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RÉPUBLIQUE FRANÇAISE

No. 112
April 2013

TRÉSOR-ECONOMICS

The world economy in the spring of 2013: a brighter outlook?

This study was prepared under the authority of the Directorate General of the Treasury (DG Trésor) and does not necessarily reflect the position of the Ministry of Economy and Finance and Ministry of Foreign Trade

- At the end of 2012, international trade and global economic growth stalled, partly because of temporary factors. The main reason growth remained flat in the United States was the fall in military spending and the impact that hurricane Sandy had on output and inventories, which cancelled out the growth of private expenditure. The dip in the United Kingdom's fourth-quarter growth offset the stronger third-quarter growth, which had benefited from the London Olympics. In the euro area, growth slowed more sharply in the fourth quarter than in the third quarter, which is somewhat surprising given the gradual easing of financial tensions over the period. However, some temporary factors affecting the euro area's main trading partners and trade within the euro area held growth down. These factors include the increase in indirect taxes in Spain and the Netherlands and the decline in automotive production in Germany.

- The preliminary data for the beginning of 2013 point to an improvement in global growth that is still fragile. Confidence is on the rise. In the United States, the improvement stems from the resolution of major budget issues that preventing the country from going over the fiscal cliff and, in the euro area, the improvement can be attributed to the combined action of Member States and European institutions, and, more specifically, the European Central Bank.

- The outlook for 2014 is for gradually stronger growth of the advanced economies, but is still will not as strong as before the crisis and large disparities will persist. This return to growth, which hinges on eliminating uncertainty, will be driven by stronger private sector growth in certain advanced economies, and primarily the United States, and against the backdrop of lessening fiscal consolidation in the euro area. Growth disparities will stem from persistent obstacles to growth in certain euro area countries, such as process of reducing the debt of households, businesses and general government, and/or structural weaknesses. Disparities will also stem from the greater progress achieved in the United States in reducing private debt and the recovery of the real estate market, and from Japan's continuing expansionary fiscal policy. The strong growth of emerging economies, and China in particular, should sustain the recovery of the advanced economies via the trade channel.

- There are also threats to growth. The driving force from the private sector could be less powerful than expected, particularly in the United States and Germany, because of the relatively comfortable situation that companies enjoy in these two economies. On the other hand, a return to enduring financial tension in the euro area would prolong uncertainty and could hamper the recovery. The global economic situation is also dependent on changes in economic policies.

Global trade growth and global GDP growth

Sources: OECD, IMF, forecasts by DG Treasury.

MINISTÈRE DE L'ÉCONOMIE ET DES FINANCES

MINISTÈRE DU COMMERCE EXTÉRIEUR

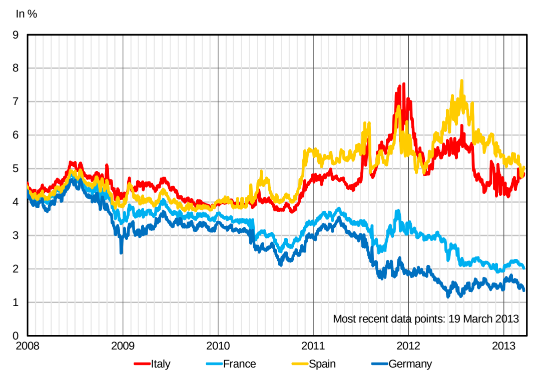
1. The decline in the euro area's growth has continued since the summer of 2012, despite easing of financial tensions, but the slide could stop in early 2013

1.1 The measures taken by governments and the European Central Bank have calmed financial tensions in the euro area...

In 2012, the combined action of governments and the ECB to stabilise vulnerable euro area countries, improve economic and fiscal governance and promote growth started to ease the tensions surrounding sovereign debt in the summer. This action started with the European Council meeting on 28 and 29 June, where work on the Banking Union and the growth and jobs pact was announced, followed by the statements made by the ECB Governor over the summer and the announcement after the ECB Governing Council meeting on 6 September of the procedures for the new Outright Monetary Transactions programme for purchases of sovereign securities on the secondary market. The programme requires the issuer to accept a financial assistance programme, but it ensures unlimited purchases of securities on the secondary market. The entry into force of the European Stability Mechanism (ESM) meant that easing continued into the autumn. The European Council meetings of 18-19 October and 13-14 December made progress on rapid implementation of a single banking supervision mechanism, which also helped to ease financial tensions.

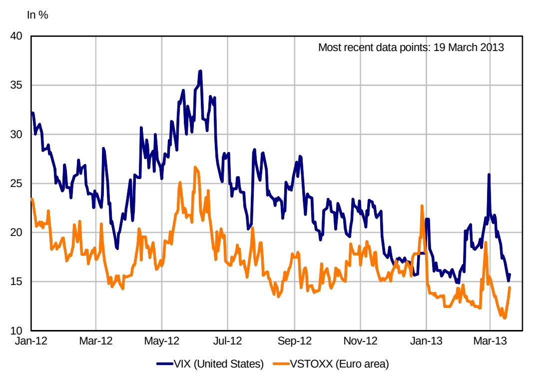
In the United States, the end of uncertainty about the fiscal cliff at the start of 2013 also helped to calm the markets. All in all, financial tensions and uncertainty have decreased substantially since the middle of 2012, leading to a widespread decline in yields in the euro area (see Chart 1), less uncertainty in Europe and America (see Chart 2) and a bounce in the main stock markets. Better financing terms for governments, however, have not led to renewed borrowing growth in the euro area, where outstanding debt continues to decline, primarily as a result of persistently weak demand.

Chart 1: Sovereign yields in the euro area



Source: DataInsight.

Chart 2: Uncertainty indicators: stock market volatility



Source:DataInsight.

1.2 ... and limited the decline in growth

In the second half of 2012, GDP in the euro area shrank by an average of 0.4% per quarter, after declining by an average of 0.1% in the first half of 2012 (see Table 1). The quarterly pattern was affected in part by temporary factors[1] that mitigated the decline in the third quarter and amplified it in the fourth quarter. Disparities between euro area countries were slightly smaller. GDP shrank moderately in France and Germany, owing to weak trade. In the Southern countries, the contraction of GDP was more pronounced, especially in Portugal, but also in Italy and Spain. In Greece, only the year-on-year growth figure was released and it shows a further big decline in GDP.

Over 2012 as a whole, the contraction of euro area GDP by 0.6%, following growth of 1.4% in 2011, results from some very contrasting situations, with moderate growth of 0.9% in Germany, flat growth in France and a sharp recession in Italy, where GDP shrank by 2.4%, and smaller contractions of GDP in Spain (–1.4%) and the Netherlands (–0.9%). In the euro area as a whole, domestic demand fell, as private and public sector debt was reduced. This meant that foreign trade was the main support for the economy, with weak imports and relatively firm exports.

1.3 The economic situations of countries outside of the euro area are highly contrasted

The United States posted moderate average growth of 0.4% in the second half of 2012, in line with the figure for the first half of the year. The United Kingdom posted an artificial bounce with 0.3% growth following a contraction of 0.2%, while Japan saw its GPD shrink by 0.5%, following growth of 0.6% in the first half of 2012. As was the case in the euro area, growth figures for its main trading partners were patchy, with more or less sharp contractions, except in China. In the United States, after posting growth of 0.8% in the third quarter, the economy was flat in the fourth quarter because of such temporary factors as the after-effect of the increase in military spending in the third quarter, inventory drawdowns following hurricane Sandy at the end of October and the uncertainty about the possibility that the country would go over the fiscal cliff at the start of 2013, even though private consumption and investment continued to support growth. Firm investment in housing underpinned the recovery of the real estate sector. In the United

(1) German automotive production bounced back in the third quarter because carmakers wanted to reduce the time lag between orders and delivery. Then, as demand declined, carmakers cut back their output sharply at the end of the year. In Spain, the top VAT rate increased by three percentage points on 1 September, from 18% to 21%. The intermediate rate increased by 2 percentage points to 10% and certain goods and services have been switched from the intermediate rate to the top rate. The reduced VAT rate was left unchanged at 4%. The VAT hike triggered an anticipation effect, boosting household consumption in Spain in the third quarter, to the detriment of fourth quarter consumption.

Kingdom, gross domestic product (GDP) shrank in the fourth quarter of 2012, after a short-lived bounce in the third quarter, stemming primarily from the effect of the Queen's Diamond Jubilee celebrations from 2 to 5 June, which involved an additional bank holiday[2], and the London Summer Olympics. In Japan, GDP was stable in the fourth quarter, when it was once again dragged down by weak foreign trade and capital expenditure by businesses, despite a slight bounce in household consumption, following the impact of the end of the "eco-car" support measures in the third quarter. China continued to post strong growth, with a 7.9% year-on-year increase in the fourth quarter. This strength is sustained by more accommodative monetary and fiscal policies, as well as brisk infrastructure spending.

All in all, the growth figures for 2012 are particularly uneven, with 2.2% growth in the United States, 2.0% in Japan, where growth was underpinned by reconstruction plans at the beginning of the year following the earthquake, and 0.3% in the United Kingdom.

Table 1: Quarterly growth of real GDP (seasonally and working-day adjusted, in %)

	2012Q1	2012Q2	2012Q3	2012Q4	2011	2012	Cumulative 2013**
United States	0.5	0.3	0.8	0.1	*1.8*	*2.2*	*0.5*
China	1.5	2.0	2.1	2.0	*9.3*	*7.8*	*3.1*
Japan	1.5	−0.2	−0.9	0.0	*−0.5*	*2.0*	*−0.5*
United Kingdom	−0.1	−0.4	0.9	−0.3	*1.0*	*0.3*	*0.2*
Euro area	**−0.1**	**−0.2**	**−0.1**	**−0.6**	***1.4***	***−0.6***	***−0.5***
Germany	0.5	0.3	0.2	−0.6	*3.1*	*0.9*	*−0.3*
France	**−0.1**	**−0.1**	**0.2**	**−0.3**	***1.7***	***0.0***	***−0.2***
Italy	−0.9	−0.7	−0.2	−0.9	*0.4*	*−2.4*	*−1.0*
Spain	−0.4	−0.4	−0.3	−0.8	*0.4*	*−1.4*	*−0.9*
Belgium	0.2	−0.5	0.0	−0.1	*1.8*	*−0.2*	*−0.2*
Netherlands	0.1	0.2	−1.0	−0.2	*1.0*	*−0.9*	*−0.6*
Greece*	n.d	n.d	n.d	n.d	*−7.1*	*n.d*	*n.d*
Ireland	−0.3	0.7	−0.4	0.0	*1.4*	*0.9*	*−0.1*
Portugal	−0.1	−1.0	−0.9	−1.8	*−1.6*	−3.2	−2.1

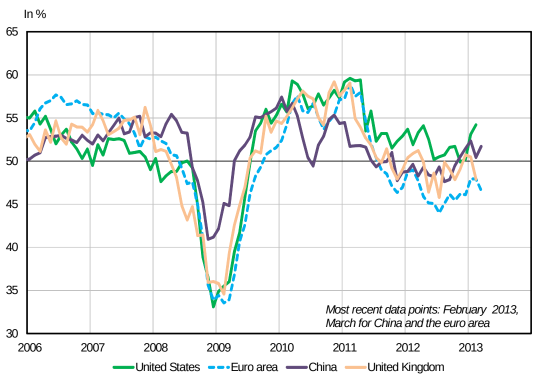
* Only the year-on-year growth figures have been released so far. ** Cumulative since the end of 2012T4.

Sources: DataInsight and Eurostat ; some minimal discrepancies with annual data may occur because of public holidays.

1.4 The outlook for growth is brighter at the beginning of 2013

At the start of 2013, the available economic indicators point to a slight improvement in the leading global economies and those of the euro area (see Chart 3), especially Germany. In the euro area, business confidence, as shown by the Purchasing Managers Index (PMI) is higher than at the end of 2012. Furthermore, the decline in manufacturing output should be smaller in the first quarter of 2013 than at the end of 2012 (see Table 2). More specifically, Germany's national business condition surveys (ZEW, IFO) have improved substantially in recent months, pointing to a recovery in growth in early 2013. Business conditions surveys in the United States are also pointing to firmer growth and job creation is still strong. In Japan, in addition to continuing accommodative monetary policy and the previous devaluation of the yen, the massive fiscal stimulus plan passed in mid-January should drive up growth in the short term by boosting public-sector demand. China's growth should remain brisk according to the latest indicators, such as the trade balance, PMI and, more particularly, manufacturing output. Ultimately, changes in manufacturing output at the end of 2012 and the beginning of 2013 point to improved growth, or smaller-than-expected declines in most of the advanced economies at the beginning of the year.

Chart 3: Purchasing Manager Indices



Sources: Markit, ISM.

Table 2: Manufacturing output (excluding construction) (monthly and quarterly variations)

	Nov. 12	Dec. 12	Jan. 13	Feb.- 13	2012Q3	2012Q4	2013Q1(*)
United States (**)	1.5	0.3	0.0	0.7	0.1	0.7	1.2
Japan	−1.4	2.6	0.3	–	−4.1	−1.6	1.6
United Kingdom	−0.0	1.1	−1.2	–	0.6	−2.1	−0.5
Euro area	−0.8	0.9	−0.4	–	0.1	−2.1	0.0
Germany	−0.4	0.8	−0.4	–	0.4	−2.5	0.0
Italy	−1.1	−0.2	0.8	–	−0.5	−2.2	0.3
Spain	−2.4	0.0	0.6	–	−0.4	−1.9	−0.3

(*) Cumulative at the end of January (February for the United States) (**) including construction.

Sources: national data, Eurostat via DataInsight.

(2) No adjustment was made for this in the national accounts to calculate growth, which artificially lowered second-quarter growth (1 less working day) and caused a bounce in third quarter growth as an aftereffect.

2. The recovery in 2013 and 2014 will be uneven, with major disparities persisting between world regions, illustrating the structural weaknesses of certain economies.

2.1 The outlook up to 2014 is for gradually stronger growth of the advanced economies, but at a slower rate than before the crisis and with persistent large disparities.

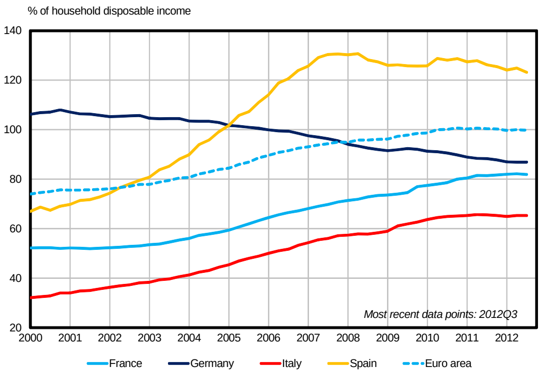
The expected recovery in growth will be driven by the private sector in certain advanced economies, starting with the United States, with very accommodative monetary policy and lessening fiscal consolidation in the euro area (see Box 1).

However, the advanced economies' economic growth will be modest compared to the output gaps still to be overcome. Growth disparities will still be very large (see Table 4), with persistent obstacles to growth in certain euro area countries, the United States' head start on reducing private sector debt and real estate market recovery and Japan's continuing expansionary fiscal policy. The strength of emerging economies will underpin the global recovery.

2.2 The recovery will be gradual in the euro area

The recovery in the euro area will be driven by gradual firming of domestic demand, stemming from the gradual weakening of the impact of financial tension on the real economy, combined with less restrictive fiscal policies, especially in 2014. But growth will not match the pre-crisis rates. The debt reduction process and/or structural weaknesses will continue to hold back growth in the Southern countries (see Chart 4), leading to a persistent and large growth differential with the countries at the centre of the euro area. In addition, the past strength of the euro vis-à-vis the other leading currencies (see Box 2) will mitigate the recent export gains achieved by the euro area. All in all, the economy will shrink further in 2013, before bouncing back in 2014.

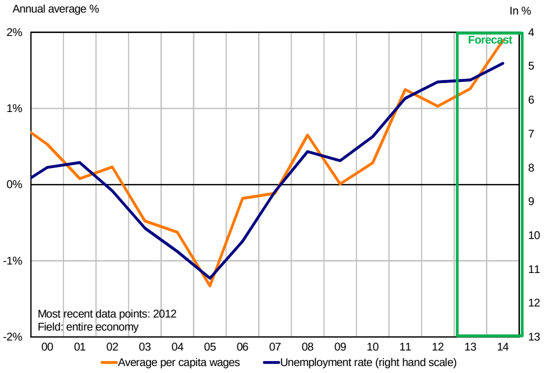
Chart 4: Household debt



Source: Banque de France.

In Germany, private demand will sustain GDP in the absence of fiscal consolidation. Households' purchasing power will be boosted by hefty new pay raises, against the backdrop of historically low unemployment (see Chart 5). After being relatively timid in 2012, because of the uncertainty surrounding the resolution of the sovereign debt crisis in the euro area, businesses are once again expanding their investment, but only moderately, given their strong financial situation. With the recovery of private-sector demand, growth will gradually start to be more balanced towards domestic demand.

Chart 5: Germany - unemployment rate and average real per capita wages

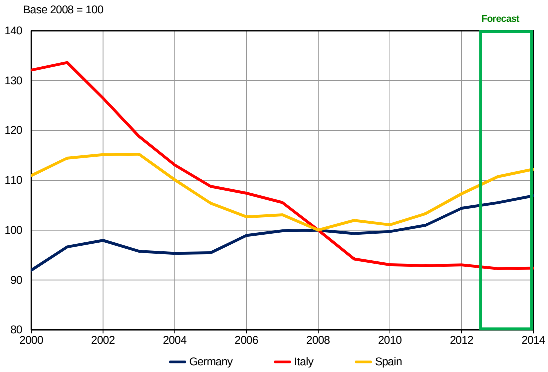


Source: Destatis, DG Treasury forecasts.

In Italy, GDP will continue to shrink and will not stabilise until the end of 2013, as fiscal consolidation slackens. Weak productivity and a competitiveness deficit are structural obstacles that will continue to hobble growth as credit remains tight, particularly for small and medium-sized enterprises.

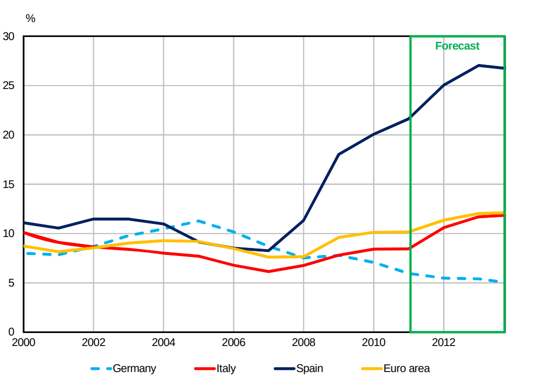
In Spain, the fast pace of fiscal consolidation is slowing growth in an adverse financial context. Foreign trade is the only support for growth, as Spain conquers larger shares of export markets (see Chart 6). However, the situation will remain serious and growth will be flat, mainly because of continuing adjustment of the real estate market, the reduction of business and household debt and the persistence of a very weak job market (see Chart 7).

Chart 6: Export performances of the leading euro area countries



Source: DG Treasury forecasts.

Chart 7: Euro area unemployment rates

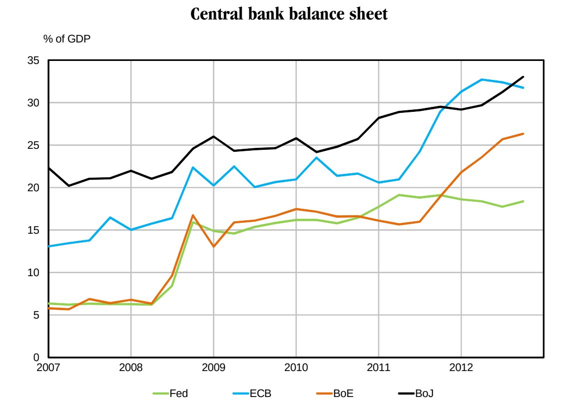


Sources: Eurostat, DG Treasury forecasts.

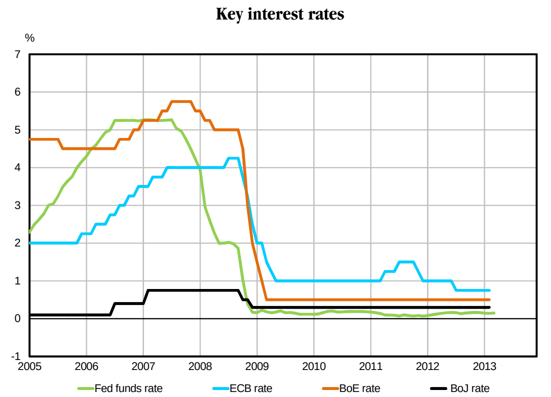
Box 1: **monetary and fiscal policies in the leading advanced economies**

The leading central banks' monetary policies should remain very accommodative (see Chart 6). The ECB has held its main refinancing rate at 0.75% since July 2012 and its deposit facility rate now stands at 0%. The ECB has reiterated its determination to maintain an accommodative monetary policy as long as necessary. Furthermore, the ECB has continued to supply abundant liquidity, which it increased through three-year refinancing operations concluded in late 2011 and early 2012. At the end of the 6 September 2012 Governing Council meeting, the ECB announced the procedures for a unlimited new programme for purchasing securities on the secondary market, focusing on short maturities and on the condition that the issuing countries accept EFSF/ESM financial assistance. Since the middle of 2012, the ECB balance sheet has shrunk slightly, as market conditions improved substantially after the summer of 2012 and banks opted to repay their three-year refinancing. The United States Federal Reserve continued to innovate with non-conventional policies, such as forward guidance. The Fed has committed itself to keeping the federal funds rate at near zero until the unemployment rate dips below 6.5% and the inflation rate goes above 2.5%. Furthermore, the Fed will continue to purchase securities until "the outlook for the labour market has improved substantially", with monthly acquisitions of USD85 billion, including USD40 billion in mortgage-backed securities and USD45 billion in Treasury securities. The Bank of England's Monetary Policy Committee meeting on 7 March decided not to extend its securities purchasing programme, which had reached approximately 25 points of GDP. The Bank of Japan modified its monetary policy stance substantially on 22 January, switching from a 1% inflation "objective" to a 2% inflation "target". Furthermore, the Asset Purchase Programme will be extended beyond its initial end date at the end of 2013 as an Asset Purchase Programme with no time limit. The monetary policy decision announced on 7 March 2013 confirmed this change of stance.

Chart 8: Monetary policies of the leading central banks



Sources: Fed, ECB, BoE, BoJ and national statistics institutes, calculations by DG Treasury.



Source: DataInsight.

The fiscal policies of the main advanced economies will continue to strive for smaller deficits up until 2014, except in Japan (see Table 3). Fiscal policy should be less tight in the euro area in 2014. In the United States, the American Taxpayer Relief Act was passed at the last minute on 1 January 2013. It avoided the fiscal cliff by reducing fiscal adjustment by more than half to 1.8 points of GDP, by extending the Bush tax cuts for incomes under USD400,000 per year, by making the inflation adjustment of the Alternative Minimum Tax automatic and by extending special unemployment benefits and business tax credits for one year. The agreement also delayed until 1 March 2013 the automatic cuts in federal spending under the sequester provided for in the August 2011 Budget Control Act. The sequester has come into force and will hamper the expected recovery. Two points still need to be resolved: Congress needs to pass a budget for the 2013/2014 fiscal year by the end of September and raise the debt ceiling by 19 May. In the United Kingdom, fiscal consolidation continues, with the main emphasis on expenditure. Finally, the new Japanese government adopted a stimulus plan on 15 January 2013 that is worth 2.2 points of GDP, with 1.1 points for infrastructure spending, 0.6 points for special programmes to stimulate public consumption and 0.5 points for new budget appropriations. Implementation of the recovery plan will be concentrated in 2013. Fiscal policy will tighten in 2014, with a rise in consumption tax from 5% to 8% slated for April and the expiry of the stimulus measures.

Table 3: Structural effort in points of GDP

	Government balance (*)	Structural effort (**)			Total
	2011	2012	2013	2014	2012-2014
United States	–10.2	1.7	1.8	0.8	**4.3**
Euro area	–4.1	1.6	1.3	0.4	**3.3**
United Kingdom	–7.8	1.1	1.2	1.4	**3.7**
Japan	–9.2	–0.6	–1.5	2.5	**0.4**

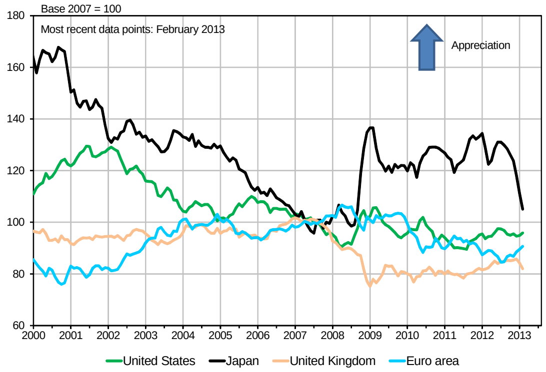
(*) National sources.
(**) Source: DG Treasury, measures having a direct impact on growth.

Box 2: **exchange rates in the recent period**

Euro exchange rates vis-à-vis the leading currencies have appreciated sharply in the recent period (see Chart 9), particularly against the yen and, to a lesser extent, against the dollar and sterling. The relative easing of financial tensions in the euro area and the increasingly accommodative policies of other central banks, like the Fed and the Bank of Japan, explain much of the euro's rise. This trend was interrupted with regard to the dollar and the yen in early February.

In March, the euro slipped slightly as uncertainty surrounded Italy's elections and restructuring of Cyprus's banking sector.

Chart 9: Real effective exchange rates



Source: DataInsight, calculations by DG Treasury.

2.3 Outside of the euro area and the United Kingdom, growth should be substantially stronger

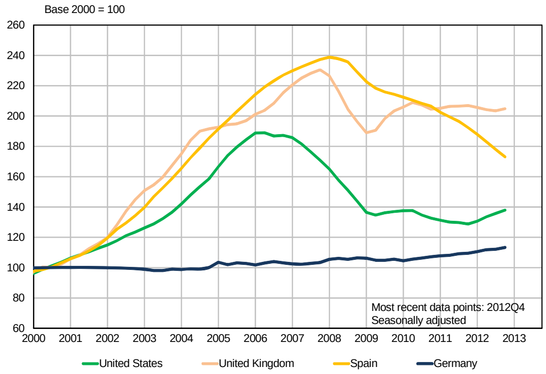
Growth in the **United Kingdom** should be modest. It will be sustained by a gradual recovery in domestic demand, as inflation falls and exports to the euro area pick up. However, it will be hobbled by a major fiscal consolidation effort, sluggish productivity and continuing losses of market share, which the sharp drop in the value of sterling will do little to prevent. All in all, growth should gradually pick up by 2014.

In the United States, despite major fiscal consolidation, particularly in 2013, growth will be brisk on the strength of firm private-sector demand. The recovery of the real estate market has been confirmed (see Chart 10) and good progress has been made on reducing households' debt, which should boost their consumption. Furthermore, businesses continue to enjoy good margins and low debt, which should help boost the expected recovery through increases in wages and capital expenditure. Ultimately, slower growth will be moderate and limited to 2013, primarily because of the substantial fiscal effort. Growth is expected to pick up in 2014.

In Japan, the growth pattern will be shaped by fiscal policy and should continue to show more strength. The fiscal stimulus package adopted in mid-January, combined with the sharp slide in the value of the yen in the past period and very accommodative monetary policy, should sustain growth in 2013. On the other hand, growth in 2014 will be penalised. The consumption tax increase slated for April is also likely to hamper growth. Ultimately, growth will gradually slow down over the forecast period.

In China, after slowing down in 2012, growth should pick up again on the strength of large-scale infrastructure projects for transport, environmental protection and urban development carried out by local and regional governments. The Chinese economy will also be boosted by increased world trade.

Chart 10: Real-estate prices



Sources: Bank of Spain, Bundesbank, VDP, Core Logic, Nationwide, calculations by DG Treasury.

Table 4: Growth forecasts for the leading economies

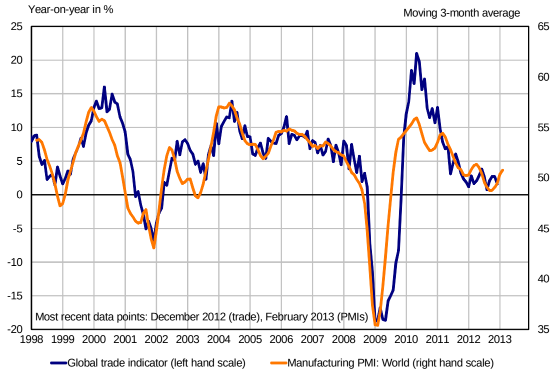
Annual average in %	2011	2012	Forecast	
			2013	2014
GDP				
World	4.2	3.2	3.2	3.9
United States	1.8	2.2	1.8	2.5
China	9.3	7.8	8.2	8.5
Japan	–0.5	2.0	1.2	0.9
Euro area	1.4	–0.6	–0.3	1.4

Sources: DataInsight, forecasts by DG Treasury.

3. The gradual recovery in world trade should amplify the recovery

Global growth will also be driven by the gradual recovery in world trade. In 2012, world trade slowed down sharply (see Chart 11) as domestic demand weakened in the euro area and the growth of emerging economies faltered. Trade growth in 2012 stood at 2%, compared to 6% in 2011. It should bounce back up to 3.75% during 2013, driven by the gradual recovery expected in the euro area and stronger growth in China.

Chart 11: Global trade indicators

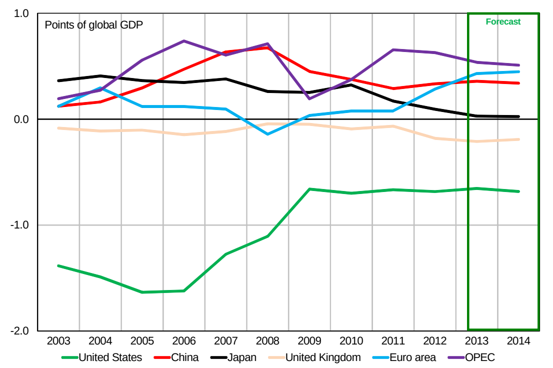


Sources: CPB, Markit.

Slower global growth in 2012 accentuated global imbalances.

In 2012, global imbalances widened slightly. Current account imbalances were still far smaller than before the crisis (see Chart 12). In 2012, the euro area's surplus posted a big increase of more than one point of GDP, primarily because of weaker domestic demand and stronger exports. The current account surplus was shared by the countries from the North and the South of the euro area. The counterpart to the euro area's larger surplus was a smaller surplus on Japan's current account, which had already been affected by the Sendai earthquake, and a larger deficit in the United Kingdom. The United States' current account deficit was stable in 2012 as the oil balance improved with the increase in domestic oil production, counterbalancing the deepening deficit on non-oil trade.

Chart 12: Current account balances - World



Sources: IMF and DG Treasury.

4. Multiple threats to global growth

The economic scenario presented here is surrounded by uncertainty and risks. Private drivers of growth could be more dynamic than expected, especially in the United States and Germany. In the United States, the very comfortable financial situation of businesses could lead to an increase in investment or wages. The real estate and automotive markets should continue to recover. In Germany, businesses' comfortable position may make them willing to grant larger wage increases. Combined with a balanced government budget, this situation provides flexibility for boosting domestic demand, as uncertainty dissipates and credit terms remain very favourable.

On the downside, a resurgence of long-lasting financial tensions in the euro area could make investors fearful.

The risk related to oil prices in the financial assumptions[3] is balanced. After peaking at USD119 in mid-February, the price of a barrel of Brent fell to USD110 on average in the first three weeks of March. A resurgence in geopolitical tensions, with Iran and North Africa, along with fairly positive growth indicators in China and Japan, have keep prices firm. On the other hand, the oil market fundamentals are still good and could keep prices down.

Pierre LISSOT and Amine TAZI

(3) In the projections, the EUR/USD exchange rate is assumed to remain at 1.31, which is its average value from 20 February to 5 March, and the price of a barrel of Brent is assumed to be USD114.

Publisher:

Ministère de l'Économie, et des Finances et Ministère du Commerce Extérieur

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English translation:

Centre de traduction des ministères économique et financier

Layout:

Maryse Dos Santos

ISSN 1962-400X

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