EEAG (2011), *The EEAG Report on the European Economy*, "Macroeconomic Outlook", CESifo, Munich 2011, pp. 17–69.

Macroeconomic Outlook

1.1 Introduction

The structural problems brought to light by the financial crisis have largely remained in place or shifted from the private (banking) sector to the public sector. In the United States, despite increased saving, household debt remains high; their wealth position has deteriorated substantially due to the bursting of the house price bubble. The real estate sector has shrunk, and the financial sector has still not fully recovered.

Owing to similar corrections in real estate markets, a number of European countries, i.e. Spain, the United Kingdom and Ireland, also find themselves in vulnerable positions. Furthermore, in most industrialised countries, the public finance situation, which was already strained in several cases before the crisis, has deteriorated drastically. Largely forced by reactions of financial markets, fiscal policies in most of these countries have switched to a consolidation course. Also in key emerging countries, fiscal policies have turned restrictive. Unlike in the advanced world, monetary policies in these countries have already changed course and have become less accommodative or even restrictive. The economic recovery in many emerging countries has already progressed so far that policymakers are now striving to prevent their economies from overheating.

At the global level, imbalances appear to be re-emerging and have reached centre-stage in many policy discussions. While China is being blamed for restricting its capital inflow and keeping its exchange rate stable vis-à-vis the US dollar, thereby preventing a swifter loss in global competitiveness, the United States is again increasingly living beyond its means. This time around it is the public sector that is in need of foreign capital. Historically, a part of the solution to such structurally diverging developments has been a move towards flexible exchange rates. Recent success stories in both Asia and Latin America are, however, largely associated with relatively fixed exchange rates. The political reluctance to leave this path is therefore understandable. In the euro area, where such structural problems have emerged on a more regional level, the economic and political costs of a dissolving monetary union are still considered to be larger than its benefits. Instead structural reforms and steps towards a stronger political union appear to be the only course to take.

The weakening of world economic dynamism, observed during the second half of last year, will keep growth subdued in most advanced economies during 2011. In the United States, due to the continuing structural problems, a strong upturn is not in sight. Mainly as a consequence of the dampening effects of the pronounced restrictive fiscal policies, the on-going recovery in Europe also remains subdued. In most emerging countries, the pace of expansion remains comparably high. Nevertheless, growth rates will stay below the levels reached last year. World trade, which last year increased by over 12 percent, will return to normal and accordingly achieve growth rates only about half as high. The remaining underutilisation in many advanced economies and more moderate growth in the emerging world will keep inflation rates low.

1.2 The current situation

1.2.1 The global economy

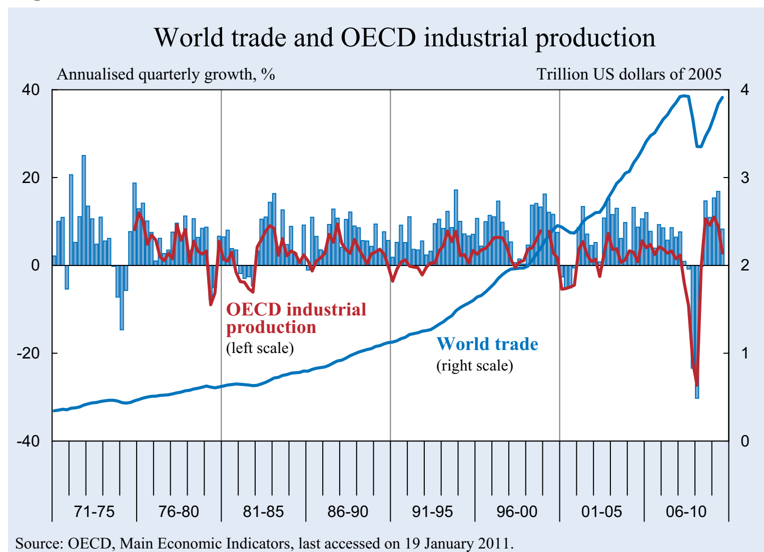
After registering an overall negative growth rate (–0.6 percent) in 2009 for the first time since the Second World War, the annual growth of the world economy clearly showed a rebound in 2010 and is expected to have reached 4.8 percent. However, during the course of 2010, the recovery of the world economy slowed down. After collapsing during winter 2008/09, world trade grew quickly for four quarters in a row, and with hindsight one can say that the world economy as measured by either trade or industrial production has witnessed a V-shaped recovery. World trade has almost reached pre-crisis levels (see Figure 1.1). However, since last summer the recovery has at least temporarily lost speed.

For instance, the United States and Japanese economies lost momentum considerably this spring after a strong expansion during the winter months. For the euro area, it is apparent that the high production growth witnessed in the second quarter of 2010 and largely driven by German developments has not lasted in subsequent quarters. Even in the emerging countries, the pace of output has slowed.

Whereas industrial production in emerging and developing countries has been able to return to its long-term growth path and surpassed its pre-crisis level by about 15 percent, in the advanced countries it is still far from pre-crisis levels (see Figure 1.2). Here, industrial production is still approximately 10 percent below the level reached shortly before the start of the financial crisis in 2008, i.e. not even half of the drop has been regained since spring 2009. Especially in the industrial world, capacity utilisation rates in industry are therefore still at historically low levels.

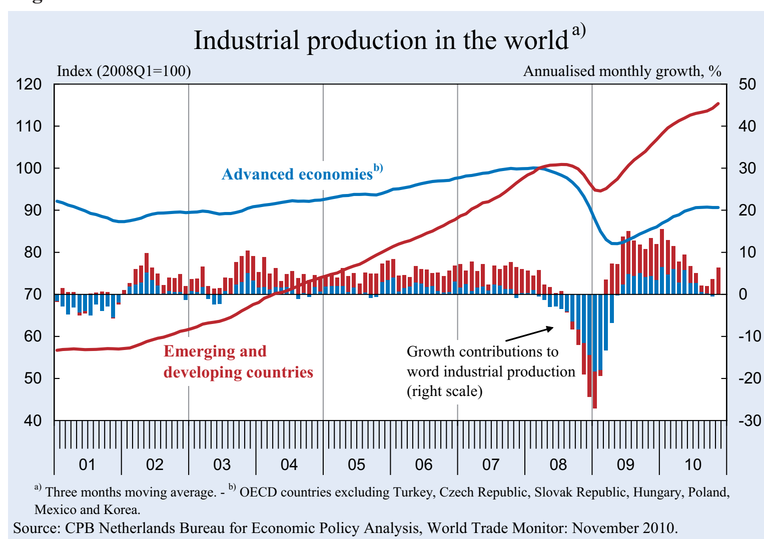
The results of the Ifo World Economic Survey also show that during the past years developments between the major continents have not been completely synchronised. The climate in Latin America and Asia remained better than that in North America and until recently in Western Europe (see Figure 1.3). Nevertheless, improvements took place in all major regions during the first half of last year. Patterns have been diverging since then. Whereas the assessments of the economic situation in Western Europe continued to rise, they have basically stagnated at high levels in the emerging economies. Due to a drop at the end of last year, the assessment level in

Figure 1.1



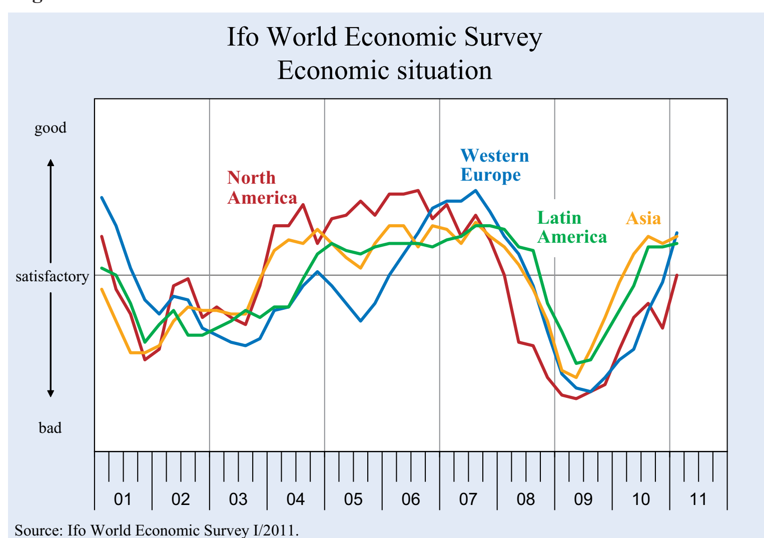
Source: OECD, Main Economic Indicators, last accessed on 19 January 2011.

Figure 1.2



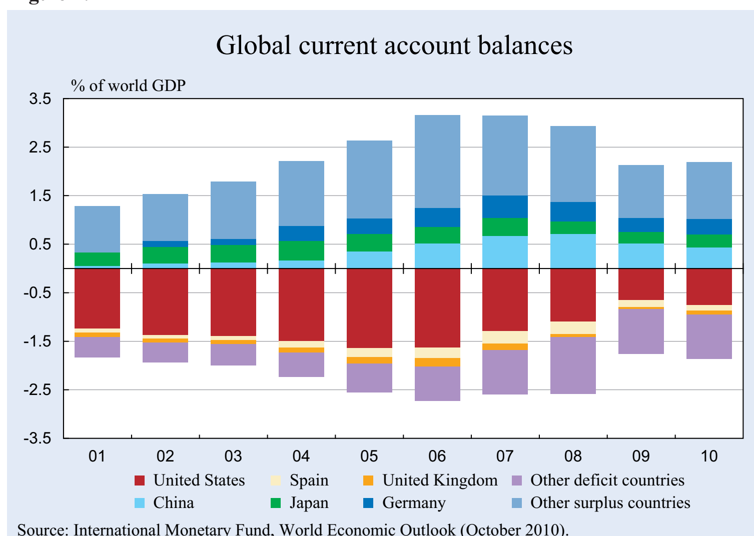
a) Three months moving average. - b) OECD countries excluding Turkey, Czech Republic, Slovak Republic, Hungary, Poland, Mexico and Korea.
Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor: November 2010.

Figure 1.3



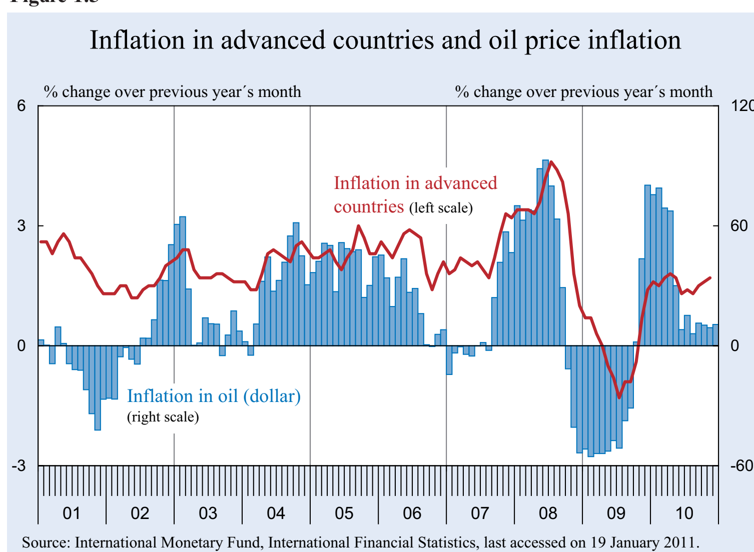
Source: Ifo World Economic Survey I/2011.

Figure 1.4



Source: International Monetary Fund, World Economic Outlook (October 2010).

Figure 1.5



Source: International Monetary Fund, International Financial Statistics, last accessed on 19 January 2011.

North America is again below those of these other regions.

After current account balances were significantly reduced in 2009 in absolute terms, last year saw a moderate step back towards the pre-crisis levels (see Figure 1.4). Of those countries running current account deficits, the larger deficits in both the United Kingdom and the United States accounted for most of this increase. The demand impulses of these two countries were met by increased net exports of most of the surplus economies. Of these, only China was an exception to this rule. Albeit at a lesser pace than the year before, it continued to reduce its current account surplus and via strong domestic growth gave further impulses to the rest of the world. Furthermore, most other deficit countries, and in particular Spain, Australia, Italy and Greece, have been successful in trying to improve their current accounts and hence have, from this perspective, also been able to benefit from developments in the United States, the United Kingdom and China.

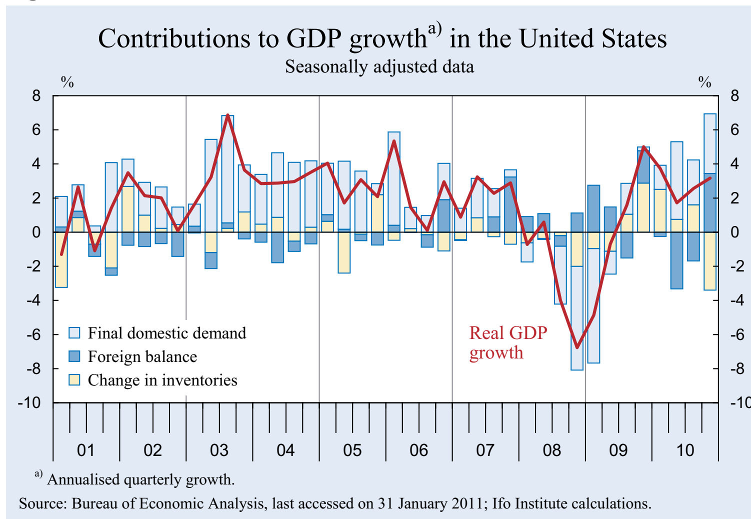
After the drop in prices during 2009, inflation picked up somewhat to levels around 1.5 percent last year. To a large extent these fluctuations were driven by movement in energy and raw material prices (see Figure 1.5). A barrel of oil cost around 40 US dollars in early 2009 but that same year its price climbed to almost 80 US dollars, a level at which it hovered throughout 2010. Also other raw materials saw sharp price increases at the end of 2009 and early 2010. Whereas in many developing and emerging countries this led to inflationary pressures, in the industrialised world low capacity utilisation rates kept inflation contained and deflationary fears alive.

1.2.2 United States

In the United States, the strong economic expansion witnessed during the winter of 2009/2010, with an annualised increase of 3.8 percent, slowed down over the course of last year. With an annualised increase of GDP of 2.4 percent during the summer half year, the slowdown was less pronounced than many expected. Also in the last quarter of 2010 annualised growth, at 3.2 percent, stayed well above recessionary levels (see Figure 1.6). Hence, the fear often stated during the summer and autumn that the United States would fall back into recession has not materialised. Overall, GDP in 2010 ended up 2.9 percent higher than in 2009 (see Table 1.A.1 in Appendix 1.A).

The loss in growth momentum has several causes mostly related to the structural problems the US economy is facing. Although house prices seem to have stabilised at low levels, problems in the real estate sec-

Figure 1.6



[a] Annualised quarterly growth.
Source: Bureau of Economic Analysis, last accessed on 31 January 2011; Ifo Institute calculations.

tor remain and the recovery of the financial sector is far from being completed. The resulting hike in unemployment, together with the still high indebtedness of the household sector as well as the rising public debt, will affect economic developments in the United States in the years to come.

From a business cycle perspective, the reduction in inventories induced by a surge in liquidity demand by firms at the peak of the financial crisis reversed and created a strong growth impulse during the first part of last year. Inventory cycles are generally not long-lived and the positive impulses have come to an end by now. This alone will lead to a slowdown in growth over the winter half year.

The increase in the investment share witnessed since mid-2009 is almost entirely due to this inventory cycle.

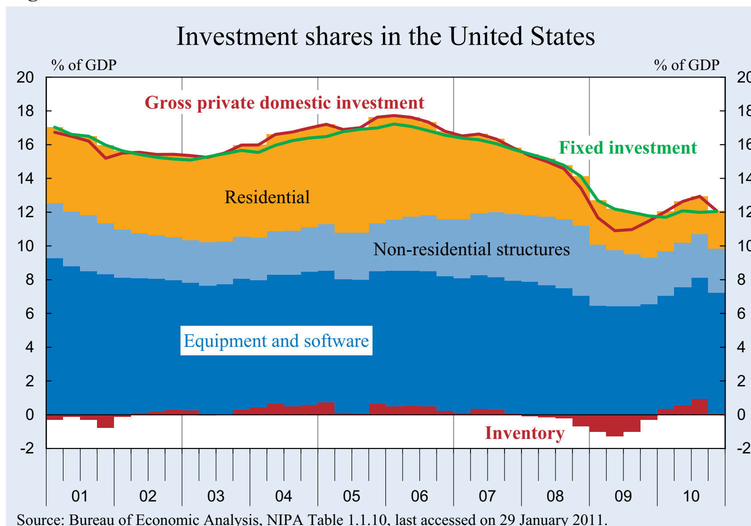
Gross fixed capital formation has done little more than stopped declining (see Figure 1.7). Although the growth rate of investment in equipment and software reached double-digits throughout 2010 due to catch-up effects, this was counterbalanced by construction investment continuing to fall. Due to the phasing out of the Home-Buyer Tax Credit Program, a temporary hike in residential investment (and thereby in gross domestic fixed capital formation) resulted in the second quarter of last year.

Although house prices stopped falling in early 2009, the real estate sector will still need time to recover. New building permits of new private housing units remain around all-time lows and the number of employees working in the residential building sector continues to decline. In the second half of last year, the number of loans that entered the foreclosure process even started to pick up again, despite the continuing fall in effective interest rates paid on home mortgages.

Despite the continuing problems in the real estate market and the associated deleveraging of the household sector as well as high unemployment and only moderate wage increases, private consumption has become a stabilising factor for the US economy. Throughout last year, consumption grew at rates of around 2 percent or above. Compared to before the crisis, these growth rates can only be described as at most moderate. However, they now appear more sustainable and stable. In that sense, private consumption has again become the backbone of the US economy.

Consequently, private savings have come down a bit from the high levels reached in 2009. Still, a share of personal savings in disposable income of 5.3 percent (in November 2010) – down from over 6 percent during mid-year – implies a tripling of the shares observed in 2005–2007. At the same time, net household lending as a percentage of GDP remain-

Figure 1.7



Source: Bureau of Economic Analysis, NIPA Table 1.1.10, last accessed on 29 January 2011.

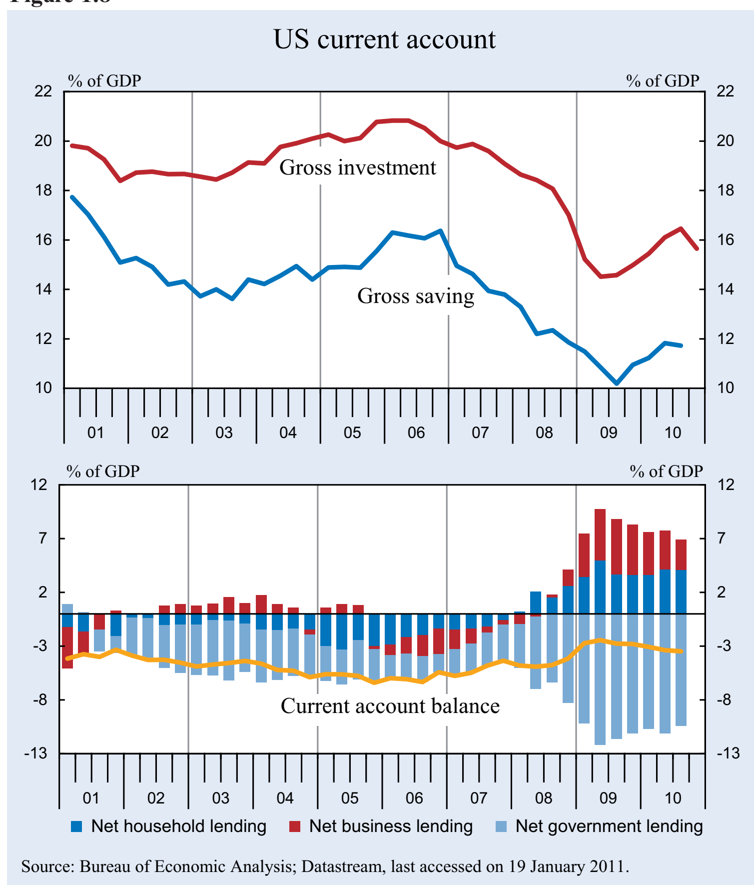
ed positive at 4.1 percent in the third quarter of 2010 (see Figure 1.8).

Nevertheless, fiscal policy became slightly less accommodating during the fiscal year 2010 (October 2009–September 2010) as compared to the year before. The budget deficit decreased by 122 billion to 1.3 trillion US dollars, or 8.9 percent of GDP (as compared to 10 percent in fiscal 2009). This historically huge deficit of the US government is also reflected in a net government lending position of 10.4 percent of GDP in the third quarter of 2010 (see Figure 1.8). This small reduction in the deficit was especially helped by lower expenses to support the ailing banking sector and the mortgage financiers Fannie Mae and Freddie Mac that were placed under state supervision. Compared to the previous year, the support for them fell by 367 billion US dollars.

In contrast, spending in the context of the American Recovery and Reinvestment Act (ARRA) rose by 110 billion to 225 billion US dollars. This stimulus package underwent additional spending to alleviate fiscal crises at the state level, to finance the Home-Buyer Tax Credit Program, and to extend the duration of public unemployment benefits. Due to the lack of recovery in labour markets and its extended duration, total spending on the unemployment system rose again by a third to 162 billion US dollars. This is more than three times as much as in 2008.

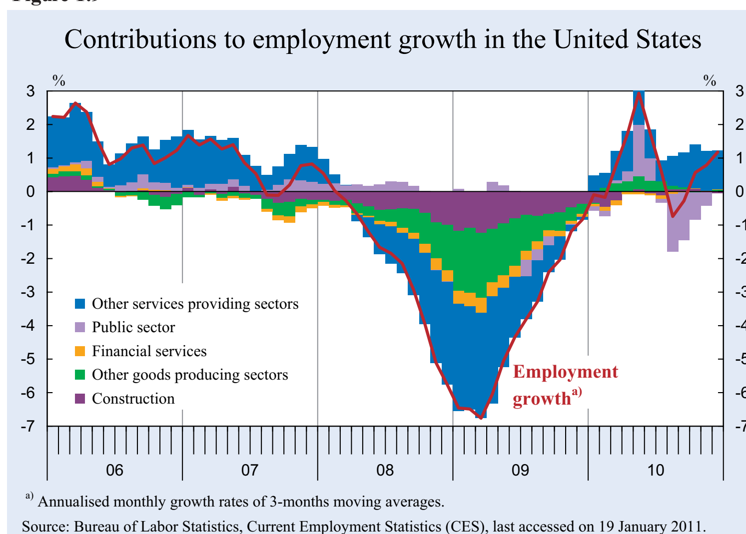
Net lending of the United States, and thereby the US current account balance, can be decomposed into net lending of the household, business and government sectors (see Figure 1.8). Whereas the government sector is borrowing heavily, both the household and business sectors have turned into net lenders during and after the financial crisis. Profits of US firms have increased substantially during the recovery of the world economy. The still prevalent uncertainty

Figure 1.8



Source: Bureau of Economic Analysis; Datastream, last accessed on 19 January 2011.

Figure 1.9



[a)] Annualised monthly growth rates of 3-months moving averages.

Source: Bureau of Labor Statistics, Current Employment Statistics (CES), last accessed on 19 January 2011.

about future US developments has kept firms from fully investing these funds domestically.

The stabilisation of the domestic economy, in particular via stable consumption growth and an uplift in equipment and software investment, has led to double-digit growth in imports. Whereas the weak dollar also fostered export dynamics, the current account and trade balance nevertheless deteriorated again – a process that started in mid-2009.

During summer and autumn of 2010, substantial job cuts in the public sector put a drag on employment developments. Although the census that was carried out last year distorted within-year developments of the number of employees in the public sector – census interviewers were first temporarily engaged and subsequently released again – about 220,000 jobs have disappeared in the public sector since the beginning of last year (see Figure 1.9). In the private sector, on the contrary, about 1.3 million jobs – of which well over 90 percent were in non-financial services – have been created.

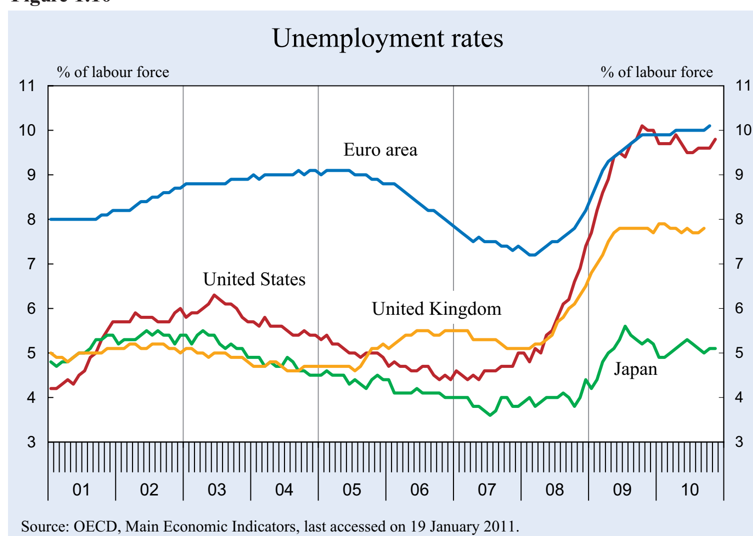
Despite this turnaround in employment developments, the US labour market remains in a dismal state. The unemployment rate of 9.4 percent in December of last year remains at a historically very high level and does not even fully reflect the actual labour market situation (see Figure 1.10). Given the high proportion of long-term unemployed in total unemployment, it appears that the functioning of the labour market has been negatively affected by low spatial mobility of over-indebted homeowners. Furthermore, the unemployment rate underestimates the inequalities in the labour market: the number of discouraged workers hat increased substantially.

In the United States, the number of unemployed workers went up by 7.35 million from the second quarter of 2008 onwards. During the same time span, employment declined by about 6.66 million people. This implies an increase in the labour force of almost 690 thousand people. However, at the same time, the working-age population has increased by about 5.88 million people. That is to say, since the start of the crisis, the United States has seen almost 5.2 million people leaving the labour force – either voluntarily or involuntarily (see Figure 1.38). Consequently, the labour market participation rate has dropped by about 2 percentage points to 64.5 percent since the beginning of 2007, which is the lowest level since the mid-1980s.

As part of the continuing difficulties in the labour market, nominal wages rose only modestly. Real disposable income, the most important determinant of private consumption, has nevertheless recovered somewhat during the second half of the year. The share of public transfer payments in disposable income, at about 20 percent, is ca. 5 percentage points above its long-term level.

After having picked up at the end of 2009, inflation fell significantly over the course of 2010. Also the core index for personal consumption expenditure – which is the preferred inflation measure of the Federal Reserve – decelerated to 0.8 percent in November. This is the lowest level since records began in the 1950s. Crucial to this development was the continuing crisis in the housing market. The residential component, which accounts for about 40 percent of the overall price index, has fallen for two years now. Another brake on price dynamics has been the decline in unit labour costs. These fell by 0.9 percent in 2010 (see Table 1.1).

Figure 1.10



Source: OECD, Main Economic Indicators, last accessed on 19 January 2011.

1.2.3 Asia

The expansion of the *Chinese* economy has – after its above-average pace during winter 2009/10 – slowed somewhat during the past quarters. The year-

Table 1.1

Labour costs

	Compensation per employee[a)]		Real compensation costs[b)]		Labour productivity[c)]		Unit labour cost[c)]		Relative unit labour costs[d,e)]		Export performance[f)]	
	1999–2009	2010	1999–2009	2010	1999–2009	2010	1999–2009	2010	1999–2009	2010	1999–2009	2010
Germany	1.1	2.0	0.2	1.2	0.4	3.3	0.6	–1.5	–0.5	–3.3	0.6	5.0
France	2.7	2.8	0.9	2.4	0.7	1.6	2.0	0.8	0.4	–5.0	–2.5	0.4
Italy	2.1	0.8	–0.4	0.1	–0.4	1.4	3.2	–0.4	2.7	–3.4	–4.6	–1.2
Spain	3.2	1.1	–0.2	0.7	0.5	1.8	3.3	–1.2	1.9	–1.7	–0.9	0.1
Netherlands	3.3	1.4	0.9	–0.2	0.8	2.4	2.6	–0.7	0.3	–4.4	0.1	0.2
Belgium	2.7	0.9	0.8	–0.5	0.7	1.6	2.3	–0.4	0.9	–4.3	–1.4	–0.3
Austria	2.2	0.7	0.7	–0.8	0.9	1.3	1.2	–0.3	–0.6	0.5	–0.2	–2.3
Greece					2.2	–1.5	4.1	–0.6	0.8	–5.9	–1.1	–9.6
Finland	3.2	1.2	1.8	–0.5	1.2	3.0	2.1	–1.0	–2.0	–5.5	–0.9	–5.9
Ireland	4.4	–2.1	2.0	–0.4	2.0	3.6	3.3	–5.0	–0.9	–11.8	2.3	–0.8
Portugal	3.8	2.5	1.1	1.4	0.9	2.7					–1.5	–0.5
Slovakia	8.3	2.6	4.2	2.5	3.9	5.8	3.0	–3.1	0.0	–0.9	2.5	3.6
United Kingdom	3.7	3.8	1.3	0.5	1.1	1.7	2.8	1.0	–0.7	6.4	–1.9	–5.5
Sweden	3.0	1.0	1.3	–0.1	1.4	3.2	1.9	–1.8	–2.7	2.4	–0.4	0.9
Denmark	3.4	2.1	1.2	–0.8	0.6	4.0	3.1	–1.3			–0.3	–6.5
Poland	4.8	6.5	1.3	4.5	3.7	2.5	2.4	2.9	–3.9	0.7	3.0	1.7
Czech Republic	6.2	2.3	3.8	2.3	3.0	3.7	2.8	–2.1	2.3	1.9	4.2	0.8
Hungary	8.0	0.4	1.9	–1.2	2.6	1.4	6.4	0.4	2.0	–6.3	4.7	3.9
Iceland	6.4	6.2	0.7	0.2	1.9	–2.9	5.4	8.4	–2.5	13.9	1.6	–8.6
Norway	5.3	3.1	0.3	–1.1	0.9	0.4	4.3	3.0	2.7	7.1	–2.8	–9.8
Switzerland	2.0	0.1	0.9	0.0	0.6	2.1	1.6	–1.1			–0.1	0.0
Japan	–1.0	1.4	0.2	3.2	1.0	4.1	–1.4	–2.2	–2.6	–5.4	–3.4	8.5
United States	3.6	2.2	1.4	1.1	1.8	3.3	2.0	–0.9	–3.4	–5.8	–1.4	–1.6
Canada	3.3	2.0	1.0	–0.8	0.7	1.3	2.6	0.9	4.4	5.7	–3.3	–6.1
China											11.4	15.8

[a)] Compensation per employee in the private sector. – [b)] Compensation per employee deflated by GDP Deflator. – [c)] Total Economy. – [d)] Manufacturing sector. – [e)] Competitiveness– weighted relative unit labour costs in dollar terms. – [f)] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD Economic Outlook, Volume 2010, Issue 2, November 2010.

on-year increase in GDP of 11.9 percent at the beginning of last year was followed by rates of 10.3, 9.6 and 9.8 percent in the subsequent quarters. This slowdown was mainly due to a reduction in industrial output. Similar developments have not been observed in the primary and tertiary sectors. For 2010, this results in a rise in GDP in China (including Hong Kong) of 9.7 percent.

The decreasing economic dynamism is likely to be due primarily to the efforts of the government to tackle the overheating property market and high lending activities through a much tighter monetary policy. The People's Bank of China increased the banks' reserve ratio six times and raised its interest rates twice last year, in October and December. It appears that using reserve ratios to rein in liquidity and credit is no longer enough, and that adjusting interest rates is needed to get price pressures under control. In particular, credit growth is still above the government's target. Furthermore, faced with rising real estate prices, lending requirements were tightened and additional restrictions to reduce speculative transactions on the real estate market, i.e. to curb speculation and to prevent the hoarding of construction land, were implemented. However, while consumer price inflation rose strongly to 5.1 percent in November, and producer price inflation to 6.1 percent, this is almost entirely due to increases in food prices. Administrative measures to counter further increases are likely to be implemented in the first half of 2011.

The slowdown in growth of GDP has been accompanied by a shift of growth contributions. Whereas the more restrictive monetary conditions and the phasing

out of fiscal stimulus measures – in particular infrastructure projects – reduced the impulses coming from the domestic economy, the trade sector gained importance again, although the increase in the trade balance was muted due to the loss in terms of trade caused by higher import prices for raw materials. Nevertheless, this led to increased fears that the global macroeconomic imbalances will soon reach pre-crisis levels again. As a consequence, the political pressure on the Chinese authorities to appreciate the renminbi increased. Last June, the government re-started its programme to allow for a steady nominal appreciation of the renminbi against the US dollar, which it originally initiated in July 2005 but suspended during the crisis. Since then, the renminbi has been allowed to appreciate by a moderate 2.5 percent.

In *Japan* the economic recovery continued throughout the summer of 2010. During the second quarter, total economic output expanded by an annualised growth rate of 3.0 percent. This increased to 4.5 percent in the third quarter, driven by strong growth in domestic demand. Consumer demand surged before the end of subsidies for the purchase of environmentally friendly automobiles and appliances. Fixed capital formation has been expanding for more than a year now. Despite experiencing a repeated double-digit increase in exports, for the first time since the end of the recession foreign trade no longer contributed significantly to growth; thanks to strong domestic demand, imports increased more than exports.

The slightly larger GDP increase in the third quarter of last year hid however the weakening economic tendencies also observed in Japan. Recent data indicate that the pace of the recovery has currently come to a virtual standstill. In particular, export and industrial production growth showed declines towards the end of 2010. The appreciation of the yen and the slowdown of other Asian economies, notably China, are mainly responsible for this.

The observed increase in private consumption was largely induced by an additional stimulus package of the government. Although some subsidy programmes will continue to run until mid-year, the removal of these support measures has already affected durable goods consumption this winter. For example, automobile sales, which in the third quarter of last year rose particularly sharply, have probably already declined in the fourth quarter. Private investment, however, has continued to rise slightly. Government consumption and public investment stagnated or even declined significantly.

To support the economy, to fight against the appreciation of the yen and to try to halt the continuing deflation, the Japanese Central Bank cut its main interest rate (from 0.1 to between 0 and 0.1 percent), intervened in the foreign exchange market and purchased securities. However, as the volumes of these transactions have been less than in other countries, its effects are expected to remain small. Because of the large carry-over from 2009 and strong growth rates in the first three quarters, the increase in economic output in 2010 is still expected to be around 4.4 percent.

In *India* overall economic activity continued to expand very quickly. After GDP grew by year-on-year rates of 8.6 in the first quarter, it increased by 8.9 percent in both the second and third quarter. This development was mainly due to strong domestic demand, while foreign trade did not provide a significant impetus. On the production side, the economic pace accelerated in both agriculture and services. On the other hand, the manufacturing sector slowed down somewhat.

As a reaction to the rising inflationary tendencies, over the last year the Reserve Bank of India increased interest rates six times – from 4.75 to 6.25 percent. Although inflation was reduced from 16.1 percent in January 2010 to 8.3 percent in November, it still remains well above the average of the past decade. Especially food price inflation is still high and was about 15 percent at the end of last year.

Also in the other East Asian countries, namely, *Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan* and *Thailand*, GDP growth has somewhat slowed down after above average growth during the first half of 2010. However, in those countries that have experienced the sharpest rebound after the crisis, GDP contracted in the third quarter (especially in Singapore). Due to strong growth during the first half, GDP is expected to have increased by 7.2 percent last year.

1.2.4 Latin America

During the first half of 2010 almost all Latin American economies grew strongly. The region comprising *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*, benefited in particular from rising

prices for raw materials. And hence, the upswing is at least partly on such exports. Prices for some industrial raw materials (agricultural raw materials, nonferrous metals and iron ore) rose to an all-time high. Along with these exports, this time around also domestic demand, supported by solid employment and real wage developments, gave strong impulses to many of these economies. As a result of the economic boom, overall inflationary pressure increased significantly. The Brazilian and Chilean central banks have responded by increasing their prime rates. The resulting lucrative returns, relative to low interest rates in developed countries, and the good growth prospects of the region since mid-2009 again resulted in an increased influx of foreign capital. This inflow is increasingly becoming a burden for the affected economies. Their currencies are under increasing pressure to appreciate against the US dollar, placing a strain on their export industries. In addition, the increased capital inflows pose a risk of the economies overheating and the creation of domestic asset price bubbles. Some governments in the region have already responded to this by implementing tighter capital controls. For instance, Brazil tripled its financial transaction tax on foreign portfolio inflows into fixed income securities to 6 percent in October.

During the second half of 2010, economic growth in Latin America increased less rapidly. The main reasons were the fading of stimulus measures and the tightening of monetary policy but also the global economic slowdown, accompanied by a lower demand for raw materials. In 2010 GDP likely increased by a total of 5.9 percent.

In *Brazil*, the increase in output was also due to an increased consumer demand triggered by higher income as well credit expansion made possible by increased capital inflow. The presidential elections in October last year also triggered an increase in government consumption.

During the second quarter of last year, *Mexico* benefited from strong import demand from the United States. This was only short-lived, and as a result economic growth declined somewhat during the second half of last year.

Argentina benefited last year, especially from the good harvest and rising international demand for agricultural commodities. The export-oriented automobile industry, has made a major contribution to the overall recovery of the Argentine economy. However, the country is still suffering from high inflation. According to unofficial estimates, consumer price inflation amounted to around 25 percent last year – substantially higher than suggested by the official statistics.

1.2.5 The European economy

The cyclical situation

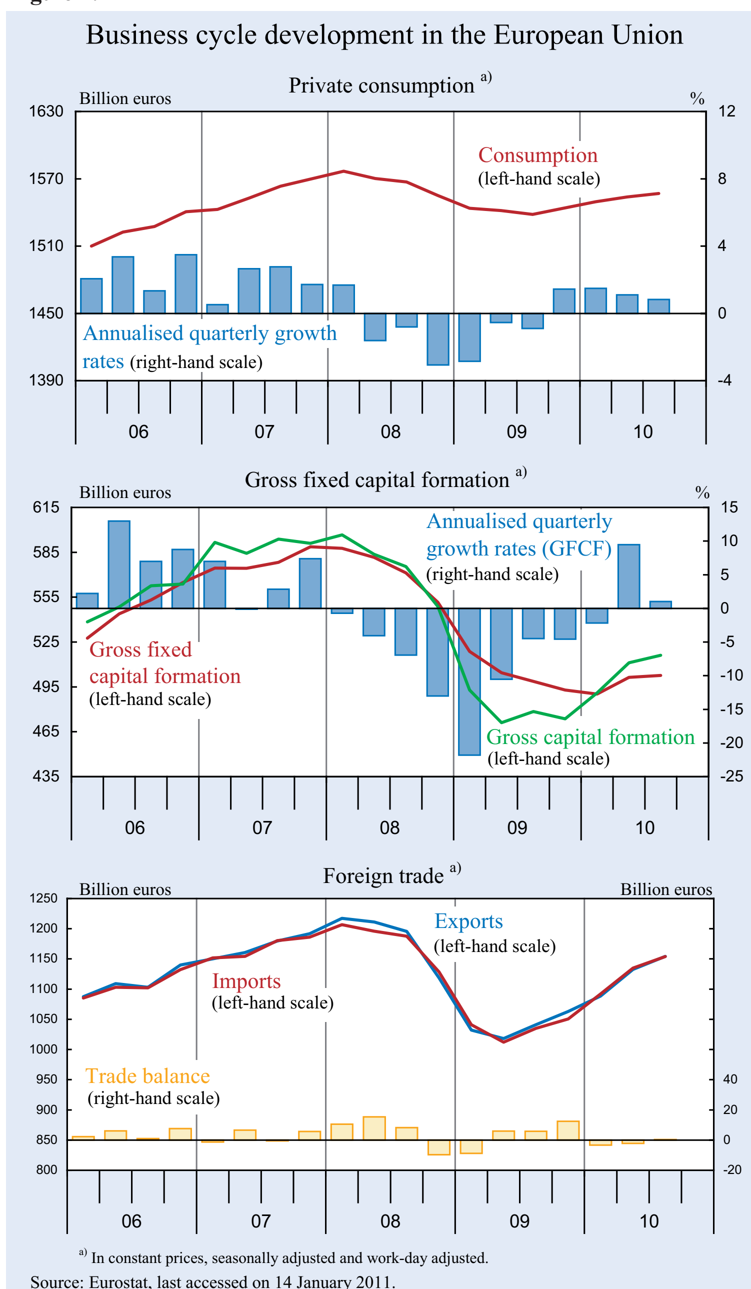
After five quarters of negative growth, it was not until the second half of 2009 that growth in the European Union turned positive again. During the first half of last year the economic recovery gained considerable momentum and reached a peak of an annualised 4.2 percent of growth in GDP in the second quarter. Although the economic recovery continued during the second half of the year, its pace has clearly slowed. In the third quarter, the annualised growth rate fell to 2 percent and is likely to have fallen below 1.5 percent in the final quarter of last year. Overall this has resulted in a growth rate of 1.8 percent for 2010.

Private consumption expenditure continued its rather weak recovery with annualised rates of around 1.2 percent throughout the year (see Figure 1.11). It was mainly affected by high unemployment and since mid-2009 shrinking disposable incomes. Still active stimulus measures in some core European countries supported private consumption, however, and allowed government consumption to reach similar growth levels.

As consumption has been relatively stable, volatility in growth resulted from investment activities, on the one hand, and from international trade, on the other. During the first half of the year a strong impulse came from inventory investments, which were the main drivers of growth (see Figure 1.12). This short-lived cycle ceased to give further positive impulses throughout the rest of the year. Private fixed capital formation has not become a reliable pillar in the recovery so far. Private investment demand has been burdened by slowly increasing capacity utilisation and remaining demand constraints. Only during the second quarter was there a temporary uplift in investment and in particular in construction activities. This was mainly caused by weather conditions, however.

Developments in the construction sector have been of key importance during the run-up to, and in the aftermath of, the financial crisis. Whereas the overall

Figure 1.11



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 14 January 2011.

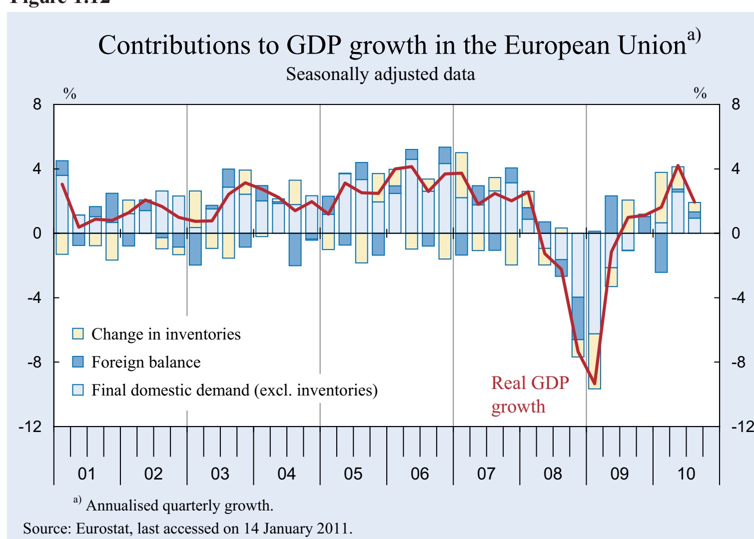
European economy shrank by 4.2 percent in 2009, value added in the construction sector plummeted by more than double that amount. Already in 2008, following the bursting of bubbles in the housing markets of peripheral European countries, the shrinking process of the European construction sector began. Although the recovery in many other sectors started in mid-2009, a further deepening of the recession in construction output is still likely to have occurred last year.

Large differences in the speed of recovery of the construction sector across countries exist. Especially the countries that have been hit by falling house prices, those that face a severe sovereign debt crisis, or both, have experienced record declines in construction activities. Spain, due to tremendously high levels of unemployment and indebtedness and a severe cutback in public spending, is witnessing a strong plunge in construction activity. A prolonged and difficult time is also expected in Ireland, where the government is implementing an extensive austerity programme. But also countries without such problems are witnessing a strong reduction in output in this sector. For instance, Denmark, the Netherlands and the Czech Republic saw severe drops in construction investment last year. The reasons for these slumps are of differing natures. They include low construction confidence as a psychological factor, which induces the avoidance of long-term commitments in investments in Denmark, a strong limitation of new construction investments and reassessment of on-going projects by a new government in the Czech Republic and the fall in demand, low consumer confidence due to the international financial instability as well as an uncertain political situation in the Netherlands.[1]

Countries like Finland, Poland, Germany and Sweden have witnessed relatively strong construction growth. The highest boost in 2010, recorded in Finland, is based on the stronger than ever consumer confidence. Tax cuts to boost private consumption, stimulus measures and the historically low interest rates on housing loans led to considerable growth in residential construction and renovation. The Polish economy is being steadily driven by a stable increase of domestic consumption, which has helped sustain construction developments. As

[1] See the 70th Euroconstruct report (Euroconstruct 2010) for more details.

Figure 1.12



a) Annualised quarterly growth.
Source: Eurostat, last accessed on 14 January 2011.

the biggest construction market in Europe, the German market saw only a modest decline during 2009 and was able to pick up strongly again last year. The low level of unemployment, the strongly improved business confidence as well as government stimulus programmes led to a quick recovery. The dominance of more stable renovation and civil engineering markets are behind the positive output of the Swedish construction market.

After a sharp deterioration of the trade balance early in the year, net exports managed to contribute positively to the growth dynamics of the European Union thereafter, even though the slowdown in the global economy since summer 2010 caused export growth to slow down. However, the phasing out of the inventory cycle and still moderate domestic demand developments allowed imports to increase even less.

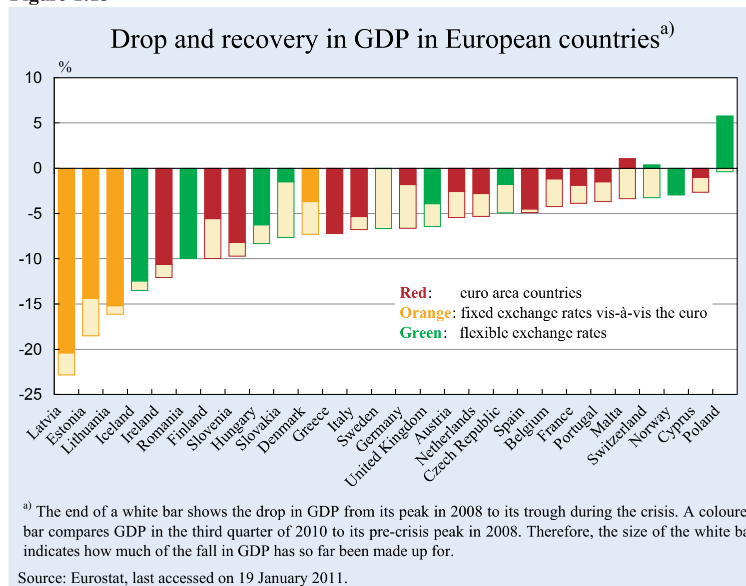
Differences across Europe

Across individual member states, economic growth is still very uneven. Only two countries – Malta and Poland – have fully compensated for the loss in GDP that occurred during the crisis in the third quarter of last year. Greece and Romania are still in a recessionary state and most others have a substantial way to go before catching up to pre-crisis levels (see Figure 1.13).

Export-oriented countries with a relatively healthy public finance situation, such as Germany, the Netherlands, Finland and Austria, benefited from the positive development in the rest of the world and performed above the EU average. Exactly the opposite was observed in the countries of the European periphery (Greece, Ireland, Portugal and Spain, GIPS). The extremely sharp fiscal consolidation measures in these countries have proven to be a heavy burden for their local economies. As a consequence, the recessions in Greece and Ireland have continued, while the Spanish economy stagnated at the beginning of the year. In Portugal, the recovery is very fragile. A third group of countries – France, Italy and Belgium – have experienced growth around the European average. These countries were not directly hit by real estate or banking crises. However, their economies suffer from relatively rigid labour and product markets that put a strain on their international competitiveness. Their exports are also much less oriented toward emerging market countries than, say, those of Germany or Finland, and thus they have benefited to a much lesser extent from the strong performance in these countries.

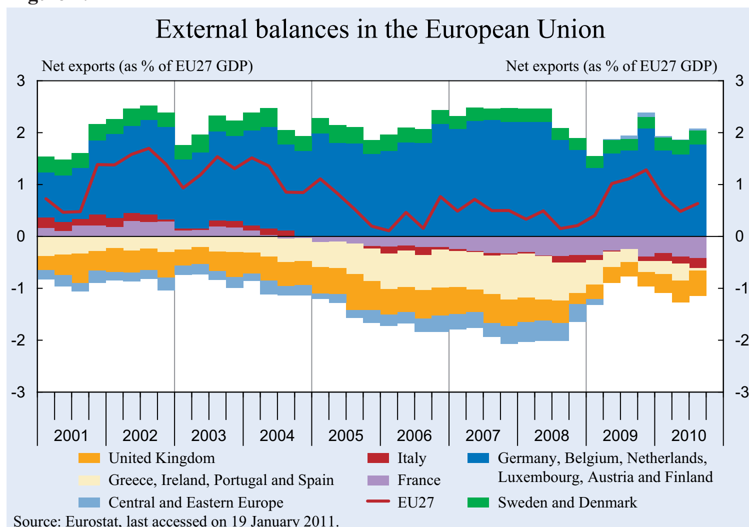
A similar picture emerges when looking at the balances of trade in Europe. These very much highlight

Figure 1.13



a) The end of a white bar shows the drop in GDP from its peak in 2008 to its trough during the crisis. A coloured bar compares GDP in the third quarter of 2010 to its pre-crisis peak in 2008. Therefore, the size of the white bar indicates how much of the fall in GDP has so far been made up for.
Source: Eurostat, last accessed on 19 January 2011.

Figure 1.14



Source: Eurostat, last accessed on 19 January 2011.

the imbalances faced within both the euro area and the European Union. In particular, most of the northern European countries are running a substantial trade surplus against the rest of the world. After a short reduction during the peak of the financial crisis, the surplus has stabilised again at almost 2 percent of EU GDP (see Figure 1.14). The reduction in the trade deficit in both the GIPS countries and the central and eastern European member states has been much stronger, or even – in the latter case – translated into a small surplus. Nevertheless, due to increased deficits in France, Italy and the United Kingdom the overall external balance of the European Union has returned to pre-crisis levels.

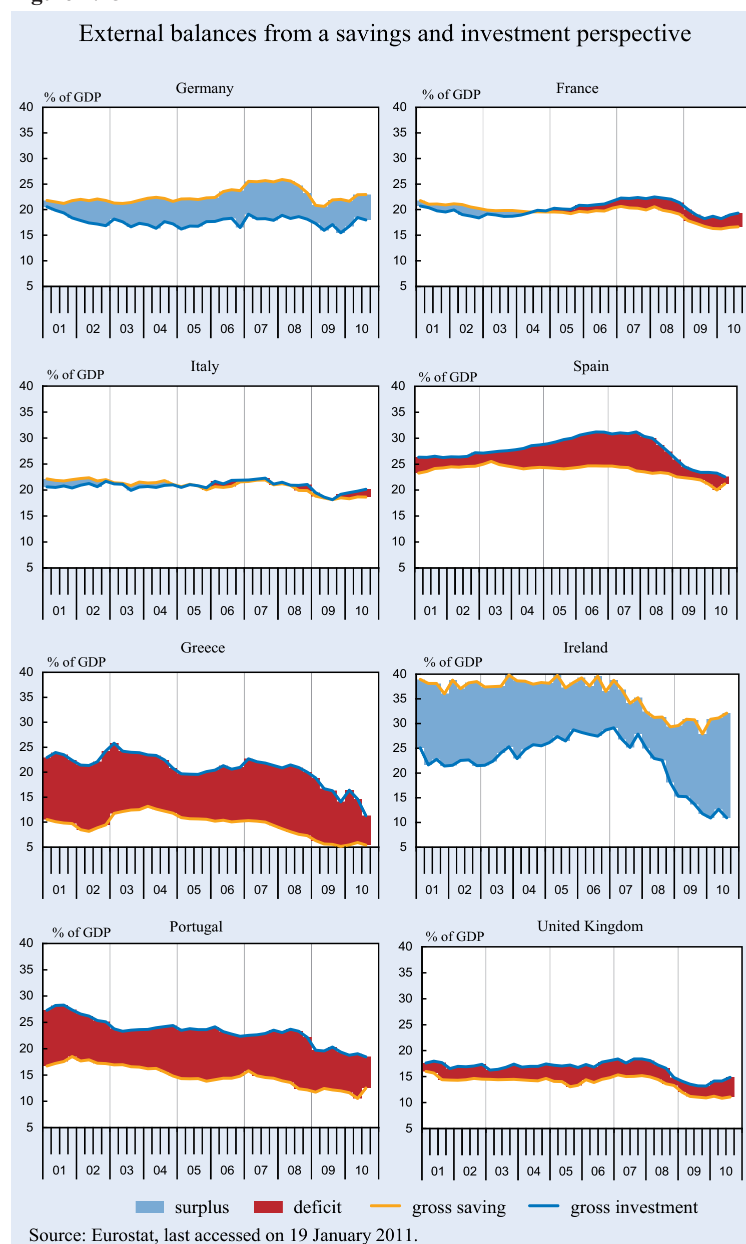
Instead of viewing the trade balance as a result of the difference between exports and imports, it is just as valid to take a financial flows perspective and regard it as the difference between domestic savings and domestic investment, i.e. the net capital outflow. Figure 1.15 shows, for selected European countries, the determinants of these net capital outflows (surplus) or inflows (deficit). In most of the countries currently in distress, the corrections are largely taking place via reduced domestic investment activities. As national savings include both private and public savings, it is to be expected that the resilience of the savings rates is largely due to increased government deficits. The austerity programmes in these countries mainly decided during the summer of 2010 cannot already be reflected in the data available, which end with the third quarter of last year. The only exception appears to be Portugal, where we saw a marked increase in the national savings rate already in the third quarter of last year.

The economic recovery led to a stabilisation of the labour market. The unemployment rate in the euro area has remained stable at around 10 percent since October 2009 (see Figure 1.10), reaching 10.1 percent in November last year. However, labour markets are quite heterogeneous across Europe. In countries with more flexible working hour arrangements and where wage cuts have taken place, job losses remained relatively contained. In Germany, Finland and the Netherlands, the unemployment rates have actually declined during the past few months. In Spain and Ireland, however, the collapse of the real estate sector led to a dramatic increase in the unemployment rates, reaching in November 2010, 20.6 and 13.9 percent, respectively.

After falling inflation rates during the crisis, inflation, measured by the year-on-year change in the harmonised index of consumer prices (HICP), started to pick up again in November 2009. In November last year, it was back at 2.3 percent in the European Union (see Figure 1.16). Crucial to this development were the upward movements in energy and raw material prices since mid-2009. Correcting for energy and unprocessed food price changes, the resulting core inflation rate bottomed out in April last year at 1.3 percent. The moderate price developments reflect the still rather weak domestic demand and the general underutilisation of machines and equipment in the industrial and construction sectors. The core inflation rate reached 1.6 percent in October. National harmonised inflation rates ranged from above 5 percent in Greece and just over 3 percent in Belgium and Cyprus, to –0.8 percent in Ireland. Tax increases in Greece, Portugal and Spain led to these temporary hikes of inflation. Excluding these effects, average price dynamics in these countries remain well below the European average, indicating that their price competitiveness has tended to improve.

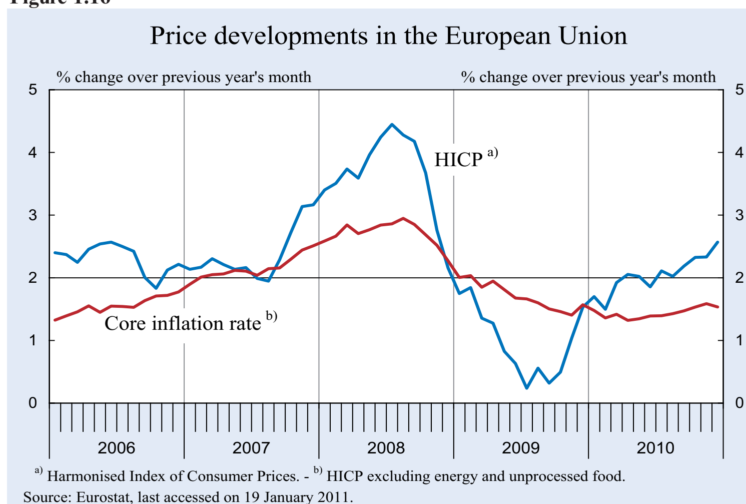
In *Germany*, the upswing continued throughout last year. After a record output growth rate in spring – it reached its highest level since unification of 9.5 percent on an annualised basis in the second quarter – the pace slowed down. GDP expanded by an annualised rate of 2.8 percent in the third quarter, leading

Figure 1.15



Source: Eurostat, last accessed on 19 January 2011.

Figure 1.16



a) Harmonised Index of Consumer Prices. - b) HICP excluding energy and unprocessed food.
Source: Eurostat, last accessed on 19 January 2011.

to an annualised rate of 4.8 percent during the first three quarters of 2010. After having been at the tail of the growth distribution in Europe for many years, the German economy is now making above-average contributions to EU growth.

Besides benefiting strongly from the uplift in world trade, a considerable part of the impulses were of domestic origin. In addition to the strong impulses from the inventory cycle during the first half of the year, investment dynamics were spurred by historically low interest rates throughout the year. As investors presently assess the risk of investments abroad substantially higher than before the financial crisis, investment opportunities in Germany have become more attractive. Together with a high amount of liquidity in the system, credit conditions have, as a consequence, relaxed in Germany. Equipment investment managed to expand strongly throughout the year. However, residential and public infrastructure investments were able to contribute to the strong growth of the second quarter, largely due to catching-up effects.

After entering a recessionary phase at the end of 2009, the largest demand component, private consumption, gained momentum throughout last year. In the first three quarters of 2010 it increased at an average annualised rate of 1.6 percent and thus outpaced the mean growth rate of consumption observed in the decade before. Public consumption, although volatile throughout the year, contributed positively to economic growth.

These domestic developments were supported by the wage restraint of the past ten years that improved German price competitiveness, lending further support to its strong export sector. Except for the first quarter of last year, in which extraordinary developments registered at the end of 2009 were corrected, exports increased at a higher pace than imports.

In the wake of the upswing, labour market conditions improved substantially. Since the first quarter of 2008, the trough in the German business cycle, the number of employed persons in Germany has increased by around 300,000. The number of unemployed declined throughout 2010. The unemployment rate fell by 1 percentage point since its peak in June 2009 to 6.7 percent in November 2010.

Compared to other major European countries, *France* was hit to a much smaller extent by the economic and financial crisis. This is mainly due to the French economy's relatively low degree of openness that shielded it from the consequences of the sharp contraction of world trade during the winter of 2008/2009. Accordingly, the counter movement during the second half of 2009 and the first half of 2010 were considerably more moderate than in Germany, for example. France did not benefit as much from the strong revival of the world economy and in particular the emerging markets. The French export sector is less well-positioned than Germany's in the dynamic emerging economies of East Asia and Latin America.

For the past seven quarters, the French economy has nevertheless been going through a recovery phase. Aggregate production increased by an annualised 1.4 percent in the third quarter of 2010, after 2.7 percent in the second quarter. Supported by currently low interest rates and still positive impulses coming from fiscal stimulus programmes, all components of domestic demand continued to contribute positively to growth in the third quarter. Private consumption increased by 2.3 percent and continued the recovery that began at the end of 2009.

The abolition of local business taxes supported private investment, in particular for machinery and equipment. Construction investment, on the other hand, continued to decline. For the second consecutive year, inventory investment gave a strong boost to economic growth. In contrast, and despite double-digit export growth, the foreign trade contribution was again negative, as imports grew much faster than exports. The economic recovery helped to stop the crisis-induced rise in the unemployment rate. Since the beginning of last year it has been stable at around 9.8 percent (see Table 1.A.2 in Appendix 1.A).

In the *United Kingdom,* GDP grew again relatively strongly in the third quarter of last year at an annualised 3.1 percent. The largest contribution was delivered by gross fixed capital formation, while private consumption grew at a lower rate than in the previous quarter. Government consumption and foreign trade – despite the continued weakness of the pound – even made a slightly negative contribution to growth.

In the real estate market, the austerity package adopted by the government for the years to come has already cast its shadow. After house prices had significantly recovered since mid-2009, they have – despite still existing tax breaks for home purchases – fallen again during the second half of 2010. The uncertain macroeconomic developments and the upcoming cost-cutting programme of the government have put potential buyers in a wait-and-see mode. In addition, the already restrictive credit conditions have tightened further in the third quarter.

Leading indicators give no cause for an optimistic picture of development this winter. While sentiment increased in the manufacturing sector last December, it fell markedly in the service sector, which is of major importance for the British economy. Furthermore, consumer confidence dropped in December as well as, in October, industrial production. Together with unusual weather conditions this even caused a drop in GDP in the fourth quarter of 2010. In particular the construction sector was hit by the strong snowfalls in December. The increased VAT at the start of this year did not bring forward enough demand to compensate for this. Overall GDP is expected to have increased by 1.4 percent last year.

The economic recovery in *Italy* suffered a set-back during the third quarter of last year. GDP only grew by an annualised 0.7 percent, after having reached 1.6 and 1.9 percent in the first two quarters, respectively. Positive impulses primarily stem from exports and private investment in machinery and equipment. Although the products it exports compete with those of emerging markets, Italy managed to benefit – albeit more moderately than Germany, for example – from the revival in world trade. The low interest rate coupled with reduced uncertainty allowed investment in machinery and equipment to grow at around 8 per-

cent last year. Construction investment declined further. Hardly any impulses were provided by private consumption. Weak growth in disposable income and consolidation efforts of the Italian government made consumption basically stagnate in the course of the year.

Despite only moderate growth, the situation in the Italian labour market is relatively stable. This can be attributed primarily to the government's short-time working programmes. Although the unemployment rate rose to 8.7 percent in November 2010, it is only about 2 percentage points above levels seen shortly before the crisis. Due to higher energy prices, the rise in consumer prices has accelerated slightly in October 2010, having reached 2 percent.

Although *Spain* officially came out of recession in early 2010, its economy hardly grew during the year. After GDP expanded by only an annualised 0.4 and 1.1 percent in the first and second quarters of 2010, it stagnated in the third quarter. This renewed economic slowdown is primarily due to a strong decline in domestic demand, in particular private consumption and private investment.

Consumer spending experienced the expected backlash to the expansion in the second quarter, which was caused by advanced purchases in anticipation of the VAT increase that took effect in July. Weak investment activities are a direct consequence of the continuing consolidation in the construction sector. Foreign trade provided a strong positive impulse. Although exports only increased by an annualised 0.3 percent, imports dropped by close to an annualised 20 percent in the third quarter of 2010. The inventory cycle still managed to contribute positively to growth throughout last year.

The situation in the Spanish labour market continued to deteriorate further during the year. The unemployment rate peaked at 20.7 percent in October last year and is by far the highest of all euro-area member countries.[2] Since the start of the crisis, the unemployment rate has risen by more than 12 percentage points. Both due to the VAT increase and a base effect resulting from deflationary tendencies in 2009, inflation was relatively high at the end of last year. It reached 2.3 percent in October 2010. The public deficit is expected to have slightly decreased to 9.3 percent in 2010 (as compared to 11.1 percent in 2009). Albeit still well below the European average, the government debt-to-GDP ratio will have increased to around 64 percent by the end of last year.

The rapid increase in public debt and the continuing economic weakness in the autumn of 2010 raised doubts about the solvency of the Spanish state. This is reflected in a rising risk premium on Spanish government bonds, especially as compared to German government bonds. The promises made by China early this year to buy Spanish government bonds – after having already done so in the cases of Greece and Portugal – did not appear to have a lasting effect on Spanish yields. Though China has not specified the size of its investment in Spain, the Spanish media reports suggest it could far exceed the investments already made in Greek and Portuguese debt.

In *Greece*, the recession has deepened significantly. GDP shrank by more than 4 percent last year. This was accompanied by expenditure- and revenue-side consolidation measures of the government. Despite the severity of the economic downturn, these measures already had a noticeable effect on the fiscal budget balance. The fiscal stimulus, as measured by the change in the primary deficit, reached in 2010 –6.7 percent of 2007 GDP levels. A significant proportion of consolidation consists of an increase in excise taxes. VAT was raised in several steps by a total of 5 percentage points to currently 23 percent. Accordingly, consumer prices rose sharply. Excluding these tax effects, prices almost stagnated. Together with the simultaneously implemented structural reforms, this suggests an improvement in price competitiveness in the coming years.

After the GDP in *Ireland* rose for the first time since the end of 2007 during the first quarter of last year, it turned negative again afterwards. In particular, private and public consumption declined. The spreads on Irish government bonds rose sharply during the year. Although the Irish government pursued a consolidation strategy, it had to spend considerable amounts of resources to rescue its banking sector and to compensate for write-downs of guarantees made earlier. As a consequence, the fiscal deficit is expected to be over 30 percent of GDP in 2010. In relation to its GDP, Ireland is bearing the greatest burden of the banking crisis in Europe.

In *Portugal*, the economy presented itself relatively strongly in the first quarter of last year. Subsequently

[2] Within the European Union only Latvia with an average unemployment rate of 20.9 percent in 2010 shows a worse performance.

it reduced its pace again. The increase during the first half of the year resulted from a rise in domestic demand. After the budget deficit amounted to 9.3 percent of GDP in 2009, it fell to about 7.3 percent last year. Most of this reduction took place during the second half of the year, after the risk premiums on Portuguese government bonds rose dramatically. In response, the government decided in May to raise value added, income and corporate taxes. Subsequently, the inflation rate rose. For the year 2010 GDP is expected to have grown by 1.7 percent.

In *Central and Eastern Europe,* the economic recovery that began in the second half of 2009 has stabilised. Nevertheless, the picture remains mixed. In Poland, where the economy did not go into recession during the financial crisis, economic growth increased its pace and reached 3.8 percent last year. Meanwhile, production levels in other countries of the region that did experience severe drops in economic activity are now also clearly pointing upward. In Slovakia and the Czech Republic, the recovery of the car industry became apparent. In the Baltic States, where in the wake of the financial crisis particularly drastic drops in economic activity had occurred, the recession also came to an end last year. In the case of Estonia, sound public finances and the decision to adopt the euro at the start of this year built up investor and consumer confidence, which supported the economic recovery. On the other hand, there are also countries where the economic recovery has not yet materialised. Production stagnated in Bulgaria, while in Romania and Latvia it continued to decline.

Impulses came first, above all, from an increase in demand from abroad. In countries with flexible exchange rates, a depreciating currency seemed supportive. Later on also the competitive position of those countries and the region that had pegged their currencies to the euro improved. The weak euro supported their trade relationship with countries outside Europe, in particular Asia and Latin America. In Poland domestic demand also increased substantially. However, in other countries it picked up only slowly.

After a sharp decline in 2009 as compared to the years before, the inflation rate initially increased somewhat last year. However, with the exception of Hungary and Romania, the observed levels remain historically low. As a consequence, there are no signs yet that those countries that follow an inflation target will soon increase their interest rates. After budget deficits had expanded strongly during the crisis, in most countries significant steps towards consolidation were taken last year. Except for Estonia, which wanted to make sure that it could enter the euro area, fiscal deficits nevertheless exceeded 3 percent of GDP last year.

1.3 Fiscal and monetary policy in Europe

1.3.1 Fiscal policy

Economic and political discussion in Europe last year centred on the sovereign debt crisis. Concerns regarding the solvency of countries like Greece, Ireland, Portugal and, to a lesser extent, Spain, have brought the need for fiscal restructuring of the national finances to the fore. As a consequence, throughout the year problems associated with government bonds escalated time and time again.

The cyclically-related public spending increase and tax revenue shortfalls together with the economic stimulus packages implemented in 2009 led to a dramatic deterioration in public finances in most European countries. The consolidated budget balance of the European Union rose to –6.8 percent of GDP in 2009 and is likely to have remained there last year (see Table 1.2). Accordingly, the public debt reached a record high of nearly 79.1 percent of economic output last year.

Given the difficulty of coming up with detailed, but still comparable, estimates of fiscal impulses and austerity measures induced by the public sector, we prefer the use of a relatively straightforward summary measure: the change in the primary deficit of the general government relative to a pre-crisis measure of the economic size of a country, i.e. its GDP in 2007.[3] It includes both discretionary measures taken by the general government as well as the automatic stabilisers, both during the expansionary and consolidation phase.

Last year stimulus measures began to be gradually reduced and thereby initiated the consolidation of government finances in Europe. Nevertheless, in

[3] As it is generally believed that changes in interest payments by the government do not have a strong impact on the economy and are not intended as such, the primary balance – which excludes these – is likely to be a better measure than the change in the fiscal balance per se. Note, however, that increased interest payments can have a substantial effect on government debt levels and therefore are important in judging the sustainability of public finances.

Table 1.2

Public finances

	Gross debt[a]				Fiscal balance[a]			
	1999–2007	2008	2009	2010	1999–2007	2008	2009	2010
Germany	63.3	66.3	73.4	75.7	–2.1	0.1	–3.0	–3.7
France	61.5	67.5	78.1	83.0	–2.6	–3.3	–7.5	–7.7
Italy	106.8	106.3	116.0	118.9	–2.7	–2.7	–5.3	–5.0
Spain	49.2	39.8	53.2	64.4	0.1	–4.2	–11.1	–9.3
Netherlands	51.7	58.2	60.8	64.8	–0.5	0.6	–5.4	–5.8
Belgium	98.8	89.6	96.2	98.6	–0.4	–1.3	–6.0	–4.8
Austria	64.8	62.5	67.5	70.4	–1.6	–0.5	–3.5	–4.3
Greece	101.2	110.3	126.8	140.2	–5.2	–9.4	–15.4	–9.6
Ireland	32.4	44.3	65.5	97.4	1.6	–7.3	–14.4	–32.3
Finland	42.1	34.1	43.8	49.0	3.8	4.2	–2.5	–3.1
Portugal	55.9	65.3	76.1	82.8	–3.6	–2.9	–9.3	–7.3
Slovakia	41.0	27.8	35.4	42.1	–5.3	–2.1	–7.9	–8.2
Slovenia	26.7	22.5	35.4	40.7	–2.3	–1.8	–5.8	–5.8
Luxembourg	6.3	13.6	14.5	18.2	2.5	3.0	–0.7	–1.8
Estonia	5.0	4.6	7.2	8.0	0.7	–2.8	–1.7	–1.0
Cyprus	60.9	48.3	58.0	62.2	–2.7	0.9	6.0	–5.9
Malta	63.5	63.1	68.6	70.4	–5.4	–4.8	–3.8	–4.2
Euro area	**68.4**	**69.7**	**79.1**	**84.1**	**–1.8**	**–2.0**	**–6.3**	**–6.3**
United Kingdom	41.1	52.1	68.2	77.8	–1.4	–5.0	–11.4	–10.5
Sweden	51.2	38.2	41.9	39.9	1.4	2.2	–0.9	–0.9
Denmark	44.3	34.1	41.5	44.9	2.5	3.2	–2.7	–5.1
Poland	43.2	47.1	50.9	55.5	–4.1	–3.7	–7.2	–7.9
Czech Republic	26.2	30.0	35.3	40.0	–4.0	–2.7	–5.8	–5.2
Hungary	59.3	72.3	78.4	78.5	–6.3	–3.7	–4.4	–3.8
Romania	19.5	13.4	23.9	30.4	–2.6	–5.7	–8.6	–7.3
Lithuania	20.6	15.6	29.5	37.4	–1.8	–3.3	–9.2	–8.4
Bulgaria	46.2	13.7	14.7	18.2	0.5	1.7	–4.7	–3.8
Latvia	12.7	19.7	36.7	45.7	–1.6	–4.2	–10.2	–7.7
EU27	**61.2**	**61.8**	**74.0**	**79.1**	**–1.7**	**–2.3**	**– 6.8**	**–6.8**

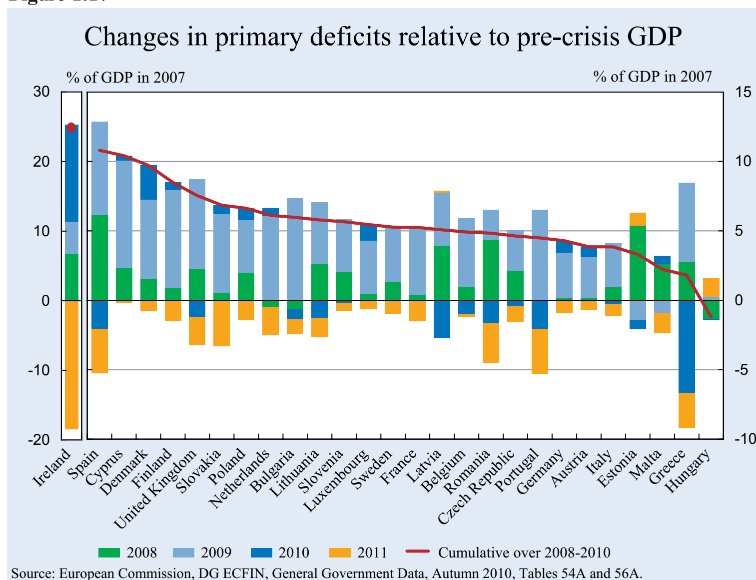
[a] As a percentage of gross domestic product; definitions according to the Maastricht Treaty. For Slovenia, the euro area and the EU27 the data on gross debt start in 2001.

Source: European Commission, Directorate General ECFIN, Economic and Financial Affairs, general government data, general government revenue, expenditure, balances and gross debt, part II: tables by series, autumn 2010.

countries such as Austria, Denmark, Germany, Luxembourg and the Netherlands, fiscal policy continued to be expansionary in 2010 (see Figure 1.17). The countries of the European periphery (Greece, Ireland Portugal and Spain) together with Belgium and the United Kingdom, however, were forced to take sharp austerity measures in the summer of 2010 in response to doubts about their solvency and sharply rising refinancing costs.[4] Accordingly, domestic demand was greatly attenuated in these countries.

[4] As Figure 1.17 shows, Ireland is a special case. By rescuing its banking sector, the Irish government experienced a huge increase in its deficits, substantially reducing the willingness of financial markets to buy Irish government bonds, which subsequently forced Ireland to be the first country to draw on the European Financial Stability Facility. As these bailout costs are (except for the induced interest payments and amortisation) one-off, an automatic, strong correction will be seen this year.

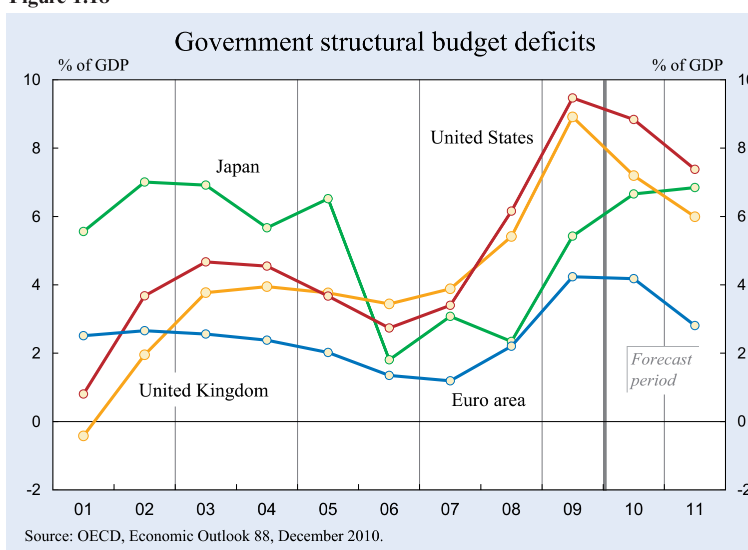
Figure 1.17



Source: European Commission, DG ECFIN, General Government Data, Autumn 2010, Tables 54A and 56A.

An important reason for the large union-wide deficit last year is the high level of spending on unemployment benefits. This year, without exception, all countries will consolidate their public finances and thereby take a restrictive fiscal policy stance. The negative effect on public spending and disposable income will significantly slow down the recovery in domestic demand. Particularly exposed to the negative momentum will be those economies that are perceived to be on the brink of insolvency, i.e. Greece, Ireland, Portugal and Spain. All in all, the induced saving efforts will reduce the overall deficit in the European Union to 5.1 percent of GDP this year (see Table 1.A.3 in Appendix 1.A).

Figure 1.18



Source: OECD, Economic Outlook 88, December 2010.

Part of the increase in deficits in recent years has been due to the automatic stabilisers built into our systems, such as the progressive tax system and unemployment and welfare benefits that depend upon economic conditions. Another part has been due to fiscal stimulus packages that were intended to be "timely", "targeted" and "temporary".[5] If these rules had been followed, then the only increase in structural budget deficits we would have seen would have been due to increased interest payments caused by the jump in government debt associated with the stimulus measures. Although not negligible, the need for substantial austerity programmes would have been circumvented. Unfortunately, it is basically impossible to adequately measure structural budget balances. Experience tells us that we can produce rough guides that still depend – at least when cycles are as pronounced as they have been in the last few years – on short-term economic conditions. Keeping this caveat in mind, Figure 1.18 shows estimates of structural deficits in the four large economic blocks in the world. The sharp increase during the crisis year 2009 is unmistakable. Also the predicted decline next year is clearly visible in the United States, the United Kingdom and the euro area. Only in Japan are there no signs of a reduction in structural deficits. At best it has managed to stabilise its structural deficits at the alleviated levels seen earlier this century.

[5] The timely principle says governments apply their stimulus as early in the downturn as possible. The targeted principle says the stimulus should go to areas where the crisis hits the hardest and which are most likely to subsequently spend a large share of the stimulus means. Finally, the temporary principle says everything governments do must be a one-off (even if spread over a few years) so that it leaves no impediment to getting the budget back in line once the economy is out of recession.

After the general government budget in *Germany* was nearly balanced in 2007 and 2008, the economic crisis in 2009 led to a deficit of 3 percent of GDP. Although the automatic stabilizers, as a result of the economic recovery, aided the consolidation of the state budget significantly, the deficit-to-GDP ratio is expected to have risen again to 3.7 percent last year. This was largely caused by the prevailing economic stimulus packages that led to declines in income and property taxes. Due to the economic upswing, general government expenditure increased moderately in 2010. Unemployment and other monetary benefits only rose slightly. The acquisition of assets and liabilities of Hypo Real Estate have led to an increase in wealth transfer. On the other hand, Germany benefited from very low interest rates. Despite the increase in government debt, it is likely that government interest expenses declined again last year.

This year, fiscal policy in Germany will turn restrictive. The consolidation efforts are supported by the working of automatic stabilizers in the context of the on-going economic upswing. The budget deficit may fall back to about 2.5 percent of GDP this year. Somewhat more than half of this improvement is likely to be of a structural nature. Government revenues will be driven here by opposing forces, which will induce the overall tax rate and the share of social security contributions to GDP to remain largely stable. The consolidation will mainly be achieved on the expenditure side. Although growth rates are much lower than in previous years, government consump-

tion will nevertheless continue to develop relatively strongly. The quantitatively most important consolidation effort is achieved by reducing social security benefits. Unemployment expenditures will decrease due to the favourable development of the labour market. The ending of specific investment packages will cause government investment to fall slightly this year. Despite further rising debt levels, interest expenditures are expected to rise only slightly. It is assumed that Germany will maintain its privileged financing conditions.

The government debt-to-GDP ratio is expected to change only marginally this year. However, there is large uncertainty with respect to the expected increase in debt caused by the rescue packages for distressed EU countries. As part of the European Financial Stability Facility, Germany has committed to a maximum aggregate liability of almost 150 billion euros. These figures are not included in this forecast.

In *France*, an important step towards reducing the structural government deficit was taken in October 2010 with the decision to increase the minimum retirement age from 60 to 62 years. Already this year, this reform will be beneficial to the debt dynamics of the country and provide a positive signal to financial markets. The government deficit in 2010 will turn out to have been 7.7 percent of GDP. It is projected to fall back to 6.3 percent this year. Accordingly, the government debt-to-GDP ratio is expected to rise from 83 percent in 2010 to close to 87 percent this year. The main risks to the economic recovery of France are again the flaring up of turmoil on the European government bond market, which would then be reflected in a rise in risk premiums for securities from European core countries. In the case of France, given that a large fraction (17.7 percent) of the outstanding debt expires this year, such a scenario would have substantial consequences for its public finances.

Also in the *United Kingdom* fiscal consolidation is underway. Since the United Kingdom will have had the largest deficit-to-GDP ratio in Europe – except for Ireland – last year, the fiscal tightening is highly necessary and will have to be substantial in nature. According to the Spending Review, published at the end of October last year, it is the intention of the government to achieve a structurally balanced budget by the end of 2016.

Tax increases, including higher social security contributions and a hike in the VAT rate are the first significant contributions to this. Since January this year, VAT has been raised by 2.5 percentage points and the time restriction on the bank levy introduced in early 2010 has been abolished. Moreover, contributions to public pension schemes will be increased, the child allowance for high-income earners will be abolished and social benefits capped at the household level.

Most of the consolidation will, however, take place on the expenditure side. The austerity programme includes savings of 81 billion pounds (97 billion euros) across all departments, except health and development aid, up to fiscal 2014/2015. Public sector wages will be frozen for two years and significant falls in government investment, consumption and transfers are envisaged. As a result, fiscal headwinds are set to strengthen – the negative fiscal impulse this year will be around 2 percent of GDP. The fiscal deficit is projected to fall to 8.6 percent of GDP this year.

Even before the recession started in 2008, *Italy* had – by European standards – a high government debt burden of over 100 percent of GDP to deal with. During the crisis the Italian government therefore decided against comprehensive economic stimulus measures. This explains why the government deficit situation saw a relatively small increase from 2.7 percent in 2008 to around 5 percent last year (see Table 1.2) and Italian bonds have performed relatively well as compared to those of other southern European countries. The Italian government has announced a further tightened fiscal policy for the years to come. Measures include a freeze of public-sector wages and significant cuts in transfers to local governments. As a consequence the fiscal deficit is scheduled to be reduced to 4.3 percent of GDP in 2011. Government debt is expected to peak at around 120 percent of GDP this year.

Fiscal policy in Greece, Ireland, Portugal and Spain

The global financial crisis and the ensuing economic collapse in 2009 resulted in a sharp deterioration of public budgets in the countries of the European periphery that turned out to be much more dramatic than in the core of Europe. A series of country-specific and common factors were decisive for this development. Thus, the collapse of real estate markets in Ireland and Spain led to a more than doubling of the respective unemployment rates and to severe shocks to the banking sector. The government budget situation of Greece was already unsustainable before the

crisis. Also Portugal already recorded deficits that were significantly higher than in most other European countries. Rigid labour markets in Greece, Portugal and Spain prevented a swift and efficient adaptation to changing conditions. Furthermore, the export sectors of Greece, Portugal and Spain are not well-positioned on the dynamic markets in East Asia and face strong competition from emerging countries.

This combination of a quickly deteriorating debt position and structural weaknesses created doubts about the sustainability of government debt in these peripheral countries. As a result, risk premiums on their government bonds skyrocketed. Greece in particular was affected. The high returns demanded by financial markets made it almost impossible for the country to meet its current financing needs, and drove it to the brink of insolvency (see Box 1.1). This was averted by establishing a rescue fund for Greece. However, the rescue package could only calm financial markets temporarily. The risk premiums rose again in June 2010 and forced Ireland, Portugal and Spain to adopt major consolidation measures as well. The austerity plans are intended to bring back the public finances of the affected countries to a sustainable path. In Spain and Portugal, profound structural labour market reforms have also been adopted.

Despite these consolidation efforts, savings targets that were set in spring last year will not be achieved in most of these countries. An important reason for this is that the negative effects on economic growth have turned out to be stronger than expected.

In *Greece*, the deficit was scheduled to be reduced by seven percentage points (from 15.4 percent of GDP in 2009 – using current data – to 8.1 percent of GDP in 2010).[6] Despite tax increases and drastic cuts in public services, this target will be missed by more than 1 percentage point. Last year's deficit is currently expected to equal 9.6 percent of GDP. Especially revenues have turned out to be lower than projected.

The government budget of *Ireland* was strongly affected by the rescuing cost of its ailing banking system in autumn last year. Accordingly, the public deficit probably reached 32.3 percent of GDP last year, while government debt rose to 97.4 percent of GDP. Without bailout costs, the deficit- and debt-to-GDP ratios would have been around 12 and 78 percent, i.e. much lower.

To avoid a further increase in uncertainty and renewed turmoil on European bond markets, the government in Dublin agreed to a rescue package by the European community, the European Commission and the IMF, by which Ireland is able to draw upon the European Financial Stability Facility (EFSF). To achieve the savings targets for the years to come, Ireland had to sharpen its original consolidation plan considerably. In November 2010, additional savings of 10 percent of GDP were decided on. The largest share will come this year, in which nearly 3.7 percent of GDP will have to be saved. Around 75 percent of the cuts will be made on the expenditure side. This concerns in particular public investment, many social benefits and the number of civil servants. However, the deficit targets are based on the growth forecasts of the Irish government, which appear to be quite optimistic. The additional cost-cutting efforts will weigh heavily on the economy and slow down its recovery significantly. The government deficit is expected to decline in 2011 to 10.3 percent of GDP, while government debt is likely to grow to nearly 107 percent of GDP.

Although *Portugal* was not hit by a real estate crisis and its deficit developed less dramatically than in other European periphery countries, it nonetheless had already accumulated a large public debt before the recession. Together with structural problems of its economy, this led to a loss of confidence in financial markets. As a result, refinancing costs increased sharply and forced the government in Lisbon to adopt an austerity package in March. However, not least because of the reluctance with which certain consolidation measures were addressed, this did not calm the financial markets. To counteract the ongoing increase in the country's risk premium, the Portuguese government presented a new and far more ambitious consolidation plan in May. According to this plan, a public deficit of 7.3 percent of GDP was envisaged for 2010, instead of the originally planned 8.3 percent. The deficit target for 2011 was also significantly adjusted downwards: from 6.6 percent to 4.6 percent of GDP. The budget for this year, which was adopted last November, included almost all measures listed in this revised consolidation plan. It is scheduled to cut spending and increase revenues by 2.2 and 1.2 percent of GDP, respectively. Various social benefits and wages in the public sector will be reduced and pensions frozen. At

[6] When the bailout package was agreed upon in May 2010, the budget deficit for 2009 was thought to be 13.6 percent. Eurostat revised this figure to 15.4 percent November last year. Hence, the targeted reduction in May was supposed to lead to a deficit of 6.6 percent last year.

the same time, VAT has been raised again by two percentage points and income tax deductions are to be reduced. However, the GDP forecast of 0.2 percent growth for 2011 published by the Portuguese government seems to be too optimistic. A decline in GDP of 0.3 percent appears more likely. If the government continues to adhere to its predetermined saving target, then it is to be expected that further consolidation measures will have to be taken. The budget deficit will then fall from 7.3 percent to 4.9 percent of GDP this year. Gross debt is likely to reach almost 89 percent of GDP this year.

Box 1.1

Solvency of the GIPS countries[1)]

Despite the establishment of the European Financial Stability Facility (EFSF) – a special purpose vehicle for providing financial assistance to countries threatened by insolvency – in spring 2010, concerns of investors about possible insolvencies of some, if not of all, peripheral countries continued to increase. The main reason for persisting turbulences on financial markets is the increasing levels of sovereign debt combined with a lack of economic dynamics. Although some of the involved countries did face liquidity problems, this does not necessarily imply that these countries are actually insolvent. In the following we examine the conditions under which these countries are in fact exposed to the threat of insolvency.

The sustainability of public finances of a country crucially depends on the long-term relationship between nominal debt growth and the average nominal interest rate on government bonds. A country is solvent if, and only if, the former is lower than the latter. Intuitively, this condition of solvency states that the present value of all future public revenues needs to be greater or equal to the sum of the present value of all future primary public expenditures and the currently existing debt. In other words, the present value of all future primary surpluses must not fall short of the current level of public debt.

To determine the long-run dynamics of government debt in Greece, Ireland, Portugal and Spain (the GIPS countries), we construct a time path for nominal GDP and proceed similarly for the primary deficit.[2)] In addition we make assumptions about the long-term development of nominal interest rates on government bonds. For 2010 and 2011 the EEAG forecasts for real GDP, the GDP deflators and the budget deficits for the four countries are taken as a basis. Beginning from 2012 the growth rates of real GDP and the GDP deflators are both assumed to gradually converge towards 2 percent. This value equals what can be considered the EU-wide potential growth rate and the long-term inflation target of the ECB. Thus, after 2020, nominal GDP is assumed to increase annually by 4 percent in each of these countries. Spain already attains its potential growth rate in 2014; for both Greece and Ireland this is the case in 2015. By contrast, Portugal goes through a period of real growth rates of around 1.5 percent, before achieving its potential in 2030. The overall deficits in 2012, 2013 and 2014 are set to the target values specified by the Stability and Growth Pact. Accordingly, in Portugal and Spain the overall deficit-to-GDP ratio is expected to already reach the Maastricht level of 3 percent in 2013, whereas Greece and Ireland are assumed to achieve this goal one year later. By assumption, all four countries maintain this level from 2014 onwards. To determine each country's current need for refinancing, figures on public debt levels in 2010 are broken down by bond categories. For new debt an interest rate of 5 percent is assumed.

Due to the assumed long-run symmetry, the primary surpluses of these countries all converge to 0.75 percent of GDP. Hence, savings are in the long run identical across these countries. However, in the medium run they differ. Portugal has to realize an annual primary surplus of about 3.5 percent between 2015 and 2030, which stands in strong contrast to the average primary surplus of 0.2 percent achieved in the years 1992 to 2006. Also Greece will have to save notably more than it did in the decade preceding the crisis. While its primary surplus averaged 1.4 percent between 1992 and 2006, it will have to obtain an annual primary surplus of close to 3 percent during the next two decades to comply with the 3 percent limit for the overall deficit. With an annual primary surplus of 1.7 percent until 2030, Ireland needs slightly less severe saving efforts. In light of the average primary surplus of 3.8 percent between 1992 and 2006 this appears feasible. Even less demanding are the saving needs in Spain. The country will have to obtain primary surpluses of less than 1 percent of GDP over the next 20 years. This is lower than its historical average of 1.2 percent. However, all these statements only hold true for this baseline scenario in which only an interest rate of 5 percent has to be paid on newly incurred debt.

Also the growth rates of (nominal) government debt levels will, with the passage of time, become increasingly similar. In the long-run, they will equal 4 percent in all countries. This value is strictly less than the assumed 5 percent average interest rate which countries have to pay on their new debt. Consequently, in the baseline scenario, all four countries are solvent: the countries will be able to generate sufficiently large primary surpluses to ensure that government debt will accumulate slowly enough to keep the debt-to-GDP ratio constant or even have it decrease. This, however, is no guarantee that actual financing of new debt is assured. For that, we need investors to be patient in so far that they tolerate a medium-term rise in government debt as long as long-term prospects remain sustainable.

[1)] This box is based on Carstensen et al. (2010), pp. 24–9.
[2)] The primary deficit is the difference between the total deficit and the interest payments.

continued: Box 1.1

However, the uncertainty about the long-term funding costs and the medium-term growth prospect of these countries is enormous. As recent developments on European sovereign bond markets have shown, yields can strongly fluctuate and also differ persistently across countries (see Figure 1.24). At the same time, medium-term growth prospects are unclear. Growth in the years before the crisis can hardly serve as indication for future growth. For these reasons, the following will explore alternatives in these two dimensions to test the solvency of the four peripheral countries.

Figure 1.19 illustrates for which theoretically possible combinations of the long-term financing costs (horizontal axis) and long-term real GDP growth rate (vertical axis) the public finance situation in these GIPS countries can be considered sustainable. Combinations along the depicted line describe situations in which the previously defined criteria for solvency are weakly satisfied. Combinations above the line allow a strictly sustainable financing of the public debt, while combinations below the line lead to insolvency. Thus a country can only absorb higher financing costs if at the same time it is able to increase its long-term growth rate. Conversely, higher growth allows for higher financing costs.

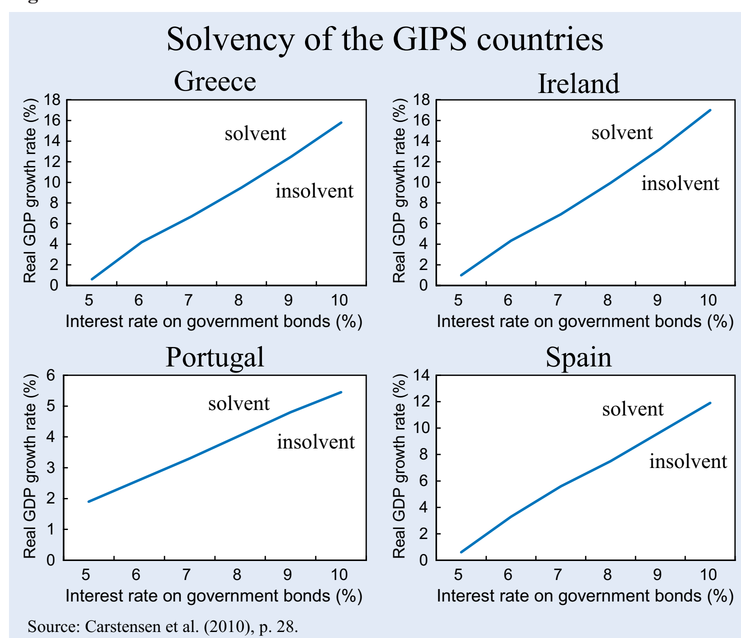
In the baseline scenario, in which financing costs were assumed to equal 5 percent and long-run growth to equal 2 percent, the public finances of all four countries are sustainable – assuming they will adhere to the Stability and Growth Pact. However, the required growth rate increases rapidly with increasing financing costs. Consequently an increase of the costs of borrowing from 5 to 6 percent does not endanger the countries' solvencies if long-term growth is able to reach 2.6 percent in Portugal, 3.3 percent in Spain, 4.2 percent in Greece and 4.4 percent in Ireland, instead of the assumed 2 percent. While these growth rates are in a range that still might be considered possible, although unlikely, an increase of the borrowing costs beyond 6 percent would especially bring Greece and Ireland, but also Spain, into a problematic situation; required long-run growth rates lie well beyond any values that appear realistic from today's perspective. Only Portugal seems to be capable of absorbing financing costs of, for instance, 8 percent.

Under current conditions, especially Greece and Ireland are unlikely to go back to the capital market without implementing additional measures that go far beyond those demanded by the European Union so far. This is, however, not implausible as both countries have lower tax and social security contribution ratios than e.g. Germany. Hence, some scope for higher taxes and social security contributions exists. The situation is most extreme in Ireland where the tax and social security contribution ratio is 11 percent below the German one. This means that Ireland could sustain an additional public debt of 200 billion euros at the currently prevailing interest rate if it had the tax and social security contribution ratio that Germany has. This sum is four times larger than the estimated costs of recapitalizing the Irish banking sector.[3)]

[3)] See Sinn (2010).

Also in *Spain*, the government has made significant consolidation efforts to counteract the loss of confidence in financial markets. The government's goal is to reduce its deficit of 11.1 percent of GDP in 2009 to first 6 percent in 2011 and subsequently 3 percent in 2013. To achieve this, a comprehensive austerity package was decided upon in May last year. It included a freeze of wages for civil servants and foremost massive cuts in public investment spending. Moreover, VAT was raised by 2 percentage points in mid-2010. Although considerable progress in consolidating public budgets has been made, the Spanish government will fall short of its objectives. Particularly due to the spending cuts and an increase in tax revenues, Spain was able to reduce its public deficit significantly last year. However, the burden of rising unemployment

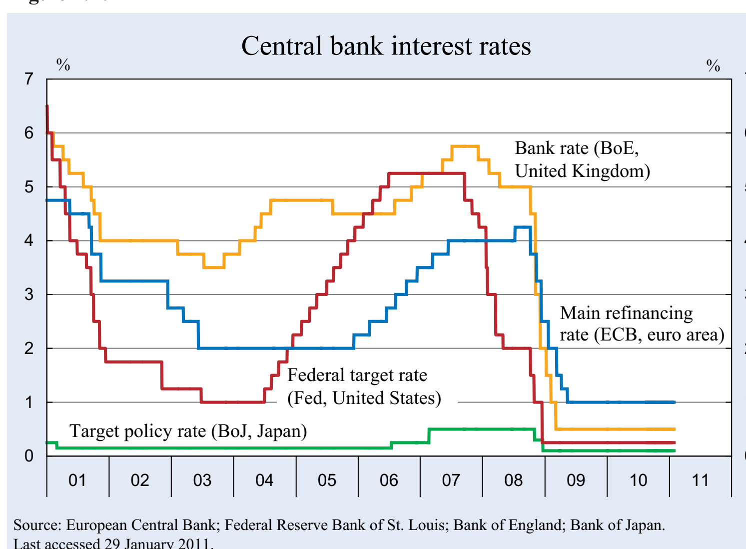
Figure 1.19



Source: Carstensen et al. (2010), p. 28.

and a weak economy continues to be a drag on public finances. The government deficit is expected to have fallen to 9.3 percent of GDP last year and will be reduced further to 6.4 percent this year. Consequently, the debt-to-GDP ratio is expected to rise from 53.2 percent in 2009 to 64.4 percent last year and 69.7 percent this year. The ongoing consolidation of savings banks, which might imply additional financial means to go into the bank rescue fund FROB, poses a significant risk to public finances in Spain.

Figure 1.20



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan. Last accessed 29 January 2011.

1.3.2 Monetary conditions and financial markets

Monetary conditions

Compared to the pre-crisis situation, central banks are now forced to keep an eye strongly focused on the stability of the financial system. Although at first glance the European sovereign debt crisis is about illiquidity or potential insolvency of individual member states, the interconnectedness in terms of cross-holdings of sovereign debt within the European banking sector also makes it a concern of inner-euro-area financial stability. Although progress has been made, it is feared that the banking system is still not capitalised well enough to withstand a debt restructuring.

The underutilisation of resources in most economies will keep inflationary pressures low, and although the large amounts of liquidity provided by central banks have raised fears that at some stage higher inflation will be inevitable, medium-term inflation expectations, at least in the euro area, remain well anchored below 2 percent.

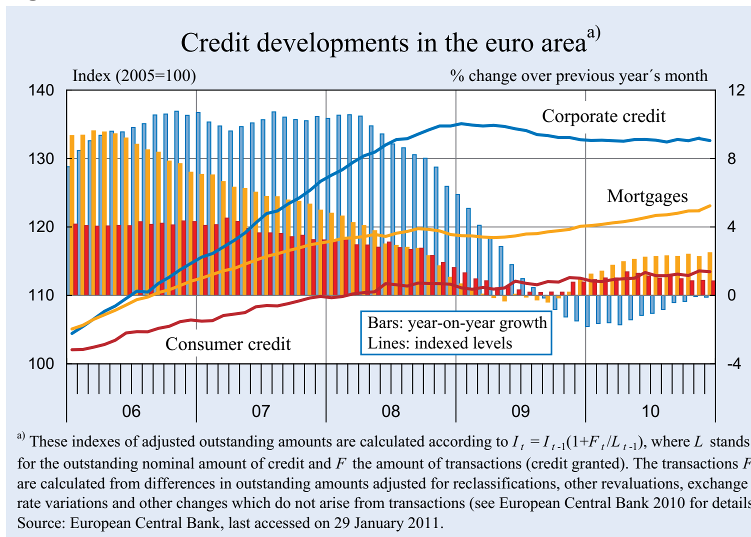
For these reasons monetary policy has remained very accommodative throughout 2010. The European Central Bank (ECB) has maintained its low interest rate policy and left the main refinancing rate at 1 percent throughout 2010 (see Figure 1.20). Open market operations were still carried out as fixed rate tenders with unlimited allocation of funds. Hence, the ECB kept on providing unlimited liquidity to the banking sector. However, the demand for euro operations, in particular with longer maturities, significantly decreased. As part of the Securities Markets Programme initiated in May 2010 to address tensions in particular securities markets, the ECB has so far bought government bonds worth around 75 billion euros. The additional liquidity thereby supplied has been completely neutralized by the simultaneous collection of fixed-term deposits with a weekly maturity.

Especially during the first half of last year, money market rates kept on indicating a limited functionality and associated segmentation of interbank markets. Both the reference rate for short-term interest rates (EURIBOR) and the effective overnight interest rate (EONIA) remained well below the main refinancing rate. However, since summer, these rates have been rising, but, relative to the main refinancing rate of the ECB, are still at low levels.

Private credit growth remained moderate last year. Only credit volumes of housing loans showed a steady increase throughout the year (see Figure 1.21). Consumer credit and loans to non-financial corporations, on the other hand, basically stagnated and compared to the average of 2009 even fell slightly. According to the ECB's bank lending survey, banks expect a stable net tightening of credit standards for enterprises, a slight net easing of credit standards for housing loans and a more sizeable net easing in consumer credit.

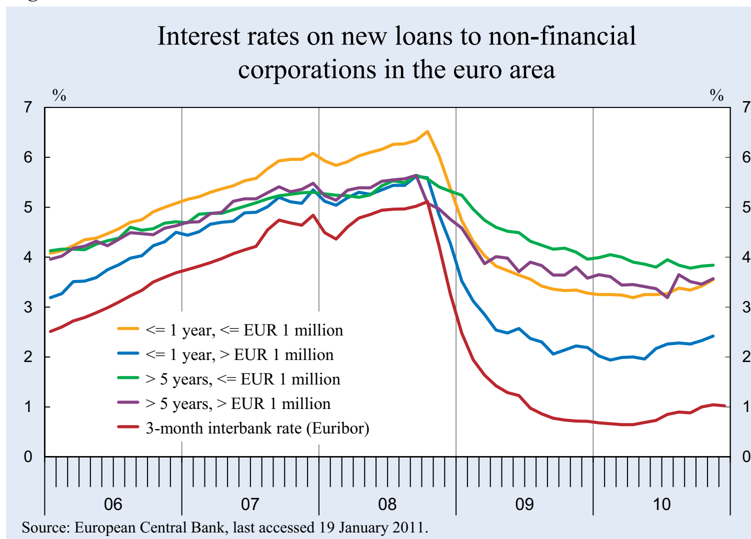
The relatively stable interest rates on money markets are also reflected in overall stagnating lending rates for the non-financial sector (see Figure 1.22). Whereas the interest rate on long-term loans managed to fall slightly over the course of the year, in recent months

Figure 1.21



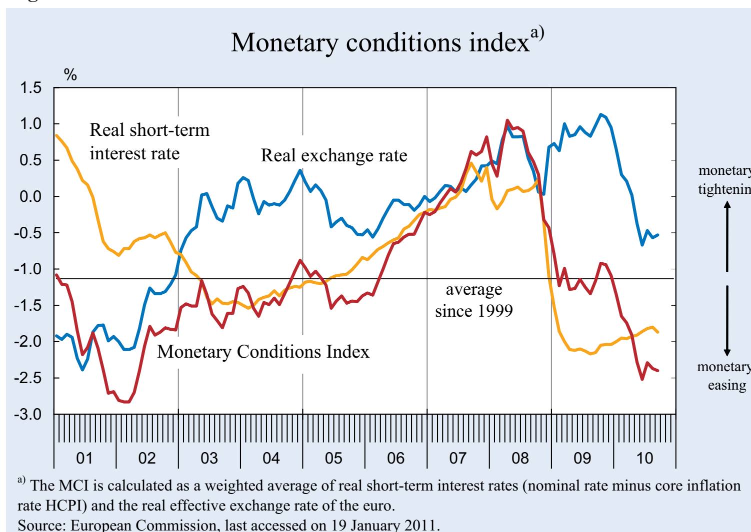
[a)] These indexes of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1+F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank 2010 for details).
Source: European Central Bank, last accessed on 29 January 2011.

Figure 1.22



Source: European Central Bank, last accessed 19 January 2011.

Figure 1.23



[a)] The MCI is calculated as a weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.
Source: European Commission, last accessed on 19 January 2011.

interest rates on loans with shorter maturities have started to pick up somewhat and surpassed levels seen early last year.

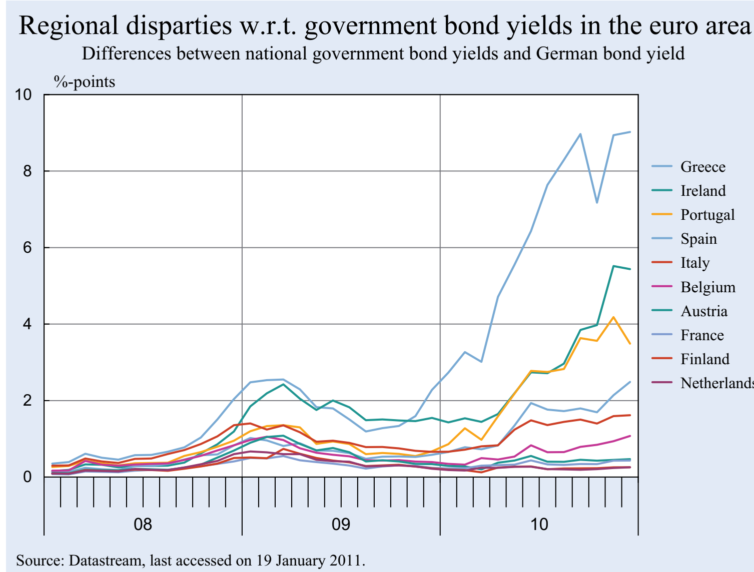
The sharp nominal and real depreciation of the euro during the first half of 2010 was only partly reversed during summer and autumn. During the winter months the euro again lost value against the dollar. Overall this has further loosened monetary conditions within the euro area considerably (see Figure 1.23).

For the time-being the ECB will leave the main refinancing rate at its current level of 1 percent. By no longer conducting open refinancing operations using maturities beyond one month and moving away from fixed rate tenders with full allotment probably in April, it is scaling back its use of non-standard monetary policy measures. When this comes to a stop in autumn, this will slowly reverse the substantial increase in narrowly defined concepts of money that has been observed since October 2008. As the economic recovery in the euro area is expected to gain some momentum again in the course of the year and beyond, it is likely that the ECB will increase its key rates by 25 basis points by the end of this year. For this reason, money and capital market interest rates are expected to slowly increase further.

Bonds, stocks and foreign exchange markets

Since 2008, the European government bond yields have moved significantly apart. Initially, this largely reflected a surge towards safe assets. After spreads fell somewhat during summer 2009, those of Greece, Ireland, Portu-

Figure 1.24



Source: Datastream, last accessed on 19 January 2011.

gal and Spain started to increase sharply again in spring last year (see Figure 1.24). The current high interest rate spreads for the peripheral countries are primarily due to an increase in their default probabilities. With a spread between its government bond yield and the German one of more than 900 basis points, as it was in December last year, financial markets assume that Greece is likely in future to default on its outstanding government bonds.

After the funding problems of Greece had become more and more pressing in April 2010 and a stand-alone solution for Greece was found, the finance ministers of the euro-area member countries agreed in May together with the IMF on the establishment of an emergency fund, the European Financial Stability Facility (EFSF). This facility amounts to up to 750 billion euros and is intended to restore confidence in government bonds markets. Immediately thereafter, the ECB adopted a programme to purchase government bond in the secondary market, the so-called Securities Markets Program (SMP).

Although de jure compatible with the statutes of the ECB, the SMP is not in line with the spirit of the Maastricht Treaty, as it facilitates the financing of budget deficits of countries in the euro area. Not only does this jeopardise the independence of the ECB in the future, the timing of its introduction has already led to discussions about its independence today.

After Greece had to request financial assistance in May last year, Ireland – due to largely political pressure – was forced to be the first country to draw upon the EFSF. The loans granted to Ireland add up to about 85 billion euros. As Ireland would have had sufficient funding up to mid-2011, it did not seek help itself. However, the interconnectedness of Irish and other European banks led the European Union to urge Ireland into the EFSF. Given the increased yields on Portuguese government bonds and country risk spreads, it seems only a matter of time before Portugal will also be put under the shield of the EFSF.

The size of the EFSF is clearly sufficient to deal with liquidity problems of these smaller economies. However, questions did arise as to whether the wings of this facility are large enough to be also able to offer sufficient shelter to larger economies if deemed necessary. The spreads on government bonds of Spain and Italy have increased significantly. If financial markets do not have sufficient confidence in the future fiscal course of – first of all – Spain, then refinancing costs will become much more expensive in the future. Hence, despite the support of Ireland, the sovereign debt crisis in Europe is far from over. It will be put to a test when Spain has to roll over part of his debt in 2011. Also the recent decision by EU finance ministers to introduce a new and permanent crisis mechanism in case of government default by having collective action clauses in future bonds was not really able to calm financial markets. The agreed terms will only apply from 2013 onwards and it will presumably take another six to eight years until the majority of the bonds will contain such clauses (see Chapter 2).

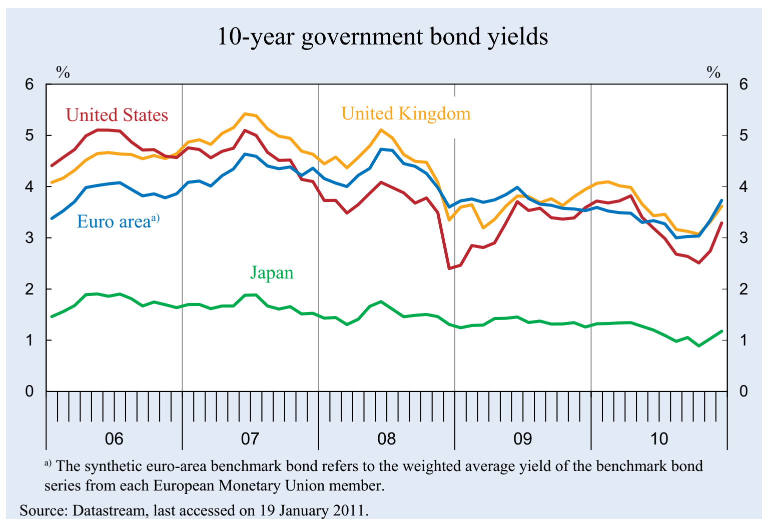
Independent of this surge in risk premiums, long-term government bond yields have started to increase after reaching a trough in September/October 2010. By the end of the year, the German yield on government bonds with a maturity of 10 years had increased by close to 60 basis points. Similar patterns can be observed for the United States, the United Kingdom and the aggregate euro area (see Figure 1.25). Albeit less pronounced, Japanese yields moved in the same direction. The average return on 10-year European corporate bonds, since its trough in September, had increased by 80 basis points by the end of last year.

The financial crisis caused all major stock markets to drop by around 50 percent as compared to their peaks in 2007. Troughs were reached in early 2009 and markets have since recovered to different extents (see Figure 1.26). After stock markets experienced a substantial setback during summer last year, they improved again. In the United States and in the United Kingdom, the end-of-year rally allowed stock markets to further steadily approach their pre-crisis levels. In contrast, Japanese and European markets overall no more than stagnated last year.

The euro exchange rate against the US dollar remains volatile. Coming from levels around 1.50 US dollars in December 2009, the euro first depreciated to below 1.20 in June last year to then gain values of around 1.40 again in November (see Figure 1.27). By the end of last year, it returned to about 1.30 US dollars. The weakening of the euro especially during the first half of last year was associated with the flaming up of the European sovereign debt crisis. In a historical perspective, however, its value in both nominal and real terms is still well-beyond levels seen during the first years of this century.

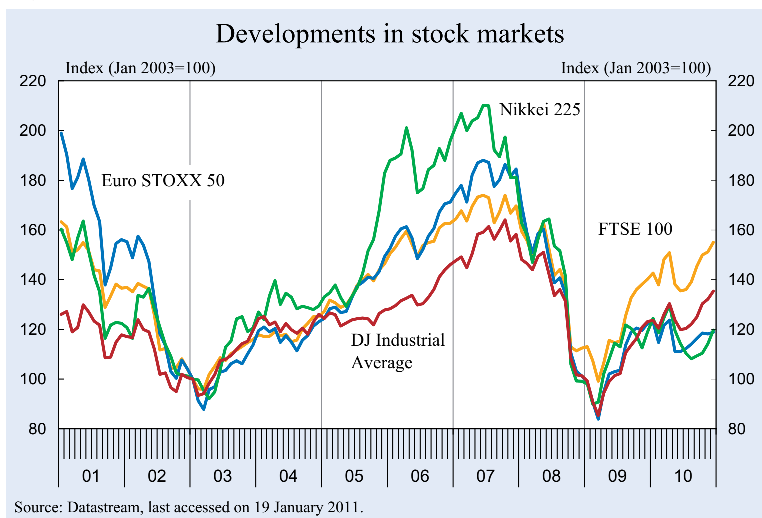
From a somewhat longer perspective of 10 years, of the larger currencies in the world, especially those of the United Kingdom and the United States appear to be relatively weak. As a safe haven currency, the Japanese yen has gained value again during the crisis. Also during the second half of last year it strongly appreciated again against its trading partners. The

Figure 1.25



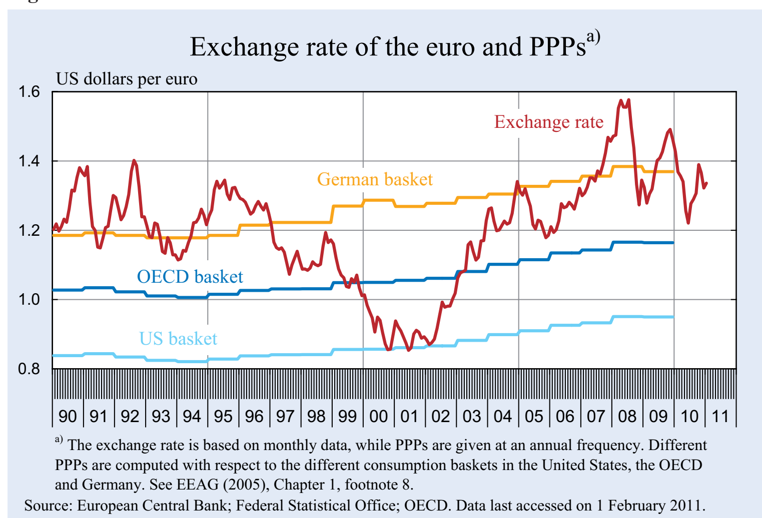
a) The synthetic euro-area benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream, last accessed on 19 January 2011.

Figure 1.26



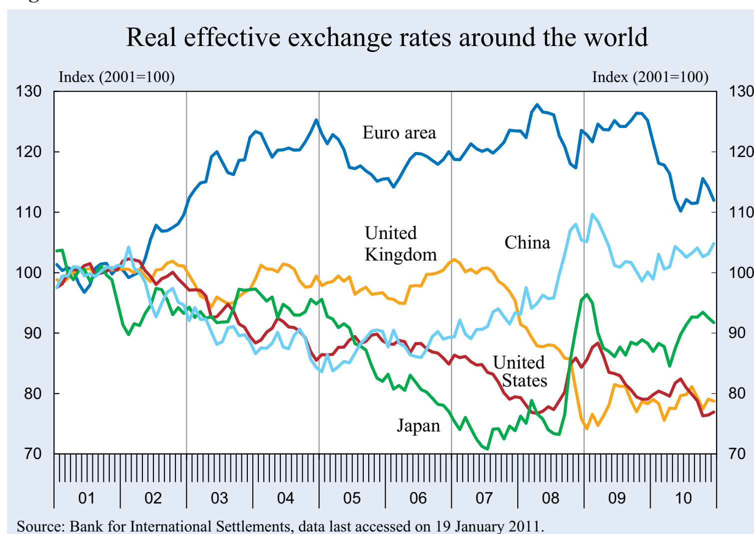
Source: Datastream, last accessed on 19 January 2011.

Figure 1.27



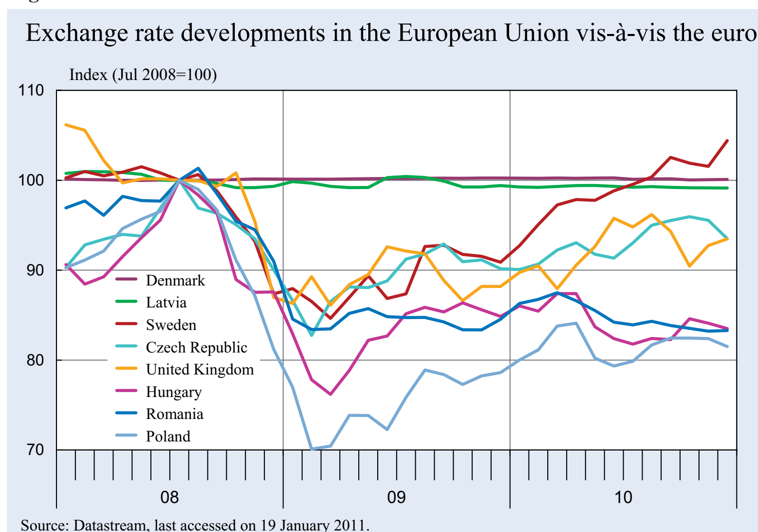
a) The exchange rate is based on monthly data, while PPPs are given at an annual frequency. Different PPPs are computed with respect to the different consumption baskets in the United States, the OECD and Germany. See EEAG (2005), Chapter 1, footnote 8.
Source: European Central Bank; Federal Statistical Office; OECD. Data last accessed on 1 February 2011.

Figure 1.28



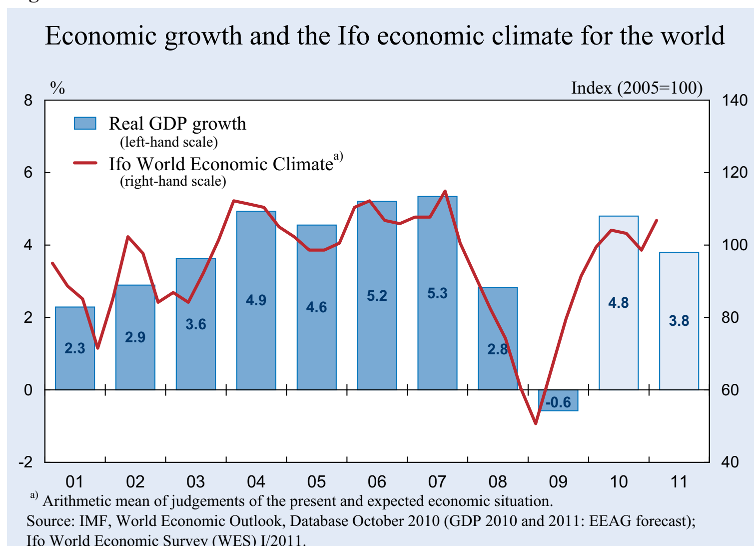
Source: Bank for International Settlements, data last accessed on 19 January 2011.

Figure 1.29



Source: Datastream, last accessed on 19 January 2011.

Figure 1.30



a) Arithmetic mean of judgements of the present and expected economic situation.
Source: IMF, World Economic Outlook, Database October 2010 (GDP 2010 and 2011: EEAG forecast); Ifo World Economic Survey (WES) I/2011.

Chinese renminbi shows a steady real increase in its value since early 2005 (see Figure 1.28).

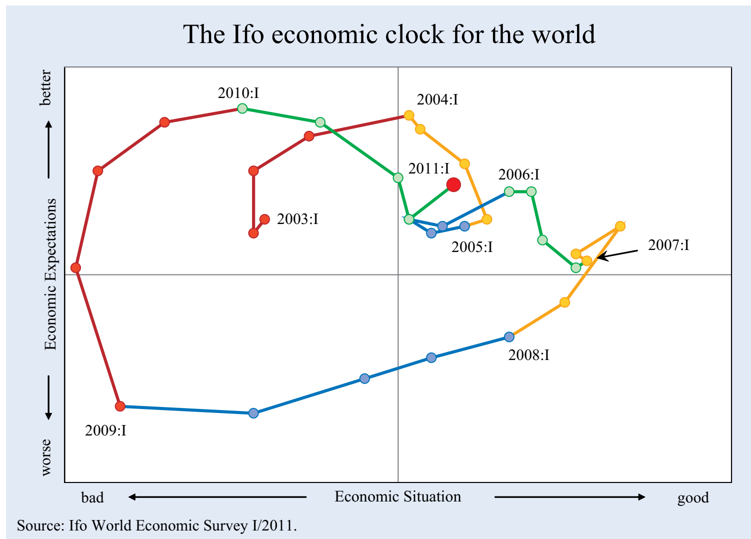
Within Europe, exchange rates did not move in a synchronised way. Although most of the European countries that do not have their exchange rates directly linked to the euro saw an appreciation vis-à-vis the euro last year, this does not hold for all of them (see Figure 1.29). Throughout the year the currencies of Romania and Hungary even depreciated slightly. Especially Sweden, which also reached its pre-crisis GDP again, witnessed a strong appreciation. The depreciation of these countries against the euro during the recession has helped cushion the crisis in those economies. Figure 1.13 shows that the Baltic states – all having their exchange rate fixed to the euro – experienced the strongest impact of the crisis.

1.4 Macroeconomic outlook

1.4.1 The global economy

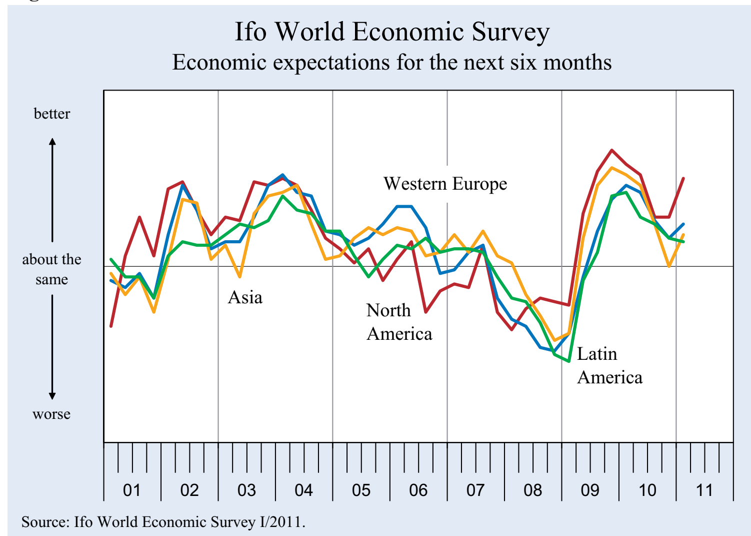
Whereas economies during the first half of last year still benefited from stimulus measures as well as from a rebound in inventories and a general recovery of the economic climate, most regions of the world recently witnessed some slowdown in economic growth. This pattern is also clearly reflected in the Ifo World Economic Climate (see Figure 1.30). This indicator first peaked in the second quarter of 2010 and fell during the subsequent two quarters. This drop was solely caused by a fall in expectations. As Figure 1.31 shows, the economic situation kept on improving throughout

Figure 1.31



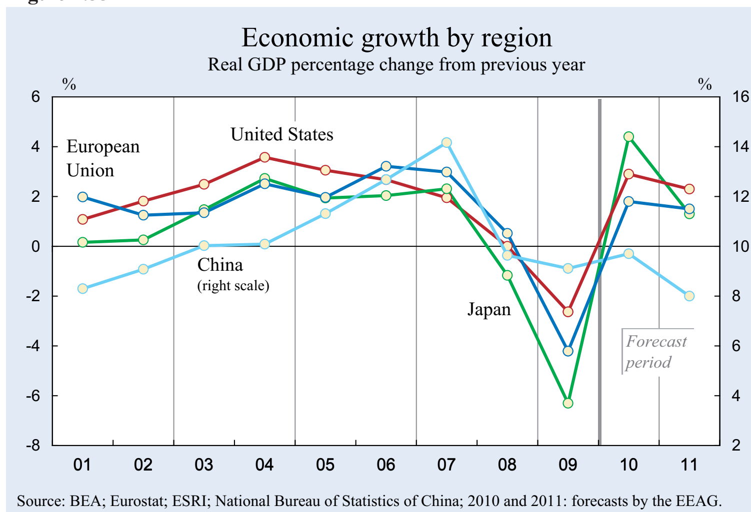
Source: Ifo World Economic Survey I/2011.

Figure 1.32



Source: Ifo World Economic Survey I/2011.

Figure 1.33



Source: BEA; Eurostat; ESRI; National Bureau of Statistics of China; 2010 and 2011: forecasts by the EEAG.

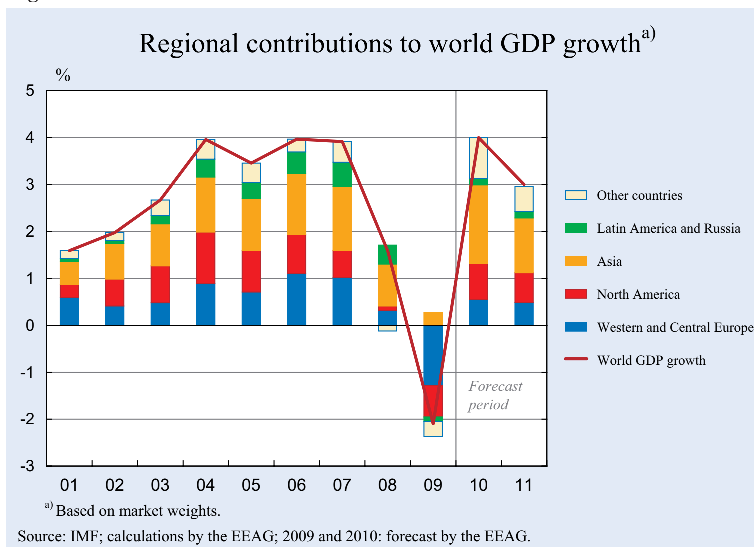
Expectations have turned causing the overall indicator to rise again in the first quarter of this year.

After having skyrocketed in all major regions of the world economy towards winter 2009/10, expectations did until recently decline. Especially in Asia, after having climbed to a historical high, the fall has been substantial. However, as in Europe and in North America, a turnaround has been achieved in the first quarter of this year: the economic conditions in half a year time are expected to improve again (see Figure 1.32). Only in Latin America this fall has not been stopped.

Although many structural problems remain unsolved or have been transferred to the public sector, the uncertainty concerning economic developments has again diminished somewhat. Nevertheless, it remains significantly higher than in the years before the run-up to the crisis. Although the huge fiscal stimulus measures together with the very expansionary monetary policy stance helped end the recession in 2009, they have now also turned into the root of the current problems. It is difficult to predict how the sovereign debt crisis in Europe and the unsustainable fiscal developments in the United States will evolve.

Austerity programmes in Europe and the phasing out of fiscal stimulus measures in the United States are not the only reasons for the current slowdown in economic growth. The inventory cycle that was triggered by the liquidity search of firms caused by the deleveraging process during the crisis has ended and will hence no longer give the strong positive

Figure 1.34



[a] Based on market weights.

Source: IMF; calculations by the EEAG; 2009 and 2010: forecast by the EEAG.

impulses to the world economy as it still did during the first half of last year.

After a strong growth last year, we expect world GDP to increase by 3.8 percent in 2011, using purchasing-power-parity adjusted weights to aggregate the economies. Using market prices, world economic growth will reach 3 percent. In either case, world economic growth will fall back to what can be considered its long-run average.

Not all regions will contribute equally to this development. Of the four largest economies, Japan shows the highest level of volatility – after strong growth last year, it will witness, as compared to the other regions, a relatively strong decline in its growth rate (see Figure 1.33). Nevertheless, we expect that Asia will once more deliver the strongest contribution. The two larger economic areas, North America and Europe, will remain below their potential (see Figure 1.34).

1.4.2 United States

Although a double-dip scenario is not likely to materialise, growth will slow down somewhat. The continued low capacity utilisation rate and the remaining problems on real estate markets and consequently within the banking industry will allow a further decline in inflation rates. The inflation rate will turn out to be around 1.3 percent this year (after 1.6 percent in 2010). To prevent the burgeoning threat of deflation and to shore up the sluggish economic recovery, the Federal Reserve already decided in November of last year to further increase its purchases of government bonds (Quantitative Easing II). It intends to buy government bonds worth nearly 900 billion US dollars on the bonds market during the period November 2010 to June 2011. Not before mid-year do we expect the Fed to slowly initiate an interest-rate-increase cycle. Hence it will stick to a very expansionary course throughout the year.[7]

The additional purchases of government bonds will partly suppress the upward pressure on long-term interest rates and will thereby reduce the financing costs of the US government budget deficit. After the decision was taken in December 2010 to extend the tax breaks introduced during the Bush era, fiscal policy is likely to turn expansionary again, with a budget deficit approaching 10 percent of GDP in fiscal 2011. Despite the already strong increase in government debt – it surpassed 90 percent in relation to GDP last year and is bound to increase beyond 100 percent this year – the US government has time and again made clear that it is determined to stimulate economic growth. The expansionary impulses, however, will further increase the already great pressure to consolidate the government budget and will thus significantly weigh on the economic outlook for the years to come. They also increase the risk that financial markets will begin to question the high credit ratings of the United States.

Besides the structural problems the US economy is facing, also some short-term factors will put a drag on growth. First, despite the weak US dollar, exports will suffer from the slowdown in world trade growth. Second, the build-up of inventories has accelerated steadily since the beginning of last year. This has ended by now and will subsequently have some growth-dampening effects.

[7] Low interest rates and a weak US dollar are already leading to what might turn out to be unsustainable developments in particular sectors. Raw material prices expressed in US dollars have risen substantially. The resulting boom in agricultural trade – the US trade surplus in agricultural products turned out to be around 40 billion US dollars in 2010 – combined with low interest rates have triggered a strong increase in agricultural land prices in the Midwest. During the second half of the 1970s, expansionary monetary policy also led to high agricultural land prices. Subsequently, during 1981–1985 the Midwest experienced its most severe agricultural crisis since the Great Depression. Tens of thousands of farmers had to give up because of unsustainable debt levels; their farms were foreclosed.

The current private domestic investment share (13 percent) is well below its 30-year average of 16 percent. Furthermore, interest rates will remain low and profits, in particular of large corporations, are currently high. Hence, there is a potential for investment growth to pick up. However, while the ISM purchasing managers' index – which focuses on large companies – has reached elevated levels again, the NFIB indicator with its focus on small- and medium-sized enterprises (SMEs) has only slightly recovered from its all-time low. Hence, the general uncertainty that still prevails in particularly in SMEs is likely to keep investment growth suppressed. In addition to the continuing bleak sales and earnings outlook, SMEs suffer from their greater dependence on bank loans. Traditionally, especially smaller banks provide these loans. However, these continue to suffer from write-offs and losses on real estate mortgages and therefore are forced to limit their lending activities. As noted above, still high foreclosure rates and low demand for real estate properties indicate that this situation is not bound to improve soon. Hence, financial constraints will remain in place for many SMEs. In previous recovery periods, it was precisely this business segment that was responsible for about two-thirds of the newly created jobs. Currently, however, the investment and employment plans of these companies remain close to their lows during the crisis.

Another important factor on the part of labour supply that also speaks against a rapid decline in unemployment is the participation rate. It has declined significantly and reached its lowest level since the mid-1980s. Many of the discouraged workers have most likely only temporarily left the job market and will, with improved employment prospects, be returning to it.[8] Due to this and moderate economic growth, the unemployment rate will decline only slightly and will average 9.5 percent this year (after 9.7 percent in 2010).

The persistently tense labour market situation that will also restrain income growth of households is likely to prevent private consumption from expanding faster than what we have seen last year. Furthermore, households still face high financial losses as a result of the real estate and financial crisis. They are also in the process of gradually reducing their debt positions in view of future interest rate increases. Finally, the temporary support of private consumption via extended unemployment benefits and other stimulus measures will ultimately have to be cut back. To cope with all this, private saving rates will continue to remain relatively high.

Overall, economic growth in the United States is expected to decelerate somewhat. GDP is likely to increase by 2.3 percent this year (after 2.9 percent in 2010).

1.4.3 Asia

In *China* growth is expected to slow down further. The risks in the housing market and rising inflationary pressures will prompt monetary policy to become more restrictive. Additional interest rate increases are expected. Furthermore, weak demand from the United States and the slow appreciation of the renminbi will affect the important Chinese export sector.

China's trade surplus will remain at a high level. However, a gradual reduction is to be expected. On the one hand, world trade growth will stabilise at a lower level given the expected economic slowdown in the advanced economies. In addition, the gradual appreciation of the Chinese currency relative to the US dollar will continue and – together with stronger price and wage developments – will slowly deteriorate Chinese competitiveness.

On the other hand, the outlook for the domestic market is still quite optimistic. Although growth will continue to slow down further, as the restrictive monetary policy measures will have negative effects particularly on investment activity, private consumption growth will further increase. The favourable situation on the labour market will lead to solid wage increases. Although growth of investment in housing and public infrastructure will be slower than last year, the expansion is likely to continue and to support growth. As the price increases in the property sector are partly a result of a lack of alternative investment possibilities, a collapse in the housing market is unlikely. Overall, the Chinese economy is expected to grow by 8 percent this year which implies a slight decrease as compared to last year (9.3 percent).

This winter, private consumption, which has been particularly strong during the recent quarters, will put a burden on the recovery in *Japan*. The phasing out of fiscal measures will lead to a contractionary

[8] During the crisis years 2008 and 2009, about 8 million jobs were lost. Last year, 1.4 million were created. At the same time, however, the working age population of the United States increased by 1.9 million. To keep the unemployment rate constant, about 0.5 million persons had to leave the labour force last year alone.

rebound effect. On top of that, the positive impulses stemming from foreign trade, which – together with private consumption – were the key forces during the boom of recent quarters, will decrease considerably. Besides the general slowdown in world economic growth, mainly the sharp appreciation of the yen will dampen exports. For these reasons, a temporary stagnation of the Japanese economy over the winter term is expected.

Both the government and the central bank are trying to counteract this slowdown in economic momentum. In November, the government put forward a renewed stimulus package worth 5 trillion yen (about 44 billion euros). However, at the time of writing it was still questionable whether – given the huge government debt – this proposal will receive the required approval from Parliament. The central bank in turn is under public pressure to resolve the still-smouldering deflation and to prevent further appreciation of the yen. To this end, it has set up another purchase programme for securities worth about 84 billion euros. For the first time since 2004, it also intervened directly in the foreign exchange market in order to weaken the yen.

These measures together with sustainable development in non-residential private investments are likely to assure that the stagnation during the winter will not result in a fall-back into recession. Order books have been recovering since mid-2009 and, thanks to rigorous cost-cutting programmes in recent years, the profit situation of companies is in a sound state.

The slow but steady improvement of the labour market situation will support future consumption and hence also benefit households. Finally, although the rapid catching-up process in many Asian economies has slowed down due to more restrictive fiscal and monetary policy measures, its growth will remain high enough to benefit the Japanese export industry. Overall, the continued global demand will be strong enough to support a sustainable development in investment activity and allow the labour market to revive – despite continuing deflation. Nevertheless, a significantly lower rate of expansion is expected for this year. GDP will grow by 1.3 percent (after 4.4 percent last year).

The outlook for *India* remains favourable, even though the exceptionally high growth rates of 2010 cannot be maintained. Survey results suggest continued optimism in the economy. For instance, indicators for the manufacturing sector have picked up again and increased significantly during the last quarter of 2010. Moreover, in 2010 – unlike the year before – the monsoon season was very favourable, which will result in a big harvest. Given the importance of the agricultural sector in India, this will have substantial effects on its business cycle.

In contrast, the tight monetary policy designed to contain inflation will have dampening effects on the economy. As at the end of last year the central bank already announced further hikes, more restrictive measures are expected. However, the strong appreciation of the rupee and the burden it puts on the export sector of the country will make it more and more difficult to implement any further steps.

Overall, the increase in economic activity will slow down somewhat during the year. Due to the strong endogenous dynamics of India's domestic demand, growth rates will nevertheless remain comparatively high. For 2011, the increase in GDP is expected to be 8.2 percent.

In the remaining emerging economies of Asia, i.e. *Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan* and *Thailand*, a reduction in growth dynamics is expected. First of all this is due to more restrictive monetary policies in these countries. For instance, to prevent inflationary overheating central banks in South Korea, Taiwan, Thailand and Malaysia already have increased their main rates repeatedly. Additional measures have already been announced. Second, the region will be impacted by declining growth in China, the main buyers of intermediate goods produced in these countries. Moreover, the high inflow of foreign capital in the region will put domestic currencies under appreciation pressure and therewith slow down export growth further. This year growth is expected to return to its long-term trend. GDP is expected to increase by 5 percent.

1.4.4 Latin America

In 2011 the Latin American region, i.e. *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*, is expected to grow by 3.9 percent, driven by sustained growth of domestic demand and supported by high raw material prices as well as solid macroeconomic fundamentals. Despite the slowdown, this is still somewhat above the long-term average for the region. Next to inflation, specific risks arise from the massive

capital inflows. An unexpected significant outflow could induce substantial short-term economic fluctuations. For Mexico, the weaker economic momentum in the United States will be of particular importance, since about 80 percent of Mexican exports flow into its neighbouring economy.

1.4.5 Assumptions, risks and uncertainties

It is assumed that the oil price will fluctuate at around 87 US dollars per barrel over the whole forecasting horizon and that the exchange rate of the euro will average around 1.33 US dollars this year. World trade is expected to increase by 5.9 percent this year, after having experienced a strong 11.8 percent growth in 2010. It is assumed that there will not be an escalation of the sovereign debt crisis in the euro area that would endanger its aggregate stability. The current level of uncertainty still witnessed in financial markets is expected to only slowly abate.

A particular risk to the forecast is based on the ongoing tensions in the markets for European government bonds. The forecast assumes that the European authorities have adopted sufficient emergency measures to prevent a future escalation and dramatic deterioration of the situation this year. Furthermore, it is assumed that the affected countries will be able to carry out the consolidation measures decided upon. A further massive increase in uncertainty in financial markets and continued concerns about the solvency of not only the currently affected peripheral countries could significantly increase the financing costs for all euro-area countries. The European Financial Stability Facility (EFSF) implies, if only temporary, a financial commitment by all member states. The associated loss in value of the outstanding debt would lead to further problems in the European banking sector. It would burden the balance sheets of many banks and could slow the recovery in lending activities, which could in turn jeopardise economic growth.

In addition, if larger countries are forced to draw upon the EFSF, then the present volume of 750 billion euros might prove to be insufficient. A possibly resulting restructuring of the affected public debt would increase the burden on the banking sector further. Fears exist that the European banking system is not well enough capitalised to withstand such a debt restructuring. Setting up an even more comprehensive insurance scheme could dampen growth prospects of countries at the core of Europe. Chapter 2 of this year's report proposes a way forward.

Another risk for global economic developments is another substantial correction in property prices in the United States. Although real house prices have fallen back to levels last seen around 2001 and have been relatively stable for almost two years now, some fear that there still is a potential of falling further. The rising supply of homes as a result of the high number of foreclosures and the continued slow demand as also indicated by the weak development of important leading indicators of construction activity could lead to further price corrections. This could trigger a further downward spiral in household wealth. Furthermore, given the still fragile equity situation of many banks, in particular small ones, this could hit the US banking sector particularly hard and thereby pose a liability to the United States and consequently the global economy.

A similar threat comes from the Chinese real estate market. The sharp rise in property prices as a result of government investment programmes in past years has some parallels to the development in the United States. Also in China, a significant proportion of portfolios of banks and firms consist of real estate assets. A sharp price correction would curb the expansion of the Chinese economy significantly and – given the increased importance of China as a sales market – could jeopardise growth in the rest of the world.

Of course, there are also upside risks to our forecast. In particular, for the United States we take a cautious position. The Quantitative Easing II programme of the Federal Reserve and the recently initiated additional stimulus measures of the federal government may not only be able to stabilise the banking sector but may also induce firms to start investing more strongly in the future of the US economy. The non-farm corporate sector is currently sitting on large amounts of liquid assets, enjoys wide profit margins and can borrow at historically low costs. A mood swing to the better would also improve labour market conditions significantly and thereby further promote private consumption.

Also with respect to Europe, a mood swing, this time on financial markets, could create a more optimistic growth scenario. Although it is our belief that the debt crisis in the European periphery is far from resolved and hence uncertainty and speculation remain key factors on government bond markets,

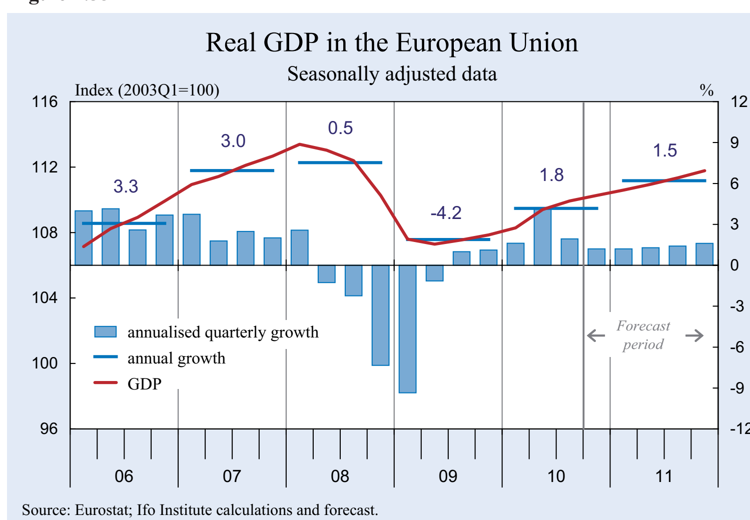
decisive and convincing action of government authorities might calm down financial markets more than currently expected.

1.4.6 The European economy

The cyclical situation

Although the recovery in the European Union is set to continue, it will initially lose momentum in 2011 (see Figure 1.35). Responsible for this is the current slowdown in global economic growth and the increasingly restrictive fiscal policy environment. Some leading indicators already point towards such a development during the winter of 2010/2011. Relative to early 2010, Ifo World Economic Surveys indicate that expectations have deteriorated (see Appendix 1.B). Furthermore, the inventory cycle will barely give any positive impulses. Throughout the year, and as indicated by the most recent Ifo World Economic Survey, the European economy will be on the mend again, in spite of continuing public saving efforts. All in all, it is expected that GDP in the European Union will increase by 1.5 percent this year, after 1.8 percent in 2010.

Figure 1.35



Source: Eurostat; Ifo Institute calculations and forecast.

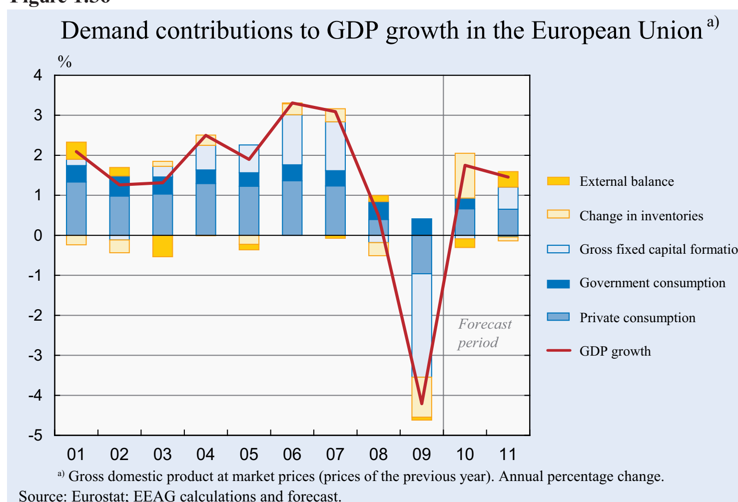
Net exports will contribute positively to growth (see Figure 1.36). Later this year, the gradually recovering world economy will foster exports, whereas the relatively weak performance of domestic demand will cause imports to increase more slowly. Exports of export-oriented member states like Germany and Finland are likely to increase at an above-average pace. Countries with lower relative competitiveness levels are likely to benefit to a much lesser extent from the continuing global economic recovery, the pace of which however has slowed down.

The recovery of exports will also lead to a strengthening of private investment in 2011. Several other factors are also likely to have a positive impact on private investment. For instance, the ECB interest rate policy will remain expansionary throughout the year, thus sustaining, particularly in the core countries of the monetary union, the low refinancing cost of firms. Also, lending standards of banks are likely to slowly normalize with the advancing clean-up of their balance sheets. Furthermore, the improved profit situation of firms should strengthen investment incentives. However, public investment will remain weak due to the consolidation efforts of governments.

Employment, sectoral output and inflation

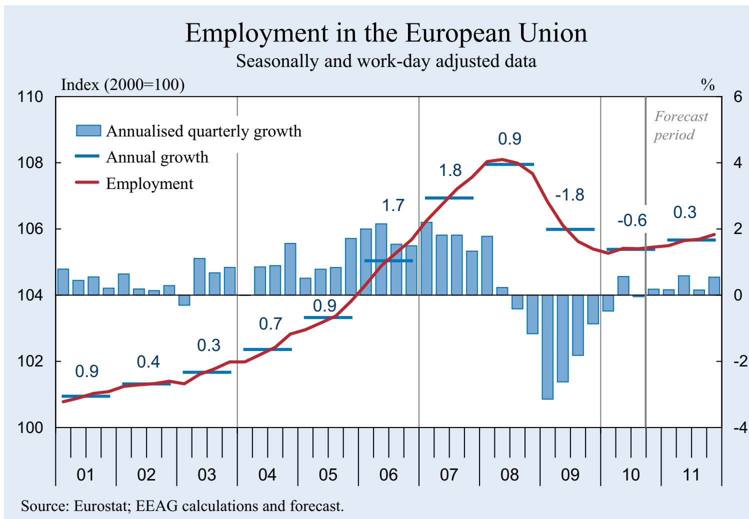
Labour markets usually react with some delay to changes in economic developments. Firms do not immediately reduce employment or hire additional personnel when the environment in which they operate unexpectedly changes. Due to its lagging characteristic, employment in the European Union reached its trough early last year (see Figure 1.37). Albeit very moderate, employment growth has been posi-

Figure 1.36



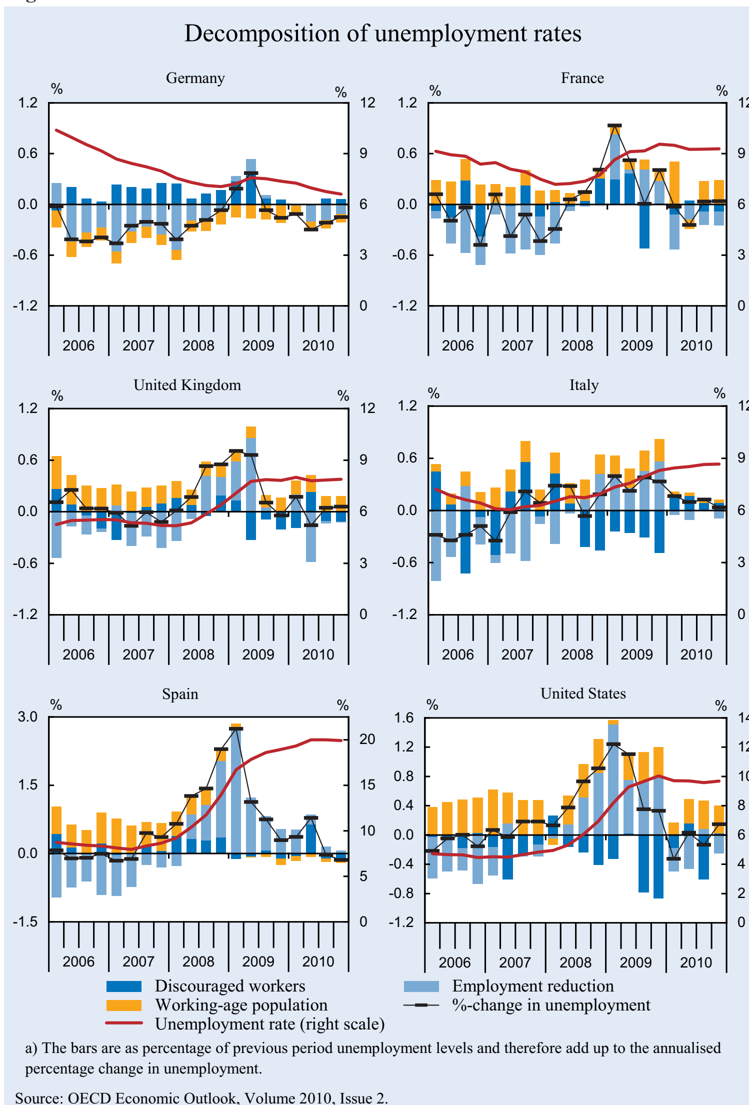
a) Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; EEAG calculations and forecast.

Figure 1.37



Source: Eurostat; EEAG calculations and forecast.

Figure 1.38



a) The bars are as percentage of previous period unemployment levels and therefore add up to the annualised percentage change in unemployment.

Source: OECD Economic Outlook, Volume 2010, Issue 2.

tive since then. Nevertheless, the unemployment rate continues its slight upward trend. This highlights that it is not sufficient to look only at employment movements, i.e. the demand side of the labour market, to forecast unemployment developments. Supply-side considerations also need to be taken into account. Hence, a more detailed analysis is worthwhile. For this we need to introduce labour force developments and developments of the working-age population, i.e. the potential labour force. A decrease in the number of unemployed persons can, per definition, then be decomposed into the increase in the number of people employed, the reduction in the working-age population and the increase in the number of discouraged workers. The latter group consists of those that decide to leave the labour force but do not leave the group of working-age population.

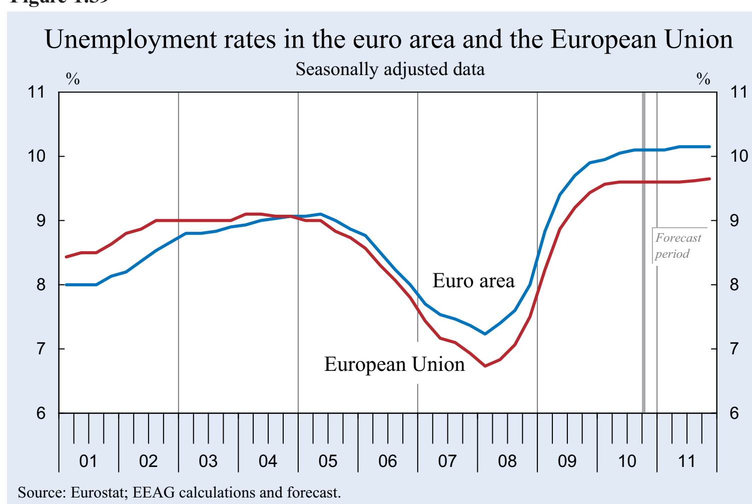
Figure 1.38 shows this decomposition for the large European countries and the United States in recent years. It becomes obvious that, besides developments in employment, also demographic factors and the movement in and out of the labour force can be quite important for understanding unemployment statistics.

For instance, in Italy, the number of unemployed workers went up by approximately 540 thousand from the second quarter of 2008 until the end of last year. At the time, employment declined by about 490 thousand people. This implies an increase in the labour force of 50 thousand persons. However, Italy also experienced an increase of 440 thousand persons in its working-age population. There-

fore, since the start of the crisis, on top of the change in unemployed workers, 390 thousand additional persons have resigned or decided to not enter the Italian labour force. In essence similar stories can be told for Finland, Ireland, the Netherlands, Portugal, Sweden and the United Kingdom. All of these countries have experienced a strong withdrawal from the labour market and therefore a significant reduction in labour force participation rates. It is likely that many of these discouraged workers have only left the labour market temporarily and will return when economic conditions improve again. Hence, although employment might pick up in these countries, this will not necessarily mean that unemployment will fall as quickly.

This phenomenon of a sharp increase in discouraged workers hardly exists in countries like France or Spain. In Spain it is striking that the working-age population has stopped increasing. A possible explanation is that net migration into Spain has declined or even turned negative. In light of this, the German labour market story has to be corrected somewhat as well. Although it is indeed true that – as compared to other countries – not many jobs were lost during the crisis, the overall downward trend in unemployment figures are also at least partly a consequence of a declining population. It is the only European country that has shown a consistent decline in its working-age population since the turn of the century. Nevertheless, together with Poland, it is at the same time the only European country that has seen a significant increase in the share of employed person in the working-age population since 2008. Demographics alone are certainly not able to explain labour market developments in Germany.

Figure 1.39



On the European level, these changes in labour force participation coupled with the slowdown of the economic recovery will most likely keep the unemployment rate from falling. It will reach an average of 9.7 percent in the European Union this year (see Figure 1.39).

Developments of individual sectors will continue to remain different. It is important to distinguish between sectors that focus on the domestic market and those that are export-oriented. The export-oriented sector will depend heavily on the markets on which these focus. Although growth will also significantly slowdown in the emerging markets, these markets will structurally continue to outperform those of more advanced economies. Development of sectors that are largely domestically oriented will very much depend upon the home market. Regional dispersion will remain high if not increase this year. Although the recovery in many other sectors started in mid-2009 and will slowly continue this year, the output of the construction sector is likely to stagnate.

On average, consumer prices will rise to a similar extent as last year, i.e. 1.7 and 1.8 percent in the euro area and European Union, respectively. After an increase during the winter months, it will come back to levels below 2 percent. More moderate growth dynamics will retard the slight upward tendency in core inflation observed in recent months.

Differences across Europe

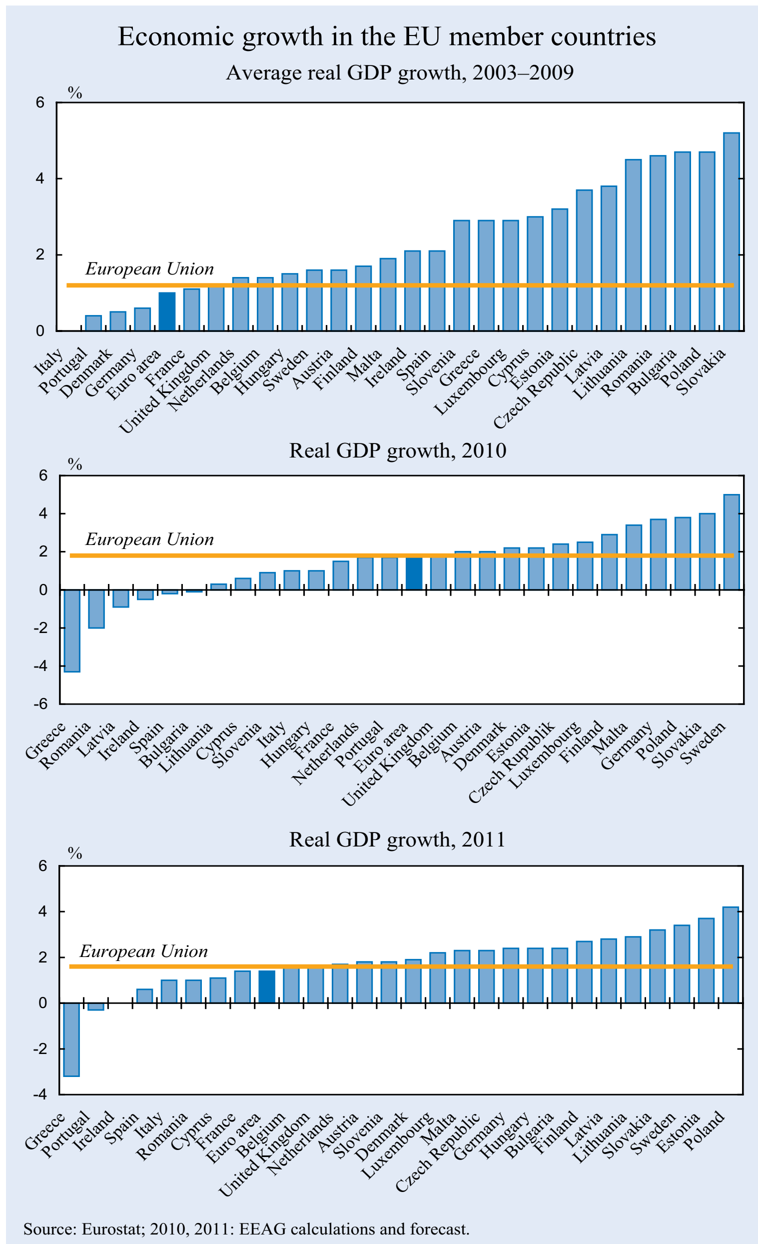
The differences between the individual member countries remain substantial (see Figure 1.40a). In export-oriented countries with relatively sound public finances and without too many structural problems such as Sweden, Finland, Germany, Denmark, Austria and the Netherlands, growth is expected to be above average. Unemployment is likely to fall during the year. In the European periphery, however, the massive crisis and the need for consolidation of public and private budgets will continue to dampen growth (see Figure 1.40b). The recovery will only come slowly, as in Italy Spain and Ireland, or the economies will remain in recession, as in Greece and Portugal. In all of these

countries, including the United Kingdom and Belgium, the labour market situation will worsen (see Table 1.A.2 in Appendix 1.A).

Next year, the *German* economy is likely to grow at an above-average rate. Favourable income prospects, job security and low interest rates will support private consumption and residential investment. The favourable financing conditions and good market prospects in Germany and – due to the weak euro – also in the rest of the world will stimulate private investment in machinery and equipment. Nevertheless, growth will probably be considerably less than last year. First, impulses coming from the world economy will abate. The strong world inventory cycle resulting from the financial crisis will have ended. Foreign trade will therefore, unlike last year, no longer provide a significant impulse to gross domestic product growth. Although exports are expected to increase further, given the strong domestic economy imports are likely to expand at least as fast. Second, the government has initiated a consolidation path, which in itself will have dampening effects. In total, GDP will expand by 2.4 percent this year, which implies that Germany will remain in the group of frontrunners in Europe.

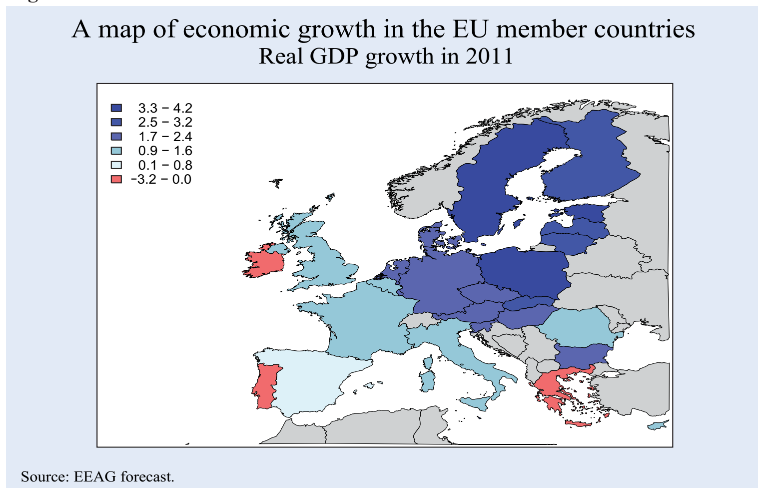
Although a number of tax benefits have been phased out, fiscal policy remained accommodative in *France* last year. This year, however, fiscal consolidation plans of the government will significantly dampen the economic expansion. Spending cuts in the public sector as well as freezing transfers

Figure 1.40a



Source: Eurostat; 2010, 2011: EEAG calculations and forecast.

Figure 1.40b



Source: EEAG forecast.

to regional administrations are scheduled. Furthermore, leading economic indicators signal a slowing of the recovery during this winter. For instance, new incoming orders have been falling and according to the Ifo World Economic Survey the assessment of the first quarter of this year is still below its long-term average. Especially as the inventory cycle will no longer deliver short-term impulses, the French economy is expected to significantly lose steam this winter.

Although growth will continue, it will be at a reduced pace in France as well this year. Restrictive fiscal policies will have a dampening effect on domestic demand. The expansionary interest rate policy of the ECB will keep funding costs low and thereby stimulate private investment. As a consequence, the latter is also expected to deliver the greatest growth contribution this year. The growth impulse from foreign trade will be slightly negative as imports continue to grow faster than exports. All in all, GDP will grow by 1.4 percent in 2011. Accordingly, inflation will turn out to be moderate and is expected to amount to 1.4 percent. The unemployment rate will remain stable around a rate just under 10 percent.

This year, supported by the weak pound, the economic recovery in the *United Kingdom* is likely to be borne by exports. Domestic demand will be retarded by the drastic consolidation measures undertaken by the British government. The decline in house prices is expected to continue with consequences for private consumption, especially given the restrictive fiscal policy stance and the deteriorating labour market situation. So far, the job market has proven to be surprisingly stable. The unemployment rate, which was at 7.8 percent as of September last year, has changed little since the spring of 2009. Now, however, signs of a deteriorating situation are setting in. The government has announced cuts of 490,000 jobs in the public sector in the next five years. It is unlikely that private labour demand can compensate for the layoffs in the public sector. In October, hiring activity in the service sector stagnated and even started to sharply decline in industrial sectors.

For 2011, slower economic growth is expected; GDP will increase by 1.1 percent. Due to the VAT increase early this year, the inflation rate, at 2.7 percent, is likely to stay above the target of the Bank of England. The unemployment rate will increase to an average of 8.2 percent.

In *Italy*, GDP is expected to increase by only 1 percent and therefore to stay below the euro-area average. Not least due to the low interest rates, positive impulses will arise from private investment, albeit the catching-up effect after the large drop during the crisis will slowly phase out. In contrast, growth contributions from private consumption and foreign trade are likely to remain moderate. Private consumption will be attenuated mainly by cuts imposed by the Italian government in the area of public service. Lack of competitiveness, an unfavourable export structure and the slowdown of world trade will constrain export developments. Weak domestic development, together with a weak euro and a slow picking-up of world trade will allow foreign trade to contribute positively to economic growth at the end of this year.

The only moderate recovery of the Italian economy and the pending reduction in short-time work will prevent a sustainable recovery of the labour market this year. The unemployment rate will only decline slightly to an average of 8.3 percent. Consumer prices will increase by 1.3 percent this year (after 1.7 percent last year).

The high government debt level has so far not led to serious doubts about the solvency of the Italian state. Although the spreads of Italian government bonds over German government bonds have risen slightly during the year, they stayed well below those of the crisis countries Greece, Ireland, Portugal and Spain. As the uncertainty in the international financial markets, however, remains high, it cannot be ruled out that the sovereign debt crisis will encroach upon Italy during our forecasting horizon. This is one of the biggest risks associated with this forecast.

GDP in *Spain* is expected to show a moderate increase of 0.6 percent this year. The consolidation of public finances, initiated in response to the loss of confidence by financial markets, will have a strong negative impact on the economic recovery of Spain. It is to be expected that in particular public investment will be reduced significantly this year.

Next to the high unemployment rate and weak wage growth, the reduction of the public deficit is also the largest negative factor affecting consumer spending. Private consumption is therefore likely to stagnate or only increase moderately. A positive impulse is to be expected from foreign trade. The weak euro and improved price competitiveness of the Spanish export sector will stimulate exports. Moreover, Spain will

benefit from the economic recovery of its trading partners in the euro area expected by the end of the year. Import growth will slow down due to weak domestic demand and will lead to an improved trade balance. Investment, however, should remain weak as adjustments in the real estate sector have not yet been completed.

The weak economy will lead to a further rise in unemployment to an average of 21.3 percent this year. Improvements in the labour market can only be expected towards the end of the year. The temporary increase in inflation observed last year will abate, and inflation is expected to average 0.9 percent this year.

Throughout the year *Greece* will remain in a recessionary state. Despite improved competitiveness, the Greek export sector will not be able to deliver impulses substantial enough to compensate for the recessionary state of the domestic economy driven by the necessary consolidation measures. GDP will decline by 3.2 percent, whereas the unemployment rate will climb to an average level of 15.5 percent.

Although the rescue of the banking sector in *Ireland* can be considered a singular event, the structural deficit has consequently increased permanently. It has led to a severe increase in interest payments to be rendered in the years to come. After the one-time emergency measures expire, the deficit for next year is expected to still remain beyond 10 percent of GDP, and is therefore still high. Nevertheless, Ireland will be able to slowly leave negative growth dynamics behind. The increased competitiveness caused by falling prices will stimulate exports. A lack of domestic demand will, however, keep the average growth rate for this year at around zero percent.

The consolidation measures in *Portugal* will cause its GDP growth to turn negative this year. It is expected that the annual growth rate will fall to –0.3 percent. As a consequence, the labour market conditions will further deteriorate slightly and raise the average unemployment rate to 11.1 percent this year.

In *Central and Eastern Europe* dynamics in domestic demand will most likely remain slow. Investment demand is declining in many countries, and private consumption is dampened by the austerity programmes of governments and the generally strong increase in unemployment. With only a modest expansion of the domestic economies, the forecasted recovery is mainly driven by impulses coming from foreign trade. All in all, GDP of this region will increase by 3 percent this year.

On 1 January this year, *Estonia* – a Baltic country with a population of 1.3 million – entered the euro area. It has become the 17th country overall, the third one of the Central and Eastern European members of the European Union and the first member of the former Soviet Republic to adopt the euro. Slovenia and Slovakia had already entered in 2007 and 2009, respectively. The currency conversion was completed without difficulty.

1.5 Macroeconomic policy

1.5.1 Fiscal policy

Chapter 3 of last year's EEAG Report was entirely devoted to the passage from the policy emergency of providing fiscal life-lines to an ailing global economy to the policy consequences of a rapid accumulation of public liabilities (EEAG 2010, Chapter 3). As anticipated, fiscal consolidation has indeed become the policy priority, arguably for the years to come.

In the latest IMF World Economic Outlook, the debt-to-GDP ratio in the G7 countries is expected to increase by staggering 40 percentage points by 2015, as compared to the pre-crisis level in 2007. Of these 40 percentage points, about 20 points can be attributed to a drop in tax revenues because of the recession. Another 7 to 8 points is due to the slowdown in growth relative to interest rates, affecting the dynamic of the debt-to-GDP ratio, and another 8 points to fiscal initiatives aimed at "saving the banks" and lending operations. Actual discretionary stimulus measures only amount to 4.5 percentage points. These figures may give the impression that the deterioration of the fiscal outlook was not so much the result of outright policy decisions, but rather followed from the mechanical effects of "automatic stabilisers" in a (strongly) recessionary period. So, was the stimulus small after all? A positive answer would be highly misleading. It would overlook the fact that, in many of the past financial crises with large output consequences, governments felt compelled to take a conservative fiscal stance. In part, a fiscal contraction in some chapters of spending was meant to free resources for "saving the financial system". In part, especially for small countries with currencies historically exposed to the risk of speculative attacks, a fis-

cal contraction complemented restrictive monetary policies in an effort to prevent large depreciation of the exchange rate. The key policy novelty in the current global crisis is that, relative to the conservative strategy commonly followed in the past, policymakers around the globe decided on the opposite course of action. As interest rates were slashed almost everywhere, governments decided to let budget deficits grow with the recession, without undertaking any offsetting measures. If anything, discretionary measures, however contained, were also expansionary. The stimulus was large overall. Whether this strategy saved the world from another great depression or not, its consequences are now troublesome in themselves.

The recovery from the crisis is currently threatened by an increasing level of fiscal risk. During the stimulus phase, in the context of an international panic in autumn 2008, deficit financing was made easier by the "flight to quality" by international investors – particularly benefiting countries with a large GDP relative to the liabilities of their financial system, with robust fiscal shoulders and with a reserve currency. The opposite scenario opened up in the fiscal consolidation phase, in 2010. Reacting to the increasing fiscal risk, markets have started to charge substantial default risk premiums to governments, especially in countries with large, explicit or implicit, fiscal liabilities relative to their perceived "fiscal capacity". As these high risk premiums spill-over to the credit conditions faced by the private sector, fiscal risk translates into a strong recessionary impulse, worsening endogenously the fiscal conditions of the country. The flight to quality has now created a great divide between the handful of governments considered fiscally solid, some of which enjoy a negative risk premium allowing them to borrow extremely cheap (although they may also suffer from the consequences of strong capital inflows), and all other countries. But because of the low risk tolerance among market participants, the border between the two groups is flexible, and almost no country can consider itself completely insulated from financial turmoil: debt consolidation is the challenge that is facing all policymakers, albeit in different ways and intensity.

What is surprising is the fact that the political debate in recent years underwent a marked shift in focus, from one crisis situation – keeping the economy going through stimulus – to another crisis situation – keeping government viable through debt consolidation, as if the two were unrelated to each other. The lack of a coherent, forward-looking approach to stabilisation policy may be understandable in a situation of high uncertainty about the size and persistence of a slowdown in global economic activity, accompanied by widespread malfunctioning of core financial markets. Yet, there is hardly any justification in treating a fiscal expansion as a "different policy", relative to the future correction measures that this eventually entails to ensure fiscal viability. The current macroeconomic conditions offer no room to downplay once again the link between current and future policy actions.

How should fiscal consolidation proceed? Virtually everyone agrees on the need to undertake strong measures to reduce deficits and stabilise public debt, especially in view of structural (i.e. largely demographic) factors that would weigh on the fiscal outlook even if the crisis had never occurred. There is no doubt that fiscal deficits are bound to be slashed by a combination of tax hikes and spending cuts. While the exact composition may and should vary across countries, a well-established literature suggests that debt consolidation is more likely to be successful when based on spending cuts, rather than tax increases. This is naturally in the cards in countries where a strong political constituency defines caps on the tax rates which are considered politically acceptable – an instance given by the United Kingdom. Yet, the size of the fiscal crisis is likely to force cuts on virtually all governments, raising sensitive issue in the reform of the public administration of countries with a particular poor record as regards the productivity of public services – such as Italy.

In many countries, indeed, the crisis creates a window of opportunity to fix inefficiencies on both the spending and the tax side of the budget. For any given target of tax revenue, for example, the crisis could provide a strong incentive to change the tax code so as to rebalance the share of revenues from direct and indirect taxation, increase fairness and, most important, reduce tax elusion and evasion.

Independently of the policy debate on the content and intensity of fiscal correction measures, strong disagreement is emerged about the timing of implementing these measures. Some favour gradualism in implementation: correction measures should be decided immediately but should be phased in over time, making sure that the strongest measures are only effective after the economy is comfortably out of recession – a key indicator would be that monetary policy is no longer stuck at a near-zero interest rate. Others emphasise the need to act immediately, front-loading

especially spending cuts, with the goal of enhancing policy credibility.

Let us examine the arguments underlying these positions in detail. Those in favour of gradualism in implementation essentially weigh the risk that early retrenchment could stem recovery. The premise here is that the recovery is still fragile while monetary policy is still constrained. Not only are policy rates still at their "zero lower bound"; financial and monetary markets are still sub-optimally segmented, jeopardising the transmission of conventional monetary measures. Most important, the balance sheets of central banks are now heavily out of balance, raising the need to design a monetary exit strategy which may be hard to keep clean of fiscal implications. To the extent that we are not out of the financial and real crisis – the argument goes – an early implementation of cuts may re-ignite vicious circles whereas low economic activity creates the premise for further contraction in demand. According to the monetary models after Eggertsson and Woodford (2003) and Christiano et al. (2009), for instance, a fiscal contraction would produce deflationary pressures that, given a zero nominal interest rate, would translate into an increase in the real interest rate faced by private agents. This effect would further depress aggregate demand, creating additional deflationary pressure, and another round of contraction.

By the same token, on the financial side, one may note that, per effect of the financial crisis, banks have arguably become more conservative in providing credit to enterprises. By cutting public spending and public work, de facto the government is cutting cash flow accruing to firms that could be used as "collateral" for obtaining credit. Hence, in a persistent state of financial crisis, a fiscal contraction would end up exacerbating further the financial constraints firms are facing, with substantial (multiplicative) effects on economic activity, well above the size of the cuts themselves. There are indeed reasons to believe that the transmission of fiscal impulses, usually quite mild when the economy is operating in normal circumstances, becomes much stronger during a financial and banking crisis. Evidence in this respect is provided by Corsetti et al. (2010c) for the OECD countries.[9] This study shows that the output and consumption effects from changing fiscal spending is quite contained in general, but become strong during years of financial crises. During these years, the point estimate of the "impact spending multiplier" for consumption and output are as high as 2: one euro of cuts (or increase) in spending would reduce (or raise) output by two euros.

The same argument is actually strengthened by conventional policy wisdom, according to which, while contemporaneous cuts are recessionary, anticipation of cuts in the future might exert an expansionary impulse in the short-run. The transmission channel works through asset prices, in particular, through changes in long-term interest rates. The mechanism, explained in detail by Corsetti et al. (2010a), is straightforward. Once the economy is out of the worst recessionary state, demand will start driving inflation up, prompting the central bank to increase policy rates, consistent with the goal of maintaining price stability. On the way out of recession, policy rates will thus tend to increase with inflation and economic activity in both nominal and real terms. If a fiscal retrenchment is implemented sufficiently far into the recovery period, it will not push the economy back into a recession, but, everything else equal, will exert a deflationary impulse: comparatively, there will be less demand, hence less inflation. As a result, the central bank will tend to contain the increase in policy rates. Now, from today's perspective, in anticipation of future retrenchment, the financial market will therefore tend to forecast a prolonged period of reasonably low rates (or more in general a period of macroeconomic stability), which will directly translate into a drop of long-term rates. This has expansionary effects already in the short-run, during the recessionary period, for any given current policy rate. While the strength of this channel in a crisis situation is debatable, there are reasons to believe that it is not negligible.

Note that anticipation of fiscal retrenchment creates an incentive for firms to contain price increases, even before the retrenchment actually takes place. Other things equal, this means a lower expected path of inflation and interest rates, from the end of the reces-

[9] Specifically, these authors find that impact multipliers for government spending on goods and services are on average quite low, consistent with the large empirical literature on the subject. But they can become much higher – as high as 2 for output and consumption – during financial and banking crises (Corsetti et al. 2010b). Unexpected changes in government spending on final goods and services affect output, consumption and investment much more than one-to-one, conditional on the economy experiencing a "financial and banking crisis", according to the classification of Reinhardt and Rogoff (2008). To be sure, the number of crisis observations in their OECD sample is relatively limited, and the empirical method adopted in the study (identifying fiscal shocks from the residuals of simple fiscal rules) is subject to on-going controversy, so that these estimates should be taken with a grain of salt. Nonetheless, the empirical evidence unambiguously points to large differences in the macroeconomic effects of government spending between crisis and non-crisis periods, which appear to be robust to many additional empirical exercises.

sion onwards. However, the opposite is true in the short-run, during the recession, because the expansionary effects of low, long-term rates on demand will tend to increase prices on impact. Everything else equal, this would stabilize current output and help the economy out of the recession and the zero-lower-bound problem.

No doubt that these arguments have merits. Both may explain, at least in part, the macroeconomic success of countries in a relatively good fiscal standing, where nonetheless the government has taken an explicitly conservative attitude, with budget deficit spread over time. These arguments emphasize the stabilizing effects of a prudent fiscal conduct, where the withdrawal of past stimulus measures, is matched by reforms generating lasting cuts in the deficits, with a progressive reversal of spending even below the pre-crisis period.

Yet, these arguments work only under the assumption that a government is able to pre-determine, in a credible way, the timing and intensity of the fiscal retrenchment over the medium term – the transmission mechanism indeed rests on the assumption that market prices are stabilised by expectations of retrenchment. Many countries (some would argue most countries) may simply not be in the condition of even trying out this strategy, because of the sheer size of public debt, adverse cyclical development and/or a record of weak fiscal institutions.

The credibility risk in designing correction measures is indeed the main argument against delayed implementation. Especially after the events of 2008/2009, market risk tolerance is low, and investors are ready to withdraw at the least sign of trouble. A lack of immediate adjustment, reassuring investors, exposes countries to the highly dangerous risk of losing market access at reasonable terms, and back precautionary but significant steps towards fiscal correction also in the short run.

These cuts will be contractionary in the sense that the negative impulse of cuts will dampen demand and therefore economic activity, with respect to an ideal, virtuous situation in which no immediate cuts are implemented, yet no risk premium is charged by international investors. Relative to this benchmark, it is difficult to expect so-called "non-Keynesian effects", where cutting public demand magically produces a boom. But assuming away risk premiums virtually amounts to assuming away the problem. In other words, a situation with no risk of default priced by the markets is not the relevant "counterfactual" against which to assess the desirability of fiscal retrenchment.

The core issue is that immediate fiscal cuts may be critical in saving a country from "much worse things to happen" by preventing financial tension in the debt markets – including the possibility of a self-fulfilling run on public debt. This point is illustrated by an extension of the already mentioned work by Corsetti et al. (2010a) that assess the effects of fiscal cuts in economies in which private investors charge a risk premium on public debt depending on (the expected path of) the debt-to-GDP ratio, realistically affecting also the interest rates charged on private debt. The analysis contrasts the effects of a given fiscal retrenchment package, implemented either immediately, or with some delay, in an economy currently in a deep recession, in which the policy rate is stuck at zero, i.e. there is no room for monetary authorities to react to negative shocks by further cutting policy rates.

The macroeconomic outcome of implementing cuts immediately is the result of two competing transmission channels. The first is the classical multiplier channel from low demand, which is negative, and can be quite strong if the economy is not out of the crisis (as stressed by the supporters of gradualism). The second is the financial channel, which is instead positive, but only to the extent that cuts are successful in reducing the risk premium charged by investors to public and private resident debtors. Which effects prevail? The simulation model used in that study suggests that, for standard values of the parameters of the model, an immediate implementation of retrenchment has actually limited or no effects on output, according to most exercises: the two channels offset each other. Small gains in output are produced only when the initial debt-to-GDP ratio for the country is very large (above 100 percent), so to make the gains in risk premiums the overruling concern. In other cases, there is a very small contraction. With the caveat that the simulation model is highly stylised, an outcome of neutrality of spending cuts is actually good news.

Conversely, the macroeconomic outcome is much more worrisome when the government delays the implementation of fiscal retrenchment for a few quarters. A small delay in starting debt consolidation at best makes the current recession worse – in general it creates room for unstable market dynamics and/or indeterminacy.

There are in fact major risks in delaying fiscal retrenchment, if this ends up being implemented over a horizon in which the economy may not be safely out of the recession. An instance of which can be illustrated as follows. Suppose that, in response to the news of a retrenchment a few quarters in the future, private agents arbitrarily developed gloomy expectations about economic activity. As a lower output means less tax revenues and higher budget deficits, they will start charging a higher risk premium on government debt. Since the cost of private debt is correlated to that of public debt, in equilibrium adverse credit conditions will also hit private agents, with contractionary effects. In normal circumstances, the central bank could react to this development by cutting interest rates. But this is not possible if monetary policy is already constrained by the zero lower bound – and alternative strategies such as quantitative easing do not offer an efficient substitute. Adverse credit conditions in the private market then cause demand and therefore output to contract, fulfilling ex post the initially arbitrary expectations of a cyclical downturn, enhancing fiscal risk.

How likely are these types of scenarios? The model and simulations by Corsetti et al. (2010b) single out a few critical parameters. First, the output elasticity of tax revenues must be realistically high, roughly in line with the OECD estimates, i.e. around 0.34. This simply means that the budget deficit is realistically sensitive to the cycle. Second public debt, including explicit and implicit liabilities, must be large enough. In the simulations, the adverse scenario occurs when debt is above 100 percent of GDP. Third, the government risk premium must be realistically correlated to private risk premiums – according to a well-established empirical fact. Finally, the risk premium must be sensitive to the stock of public debt. In the simulations presented in that paper, such sensitivity is estimated through an empirical fit of the cross-country evidence on credit default spreads in April 2010. Unfortunately, however, this parameter is quite difficult to nail down, and, most importantly, appears to be extremely volatile. In view of this consideration, the conditions under which policymakers may find their country vulnerable to market turmoil can be much less extreme; the debt threshold may be much lower than 100 percent, for instance.

We believe that it is the risk inherent in the above scenario that provides the most compelling argument in favour of front-loading deficit cut measures. We therefore expect that, at least in the industrial world, countries with an even moderate imbalance in public finance will take a precautionary stance on the timing of contractionary measures.

While fiscal consolidation of the crisis is inescapable, the above considerations nonetheless suggest that the appropriate strategy is not the same everywhere. Obviously, sharp corrections are needed in countries that already face high and increasing risk premiums on their debt. Failure to consolidate would not only raise the cost of borrowing for the government; it would also undermine macroeconomic stability with widespread economic costs. In these cases, immediate cuts in spending and tax hikes would signal the government's commitment to consolidation, even if, other things equal, their short-run costs in terms of output are not negligible (but would be much higher in the absence of correction).

Yet it is important to emphasise that the credibility and success of fiscal correction measures will not be judged by their capacity to generate a positive cash flow for a few quarters, but on the grounds of their sustainability, and their budget and growth effects in the medium to long run. Now is not the time for accounting tricks and budget gimmicks.

In countries where risk premiums have remained low, improving the fiscal outlook is no less urgent, but it would be advisable to design consolidation strategies that foresee more steady adjustment. Adopting strongly frontloaded strategies, to signal immediate improvement in fiscal cash flows, can be tempting as an extra insurance against market jitters. However, under the present circumstances, it would be wise to also assess the downside risks very carefully. Through their effects on aggregate demand, excessive contractionary measures may actually be bad for the fiscal outlook, and inconsistent with the overall goal of providing a stable macroeconomic environment for households and firms to recover confidence.

1.5.2 Monetary policy

Since the launch of the monetary union, significant macroeconomic imbalances have developed between the euro-area countries, taking the shape of massive current account deficits in the peripheral countries and significant surpluses in other countries, specifically Germany. In principle, such imbalances can have positive effects if current account surpluses or deficits trigger cash flows that lead to higher investments in

the countries in which the marginal productivity of capital is high. The problem in the euro area does not consist of the asymmetries per se but in the fact that capital inflows in many countries have financed a consumption boom, non-sustainable levels of government and private debt as well as real estate bubbles. This in turn has led to substantial price increases with drastic effects on the countries' competitiveness.

What the deficit countries need – not least to stabilise their debt situation – is to increase their competitiveness in order to reduce their current account deficits. However, as members of the euro area, raising competitiveness via currency devaluation is no longer an option. Consequently, various price trends – and thus the real exchange rate – must play this role here. This process has already started: excluding various tax increases, inflation rates in the peripheral countries are now well below the euro-area average.

The price adjustment process may be expected to continue. The crisis in the peripheral countries is substantially more serious and tenacious than in other euro-area countries, not least due to the acrimonious fiscal consolidation packages. In this context, persistently high unemployment will place a significant strain on wages. In contrast, due to continuous improvements on the labour market, private domestic demand is expected to make a more significant contribution towards growth than in the pre-crisis years, especially in Germany.

Given this background of persistent asymmetries between the euro-area countries, the formulation of monetary policy remains a challenging task for the ECB. Nevertheless, monetary framework conditions in the coming years are expected to promote a further decline in foreign trade imbalances via relative price trends in the euro area. Monetary policy in the euro area is guided by the inflation prospects of the entire euro area. As a consequence, the decisive ECB interest rate may be too restrictive for some countries and too expansive for others.

One way of researching this diverging economic effect of monetary policy consists in estimating the ECB's interest rate setting behaviour for the entire euro area with the help of a so-called reaction function and comparing it with an analogously calculated counterfactual target interest rate for each member state.[10] The country-specific interest rate indicates the interest rate the ECB would have chosen had the conditions in the respective country been prevalent in the entire euro area. Where the difference between the two interest rates is positive, the country's situation requires a higher interest rate than the one set by the ECB. If, on the other hand, the difference is negative, the ECB's target interest rate is too high.

The ECB target rate is estimated to be 0.75 percent by the end of last year. Comparison of the deviation between the individual appropriate interest rates and the ECB interest rate shows that, in the years before the crisis, the ECB interest rate was systematically too low in Greece, Ireland and Spain (see Figure 1.41). In contrast, the ECB interest rate was almost consistently too high in the case of Germany. Since the outbreak of the crisis, however, the situation in numerous euro-area countries has been reversed. If, for example, the recession were as serious in all countries as it is in Greece, Ireland and Spain (and no zero interest rate barrier existed), the ECB would currently opt for a significantly lower interest rate. Germany represents the other extreme: if the ECB was guided by the German economy, the target interest rate would currently be around 2 percent.

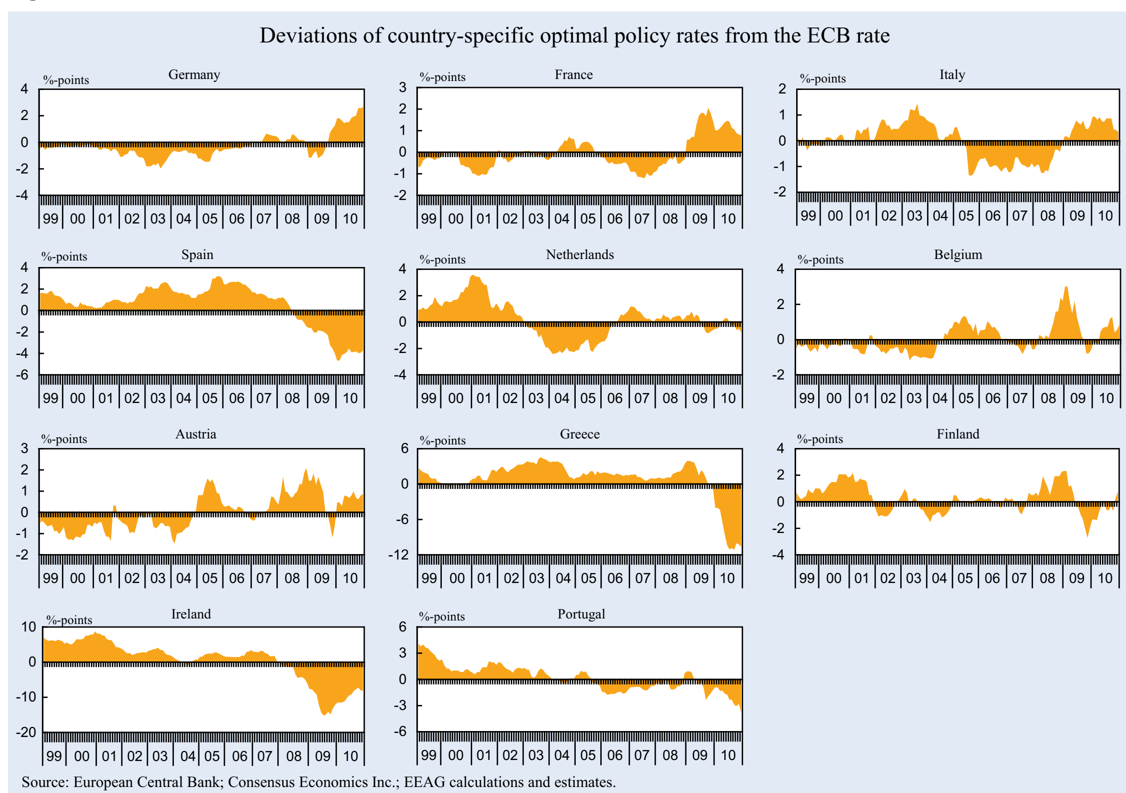
However, since the ECB's decisions are based on the situation of the entire euro area, the discrepancies are expected to persist, with price trends continuing to diverge substantially in the coming years. On the one hand, expansive interest rates in Germany will stimulate economic activity and will tend to result in price increases. On the other hand, the restrictive interest rates in the peripheral countries will contribute towards slowing down their economic activity.

Although these developments are certainly not welcome from an economic policy point of view, as well as increasing the risk of a deflationary spiral, they also put a lid on inflation rates. In the long term, this would boost the competitiveness of the countries in question.

The estimated ECB reaction function can also be used to forecast the interest rate policy in the near future. Assuming that the current ECB interest rates again follow the model applicable to the first decade of the single monetary policy, this rule indicates that the appropriate interest rate since August, 2010 has assumed positive values again. In December 2010, the estimated target rate for the euro area equals 0.75 per-

[10] The approach taken here is based on Sturm and Wollmershäuser (2008) and used in the 2007 and 2009 EEAG reports.

Figure 1.41



Source: European Central Bank; Consensus Economics Inc.; EEAG calculations and estimates.

cent. Its difference with the actual main refinancing rate and the interbank market rate has been reduced substantially.

Given that inflation will remain below 2 percent and no strong growth is expected, the ECB should keep its main refinancing rate at 1 percent. In view of increasing capacity utilisation rates in 2012, it should implement a first interest rate adjustment by the end of this year. Using our forecast to extend the estimated reaction function indeed suggests a first hike by the end of 2011.

Also for other reasons such a rise is to be favoured. Notwithstanding its influence on production and prices, a continuing very low interest rate is also associated with risks to financial stability. Negative real lending rates imply that also banks without a sustainable business model will continue to be supported and compromise the functioning of the interbank money market. Another problem may arise when insurance and pension funds, engaged in long-term financial obligations, cannot earn the required returns by investing in safe securities. This will raise the incentive to take on excessive risks.

Furthermore, banks that expect low interest rates to remain at the short end of the term structure have an incentive to increase short-term debt positions. This increases their liquidity risk that may materialise at a later stage. In addition, market participants might expect that the effects of future liquidity crises in the banking sector will again be alleviated by monetary policy measures. This effect could also increase the incentives for banks to choose riskier lending strategies.

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Appendix 1.A
Forecasting tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in %	GDP growth			CPI inflation			Unemployment rate[d]		
		in %						in %		
		2009	2010	2011	2009	2010	2011	2009	2010	2011
Industrialised countries:										
EU27	31.9	–4.2	1.8	1.5	0.8	1.9	1.8	9.0	9.6	9.6
Euro area	24.2	–4.0	1.7	1.4	0.3	1.6	1.5	9.5	10.1	10.1
Switzerland	1.0	–1.9	2.7	1.9	–0.7	0.6	0.8	4.3	4.7	4.2
Norway	0.7	–1.4	1.9	2.1	2.3	2.6	2.1	3.2	4.8	4.8
Western and Central Europe	33.6	–4.0	1.8	1.6	0.8	1.9	1.7	8.8	9.5	9.5
United States	27.6	–2.6	2.9	2.3	–0.3	1.6	1.3	9.3	9.7	9.5
Japan	9.8	–6.3	4.4	1.3	–1.4	–0.9	–0.4	5.3	5.8	5.6
Canada	2.6	–2.5	3.2	2.6	0.3	1.8	1.8	8.3	8.7	9.0
Industrialised countries (total)	**73.6**	**–3.7**	**2.6**	**1.9**	**0.1**	**1.4**	**1.3**	**8.4**	**9.0**	**8.9**
Newly industrialised countries:										
Russia	2.4	–7.9	4.4	4.3						
China and Hongkong	9.9	8.2	9.7	8.0						
India	2.4	6.7	9.3	8.2						
East Asia[a]	4.9	0.2	7.2	5.0						
Latin America[b]	6.8	–2.1	5.9	3.9						
Newly industrialised countries (total)	**26.4**	**2.5**	**7.7**	**6.1**						
Total[c]	**100.0**	**–2.1**	**4.0**	**3.0**						
World trade, volume		–1.1	11.8	5.9						

[a] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Philippines, Singapore. Weighted with the 2009 levels of GDP in US dollars. – [b] Weighted average of Argentina, Brasil, Chile, Columbia, Mexico, Peru, Venezuela. Weighted with the 2009 levels of GDP in US dollars. – [c] Weighted average of the listed groups of countries. – [d] Standardised unemployment rate.

Source: EU, OECD, IMF, National Statistical Offices, 2010 and 2011: forecasts by the EEAG.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth in %			Inflation[a] in %			Unemployment rate[b] in %		
		2009	2010	2011	2009	2010	2011	2009	2010	2011
Germany	20.4	–4.7	3.7	2.4	0.2	1.2	1.8	7.5	6.9	6.2
France	16.3	–2.5	1.5	1.4	0.1	1.7	1.4	9.5	9.8	9.9
Italy	12.9	–5.0	1.0	1.0	0.9	1.7	1.3	7.9	8.5	8.3
Spain	8.9	–3.6	–0.2	0.6	–0.2	1.7	0.9	18.1	20.1	21.3
Netherlands	4.8	–3.9	1.7	1.7	1.0	1.0	1.4	3.7	4.5	4.3
Belgium	2.9	–2.8	2.0	1.6	0.0	2.3	1.6	7.9	8.4	8.9
Austria	2.3	–3.9	2.0	1.8	0.4	1.6	1.9	4.9	4.7	4.3
Greece	2.0	–2.3	–4.3	–3.2	1.3	4.7	1.7	9.5	12.4	15.5
Finland	1.4	–8.0	2.9	2.7	1.6	1.7	2.2	8.2	8.4	8.0
Ireland	1.4	–7.6	–0.5	0.0	–1.7	–1.6	0.0	11.9	13.5	14.8
Portugal	1.4	–2.6	1.7	–0.3	–0.9	1.4	0.9	9.6	10.9	11.1
Slovakia	0.5	–4.8	4.0	3.2	0.9	0.7	2.3	12.0	14.5	14.0
Slovenia	0.3	–8.1	0.9	1.8	0.9	2.1	2.5	5.9	7.2	7.0
Luxembourg	0.3	–3.7	2.5	2.2	0.0	2.8	2.1	5.1	4.7	4.7
Cyprus	0.1	–1.7	0.6	1.1	0.2	2.6	2.4	5.3	6.8	7.2
Estonia	0.1	–13.9	2.2	3.7	0.2	2.7	3.2	13.8	17.5	16.0
Malta	0.0	–2.1	3.4	2.3	1.8	2.0	2.4	7.0	6.8	6.4
Euro area[c]	76.1	**–4.0**	**1.7**	**1.4**	**0.3**	**1.6**	**1.5**	**9.5**	**10.1**	**10.1**
United Kingdom	13.3	–4.9	1.4	1.1	2.2	3.2	2.7	7.6	7.9	8.2
Sweden	2.5	–5.1	5.0	3.4	1.9	1.9	2.0	8.3	8.4	7.5
Denmark	1.9	–5.2	2.2	1.9	1.1	2.2	2.5	6.0	7.4	6.6
EU20[c]	93.8	**–4.2**	**1.8**	**1.5**	**0.6**	**1.8**	**1.7**	**9.1**	**9.6**	**9.7**
Poland	2.6	1.7	3.8	4.2	4.0	2.7	2.9	8.2	9.6	9.2
Czech Republic	1.2	–4.1	2.4	2.3	0.6	1.2	1.9	6.7	7.2	7.0
Romania	1.0	–7.1	–2.0	1.0	5.6	6.0	5.1	6.9	8.3	8.7
Hungary	0.8	–6.7	1.0	2.4	4.0	4.7	4.1	10.0	11.0	10.7
Bulgaria	0.3	–4.9	–0.1	2.4	2.5	3.0	2.9	6.8	9.8	9.4
Lithuania	0.2	–14.7	0.3	2.9	4.2	1.1	2.1	13.7	18.1	17.5
Latvia	0.2	–18.0	–0.9	2.8	3.3	–1.2	1.0	17.1	20.9	18.6
New members[d]	6.2	**–3.3**	**1.8**	**2.9**	**3.5**	**3.0**	**3.1**	**8.2**	**9.8**	**9.6**
EU27[c]	100.0	**–4.2**	**1.8**	**1.5**	**0.8**	**1.9**	**1.8**	**8.9**	**9.6**	**9.6**

[a] Harmonised consumer price index (HCPI). – [b] Standardised unemployment rate. – [c] Weighted average of the listed countries. – [d] Weighted average over Poland, Czech Republic, Romania, Hungary, Bulgaria, Lithuania, Latvia.

Source: EUROSTAT, OECD, IMF, 2010 and 2011 forecasts by the EEAG.

Table 1.A.3

Key forecast figures for the EU27

	2008	2009	2010	2011
	Percentage change over previous year			
Real gross domestic product	0.5	–4.2	1.8	1.5
Private consumption	0.7	–1.7	0.9	1.1
Government consumption	2.3	2.0	0.8	–0.2
Gross fixed capital formation	–0.8	–12.1	–0.7	2.9
Net exports[a]	0.2	–0.1	–0.2	0.4
Consumer prices[b]	3.7	0.8	1.9	1.8
	Percentage of nominal gross domestic product			
Governmental fiscal balance[c]	–2.3	–6.8	–6.8	–5.1
	Percentage of labour force			
Unemployment rate[d]	7.0	8.9	9.6	9.6

[a] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b] Harmonised consumer price index (HCPI). – [c] 2010 and 2011: forecasts of the European Commission. – [d] Standardised unemployment rate.

Source: EUROSTAT, 2010 and 2011 forecasts by the EEAG.

Table 1.A.4

Key forecast figures for the euro area

	2008	2009	2010	2011
	Percentage change over previous year			
Real gross domestic product	0.3	–4.0	1.7	1.4
Private consumption	0.4	–1.1	0.8	0.8
Government consumption	2.3	2.4	0.7	–0.1
Gross fixed capital formation	–1.0	–11.4	–0.9	2.5
Net exports[a)]	0.1	–0.7	–0.1	0.5
Consumer prices[b)]	3.3	0.3	1.6	1.5
	Percentage of nominal gross domestic product			
Governmental fiscal balance[c)]	–2.0	–6.3	–6.3	–4.6
	Percentage of labour force			
Unemployment rate[d)]	7.5	9.5	10.1	10.1

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2010 and 2011: forecasts of the European Commission. – [d)] Standardised unemployment rate.

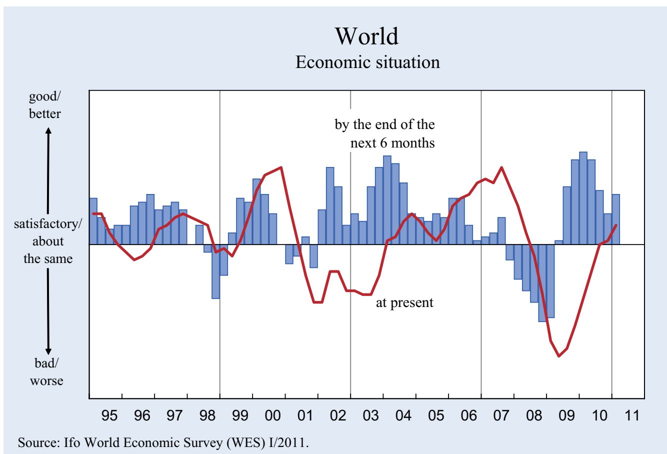
Source: EUROSTAT, 2010 and 2011 forecasts by the EEAG.

Appendix 1.B
Ifo World Economic Survey (WES)

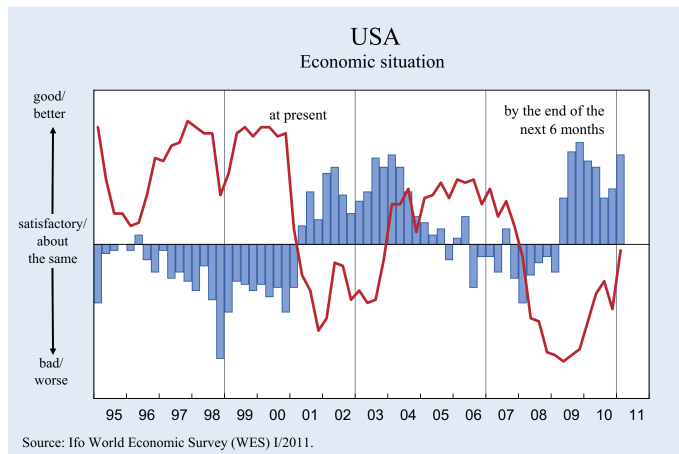
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organizations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2011, 1,117 economic experts in 119 countries were polled. WES is conducted in co-operation with the International Chamber of Commerce (ICC) in Paris.

The survey questionnaire focuses on qualitative information: on assessment of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The "grading" procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

Ifo World Economic Survey (WES)



Source: Ifo World Economic Survey (WES) I/2011.



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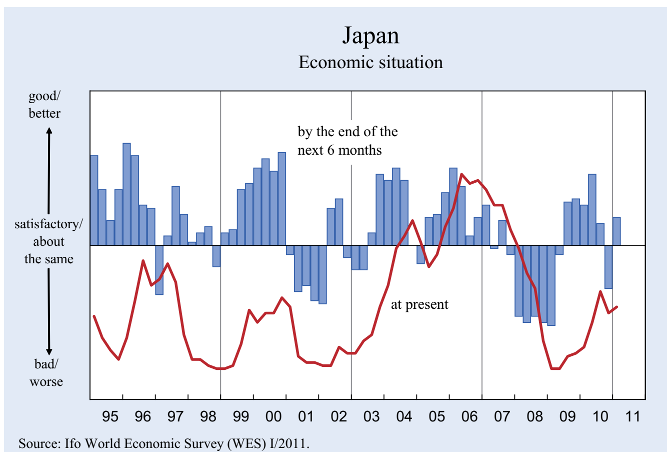

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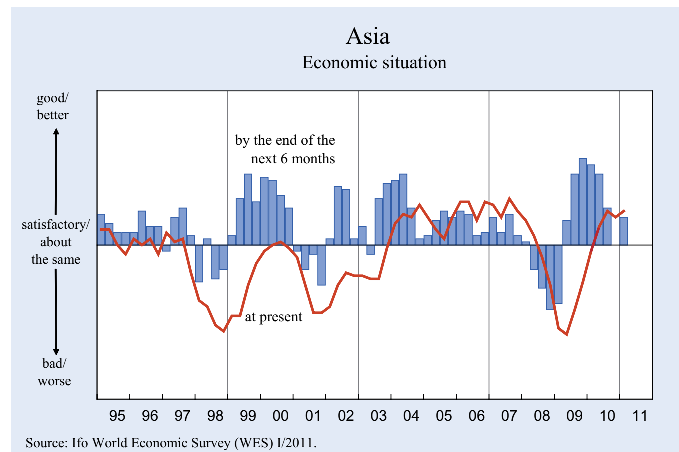

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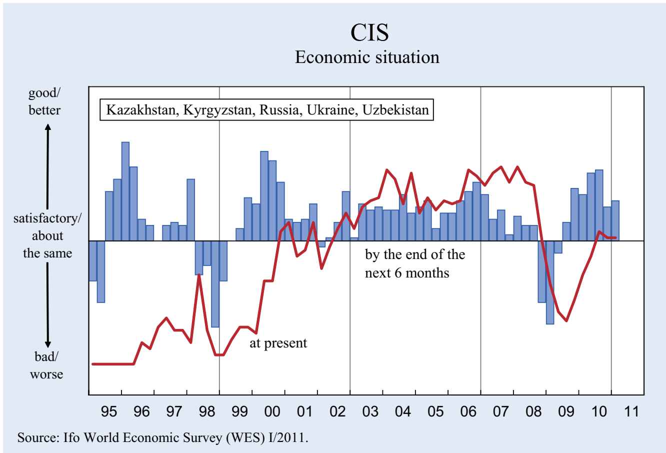
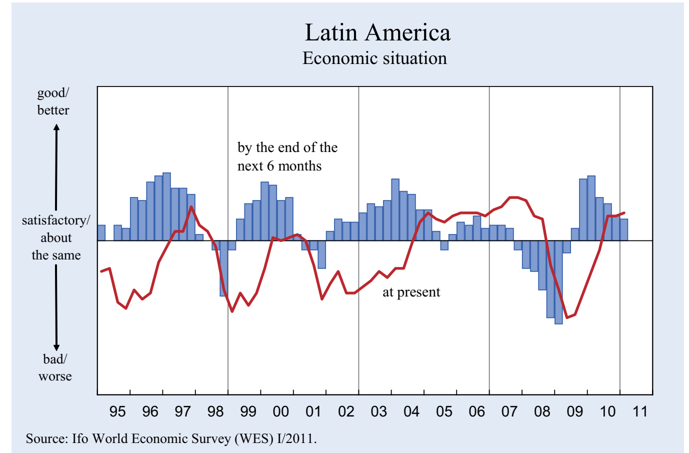

CIS
Economic situation
Kazakhstan, Kyrgyzstan, Russia, Ukraine, Uzbekistan
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11
Source: Ifo World Economic Survey (WES) I/2011.


Latin America
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
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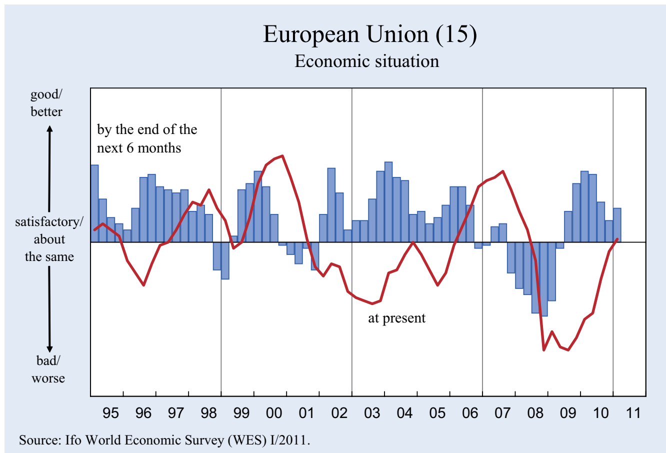
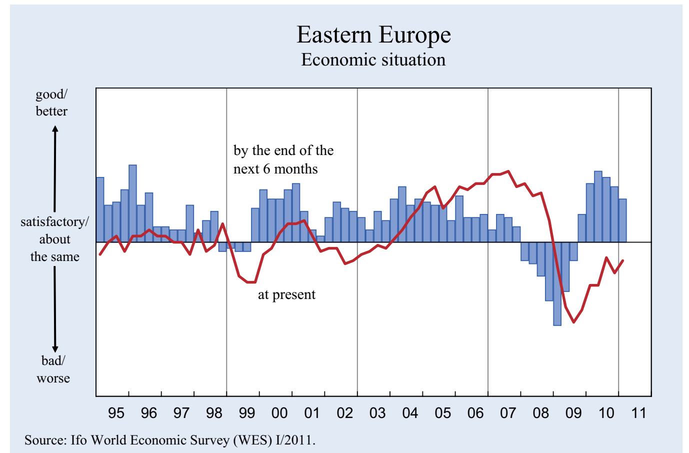
Source: Ifo World Economic Survey (WES) I/2011.


European Union (15)
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11
Source: Ifo World Economic Survey (WES) I/2011.


Eastern Europe
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
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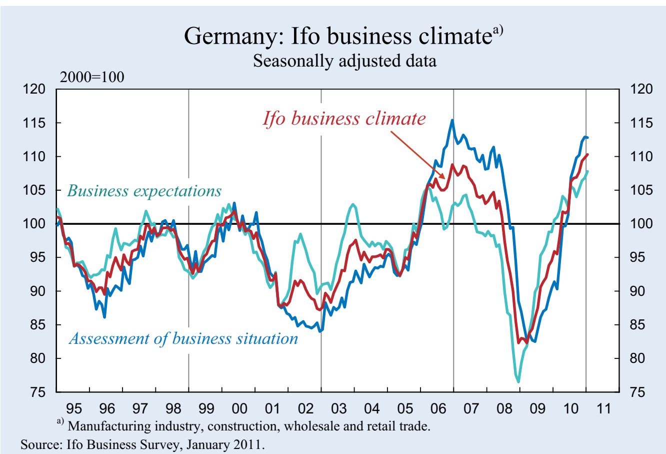
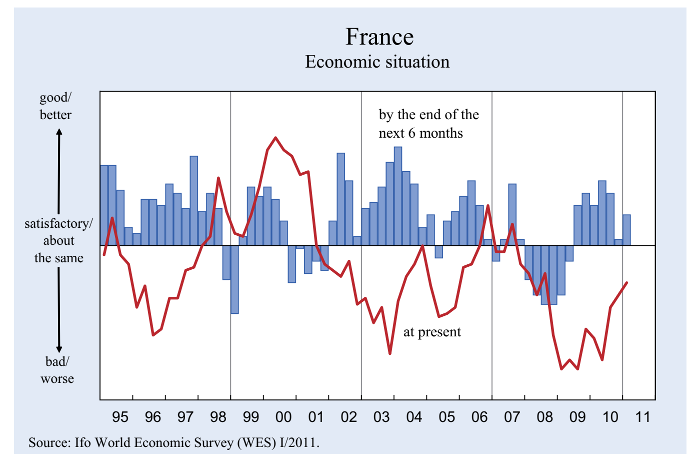
Source: Ifo World Economic Survey (WES) I/2011.


Germany: Ifo business climate[a)]
Seasonally adjusted data
2000=100
Ifo business climate
Business expectations
Assessment of business situation
120
115
110
105
100
95
90
85
80
75
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11
a) Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2011.


France
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
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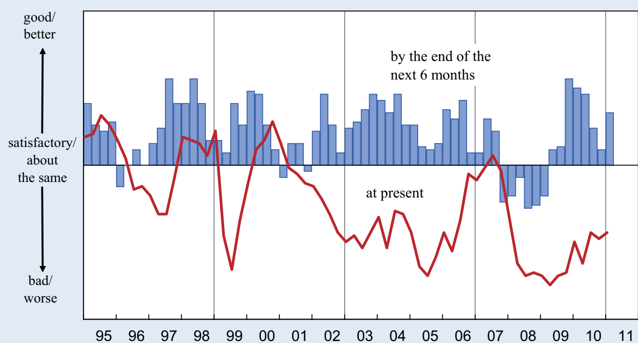
Source: Ifo World Economic Survey (WES) I/2011.



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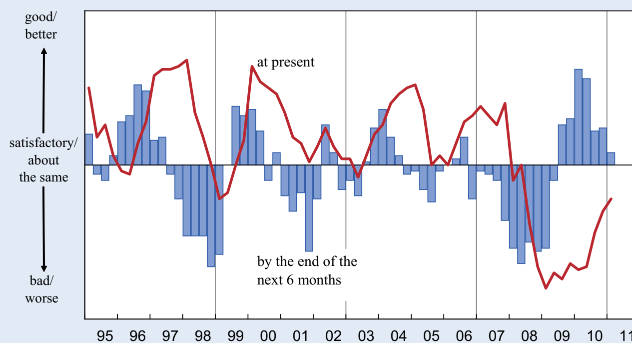

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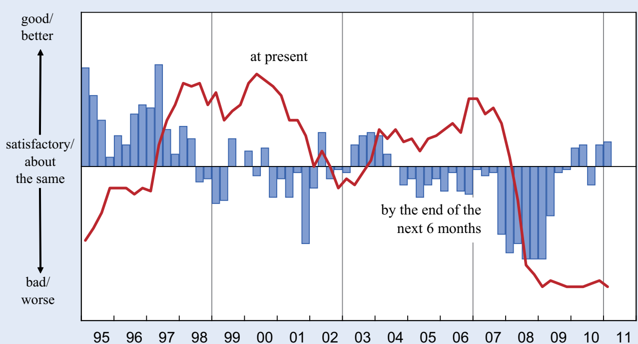

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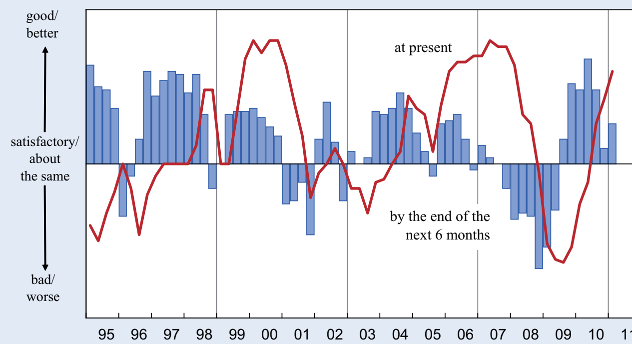

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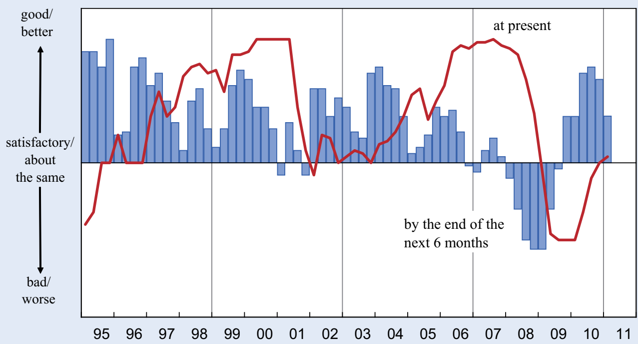

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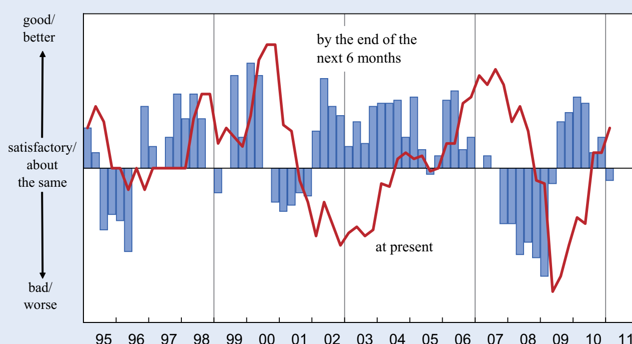

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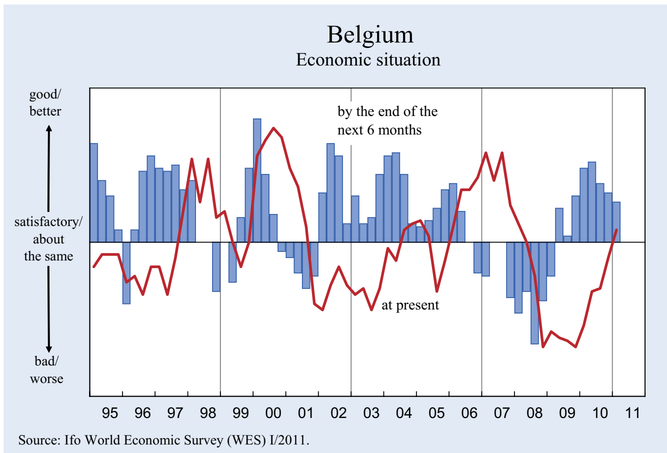

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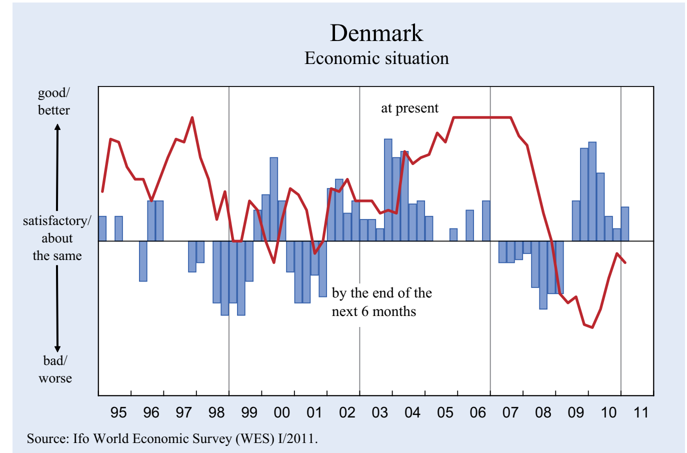

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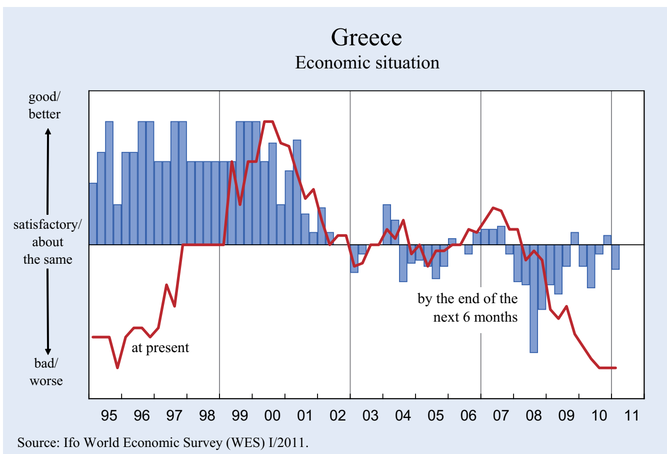

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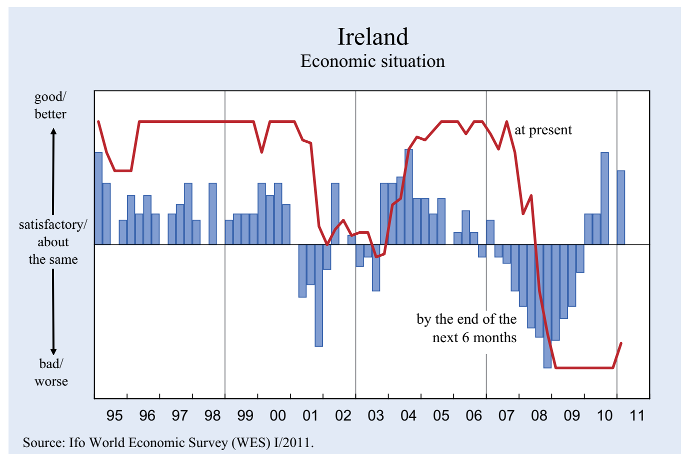

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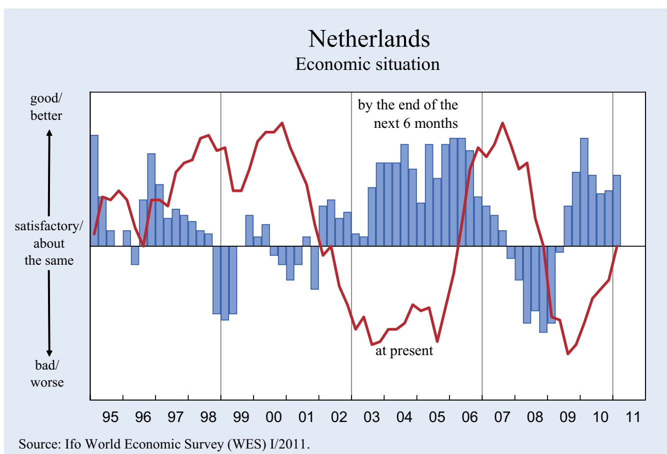

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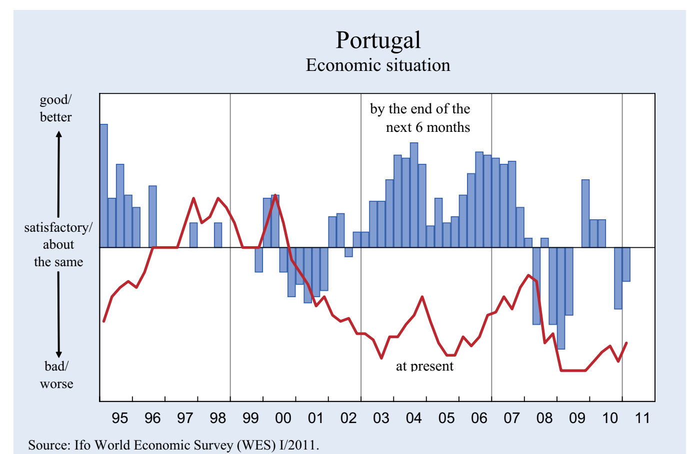

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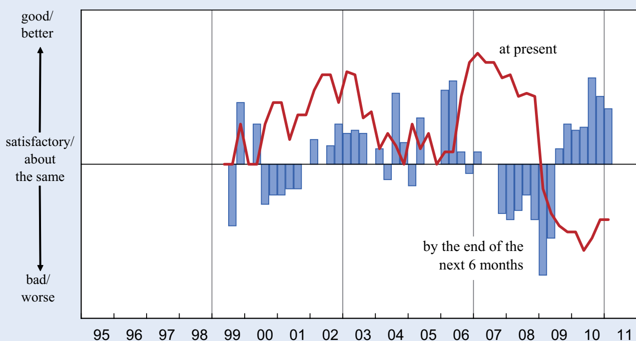

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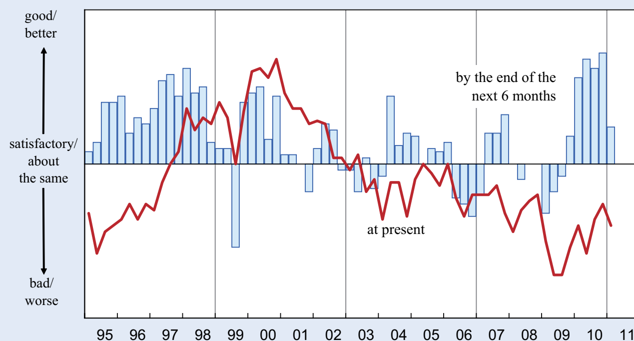

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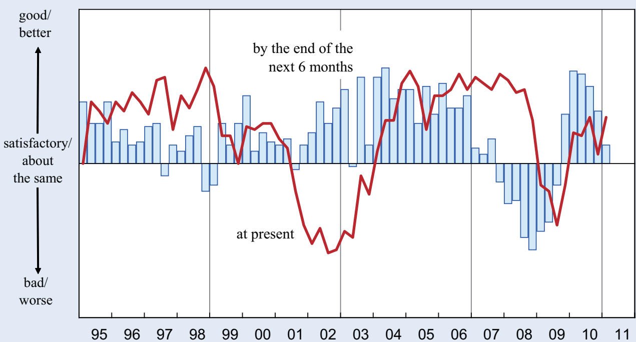

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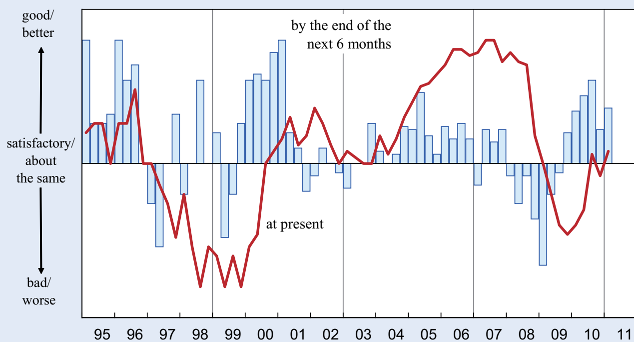

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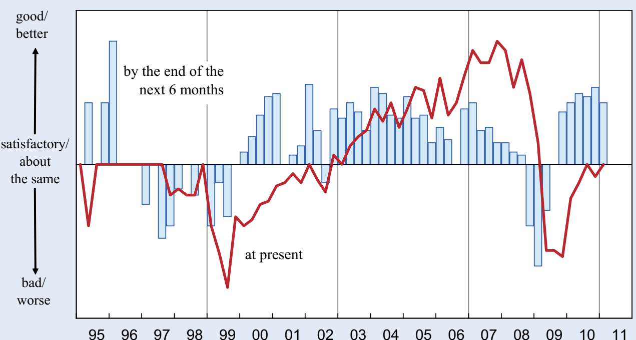

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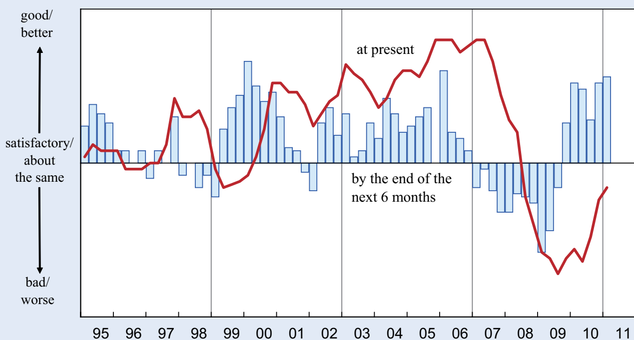

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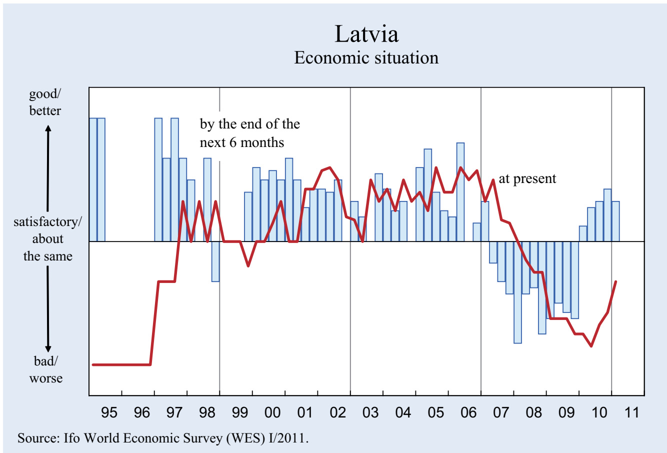

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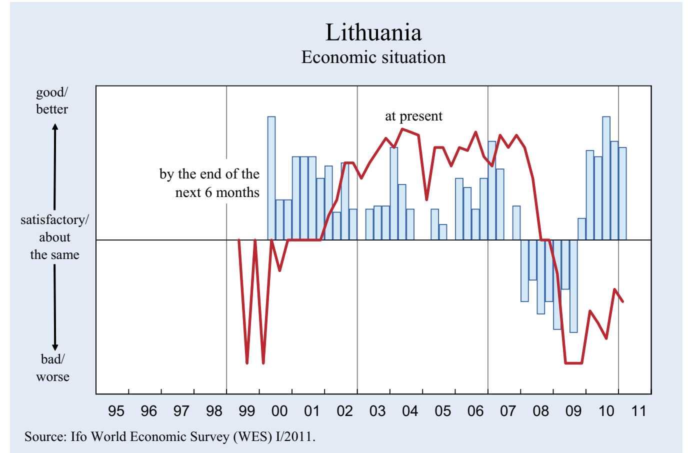

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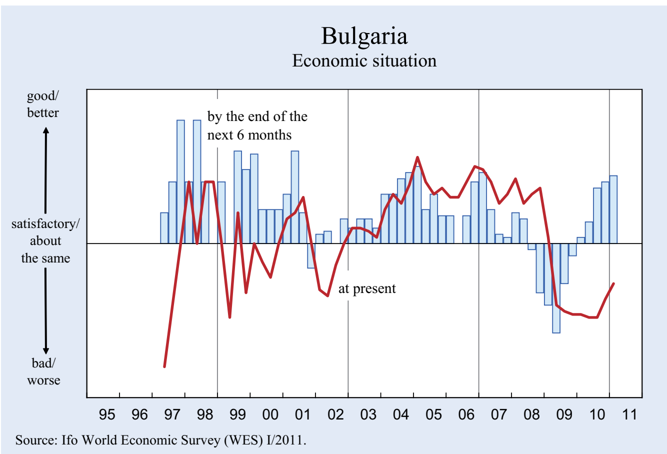

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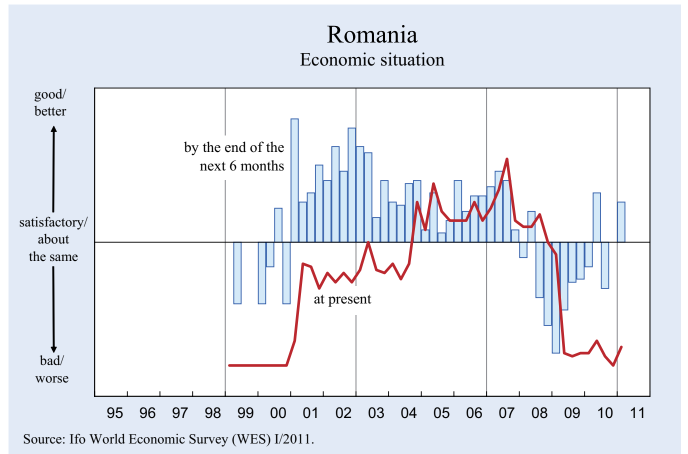

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