2. International Economic Developments

Global economic growth continued to slow down, albeit slightly, in the last quarter of 2011, and growth forecasts for 2012 were revised downwards. The downward revision of the global growth forecasts mostly reflects lower growth in advanced economies, especially the Euro Area, which diverged from other countries.

The Euro Area debt crisis was heightened further in the last quarter, with problems spreading from the financial sector to the real economy. The worsening outlook urged the Euro Area leaders to take new measures on the December 9 summit. However, uncertainties regarding viability of the summit decisions as well as concerns over the capability of the adopted measures to solve problems caused debt crisis to further occupy the agenda. Though lacking in measures to solve the internal imbalances in the Euro Area, assuming that legal issues will be overcome, December 9 decisions at least save time for the peripheral countries, which were crushed by the debt crisis, enabling them to solve their structural problems by providing new financing opportunities (Box 2.1). Having faced capital adequacy problems amid the debt crisis, the harmonization of the Euro Area banking sector to new regulations to be introduced on the capital adequacy ratios constitutes another source of uncertainty. Under these circumstances, the Euro Area problems are likely to be solved only gradually over time.

The U.S. economic indicators pointed to a slightly better-than-expected performance in employment and household spending in the last three months, while, investments paced down and the real estate sector remained subdued. Accordingly, the Fed continued with its expansionary monetary policy to stimulate the economic activity, and hence, further engaged in qualitative easing by purchasing long-term Treasury bonds in exchange for short-term ones. Moreover, in view of the anticipated downside risk to inflation, the Fed also announced that policy rates would be kept at their currently low levels at least until the end of 2014. The Fed underlined that by keeping policy rates at low levels for an extended period as well as further implementing the easing packages, the monetary policy would continue to bolster the economic activity in the forthcoming period.

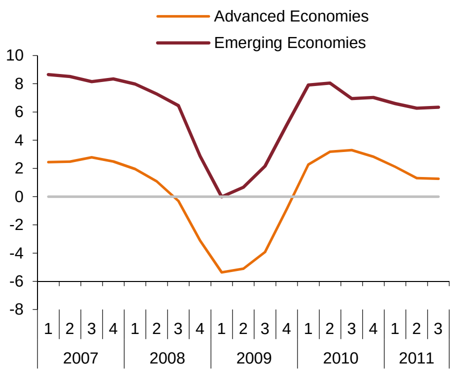
Leading indicators point that emerging economies were affected adversely by the global turmoil and the economic activity has started to lose pace in these countries. Despite having sound macroeconomic fundamentals, emerging economies can still be adversely affected by the problems in advanced economies through trade, funding and expectations channel. These adverse effects, which are more heavily felt in Eastern European economies, will persist in the forthcoming period, thus causing delays in the re-acceleration of capital flows to emerging economies.

Having slumped in the third quarter, commodity prices increased merely in the last quarter. In line with the slowdown in the global economic activity, downward revision of demand expectations may contain increases in commodity prices in the forthcoming period. However, persisting supply-side problems pose an upside risk, especially on oil prices.

2.1. Global Growth

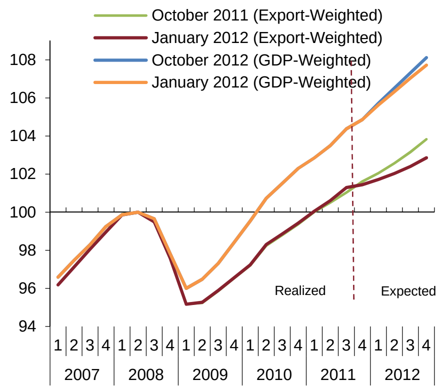
Global economic growth in advanced and emerging economies remained unchanged in the third quarter in annualized terms (Chart 2.1.1). GDP-weighted global production index points to a slightly weaker external demand outlook for 2012 in the inter-reporting period. Meanwhile, export-weighted index signals an even weaker outlook amid the negative divergence of the European countries, Turkey's main export destination having a major weight in the export-weighted index, from other countries, especially the U.S. (Chart 2.1.2).

Chart 2.1.1.
Global Growth Rates*
(Annual Percent Change)



* Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

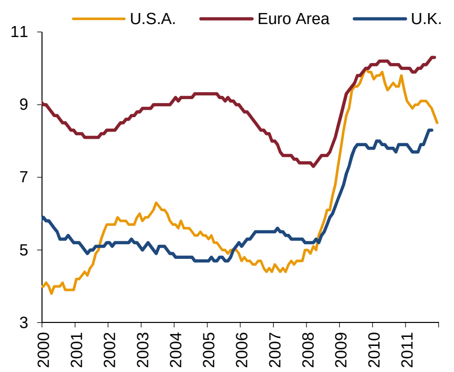
Chart 2.1.2.
Global Production Indices*
(2008Q2=100)



* Weighted by each country's share in global GDP and in Turkey's export for GDP-weighted and export-weighted, respectively.
Source: Bloomberg, Consensus Forecasts, CBRT.

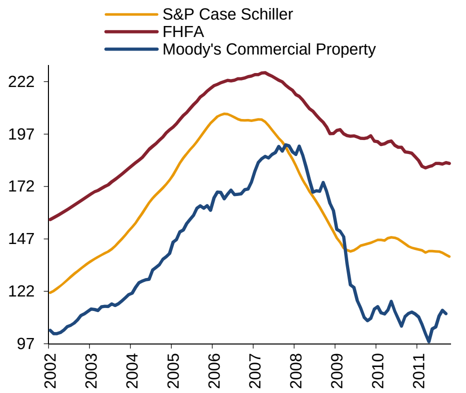
Even though labor market dynamics differ across Euro Area countries given their structural differences, unemployment rates still remain on the rise in general. As for the U.S., the unemployment rate remains well above its pre-crisis level despite having followed a downtrend since the second half of the year (Chart 2.1.3). Meanwhile, the U.S. real estate market has yet to recover given the edging up in commercial real estate prices (Chart 2.1.4).

Chart 2.1.3.
Unemployment in Advanced Economies
(Percent)



Source: Bloomberg.

Chart 2.1.4.
Real Estate Prices in the U.S.



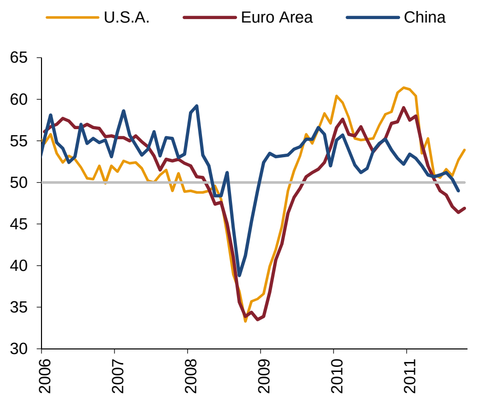
Source: Bloomberg.

After falling sharply, the JP Morgan Global PMI indices stagnated in the fourth quarter, signaling a weak outlook for the global growth (Chart 2.1.5). The Euro Area and the Chinese PMI remained below neutral, while the U.S. PMI posted a notable increase in the last quarter of 2011 (Chart 2.1.6).

Chart 2.1.5.
JP Morgan Global PMI Indices

Source: Bloomberg.

Chart 2.1.6.
PMI Indices



Source: Bloomberg.

2012 growth forecasts of the January Consensus Forecasts bulletin were revised upwards for the U.S., and significantly downwards for the Euro Area in the inter-reporting period (Table 2.1.1).

Against this background, the external demand outlook for the baseline scenario in the last section of this Report was revised downwards as growth expectations for the Euro Area countries, Turkey's main export destination, were lowered compared to the October Inflation Report.

Table 2.1.1.
Growth Forecasts for end-2012
(Annual Percent Change)

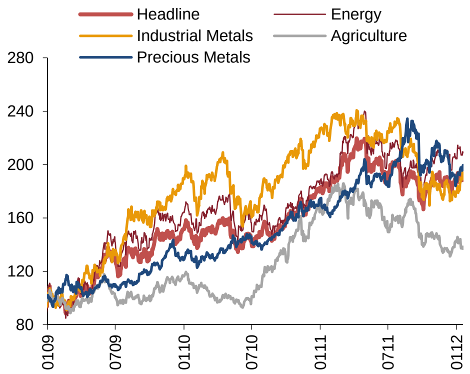
	October 2011	January 2012
World	3.0	2.6
Advanced Economies		
U.S.A.	1.9	2.2
Euro Area	0.6	-0.3
Germany	1.0	0.5
France	0.9	0.0
Italy	0.0	-1.3
Spain	0.6	-0.4
Greece	-2.9	-4.1
Japan	2.2	1.9
U.K.	1.5	0.5
Emerging Economies		
Asia-Pacific	5.2	5.0
China	8.5	8.4
India	7.9	7.3
Latin America	4.0	3.5
Brazil	3.9	3.3
Eastern Europe	3.4	2.6

Source: Consensus Forecasts.

2.2. Commodity Prices

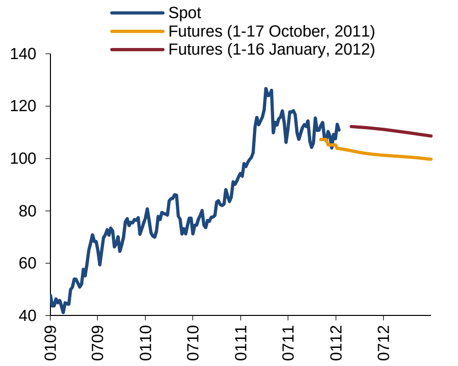
Commodity prices edged up on energy prices in the last quarter of 2011. Industrial metal prices followed a flat course given the problems in the Euro Area, as well as the anticipated slowdown in the Chinese economy. Precious metal prices reaching historical peaks in the third quarter on Euro Area debt crisis and the U.S. downgrade, followed a volatile course in the last quarter (Charts 2.2.1 and 2.2.2). Stagnating precious metal prices notwithstanding the financial and geopolitical risks can be interpreted as investors' switching to more liquid assets due to heightened financial risks.

Chart 2.2.1.
S&P Goldman Sachs Commodity Prices
(January 2009=100)



Source: Bloomberg.

Chart 2.2.2.
Crude Oil (Brent) Prices
(USD/bbl)



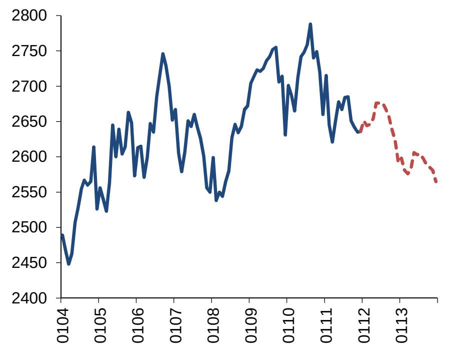
Source: Bloomberg.

Despite lower global growth forecasts and the relatively smooth weather conditions in the U.S., supply-side developments continue to pose upside pressure on oil prices. Retaliating against the economic sanctions contemplated by Europe, Iran's threats to close the Strait of Hormuz to oil trade pushed oil prices upwards. The Strait of Hormuz is especially important for Asian countries as it provides nearly 35 percent of the global maritime crude oil trade with a daily passage capacity of seventeen million barrels. The realization of this threat may generate substantial risks as it would build on political risks in the region, and call for the use of costly alternative routes for oil trade. Even if oil trade security is ensured, partial withdrawal of Iran's production from the market may lead to a sizeable capacity contraction in other producer countries, causing increased sector fragility.

Apart from Iran's threat, the reluctance of OPEC countries to raise their production is another factor that hinders the decline of oil prices (Box 2.2). As a matter of fact, OPEC's decision on its regular meeting in December to raise the production ceiling only caused quota levels to come to line with the output, without causing the production to increase in effect.

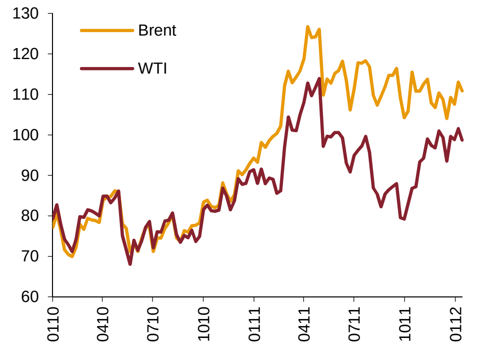
Energy prices surged recently on increases in WTI crude oil prices. While WTI crude oil prices soared by 24.7 percent, Brent crude oil prices increased by a mere 3.1 percent in the last quarter. Inventory declines in the U.S. pushed WTI prices upwards, while the rising production in Libya contained the increase in Brent crude oil prices, causing WTI and Brent crude oil prices to converge (Charts 2.2.3 and 2.2.4).

Chart 2.2.3.
OPEC Crude Oil Inventories*
(Million Barrel)



* Dotted lines represent estimate.
Source: U.S. Department of Energy.

Chart 2.2.4.
Oil Prices
(USD(bbl)



Source: Bloomberg.

Agricultural prices followed a volatile course in the fourth quarter, reaching the previous quarter levels by the year-end. Soaring inventories on the back of higher production and cultivated land are featuring supply-side developments in this period. Even though agricultural price forecasts were revised downwards for 2012, dry and hot climate in the Latin America, particularly in Argentina, remains as a major factor of uncertainty on agricultural prices (Table 2.2.1).

Table 2.2.1.
Production, Consumption and Inventory Forecasts for Agricultural Commodities

	2009/2010	2010/2011	2011/2012
WHEAT(million tons)			
Initial Inventory	167.0	202.1	200.0
Production	685.4	651.7	691.5
Consumption	650.3	653.9	681.4
Period-end Inventory	202.1	200.0	210.0
CORN (million tons)			
Initial Inventory	147.3	144.1	128.1
Production	819.2	827.4	868,1
Consumption	822.5	843.4	868.0
Period-end Inventory	144.1	128.	128.1
COTTON (million bales)			
Initial Inventory	61.7	44.4	45.4
Production	101.7	115.3	122.9
Consumption	119.0	114.3	110.0
Period-end Inventory	44.4	45.4	58.4

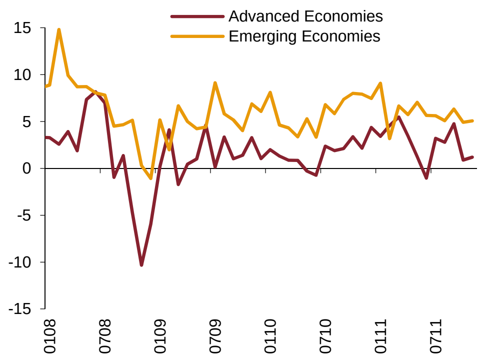
Source: U.S. Department of Agriculture.

In sum, despite the persisting supply-side uncertainties, commodity prices are expected to follow a milder course in 2012 amid the slowdown in the global economy.

2.3. Global Inflation

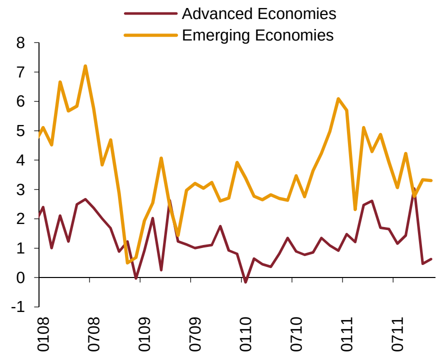
Inflation rates remained flat in emerging economies, and went down in advanced economies in the fourth quarter of 2011 (Charts 2.3.1 and 2.3.2). The upward pressure on inflation in emerging economies, posed by the recent appreciation of the exchange rates as well as the slight increase in commodity prices were balanced by the slowing domestic demand, causing seasonally adjusted consumer and core Inflation rates to remain unchanged in the inter-reporting period. Meanwhile, the ongoing problems in the advanced economies, the Euro Area in particular, significantly slowed down the economic activity, thus leading to a sizeable fall in inflation rates. Inflation compensation in the Euro Area increased slightly in the last quarter of 2011, while, in the U.S., inflation compensation remained flat, giving room to the Fed to continue with its expansionary policy bolstering economic activity (Chart 2.3.3).

Chart 2.3.1.
CPI Inflation in Advanced and Emerging Economies (Seasonally Adjusted, Annual Percent Change)



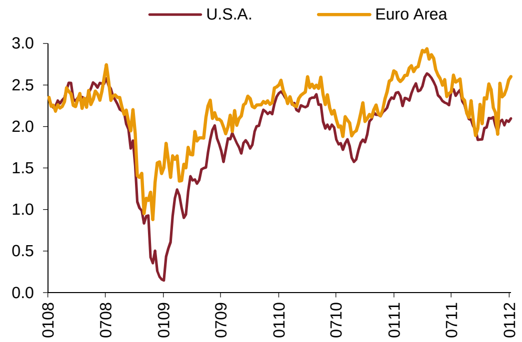
Source: Bloomberg, CBRT.

Chart 2.3.2.
Core Inflation in Advanced and Emerging Economies (Seasonally Adjusted, Annual Percent Change)



Source: Bloomberg, Datastream, CBRT.

Chart 2.3.3.
Inflation Compensation in the U.S. and the Euro Area (Percent)



Source: Bloomberg.

Global inflation forecasts for 2012 edged down in the inter-reporting period (Table 2.3.1). Inflation expectations for advanced economies were revised downwards for the U.S. and upwards for the Euro Area, while inflation expectations for the emerging economies in Asia and Latin America went down in the same period. Expectations for a weakening demand in emerging economies, especially in China and Brazil, build on the perception that inflation will go down in 2012. Meanwhile, the rise in inflation expectations for Turkey, Hungary and the Czech Republic were instrumental on the upward revision of inflation expectations for the Eastern Europe.

Table 2.3.1.
Inflation Forecasts for end-2012
(Annual Percent Change)

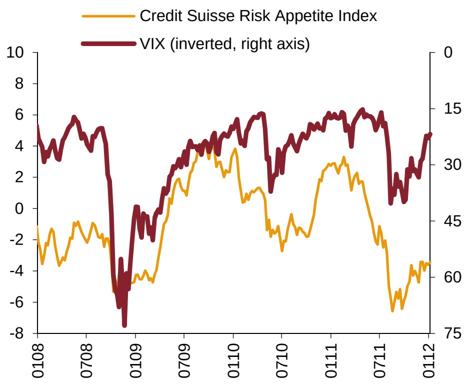
	October 2011	January 2012
World	2.9	2.8
Advanced Economies		
U.S.A.	2.1	1.9
Euro Area	1.8	1.9
Germany	1.9	1.8
France	1.7	1.7
Italy	2.0	2.3
Spain	1.6	1.6
Greece	1.1	0.8
Japan	-0.2	-0.3
U.K.	2.7	2.7
Emerging Economies		
Asia-Pacific	4.3	4.0
China	4.0	3.5
India	7.1	7.2
Latin America	6.4	6.2
Brazil	5.6	5.3*
Eastern Europe	6.0	6.3

* As of December.
Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

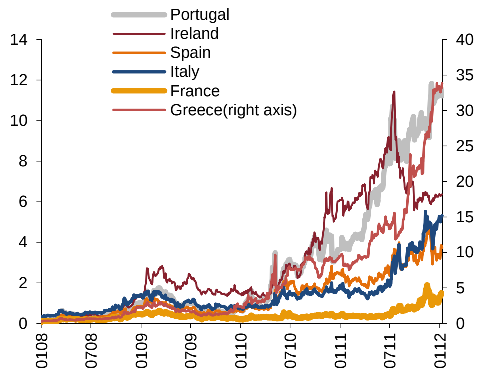
The Euro Area debt crisis, which aggravated in the last quarter of the year, was further influential on financial markets. The announced measures on December 9, and the subsequent increased interventions by the ECB relieved the financial markets by also easing the risk appetite (Chart 2.4.1). However, legal uncertainties regarding the implementation of December 9 decisions coupled with concerns over whether the adopted measures would bring a permanent solution, added to the elevated worries on economic contraction and averted a marked improvement in bond returns in countries experiencing debt problems (Chart 2.4.2). In the mid-January, the downgrade by a credit rating agency of many Euro Area countries, including France, was already anticipated, thus leaving financial markets unaffected.

Chart 2.4.1.
Global Risk Appetite
(Points)



Source: Bloomberg, Credit Suisse.

Chart 2.4.2.
Bond Yield Spreads in Selected Countries over German Bonds (10-year, Points)



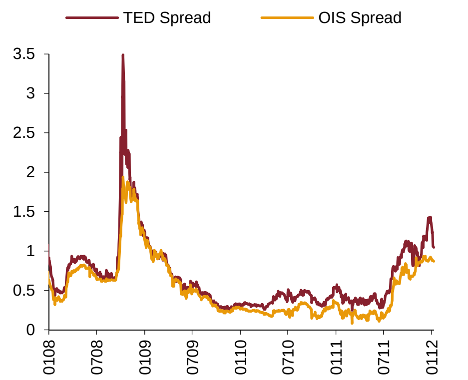
Source: Bloomberg.

Debt crisis continued to weigh severely on the European banking sector in the last quarter (Chart 2.4.3). Accordingly, TED and OIS spreads, which denote banking sector counterparty risk, remained elevated (Chart 2.4.4). Despite the heavy demand for ECB's 3-year liquidity operation, banking sector indicators displayed a minor recovery, signifying the acute outlook facing the sector. The uncertainty regarding the regulations on raising capital and their dates of effectiveness to remain unspecified create another source of ambiguity on the European banking sector.

Chart 2.4.3.
ITraxx Europe Senior Financials Index
(5-year, Basis Points)

Source: Bloomberg.

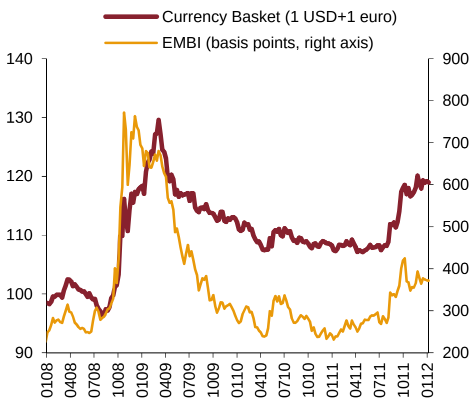
Chart 2.4.4.
3-month TED and OIS Spreads
(Points)



Source: Bloomberg.

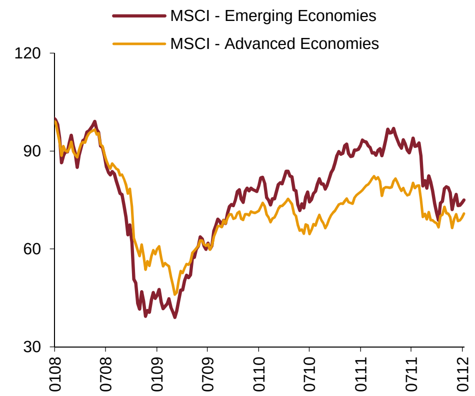
Risk appetite continues to follow a weak course notwithstanding the partial improvement, adversely affecting the emerging economies. Capital outflows from emerging economies, albeit being limited quarter-on-quarter, posed further pressure on exchange rate and asset prices in the local economies (Charts 2.4.5 and 2.4.6).

Chart 2.4.5.
Exchange Rate and Risk Premium Indicators for Emerging Economies*



* Arithmetical average of the exchange rates of emerging market currencies against the currency basket of 1 USD and 1 euro. Equals 100 on June 2007, and an upward movement denotes depreciation of emerging market currencies.
Source: Bloomberg.

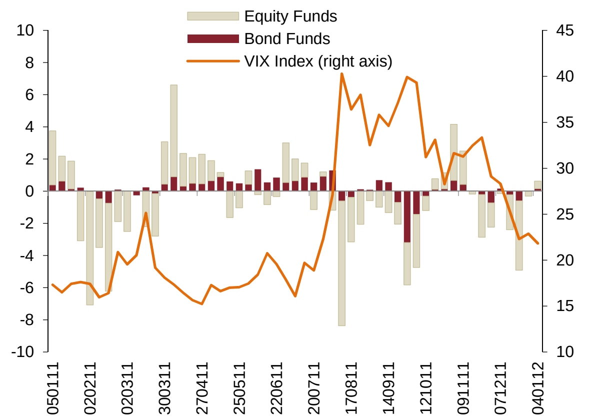
Chart 2.4.6.
Global Stock Markets
(December 2007=100)



Source: Bloomberg.

A more detailed analysis of the capital flows in emerging economies in the last quarter of 2011 depicts that the outflows were notably driven by equity funds (Chart 2.4.7).

Chart 2.4.7.
Portfolio Flows to Emerging Economies
(Billion USD)



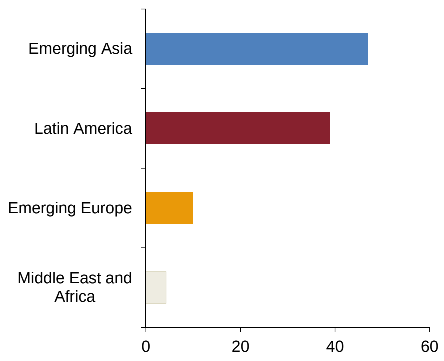
Source: EPFR, Bloomberg.

A comparison between fund outflows in the last quarter from the emerging economies and the fund inflows during the 2005-2008 period highlights significant variations as per regional distribution (Charts 2.4.8 and 2.4.9).[1] The recent outflows from Asian countries, which have the highest share

[1] Total inflows amounted to USD 79.3 billion between 2005 and the first half of 2008, with a quarterly average of USD 4.4 billion. Total outflows amounted to USD 10.8 billion in the last quarter of 2011.

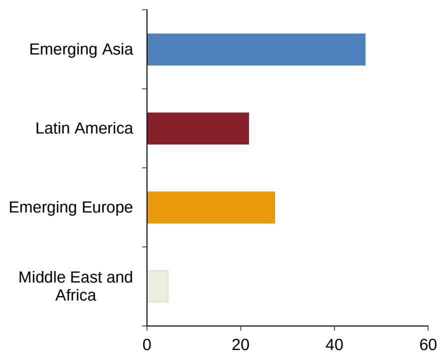
in portfolio flows, are comparable to fund inflows in the pre-crisis period, while the outflows from the Latin American countries are relatively lower. This observation reflects upon the fact that investors withdrew their investments more heavily from emerging economies having strong commercial connections with the Euro Area, which is struggling with an intense debt crisis.

Chart 2.4.8.
Regional Distribution of Portfolio Flows to Emerging Economies in the Pre-Crisis Period
(2005-First Half of 2008, Percent)



Source: EPFR.

Chart 2.4.9.
Regional Distribution of Portfolio Outflows from Emerging Economies in the last Quarter
(Oct. 5, 201 –Jan. 4, 2012, Percent)

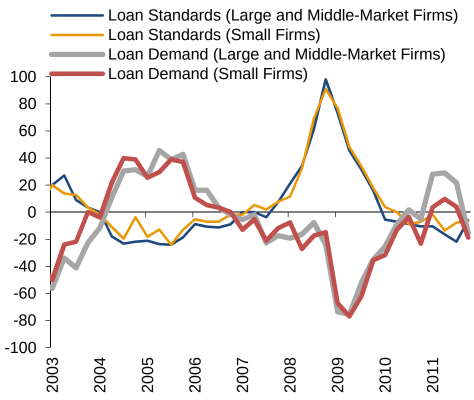


Source: EPFR.

Further implementation of expansionary policies in advanced economies as well as growing differentials of growth and interest rate between advanced and emerging economies, in favor of the latter, are expected to accelerate portfolio flows in the forthcoming period. However, concerns over the absence of an exact solution to the problems in advanced economies will remain as a major factor to put a cap on capital flows in the forthcoming period.

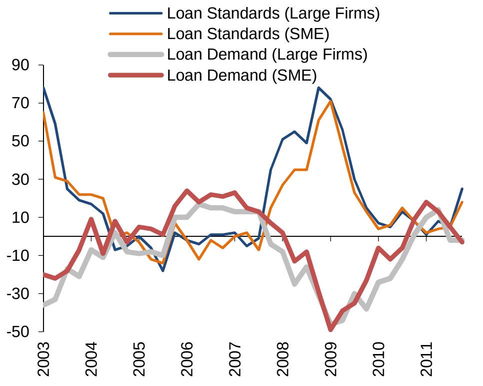
Credit markets were also subdued like financial markets. Fed's Lending Survey points to an ongoing, yet slower easing in credit conditions in the U.S., and also indicates a slowdown in loan demand (Chart 2.4.10). Meanwhile, ECB's Lending Survey suggests tighter credit conditions in the Euro Area and a receding demand for loans (Chart 2.4.11).

Chart 2.4.10.
U.S. Lending Survey*
(Percent)



* Upward movements indicate tightening in credit conditions.
Source: Fed.

Chart 2.4.11.
Euro Area Lending Survey*
(Percent)



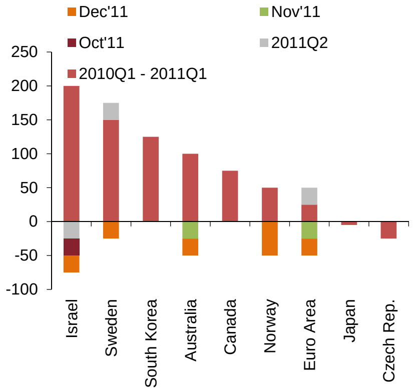
Source: ECB.

2.5. Global Monetary Policy Developments

Global monetary policy was eased in the last quarter on account of the unfavorable course of the global growth outlook. Advanced economies, which are currently dominated by disinflation, implemented further expansionary monetary policies, by lowering policy rates and extending quantitative easing packages. Emerging economies also opted for policy rate cuts. However, in order to balance macro financial risks, few central banks in emerging economies continue with tight monetary policy practices by utilizing macroprudential measures, as well as policy rate hikes.

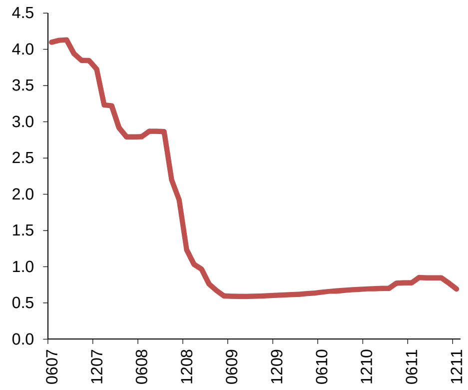
In the last quarter of 2011, monetary policy in advanced economies saw a sizeable easing compared to the previous quarter. Major central banks, and especially the ECB, lowered policy rates (Chart 2.5.1). In fact, aggregated indices suggest that composite policy rate in advanced economies posted a quarterly decline by 15 basis points to 0.69 percent (Chart 2.5.2).

Chart 2.5.1.
Policy Rate Changes in Advanced Economies from Jan. 2010 to Dec. 2011
(Basis Points)



Source: Bloomberg, CBRT calculations.

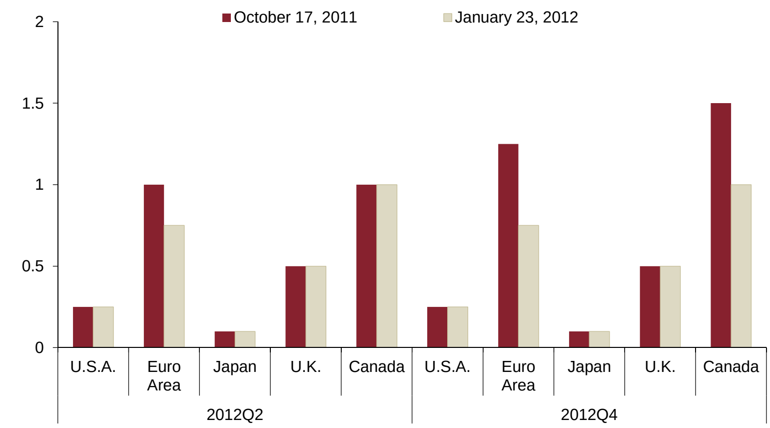
Chart 2.5.2.
Policy Rates in Advanced Economies
(Percent)



Source: Bloomberg, CBRT calculations.

Policy rates in advanced economies are expected to remain low for an extended period. Expected policy rates for end-2012 remained unchanged for the U.S., Japan and the U.K., and were revised downwards for the Euro Area and Canada in the inter-reporting period (Chart 2.5.3). Moreover, according to January 25 forecast of the Fed that has taken a recent decision to regularly release the forecasts of the FOMC members, policy rates are expected to remain unchanged at the currently low levels, at least until the end- 2014.

Chart 2.5.3.
Expected Policy Rates in Advanced Economies
(Basis Points)



Source: Bloomberg.

In addition to keeping policy rates low, advanced economies opted for monetary easing also by announcing new packages in the last quarter of the year. For instance, in order to lower borrowing costs, the Fed announced a new package of USD 400 billion entailing the purchase of long-term bonds in exchange for short-term bonds, without changing the size of the balance sheet. In addition, the Fed also hinted signals for purchasing securities backed by new mortgages. Meanwhile, following the MPC meeting on October 6, the Bank of England announced that the amount of the asset purchasing program was raised in order to solve the funding problems of the banking sector. As for the Bank of Japan, asset purchases gained pace in line with the announced program in October. In the last quarter of the year, the ECB stood out as the major central bank most heavily opting for traditional as well as non-traditional policy tools. In this regard, following its October meeting, the ECB announced a new program entailing bond purchases of up to euro 40 billion, effective between November 2011 and October 2012 in primary and secondary markets, and decided to further implement liquidity operations with 3-month and 1-year maturities. Subsequent to the rate reduction of 25 basis points in November, the ECB opted for another reduction of 25 basis points in its December meeting, and pulled required reserve ratios down from 2 percent to 1 percent. Also, in December, the ECB, in order to ease liquidity, provided the banking sector with euro 489 billion liquidity for a maturity of 3 years under the long-term refinancing operations. In sum, by the end of the last quarter, monetary policy in advanced economies was eased further through lower policy rates, as well as extended easing packages.

The previous quarter was marked by an overall easing in emerging economies. Despite the brisk domestic demand, central banks of many countries opted for policy rate cuts, given the downside risks regarding global growth and the resulting weak external demand (Chart 2.5.4). As a matter of fact, the composite policy rates of the emerging economies reached 6.27 percent, with a quarterly fall of nearly 30 basis points at the year-end (Chart 2.5.5). Meanwhile, the Chinese central bank left policy rates unchanged, while easing monetary policy through 650 and 50 basis points reduction in required reserve ratios from the onset of 2010 till the midst of 2011, and in December, respectively. On the other hand, few central banks continue to implement tight monetary policy with a view to observe financial stability. For example, the Magyar Nemzeti Bank, in order to lessen the risk of funding and to alleviate the downside risk on the domestic currency, raised policy rates by a cumulative 100 basis points in the last quarter, thus was ranked as one of the central banks with a tight stance in a period of fairly eased global monetary policy implementations. Similarly, Colombia was also among those emerging economies with a policy rate hike in the last quarter. As for Turkey, monetary tightening was implemented through the widening of the interest rate corridor (Chart 5.1.7).

Chart 2.5.4.
Policy Rate Changes in Emerging Economies from Jan. 2010 to Dec. 2011
(Basis Points)

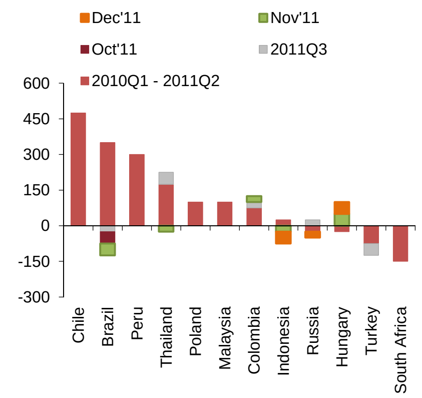
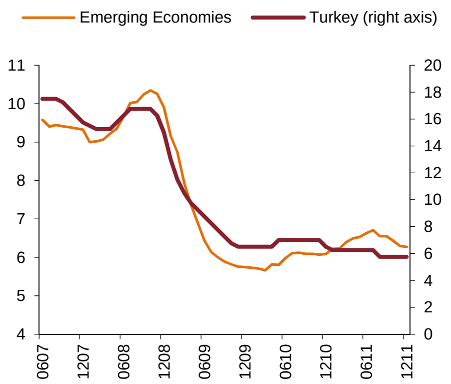


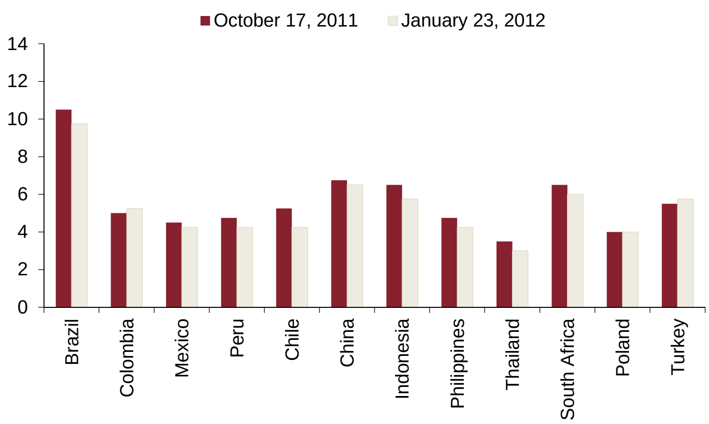
Chart 2.5.5.
Policy Rates in Inflation-Targeting Emerging Economies
(Percent)



Source: Bloomberg, CBRT calculations.

On account of the anticipated slowdown in global growth coupled with the expectations for a further monetary easing in advanced economies, expected policy rates for end-2012 were revised downwards in most emerging economies the inter-reporting period (Chart 2.5.6).

Chart 2.5.6.
Expected Policy Rates for end-2012 in Emerging Economies
(Basis Points)



Source: Bloomberg.

Box 2.1 December 9 Decisions and the Euro Area Debt Crisis

The debt crisis, which aggravated in the second half of 2011, required the EU leaders to adopt new measures. The new package of measures that was finalized on December 9, 2011 took great effort from the European leaders, Germany and France in particular, as well as great determination. Main points of the new package can be summarized as follows:

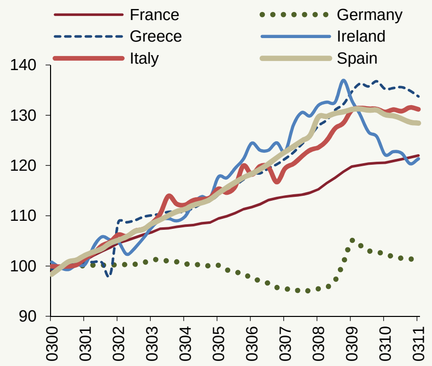
- The annual structural public deficit must not exceed 0.5 percent of the nominal GDP. Such a rule will also be introduced in member states' national legal systems at constitutional level. The rule will contain an automatic correction mechanism that shall be triggered in the event of a breach of the 3 percent ceiling.
- Euro Area countries will provide up to euro 200 billion in additional resources to the IMF, through bilateral loans, to ensure it has adequate resources to deal with the crisis. The amount is aimed to be increased further through the participation of non-EU members.
- The European Stability Mechanism (ESM) should enter into force in July 2012, instead of July 2013. Unlike the temporary European Financial Stability Facility (EFSF), ESM's effective lending capacity is envisioned as Euro 500 billion, in the form of paid-in capital.
- The regulation on forced private sector involvement (PSI) in the case of a debt re-structuring was ruled out as the ESM will enter into force.

However, U.K. vetoed the package on the rejection of its request for special exemptions regarding the functioning and the surveillance of its financial sector. Accordingly, implementation of December 9 measures under the current institutional framework of EU has turned controversial. While some EU leaders sought legal ways to get around the U.K. veto, debates on whether Ireland needs a referendum added to the uncertainty.

The announced package provides the troubled countries incurring higher borrowing costs due to crisis with new financing opportunities, also giving more room for intervention to the formerly cautious ECB through envisioned fiscal discipline. Considered to be positive regarding fiscal measures and increased opportunities for financing, the package is yet criticized for not encompassing a concrete step addressing structural measures that would eliminate the internal imbalances in the Euro Area as well as re-settle the troubled countries into a growth path. The package is also criticized for concentrating on problems solely from the fiscal perspective. Hence, focusing on the pre-crisis developments in order to analyze the dynamics putting these countries into stress will be beneficial in assessing the extent of benefits the package will provide, if accepted.

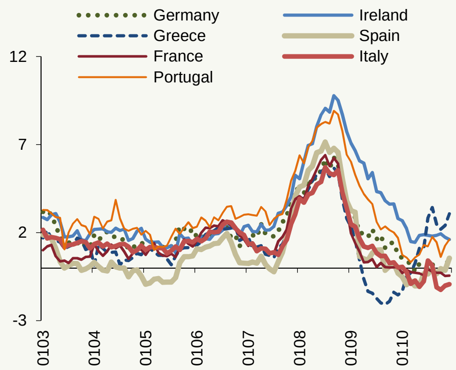
A major structural problem in the Euro Area countries is the divergence of competitiveness on rapidly adjusting wages to varying inflation rates across member countries, especially in Ireland and Greece, where soaring real wages exacerbated the outlook. Subsequent to the global crisis in 2008, only Ireland gained competitiveness, while other countries continued to diverge from Germany (Chart 1).

Chart 1. Unit Labor Costs
(2000=100, Points)



Source: OECD.

Chart 2. Euro Area Business Loans with Maturity less than 1-year (Ex-post Real, Percent)



Source: Eurostat.

Meanwhile, nominal interest rates converged considerably amid accelerated capital flows and the elimination of the exchange rate risk after adoption of the common currency, occasionally resulting in lower cost of borrowing than Germany for the currently troubled countries, especially for Greece. Due to inflation differentials, real rates dropped even below zero in these countries at times of brisk economic activity (Chart 2).

Analysis of the pre-crisis period indicates that the spending discipline has deteriorated significantly, especially for the private sector, as a result of increased liquidity facilities, lower interest rates and the advantages brought about by holding reserve money. In Greece, Portugal, Ireland and Spain, the four peripheral countries that were most severely hit by the debt crisis, private savings deficit also diverged notably from other countries. Furthermore, private savings have declined significantly also in Italy and France, two core economies of the Euro Area, even turning negative in the former immediately before the global crisis. Private savings in Germany on the other hand, increased amid adoption of the euro (Chart 3). As for the public savings, the positive pre-crisis performances of Ireland and Spain, two peripheral countries, are noteworthy. Having managed to balance its public finances just before the outburst of the global crisis, Germany diverged from other countries one more time, while peripheral countries in addition to Italy and France constantly posted fiscal deficits throughout the period (Chart 4).

Chart 3. Private Savings to GDP* (Percent)

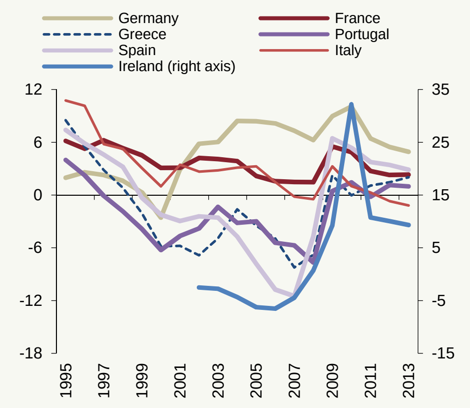
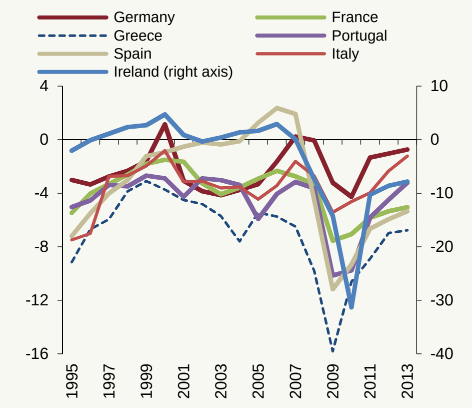


Chart 4. Public Savings to GDP (Percent)



* The surging private savings in Ireland during 2010 reflects public transfers under banking sector rescue plans.
Source: European Commission, AMECO.

Applying the national savings identity to each country, the sum of private and public savings given in Charts 3 and 4 yields the current account balance of the respective economy. Accordingly, the troubled countries with hefty fiscal deficits have also suffered from tremendous current account deficits, given their deteriorated private sector balance sheets amid easy financing opportunities as well as loss of competitiveness. Furthermore, appreciation of the euro against the USD during this period brought loss of competitiveness to troubled countries not only against the other Euro Area countries, but also at a global scale.

A further analysis on the fiscal expenditures of these countries highlights the major role of transfer payments, which can be considered to be rigid. The October 2011 issue of the Global Fiscal Outlook Report by the IMF indicates that these countries will also have to face rising health and pension payments in the future due to demographic transformation, thus pointing that the enforcement of the adopted measures will be troublesome. Meanwhile, resorting to fiscal consolidation in a period of reduced private spending heightens concerns over recession.

In conclusion, the Euro Area debt crisis should not only be associated with fiscal problems. The structural problems experienced by these countries disable them to re-start growth, fuelling the crisis of confidence as well. Failure to re-settle growth and confidence translates into reduced appetite for lending, thus causing further deterioration of the debt dynamics. By alleviating the acute borrowing problem, December 9 decisions will save time to troubled countries for the solution of their structural problems. However, these decisions are considered to be incapable of eliminating these problems permanently. In sum, Euro Area problems are likely to occupy the agenda for quite a while.

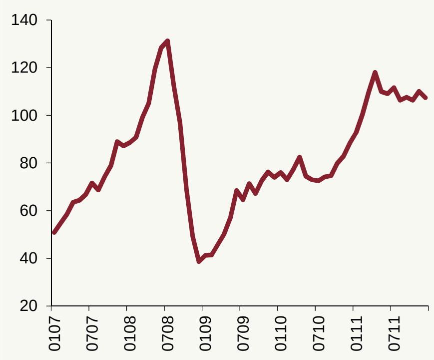
Box 2.2 Possible Impacts of Soaring Public Spending in the MENA Region on Crude oil Prices

The Euro Area debt crisis and the lack of a consensus on the road map to the solution of the crisis caused downward revisions in global growth forecasts and commodity prices to decline by the second quarter of 2011, with a divergence in energy prices, the major subcategory of the commodity prices. With a view to contributing to the better understanding of the recent dynamics in energy prices, this Box analyzes some issues regarding the oil supply and the pricing behavior of the OPEC countries.

Global Crisis and the Oil Prices

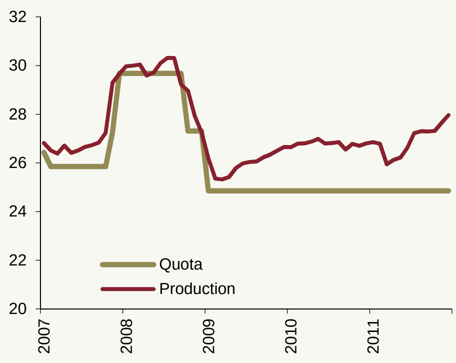
Expectations of a global recession amid the gradually spreading and deepening global financial crisis brought about a plunge in commodity prices, energy prices in particular, in the second half and especially in the last quarter of 2008. Brent crude oil prices went down to USD 34 per barrel in this period, hitting the 4-year low (Chart 1). Accordingly, OPEC countries decided to cut down production in their October and December 2008 meetings (Chart 2). In other words, amid collapsing oil prices, OPEC opted for a production cut in order to prevent possible downside risks on prices.

Chart 1. Crude Oil Price
(OPEC Basket, USD/bbl)



Source: Bloomberg.

Chart 2. OPEC Quota and Production Developments*
(Million Barrels/day)



* As of December 2011 without reflecting the decision taken on December 14, 2011 meeting to raise quotas.
Source: Bloomberg.

OPEC's reaction to plunges in crude oil prices in 2008 signifies the presence of a critical level beyond which oil prices would hardly fall. This critical level is occasionally hinted by OPEC's statements referring to a 'reasonable' level of oil prices.

Developments in the MENA Region and Oil Prices

The social and political commotion rapidly spread across MENA countries towards the end- 2010, with some countries experiencing massive protests, while most others undergoing cabinet and even regime changes. Countries not experiencing any regime changes sought to avert unrest through increased public spending.

Chart 3. Percent Change in Public Spending over 2008-2011

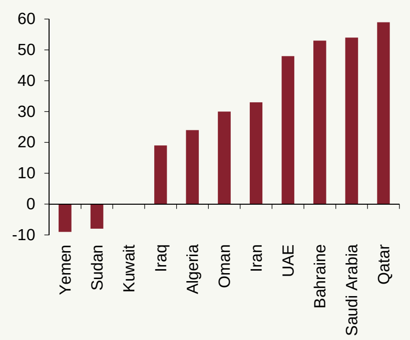
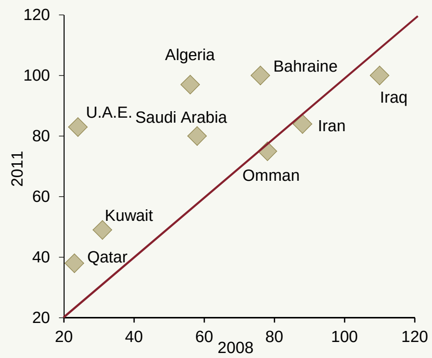


Chart 4. Break-even Crude Oil Prices (USD/bbl)



Source: IMF Regional Economic Outlook: Middle East and Central Asia, October 2011.

The October 2011 issue of the Regional Economic Outlook: Middle East and Central Asia by the IMF analyzes the rising public spending and to what extent the soaring oil prices would allow for increases in public spending. Chart 3 demonstrating the percent change in public spending between 2008 and 2011, suggests that 8 countries out of 11 experienced rising public spending[2], with the rate of increases in the U.A.E., Bahrain, Saudi Arabia and Qatar by 48, 53, 54 and 59 percent, respectively. The additional spending packages announced in February and March 2011 mounted to 19 percent of the GDP in Saudi Arabia, while in Iraq, Kuwait, Qatar and Algeria additional spending packages corresponding to 3-4 percent of GDP were announced during the same period.

[2] Yemen, Sudan, Oman and Bahrain are not OPEC members.

As a result of soaring public spending, the break-even oil prices[3] that provide fiscal balance increased notably, causing 6 out of 9 countries to remain significantly above the 45 degree line (Chart 4). In other words, compared to 2008, oil prices consistent with the fiscal balance rose remarkably in 2011. In particular, the break-even prices rose nearly USD 60/bbl in U.A.E., and by USD 20/bbl in Saudi Arabia, the leading oil producer among the OPEC countries. While the average break-even oil price in Chart 4 is USD 60.4 /bbl in 2008, it went up to USD 78.4/bbl in 2011.

In sum, the developments at end-2008 are regarded as remarkable indicators of the widely acknowledged fact that OPEC opts for a production cut in order to prevent further downward price movements when crude oil prices tend to fall due to demand shortage or supply/demand imbalances. The break-even crude oil price for 5 countries,[4] making up nearly 65 percent of the OPEC production, exceeded USD 80/bbl, greatly explaining the underlying reason for the high energy prices despite the recent sizeable downward revision to global economic growth forecasts. This observation also points to the presence of a de facto lower limit to crude oil prices even if the downside risks on the global economic activity would materialize in the forthcoming period.[5]

[3] The price of oil that provides fiscal balance when spending and non-oil revenues are kept constant.

[4] Saudi Arabia, Iraq, Iran, U.A.E. and Algeria.

[5] The production cut to prevent decline in crude oil prices in OPEC countries, which are experiencing increased public spending, implicitly relies on the assumption that a break-up in OPEC is unlikely. The idle capacity of the OPEC is concentrated in few countries, and primarily in Saudi Arabia. This situation implies that while the quota reduction leads to lower production in some countries, it also disables the other countries to compensate for the reduced production by their own production facilities. As of December 2011, 62 percent of the idle capacity of OPEC belongs to Saudi Arabia (share of Saudi Arabia increases to 71 percent when adjusted for its temporary compensation of the production losses in Libya), while the other countries constitute the remaining 38 percent. In other words, OPEC countries excluding Saudi Arabia are less likely to be able to raise production. Moreover, compliance with the 2008 quota reduction by the member countries signifies a strong cooperation, albeit occasional setbacks.