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Global Economic Trends and Recovery Prospects

by Domenico Lombardi and Samantha St. Amand

ABSTRACT

Despite a relatively favourable outlook for global growth and demand in 2014, there are downside risks to the world's economic giants that could create substantial spillover effects. The Eurozone will finally emerge from the recession that the sovereign debt crisis triggered in 2011. A major risk going forward stems from potential further downgrades to sovereign and non-sovereign credit ratings (Italy has the highest risk of a downgrade because of its fragile banking system and vulnerable debt dynamics). The outlook for the United States is favourable but upcoming events such as the unwinding of the Fed's asset purchase program or political disruptions could trigger instability in global markets. In China the transition to a more consumption-driven economy may further exacerbate the growth slowdown over the short and medium-term. The IMF nonetheless projects that growth in China will be 7.5 percent in 2014. For President Xi this is the minimum acceptable growth rate and it is likely that expansionary fiscal policy or even easing monetary policy will be implemented to attain this target. The year ahead will be a test to the resilience of the restructured, but still fragile, post-crisis global financial system.

keywords

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Introduction

Despite progress in the global economic recovery, there are major challenges for the world's economic giants: the United States, the Eurozone, and China.

A stronger recovery in the United States and steps toward winding down the Federal Reserve's asset purchase program indicate that we are approaching the eventual withdrawal of the Federal Reserve's extraordinarily accommodative monetary policy. Tightening monetary policy and eventually unloading approximately 3 trillion dollars of assets from the Federal Reserve's balance sheet will have to be carefully mastered in order to minimize disruptions to both domestic and global financial markets and real economies.

Indeed, the winding down of the Federal Reserve's current asset purchase program has already created turmoil in emerging market economies, particularly in Brazil, India, Indonesia, Turkey, and South Africa, who are experiencing an outflow of capital and depreciating currencies. Many central banks in emerging market economies have introduced counter measures to stabilize their currencies by tightening domestic monetary policy. Contractionary macroeconomic policies are, however, further constraining real economic activity as growth in emerging markets continues to slow.

In Europe, despite improvement in financial conditions, geographic fragmentation persists, business and consumer confidence remains low, and there are few signs of a recovery in labour markets. In order to overcome divergent growth patterns in the Eurozone, a stable and cooperative monetary, banking, and fiscal union with more power invested in supranational authorities must be established. Tensions emanating from Germany coupled with uneven implementation of reforms in Southern Europe are stalling a balanced integration process that is necessary for maintaining the single currency.

* Domenico Lombardi is director of the Global Economy program at the Centre for International Governance Innovation (CIGI) and scientific advisor of the Istituto Affari Internazionali (IAI). Samantha St. Amand is research associate at CIGI.

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China, on the other hand, has persistently been the top direct contributor to global growth since 2001. Its economy, however, is facing a growth slowdown and will require significant structural reforms to transition from an investment-driven to a consumption-driven economy. President Xi Jinping released a comprehensive reform plan detailed in the communiqué of the Third Plenum Session of the 18th Central Committee in November 2013[1] that includes measures aimed at addressing the growth slowdown. Over-investment, a potential housing bubble heated by expansive fiscal and credit policies to address the global financial crisis, and uncertainty concerning the resilience of the Chinese financial sector could be cause for concern going forward.

The United States, the Eurozone, and China represent approximately 48 percent of the global economy, 43 percent of world trade flows, 49 percent of global market capitalization of listed companies, and house 68 percent of the global systemically important financial institutions. Suffice it to say that these highly integrated economies are capable of inducing significant volatility both in real economies, through the size of their domestic demand, and in financial markets, from the potential contagion effects of their institutions.

1. The US economy

There have been clear signs that the United States economic recovery is picking up speed. Real GDP growth was 1.9 percent in 2013, and the unemployment rate experienced its sharpest one-year drop, falling 1.2 percentage points to 6.7 percent. Consumer demand has surpassed its pre-crisis levels and housing prices have rebounded. And while investments in residential and non-residential structures remain well below their pre-crisis peaks, there is evidence that investment demand is making a strong comeback. Specifically, industrial production and capital utilization rates have either returned to or surpassed, their pre-crisis levels. Elevated capital utilization rates suggest that higher returns to capital will stimulate investment. This will in turn create more jobs and stimulate household savings and investment.

As the real economy regains its strength, financial markets will be focused on the Federal Reserve and its new Chair, Janet Yellen, as it progresses toward a more conventional monetary policy stance. In addition, Congress and the White House have signed a two-year budget agreement, easing concerns of another government shutdown, but constraining the scope of fiscal policies; thus, all eyes will be on the Fed to provide flexible monetary policies for a sustainable recovery.

With a change in leadership at the Federal Reserve, one might expect financial market volatility to pick up. The transition from Ben Bernanke to Janet Yellen,

[1] English version available in China.org.cn: http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm.

however, will not be the same as the transition from Greenspan to Bernanke. In fact, Yellen and Bernanke share similar views in the conduct of monetary policy and the exit from the accommodative stance, and both are strong advocates of a more open and transparent Federal Reserve. As Vice Chair of the Federal Reserve Board of Governors and leader of the Federal Open Markets Committee (FOMC) subcommittee on communication, Yellen was Bernanke's right-hand woman and a strong advocate for improving transparency and communication. She also led the establishment of longer-run goals for the FOMC, which significantly improved the transparency of its monetary policy strategy. Stanley Fischer is set to be a second addition to the Board of Governors as the Vice Chair: his reputation and highly-regarded international experience will significantly add to the new leadership. Against this backdrop, the Federal Reserve under Janet Yellen and Stanley Fischer should be broadly similar to what it has been for the last eight years. It will likely include steady improvements in transparency and a consistent approach to monetary policy that is well-understood and likely anticipated.

Although the Federal Reserve is only at the initial stage in unwinding its exceptionally accommodative monetary policy stance, the FOMC has so far approached this process credibly and relatively transparently. The FOMC, former Chairman Bernanke, and Chair Yellen repeatedly confirmed that the unwinding process would begin when there were substantial and stable improvements in the labour market: they have been true to their word. In addition, the Fed's steps toward tapering have been rather cautious, cutting its asset purchases by 20 billion dollars a month over the last two meetings while continuing purchases of 65 billion dollars a month in an effort to ease markets into the unwinding process.

The process of tightening monetary policy will be gradual and will depend on developments in the real economy.[2] Although the unwinding of the unconventional monetary policies is certainly not on a pre-set path, the order and timing of the change in the Fed's policies can be inferred based on economic projections and the clear communications of the FOMC and its members. If labour market activity continues to improve and longer-term inflation remains well-anchored, then the Fed will continue winding down its asset purchases.

The second step in unwinding its accommodative monetary policy stance will be to raise the Federal Funds rate. Yellen is committed to keeping rates at their current level until, at the very least, one of the thresholds - 6.5 percent unemployment or 2 percent longer-term inflation expectations - is breached.[3]

[2] The tightening process will, however, take a different form if longer-term inflation becomes unanchored, financial markets exhibit irrational exuberance, or there are substantial unforeseen shocks.

[3] Janet L. Yellen, *Challenges Confronting Monetary Policy*, Speech at the 2013 National Association for Business Economics Policy Conference, Washington, 4 March 2013, http://www.federalreserve.gov/newsevents/speech/yellen20130302a.htm.

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The FOMC currently expects the unemployment rate to reach 6.5 percent in late 2014 or early 2015, and the IMF has projected that the unemployment rate will not fall below 6.5 percent until 2016. While the unemployment rate fell faster than anticipated in 2013, ending 0.2 percentage points higher than the threshold, there remains significant slack due to the number of underemployed workers and discouraged individuals who have dropped out of the labour force.

Given current expectations concerning the path of the real economy, it is very unlikely that the policy rate would be tightened prior to 2015. Furthermore, the FOMC has confirmed that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens" and that they will likely keep the federal funds rate at zero to 25 percent well after the 6.5 percent unemployment threshold has been reached.[4] As of December 2013, 70 percent of FOMC members see rates being lifted in 2015 and another 18 percent believe it will occur in 2016.[5]

The final step in withdrawing from the extraordinarily accommodative monetary policy stance will be the sale of assets from the Federal Reserve System's balance sheet. This process will be gradual so as not to significantly disrupt financial markets, openly communicated with an important role for forward guidance, and dependent on developments in the real economy. It will indeed be a gradual return to a more normal monetary policy stance: the eventual unloading of approximately 3 trillion dollars from the Federal Reserve System's balance sheet will likely be completed in 2020 at the earliest.

2. The Eurozone economy

Despite growth of 0.3 percent in the third quarter of 2013, the Business Cycle Dating Committee at the Centre for Economic Policy Research has indicated that, given the state of economic activity, it is not yet appropriate to declare that the Eurozone has emerged from the recession that began in 2011.[6] Most importantly, growth and recovery patterns are projected to remain highly uneven across the Eurozone. Moreover, while most of the periphery countries are projected to emerge from their recessionary troughs in 2014, the sustainability of their recoveries varies. For example, the IMF projects that Italy and Spain will both grow by 0.6 percent in

[4] FOMC, *Press release following the FOMC meeting on 18 December 2013*, http://www.federalreserve.gov/newsevents/press/monetary/20131218a.htm. See also *Monetary Policy Report*, submitted to the Congress on 11 February 12014: http://www.federalreserve.gov/monetarypolicy/mpr_20140211_part2.htm.

[5] FOMC, *Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents*, December 2013, http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20131218.pdf.

[6] Centre for Economic Policy Research (CEPR), *Euro Area Business Cycle Dating Committee*, October 2013, http://www.cepr.org/node/313.

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2014;[7] however, Italy's projections have been revised downward while Spain's has been substantially revised upward. The downside risks to the recovery in Italy are stronger because its high level of debt and weakness in its banking system leave its debt dynamics vulnerable.[8]

Repairing the damage to the financial system in the Eurozone requires both bank recapitalization and prudent sovereign debt management. As banks in the Southern economies are finding it more difficult to raise capital in financial markets, they are reducing their loan portfolio. This raises risk premiums on interest rates to industry and households and decreases the availability of credit. There is, however, evidence of a reduction in geographical financial fragmentation presented through convergence on sovereign bonds yields and interest rates on loans to households.

Despite some convergence, fragmentation persists, especially in financial conditions on bank lending to non-financial corporations. Furthermore, access to finance remains the second most pressing issue for small and medium-sized enterprises (SMEs) in the Eurozone. It is the most pressing problem for less than ten percent of firms in Belgium, Germany, and Austria, and the most pressing problem for more than twenty percent of firms in Ireland, Greece, Spain, and Italy. Despite confidence that access to finance is improving in the South, especially in Spain and Portugal, the outstanding stock of loans to households and non-financial corporations has fallen in Southern countries, but risen modestly in the North.

Repairing financial markets is a necessary but not a sufficient condition for a recovery in the real economy. Beyond access to finance, the most pressing issue facing firms is the difficulty of finding consumers.[9] A demand-side push is required to restore production, improve capital utilization and investment, and create jobs. However, high rates of unemployment and low levels of consumer confidence, as well as fiscal consolidation requirements suggest that a demand-side recovery will not be stimulated by domestic consumption or government expenditures.

Certain Southern economies have recently observed export driven growth; specifically, Spain and Portugal have experienced 3.3 and 6 percent growth in exports over the last four quarters, respectively. Associated with this external demand-side push is growth in industrial production, even though it is stagnant in the North; moreover, improvements in business confidence are converging with that of the North. Italy and Greece, on the other hand, are not experiencing similar growth in production or exports. Eurostat, for example, projects that Italian exports

[7] IMF, *World Economic Outlook Update: Is the Tide Rising?*, 21 January 2014, http://www.imf.org/external/pubs/ft/weo/2014/update/01.

[8] Domenico Lombardi and Samantha St. Amand, "Debt Dynamics Indicate That Italy Remains Vulnerable as Spain Stabilizes", in *CIGI Commentaries*, January 2014, http://www.cigionline.org/publications/2014/1/debt-dynamics-indicate-italy-remains-vulnerable-spain-stabilizes.

[9] BCE, *Survey on the access to finance of SMEs in the euro area (SAFE)*, April-September 2013, https://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html.

will not reach 2007 levels (in real terms) until sometime in 2014.[10] For Greece, this is not expected to occur until sometime after 2015. By comparison, exports returned to their pre-crisis peak in France, Germany, Portugal, Ireland, and Spain by early 2011.

Growth in Portuguese and Spanish exports are improving labour market conditions in those economies, reflected in a fall in the unemployment rate by 1.9 and 0.5 percentage points in 2013, respectively. Italy and Greece, on the other hand, have observed continued deterioration of labour market conditions in 2013. More than five years after the global financial crisis began, there remains a significant gap between the North and the South in unemployment and consumer confidence.[11]

3. China

China has been one of the main sources of strength in the world economy throughout the global financial crisis, representing approximately 42 percent of global growth from 2008 to 2013. At the same time, it is facing a significant growth slowdown. The basic explanation for China's slowdown is that the investment and export-driven growth model that drove 10 percent growth rates over the last two decades has become unsustainable. Problems with over-investment and a misallocation of investment have led to decreasing returns to capital.[12]

Furthermore, investment rates will fall as urbanization rates decrease and the demand for big ticket items such as real estate, vehicles, and air transportation declines. In addition, a potential housing bubble[13] suggests that continued reliance on investments could have harmful effects on the banking sector and the real

[10] Eurostat Database, *Exports of goods and services* (millions of euros, chain-linked volumes with 2005 reference year and 2005 exchange rates).

[11] The average unemployment rate in Northern Europe (including Austria, Belgium, Finland, France, Germany, and the Netherlands) is 7.4 percent; the rate is higher than 12 percent in Italy and Portugal and higher than 25 percent in Spain and Greece. The average level of consumer confidence in the North is -4; the level is -12 in Spain, -19 in Italy, -32 in Portugal and -65 in Greece. The consumer confidence indicator measures current expectations over the next 12 month and can range between -100 (all consumers expect the worst outcome) to +100 (all consumers expect the best outcome).

[12] See for example, Chong-En Bai, Chang-Tai Hsieh, Yingyi Qian, "The Return to Capital in China", in *NBER Working Papers*, No. 12755 (December 2006), http://www.nber.org/papers/w12755; Sai Ding, Alessandra Guariglia and John Knight, "Does China Overinvest? Evidence from a Panel of Chinese Firms", in *University of Oxford Working Papers. Department of Economics Discussion Paper Series*, No. 520 (December 2010), http://www.economics.ox.ac.uk/kadf; and Qiao Liu and Alan Sui, *Institutions, Financial Development, and Corporate Investment: Evidence from an Implied Return on Capital in China*, December 2006, http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1162.pdf.

[13] See for example, Christian Dreger and Yanqun Zhang, "Is There a Bubble in the Chinese Housing Market?", in *DIW Discussion Papers*, No. 1081 (November 2010), http://www.diw.de/sixcms/detail.php?id=diw_01.c.364153.de; Joseph Gyourko, Yongheng Deng , Jing Wu, "Just how risky are China's housing markets?", in *voxEU.org*, 28 July 2010, http://www.voxeu.org/node/5353.

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economy. Export growth, the second main driver of economic growth over the last decade, is also slowing due to an appreciating currency, rising real wages, and weak external demand from advanced economies.

In order to maintain high and stable growth rates, China needs to carry out transition from an investment-driven to a consumption-driven economy. Crucial to this transition is building a stronger middle class, reducing inequality, and improving the resilience of the financial system and the real economy. Automatic fiscal stabilizers through a social safety net will improve the economy's resilience to external shocks and reduce inequality. The resilience of the financial system can be strengthened by ensuring a strong regulatory and supervisory framework and developing consumer and shareholder protection mechanisms in periods of distress.

President Xi Jinping released a detailed reform plan in the communiqué of the Third Plenum Session of the 18th Central Committee in November 2013 aimed at addressing the growth slowdown and transitioning to a more consumption and innovation driven economy. Although the plan offers little details on the timing and sequence of the reforms, it signals that the party wishes to restructure the economy, allowing for a stronger role for markets in the allocation of resources while still maintaining socialist ideals.

It is expected that China will pursue these reforms at a cautious pace leading up to the 2020 deadline. Certain components of the reform plan, including the fight against corruption and reform of state-owned enterprises, may certainly be propaganda. Part of the plan, however, appears to reflect a genuine commitment to reform. Specifically, the communiqué indicated that the reforms would create a more "decisive role" for the market in allocating resources; this marks a change from the previous role for the market defined as "basic" in 1992 when the country set out to become a "socialist market economy".[14]

This statement is accompanied by many reform proposals that give a stronger role for market-determined allocation of resources.[15] Perhaps more pressing is the government's preference for developing the domestic equity and fixed income markets and liberalizing financial markets. Internal push factors from the People's Bank of China (PBoC) and influential business people, as well as reforms that are already underway indicate that these reforms are going to be implemented sooner

[14] Chen Zhi, "Streamlining gov't administration ensures market's 'decisive' role: analyst", in *Xinhuanet*, 25 November 2013, http://news.xinhuanet.com/english/indepth/2013-11/25/c_132915729.htm.

[15] Proposed reforms of this nature include, among others: liberalize of interest rate setting; reducing monopoly power of state-owned enterprises to eliminate monopolistic pricing of utilities, transportation, and telecommunication, and allow more private investment in state-owned enterprises; improving property rights to farmers; reduce barriers to entry including reform of the business registration system to promote private-sector competition, and; gradual internationalization of the RMB.

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rather than later.[16]

The reforms seek to establish a stronger social safety net and address inequality. The plan indicates that social welfare contributions of state-owned enterprises will approximately double. Tax revenues will increase through the gradual introduction of a comprehensive personal income tax system, consumption taxes will be adjusted with higher taxes on luxury goods, and improvements will be made to real-estate taxes. The plan also includes measures to decrease the rural-urban divide, improving farming land rights as well as access to, and quality of, education in rural areas. Furthermore, reform of the "hukou" housing registration system will improve labour mobility by allowing rural migrants to register in their immigrated cities, granting them the receipt of local government services such as education and health care.[17]

The reforms also aim to improve market-driven competition and make it easier or less risky to start a registered business. These foresee improvements to the judicial system, such as adherence to the rule of law, stronger property rights and improved bankruptcy procedures, decreasing barriers to entry by improving the business registration system, and facilitating access to finance through IPO system reforms.

These reforms could improve resource allocation and total factor productivity, and thus decrease spare capacity created from over-investment. Other reforms that could stimulate productivity include measures to improve China's technological capacity, such as strengthening intellectual property rights registration and protection and relaxing policies on high-technology foreign firms to establish their businesses in free trade zones.

Many of the reforms aimed at liberalizing the financial sector are likely to be implemented because of support by the People's Bank of China (PBoC) and its governor, Zhou Xiaochuan. Some envisaged measures are market driven, including competitive interest rate setting, liberalization of the capital account, and the internationalization of the currency. Other measures aim to reduce fraud and establish consumer protection, including the introduction of deposit insurance and reforms that have already been implemented that make companies liable for shareholder financial losses if they were misled.

With much uncertainty about the resilience of the Chinese economy and little discussion of an action plan to implement the reforms over the next 6 years, the transition to a consumption-driven economy may not be smooth. A decline in returns to investments triggered by interest rate or exchange rate fluctuations could cause asset price volatility and have significant real economic effects. The

[16] The freeze on initial public offerings was lifted in December and reforms allowing investor-determined pricing have been implemented, and restrictions on the setting of lending rates were lifted in July of 2013.

[17] Excludes Tier 1 cities, for example Shanghai, Beijing, Guangzhou, Shenzhen, and Chongqing.

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vulnerability of the Chinese economy to internal shocks is up for debate and will depend on the resilience of its financial sector, regulatory landscape, and fiscal stabilizers in the event of a shock.

Conclusions

Despite a relatively favourable outlook for global growth and demand in 2014, there are downside risks to the world's economic giants that could create substantial spillover effects.

In the Eurozone, geographical financial fragmentation has been improving and it is projected that it will finally emerge from the recession that the sovereign debt crisis triggered in 2011. A major risk going forward stems from potential further downgrades to sovereign and non-sovereign credit ratings that could push the ratings of some entities to the brink of the non-investment grade threshold.

Facing a negative outlook from all three of the big credit rating agencies, Italy has the highest risk of a downgrade because of its fragile banking system and vulnerable debt dynamics. In addition, Standard & Poor's has recently changed its methodology for ratings of non-sovereign borrowers which could have negative implications for banks based in Italy and other stressed Eurozone countries. This has the potential to further constrain credit to banks in the euro periphery, increase financial fragmentation, and reverse or at the very least slow the recovery process.

A second risk stems from low inflation and the potential of deflation. In the event of further financial market deterioration or changes to the outlook for inflation, the ECB will have to act boldly and decisively by engaging in targeted lending practices or further easing its monetary policy stance to prevent the Eurozone from dipping into another recession.

The outlook for the United States is favourable: the IMF is projecting growth of 2.8 percent in 2014, up from 1.9 percent growth in 2013.[18] Given the importance of the United States in global financial markets, upcoming events such as the unwinding of the Fed's asset purchase program or political disruptions could trigger instability in global markets.

It is important that the Fed unwinds its accommodative policy cautiously and credibly so that fiscal consolidation does not become unfeasible, balance sheet adjustments in the financial sector can be supported, and emerging markets have the appropriate information and time to adjust macroeconomic and regulatory policies accordingly.

[18] IMF, *World Economic Outlook Update: Is the Tide Rising?*, cit.

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The transition to a more consumption-driven economy in China may further exacerbate the growth slowdown over the short and medium-term. The People's Bank of China has been showing a strong commitment to tighten interest rates in order to curb credit growth which could further constrain output. The IMF projects that world output will grow by 3.7 percent in 2014 and that approximately 32 percent of that growth will be driven by China. If the Chinese economy were to slow by a third of its projected growth to 5 percent, world growth would fall by at least 0.4 percent. In order to recover those losses, the United States, the second largest contributor to world growth, would have to expand by 5 percent. In other words, due to its massive size and importance for world output, Chinese domestic policies will have global implications. The IMF nonetheless projects that growth in China will be 7.5 percent in 2014. Despite the transition and tightening of monetary policy, President Xi has set the minimum acceptable growth rate at 7.5 percent and it is likely that expansionary fiscal policy or even easing monetary policy will be implemented to attain this target.

The year ahead will be a test to the resilience of the restructured, but still fragile, post-crisis global financial system.

The unwinding of the extraordinarily accommodative monetary policy stance in the United States could spark significant global financial market volatility, or even reveal pockets of asset bubbles from the search for yields in emerging economies.

As the real economy strengthens in the United States, however, so too will its demand for exports; thus its recovery has the potential to foster an export-led recovery in the Eurozone and other economies reliant on exports to the United States.

A stable global economy requires significant structural reforms in the Eurozone and in China. In addition, continued reforms in the global financial architecture are critical to strengthening its resilience and preventing another major financial crisis.

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T +39 06 3224360
F + 39 06 3224363
iai@iai.it
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