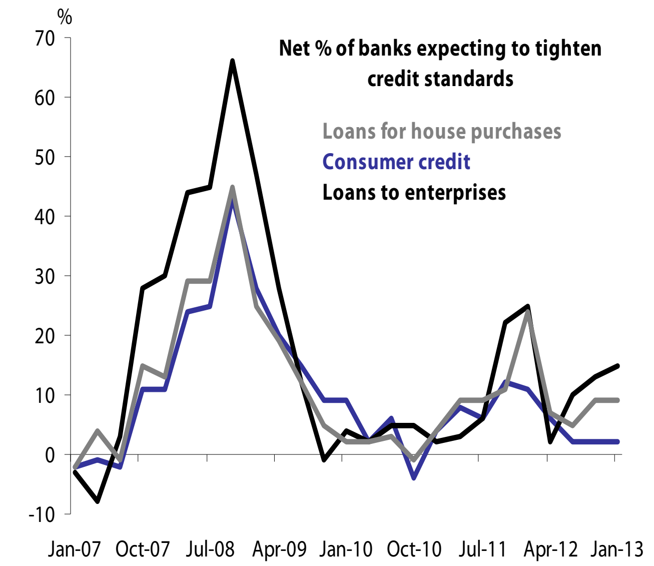
Table 2.1

Change of cyclically adjusted budget balance as % of GDP				
	2011	2012	2013	2014
Belgium	-0.5	1.9	1.1	0.6
France	1.7	1.2	1.8	0.7
Germany	2.4	0.6	0.2	-0.2
Greece	4.4	5.0	2.5	1.4
Ireland	16.3	5.0	0.5	1.6
Italy	0.3	2.0	1.0	-0.4
Netherlands	0.4	1.3	1.5	0.7
Portugal	5.9	0.8	1.2	1.6
Spain	0.7	2.4	2.7	0.7
euro area	**1.7**	**1.4**	**1.2**	**0.3**

Note: Positive numbers indicate reduction of the cyclically adjusted deficit relative to the previous year.
Source: OECD

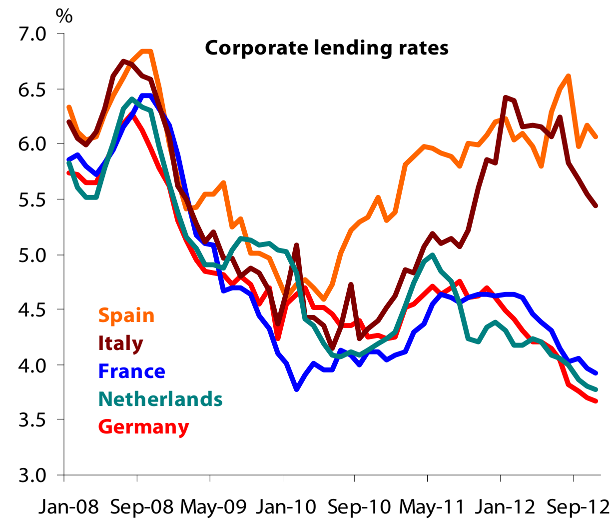
Despite the improvement in financial markets, tight credit conditions constitute another major headwind to the euro area economy. Excess liquidity provision has failed to translate to credit expansion. Euro area banks have continued tightening lending standards in Q3 2012 on the backdrop of adverse expectations of economic activity, while further tightening is expected in Q4 (Figure 2.3). The normalization in financial markets due to the OMT allowed lending rates to decline in both core and peripheral members. However, rates in the latter group remain high (Figure 2.4), hindering financing of the real economy. Looking forward, further recoup of confidence and progress in banking sector restructuring may allow a gradual easing of credit standards in periphery countries.

Figure 2.3



Source: ECB Bank Lending Survey

Figure 2.4



Note: Bank lending rates for loans to NFCs over 1 and below 5 years, up to €1mn
Source: ECB

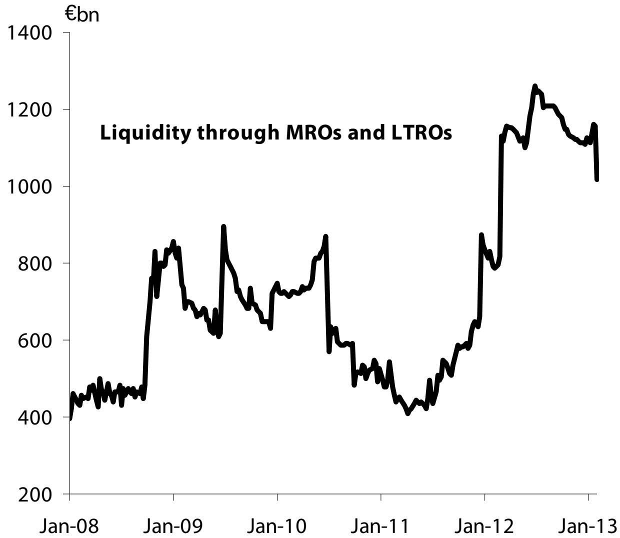
Besides risks stemming from within the euro area, shocks to the global cycle could also derail the euro area recovery. Policy mistakes in the US on negotiations over fiscal issues could create shockwaves affecting the global economy. Moreover, euro area exports would take a hit if the economic rebound in China does not prove sustainable. In particular, a hike in commodity prices would fuel inflationary concerns in China and lead to a reversal of monetary easing, affecting adversely the Chinese economic expansion.

Overall, the way forward for the euro area will most likely remain bumpy. Whereas we would assume that European policymakers and the ECB will do everything they can to safeguard the euro, the multiple sources of uncertainty aforementioned only allows a cautious optimism that the worst phase of the sovereign crisis might be behind us.

ECB to remain on hold

Improvement of financial conditions has reduced banks' dependence on liquidity from the ECB, as it is evident from shrinking outstanding liquidity over the past six months (Figure 2.5). Excess liquidity is expected to decline further as easier inter-bank lending conditions will encourage banks to start repaying funds borrowed through the two 3-yr LTROs. Unless negative risks materialize, particularly in the case of sustained euro appreciation, we expect the ECB to remain on hold throughout 2013, as growth is expected to stabilize and financial conditions and business confidence to continue improving. In our view, further conventional easing would have symbolic merit rather than practical importance for weak countries. With loose monetary policy being materially hindered from passing through to bank lending rates in peripheral countries, the ECB will keep prioritizing the amendment of the monetary transmission channel over rate cuts. Whereas the OMT program has paid valuable service in stabilizing sovereign bond markets, it may not prove fully effective to re-ignite credit growth given the adverse economic conditions prevailing in these countries. To complement the OMT effect, the ECB could launch credit easing measures to stimulate bank lending in periphery members. Funding schemes such as the Bank of England's funding for lending program and/or asset purchases could be possible initiatives.

Figure 2.5



Source: Bloomberg

3. The Japanese Economy

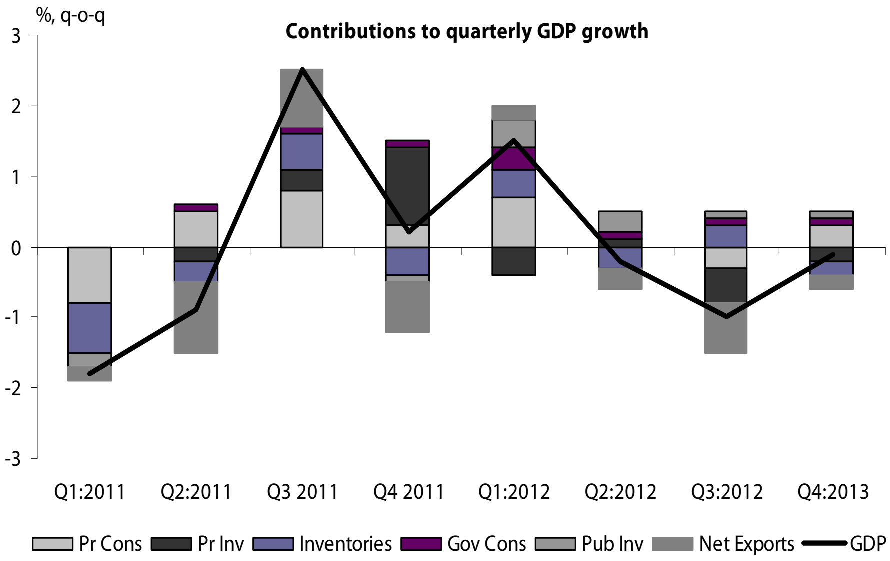
Dimitris Malliaropulos, Vasilis Zarkos

- After experiencing a technical recession in 2012, Japan's GDP growth is expected to return to positive territory in 2013 due to a combination of accommodative fiscal and monetary policy and a pick up of global demand.
- Under the government's strong pressure, the Bank of Japan is expected to become more proactive in combating chronic deflation and preserving yen weakness. Likely succession of current vice-Governors (in March) and the Governor (in April) by more dovish officials may facilitate monetary policy guidance by the government.
- Escalation of Sino-Chinese tensions, policy mistakes in the US and new bouts of uncertainty in Europe pose downside risks to the Japanese economy. Inadequate policy action in the front of structural reforms to increase potential growth could hamper government's plans for an exit from deflation.

Economic rebound due to easier monetary and fiscal policy

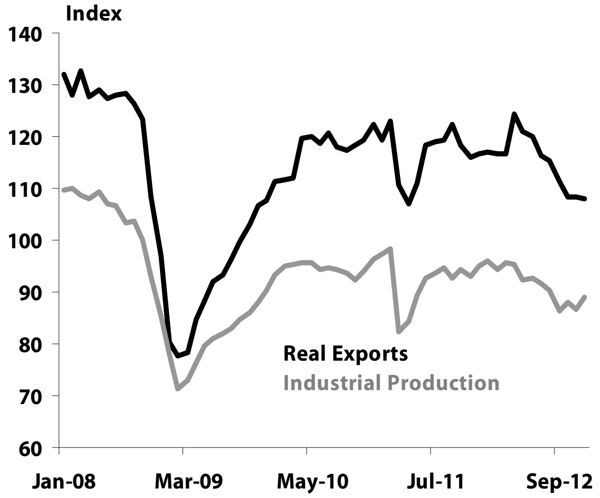
The Japanese economy has experienced a recession in the last three quarters of past year (Figure 3.1), as heightened uncertainty in Europe, expiry of eco-friendly car subsidies and a Chinese boycott weighed on the country's production and exports (Figure 3.2). In 2013, the Japanese economy is expected to gain momentum on the backdrop of an emergency stimulus package approved by the government in mid-January, a weaker yen due to easier monetary policy and a pick up in global growth. With a focus on the July upper-house elections, the newly elected Abe administration has been very decisive in taking bold steps to promote growth. A supplementary budget plan worth ¥10.3tn to provide fiscal stimulus (of which ¥5.2tn is dedicated to infrastructure) is expected to partially shield the Japanese economy from external shocks. Bold fiscal and monetary action by the Abe administration has caused a euphoria reflected in a net balance of both households and firms expecting conditions to improve in the next three months, for the first time since April 2012 (Figure 3.3).

Figure 3.1



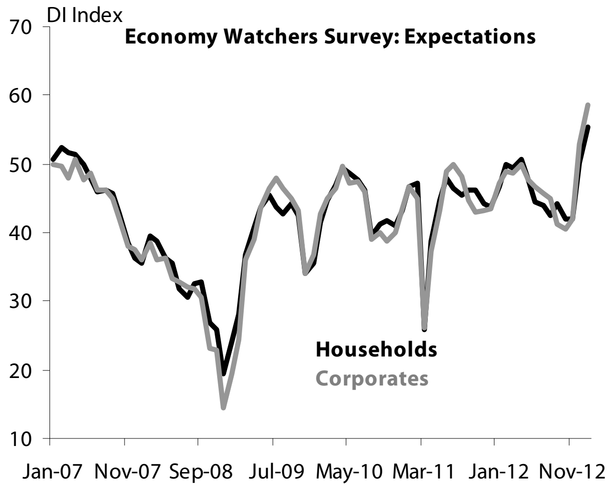
Source: Cabinet Office

Figure 3.2



Source: Bloomberg

Figure 3.3



Source: Bloomberg

Looking further ahead in 2014, the economy is likely to pick up momentum, expanding at a somewhat faster pace (1%). Whereas the contribution from public investment is expected to turn negative and the boost from residential investment to fade, the economy will likely benefit from a rise in exports and private capital expenditures on the backdrop of stronger global growth. On a quarterly basis, GDP growth is expected to be distorted by sharp fluctuations of private consumption due to a VAT hike from 5% to 8% scheduled for April 2014.

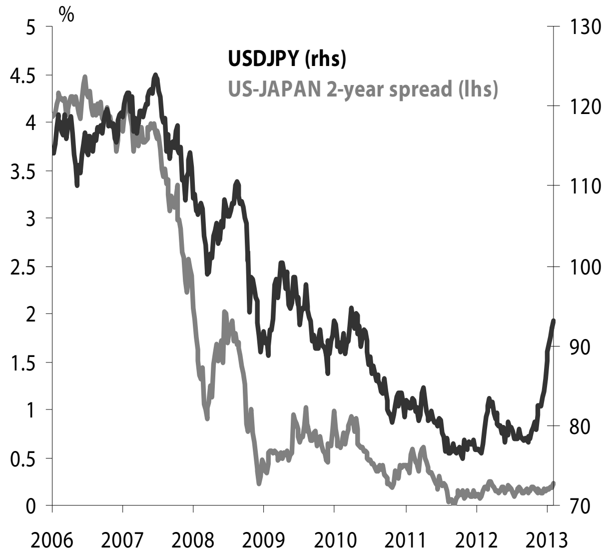
BoJ under close government monitoring

Under the government's strong pressure the Bank of Japan raised its annual inflation target to 2% from 1%, as deflation has been blamed for the underperformance of the Japanese economy. Through a clear cut commitment to defeat price declines, the government aims at inciting both firms and households to increase borrowing and spur economic growth. With respect to the Asset Purchase Program (APP), unlimited quantitative easing has been delivered, as the BoJ switched to an open-ended mode. A predetermined cap will be abolished from January 2014 and replaced by a predetermined amount of monthly purchases with no termination date announced. The BoJ will be purchasing ¥13tn of assets each month, including ¥10tn of short- term and ¥2tn of long-term government bonds.

Even more important than the change of the inflation target and the announcement of unlimited QE is the close interaction between fiscal and monetary policy. Progress of the BoJ to attain the inflation target will be monitored by the Council of Economic and Fiscal Policy, an advisory council chaired by the Prime Minister and including other ministers of the government. Under this new regime it is likely that the council will not only monitor but also transmit the monetary policy to the BoJ. Monetary policy guidance should be facilitated by the succession of current vice-Governors and the Governor in March by most probably more dovish officials. Given that achievement of the new inflation target will be a challenging task, pressure for further monetary easing should remain elevated. Next steps would include maturity extension for JGB purchases (current maturity range of 1-3yr may be expanded to 1-5yr), a rise of the pace of monthly purchases, abolition of the interest on banks' excess reserves and bringing forward the operation switch of the APP program.

The yen has already weakened substantially due to a strong easing bias of monetary policy. A sustained yen weakness may assist authorities to combat deflation through imported inflation and stronger domestic demand led by higher exports. Looking forward, sustained yen depreciation is expected as i) a more aggressive stance of the BoJ relative to its peers (the BoJ is the only major central bank to continue to expand its QE program in 2014), will drive yield differentials against the yen (Figure 4) and ii) further stabilization in the euro area, as envisaged in our baseline scenario, will weigh against the yen as a safe heaven currency.

Figure 3.4



Source: Bloomberg

External shocks and economic policy pose downside risks to the Japanese growth

Tensions in the Sino-Japanese relations pose a risk to Japanese exports, which may not benefit from a forecasted pick-up of economic growth in China. Fears of a tougher stance against China may materialize if the ruling LDP party wins the upper house elections in July, leading to a more extensive boycott of Japanese products. Furthermore, Japan remains vulnerable to policy mistakes over the fiscal cliff in the US as well as a rekindle of tensions in Europe. Both developments would hurt the economy through reduced exports and yen appreciation.

Medium to longer term, inadequate policy action in the front of structural reforms could hamper government's plans to exit deflation. Easier monetary policy alone is not enough to end deflation, as a rise in inflation target does not automatically increase inflation expectations. For the latter to materialize, growth expectations should be improved. Fiscal stimulus is certainly not a sustainable practice to spur growth, while it deteriorates Japan's already stretched public finances. In our view, loose monetary policy should be combined with initiatives for structural reforms which would increase Japan's potential growth and persuade firms to ramp up investment and hiring.

4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- Economic activity across emerging markets has started to gain momentum over the past few months, supported by earlier policy rate cuts and fiscal stimulus in some countries. Forward looking indicators suggest that this upturn in activity is continuing in the early months of 2013.
- Capital flows to emerging markets rose strongly in 2H 2012, with the current momentum remaining strong. The medium term prospects for capital flows to emerging economies are strong, as economic fundamentals in EM will continue to be robust and growth prospects are expected to remain substantially higher than in advanced economies.
- Headline inflation across EM economies declined significantly since its recent peak in September, in tandem with a significant fall in world food prices. Most of the EM central banks that target inflation fulfilled their objectives in 2012 and are expected to do so in 2013.
- Against the background of improving EMs growth outlook, most central banks in emerging markets stayed on hold over the last part of 2012. We expect most emerging markets' central banks to keep interest rates unchanged for most of 2013. Admittedly, with inflation below the targets and a still fragile external backdrop, there will be ample room to ease if growth starts to disappoint again.
- With fiscal consolidation continuing in most developed markets, growth rates of EMs exports will remain relatively modest and below historical standards. Given that a significant share of the current slowdown in EM is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade.

Economic activity has started to strengthen among emerging economies

Economic activity across emerging markets has started to gain momentum over the past few months, supported by earlier policy rate cuts and fiscal stimulus in some countries. Industrial production in emerging economies increased by an annualized pace of 10.7% in the three months to November compared to 5.6% the previous month (Figure 4.1). Strengthening domestic demand boosted import growth, which climbed gradually to 8.8% y-o-y in October from 1.9% y-o-y in August (Figure 4.2). In addition, developing country export growth has started to show some signs of recovery, with our BRIC's leading indicator implying a gradual pick up of EM exports looking forward (Figure 4.3). Reflecting these favourable developments, real GDP in emerging and developing economies accelerated to an average of 5.8% q-o-q annualized in the second half of 2012 from 5.3% in H1 2012 (according to IMF data). Forward looking indicators, notably the Purchasing Manager Index (PMI), suggest that this upturn in activity is continuing in the early months of 2013. China's HSBC/Markit flash PMI for January indicates that production continues to hold up, as it increased to 51.9, from the final reading of 51.5 in December. Also, both Chinese export and new orders have been rising since the trough reached in the summer. Additionally, economic sentiment indicators across all EM regions indicate stabilization in economic activity over the next six months (Figure 4.4).

Figure 4.1

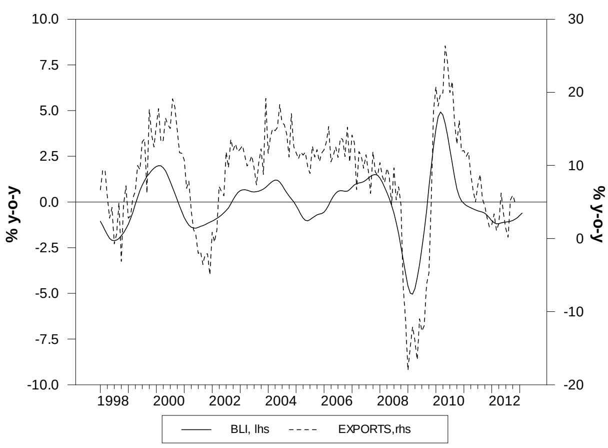
Source: CPB Netherlands Bureau for Economic Policy Analysis

Figure 4.2

Source: CPB Netherlands Bureau for Economic Policy Analysis

Figure 4.3

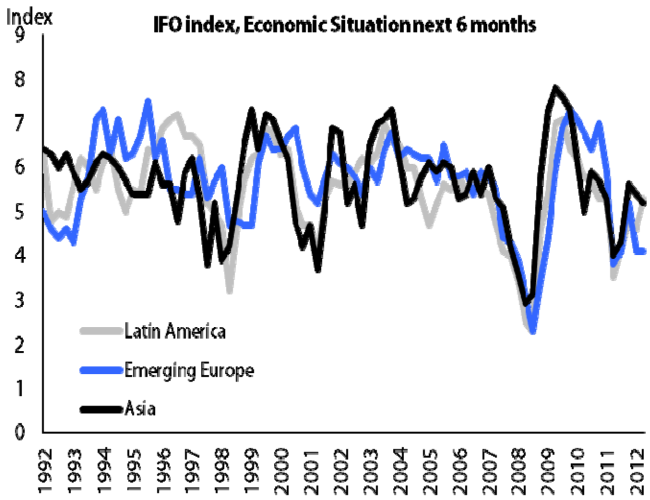
BRICs Leading Indicator* & Exports



** 3 month forward*

Source: Eurobank Research

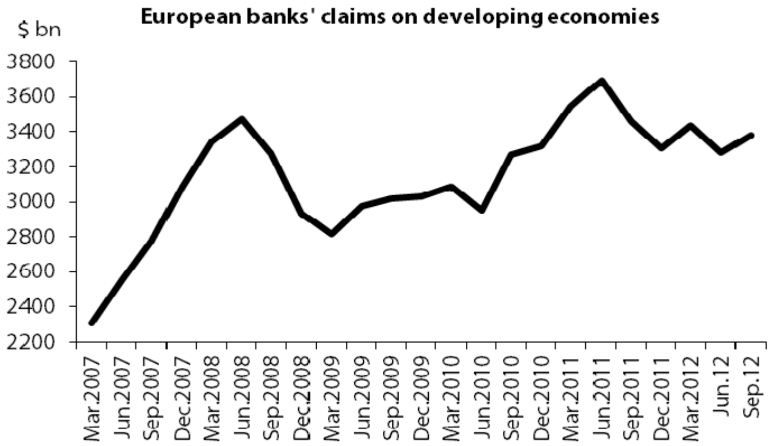
Figure 4.4



Source: Ecowin

Capital flows to emerging markets rose strongly in 2H 2012, with the current momentum remaining strong

The recent easing of financial market tensions, led to an improvement in the global economic sentiment. This, along with accommodative monetary policies in advanced economies steered foreign portfolio flows back towards emerging markets, after a bout of earlier weakness. According to the Word Bank, in Q4 2012, gross capital flows to developing countries reached about $170 billion -close to a record inflow- from about $100 billion in the second quarter of 2012. The increase is concentrated mainly in bond issuance. Meanwhile, in Q3 2012, European banks, which have been among the major sources of capital outflows from EM, increased their claims on EM economies (account for about 20% of their GDP), offsetting the decline in Q2 (Figure 4.5).



Source: BIS

For 2013, according to the Institute of International Finance (IIF), total net capital inflows to EM are projected to increase modestly to $1,118 billion, from $1,080 billion in 2012 (Table 4.1). Generally, the medium term prospects for capital flows to emerging economies are strong, as economic fundamentals in EM will continue to be robust and growth prospects are expected to remain substantially higher than in advanced economies. Moreover, monetary policy in EM is expected to remain tighter than in advanced economies, attracting portfolio investment flows as investors hunt for yields abroad which are higher than those available at home. However, there are still some risks for disruptive events in the euro area that would no doubt trigger new capital outflows towards safe-haven assets. European investors have historically been important suppliers of capital to EMs. Additionally, uncertainties are stemming from the US regarding the decision on spending cuts, which can weigh also in capital flows to EM, particularly if the problem is not addressed and undermines the US and global growth.

Table 4.1

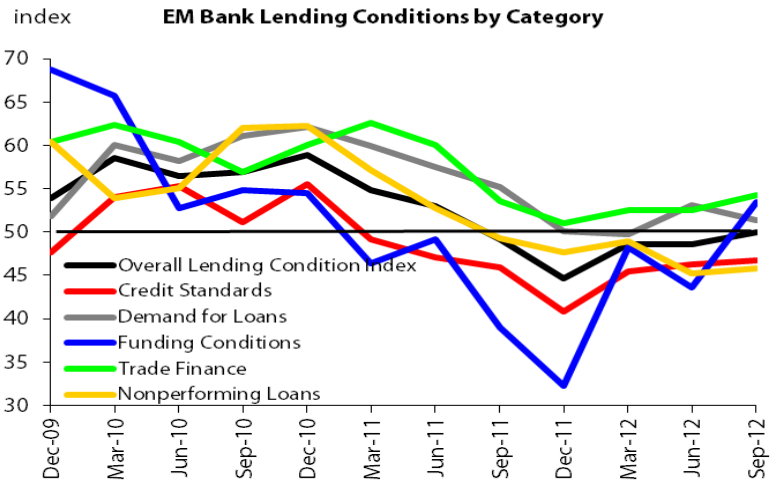
Capital flows to emerging markets

($ billion)	2010	2011	2012e	2013f	2014f
Total inflows, Net	**1,157**	**1,145**	**1,113**	**1,173**	**1,209**
Private flows, net	1,088	1,084	1,080	1,118	1,150
Equity investment, net	607	528	572	616	646
Direct equity investment, net	459	524	499	517	536
Portfolio equity investment, net, net	148	4	73	99	110
Private Creditors, net	481	556	508	502	504
Commercial banks, net	159	177	143	152	175
Non banks, net	322	379	365	351	329
Official flows, net	69	61	33	55	59
International financial institutions, net	31	17	0	18	22
Official bilateral creditors, net	38	44	33	37	37

Source: Institute of International Finance

EM bank funding condition improve

Encouraging signs come also from the latest Emerging Market Bank Lending Survey, conducted by the Institute of International Finance. The IIF index of emerging markets bank lending conditions rebounded in Q3 2012 to a five quarter high of 49.9, from 48.6 in Q2 2012 (Figure 4.6). Moreover, the survey shows that funding strains, which have been a fact in emerging economies since early 2011, have improved significantly for the first time since the last quarter of 2010. It's worth noting that the most encouraging developments were evident in emerging Europe, which was the region that suffered the most due to its close links with the euro area. Apparently, the ECB's commitment to unlimited sovereign bond purchases under the OMT program enabled some banks in the region to access international funding more easily. Despite, the overall encouraging signs of the survey, the problem of non-performing loans continues to be a major concern across all regions.



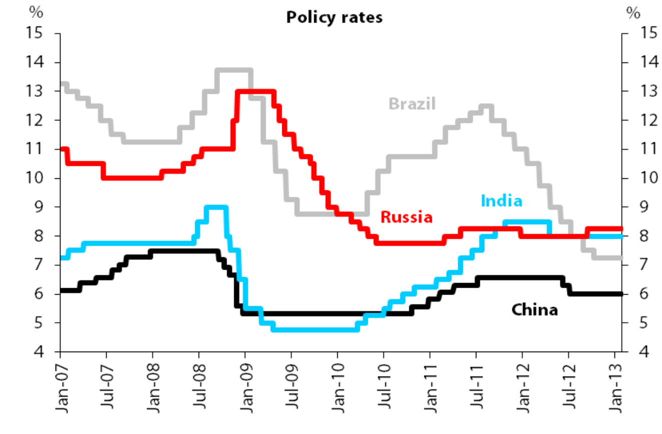
Notes: Values above 50 indicate improving conditions. Values below 50 indicate deteriorating conditions. The sample size more than doubled in 11Q1, introducing a statistical break in the data.

Source: IIF

Monetary policy will continue to be supportive for growth as inflation pressures are expected to remain subdued

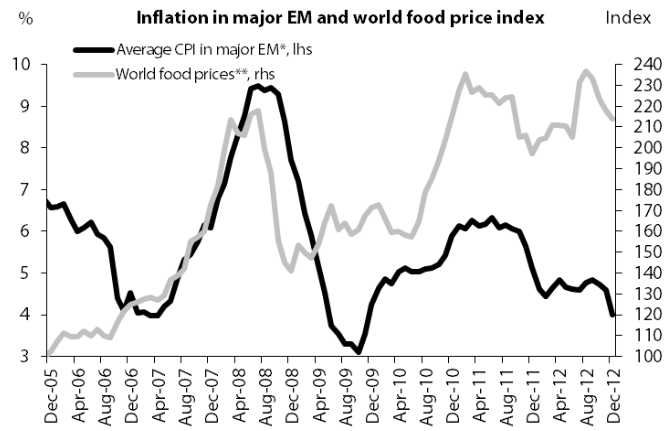
Against the background of improving EMs growth outlook, most central banks in emerging markets stayed on hold over the last part of 2012 (Figure 4.7). Meanwhile, average headline inflation across major EM economies has started to decline significantly since September 2012, with the inflation rate falling from 4.8% to 4.0% in December, in tandem with a significant fall in world food prices (Figure 4.8). As a result, most of the EM central banks that targets inflation fulfilled their objectives in 2012 and are expected to do so in 2013. Generally, inflation expectations remain anchored around the current target inflation rates, due to soft global demand, which helped moderate core inflation. There are, however, some upside risks to the inflation outlook. As global demand recovers in 2013, inflation will pick up, but should do so only slowly. Upside risks to inflation forecasts stem also from the continuous policy easing by central banks in advanced economies, which could have positive effects on inflation expectations. We expect most emerging markets' central banks to keep interest rates unchanged for most of 2013. Admittedly, with inflation below the targets and a still fragile external backdrop, there will be ample room to ease if growth starts to disappoint again.

Figure 4.7



Source: Bloomberg

Figure 4.8



** Brazil, Chile, China, India, Indonesia, Philippines, Russia, Singapore*

*** The Economist Food Price Index*

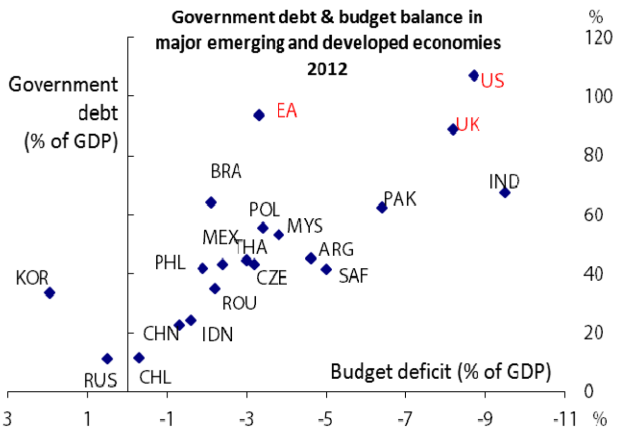
Source: Ecowin

Growth in EM economies is expected to rebound slightly in 2013

Improved financial conditions, policy easing, monetary stimulus in emerging markets and somewhat stronger growth in advanced economies suggest a firming of EMs economic activity in 2013. Their growth will be mostly driven by domestic demand. In China, for example, fiscal measures, although contained, are expected to support particularly domestic demand. In Brazil, as the lagged effects of monetary easing unfold, GDP growth may rise from 1% in 2012 to 3% this year. With fiscal consolidation continuing in most developed markets, however, growth rates of EMs exports will remain relatively modest and below historical standards. Given that a significant share of the current slowdown in EM is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade. The outlook is largely dependent on developments in the euro area and the handling of the US fiscal situation. Generally, risks still remain as long as the recovery in the global economy remains fragile and, thus, vulnerable to sudden shocks, all of which could dampen global demand.

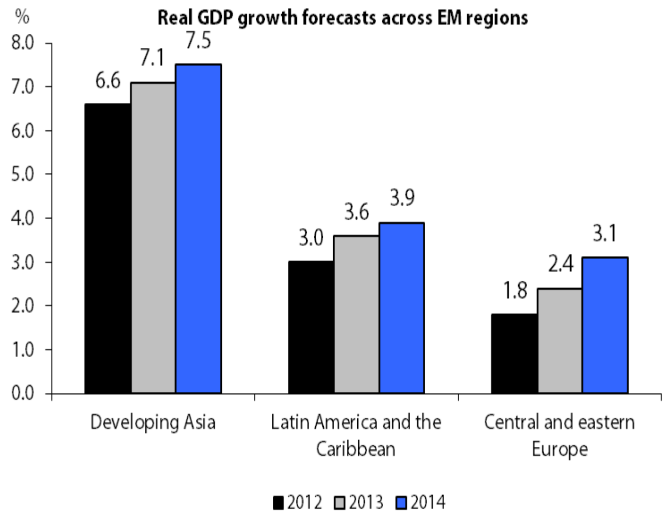
Nonetheless, EM will continue to grow much faster than advanced economies. Economic prospects in most developing regions remain brighter than in the developed world, as EM are better placed to face adverse shocks and has the resources and policy space to counteract their negative effects on growth. The almost unchanged fiscal stance in emerging economies continues to constitute one of the main reasons for their more favorable growth prospects (Figure 4.9). As we have already mentioned, there is also significant scope for monetary easing. According to the latest IMF forecasts, in 2013 growth in emerging and developing economies is expected to increase to a rate of 5.5% from 5.1% in 2012 and rebound further to 5.9% in 2014. Emerging Asia will retain its status of the world's fastest growing region, with growth of 7.1% this year versus 6.6% in 2012 (Figure 4.10). The ongoing turnaround in China, the easing of global tail risks and the lagged effects of past monetary policy should support the region's growth in 2013. In Latin America the rebound in China has boosted demand for commodities exports in recent months and is expected to continue to support the region's commodity exporters. Emerging Europe's economic performance is expected to be the weakest in the emerging world, as the region is the most exposed to the troubles in the euro area. Its economic outlook will rely mainly on the depth of the euro area's recession. Stronger activity in Europe translates into increasing exports to emerging Europe and thus higher growth. Even so, the improvement will be slow and gradual. At the same time, there are home-grown vulnerabilities. Most countries in the region are under fiscal austerity, either because of the need to meet EU targets, or because of financing constraints. Consequently, domestic demand will fail to offset the slack from weaker exports.

Figure 4.9



Source: IMF

Figure 4.10



Source: IMF

III. Macro Forecasts

Real GDP growth						
	2011	2012e	2013f		2014f	
			Eurobank	Consensus	Eurobank	Consensus
US	1.8	2.2	1.8	2.0 (1.1 – 3.5)	2.5	2.8 (0.9 – 4.4)
EA	1.5	-0.4	0.0	-0.1 (-0.8 – 1.0)	1.0	1.1 (-0.4 – 2.8)
Japan	-0.6	1.9	0.8	0.9 (-0.3 – 2.5)	1.2	1.2 (0.0– 2.5)
China	9.3	7.8	8.0	8.1 (7.5 – 9.0)	8.2	8.0 (7.3 – 8.9)
India	7.5	5.5	6.0		6.5	
Russia	4.3	3.4	3.5	3.3 (2.0 – 4.3)	3.6	3.8 (2.0 – 4.7)
Brazil	2.8	1.0	3.0	3.5 (2.5 – 4.5)	3.7	4.0 (3.3 – 4.4)

Inflation						
	2011	2012e	2013f		2014f	
			Eurobank	Consensus	Eurobank	Consensus
US	3.2	2.1	1.9	1.9 (1.1 – 2.7)	2.2	2.1 (1.0 – 3.1)
EA	2.7	2.5	1.8	1.9 (1.5 – 2.7)	1.7	1.8 (1.2 – 2.5)
Japan	-0.3	0.0	0.1	0.0 (-0.7 – 0.5)	1.7	1.7 (0.1 – 2.8)
China	5.4	2.7	3.2	3.1 (1.8 – 4.0)	3.5	3.6 (2.5 – 5.0)
India (WPI)	9.5	7.5	6.5		5.5	
Russia	8.5	5.1	6.5	6.5 (5.8 – 7.6)	5.5	5.7 (4.8 – 6.7)
Brazil	6.6	5.4	5.7	5.8 (5.2 – 6.3)	5.5	5.5 (5.0 – 6.5)

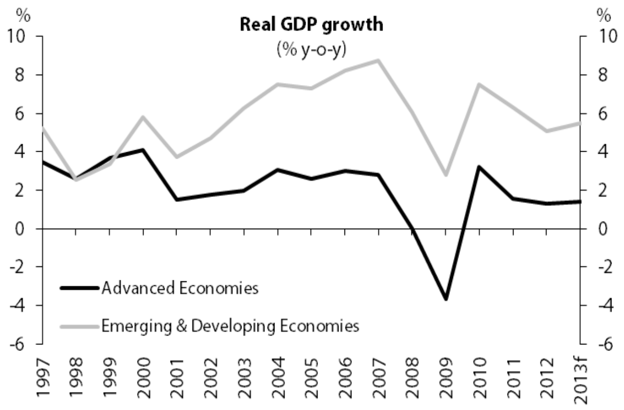
Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

Policy Rates					
		Eurobank			
	Current	Q1 13f	Q2 13f	Q3 13f	Q4 13f
US	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25
EA	0.75	0.75	0.75	0.75	0.75
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	6.00	6.00	6.00
India	7.75	7.50	7.00	7.00	7.00
Russia	8.25	8.25	8.00	8.00	8.00
Brazil	7.25	7.25	7.25	7.25	7.25

IV. GRAPHS

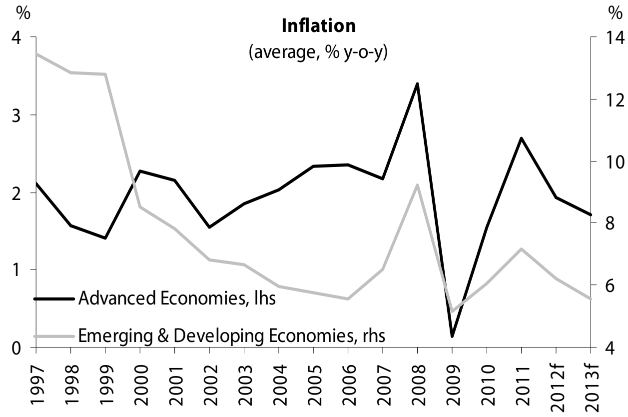
Global Economic Indicators – World Economy

World Economy

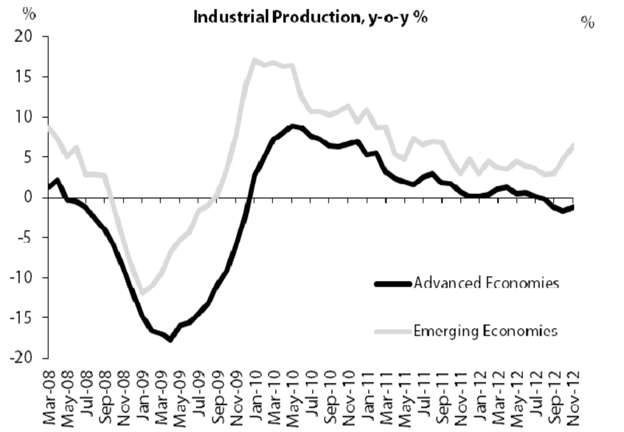


Source: IMF

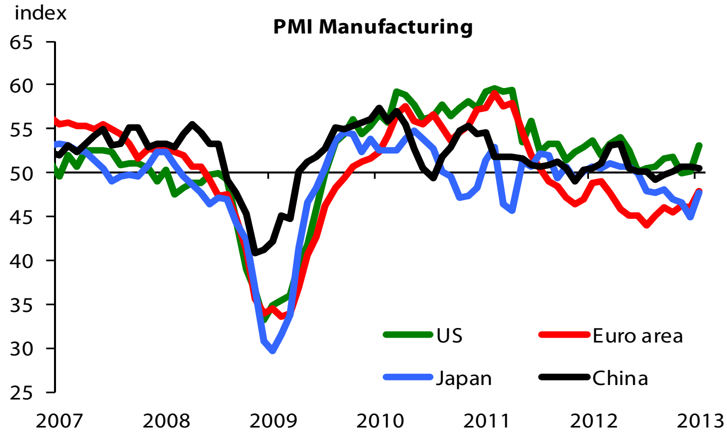
World Economy



Source: IMF

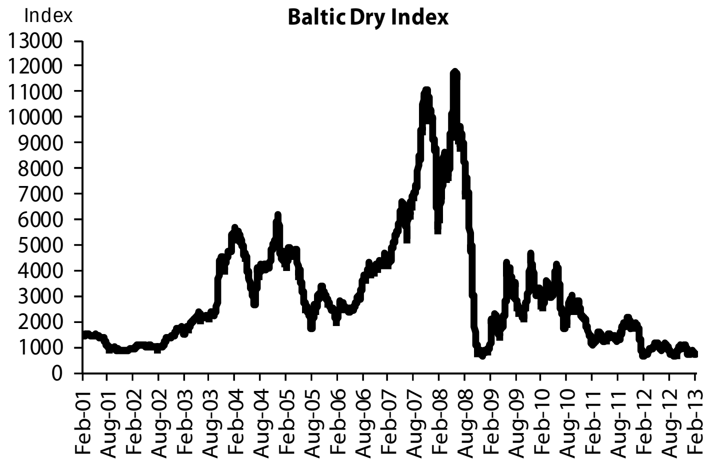


Source: CPB Netherlands Bureau for Economic Policy Analysis



Source: Bloomberg

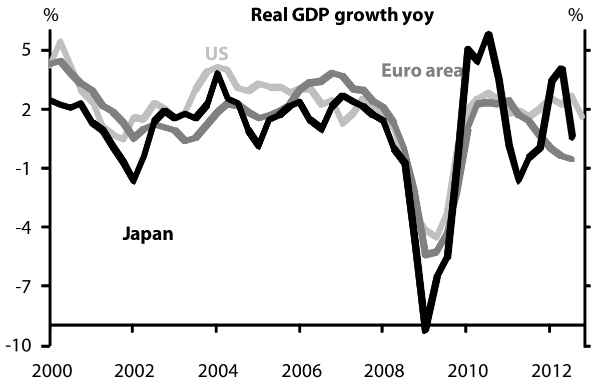
Source: CPB Netherlands Bureau for Economic Policy Analysis



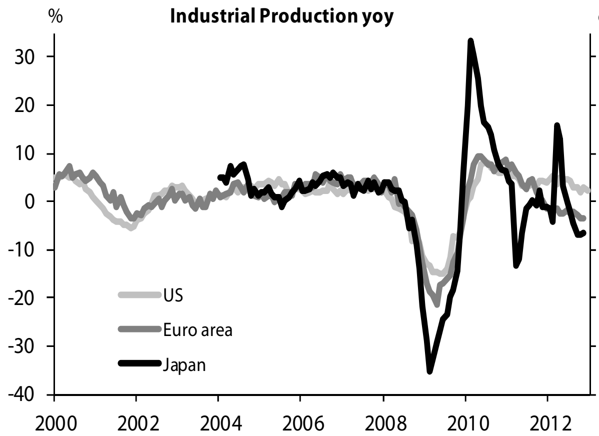
Source: Bloomberg

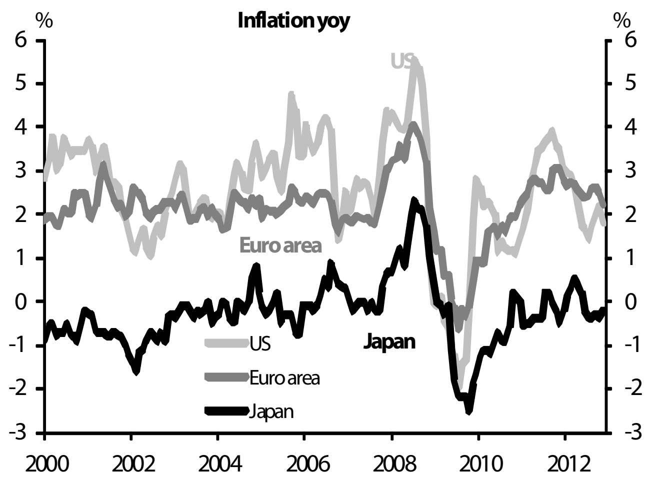
Global Economic Indicators

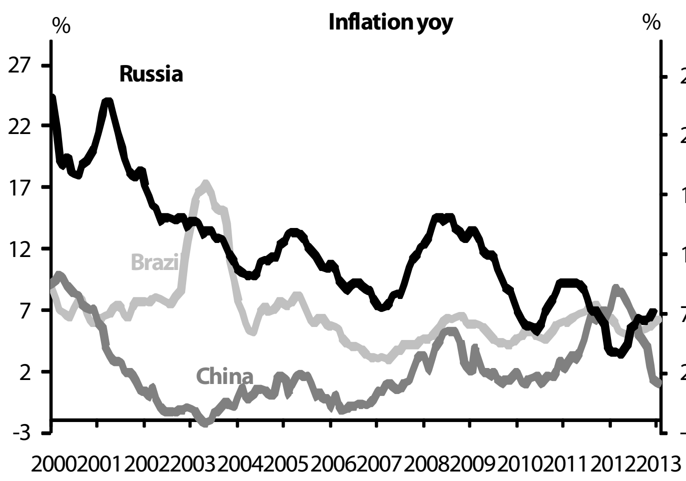
Advanced Economies



Emerging Economies





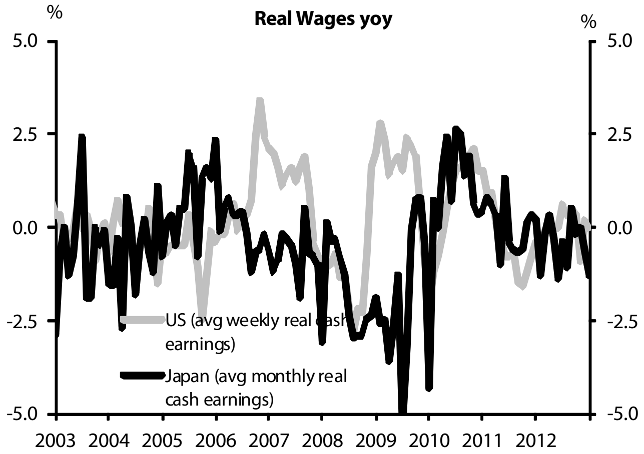


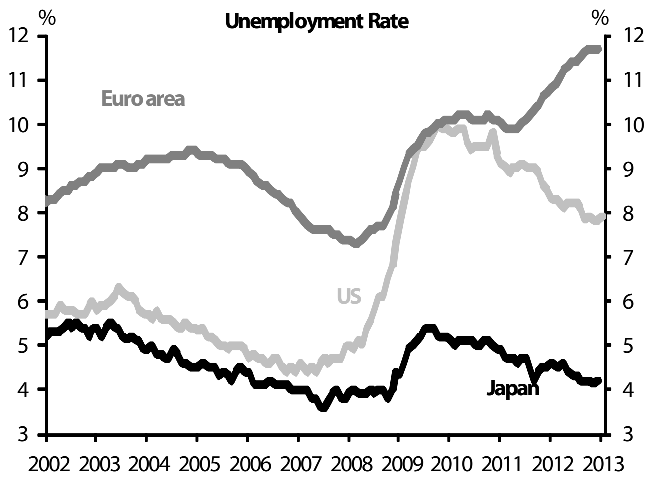
Source: Bloomberg, Ecowin

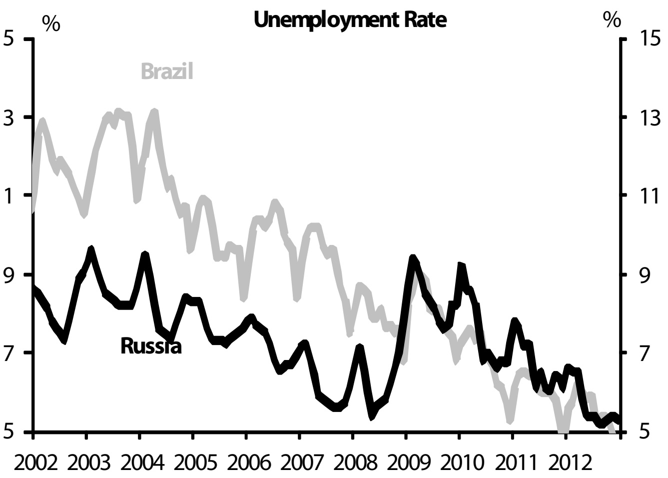
Global Economic Indicators

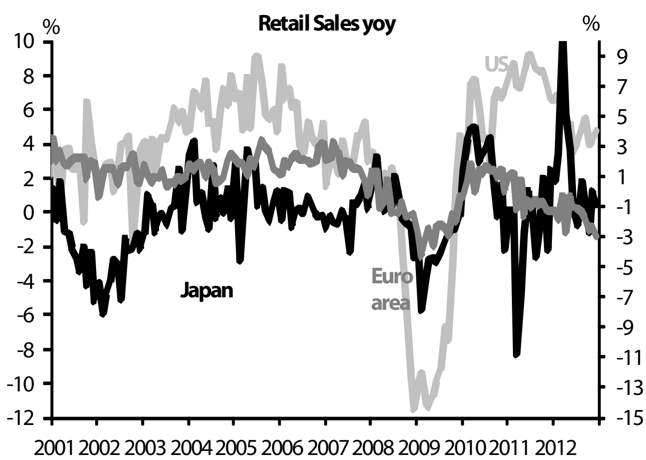
Advanced Economies

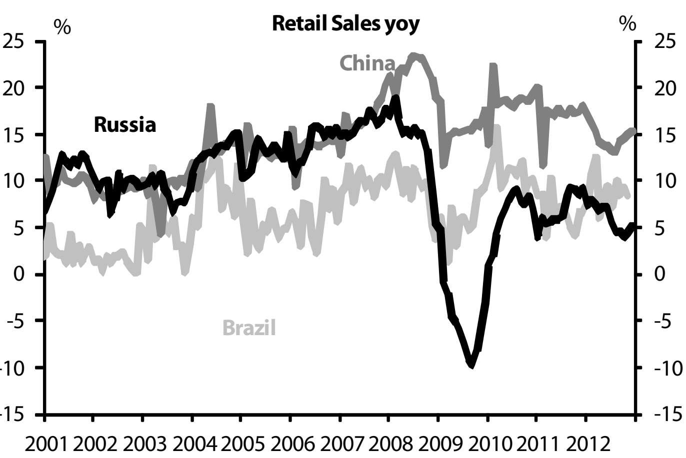
Emerging Economies







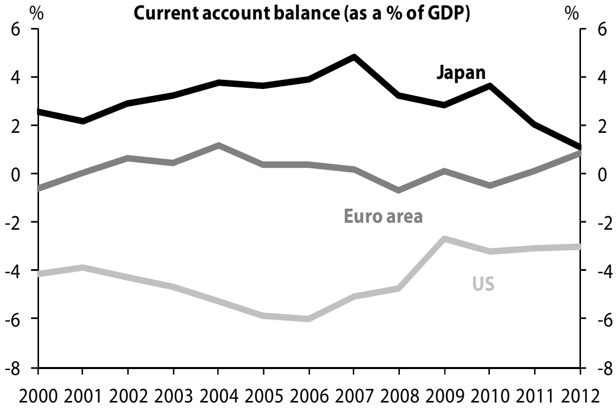




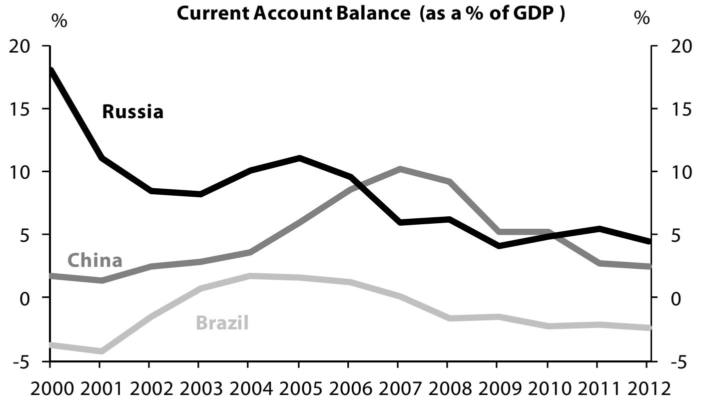
Source: Bloomberg, Ecowin

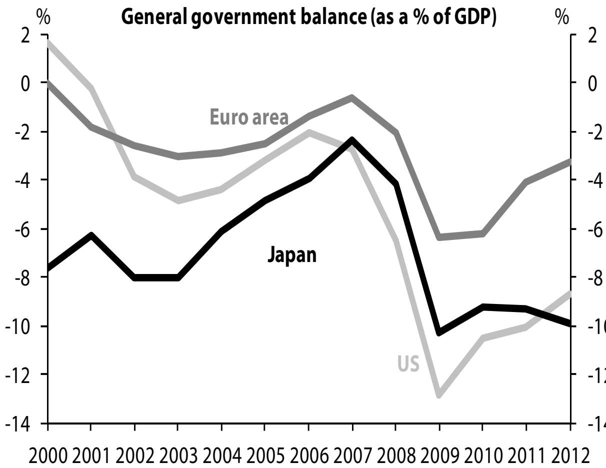
Global Economic Indicators

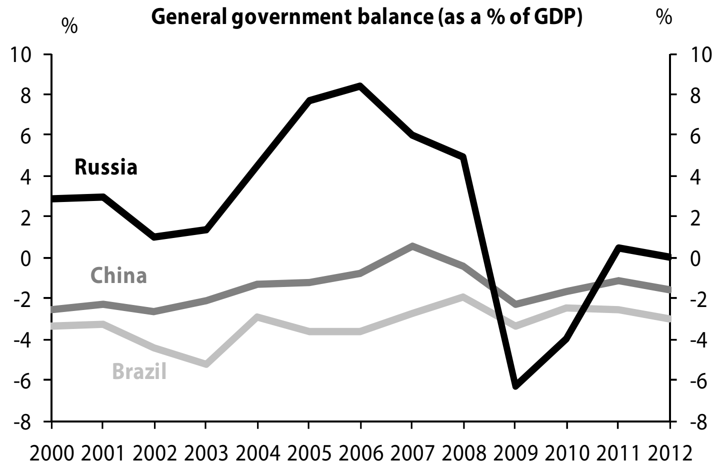
Advanced Economies

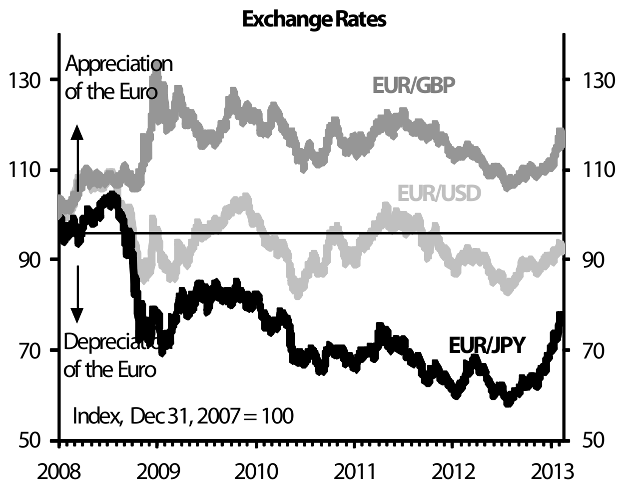


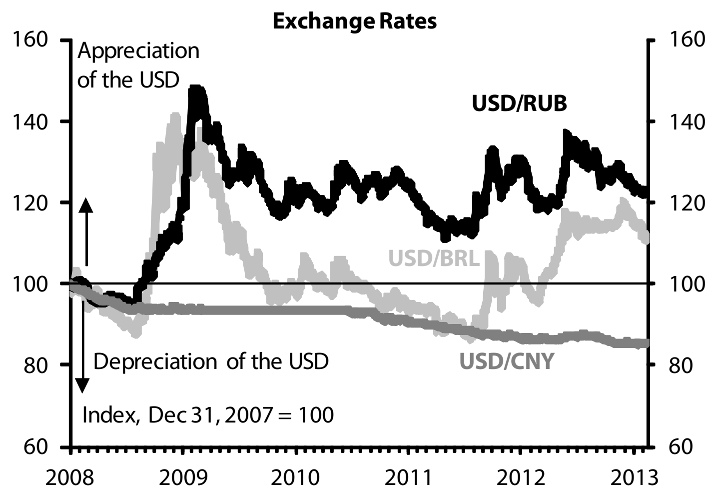
Emerging Economies





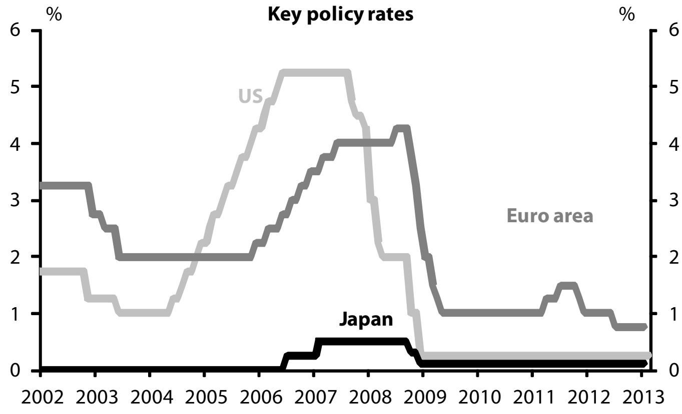


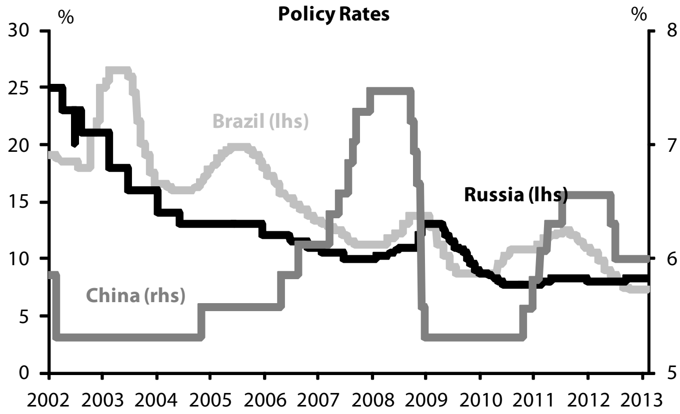


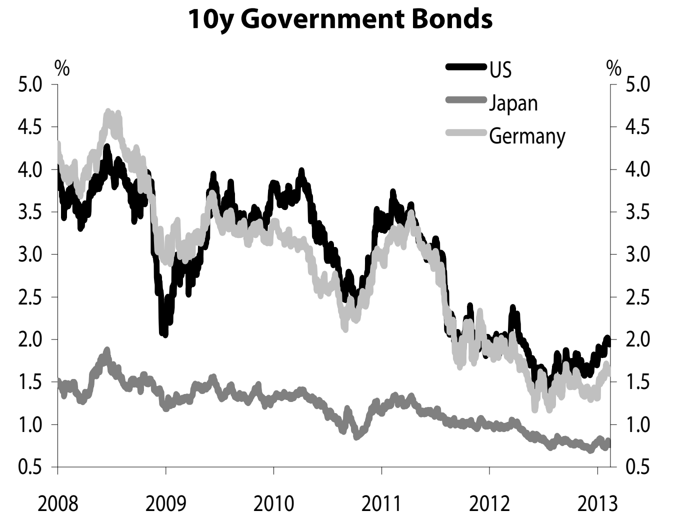


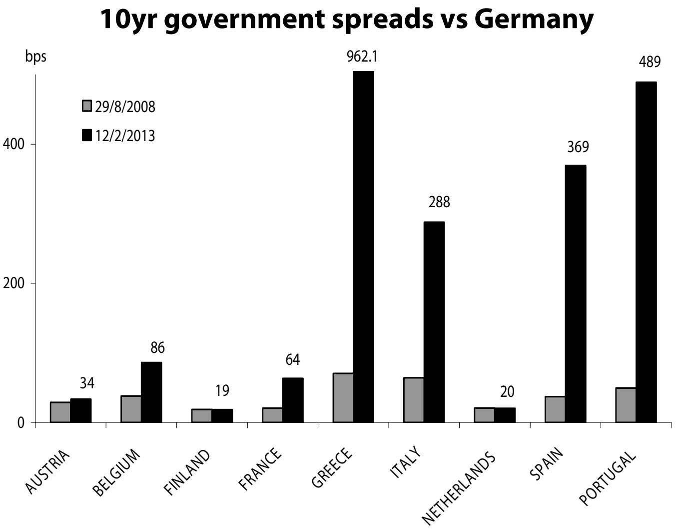
Source: Bloomberg, Ecowin, IMF, Eurobank Research

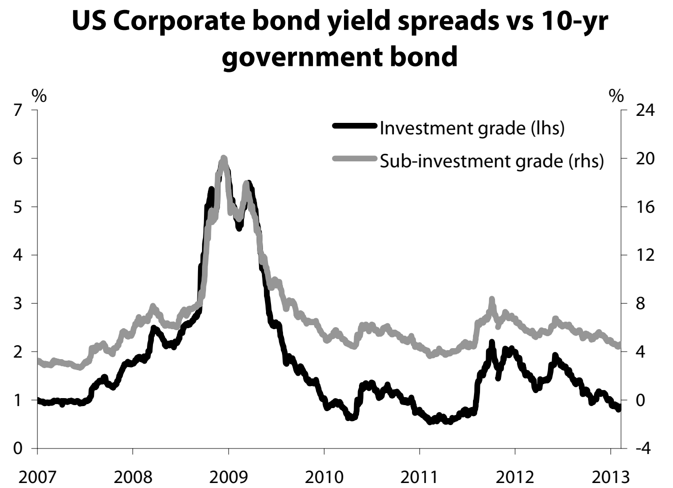
Global Economic Indicators

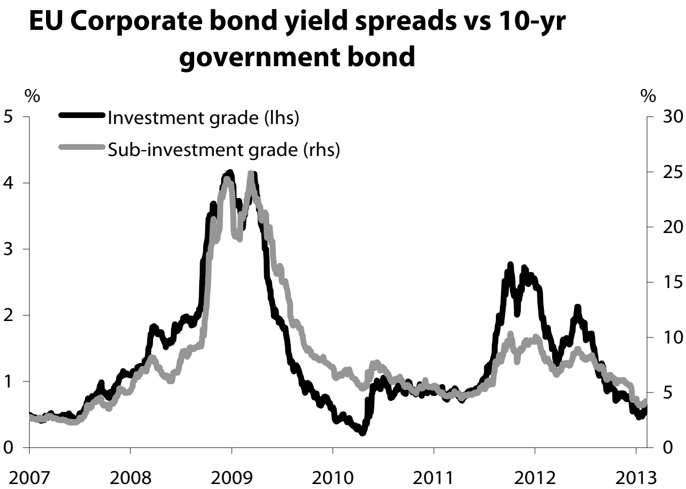












Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of February 12, 2013

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2012
US	S&P 500	1519.4	0.5	3.2	8.2	12.4	6.5	13.4
EURO AREA	DJ Euro Stoxx 50	2648.8	1.2	-2.5	9.6	6.3	0.5	13.8
GERMANY	DAX	7660.2	1.0	-0.7	10.9	13.7	0.6	29.1
FRANCE	CAC 40	3686.6	1.2	-0.5	7.6	8.9	1.2	15.2
UK	FTSE 100	6338.4	0.7	3.5	8.7	7.3	7.5	5.8
JAPAN	Nikkei	11369.1	2.9	5.3	28.0	26.3	9.4	22.9
CHINA	CSI 300	2771.7	1.0	11.6	15.5	9.4	9.9	7.6
INDIA	SENSEX	19561.0	-0.4	-0.5	10.9	10.1	0.7	25.7
RUSSIA	MICEX	1512.0	-1.2	0.1	4.1	-3.0	2.5	5.2
BRAZIL	IBOV	58497.8	-3.1	-4.9	-1.3	-8.6	-4.0	7.4

Source: Bloomberg

Sector performance as of February 12, 2013

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2012
1. Consumer Discretionary	402.2	0.8	3.7	14.0	19.3	6.9	21.9
2. Consumer Staples	386.4	0.4	4.0	5.2	14.9	7.1	7.5
3. Energy	577.8	0.1	5.0	7.1	5.6	8.4	2.3
4. Financials	239.8	1.3	4.0	19.3	21.2	8.4	26.3
5. Health Care	500.5	-0.1	3.5	12.1	20.1	8.1	15.2
6. Industrials	353.3	0.7	4.3	11.2	9.6	7.5	12.5
7. Information Technology	476.8	0.5	0.4	-1.4	3.4	2.8	13.1
8. Materials	248.7	0.1	0.9	10.1	5.8	4.6	12.2
9. Telecommunication Services	152.3	0.5	2.7	-1.4	19.7	4.3	12.5
10 Utilities	187.3	1.0	4.1	-1.1	6.4	5.5	-2.9

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of February 12, 2013

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2012
1. Consumer Discretionary							
Automobiles & Components	556.6	1.7	1.9	16.0	10.6	4.1	39.2
Travel & Leisure	266.9	1.9	4.9	16.9	31.5	7.2	33.6
Media	325.0	0.5	1.0	8.2	19.8	2.3	21.6
Retail	496.5	2.0	3.2	6.4	18.2	3.6	12.4
2. Consumer Staples							
Food & Beverage	789.7	0.5	3.1	5.1	23.1	3.3	21.7
Personal & Household Goods	894.0	0.5	1.0	2.8	17.8	2.0	24.2
3. Energy							
Oil & Gas	644.8	-0.9	-3.4	-6.8	-6.2	-0.7	-0.6
4. Financials							
Banks	357.0	3.4	0.7	31.1	18.9	9.4	27.4
Financial Services	528.0	1.8	4.4	18.0	21.8	8.7	26.6
Insurance	310.6	1.7	-2.1	15.8	22.7	1.3	38.7
Real Estate	126.3	1.6	-1.2	2.0	13.6	-2.3	24.9
5. Health Care	769.8	-0.4	1.0	3.4	18.0	3.6	15.5
6. Industrials							
Industrial Goods & Services	559.0	0.5	0.0	9.8	15.3	2.2	25.2
7. Information Technology	246.7	0.9	3.0	18.4	21.6	7.5	21.8
8. Materials							
Basic Resources	818.6	-0.2	-3.0	1.2	-11.1	-2.6	7.1
Chemicals	1180.6	0.5	0.6	10.8	19.7	0.2	32.5
Construction & Materials	455.8	1.2	-1.2	11.4	7.3	0.0	19.2
9. Telecommunication Services	469.6	0.2	-3.1	-8.1	-2.2	1.8	-5.2
10. Utilities	558.8	1.6	-2.8	-2.3	0.7	-2.9	4.7

Source: Bloomberg

Sector performance as of February 12, 2013

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2012
1. Consumer Discretionary	9430.5	0.0	-4.6	-10.6	-9.3	-5.8	5.3
2. Consumer Staples	12425.6	5.2	-0.6	0.8	-17.7	-2.1	-9.1
3. Energy	13660.7	-4.3	-5.5	7.0	-6.5	-4.9	21.7
4. Financials	3873.8	-1.9	0.6	16.4	12.6	2.7	26.5
5. Industrials	2903.9	-2.7	-1.8	9.1	0.5	-0.4	21.9
6. Information Technology	12385.5	1.6	-2.7	16.7	24.7	-3.5	40.9
7. Materials	3927.8	-0.7	-3.0	-0.7	-9.2	0.6	-0.6
8. Telecommunication Services	2828.6	0.8	-1.0	-0.9	8.2	-2.4	14.8
9. Utilities	4049.0	0.1	2.5	10.8	18.2	2.7	15.0

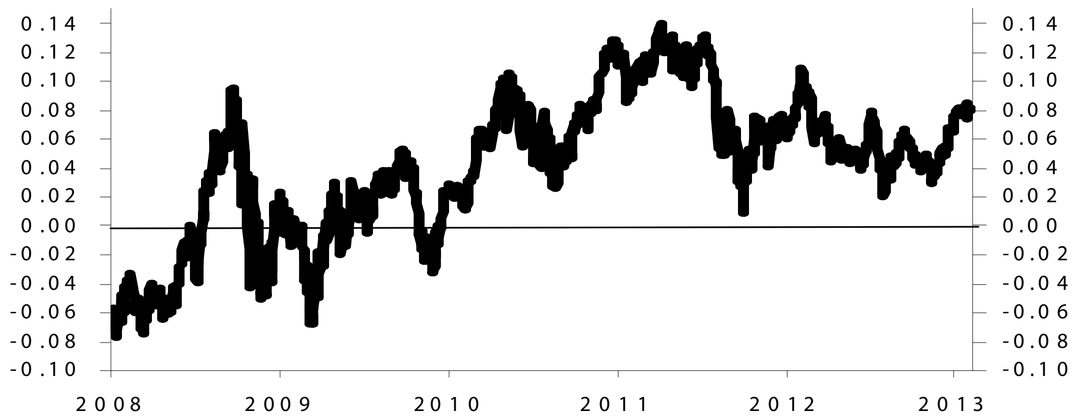
Source: Ecowin

US Style Equity Indices

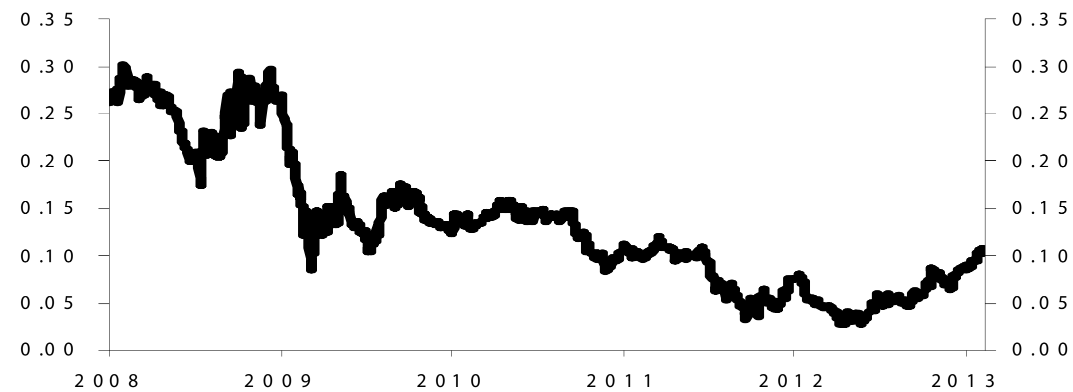
Total Return (%) as of February 12, 2013

US Style Indices (in USD)								
Index	**Last Price**	**1w**	**1m**	**6m**	**12m**	**YTD**	**2012**
Russell 1000 (Large Cap)	843.9	0.6	3.4	9.2	12.6	6.8	13.9
Russell 2000 (Small Cap)	917.5	1.0	4.2	14.8	11.2	8.0	14.6
Relative performance (Small vs Large)		0.4	0.8	5.5	-1.4	1.2	0.7
Russell 1000 Value	775.2	0.8	4.5	12.2	16.0	8.2	14.5
Russell 1000 Growth	693.8	0.3	2.2	6.2	9.2	5.4	13.3
Relative performance (Value vs Growth)		0.5	2.3	6.0	6.8	2.8	1.2

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)



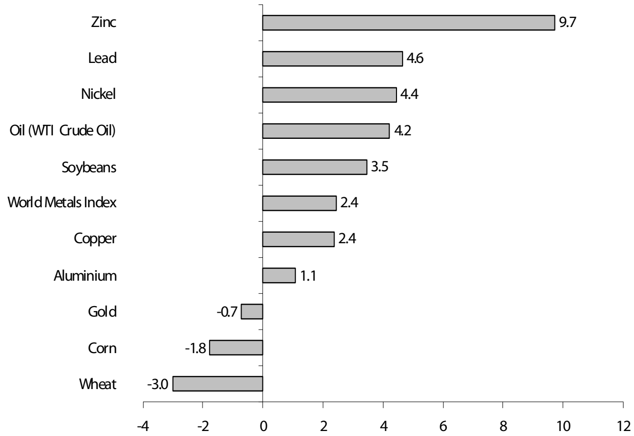
Source: Bloomberg

Commodities

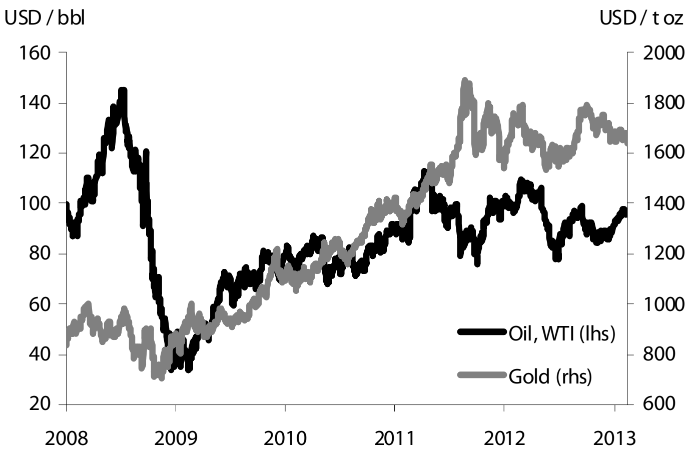
Commodity Performance (%) as of February 12, 2013

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2012
Oil (WTI Crude Oil)	USD/bbl	97.5	0.9	4.2	5.2	-3.4	6.2	-7.1
Gold	USD/t oz	1648.7	-1.7	-0.7	2.4	-4.3	-1.6	7.0
Base Metals								
World Metals Index		3590.6	0.2	2.4	14.9	-2.4	3.9	4.5
Aluminium	USD/lb	2120.0	0.4	1.1	12.7	-5.5	2.3	2.6
Copper	USD/mt	8236.0	-0.4	2.4	10.0	-2.9	3.8	4.4
Lead	USD/mt	2414.0	-1.9	4.6	27.6	13.0	3.6	14.5
Nickel	USD/mt	18365.0	-1.8	4.4	19.3	-11.3	7.6	-8.8
Zinc	USD/mt	2210.0	1.5	9.7	20.4	6.4	6.3	12.7
Agriculture								
Corn	USD/bu	696.3	-3.6	-1.8	-11.1	8.9	-0.3	8.0
Soybeans	USD/bu	1420.8	-4.5	3.5	-6.1	12.3	0.8	15.2
Wheat	USD/bu	732.0	-3.9	-3.0	-14.6	14.2	-5.9	19.2

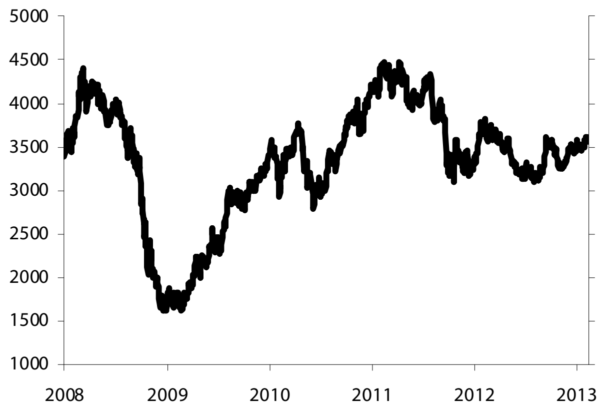
1-Month Return



Oil & Gold

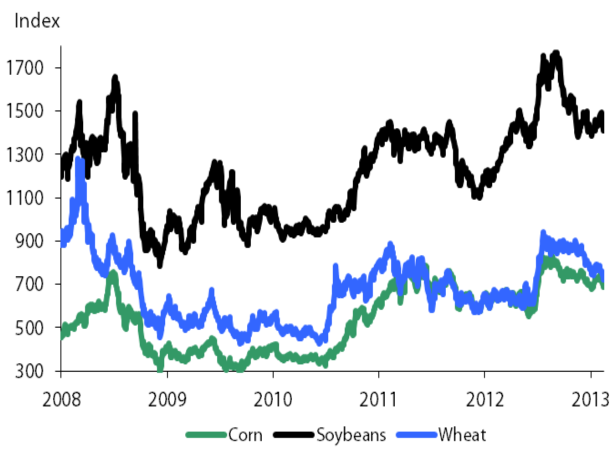


World Metals Index



Agricultural Index

Agricultural Indices



Source: Bloomberg, Ecowin

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