GLOBAL ECONOMIC OUTLOOK – APRIL

2014

Monetary and Statistics Department
External Economic Relations Division

CZECH NATIONAL BANK

Cut-off date for data
14 - 18 April 2014

CF survey date
14 April 2014

GEO publication date
25 April 2014

Notes to charts
ECB and Fed: midpoint of the range of forecasts.
The arrows in the GDP and inflation outlooks indicate the direction of revisions compared to the last GEO. If no arrow is shown, no new forecast is available. Asterisks indicate first published forecasts for given year.
Forecasts for EURIBOR and LIBOR rates are based on implied rates from interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizons). Forecasts for German and US government bond yields (10Y Bund and 10Y Treasury) are taken from CF.

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The April issue of Global Economic Outlook presents its regular overview of recent and expected developments in selected territories, focusing on economic fundamentals: inflation, GDP growth, leading indicators, interest rates, exchange rates and commodity prices. At the start of the second quarter of this year, we also focus on analysing the heterogeneity of financial conditions in euro area countries. The analysis shows how the initial expected convergence of long-term government bond yields and interest rates on loans to the private sector in euro area countries was interrupted by the financial crisis. The subsequent escalation of the euro area's debt problems led to a widening of the differences between euro area countries. This would have serious implications for the recovery in the euro area as a whole if the differences were to persist.

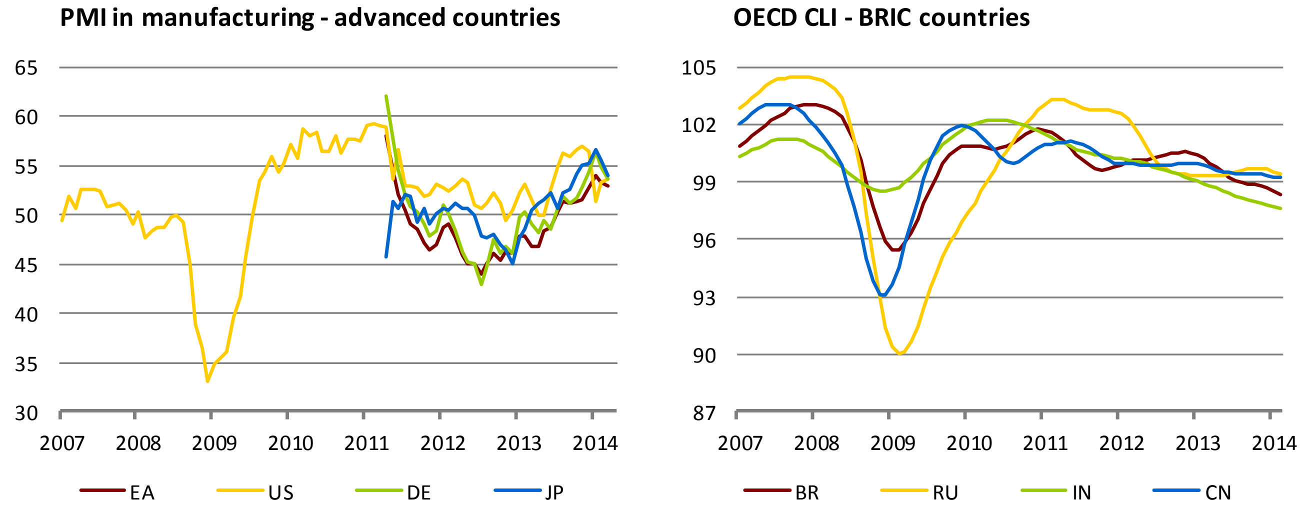
The economic trends in advanced countries are continuing to improve slightly overall, although the latest leading indicators in industry suggest a slight correction. This year the global economic recovery should be driven by the USA, owing to its expected growth of 3%. The euro area should also grow faster over the same period, albeit at roughly one-half the pace of the US economy. The Japanese economy is also showing satisfactory overall developments, although industry there will face a gradually appreciating yen. The inflation outlooks in advanced countries remain very low. In the euro area in particular, they are still falling, though with a hint of a return above 1% in 2015. This situation is forcing the ECB to continue considering easing the monetary conditions.

The Chinese economy is continuing to slow, gradually moving away from the government's growth target of "around 7.5%" for this year. The outlooks for the Brazilian economy are none too optimistic owing to domestic economic problems and unsuccessful reforms, which are leading to rising inflation pressures. Large capital outflows and currency depreciation due to the political tensions between Russia and Ukraine still represent a risk to the Russian economy. By contrast, positive outlooks – i.e. rising economic growth and a marked disinflationary process – prevail in the Indian economy.

The interest rate outlooks remain low for the euro area this year, but are expected to rise gradually in the USA at the end of this year, a trend which should continue into 2015. Growth in euro area rates is expected to be more gradual and start later. According to CF, the US dollar should appreciate against the euro and the Japanese yen. The dollar is expected to appreciate against the Brazilian and Russian currencies as well. It will also appreciate slightly against the Indian currency while depreciating against the renminbi, according to the outlooks.

The price of oil is fluctuating within a relatively narrow band around USD 110 a barrel. The outlook remains slightly falling, as expected growth in extraction (especially in North America) exceeds expected growth in demand. A decline in prices of oil (and commodities in general, including natural gas) should also be fostered by the expected appreciation of the dollar due to the gradual US monetary policy tightening, which should lead to investors withdrawing from commodity markets. Commodity market developments remain mixed, although a falling trend prevailed in most markets as demand from large emerging economies continued to weaken. The price outlooks for other commodity markets have stabilised, although they are currently showing mixed developments, as visible in a recent rise in prices of food commodities, especially wheat and corn.

Available PMI time series for countires followed in the GEO



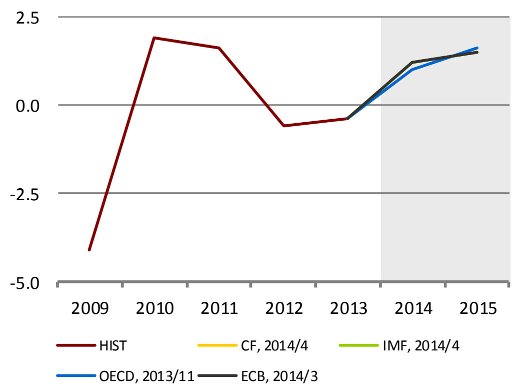
Source: Bloomberg, Datastream

II.1 Euro area

As in previous months, new macroeconomic data published in March and early April point to a continuing modest recovery in the euro area accompanied by subdued inflation pressures. Most of the main coincident indicators, including industrial production and retail sales, improved in February. However, the improvements have yet to feed through to the euro area unemployment rate, which has been at 11.9% since October. Most of the leading indicators also improved, although some (including the PMI) declined in March; even so, they are above the levels observed in late 2013. The April CF increased its GDP growth outlooks for 2014 and 2015 by 0.1 pp. The new IMF prediction also revised the growth upwards and is thus, like CF, in line with the ECB forecast published last month. However, the IMF points to continuing risks to the growth outlook, stemming mainly from a slowdown in structural reform efforts in the euro area, newly accompanied by a risk of very low inflation or even deflation.

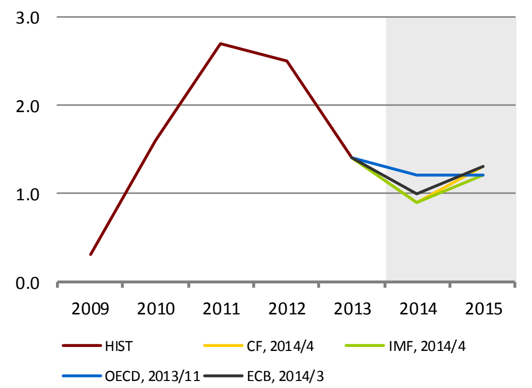
Annual inflation fell from 0.7% in February to 0.5% in March. The decline was due partly to base effects linked with higher prices of services in March 2013 (owing to Easter). As regards the components of the HICP, lower prices of fuels and telecommunication services were the biggest contributors to the year-on-year decline in inflation. The ECB again decided not to ease monetary policy further at its April meeting. However, it admitted it could use both conventional and unconventional policy instruments if the inflation outlook decreases. The CF inflation outlook was unchanged from a month earlier, but the new IMF prediction shifted slightly downwards. The IMF also recommends further monetary policy easing in order to prevent a deflationary scenario in the euro area. Money market interest rates remain stable and are not expected to start rising until the second half of 2015. The higher probability of the ECB using unconventional monetary policy instruments contributed to a drop in yields in the euro area periphery, and to some extent also to the success of the first auction of Greek five-year bonds since 2012.

GDP growth, %



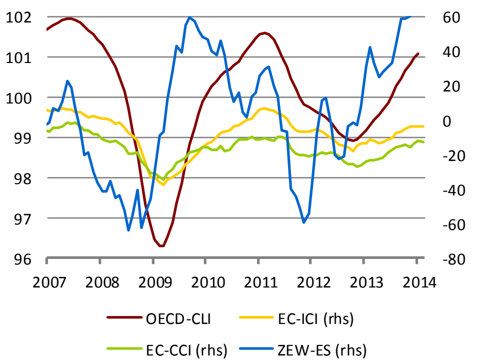
	CF		IMF		OECD	ECB	
2014	1.2	↗	1.2	↗	1.0	1.2	↗
2015	1.5	↗	1.5	↗	1.6	1.5	→

Inflation, %



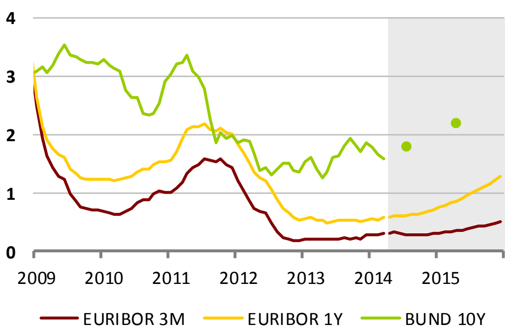
	CF		IMF		OECD	ECB	
2014	0.9	→	0.9	↘	1.2	1.0	↘
2015	1.3	→	1.2	★	1.2	1.3	→

Leading indicators



	OECD-CLI	EC-ICI	EC-CCI	ZEW-ES
1/14	101.1	-3.8	-11.7	73.3
2/14		-3.4	-12.7	68.50
3/14			-9.3	61.50

Interest Rates

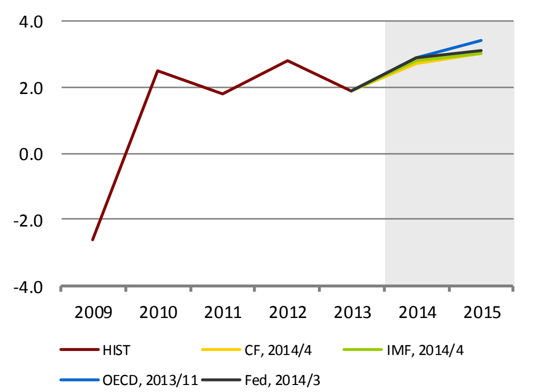


	03/14	04/14	06/14	12/14	06/15	12/15
3M EURIBOR	0.31	0.31	0.31	0.30	0.39	0.52
1Y EURIBOR	0.58	0.59	0.60	0.72	0.96	1.29
	03/14	04/14	07/14	04/15		
10Y Bund	1.59		1.8	2.2		

II.2 United States

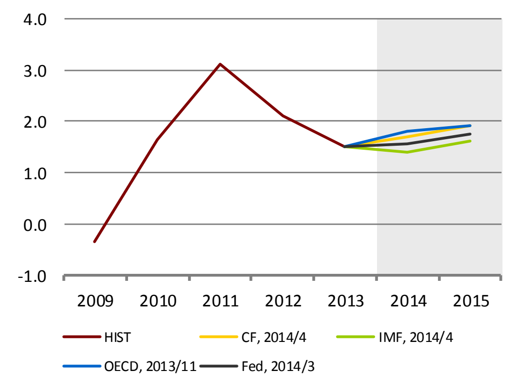
US economic growth should be close to 3% this year and accelerate slightly further in 2015. According to the IMF, therefore, the United States should be the main driver of global economic growth this year. The economic recovery will be accompanied by subdued inflation pressures, with the monitored institutions expecting consumer price inflation to be below the Fed's target of 2% over the next two years. The annual growth rate of industrial production accelerated further in March, exceeding the level expected for this year as a whole. Further growth in the PMI leading indicator for industry in March confirms the strength of the recovery. Consumer confidence indicators also went up in March (Conference Board) and April (University of Michigan). In addition, nominal retail sales rose markedly in March. According to the Fed, however, even the observed recovery may not result in a rise in inflation pressures, increasing the likelihood of monetary policy remaining easy for an extended period (near-zero interest rates further into 2015). Although the unemployment rate stayed at 6.7% in March, the high proportion of part-time employment and long-term unemployment is worrying according to the Fed. In line with the tapering of QE, ten-year government bond yields are expected to rise at one year. Market expectations regarding short-term interest rates are also rising in the course of 2015. The average exchange rate of the dollar against the euro weakened further in March and has stayed weak so far in April. This is probably due to the ECB's inactivity (the absence of further monetary policy easing despite the low inflation outlook) and the better euro area GDP data for 2013 Q4. At the one-year horizon, however, CF expects the dollar to firm by 6% to USD 1.30 to the euro, in line with long-term fundamentals.

GDP growth, %



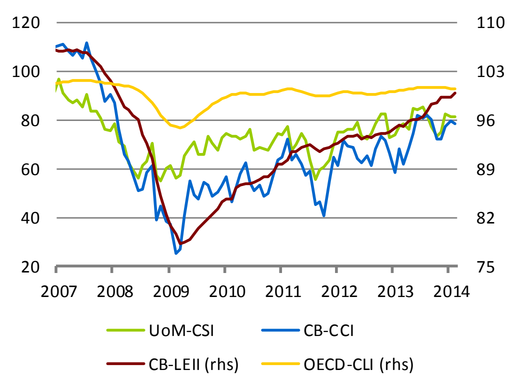
	CF	IMF	OECD	Fed
2014	2.7	2.8	2.9	2.9
2015	3.0	3.0	3.4	3.1

Inflation, %



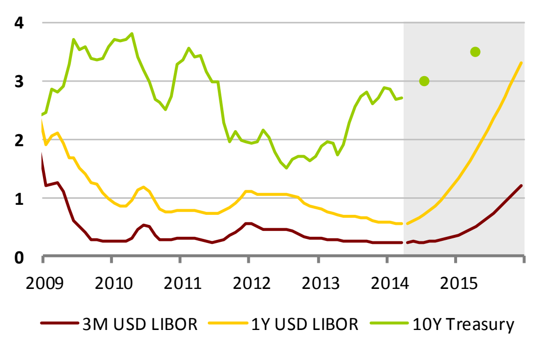
	CF	IMF	OECD	Fed
2014	1.7	1.4	1.8	1.6
2015	1.9	1.6	1.9	1.8

Leading indicators



	CB-LEII	OECD-CLI	UoM-CSI	CB-CCI
2/14	99.8	100.5	81.6	78.3
3/14			80.0	82.3
4/14			82.6	

Interest Rates

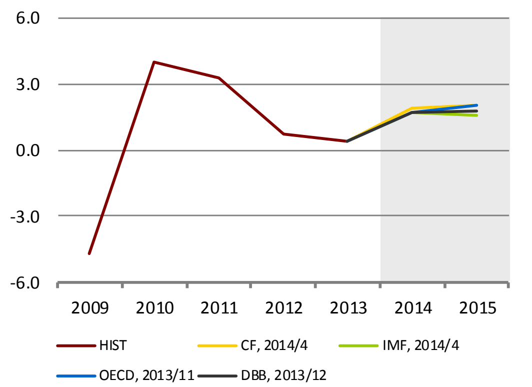


	03/14	04/14	06/14	12/14	06/15	12/15
3M USD LIBOR	0.23	0.23	0.25	0.33	0.66	1.21
1Y USD LIBOR	0.56	0.55	0.66	1.20	2.16	3.30
	03/14	04/14	07/14	04/15		
10Y Treasury	2.72		3.0	3.5		

II.3 Germany

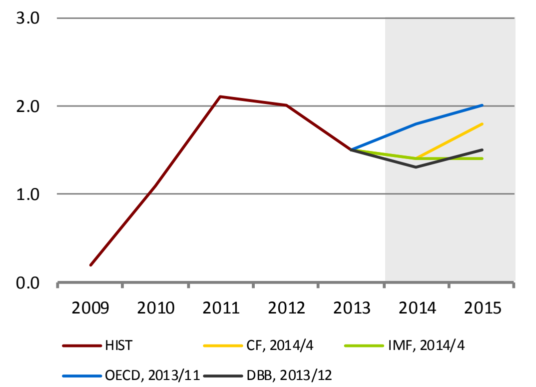
Both quarterly and annual GDP growth in Germany picked up pace in 2013 Q4 as compared to the previous quarter, mainly because of a rise in net exports. The April CF expects a further pick-up in annual economic growth in 2014 Q1. This is also indicated by data on industrial production and retail sales in the first two months of Q1. The annual growth rates of both indicators were much higher in this period than in the previous quarter. The April CF expects economic growth to accelerate to 1.9% in 2014 as a whole. Growth should be driven mainly by stronger growth in domestic demand, in particular household consumption. This is also suggested by leading indicators. The consumer confidence indicators increased in particular. In the business sector, by contrast, concerns about the economic impacts of the Ukraine crisis on the euro area and above on all Germany are rising.

GDP growth, %



	CF	IMF	OECD	DBB
2014	1.9	1.7	1.7	1.7
2015	2.0	1.6	2.0	1.8

Inflation, %

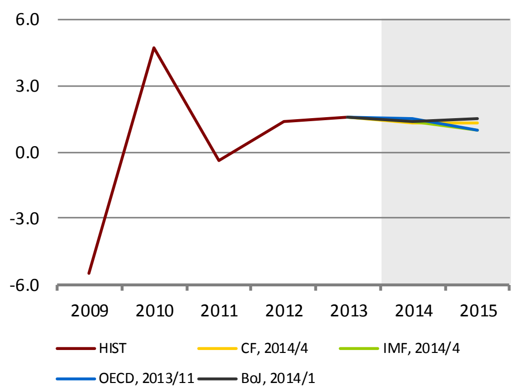


	CF	IMF	OECD	DBB
2014	1.4	1.4	1.8	1.3
2015	1.8	1.4	2.0	1.5

II.4 Japan

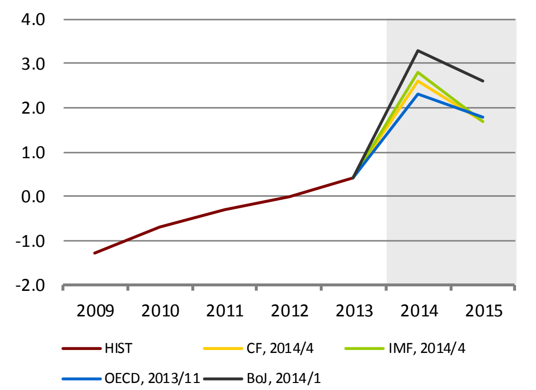
In February, inflation in Japan was unchanged from the previous months (1.5%). This, together with a further drop in unemployment (to a record low of 3.6%), supports the hypothesis that Japan is successfully exiting the deflationary environment. On the other hand, a slowdown in industrial production and consumption expenditure suggests that the economic outlook remains uncertain at the very least. A further decrease in demand can be expected in Q2 following an increase in VAT from 5% to 8% on 1 April, the first such rise in 17 years. The tax increase was motivated by concerns about the sustainability of Japan's debt given its ageing population. The outlook for Japan's main trading partner countries, especially China, is also a source of uncertainty. However, the central bank regards the current trends as positive. So far, therefore, it has not eased monetary policy further. This led to a strengthening of the Japanese currency in early April. In line with new data, the April CF (and the IMF) revised the GDP outlook for this year downwards by 0.1 pp, while the prediction for 2015 remains unchanged.

GDP growth, %



	CF	IMF	OECD	BoJ
2014	1.3	1.4	1.5	1.4
2015	1.3	1.0	1.0	1.5

Inflation, %

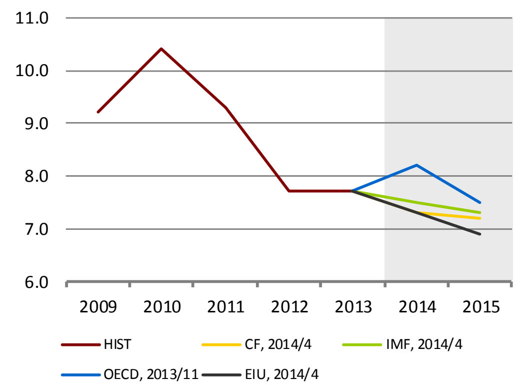


	CF	IMF	OECD	BoJ
2014	2.6	2.8	2.3	3.3
2015	1.7	1.7	1.8	2.6

III.1 China

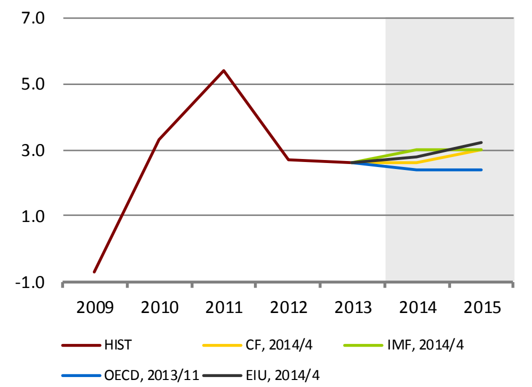
Annual GDP growth in China slowed to 7.4% in 2014 Q1 from 7.7% in 2013 Q4, while quarterly growth moderated to 1.3%. Growth in industrial production and fixed investment is slowing, too. Exports fell by 3.4% year on year at current prices, whereas imports rose by 1.6%. The new CF, EIU and IMF outlooks expect growth of 7.3%–7.5% this year and a further slowdown to 6.9%–7.3% in 2015. According to the new outlooks, consumer price inflation will be below the 3.5% target announced by the Chinese government. Prices may start rising slightly faster next year. The Chinese central bank widened the fluctuation band for the renminbi in mid-March, which led to a sharp depreciation of the Chinese currency. At the outlook horizon, however, a return to an appreciation path is expected, and at the two-year horizon the renminbi should strengthen against the dollar to CNY 6.

GDP growth, %



	CF	IMF	OECD	EIU
2014	7.3	7.5	8.2	7.3
2015	7.2	7.3	7.5	6.9

Inflation, %

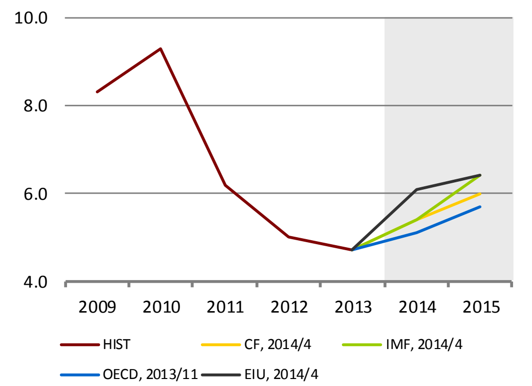


	CF	IMF	OECD	EIU
2014	2.6	3.0	2.4	2.8
2015	3.0	3.0	2.4	3.2

III.2 India

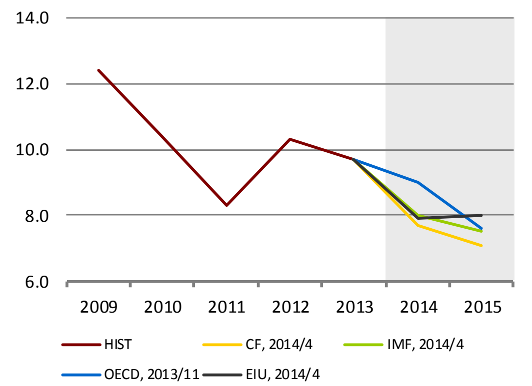
In past months the rupee was supported by a monetary tightening and an inflow of longer-term capital. The weaker and more competitive exchange rate (following the weakening in 2013) should boost exports and foster an improvement in the growth prospects of the Indian economy. The development of important investment projects will depend on the results of the election to be held in April and May. The outlook for India is generally favourable: GDP growth should rise from 4.7% in 2013 to 5.4% in 2014 and 6% in 2015. By contrast, consumer price inflation should decline from 9.6% in 2013 to 7.7% in 2014 and 7.1% in 2015. The current exchange rate of the rupee is around INR 60.2 to the dollar and the April CF predicts a slight depreciation to levels close to INR 62 to the dollar at one year.

GDP growth, %



	CF	IMF	OECD	EIU
2014	5.4	5.4	5.1	6.1
2015	6.0	6.4	5.7	6.4

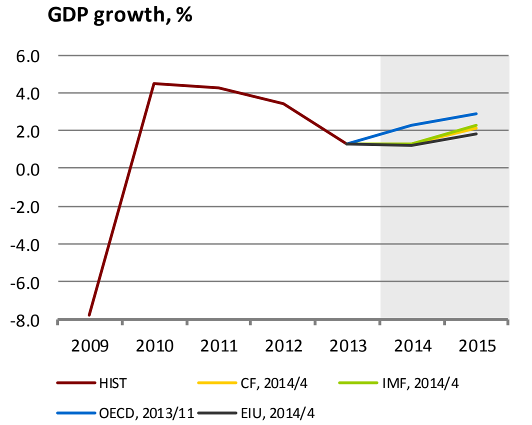
Inflation, %



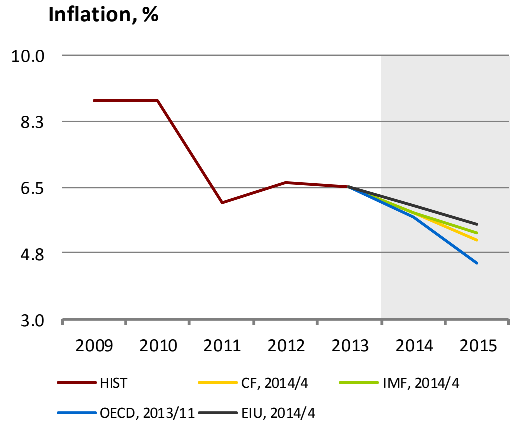
	CF	IMF	OECD	EIU
2014	7.7	8.0	9.0	7.9
2015	7.1	7.5	7.6	8.0

III.3 Russia

According to the latest data, Russian GDP growth slowed from 3.4% in 2012 to 1.3% in 2013. Unfavourable macroeconomic data contributed to a significant deterioration of the outlooks for this year. CF, EIU and WEO reduced their growth outlooks to just above 1%; by contrast, the inflation outlooks are higher than in the past. Weaker economic activity is also indicated by a preliminary outlook from Russia's Ministry of Economic Development, as its baseline scenario expects growth of 1.1% assuming that the economy receives fiscal support. However, the Ministry does not rule out growth of only 0.5%, stressing that activity is being dampened by a marked net outflow of capital, whose preliminary estimate for 2014 Q1 is close to the figure for 2013 as a whole. The Russian central bank expects growth to slow to less than 1% and the Ministry of Finance does not rule out near-zero growth, according to Interfax. The World Bank's new outlook expects the Crimean conflict to have an adverse impact on investment. The World Bank reduced its GDP growth outlook for 2014 to between 1.1% and -1.8% (should the Ukraine crisis deteriorate substantially).



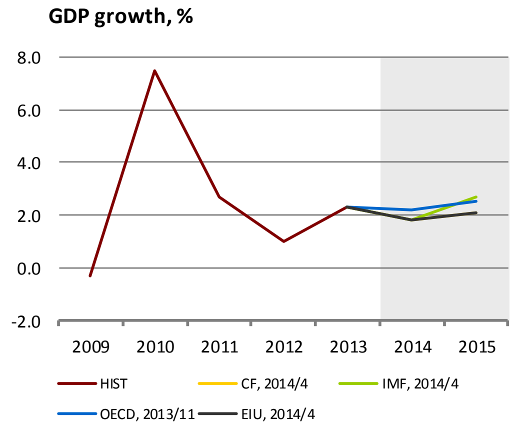
	CF		IMF		OECD	EIU	
2014	1.3	↘	1.3	↘	2.3	1.2	↘
2015	2.1	↘	2.3	↘	2.9	1.8	↘



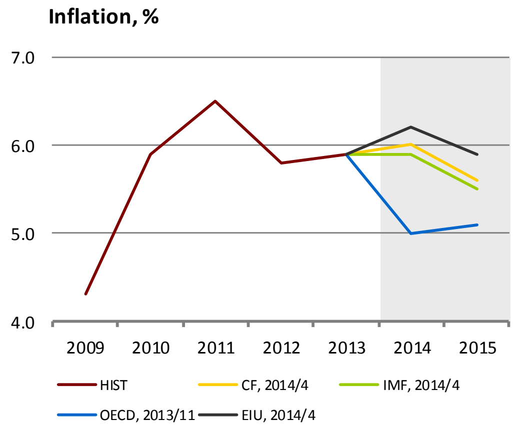
	CF		IMF		OECD	EIU	
2014	5.8	↗	5.8	↗	5.7	6.0	↗
2015	5.1	→	5.3	↗	4.5	5.5	↗

III.4 Brazil

The real has rebounded in recent weeks despite a downgrade by Standard & Poor's to BBB- in March. The downgrade was due to economic reforms ushered in by President Dilma Rouseff, who tried to revive Brazil's economic growth by cutting taxes and increasing spending. However, she failed to kick-start the economy and external debt increased. The recent appreciation of the real mainly reflects a monetary tightening by the central bank, which raised the interest rate towards 11% in March. However, weak growth, high inflation and a large external deficit suggest that the appreciation of the real is likely to be short-lived. In 2013, GDP rose by 2.3% and consumer prices by 5.9%. The April CF predicts low GDP growth of around 1.8% in 2014 and 2.1% in 2015. Consumer prices should rise by 6% in 2014 and around 5.6% in 2015. The real is currently at about BRL 2.1 against the dollar. CF expects it to weaken to BRL 2.42 at one year.



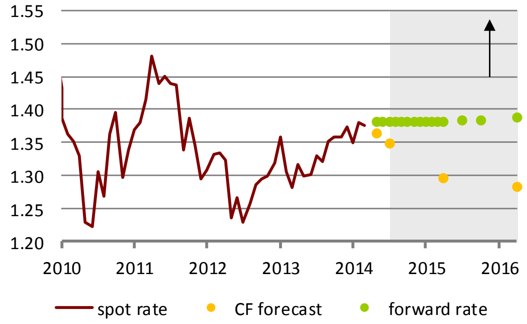
	CF		IMF		OECD	EIU	
2014	1.8	↘	1.8	↘	2.2	1.8	→
2015	2.1	↘	2.7	↘	2.5	2.1	→



	CF		IMF		OECD	EIU	
2014	6.0	↗	5.9	↗	5.0	6.2	↗
2015	5.6	↗	5.5	↗	5.1	5.9	→

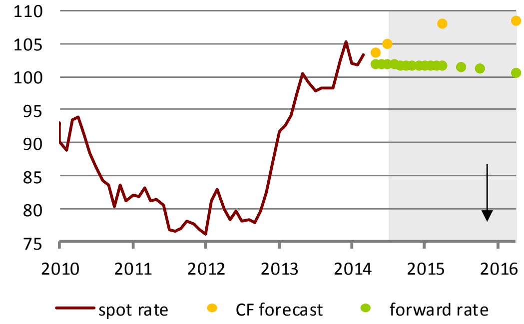
IV. Outlook of exchange rates vis-à-vis the US dollar

THE EURO



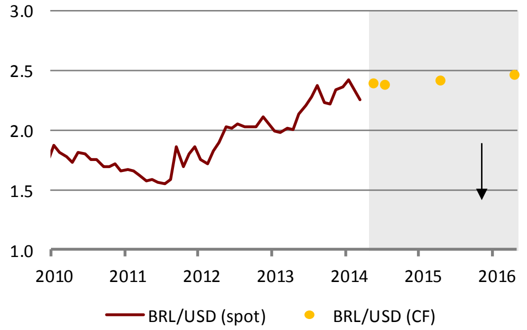
	14/04/14	05/14	07/14	04/15	04/16
spot rate	1.382				
CF forecast		1.363	1.349	1.297	1.283
forward rate		1.382	1.382	1.382	1.388

THE JAPANESE YEN



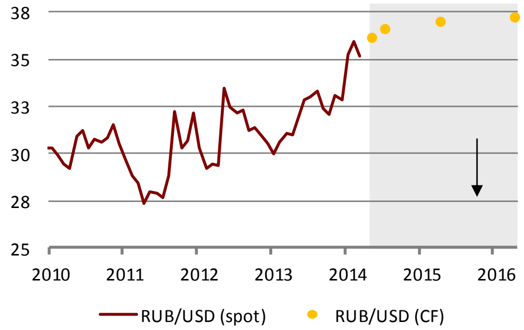
	14/04/14	05/14	07/14	04/15	04/16
spot rate	101.90				
CF forecast		103.70	104.90	108.00	108.40
forward rate		101.83	101.80	101.57	100.63

THE BRAZILIAN REAL



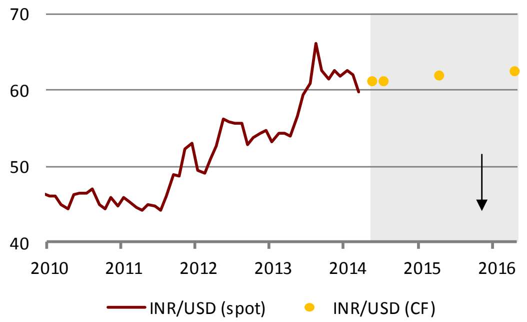
	14/04/14	05/14	07/14	04/15	04/16
spot rate	2.21				
CF forecast		2.39	2.38	2.42	2.46

THE RUSSIAN ROUBLE



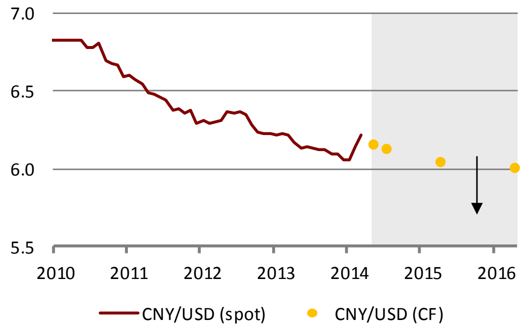
	14/04/14	05/14	07/14	04/15	04/16
spot rate	35.92				
CF forecast		36.14	36.57	36.95	37.19

THE INDIAN RUPIE



	14/04/14	05/14	07/14	04/15	04/16
spot rate	60.24				
CF forecast		61.18	61.21	61.92	62.40

THE CHINESE RENMINBI



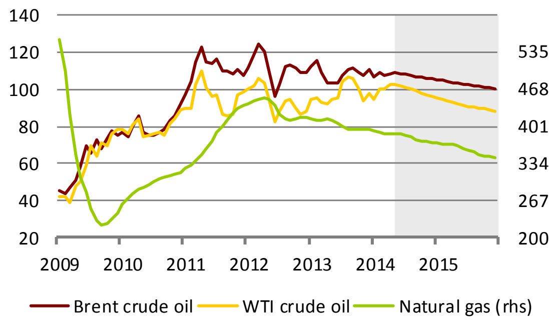
	14/04/14	05/14	07/14	04/15	04/16
spot rate	6.22				
CF forecast		6.15	6.13	6.05	6.00

Arrow indicates currency appreciation against US dollar. Exchange rates as of last day of month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibility of hedging future exchange rate.

V.1 Oil and natural gas

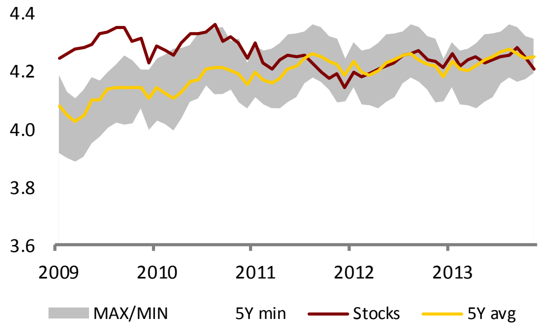
The Brent crude oil price stayed within a relatively narrow band of USD 107–112 a barrel in March (for the ninth consecutive month), averaging USD 107.8 a barrel. In the first half of March the price fell on concerns of a slowdown in economic activity in China and lower seasonal demand, with sufficient supply growth dampening risks stemming from local extraction shortfalls and the political tensions in Ukraine. At the close of the month the price fluctuated as the Western powers stepped up their sanctions against Russia and as political talks between the two sides progressed. An agreement between rebels and the Libyan government to open two small oil export terminals pushed the Brent price down temporarily. In early April, however, the price began to rise again as it became clear that growth in oil exports from Libya would only be gradual and as armed clashes broke out in Ukraine. The price was also supported by favourable data from the US labour market. The oil price outlook remains falling, as expected extraction growth (especially in North America) exceeds expected demand growth. These expectations, coupled with lower concerns about inflation (owing to the tapering of the monetary stimulus in the USA) have also led to financial investors leaving commodity markets (and moving to stock markets). Low and falling stocks of oil products in OECD countries have so far been acting against a sharper decline in oil prices. The EIA expects an average Brent crude oil price of USD 105 and USD 101 a barrel this year and the next respectively. The April CF expects the price to stagnate around USD 106 a barrel at one year. The WTI oil price has been rising since the opening of the pipeline from the US inland to the Gulf Coast in mid-January (despite a temporary drop in the first half of March) owing to falling oil stocks at the Cushing terminal. The Brent-WTI spread also declined as a result.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS

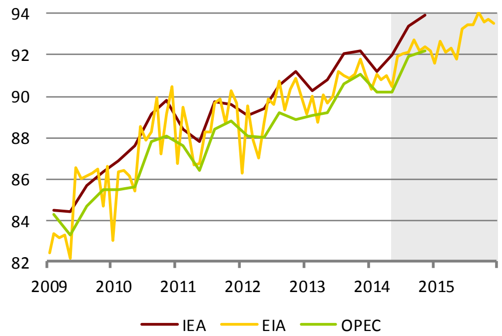


	Brent	WTI	Natural gas
2014	-1.08	1.78	-5.05
2015	-4.43	-8.20	-6.38

TOTAL STOCKS OF OIL AND OIL PRODUCTS IN OECD

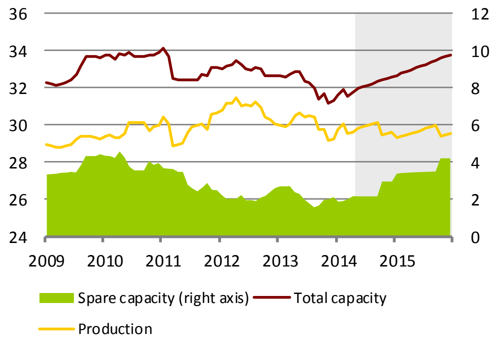


GLOBAL CONSUMPTION OF OIL AND OIL PRODUCTS



	IEA	EIA	OPEC
2014	1.42	1.36	1.25
2015		1.48	

PRODUCTION, TOTAL AND SPARE CAPACITY IN OPEC COUNTRIES



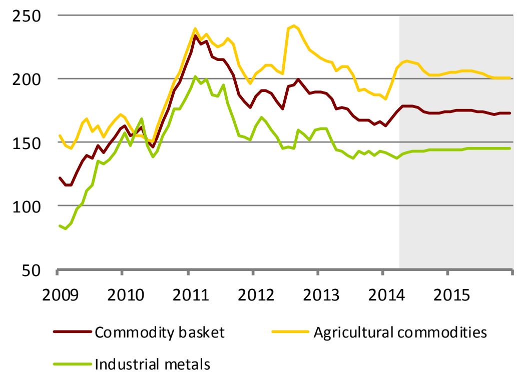
	Production	Total capacity	Spare capacity
2014	-0.77	-0.26	6.79
2015	-0.66	3.55	58.34

Note: Oil price in USD/barrel, price of Russian natural gas at German border in USD/1,000 m3 (IMF data, smoothed by the HP filter). Future oil prices (grey area) are derived from futures and future gas prices are derived from oil prices using model. Tables show annual percentage changes. Total oil stocks (commercial and strategic) in OECD countries including average, maximum and minimum in past five years in billions of barrels. Global consumption of oil and oil products in millions of barrels a day. Production and extraction capacity of OPEC in million barrels a day (EIA estimate).
Source: Bloomberg, IEA, EIA, OPEC, CNB calculations

V.2 Other commodities

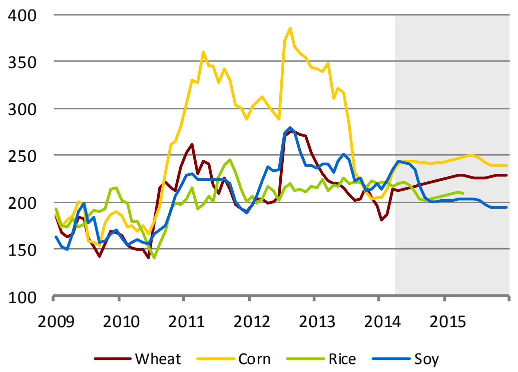
Commodity market developments remain mixed, although a falling tendency prevailed in most markets as demand from large emerging economies continued to weaken. Financial investors withdrew from commodity markets and moved their investments to equity markets in advanced countries, as the perceived inflation risk (and the need to hedge against it) is falling as a result of the tapering of the monetary stimulus in the USA and rising interest rates. For non-energy commodities, this was most apparent in the industrial metals price index, especially the price of copper. Only nickel and tin prices increased, as the Indonesian government is considering a ban on exports of unprocessed minerals. However, the overall non-energy commodity price index rose in March and the first half of April as a result of a marked increase in the food commodity price index. This was due mainly to prices of wheat and corn owing to the political situation in Ukraine and bad weather in Brazil. Ukraine is the third largest corn exporter and the sixth largest wheat exporter in the world, while Brazil is the second biggest exporter of corn.

PRICES OF NON-ENERGY COMMODITIES



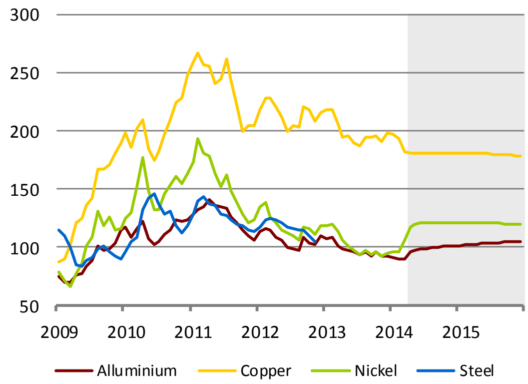
	Overall comm. basket	Agricultural comm.	Industrial metals
2014	-0.4	1.7	-2.1
2015	0.0	-0.7	1.8

FOOD COMMODITIES



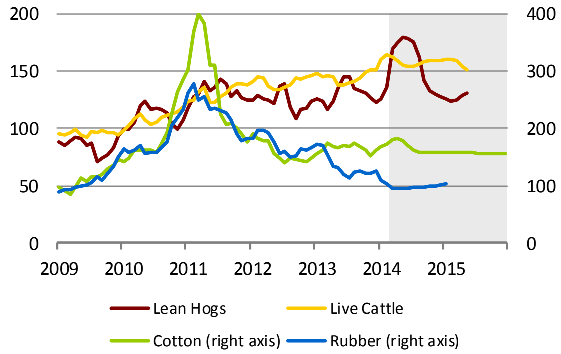
	Wheat	Corn	Rice	Soy
2014	-1.1	-15.0	-3.2	-4.4
2015	7.0	3.4	-1.4	-9.9

METALS



	Aluminium	Copper	Nickel
2014	-0.4	-7.8	12.8
2015	6.7	-1.8	4.7

MEAT, NON-FOOD AGRICULTURAL COMMODITIES



	Lean hogs	Live Cattle	Cotton	Rubber
2014	17.2	9.5	1.1	-26.5
2015	-16.9	-0.9	-6.1	

Note: Indicies calculated based on prices in USD. Structure of non-energy commodity price indices corresponds to composition of The Economist commodity indices. All prices are given as indices, 2005 = 100 (charts) and percentage changes (tables).
Source: Bloomberg, CNB calculations.

Heterogeneity of financial conditions in euro area countries[1]

Following the creation of the euro area, long-term government bond yields and, in parallel, interest rates on loans to the private sector converged across the euro area countries as expected. Such convergence is an important condition for the single monetary policy in a monetary union to function successfully. In 2008, however, the financial crisis interrupted the convergence process, and the euro area debt crisis contributed to a further increase in the interest rate differences between countries. The high interest rates faced by non-financial corporations and households in countries hit by the debt crisis are a major factor hampering their growth and hindering the recovery in the euro area as a whole. However, easing the monetary conditions in the periphery countries requires unconventional central bank or government instruments, and finding an optimal tool that is acceptable to all euro area countries seems difficult.

Introduction

This analysis describes the evolution of financial (lending) conditions in the euro area, where financial integration accompanied by interest rate convergence after the creation of the euro area was replaced by interest rate divergence during the financial crisis. The high interest rates faced by households and businesses, particularly in euro area periphery countries, are regarded as one of the main obstacles to a recovery in the euro area, as they are preventing firms from investing (which is having an adverse effect on long-term growth and unemployment) and hampering private consumption growth. We will focus specifically on the market for loans to non-financial corporations and households and describe the tools mentioned in the literature which central banks or governments can use to ease the monetary conditions in euro area periphery countries.

1. Convergence and divergence of interest rates in the euro area

For a monetary union to function smoothly, it is vital that interest rates are similar across countries and reflect central bank policy. In such a situation, the central bank can – by changing its monetary policy rate – affect the financial conditions of corporations and households, and thereby influence economic activity and achieve price stability.

After the EMU was established and the single European currency introduced, interest rates really did converge (see Chart 1). In other words, the differences in rates on loans to non-financial corporations and on mortgages actually decreased. This convergence occurred for several reasons. First, the single monetary policy led to the elimination of differences in term premiums on euro area assets. The funding costs of banks, particularly in the southern periphery of the euro area, decreased further thanks to access to the single interbank market. Another reason was convergence of government bond yields. The decrease in yields was reflected in lower external financing costs in the southern countries.

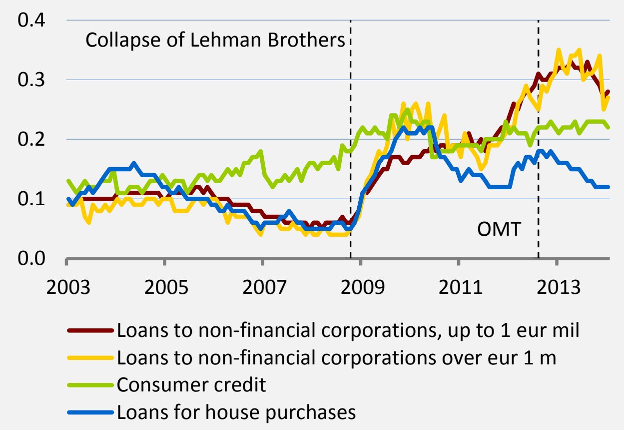


Chart 1 Coefficient of variation for interest rates on new loans in the euro area
Source: ECB
Note: The coefficient of variation is the ratio of the standard deviation to the mean. An increase in its value thus signifies divergence adjusted for the change in the mean rate.

However, the rate convergence process was interrupted by the financial crisis in 2008, when investors started to see differences between countries and their governments and banking sectors. The amount of interbank loans started falling across the euro area countries (the banking sector started to fragment). Bond yields in southern euro area countries and Ireland rose, as did yields on bank bonds. The increase in rate differences intensified during the euro area debt crisis. One bank rate component – sovereign default risk – rose in the periphery countries but fell in the core countries owing to flight to quality. Another component that increased was the credit premium, as corporate credit risk increased in the periphery countries due to their lower growth potential, which was further reduced by ongoing fiscal consolidation. The volumes of cross-border loans on the interbank market continued falling.

[1] Written by Tomáš Adam (tomas.adam@cnb.cz). The opinions expressed in this article are those of the author and do not necessarily reflect the official position of the Czech National Bank.

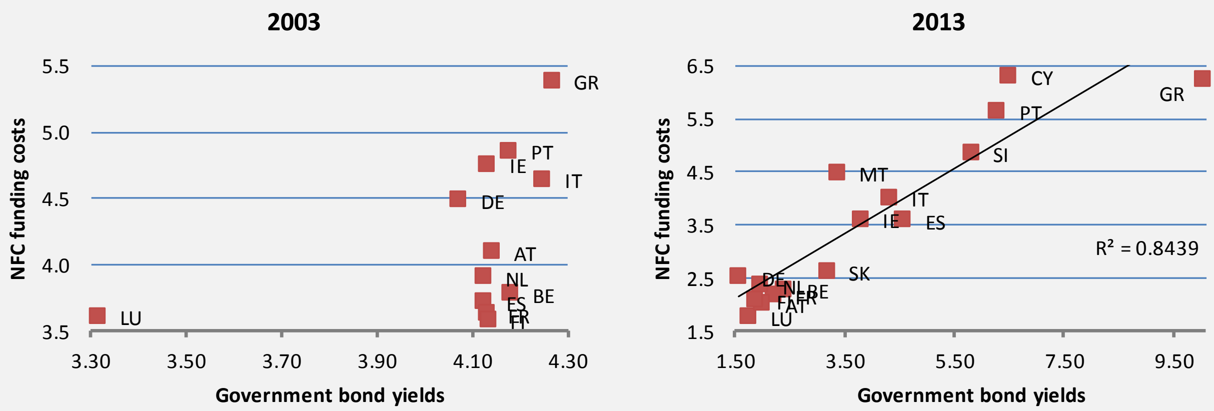


Chart 2 Government bond yields and funding costs of non-financial corporations

Source: ECB

Note: The ECB calculates funding costs by weighting the interest rates on existing loans (the chart shows annual averages of monthly data). Government bond yields are taken from the benchmark bond yields used for the convergence purposes of the ECB.

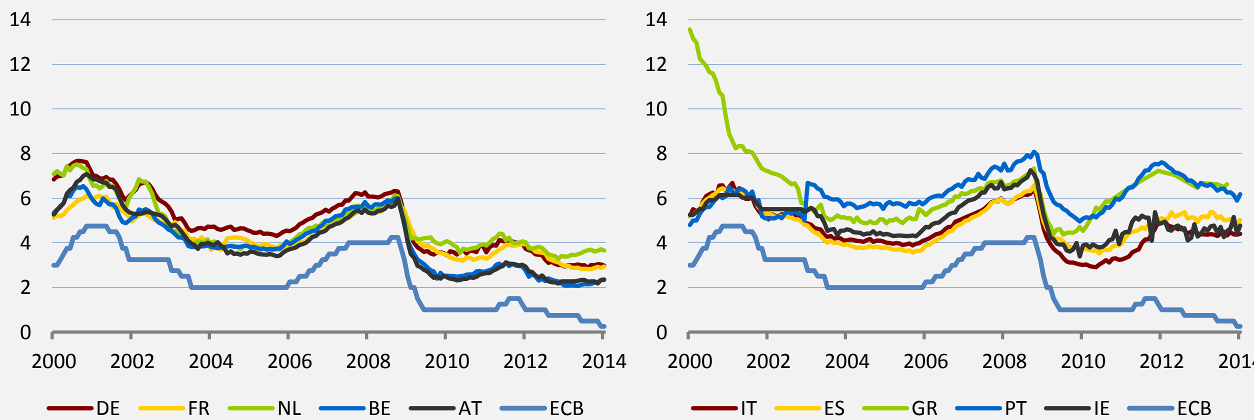


Chart 3 Rates on new loans to non-financial corporations of up to EUR 1 million

Source: ECB

Note: ECB = ECB's main refinancing rate

The fragmentation of the banking sector resulted, among other things, in a situation where interest rates in the periphery countries failed to go down despite the rate cuts made by the ECB from the end of 2011 onwards (see Chart 3). This indicates that the monetary policy transmission mechanism in these countries was impaired. The situation escalated in mid-2012 owing to problems in the Spanish banking sector, giving rise to concerns about the sustainability of the euro area. The ECB reacted by declaring that it was "ready to do whatever it takes to preserve the euro"[2] and by introducing Outright Monetary Transactions (OMTs). This led to some reduction in government bond yields by eliminating the risk of a euro area break-up (Cœuré, 2013). Nonetheless, the differences in client loans are still significant.

Chart 2 illustrates the relationship between debt funding costs and government bond yields. It shows that both the government bond yield spread and the differences in client loan rates were small just after the euro area was created. Interestingly, the countries currently in distress already faced higher rates back then, although those rates were only slightly higher than in Germany, for example. By contrast, the spread in 2013 (i.e. after the OMT programme had calmed the situation somewhat) was wide, and a clear relationship between yields and rates is visible. To interpret this, however, we should bear in mind the endogeneity between bank and government bond risk.

2. Differences in financial conditions across sectors

Both households and small and large firms in euro area periphery countries are being hit by high funding costs. However, the difference in these costs compared to the core countries varies across sectors. From the macroeconomic point of view, the situation in the SME sector (small and medium enterprises, i.e. firms with a turnover of less than EUR 250 million and with less than 250 employees) is of particular concern (see Chart 4).

[2] https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

Chart 5 shows the difference between rates on new loans of up to EUR 1 million and over EUR 1 million. Smaller loans are demanded by smaller firms, for which credit risk is higher and a higher risk premium is therefore required. The chart shows that the differences between large and small loans are larger in the periphery countries than in the core countries and have also been tending to rise recently. In addition, SMEs do not have access to the stock or bond market, so they are dependent on bank loans. This is worrying when we realise that such firms account for a large proportion of employment in the euro area (87 million people were working in the SME sector in 2012) and have the biggest growth potential. Another worrying fact is that the mentioned statistics are underestimated because they only cover loans granted. They thus do not reflect rates on loans that were not provided or were rejected by the applicant (because of high interest rates or strict collateral requirements).

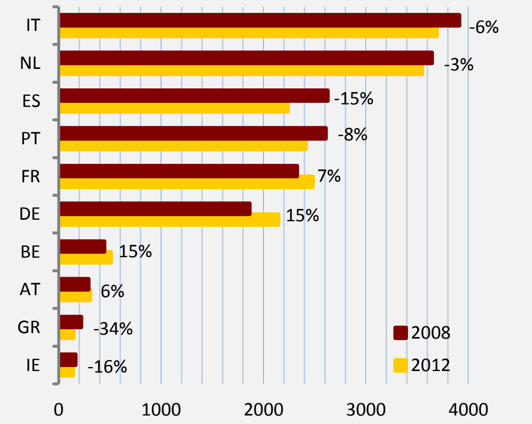


Chart 4 Number of SMEs in the countries under review
Source: European Commission
Note: No. in thous.; the column legend gives the percentage change in the number of SMEs between the given years

The household sector is also affected by interest rate divergence, albeit to a lesser extent than the non-financial corporations sector. For example the spread on mortgage loans between the two parts of the euro area is lower than that on loans to corporations (see Chart 6). Finally, consumer credit rates were not converging much before the crisis either, and the degree of divergence is also rather lower. Despite this, these rates often do not reflect the ECB's key rate.

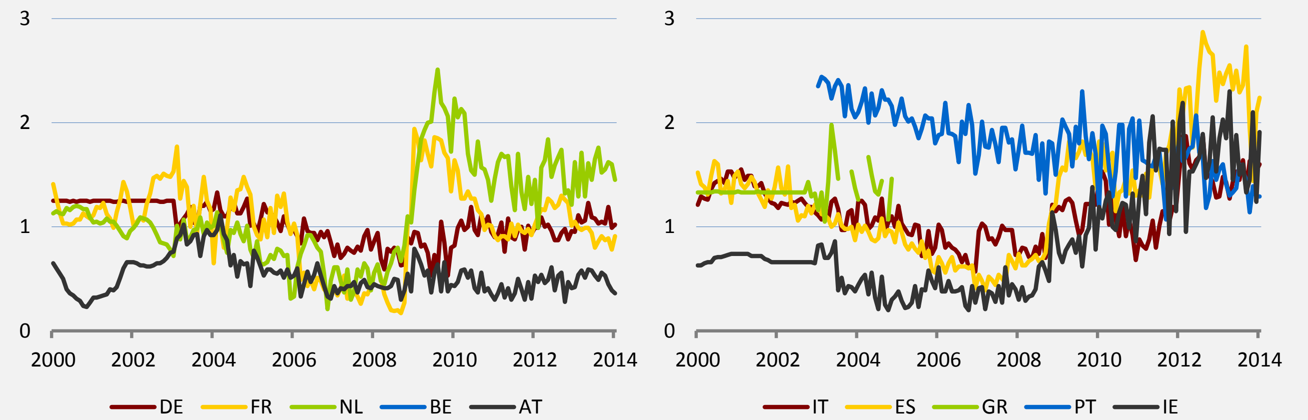


Chart 5 Loans to non-financial corporations – difference between rates on new loans of over EUR 1 million and up to EUR 1 million
Source: ECB

To sum up, interest rates on loans to SMEs – the most important sector for economic growth – are high in the periphery countries compared to the core countries and often still at pre-crisis levels, when economies were in the growth phase of the business cycle. However, the situation is exacerbated by the fact that the periphery countries have low inflation or deflation, so that the real monetary conditions are even stricter for them than the above charts show.

The high interest rates on loans are reflected in loan volumes (see Chart 7). The chart shows that the volume of loans rose faster in the periphery countries than in the core countries after the creation of the euro area, when the countries faced similar low rates, although this trend reversed after the crisis. However, high funding costs are not the only cause of this decline; we must also take into account bank deleveraging, defaults in periphery countries and low corporate demand for loans. On the other hand, survey evidence (e.g. European Commission, 2013) and anecdotal evidence (e.g. Gordon, 2014) suggest that firms often turn down loans because of high borrowing costs. The fact that high costs discourage some firms from applying for loans can also be seen in the increased use of non-bank funding (e.g. P2P lending – direct lending and mini bonds in Italy). Such funding, however, is of little macroeconomic significance.

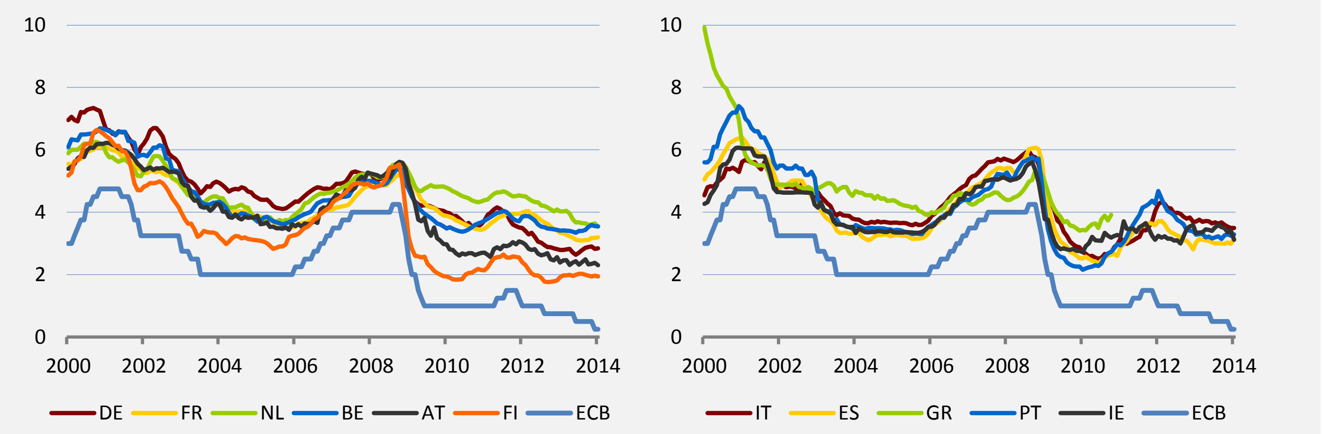


Chart 6 Rates on loans to households for house purchase (new business)

Source: ECB

Note: ECB = ECB's main refinancing rate

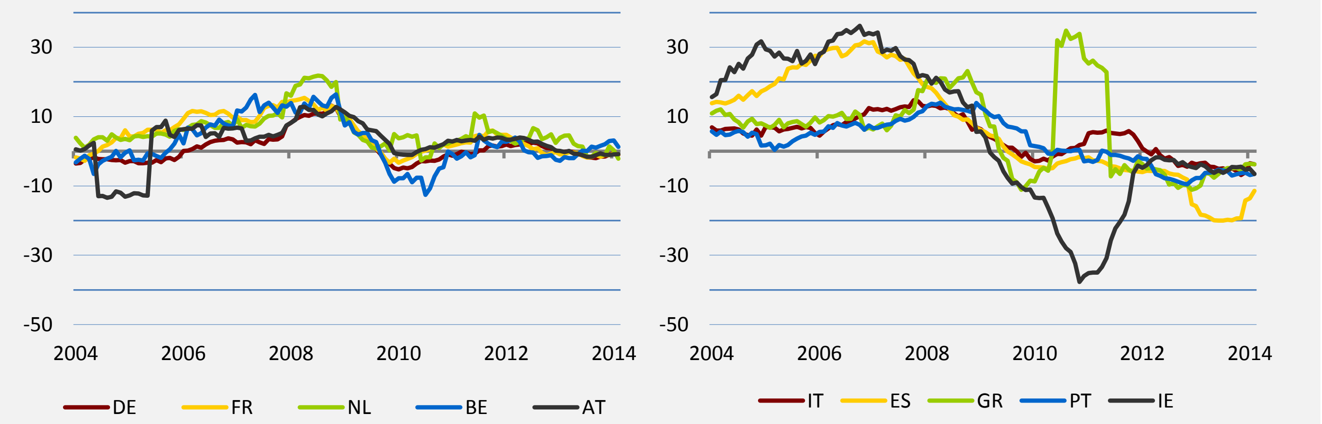


Chart 7 Annual growth in loans to non-financial corporations (%)

Source: ECB

Note: The decline in the volume of loans in Austria in 2004/2005 was due to base effects, as loans were denominated for the new member states after its neighbours entered the EU in May 2004. The positive growth in Greece in 2010/2011 was due to financial assistance provided to corporations (including state-owned ones) by the Greek government.

3. Further monetary easing in the periphery countries

The above discussion shows that the euro area is in a paradoxical situation where firms in countries in the down phase of the cycle are facing tighter monetary conditions than those in the core countries, which are in the recovery phase. This situation is preventing, or at least hindering, a recovery in the periphery countries, which are at risk of further real divergence from the core. Although demand for new loans is not high in this phase of the cycle, potentially lower borrowing costs could lead to refinancing of corporate loans, which would be reflected in their profits and subsequently also in employment. The question is whether, and to what extent, the ECB should intervene in this situation (e.g. Dombret, 2013), as a large part of the interest rate differential is determined by fundamentals and historical experience shows that very similar rates in the monetary union result in excessive credit growth in some countries.

There is no doubt, however, that any efforts to further ease the monetary conditions in the periphery countries will require the use of unconventional monetary policy instruments, not only because the ECB's key rate is only just above zero, but also because the transmission mechanism (the effect of the ECB's monetary policy rate on client loan rates) in the southern states is impaired. However, it is hard to reach a consensus across the euro area countries. One example is the August 2012 OMT programme, which was followed by a sharp fall in yields on periphery countries' bonds and thus in one of the determinants of corporate interest rates. However, this measure was opposed by Germany, which argued that, owing to potential bond purchases by the ECB, it might ultimately lead to monetary financing of governments.

The launch of the banking union should help further loosen the link between government bonds and banks. The question is, however, whether it will have a significant effect in its currently agreed form, as there is speculation about the project's credibility and it will take eight years to fill up the Single Resolution Mechanism's fund. Nonetheless, even if the link between government bonds and banks is broken, the differences in interest rates on client loans cannot be expected to return to their pre-crisis levels, as recent experience has made investors and banks more sensitive to the structural differences between countries and their different growth potentials.

One way a central bank can help ease the monetary conditions in the present situation is to affect the final part of the transition mechanism, i.e. to cut bank funding costs. Take, for example, the UK's Funding for Lending Scheme (see Box 1), where the Bank of England (and ultimately the Treasury) bears part of the credit risk of corporations. A similar measure is being considered in the euro area, as evidenced by the ECB President's speeches on ABS derivatives purchases (Draghi, 2014), where loans to SMEs would be the underlying assets. However, unlike the BoE, the ECB will – if the measure is implemented – have to resolve the issue of who would be the final risk bearer. Moreover, there is virtually no ABS product market in the euro area after the financial crisis, so the use of this instrument is problematic.

Box 1. Funding for Lending Scheme (FLS)

The Funding for Lending Scheme was launched in the UK in August 2012 in order to encourage lending to households and companies. Easier access to bank credit should boost investment and consumption, leading to higher incomes and economic growth. The FLS provides banks and building societies with cheap funding, which they then lend to corporations and households. The scheme was meant to be discontinued at the end of 2014, but was extended by one year.

The FLS was launched because of a sharp fall in lending in the UK. In 2012, moreover, the escalation of the debt crisis gave rise to a risk of higher bank funding costs spilling over to higher rates on client loans. This would probably have led to a further decline in the volume of loans and to an economic downturn.

The FLS operates in practice as follows. The BoE lends UK Treasury bills with nine-month maturity to eligible banks at a low interest rate. Both the interest rate and the amount of Treasury bills lent depend on the increase in the amount of lending a bank undertakes (i.e. new lending minus repayments). The term of borrowing is four years, but banks may return the Treasury bills earlier. To protect the BoE from incurring losses, the loans are secured and banks may use a broad range of assets as collateral, including loans just provided, to which a conservative haircut is applied.

Banks may use the Treasury bills as collateral to borrow cash on a secured market or in the BoE's open market operations. Another option is for banks to substitute them for reserves in their liquid asset buffer.

The scheme's success is under debate. The BoE and the Treasury consider its results to be positive, but lending growth has remained subdued since the introduction of the FLS (see ChartChart 8). There is no doubt that the scheme has led to lower funding costs, but it has not been able to affect demand for loans. Without the FLS, however, lending growth might have been even lower.

Mortgages were among the fastest growing loan products. The BoE reacted to this in early 2014 by ceasing to fund mortgages and other loans to households, as it believes that housing market activity is sufficient and no further support is needed.

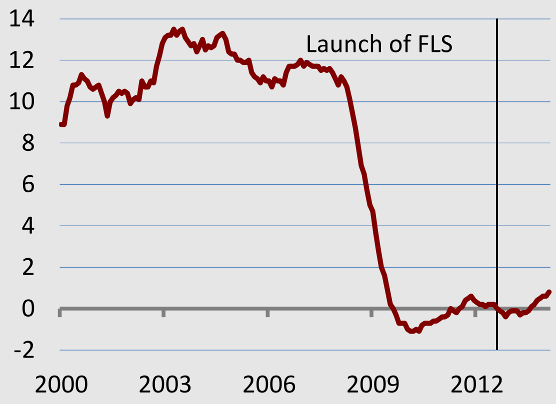


Chart 8 Annual growth in loans to non-financial corporations and households in the UK (%)
Source: ECB

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A1. Change in GDP predictions for 2014

	CF		IMF		OECD		CB / EIU	
EA	0.1	2014/4 2014/3	0.2	2014/4 2014/1	-0.1	2013/11 2013/5	0.1	2014/3 2013/12
US	-0.1	2014/4 2014/3	0.0	2014/4 2014/1	0.1	2013/11 2013/5	-0.1	2014/3 2013/12
DE	0.1	2014/4 2014/3	0.1	2014/4 2014/1	-0.2	2013/11 2013/5	0.2	2013/12 2013/6
JP	-0.1	2014/4 2014/3	-0.3	2014/4 2014/1	0.1	2013/11 2013/5	-0.1	2014/1 2013/11
BR	-0.2	2014/4 2014/3	-0.5	2014/4 2014/1	-1.3	2013/11 2013/5	0.0	2014/4 2014/3
RU	-0.7	2014/4 2014/3	-0.7	2014/4 2014/1	-1.3	2013/11 2013/5	-1.7	2014/4 2014/3
IN	0.0	2014/4 2014/3	0.0	2014/4 2014/1	-1.3	2013/11 2013/5	0.1	2014/4 2014/3
CN	-0.1	2014/4 2014/3	0.0	2014/4 2014/1	-0.2	2013/11 2013/5	0.1	2014/4 2014/3

A2. Change in inflation predictions for 2014

	CF		IMF		OECD		CB/EIU	
EA	0.0	2014/4 2014/3	-0.6	2014/4 2013/10	0.0	2013/11 2013/5	-0.1	2014/3 2013/12
US	0.0	2014/4 2014/3	-0.1	2014/4 2013/10	-0.1	2013/11 2013/5	0.1	2014/3 2013/12
DE	-0.1	2014/4 2014/3	-0.4	2014/4 2013/10	-0.2	2013/11 2013/5	-0.2	2013/12 2013/6
JP	0.0	2014/4 2014/3	-0.1	2014/4 2013/10	0.5	2013/11 2013/5	0.0	2014/1 2013/11
BR	0.1	2014/4 2014/3	0.1	2014/4 2013/10	-0.2	2013/11 2013/5	0.2	2014/4 2014/3
RU	0.4	2014/4 2014/3	0.1	2014/4 2013/10	0.3	2013/11 2013/5	0.2	2014/4 2014/3
IN	-0.3	2014/4 2014/3	-0.9	2014/4 2013/10	2.1	2013/11 2013/5	-0.9	2014/4 2014/3
CN	-0.3	2014/4 2014/3	0.0	2014/4 2013/10	-0.2	2013/11 2013/5	0.0	2014/4 2014/3

A3. List of abbreviations

BoJ	Bank of Japan	**DE**	Germany
BR	Brazil	**EA**	euro area
BRIC	Brazil, Russia, India and China	**EC**	European Commission
CB-CCI	Conference Board Consumer Confidence Index	**ECB**	European Central Bank
CB-LEII	Conference Board Leading Economic Indicator Index	**EC-CCI**	European Commission Consumer Confidence Indicator
CBOT	Chicago Board of Trade	**EC-ICI**	European Commission Industrial Confidence Indicator
CF	Consensus Forecasts	**EIU**	The Economist Intelligence Unit database
CN	China	**EEA**	European Economic Area
CNB	Czech National Bank	**ES**	Spain
DBB	Deutsche Bundesbank	**EU**	European Union

EMI	European Monetary Institute	**JP**	Japan
EURIBOR	Euro Interbank Offered Rate	**JPY**	Japanese yen
Fed	Federal Reserve System (the US central bank)	**LIBOR**	London Interbank Offered Rate
FRA	forward rate agreement	**N/A**	not available
GBP	pound sterling	**OECD**	Organisation for Economic Co-operation and Development
GDP	gross domestic product	**OECD-CLI**	OECD Composite Leading Indicator
GR	Greece	**PMI**	Purchasing Managers' Index
CHF	Swiss franc	**PT**	Portugal
ICE	Intercontinental Exchange	**RU**	Russia
IE	Ireland	**UoM**	University of Michigan
IFO	Institute for Economic Research	**UoM-CSI**	University of Michigan Consumer Sentiment Index
IFO-BE	IFO Business Expectations	**US**	United States
IMF	International Monetary Fund	**USD**	US dollar
IN	India	**ZEW-ES**	ZEW Economic Sentiment
IRS	interest rate swap		
IT	Italy		

A4. List of thematic articles published in the GEO

2014

	Issue
Heterogeneity of financial conditions in euro area countries (Tomáš Adam)	2014-4
The impacts of the financial crisis on price levels in Visegrad Group countries (Václav Žďárek)	2014-3
Is the threat of deflation real? (Soňa Benecká and Luboš Komárek)	2014-2
Forward guidance – another central bank instrument? (Milan Klíma and Luboš Komárek)	2014-1

2013

	Issue
Financialisation of commodities and the structure of participants on commodity futures markets (Martin Motl)	2013-12
The internationalisation of the renminbi (Soňa Benecká)	2013-11
Unemployment during the crisis (Oxana Babecká and Luboš Komárek)	2013-10
Drought and its impact on food prices and headline inflation (Viktor Zeisel)	2013-9
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