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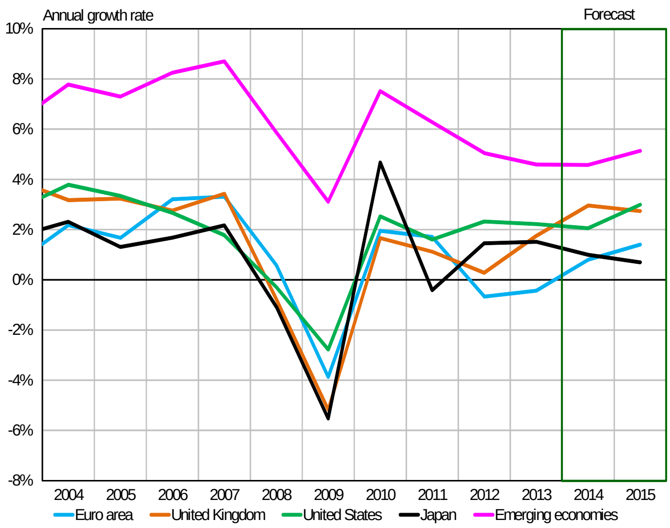
The world economy in summer 2014: rising uncertainty

- The global economic situation remained weak and uneven in summer 2014. The recovery gathered pace in the Anglo-Saxon countries but has yet to materialize in the euro area and in Japan. Growth in the emerging countries, meanwhile, continued to slow down. While many factors still point to a continuing global recovery, some downside risks have intensified, notably concerning the scale of the emerging countries' slowdown and the crisis in Ukraine.
- Activity remains buoyant in the Anglo-Saxon countries, after the dip in the US economy in the first quarter due to an exceptionally cold weather. Strong Q2 figures in both the US and the United Kingdom confirmed their recovery scenarios; while real enough, the weaknesses identified (e.g. the possible formation of another real estate bubble) are unlikely to have any negative short term impact.
- The situation in Japan, on the other hand, is more fragile, as the positive effects of "Abenomics" struggle to take firm root, just as the impact of the first VAT increase is starting to be felt. Growth should consequently be subdued in 2014 and should slow further in 2015. However, the economy could receive a boost should the government or the Bank of Japan respond with additional measures.
- Recovery in the euro area too remains to be confirmed, after particularly disappointing Q2 figures in several major countries, including a significant dip in activity in Germany (due in part to transitory factors) and Italy. The reduced pace of fiscal consolidation and the still favorable monetary and financial conditions should provide a substantial support to euro area growth. However, the considerable efforts made between 2010 and 2013 are still weighing on activity, while new risks (e.g. geopolitical tensions surrounding the situation in Ukraine) could now cast a shadow on the growth outlook. Looking to the end of the year, the recent deterioration in business sentiment suggests activity could remain persistently weak. The real surprise compared with spring 2014 comes from the drop in inflation to especially low levels. Given this situation and very high unemployment, the euro area's policy mix is open to question.
- In the main emerging economies, growth in 2014-2015 is likely to be more sluggish than before the crisis, in China, Brazil and Russia especially. The prospect of rising geopolitical tensions, with Russia in particular, is a major downside risk. One cannot rule out a sharper than expected slowdown in China affecting the commodity exporting countries (e.g. Russia and Brazil), or a revival of financial tensions.
- World trade is forecast to pick up very gradually in 2014 (+3.7%) and 2015 (+5.2%), and more slowly than forecast in the spring, while not recovering its pre-crisis growth rate. Global demand for French goods and services is expected to follow a similar pattern, as demand from France's European trade partners recovers only slowly.

Annual GDP growth in the world's leading economies



Source: National data, DG Trésor forecast.

MINISTÈRE DE L'ÉCONOMIE
DE L'INDUSTRIE ET DU NUMÉRIQUE

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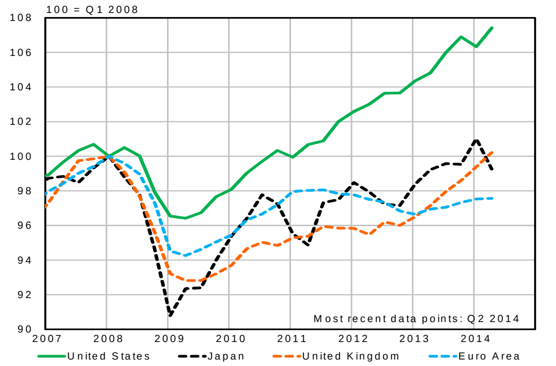
1. The global economy marked time at the beginning of the year, reflecting certain transitory factors as well as potentially longer-term weaknesses

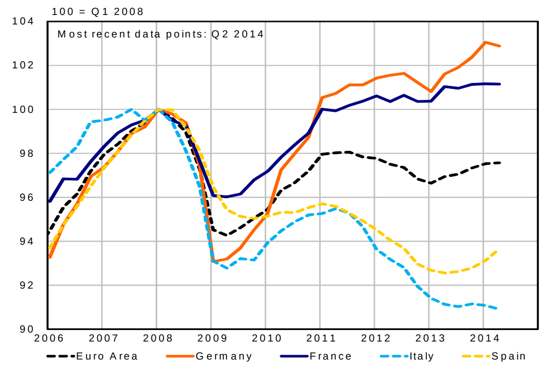
The global economy was still convalescent and contrasted in summer 2014; recovery gathered pace in the Anglo-Saxon countries but struggled to take root in the euro area and Japan (see Charts 1 and 2), while the emerging countries growth continued to slacken.

Chart 1: GDP trends in the world's leading economies



Source: National data.

Chart 2: GDP trends in the leading euro area countries



Source: National data.

Dotted lines concern countries whose national accounts are still compiled under SNA 1993 (the others are compiled under SNA 2008).

1.1 Amidst rising geopolitical tensions, financial conditions in the advanced economies remain accommodative but have deteriorated in the emerging economies

Growing uncertainty in Ukraine and Iraq in the first half of 2014 sparked fears of a steep oil price hike and renewed tension in the financial markets. Nevertheless, volatility remained subdued, and the price of Brent rose only briefly and mildly (peaking at €115.19). Indeed the price of Brent has retreated since 23 June, reverting to its September 2013 level, the conflicts in Iraq having left the oil-producing region unaffected.

Borrowing conditions in the euro area countries have continued to improve. Sovereign debt yields are nudging historical lows and spreads continue to narrow, with the announcement of further easing by the European Central Bank (ECB) in June and September (see Chart 3). In the euro area, however, the benefits of lower rates have been tempered by falling inflation. Sovereign yields have fallen in the Anglo-Saxon countries too since the beginning of the year, but they remain higher than in the euro area due to their stronger recovery and expectations of a less accommodative monetary policy.

On the other hand, the normalisation of US monetary policy and rising tensions in some emerging economies since the beginning of the year (in Ukraine and Argentina especially) have again prompted asset reallocations, seriously impacting the more fragile emerging economies from January onwards (see Chart 4), while monetary policy is being tightened to counter high inflation.

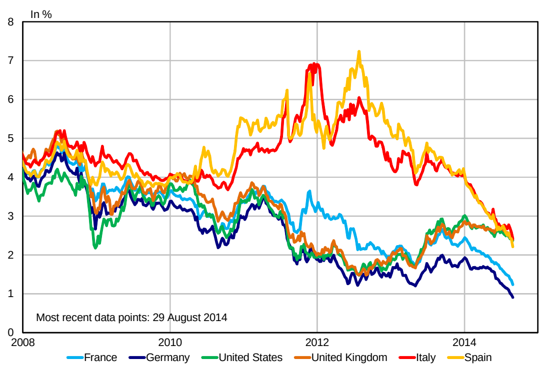
The tensions in Ukraine and the first sanctions or embargo measures between the EU and Russia have probably had only a limited direct impact on activity in Europe at this point in time (notably because Russia accounts for only a small percentage of euro area foreign trade). However, these geopolitical tensions could dent the business outlook and confidence, in Germany especially (as suggested by the downturn in German business sentiment).

1.2 First-half activity surprised on the downside, a reminder of the recovery's fragility, in the euro area especially

After a fairly positive second half in 2013, the recovery faltered in the first half of 2014 (see Table 1). Activity is struggling to put down firm roots even though the foundations of a recovery exist (with good financing terms and a more favourable policy mix). Carried-over growth at the end of Q2 has been modest for the most part (around 0.5% for the euro area, but 1.5% for the United States and 2.5% for the United Kingdom).

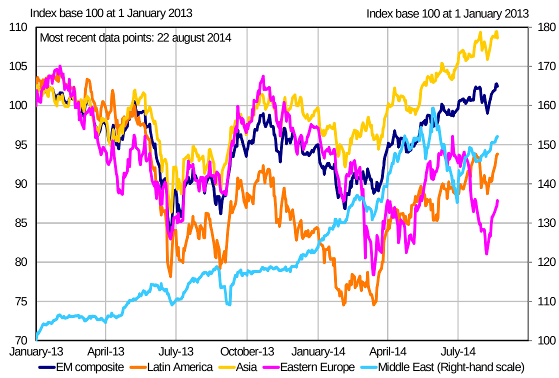
Outside the euro area, the year got off to a rocky start, though largely due to temporary factors. Abnormal weather disrupted activity in the United States, falling by 0.5% in Q1 before rebounding strongly (+1.0%) in Q2. In Japan, a vigorous first quarter (+1.5%) in anticipation of the VAT increase was followed by a very sharp decline (–1.7%) in Q2. In the United Kingdom, on the other hand, growth maintained the brisk pace observed since mid-2013 (+0.8% in both Q1 and Q2-2014).

Chart 3: World sovereign yields



Source: IHS Global Insight.

Chart 4: MSCI Emerging Markets Index



Source: Morgan Stanley.

The recovery in the euro area stalled in Q2 and looks more fragile. Spain was the only large economy in the currency union to register buoyant growth (+0.6%) this quarter, bolstered by reviving domestic demand. Activity grew in the Netherlands too, despite persistently weak domestic demand, and to a lesser extent in Belgium, while it remained stable in France. It was especially depressed in Italy, though, falling 0.2% in Q2. Finally, after a brisk first quarter (+0.7%), Q2 activity contracted by 0.2% in Germany also, albeit partly for transitory reasons (e.g. the after-effects of mild weather at the beginning of the year, and due to the long weekend breaks in May). Tensions in Ukraine also appear to be weighing on the German economy, both directly (with a sharp drop in exports to Russia, even though these represent roughly only 3% of German goods exports) and indirectly via the impact on confidence and the business outlook. At the end of Q1, carry-over growth for the euro area as a whole for 2014 was positive but modest (+0.6%).

Finally, in the main emerging economies, after dipping in Q1, the Q2 growth picture was a mixed one, against a background of fallout from financial tensions. There was a slight improvement in China, and a more pronounced one in India according to recent cyclical indicators. The most recent figures for Brazil and Turkey point to a more marked slowdown, while Russia's growth stabilised in Q2.

Table 1: Quarterly GDP trends (quarter-on-quarter real GDP growth, adjusted for seasonal and working-day variations, in %)

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	2013	2014* carry-over
Developed economies (quarter-on-quarter real GDP growth, adjusted for seasonal and working-day variations)								
United States	0.7	0.4	1.1	0.9	–0.5	1.0	*2.2*	*1.5*
Japan	1.3	0.9	0.4	0.0	1.5	–1.7	*1.5*	*0.5*
United Kingdom	0.5	0.7	0.8	0.7	0.8	0.8	*1.7*	*2.5*
Zone euro	**–0.2**	**0.3**	**0.1**	**0.3**	**0.2**	**0.0**	***–0.4***	***0.6***
Germany	–0.4	0.8	0.3	0.4	0.7	–0.2	*0.2*	*1.2*
France	**0.0**	**0.7**	–0.1	**0.2**	**0.0**	**0.0**	***0.3***	***0.3***
Italy	–0.6	–0.3	–0.1	0.1	–0.1	–0.2	*–1.8*	*–0.3*
Spain	–0.3	–0.1	0.1	0.2	0.4	0.6	*–1.2*	*0.9*
Belgium	0.0	0.2	0.3	0.3	0.4	0.1	*0.2*	*0.9*
Netherlands	0.3	–0.3	0.2	0.6	–0.4	0.5	*–0.7*	*0.5*
Emerging economies (year-on-year, not adjusted for seasonal and working-day variations)								
Brazil	1.9	3.5	2.4	2.2	1.9	n.d.	*2.3*	–
China	7.7	7.5	7.8	7.7	7.4	7.5	*7.7*	*5.9*
India	4.4	4.7	5.2	4.6	4.6	n.d.	*4.4*	–
Russia	0.8	1.0	1.3	2.0	0.9	0.8	*1.3*	–
Turkey	2.9	4.5	4.3	4.4	4.3	n.d.	*4.0*	–

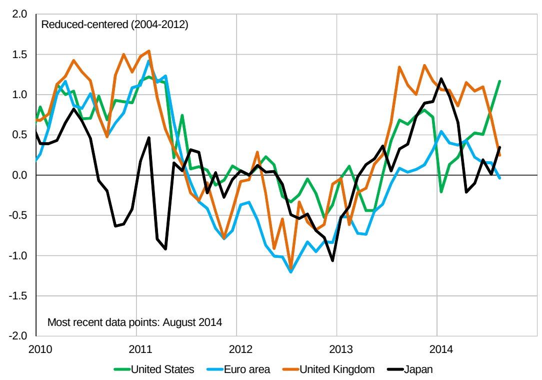
* End of Q2-2014.

Source: DataInsight and Eurostat; there may be minor discrepancies with annual accounts due to the method used to compute working days.

1.3 A gradual but uneven recovery remains the most likely scenario for the second half of 2014

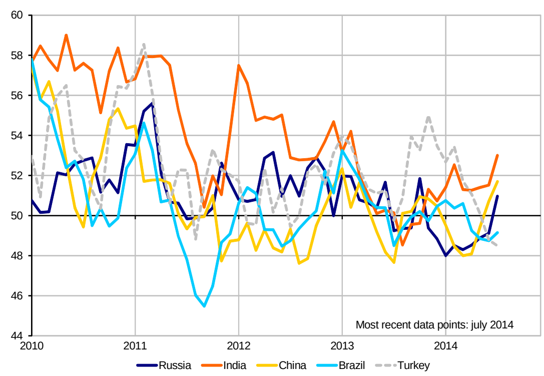
Cyclical indicators available at the time of writing (by the end of summer 2014) point to robust growth in the Anglo-Saxon countries in the second half of the year, but to persistent weakness in the euro area (see Chart 5). In the United Kingdom, PMI surveys of purchasing managers in manufacturing industry, despite their recent deterioration, continue to suggest further growth in a rapidly improving labour market. In the United States, surveys also point to strong expansion, and household confidence has regained its 2008 level. Job creation is vigorous and the construction sector is recovering progressively. In Japan, on the other hand, even if data confirm the recovery, the effects of Abenomics seem to be petering out and the VAT increases will penalise activity. In the euro area, recent surveys indicate a distinct drop in business sentiment, prompting fears of persistent weakness at year-end. In the emerging economies, activity is expected to slow further in countries such as Brazil and Turkey, whereas China's activity in the second semester could register a modest improvement, as PMI surveys suggest (see Chart 6), helped by targeted fiscal and monetary measures.

Graphique 5 : Manufacturing industry purchasing managers surveys, advanced economies



Source: ISM, Markit.

Graphique 6 : Manufacturing industry purchasing managers surveys, emerging economies



Source: Markit.

2. World growth is forecast to pick up progressively in 2015, driven by the Anglo-Saxon countries

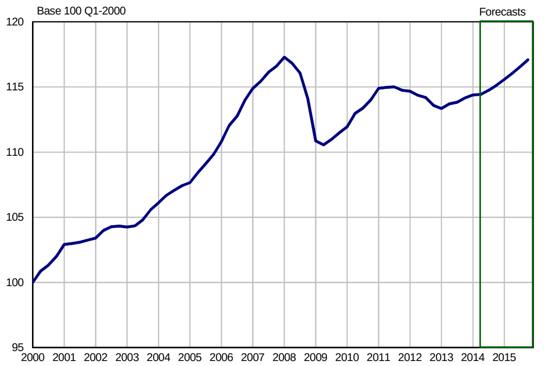
The expected rebound in world growth, led by the advanced economies-the Anglo-Saxon countries primarily-will stem from a combination of fiscal easing and continuing generally accommodative monetary policy (see Box 1).

2.1 Euro area activity will accelerate only very progressively and still more sluggishly than before the crisis

Euro area activity has been recovering since 2013 and is expected to continue to do so at a very sedate pace in 2014 and 2015, lagging still further behind the pre-crisis trend (see Chart 7).

Private demand-households and businesses-is expected to be the main driver of growth thanks to fiscal easing, improved borrowing conditions and reduced uncertainty. Activity in the different member states will continue be highly contrasted, however.

Chart 7: Euro area GDP trends since 2000



Source: Eurostat, DG Trésor calculations.

In Germany, assuming the uncertainties surrounding the situation in Ukraine dispel gradually, growth should be relatively buoyant in 2014 and 2015, thanks chiefly to stronger domestic demand. With the labour market remaining healthy, rising wages (bolstered by the phasing-in of a minimum wage from the start of 2015) and very subdued inflation should lift private consumption. Diminished uncertainty in the euro area combined with healthy corporate finances should spur private investment, which has proved disappointingly sluggish from the standpoint of activity since the crisis.

In Spain, activity is forecast to pick up progressively in 2014 and 2015, as the combined rebound in non-construction investment, and to a lesser extent in private consumption, boost exports. Investment excluding construction is expected to remain vigorous, buoyed by accelerating final demand and healthy corporate profitability. Investment in construction, on the other hand, will remain hampered by ongoing adjustment in the property market. Private consumption will be sustained by household purchasing power as the burden of fiscal consolidation eases. Unemployment should continue the recovery begun in late-2013 but will still remain very high (well above 20%), and inflation will remain very low (less than 1% in 2015). Finally, the external account will contribute to the recovery via healthy exports, thanks to accelerating global demand, improved competitiveness and businesses actively seeking new outlets abroad.

Italy will once again experience negative growth in 2014. Domestic demand will be livelier in 2015, but growth will remain subdued. Private consumption is forecast to rise slightly after 3 years of decline, despite a persistently depressed jobs market. Investment in producer goods will revive only slowly, since Italian firms, SMEs especially, are undercapitalised and dependent on bank lending. Finally, against a background of resurgent global demand, Italy's export dynamism will be held back by the country's lack of competitiveness.

2.2 In the rest of the world, the Anglo-Saxon economies alone will return to their pre-crisis level

The Anglo-Saxon economies are forecast to experience relatively strong growth, setting the scene for gradual withdrawal of monetary support for the economy. Activity in Japan, on the other hand, will mark time due to fiscal tightening. Finally, growth in the emerging economies is expected to remain fairly robust, though it is likely to settle at a durably slower pace.

The United States is forecast to experience another year of vigorous growth in 2015, growth in 2014 having been penalised by the poor Q1 figures. Against a background of fiscal easing and gradual normalisation of monetary policy, the private sector will be the main driver of activity, led by household consumption. The improving labour market should help to boost household incomes, which should in addition enjoy the wealth effect from the recovering property market. Consequently, consumption is expected to be vigorous, bolstered also as households gradually start borrowing again. That said, the United States has not returned to its pre-crisis growth model characterised by vigorous debt-fuelled consumption and a strong contribution from residential construction. Businesses have considerably improved their finances since the crisis, and are expected to increase investment spending thanks to the improving outlook for domestic and external demand and reduced uncertainty. Dynamic domestic demand should lead to a steeper rise in imports, despite export growth, and the external account is likely to penalise growth.

In the United Kingdom, activity is set to slow slightly in 2015 but should experience yet another year of strong growth, comparable to the pre-crisis performance. Here too, growth will be driven by private consumption, buoyed by the country's dynamic labour market. As the outlook for demand brightens, businesses are forecast to boost spending on capital goods to make up for the hefty investment shortfall since the onset of the crisis. Finally, the external account is expected to be neutral for growth and the current account deficit will remain substantial. The property market is a possible source of weakness and is a matter of concern to the Bank of England (BoE). House prices have soared (9.2% in one year) since the beginning of 2013, boosting household wealth (with no attendant increase in household debt, so far), with investment in residential property making a positive contribution to growth. The BoE and the regulators have responded with a series of restrictive measures, such as excluding mortgage lending from the Funding for Lending Scheme (FLS) and introducing tougher conditions for property loans.

Activity in Japan will hold up, but at a slower pace. Private demand will remain the number one growth driver, while public demand is expected gradually to run out of steam due to fiscal tightening. Business investment should gradually pick up thanks to healthier margins and more advantageous taxation. Household consumption will be hit by a second VAT increase in October; inflation, which is partly imported, should only partially spill over into wages, squeezing purchasing power. Nor is external trade likely to support activity significantly, due to the low sensitivity of exports to the yen's depreciation.

Finally, **in the emerging economies,** growth is expected to be relatively stable in 2014. Brazil, Russia, China and Turkey are all expected to experience slower growth than in 2013, following monetary policy tightening to combat high inflation, along with the fallout from the financial tensions at the beginning of the year, plus geopolitical tensions in the case of Russia.

But this slowdown should be offset by distinctly faster growth in India.

Growth is then expected to pick up progressively in several countries in 2015, albeit distinctly below its average rate for the 2000s, and China will continue to slacken. Structural factors go some way towards accounting for flagging growth in the emerging countries, as gains from the process of catching up with the advanced economies and the surge in their share of world trade gradually fade. In addition, though, the challenges differ from one country the challenges differ from one country to another, ranging from the difficulty of shifting the growth model towards domestic demand, to difficulties in keeping inflation in check where investment in infrastructure is lacking, and problems of competitiveness and governance in some countries.

Box 1: **Economic policy in the advanced economies, six years after the crisis**

The main advanced countries' economic policies are moving towards a fiscally neutral-or less restrictive-stance overall, while continuing to pursue accommodative monetary policies.

Fiscal policy in the advanced countries is globally less restrictive, after a period of severe fiscal consolidation. Fiscal policy in the euro area as a whole and in the Anglo-Saxon countries was initially strongly accommodative in 2009 after the onset of the world recession, before turning restrictive from 2010 (or 2011 in the United States) onwards. Japan, conversely, after a hefty stimulus in 2013 (the 2nd "arrow" of Abenomics), has now entered a phase of fiscal consolidation. The pace of the stimulus is flexible, however, Shinzo Abe having announced several measures in June aimed at supporting activity (notably via a cut in corporate income tax).

<u>One important difference between the euro area and the Anglo-Saxon countries in the recent period concerns their respective position in the business cycle</u>: **in the euro area, fiscal policy has remained restrictive even as the currency union entered recession and in the midst of a sovereign debt crisis, whereas in the United States and the United Kingdom fiscal consolidation went hand-in-hand with a more vigorous upturn in activity. This decoupling is forecast to narrow in 2014 and 2015, if the easing of fiscal consolidation and the upturn in activity are confirmed in the euro area.**

Meanwhile, the main central banks have been pursuing accommodative monetary policies since 2008, albeit in different forms-but these are expected to diverge progressively. The ECB and BOJ are easing their stance in response to the weak recovery and low inflation, whereas the Anglo-Saxon central banks have entered a process of normalisation. The ECB announced additional measures in June and September, including a cut in interest rates, TLTRO (targeted longer-term refinancing operations) and outright purchases of asset-backed securities (ABS). The BOJ, which has pursued a highly accommodative monetary policy, could also announce further measures in the course of the year if it fails to meet its inflation target.

Conversely, the Anglo-Saxon central banks have begun normalising their monetary policy and will probably hold to that course. The Fed is continuing to reduce its asset purchases, which are expected to cease in the autumn. At the same time it is considering the timetable and mechanisms for raising its key rates, though these should remain rock bottom "for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2% longer-run goal". For its part, the Bank of England (BOE) has kept its policy unchanged since February. Its balance sheet has remained stable and its key rates are unchanged. In both the United States and the United Kingdom, raising key rates raises a number of risks, over and beyond the question of their implementation. As the date of the first rise in key rates approaches, any over-reaction of long-term yields (unlikely for now) could affect the recovery via the financial and property markets, or could trigger new capital flows the emerging economies would find hard to deal with. Consequently, any rise in interest rates will need to be carefully gauged and appropriately communicated.

Table 2: Growth forecasts

GDP (annual average, in %)	Average 2000-2007	2012	2013	2014	2015
				(Forecast, adjusted for working-day variations)	
Global growth	**4.2**	**3.2**	**3.0**	**3.2**	**3.8**
Advanced economies	**2.6**	**1.2**	**1.4**	**1.8**	**2.4**
United States	2.7	2.3	2.2	2.1	3.0
Japan	1.5	1.5	1.5	1.0	0.7
United Kingdom	3.2	0.3	1.7	3.0	2.7
Euro area	**2.2**	**–0.7**	**–0.4**	**0.8**	**1.4**
*Germany**	*1.7*	*0.9*	*0.5*	*1.5*	*1.7*
Italy	*1.6*	*–2.4*	*–1.9*	*–0.2*	*0.9*
Spain	*3.6*	*–1.6*	*–1.2*	*1.3*	*1.9*
Emerging economies	**6.6**	**5.1**	**4.6**	**4.6**	**5.1**
Brazil	*3.5*	*1.0*	*2.3*	*0.8*	*1.2*
China	*10.5*	*7.7*	*7.7*	*7.4*	*7.0*
India	*7.1*	*4.7*	*4.4*	*5.4*	*6.4*
Russia	*7.2*	*3.4*	*1.3*	*0.1*	*1.0*
Turkey	*5.2*	*2.2*	*4.0*	*2.8*	*3.7*
World trade	*7.6*	*2.7*	*3.0*	*3.7*	*5.2*
World demande - France	*6.9*	*1.0*	*2.0*	*3.8*	*5.1*

* At the end of August, Destatis published its accounts under SNA 2008. Under this new methodology, Germany's GDP growth was respectively 0.6% and 0.2% in 2012 and 2013.

Source: IMF, IMF and DG Trésor forecasts.

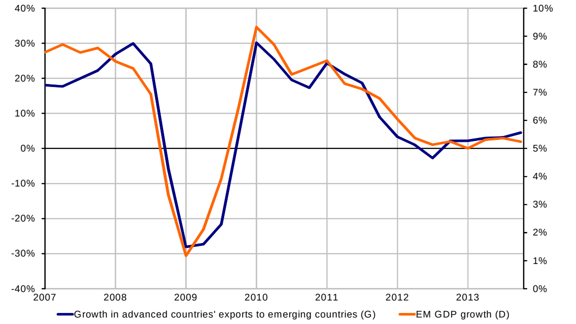
Box 2: How will the emerging economies' slowdown affect the advanced economies via the trade channel?

The emerging economies have been slowing continuously ever since the post-crisis rebound, with growth slipping from 7.5% in 2010 to 4.7% in 2013. The IMF's July forecast for this year now expects an aggregate rate of 4.6% in the emerging economies, making this the fourth consecutive year of slowing growth.

This slower growth is hurting exports from the advanced to the emerging economies, and their rate of growth has been slowing for some years now. Since 2011, exports to the emerging economies have been slowing, with an average annual growth rate of around 3-4% since mid-2012, compared with 15% per year in the pre-crisis period. Yet the emerging countries' share of developed countries' exports has expanded sharply in recent years: the advanced economies exported $3,700 billion worth of goods and services to the emerging countries in 2013, representing a third of their total exports and 8.2% of their GDP.

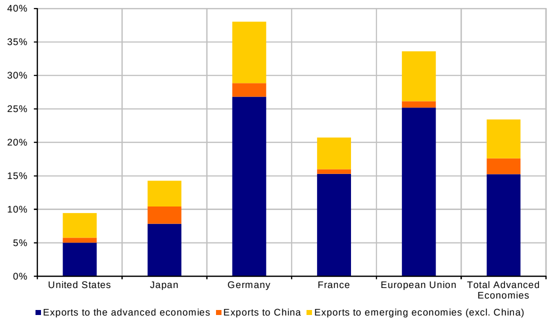
According to IMF[a] and OECD[b] estimates, a 1% negative shock to growth in the emerging countries would reduce the advanced economies' growth by around a quarter of a percentage point in the same year, chiefly via the trade channel.

Chart 8: Advanced countries' exports to emerging countries and annual growth in the emerging countries (year-on-year %)



Source: IMF, DG Trésor calculations.

Chart 9: Advanced economies' exports by destination (2013, % GDP)



Source: IMF, DG Trésor calculations.

Table 3: Impact of a one percentage-point decline in emerging economies' growth

	IMF	OECD
Advanced economies	–0.2/–0.3	–0.25
United States	–0.1	–0.2
Japan	–0.3/–0.5	–0.4
European Union	–0.3	/

Source: IMF and OECD.

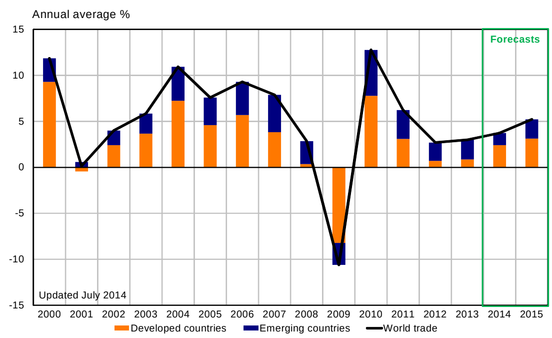
a. Spillover Report 2014.
b. "Would a growth slowdown in emerging markets spill over high income countries? A quantitative assessment" (ECO/WKP (2014)6).

3. Consequently, world trade is forecast to accelerate moderately after its recent sluggish period, as is demand in the countries to which France exports

World trade grew slowly (+3.0%) in 2013 as a result of sluggish global activity. Looking to 2015, world trade is forecast to pick up moderately, as activity in the advanced economies gathers pace (see Chart 10). The pace of growth (3.7%/5.2% in 2014/2015) will nevertheless remain significantly below its historical average (6 ¼% over the 1982-2007 period).

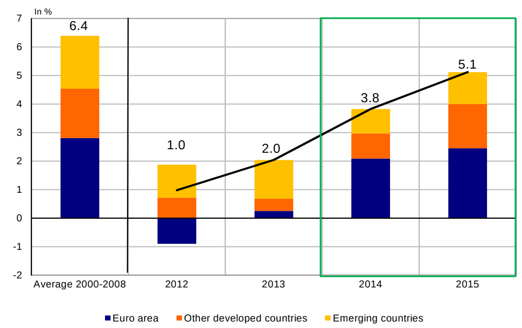
Foreign demand for French goods and services is forecast to exhibit the same profile (+3.8% in 2014 and +5.1% in 2015, see Chart 11).

Chart 10: World trade (growth and contributions by zone, in %)



Source: IMF, World Economic Outlook, DG Trésor forecast.

Chart 11: Global demand for French goods and services (growth and contributions by zone, in %)



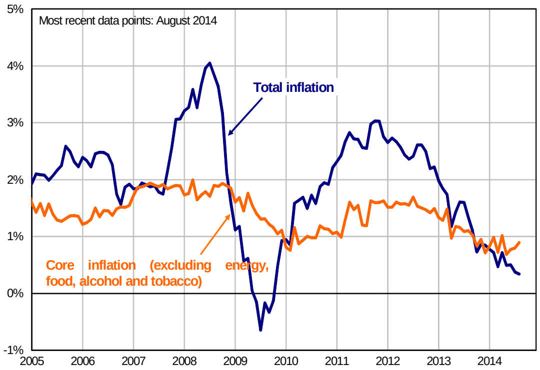
Source: DG Trésor.

Box 3: **The consequences of historically and persistently low inflation on euro area adjustments**

Euro area inflation fell to a new post-2009 low in August 2014 of 0.3%. All euro area countries are experiencing low inflation, below the ECB's target of "close to but below 2%" everywhere. Inflation is especially low in the southern euro area countries, those that have adjusted most severely since the crisis. In Spain, notably, inflation stood at –0.5% in August 2014.

The decline in euro area inflation since summer 2012 is partly due to the fall, then stabilisation, in commodity prices and the rise of the euro. But over and beyond these recent trends, inflation has been trending downwards, given that core inflation too (excluding energy and the most volatile components) has fallen since last summer, with a figure of 0.9% in August (see Chart 12).

Chart 12: Total and core euro area inflation-HICP year on year, %



Source: Eurostat.

This historically low level of inflation since the end of 2013 has raised fears of deflation in the event of an adverse shock, especially in countries such as Spain and Portugal where inflation has already turned negative[a].

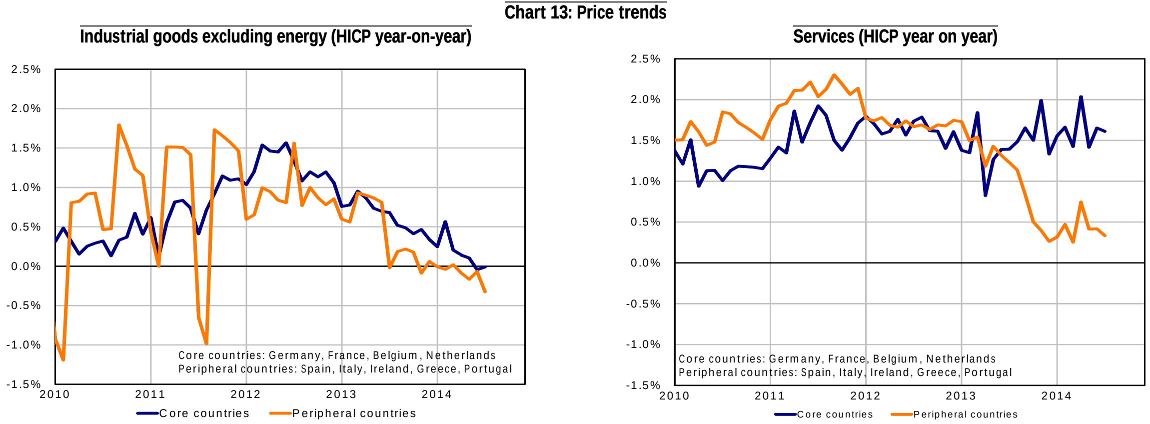
Low inflation in the euro area is part of a structural trend in the main developed economies. **But macroeconomic adjustment and economic policy post euro-area crisis have also adversely affected growth and inflation.** In particular, the rebalancing process embarked on in several of the zone's peripheral countries (Spain included) has involved shrinking domestic demand and wage costs. This is reflected in the sharper fall in inflation in services in the "peripheral" countries than in the core countries (see Chart 13).

Deleveraging by private and public agents (via severe fiscal consolidation centred on the highest-risk countries) and financial fragmentation have adversely affected growth and inflation. What is more, these adjustments have gone hand in hand with a sharp rise in the euro area's current account surplus, tending to push up the euro and mechanically pushing down inflation[b] (in the short run via a fall in euro-denominated imports and above all via a negative effect on exports).

In turn, persistently low inflation complicates the process of private sector deleveraging and intra-zone rebalancing. Very low inflation is hindering deleveraging in countries that need to do so (making it harder to repay the past nominal stock of debt). Moreover, in countries with large current account surpluses, low inflation complicates the task of rebalancing price competitiveness within the euro area, since the only way to achieve the necessary relative competitiveness gains is via adjustments in nominal wages. But the more or less downward rigidity of nominal wages makes this difficult to bring about, and could put further pressure on demand, thereby accentuating deflationary risks. In addition, it is harder to turn the public finances around in the context of a downside inflation surprise, since public spending responds partially and belatedly, owing to standards and recovery measures being expressed in real terms.

Given the risk of persistently very low inflation and its consequences, it is critical to gauge the policy mix precisely. To head off any risk of self-perpetuating effects, it is vital to gauge the euro area's fiscal adjustment carefully and promote more symmetrical intra-zone adjustment between surplus and deficit countries.

Chart 13: Price trends



Source: Eurostat, DG Trésor calculations.

a. See Bouvard F., El Kasmi S., Sampognaro R. and Tazi A., (2014), "A spell of deflation in the euro area?" Trésor Economics no.130, June.
b. According to the ECB, of the 2 percentage point drop in inflation since 2012, nearly ½% is due to the euro's appreciation (more than +10% in effective terms over the period).

4. Several uncertainties still surround this scenario of a progressive and low-key improvement in global activity, led by the advanced countries

In the euro area, any aggravation of geopolitical tensions between Russia and Ukraine could adversely impact the outlook, as already seems to be the case for Germany. Financial conditions could improve faster than expected following publication of the results of the **ECB's comprehensive assessment of bank balance sheets**; nor can one rule out a revival of tension should some banks require unexpectedly large recapitalisation. Moreover, this scenario assumes persistently low inflation, complicating efforts to deleverage and intra-zone rebalancing (see Box 3). A more "symmetrical" euro area rebalancing, notably via a stronger stimulus to domestic demand in the current account surplus countries, would diminish the risk of deflation while supporting growth in the euro area.

Outside the euro area, while Japan's aggressive policy mix appears to be performing as promised for the time being, success is still far from assured and will notably depend on the extent to which rising inflation translates into higher wages, and on the implementation of structural reforms to support growth and bring the public finances under control. **In the Anglo-**

Saxon economies, while the normalisation of monetary policy is not expected to entail any major risk, timing will be important, especially as this is complicated by the uncertainty surrounding the situation with regard to productivity and the labour market.

Finally, about emerging economies are concerned, the risk of increased political tension, concerning Ukraine in particular as well as the Near and Middle East, represents a major downside risk, especially for the Russian economy. One cannot rule out either a more pronounced slowdown in the Chinese economy (notably in connection with a flagging property sector), with potential consequences for the world economy, especially the commodity exporting countries (e.g. Russia and Brazil), or renewed financial tensions. Conversely, potential upside surprises include a more vigorous recovery in the developed countries or monetary easing in the emerging economies starting in 2014.

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