THE EUROPEAN ECONOMY

IN THE MEDIUM AND LONG TERM

Report prepared by IBRKK for the AIECE spring meeting

Frankfurt am Main 4-5 May 2017

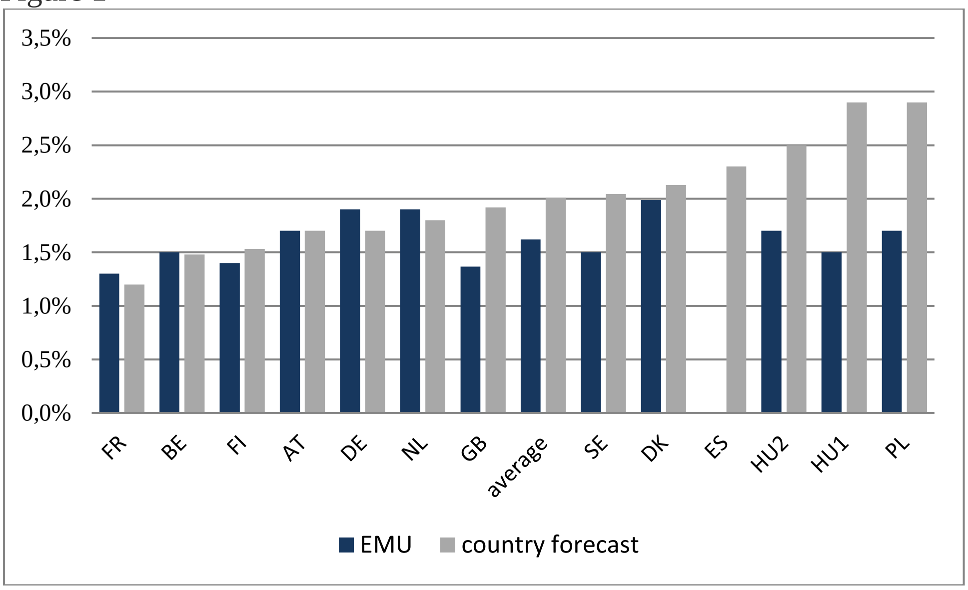
IBRKK prepared this Report using 13 AIECE completed questionnaires. From the AIECE answers we deem that in the medium and long term especially the EU countries could be confronted with the following structural problems: (1) with the construction of investment-led growth policy also in the context of the fiscal EU regulations; (2) with the need to increase productivity, in particular, the one based on the innovative policy and (3) with the future of the EU – by which we could understand decisions about the way the EU will, or will not extend cooperation between countries.

There are also other issues like sovereign debt level, financial stability, not to mention, specific strictly political issues. We begin the Report with a survey of the projection of the main economic indicators.

MAIN INDICATORS

The AIECE institutes forecasted the Eurozone growth rate, in the coming five years, on average, of 1.6% p.a. It is twice as much as in the previous period, when we noticed the average GDP growth rate of 0.75% p.a (AMECO). When we compare the current forecast for the euro-zone growth rate with the projections made by the responding AIECE institutes for each country's economy, cf. Figure 1, one can presume that the countries outside the Euro zone are more optimistic than the EMU members.

Figure 1



Source: AIECE institutes

We could find the following rationale behind the individual country's forecast:

1. Inflation according to the AIECE institutes should be moderate and stay on average at 2% p.a. (the increase from 0.9% in the previous period). Higher energy prices have caused inflation to exit what European Central Bank President Mario Draghi has called the "danger zone" of below 1.0%, easing concerns that the euro area was stuck in a deflationary area.
2. An improving labor market and ultra-easy monetary policy should support the domestic economy. Unemployment should fall from the average, in the previous 5 years - which was 10.1% - to 6.2%. Although there will still be major differences between the EU members (standard dev. = 3.2). cf. Figure 2.

Figure 2

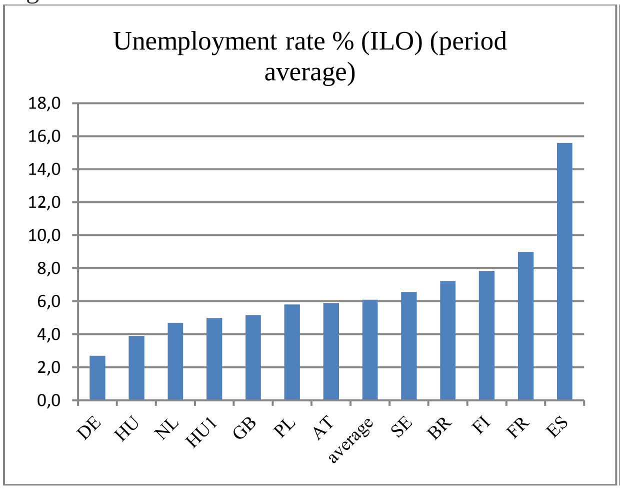
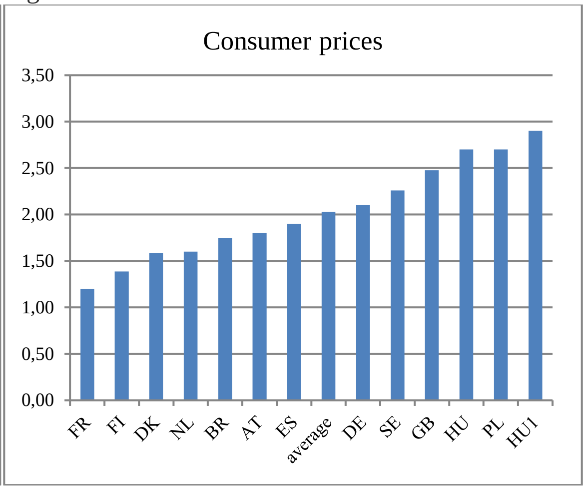


Figure 2a



Source: AIECE institutes

3. The external sector should benefit from a pick-up in global trade growth rate projected by some of AIECE members on average of 3.5% p.a. External balance should be therefore under control. Average exports growth is projected at 3.3% p.a. and imports at 2.9% p.a. There are, however, worries among AIECE institutes concerning possible strong appreciations of euro.
4. Fiscal balance is projected to stay under control as a general government balance should improve, and the share of the public debt in GDP could fall by a couple of percentage points, cf. Figure 3 and Figure 3a.

Figure 3

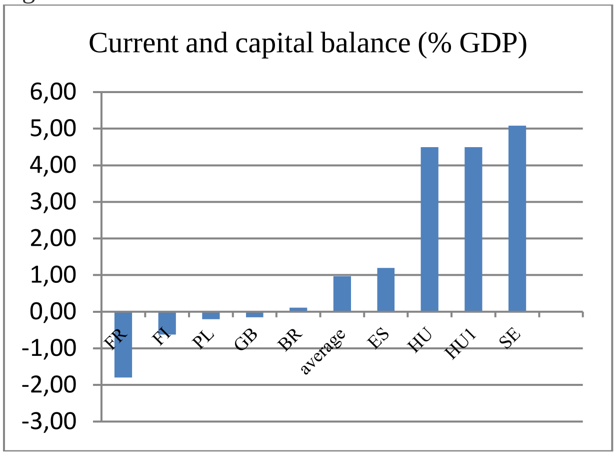
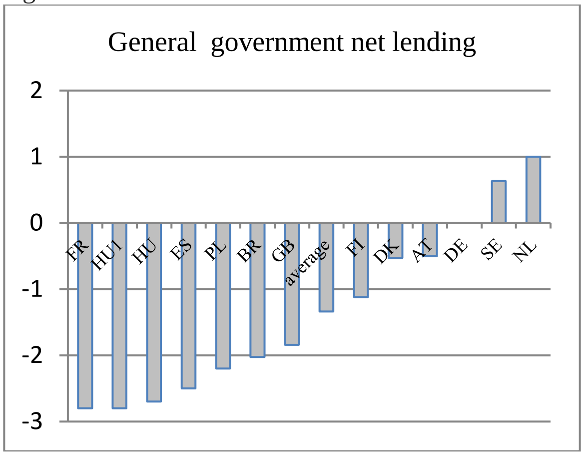


Figure 3a



Source: AIECE institutes

From each country's economy forecasts made by the responding AIECE institutes, we can read the following average projections of the main income components, cf. Table 1.

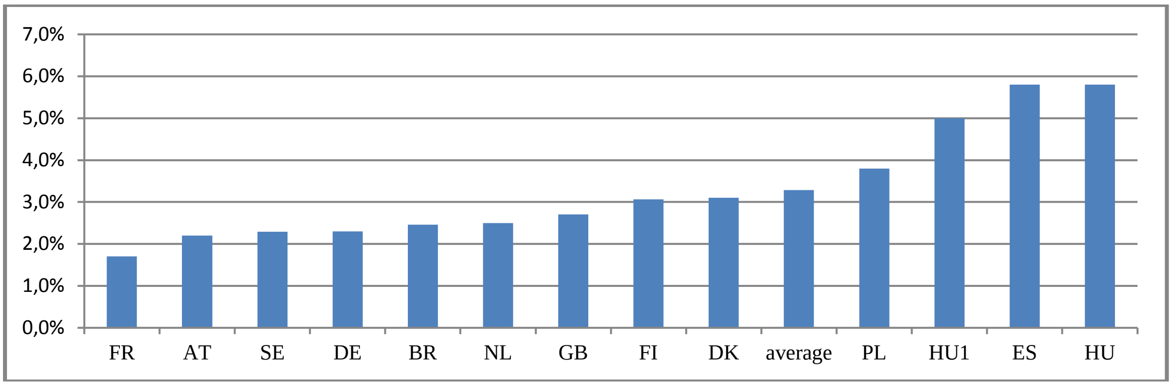
Table 1

Volume % change	2012-2016 average	2017-2021 average	*st.dev.*
GDP	1.05	2.01	*0.51*
Private consumption	1.06	1.88	*0.77*
General government consumption	0.94	1.44	*0.93*
Gross fixed-capital formation	0.67	3.29	*1.34*
Domestic demand (incl. stockbuilding)	0.88	2.29	*0.83*

Source: AIECE institutes

From table 1 we can see that the next five years should be better than past five years – not much, but the change should be visible ; and investments are projected to recover markedly, cf. Figure 4.

Figure 4
Gross fixed capital formation



Source: AIECE institutes

Although growth remains tepid figures in the table show that there are chances to grow faster. Especially as our projections concerning the oil prices and the cost of money do not envisage rapid price changes, cf. Figure 5 and Figure 5a.

Figure 5 Oil prices

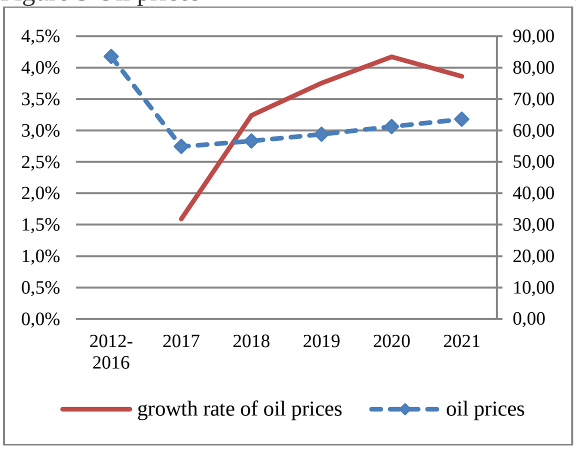
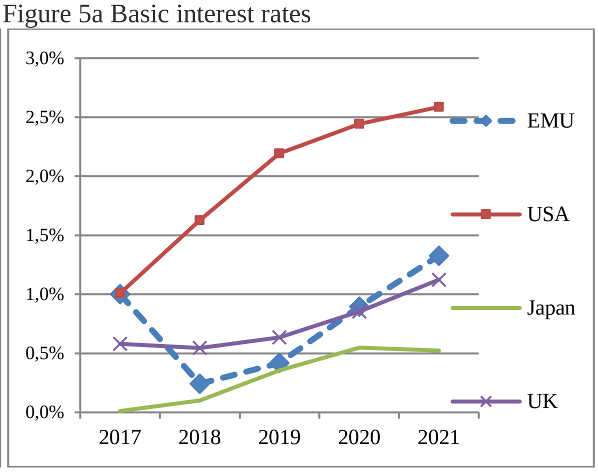


Figure 5a Basic interest rates



Source: AIECE institutes

The medium term AIECE institutes cautious projections brought about questions concerning major impediments for growth as the IMF has stated that: “significant downside risks continue to cloud the medium-term outlook”.

WHAT ARE MAIN IMPEDIMENTS FOR STABILITY AND GROWTH?

From the AIECE institutes ratings we find that the most important downside risk factors are the following, in descending order: extended sovereign debt crisis in EU, political tensions in the EU, USA trade policy, the financial crisis in emerging economies (China) and lack of consensus over the EU reforms. We see oil prices changes, interest rates increases and refugee situation as a minor problem. These situations do not obviously exhaust the subject.

THOUGHTS ON SECULAR STAGNATION IN THE EURO AREA

From the questionnaires we can read that 60% of answers favoured an opinion that we face secular stagnation in the EU. It could mean that we believe in a chronic deficiency in demand and do not support the thesis that the weak growth is a result of deleveraging, “borrowing headwinds”, persistence unemployment level, the eurozone debt and policy response (debt negotiations, weak central banks responses) etc. There are many reasons for stagnation: demographic decline, stagnating technology – innovation etc. But there could be also another explanation of low interest rates level and weak GDP growth and credit performance: new banking regulations, banks favouring low risk borrowers, collateral requirements, rising tail risks, government spending etc. We could also reach the end of the deleveraging cycle as low interest rates could mask tight financial conditions for firms.

If secular stagnation is the reality, a question arises: should pro-investment policies assume direct involvement of the public sector. As L. Summers indicated – the problem is how to identify and finance productive investments if public investments should increase? There are two questions we possibly could address: would direct public involvement into investment activity (e.g. infrastructure) crowd out private investments, and do we believe that low interest rates will stay for a longer time?

There is also another dilemma: intertemporal obligations, consequences of an aging society and the social contracts once established (pension and health security in almost all developed countries), public debt management, youth unemployment all call for the GDP growth. But the GDP growth can be achieved if domestic absorption rises not only on the consumption side. Therefore, should we increase public investments (e.g. infrastructure) in the EU and not change present fiscal policy stance? If it is the case how the present fiscal stance should be changed?

In the medium term the most important factors for the GDP growth, in the opinion of responding institutes, are different. But most institutes are inclined towards two factors: capital investments (38%) and consumption (37%), which corresponds with the opinion about investment’s role in the coming years.

If the pro-growth industrial policy should be implemented in the EU, that being the case, from our answers we can draw the following conclusions:

- The EU budget structure should be changed (50% of the answers)
- Juncker's Plan (European Commission's Investment Plan for Europe) for the time being of a minor significance (40%) should be part of the Commission budget (35%)
- The EU new fiscal policy should incorporate harmonisation procedure allowing for increase of public investment – organized directly and indirectly through support of local entities

That poses a question about the role of the present EU fiscal policy adequacy, the question concerning potential dilemma between the EU fiscal rules and the local fiscal instruments which should increase growth.

AIECE institutes reported a broad range of reforms (systemic changes) made in their home countries, several pro-growth. There are different examples; in some countries measures already undertaken were positive (income tax cuts Finland), neutral fiscal policy (Sweden), public investment rise (Germany, Hungary), social spending (Poland). But at the same time, we recorded lagging government consumption (Finland), spending costs for health care, education (Hungary), tax increases in Spain, Greece, effective tax rates increases (Poland), contractionary fiscal policy (Denmark), ceiling in the unemployment benefit system (Sweden) or measures in unemployment insurance and pension system that reduce labour supply (Germany).

Since the crisis, the EU has placed fiscal rules at the forefront of the debate. The Fiscal Compact, a revised Stability and Growth Pact allowing for more easily applied and graduated sanctions, and the obligation on Eurozone countries to submit their planned budgets for scrutiny by the Commission, all had the aim of enhancing the long-run sustainability of budgetary policies. We have two options in this topic. The already introduced regulations could be not sufficiently flexible to allow major investments to be financed from the budget when countries still have the deficit budget, and Commission should make proper amendments, or the present solutions should stay and be obeyed.

The unanswered questions concerning sectors in which eventually public investments are to be made lead to the next important topic concerning productivity and innovations.

INNOVATIONS, EFFICIENCY, PRODUCTIVITY

Almost 29% of answers indicated productivity, seen as more important than unit labour costs (about 20%), as a main factor effecting competitiveness of the economy. This is connected with the future investment structure and ability to create innovations. But 80% of responses of the EU institutes indicated that public involvement in research and development (R&D) is not satisfactorily organized and financially sufficient. Nevertheless, institutes indicated certain structural reforms undertaken already in their countries which should improve productivity: e.g. competitiveness pact made between unions and employer organizations, active labour market policy and educational policy, labour market reforms, increasing structural employment, measures which would enable immigrants to obtain required qualifications
It is, therefore, an important topic for the medium-term growth which relates to innovation investment activity. Considering that capital market in the EU is rather weak, should we expect public authorities to become involved in that process directly or indirectly?

DEBT PROBLEMS

Although the majority of the AIECE institutes do not see Greece debt problem as a crucial factor for the existence of the EMU the unresolved debt overhang once on target of the financial markets remains the weakest point of the EMU financial system.

Deficits have come down in the great majority of member states. However, the debt picture is still not positive. The situation is further complicated by additional budget needs resulting from social obligations: pensions and health care requirements (age-related costs). On the basis of the current policies most public sectors in the EU are in a negative equity position. The ECB quantitative easing activity created overcapacity of external financing accompanied by falling marginal efficiency (measured by GDP). That did not strengthen the ability of the EMU' economies to service their already accumulated debt when the interest rate will go up especially if the ECB unwinds its policy stance. If GDP growth rate does not rise and the interest rates climb e.g. to the historical levels, for various external reasons, the financial stability not only in the EMU but in whole the EU could be endangered. For these circumstances the EU is not prepared. There is also a problem of the weak EU's budget pro-growth capabilities, weaken now by Brexit. That creates momentum in financial - budgetary reorganization of the EU. Having this in mind do we agree that to consolidate financial markets in the EU, or rather in the EMU, the difficult decision about mutualisation of at least a part of member states' debt issuance is necessary? Or differently – how should we change debt management ability in the

EMU – EU if debt mutualisation is out of order. The debt problem is connected with the financial stability and banking system resilience. That leads to the financial stability topic.

FINANCIAL SYSTEM STABILITY

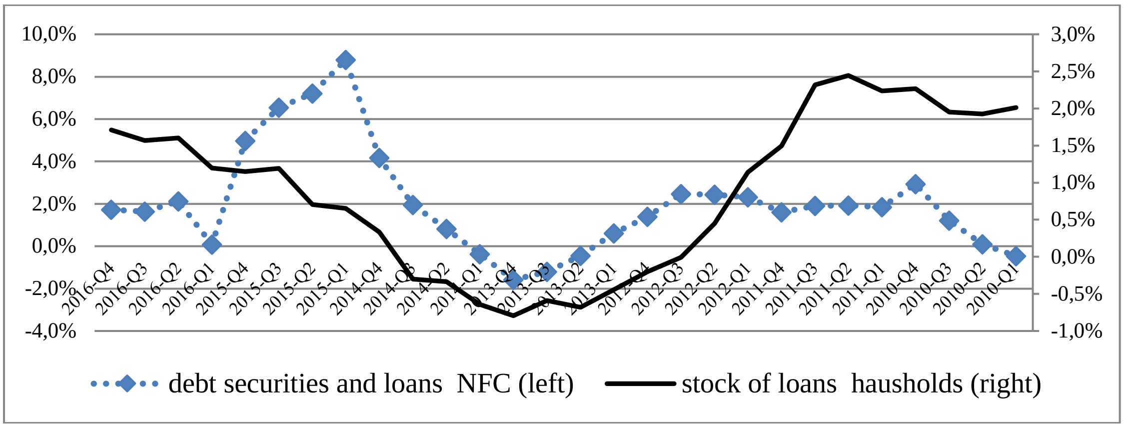
The important issue, except for the public sector finances consolidation effort, relates to the management of the whole financial system. The debt (private and public) was created by financial institutions, with the consent of the public authorities regulating and supervising banks, and to a certain extent by a shadow banking segment (which in the EU amounts to 50% of the assets of the banking sector (ECB)). Despite the already implemented in the EU reforms, the IMF believes that high risks still remain (although financial stability in EU has improved).

In that context, it is interesting that almost all (92%) of the responding institutes assess country's financial system as stable. Only in one case that judgment was conditioned: provided there are no interest rates changes.

Moreover, there is a problem of the ability of the private sector to credit-less recoveries and the new Banking Union to effectively supervise banking sector in their activities leading to growth. Almost 60% of answers of the AIECE institutes indicated that there is no creditless recovery in their countries, which means that the further growth, projected to rise, would depend on the credit expansion.

For the time being, the situation is not clear, as there is no visible credit activity increases, cf. Figure 6.

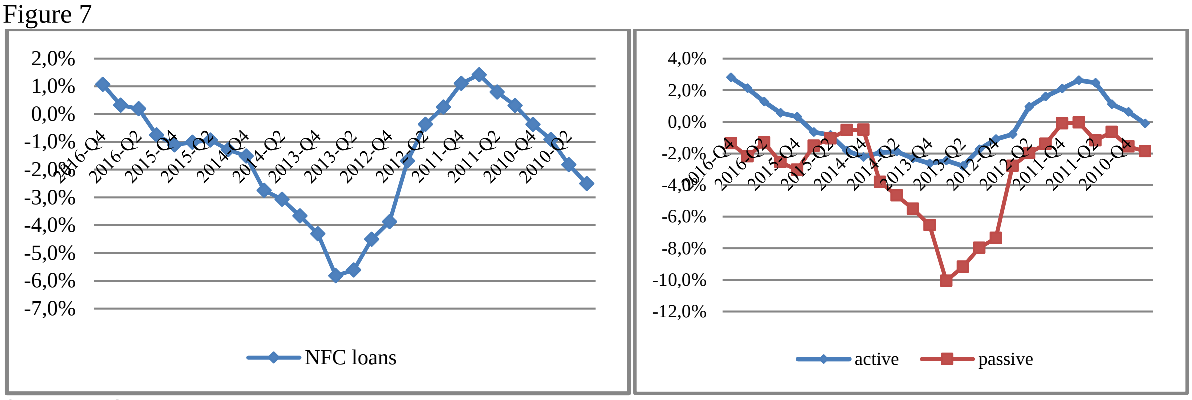
Figure 6



Source: ECB

If we decompose the loans vis-a-vis euro area NFC (industry activities) reported by MFI excluding ESCB in the euro area (stock) we see that loans (yoy) rises only in the so-called active sectors which absorb about 60% of credit (real estate activities, professional, scientific and technical activities, administrative and support service activities, education; human health and social work activities; arts, entertainment and recreation; other service activities; activities of households as employers; undifferentiated goods, electricity, gas, steam and air conditioning, water supply, sewerage, waste management and remediation activities mining and quarrying), cf. Figure 7

Figure 7



Source: ECB

The gross capital formation growth rate is projected, by the AIECE institutes, on average of 3.3% p.a. Does it mean that we assume for the next five years low capital costs and growing appetite risk also within financial institutions?

Financial stability issues call for a couple of questions. First, improving financial stability Banking Union was implemented (and not completed) but does Banking Union lower systemic risk? Second, are banks sufficiently capitalized, did we get effective stress-tests (with an excessive focus on risk-weighted capital ratios instead of direct leverage)? Recently

European supervisory authorities called for changes to stress test methods. Third - what is the role of central bank in supporting debt's implicit guarantees? Central banks managers (1/3) began investments in the non-traditional asset classes, such as corporate bonds, equities and/or emerging-market debt.

HOW WE ASSESS EUROPEAN COMMISSIONS REFORMS PROPOSALS

Two years ago our Danish colleagues asked questions "are we facing a situation where it is no longer possible to establish consensus on important things?" From your answers one can think that now it is difficult even to correctly assess the EU reforms possibilities and effectiveness. To put it simply one can conclude that the current framework suffers from excessive complexity and the potential conflicts arise from multiple rules. One can also point to a lack of enforcement ability, reflecting the deficiency of trust between the main actors in that complicated game.

The first issue, for today, seen from the medium-term perspective, is about the EU's budget pro-growth capabilities, weakened now by Brexit. That could create momentum to financial-budgetary reorganization in the EU. It is interesting that over 1/3 of the AIECE institutes answers indicated that in order to improve convergence in the EU and diminish differences in the medium term each country should rely mostly upon own policy. Could it signify a lack of confidence in the present system? Many answers indicated though the importance of changes of the structure of the EU budget.

The assumption that the EMU will exist owing to its large potential and estimated great costs of a break-up of the Eurozone seems to be speculative. The present state of affairs is a result of the strategic game carried on between peripheral and central countries as well as within both coalitions involved. As long as the payoff of an individual member of the coalition is assessed as being bigger than in the situation when the coalition is dissolved, the present policy will be continued. But if the economic, as well as political, judgment shows that an individual member can get a bigger pay-off breaking the rules of the presently conducted game, the situation, which we examine today, will not be sustainable. The already decided Brexit is a clear evidence of that. In this context, our assessment of the role of Brexit negotiations for a greater cooperation within the existing EU institutions was vague. 41% answers suggest that we should expect that Brexit increases cooperation possibilities, but 39% suggest that Brexit will not change the EU's relations and 20% that it will decrease level of cooperation.

In this context do we foresee that Brexit negotiations will slow down or even stop already projected changes?

One of the biggest problems concerning functioning of the EU lies in the built-in contradiction between the level of democracy and the level of required enforcement. And the genuine problem is that no meaningful coordination is conceivable unless there is the possibility to oblige a minority to do what the majority wants. That requires for some of the member changing political philosophy. If this is a case it would be difficult to expect harmonious implementation of the projected deep structural changes. More than 2/3 of our opinion indicates that the Commission lacks the enforcement ability. But there is also a question concerning the appropriateness of the existing rules.

In September 2016, the EU-27 leaders (meeting informally) held an initial discussion in Slovakia. The resulting Bratislava Declaration asserts that “although one country has decided to leave, the EU remains indispensable for the rest of us”; EU leaders also pledged to find “common solutions” to current challenges and to improve communication between the EU and its citizens.

The accompanying Bratislava Roadmap sets out “concrete measures” for addressing some aspects of the migration crisis; countering terrorism; strengthening EU security and defining cooperation; and improving economic opportunities, especially for young people. The political spirit of that declaration was accentuated by the topics agreed upon.

Before the summit in Rome the European Commission published white paper on the future of Europe as reflections and scenarios for the EU27 by 2025[1]. “The White Paper maps out the drivers of change in the next decade and presents a range of scenarios for how Europe could evolve by 2025”. It presents five scenarios of the possible involvement of each of 27 Member States in the realization of the financial, economic, fiscal and political union.

Our judgment concerning the feasibility of the proposed in March 2017 five scenarios is rather simple. The AIECE institutes which were surveyed are of the opinion that “we will carry on” - no changes should be expected; and as far as the desired scenarios are concerned - there was no preferred option chosen (but nobody opted for single market only). That poses a question - do we believe that without important changes within the EU our medium-term projections will be accomplished?

[1] https://ec.europa.eu/commission/sites/beta-political/files/white_paper_on_the_future_of_europe_en.pdf

It is clear that majority of the problems concentrate around the EMU activity, although there are issues which could be of interest to the countries not being members of the EMU. But the decision of some of the EU's members, not participating in the EMU, to embark on negotiations on certain issues from the presented "agenda" could be also difficult as many proposals are open and hard to decide whether they are inclusive or exclusive for the non-euro-zone economies. When we recall e.g. the Five Presidents' report concerning the Economic Union we find some very spacious, very vague targets as: strengthened implementation of Macroeconomic Imbalance Procedure, a greater focus on employment and social performance, stronger coordination of economic policy, etc. That kind of phraseology could suggest that the real changes will happen most of all within the core of the EMU, particularly if in this sort of the game the participants decide that it is better to stay together than leave the present coalition.

In our assessments concerning threats to public debt sustainability 47% answers indicated as the most important "two speed" the EU and only 27% Greece leaving the EMU. Having that in mind let us try to define what the "two speed" EU really means.