Summary

The world economy showed strong signs of recovery in 2013, with the United States providing solid support. The euro area's economy also performed better last year than in 2012, although its performance varied across the different member states. The sovereign and banking crises have also eased, but the situation nevertheless remains fragile. Mass unemployment in several euro area countries is keeping social tensions at a high level; while internal and external rebalancing continues in the periphery. The sovereign debt crisis may have eased in 2013, but it certainly was not resolved; and debt levels increased further. Although several reforms on euro area level are being implemented, their outcome and impact remain uncertain. This year's EEAG report emphasises that supporting cohesion between member states, as well as maintaining fiscal and regulatory discipline, is crucial for Europe.

Chapter 1 of the report discusses the immediate macroeconomic outlook for the global economy, with a particular focus on the European situation. Chapter 2 focuses on Switzerland, and specifically on the lessons that Europe can learn from the Swiss experience in maintaining cohesion while supporting diversity, and in reaching pragmatic compromises in the creation of common institutions and policies. Chapter 3 analyses the much debated issue of austerity and highlights that fiscal discipline is not only needed to ensure the long-term sustainability of public debt, but also for external rebalancing, which is vital to the long-term sustainability of the euro. Finally, Chapter 4 looks at plans and measures to implement a banking union in Europe and discusses who will pay for future banking crises, and who will end up footing the bill for the latest crisis.

Chapter 1
Macroeconomic Outlook

Last year saw a slight acceleration in the pace of global economic expansion. Global development was – as in the years prior to 2013 – characterised by strong heterogeneity amongst individual regions. For the first time in over four years, the developed countries, and particularly the United States and the United Kingdom, became the driving forces behind the current and ongoing economic recovery.

The emerging economies will nevertheless continue to grow at rates that are higher than those seen in industrialised countries; but their pace of growth is, for structural reasons, unlikely to increase this year. Several key emerging economies are experiencing a marked flattening out of their population growth, which slows down the increase in labour force potential and thus also reduces potential growth. In addition, China sustains losses vis-à-vis other emerging markets due to the relatively rapid increase in its labour costs, which noticeably impacts competitiveness. Moreover, there are a growing number of signs to suggest that the potential of the Chinese model of growth based on capital accumulation is slowly running out of steam.

In the developed economies, real GDP growth rates gradually started to increase in 2013. In the United States, the contractionary impetus provided by fiscal policy was more than compensated for by improved domestic demand. Private consumption in the United States will probably continue to grow, supported by further improvements in the employment and housing markets, as well as to lending conditions. Business investment should also benefit from the recovery in domestic demand and the continued pursuit of highly expansionary monetary policy, which will secure relatively favourable refinancing conditions. Finally, the fiscal impulse will be less contractionary than last year.

In Japan, monetary and fiscal policy has been extremely expansionary since the beginning of 2013, which boosted private consumption and investment expenditure, while the domestic export industry reaped the benefits of a severely weakened yen. Although this scenario has allowed Japan's economy to expand strongly during the past winter months, its economic growth is expected to gradually decline over the year, as the positive fiscal impulse is bound to ebb away, while structural problems are likely to persist.

Most importantly for the world economy, spring 2013 saw the European Union finally emerge from the recession that had plagued it since the end of 2011. The EU economy has recorded moderate growth since then and has finally ceased to choke the world economy. This development was supported by reduced fiscal austerity, as well as fading uncertainty regarding the future of the currency area.

Several euro area countries nevertheless continue to suffer from very high public and/or private debt. The situation in the Portuguese, Spanish, Italian and Greek banking sectors also remains highly fragile. In addition, these economies are suffering from both a lack of competitiveness and weak domestic demand, as the price adjustments required have not fully materialised. Progress with necessary fundamental structural reforms is slow due to sturdy socio-political resistance, the generous provision of aid funds from the European relief package, the relaxation of fiscal policy objectives granted by the European Commission at the beginning of 2013, as well as the European Central Bank's (ECB) measures to reduce country-specific risk premiums on interest rates. Many governments have seen these measures reduce both their previously very high funding costs and massive market pressure to carry out structural reforms. At the same time, however, these policy measures have helped to take the existing anxiety out of the financial markets and thereby support the moderately changing economic climate in Europe. Without a strong self-reinforcing economic recovery the sustainability of such accommodating policies may, however, be called into question.

Overall, the economic situation in the euro area remains unclear. The moderate recovery that began last spring is nevertheless expected to continue this year; and this change compared to the previous two years does imply a positive impulse for the world economy. The negative impulse coming from fiscal austerity measures is expected to weaken further. In addition, net exports will also have a favourable effect, both due to the continuing weak imports noted in crisis countries and the moderate upturn in the world economy. Finally, the ongoing pressure on domestic prices in some of the structurally weak countries is expected to lead to an improvement in their international competitiveness. Accordingly, the euro area is likely to benefit somewhat more strongly from the recovery in world trade than in the past.

Domestic demand in the United Kingdom is likely to undergo an increasing revival this year, supported by an improvement in the asset positions of private households and expansionary monetary policy.

All in all, total economic production in the world looks set to increase by 3.0 percent in 2014, following 2.3 percent in 2013.

Inflation is expected to accelerate slightly in the advanced economies, with the exception of the euro area. The effect of the value added tax increase scheduled for April 2014 is playing an important role in Japan. Given the moderate development of commodity prices in recent months, inflation in emerging economies is not expected to provide any incentive to tighten monetary policy.

Chapter 2
Switzerland: Relic of the Past, Model for the Future?

In the aftermath of World War II, European nations started to deploy economic integration as the means to the end of achieving cultural and political convergence. Switzerland is an interesting exception in this context: It allows different cultures and fiercely independent political entities to coexist within its boundaries, has only slowly integrated its internal economic and institutional structure, and has not taken part in the European unification project that is challenged by the current crisis. The second Chapter of this year's EEAG report studies the origins and recent evolution of the Swiss Confederation's socio-political configuration, and outlines how some of its features may be adapted for use in the European Union.

The critical tensions that currently threaten to derail Europe's Economic and Monetary Union are largely absent in Switzerland because the Swiss Confederation is very different from the European nation states, which traditionally aimed to build consensus around centralised institutions through cultural assimilation. That approach unfortunately tended to trigger intra-European wars, is currently challenged by globalisation and migration trends, and is extremely unlikely to be implementable at the European Union level. Switzerland largely refrained from engaging in the nation-building phase of European history, remained neutral in its wars, and long maintained a fiscally decentralised and traditional type of socio-economic organisation, similar to that which prevailed throughout Europe before the Industrial Revolution. Swiss history and current policy issues, however, are deeply connected with those of its European neighbours, which have interacted with its economy through fiscal as well as market channels. Indeed, Europe influenced Switzerland's social and political configuration as the Swiss Confederation's cohesion was fostered by the need to defend itself from aggression.

Switzerland currently faces many of the welfare state and financial problems that trouble its European neighbours. It has developed an internal common market linked to the European Union's, its federal social insurance schemes are approaching the size and unsustainability typical of continental European nations, and it has faced financial and monetary crises similar to those that threaten to break up the euro area. The Swiss socio-political structure, however, appears in a better position than supranational European Union institutions to find pragmatic and democratic solutions to those problems: It supported early and effective implementation of public deficit restraints, and like the United States (but unlike European federal countries) refrains from debt mutualisation, relying on bankruptcy risk to deter excessive borrowing by sub-national public bodies.

Switzerland enjoys a successful policy performance record despite its deep internal cultural heterogeneity. The country's need to confront such heterogeneity may, in fact, be the key factor explaining its proverbial stability and its ability to devise and implement sensible economic policies. In Switzerland, cooperation is rooted in the "Konkordanz" principle of compromise between heterogeneous special interests with decentralised decision powers. This principle was developed after a civil war and required to manage the peaceful coexistence of cultures ranging from the Germanic, catholic, rural, and conservative cultures of the original Cantons, to the Protestant, Romanic, and enlightened culture of Geneva, through a large variety of multi-dimensional local cultural specificities.

Language and culture influence economic and political interactions even more forcefully than voting rights and tax obligations not only within Switzerland, but also within and across European countries. Nation states traditionally root cooperation, solidarity, and market integration in processes of cultural assimilation. Swiss history however suggests that cooperation and trade across culturally different societies, while neither easy nor riskless, is certainly possible and fruitful. Differences do not need to be eradicated when public policies and institutions seek cooperative solutions to common problems, and durable compromises are cemented by the self-enforcing realisation that breaking agreements in pursuit of immediate gains would entail larger losses.

Switzerland is becoming more similar to its European neighbours in various ways, and more tightly integrated with their financial, fiscal, and market structure. Europe may, in turn, benefit from becoming more Swiss in its approach to solving the key issue of defining and designing a new set of policies and political interactions that works consistently both at lower levels than that of legacy countries, and across the boundaries of historical nations. At the same time as the Swiss Confederation implements some institutional features of the European socio-economic system, the European Union might find it useful to implement some Swiss institutional features that are looser and less centralised than in traditional nation states, but pragmatically focused on the administrative, legal, monetary, and fiscal instruments that support market relationships, and held together by the common foreign policy and shared external concerns. The strength of such concerns may become more apparent as the evolution of the world's geo-political configuration makes it necessary for Europe to assert its common economic interests without the support of the United States.

Chapter 3
Austerity: Hurting but Helping

Since the sovereign debt crisis erupted in the euro area, there has been much discussion about the costs and benefits of fiscal adjustment or austerity during a recession. However, it also must be emphasised that austerity and the recession are also part of the adjustment process. In the course of this process the external imbalances of the euro area periphery countries are reduced, and the production factors that were misallocated in these countries during the pre-crisis boom get reallocated to their long-term sustainable use. It follows that neither austerity nor the recession was completely avoidable.

During the run-up to the crises optimistic expectations about income convergence generated an investment, and more specifically a construction boom in the periphery accompanied by ballooning current account deficits financed by private capital inflows. This demand expansion generated a faster rise in prices, including real-estate prices, in the periphery than in the core. This eroded the competitiveness of the periphery countries, which reinforced the increase in current account deficits. In addition, the boom also resulted in a misallocation of resources within countries across different activities and firms. After the onset of the financial crisis private capital flows stalled, and in some cases even reversed; and the investment boom collapsed causing a recession.

Initially policymakers in the periphery perceived the financial crisis as a temporary demand shock and, with the exception of Ireland, reacted with fiscal expansion in 2008 and 2009 to offset its recessionary effects. However, the shock turned out to be a combination of a longer-lasting negative demand and supply shock. The negative demand shock in the periphery was longer-lasting than in a normal recession because households in the periphery downwardly revised their expectations about the speed of convergence to the euro area core. A more permanent supply shock originated from the pre-crisis misallocation of production factors. Once the crisis erupted, many firms realised that the employment levels of the boom years would not only be unsupported in the short term, but also in the long run. Thus production factors, and particularly labour, had to be reallocated across firms and economic activities, resulting in sharply falling employment levels.

The financial crisis led to the European sovereign debt crisis. Firstly, the tax revenues of the boom years, particularly from the construction industry, were unsustainable in the long run. The sharp decline in tax revenues had a negative effect on government balances. Secondly, the collapse of the construction boom led to rising delinquency rates at the periphery banks. As the quality of the loan portfolio of the periphery banks deteriorated, governments had to bail out some of their banks, leading to a further worsening in fiscal positions. Thirdly, the initial efforts of the periphery governments to offset the recessionary effects of the financial crisis turned out to be ineffective, as the latter faced a more permanent demand and supply shock, instead of a temporary demand shock. In fact, the expansion itself led to further deterioration in fiscal balances.

The on-going adjustment in the euro area periphery is characterised by slowly declining prices relative to the core, by the reallocation of resources across activities, and by a slow improvement in external balances. The adjustment in prices is crucial both to external balances and labour reallocation, but hampered by several factors. Firstly, prices are sticky, so shocks are absorbed by a fall in output and employment to a larger extent. Secondly, extensive credits granted by the national central banks and fiscal rescue funds reduced pressure to implement austerity measures and hence slowed the pace of reform. Thirdly, expectations about the future path of prices were influenced by expectations regarding the break-up of the euro area. If the euro area were to break up, the currencies of periphery countries would devalue, and their prices would rise relative to those of the core countries. In periods when such a break-up was expected, prices in the periphery rose faster (fall slower) than in the absence of such expectations. In other words, such expectations slowed down internal devaluation in the periphery countries. Fourthly, labour market rigidities in the periphery countries make labour reallocation particularly slow, leading to a prolonged recession.

The adjustment towards a labour allocation and relative prices that are consistent with smaller external balances is accompanied by a recession, as is usually the case with any large-scale reallocation of labour. The recession provides incentives for periphery firms to reduce their prices and wages, which, in turn, induces the reallocation of labour. Consequently austerity did not cause the recession in itself, but it contributed to it. A certain amount of austerity is a necessary part of the post-financial crisis adjustment. Hence, neither the austerity nor the recession was completely avoidable.

Chapter 4
Banking Union: Who Should Take Charge?

The European Union is putting in place a scheme for a banking union. The concept of a banking union has come to mean the centralisation of banking regulation, supervision, resolution, and deposit insurance at the level of the euro area, with a common regulatory rule-book, supervisor, resolution authority, and deposit insurance scheme. In short, it amounts to applying single market principles to banking.

An EU Regulation for the “Single Supervisory Mechanism” came into force in November 2013. One year later, in November 2014, the ECB is due to take over supervision of the 130 largest and most important financial institutions in the euro area. Before that date, it will carry out an assessment of the balance sheets of those institutions, with a view to identify and remedy existing problems: the so-called legacy issues.

The European Commission has put forward a proposal for a Single Resolution Mechanism, on which agreement between the Council of the European Union and the Commission has now been reached. They aim to reach an agreement with the Parliament by May 2014, so that the regulation can be enacted. A common system of deposit insurance has not been given much attention yet, but is a relatively less urgent issue, given existing national provisions, which have been reinforced by changes made in December 2013, and slightly improved co-ordination of which will provide a reasonable interim solution.

The main argument in favour of a banking union is that fiscally weak governments and fragile banking systems have become too closely connected. In addition, many banks operate across national boundaries within the euro area. For these reasons, regulation and supervision could be more effectively performed by one supervisor; while the resolution of such banks could be achieved more cleanly and quickly by a single euro area authority than by national authorities attempting to coordinate with each other. Another argument often put forward is that national regulators have become too close to the banks they regulate, too susceptible to political pressure, too prone to delaying intervention and have incentives to offload costs onto the euro area as a whole. According to this line of argument, centralised supervision will be better supervision. There are euro-area-wide spill-over effects from a bank failure in a member state. Even small banks can have systemic effects.

It is efficient to pool resources to provide insurance for the costs of bank failure, rather than having individual member states pay for failures that occur in each jurisdiction. Pooling resources goes some way towards addressing the problem of institutions that are "too big to fail".

In addition, if the ECB is to act as lender of last resort to euro area banks, it needs information on their solvency, it must supervise them, it requires control, and it needs to be able to resolve failing institutions.

The principal arguments against centralisation are that it effectively represents a scheme for transferring resources to the financially weak states from the rest; and that it places too much power and responsibility in the hands of a single institution.

The idea of having a banking union follows many interventions by the EU authorities since the financial crisis that were aimed at solving the euro area's public debt and banking problems, and have enjoyed little success to date. These measures can be divided into four groups: (i) providing loans ("bailouts") to heavily indebted governments unable to access commercial markets; (ii) reinforcing banking regulation; (iii) reviving the "Stability and Growth Pact" in the form of the new "Fiscal Compact", with the aim of increasing the credibility of member states' plans for fiscal consolidation; and (iv) the ECB's provision of liquidity to banking systems and its policy of low interest rates. However, none of these measures has had the desired effect of lowering interest rates for private sector borrowers in periphery member states to the level of the rates paid in Germany and other fiscally sound, typically northern, euro area member states. Only the ECB's policy of "Outright Monetary Transactions", announced in September 2012, but not yet actually used in practice – the euro area's long sought-after "big bazooka" – has met with partial success.

It is not yet clear how effective the banking union will prove in insulating the banking system and public finances from each other in periphery member states, in improving the standards of bank supervision, and in providing a more effective mechanism for resolving failing institutions. A great deal depends on how the comprehensive assessment of banks' balance sheets is undertaken in 2014, the rigour with which the legacy issues are identified, and the financing methods used. Looking further ahead, after the ECB takes over supervision in November 2014, the banking union's impact will depend on the effectiveness of supervision and regulation by the ECB, and the way that the resolution regime operates.

The resolution authority is intended to draw as little as possible on public funds, and to use the resources of banks and their creditors to resolve failed institutions instead. The Single Resolution Mechanism, according to current EU proposals, bails in creditors, in reverse order of seniority, but only after a large number of bank liabilities have been exempted. There is concern that the list of exemptions is too long, and that banks will have insufficient liabilities that may be bailed-in to meet the costs of resolution: the targeted minimum of 8 percent may too low. As a back-up, the proposed "Single Resolution Authority" will accumulate a 55 billion euros fund, raised by a levy on banks, to be used when the resources of institutions under resolution have been exhausted. But this Single Bank Resolution Fund is likely to be too small to be useful. In any case, it will not be fully accumulated until 2026, prior to which individual countries will remain partly responsible for the costs of bank resolutions in their own jurisdictions, if the bailing-in of the banks' creditors is insufficient. This has an ambiguous effect on the attempt to separate sovereigns from banks. On the one hand, it reduces the possibility of disentangling banks and sovereigns concerning legacy assets, on the other hand it reduces the incentives of banks to further load their balance sheets with new toxic government bonds and turns the entire European banking system into a tool to absorb even more government bonds. On current plans, a scheme for a euro-area-wide mutual backstop to the Single Bank Resolution Fund will be devised, but it may not come into effect until 2026.

While the banking union could, in principle, prove a useful institution for pooling risk among states, improving the standards of bank supervision and regulation, and reversing the fragmentation of euro area banking, there remains a distinct possibility that it will, in fact, substantially act as a means of channelling resources from financially sound, predominantly northern member states to southern periphery states with financial and banking problems.