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1

Key developments

1.1 Industrialised economies and Euro Area struggling with stagnation

The economic development in the EU and in the Euro Area in particular has been very dismal after the peak in production before the Great Recession. The upturn from the trough of the Recession was initially relatively fast, but economic development subsequently stagnated. In fact, the Euro Area has been in a recession since the third quarter of 2011. While the growth stayed at 0.1 (q/q) per cent in that quarter and at 0 per cent in the first quarter of 2012, all other quarterly growth rates were negative. The growth rates in the last quarter of 2012 were negative in all EU countries except Poland, Romania, Slovakia, Lithuania, Estonia and Latvia.

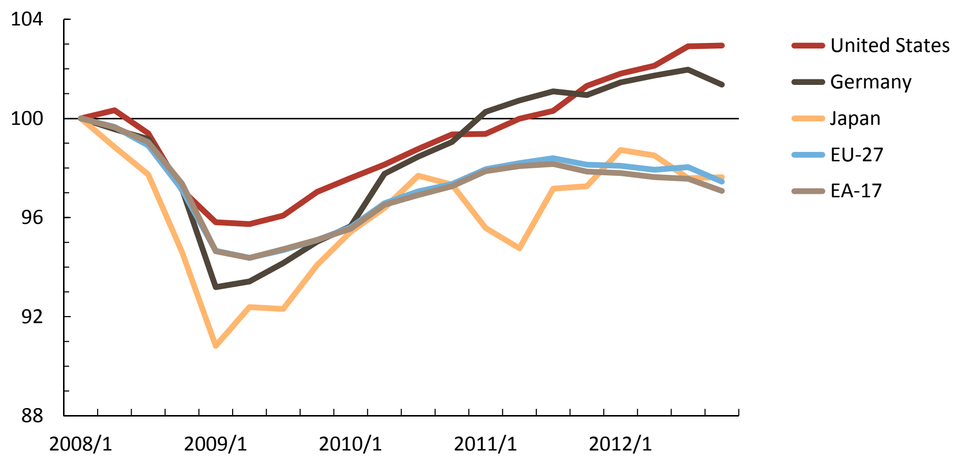
As a result, the EU and the Euro Area GDP was 2.6 and 2.9 per cent lower, respectively, in the fourth quarter of last year than in the first quarter of 2008.

While the general picture is a long-lasting recession, there are wide differences across the member states of the EU and Euro Area. The development in Greece has been the weakest. The GDP in the fourth quarter of 2012 was 21.5 per cent lower than in the first quarter of 2008. Correspondingly, the total output in Spain, Finland, Ireland, Hungary, Italy, Portugal and Slovenia has stayed well below that of the first quarter 2008, which in the most countries was also the quarter with peak production.

Production in six countries had by the last quarter of 2012 climbed above that prevailing in the first quarter of 2008. Poland is leading this race clearly by 13.9 per cent growth before the Slovak Republic (6.9%), Sweden (5.3 %) and Germany (1.4 %), Austria (1.1 %) and Belgium (0.4 %). The expansion in the other countries in the EU was modest. The GDP in the two AIECE countries Norway and Switzerland, which are not members of the EU, was 3.6 and 4.7 per cent higher than in the last quarter of 2012 than in the first quarter of 2008.

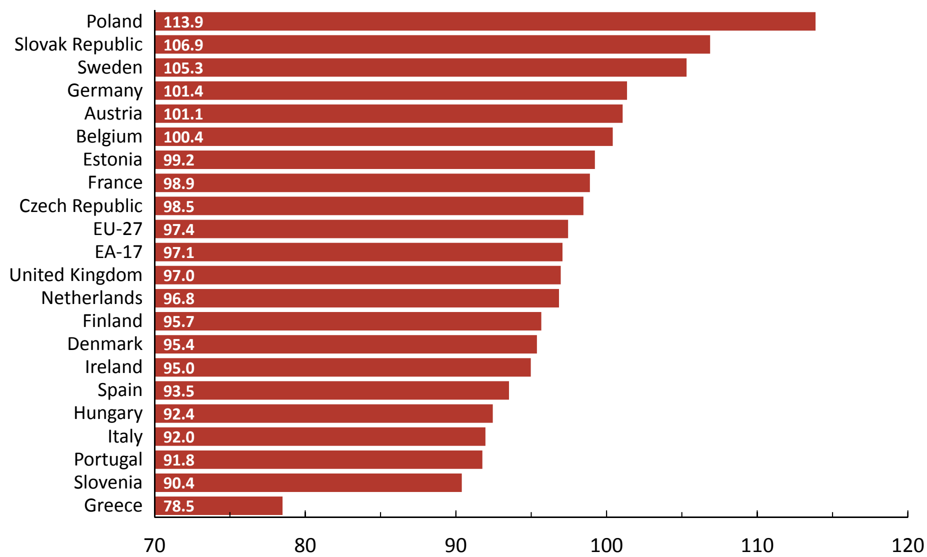
The European growth has been weak also in the international comparison, even among industrialised countries. In the end of 2012, the Japanese production recorded "only" 2.5 per cent lower production than in the previous peak, although Japan had gone

Figure 1.1
Quarterly profile of GDP in selected countries since the first quarter of 2008



Sources: OECD, ETLA.

Figure 1.2
GDP in the fourth quarter of 2012 per GDP in the first quarter of 2008 in EU countries, %



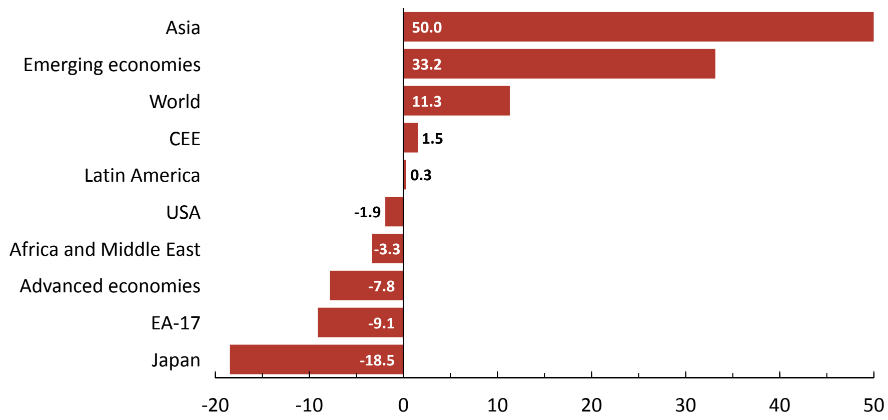
Sources: OECD, ETLA.

through a triple catastrophe with a record strong earth quake, massive tsunami and a very bad nuclear accident. The production in the EU-27 was 2.6 per cent higher. There is no quarterly seasonally adjusted comparable data on GDP, but in in emerging economies, emerging Asia and in the dominant China the yearly comparision of the total output in 2012 was 31, 45 and 56 per cent higher than in 2007.

European countries have fared even worse if the industrial developments are compared across the global regions and major economies. Industrial production in Asian emerging economies, in emerging economies and in the world on average was up by 50.3, 33.2 and 10.7 per cent between December 2012 and the previous peak production month

Figure 1.3

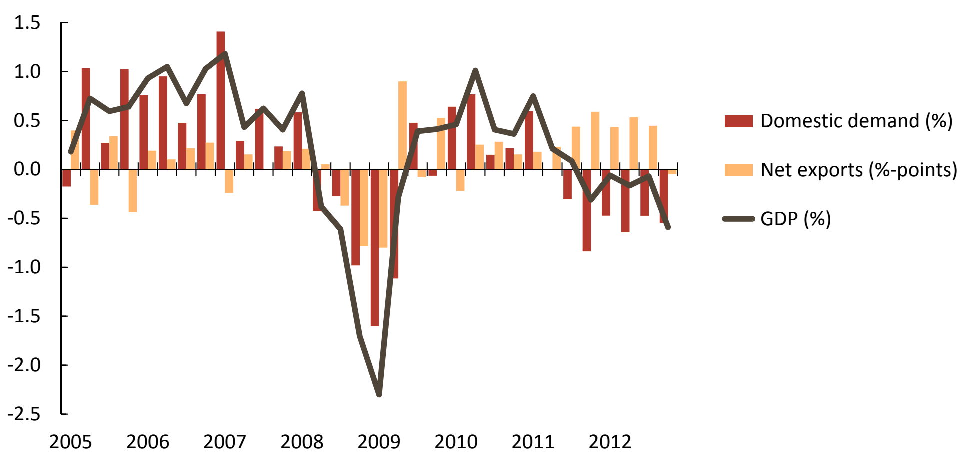
A change in industrial production in December 2012 from previous peak* before great recession in winter 2008–2009, %



* Peak month varies.
Sources: BEA, ETLA.

Figure 1.4

The Euro Area domestic demand and net trade contributions to the GDP



Sources: Eurostat, ETLA.

before the Great Recession. Among industrialised countries, the industrial growth has been lower than the Euro Area growth only in Japan, where triple disaster-related damages and power problems have stagnated production. The Euro Area industrial production was 12.7 per cent lower in December 2012 and 10.6 per cent lower in February 2013 than in the previous peak in April 2008. In Japan and in industrialised countries on average, the industrial production was 18.6 and 8.9 per cent lower, respectively, than the previous peak production. In contrast, the US decline was only 2 per cent.

Obviously, the strongly differing trends in total output and in industrial production in particular reflect the changed role of emerging economies and especially China in the global division of labour. The emergence of low labour cost competition has obviously had a strong effect on localisation and growth patterns of the labour intensive industries across the industrial economies and the Euro Area in particular. Long-lasting "de-industrialization" has continued to be strong in the 2000s. In terms of employment, the share of industry including construction in total employment has declined from 26.8 per cent in 2000 to 24.7 per cent in 2007 and to 22.2 per cent in 2012.

Questions:

Q1 What is your opinion on the strong change in the role of Euro Area in global production?

Q2 Do you see strong scars in the AIECE economies in terms of
a) the level of potential output?
b) the growth of potential output?

1.2 Inflation is under control

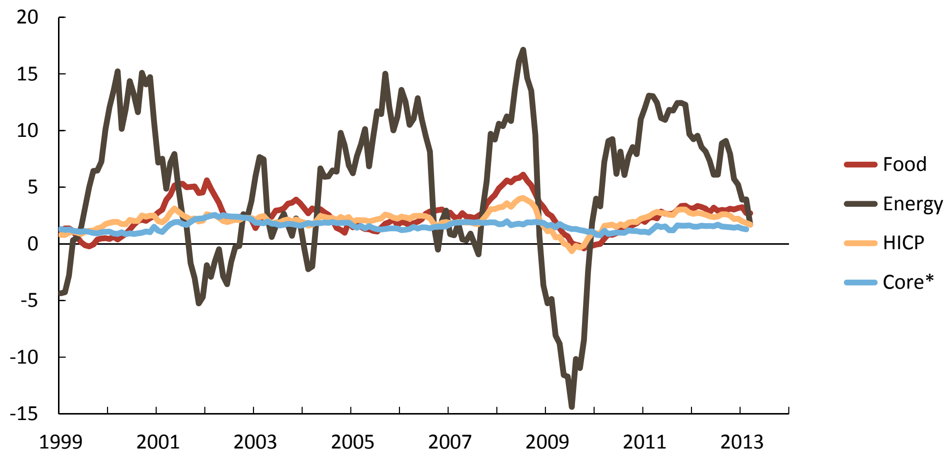
Euro Area inflation on average and across the countries has fluctuated strongly in recent years due to very volatile commodity prices. In addition to commodity price effects, the headline price level has been shifted upwards by increases of taxes and administrative prices to help governments finance their budgets during the recession.

Crude oil prices have had the largest impact due to the importance of energy and very large swings in prices. However, food prices have contributed to changes in inflation also due to large price hikes of food, alcohol and tobacco with the share of 19 per cent in the consumption basket.

As indicated by an adjoining chart, the commodity price influences are from time to time very large, but the effects have been later dissipated. Even though commodity prices have risen many-fold since the early 2000s, the effect on inflation has been only temporary as much-feared second round effects have not been significant. In the absence of second round effects, the base effect would smooth one-off price rises like in cases of taxes and administrative prices. Likewise large continuous contributions of energy to HICP changes would require large continuous changes in energy prices.

Domestic unit labour costs, or labour costs adjusted for labour productivity, on the other hand, have shown divergent trends in different Euro Area countries. They have risen in Germany, France, Italy, and Finland, but declined strongly in Spain, Greece, Ireland and Portugal since the onset of the Great Recession in winter 2008–2009. The decreasing unit labour costs in many Euro Area countries reflect the crisis in sovereign finance and the need for a major rebalancing in the affected economies. The very difficult recession

Figure 1.5
Inflation in Euro Area, %



* Excl. energy, food, alcohol and tobacco.
Source: Eurostat.

has entailed rapidly declining total output and even more rapidly declining wages and employment. This has allowed relative cost levels to approach a more competitive level.

Core inflation (inflation less energy, food and tobacco) has been well under control and it has hovered around 1.5 per cent in the Euro Area since spring 2009. In March 2013 it was 1.5 per cent.

Question:

Q1 Why many-fold rise in commodity prices, and especially oil prices has not feeded into core inflation?

1.3 Labour market struggles with very high unemployment

The recovery of employment and total output continued in 2012 in industrialised countries, but divergent trends between the economic areas continued ass the downturn in the Euro Area deepened. The average OECD employment improved by one per cent as in the 2011.

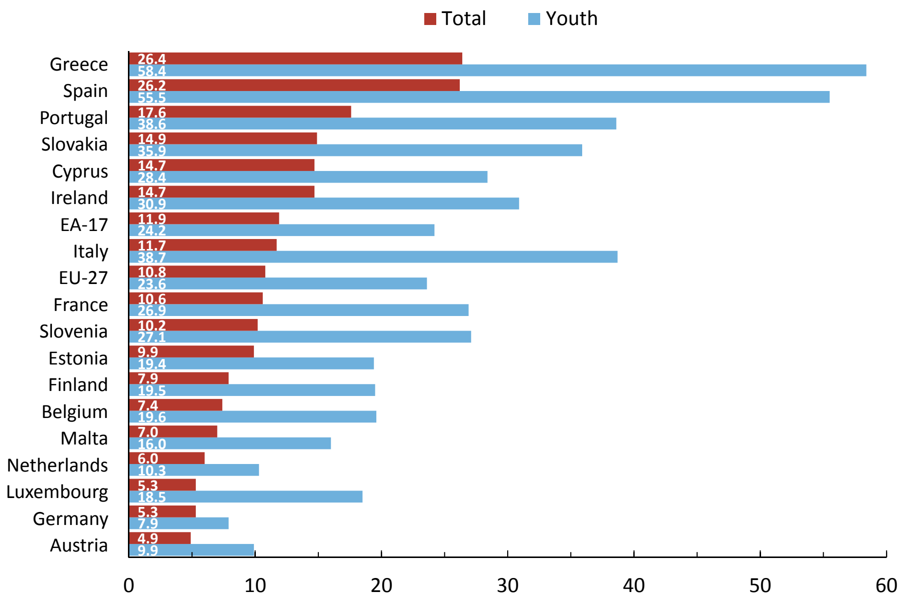
The employment in the Euro Area decreased last year by 0.7 per cent. In the other EU countries the slow improvement of employment continued with the rate of 0.2 per cent on average. In the U.K. and Sweden employment rose like in the OECD countries by one per cent.

In the Euro Area, the employment trends continued their divergence. In the crisis countries (Italy, Spain, Portugal, Greece and Ireland) the employment diminished close to three per cent last year. The employment shrank most in Greece, where eight per cent of vacancies was lost. In the other Euro countries save the crisis countries, employment rose by 0.6 per cent on average. The strongest growth was seen in Germany and Austria.

The weakened employment possibilities of enterprises and public sector have affected to the structure of employment. Labour-cost saving jobs became more general. In particular, the part-time work came more popular. In the Euro Area part-time vacancies rose by 2 per cent and the share of part-time work of total employment rose last year by 0.6 percentage points to 20.9 per cent.

Figure 1.6a

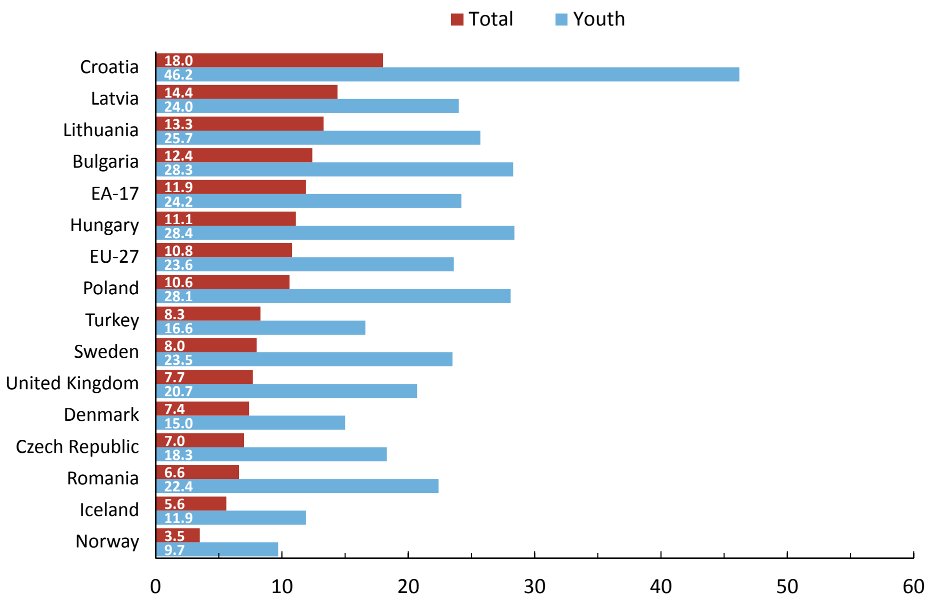
Unemployment rates in the Euro Area, January 2013, %



Sources: Eurostat, ETLA.

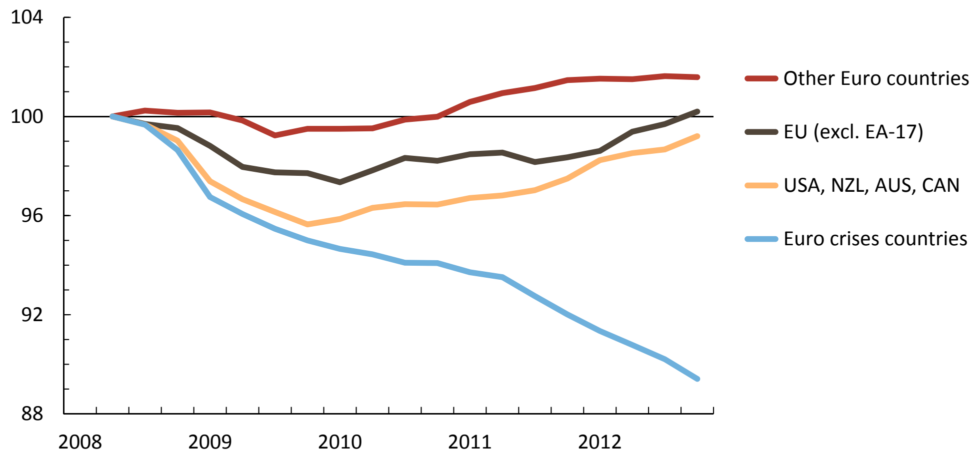
Figure 1.6b

Unemployment rates in non-Euro Area countries, January 2013, %



Sources: Eurostat, ETLA.

Figure 1.7
Employment development in different economic zones, index, 2008/2=100



Source: OECD, Short-Term Labour Market Statistics.

Industry and construction were the biggest losers by activities in the Euro Area employment. The jobs provided by the main industries decreased by 1.6 per cent in 2012. In the Euro Area, jobs declined by a bit over 2 per cent on average, while the decrease in the crisis countries was no less than 6 per cent.

The EU employment in the service sector was unchanged in 2012, but in the crisis countries it decreased by 1.5 per cent.

A break in the growth of employment and the rather rapid rise in the supply of labour increased the EU unemployment rate by 0.6 percentage points to 10.2 per cent and the Euro Area rate by 1.2 per cent to 11 per cent in 2012. In February 2013 the unemployment rates in the EU and in the Euro Area were 10.9 and 12 per cent. The youth unemployment rates rose up to 23.5 and 23.8 per cent, respectively.

The growth of unemployment in the Euro Area results mainly from the weak development in the crisis countries. In the countries, which were not hit directly by the crisis, the unemployment rates were unchanged in 2012 in 7 per cent. Instead the growth of unemployment rates in the crisis countries accelerated by 2.7 percentage points to 16.2 per cent.

The share of long-term unemployed (continuous unemployment, which lasts more than one year) of the labour force, rose by 0.5 percentage points to 4.7 per cent in the EU. The rate in the Euro Area rose a bit faster (0.7 %-points) to 5.7 per cent. In the crisis countries, the long-term unemployment rate jumped by almost 2 percentage points to 8.7 per cent.

The rise of labour costs continued rather rapidly in 2012, although the Area was in recession. The unit costs in the non-crisis Euro Area countries, the costs rose 2.7 per cent, while the costs declined by 0.5 per cent in the crisis countries. The competitiveness of the crisis counties has improved with this measure by 11 per cent in 2008–2012.

1.4 Public sectors in consolidation

Public deficits in industrialised countries continued shrinking in 2012. According to the recent estimate by the OECD, the deficits in relation to GDP decreased last year by one percentage point to 5.5 per cent. In the EU the deficits decreased much less as the balancing of budgets ceased in the crisis countries.

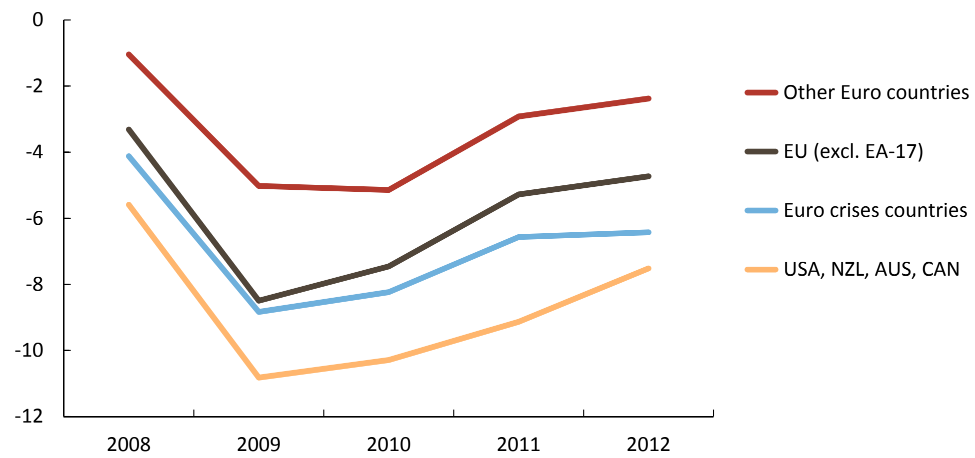
Incurring of public debt rose markedly in OECD counties in 2012 by 5 percentage points to 110 per cent in relation to GDP. The growth of the debt ratio in the EU rose by 3 percentage points to 85 per cent. The Euro Area crisis countries raised their debt by 9 percentage points to 115 per cent.

The settings of fiscal policies differ clearly by the OECD countries. In countries with stronger-than-average growth and good credit ratings like in the US, the automatic stabilizers are allowed to function quite freely. In contrast, the countries in sovereign debt crisis with high risk premiums continued very strict fiscal policies.

The strength of the fiscal policy is clearly visible in changes of revenues and outlays in the primary balance. In the Euro Area crisis countries, the conditions of the rescue packages forced to raise the tax rates and to reduce the GDP share of public sectors. The primary deficit in these countries (net lending excluding interest expenditure) decreased by 2.7 percentage points to 1.9 per cent (See table 1.1). The primary deficit declined as the tax rate rose by 1.2 percentage points and the expenditure in relation to GDP shrank by 1.4 percentage points. The tightness of the policies is stressedby their adoption in the middle of a deep recession.

Countries with a good credit rating were also bound to tighten their fiscal policies by obstructing the rise of public expenditure by adopting co-called solidarity taxes, reducing tax deductions and rising commodity taxes (Germany, Denmark, Belgium, and Finland). In these non-crisis Euro Area countries the primary deficit declined in two years by 2.8 percentage points to a slim surplus in 2012. A decline in the primary deficit was contributed by a 1.4 percentage points rise in the gross tax rate and by a 0.5 percentage

Figure 1.8
Net lending per GDP in different zones, %



Sources: Eurostat, OECD database.

Table 1.1
Primary balances in the EU countries, % of GDP

	2010	2011	2012	2010–2012 percentage change
Euro crises countries	-4.6	-2.4	-1.9	2.7
Other Euro countries	-2.7	-0.4	0.1	2.8
EU countries (excl. Euro Area)	-5.0	-2.6	-2.3	2.7
EU-27	-3.8	-1.1	-0.6	3.2

Source: Eurostat database.

points decline in the expenditure share, measured as a share of the GDP. The deficit was diminishing 0.8 percentage points for other reasons , like a decline in the bank subsidies in Germany and in the Netherlands.

The primary deficits of the Euro Area crisis countries have declined markedly due to tight fiscal policies, but the fiscal balances including interest expenditure – used in the Excessive Deficit Procedures, EDP – is developing more modestly. The EDP deficit in relation to GDP declined in 2011–2012 by 1.8 percentage points to 2.8 per cent in the crisis countries, i.e., one percentage point more slowly than the primary deficit. In the countries with better credit ratings the EDP deficit diminished by 2.8 percentage points, as fast as the primary deficit.

The different speed of adjustments was affected by a faster growth of debt in the crisis countries and higher costs of debt service. In 2012, the effective interest expenditure was 3.9 per cent in the crisis countries. In Euro Area countries with good credit ratings, the respective cost was 3.1 per cent.

1.5 External balance

The current account for the whole Euro area has on average been quite close to balance in the 2000s. In the year 2000 there was a deficit which was around 0.4 per cent of GDP. Also in 2008 there was a deficit, which was 0.6 per cent of GDP for Euro Area 12 countries, and 0.7 per cent of GDP for Euro Area 17 countries. In all other years there has been a surplus. In 2012 the Euro Area current account was largest at 1.8 per cent of GDP for Euro Area 17 countries. The EU-27 countries show a weaker current account with a biggest surplus of 1 per cent of GDP in 2012 as well.

The development of the current account is dominated by the development of the balance of goods and services in some countries like in Finland, France and Norway. In Germany and Belgium the current account does not go directly hand in hand with the balance of goods and services, but mainly follows the same pattern. Also in Italy, Spain, Ireland and Hungary the development of the current account is to a large extent determined by the development of the balance of goods and services, but the negative balance of income and current transfers play also an important role. In Serbia the situation is the other way round, balance of income and current transfers is positive.

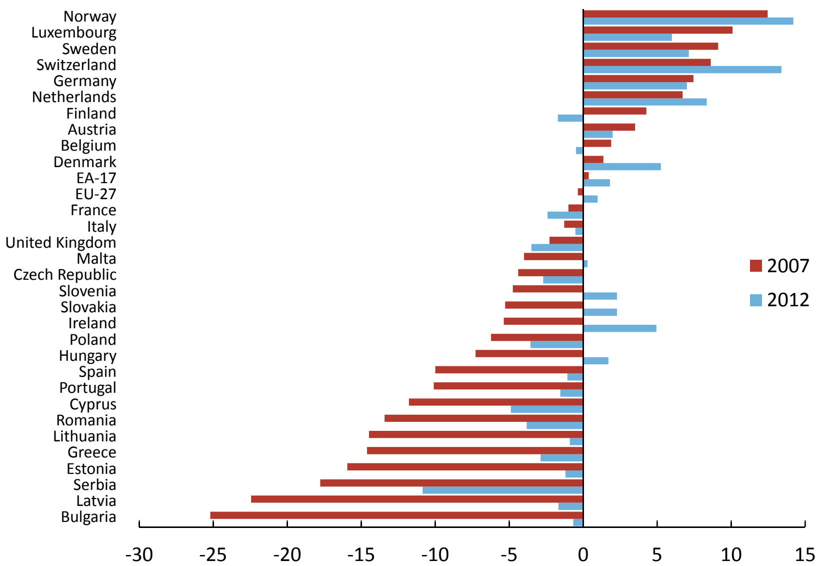
In the Netherlands the current account surplus was around 8 per cent of GDP during the years 2004–2007, declined to 3–5 per cent in the years 2008–2009 and jumped back to a surplus of 7–9 per cent of GDP in 2011 and 8.3 per cent in 2012. The current account surplus of the Netherlands is largely driven by the balance on goods, where natural gas production plays a central role. The country's trade balance would be about 2.5 percentage points lower without the natural gas exports. In the Netherlands re-exports account for about half of the goods balances, i.e., prices of re-exported goods are higher than the prices of original imports of these goods. The port of Rotterdam is a trade gateway to Germany and this has had an increasing effect on re-exports.

Also Germany has a very high current account surplus of about 6–7 per cent of GDP in the years 2008–2012. German exports have become more competitive and so the exports have been growing and the current account surplus has increased. Unit labour costs have risen much more slowly than in many other countries in the Eurozone during the last decade. Consumer demand, on the other hand, has been weak, which has slowed down the growth of imports.

In Belgium the current account surplus has decreased from 4.5 per cent of GDP in 2002 to -0.5 per cent in 2012 as the international competitiveness of Belgium has deteriorated. The trend is quite clear. The port of Antwerp, however, is important in maritime traffic, which has kept on the development of trade and logistics services. In Belgium the trade in services shows a surplus which is steadily increasing, but this is not strong enough to counterweigh the deterioration of the trade surplus.

In Finland the current account showed a surplus of about 8 per cent of GDP in 2001–2002, but the surplus has steadily decreased year after year and turned into a deficit in 2011. In 2012 current account showed deficit of -1.6 per cent. The main reason for this development is the ending of the golden days of the production of Nokia mobile phones in Finland as well as the huge volumes of re-exports of mobile phones followed by some problems with the competitiveness of new phone models and then ultimately stepwise closing down of the production in Finland in the years 2011–2012. The end of the mobile phone era in Finland began when the worldwide recession started in 2009.

Figure 1.9
Current account as a per cent of GDP in selected countries in 2007 and 2012



Source: IMF.

In France, the current account has changed from a surplus of about 3.1 per cent of GDP in 1999 to a deficit of 2.4 per cent of GDP in 2012. The current account turned into a deficit already in 2005 due to the worsening of exports. Income and transfers balances have been relatively stable over the years.

In Italy, Spain, Portugal and Greece the current account has been in a deficit already for the past ten years. The deterioration of the deficit in Italy has not stopped yet. In Spain the deficit was around 9–10 per cent of GDP in 2006–2008, but the deficit has shrunken to only around 3.7 per cent in 2011 and to -1.9 per cent in 2012. as the balance of goods and services improved. In Greece the current account deficit was already about 12 per cent in the year 2000. During 2007–2008 it rose up to 18 per cent of GDP but fell

Box 1.1
Re-exports add to current account

In the old days it was quite easy to analyse current account developments. The goods and services balance reflected "true" competitiveness of the firms in each country. Income and current transfers were uncomplicated and easy to understand. However, during the last ten years the world has changed a lot as a result of the very rapid globalization process. Before we look at the current account figures for different countries, it is therefore good to keep in mind a few things which make interpretation of the current account figures more difficult than in earlier days.

The most important change is that the meaning of exports of goods has changed during the last decade. In the earlier days exports included only products which were produced in the country they were exported from. This is not the case anymore. New kinds of exports are for example re-exports, and goods which are sent abroad for processing. Re-exports, i.e. importing goods and then exporting them after for example some minor improvement in the goods, has become common and is in the statistics included in normal exports of goods. The Netherlands, Belgium and Germany are important re-exporting countries. In some cases the imported goods leaves the country again without no further processing.

One example of re-exports is goods that are imported for minor processing such as re-packaging and then exported. The added value is relatively low, but often it can be a very profitable business as the products are exported at a much higher price than their import value. Multinational companies move goods between different countries within the group for processing, storage or distribution. Goods in transit however are only moving through a country and these goods are not included in the export statistics.

Goods sent abroad for processing are difficult to track in the statistics. Many parts can be involved and the final goods seldom return back to the sending country. In some cases exports of goods may even be seen in the statistics as exports of a country although the products physically never have been in that country. They have been produced or processed in a second country and then shipped to a third country.

Many of the multinational firms with production in several countries nowadays make centralized decisions regarding in which country to produce when demand for their products is increasing. For example the Finnish paper industry can decide whether to produce in Finland, Sweden or Germany. Labour costs, energy costs and transportation costs are perhaps the most important determinants. As it comes to multinational firms all the profits does not stay in the country where the production takes places. A big part of profits are moved to the country were the head office of the multinational firm is situated.

Q: Have increased re-exports changed the interpretation of the concept of exports?

back to 12 per cent of GDP in 2011 thanks to the improvement of the trade and services balance. These countries suffering from the sovereign debt crisis have severe economic problems and consumer demand is low, which also keeps imports low.

In Ireland the current account deficit was about 5 per cent of GDP in 2007–2008, but it turned into a small surplus in 2010 and 2011, when the balance of goods and services increased sharply to around 20 per cent of GDP. The situation in Ireland differs a lot from that of the other countries. The current account has been weak during the past decade although Ireland during the whole period has shown a very strong surplus in the trade and services account. The merchandise balance has shown a surplus every year during the last decade, but the services balance has been negative. The value of the flow of income from Ireland to the rest of the world has been quite close to the value of the trade balance. Current transfers have been rather small and they turned into a deficit in 2006. The weak current account does not necessarily mean that Ireland has a low competitiveness. The very high trade balance combined with the weak current account indicates that foreign firms have production in Ireland and profits are shifted to other countries.

2

Economic outlook for 2013–2014

2.1 External assumptions of the forecast

The views of the institutes have quite a large variation between 105–118.5 in 2013 and 99–122 dollars per barrel (Brent) in 2014 around their means of around 111 USD dollars in their oil price forecasts. The standard deviation of the oil price assumptions was, however rather small reflecting the consensus of the order of magnitude of the oil price forecast. In 2014 the standard deviation doubled and the distribution had two peaks in the sub-range of 106–108 and greater than 116 USD per bbl. The price of crude oil (Brent) was close to 100 USD/bbl in the later part of April 2013 after 116.5 USD/bbl in February and 109 USD/bbl in March.

The assumptions on the US dollar vis-à-vis euro were on average around 1.30 and many of the institutes had fixed the rate. A majority (7/13) of the respondents providing the quarterly path for the ECB steering rate assumed that the steering rate of the ECB will be at 0.75 at least until the end of 2014. Three institutes (IRES, Bipe and Kopint-Tarki) assumed a decrease of the rate to 0.5 per cent in the second quarter of this year. Only one institute (Ceprede) assumed a rise in the rate in the second quarter of 2014, which would reflect the relative robust rise in the Euro Area GDP.

2.2 Euro Area recession close to the through?

The long-lasting European recession deepened unexpectedly in the end of last year,

Table 2.1

Assumptions on oil prices, ECB steering rates and EUR-USD exchange rate

	Oil Price*		Short term interest rates**		Euro in USDs	
	2013	2014	2013q4	2014q4	2013	2014
Mean	110.9	111.3	0.66	0.70	1.31	1.3
Median	110.5	109.4	0.75	0.75	1.31	1.3
Max	118.5	122.3	0.75	1.00	1.35	1.36
Min	105.0	99.1	0.20	0.20	1.25	1.21
Stdev	3	6	0.17	0.19	0.03	0.04
Stdev/avg.	0	0.1	0.25	0.27	0.02	0.03
Number	23	21	12	11	15	13

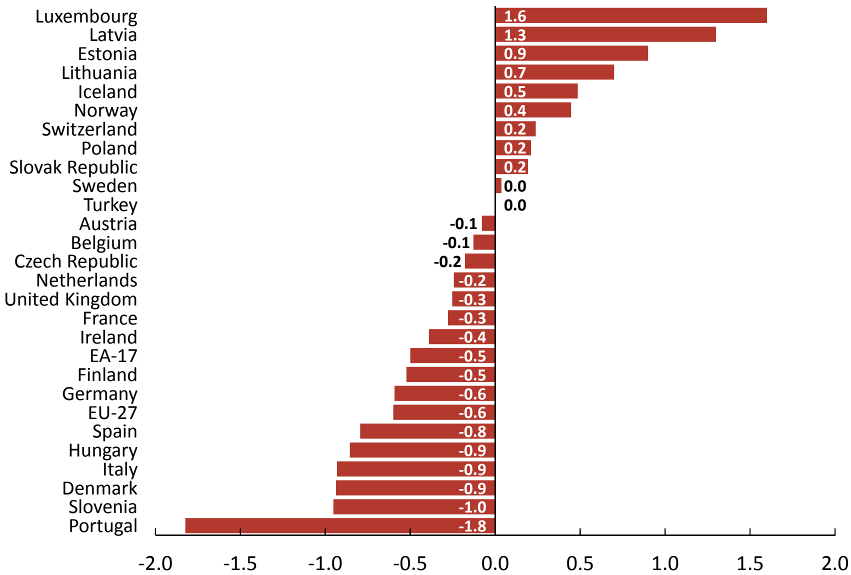
* Brent. ** ECB steering rate.

Source: AIECE institutes.

when the seasonally adjusted EU GDP declined by 0.5 per cent and the Euro Area GDP by 0.6 per cent from the preceding quarter. All Euro Area economies but Estonia, Slovak Republic and Luxemburg experienced a drop in production. Among other EU countries Swedish GDP unchanged, while the GDP in Poland grew by 0.2 per cent. The total output in Switzerland and Norway, two AIECE members outside the EU, grew as well. Greece is a special case. Due to statistical difficulties, seasonally adjusted quarterly data is not published. A decline of GDP from a year earlier was 6 per cent and a quarterly growth estimate using year-on-year rates gives a -5.5 per cent decline. On average, the growth of all demand components except inventories declined strongly (year-on-year). Private consumption and fixed investments dropped roughly by a tenth. Imports declined as well, which eliminated the negative contribution of exports.

Figure 2.1

GDP growth in selected European countries, %-change over the previous quarter in the fourth quarter of 2012



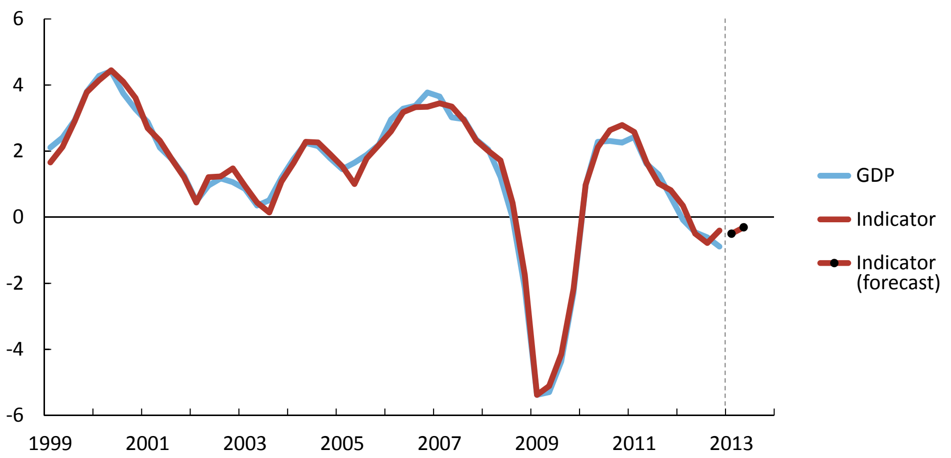
Source: OECD.

While the real European data paints a gloomy picture about the economic situation, there are some positive signs as well. The Euro Area sovereign debt crisis has calmed since last summer, when speculation of a break-down of the euro was intense. Economic growth continues in emerging Asia and also in the US, which supports a turn for the better. In addition, many indicators utilising survey data point to better albeit weak development. The Business and consumer survey by the commission has showed continuous improvement in industrial and economic sentiment between November 2012 and February 2013. In March, all indicators except consumer confidence, however, dropped. The sentiment declined by 1.1 points to 90 in the Euro Area driven by the decline in industrial and retail trade confidence curbing somewhat the improving trend in confidence.

Other positive signs are provided by the OECD composite leading indicator and the Eurogrowth indicators of the Euroframe for the Euro Area. The former saw a turning point in the growth of the Indicator already in March 2013, which should foresee a turning point growth of GDP after six months and continued to signal it in April. The Eurogrowth indicator points to positive quarter-on-quarter growth already in the first quarter, although weakening growth in the second quarter of this year.

In the survey made among the AIECE countries, the respondents, who formed a quarterly path for the evolution of GDP until 2014, see the recession finally easing in the course of 2013 with the exception of Greece. The AIECE's Greek member KEPE sees negative quarterly rates up to the end of 2013 and does not produce a longer forecast. The Greek year-on-year growth rates are -4.1 and -1.5 per cent for 2013 and 2014, respectively. SKEP from Slovenia, Prometeia from Italy and Ceprede from Spain estimate troughs in the first quarter of 2014, the first quarter of 2013 and in the second quarter of 2013, respectively. In France COE-Rexecode sees the trough in the second quarter of 2013, while Bipe sees flat growth until the fourth quarter of 2013. All other respondents see either flat or positive quarterly growth already in the first quarter. The recovery in Germany is seen to be strong compared to the growth in the other countries. DIW, IfW and IFO see a

Figure 2.2
Eurogrowth Indicator, April 2013, % y/y



Source: Euroframe.

strong first quarter and some weakening after that. RWI from Essen expects a bit weaker growth in the first quarter than the other German respondents, following a stronger second quarter.

European Union

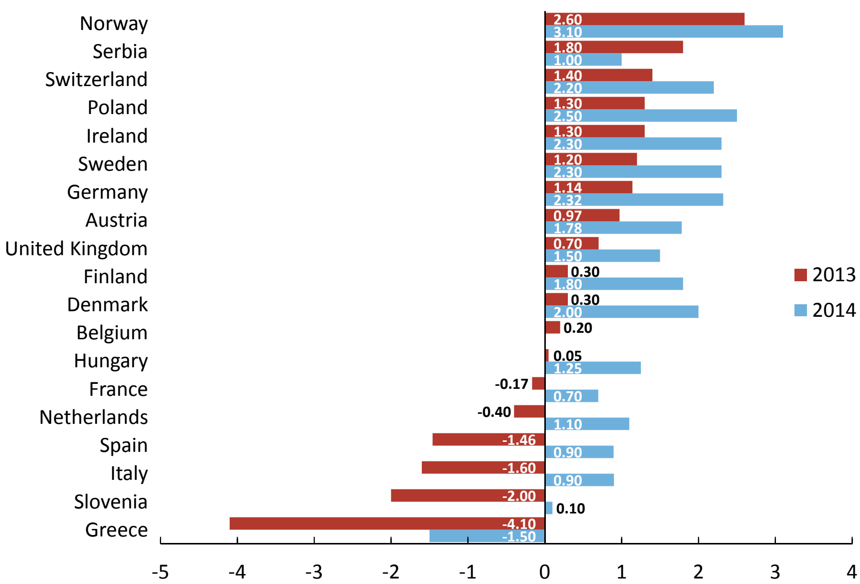
Almost all respondent AIECE institutes forecast a recovery for 2014. The turning point will occur in 2013. The mean of the AIECE institutes forecasts for GDP growth of the EU as a whole is -0.1 per cent in 2013 and 1.2 in 2014. We received forecasts from 12 institutes. The views of the institutes seem to be very near to each other. The standard deviation for the 2013 forecast is just 0.1 percentage points. For 2014 it is also rather small, 0.4 percentage points.

Table 2.2
EU GDP, % change

	2013	2014
Mean	-0.1	1.2
Median	0.0	1.3
Max	0.2	1.6
Min	-0.3	0.0
Stdev	0.1	0.4
Stdev/avg.	-2.5	0.3
Number	12.0	12.0

Source: AIECE institutes.

Figure 2.3
GDP forecasts by AIECE institutes, %



Source: AIECE institutes.

Euro Area

For the Euro Area the mean forecast of the institutes is -0.4 per cent for 2013 and 1.1 per cent for 2014. This forecast differs only slightly from the forecast of the European Commission, i.e. -0.3 per cent for 2013 and 1.4 per cent for 2014.

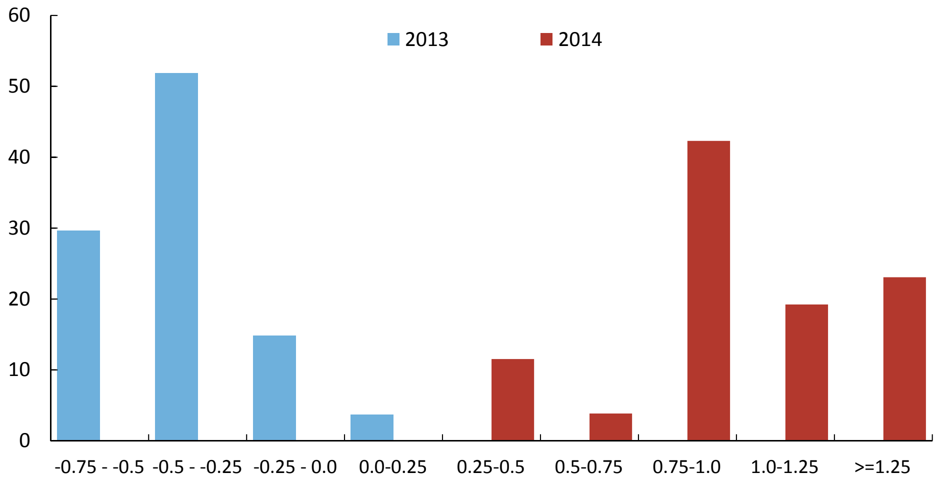
Export growth will accelerate from 2.5 per cent in 2013 to 4.6 per cent in 2014. Private consumption will decline in 2013, but it will stage an upswing of 1.1 per cent in 2014.

Table 2.3
Euro Area forecast* by the AIECE institutes

	Change to previous period, %		
	2012	2013	2014
Private consumption	-1.3	-0.2	1.1
Public consumption	-0.4	0.1	0.7
Gross fixed capital formation	-4.1	-2.2	1.5
Private business investments	..	-2.4	2.4
Public investments	2.1	-1.1	2.6
Residential investments	..	-1.4	1.0
Total domestic demand	-2.2	-1.0	0.6
Exports of goods and services	2.7	2.5	4.6
Imports of goods and services	-0.9	0.9	4.2
GDP	**-0.6**	**-0.4**	**1.1**
Other indicators			
Harmonised consumer prices	2.5	1.7	1.6
Unemployment rate (%)	11.4	12.2	12.1
Public balance (% of GDP)	-3.7	-2.9	-2.5
Public debt (% of GDP)	90.6	94.4	93.7
Current account (% of GDP)	1.6	2.9	3.2

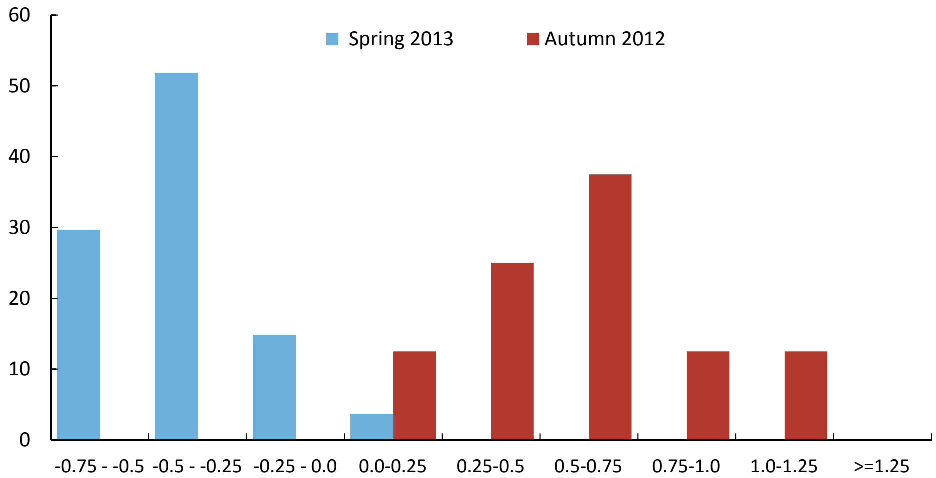
* Mean across institutes. Number of institutes varies by items. Partly estimated.
Source: AIECE institutes.

Figure 2.4
Frequency distribution of the AIECE forecasts, %



Source: AIECE institutes.

Figure 2.5
Frequency distribution of the AIECE GDP forecasts for Euro Area, %



Source: AIECE institutes.

The recovery in export and private consumption will be reflected as faster investment growth in 2014. Also import growth will accelerate in 2014 due to faster domestic demand.

Inflation will stay clearly below 2 per cent in 2013 and 2014. The average forecasts for consumer price inflation are 1.7 per cent for 2013 and 1.6 per cent for 2014. The unemployment rate will stay at about 12 per cent in both years. The response to faster GDP growth will be slow.

The public deficit of the Euro Area will be below 3 per cent of GDP in both forecast years. The average public debt/GDP ratio will decline slightly to 93.7 per cent in 2014.

The GDP forecasts for 2013 are located in a rather narrow span. For 2014 the distribution is flatter, which is to be expected because the year is further ahead.

Largest EU Economies

For Germany DIW, IFO and IfW forecast almost the same GDP growth for 2013 and 2014: 0.6–0.7 per cent for 2013 and 1.5–1.7 per cent for 2014. The forecast of RWI differs clearly: 2.1 per cent in 2013 and 3.8 per cent in 2014. RWI forecasts a clearly higher growth in private consumption and private investment than the other three institutes: 2.1 per cent in 2013 and 2.8 per cent in 2014. The other three forecast a growth of 0.6–0.8 per cent for 2013 and 0.7–1.5 for 2014. All institutes forecast a rather brisk export growth: 2.5–4.6 per cent for 2013 and 5.6–7.0 per cent for 2014. The consensus view thus relies on exports as the driver for GDP growth. The output gap is forecast to be zero or negative in 2013, whereas in 2014 it will be closed.

For GDP growth in France, COE-Rexecode and OFCE forecast -0.2 per cent for 2013 and 0.6–0.7 per cent in 2014. According to COE, private consumption will decline in 2013 and will remain stagnant in 2014. OFCE forecasts stagnation in 2013 but a slight recovery (0.8 per cent) in 2014. There will be a pickup in export growth in 2014: OFCE forecasts

2.2 per cent and COE 4 per cent. Investment activity will remain weak. According to COE, the output gap will stay at -4 per cent in 2013 as well as in 2014.

In Italy Prometeia, REF Ricerche and ISTAT agree on about -1.5 per cent GDP change for 2013. For 2014 the difference is not huge either, the forecasts lying between 0.5–1.0 per cent. Export growth forecasts are in the range of 1.3-2.3 per cent in 2013 and 3.6-3.9 per cent in 2014. The gross public debt is forecast to decrease somewhat in 2014.

For the UK NIESR forecasts a GDP growth of 0.7 per cent in 2013 and 1.5 per cent in 2014. Private consumption is forecast to grow rather steadily by 1.2-1.4 per cent in 2013 and 2014. In exports there will be a pick-up in growth from 0.8 per cent in 2013 to 5.9 per cent in 2014. There will be a clear recovery in investment in dwellings as well as in government investment in 2014. Gross public debt will increase in 2014.

Crisis countries

ESRI forecasts that in Ireland GDP will grow by 1.3 per cent in 2013, and by 2.3 per cent in 2014. Private consumption will still decline by 0.5 per cent in both forecast years. Unemployment will remain above 14 per cent, declining only slightly in 2014. The public sector fiscal balance will improve from -7.5 per cent/GDP to -5.1 per cent/GDP. The still high deficit reflects the burden of the past bailout of Irish banks. Gross public debt per GDP will decline slightly from 121 per cent in 2013 to 118 per cent in 2014. The good news is that exports will grow by 3.9 per cent in 2013 and by 4.9 per cent in 2014. Investments will also grow by more than 3 per cent in both years.

For Spain L.R. Klein-CEPREDE forecasts a decline in GDP by 1.5 per cent in 2013 and a growth by 0.9 per cent in 2014. Private consumption will decline by 2.5 per cent in 2013 and will remain stagnant in 2014. This reflects a decline in real disposable income of households by 3.3 per cent in 2013. The unemployment rate will remain at about 27 per cent in both years. Exports are forecast to grow by 3.2 per cent in 2013 and by 4.9 per cent in 2014. The public sector fiscal balance/GDP will improve slightly from -5.1 per cent in 2013 to -4.7 per cent. Public debt declines slightly in 2014 to below 78 per cent of GDP.

For Portugal there is no AIECE forecast. The EU Commission forecasts a GDP change of -1.9 per cent in 2013 and 0.8 per cent in 2014. Private consumption is forecast to decline by 2.8 per cent in 2013, but in 2014 it will pick up to a growth rate of 0.5 per cent. Exports will grow by 1.4 per cent in 2013, but the growth will accelerate to 4.6 per cent in 2014. The unemployment rate will decline from more than 17 per cent in 2013 to slightly below it in 2014. The general government balance/GDP will improve from -4.9 per cent in 2013 to -2.9 per cent in 2014. General government gross debt will grow from 125 per cent in 2013 to almost 126 per cent in 2014. The forecasts related to the public sector are, however, challenged by the Supreme Court decision not to allow planned wage cuts in the public sector.

For Greece KEPE forecasts a GDP change by -4.1 per cent in 2013 and -1.5 per cent in 2014. Private consumption will decline by 7 per cent in 2013 and by 5.6 per cent in 2014 due to the high unemployment rate and decreases in real income. Exports will grow by 2.9 per cent in 2013 and by 4.1 per cent in 2014. This growth will be insufficient to lead to positive GDP growth during the forecast period. The unemployment rate will remain at about 30 per cent.

For Cyprus there is no AIECE forecast. We do not present any other forecast, either, because the situation in the country is still unsettled after the bail-in of the banks in March 2013. The implementation of the decisions, among other things, is uncertain.

2.3 Inflation continues to be moderate

In *the Euro Area* inflation will stay clearly below 2 per cent in 2013 and 2014. The average forecasts for consumer price inflation are 1.7 per cent for 2013 and 1.6 per cent for 2014.

For *Germany* the inflation forecasts of the institutes differ somewhat. DIW, IFO and RWI forecast a consumer price increase of 1.6 per cent in 2013 and 1.8–2.0 per cent in 2014. IfW instead forecasts 2.0 per cent in 2013 and 2.6 per cent in 2014.

For *France* Coe-Rexecode forecasts a 1 per cent increase in consumer prices in 2013 and a 1.6 per cent increase in 2014.

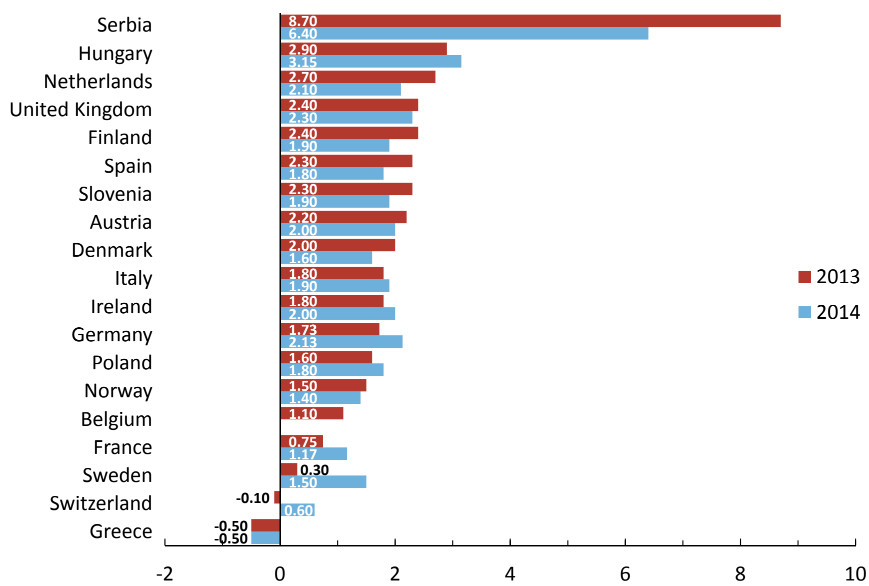
In *Italy* the inflation forecasts of the three AIECE institutes are in a rather narrow range of 1.7–1.9 per cent for 2013 and 1.8–1.9 per cent in 2014.

In *the UK* consumer price inflation will stay at about 2.3–2.4 per cent in 2013–2014.

Among the crisis countries there will be deflationary tendencies only in Greece. According to KEPE, consumer prices will decline in *Greece* by 0.5 per cent in 2013 as well as in 2014. For *Ireland* ESRI forecasts an increase of 1.6 per cent in both years. For *Spain* L.R. Klein-CEPREDE forecasts 2.3 per cent in 2013 and 1.8 per cent in 2014.

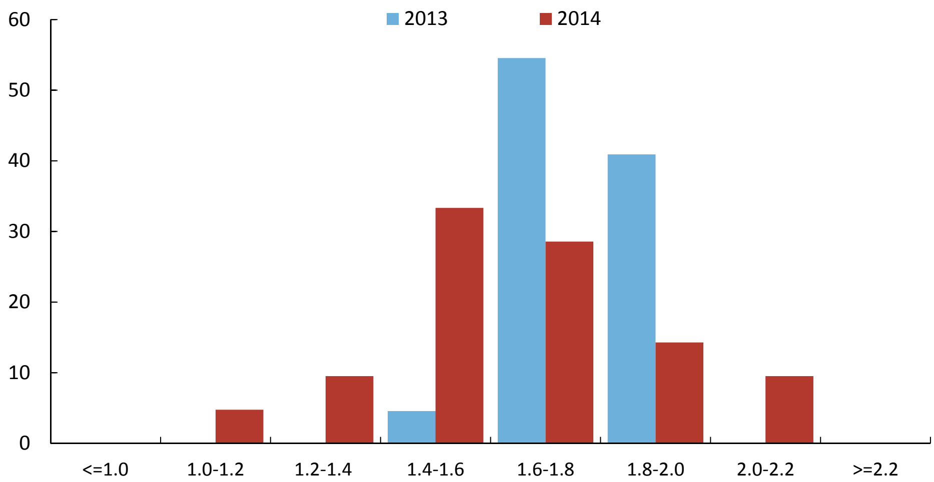
The HICP forecasts for the Euro Area 2013 and 2014 are about normally distributed. For 2014 the distribution is flatter as be expected, because the year is further ahead. Inflation forecasts for 2013 have become more moderate since last autumn.

Figure 2.6
Inflation forecasts by AIECE institutes, %



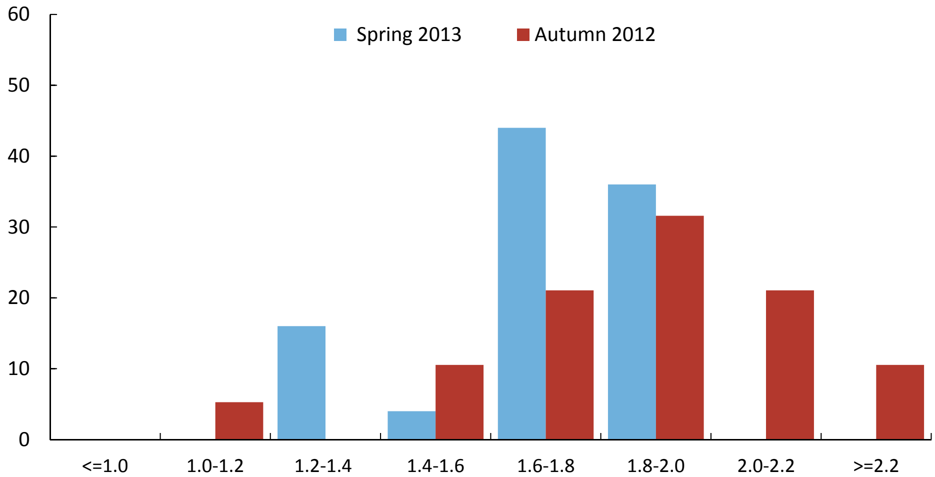
Source: AIECE institutes.

Figure 2.7
Frequency distribution of the AIECE forecasts for the Euro Area GDP, %



Source: AIECE institutes.

Figure 2.8
Frequency distribution of AIECE forecasts for Euro Area HICP in 2013, %



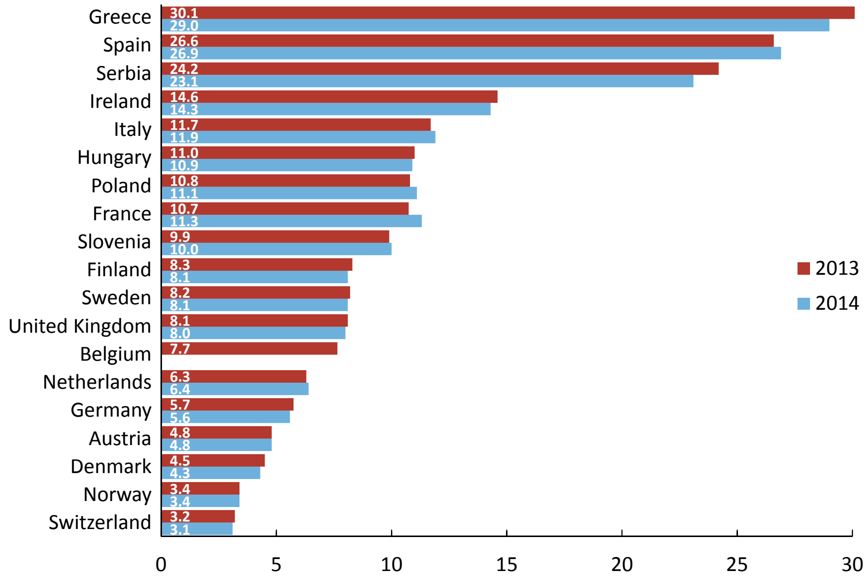
Source: AIECE institutes.

2.4 Unemployment continues to be a severe problem

According to the forecasts of the AIECE institutes, the Euro Area unemployment rate will stay at about 12 per cent in both years. The response to faster GDP growth will be slow.

Among the large countries, Germany will have the lowest unemployment rate, about 5 per cent in both years. In France it will be about 11 per cent and in Italy about 12 per cent. In the UK it will be 8 per cent.

Figure 2.9
Unemployment rate forecasts by AIECE institutes, %



Source: AIECE institutes.

Unemployment will be the highest in Greece, 30 per cent in 2013 and in 2014. In Spain it will be about 27 per cent in both years. According to the EU Commission the Portuguese unemployment rate will be 17 per cent during the forecast period. Also in Ireland the unemployment rate will still be high, 14.5 per cent in 2013–2014.

In several countries the aggregate unemployment starts to be a severe problem. Youth unemployment percentages are especially high. They are the highest in Greece and in Spain. Unemployment is already a risk for social unrest in some countries.

2.5 Public balances consolidating

In Germany the public sector is forecast to be about in balance in 2013. For 2014 the institutes forecast a surplus of 0.3–0.4 per cent in relation to GDP. The public debt/GDP ratio will decline from about 80 per cent in 2013 to about 77 per cent in 2014.

In France the public sector fiscal deficit/GDP is forecast to be 3.8–3.9 per cent in 2013 and 3.0–3.2 per cent in 2014. The gross public debt/GDP will increase form 93–94 per cent in 2013 to 95–96 per cent.

In Italy the public sector fiscal deficit will be 2.6–2.9 per cent in 2013 and about 2.5 per cent in 2014. The gross public debt/GDP will decline slightly from 129–130 per cent in 2013 to 126–129 per cent in 2014.

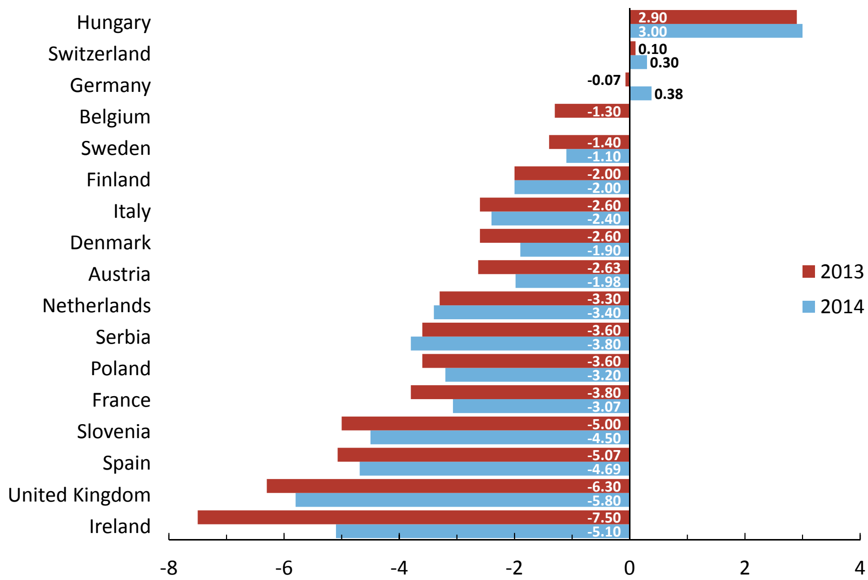
In the UK the public sector fiscal deficit/GDP will be 6.3 per cent in 2013 and 5.8 per cent in 2014. The gross public debt/GDP will increase from 93.8 per cent in 2013 to 95.9 per cent in 2014.

For Ireland ESRI forecasts a public sector fiscal deficit of 7.5 per cent per GDP in 2013 and 5 per cent in 2014. The public sector gross debt/GDP will decline from 121 per cent in 2013 to 118 per cent in 2014.

For Spain L.R. Klein-CEPREDE forecasts a public sector deficit of 5.1 per cent in 2013 and 4.7 in 2014. The gross public debt/GDP will decline from 78.6 per cent in 2013 to about 78 per cent in 2014.

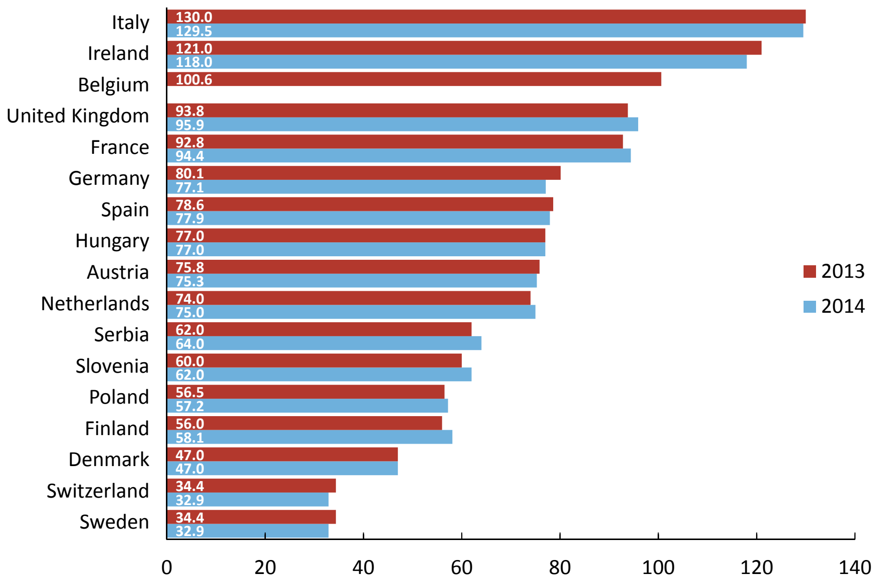
For Greece KEPE does not give public sector forecasts. The Commission forecasts a deficit of 4.6 per cent in 2013 and 3.5 per cent in 2014. The gross debt/GDP will stay at about 175 per cent. The decline will be less than half a per cent.

Figure 2.10
Public balance forecasts by AIECE institutes, %



Source: AIECE institutes.

Figure 2.11
Public debt forecasts by AIECE institutes, %

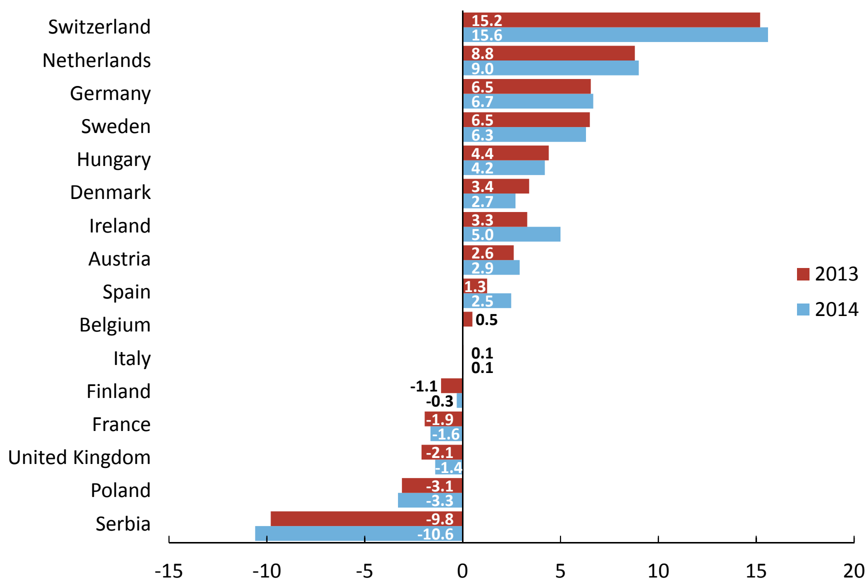


Source: AIECE institutes.

According to the forecast of the EU Commission, the Portuguese public sector deficit/GDP will decline from 4.9 per cent in 2013 to 2.9 per cent in 2014. The general government gross debt/GDP will increase from 124 to almost 125 per cent. The forecasts related to the public sector are, however, challenged by the Supreme Court decision not to allow planned wage cuts in the public sector.

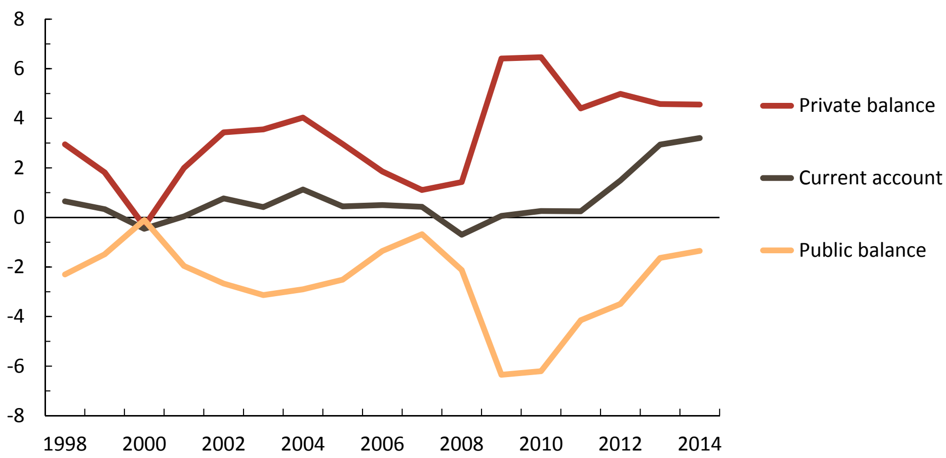
In the Euro Area the public deficit declines strongly in 2013 to 2.9 per cent of GDP from 3.7 per cent in 2012, but stabilizes at 2.5 per cent in 2014. A strong rise in public debt stabilizes in 2014 as well.

Figure 2.12
Current account forecasts by AIECE institutes, %



Source: AIECE institutes.

Figure 2.13
Financial balances in the Euro Area, % of GDP



Sources: Ameco, AIECE.

2.6 External imbalances are persistent

For Germany the institutes forecast a current account surplus of 6–7 per cent in relation to GDP in 2013–2014. For France Coe forecasts a current account deficit of 2.2 per cent in 2013 and of 1.7 per cent in 2014. In Italy the current account is forecast to be in about balance. For the UK NIESR forecasts a current account deficit of 2 per cent in 2013 and 1.4 per cent in 2014.

In Ireland the current account will run a clear surplus: 3.3 per cent in relation to GDP in 2013 and 5 per cent in 2014. Also in Spain the current account will be in surplus, 1.3 per cent in 2013 and 2.5 per cent in 2014. These surpluses reflect an improving export performance as well as weak domestic demand. The forecast "private balance", the sum of current account and public balance, continues to show a strong surplus.

For Portugal the Commission forecasts a deficit of 1.2 per cent in 2013 and 1.2 per cent in 2014. For Greece the deficit-forecast of the Commission is 4.3 per cent in 2013 and 3.3 per cent in 2014.

2.7 Risks of the forecast

There are considerable risks around the forecasts. In general, the commodity prices, mostly oil and food prices and deeper recession were mostly seen as an upward risk on inflation, though some also indicate a possible risk to downwards (ETLA, IfW, NIESR). The common accommodative monetary policy in the Euro Area with low interest rates and a massive use of unconventional measures is seen as a risk for inflation. It also makes difficult the eventual withdraw of liquidity from the markets.

In Spain and Greece there is a considerable downward risk in inflation due to declining wages according to national institute. In Germany, raising wages may feed into unit labour costs and prices stronger than expected in a relatively expansionary monetary environment. Special upward risk on inflation is the possible depreciation of their currencies in the U.K., Poland and Hungary. In Hungary, there is also a hidden pressure on inflation due to decreases of many regulated prices to unsustainably low level. In Italy and Slovenia there is a risk of the rise of indirect taxes.

The institutes see the risks on growth to stem from the weaker-than-expected growth outside Europe and a deeper recession in the Euro Area. In the Euro Area, 'a new round in the sovereign debt crisis with turmoil on financial markets could weigh down confidence' and growth. An inability to implement reforms in program countries due to, e.g., political instability poses a risk an escalation of the crisis. It was also noted that 'it is highly uncertain, if program countries will be able to return to robust growth, lower deficits and reduced unemployment within the next few years'.

The development of external development with lower growth and/or higher oil prices was seen a key risk on single AIECE countries by their own experts. In France, 'the main risk is associated with the enforcement of fiscal package and the reaction of agents (both households and enterprises) and more specifically on the implicit bet made by government on a significant decrease in savings ratio of households.' 'The main factor of growth for France will be associated with its ability to address its structural problem of low competitiveness.' In Germany, the extremely expansionary stance of monetary policy may be creating looming imbalances to the economy. In Greece, the fiscal consolidation measures and lack of liquidity depress the economy. In Spain the possible new wave of pressure on public finance is a risk downwards, while the recovery in private investments could surprise positively. In Poland social unrest and a possible outflow of multinational enterprises' production from Poland add to uncertainties. Slovenia, the risks on banking sector and deleveraging of corporate sector among other risks for the growth.

3

Crisis and the policy analysis

Economic development in industrial countries and particularly Euro Area countries has been dismal since the Great Recession in winter 2008/9. While many emerging economies, notably China, got back on a relatively strong growth path, albeit slower than before the recession, the US growth has been moderate and the Euro Area has been bogged down in the sovereign debt crisis. The effects of revelation of irresponsible public sector housekeeping in Greece, blowing of housing market bubbles in Spain and Ireland and weak general development in Portugal and a very high debt in Italy led to vicious circles between more expensive financing of public sectors, deteriorating value of assets of banks and adverse economic developments especially in the "crisis" countries. Greece, Ireland and Portugal were obliged to implement strictly conditional bailouts (E.g. Euroframe 2013). The Spanish and Italian bond markets were supported by bond purchases of the ECB in autumn 2011, when their yields rose markedly. Spain has got an option to finance its banks through the European Stability Mechanism. Cyprus was forced to implement the bail out in March 2013. The special feature of the package, in addition to the conditional aid, this time also the balances of large uninsured deposits were cut (see box 3.3 p. 50).

In spite of the bailouts and strengthening governance of the Euro Area, the euro system was facing a severe test last summer with strong speculation of the break-up of the euro. The threat was prevented by the promise of Mario Draghi, the president of the ECP "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro". This was followed by the establishment of Outright Monetary Transactions (OMT), which effectively allowed unlimited bond buying of government bonds up to three years under certain conditions (see Technical features of Outright Monetary Transactions, http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html...)

Recently, in spite of the bailout of Cyprus and speculations on difficulties of Slovenia and some other countries, the situation in the financial markets has continued to be calm. The return of Ireland to government bond markets is being prepared, and the large debt service of rescue loans of Portugal and Ireland has been alleviated by lengthening the maturity of their debts. In addition, Ireland has got an agreement, where it can convert the 7–8 year maturity promissory notes to long-term government bonds with an average maturity of 34–35 years.

The decisions of the ECB and the development of governance of the Euro Area (e.g., six pack, two pack and Treaty on Stability, Co-ordination and Governance) is progressing and giving more longer-term ground for the turn-a-round to growth. So far, no concrete signs are visible, yet.

The Euro Area like other European countries faces very difficult challenges on economic policy.

- The Euro area has been in a recession practically from the third quarter of 2011
  - Output gaps, though difficult to measure, are high
  - The unemployment rate (s.a.) rose to 12 per cent in the Euro Area on average in February 2013. In Spain and Portugal the unemployment rates have risen to 26.3 and 17.5 per cent. The respective youth unemployment rates were 55.7 and 38.2 per cent. In Greece, there are no fresh statistics, but obviously the rates are close to the Spanish ones.
  - Public balances improved, but public debts are in many cases unsustainably high in relation to the GDP.
  - The current account deficit has improved, but has reflected much by a decline in domestic demand.

As usual, in a preparation of this report, a questionnaire on macro forecast with multiple questions on specific policy options was sent to all the members of the AIECE to tackle these issues. We got 27 responses.

The questions on policies were formulated as statements with 5 alternatives (2 = strongly agree, 0 = no opinion, -2 = strongly disagree). In the description, we use weighted balances of different alternatives as the Commission does in its Business and Consumer Surveys', i.e., extreme alternatives have a weight '1' and interim responses weight '0.5' and the 0-responses are not taken into account.

3.1 Monetary policy continues accommodative

The effectiveness of conventional monetary policies has decreased markedly in European countries as the short-term interest rate have decreased close to zero. While there is still some room for reducing the steering rate, currently 0.75%, an additional problem is that the normal monetary transmission channels have been impaired. Financial market conditions have improved, but the better conditions are not yet reflected in credit creation due to low profitability and weak capital base of banks and in many cases weak

Box 3.1

The design flaws of the Euro Area and the OMT?

A country joining a monetary union loses control on the currency. While it may produce monetary stability, it may also rise vulnerability in two ways. First, the common monetary policy based on averages may not be appropriate for an individual country. Secondly, there is no central bank that would back up sovereign debt. The first problem was evident in the run-up to the current crisis, when monetary policy was too loose for the peripheral economies. The second problem has come to the forefront now when the debt service capacity of some member states has been increasingly questioned.

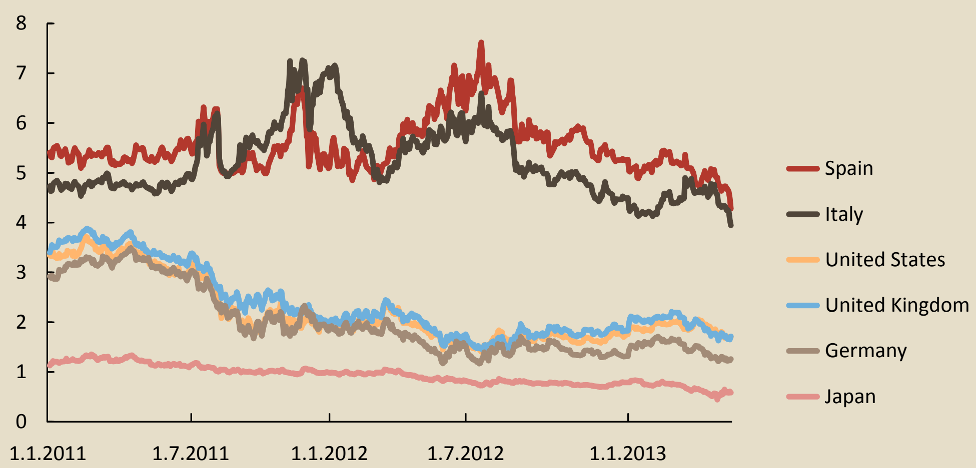
The fact that there is no central bank that could automatically stand in as a buyer of last resort for a member states debt creates a possibility to successful speculation against a single member state or several states. Greece, Portugal, Ireland, Spain and Italy are good examples of this. On the other hand, the strong countries like Germany will benefit from lower yields due to e.g. safe heaven effects. In addition, in the case of EMU, the original decision to keep the bank supervision and resolution regimes at the state level did prove to be a weakness adding to the strength of speculation due to the a linkage between state finances and banking sectors.

The introduction of the OMT and decisions to a move towards a banking union seek to address these shortcomings. The development of sovereign debt yields suggests that these measures, or at least the OMT, have worked as intended. The OMT can be credited for much of the reduction of the yield spreads in Italy and Spain in particular. Even the recent turbulence around the Cyprus package which – for the first time involves a significant bail-in of large depositors, or the recent political instability in Italy have failed to lead to higher spreads for any longer period of time.

At the same time, it is obvious that there are limits to how much the ECB can support individual member states' sovereign debt market. Buying sovereign bonds from emission is prohibited by the Treaty, and the whole philosophy of the ECB of not engaging in monetary financing constrains unlimited support for individual states. This is reflected in the conditionality of the OMT support, i.e. the requirement that a member state willing to make use of the OMT will have to request for conditional rescue from the European Stability Mechanism, ESM.

The conditionality is a clever way to provide unlimited liquidity support for a sovereign state while not violating – at least not too much – the principles non-monetary financing and giving a major fiscal role for the independent central bank. However, at the same time the requirement to set up a financial assistance programme, approved and monitored by the ESM, limits the effective central bank guarantee. The member states are very hesitant to ask for such assistance as it limits the applicant country's fiscal sovereignty. On the other hand, the "creditor countries" are likely to require quite tough conditions. The ECP may drift into a difficult situation where a country is not able to fulfill the set of conditions. For these reasons the markets are unlikely to fully trust in an open-ended backstop through the OMT. Clearly, while OMT has been a major step to calm down markets, it is unlikely to be sufficient on its own.

10-year government bond yields in selected countries, %



Sources: Bloomberg, ETLA.

borrower balance sheets. In response to this development, the ECB resorted to unconventional measures like banks' longer-term asset purchases on the secondary markets preceeding the OMT as the short rate cannot move because of zero lower bound. In contrast to similar practices in the US and in Japan, the ECB attempted to sterilize the asset purchases as it did not aim to add monetary stimulus to the economy, but to 'improve the transmission of its policy'.

The threat to the inflation target 'below but close to 2 per cent' is low. Inflationary pressures in the Euro Area and in most European countries are quite limited due to the recession as shown by the core inflation and survey information. While output gaps are notoriously difficult to estimate, the gaps reported by the institutes like also those produced by the Commission, point to rather large gaps except for Switzerland and Germany and for some smaller countries like Estonia and Ireland in 2013–2014.

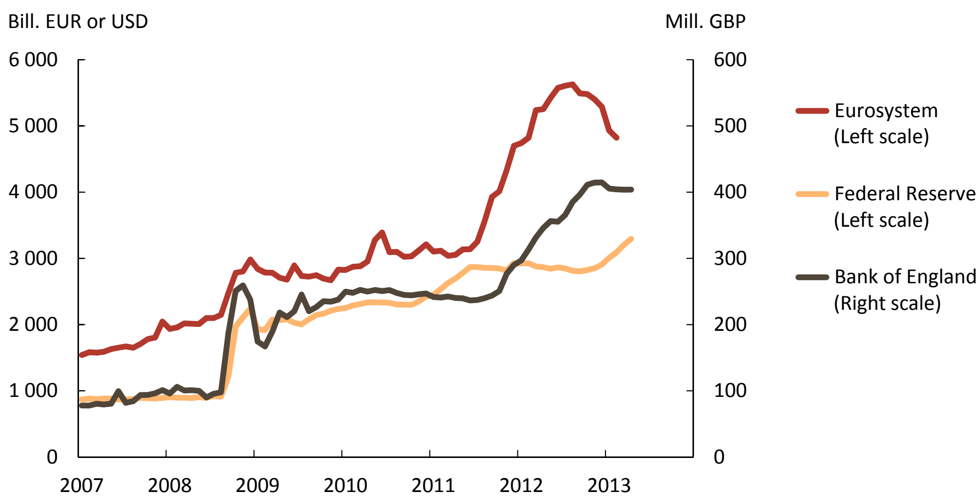
The provided estimates reveal the difficulty of this measure. In Switzerland, there is a positive gap, but Sweden, the other growth country, has a sizable negative output gap. The case of Germany is very interesting. DIW and RWI provide negative output gaps, but

Table 3.1
Output gaps in selected countries

	2013	2014
Denmark (DEC)	-5.5	-4.9
France (COE-Rexecode)	-4.0	-4.0
Germany		
– DIW	-1.1	-0.5
– IfW	0.1	0.4
– RWI	-1.1	-0.4
Poland (IBRKK)	-2.0	-2.5
Sweden (NIER)	-2.7	-2.1
Switzerland (KOF)	0.7	1.5

Source: AIECE institutes.

Figure 3.1
Central bank assets in domestic currencies



Sources: FED, ECB, BOE.

IfW estimates the gap to be already positive in 2013 and 2014. Different estimates and the related uncertainty impairs the usefulness of this otherwise clear-cut measure.

The members were asked to present their views on the effects of the new unconventional measure, the OMT. The announcement of the Outright Monetary Transactions, OMT in September 2012 together with plans to develop the EU-wide banking inspection had a substantial calming effect on the government bond markets, which were struggling with speculation of a break-up of the euro. The ECB has promised to restart buying high-yield countries' bonds, if a member state applies for financial assistance with strict conditions from the ESM. The OMT implies, in principle, unlimited bond purchases up to the maturity of three years and has already shown its potential to calm down the markets and reduce interest rates, though it has not yet even been utilised.

The respondents see it as the main tool for reducing bond yields in crisis countries and estimate that it has ended the speculation on the break-up of the euro. Some see it also useful in strengthening the monetary transmission in the Euro Area. The views of the institutes on this new tool of the ECB were mixed as shown by the comments.

On the one hand, it was seen as "a game changer" as it ended the massive speculation on the euro. On the other hand, it was stressed that the operation only "bought some time to implement major structural reforms", which is "being squandered".

Figure 3.2a
Effects of Outright Monetary Transactions (OMT) of the ECB by the AIECE institutes
Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

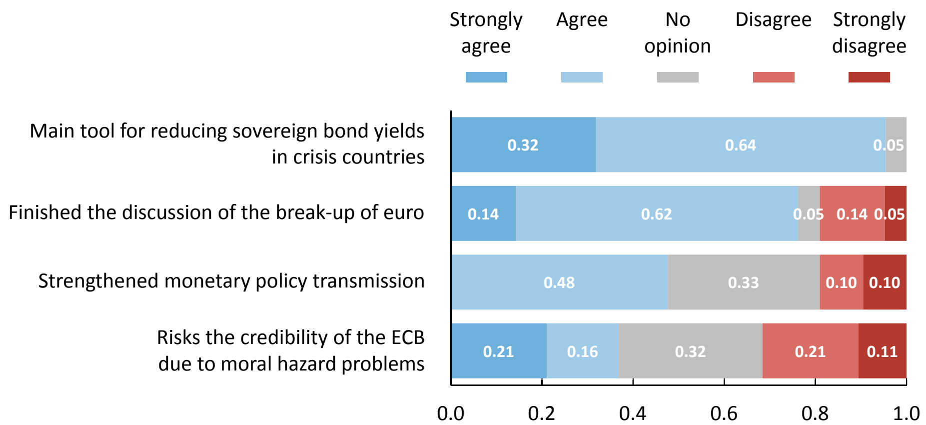
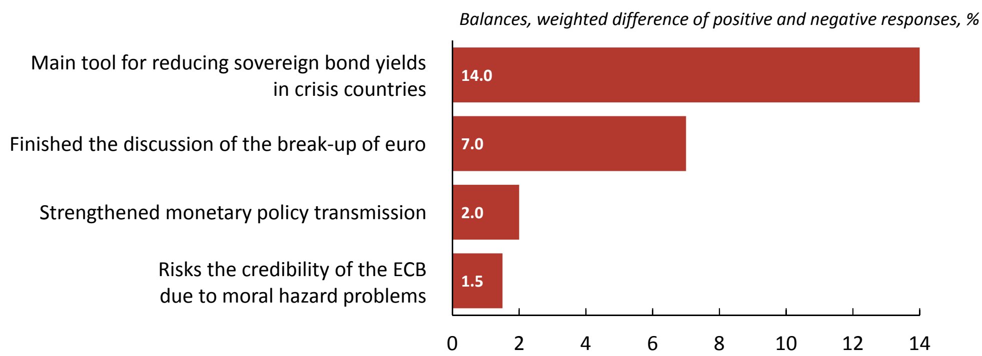


Figure 3.2b
Balances of evaluation



Source: AIECE institutes.

The ECB is nevertheless "in an uncontrollable territory", where monetary policy is not independent from the fiscal authorities. Also the problem of the credibility of the central bank was brought forward. "How will the ECB react, if a government does not stick to the agreed program" or "if the crisis escalates and there is no government to apply for the rescue from the ESM".

With regard to traditional monetary policy, only three respondents expect a decline in the steering rate as described in the "assumptions". One institute even foresees a rise in the horizon. The ECB terminated its Security Market Program (SMP), when it established the OMT. This is reflected in a strong decrease in the assets of the ECB since last summer. The ECB may search for an exit of the use of the unconventional measures or preparing for the new fights.

Questions:

Q1 Is the ECB preparing for the exit of unconventional measures as the reduction of assets suggets or for the intensifying crices?

Q2 What might strenghthen the transmission of monetary policy?

Q3 Do you see any problems in the design of the OMT?

3.2 Fiscal consolidation continues

In the EU, 27 countries are responsible for the fiscal policy for their countries. The EU provides the common framework and rules for the policies. The policies were strongly challenged by the legacy of the Great Recession and the sovereign debt crisis. The crises revealed the weaknesses of the governance, which has led to tightening of the rules and to the stronger unity of the EU.

Recent developments of governance are introduction of better surveillance systems, clearer policy rules and swifter sanctions for breaking the rules. These new rules and practises are defined in the so-called six-pack, two-pack and the Treaty on Stability, Coordination and governance. There will be a stronger focus on debt, with a limit of 60 % of GDP, while the deficit target is 3% of GDP. One slightly controversial rule (fiscal pact) is (since 2014 for 25 member states) to limit the structural deficit to 0.5 % of GDP.

The basic method of the Commission and national governments to solve the crisis and push the economies back to growth is to consolidate public finances and enhance growth potential with structural policies. Most EU countries are obliged to balance their public sectors under the Excessive Deficit Procedure (EDP) as they breach either the deficit or debt criteria. Greece, Ireland and Portugal and Cyprus have been bailed out and their policies are formulated by the conditions to the bailout defined in the Memorandum of Understanding (MoU).

In 2012 9 Euro countries and 5 other EU countries breached the deficit target. The debt target was breached by 12 Euro countries and 2 other member states. In April 2012 there were 17 ongoing Excessive deficit procedures. The Council has issued a decision on the existence of an excessive deficit in twelve of 17 Euro Area countries and eight of 10 other European EU countries. As an adjoining table indicates, the prolonged recession has deepened the deficits and it is obvious that many of the current country procedures should be reformulated and more countries will be interpreted by the Council to have excessive deficits. The Euroframe group estimates that the effect of fiscal tightening in

2012–2014 resulted 1.7 percentage points slower growth in 2012 than realized. In 2013–2014 the effects would be 1.9 and 0.8 percentage points.

The scope of manoeuvres differs greatly by countries. The crisis countries, especially counties with aid packages, are not able to borrow from the markets with sustainable yields and they are obliged to implement austerity policies under the bailout programs. Healthier countries, in many cases with heavy debt loads, on the other hand, can finance their deficits with low rates. However, also they fear the threat of market pressure and practise austerity policies as well.

The austerity policies in the crisis countries are dictated by the availability of finance. Market finances developed too expensive and the stronger countries have been careful in granting or guaranteeing loans either directly (Greek I) or through the preliminary or permanent stability mechanisms. Basically, this kind of risk sharing is not compatible to the rules of the EU.

Table 3.2
Public balance and debt per GDP, excessive deficit deadline, and some forecasts

	Public balance, 2012*	Year, forecast	EDP, deadline	Public debt, 2012	Year, forecast
Spain	-10.6	2016	2014	84.2	2024
Ireland	-7.6	2015	2015	117.6	2020
Greece	-10.0	2016+	2016	156.9	2020+
Serbia	-6.4	2016		59.2	ok
United Kingdom	-6.3	2017	2014/15**	90.0	n.a.
Cyprus	-6.3	n.a.	2012	85.8	n.a.
Czech Republic	-4.4	n.a.	2013	45.8	ok
Portugal	-6.4	n.a.	2014	123.6	n.a.
Slovakia	-4.3	n.a.	2013	52.1	ok
France	-4.8	2015	2013	90.2	n.a.
Slovenia	-4.0	n.a.	2013	54.1	ok
Netherlands	-4.1	n.a.	2013	71.2	n.a.
Denmark	-4.0	n.a.	2013	45.8	ok
Poland	-3.9	2015	2012	55.6	ok
Lithuania	-3.2	n.a.	2012	40.7	ok
Austria	-2.5	ok	2013	73.4	n.a.
Belgium	-3.9	213	2012	99.6	n.a.
Romania	-2.9	n.a.	2012	37.8	ok
Italy	-3.0	n.a.	2012	127.0	2020+
Malta	-3.3	n.a.	-	72.1	n.a.
Hungary	-1.9	ok/16?	2012	79.2	2022
Finland	-1.9	ok	-	53.0	ok
Latvia	-1.2	ok	2012	40.7	ok
Luxembourg	-0.8	ok	-	20.8	ok
Bulgaria	-0.8	ok	-	18.5	ok
Estonia	-0.3	ok	-	10.1	ok
Sweden	-0.5	ok	-	38.2	ok
Germany	0.2	ok	-	81.9	2021
Switzerland	0.2	-	-	-	-
Norway	13.0	-	-	28.1	-
EU-27	-4.0	-	-	87.2	-
EA-17	-3.7	-	-	93.1	-

* Estimate, Eurostat. ** Fiscal year.
Sources: AIECE institutes, European Commission, Eurostat.

This policy is criticized by a few academic economists in Europe and more from the US. Even the IMF has discussed the current austerity policies "The widespread need for major fiscal adjustment and the difficulties associated with austerity programs rekindled a debate on fiscal multipliers, the optimal speed of fiscal consolidation, and the design of medium-term adjustment programs to reassure market participants and the public at large". (Rethinking Macro Policy II: Getting Granular. Prepared by Olivier Blanchard, Giovanni Dell'Ariccia, Paolo Mauro April 15, 2013)

There is actually a heavy debate on the austerity policies, sizes of the multiplier etc. and the role of monetary policy. A debate on the size of fiscal multipliers has been very vivid since the start of the Great Recession. Some think that there is no fiscal effect or that it is very small as forward looking agents smooth the potential effects. In the Keynesian tradition, they are estimated to be very effective, while the estimates of "international work horse" models like Quest in the Commission or NiGEM in the NIESR are typically below one.

The additional feature is that the normal fiscal and monetary mix is not possible as the interest rates are close to zero (zero lower bound, zlb). The usual accommodative monetary policy to counterweight the tightening fiscal policies is strongly restricted. This is argued to raise the size of the multipliers significantly. In the following we touch a bit on these issues by investigating the views of the AIECE institutes.

Questions:

Q1 How would you evaluate the measuremant of structural deficit and a 0.5 %/GDP target?

Q2 What is your view on the discussion on the size of multipliers?

Q3 Is it possible for France to achieve a 3 %/GDP deficit target this year?

Table 3.3
Structural balance in selected countries

	2012	2013	2014
Belgium (FPB)	-2.8	<-2.4	
Denmark (DEC)	-1.1	-0.1	0.1
Finland (ETLA)	-0.1	0.1	0.2
France (COE)	-4.0	-2.8	-2.0
Germany			
– DIW	0.0	0.6	0.7
– IFW	0.3	0.0	0.1
Greece (KEPE)	0.8	1.8	n/a
Hungary (GKI)	1.0	0.5	0.5
Ireland (ESRI)	4.9	4.5	2.1
Italy			
– Prometeia	-1.5	-0.5	-0.4
– REF	2.2	0.9	0.9
Netherlands (CPB)	-2.4	-1.4	-1.7
Poland (IBRKK)	-3.0	-2.5	-2.0
Spain (CEPREDE)	-3.6	-1.6	-1.2

Source: AIECE institutes.

3.3 Turning the cycle to better?

The question "The following factors are useful in turning the current cycle in your country" got understandably a very different reaction from the respondents depending on their economic situation. On the one hand, in Switzerland and in Germany, there is no need for extra expansive policies as the economy has been in upswing since the Great Recession in Switzerland and Germany is in a "boom period". In the case of Germany there is a need for public infrastructure expenditures, but due to the cyclical situation, the private-financed infrastructure projects would be preferable like "road pricing". In Sweden, no action is needed as the recent moderation in growth forecasts is explained by the weak external environment.

Figure 3.3a

Following factors are useful in turning the current cycle in your country by the AIECE institutes

Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

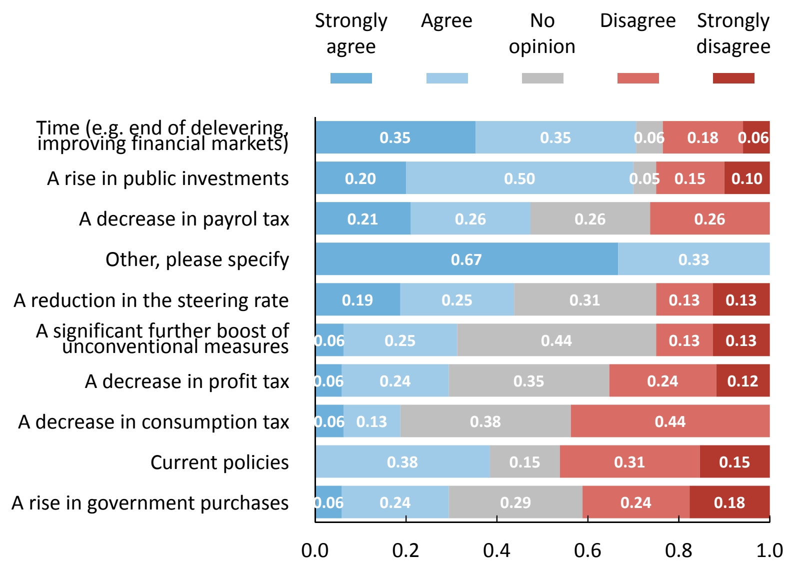
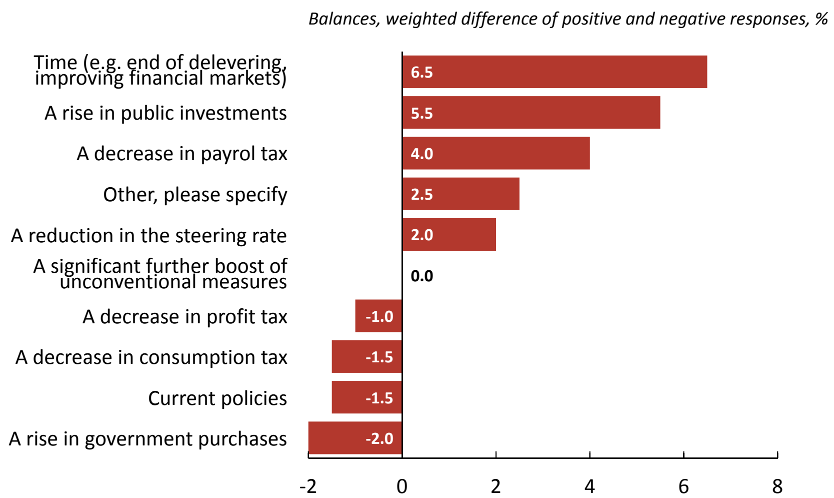


Figure 3.3b

Balances of evaluation



Source: AIECE institutes.

A natural choice, a rise of public investments, got strong support in Slovenia and Serbia. In Slovenia a reduction of labour taxes was also stressed. In Hungary, the new debt financed actions were seen very risky. In Spain and Italy the restoring of private confidence was seen as a key factor. In Italy, a clarification of the political situation was seen very useful. In Greece, which is facing a most difficult downturn among the AIECE countries, a combination of factors like active labour market policies with "aggressive" export policies and utilizing high multipliers of productive investments would be needed according to a Greek respondent.

The most popular reason for the forthcoming upturn was just endogenous processes in the economies, which got the highest rank with 6.5 points. A reduction of the steering

Figure 3.4a

Following factors are useful in turning the current cycle in the Euro Area by the AIECE institutes

Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

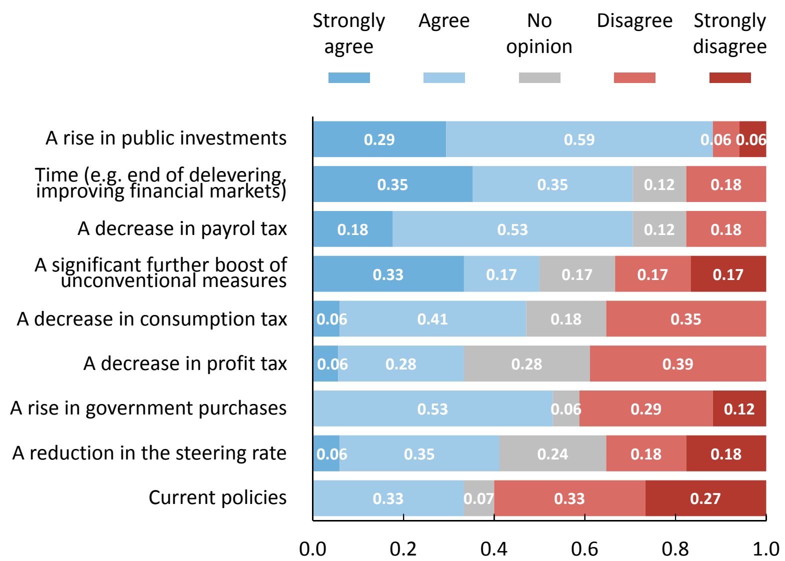
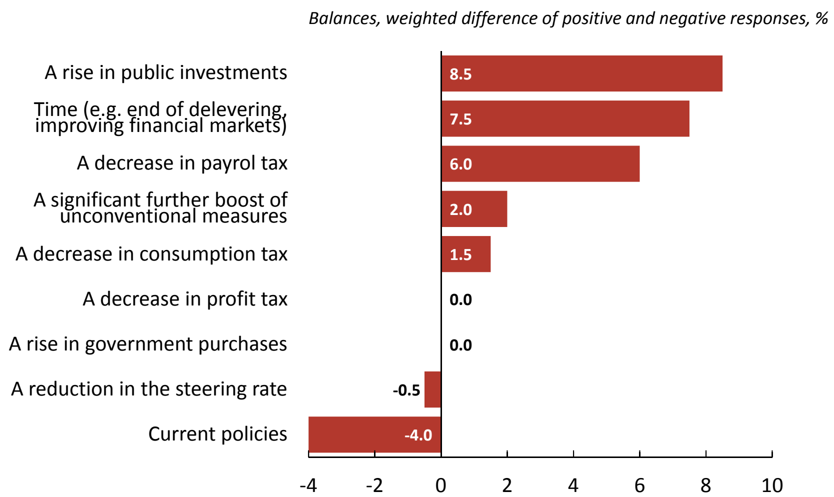


Figure 3.4b

Balances of evaluation



Source: AIECE institutes.

rate of the ECB was also supported. A bit surprisingly a reduction of profit taxes did not get support, while the negative attitude towards a reduction of consumption taxes was expected due to its importance for government finances under the fiscal problems.

Similar question on "turning the cycle of the Euro Area" got contradictory responses relating to active policies. A rise in public investments got the best marks (8.5), while current policies got the worst marks (-4). A decrease in payroll tax and a further boost of unconventional measures were supported by the institutes on average. Institutes were indifferent with respect to a rise of government purchases.

In some comments the "utter failure" of the austerity policies was seen to be proven and at least it was not seen useful in turning the cycle. On the other hand, expansionary fiscal policies could be of help in the short run, especially when monetary policy faces a zero lower bound, but it could not solve the structural problems. A consolidation of public budgets was, on the other hand, seen as important in gaining a credibility of a sustainability of public finances. It was also noted that problems in crisis countries are of structural nature, which makes deficit spending unsuitable for curing the problems. A significant improvement in EMU architecture, e.g., a banking union was also brought forward.

It was also noted that it might be useful to support the turn by relaxing consolidating plans in "stronger" countries to support the demand of crisis countries, which are trapped to policies agreed with the EFSF/ESM and the markets.

Questions:

Q1 How do you see the austerity policies: utter failure or market dictated necessity?

Q2 Do you see any room for change of fiscal policies to less restrictive direction in the no-crisis countries?

Q3 The German GDP in the last quarter of 2012 was 1.4 per cent (and industry 5.7 per cent below) above the peak before the Great recession after 5 years' development and the current account per GDP last year was 6.3 per cent. Is the underlying growth so fast that any stimulus would be harmful?

Box 3.2
Ireland's slow turnaround

The causes of the disaster that hit the Irish economy in late 2008 are well known. An exceptionally large property market bubble was allowed to develop over the course of the last decade. While fiscal policy conformed to the Stability and Growth Pact guidelines, running a small surplus, this still represented an inappropriately stimulatory fiscal stance. Side by side with this fiscal policy failure, the financial regulator totally ignored the massive rise in the exposure of the banking system to the domestic property market. The rapidly rising current account deficit, resulting from the building boom, was financed by short-term inflows through the banking system.

When the economy hit the financial iceberg in September 2008 the regulatory authorities and the government did not realise the full magnitude of the financial crisis. A guarantee of the liabilities of the banking system was issued by the government unaware of the fact that two of the banks were seriously insolvent. The consequence of this policy mistake was further aggravated by an insistence by the ECB that even the unguaranteed bank bonds issued by these banks be fully repaid. By the end of 2011 the cost of the guarantee of the insolvent banks amounted to 20% of GDP. In addition, the rest of the banking system needed to be recapitalised and the total bill for this latter operation in 2009-11 amounted to another 20% of GDP. Thus the cost of the banking disaster, on its own, amounted to a total of 40% of GDP.

In addition, to the costs of the banking crisis, the associated collapse in the economy saw government borrowing rise dramatically. The tax base had been very dependent on building and property transactions. In addition, the collapse in building output saw the unemployment rate rise rapidly from under 5% to over 14%. The net result of these factors was that the debt GDP ratio, which stood at 25% of GDP in 2007, is peaking at around 120% of GDP.

The government was slow to tackle the fiscal crisis. While a tough budget was implemented in 2010, it only served to slow the deterioration. By late Autumn 2010 it was clear to the then government that further dramatic fiscal action was needed to restore the public finances to a sustainable level. A plan for adjustment was introduced covering the period to 2015. This plan was accepted as being realistic by the Troika when they were asked to provide major financial support for Ireland at the end of 2010.

The 2010 fiscal adjustment plan was adopted by the government knowing that it would lose an election within two months. By adopting a plan which was politically feasible for the incoming government to implement, the outgoing government facilitated the transition process. This contrasts with the case of Spain where the outgoing government overpromised in late 2011 making the task of the incoming government even more difficult. In the case of Ireland, the outgoing government, by adopting a politically realistic plan, made it possible for the incoming government to outperform its targets each quarter over the period 2011–13. This has helped build confidence in financial markets, allowing the government to return to the financial markets over the last 6 months, borrowing at interest rates of under 4% for long dated bonds.

The real economy saw a very big fall in output of around 8.4% in the 2008–10 period. However, since 2011 there has been a return to growth, albeit of a rather anaemic character of around 1% a year. This growth must be seen against the background of the continuing large budgetary adjustments, which are estimated to have reduced the rate of growth by around one percentage point each year between 2010 and 2012. Were it not for the fiscal adjustment in Ireland, the economy would have grown at over 2% a year in 2011 and 2012.

The resilience of the Irish economy in the face of its domestic traumas reflects a strong tradable sector, which has not been permanently damaged by recent events. There has been a substantial improvement in competitiveness, which has restored some of the losses of the boom period. The economy has also specialised into sectors with a high income elasticity of demand (pharmaceuticals, IT hardware, health care equipment, software and some financial services). This has allowed growth in exports and tradable sector output in spite of the weakness in demand in the country's main trading partner, the rest of the EU. In turn this has resulted in an elimination of the large current account deficit replacing it with a significant surplus in 2013.

Nonetheless, the exceptionally poor performance of the Euro area economy is having a serious impact on the Irish economy delaying a full recovery. The slow recovery in the US economy, which is also of considerable importance for Ireland, is also having a deleterious effect on current performance. While substantial progress has been made in bringing the public finance crisis under control, there is a still a need for at least one more tough budget. This may well be enough to eliminate the structural deficit. However, the procyclical fiscal policy in the Euro area (reducing growth by c. 1% this year, Euroframe 2013) means that the actual deficit will still be significant next year.

3.4 Measures to tackle the difficult unemployment problem

Responses to the question on measures effective to reduce the unemployment, the market based measures were not at the top. Instead, a removal of fixed-term contracts was ranked as the least effective action among the measures. In addition, a fostering of apprenticeship programs was seen as being the most effective tool. The next best tools were a special youth unemployment program and a liberalization of employment protection legislation with the same high ranking. The next most popular measures were a liberalization of collective wage setting, a reduction in social security or unemployment benefits and a reduction of minimum wages. The Spanish institute suggests changes in part time regulation to foster part–time employment as a very effective measure.

Figure 3.5a
Following measures are effective in reducing unemployment by the AIECE institutes
Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

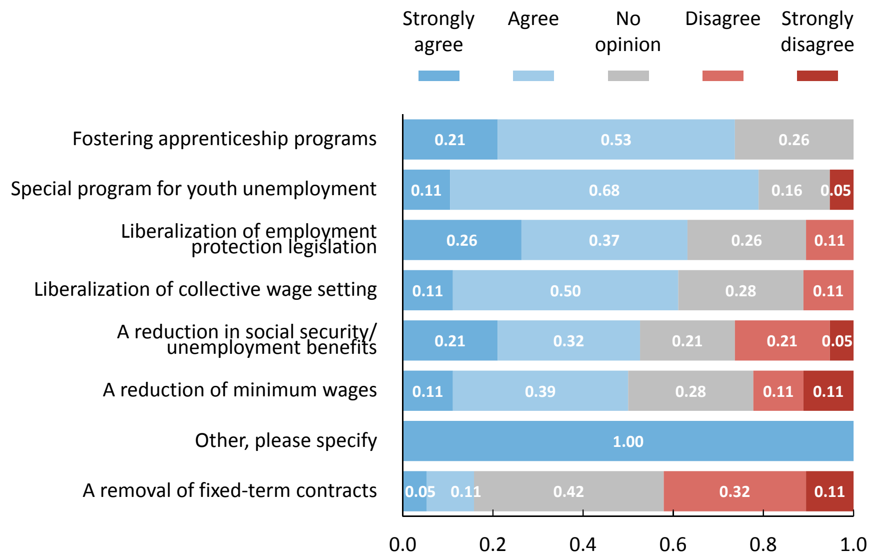
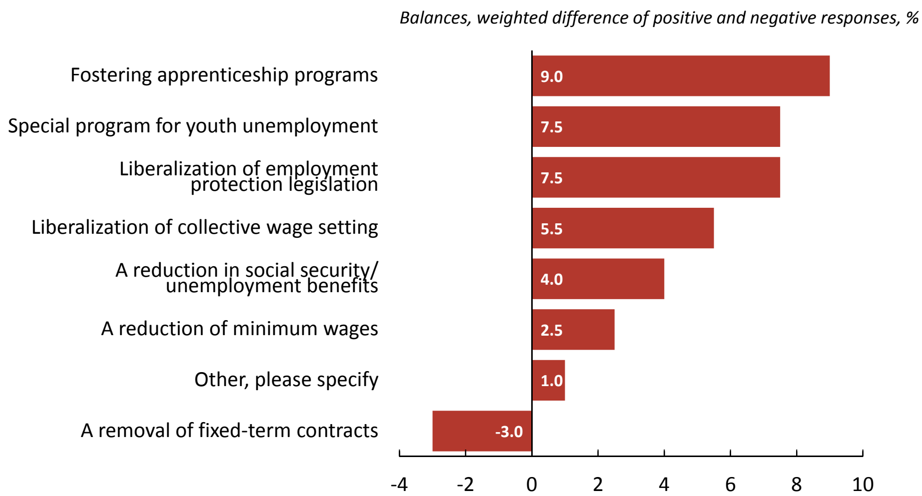


Figure 3.5b
Balances of evaluation



Source: AIECE institutes.

While many of the institutes welcomed the suggested measures, it was also noted that, if the high youth or general unemployment is due to separation of labour markets by entry barriers, insider-outside effects etc., the root of the problem should be addressed. It was also brought forward that the measures affect slowly and are of longer-term nature. In Hungary, the employment protection legislation has already been liberalized with controversial results. In practical terms, there is no more room for further reduction in minimum wages and social protection after former actions. In Poland, the reduction of minimum wages is not politically feasible. Instead a rise or at least stabilization of it would be a real alternative. In Italy, the unemployment is demand-driven with minor short-term effects of changes in labour market institutions. A bit surprisingly, no one suggested a strong fiscal expansion to raise the aggregated demand along the Keynesian tradition.

In Sweden, the country-specific studies find no significant effects of employment protection legislation (EPL), although the strict EPL may have negative effects four groups on the margin of the labour markets. OECD studies hint that EPL may reduce the labour flows. The Swedish experience shows small or even negative effects of youth programs, though investment in regular school system should have positive effects.

Question:

Q1 Do you have experiences on the benefits of apprenticeship programs?

3.5 Debt problem in review

The legacy of the Great Recession in general and in addition a sovereign debt crisis in the Euro Area has made the size of the debt unsustainable in most industrialised countries. Many countries are struggling to meet the deficit (3% of GDP) and debt targets (60% of GDP) set in the Stability and Growth pact in the recession. The development of the governance of the EU means stricter rules. For example, the debt target was made operational by the introduction of so-called six pack. If the debt exceeds 60 per cent of GDP, a country is obliged to diminish the debt by at least 0.5% a year over three years. Also the growth of public spending must not rise faster than medium-term potential growth, if matched revenues are not found.

In the group of AIECE countries and Finland, Denmark, Poland, Sweden and Switzerland, have public debt to GDP ratios below the criteria of 60 per cent in 2013–2014 according to their forecasts. On the other hand Italy, Ireland and Belgium have debt ratios exceeding 100%, while the rest of the respondent countries have debt loads between 60–100 per cent of GDP.

The responses to the question "following permanent actions are useful in reducing debt in the long term in your country" only a rise in consumption tax was seen useless on average. A change in the structure of public spending and a rise in the pension age were seen to be very effective. A reduction in corruption and in the shadow economy, as well as an acceleration of labour market reforms was also regarded as effective. A joint coordinated action, a reduction in government purchases and a reduction of labour taxes and offsetting consumption taxes (internal devaluation) were the next actions in the ranking. Eurobonds on a country level, i.e., mutualisation of the debt across countries was seen very positively by one of the institutes.

EU countries have been active in reducing the debt under the new stricter rules. In Germany, most states have introduced debt brakes to comply with the fiscal compact and national debt brake. In France, the government aims to fulfil the deficit criteria, but it will quite certainly miss the target this year and probably also next year unless new cuts in expenditures are introduced.

In Finland Government plans to stabilize the public sector by rising taxes, e.g. the value added tax was raised by 1 %-point since the beginning of 2013, although it is not generally seen as being useful.

In Greece after the second bailout package in spring 2012 with private sector involvement, the longer-term aim is to reduce the fiscal balance below 3% and to generate a

Figure 3.6a
Following permanent actions are useful in reducing debt in the long-term in your country by the AIECE institutes
Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

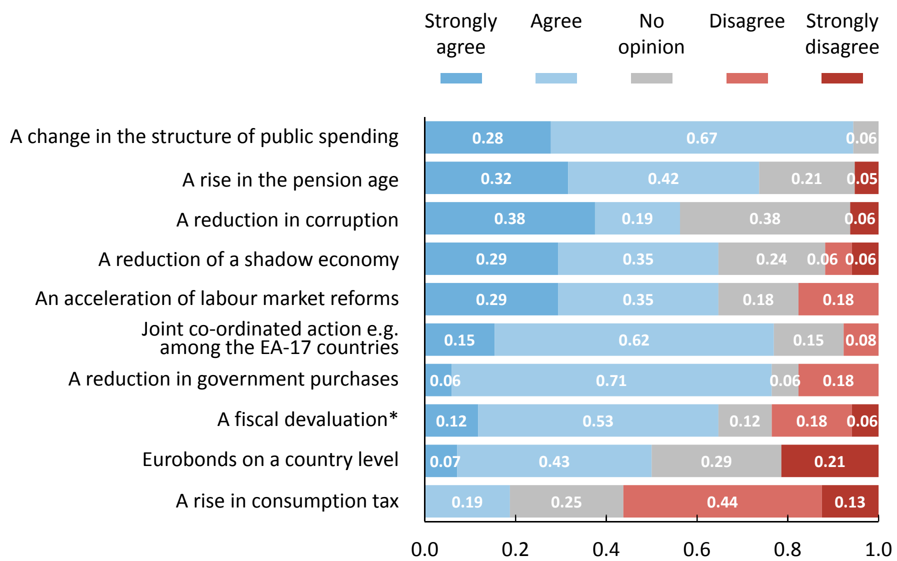
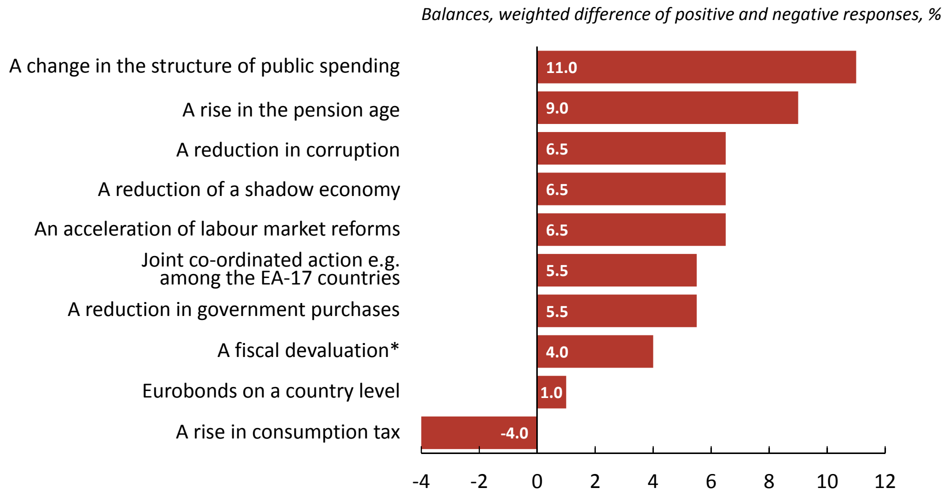


Figure 3.6b
Balances of evaluation



* A reduction of labour taxes and an offsetting rise in consumption taxes.
Source: AIECE institutes.

primary surplus of around 4.5 % in relation to GDP and lower interest burden on the debt stock by improved debt management.

The government of Hungary has no specific measures apart from those aimed at reducing the general government deficit. The size of the general government deficit relative to GDP will be influenced by the exchange rate developments due to the high share of external debt. Measures to take care of the shadow economy and corruption were not regarded successful.

Ireland has a huge debt load thanks to a rescue of its banking system after the bursting of the housing bubble. One legacy of those operations, "promissory notes" with 7 to 8 years maturity are being transformed to long-term government bonds with an average

Figure 3.7a
Following permanent actions are useful in reducing debt in the long-term in the Euro Area by the AIECE institutes
Evaluation on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree)

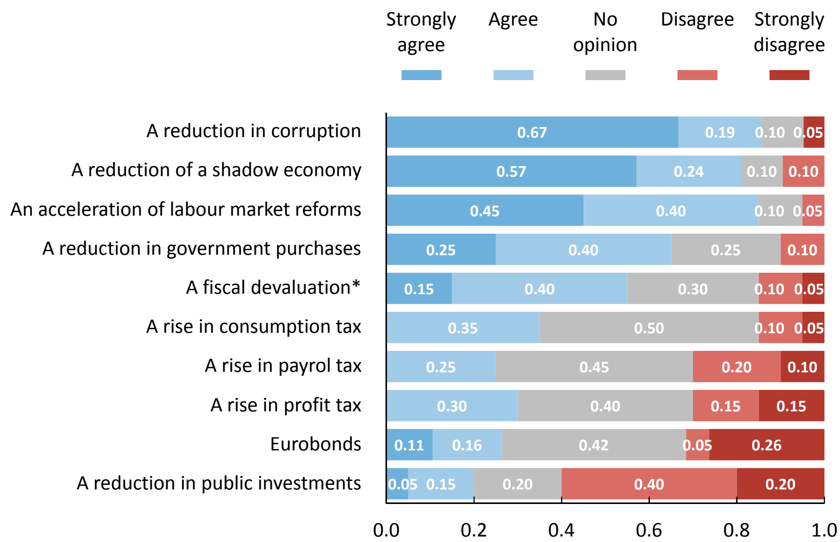
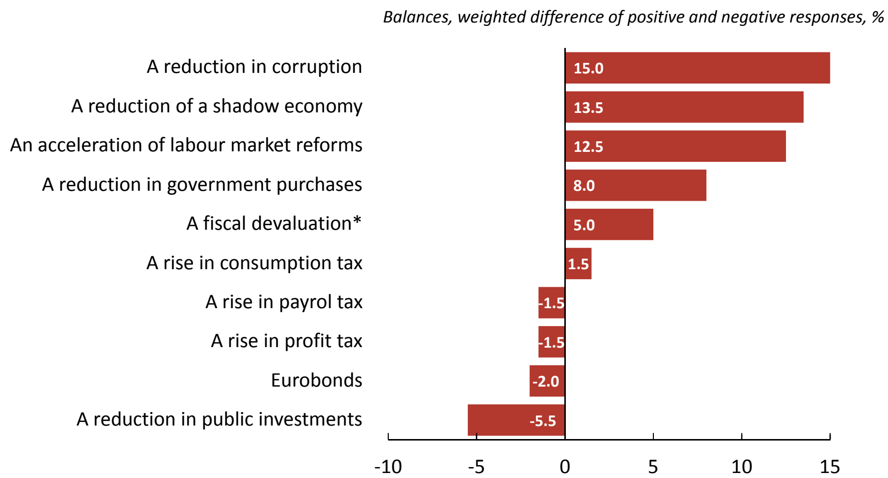


Figure 3.7b
Balances of evaluation



* A reduction of labour taxes and an offsetting rise in consumption taxes.
Source: AIECE institutes.

maturity of 34–35 years. The promissory notes from the Irish government were provided to two Irish financial institutions during 2010. These promissory notes amounted to €29.9 billion and were scheduled to provide a series of payments over the next 20 years.

In the Netherlands, the debt is reduced partly by accounting practises. The Lower government is obliged to deposit their savings at a general government account. This reduces the EMU debt by 1%-point.

In Poland, a yearly real growth of expenditures is restricted to 1 per cent.

In Sweden there is no debt problem, so no measures are needed.

The Swiss raise unemployment insurance fees and cut in benefits (2011). Spending cuts at the federal level from 2014 are announced but they have not yet entered into force.

The British fiscal policy over the next 5 years is currently focused on closing the budget deficit. Over the long-term, moving to a primary budget surplus with sustainable growth will shrink the debt stock. This natural process will happen more quickly due to the government's attempts to incentivise the extension of working lives. However, the Office for Budget Responsibility has indicated that further structural budget improvements of 1.1 per cent of GDP are needed in the future to deal with the rising pension and healthcare costs of an ageing population. Such estimates are, however, highly sensitive to assumptions about future life expectancy and the productivity profile of the healthcare sector.

When the views on the actions to reduce debt at the level of the Euro Area were reviewed, a reduction of corruption was seen as the most important measure followed by a reduction of a shadow economy. An acceleration of the labour market reform was at the third place. A fiscal devaluation and a rise in the consumption tax were also seen to be effective. A rise of payroll tax was seen as negative. This is in line with the view of its usefulness in supporting the growth. A rise in profit tax and a reduction in public investments were not seen useful. The introduction of eurobonds did not get support on the Euro area, either.

Questions:

Q1 In your opinion, what would be a useful change in the structure of public spending?

Q2 What if the crisis escalates in a big country like Spain or Italy?

Q3 Does a new system using bail in of depositors ease the crisis solving?

Q4 Does lengthening of the maturities of debt in cases of Ireland and Portugal help in restoring confidence in the financial markets?

Box 3.3

Does the Cyprus crisis provide a solution for changing the rules of the game?

The government of Cyprus was the 4th country to request a bailout in the Sovereign debt crisis of the Euro Area. The Cyprus crisis is the first case for the European Stability Mechanism (ESM), which together with the IMF offered the 10 billion euro bail-out package under the condition that Cyprus covers the rest (around 13 bn euros) to ensure "restoring sustainable growth and sound public finances over the coming years" and commits to "efforts in the areas of fiscal consolidation, structural reforms and privatisation"

The final solution consisted of the resolution of the two largest banks. The size of the banking sector will be reduced to the European average (about 3.5 times of GDP) by 2018. In this process, the second largest bank in Cyprus, Laiki Bank will be closed and the largest bank, Bank of Cyprus will be restructured

The Laiki bank will be split into a good and bad bank and the good part will be merged to Bank of Cyprus. It will take 9 billion euros of European Central Bank liquidity with it to Bank of Cyprus. Laiki Bank's as well as Bank of Cyprus' branches in Greece are being sold to Piraeus Bank, but all loans and credit facilities to Laiki Bank customers are transferred to Bank of Cyprus. Shareholders and bondholders in Laiki Bank will lose their investments. Non-performing loans and uninsured deposits above 100,000 euros in the Laiki bank will be placed in a bad bank, which will be liquidated over time. This is set to raise 4.2 billion euros for the rescue. The haircut of deposits in the bank of Cyprus may end up at 60 per cent, as this could bring the capital ratio up to the target of 9 per cent. An interesting detail in this process is that foreigners, who lost more than 3 million euros of their deposits under the EU bailout of the island would be given passports of Cyprus.

According to the central bank of Cyprus, the haircut of deposits in Bank of Cyprus depend on the balances of credit and loan facilities and deposits. If the sum of the balances of loans and credit facilities is greater than or equal to the amount of deposits exceeding 100,000 euros, then the resolution measures are not applied. If not, then

- 37.5% of this difference is automatically converted into shares of Bank of Cyprus
- 22.5% of this difference is temporarily 'frozen' and possibly part or the whole of it will be converted into shares of Bank of Cyprus
- The remaining 40% of the difference is temporarily 'frozen' for liquidity purposes. The interest continues to be calculated for this deposit based on the existing interest rate, plus an increment of 10 basis points. This amount will be 'unfrozen' in a short period of time and will not be used for resolution purposes.
- The plan is still to be approved by the Parliament of Cyprus.

The rescue operation of Cyprus differs from the previous three rescue operations as in addition to the bail-out of the government, the bail-in of investors or investor-responsibility is also applied. It is the first time, when a rescue of a crisis country in the Euro Area has included a bail-in of bank depositors. It is rather remarkable that this new element of the rescue operation did not affect the markets much, even though the short-lived attempts to touch also on the insured below 100,000 euro deposits spooked the markets.

It looks very likely that bailing in creditors including possibly large uninsured deposits will be part of the possible future rescue operations. This is a very significant development. It will reduce costs of future rescue operations for the governments. In doing so it should also alleviate the fears that a banking union would automatically lead to large transfers from financially stronger member states to those experiencing significant banking problems. This should help the process of establishing a banking union. In addition, resorting to a significant bail-in of creditors without excessive financial market turbulence could also help to restore some credibility of the non-bailout principle with regard to the sovereign debt, too.

References:

Clarifications for the better understanding of the resolution measures implemented under the Resolution of Credit and Other Institutions Law, 2013 at the Bank of Cyprus and Laiki Bank, 30 March 2013

http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12631

Eurogroup Statement on Cyprus, 25/03/2013 - Statement

http://www.eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

Appendix Comments on the questions by countries

A.1 The following factors are useful in turning the current cycle in your country. Please, evaluate on a scale between -2 and 2 (2 = strongly agree, 0 = no opinion, -2 = strongly disagree).

- A rise in consumption tax
- A reduction of labour taxes and an offsetting rise in consumption taxes*
- A reduction in government purchases
- A change in the structure of public spending
- Joint co-ordinated action e.g. among the EA countries
- An acceleration of labour market reforms
- A rise in the pension age
- A reduction of the shadow economy
- A reduction in corruption
- Eurobonds on a country level
- Lower taxes on labour and offset this by raising taxes on consumption

Comments:

Germany

RWI The economic conditions in Germany are good in this year. The upswing is expected to continue in the course of the year.

IFW "Germany is facing a boom period, therefore expansionary programmes are currently not advisable.

While higher infrastructure expenditures are necessary (the public capital stock is projected to further decline over the next 5 years) extra public investment spending is problematic as long as public social expenditures remain at their current levels; enabling private investors to finance parts of the infrastructure (in particular in the field of transportation) are highly advisable (e.g. via road pricing)"

Greece

KEPE A combination of factors can -in the medium term- enable economic resumption. Active labour market policies coupled with a more aggressive exports policy and a boost to high value-added productive/investment activities of 'high multiplier' impact need to be promoted more aggressively.

Hungary

GKI Considering the current state of the Hungarian economy (the size of the general government deficit and government debt relative to GDP and with a view to the excessive deficit procedure against Hungary), it is not possible or it is very risky to take fiscal measures as a result of which the general government deficit is increasing. At present the majority of the measures listed above cannot be applied in Hungary.

Italy

Prometia A clarification in the political situation will be very useful in improving confidence.

Slovenia

SKEP Slovenia needs a boost to growth that can be induced by public investments to multiplicative productive projects generating value added and jobs. We strongly oppose a rise in VAT, since it will not help the economy to grow, but only redistribute scarc public finance resources into day to day liquidity. A significant shift of taxation away from labour is needed, to help create jobs and boost private investment to productive industries.

Spain

CEPREDE The key factor is the recovery of private confidence, especially in firms, which must relaunch their investment projects.

Sweden

CSE The weak growth projections for Sweden are being mainly driven by the weak external environment. Therefore there is no need for any extraordinary measures.

Switzerland

KOF The question does not conform to the current Swiss case. Switzerland has been on a moderate upswing since the end of the great recession (admittedly, in this respect Switzerland is an exception in Europe).

Serbia

FTRI Public investment and exports will spur the growth of GDP.

A.2 Details on newly planned (fiscal) measures since autumn 2012

Belgium

FPB

Expenditure side

Savings on the expenditure side (decided in the federal budget conclave of November 2012) will come mainly from lower expenditure on development cooperation, a reduction in subsidies to state rail and post companies, savings in health care expenditure and fighting against social-security fraud. This budget was based on assumptions of GDP and inflation growth rates of 0.7% and 1.8% , respectively. The new budget conclave (in view of the traditional budget review of March) has not yet ended. Given the weak economic context the original aim (a general government deficit of 2.15% of GDP in 2013) will probably not be reached, but there seems to be a consensus to reach a structural improvement of the government deficit of about 1 %-point of GDP this year and to keep government debt below 100% of GDP.

Revenue side

The 2013 federal budget (decided in November 2012) relies on higher receipts from tax measures, among which are: increased withholding tax on dividends and interest; changes to the tax amnesty regulations; adjustments to the corporate tax system (concerning the risk capital deduction and the taxation of capital gains); increased excise duties on tobacco and alcohol; and increased taxation on life insurance investment premiums.

Finland

ETLA

Revenue side

The planned rise of employers' and employees social security rates was not carried out for 2013.

France

COE

Expenditure side

Frozen expenditure credits. Very few and detailed measures were announced as regards the expenditure side. It has mainly been an announcement of a global package more than a detailed program.

Revenue side

Increases for both households and enterprises tax. Some tax rebates have been significantly reduced (for example, tax rebates for interest payments). The size of the package for households is close to 1 % of their disposable income (about 14 billion euros) and 5 % of earnings (before distribution) for enterprises (about 12 billion euros of increase in taxes in 2013 as compared with 2012 baseline). The preceding increase takes into account new measures enforced during autumn 2012 as well as measures adopted earlier.

Structural reforms

Introduction of a compact of measures to boost competitiveness and employment with, in particular, a new tax rebate for enterprises to be due in 2014. Some reforms have been introduced in the labor market through a negotiation between social partners in order to adopt a move towards a greater flexibility as well as more security for people employed. A new scheme for retirement is to be discussed as well as evolution in social expenses (family policy).

Germany

RWI

Expenditure side

The expiry of the economic stimulus package reduces expenditure increase.

Revenue side

The rate of the contribution to the statuary pension scheme has been reduced at the beginning of 2013 from 19.6 to 18.9%, because the pension insurance fund reserves overshot significantly the upper reserve limit at the end of 2012. Furthermore the government reduced the fiscal drag which will result in a revenue loss of € 1.9 bn in 2013. As a consequence of the expansive fiscal policy and the economic slowdown a general government deficit is likely to reappear in 2013 which could reach ½% of GDP.

IFW

Expenditure side

Childcare support for families starting in August 2013 (annual expenditures: 1 bn euro).

Revenue side

Slightly reduced healthcare fees as of January 2013 (2 bn per year).

Greece

KEPE

Expenditure side

Rationalization of the Wage and Pension bill - Reduction in Gen. Gov. Operational Expenditure - Merging and Closures of SOEs - Restructuring of Public Enterprises - Reduction in Military and Health Expenditure - Rationalization of Medical and Drugs Expenditure - Reduction in Tax Breaks and Tax Exemptions - Broadening the Tax Base - Improve Efficiency of Property Taxes and Taxes on Energy - Adjustments in Social Benefits Expenditure.

Revenue side

Improved Local and Regional Governments (LRGs) revenue inflows esp. from combating Tax Evasion - Improved Tax Compliance - Improved Tax Administration and Management - Improved Revenues from Public Investment Programs - Improved Revenue Collection of LRGs - Solidarity Tax - Revenues from State Guarantees - Improved VAT receipts.

Structural reforms

A series of structural reforms are under way including: Privatization of State assets - Opening up remaining closed professions - Improved Enterprises and Business Registry to reduce Administrative Burden and assist in the simplification of business start-up procedures - Finalize the system of e-procurements - telecommunications and radio frequencies - Improve the National Prices Observatory - Liberalize the Postal Market - Privatize Railways network, Airflight Services/Airports and Transportation - Decentralization of the Public Investment Program - Reform Administrative Structures and e-Governance - Continue reforms in the areas of Health, Defence, Culture, Environment, Energy &* Climate change - Sports, Justice, Tourism, Agriculture and Shipping.

Hungary

GKI

Expenditure side

In 2013 expansive fiscal policy will take place, the general government deficit relative to GDP will increase from 2.5 per cent to 3.5 per cent. The loosening will occur mainly on the expenditure side. In 2014 tightening is expected again.

Revenue side

Austerity fiscal measures concerning Hungary's general government were taken 12 times in 2012 and 3 times in the first quarter of 2013. Most of them concerned the revenue side of the general government in terms of imposing different taxes and levies on the business sphere and on consumption. The risks of the implementation of the 2013 package are considerable. Another risk is that GDP at current prices will be lower than envisaged while planning the budget. There are counterbalancing items on the revenue side including significant tax increases and tax reductions (the size of the restructuring amounts to 1.5 per cent of GDP).

Structural reforms

There are no signs of structural reforms. The government tries to reduce the general government deficit by ad hoc measures including unconventional or unorthodox ones regardless of their long-term consequence.

Ireland
ESRI
Expenditure side
A cut in public sector pay has been proposed. If implemented it will take effect from July 2013. This follows the introduction of a public sector pension levy in 2009 and a public sector pay cut in 2010.

Italy
REF
Expenditure side
Stability Law (Oct. 2012): additional expenditure cuts in the wake of the Spending review process initiated during the summer of 2012; refinancing of some funds to finance social expenditure and investment in public transports. Decision (stated in the Relation to the Parliament, decree is forthcoming) to pay arrears to firms for 40bn (20 in 2013 and 20 in 2014). The part of arrears payments that will affect public deficit is only the one related to investments (8bn in 2013, 0.5% of GDP); current expenditures (12bn in 2013 and 20bn in 2014) will solely affect public debt and GG borrowing requirement.

Revenue side
Stability Law (Oct. 2012): Cancellation of the envisaged increase in VAT rate of 1 percentage point; introduction of some tax reliefs, both for firms (related to permanent hiring) and for families (related to children); increase of excise duties on oil products to cover expenditures due to the earthquake in Emilia; increase in taxation on financial transactions.

Structural reforms
Public spending review (summer 2012).

Netherlands
CPB
Expenditure side
All expenditure measures already known in autumn 2012, no new spending cuts since autumn announced.

Revenue side
Most revenue measures already known in autumn 2012. New measures since autumn: in 2013 lowering tax exemptions on course of life savings (€1 bn), lower VAT on investment in housing maintenance (-€0,2 bln), in 2014 introducing additional banking tax (€1 bln).

Poland
IBRKK
Expenditure side
Prolongation of a freeze on wages of public sector employees; start of a gradual increase of retirement age Revenue side.

Prolongation of a freeze in PIT thresholds; revenues from CO2 emission rights auctions; abolition of tax relief on Internet use; introduction of a less generous tax relief on children.

Structural reforms
Introduction of flexible working time arrangements.

Slovenia
SKEP
Expenditure side
Key measures with effect in 2013 and 2014: i) Labour cost in public sector should be lowered by an additional 5% in comparison to 2012: no-indexation of basic salaries, restrictive employment policy, boosting retirements, fringe benefits cuts (holiday bonus, meal allowance, travel reimbursement…), organisational improvements ii) Welfare allowances: - Implementation of pension reform from 2013 (lower indexation, higher retirement age). - Parental protection and family benefits cuts; child benefits for higher incomes cuts; no adjustment of child benefits; abolishment of no-charge nursery for second child; nursery school co financing lower introduced in 2012 - Lower unemployment benefits ratios.

Revenue side
- Corporate income tax lowered to 17% - Corporate income tax on capital gains increased to 25% - Personal income tax: temporary introduction of 50% bracket for highest incomes - Personal income

tax: widening of mid-income bracket (to lower labour cost!) - Tax on financial services (1% from any financial transaction) - Tax bank assets - Tax on immovable propriety (above the value of 0,5 million EUR) - CO2 environmental tax and increase in CO2 emissions tax - Increasing of excise duties - Higher taxation on motor vehicles, and registration fees, tax on water vessels.

Structural reforms
"Pension reform, in force from 1 January 2013:
(i) increases statutory retirement age to 65 years for men and women;
(ii) raises the effective retirement age by increasing the required years in employment to 40 with minimum age of 60 in order to obtain an old-age pension; full pension rights under age of 65 years are obtained through fulfilling additional condition of minimum 15 years of insurance period;
(iii) extends the pension rating base from 18 to 24 years to ensure a stronger linkage between the paid-in contributions and paid out benefits pensions;
(iv) reassess the formula for the valorisation of past earnings and reduce the indexation of paid out benefits pensions (60% wages, 40% CPI);
(v) introduces personal information accounts to enable insured person to follow all the details relevant for their pension benefits;
(vi) strengthens incentives and disincentives for early retirement; more favourable conditions for social contributions for older workers
(vii) promotes greater professional rehabilitation of disabled persons;
(viii) includes more flexible forms of retirement such as partial retirement;
(ix) modernises the supplementary pension system in order to raise participation as well as funds and
(x) ensures greater supervision over the operation of pension funds.

Labour market reform, in force from April 1 2013:

- lowering the segmentation of labour market, lower severance payments, lower unemployment benefits, more flexible work contracts Strengthening stability of Banks: measures that will have a swift impact on the banking system and provide for the legal basis to deal with bad assets of the banks rapidly through transfer of those assets to the Banking assets management company (BAMC). Among the objectives are minimizing costs and recovery of funds from taxpayers, promoting lending to non-financial sector, privatization of state owned banks and determination of accountability for the creation of bad assets. The issuance of government-guaranteed bonds is allowed, the assets of which will be transferred to the BAMC. The Act also allows for the issuance of a state guarantee for the obligations of the special purpose vehicles, established by banks or by banks and BAMC for the purpose of assuming banks' risks. Possible measure will also be a recapitalization of banks with assets of the BAMC. The assets, transferred to the BAMC, are not defined in the Act, where it is inter alia defined that the Government will, by way of implementing regulation, issue more detailed provisions concerning (1) the type of risk positions which may be acquired or the risks of which may be covered, (2) the type of acquisition or cover, including the measures, (3) upper limits for the assumptions of risks in relation to individual financial-sector enterprises as well as for certain types of risk positions, (4) rights for the benefit of the repo and repo obligations to the detriment of beneficiaries of the measures and other appropriate forms of participation in taking risks, (5) valuation issues of transferred assets.

In February 2013 government appointed 4 non-executive directors and adopted companies Statute. On the preparation of implementing regulations, the ministry is in constant contact with the International Monetary Fund, European Central Bank and the European Commission.

Spain
CEPREDE
There has not been any new package since last Budget in autumn 2012. Figures are Baseline estimations.

Sweden
NIER
Expenditure side
Budget Bill for 2012: Public consumption 5.5 billion SEK, Public investments 1.3 billion SEK, Transfers to households 4.8 billion SEK Budget Bill for 2013: PUBLIC CONSUMPTION: 7.7 billion SEK, PUBLIC INVESTMENTS: 1.6 billion SEK, HOUSEHOLD TRANSFERS: 2.9 billion SEK, OTHERS: 1.0 billion sek. Revenue side.

Budget Bill for 2012: Direct taxes households 1.2 billion SEK, Direct taxes firms -0.3 billion SEK, VAT -5.4 billion SEK, excise duties 0.8 billion SEK Budget Bill for 2013: DIRECT TAXES HOUSEHOLDS (lowered tax for pensioners): -1.3 billion SEK, DIRECT TAXES FIRMS (lowered company tax): -8.2 billion SEK, CAPITAL TAXES (deduction for investments): -0.7 billion SEK, OTHERS (VAT and excise duties): +0.8 billion SEK.

Structural reforms

2012: Approximately 70 per cent of the total amount 15.3 billion SEK are structural reforms. Focusing on consumption and investment in infrastructure, labour market reforms and reduced VAT on restaurants. 2013: Total amount approximately 70 per cent of the total measures for 2013 mentioned above (total amount 22.7 billion SEK) are structural reforms. Focusing on investments in infrastructure, research and innovation and improved conditions for enterprises and entrepreneurship.

Switzerland

KOF

Expenditure side

Expenditure cuts of around 574 Mio. of € per year over the period 2014-2016 at the federal level. It is expected to be broken down as follows: Administration(64 Mio.)//Development and cooperation (32 Mio.)//Diplomacy (12 Mio)//Interest payment to invalid insurance fund (120 Mio.)//Education and research(24 Mio)//Migration(14 Mio)//Defence (52 Mio)//Transfers(16Mio.)//Roads (72Mio.)//Rail(16Mio)//Environment (16 Mio.)//Miscellaneous.

The Federal Republic of Yugoslavia

FTRI

Expenditure side

A strong reduction in the government deficit is planned in 2013 – from 6.7% of GDP in 2012 to 3.6% of GDP. The sharp deficit reduction is necessary in order to stop the almost uncontrolled public debt growth at the end of 2013. The public debt has doubled its share in GDP since 2008 (from 30% of GDP to 60% of GDP) and if a similar trend continues in 2013 as well, there will be a public debt crisis – macroeconomic instability, a decrease in GDP and a high increase in unemployment. On the public expenditure side, the strongest austerity measure is the restriction of increase in public sector wages and pensions to 2% in October 2012 and 2% in April 2013. The achievement of the planned budget deficit in 2013 will also require a sharp reduction of the expenditure for the procurement of goods and services and for subsidies.

Revenue side

The revenue of the republican budget in 2013 is planned in an optimistic manner but it is still likely to be collected due to inflation acceleration. Current analysis indicates that the public revenue increase in 2013 is basically overestimated, particularly in the corporate income tax and non-tax revenue items. However, the latest available data on inflation indicate that it is very likely that inflation will be slightly higher than the one used for the preparation of the budget. Due to higher inflation than planned, the republican revenue will increase, and the planned total revenue of the republican budget in 2013 will most probably be reached.

Structural reforms

Most of the planned deficit reduction will undoubtedly be achieved and this is due to structural measures relating to wages, pensions and taxes. We believe that the remainder of the anticipated savings is insufficiently well prepared and therefore more difficult to achieve.

United Kingdom

NIESR

Fiscal policy announcements since the Autumn have been fiscally neutral.

A.3 Risks of forecast by countries

	Risks of inflation	Risks for economic growth
Belgium *FPB*		Belgian economic growth should gradually pick up throughout this year (up to 0.3% qoq in 2013Q4), but remain limited to 0.2% on a yearly basis. Export growth should gradually accelerate, driven by the improving international economic situation. Household purchasing power should increase, but the pickup in private consumption remains limited as the rise in unemployment continues to weigh down on consumer confidence. Reduced profitability and a low capacity utilization rate will hold back business investment. Employment should stabilize this year. There are not country specific risks, see risks for the euro area.
IRES	Energy prices, possibility of increase in indirect taxes	Slower growth at trading partners (in particular in the euro zone), consumer confidence stagnating longer than expected due to new shocks.
Finland *ETLA*	Commodity prices, especially food and energy. Risk is in both directions.	Slower-than-expected growth in the external markets, and especially in the Euro Area.
France *COE-Rexecode*	An increase in VAT will temporarily add about 0.4 to 0.6 point of inflation at the beginning of 2014. Food prices have been on an ascending trend last months, they still give a significant impulse to price. Nevertheless, underlying inflation tends to slow down in relation with the decrease in wage pressure.	The main risk is associated with the enforcement of fiscal package and the reaction of agents (both households and enterprises) and more specifically on the implicit bet made by government on a significant decrease in savings ratio of household. Such a decrease is quite hazardous in a context of rising unemployment. As long as 99% of world GDP growth will come from outside Euro Area in the coming two years, the main factor of growth for France will be associated with its ability to address its structural problem of low competitiveness.
Germany *DIW*	Wage growth spilling over to prices stronger than expected, higher oil prices.	Weaker than expected external demand, higher oil prices.
IFW	Increasing unit labour cost (following higher momentum in upward wage dynamics) accompanied by higher credit growth in the run-up to a monetary boom in Germany.	Investment-driven upswing fuelled by an extremely expansionary stance of monetary policies; risks: any form of distortions of the capital stock/production structure (e.g. housing booms) that are typically associated to strong credit growth or other forms of monetary injections. While it is very unlikely that massive effects materialize in the short run, the period 2013/2014 might be the launching pad for such a development.
RWI	The main factor driving inflation will be a stronger endogenous price trend due to a relatively expansionary monetary policy due to the common monetary policy in the EMU. Downward risk: Debt crisis, especially if big countries such as Italy or Spain are affected. Upward Risk: Energy prices, as the switch to renewable energy sources requires substantial investments, consumers will have to pay for. Debt crisis further drags economic development on the periphery without escalating, which will result in a more expansionary policy stance for Germany.	
Greece *KEPE*	1. Further wage reductions 2. International commodity prices	1. Fiscal consolidation measures, 2. Lack of liquidity
Hungary *GKI*	The reduction of regulated prices (electricity, natural gas, heat, water, sewage, waste) by legal rules built in hidden inflationary pressure in the economy. Depressed prices cannot be maintained in the long-run, therefore the acceleration	The risks are of political nature. First, the government dismantled legal certainty, this has an adverse impact particularly on investments and the inflow of foreign direct investments. Second, the unorthodox measures to reduce

	Risks of inflation	Risks for economic growth
	of inflation is expected. With the phasing out of the impact of the rise in VAT rates the rate of inflation should drop. Additional taxes imposed on utility service providers would exert upward pressure on inflation. Increasing food prices tend to lift the inflation rate. Government measures confuse the inflationary expectations and price formation of economic organisations.	the general government deficit tend to stifle GDP growth. Third, prior to the parliamentary elections in the spring 2014 the government may loosen focal discipline.
KOPINT-TARKI	The main risk is posed by the weakened forint: a persistently weak forint may give a boost to inflation.	A possible continuation of bad export performance and of a growth rate of imports higher than exports could result in an on-going recession in 2013. Although several factors leading to the recent unfavourable export trends seem to be temporary, the negative growth of food exports may persist at least in the first half of the year. Although the necessity for further fiscal austerity measures might arise in the second half of 2013 and in 2014. Such measures could kill the first "green shots" of recovering domestic demand.
Italy *PROMETEIA*	Headline inflation will be shaped by the planned increase in VAT rate (from July 2013).	Global demand is the main factor supporting Italian GDP growth over the next quarters, as domestic demand will continue to be negatively affected by restrictive fiscal policy, credit squeeze and low consumer and firm confidence.
Poland *IBRKK*	Factors: 1) GDP slowdown; 2) rise of unemployment. Risks: Increase in risk aversion -> capital outflow -> zloty depreciation	1. Fall of the GDP in the euro area; 2. Transfer the multinationals' production from Poland to the mother country. 3. Social unrest.
Serbia *FTRI*		Recessionary pressures in the euro area is a risk for merchandise exports to EU.
Slovenia *SKEP*	Main risk to inflation is trends in commodities markets (especially oil and food), as well as increasing excise duties and the possibility of VAT increase.	Beside the developments in international markets, key risks for growth prospects in Slovenia are: stabilization of banking system, deleveraging of corporate sector, access to capital markets, access to working capital; trends on real estate markets, developments in construction sector and competition in construction sector. Other risks are possible increase in consumption taxes and low investment activity – connected also to the use of EU cohesion funds.
Spain *CEPREDE*	Possible downward risk stems from lower wage rates.	On the downward side, a new wave of financial pressures on Public debt, and on the upward side a higher than expected recovery in private (firms) investment
Sweden *CSE*		The main threat to the Swedish economy is the risk that the euro area continues to be in a recession.
United Kingdom *NIESR*	Further depreciation of sterling; further robust increases in domestic gas prices.	Downside risks include: deterioration of the Euro Area crisis; weaker Euro Area demand than forecast; far large fiscal multipliers than previously thought; continued weakness in the domestic banking sector. One upside risk is the future path of oil prices, partly related to the evolution of the shale oil and gas extraction, particularly in the US.