Association d'Instituts Européens

de Conjoncture Economique (AIECE)

AIECE General Report: Part 1

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AIECE General Report, Part 1

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1. Key global developments

Global GDP growth is projected to remain flat at 3.1 per cent in 2016, and modest acceleration is expected in 2017 with a growth rate of 3.2 per cent and 3.4 per cent as predicted by the OECD and the IMF, respectively[1]. The forecasts of both the IMF and the OECD were **revised down** slightly by 0.1 percentage point for both 2016 and 2017 relative to April and June, respectively (Table 1). Nevertheless, the projected global growth rate is far below the historical figures. Global growth is held back by the sharp slowdown of world trade growth in 2015 and 2016 and the expected rather weak recovery in 2017. Slow productivity growth, too, is a drag on the world economy.

Other indicators, too, refer to downbeat sentiment in the world economy. The **IfO index for the world economy** fell by 4.5 index points to 86.0 in the third quarter of 2016 compared to the second one, reaching its lowest level in over three years, 10 index points below the long-term average.[2]

As a result of the referendum on leaving the European Union in the United Kingdom as well as weaker-than-expected GDP growth in the US, **outlook in the advanced countries** is more subdued than in the rest of the world. **Uncertainties and risks** are numerous. Although the overall market reaction to the **British depart from the EU** outside the United Kingdom was rather moderate, the ultimate impact of Brexit on the global economy in general and on the developed countries in particular that depends on the arrangement establishing the institutional and trade relations between the EU and the UK is still rather uncertain. In the member states of the European Union, intensified political discontent weigh on the expectations and prospects. The **US presidential campaign** is causing uncertainty at least until the election. With slow global growth and the recent appreciation of the yen, **Japan's GDP growth** is projected to remain weak in spite of the recently announced fiscal and monetary easing. According to the projection of the IMF**, GDP of the advanced economies is likely to grow by 1.6 per cent in 2016 and 1.8 per cent in 2017.**

The subdued outlook of advanced economies is offset to some extent by the gradual improvement in some **developing and emerging countries**. **Financial conditions** have improved with a positive impact on almost all countries. The increase of the **price of oil** (that of Brent was up from USD30.8/bbl in January 2016 to USD46.2/bbl in September) and to a lesser extent that of some other commodities support GDP growth in the major commodity exporting emerging economies. The economy of **Russia and Brazil** set to stabilise in 2017. As a consequence of growth promoting measures as well as the first results of rebalancing, the risks about the near-term slowdown in **China** have eased. GDP growth in **India** continues to be dynamic, and so is that in some other Asian countries, whereas the largest **sub-Saharan economies** are facing slowdowns or recessions. As the combined result of diverging trends, according to the IMF **GDP in the developing and emerging economies is projected to increase by 4.2 per cent in 2016 and 4.6 per cent in 2017.**

Long-term interest rates have fallen in recent months and reached record low levels in many countries. **Equity valuations** (particularly in the US), **bond prices** (particularly in Europe and Japan) and **real estate prices** are high and have even mounted recently. Both credit quality and credit spreads are decreasing in a number of countries. The **financial and real estate bubbles** represent risks to global recovery.

The **monetary stance** of the US Fed seems to be too loose with expectations of gradual minor

[1] International Monetary Fund: World Economic Outlook, October 2016, http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/text.pdf
OECD Interim Economic Outlook, 21 September 2016, http://www.oecd.org/eco/outlook/OECD-Interim-Economic-Outlook-September-2016-handout.pdf

[2] CESifo World Economic Survey, August 2016, file:///C:/Users/Keynes/Downloads/WES_3_16_online.pdf

reference rate lifts, that of Europe and Japan accommodative. The further appreciation of the US dollar against major currencies may have a drag on the global economy.

As far as **the evaluation of the global environment by the AIECE institutes** is concerned**, the average per barrel price forecast of crude oil** (Brent) **by AIECE institutes** amounted to USD44.4 in 2016 and USD52.6 in 2017 (Table 2). The average price forecast of the AIECE institutes are close to the projections of the IMF for both years. Nevertheless, the expectations of the institutes are rather diversified since the difference between the minimum and the maximum figures amounted to nearly USD10 in 2016 and close to USD13 in 2017. (The details are included in Part 2 of the General Report).

AIECE institutes forecast **world trade** to grow by 1.9 per cent in 2016 and 3.2 per cent in 2017. This is more pessimistic than the projection of the IMF with 2.3 per cent in 2016 and 3.8 per cent in 2017.

Three quarters of the institutes (sample: 16) project **a rate rise by the US** Fed in the fourth quarter of 2016 with its size totalling mostly 25 basis points. By the fourth quarter of 2017, half of the AIECE institutes expect the US federal funds rate to represent 1.00-1.25 per cent, 43.8 per cent 0.75-1.00 per cent (Figure 1). **In Japan**, only 30 per cent of the AIECE institutes expect minor tightening (sample: 14), the rest unchanged or even somewhat looser monetary conditions.

AIECE institutes anticipate **the gradual appreciation of the dollar against the euro** with an EUR/USD exchange rate of 1.10 by the fourth quarter of 2017 (Table 3). The minimum exchange rate projection was EUR1.05, the maximum EUR1.13.

Table 1

Global GDP forecasts

	2016	2017
Forecasts in per cent		
OECD	3.1	3.2
IMF	3.1	3.4
Revisions in percentage points		
OECD (compared to June 2016)	-0.1	-0.1
IMF (compared to April 2016(	-0.1	-0.1

Source: OECD, IMF forecasts

Table 2

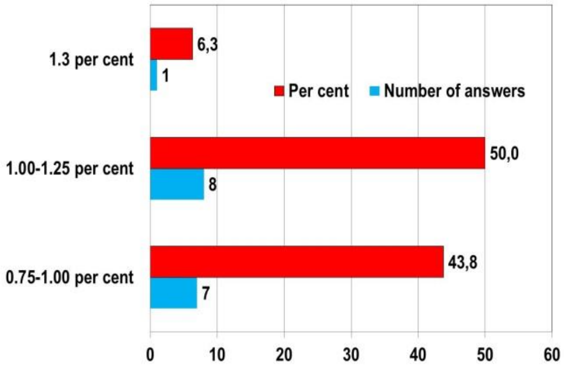
Crude oil prices (quarterly averages)

Year	Brent USD/barrel
2015 Q1	53.9
Q2	62.1
Q3	50.0
Q4	43.1
2016 Q1	34.4
Q2	46.0
Q3	47.1
Q4	49.3
2017 Q1	50.3
Q2	51.8
Q3	53.0
Q4	54.0

Note: 2015Q1-2016Q2: actual figures
2016Q3-2017Q4: projections of AIECE institutes
Source: World Bank, AIECE institutes

Figure 1

The projection of the US federal funds rate by the AIECE institutes in Q4 2017



Source: AIECE institutes

Table 3

The exchange rate of the euro to the US dollar (Quarterly averages)

Year	EUR/USD
2015 Q1	1.10
Q2	1.13
Q3	1.12
Q4	
2016 Q1	1.10
Q2	1.13
Q3	1.12
Q4	1.11
2017 Q1	1.11
Q2	1.10
Q3	1.10
Q4	1.10

Note: 2015Q1-2016Q3: actual figures
2016Q4-2017Q4: projections of AIECE institutes
Source: Eurostat, AIECE institutes

2. Outlook for Europe

2.1. Euro area outlook

GDP in the euro area grew by 2.0 per cent in **2015**. This is a highly **distorted figure** caused by Ireland whose GDP increased by 26.3 per cent, and by EUR62.7 billion in nominal terms. The explanation behind it is rather complicated. It is associated with the implementation of the Base Erosion and Profit Shifting (BEPS) Project by the OECD. Namely, the increment of Irish GDP includes the transfer of intangible assets (intellectual property) and in some cases, entire balance sheets to Ireland by multinational corporations. Ireland's underlying GDP growth is estimated at about 6 per cent in 2015.

The quarterly **projections of the AIECE institutes** for the euro area are rather stable and so are the predicted annual average growth rates totalling 1.6 per cent in 2016 and 1.5 per cent in 2017 (Table 4). The relatively **narrow range of the projections** produced by the institutes indicates a low level of uncertainty concerning the outlook, particularly on the negative side. The lowest forecast was namely 1,4 per cent for 2016 and 1.2 per cent for 2014, whereas the highest one 2.1 per cent and 2.4 per cent, respectively, signifying the optimism of some AIECE institutes.

The averages of the forecasts of the institutes are close to those of the IMF (1.7 per cent and 1,5 per cent, respectively). **Compared to the spring forecast,** the AIECE institutes are now slightly less optimistic indicated by a **downgrade** valued at 0.1 percentage point for 2016 and 0.2 percentage points for 2017 but positive GDP growth thereafter.

Table 5 summarizes **the forecasts of the AIECE institutes for their own counties** representing the euro area and other EU and non-EU countries as well. GDP is expected to mount in every country except Greece, since the Greek economy is likely to experience a moderate recession in 2016.

Table 4

GDP forecasts for the euro area

	2016	2017
Forecasts in per cent		
AIECE institutes	1.6	1.5
IMF	1.7	1.5
Revisions in percentage points		
AIECE institutes (compared to May 2016)	-0.1	-0.2
IMF (compared to April 2016(	-0.2	-0.1

Source: IMF forecasts, AIECE institutes

Table 5

GDP growth in European countries

(Percentage change over the previous period)

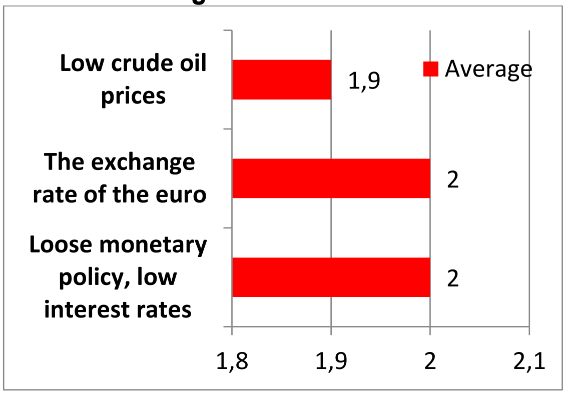
	2015	2016	2017
Austria	0.9	1.7	1.5
Belgium	1.4	1.4	1.4
Denmark	1.0	1.0	2.0
Finland	0.2	1.1	1.2
France	1.3	1.4	1.3
Germany	1.5	1.8	1.3
Greece	-0.2	-0.1	1.9
Hungary	2.9	2.1	2.8
Ireland	26.3	4.3	3.8
Italy	0.8	0.7	0.8
Netherlands	2.0	1.7	1.7
Norway	1.6	0.9	2.1
Poland	3.6	3.2	3.4
Spain	3.2	0.0	0.0
Sweden	4.2	2.9	2.1
Switzerland	0.8	3.4	2.3
United Kingdom	2.2	1.7	1.0

Notes: 2015: actual figures; 2016 and 2017: forecasts of AIECE institutes

Source: Eurostat, AIECE institutes

As far as **the contribution of certain factors to GDP growth** in 2016 is concerned, AIECE institutes attached equal importance to loose monetary policy and low interest rates on the one hand and to the exchange rate of the euro and low crude oil prices on the other hand (Figure 2). The other factors contributing to GDP growth in 2016 vary from country to country including the improvement of the labour market, the reduction of labour costs, improvement in capacity utilisation, etc.

Figure 2
The contribution of three factors to GDP growth in 2016

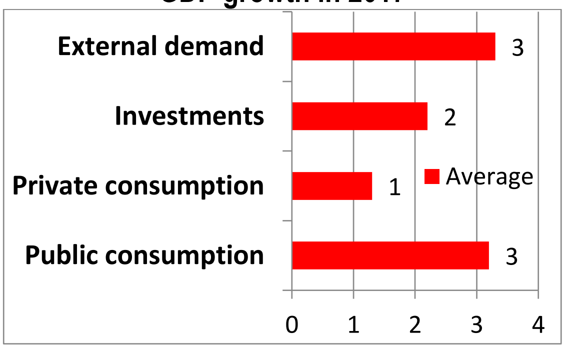


Source: AIECE institutes

The main driving force of growth in 2017 will be private consumption and investments, followed by external demand and public consumption (Figure 3).

The **factors constraining GDP growth** in 2017 varies across the member countries of the euro area. The major issues include the slowdown in the purchasing power of household with the increase in oil prices, mounting unit labour costs, worsening international competitiveness of certain euro area member states, considerable calendar effects in terms of less working days in 2017 and in some countries government measures aiming at the reduction of the general government deficit and gross government debt. Most of the other factors mentioned by the institutes are basically **risks to the forecast** that are addressed in Chapter 4.4.3.

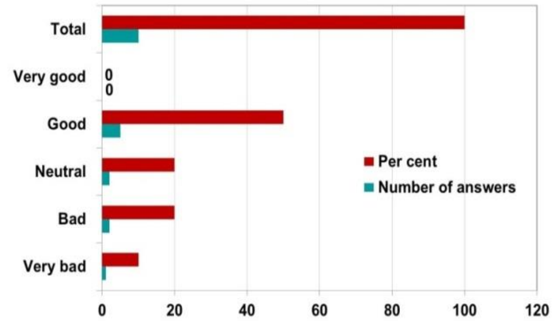
Figure 3
The ranking of the main driving forces of GDP growth in 2017



Source: AIECE institutes

Investments are crucial elements of GDP growth. AIECE institutes are rather divided on the evaluation of the private investment activity in the light of their country's cyclical position. Half of the responding institutes graded it good, 20 per cent neutral and bad each and 10 per cent very bad (Figure 4).

Figure 4
The evaluation of the investment climate in the own country

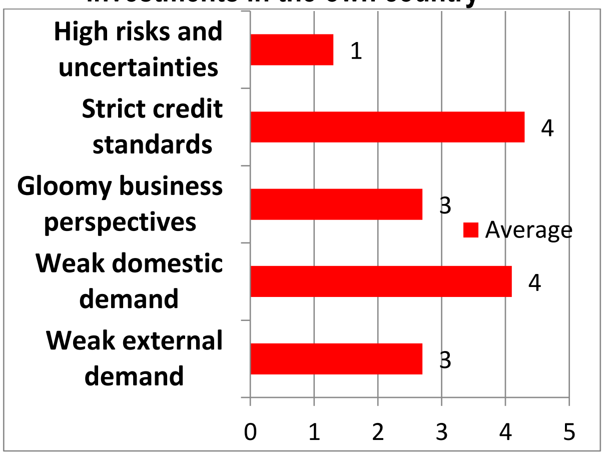


Source: AIECE institutes

The most important **factor limiting investment activity** is high risks and uncertainties, followed by gloomy business perspectives and weak external demand. Finally, weak domestic demand and strict credit standards ranked last (Figure 5).

The institutes considered strict credit standard the less limiting factor of investments. It is consistent with the low **interest rate** environment. The arithmetic average of the **short-term interest rate forecast** of the euro area by AIECE institutes is -0.3 per cent for 2016 and 2017, that of **long-term** (10 year) interest rates 0.6 per cent and 0.7 per cent, respectively.

Figure 5
The evaluation of factors limiting investments in the own country



Source: AIECE institutes

Short-term interest rates are in **negative territory or zero** in almost every euro member state involved in the report. Long-term interest rates are the highest in Spain and Italy. Low interest rates constitute one necessary but not sufficient precondition of promoting investment activity in the private sector.

In spite of the limiting factors mentioned, investment activity is likely to be rather favourable in the euro area. AIECE institutes of the euro area forecast **gross fixed capital formation** to grow by 3,8 per cent in 2016 and 4.1 per cent in 2017 in the average. These projected rates are more than twice as high as those of GDP growth rates. Nevertheless, there are huge differences behind the arithmetical average of the euro area. Namely, investments are likely to increase most dynamically in Ireland (by 16.2 per cent and 18.6 per cent, respectively), followed by Greece (by 9 per cent in 2017) and Spain and Belgium.

GDP growth in the euro area seems to be accompanied by the reduction of **current account** imbalances. The combined current account surplus relative to GDP is likely to decrease from 3.3 per cent in 2016 to 2.6 per cent in 2017 according to the forecasts of the responding euro area institutes. Both the deficits and the surpluses of the individual countries relative to GDP tend to decrease over the forecasting horizon. Thereby the differences across the countries are becoming less pronounced.

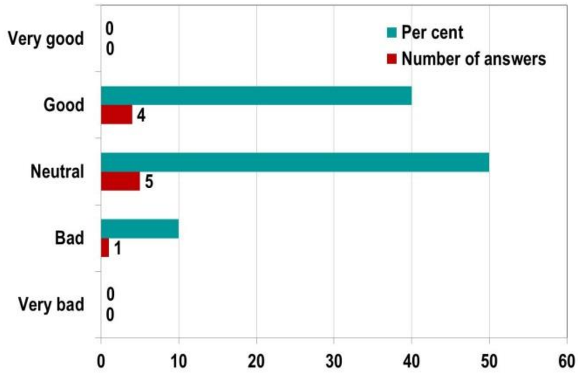
Although according to the forecast of the AIECE institute of the euro area **consumer price inflation** is going to pick up from 0.4 per cent in 2016 to 1.2 per cent in 2017. In other words, it is likely to remain rather subdued. The projected rate for 2017 will still be much below the inflation target of the European Central Bank.

As far as **employment** is concerned, half of the responding AIECE institutes graded the government measures to raise employment neutral, 40 per cent good and the remaining 10 per cent bad (Figure 6). The overall net result of the evaluation is positive.

The next question concerning employment is closely related to the previous one. The government measures aimed at reducing **unemployment** was qualified as satisfactory by 70 per cent of the respondent AIECE institutes (Figure 7).

Figure 6

The evaluation of government measures to raise employment

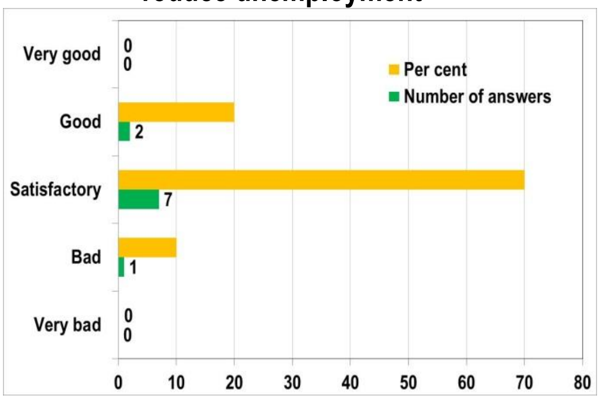


Source: AIECE institutes

The share of those considering them good amounted to 20 per cent, that grading it bad totalled 10 per cent.

Figure 7

The evaluation of government measures to reduce unemployment



Source: AIECE institutes

The verbal comments to these questions pertain basically to the individual countries. The answers of common interest with lessons to be drawn include the following:

- measures aiming at changes in the tax structure in terms of reducing taxes and duties on labour, and raising taxes on consumption (VAT rates, etc.);
- reducing labour costs in general in cooperation between trade unions,

employers' organisations and the government under the umbrella of collective agreements as well;
- introducing tax credit for companies hiring low to medium wages employees;
- relinquishing automatic wage indexation;
- using subsidized employment contracts;
- launching action plans with the aim of increasing education and skill levels;
- funding further education for unemployed youth and long-time unemployed;
- the integration of refugees requires additional labour market measures.

Questions for discussion

- Will the projected increase of crude oil prices drag on GDP growth in the euro area?
- Do current account imbalances (high surpluses and high deficits in individual countries) in the euro area restrain GDP growth?
- Is the competitive position of the euro area and its member states going to improve over the forecasting horizon?
- Is the euro area characterized by "jobless recovery"?
- Is there place in the euro area for a growth enhancing strategy? What should governments do to promote GDP growth (and the improvement of productivity as one of the main elements of GDP growth)?

2.2. Developments in EU countries not belonging to the euro area

2.2.1. United Kingdom

In the United Kingdom, a strong start to the second quarter raised GDP growth to 2.4 per cent at a seasonally adjusted annualised rate (from 1.8 per cent in the first quarter of 2016). This momentum weakened in May and June (until the referendum). Survey results indicate a marked slowdown in July and August in manufacturing. Nevertheless, retail sales did not suffer much from Brexit.

This forecast is based on the assumption that **the depart of the EU by the United Kingdom is going to proceed orderly and smoothly**, and the increase of regulatory, trade, migration and other barriers will be limited. British GDP is projected to grow by 1.7 per cent in 2016 and 1.0 per cent in 2017 compared to 2.2 per cent in 2015 (Table 6). **In 2016** GDP growth was mainly driven by loose monetary policy and low interest rates as well as low crude oil prices. **In 2017** external demand and public consumption will be the main engine of GDP growth.

As a consequence of the Brexit vote, **uncertainty** weighs heavily on business investments as well as on the decisions of households concerning the purchase of durable consumption goods and real estate. Consumption is also hit by the by the loss of purchasing power due to **the depreciation of sterling**. In addition to uncertainty, weak external demand, too, holds back investments. Consequently, **gross fixed capital formation** is likely to fall by 3.8 per cent in 2016 and 5 per cent in 2017.

The government's measures to reduce unemployment are satisfactory. The effect stems from previous active labour market policies aimed at improving the public employment exchange programme and benefit delivery system, rather than new policies. New overhaul of the benefit system has been delayed significantly, and so it has had next to no effect on labour market. In spite of these factors, the **unemployment rate** is likely to increase from 5 per cent in 2016 to 5.5 per cent in 2017.

As far as **fiscal policy** is concerned, no change is expected to fiscal measures since the March Budget. Overall consolidation is planned over the next five years. Nevertheless, one can reckon with the loosening of fiscal policy for 2017. Relative to counterfactual (forecast published in July) this will be expansionary.

Monetary policy is likely to be expansionary in both 2016 and 2017. In August 2015, the Bank of England cut the Bank Rate from 0.5 per cent to 0.25 per cent and extended its quantitative easing program by envisaging the purchase of an additional £60 billion of government bonds and £10 billion of corporate bonds.

Sterling depreciated by 15 per cent on a trade weighted basis since the Brexit vote and it is close to its level reached in the 2008-2009 financial crisis. In turn, **consumer price inflation** is projected to increase from 0.5 per cent in 2016 to 2.5 per cent in 2017. The **current account deficit** is close to 6 per cent of GDP in 2016 exposing the British economy vulnerable to **external shocks** including the deceleration or the stop of capital inflows but it is likely to recover somewhat in 2017.

Table 6

Figures on the UK

	Volume change in %	
	2016	2017
GDP	1.7	1.0
Private consumption	2.3	-0.1
Public consumption	0.8	0.6
Gross fixed capital formation	-1.9	-3.3
Total domestic demand	1.1	-0.8
Exports of goods and services	1.9	3.7
Imports of goods and services	0.9	-2.1
Net exports	0.3	1.8
Consumer prices	0.5	2.5
Employment	1.3	0.2
Unemployment rate (%)	5.0	5.6
General government balance in % of GDP	-3.7	-3.5
Gross public debt in % of GDP	89.4	90.4
Current account balance in % of GDP	-6.0	-3.2

Source: NIESR

Questions for discussion

- How will Brexit look like? Will there be a soft Brexit (with a priority to the access to the single market at the expense of limitations over borders and laws as well as contributing to the EU budget) or a hard one (with an emphasis on regulatory sovereignty at the expense of the access to the single market)?
- Do limitations on immigration not risk the normal functioning of the British economy? Can the British economy strive without foreign workers?
- Is Britain able to obtain a better position outside the EU than inside it in economic terms?
- What may be the net effect of the depreciation of the pound sterling? Can it be a remedy to the huge current account deficit?
- Do capital inflows fund the huge current account deficit?
- Does the depreciation of the pound sterling not endanger the meeting of the Bank of England's 2 per cent inflation target?
- Is the United Kingdom becoming a more inward looking and illiberal country after Brexit?

2.2.2. Denmark

In the second quarter of 2016 Denmark's economy grew for a second consecutive quarter, although **growth remained meagre** with GDP increasing 0.5 per cent quarter-on-quarter against 0.8 per cent of the first quarter. The key external sector and public spending supported growth that was set off to a certain extent by weaker household spending and fixed investment activity. **Subdued business and consumer confidence** in August and September, respectively, suggest that sluggishness continued in the third quarter. Prime Minister Lars Locke Rasmussen (Liberal Party) presented a **10-year economic plan** in August that envisages tax cuts and other measures to revive the economy. Nevertheless, the approval of the plan is surrounded with **uncertainty.** Among the parties supporting Rasmussen's minority government consisting of the Liberal Alliance and the Danish People's Party, there is strong disagreement on the proposed tax cuts. Tensions among the parties intensified in September, increasing the political risk of a collapse in government.

Against this background **Denmark's GDP is projected to grow by 1.0 per cent in 2016 and 2 per cent in 2017** driven mainly by domestic demand (Table 7). In 2017 private consumption will be supported by mounting real incomes associated with higher employment, real wage increases and rising property prices. Exports are projected to rebound in 2017 following the weak years of 2015 and 2016. Spare capacity in the economy is diminishing.

Fiscal policy is likely to move gradually towards a more neutral stance. Public finances are rather sound both in the medium- and the long-run, fiscal sustainability indictors are positive **Investment activity** could benefit from the accommodative monetary policy stance. In spite of increasing real wages and real estate prices, **consumer price inflation** is anticipated to remain subdued with 0.4 per cent in 2016 and 1.5 per cent in 2017. **The peg of the Danish currency to the euro** as well as the **negative deposit rate** of the central bank are assumed to remain effective. Moderate productivity growth continues to be a major long-term challenge. More structural reforms are needed, particularly in domestic services and innovation.

Table 7

Figures on Denmark

	Volume change in %	
	2016	2017
GDP	1.0	2.0
Private consumption	2.0	2.3
Public consumption	1.2	0.5
Gross fixed capital formation	1.4	3.2
private excl. dwellings	2.1	3.8
dwellings	4.3	4.3
government	-3.6	-0.1
Total domestic demand	1.2	2.2
Exports of goods and services	0.4	2.5
Imports of goods and services	0.6	2.8
Consumer prices	0.4	1.5
Unemployment rate in %	3.2	3.1
Public sector fiscal balance in % of GDP	-0.6	-1.6
Gross public debt (6,7)	40.4	40.8
Current account balance	6.0	5.7

Source: Secretariat of The Danish Economic Councils

2.2.3. Sweden

Sweden's GDP grew by 4.2 per cent in 2015 at the fastest rate since 2010. Growth was driven by private and public consumption, but investments and net exports, too, were rather strong. According to the Swedish AIECE institutes, **GDP is projected to grow by 3.4 per cent in 2016 and 2.3 per cent in 2017** (Table 8). In 2017 the major **driving force of GDP growth** will be private consumption. Exports will be weak. The growth rate of i**nvestments** is likely to decelerate although it is likely to exceed that of GDP in spite of rather high risks and uncertainties. High **housing demand** will continue to underpin residential investment. Housing demand and households' debt that are destabilising factors are under control. The **inflow of refugees** will have a favourable impact on GDP growth in the forecasting horizon.

Employment is likely to mount by 1.5 per cent in 2016 and 1.3 per cent in 2017 with gradually declining unemployment. **Labour shortage** in specific sectors, e.g. in construction will be limiting factors to growth. Particularly workers with the right skill are on short supply. The integration of migrant workers into the labour market and their relatives into society is the major challenge Sweden is facing.

Table 8

Figures on Sweden

	Volume change in %	
	2016	2017
GDP	3.4	2.3
Private consumption	2.8	2.3
Public consumption	3.4	2.2
Gross fixed capital formation	6.7	3.1
Exports of goods and services	2.6	3.2
Imports of goods and services	4.5	3.3
Consumer prices	1.0	1.4
core consumer prices	1.4	1.2
Unemployment rate	6.8	6.5
Gross public debt in % of GDP	40.9	39.1
Current account balance in % of GDP	4.7	5.2

Source: Confederation of Swedish Enterprise, NIER, Stockholm

Based on Sweden's knowledge-based economy and highly skilled workers, **productivity growth** has accelerated recently. **Inflationary pressures** are projected to remain subdued. One reason for this is that wage settlements will lead to only moderate increases in household income. **Monetary policy** is expected to remain expansionary, supportive to growth until the inflation target of the central bank is not met. In spite of **the negative deposit rate** of the central bank, the Swedish currency is under appreciati**on pressure**. With low general government deficit and government debt ratios, fiscal policy was neutral in 2016, and it should be tighter in 2017.

2.2.4. Poland

Poland's GDP grew by 3.6 per cent in 2015, its fastest annual space since 2011. The main driving force of GDP growth was private consumption supported by the increase of wages and employment that reached its highest level since the 1990s. Investments bolstered by rising disposable incomes of households, improving corporate profits, cheap financial conditions and low energy prices, too, contributed to GDP growth.

Table 9

Figures on Poland

	Volume change in %	
	2016	**2017**
GDP	3.2	3.4
Private consumption	3.6	3.3
Public consumption	3.0	2.8
Gross fixed capital formation	3.1	6.1
Total domestic demand	2.7	3.5
Exports of goods and services	6.3	5.8
Imports of goods and services	7.3	7.1
Consumer prices	-0.4	1.2
core consumer prices	0.3	1.4
Unemployment rate in %	9.2	9.2
Public sector fiscal balance in % of GDP	-2.9	-3.7
Gross public debt in % of GDP	53.1	53.9
Current account balance in % of GDP	2.2	0.8

Source: IBRKK Warsaw

Poland's GDP is projected to grow by 3.2 per cent in 2016 and 3.4 per cent in 2017 (Table 9). The main **engine of GDP growth** will be consumption supported by rising employment and wages as well as higher social transfers ordered by the new government in 2016. Nevertheless, **employment** is likely to increase at a modest rate in the forecasting horizon and the **unemployment rate** to remain unchanged. In 2017 accommodative **credit conditions** combined with **infrastructural projects** (mainly in public transport) financed by EU funds will raise investments. In the long run, they will probably contribute to the improvement of **productivity**. **Consumer price inflation** is projected to leave negative territory in 2017 and reach 1.5 per cent as a result of growing energy prices and tightening labour market.

The relationship between monetary and fiscal policy is neutral. In the light of growing inflationary pressure, the central bank could lift its reference rate next year. Additional fiscal consolidation could make more room to finance new social spending and investments in infrastructure and skills over the longer term. The new **tax structure** is eventually leading to higher taxes.

Political uncertainties are weighing heavily on the future development of the Polish economy. The elimination of checks and balances in general, control mechanisms and institutions in the economy in particular in order to implement political priorities related to maintaining and/or expanding the power of the ruling party may have an adverse impact on the development trends of the Polish economy.

2.2.5. Hungary

Hungary's GDP grew by 2.9 per cent in 2015. Based on the average of the two Hungarian AIECE institutes, **GDP is projected to increase by 2.1 per cent in 2016 and 2.8 per cent in 2017** (Table 10), the lowest rate in the Central and Eastern European region. In 2016 growth was supported by low energy prices and loose monetary policy and low interest rates. Hungary's GDP growth is largely dependent on the inflow of **EU transfers**. Due to the phasing-out of the 2007-2013 EU budgetary period and the difficulties related to the launch of the next one, their inflow slowed down in 2016, but it is expected to recover in 2017 providing an explanation for the acceleration of GDP growth in 2017.

In 2017, the major **driving force of GDP growth** will be private consumption followed by external demand and public consumption. After the 10 per cent decline in 2016, **investments** are likely to recover in 2017 mainly due to the restart of EU transfers. **Faster growth is impeded** by the shortage of skilled labour (the shortage of skilled workforce is becoming a pressing problem in a number of industries particularly in manufacturing and tourism) and capital to invest, the business and regulatory environment causing these problems and the exceptionally high dependence on EU transfers.

Internal and external equilibria are expected to remain very favourable in spite of a slight deterioration. **Consumer price inflation** is very low, with a minor upward trend. The improvement in external and internal equilibria was acknowledged by the fact that three international credit rating agencies (Fitch, Standard & Poor's and Moody's) **upgraded** Hungary's sovereign debt to investment grade. A similar move is expected from Moody's Investor Service.

The **general government deficit relative to GDP** is well below the critical 3 per cent ceiling providing the government with some room of manoeuvring. Regarding the latest measures, based on a price-dependent mechanism, the excise tax on gasoline and diesel was raised in October 2016. On the other hand, the VAT rate of restaurant services will be cut in 2017 and 2018. The government also announced its plan to cut the employers' social security contribution in 2017, and other recently submitted tax changes may contribute to GDP growth.

Employment is a crucial problem in Hungary particularly. On the one hand, several thousands of Hungarians emigrated to get better-paid jobs in other EU member countries. On the other hand, unemployment is still quite significant.

Table 10

Figures on Hungary

	Volume change in %	
	2016	**2017**
GDP	2.1	2.8
Private consumption	4.6	3.6
Public consumption	2.8	1.8
Gross fixed capital formation	-10.0	4.3
Total domestic demand	1.8	3.0
Exports of goods and services	6.0	6.5
Imports of goods and services	6.1	7.2
Consumer prices	0.5	1.6
Unemployment rate in %	5.3	5.0
Public sector fiscal balance in % of GDP	-1.9	-2.5
Gross public debt in % of GDP	74.2	73.3
Current account balance in % of GDP	5.2	4.7

Note: The arithmetical averages of the forecasts of KOPINT and GKI
Source: KOPINT and GKI Budapest

The main tool applied by the government to raise employment levels is still the expansion of the public workfare budget. But the public workfare schemes are not designed in a way that would improve the employability of the public workers at the normal labour market. At the same time, the budget for active labour market policies (e.g. retraining) remains very limited. The government hopes to boost employment from the reduction of employers' social security contributions.

2.3. Other European countries

2.3.1. Switzerland

Following weak growth valued at 0.9 per cent in 2015 mainly as a consequence of the strong national currency, the Swiss economy is forecast to pick up slowly in 2016 and 2017 with projected GDP growth rates of 1.6 per cent and 1.8 per cent, respectively, partly with the waning of the effects of the formerly extremely appreciated Swiss franc (Table 11).

In 2016 recovery is supported by low oil prices and loose monetary policy and interest rates. In 2017 the major **driving force of GDP growth** will be external demand and private consumption, the latter bolstered by negative interest rates and increasing real wages. Following a recent rise, **unemployment** may start to decrease slowly in 2017, although this will not be manifested in the unemployment rate that is likely to remain stable at 4.6 per cent over the forecasting horizon.

With the predicted rise of crude oil prices and wage increases **consumer price inflation** is likely to mount from -0.4 per cent in 2016 to +0.2 per cent in 2017. The **general government** is sound, the **deficit** is negligible by international standards, the **gross public debt** ratio is also low by international comparison, there is room for expansion. The expansionary monetary policy setting is appropriate and it is likely to remain so over the forecasting horizon. However, the **housing market** deserves some special attention. The relationship between monetary policy and fiscal policy is neutral. The huge **current account surplus** is likely to persist. Although its level is high, **productivity** is improving slowly.

Table 11

Figures on Switzerland

	Volume change in %	
	2016	**2017**
GDP	1.6	1.8
Private consumption	1.0	1.2
Public consumption	1.5	1.0
Gross fixed capital formation	2.0	0.2
Exports of goods and services	3.5	2.3
Imports of goods and services	3.3	2.7
Consumer prices	-0.4	0.2
Unemployment rate in %	4.6	4.6
Real household disposable income	1.3	2.0
Public sector fiscal balance in % of GDP	0.4	-0.1
Gross public debt in % of GDP	33.8	34.0
Current account balance in per cent of GDP	10.7	9.9

Source: KOF Swiss Economic Institute

After seven hours of debate, in late September 2016 the federal Swiss legislation defied the expressed will of the people manifested earlier at a referendum and set aside the draft constitutional amendment on the **imposition of quotas on foreign residents**. This would have contradicted to the four freedoms (free movement of goods, services, capital and labour force) of the EU on which its single market is based. Switzerland opted for maintaining its access to the single market at the expense of greater national sovereignty.

2.3.2. Norway

Norway's GDP is projected to grow by 0.9 per cent in 2016 and 2.1 per cent in 2017 (Table 12) after a growth rate of 1.6 per cent in 2015. The deceleration of the growth rate in 2016 is caused by the fall of crude oil prices since decreasing oil revenues had a negative impact on the economy primarily through resource-related investments and spillovers to the rest of the economy. This trend is likely to reverse in 2017 when economic growth will be supported by expansionary fiscal and monetary policy, a more competitive exchange rate and a gradual increase in oil prices. **Constraints to growth** include external demand and private investments, particularly in petroleum and related industries. However, housing investments are predicted to soar driven by low interest rates and rising housing prices.

Unemployment will peak in 2016, the unemployment rate will decrease from 4.7 per cent in 2016 to 4.5 per cent in 2017. **Consumer price inflation** will drop form 3.0 per cent in 2016 to 1.9 per cent in 2017 partly as a consequence of the waning of the effects of the former appreciation of the national currency.

Monetary policy is expansionary as a result of which the depreciation of the Norwegian national currency is likely. **Risks** related to the housing market and the indebtedness of households are manged by macro-prudential tools. **Fiscal policy**, too, is expansionary. Tax cuts that dominate have limited effects on domestic demand. Monetary policy and fiscal policy support each other.

Table 12

Figures on Norway

	Volume change in %	
	2016	**2017**
GDP **Mainland Norway**	0.9	2.1
Private consumption	1.9	2.0
Public consumption	2.6	1.9
Gross fixed capital formation **Mainland Norway**	4.3	5.1
Total domestic demand **Mainland Norway**	2.6	2.6
Exports of goods and services **Traditional goods**	-1.4	3.3
Imports of goods and services	0.8	2.3
Consumer prices	3.4	2.0
core consumer prices	3.0	1.9
Employment	-0.2	0.7

Source: Statistics Norway

Questions for discussion: outlook in the countries outside the euro area

- What are the advantages of independent monetary policy for the countries not belonging to the euro area?
- Is the independent exchange rate policy a positive contribution to economic growth and structural adjustment in the counties outside the euro area?
- How do Danish, Swiss and Swedish economic policy decision makers manage the effects of the appreciation of their currencies originating in heavy capital inflows?
- Are there any lessons to draw for the United Kingdom from Switzerland's relations with the EU?
- To what extent is GDP growth dependent on the inflow of EU funds in Poland and Hungary? What will be the driving forces of GDP growth when the inflow of EU starts to phase out?

3. Policy environment

3.1. Monetary policy

Until recently the **reduction of the reference rates** and the **quantitative easing** programs of the large central banks of the world could mitigate the sovereign debt crisis. They were deployed to fight against low inflation and deflationary pressure and to promote investments and private consumption by improving credit supply conditions.

Nevertheless, this kind of monetary policy have some **negative side effects** as well. With low or negative interest rates, monetary policy is losing its effectiveness, and the risk of **liquidity trap** is looming. Liquidity trap is a situation, in which injections of cash into the private banking system by a central bank fail to decrease interest rates and hence make monetary policy ineffective. The extremely low and the negative interest rates **distort financial markets** by boosting the rise of the prices of shares, bonds and real estate, and nurture asset bubbles. They challenge the business model and the sustainability of financial institutions by undermining the profitability of banks and the solvency of pension funds and life insurance companies. Thus, low interest rates in general and negative ones in particular involve **substantial risks** for the financial sector. With past and current purchases, central banks are the major holders of sovereign debt. They intervene in other financial market segments (corporate bonds and equities) as well.

The world-wide stock of **government debt with negative yields** totals now USD14tn corresponding to 35 per cent of OECD government debt. Regarding the AIECE region, negative central bank deposit rates prevail in the euro area, Denmark, Sweden, Switzerland and Hungary.

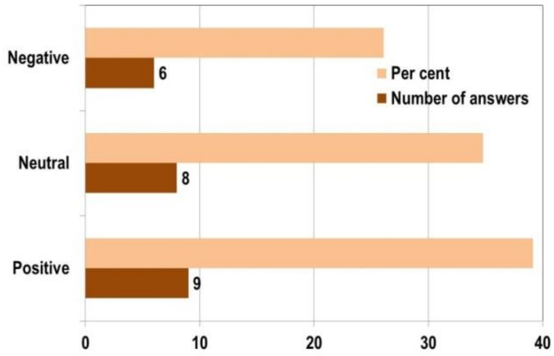
On the other hand, with low inflation and sluggish growth the rise of interest rates can hardly be justified in many economies. E.g., in specific countries a rise in yields could trigger substantial tensions because of the high government debt.

The **global situation** is rather complicated and controversial since the ECB and the Bank of Japan are interested in maintaining rather loose monetary conditions, whereas referring to positive macroeconomic trends (particularly those of inflation and employment), the Fed in the US is inclined to raise its reference rates.

We asked the opinion of the AIECE institutes on the monetary policy of the European Central Bank. Almost 40 per cent of the AIECE institutes judged **the monetary stance of the ECB** positive, one third neutral and one quarter negative (Figure 8).

Figure 8

The assessment of the monetary stance of the ECB by the AIECE institutes

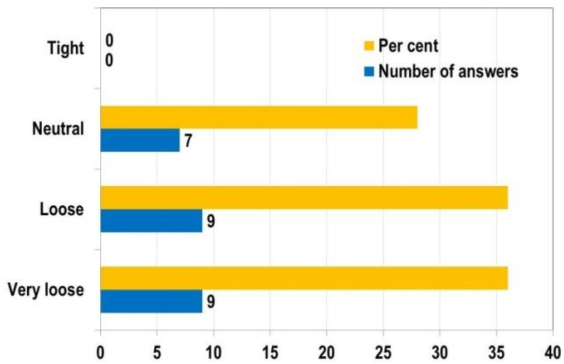


Source: AIECE institutes

Nearly three quarters of the AIECE institutes thought that **the desirable monetary stance of the ECB** should be loose and very loose (Figure 9).

Figure 9

The desirable monetary stance of the ECB according to AIECE institutes



Source: AIECE institutes

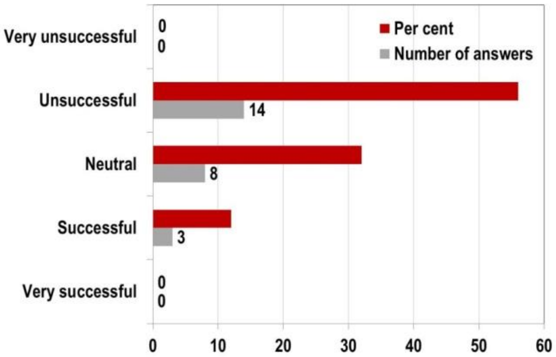
There was not a single institute justifying tightening, and those dissatisfied with tightening opted for neutral stance. The replies to this question are consistent with the previous ones.

In spite of this, 8 institutes out of 19 ones (40 percent) expected **rate rise** from the ECB from the fourth quarter of 2016 on. More precisely, 6 institutes projected 0 per cent reference deposit rate of the ECB instead of the present -0.40 per cent, one institute predicted a more aggressive rate increase with 0.25 per cent in the fourth quarter of 2017 and one institute reckoned with a rise to -0.3 per cent and -0.2 per cent, respectively, over the forecasting horizon.

Nevertheless, **the assessment of the successfulness of the ECB's monetary policy** is more controversial, the views are rather divided. Although more than half of the institutes expressed neutral opinion on the issue, more than half of them are not content with the effectiveness of monetary policy and they considered it unsuccessful (Figure 10). The number of those having submitted positive judgement is rather limited. Nevertheless, the two extreme views (very successful and very unsuccessful) are missing, thus the picture indicates a temperate golden mean.

Figure 10

The assessment of the performance of the ECB in achieving its policy targets

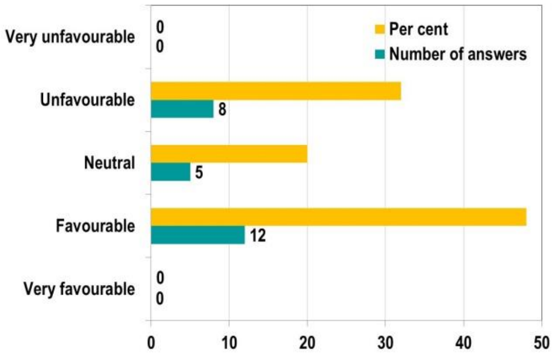


Source: AIECE institutes

AIECE institutes are divided over the issue of **negative interest rates.** In spite of the negative risks involved, nearly half of them graded it favourable, one third unfavourable with 20 per cent in between, i.e. neutral (Figure 11). The responses are consistent with the general public opinion in the world (if such a thing exists at all), which is divided between supporters of and opponents to negative interest rates.

Figure 11

The assessment of the negative deposit rates

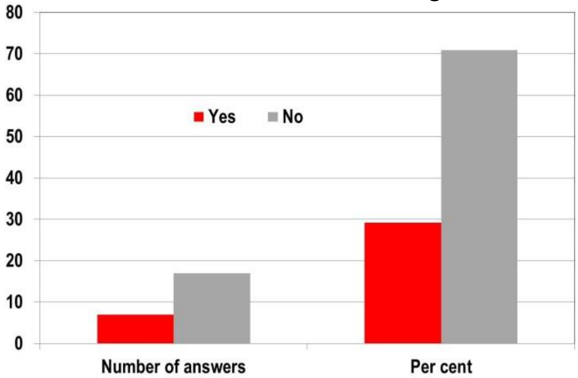


Source: AIECE institutes

Referring to the opinions concerning the successfulness of the ECB's activity, the logical question arises **how to improve monetary policy**. Part of the issue is continuity or the discontinuity of the present monetary policy line. 70 per cent of the institutes rejected the idea that the ECB should take further measures to lift inflation and encourage GDP growth (Figure 12). The answers to these questions suggest that the direction of monetary policy pursued by the ECB is good, but the implementation of monetary policy is not or less satisfactory.

Figure 12

Should the ECB take further measures to raise inflation and bolster GDP growth?



Source: AIECE institutes

Considering the **verbal comments** of AIECE institutes, one opinion **rejecting the necessity of the implementation of further measures** by the ECB refers to the expected pick-up of inflation next year, essentially due to the base effect of energy prices. Consequently, no more monetary easing is necessary. In this view, monetary policy has reached its limits. According to another standpoint, the ECB already offers negative rates and has implemented a large-scale asset purchasing program, there is no more room for further easing. Some other assessments, too, are consistent with this. The barrier of the possibilities of what monetary policy can and should reasonably do to bolster economic activity has been reached.

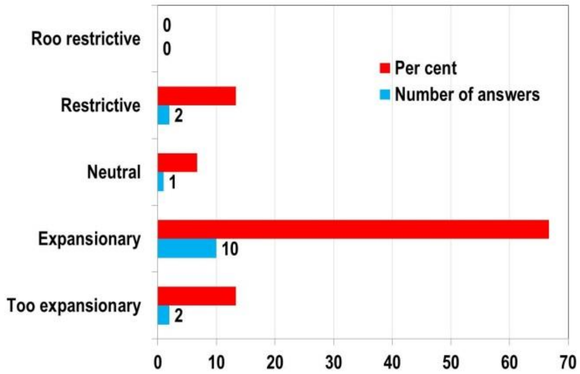
The other set of opinions is **in favour of additional monetary easing** in terms of applying even lower negative deposit rates, lifting the inflation target above 2 per cent, buying directly public debt in primary market, purchasing bank bonds, expanding the set of unconventional measures as the Fed did after the past crisis and relaxing constraints on the increase of the balance sheet and tapering EAPP only gradually, not abruptly.

Finally, the third set of opinions point to the necessity of **phasing out the present loosening**, since negative policy rates and quantitative easing should not last indefinitely. They are exceptional measures and should not constitute the "new norm".

We asked the view of the AIECE institutes about **the monetary stance of their own countries**. The answers to this question cannot be compared directly to those related to the ECB since, on the one hand, the sample is smaller because less institutes responded, on the other hand, the sample comprises countries that are not members of the Economic and Monetary Union where the monetary conditions are determined by their national banks rather than the ECB. In 2016, 80 per cent of the institutes perceived the monetary environment expansionary and too expansionary (Figure 13). The results are exactly the same when asked about monetary conditions expected in 2017 (Figure 14).

Figure 13

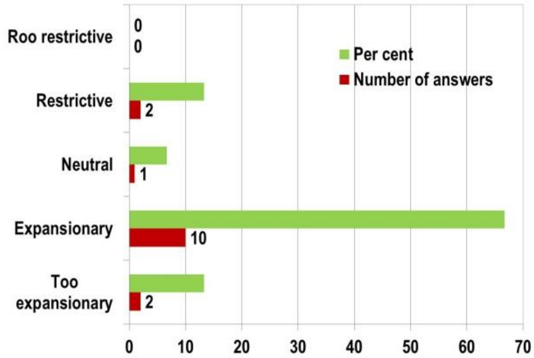
The assessment of the monetary policy environment in the own country in 2016



Source: AIECE institutes

Figure 14

The expected monetary policy environment in the own country in 2017

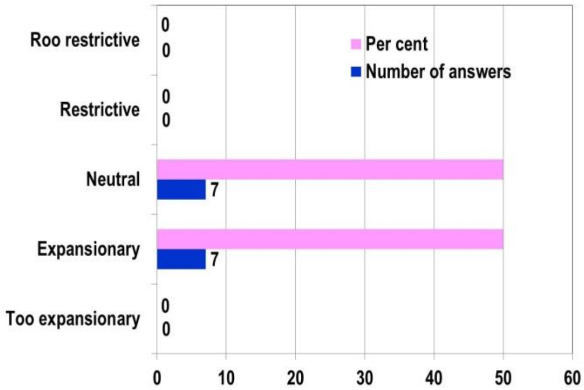


Source: AIECE institutes

As far as the **desirable monetary policy stance in 2017** is concerned, it should be expansionary by half of the institutes and neutral by the other half.

Figure 15

The desirable monetary stance in the own country in 2017



Source: AIECE institutes

Questions for discussion

- Would you comment on the monetary policy of the ECB please? Is there deflationary pressure in the euro area?
- Monetary conditions in the euro area depend to a large extend on the monetary policy of the US Fed. How can the monetary stance of the Fed and the short-term prospects of its monetary policy be evaluated?
- What would the implications of rate hikes by the Fed on the monetary policy of the ECB be?
- What are the advantages and disadvantages as well as the risks of the zero or negative interest rate policy of the major central banks?
- Is the risk of liquidity trap present in the euro area?
- Are there currency wars on the horizon?
- Stock indices and real estate prices reached all time high levels in the US and in some EU member states not least as a result of loose monetary policies. Are stock markets and real estate markets overvalued and posing threats to financial stability?
- How do the ECB's standard and non-standard monetary policy measures spill over to countries outside the euro area?

3.2. Fiscal policy

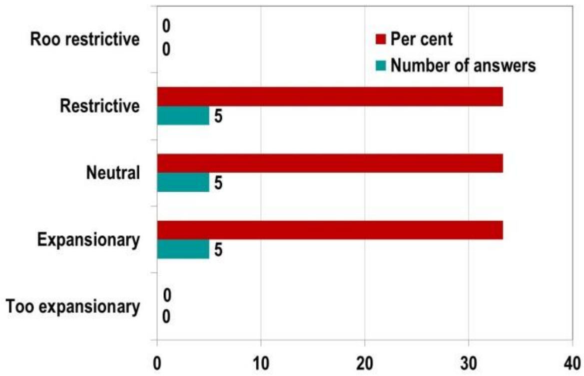
According to the latest Economic Outlook published in September, 2016 by the OECD, the **room of manoeuvring of fiscal policy widened** in many advanced countries since interest rates declined by more than GDP growth. This decrease more than outweighs the increase in the debt-to-GDP ratio, thereby lifting the amount of debt that can be sustained. Relying on these trends, in Canada, Japan and the US measures aiming at fiscal expansion were signalled. In the United Kingdom, too, some softening in the budgetary stance was anticipated. Fiscal consolidation was ended in the euro area in 2015.

According to the **forecasts** of the AIECE institutes, in 2016 and 2017 the **general government deficit** remains below 3 per cent of GDP (the deficit rule of the Stability and Growth Pact) in 2016 and 2017 in all countries except France, Spain, the United Kingdom and Poland, the latter in 2017. In 2017 the general government deficit ratio is expected to decrease in the majority of the countries represented by the AIECE institutes. Minor increase, sometime in the range of statistical margin of error is envisaged in Italy, Hungary and Finland, whereas more profound easing in Denmark and Poland, suggesting a rather strong fiscal easing.

We asked the AIECE institutes about the **fiscal policy stance of their countries** in 2016 and 2017. Regarding **the year 2016**, the result is equal distribution of the answers among expansionary, neutral and restrictive (Figure 16).

Figure 16

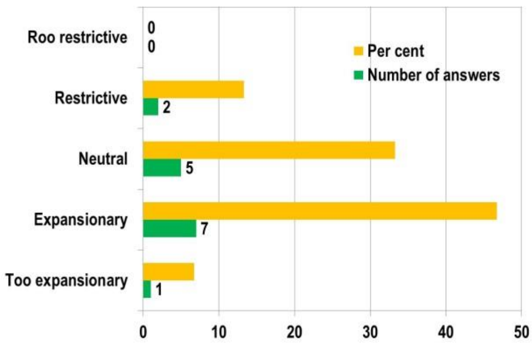
The evaluation of the fiscal policy stance in 2016



Source: AIECE institutes

Figure 17

The evaluation of the fiscal policy stance in 2017



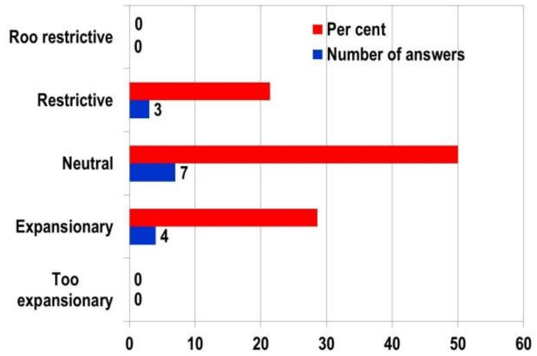
Source: AIECE institutes

The picture changed concerning the forecast **for 2017**. The share of expansionary stance grew at the expense of the restrictive feature and one institute predicted too expansionary fiscal policy posture (Figure 17). In Finland, e.g. fiscal policy is definitely contractionary from the expenditure side in 2017.

The **fiscal policy stance held desirable** by the institutes for 2016 is slightly different from the forecasts (Figure 18). Half of the institutes called for neutral fiscal policy stance, whereas 28.6 per cent for expansionary and 21.4 per cent for restrictive one. In other words, four institutes had the view that there was some space for fiscal expansion.

Figure 18

The desirable fiscal policy stance in 2017



Source: AIECE institutes

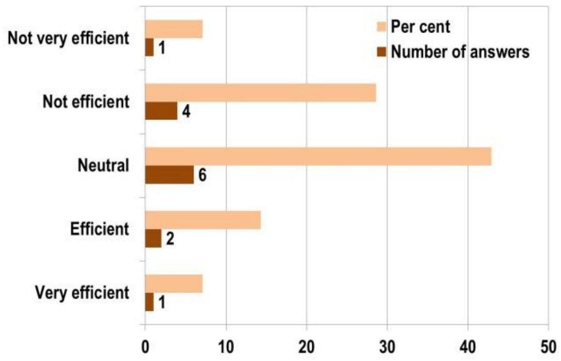
The **gross government debt** is also an important part of the general government. According to the projections of the institutes, gross government debt relative to GDP is also likely to decrease in the majority of the countries surveyed. (The arithmetic average of the AIECE institutes was 78.5 per cent for 2016 and 78.1 per cent for 2017.) The exceptions included Denmark, Finland, France, Italy, Poland, Switzerland and the United Kingdom. Nevertheless, apart from Finland and France, the increase was very small, even negligible in every of them.

The evaluation of the **recent government measures to reduce the general government ratio** seems to be consistent with the views of the institutes over the fiscal stance. 21.4 per cent of the institutes considered them very efficient and efficient, 42.3 per cent maintained neutral view and 35.7 per cent qualified the not efficient or not very efficient (Figure 19).

Given the low to negative interest rates, public investment in education and research might be a more efficient way to reduce government debt in the long-term by improving growth prospects, rather than aiming at small surpluses in public finances now at all costs.

Figure 19

The evaluation of the currently implemented measures to reduce the general government debt



Source: AIECE institutes

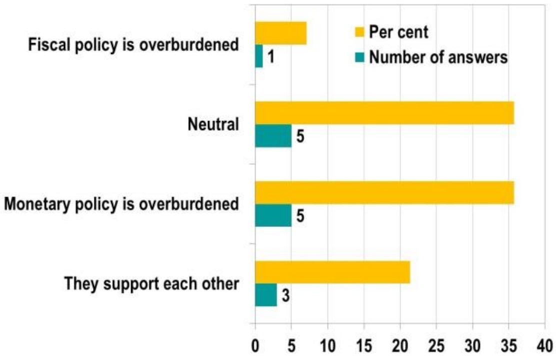
Finally, we asked the opinion of the institutes about **the relationship between monetary policy and fiscal policy**. The background of this question is the conclusion of the OECD according to which **monetary policy is overburdened**. If strong fiscal policy and structural reforms are absent, it is impossible to break out of the low-growth trap. Relying on the results of fiscal consolidation achieved so far as well as on low borrowing costs, there is **room for fiscal expansion** in many countries. Meanwhile, monetary policy should remain accommodative. The general recommendation of the OECD is that the possibility of restructuring their spending and tax policies promoting GDP growth are available to all countries. Budgetary spending on hard and soft infrastructure, well-targeted active labour market policies, etc. should be raised.

35.7 per cent of the AIECE institutes share the view that monetary policy is overburdened, and the same share is neutral on this issue (Figure 20). A quite high share of the institutes thinks that monetary policy and fiscal policy support each other.

The two verbal comments that came from the institutes agree on the point that more role should be assumed by fiscal policy to promote GDP growth and partially governments with the necessary fiscal space should allow for a stimulative budgetary policy (e.g. in Germany).

Figure 20

The evaluation of the relationship between monetary policy and fiscal policy



Source: AIECE institutes

Questions for discussion

- How can monetary policy and fiscal policy be reconciled in the present situation?
- What are the risks for the forecast of the general government deficit and gross government debt ratio?
- Which could the most important growth promoting tools of fiscal policy be?
- Which may be the main features of structural reforms in your country?
- What is the relationship between growth promoting budgetary measures and structural reforms?
- Should the fiscal rules enshrined in the effective EU law be changed in order to ensure growth promoting fiscal policies?
- Structural reforms usually tend to increase general government expenditures. Is the implementation of structural reforms compatible with meeting certain criteria on the general government deficit and government gross debt?

4. Challenges for Europe and the risks to the forecast

It is a commonplace that European integration has developed under the pressure of crises as well as challenges. At present, the EU is facing a great number of external and internal challenges as well as risks.

Internal challenges and risks are as follows:

- the revival of the sovereign debt crisis in Greece;
- the poor state of the Portuguese and the Italian banking system, in Italy combined with the high level of gross government debt;
- the precarious state of some large banks (such as Deutsche Bank, fraud at Wells Fargo);
- the adverse consequences of negative interest rates;
- deteriorating international competitiveness;
- the departure of the United Kingdom from the EU;
- the spread of Euroscepticism and lack of credibility in a great number of member states;
- deep political division, inflexibility of EU institutions.

External challenges and risks comprise the following:

- the US presidential elections;
- geopolitical tensions in the Middle East (the Islam State, the war in Syria, instability in Afghanistan, Iraq, Iran, the illiberal Turkish state etc.);
- the refugee crisis;
- the frozen conflict between Russia and Ukraine;
- the deceleration of the rate of GDP growth in China and the sharp depreciation of the renminbi;
- the possible tightening of US monetary policy;
- terrorism.

The response to these challenges and the management of these risks may have a significant impact on the economic development of European countries.

4.1. Financial stability

To put the topic into global perspective, according to the IMF, although the short-term risks have eased, the long-term ones such as the continuing unprecedented low-yield environment combined with the vulnerability of banks, increasing debt in China (including the recapitalisation needs of the Chinese banking sector) and the huge indebtedness of companies in emerging countries **may cause severe problems** in the longer run. The low yield environment is a threat for the solvency of life insurance companies and pension funds.

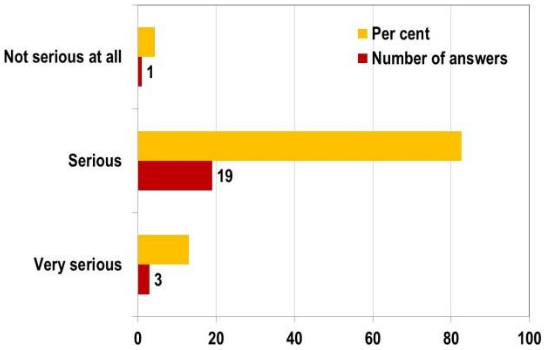
Major challenges and risks are related to **financial stability** in the euro area as well. According to the IMF, one third of European banks with USD8.5 trillion in assets are too weak to recover. Eight years after the outbreak of the financial crisis, the spectacular problems of Deutsche Bank and the poor state of the banks in some peripheral countries in general and in Italy and Portugal in particular have not been solved.

We asked the view of AIECE institutes on the **Italian situation** where the troubled banking system combined with enormous public sector indebtedness, political instability and the inflow of refugees may pose a challenge to financial stability not only in Italy but the euro area as well. The overwhelming majority of the institutes assessed the situation as serious and very serious (Figure 21).

The verbal comments of the institutes are diverse. To start from a wider perspective, in spite of the ECB's stress tests, several European banks still seem to have **inadequate capital levels**. This is the legacy of the lack of clean-up of balance sheets by European banks after the financial crisis. In the US banks were forced to take government capital, this was often not the case in Europe. As long as there are problems in the European banking sector, a healthy economic recovery shifts further ahead.

Figure 21

The assessment of the impact of the poor state of the banks, high public indebtedness, referendum on constitutional reform in Italy on the financial stability of the euro area



Source: AIECE institutes

In Italy, the greater problem is the banking sector. The fragility of the Italian banking sector may lead to a lack of confidence and risk awareness of market players. Current low interest rates may not persist forever and Italy seems unprepared for a rise. In case of a worsening situation or the collapse of some banks it may come to a new the financial crisis in the euro area. Consequently, the Italian banks overburdened with non-performing loans are too big to fail. On the other hand, domestic economic participants, including the government do not have the financial sources to bail them out.

Due to orders of magnitude, Italian banks constitute **a challenge to the EMU** as well, the capital needed to bail them out may exceed the available financial sources of the euro area. The new banking regulation introduced after the financial crisis was apparently unable to solve the problem of systemic risk (it may have redistributed some of it, but made some problems worse).

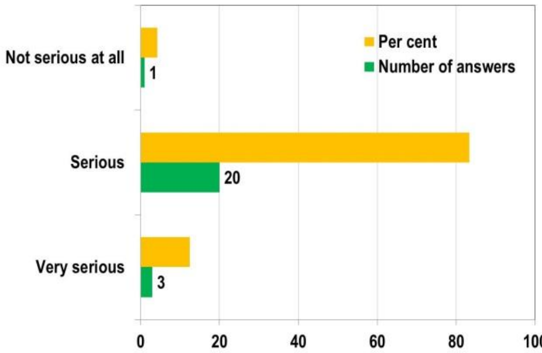
The high level of government debt alone is not a problem if the tax collection capacity of the government is satisfactory. The question is whether or not the Italian government can collect taxes necessary to fund the general government.

The referendum on the constitutional reform alone will not strengthen political stability, additional measures, too, are required to reform the Italian state. The rejection of the constitutional reform would probably be accompanied by political turmoil, Prime Minister Matteo Renzi could resign, which would raise the already high world political uncertainties (government crisis in Spain, presidential elections in the US and France and parliamentary elections in Germany). The rejection of the constitutional reforms may open the way to the 5*movement led government and an Italexit.

Another threat to financial stability in the euro area may come from **the precarious state of some large banks** such as Deutsche Bank. The overwhelming majority of AIECE institutes consider this threat serious or very serious (Figure 22).

Figure 22

The assessment of the impact of large banks on financial stability in the euro area

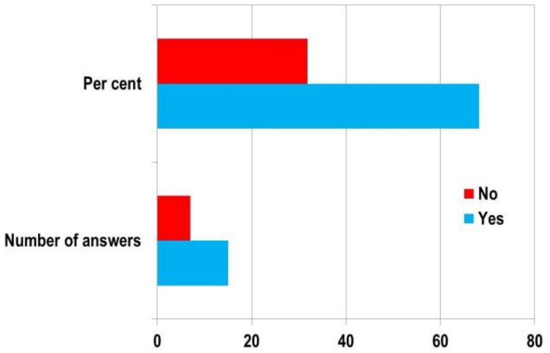


Source: AIECE institutes

The next question is closely interrelated with the previous one. More than two thirds of AIECE institutes maintain the view that in case of emergency **national governments should bail out banks with financial difficulties** (Figure 23) It is obvious that under emergency circumstances a situation is meant in which the stability of the financial system is challenged. This is a serious risk that cannot be incorporated in the forecasts.

Figure 23

In case of emergency, should national governments bail out large banks in the euro area



Source: AIECE institutes

The **verbal comments** made by AIECE institutes in the context of Deutsche Bank are completely in line with this opinion. The size of the problem is indicated by the fact that **Deutsche Bank has a higher leverage ratio** than its European peers and a Tier 1 capital ratio that deteriorated significantly in the last quarters. Moreover, because of the size of its investment's arm, **it has riskier assets**. If it comes to recapitalisation, it should be done in accordance with the higher risks it bears.

Most of the recent stress on DB's market share comes from short-term shocks (the USD14bn fine by the US Department of Justice, Angela Merkel's announcement that there would be no public bail-in, the withdrawal of some hedge fund from the bank assets), although DB's problems originate largely in accumulated management mistakes. Nevertheless, its liquidity position may remain solid. However, the emergence of a liquidity crisis cannot be forecast.

Since DB is one of the largest banks in the world, its possible default may cause much harm to financial markets and endanger financial stability not only in Germany but elsewhere as well (triggering a crisis similar to that of Lehman Brothers). This is also likely to cause increasing uncertainty for consumers and investors which will limit economic growth especially if there is a systemic risk to other banks.

The real question is whether private investors will supply enough capital to restore its solvency position. In case of turmoil and if its capital sinks to a certain level, **the German government will have no choice but to back Deutsche Bank**. (A somewhat strong opinion: in case of emergency the bank should be nationalised.)

Nevertheless, if the German government is willing to step in, the Italian and Portuguese authorities would probably follow suit, thus reviving the very **bank-sovereign loop** that the Banking Union was meant to break. Before the parliamentary elections due in 2017 the German government is not likely to give financial assistance to DB.

If national governments are not ready to bail out large banks, the consequences can be serious since those of the last crisis have not been fully coped with. The way how these problems are solved - i.e. who would raise capital – governments or market participants - will decide how the financial system will evolve.

On the other hand, according to the view of one AIECE institute, with its new **Banking Union** the EU is better equipped to face the threats to financial stability caused by the problems of large banks. There are other evaluations as well. According to them, the new banking regulation since the financial crisis was apparently unable to solve problem of systemic risk (it may have redistributed some of it, but made some problems worse). Maybe regulation should shift away from focusing on the asset side, processes, etc. to focus more on increased equity requirements.

Questions for discussion

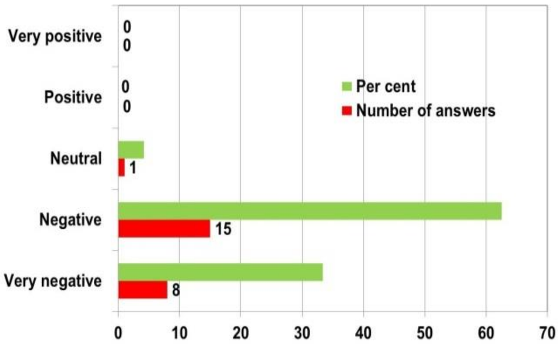
- How efficient are the rules introduced after the financial crisis on bank resolution?
- How credible are the rules introduced after the financial crisis on bank resolution?
- Where will the money come from for bank resolution?

4.2. Brexit

The General Report prepared for the spring meeting of AIECE has already discussed issues related to **Brexit.** Nearly six months ago the majority of the AIECE institutes judged the likelihood of Brexit less than 50 per cent. As it is well-known, according to the outcome of the referendum held on 23 June 2016, the UK will leave the European Union.

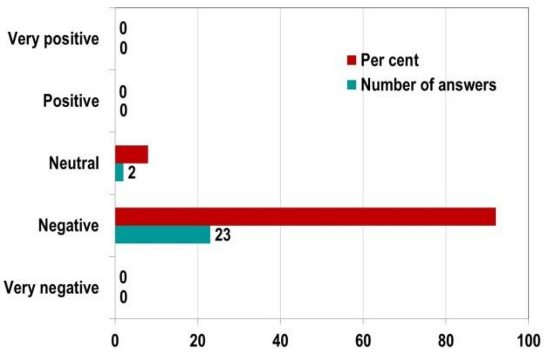
The overwhelming majority of the AIECE institutes think **the impact of Brexit on the British economy** will be negative (62.5 per cent) or very negative (33.3 per cent, Figure 24). Only one institute attached neutral impact to Brexit. AIECE institutes became more pessimistic about the issue compared to the last meeting.

Figure 24
The evaluation of the impact of Brexit on the UK economy



Source: AIECE institutes

Figure 25
The evaluation of the impact of Brexit on the EU economy

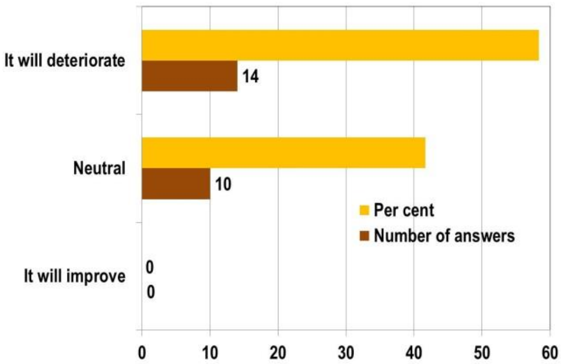


Source: AIECE institutes

The picture is less gloomy concerning **the impact of Brexit on the economy of the remaining EU countries** (Figure 25). With two exceptions, the institutes considered the impact negative, i. e. it is less muted than in the case of the UK. In spite of the slight difference, the answers imply that Brexit will have an adverse effect not only on the economy of the UK, but on that of the EU as well. A separate issue that deserve attention is **the impact of Brexit on political integration in the EU**. Will Brexit speed up political integration, or on the contrary, hold back?

Within the broader economy, competitiveness has assumed outstanding importance in the recent years. According to nearly 60 per cent of the institutes, the competitiveness of the EU is likely to deteriorate (Figure 26). The remaining share of the institutes reckon with neutral effects.

Figure 26
The evaluation of the impact of Brexit on the competitiveness of the EU

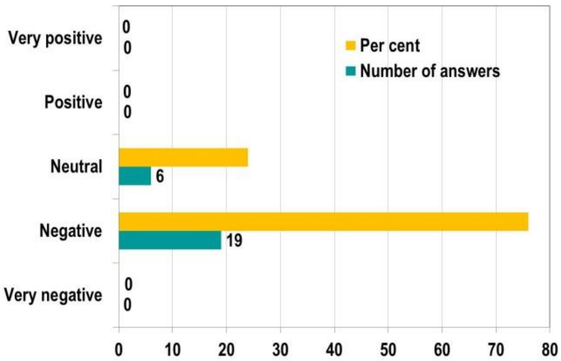


Source: AIECE institutes

The responses to the question concerning **the impact of Brexit on the own country** are more diversified (Figure 27). Slightly more than four quarters of the institutes assessed the impact negative, the rest neutral. Presumably, there are European countries whose economic ties with the UK are less strong and less complex, the effects of Brexit on them are likely to be much more limited.

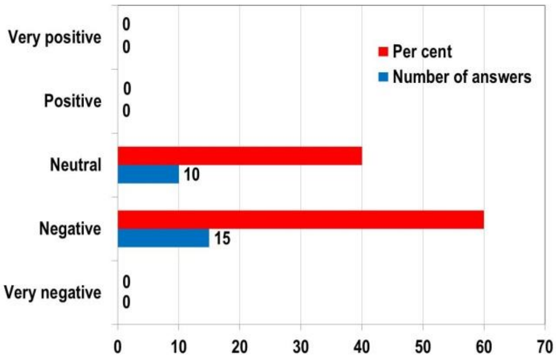
The global implications of Brexit are also rather significant, although with the higher share of the neutral assessment they are less severe than those the UK, the EU and the own country of the institutes (Figure 28). Anyway, the replies indicate that Brexit is not only a nationall and regional problem (that concerns the UK and the EU), but a global issue as well.

Figure 27
The evaluation of Brexit on the own country



Source: AIECE institutes

Figure 28
The evaluation of the impact of Brexit on the global economy

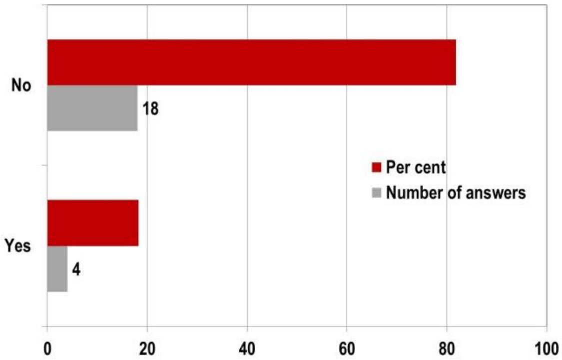


Source: AIECE institutes

A frequently maintained view in the public has been that **Brexit could induce other member states to leave the EU** (Figure 29). Slightly more than eight tenths of the institutes rejected the idea that other countries might depart from the European Union. The remaining institutes are rather pessimistic in this respect. Among the **possible candidates of leaving** the EU they named the Visegrad countries (the Czech Republic, Hungary, Poland and Slovakia) as well as Finland, Italy, Austria, the Netherlands and Denmark.

According to one **comment**, leaving the EU is a possibility that cannot be ruled out though it remains unlikely in the short run. Referendums tend to be a rather popular, though double-edged tool. Nevertheless, there is a barrier to exit from the EU club for the countries that belong to the euro area and for those from Central and Eastern Europe that benefit from substantial structural and cohesion funds.

Figure 29
Would other member states leave the EU as a result of Brexit?



Source: AIECE institutes

The **other comment**, too, considered leaving the EU a possibility. It could start with the more Eurosceptic member states of the EU, especially the ones that opposed EU solutions to the refugee crisis (i.e. the quota). They include Hungary or Austria. But nationalist movement are also threatening in Poland, or France.

Questions for discussion

- Have recent developments in the British economy underpinned the reliability of the impact assessments?
- Are the impact assessments of Brexit not too pessimistic?
- What will be the most probable model in the relations between the EU and the UK: from the point of view of the UK, the EU and what would be a working compromise?
- Is London's role as an international financial centre challenged because of Brexit?
- What will be the impact of Brexit on political integration within the EU?
- What will be the long-term implications for the EU?

4.3. The response of the EMU and the EU to the challenges

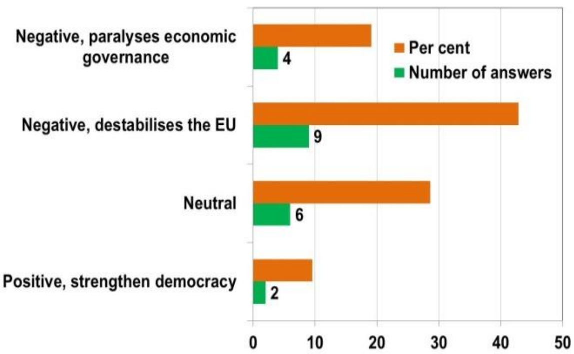
One of the major challenges the EU is facing is **the spread of referendums**, not least bolstered by the British one on EU membership this June. Since 1972 there have been 54 referendums (excluding the latest one in the UK) on matters related to European integration (such as the approval of the accession of new member states, the ratification of primary legal rules and policy issues). After 2000 the outcome of 6 referendums supported by the ruling political parties, the media and professional organisations out of 21 ones was negative even in member states such as France and Ireland where the public support of integration is otherwise rather significant.

Based on the survey of the European Council on Foreign Relations conducted in 28 member states, radical parties in 18 member countries are urging referendums on the following issues:

- EU membership;
- the transatlantic trade and investment partnership;
- compulsory quotas on the distribution of refugees among member states;
- the free flow of workers, etc.

Figure 30

What impact of such referendums related to EU matters will have on European integration?



Source: AIECE institutes

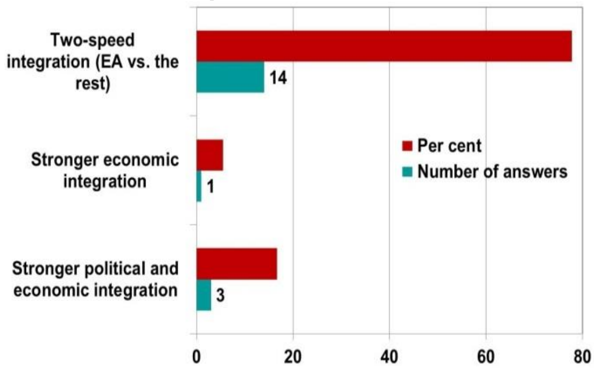
Apart from the fact that their results are assumed to be influenced by the British vote, these referendums may **have an impact on the future development of the European Union**. Therefore, we asked the views of the AIECE institutes on this issue.

The majority of the AIECE institutes evaluated **the impact of referendums related to EU matters on the future of EU integration** (Figure 30). The assessment of the majority of the institutes was rather pessimistic, with the view that referendums destabilise the EU or paralyse economic governance. Neutral opinions are also numerous, whereas the number of optimist ones is rather limited.

The next question was about **the impact of Brexit on EU integration** (Figure 31). The prevailing view is that the most probable outcome is two-speed integration is most probable. The possibility of stronger economic integration is negligible, whereas more chance was given to stronger political and economic integration. Nevertheless, according to one comment the option 'less political/economic integration' was missing. The inclusion of this pessimistic but at the same time realistic option in the choices would have given another, more diversified picture on the issue.

Figure 31

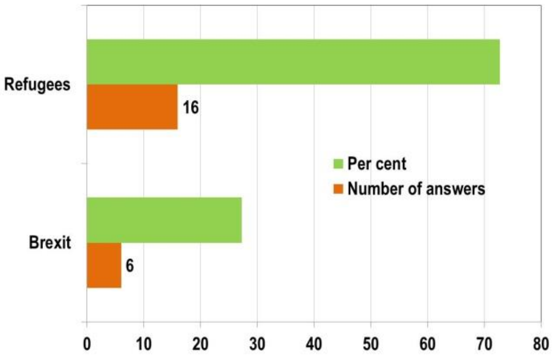
The assessment of the EU's medium-term response to Brexit



Source: AIECE institutes

Another significant challenge to the EU is **the refugee crisis**, although it has not been in the forefront since the referendum on the UK's EU membership. Nearly three quarters of the institutes perceive the refugee issue a more serious challenge to the EU than Brexit (Figure 32).

Figure 32
Which is the more severe challenge for the EU: Brexit or the refugee issue?



Source: AIECE institutes

On the other hand, 76.5 percent of the institutes qualified **the impact of refugees on GDP growth** neutral in both 2016 and 2017. Positive impact was assumed by 3 institutes for 2016 and one institute for 2017.

The first conclusion that can be drawn from the replies is that the refugee crisis has been a political problem until recently. The second conclusion is that the impact of the refugee crisis has not spilled over to GDP growth yet, it must have stayed at the bearable level of general government expenditure and the disbursement side of the EU budget.

Questions for discussion

- In what direction will the EU develop most probably after Brexit?
- How can referendum initiatives concerning EU matters be contained in order to maintain economic governance in the European Union?
- What may be the direct and indirect economic implications of the refugee crisis?
- Does Brexit have any direct or indirect impact on the EU's refugee crisis?

4.4. Risks to the forecast

The forecasts produced by the AIECE institutes involve a great number of negative and positive risks. The most important **negative or downside risks** (Figure 33) perceived and ranked by the institutes are as follows:

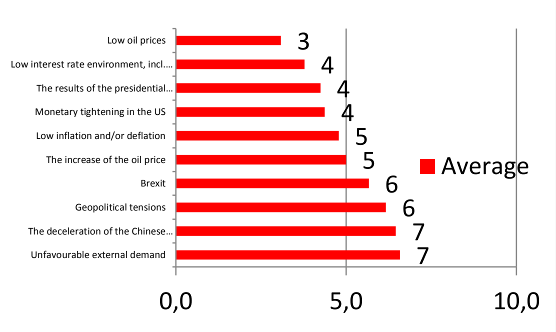
- unfavourable external demand;
- the deceleration of the Chinese economy;
- geopolitical tensions such as the situation in the Middle East and the frozen war between Russia and Ukraine.

These risks originate basically in the global economy. Brexit with an unfavourable outcome of the negotiations ranks only fifth on the list, followed by the increase of the oil price. The remaining risks, such as low inflation or deflation, monetary tightening in the US, the US presidential elections, low interest rates are more or less produced by the advanced market economies. The least important risk to the forecast is the low oil price.

Additional negative risks mentioned by the institutes are as follows:
- financial market turmoil once central banks (try to) normalize monetary policy (related to risk on US monetary tightening);
- surge in bond yields / interest rates;
- banking crisis due to the poor state of large Portuguese, Italian and some German banks;
- financial problems in China;
- the appreciation of the euro against major currencies, extreme exchange rate fluctuations, currency wars;
- economic and political crisis in Italy driven by a negative result to the Renzi referendum and/or a bank failure;
- terror attacks in France/Germany/Belgium hitting tourism most seriously;
- the refugee crisis with the introduction of border controls in Europe;
- potential uncertainty with regard to the financial assistance programme for Greece and an agreement over the Greek debt;
- GREXIT;
- large public and private debts;
- economic problems and tensions in developing countries (e.g. Brazil & Russia).

Figure 33

The importance downside risks to the projection of the euro area



Source: AIECE institutes

The institutes defined the **following upside risks**:

- Governments (in the US, the UK, the euro area) decide to loosen fiscal policy.
- The Greek, the Portuguese and particularly the Italian economy gain grip and start a strong recovery, thereby confidence on the stability of the Euro area would be enhanced. Thereby, the moderate recovery of the whole euro area could gain momentum.
- The significant devaluation of the euro against major currencies would support economic growth.
- Low fuel and commodity prices as well as low financing costs, too, may underpin GDP growth in the developed economises.
- A long-lasting weak euro exchange rate would raise the competitiveness of the euro area. The depreciation could come as a consequence of a stronger-than-expected monetary tightening in the US.
- Productivity increase due to new technologies and innovation.
- The end of Russian-Ukrainian conflict;
- Stronger than expected and lasting positive spiral for investments (productive and/or residential).
- More economic integration in the Euro area, thanks to the Brexit shock.
- Defeat of populist parties in the election forthcoming in Europe and the US.

Questions for discussion

- How do you evaluate the impact of the US presidential elections on the EU economy?
- What is the probability of the realisation of positive risks to economic growth in the euro area?
- How can the geopolitical risks be evaluated with the increase of oil prices?
- What are the preconditions of the realisation of positive risks?