Federal
Planning Bureau
Economic analyses and forecasts

AIECE General Report

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Part 1

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Federal Planning Bureau

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Executive summary

This report contains a brief overview of the current state of the world economy. It also digs deeper into certain topical themes such as the effects of the future ending and retraction of central banks' balance sheets' expansion on financial markets; the nature of the Chinese credit bubble, its effects on future Chinese economic growth and the consequences for the world economy; the likelihood of the end of deflation in Japan; the shale gas and oil boom in the US; the secular stagnation thesis (stating that growth in developed economies remains weak for another decade); the likelihood of deflation to materialise in the euro area and what the ECB could do to avoid such an outcome; the feeble state of the European banking system and the remedies to bring it to health again; the nature of the improvement in the current account balances of peripheral countries in the euro area.

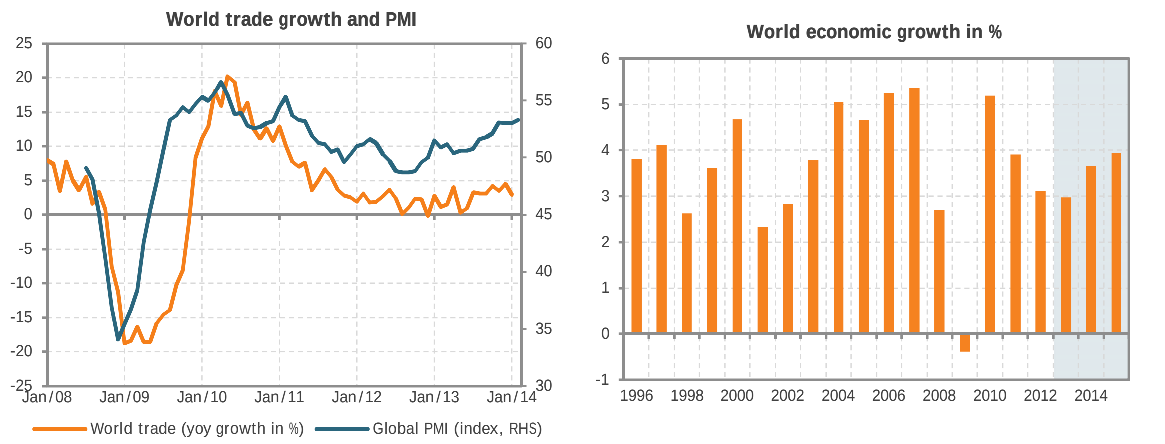
The report generally represents the authors' views, but the opinion of the AIECE institutes that participated in the survey are presented throughout the document.

1. The recent past and the near future

1.1. The world economy

The slowdown of the world economy, which started in 2011 after the post-financial crisis bounce, came to an end in 2013 under the influence of a new phase of quantitative easing in the US, an expansive monetary and fiscal policy in Japan and a less restrictive fiscal policy in the euro area. Most of all, the promise of the ECB to stand behind the euro, no-matter-what, ended speculation about a possible dissolution of the euro area. This ended the turmoil in financial markets, which itself had weighed down heavily on consumer and producer confidence. The recovery was hesitant at first, but gained ground in the second half of 2013. The growth profile of the world economy is also reflected in the evolution of world trade (see figure below), although the latter is characterized by more pronounced movements.

Graph 1 Indicators world economy



Source: CPB, Markit, IMF

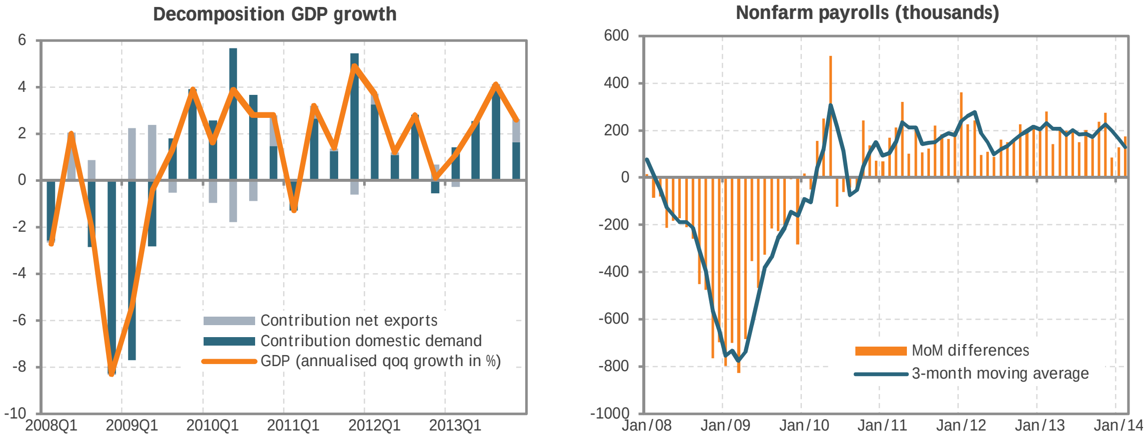
The global PMI indicator[1] rose significantly in the second half of 2013, reaching its highest level since early 2011. This suggests that global economic growth might firm in 2014Q1. Further improvement of global economic activity is expected in the rest of the year and next year, but without expecting the buoyancy seen in the years preceding the financial crisis. In its latest outlook, the IMF counted on an acceleration of global GDP growth from 3% in 2013 to 3.6% in 2014 and to 3.9% in 2015, mostly on the back of an acceleration of economic growth in advanced economies.

1.2. United States

In spite of an exceptionally large tightening in fiscal policy, US economic growth remained firm in 2013. GDP growth accelerated from a quarterly average of 0.4% in the first half of the year to 0.8% in the second half, when it was mostly driven by private consumption, an inventory build-up (in Q3) and a sizeable contribution of net exports (in Q4).

1 An indicator derived from monthly surveys of purchasing managers probed for their assessment of production levels, order books, employment, exports, stocks of raw materials and finished goods and prices of input and of finished goods.

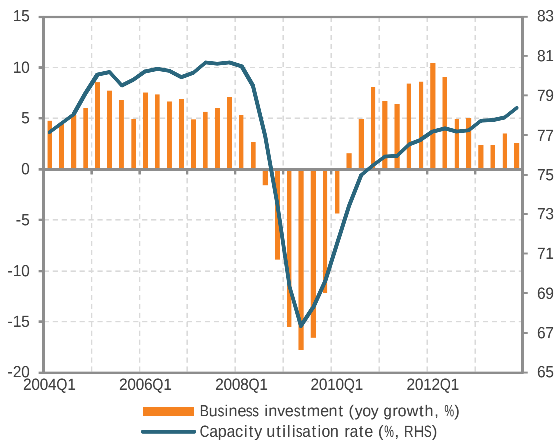
Graph 2 US GDP and employment growth



Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics

The weakness in economic indicators (e.g. non-farm payrolls) at the start of this year probably had to do with a lull in activity due to the cold winter spell and was of transitory nature as was indicated e.g. by the jump in non-farm payrolls in March. The weather related weakness and the payback for past rises in inventories have probably led to a slower growth rate in 2014Q1, but overall GDP growth is expected to strengthen in 2014. Business investment growth, which remained weak in 2013 as it was weighed down by the uncertainty over the budget and the debt ceiling, ought to firm significantly. A rising capacity utilisation rate and (extremely) favourable financing conditions also point to a strengthening of business investment. A much less restrictive fiscal policy (from 1.75% of GDP in 2013 to 0.5%), the cutback in the household debt rate and positive wealth effects (as house and stock prices have risen considerably) should prove a stimulus for consumer spending. Debt servicing, the part of income used to pay down debt, is at it lowest level in at least 35 years. Finally, the surge in production of shale gas and oil has led to a wide divergence between energy prices in the US and those in Europe and Asia and ought to be a boon for US (heavy) industry and be supportive of growth in 2014 and 2015.

Graph 3 US business investment



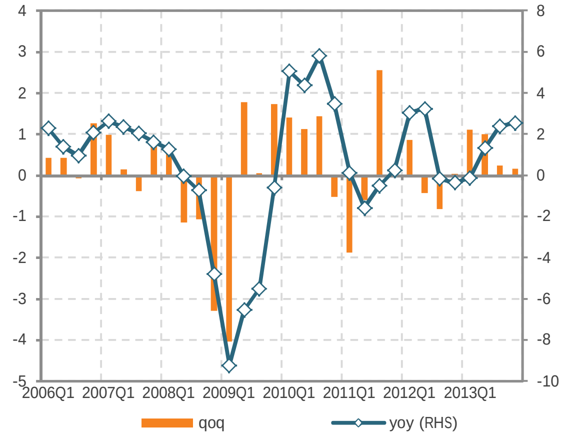
Source: US Bureau of Economic Analysis, Federal Reserve

All in all, *AIECE institutes* expect US GDP growth to amount to 2.7% in 2014 and to 3.0% next year on average. This is exactly in line with the latest Consensus Economics forecasts (April 2014) for the US economy.

1.3. Japan

Japanese economic growth bounced back strongly in the first half of 2013 under the impulse of an ambitious fiscal and monetary stimulus programme, but weakened again in the second half of the year. Economic activity in 2013 was mostly driven by private consumption and exports, the latter helped by the strong depreciation of the yen. The outlook for this year is highly uncertain as the VAT rate was raised from 5% to 8% on April 1st. This presumably led to a carry-forward of consumer expenditures which is likely to lead to (strongly) negative economic growth in 2014Q2 in spite of the government's new fiscal spending package created to counterbalance the downward effect of the VAT rate hike.[2]

Graph 4 **Japanese GDP growth**
Growth rates in %

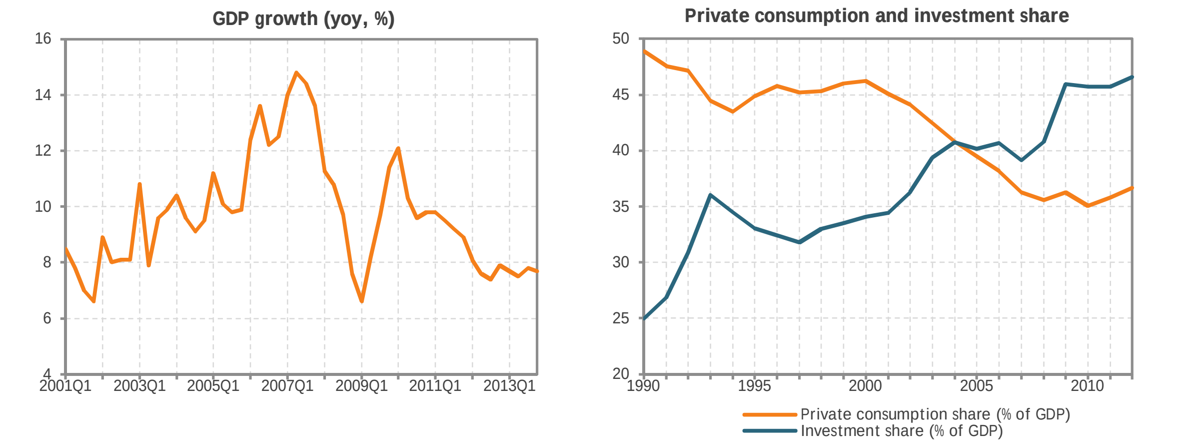


Source: Cabinet Office

1.4. China

When the financial crisis erupted and exports plunged, Chinese authorities engineered an investment boom by flooding the economy with cheap loans. This led to a remarkably fast and vigorous bounce in economic growth, but also to an even more unbalanced economy, to a surge in real estate prices and to an explosion of debt, mostly of companies and local authorities. Chinese authorities have now embarked on a mission to slow credit growth without causing a crash of the housing market or a strong slowdown of the economy. Official GDP figures show a slowdown of growth from a pace of about 12% around the time of the financial crisis to a rate of about 7.5% over the past two years.

Graph 5 **Chinese economic indicators**



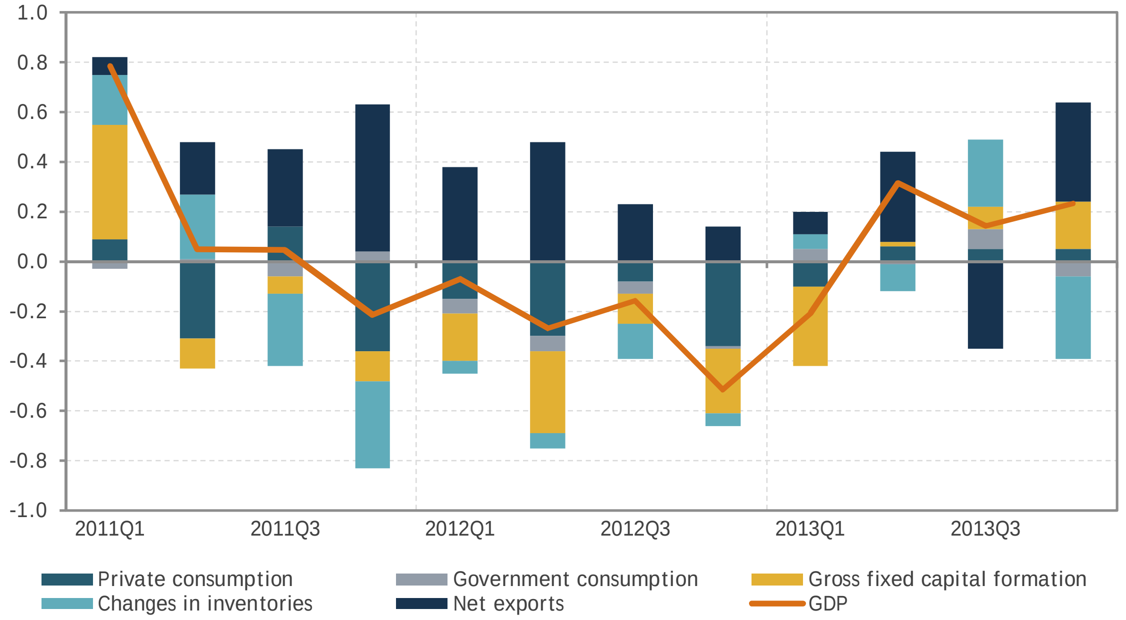
Source: International Monetary Fund

2 The last time Japan raised its VAT rate (in 1997) the economy entered a recession, although the Asian crisis also played a role at that time.

1.5. Euro area

After six quarters of negative growth, the euro area economy started to recover in from 2013Q2 (0.3%). In 2013Q3 GDP growth slowed down again (0.1%) due to a stagnation of exports and disappointingly low growth in France. In 2013Q4, economic growth strenghtened slightly to 0.2%, driven by exports and investment.

Graph 6 Decomposition of euro area GDP growth
Contributions to qoq GDP growth in percentage points



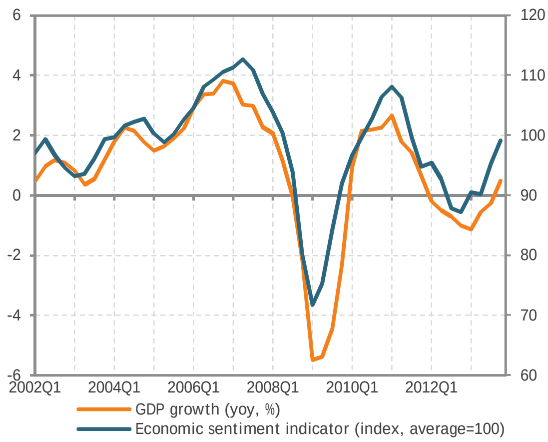
Source: Eurostat

In 2013Q4 all peripheral countries (except for Greece for which no real qoq GDP data exist anymore) showed positive growth rates. Nevertheless, the growth divergence between the core and the periphery of the euro area remains large.

Graph 7 Comparison of GDP developments in core and peripheral euro area countries

Source: Eurostat

Graph 8 Euro area economic sentiment



Source: Eurostat, European Commission

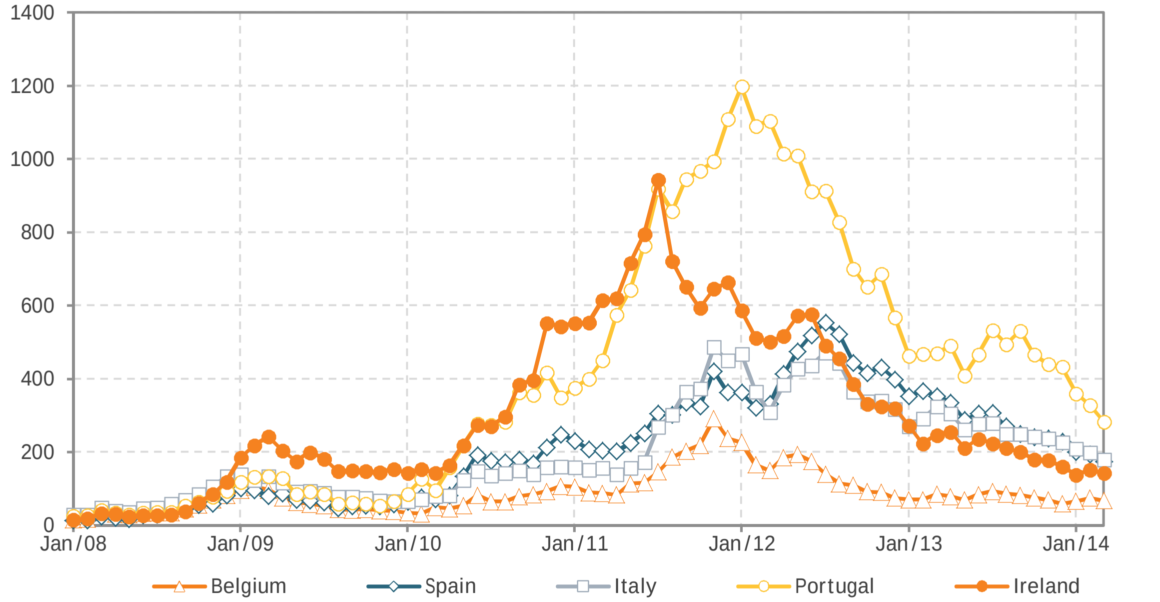
Gross domestic product in the periphery also remains strongly below the level seen before the financial crisis, while the core as a whole is just above its pre-crisis level.

Considerable improvement in economic sentiment and other leading indicators point to a firming of economic growth in the coming quarters. The improvement in confidence is broad-based and should allow for a growth acceleration in virtually all member states.

Arguably the main reason behind the continuation of the recovery is the further reduction in the fear for a calamity in the euro area as is also reflected in the decline of yield spreads in the European sovereign bond market[3]. Also, the pace of fiscal tightening will be significantly lessened in 2014 (see paragraph 1.5.2 on fiscal policy) while private consumption ought to accelerate due to a substantial increase in real disposable income that declined over the previous four years.

Graph 9 Sovereign bond yield spreads vis-à-vis Germany

10Y-maturity, interest rate differentials in basis points

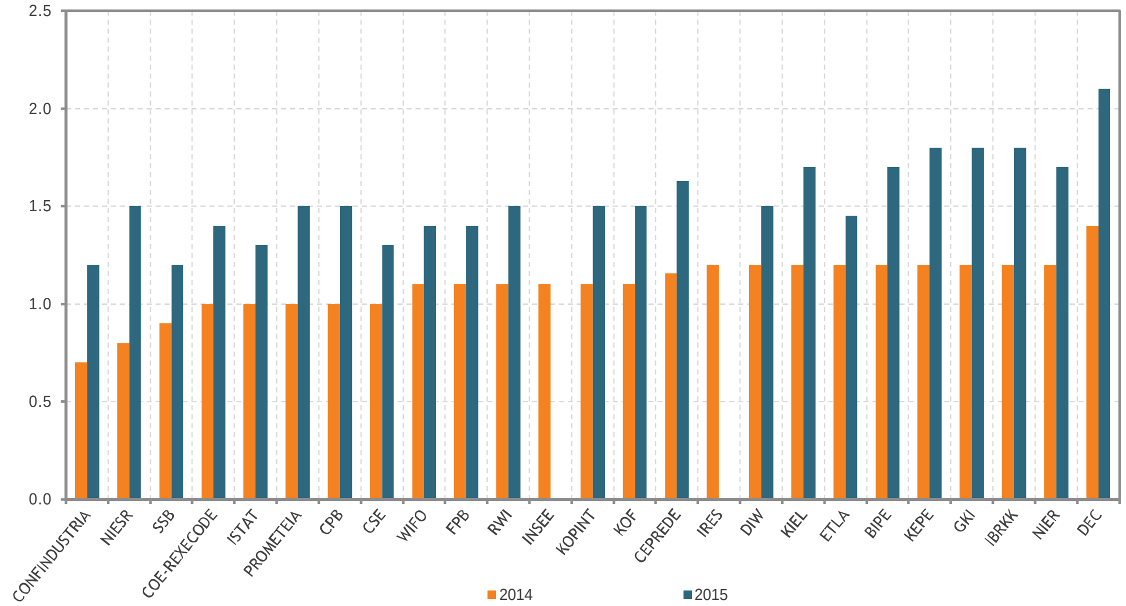


Source: Thomson Reuters Datastream

[3] Part of the more recent decline in yield spreads is probably due to the anticipation of quantitative easing by the ECB.

On average, the *AIECE institutes* expect GDP growth in the euro area to remain limited to 1.1% (range 0.7% to 1.4%) this year and to 1.4% (range: 1.2% to 2.1%) next year. This is very close to the most recent IMF and Consensus Economics forecasts (1.2% in 2014 and 1.5% in 2015), but below the more optimistic forecasts of the European Commission and the OECD (1.2% in 2014 and 1.8% in 2015). The Danish economic council has the highest GDP forecast for both years, while the NIESR, Confindustria, Istat, CSE and Statistics Norway are among the more pessimistic forecasters. In the autumn 2013 AIECE survey, euro area GDP forecasts for this year were just a touch lower (1.0%), but significantly weaker for 2015 (1.2%).

Graph 10 Euro area GDP forecasts by AIECE institutes
Growth rates in %



Source: AIECE institutes

The relatively weak GDP growth forecasts for the euro area have to do with still high debt rates (in both the public and the private sector) as, contrary to the US, deleveraging has not taken place yet. Furthermore, extremely high unemployment rates in the periphery and high overall unemployment are bound to weigh on private consumption.

Table 1 Key variables for the euro area from the survey among AIECE institutes
Growth rates in % unless otherwise mentioned

	2014			2015		
	average	min	max	average	min	max
GDP	1.1	0.7	1.4	1.5	1.2	2.1
Private consumption	0.6	0.4	0.9	1.1	0.6	1.5
Public consumption	0.3	-0.2	0.5	0.6	0.2	1.1
Gross fixed investment	2.1	0.6	3.1	3.1	2.3	4.5
Private business investment	2.1	0.7	2.9	2.8	2.5	3.2
Government investment	0.7	0.7	0.7	0.3	0.3	0.3
Residential investment	1.1	1.1	1.1	1.6	1.6	1.6
HICP	1.0	0.7	1.3	1.4	1.2	1.8
Unemployment rate (% of labour force)	12.0	11.6	12.1	11.6	10.8	12.0

Source: AIECE institutes

AIECE institutes on average do not expect the euro area unemployment rate to fall in 2014 (12%) and expect only a small decline in 2015 (to 11.6%). Private consumption growth ought to be limited this year (0.6% versus -0.3% in 2013) and should accelerate to 1.1% in 2015.

Finally, low capacity utilisation rates (except for Germany) and tight and expensive credit (in the periphery) could remain a drag on growth in business investment. Nonetheless, the AIECE institutes (on average) anticipate a gross fixed investment increase of 2.1% in 2014, following a decline of 2% last year. Next year, investment growth is expected to accelerate to 3.1%.

1.5.1. House prices

From the answers in the *AIECE* questionnaire one could deduce that house prices are not really a major source of concern, except perhaps in Germany and the UK. While it is way too soon to talk of a bubble in the German housing market, some German institutes start to worry about the increase in prices in the past years and expect a further rise in the next years. In the UK there are some worries that the government initiatives taken have led to some unfavourable outcomes such as the rising percentage of mortgages with (very) high loan-to-value ratios and the acceleration in house price inflation, hereby exacerbating affordability concerns.

In a recent presentation at the European Commission, of which the results will be published soon within the framework of the macroeconomic imbalance procedure, an analysis was made of the extent to which countries are more or less prone for a (further) house price correction or, on the contrary, can expect a rise in house prices.

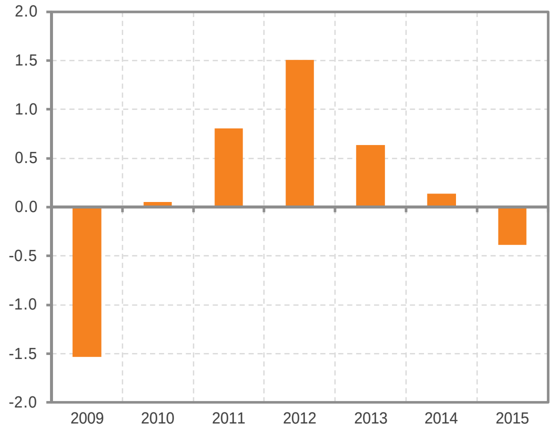
Two major axes of analysis were selected. The first was house price cycle analysis where the current cycle was compared to previous cycles. The second was the calculation of a host of overvaluation indicators (such as price-to-rent, price-to-income, ...) and a model that took population growth, income per capita, housing investment and interest rates into account. On this basis countries such as Belgium, Malta, the UK, France and Sweden were considered most overvalued, while Germany, Estonia, Ireland, Slovakia and Portugal were seen as most undervalued. In a second stage credit market conditions and household balance sheets were taken into account, which altered the ranking considerably. Portugal e.g. now turned into a country (together with Greece and Cyprus) most likely to witness a sizeable decline in house prices while this was just the reverse in the first stage.

This example illustrates that it is very precarious to make forecasts for house prices as taking one or two additional factors into account can change the outcome of the analysis considerably. A telling example is the case of Belgium which is considered over many years by the IMF, the Economist and the OECD to suffer from a large overvaluation of houses and, hence, a risk of a (major) house price correction. However, during the financial crisis and the great recession, Belgian house prices hardly declined (-0.5% in 2009) and have been growing at a pace of 0-5% in the past four years.

1.5.2. Fiscal policy

Fiscal policy is expected to weigh less on economic growth in 2014 than it did last year, while it could even be expansionary in 2015. This can be seen in the evolution of the euro area's structural balance in % of GDP as forecast by the EC in its latest forecast. However, it should be noted that the EC produces unchanged policy forecasts. In view of the noticeable public deficits, it seems likely that fiscal policy in 2015 will be more restrictive than one would conclude on the basis of Graph 11.

Graph 11 Euro area structural budget balance
Change from previous year in % of GDP (rise implies tightening of fiscal policy, decline implies loosening of fiscal policy)

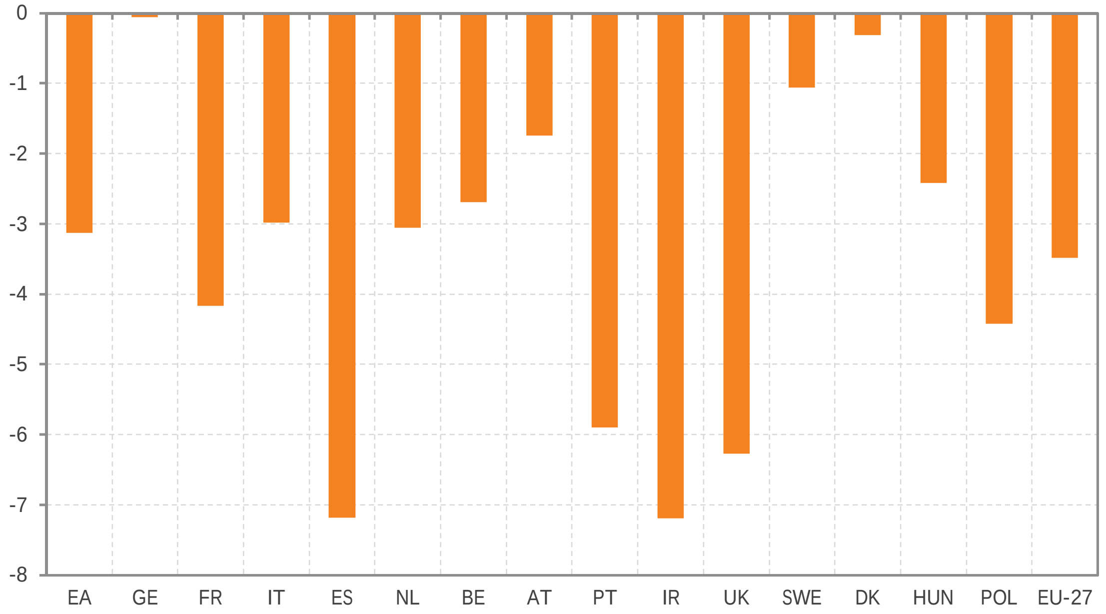


Source: European Commission, Ameco, Winter 2014

This holds for most countries in the euro area and the European Union, although there are a few exceptions such as Portugal, Sweden and Denmark. This was confirmed by the AIECE institutes' answers as they generally saw their countries' fiscal policy becoming less contractionary between 2013 and 2015. Only two countries represented in AIECE called their countries' fiscal policy outright expansionary, i.e. Germany and Austria.

Years of fiscal tightening and a return to positive growth have reduced the general government deficit in the euro area from -6.2% of GDP in 2010 to -3.1% in 2013. Differences among the member states of the euro area and the European Union remain large however (see graph below). The largest deficits were witnessed in Greece, Slovenia (both not on the graph to not ruin the scales), Ireland, Spain, the UK and Portugal. For both Greece and Slovenia a spectacular improvement of about 10 percentage points in the deficit is expected for this year. Germany had the smallest deficit, but KIEL institute warns that Germany's fiscal soundness looks better than it actually is as the fiscal situation is flattered by the unsustainably low interest rates, the low level of public investment (which cannot last) and the risk of an overestimation of Germany's potential output.

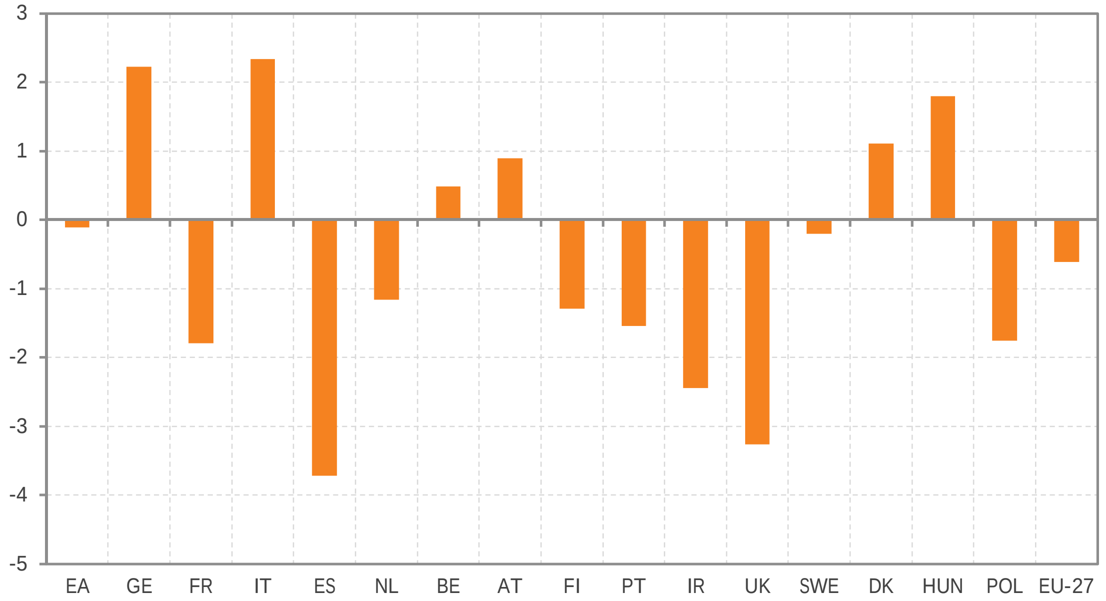
Graph 12 General government balances in 2013
% of GDP



Source: European Commission, Ameco, Winter 2014

The differences between core and periphery are significantly smaller if we look at primary balances as interest payments are highest in the latter countries. Interest charges are between 3.5% and 5.5% of GDP in these countries, but these levels seem far from alarming compared to the high interest charges (above 10% of GDP) Italy, Belgium and Greece had to cope with in the early 1990s.

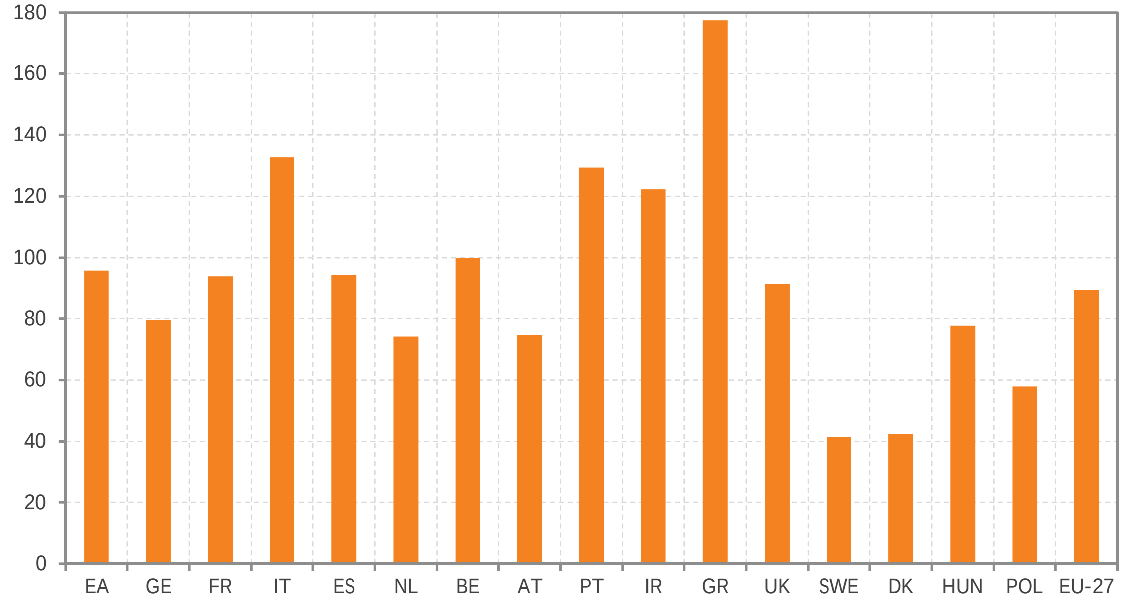
Graph 13 General government primary balances in 2013
% of GDP



Source: European Commission, Ameco, Winter 2014

While deficits were strongly reduced over the past three years, debt rates have hardly budged and are not expected to do so soon. Six countries have debt rates of 100% of GDP or above (IT, BE, GR, PT, IR, CYP), but the euro average was also close to 100% in 2013 (96% compared to 67% in 2007).

Graph 14 Public debt in 2013
% of GDP

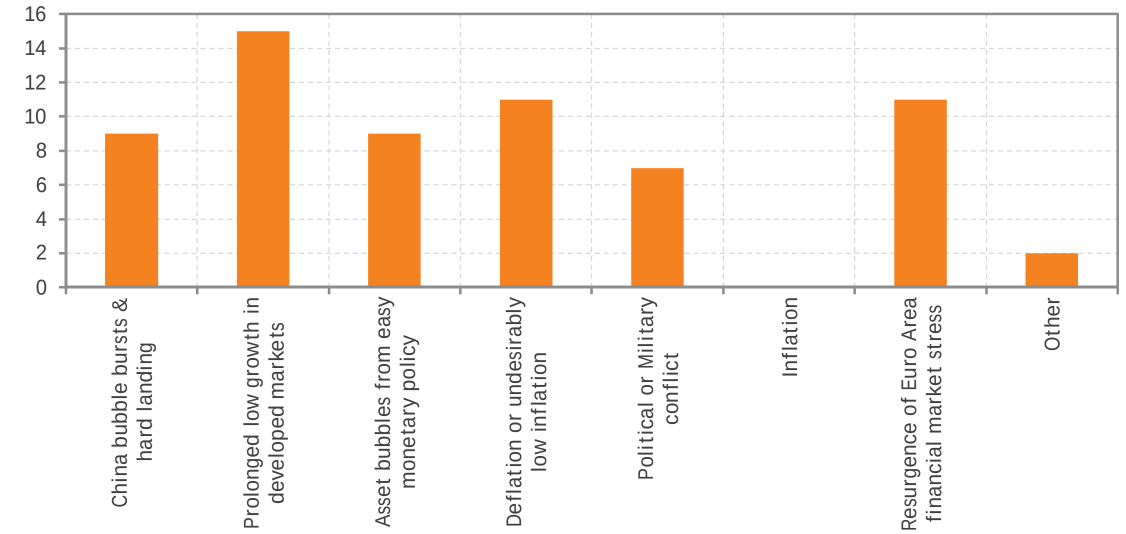


Source: European Commission, Ameco, Winter 2014

1.6. Risks

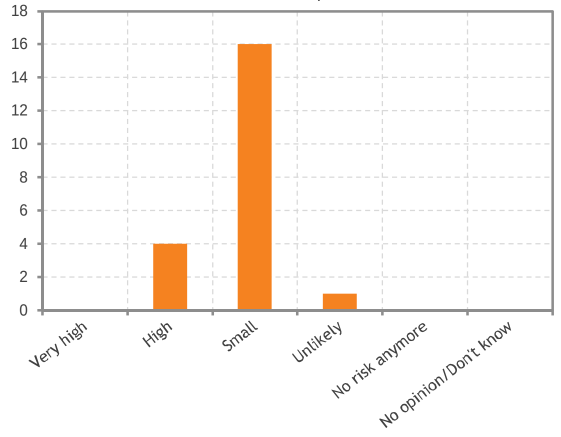
AIECE institutes were asked, out of a list of seven possibilities, what they saw as the biggest risks likely to derail world economic growth. The prime risk, mentioned 15 times out of 65, is considered to be low growth in developed economies. The next five risks (hard landing in China, undesirably low inflation, return of financial market stress in the euro area, asset bubbles and the possibility of a political or military conflict) are cited an almost equal number of times. Nobody sees high inflation as a risk and ETLA and INSEE believe another, not specified risk to be more pertinent.

Graph 15 Assessment of main risks for the world economy by AIECE institutes
Number of times the considered risk was cited



Source: AIECE institutes

Graph 16 Assessment of the likelihood of the return of a sovereign debt crisis in the euro area
Number of AIECE institutes per answer



Source: AIECE institutes

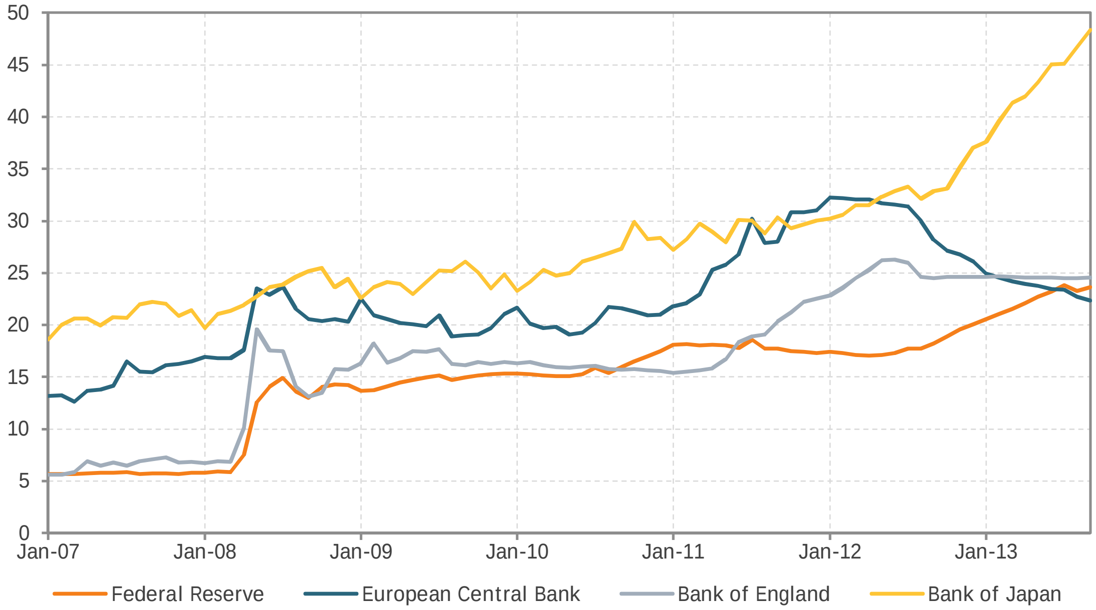
When asked specifically about the resurfacing of the euro area sovereign debt crisis, the large majority of institutes consider the chance to be small. Only four institutes (FPB, ETLA, SSB and NIER) are more preoccupied. As to the reasons for a new euro area crisis several answers come back repeatedly: a new weakening of growth/recession, the slipping of budget targets, a banking failure or the poor health of the financial system in general. Also mentioned are the political risk (Ukraine crisis slipping out of control), a (strong) rise in interest rates and a poor Asset Quality Review by the ECB.

2. Themes

2.1. The (beginning of the) end of quantitative easing

Since the financial crisis erupted, the major central banks have intervened massively in financial markets by offering unlimited amounts of cheap loans to the financial sector and/or by the purchasing of all kinds of financial assets (quantitative easing, QE). The inflation of central banks' balance sheets has probably pushed up asset prices across the board and worldwide. While central banks' QE was focused on government bonds and mortgage backed securities, the resulting decline in yields of these assets has probably pushed investors to other classes of assets in their search for yield.

Graph 17 Central banks' balance sheets
% of GDP

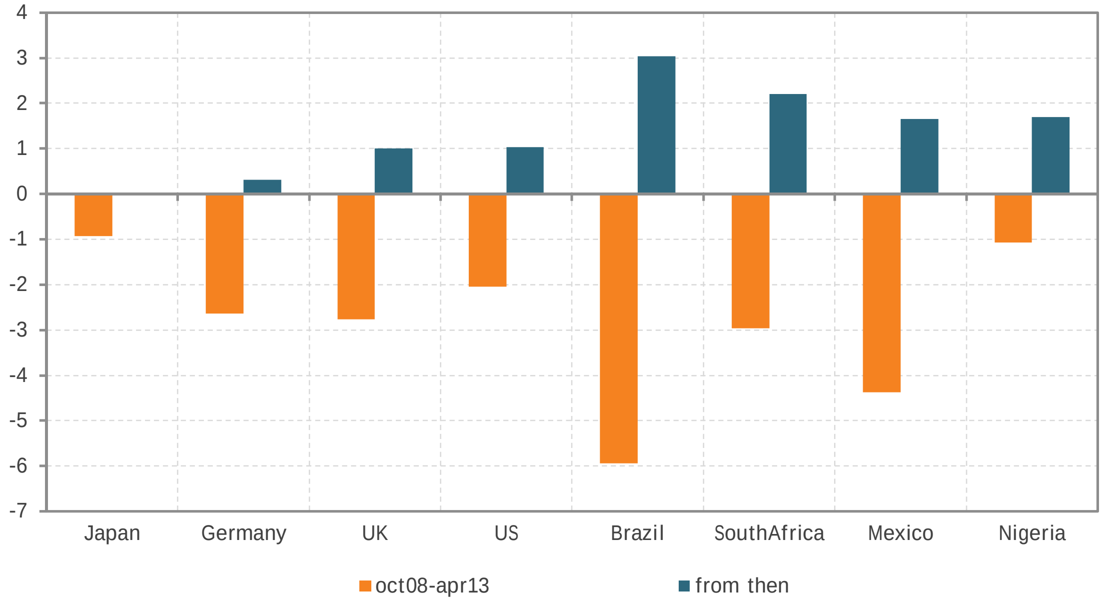


Source: Federal Reserve, ECB, Bank of England, Bank of Japan

When the Federal Reserve merely hinted at a possible reduction in the pace of quantitative easing (or tapering) in early May 2013, prices of bonds and stocks declined heavily worldwide. The first effective tapering of QE was finally postponed to early 2014. The effects of the phasing out of US QE on financial markets have all in all remained relatively subdued possibly because of QE gathering pace in Japan and/or the expectation of a QE move by the ECB and/or the Fed's insistence that the end of QE does not imply an interest rate hike in the near term. Nevertheless, the question stands what will happen when QE worldwide is turned back. Several asset markets seem richly valued.

Sovereign bond yields reached or were close to record lows in the course of 2013. Since the Fed signalled it would phase out QE, however, yields have risen considerably (and mostly so in emerging markets). It seems arguably unlikely that sovereign bond markets (in developed economies) will experience a major correction in 2014-2015 as yields have not risen much since the actual tapering of QE (at the start of 2014) and as inflation is likely to remain (very) low.

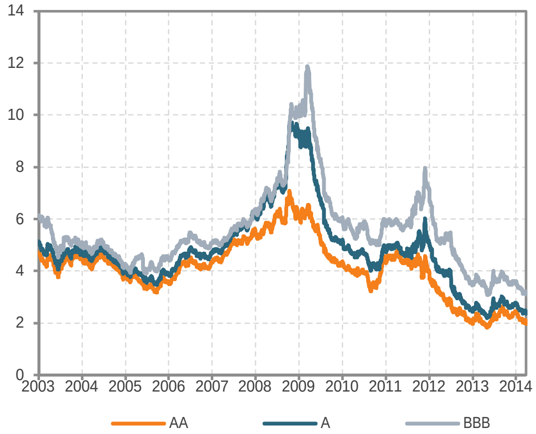
Graph 18 Development of bond yields during quantitative easing and since the mentioning of 'tapering'
Differences of 10Y government bond yields in %-points



Source: Thomson Reuters Datastream

The asset class which has been affected most so far are *emerging markets*. Especially those emerging markets that depend on foreign capital are seen as most vulnerable for a decline in global liquidity.

Graph 19 Corporate bond yields (%)

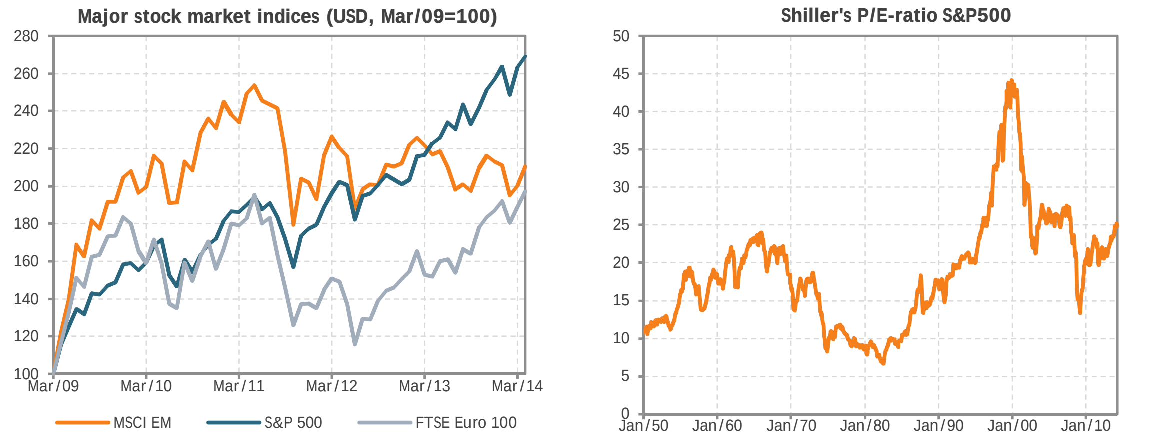


Source: Thomson Reuters Datastream

*Corporate bond i*ssuance was at record levels in 2013 and in early 2014, with especially large volumes of junk bonds being issued. Worldwide both yields and yield spreads vis-à-vis government bonds are at or close to record lows. Securitization is on the rise and underwriting practices have deteriorated significantly as is shown by the increased use of covenant-lite and payment-in-kind loans[4]. The fact that companies are able to borrow at extremely low rates and loose conditions suggests that corporate bond investors are not accurately pricing the risk of default.

[4] Covenant-lite loans are loans that do not contain the usual protective covenants (the requirement to report and/or maintain loan-to-value, gearing, EBITDA ratios, annual accounts, …) for the lending party. Payment-in-kind loans are loans by which interest is capitalized and added to the principal.

Graph 20 Stock markets



Source: Thomson Reuters Datastream

Most *stock market* indices have surged since the troughs reached at the depth of the financial crisis (early March 2009). In the US, the S&P500 has long surpassed the high reached before the financial crisis. In terms of the price-earnings ratio as defined by Shiller, the S&P 500 recently passed the threshold of 25. This level has only been reached three times historically: in the years before the financial crisis, during the stock mania of the late 1990s (when it surpassed a level of 40) and just before the stock market crash in 1929.

Real estate in some countries. The examples that spring most in mind are London and China.

The *AIECE poll* reveals that many institutes consider the chance of some fall-out in financial markets from the future ending of QE to be relatively high. The median chance is 30%, the average 36% with some institutes going as high as 70%. KIEL, FPB, KOPINT, GKI, NIER and ETLA have the highest percentages, while RWI, CEPREDE, ESRI, CONFINDUSTRIA and CPB are among the more sanguine. When asked what asset market might be affected most, stock markets are mentioned most (13 times), followed by sovereign bond markets (9 times).

Graph 21 Opinion of AIECE institutes on consequences of the end of QE
Number of institutes

Source: AIECE institutes

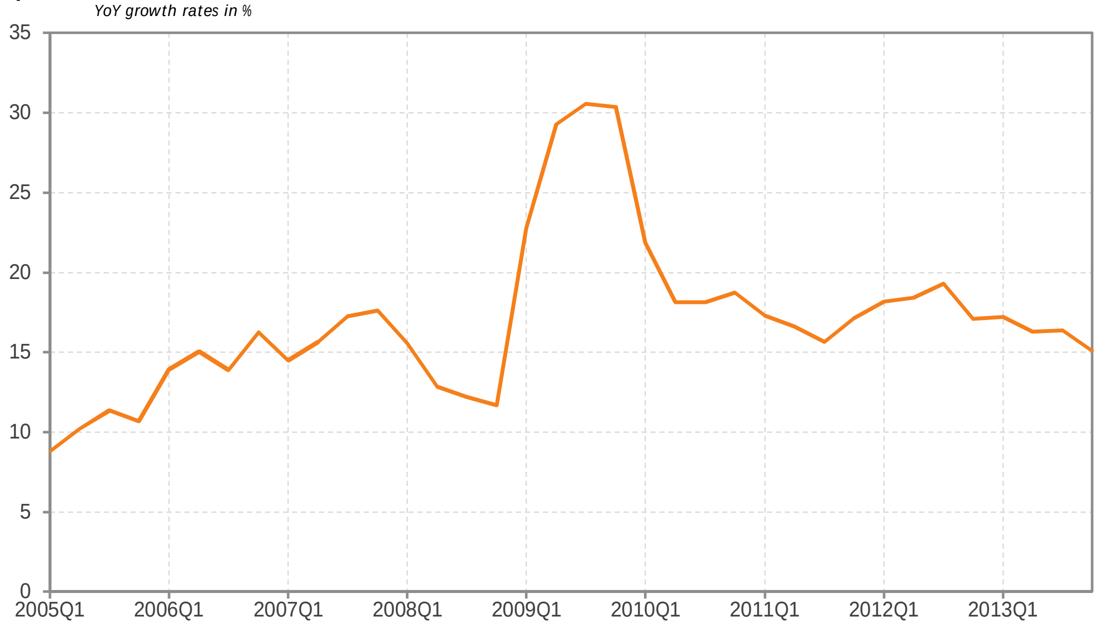
Many AIECE institutes wonder to what extent the expected reduction in the pace of QE and the eventual reduction of central banks' balance sheets is already priced in financial markets.

2.2. China's credit bubble and future growth rate

2.2.1. The credit bubble

Early 2009, Chinese authorities launched a large-scale stimulus plan to counter the effects of the collapse in external demand. The Chinese banking system, which is dominated by the state, increased the supply of loans to all sectors and economic agents. The main beneficiaries of this lending binge were real estate, construction and infrastructure companies and local governments. All in all, bank lending rose by a staggering 32% or 9.62 trillion Yuan in 2009. This pushed the already high investment rates to exorbitant levels (48% of GDP).

Graph 22 China domestic credit
YoY growth rates in %



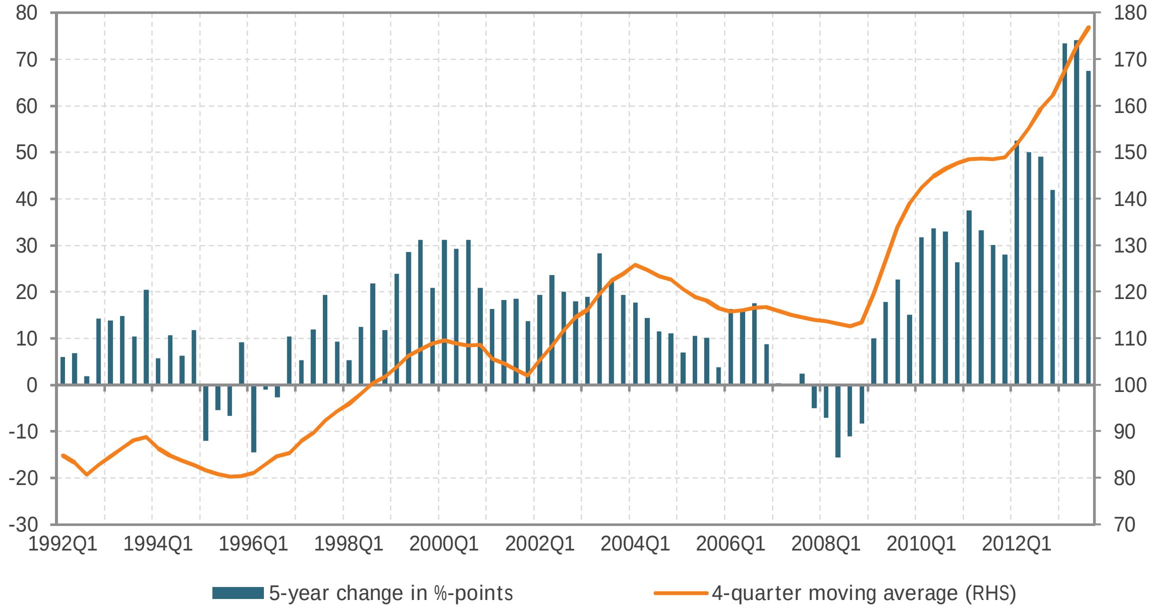
Source: International Financial Statistics IMF

In 2010 the tightening of monetary policy led to a slowdown in bank loan growth. Banks, however, circumvented this tightening by transferring loans off-balance sheet and by offering alternative financing products (to circumvent the cap on deposit rates). This so-called shadow banking[5] developed very rapidly and constituted 30% of overall lending by 2013.

All in all, private non-financial sector's domestic debt soared from about 115% of GDP in 2008 to about 180% in 2013. China's overall indebtedness (across all institutional sectors) surged from 130% in 2008 to 220% in 2013. There are indications that the debt rate has strongly increased in 2014Q1 as well.

[5] The financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight. The shadow banking system also refers to unregulated activities by regulated institutions.

Graph 23 Non-financial sector private debt
% of GDP



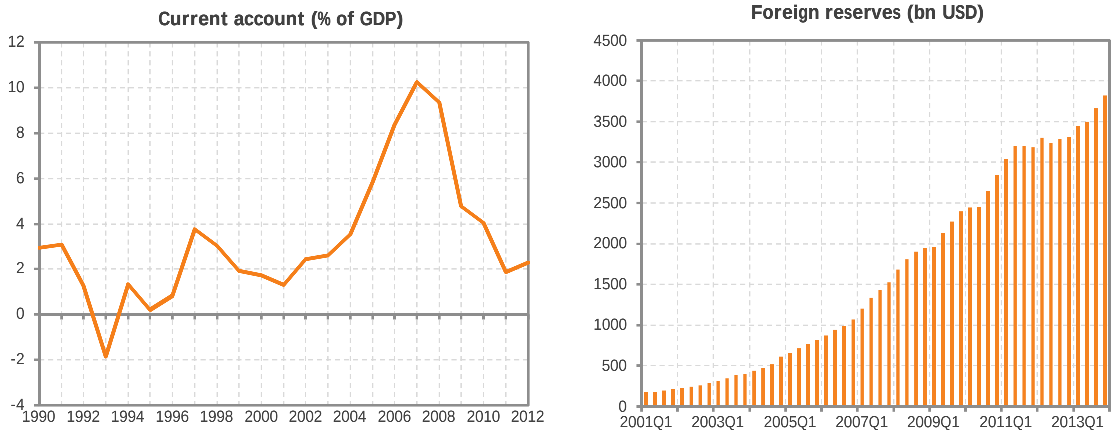
Source: Bank for International Settlements, Thomson Reuters Datastream

Obviously this tidal wave of credit went hand in hand with a deterioration in the efficiency of credit, i.e. the amount of financing (and investment) required to generate one percentage point of GDP growth. It kept afloat many inefficient state-owned enterprises and bankrolled the construction of huge overcapacity in the manufacturing sector. The percentage of non-performing loans in the banking sector is likely to be underreported. The wave of easy money also drove up property prices.

In 2012 and 2013, there were significant slowdowns in economic growth (to 6% yoy) and on both occasions the authorities responded by cranking up credit and investment. Central bank concerns about potentially reckless borrowing led it to withdraw liquidity from the interbank markets on two occasions in 2013, prompting strong increases in interbank rates. Chinese authorities want to slow credit growth without causing a crash of the housing market or a strong slowdown of the economy

China will probably not experience a Lehman-style crisis as its financial system is not reliant on securitizations or interbank lending and is not very much integrated with the global financial system. It furthermore is not going to experience a balance of payments crisis. The gigantic war chest of foreign reserves and the current account surplus imply it is not dependent on foreign capital flows. A domestic credit crisis, however, is a distinct possibility although it can still be avoided if managed correctly.

Graph 24 Chinese current account and foreign reserves



Source: State Administration of Foreign Exchange, People's Bank of China, National Bureau of Statistics China

2.2.2. Future economic growth

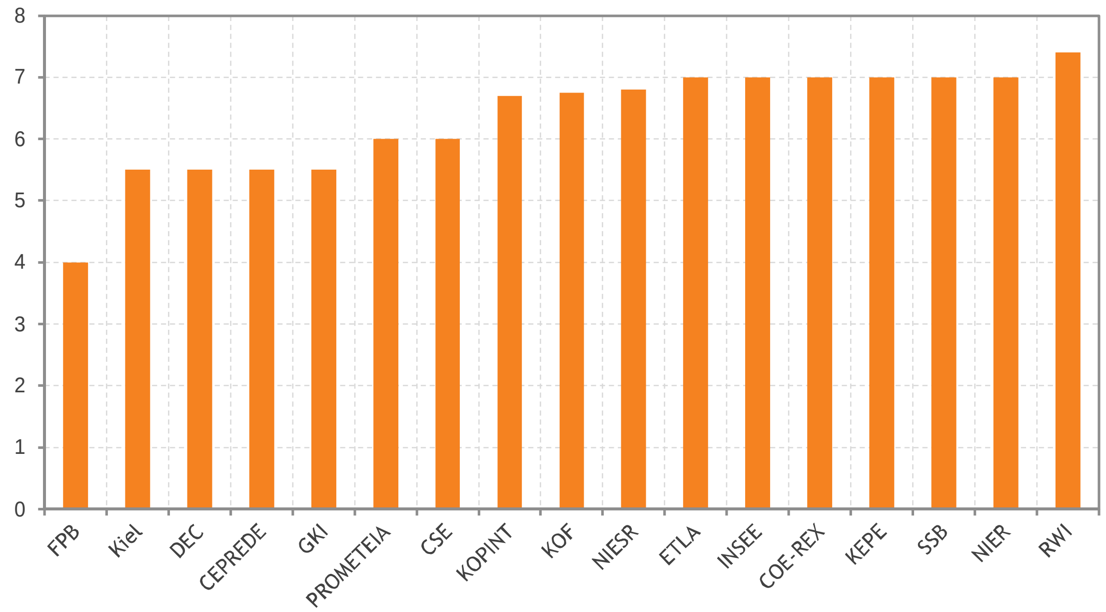
The Chinese economy is now slowing again, as can be seen e.g. in PMI data, probably to a rate below the authorities' target of 7.5%. While official data suggest that GDP growth slowed to 7.4% yoy and to 1.4% qoq in 2014Q1, some China watchers reckon growth to have turned negative. Will authorities allow a stronger than wanted slowdown or will they again opt for more stimulus (as happened in 2011 and in 2012), hereby raising economic imbalances and increasing the probability of a real crisis?

Even in the case where a crisis is avoided, GDP growth is bound to become significantly weaker than the current growth rate. The current credit-fuelled investment-driven growth is simply unsustainable. Investment growth does not merely need to slow down, but ought to decline as is shown by the huge underutilisation of manufacturing capacity (the IMF reckons capacity utilisation might be as low as 60%). In housing too, overcapacity seems to be (very) high. This is perhaps best symbolized by the existence of numerous ghost districts and ghost cities.

As investment constitutes about 47% of GDP, private consumption growth would need to accelerate very strongly to compensate for the expected weakness in investment. This seems unlikely. Neither can exports be much of a counterbalancing factor as China's export markets are unlikely to prove buoyant and as Chinese competitiveness has deteriorated considerably in the past five years (by a combination of higher wage costs and the appreciation of the Yuan).

The *AIECE* institutes are much divided on this subject as the number of institutes considering a hard landing to be (very) likely is equal to the number of institutes that China would not suffer from a hard landing. This result comes as no surprise as the larger community of economists also appears to be divided equally on this topic. Note that this is a sea change compared to one or two years ago when China pessimists were much harder to find.

Graph 25 China's future GDP growth (%) according to AIECE institutes



Source: AIECE institutes

Asked on China's future growth rate in three to five years' time, the AIECE institutes on average expect 6.3%. The range of answers is perhaps smaller than could have been thought (in view of the answers on the question mentioned above) with the most pessimistic at 4% (FPB) and 5.5% (KIEL, DEC, CEPREDE and GKI) and the most optimistic at 7 to 7.4%. Note also that all answers are below the authorities' self-declared growth target of 7.5%.

2.2.3. Consequences for the rest of the world

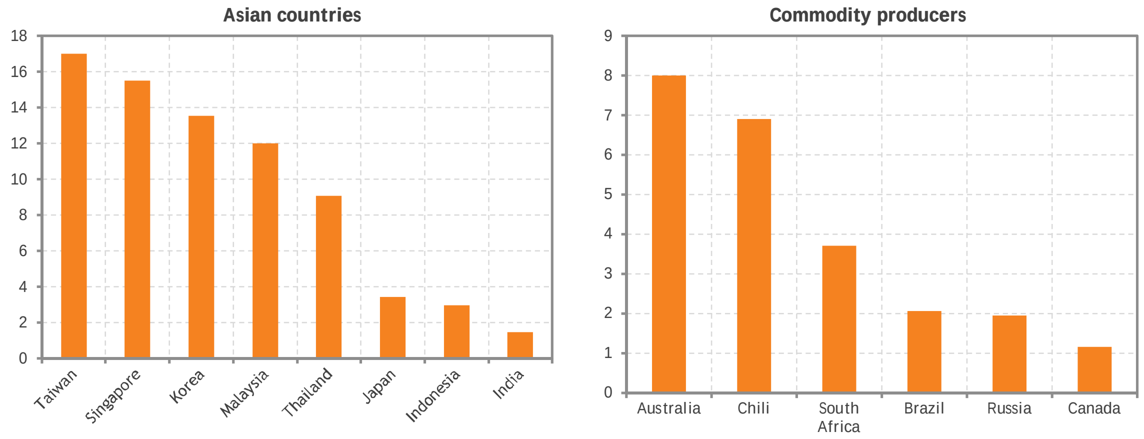
So if China is on the way to a substantial slowdown, who will suffer most from it in the developed world and in emerging markets?

The most direct effect is via trade links. A slowdown of the Chinese economy would lead to reduced exports for many countries. To get a rough idea about who is most vulnerable, it is arguably most instructive to look at the weight of exports to China in each country's GDP[6].

The countries that will be hit most are China's neighbours such as Korea, Taiwan, Singapore, Malaysia, Thailand and to a lesser extent Japan. These countries often intervene in the production process of Chinese products.

[6] By simply multiplying the weight of exports to China in a country's overall exports by the weight of this country's exports in its GDP

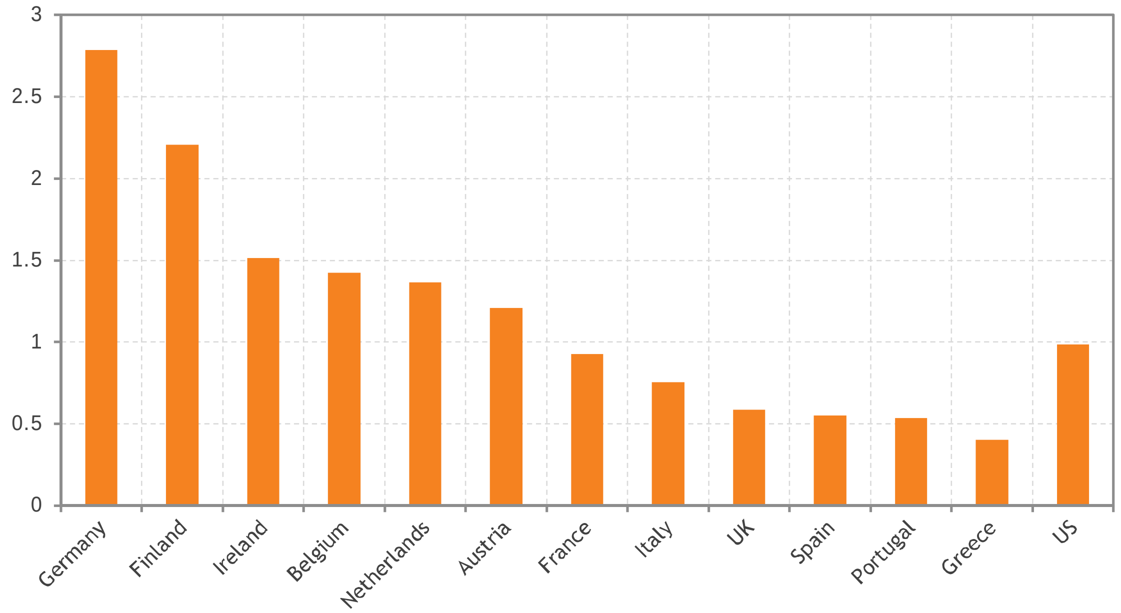
Graph 26 Exports going to China
Share in national GDP in %



Source: World Economic Outlook Database and Direction of Trade Statistics IMF

A second group of countries are the commodity producers that have become dependent on Chinese demand for commodities over the past years. For many commodities (e.g. copper and iron ore) China accounts for more than 50% of global consumption. The expected weakness in construction and infrastructure investment especially should lead to much lower imports of commodities. The countries that would be most affected by a reduction in Chinese demand for commodities are Australia, Chili and South Africa.

Graph 27 European and US exports going to China
Share in national GDP in %



Source: World Economic Outlook Database and Direction of Trade Statistics IMF, Eurostat

The US and Europe do not seem particularly vulnerable, with perhaps the exception of Germany where the weight of exports to China in its GDP is relatively high.

In the paragraphs above the consequences of a slowdown in China are looked upon in an isolated way. However, if the deceleration of growth in the first group of countries is taken into account, the effect on developed economies and world GDP will be substantially higher than suggested by the graphs above.

In addition to the direct effect on economic growth via trade links two more effects from the slowdown in China might exert influence. The first is via the global financial system. Here, the influence should remain limited as China has a more or less closed capital account and as its financial system is not much integrated with the global financial system. However, the second one, the psychological or confidence effect, where the China downturn weighs on financial markets and business confidence worldwide, could have a larger impact than that of trade.

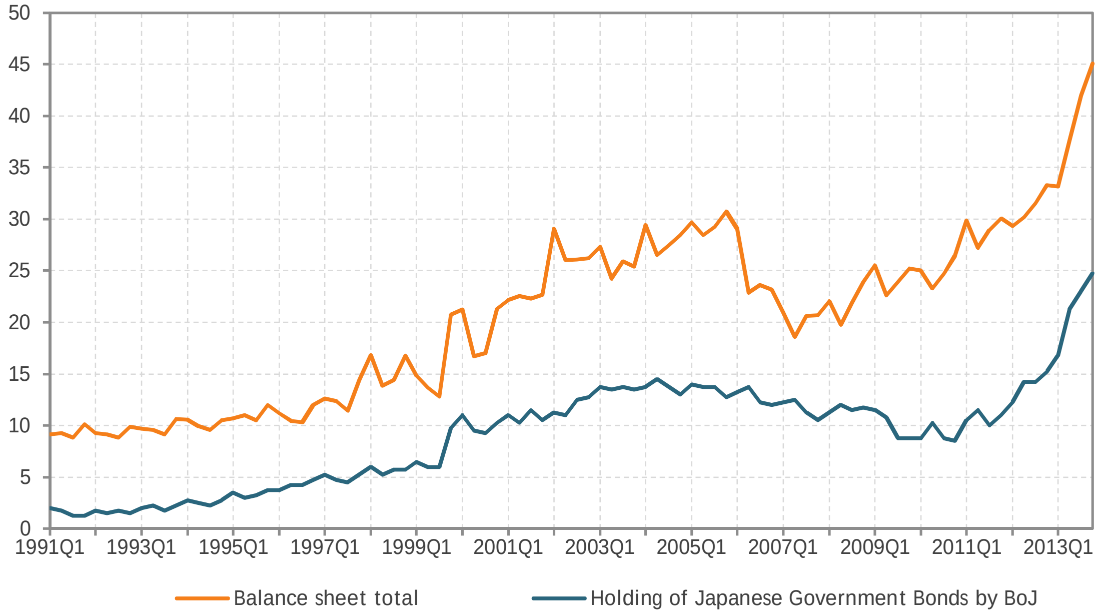
China's weakness ought to bring some benefits too however, as the expected fall in commodity prices (China is the biggest consumer of many commodities) should reduce inflation and raise purchasing power of commodity importing countries. The price of base metals is expected to decline most, but even oil prices should decrease.

2.3. The end of deflation in Japan

Ever since deflation manifested itself at the end of the 90s several (half-hearted) attempts have been made to get the Japanese economy out of the downward price spiral. In 2013 a new, more ambitious effort was launched to eradicate deflation. The Bank of Japan (BoJ) stated it would double its holdings of government bonds, purchase exchange traded funds and in the process double the size of the monetary base by the end of 2014. This already resulted in an increase of the size of the BoJ's balance sheet from 33% of GDP at the start of 2013 to 46% in March 2014 (compared to about 25% for the Fed, the ECB and the BoE). The BoJ furthermore promised to continue with quantitative easing until inflation reaches its new target rate of 2%.

Graph 28 Bank of Japan balance sheet indicators

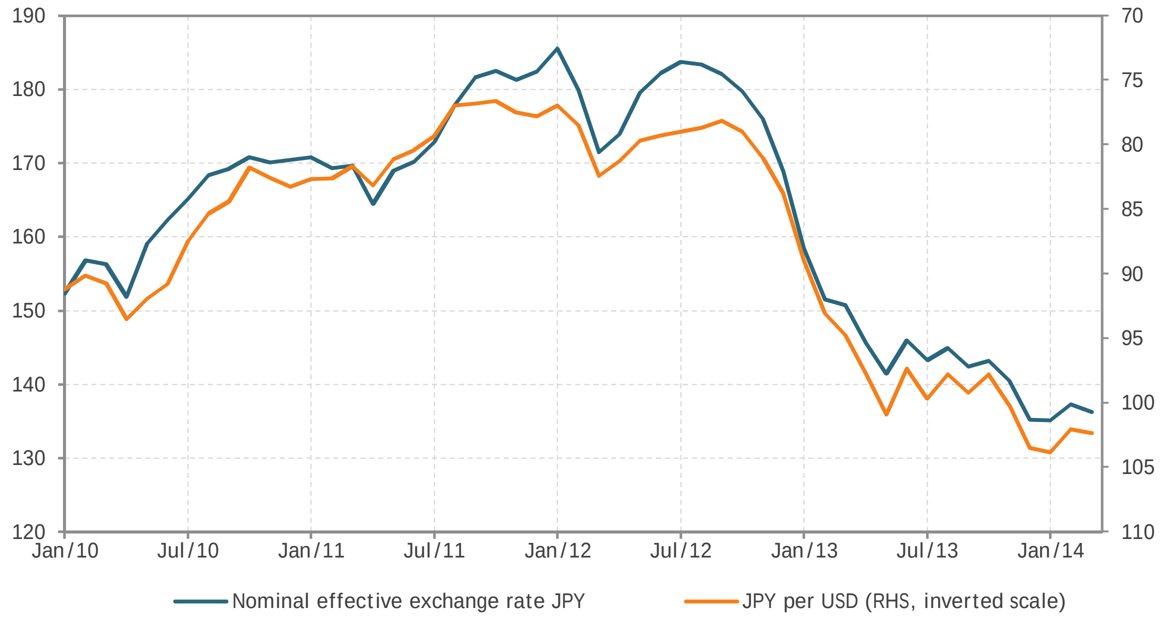
% of GDP



Source: Bank of Japan, Cabinet Office

The flooding of the market with yen resulted in a strong depreciation of the yen against other currencies. The weakness of the yen resulted in a strong rise in import inflation which has filtered through in overall inflation (1.5% at the start of the year). Core inflation is considerably lower (0.7%), but is still at its highest level in 15 years. The monetary easing has also led to a surge in equity indices. It remains to be seen what will happen once the Bank of Japan stops boosting its balance sheet and the yen stops depreciating.

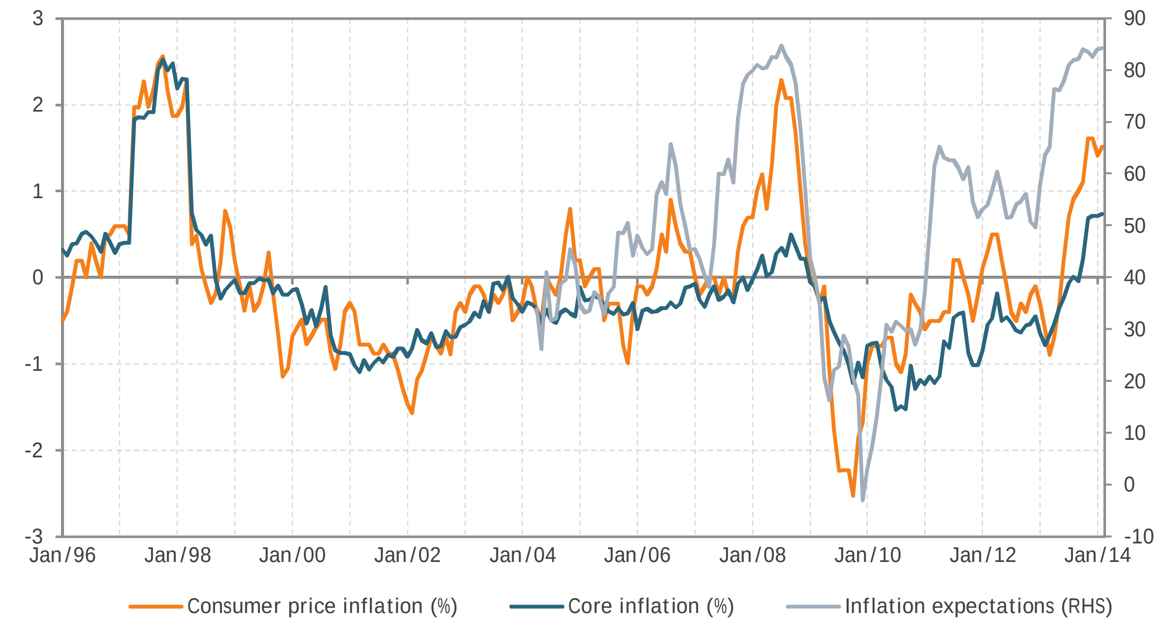
Graph 29 Exchange rate of Japanese Yen



Source: Thomson Reuters Datastream, Bank of England

Crucial for inflation to take hold is that inflation expectations are altered and this depends on the credibility of the move of the Bank of Japan. Inflation expectations (part of the consumer confidence survey) show that a large majority (80%) of the interviewees expect prices to rise. Unfortunately this is still no proof of success as similar percentages were obtained in 2008 when inflation temporarily turned positive as the oil price surged to a record high. Soon after deflation re-emerged.

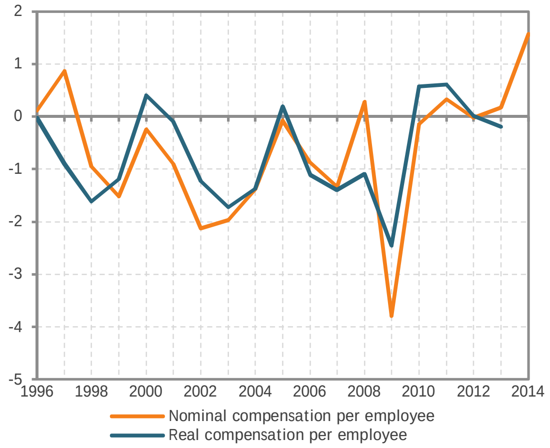
Graph 30 Japanese inflation indicators



Source: Thomson Reuters Datastream, Statistics Bureau Japen, Cabinet Office, OECD Main Economic Indicators
Note: Inflation expectations are calculated as the share of consumers (in %) expecting inflation minus the share of consumers expecting deflation

It is also important to monitor the evolution of wages to determine if deflation could come to an end. The government has put pressure on many big companies to allow for an acceleration of wage inflation. Although the jury is still out, there are some signs that indeed point to a rise in nominal wages. Wages are not rising as much as inflation however, leading to a slide in consumers' purchasing power.

Graph 31 Private sector compensation per employee
Growth rates in %



Source: OECD Economic Outlook Database

The OECD banks on growth of nominal compensation per employee of about 1.5% in 2014, which would be the highest wage growth since the Japanese bubble burst.

Along with this deflation-combatting measure two stimulus programs were launched, one to quick-start the economy (in the first half of 2013) and another one (starting in 2014Q2) to counterbalance the downward effect of the VAT rate hike on GDP growth. The VAT hike itself will evidently temporarily accelerate inflation.

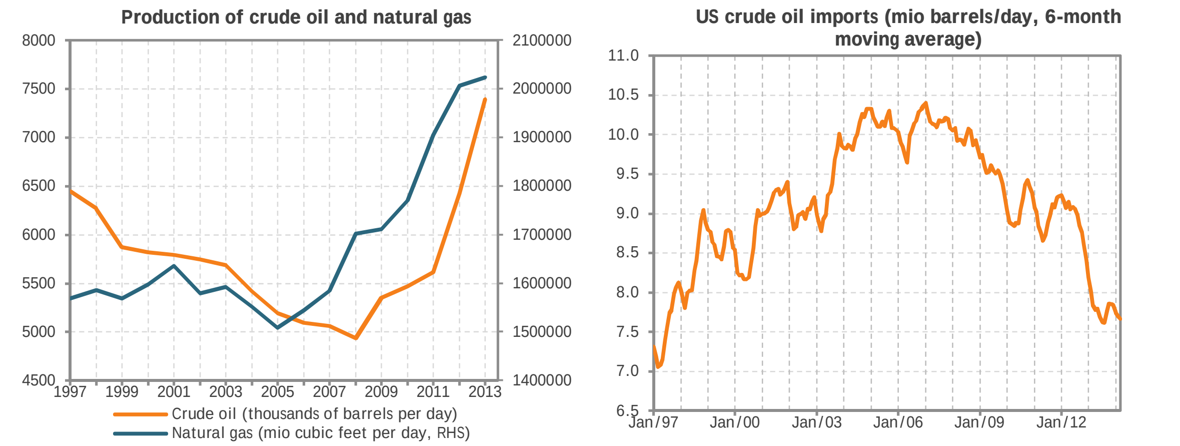
The third axe of the so-called Abenomics economic policy was to start a host of structural reforms, but on that account the government has largely failed to deliver up till now.

The *AIECE poll* reveals that most institutes believe that deflation could be ended by the above-mentioned initiatives, while only 4 out of 20 think it to be unlikely. GKI e.g. is most sceptic about the feasibility of the Abenomics programme and fears (negative) side-effects. SNN states its concern for the combination of the huge debt pile and the ageing population. NIESR acknowledges that core inflation (excl. energy) is at it highest in 15 years, but stresses the fact that wages need to rise (more) for the period of deflation to be permanently ended.

2.4. US shale oil and gas

Thanks to new techniques such as horizontal drilling and hydraulic fracturing previously inaccessible or economically unviable shale gas and shale oil reserves suddenly became available for exploitation. This has led to a surge in US production. Between 2005 and 2013 US production of crude oil and natural gas has soared by about 50%. At least in the next two to three years production is expected to continue to rise sharply.

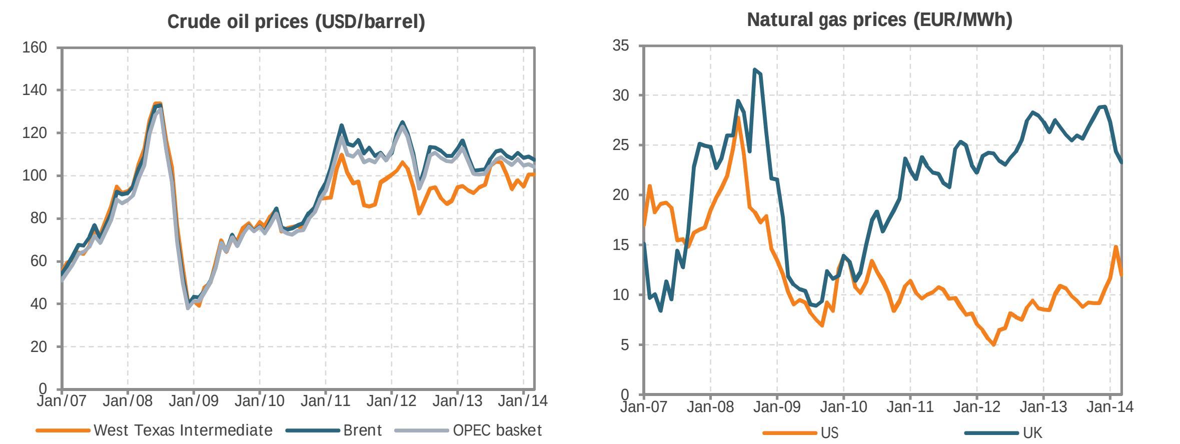
Graph 32 Production and imports of energy products in the US



Source: Energy Information Administration, US Department of Energy

Transport bottlenecks and export bans (dating back from the oil crises in the 1970s) have led to an oversupply of crude and gas on US soil and hence to a sharp difference with world prices (especially for gas). Note that the surge in US supply does already have an impact on world prices as US imports of oil and natural gas have declined significantly.

Graph 33 Crude oil and natural gas prices in different regions



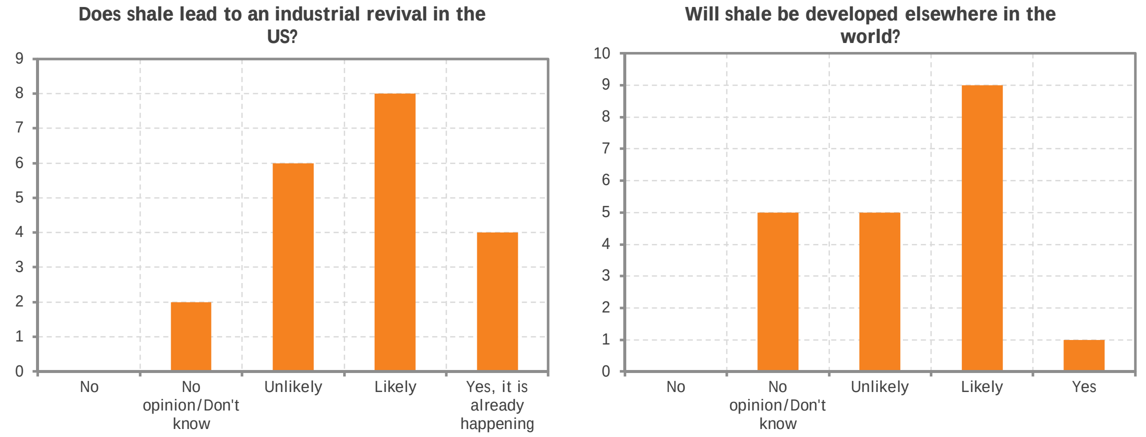
Source: Thomson Reuters Datastream

The sharp difference in prices with the rest of the world has led to an important competitive advantage of heavy energy users in the manufacturing sector in general and of oil refiners in particular. The export ban is being put into question, however, by the shale oil and gas producers as they could get a higher price in international markets. Producer's lobbying efforts are being reinforced by geopolitics as tensions in the Ukraine plead for a lessening in dependence on foreign suppliers of energy products.

The export ban also exists for natural gas, but there the main impediment for exports is that the capacity to liquefy the natural gas and the LNG vessels needed for transportation abroad are simply not there. Huge investments have been made but the lead times of LNG terminals (and LNG vessels) are rather long.

Asked about the possibility of a revival of US industry because of lower energy prices, four *AIECE institutes* state this is already the case, while another eight consider it likely to happen in the future. Only six institutes do not buy the US industrial revival story with the most-cited reason being the fact that energy costs represent only a small part of total production costs.

Graph 34 Opinion of AIECE institutes on shale oil and gas
Number of institutes

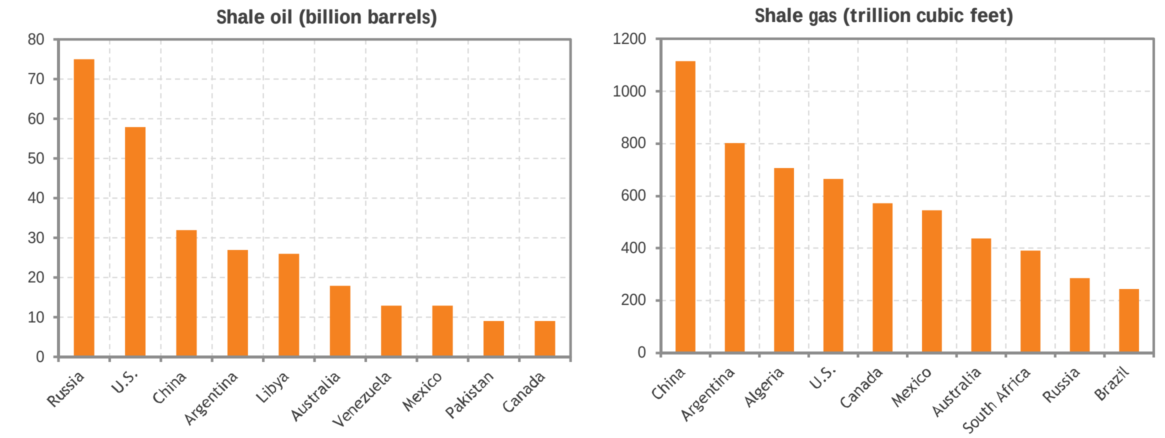


Source: AIECE institutes

A majority of AIECE institutes believes that shale oil and/or gas will be developed elsewhere in the world. A relatively large number have not expressed an opinion on this question.[7] In the graphs below the countries with the biggest deposits of shale oil and gas are shown.

[7] Due to an error in the questionnaire, the answers to the question if the surge in shale oil and gas would lead to lower energy prices globally, could not be given.

Graph 35 Top 10 countries with technically recoverable shale oil and gas

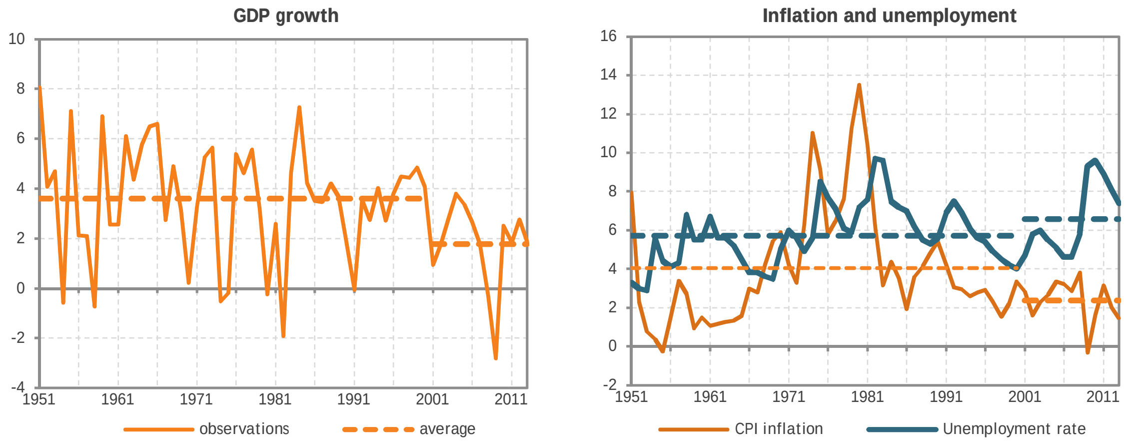


Source: US Energy Information Administration

2.5. Secular stagnation

L. Summers recently launched a debate on secular stagnation, an idea developed by A. Hansen in the late 1930s that states that the normal properties of an economy are not sufficient to allow sustained full employment in the absence of extraordinary expansionary policies. The fact that we would be in a phase of secular stagnation is underpinned by the observation that, over the last 10 to 15 years developed economies – and certainly the US economy – were characterised by the appearance of bubbles (ICT around 2000, housing and credit before the financial crisis) while economic growth remained rather limited compared to previous recoveries. Moreover, economies hardly suffered from overheating that should have led to rising inflation. The labour market was not even near full employment that should have been accompanied by historical low levels in unemployment rates.

Graph 36 Economic indicators United States since 1950



Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics

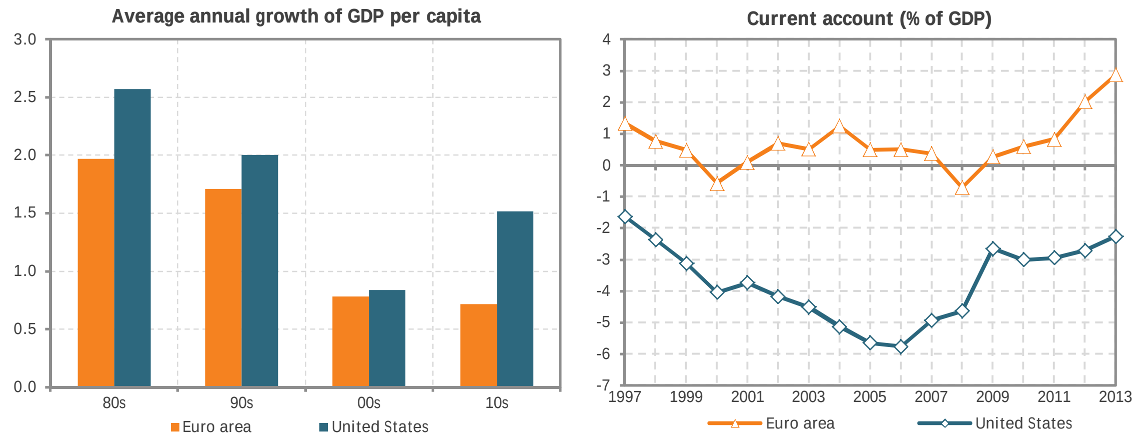
Despite very loose monetary policy conditions, economic growth has remained limited since the financial crisis. The secular stagnation hypothesis states that this would not be due to the financial crisis itself, but to the fact that the economy itself is not capable of generating sufficient demand. This lack of demand is often linked to the fact that rising inequality – between 'creditor' and 'debtor' economies, but also between the 'rich' and the 'poor' inside a country – leads to an increase in the average savings rate that is not accompanied by an increase in investment (the so-called 'savings glut').

The existence of secular stagnation would imply that monetary policy can continue to be very expansionary for a long time. It could even be hampered by the zero lower bound on interest rates as the interest rate needed to clear the balance between savings and investment is possibly negative. In this respect, creating inflation could help as it allows for pushing the real interest rate down and for increasing (consumptive) expenditure growth.

The most suggested measure to get out of the secular stagnation scenario is to launch a massive debt-financed infrastructure programme as the government can almost borrow for free. These investments should raise economic potential and should not lead to an explosion of debt thanks to low interest rates. This argument is made especially for the US, where decades of underinvestment in infrastructure have led to many obsolete roads, bridges, airports and public school buildings.

On the other hand, it is also suggested that the decline in economic growth should not be a big source of concern as it is merely the consequence of slowing population growth and persistent trade deficits that need to be financed by a build-up of domestic savings.

Graph 37 Real GDP/Capita and CA balance as % of GDP



Source: IMF WEO database

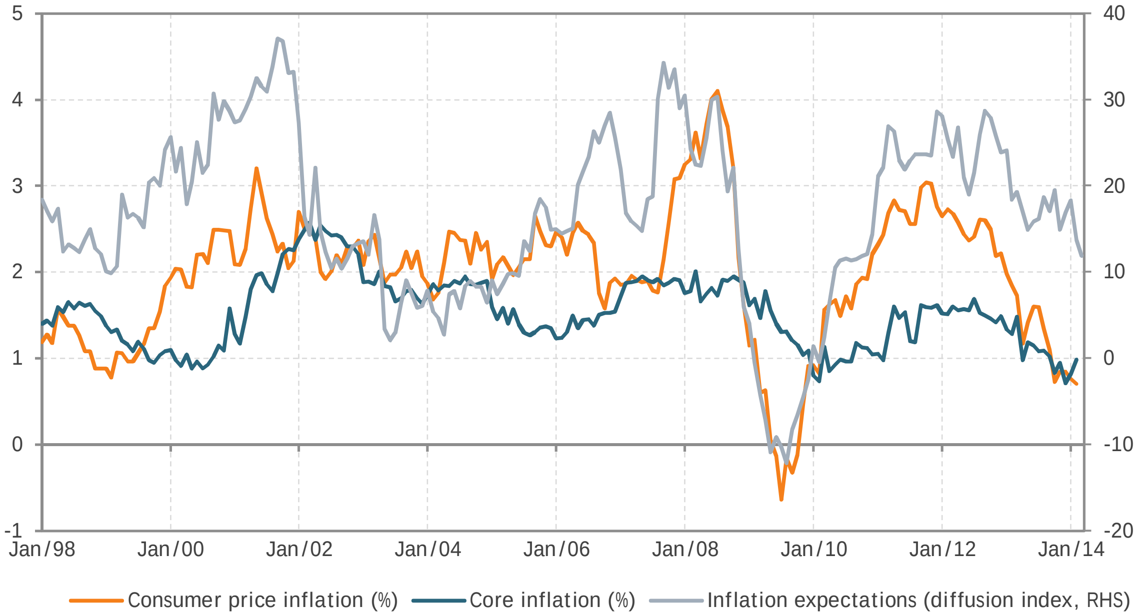
The *AIECE institutes* are divided on the likelihood of a secular stagnation in developed economies. Ten institutes are convinced or consider it likely to happen, while seven consider it unlikely. Several institutes explicitly mention to see the bigger risk of future economic weakness in the euro area. Some point to the fact that the reason for future subdued growth might lay in the sustained fiscal tightening that might be expected in the light of still high debt levels. Another reason mentioned several times is the ageing of the population.

2.6. Deflation in the euro area

At the start of the year euro area core inflation dropped to its lowest level (0.5%) since at least the middle of the 90s. This ignited talk about the risk of deflation in the euro area. Deflation, defined as a situation where price level declines occur across a significant number of countries, across a significant number of goods and in a self-fulfilling way, is still some way off, but the risk is that one major negative shock might suffice to tilt the entire euro area into deflation.

Note that the slide in inflation is a global phenomenon, a consequence of weak economic growth, large amounts of spare capacity, the stabilization of energy prices and the decline of several commodity prices. In the euro area price pressures have furthermore been subdued owing to the strength of the euro and the passing of the upward effect from increases in indirect taxes in many countries.

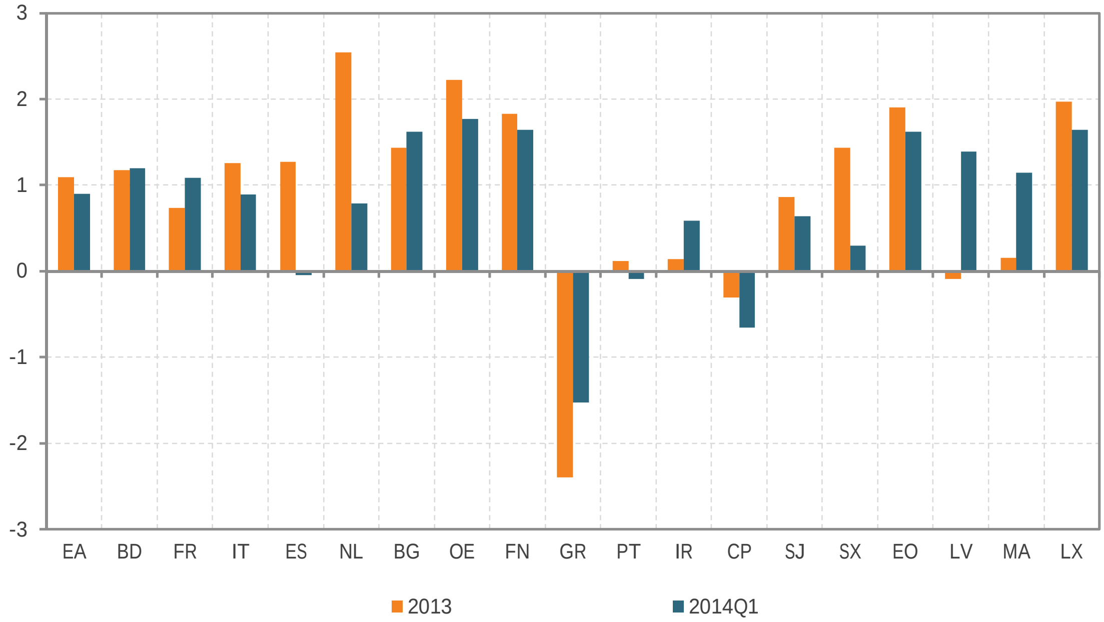
Graph 38 Euro area inflation indicators



Source: Eurostat, European Commission

One should not take comfort in the fact that inflation expectations (as part of the consumer survey or as in the market-based inflation swap rates) appear relatively stable as this was also the case in Japan just before deflation erupted. Moreover, low inflation itself is costly under the current circumstances as it makes the adjustment of prices and wages in the periphery vis-à-vis the core and the reduction of current debt piles more difficult. Outright deflation would make the above-mentioned adjustment of prices and debt reductions even more onerous and perhaps impossible.

Graph 39 Recent core inflation developments in euro area countries
Average inflation rates in %

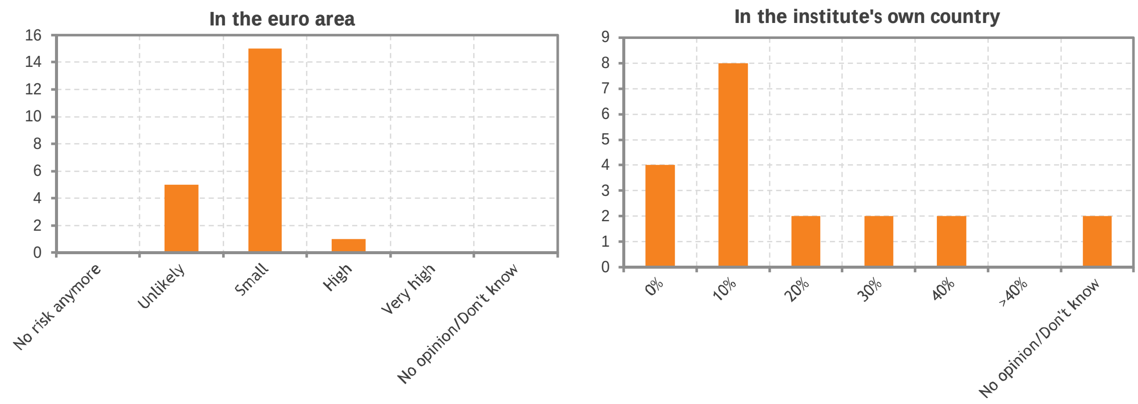


Source: Eurostat

The IMF, in its latest World Economic Outlook[8], estimated the risk of deflation to take hold in the euro area at 20%. This is more or less in line with the *AIECE institutes* as almost everyone considers the chance of deflation to be small or unlikely to materialise for the euro area as a whole. DIW sees no real threat of deflation as it expects the euro to weaken against the dollar as the ECB is about to loosen and the Fed is moving towards a tightening of monetary policy. KIEL focuses on the temporary factors that subdue inflation at the moment and is reassured by the fact that core inflation did not decline significantly in the past few months.

The odds of deflation in their domestic country are seen as somewhat less unlikely (20 to 40%) by KEPE, INSEE, ESRI and PROMETEIA. Four institutes excludes the possibility of declining consumer prices altogether (KIEL, WIFO, KOPINT and IBRKK).

Graph 40 Likelihood of deflation according to AIECE institutes
Number of institutes



Source: AIECE institutes

[8] World Economic Outlook, April 2014, page 15.

2.7. Should the ECB do more?

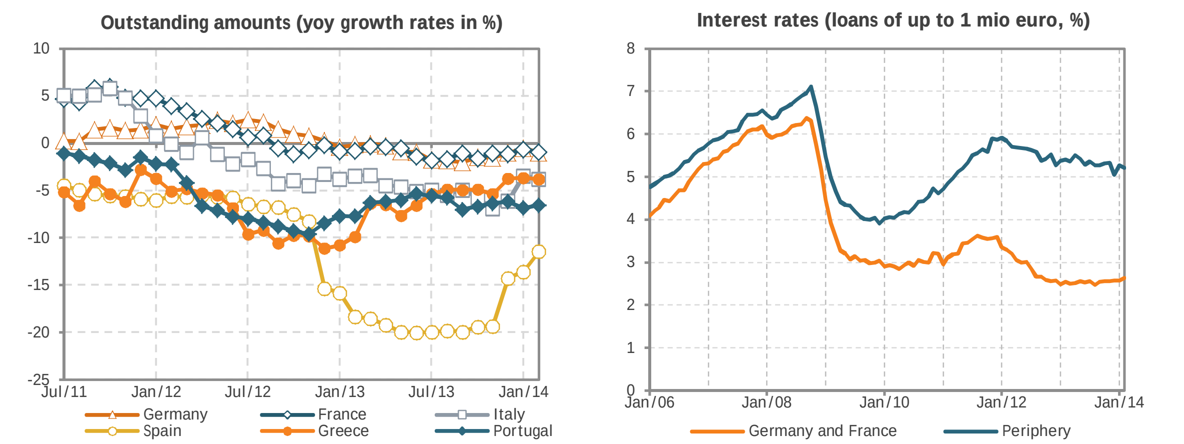
With inflation at very low levels and a lacklustre economic recovery, the question can be asked if the ECB has to do more. The *ECB forecasts inflation* rates of 1%, 1.3% and 1.5% for 2014-2016, while its official target is for inflation to be slightly below 2%. The failure of the ECB to hit its own inflation target in the next three years is the main reason for expecting more monetary intervention.

Using *Taylor rules*, the ECB's refinancing rate ought to be higher for Germany, Austria, Belgium and Finland. It has about the right level for France and Ireland, while Spain, Portugal, Italy and especially Greece would need negative policy rates. Taking the euro area as a whole, the refinancing rate is about at the right level for the moment. The one-size-fits-all policy is an unavoidable feature of a monetary union.[9]

While sovereign rate spreads have come down spectacularly within the euro area, spreads for interest rates to non-financial companies and to consumers remain very wide between the northern and the peripheral countries. Banks in the periphery have higher loan rates as they want to be rewarded more because of the higher credit risk they take on and because of their higher funding costs.

This persistent *credit fragmentation* pleads for a more activist ECB. Official ECB interest rate data on loans might even underestimate the size of the problem. These figures omit the potential borrowers who declined loans with high interest rates, those who have been refused credit and those who have become too discouraged to seek for a loan.

Graph 41 Loans to non-financial companies in the euro area



Source: European Central Bank

Also, *overall credit growth in the euro area remains very weak*. While deleveraging of the corporate sector in many peripheral countries seems warranted, growth in loans to non-financial companies in e.g. Germany and France has been negative or close to 0% for the past two years. Moreover even perfectly healthy SMEs in the periphery are struggling to get loans.

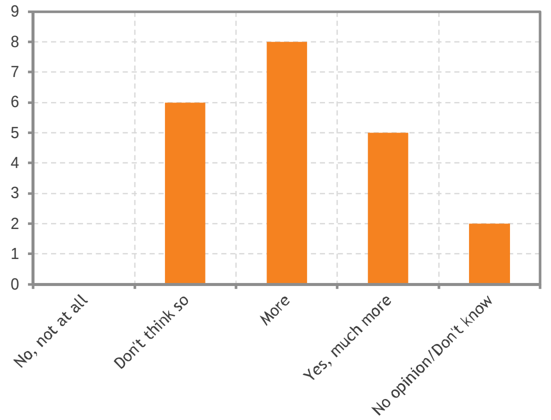
[9] Two German institutes are concerned about the looseness of monetary policy for the Germany economy. One of them (KIEL) even think Germany was on the brink of overheating.

Inflation forecasts, credit fragmentation and overall weakness in credit seem to plead for a more activist ECB, although Taylor rules do not seem to warrant a further relaxation in monetary policy. A two-third majority of AIECE institutes thinks the ECB should do more or much more, while only 6 of the 21 respondents do not deem more relaxation necessary.

Until recently the opposition of Germany and other Northern countries to a more unconventional policy appeared to be strong. This opposition seems to have eased as different ECB board members seem to be preparing the market for a new easing move in the coming weeks. Whatever the measure chosen, if credible, it is likely to have a downward effect on the euro, which should help ease the risk of deflation[10].

Graph 42 Opinion AIECE institutes on necessity to relax monetary policy further

Number of institutes



Source: AIECE institutes

Most AIECE institutes in favour of a loosening monetary policy point to the fact that the ECB is not respecting its own mandate and that with the large amount of slack in the economy, inflation is unlikely to rise in the short run. Two German institutes (RWI, KIEL) fear a further loosening would pose a risk for financial stability. KOPINT is sceptic about the success of further ECB measures.

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[10] A leaked ECB report claims the ECB modelled the effects of buying up to 1 trn EUR of non-specified assets would add 0.2 to 0.8 percentage points to inflation by 2016.

2.8. What should the ECB do?

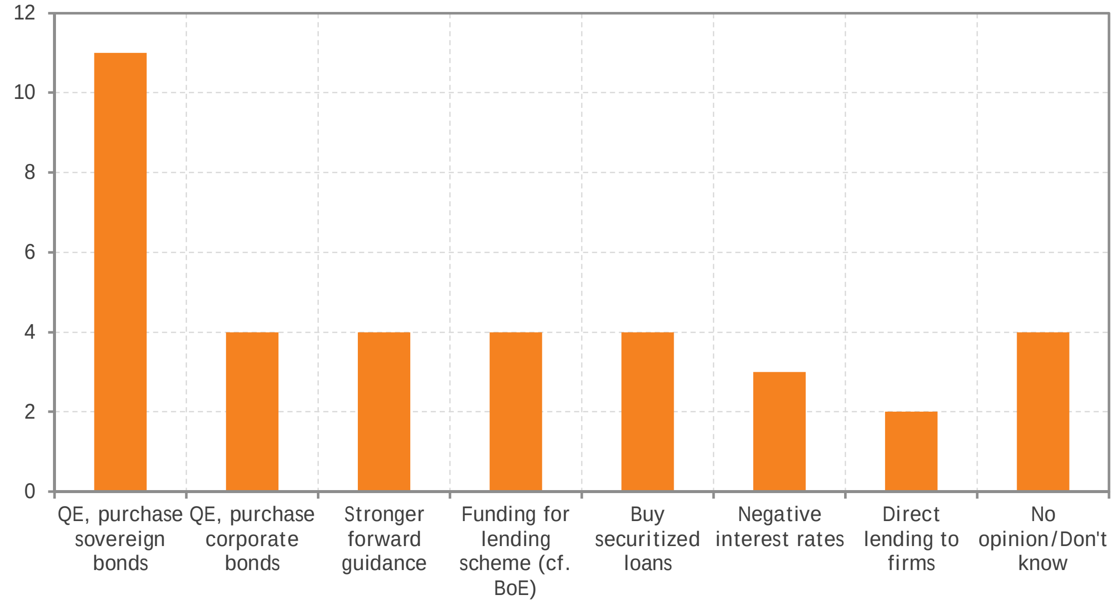
If the ECB needs to intervene more aggressively, the question is what it should do as the main refinancing rate is already at 0.25%.

A non-exhaustive list of options (put forward in the questionnaire) for the ECB to raise demand and inflation and to improve the functioning of credit markets is summarised below.

- A QE programme for government bonds: Buying a basket of bonds on the secondary market from different countries in proportion to the economic weight of each country. This would lower government bond yields, which, as they serve as a benchmark for many lending contracts, is also expected to translate into lower borrowing costs for firms and households. The ECB might be less keen on this option, because of political sensitivities, but the EU's Fiscal Compact should be the mechanism for preventing moral hazard.
- A QE programme for corporate bonds, which should directly lower corporate bond yields. Corporate bonds only serve as a source of financing for bigger companies as there are a lot of (fixed) costs related to bond emissions. It would hence not help SMEs in need of credit. Moreover, corporate bond yields are already at record lows (see 2.1).
- Buying of securitized loans: Buying of asset-backed securities in order to get more loans off banks' balance sheets, freeing capital for new lending. The size of the ECB's program would likely remain limited as the relatively small size of the securitization market poses liquidity problems. Furthermore as in the option above, SMEs constitute only a small part of this market.
- Installing a symmetrical inflation target of 2% indicating the ECB considers lower inflation as big as a problem as higher inflation.
- Negative interest rates: Charge banks for keeping money at the ECB which could spur banks to lend more to the private sector. Sweden's Riksbank and Denmark's National Bank have tried this policy in the past.
- Stronger forward guidance: e.g. Pledging not to raise interest rates before the unemployment rate reaches a certain threshold.
- A funding for lending scheme: Incentivising banks and building societies to boost lending by providing them funding for an extended period with both price and quantity of funding linked to their lending performance
- Direct lending to firms

An overwhelming majority of *AIECE institutes* believes the ECB should start to buy sovereign bonds. The other, less popular, options (buying corporate bonds, negative interest rates, stronger forward guidance, funding for lending, buying of securitized loans and direct lending to firms) all receive between two and four votes. Several institutes mention that it is perhaps not so important which instrument will be chosen, but that the intervention should be done in a forceful and credible way. Many institutes also mention that this is likely to lead to a depreciation of the euro. The SSN stresses the fact that the transmission mechanism is not working properly and the best way to address this problem is by direct lending to firms and the funding for lending scheme. Two institutes come up with measures not suggested in the questionnaire, i.e. increasing the amount of LTRO (NIESR) and stop sterilising past purchases of government bonds (CPB).

Graph 43 Opinion AIECE institutes on what the ECB should do
Number of institutes

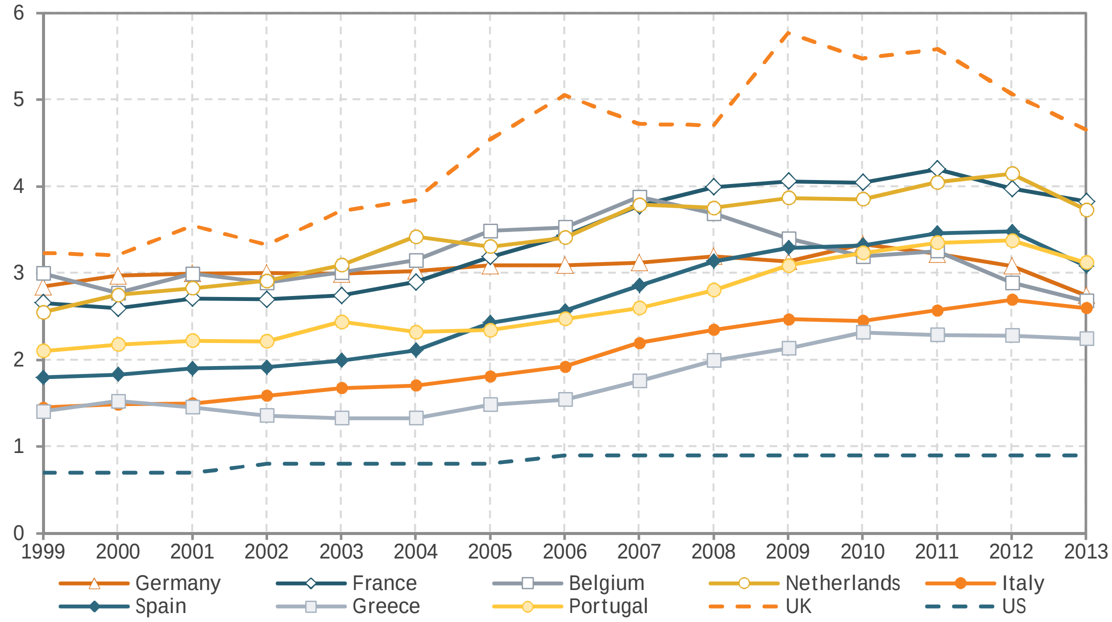


Source: AIECE institutes

2.9. Make the European banking system healthy again

In contrast with the US, where financial institutions were forced by regulators to clean up their balance sheets and to *recapitalize*, European banks have not followed this move. The main reasons for this omission are probably that several European banks are too big (in % of their national GDP) to be recapitalized by their respective national governments and the fact that a European burden-sharing mechanism did not exist.

Graph 44 Size of the banking sector
Total assets of financial institutions as a percentage of GDP



Source: European Central Bank,FDIC (US), Eurostat

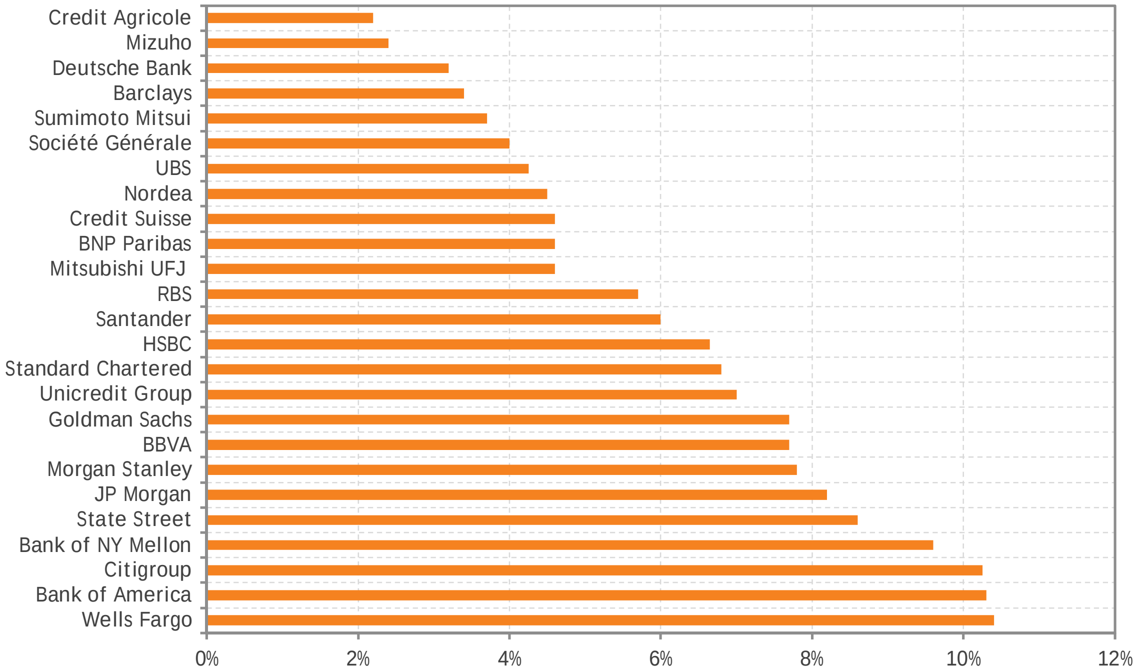
This leaves European banks strongly undercapitalized. Estimates about the size of the undercapitalisation differ widely, but go as high as 2000 bn EUR (Blackrock). This leads to an ongoing shrinking in bank lending and leaves the European banking system vulnerable for a new negative shock.

According to the new Basel Accord[11] (Basel III), the leverage ratio[12] ought to exceed 3%. This measure, where banks are obliged to hold a minimum percentage of equity vis-à-vis its assets to absorb losses did not exist before and was introduced to have a more reliable, simpler, yet cruder indicator than the risk-weighted measures of Basel II. Many European banks do not meet the Basel threshold at the moment, but should be able to reach this 3% leverage ratio relatively easy in the future (although in some cases government guarantees for recapitalization would be needed)[13]. The 3% ratio seems like an absolute minimum however, as it is all too conceivable for a bank's assets to lose 3% of their value. In the US, regulators have imposed a leverage ratio of 5%, while it will probably raise the leverage ratio of the eight largest banks to 8%. It is hence no surprise to see a huge difference between the leverage ratios

[11] To be implemented before March 2018
[12] Defined as a Tier 1 equity divided by total assets
[13] See Vox "Falling short of expectations? Stress-testing the European banking system", Viral Acharaya & Sascha Steffen, 17th Jan 2014.

of US and European banks. In Switzerland regulators are thinking about raising the leverage ratio to 6%, or even 10%.

Graph 45 Financial leverage of selected banks (2013)
Common equity divided by total assets

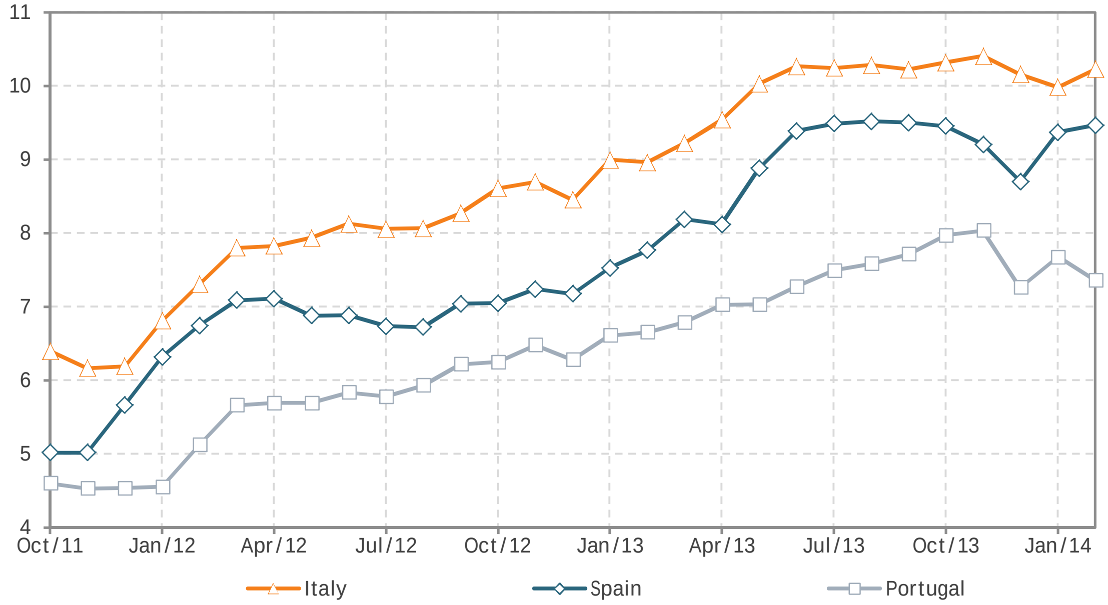


Source: Thomson Reuters Datastream

European bank balance sheets also contain an ever rising volume of non-performing loans. Officially reported figures on non-performing loans are probably underestimating the true size of the problem as acknowledging more non-performing loans implies a reduction of capital, which European banks lack and hence often results in the ever greening of bank loans and keeping zombie companies in live.

Meanwhile the *link between sovereigns and their banks* has been reinforced as banks strongly raised their holdings of national government bonds since the OMT promise of the ECB. Spanish banks e.g. increased their holding of Spanish government bonds from 4.5% to 9% of total assets in the space of just two years. This increased coupling makes banks and sovereigns vulnerable to a downward spiral of shocks that could quickly spread from one to the other.

Graph 46 Banks' holdings of national sovereign bonds
Percentage of total assets



Source: European Central Bank

The *current banking union plan* fails to address all these problems as there is no real sharing of the burden of the rescuing or dissolution among the different countries. As the common backstop (55bn EUR to be built up in the next 10 years) is way too small, the link between sovereigns and banks is not broken.

Moreover, this creates a major problem with the asset quality review of the ECB, to be held in November 2014. While the common supervision of the European banks by the ECB is a good thing, it will be difficult for the ECB to demand that banks raise capital without the common backstop as it could risks financial stability if it exposes a bank that has no access to outside capital.

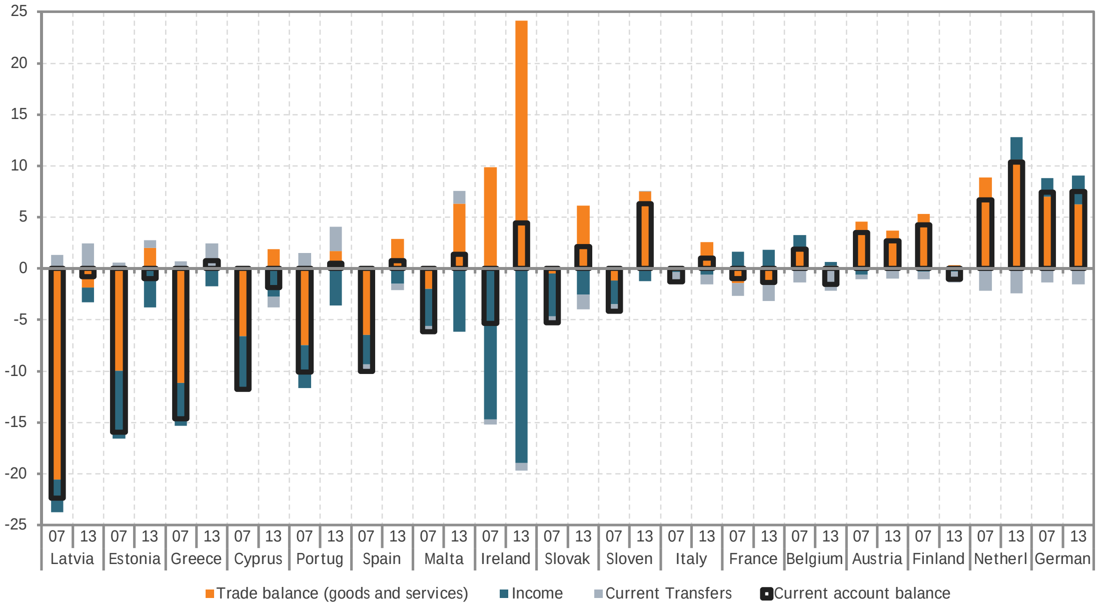
The *AIECE institutes'* proposed solutions to make the European banking system more healthy encompass an increase of the capital base (by the private or public sector), genuine stress tests, breaking the link between banks and sovereigns by ending the preferred regulatory treatment of government bonds, a bigger resolution fund, a common deposit-guarantee scheme and tighter controls of financial institutes.

2.10. Have current account imbalances structurally improved?

The graph below provides (the decomposition of) the current account balance of all euro area countries[14] for the years 2007 and 2013. It shows that a large group of countries (Latvia, Estonia, Greece, Cyprus, Portugal, Spain, Malta, Ireland, Slovakia and Slovenia) faced current account deficits close to or well over 5% of GDP in 2007, but managed to restore their current account by 2013. The graph also shows that the biggest part of these current account adjustments were realised by an improvement in the trade balance, while the contributions of income and current transfers to the change in the current account were much less significant.

Graph 47 Decomposition of current account balance

% of GDP



Source: Eurostat

In almost all euro area countries, the part of exports in GDP has gone up between 2007 and 2013. This should not come as a surprise as world trade (also after correcting for the geographical orientation of exports) grows faster than GDP of the considered countries. Moreover, a lot of countries registered a gain in export market shares[15] during the period 2007-2013. A few countries faced a decline of the share of their exports in GDP due to large export market share losses (e.g. Austria and Finland).

The development of imports depends for a large part on the evolution of domestic demand and exports as they generate demand for imports. As the import intensity of exports and investment (relatively fast-growing demand components) is generally higher than that of other demand components, imports tend to grow faster than GDP in advanced economies. However, during the past few years many economies in the periphery of the euro area had to rebalance their economy through cutting wages,

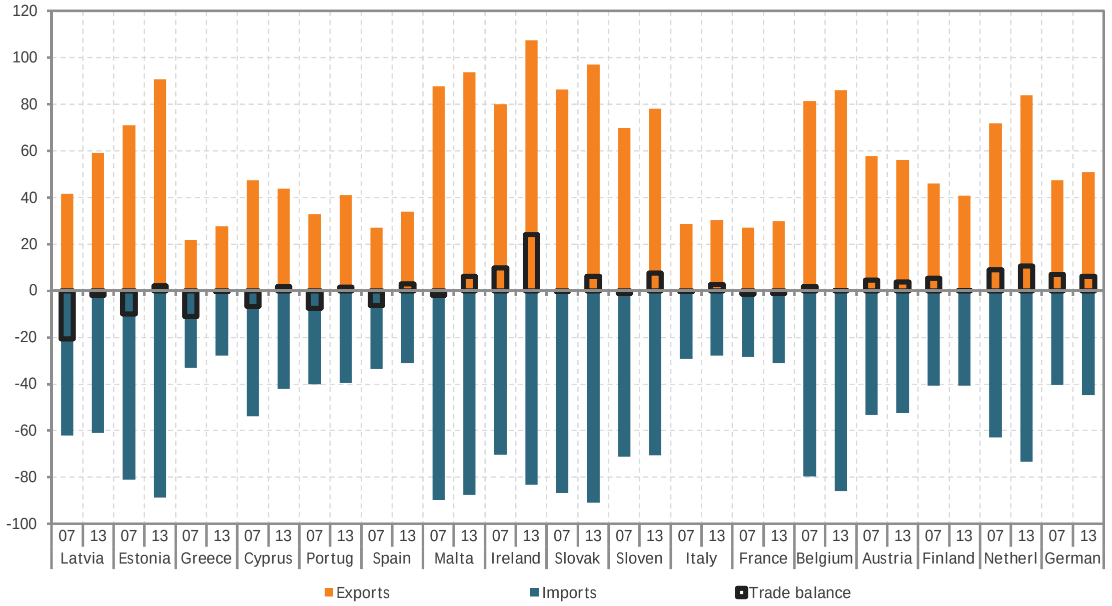
[14] Luxemburg is not discussed due to the very specific composition of its current account, characterised by a large surplus of the goods and services balance that is offset by a deficit on the balance of incomes.

[15] This implies that a country's growth of exports was higher than the weighted average growth of its trading partners' imports.

lowering public expenditures etc. These measures caused a decline in domestic demand in some countries to such an extent that it pushed down the share of imports in GDP.

Graph 48 Decomposition of trade balance

% of GDP

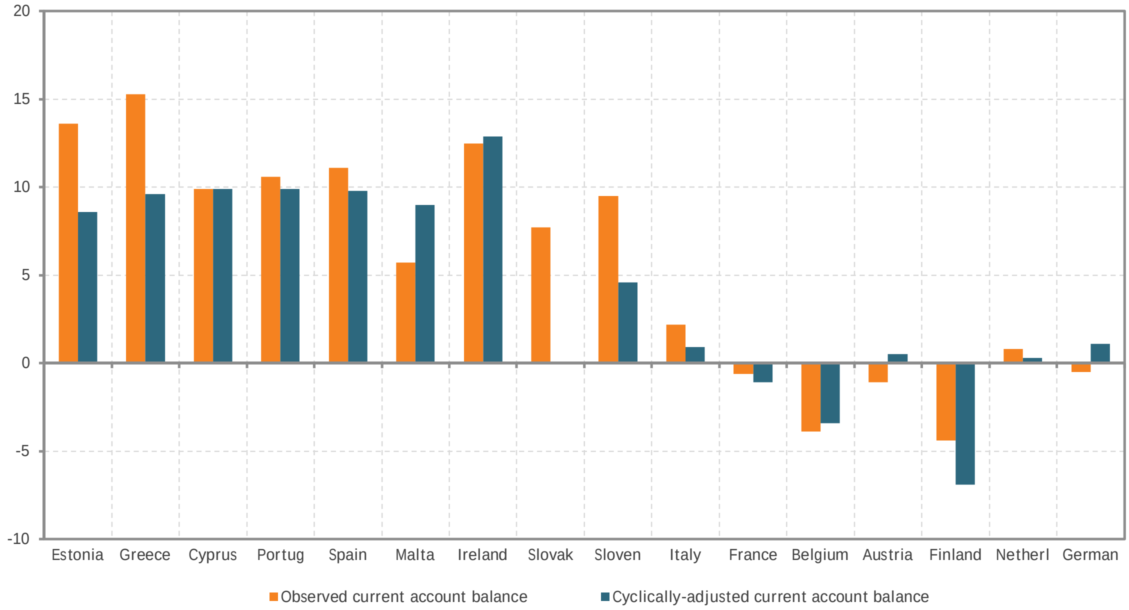


Source: Eurostat

In the meantime, current account balances have reached a more sustainable level, so that the question is whether the countries in the periphery of the euro area will manage to avoid a new worsening of their current account balances if domestic demand growth picks up. To evaluate that, calculating cyclically-adjusted trade balances gained interest recently. The IMF started calculating these balances in the framework of its “Pilot External Sector Reports” and the European Commission recently presented the results of a proper analysis in its winter 2014 forecast.

To calculate cyclically-adjusted balances, one should first determine which part of the current account can be considered as cyclical. As relative price effects, changes in flows of transfers and incomes and shifts in the composition of output are all considered to be structural determinants of the current account, only the performance of domestic relative to foreign demand is seen as a factor that is influenced by business cycle developments. Consequently, the cyclical adjustment of the current account is based on an adjustment of the trade (goods and services) balance. This adjustment is based on the output gap of the considered country relative to the weighted average of the output gaps of its trading partners. If, for example, a country’s import demand slows down due to a decline in potential GDP growth, the resulting improvement in the trade balance should be more permanent than in the case of a widening of a negative output gap.

Graph 49 Development in current account balances
% of GDP, 2013 compared to 2007



Source: European Commission

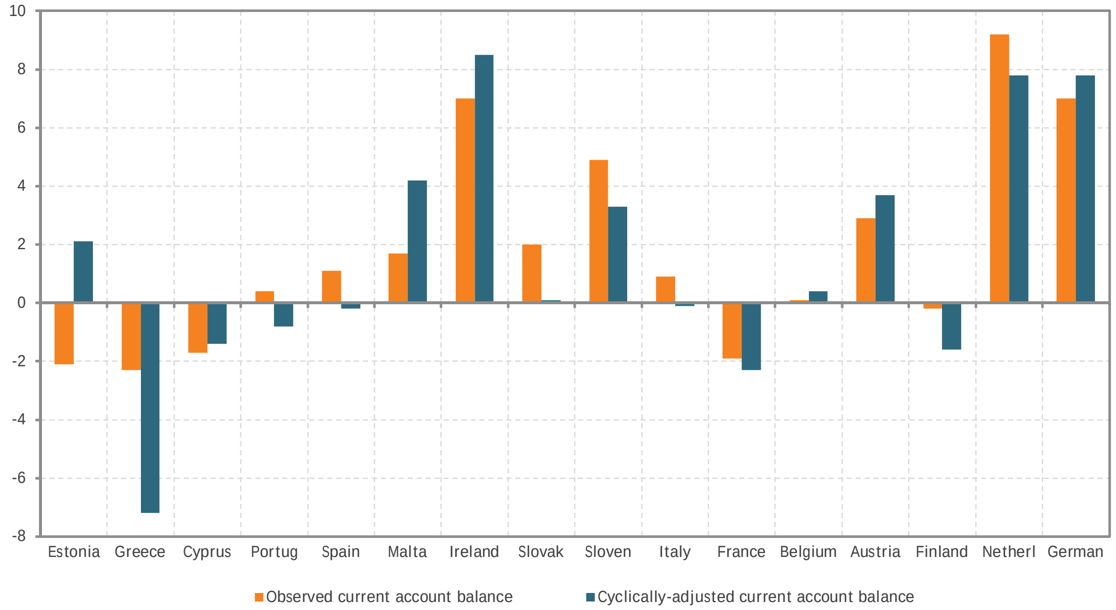
The graph above provides the differences between 2013 and 2007 (in % of GDP) for the observed and the cyclically-adjusted current account balances as calculated by the European Commission. It shows that the developments in the observed and the cyclically-adjusted current account balance are generally quite close to each other. This implies that (a large part of) the significant improvement in the current account balances of several 'vulnerable' euro area countries was structural, i.e. due to low growth of potential output as compared to their trading partner countries or due to other structural factors such as improved price competitiveness.

However, to evaluate what will happen if output gaps in all countries are closed in the medium term, which is a traditional forecasting hypothesis, one should compare the level of the observed and the structural current account balance. The graph below shows that only a few countries could experience an improvement of their current account balance when closing their output gap because their output gap is negative but relatively small (e.g. Germany, Austria, Ireland) or because their output gap is positive (Estonia). Most other countries risk to be confronted with a worsening of their current account balance when closing their output gap.

It should be noted that a correct evaluation of output gaps is crucial to the calculation of cyclically-adjusted current account balances presented here. As revisions of output gaps can be very large over time, this analysis should be interpreted with caution. Moreover, the fact that current account adjustments are currently considered as mainly structural is not necessarily good news as it also implies that the productive capacity (measured as potential output) of some economies was negatively affected during the rebalancing process.

Graph 50 Observed and cyclically-adjusted current account balance in 2013

% of GDP



Source: European Commission