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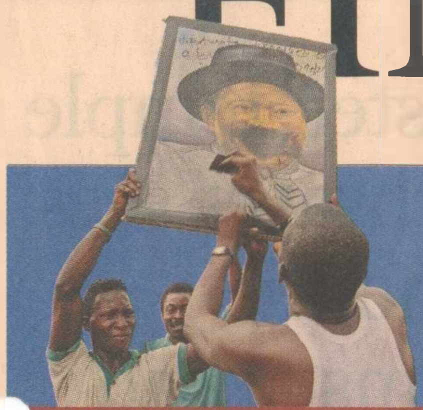
FINANCIAL TIMES

EUROPE Wednesday January 25 2012



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News Briefing

Ray of hope for bourses' merger bid
Deutsche Börse and NYSE Euronext have been given some hope of mustering support to save their merger after action from Europe's top financial regulator. **Page 15; www.ft.com/tradingroom**

Clouds over Davos
Experts preparing to appear at the World Economic Forum in Davos are pessimistic in spite of the improvement in the mood in financial markets in 2012. **Page 2; www.ft.com/davos**

India fiscal warning
The country's central bank has issued a stern warning to the government about its fiscal lassitude. **Page 3**

UniCredit bonds plan
Italy's largest bank by assets is planning to raise up to €25bn through the issue of covered bonds amid pressures on eurozone bank liquidity. **Page 15**

China employer woes
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Sarkozy hints at exit
The French president has said he will give up politics if he fails to win re-election in three months' time. **Page 4; www.ft.com/france**

Egypt revolution call
On the anniversary of the uprising, Egypt's young political activists who launched the movement that unseated Hosni Mubarak as president call for further revolt. **Page 6; www.ft.com/egypt**

Telling the future
The global economic war is not over and there are more storms coming for the US and Europe, according to a soothsayer in the eastern Chinese city of Suzhou. **Global Insight, Page 2**

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Eastern Europe gloom
The outlook for much of the region is continuing to darken as the eurozone crisis refuses to abate and banks reduce lending, the EBRD said. **Page 2**

Russia looks to Assad
As Bashar al-Assad, Syria's president, becomes more isolated, Russia seems to be strengthening its attachment to him. **Page 6; www.ft.com/syria**

Anglo-German standoff
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IMF calls on ECB to take hit on Greek debt

Europe pressed to take greater share of burden

Central bank holds €40bn of bonds

By Peter Spiegel in Brussels and Ralph Atkins in Frankfurt

The International Monetary Fund has turned up pressure on European officials to take on more of the burden of filling a widening gap in Greece's budget by pressing the European Central Bank to take a hit on its €40bn in Greek bond holdings, eurozone officials said.

The ECB bought the bonds at below face value as part of a programme to prevent the collapse of Greek debt markets in 2010. It has also been accepting Greek bonds as collateral for cheap loans to teetering Greek banks. The bonds, with estimated yields in excess of 7 per cent will provide a big return if Greece does not default and they are held to maturity.

An IMF official denied the fund was pressing the ECB to take writedowns on the bonds. But eurozone officials involved in the talks said pressure to earmark potential gains to fill Greece's financing hole was fiercely resisted by the ECB.

Private investors have begun to chafe at the ECB's insistence its bonds be paid in full while the private bondholders are being urged to agree to a cut of at least 50 per cent on the face value of their holdings.

Charles Dallara, the lead negotiator for a consortium of banks and insurance companies, yesterday called on "all parties to honour those commitments", including the ECB.

Despite the ECB's resistance, its 23-member governing council has discussed fallback positions. These included the possibility of the ECB forgoing the profits it expects to make on the bonds, according to one person familiar with its discussions. Another option would be to take losses on Greek bonds held by eurozone national central banks.

The IMF has concluded the €130bn bail-out plan for Greece agreed in October will no longer enable Athens to get its €350bn debt pile down to a sustainable level by 2020 – the plan's main goal. Unless bondholders agree to more losses, eurozone governments will have to find more bail-out loans to hit the target.

The IMF analysis, which has determined the October plan would get Athens to a debt level of about 130 per cent of economic output rather than the 120 per cent originally targeted, has also coloured its stance towards private holders of Greek debt. There, the IMF was backing the tough stance taken by eurozone negotiators to squeeze more losses out of private bondholders, officials said.

IMF officials have said the fund does not take a view on where Greece finds support. It also ratcheted up pressure on eurozone states to increase the size of their own rescue fund.

Additional reporting by Alan Beattie in Washington, Alex Barker in Brussels and Patrick Jenkins in Zurich

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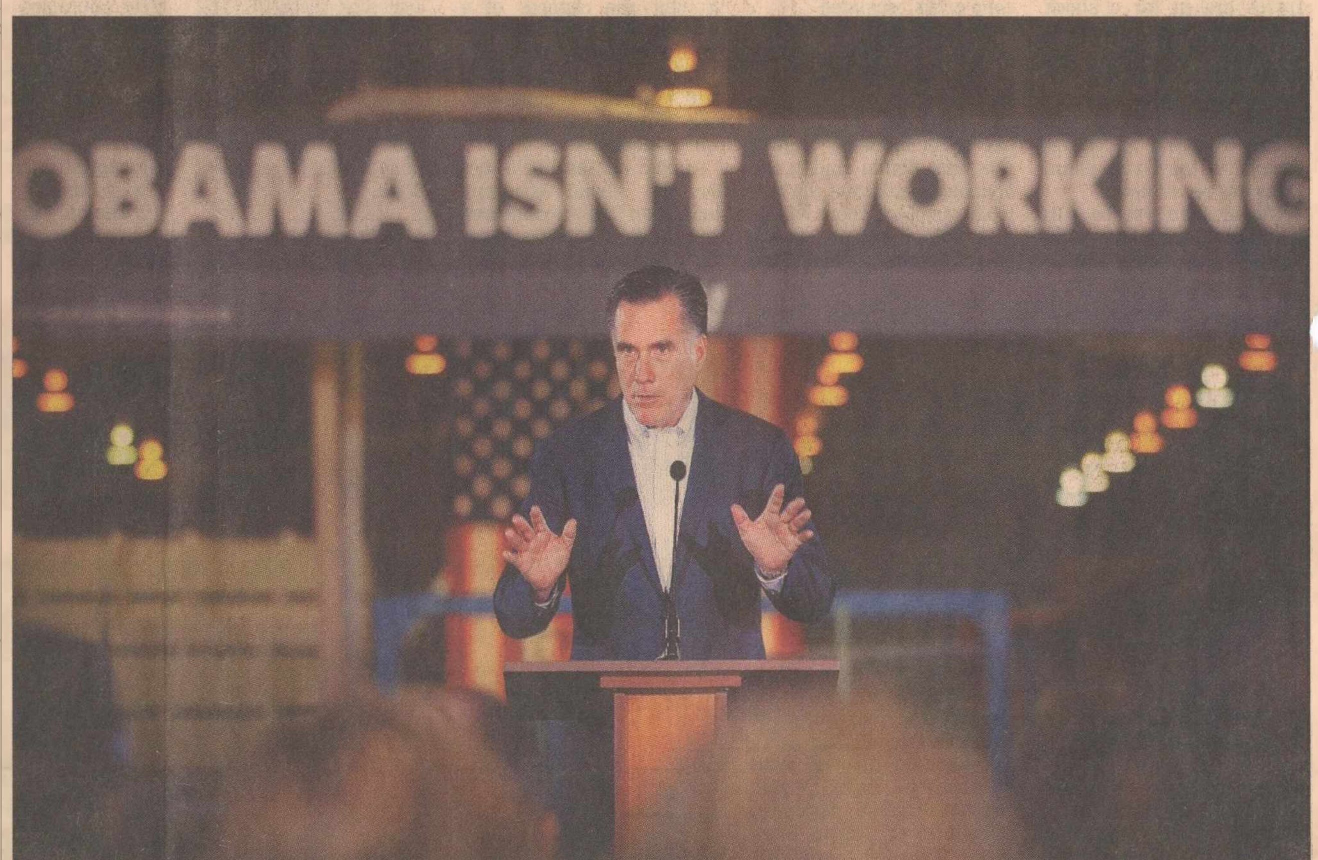
Video at www.ft.com/wefpreview

Obama to target tax as Romney reveals he paid at rate of 13.9%



Mitt Romney in Tampa, Florida, where he said he would have paid almost no federal taxes under Newt Gingrich's plans Reuters

By Richard McGregor in Washington

Barack Obama laid down the battle lines for the presidential election campaign last night as he promised a "fairer" tax regime on the day Mitt Romney, the leading Republican contender, revealed that he paid an effective federal income tax rate of just 13.9 per cent in 2010.

Responding to intense pressure from his Republican challengers, Mr Romney released 547 pages of documents on his website yesterday detailing his tax affairs. For 2010 he paid about $3m in taxes on income of $21.7m, in large part derived from investments during his time as head of one of the country's most successful private equity firms.

For 2011, Mr Romney expects to pay $3.2m at a slightly higher rate of 15.4 per cent. This comparatively low rate reflects the fact that most of his income is taxed as capital gains.

Mr Romney's release of his returns came hours before the US president's state of the union speech in which his advisers said he would outline plans to ensure the wealthy paid higher taxes to ease the burden on middle-class Americans.

Mr Obama's benchmark tax policy, the Buffett rule, named after investor Warren Buffett, says the richest Americans should not pay tax at a lower rate than their secretaries.

The White House invited Mr Buffett's secretary to sit with Michelle Obama, first lady, to watch the speech. Most of Mr Buffett's income also comes from capital gains and he has said it should not be taxed at the lower rate.

The executive director of the Democratic National Committee, Patrick Gaspard, said the returns showed Mr Romney paid a lower tax rate than "teachers, firefighters and police, and he doesn't want that to change".

Fred Goldberg, a former commissioner of the US Internal Revenue Service, who was on the Romney campaign conference call, said the returns complied with the law.

"There is no indication or suggestion of any tax-motivated or aggressive tax planning activities. In my judgment they have fully satisfied their responsibilities as taxpayers," he said.

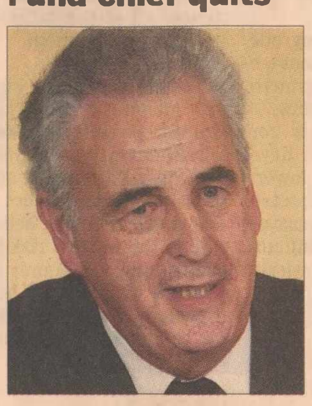
More than 16 per cent of Mr Romney's income was given away, a large part of it to the Mormon church. Mormons are expected to pay 10 per cent of their gross or net income in tithes to the church.

Mr Romney has been struggling to halt the electoral surge of Newt Gingrich, the former speaker, who won a crushing victory in South Carolina at the weekend. The latest polls suggest the firebrand conservative is on course to win Florida on January 31. In a debate on Monday in Tampa, Mr Romney pointed out he would have paid almost no federal taxes under Mr Gingrich's plans to scrap capital gains tax altogether.

> Romney paid a lower rate than 'firefighters ... and he doesn't want that to change'
>
> **Patrick Gaspard, Democratic National Committee**

Gingrich ahead, Page 6
Lloyd Green, Page 11
www.ft.com/republicans

Fund chief quits



Michel Kazatchkine, director of The Global Fund to fight Aids, Tuberculosis and Malaria – the celebrity-backed health organisation that has struggled to meet its fundraising targets and faced criticism from its biggest donors – has been forced to step down. The board hopes the change will allow the organisation to seek fresh funding from donors, who have used the turmoil to freeze some pledges of support.

Report, Page 2

McDonald's Twitter ad campaign backfires as customers vent anger

Group pulls 'promoted tweets' within hours

By Tim Bradshaw in London and Alan Rappeport in New York

Critics of McDonald's have turned the fast-food chain's ad campaign on Twitter against it, unleashing a torrent of abusive tweets in the latest example of how social media marketing can backfire.

McDonald's bought two "promoted tweets" using Twitter's nascent advertising system, which it hoped would encourage happy customers to share their "McDStories" on the quick-fire messaging site.

But the clickable "hashtag" McDonald's used to aggregate these tweets was quickly hijacked by less-than-satisfied diners, who used Twitter to vent claims of food poisoning and allegations of low standards of employee and animal welfare.

Such was the volume of negative stories using the #McDStories hashtag that McDonald's was forced to pull the ad campaign – which had meant to focus attention on the quality of its ingredients – within hours. Clicking on a hashtag takes any visitor to Twitter's website to a list of the latest and most popular tweets on the subject, which in the case of McDonald's was dominated by hostile messages.

Rick Wion, social media director for McDonald's USA, acknowledged that the campaign had not worked out as the company had hoped.

"With all social media campaigns, we include contingency plans should the conversation not go as planned," Mr Wion said. "The ability to change midstream helped this small blip from becoming something larger."

Marketing mishaps notwithstanding, McDonald's continues to show strength amid a weak global economy. Yesterday it reported robust fourth-quarter and 2011 earnings as customers flocked to its restaurants.

Although Twitter says most advertisers are happy with promoted tweets, the McDonald's incident last week – dubbed "McFail" by some observers – follows backlashes against campaigns from brands including Wendy's, a fast-food chain, and Qantas. The Australian airline's promotion came after it grounded its fleet and led to angry tweets from customers.

"Social audiences aren't going to respond in the ways you might hope to what is transparently a marketing ploy," said Paddy Herridge, chief operating officer of Social360, a social media monitoring firm.

Lex, Page 14
Sales beefed up, Page 17

World Markets

STOCK MARKETS

	Jan 24	prev	%chg
S&P 500	1313.55	1316.0	-0.19
Nasdaq Comp	2784.02	2784.17	-0.01
Dow Jones Ind	12669.39	12708.82	-0.31
FTSEurofirst 300	1045.01	1048.21	-0.31
Euro Stoxx 50	2432.07	2441.44	-0.38
FTSE 100	5751.9	5782.56	-0.53
FTSE All-Share UK	2962.12	2980.33	-0.61
CAC 40	3322.65	3338.42	-0.47
Xetra Dax	6419.22	6436.62	-0.27
Nikkei	8785.33	8765.9	+0.22
Hang Seng	(c)	20110.37	-
FTSE All World $	(u)	207.94	-

CURRENCIES

	Jan 24	prev		Jan 24	prev
$ per €	1.298	1.305	€ per $	0.770	0.766
$ per £	1.559	1.560	£ per $	0.642	0.641
£ per €	0.833	0.837	€ per £	1.201	1.195
¥ per $	77.7	77.0	¥ per €	100.9	100.5
¥ per £	121.1	120.1	£ index	81.1	80.8
$ index	80.1	79.7	€ index	90.38	90.57
SFr per €	1.207	1.208	SFr per £	1.450	1.444

COMMODITIES

	Jan 24	prev	chg
Oil WTI $ Mar	98.95	99.58	-0.63
Oil Brent $ Mar	110.03	110.58	-0.55
Gold $	1,677.30	1,658.65	18.65

INTEREST RATES

	price	yield	chg
US Gov 10 yr	99.45	2.06	-0.01
UK Gov 10 yr	113.50	2.19	0.02
Ger Gov 10 yr	100.09	1.99	0.02
Jpn Gov 10 yr	99.91	1.01	0.01
US Gov 30 yr	99.50	3.15	0.00
Ger Gov 2 yr	100.07	0.21	0.01
	Jan 24	**prev**	**chg**
Fed Funds Eff	0.09	0.09	-
US 3m Bills	0.05	0.05	-
Euro Libor 3m	1.10	1.11	-0.01
UK 3m	1.01	1.01	-

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Egypt	E£19	Poland	Zl 16
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Finland	€3.80	Qatar	QR15
France	€3.50	Romania	Ron17
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Kuwait	KWD1.50	Syria	US$4.74
Latvia	Lats3.60	Tunisia	Din6.50
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Luxembourg	€3.50	Ukraine	€5.00
Macedonia	Den220		

Pessimism hangs in mountain air

Davos 2012

Global elite fears renewed downturn

Eurozone woes still preoccupy experts

By Chris Giles in Davos

Delegates heading for the World Economic Forum in Davos are in for a shock. Although the mood in financial markets has improved in 2012 and economic data have exceeded expectations, experts preparing to appear at the conference in the Swiss mountains are pessimistic.

No one can yet be sure whether this is a case of the global elite being out of touch with more positive feelings in New York, London, Tokyo and Beijing, but it is certain that though the snow is deep, Davos will provide little mountain respite this year.

The Financial Times contacted the big name economists attending the World Economic Forum to seek their views on the eurozone crisis and its likely implications. Almost as one, the respondents chimed with the downbeat mood expressed by the International Monetary Fund, saying the global economy was weakening and was at risk of another crunch if the eurozone crisis escalated.

Disagreement related to how bad things were likely to be. Carmen Reinhart, senior fellow at the Peterson Institute for International Economics, argued that with denial among policymakers still rife, the outlook was poor. There will be a "serious economic crunch or yet another sub-par year of stubbornly high unemployment, weak growth and delayed recovery in general in all the advanced economies", she said.

Joseph Stiglitz of Columbia University also warned of the risk of another crunch, particularly with policy constrained in some countries and deliberately tight in others. Any crisis will be "all the worse because of the weakness of appropriate government responses", he said.

But if the eurozone muddled through without the crisis intensifying, Mario Blejer, former governor of Argentina's central bank, thought the chances of a crisis in 2012 were diminishing even though "the world economy will grow less in 2012, and some regions outside Europe will be in a minor recession".

Almost all the big issues for the global economy depend on the eurozone getting to grips with its banking, sovereign debt and competitiveness crises. A powerful consensus exists among economists on what the 17-nation single currency bloc should do.

In what Moisés Naím of the Carnegie Endowment for International Peace described as "the most overdiagnosed and underacted-upon" crisis, the vast majority agreed the eurozone needed an urgent plan incorporating five elements:

- austerity and structural reforms in peripheral countries;
- fiscal integration with risk sharing, including eurobonds;
- interim liquidity support for countries struggling to borrow, preferably with strong support from the European Central Bank;
- a deep restructuring of Greek sovereign debt;
- and a eurozone-wide recapitalisation of European banks.

The only material dissenters from this consensus were Michael Spence of New York university and Kenneth Rogoff of Harvard, who argued that some countries probably had to face up to an exit from the euro. "Greece and probably Portugal need to exit, because there is not a potential for growth," said Prof Spence.

Prof Rogoff said: "Will the eurozone finally wake up to the fact that a minimum of two or three periphery countries require huge writedowns and quite possibly a sabbatical from the euro?"

But almost all the economists were pessimistic that eurozone leaders would rise to the challenge, given the political constraints they faced. Daniel Gros, director of the Centre for European Policy Studies, said: "There is no chance they will do any of this unless the euro is about to implode."

Prof Rogoff added: "The political paralysis is tremendous."

Multimedia and reports, www.ft.com/davos

Chinese rebuff

China will break with a 30-year tradition by not sending high-level officials to the World Economic Forum at Davos, which falls this year in the midst of Chinese new year festivities, **writes Lifen Zhang in Davos**.

Beijing approached WEF organisers early in 2011 and suggested they move this year's gathering to an earlier date. "Can we imagine that this event takes place in Christmas?" asked Cheng Li, a China specialist at the Brookings Institution in the US.

Zhang Xiaoqing, vice-minister of the National Development and Reform Commission and a regular at Davos, and Donald Tsang, chief executive of Hong Kong, will represent China.

www.ft.com/china

IMF issues world growth reality check

By Chris Giles in Davos and Ralph Atkins in Frankfurt

World economic growth is set to be significantly weaker than previously thought, the International Monetary Fund has said, as it challenged the European Central Bank to loosen monetary policy further to arrest the crisis.

The IMF joined the World Bank in warning yesterday that a failure of the euro would prompt another global recession on the scale of that which followed the collapse of Lehman Brothers in 2008.

"The current environment – characterised by fragile financial systems, high public deficits and debt, and interest rates close to zero – provides fertile ground for self-perpetuating pessimism," the fund concluded in its updated World Economic Outlook.

The gloomy assessment from the IMF came as a survey showed that the private sector in the eurozone expanded output in January for the first time in five months, raising hopes that it will escape falling into recession.

Purchasing managers' indices for the 17-country bloc showed that manufacturing and services activity rebounded unexpectedly sharply in January, driven by robust output growth in Germany and a modest expansion in France.

January's improvement was boosted by companies running down order backlogs. Exports were helped by a weaker euro, and confidence might also have been strengthened by the ECB's crisis-fighting measures: it provided €489bn in three-year loans to eurozone banks in December.

Yesterday's survey was "a reality check", said Carsten Brzeski, European economist at ING in Brussels. "The debt crisis is mainly about public finances and financial markets. The real economy is a bit different . . . It doesn't mean the crisis is over, but corporates were simply better prepared for this downturn than they were after the collapse of Lehman Brothers in 2008."

Yet despite the better economic data, the IMF forecasts that weak momentum from the sovereign crisis of late 2011 will push eurozone economies into recession even if a fresh crisis is averted. To avoid an escalation of the crisis, the fund has gone further than before in prescribing its vision of a solution to the eurozone's woes – one that is not likely to find favour with the ECB, Germany or other creditor nations.

Calling for fiscal "risk sharing across euro area members", the fund has for the first time put its weight behind the idea of eurobonds, which are still anathema to Germany. To stop countries free-riding on cheap finance, it also advocates "stronger fiscal discipline or centralisation".

It called on the ECB to loosen monetary policy further and continue to buy sovereign debt of peripheral countries in its securities markets programme, which has so far bought €219bn, although additional purchases have slowed to a crawl in recent weeks.

For the medium term, the IMF called on peripheral European economies to push ahead with structural reforms and austerity drives.

But it urged Europe to agree to "substantial" additional money for a firefighting fund, going further than merely running the European Financial Stability Facility and its successor, the European Stability Mechanism, in parallel.

With so much scope for damaging economic trends, the IMF has significantly downgraded its economic forecasts. It expects the global economy to grow 3.3 per cent in 2012, 0.7 percentage points lower than its September forecast.

Most of the downgrade stems from a 1.6 percentage point fall in the growth forecast for the eurozone.

The IMF's forecasts for the rest of the world have also been revised lower, although the US is expected to be relatively immune from the eurozone's difficulties so long as a disorderly break-up is avoided.

See Comment

A shoe factory in northern Portugal: exports from Europe have been helped partly by a weaker euro Getty

Mixed signals

'Master' temple soothsayer sees economic storms ahead

GLOBAL INSIGHT

Jamil Anderlini
In Beijing

On the first day of every lunar new year, scores of minor government officials, businessmen and ordinary peasant farmers congregate at a small Buddhist temple in the hills outside the eastern Chinese city of Suzhou.

They come to consult the resident "master", the abbot of the increasingly wealthy and popular temple who has made a name for himself as an unnervingly accurate soothsayer.

As the Chinese world bid farewell to the year of the rabbit and entered the year of the black water dragon on Monday, I went to ask this oracle what he thought was in store for the global economy and for China in the coming months.

The dragon is the only mythical beast of the 12 animals in the Chinese zodiac and is supposed to bring unpredictability and change.

But the master's forecast for the European economy was predictably gloomy and his outlook for the US was not much better.

"The global economic war is not yet over and there are more storms coming for the US and Europe – this will negatively affect Chinese imports and exports alike," he said.

China's domestic economy was likely to be worse than last year and quite a few export-oriented factories would go bust, he offered. But the country would not experience a crisis in its financial sector this year, the master confidently predicted.

This is a big call, considering the huge mountain of local government debt that has built up in the banking system and rising concerns about a growing crisis in the "shadow banking" system.

A significant portion of the enormous and historically unprecedented loan growth in the Chinese economy in the last few years has gone to building property, which makes up almost all of the collateral for local government lending.

There are growing signs of a looming crash in the Chinese property market, which directly accounts for well over 10 per cent of gross domestic product, and many analysts believe this is the biggest risk to the country's economy this year. In what should be especially reassuring news for commodity-exporting economies like Brazil and Australia, the fortune-telling Buddhist master sees a year of house price stagnation but no big collapse in the all-important sector.

He is less sanguine about the slumping Chinese equity market, which is down about 14 per cent from this time last year.

"The Chinese stock market and stock investors are like little children playing with toys – there are no rules and it is very immature and this year will be especially inauspicious," he said.

Far more important for the country will be its growing investments overseas, which will see big losses this year if the master has divined the future correctly.

But he also foresees China's enormous fiscal and financial resources as being ample for the government to do what is necessary to keep growth at home humming along at a fast clip.

It is not all economics. The year of the dragon has in the past often prompted momentous shifts in the global political landscape.

> 'The Chinese stock market and stock investors are like little children playing with toys'

The dragon year of 1988 prepared the world for the demise of the Soviet Union and global communism the following year and also set the stage for the 1989 Tiananmen Square uprising and subsequent massacre in Beijing.

The previous dragon year, in 1976, saw the death of Mao Zedong, the official end of the Cultural Revolution, and the worst earthquake in Chinese history level the city of Tangshan, killing hundreds of thousands.

The last time the world saw a black water dragon was in 1952, the year that Queen Elizabeth II ascended the British throne.

Towards the end of this year, China's own version of royalty will ascend the dragon throne in the stout form of Xi Jinping, the "princeling" son of a revolutionary general who will take over as Communist party general secretary from President Hu Jintao.

If the Buddhist master of Suzhou is correct, and not just saying what his nominally atheist Communist party followers want to hear, then they have nothing to worry about and China's one-party political system will remain solidly intact in what is otherwise shaping up as a year of change and upheaval.

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Under-fire global diseases agency forces French chief to quit office

Kazatchkine resigns as fund's director

By Andrew Jack in London

The Global Fund to Fight Aids, Tuberculosis and Malaria, the celebrity-backed health organisation that has struggled to meet its fundraising targets and faced criticism from its biggest donors, has forced its French director to step down.

Michel Kazatchkine, the French former Aids ambassador, will quit his role as executive director of the Global Fund more than two years before the end of his contract. The Global Fund, whose backers include the Bill and Melinda Gates Foundation and Chevron, the US oil company, became the world's largest funder of global health programmes after raising $30bn over the past decade.

He will be temporarily replaced by Gabriel Jaramillo, a Colombian-born banker, pending the appointment of a new permanent head and wider boardroom changes. The board hopes the changes will allow it to seek fresh funding from donors, which have used the turmoil to freeze some pledged support.

The reshuffle follows intense political battles among board members, which include governments, non-profit groups including the Gates Foundation and business executives, over the future of the fund, which channels billions of dollars a year from donors to health programmes in developing countries.

The Global Fund has drawn criticism over its financial controls and its management, while also facing demands for better use of donor funds since the financial crisis began to squeeze donations.

A pledging conference in 2010 raised less than its lowest target of $13bn over three years, and nearly $2bn of the fresh money agreed has been held back.

The French government resorted last year to high-level diplomatic *démarches* in efforts to retain Mr Kazatchkine, who was the target of allegations of favouritism in funding an HIV awareness campaign co-ordinated by friends of Carla Sarkozy Bruni, wife of Nicolas Sarkozy, the French president, whom he named as the fund's first global Aids ambassador.

The charges were investigated and found baseless by the board and firmly denied by Mr Kazatchkine, who is close to the French Socialist party. He had a strong reputation as an advocate and technical specialist, but insiders say he was perceived to be less focused on management and there was deep internal frustration over lack of consultation.

Simon Bland, the British government representative who took over last year as chairman of the Global Fund, said: "This is a financing and grant-making body which could be working a lot better. It is a Swiss foundation not bound by the rules of the United Nations. The immediate focus is on reorganisation, implementing a new strategy and ensuring more impact with our resources."

Critics have argued that the fund and its management are tied by an unwieldy and politicised board that jointly have made only modest progress in focusing funding on countries where the disease burden is greatest, resources are most limited or the programmes supported provide the best return in tackling the world's three most lethal infectious diseases.

Large sums have gone, for example, to support malaria programmes in China, one of the richer emerging countries where the disease claims only a few lives each year.

The concerns were highlighted in a report produced by a commission of outsiders last year.

Prospects worsen for eastern Europe

By Neil Buckley, East Europe Editor

The economic outlook for much of eastern Europe is continuing to darken as the eurozone crisis refuses to abate and western banks reduce lending in the region, according to the European Bank for Reconstruction and Development.

The bank said yesterday that figures from the third quarter of last year showed the first net capital outflows from the region since the 2009 crisis. The western banks that dominate banking in central and east Europe, under regulatory pressure to rebuild balance sheets at home, "appear to be deleveraging since the autumn".

In its latest quarterly forecasts, the EBRD has cut its 2012 projected growth for central Europe, including Poland, Hungary, and Slovakia, and the Baltic states to 1.4 per cent this year, from the 1.7 per cent it was forecasting three months ago. The bank forecasts that Hungary and Slovenia will go into recession, although those are the only countries out of the 29 where the bank operates whose economies are expected to contract this year.

The EBRD, set up two decades ago to help fund former communist states' transition to the market, now expects growth in south-east Europe at only 1 per cent this year.

In October it forecast 1.6 per cent growth for that area, which includes Romania, Bulgaria and ex-Yugoslav states, where Greek banks are often important to the banking system.

It continues to see Russia growing at 4.2 per cent.

The EBRD's concerns are focused on central and south-east Europe, which rely heavily on the eurozone as an export market and a source of foreign direct investment and more short-term financing.

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Central bank tells India ministers to rein in spending

Threat of instability and inflation seen

Coalition's populist intention suspected

By James Lamont in New Delhi

With five hotly contested state elections pending in February and March, India's central bank has issued a stern warning to the government on its fiscal lassitude.

There is "urgent need for decisive fiscal consolidation", Duvvuri Subbarao, the governor of the Reserve Bank of India, has told the Congress party-led administration after it responded to the global economic downturn by increased public spending.

"The anticipated fiscal slippage – which is caused largely by high levels of consumption spending by the government – poses a significant threat to both inflation management and to macroeconomic stability," Mr Subbarao said.

Speaking after a monetary policy review meeting in Mumbai yesterday, Mr Subbarao appealed to Pranab Mukherjee, the finance minister, to start reining in spending in a "credible and sustainable way" in the national budget in March.

The ministry said it was attempting fiscal consolidation on a "continuous basis".

Mr Mukherjee is expected to miss a fiscal deficit target of 4.6 per cent of GDP that was set for this year and which does not include spending by India's states. Including the states' spending, the consolidated fiscal deficit is forecast to hit 9 per cent of GDP, which would trigger higher government borrowing and damage growth by curbing private investment, said Deepali Bhargava, chief economist at Espirito Santo, a Mumbai investment bank.

With state election campaigns under way and a parliamentary election in 2014, many economists are worried that the ruling coalition is preparing spending packages to shore up its popularity and to prevent economic growth from falling below 7 per cent.

Mr Subbarao warned that "fiscal slippage" was a threat to the central bank's efforts to bring down near double-digit inflation and would crowd out credit to the private sector.

The call follows that by Manmohan Singh, the prime minister, who over the past year has faced criticism for his economic management, high-profile corruption scandals and management of coalition partners. Mr Singh used a New Year's address to emphasise that one of his biggest fears was fiscal indiscipline that could upset the sustainability of India's fast-paced growth.

Overspending by government has in the past led to debilitating debt and balance of payment problems.

Economists viewed the RBI's warning as a challenge to the government to rely less heavily on stimulus measures and to show greater courage in carrying out structural reform, such as shaking up the retail sector and cutting subsidies, to modernise Asia's third-largest economy.

Suman Bery, director of the International Growth Centre in New Delhi, said the RBI was sending a message to the finance ministry to do more to enable India to integrate with a global economy that has considerably lower inflation rates.

"It is saying to the politicians, 'We feel your pain. The economy is slowing but the balance of the battle is on your side. Show in your budget that you are capable of more than populism'," he said. "This is a government with three years left. We should be prepared for some short-term pain for longer-term gain."

See Lex

Japan trade dips

Japan is expected to reveal its first trade deficit since 1980 today, **writes Ben McLannahan in Tokyo.** The deficit represents a shift from the surpluses – equivalent to an average annual 2.7 per cent of gross domestic product – that Japan has sustained over 50 years.

After the earthquake and tsunami in March, exports were hit by damaged plants and infrastructure. Floods in Thailand knocked out more Japanese production capacity, while overall shipments were hurt by a strengthening yen, up 17 per cent against the euro over that period.

The shutdown of nuclear power facilities caused Japan to be more reliant on expensive fuel imports.

The Bank of Japan downgraded its growth forecasts, while keeping its key interest rate at virtually zero.

Festival fun: a young performer at lunar new year celebrations in Beijing. The next few weeks threaten great uncertainty for factory owners Getty

China groups face migrant worker lottery

Job hopping

Large numbers of employees will opt to remain inland after new year celebrations, write FT reporters

Li Weihang's order book is full. And yet the executive at Weixin Seamless Underwear Company in the eastern Chinese light industry hub of Yiwu, doesn't dare relax for the spring festival, when the country comes to a halt as tens of millions of migrant workers travel home to gather with their families.

After the holiday ends next week, Mr Li will have to set about finding new workers as he expects more workers than ever before will not return – up to 30 per cent of his 140-strong workforce – as many migrants take up new jobs in inland provinces.

"The only way of finding new workers will be to raise wages again – I think we'll have to raise by at least 15 per cent," he said.

The lunar new year is the prime job-hopping season in China, offering signs for the direction of the labour market in the world's second-largest economy over the coming year.

After two years of record jumps in wage levels and rising labour unrest, most companies expect slightly less steep increases in the cost of labour this year. But employers are resigned to a new labour reality in China where workers are scarce and wages continue to increase.

Large electronics contract manufacturers like Foxconn, Quanta and Compal have built new factories inland over the past two years. Foxconn employs 100,000 workers in each of its two new plants in Henan and Sichuan, provinces which are among the largest exporters of migrant workers to coastal areas, and the headcount at those two factories is expected to reach 300,000 each.

These new factories have made many smaller manufacturers in coastal areas less attractive employers to young migrants. Like Weixin, Shunchang, a small shoe industry supplier in Dongguan in the southern province of Guangdong, says the number of migrant workers who won't return after the lunar new year holiday will increase.

One executive says that many migrant workers consider a monthly wage of about Rmb1,500 ($237) in their inland home province more attractive than the little over Rmb2,000 Shunchang can offer, because the cost of living is much lower at home and they can stay close to their family.

> 'The only way of finding new workers will be to raise wages again'
>
> **Li Weihang**
> **Company executive**

However, there are big differences between different regions and industries. Some companies, such as Rondor Housewares, a kitchen utensils factory in Guangdong, plan to introduce more automation after Chinese new year, reducing their reliance on cheap labour.

Others will need fewer workers as global demand weakens. Sam Chern, marketing head at MSi, a Taiwanese manufacturer of computer systems and components, said that as global PC demand is pretty soft, the company will not need as many employees.

He added that the decision of the largest PC manufacturers to move some of their capacity to China's inland provinces might help, because it spreads out the demand for workers.

Giant, the Taiwanese bicycle maker, believes the impact from the move inland on the coastal labour market is decreasing.

"When [workers go back home to inland provinces] they find the lifestyle, living standard, the convenience, are not there, so more and more people are actually coming back," says Tony Lo, chief executive. "So I think this year will not be as bad as last year."

Companies also point out that workers from poorer provinces are more likely to return after the holiday and are slightly less demanding than their peers from more affluent provinces because they are less likely to find employment back home.

But even they, just like all younger migrant workers today who are no longer willing to take the hardships their parents' generation put up with, have become picky.

Reporting by Kathrin Hille in Beijing, Robin Kwong in Taipei and Josh Noble in Hong Kong

Greek debt talks

ECB faces dilemma it always feared

Central bank at risk of large losses

Athens threatens to force a deal

By Ralph Atkins in Frankfurt

These are uncomfortable days for owners of Greece's government bonds. For the European Central Bank, the largest bond holder, they are especially so.

With negotiations close to breaking down on "private sector involvement" in a fresh Greek bail-out, the ECB is under pressure from the International Monetary Fund and the financial industry to take a hit. The ECB faces the dilemma it always feared: might it have to take substantial losses on the estimated €35bn-€40bn it spent on Greek bonds, with potentially damaging consequences for itself and the eurozone?

The ECB started buying Greek bonds in May 2010, when the eurozone debt crisis first erupted. The objective of Jean-Claude Trichet, president, was to stabilise financial markets. The assumption was that bonds bought at market prices would be held until maturity, when the ECB would book a tidy profit.

Having taken action when the private sector held back, it justifiably feels it should not have to pay a price now, said Erik Nielsen, chief economist at UniCredit. "In an emergency, the fire brigade goes in – but the deal is that it is protected."

Economists estimate that a 70 per cent "haircut" on the face value of the ECB holdings could leave a loss of more than €20bn – a significant but not disastrous sum given the size of the reserves held by the ECB and eurozone national central banks. But the ECB's resistance to accepting losses is not just principled. Agreeing to take a loss could be viewed as providing financial assistance to Greece – and in violation of the European Union's ban on central banks funding governments.

One possibility discussed by the ECB's governing council would be to sacrifice its anticipated profits. These could also be substantial – economists' estimates of the difference between the price paid by the ECB and the face value of its bonds range from €5bn to more than €15bn. It has also earned interest. An alternative is for the eurozone's national central banks to take losses on Greek bonds held in their own portfolios – although the sums involved may not be large. But such steps would be controversial within the ECB and outside.

The ECB may be unable to control the course of events. Athens has threatened to force a deal with bond holders by inserting, retroactively, "collective action clauses" (Cacs) to bring a recalcitrant minority into line. Although the ECB may support such action, it would attempt to have its own holdings excluded – perhaps by having them swapped for other bonds that did not include Cacs or transferred to the European Financial Stability Facility, the EU's bail-out fund. But the risk is of a legal challenge from other bond holders claiming unfair treatment.

In such a situation, the ECB may anyway decide the least worst course is simply to accept a loss. The risk of the central bank being treated as senior to other bond holders is that its intervention in other governments' bond markets becomes less effective. Investors in Spanish or Italian bonds would also fear preferential treatment for the ECB. "It's a very bad message to send to markets," said Stephane Deo, European economist at UBS.

One thing is evident: the ECB would make clear that ultimately it was eurozone taxpayers who picked up the bill, if necessary by providing fresh capital for their central bank. A strongly held view in Frankfurt is that governments should realise the consequences of pushing the ECB into a corner.

Hedge funds steer clear of legal battle in bonds minefield

News analysis

Firms face great uncertainty if they take on Athens for larger sums, say **Sam Jones** and **Caroline Binham**

For the hedge funds circling Greece, one thing seems clear – for now, the law is not on their side.

In recent weeks lawyers and traders at top hedge fund firms have pored over the country's laws and constitution – even looking at possible routes of appeal to the European Court of Human Rights – in search of ways in which they might lever greater concessions in the fraught negotiations through which the Greek government hopes to restructure its debts.

But there are few, if any, methods for challenging the government to pay larger sums than are being offered. The problem: nine-tenths of Greece's bonds are under the sole jurisdiction of Greek, and not international, laws.

It is a conclusion reflected in the conspicuous absence of one big group of hedge fund managers from the talks to date – the distressed debt specialists, more unkindly known as vulture funds, that might ordinarily have piled into Greece's highly discounted bonds, which trade for a fraction of their par value.

Flying the flag: Greek protester

US hedge fund firms such as Elliott Associates, FirTree and Gramercy, with histories of taking on governments through long and protracted legal battles to extract value, have largely passed Greek bonds over. Other debt trading hedge funds, such as Och-Ziff and York Capital, have even been forced to issue terse press releases denying their involvement.

As Rob Rauch, head of research for Gramercy – a $2.7bn Connecticut-based fund manager that led the pack of creditors negotiating Argentina's debt restructuring in 2007 – points out, investors that have bought so far have mostly been "long and wrong".

"The terms of the Greek law debt [debt issued under Greek law] can be changed by government fiat – there is no recourse for holders of that debt," says Mr Rauch.

> One factor gives funds succour that a legal challenge could succeed: the position of the ECB

Whitney Debevoise, partner at the US law firm Arnold & Porter and a former executive director of the World Bank, says: "The most likely outcome [of a legal challenge] is that you are faced with a long road and a lot of transaction costs just to get a restructuring of the instrument you already hold."

Just two hedge funds have been actively involved in the current PSI discussions between creditors and the Greek government – Marathon and Greylock Capital – and both are pushing for a "voluntary" agreement rather than seeking legal action. Other hedge funds have taken positions based on tactical, short-term trades, with little interest in negotiations.

Ways in which more active hedge funds have challenged sovereign creditors in the past, such as suing governments in the US, are unlikely to be viable in the Greek case. While some Argentinian bonds had clauses which submitted to the jurisdiction of the New York courts, Greek law bonds do not.

"In the US, for a Greek law bond, there's almost zero chance of any type of action that could turn up any Greek assets," says Mr Debevoise. "Lots of people talk about it, but they don't really consider what assets we are talking about. It's a lot of brave talk. If the National Greek Bank had deposits [in the US] they would be protected."

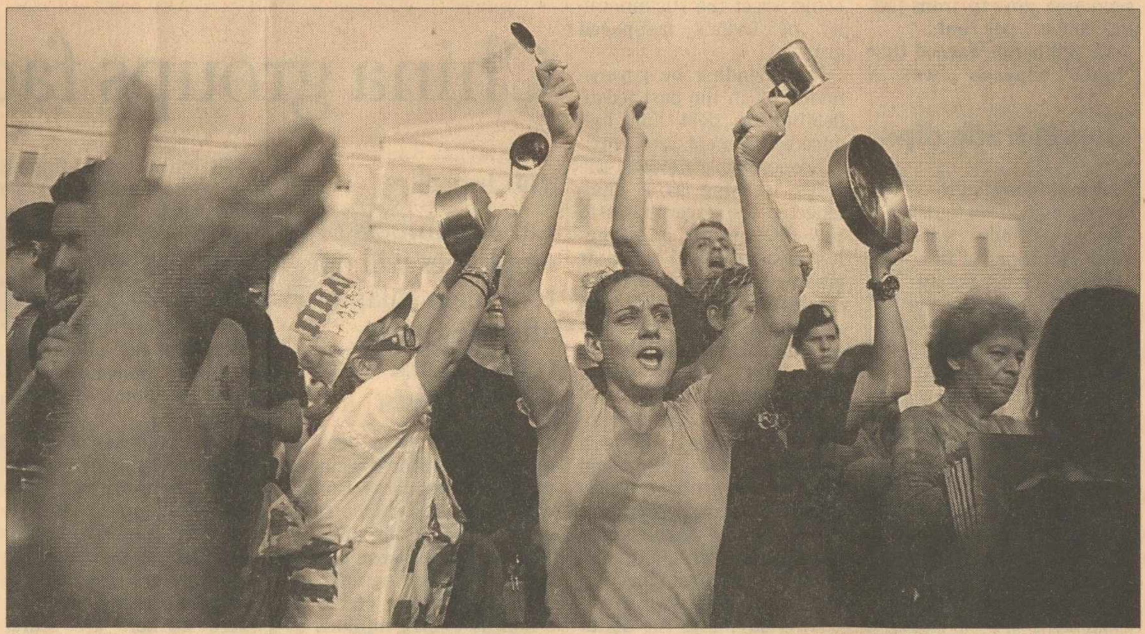
The potential for legal challenges therefore hinges on whether the Greek government passes legislation retrospectively to introduce so-called "collective action clauses" into its debt, under which recalcitrant bond holders could be forced to accept restructurings by a majority vote.

Creditors could first seek to challenge such Greek CAC legislation locally on the grounds that it was unconstitutional, but the process would be lengthy, costly, and likely unsuccessful, lawyers warn. Challenges in US or UK courts about the recognition of such law would also be tricky, since a claimant would have to argue that the Greek government's actions amounted to confiscation and had failed the "Wednesbury" test of unreasonableness in public bodies.

A final option – to mount a challenge under protocol one of the European Convention on Human Rights, which protects against depriving property without due process and compensation – would, meanwhile, take "years", according to a partner at one top law firm in London who said it was "in the realm of fantasy football".

Only one factor gives hedge funds some succour that a legal challenge could succeed – or at least have grounds to be taken seriously as a threat: the position of the European Central Bank.

The ECB and other European central banks' insistence on exemption from any voluntary restructuring on their €50bn of Greek bond holdings could leave Greece open to attack – if not only on legal grounds, then for the risk of setting a dangerous precedent to spook bondholders in other troubled economies.



Banging the drum: protests in Athens (above) and in Buenos Aires 10 years ago when Argentina defaulted on its debt AFP/Reuters

Default option

Argentina vs Greece, debt prices

Source: Gramercy

Debt as % of GDP, 2010

Greece	143
Italy	119
Ireland	96
Portugal	92
Spain	60
Average of 18 default episodes in 10 countries, 1981-2008	54

Sarkozy to quit if he loses poll

President remarks on leaving politics

By Hugh Carnegy in Paris

President Nicolas Sarkozy has said he will give up politics and "change life completely" if he fails to win re-election in three months' time, in a rare admission that he could be defeated.

The president's comments, made to journalists accompanying him on a visit last weekend to French Guiana, came when he was asked if he would leave the political scene if he lost the election, which takes place over two rounds in April and May.

"Yes, that's a certainty. I'm 56, I've been a politician for 35 years . . . I will change life completely, you won't hear any more talk of me if I am beaten," he replied, according to the account of AFP, the French news agency.

Newspaper reports of his remarks fuelled speculation – strongly denied by the Elysée palace – that Mr Sarkozy and his ruling centre-right UMP party were increasingly concerned about his prospects following several discouraging polls and a strong performance by François Hollande, the Socialist party candidate, at the challenger's first big rally of the campaign on Sunday.

A slow but steady recovery in Mr Sarkozy's standings in the latter part of last year has at least for the moment stalled and he was hit earlier this month by the loss of France's triple A sovereign debt rating.

A poll on Sunday said his approval rating had slipped to just 32 per cent. Another poll published in Le Parisien newspaper yesterday – taken before Mr Hollande's performance on Sunday – put the president well behind the Socialist candidate on key issues such as the ability to deal with unemployment and the public debt, although it showed Mr Sarkozy ahead in terms of fulfilling the stature of the presidency.

"Nicolas Sarkozy and the UMP filled with fear of defeat," ran the front page headline in Le Monde over an article that recounted the president's comments about getting out of politics.

But the Elysée insisted Mr Sarkozy's remarks had been over-interpreted. "He has always said that in an election as a candidate you have to be aware that you might not win. It is up to the French people to decide," said a senior official.

The president had also said he was convinced he could still win a second term, the official said, adding he was highly active and unconcerned about the polls with three months still to go until the election.

Mr Sarkozy is due to unveil in the next few days a package of measures to stimulate jobs and growth, including moves to cut France's high social charges on employment.

He is betting that driving on with reform to combat the eurozone crisis will swing support back to his side as voters compare him to Mr Hollande, who has never held ministerial office.

"We have to wait until [Mr] Sarkozy gets into the campaign in March and then we'll see. I don't feel a defeatist mood," said an adviser to the UMP leadership.

Turkey hits at 'racist' French law

Turkey has labelled a new French law as "racist" in a bitter dispute with Paris, **writes Daniel Dombey in Istanbul.**

Recep Tayyip Erdogan, Turkish prime minister, said Ankara would take a "step-by-step" approach. Turkey may opt not to impose at once a range of sanctions planned against Paris.

Mr Erdogan denounced the new law – which makes it a crime to deny that the mass killings of Armenians in 1915 was genocide – as "discriminatory, racist and unjust". French legislation includes up to a year in prison and a €45,000 fine.

Ankara has always denied that the mass slaughter of Armenians in the last days of the Ottoman Empire – predecessor state to the Turkish Republic – constituted genocide. France's government, however, said it was important to "take action against negationists".

Squabble over location of court blocks EU patent deal

By Alex Barker in Brussels and Jonathan Moules in London

An Anglo-German standoff over the location of Europe's new patent court is dashing hopes of a summit deal next week to break almost four decades of deadlock on reforming Europe's Byzantine patent system.

The political tussle over London, Munich or Paris hosting the court is the final element of a deal to usher in a streamlined intellectual property regime, which European Union officials see as the most simple and beneficial decision that could be taken at the bloc's "growth summit" in Brussels on Monday.

Yet after a round of intense back-channel diplomacy, officials are now resigned to the dispute dragging on for at least a few more months, as negotiators await more permissive political conditions for the losing sides to save face.

Last week, José Manuel Barroso, European Commission president, called on France, Germany and the UK "who are holding this up over a side issue of some offices to swiftly find a compromise. It is not acceptable . . . that such a crucial initiative is blocked over such a trivial disagreement".

Businesses have long lamented Europe's baffling patchwork of patent laws that requires them to defend their inventions separately in each EU member state. At present, it costs about €30,000 to acquire national patents for all 27 states – about 15 times the cost of a typical US patent.

José Manuel Barroso: block 'is not acceptable'

For decades, EU countries have squabbled over the language rules for a single patent regime – an issue that was potentially resolved last year by 25 EU countries agreeing to move ahead with a treaty without Spain and Italy, which were implacably opposed.

But plans for the deal to be signed off in December were scuppered by the dispute over the court.

Chancellor Angela Merkel of Germany has made clear that she is unwilling to drop her demands. But few other EU countries are happy with a Munich seat because the city is already the home to the European Patent Office. David Cameron, UK prime minister, is blocking the Munich bid, but London's application is floundering because Britain lacks allies.

Paris has pitched itself as the "compromise" solution and has emerged as front-runner. But some officials in Brussels grumble that French inflexibility has been damaging.

Investors nervously await Fed rates forecasts

By Michael Mackenzie in New York and Robin Harding in Washington

Federal Reserve policymakers are set to publish their first forecasts of future interest rates today, but investors are nervous that such clarity may put pressure on the bond market and send yields higher.

As the Federal Open Markets Committee began a two-day meeting yesterday, bond traders fretted about when the US central bank will forecast its first rate rise and its estimate of rates in the "longer run".

Market reaction tomorrow will be the first test of the Fed's new communications regime. The forecasts are meant to increase transparency and make the Fed intentions clearer to markets. However, some investors fear that the design of the forecasts could draw attention to the wrong information and lead to a volatile response.

In particular, the Fed will estimate a longer-run "neutral" interest rate, likely to be much higher than current overnight rates of zero to 0.25 per cent.

"A shorthand estimate would be potential GDP plus target inflation," said Dana Saporta, US economist at Credit Suisse in New York. "This long-term funds rate projection could be centred at 4-4.5 per cent with a wide range around that."

0.9%

Current yield for five-year Treasury bonds

2.1%

Current yield for 10-year Treasury bonds

Fear of interest rates returning to that level after 2014 may unsettle markets because Treasury bonds maturing in five to 10 years currently yield only 0.90 and 2.10 per cent. If the disclosure drives up bond yields, it could defeat the Fed's goal of supporting the economic recovery.

"We know they are not raising rates for two years, but if they think 4.5 per cent is a normal level then that leaves the 10-year looking vulnerable," said Rick Klingman, managing director at BNP Paribas.

"The Fed's communication process is designed to increase transparency but that entails the risk of shocking the market in the short term," said Ian Lyngen, strategist at CRT Capital. "They need to come up with a forecast they can stick with over a certain period of time."

The economy's neutral interest rate is hard to measure and changes over time. Faster population growth or a string of scientific breakthroughs could increase the relative price of capital – which the neutral interest rate measures.

Some analysts think the Fed may alter its view of neutral Fed funds after its purchases of medium- and long-dated Treasury debt. Under quantitative easing and Operation Twist, the yields on the benchmark 10-year note have been pulled below 2 per cent.

"It is possible that structural changes in the financial system and regulatory environment will nudge the equilibrium rate back down . . . but our guess is that it is still above 4.5 per cent," said Lou Crandall, economist at Wrightson Icap.

There is unease within the Fed about the format of its interest rate forecasts, which will be presented as a graph, with a dot showing the estimate of each official for the end of each year. Minutes of its December meeting say: "A number of participants suggested further enhancements."

The format means it will not be possible to link individual forecasts of future interest rates to forecasts of growth and inflation. It will also weight all the forecasts of all 17 members equally, which may be misleading if influential figures such as Ben Bernanke, the chairman, are at one end of the range.

The World

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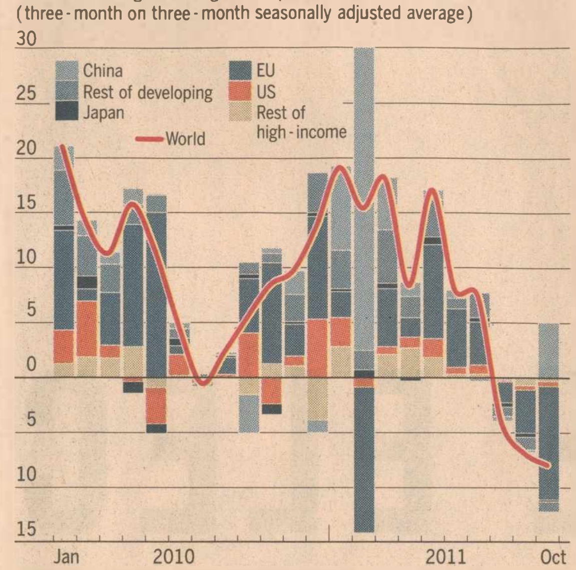
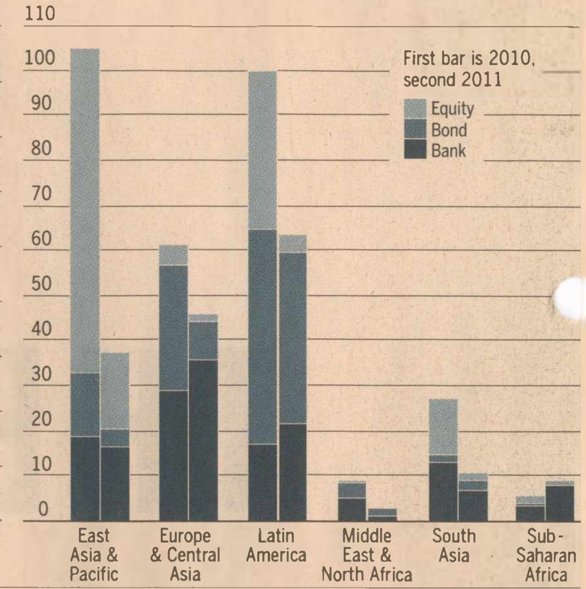
Vulnerability means the risks are on the downside

Consensus forecasts for real GDP growth in 2012
(annual % change)

Contribution to growth of global import volumes
(three-month on three-month seasonally adjusted average)

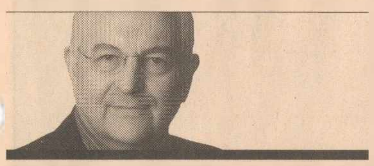


Gross capital flows, July to December
($bn)



Sources: Consensus Economics; The World Bank

Yet another year of living dangerously



Martin Wolf

What can we see in the world economy in 2012? Risks galore, is the answer.

The debt crisis of the high-income countries is already four and a half years old. Yet it shows no sign of abating, particularly in the eurozone. While emerging and developing countries are in reasonably robust condition, they would be vulnerable to an intensification of the crisis, which could hit them via several channels: trade, finance and remittances. Many countries – both high-income and developing – are in a weaker condition than they were in 2008 and would, accordingly, find it harder to respond effectively.

The January 2012 consensus of forecasts for this year is lower than it was in January 2011 for all the world's significant economies, including even fast-growing China and India (see chart). The cuts for eurozone countries are dramatic: eurozone growth is now forecast at -0.3 per cent this year, against 1.6 per cent a year earlier; German growth is forecast at 0.5 per cent, down from 1.8 per cent; French growth is forecast at zero, down from 1.7 per cent; and Italian growth is forecast at -1.3 per cent, down from 1.1 per cent.

Anybody who imagines fiscal outcomes will improve against such a grim background is living in a fantasy world. Improvements in structural deficits will be largely – if not entirely – offset by deterioration in the cyclical balances.

Among high-income countries, the bad news is not restricted to Europe. But it is much worst there. US growth in 2012 is now forecast at 2.2 per cent, a small improvement on the October consensus of 1.9 per cent, but still well below last January's 3.3 per cent. Japan's forecast has fallen least, from 2 per cent to 1.9 per cent, though that is largely because of the recovery from the impact of the tsunami.

The US and Japan have their own vulnerabilities, both economic and political. Huge US structural fiscal deficits and the extreme partisanship in Washington are causes for concern. But the eurozone is the epicentre of current fragility, because of the inability of its members to halt and reverse the dire interaction between financial and fiscal turmoil in a rapidly growing number of vulnerable countries.

What makes this stage of the long-running debt crises even more difficult to manage is that sovereign creditworthiness has deteriorated substantially. The more vulnerable sovereigns – including those of Italy and Spain – could not easily rescue their banks, should they need to do so. Even in countries whose sovereign borrowing costs remain low, such as the US, UK and Germany, it is not clear that governments would be willing – or be permitted by domestic politics – to intervene as aggressively, in support of their financial systems, as in 2008.

These vulnerabilities bring substantial downside risks. As the World Bank's latest Global Economic Prospects argues: "While contained for the moment, the risk of a much broader freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains. In particular, the willingness of financial markets to finance the deficits and maturing debt of high-income countries cannot be assured. Should more countries find themselves denied such financing, a much wider financial crisis that could engulf private banks and other financial institutions on both sides of the Atlantic cannot be ruled out."

In sum, the world is certain to live for years with the consequences of the private and public debt accumulations in the high-income countries in the years up to 2007, which were themselves in part the result of the huge global macroeconomic imbalances of that era. But the economic, financial and political defects of the eurozone have hugely exacerbated the fragility. The members of the eurozone are unable either to dissolve their union or eliminate its structural frailties.

What does this actual and potential turmoil in high-income countries mean for the world economy as a whole? In response the Institute for International Finance argues in its most recent Capital Markets Monitor that "the key question for 2012 is whether the resilient parts of the global economic and financial system – the emerging market economies and the non-financial corporate sectors – are robust enough to cushion the potential impact of high credit risk in the mature economies".

In its latest Global Economic Prospects, the World Bank forecasts a slowdown in world trade, with the volume of growth forecast at 4.7 per cent down from 6.6 per cent last year. It forecasts a decline in net private capital flows to developing countries, from $1,055.5bn in 2010 and an estimate of $954.4bn in 2011 to $807bn this year. It has also downgraded the forecast for economic growth in developing countries to 5.4 per cent, from 6.2 per cent forecast in June 2011.

On the face of it, none of this looks too serious. Overall, that judgment is probably right. But we can identify at least two important qualifications to such comforting optimism.

First, averages conceal as much as they reveal. Even such a deterioration in external conditions would pose a substantial problem for many developing countries. Many countries have large current account deficits. Many also have substantially worse fiscal positions than in 2008. All such countries are vulnerable to even modest interruptions in the flow of global finance and the buoyancy of receipts from exports and remittances. Some of these vulnerable countries are important: Turkey, with a forecast current account deficit of around 10 per cent of gross domestic product this year, is a good example.

Second, the shocks in high-income countries might be far bigger than those in the baseline scenarios. At worst, these shocks could be as big as they were in 2008. A collapse in commodity prices, to take an example, would devastate the finances of many emerging and developing countries. Yet there is likely to be a far smaller capacity to combat such shocks in both the high-income and the emerging and developing countries than at that time.

In sum, as the World Bank argues, "developing countries need to prepare for the worst". Unfortunately, that is precisely what the non-financial corporate sector and solvent households of the high-income countries have now been doing for some years. The result has been private sector austerity in these countries and so what might best be described as a "contained depression". But containing that depression has depended on support from huge fiscal deficits and highly expansionary monetary policies. This is going to remain true in 2012.

If governments cannot – or will not – persist with providing such support, a true depression remains possible. Everybody would then be affected, including the most vigorous emerging economies. These remain difficult times: 2012 will not be the end of them.

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"Without fear and without favour"

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Europe's avoidable growing pains

Economic stagnation is a threat to debt sustainability

The fears that Christine Lagarde, the managing director of the International Monetary Fund, would be a eurozone stooge were unfounded: Ms Lagarde has been a vocal teller of inconvenient truths to Europe's disorganised monetary union. In a speech in Berlin on Monday, she impressed on her hosts what measures are required to avoid a "1930s moment". Berlin quickly signalled that it may consider a larger eurozone rescue fund. It would be good if it did – and heeded Ms Lagarde's other veiled criticisms as well.

The eurozone's current position is to limit the combined capacity of the permanent European Stability Mechanism (once operational) and the European Financial Stability Facility to €500bn. Ms Lagarde points out that this is too thin a financial firewall to prevent Spain or Italy from bond-market runs with "disastrous implications". She proposes adding the EFSF to the ESM and increasing the ESM's size. Berlin intimates it may accept the former when this is revisited by the European Council in March. It should accept the latter as well.

But Angela Merkel, Germany's chancellor, is not disposed to concessions without exacting a pound of flesh. To convince her restive parliamentarians, she wants to tighten the screws envisaged in the eurozone's new fiscal compact.

This is the wrong approach. She should instead – and not before time – make the case to her party and her people that threats to debt sustainability now come as much from economic stagnation as from fiscal incontinence. Europe's deficit obsession fails to discriminate between states that must cut and those with room for fiscal manoeuvre. With predictable results. As Ms Lagarde rightly put it: "Resorting to across-the-board, across-the-continent, budgetary cuts will only add to recessionary pressures" – and to markets' concerns about the burden of public debts.

It is imperative to add short-term growth measures to the eurozone policy mix. The core must compensate for peripheral austerity by spending more – not necessarily fiscally; policy can aim to remove obstacles to greater private spending. Even some crisis-hit states should watch against cutting too fast – in particular Spain, whose debt is low by eurozone standards.

Ms Merkel's nods to growth have been limited to supply-side measures such as undeniably necessary structural reforms. But growth is needed sooner than these can bear fruit. In the US, looser fiscal policy has kept the economy better afloat and allowed a quicker deleveraging of private debt. The eurozone should look and learn.