GLOBAL ECONOMIC OUTLOOK – FEBRUARY

2012

Monetary and Statistics Department
External Economic Relations Division

CZECH NATIONAL BANK

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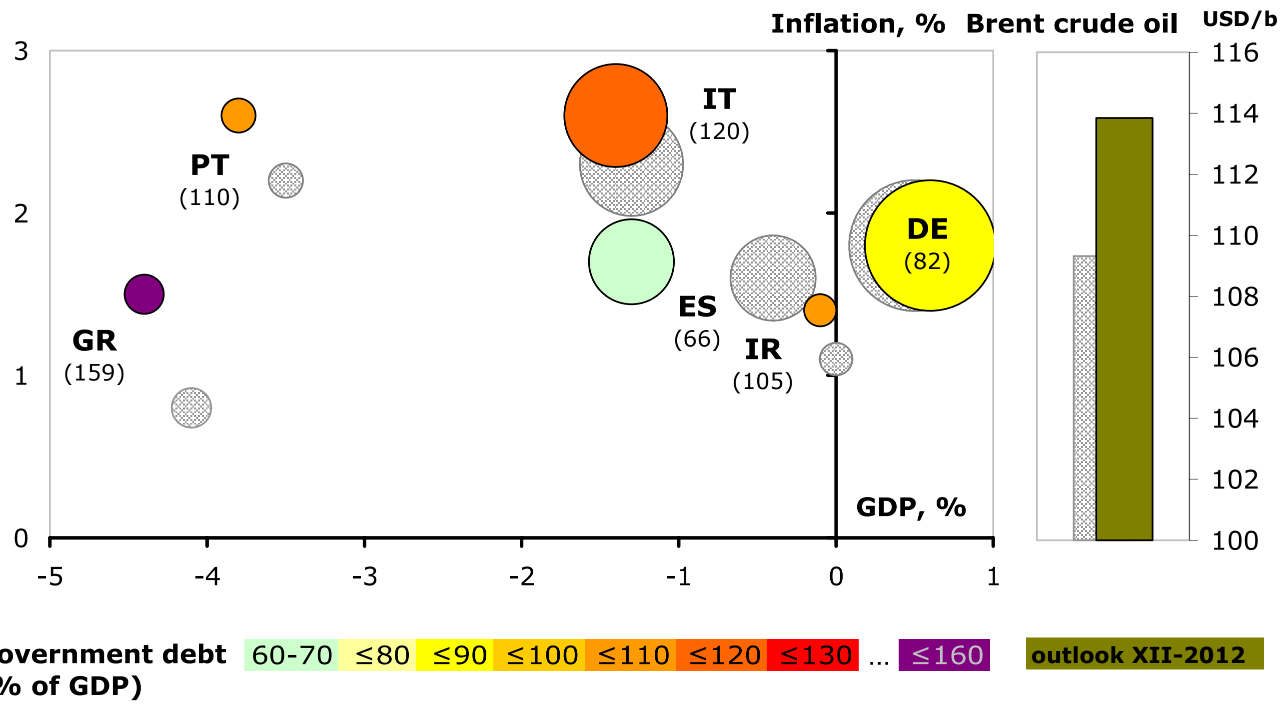
The February issue of the Global Economic Outlook presents an overview of recent and expected developments in selected territories in terms of standard indicators such as GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices. In this issue, we also focus our attention on analysing euro area bond market developments during the current debt crisis.

The latest outlooks for the advanced countries confirm that 2012 will be a year of lower economic performance compared to 2011. The USA, whose economic condition is gradually improving, is expected to be the exception. As regards euro area countries, the threat of renewed recession still cannot be ruled out. The German economy is the only large euro area economy showing at least slight economic growth and is therefore acting as the economic engine of the euro area. The protracted process of resolving the problems of the overleveraged and insolvent Greece and other countries on the southern periphery of the euro area (Portugal, Spain and Italy) remains at the epicentre of the problems in Europe. The figure below shows that the situation in the troubled southern countries is unenviable, as no improvement in their debt position can be expected given the marked economic decline predicted for this year, the estimates of which, moreover, are increasing. The situation of Greece and Portugal is particularly alarming.

Emerging economies – in particular the BRIC countries (Brazil, Russia, India, China) – are showing robust economic growth amid acceptable rates of inflation (except for the inflation outlook for India). The good news for the global economy is that the BRIC countries are not so tied up in debt (except Brazil). This makes it easier for them to conduct economic policy and is not acting as a barrier to growth.

The global economy will continue to face high oil prices in 2012 with a slightly upward outlook. With the dollar appreciating, this would imply a further increase in inflation risk in numerous countries. Prices of food and industrial commodities should be slightly higher at the end of 2012 than at present. No further reduction in ECB rates is expected in 2012. US rates are expected to remain unchanged even beyond this year.

Economic outlook for selected countries in 2012



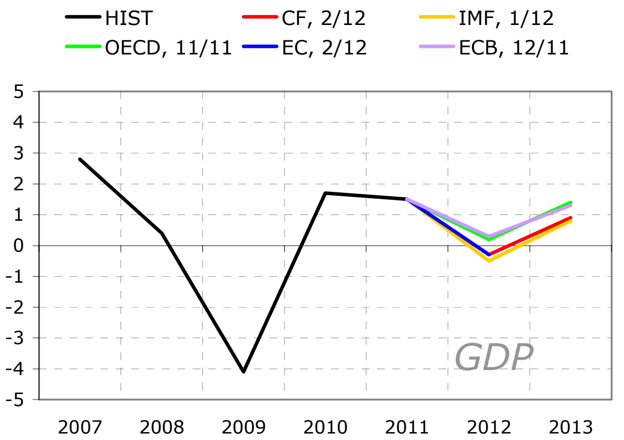
Note: DE – Germany, GR – Greece, IE – Ireland, IT – Italy, PT – Portugal, ES – Spain. The size of each point represents the size of the country/region according to nominal GDP. The points are coloured according the size of the public debt-to-GDP ratio in 2011 Q3 (see the figures in parentheses). The grey colour is the CF forecast (GDP, inflation) or Bloomberg survey (oil price) from the previous month. [Cut-off date for data: 17 February 2012]

Source: CNB calculation using Bloomberg, Consensus Economics and Eurostat databases.

II.1 GDP

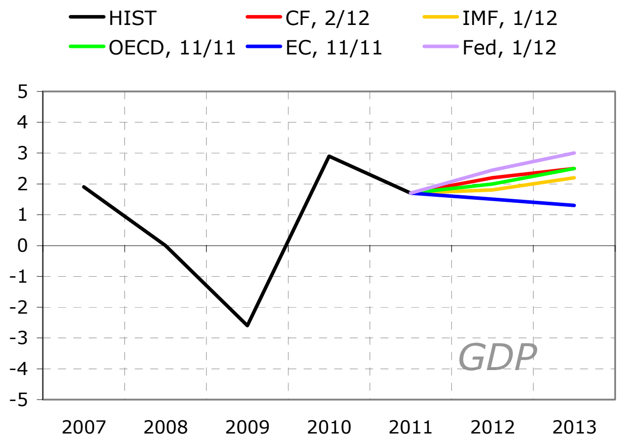
Although surveys are indicating some stabilisation of the euro area economy, the macroeconomic data testify to a continuing slowdown. **In 2012**, economic activity in the euro area will decline by 0.3–0.5%. According to the January *World Economic Outlook*, growth in the region will be hampered by rising yields on some countries' government bonds, fiscal instability and additional fiscal consolidation. The deleveraging of banks will also negatively affect the real economy. According to the February CF, Germany will again be the only large economy in the region to show positive, albeit slow, growth. According to the new CF, EC and IMF forecasts, Germany will achieve growth of 0.3–0.6%. The outlook for US growth (CF, IMF and Fed) is rather better (1.8–2.5%) and is supported by macroeconomic data, in particular more optimistic labour market data. The worse prospects for the external environment will negatively affect not only advanced, but also emerging economies. Economic growth in China will not exceed 8.2–8.4% according to the new CF and IMF forecasts. **In 2013** economic activity is expected to recover gradually. Euro area GDP growth will turn positive, but will stay below 1%; growth of 1.5% is expected in Germany. Economic growth in the USA and China will rise by less than 0.5 p.p.

EURO AREA



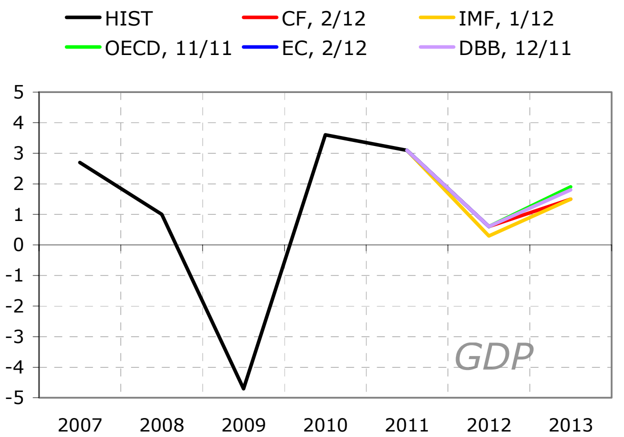
	HIST	CF	IMF	OECD	EC	ECB
2011	1.5					
2012		-0.3	-0.5	0.2	-0.3	0.3
2013		0.9	0.8	1.4		1.3

USA



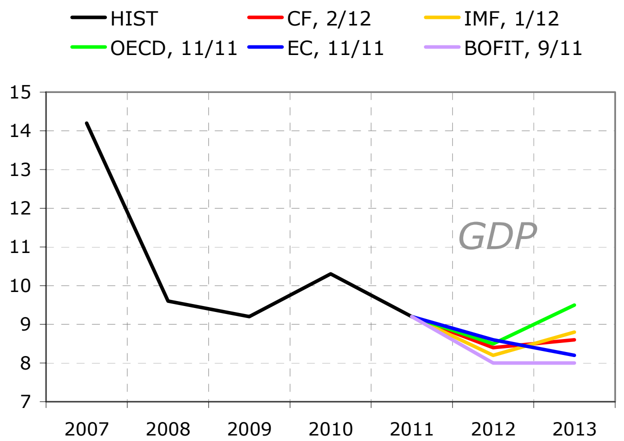
	HIST	CF	IMF	OECD	EC	Fed
2011	1.7					
2012		2.2	1.8	2.0	1.5	2.5
2013		2.5	2.2	2.5	1.3	3.0

GERMANY



	HIST	CF	IMF	OECD	EC	DBB
2011	3.1					
2012		0.6	0.3	0.6	0.6	0.6
2013		1.5	1.5	1.9		1.8

CHINA



	HIST	CF	IMF	OECD	EC	BOFIT
2011	9.2					
2012		8.4	8.2	8.5	8.6	8.0
2013		8.6	8.8	9.5	8.2	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: 23 February 2012]

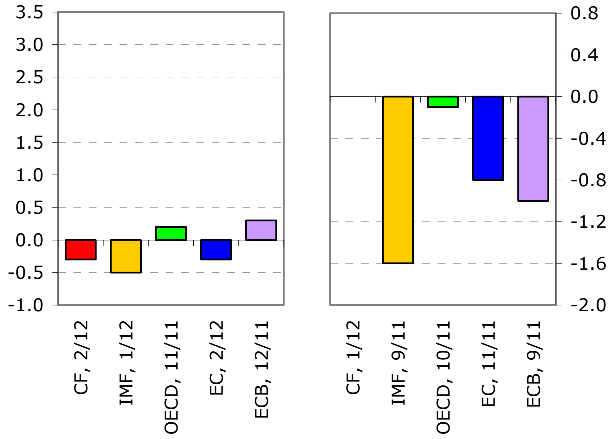
Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

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

Although the February CF left the aggregate outlook for euro area GDP growth **in 2012** unchanged, the forecasts for individual countries, i.e. those based on information provided solely by domestic institutions, show a fall in economic activity of 0.13 p.p. on average compared to the January CF (for 11 countries representing 98% of the monetary union's GDP; CNB calculations). The outlook for GDP growth in Germany was revised upwards by 0.1 p.p; The European Commission's outlook deteriorated. According to the January IMF forecast, the GDP growth outlook deteriorated for all the countries under review except the USA, where it remained the same as in the autumn. The Fed's new quarterly outlook is 0.3 p.p. lower than the previous figure, but remains at the upper bound of the USA outlooks monitored in the GEO.

EURO AREA

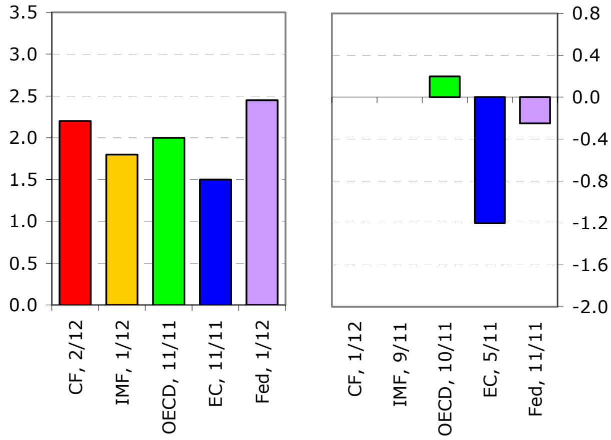
Forecast for 2012 — Change from previous forecast



	2011	CF	IMF	OECD	EC	ECB
Forecast	1.5	-0.3	-0.5	0.2	-0.3	0.3
Change		0.0	-1.6	-0.1	-0.8	-1.0

USA

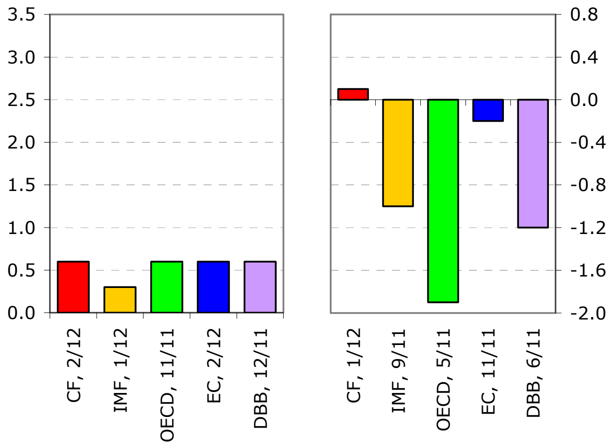
Forecast for 2012 — Change from previous forecast



	2011	CF	IMF	OECD	EC	Fed
Forecast	1.7	2.2	1.8	2.0	1.5	2.5
Change		0.0	0.0	0.2	-1.2	-0.3

GERMANY

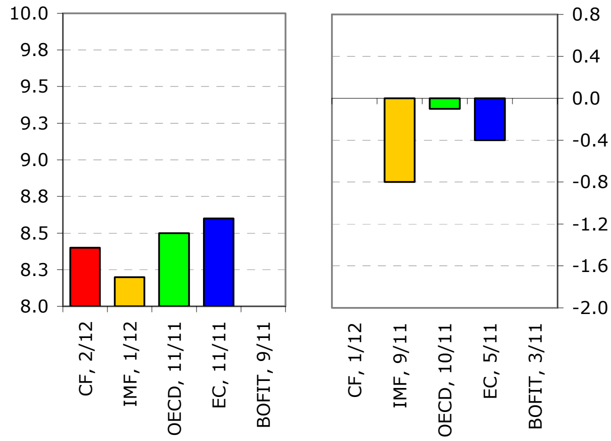
Forecast for 2012 — Change from previous forecast



	2011	CF	IMF	OECD	EC	DBB
Forecast	3.1	0.6	0.3	0.6	0.6	0.6
Change		0.1	-1.0	-1.9	-0.2	-1.2

CHINA

Forecast for 2012 — Change from previous forecast



	2011	CF	IMF	OECD	EC	BOFIT
Forecast	9.2	8.4	8.2	8.5	8.6	8.0
Change		0.0	-0.8	-0.1	-0.4	0.0

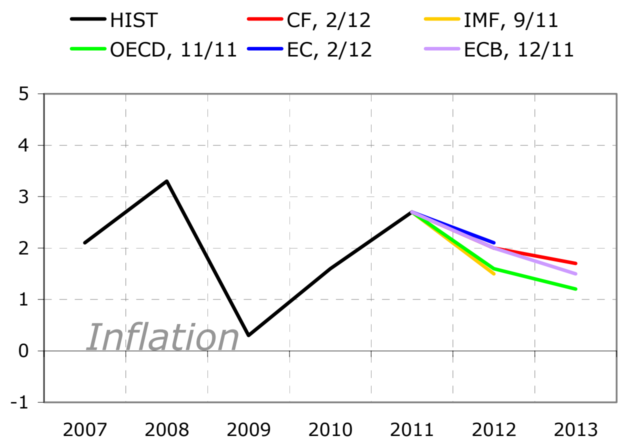
Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range.
[Cut-off date for data: 23 February 2012]

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

II.3 Inflation

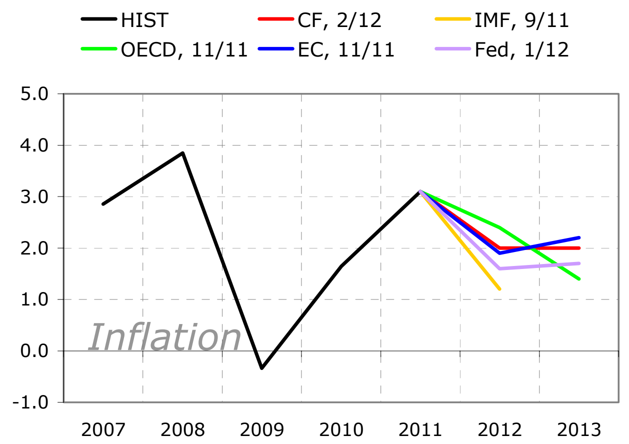
The inflation outlook is again overshadowed by reports about recession and the debt crisis in the euro area. The global economic downturn is affecting inflation, which is falling in all the countries under review. According to the new CF outlooks, the EC outlooks (for Germany and euro area) and the Fed outlook (for the USA), Germany, the euro area and the USA will have inflation of 1.6–2.1% **this year**. Inflation in China will reach 3.3% (CF). **Next year** it will stay in the same range in the advanced economies and rise to 3.7% in China.

EURO AREA



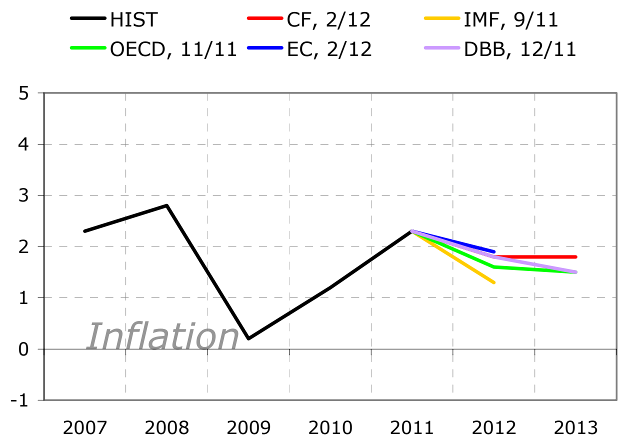
	HIST	CF	IMF	OECD	EC	ECB
2011	2.7					
2012		2.0	1.5	1.6	2.1	2.0
2013		1.7		1.2		1.5

USA



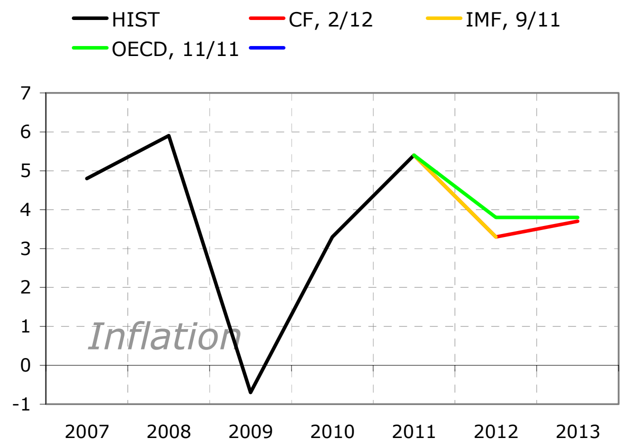
	HIST	CF	IMF	OECD	EC	Fed
2011	3.1					
2012		2.0	1.2	2.4	1.9	1.6
2013		2.0		1.4	2.2	1.7

GERMANY



	HIST	CF	IMF	OECD	EC	DBB
2011	2.3					
2012		1.8	1.3	1.6	1.9	1.8
2013		1.8		1.5		1.5

CHINA



	HIST	CF	IMF	OECD
2011	5.4			
2012		3.3	3.3	3.8
2013		3.7		3.8

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: 23 February 2012]

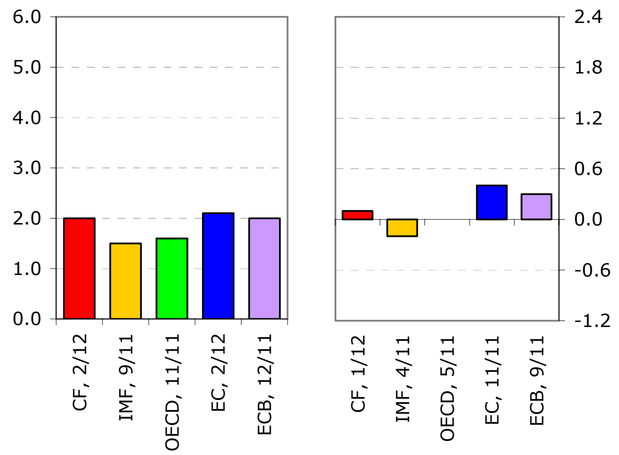
Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.4 Inflation forecast and change from the previous forecast

The new CF, Fed and IMF outlooks bring a slight revision to inflation in all the advanced countries under review. The February CF revised **this year's** outlook for inflation in China downwards (by 0.2 p.p.). By contrast, the January IMF expects inflation to rise by 0.8 p.p. compared to its September outlook, which was much lower than the CF outlook from the same period.

EURO AREA

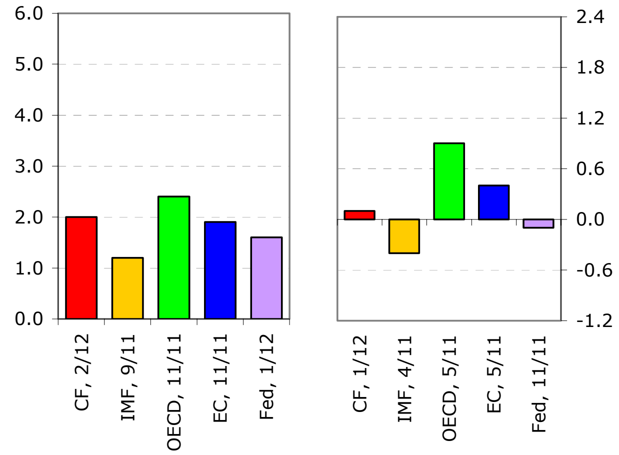
Forecast for 2012 | Change from previous forecast



	2011	CF	IMF	OECD	EC	ECB
Forecast	2.7	2	1.5	1.6	2.1	2
Change		0.1	-0.2	0.0	0.4	0.3

USA

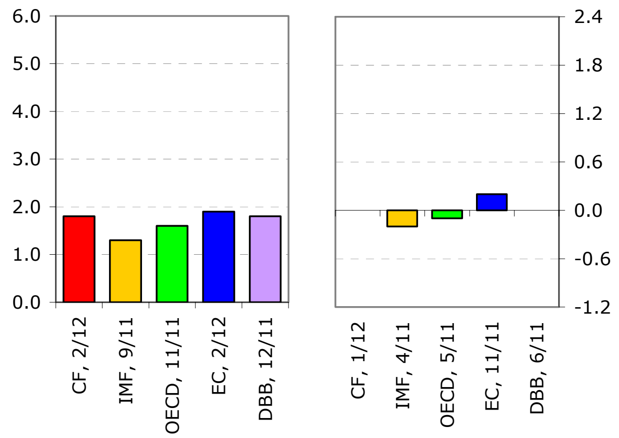
Forecast for 2012 | Change from previous forecast



	2011	CF	IMF	OECD	EC	Fed
Forecast	3.1	2.0	1.2	2.4	1.9	1.6
Change		0.1	-0.4	0.9	0.4	-0.1

GERMANY

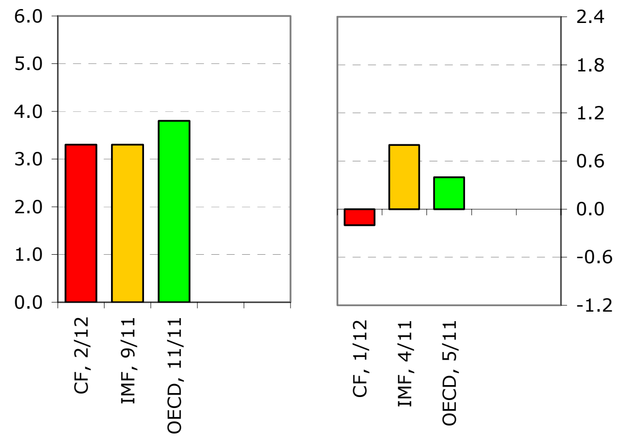
Forecast for 2012 | Change from previous forecast



	2011	CF	IMF	OECD	EC	DBB
Forecast	2.3	1.8	1.3	1.6	1.9	1.8
Change		0.0	-0.2	-0.1	0.2	0.0

CHINA

Forecast for 2012 | Change from previous forecast



	2011	CF	IMF	OECD
Forecast	5.4	3.3	3.3	3.8
Change		-0.2	0.8	0.4

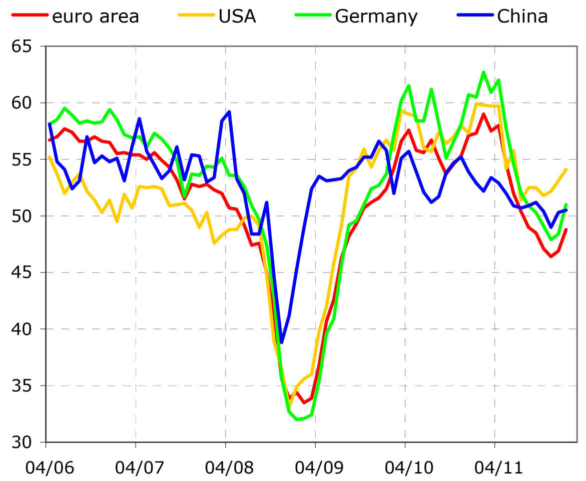
Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range.

[Cut-off date for data: 23 February 2012]

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

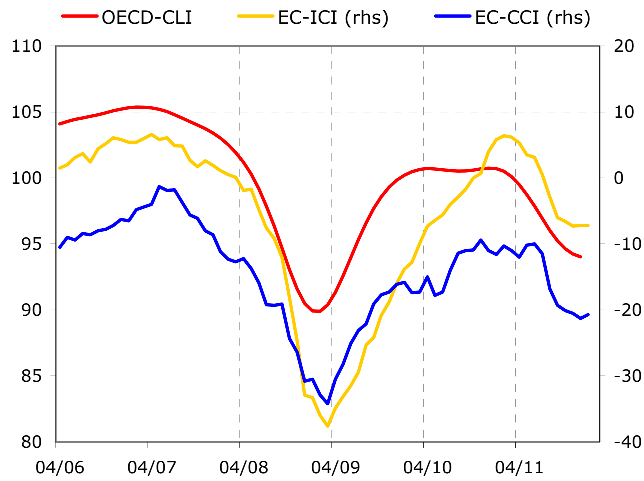
The global outlook for industrial production in 2012 H1 is favourable. The PMI (Purchasing Managers' Index) in industry increased in all the countries and regions under review. Expectations in the other sectors are mixed. The outlook for the USA is generally favourable. Consumer confidence deteriorated after several months of improvements, but the PMI in industry increased significantly further (to above 50%) and the composite indicators continued to rise. The outlook for the euro area is rather worse. Despite rising, the PMI remains below 50%, the composite indicators are flat and only consumer confidence improved slightly. The outlook for the German economy differs clearly from the situation in the euro area as a whole. In addition to the PMI, which returned above the 50% level for the first time in four months, improvements were seen in the expectations of both businesses and consumers.

PMI IN MANUFACTURING



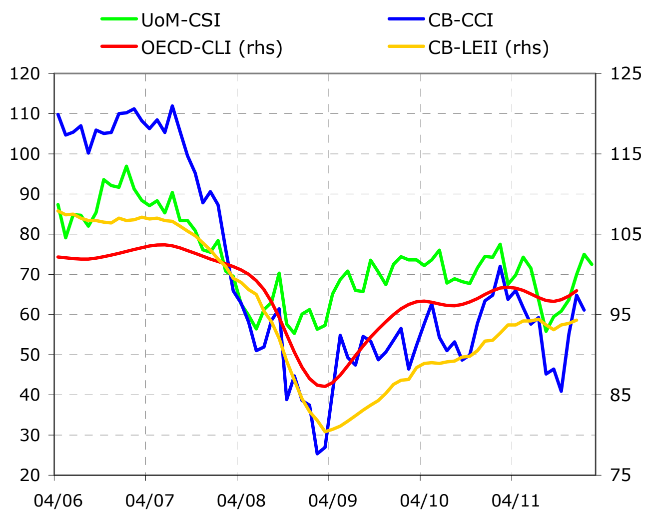
	EA	US	DE	CN
11/11	46.4	52.2	47.9	49.0
12/11	46.9	53.1	48.4	50.3
1/12	48.8	54.1	51.0	50.5

EURO AREA



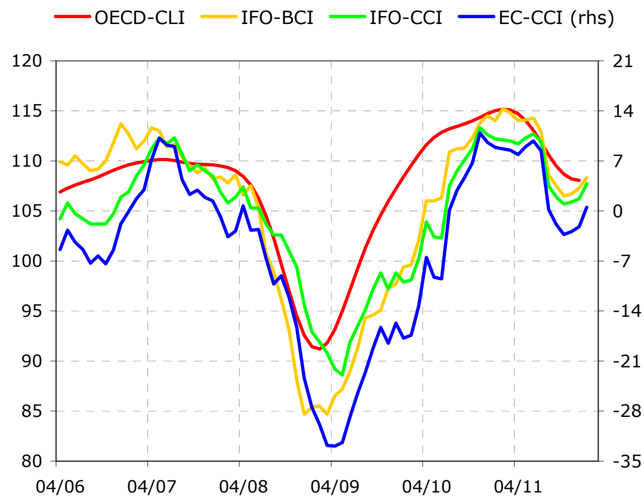
	OECD-CLI	EC-ICI	EC-CCI
11/11	94.2	-7.3	-20.5
12/11	94.0	-7.2	-21.3
1/12		-7.2	-20.7

USA



	OECD-CLI	CB-LEII	UoM-CSI	CB-CCI
11/11	97.3	93.9	63.7	55.2
12/11	98.0	94.3	69.9	64.8
1/12			75.0	61.1

GERMANY



	OECD-CLI	IFO-BCI	IFO-CCI	EC-CCI
11/11	108.2	106.7	105.9	-2.9
12/11	108.1	107.3	106.2	-2.2
1/12		108.3	107.7	0.5

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 February 2012]

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

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

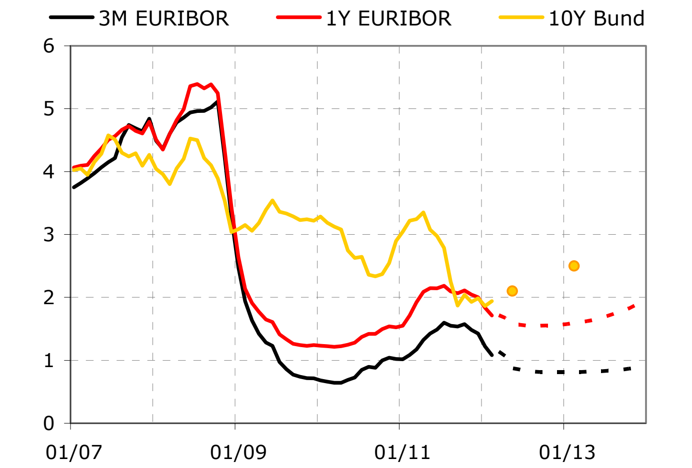
Owing to the unlimited liquidity that the ECB provided to banks in three-year refinancing operations (LTROs) in December 2011, 3M and 1Y EURIBOR interbank rates rose rather faster last month than implied in our previous prediction. The current forecast based on implied rates thus shifted slightly (less than 0.1 p.p.) downwards at both maturities.

At its meeting on 9 February, the ECB left its key refinancing rate at 1%. Its assessment of the economic situation did not change much either. The ECB expects economic activity in the euro area to stabilise at a low level with potential downside risks. Inflation is likely to stay elevated for several months before declining to below 2%.

The risk premium in the interbank market has decreased sharply since the start of the year, confirming the effectiveness of the ECB's monetary policy and LTROs. The CF analysts' opinion has therefore changed significantly. They no longer expect the ECB to ease its monetary policy this year by lowering rates further.

The German 10Y average government bond yield has been just below 2% since November 2011. The CF analysts left its slightly upward outlook unchanged.

EURO AREA



	01/12	02/12	06/12	12/12	06/13	12/13
3M EURIBOR	1.22	1.08	0.86	0.82	0.83	0.90
1Y EURIBOR	1.84	1.71	1.57	1.57	1.68	1.93
	01/12	**02/12**	**05/12**	**02/13**		
10Y Bund	1.86	1.94	2.10	2.50		

Note: Forecast for EURIBOR rates is based on implied rates from interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizons). Forecast for German government bond yield (10Y Bund) is taken from CF. Dashed lines and points represent outlook. [Cut-off date for data: 13 February 2012]

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

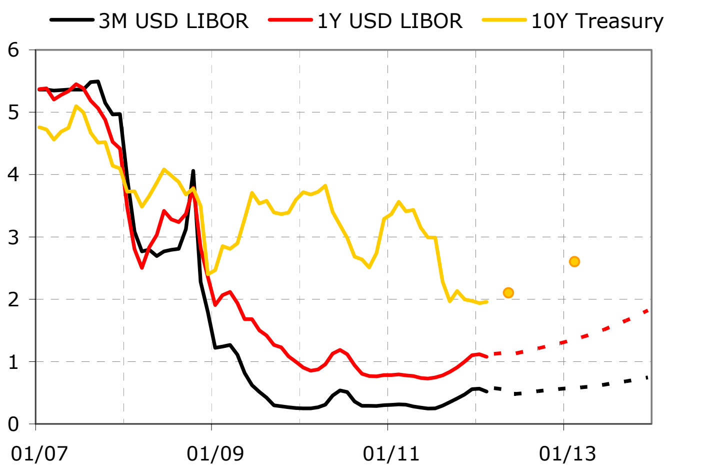
IV.2 Outlook for short-term and long-term interest rates: USA

The rise in 3M and 1Y LIBOR dollar rates observed in 2011 H2 halted at the start of this year as expected. The implied future 3M and 1Y LIBOR rate path was virtually unchanged from the previous month. The 3M rate should thus remain flat for most of 2013, while the 1Y rate should start to rise gradually from mid-2012 onwards.

The Fed's monetary policy stance remains unchanged after the January FOMC meeting. Subdued inflation should allow it to keep the key monetary policy rate at the present level of 0–0.25% through most of 2014.

The 10Y average monthly government bond yield has been just below 2% without a clear trend since November 2011. Having previously increased its expected growth, CF02 moved it back downwards (from 2.8% to 2.6% at the one-year horizon).

USA



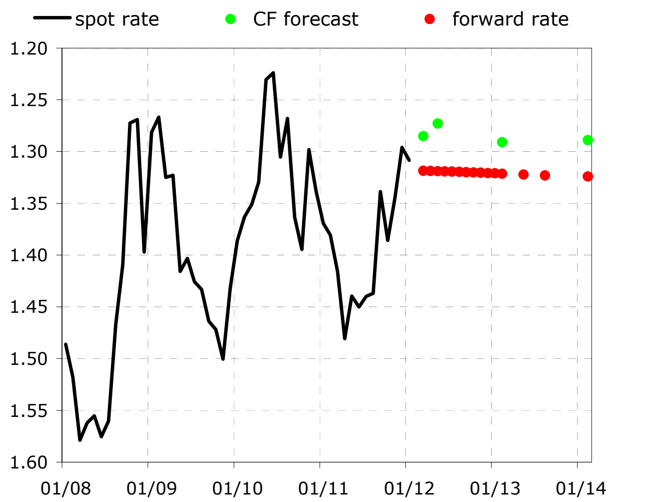
	01/12	02/12	06/12	12/12	06/13	12/13
3M USD LIBOR	0.57	0.52	0.48	0.56	0.63	0.75
1Y USD LIBOR	1.12	1.08	1.13	1.29	1.51	1.82
	01/12	**02/12**	**05/12**	**02/13**		
10Y Treasury	1.94	1.96	2.10	2.60		

Note: Implied LIBOR rates are derived from London interbank market yield curve. Forecast for 10Y Treasury yield is taken from CF. Dashed lines and points represent outlook. [Cut-off date for data: 13 February 2012]

Sources: Thomson Reuters, Bloomberg, CNB calculations.

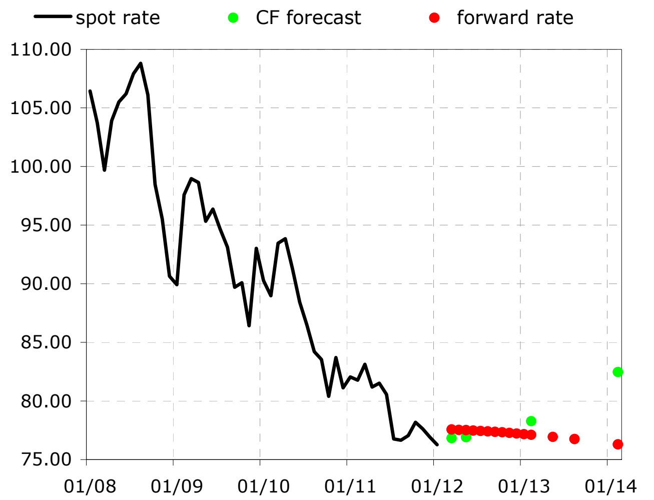
Demand for the US dollar fell in mid-January owing to a decline in risk aversion and to less-pessimistic-than-expected new data on the major economies. The ECB's set of measures not only supported commercial banks' liquidity, but also eased tensions in the bond markets (see "Focus"). The euro area's difficult situation is, however, being exacerbated by the unresolved debt restructuring process in Greece, which led to further depreciation of the euro against the dollar at the end of January. The new forecast has also shifted towards a weaker euro, which is expected to remain above USD 1.3/EUR at the two-year horizon. The fall in risk aversion also affected the Japanese yen and the Swiss franc, which are both expected to depreciate by more than 7% against the dollar at the two-year horizon. The UK's worse economic prospects led Moody's to issue a rating downgrade warning. The new CF forecast has also shifted towards a weaker pound against the dollar. The Bank of England is trying to support the domestic economy by supplying extra liquidity amid concerns about contagion from the euro area.

US$ per Euro



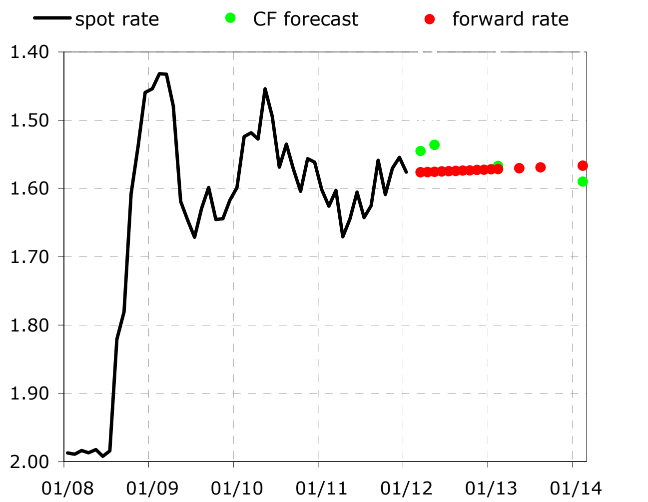
	13/2/12	03/12	05/12	02/13	02/14
spot rate	1.319				
CF forecast		1.285	1.273	1.291	1.289
forward rate		1.319	1.319	1.321	1.324

Yen per US$



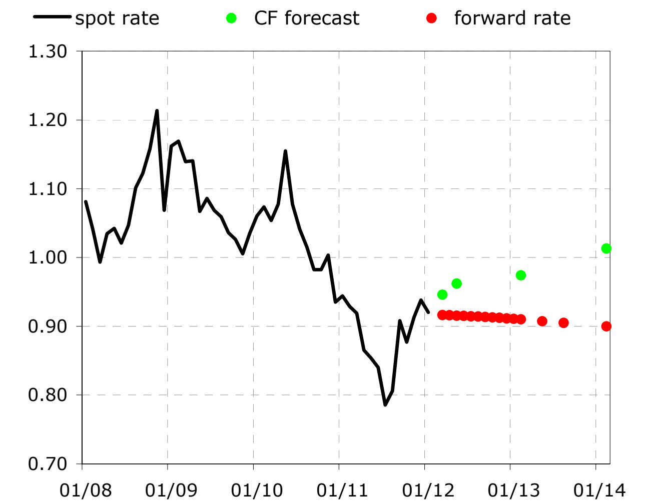
	13/2/12	03/12	05/12	02/13	02/14
spot rate	77.57				
CF forecast		76.81	76.91	78.27	82.46
forward rate		77.55	77.50	77.10	76.28

US$ per UK£



	13/2/12	03/12	05/12	02/13	02/14
spot rate	1.577				
CF forecast		1.545	1.536	1.567	1.590
forward rate		1.576	1.576	1.572	1.566

Swfr per US$



	13/2/12	03/12	05/12	02/13	02/14
spot rate	0.908				
CF forecast		0.946	0.962	0.974	1.013
forward rate		0.916	0.915	0.910	0.900

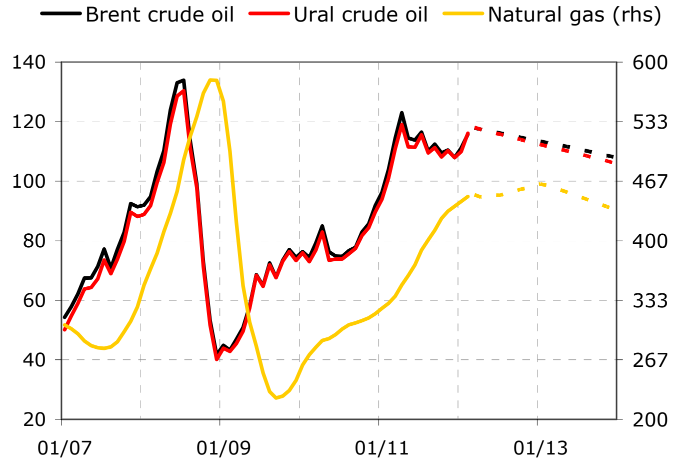
Note: Increase in currency pair represents appreciation of US dollar; data as of the last day of the month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibilities for securing future exchange rate. [Cut-off date for data: 16 February 2012]

Source: CNB calculation using Bloomberg and Consensus Forecasts databases.

VI.1 Oil and natural gas

Favourable data on the US economy, tensions surrounding Iran and a weakening US dollar kept the Brent crude oil price in January in the upper part of the range of USD 100–115 a barrel, where it had been almost continuously since August 2011. In the first half of February it rose further to just below USD 120 a barrel, a level last observed in July 2011. The market thus responded to better-than-expected data on the US labour market. The price was also supported by unusually heavy frosts in Europe. Further growth was recorded after the disclosure of high oil imports to China in January. The generally favourable process of approval of austerity measures in Greece helped to quell concerns of a European financial crisis, and firms ignored another modest lowering of expected oil consumption this year by both the IEA and OPEC. Owing to the currently high prices, the futures-based forecast shifted strongly upwards again, although mainly at the short end. The price is expected to fall by about USD 10 to USD 108 a barrel at the two-year horizon.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS



	02/12	06/12	12/12	06/13	12/13
Brent crude oil	115.8	116.5	113.8	111.2	108.2
Ural crude oil	116.1	116.2	112.9	109.6	106.2
Natural gas	449.6	451.1	462.2	451.6	435.3

Note: Brent oil price in USD/barrel (ICE quotation). Price of Russian natural gas at German border in USD/1,000 cubic m (IMF database). Future oil prices are derived from oil prices. Dashed line represents outlook.

[Cut-off date for data: 13 February 2012]

Source: Bloomberg, IMF, CNB calculations.

VI.2 Other commodities

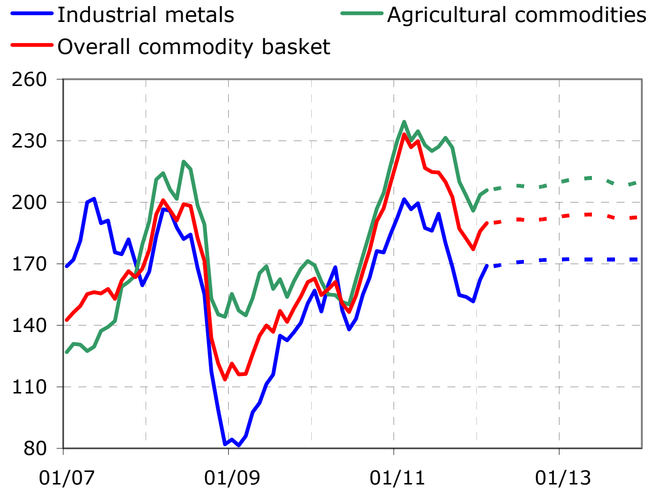
The forecast for the average monthly food commodity price index was almost unchanged from the previous month, but the industrial metals price index started to rise quickly in January after being flat for three months.

As for industrial metals, the tin price showed the largest rise (almost 30%) in mid-February compared to the December average. Nickel, platinum, copper and carbon steel also recorded growth of above 10%. However, aluminium and zinc prices also went up by about 8%, as did the price of rubber. As usual, only aluminium has a rising outlook. Prices of other metals should be flat according to futures-based forecasts.

Prices of most food commodities rose in the second half of December and stayed unchanged in January and the first half of February despite some volatility. Only wheat and beef prices have a strongly upward outlook.

The fall in coal prices visible since September 2011 continued, but the outlook is still rising. Electricity prices were showing a similarly long decline, but this came to a halt in January.

OUTLOOK FOR OTHER COMMODITY PRICES



	02/12	06/12	12/12	06/13	12/13
Industrial metals	169.1	170.5	172.0	172.1	172.0
Agricultural commodities	205.8	208.2	209.3	211.8	209.7
Overall commodity basket	189.9	191.5	192.6	194.0	192.8

Note: Chart shows price indices, year 2005 = 100. Dashed line represents outlook based on futures.

[Cut-off date for data: 13 February 2012]

Source: Bloomberg, outlooks based on futures.

THE EURO AREA BOND MARKET DURING THE DEBT CRISIS[1]

The financial crisis and a lack of fiscal discipline have adversely affected the finances of some governments in the euro area, which is now no longer viewed as a homogeneous group. The bonds of Portugal, Italy, Ireland, Greece and Spain have become the focus of attention. A risk of contagion has also emerged following the escalation of the Greek debt crisis in August 2011. This risk may increase further in 2012 Q1 as bonds mature. The steps taken by the European Central Bank (ECB) to stabilise the financial markets are crucial, but the risk of it incurring financial losses and harm to its reputation is also rising.

Introduction

This article examines the debt of selected euro area countries from the perspective of financial system stability. The problems of these countries have grown into a risk of systemic crisis, which has not yet been fully averted. Above all, there is a risk of mistrust spilling over between markets. Moreover, a functioning euro area bond market is critical for the secured money market; a drop in the value of bonds leads to a collateral crunch, which we discussed in the previous issue.

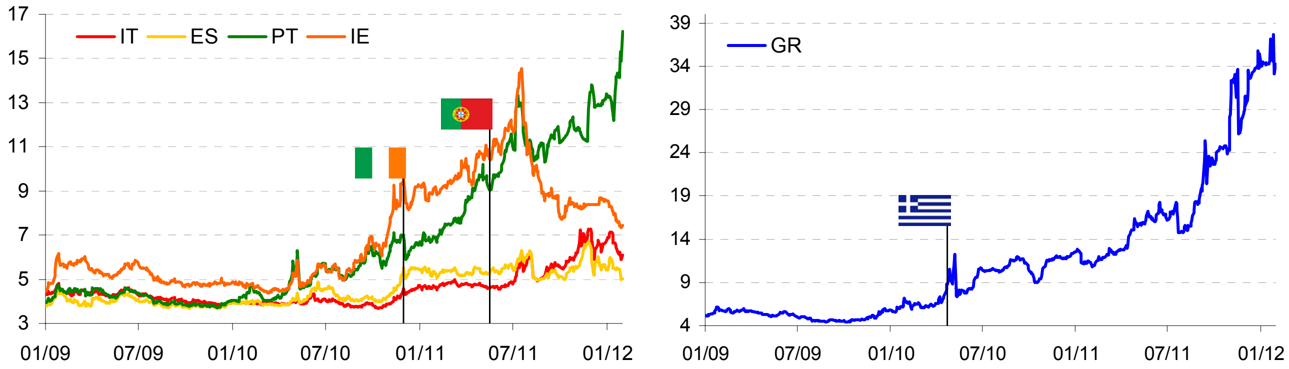
1. European sovereign debt crisis

Before the financial crisis erupted in 2008, the prevailing view was that the long-term interest rates of the euro area countries would gradually converge as the economic alignment of these countries increased. Convergence of long-term interest rates is one of the criteria a country must meet before joining the euro area. Following the creation of the euro area, markets had confidence in the single currency and viewed its member countries as a broadly homogeneous group (see CNB, 2011, section D1). At the end of 2008, however, the financial crisis began to have different impacts on the euro area economies. Coupled with budgetary indiscipline, these differences caused the yield spreads between national bonds to start growing. The interest rates of the core countries decoupled from those of the southern countries and Ireland (see Figure VII-I). In the case of Ireland, this was due to a high budget deficit arising from the bail-out of domestic banks. As for the southern periphery, there were concerns that these countries would be unable to cope with economic stagnation and would therefore become insolvent, especially given their low productivity and high structural deficits.

The rising costs of financing public debt eventually forced Greece, Ireland and Portugal to seek bailout from the International Monetary Fund (IMF) and the European Union. In Ireland, confidence in the government's austerity measures was reflected in a decline in yields in the second half of 2011; a return to the bond market and the discontinuation of IMF aid in 2013 are under consideration. By contrast, the measures taken by Greece have been insufficient and its debt trend appear unsustainable from the long-term perspective. Given the risk of contagion within the euro area, actions have been taken to restructure the Greek debt. The provision of further assistance has been made conditional on reaching a deal with private creditors. In November 2011, tensions also increased sharply in the Italian bond market, with Italian credit default swap (CDS) spreads almost tripling compared to early 2011.

[1] Written by Tomáš Adam (Tomas.Adam@cnb.cz) and Soňa Benecká (Sona.Benecka@cnb.cz). The views expressed in this contribution are those of the authors and do not necessarily reflect the official views of the CNB.

Figure VII-1: Yields in selected euro area countries

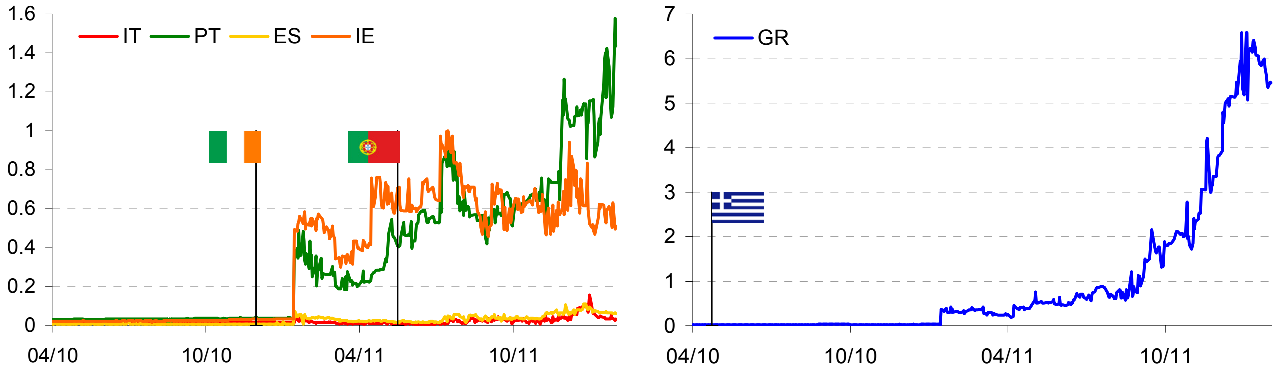


Note: Daily yields on ten-year government bonds in per cent. The flags indicate the dates on which Greece, Ireland and Portugal were granted financial aid from the IMF and from EU rescue funds. The following abbreviations are used in the figures: Greece (GR), Ireland (IE), Italy (IT), Portugal (PT), Spain (ES).

Source: Datastream.

The provision of long-term liquidity in December and interventions by the ECB calmed the Spanish and Italian bond markets in January 2012. Currently, the yields on the bonds of these two countries are below 6%. However, the liquidity of the Portuguese bond market remains low, as indicated by a rising bid-ask spread (see Figure VII-2).

Figure VII-2: Bid-ask spread on long-term government bond yields



Note: The bid-ask spread on the yields of ten-year government bonds (five-year bonds in the case of Ireland) in percentage points. The flags indicate the dates on which Greece, Ireland and Portugal were granted financial aid from the IMF and from EU rescue funds.

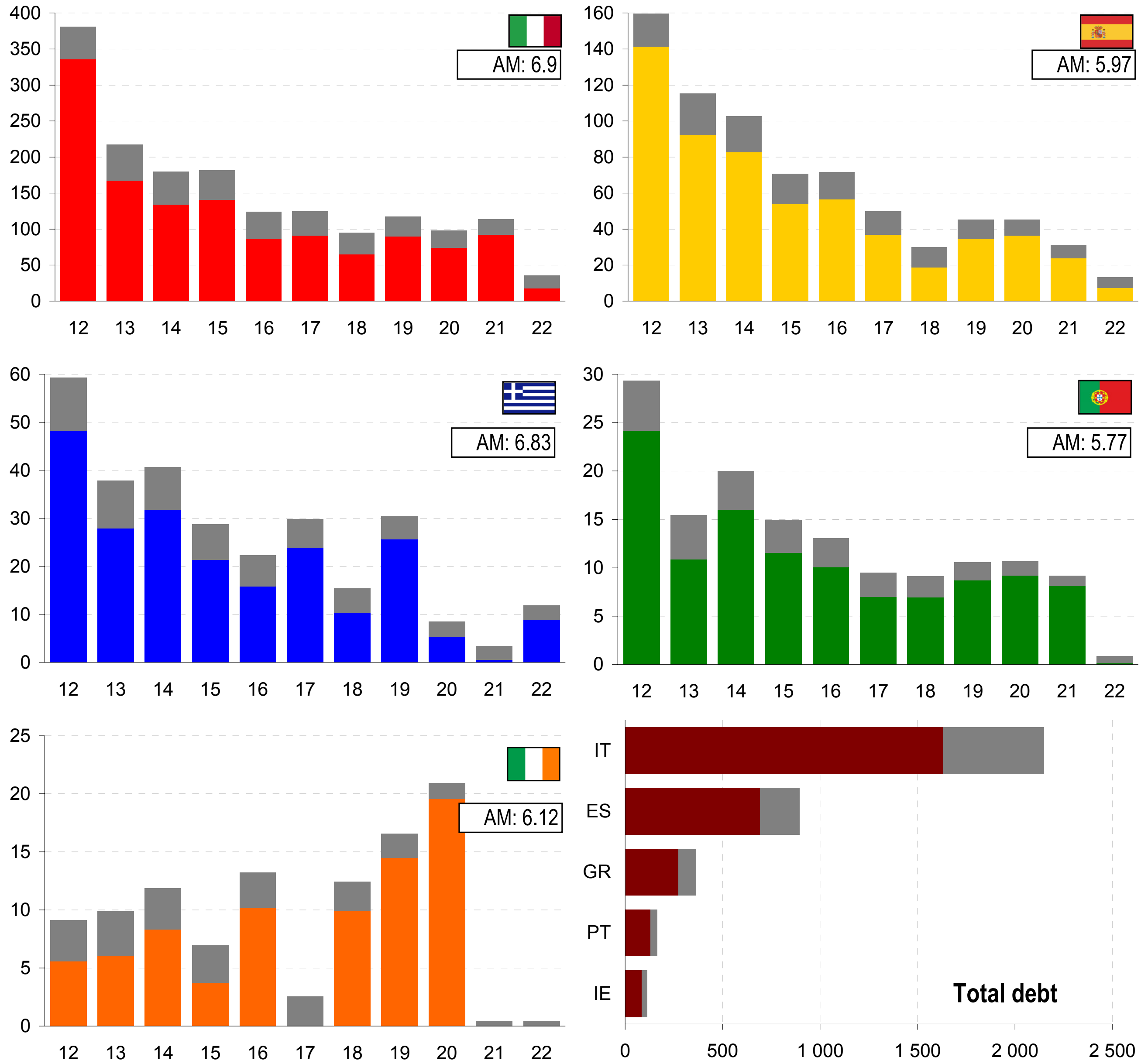
Source: Bloomberg.

The impacts of various factors (e.g. market liquidity and contagion) on bond spreads during the financial crisis are examined in a number of studies, e.g. Barbosa and Costa (2010). De Santis (2012) covers the onset of the euro area debt crisis. His analysis shows that country credit risk and the contagion effect of the Greek crisis were the main factors between September 2008 and August 2011. The impact of aggregate factors, which had been important before 2007, was limited and the effect of liquidity was only very small. Distinguishing between factors is important from the point of view of the central bank, as its interventions are only meaningful in the event of contagion risk or at times of low liquidity. By contrast, country credit risk can be changed mainly by prudent fiscal policy. According to De Grauwe (2011), the two policies are complementary in a monetary union, as bond markets in a monetary union are fragile due to asset mispricing, and the risk of self-fulfilling liquidity crises occurring is higher.

2. Expected debt developments in 2012

The current situation in the euro area bond markets can be regarded as tense. The expected repayment schedule is being closely observed (see Figure VII-3), as principal and interest repayments will have to be financed by new bonds owing to limited scope for economic growth.[2] In 2012 alone, the selected euro area countries will have to repay EUR 555.12 billion in principal.

Figure VII-3 Maturity of bonds of selected euro area countries in 2012–2022



Note: Maturity of bonds. The coloured parts of the columns indicate principal and the grey ones debt service; in EUR billions. AM = average maturity of bonds in years. Data as of 1 February 2012.

Source: Bloomberg.

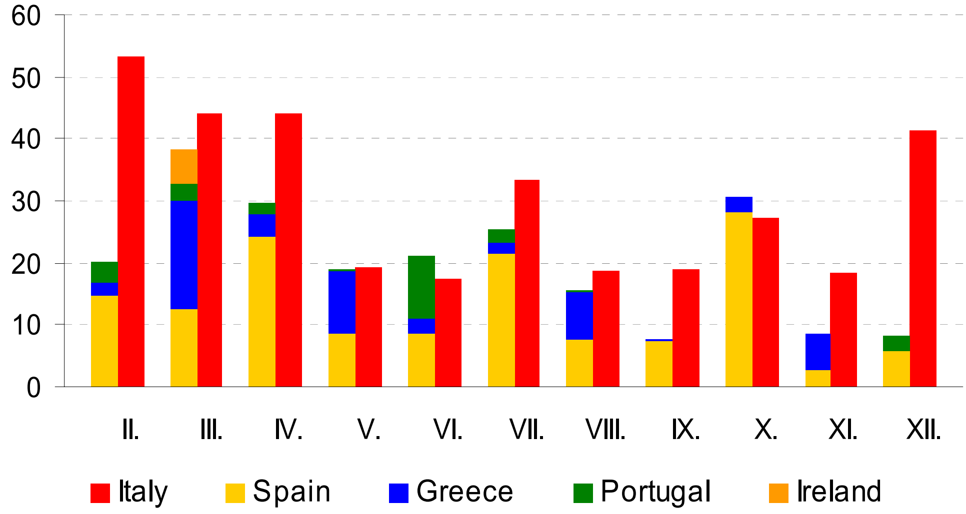
[2] The February CF expects GDP to drop by 1.4% in Italy, 1.3% in Spain, 4.4% in Greece, and 3.8% in Portugal and 0.1% in Ireland this year; next year, GDP is expected to rise by 0.1% in Italy, 0.3% in Spain and 1.4% in Ireland, while declines are expected for Greece (0.7%) and Portugal (1.3%).

Besides the absolute and relative amount of debt (usually expressed as a percentage of GDP), the maturity profile is an important property of a country's debt. With investors demanding high yields on bonds of some of the most indebted countries, it is now advantageous for these countries to repay the face value of their debt over the longest possible time. That way the higher interest will manifest itself later on, when the yields demanded by investors may be lower. At almost seven years, Italy has the longest average maturity (see Figure VII-3). By contrast, Portugal generally issues bonds with shorter maturities and so lacks a similar buffer to dampen the effect of rising yields.

The largest volume of principal repayments is scheduled for 2012, and the critical period for the future evolution of financial markets will be February–April (see Figure VII-4). Italy in particular will need to issue bonds in this period (around 45% of its repayments for 2012 as a whole). Its market is one of the largest and most liquid in the euro area. Any problems with these issues might quickly increase market nervousness. On the other hand, a large proportion of Italian bonds, short-term ones in particular, are held by residents. Household debt is relatively low, so Italy's total debt as a country, despite government debt amounting to 120% of GDP, is not too high compared to other countries. The maturity of Italian bonds is also relatively long, so the higher costs will emerge later. The reforms of the new caretaker government, whose actions are viewed positively by the markets, might have taken effect by then. Moreover, until recently (except in 2009) Italy had primary budget surpluses despite stagnant growth, so it should be able to repay its debts and stabilise its debt through faster economic growth.

Given the developments in the secured money (repo) market, which is a major source of demand for bonds, there has also been speculation that newly issued debt in Italy might shift towards shorter maturities. Risk aversion leads to a preference for safe collateral with shorter maturity, but the change in time structure entails higher liquidity risk and hence also credit risk, which would again be reflected in market expectations.

Figure VII-4: Maturity of bonds of selected euro area countries in 2012



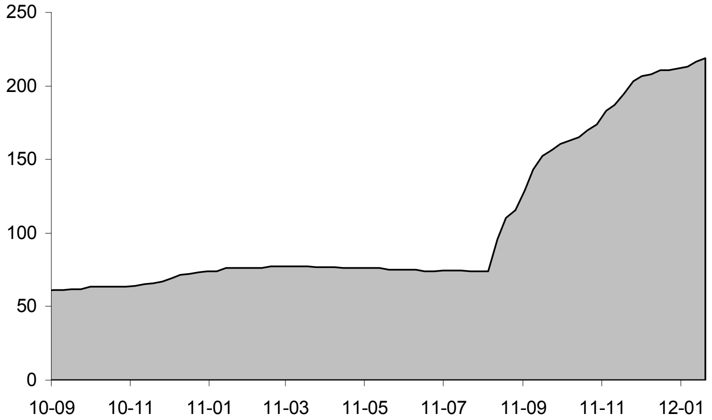
Note: Maturity of bonds in 2012 in EUR billions. The amount does not include coupon payments. Data as of 1 February 2012.

Source: Bloomberg.

3. The role of the ECB

The European Central Bank plays a major role in stabilising the bond market. According to publicly available information, the ECB intervenes on a large scale only if bond yields exceed a certain limit and the market situation is unstable. The escalation of the debt crisis in Greece in August 2011 caused the Securities Markets Programme (SMP) to be renewed. Another example of stabilisation occurred in November 2011, when Italian bond market yields exceeded 7%, which investors view as a risky level. Figure VII-5 shows the SMP purchases made by the entire Eurosystem (the system of euro area central banks). The total now exceeds EUR 200 billion, or around 1% of euro area GDP. By contrast, the assets purchased in the two rounds of quantitative easing by the Fed and the Bank of England exceeded 16% of their countries' GDP.

Figure VII-5: Value of accumulated SMP purchases, EUR billions



Source: ECB

The second indirect channel of euro area bond market stabilisation is long-term refinancing operations (LTROs), i.e. loans with long maturities secured by government bonds and other collateral. They therefore take the form of repo operations and do not involve clear-outs of bad assets from commercial banks. On the contrary, higher liquidity of banks is meant to foster greater willingness to buy securities in the market and thereby reduce tensions in bond markets.

The latest auction of three-year loans, held in December, raised almost EUR 490 billion for the banking sector; the list of assets eligible as collateral was also extended. The exact proportion of government bonds in these assets is not known, but in previous years it was around 40% according to the ECB's annual reports. The ECB applies a haircut to the collateral, i.e. it reduces the bond price by a certain percentage for collateral purposes. This is a standard approach in bank risk management.[3] However, it is fostering different perceptions of different euro area countries (see the aforementioned decoupling). Its effectiveness, i.e. the extent to which banks will voluntarily buy bonds of overleveraged countries, is also an issue. A decline in yields in the markets in January 2012 suggests that banks are showing renewed interest in these securities. A further drop in yields can be expected in February, as the ECB will offer long-term liquidity again at the end of the month.

With its operations, the ECB has also significantly influenced the interbank repo market, which is dependent on a functioning bond market. A new study conducted by the ICMA (2012) shows that the share of repo operations in the public German collateral market has declined, with investors preferring to hold these securities. The share of Italian bonds also fell, but credit risk plays a role here. Banks are thus probably using bonds of countries of the southern periphery in long-term operations with the ECB, but this

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[3] More information about the ECB's risk control measures is available at http://www.ecb.int/paym/coll/risk/riskcontrol/html/index.en.html.

cannot be confirmed from publicly available information. If Moody's and Fitch were to downgrade their ratings of, say, Italian bonds to BBB, it might trigger a margin call by the ECB. Banks would then have to provide further collateral. Given the limited functioning of the unsecured money market in the euro area, this would have a domino effect on repo markets in general and the 2008 scenario would be repeated.

To sum up, the bonds of southern EU countries make up a significant part of the ECB's portfolio and also form a large part of the collateral it accepts. Of course, this is giving rise to concerns about credit risk and potential central bank losses. Information about the restructuring of Greek debt is therefore being monitored closely. As this restructuring primarily involves reaching agreement with private creditors, the ECB has not joined the discussions yet. However, it did purchase Greek bonds at a premium, so there was speculation about a sale to the EFSF at purchase prices.[4]

Conclusion

A lack of confidence in governments' ability to tackle the high debt of certain euro area countries significantly affected the financial markets in 2011. A set of ECB measures in early January eased the tensions in bond markets and elsewhere, but many risks remain. In addition to the risk of no agreement being reached on the voluntary write-off of Greek debt, there is a threat of a further downgrading of Italy's rating, which would have a negative impact on money and other markets. The key period for safeguarding sovereign debt financing will be until the end of April 2012, but another long-term refinancing operation by the ECB reduces the likelihood of the debt crisis escalating.

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[4] The ECB ultimately agreed to this step as part of the solution to the Greek debt crisis. At the end of February a deal was reached to reduce Greece's government debt level. The country will receive a further package of rescue loans worth EUR 130 billion and private investors will write off 53.5% of the nominal debt in a bond exchange.

BOFIT	Bank of Finland Institute for Economies in Transition
BRIC	Brazil, Russia, India and China
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
ES	Spain
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
GR	Greece
CHF	Swiss franc
ICE	Intercontinental Exchange
IE	Ireland
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
IT	Italy
JP	Japan
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
PT	Portugal
UoM	University of Michigan
UoM-CSI	University of Michigan Consumer Sentiment Index
US	United States
USD	US dollar

2012

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