Q-Review 4/2013

December 2013

Hidden risks threaten the recovery

- According to our forecasts, the world economy is turning to a path of more robust growth during next year.
- We forecast the economies of the Eurozone and Finland to growth around 1.6 percent and around two percent next year. The US is forecasted to grow around 2.8 percent.
- World economy is recovering, but hidden market risks threaten this recovery.
- If central banks continue their unconventional measures, they risk of increasing not diminishing the instability in the financial markets.

The improving employment numbers from Europe and the United States have increased optimism during the last quarter. Positive news is welcomed as the world economy has to return to the market based pricing of assets as soon as possible.

The economy of the Eurozone shows some signals of improving. The manufacturing purchasing manager's index has risen for the past five months but industrial production remains subdued, especially in the South where the slight improvement in the employment rate has been frustrated by the increase in the youth unemployment to its new record of 24.4 percent.

As the market-driven fears of the immediate breakup of the Eurozone have subsided, prolonged recession and unemployment have shifted these fears to long term issues. If current unfavorable trends in economic growth and employment continue, the dissatisfaction towards euro and even towards EU may keep increasing. This may cause unexpected political shifts in the crisis countries and thus threaten the future stability of the euro.

Increasing industrial production has been one of the corner stones of US recovery but this has not been transmitted to the SME sector, where the optimism-index has not yet exceeded its 2007 value. Consumer confidence is increasing, which should eventually translate into better expectations on the SME sector as well. However, the rather uncertain growth prospects complicate the anticipation of the decisions of the Fed. Several economists and the Bank of International Settlements, BIS, have already warned about the risks of perpetual *quantitative easing*. The longer the Fed delays its decision of tapering, the higher are the risks of distorting the markets.

In the second Q-review of this year (2/2013), we discussed the possibility of a "zombie-economy", where uncompetitive firms and banks are kept alive by ultra-low interest rates and unconventional monetary policy tools, like QE, and OMT. There is a serious possibility that the measures taken by the central banks have already created a situation in which their actions increase rather than decrease financial instability. This is due to the fact that if the actual price of an asset does not meet its market based value, the true level of risk is not properly revealed. Socialization of risks of private entities with monetary or fiscal measures hides the risks behind politically motivated decision. Bailouts of private entities may be justified during financial crises to reach financial stability but if financial measures are used to manipulate markets for an extended period the markets cannot provide the best allocation of risks and assets. In the worst case, the risks are massively mispriced in the markets. Currently, the central banks are dangerously close to this situation.

In Q-review 2/2013, we also discussed the possibility of a new global banking crisis and listed four factors that could trigger it: the bankruptcy of some large global bank, stock market crash in some big market, collapse of the sovereign bond market of some developed country, or a war in Middle-East. If the situation in Middle-East remains as it is, the biggest short and medium term risk for the world economy lie in the link between the banking sector and bond and stock markets. The measures taken by central banks have driven the yields of the bonds of well performing firms and sovereigns to a very low level. For this reason investors and banks have looked for profits on the higher yields of the bonds of more risky sovereigns and firms. At the same time, many stock markets have reached new peaks. Prices of many assets currently refer to booming economies, which naturally is not the case. When money market conditions normalize, as they will sooner or later, asset prices start to reflect the real risk levels. This is likely to lead to major price drops in some assets classes, which may have serious effects on banks' balance sheets. Especially banks in the Eurozone have patched their balance sheets with the "riskless" sovereign bonds of the peripheral Europe. It is thus possible that the normalization in money markets will lead to considerable losses for banks in Europe and, in the worst case, to a global Europe-born banking crises.

However, the probability of a new crisis remains to be somewhat subdued. One reason for this is that money markets have already shown some signals of normalization. Asset class correlations have dropped considerably during the fall and the acute phase of the European debt crisis seems to be over. According to our estimate, the likelihood of a new global banking crisis is 10%.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of Finland, the United States and the Eurozone.

Table 1. Forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2013:1	-0.17	-0.20	0.29
2013:2	0.07	0.30	0.61
2013:3	-0.04	0.08	0.89
2013:4 (nc)	0.43	0.17	0.77
2013	0.29	0.35	2.55
2014	2.1	1.7	2.8
2015	2.5	1.6	2.8

If the nowcast is accurate, the economy of Finland will grow some 0.5 percent this year. Next year, the growth will accelerate to some two percent and to over 2.5 percent in 2015. According to our forecasts, the Eurozone will return to mediocre growth during the next year. Growth in the US is also clearly picking up steam. However, if a new banking crisis hits the world economy next year, economies would start contracting again. According to our estimates, GDP would fall by almost nine percent in Finland, by four percent in the Eurozone and three percent in the US, when facing a new crisis.

Nevertheless, the likelihood of a new crisis is small and the global growth seems to be picking up next year. This would be the best medicine for woes in the Eurozone and it would also make it possible for the central banks to withdraw from their risky financial measures.

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real

Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

The next Q-review will be published in March 2014.

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