

# ifo WORLD ECONOMIC SURVEY

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## World Economic Climate

ifo World Economic Climate Deteriorates

## Advanced Economies

Previous Uptick in Confidence in Advanced Economies Vanishes

## Emerging and Developing Economies

Emerging Markets and Developing Economies Face a Renewed Downturn

## Special Box

The South Caucasus Countries between Russia and the European Union

## Special Topic

Measuring Experts' Macroeconomic Models



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## **NOTES**

The World Economic Survey (WES) assesses global economic trends by polling transnational and national organizations worldwide on current economic developments in their respective countries. Its results offer a rapid, up-to-date assessment of the current economic situation internationally. In July 2019, 1,173 economic experts in 116 countries were polled.

## **METHODOLOGY AND EVALUATION TECHNIQUE**

The survey questionnaire focuses on qualitative information: assessments of a country's general economic situation and expectations regarding key economic indicators. It has proven to be a useful tool, since it reveals economic changes earlier than conventional business statistics.

The qualitative questions in the World Economic Survey have three possible categories: "good / better / higher" (+) for a positive assessment or improvement, "satisfactory / about the same / no change" (=) for a neutral assessment, and "bad / worse / lower" (-) for a negative assessment or deterioration. The individual replies are combined for each country without weighting as an arithmetic mean of all survey responses in the respective country. Thus, the respective percentage shares for (+), (=), and (-) are calculated for the time  $t$  for each qualitative question and for each country. The balance is the difference between (+) and (-) shares. As a result, the balance ranges from -100 points to +100 points. The mid-range lies at 0 points and is reached if the share of positive and negative answers is equal.

The survey results are published as aggregated data. The weighting factors used to aggregate the country results into country groups or regions are calculated using each country's gross domestic product based on purchasing power parity.

# ifo World Economic Climate Deteriorates

The ifo World Economic Climate has clouded over. The indicator fell from -2.4 to -10.1 points in the third quarter (see Figure 1). The falling trend of the indicator was interrupted due to easing trade tensions last survey. With the resurgence of the trade dispute this quarter the downward tendency of the economic climate indicator resumed. Both the assessment of the current situation and expectations dropped significantly. The intensification of the trade conflict is having a considerable detrimental effect on the world economy. The economic climate deteriorated in all regions (see Figure 2). In the advanced economies and in Asia's emerging and developing economies, experts have revised both their assessment of the situation and expectations downwards. By contrast, in Latin America, the Commonwealth of Independent States, and the Middle East and North Africa, only the assessment of the situation was more negative, while estimates for the months ahead remained broadly unchanged. The experts expect significantly weaker growth in world trade. Trade expectations are at their lowest level since the outbreak of the trade conflict last year (see Figure 8). Respondents also expect weaker private consumption, lower investment activity, and declining short- and long-term interest rates (see Figure 9).

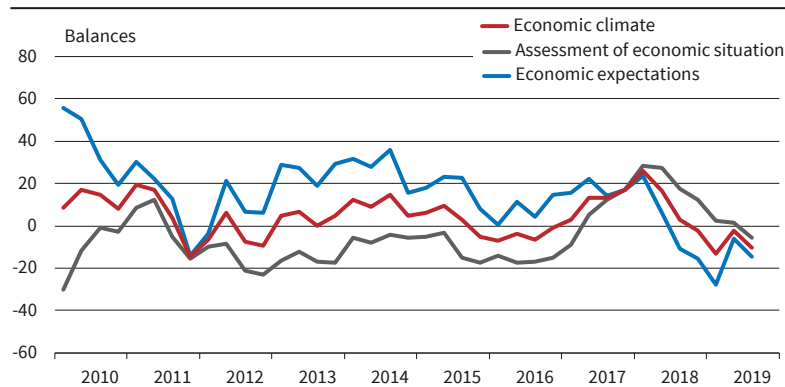
## PREVIOUS UPTICK IN CONFIDENCE IN ADVANCED ECONOMIES VANISHES

The previous uptick in confidence amongst WES experts in the advanced economies vanished again this survey. As a result, the economic climate indicator dropped from -2.2 points to -8.2 points (see Figure 10.1). The main downward risk is the potential escalation of the trade tensions between the US and China. Trade expectations are at their lowest level since 2009 (see Figure 8). Also, weaker private consumption and lower investment activity is expected. An increasing pro-

portion of experts expect short- and long-term interest rates to fall.

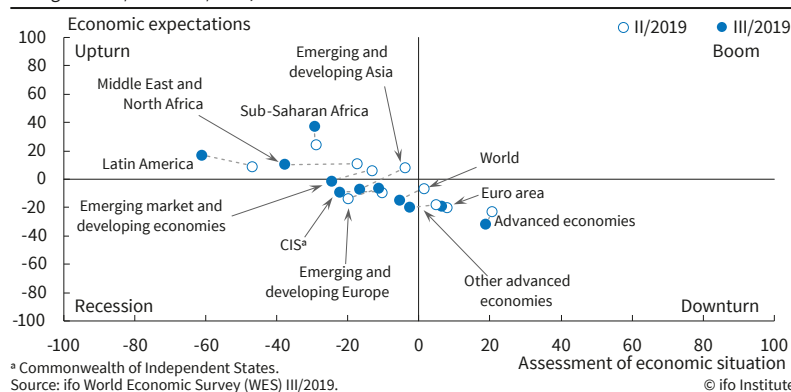
In the **euro area**, the economic climate indicator hardly changed. There was a minor drop from -6.3 to -6.7 points. This is similar compared to the European Union as a whole, where the indicator dropped by 0.6 points to -9.7 points on the balance scale. Assessments of the current situation in the euro area deteriorated further, whereas the economic expectations remain at the same unfavorable level as previous survey. Economic activity lacks momentum. Respondents expect hardly any growth in consumption, investments, and exports. External uncertainty in the form of growing protectionism and Brexit is mostly hindering manufacturing and trade. Consumption remains strong, although no further growth is expected. The euro area panelists continue to assume an inflation

Figure 1  
ifo World Economic Climate



Source: ifo World Economic Survey (WES) III/2019. © ifo Institute

Figure 2  
ifo Business Cycle Cock for Selected Country Groups  
Change from II/2019 to III/2019; balances



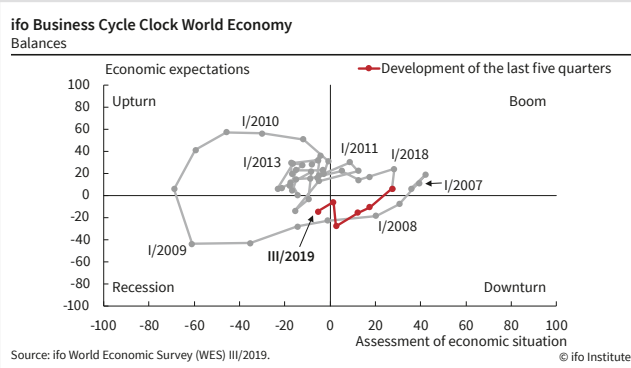
\* Commonwealth of Independent States. Source: ifo World Economic Survey (WES) III/2019. © ifo Institute

### IFO BUSINESS CYCLE CLOCK FOR THE WORLD ECONOMY

A glance at the Ifo Business Cycle Clock, showing the development of the two components of the economic climate in recent years, can provide a useful overview of the global medium-term forecast. The business cycle typically proceeds clockwise in a circular fashion, with expectations leading assessments of the present situation.

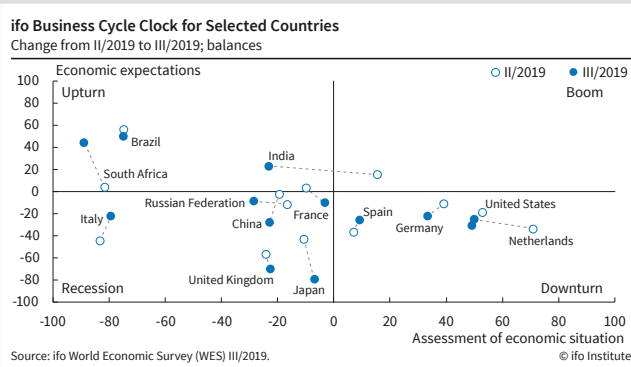
According to the results of the July survey, the Ifo indicator for the world economy dropped. After the temporary improvement of expectations in the last survey, experts turned substantially more pessimistic (see Figure 3.1). In combination with a negative economic situation, the indicator entered the recession quadrant. On a global scale, last quarter's rekindled confidence largely faded away.

Figure 3.1



To further analyze which countries are the main drivers behind this slight deterioration, we took the main advanced economies and key emerging markets in the Business Cycle Clock above and plotted them below to visualize the change from the previous quarter to the current quarter (see Figure 3.2). All advanced economies are now in either the downturn or the recession quadrant. Respondents revised their economic expectations downwards for Germany, the United States, France, Japan, and the United Kingdom. Experts in the United States and Germany additionally scaled back their positive assessments of the current situation. The Netherlands saw the largest deterioration of the present economic situation, while Japan experienced the strongest drop in expectations. Out of all advanced economies, only in Spain and Italy did both indicators improve slightly. The emerging markets of South Africa and Brazil remain in the upturn quadrant. They are joined by India, which moved from the boom quadrant as a result of a drastic deterioration in its current situation. Expectations for South Africa were revised considerably upwards, while China saw its economic outlook cloud over again. Brazil stayed nearly at the same position as last survey.

Figure 3.2



The Ifo World Economic Climate is the geometric mean of the assessments of the current situation and economic expectations for the next six months. The correlation of the two components can be illustrated in a four-quadrant diagram (the Ifo Business Cycle Clock). The assessments of the present economic situation are positioned along the X-axis, the responses on economic expectations on the Y-axis. The diagram is divided into four quadrants, representing the four phases of the business cycle. For example, the upturn phase (top left quadrant) represents negative assessments and at the same time positive expectations.

rate of 1.5 percent for the current year. This is somewhat lower than the inflation rate of 1.8 percent expected in the European Union (see Figure 4). An increasing share of experts expect short- and long-term interest rates to fall. WES experts' assessments for **Germany** have clouded over again, taking on a gloomier tone for both the situation and expectations (see Figure 11.2). The climate indicator fell in **France**, too, but solely because of more pessimistic expectations; the current situation was assessed somewhat less negatively (see Figure 11.1). In **Italy** and **Spain**, both the assessment of the present situation and economic expectations have been revised upwards (see Figures 11.2 and 11.3). Italy's experts are much less pessimistic about the coming months. The economic climate in **Greece** reached positive numbers again for the first time since the fourth quarter of 2007. With 3.9 points on the balance scale, the economic climate reached its highest level in more than ten years. The main improvement was seen in the economic outlook, which is considerably more optimistic than in recent surveys. Also, the assessment of the current situation improved, but remains at an unfavorable level. This positive turn in sentiment among the WES respondents in Greece might be due to the recent election on July 7, 2019, where, as the opinion polls had anticipated, the conservative New Democracy party won a majority in parliament. Prime Minister Kyriakos Mitsotakis has proposed a business-friendly policy mix, but the strict fiscal targets that the government is committed to could weigh down recovery (The Guardian 2019). Experts still judge investment and consumption to be weak, however they expect growth in the months ahead. The economic climate for **Finland** worsened considerably. The experts assess the current situation as less favorable than before. They are also more skeptical about economic developments in the near future.

The economic climate in the **United States** lost some of its momentum. The climate indicator dropped by 9.2 points to 5.2 points on the balance scale. The current situation is still assessed as very favorable, but expectations clouded over even further (see Figure 11.3). Both investment and trade are facing headwinds, due to a general global slowdown; the only positive note is private spending. Monetary conditions remain expansive as the supply of bank credit to firms remains unconstrained, according to WES experts (see Table 1). In addition, the share of respondents that expect a decrease in short- and long-term interest rates rose considerably (see Figure 9). The Fed already moved in this direction with its recent interest rate cut on the July 31 – its first cut since 2008 (CNBC 2019). For the remainder of 2019, trade tensions between the US and China will be the highest risk for the US economy. In recent weeks, trade talks appear to have stalled due to disagreements over Huawei, while US President Trump has threatened to impose more tariffs on USD 300 billion worth of Chinese imports (CNBC 2019). In **Japan**, the economic climate indicator dropped to its lowest

level since the third quarter of 2009. While assessments of the present economic situation were marginally less unfavorable than in the previous survey, respondents turned very pessimistic regarding the months to come (see Figure 11.2). The expectations indicator dropped by 36.4 to -79.3 points. This is the most pessimistic that Japanese experts have been in the history of the WES. Besides the effects from the trade disputes between China and the US, there is additional headwind coming from the trade war between Japan and South Korea. Japan set some administrative requirements for companies looking to export to South Korea certain chemicals that are used for the production of computer chips, display panels, and other high-tech products (The Diplomat 2019). A planned sales tax hike for October this year might not prove as detrimental as expected (Nohara 2019). Private consumption has not picked up in preparation for the tax hike, and WES experts don't expect any further growth. Inflation for 2019 dropped slightly and amounts to 0.8 percent for 2019. Experts revised their inflation forecast for 2024 upwards to 1.4 percent (see Figure 4). Economic sentiment in **Canada** improved. The economic climate brightened further, as the current situation was more favorably assessed than in the previous survey. Experts also turned slightly more positive for the months ahead (see Figure 11.1). Private spending remains strong. Investment, on the other hand, weakened somewhat compared to the previous survey, but is likely to rebound in the coming months. Inflation is forecast to be 1.9 percent in 2019; this is a 0.1 percentage point upward revision since last quarter. Medium-term inflation expectations amount to 2.1 percent, which is unchanged from previous survey (see Figure 4). Trade volumes are not expected to expand in the coming months. The economy of the **United Kingdom** is expected to perform poorly. The recent appointment of Boris Johnson as prime minister did not alter the uncertainty regarding Brexit, such that leaving with a deal, a no-deal Brexit, as well as a No-Brexit all remain on the table. The current situation was assessed as marginally better than previous survey, albeit remaining at a negative level. The forecast for the coming six months deteriorated further, as experts kept their pessimistic outlook (see Figure 11.3). The only positive change over the previous quarter is a slight improvement in domestic consumption.

The economic climate for **other advanced economies** remains subdued (see Figure 10.2). Both components of the climate indicator dropped, and the country group moved into the slight recession quadrant of the ifo Business Cycle Clock (see Figure 2). Confidence in trade activity is at its lowest levels since 2009 and is expected to decrease further in the coming months. Especially the Asian countries in this country group, **Hong Kong, Republic of Korea, Singapore, and Taiwan**, see a lack of momentum in their economies. Only the climate indicator for South Korea moved upwards, although it remains negative (see Figures 11.2 and 11.3). Hong Kong saw a very sharp drop in its economic

climate indicator as experts turned extremely pessimistic regarding the six-month economic outlook and downgraded the assessments for the current situation as well. The current political unrest there as a response against the proposed bill allowing extradition to China is likely to hurt business and consumer confidence (CNA 2019). In **Denmark**, the economic climate indicator fell by 20 points and lies now at -0.6 points on the balance scale. This is still near the zero line, which indicates economic growth according to trend. It is nevertheless the lowest value of this indicator since 2013. This decline was a result of less favorable assessments of the current situation and a more pessimistic economic outlook. Inflation was revised downwards and is now forecast to be 1.1 percent in 2019. Medium-term inflation remains at 1.6 percent (see Figure 4). The economic climate in **Switzerland** remains stable. WES experts remain slightly skeptical regarding economic prospects but valued the current situation more favorably than in the previous survey. Both forecasts for short- and medium-term inflation were revised downwards. Experts now expect inflation for 2019 to be 0.6 percent, while inflation by 2024 is expected to be 1.0 percent (see Figure 4). In **Norway, Sweden, and Israel** a bright economic climate persists, with the best economic prospects for Norway. In Norway and Israel, the current situation improved but experts turned more skeptical for the months ahead. In Sweden, in contrast, the current economic sentiment was downgraded, but remains favorable. Respondents have more optimistic projections for the months ahead (see Figure 11.3). The economic climate in **Australia** brightened, but at -6.8 points remains below the zero line (see Figure 11.1). The current situation saw hardly any change in its unfavorable assessment. The economic outlook improved considerably and experts expect no further slowdown of the Australian economy. Trade expectations turned negative, especially for export volumes. The inflation forecast for 2019 was revised downwards by 0.4 percentage points to 1.6 percent. Regarding medium-term inflation, experts also revised their expectations downwards to 2.3 percent from 2.6 percent (see Figure 4). In **New Zealand**, the economic climate indicator reached 14.0 balance points – its lowest level since the third quarter of 2009 (see Figure 11.2). This was mainly due to the current situation deteriorating considerably. The expectations, in contrast, saw only a marginal decline, and remain negative. Above all, the WES experts see investment contracting. The **Czech Republic** has now experienced a downward tendency in its economic climate indicator for four consecutive quarters (see Figure 11.1). Whereas the indicator stayed around the zero line in the previous survey, this time it dropped further to -7.9 points on the balance scale. The current situation remains favorable, but less pronounced than three months ago. Regarding economic developments in the next six months, respondents remain as pessimistic as previous survey.

## EMERGING MARKETS AND DEVELOPING ECONOMIES FACE A RENEWED DOWNTURN

The slight recovery in the economic climate of **emerging markets and developing economies** seen in the second quarter was only short-lived. Assessments of the present economic situation reached -24.6 points, the most negative level since early 2017. Economic expectations turned skeptical again, suggesting there will be no substantial improvement to current weak economic conditions in the months ahead (see Figure 10.1). Similar to advanced economies, trade expectations are at their lowest level in ten years, reflecting the intensification of the trade conflict (see Figure 8).

The economic climate continues to remain weak for all subgroups of this aggregate (see Figure 10.2). Nevertheless, the regions are in different stages of the business cycle, following the classification of the ifo Business Cycle Clock (see Figure 2). **Emerging and developing Europe** and the **Commonwealth of Independent States** remain in “recession”, as experts’ assessments of the present situation and economic outlook remain pessimistic. **Latin America, the Middle East and North Africa**, and **Sub-Saharan Africa** are still situated in the upturn phase. These regions currently report a weak economic situation but expect it to improve in the months ahead. The slight recovery seen in the **emerging markets of Asia** was only temporary. Economic experts revised their appraisals of the present economic situation and economic expectations downwards. This group has shifted back into the “slight recession” quadrant of the Business Cycle Clock (see Figure 2).

The economic climate for important emerging markets (**Brazil, Russia, India, China, and South Africa – BRICS**) clouded over again, after a slight improvement in the second quarter. The indicator fell to -18.1 balance points, from -5.6 in the previous quarter (see Figure 10.1). The assessment of the present economic situation was the most negative since the end of 2016. This mainly reflects the strong downward revision for **India**. Here, the current situation is as weak as in late 2014 (see Figure 12.2). This led to a slightly negative economic climate (-1.3 points), despite some uptick in the economic outlook. India’s experts reported waning consumption and investments; they consider credit to firms as constrained (see Table 1). Neither do they expect much impetus from the export sector. The economic climate for **Russia** and **China** deteriorated again, after having improved at a low level in the second quarter. In both countries, assessments of the present economic situation are more negative than three months ago. The economic outlook for China turned pessimistic again, probably due to weak trade expectations reflecting the persisting trade conflict (see Figure 12.1). Chinese respondents expect private consumption and investment activity to remain weak. As a result, China moved deeper in the “recession” quadrant of ifo Business Cycle Clock (see Figures

3.2 and 5). Russia also remains in the “recession” quadrant, although economic expectations became less pessimistic than three quarters ago (see Figure 12.3). Inflation for 2019 continued to ease from 5.8 to 5.2 percent, whereas the estimated inflation figure in five years’ time went up by 0.8 percentage points to 5.9 percent (see Figure 4). More experts than in the previous survey expect short- and long-term interest rates to fall in the coming six months. There were hardly any changes in the economic conditions of **Brazil**: the economic climate indicator dropped slightly from -21.0 to -23.2 balance points (see Figure 12.1). The present economic situation remains weak and economic expectations are slightly less optimistic (see Figures 3.2 and 5). Inflation expectations for 2019 and in five years’ time are nearly unchanged at 4.0 percent and 3.8 percent respectively (see Figure 4). A considerably greater share of experts than three months ago expect interest rates to fall in the months ahead (see Figure 9). Three quarters of Brazilian experts (compared to 60 percent in the first quarter of 2019) report bank credit to firms to be constrained (see Table 1). **South Africa** was the only country in the BRICS group where the economic climate improved – although at -35.2 balance points, it remains very negative (see Figure 12.3). The assessment of the present economic situation was weaker as in the previous survey. But in combination with considerably more optimistic expectations, South Africa is heading back to a more consolidated upswing (see Figures 3.2 and 5). The current weak performance of capital expenditures and private consumption is expected to recover slightly in the course of the next six months. Most experts anticipate decreasing short- and long-term interest rates (see Figure 9). The expected inflation rate for 2019 was revised downwards from 5.3 to 4.7 percent (see Figure 4).

## OTHER EMERGING MARKETS

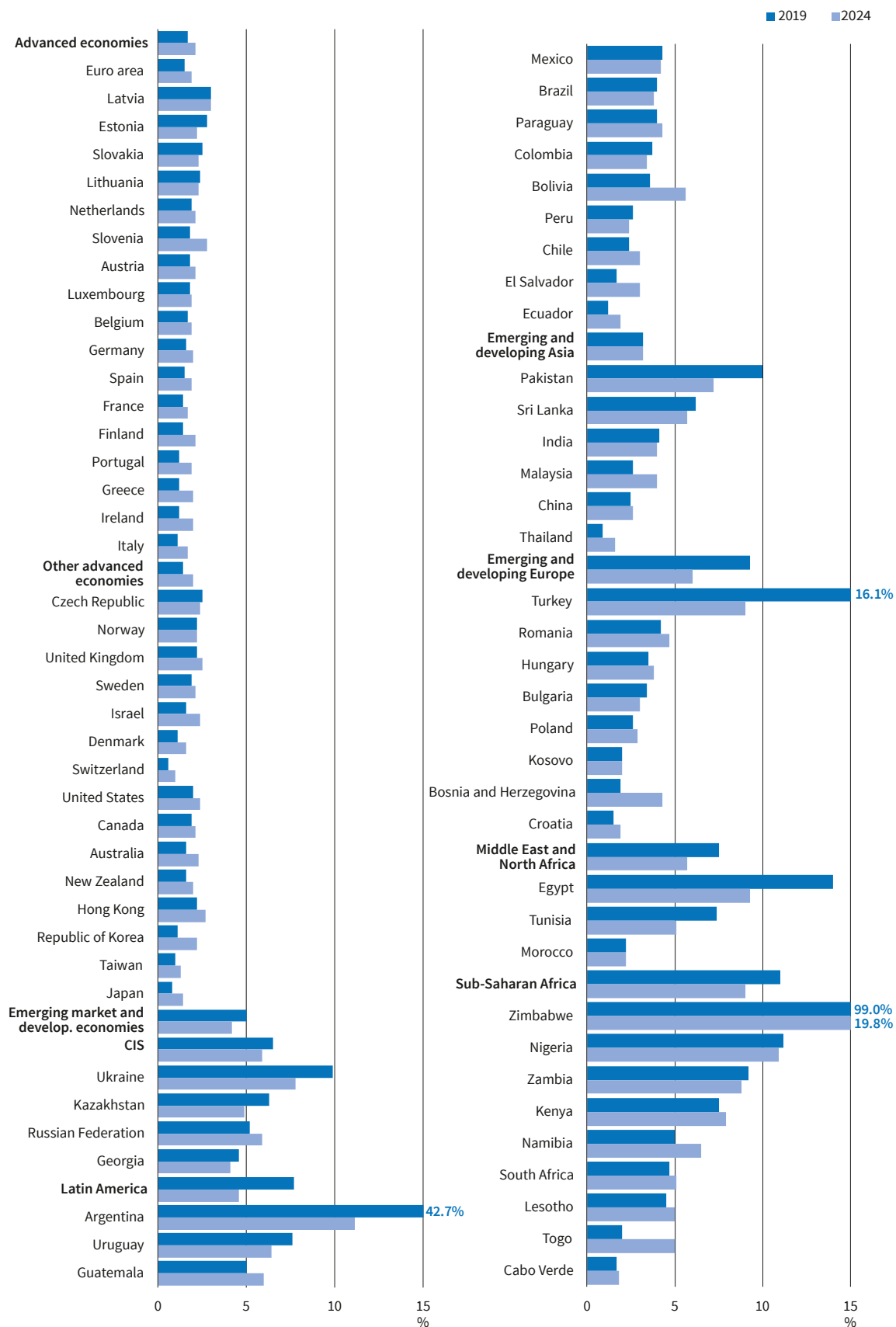
In **emerging and developing Asia**, the climate indicator fell, from +2.1 to -12.1 balance points. This figure mainly reflects the negative developments in **China** and **India**.<sup>1</sup> The **ASEAN-5** countries (comprising **Indonesia, Malaysia, the Philippines, Thailand, and Vietnam**) saw a renewed downturn in their economic climate, from 34.6 to 21.3 balance points. The present economic situation continued to deteriorate but remained at a satisfactory level. Economic expectations are less positive than three months ago (see Figure 10.1). Out of this group, the best economic climate was reported for Malaysia and the Philippines (see Figures 12.2 and 12.3). The Malaysian economy is beginning to perk up and is likely to post higher than expected GDP growth in 2019, one expert added. The Malaysian ringgit is undervalued vis à vis the US dollar, which may work in the Malaysia’s favor in terms of export competitiveness.

<sup>1</sup> For a more detailed description of China and India, see the BRICS section.



Figure 4

**Inflation rate expectations for 2019 and 2024**  
Country groups<sup>a</sup> and countries



<sup>a</sup> To calculate country groups, country weights are based on gross domestic product based on purchasing-power-parity (PPP) in international dollars (database IMF's World Economic Outlook).  
Source: ifo World Economic Survey (WES) III/2019.

Table 1

**Supply of Bank Credit to Firms**

Percentage of experts who report moderate or strong constraints	
<b>Euro area and/or G7</b>	
Greece	100.0
Italy	88.9
Portugal	78.9
Ireland	66.7
Latvia	61.5
Lithuania	60.0
Spain	59.1
Netherlands	55.0
France	48.3
Austria	46.2
Belgium	42.9
Slovakia	41.2
United Kingdom	38.5
Germany	31.8
Japan	25.9
Canada	23.5
Slovenia	22.2
Finland	18.2
United States	13.0
<b>Other advanced economies</b>	
New Zealand	85.7
Australia	73.3
Republic of Korea	37.5
Denmark	33.3
Norway	33.3
Switzerland	19.2
Czech Republic	16.7
Taiwan	12.5
Sweden	11.1
<b>Emerging and developing Europe</b>	
Romania	75.0
Turkey	66.7
Bulgaria	63.6
Hungary	46.2
Poland	26.7
Croatia	0.0
<b>Emerging and developing Asia</b>	
India	92.3
Pakistan	84.6
China	77.8
Philippines	16.7
Latin America	50.0
Bolivia	75.0
Brazil	75.0
Argentina	61.5
Mexico	50.0
Paraguay	50.0
Chile	40.0
Colombia	33.3
Peru	30.8
Uruguay	28.6
<b>Commonwealth of Independent States</b>	
Ukraine	100.0
Georgia	76.9
Russian Federation	74.3
<b>Sub-Saharan Africa</b>	
Kenya	100.0
Zimbabwe	100.0
Namibia	60.0
Zambia	60.0
South Africa	50.0

Only countries with more than four responses were included in the analysis.  
Source: ifo World Economic Survey (WES) III/2019.

The economic climate indicator for **emerging and developing Europe** continued its upward trend, improving from -17.0 to -8.9 points on the balance scale (see Figure 10.1). Assessments of both the present economic situation and economic expectations are less negative than three months ago. The country group, nevertheless, remains in the “recession” quadrant of the ifo Business Cycle Clock (see Figure 2). Compared to the survey in January, a slightly lower share of respondents report bank credits to firms to be constrained. This situation eased especially in Romania and **Turkey**, where in the first quarter of 2019 about 90 percent of experts saw bank lending as constrained: these shares decreased for Romania to 75 percent and for Turkey to about 67 percent (see Table 1). Inflation rate expectations for 2019 and in five years’ time increased in most countries of this region except Turkey. Here, both rates are slightly lower than three months ago, but still rank among the highest in emerging markets (see Figure 4). The Turkish experts had anticipated the massive interest rate cut from 24 percent to 19.75 percent of newly installed central bank chief Murat Uysal, as the majority of WES experts expected decreasing short- and long-term interest. The Turkish lira has steadied in recent months and experts even see it as overvalued vis à vis the four main currencies euro, US dollar, yen, and British pound. Amid these positive developments, the economic climate continued to recover by 9.5 balance points to -33.3 (see Figure 12.3). With economic expectations turning positive for the first time in two years, the country moved from the “recession” into the “upturn” phase of the business cycle (see Figure 5). The economic climate for **Romania** improved, too, due to a positively revised present economic situation. In turn, economic expectations remain subdued. The best economic climate in this region currently prevails in **Bulgaria** and **Poland** (see Figures 12.1 and 12.3). The climate’s two components, present situation and expectations, improved in both countries; however, in Poland the economic outlook remains negative on balance.

The economic climate for **Latin America** deteriorated slightly, from -21.1 to -26.4 balance points, due to considerably more negative assessments of the present situation. The economic outlook improved again, signalling some potential easing of current weak levels (see Figures 2 and 10.2). This region is also suffering from the trade tensions, and trade expectations reached their lowest levels in nearly four years (see Figure 8). In contrast to recent surveys, WES experts no longer expect short- and long-term interest rates to rise within the next six months. Economic activity is expected to remain sluggish in **Brazil**<sup>2</sup> and **Mexico**. The latter country experienced the worst economic climate in the region and, at -55.1, reached its lowest level in over two years (see Figure 12.2). With very weak assessments of both the present economic situation and economic expectations, the country remains in the

<sup>2</sup> For a more detailed description of Brazil, see the BRICS section.

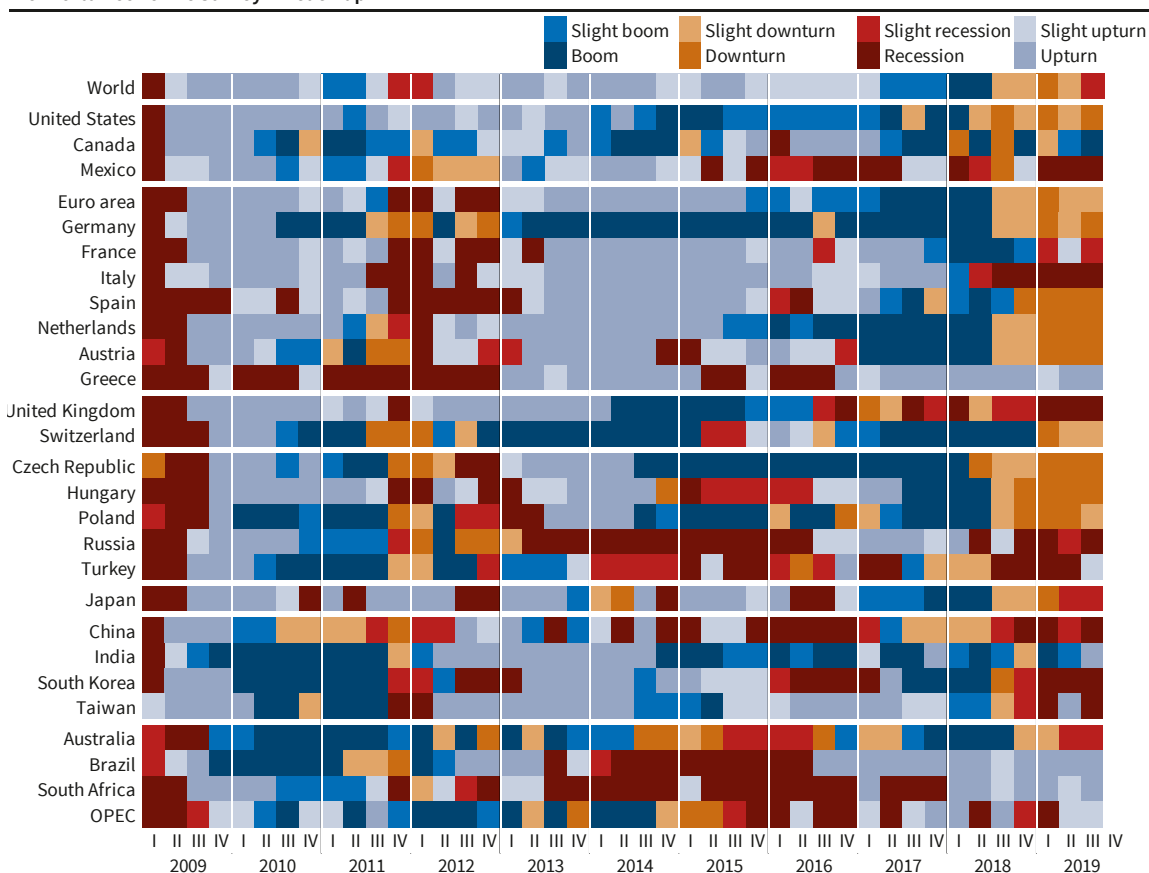
“recession” phase of the ifo heatmap (see Figure 5). According to WES experts, flagging capital expenditures and private consumption show no signs of recovery in the next six months. While inflation is expected to remain contained (see Figure 4), the Mexican peso continued to devalue against the US dollar and euro. **Argentina** saw a renewed brightening in its economic climate and the indicator rose by 32 points to -21.2 balance points. This was tracked by exceptional optimistic economic expectations (see Figure 12.1). On the other hand, assessments of the present economic situation, investment, and consumption remain extraordinarily weak. At 42.7 percent, the inflation rate for 2019 remains in double digits and ranks besides Venezuela among the highest figures in the world (see Figure 4). Nevertheless, the WES experts consider a cut in short- and long-term interest rates in the next six months as likely. The best economic climate in Latin America prevails in **Chile** at 13.5 balance points. In **Colombia**, too, the climate indicator remains positive, despite some downward correction compared to the survey three months ago (see Figure 12.1). Assessments of the present economic situation turned negative in both countries this quarter. In contrast, experts have become more optimistic regarding the six-month economic outlook. In

both countries, credit to firms seems to be less constrained than in other countries of this region (see Table 1).

The economic climate for the **Commonwealth of Independent States (CIS)** deteriorated again and fell to -15.8 balance points, after having slightly recovered in the second quarter. The survey results continue to indicate weak economic performance with no signs of recovery in the months ahead (see Figures 2 and 10.2). This pattern certainly reflects economic developments in Russia, whose weight accounts for nearly 80 percent of this aggregate. Whereas inflation pressure in **Russia** is likely to recede, the experts surveyed expect higher price increases for 2019 for the **Ukraine, Kazakhstan, and Georgia** (see Figure 4). Most of the region’s currencies are continuing to lose some ground against the US dollar; Kazakhstan is an exception, with experts seeing the tenge more or less at its proper value vis à vis the US dollar. Ukraine’s central bank trimmed its key policy rate for the second time this year, a move that was anticipated by WES experts as the majority of them saw short-term interest rates falling in the near future. All Ukrainian respondents agree that the supply of credit to firms is constrained (see Table 1). The economic conditions deteriorated most in Georgia: its economic cli-

Figure 5

ifo World Economic Survey – Heatmap <sup>a</sup>



<sup>a</sup> The assessments of the current situation and economic expectations for the next six months are visualised by a four colour scheme that illustrates the four phases of a business cycle: boom, downturn, recession, upturn. The transition areas between these four phases are illustrated with lighter colours and are defined as follows: Slight boom when the current situation is smaller than +20. Slight downturn when expectations are between 0 and -20. Slight recession when the current situation is between 0 and -20. Slight upturn when expectations are smaller than +20.

Source: ifo World Economic Survey (WES) III/2019.

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## THE SOUTH CAUCASUS COUNTRIES BETWEEN RUSSIA AND THE EUROPEAN UNION

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(PMC Research Center)*

**Armenia, Azerbaijan, and Georgia**, the three countries that make up the South Caucasus, have little in common in terms of ethnic, linguistic, or political-economic affinities. Since the collapse of the Soviet Union in 1991, the South Caucasus emerged as a region where Western and Eastern actors sought to expand, both politically and economically. This article reviews the South Caucasus countries' political and economic relations with the European Union and Russia. First, a review of the core political economic interests and political relations of the EU and Russia in the South Caucasus region is set out. Second, we discuss whether political relations with the EU or Russia have an influence on trade activity.

Following the collapse of the Soviet Union, the South Caucasus emerged as an area of competition between the EU and Russia (see Figure 6.1). The two powers sought to expand their spheres of influence in the region. The President of Russia, Vladimir Putin, considers the South Caucasus region to be part of Russia's "sphere of influence" (The New York Times 2001). Any presence of Western powers such as the US or the EU in the South Caucasus region is considered a threat to Russia's national security. In the South Caucasus region, Russia's political relations are strongest with Armenia and weakest with Georgia, while Azerbaijan remains somewhere in between. Russia began to expand its economic and political presence in the region during the mid-1990s and targeted **Armenia** as a close ally in the process by acquiring a military base there in 1995. Armenia's National Security Strategy document, drafted in 2007, states that

Armenia is in a "strategic partnership" with Russia. The country is a loyal member of the Commonwealth of Independent States (CIS). Armenia's concerns about security stem from the Nagorno-Karabakh War, which has yet to be resolved. To protect themselves from Azerbaijan's arms buildup, Armenia relies on Russia for security (Oddo 2019). These close political ties have contributed to the interconnectivity between the economies of the two nations. This strengthened further as a result of Armenia's membership in the Russian-led Eurasian Economic Union and the rejection of the planned Association Agreement (AA) with the EU in 2013 (New Eastern Europe 2019).

After the Rose Revolution of 2003, **Georgia** rapidly shifted its foreign policy away from Russia to the US and the EU. Russia actively opposed Georgia's pro-Western direction through energy disputes and a variety of sanctions on Georgian products in the early 2000s. The Russo-Georgian War of 2008 completely deteriorated political relations between Russia and Georgia. This resulted in Georgia's immediate withdrawal from the CIS and Russia's heavy sanctioning of Georgian products, affecting wine and tourism in particular. Political relations between Russia and **Azerbaijan** are characterized by cooperation in the oil sector, particularly the transit of oil and gas from the Caspian basin to Europe. In attempts to take advantage of Azerbaijan's valuable oil supply, Russia sought to position itself as a middleman in the transit of oil and gas from the Caspian basin to Europe to control energy trade for the entire South Caucasus.

From the European Union's perspective, the tensions in the South Caucasus undermine the region's potential as a land bridge linking Europe to Central Asia and the Caspian Sea. Therefore, despite Russia's opposition, in 2004 the EU launched the European Neighborhood Policy (ENP) with 16 countries, including Armenia, Azerbaijan, and Georgia, in order to foster democratic processes, support the peaceful resolution of regional conflicts, and prevent further conflict. In 2009, as a specific dimension of the ENP, the EU started the

Eastern Partnership (EaP) initiative with six post-Soviet countries including Armenia, Azerbaijan, and Georgia in order to facilitate a common area of democracy, prosperity, stability, and increased cooperation with Europe. Only **Georgia** signed an Association Agreement (AA) with the EU in 2014, and since then benefits from the Deep and Comprehensive Free Trade Area (DCFTA). Both Armenia and Azerbaijan have rejected the AA, partially due to concerns

Figure 6



related to Russia, in 2013 and 2016 respectively. The EU's current relationship with Azerbaijan is based on the EU-Azerbaijan Partnership and Cooperation Agreement, which has been in force since 1999 (Alieva, Delcour, and Kostanyan, n.d.). In 2004, Azerbaijan was one of sixteen nations involved in the ENP. In 2009, the country was involved in the Eastern Partnership with the EU; however, in 2016, it rejected the Association Agreement with the EU (Oddo 2019). Despite this, Azerbaijan is the only country

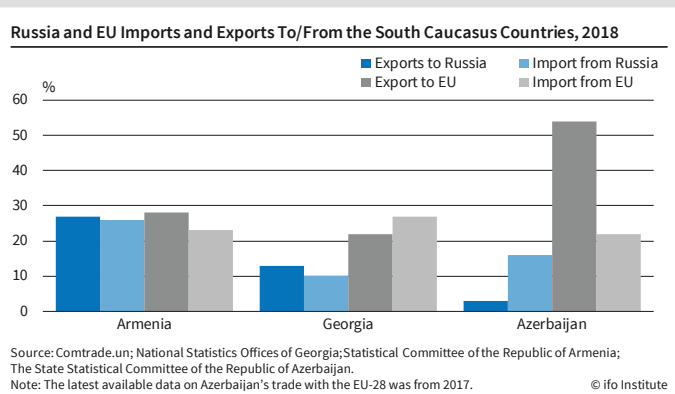
that has access to European markets for its natural resources. Because of energy dependence, the EU is willing to start negotiations on a new framework agreement with **Azerbaijan** (Eastern Partnership n.d.). Due to Armenia's close cooperation with Russia, it is difficult to establish more integration with the EU. After Armenia announced its plans to join the Eurasian Economic Community Customs Union in 2014, EU politicians stated this would be incompatible with previous agreements, such as the establishment of the Deep and Comprehensive Free Trade Area, which took four years to negotiate (Yekaterina Poghosyan n.d.). Currently, relations between the EU and Armenia are based on the EU-Armenia Comprehensive and Enhanced Partnership Agreement (CEPA), which entered into provisional force on June 2018.

As figure 7 shows, Russia and the EU are both important trade partners for the South Caucasus countries. Russia is especially important for Armenia, with 26 percent of **Armenia's** imports coming from and 27 percent of its exports going to Russia. For Georgia, the EU is clearly more important than Russia, with 22 percent of total Georgian exports going to and 27 percent of its imports coming from the EU. Azerbaijan clearly stands out with exports to the EU, but has a lower share of exports to Russia than Georgia does. Among the three countries, Georgia is the most dependent on imports from the EU, which amounted to 27 percent of its total imports.

## CONCLUSION

Clearly there is a relationship between political ties and trade in the South Caucasus region. Armenia's political ties with Russia are also reflected in trade. In 2018, Russia accounted for 26 percent of Armenia's total trade revenue – the highest among the South Caucasus countries. Nevertheless, Armenia's move away from the EU was not really reflected in its trade volume. The EU's share

Figure 7



of Armenia's trade was a bit lower compared with EU-friendly Georgia. Georgian-Russian relations are the least favorable, while the country has the closest political ties with the EU. Although political tension and turmoil between Georgia and Russia persists, Russia remains an important trade partner for Georgia. Georgia is the only South Caucasus country that has signed an AA, but it has a lower share of trade with the EU than Azerbaijan does. Azerbaijan occupies a unique stance regarding its international relations as it tilts neither towards the EU nor towards Russia compared to Armenia's pro-Russian and Georgia's pro-Western stance. While Azerbaijan rejected the AA with the EU in 2016, similar to Armenia, it seems that Azerbaijan's external trade was not affected by that political decision. Compared with the other two South Caucasus countries, Azerbaijan leads in terms of trade with the EU. It also plays a significant role in EU's Southern Gas Corridor. Its political neutrality – e.g., not signing an AA with the EU but also not being part of the Eurasian Economic Union – allows Azerbaijan to trade with Russia as well.

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mate indicator fell considerably from +13.3 to -19.6 balance points. Appraisals of both the present economic situation and economic expectations turned considerably negative. The performance of consumption, investments, and exports is currently subdued, and respondents expect no growth in the next six months either.

The economic climate for countries in the **Middle East and North Africa (MENA)** clouded over again, after having slightly brightened in the second quarter. The respective indicator fell from -3.8 to -15.2 balance points. Experts in this region revised their assessments of the current situation downwards and attested to a current weak economic performance. No change was reported to the positive economic outlook (see Figures 2 and 10.2). Regional inflation for 2019 is again set at 7.5 percent: higher price expectations for **Egypt** were offset by estimated lower prices in **Algeria** and **Tunisia** (see Figure 4). While economic performance in Algeria, Egypt, and Tunisia was reported to be weak at present, with hardly any signs of a recovery in the next six months, the situation in the **United Arab Emirates** is more positive than in the region as whole; the current satisfactory situation is likely to persist in the months ahead.

In **Sub-Saharan Africa**, the economic climate continued to improve from -4.1 to +1.1 balance points, due to more optimistic economic expectations (see Figure 10.2). As a result, the aggregate is now located in a more consolidated “upturn” phase of the ifo Business Cycle Clock (see Figure 2). The region seems to be in a more robust economic shape than other country groups, however with considerable differences between the individual African countries. In **Nigeria** and **Côte d’Ivoire**, the economic climate remains friendly, with a satisfactory present situation and a positive economic outlook (see Figure 12.2). In **Kenya**, the economic climate clouded over, due to considerable deterioration in the present economic situation. In contrast, economic expectations turned positive again, indicating that the current weak economic performance should be only short-lived (see Figure 12.2). All Kenyan experts surveyed reported bank lending to firms as moderately constrained (see Table 1). In **Namibia**, some easing of the tight financial restrictions to firms was reported as the share of experts that reported constraints dropped by 15 percent since the January 2019 survey. Nevertheless, the present economic situation for Namibia remains negative, with no signs of substantial improvement in the months ahead (see Figure 12.2). The economic situation in **Zambia** and **Zimbabwe** remained more or less the same as in the previous survey and continues to be very weak. Experts revised their economic expectations upwards slightly, but these remain pessimistic on balance and signal a further deterioration in the weak current economic conditions (see Figure 12.3). The statistics agency in Zimbabwe suspended releasing annualized inflation numbers until February of next year. Prices are

no longer measured in US dollars, making the figures incompatible (Aljazeera 2019). WES experts see the inflation rate climbing to 99 percent in 2019, making it the highest figure in the world apart from Venezuela (see Figure 4).

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## MEASURING EXPERTS' MACROECONOMIC MODELS

*Peter Andre, Carlo Pizzinelli, Christopher Roth, Johannes Wohlfart*

Macroeconomic expectations of households and firms are at the core of fiscal and monetary policymaking. For instance, with interest rates at the zero lower bound (ZLB), central banks around the world have turned to measures that try to change the behavior of economic agents primarily through their effect on expectations, such as forward guidance about future interest rates. Expectations are also at the core of macroeconomic models, and biases in the way economic agents form expectations have substantial effects on the theoretical transmission mechanism of monetary and fiscal policy.

Due to their importance for policymaking and macroeconomic modeling, there has been increasing interest in collecting survey evidence on the way households and firms form expectations about the macroeconomy (Armantier et al (2015); D'Acunto et al (2019a,b,c,d); Das et al (2018)) and how these expectations shape economic behavior (Armona et al (2018); Bachmann et al (2015); Roth and Wohlfart (2019); Vellekoop and Wiederholt (2019)). Among others, these papers have shown that people's macroeconomic expectations are shaped by their shopping experiences (Cavallo et al (2017); D'Acunto et al (2019)), their experienced macroeconomic environment (Goldfayn-Frank and Wohlfart (2019); Kuchler and Zafar (2018); Malmendier and Nagel (2015)), and social interactions (Bailey et al (2018a,2018b)). However, there is little systematic evidence on people's mental representation of the economy, and in particular whether their "subjective models" of the economy are in line with empirical evidence and theoretical models. The assumption that agents form their expectations with knowledge of the true structure of the economy is maintained in almost all macroeconomic models, which makes this question of high interest to both academics and policymakers.

In a recent paper (Andre et al. (2019)), we propose an approach to measure people's subjective models of the macroeconomy using hypothetical vignettes. We use both representative surveys of the US population as well as a sample of experts from academia and policy institutions. In the hypothetical vignettes, respondents predict future unemployment and inflation under different hypothetical macroeconomic shocks. We designed the survey to have several advantages compared to existing evidence: first, our approach holds constant beliefs about the source of the shock. Second, the approach ensures that the shocks are perceived to be exogenous, a critical feature that allows us to benchmark our estimates with theoretical models.

We focus on four different exogenous shocks that are of particular interest for both policymakers and macroeconomic theory: we study an oil price shock, a monetary policy shock, a government spending shock, and an income tax shock. The key idea of our vignettes

is that we elicit expectations about the unemployment rate and the inflation rate under two different scenarios. In the baseline scenario, respondents are told to assume that the shock variable of interest will not change over the next 12 months. In the other scenario, participants are asked to assume that the shock variable either increases (rise scenario) or falls (fall scenario) compared to the baseline scenario. To clarify further, we illustrate our design in the context of the oil price vignette. In the baseline scenario, respondents are told that the oil price will remain at the same level over the next 12 months on average. In the "rise scenario", we tell them that the oil price will be on average USD 30 higher over the next 12 months, while in the "fall scenario", we tell them that the oil price will be on average USD 30 lower over the next 12 months. We tell our respondents to assume that these changes in the oil price are due to unexpected improvements in or problems with the local production technology in the Middle East. These vignettes enable us to compare the responses of participants in the rise/fall scenario with the expectations in the baseline scenario. After differentiating idiosyncratic individual-level expectations about the levels of unemployment and inflation, we can then measure people's beliefs about the effects of these shocks on the economy.

In addition to data from a representative sample and a sample of experts from academia and policy institutions, in July 2019 we collected data with the World Economic Survey. We want to leverage this data to better understand the determinants of people's subjective models of the economy. In particular, the World Economic Survey allows us to shed light on this question with large, heterogeneous samples of experts with diverse educational, institutional, and economic characteristics. The size of the World Economic Survey allows us to analyze the determinants of subjective models using high statistical power.

We aim to use this data for several purposes. First, we want to examine whether and how experts who were trained in different schools of economic thought differ in their beliefs about the functioning of the macroeconomy. Second, we would like to use this data to assess the current vulnerability of the US economy to different types of shocks according to expert opinions. Finally, we aim to use this data as a benchmark for the predictions of participants in our previous surveys on samples of households and experts from academia and policy institutions. Given that participants in the World Economic Survey are used to making macroeconomic predictions, we view their predictions as an upper bound on how well households could possibly predict the response of the macroeconomy to shocks.

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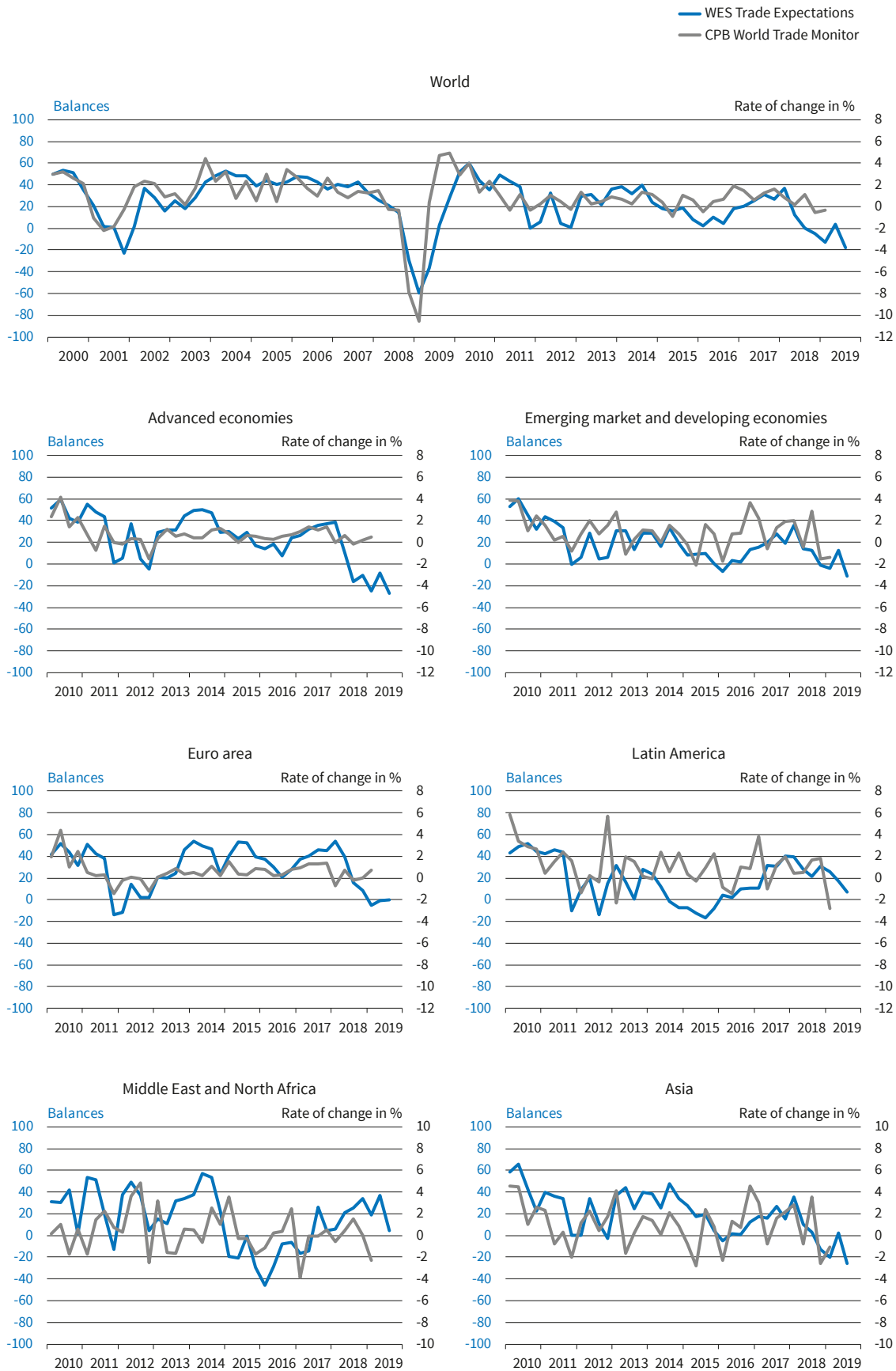
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Figure 8

Comparison of WES Experts Trade Expectations and the CPB World Trade Monitor in Selected Aggregates



Source: ifo World Economic Survey (WES) III/2019; CPB Netherlands Bureau for Economic Policy Analysis (CPB).

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Figure 9

Expected Trend for the Next 6 Months for Short- and Long-term Interest Rates

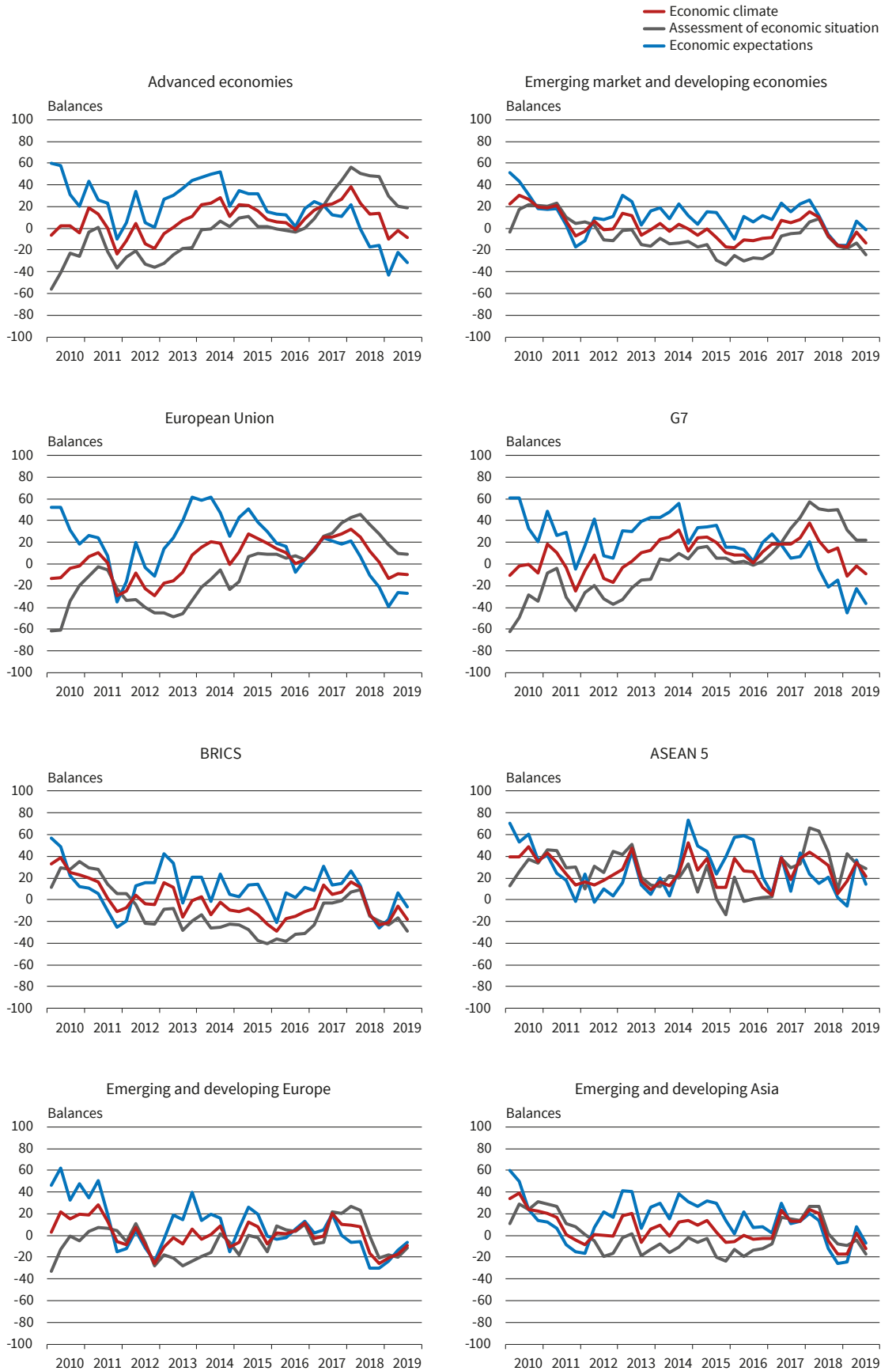


Source: ifo World Economic Survey (WES) III/2019.

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Figure 10.1

Selected Aggregates

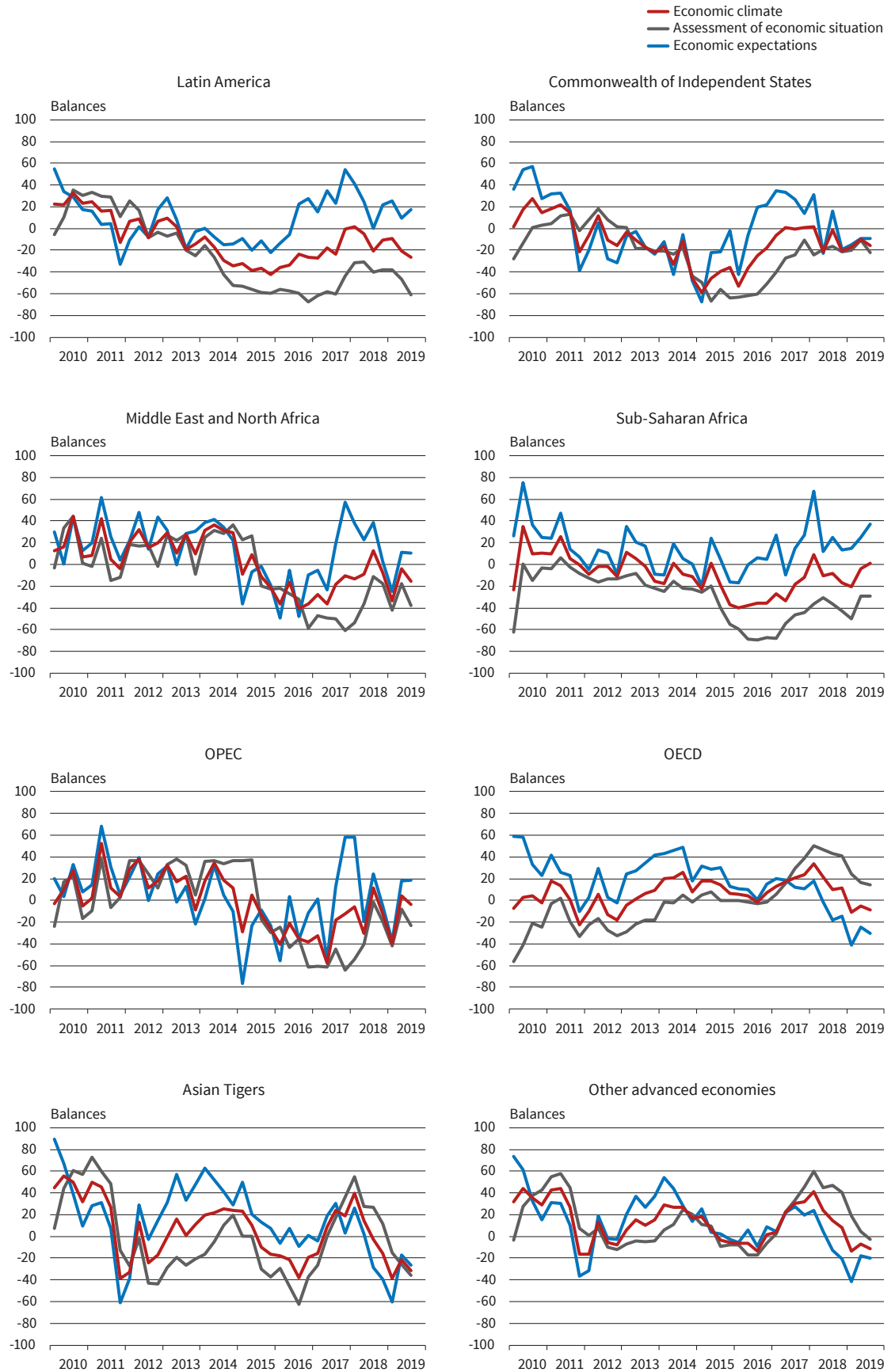


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Figure 10.2

Selected Aggregates

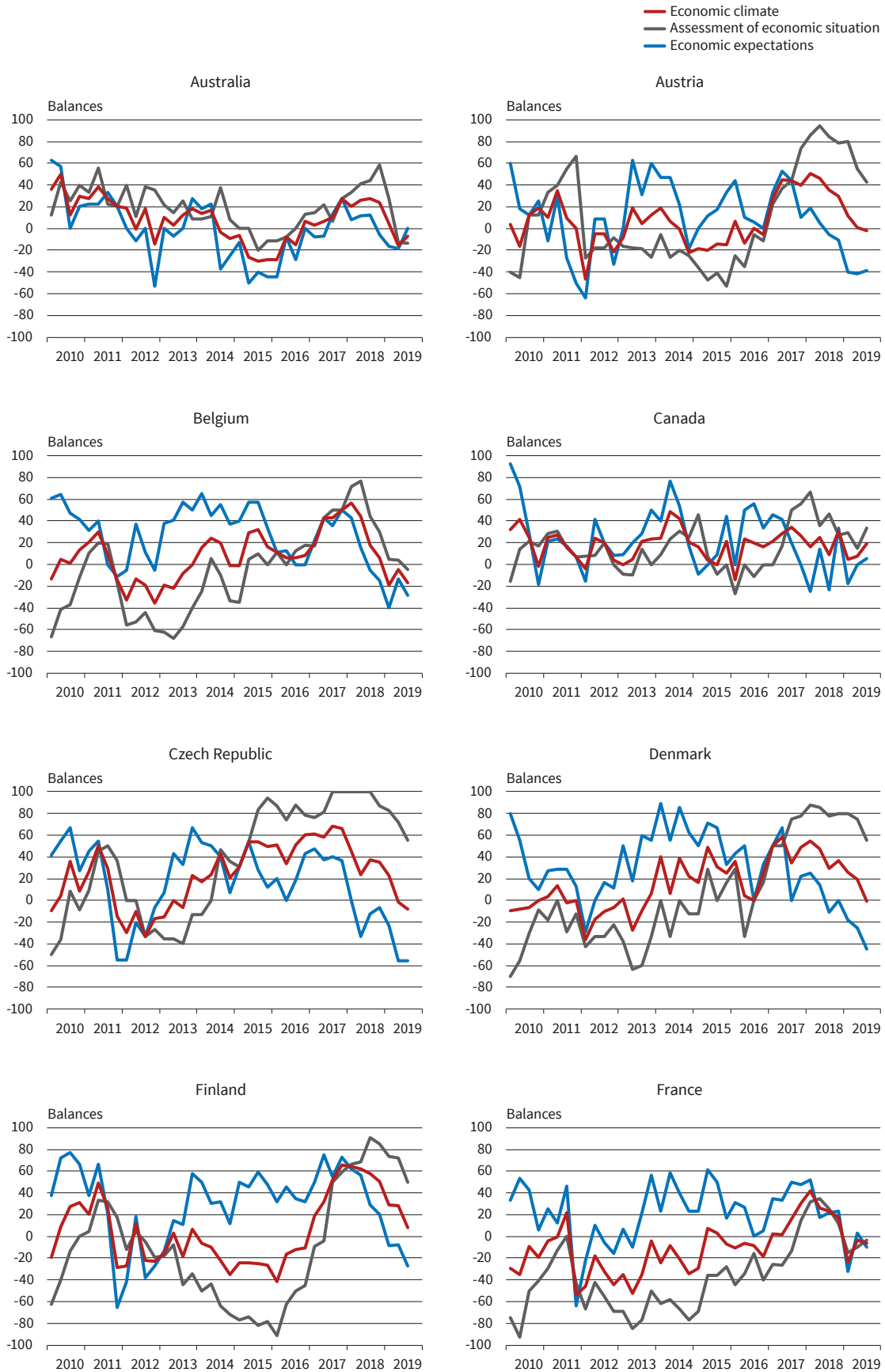


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Figure 11.1

Advanced Economies



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Figure 11.2

Advanced Economies



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Figure 11.3

Advanced Economies

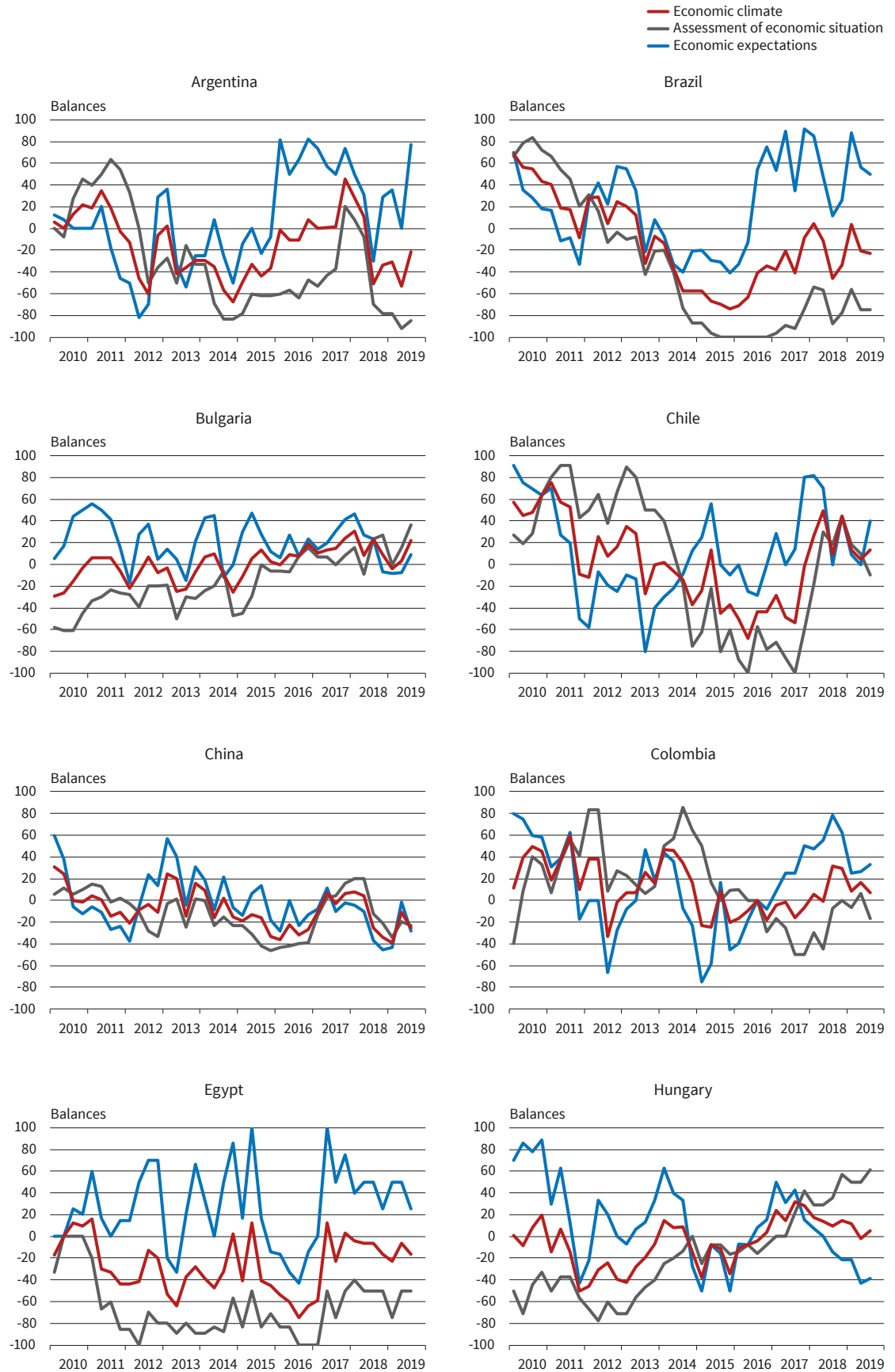


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Figure 12.1

Emerging Markets and Developing Economies



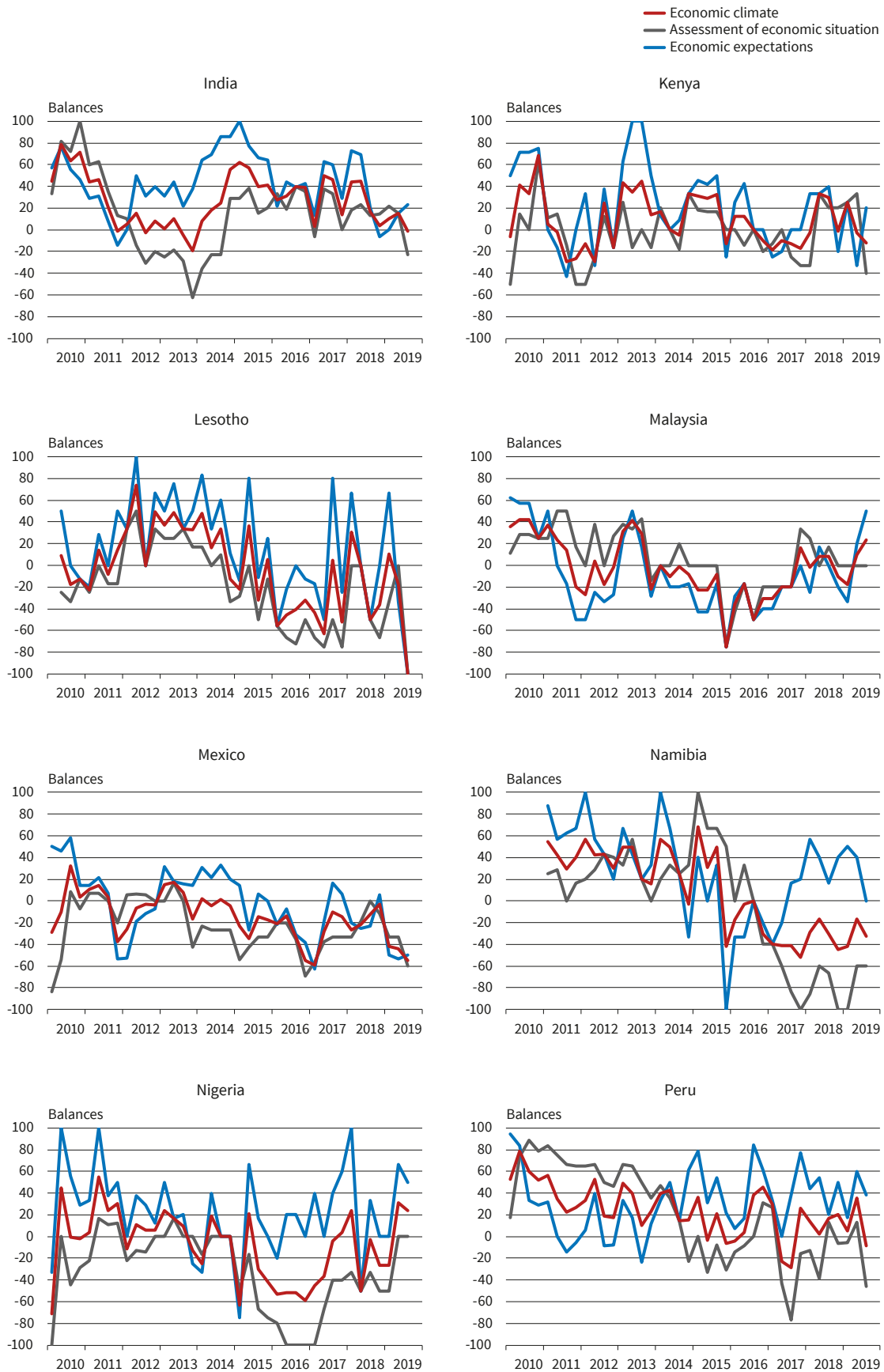
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Figure 12.2

Emerging Markets and Developing Economies

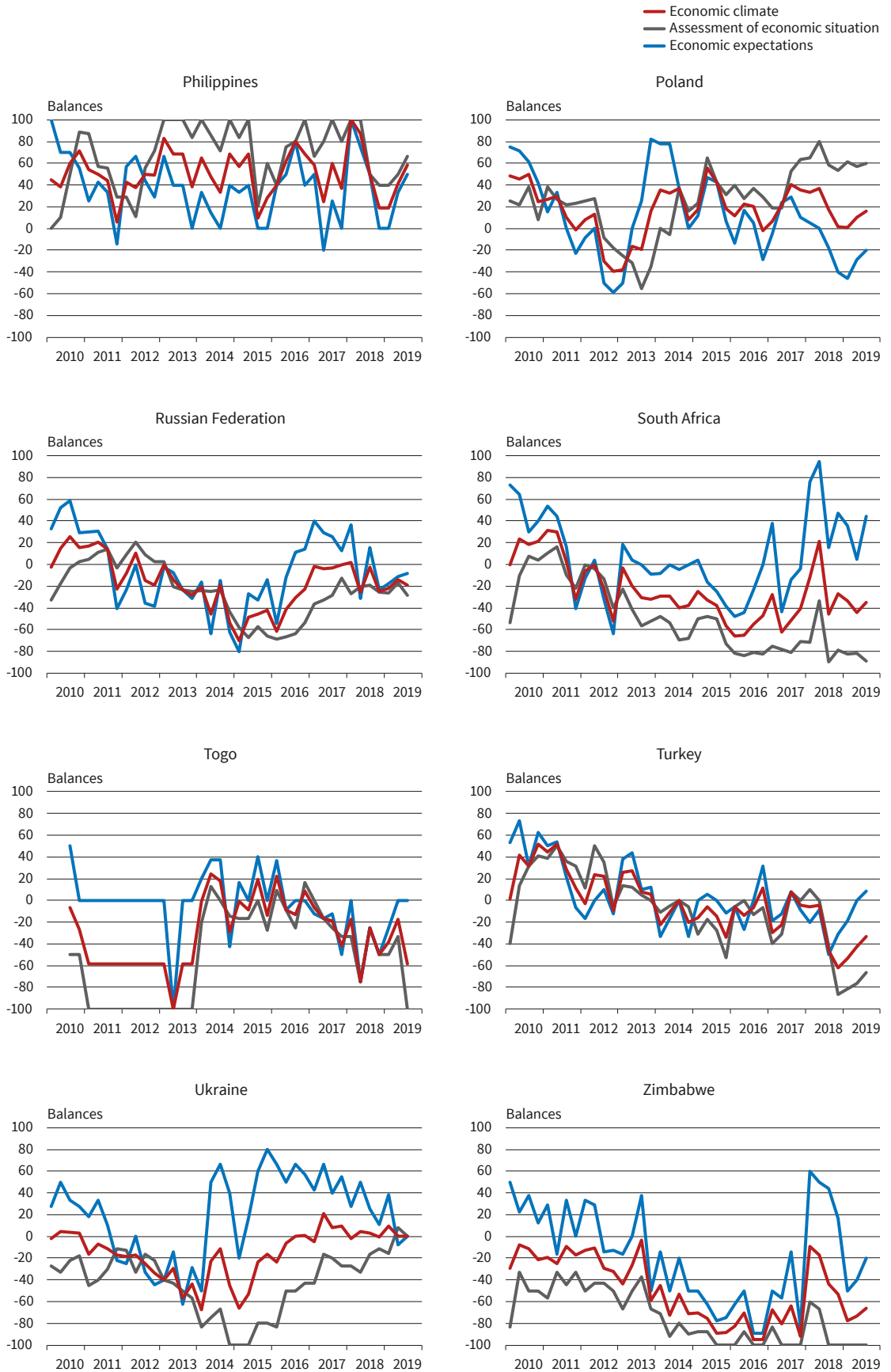


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Figure 12.3

Emerging Markets and Developing Economies



Source: ifo World Economic Survey (WES) III/2019.