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Association d'Instituts Européens

de Conjoncture Economique (AIECE)

AIECE General Report: Part 1

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1. Contents

2. Key Developments

World economy with less momentum in early 2016

At the beginning of 2016 it became clear that the world economy had cooled down markedly in the preceding months. In China, structural change continues at a rapid pace, leading to declining demand for commodities. This, in turn, led to a decrease of raw material prices (Figure 1) and dampened growth in commodity-exporting countries such as Brazil and Russia. Furthermore, growth momentum in advanced economies declined noticeably. As a consequence, the first months of the year 2016 were characterized by declined consumer and producer confidence as well as heightened asset market volatility.

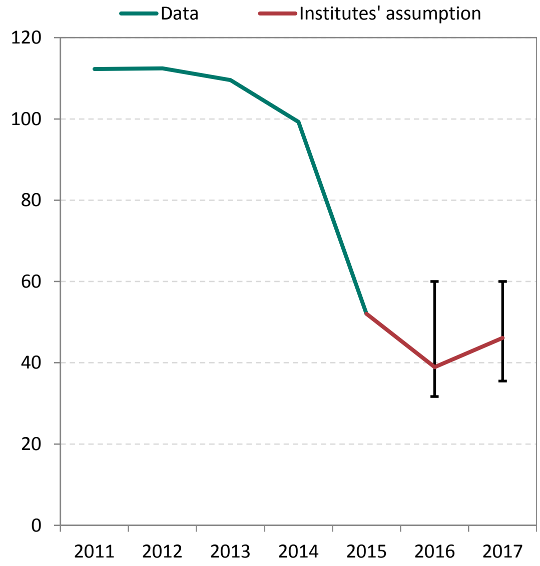
Stabilization of global economic growth to be expected

In the meantime there are growing signs that international economic activity will not weaken any further in the first half of 2016. In advanced economies in particular the dynamic has already gained momentum slightly. Production growth, by contrast, will remain moderate on the whole. US monetary policy will gradually become less expansionary, with the strong US dollar curbing international demand. In the euro area last year's stimulus provided by the strong depreciation of the euro will disappear (Figure 2). The Chinese economy will continue to struggle with structural change, as well as the high indebtedness of several state-owned manufacturers. In Japan production will increase again, as the drop seen at the end of last year was mainly due to temporary factors. It has become clear, however, that its economic policy ("Abenomics") implemented with high expectations has failed to trigger any self-sustaining upturn.

Although the financial markets have calmed down since mid-February, the risks underlying their unrest have not dissipated. On the one hand, it is still possible that structural change in China will affect the whole country's economy to a greater extent than previ-

Figure 1: Raw oil prices

(USD/barrel)

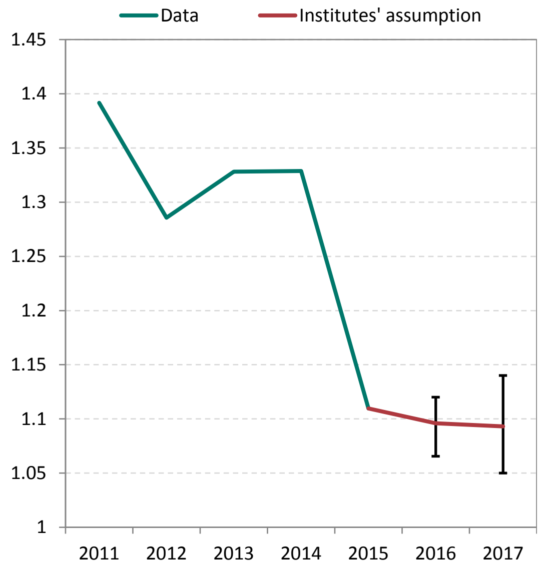


Note: Error bands indicate the upper and lower extremes of the member institutes' projections.

Source: Datastream, AIECE Institutes.

Figure 2: Euro exchange rate

(USD/EUR)



Source: Datastream, AIECE Institutes.

ously. Inflation, on the other hand, could increase more rapidly than predicted, obliging central banks to make swift interest rate increases. This may cause turbulence in financial markets, and especially in emerging economies. Finally, Europe's economy faces significant political risks. Forces in favour of reversing the political and economic integration achieved in the European Union have been gathering power for several years. There is a possibility that Britain may vote to exit the European Union in June. Moreover, it is difficult to estimate the implications that this may have for trade and financial flows within the EU.

Substantial downside risks

2.1. Euro Area Outlook

In the euro area, GDP rose by 1.6% over the year 2015. Among the home countries of the AIECE member institutes in the euro area, 2015 GDP growth was higher than the euro area average in Ireland, Spain, Slovenia, and the Netherlands (Figure 3). The economy in Germany and Belgium expanded approximately with the same rate as the euro area as a whole, while growth lagged behind in France, Austria, Italy, Finland and Greece, the latter experiencing another decline of GDP.

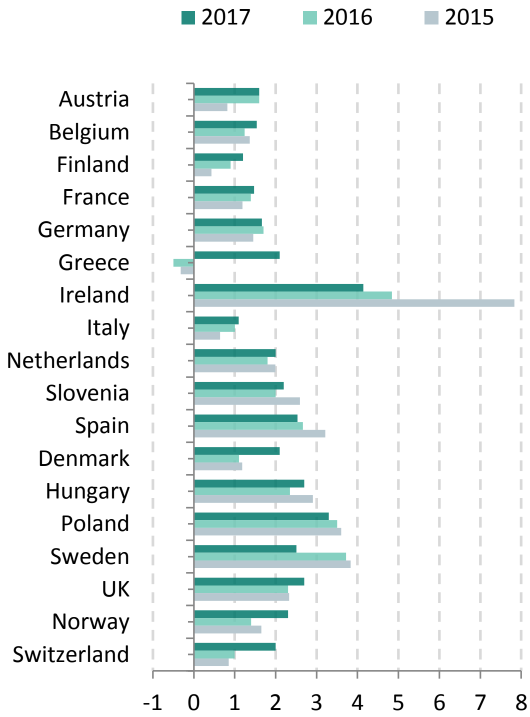
Euro area growth with substantial heterogeneity

Looking forward, member institutes on average expect growth in the euro area to slightly pick up in the coming quarters, compared to the fairly low expansion rates seen in the second half of 2015 (Figure 4). On annual average, rates are expected to be roughly stable, with projected growth of 1.5% and 1.7% for 2016 and 2017, respectively (Figure 5).[1] Uncertainty about the outlook appears to be fairly small, judged by the range of projections submitted by the institutes.

Growth expected to stabilize at 2015 rates

Figure 3: Growth in European economies

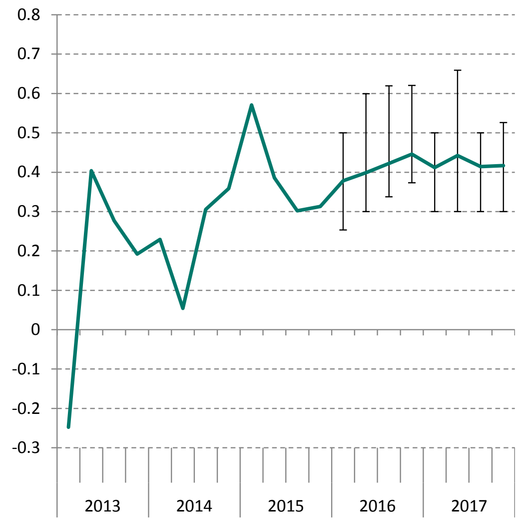
(in percent)



Source: Eurostat, AIECE Institutes.

Figure 4: Quarterly euro area real GDP growth

(q-o-q percent growth)



Source: Eurostat, AIECE Institutes.

[1] Those numbers are consistent with an approximate euro area figure calculated on the basis of the AIECE institutes' projections for the respective euro area member countries, with the GDP-weighted average indicating flat growth of 1.6% between 2015 and 2017 for the euro area.

Low energy prices are the primary positive influence on growth

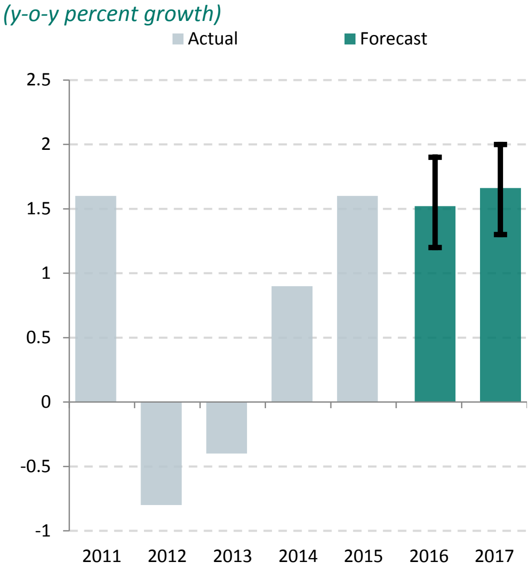
Growth in the euro area is primarily driven by the low energy prices, with the weak euro exchange rate and low interest rates ranked fairly equal as positive factors of secondary importance (Figure 6, Figure 8). Other positive influences named by some of the member institutes further include an expansionary/less restrictive fiscal policy (Austria, Belgium, Germany, Italy, Netherlands), partly due to higher public expenditures in the context of the increased number of refugees, partly due to lowered taxes and social security contributions.

The weak external environment is the most important negative factor

On the other hand, growth in euro area countries is reduced by several influences (Figure 7, Figure 9). Primarily, AIECE institutes mention the weak external/global environment as a dampening factor. For some euro area countries, the legacy of the crisis – including high private and/or public debt, financial sector weakness, low investment and high unemployment – still poses problems. Low productivity growth is also considered for some countries to be an important impediment to growth. In addition, some AIECE institutes mention high political uncertainty as a dampening factor (Greece, Ireland).

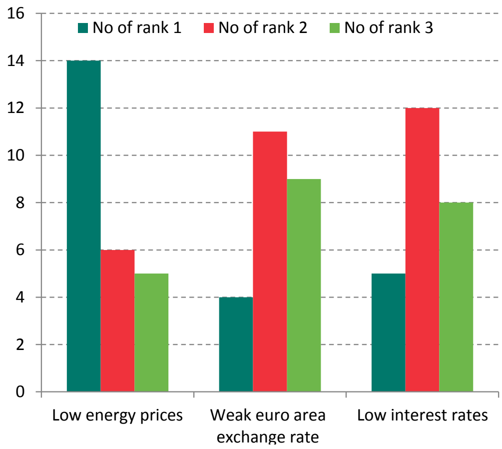
Figure 5: Annual euro area real GDP growth

(y-o-y percent growth)



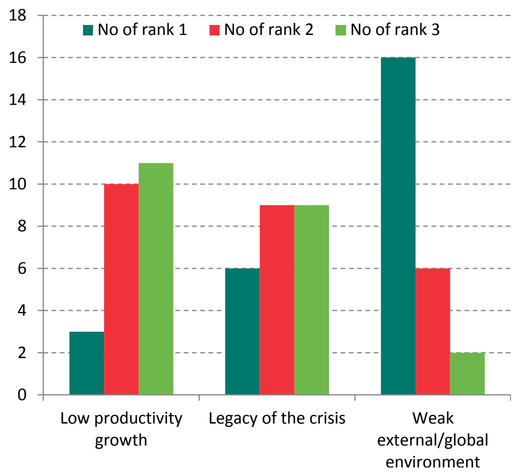
Source: Eurostat, AIECE Institutes.

Figure 6: Positive factors for 2016 growth



Source: AIECE Institutes, question A.1.1.[4]

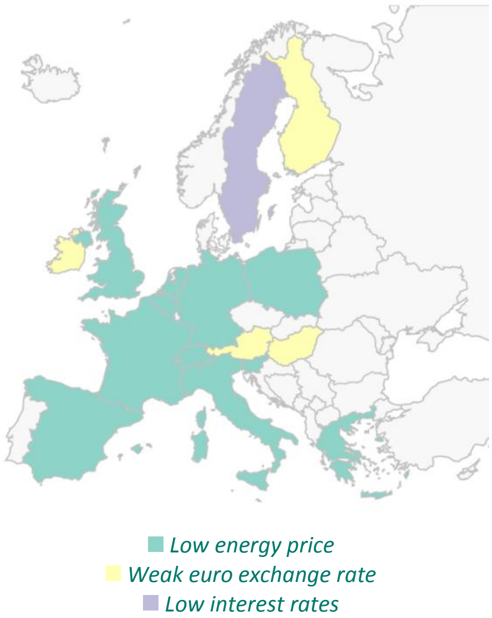
Figure 7: Negative factors for 2016 growth



Source: AIECE Institutes, question A.1.2.[5]

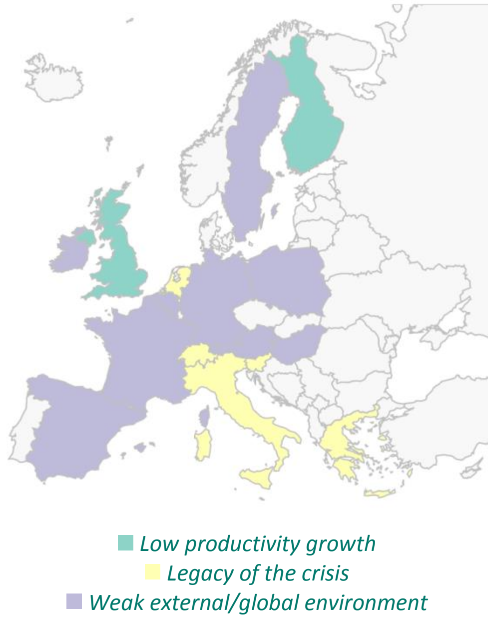
[4] Questions refer to the questionnaire filled out by the AIECE institutes; see the appendix in section 5 of this report.

Figure 8: Most important positive factor for 2016 growth



Source: AIECE Institutes, question A.1.1.

Figure 9: Most important negative factor for 2016 growth



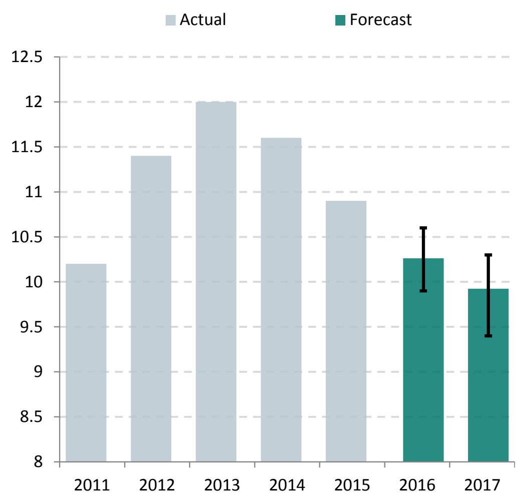
Source: AIECE Institutes, question A.1.2.

Unemployment is high and decreases only gradually

Despite three years of fairly solid growth in the euro area, unemployment remains elevated (Figure 10). In 2015, euro area unemployment averaged 10.9%. Very high unemployment is a particular problem in Greece and Spain, which both had an unemployment rate of above 20% in 2015 (Figure 11). Unemployment is also high in Finland, France, Ireland, Italy and Slovenia, with rates having been close to or above 10% in those countries. Looking forward, member institutes expect unemployment to decrease slightly in the euro area, with average unemployment being projected to reach 10.3% in 2016 and 9.9% in 2017.[2]

Figure 10: Euro area unemployment rate

(in percent)



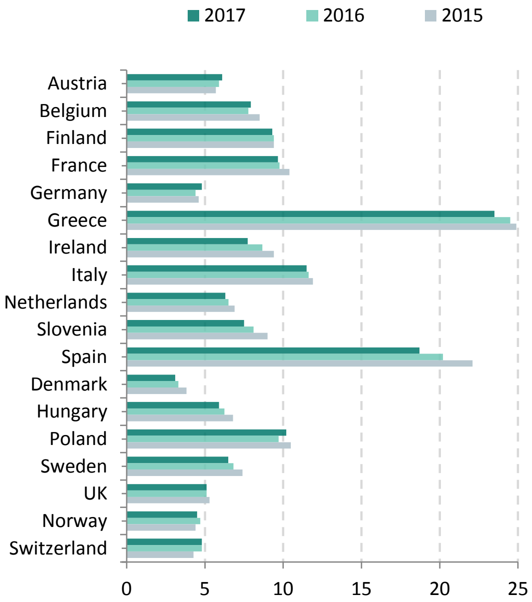
Source: Eurostat, AIECE institutes.

[5] Legacy of the crisis includes high private and/or public debt, financial sector weakness, low investment, high unemployment.

[2] An approximate euro area figure calculated on the basis of the AIECE institutes' projections for the respective euro area member countries signals a small upside risk to this projection, with the weighted average indicating unemployment rates of 10.5% for 2016 and 10.2% for 2017.

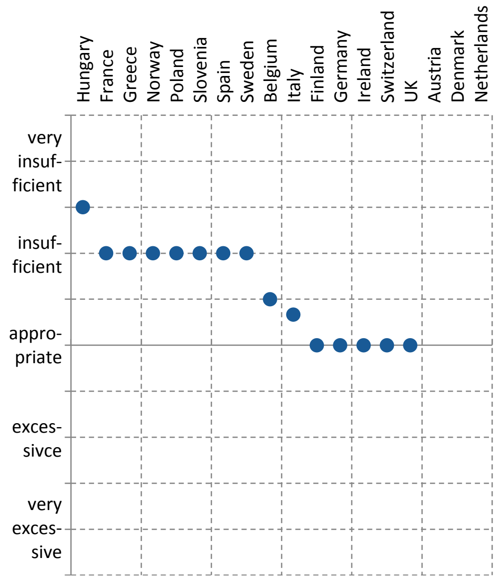
Figure 11: Unemployment rate in European economies

(in percent)



Source: Datastream, AIECE Institutes.

Figure 12: Government measures against unemployment

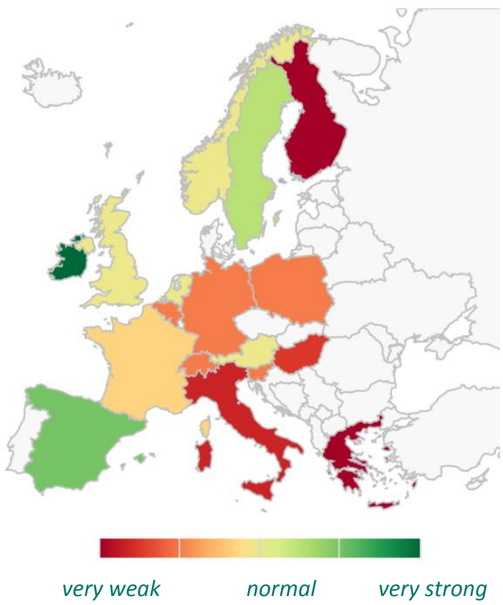


Source: AIECE Institutes, question A.4.1.

Govern-ment measures against unemploy-ment are widely considered insufficient

Accordingly, a large majority of the member institutes considers their respective government's measures to bring down unemployment as insufficient (Figure 12). Some institutes highlight certain government "action plans" – including training programs, subsidized jobs or decreased incidental wage costs – to potentially have a positive effect on employment (Belgium, France, Greece, Ireland, Italy); other institutes stress that the current employment situation benefits from reforms in the past and that more recent measures taken by the government could be a drag on employment (Germany).

Figure 13: Private investment dynamics



Source: AIECE Institutes, question A.4.3.

Private investment continues to be weak

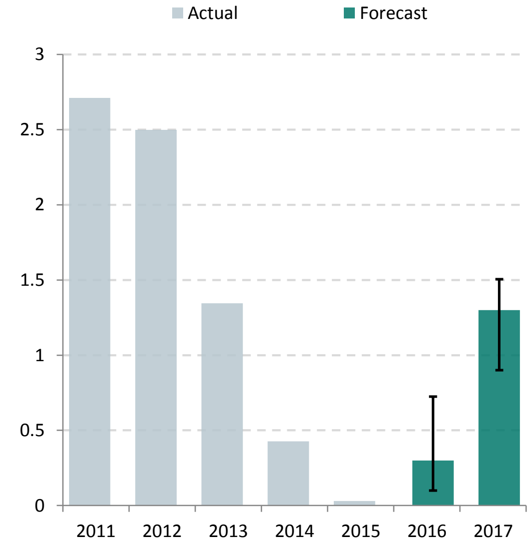
Private investment continues to be an impediment to growth in many euro area countries. Except for the institutes based in Austria, Ireland, the Netherlands and Spain, all AIECE institutes in euro area countries characterize private investment dynamics in their home country – judged by the respective cyclical situation – as weak or very weak (Figure 13). Reasons indicated by the institutes in many member countries include faintness of and uncertainty about the external environment, policy uncertainty, weakness of domestic demand in several countries and a lack of credit in some of the former crisis countries.

Price dynamics are very low, but inflation expected to increase substantially

Due to the decline of raw material prices and the continued underutilization of capacities – Eurostat estimates the output gap for 2015 to have been close to two percent in the euro area – price dynamics continue to be very low. HICP inflation in the monetary union was 0,0% in 2015 (Figure 14, Figure 15). Looking forward, AIECE institutes expect price dynamics to pick up, with the projected euro area inflation rate for 2016 being 0.3% and 1.3% for 2017. The outlook appears to be fairly uncertain, as indicated by the wide projection interval of the member institutes' projection, which range from 0.1% to 0.7% for this year and from 0.9% to 1.5% for the coming year.

Figure 14: Euro area HICP inflation rate

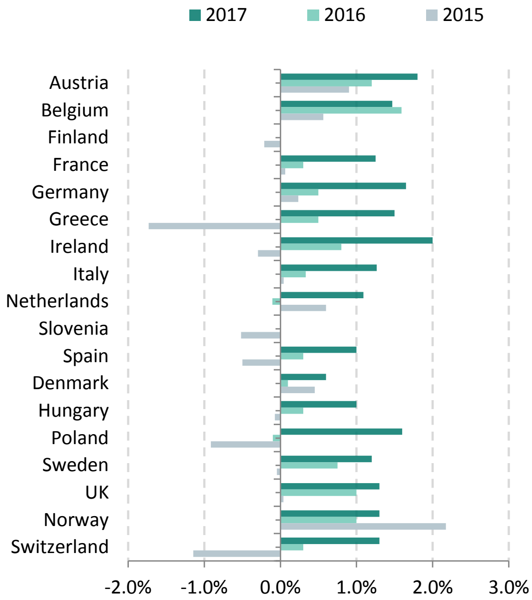
(in percent)



Source: Eurostat, AIECE Institutes.

Figure 15: Inflation in European economies

(in percent)



Source: Eurostat, AIECE Institutes.

Questions for Discussion

- Is the slowdown in emerging economies expected to be temporary or persistent?
- Despite fairly high GDP growth rates projected for some of the euro area member countries, why is the unemployment rate only decreasing gradually?
- What policy measures could contribute to an acceleration of investment dynamics in the euro area? What's the role of the banking system in this context?
- What is the effect of low interest rates on different parts of the economy?
- What are the perspectives for the output gap in euro area countries and the euro area as a whole?
- Are price dynamics expected to accelerate beyond the fading influence of the decline of commodity prices? How is core inflation expected to develop?

2.2. Non-Euro-Area Outlook

2.2.1. EU Country Developments

United Kingdom

Although the UK cycle is intact, the referendum is weighing on the economy

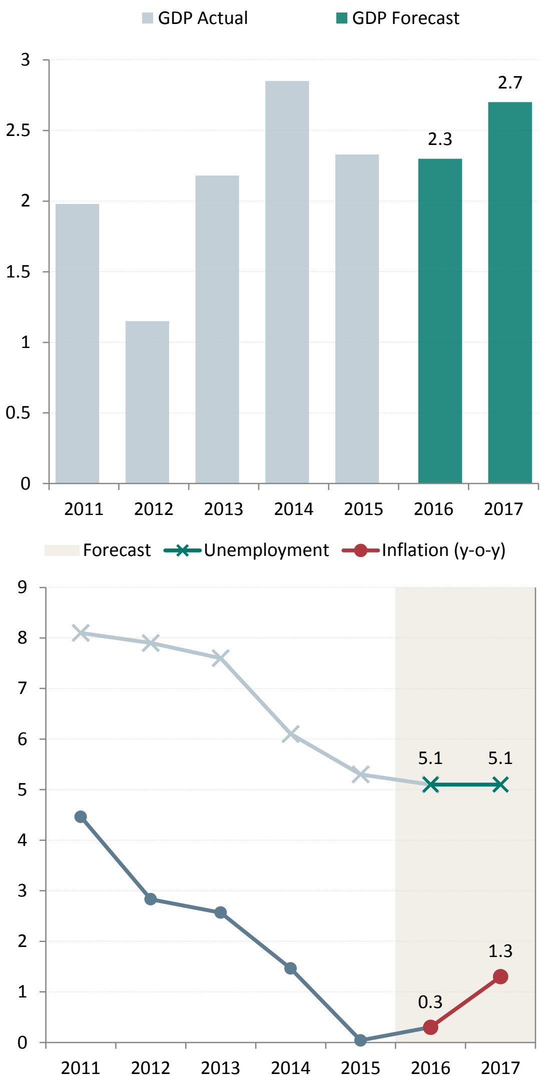
Economic activity was strong in the UK in the second half of 2015, growing on average by 0.5 percent on a quarter on quarter comparison. The expansion was mainly driven by domestic demand, supported by an increase in disposable income due to real wage increases and employment growth. On the production side, main drivers are the services and the construction sector. The economy is facing tailwinds originating from the referendum on EU membership that takes place in June 2016, which introduces considerable uncertainty for investment plans. Preliminary GDP estimates are pointing towards a weaker first quarter with 0.4 percent with potential of downward revisions. Leading indicators such as retail sales and industrial production point toward a slowdown of economic activity. Albeit the hard-to-predict result of the referendum and its consequences for growth, the AIECE institutes forecast a temporary slowdown of economic growth in 2016 at 2.3 percent and a re-acceleration in the course of 2017, when the economy is expected to grow at 2.7 percent (Figure 16).

The unemployment rate is stable at 5.1 percent and marks slightly below the pre-crisis value in 2008. There was zero price inflation in the harmonized index of consumer prices (HICP) over the year 2015. Going forward, it is projected by the AIECE institutes to mark persistently below the inflation target of the Bank of England of two percent.

Sweden

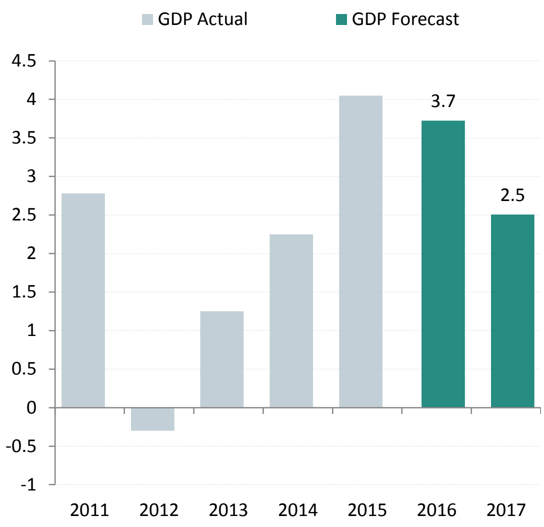
The Swedish economy was growing in the fourth quarter of 2015 at 1.3 percent in comparison to the previous quarter, which was

Figure 16: United Kingdom



Source: Datastream, AIECE institutes.

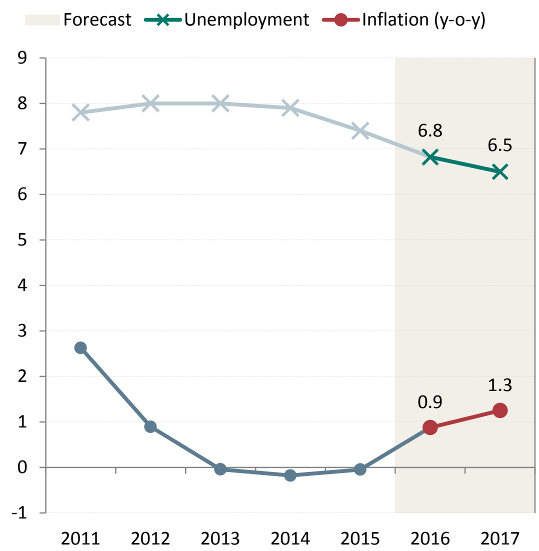
Figure 17: Sweden



Migration is increasing Swedish unemployment only as of 2018

higher than expected. Expansionary monetary policy to fight deflation and additional public spending in response to the refugee inflow are partly responsible for the dynamic economic activity. Further, domestic demand is robust and exports are picking up. The labour market is improving in this environment and employment rises. The high number of migrants is likely to increase the unemployment rate only as of 2018.

Economic activity is projected to be more moderate in the coming years. AIECE institutes' forecasts see a decline to 2.5 percent in 2017 and a less rapid decline in the unemployment rate (Figure 17). Domestic inflation is picking up only slightly and remains subdued for 2016 and 2017.



Source: Datastream, AIECE institutes.

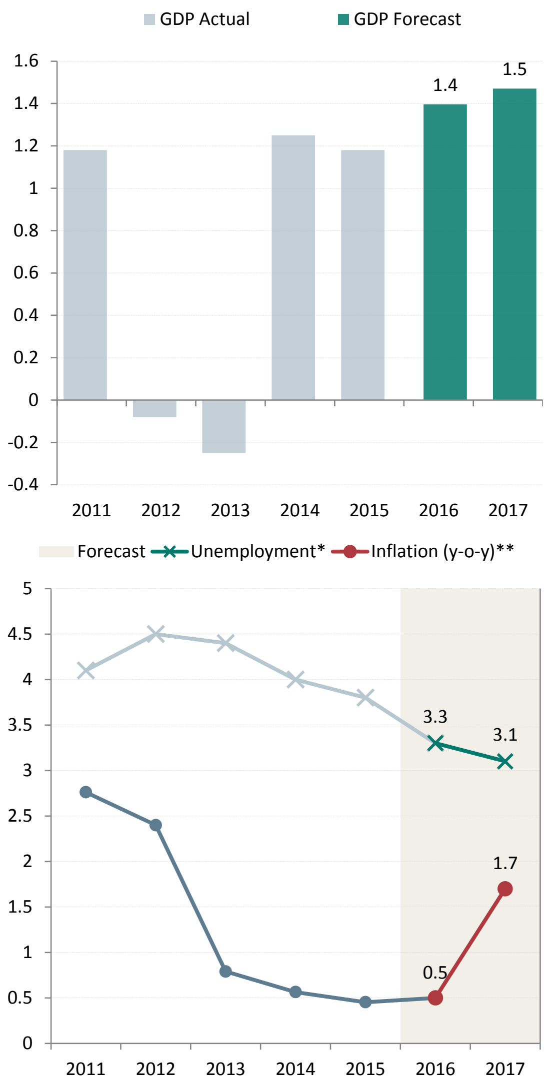
Denmark

Growth slowdown in Denmark is only temporary

As economic activity was losing momentum in the second half of the year, the Danish economy was growing at a moderate 1.2 percent in 2015. Domestic demand was the main driver for economic growth, while exports and imports were both declining due to the weak external environment. Despite moderate growth, the labour market improved gradually.

Gains in disposable income are likely to stimulate private consumption in the next years, which will increase private investment. Further, private investment is going to benefit from a likely recovery of world trade. The AIECE institutes' forecasts imply a pick-up of economic activity in the next two years and perpetual reductions in the unemployment rate (Figure 18).

Figure 18: Denmark



Source: Datastream, AIECE institutes.

Poland

GDP growth accelerated throughout the year 2015 to 3.6 percent, up from 3.3 percent in the previous year (Figure 19). While private consumption and investment were growing at a

Continued growth expected for Poland

slower pace in the fourth quarter of 2015, government consumption went up by 2.5 percent. Domestic demand is likely to continue growing, despite at a lower rate, given the buoyant labour market and increases in real wages that boost disposable income. Investment activity is going to remain strong given the accommodative financing conditions. However, uncertainties surrounding the direction of the political future due to the controversy surrounding the independence of the Constitutional Tribunal might dampen investment activity. Overall, AIECE institutes forecast a continued expansion of Polish economic activity, but a reversal in the declining unemployment rate in the course of 2017. Inflation is projected to be positive over the next two years, however picking up only gradually.

Hungary

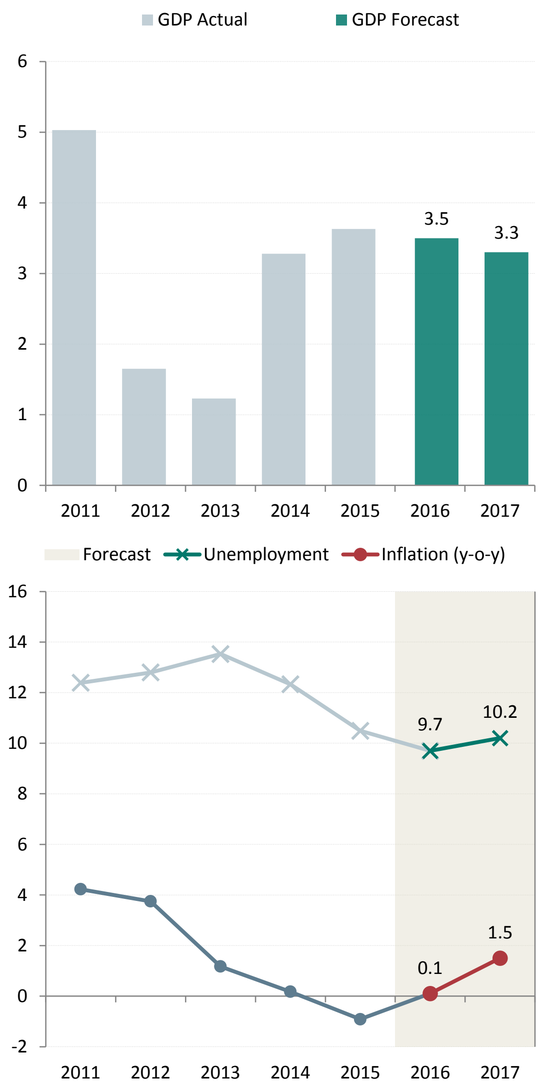
GDP growth in Hungary dropped to 2.9 percent in 2015, from 3.9 percent in the previous year. Domestic demand was boosted by a low inflation environment and a gradual improvement in employment numbers (Figure 20). Economic activity is projected by the AIECE institutes to decelerate further in 2016 to 2.4 percent, before picking up again in the course of 2017. The main reason for the temporary slowdown of economic activity is a lower absorption of EU funds in 2016, which are accompanied by a drop in investment spending. Given the robust improvement in real disposable income and novel central bank measures to improve lending to SMEs, economic activity is likely to accelerate thereafter. Finally, inflation rates pick up only gradually and stay well below the central bank's inflation target of three percent throughout the forecast period.

Temporary effects in 2016 stemming from lower absorption of EU funds in Hungary

2.2.2. EU Outlook

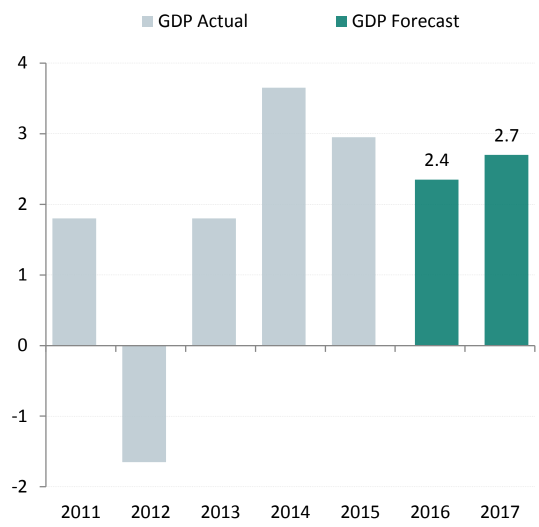
In 2015, GDP in the EU as a whole expanded by 1.8 percent. Going forward, the AIECE in-

Figure 19: Poland



Source: Datastream, AIECE institutes.

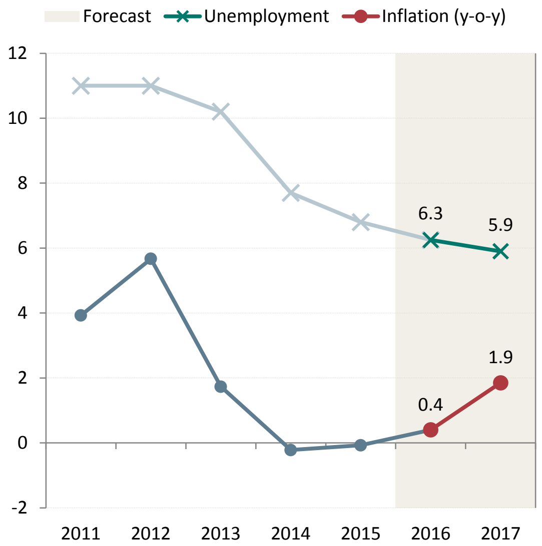
Figure 20: Hungary



stitutes expect GDP growth in the EU to decelerate slightly and GDP to grow with a rate of 1.7 percent in 2016 (Figure 21).

Moderate growth expected for the EU as a whole

Improvements are likely to stem from increases in investment activity due to less spare capacity after continued improvements in private consumption through disposable income over the last years. The current drag on exports is likely to fade out slowly with a gradual recovery of global trade. In contrast, a moderate pick-up in inflation is expected to dampen private consumption spending slightly, still off-set by continued gains in employment. Overall, economic activity is anticipated to accelerate moderately to a rate of 1.9 percent in 2017.

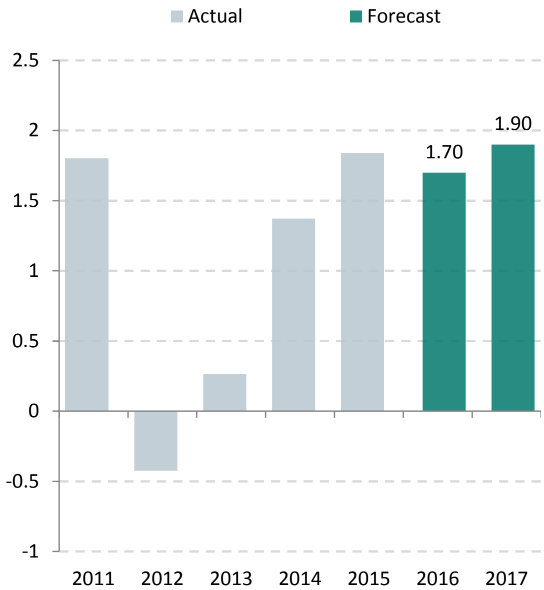


Source: Datastream, AIECE institutes.

2.2.3. Other European Countries

Switzerland

Figure 21: EU GDP growth forecast

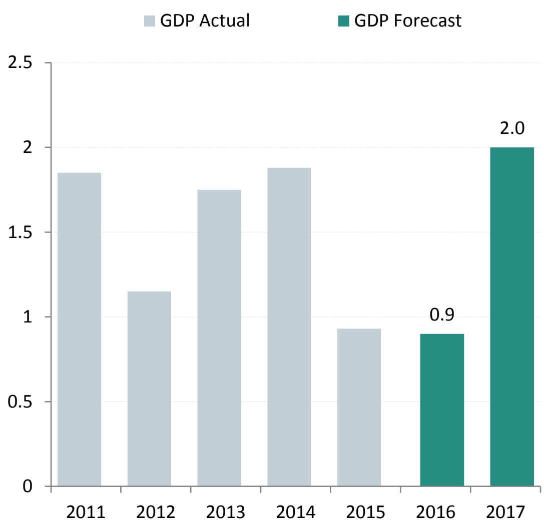


Source: Datastream, AIECE institutes.

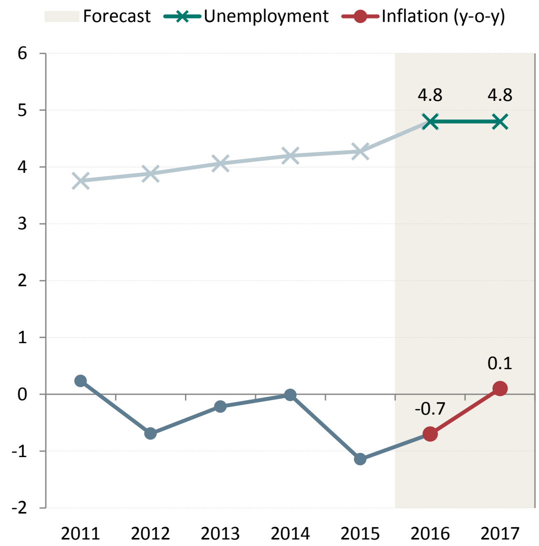
Only gradual recovery in Switzerland from currency revaluation

The Swiss economy grew by a subdued 0.9 percent in 2015 (Figure 22). The export sector was challenged by a sudden currency appreciation by around 20 percent at the beginning of the year, when the Swiss National Bank abandoned a currency peg to the Euro. The reduction in profit margins reduced private investment, while private and public consumption contributed positively to economic growth. Economic activity is expected to pick up slightly over the forecast horizon, albeit still dampened by the high value of the Swiss Franc. The AIECE institutes expect a continued low growth period throughout this year, were GDP is likely to increase by less than one percent. Contributions to growth are originating in robust domestic demand and the construction sector. Purchasing power is benefiting from low inflation, which is projected to remain in negative territory this year, moving only slowly up to 0.1 percent in 2017. Given a slowly improving competitiveness position, heavily affected export sectors recover only gradually, benefiting subsequently from a

Figure 22: Switzerland



pick-up in global trade. Therefore, Swiss GDP is likely to grow more dynamically in 2017 by approximately 2 percent.



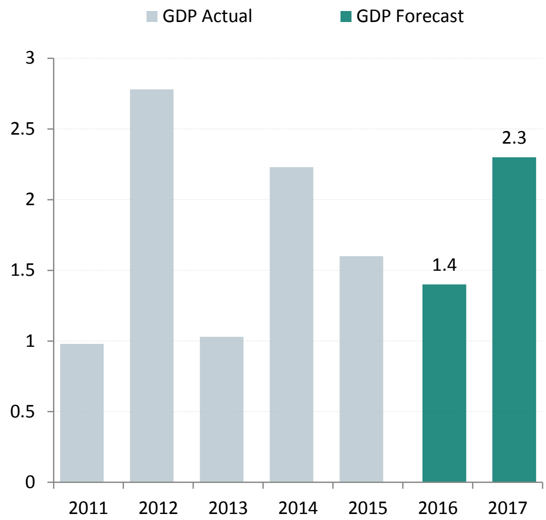
Source: Datastream, AIECE institutes.

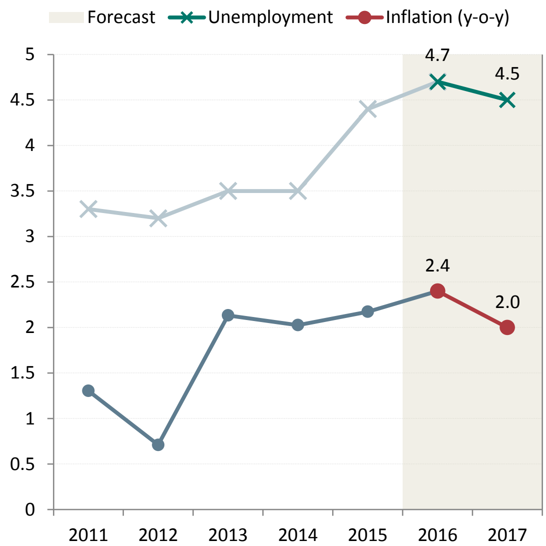
Norway

Temporary slowdown in Norway due to low oil prices

The pronounced decline in oil prices in 2015 had an adverse impact on economic activity in Norway. The GDP growth rate declined to 1.6 percent from 2.2 percent in the previous year. Meanwhile, reduced investment in off-shore petroleum and gas extraction spills over to mainland activity and weighs on employment and consumer confidence. AIECE institutes expect a further deceleration of GDP growth to 1.4 percent in 2016, before the economy picks up again and grows at above two percent in 2017 (Figure 23). Private consumption, albeit at lower rates, and the construction sector are likely to contribute to economic growth over the forecast horizon. An increase in the unemployment rate is projected to be temporary. The comparatively high level of inflation in Norway is mainly due to the depreciation of the krone. Inflation is expected to increase slightly due to a gradual pass-through and since the central bank has cut the policy rate.

Figure 23: Norway





Source: Datastream, AIECE institutes.

Questions for Discussion: Non-EA Outlook

- How do the ECB's non-standard monetary policy measures spill over to non-Euro area economies? What are the main implications for financial stability and growth?
- How important is fiscal stimulus in your country over the forecast horizon?
- Do you consider inequality and wealth distribution to be a severe problem for growth in your country? If so, what can and what should be done about it?

2.3. Risks to the Outlook

China, "Brexit", and deflation biggest risks to home and EA outlook

AIECE institutes have been asked to evaluate ten main downside risks to the projection for the home economy as well as to the projection for the Euro Area according to their importance. A hard landing in China, an exit of the UK from the EU, and deflation in the Euro Area are regarded as the biggest risks, both for the home countries and for the Euro Area (Figure 24/25). Importance is also attributed to a new escalation of the European sovereign debt crisis and geopolitical developments. In particular for the home country forecasts, the former is perceived as similar risky as the risks associated to a "Brexit" or deflation.

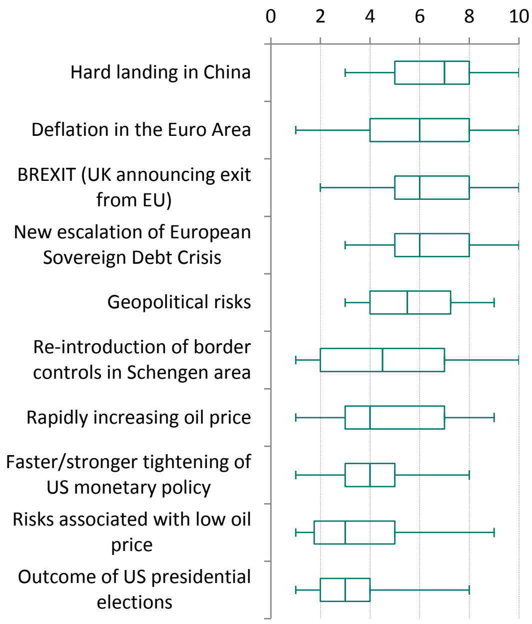
Similar perception of hard landing risk, but different perception of deflationary risks

However, there are pronounced differences between how individual institutes evaluate these growth risks. While a large majority of the institutes perceive the risk for their Euro area forecast coming from a hard landing in China or a "Brexit" as important (75 % give it a rating of at least 6), there is less consensus on the risk associated with price deflation. Here, the middle 50 % quantile spans from "not so important" to "very important". A similar picture emerges for the home country forecasts, albeit the risks stemming from China and the UK are evaluated as slightly less important compared to the euro area as a whole by some institutes.

Low risks associated with US policy and oil prices

Risks associated to a re-introduction of border controls in the Schengen area, to low oil prices, rapidly increasing oil prices, a stronger tightening of US monetary policy, or the outcome of the US presidential elections are seen as less serious threats. Regarding a re-introduction of border controls, however, there is considerable heterogeneity in the risk assessment. More than 25 % of the institutes perceive this as an important risk (7 or higher) for both their home country as well as their euro area forecasts. On the other hand, a large majority of institutes agrees to only associate

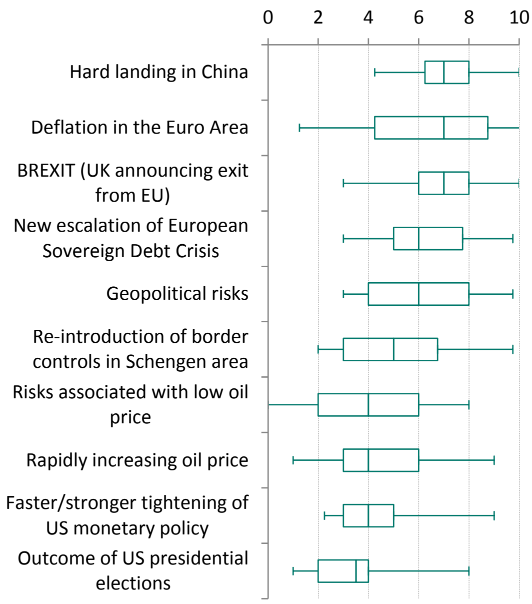
Figure 24: Main downside risks to the projection for the home economy



Note: The figure shows how AIECE institutes evaluate 10 main downside risks to the projection according to their importance (from 1: not important at all, to 10: very important). For each risk, the figure shows a box plot with the minimum, the 25 %-quantile, the median, the 75 %-quantile, and the maximum of the member institutes' answers.

Source: AIECE Institutes, question A.5.1

Figure 25: Main downside risks to the projection for the Euro area



Source: AIECE Institutes, question B.5.1.

low importance to a stronger US monetary tightening or the outcome of the US presidential elections.

Institutes also fear increased support for extreme right wing and anti EU parties

Regarding their euro area forecasts, several institutes see risks associated with a further inflow of refugees into the EU. In particular, institutes worry about a further resurgence of xenophobic tendencies and a pick-up of extreme right wing and anti EU political parties in some member states. Lastly, the threats of a banking crisis in a euro area country and of a collapse in equity prices are mentioned. Selected institutes have also stated additional downside risks to their home country forecasts. In Poland, the volatile policy of the ruling party may exert negative effects while in Norway financial imbalances and high house prices due to low interest rates constitute additional risks. For Slovenia, risks of deviations from the required fiscal path and of the government not being able to implement structural reforms are mentioned.

3. Policy Environment

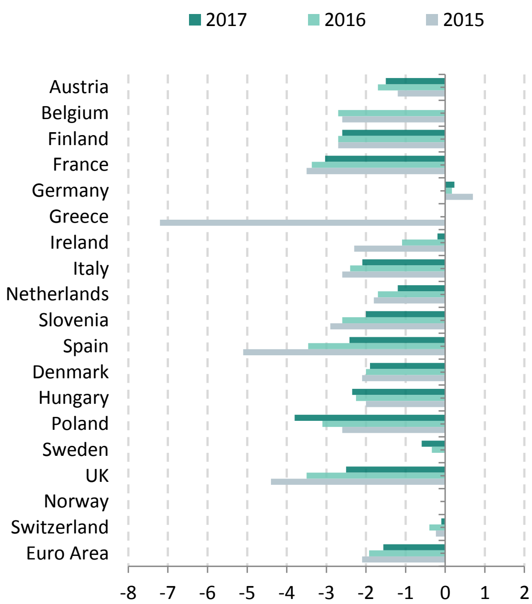
3.1. Fiscal Policy

Public finances have improved, but deficits continue to be high

In the euro area as a whole, the situation of public finances has eased in 2015, primarily due to the gradual recovery of the economic situation and the continuously low interest rates. In some economies, decreased expenditures for financial market stabilization contributed to the decline of fiscal deficits (e.g. Austria and Slovenia). On the other hand, governments in some countries were faced with substantial expenditures related to the refugee migration (e.g. Austria, Germany, Greece, Italy, and the Netherlands). On average, the general government deficit in the euro area was 2.0% in 2015, after 3% in 2013 and 2.6% in 2014. Among euro area member countries, France, Spain, Portugal and Greece failed to abide to the three-percent-rule of the Stability and Growth Pact in 2015 (Figure 26).

Figure 26: Public sector fiscal balance in European economies

(in percent of GDP)



Source: Eurostat, AIECE Institutes.

Deficits are expected to shrink only gradually

AIECE institutes expect the state of public finances to further improve in 2016 and 2017. For most member countries of the euro area, deficits are expected to shrink only gradually, however. For the euro area as a whole, the institutes' country projections indicate a further decline of the fiscal balance to 1.9% in 2016 and 1.6% in 2017.[3]

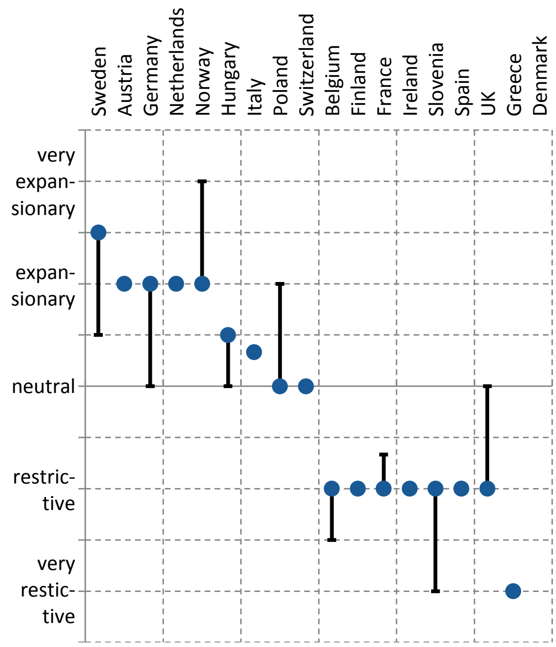
Fiscal policy in former crisis countries remains restrictive, expansionary in other countries

Despite the increase of the fiscal balance unequivocally expected by AIECE members for their respective euro area country, the institutes' assessment of the fiscal policy situation in the EMU countries is heterogeneous (Figure 27). In the former crisis countries – with the notable exception of Italy – fiscal policy is judged to be restrictive, while the fiscal stance in those countries that were not directly affected by the crisis in the euro area – Austria, Germany and the Netherlands – is assessed to be expansionary. A majority of the institutes considers the fiscal policy of their respective government appropriate, independent of the actual fiscal stance. Only fiscal policy in Germany, Slovenia and Belgium is judged "too expansionary" by the respective domestic institutes on average. France is the only euro-area country, whose government's fiscal policy is considered slightly "too restrictive" by the local institutes on average. The governments' efforts to bring down public debt are widely considered insufficient, however (Figure 28).

Questions for Discussion: Fiscal Policy

- When are member countries expected to meet the deficit rule of the SGP?
- Why should governments engage in further bringing down public debt levels?
- What are the risks for the projection of public finances?
- Is fiscal policy focusing on the short or long-term– and what should it do?

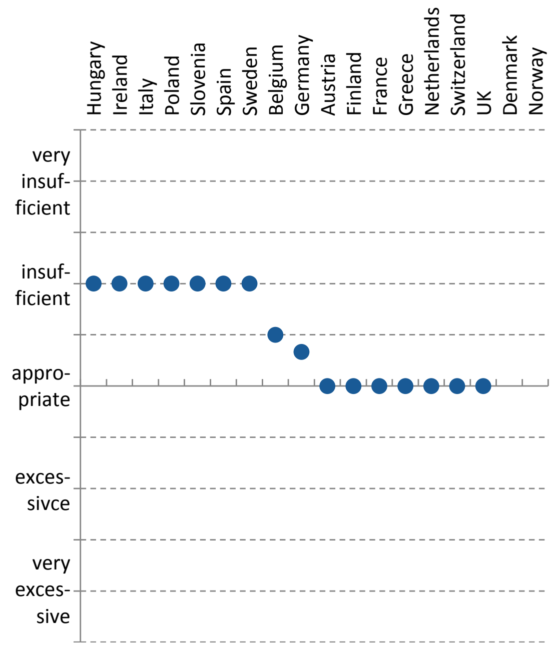
Figure 27: Fiscal policy stance in European economies



Note: Blue bullets indicate the current fiscal policy stance, black lines indicate the direction and (qualitative) extent of changes to the fiscal stance suggested by the respective member institutes.

Source: AIECE Institutes, questions A.3.3 and A.3.4.

Figure 28: Government measures against public debt



Source: AIECE Institutes, question A.3.5.

[3] Estimates for the euro area aggregate are based on a linear regression on the country-specific projections.

3.2. Monetary Policy

3.2.1. Monetary Policy Environment

ECB policy rates have been lowered in March 2016

Given the low-inflation environment, it seems consistent that central banks with the objective of price stability defined as an annual inflation rate of close to 2 percent have become more expansionary over the last year. In particular, the European Central Bank (ECB) was lowering the deposit facility – already in negative territory - in December 2015 by another 0.1 percentage points (Figure 29). In March 2016, the ECB made another move to lower the main refinancing rate to zero percent, along a further reduction of the interest rate on central bank deposits which is now at -0.4 percent.

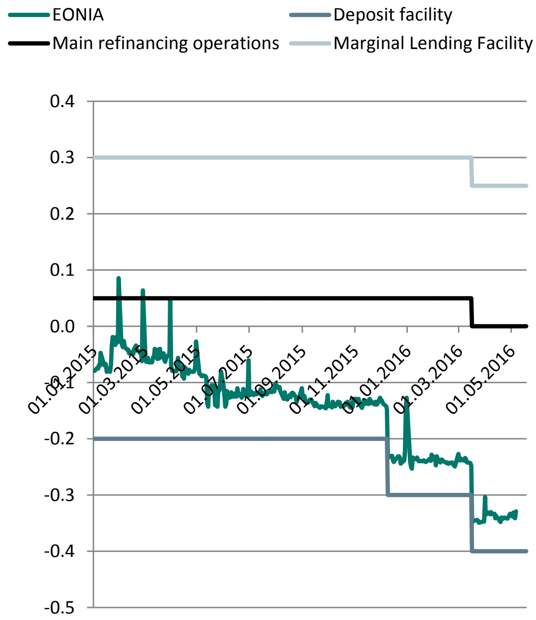
Non-standard monetary policy leads to high excess liquidity

Given that the ECB's interest rate for the main refinancing operations is now at the zero lower bound, further non-standard measures are used in order to push interest rates downward. In particular, asset purchases programs and targeted lending operations have been extended, which both lead to a further accumulation of excess liquidity by the financial system on the central bank's balance sheet (see items 'net recourse to deposit facility' and 'current account' in Figure 31). Excess liquidity is exercising pressure on the interest rate in the interbank market. As a result, the EONIA market rate was declining further over the last months, getting close to the rate of the deposit facility (Figure 29).

Monetary policy environment is expansionary in almost all countries

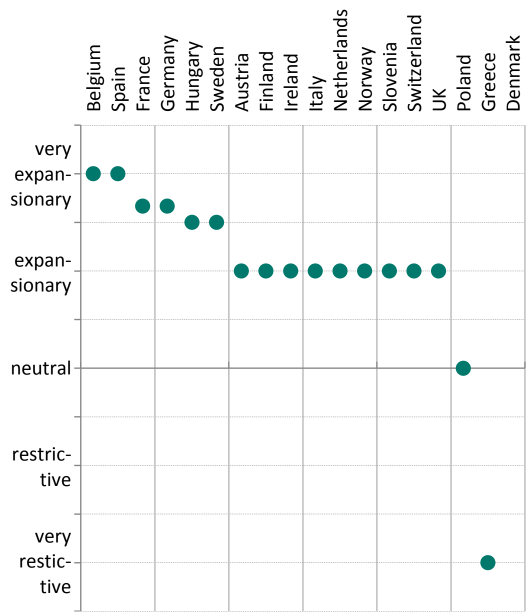
The majority of the AIECE institutes judge the monetary policy environment to be either expansionary or very expansionary (Figure 30). There are only two exceptions, namely Greece and Poland. As Poland is not part of the European Monetary Union (EMU) and can pursue an independent monetary policy, the policy rate marks currently at 1.5 percent, down from 2 percent a year before. In contrast, the judgment that monetary policy is

Figure 29: Policy rates of the ECB



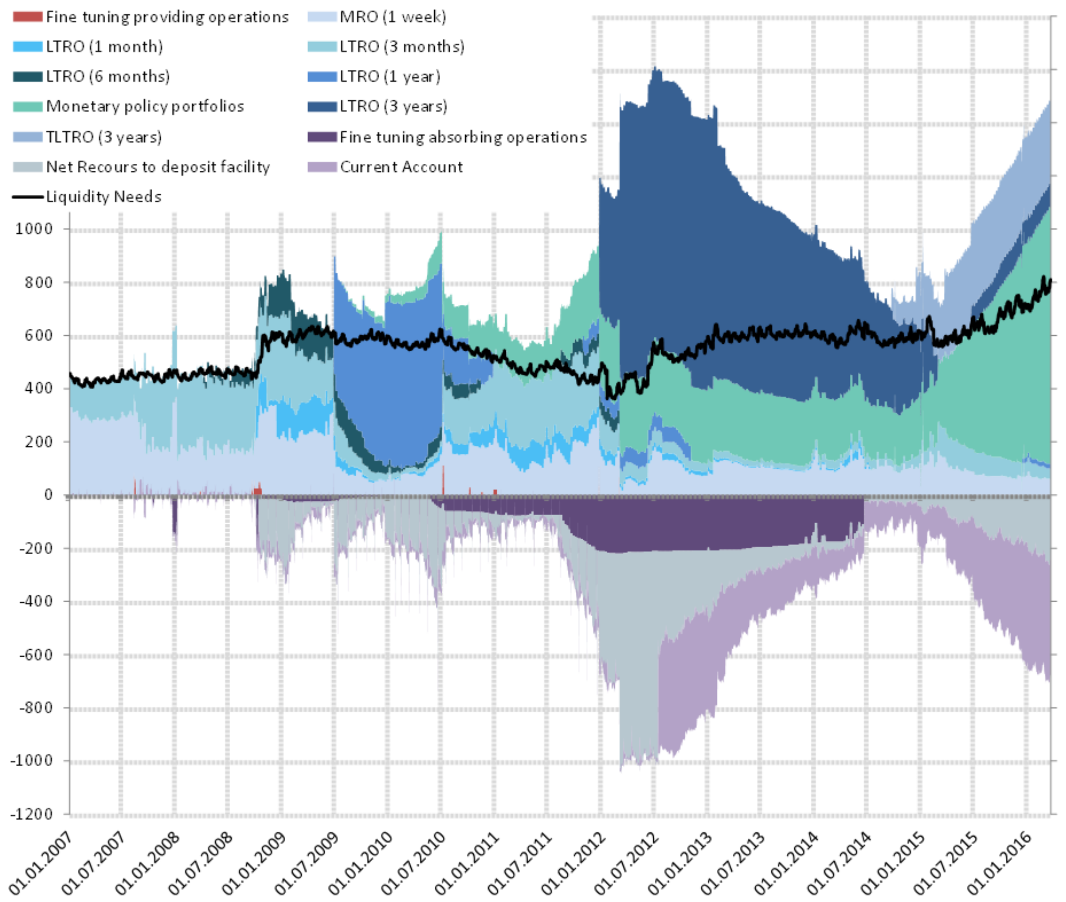
Source: Datastream.

Figure 30: Monetary policy environment



Source: AIECE Institutes, question A.3.1.

Figure 31: ECB balance sheet



Source: European Central Bank.

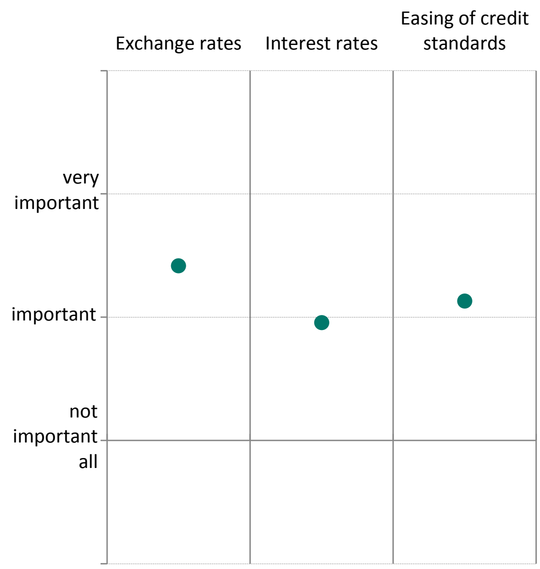
very restrictive needs to be interpreted within the light of significant heterogeneity within EMU despite a common monetary policy.

The exchange rate channel is judged most important for the transmission

The AIECE institutes consider the exchange rate channel as most important for monetary policy being transmitted to the member countries. Over the year 2015, the Euro devalued vis-à-vis the US dollar by 17 percent and is expected to continue to depreciate over the forecast horizon (Figure 2). This may have contributed to the external competitiveness of exporting firms in the EMU. However, given the weak external environment, this channel could not take its full effect yet.

Likewise, the interest rate channel and the easing of credit standards are reported to be close to equally important channels to transmit the current monetary policy stance. In

Figure 32: Transmission channels

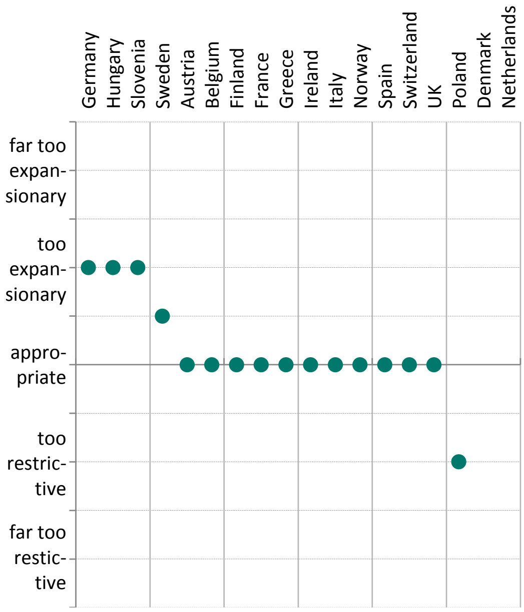


Source: AIECE Institutes, question B.4.4.

fact, the ECB's measures to expand its balance sheet are to some extend effective in pushing the short-term interbank rate downward (Figure 29).

Regarding the effect on lending standards, the recent bank lending survey of the ECB (April 2016) documents a comparatively strong effect of recent monetary policy measures on credit standards, which have eased on average in the first quarter of 2016 and are expected by reporting banks to decline further in the second quarter of 2016. However, there is some degree of heterogeneity across different lending segments. While credit standards for households and enterprises are reported to loosen, the standards for housing loans begin to tighten slightly.

Figure 33: Monetary policy stance



Source: AIECE Institutes, question A.3.2.

3.2.2. Further ECB Measures

The majority of institutes think that monetary policy stance is appropriate

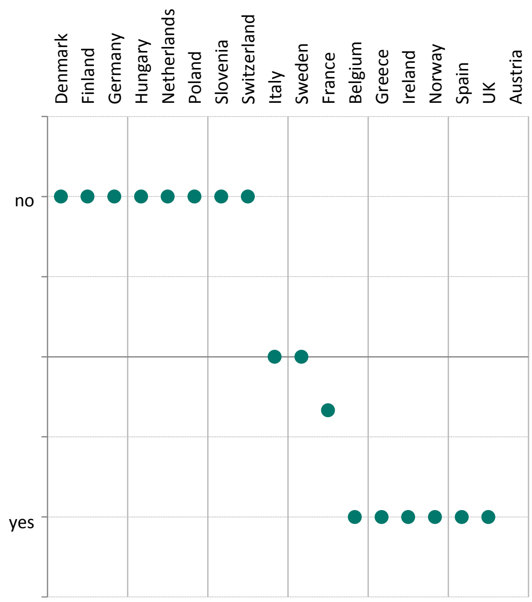
Given the low inflation environment in most European economies, the natural question arising is if the non-standard measures of central banks are normatively perceived as appropriate or not. The majority of the AIECE institutes have the opinion that this is indeed the case (Figure 33). However, a sub-group is concerned about a too expansionary course of monetary policy. Only in Poland is monetary policy perceived as being 'too restrictive'.

The AIECE institutes are divided on the question whether the ECB should do more

The AIECE institutes are split on the question whether the ECB should take additional measures in order to raise inflation and accommodate economic growth (Figure 34). While in six countries the tendency is to say that the ECB should engage in further expansionary monetary policy, eight countries do not await further action.

Figure 34: Further action of the ECB

Q: Should the ECB do more to raise inflation / boost growth?



Source: AIECE Institutes, question B.4.1.

On top of the split opinion regarding future action of the ECB, it is also controversial whether the toolkit of the ECB might be depleted or not. Specifically, limitations to monetary policy are likely to arise from sidetracking behaviour. For example, banks, households and firms can start to accumulate and store larger sums of cash in order to avoid the negative interest rate on the ECB's deposit facility. Further, restrictions on further extending asset purchase programs arise from limitations on the size of the bond and securities markets.

The toolkit of the ECB is not (yet) empty

Nevertheless, the majority of AIECE institutes is of the opinion that the ECB still has remaining leeway to act (Figure 35).

The institutes are skeptical about 'helicopter money'

Regarding the concrete measures that are available to the ECB, the majority of AIECE institutes is sceptical about a further reduction of the interest rate on the deposit facility (Figure 36). Further, the institutes are very critical towards so-called 'helicopter money', which implies a transfer of newly printed money to the general public. Also direct lending to firms in the euro area is seen skeptical by the majority of AIECE institutes, possibly also due to legal limitations and the requirement to change European law to engage in either helicopter money or direct lending to firms.

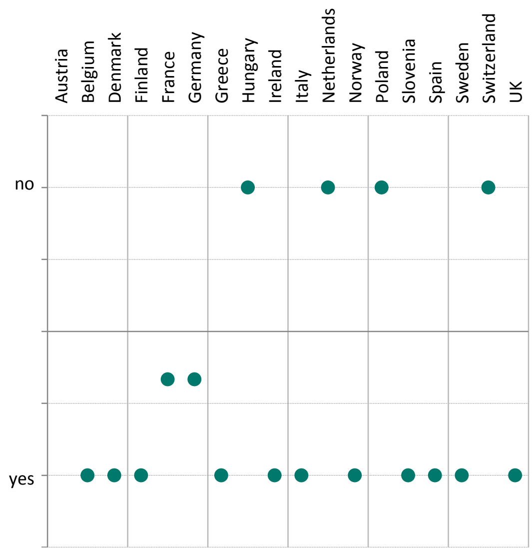
On the other side, most institutes are open to extensions and enlargements of existing asset purchasing programs and funding for lending-type programs which will be discussed in more detail below.

There is a risk that structural reforms are deferred due to the ECB's asset purchases

What are the most important side-effects of the expansionary monetary policy in the euro area? According to the respondents from the AIECE institutes, the most detrimental effect of an accommodative stance of monetary policy is the reduced incentive to engage in structural reforms on the national level (Figure 37). Second, it is considered to be an important side-effect that there is more risk-taking, eventually fuelling new fragilities in the financial system that might have disruptive consequences in the future. Thirdly, the possibility

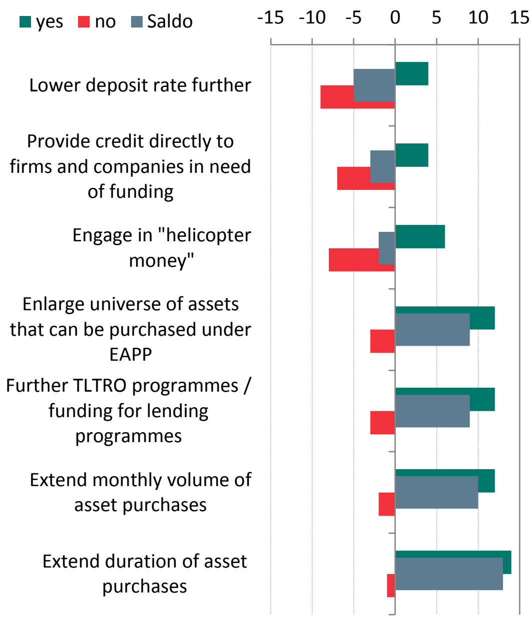
Figure 35: Is the ECB's toolbox empty?

Q: Can the ECB do more to raise inflation / boost growth?



Source: AIECE Institutes, question B.4.2.

Figure 36: Remaining measures available to the ECB



Source: AIECE Institutes, question B.4.3.

of a major competition between the euro area on one side and other monetary blocks like China, Japan and the US on the other side in a 'Currency War' is not regarded as a major threat of the current monetary policy stance.

Targeted longer-term refinancing operations

The first wave of target longer-term refinancing operations (TLTRO) was launched in autumn 2014. They were designed, among other purposes, to replace a share of the LTROs with a maturity of 3 years that have been issued at the end of 2011 and beginning of 2012. Under the first TLTRO program, banks could bid for central bank financing up to a fixed fraction of their total outstanding loan portfolio to households and non-financial corporations, excluding mortgage loans. This created a direct link to the real economy.

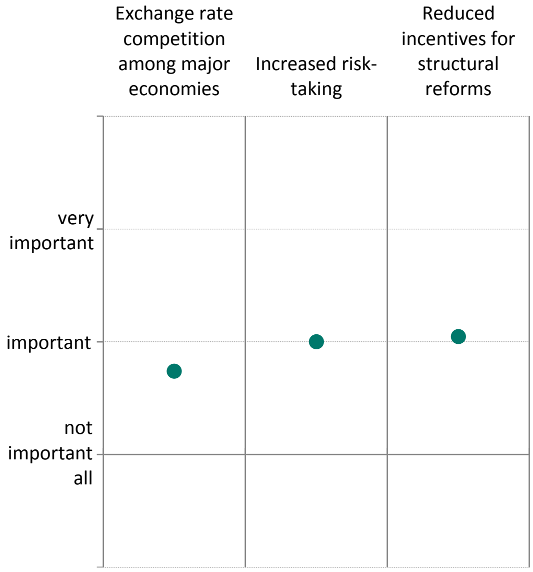
The second wave of TLTRO, called the TLTRO2 program, will feature a bigger total lending volume since the percentage share of eligible loans was increased from 7 to 30 percent. Further, there is a modified incentive structure. Most importantly, the new funding for lending scheme allows for a negative effective interest rate over the lending period if banks fulfil two requirements. First, the borrowing financial institution needs to exceed a participation threshold, and second, it has to keep its volume until 2018 by not making use of the early payment option.

However, there is a less strong conditionality clause with respect to lending to the real economy. In particular, there is no requirement on banks to repay the loans obtained under the TLTRO2 program if the lending volume could not be reached.

While most institutes think that TLTRO2 will not boost lending in their home country…

The new TLTRO2 program is expected to stimulate lending to the private sector only marginally. Countries with a likely positive impact, according to the survey responses, are

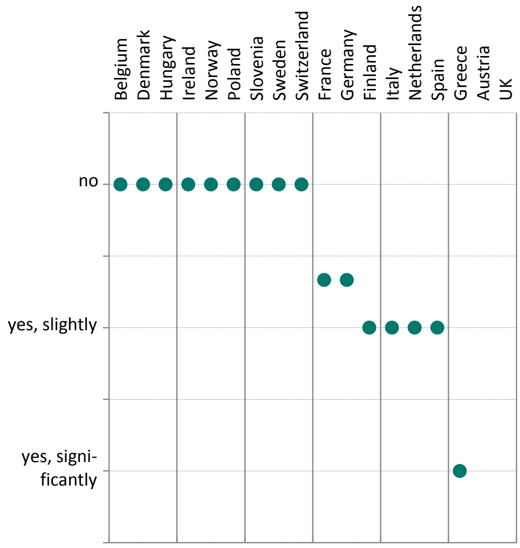
Figure 37: Risks from asset purchasing programs



Source: AIECE Institutes, question B.4.5.

Figure 38: Effects of TLTRO2 in home country

Q: Do you think that the TLTRO2 programme will boost lending in your home country?



Source: AIECE Institutes, question B.4.6.

France, Germany, Finland, Italy, Netherlands and Spain (Figure 38). The program might even have a significantly positive effect in Greece. Notwithstanding some positive effects, there is a majority of institutes which expect no significant boost on lending from the TLTRO2 program. In contrast, there is a general perception that aggregate lending in the euro area is positively affected by the TLTRO2 program (Figure 39).

…institutes expect a slightly positive effect in the EA as a whole

As discussed above, the TLTRO2 program contains the possibility of central bank lending at a negative interest rate to financial institutions. This could provide a stronger stimulus to bank lending in the euro area compared to the previous funding for lending program. On the other side might the weaker conditionality in terms of a missing repayment clause given that the lending volumes are not reached weaken the link to the real economy. Therefore, it is a priori not clear what the overall effect of the changed rules for the TLTRO2 will be. The majority of AIECE institutes is of the opinion that the change in the incentive structure will lead to a net increase in lending to the real economy (Figure 40). Only institutes in Belgium, Denmark, Poland, Spain – and to some extent France - remain mostly skeptical.

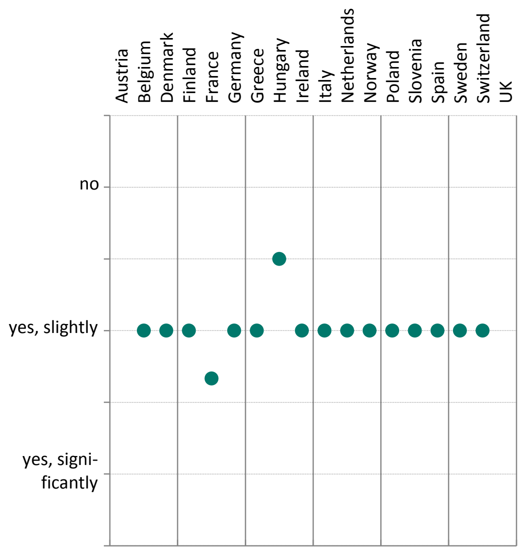
There is no consensus whether the TLTRO2 design will help to stimulate lending

Questions for Discussion: Monetary Policy

- Noting that the inflation rate in the US is higher compared to the euro area, what are the main reasons for the inflation differential?
- There are recent proposals to abolish the zero lower bound on interest rates. This could be done, for example, through abolishing currency such that negative interest rates could be implemented from a technical point of view. Do you think that this could prevent Europe from entering a liquidity trap?

Figure 39: Effects of TLTRO in the EA

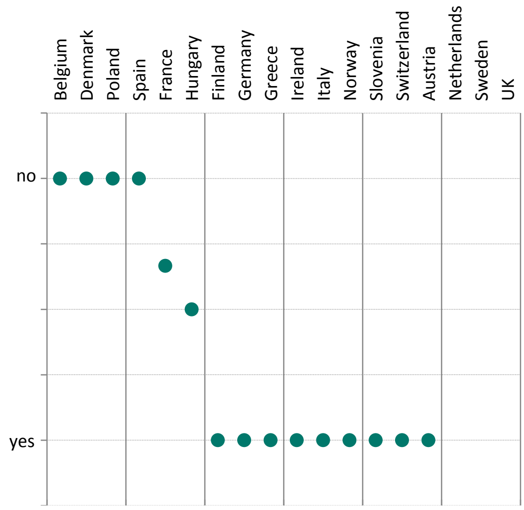
Q: Do you think that the TLTRO2 programme will boost lending in the euro area as a whole?



Source: AIECE Institutes, question B.4.7.

Figure 40: Modalities of the TLTRO2 program

Q: Do you think that the modalities of the TLTRO2-programme raise the banks' incentives of banks to provide funding to the real economy compared to the previous TLTRO-programme?



Source: AIECE Institutes, question B.4.8.

4. Challenges for Europe

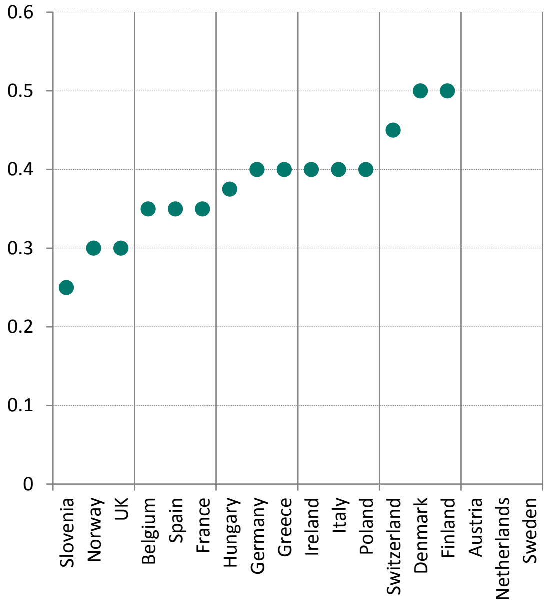
4.1. BREXIT

The likelihood of a Brexit is perceived to be very low

On 23 June, the population in the United Kingdom will have the opportunity to decide about the membership to the European Union. How likely is the scenario of an exit from the EU ('Brexit')? What are the consequences from such a break in European integration, both economically, but also politically? This section summarizes the answers from the AIECE institutes to these questions.

The likelihood of a Brexit is judged to be only minor according to the AIECE institutes, ranging from 25 to 50 percent (Figure 41).

Figure 41: Likelihood of a Brexit

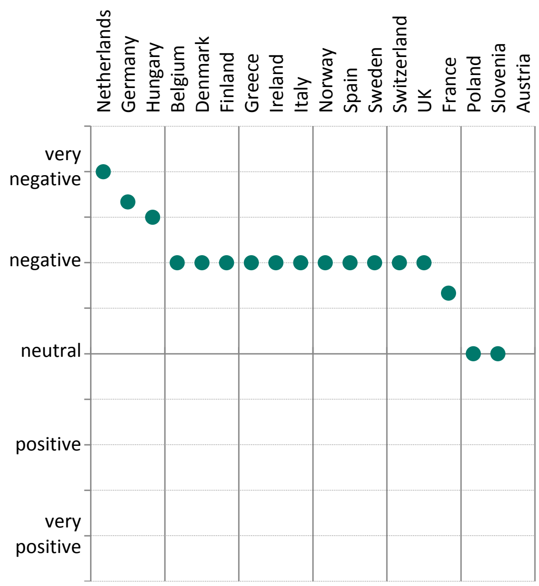


Source: AIECE Institutes, question B.3.1.

A Brexit would have negative effects on the economy, for the UK…

The long-term economic effect of a Brexit on the economy of the United Kingdom is expected to be negative (Figure 42). There are only two institutes expecting that there is on balance a neutral long-term economic effect, while there are also only very few institutes that think Brexit having a 'very negative' effect on the long-term prospects for growth.

Figure 42: Economic effect of Brexit on the UK economy



Source: AIECE Institutes, question B.3.2.1.

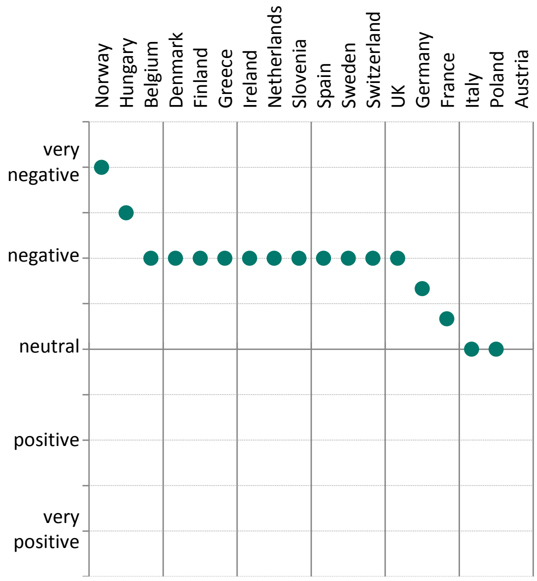
…as well as for the remaining EU Member States

The picture is very similar when asking for the long-term economic consequences for the remaining EU Member States (Figure 43). The answers suggest that there is the possibility of a win-win situation if the UK would remain within the European Union.

Brexit is expected to decelerate European political integration

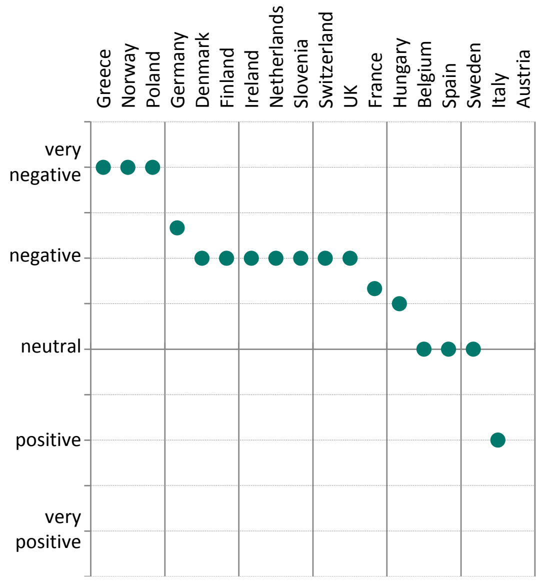
The political consequences are – in line with the economic effects – assumed to be mostly negative (Figure 44). Only institutes from Italy see a net positive effect of the UK leaving the EU on political integration over the next decade.

Figure 43: Economic effect of Brexit on EU countries



Source: AIECE Institutes, question B.3.2.2.

Figure 44: Effect of Brexit on political integration



Source: AIECE Institutes, question B.3.2.3.

4.2. Refugee Inflow

Positive demand side effects of refugee inflow on GDP expected

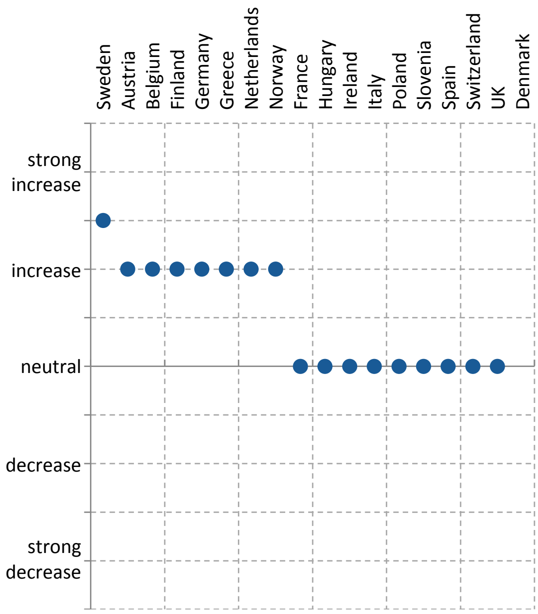
The strong increase of refugee migration in previous years is presenting major challenges to the absorptive capacity of European labour markets. For the short run, AIECE institutes in some euro area countries expect noticeable positive (demand-side) effects of the refugee inflow on GDP growth (Figure 45). Quantitatively, AIECE institutes in Germany expect the strongest effect (0.33 percentage points on average) on GDP growth; institutes in other euro area countries expect effects of below 0.1 percentage points.

Effect on unemployment rate expected to be limited

Despite the strong migration, which results in a corresponding increase of the labour force, short-run effects of the refugee inflow on the unemployment rate are expected to be limited (Figure 46). Institutes in Belgium, Finland and Germany expect an increase of the unemployment rate between 0.14 and 0.33 percentage points. For other euro area countries, no effects on the unemployment rate are anticipated.

Expected effects of the current migration on public finances are mixed (Figure 47). Institutes in Austria, Greece and Italy anticipate an

Figure 45: Short-run effect of refugee inflow on GDP growth



Source: AIECE Institutes, question A.2.1.

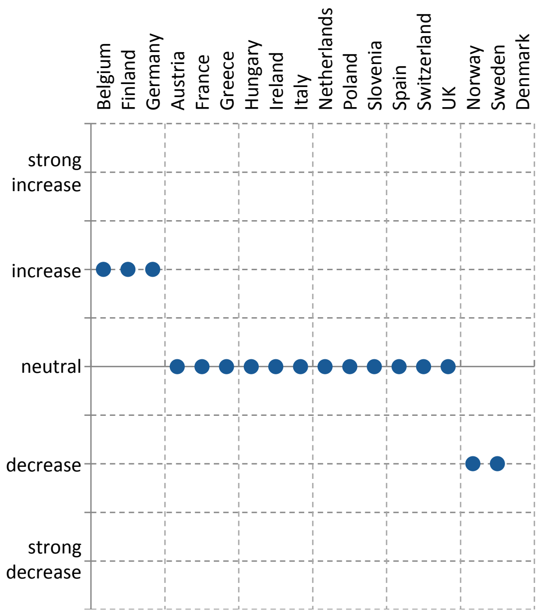
Heterogeneous effects on public finances

increase of the fiscal balance related to the refugee inflow. Institutes in Belgium, Germany, Finland, the Netherlands and Slovenia expect a worsening of the fiscal balance of up to 0.5 percentage points relative to GDP.

Potential GDP growth expected to be increased by refugee inflow

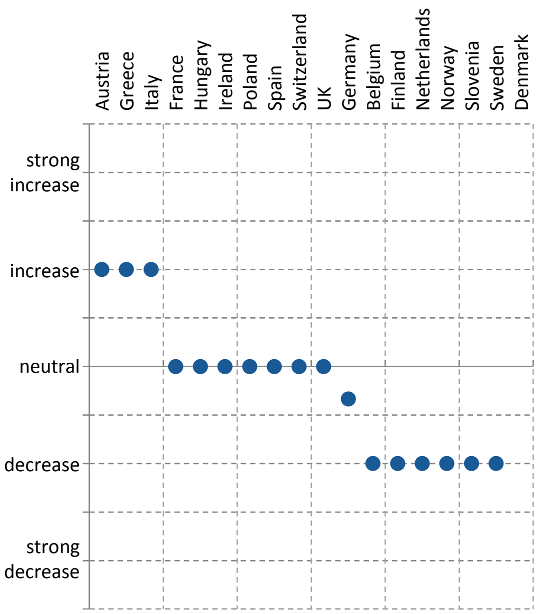
For the medium-run, AIECE institutes in most euro area countries expect an increase of potential GDP related to the refugee inflow (Figure 48). Among euro area countries, only institutes in France, Italy and Spain expect no effect on potential GDP; institutes in all other EMU countries expect an increase of potential GDP growth of up to 0.2 percentage points in the medium run.

Figure 46: Short-run effect of refugee inflow on the unemployment rate



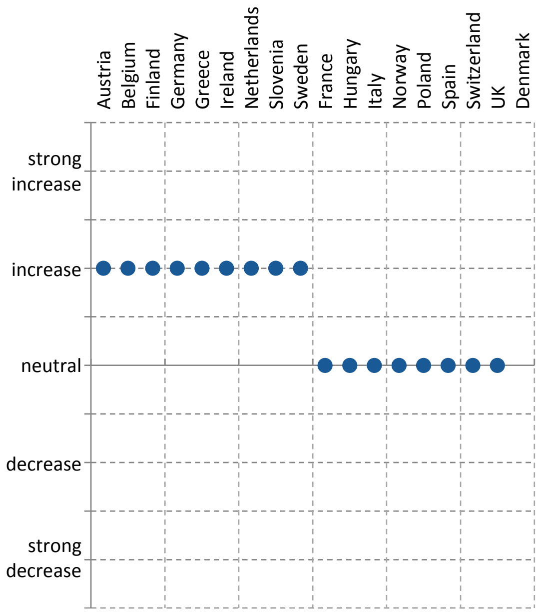
Source: AIECE Institutes, question A.2.3.

Figure 47: Short-run effect of refugee inflow on the fiscal balance



Source: AIECE Institutes, question A.2.5.

Figure 48: Medium-run effect of refugee inflow on potential GDP

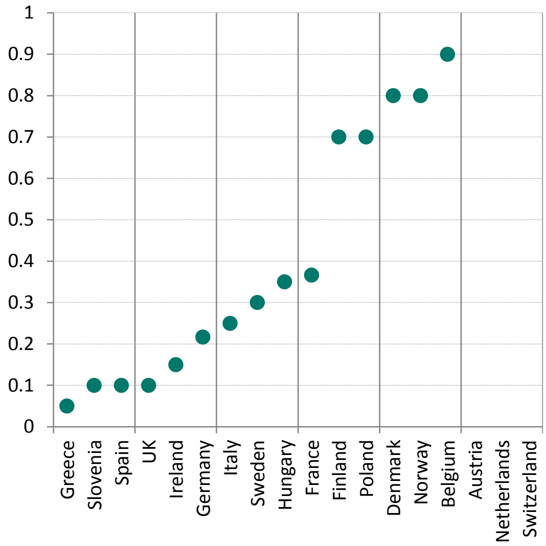


Source: AIECE Institutes, question A.2.7.

4.3. Sovereign Debt Crisis

In May 2016, creditor countries to Greece together with the International Monetary Fund (IMF) are re-negotiating the terms for the third bailout package which is supposed to provide the necessary financial means to pay down outstanding Greek government debt in July. Without an agreement, heated discussions about Greece leaving the euro area (‘*Grexit*’) might be back on the table in the summer of 2016, with possibly adverse consequences for the European economy.

Figure 49: Likelihood of a haircut on Greek debt in the course of 2016/2017



Source: AIECE Institutes, question B.1.1.

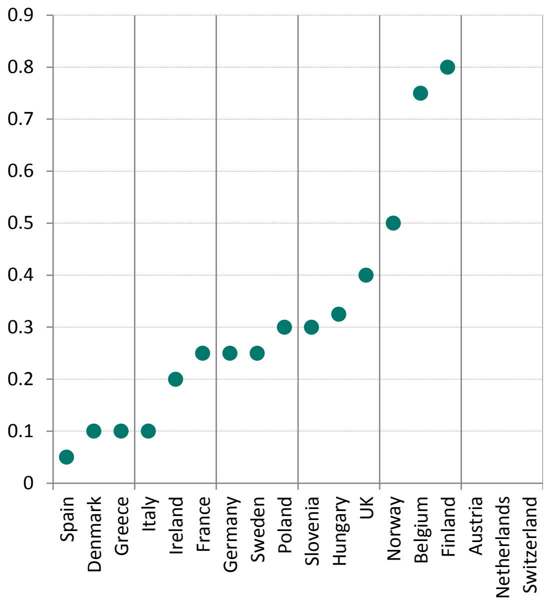
The likelihood of a haircut on Greek debt is hard to evaluate

Controversies arise along two lines. First, between Greece and the creditor countries about the budgetary reforms. Second, between the IMF on the one side, who requests a debt-restructuring for Greece to remain within the set of institutions surveying the progress of Greek reforms, and a number of creditor countries on the other side who refuse another haircut on Greek debt, among them Germany.

Significant uncertainty is due to a possible renewed fiscal stress in the euro area

The controversies are mirrored by the respondents among the AIECE institutes. Specifically, there is a lot of heterogeneity regarding the assessment of the probabilities regarding whether the IMF will be able to achieve a debt restructuring. Probabilities are ranging from 5 to 90 percent on this question, basically showing that policymakers do not have reached a consensus yet, potentially fuelling uncertainty (Figure 49).

Figure 50: Likelihood of renewed escalation of the sovereign debt crisis in 2016/2017



Source: AIECE Institutes, question B.1.2.

There is similar heterogeneity regarding the assessment of AIECE institutes on the likelihood of a renewed escalation of the European sovereign debt crisis (Figure 50).

Fiscal coordination and architecture of euro area institutions

In response to the European sovereign debt crisis, a broad range of measures to achieve long-term financial stability and fiscal sustainability have been implemented among euro area member countries and EU Member States on a voluntary basis. How do the AIECE institutes assess these advancements?

There is no consensus among AIECE institutes whether fiscal coordination is sufficient

Regarding the degree of fiscal coordination, there is a narrow majority among the institutes which is of the opinion that these reforms are not sufficient to maintain fiscal sustainability (Figure 51).

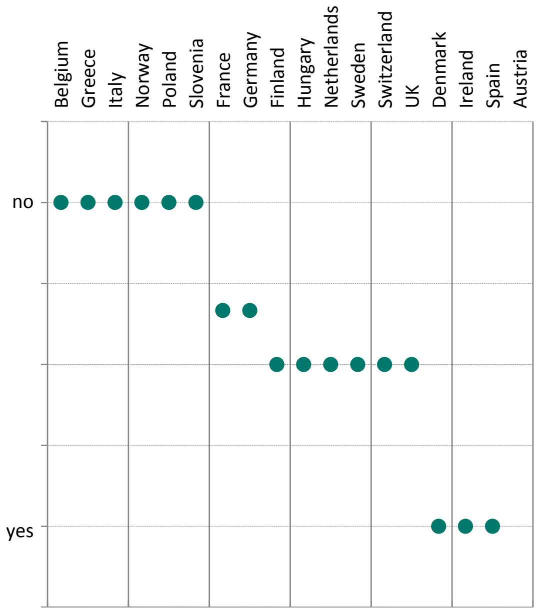
Consequently, fiscal coordination ranks second in terms of relative importance among a set of 10 different areas for economic reform on the European level (Figure 52). Other highly important projects are – according to the institutes – the banking union, a debt restructuring mechanism and the capital markets union to foster financial stability. The institutes assess a European approach to social protection and unemployment insurance the lowest.

Most heterogeneity regarding the future of institutions in the EA is related to pillars of a fiscal union

Questions for Discussion: Challenges

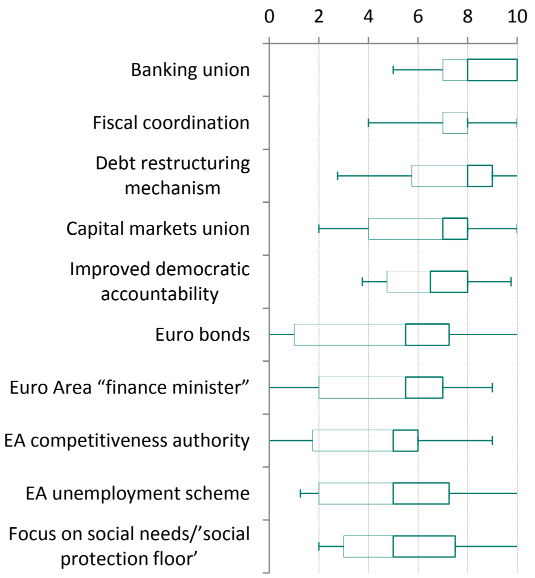
- Do you think that EU Refugee bonds are the right answer to the present influx of migrants?
- If a fiscal union within the euro area is unlikely in the near future, what is the most important step to reach adequate fiscal coordination?

Figure 51: Fiscal coordination in the euro area sufficient for fiscal sustainability?



Source: AIECE Institutes, question B.1.3.

Figure 52: Institutional architecture of the euro area



Note: The figure shows how AIECE institutes evaluate elements of a future European architecture according to their importance (from 1: not important at all, to 10: very important; with 0: undesirable). For each element, the figure shows a box plot with the minimum, the 25 %-quantile, the median, the 75 %-quantile, and the maximum of the member institutes' answers.

Source: AIECE Institutes, question B.2.1.

5. Appendix: Questionnaire

Country Questions

A.1.1 Please rank the following positive factors according to their effect on 2016 growth in your country (1: most important … 3: least important): *Low energy prices / Weak euro exchange rate / Low interest rates*

A.1.2. Please rank the following negative factors according to their effect on 2016 growth in your country (1: most important … 3: least important): *Low productivity growth / Legacy of the crisis (high private and/or public debt, financial sector weakness, low investment, high unemployment) / Weak external/global environment*

A.1.3. Which other factors will have a significant effect on 2016 growth in your country (please indicate if positive or negative)?

A.2.1. What will be the short-run effect of the refugee inflow on GDP growth in your country? *strong increase/ increase / neutral / decrease / strong decrease*

A.2.2. Please estimate the effect of the refugee inflow on 2016 GDP growth in your country (in % points)

A.2.3. What will be the short-run effect of the refugee inflow on the unemployment rate in your country? *strong increase/ increase / neutral / decrease / strong decrease*

A.2.4. Please estimate the effect of the refugee inflow on the 2016 unemployment rate in your country (in % points)

A.2.5. What will be the short-run effect of the refugee inflow on the fiscal balance in your country? *strong increase/ increase / neutral / decrease / strong decrease*

A.2.6. Please estimate the effect of the refugee inflow on the 2016 fiscal balance in your country (in % points)

A.2.7. What will be the medium-run effect of the refugee inflow on potential GDP growth in your country? *strong increase/ increase / neutral / decrease / strong decrease*

A.2.8. Please estimate the effect of the refugee inflow on potential GDP growth in your country (in % points)

A.3.1. From your country's perspective, the monetary policy environment is … *very expansionary / expansionary / neutral / restrictive / very restrictive*

A.3.2. Normatively, the monetary policy stance is … *far too expansionary / too expansionary / appropriate / too restrictive / far too restrictive*

A.3.3. The fiscal policy stance in your country in the recent past and in the near future (2015-2017) is … *very expansionary / expansionary / neutral / restrictive / very restrictive*

A.3.4. Normatively, the fiscal policy stance is … *far too expansionary / too expansionary / appropriate / too restrictive / far too restrictive*

A.3.5. The currently implemented measures to bring down public debt are … *very insufficient / insufficient / appropriate / excessive / very excessive*

A.3.6. Please note any significant fiscal measures recently implemented, or with a high likelihood of being implemented

A.4.1. Your government's measures to bring down unemployment are… *very insufficient / insufficient / appropriate / excessive / very excessive*

A.4.2. Please indicate the nature of your government's measures to bring down unemployment, if any

A.4.3. Judged by your country's cyclical position, private investment is… *very weak / weak / normal / strong / very strong*

A.4.4. What is the most important drag on investment in your country, if any?

A.5.1. What are the main downside risks to the projection for your home country? Please evaluate according to their importance from 1: not important at all to 10: very important: *Deflation in the Euro area / Hard landing in China / Risks associated with low oil price / Rapidly increasing oil price / Faster or stronger tightening of US monetary policy / BREXIT (UK announcing exit from EU) / Re-introduction of border controls in Schengen area / New escalation of European Sovereign Debt Crisis / Outcome of US presidential elections / Geopolitical risks*

A.5.2. Other very important downside risks:

EA & EMU Questions

B.1.1. How likely do you judge the possibility that the institutions and the euro area governments agree on a haircut on outstanding Greek debt held by public creditors in the course of 2016/2017 (in % probability)?

B.1.2. What is the likelihood of a further escalation of the European Sovereign Debt crisis in 2016 /2017 (in % probability)?

B.1.3. Do you think that the degree of fiscal coordination in the euro area is sufficient to maintain fiscal sustainability? *Yes / No / Do not know*

B.1.4. If no, what other measures should be implemented to increase fiscal sustainability in the Euro area?

B.2.1. Regarding the future institutional architecture of the euro area, evaluate the following reform projects according to their importance (from 1 = not important at all to 10 = very important; please use 0 to indicate undesirable policy areas): *Banking union / Capital markets union / Fiscal coordination / Euro bonds / Debt restructuring mechanism / EA competitiveness authority / EA unemployment scheme / Focus on social needs ('social protection floor') / Improved democratic accountability / euro area "finance minister"*

B.3.1. In your opinion, how likely is the scenario of the United Kingdom leaving the EU ("Brexit") following the referendum in June 2016 (in % probability)?

B.3.2. In the scenario where the United Kingdom leaves the EU after the referendum:

B.3.2.1. What will be the overall economic effect for the United Kingdom over the next decade, i.e. until 2026? *very negative / negative / neutral / positive / very positive*

B.3.2.2. What will be the overall economic effect for the remaining EU member countries over the next decade, i.e. until 2026? *very negative / negative / neutral / positive / very positive*

B.3.2.3. What will be the overall effect for further political integration between EU member countries over the next decade, i.e. until 2026? *very negative / negative / neutral / positive / very positive*

B.4.1. Should the ECB do more to raise inflation / boost growth? *Yes / No*

B.4.2. Can the ECB do more to raise inflation / boost growth? *Yes / No*

B.4.3. If yes to previous question: What further measures can the ECB undertake (yes/no)? *Lower deposit rate further / Extend monthly volume of asset purchases / Extend duration of asset purchases / Enlarge universe of assets that can be purchased under EAPP / Further TLTRO programmes / funding for lending programmes / Engage in "helicopter money" / Provide credit directly to firms and companies in need of funding*

B.4.4. Given the current economic environment, how important do you consider the following transmission channels of the ECB's extended asset purchases, with respect to their effect on inflation and growth in the euro area (very important, important, not important at all)? *Exchange rates / Interest rates / Easing of credit standards / Asset prices / Others important channels*

B.4.5. What are the risks associated with large-scale asset purchases under the EAPP? Please evaluate according to their importance: very important, important, not important at all: *Exchange rate competition among major economies / Increased risk-taking / Reduced incentives for structural reforms / Asset price bubbles / Misallocation of resources and capital / Other important risks*

B.4.6. Do you think that the TLTRO2 programme will boost lending in your home country? *Yes , significantly / Yes, slightly / No*

B.4.7. Do you think that the TLTRO2 programme will boost lending in the euro area as a whole? *Yes , significantly / Yes, slightly / No*

B.4.8. Do you think that the modalities of the TLTRO2-programme raise the banks' incentives of banks to provide funding to the real economy compared to the previous TLTRO-programme? *Yes / No*

B.5.1. What are the main downside risks to the projection for the euro area? Please evaluate according to their importance from 1: not important at all to 10: very important: *Deflation in the euro area / Hard landing in China / Risks associated with low oil price / Rapidly increasing oil price / Faster or stronger tightening of US monetary policy / BREXIT (UK announcing exit from EU) / Re-introduction of border controls in Schengen area / New escalation of European Sovereign Debt Crisis / Outcome of US presidential elections / Geopolitical risks*

B.5.2. Other very important downside risks: