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1. RECENT DEVELOPMENTS

Global economic expansion slowed down during the first half of 2012, to a certain extent owing to the European sovereign debt crisis which has not been resolved yet. The measures to consolidate public finances - though being drastic - have quite often not been able to restore confidence in the sustainability of public debt in various countries. Instead they weigh heavily on domestic demand and production in many Euro area economies. Via different channels, the recession spills over to other European countries and also to many economies outside of Europe: First, international trade has been dampened by decreasing imports of the Euro area. Second, capital has been seeking for “safe havens”, which triggered an appreciation of the US-Dollar and the Yen, reducing price competitiveness of these countries. Finally, due to the high degree of financial integration, shocks on the Euro area were also felt in financial markets in other regions.

The devaluation of the Euro accelerated since spring. At that time, in particular the southern Euro area countries slipped deeper into recession and the debt crisis appeared more and more difficult to resolve. The consolidation goals were not achieved in several countries despite enormous endeavor, and often problems of the banking sector became virulent. In June, deteriorated public finances led the Spanish Government to announce a request for financial assistance from the EFSF to recapitalize its banking sector. However, it did not apply for help until now.

The European Central Bank reacted to the recession by reducing its reference rate to an historical low of 0.75 per cent. Furthermore, it continued to provide unlimited liquidity to the banking sector. When interest rate spreads between Euro area countries increased again in the summer, the ECB finally announced new measures of buying sovereign bonds. Officially, the *Outright Monetary Transactions* (OMT) were introduced to restore the functioning of the monetary transmission mechanism, particularly in countries with high debt. However, there is danger that the program will result in an unconditional financing of sovereign debt.

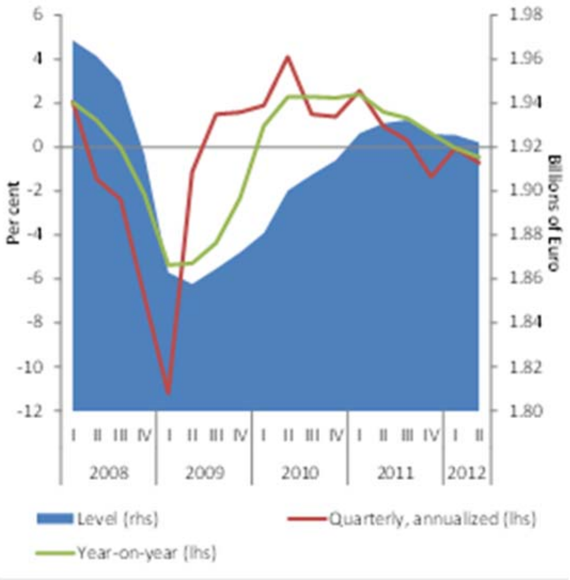
Whether the monetary and fiscal policy stance is adequate to ease the debt crisis, and whether it can help restoring confidence among enterprises, investors and consumers remains highly uncertain. It is the aim of this report to collect and evaluate the latest forecasts of 27 AIECE Institutes and thereby to analyze a wide range of expert opinions regarding the economic situation and perspective in Europe.

1.1 GDP growth

The Euro Area turned into recession in the fourth quarter of 2011 and remained in an economic downturn since then. In the first quarter of 2012 the economy stagnated (Figure 1.1). In the second quarter, economic activity declined, the year-on-year rate fell to -0.5 per cent. The annualized quarterly rates were negative throughout the first half of 2012. With -0.1 per cent in the first and -0.7 per cent in the second quarter the Euro Area GDP growth decreased for three quarters in a row.

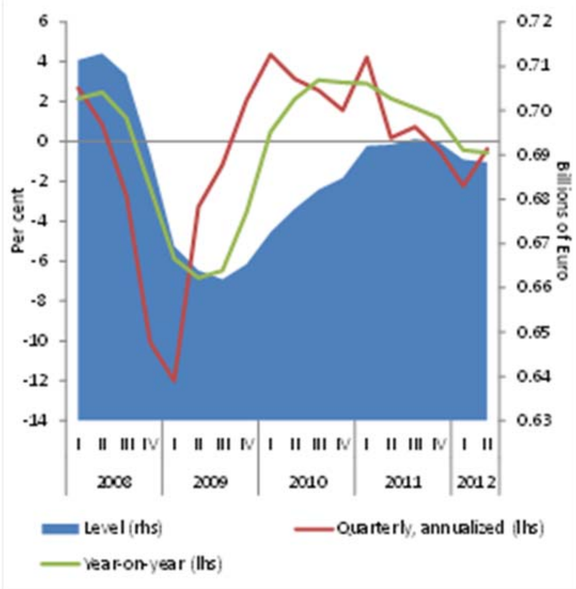
Looking ahead, latest releases of coincident and leading monthly indicators point out that there will be no turnaround in the third quarter (see Figure 2.1a and 2.1b).

Figure 1.1 GDP profile EA 17



Source: Eurostat

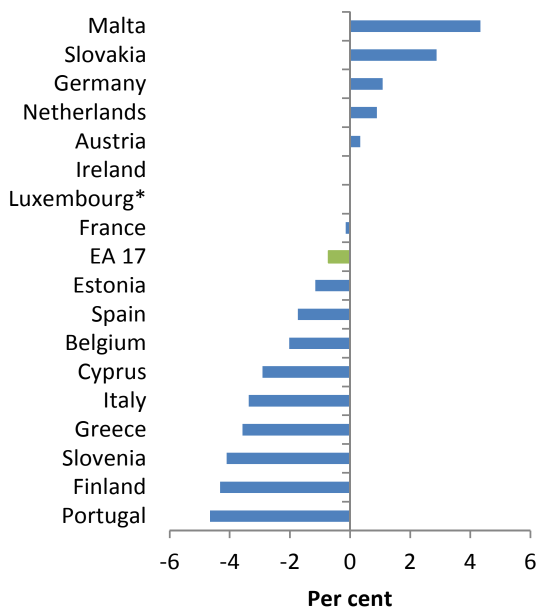
Figure 1.1 GDP profile EU



Source: Eurostat

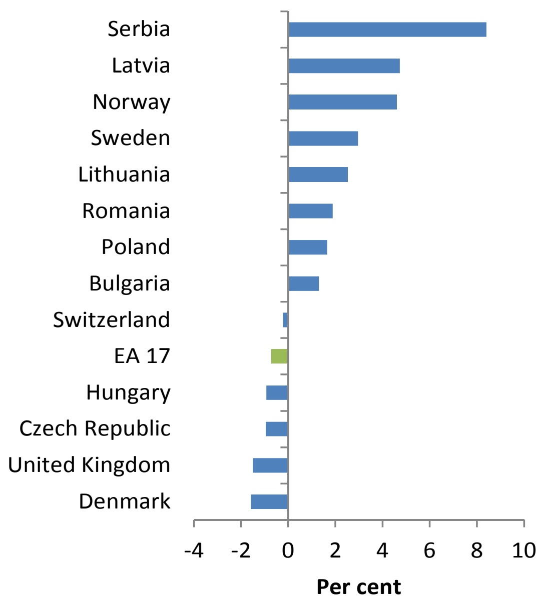
Similarly, the year-on-year rates in the EU countries outside the Euro Area deteriorated in the first half of 2012 (Figure 1.2). Economic growth slowed down to 0.5 per cent in the first quarter and decreased further to 0.1 per cent in the second quarter. In annualized quarterly terms, the aggregated GDP of the Non-Euro Area countries fell by 0.3 per cent in the first quarter and was more negative in the second quarter with -0.7 per cent. Figure 1.3 shows that annualized quarterly growth in the second quarter of 2012 was negative in 9 out of the 17 countries. Especially in Portugal and Finland the economy contracted strongly with annualized rates of -4.6 and -4.3 per cent, respectively. Malta performed well, growing at an annualized quarterly rate of 5.2%. Austria, Germany and the Netherlands are growing with a rate less than 1 per cent.

Figure 1.3
Annualized GDP growth 2012 Q2, EA 17



Source: Eurostat

Figure 1.4
Annualized GDP growth 2012 Q2, Non-EA

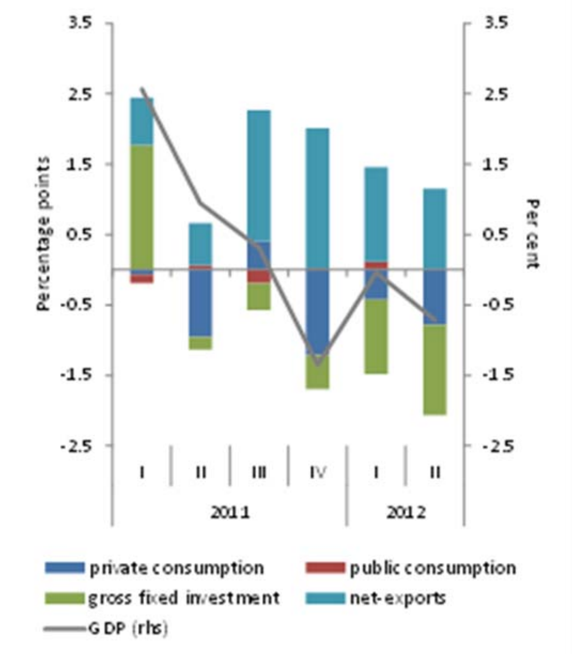


Source: Eurostat

Figure 1.4 illustrates that the situation in the Non-Euro Area countries is more positive in general. Only 5 of the 13 countries recorded negative growth rates. In particular the northern European countries, but also the Baltic states performed clearly better than the rest of the Non-Euro Area countries.

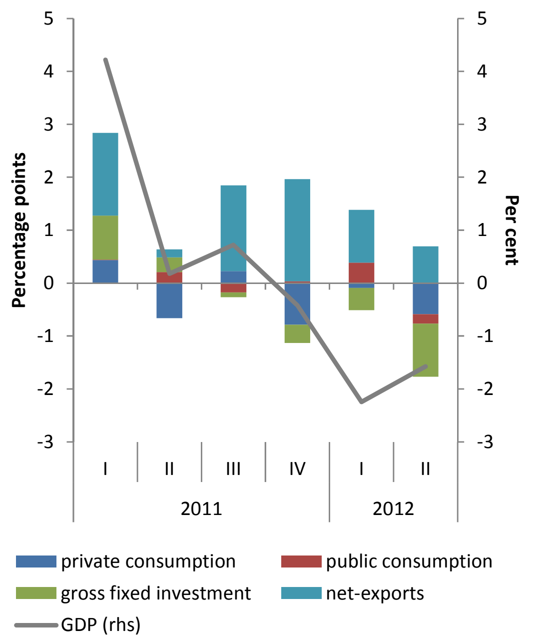
Figures 1.5 and 1.6 present the contributions of the demand side components to growth. In the Euro area, the decline of GDP was mostly reflects a decline of, gross fixed investment; it receded continuously since the second quarter of 2011. Nearly the same is true for private consumption, which only expanded in the third quarter of 2011. This suggests how the sovereign debt crisis affects domestic demand, e.g. via burdensome consolidation. The decline of private investment, however, can partly be explained also by the fact that in several European countries the construction sector is still in crisis. In turn, net exports' positively contributed to growth in each of the quarters under consideration. Rather than fast growing exports, this is a result of weak domestic demand, too: During the period illustrated, imports have been on a downward trend, with negative year-on-year growth rates in the first and second quarter of 2012. In the European Union as a whole, the factors contributing to growth are the same, but the impact of fixed investment and private consumption is less negative as well as the contribution of net exports is less positive.

Figure 1.5 Contribution to annualized GDP growth EA 17



Source:: Eurostat and RWI calculations

Figure 1.6 Contribution to annualized GDP growth EU



Source: Eurostat and RWI calculations

1.2 Inflation

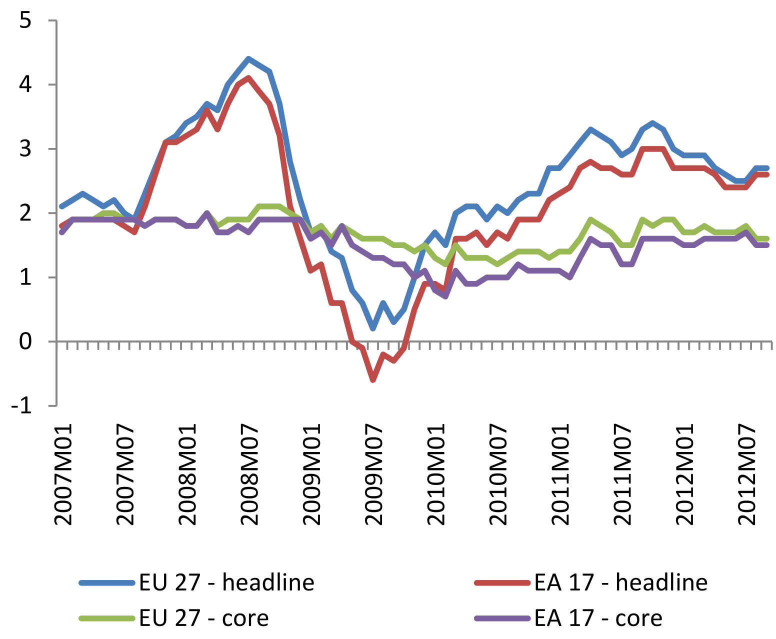
In the last twelve months consumer price inflation in the Euro Area declined by 0.4 percentage points to 2.6 per cent in September 2012 (Figure 1.7). Nevertheless, the rate is still rather high considering the current economic situation in the Euro Area and given the ECB target of 2 per cent. However, the figures above all reflect high prices of energy and food. Since June the crude oil price (Brent Blend, spot price) raised from around 90 US$/Barrel to more than 115 US$/Barrel in October. Furthermore, prices for cereals sharply increased during the first half of 2012 and the remained high since then

Domestic inflation, on the other hand, is quite low, as a consequence of the recession and structural adjustments undertaken by various countries to increase price competitiveness. Thus, core inflation (excluding energy, food, alcohol and tobacco) is below the headline rate since January 2010 in the Euro Area as well as in the European Union.

Although themselves not being in recession, Germany, France, Ireland and the Netherlands recorded headline rates which were lower than the Euro Area average (Figure 1.8). In turn, eight out of the seventeen countries recorded headline rates above 3 per cent. In Estonia, inflation reached 4.1 per cent in September, while Slovakia and Slovenia recorded rates of 3.8 and 3.7 per cent, respectively. In almost all Euro Area countries, however, core inflation is below 2 per cent. An exception is Slovakia with a core inflation of 3.1 per cent. Five other countries have core inflation rates between 2.1 and 2.4 per cent.

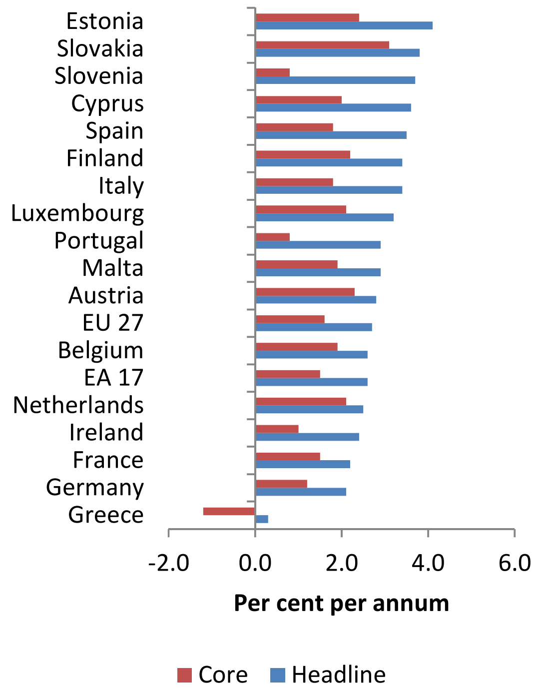
However, the underlying trend in domestic prices is even lower, since inflation in recent months has also been the result of the increase of indirect taxes. In Italy, e.g., the VAT rate has been raised in September 2011. In Spain the VAT rate was lifted in this year's September, so that inflation can be expected to remain high in the next twelve months to come. Greece, in contrast, experienced a deflation in core rate despite of excise duties having been raised. The core rate recorded at -1.2 per cent in September and headline inflation was no more than 0.3 per cent. Thus, Greece is the only country in the Euro Area, where headline inflation is currently below 2 per cent.

Figure 1.7 Headline and core inflation (measured by HICPS) in EA and EU



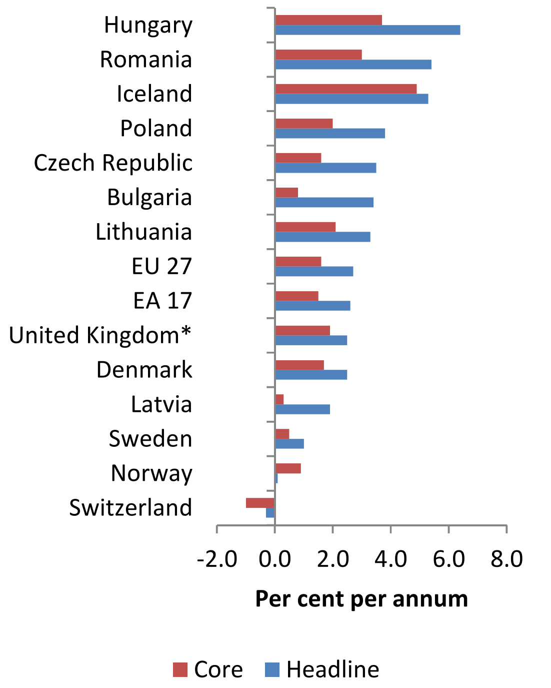
Source: Eurostat

Figure 1.8 Consumer price inflation (HICP), September 2012, EA 17



Source: Eurostat

Figure 1.9 Consumer price inflation (HICP), September 2012, EU



* August 2012;Source: Eurostat

Outside the Euro Area the picture looks quite similar. In the European Union headline inflation is slightly higher than in the Euro Area with 2.7 per cent in September. In seven countries inflation was above 3 per cent, while only four out of the selected countries recorded headline rates below the 2 per cent threshold; rates are particularly high in Hungary (6.4 per cent) and Romania (5.4 per cent). Outside the European Union, Iceland showed a high headline rate (5.3 per cent). In contrast, Switzerland experienced deflation with a headline rate of -0.3 and a core rate of -1 per cent. In most countries outside the Euro Area, core inflation was lower than the headline rate in September 2012. An exception is Norway, where the core rate of 0.9 per cent was 0.8 percentage points higher than the headline rate. Moreover, in most of the selected countries, the core rate fell below 2 per cent. For the European Union as a whole the core rate was equal to 1.6 per cent.

1.3 Labor market

During the Great Recession unemployment rose in all EU countries with the exception of Germany and Poland. In the Euro Area as a whole, seasonal adjusted employment declined between June 2008 and June 2009 by almost 3 Mio to 137.5 Mio people. While the trough of the recession was reached in the second quarter of 2009 and GDP recovered in 2010 and 2011 (the Euro Area economy has grown by 4 per cent in 2009Q2-2011Q2), employment showed a very mild recovery (see Figure 1.10). During the subsequent three years, it stagnated more or less, showing only some improvement in the first half of 2011. Since then, it is declining again. In August 2012, employment was down to 136.8 Mio people.

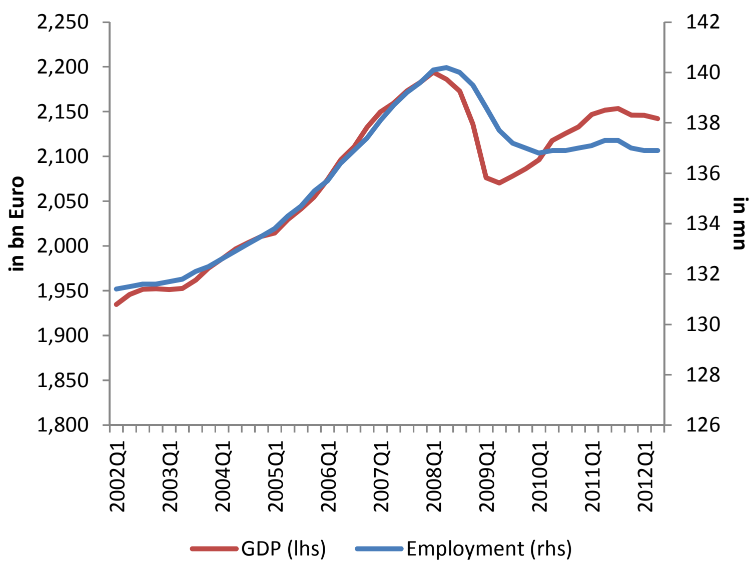
The weak performance of the labor market has different causes. First, labor hoarding made employment decrease less than production during the crisis in 2008/2009 (Figure 1.10). As a consequence, there was less job creation during the period of economic recovery. A second line of reasoning relates to the phenomenon of structural unemployment. A considerable portion of job losses during the crisis, took place in sectors that did not recover after the crisis, in particular in the construction sector. Third, job creation after the crisis has most probably also suffered from economic insecurity and efforts to increase productivity in the private sector. Fourth, in the course of public consolidation, public employment declined as well.

The missing employment recovery is mirrored in the development of unemployment rates in the various countries (Figures 1.11 and 1.12). Except for Germany and Austria, unemployment has risen throughout Europe within the last five years. Naturally, the change of unemployment throughout the period reflects the depth of the economic recession. In Cyprus, Ireland, Greece and Spain, unemployment more than doubled in the last five years. Outside the Euro Area this is true for Lithuania and Latvia. Comparing the Euro Area and Non-Euro Area countries one difference is striking. The bulk of the unemployment increase in countries outside the Euro Area took place during the Great Recession in 2008 and 2009. Only few countries experienced a worsening of labor market conditions subsequently. In turn, in most of the Euro Area countries, unemployment rates continued to increase until now.

Among the countries that managed a considerable turnaround are Germany and Estonia. Moreover, in Austria and Belgium unemployment remained roughly the same over the last five years.

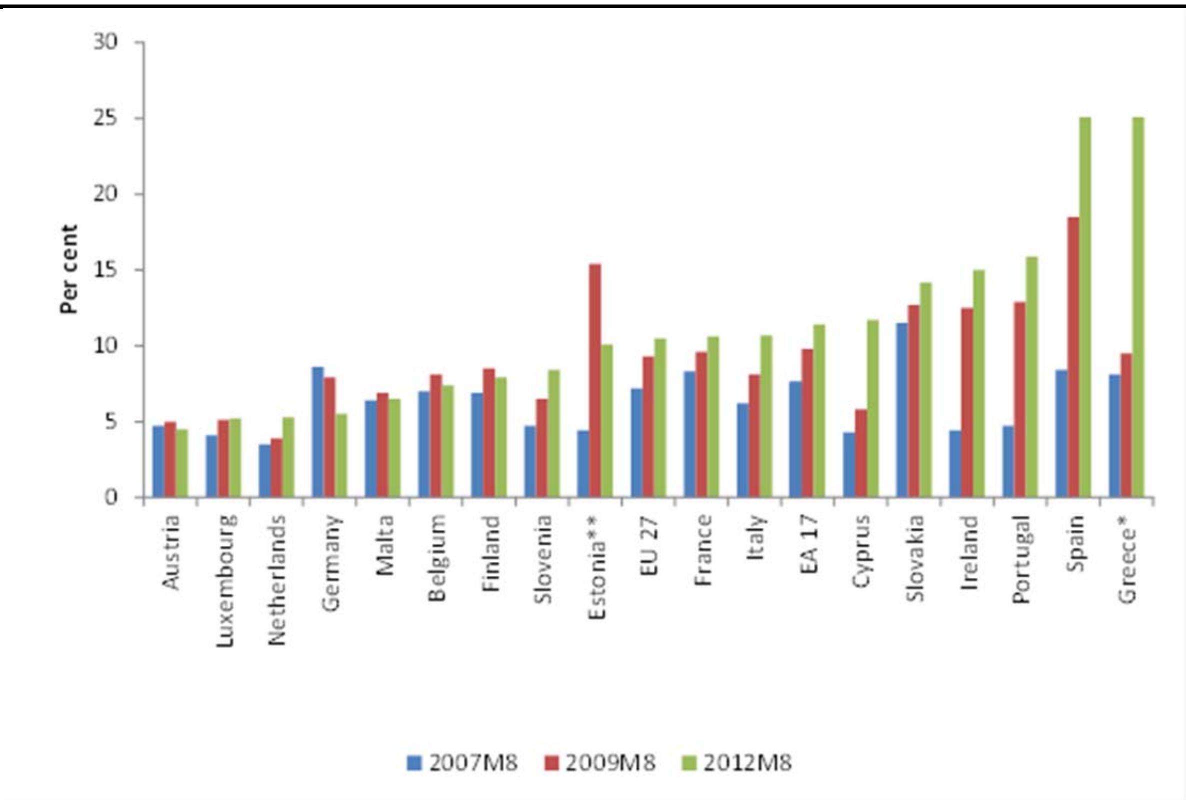
Outside the Euro Area, however, there are only Denmark, Poland and Bulgaria that suffer from increasing unemployment since 2009.

Figure 1.10 Employment (sa) and GDP



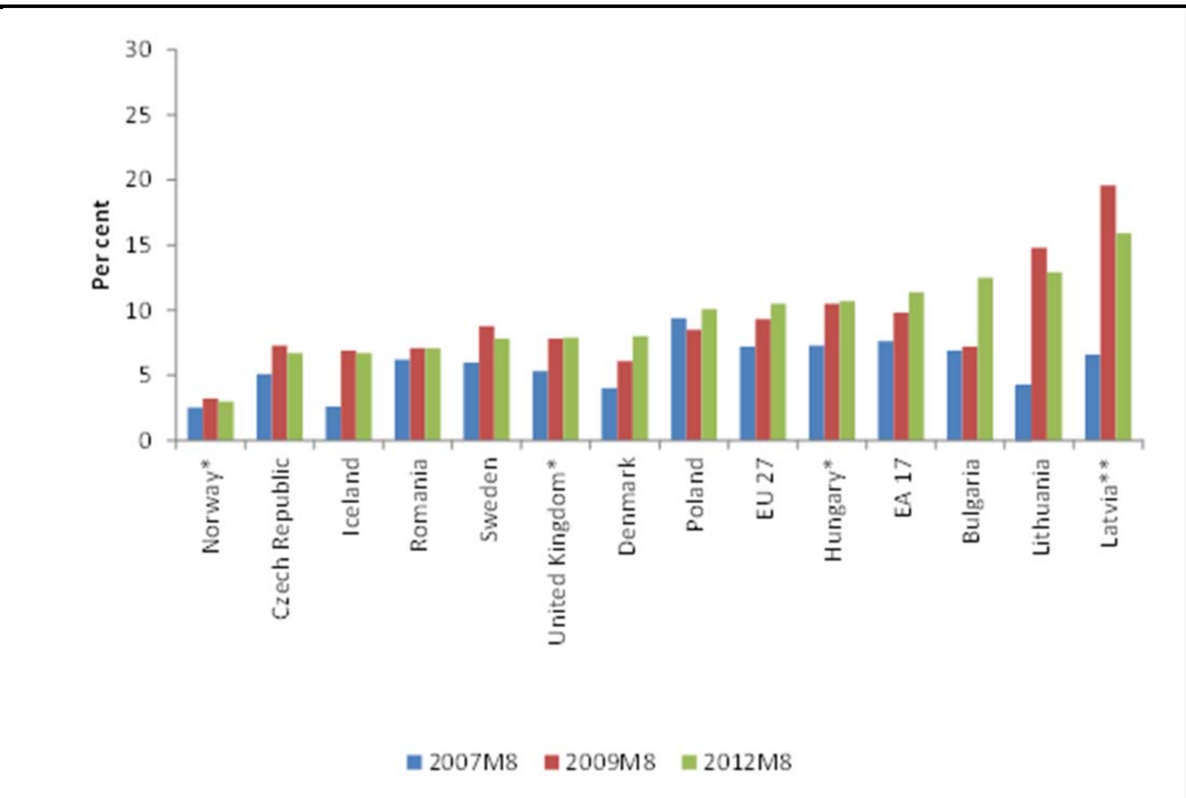
Source: Eurostat and RWI calculations

Figure 1.11 Unemployment rates, September 2012, EA 17



Source: Eurostat

Figure 1.12 Unemployment rates, September 2012, Non-EA

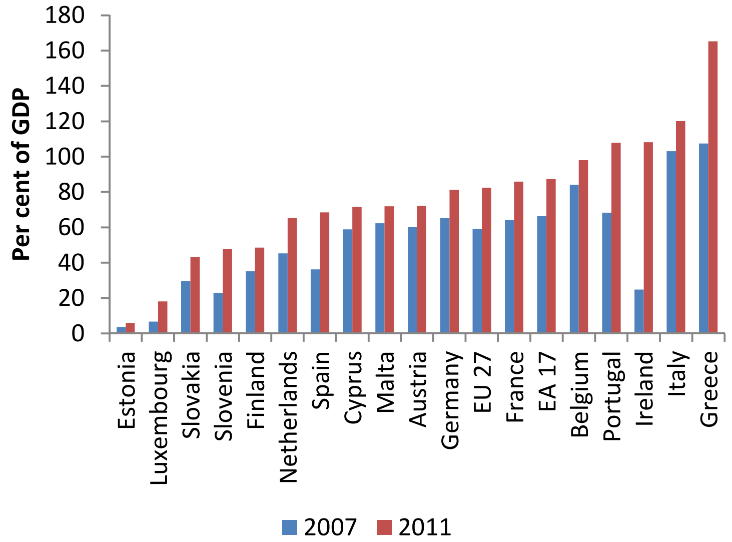


Source: Eurostat

1.4 Public deficit and debt

General Government debt

Figure 1.13 General Government debt in per cent of GDP, EA 17

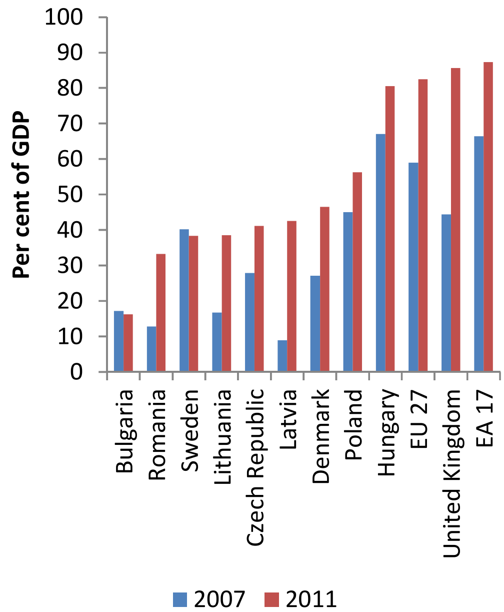


Source: Eurostat

In most of the Euro Area countries general government debt has increased steadily since 2007. In the Euro Area as a whole debt was equal to 66.4 per cent before the crisis, rising to above 87 per cent in 2011 (Figure 1.13). At the end of last year, only five countries fulfilled the Maastricht criterion according to which debt should not exceed 60 per cent of GDP. Particularly the situation in Greece, Italy, Ireland and Portugal deteriorated during or in the wake of the Great Recession, and it was judged increasingly critical by the financial markets. This led to sharp increases of interest rates and interest liabilities. As a result, Greece faced a debt burden of 165.3 per cent of GDP at the end of 2011, while the quota exceeded 100 per cent in Italy, Ireland and Portugal as well. Compared to that, in France, Germany, Austria, Spain and the Netherlands, the debt stock only reached figures between approx. 65 to 85 per cent of GDP in 2011. The lowest debt stocks can be found in Estonia and Luxembourg. Debt stocks still fall below 20 per cent of GDP.

Source: Eurostat

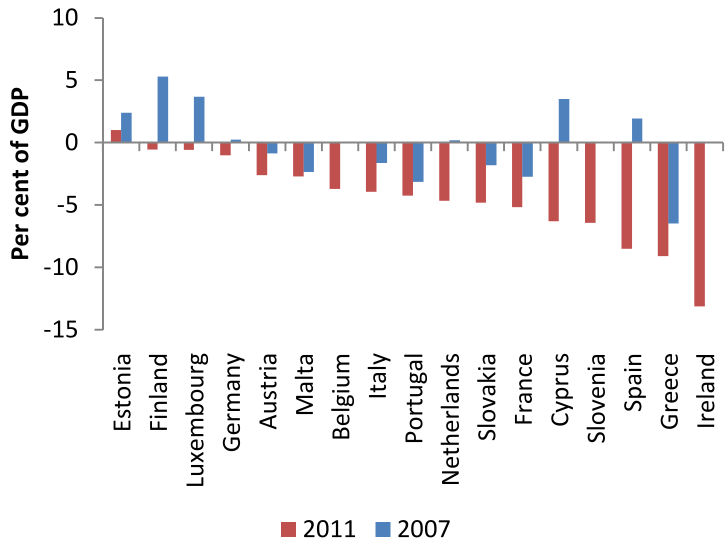
Figure 1.14 General Government debt in per cent of GDP, Non-EA



Source: Eurostat

In contrast to the high-debt Euro Area, debt fell below 100 per cent of GDP in all of the selected EU countries outside the Euro Area at the end of 2011. However, the debt ranking among the countries has changed drastically since 2007. Bulgaria, which faced a larger debt stock than Romania, Lithuania and Latvia before the crisis, could even reduce debt in the meantime. It is now the least indebted among the countries shown in Figure 1.14. In turn, in Latvia the debt stock is more than four times as large as it was in 2007. However, the country that faces the largest debt rate among the countries selected is UK. Since 2007, Government debt rose from 44.4 to 85.7 per cent of GDP, largely owing to high public deficits in the wake of the recession and of measures to stabilize the financial sector.

Figure 1.15 General Government budget balance in per cent of GDP, EA 17



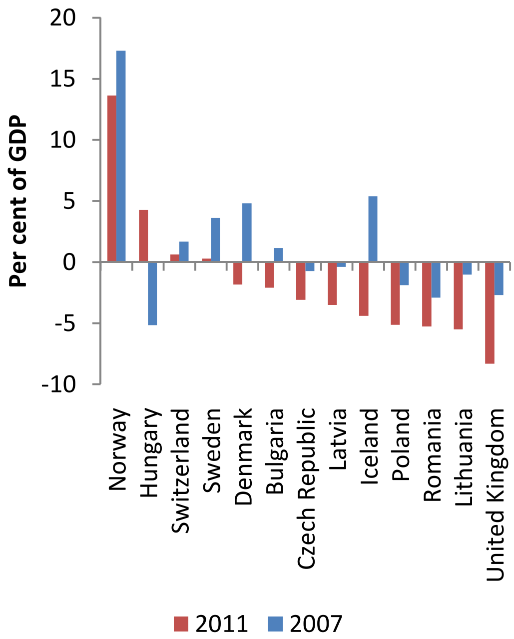
Source: AMECO

In line with the economic heterogeneity in the Euro Area, General Government budget deficits substantially differ between its members. While consolidation efforts in countries with high debt are larger, deficits do not necessarily fall below those of low debt countries. Since several high debt countries suffer from a recession, it becomes difficult to generate the revenues necessary to balance the budget. Moreover, with low growth the budget deficit as a ratio of GDP increases per se. In Figure 1.17, it can be seen that in 2011 deficits were to a large part the result of interest payments on debt stocks as well as the bad economic situation. For instance, Greece and Italy even generated structural primary surpluses in 2011.

Outside the Euro Area, deficits have not been as large as in the Euro Area in 2011 and mostly fell below 5 per cent of GDP. However, similar to the Euro Area countries, budget balance worsened in all but one country (Hungary) since 2007. Before the Great Recession, only a few countries recorded a negative budget balance. Among them only Hungary showed a deficit larger than 3 per cent. Among the countries in deficit in 2007 there was also the UK, where the balance worsened considerably in the last five years, reaching 8.3 per cent of GDP in 2011, the highest figure among the countries listed in Figure 1.16. In turn, Norway's financial situation is still outstanding, given its receipts from the oil sector. While the budget surplus was more than 17 per cent of GDP in 2007, four years later, the surplus still equals almost 14 per cent of GDP. In Iceland, Denmark and Bulgaria, however, the balance turned around since 2007. While these countries generated surpluses before the crisis, in 2011, the budget was no longer in balance.

To rule out the impact of cyclical factors and of interest liabilities on current General Government budget balances in the Euro Area, Figure 1.17 illustrates primary as well as structural primary balances in Euro

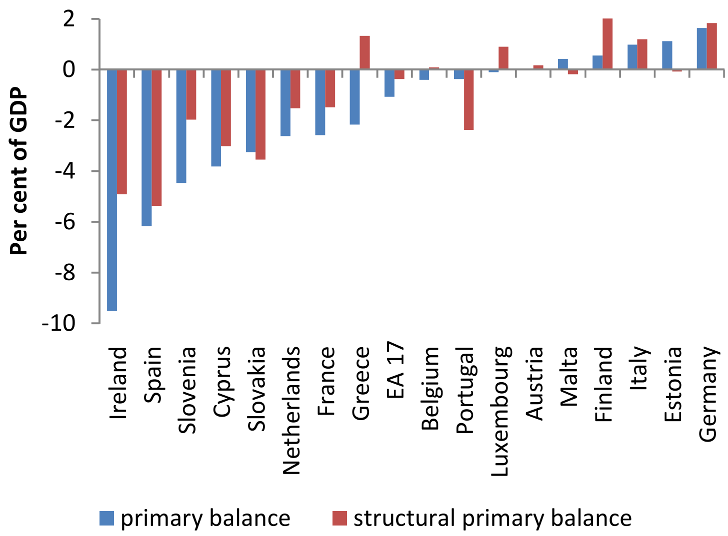
Figure 1.16 General Government budget balance in per cent of GDP, Non-EA



Source: AMECO

Area countries in 2011. Indeed, the graph suggests that current budget balances highly suffer from the bad economic situation. Except for Slovakia, Portugal, Malta and Estonia, structural primary surpluses exceed primary balances throughout the Euro Area. Controlling for cyclical influences, Greece, Belgium, Luxembourg and Austria have generated structural surpluses in 2011, while their respective primary balances have been negative. The discrepancy is most remarkable in Greece.

Figure 1.17 Primary balance and structural primary balance of EA countries in 2011



Source: AMECO and Eurostat

2. OUTLOOK FOR 2012-2013

In this part we present and discuss the forecasts of GDP, inflation and unemployment the AIECE members provided to us in their questionnaires. For the Euro Area as a whole, a vast majority of the institutes shares the view that GDP will decline in 2012. For 2013 differences between the predictions become more pronounced, probably owing to larger uncertainty. Notwithstanding, all institutes expect GDP to grow compared to 2012. Moreover, since the last General Report in April, expectations have deteriorated. This is also true for the country-specific forecasts, which, by the way, are highly consistent with the forecasts for the Euro Area and EU. A large majority expects their countries to grow at a smaller, in some cases negative rate in 2012 but predicts the rate to increase again in 2013. Compared to April, almost all national forecasts for 2013 have been revised downwards. For 2012, however, the picture is mixed. Interestingly, in countries with gloomy forecasts in April, the latest forecasts have been revised downwards again. In turn, in several countries with already positive forecasts in April, the outlook has improved again.

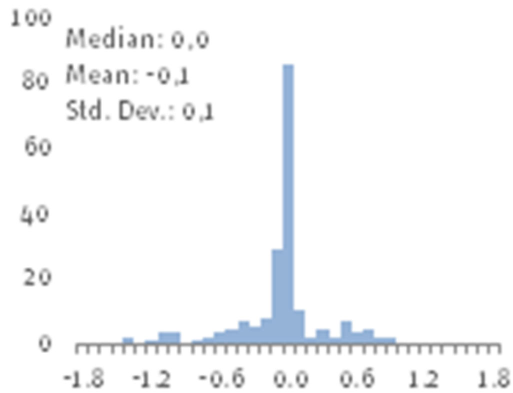
Inflation is expected to come down in the short-term both in the Euro Area and the EU as well as in the individual countries. In the medium term, the majority expects the rate to remain stable.

The unemployment expectations are pessimistic. Even according to the most optimistic view unemployment is forecasted to increase both in 2012 and 2013. However, this is not fully in line with country-specific forecasts, which are much more optimistic on average. In particular, this is true for the countries currently suffering from extremely high unemployment. In Spain and Greece, for example, institutes expect the increase of unemployment to come to a halt in 2013.

2.1 GDP growth

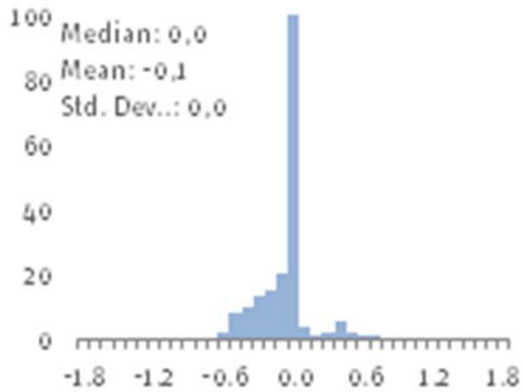
Short term forecast for the Euro Area

Figure 2.1a RWI EA forecast 2012 Q3



RWI-Calculations

Figure 2.1b RWI EA forecast 2012 Q4



RWI-Calculations

Using a large number of monthly indicators, RWI conducts quarterly GDP forecast for the Euro Area over the short horizon. First, to solve the mixed frequency problem, indicators are transformed into quarterly data ("Bridging"). To use both leading and coincident indicator properties, missing monthly indicator values have to be filled over the forecasting horizon in the first place. To do so, several methods are tested (naïve methods as well as univariate time series approaches). Then, based on quarterly aggregates of the indicators, they are employed as regressors to estimate GDP growth in sample ("bridge equations"). Different combinations of bridge equations are tested, either with one or two indicators and supplemented by the lagged value of GDP growth. Using the optimal lag structure of each bridge equation, out-of-sample forecasts are computed and pooled in an appropriate way. In addition to rather simple pooling approaches (mean, median), we also use more sophisticated weighting schemes, either based on equations' goodness of determining GDP growth in sample or based on out-of-sample forecast errors the single models conducted in past forecasting rounds. For the third and fourth quarter of the current year, the short term forecasting model predicts GDP to decline by -0.1 per cent on average. However, the distribution of the forecasts is biased negatively for the fourth quarter.

Figure 2.2 GDP growth in the Euro Area

Source: AIECE Questionnaires.

Euro Area and European Union

After the Great Recession, GDP in the Euro Area recovered with strong growth rates in 2010. However, during 2011 quarterly growth rates declined continuously from 0.6 to -0.3 per cent and the Euro Area subsequently turned into recession.

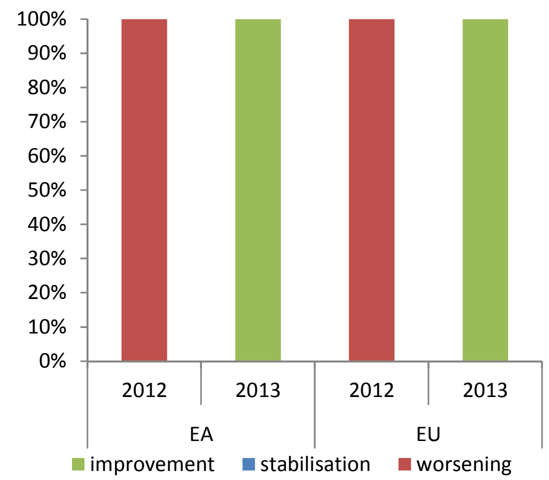
Figure 2.3 GDP growth in the EU

Source: AIECE Questionnaires.

While GDP grew at a rate of 1.4 per cent in 2011, all but one institute forecast contraction of GDP in 2012 while the majority of institutes expects small growth in 2013 (Figure 2.2). On average the AIECE institutes predict GDP in the Euro Area to shrink by 0.43 per cent in 2012. The same is true for the fourth quarter of 2012. On average, the likelihood of an annualized GDP rate between 0 and -1 per cent is assessed by 80 per cent (Figure 2.6). Regarding 2013, a recovery is expected, with the average forecast recording 0.38 per cent. For 2013Q4, the institutes expect GDP growth to be positive. Only about 30 per cent expect annualized GDP growth to be negative (Figure 2.6). Among the institutes, the lowest forecast figures are -0.7 per cent for 2012 and -0.2 per cent for 2013, respectively. The most optimistic GDP forecast does not record positive growth for the Euro Area 2012 and says that GDP will increase by 0.9 per cent in 2013. The GDP-weighted average of institutes' individual country forecasts is highly in line with the average of Euro Area forecasts.[1] For 2012 the figure equals -0.45 per cent, while it records 0.32 per cent in 2013.

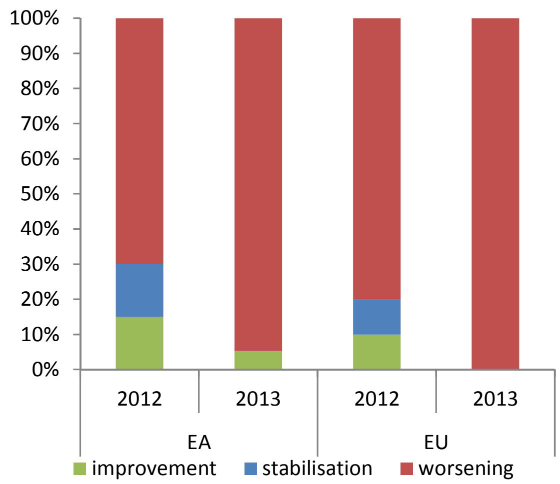
For the European Union, on average it is expected that GDP will decrease by -0.21 per cent in 2012 after it accelerated by 1.5 per cent in the year before (Figure 2.3). Analogously, almost 70 per cent of AIECE members expect annualized GDP rate to be in a range between 0 and -1 per cent in the last quarter of 2012 (Figure 2.7). This is consistent with the forecast on 2013Q4, with nearly 70 per cent of the institutes predicting the economy to grow at a rate between 0 and 1 per cent. The expected slowdown in 2012 is

Figure 2.4 Improvement/ no change/ worsening in GDP growth in EA and EU



Number of forecasts: EA 2012 24/27, EA 2013 23/27, EU 2012 15/27, EA 2013 14/27
Values for 2011: Eurostat

Figure 2.5 Comparison to April forecast of GDP growth in EA and EU



Number of institutes with forecast in April and Sept.: EA 2012 20, EA 2013 19, EU 2012 10, EA 2013 10

[1] The weights are calculated based on GDP values from 2011 taken from the institutes' questionnaires or Eurostat in case an institute did not provide the figure.

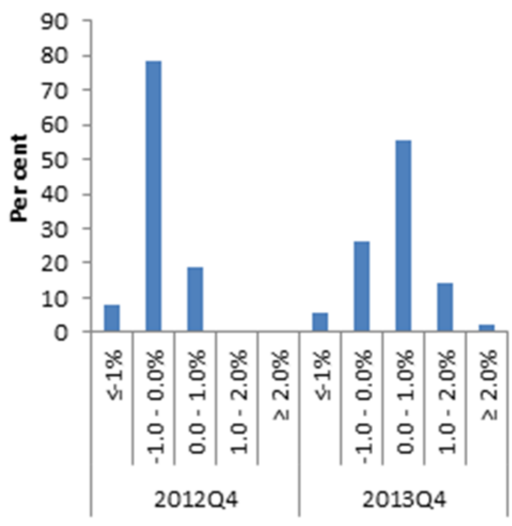
predicted to be followed by a weak expansion in 2013. The institutes forecast the economy to expand at a rate of 0.62 per cent on average. Again, the individual forecasts on the European Union GDP are consistent th the aggregation of institutes' predictions for their respective own countries, which records a decrease of GDP growth at a rate of -0.31 per cent in 2012. For 2013 an improvement of 0.58 per cent is predicted, when computing the weighted average of country-specific forecasts. Note that part of the discrepancy between the weighted average of national predictions and the average of EU-wide forecasts is probably due to the fact that several EU 27 countries are not represented by the group of AIECE members.

ot surprisingly, there is no institute among the surveyed AIECE members expecting annual GDP growth in the Euro Area as well as in the EU to improve in 2012 compared to 2011 (Figure 2.4). In contrast to that, the institutes consistently anticipate an improvement of GDP growth in 2013 in both the Euro Area and the EU. In comparison to the forecasts given by the participating AIECE institutes in April this year, the researchers worsened their expectations in September 2012 (Figure 2.5). The vast majority of institutes have published a lower forecast on GDP growth in 2012 and 2013 for the EA and EU. For 2012, 70 per cent of the institutes expect a worsening in growth rates of GDP in comparison to the forecast of April for the EA, and even 80 per cent expect the EU economy to grow less than in 2011. 15 per cent of the institutes have not changed their minds regarding their forecasts in April on the Euro Area GDP, while this is true for 10 per cent of institutes regarding the EU-wide economy. A minority of the institutes (15 per cent for EA and 10 per cent for EU) expect GDP in 2012 to grow at a larger rate than they did in April. For 2013 all institutes adjusted their projections downwards for the EU. For the Euro Area only 5 per cent predict larger growth than in April.

Figures 2.8 and 2.9 graph the distributions of institutes' forecasts of Euro Area GDP growth in 2012 and 2013, respectively. Naturally, with GDP growth in the first and second quarter of 2012 already realized, uncertainty regarding growth in 2012 is considerably lower than for 2013. Almost 80 per cent of forecasts for 2012 lie in a range between -0.6 and -0.3, apparently normally distributed around the mean (-0.43). The standard deviation of forecasts for 2013, in turn, is much larger. However, forecasts are still relatively normally distributed. Around 80 per cent of forecasts lie in an interval between 0 and 0.8.

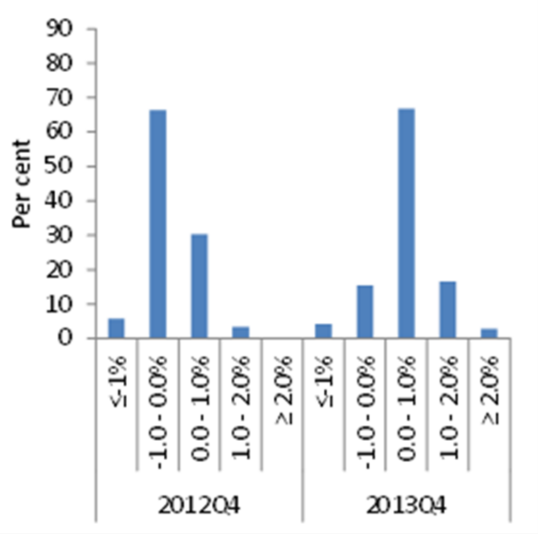
Analogously, Figures 2.10 and 2.11 show the distributions of institutes' forecasts on EU-wide GDP growth in 2012 and 2013, respectively. In contrast to forecasts for the Euro Area, the distributions appear less normally

Figure 2.6 Probabilities of GDP-growth in EA



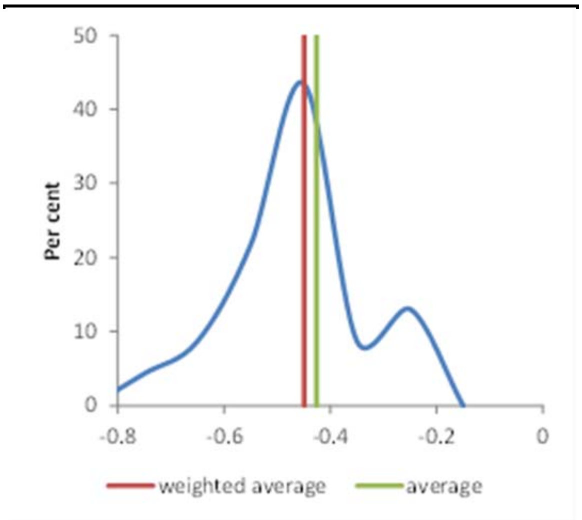
Number of forecasts: 2012Q4 19/27, 2013Q4 18/27

Figure 2.7 Probabilities of GDP-growth in EU



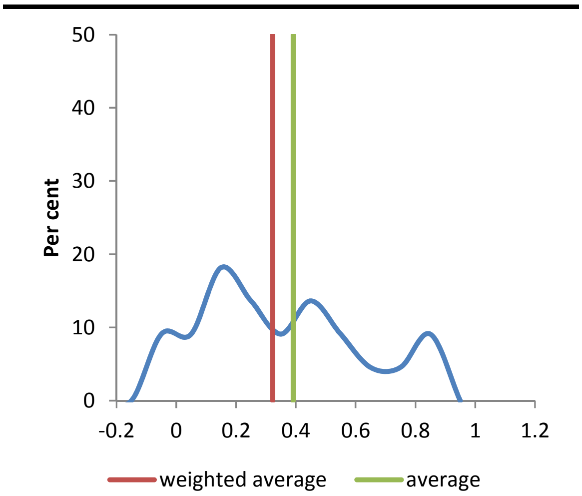
Number of forecasts: 2012Q4 9/27, 2013Q4 9/27

Figure 2.8 Distribution of forecast of GDP for EA in 2012



Number of forecasts: 23/27

Figure 2.9 Distribution of forecast of GDP for EA in 2013



Number of forecasts: 22/27

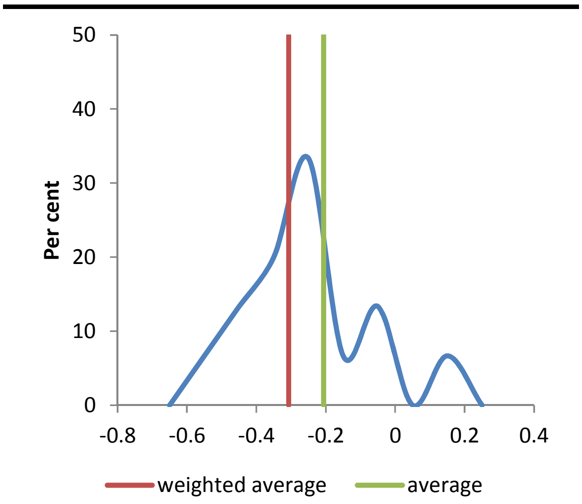
distributed. This may potentially be the result of the lower frequency of forecasts available. For 2012, the picture is a bit skewed to the left, with 4 out of 15 institutes expecting GDP to grow at a rate of more than -0.2 per cent. For 2013, the forecasts are in a sense triple-peaked, with about 30 per cent of institutes expecting GDP in the EU to grow at a rate less than 0.4 per cent, 35 per cent forecasting 0.4 to -0.6 per cent GDP growth, and 35 per cent predicting the economy to grow by more than 0.8 per cent.

AIECE countries

Short term forecast

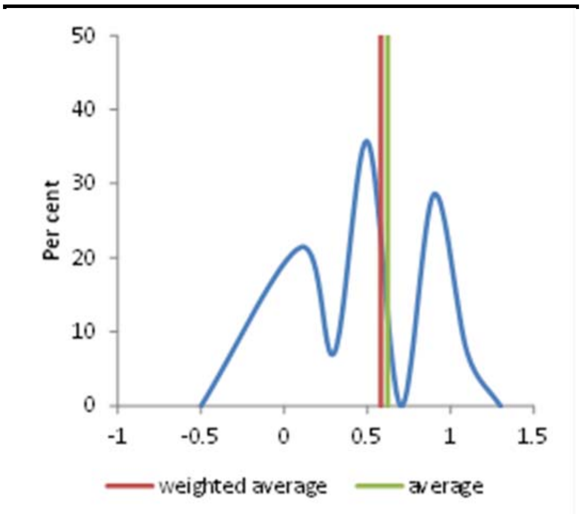
Looking at institutes' short-term forecasts, the expectations are rather subdued (Figure 2.12). Only in Switzerland, Germany, Poland and the UK, annualized GDP is predicted to grow at a positive but low rate in the third quarter. However, with the exception of Greece and Slovenia, growth is also expected to only

Figure 2.10 Distribution of forecast of GDP for EU in 2012



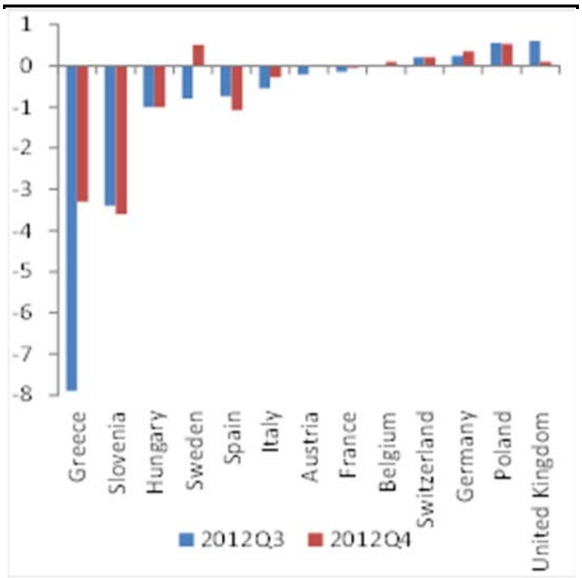
Number of forecasts: 23/27

Figure 2.11 Distribution of forecast of GDP for EU in 2013



Number of forecasts: 23/27

Figure 2.12 GDP growth forecast for 2012Q3 and 2012Q4



decrease at a small rate. In Greece, the forecast is Looking at institutes' short-term forecasts, the expectations are rather subdued (Figure 2.12). Only in Switzerland, Germany, Poland and the UK, annualized GDP is predicted to grow at a positive but low rate in the third quarter. However, with the exception of Greece and Slovenia, growth is also expected to only decrease at a small rate. In Greece, the forecast is by far the worst. Annualized GDP growth is expected to be almost -8 per cent in the third quarter. Looking ahead, in the last quarter of 2012, expected growth rates are broadly the same as in the third quarter, except for Greece, Sweden and the UK. In the former two, growth rates are expected to accelerate, but growth in Greece is still predicted to be negative. In the UK, growth is predicted to be hardly positive in the fourth quarter. by far the worst. Annualized GDP growth is expected to be almost -8 per cent in the third quarter. Looking ahead, in the last quarter of 2012, expected growth rates are broadly the same as in the third quarter, except for Greece, Sweden and the UK. In the former two, growth rates are expected to accelerate, but growth in Greece is still predicted to be negative. In the UK, growth is predicted to be hardly positive in the fourth quarter.

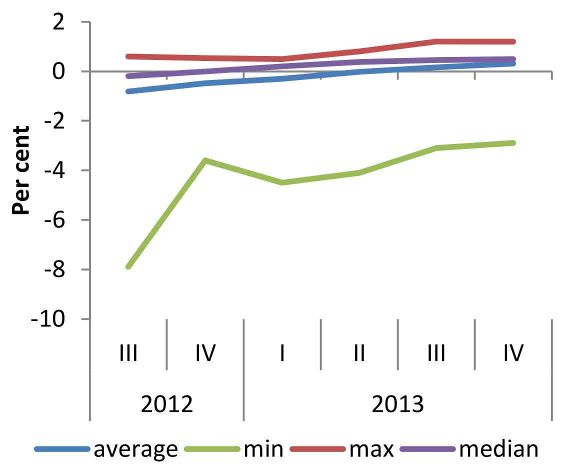
We would have liked to explore if the rather pessimistic views over the short horizon proved true. However, the first estimates on GDP figures for the third quarter have not been available by completion of this report.

Quarterly forecast

Figure 2.13 gives a summary statistic for the quarterly profile of individual institutes' GDP forecasts for their respective own countries. First, it can be seen that in 2013 growth rates are expected to accelerate compared to 2012. However, on average, growth rates are not predicted to be positive until the third quarter of 2013. Second, the worst forecast (green line) is by far more negative than the average, while the best forecast (red line) lies close to the average. This suggests that the green line is rather determined by an outlier and that the bulk of countries are expected to grow at a positive rate at least in the second half of 2013.

This can also be seen from Figure 2.14. For the six quarters between 2012Q3 and 2013Q4, it shows the frequency distribution of quarterly forecasts of the AIECE members on their respective own countries. The profile clearly shows how the forecasts improve from quarter to quarter. While almost 70 per cent of institutes expect GDP to contract in

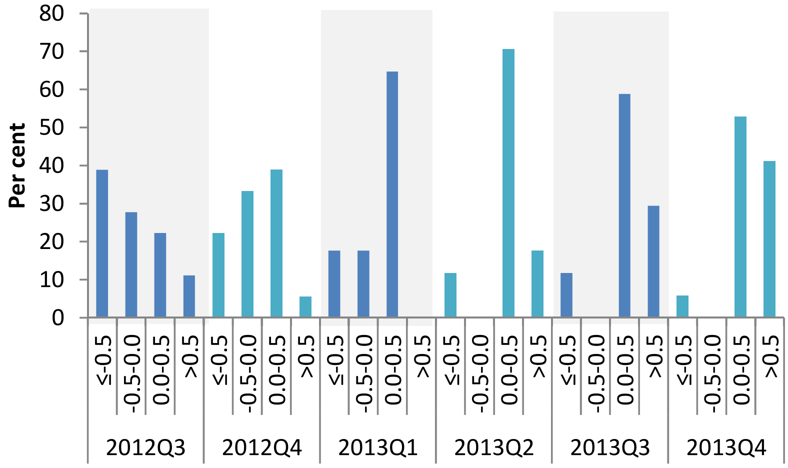
Figure 2.13 Quarterly GDP growth in AIECE countries (q/q)



Number of forecasts: 2012 18/27, 2013 17/27

2012Q3, a negative growth rate is only predicted by some 50 per cent in the last quarter of 2012. This development continues in 2013. The fraction of institutes forecasting negative quarterly growth rates for their own countries decreases continuously from quarter to quarter. While around 30 per cent of institutes predict their economies to decrease in the first quarter, there is only one institute that expects GDP to decline in the last quarter of 2013. Moreover, among the positive expectations, the fraction of institutes forecasting their economies to grow at a quarterly rate larger than 0.5 steadily increases over time.

Figure 2.14 Frequency distribution of quarterly GDP growth of AIECE countries



Number of forecasts: 2012 18/27, 2013 17/27

Comparing institutes' latest forecasts to the figures published in April, it sticks out that the variance of forecast figures has increased for 2012 (Figures 2.15 and 2.16). In Norway, Iceland, Sweden, Switzerland and Austria, where expectations have already been positive in April, the views have even brightened since then. On the contrary, institutes from Greece, Slovenia, Italy and Spain have worsened their forecasts, which have already been negative in April. We conjecture that such results owe to the still heterogeneous economic developments in Europe that might have not been expected in April to that extent, both on the positive as well as on the negative side.

All in all 58 per cent of the institutes expect GDP growth to be worse than they did in April, while 33 per cent revised their forecast upwards (Figure 2.18). Interestingly, for 2013, the latest releases of GDP figures led all institutes, except for those from Denmark, Norway and Belgium, to revise their forecast downwards (see right bar in Figure 2.18). Institutes from Slovenia, Italy and Spain even watch their domestic economies to contract after they forecasted positive growth in April. In Slovenia the view has changed drastically. Forecasting 0.7 per cent GDP growth in spring, the institute from Slovenia expects GDP to decrease by -1.7 per cent in the year to come.

As for the Euro Area and the EU as a whole, a vast majority of 23 out of 26 institutes project GDP growth in their country to fall below the rate in 2011. The opposite holds for 2013. Less than 10 per cent expect their economy to grow with an even lower rate than in the year before (Figure 2.17).

Figure 2.15 GDP growth forecast 2012, April forecast compared to September forecast

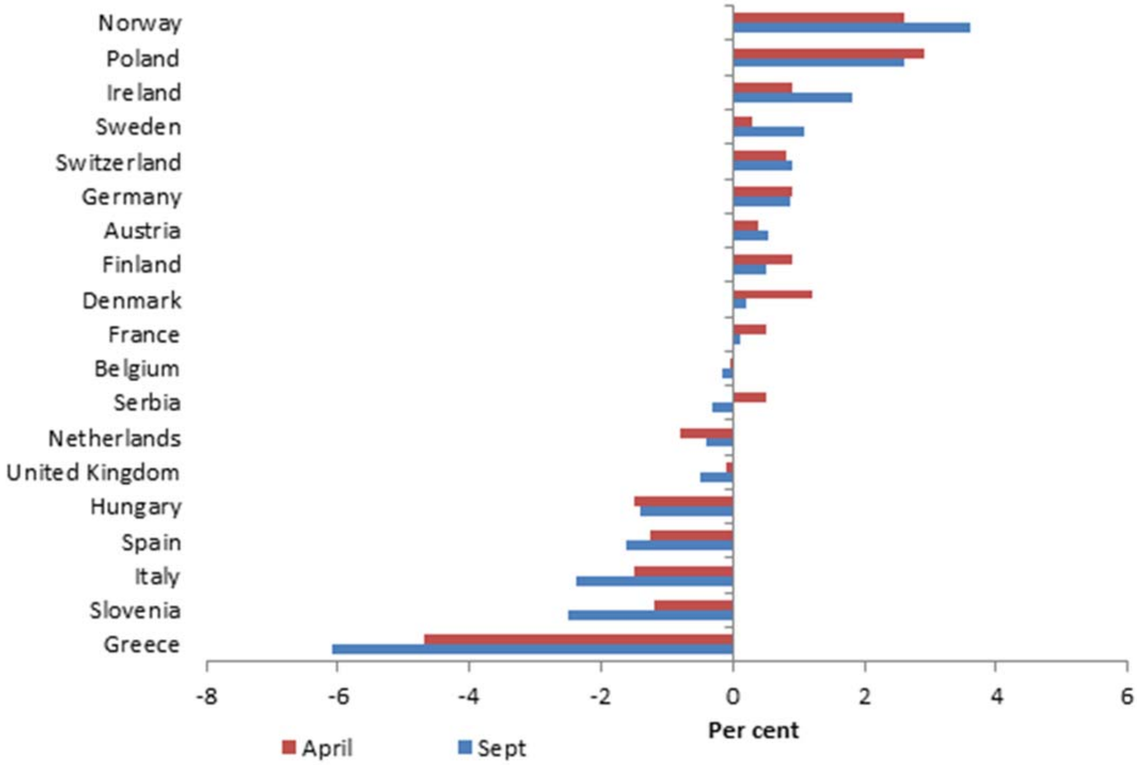


Figure 2.16 GDP growth forecast 2013, April forecast compared to September forecast

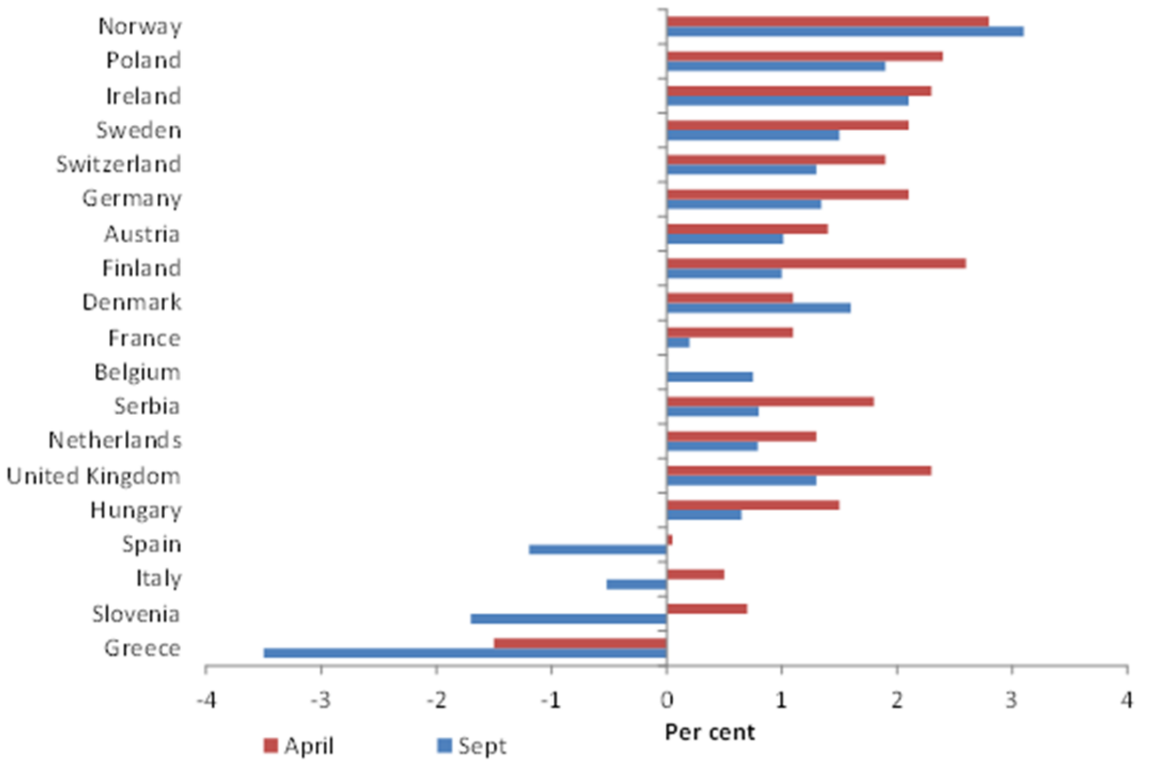
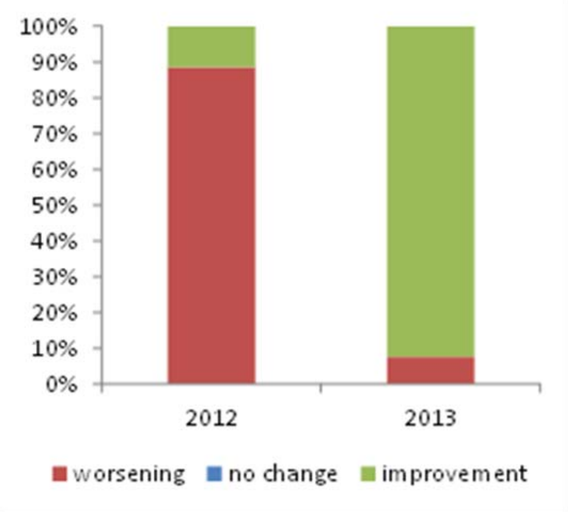
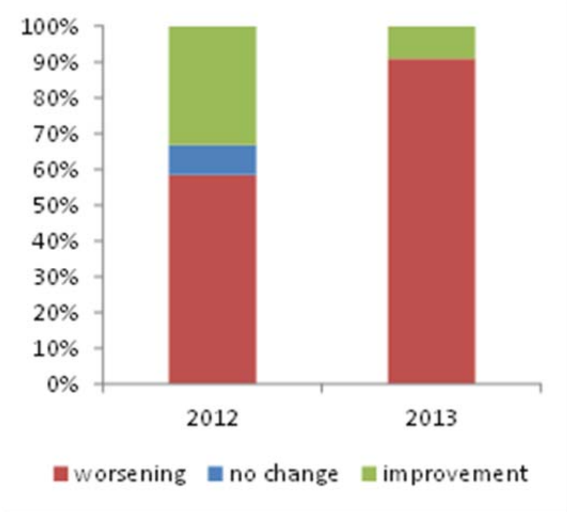


Figure 2.17 Improvement/ no change/ worsening in GDP growth



Number of forecasts: 2012 26/27, 2013 26/27
Values for 2011: Eurostat

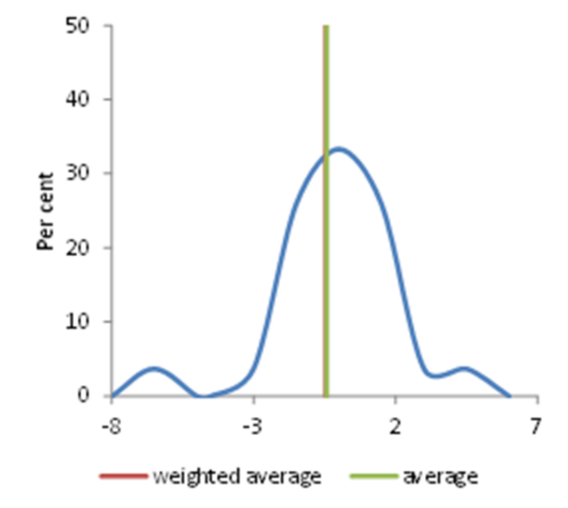
Figure 2.18 Comparison to April forecast of GDP growth



Number of forecasts: 2012 24, 2013 22

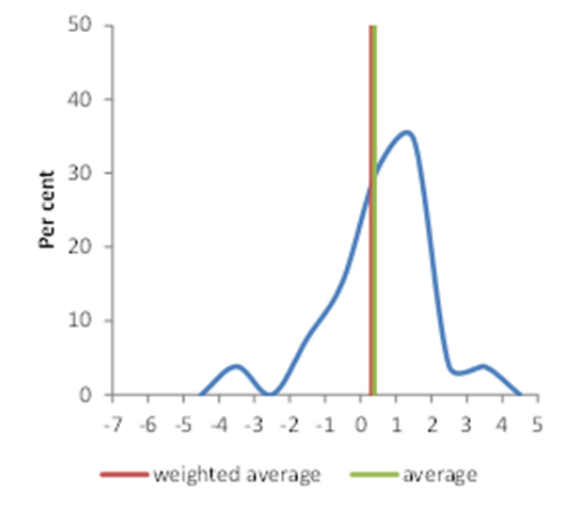
Provided that the i nstitutes' forecast accuracy on their own country is high, Figures 2.19 and 2.20 can be interpreted in the sense that GDP growth in EU member states will become more homogenous in 2013. For 2012, national forecasts are almost perfectly normally distributed around zero growth between -4 and 4 per cent. However, the Greek economy is expected to decline by -6.1 per cent. In 2013, forecasts are distributed closer to the mean. On the positive side, a larger fraction of institutes expect GDP to grow at a rate above 2 per cent, while the number of negative forecasts reduces compared to 2012 and the worst forecast not being less than 4 per cent for 2013.

Figure 2.19 Distribution of the GDP forecasts for the AIECE-countries in 2012



Number of forecasts: 27/27

Figure 2.20 Distribution of the GDP forecasts for the AIECE-countries in 2013



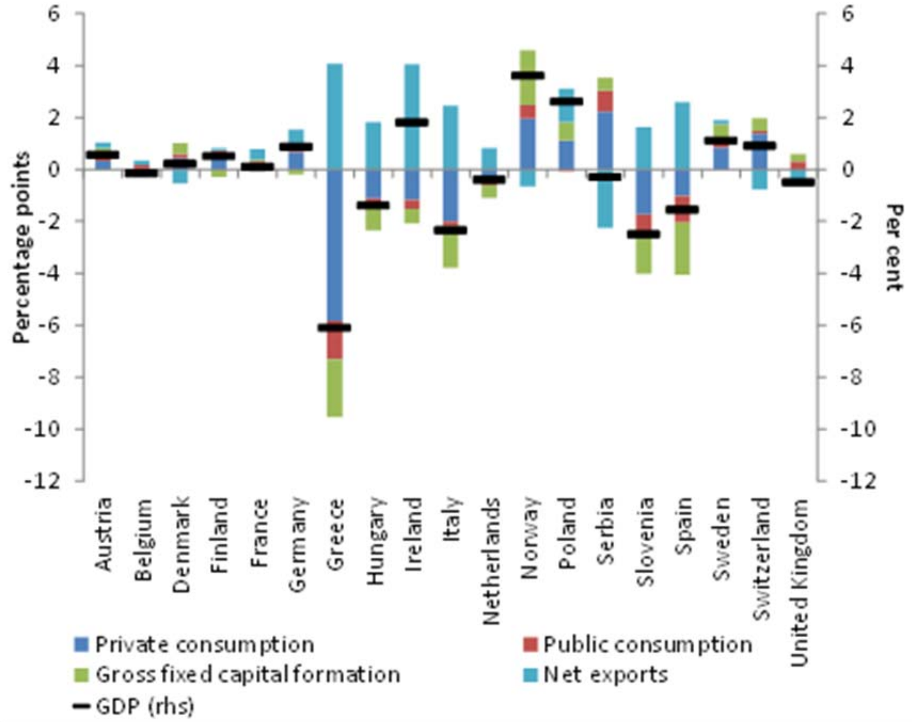
Number of forecasts: 27/27

Growth contribution

Focusing on the main contributors to GDP growth among EU-member countries, institutes expect that external factors are the major drivers of growth, while internal demand components either contribute to a lower extent or drag down growth (see Figure 2.21). In those European countries that suffer from solvency problems and are thus overshadowed by incisive consolidation, private consumption as well as gross fixed capital formation are expected to decline drastically. In Italy, Ireland, Spain, Slovenia, Hungary, and Greece, domestic private sector demand is largely seen as the main obstacle to growth.

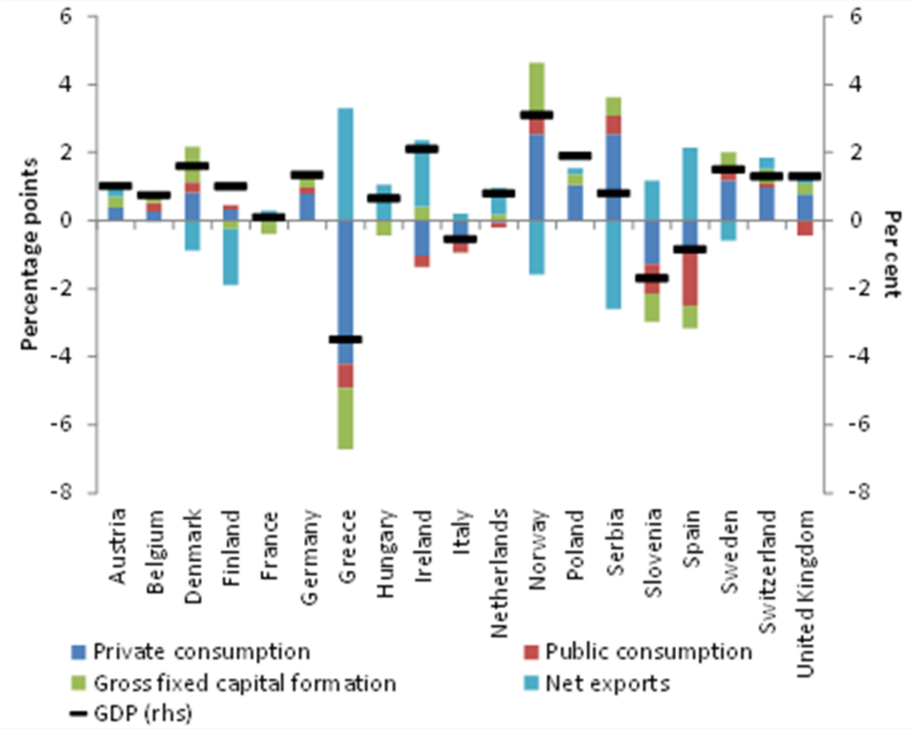
In 2013 the depicted role of contributors is less uniform (Figure 2.22). Net exports are predicted to contribute to a large fraction of growth in Greece, Spain, Slovenia, Ireland, the Netherlands and Hungary, but is predicted to spur contraction in Denmark, Finland, Norway, Serbia and Sweden. Such heterogeneity may well be the result of domestic demand contributions,

Figure 2.21 Contribution to GDP growth in 2012



Net exports calculated from export and import data. For Norway trade data include traditional goods and services (excluding petro and shipping)

Figure 2.22 Contribution to GDP growth in 2013



Net exports calculated from export and import data. For Norway trade data include traditional goods and services (excluding petro and shipping)

Figure 2.23 Private consumption
year over year growth

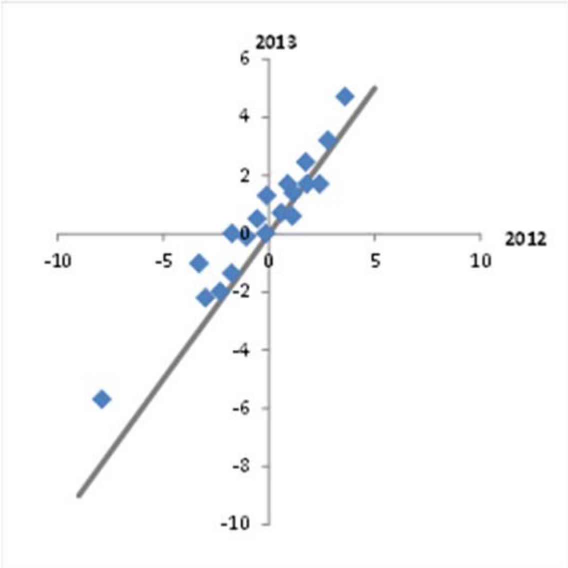
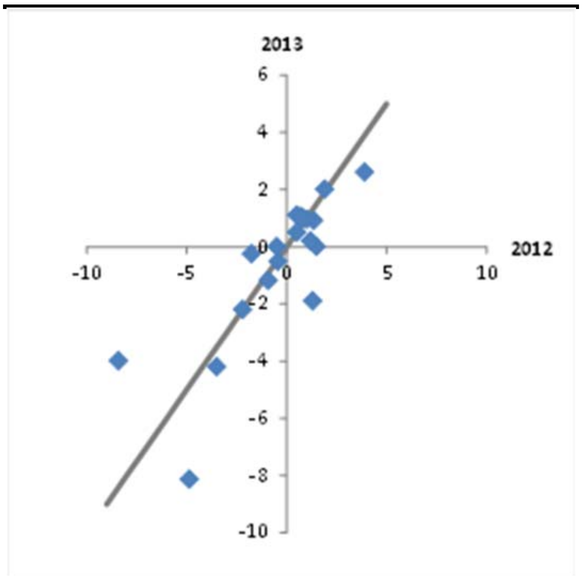


Figure 2.24 Public consumption
year over year growth



affecting imports. Private consumption and investments are expected to decline in the former group of countries, while the latter economies are expected to benefit from domestic demand components.

Figures 2.23-2.26 show that institutes expect the rate of growth of private demand components in their countries to increase in 2013 in comparison to 2012, while public consumption is forecasted to contribute to growth in a similar extent in both years. Net exports are predicted to contribute less to growth in the year to come, potentially owing to increasing domestic demand for foreign products.

Figure 2.25 Gross Fixed Capital Formation
year over year growth

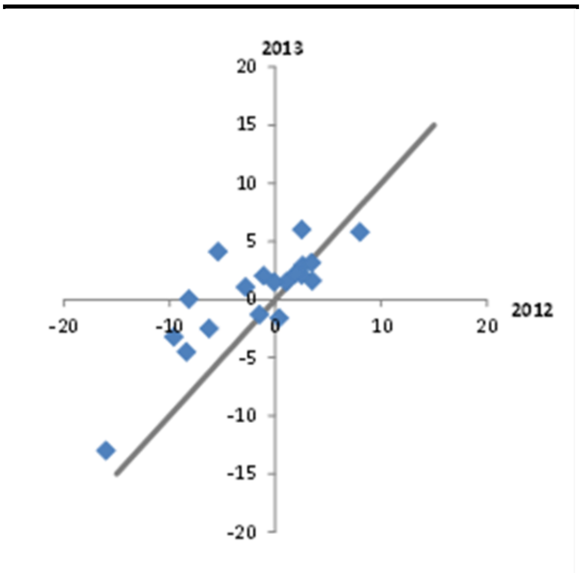


Figure 2.26: Net exports
contribution to growth

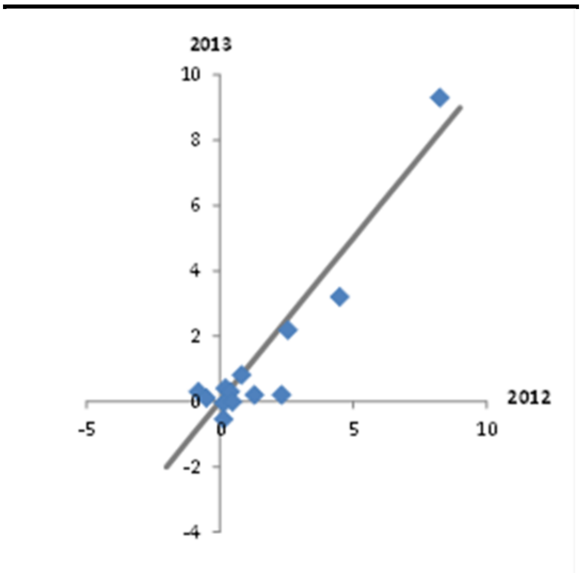
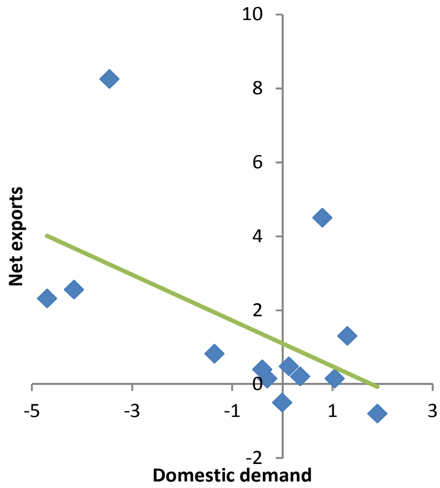
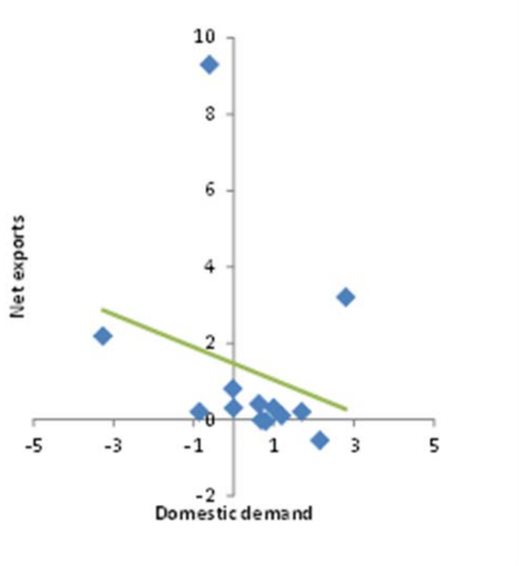


Figure 2.27: Net exports versus domestic demand 2012



Net exports as per cent of GDP of previous year (contribution to growth)

Figure 2.27: Net exports versus domestic demand 2013



Net exports as per cent of GDP of previous year (contribution to growth)

Table 2.1 Risks affecting growth forecast

	Own Country	EA and EU
FPB		EA: • Escalation of euro crisis • China hard landing • Oil price surge • US fiscal cliff
IRES	• Consumers' and business confidence • International economic slowdown limiting exchanges • Evolution of commodity prices	EA: • Consumers' and business confidence • International economic slowdown limiting exchanges • Evolution of commodity prices
DEC	• Consumers remain very cautious (high saving ratios) • Gradual return to a higher level of confidence	
COE		EA: • Structural adjustment regarding fiscal deficit • Lower inflation will alleviate the burden on private income
IFW	• Continuation of investors' attentism due to an ongoing simmering euro area debt and confidence crisis • Short-term stimulating effect (but long-term harm): Real-estate bubble that pushes housing investment further due to inflation fears	EA: • External environment (US growth slowing; emerging economies struggling to revive growth; high oil prices) • Tight fiscal policy • Accommodative monetary policy, but extraordinary problems • High risk premia in crisis countries, assumed to gradually decline. • Relay on appropriate policies in crisis countries (i.e. implementation of structural reforms and fiscal consolidation programs)

		• If economic policy fails to convince markets: uncertainty and slow/no gradual recovery • Risks for price stability • Raises of de-anchored inflationary expectations (negative impacts in financial markets)
KEPE	• Fiscal measures • Liquidity constraints • Expectations	EA and EU: • Fiscal consolidation measures • Debt crisis in the southern euro area countries
GKI	• unorthodox economic policy of the government (unpredictability of economic policy measures) • Low business and household confidence	• Management of the sovereign debt crisis in the EMU • Management of the government debt in the US • Deceleration of GDP growth in China • Increase of oil prices
KOPINT-TARKI	• Impacts of fiscal policy (fiscal restrictions) • Muted investment due to incalculability of economic policy • Restrained private consumption due to high unemployment and growing uncertainties concerning labor market outlooks • Volatile exchange rate (uncertainties concerning the IMF agreement) • Sluggish growth in major trade partners will dampen export outlooks	EA: • unsolved debt crisis • Delayed responding to problems and increasing diversion of national interests will have a delaying effect on investors' activity • High unemployment will dampen private consumption • Fiscal restrictions EU: • Slow growth in new Member States • High unemployment • Fiscals restrictions • Fiscal imbalances • Rising inflation Sluggish external outlook
ESRI	• Performance of exports • In 2013: some possible contribution from a return to investment growth • Weak European economic growth	
CONFIN-DUSTRIA	• Effects of fiscal tightening (3.2% of GDP in 2012 and additional 1.1% in 2013; expected to lower GDP growth by at least 2 percentage points in 2013/2013) • Persisting tight credit conditions • Slowdown in global demand and trade • Deterioration of the labor market with rising unemployment and low income growth	EA: • Tight budget policies • Tight credit conditions • High unemployment which makes consumers cautious and encourages savings • Slowdown in global demand and trade. • Uncertainty with regard to the solution to the sovereign debt crisis (contributing to the deterioration of firms and consumers' confidence)
IBRKK	• Uncertain developments in the Euro Area and Germany in 2013	EA and EU: • performance of the ESM and SSM projects • Durable unemployment • Social unrest in indebted EA countries • Global political and economic factors (instability in the Middle East, changes in energy and food prices, economic slowdown or weak recovery in the US, China, Japan) EU: • (Un)sustainability of the EU cohesion policy and fragility of the EU budget

FTRI	• Contraction in agricultural production • Deterioration of the growth prospects of the EA • Will slow down economic activity and trade	
SKEP	• Outcome of the reform proposals (pension system and labor market) • Implementation of measures to improve and recapitalize banking sector • Privatization • Implementation of fiscal consolidation	EA: • Outcomes from the measures taken in Spain, Italy, Greece • Growth in big countries like Germany and France • Outcome of the measures taken on Euro area level (banking union, economic governance procedures) EU: • Outcome of the euro area • Convergence path of less developed EU countries
CEPREDE	• Uncertainty • Scenario of increased risk premium that forced the ransom request formal: fall in growth rate (more than three points), as a result of both, direct impact of the new measures, induced effect by deterioration of expectations. • Scenario of rapid correction of risk premium and clarification of the amount of public budget adjustment: revive domestic demand using accumulated financial resources	EA: • Extension of sovereign debt crisis and the way out of some country from the EMU
CSE	• Weak export demand, mainly from the EA • Appreciation of the Swedish krona	EA: • Fiscal consolidation and weak GDP growth • How the euro crisis is handled • Partial breakup of the EA would most likely have significant negative effects • Monetary stimulus stemming from the ECB and the Fed: could potentially buy enough time to fix some of the underlying problems regarding debt levels, productivity and unit labor costs
NIER	• External demand • Disruption in global financial market • Fall in Swedish asset prices, particularly a house price fall (but not extremely high probability).	EA and EU: • Uncertainty • Contractionary fiscal policy • Weak external demand • Same factors hold back growth in 2013, but to a lesser extent • Rebalancing of costs within the union will hold back demand
KOF	• See EA • highly exposed to the development in EA	EA and EU: • Uncertainty in EA is gradually reduced when more and more actions and reforms are initiated to solve the crisis (on European and country level) • Due to reduction of uncertainty, investment and consumption should slowly pick up again. • Delayed or insufficient reforms: could increase uncertainty
NIESR	• Evolution of the Euro Area crisis • US fiscal cliff leading to tighter US fiscal policy • Under-estimate of fiscal multipliers both in the UK and the Euro Area	EA and EU: • Evolution of the Euro Area crisis • US fiscal cliff leading to tighter US fiscal policy • Under-estimate of fiscal multipliers both in the UK and the Euro Area

2.2 Inflation

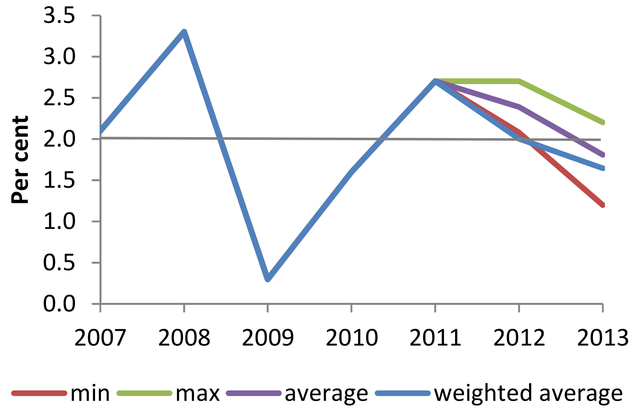
Euro Area and European Union

For the Euro Area as a whole the institutes expect inflation to decelerate over the next two years (Figure 2.29). While institutes forecast only a slight decline for the Euro Area in 2012, the weighted average of national inflation forecasts suggests inflation to already fall below the target line of 2 per cent in this year. This appears surprising, given that inflation recorded 2.6 per cent in the first three quarters of 2012. Hence, institutes rather expect inflation to decline in their own countries but potentially to a lower extent in other member countries. The weighted average for 2012 is even smaller than the minimum forecast for the Euro Area.

In the EU, this is even more evident (Figure 2.30). The weighted average of country-specific forecasts is even markedly lower than the minimum of EU-wide forecasts.

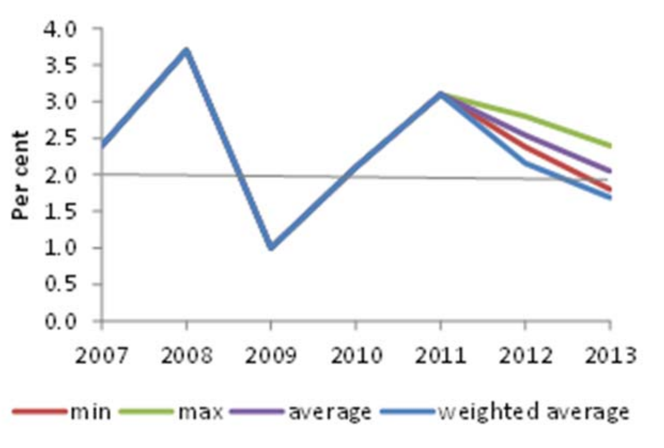
Nevertheless, all AIECE members - except for two institutes - expect inflation to come down in 2012 and further in 2013 both in the Euro Area and in the EU (Figure 2.31).

Figure 2.29 Inflation in the Euro Area



Source: Eurostat, forecast of the AIECE institutes

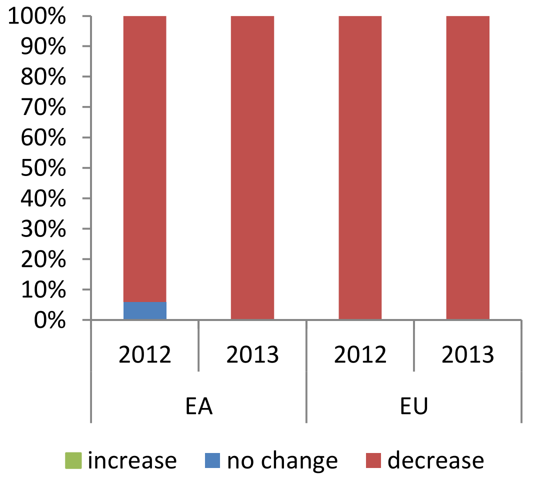
Figure 2.30 Inflation in the European Union



Source: Eurostat, forecast of the AIECE institutes

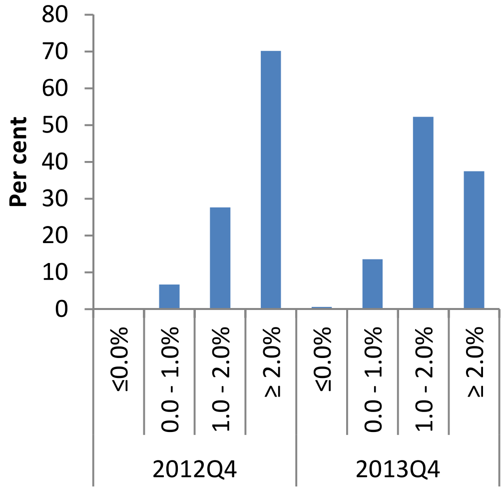
This is in line with the probability distributions that institutes stated in the questionnaires (Figure 2.32). While each institute rules out that Euro Area inflation will fall below 0 per cent, both in the last quarter of 2012 and 2013, the averaged likelihood of inflation being less than two per cent equals more than 30 per cent in 2012Q4 and about 60 per cent in the final quarter of 2013.

Figure 2.31 Increase/no change/ decrease in inflation



Number of forecasts: EA 2012 17/27, EA 2013 17/27, EU 2012 7/27, EU 2013 7/27

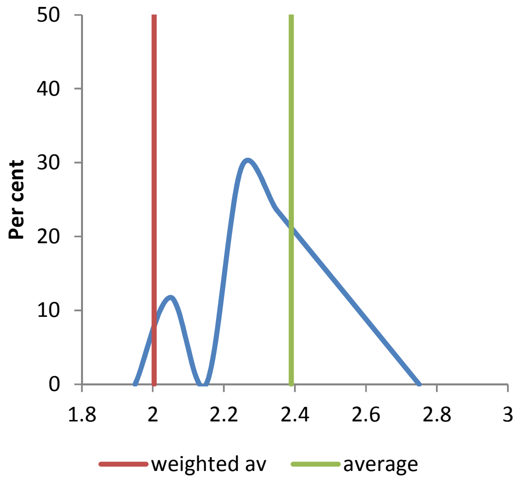
Figure 2.32 Probabilities of inflation in EA



Number of forecasts: 2012Q4 15/27, 2013Q4 15/27

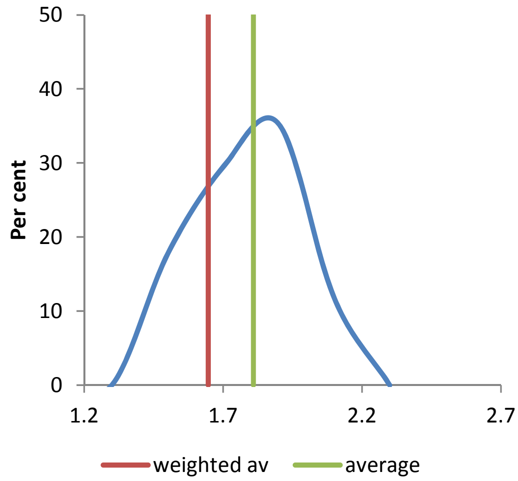
The discrepancy between country-specific and Euro Area/EU-wide forecasts which was foreshadowed by Figures 2.29 and 2.30 can also be seen when looking at Figures 2.33 and 2.34. While the average of Euro Area forecasts records 2.4 per cent, the weighted average of country-specific forecasts equals just about 2 per cent in 2012. Similarly, for the EU, the average of forecasts exceeds the weighted average by 0.4 percentage points.

Figure 2.33 Distribution of forecast of inflation for EA in 2012



Number of forecasts: 17/27

Figure 2.34 Distribution of forecast of inflation for EA in 2013



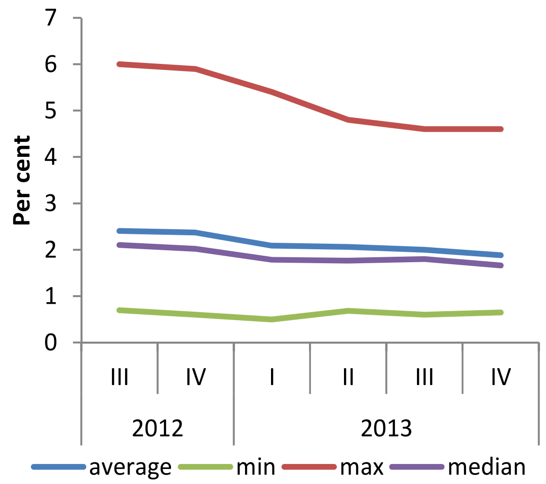
Number of forecasts: 17/27

AIECE countries

Quarterly forecast

Focusing on institutes country-specific forecasts, the quarterly profile illustrates that on average AIECE members expect inflation to come down continuously from 2.4 in the third quarter of 2012 to 1.9 per cent in the last quarter of 2013 (Figure 2.35). However, the volatility of forecasts is large. The minimum of country-specific forecasts expects inflation to be less than 1 per cent until the end of 2013 (Sweden in 2012; Poland in 2013), while in Hungary, GKI expects inflation to not fall below 4.5 per cent until the end of 2013. However, the median forecast is only slightly lower than the average over the forecasting horizon, suggesting that high and low inflation forecasts level out.

Figure 2.35 Quarterly inflation in AIECE countries

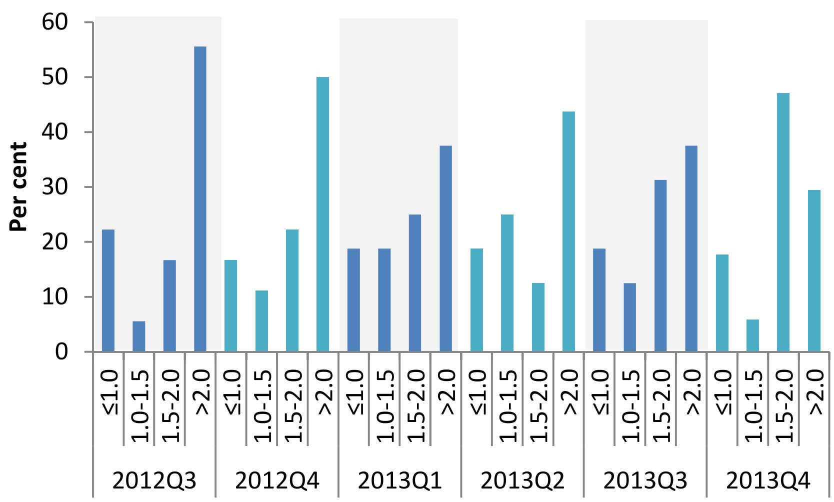


Number of forecasts: 2012 18/27, 2013 Q1-Q3 16/27, 2012Q4 17/27

This tendency is also shown in Figure 2.36. While more than 50 per cent of participating institutes expect inflation to be above 2 per cent in the third quarter of 2012, this figure decreases over the forecasting horizon. In the last quarter of 2013 no more than 5 out of 17 institutes predict inflation to exceed 2 per cent in their own country. For the last quarter of 2013, almost 50 per cent of AIECE members expect inflation to be in a range between 1.5 and 2 per cent. Over the whole forecasting horizon, however, institutes expecting inflation to fall below 1 per cent in their country form the minority.

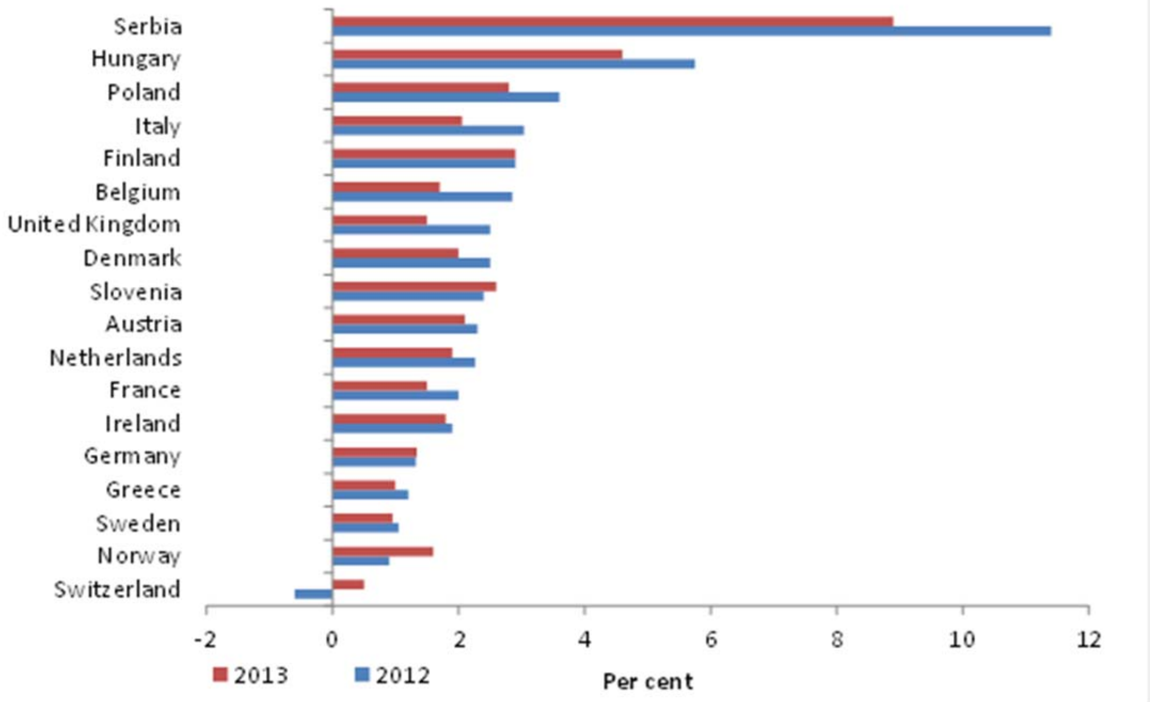
A detailed survey of country-specific inflation forecasts for 2012 and 2013 can be seen in Figure 2.37. Except for Slovenia, Germany, Switzerland and Norway, inflation is forecasted to be lower in 2013 than in 2012. Moreover, the range of inflation forecasts is perceivably lower than in 2012 (see also Figures 2.38 and 2.39). Interestingly, countries with high inflation in 2012 are predicted to reduce inflation in 2013 by more than countries with lower inflation in this year. Such tendency of convergence is especially true for Serbia, Hungary, Poland, Italy, Belgium and the UK. Except for Poland, institutes from these countries on average expect inflation to decline by more or equal to 1 per cent in 2013. In turn, the Switzerland and

Figure 2.36 Frequency distribution of quarterly inflation of AIECE countries



Number of forecasts: 2012 18/27, 2013 Q1-Q3 16/27, 2012Q4 17/27

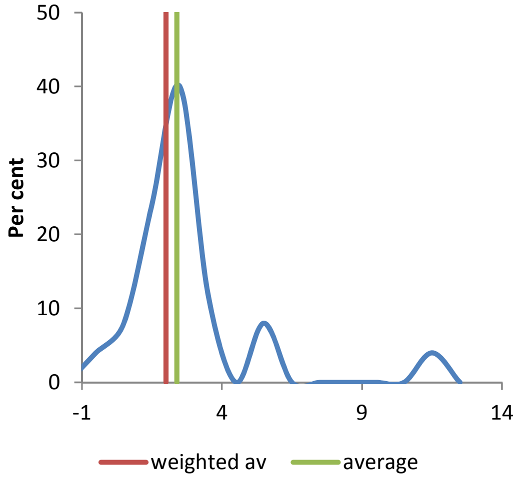
Figure 2.37 Inflation in AIECE countries



Norway, which are predicted to exhibit the lowest inflation among the surveyed countries in 2012, are expected to have higher inflation in 2013 than in 2012.

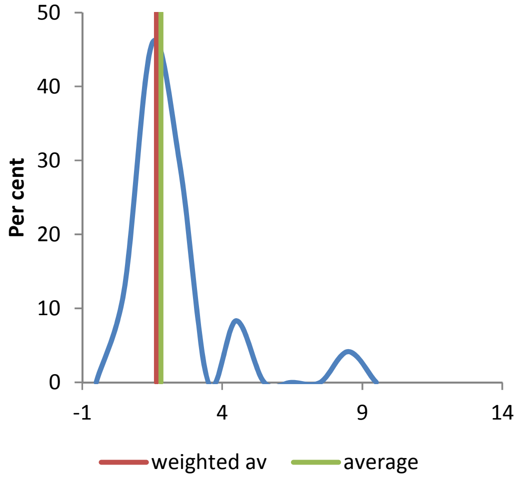
Figures 2.38 and 2.39 illustrate the distributions of country-specific inflation forecasts for the years 2012 and 2013. The forecasts look very similar to a normal distribution in both years. As foreshadowed by Figure 2.37 forecasts are less volatile in 2013.

Figure 2.38 Distribution of the inflation forecasts in the AIECE member countries,2012



Number of forecasts: 25/27

Figure 2.38 Distribution of the inflation forecasts in the AIECE member countries, 2013



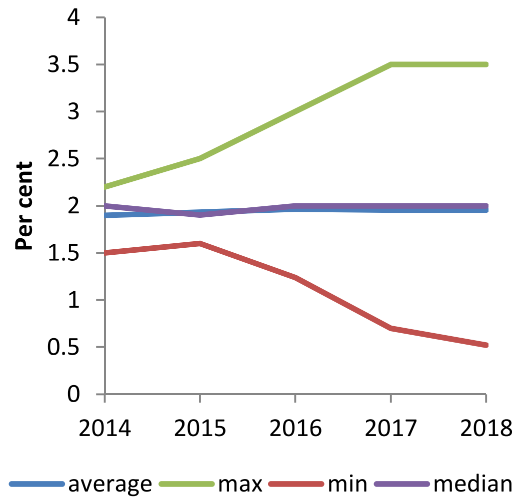
Number of forecasts: 24/27

Long-term forecast

Long-term inflation expectations strongly reflect the assumption that inflation reverts to its target. This suggests that institutes believe monetary policy to be effective in reaching its long-term benchmark. However, there are institutes that highly deviate from that view, although outnumbered. First, one out of 13 institutes expects inflation to increase steadily in the Euro Area, with inflation being about 3.5 per cent in 2018. On the contrary, there are less than a handful of AIECE members, which predict inflation to decline continuously, coming down to only 0.5 per cent in 2018. Hence, among the AIECE members, there are two extreme views regarding the medium- and long-term inflation development.

Focusing on the frequency distribution of forecasts on the Euro Area (red bars in Figure 2.41), it turns out that almost every institute expects inflation to exceed 1 percent throughout the medium and long term. While the responses are fairly homogenous, there seems to be a break between expectations for the medium term (2014-2015) and the long term (2016-2018). In the medium term the shares of institutes forecasting inflation below and above 2 per cent are about the same. In the long term however, a vast majority of more than 60 per cent expect inflation to exceed 2 per cent. Nevertheless, in the long term one institute comes up with an inflation forecast even below 1 per cent. What is more, forecasts for 2016-208 are more volatile than in the medium term, potentially owing to larger uncertainty,

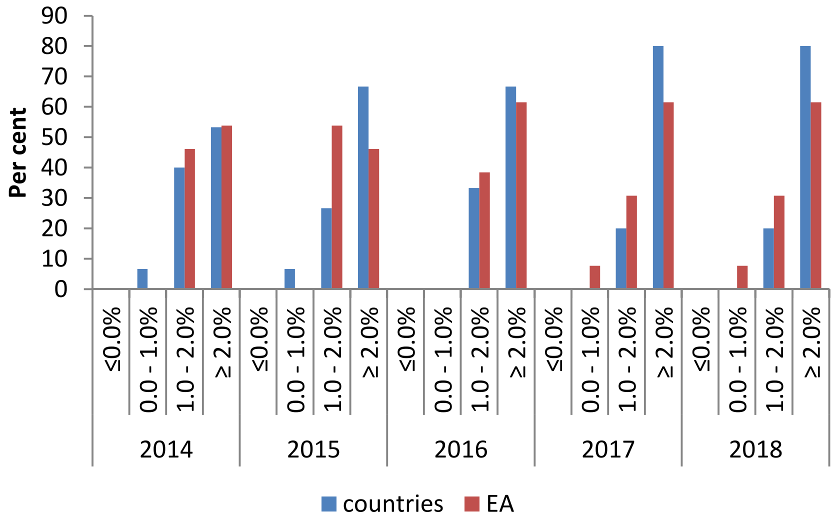
Figure 2.40 Long-term inflation in EA



Number of forecasts: 13/27

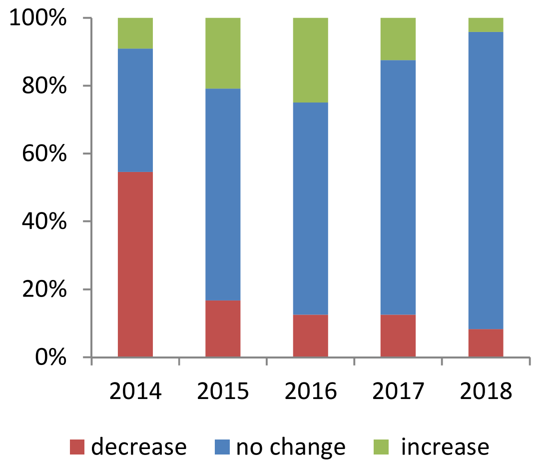
Country-specific forecasts provide an even clearer picture. Over the years, a larger fraction of members predict inflation rates to be above 2 per cent in their countries, while the share of members forecasting inflation to fall below 2 per cent gradually decreases from more than 40 per cent in 2014 to less than 20 per cent in 2018. Inflation below 1 per cent in 2017 and 2018 is excluded by each institute.

Figure 2.41 Frequency distribution of long-term inflation



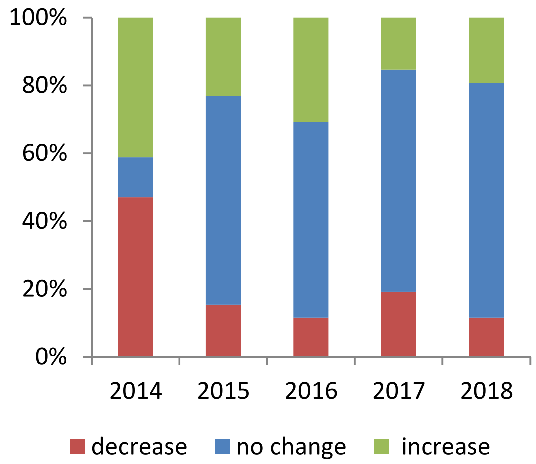
Number of forecasts: 15/27 for countries, 13/27 for EA

Figure 2.42 Increase/ no change/ decrease in long-term inflation in EA



Number of forecasts: 13/27

Figure 2.43 Increase/ no change/ decrease in long-term inflation in the single countries



Number of forecasts: 15/27

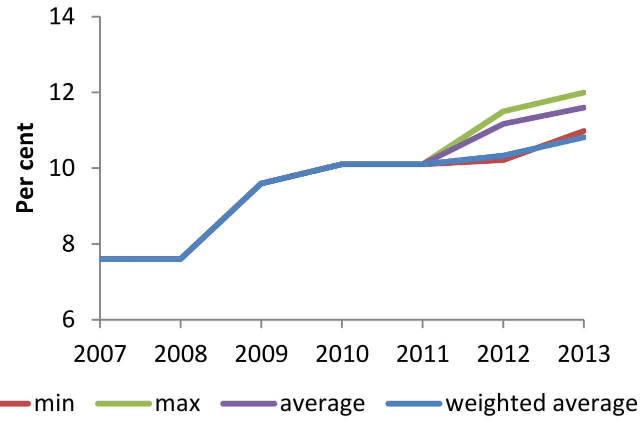
Analyzing the consistency between country-specific and Euro Area-wide forecasts, it sticks out, that institutes rather expect growing inflation in their countries over the years, but to a lower extent for the Euro Area as a whole.

Figure 2.42 illustrates institutes' qualitative assessments on the development of inflation. For the Euro Area, AIECE members believe inflation will not change distinctly over the years to come. The fraction of institutes that expect increasing annual inflation first increases until 2016 but decreases in 2017 and 2018. While the bulk of institutes expects inflation to decrease in 2014, there are only very few AIECE members that forecast declining Euro Area inflation from 2015 onwards.

The country-specific views are quite similar, but also express the result foreshadowed in Figure 2.41: For their own countries inflation is rather expected to increase than in the Euro Area as a whole. While each a fraction of about 40 per cent expects inflation either to decrease or to increase in 2014, the number of institutes that expect inflation to increase in 2015-2018 exceeds the number of institutes that forecasts declining inflation. Nevertheless, a vast majority does not expect inflation to change notably from year to year in the period 2015-2018.

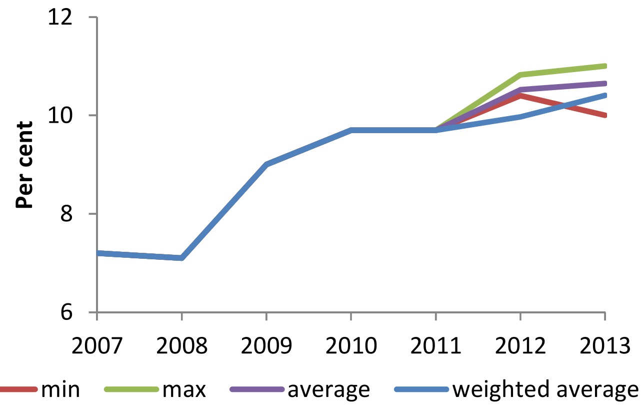
Euro Area and European Union

Figure 2.44 Unemployment rate in Euro Area



Source: Eurostat, forecast of the AIECE institutes

Figure 2.45 Unemployment rate in the European Union



Source: Eurostat, forecast of the AIECE institutes

Unemployment has increased markedly during the crisis in 2009. While it did not come down since then, this trend decelerated in the last two years. However, in line with the economic downturn in the Euro Area, AIECE members expect the Euro Area unemployment rate to increase again in 2012 and 2013 (Figure 2.44). Even the most positive view expresses rising unemployment over the forecasting horizon. Interestingly, the average of Euro Area forecasts is not fully consistent with the GDP-weighted average of country-specific forecasts in that the country-specific view is more positive than the Euro Area view.

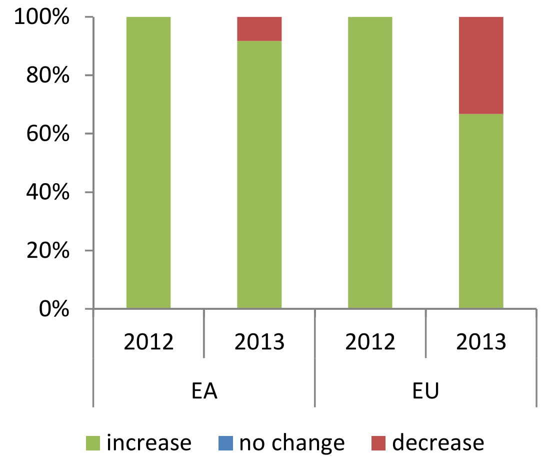
Looking at the EU (Figure 2.45), forecasts for 2012 express a worsening of labor market conditions similar to the Euro Area. As in the Euro Area, this development is expected to proceed, but at a decelerated speed. According to the most positive forecast, unemployment is even expected to decline in 2013. While EU-wide predictions are slightly more positive than forecasts for the Euro Area, again the weighted average of country forecasts is a bit at odds with forecasts for the EU. Especially for 2012, country-specific expectations are even considerably less negative than the most optimistic forecast for the EU. Naturally, this may be an artifact since several EU countries are not covered by the AIECE.

In line with figures 2.44 and 2.45, all institutes expect unemployment rates to increase in the Euro Area and the EU in 2012. For 2013, at least 11 out of 12 and 4 out of 6 institutes predict an improvement of labor market conditions in the Euro Area and the EU, respectively (Figure 2.46). Interestingly, not a single institute expects unemployment rates to stabilize in 2012 or 2013.

Figures 2.47 and 2.48 indicate that in contrast to the rather bad outlook for the Euro Area and EU as a whole, institutes view their own countries less pessimistic (see the red and the green bars in Figures 2.47 and 2.48). For 2012, the weighted average of country-specific forecasts is less pessimistic than all but one forecast for the Euro Area. This is very similar for 2013, with only two institutes being more optimistic on the Euro Area than the forecast calculated from the weighted average of country forecasts.

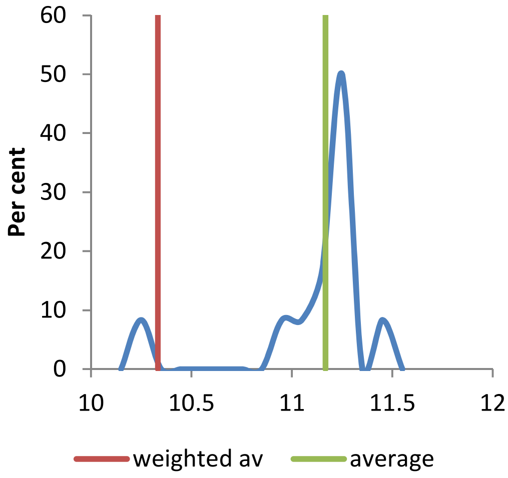
As for GDP and inflation, unemployment forecasts are relatively normally distributed, where forecasts are less volatile in 2012, likely owing to larger uncertainty in 2013. For 2012, 10 out of 12 institutes expect unemployment to be in a range between 11 and 11.5 per cent. For 2013, 9 out of 11 institutes expect unemployment to range between 11.2 and 12 per cent.

Figure 2.46 Increase/ no change/ decrease in unemployment rate in EA and EU



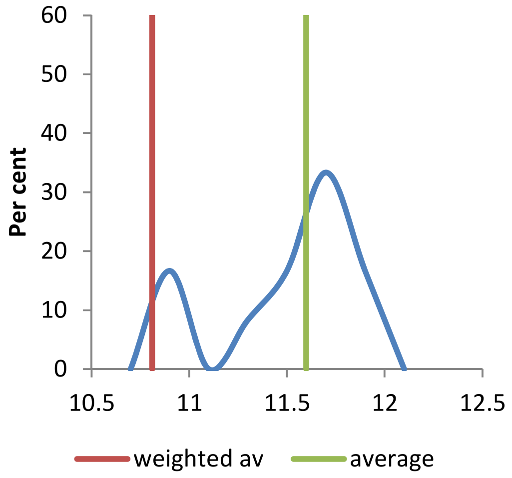
Number of forecasts: EA 12/27, EU 6/27

Figure 2.47 Distribution of forecast of unemployment for EA in 2012



Number of forecasts: 12/27

Figure 2.48 Distribution of forecast of unemployment for EA in 2013



Number of forecasts: 11/27

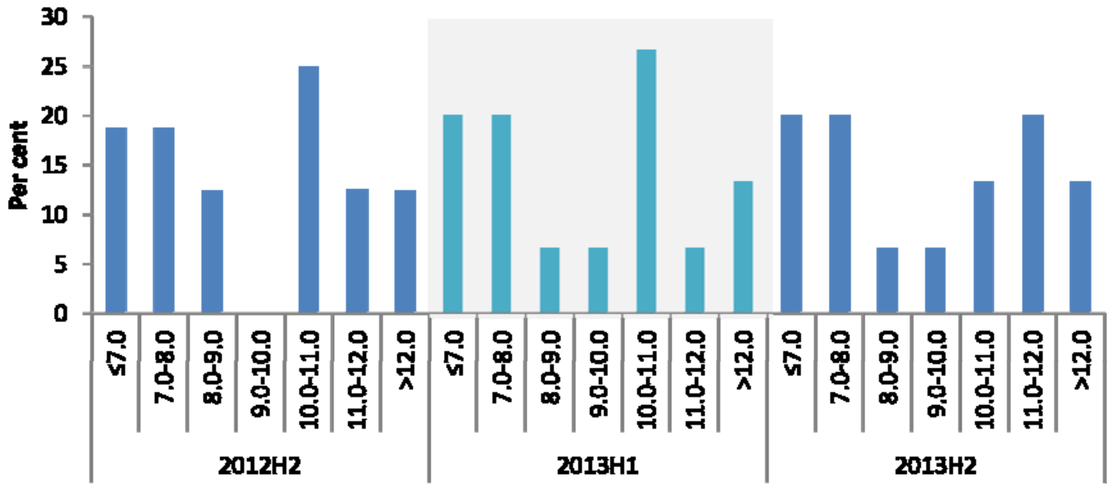
AIECE countries

Quarterly forecast

Focusing on the unemployment forecasts for the single countries, a vast majority of AIECE members expects unemployment to grow in 2013 compared to 2012. Among those, expected increases range between 0.1 percentage points in Germany to 1.2 percentage points expected for Greece. Only in Ireland, Hungary and Serbia the unemployment rates are forecasted to decline in the year to come (see Table 2.2). While this suggests a further worsening of labor market conditions throughout Europe in 2013, this is not true. Given the latest unemployment figures for August and September 2012, for Greece, Ireland and Hungary it is expected that unemployment will decline in 2013, and in Spain institutes expect that unemployment will at least not increase further in 2013. In turn for countries with lower unemployment rates such as Norway, Switzerland, Germany, the Netherlands and Austria the rates are predicted to increase on average during the next year. Hence, given the latest releases, forecasts of AIECE members suggest rather convergence than further divergence of unemployment rates.

Looking at Table 2.2 in combination with the distribution of country-specific unemployment forecasts (Figures 2.50 and 2.51) we can detect five groups of countries. In Austria, Denmark, Germany, Norway, Switzerland unemployment rates are below five per cent and the respective institutes do not expect that unemployment rates will exceed that threshold over the short forecasting horizon. The second group is among Belgium, Sweden, Finland, the UK and Slovenia with unemployment forecasted between 5 and 10 per cent in 2012 and 2013. A third group includes Poland, France, Italy and Hungary with the forecasts ranging between 10 and 15 per cent, while the fourth group only consists of Ireland with unemployment predicted at around 15 per cent in 2012 and 2013. Last, in a fifth group there are Serbia, Spain and Greece struggling with very high and fast growing unemployment rates. While institutes from Spain and Greece forecast unemployment rates to remain above or close to 25 per cent in 2013, their forecasts imply unemployment reduction during 2013.

Figure 2.49
Frequency distribution of unemployment rate



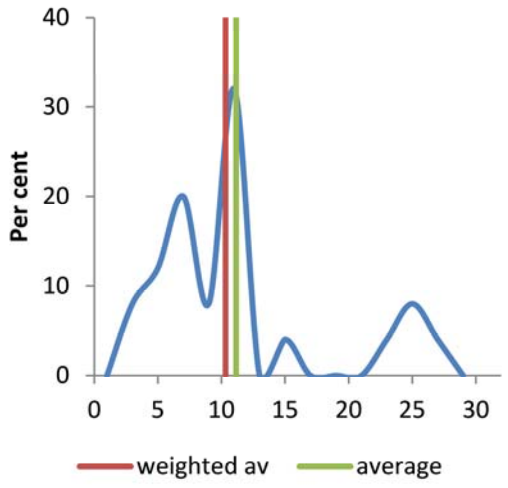
Number of forecasts: 2012 16/27, 2013 15/27

Table 2.2 Unemployment rate in AIECE countries

	Jan 12 - Aug 12	2012	Aug 12	2013
Norway*	3.1	3.1	3.0	3.3
Switzerland**	2.8	3.1	2.8	3.3
Germany	5.6	5.3	5.5	5.4
Austria	4.3	4.4	4.5	4.8
Netherlands**	5.1	5.3	5.4	5.9
Belgium	7.3	7.2	7.4	7.5
Sweden**	7.6	7.7	7.8	8.0
Finland**	7.6	7.7	7.9	8.0
United Kingdom*	8.1	8.2	7.9	8.5
Slovenia	8.3	8.3	8.4	9.0
Poland	10.0	10.2	10.1	10.5
France	10.3	10.5	10.6	11.0
Italy	10.4	10.7	10.7	11.7
Hungary*	11.0	11.0	10.7	11.0
Ireland	14.8	14.9	15.0	14.4
Greece*	23.2	23.5	25.1	24.7
Spain	24.4	24.7	25.1	25.2
Serbia	na	27.2	na	26.4

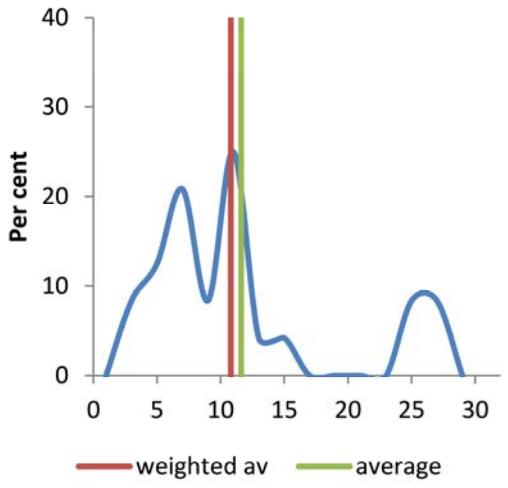
Source for Data Jan 12-Aug 12: Eurostat, *July. **September

Figure 2.50 Distribution of forecast of unemployment for countries in 2012



Number of forecasts: 25/27

Figure 2.51 Distribution of forecast of unemployment for countries in 2013



Number of forecasts: 24/27

NAIRU

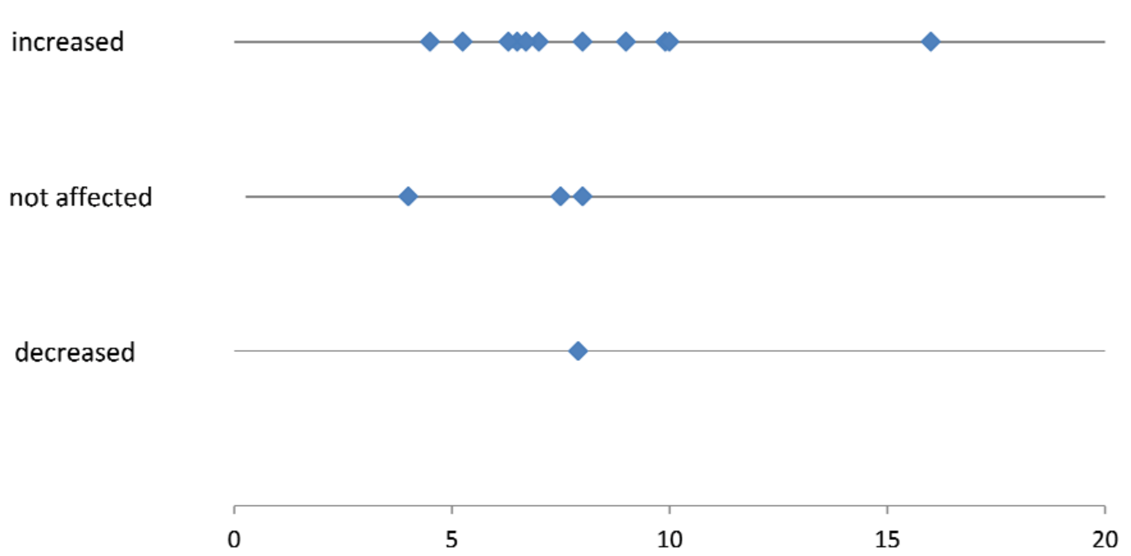
In the questionnaire we asked institutes for their estimations on the natural rate of unemployment before the Great Recession in their country and wanted to know if and how the NAIRU was affected by the crisis. Figure 2.52 shows a scatterplot that relates those two assessments to each other. Not surprisingly, a vast majority of 14 out 20 institutes reported an increasing unemployment rate at normal capacity utilization triggered by the crisis 2008/2009, while only one institute finds a positive effect of the crisis on employment. Figure 2.52 also shows that there is no correlation between the NAIRU initially assessed and the expected effect of the crisis on the development of the natural rate of unemployment. This suggests that the crisis has led to increasing structural unemployment in various countries throughout Europe, but seemingly unrelated to countries' pre crisis natural rates of unemployment.

Labor market reforms

To reduce unemployment in the medium and long term, various governments are taking significant actions aimed at reforming the labor market. Figure 2.53 illustrates institutes' assessments on the elements of current labor market reforms in their countries.

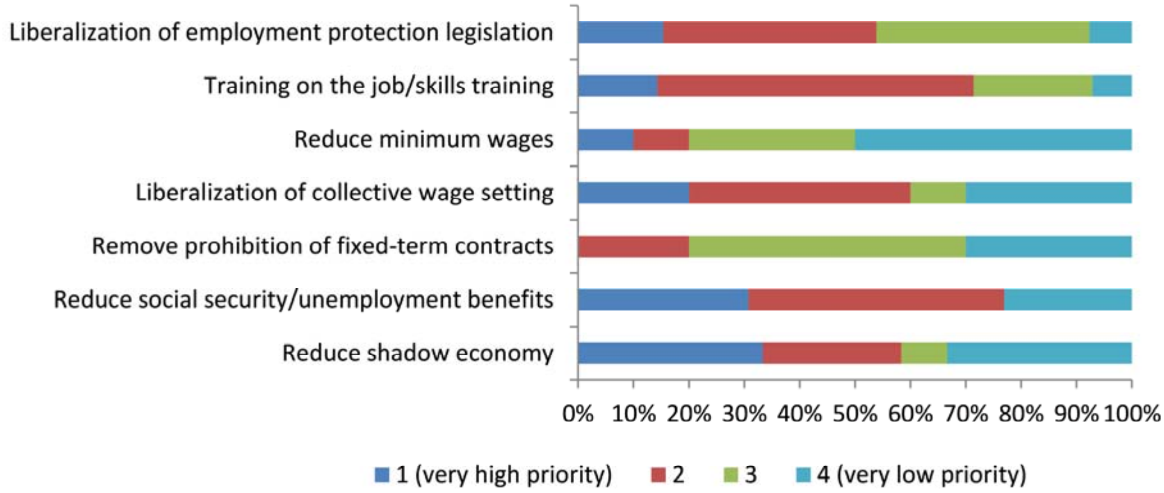
The measures can broadly be grouped into those reforms that (1) aim at increasing employers' incentives for employment and (2) aim at increasing the incentives of unemployed workers to find a job. A large majority of institutes reported that priority is given to reforms that affect the employee side. 11 out of 14 institutes reported that high priority is given to reduction of unemployment benefits. 9 of the 13 responding institutes stated that skills training would be given high priority in their country. On the employer side rather the reforms that aim at reducing administrative barriers and inefficiencies are given priority. At least 7 out of 12 institutes feel that liberalization of employment protection legislation and 6 out of 10 AIECE members think that liberalization of collective wage setting are relevant issues on their governments' labor reform agendas. Fighting the shadow economy seems to be an aspect which is highly relevant in about 35 per cent of the

Figure 2.52 Average NAIRU pre crisis and development during crisis



Number of forecasts: 15/27

Figure 2.53 Priority of labor market reforms carried out in 2012/2013



Number of forecasts for each answer: A1 12/27, A2 13/27, A3 10/27, A4 10/27, A5 10/27, A6 14/27, A7 13/27

countries, while roughly the same fraction does not see their governments to place any weight on that issue. Moreover, it seems that governments largely abstain from reforms which may increase employment but potentially affect employees in a negative way: "Reduction of minimum wages" as well as the "introduction of fixed-term contracts" is hardly chosen to increase employment in the medium and long term.

Table 2.3 gives additional labor market reforms in the host countries of the single AIECE members. Among the various answers, e.g. one can find reforms to increase the age level for retirement as well as attempts to increase labor market flexibility such as liberalization and enhancement of flexibility of wage setting.

Table 2.3 Additional goals of labor market reforms

ETLA	• Increase flexibility of wages and working conditions on enterprise and plant level.
IFW	• Federal government launched an initiative to provide professional training for young immigrants from EA crisis countries.
KEPE	• Legislations towards the liberalization of wage setting and of employment protection are taking place in an effort to increase returns on enterprises and thus productivity.
GKI	• Extensive workfare programs: plans to involve a great number of people in public work schemes (but these schemes cannot create sustainable jobs)
KOPINT-TARKI	• Public work program: the explosion of the number of public workers raises the statistical number of employees and decreases the statistical number of the unemployed, even if the actual labor market situation does not really improve. • Intends to encourage job creation among the SME's, the relatively more labor intensive segment of the Hungarian business sector • Beside the above-mentioned selective cut of social security contributions, an introduction of a new tax system for small and micro-sized enterprises is planned, with a cash-flow income tax for small enterprises and a lump-sum tax for individual entrepreneurs.
CPB	• shift pension-age from 65 to 67

IBRKK	• Starting from the next year, the retirement age would be gradually raised to 67 years for both men and women from current 65 years (men) and 60 years (women). • Initiated the process of access liberalization to licensed professions.
SKEP	main goals of the proposed new Labor Relations Act are: • Provide an appropriate relationship between security of employees and labor market flexibility to reduce the labor market segmentation which is a result of the differences in the statuses of workers employed on fixed-term contracts and those employed on permanent contracts. • Reduction of the differences in rights arising from different forms of contractual agreements and by limiting the grounds for the use of temporary employment contracts. • Ease the transition of workers from flexible to more stable forms of employment, a system will be set up in order to increase the rights of employees, related to the termination of the employment contract, gradually, so as to give the employees fewer reasons to avoid offering long-term employment. • Notice periods will be shortened and will increase progressively up to a certain limit. • Reduction of severance pay. • Simplified procedures for the conclusion and termination of employment contracts. • Simplified disciplinary proceedings, all of which will enhance the effectiveness of labor protection legislation.
CEPREDE	• Share of part-time work should be promoted in coming years as the only way to reduce the huge unemployment rate gap accumulated in last years.
NIER	• Reducing long-term unemployment by increased support to those in labor market programs
NIESR	• Policies to raise aggregate demand (labor market one of the most flexible and lest regulated) • Policies such as training and work experience programs targeted at young people will likely have a positive effect on the target group.

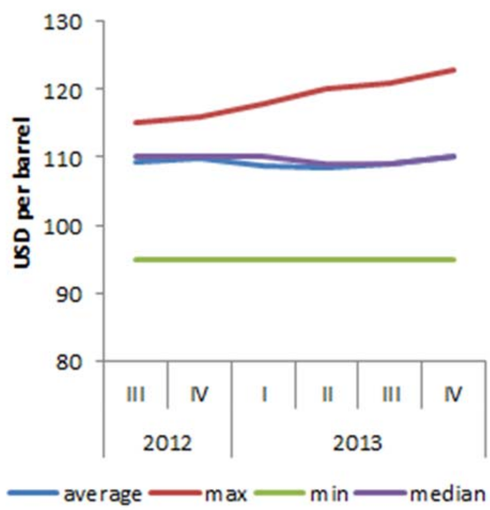
2.4 Oil prices, interest and exchange rates

Oil prices

Regarding the development of oil prices a number of institutes share a technical “no-change-assumption”. Others expect oil prices to continuously increase until the end of 2013 while a third group forecasts oil prices to come down first but to rise again in the second half of next year.

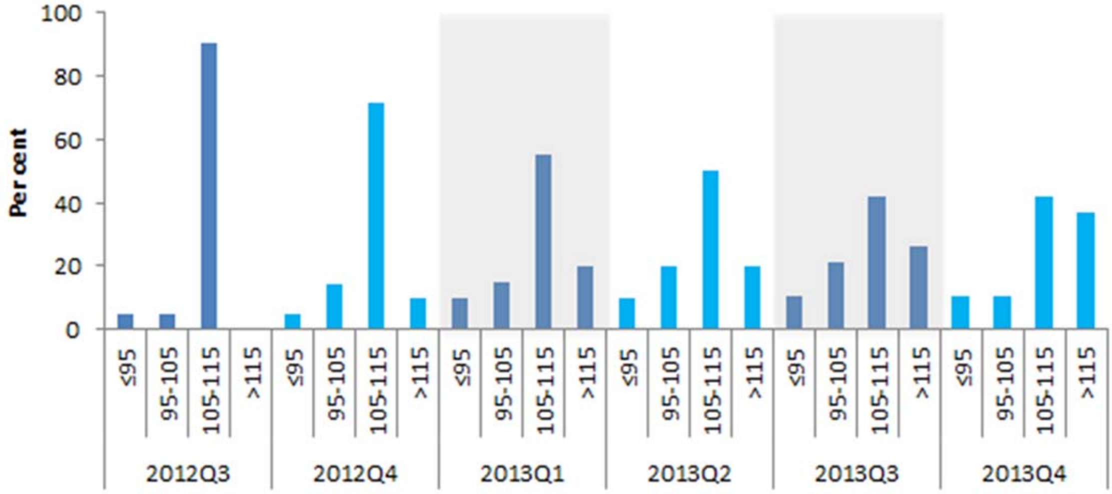
Figure 2.55 illustrates the growing spread of oil price forecasts over the forecast horizon. While about 90 per cent expects oil prices to be in the range between 105 and 115 USD per barrel in 2012 Q3, this is only true for around 40 per cent in 2013 Q3, while 25 per cent either forecast oil prices to exceed 115 or fall below 105 USD per barrel.

Figure 2.54 Oil price forecast (USD per barrel)



Number of forecasts: 2012 Q1-2 21/27, 2013 Q1-2 20/27, 2013 Q3-4 19/27

Figure 2.55 Frequency distribution of forecast for oil price



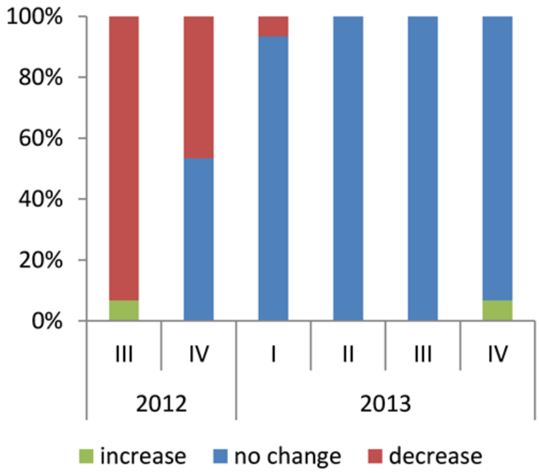
Number of forecasts: 2012 Q1-2 21/27, 2013 Q1-2 20/27, 2013 Q3-4 19/27

Interest rates

With respect to the monetary policy of the ECB, all but one institute expect the ECB to reduce its main refinancing rate shortly. Around half of the institutes expect the ECB to do so – potentially again - in the last quarter of 2012. For 2013, no further interest rate reduction is forecasted (Figure 2.56).

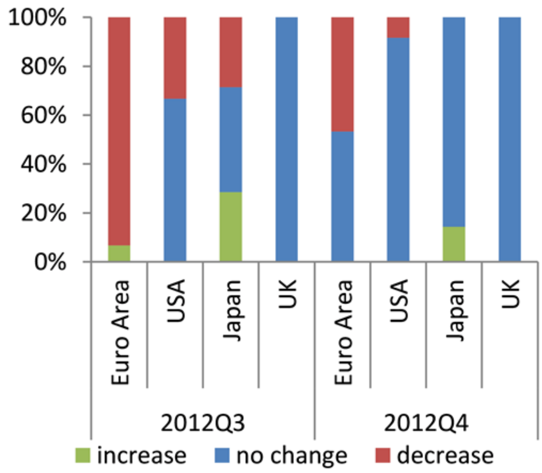
Regarding the UK, no policy change is expected for the second half of 2012. For the US, the Fed is only expected to decrease its main refinancing rate by few institutes. Last, for Japan, the picture is rather mixed for the third quarter, and most of the institutes expect no change in the fourth quarter (Figure 2.57).

Figure 2.56 Increase/ no change/ decrease in main refinancing rate in EA



Number of forecasts: 2012 16/27, 2013 15/27

Figure 2.57 Increase/ no change/ decrease in interest rates



Number of forecasts: EA 16/27, USA 13/27, Japan 8/27, UK 8/27

Exchange rates

Table 2.4 Descriptive Statistics on institutes' exchange rate forecasts

1 Euro = x $	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Average	1.250	1.262	1.262	1.262	1.263	1.261
Std. dev.	0.018	0.027	0.038	0.043	0.047	0.048
Max	1.300	1.310	1.330	1.350	1.370	1.360
Min	1.230	1.220	1.176	1.166	1.161	1.147

1 £ = x Euro	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Average	1.255	1.249	1.249	1.244	1.236	1.239
Std. dev.	0.015	0.017	0.015	0.018	0.033	0.037
Max	1.270	1.270	1.270	1.270	1.270	1.280
Min	1.230	1.220	1.230	1.220	1.176	1.177

1 $ = x Yen	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Average	79.201	78.924	79.567	80.071	81.030	81.712
Std. dev.	1.430	1.086	1.338	2.318	3.119	4.116
Max	82.100	80.100	81.460	84.000	87.000	90.000
Min	76.570	77.300	78.000	78.000	78.000	78.000

Table 2.4 shows summary statistics of institutes' views regarding the development of exchange rates. On average, the Euro is expected to appreciate against the Dollar until the end of this year. For 2013, the rate is expected to remain broadly stable on average. However, the volatility of forecasts increases over the quarters.

As against the Dollar, the Euro is also expected to appreciate against the British Pound, and even continuously until 2013 Q3. Again, the standard deviation of forecasts increases over the quarters of 2013.

Last, the Dollar is predicted to appreciate against the Yen, at least during 2013. However, it seems that uncertainty is high since the standard deviation proliferates from quarter to quarter in 2013.

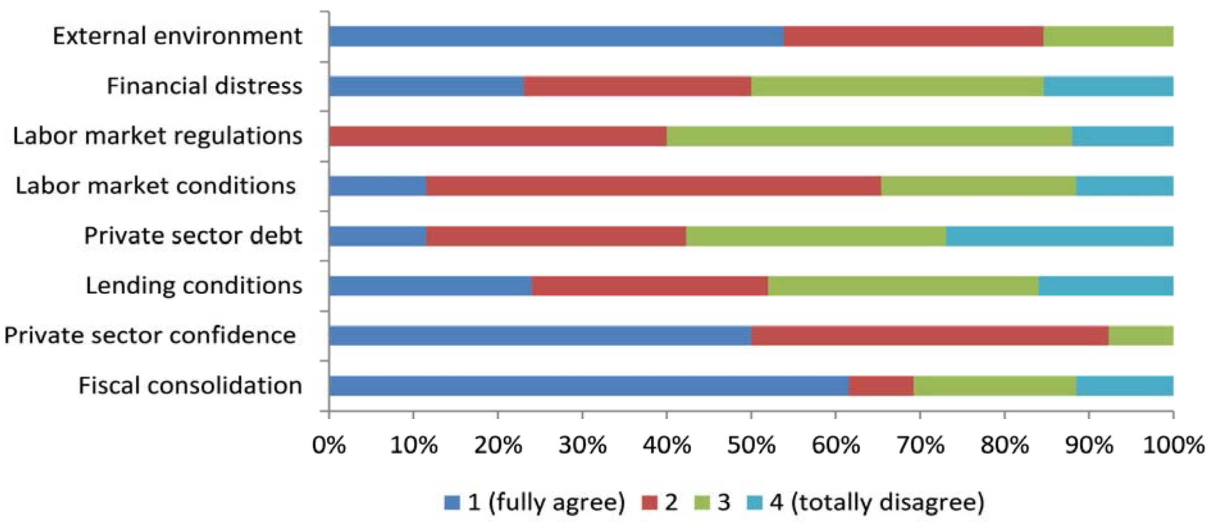
3. ECONOMIC DEVELOPMENTS AND RESPONSES TO THE CRISIS

Subsequently various aspects will be discussed, how economic policy in the European Union should react to the Euro crises. Of course, the most elegant way would be to grow out of the crises. Therefore factors hampering growth are in the focus of the first part of this chapter. However, although nobody will deny that growth is important, much diversity about the remedies that will help comes out of the questionnaires. A second response to the crisis is to make public debt more sustainable (Chapter 3.2). Again, interesting differences appear in the evaluation of different measures on a European and on a national level. Measures proposed tor the Euro area as a whole are often considered to be less effective for the own country et vice versa. A third aspects in the chapter relates to monetary policy and to the financial sector (Chapter 3.3). Here, firstly the Outright Monetary Transactions announced in September by the ECB area evaluated. But we also focus on effects of public default, in particular the contagion effects it might trigger, and on the proposals for a banking union.

3.1. Factors hampering growth

The recovery after the 2008/09 recession has been sluggish in many countries. This gives reason to assume that the financial crisis has also influenced potential output. Either, the capital stock has been partly devalued, leading to a lower output level, or trend growth has been reduced. In the worst case, both things happened at the same time. In the questionnaire, the AIECE has been asked therefore, what factor they think will hamper growth in their countries. Among the factors we presented, most institutes answering

Figure 3.1 Evaluation of factors hampering growth in 2012-2013 in AIECE countries



Number of forecasts for each answer: A1 26/27, A2 26/27, A3 25/27, A4 26/27, A5 26/27, A6 25/27, A7 26/27, A8 26/27 fully agreed that fiscal consolidations hampers growth in their countries. Equally important seems to be the unfavorable external environment and the poor private sector confidence. None of the institutes answering totally disagreed to these two arguments. In view of the high priority which is given to structural reforms in the labor markets as a measure to foster growth, the reception of labor market regulations as an obstacle to growth is surprisingly weak. None of the institutes answering agreed fully to this argument; and the share of those who disagreed at least partly is above 50%.

In addition to the factors we proposed in the questionnaire, many institutes gave further arguments for the weal growth performance in their countries. Some are variants of the factors already mentioned. Thus, two institutes pointed at more differentiated influences from the international environment. In particular, weaknesses in Intra-EU-trade hamper growth, whereas Extra-EU-trade means a smaller problem. Other factors mentioned additional reflect above all the specific situation in some countries.

Table 3.1 Additional factors hampering growth in 2012-2013 in AIECE countries

ETLA	• High inflation and relating modest growth in purchasing power due to tax measures.
COE	• European external environment dampens growth (less the case for extra-euro external environment). • Competitiveness issue critical for the recovery of growth.
IFW	• Low investment spending ratio in overall government expenditure (public capital stock is decreasing causing already problems in businesses heavily dependend on transportation infrastructure).
GKI	• Economic policy is subordinated to political priorities. • Problems: unpredictability, the breaching of legal rules, retroactive legislation, extensive government intervention in the economy according to principle that are not compatible with the market economy, over-taxation of businesses, etc. Corrections are introduced only under external market and institutional pressure.
ESRI	• Weak European growth.
IBRKK	• Stagnating TFP gains.
FTRI	• Low level of private investment and decreasing domestic demand.
SKEP	• Banking system: need of capital support due to the deterioration of the asset quality • In first quarter 2012, non-performing loans rose to near 12% of all outstanding bank loans (concentrated in the non-financial corporate sector).
CEPREDE	• Uncertainty about the final impact of fiscal consolidation and new requirements of the bailout.
NIESR	• Inflation has run ahead of wages over the past four years reducing consumers purchasing power. Sharp depreciation of the exchange rate, the increase in VAT and the oil price explain much of this, but inflation more sticky than expected. • As household saving ratios continue to rise significantly weaker domestic demand growth than currently expected next year.

3.2 Deficit and debt

In many AIECE countries, public finances will not meet the Maastricht criteria in 2012. In 8 out of 19 countries public deficit exceed 3% of GDP. Public debt is even in 11 out of 19 countries above the Maastricht threshold of 60% in relation to GDP. For 2013, the forecast suggest not significant improvement. Concerning deficit, only for xx countries an improvement compared to 2012 is expected, and the debt to GDP ratio will decline only in xx countries.

However, public deficits as well as public debt are difficult to interpret currently. They are not only influenced by the governments' decisions on their current receipts and outlays, but they also reflect special

Figure 3.2: Public sector fiscal balance in 2012 and 2013
in % of GDP

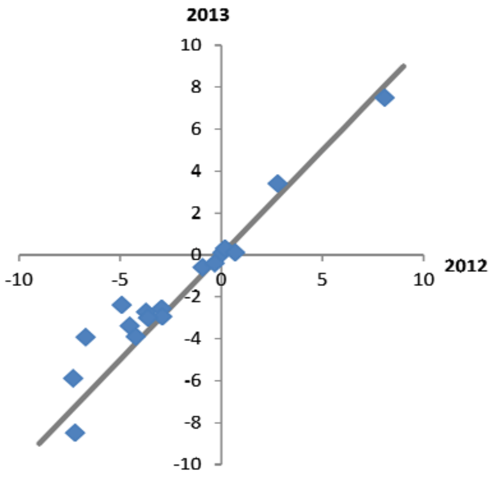
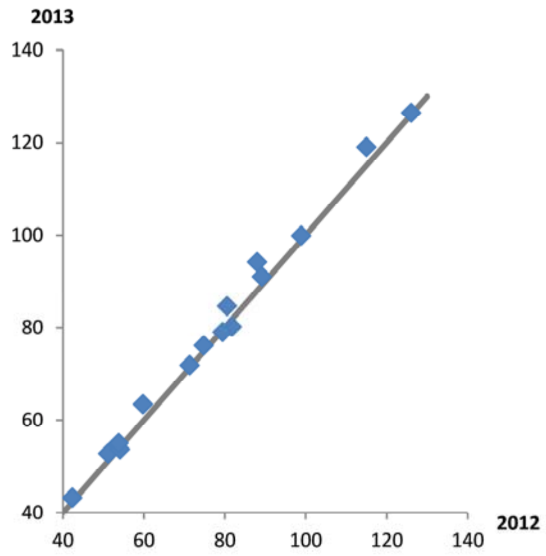


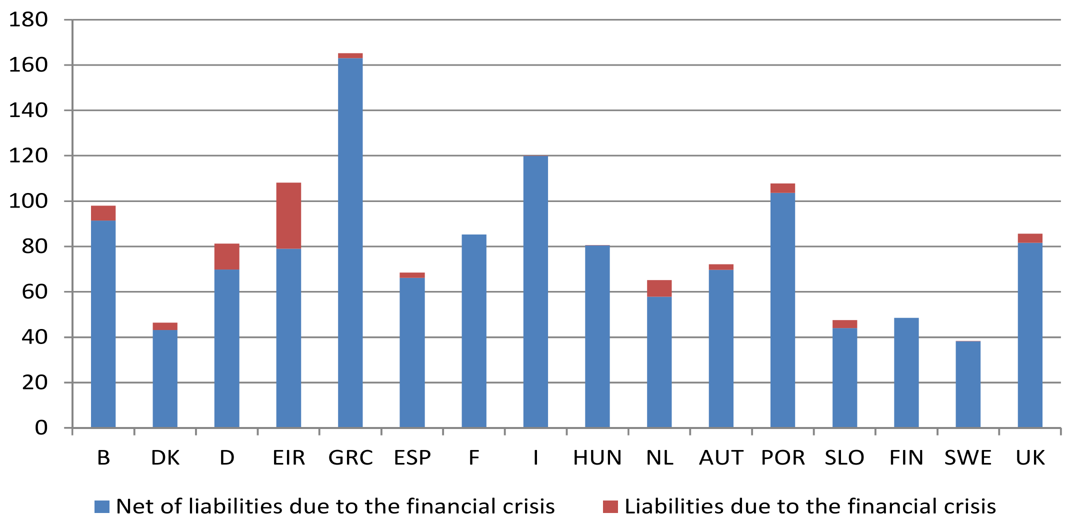
Figure 3.3: Gross public debt in 2012 and 2013
in % of GDP



measures taken by many countries to rescue banks and – up to now to a lower extent – payments made to other EU countries in the context of the European rescue packages; and – not to forget – the decisions of EUROSTAT, how these measures should be treated statistically.

Figure 3.3 makes evident that the impact of measures associated with the financial crisis on the debt to GDP ratio differs quite substantially between the EU countries. In particular in Ireland, but also in Germany they form a substantial part of public debt, indicating that these countries have already made efforts to restructure the banking sector. In some other countries, e.g. in Austria, Belgium, and the Netherlands, the liabilities due to the financial crisis account for a smaller part of general government debt. In some countries, in particular in Greece and in Spain, where the banking sector is still in severe problems, the needs to restructure do not yet fully shine up in the fiscal debt. If the problem is tackled, the debt to GDP ratio can be expected to rise further.

Figure 3.3: Impact of the financial crisis on the debt/GDP ratio
2011, in %

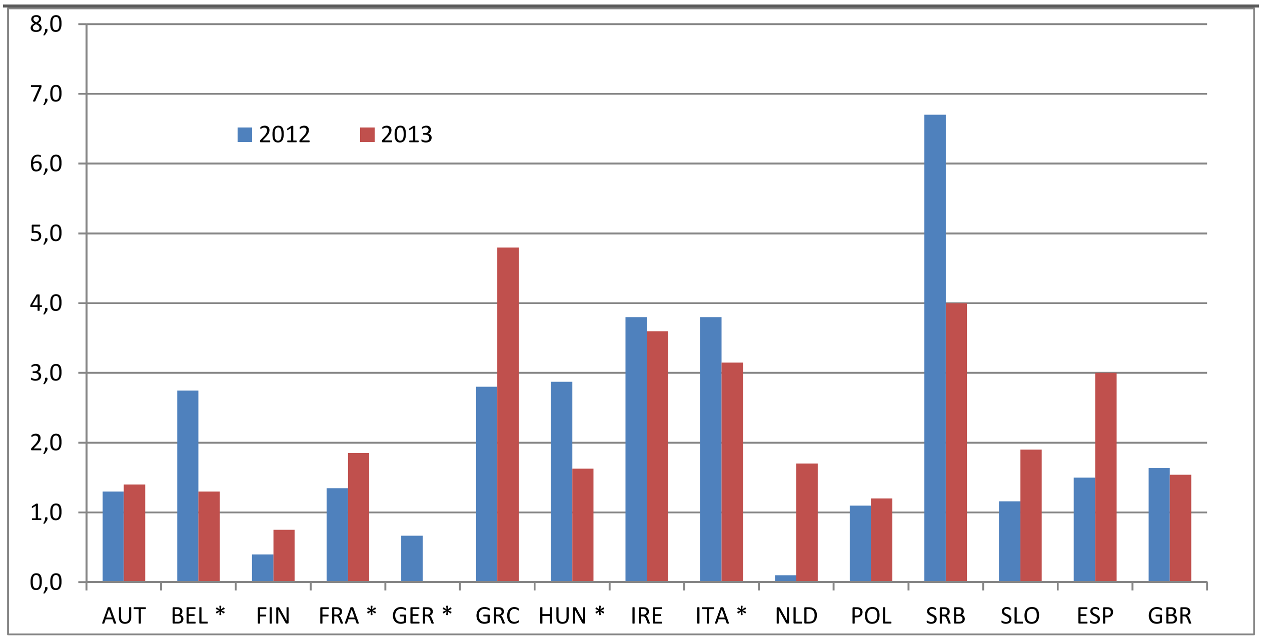


To get more information about fiscal policy stance we included questions on the size and the structure of the consolidation packages, and in their impact on GDP as well as on the fiscal budget. Whereas most AIECE institutes were able to give data on the size of the packages, we were obviously a bit over ambitious concerning the information we asked for on the structure and the impact of the packages. Here, the number if institutes providing concrete figures was significantly smaller, although many gave qualitative information on fiscal policy strategies.

Most AIECE member country's governments implemented fiscal consolidation packages for this year, and they plan to do so in the next (Figure 3.4). One major exception is Sweden which is not part of figure 3.4., since the Swedish institutes did not quantify the measures in terms of % of GDP, fiscal policy will be expansionary, too, with the government increasing investment in infrastructure and reducing corporate taxes. The size of the packages, however, varies significantly between countries. In Germany, where the budget is close to balance, fiscal policy is only slightly restrictive in this year and it will be neutral in the next. In particular in the countries affected heavily by the Euro crisis the consolidation packages reach more than 3% of GDP. But also in Serbia fiscal policy is highly restrictive. On average, the consolidation packages in the AIECE member countries reach 1.6% of GDP (weighted average) in this year and 1.8% in the next year. More or less the same number of countries has planned to intensify and to reduce consolidation efforts.

Only seven institutes were able to provide an assessment of the impact of the fiscal packages on output in their countries. There was consensus among these institutes that fiscal multipliers are smaller than one, meaning that the output will be reduced by less than the original fiscal impulse. Nevertheless, the size of the multiplier differs, the multiplier seems to be small in Spain (fiscal impulse -1.5% resp. -3% of GDP, output -0.6 resp. -1.3 in 2012 and 2013), and higher in France. However, given the small number of observations, it is difficult to say to what extent this reflects differences between countries or a different perception of the institutes.

Figure 3.4: Magnitude of the fiscal consolidation packages 2012 and 2013, in % of GDP



From the AIECE questionnaires – *Averages of the assessments of more than one institute.

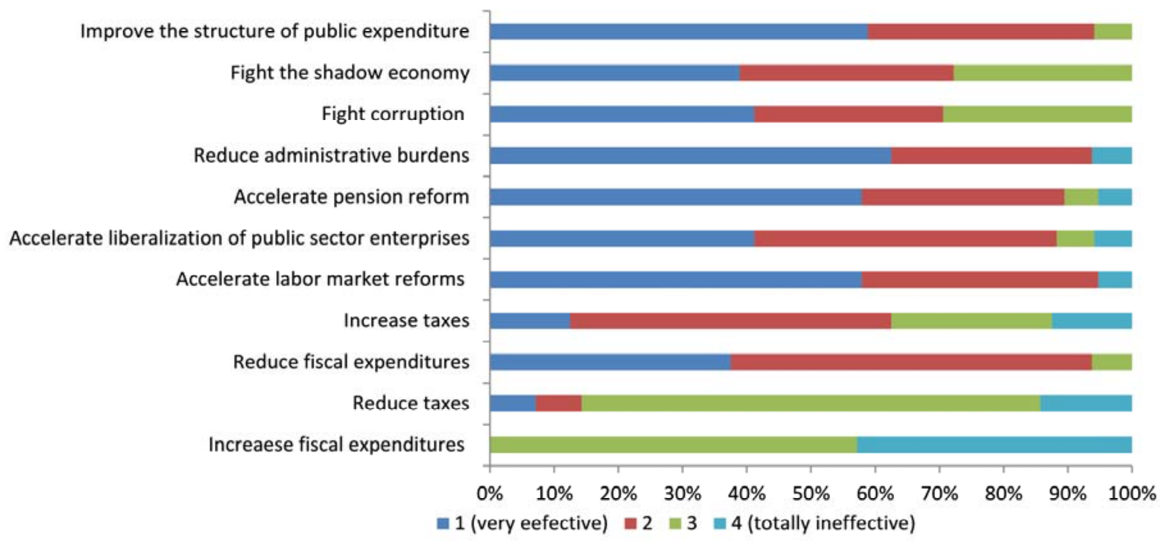
As far as information on the structure of the measures was provided, policy strategies seem to differ between countries as well as over time. In 2012, increasing revenues is the predominant strategy in many countries (Finland, France, Hungary, Ireland, Italy, United Kingdom), Some countries (Slovenia, Spain) focus more on reducing expenditure, whereas others follow a balanced strategy, tackling deficits at the same extent from the expenditure and the revenue side. For 2013, the focus shifts to the expenditure side in Italy and the United Kingdom, whereas higher revenues are expected to contribute more to consolidation in Spain.

Despite of presenting a wide range of different measures, the answers from the AIECE institutes also show some similarities between the countries.

- On the expenditure side, cutting or at least freezing wages in the public sector forms an important part of the consolidation packages in many countries. According the comments in the questionnaire, "special wage regimes" will be cut in Greece. In Slovenia, basics salaries in the public sector will be reduced by 8%. In Spain, the Christmas bonus of public employees will be suppressed. The Polish government, finally, has announced a freeze of the nominal wage fund.
- On the revenue side, many countries plan to increase the Value Added Tax. In Finland it will be raised by 1 percentage point at the beginning of 2013; in the Netherlands it will be increased from 19% to 21%, in Serbia from 18% to 20% (Oct. 1st 2012); and in Spain from 18% to 21%. Slovenia focusses more on excise duties on tobacco, alcohol and other goods; but the government has already announced to raise the VAT, if the measures will be not effective. Interestingly, some governments also plan to utilize the impact of inflation on nominal incomes to increase tax receipts. Thus, in France as well as in Finland the inflation adjustment of the income tax schedules will be suspended.

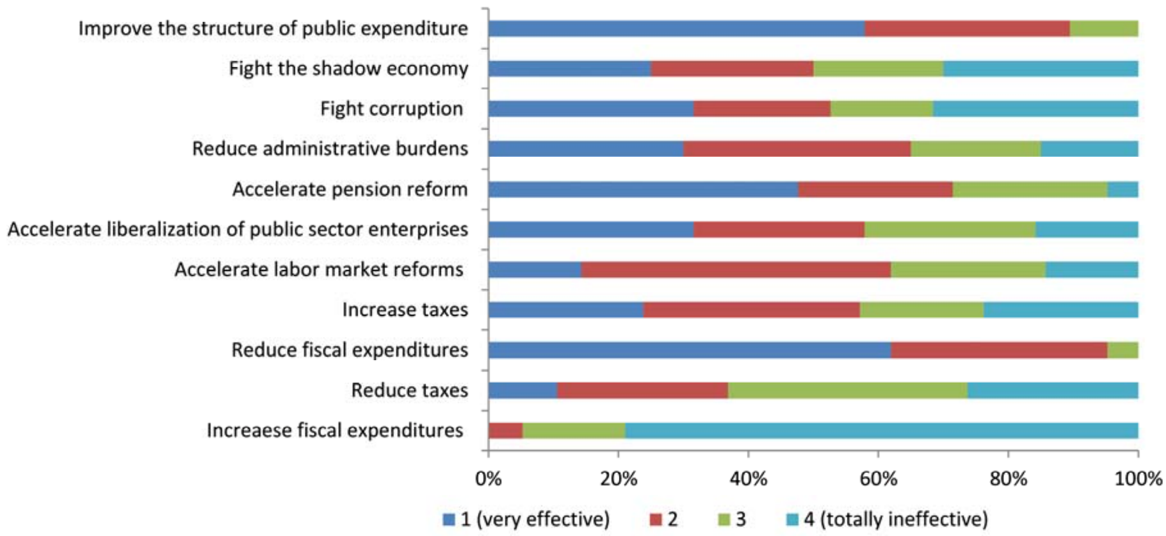
Asked for the effectiveness of the various measures to reduce debt, the assessments differed substantially depending on the region the measures hat to be judged for (Figures 3.5 and 3.6). This particularly holds for expenditure cuts. Whereas only 38% of the institutes gave them the highest ranking ("very effective") on a Euro area level, it were more than 60% assuming it is very effective for their country. Apparently, there is

Figure 3.5 Evaluation of factors reducing debt in 2012-2013 in EA



Number of forecasts for each answer: A1 14/27, A2 14/27, A3 16/27, A4 16/27, A5 19/27, A6 17/27, A7 19/27, A8 16/27, A9 17/27, A10 18/27, A11 17/27

Figure 3.6 Evaluation of factors reducing debt in 2012-2013 in AIECE countries



Number of forecasts for each answer: A1 19/27, A2 19/27, A3 21/27, A4 21/27, A5 21/27, A6 19/27, A7 21/27, A8 20/27, A9 19/27, A10 20/27, A11 19/27

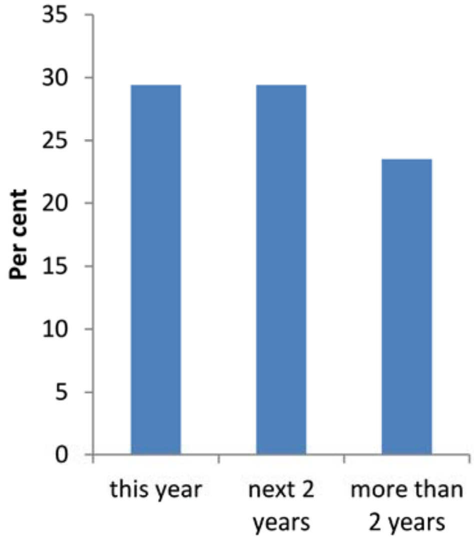
an inconsistent view on reducing expenditure: Many of us obviously feel uncomfortable, when a measure we think to be effective in our countries is taken in all countries at the same time. Similarly diverging views, although the differences are smaller in this context, can also be found concerning increasing taxes. Again, these measures seem to help more on the national level than on an EU scale. For reforming the pension system and the labor market as well as for reducing administrative burdens the opposite is the case: The share of institutes thinking them to be highly effective measures is higher when asked for the Euro area as a whole than when asked for the own country. Maybe we over interpret these results. But there seems to be the attitude that what is good for the own county will not be good for the Euro area as a whole et vice versa. However, one recommendation seems to be common sense: Improving the structure of public expenditure is considered to be very effective in reducing public debt.

Looking at the additional approaches to reduce debt the AIECE institutes mentioned in their questionnaires, it becomes evident that quite often county specific problems have to be solved. For France, e.g., changing tax structure from, taxes on labor to tax on income and consumption was mentioned. For Hungary, improving the credibility of policy seems to be an important problem. For the Netherlands, better rules for mortgages are recommended. For Spain, a pluriannual budget planning process is proposed. And for the United Kingdom, a further up-rating the retirement age is important to achieve a balanced budget.

For the Euro area, the recommendations how to reduce debt are more uniform. The answer often given is "Accelerating long term growth". However, it is difficult to say, how to do this. The effectiveness of the remedies economist often offer (labor market reform; liberalization and privatization) is rated quite skeptical, as it can be seen from the figures 3.5 and 3.6.

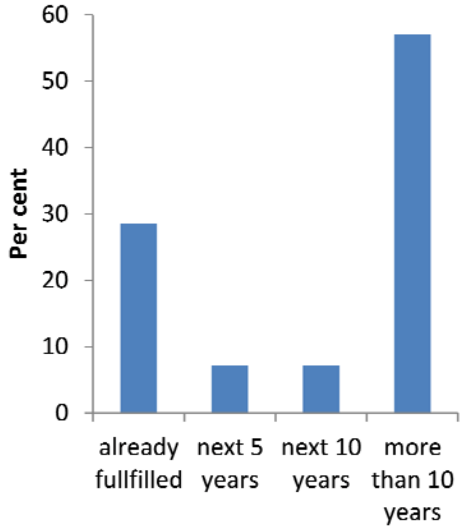
A last question in this fiscal policy block of the questionnaire is related to the time frame in which the countries will fulfill the Maastricht criteria for the fiscal deficit and the public debt. We only received 16 answers to this question related to 14 countries, what reduces the meaningfulness of the following results.

Figure 3.7 Deficit target in AIECE countries



Number of forecasts: 14/27

Figure 3.8 Debt target in AIECE countries



Number of forecasts: 14/27

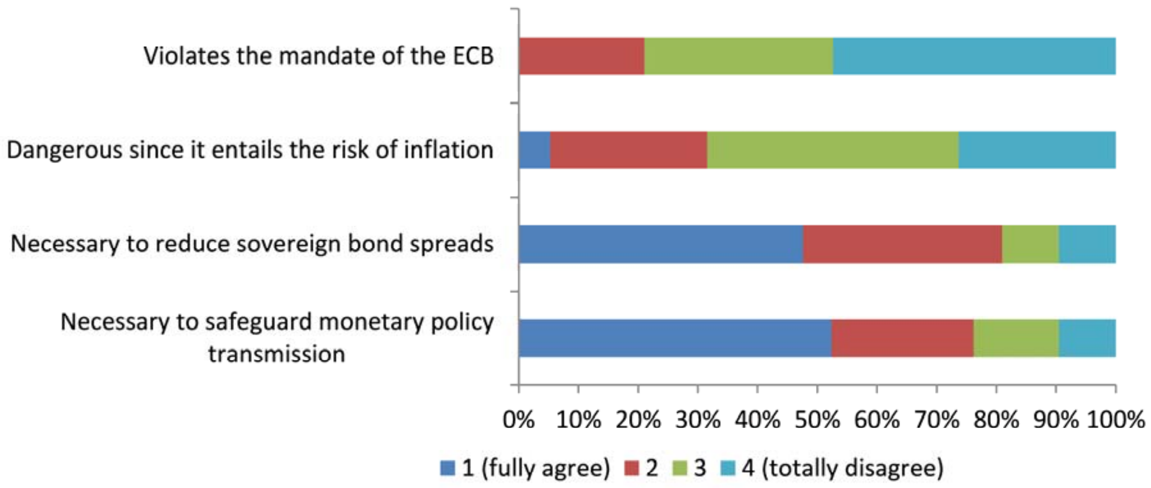
Concerning fiscal deficit, the AIECE institute were quite confident that it will go below the reference value of the Maastricht Treaty of 3% of GDP within the next years. In five counties the deficit was below the Threshold already in 2012; another 5 are expected to reach it within the next two years. In 4 countries, however, it will take longer to reduce the deficit sufficiently, but the 3%-margin should be surpassed in 2017 latest. To push the debt to GDP ratio below the 80%-margin will take much longer. In only four of the countries we received questionnaires from it is already below 60%, in two of the new EU member states (Slovenia and Poland) and in two Scandinavian countries (Denmark and Sweden). For the vast majority of countries, it is forecasted that it will take more than 10 years to bring the debt/GDP ratio below 60%. For two countries (France and Greece) the institutes answering stated explicitly that the 60% target wioll be reached “far beyond the scope of forecast”.

3.3 Monetary Policy and the Financial Sector

Outright monetary transactions

In late July, Mario Draghi had announced in a speech he gave in London that the ECB is ready to defend the Euro by all means within its mandate. On September 6th the Governing Council made this plan concrete by deciding on Outright Monetary Transaction (OMTs) in secondary markets for sovereign bonds in the Euro area. The ECB justified these measures by difficulties in the monetary transmission process that could arise in case of severe distortions in the government bond markets. The necessary condition for the OMTs, however, is strict and effective conditionality. The ECB announces, only to buy bonds of countries that are attached to an appropriate MFSF/ESM programme. On the one hand, this conditionality may push countries towards to tackle high public debt and problems in the banking sector under the conditions of an European programme. On the other hand, the conditionality also means that the ECB becomes increasingly dependent on fiscal policy decisions. Against this background it is interesting to know, how the AIECE institutes evaluate the OMTs.

Figure 3.9 Evaluation of outright monetary transactions of ECB



Number of forecasts for each answer: A1 21/27, A2 21/27, A3 19/27, A4 19/27

All in all, the institutes assess the OMTs quite positively. We received no answer saying that they clearly violate the mandate of the ECB (Figure 3.9). The vast majority of institutes is also quite relaxed concerning the inflation risk which may be associated with the measures. Finally, more than 50 of the institutes fully agreed that the OMTs are necessary to reduce sovereign bond spreads and to safeguard the monetary transmission process. However, in the additional comments some AIECE members made also a critical tone could be heard. Some institutes see it as a problem that the ECB is taking a step towards fiscal policy. Some also see the risk that OMT might undermine the ECB's credibility. Many institutes point out, however, that the OMTs mean no solution to the existing problems but they help winning time for politicians to implement long run solutions. On the positive side, one institute assumes that the unlimited intervention could scare off speculators betting on a break-up of the euro area; and another argues in a similar direction referring to the impact of the OMTs on expectations.

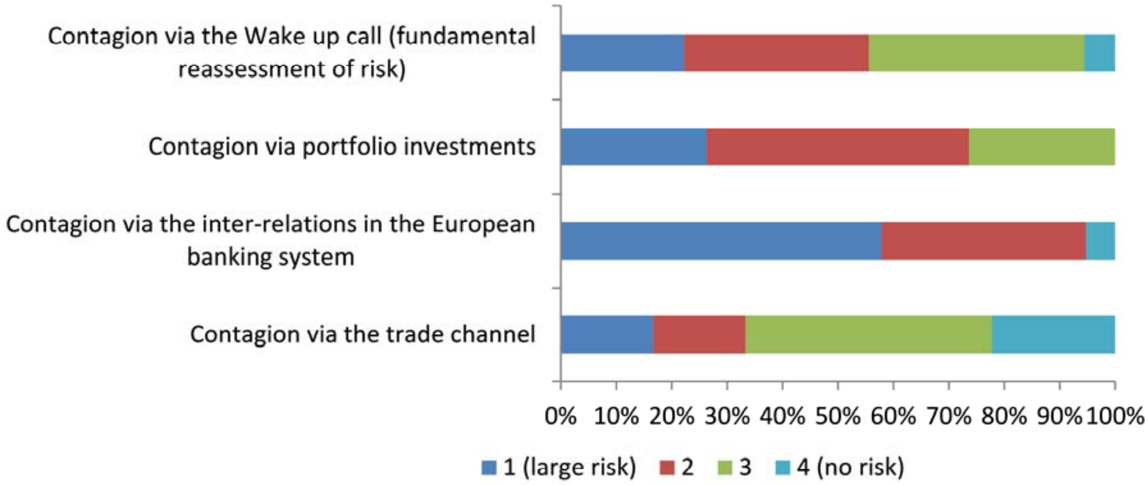
Sovereign default risk

Interest rate spreads are an indicator of the risk of a sovereign default. Maybe, the markets exaggerate sometimes, and the spreads were implausibly high at some point of time in the past. But the haircut of Greek debt was a first case of a partial default in Monetary Union signaling that future defaults are not entirely out of reach. Whether future defaults should be avoided or whether they are a policy option that should be taken into consideration largely depends on the assessment, how strong contagion effects could be. In a recent paper, Forbes distinguished four channels through which contagion can come into effect[2]. In the questionnaire we asked the AIECE members how important they consider these channels to be (Figure 3.10). For the most important the institutes consider contagion through the inter-relation of banks. The least important seems to be the trade channel.

To get an idea of the exposure of the different countries to a default of the five highly indebted Euro area members (Greece, Ireland, Italy, Portugal, Spain), we got only a rather small number of answers, which indicates that the holding of foreign debt is rather difficult to trace currently. All in all the answers give

[2] Forbes, K.J. (2012), The Big “C“: Identifying and Mitigating Contagion. Paper prepared for 2012 Jackson Hole Symposium hosted by the Federal Reserve Bank of Kansas City on 08/31/12 to 09/01/12.

Figure 3.10 Evaluation of factors affecting risk of sovereign default



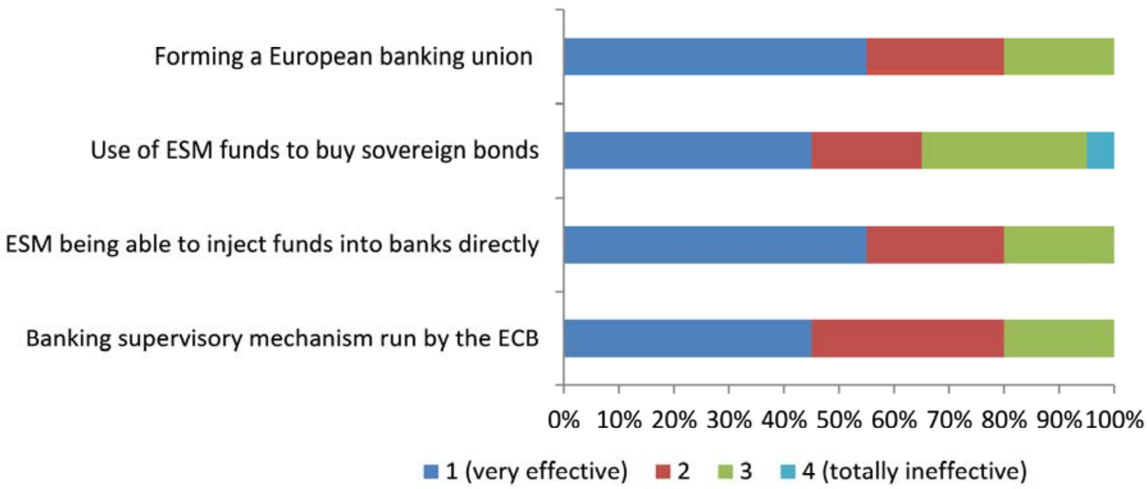
Number of forecasts for each answer: A1 18/27, A2 19/27, A3 19/27, A4 18/27

some incidence that banks have already withdrawn from these markets considerably, which is also supports by analyses e.g. from the BIS. Of course, an Irish sovereign default means a major problem for Irish banks, just as a Spanish default for Spanish banks and an Italian default for Italian banks. But besides this, there was little to learn from the questionnaires.

Failure and financial stability

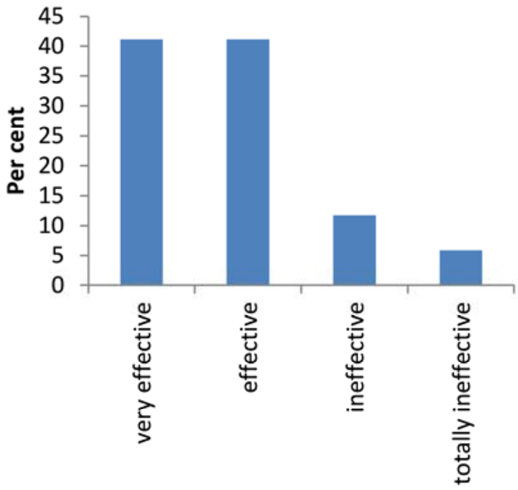
Given the high importance of the bank channel for contagion, it is no wonder that the AIECE members consider a European banking union as a very effective measure to reduce the risk of bank failure and to

Figure 3.11 Evaluation of effectiveness of reforms for reducing bank failure and restoring financial stability



Number of forecasts for each answer: A1 20/27, A2 20/27, A3 20/27, A4 20/27

Figure 3.12 Evaluation of segregation



Number of forecasts: 17/27

restore financial stability (Figure 3.11). However, the assessment of the four measures proposed in the questionnaire does not differ significantly. Thus, the use of ESM means to buy sovereign bonds as well as to restructure banks are considered equally effective. The measures address different dimensions of the problem that are equally important. The number of additional comments to that question was rather small. By one institute the necessity of macro-prudential policies, others made reference to the BASEL III rules.

As another issue of banking regulation we also tried to find out how the AIECE institutes assess the segregation commercial banking and investment banking. More than 80% of the institutes answering that question evaluated this measure being very effective or effective /figure 3.12)

4. How to restore the credibility of the euro

4.1 How to restore the credibility of the euro
Comment by Paavo Suni[3], ETLA

A country joining into a monetary union loses its control on the currency (see, e.g., De Grauwe 2011), which makes it vulnerable to speculation, if doubts about the solvency of the public sector arise. A speculation would spring up the public sector yields and without a backstop provided by the central bank or by other member states, financial markets can force a country into default. This had probably happened to Greece, Ireland and Portugal, if the rules of the EMU had been followed and no bail-out had been offered.

Financial markets did not care about sustainability of the public debt in EMU countries before summer 2007, when the first signs of the Great Recession became visible. The suspicion however, rose somewhat in Great Recession exploded in spring 2010, when deep Greek debt problems were revealed and a (long) process of solving the Greek-related market panics started. As a first step Greek was bailed out and the preliminary stability mechanism (EFSF) was established. Later the governance of EMU is strengthened and a permanent stability mechanism (ESM) was established.

Investors, however, anticipated problems in other countries as well. A contagion spread to Ireland and Portugal and finally these countries were bailed out, too. The high bond yields of the crisis countries damaged the balance sheets of banks also outside the crisis countries, notably in France and Germany. A negative and complex loop between banks and the state finances crisis became a part of euro area crisis.

One of the main drivers of the crisis was a long period of low interest rates – both public and private, which led to a rapid growth of domestic demand and output, while price levels were converging quickly toward the level achieved in more developed economies. As a result, the price competiveness in Greece and in other crisis countries weakened substantially, current account deficits and debts in the private sector and/or the public sector accumulated without any attempts of “bond vigilantes” to constrain borrowing. The credibility of euro was strong.

A speculation on the large countries woke up a fear of the break-up of euro

The credibility problems of euro arose from in context of the increasing speculation of solvency of Spain and Italy, which peaked in summer 2012 due to low growth and rising imbalances of economies. These countries and especially Italy are too large for backstops to remain credible sources of financial assistance. In addition, the spillovers to other member states and their banking sectors would create a situation, where euro would most likely break-up.

After a long march, a chance to turning the tide may be available. The governance of euro area has gradually strengthened, which may help in anchoring long-term expectations. In addition governments in the crisis countries and also in non-crisis countries have made number of decision to deleverage to raise the confidence. According to the political agreement reached in June, the ESM will have a possibility to finance euro area banks directly, once a common banking supervision agency has been established in 2013. This

[3] I would like to thank Vesa Vihriälä and Niku Määttänen from ETLA for valuable comments. All the possible mistakes are, however, on my responsibility

should help breaking the link between banks and the state finances as this aid is not counted as part of the public debt.

The OMT is a "big bazooka" of the ECB to calm the markets

In response to a difficult situation, the ECB has promised to restart buying high-yield countries' bonds on the condition that the member state applies for financial assistance from the ESM (ECB). These Outright Monetary Transactions (OMT) imply in principle unlimited bond purchases and have thus a potential of calming down the markets and reducing the interest rates in the problem countries substantially. The market reactions to the OMT announcement have in fact been very favorable and suggest that the strategy is working, even if no application has been submitted and no purchases have taken place.

However, the question remains whether the reduction of the long-term interest rates will be enough for the problem countries to recover. For that to happen they would need to use the breathing space efficiently to reduce public deficits and the implement reforms that improve competitiveness. These reforms are difficult politically and their short-term impacts on growth uncertain. A possibility of a negative spiral of budget cuts, decline of GDP and stagnating if not increasing debt to GDP ratios cannot be excluded.

To get some more insight on the possible developments of the Euro Area, we simulated the developments of crisis countries with NiGEM. We assumed that the processes to safeguard euro including the OMT by the ECB would significantly raise confidence and reduce government bond yields to roughly 5 per cent in crisis countries (Italy, Ireland, Spain, Greece and Portugal) and cut the investment risk premium to around half. No extra consolidation in crisis countries was assumed, but instead it was assumed that the "Northern countries" (Germany, Netherlands, Austria and Finland) would cut payroll taxes by worth of 1 % of GDP permanently or increase public spending by the same amount for three years to alleviate the effects of wide spread austerity in the Euro Area as the monetary policy has not been able to compensate the effects of the fiscal policy due to the zero lower bound of interest rates. I.e. multipliers have probably been larger than assumed. (Holland, Müller)

The results suggest that both policy combinations would strengthen the growth in in Southern economies in particular. Naturally, the increase in Northern public spending would rise the Northern GDP more strongly than the tax cuts in the short term. External balances in Crisis countries would deteriorate slightly, but public balances would improve. The effects may be even stronger than indicated by the attached graphs as an important channel of decreasing credit rationing of households was not taken into account.

On the other hand, the assessment above assumes that a problem is a case of illiquidity. Some member states may however, in fact, be insolvent. According to many assessments Greece is a case of insolvency, while the jury is out for Portugal and Spain, and perhaps even for Ireland and Italy. To the extent there is a genuine solvency issue, it would be important to tackle it upfront. This would require either transfers from the other member states or debt restructuring or both.

Finally, the history shows the weaknesses of even strong commitments to the stability of the Euro Area. The disciplining effects of the bond markets cannot therefore be disregarded. This would imply only a limited role for the Eurobonds in risk sharing of a single member state.

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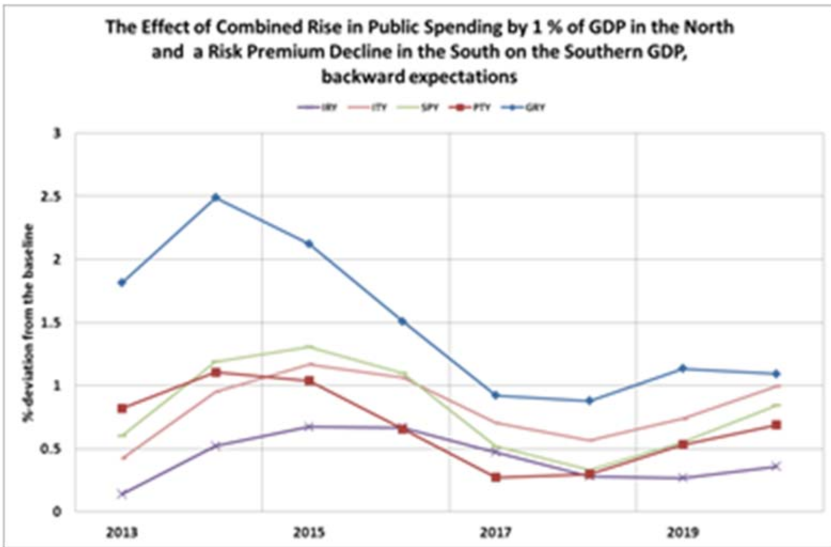
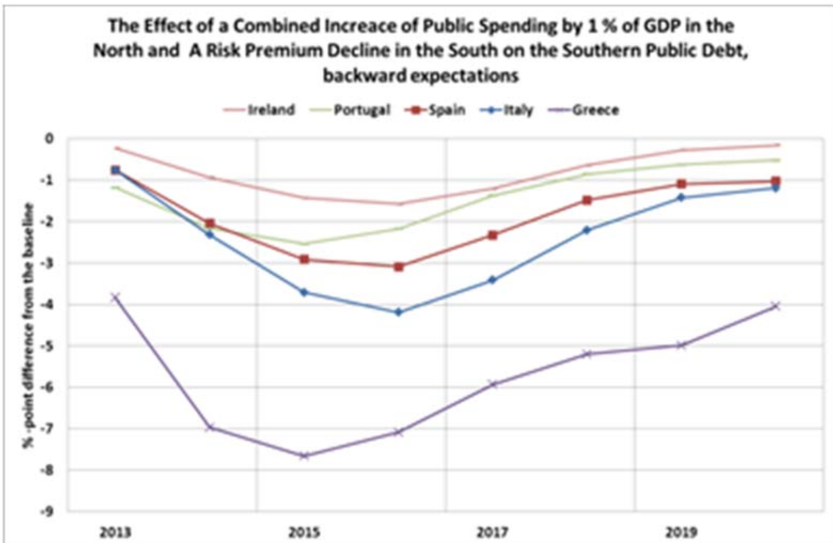
Long-term rates in Selected Euro Countries

	2012/7	2012/8	2012/9	2012/10	31.10.2012	dprem 1)
Greece	25.12	20.93	20.81	17.87	17.77	-10.00
Portugal	10.25	8.65	8.61	8.13	8.19	-3.00
Spain	6.73	5.97	5.92	5.67	5.62	-1.00
Italy	5.94	5.20	5.16	4.96	4.96	-1.00
Ireland	6.14	5.40	5.37	4.86	4.73	-1.00
Germany	1.36	1.53	1.54	1.52	1.46	0.00
Finland	1.54	1.75	1.76	1.78	1.73	0.00

1) Assumed change in investment risk premium due to OMTs by the ECB



The Effect of Combined Rise in Public Spending by 1 % of GDP in the North and a Risk Premium Decline in the South on the Southern GDP, backward expectations



The Effect of a Combined Increace of Public Spending by 1 % of GDP in the North and A Risk Premium Decline in the South on the Southern Public Debt, backward expectations

4.2 Kiel Policy Package: Roadmap for resolving the Euro Area crisis
Comment by Klaus-Jürgen Gern and Stefan Kooths, IfW

The Kiel Policy Package is designed to lead the way to a sustainable institutional framework of the European Monetary Union in the longer term while providing temporary assistance to for troubled member states in the short term. Starting from the assumption that the key Maastricht foundations of the EMU remain in place (common monetary policy to provide a stable currency, fiscal policies in the realm of national authorities), this package acknowledges that responsibility for the current situation lies with all member states, debtor as well as creditor countries, and that all countries would benefit from a solution to the crisis. This motivates elements of transnational transfers. However, as the long term is formed by a succession of short terms, it is important that short-term fixes be consistent with the longer-term goals or be at least reversible from a political economy point of view.

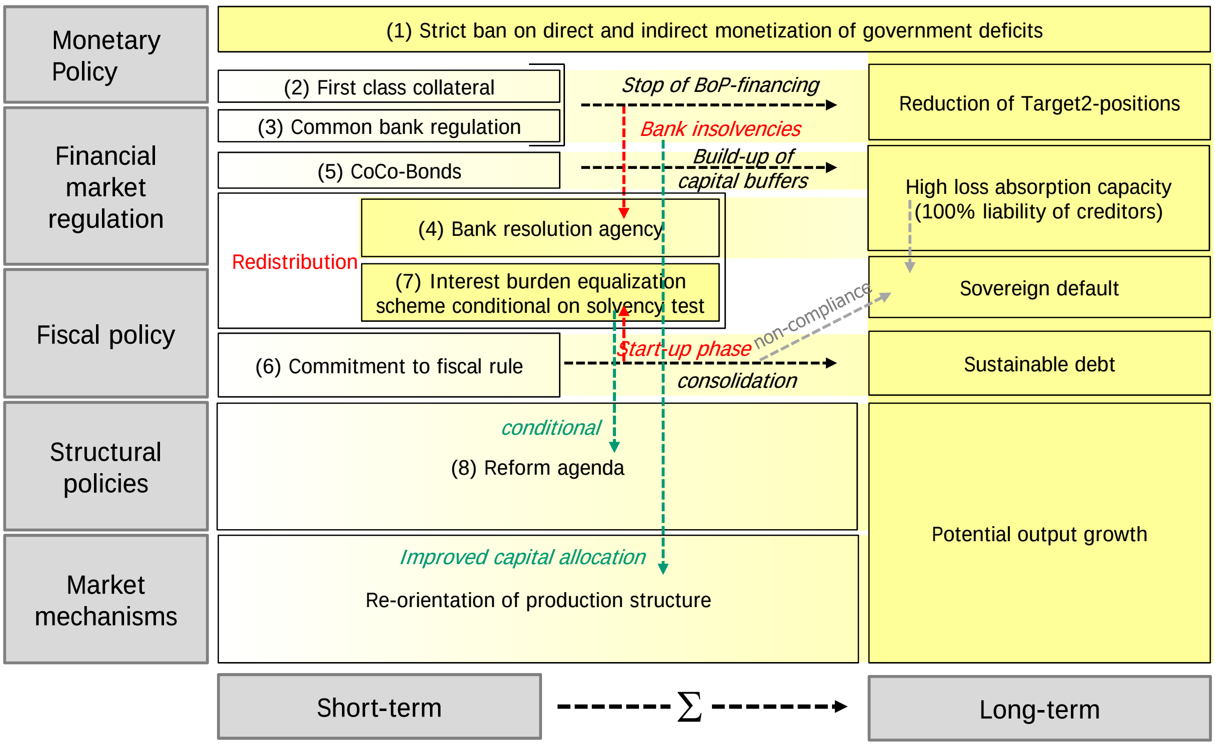
Currently the European Central Bank is left with the task to prevent the EMU from falling apart by pursuing extraordinary measures resulting in extremely permissive monetary policies. This cannot go on for much longer without ultimately damaging the very foundations of the monetary union. The ECB should not be pushed to try solving by monetary means economic problems which are not monetary by nature. This means that for a sustained solution to the Euro Area crisis policy fields such as financial regulation, fiscal policy and structural policies need to be activated that consist of policy instruments which can make a difference in tackling the root causes of the crisis. The Kiel Policy Package provides such an integrated approach laying out specific measures that are appropriate to accomplish the transition from the fragile situation as of today to the much more robust framework for the long-term future (Exhibit 1).

- **European monetary policy** is freed from the problem to strike a balance between monetary requirements and financial market stability considerations and can return to focus on the target of price stability. Policy measures include: (1) Direct and indirect state financing is strictly banned; (2) Only high quality collateral is accepted.
- **European financial regulation** is redesigned in order to increase monetary integration (overcome the national segmentation of banking markets) and improve the stability of the system by tackling the "too-big-to-fail" problem and credibly implementing the principle of liability. In order to achieve this, (3) common European bank regulation standards are implemented; (4) a European Bank Resulution Authority is set up to deal with ailing banks using ESM-funds which are henceforth exclusively reserved for this purpose; (5) Contingent convertible bonds become mandatory for all non-deposit outside financing operations of the banking business; this will strengthen the ability of banks to absorb losses and minimize the risk of bank failures.
- **National fiscal policies** will be credibly committed to adhere to the targets laid out in the Maastricht framework without disposing of the possibility to engage in countercyclical policies during recessions. Solvent countries in a sovereign debt crisis are supported on a temporary basis in the early phase of getting the consolidation process on track. A common risk pool for existing or new national sovereign bonds is not part of this package –national fiscal sovereignty is fully preserved. To achieve this, (6) Long-term fiscal rules with constitutional status are implemented. The rule defines a target for the debt-to-GDP ratio in the long term (the Stability and Growth Pact implies a maximum level of 60 %), the speed of adjustment towards this target level and the degree to which fiscal policy is allowed to respond to cyclical downswings (implying symmetrical counter-actions in upswings). In order to raise credibility the rule should get constitutional status and, while the specific design of the rule can be decided by the national governments, compliance will be monitored on a European level. In order to

help governments getting on a consolidation track in a transitional period in which financial markets may continue to perceive a lack of credibility (7) Solvent countries will have access to funds from an interest equalization scheme that will reduce the interest burden towards the euro area average level (using funds from those countries benefitting from below-average interest rates partly due to save-haven financial flows). Access to this scheme will be conditional on compliance to adjustment programs designed in co-operation with European authorities.

- **Structural policies** are implemented to increase the productive potential of the economies and help accelerate structural change. The current severe situation in the crisis countries is to a large part rooted in structural deficiencies of the respective economies that have to realign its production potential which requires structural adjustments on a large scale. Government policies to facilitate these changes and boost growth in the medium term include (8) more flexible labor markets, more competition on markets for goods and services, less red tape and bureaucracy, privatization of economic activities currently run or dominated by governments. European and international organizations will provide assistance in setting up and implementing reform agenda if so asked for by reform countries.

Exhibit 1 „Policy measures and effects over time“



Shading indicates increasing or decreasing effect/importance over time.

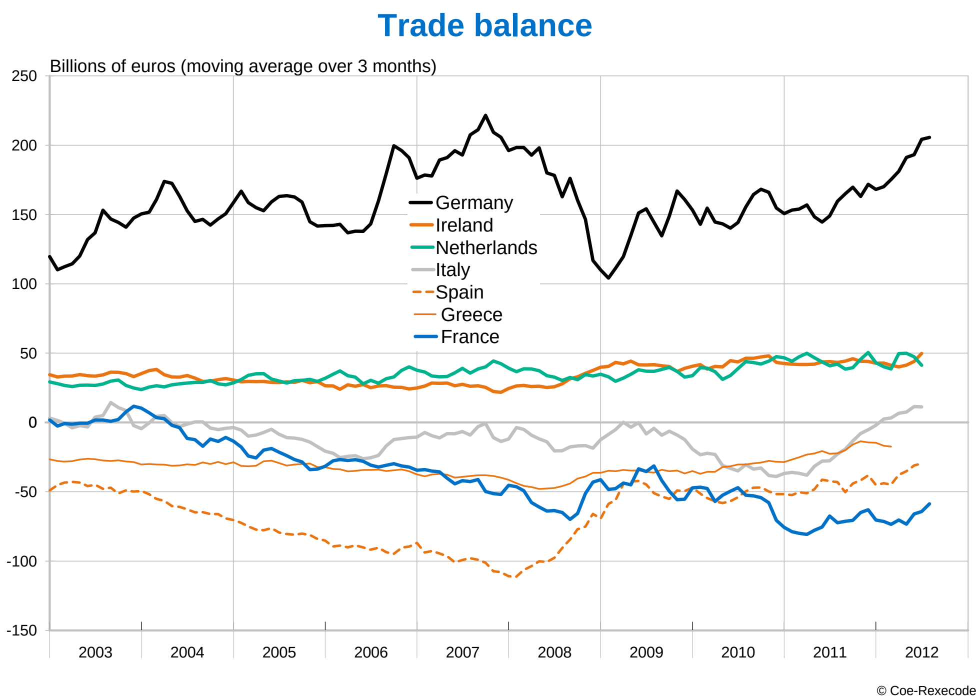
4.3 Rebalancing the Euro Area

Comment by Alain Henriot, Coe-Rexecode

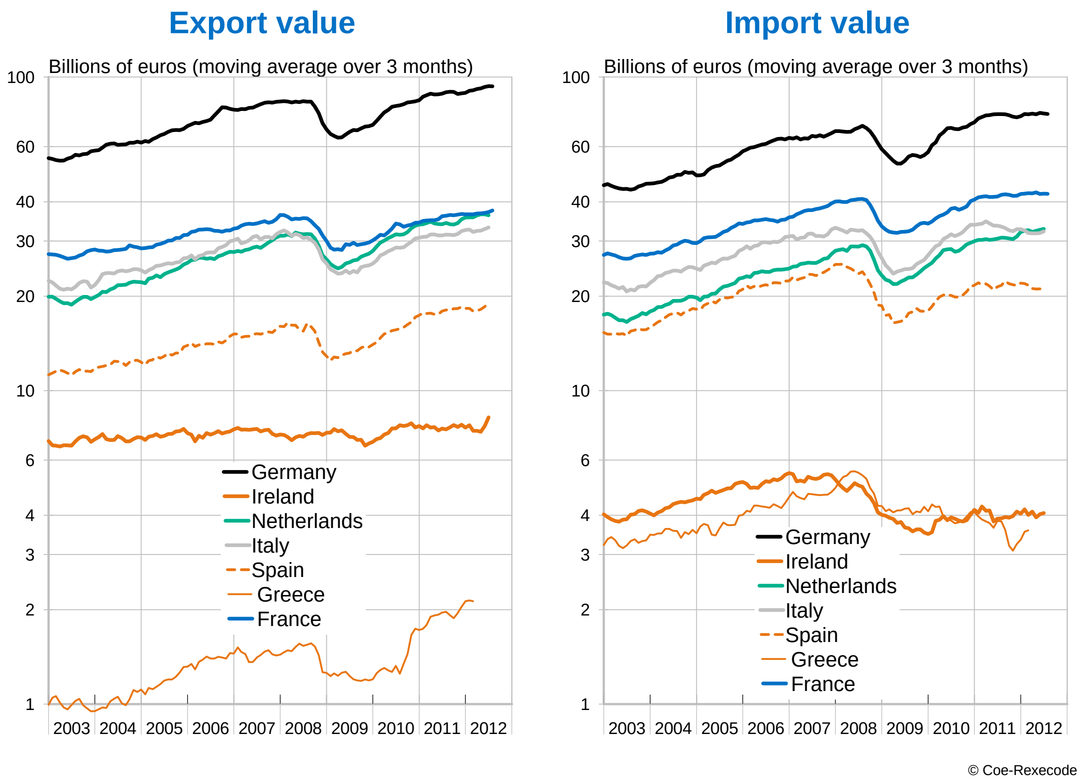
Main economic indicators show that the economic situation of the Euro area in terms of internal and external equilibrium is better than the one observed for the U.S. Nevertheless, the confidence of financial investors in the future of the monetary union has been hit severely in the last two years. This is mainly due to huge imbalances within the Euro area. This was reflected in external balances of Euro area countries. Recently, countries which showed the largest deficits have known a reduction of their imbalances. But, at the moment, this is mainly the result of the moderation of import growth. However, if we consider unit labor costs, the competitiveness gap seems reducing, even though it is not closed. But in the medium run the current crisis is a call for in-depth transformation of the productive sector of some countries, a huge challenge.

1/ Short term aspects

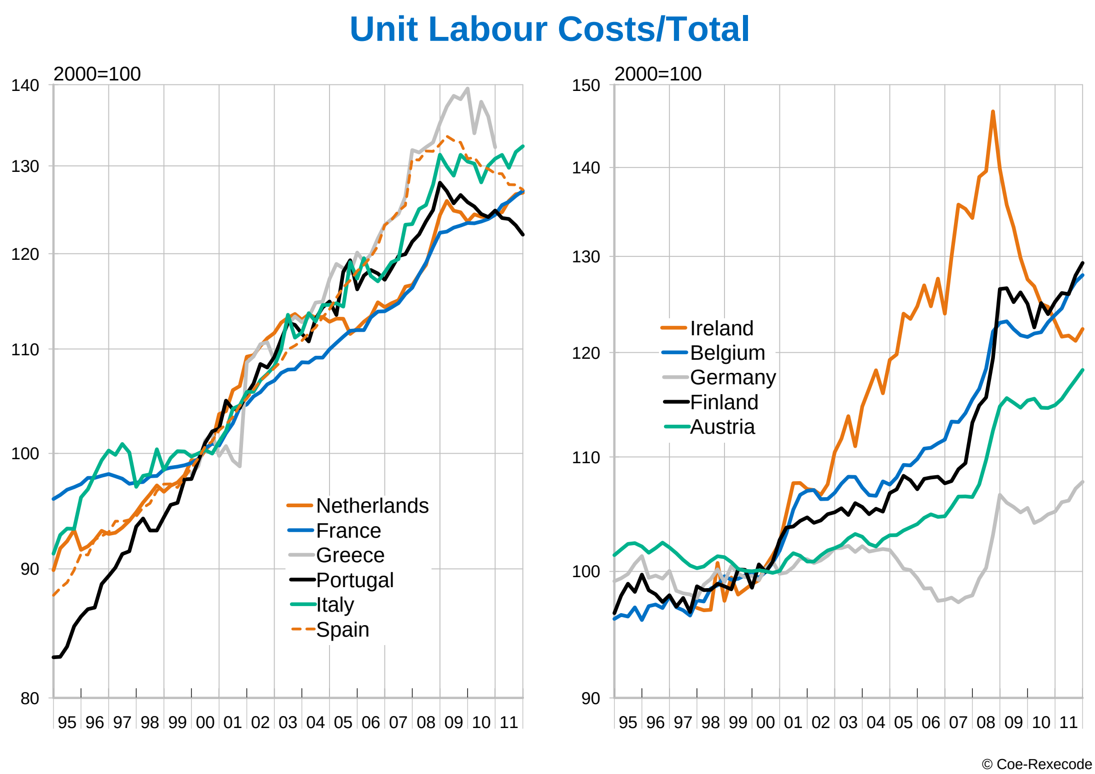
The roots of the current crisis are now rather well known. Low interest rates boosted the internal demand in some countries, leading to the emergence of bubbles, in particular in the construction sector. Regarding the supply side, some countries faced also strong external shocks due their initial international specialization. As a consequence, strong internal demand boosted wages and caused a deterioration of the competitive position of those countries. This led to strong imbalances in terms of external trade.



Recently, the external balance of countries in difficulty improved. Trade balance of Italy is now even in surplus. But this is mainly the consequence of weak developments of imports. This is not the consequence of a compensation between deficit and surplus countries, as for instance Germany has even increased its own trade surplus.



However, regarding the question of price competitiveness, cuts in unit labor costs have been observed in countries in crisis, in line with the sharp rise in the unemployment rate. On the opposite, unit labor costs have increased in countries experiencing a low level of unemployment. Taking 2000 as a reference year, unit labor costs in Spain have experienced on average the same developments than in Austria. Only Germany keeps a strong advantage in terms of labor costs developments.



2/ Medium term aspects

Rebalancing the euro area cannot be only based on price competitiveness. It also means changes in the governance of countries, implementing structural reforms and researching new engines for growth. This is particularly true for international specialization. Countries like Portugal or Greece suffered from the increasing weakness of their comparative advantages, with an increasing competition from Asian countries. This heterogeneity is clearly illustrated by a wide difference in the weights of products in the export structure among Euro area countries.

The main challenge for those countries is to put in place a new strategy of specialization. Due to the current context of contraction of the activity, this will take time as never the private nor the public sector have the means to develop such strategies which should be based on research-development, investment and education.

This is a far most difficult challenge than the convergence of unit labor costs as this latter one should be the result of the macroeconomic context.

Structure of exports by main group of products (%)

	France	Germany	Italy	Ireland	Spain	Greece	Portugal
Total	100	100	100	100	100	100	100
Energy	3,7	1,9	4,9	1,2	5,1	11,0	6,7
Food agriculture	12,5	5,6	8,3	9,5	15,6	27,0	12,4
Textiles	4,4	2,8	11,4	0,7	6,2	8,4	13,7
Wood paper	5,0	5,4	5,9	6,3	4,7	3,6	10,2
Chemicals	21,6	18,3	16,2	59,4	19,6	19,4	16,1
Iron & steel	3,7	2,9	4,4	0,2	4,3	4,7	2,8
Non ferrous	1,8	2,5	1,8	0,9	2,9	7,7	2,7
Machinery	21,7	20,3	25,0	3,1	11,5	7,6	10,2
Vehicles	10,0	16,0	7,5	0,4	18,4	1,0	11,5
Electrical	4,9	6,9	5,7	1,3	4,9	3,3	5,4
Electronic	7,4	9,7	4,5	13,1	3,2	3,1	5,3
N.E.S.	3,4	7,5	4,3	3,9	3,6	3,1	2,9

Source : Cepii-chelem database; authors'calculations

4.4 How to restore the credibility of the euro? Country level vs. European level strategies

Comment by Ersi Athanassiou, Ekaterini Tsouma, KEPE

In the aftermath of the recent world economic recession, the European common currency has suffered in terms of credibility against the background of the European sovereign-debt crisis. The re-establishment of losses in Euro credibility requires targeted strategies on all levels on which the respective credibility losses have occurred.

The first relevant level is the individual country-level, since the weakening of the trustworthiness of single member countries concerning their political willingness and/or practical capability to reinforce the strength and cohesion of the common currency has been to a certain degree transformed and translated to a loss of credibility of the Euro. It follows, hence, that one part of the necessary strategies to restore the credibility of the Euro must be directly addressed towards re-establishing the determination of single member countries to support the stability of the common currency. Herein lies a certain degree of asymmetry, since not all member countries are bound to bear the same kind of responsibility.

On the one side, namely, a heavy burden falls on all countries which are characterized by significant internal imbalances, mostly pertaining to poor fiscal stances, unfavorable current account positions or fragile banking systems, fuelling the questioning of internal and, hence, European financial stability. Corrective and adjusting political actions in these countries must be strictly and effectively pursued, so as to create the certainty of commitment and determination to tackle the existing weaknesses. The creation of confidence in the resolution of single countries towards internal and, thereby, European stability will generate a channel for the transmission of reliability back to the common currency. Of course, individual countries should see themselves forced to undertake such policies not only after they have come under pressure by markets, but instead in connection with the mere presence of such imbalances. In other words, it is important for the restoration of the internal single-country credibility, and as a result the overall credibility of the Euro, that decision making on the individual country level involves both convincingly and decisively reacting and timely acting in advance of unfavorable developments which might lead to imminent losses of trustworthiness.

On the other side, another kind of heavy weight falls onto single countries, which might be or not be characterized by important internal vulnerabilities, but are seen to bear a disproportionally greater degree of power and influence. These countries are more responsible than the weaker ones for adopting strategies which can create the expectation and provide the necessary confidence for the future of the common currency, at the back of their ability to credibly enforce the confrontation of shortcomings and handling of drawbacks in crises cases. In the case of these countries too, the restoration of the credibility of the Euro requires strategies on both the level of reacting to a resulting need to handle and acting in order to prevent the destabilization, and weakening of the common currency.

Strategies at the country level are of course not sufficient for addressing all issues related to the crisis and for restoring credibility of the common currency, unless combined with collective reaction and action at the European level. At this second level, the key requirement is the deepening of the EMU, an agenda on which was clearly set out by European authorities in June 2012[4] and includes further integration of both financial and budgetary frameworks in the Euro-area.

Concerning budgetary integration, the debt crisis has accentuated the need for greater pooling of both budget decision making and risks. The first requirement toward this end is the establishment of effective mechanisms for the prevention and correction of unsustainable fiscal policies in individual Member States. Following the implementation and proof of robustness of these mechanisms, a subsequent, more radical step to the direction of a 'fiscal union' is the issuance of common debt.

With respect to financial integration, the financial crisis and Europe's negative bank-sovereign debt feedback loop have brought to the surface the necessity of strengthening banking system regulation and supervision, breaking the link between banks and sovereigns and minimizing the cost of bank failures to European citizens. As a first step towards financial integration, all responsibilities and powers for the authorization and prudential supervision of Euro area credit institutions have to be transferred to a single supervisory mechanism (SSM). Further steps towards a 'banking union' include the introduction of a pan-European deposit guarantee scheme and direct ESM bank recapitalization.

Thus far, progress with integration has been rather slow, and has advanced mainly with respect to the establishment of the SSM, on which European leaders have committed to reach an agreement by the end of 2012. Further actions towards a banking union have been delayed until effective operation of the SSM has been confirmed, while plans on budgetary integration have been left behind, in the midst of the struggle to overcome the current crisis. These delays are to some extent justified by the step-by-step nature of the financial and budgetary integration, which for example implies that, before pooling risks, mechanisms for the supervision and enforcement of rules should be effectively in place. Furthermore, delays also explained by political concerns and factors, and by the fact that the efforts of Euro-area leaders and authorities are still largely devoted to the resolution of urgent crisis-related matters. Although, however, these matters do justify a careful and progressive approach towards integration, they do not explain the apparent lack of a clear time frame on the actions required, and the resulting uncertainty on how far Europe is prepared to go in the direction of EMU deepening is currently not helping to provide a positive signal of credibility to Euro-area partners and global investors. Since banking and budgetary integration are fundamental to guarantee the future of the EMU, and can even form a key part of the solution to the current crisis, clear political resolution and systematic action towards a fiscal and banking union can arguably go a long way towards restoring the credibility of the Euro.

At a third level, strengthening the credibility of the Euro depends on the interrelations between single-country level and European level political decisions and actions. It is evident for example that progress with budgetary integration will depend critically upon the success of the fiscal adjustment programmes in individual member countries, while at the same time, collective decisions on financial integration will contribute to domestic financial stability in single-member countries. It is the simultaneous pursuit of the country-level and European level strategies outlined above that will create the conditions and provide the signals of Euro stability and irreversibility.

[4] 'Towards a genuine economic and monetary Union', Report by President of the European Council Herman Van Rompuy, Brussels, 26.6.12 (EUCO 120/12)

4.5 How to restore the credibility of the euro

Comment by Roland Döhrn, RWI

In retrospective, European integration often followed the same sequencing. It started with a step towards economic integration connected with the hope that political integration will follow sometimes. This strategy did not cause many problems, as long as the political dimension of the integration steps was limited, as it was the case when the customs union was formed. However, in the early 1990s when the economic deepening reached a new quality after the internal market was completed and the Monetary Union was set on the European agenda in the Maastricht treaty, political integration remained slow. Partly this might reflect that the fall of the iron curtain came – when thinking strictly in economic integration terms – at the wrong time. In the late 1980s there was the consensus in the EU that deepening should be given the priority to widening the EU. But when the political landscape changed, the EU had to master a widening, but it did not want to revise its plans on the deepening. Thus, the integration became entirely unbalanced when Monetary Union started. On the one hand, there was a single monetary policy, and the members of the EMU gave up the exchange rate as an adjustment instrument. On the other hand fiscal integration consisted of a handful of rules which politicians considered to be not very binding. Although being part of the treaty, the fiscal criteria were not taken very serious, and they were often interpreted in a very creative manor. In the end, the view was far spread that fiscal policy was as independent after entering the monetary union as it had been before, and the same was true for other policy fields like the labor market policy.

For many years, these deficits in the setup of the European Union did no harm to the economy. Those countries that potentially would suffer most from the loss of the exchange rate as an adjustment instrument benefitted substantially from the decline in interest rates that followed the introduction of the single currency. The latter was something like a windfall profit, which reduced the costs of serving debit for governments, companies, and private households. This windfall profit was used in a different way; in some countries it lead to boom in housing investment, in others in private consumption. And sometimes the limits for public debt were extended, since the interest payments were reduced significantly.

If this analysis is right, restoring the credibility of the Euro would require new rules for fiscal policy and a deepening of political, above all fiscal policy integration. Concerning the first point, already some progress has been made, since the ‘six-pack" was set in force and a general agreement was reached on the fiscal union. The possibility that a deepening of political integration will be achieved, however, is rather small. From time to time proposals are made, such as giving more competences to the Commission, or extending the budget of the Union, but they are discarded as soon as they appear. With a strong fiscal policy actor missing, the monetary policy actor, namely the ECB, took more and more the responsibility for the functioning of the Euro area. It became the general purpose answer to all challenges arising: To stabilize production, the main refinancing rate was reduced to a historic low; to ensure the solvency of the banking system, a unlimited supply of liquidity was provided to banks; to reduce the refinancing costs of governments, at first the SMP and later the OMT programmes were launched; finally, also the responsibility for supervising European banks will according to the existing plans be given to the ECB.

To restore the credibility of the Euro, the strain on ECB must be relieved so that it will be able to concentrate on its main goal, i.e. to ensure price stability. Currently, there are two vicious circles that must be broken. The first is the adverse loop between sovereigns and banks. The second is the negative loop between consolidation and growth. The first can be broken by a banking union, on which the European Union as agreed in principal in the last summer. But such a union is difficult to achieve. On the one hand there is the need for action, on the other hand a hasty completion – as it seems to be preferred by some countries – of the union bears the danger of making new failures in the institutional setup. The German Council of

Economic Experts recently pointed out that a banking Union is a long term project and not a solution for acute problems. It proposed a three step plan towards a banking union that will set a union in force in 2019 (GCEE 2012). It includes a clear separation of monetary policy and supervision. But a long term strategy requires solutions to deal with the legacies from the past, i.e. the increasing amount of non-performing assets.

Not less difficult to break is the second negative loop. In many European countries the consolidation measures did neither result in a significant lowering of public deficits, nor did they restore confidence in public finances. It is cheap to say that a better implementation would have led to better results, since markets expect quick results, whereas a good implementation may require time. Thus raising excise duties may be a way to increase the receipt in the short run, but when e.g. the effectiveness of the administration is the problem, the effects on the budget might may be short living, and the negative effects of higher taxes on real income may be larger than the potential effects of more solid public finances on growth. Thus insulating governments at least for some time from the capital markets may give them some room for implementing structural reforms that improve their budget situation sustainably. As it stands now, European politicians seem having agreed upon that it in the competence of the ECB to do this job. Of course, the ECB will purchase sovereign debt on the secondary market only, and only of countries which are under a restructuring programme. But the distinction between primary and secondary market may be artificial. Sovereign bonds may be purchased, e.g., by state owned banks which sell them the same day in the secondary market. And what country is how successful under a restructuring programme is in the end defined by fiscal policy. Thus it may happen that the ECB will be forced to purchase an unlimited amount of government bonds one day.

There are alternatives for insulating countries from the markets. A popular option is issuing Eurobonds, which in the end mean that the community as a whole is liable for the members' debt. However, these bonds are associated with negative incentives and it will be difficult to ensure sustainable public finances, in particular when the control mechanism a weakly established. Another option is a European redemption plan, as it was proposed by the German Council of Economic Experts two years ago. The idea is that all Euro area members except those already under a specific restructuring scheme refinance all their debt above 60% of GDP via a Redemption Pact. In a roll-in phase, thus all debt is refinanced through the pact. After that, the countries start to pay back their debit at fixed rates. To ensure repayment the pact is ascertained by special tax provisions. After 25 years, the debt will be paid down. All new debt is in the responsibility of the individual countries.

There are many arguments against such a plan. In particular the enormous volume of the guarantees that are associated with such a plan makes it difficult to get support for it by politicians in particular in countries with currently low debt. However, not having such as plan does not mean that the debt disappears, and the current solution with the ECB intervening also bears significant costs for the tax payers. The main difference is: No parliament and no politician have control over the risks the ECB will accumulate in its balance sheet. About a redemption pact, the parliaments would have to decide. Thus the resolution of the public debt crisis would be back in the playing field of fiscal policy.

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