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ASSOCIATION D'INSTITUTS EUROPEENS DE CONJONCTURE ECONOMIQUE

ASSOCIATION OF EUROPEAN CONJUNCTURE INSTITUTES

KOPINT-TÁRKI
Konjunktúrakutató Intézet Zrt.

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PART I

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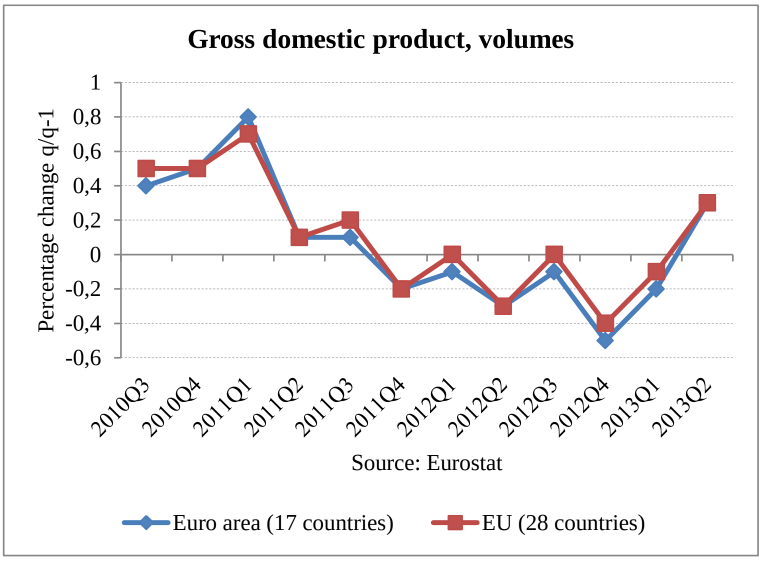
1. Key developments

1.1. Economic growth in Europe

There are more and more signs that the recession in the Euro Area has come to an end. The ESI indicator has shown since May this year a steady improvement and in Q2 2013 there was a modest growth of 0.3% in terms of real GDP as compared to the previous quarter. After a period of about one and a half year, this was the first positive q/q rate. The above development could be attributed in the first line to the performance of Germany and France, and to the fact that the fall of GDP slowed down in case of Italy. As regards the crisis countries in Spain, in Ireland and in Portugal positive growth rates could be observed, in case of Greece the slowdown moderated, but together with Slovenia and Cyprus the recession is still holding on.

Chart 1: Real GDP growth in Europe



Despite of positive signs the recovery from the financial crisis has been considerable slower in Europe, particularly in the Euro area as in the OECD as a whole. The moderate positive growth for Q2 2013 still means that on YoY basis there was a fall of 0.5% of GDP. The relative improvement was substantially a result of the development of exports and a positive net export rate. But a slight recovery could be observed in case of private consumptions as well due in the first line to good performance in Germany, but also in case of a number of smaller countries private consumption showed quite a dynamic growth as compared to the quarters before. Fiscal consolidation efforts have shown first results but still a long process is ahead having a dampening effect on overall economic growth. Labour market recovery is still sluggish in most of the countries, and unemployment will remain very high (with the exception of some countries) during the forecast period. External factors might have a negative influence on future economic performance in Europe. Exogenous risks may arise on behalf of the US in case of a failing compromise on the budget next year and on behalf of emerging countries where there are some signs of a possible slowdown of growth.

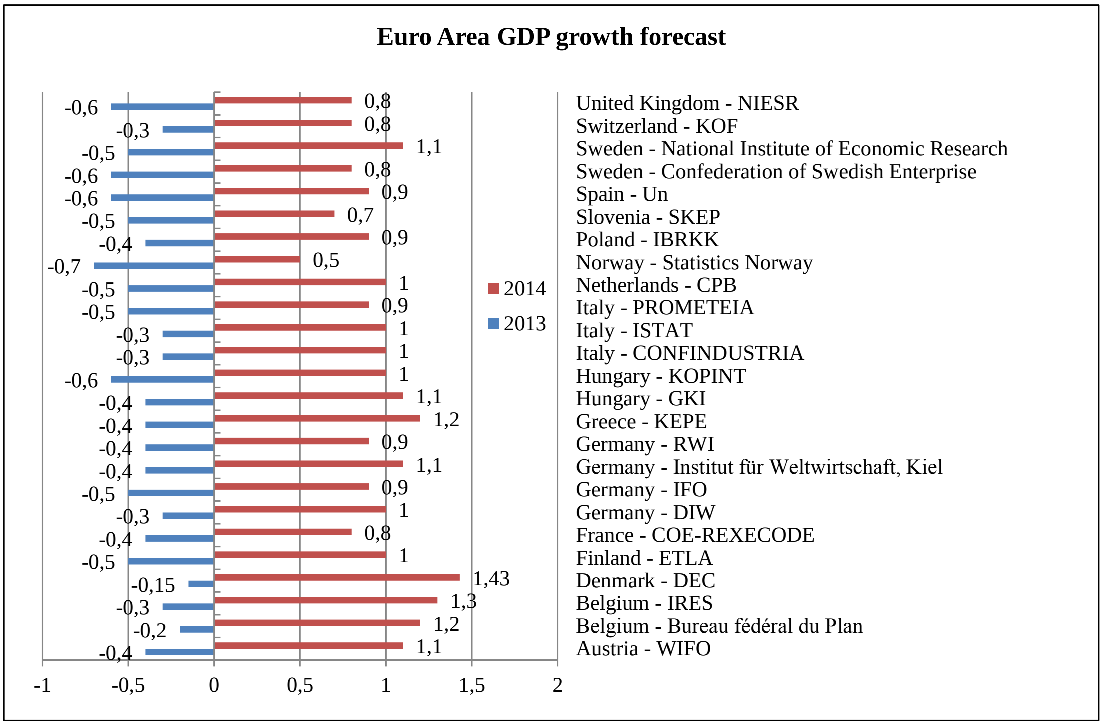
Taken as a whole the recession seems to be over, however, a dynamic growth is not to be expected neither for the Euro Area nor for the EU 28. Sluggish domestic demand and necessary fiscal consolidation will permit only a moderate growth rate next year in case of the Euro Area. At the same time in countries outside the Euro Area all forecasts suggest a more dynamic growth.

1.2. Assessment of AIECE member institutes on GDP growth in the Euro Area and in the EU 28

There is full agreement among AIECE member institutes that the economic growth will be negative for 2013 as a whole whilst for the next year only a modest improvement is to be expected. To our question concerning short-term forecast on GDP in the Euro Area and in the EU 28 (*Q20: Please provide your forecasts for the following economic variables)* we received the following answers.

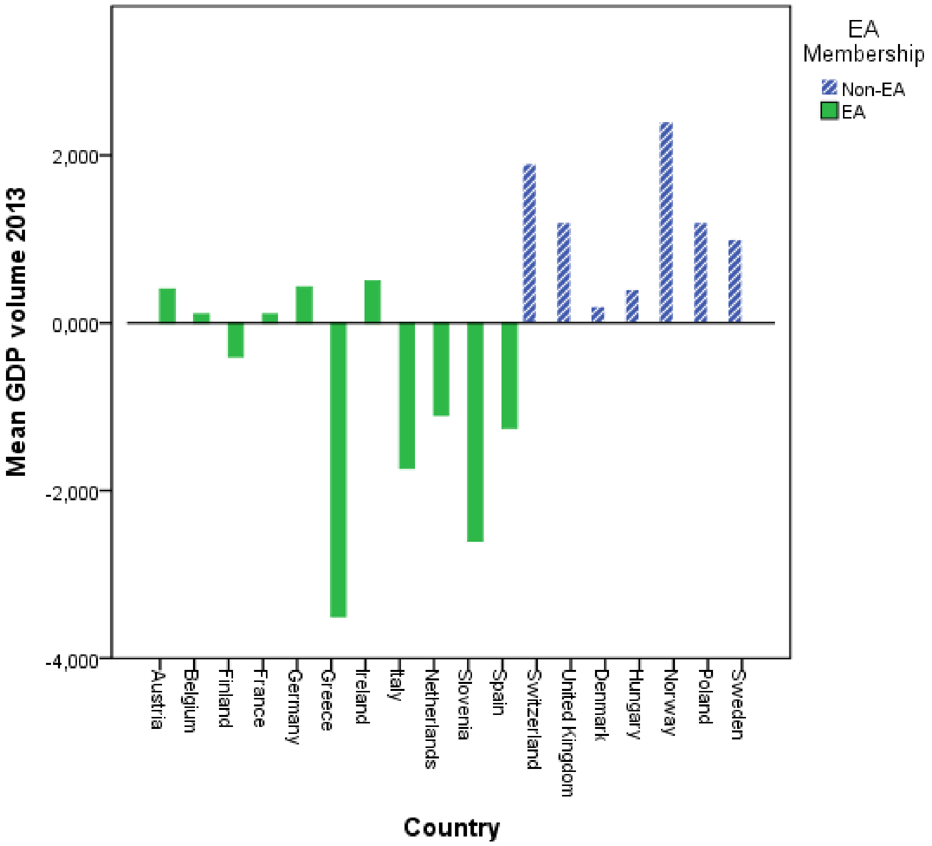
On the average AIECE members forecast a shrinking GDP rate of -0.4% for 2013, whilst they reckon with a recovery of 0.97% for next year. The corresponding figures for the EU 28 are -0.1% for 2013 and 1.2% for 2014.

Chart 2: Assessment of AIECE member institutes



The forecast of the AIECE members on average GDP growth of the Euro Area is in line with that of the recently published Autumn Forecast of the European Commission. (See Chart 3) However, as far as longer term prospects are concerned, the Commission seems to be more optimistic than AIECE members.

Chart 2a: Heterogeneity in Europe in 2013 and 2014
(Home country forecasts)



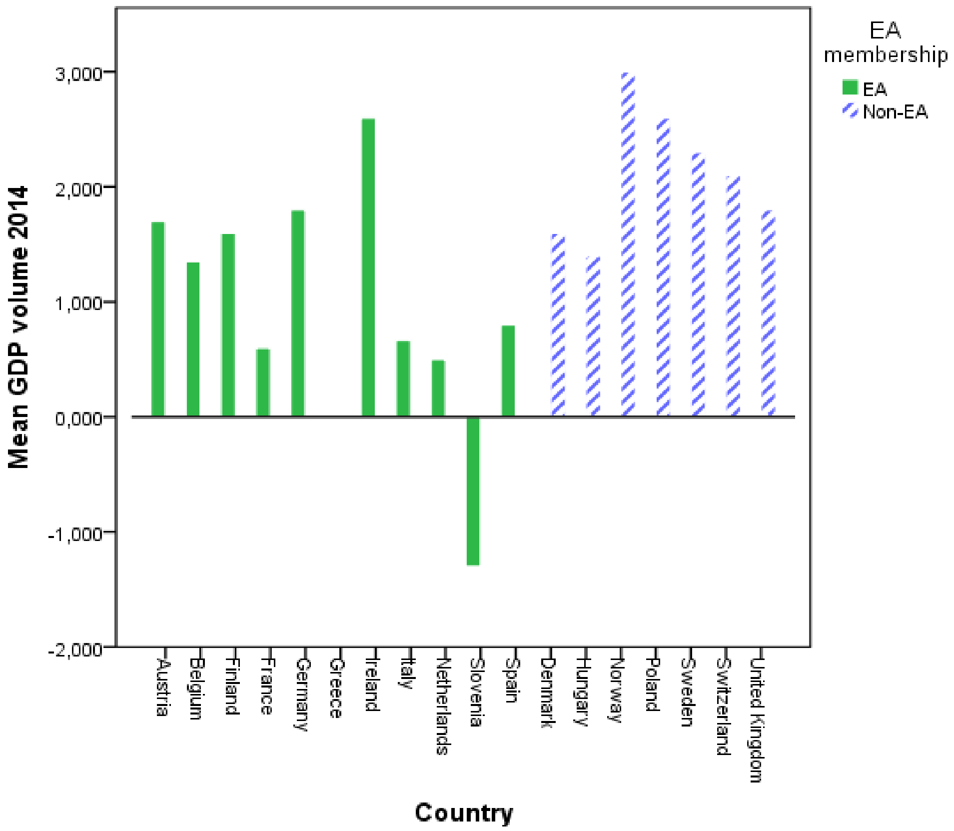


Chart 3: A comparison of the Autumn Forecast of the European Commission with that of AIECE members

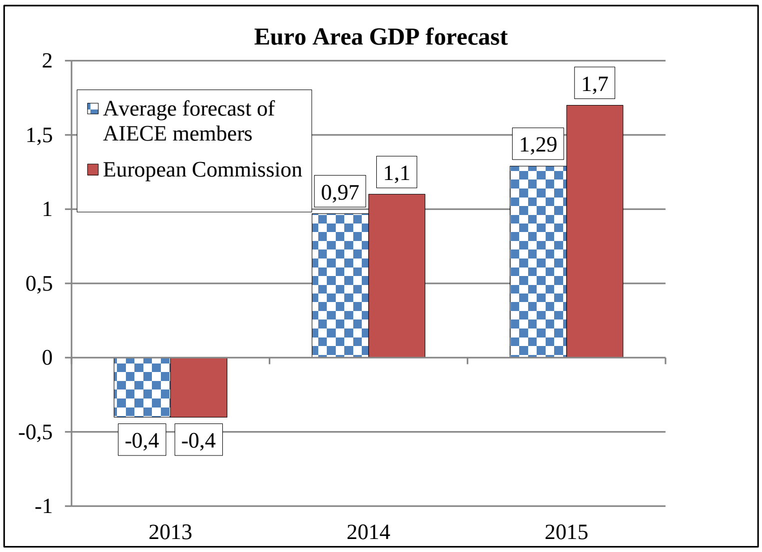


Chart 4: Variety of growth assessment for 2013

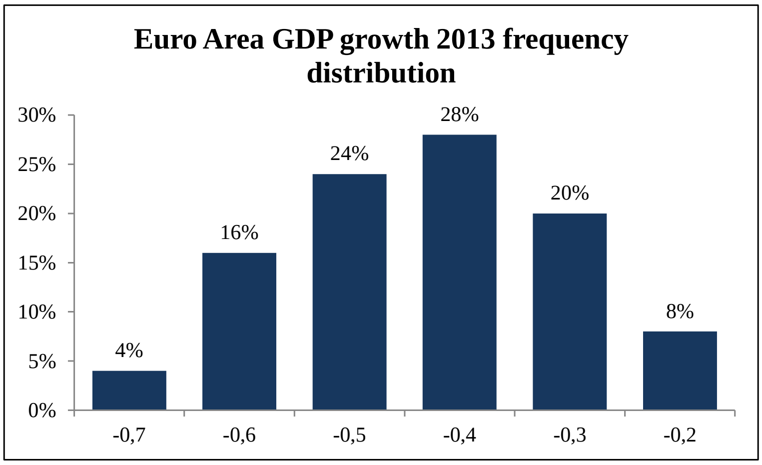
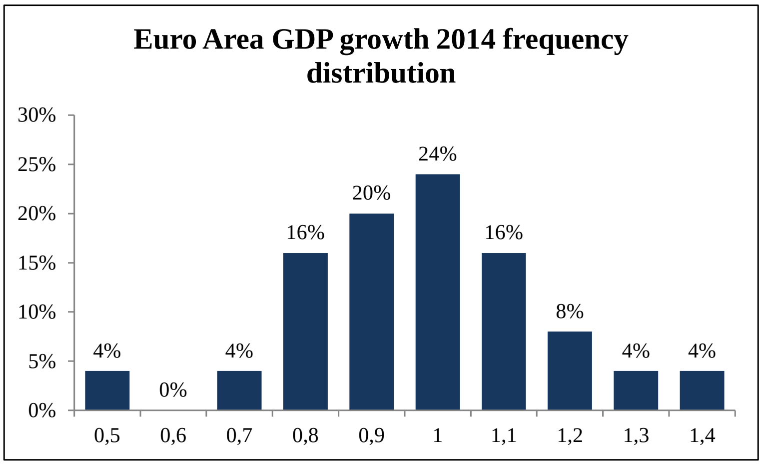


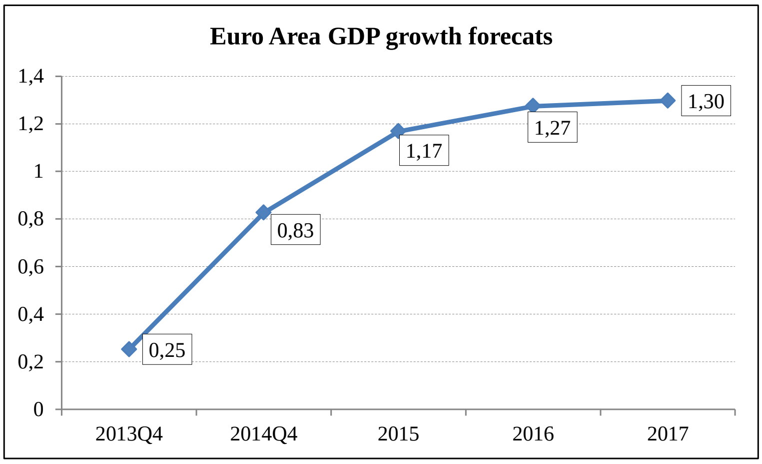
Chart 5: Variety of growth assessment for 2014



As regards forecasts for 2013 opinions show only a moderate variety: growth rates are ranging from -0.7 to -0.2. 28%. On the average institutes responding to the questionnaire forecast for the Euro Area a GDP ratio of -0.4%. Answers are more mixed concerning 2014: here the highest assessment of 1.4% comes from Denmark, whilst the least optimistic forecast of 0.5% from Norway. The majority of the answers (44%) move in the range of 0.9 to 1%. (See Chart 5)

We also asked AIECE members to give some longer term forecast on growth in the Euro Area. To our question *Q30: Please give probabilities on GDP growth in the Euro Area for the following periods* we received the following answers. (See Chart 6 and 7)

Chart 6: Forecast trends



According to longer term forecast there will be a slow acceleration of growth in the Euro Area, however on the average growth rates will remain modest, and will be most likely under that of the US.

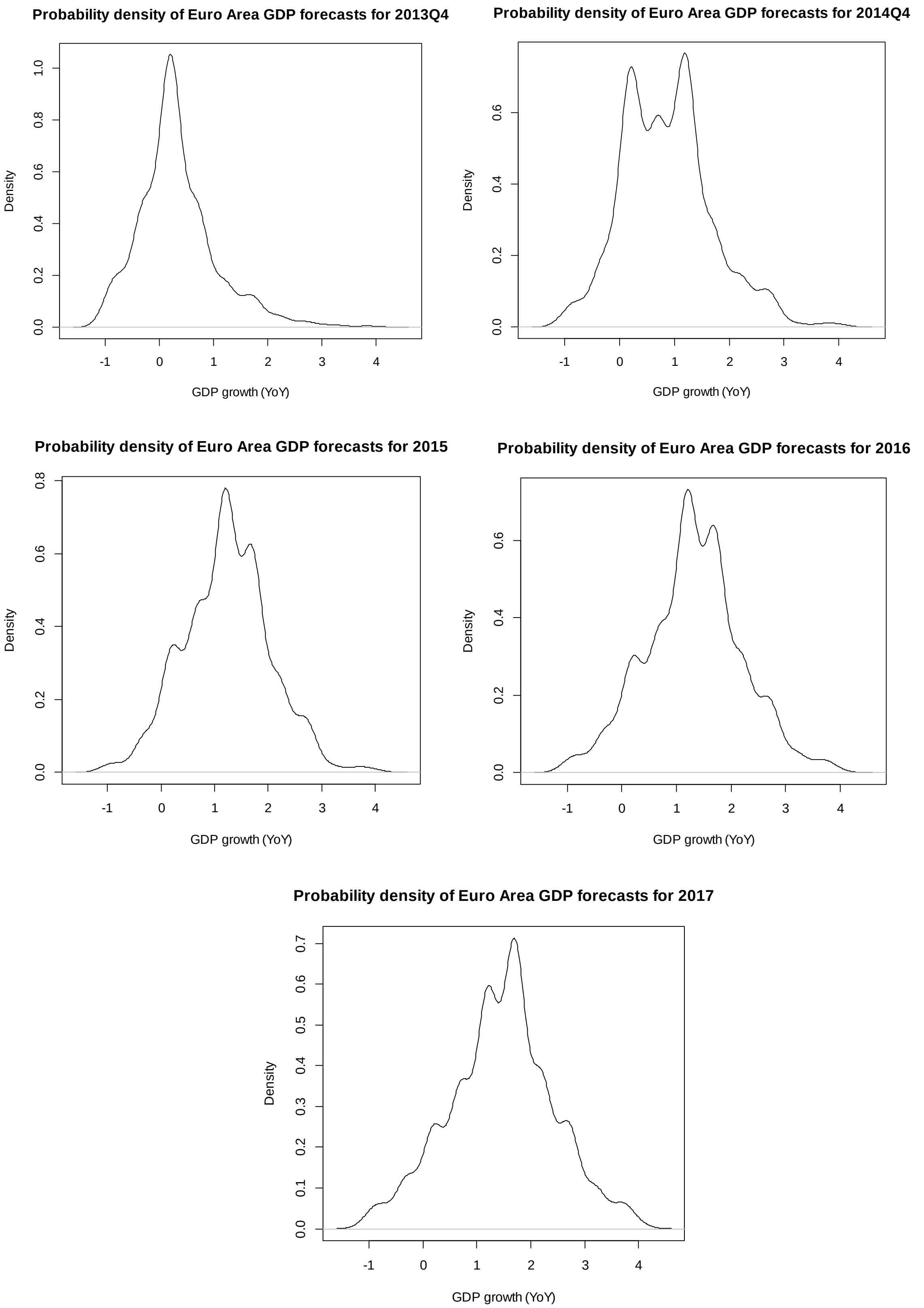
There is significant concordance among the institutes regarding the 2013Q4 growth. The expected value of growth calculated from the probabilities is 0.3%. We cannot experience that consensus in case of the forecasts for 2014Q4. The expected value is 0.8% but as one can see it from the density distribution the majority of the institutes expect GDP growth over 1%, while there is another group of institutes which considers GDP growth not too much below 1%.

For 2015 the concordance can be seen again, the expected value is 1.2% and the standard deviation is 0.40. The distribution is not normal because some institutes forecasted much more growth rates: the expected value for Euro area growth by DEC (Denmark) is 2%, and by KOPINT (Hungary) is 1.6%. There is left side tail of the distribution as well: Bureau Fédéral du Plan (Belgium) forecasted 0.3%, while IBRKK (Poland) answered 0.5%.

No doubt that the institutes expect growth in 2016 and 2017. The expected value in both years is 1.4%, although in the latter year there are more institutes which forecast above 1.5%; Universidad Autonóma de Madrid (Spain) expects 2.2%, DEC (Denmark) 2.2%. Fédéral du

Plan (Belgium) forecasted 0.3% again, if we omit their prognosis, the average growth rate for 2017 will be 1.6%.

Chart 7: Probability densities of GDP forecasts for the Euro Area



Source: AIECE Institutes

As to growth of EU 28 we received less estimates. On general we can say that forecasts for 2013 are quite homogeneous: varying from -0.4 to 0%. Whilst for 2014 the spreading is much larger with rates moving from 1 to 1.8%.

We also asked AIECE members about their assessment how different components of GDP will affect growth in longer run. *(Q 21: How do the following indicators affect GDP growth until 2015?)*

As regards major components of growth the development of *net exports* is regarded as the most important driving force in the coming years. As you can see in Chart 8 the majority of responders think that net exports have and will have a strong or very strong supporting influence on economic growth.

Chart 8: Assessment concerning the importance of net exports

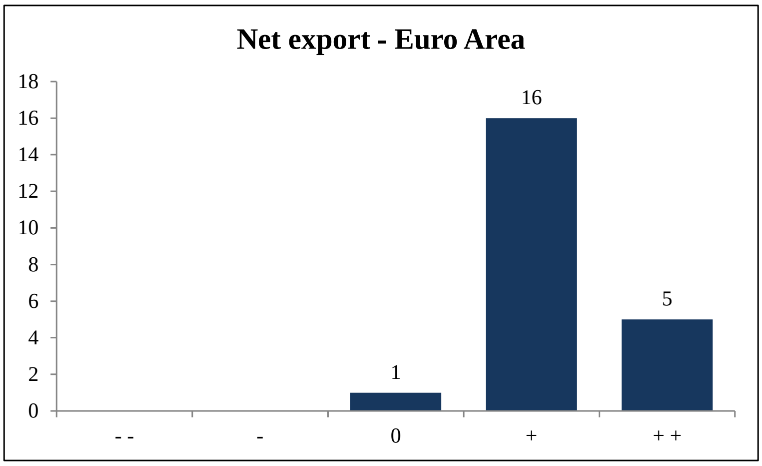


Chart 8a: Diverging export performance
(Home country forecasts)

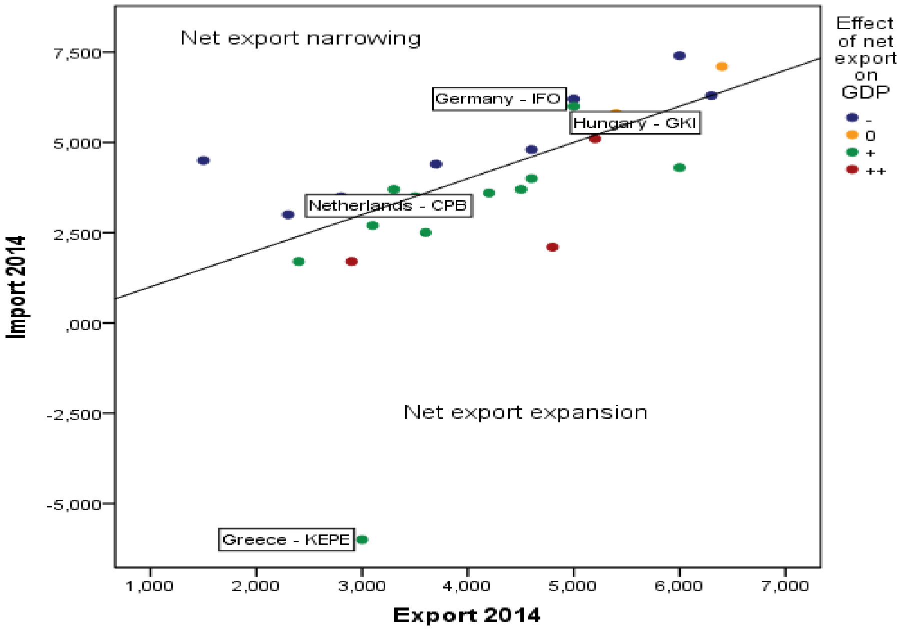
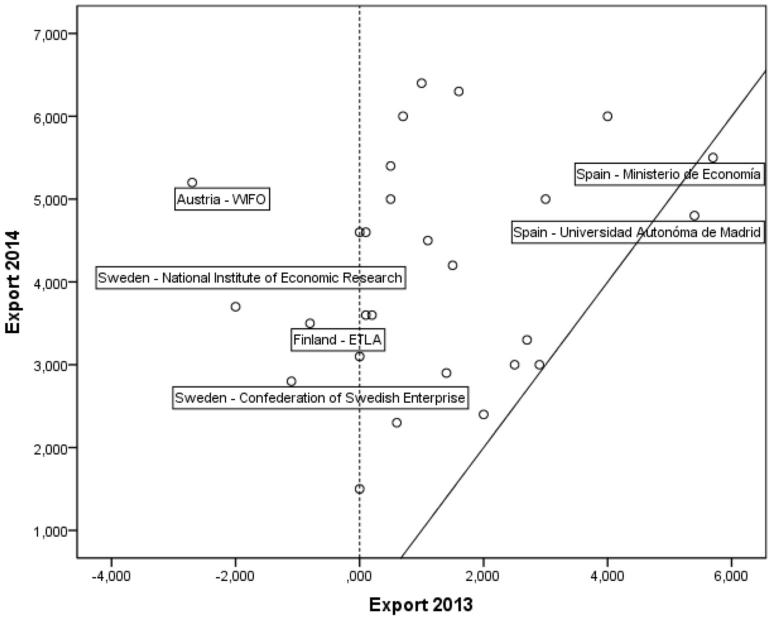


Chart 8b: Export remains the main driving force? A comparison of Euro Area and non-Euro Area countries
(Home country forecasts)



As regards *domestic demand* the picture is more mixed. Here a smaller majority thinks the domestic demand will support growth in the forecast period, but almost the half is of the opinion that it will have either a neutral effect or it will not support growth at all.

Chart 9: Assessment concerning the importance of domestic demand

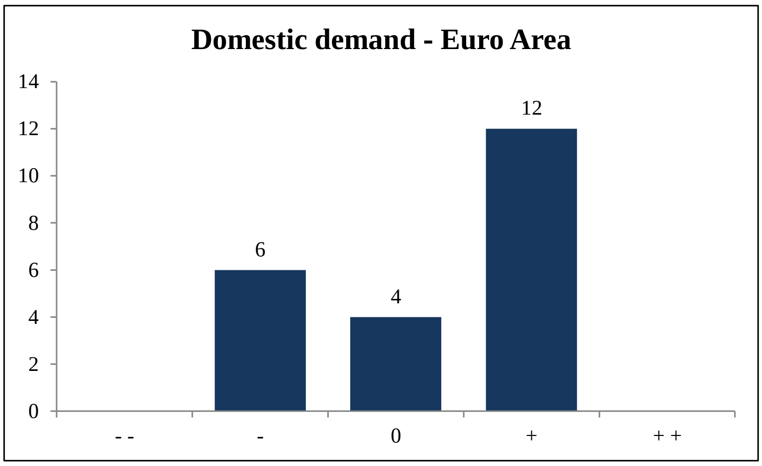
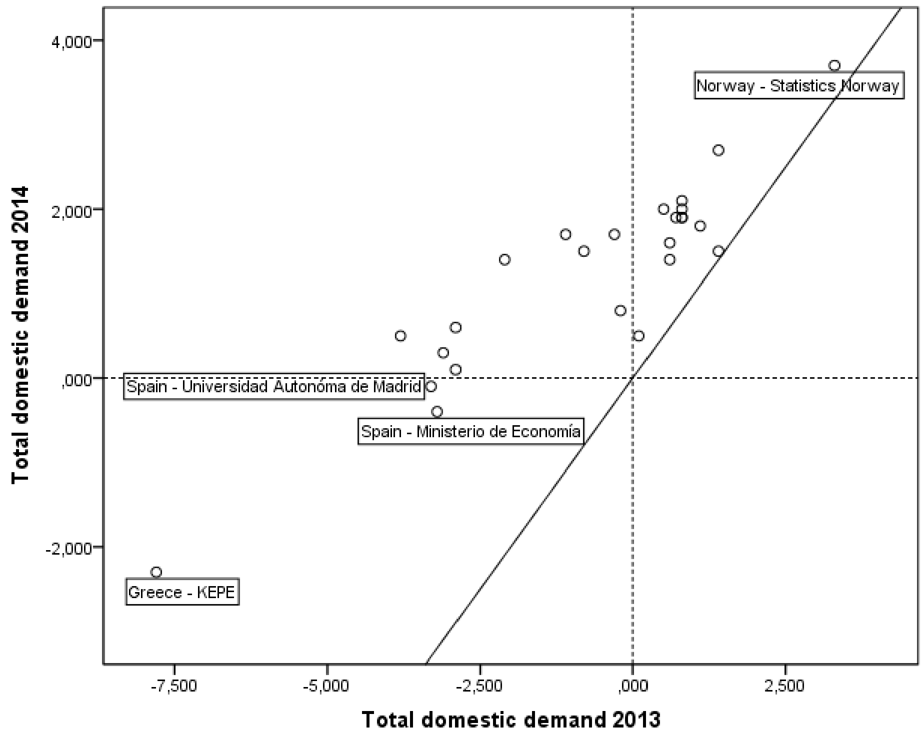


Chart 9a: Domestic demand is increasingly supporting growth



As to *gross capital formation* the picture is again rather mixed. (See Chart 10). More than the half of the respondents are estimating a revival of investment activity and thus exerting a strong positive influence on growth, whilst the others are less optimistic and are of the opinion that capital formation will have no substantial positive contribution to economic growth in the forecast period.

Chart 10: Assessment concerning the importance of gross capital formation

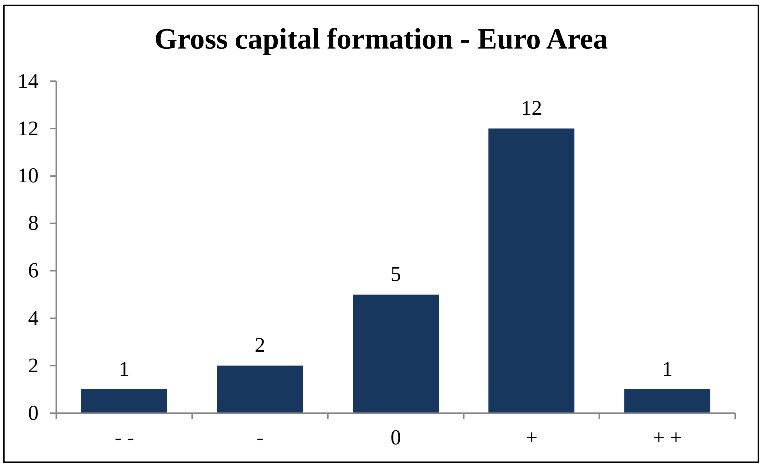
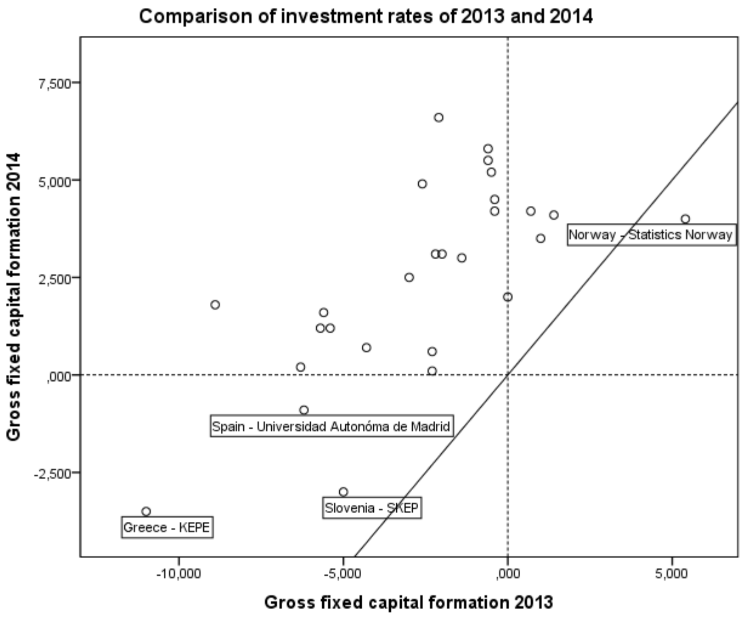
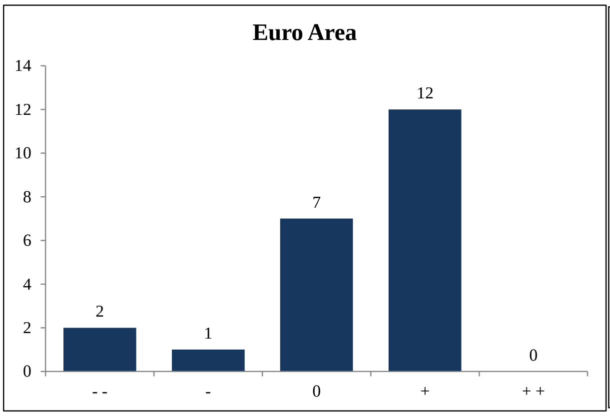


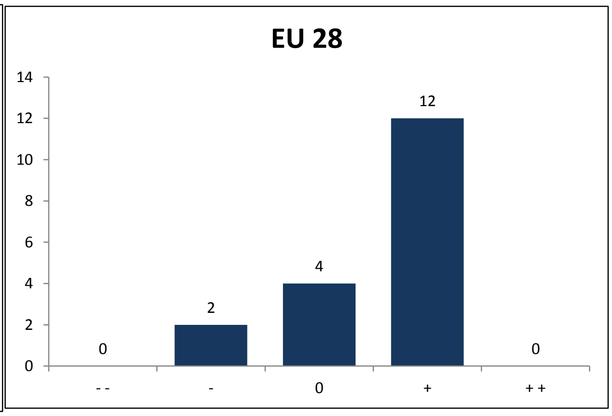
Chart 10a: Is an investment recovery ahead?
(Home country forecasts)



According to the majority of AIECE members the forecast modest growth for 2014 may prove sustainable in the coming years, i.e. we may reckon with the fact that the recession is over, and a period of slow but relatively stable growth is coming. *(Q22: How sustainable is economic growth in the Euro Area and in the European Union until 2015?)*

Chart 11: Assessment concerning the sustainability of economic growth until 2015





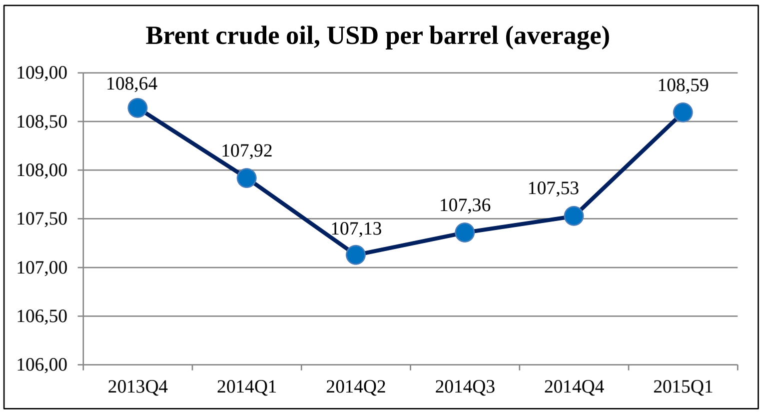
1.3. Assessment of exogenous factors affecting growth of the Euro Area and of the EU 28

We asked AIECE members about their opinion concerning exogenous factor having an influence on growth in the forecast period. We received a number of answers where different aspects of external demand were considered. One of the most important response was the importance of the economic development in the BRIC countries and the political development in the US, as to the latter the importance of the future stance of US fiscal policy and its consequences were emphasized. The lack of a compromise on the debt ceiling and budget corrections in the US may have substantial effects on global growth as a whole. The future of the monetary policy followed by the FED is reckoned also as an important exogenous factor.

Growing uncertainties in the global economy as a whole, economic and political instability in the MENA region, slowdown in Asia, coupled with international migration problems may also cause additional exogenous risks for European growth. As a special threat was mentioned the possible slowdown of the Chinese economy, as China has become one of the most important markets of the EU countries, sluggish demand would have negative consequences on EU exports.

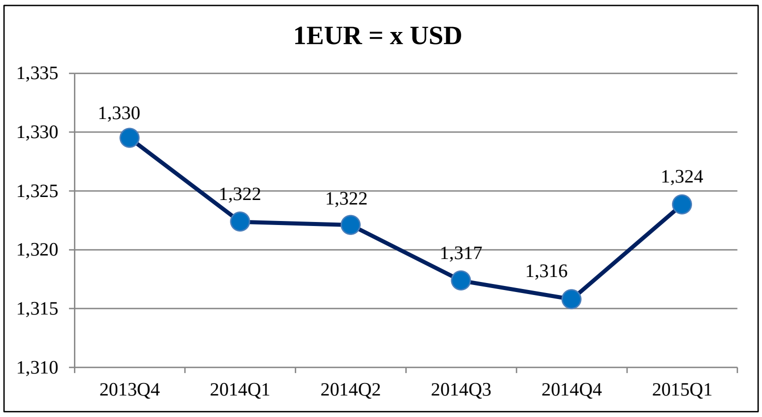
Some additional risks may come from the development of energy and raw material prices. Especially oil prices may rise if tensions in the Syrian and Egyptian regions accelerate. However on the average, AIECE members share the opinion that no radical rise of oil prices is to be expected. For next year they estimate even a slight fall of Brent oil prices, and by the beginning of 2015 – responding to reliving demand – it should climb back to the level of Q4 2013. (See Chart 12)

Chart 12: Forecast on Brent oil prices



According to the majority of AIECE members the EUR/USD exchange rate will fluctuate in the range 1.31 to 1.33 in the forecast period. Some expressed the view that an escalation of US fiscal problems may bring about an appreciation of the Euro that may have adverse impacts on the competitiveness of the Euro Area as a whole. However, on the basis of forecasts we

Chart 13: EUR/USD forecast



1.4. Assessment of endogenous factors affecting growth of the Euro Area and of the EU 28

There are a number of endogenous factors which are considered as potential risks for future development. The sovereign debt crisis is considered as the major risk for the Euro Area, and still growing debt/GDP ratios suggest that this challenge is a durable risk potential. Restrictive fiscal measures will remain characteristic next year as well having a dampening effect on overall growth rates.

In the opinion of institutes additional risks may come from 1) No agreement on the banking union; 2) The continuation of a too restrictive fiscal policy; 3) A too early abandon of accommodative monetary policies by the ECB; 4) No improvement in establishing a new political governance in the Eurozone.

According to responses of AIECE members adjustments in current accounts and a persistent decrease of credit lending may have dampening effects on growth. Rising unemployment in some countries and failing social cohesion together with political tensions may also cause a future threat for overall growth in the Euro Area.

It is a special problem that despite of low interest rates investment activity continues to remain moderate and without investments a recovery of growth cannot be reckoned with. The improvement in business confidence and the outcome of structural reforms may have positive impacts in respect of future development.

1.5. Assessment of the situation of some countries with special problems

In order to have some country specific information we asked several institutes from countries with special problems, with special difficulties in combating the effects of the crises to give their assessment on special factors hindering or supporting a recovery in the country in question.

We put the following questions to some of AIECE member institutes:

1. *How far consequences of the crisis could be offset in your country?*
2. *Do you see a recovery in the credit business in your country?*
3. *What kind of internal structural problems are characteristic for your country?*
4. *Please describe special policy challenges for the national government in your country.*

1.5.1. Ireland – Understanding the Data[1]

This year there are exceptional problems in interpreting what has actually happened in the Irish economy using normal data sources.

Ireland is one of the major centres for manufacture of pharmaceutical products in Europe. Because of a change in the patent status of certain pharmaceutical products manufactured in Ireland there is a major distortion in published data for 2012 and 2013 for industrial output, exports and GDP. Under national accounting conventions, all of the effect of a drug dropping out of patent is treated as a volume change in these aggregates. The loss in revenue from sales of a single drug, which dropped out of patent at the end of 2011 and in the first half of 2012, amounted to $5.6 billion, or 2.6% of GDP. While all of the loss of profits from the loss of patent status is a cost to the foreign owner of the drugs, the fall in revenue can have a big effect on GDP. However, the effects on GNP and Gross National Income are very small as these aggregates exclude the profits of foreign firms producing in Ireland. Thus our forecast for GDP growth for 2013 is +0.5% whereas our forecast for GNP growth is +2.0%. The forecast for GNP growth is much more consistent with developments in the labour market where we are forecasting a rise in employment in 2013 of 1.9%.

The government plan for adjustment in the public finances was agreed with the Troika in December 2010. This plan remains on track, with borrowing in 2014 expected to come in comfortably below target.

There are serious concerns that the continuing problems with the domestic financial sector may hamper recovery in 2014 and 2015. At present shortage of credit is not posing a major

[1] John Fitzgerald, ESRI

problem as the evidence suggests that there is little demand for such credit from the company or household sector.

1.5.2. The crisis effects in case of the Spanish economy[2]

The main consequences of the crisis on the Spanish economy have been the drastic rise of the unemployment rate and the need to reduce the high external indebtedness.

Regarding the first factor, there is no easy short-term solution in view as growth prospects are quite moderate and clearly insufficient to generate an adequate amount of new jobs needed to reduce the unemployment rate.

In this sense, the main challenge facing economic policy makers is to design a new labour framework that allows a higher level of occupation even without a significant progress in production.

This new framework for labour relations cannot be limited to the reduction of labour cost as it was the case during the last labour reform. For reducing the cost of employment on its own would generate adverse redistribution effects, i.e. increasing the non-wage income at the expense of wage income, instead of an expansion in labour demand.

A possible solution could be the promotion of part-time work in which our country has an important differential to the average of Eurozone countries.

Regarding the evolution of external debt, it seems unavoidable for the Spanish economy as a whole to continue the process of deleveraging started in recent years and to ensure positive net external financing capacity (i.e. a positive balance of the current account) which has already been registered in 2013.In addition, restrictions of credit taken by the private sector should be extended. The credit-to-GDP ratio should return to levels close to 100% in the coming years after having reached record values of around 175% in 2010.

1.5.3. Greece - Crisis impacts[3]

1. How far consequences of the crisis could be offset in your country?

In the second half of 2013 all indicators in the Greek economy signal a moderation of the downturn. KEPE forecasts a real GDP rate for 2013 of about -3.5%, reflecting the narrowing of the depth of the recession. Still, the Greek economy is in the sixth year of a particularly deep and severe economic recession, with the cumulative contraction in output – taking into account the 2013 forecast – expected to reach 25% in the end of 2013. The situation has been deteriorated by a substantial decline in incomes, and, most significantly, the fact that unemployment is still on the rise and has reached an average of 27.1% in January-July 2013.

[2] Julian Perez, Institute “L.R.Klein”-CEPREDE
[3] Kepe, Yannis Panagopoulos

Hence, economic crisis has not been over by any means in Greece. Moreover, severe financial liquidity constraints and a lack of funding as an effect of the recession still heavily weigh upon the Greek economy.

2. Do you see a recovery in the credit business in your country?

Unfortunately, bank lending has not yet come to a recovery in the Greek economy. This fact is reflected on the one hand by the significant outstanding credit amounts (in August 2013 total credit amounted to 254 billion euros, of which 221 billion euro to the private sector), in combination with difficulties encountered in debt-servicing. On the other hand, a negative flow of credit continues to characterize Greece: in January-August 2013 negative credit flows amounted to 15 billion euros and outstanding credit for this period was 6.3% smaller than in the corresponding period of 2012. Any potential progress in the domestic credit business will crucially depend upon the return of deposits, the ability of Greek banks to resort to external financing and in the longer term upon the evolution of savings.

3. What kind of internal structural problems are characteristic for your country?

Until the outbreak of the crisis, a significant structural characteristic of the Greek economy with negative implications had been an excessive reliance on consumption instead of investment, accompanied by excessive external sector deficits. Recessionary conditions have caused a forcible adjustment via tremendous declines in both consumption and imports. At the same time, Greece faces considerable structural problems regarding public administration, competition, closed professions and the existing tax system.

4. Please describe special policy challenges for the national government in your country.

Since the beginning of the recession, Greece has made significant progress in a number of dimensions and particularly in facing fiscal challenges. Still, to ensure a smooth transition to a recovery and growth process in the medium term, the Greek government faces a variety of elementary challenges. Among the most fundamental policy challenges facing Greece are: (a) ensuring stability and credibility and maintaining commitment to economic consolidation and structural reforms (b) preparing a new growth strategy plan guaranteeing long-term sustainability and (c) urgently tackling the major issue of excessively high unemployment rates to put a halt in the continuous decline in citizens' prosperity and to promote social cohesion.

1.5.4. SLOVENIA – SKEP

- How far consequences of the crisis could be offset in your country?

In the crisis year 2009 the Slovenian economy was hit strong with a drop of 7.9% in GDP. The recovery in 2010-2011 was weak and in 2012 Slovenia slipped again into recession. At the same time, public finance started to worsen considerably, reaching a general government deficit of around 6% of GDP in 2009-2011. In 2012, the government pursued an ambitious austerity plan, reducing the general government deficit to 3.8% at the expense of economic growth. In 2013-2014 Slovenian economic growth is estimated to remain negative, with subdued domestic demand and somewhat better prospects on export markets. The government imposed higher VAT and other tax burdens that impede competitiveness. The key challenge ahead is the restructuring of the banking sector, where capital needs appear to be much larger than expected before. Indebtedness of the corporate sector is another key challenge and the restructuring of the sector is inevitable to revival of growth. Consequences of the crisis include lower employment and increasing youth unemployment as well as lower disposable income of households due to downward wage pressures. Yet, we expect some positive turn in 2015, when key structural issues should be improved.

- *Do you see a recovery in the credit business in your country?*

Credit recovery is not expected until banks improve their capital adequacy ratios and NPLs stop rising. Their current level (Moody's definition of being 90 days in arrears) was in mid2013 31% for the first and the third largest banks and not far less for the second largest one. Level of loss recognition is about the half of this due to collaterals that are mostly real-estates. Yet, real estate prices are under pressure due to soaring unemployment, large inventories for sale, tougher credit standards for households and a forthcoming tax on real estate, which will be the main source of additional revenue for the government next year.

All the largest banks have below-investment grade rating with negative outlook that makes the banking crisis systemic. On the demand side, companies are still overleveraged with unsustainable long term debt ratios (measured by equity-to-assets and net debt-to-EBITDA), especially in cases of the largest firms.

- *What kind of internal structural problems are characteristic for your country?*

Labour is overburdened by tax and social levies and the level of redistribution and state involvement in the economy is too high.

The state is still the majority owner in the banking sector as well as in several important companies (directly or via cross holdings) and the corporate governance culture remains underdeveloped.

The pension and healthcare reforms will have to be more thorough to ensure sustainability of both systems in a medium term.

- *Please describe special policy challenges for the national government in your country!*

Stabilizing public finances and debt sustainability are preconditions for attaining healthy economic growth. At the same time, the government should support productive investments and improve the efficiency of public spending.

Bringing down the yield-to-maturity of Slovenian government bonds until the beginning of next year is another challenge. Yields currently are above 6%. The fiscal consolidation path based exclusively on tax increases is likely to face hurdles. Spending cuts have to be implemented in the public sector that is too big to be sustained by the private sector according to international comparisons.

Improving business conditions and attracting FDI could be a means to promote economic growth and trigger productivity gains.

Privatization should be transparent while the state should not lose any more time to clean up state capital investments and reduce its ownership considerably, even if asset sales can be only conducted at relatively low prices during the crisis.

A further pension reform will be needed in five years due to an ageing population with increasing costs of pensions, healthcare and long term care.

1.5.5. Finland[4]

The Finnish GDP was 3.7 per cent lower in 2012 than in 2008 before the financial crisis. The level of exports was 13 per cent lower. Unemployment rate was 6.4 per cent in 2008 and 7.7 per cent in 2012. The relatively modest increase in unemployment reflects the retirement of the baby boom generation born after the war. The decline in the GDP has also occurred to a large extent in those branches of industry, where productivity growth has been high. Fiscal policy was loose immediately after the crisis. Private consumption could support economic growth during this time. Gradually the fiscal stance has been tightened due to increasing public sector deficits. Growth in private consumption has decelerated substantially.

Investment demand has weakened due to the crisis. The demand for credit has accordingly slowed down. Due to tightening financial regulation, the banks have increased their margins. They also monitor carefully the creditworthiness of the firms. This is reflected in new credits of the small firms. Good ideas get anyway financing. If the recovery will strengthen, demand for credit will increase in the coming months.

The poor performance of the economy reflects weak international demand, but there are also other reasons behind this. About 2/3 of the above mentioned 3.7 per cent decline in GDP in 2008-2012 is due to the decline in Nokia's contribution to the GDP. Nokia's share in the Finnish GDP was 2.5 per cent in 2008, but about zero in 2012. Nokia's only mobile phone factory in Finland was closed in autumn 2012. The weak performance of the company has been reflected also in its services production. Nokia's profits from its foreign units are to a large extent channelled through exports of services. In addition to Nokia itself, also its subcontractors have suffered. An additional structural problem of the Finnish economy has been the weak demand for printing and writing paper. Cost competitiveness of the economy has deteriorated due to too high increases in contract wages, and due to the slowing down in the productivity growth. Currently the economy is adjusting to the Nokia shock. The former

[4] Markku Kotilainen/ETLA/

employees try to find employment in other firms or to establish new firms (start-ups). The high education level of them helps in finding a job. A modest centralized wage agreement (0.4 % annual increase in contract wages for 2 years) has been negotiated in autumn 2013. Active measures to accelerate investment activity and R&D have been taken. One tool in this is to reduce the corporate income tax rate from 24.5 to 20 per cent by 2014.

The central and local government's financial deficit increased one percentage point to 4.9 per cent of GDP in 2012. The central government deficit was 3.8 per cent of GDP. Slower economic growth eliminated the impact of spending cuts and tax increases. In 2013, the central and local government's deficit will decline slightly to 4.7 per cent as a percentage of GDP. As a consequence of tax increases, spending cuts and the upturn in economic growth, the central government's deficit-to-GDP ratio will decrease to 3.4 per cent in 2014 and to 3 per cent in 2015. The general government's EMU deficit will be 0.9 per cent of GDP in 2015. The ratio of the general government's EMU debt to GDP will continue to climb, exceeding the 60 per cent ceiling stipulated in the Stability and Growth Pact in 2015.

In August 2013 the government presented its structural policy programme, which aims to reduce the long-term sustainability gap caused by the aging of the population. The programme will not have much time to affect the public sector's fiscal balance during the forecast period. If the programme can be implemented in a credible way, it will reduce the pressure for further austerity measures in the short term. The rise in the EMU debt above 60 per cent of GDP will nevertheless constrain the manoeuvring room in economic policy. For this reason, measures to shore up the general government's financial position will still be necessary in the medium term.

1.5.6. Economic outlook for Hungary[5]

Due to the still fresh memories of very high fiscal deficits, and to the toxic combination of high public and external debt, the outbreak of the global crisis in 2008 found Hungary in an extremely shaky credit standing. The crisis brought about a further deterioration of credit standing, reflected by the plunge of the HUF/EUR exchange rate. As a result of high indebtedness, the government did not have the room to manoeuvre to offset the crisis – instead, it pursued a pro-cyclical restrictive policy in 2009. The only alleviating measure, a two-step personal income tax (PIT) rate cut in 2009-10, benefited the middle class while exacerbated the situation of the most vulnerable low-income households.

Another round of aggregate PIT rate cut in 2011 failed to stimulate household demand since it was accompanied by a strongly degressive redistribution of the tax burden, and benefited mostly the wealthy minority of households.

Since then, the government has made repeated attempts to deal with the problem of the FX-indebted households, which has been a main drag on household demand since the beginning of the crisis due to the sharp depreciation of the forint. The outcome of these attempts so far

[5] Zoltán Matheika, Kopint-Tárki

has been mixed at best, since they could not reach the lower income households, among whom the most financially vulnerable ones can be found.

As a result, a recovery of lending has started only very recently, and its effects are still limited. Some increase in non-residential lending to households and a very limited upturn in non-overdraft loans to corporations can be observed. This is likely to change, at least in part, due to the extended „Lending for Growth" program of the NBH, which offers zero interest loans to commercial banks (up to HUF 2 trillion) to lend on to SMEs at an annual interest rate of no more than 2.5%. This program, although not without considerable risks, is likely to give a palpable boost to corporate lending.

An important policy challenge is posed by the low investment rate – also low compared to the other Visegrad countries – which threatens with a growing technological lag between Hungary and other countries within the region. Part of the problem is that corporate investment is hindered by – among others – the unconventional policy line of the government, such as the sector specific taxes, which tend to alienate foreign investors, notably the parent banks of major banks of the Hungarian banking sector. Worryingly, it is unclear how the government will keep the fiscal deficit low without these taxes. In this sense, the government seems to have gotten itself into a policy conundrum.

An important structural problem – which has been less manifest in recent crisis-ridden years but may return soon – is the chronic external imbalance of the economy, caused by the fact that most modern technology is imported and the industrial production system is highly import-dependent. This means that at times of reasonable growth, a substantial trade deficit tends to accumulate along with a high current account deficit and an increasing level of external debt. As the economic recovery proceeds and the level of consumption and – hopefully – investment picks up, the problem of external imbalances is likely to return, with no evident strategies at sight to address it, since this has been a structural problem of the economic system since the 1960s.

1.5.7. Note on Poland[6]

How far consequences of the crisis could be offset in your country?

Poland has avoided an open recession but not a serious slowdown. Situation of the construction sector is especially painful. It could offset the crisis consequences no earlier than in 2015. Public sector workers have been suffering from a purchasing power decline due to a prolonged freeze of nominal wages. Private sector has stopped to create new jobs with a youth employment especially affected.

[6] IBRKK

Do you see a recovery in the credit business in your country?

A recovery is very modest, primarily because of cyclical reasons but also due to a pro-cyclical tightening of access to consumer credit by the Financial Supervision Authority regulations. They are now to be amended. Tight lending policies by banks, particularly with respect to SME have forced the government to introduce a program to partially (up to 60%) guarantee SME credit.

What kind of internal structural problems are characteristic for your country?

Despite of a significant labor supply reduction due to a massive migration Poland still experiences a high structural unemployment. Country competitive position is primarily based on relatively low wages. There is no enough inflow of innovations to enterprises from domestic sources.

Please describe a special policy challenges for the national government in your country.

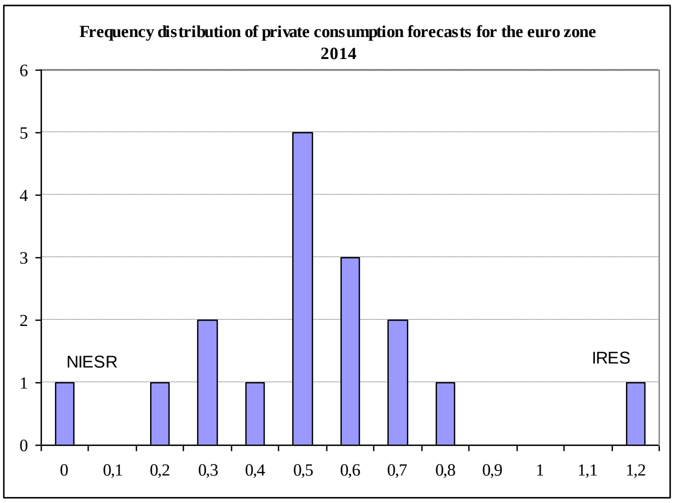
1. A reform of a pension system to make it affordable for the public finance.
2. A reasonable absorption of the EU funds under the Financial Perspective 2014-2020.
3. An increase of labor participation and a reduction of structural

2. Euro area inflation – lack of domestic demand puts prices into the shade of deflation in 2013

Monthly (year over year) inflation rates have been decreasing since the beginning of 2012. In October 2013 the most recent statistics show a 0.7% consumer price index which is the lowest rate since 2012. Although both short and long term interest rates are relatively low in the Euro Area (except crisis countries) it is not enough to fuel private consumption. According to AIECE institutes domestic demand in the Euro Area is likely to decrease by 0.6% in 2013, and only 0.5% increase is expected in 2014.

Low demand is also mirrored in the consumer confidence indices of the European Commission; although there are certain signs of slight improvements, consumer confidences are still negative in most of the member states. In 2014 significant positive changes are awaited in the Euro Area states. Every institute forecast an improvement which turns the average into positive; no negative values of private consumption are reported for 2014. The most pessimistic forecast for private consumption belongs to NIESR (UK, 0%), while the highest increase is expected by IRES (Belgium, 1.2%).

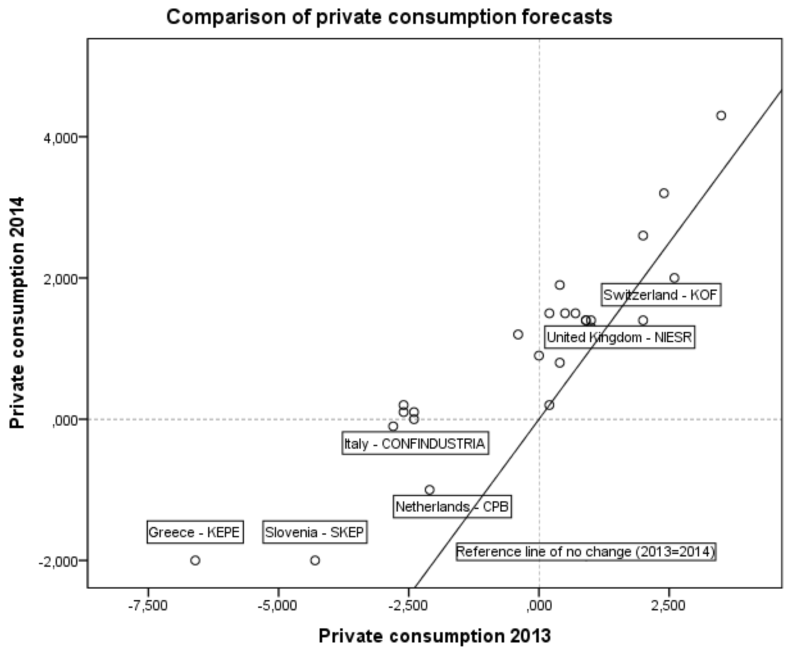
Chart 14: Frequency distribution of private consumption forecasts



Source: AIECE Institutes

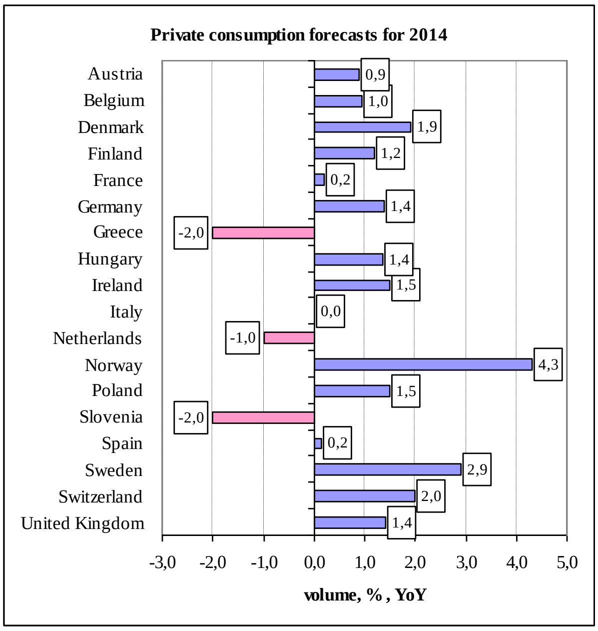
At the same time home country forecasts are rather unfavourable concerning private consumption: in case of Greece, Slovenia, Netherlands and Italy (Confindustria) a decrease is expected. In case of the United Kingdom and Switzerland a slight moderation is expected in 2014. All other AIECE member states reported increasing private consumption for next year.

Chart 15: Private consumption forecasts



Source: AICE institutes

Chart 16: Private consumption forecasts



Descriptive statistics

No. of answers: 27

Minimum: -2% (Greece)

Maximum: 4,3% (Norway)

Median: 1,2%

Std. deviation: 1,37

Variance: 1,877

Source: AICE institutes

As one can see the relative standard deviation (standard deviation / mean) is very high (1.42) which means that some states take extreme low and high values compared to the mean. Slovenia, Greece and the Netherlands are suffering from lack of demand while Norway, Sweden, Switzerland and Denmark will experience high consumption rates in 2014. Other member states are varying around 1.2%, which is still a lower value compared to the pre-crisis period.

The lack of demand caused asymmetric price fluctuations in many member states which resulted temporary **deflation** in some COICOP groups:

Table 1: Consumer price development by country groups

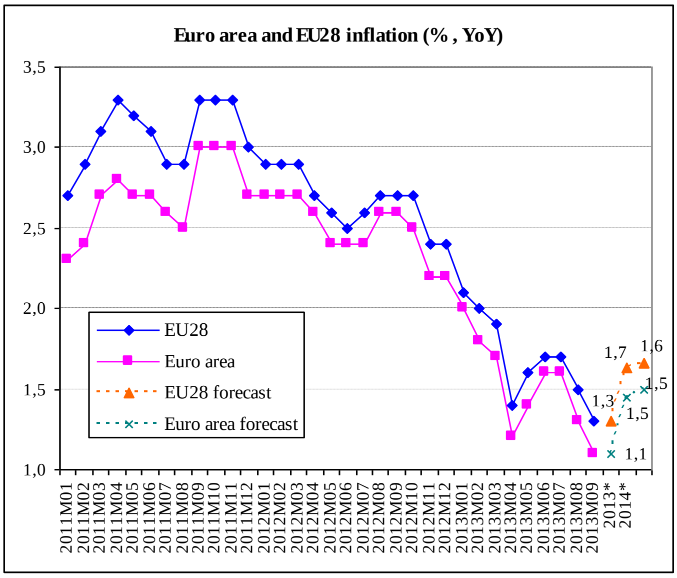
COICOP Group (number of countries)	Temporary deflation (YoY) in 2013 (no. of months out of 10)
Food and non-alcoholic beverages (6)	Bulgaria (1), Denmark (1), Greece (2), Cyprus (2), Romania (1), Norway (4)
Alcoholic beverages, tobacco and narcotics (1)	Latvia (1)
Clothing and footwear (23)	Bulgaria (4), Czech Republic (6), Denmark (4), Germany (2), Ireland (9), Spain (2), Croatia (9), Italy (3), Cyprus (8), Latvia (5), Lithuania (2), Hungary (7), Malta (4), Netherlands (2), Austria (3), Poland (9), Portugal (9), Slovenia (5), Finland (8), Sweden (3), United Kingdom (3), Norway (8), Switzerland (6)
Housing, water, electricity, gas and other fuels (10)	Belgium (8), Bulgaria (3), Spain (3), Cyprus (6), Latvia (3), Lithuania (3), Hungary (9), Malta (2), Slovakia (2), Switzerland (5)
Furnishings, household equipment and routine maintenance of the house (14)	Bulgaria (3), Czech Republic (9), Denmark (3), Ireland (9), Greece (9), Croatia (1), Cyprus (8), Latvia (6), Portugal (9), Slovenia (9), Slovakia (1), Sweden (9), Norway (5), Switzerland (9)
Health (12)	Bulgaria (7), Denmark (1), Germany (9), Estonia (1), Greece (9), France (8), Croatia (5), Cyprus (9), Portugal (3), Slovenia (5), Finland (1), Switzerland (9)
Transport (26)	Belgium (5), Bulgaria (6), Czech Republic (8), Denmark (7), Germany (5), Estonia (9), Ireland (7), Greece (1), Spain (1), France (1), Croatia (4), Italy (1), Latvia (9), Lithuania (7), Luxembourg (4), Hungary (5), Malta (6), Austria (4), Poland (9), Portugal (7), Romania (3), Slovenia (3), Slovakia (6), Sweden (7), United Kingdom (1), Switzerland (5)
Communication (27)	Belgium (9), Bulgaria (9), Czech Republic (9), Denmark (7), Germany (9), Estonia (9), Ireland (9), Greece (9), Spain (9), France (9), Croatia (7), Italy (9), Latvia (9), Lithuania (9), Luxembourg (7), Malta (9), Netherlands (8), Austria (1), Poland (9), Portugal (3), Romania (4), Slovenia (7), Slovakia (2), Finland (9), Sweden (9), Norway (9), Switzerland (9)
Recreation and culture (17)	Belgium (1), Bulgaria (9), Czech Republic (3), Denmark (3), Germany (1), Ireland (3), Greece (9), France (6), Italy (2), Cyprus (4), Latvia (7), Poland (2), Portugal (3), Slovenia (7), Finland (1), Sweden (9), Norway (3)
Education (6)	Estonia (1), Greece (9), Cyprus (1), Latvia (8), Poland (1), Slovenia (1)
Restaurants and hotels (4)	Greece (9), Cyprus (4), Latvia (3), Malta (6),
Miscellaneous goods and services (5)	Denmark (9), Ireland (5), Greece (9), Portugal (6), Slovakia (3)

Source: Eurostat

Although there is no country which does not have at least one deflating product group, inflation forecasts rather optimistic. Only 2 member states forecasted *negative* consumer price index – Greece (-0.3%) and Switzerland (-0.2%). In 2014 only Greece expects deflation (-0.3%), while other countries are awaiting increasing inflation.

The consecutive year will be much different in terms inflation according to AIECE institutes. Forecast HCPI rates for 2014 are *significantly higher* than the forecast values in 2013. At the same time neither private consumption nor total consumption will grow at a pace which would fuel prices thus the main source of higher inflation will not be the final demand but rather the supply side.

Chart 17: Euro Area and EU 28 inflation forecasts



34,6% of the institutes consider that consumer loans does not support growth and only 26,9% thinks that it positively affects GDP (15,4% gave neutral answer and 23,1% was missing). Regarding the future development of consumer loans the following comments were recorded:

Table 2: Assessment of consumer loan development

Belgium - Bureau fédéral du Plan	Both for consumer credit as well as business credit we cannot expect great strides in the coming years. In fact, possibly the total credit volume to GDP ratio will continue to decrease in the short term.
Finland - ETLA	Growing. No problems with availability of credit.
France - COE	Due to low indebtedness of households, it will outpace the growth of other types of loans.
Germany - DIW	The latest Bank Lending Survey for Germany (July) indicates that credit standards for consumer credit are slightly tightening, primarily due to higher margin requirements which are going to decrease demand for consumer

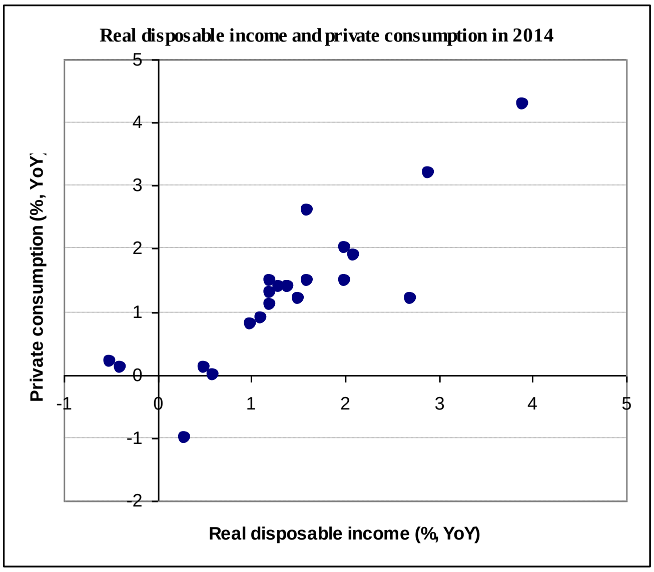
	credit. Overall, the conditions remain favourable due to the positive outlook for economic activity.
Germany - Institut für Weltwirtschaft, Kiel	Reduction
Germany - RWI	Lending decreasing rapidly
Greece - KEPE	increasing again
Hungary - GKI	There may be problems for the financial sector in financing expansion of activity.
Hungary - KOPINT	Fairly normal credit conditions. Growth more or less in line with household income growth.
Ireland - ESRI	The household debt to disposable income ratio is reaching 170 percent. This is a level that may to be a risk to financial stability. The central bank, Riksbanken, has regarded this as an argument for not lowering the policy rate. The government is monitoring the development and are implementing measures to dampen the increase in private indebtedness. This will most likely continue.
Italy - PROMETEIA	With a recovery strengthening and envisaged liberalization of credit access, a volume of loans should increase.
Poland - IBRKK	no changes
Slovenia - SKEP	Households are reducing their debts denominated mainly in foreign exchange. The high volume of FX loans is a limit to the increase of consumer ones.
Spain - Universidad Autonóma de Madrid	No major change
Sweden - Confederation of Swedish Enterprise	we expect an improvement in credit conditions but at a very slow pace
Sweden - National Institute of Economic Research	Continued modest expansion of the stock of consumer loans. Mortgage lending is expected to pick
Switzerland - KOF	A cautious increase is expected.
United Kingdom - NIESR	Consumer credit is not expected to expand in the short term, both due to falling consumer demand and tight conditions for the supply of credit on the part of banks.

Source: AIECE member institutes

The comments regarding consumer loans suggest that significant increase is not expected next year either, even some institutes reported decreasing pace for the consecutive years.

Regarding the **real disposable income** forecast for 2014 the average increase is 1.4% and there are no major differences among the institutes. The highest increases are expected in Norway (3.9%), Sweden (National Institute of Economic Research – 2.9%), Finland (2.7%), while decrease can be expected in France (COE-REXECODE - -0.5%), Spain (University of Madrid - -0.4%). Other countries are varying around 1.4% increase. This average amount of growth of disposable income is enough to feed private consumption as it can be seen on the next chart:

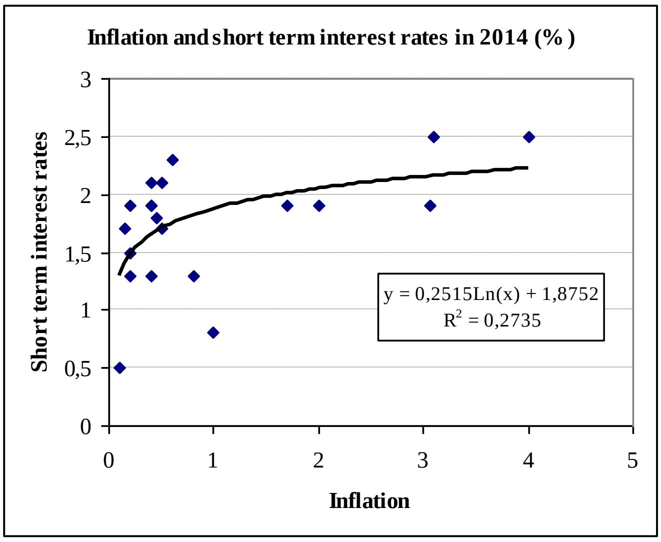
Chart 18: Real disposable incomes



Source: AIECE institutes

Still, inflation is rather determined by the **mutual interaction between interest rates and consumer prices** and this is suggested by the answers to the questionnaire (see the next chart). Due to the fact that short term interest rates in the euro area are influenced by ECB operations high inflation would mean negative interest rates which distracts the economy from the equilibrium. On the other hand higher interest rates burden the budget of the central government. Thus, inflation is more likely to be neutral to the changes of disposable income as monetary policy is not strict in the region and prices are also affected by governmental actions. In spite of the low interest rates neither consumer nor corporate (NFC) crediting is expanding, the money market turned to the riskier investments. Private consumption is also increasing but not in pace which could feed inflation.

Chart 19: Inflation and short term interest rates



Source: AIECE institutes

There is not too much uncertainty concerning Euro Area inflation forecasts. The table below summarises the comments made by AIECE institutes on EA CPI expectations. There are two main sources of inflationary pressures in the Euro Zone; imported inflation through raw materials and escalation of sovereign debt crises. Weak purchasing power and high unemployment in the EMU is also mentioned.

Table 3: Sources of inflationary pressures

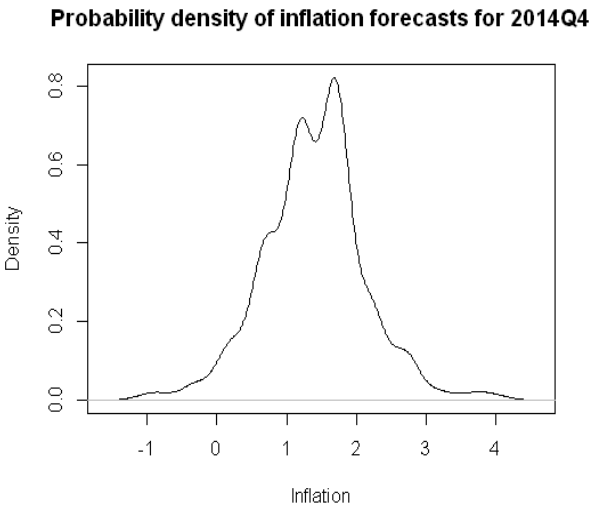
Belgium - Bureau fédéral du Plan	* sovereign debt crisis resurfaces, * surge in long-term interest rates due to end of QE or US failing to raise debt ceiling , * hard landing of China/emerging markets, * oil price hike due to geopolitical tensions
Denmark - DEC	The risk of a new peak of the sovereign debt crisis. Energy prices. A sudden normalization of the money multiplier.
Finland - ETLA	Sluggish growth, commodity prices (oil)
Germany - DIW	Overcapacities and unemployment, i.e. low purchasing power, put downside pressure on EA inflation. Administered prices due to tax increases to improve the fiscal balance are risks for hikes in inflation, as well as energy prices.
Germany - RWI	The aftermath of the loose monetary policy of the ECB
Hungary - GKI	There are no signs of accelerating inflation in the euro area. Inflationary expectations are subdued and they are expected to remain so in the medium term as well.
Hungary - KOPINT	We don't see many risks concerning our forecast. As we do not expect raw material prices to explode and forecast a slow rise in food prices, we do not reckon with an acceleration of inflation. Demand side upward push affects will remain moderate as well.
Italy - PROMETEIA	Weak domestic demand and weak labour markets are contributing to keep inflation subdued. In most countries, especially in the peripheral ones, risks are on the downside due to the still restrictive measures from fiscal policy. If

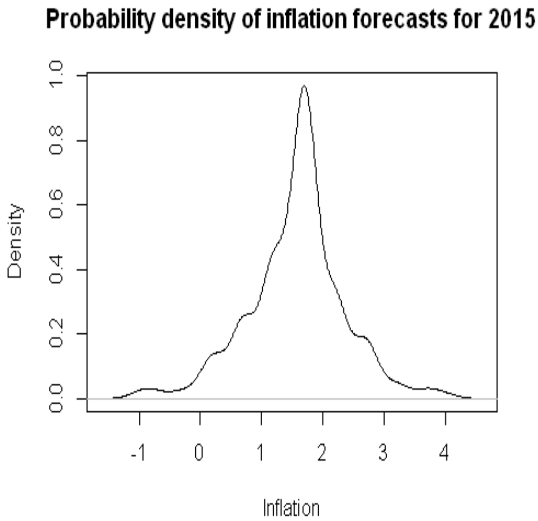
	recovery consolidates in 2015 and 2016, inflation could be closer to 2 percent.
Poland - IBRKK	In the perspective 2013-2014 inflation in the Euro Area does not seem a real danger. It may increase afterwards, if there is an overall revival of the economic activity; or under influence of internal and external shocks, eg. if some countries are obliged to abandon the Euro Area and devalue strongly their currencies.
Slovenia - SKEP	Import prices of commodities, developments in relation EUR/USD
Sweden - National Institute of Economic Research	Inflation remains under ECBs target and given the low resource utilisation with high unemployment, this raise concerns about underlying disinflationary trends. In the forecast, however, the inflation remains relatively stable.
Switzerland - KOF	Oil prices.

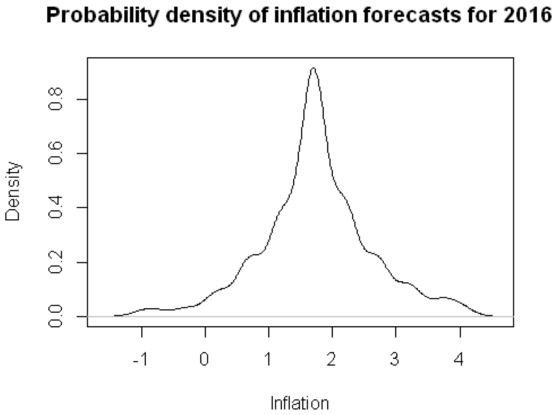
Source: AIECE institutes

AIECE institutes expect slightly increasing inflation indices after 2013, which also means that the disinflation period is likely to come to an end in this year. Forecasts indicate upward risks, institutes are rather uncertain in higher rates of CPI, and there is consensus that the euro zone inflation will not go below 0.7% on average after 2014. The relative standard deviation is quite low, only 16% which indicates high concordance for 2014 among the institutes. The following charts present the probability densities for the Euro Area between 2014 and 2017:

Chart 20: Probability densities for Euro Zone







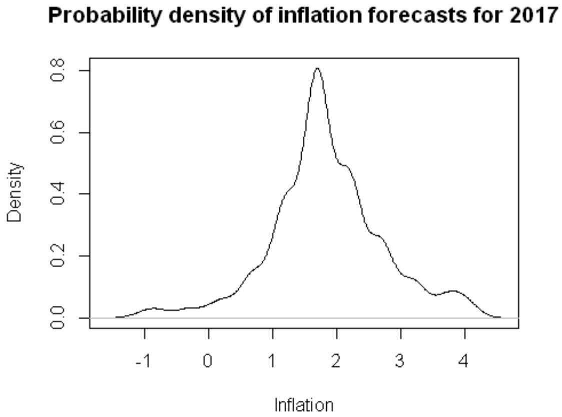


Table 4: Euro zone inflation forecasts from probabilities

Institute	2013Q4	2014Q4	2015	2016	2017
Denmark - DEC	1.2	1.7	2.0	2.0	2.0
Finland - ETLA	1.2	1.3	1.5	1.5	1.6
France - COE-REXECODE	1.2	1.2	1.7	1.7	1.8
Germany - DIW	1.4	1.4	1.4	1.6	1.6
Germany - IFO	1.1	1.4			
Germany - Institut für Weltwirtschaft, Kiel	1.4	1.3	1.5	2.0	2.1
Germany - RWI	1.2	1.1	1.2	1.2	1.5
Greece - KEPE	1.0	1.0			
Hungary - GKI	1.7	1.7	1.7	1.7	1.9
Hungary - KOPINT	1.7	1.7	1.7	1.7	1.7
Italy - ISTAT	1.2	1.7			
Italy - PROMETEIA	1.2	1.2	1.5	1.5	0.0
Poland - IBRKK	1.5	1.7	1.8	1.9	1.9
Slovenia - SKEP	1.4	1.5	1.9	1.9	1.9
Spain - Universidad Autonóma de Madrid	1.1	1.6	1.7	2.2	2.2
Switzerland - KOF	1.2	1.4	1.6	1.7	1.9
United Kingdom - NIESR	1.0	1.4	1.6	2.0	2.2
Euro Area (arithmetic average)	**1.3**	**1.4**	**1.6**	**1.7**	**1.7**

Source: AIECE institutes

Table 5: Home economy inflation forecasts from probabilities

Institute	2013Q4	2014Q4	2015	2016	2017
Belgium - Bureau fédéral du Plan	0.8	1.2	1.5	1.6	1.6
Belgium - IRES	0.9	1.4			
Denmark - DEC	1.2	1.2	1.7	1.7	1.7
Finland - ETLA	1.5	1.5	1.5	1.5	1.5
France - COE-REXECODE	1.1	1.3	1.4	1.4	
Germany - DIW	1.8	1.8	1.9	1.9	2.0
Germany - IFO	1.6	1.8			
Germany - Institut für Weltwirtschaft, Kiel	1.8	2.2	2.7	2.7	2.2
Germany - RWI	1.5	1.7	1.8	1.6	2.0
Greece - KEPE	-1.0	-0.1			

Institute	**2013Q4**	**2014Q4**	**2015**	**2016**	**2017**
Hungary - GKI	2.1	2.7	335.0	3.4	3.3
Hungary - KOPINT	1.3	3.4	2.9	3.0	2.9
Italy - CONFINDUSTRIA	1.2	1.7	1.9	2.0	2.0
Italy - ISTAT	1.6	1.5			
Italy - PROMETEIA	1.1	1.7	1.7	1.7	1.7
Poland - IBRKK	1.5	2.2	2.5	2.7	2.7
Slovenia - SKEP	2.1	2.0	1.7	1.7	1.6
Spain - Un	1.1	1.0	1.7	2.2	2.2
Switzerland - KOF	0.2	0.5	0.6	0.6	0.6
United Kingdom - NIESR	2.8	2.1	1.9	1.7	1.6

Source: AIECE Institutes

3. Assessment of AIECE member institutes on monetary policy environment

The monetary policy environment will support economic growth also in the future. Recent communication on behalf of the ECB and the FED suggest that monetary policy will continue to remain on the expansive stance. According to the assessment of AIECE members the likelihood that the ECB will take restrictive measures in the forecast period is very small (see answers to Q 23, Chart 20) Majority of the institutes is of the opinion that the ECB will furnish the market with liquidity in 2014 as well, and no alteration of the base rate is expected.

Chart 21: Evaluation concerning possible change of monetary policy on behalf of the ECB

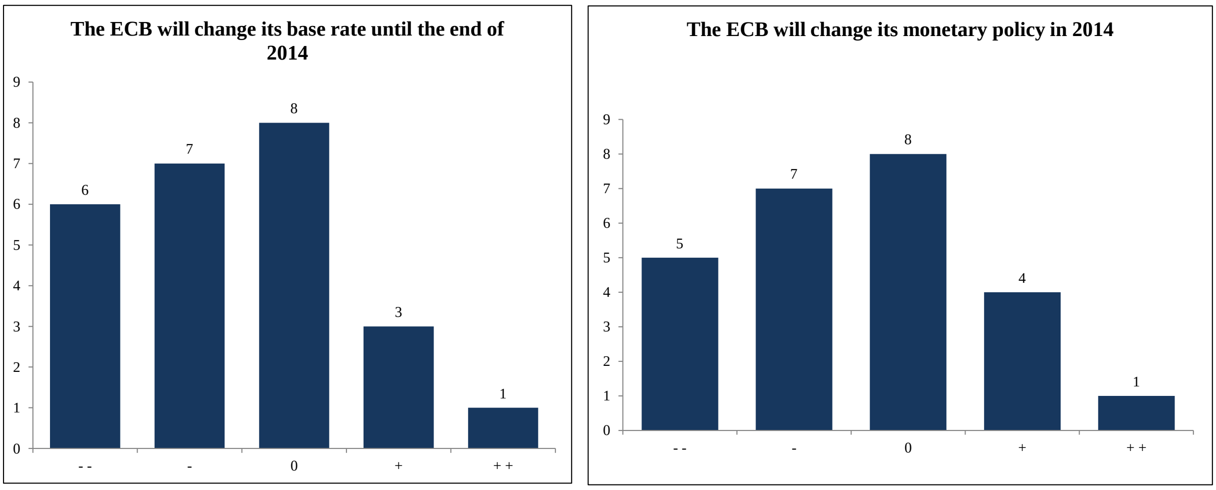
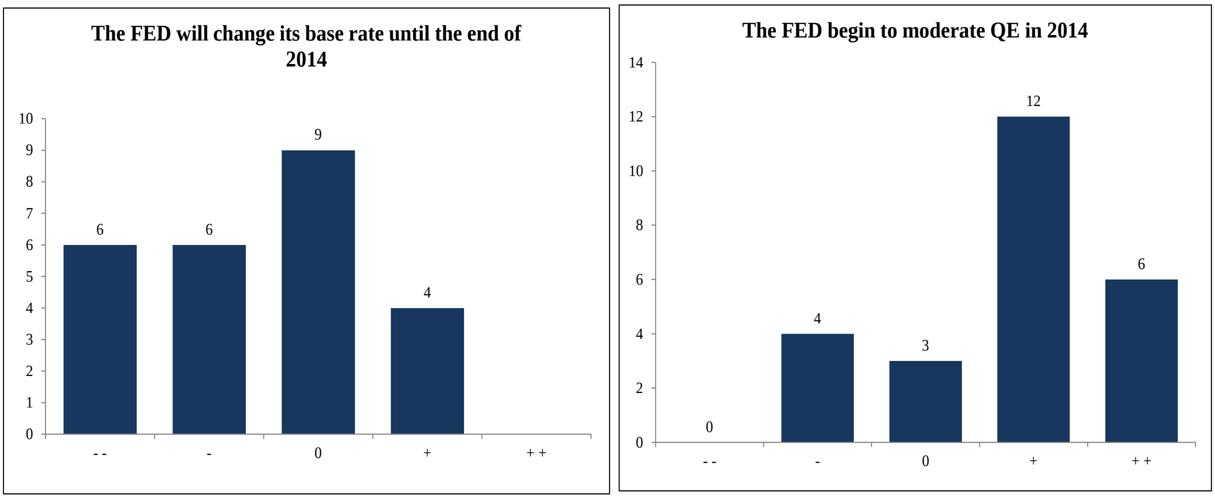


Chart 22: Evaluation concerning possible change of monetary policy on behalf of the FED



According to the recent announcement of the Federal Open Market Committee[7] it was decided to keep the target range for the federal funds rate at 0 to 1/4 % and to maintain a highly accommodative stance of monetary policy as long as the unemployment rate remains above 6-1/2 %, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 % longer-run goal. This means that the expected tapering will not start in the short-run, and this is also reflected in the assessment of the AIECE member institutes. (See Chart 21)

We asked AIECE members what they think under what conditions the FED will start to change its asset purchase programme. *(Q32: What do you think when and under what conditions will the FED start to change its asset purchase program?)* According to most responders it might come to a beginning of tapering during the first half of 2014. However, the timing of the withdrawal from unconventional monetary policies will depend on the macroeconomic situation in the US, and situation on the currency and financial markets. As the reaction of markets was relatively strong, long term interest rates have gone up (even before the FED actually started the tapering), the FED will remain careful. The on-going severe debates around fiscal policy and the rise of the debt ceiling are likely to negatively impact on economic growth and the job market situation, until there is change in this respect, a tapering will most unlikely begin.

In this connection we also asked what member institutes think about the consequences of a failing compromise concerning the US fiscal policy for global growth and the Euro area. (*Q33: What consequences will have a failing compromise concerning the US fiscal policy for global growth and the Euro area?)* All members agreed that the global consequences for economic growth would be tremendously, although unpredictable. Financial market conditions are still fragile, in the US and in Europe. The role of US government securities as the major pricing benchmark in financial markets is of outstanding importance, therefore its systemic dimension. In the worst case, US economy could fall into recession and global financial markets would be severely hit, which would severely hurt European growth. However, in the more likely case of a lingering uncertainty about fiscal policy with a partial government shutdown for a longer period of time, the impact on Europe would not be that severe. Another risk would be the effect on exchange rate development: a durably weak dollar would have adverse impacts on the competitiveness of Euro Area exports. On the other hand the pressure inside and outside the US is strong enough to enforce a compromise. This view is also shared by a number of responders.

We also asked AIECE members what they think about the future trends of CDS spreads. (See *Q36: Do you consider that standard deviation of CDS spreads will increase or decrease in 2014?*) In this respect opinions were rather split. Although the majority of responders are of the opinion that CDS spreads will decline in the forecast period because of expected improvement of economic activity that could help in managing crisis in indebted countries. A further progress in the field of banking & political union may also contribute to this trend. However, a number of responders expressed the opposite view: the fact that many problems

[7] http://www.federalreserve.gov/newsevents/press/monetary/20131030a.htm

remain unaddressed in the euro area (e.g. still no banking union), it is only a matter of time that they resurface and markets' fear for a country splitting from the euro area rises again, this will raise credit default spreads again. Also a growing divergence in the performance and the equilibrium conditions of individual countries may bring about increased deviation in CDS spreads. Another aspect might be if the major central banks start withdrawing from quantitative easing policies, the volatility in the financial markets will increase. Finally there are responders who represent a neutral attitude. They think that no major changes are to be expected next year as although financial market conditions are likely to improve, market participants are going to differentiate more in the future between different creditors. As these two effects drive the standard deviation of CDS spreads in opposite directions, no major changes should occur in 2014.

4. Assessment of AIECE member institutes on fiscal policy environment

Fiscal policy problems and consolidation efforts have been characteristic for the Euro Area in the last years. As a result of efforts the deficit of the Euro Area made 3.7% of the GDP last year as compared to 6.4% in 2009. According to estimates in the forecast period a further slow reduction of the deficit ratio can be reckoned with. Fiscal problems affected also non Euro Area members: the deficit ratio for the EU 27 made -6.9% in 2009, and dropped to -3.9% by 2012. Despite of consolidation efforts the aggregate general government gross debt as a percentage of GDP for the EU 27 rose from 74.5% in 2009 to 85.2% by 2012, whilst for the Euro Area the same figures are 79.9% and 92.6%. According the Autumn Forecast of the European Commission in the coming years a further rise may be expected. This year the debt/GDP ratio 95.5% and only a minimal decline to 95.4% is predicted for 2015. Restrictive fiscal policy measures were also responsible for the long lasting recession in the Euro Area, and on-going fiscal consolidation will dampen growth in the forecast period as well.

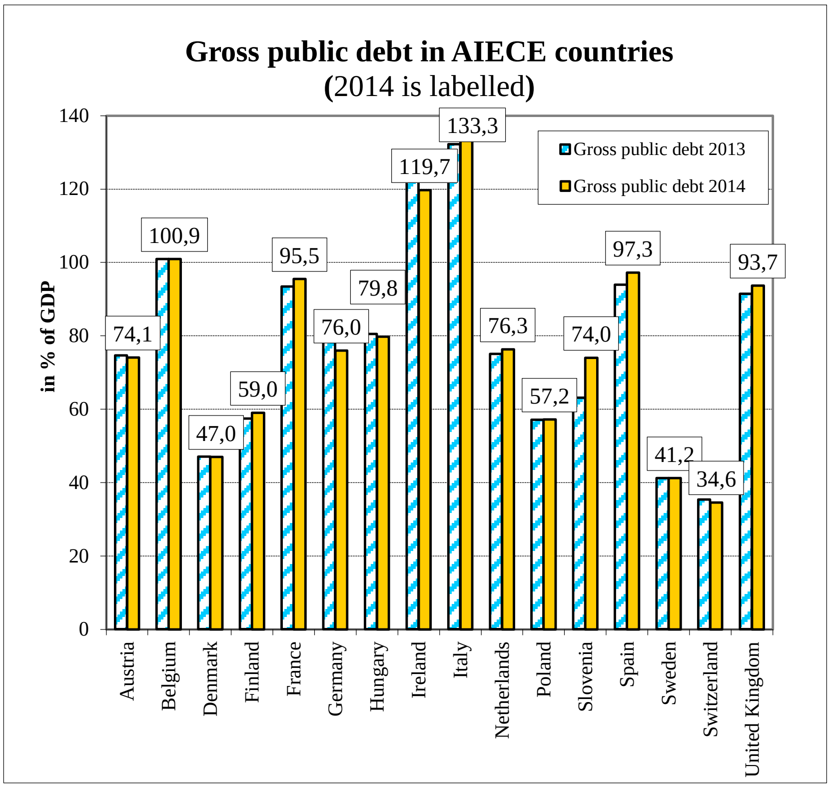
The own country forecasts of AIECE members show that the debt problem will be a challenge for a great number of countries in the forecast period.

Table 6: Level of general gross debt as compared to the GDP, %

	Gross public debt 2013	**Gross public debt 2014**
Austria - WIFO	74.6	74.1
Belgium - Bureau Fédéral du Plan		
Belgium - IRES	100.9	100.9
Denmark - DEC	47	47
Finland - ETLA	57.4	59
France - COE-REXECODE	93.5	96.1
France - OFCE	93.3	94.9
Germany - DIW	79.4	76.8
Germany - IFO	79.4	75.1
Germany - Institut für Weltwirtschaft, Kiel	78.4	75.5
Germany - RWI	79.5	76.5

	Gross public debt 2013	Gross public debt 2014
Greece - KEPE		
Hungary - GKI	80	79.5
Hungary - KOPINT	81	80
Ireland - ESRI	123.9	119.7
Italy - CONFINDUSTRIA	131.7	132.3
Italy - ISTAT		
Italy - PROMETEIA	132.6	134.3
Netherlands - CPB	75	76.3
Norway - Statistics Norway		
Poland - IBRKK	57.1	57.2
Slovenia - SKEP	63.1	74
Spain - Ministerio de Economía	94.2	98.9
Spain - Universidad Autonóma de Madrid	93.6	95.6
Sweden - Confederation of Swedish Enterprise		
Sweden - National Institute of Economic Research	41.2	41.2
Switzerland - KOF	35.3	34.6
United Kingdom - NIESR	91.4	93.7

Chart 23: Gross public debt in different AIECE member countries according to responses to the questionnaire[8]



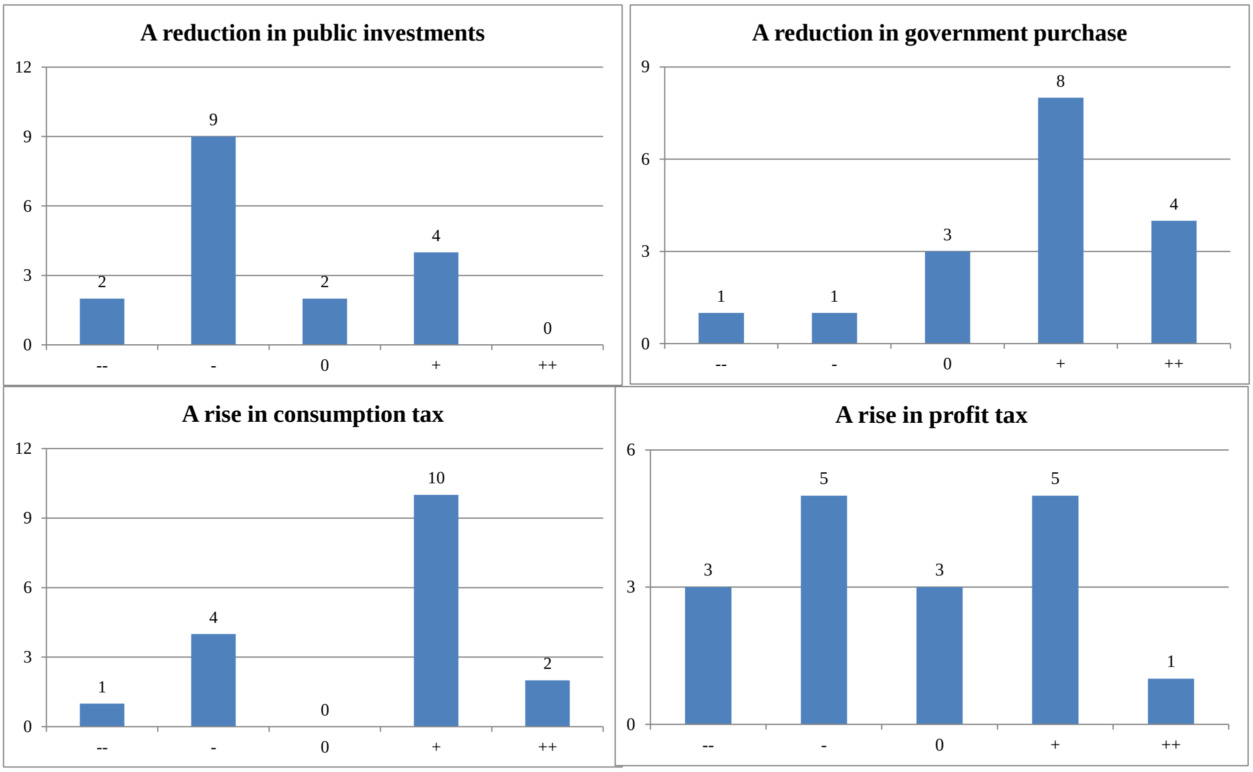
8 In case of several answers to one country we took the average of the institute responses.

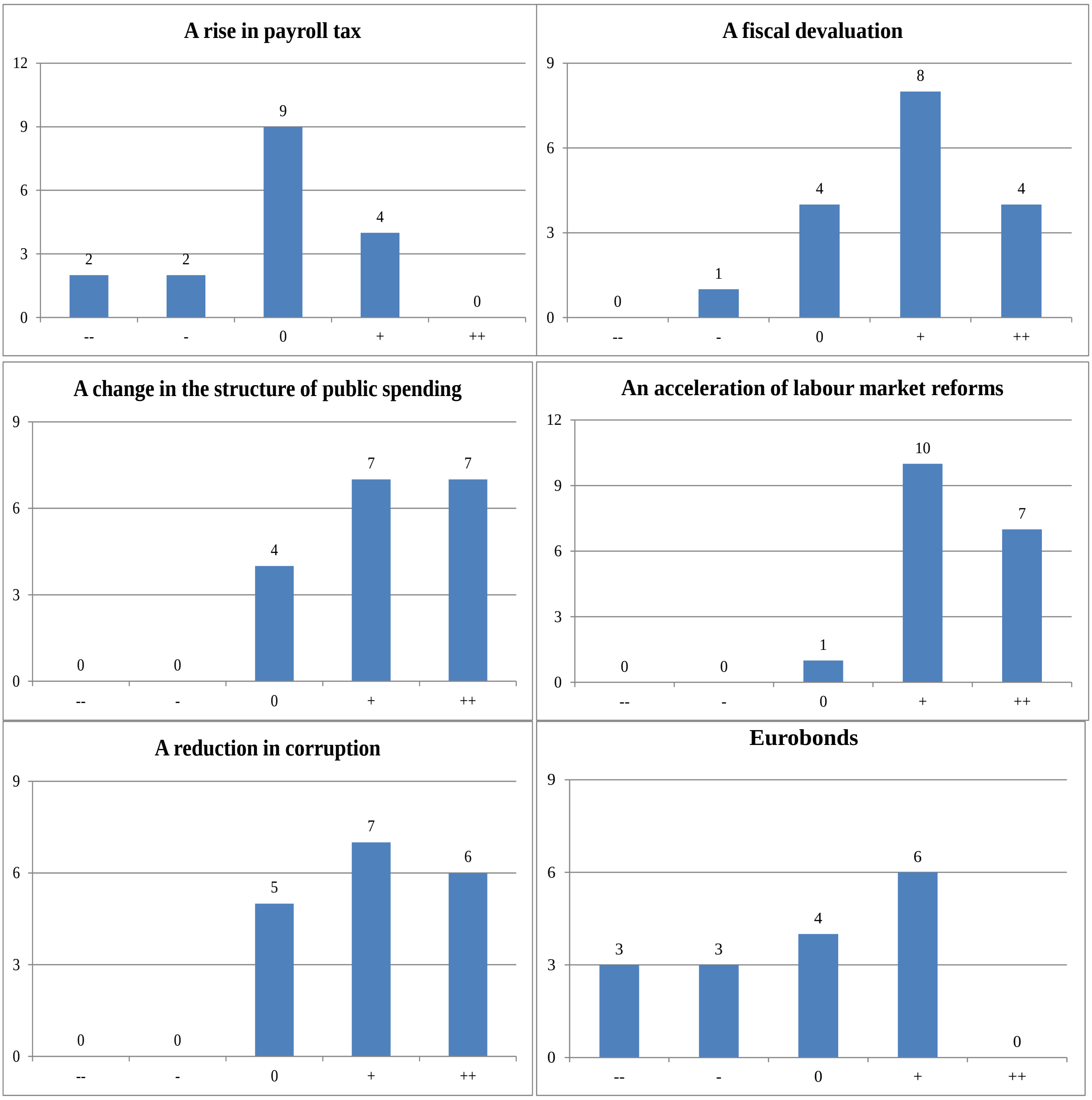
That's why we asked AIECE member institutes what measures they would find useful for handling this problem. All institutes agreed that fiscal policy constraints are one of the major risks concerning forecasts. We asked the following questions: *Q24: Please evaluate the effects of following actions to reduce public debt on the long run in the EURO AREA.*

Table 7

Questions on the evaluation of the effects of the following measures on public debt
1. A reduction in public investments 2. A reduction in government purchase 3. A rise in consumption tax 4. A rise in profit tax 5. A rise in payroll tax 6. A fiscal devaluation (Lower taxes on labour and offset this by raising taxes on consumption) 7. A change in the structure of public spending 8. An acceleration of labour market reforms 9. A reduction in corruption 10. Eurobonds

Chart 24: Evaluation of the effects of different measures on public debt





A change in the structure of public spending, an acceleration of labour market reforms and a reduction in corruption are unanimously regarded as measures having positive influence on public debt development. The majority of responding institutes are of the opinion that reductions in government purchase, a rise in consumption tax will have also positive effects on the level of public debt; however in that respect there is a greater variety of opinions. The introduction of Eurobonds is not regarded by the majority of AIECE institutes as an efficient measure for reducing public debt, only one third of responding institutes think that it may also bring a positive contribution.

We also asked AIECE members what they think about the necessity of further bailing out actions. *(Q34: What is your opinion, in case of which member state(s) might it come to a bail out action in the forecast period?)* According to most opinions Greece, perhaps Slovenia or Portugal may be candidates for further bail out actions. A debt restructuring for Greece is likely in 2014 or 2015. Some expressed the view that although conditions of public debt and financial markets are still fragile in some member states of the Euro Area, with an improved economic outlook the fiscal consolidation is likely to progress such that no case for bail out in the forecast period is likely.

In connection with the above question we also asked *Q35: Do you consider that bailing out is the right solution on the long-run or there are other possibilities?* Here again we received a variety of answers. See some examples:

Table 8: *Q35: Do you consider that bailing out is the right solution on the long-run or there are other possibilities?*

The right long run solution is to form a fiscal, political union as in the US.
Bailing out is necessary as a crisis instrument. It was never regarded as a long run policy tool. Financial market reforms currently under implementation try to address the Too-big-to-fail problem which is explicitly designed to prevent future bail outs of banks, Also on the level of EA member states, future bailouts should be prevented through increased fiscal coordination and surveillance.
Bail out is the only solution if Greece is to remain in the euro area. In the long run it would be preferable for Greece to leave the euro area.
In case of Greece probably necessary. In other cases relaxation of terms could do the job.
Bail-outs are cheaper than defaults.
It should be matched with other political solutions.
Debt cuts.
That depends on the time frame you are looking on. As it has been so often in the past, it might be necessary to get a decision over weekend, before the markets open on Monday. Then, not bailing out might be dangerous. However, up to now European governments an institution always found a way to make a bail out without calling it a bailout. And no to forget: In the case of Greece there also has been a bail in.
Bailing out is a short run solution and it leads to a result only if the country's economy is able to necessary structural adjustments.
Owners and creditors should be held responsible for the risk they have taken on in the financial sector.
Structural reforms in the financial system of the EA is necessary Banking Union
Bailing out is the right solution in the long-term, as it guards stability in the EU, and provides the opportunity for the countries rescued to pursue economic adjustment without suffering the heavy economic and social costs associated with insolvency.
Country can leave the EMU area and regain its competitive position via exchange rate depreciation, but this would be a more risky scenario.

5. Assessment of the crisis management in the European Union

We asked AIECE members about their opinion concerning crisis management in the European Union. (*Q37: What is your opinion regarding the crisis management in the European Union?*) Here again we received different answers: some of the institutes are of the opinion that crisis management has been insufficient. Others shared the view that a lot of has been done, and things go in the right direction, however too slowly and too much time has been wasted. But all statements suggest that an urgent political compromise and more political coordination are unavoidable. See a couple of the answers below in Table 8.

Table 9: Responses of AIECE members concerning debt crisis management in the Euro Area

Unsatisfactory, one does only do the minimum to avert calamities.
The policy response has too often been too weak, too late and too imprecise.
So far crisis management appears to have kept in check the sovereign debt crisis, but the fundamental problems remain to be solved (excessive public debt, low competitiveness, lack of structural reforms, weak banks, too little coordination of fiscal policy in the euro area). However, the banking union initiative is a very important improvement.
The new institutions and the legal rules adopted have improved the conditions of crisis management.
The crisis management in the EU goes in the right direction, but without a radical improvement might be hindered by nationalistic interests and attitudes.
It seems that the worst phase of the crisis is already over. The main challenge for policy makers is forming an efficient banking union now.
Every step in the crisis management has required long time and has been accompanied by a lot of uncertainty due to the lack of a unique political response, as the idea of monetary union behind each country was(is perhaps) very different. A stronger monetary union would have reduced time reaction to the crisis possibly lowering its cost.
Up to now, it mainly was the ECB that stabilized the situation in the EU, on the one hand because it is the only institution that can react quickly, on the other hand because economic policy moved too slowly. Some progress has been made. The ESM exists; although it is often criticised, it is an institution that can react quickly. The rules on public debt have been hardened. There also is a general agreement on a European banking supervision. However, the big danger is that politicians will now move more slowly, if they will not make steps back, because the ECB has eased pressure form financial markets.
[In the short run crisis management was successful in a sense that a deepening of the crisis and a collapse of the euro area could be avoided. Major institutional questions like a coordination of fiscal policies are still unsolved.]
The mislead belief in expansionary austerity has contributed to the catastrophic development the labour markets. Not holding owners and creditors responsible leads to
Actions on the level of preserving financial stability within the EU and more precisely the EA (such as establishment of ESM -earlier EFSF and EFSM- and ELA mechanism) have played a significant role in crisis management. However, on a macroeconomic level crisis management in the European Union

focused primarily on fiscal adjustment and austerity.
Rhetoric of politicians is home bias oriented as they lack common European sense. Technically, there are too many procedures (EDP, MIP) that are difficult to follow and to comply, too many documents required from countries (NRP, SP, EPP, DBP…) and produced by EK (CSR, AMR, AGS, IDR). This is problematic especially for small countries with limited staff and capacity.

We wanted also to know what can be done better. There again we received different answer but they all show in the direction of urging a real political and fiscal union.

Table 10: What measures are or could be effective in the future?

To form a real political and fiscal union.
1. Shifting the focus towards economic growth: Increased cooperation through the European Investment Bank., 2. Establishing missing elements in the institutional framework of the euro area: A banking union with a powerful resolution mechanism for systemically important financial institutions (SIFIs)., 3. Maintaining elements that prevent future crises: ESM, Fiscal compact.
Implementation of fiscal union in the euro area. A coordinated fiscal stimulus. Recapitalization of weak banks.
Central bank actions]
The progress toward a bank union could be very effective.
All European and global actions and solutions.
Effective early warning systems that would identify a build-up of imbalances (financial, fiscal, current account imbalances) at early stages
More integration among countries
In my view, restructuring the banking sector in the peripheral countries is key. The loose monetary policy will not bring down interest rates in these countries, and credits to the corporate sector will no increase without a functioning banking sector. The restructuring must take place before the banning union starts which should not be burdened by inherited problems.
Counter cyclical fiscal policy. When the private sector consolidates and international demand is weak, it is not the right time for deep spending cuts in public budgets
Banking Union will be crucial, but we should proceed much faster than we are doing now.
Measures and policies are required in order to promote a more targeted growth strategy taking into account the strengths and weaknesses of the individual member countries. Crisis and crisis management effects on unemployment have not been anticipated adequately and now special emphasis is required in order not to let high unemployment rates become a longstanding phenomenon in the Union.
Common framework for bailing out banks (banking union) and countries.

We also asked AIECE member institutes what they think under what conditions it would be necessary for some member state to leave the Eurozone. See a couple of answers below.

Table 11: *Q 25: Under what conditions would it be necessary for a member state to leave the Euro Area?*

From my point of view the membership of the single currency is a road of no return, so I do not consider that there exist any conditions for a country to leave the currency. So, what you should be done is to ensure that each country carry out the policies (mainly fiscal ones) to guarantee the stability of each economy within the system.
Complete and definite failure to comply with conditionality attached to EU level financial support.
Due to democratic conditions and political instability.
Leaving the euro area is most of all a political decision. Therefore, the answer can only be political in nature: Given that there is no democratically elected government able to implement the necessary reforms to stay within the euro area, this would certainly be a case to consider an exit from the euro area.
An outright sovereign default would probably make it necessary to leave the euro area
If a country does not try to fulfil its obligations and the other countries do not tolerate it.
It will not be necessary.
In case of protracted crisis in the Euro Area and default of specific member states.
If no consensus on basic principles of economic policy is possible.
It seems that the risks of an exit of a Euro Area member from the single currency block have abated.
No conditions. It is not an option
When a majority of the population is in favour of doing so.
It should be a free decision of the member state with considering the advantages and the costs of switching back to the national currency and the national monetary policy. The transition should be well prepared in order to avoid an outflow of capital. If a country is not able to stick to the Maastricht criteria in the long run, and it is not able to carry out an internal devaluation to an extent making its economy competitive, it should consider an exit from the euro zone.
None!!!
If the adjustment in fiscal policy is too harsh and companies cannot sufficiently gain on competitiveness.

6. Labour market problems in Europe

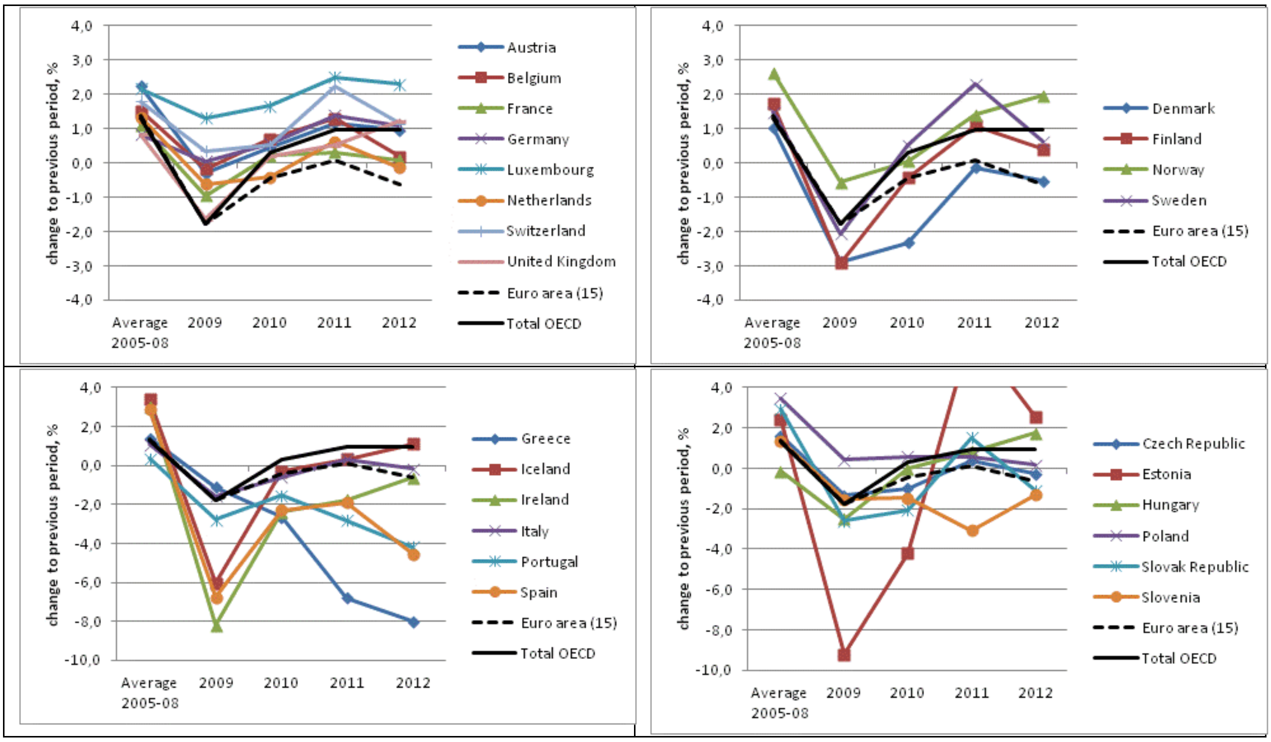
While there was an employment growth in the OECD total, corresponding to the economic development, the employment growth in the Euro area lagged behind the OECD average with employment decrease in 2012. The OECD forecast the trend change in 2014. In line with the disadvantaged labour market situation in Europe the unemployment rate is much above the OECD average and constantly increasing in contrast to the stable unemployment situation in the OECD total. (Chart 25)

Chart 25: Labour market development following the crisis: OECD countries total and the Euro area

Source: OECD http://dx.doi.org/10.1787/888932853340

Differences are essential in Europe, however. While employment growth in most of Western and Northern Europe has been above the Euro Area average with considerable difference among the countries, the employment growth in the Southern European regions and in some other countries particularly hit by the crisis (Iceland, Ireland) has lagged behind the employment growth in Euro Area. Greece, Spain and Portugal have been facing with particularly sharp drop in employment. As for the New EU members of Eastern Europe, employment growth is mostly above the Euro Area average in these countries with some difference among the countries, a strong drop in Slovenia and oscillation in Estonia. (Chart 26)

Chart 26: Employment growth in various OECD regions, 2005-2012



Source: OECD http://dx.doi.org/10.1787/888932853340

The unemployment situation in Europe, corresponding to the labour market recovery and economic and employment growth has been relatively low – below the Euro Area or even below the OECD average in Western and Northern European countries. The Mediterranean countries as well as Ireland face strong and increasing unemployment much above the Euro area average. These countries push, in fact, the Euro area average of the unemployment rate high. Unemployment in the New EU countries of Eastern Europe has the in-between unemployment situation with a high unemployment in Slovakia, Estonia and somewhat below the Euro region average in others.

In *Q26* we asked AIECE members on their forecast on different variables, among others also on unemployment in the Eurozone. They agreed that unemployment will remain high in the forecast period, but a slow improvement can be expected. However, economic growth will not be enough for bringing a radical improvement on labour market, thus the unemployment rate forecast for early 2015 will only be slightly below 12%.

Chart 27: Quarterly development of unemployment rate
(%, seasonally adjusted)

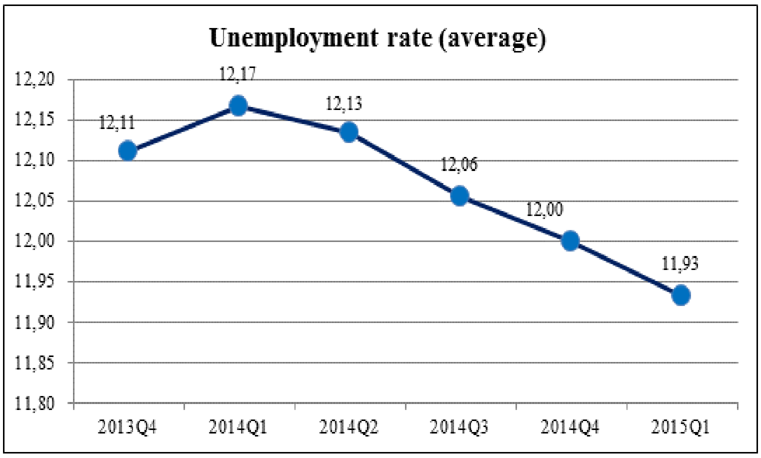


Chart 28: Estimated annual unemployment rates for the Euro Area by AIECE members

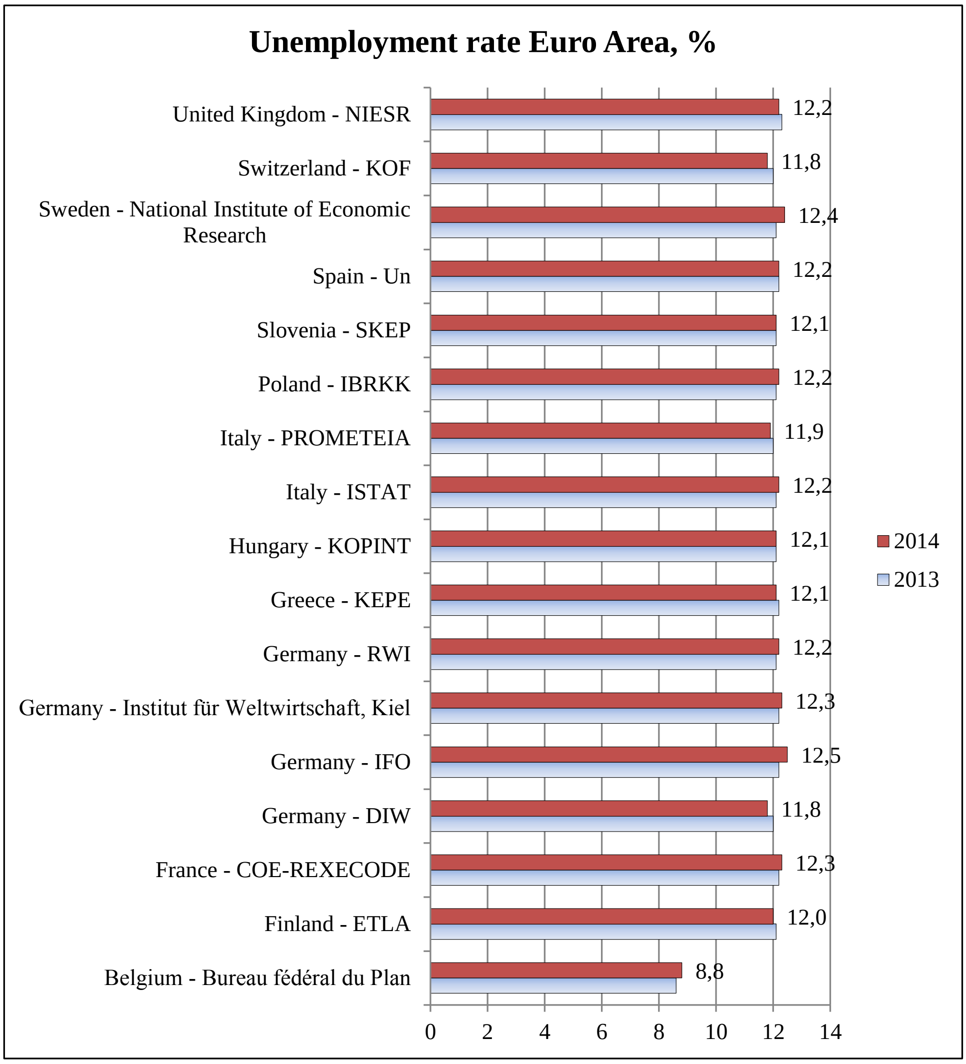
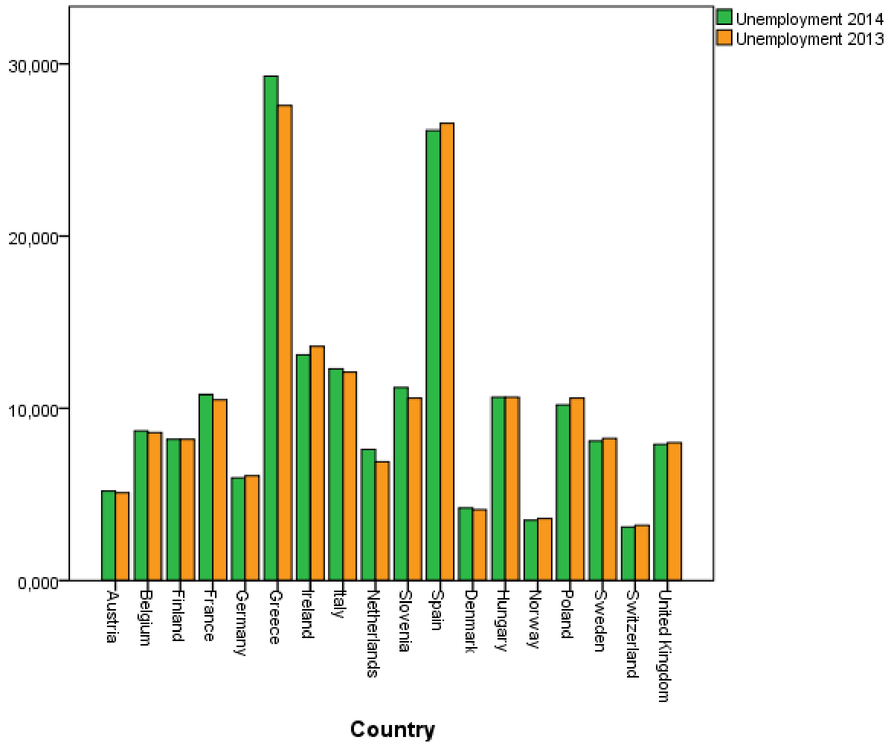


Chart 28: Diverging unemployment rates
(Home country forecasts

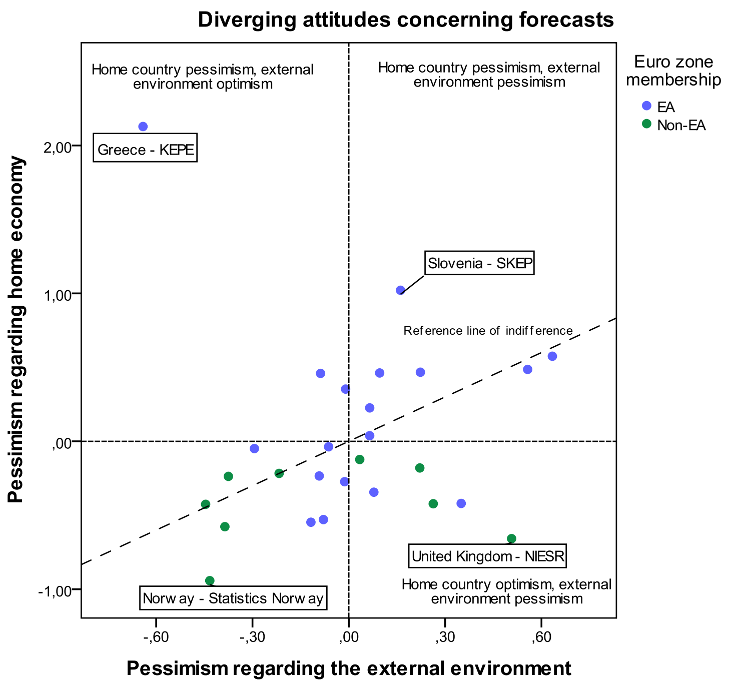


7. Relative pessimism among the institutes

Institutes are moderately optimistic regarding both their home country and the European Union. According to responses of AIECE members the evaluation of domestic and external environment is relatively symmetric – i.e. those who consider that the EU will show a better performance in the consecutive years also assume that their home country will do better during the same period (thus, this is true vice versa).

The questionnaire was composed of altogether 37 questions. The 37 questions resulted more than 630 variables. By multidimensional scaling one is able to map the perceptions of the institutes in two dimensions. The method is based on distances from the average opinion of the institutes (in other words it depends on the distance from the average opinion; those who are far from the average toward to an unfavourable direction are considered as pessimistic). The methodology assumes a complete proximity matrix thus in order to minimize the risk of omitting a country, only those questions were included in the analysis for which all institutes have answered. 24 variables remained (regarding both home economy and European Union) on which PROXSCAL algorithm was applied to scale the variables into 2 dimensions.

As the distances between the forecasts are not so big, the map drawn from the answers is relatively crowded although there is a clear direction of the data. The 2 dimensions mirror the level of pessimism of the institutes. Level 0 represents the centre (the interception of the vertical and horizontal line); Belgium (Féderal du Plan), Ireland (ESRI) and Hungary (KOPINT) are the closest to the centre. Norway (Statistics Norway), Sweden (both institutes) and Switzerland (KOF) are the most optimistic institutes.



Note: The higher the value the stronger the pessimism.

Greece (KEPE) is extreme pessimistic regarding its home economy but far more optimistic concerning the external environment. Other institutes in the upper right part of the chart are the most pessimistic ones like Slovenia (SKEP), and Spain (both institutes).

United Kingdom (NIESR), Germany (Kiel Institute) and Poland (IBRKK) are those who are relative optimistic concerning their home country but rather pessimistic regarding the external environment.