1. Development of the global economy

1. 1. GDP and sovereign debt crisis

- ***Only fragile growth in 2010 and 2011***

2011 was not the first post-crisis year, as economic experts still hoped back in 2009. The sovereign debt crisis that struck Europe, the USA and Japan as well brought a necessity to cut expenditures from public budgets – and the need to pay for state liabilities (but also liabilities of NGO's and private entities) made both the public and private sectors seek ways to cut expenditures. Therefore, state budgets sought and continue to seek new sources of income. The strategies developed to create savings differed across countries, resulting in a slowdown of economic growth that will probably last into the coming years as well. This was reflected in the slowdown of growth in the developed countries in 2011 and was followed by gradual slide back into recession. No sooner than at turn of 2011 and 2012, the EU started to find measures against this development.

- ***By putting more emphasis on growth support, the USA saw more growth-positive development than Europe***

Even in crisis, the economic policy of the USA put rather more emphasis on the support of economic growth than savings. This strategy was partially successful. The US GDP grew at 1.7% in 2011, which represents a significant slowdown from 3% growth in 2010, but it still means a rate that exceeds GDP in the EU as a whole and in the Eurozone too (both are at 1.5%). However, this growth was not accompanied by improvement of other indicators that are necessary for economic balance, employment in particular – in 2011 the unemployment rate was 8.5%, a year before 9.1%, and 7.2% in December 2008.[1] However, even monetary strategies to support growth keep failing.

- ***The largest developing economies with no significant problems, "new EU countries" struck by the crisis relatively less seriously***

The economies of countries in Southeast Asia and Latin America and to some extent Russia managed to avoid the crisis. Asia and Latin America, specifically Brazil, Argentina and Chile, have gone through many financial crisis in the 1990s that they managed to solve autonomously. In economic terms these solutions included various reforms, nationalization, devaluation of national currencies and declarations of bankruptcies, i.e. in general by writing off one half of state debt. However, such tools are not available to the European Monetary Union.

Due to extensive fiscal and economic reforms that have been adopted to meet the so-called Maastricht criteria, the "new" countries were caught unaware by the debt crisis relatively less seriously than the EU-15 countries, some of which had not been fulfilling the Maastricht criteria prior to the outbreak of the crisis

- ***Growth rates in the EU, Eurozone and in the USA***

The year on year GDP growth rate in 27 of the EU countries rose from 1.3% per year in 2002 to 3.3% in the peak year of prosperity (2006). In the pre-crisis year of 2007, the EU economy grew by 3.2%. Eurozone countries recorded a year on year growth of 0.9% in 2002 and 3% in 2007 – in the same period, the German economy had grown from stagnation in 2002 to 3.3% in 2007. Estonia, which had to dig deep to cope with the financial crisis, posted an average annual GDP growth of 7.9% in this period. In 2007, Slovakia recorded a year on year growth of 10.5%, while in 2002 it was 4.6%. The economy of the Czech Republic had steadily sped up from 2.1% in 2002 to 7% in 2006. Even a year later, its GDP grew by 5.7%.

The USA found itself in a rather shifted rhythm. It experienced economic growth exceeding 4% from 1997 to 2000, but at the turn of the century the GDP rate in the USA slowed down to 1–2%. The American economy saw its best years already in 2004 and 2005 with GDP growth at 3.5%, or at 3.1% respectively.

[1] At that time, this fact was commented on as "the highest unemployment in the last 16 years".

1.2. Quantitative easing as an instrument for economic recovery

- ***Printing money as a tool for the growth of the US economy until 2011, lowering interest rates in Europe***

The Fed, the American central bank, confronted the recession by employing a strategy of so-called quantitative easing when traditional monetary instruments, in particular the drastic lowering of basic interest rates, did not yield the desired outcomes – lending transactions did not recover, the economy (both enterprises and consumers) did not draw down the cheap money and no growth occurred. Essentially, this was a bad debt redemption by the central bank for cash. In some cases, the government took part in the program by acquiring ownership interests for redemption of bad debts in some financial institutions. Following the restructuring of loans and financial stabilization, such ownership interest was resold to the original owners for a market price. (According to US government calculations, most of these investments have been paid up.) The second round of quantitative easing ended in 2011 with purchased state bonds of USD 600 billion (totalling USD 1200 billion from December 2008 to March 2010).

The European Central Bank (ECB) hesitated with the lowering of interest rates and did not act to make use of quantitative easing during this phase of the crisis. Aid for the banks at risk was left to the decision of the individual governments of the EMU member states.

- ***Fast debt generation of problematic European countries…***

Efforts of problematic European countries to prop up their own banks and to stabilize the economy to avoid recession resulted in fast debt generation by these countries. In spite of this, the plan was almost successful: the banking sector released loan flows and in 2010 there was an economic growth recovery (EU-27 +2% in 2010, Eurozone +1.9%, Germany +3.7%, Czech Republic +2.7%). However, this recovery was not strong enough to put an end to chronically increasing debt of public budgets. Unemployment did not improve and there was growth of inflation. At the same time, basic interest rates stood, from a long-term perspective, at historical minimums. The reason might be that the new money was for the most part used to prop up banks and public budgets. Much of this money did not enter the real economy as it may have seemed. Moreover, there is a probability that should this newly issued money enter the real economy, it would have been used to cover the current debt of business (from loans and insolvency) and households rather than for new investments, creation of job opportunities or growth of salaries.

- ***… despite actions taken with no positive result***

Incomes of state budgets were not sufficient to cover social expenditures. The unfavourable socio-demographic development in European countries continued to create deficits on retirement accounts. Weak economic growth did not create job opportunities, which again encumbered the social expenditures of the state and in turn limited the sources of budget income. Therefore, in 2011 a significant downturn of economic growth occurred, falling to 1.5% in both the EU and Eurozone, to 1.7% in the Czech Republic and less seriously in Germany to 3%. The downturn of economic growth in 2011 had been proceeding gradually since the beginning of the year.

The first problems were reported by Ireland and soon after by Greece. Spain, Portugal and Italy followed. The interest from bonds and/or revenues, that were asked by investors with the securities of these countries, reached an amount that would not, given their economic performance, allow these countries to pay for their liabilities. This resulted in a lack of liquidity and an inability of the governments to fulfil their obligations even towards their own citizens. These countries lost credit at financial markets which refused to lend money to cover increasing state debts with no prospects that the general functioning of these economies would improve.

- ***A new fall into recession…***

In this environment, both business and households started having problems with their liabilities, and subsequently risk assets of the banks started to grow. Instead of the anticipated stabilization of the economy and a slow transition to moderate but stable economic growth, as early as the second half of the year it was apparent that a second fall into economic recession was much more likely. The governments of European countries did not have financial reserves, while global financial markets

refused to provide loans for affordable interest. This was also the reason why the second fall into recession threatened to have much more serious consequences than in 2008 (including concerns that the Eurozone would disintegrate).

- ***… despite the approach of quantitative easing also taken by the ECB***

The European countries launched extensive programs of public expenditure cuts and growth of state income (particularly from taxes). However, this did not lead to the reduction of state budget deficits or at least to such an extent as planned by the governments. In addition, these cuts have significantly contributed to the reduction of GDP dynamics.[2]

The ECB reacted to the closing of loan transactions with problematic states on financial markets at the end of 2011 when the first round of quantitative easing was launched.[3] Limited by its mandate that did not allow the banks to provide direct loans to governments, it provided 523 institutions, mostly commercial banks, with cheap loans in the form of 3-year bonds at a total amount of EUR 489 billion in 2011. (The second round of the program was announced at the end of February with the amount of cheap loans up to EUR 530 billion and 800 institutions asked for the newly emitted funds.) The volume of funds disbursed as part of the program was not large enough to solve the debt crisis of the peripheral states. However, it averted the acute threat of a closing of the loan market, as well as a collapse of financial institutions in the most affected countries and the most laden banks.

- ***Formation of the so-called European bailout funds***

By forming special institutions, namely the European bailout funds, the political representation of the Eurozone decided to bypass the fact that the ECB cannot provide loans directly to governments, as well as the fact that, according to the rules for the functioning of the Eurozone, each member state is responsible for its budget deficits. In May 2010, the EU-27 decided to form the Financial Stability Fund to help the states struck by debt crisis.[4] Its lending capacity is EUR 440 billion and it shall cease to exist when the bonds issued are paid up (probably in 2013). In order to ensure that the Eurozone would have a permanent ability to prop up problematic economies, it was decided that a permanent European Financial Stabilization Mechanism[5] be formed to obtain relatively cheap funds on financial markets (up to EUR 60 billion combined with the lending capacity of the above-mentioned Financial Stability Fund). Lending instruments of the International Monetary Fund (IMF) form the third part of the European bailout funds in the amount of EUR 250 billion. In order to save the peripheral member states of the Eurozone, loans in the amount of EUR 750 billion should thus be available. Upon their request, the total guarantees were increased to EUR 780 billion in October 2011.[6]

- ***USA, an exception in GDP rates***

Economic recovery in the USA and the EU's 2011 political measures significantly reduced a probability of a deep and steep slump that would have an impact on the growth of the global economy. It appears however that the measures agreed upon were taken too late. The trust of businesses in the future economic development and doubts of financial markets drove the yields from bonds of Eurozone states high

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[4] The IMF estimates that measures aimed to reduce the deficit by 1 percentage point in relation to GDP will cause the slowdown of economic growth also by 1 percentage point.

[3] The official name of the program is Long-Term Refinancing Operation (LTRO).

[4] This is the European Financial Stability Facility (EFSF), a special institution to help states struck by the debt crisis with a seat at Luxembourg. It may issue bonds, from the sale of which it may provide loans to countries in the Eurozone in trouble or use them for recapitalization of commercial banks and for the purchase of risk assets. The bonds issued by EFSF are guaranteed by Eurozone member states in the same proportion to their capital deposits in the ECB.

[5] European Financial Stabilization Mechanism – EFSM.

[6] Recipients of these cheap loans are Eurozone member states that asked for help and whose programs to recover public finances have been discussed with the EC and IMF and approved by the ministers of finances of the Eurozone countries. Another condition is that the applicant is not able to obtain the money required on the financial market under acceptable conditions. In November 2010, support of Ireland was approved. Ireland asked for EUR 85 billion (23 billion from EFSM and 18 billion from EFSF – the first issue of bonds of the EUR 5 billion was offered on the market by EFSF in January 2011). The second country to ask for help was Portugal (April 2011), therefore in total the support will reach EUR 78 billion. The support for Greece in the amount of the EUR 110 billion from 2010 was not an operation of EFSF, but is backed by bilateral agreements between Greece, the IMF and the Eurozone member states. Slovakia and Estonia (which were not yet members of the Eurozone) did not participate in the agreement.

again, the debt crisis grew more serious and in the last quarter of 2011 the moderate economic growth changed into a year on year fall of 1.3%. GDP fell also in Japan as a result of natural disasters and the drop in foreign demand for Japanese production. On the other hand, economic activity kept growing in the USA, final consumption investments recorded an increase and a recovery in the loan and labour market could be seen.

1. 3. New developing countries

- ***Latin America and Asia lost dynamic, but growth of these countries persisted***

The fast-growing economies of Southeast Asia and Latin America responded to the crisis in Europe and to the threat of Eurozone disintegration relatively sensitively. Firstly, they were jeopardized by a drop of export potential, and secondly, the influx of foreign investments in these countries declined. The overheating of the economies of China and India in previous years is responsible for the slowdown of their economic growth rate. As opposed to the developed countries or the countries of Central and Eastern Europe, the unemployment rate of the large and developing economies of Asia and Latin America remains relatively low as a result of their previous dynamic growth.

Table 1: Year on year GDP growth (in %)

	2010	2011	4.Q2011
World	5.3	3.9	3.2
EU	2.0	1.6	0.9
Eurozone	1.9	1.4,	0.7
Central and Eastern Europe	4.5	5.3	3.8
USA	3.0	1.7	1.6
Japan	4.4	-0.7	-0.6
New fast-growing Asian economies in total	8.5	4.0	3.1
China	10.4	9.2	8.9
India	10.6	7.2	6.1
Latin America and Caribbean countries	6.2	4.5	3.6

Source: MMF

1. 4. Commodity markets

- ***Prices of commodities were the only inflation impulse, but their increase is only temporary as a result of the weakening pace of the global economy***

On a global scale, the inflation rate was relatively low due to the fact that basic interest rates in the strongest economies were close to zero and large new liquidity sums were issued by central banks. The only inflation pressure was recorded in the prices of commodities. In the half year of 2008, oil prices posted a historical high. In the beginning of 2011, following the information concerning the quantitative easing of central banks, the prices were around USD 115. They dropped later towards USD 100 and after the next growth wave rose to USD 115 per barrel.

Similarly, other industrial commodities are on the decline. This development reflects the downturn of economic activities, including the expectations concerning a further slowdown in the growth rate of the global economy in the coming period. Based on these arguments, i.e. by correlation of the prices of commodities and anticipated economic growth (i.e. by consumption), sharp stock market movements during the oil and food crisis in 2007 and 2008 could be explained. (Increasing demand in China and India was responsible for the increase of rice prices and so on.) However, commodity stock markets respond with growth also to an increased uncertainty on financial markets. Merchants who do not purchase commodities for consumption or physical business with commodities use commodity contracts to increase risk margins and to cover higher costs incurred to secure their speculations. However, in the absence of demand signals, this led to the opposite effect – as movements on both stock and commodity markets become more and more synchronized. Therefore, the year 2011 showed that investors started to pull away even from commodity markets.

Chart No. 1 **Price of Brent oil** (in USD per barrel)

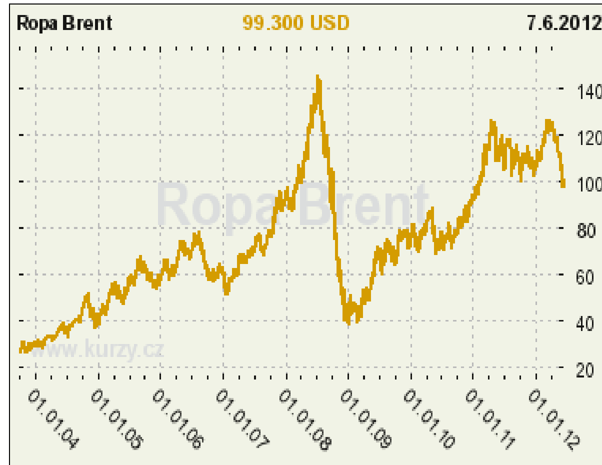


Chart No. 2 **Price of copper** (in USD/100 per pound)

Source: kurzy.cz

1. 5. Financial markets

- ***Shares stagnated over the large spectrum***

Since 2000, global stock markets have been very volatile and have more or less stagnated over the large spectrum of values. Price fluctuations had a global character, with markets oscillating irrespective of the region, and with partial variances with regard to their dynamics. In 2011, the American market was the most effective, mostly thanks to the stimulus policy of the Fed. Concerning the performance of stock markets, Europe, as a whole, lagged behind, with German and British stock markets the strongest. Poor performance was also shown by the Japanese stock market which did not perform much differently than Southern Europe. The growth from 2009 to 2011 was a combination of steps taken by central banks, particularly by the American Fed with an aim to pump new liquidity into the market and stimulate economic growth. In this regard, 2011 was no exception. Following the end of each of the American programs of quantitative easing, QE1 and QE2 stock markets corrected downwards. The mere announcement of the intention to proceed with the next round in August 2010 and September 2011 became a signal for growth. Thus, the weakening or strengthening of the American dollar was a dominant determinant for price movements.

Chart No. 5 **DAX stock index** (spread 2–9 thousand points b.)

Chart No. 6 **Nikkei 225 stock index** (spread 5–20 thousand points)

Source: www.thinkorswimm.com and www.saxobank.com

Chart No. 7: S&P 500 stock index since 2000 (Development in each of the phases of quantitative easing shown)

Source: www.thinkorswimm.com and www.saxobank.com

- ***Globalization: markets move together in trend terms***

Stock indexes of the markets of USA (S&P 500), Germany (DAX-30) and Japan (NIKKEI-225) move together in trend terms. From the long-term perspective, the Japanese index is the weakest. American S&P 500 recorded a historical maximum in October 2007 and in the end of 2011 was by one fifth lower, with the German DAX down by almost 30% and the British FTSE-100 by almost 20%. The yields of American government bonds with ten year maturity have been falling for a long time (since 1982). As a result of the interventions by the Bank of Japan, the yields of bonds of the Japanese government saw the same trend. The yields of government bonds of Germany (Chart 8) have also been falling since 1990s. No sooner than in 2012, the bonds of Spain (Chart 9) reacted to fading demand of investors connected with difficulties of the country.

Chart No. 8 Yields of German government bonds

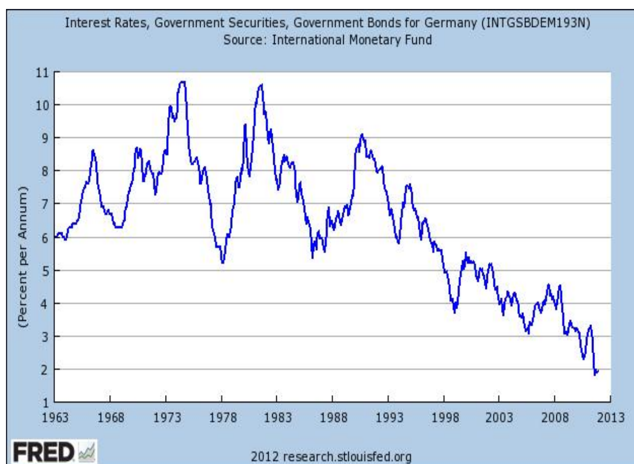
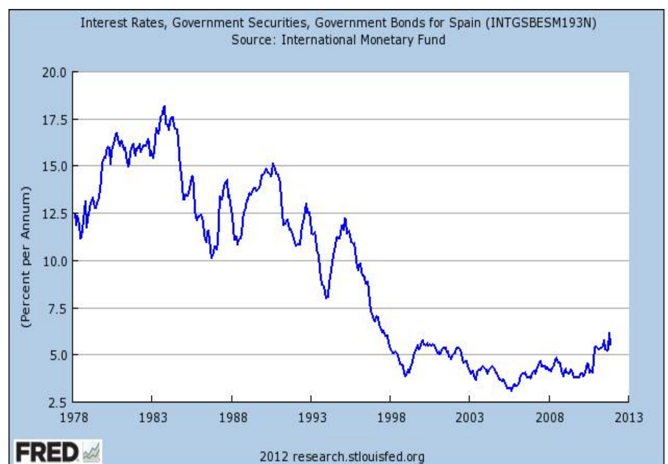


Chart No. 9 Yields of Spanish government bonds



Source: http://research.stlouisfed.org

- ***Fed took over the initiative on capital markets with new initiative called Operation Twist; with one of the results being the weakening of American dollar***

Since 2008, American Fed, mostly due to its stimulation programs of QE1 and QE2 quantitative easing, or their modification with extended maturity of bonds called Operation Twist in 2011, is the key factor determining to a great extent the behaviour of capital markets in the aftermath of American subprime mortgage and bank crisis. Even the mere announcement of intentions (November 2008 for QE1, August 2010 for QE2 and September 2011 for Operation Twist) to support economic growth through stimulation packages led in both QE cases to weakening of the dollar connected with the rise of prices of other investment assets – in particular, stock markets and yields from government bonds. In both

cases, such stimulation of growth was limited in time by pumping of artificially supported liquidity into the markets and soon after its end it was followed by steep corrections.

- ***Investors sought “safe havens” in the overall uncertainty on financial markets***

In the end of 2011, the trust according to global index of purchasing managers reached its peak in the past 9 months, which indicated potential positive development for the beginning of 2012. However, the problem was that this index maintained positive values only due to positive forward-looking expectations in India, Canada, the United States, Turkey and Russia. Also hard data from real economy in the last quarter of 2011 later showed that in many countries important for the development of global economy this quarter recorded the poorest performance since the crisis year of 2009.

In 2011, financial investors concerned with small progress regarding the solution of the crisis in the Eurozone, and uncertain whether or not there is a permanent strong growth of the Chinese economy and due to overall imbalance of the global economy, sought safe placements for their assets. This was not very succesful, so cash was piling up. Nevertheless, the so-called “safe havens", in particular investments into precious metals, and specifically gold, worked again. In the half of 2011, the price of gold surged to around USD 1800 per troy ounce, which was approximately twice as much as in the crisis year of 2009. At the same time, it must be said that the price of gold on commodity markets did not exceed USD 500 per troy ounce in the entire first half of the past decade. Swiss franc was similarly attractive as gold. Strong demand for this currency made the Swiss central bank to intervene fearing that strong currency might inhibit the competitiveness of the country. The intervention was successful and the Swiss franc weakened in the half of the year.

Chart No. 10 **Price of gold** (in USD per troy ounce)

Chart No. 11 **Exchange rate dollar to Swiss franc**

Source:www.saxobank.com