

THE WORLD ECONOMY FACED WITH A CHANGE IN SCENARIO. DEVELOPMENTS, OUTLOOK AND RISKS

Article by the Associate Directorate General International Affairs.

Introduction

In 2013 the world economy grew by 3%, practically the same rate as in the previous year. The advanced economies grew by 1.3%, while the GDP of the emerging market economies rose by 4.7%, down 0.1 pp and 0.2 pp respectively from 2012. The similarity of these figures masks, however, notable changes in the global economic scenario.

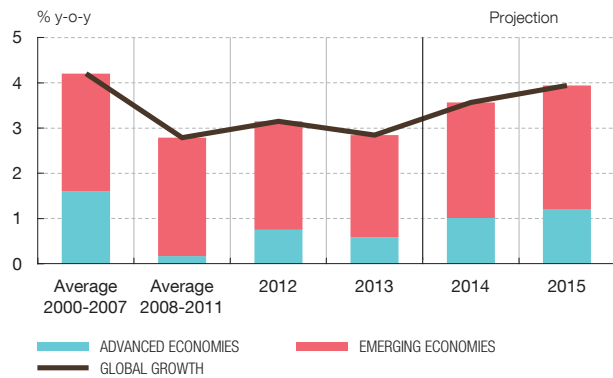
Firstly, as regards their contribution to world dynamism and to the perception of vulnerabilities, the advanced and emerging market economies have switched roles (see Chart 1). The former, led by the United States, have seen recoveries which have firmed at different speeds and intensities, after similarly uneven progress in the adjustments imposed by the crisis and in the correction of past imbalances. Also, the uncertainty derived from the external risks which had been weighing upon these economies, particularly the euro area, has tended to dissipate, giving rise to lower financial volatility. By contrast, the emerging market economies, which held up fairly well during the crisis and recovered with notable vigour, attracting strong capital flows, have seen a slowdown in activity as their economic outlook and investors' perceptions worsened. In this setting, many vulnerabilities have emerged, some built up during the boom and masked in the recovery.

The second change is in the monetary policy stance of the major economies which, particularly in the case of the US Federal Reserve System (the Fed), anticipates the beginning of the exit from the protracted, ultra-expansionary and unconventional monetary cycle which followed the crisis. In some countries (particularly the United States and the United Kingdom), this new phase is associated with the prospects of recovery and the process of economic and financial normalisation, and has arisen in a setting of low inflation, despite the monetary stimuli of the last few years. In any event, the stage of stimulus withdrawal will take place in a monetary policy framework featuring revamped communication strategies (forward guidance) designed to steer more effectively the expectations as to future interest rates. This change in approach has had a major impact on financial markets. Specifically, the announcement of the possible easing of asset purchases by the Fed (tapering) triggered a period of financial volatility and prompted a re-assessment of market risks which particularly affected certain segments, such as emerging markets. This response to decreasingly lax global financial conditions was largely unexpected, but may inspire greater caution among investors and agents and better discrimination between countries and segments based on the quality of their fundamentals.

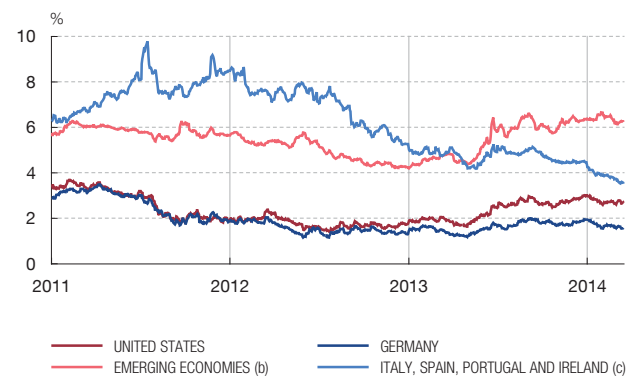
Finally, note should be taken of the development of a financial environment characterised by two features: a fall-off in banking activity accompanied by the corresponding expansion of financing through the capital markets, and a reduction in international financing flows.

The remainder of the article reviews recent economic developments, analyses in more detail the basic features of the change in scenario at global scale and describes the outlook for the current year, when growth is expected to accelerate in the developed economies and to steady in the emerging market economies, with greater downside risks in the latter.

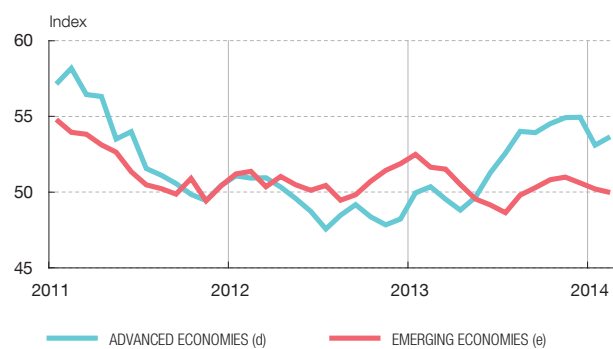
GLOBAL GROWTH AND CONTRIBUTIONS BY AREA (a)



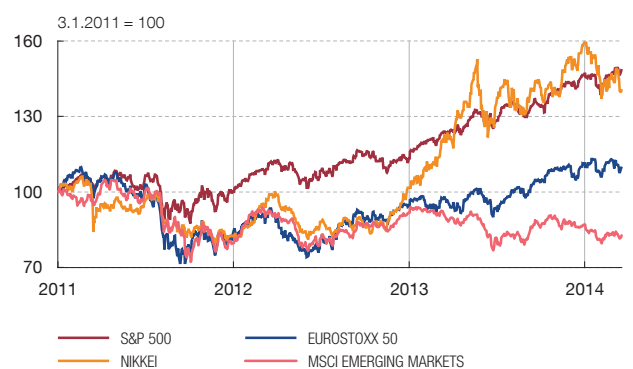
TEN-YEAR INTEREST RATE



MANUFACTURING PMI



STOCK MARKET DEVELOPMENTS



SOURCES: IMF, Datastream-Thomson Reuters, JP Morgan and Markit Economics.

- a IMF aggregates.
- b The rate for the emerging economies is calculated by adding the spread of the EMBI+ Composite to the US interest rate.
- c Simple average.
- d United States, euro area, Japan, United Kingdom, Australia and Switzerland.
- e China, India, Russia, Brazil, Mexico, Turkey, Poland and Czech Republic.

Economic and financial developments

In 2013 and 2014 to date, the world economy has passed through various phases. 2013 commenced with expectations of global recovery and a favourable climate in the international financial markets, in line with the mitigation of some extreme risks. These risks were associated mainly with the sovereign debt crisis in the euro area and with the so-called “fiscal cliff” in the United States, an issue on which a solution, albeit partial, temporary and with strong contractionary effects, was reached on the first day of the year. The position of the central banks, based on keeping interest rate expectations anchored at low levels for a protracted period to promote a firmer recovery in the developed economies, was a supporting factor.

In the months up to mid-May, signs of reactivation of the global economy were perceptible, although they were moderate and diverged significantly across regions (see Table 1 and Chart 2). Activity became progressively more dynamic in the advanced economies, although the United States posted low growth rates and the euro area remained in recession until the first quarter of the year. By contrast, activity in the emerging market economies slowed somewhat and its growth, albeit with notable divergences across areas, tended to stand below expectations. In particular, towards end-March fears of an abrupt slowdown in the Chinese economy re-emerged following a sequence of unfavourable

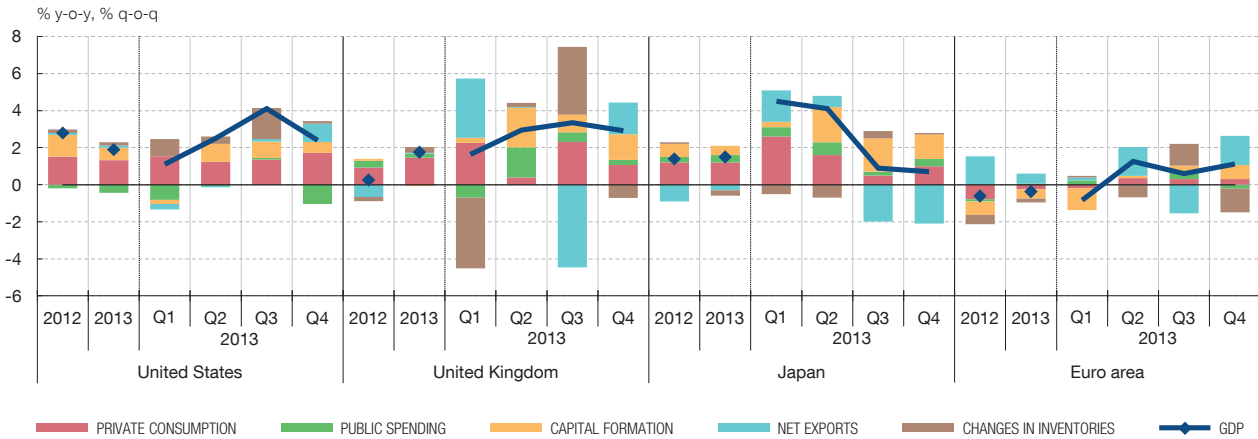
MAIN MACROECONOMIC INDICATORS
TABLE 1

	2010	2011	2012	2013	2012				2013			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
United States												
GDP (% y-o-y)	2.5	1.9	2.8	1.9	3.3	2.8	3.1	2.0	1.3	1.6	2.0	2.5
CPI (% y-o-y) (a)	1.6	3.2	2.1	1.5	2.8	1.9	1.7	1.9	1.7	1.4	1.6	1.2
Current account balance (% of GDP)	-3.0	-2.9	-2.7	-2.3	-3.0	-2.7	-2.6	-2.5	-2.5	-2.3	-2.3	-1.9
General government balance (% of GDP)	-10.5	-9.4	-8.4	-5.8	-8.3	-8.7	-8.4	-8.1	-6.5	-5.1	-6.4	-5.2
Net public debt (% of GDP)	62.8	67.3	71.3	73.6	67.6	68.3	68.9	70.5	72.1	71.4	70.8	72.3
Euro area												
GDP (% y-o-y)	1.9	1.8	-0.6	-0.4	-0.2	-0.5	-0.7	-1.0	-1.2	-0.6	-0.3	0.5
HICP (% y-o-y) (a)	1.6	2.7	2.5	1.4	2.7	2.5	2.5	2.3	1.9	1.4	1.4	0.8
Current account balance (% of GDP)	0.1	0.1	1.3	2.3	-0.2	1.1	1.8	2.6	1.0	2.4	2.0	3.6
General government balance (% of GDP)	-6.2	-4.2	-3.7	-	-	-	-	-	-	-	-	-
Net public debt (% of GDP)	65.6	68.2	72.2	74.9	-	-	-	-	-	-	-	-
United Kingdom												
GDP (% y-o-y)	1.7	1.1	0.3	1.8	0.6	0.0	0.2	0.2	0.7	1.8	1.9	2.7
CPI (% y-o-y) (a)	3.3	4.5	2.8	2.6	3.5	2.7	2.4	2.7	2.8	2.7	2.7	2.1
Current account balance (% of GDP)	-2.7	-1.5	-3.7	-	-3.1	-4.4	-3.6	-3.8	-4.7	-1.5	-5.1	-
General government balance (% of GDP)	-10.0	-7.8	-6.2	-5.8	-7.8	-5.9	-6.0	-6.2	-5.3	-6.1	-6.0	-5.8
Net public debt (% of GDP)	65.0	70.4	74.4	75.7	70.9	71.4	72.4	74.4	73.8	74.3	74.5	75.7
Japan												
GDP (% y-o-y)	4.7	-0.5	1.4	1.5	3.2	3.2	-0.2	-0.3	0.0	1.2	2.3	2.6
CPI (% y-o-y) (a)	-0.7	-0.3	0.0	0.4	0.3	0.2	-0.4	-0.2	-0.6	-0.3	0.9	1.4
Current account balance (% of GDP)	3.9	2.1	1.1	0.7	1.6	1.5	1.2	1.1	0.9	1.0	1.0	0.7
General government balance (% of GDP)	-7.5	-7.9	-8.2	-	-8.8	-8.7	-8.3	-8.2	-7.6	-7.6	-7.3	-
Net public debt (% of GDP)	113.9	127.1	130.7	-	122.4	129.9	133.5	131.5	129.5	127.6	129.6	-
China												
GDP (% y-o-y)	10.4	9.3	7.7	7.7	8.1	7.6	7.4	7.9	7.7	7.5	7.8	7.7
CPI (% y-o-y) (a)	3.3	5.4	2.7	2.6	3.8	2.9	1.9	2.1	2.4	2.4	2.8	2.9
Current account balance (% of GDP)	4.0	1.9	2.3	2.0	2.1	2.2	2.5	2.3	2.6	2.5	2.1	2.0
General government balance (% of GDP)	-2.5	-1.8	-1.5	-1.9	-2.2	-2.2	-2.8	-1.5	-1.7	-1.7	-1.4	-1.9
Emerging Asia (excluding China) (b)												
GDP (% y-o-y)	8.3	5.9	4.6	4.4	4.7	4.3	4.1	5.2	4.1	5.2	4.2	4.2
CPI (% y-o-y) (a)	7.6	6.6	6.1	6.9	5.3	6.6	6.2	6.3	6.2	6.3	7.1	6.5
Current account balance (% of GDP)	0.9	0.4	-1.2	-	-0.2	-0.5	-0.7	-1.2	-0.7	-1.2	-1.3	-
General government balance (% of GDP)	-1.9	-3.4	-2.8	-	-2.5	-2.8	-3.1	-2.8	-3.1	-2.8	-2.5	-
Latin America (c)												
GDP (% y-o-y)	6.2	4.5	2.9	-	3.6	2.8	2.5	2.9	1.9	3.5	2.8	-
CPI (% y-o-y) (a)	4.0	4.8	4.5	4.5	4.7	4.3	4.5	4.4	4.5	4.9	4.4	4.3
Current account balance (% of GDP)	-0.9	-1.0	-1.6	-	-1.0	-1.3	-1.4	-1.6	-2.1	-2.3	-2.5	-
General government balance (% of GDP)	-2.2	-2.1	-2.3	-	-2.0	-1.8	-2.0	-2.1	-2.0	-2.2	-2.6	-
Eastern Europe (d)												
GDP (% y-o-y)	1.9	3.2	0.8	1.3	1.8	1.0	0.3	0.1	0.2	0.6	1.8	2.6
CPI (% y-o-y) (a)	3.0	3.8	3.7	1.4	3.8	3.6	4.0	3.4	2.2	1.5	1.2	0.7
Current account balance (% of GDP)	-3.1	-3.6	-3.1	-	-3.8	-3.1	-2.9	-2.5	-2.0	-1.2	-0.9	-
General government balance (% of GDP)	-6.5	-3.7	-3.4	-	-	-	-	-	-	-	-	-
Memorandum item: GDP growth (e)												
World (% y-o-y)	5.2	3.9	3.1	3.0	3.7	3.2	2.9	2.9	2.5	2.7	3.2	-
Advanced economies (% y-o-y)	3.0	1.7	1.4	1.3	2.0	1.7	1.3	0.8	0.5	1.1	1.5	2.1
Emerging economies (% y-o-y)	7.5	6.2	4.9	4.7	5.8	5.2	5.0	5.6	4.9	4.8	5.3	-
Memorandum item: inflation (a) (e)												
World (% y-o-y)	3.6	4.8	4.0	3.8	3.6	3.2	3.0	3.1	3.1	3.0	3.2	3.1
Advanced economies (% y-o-y) (a)	1.5	2.7	2.0	1.4	2.4	1.9	1.8	1.8	1.5	1.3	1.5	1.2
Emerging economies (% y-o-y) (a)	5.9	7.1	6.0	6.1	5.0	4.9	4.7	4.7	5.1	5.1	5.4	5.5

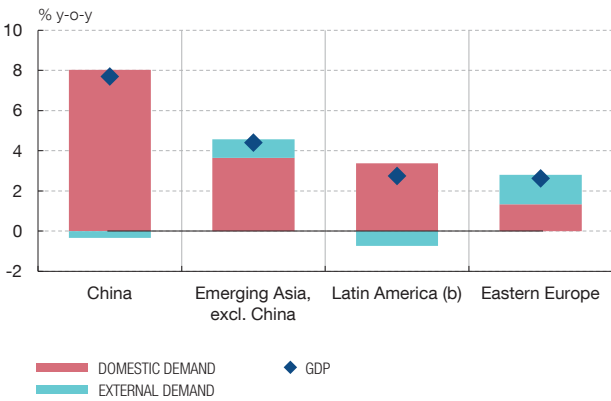
SOURCES: IMF, Banco de España, Eurostat and national statistics.

- a Quarterly CPI is quarter average.
b Emerging Asia includes: China, India, South Korea, Indonesia, Thailand, Malaysia, Philippines, Hong Kong and Singapore.
c Latin America: Brazil, Mexico, Argentina, Colombia, Venezuela, Peru and Chile. Argentina and Venezuela are excluded for the CPI aggregate, and Venezuela for the general government balance.
d Eastern Europe: Poland, Czech Republic, Rumania, Hungary, Bulgaria, Croatia, Lithuania and Latvia.
e The annual data reflect the IMF's latest publicly available forecasts at the time of this report going to press. The quarterly data are calculated using a sample of 41 economies (17 advanced and 24 emerging) that account for almost 90% of world GDP, weighted on the basis of their weight in PPP. All the economies referred to in notes b, c and d are included in the sample.

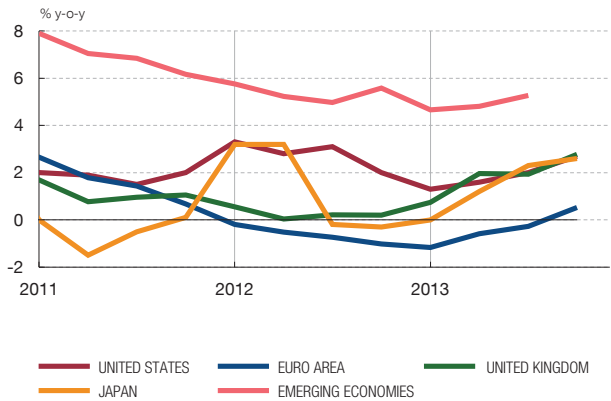
CONTRIBUTION TO QUARTER-ON-QUARTER GDP GROWTH IN ADVANCED ECONOMIES



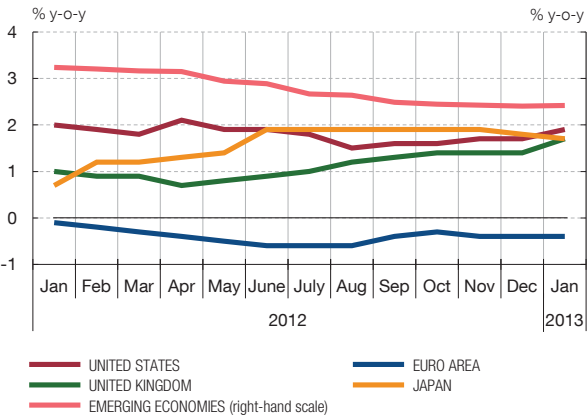
CONTRIBUTIONS TO GDP GROWTH IN 2013. EMERGING ECONOMIES



YEAR ON YEAR GDP GROWTH



GROWTH PROJECTIONS FOR 2013



VOLATILITY INDICES



SOURCES: IMF, national statistics, Consensus Forecast, CEIC and Datastream-Thomson Reuters.

- a For breakdown of countries, see notes to Table 1.
- b Calculated on the basis of the first three quarters of 2013.

figures and the exacerbation of certain imbalances, such as high credit growth, which prompted the adoption of stimulus measures a few months later. These misgivings contributed to declines in commodity prices, notably of industrial metals, and prompted downward revisions of growth prospects in the emerging regions.

Along with the healthy tempo shown by the financial markets as a whole, and as a new development contrasting with previous years, the developed markets outperformed the emerging markets. This feature lasted the whole year, along with a trend towards lower volatility. The sound performance of markets (mainly the advanced ones) persisted despite the emergence of some sources of tension such as the Cyprus crisis, which had a modest and localised impact. Meanwhile, sovereign yields dropped in the advanced economies and rose slightly in the emerging ones, where nevertheless fixed-income issues and inflows into bond funds and stock markets continued to post historical highs.

At end-May 2013 the world economy moved into a new phase, prompting the Fed to expressly announce that it might gradually reduce the pace of asset purchases (tapering) in the ensuing months (see the section below on monetary policy in the advanced economies). This announcement gave rise to a stage of financial market instability extending to the end of the summer in which the unfavourable course of the emerging markets was aggravated markedly. At the centre of the turmoil was the rise in advanced-economy government bond yields on the back of expectations of the normalisation of monetary conditions, along with the widespread upturn in volatility. The emerging markets, which were already being affected by the slowdown in activity, saw substantial rises in sovereign spreads, stock market falls, exchange rate depreciations, capital outflows and slowdowns in fixed-income issues. These movements were initially across the board, but gradually differences between countries became apparent, determined by the relative weakness of their fundamentals. This bout of uncertainty was further fuelled by the liquidity tensions in the Chinese interbank market and by the geopolitical tension in Syria.

The sharp reaction of the financial markets to the expectation that it would start to withdraw monetary stimuli forced the Fed to clarify its strategy in order to redirect expectations about its next decisions. The decision in its September meeting to hold unchanged its asset purchase programme, against a background of heightening fiscal conflict, gave rise, from the middle of that month, to a decrease in volatility and risk aversion, to a step-up in the search for returns and to a certain improvement in emerging markets.

That final stage of the year, characterised by financial market recovery, was also marked by improved behaviour of activity in the advanced economies (basically driven by domestic demand), whose growth rate in the second half of the year exceeded expectations, particularly in the United States and United Kingdom. This development tended to offset the impact on world growth of the slowdown in the emerging market economies, which, in the case of Asia, tended to steady late in the year. The year concluded with a favourable market climate, low volatility and lower uncertainty as to the course of economic policies in the short term. Indeed, when it was finally decided in December to commence tapering, the markets reacted favourably in view of the expectations of recovery in the advanced economies and of stabilisation in the emerging market economies.

The start of 2014 has however been marked by a fresh bout of turbulence in the emerging markets, which initially again had a widespread impact, although this time the differences between countries very quickly became apparent. On this occasion the turbulence was prompted by events which, a priori, were of limited importance, such as the exchange rate

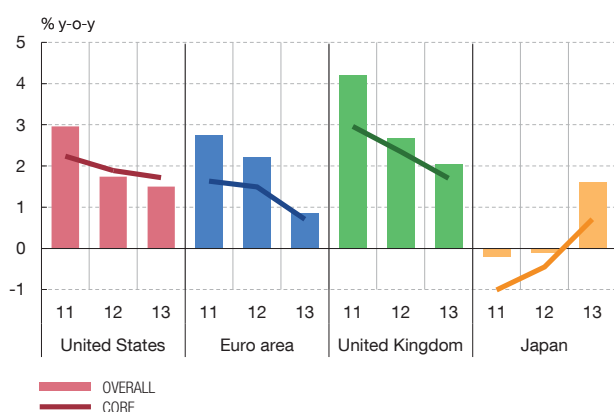
tensions in Argentina (a country without access to the global financial markets) against a backdrop of fresh signs of weakness in activity and of risk to financial stability in China. Although the turbulence was short-lived, the succession of somewhat worse-than-expected economic data and the tension in Ukraine contributed to cooling the bright economic and financial expectations with which the year had begun.

To sum up, in 2013 the global economy grew at a rate similar to that in the previous year (3% compared with 3.1%), although there was notable regional heterogeneity and marked fluctuations in the momentum of activity. The advanced economies grew by an annual average of 1.3% in 2013 (1.4% in 2012), although their year-on-year growth rose from 0.8% in 2012 Q4 to more than 2% in 2013 Q4 as a result of the progressively stronger activity. The improvement in activity was driven basically by domestic demand (mainly private consumption and, in Japan, also public investment) except in the euro area. Although the pattern of gradual acceleration was the norm, the different starting points are reflected in divergences in annual growth rates, which ranged from 1.9% in the United States and 1.8% in the United Kingdom to 1.5% in Japan (in this case with a downward trend) and -0.4% in the euro area, becoming positive in Q4 for the first time since 2011.

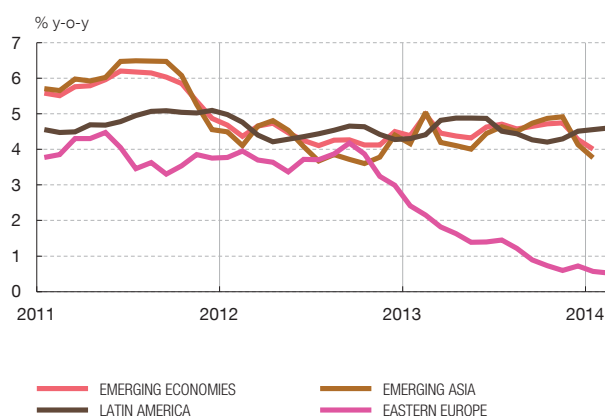
The emerging market economies grew by 4.7% in 2013 (4.9% in 2012) and did not have such a definite time pattern as the advanced economies, except for the new EU Member States (whose cycle is more closely linked to that of the euro area), which did manage a slow recovery. The growth of the emerging market economies continued to be based on the expansion of domestic demand, although a certain moderation with respect to the previous year was apparent. The activity of the Asian economies generally showed a slightly downward path in the first part of the year, which tended to reverse subsequently, while in Latin America there was no definite trend in the year. The relative vigour of the emerging regions in 2013 was similar to that in the previous year: China grew by 7.7%, the rest of emerging Asia by 4.4%, Latin America by around 3% and the new EU Member States by 1.3%. There was notable heterogeneity within Latin America, with less-than-expected growth by Brazil and Mexico, significant deterioration in Argentina and Venezuela and ongoing relatively robust growth in Chile, Colombia and Peru.

Turning to prices, the ongoing reduction in inflation rates in the advanced economies in 2013 is striking, against a background of recovery in growth and highly accommodative monetary policies. At end-2013 the overall inflation rate stood at 2% in the United Kingdom, at around 1.5% in the United States and below 1% in the euro area. All these rates are lower than in 2012, being more than 1 pp less in the case of the euro area. By contrast, the inflation of 1.6% in Japan was a big departure from the negative rates of previous years (see Chart 3). In the emerging market economies inflation was more uneven, with low rates in eastern Europe (possibly due to weak demand from the euro area) and relatively moderate rates in Asia and Latin America. However, some countries, such as Brazil, India, Indonesia and Turkey, ended the year with rates between 6% and 9%, partly as a result of the depreciation pressures on their currencies at different times of the year. Contributing to the inflation behaviour in the advanced economies were the negative output gaps and the reversal of the impact of the indirect tax rises of previous years (in the United Kingdom and certain euro area countries) and, more generally, the moderation of commodity prices, with falls in food and metals. Particularly striking in this respect is the steadiness of oil prices since the beginning of 2013. The Brent oil price stood at around USD 110 per barrel, in line with the average for the last three years, which is consistent with the adjustment of OPEC production in response to various shocks: changes in the demand outlook of the emerging

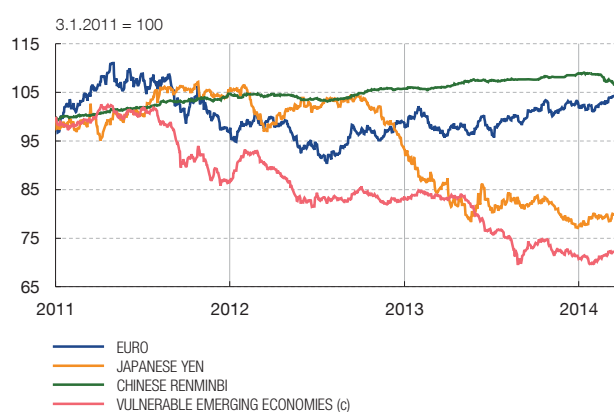
CONSUMER PRICES IN ADVANCED ECONOMIES (a)



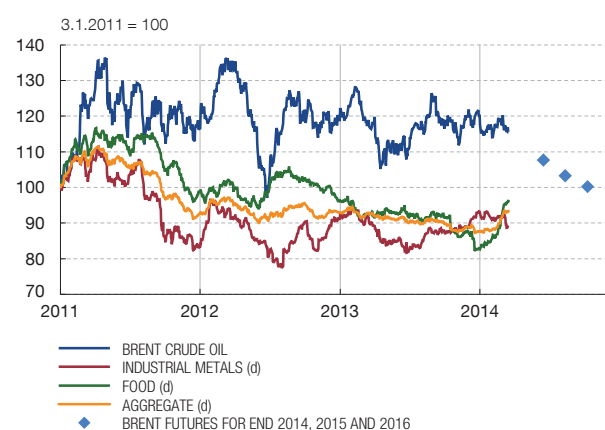
CONSUMER PRICES IN EMERGING ECONOMIES. OVERALL INDEX (b)



EXCHANGE RATE AGAINST US DOLLAR



COMMODITY PRICES



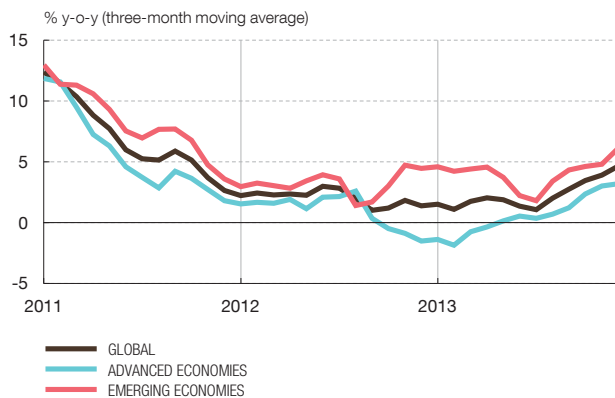
SOURCES: IMF, OECD, Eurostat, Datastream-Thomson Reuters, national statistics and Commodity Research Bureau.

- a Year-end data.
 b For breakdown of countries, see notes to Table 1.
 c Vulnerable emerging economies include Brazil, India, Indonesia, Turkey and South Africa.
 d Indices prepared by the Commodity Research Bureau.

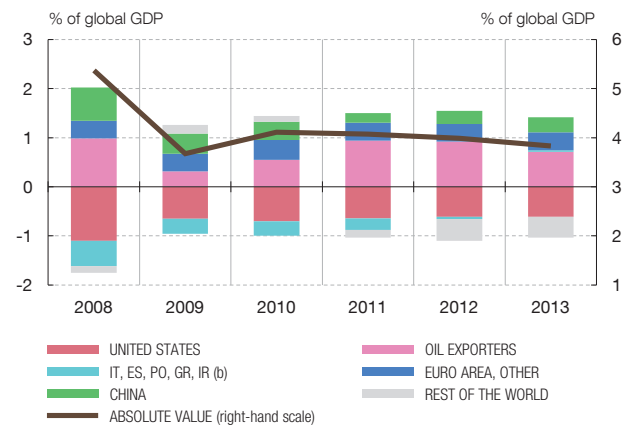
market economies, fluctuations in supply for geopolitical reasons and, in particular, the substantial increase in oil production from unconventional sources (shale oil) in the United States and Canada, which is becoming a significant factor in oil market dynamics.

Finally, world trade again showed notable weakness in 2013, in line with the behaviour of global activity, and only grew by 2.9% (1.9% in 2012), moving on a decelerating path until mid-year. It then recovered somewhat in both the advanced and the emerging market economies, ending the year at growth rates slightly above 4% which are expected to continue in 2014 (see Chart 4). In 2013 an agreement with the World Trade Organisation to simplify customs formalities was reached in Bali and regional initiatives were stepped up, including most notably a possible agreement between the United States and the European Union, and the Trans-Pacific Agreement. Against this background, the trend of global imbalances to diminish slightly continued. Most notable was the smaller surplus of oil exporting countries and, contrastingly, the higher surplus of the euro area, basically reflecting a contraction in the imports of economies under financial stress against a background of limited restructuring of demand in the surplus economies. The expectations of normalisation in the euro area, the trimming of the US energy deficit (due to the surge in

TRADE VOLUME (EXPORTS) (a)



CURRENT ACCOUNT BALANCE BY AREA



SOURCES: IMF, Datastream-Thomson Reuters and CPB Netherlands Bureau for Economic Policy Analysis.

- a The aggregates of the CPB Netherlands Bureau for Economic Policy Analysis are taken.
 b Italy, Spain, Portugal, Greece and Ireland.

unconventional hydrocarbons) and the possible containment of the Chinese surplus as its growth model refocuses on domestic demand, suggest that the imbalances will remain contained in the short and medium term.

Basic features

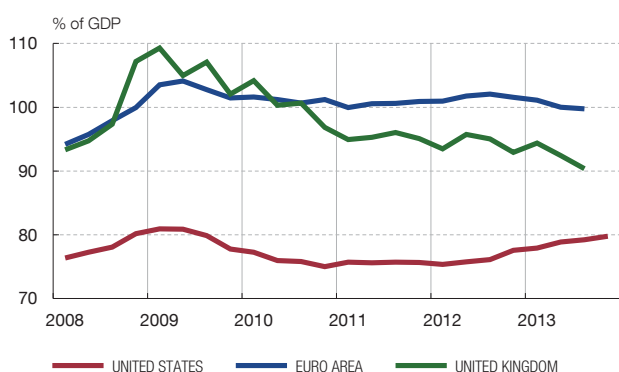
IMPROVEMENT IN THE ADVANCED ECONOMIES' FUNDAMENTALS

The protracted process of profound adjustment after the crisis in the developed economies followed its course in 2013 and, in some cases, is now at a highly advanced stage (see Chart 5). In particular, in the United States the headway made in this process brought an improvement in the economic fundamentals which was necessary as a platform for a more sustainable and ongoing recovery. The main areas in which this progress is apparent are the balance-sheet clean-up in the private sector, the gradual recovery of the real estate market, the process of fiscal consolidation and the reduction of the high unemployment rates.

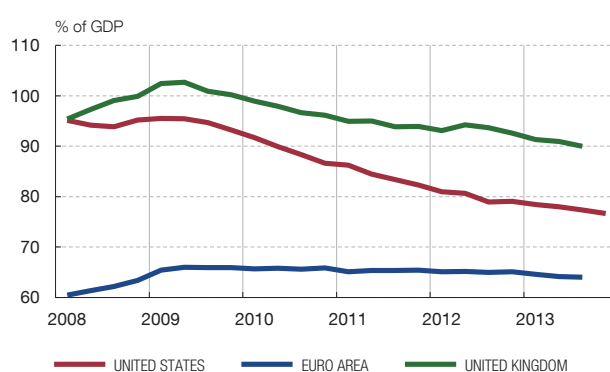
This progress, along with the mitigation of the serious tail risks weighing on the world economy in the last few years, and the more predictable nature of economic policies have made for lower financial market uncertainty and, more generally, improved confidence in economic agents, in a process that has had a positive feedback loop over the past year.

As regards the clean-up of household and corporate balance sheets in the most indebted countries, the process of adjustment of the last five years has enabled debt ratios to be pruned considerably, albeit with differences in the pace and manner of that adjustment. Thus, since the beginning of 2009 household debt has decreased by 19 pp of GDP in the United States and by 12 pp in the United Kingdom to 76% and 91% of GDP, respectively. The debt ratio of non-financial corporations has fallen in the United Kingdom, from 110% to 91% of GDP, over the same period, whereas in the United States, where it started from a relatively low level, it has risen in the last year-and-a-half, in line with the more favourable behaviour of credit in that economy, from 75% to 80% of GDP. These changes contrast with the slow pace of deleveraging in the euro area as a whole, where the correction of household and corporate debt ratios has been scarcely 4 pp and 1 pp of GDP, respectively. However, households started from a generally sounder position, and in the economies under greater financial stress the adjustment has been sharper.

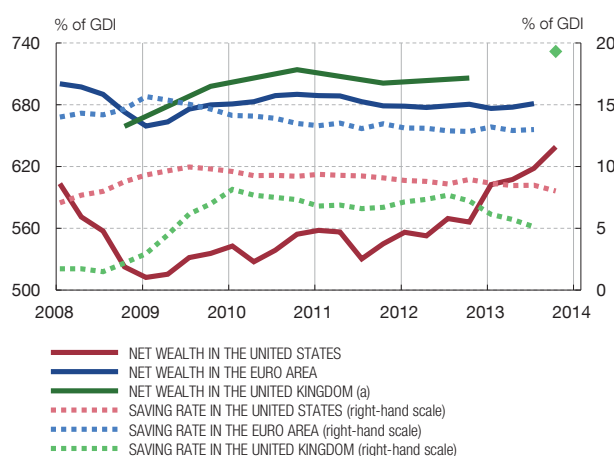
DEBT OF NON-FINANCIAL CORPORATIONS



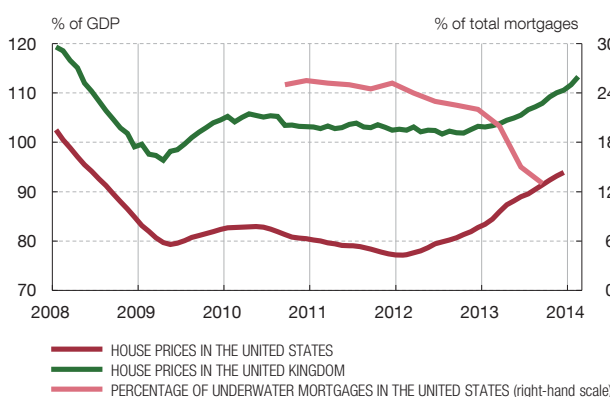
HOUSEHOLD DEBT



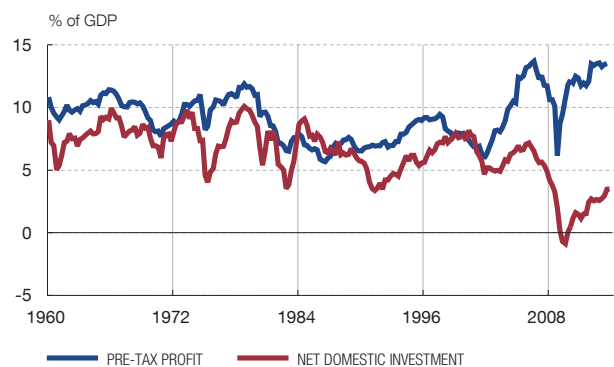
NET WEALTH AND HOUSEHOLD SAVING RATE



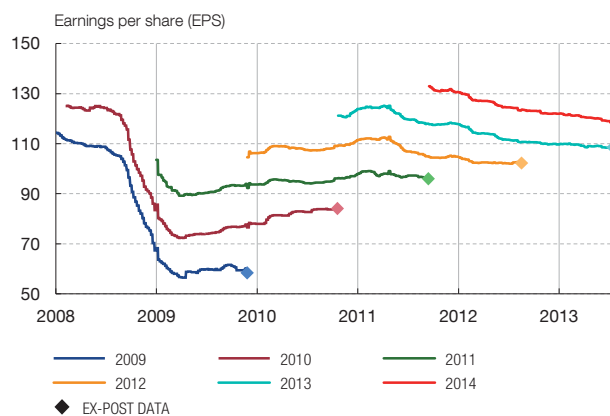
HOUSE PRICES AND UNDERWATER MORTGAGES



PRE-TAX PROFIT AND NET INVESTMENT IN THE UNITED STATES



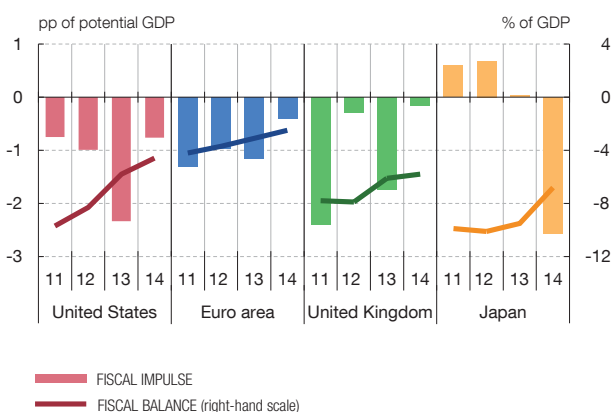
PROFIT EXPECTATIONS IN THE UNITED STATES



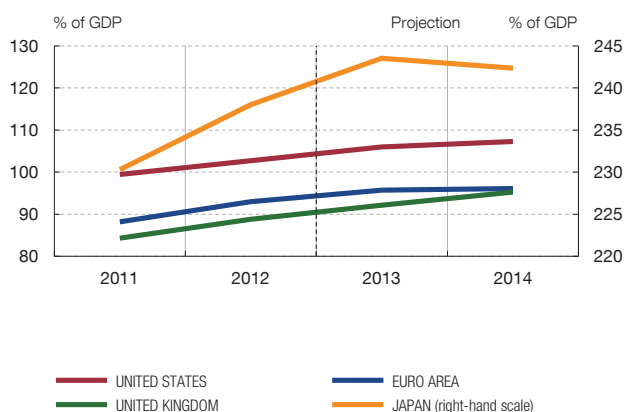
SOURCES: National statistics, IBES and Standard & Poors Case-Shiller.

a The data for 2013 shows an estimation based on the expected growth of net wealth and disposable income.

FISCAL BALANCE AND IMPULSE (2011-2014) (a)



PUBLIC DEBT



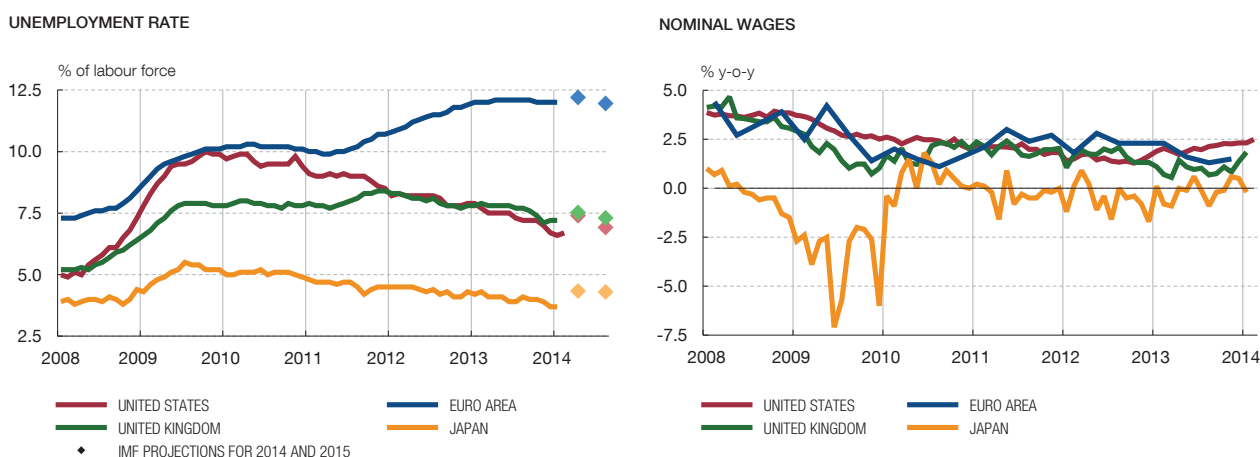
SOURCE: IMF.

a The data for 2013 and 2014 are IMF projections. Fiscal impulse is defined as the change in the cyclically-adjusted general government balance.

The reduction of debt ratios, along with lower interest rates, has made for a lighter financial burden and a rise in household and corporate wealth, thanks to strongly performing financial markets and higher real estate prices. Thus, for example, in both the United States and the United Kingdom the ratios of wealth to disposable income are above their levels before the crisis. This has boosted private consumption and meant that household saving rates, which rose after the crisis, have fallen back in the past year. In the euro area, the increases in household net wealth and hence its impact on consumption were limited, against a background in which the saving rate remained unchanged. The liquidity position and profits of firms have also improved substantially in recent years (in the United States the ratio of profit before tax to GDP is at the highest level in fifty years), which, added to the more favourable financial conditions and to the lower uncertainty, should help to drive corporate investment, which has lacked force in the recovery of most of the advanced economies.

For most of 2013 the gradual recovery of real estate markets continued in some of the countries hardest hit by adjustments after the crisis, such as the United States and the United Kingdom. To the improvement in demand and supply indicators was added the rise in house prices, which allowed an increase in household wealth and a substantial reduction in the percentage of mortgages whose value exceeded that of the house (underwater) in the United States. Although the announcement that tapering may be started in May prompted an increase in mortgage interest rates and a certain fall in mortgage applications, generally the prospects of recovery for the US real estate sector remain firm. In the United Kingdom, the reactivation of the market manifested itself mainly in demand and in prices, thanks partly to stimuli under government support programmes, such as the general Funding for Lending Scheme (FLS) and Help to Buy, which is focused on housing. Supply, however, responded less strongly, prompting the UK authorities to announce a battery of measures to contain the risks which may derive from accelerating house prices and to refocus the FLS programme solely on corporate loans. In the euro area, by contrast, in 2013 house prices continued to fall, albeit more moderately, in the countries which started out from more marked over-valuations in this market.

Another area in which headway has been made in recent years is that of fiscal consolidation (see Chart 6). The developed economies reduced their government deficit by 1.5 pp of



SOURCES: IMF, Eurostat and national statistics.

GDP in 2013 (with a similar reduction in cyclically adjusted terms) and in 2014 the adjustment is expected to be somewhat less, at 1 pp. The exception to this pattern is Japan, where the adjustment will be much larger this year and the next, owing to the planned increase in the tax on consumption, although the contractionary impact will be mitigated by off-setting fiscal packages. Fiscal developments in the United States were again marked by political disagreements, which prompted sharp tax increases and spending cuts (sequester) at the beginning of the year and came to a head in October with the difficulties in raising the ceiling on public debt and the partial shutdown of the Federal administration due to the lack of agreement on extending the budget, although the tensions caused by this conflict affected the financial markets less than on previous occasions. Although the recent fiscal agreements in the United States seem to mitigate one of the main tail risks in the global picture, the high levels of government debt in the developed countries and the absence of medium-term reform plans in some of them (the United States itself and Japan) continue to pose a significant risk to the achievement of a fiscal scenario sustainable at long term.

As to the labour markets, 2013 saw notable decreases in the unemployment rates of the main non-euro area advanced economies, in some cases sharper than in previous years (down in the United States from 7.9% to 6.7%, in the United Kingdom from 7.8% to 7.2% and in Japan from 4.3% to 3.7%; by contrast, in the euro area it remained at around 12%), against a background of ongoing wage moderation (see Chart 7). However, although the declines in the unemployment rate in the United States and the United Kingdom were larger than expected, they were caused by developments which were not totally favourable, such as the sharp fall in the participation rate and the stagnation of the employment rate in the United States, or the poor behaviour of productivity in the United Kingdom. Moreover, these developments have significantly affected the management of monetary policy in these countries, as explained in Box 1 below.

MONETARY POLICY IN THE ADVANCED ECONOMIES

In 2013 monetary policy was again to the fore, this time on account of the prospects for a change in the policy cycle, especially in the United States. Although interest rates remain anchored at very close to zero (see Chart 8), policy trends point to future withdrawal of the large stimuli applied as a result of the crisis, especially in the United States and the United Kingdom. This has opened up a gap between the policy stances of the main central banks,

Forward guidance strategies can take several forms. They can: signal that a specific monetary policy shall be maintained over an indefinite period of time [the Federal Open Market Committee (FOMC) decision in December 2008, or the ECB's recent announcement]; allude to specific dates (from August 2011, the FOMC announced periods over which it would not raise the official rate); or set down arrangements contingent on specific economic variables, such as those adopted by the FOMC in December 2012 and by the Bank of England Monetary Policy Committee (MPC) in August 2013. Strategies based on commitments linked to specific dates pose a problem of time-inconsistency, since the central bank will have incentives to readjust its plans if economic conditions change, failing to fulfil its initial announcement. Contingent strategies, in which the monetary authority's commitment is conditional upon how certain variables evolve (e.g. inflation or the unemployment rate), retain some leeway to react to unexpected events, while they lessen the risk of loss of credibility from acting contrary to what was announced, whereby their attractiveness, a priori.

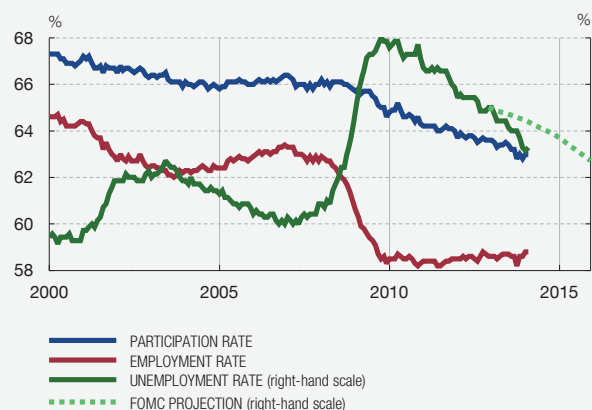
Both the Federal Reserve System (the Fed) and the Bank of England (the BoE) adopted forward guidance strategies based on commitments conditional upon certain variables, such as the unemployment rate and inflation, reaching certain reference values (thresholds). In December 2012, the Fed committed itself to not raising its official rate, provided that the unemployment rate continued to stand above 6.5%, that the one- and two-years-ahead inflation forecast did not exceed 2.5% and that long-term inflation expectations remained well-anchored. In August 2013 the BoE announced that it would maintain its official rate and the amount of the asset purchase programme at least as long as the unemployment rate did not fall to 7%, provided that the inflation

forecast over a horizon of 18 to 24 months did not exceed 2.5%, that medium-term inflation expectations were well-anchored and that the Bank's own Financial Policy Committee did not consider this commitment to pose a threat to financial stability that could not be countered by means of the habitual macroprudential instruments. In both cases, what were involved were necessary but not sufficient conditions, which provided additional headroom to respond to unexpected changes in the economic situation.

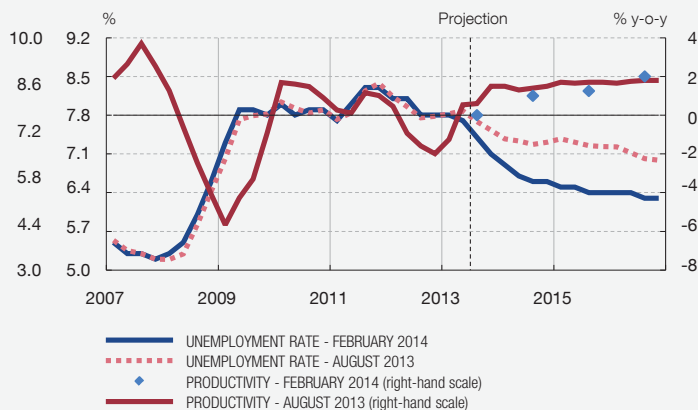
However, over a short space of time, design and communication problems have come to light in both proposals. In particular, the unemployment rates of both countries have drawn close to the established thresholds much earlier than envisaged, in a setting in which their labour markets have evidenced particularities that give rise to considerable uncertainty over the future course of unemployment rates and their relationship to other macroeconomic variables.

The Fed, at the time of introducing contingent forward guidance, projected that the unemployment rate would be close to the 6.5% threshold in the second half of 2015; yet everything points to this figure being reached in the first quarter of 2014 (see the left-hand panel in the accompanying chart). This swift decline in the unemployment rate has not been due to greater job creation but to the sizable fall in the participation rate, which has decreased by 2.7 pp (to 63%, close to its historical low) since the start of the recovery. It is estimated that around 1.4 pp of the decline are attributable to structural factors (such as population characteristics or women joining the labour market); the remainder would be due to conjunctural factors, whose persistence may vary. Debate focuses precisely on which portion of these factors is merely cyclical and on whether a temporary situation may become permanent owing to

PARTICIPATION, UNEMPLOYMENT AND EMPLOYMENT RATES IN THE UNITED STATES



UNITED KINGDOM. UNEMPLOYMENT RATE AND PRODUCTIVITY (a)



SOURCES: Bureau of Labor Statistics, Bank of England, national statistics and Datastream-Thomson Reuters.

a BE calculations based on data from Bank of England inflation reports published in August 2013 and February 2014.

hysteresis effects. This debate is key to determining the extent to which changes in the unemployment rate reflect slack in the economy and is, therefore, pivotal in respect of the Fed's conduct.

In the case of the United Kingdom, the unemployment rate has been closely linked to productivity. Since the onset of the crisis, apparent labour productivity has been markedly weak, which is difficult to explain solely as a temporary mismatch between the responses of output and employment. Some analyses indicate that low productivity reflects an underlying trend in the British economy linked to a shortage of capital, while others relate it rather to demand-side factors. The BoE, by announcing its commitment to forward guidance, assumed that productivity would recover swiftly as demand growth reduced slack, whereby the unemployment rate would reach 7% only at end-2016 (see the right-hand panel of the chart). However, more buoyant economic activity in the United Kingdom in recent quarters has been accompanied by a notable rise in employment and by a scant response by productivity, meaning that the unemployment rate has rapidly drawn closer to the reference threshold and is now expected to reach it in the second quarter of 2014.

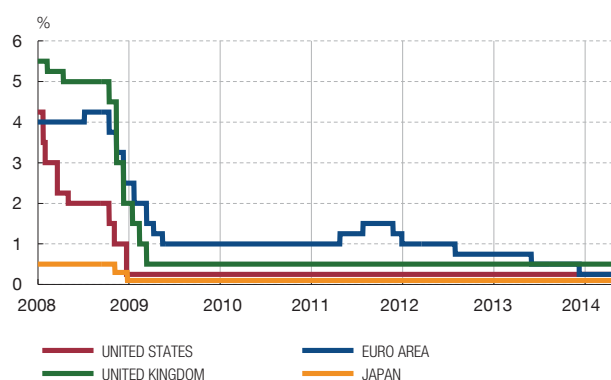
This rapid convergence on the thresholds set has prompted a reformulation of the commitments in place. Both central banks

have once more introduced qualitative elements into their strategies in order to signal that official rates will be held at their current levels beyond the thresholds. Thus, the Fed announced after its December 2013 meeting that it considers it appropriate to maintain the official rate within its current range for a prolonged period once the unemployment rate stands below 6.5%, especially if projected inflation continues to be below 2% (the official target) and, subsequently, at its March 2014 meeting, it abandoned its thresholds for the unemployment rate and inflation expectations, replacing them with a qualitative assessment of indicators of labour market conditions, inflationary pressures and financial stability. The BoE, for its part, stated in its February 2014 *Inflation Report* that it has discarded the unemployment rate as the sole reference of the degree of slack, broadening its set of benchmark indicators. At the same time, it has reformulated its commitment by pointing out that it is necessary to reabsorb such slack before raising the official rate and that, when this comes about, it will be done gradually and that the average for the pre-crisis stage (5%) will not be reached. These two experiences illustrate the complexity of forward guidance strategies based on quantitative references, especially if the degree of uncertainty surrounding the projection of the reference variables is very high, as in the current situation.

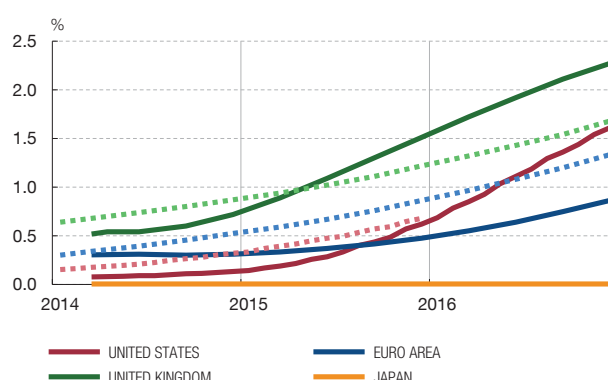
since the Bank of Japan is in the midst of an ambitious new quantitative easing programme (see Chart 2) and the ECB reduced its interest rates again and is currently considering the adoption of further non-standard measures. Notable in the area of policy implementation has been the widespread adoption of forward guidance (see Table 2). These strategies which have been developed recently in Japan and in the United States to provide a greater stimulus when interest rates are close to the zero bound, have encountered design and communication problems in the new phase, in which gradual withdrawal of these stimuli is now discernible.

In the case of the Fed, which had linked its forward guidance to employment developments in December 2012 (see Box 1), a debate began in the spring about the possibility of tapering, in step with the gradual firming of the economic recovery and increasing concern over the diminishing benefits of asset purchases and their possible risks, basically in terms of financial market distortion. In May, the Fed mentioned the possibility of commencing tapering at an upcoming meeting (earlier than the markets had anticipated), if the labour market continued to improve. Specifically, in June, the Fed Chairman suggested that asset purchases might end in mid-2014, when the unemployment rate was expected to have fallen to 7%. These announcements generated some confusion on financial markets, which linked tapering to sooner-than-expected official rate rises, prompting US long-term government bond rates to rise by more than 1% and having a very notable impact on the international financial markets. This stronger-than-expected reaction led the Fed to try to clarify its strategy, uncoupling tapering from possible official rate rises, which were to be guided by the forward

OFFICIAL INTEREST RATES



INTEREST RATE EXPECTATIONS (a)



SOURCES: Federal Reserve, ECB, Bank of England, Bank of Japan and Datastream-Thomson Reuters.

a Solid lines show latest available data and dotted lines show the data as of 4 January 2013.

guidance policy. Specifically, it stressed that the labour market situation remained unsatisfactory and that there would be a gap between the cessation of asset purchases and the commencement of official interest rate rises.

The rise in long-term interest rates prompted by expectations of a reduction in monetary stimuli in the United States affected the interest rates of other developed economies, whose central banks attempted to ring-fence them from these movements, likewise by using forward guidance. The Bank of England (under a new governor) adopted forward guidance in August, establishing an unemployment threshold of 7%; and the ECB did so, on a more qualitative basis, that same month, to adjust agents' expectations of the future path of official rates. These measures and the Fed's decision, in September, not to commence tapering (in view of the moderation in job creation, the tightening of financial conditions and the uncertainty regarding fiscal negotiations) calmed the markets notably. Finally, at its December meeting, the Fed announced that the rate of asset purchases would begin to be reduced from January 2014, from \$85 billion to \$75 billion per month, a reduction of \$10 billion that was repeated at the subsequent January and March meetings.

A notable aspect of the monetary strategies of the main central banks was the difficulty of communicating them satisfactorily. In addition to the negative experience of the Fed, when it indicated its intention to gradually cut asset purchases, problems have arisen from the use of forward guidance strategies conditional upon quantitative thresholds in the United States and the United Kingdom, which have led to the refinement or modification of these strategies in recent months, in view of the faster-than-expected reduction in unemployment, as discussed in Box 1.

EMERGING MARKET ECONOMIES

The year 2013 was characterised by a worsening of perceptions regarding the economic prospects and vulnerabilities of the emerging market economies. This change had its correlate in the unfavourable developments from the beginning of the year, which intensified from May, once the start of the change in the world monetary cycle had been discounted. This change in perceptions seems persistent and is being incorporated into the outlook for these economies (whose potential growth has been revised downwards) and for the world economy over the coming years. The episode of volatility that began in May exposed the main vulnerabilities that have built up in recent years in some countries, in particular those

The Japanese economy has been immersed for two decades in a deflationary process which, despite the various initiatives adopted by the authorities, appeared difficult to break. In December 2012 Shinzo Abe was elected as prime minister, against a background in which the economy was falling into recession for the fifth time in 15 years, public debt exceeded 200% of GDP (see Chart 6 in the main body of the text) and the persistent decline in prices was depressing consumption, confidence and corporate investment. Abe's electoral programme goals included reviving the economy and doing away with deflation, and these were based on a strategy dubbed *Abenomics*, structured on three mutually reinforcing pillars of a monetary, fiscal and structural nature.

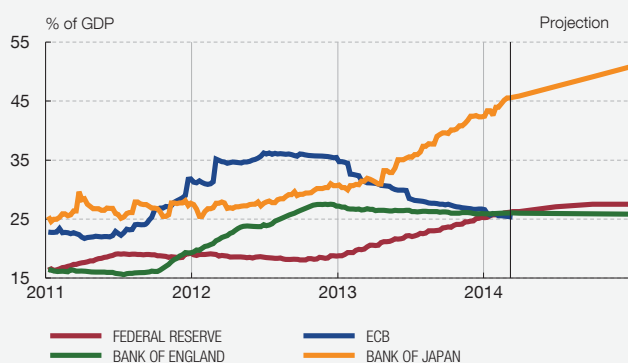
The first pillar was activated with the approval in April 2013, following the appointment of the new central bank governor, of an ambitious monetary easing programme. This was aimed at attaining stable growth in prices, defined as annual inflation of 2% over the course of two years. In this connection, the Bank of Japan announced that it would double the size of its balance sheet in that period by means mainly of government bond purchases (longer-dated bonds than in previous programmes), for an amount of between Yen 60 and 70 trillion per annum. The adoption of additional measures should these goals not be reached was not ruled out. This monetary easing exceeds, in terms of scale, that pursued by other central banks during the crisis; compared with the Federal Reserve System, the Bank of England or the ECB, whose balance sheets stand at around 25% of GDP, that of the Bank of Japan will foreseeably rise to more than 50% of GDP at the end of 2014 (see accompanying panel 1). The monetary easing reinforced the depreciating trend of the yen that began after two monetary easing drives were announced in autumn 2012 and early elections were called, and a cumulative depreciation of 35% had occurred by end-December 2013. This monetary strategy has had a positive bearing on economic activity through two main channels: by stimulating consumption, as a result of the wealth effect associated with the stock market rise; and by impacting exports, through the depreciation. Nonetheless, this latter effect has more

than been offset by dearer energy imports and the increased energy dependence on abroad (the result of the 2011 tsunami and the subsequent nuclear leak at Fukushima), whereby the current account balance worsened to the extent the country was running a deficit in the closing months of 2013.

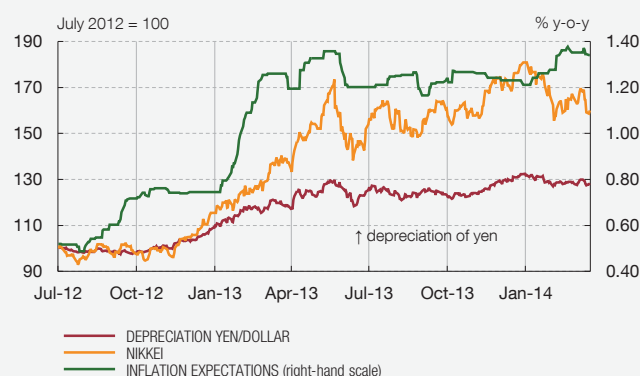
The second pillar consists of a flexible fiscal policy to boost the economy in the short run, with the commitment to restore the sustainability of public debt in the medium and long term. In this connection, a target has been set to halve the deficit in fiscal year 2015 and run a balanced budget in fiscal year 2020. In January 2013 a Yen 10.3 trillion expansionary fiscal package equivalent to 2.2% of GDP was announced, bolstered in December by a new Yen 5.5 trillion programme (1.1% of GDP). The high level of public debt – along with the commitments arising from population ageing – also requires a medium- and long-term consolidation plan. Here, the previous Government had already approved two increases in the tax on consumption, from 5% to 8% in April 2014, and from 8% to 10% in October 2015. The first rise is firm, but the second is subject to the prevailing economic conditions allowing it. The confirmation of the first rise has been criticised owing to its impact on activity, but from the standpoint of fiscal sustainability it cannot be put off. Indeed, the envisaged tax rises are currently clearly insufficient to ensure this sustainability and, although the tax rise has been a step in the right direction, doubts remain over the Government's commitment to meeting its fiscal targets.

The third pillar, focusing on structural reforms, seeks to raise the economy's long-term growth rate. To strengthen this pillar, committees have been set up to monitor the different plans and the reform agenda will be assessed next June. Among the measures envisaged (most have still to be implemented) are the reduction in protectionist rules in sectors such as agriculture, the commercialisation of pharmaceuticals and energy; the elimination of rigidities in the labour market to promote, among other objectives, the incorporation of women; and measures aimed at enhancing education, promoting innovation and eliminating

1 CENTRAL BANK BALANCE SHEETS. TOTAL ASSETS



2 STOCK EXCHANGE, EXCHANGE RATE AND INFLATION EXPECTATIONS



SOURCES: Federal Reserve, ECB, Bank of England, Bank of Japan, Barclays Capital and Datastream-Thomson Reuters.

inefficient regulations. Significantly in this area, Japan finalised in 2013 its entry into the Trans-Pacific Strategic Economic Partnership Agreement, an alliance whose aim is to create a platform conducive to economic integration in the Asia-Pacific region.

One year on from the start of Abenomics, the verdict is still not conclusive. On one hand, the inflation rate has moved into positive territory, standing at a year-on-year rate of 1.4% in January (0.7% in the case of core inflation), while medium-term inflation expectations stand at an annual rate of over 1.3% (see panel 2). However, what is involved is an increase largely driven by the rise in import prices stemming from the depreciation of the yen, whose effects will progressively peter out over the course of the year. Hence the dynamism of domestic prices and, even more so, of wages will be decisive in entrenching the increase in inflation. Along these lines, wages are expected to increase in the Spring bargaining round, while public-sector employees will recover the 10% cut they underwent in the wake of the Fukushima

catastrophe. The depreciation has also contributed to bigger profits for exporting companies which, along with improved confidence, has seen the stock market rise considerably. Further, the fiscal packages introduced have contributed to boosting activity (although the growth rate has dipped in the second half of 2013), and the raft approved at the end of the year is expected to soften the impact of the tax rise, with further monetary impulses not being ruled out. In sum, the fiscal and, above all, monetary measures have exerted notable influence on activity, largely affecting agents' expectations and supporting the expansion of domestic spending. However, these demand-side effects – particularly bearing in mind the need for a forceful medium-term fiscal consolidation drive – will tend to taper off if a strong boost is not given to the pillar for structural reforms, which operate mainly on the supply side. The meagre progress in this respect and the opposition of numerous interest groups to the structural reforms heighten uncertainty over the final outcome of the strategy.

with weaker external positions, such as Brazil, India, Indonesia and Turkey (see Chart 9). Abundant global liquidity and the relative attractiveness of these markets had not only been masking these vulnerabilities, but had also been contributing to them.

At least two reasons can be identified to explain why the emerging countries have been so sensitive to the perceptions of a change in the world monetary cycle:

- First, the emerging market economies had been resilient to the global crisis and saw a strong and rapid recovery between 2008 and 2010, which made them more attractive (in terms of yield and in some cases even risk) relative to the advanced economies. This favourable perception was largely based on a reduction in the traditional vulnerabilities associated with the emerging countries, such as their excessive foreign currency debt, the weakness of their banking systems and artificially overvalued fixed exchange rates. This situation, in combination with the loose liquidity and financing conditions stemming from the ultra-expansionary monetary policies applied by the advanced economies to overcome the crisis, led to heavy flows of finance towards the emerging market economies (at above the long-term trend rate), with a corresponding squeeze on lending spreads, exchange rate appreciation and asset price rises.
- Second, since 2011 there has been a somewhat unexpected deceleration in the main emerging market economies, whose growth rates have repeatedly disappointed the expectations of recovery held by the consensus of analysts. This has eventually led to a significant downward revision of economic forecasts and, more relevantly, of potential growth (of between 0.25 pp and 1.5 pp in the case of the BRICs, according to the IMF). In the specific case of

Central bank announcements

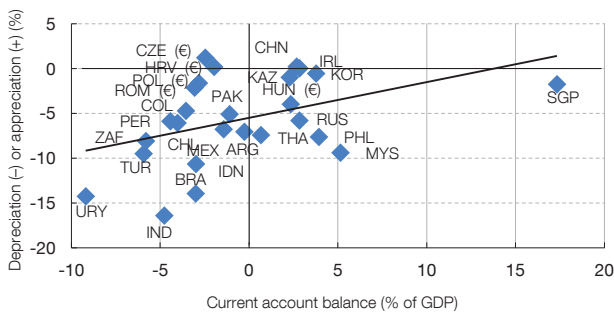
Central bank	Type of forward guidance	Date of decision	Announcement
	Conditional	February 2012	Until price stability is in sight, with a goal of inflation at 1%
Bank of Japan	Conditional	April 2013	The Bank will continue with quantitative and qualitative monetary easing as long as is necessary to maintain the 2% target for price stability, with a time horizon of about two years
	Open-ended	December 2008	For some time
	Open-ended	March 2009	For a long period of time
	Fixed period	August 2011	At least until mid-2013
	Fixed period	January 2012	At least until end-2014
	Fixed period	September 2012	At least until mid-2015
US Federal Reserve	Conditional	December 2012	As long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than 2.5% and longer-term inflation expectations continue to be well-anchored
	Conditional, with a higher qualitative assessment	December 2013	Labour market indicators will be considered more and official rates may be maintained well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2%
	Conditional, with qualitative assessment	March 2014	In determining how long the current 0% - 0.25% official interest rate will be maintained, various measures of labour market conditions, indicators of inflation pressures and inflation expectations and financial developments will be considered
	Conditional	August 2013	At least until the unemployment rate falls to 7% subject to three knockouts relating to inflation and financial stability
Bank of England	Conditional, with qualitative assessment	February 2014	There remains scope to absorb spare capacity before raising official rates. The path of rates over the next few years will depend on economic developments, although the rate rise will be gradual and will remain below 5%.
ECB	Open-ended	July 2013	For a prolonged period of time. These expectations are based on the medium-term outlook for inflation remaining generally subdued, given the broad-based weakness of the economy and sluggish money and credit creation
Bank of Canada	Fixed period	April 2009	Until 2010 Q2, conditional upon the inflation outlook
Sveriges Riksbank	Fixed period	April 2009	Until early 2011

SOURCE: Federal Reserve, ECB, Bank of England, Bank of Japan, Bank of Canada and Sveriges Riksbank.

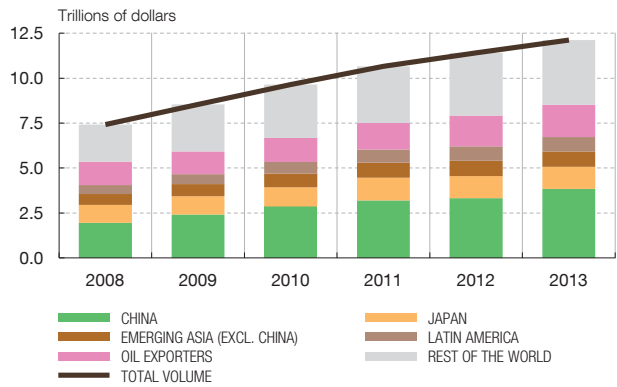
NOTE: Conditional: conditional upon economic variables.

China, the revision has been influenced by the change in the growth model considered necessary to correct its internal imbalances and ensure long-run sustainability, which probably entails slower economic development. China seems to be undergoing a process of deleveraging following years of strong credit growth and the new Government has signalled its intention to be more reformist and liberalising in relation to the financial system and trade.

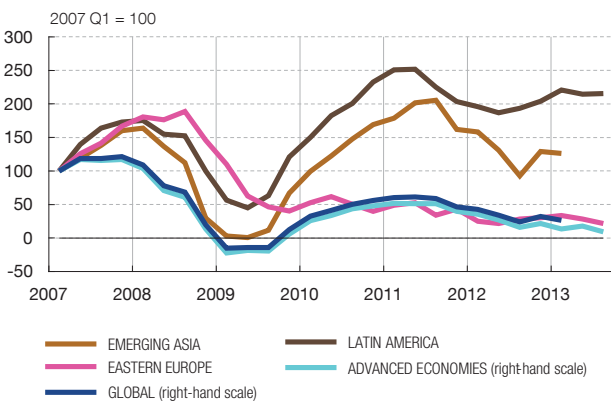
CURRENT ACCOUNT BALANCE (a) AND EXCHANGE RATE (b)



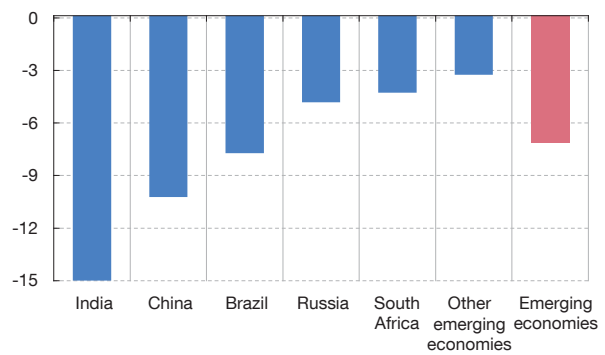
INTERNATIONAL RESERVES



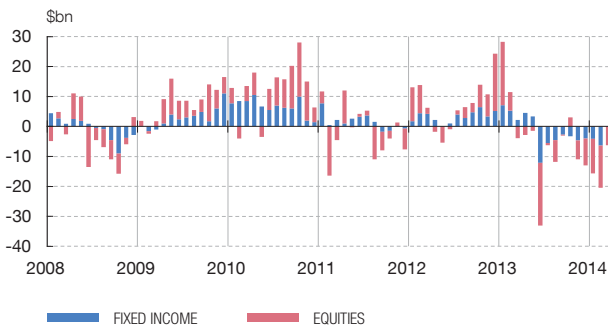
FINANCIAL FLOWS



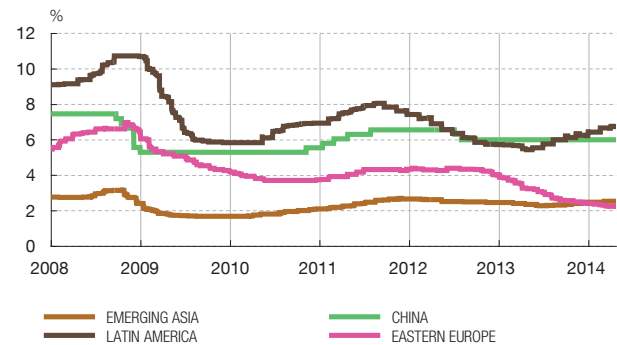
CUMULATIVE REDUCTION IN GROWTH PROJECTIONS FROM 2012 TO 2016 (f)



NET CAPITAL FLOWS (d)



OFFICIAL INTEREST RATES (e)



SOURCES: IMF, World Bank, national statistics, Bloomberg, Datastream-Thomson Reuters and EPFR Global.

- a Data for 2013 Q1.
- b Against the dollar or euro, from 22 May to 27 August 2013.
- c For breakdown of country aggregates, see notes to Table 1.
- d Fixed-income and equity flows.
- e Areas considered: Emerging Asia (India, South Korea, Indonesia, Thailand, Malaysia and Philippines), Latin America (Brazil, Mexico, Colombia, Peru and Chile) and Eastern Europe (Poland, Czech Republic, Romania and Hungary).
- f Differences between WEO October 2013 and WEO September 2011.

Against this background, the change in the global monetary cycle and the smaller expected growth differential between the emerging market and advanced economies combined in 2013 to give rise to notable volatility on the markets and a moderate reversal of capital flows, which could be interpreted as a normalisation. From this perspective, in which the firming of the recovery in the advanced economies anticipates a more favourable and stable global economic horizon and greater external demand for the emerging market economies, the situation should not necessarily be assessed negatively, despite the heightened sensitivity recently exhibited by the markets.

The eventual outcome will depend on the fundamentals and the degree of vulnerability of these economies. In this respect, it should be noted that the current-account, fiscal and credit positions of some emerging market economies (various Asian and Latin American ones), which were very solid until the mid-2000s, have tended to deteriorate in recent years. With some exceptions, the deterioration has been moderate and the levels of vulnerability smaller than in the past. In addition, there are mitigation mechanisms, such as the absorption capacity generated by exchange rate flexibility (in a context of smaller currency mismatches) and the large reserves of many of these countries. In any case, the greater market sensitivity, in the form of the turbulence of 2013 and early 2014, can be interpreted as a wake-up call that may have disciplinary effects on agents and policies. It has also prompted markets to be more selective, penalising countries with greater vulnerabilities more, to the extent of generating doubts over the sustainability of some of them in a context of less availability of financing. Notably there has been some discrimination between risks, and the solidity of the fundamentals and progress made in implementing the reformist agenda in countries such as Mexico, Peru and Colombia have been favourably assessed by the markets.

There have also been significant changes in the conduct of monetary policy, partly explained by this change in perception. Thus, while the countries with more solid fundamentals have been able to float their exchange rates and reduce interest rates (inter alia, Mexico, Chile and Korea), those with inflation or external financing problems (Brazil, India, Indonesia, Turkey) have had to tighten their monetary policies, restoring the pro-cyclical bias to their economic policies. Also, certain macroprudential measures to curb capital flows, applied during the upturn in countries such as Brazil and Peru, have had to be lifted, while fiscal policies have remained very much in the background.

FINANCIAL AND BANKING SITUATION

The situation of the financial markets and systems in the developed countries improved somewhat in 2013, in step with signs of economic recovery and the progress made in regulatory reform in the banking sector towards a more stable and less pro-cyclical model (see Charts 1 and 10). By contrast, the emerging markets were influenced by the less positive economic growth outlook and the episodes of volatility mentioned above.

In any event, financial indicators in 2013 continued to move against a background of extraordinary levels of liquidity, which coincided with a reduction in the significant tail risks present in market valuations in certain areas. In this environment, the appetite for risk was high and volatility low (see Chart 1), and narrower credit spreads and smaller differences between euro area and US credit risk indicators were observed. Debt issuance in segments considered as higher risk was also at high levels.

The tapering discussion in May served to highlight the vulnerability of some agents to a rising interest rate scenario, spurring them to take measures to mitigate the effects of this risk scenario in the future. In this environment, the importance for the financial markets of

the uncertainty deriving from monetary policy and tail risks has been reduced, and the doubts regarding the rate of economic growth have become more prominent. Thus the turbulence seen at the beginning of 2014 had barely any impact on the volatility of US fixed income, while its effects were more significant in the case of the foreign exchange and equity markets.

At the same time, the financial markets remain constrained by structural changes that occurred after the financial crisis and by the subsequent regulatory and institutional reaction. In this respect, a process of banking disintermediation continues to be observed, reflected in the low volumes of banking sector issuance in the primary markets, and a greater presence in placements of non-financial institutions. This process (partly linked to the regulatory changes made to strengthen the solvency position and liquidity of credit institutions and to limit their potential levels of leverage) is also apparent in the moderate growth of lending, even in the most buoyant areas, such as the United States.

This disintermediation varies in intensity, both at the geographical level, with a greater incidence in the case of areas with a higher degree of banking activity, and at the sector level, being most evident in the case of large firms. The consequence is that some segments, such as SMEs and long-term project financing, are having difficulty replacing bank financing by alternative sources. The very gradual resumption of activity in complex financial products, such as securitisations, since 2012, may enable banks to channel funds towards these segments.

Finally, capital flows remain depressed at the global level, and in particular among the advanced economies. This is partly a result of the steep decline in cross-border links between banks, especially European ones, which is in turn a consequence of both conjunctural factors (related to the depth of the crisis and the reallocation of flows as yield and risk prospects change) and regulatory factors, given the stricter requirements made by domestic regulators in relation to the activity of foreign banks.

Outlook and risks

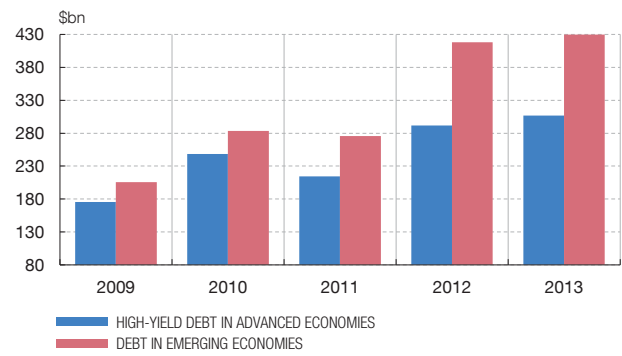
The central scenario for 2014 envisages a slight rise in growth for the world economy, to around 3.5%, 0.5 pp higher than in 2013. This will be driven mainly by the strengthening recovery in the advanced economies (which are projected to grow on average by somewhat more than 2%, around 1 pp more than in 2013) and by the stabilisation (or slight rise in some cases) in the emerging regions (with average growth of around 5%, several tenths of a percentage point higher than in 2013), although the tensions on the markets and the publication of certain adverse macroeconomic data at the start of the year may call into question the slight improvement in these economies.

In the advanced economies the gain in traction can be expected to take place across the board, in an environment marked by continuation of the accommodating monetary policy stance and a lower rate of consolidation of public finances that will be conducive to a less contractionary fiscal policy stance. Against this background, the improvement in labour markets and the recovery of trade flows can be expected to continue. According to the latest forecasts the growth rate is expected to rise in 2014 by around 1 pp in the United States and in the United Kingdom (to almost 3% in both cases) and by around 1.5 pp (to around 1%) in the euro area. The Japanese economy (where growth will remain at around 1.5%) may be an exception, insofar as the consumption tax rise scheduled for 2014 affects this component of spending and the positive initial impact of the profound changes in economic policy tails off.

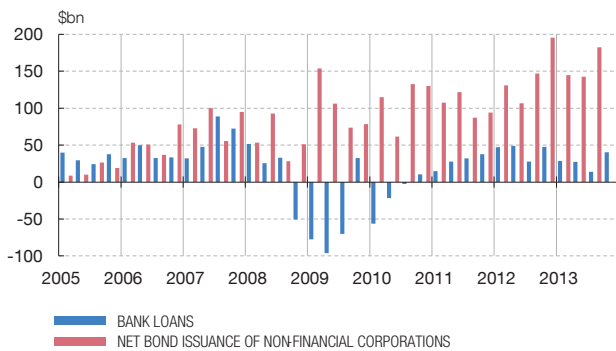
CDS RATIOS



HIGH-YIELD CORPORATE DEBT ISSUANCE IN ADVANCED ECONOMIES AND DEBT ISSUANCE IN EMERGING ECONOMIES



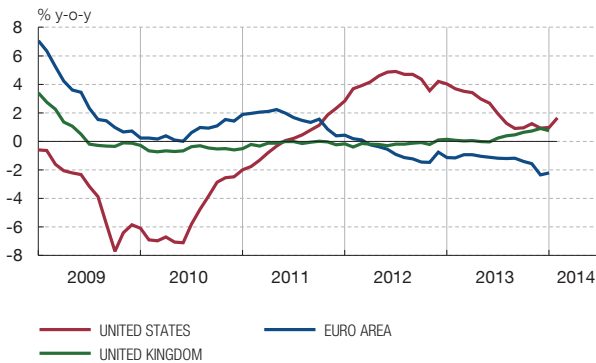
FINANCIAL FLOWS OF NON-FINANCIAL CORPORATIONS IN THE UNITED STATES



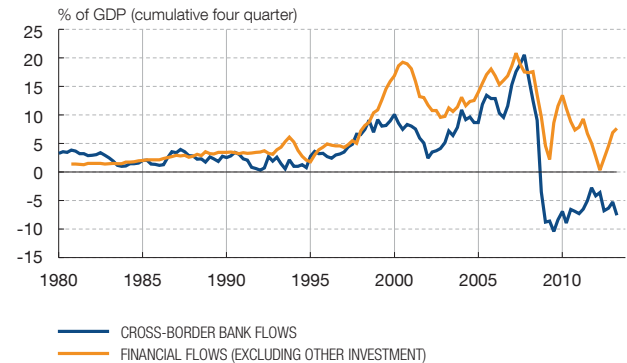
FINANCIAL FLOWS OF NON-FINANCIAL CORPORATIONS IN THE EURO AREA



BANK LENDING TO PRIVATE SECTOR



FINANCIAL FLOWS TO ADVANCED ECONOMIES (a)



SOURCES: IMF, BIS, Federal Reserve, ECB, Datastream-Thomson Reuters, Bloomberg and JP Morgan.

a Simple average of 17 countries.

In any event, over a somewhat longer horizon, the path of the recovery is still limited by the long-run growth capacity and several factors that influence it: public debt, the increase in long-term unemployment, the greater weight of activities with lower productivity and, even, the increase in inequality (which may limit the economies' level of consumption). Moreover, it should not be forgotten that the persistence of broad monetary stimuli is a source of uncertainty for the long-term outlook. Specifically, the scope and impact of the structural factors mentioned above are and will continue to be present in the management of monetary policies during the exit from the crisis, and in particular during the stimuli withdrawal process, as highlighted in Box 1.

The forecasts for the main emerging market economies suggest that growth will stabilise at somewhat lower rates than have been recorded in recent years. The sources of growth can be expected to rotate, with a shift towards external demand (driven by the improvement in the advanced economies). The outlook is somewhat more uncertain, especially given adaptation to a context of moderating capital flows as monetary policy returns to normal in the advanced economies, and principally in the United States. This will lead, in principle, to a gradual tightening of global financial conditions and a lower rate of capital inflows. In the case of China, the transition to a growth model based more on private consumption can be expected to give rise to growth rates of around 7.5%, down from those observed in recent years. Lower Chinese demand may moderate activity in other emerging market economies, especially in Asia and in the commodity exporting countries. In any event, growth is projected to stabilise (or rise slightly) in emerging Asia (excluding China), Latin America and Eastern Europe.

The balance of risks in this central scenario is less skewed towards the downside than in previous years, as the tail risks that have weighed on the world economy in recent years have been largely dispelled.

That said, downside risks to the growth of the advanced economies persist. First, growth may weaken if the process of monetary normalisation leads to sharp interest rate rises at all maturities, which could depress domestic demand and affect financial stability. Second, inflation remains very low, especially in the euro area, and, although inflation expectations remain anchored at around the central bank target rates, the very persistence of very low inflation rates poses risks for the recovery. In the longer term, public finances, especially in Japan, but also in the United States and in other advanced economies, are delicately balanced between long-term fiscal consolidation and implementation of a milder adjustment over the immediate horizon that does not hinder the recovery. An over-lax approach may destroy confidence in fiscal sustainability and prompt a sharp rise in the cost of public debt, especially in the current context of prospective monetary normalisation. Finally, the growth of the advanced economies may be affected by shocks in any of the systemic emerging market economies. Some upside risks can also be identified, in particular if the virtuous circle of improving activity, confidence and demand gains traction, prompting a larger than expected recovery in investment.

In the emerging market economies the risks are more skewed towards the downside. The turbulence of the beginning of the year has shown that the financial markets are now more sensitive to the situation of these economies, so that the expected tightening of financial conditions may be accompanied by episodes of volatility, with an impact on the more vulnerable economies. However, although significant fragilities still exist, a large number of the emerging market economies have more solid fundamentals today and better economic policies than in previous crisis periods, so that the tail risks for the emerging market economies seem to be contained and limited to a small number of vulnerable economies.

In short, the world economy, supported by the strengthening recovery in the advanced economies, is on the road to a horizon of economic (and policy) normalisation. This process is not free of risks and difficulties, which, in the current context, seem to affect the emerging regions to a greater extent. However, the recovery in the advanced economies, even if their growth rates do not return to their pre-crisis levels, may sustain a more stable global outlook and a progressive recovery in trade and financial flows, which will benefit the whole of the global economy.

20.3.2014.