**TAKE HOME FINAL – Chapter 12**

**Collaboration on this exam is forbidden.**

**Chapter 12 – Portugal and Eurozone**

**1. Is Portugal a closed economy, a small open economy or a large open economy?**

**2. Based on your answer to #1 and using the appropriate short-run IS-LM model show how a decrease in foreign investment into Portugal would impact the Portuguese economy in the short-run and the long-run.**

**3. Is the Eurozone (as a whole) a closed economy, a small open economy or a large open economy?**

**4. Based on your answer to #3 and using the appropriate short-run IS-LM model show how a decrease in foreign investment into the Eurozone would impact the Eurozone economy in the short-run and the long-run.**

**Chapter 12 – Brazil Downturn**

**1. How would an increase in interest rates by the Central Bank impact the Brazilian economy?**

**2. The article notes the increase in consumer credit in recent years. How does the increase in consumer credit impact the Brazilian economy?**

**3. How do you think the World Cup impacted the Brazilian economy in the short-run and long-run?**

**Chapter 12 – Russian Sanctions**

**1. What type of industries are largest in Russia?**

**2. Suppose the sanctions reduce the imports of intermediate and capital goods into Russia. How would this impact the Russian economy?**

**3. How would a decrease in the Russian ruble impact the Russian economy? How would increased Russian government borrowing impact the Russian economy?**

# **Portugal Isn't Euro Zone's Biggest Problem**

## **What should worry investors is how growth appears to be stalling in some of the euro zone's biggest economies**

By

SIMON NIXON

[**CONNECT**](http://online.wsj.com/articles/portugal-isnt-euro-zones-biggest-problem-1405284767)

July 13, 2014 4:52 p.m. ET

For a few days last week, it was déjà vu all over again.

Fears over the collapse of a Portuguese bank spooked the market. European stock markets fell; bond spreads for euro-zone peripheral countries widened, spreads for core countries tightened; a Spanish bank pulled its bond auction and a Greek government bond issue raised less than hoped.

Ghosts that investors had begun to assume had been finally banished appeared to be haunting the markets again: the fragility of the euro-zone banking system and the risks of contagion.

Some would argue that a market wobble was long overdue. The tide of money that has poured into southern Europe this year has been extraordinary. The markets have been wide open to every government and bank. Even Cyprus has issued bonds and its largest bank is on the road raising equity. The European high-yield bond market is on track for its best year by volume. Regulators have taken to warning that investors may be underestimating the risks still lurking in the euro zone—perverse given that central-bank policies have been explicitly designed to encourage investors to take such risks.

The travails of Banco Espírito Santo may have struck many investors as a good excuse to take money off the table. The Portuguese bank is controlled via a cascade of family-owned holding companies and came under pressure when financial irregularities were uncovered at its ultimate parent, Espírito Santo International SA, a conglomerate with diverse interests all over the world. Not only was the Portuguese bank a lender to these family interests, but it had allowed units higher up the shareholder structure to sell bonds directly to its own customers. The market feared a black hole.

But there are good reasons to believe that BES isn't a serious threat to the financial stability of Portugal, let alone the euro zone. There are other risks that should worry investors more—and may have been a factor in last week's selloff.

The situation at BES looks better contained than initially feared. Its exposure to companies higher up the shareholder structure turns out to be just €1.1 billion ($1.5 billion)—that is manageable in the context of a €100 billion balance sheet and its €7 billion of equity, €2.1 billion above the regulatory minimum. Even if, in a worst-case scenario, BES came under pressure to honor guarantees given by its controlling shareholder to buyers of its bonds, the total exposure would rise by €700 million to €1.8 billion.

The debacle at BES is sure to be painful for the bank's shareholders, many of whom only recently subscribed to a €1 billion capital increase and are already nursing losses on their new shares. The shares have so far lost more than half their value since early June.

Now they face the prospect of not only filling the hole caused by any losses on exposures to the bank's controlling shareholders, but also the prospect of a 25% stake in the bank coming onto the market should the family be forced to sell. If they refuse to put up money, the government still has €6 billion of its bailout money earmarked for bank recapitalizations available to fill any shortfall, threatening shareholders with even deeper dilution.

But there is no reason so far why BES's problems should cause longer-term difficulties for Portugal beyond any short-term knock to confidence. The country is already seeing the benefits of a far-reaching reform program; growth this year is expected to be above the euro-zone average at 1.2%, rising to 1.5% next year. Unemployment has fallen for seven consecutive quarters to 14.3% from a peak of 17.5%, which has helped fuel a recovery in domestic demand.

Despite BES's problems, growth should be supported by a healthier banking system. Portugal's second-largest listed lender, [Millennium BCP](http://quotes.wsj.com/PT/BCP), [BCP.LB +4.88%](http://quotes.wsj.com/PT/BCP) is raising €2.25 billion of new equity via a fully underwritten rights issue. The Portuguese banking system should also be the beneficiary of a new European Central Bank long-term cheap-funding facility announced in June.

What should worry investors is less Portugal but the fact that growth appears to be stalling in some of the euro zone's biggest economies.

The latest surveys point to manufacturing having contracted in June in Germany, France and Italy. Some of this may be explained by one-off factors, including weather disruptions and the timing of public holidays. The crisis in Ukraine also appears to have hit German exports.

The real disappointment has been in the weakness of the recovery in the new sick men of Europe: France and Italy, both of which have been slow to deliver the reforms that have been boosting productivity and competitiveness elsewhere in the euro zone. Whereas J.P. Morgan last week raised its growth forecast for Spain for this year to 1.5%, reflecting the success of its structural reforms, it downgraded its forecast for Italy to 0%.

Given the size of Italy's economy and the scale of its public debt—at 133% of gross domestic product—its lack of growth remains the single biggest threat to the stability of the euro zone. Yet to the concern of many policy makers and investors, Prime Minister Matteo Renzi appears to be spending the most political capital seeking changes to euro-zone fiscal rules to allow Italy to borrow more, rather than pushing through reforms that might boost Italy's growth prospects.

When Mr. Renzi took office in February, he announced an ambitious 100-day program to change Italy. Having failed so far to deliver on any of his goals, he has now given himself a new deadline of 1,000 days. Yet the only substantial reform that now looks likely to be achieved this year is an overhaul of the electoral rules and the Senate—reforms of totemic significance to the Italian political class but of zero economic consequence.

Far-reaching reforms of the public administration, judicial system, government spending and labor market have been promised but details remain scarce and timing unclear.

Until Mr. Renzi proves he can live up to his own domestic reforming rhetoric, investors should brace themselves for more wobbly weeks like the last one.

**Write to**Simon Nixon at simon.nixon@wsj.com

## [**LATIN AMERICA NEWS**](http://online.wsj.com/public/search?article-doc-type=%7BLatin+America+News%7D&HEADER_TEXT=latin+america+news)

# **Brazil's Economy Seen in a Major Downturn**

## **New Data Suggest Growth Weakened Over Past Two Quarters**

By

PAULO TREVISANI in Brasilia and

LORETTA CHAO in São Paulo

[**CONNECT**](http://online.wsj.com/news/articles/SB10001424052702304703804579383274090741140)

Feb. 14, 2014 8:11 p.m. ET

Brazilian data released Friday suggest economic growth has weakened over the past two quarters, illustrating how far a country once considered the darling of emerging-market investors has fallen.

The central bank's economic activity index fell 1.35% in December from November, dented by a drop in industrial production and weak retail sales. Economists say the data mean the government is likely to declare that economic growth declined in the year's last quarter after contracting 0.5% in the third period, suggesting the country had entered a technical recession.

Although preliminary data suggest the economy will grow again in the first quarter, a dip into a recession would be a major turnaround for an economy that grew 7.5% in 2010. As China's growth has slowed and prices for commodities like the soy and iron ore that Brazil exports have cooled down, the country has found itself without an external engine for its economy.

Brazil's economic performance today is a far cry from its emerging-market peers China and India, which are still growing strongly despite their slowdowns. The collective cooling of the markets has been an unexpected setback for many, particularly consumer companies that invested heavily in these countries in recent years, relying on them as a cushion as demand slowed in developed markets.



Economists now expect Brazil's economy to grow as little as 1.5% this year, less than the 2.3% estimated growth for 2013.

The contraction comes as President Dilma Rousseff gears up for a re-election year amid challenging economic conditions at home and abroad. Mass street protests over rising prices and poor public services racked the country in June and have continued on a smaller scale in the largest cities as the country is struggling with preparations to host the soccer World Cup this year.

"My company laid off 12 people last month. We're almost closing our doors. A lot of stores here have already closed because people can't make rent," said Angela Marques, 39, manager of an electronics wholesaler in downtown Rio de Janeiro. She isn't hopeful that the World Cup will turn things around.

Ms. Rousseff's popularity has rebounded after falling sharply during the protests, which were sparked by a decision to raise bus fares. But the slowdown adds pressure on her administration, which won popularity by continuing her predecessor's policies, including expanding social welfare and granting billions of dollars in loans through government banks, fueling consumption.

Consumption remains a growth driver, but even so, retail sales grew only 4% in 2013 from 2012. That is the worst performance since 2003, leading economists to believe Brazil will no longer be able to depend on consumption to drive growth.

Geraldo Mello, manager of a large mall in Brasilia called Brasilia Shopping, said sales grew 20% to 35% each year until 2008, but only 10% last year.

Consumers "accumulated debt with mortgages, new cars and other items and now their budget is tight.…They are insecure about the future, so they hold off on spending," Mr. Mello said.

Investments are expected to disappoint as well. A recent survey by Brazil's National Confederation of Industry showed that private investment intentions have fallen to the lowest level since 2010.

Meanwhile, government investment will be limited as Brasilia comes under pressure to cut spending and Brazilian banks tighten lending after a credit expansion in the past decade.

"Brazil will struggle to see growth of 2% this year," said Robert Wood, a Brazil-focused economist with Economist Intelligence Unit in New York. "Consumption will be less of a driver for growth and there are no signs that investment is picking up."

Bruno Roval, a São Paulo-based economist at [Barclays](http://quotes.wsj.com/UK/BARC), [BARC.LN +1.08%](http://quotes.wsj.com/UK/BARC) said the latest data make it likely he will lower his outlook. "The negative influence will be carried over into 2014. We were expecting a GDP expansion of 1.9% But there is a real chance we will revise that downwards after the GDP results for 2013 and the fourth quarter are released at the end of February," he said.

Industry has been one of the weakest points of the economy in recent years as output has stagnated, and Brazilian manufacturers have struggled to compete with international rivals.

"The ongoing situation in Argentina may have a substantial impact on Brazilian industry, as over three-quarters of Brazilian exports to Argentina are manufactured goods," said economists at Nomura Securities in a note.

The silver lining for Brazil is that unemployment rates remain at record lows and wages are growing. Unemployment in six of Brazil's largest metropolitan areas dropped to an average of 5.4% in 2013, from 5.5% in 2012, according to the Brazilian Institute of Geography and Statistics. Average monthly wages rose 1.8% in real terms.

But persistently high inflation continues to squeeze Brazilian consumers. Last week, Brazil said annual inflation in January was 5.59%, above the central bank's target of 4.5. As a result, the central bank has gradually raise interest rates, a move that could slow growth even more. The central bank has raised its base interest rate to 10.5% from 7.25% in the past year.

"The main problem I see is not a cooling of the economy," said Davi Alves, 24, the sous-chef of a high-end restaurant in São Paulo. "The problem I see is of high prices. Everything, from cars to homes, is expensive."

—Rogerio Jelmayer, Paul Kiernan and Matthew Cowley contributed to this article.

**Write to**Paulo Trevisani at paulo.trevisani@wsj.com and Loretta Chao atloretta.chao@wsj.com

## [**EUROPE NEWS**](http://online.wsj.com/public/search?article-doc-type=%7BEurope+News%7D&HEADER_TEXT=europe+news)

# **Europe, U.S. Significantly Expand Sanctions Against Russian Economy**

## **Many Western Officials Don't Expect Putin to Withdraw Support of Pro-Russia Rebels in Ukraine**

By

MARCUS WALKER in Berlin,

MATTHEW DALTON in Brussels and

CAROL E. LEE in Washington

[**CONNECT**](http://online.wsj.com/articles/europe-u-s-significantly-expand-sanctions-against-russian-economy-1406666111)

Updated July 29, 2014 11:15 p.m. ET

The U.S. and the European Union adopted sweeping economic sanctions against Russia on Tuesday to punish Moscow's unbending stance in the Ukraine conflict.

The question for the West now is whether the move will make Russian President[Vladimir Putin](http://topics.wsj.com/person/P/Vladimir-Putin/6409) more cooperative or prompt him to dig in.

The trade and investment restrictions that EU governments, after much agonizing, agreed upon mark a major escalation of sanctions against Russia, which so far have been mostly token measures targeting individuals. New measures hitting Russia's banks, oil industry and military could increase financial strains in its already sluggish economy while withholding technology that the nation's modernization relies on.

The U.S. followed the EU's move by announcing similar sanctions against Russian banks as well as the energy, arms and shipping sectors. President [Barack Obama](http://topics.wsj.com/person/O/Barack-Obama/4328)hailed Europe's adoption of its most significant sanctions yet against Moscow, saying the U.S. and EU steps would have "bigger bite."

The rift with Russia is "not a new Cold War," Mr. Obama said Tuesday. "What it is is a very specific issue related to Russia's unwillingness to recognize that Ukraine can chart its own path," he said.

A number of Western companies are bracing for the sanctions' impact. [BPBP.LN +0.29%](http://quotes.wsj.com/UK/BP.) PLC said ahead of the sanctions announcement that new measures could have an "adverse impact on…our business and strategic objectives in Russia and our financial position and results of operations." [Bank of America](http://quotes.wsj.com/BAC) Corp. [BAC +0.24%](http://quotes.wsj.com/BAC) said it had cut its exposure to Russia by 40% to $3.94 billion since the end of December in anticipation of further geopolitical tension sparked by "Russian intervention in Ukraine."

Some Western officials say they don't expect Mr. Putin to withdraw his support for pro-Russia rebels, who are widely suspected of having shot down a [Malaysia Airlines3786.KU +1.96%](http://quotes.wsj.com/MY/MAS) jetliner over eastern Ukraine on July 17 and who are under growing military pressure from Ukrainian government forces. Russia and the rebels deny involvement in the downing of the plane.

EU governments are aiming to make clear to Mr. Putin's inner circle the costs of continuing to destabilize Ukraine. Though European officials say they don't expect the Kremlin to make a quick about-face, they hope a tightening economic squeeze will dissuade Mr. Putin from escalating the conflict, and will eventually push him and the rebels to the negotiating table.

A big concern is that Russia's leadership is too invested in the outcome in Ukraine, which it views as being within its rightful sphere of influence, to let the rebellion fail—even if the cost is recession in Russia.



Russian public support for Mr. Putin has surged since Moscow intervened in Ukraine, annexing Crimea and, Western governments say, arming the rebellion in Ukraine's east. The Kremlin denies giving the rebels more than moral support.

Opinion polls show Russians are less worried now about international economic sanctions than they were at the start of the Ukraine crisis. That suggests the expected economic fallout from Russia's growing isolation may not be an immediate political problem for the Kremlin.

The EU's monthslong effort to find a way to influence Russian policy in Ukraine has been hampered by the divergent economic interests of Western Europe's major nations, which stand to lose in differing ways from embargoes against Russia. The U.S. has tried to move in lock step with Europe, while encouraging EU governments to go beyond their limited previous measures.

The new package of measures reflects what governments in Berlin, Paris, London and elsewhere were able to agree on, rather than just a calculation of how to sway Mr. Putin. An EU compromise that targeted some business dealings with Russia while sparing others was designed to spread and limit the sacrifices among the bloc's 28 countries.

The U.K., although a strong supporter of sanctions, was worried that rich Russians and their companies could turn away from its financial center in London. France wanted to protect its contract to deliver two warships worth more than $1.5 billion to Russia. Germany sought to preserve its business selling advanced equipment to Russia's energy sector.

Tuesday's deal seeks to dampen the impact of sanctions in Europe's economy, much of which is still in a fragile recovery from the global financial crisis, by excluding existing contracts. That means France could still sell at least one ship to Russia, while German engineering firms could continue supplying Russian energy giants OAO[Rosneft](http://quotes.wsj.com/RU/ROSN) [ROSN.MZ +1.96%](http://quotes.wsj.com/RU/ROSN) and OAO [Gazprom](http://quotes.wsj.com/OGZPY), [OGZPY +2.03%](http://quotes.wsj.com/OGZPY) at least in the short term.

Russia's main economic role in Europe—as a supplier of natural gas—is so important to both sides that it is likely to continue, unless vital pipeline links fall victim to an escalation of the war in Ukraine.

Details of the EU sanctions are expected to be published Thursday and the measures are supposed to kick in on Friday.

With the steps announced Tuesday, the U.S. now has sanctioned five out of Russia's six largest state banks. But the penalties are nuanced, stopping short of total bans on doing business that Washington imposed on Iranian banks and instead blocking the ability of the institutions from obtaining medium and long-term debt.

Similarly, the U.S. took steps to penalize Russia's energy sector by restricting the export of technology that could be used to expand Russia's deep-water, Arctic offshore or shale oil production. But administration officials said the restrictions were designed to avoid affecting current energy production capabilities.

The sanctions may well hit hardest in the financial sector, meaning that the U.K. could pay for its hawkish line by absorbing more of the pain. "Given the bulk of the new measures focuses on finance, there is going to be a disproportionate impact this round on the British and the City of London," said Mujtaba Rahman, analyst at London-based political-risk consultancy Eurasia Group.

The financial sanctions would sharply restrict the ability of Russia's state-controlled banks, such as [Sberbank](http://quotes.wsj.com/RU/SBER) [SBER.MZ +2.03%](http://quotes.wsj.com/RU/SBER) and [VTB](http://quotes.wsj.com/RU/VTBR) [VTBR.MZ +2.09%](http://quotes.wsj.com/RU/VTBR) Group, to raise capital on European markets, EU officials said. A ban on selling equity and most kinds of debt to EU investors could create major headaches for the banks, which have large debts denominated in foreign currencies. Analysts at Citibank said VTB appears to be the most vulnerable bank, since it relies heavily on bond markets for funding.

The restrictions could push banks to seek funding from the Russian government or central bank, economists said. That could present Moscow with the unattractive options of drawing down its large foreign-currency reserves, worth about $500 billion, or letting the ruble fall sharply, which could add to inflation.

German Chancellor [Angela Merkel](http://topics.wsj.com/person/M/Angela-Merkel/5351) said Tuesday's move was "unavoidable" given what she described as Russia's continued destabilization of eastern Ukraine. "It is now up to the Russian leadership to decide whether it wants to take the path of de-escalation and cooperation," Ms. Merkel said. "The EU's sanctions can be reviewed, but additional steps are also possible."

As Moscow returned to the forefront of concern in Washington, U.S. lawmakers moved toward approval of a new American ambassador to Russia. The Senate Foreign Relations Committee voted Tuesday to approve Mr. Obama's nomination of John Tefft, who was previously ambassador to Ukraine, Georgia and Lithuania. The full Senate is expected to act soon.

Mr. Obama accused Russia of transferring military equipment to the rebels, massing troops at the border with Ukraine and firing artillery into Ukraine. He said Russia would achieve more influence in Ukraine by being a "good neighbor."

Asked whether the U.S. is considering military assistance to Ukraine, Mr. Obama said Ukraine's forces are better armed than the separatists. "The issue is how do we prevent bloodshed in eastern Ukraine…and the main tool that we have to influence Russian behavior at this point is the impact it's having on its economy," he said.

Economic growth in Russia is already stalled, and Russian and foreign investors have been pulling money out of the country. If markets see the new round of sanctions as a signal that Russia's economy is increasingly off limits, and that further measures may follow, it could have a chilling effect on financial and other business dealings with the country, analysts said.

"Unless you've got a very high tolerance for risk, no one is going into Russia," said Neil Dooley, an attorney at Steptoe & Johnson in London who advises companies on Russian sanctions issues.

The International Monetary Fund last week cut its growth forecast for Russia's economy this year to 0.2%. A year ago, the IMF expected Russia to grow by 3.8% in 2014. The gathering chill in Russia's international ties means "Russia's already weak growth could become clearly negative," said Adam Slater, senior economist at U.K.-based consultancy Oxford Economics.

Despite the growing economic squeeze on Russia—with its unpredictable fallout for the EU's own markets, trade and growth—many EU officials believe they have only limited influence over the Kremlin.

Some EU officials voiced fears on Tuesday that Mr. Putin appears to be preparing Russians for international isolation. In Russia too, analysts said Mr. Putin was more likely to increase aid to the rebels in Ukraine in response to Kiev's military offensive than he was to back down.

"There are no signs that we will soon get another chance to find a political solution" to the Ukraine conflict, said Gernot Erler, the German government's coordinator for Eastern European issues. The governments in Moscow and Kiev are both "digging in," he said.

"We've no longer heard any reasonable signals from Moscow" since the downing of Malaysia Airlines Flight 17, Mr. Erler said.

—Gregory L. White, Laurence Norman and Anton Troianovski contributed to this article.

**Write to**Marcus Walker at marcus.walker@wsj.com, Matthew Dalton atMatthew.Dalton@wsj.com and Carol E. Lee at carol.lee@wsj.com