showCASE
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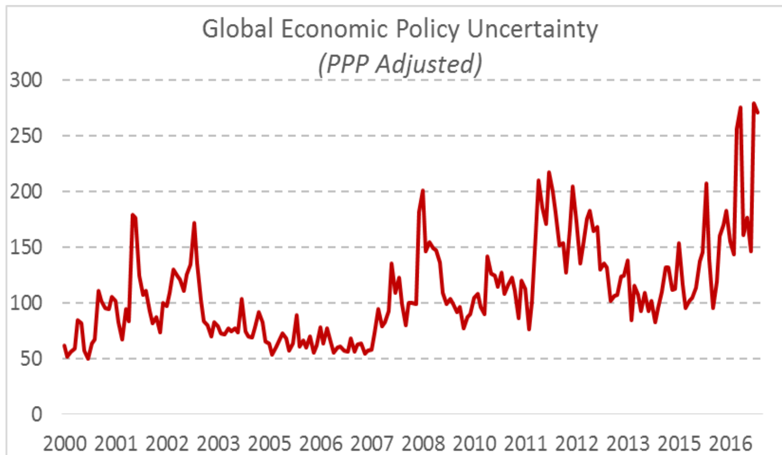
CASE – Center for Social and Economic Research

Overview: In this week's showCASE, our experts share their views on how uncertainty could play a key role in 2017 economic developments. CASE also weighs in on the speculation surrounding the fate of London's prized euro clearing business and whether or not major UK central counterparties will be forced to set up shop in the Eurozone.

Uncertainty in the outlook for economic growth in 2017

By: Iakov Frizis

Browsing through headlines of economic newspapers one gets the feeling that uncertainty will be the buzzword of 2017. The term was used 123 times in the minutes of the Bank of England's Monetary Policy Committee; the Deutsche Welle described the US President elect's absence from the 2017 Davos meeting as *The Great Uncertainty*; while Harvard Kennedy School Professor Carmen Reinhart recently described economic uncertainty as the biggest challenge that policy makers will have to confront in 2017.



Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

Policy uncertainty is growing in prominence among academics and researchers, as it is shown to be associated with significant macroeconomic implications. Baker, Bloom and Davis demonstrate that a decline in economic agents' capacity to use past information as an accurate indicator for future outcomes tends to lead to increases in stock price volatility as well as overall declines in investment, output and employment.

In December 2016, the ECB added to global uncertainty with its surprise decision to scale back asset purchases from EUR80bn to EUR60bn. By going against the previous objective of inflation targeting, the Bank has introduced significant uncertainty in how future guidance should be interpreted.

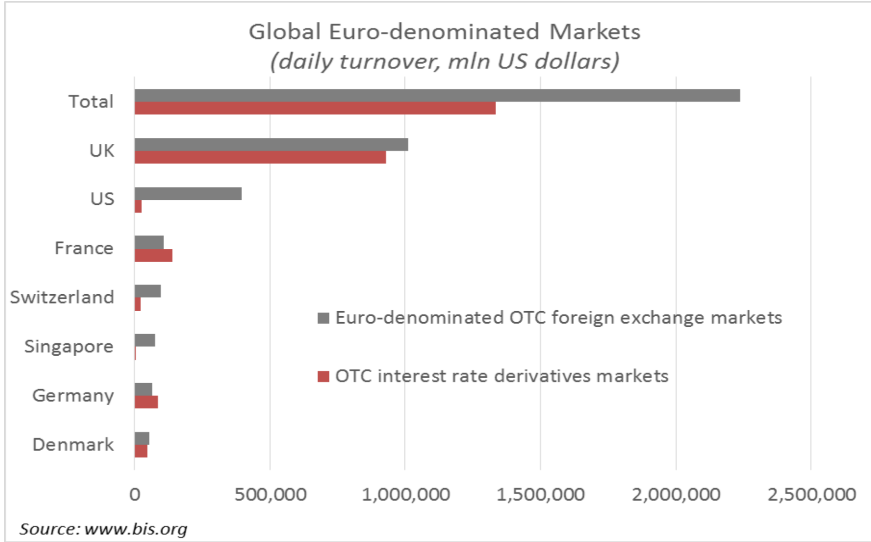
Across the Atlantic, potential upcoming changes to the US policy-platform is also increasing uncertainty, as mixed signals are making markets increasingly nervous over financial market volatility. On the one hand, prospects of pro-growth fiscal policy is positively viewed, while on the other hand, fears associated with potential disruption of cross border supply chains due to protectionist backlash are creeping in.

On a global scale, as stressed by CASE experts, the recent resurgence of economic uncertainty relates to issues such as the Trump presidency, the rise of populism in Europe, mixed monetary policy guidance by the ECB and discussions surrounding Brexit. These events, have substantiated the rise of global economic policy uncertainty to the highest level since the beginning of the 21st century.

The persistence of these types of events creates the potential for increased demand for safe assets, which will further dampen the current recovery path set out by the EU and the US. In order to avoid this, it is of the essence for policy to become more transparent, articulating with consistency forward guidance. If the current slow recovery across the EU has taught us anything, it is that uncertainty can create quagmires in an already sluggish investment environment, which bears a high cost on potential economic growth.

Could London lose its role in Euro swap clearing post-Brexit?

By: Paul Lirette



The vote for the UK to withdraw from the EU has created speculation surrounding the fate of London's prized euro clearing business. Will the European hub for swap trading remain in London or will major UK central counterparties be forced to set up shop in the Eurozone?

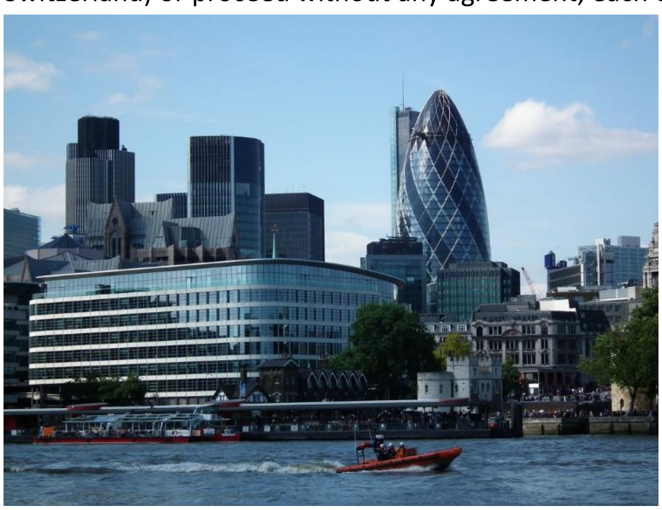
London has been the center for European financial services since the inception of the EU. According to the latest BIS's Triennial Central Bank Survey, the UK houses the largest "over the counter" (OTC) Euro foreign exchange transactions market and the largest OTC interest rate derivatives market in the world, exchanging nearly 1 trillion euros per day.

London based central counterparties (also known as clearing houses) play a key role in managing financial risk stemming from payment defaults in these markets. The largest of which, London Clearing House, cleared roughly 430 billion euros worth of transactions, daily, saving the industry billions in margin and capital requirements.

All other things being equal, once Brexit occurs, the majority of euro denominated clearing will be performed outside of the Eurozone. The ECB is determined to restrict this clearing to EU based firms, given that during periods of significant systemic risk its ability to intervene (where appropriate) in the provisions of euro-clearing services would be limited. However, this determination, often echoed by French President Françeois Hollande, has been unsuccessfully put into action even before the Brexit referendum.

Ultimately, the future of the UK's passporting rights, which allow UK businesses to provide financial services anywhere in the EU, will determine the impact on UK financial services. A Brexit that remains "in" or re-joins the European Economic Area (EEA) would maintain current passporting rights and allow for business to continue as usual.

Outside of retaining EEA membership, the UK could negotiate some level of bilateral agreement (as exists with Switzerland) or proceed without any agreement, each option potentially jeopardizing the UK's ability to provide these financial services to the EEA. PWC estimates that a loss of euro denominated clearing houses in the UK could decrease financial sector gross value add by 1.8%-4.0% and decrease domestic GDP by as much as 3.5% by 2030, which would lead to substantial job loss (and surely impact EU external demand).



City of London. Source: Stewart Morris, Flickr, CC.

Whether or not these economic and financial realities will outweigh political will to punish bad behavior remains to be seen. Given that both sides of the English Channel has significant skin in the game, a joint approach (as outlined by the Financial Service Negotiation Forum earlier this week) as opposed to a tit-for-tat style retaliation could be the best outcome for all.

At a glance

On January 13, Moody's and Fitch announced they will leave Poland's sovereign ratings unchanged at A2 and A-, respectively. These ratings remained unchanged despite recent downward revisions of GDP growth. CASE experts forecast that Poland's flash GDP growth estimate for 2016, which will be published on January 31, will amount to 2.8 per cent y/y. While private consumption has increased, investment activity remains subdued. Moreover, import growth has been stronger than export growth, dragging down the current account balance. The economy may accelerate slightly above 3% growth in 2017. However, high deficit levels caused by inflated social spending could likely lead to deficits exceeding three percent threshold, which, together with increasing policy uncertainty, may hamper future GDP growth.

CASE 2017 real GDP forecast down to 3.2%

Real GDP forecast (%)	2017	2018
CASE	3.2	-
IMF WEO	3.4	3.3
OECD	3.2	3.1

Recent OECD forecasts show that, following two years of recession, Russia's economy is expected to experience growth in 2017. According to the World Bank's specialists, the essential part of Russia's way back to sustainable and inclusive economic growth is investments in human capital and services, as well as increases in productivity. Russian GDP contracted by 0.4% in Q3 y/y, the smallest contraction in 7 quarters. An additional chance for rebound might be the recent cut in oil production, which is supposed to lead to higher oil prices. Inflation continues to decrease and reached 5.4% in December 2016, reflecting the lowest rate since June 2012. However, the Russian unemployment rate reached 5.4% in Q3 and is expected to continue growing in Q4, eventually reaching 5.7%.

Dec. inflation decreased, reaching 5.4%

Real GDP forecast (%)	2017	2018
IMF WEO	1.1	1.2
OECD	0.8	1.0

Germany took a positive first step in 2017, pointing towards expectations for robust economic activity of the first quarter, as quoted by rises in the ZEW current conditions and economic sentiment indexes. According to the Bundesbank's latest outlook for Germany the economy is poised to record GDP growth rates of 1.8%, 1.6% and 1.5% over 2017, 2018 and 2019, respectively. This robust growth path is based on strong domestic demand supported by rising household incomes, and a dynamic labour market. Projections for the German economy are also strongly optimistic in terms of inflation, attributing muted growth to low energy prices. According to the Bundesbank's forecasts, HICP (excluding energy components) is anticipated to reach 1.4% over the next year, while for 2018 and 2019 is expected to climb at 1.7% and 1.9%, as labour costs pick up.

Dec. Manuf. PMI (final) up to 55.60 from 55.50 in Nov.

Dec. Services PMI (final) up to 54.30 from 53.80 in Nov.

Real GDP forecast (%)	2017	2018
IMF WEO	1.4	1.4
OECD	1.7	1.7

At a glance

In the first week of January, the National Bank of Ukraine released preliminary data according to which the country's international reserves had increased by 17% in 2016, currently amounting to USD 15.5 billion. The main contribution to the increase in reserves was foreign exchange intervention carried out by the NBU, with net FX purchases equal to USD 1.6 billion since late September 2016. The foreign reserves are 2 billion short of the forecast and are sufficient to cover 3.7 months' worth of imports. Revised macroeconomic data for Q3 2016 reveal 2.0% real growth (y-o-y), which is a better result than the data previously released by the National Bank of Ukraine (1.8%). Investments were the key driver of growth in the reference period, with gross fixed capital formation reaching 25% y-o-y. The interest rate has remained at 14% since December 14th.

International reserves grow by 16.0% in 2016

Real GDP forecast (%)	2017	2018
IMF WEO	2.5	3.0
OECD	-	-

The pace of growth in the Czech economy accelerated in the final quarter of 2016. The recently released data for November 2016 shows that the industrial production increased by 7% y-o-y and receipts from sales of retail trade grew by 7.9% y-o-y. The general unemployment rate for the working age population (15-64) decreased in that month by 0.8 p.p. y-o-y, down to 3.8%. The average inflation rate for 2016 was 0.7%; the Czech National Bank inflation forecasts remain unchanged, with 2.3% for Q4 2017 and 2.4% for Q1 2018. The growth in nominal GDP (by 1.58 p.p.) and declines in the nominal debt resulted in the general government consolidated gross debt decreasing annually to 38.73% of the GDP, and the surplus of the general government balance grew by 1.4 p.p. up to 2.16% of GDP. Meanwhile, the newly approved 2017 budget envisages a small fiscal deficit.

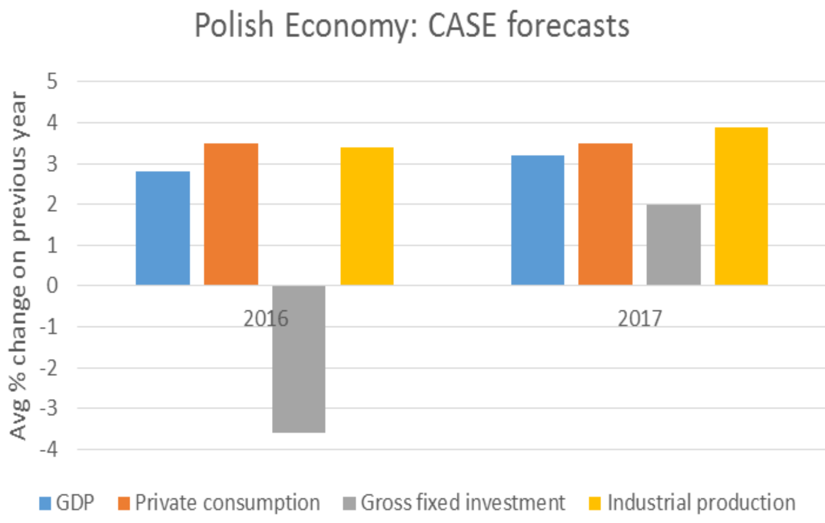
Average inflation rate in 2016 was 0.7%

Real GDP forecast (%)	2017	2018
IMF WEO	2.7	2.4
OECD	2.5	2.6

Hungarian bond yields increased 3-5 basis points following a US Federal Reserve meeting, where Janet Yellen made the case for the Federal Reserve to gradually raise interest rates throughout 2017. In general, Fed rate hikes have a tendency to make CEE bonds relatively less appealing, applying downward pressure on prices (inversely related to yields). The Federal Reserve meeting was held just days ahead of bond auctions in both Bucharest and Budapest. The Hungarian economy is expected continue low but steady growth in 2017, estimated by both the IMF and OECD to be 2.5%. The main drivers of growth are expected to be EU structural funding, declining government debt burdens and waning external vulnerabilities.

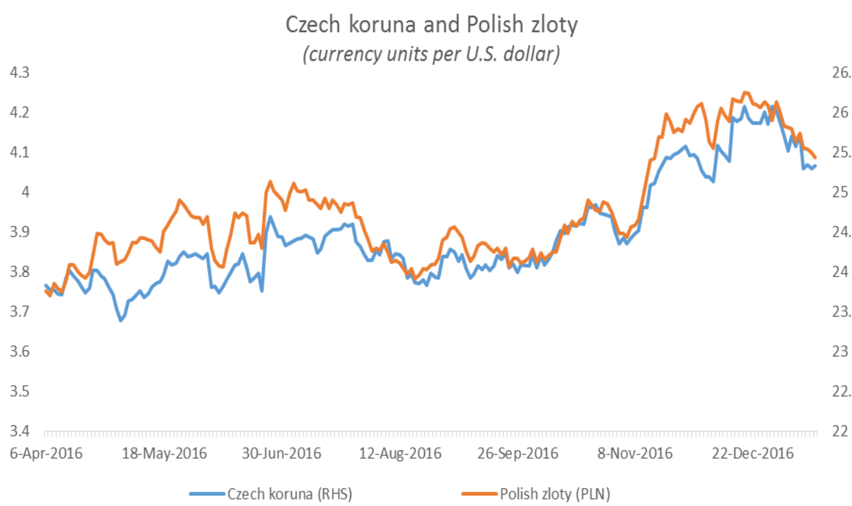
CPI accelerates to 1.8% y-o-y in December 2016, up from 1.1%

Real GDP forecast (%)	2017	2018
IMF WEO	2.5	2.4
OECD	2.5	2.2

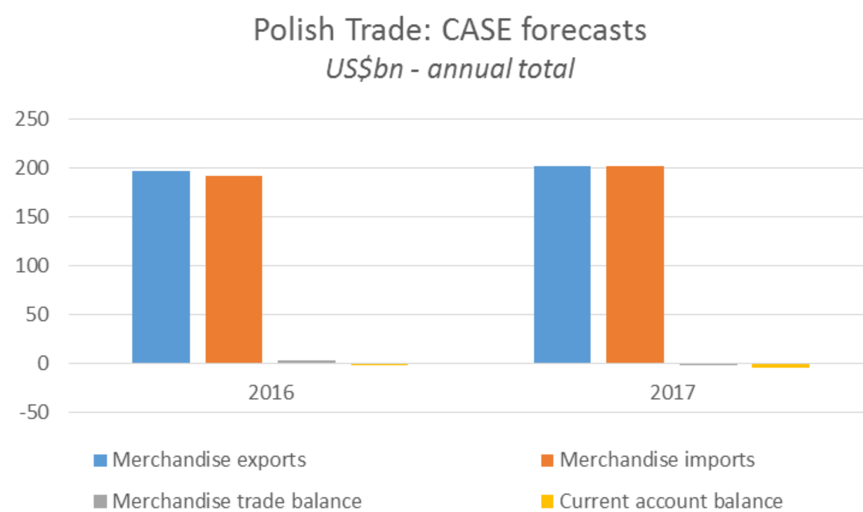


Source: CASE forecasts, forecast updated December 23, 2016

Source: CASE, most recent observation December 19, 2016



Source: IMF, most recent observation January 18, 2017



Source: CASE forecasts, forecast updated December 23, 2016

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