OXFORD ECONOMICS

Is the economic recovery sustainable in the US and Europe?

Executive Summary

- Following the worst recession since the 1930s, the US, UK and Eurozone economies have all now returned to positive growth. With the boost from policy stimulus and the inventory cycle peaking, however, this raises questions about the sustainability of the current rebound.
- The analysis presented here suggests that the recoveries in both the US and Europe will be relatively muted compared to recent historical experience. The US is likely to be the growth leader, reflecting the more dynamic nature of its economy and financial sector.
- A key uncertainty relates to how labour markets will perform during the recovery phase. To date, the rise in US unemployment been particularly severe when compared to the experience of Europe. In light of the sharp falls in European productivity, we expect employment gains in Europe to be more muted in the recovery phase than in the US.
- The performance of residential real estate markets also remains important. Home prices in the US are now close to fair value by most metrics, suggesting that the correction in prices is likely to be bottoming out. In Europe, only Spain and Ireland appear to be in the midst of substantial housing market corrections.
- Commercial real estate markets are also facing ongoing corrections in many countries. While conditions in the US and Eurozone may deteriorate further, commercial property values appear to be stabilising in the UK following earlier sharp declines.
- The ability of the banking sector to finance the economic recoveries in the US and Europe remains a key risk to the growth outlook. As the process of absorbing credit losses and rebuilding capital is likely to be protracted, the normalisation of lending standards is likely to take longer than following recent recessions. This is a particular concern for the Eurozone, where bank funding is more important for companies.
- Whether domestic demand in the US and Europe recovers will also depend on whether private sector deleveraging has further to run. The destruction of household net wealth in the US suggests that the personal savings rate has further to rise, whereas there no longer appears to be a pressing need for households in the UK and Eurozone to consolidate their balance sheets. In contrast, non-financial corporations in the US are in a stronger financial position than their European peers, having not increased debt levels as rapidly during the credit boom.
- Risks around public finances have received the most attention in recent weeks. In particular, the adjustments underway in Greece pose a risk of potential contagion from sovereign credit risk that could threaten growth on both sides of the Atlantic.

Introduction

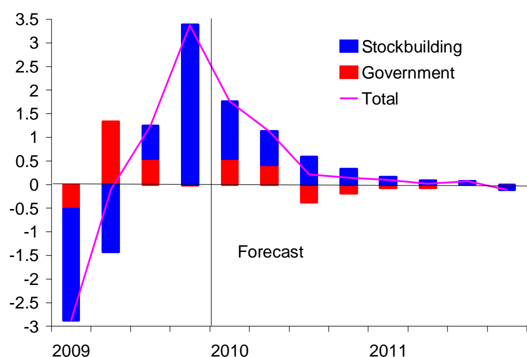
Global conditions have gradually improved since the first quarter of 2009 and recent data indicate that economic activity is expanding again in most countries. But the pace of recovery is likely to differ widely between economies over the coming two years, reflecting differences in the structural problems to be addressed and national policy responses in the wake of the crisis. This article explores the key features of the adjustments underway in the US, UK and Eurozone economies, drawing out the implications for the future path of their recoveries and the risks to a sustained upturn in activity.

Temporary factors support the rebound

Following the worst recession since the 1930s, the US and Eurozone economies returned to positive growth in the third quarter of 2009 and the UK followed suit in the final quarter of the year. However, the upturn in activity has been supported by a number of short-term factors that will begin to fade over the course of 2010.

US: Short-term supports to GDP growth

% points contribution to GDP growth



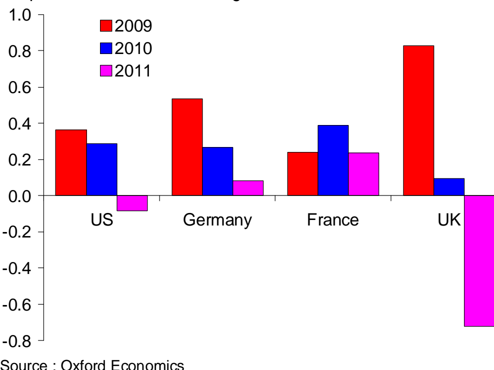
Source : Oxford Economics/Haver Analytics

One of these key supports to growth is the impact from fiscal stimulus measures. In the US, the federal government has provided substantial funds to stimulate economic activity through programs such as the “cash for clunkers” scheme to support vehicle sales and the extension and expansion of the homebuyers’ tax credit. The IMF estimate that these discretionary measures amounted to 3.7% of GDP in 2009-10. Although fiscal policy will remain supportive for 2010 as a whole, we estimate that the contribution to GDP growth will fade over the course of the year as these initiatives wind down. Indeed, the positive contribution to growth from public spending measures is currently set to end by mid-2010, although another fiscal stimulus package should not be ruled out.

In the Eurozone, several large countries, including Germany, France and Spain, have implemented substantial fiscal stimulus packages in addition to the considerable support provided by automatic stabilisers in the region (notably, Italy did not introduce any significant discretionary measures). For the Eurozone as a whole, the IMF estimate that these discretionary measures amounted to around 1.6% of GDP in 2009-10. These stimulus packages have proved to be more costly than expected, particularly as some packages have been augmented with measures that are permanent in nature. With the effects of many of these discretionary stimulus packages extending into 2010 in addition to the continued positive impact from automatic stabilisers, it is expected that the boost to GDP growth from public spending will not peak until the first half of this year.

Fading contributions from public spending

% points contribution to GDP growth



Source : Oxford Economics

Following the implementation of fiscal stimulus measures equivalent to around 1% of GDP in 2009, the UK is one of the few countries in Europe (apart from Greece and Ireland) where the positive contribution of public spending to GDP growth is expected to disappear almost completely in 2010. This withdrawal of fiscal policy stimulus has been necessitated by the sharp deterioration in the UK’s public finances. In the December Pre-Budget Report, the UK Treasury predicted a deficit of 12.6% of GDP in 2009/10, representing a doubling from the previous year and by far the highest deficit since the last World War. In our view, even these dismal

projections are too optimistic and we expect significant fiscal tightening after the election.

Another important factor supporting economic activity has been monetary stimulus. Central banks in all three economies have cut interest rates to exceptionally low levels and employed unconventional measures to provide additional liquidity to financial markets. Given the fragility of the recovery, the Fed, ECB and BoE are likely to hold their policy rates close to the lower bound until late-2010 or possibly beyond. Similarly, the exit strategies from unconventional measures will also be very gradual as central banks will wish to maintain abundant liquidity and avoid unsettling financial markets. The Fed has already started to scale back its asset acquisition programme, albeit marginally, while the ECB has begun to wind down its exceptional liquidity measures. The Bank of England announced on 4 February that it would halt its asset purchase programme for the time being, but noted that further purchases were possible if conditions warranted.

Finally, the recent rebound in growth has owed much to a turn in the ‘inventory cycle’ following the sharp liquidation of stocks that occurred at the peak of the crisis. This re-stocking effect has been particularly important for the US economy, having contributed 0.7 and 3.4 percentage points to GDP growth in the third and fourth quarters of 2009 respectively. As production catches up to demand and inventories begin to stabilise, however, this short-term support to the expansion will end. In the United States, we expect this to occur by mid-2010, although the positive effect is likely to be spread out over a longer period in the UK and Eurozone.

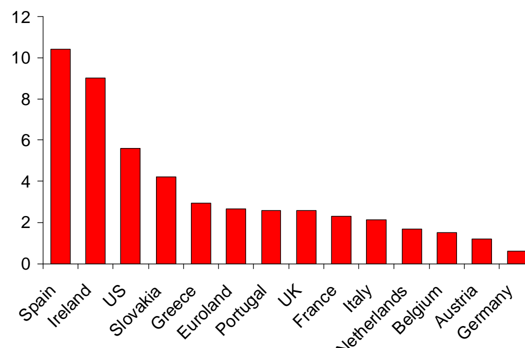
Labour market performance a key issue

With the growth boost from policy stimulus and the inventory cycle peaking, this raises questions about the sustainability of the current rebound in the US, UK and Eurozone economies. Sustainable recoveries in 2010 and beyond will require growth to transition towards more permanent sources of final demand, namely consumer spending, business investment and exports.

A key uncertainty relates to how labour markets will perform during the recovery phase; dynamic labour markets associated with solid income gains will in

Comparing the rise in unemployment rates

% points from trough

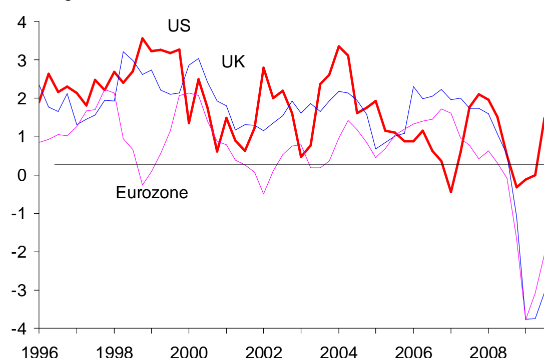


Source : Oxford Economics/Haver Analytics

turn support consumer spending. The chart below illustrates how the scale of job losses experienced so far has varied between countries. What is immediately evident is that the rise in US unemployment has been particularly severe when compared to the experience of Europe – only Spain and Ireland have witnessed sharper rises. Data indicate that wage growth in the United States has also been very modest. These adjustments in the labour market have resulted in very different patterns in *implied* productivity growth, with sharp declines in the UK and Eurozone contrasting with solid gains in the US.

Divergent trends in productivity growth

annual growth, %



Source : Oxford Economics/Haver Analytics

In part, these differences have been driven by European policies aimed at limiting the rise in job losses (particularly in Germany). The US labour market does also tend to be more cyclical than those of other economies. Nonetheless, the scale of job losses is still surprising. One possibile explanation is that employers in the US cut payrolls more sharply than necessary due to uncertainty regarding the severity of the downturn. This would imply that pent-up demand for hiring will result in a strong upturn in

coming quarters[1]. On the other hand, there are reasons to believe that job growth is likely to be more moderate, such as the desire by employers to preserve productivity gains, lingering doubts around the strength of the recovery, and uncertainties over the future evolution of labour costs, especially healthcare. We expect the US unemployment rate to edge higher in the coming months as these factors restrain payroll gains, but the jobless rate should start to fall in the second half of 2010 as employment growth gathers pace.

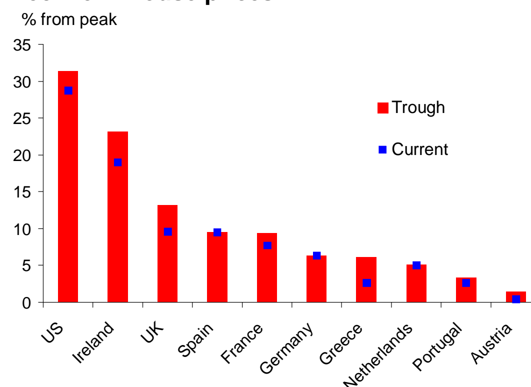
By contrast, overall employment levels in the UK and some Eurozone member states look surprisingly high given the depth of the downturn. In light of the sharp falls in productivity experienced by these economies, this suggests that there was significant labour 'hoarding' during the recession. We therefore expect that employment in both the UK and Eurozone will continue to fall over the coming year, with the unemployment rate only stabilising in the first half of 2011. With higher transfers cushioning the impact of the decline in employment income, this downbeat outlook for the labour market is still consistent with the moderate recoveries we envisage for these economies in 2010. Still, there is a risk that employment may decline more sharply than expected, which could prove destabilising to these fragile recoveries.

Housing markets may still surprise

The performance of residential real estate markets also remains important, not least because of the impact on household wealth and bank balance sheets. The chart below compares the declines in average house prices from their peaks experienced in the US and Europe. With the global financial crisis and recession having its origins in the US housing market, it is perhaps not too surprising to find that the US stands out as having experienced the sharpest falls.

Recent news on the US housing market has been mixed. Home sales have picked up recently and inventories of new and existing homes have declined dramatically, improving the balance between supply and demand. But this recovery in housing activity owes much to government subsidies, such as the homebuyer tax credit, rather than a revival in private demand, which suggests that there is a risk of some "payback" when these incentives expire. Credit availability also remains a hurdle, especially for first-time buyers. Indeed, recent news on house prices has been less positive, with home price measures having eased following upside surprises in the spring and summer. Still, home prices in the US are now close to fair values by most metrics and traditional measures of affordability have climbed sharply, suggesting that the correction in house prices is likely to be bottoming out. But a solid recovery is unlikely until employment and income conditions improve.

Decline in house prices



Source : Oxford Economics/Haver Analytics

The UK also experienced a significant housing bust, although house prices actually rose modestly in 2009. This recent recovery in prices appears mainly to reflect an acute shortage of properties available for sale, with many homeowners either trapped in negative equity or reluctant to sell for fear of locking in the losses of the past two years. A "double-dip" in house prices is therefore a risk in 2010, as these temporary supports from technical factors give way to downward pressures from credit constraints and the rising unemployment rate.

Housing markets in the Eurozone did not generally experience the same debt-fuelled excesses as the US and UK, so have not suffered correspondingly sharp corrections. Two notable exceptions are Spain and Ireland, whose housing markets still appear overstretched.

In Ireland, the housing market had experienced one of the most pronounced booms among the industrialised nations. Prices have fallen by almost

[1] Another possible explanation is that official estimates of GDP in the US may be overstating the true growth picture, while data for the UK and Eurozone may have been underestimated. But we will not know whether this argument holds water until data revisions are completed in a couple years.

25% from their peak in late 2006 and residential construction has witnessed a sharp contraction in output and employment. Although affordability measures have eased considerably, the overhang of excess supply remains substantial and continues to weigh on house prices. Residential construction is also likely to remain weak, especially if recent patterns of net out-migration persist, which could cause a prolonged slump in new private housebuilding.

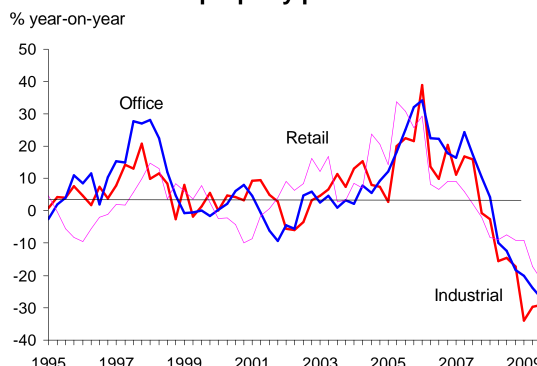
In Spain, the downward correction in house prices may well have a long way to go, having lagged behind the adjustments in other regions. Despite the massive debt-fuelled run up in house prices in recent years, prices have so far only fallen by around 12% from their peak. Measures of overvaluation, such as the ratio of prices to income or rents, suggest that the market remains significantly overstretched. Construction investment, one of the main supports to the Spanish economy in recent years, has already contracted sharply in response to the downturn in the housing market. But the economy remains heavily unbalanced, so further painful adjustments are likely.

In summary, it appears that the US housing correction is bottoming out, while in Europe only Spain and Ireland are currently experiencing significant housing market adjustments. As a result, these economies are more likely to experience subdued consumer spending growth due to confidence and wealth effects. Banking systems in those countries may also come under further strain due to residential mortgage-related losses.

Commercial property under pressure

Commercial real estate markets are also facing ongoing corrections in many countries, with rising defaults and foreclosures adding to the pressure on the financial system.

In the US, the slowdown in the economy has contributed to high and rising vacancy rates in commercial properties. Rents are therefore being negotiated lower and property values are declining. Financing is also very difficult to obtain for new projects. These factors have resulted in a significant contraction of non-residential construction activity as many commercial projects are delayed or cancelled. Although supply excesses do not appear to be as



severe as during the real estate bust of the late 1980s and early 1990s, there are certain sectors, such as retail, where developments often coincided with housing construction. Further price declines are expected this year, with the largest falls likely to be in regions that have experienced the sharpest declines in housing. Non-residential construction is also likely to continue to contract sharply in 2010. Equally worrying for investors and banks is the volume of loans that will require refinancing – around $1.6 trillion of commercial mortgage debt will mature in the next five years.

Commercial property values in the UK have already declined by around 45% from their peak in early 2007, but there are signs that prices have begun to stabilise recently. Still, with loan-to-value ratios now much higher than pre-crisis levels, many loan-covenants have been breached, real estate companies are struggling to service their debts, and banks are having difficulties refinancing loans. This could eventually translate into substantial further losses for UK banks, as loans to the real estate sector account for around half of all corporate lending. There is also a risk that prices could fall

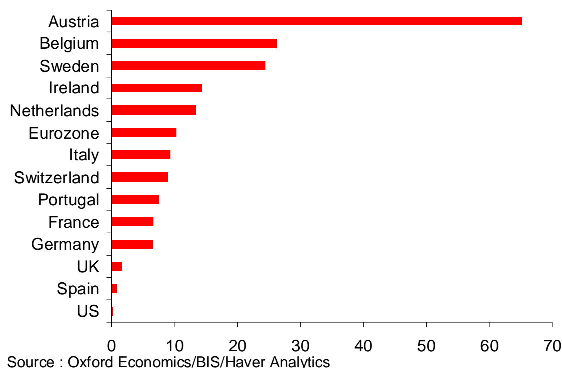
further, driven by a fresh wave of corporate bankruptcies or if repossessed properties are dumped onto the market.

In the Eurozone, conditions in the non-residential real estate market have also deteriorated. Values for prime property fell by 12% in the year to Q3, with all countries experiencing declines. Conditions in Spain look particularly dire; prices of office buildings in Madrid, for example, have fallen by around 50% since the end of 2007. Property values in the Irish market have also suffered sharp declines of around 60% from their peak; although there have lately been signs of stablisiation in Ireland, it is too early to expect any rebound in values. As commercial property markets are highly cyclical, the outlook across the Eurozone will depend greatly on the strength of the economic recovery.

CEE exposures may also turn sour

European banks also face the risk of substantial losses relating to loan exposures in Central and Eastern Europe (CEE), as the scale of the collapse in output in some CEE countries points toward the risk of significant defaults. These risks are compounded by the prevalence of unhedged foreign currency borrowing in the region. The sharp depreciation of exchange rates in the region following the onset of the crisis has increased the local currency value of debts and raised the cost of interest payments. Although economic conditions in CEE have improved lately, defaults tend to lag the business cycle.

Bank exposures to Eastern Europe



Source : Oxford Economics/BIS/Haver Analytics

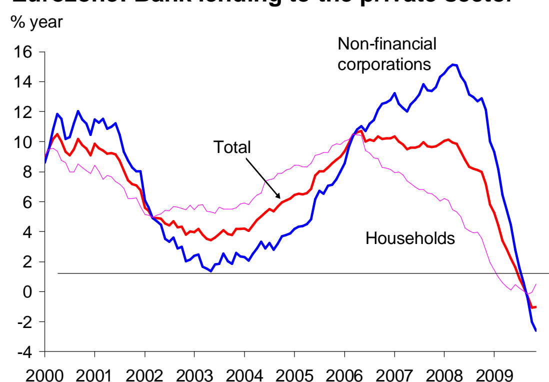
Total exposures by banks in the Eurozone to CEE amount to around 10% of GDP. The distribution of exposures across the Eurozone is highly uneven, however, so the problem is much greater at the individual country level in certain cases. Bank exposures to CEE are greatest in Austria, where they amount to 65% of GDP, followed by Belgium, with exposures equivalent to 26% of GDP, Sweden at 24% of GDP, Ireland at 14% of GDP, and the Netherlands at 13% of GDP.

Bank health remains important…

The ability of the banking sector to finance the economic recoveries in the US and Europe remains a key risk to the growth outlook – both on the upside and downside. If further losses erode bank capital, this could potentially undermine the flow of credit to the economy. There is also a risk that new international rules on bank liquidity and capital requirements could lead to renewed pressure on banks to shrink their balance sheets.

The banking sector is particularly important as a source of finance in the Eurozone. Bank lending accounts for more than half of the total financing of the non-financial corporate sector in the Eurozone, in contrast with the US, where corporate bonds outstanding are around six-times the size of all bank loans to businesses.

Eurozone: Bank lending to the private sector



Source : Oxford Economics/Haver Analytics

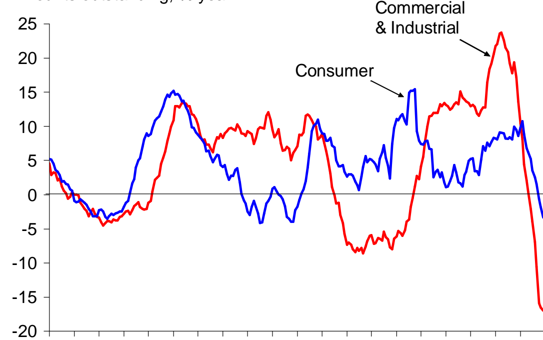
Eurozone GDP growth has historically shown a close correlation with movements in bank lending. Against this background, the unprecedented contraction in bank lending is worrying (see above chart). But it is difficult to determine the direction of causality in this relationship. With house prices falling, unemployment rising, and capacity utilisation at very depressed levels, it is perhaps not surprising that demand for loans is low. Supply-side factors are also likely to be part of the story. The ECB's survey of bank lending has shown that credit standards continue to be tightened for both businesses and

households, although the pace of tightening has moderated recently.

The future evolution of factors that drive the supply of lending remains unclear. A positive development on this front is that funding availability has improved, with conditions in the interbank market having returned close to pre-crisis levels (although securitisation markets still remain impaired). On the other hand, the outlook for future bank losses appears less positive. In October 2009, the IMF estimated that Eurozone banks had only recognised around 43% of the losses they would ultimately incur as a result of the downturn. The ECB was more optimistic in their December 2009 *Financial Stability Review*, suggesting that Eurozone banks had accounted for around two-thirds of their expected losses. But that still leaves banks in the region with a further €187bn of unrecognised further losses. Of course, these estimates are highly uncertain, but if they are anywhere close to reality, losses on this scale could substantially affect banks' ability to lend.

US: Bank lending to the private sector

Amounts outstanding, % year



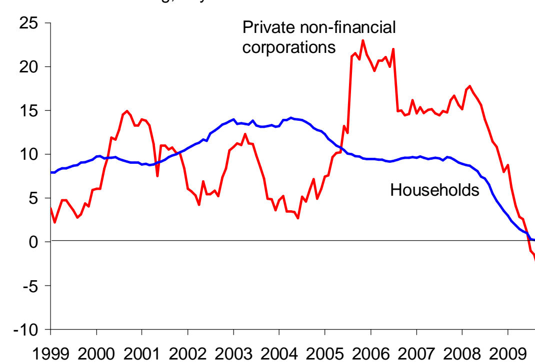
Source : Oxford Economics/Haver Analytics

In the US, bank lending to the private sector is also contracting. Again, this likely represents a combination of both supply and demand factors. On the supply-side, the Federal Reserve Senior Loan Officer Survey shows that banks are continuing to tighten lending standards, although the net percentage of banks reporting tightening standards has fallen significantly. For large companies, the improvement in capital markets has helped to offset the reduction in availability of bank credit - both the investment-grade and high-yield debt markets have experienced a resurgence in new issuance recently. But capital markets are not a complete subsitute for bank lending, particularly for small companies and households who cannot access them.

There are reasons to believe that banks will not quickly normalise their lending standards as happened in the aftermath of the credit crunches of the 1970s and early 1980s. The pressures on the banking system during these earlier periods reflected the aggressive tightening of monetary policy in response to rising inflation; when inflation fell, interest rates followed and the pressure on banks quickly subsided. In contrast, the present tightening of lending standards reflects pressure on bank balance sheets arising from credit losses. As the process of absorbing these losses and rebuilding capital is likely to be protracted, the normalisation of lending standards is also likely to take longer than following the recessions of the 1970s and early 1980s. Still, US banks are at a comparatively more advanced stage of recognised and absorbing loan losses and writedowns than their Eurozone partners, which should help them to recover relatively more rapidly.

UK: Loans to the private sector

Amounts outstanding, % year



Source : Oxford Economics/Haver Analytics

In the UK, the Bank of England Credit Conditions Survey for 2009 Q4 showed that credit is becoming more readily available to businesses and to households on a secured basis. While the availability of unsecured credit to households continued to fall, it was expected to stabilise over the following three months. In aggregate, UK firms have also been able to raise significant funds from issuance of securities. But smaller firms without access to financial markets are still struggling to obtain funding.

Looking forward, there are strong incentives for UK banks to resume lending. In particular, the large UK banks are now relatively well capitalised, default rates are likely to be close to peaking and official

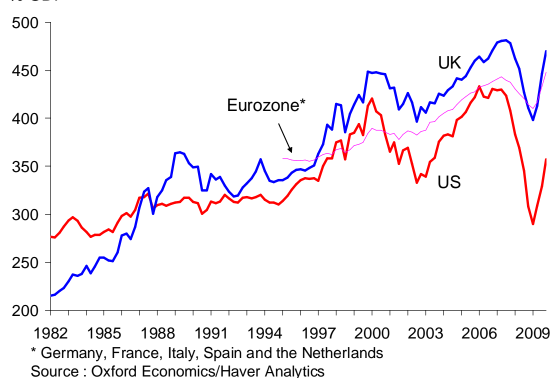
interest rates are at all-time lows. But much will depend on how rapidly confidence returns.

In summary, the state of the financial system remains the single most important source of risk to the economic recoveries underway in the US and Europe. It is likely that the normalisation of lending standards will take longer than following recent recessions as banks must absorb substantial credit-related losses. As US and UK banks appear to be at a comparatively more advanced stage of this process than their Eurozone peers, this should help the financial systems in these economies to recover relatively more rapidly.

… but will private demand recover?

Another key question for the economies of the US and Europe is whether deleveraging by consumers and the non-financial corpoate sector has further to run. This is critical, as when the support of stimulative macro policies begins to fade, private final demand will need to become the locomotive of growth.

Household net wealth (financial & housing)

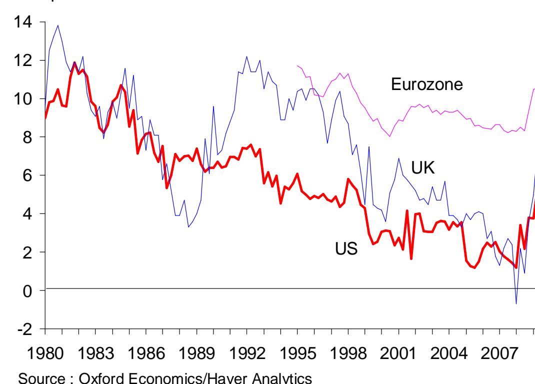


* Germany, France, Italy, Spain and the Netherlands
Source : Oxford Economics/Haver Analytics

Consumer spending is particularly important as it represents the largest portion of final demand and it has significant "multiplier effects" in the domestic economy. As shown in the chart below, the net wealth of households suffered a substantial negative shock during the downturn. It is therefore not surprising that there has been a sharp rise in savings ratios on both sides of the Atlantic in recent quarters as households endeavour (or are forced through defaults and foreclosures) to repair their balance sheets.

Net wealth levels in the UK and Eurozone have now largely recovered to pre-crisis levels, however, helped by the strong recovery in equity markets and the renewed upturn in house prices in some countries. In aggregate, this would suggest that there may no longer be a pressing need for households in these economies to consolidate their balance sheets and future downward pressure on consumer spending from rising savings rates should therefore be limited. This conclusion is also supported by the fact that savings rates in both regions have already risen sharply to levels in excess of their long-term averages. Of course, this will not necessarily be true for some individual member states within the Eurozone.

Household savings ratio

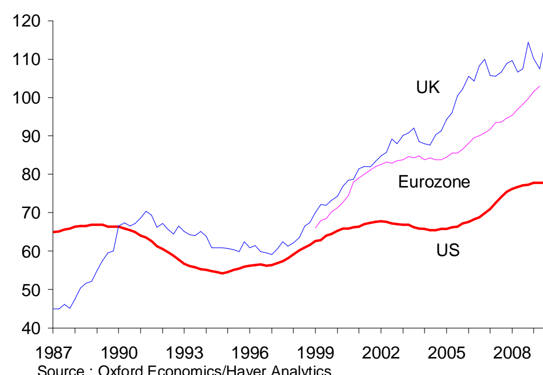


Source : Oxford Economics/Haver Analytics

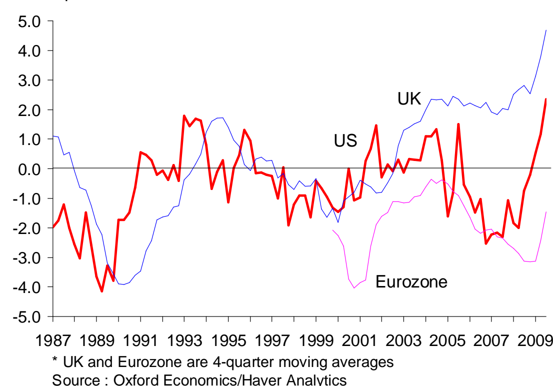
In the US, the negative shock to household wealth has been more substantial than in Europe, mainly due to the sharper downturn in US house prices. This would seem to imply that the household savings rate has further to rise, particularly as is still seems low on a historic basis and a higer ratio would be more consistent with 'normal' expectations of capital gains on existing assets. In light of the projected muted growth in household incomes, however, this adjustment process is likely to be gradual.

A closer look at the financial position of the corporate sector is also useful to provide an insight into the likely future path of investment expenditure. The chart below shows that companies in the UK and Eurozone took advantage of easy credit conditions to increase their debt levels much more rapidly than their US counterparts prior to the onset of the financial crisis. These high debt ratios have left European companies exposed to the rise in financing costs, which is likely to create pressure to deleverage. These pressures will be exacerbated by the fact that their vulnerable financial positions have

damaged creditworthiness at a time when banks are seeking to reduce risk in their loan portfolios.



The financial balance of the UK non-financial corporate sector shows a more positive picture, with firms running substantial financial surpluses (see the chart below). In aggregate, this indicates that funding requirements for fixed investment expenditure are more than covered by firms' own saving. Still, this aggregate data may mask the fact that the firms with large cash surpluses are not the same as those that wish to expand their capital spending. If the financial system is impaired, then funding constraints may still act to dampen investment growth.



Firms in the US also started to run financial surpluses recently, having experienced a sharp swing from deficit. Given the sharp decline in investment expenditure that occurred during the recession, this increase in savings was not unexpected. In contrast, firms in the Eurozone have continued to run significant financial deficits, however, as they have struggled to increase savings in the face of the sharp fall in profitability. With capacity utilisation levels at an all-time low in the Eurozone, this adds to the headwinds facing the outlook for investment in the region. Again, the headline data for the Eurozone will mask a considerable degree of divergence at the country level.

In summary, the analysis of the financial position of the household sector presented here suggests that consumer spending in the UK and most Eurozone countries should not face significant headwinds from further rises in the savings ratio, but this does present a more significant risk in the US. By contrast, deleveraging pressures are less likely to weigh upon the non-financial corporate sector in the US relative to Europe, where debt levels are higher.

Markets focussing on public finances

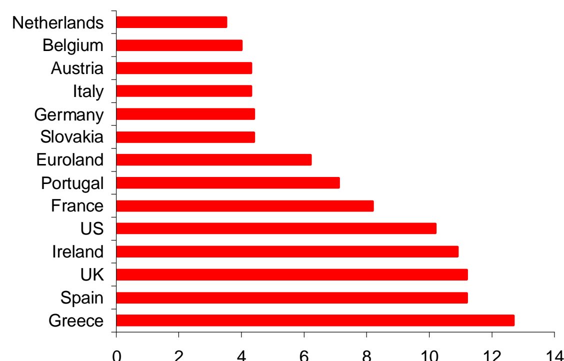
When discussing risks to the outlook, it is public borrowing that has received the most attention in recent weeks. While higher public spending was necessary to rescue the economies of the US, UK and the Eurozone from recession, these massive stimulus packages have left yawning fiscal deficits in their wake.

In the Eurozone, there has been a sharp divergence in performance between the economies of the north, such as Germany, which have generally maintained a firm control on their public finances, and those in the periphery, which have been more profligate. Market scrutiny is currently focussed on Greece, after the newly elected government revised up the estimate for the 2009 budget deficit from 6.7% of GDP to 12.7%, and with public debt expected to reach 125% of GDP in 2010, the highest level in the Eurozone. The revelation shocked investors, leading to a sell-off in Greek government debt. Bond yields in other Eurozone member countries with large deficits such as Ireland, Spain and Portugal, have also widened significantly as concerns have spread.

A key test will come in April-May this year, when the Greek government needs to raise €25bn to roll over its debt and finance the budget deficit. A Greek default would have substantial repurcussions in terms of contagion to other sovereign debt and financial assets more generally, which could potentially undermine the global economic recovery. At the time of writing, the European Union had

agreed to support Greece, although precise details of the rescue package had not been determined.

Recession has widened fiscal deficits
2009 fiscal deficit, % GDP



Source : Oxford Economics/Haver Analytics

Outside the Eurozone, budget deficits in the US and UK have both reached double-digits as a share of GDP, but market pressures have been much less acute. This may not last, particularly in the UK, if the government fails to outline a credible fiscal consolidation path following the general election in May. Uncertainty about the outcome of the general election and the possibility of a hung parliament adds to these concerns. The US so far appears fairly insulated from such market worries due to its 'safe-haven' status. Still, Moody's recently warned that the country's AAA-rating should not be taken for granted and there are signs that global investors and Asian central banks have recently become more hesitant to buy US debt without a price concession.

In summary, large budget deficits and high public debt levels threaten to put upward pressure on bond yields, raising financing costs in many economies across Europe and even the US. While market concerns are currently focussed on Greece, there have already been spillovers to debt markets in Portugal and other peripheral European countries. Contagion from sovereign risk could undermine financial asset prices more generally, posing a threat to economic growth across Europe and the US.

Monetary policy 'exit strategies'

Although fiscal policy has been the focus of markets in recent weeks, there are also risks around the unwinding of monetary policy stimulus. Many securities have benefitted from the extraordinary provision of liquidity by central banks around the world and there is a risk that fragile financial markets could react negatively to an abrupt withdrawal of that support. In particular, central banks could exacerbate upward pressure on bond yields as they attempt to soak up excess reserves from the banking sector. Mindful of these risks, central banks are therefore likely to normalise policies in a very gradual and transparent manner. We expect that interest rates will remain below their neutral levels well into 2011.

Conclusion: A bumpy ride ahead

Although the US, UK and Eurozone economies have emerged from recession, questions remain around the sustainability of these recoveries. As macro policy settings are normalised, a transition toward solid growth based on private final demand will require significant structural adjustments in many economies.

Given the substantial losses already shouldered by banks in the US and Europe, the ability of lenders to finance the recovery is a key uncertainty. As US and UK banks appear to be at a comparatively more advanced stage of recognised and absorbing loan losses and writedowns than their Eurozone peers, this should help them to recover relatively more rapidly. In light of the comparatively larger role that banks play in financing the Eurozone economy, credit constraints would appear to represent a more significant risk to the recovery in this region.

Whether private sector demand for loans recovers will depend very much on the extent to which the deleveraging process has run its course. Overcapacity in the business sector looks more acute in Europe than the US, even though construction in the US will likely remained subdued due to significant oversupply in both residential and commercial property. On the other hand, trends in net household wealth suggest that further adjustment in savings ratios is likely to be limited in the Eurozone and UK, but household savings rates likely have further to rise in the US.

Although consumer spending in the US faces the headwinds of ongoing deleveraging, we still expect growth to surpass that of the UK and Eurozone. This reflects the fact that US companies cut jobs more aggressivley during the downturn, so labour markets are more likely to show improvement this year and next. Nonetheless, unemployment is likely to remain high in both the US and Europe as structural

adjustments leave many workers with the wrong skills.

Taken together, this analysis suggests that the recoveries in both the US and Europe will be relatively bumpy and muted compared to recent historical experience. The US is likely to be the growth leader, reflecting the more dynamic nature of its economy and financial sector. Within the Eurozone, there will be significant divergence in performance at the country-level. In particular, the substantial structural adjustments underway in Greece pose a risk of potential contagion from sovereign credit risk that could threaten financial markets and economic growth on both sides of the Atlantic.