VAKIFBANK GLOBAL ECONOMY WEEKLY

Public Finance: Smaller Threat to the Financial Stability?

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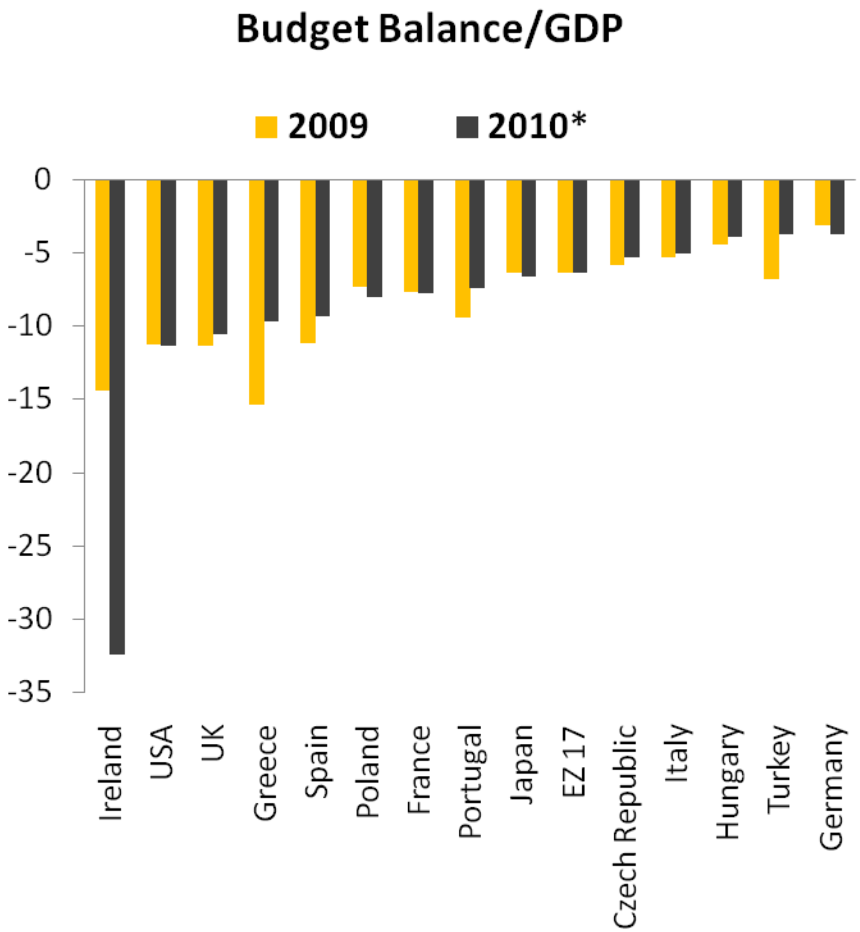
Reducing the budget deficits can take time…

Threats to Global Financial Stability

- **Sovereign risks due to high public deficits**
- **Asset bubbles**
- **Protectionism in foreign trade**

- All of the above financial instability sources prevailed in 2010, but the high budget deficits of the Eurozone countries were the main threats to global financial stability during the first half of 2010.
- The increasing capital flows to EM countries and the uncertainties regarding the global recovery have introduced the asset bubble risks since 2010 Q3.
- But the continued financial struggles in Eurozone still seem to be the most important threat to global financial stability for the moment.

The troubled budget of Greece relieved slightly in 2010 but Ireland took the firstplace with a sharp increase in its budget deficit...

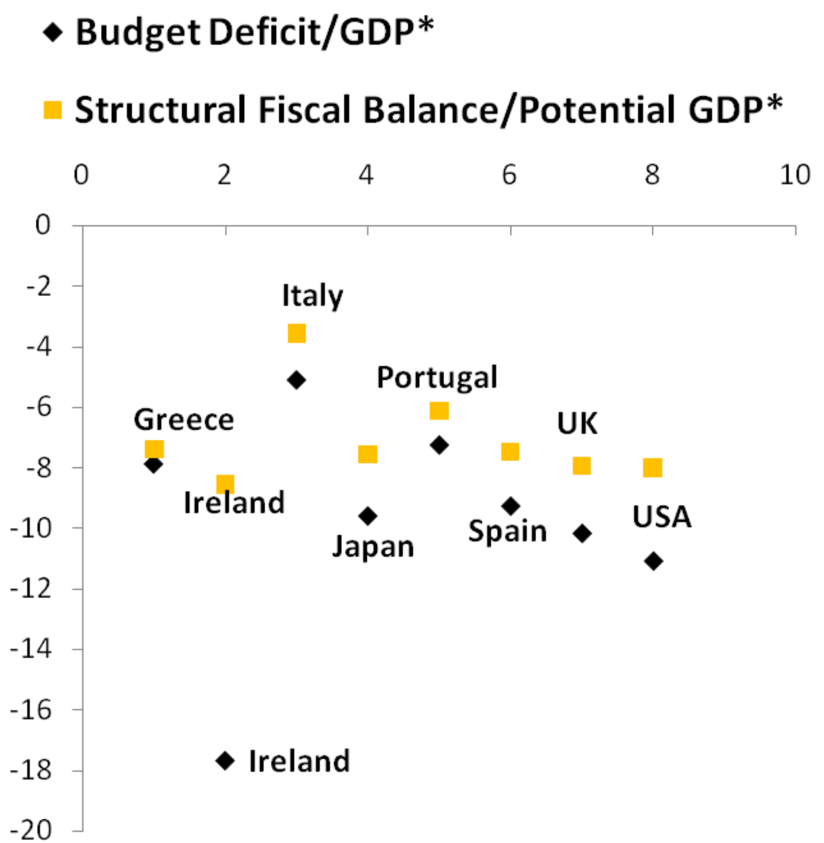


Source: EU Commission
*EU Commission Forecasts

- In Ireland due to the increasing burden of banking sector on government caused the public deficit to widen significantly in 2010.
- It is expected that the budget deficit to GDP ratio of Ireland will decline to -10% in 2011.
- With the effect of the fiscal measures taken in 2010, budget deficit to GDP ratios of the other troubled Eurozone countries such as Spain, Portugal and Italy are also expected to decline.
- The solution of the budget problems of Eurozone countries is closely related with the strength of the European banking sector.

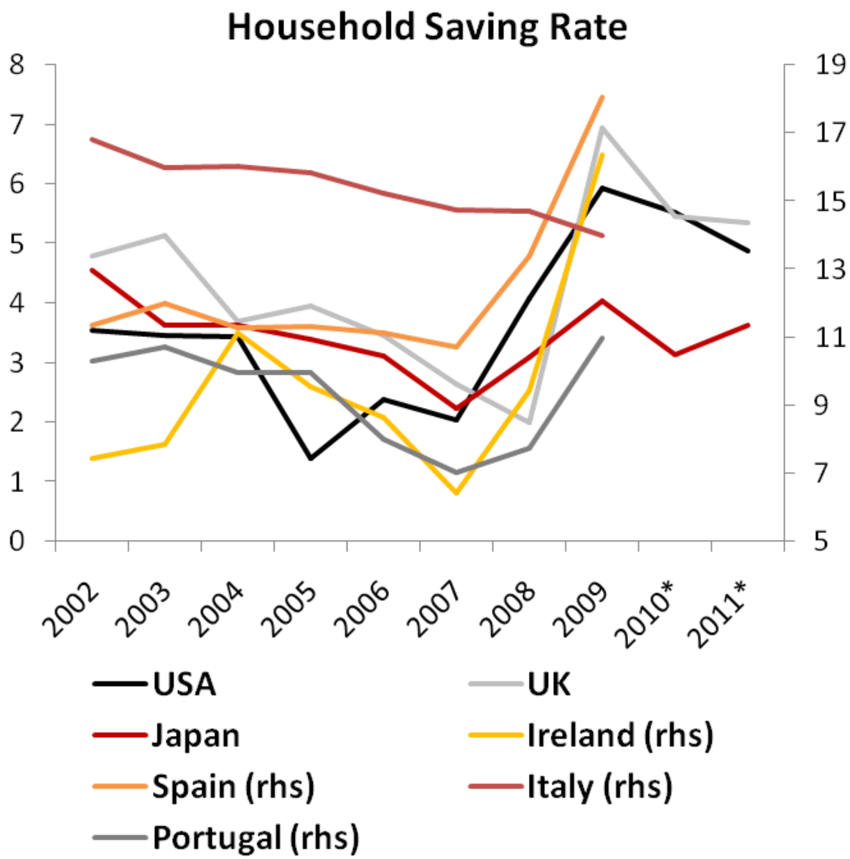
Looking through the window of structural fiscal balance...

- The structural fiscal balance is computed by the adjustment of the government revenues and expenditures from the cyclical movements. It is assumed that the cyclical factors have no effect on the fiscal balance when the economy is on its potential GDP level.
- There is a gap between the budget deficit to GDP and structural fiscal balance to potential GDP ratios of selected countries except for Greece. The gap between Ireland's ratios is the widest. The small gap between Greece's ratios shows that the measures taken in the first half of 2010 started to be effective.



Source: IMF
*2010 IMF forecasts

Household savings are expected to have positive effects on budget deficits in 2011...



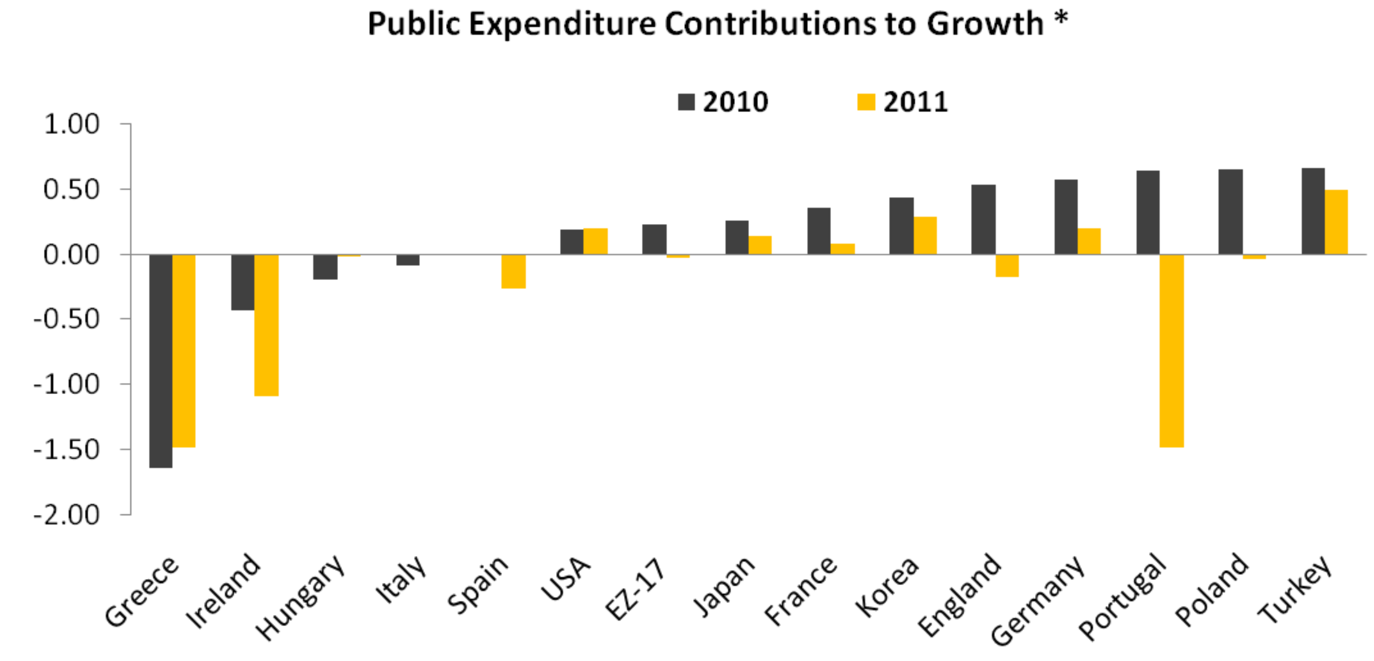
Kaynak: IMF, Eurostat
*IMF forecasts

- Due to the increase in household savings in the recent crisis, governments had to increase the expenditures or gave up their tax revenues to some extent to compensate the decrease in the economic activity.
- Household savings increased significantly in the US and the UK in the recession period. And, with the sovereign debt crisis this rate had a sudden increase in Portugal, Spain and Ireland. In Japan where household savings are already high since 1990's because of deflation, this increase in household savings has been relatively low.
- IMF expects that household saving rate will decrease in 2011. This probability may provide a suitable environment for the reduction of public deficits.
- Possibility of decreasing saving rates in troubled Eurozone countries in 2011 is low for the moment because of fiscal measures taken and the existing economic problems.

The potential economic impact of public debt, deficits and the fiscal measures taken…

- *Government borrowing is an instrument of financing public services, and it became a regular source of public finance such as taxes in the course of time.*
- *During the global financial crisis, public debts have increased significantly throughout the world due to the compensatory government fiscal policies.*
- *The concerns on sustainability of high public debt levels and public deficits of Euro Zone countries have increased sovereign risks in 2010.*
- *The potential crowding out effects of public debts have also been a cause for concern during this period.*
- *The distressing public debt and deficit problems of mainly Greece, Spain, Portugal, Ireland and Italy forced these countries to take contractionary fiscal measures .*
- *These precautions might have caused a slowdown in these economies and increased unemployment. But the consequent positive medium and long term gains on these fields make the short term costs worth it.*

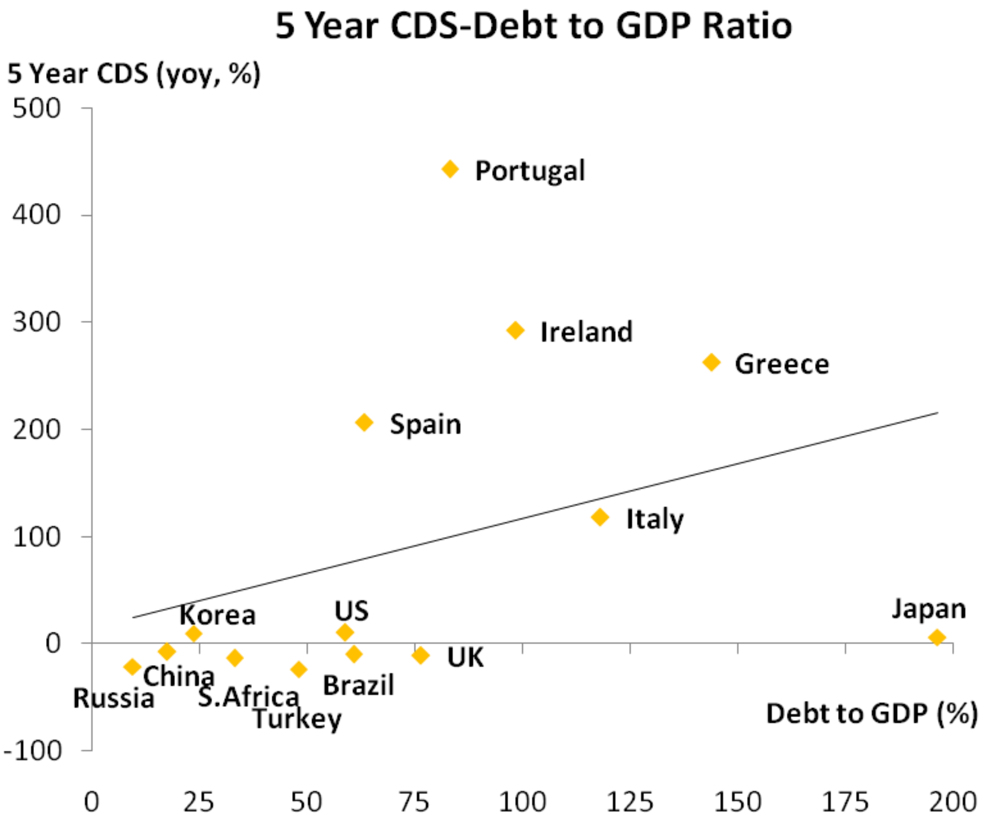
The contributions of public expenditures on growth rates…



*EU Commission Forecasts
Source: EU Commission

- *According to the EU Commission forecasts the contractionary fiscal precautions of Greece are expected to decrease growth performance 1.65% in 2010.*
- *The negative contribution of public spending is expected to be the highest in Portugal and Ireland in 2011.*
- *The EU Commission's forecasts on Turkey indicate that the positive contribution of public spending will decrease relatively in 2011. This implies that Turkey will probably be ahead of the EU countries in terms of budget performance in 2011 as a result of its disciplinary budget policies.*

Concerns on debt sustainability of Eurozone countries continue...

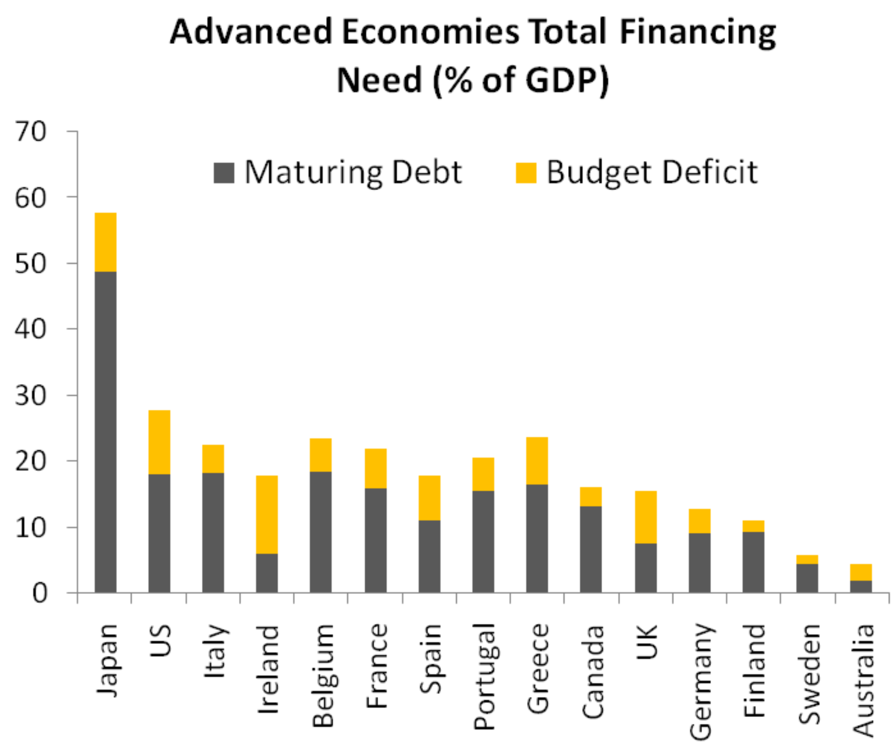


Source: Bloomberg

- The 5 year CDS spreads of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) increased rapidly and their debt stocks rose compared to the end of 2009.
- The increase in CDS spreads indicate upward pressure on sovereign risks.
- Cost of supporting the financial sector especially in the Eurozone countries caused concerns about financial flexibility and the possibility of increasing debt to GDP ratio in the next term.

- Japan's debt to GDP ratio (196.4%) is the highest among the selected countries while its 5 year CDS spread increased by only 6% to 72. Despite it's high debt stock, this implies that the confidence of investors to Japanese economy is higher.

Public deficit is still a big problem for global financial stability…



Source: IMF Fiscal Monitor Nov. 2010

- The troubled Eurozone countries borrowing rates are higher compared to the previous years, but the average interest rate of their total debt is lower than emerging countries and the amount of their medium to long-term debt is higher.
- This indicates that their need for debt restructuring is lower than esteemed.
- The European Stability Mechanism has somehow become a safeguard for the troubled Eurozone countries. But the solvency of these countries is still being questioned.
- Since the advanced countries sovereign financing requirement is still very high, public deficits remain as an important threat to global financial stability which can't be ignored.

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