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UK's MPC Meeting; Norway's Monetary Policy; Portugal's Budget Plan; Hungary's Credit Rating; Russia's Retail Sales; EZ Calendar

By Katharina Jungen, Parul Walia, Mikko Forss, Jelena Vukotic and Tetiana Sears

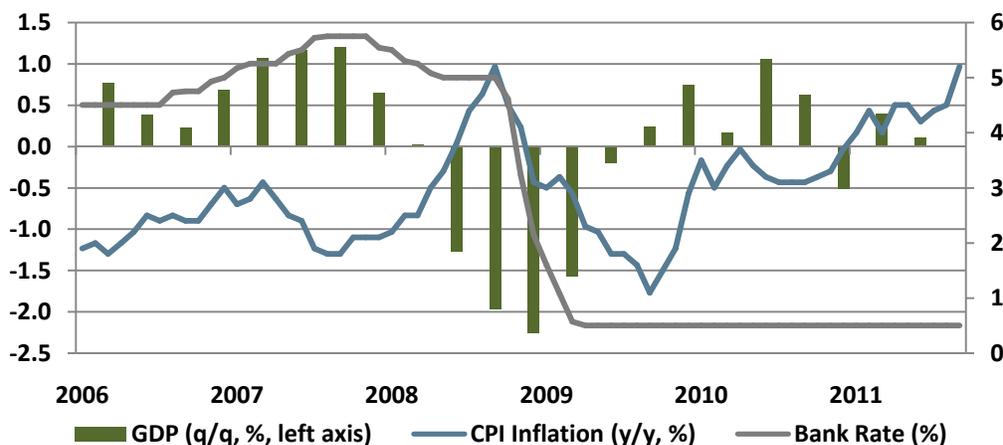
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UK: MPC Leaning Toward More Quantitative Easing?

By Parul Walia

The [minutes](#) of the latest UK monetary policy committee (MPC) meeting confirmed a 9-0 vote for the £75 billion increase in the size of the asset purchase facility ("QE2"). All members cited that the case for QE2 was "compelling," and some members actually favored a larger stimulus, owing to considerable downside risks to growth. The MPC believes that "the available indicators suggested that the underlying rate of growth had moderated and would be close to zero in the fourth quarter." The minutes are very dovish, as expected, and leave the door open for more QE in the future. In our view, given the weak economic growth forecast for the UK, another round of QE to the tune of £25 billion is likely in January or February 2012. In terms of an interest rate hike, we expect the Bank of England (BoE) to stay on hold through next year.

Figure 1: UK GDP, CPI Inflation and Bank Rate



Source: Office for National Statistics, BoE

The minutes show that the MPC did not have pre-release access to the latest [inflation](#) figures, according to which inflation rose to 5.2% y/y in September. However, this information would have made little difference as the committee believed that “inflation was likely to rise to above 5% in the near term” and would “fall back sharply in the first part of 2012.” The MPC did discuss the option of delaying the QE2 until the November Inflation Report, but decided to act “quickly and decisively.” The [decision](#) to launch QE2 prior to November indicated that the BoE was highly worried about the UK’s growth prospects and is keen to support economic growth—and in particular domestic demand—against a backdrop of marked uncertainty abroad and painful fiscal austerity at home.

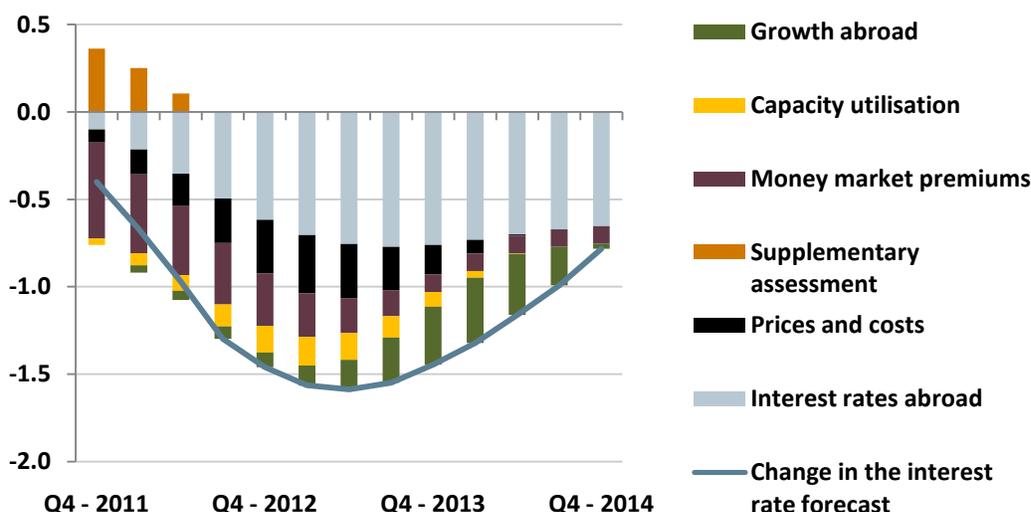
Meanwhile, on October 18, the BoE governor Mervyn King [said](#) that, without monetary stimulus, “growth will stall.” Though he emphasized that there are limits to what policy—monetary and fiscal—can do in a single country in isolation and emphasized the need for global rebalancing (especially in the eurozone—EZ), the tone of the speech indicated that the bias in terms of monetary policy is toward more loosening rather than less. (See related Critical Issue on [UK monetary policy](#).)

Norway: Dovish Monetary Policy Increases Risks of Financial Instability

By Mikko Forss

Norway’s central bank—Norges Bank—left the policy rate unchanged at 2.25% at its October 19 meeting. However, the rate path forecast was lowered significantly and now signals only one 25 bps hike by end-2012 (in H2 2012). This is 1.5 percentage points less than in Norges Bank’s June forecast (Figure 2), but in line with RGE’s [rate path forecast](#) in our October Central Bank Watch. Lower expectations for international interest rates are having the greatest negative effect on the rate path forecast, though all factors contribute to the same direction. To smooth the rate path, Norges Bank has added a “supplementary assessment” factor that lifts the rate path to avoid signaling a cut in the near term, as the bank believes that cutting rates for a short time period only would violate its “gradualist” approach.

Figure 2: Factors Behind Changes in Norges Bank’s Interest Rate Forecast Since June (percentage points)



Source: Norges Bank

Norges Bank's growth forecast for the non-oil economy in 2012 is very optimistic in our view: The bank expects growth of 3.75%, compared with RGE's forecast of 2.4%. Given Norway's domestic strength, our view has been that the country will "[partially decouple](#)" from other advanced economies, which we expect to [fall in recession](#) in late 2011 or early 2012, but Norges Bank seems to expect more of a "full decoupling." If that scenario materializes, the danger of domestic imbalances building up increases, as house prices keep rising rapidly and credit growth remains speedy. These imbalances are a key reason why we continue to expect one hike before end-2012, though a more dovish Norges Bank and the increased risks emanating from the EZ especially pose a downside risk to our forecast, which means there is still a good chance that Norges Bank will have to cut in 2012. (See related critical issue on [Norway's economic policy](#).)

Portugal: Stepping Into Greece's Shoes?

By Katharina Jungen

Even though the Portuguese government appears highly committed to its IMF/EU/ECB (the "troika")-designed adjustment program, it may just be a matter of time until deteriorating growth prospects, fiscal slippage and social unrest see Portugal follow in Greece's wake. On October 18, the Portuguese government presented its 2012 budget plan, which adds additional savings measures on top of those included in the adjustment program. Additional budget cuts became necessary to meet the troika's fiscal targets in light of expectations of a larger [economic contraction](#) in 2012-13 as well a budget overshoot in H1 2011 following the discovery of a substantial amount of hidden regional debt. The Portuguese government relied largely on spending cuts to ensure honoring its fiscal consolidation agenda, which sets out a reduction in the deficit from 9.8% in 2010 to 5.9% in 2011 and 4.5% in 2012. Measures include a cut to public sector workers' and retirees' bonuses equivalent to two months of salary in 2012 and 2013—roughly a 15% wage cut—for those who earn more than 1,000 euro a month as well as cuts to health-care and education spending. Further, in an effort to boost competitiveness, private-sector firms now have the option to increase working time by 30 minutes per day without additional pay. Tax measures include an increase in value-added tax for several goods and the reduction of tax deductions. Several of the budget cuts are temporary in nature, implying that, once they have expired, the government will announce additional measures.

The [center-right government](#) expects the harsh austerity measures to push Portugal into the most severe recession seen in the past 30 years, with GDP falling 5% in 2011-12. Portugal's two main union confederations responded to the budget plan with the announcement of a general strike scheduled for November 24 in a sign that social unrest—which has so far been limited—is on the rise. The opposition harshly criticized the budget and it remains uncertain whether they will support the government's plan. However, given that Prime Minister Pedro Passos Coelho enjoys a solid majority, the budget plan should easily pass through parliament, with the vote scheduled for November 29. (See related Critical Issue on [Portugal public finances](#).)

Hungary: Teetering on Junk Status?

By Jelena Vukotic

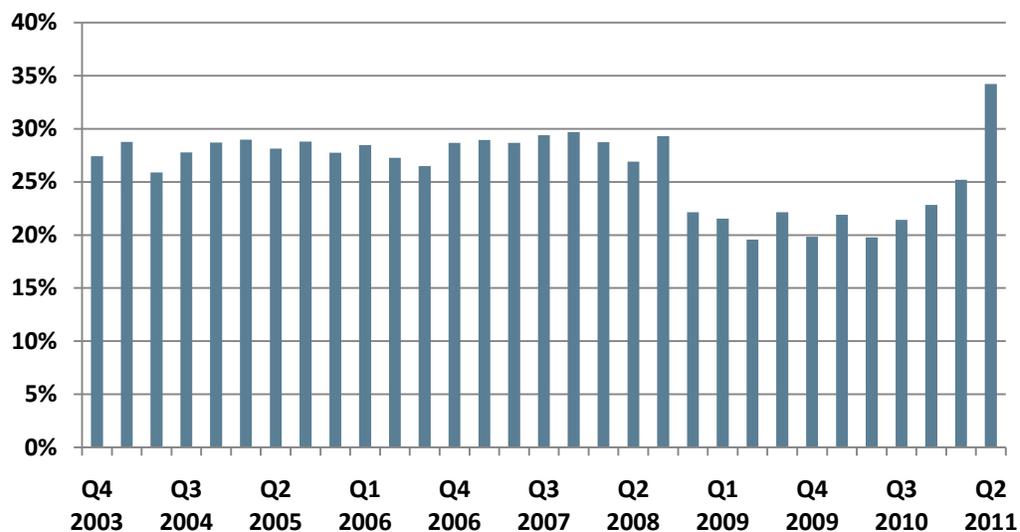
Teams from S&P and Moody's—both of which rate Hungary one notch above "junk" status with a negative outlook—will visit the country this month to review its rating. Owing to Hungary's erratic policy environment, [deteriorating growth prospects](#) and the more challenging fiscal outlook, there is a high risk that at least one agency will opt for a rating downgrade. Markets remain jittery—the risk premium on the country's debt remains elevated and the Hungarian forint (HUF) continued to slide this week, increasing the country's external debt burden (at

133% of GDP) in local currency terms. In RGE's view, slipping into "junk" territory would exert pressure on the government bond markets and likely force Hungary's policy makers to knock on the IMF's door again.

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The recent signals sent by the rating agencies are not very encouraging. Both Fitch and Moody's have expressed concerns about the government's [foreign-currency mortgage repayment scheme](#), which will lead to large losses for banks, undercutting their lending capacity and exacerbating the already uncertain policy environment. Anemic credit supply will further constrain domestic demand as a sharp slowdown in the EZ economy stifles exports. The deteriorating growth outlook will weigh on Hungary's public finances, which are closely monitored by rating agencies and investors alike. Following a one-off fiscal improvement in 2011, the government's 2012 budget deficit target of 2.5% of GDP looks increasingly out of reach, as does its underlying growth assumption of 1.5%.

Figure 3: Non-Resident Holdings of Government Debt Spike Sharply in 2011 (% of total)



Source: AKK

A sovereign debt downgrade would increase the country's borrowing costs, put pressure on the government bond markets and accelerate the currency slide. After breaking ties with the IMF in 2010, Hungary relies on debt markets to meet its financing needs. A downgrade would limit the country's access to capital markets, even as it needs to finance the €4.7 billion in external debt coming due in 2012. Moreover, with non-resident holdings of government debt at an all-time high (around one-third of total stock), the risk of a sharp sell-off due to a rating downgrade is significant.

Given the worsening EZ turmoil, a negative rating action could thus help create an adverse environment similar to that seen at the height of the previous crisis. In 2008, a sharp government debt sell-off by foreigners, failed bond auctions and sliding currency quickly translated into a liquidity crisis, forcing the authorities to ask for an IMF bailout. If EZ policy makers fail to come up with a credible plan to contain the debt crisis, Hungary might once again ask for IMF support. (See related Critical Issue on [Hungary's credit rating](#).)

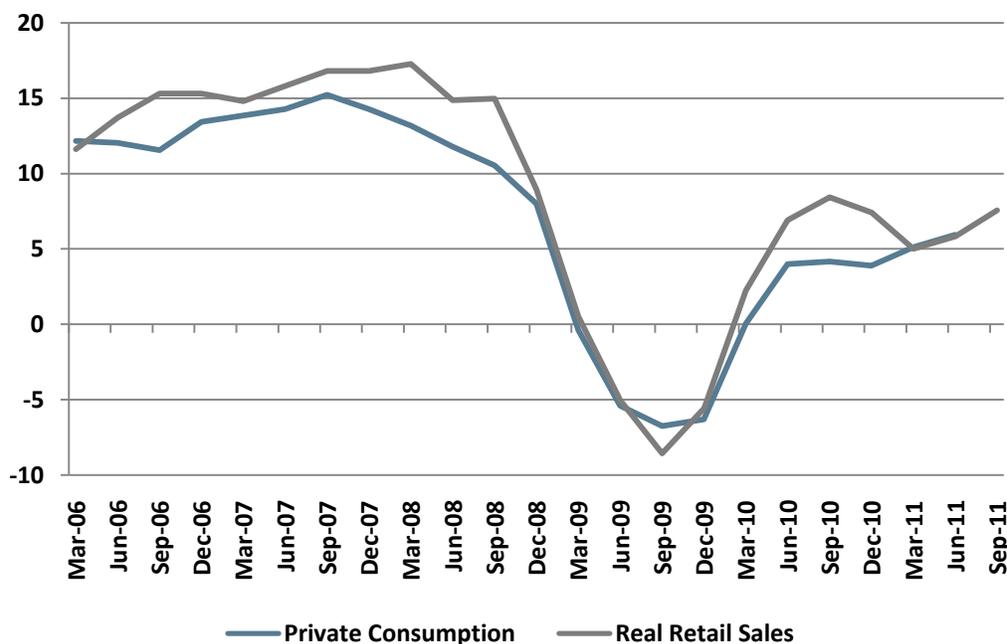
Russia: Consumers Still Leading the Way

By Tetiana Sears and Rachel Ziemba

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Russian real retail sales accelerated to 7.6% y/y in Q3 from 5.8% in Q2, with both food (3.7% y/y) and durable (11.5% y/y) consumption accelerating. Russia's private consumption remains the key growth driver, strengthening further in Q2 to 5.9% y/y from 5.1% in Q1. Available Q3 data on consumer spending indicate that consumers stepped up their efforts in the quarter and we expect this trend to continue into Q4 and early 2012 due to a number of factors. First, real disposable income recovered in Q3 as inflation eased, growing 1.7% y/y, following two quarters of negative prints. Second, inflation is set to continue moderating from its peak of 9.5% in Q2 due to an exceptionally good harvest and supportive base effects. Third, social spending and government transfers ahead of the March 2012 presidential election will continue to boost household income and spending. In fact, the government's decision to delay utility-tariff hikes usually slated for January until after the elections will boost disposable incomes in the near term. Retail trade is expected to hold up in Q4 and early 2012, also bolstered by the increase in bank lending.

Figure 4: Russian Consumer Spending and Real Retail Sales (% y/y)



Source: Haver

While consumption will remain a key growth driver, the weakening global growth outlook will weigh on GDP growth into 2012, particularly as investment continues to disappoint. Faltering external demand is adversely affecting Russian manufacturing, as indicated by [September's slowdown](#) in export-oriented industrial goods, which was in line with the weakening of the PMI in recent months. In the face of external headwinds, fiscal stimulus targeted at households and moderate inflation should support real income and spending. However, beyond 2012, the government's ability to do this will be increasingly constrained. (See related Critical Issue on [Russian consumption](#).)

Eurozone Calendar of Events (to end-2011)

Date	Event	RGE View
Oct. 21	Summit of EU Finance Ministers	
Oct. 23	European Council meeting	RGE expects the announcement to include at least a 50% haircut on Greek government debt, a leveraged EFSF and a plan for forced bank recapitalizations at a national level.
Oct. 24	Troika may issue report on Greece	Troika likely to release next tranche of funding in exchange for additional austerity measures.
Oct. 24-26	Follow-up meeting on Oct. 23 EU summit	
Early Nov.	Provisional disbursement of €8 billion sixth tranche	RGE expects the tranche to be disbursed alongside a revised bailout program to reflect the greater-than-expected GDP contraction and less rosy fiscal targets. Greece will almost certainly have to accept more austerity measures.
Nov. 1	Mario Draghi takes over ECB presidency	Draghi will feel some pressure to act as a hawk given that he comes from a peripheral country and the ECB recently lost one of its biggest hawks, Juergen Stark. We think he'll hold off on cutting rates until December at the earliest.
Nov. 3	ECB policy meeting	RGE forecasts the ECB to keep rates on hold.
Nov. 3-4	G20 Summit in Cannes	More details of measures announced at October 23 EU summit likely to be provided.
Nov. 7	Eurogroup meeting	
Nov. 8	ECOFIN meeting	
Nov. 11	Spain Q3 GDP flash estimate	RGE forecasts a further slowdown in economic activity.
Nov. 14	Portugal Q3 GDP flash estimate	We expect the economic contraction in Portugal to have accelerated further in Q3.
Nov. 15	EZ Q3 GDP flash estimate	RGE expects Q3 GDP growth in the EZ to be flat at best.
Nov. 15	Germany, France, Greece Q3 GDP flash estimates	RGE expects the French and German economies to stagnate at best. The contraction in Greek economic performance will have accelerated in Q3.
Nov. 20	Spain general election	We expect the opposition centre-right Partido Popular to win a majority.
Nov. 29	Eurogroup meeting	
Nov. 29	Portuguese parliament 2012 budget vote	We expect the Portuguese budget to pass through parliament with a clear majority.
Nov. 30	ECOFIN meeting	
Dec. 8	ECB policy meeting	RGE expects the ECB to cut interest rates by 25 bps.
Dec. 9	European Council meeting	
Dec. 27	Ireland Q3 GDP flash estimate	We expect Ireland's GDP to continue to grow, albeit sluggishly.

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