EEAG (2013), *The EEAG Report on the European Economy*, "Macroeconomic Outlook", CESifo, Munich 2013, p. 13–53.

Macroeconomic Outlook

1.1 Introduction

The euro crisis is putting a strain on the world economy. As a result, economic activity lost momentum nearly everywhere over the course of last year and the world economy is going through a weak phase this winter. The underlying adjustment processes that have been at work in the United States and in other advanced economies ever since the real-estate bubble burst in 2007, and which have not yet been completed, also continue to curb economic activity. Economic growth will therefore remain weak for the moment, and only looks set to recover again slightly over the course of the year.

The global economy will gradually recover after these winter months, assisted by the relaxation of monetary policy in the United States and Europe, as well as stronger economic momentum in the emerging markets. In the case of China in particular, it is safe to assume that the government will continue to follow its recent course, and will upscale the expansionary character of its policy until economic activity clearly starts to pick up again. Furthermore, European financial markets are likely to become more stable as the resolutions of the EU summit in June 2012 (such as the introduction of a banking union) are implemented. This offers the perspective that the uncertainty currently crippling economic activity in the crisis countries will continue to slowly subside.

Gross domestic product (GDP) is expected to increase by 0.1 percent in the European Union this year, with foreign trade as the main driver of growth; while inflation looks set to increase modestly. The situation in the labour market will deteriorate further, with the unemployment rate rising to an average of 10.9 percent this year. The euro area will remain in a mild recession for the time being. Growth should gradually pick up in the United States after an initial decline due to partial implementation of the fiscal cliff, since the structural problems in the banking and real-estate sectors will diminish and the labour market is also expected to continue to recover.

1.2 The current situation

1.2.1 The global economy

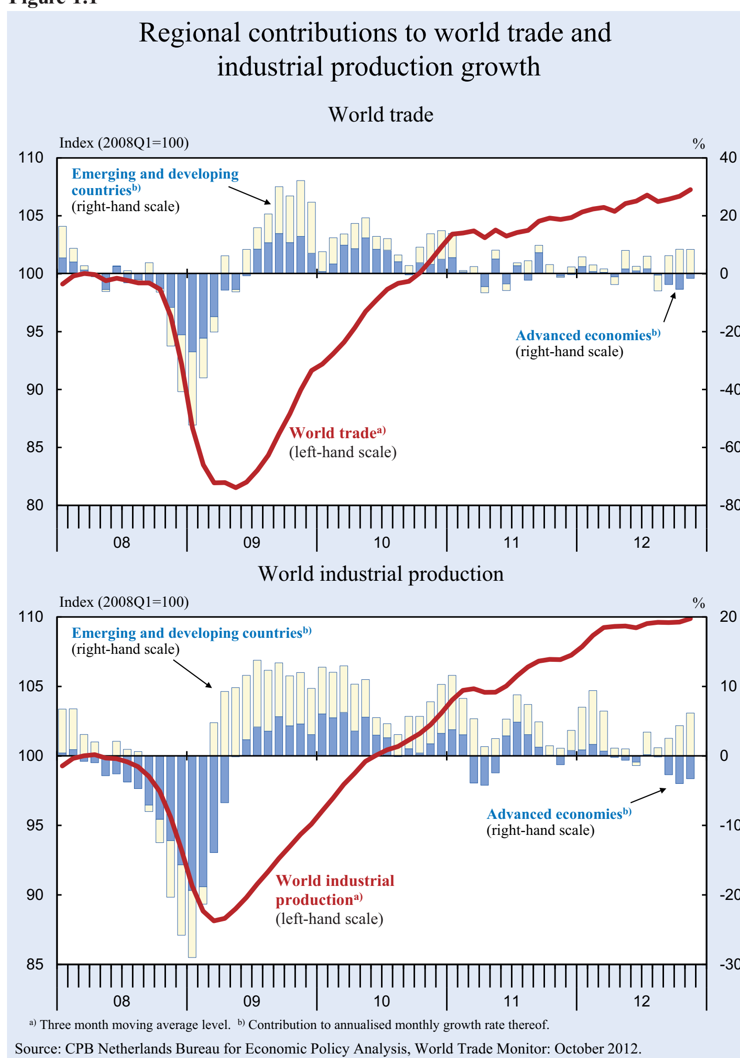
With the further escalation of the euro area debt crisis in spring 2011 the world economy has moved out of recovery mode and into what can broadly be described as stagnation. World trade has been faltering around a historically low growth rate of below 3 percent (see Figure 1.1)[1] for roughly two years. This has been apparent in all key economic regions, albeit to differing degrees. A look at world industrial production reveals that there were signs of recovery during summer 2011 and early 2012. There were hopes that the relatively strong growth performance of the emerging markets during the first quarter of 2012 would act as a sparking plug for the world economy. However, a further escalation of the euro area crisis together with a stronger than expected slowdown in Chinese growth caused world industrial production to basically stagnate from the second quarter of last year onwards. Whereas the emerging world has recently shown signs of recovery, industry in the advanced economies appears to have taken a downturn.

The global economic slowdown has been accompanied by a marked decline in the results of the Ifo World Economic Survey since spring 2011. The assessment of the economic situation by the participating experts has fallen for all regions overall and is now, despite the recent increase in North America and Asia below its neutral levels (see Figure 1.2). Producers and consumers in the euro area also became fare gloomier, although sentiment has stabilised somewhat in recent months. In the United States, China and several East Asian and Latin American emerging markets, a number of confidence indicators stabilised, and even improved in the winter after suffering drastic drops in the preceding months. The overall sentiment in these economies nevertheless remains at a fairly low level.

The slackening of global economic momentum since spring 2011 is primarily due to the huge adjustment processes that are currently taking place in the euro

[1] If not mentioned otherwise, all growth rates reported are annualised growth rates.

Figure 1.1



[a)] Three month moving average level. [b)] Contribution to annualised monthly growth rate thereof.

Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor: October 2012.

Figure 1.2

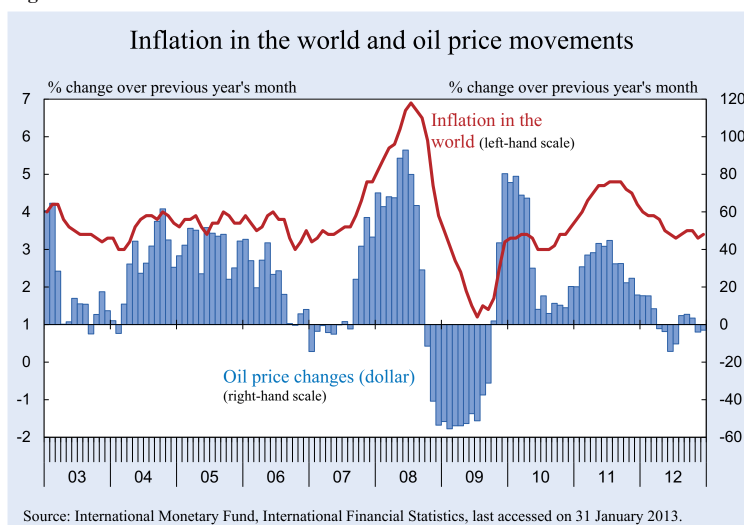
Source: Ifo World Economic Survey I/2013.

area. In a number of countries, especially after the bursting of real estate bubbles, workers have been released in large numbers and incomes have declined resulting in often very high levels of private debt that are no longer serviceable. This in turn brought the banking sector into further distress causing the macroeconomic conditions for finance to deteriorate significantly as the inflow of private capital from abroad dried up or even reversed in the form of capital flight. The requisite deleveraging of private debt and the reallocation of production factors will most likely take some time. The problems are considerably heightened by the state of public finances in the crisis countries (Greece, Ireland, Portugal, Spain, Cyprus and Italy) which were either already overloaded or fell into disarray as a result of the public sector having to shoulder increasingly higher burdens caused by the new economic reality. In response to the sharp increase in perceived solvency risks since the spring of 2010, these countries have undertaken extensive austerity programs and a series of structural reforms. Confidence in the sustainability of their public finances continued to erode during 2011, causing private financing conditions to deteriorate even further, and encouraging the crisis countries to step up the intensity of their reform efforts. The resulting contraction in their economies not only carried over to the rest of world via massively reduced import demand, but also through a further increase in uncertainty resulting in a sharp decline of capital flows to the emerging economies of Asia, Latin America and Eastern Europe. Circumstances like these tend to result in investors moving their assets to countries seen as "safe havens" such as the United States, Japan, Germany or Switzerland.

Moving into the second half of last year, the recession in the euro area persisted and macroeconomic uncertainty remained exceptionally high. Global

investors, producers and consumers remained unsettled by next to no easing up of concerns about the solvency of the state and the banking system in the euro area crisis countries and the risk of disorderly exits from the European Monetary Union. This has resulted in the postponement of many private investment projects and suppressed the demand for durable goods. In September 2012, the European Central Bank (ECB) announced that it was ready to undertake extensive interventions in the sovereign debt markets when needed. This has somewhat reduced the risk of disorderly exits of member states from the monetary union and has since been reflected by the lowering of risk premiums on the European sovereign debt markets.

Figure 1.3



Source: International Monetary Fund, International Financial Statistics, last accessed on 31 January 2013.

In the United States, the recovery after the financial crisis of 2007–2008 has been steady but slow. Many private households in the United States are still engaged in reducing their debt to sustainable levels. This process has curbed consumption somewhat. Uncertainty as to the future orientation of fiscal policy has also had an adverse impact on the United States. The threat of dramatic tax increases and expenditure cuts triggered by a "fiscal cliff" at the beginning of this year caused concern for some time, and not just to US investors. Although a large part of the fiscal cliff has been dealt with earlier this year, some decisions – notably on cuts to defence and education spending – have only been delayed into March. Hence, some uncertainty still remains.

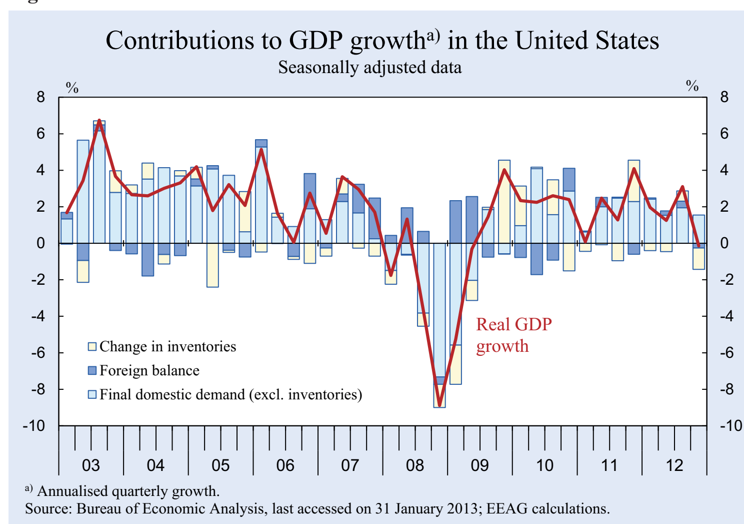
In key emerging markets, the slowdown in the rate of expansion was also in part caused by domestic concerns. In order to counter high inflation and overheating in credit markets, monetary policy became significantly more restrictive in many places by mid-2011. These measures began to show their impact in the quarters that followed. Between summer 2011 and summer 2012 inflation rates in emerging and developing countries fell considerably.

The overall slowdown of the world economy together with an overall sideward movement of energy and food prices allowed world inflation to steadily fall by in total 1.5 percentage points to a level of slightly above 3.2 percent by mid-2012 (see Figure 1.3). It more or less stabilised at that level since.

1.2.2 United States

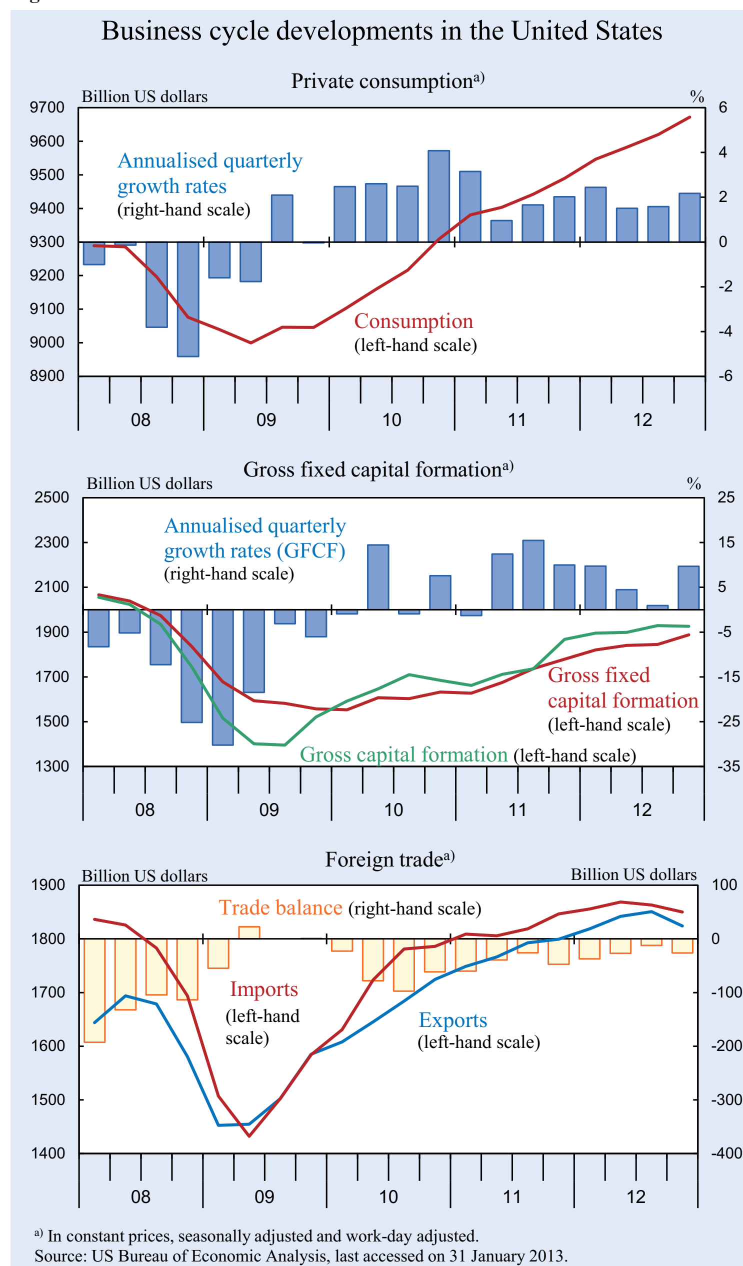
Albeit steady, the economic recovery in the United States continues to lag behind past recoveries. Since early 2010, real GDP growth has hovered around 2 percent before temporarily dropping in the last quarter of 2012 (see Figure 1.4). The restructuring of the real estate and the deleveraging of the financial and household sectors are taking their time and will have to be followed by a prolonged period of fiscal consolidation. Private consumption and investment in

Figure 1.4



a) Annualised quarterly growth.
Source: Bureau of Economic Analysis, last accessed on 31 January 2013; EEAG calculations.

Figure 1.5



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2013.

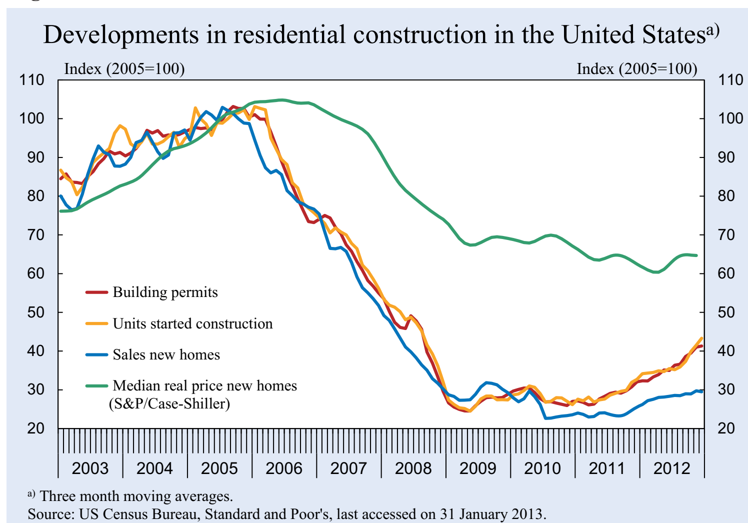
equipment and machinery continue to contribute positively to economic growth (see Figure 1.5). The drop in GDP growth in the fourth quarter of 2012 was primarily due to a negative growth impulse coming from investments in inventories. This reflected the uncertainty about the implementation and severity of then the forthcoming fiscal consolidation. At the same time, however, it brought forward substantial defence spending in the third quarter of last year.

Foreign trade also contributed positively throughout the year 2012. Although export growth fell to just 3.2 percent (following 6.7 percent in 2011) due to the weak global economy, the even weaker development of imports – up by only 2.5 percent from last year – caused by weak domestic demand for capital goods in particular was able to outweigh this.

Other impulses were provided by the private housing sector. Coming from historical lows the number of private housing construction starts and the number of building permits have both increased by well over 25 percent last year (see Figure 1.6). Housing starts were given a sustainable boost as the supply of excess unsold real estate began to drop. As compared to 2011, the sales of new homes have picked up by on average 20 percent. The average financial burden on home owners posed by payments on mortgage interest and principal dropped from 11.3 percent of their disposable income in the fall of 2007 to 9.0 percent by mid-2012. This value is significantly below the long-term average since the 1980s. At the same time, the Case-Shiller Index of real estate prices rose in the past 12 months by nearly 4 percent. This increase was supported mainly by a far-reaching reduction in the surplus of unsold residential real estate brought about by the financial crisis. Household debt also fell from its peak in the third quarter of 2008 nominally to around 1.4 trillion dollars; a drop of almost 11 percent, which when adjusted for inflation is almost twice as high. Against this background, the decline in the average savings rate of 5.5 percent during summer 2010 to 4.7 percent in the fourth quarter of 2012 reflects a progressive improvement of the asset position of households.

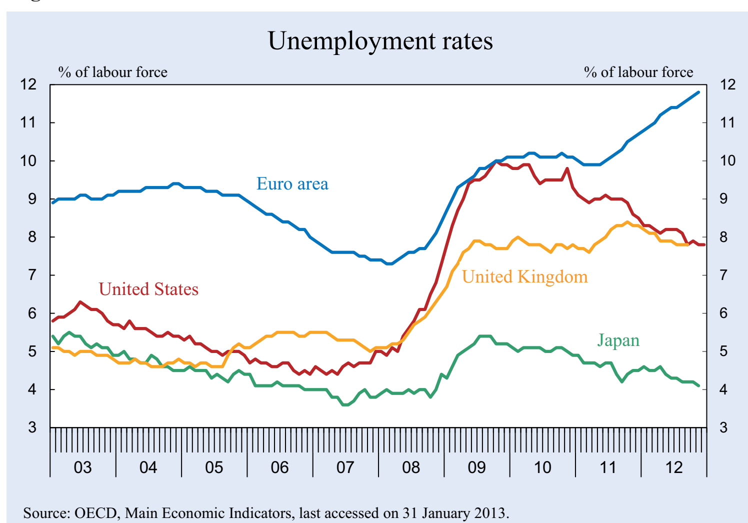
The labour market has resumed some momentum in the second half of last year. After a slow period in early summer, an average of 160,000 new jobs has been created since July, causing the unemployment rate to decline to 7.8 percent in December (see Figure 1.7). Yet employment growth remains below average in comparison to previous recoveries in the

Figure 1.6



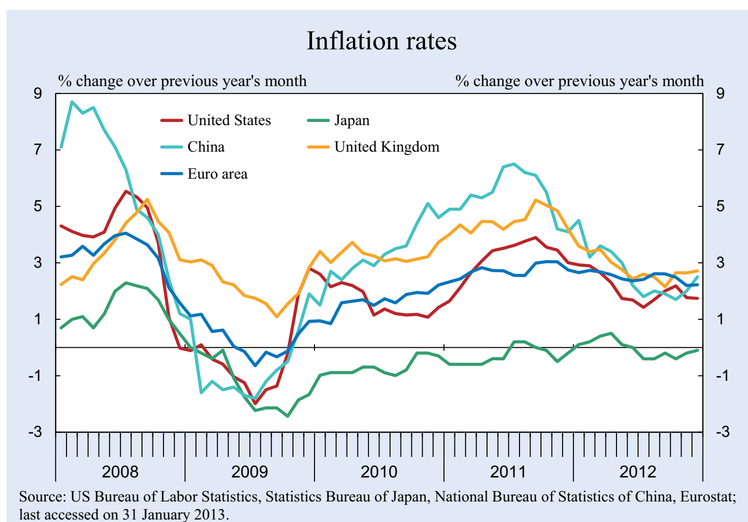
a) Three month moving averages.
Source: US Census Bureau, Standard and Poor's, last accessed on 31 January 2013.

Figure 1.7



Source: OECD, Main Economic Indicators, last accessed on 31 January 2013.

Figure 1.8



Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2013.

United States and the unemployment rate is dropping at a modest pace. A major hurdle to employment growth is the still hesitant attitude of business and consumers. A clearer upturn on the labour market can be expected no earlier than when the two major parties in Washington agree on the course of fiscal policy consolidation to be taken. Although progress has been made on this earlier this year, the necessary lifting of the debt ceiling – i.e. the amount the US government can borrow which is capped by legislation –, the automatic spending cuts still in the pipeline and the fact that the United States has been operating without a federal budget since October last year which will need to be passed by March all create uncertainties regarding the future course of fiscal policy.

After having peaked in September 2011 at 3.9 percent, the inflation rate in the United States swiftly came down again reaching a low of 1.4 percent in July last year (see Figure 1.8). As also indicated by the by then stable core inflation rate, i.e. the rate of inflation excluding energy and food costs, the subsequent increase was primarily due to higher energy prices. Overall, actual inflation has reached an average of 2.2 percent in 2012.

1.2.3 Asia

After a clear cooling over the winter of 2011/2012, the *Chinese* economy has been able to resume some momentum again in the course of the year. Its GDP grew by around an annualised 8 and 9 percent during the second and third quarter, respectively, up from a low of approximately 6 percent during the first quarter.

The economy is more and more supported by private consumption and the continued expansion of investment. Exports, on the other hand, have from an historical perspective developed in a rather restrained manner. Besides the slowdown of the world economy, the in recent years rapidly rising labour costs in China have affected its price competitiveness and thereby also negatively impacted its exports. Simultaneous strong increases in real imports led foreign trade to deliver a negative contribution to the overall economic expansion for seven quarters in a row. The total overall increase in GDP amounted to 7.8 percent in 2012 (after 9.6 percent in 2011).

Overall, it appears that China is in a transition towards a lower trend growth path. Its labour force tends to grow at a slower pace and labour costs have been increasing in international comparison. In addition, the real estate sector is in a downturn since 2011. The slowdown in growth was merely masked by the stimulus measures undertaken during the Great Recession.

The weaker economic expansion has apparently not led to a significant increase in unemployment – the unemployment rate in urban areas has been around 4.1 percent and thereby similar as in 2007. This suggests that the economic growth rate required to integrate the additional labour, which used to be estimated at around 8 percent, has decreased. The in March last year to 7.5 percent reduced official growth target is in line with this.

After having peaked at 6.5 percent in summer 2011, the inflation rate swiftly came down to slightly below 2 percent last autumn. This allowed the Chinese central bank, the People's Bank of China, to respond to the slowdown in economic growth by loosening its monetary policy stance. Firstly, reserve ratios were reduced in three steps by in total 1.5 percentage points. Subsequently, its key interest rate was lowered in two steps by 56 basis points to 6 percent in July 2012. And finally, by the end of August 2012, the central bank increased the liquidity in the banking sector quite strongly. Pronouncements by officials point to a possible further easing of monetary policy.

In addition to these monetary measures, the Chinese government again resorts to fiscal stimuli measures to avoid a fall in the growth rate below its target. Early September 2012 they decided to support export-oriented firms by introducing tax breaks and less bureaucratic and expensive export approval procedures. Furthermore, various infrastructure projects are introduced or brought forward in time.

With negative growth rates in the second and third quarter of 2012, *Japan* moved once again back into recession. Whereas in 2011 the earthquake and nuclear reactor disaster caused a sharp decline in economic activity, this time the decline can largely be attributed to a drop in exports resulting from falling world demand, a continued overvaluation of the yen and the territorial dispute with China (and Taiwan) regarding the Senkaku/Diaoyu islands. The latter led to the boycott of Japanese goods and services (including tourism) and to the disruption of Japanese business activities in China. As a result, the Japanese trade balance has turned persistently negative since spring 2011. In addition, there were declines in domestic consumption and investment activity after reconstruction and fiscal measures had injected some life into the domestic economy in the winter of 2011/2012. Due to high GDP growth during the second half of 2011 and the beginning of 2012, aggregate output for 2012 is expected to have risen by 2.1 percent as compared to 2011.

Although actual inflation rates turned positive during the first half of the year the underlying core inflation dynamics, reflecting the strong appreciation of the yen and the overall weak economy, remained negative throughout. For 2012 the inflation rate is expected to have been – 0.1 percent, after – 0.3 percent in 2011. Japan has so far not been able to escape the "secular stagnation" from which it is suffering since 1997. It is a persistent challenge for the Western world not to fall into such a Japanese liquidity trap.

India's economic growth has cooled noticeably since the beginning of 2012. After year-over-year growth rates of 5.6 and 3.9 percent in the first and second quarter, respectively, GDP only expanded by 2.8 percent in the third quarter of 2012. This was mainly due to a slowdown in private capital investment and exports. Private consumption, which accounts for more than half of GDP, has also reduced pace. One reason might be that consumer price inflation, partly due to the weak monsoon and reduced subsidies on fuel, accelerated again during the first half of 2012 to approximately 10 percent and stayed around that level since. After going through stepwise increases from its low of 4.75 percent in spring 2010 to 8.5 percent in October 2011, the Reserve Bank of India cut its key short-term lending rate by 50 basis points in April last year. In addition, the Indian government

announced some structural reforms such as the liberalisation of the retail trade and the aviation sector. Although there is still uncertainty regarding the implementation of these reforms, these announcements together with the interest rate cut and the improved global economic outlook seem to have strengthened investor confidence. As a result, both portfolio investment and foreign direct investment have started to recover in the third quarter after having been eroded in spring last year.

The East Asian countries *Indonesia, South Korea, Malaysia, Taiwan, the Philippines* and *Singapore* (in the order of their economic significance) have seen a further reduction in economic growth. This is mainly attributable to weak foreign trade, which struck hard in this region due to its high dependence on exports. In the third quarter, in particular Taiwan began to benefit from the increased momentum in China. South Korea, on the other hand, experienced with an annualised 0.2 percent the lowest growth of its economy since the Great Recession. As a reaction the Bank of Korea reduced its base rate in two steps from 3.25 percent to 2.75 percent. Given a moderate inflation rate of below 1.5 percent since summer last year, it has enough room for additional interest rate cuts. Also the government has some leeway as there is currently no need for fiscal consolidation given the low government debt of approximately 35 percent of GDP. The economies of Indonesia, Malaysia and the Philippines have remained relatively stable last year. Although the global economic slowdown also impacted their exports, this was outweighed by a strong expansion in domestic demand. Overall, it is expected that the economic performance of these East Asian countries will have increased by only 3.6 percent last year.

1.2.4 Latin America

In most Latin American countries such as *Chile, Colombia, Mexico* and *Venezuela* the economies were still running smoothly during the first half of 2012. Although the expansionary dynamics cooled down somewhat during the rest of the year, economic performance overall remained relatively robust despite the weak global environment. High prices for soy, corn and wheat helped the exporters of these goods. While a solid labour market provided ample domestic consumption, expansionary monetary and fiscal policies also supported economic activity.

In the two largest economies of the region, *Brazil* and *Argentina*, the economic expansion was, however, already in the first half of 2012 considerably weaker. The Argentine economy even shrank in the second quarter. Private consumer demand and consumer confidence remained subdued due to double-digit inflation and continued restrictions on exchanging domestic currency for US dollars. The dissatisfaction of the population also was on the rise, expressed increasingly in protests and demonstrations against the government. Finally, the investment climate, as well as relations with important trading partners for Argentina (Spain and its MERCOSUR partners), both deteriorated due to increasing government intervention in the form of nationalisation, import controls or foreign exchange controls.

Brazil is only slowly finding its way out of the weak expansion still lingering since the middle of 2011 largely caused by the strong appreciation of its currency during and after the global financial crisis. The pace of growth picked up somewhat in the past two quarters with the GDP rising by 2.4 percent in the third quarter. As in the previous quarters, the increase was mainly driven by consumption; investment continued to recede. Tax breaks and step-wise interest rate cuts bringing the main refinancing rate to an historical low of 7.25 percent appear to take hold only hesitantly.

1.2.5 The European economy

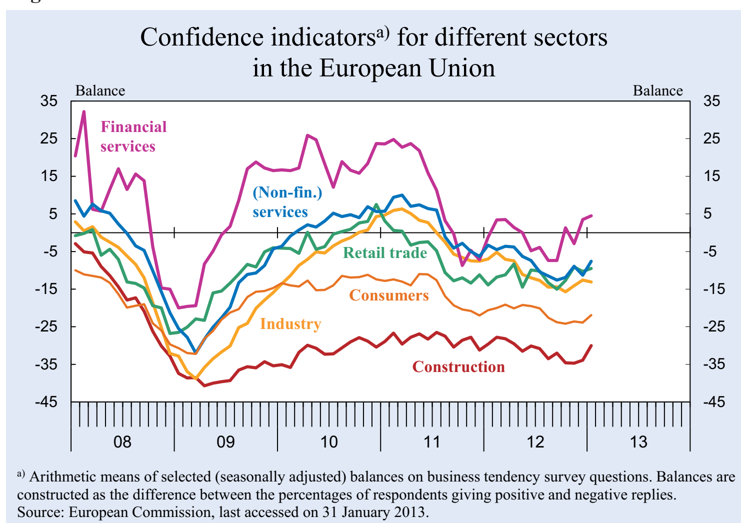
The cyclical situation

The economic development of the European Union is still under the shadow of the European debt crisis. The World Economic Survey for Western Europe in January continued to deteriorate, following its downward trend since the mid-2011 (see Figure 1.2). Although the risk premiums on government bonds of several member states decreased markedly throughout the year, they nevertheless remained quite high as compared to pre-crisis years. This still reflects the continuing doubts of financial markets on the ability of the relevant countries to bear the burden of their sovereign debt. Concerns over a possible breakup of the currency union and concomitant exchange rate risks and financial market turmoil remained present, but weakened substantially, particularly as of September 2012. These fears began to escalate in the early summer of 2012 when it appeared uncertain if and how legislative action

could help recapitalise the ailing Spanish banking sector. After the parliamentary elections in June, Greece also had enormous difficulties in forming a functioning government ready and willing to meet the conditions agreed upon with the “troika”.[2]

Some economic decisions in the summer and early autumn have had a calming effect on the financial markets. It was agreed in July that Spain will receive up to 100 billion euros from the European Stability Mechanism’s (ESM) permanent rescue fund to support its banking sector.[3] In addition, the early election in the Netherlands handed anti-euro parties a bitter defeat and produced a relatively stable coalition which has agreed to continue fiscal consolidation. Moreover, the German Constitutional Court gave green light for the permanent ESM bailout mechanism. Finally, the ECB announced shortly thereafter a new programme of unlimited purchasing of government bonds. If needed, the ECB will purchase public bonds issued by countries engaging in reasonable structural adjustment programmes, whose interest rates are classified by the ECB as exaggerated.

Figure 1.9

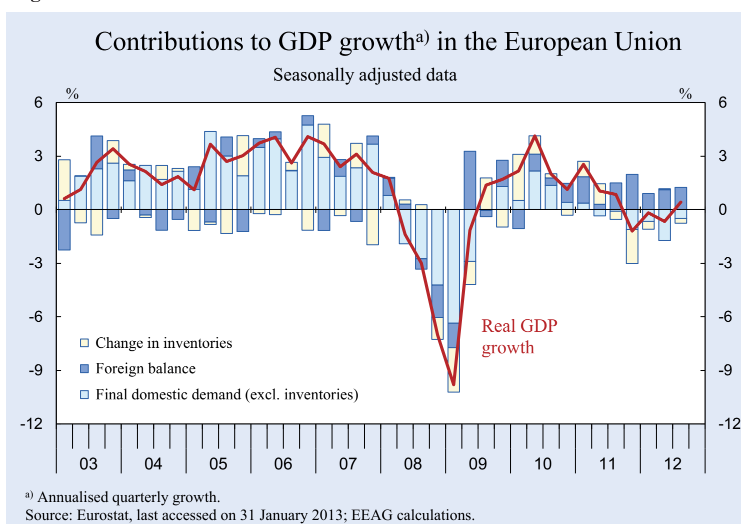


[a)] Arithmetic means of selected (seasonally adjusted) balances on business tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.
Source: European Commission, last accessed on 31 January 2013.

Consumer and manufacturer confidence in the European Union continued to slide before stabilising at a nadir in autumn. More service-oriented sectors have recovered slightly in recent months, as has construction more recently (see Figure 1.9). The nevertheless still overall prevailing pessimism reflects doubts whether enough political will is present in the crisis countries to continue eliminating the structural weaknesses at the core of the debt crisis. As a result, macroeconomic uncertainty remained high. Since the beginning of the debt crisis it has been throttling the willingness of consumers and companies to spend and final domestic demand has thereby contributed negatively to GDP growth since the second quarter of 2011 (see Figure 1.10). During the forecast period, uncertainty will remain an essential burden on economic development in the European Union and the euro area in particular.

In view of growing doubts about their solvency in the wake of the debt crisis and the resulting increase in market pressures, crisis countries have been forced to initiate massive structural adjustments in many areas including fiscal policy, labour markets, goods and service markets, and pension and health care systems. These measures are likely to promote the soundness of public finances, competitiveness and the growth potential of these economies in the long term. However, the resulting fiscal cuts and reallocations of

Figure 1.10



[a)] Annualised quarterly growth.
Source: Eurostat, last accessed on 31 January 2013; EEAG calculations.

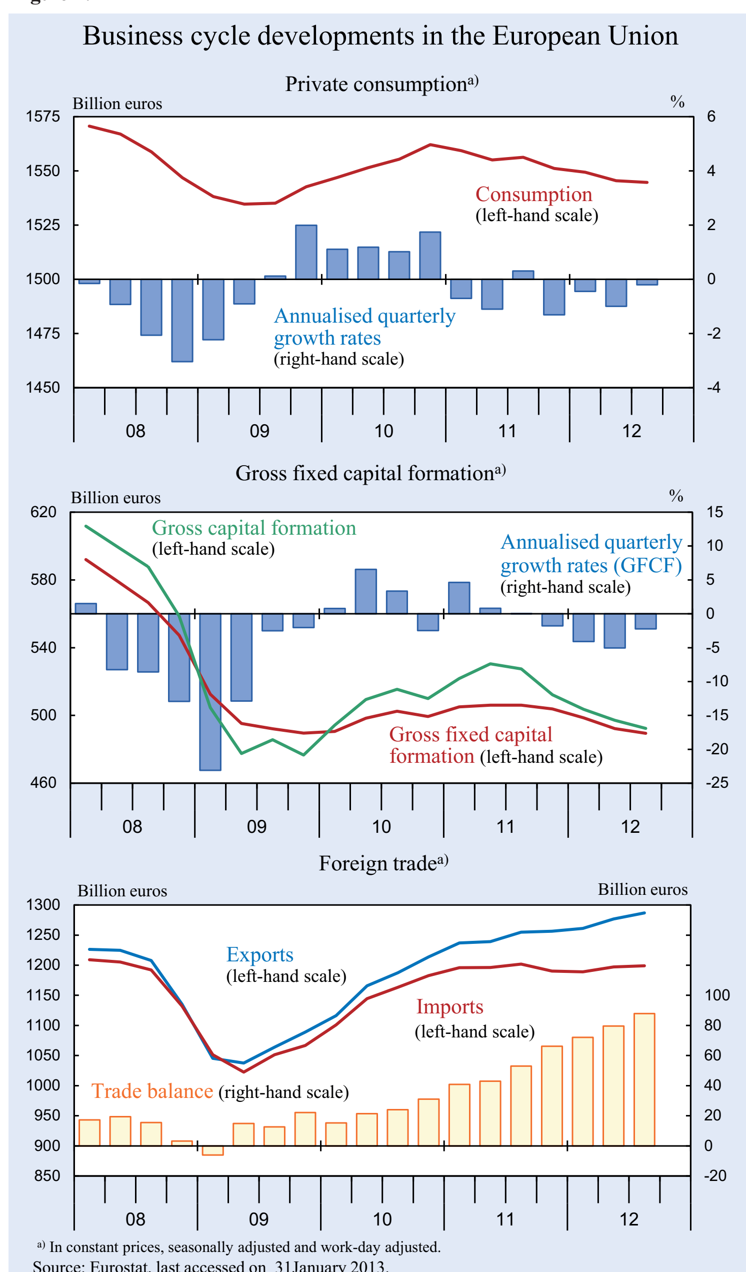
[2] The “troika” consists of the European Commission, the International Monetary Fund and the ECB.
[3] At the time that the agreement with Spain was made, it was not entirely sure the ESM would be approved. In particular, Germany’s Constitutional Court had not yet given the ESM a green light. In a back-up scenario the financial means would have stemmed from the EFSF.

production factors are causing significant burdens on these economies in the short term.

Fiscal policy has had a particularly strong dampening effect. With the exception of Ireland, in especially the crisis countries the degree of restrictiveness has increased sharply since mid-2011. As a result, Italy and Spain, the third and fourth largest economies of the euro area, as well as Cyprus, have slid into a deep recession, while the economy has continued to contract in Greece and Portugal.

In the face of a strong decline in demand from crisis countries, the high level of uncertainty and restrictive financial policy pursued in almost all member states, the level of economic activity in the European Union has dropped sharply since autumn 2011. Aggregate economic performance in the European Union shrank by a cumulative 0.5 percent between autumn 2011 and mid-2012, after which the stronger growth performance of the United Kingdom caused by the catch up of the additional holiday for the celebrations marking 60 years of the Queen's reign and the Olympic Games kicked in. In the euro area the recession continued and has now resulted in a cumulative reduction of GDP of 0.6 percent. Private consumption and both private and public investment have declined rapidly. Only foreign trade has made significant positive contributions to growth, mainly due to extremely weak growth in imports (see Figure 1.11).

Figure 1.11



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 31January 2013.

Economic developments in the euro area are characterised by a growing divide among the individual member states in recent years. Cyprus, Greece, Portugal, Spain and Italy are experiencing a deep recession. The numerous structural adjustments are playing a decisive role in addition to highly contractive fiscal policy. The financing conditions for the private sector in these countries are also significantly less favourable than anywhere else in the monetary union, despite the extremely loose monetary policy of the ECB. Economic development was somewhat more robust in Belgium, France, Finland and the Netherlands, where fiscal policy was much less restrictive than in the crisis countries. However, these countries also suffer from some structural weaknesses. Finland and Belgium appear to have a poor competitive position internationally, as they are posting losses in their share of world markets (see Table 1.1). The Netherlands has a highly indebted private sector painfully hit by plummeting real-estate prices. Finally, some member states (Austria, Germany, Malta and

Table 1.1

Labour costs[a]

	Compensation per employee[b]		Real compensation costs[c]		Labour productivity		Unit labour costs		Relative unit labour costs[d]		Export performance[e]	
	1999–2011	2012	1999–2011	2012	1999–2011	2012	1999–2011	2012	1999–2011	2012	1999–2011	2012
Germany	1.2	1.9	0.4	0.5	0.8	– 0.1	0.5	2.8	– 1.6	– 2.2	0.9	3.0
France	2.7	2.8	1.0	1.3	0.7	0.2	2.0	1.9	0.3	– 2.8	– 2.3	1.2
Italy	1.9	2.0	– 0.2	0.9	– 0.1	– 1.7	2.6	2.4	0.8	– 2.3	– 3.1	– 1.1
Spain	2.8	2.0	– 0.2	1.7	0.7	2.9	2.7	– 2.7	1.0	– 5.7	– 0.4	2.8
Netherlands	2.9	2.0	0.8	1.2	0.9	– 0.8	2.2	1.5	0.5	– 4.2	– 0.1	1.1
Belgium	2.5	3.1	0.6	1.0	0.7	– 0.4	2.0	3.4	0.6	– 1.9	– 1.5	– 1.5
Austria	2.1	2.7	0.5	0.7	1.0	– 0.6	1.1	3.6	– 0.5	– 0.7	– 0.4	– 0.1
Greece	4.8	–	2.0	–	1.2	2.1	3.4	– 0.2	1.0	– 11.4	– 2.2	– 5.0
Finland	3.2	2.1	1.7	0.1	1.2	0.5	2.0	3.2	0.0	– 2.8	– 1.8	– 3.9
Ireland	3.8	1.4	2.1	– 0.4	2.4	2.0	2.0	– 0.8	0.8	– 6.2	1.6	1.5
Portugal	3.4	0.7	1.0	0.9	1.0	0.8	2.7	– 0.4	0.7	– 6.5	– 1.1	3.8
Slovakia	7.2	3.4	3.6	1.7	3.7	2.2	2.6	0.5	2.7	– 3.2	2.9	7.7
United Kingdom	3.6	2.3	1.3	0.2	1.3	– 1.1	2.4	3.2	– 1.4	5.4	– 1.7	– 2.2
Sweden	2.9	3.6	1.2	2.5	1.7	0.5	1.4	2.5	– 0.6	1.3	– 0.4	– 1.4
Denmark	3.1	1.9	0.8	0.0	0.8	0.5	2.6	1.0	0.9	– 4.1	– 0.7	0.2
Poland	5.1	6.5	1.8	4.0	3.7	2.1	2.1	1.8	– 0.3	– 3.5	2.6	0.1
Czech Republic	5.7	2.8	4.0	1.8	3.1	– 0.9	2.0	2.4	3.3	– 2.9	3.1	2.1
Hungary	7.3	3.8	1.6	0.9	2.3	– 2.3	5.6	5.9	2.8	– 2.3	4.0	– 0.5
Iceland	6.5	5.5	1.0	1.9	1.6	2.8	5.8	5.3	– 1.5	0.9	0.5	3.2
Norway	4.6	4.2	– 0.6	0.8	0.6	1.3	4.4	2.6	3.4	0.9	– 3.8	– 1.1
Switzerland	1.8	1.2	0.7	1.0	0.7	– 0.3	1.1	1.5	1.6	– 2.1	– 0.6	– 2.2
Japan	– 0.8	1.2	0.5	2.1	1.0	1.3	– 1.5	– 1.8	– 1.4	– 3.7	– 2.7	– 2.7
United States	3.5	1.7	1.3	– 0.2	1.8	0.8	1.9	1.3	– 1.9	1.5	– 1.5	0.4
Canada	3.1	3.3	0.6	2.3	0.8	1.0	2.4	1.5	3.0	0.5	– 3.0	– 1.1
China	–	–	–	–	–	–	–	–	–	–	10.8	2.3

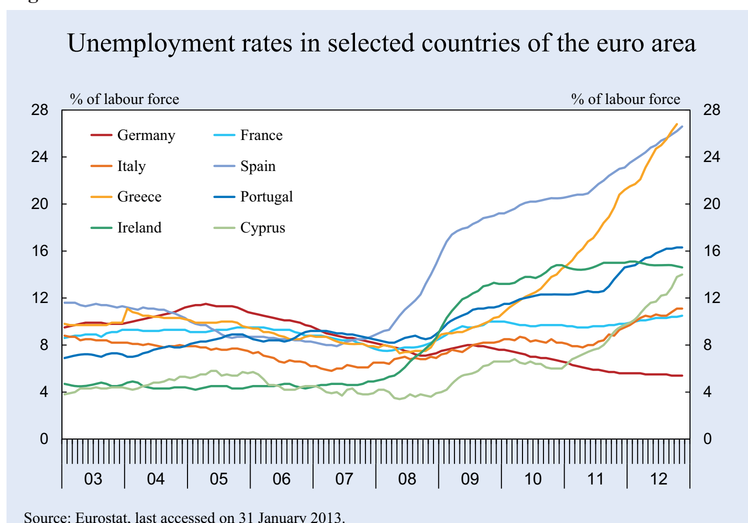
[a] Growth rates for the total economy. – [b] Compensation per employee in the private sector. – [c] Compensation per employee deflated by GDP Deflator. – [d] Competitiveness – weighted relative unit labour costs. – [e] Ratio between export volumes and export markets for total goods and services. A positive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

Source: OECD Economic Outlook No. 92, December 2012.

Slovakia) have seen far more robust economic momentum in recent years. They have benefitted from the relatively solid condition of their public and private finances, as well as their high level of international competitiveness.

The deterioration of the economic situation in the euro area has had a noticeable impact on the labour market, where the unemployment rate increased from 9.9 percent in summer 2011 to 11.7 percent in October 2012. This rapid rise was preceded by a period of stabilisation in 2010 and in the first half of 2011 (see Figure 1.7). Developments in national labour markets continue to be marked by increasing heterogeneity. Unemployment in countries with relatively robust economies (Austria, Denmark, Germany, the United Kingdom and the Baltic states) has declined slightly over the past year. The crisis countries of Cyprus, Greece, Italy, Portugal and Spain, which were suffering from structural problems, saw noticeable rises in unemployment (see Figure 1.12). In Spain and Greece roughly a quarter of the work force is now unemployed. In Chapter 2 we attribute this disaster to an inflationary credit bubble that deprived these coun-

Figure 1.12

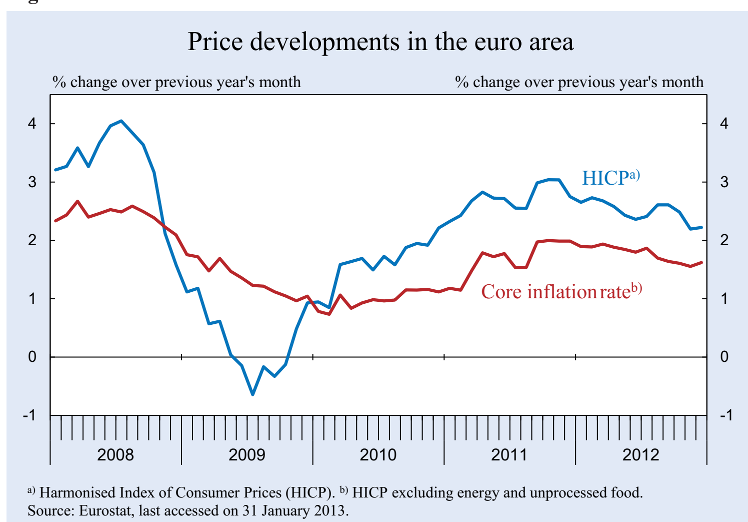


Source: Eurostat, last accessed on 31 January 2013.

tries of their competitiveness. The effects of this credit bubble will have to be overcome via a downward realignment of prices and wages. Ireland, which also belongs to the group of crisis countries, is the only country in which the situation in the labour market has broadly stabilised, with unemployment declining slightly from its peak of 15.1 percent in January 2012 to 14.7 percent last October, following a sizeable real devaluation.

The inflation rate in the euro area has been declining since autumn 2011 falling from 3.0 percent in September 2011 to 2.2 percent in December 2012 (see Figure 1.13). Increasingly weak domestic demand and the slowing of wage growth were mainly responsible for this drop. The inflation rate nevertheless sank less quickly and less pronouncedly than may have been expected based on the recessionary state of the euro area. Excluding energy and unprocessed food items, i.e. looking at core inflation, the trend is similar, albeit less pronounced. This was primarily due to the increase in administered prices and excise duties arising from fiscal consolidation in some member states. Both actual and core inflation would have been 0.4 percentage points lower on average throughout 2012 if the direct effect of excise taxes had been excluded. Inflation has especially been driven by tax increases in the crisis countries of Italy, Portugal and Greece.

Figure 1.13



a) Harmonised Index of Consumer Prices (HICP). b) HICP excluding energy and unprocessed food.
Source: Eurostat, last accessed on 31 January 2013.

Differences across Europe

After a strong start, overall economic output in *Germany* increasingly lost momentum over the course of 2012. The cooling down in the world economy combined with the recession in Southern Europe did slightly infect the German economy via its exports. Furthermore, lingering uncertainty resulting from the European debt crisis curbed the upward forces of domestic demand. Out of all segments of domestic demand, investment in equipment and machinery was the most seriously affected and fell sharply over the course of the year, despite extremely favourable financing conditions. Investments in buildings also dropped somewhat until the middle of last year, but this was mainly due to a slump in public sector investment in construction after the subsidies of the economic stimulus packages agreed upon during the last recession expired at the end of 2011. In residential construction, on the other hand, low interest rates and the uncertainty over investing abroad continued to stimulate domestic investment demand. Although impulses clearly weakened in autumn 2012, growth was particularly boosted by international trade last year.

The economic slowdown has also impacted the labour market. The number of persons in work stopped rising recently, while the number of hours worked dropped considerably. Companies have

obviously been able to offset lower demand for staff by reducing overtime work. The fact that unemployment has been increasing since the spring, however, is primarily due to a reduction in active labour market policies.

In the fourth quarter of 2012 overall economic output growth was negative. However, Germany does not look set to slip into an outright recession. The Ifo Business Climate Index started to rise again slightly for the first time in six months in November 2012. This increase was accompanied by a clear improvement in the outlook component of the index. The economy therefore looks set to recover in the first quarter of 2013. Overall economic production is likely to have reached a growth rate of 0.7 percent for 2012 and, on balance, should stagnate in the winter months of 2012/2013.

France's economy is in the doldrums. The probability of a recession in the winter months is high. After slightly negative growth during the first half of 2012, real GDP rose again in the third quarter of 2012, albeit by only 0.9 percent. It was particularly impacted by declining gross investment. Public and private consumption, however, provided a positive contribution. Private consumption showed a much weaker than usual increase which can mainly be attributed to higher unemployment. After an overall tendency of the trade balance deficit to increase, exports picked up somewhat, while imports declined in the third quarter of 2012. With a growth rate of 0.0 percent, GDP has stagnated in 2012.

The French unemployment rate stood at 10.7 percent in October 2012, its highest level since 1999, and reached 10.4 percent on average in 2012. The annual inflation rate fell to 2.1 percent in October 2012, down from 2.6 percent at the start of the year. Higher energy and food prices resulted in a comparatively strong increase in the price level over the last year. These effects are now nearly expired and annual inflation reached 2.3 percent last year.

After shrinking for three consecutive quarters, GDP in the *United Kingdom* grew by 3.8 percent in the third quarter of 2012, i.e. between July and September. This strong growth can be explained by temporary special factors. According to an estimate of the Bank of England, there were catch-up effects after a 0.5 percent loss of production due to the Queen's Diamond Jubilee in spring and a 0.4 percent demand increase during the Summer Olympics in London. Given that these were one-time events, however, economic performance did again decrease by 1.2 percent in the fourth quarter. Total economic output overall stagnated last year. The unemployment rate fell slightly during the course of last year and averaged at 7.9 percent. Inflation slowed down from 4.5 percent in 2011 to 2.9 percent in 2012. However, despite the overall weak economy it still remained at an elevated level.

Italy remains embroiled in recession. GDP has been falling since the third quarter of 2011, primarily due to a significant decline in private investment, which is suffering from the banks' restrictive lending conditions, high interest rates and uncertainty about the future course of the sovereign debt crisis, as well as a sustained flight of capital. Consolidation measures initiated by Monti's government have also placed a heavy millstone on public investment and caused government spending to decline slightly. Private consumption, driven down by rising unemployment, higher taxes and higher energy and food prices, has also contributed negatively to the economic growth. Only net exports have had an expansionary impact. This, however, is less due to a revival in exports, and more to a decline in imports. Nevertheless, it turned the prevailing trade deficit of recent years into a surplus in the second quarter of 2012. Overall, GDP shrunk by 2.0 percent last year.

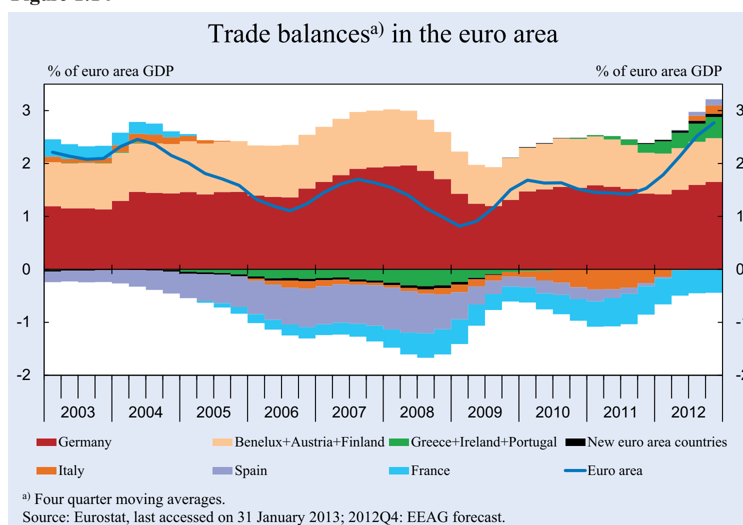
The unemployment rate continued its rise and stood at 11.1 percent in October 2012, its highest level in 13 years. The average unemployment rate was 10.6 percent last year. The Italian labour market is characterised by strong segmentation into a core of well-protected workers with permanent contracts and a growing number of temporary employees – mainly young workers. A central project of Monti's government was to break this segmentation within the framework of comprehensive labour market reforms, and to improve the functioning of the labour market. Under pressure from the political parties, industry and trade unions, the planned measures, however, were mitigated to the extent that they now appear inadequate to bring about a sustainable recovery of the labour market in the near future.

After an increase in value-added tax (VAT), consumer prices have risen sharply in 2012. Inflation, which peaked in March 2012 at 3.8 percent, has since fallen to 2.6 percent in November. The average annual inflation rate stood at 3.0 percent last year, which is well

above the euro area average and continues to undermine Italian competitiveness.

Spain is experiencing a cyclical and structural crisis. In the third quarter of 2012, GDP declined by an annualised 1.1 percent, the fifth quarterly decline in a row. Spain's annual growth rate amounted to – 1.3 percent for 2012. With the exception of net exports, no demand component has been able to make a positive contribution. State expenditure has been slashed considerably due to the central government's consolidation measures. Uncertainty about the stabilisation of the banking sector, as well as high interest rates and persistent capital flight, are hampering private investment. Excess capacity in the construction sector has not yet been relieved. Private consumption is falling because of record unemployment and a high level of household indebtedness.

Figure 1.14



a) Four quarter moving averages.
Source: Eurostat, last accessed on 31 January 2013; 2012Q4: EEAG forecast.

Exports have been significantly revived in recent years and are increasingly supporting economic activity. Recent structural reforms, particularly aimed at improving price competitiveness, are starting to bear fruits: in the second quarter of 2012, exports exceeded imports for the first time since 1998. The trade balance is now showing a surplus, while the deficit in the current account has declined significantly. However, as in the other crisis-stricken countries, the improvements come primarily from imports declining due to the recession, rather than structural improvements in the economy resulting from a real devaluation (see Chapter 2).

The labour market situation has worsened again. The unemployment rate stood at 26.2 percent in October 2012, the highest level ever recorded. The average unemployment rate stood at 25.1 percent in 2012. The annual rate of inflation has accelerated significantly during autumn last year to 3.5 percent, which is largely due to an increase in VAT by 3 percentage points in September. The average change in consumer prices was 2.1 percent in 2012.

Greece, Portugal and *Ireland* have been undergoing an adjustment programme agreed with the "troika" designed to bring public finances, as well as the development of the external debt of these countries, on a sustainable path through a series of structural reforms. All three economies have made significant efforts since the beginning of the debt crisis; but each of the three has achieved very different levels of progress.

As seen in the continuous improvement of national trade balances over the course of the last four years, the accumulation of external liabilities has slowed noticeably in all three countries since the outbreak of the financial crisis in 2008 (see Figure 1.14). However, again, a significant part of this adjustment only reflects the cyclically-related decline in imports relative to exports. The low interest rate for aid loans and the extra ECB refinancing credit standing behind the target liabilities have contributed to the improvement in current accounts, because interest payments on foreign loans are posted as debits on these balances. Current account adjustments are sustainable only if the crisis countries can permanently increase their price competitiveness, which fell heavily in the decade prior to the outbreak of the financial crisis. In this respect, a very mixed picture emerges in the three countries.

Ireland enjoyed comparatively flexible labour and product markets already before the outbreak of the financial crisis. The country was accordingly able to restore its price competitiveness compared to the rest of the euro area swiftly via a sectoral redistribution of its labour force combined with rapid wage and price reductions. Whereas Ireland's unit labour costs have declined by 12.5 percent since 2008, relative to those of its competitors this even amounted to 24 percent. In addition, the noticeable improvement of the Irish current account is due to advantageous sectoral and

regional specialisations of the Irish export sector. Ireland benefitted from the clearly more robust economies in the United States and in the emerging markets.

In contrast to Ireland, both Greece and Portugal face severe economic rigidities and a significantly less favourable sectoral and regional specialisation. A noticeable recovery in international competitiveness can only be expected in Greece and Portugal after profound reforms in the labour and product markets, and only to the extent that these reforms enable widespread wage and price cuts. These processes, however, only began after adjustment programmes were adopted in 2010 by Greece and in 2011 by Portugal. As a result, unit labour costs did still increase by 5 percent in Greece and 4 percent in Portugal overall since 2008. The competitiveness of these economies has only started to improve in more recent years and relative to their trading partners.

It is difficult to assess whether the implemented and scheduled reforms are sufficient to bring about the necessary price movements in Greece and Portugal in the years ahead. Although some significant progress has been made, this does not yet seem to have been substantial enough to warrant a sufficient improvement of competitiveness in the medium term. The improvement seen in the current account has only been induced by price effects to a limited extent, and is primarily the result of the recession in the wake of the collapse in domestic demand for imports.

The three crisis-afflicted countries also showed very different developments last year. While Ireland's economic output stagnated, Greece and Portugal continued to shrink sharply. The relatively positive development in Ireland was mainly due to the dynamic expansion of exports to countries outside of Europe. Nevertheless, there are still structural problems in Ireland. The real-estate bubble burst in 2008, leaving a debt-ridden household sector and severely troubled banks, and creating a large number of unemployed workers in the construction sector.

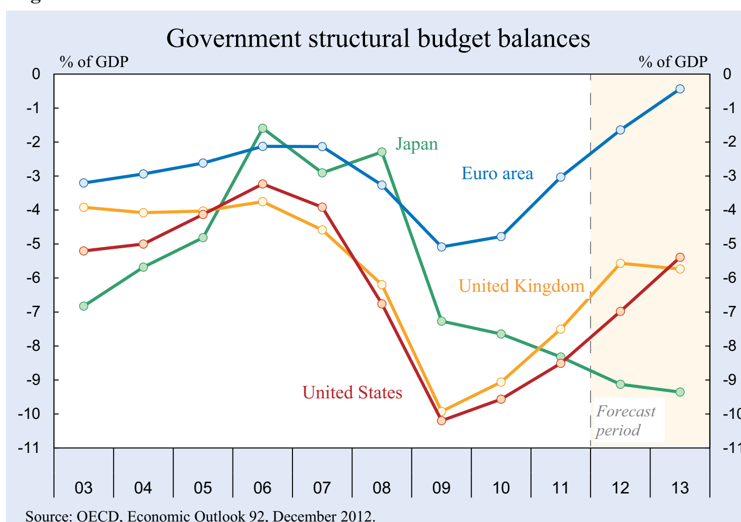
With the decline in demand from the euro area, the economic recovery has ground to a standstill in all countries of *Central and Eastern Europe*. The increase in exports slowed significantly in the first half of 2012 and the confidence of businesses dropped everywhere. Although production growth was still positive in some countries, especially in Poland and the Baltic states, the expansion slowed significantly over the course of last year. The Czech Republic and Hungary, on the other hand, moved into recession at the start of 2012. While consumer spending declined in the Czech Republic, Hungary recorded a sharp decline in investment. In both countries, inflation rates rose as a result of increases in excise taxes. Political turmoil in Romania led to a significant devaluation of the Romanian leu, an increase in inflation and higher risk premiums.

1.3 Fiscal and monetary policy in Europe

1.3.1 Fiscal policy

The growing concern of financial markets about the sustainability of public debt has forced many advanced economies to consolidate. In 2010 and 2011 substantial parts of the resulting improvement in fiscal balances could be ascribed to improvements in economic conditions (relative to the crisis years of 2008/2009) automatically leading to improved tax revenues and reduced unemployment and welfare benefits; in 2012, however, this was not the case as the year saw a return to recession in Europe and a weakening of global dynamics. Furthermore, the relatively easy to implement cut-backs of fiscal stimulus packages introduced during the Great Recession were largely implemented in the first years after it. Nevertheless sharp declines in structural deficits, i.e. deficit measures that attempt to exclude business cycle effects,

Figure 1.15



Source: OECD, Economic Outlook 92, December 2012.

remain visible for the euro area and the United States in 2012 (see Figure 1.15). However, while this year's structural budget deficits will also remain substantially above pre-crisis levels in the United States, Japan and the United Kingdom, the euro area's structural budget deficit is estimated to fall to 0.4 percent of GDP in 2013, its lowest level since 1991, i.e. the first year for which this data is available.

Fiscal policy in most countries of the euro area remained restrictive in 2012 (see Table 1.2). The improvement in the overall fiscal balance, however, was, mainly due to the business cycle and was less pronounced than in 2011. For most EU countries the improvements in primary fiscal balances lagged behind those of the year before. Some countries with relatively sound fiscal histories, notably Sweden,

Table 1.2

Public finances

	Gross debt[a]					Fiscal balance[a]				
	1999–2007	2008–2010	2010	2011	2012	1999–2007[b]	2008–2010	2010	2011	2012
Germany	63.7	74,6	82.5	80.5	81.7	– 2.2	– 2.4	– 4.1	– 0.8	– 0.2
France	61.7	76,6	82.3	86.0	90.0	– 2.7	– 6.0	– 7.1	– 5.2	– 4.6
Italy	106.4	113,9	119.2	120.7	126.5	– 2.9	– 4.1	– 4.3	– 3.8	– 2.8
Spain	49.4	51,9	61.5	69.3	86.1	0.2	– 8.5	– 9.7	– 9.4	– 8.0
Netherlands	51.7	60,8	63.1	65.5	68.8	– 0.5	– 3.4	– 5.0	– 4.4	– 3.6
Belgium	98.6	93,5	95.5	97.8	99.9	– 0.4	– 3.5	– 3.9	– 3.9	– 3.1
Austria	64.7	68,3	72.0	72.4	74.6	– 1.8	– 3.2	– 4.5	– 2.5	– 3.2
Greece	102.3	130,3	148.3	170.6	176.7	– 5.3	– 12.1	– 10.8	– 9.5	– 6.8
Ireland	31.8	67,2	92.2	106.4	117.6	1.6	– 17.4	– 30.9	– 13.3	– 8.4
Finland	42.1	42,0	48.6	49.0	53.1	3.9	– 0.4	– 2.8	– 0.9	– 2.0
Portugal	59.9	82,8	93.5	108.1	119.1	– 4.1	– 7.9	– 9.8	– 4.4	– 5.0
Slovakia	41.0	34,8	41.0	43.3	51.7	– 5.3	– 5.9	– 7.7	– 4.9	– 4.9
Slovenia	26.2	31,9	38.6	46.9	54.0	– 2.3	– 4.5	– 5.7	– 6.4	– 4.4
Luxembourg	6.3	16,3	19.2	18.3	21.3	2.5	0.5	– 0.8	– 0.3	– 1.9
Estonia	5.0	6,1	6.7	6.1	10.5	0.7	– 1.6	0.2	1.2	– 1.1
Cyprus	64.3	56,2	61.3	71.1	89.7	– 2.7	– 3.5	– 5.3	– 6.3	– 5.2
Malta	62.9	66,0	68.3	70.9	72.3	– 5.2	– 4.0	– 3.6	– 2.7	– 2.6
Euro area	**69.0**	**78,6**	**85.6**	**88.1**	**92.9**	**– 1.9**	**– 4.9**	**– 6.2**	**– 4.1**	**– 3.3**
United Kingdom	41.1	66,5	79.4	85.0	88.7	– 1.4	– 8.9	– 10.2	– 7.8	– 6.2
Sweden	51.5	40,3	39.5	38.4	37.4	1.3	0.4	0.0	0.2	– 0.2
Denmark	44.3	39,0	42.9	46.6	45.4	2.4	– 0.7	– 2.7	– 1.9	– 4.0
Poland	43.2	50,9	54.8	56.4	55.5	– 4.1	– 6.3	– 7.9	– 5.0	– 3.4
Czech Republic	25.2	33,6	37.8	40.8	45.1	– 3.9	– 4.3	– 4.8	– 3.2	– 3.5
Hungary	59.8	78,2	81.8	81.4	78.4	– 6.4	– 4.2	– 4.5	4.3	– 2.6
Romania	19.6	22,5	30.5	33.4	34.6	– 2.6	– 7.2	– 6.8	– 5.5	– 2.8
Lithuania	20.5	27,6	37.9	38.5	41.6	– 1.8	– 6.6	– 7.2	– 5.5	– 3.1
Bulgaria	46.2	14,8	16.2	16.3	19.5	0.6	– 1.9	– 3.1	– 2.0	– 1.5
Latvia	12.7	33,7	44.5	42.2	41.9	– 1.6	– 7.3	– 8.1	– 3.4	– 1.7
European Union	**61.9**	**72,3**	**80.2**	**83.0**	**86.8**	**– 1.7**	**– 5.3**	**– 6.5**	**– 4.4**	**– 3.6**
United States	62.0	88,1	98.6	102.9	107.2	– 3.1	– 10.4	– 11.2	– 10.1	– 8.7
Japan	166.1	205,8	215.3	229.6	236.6	– 6.0	– 8.0	– 9.4	– 9.8	– 10.0

[a] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States and Japan, definitions according to the IMF. – [b] For the United States, 2001–2007.

Source: European Commission, Autumn 2012; IMF World Economic Outlook, October 2012.

Austria, Finland, Estonia, Luxembourg and Denmark, were even able to provide their economies with some fiscal impulses (see Figure 1.16).

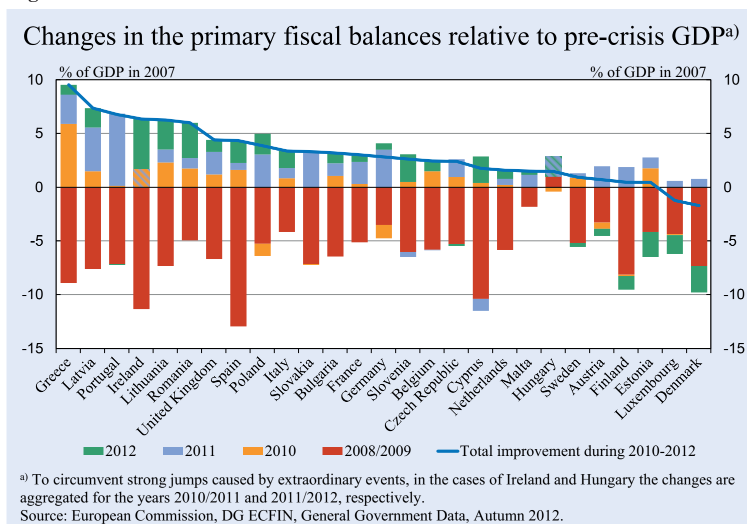
However, consolidation efforts in recent years have nevertheless been very pronounced leading to a clear concomitant dampening of domestic demand almost everywhere. Given the scope of the austerity measures, demand is particularly weak in the crisis countries of Greece, Ireland and Portugal, Spain and more recently Cyprus. Spain was even forced to step up consolidation once again last summer. This was a response to the looming threat of missing the deficit target for that year, as well as the additional financial requirements of regional authorities. As a result, financial markets put the government in Madrid under substantial pressure by withdrawing capital at a temporarily accelerated rate in early summer. Despite the additional 13 billion euros consolidation package agreed in August last year, the Spanish government failed to push the 2012 budget deficit to the targeted 5.3 percent of GDP. This was due to substantial revenue losses and expenditure increases caused by the recession. Italy also responded to the financial market turbulence and inadequate progress in restructuring its public budget by passing additional austerity measures. The majority of the other member states have also passed extensive austerity measures to cut their public deficits, as these currently lie above those permitted by the Fiscal Compact.

Although to a somewhat smaller degree than in previous years, fiscal policy in the euro area will remain highly restrictive in 2013. Largely due to slightly improved business cycle conditions, the degree of restrictiveness will be slightly lower than in 2012 in almost all member states. As a result, the negative impact on domestic demand should also be somewhat less pronounced than in 2012. This forecast is based on the assumption described in the baseline scenario that the consolidation and reform measures announced by the European governments will be uniformly implemented. All in all, the cost-saving efforts, and particularly the increases in tax revenues in the euro area, will decrease the combined deficit of 3.3 percent of GDP in 2012 to 2.6 percent in 2013. The debt-to-GDP ratio will rise from 92.9 percent in 2012 to 94.5 percent in 2013.

In Portugal the deficit-to-GDP ratio of 9.8 percent in 2010 fell to 4.4 percent in 2011, causing the “troika” to give a positive testimony. This substantial deficit reduction, however, was largely caused by special circumstances. The primary deficit was not reduced any further last year as a result. Nevertheless, Portugal’s most recent budget figures indicate a continued reduction in the near future. The fixed deficit targets of both last year and this year, however, are likely to be missed, because the consolidation plans are, as is often the case, based on macroeconomic developments that must be regarded as overly optimistic from today’s perspective. The public deficit in relation to GDP amounted to 5 percent last year, and is likely to reach 4.7 percent this year.

In Greece, the deficit-to-GDP ratio was only slightly retracted from 10.8 percent in 2010 to 9.5 percent in 2011, which was well above the originally targeted 7.6 percent of GDP. This was largely due to the intensification of the recession, the failure to implement more structural reforms in the state apparatus, as well as insufficient progress in the privatisation of state-owned enterprises. Greece also failed to reach the deficit target of 4.2 percent of GDP, despite a successful cut to its privately-held debt. Early summer saw strong delays in implementing the consolidation programme due to the inability of the Greek government to act. The public deficit probably amounted to around 7 percent of GDP in 2012 and is forecast to drop to about 6 percent this year. The interest forgiven to Greece according to the renegotiated debt relief

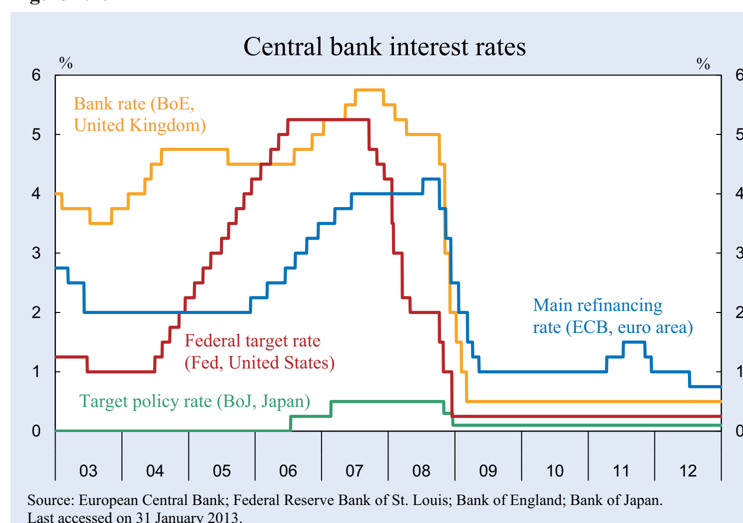
Figure 1.16



a) To circumvent strong jumps caused by extraordinary events, in the cases of Ireland and Hungary the changes are aggregated for the years 2010/2011 and 2011/2012, respectively.
Source: European Commission, DG ECFIN, General Government Data, Autumn 2012.

programme of autumn 2012 will provide some relief to Greece's public finances. However, huge primary surpluses are needed in the years ahead to reduce the government debt-to-GDP ratio as agreed. According to estimates by the European Commission, the primary fiscal balance is supposed to be close to zero this year (coming from – 10.5 percent of GDP in 2009). We will be surprised if these official forecasts do not turn out to have again been overly optimistic.

Figure 1.17



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan. Last accessed on 31 January 2013.

In contrast to Greece and Portugal, the consolidation of public finances in Ireland has largely followed the plan agreed with the "troika". The deficit-to-GDP ratio declined to 13.3 percent in 2011, after reaching 30.9 percent in 2010 as a result of the rescue measures for the banking sector. The deficit reduction of 19.1 percentage points, as intended in the rescue plan, was almost achieved. Fiscal consolidation is likely to remain on schedule. A deficit of 8.4 percent of GDP in 2012 is expected to drop to 7.3 percent in 2013.

1.3.2 Monetary conditions and financial markets

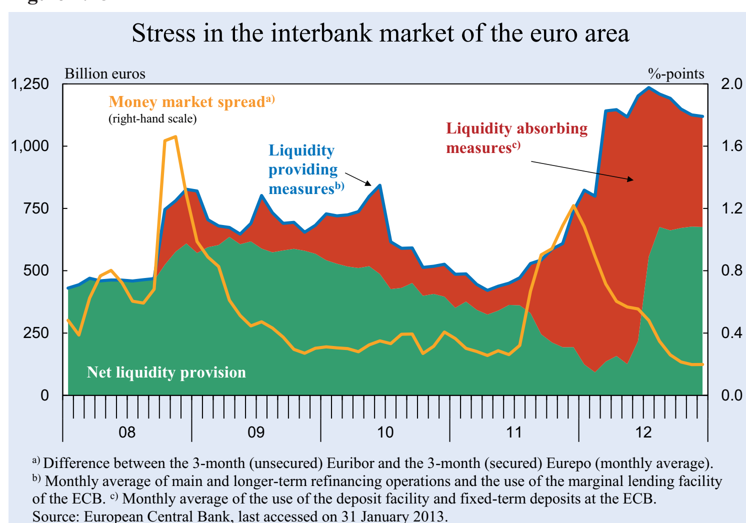
Monetary conditions

Monetary policy has recently become more expansionary in all major industrial countries and emerging markets. In September 2012 the ECB signalled that it is willing to expand its purchase of the sovereign debt of countries that have agreed to a fiscal adjustment policy. This decision was apparently made in response to rising rates on Italian and Spanish government bonds. ECB policy is expected to remain extraordinarily expansionary during this forecast period since the deep recession in the peripheral euro area countries will keep the pressure on the EU-wide price level extremely low. The US Federal Reserve (Fed) announced another round of monetary easing given the persistent weakness in the labour market. The Fed continues to purchase mortgage-backed securities, at least initially, without predefined limits. Furthermore, the Fed has announced further expansion of the monetary policy if the economic situation does not improve in the foreseeable future. The Bank of England and the Bank of Japan also expanded their securities purchases significantly last year.

Most emerging economies also started to gradually ease their monetary policies as of mid-2012, after having tightened them repeatedly in the preceeding year and a half. The easing of monetary policies should counteract the economic slowdown primarily due to falling demand from the euro area and high levels of uncertainty. Given the relatively low inflationary pressure since the beginning of 2012, monetary policy is likely to become more expansionary in the majority of emerging economies this year, especially if the global economic outlook continues to look unfavourable.

Since its last 25 basis point cut in July 2012, the ECB has left its interest rate for open market operations unchanged at 0.75 percent (see Figure 1.17). The liquidity provided through refinancing operations is still plentiful. While the outstanding volume of longer-term refinancing loans has remained relatively constant since the second round of three-year loans was announced in March 2012, demand for the weekly main refinancing operations has continued to drop since the summer. Government bond purchases had not been made since March 2012. The programme to purchase government bonds replacing the previous programme for securities markets as decided in September 2011 has not yet been implemented. Overall, the liquidity pumped into the banks in the euro system started to fall at a moderate, but continuous pace from its peak in July 2012 until the end of last year (see Figure 1.18). Over summer, the liquidity actually

Figure 1.18



a) Difference between the 3-month (unsecured) Euribor and the 3-month (secured) Eurepo (monthly average).
b) Monthly average of main and longer-term refinancing operations and the use of the marginal lending facility of the ECB. c) Monthly average of the use of the deposit facility and fixed-term deposits at the ECB.
Source: European Central Bank, last accessed on 31 January 2013.

in circulation had risen quite substantially because banks reduced the amount of liquidity parked in the euro system (fixed-term deposits, deposit and surplus reserves). As the overnight deposit rate was reduced to 0 percent in July, the incentive to park money in the ECB's deposit facility disappeared.

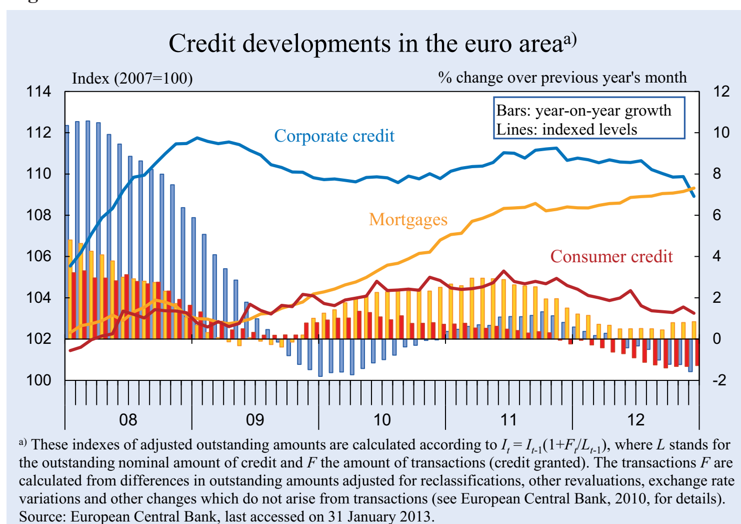
As a result of ample liquidity, interest rates in the interbank money market have fallen substantially during 2012. Since July, the interest rate for secured three-month money (Eurepo) on the interbank money market has even turned negative. The interest rate for unsecured three-month cash (Euribor) offered only slightly higher interest rates of less than 0.2 percent at the end of last year. Hence, the money market spread, i.e. the risk premium on the money market, fell significantly during the course of last year and is only 10 to 15 basis points above levels that pertained in the years before the housing market bubble burst in the United States. This reduction in the risk premium on the money market allowed unsecured money market rates to fall by approximately 120 basis points during the year.

Lending rates on new corporate and consumer loans also fell during 2012. In the euro area as a whole, such rates were reduced by between 30 and 90 basis points. However, these declines were seen primarily in the core countries of the euro area (especially in Germany, Finland and the Netherlands), while lending rates in most crisis countries fell by sub-average amounts, or even rose as in the case of Italy.

Despite these falls in rates triggered by a further easing of monetary conditions, the volume of outstanding bank loans to the private sector in the euro area has been declining since the end of 2011. Lending to non-financial corporations, which accounts for roughly half of total credits to the non-financial sectors of the economy was significant in this respect (see Figure 1.19). The outstanding amount of consumer credits also declined considerably during the year. Only the amount of mortgages continued to expand, albeit at a somewhat more moderate pace compared to previous years.

As with lending rates, the credit dynamics have differed widely across the euro area. While lending in most of the core countries is still expanding (especially in the Netherlands), loan portfolios in the crisis countries have dropped, in some cases substantially. Despite declining lending to the private sector in the euro area as a whole, the monetary aggregate M3 managed to expand by 3.5 percent in October 2012 as compared to the year before. The discrepancy between the growth rates of M3 and the expansion of loans to the private sector is mainly due to growth in loans to the public sector, as well as a decrease in the long-term liabilities of the banks among each other.

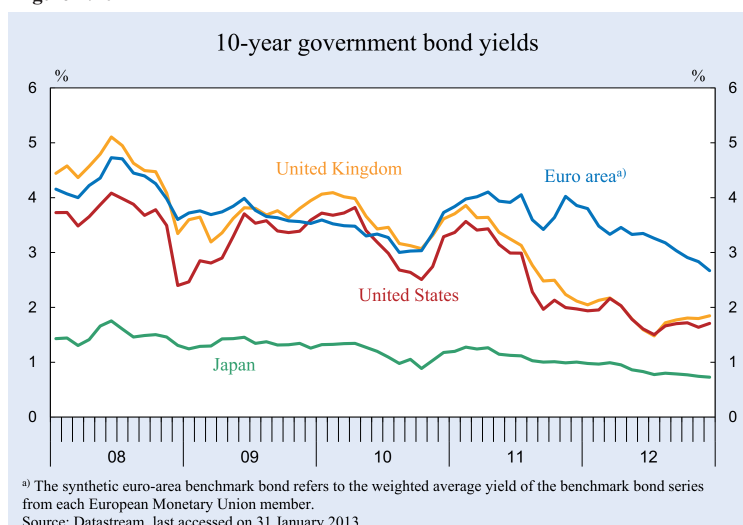
Figure 1.19



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 31 January 2013.

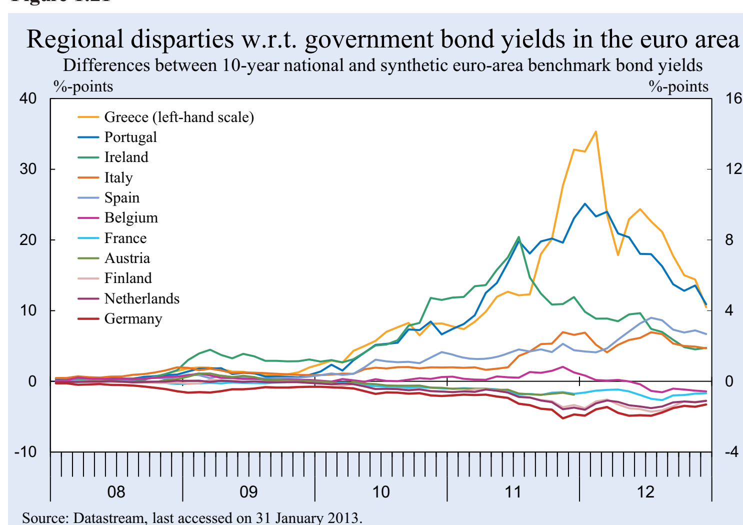
Although not very likely, it is still possible that the ECB will again lower its key interest rate by 25 basis points to 0.5 percent during the first half of this year. Such a move would correspond to the logic behind the previous interest rate changes. Since then the economic situation has deteriorated and inflationary pressure has eased. However, because money market interest rates and credit and capital market interest rates in the core countries are already at historically extremely low levels, such an interest rate cut is likely to remain largely ineffective. It would only benefit those banks in the crisis countries that have only managed to keep afloat to date with the help of ECB refinancing loans. Under the assumption that the ECB will continue these unconventional measures, the liquidity of the banking system will remain ample and money market interest rates will remain low. The announced unlimited government bond purchase programme has reduced, and will reduce, the risk premiums on bonds from crisis countries. After all, the ECB has implicitly declared that it will take over the bonds of any bankrupt state of the euro area before they default, and has thus guaranteed the repayment of these bonds. Through a cut in ECB profits redistributed across national governments, any costs arising from bond purchases will ultimately be borne by the taxpayers.

Figure 1.20



[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 31 January 2013.

Figure 1.21



Source: Datastream, last accessed on 31 January 2013.

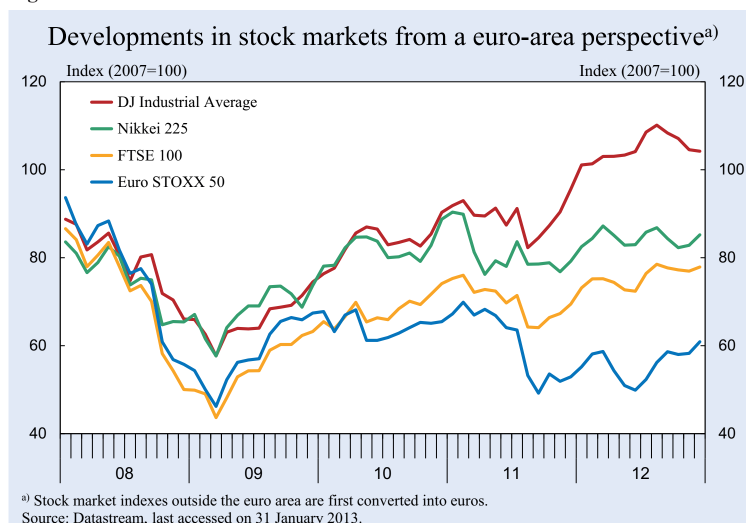
Bonds, stocks and foreign exchange markets

The implicit guarantees provided by the ECB and the new permanent rescue fund, ESM, have halted the trend (particularly marked during 2011) towards government bond yields in the euro area decoupling from those in other major regions in the world, and even started to reverse it in summer 2012. Whereas in the United States and the United Kingdom these long-term interest rates basically stagnated at historically low levels during the second half of 2012, they underwent a substantial reduction in the euro area over the course of the year (see Figure 1.20). German government bond yields have remained more or less unchanged since summer 2012, at least partly because of Moody's announcement that it is considering downgrading Germany based on its exposure in rescue operations. The yields on bonds from crisis countries, however, have declined substantially (see Figure 1.21).

Monetary easing boosted the stock markets in Europe, the United States and many emerging markets. Measured in local currencies, the Dow Jones industrial average, the Nikkei 225, the FTSE 100 and the Euro STOXX 50 correspondingly improved by 8.8 percent, 15.8 percent, 8.1 percent and 15.1 percent respectively during 2012 (see Figure 1.22) as investors are increasingly willing to reallocate their wealth away from low-interest assets. The realised appreciations of

Figure 1.22

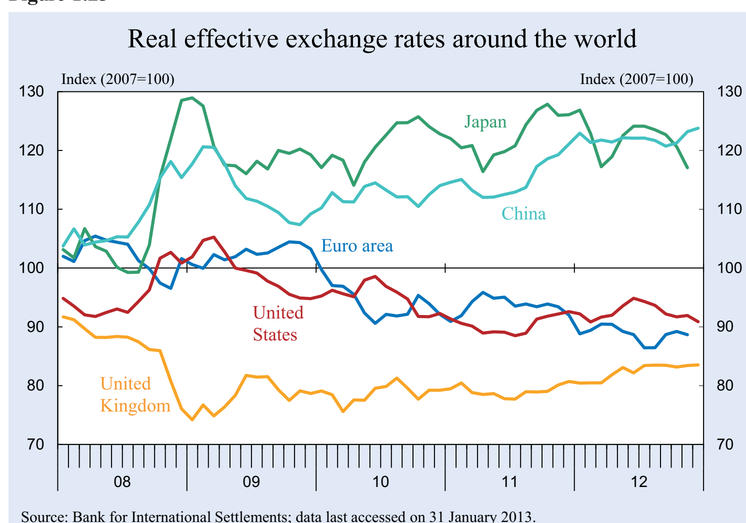
Developments in stock markets from a euro-area perspective[a)]



[a)] Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2013.

Figure 1.23

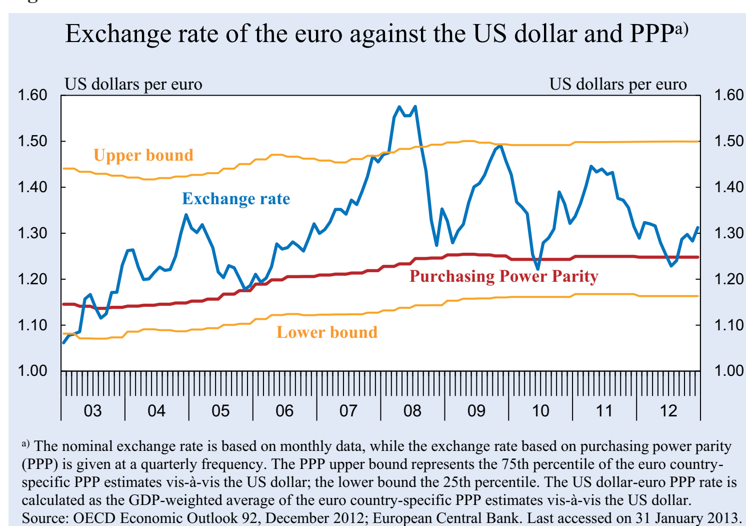
Real effective exchange rates around the world



Source: Bank for International Settlements; data last accessed on 31 January 2013.

Figure 1.24

Exchange rate of the euro against the US dollar and PPP[a)]



[a)] The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The PPP upper bound represents the 75th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 25th percentile. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar.
Source: OECD Economic Outlook 92, December 2012; European Central Bank. Last accessed on 31 January 2013.

the UK pound and Japanese yen relative to the euro reduce these gains somewhat from a euro area perspective (see Figure 1.23). The dollar-euro exchange rate, on the other hand, remained more or less stable in 2012 and compared to other years (see Figure 1.24). Although there was some depreciation of the euro relative to the dollar during the first half of the year, the overall stabilisation of European financial markets has led to a subsequent appreciation of a similar magnitude since summer 2012.

As far as the other major currencies in the world are concerned, only the yen turned out to be relatively volatile again last year, reflecting the fast-changing sentiments in financial markets regarding the importance of so-called safe haven currencies. After a substantial depreciation in early 2012 and a comparable appreciation during the summer, it lost ground again at the end of the year. The real effective exchange rate of the United Kingdom remained on a steady appreciation path that began mid-2011. For China, the stabilisation in inflation also implied a relatively flat development in its real exchange rate.

1.4 The macroeconomic outlook

1.4.1 Assumptions, risks and uncertainties

How well the European debt crisis is controlled remains a decisive factor for global economic growth. The bail-out promise of the ECB, the ruling of the German Federal Constitutional Court upholding the ESM and the agreement to provide ESM loans to support the Spanish banking sector calmed the finan-

cial markets substantially after summer 2012. This also led to a decline in risk premiums on government debt issues by the crisis countries Greece, Portugal, Spain, Italy and Ireland. This respite does not hide the fact that the European debt crisis is far from over. The ECB support programme will only be able to alleviate the symptoms of the crisis in the short term, and does not eliminate its structural causes. Tackling the systemic problems will depend heavily on how successfully the crisis countries implement structural reforms to restore their public finances, to improve their price competitiveness, and ultimately, to enhance their growth potential.

This forecast is based on the assumption that there will be no further escalation of the European debt crisis during the forecast period. This assumes that the crisis countries will strictly adhere to the course of fiscal consolidation and implement the planned structural reforms in many areas. However, it also means that other euro area countries (France, Belgium and the Netherlands) will have to implement the measures already decided or envisioned to reduce public deficits and to improve the international competitiveness without amendment and in a timely manner. This is the only way that the financial markets will be convinced that these countries will be able to service their public and foreign debt without disruption in the future.

Based on these assumptions, it is likely that investor, producer and consumer confidence will gradually stabilise over the forecast period, albeit at a low level. Today's still heightened levels of uncertainty are not expected to increase again either. This opens up the possibility that the euro area, supported by the German economy and the recovery of non-European economies, will exit the recession in 2013. Albeit to a lesser extent than last year, it still implies on-going publicly organised capital outflow from Germany to fund continuing European bail-outs; it will probably also allow for a slow, but steady reduction of the imbalances in the Target system of the European Monetary Union.

These assumptions, however, do not mean that all member countries of the euro area can expect an economic recovery in the year ahead. The structural problems in some crisis countries are simply too big to be solved at short notice. The discussions over Greece's potential exit from the euro that culminated in early summer 2012 have tapered off, at least for the time being. They may only flare up again if the crisis re-escalates. Such a scenario appears less likely from today's perspective and this baseline scenario excludes the possibility that any such speculation will lead to on-going turmoil and contagion in the European financial markets.

However, there remains a high risk of a marked deterioration in the economic situation in the euro area, or even of a massive escalation of the crisis. This represents the main threat to the world's economic development. The success of reform efforts in the crisis countries is far from assured because their governments face strong political opposition at home. The premature resignation of the Italian government under Mario Monti illustrates this risk. In particular, the announcement of the ECB's willingness to extensively intervene in the government bond markets, or the currently discussed possibility of directly recapitalising banking systems through the ESM could reduce the willingness to reform. If the structural adjustment processes in the crisis countries slow down or fail entirely, increased macroeconomic uncertainty, a significant decline of confidence in the euro area and a new recession can be expected. In such a situation the flight of capital from the crisis countries would probably continue, which would further increase demands on the part of local banks to be financed by the euro system and the ESM. However, if the ESM's outstanding loans were to grow strongly, its credit rating could be downgraded again. This could be intensified further if confidence were to drop in the fiscal solvency of important core countries like France, Belgium or the Netherlands that are backing up the ESM although they have their own high levels of public debt and structural weaknesses. In this case, the ESM and the euro area would probably be on the verge of collapse. Depending on how strongly the escalating debt crisis succumbs to this risk scenario, this could unleash different levels of burden for the real economy and the financial sector in almost all industrialised and emerging economies. In extreme cases, it could even come to a worldwide recession.

Risks emanate from the monetary policy of the ECB and the Fed. Both central banks announced additional, and this time unlimited programmes to purchase securities in late summer 2012. Moreover, the provision of liquidity in both regions has been very expansive since the beginning of the global financial crisis. This extremely loose monetary policy could encourage the formation of bubbles in various asset markets. The credibility of the two central banks

Box 1.1

The ECB and medium-term price stability[1]

During the global financial crisis which was followed by the euro crisis, the ECB exhausted its traditional monetary policy instruments and gradually took a rising number of extraordinary measures. The associated potential consequences for future price stability have led to heated debates in- and outside of the profession. In the short term, it is understandable that the ECB has entered the political vacuum that exist(ed) in the European Monetary Union. Medium- to long-term threats to their independence and credibility, and thus to medium-term price stability in the euro area, however, appear to be high.

The primary objective of the ECB, or more precisely of the Eurosystem (i.e. the ECB and the national central banks of the member states that use the euro), is the maintenance of price stability in the euro area. To achieve this target in the medium to long term, the independence and credibility of a central bank are nowadays considered to be essential. The price setting behaviour of economic agents is often based on future price expectations. A credible central bank is able to influence these expectations and thereby achieve the goal of price stability with lower social costs.

Politicians, however, have a potential interest in using the central bank for their often more short-term oriented purposes. They could try to persuade the central bank to buy government bonds in order to finance additional government spending, or lower interest rates in order to generate short-term above-average economic growth. In normal circumstances, both would lead to a loss in credibility and subsequently in price stability. Therefore, it is socially desirable to have monetary policy decisions take place independent of political considerations. This theoretical finding is confirmed in many empirical studies: more independent central banks generally have lower average inflation rates and lower inflation variability.[2]

Although the primary objective of the ECB is price stability, the ECB also has to assure a properly functioning financial system. To secure the functioning of this system the ECB, like other central banks in the major industrialised nations in 2008 and 2009, was forced to intervene heavily. Almost all of the extraordinary measures taken since can be attributed to this. As indicated by the sky-rocketing risk premiums in interbank money markets in autumn 2008, banks lost trust in other banks and were barely willing to lend each other money. Central banks stepped in and provided the credit that the market was no longer willing to provide, or not at the same conditions.

The subsequent liquidity and solvency problems of some governments, the fragile situation in the banking sector and the balance-of-payments problems that have resulted from capital flight in Europe, prevented risk premiums on the interbank market from returning to pre-crisis levels and, during the second half of 2011, even triggered a sharp rise again. This prompted the ECB to take further measures and to again expand gross liquidity supply substantially in countries from which private capital had fled. More specifically, the introduction of so-called long-term refinancing operations providing liquidity via three-year tenders led to a substantial increase in gross liquidity. However, a large part of this money was hoarded, i.e. kept at deposits at the ECB. As a result, net liquidity provision, even if narrowly measured, fell substantially during the second half of 2011 (see Figure 1.18). The official net liquidity provision only jumped to historical heights when the overnight deposit rate of the ECB fell to zero percent in July last year and there was no longer any incentive to transfer money to the deposit facility provided by the ECB system. Total credit provision and the development of broad monetary aggregates, however, still indicate that this ample liquidity is being hoarded by the financial sector and hence is not really being put into circulation. Short-run inflationary pressures coming from this side therefore remain extremely moderate. Nevertheless, in the medium to long term, this ample liquidity could, in principle, make it difficult for the ECB to maintain price stability. If needed, the ECB has enough instruments at its disposal to circumvent a strong increase in the demand for credit. It could raise interest rates or limit the liquidity provided to the banking sector. The only question is whether the ECB would be willing to use these instruments given that it would thereby create problems for over-indebted countries and banks.

The real danger for the ECB therefore lies in the loss of its political independence, i.e. its ability to fulfil its mandate without political interference from over-indebted countries and banks. In addition, the ECB has an extreme interest in keeping the euro project alive: its own existence depends on it. From a political-economy perspective, this opens the door for time-inconsistent behaviour on the side of the ECB and thereby is another source that jeopardises its credibility. This raises the question of whether the public is already starting to have doubts regarding the future objectives of the ECB and thus its independence. For this purpose it is useful to evaluate the current situation with regard to its primary mandate of maintaining price stability.

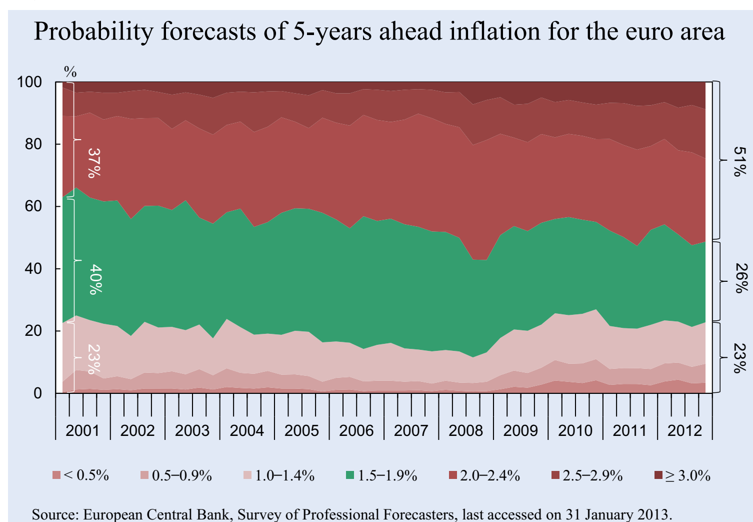
The anchoring of medium-term inflation expectations is important for this. Medium-term expectations are largely unaffected by cyclical and other temporary price effects, and are therefore a good way of judging whether economists trust a central bank to realise that mandate. According to the ECB Survey of Professional Forecasters, although the average inflation expectations for the euro area have remained at around 2 percent, their distribution has become more dispersed over time.

When asked to assess the probability of euro area inflation being in between 1.5 and 1.9 percent in five years – which can be interpreted as "below but close to 2 percent", i.e. the ECB's interpretation of price stability – then participating professional forecasts consistently on average answered around 40 percent prior to the crisis. This

continued Box 1.1

probability has been reduced substantially during the crisis to close to 25 percent more recently (see Figure 1.25). Both the probability that inflation could move beyond 2.5 percent and the likelihood of inflation rates below 1.5 percent have increased substantially. Whereas the former could be interpreted as evidence that the ECB might lose control at the upper end as a result of expected political pressure, the latter rather suggests a prolonged weakness of the European economy which is sure to be a matter of concern to politicians.

Figure 1.25



Source: European Central Bank, Survey of Professional Forecasters, last accessed on 31 January 2013.

In summary, the amalgamation of public finance and monetary policy could harm the independence of the ECB and thus its credibility. Medium-term inflation expectations that are less well anchored can, as in the past, be seen as the first signs pointing in such a direction.

[1] This box is based on Lamla and Sturm (2012).
[2] See for instance Klomp and De Haan (2010) for a broad survey of this literature.

might suffer to the extent that inflationary expectations could become less attached to their current medium-term anchors of approximately 2 percent (see Box 1.1). In the euro area this could be encouraged by the ECB actually implementing its recently adopted securities purchase programme or expanding its financing of crisis banks. This would reinforce the impression that the ECB is no longer independent or has embarked on the course of monetary financing of the state. Even in the short term such fears could lead to a significantly enhanced flight of capital into secure investments. The resulting reallocations and international capital flows could immediately lead to distortions in financial markets, but also in the real economy, which would become a heavy burden for the world economy.

The further tightening of the fiscal reins in the United States in March of this year via the still open ends of the fiscal cliff, the so-called “sequester”, represents some smaller risks to the United States, and thereby to global economic development. If these still scheduled automatic spending cuts in the fields of education, defence and infrastructure as agreed upon in 2011 on the occasion of raising the debt ceiling were to be fully implemented, this would imply a negative impulse of around 110 billion US dollars. Although large, the concomitant loss of demand would probably not pull the United States into a recession again.

If, on the other hand, the government were to have to shut down in March, due to the lack of any agreement to raise the debt ceiling again, then that would have far greater implications for both the United States and the world economy.

Finally, there is an appreciable risk emanating from the recent tensions in the Middle East. A worsening of the situation in this region could lead to significant drops in oil production and thus a sharp rise in the price of oil. Such an oil price shock would be a substantial burden to economic development in the oil-importing countries.

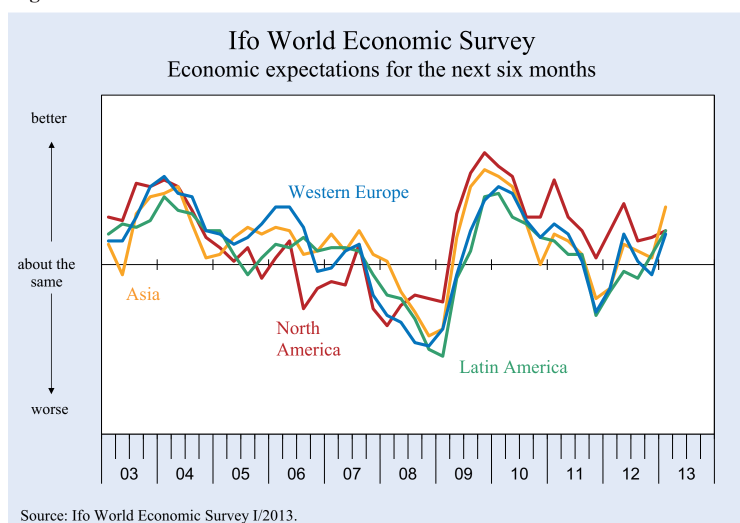
1.4.2 The global economy

Most of the advanced and emerging economies are experiencing a period of economic weakness this winter. This is particularly intense in the euro area, where aggregate economic performance very probably shrunk in the fourth quarter of last year. The decisive factor for this will be the progress made in the adjustment processes of the private and the public sector in the euro area.

Even the United States is likely to tighten its fiscal reins significantly during the forecast period. The “fiscal cliff”, the automatic expiration of numerous

fiscal support measures at the beginning of this year, has been partly avoided. This forecast assumes that about 60 percent of the measures taken in the United States will be extended either permanently or into the next year; but even the remaining 40 percent is likely to be a significant burden to the US economy. As long as no clear political agreement is made in the United States about the structure of the budget, planning will remain highly uncertain for many companies. This is likely to weigh on investment demand in the United States, as well as in other regions of the world, at least during the remaining winter months. Of the developed countries, an expansionary fiscal policy is basically only likely to be implemented in Japan this year.

Figure 1.26



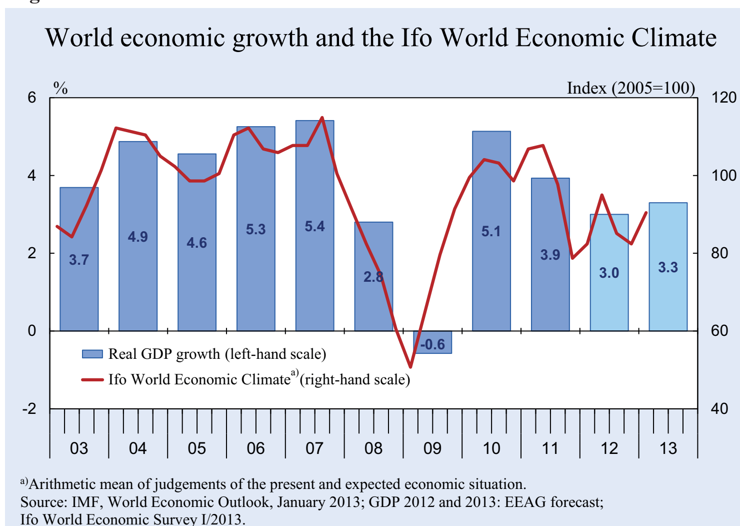
Source: Ifo World Economic Survey I/2013.

In contrast to developed countries, most emerging economies have relatively low public debt levels and thus significantly more fiscal scope to stimulate the economy if needed. These low debt levels drove decisions taken in autumn 2012 by some major emerging countries (China, Brazil and South Korea) to respond to the economic slowdown with measures to stimulate the economy. Many emerging economies are also expected to further ease their fiscal policies this year, albeit to an initially moderate degree.

These expected developments also mean that the overall world economy is not expected to slip into a recession during the forecasting period. Ifo World Economic Survey participants foresee some improvement in the economic situation in all major regions during the first half of 2013 (see Figure 1.26). Hence, the global economic expansion is expected to accelerate somewhat in the course of the year, although it should remain below potential. We expect world GDP to increase by 3.3 percent in 2013 (after 3.0 percent last year), using purchasing-power-parity adjusted weights to aggregate the economies (see Figure 1.27). Using market prices, world economic growth will reach 2.5 percent (versus 2.3 percent last year, see Table 1.A.1).

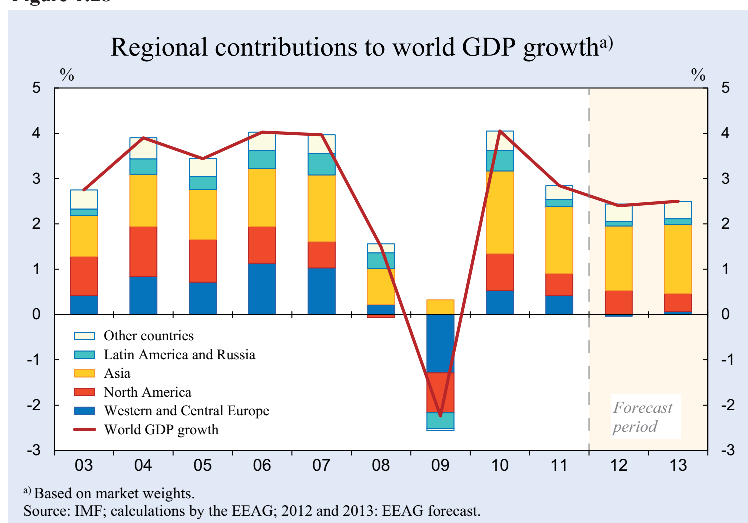
A noticeable acceleration in economic activity is likely in emerging countries due to the monetary and fiscal stimulus measures already taken and those awaiting implementation in the near future. Furthermore, disposable income in these countries is likely to remain strong, thereby giving additional stimulus to private consumption. The advanced economies are also expected to experience slightly higher growth this year as the contractive fiscal impulse in the euro area is likely to have a less severe impact than in 2012. The United States should be able to stick to its moderate growth path, i.e. after the negative fiscal shock at the beginning of the year growth will gradually strengthen again. This will be driven by the already improving

Figure 1.27



[a] Arithmetic mean of judgements of the present and expected economic situation.
Source: IMF, World Economic Outlook, January 2013; GDP 2012 and 2013: EEAG forecast; Ifo World Economic Survey I/2013.

Figure 1.28



a) Based on market weights.
Source: IMF; calculations by the EEAG; 2012 and 2013: EEAG forecast.

real-estate market, as well as the slowly but steadily improving asset positions of private households. Nevertheless, the consolidation efforts required of the private and public sectors will dampen the pace of expansion in virtually all advanced economies, once again implying that the strongest contribution to world economic growth will be made by the emerging markets, and particularly Asia (see Figure 1.28). Accordingly, after having expanded by a weak 2.4 percent last year, world trade growth will be able to recover somewhat to 3.6 percent this year. The trade balances of most emerging markets are likely to deteriorate further due to rising domestic demand. In the euro area, however, the extremely weak domestic economy is expected to lead to an improvement in the current trade balance, while the current US trade deficit is likely to remain virtually unchanged. Given the weak recovery, overall inflationary pressures will remain subdued.

1.4.3 United States

US fiscal policy will determine the momentum of economic activity during the winter months. At the end of 2012, numerous economic stimulus measures including the 2010 Tax Relief Act, which among others prolonged the Bush tax cuts of 2001 and 2003, expired and the automatic spending cuts made under the Budget Control Act of 2011 to increase the federal debt ceiling were to set in at the beginning of this year. Although a substantial part of this fiscal cliff has been resolved, there are still heavy negotiations going on between the Republicans and Democrats over across-the-board spending cuts that have only been delayed until March to date. If the two parties fail to reach an agreement, then the federal budget deficit will be relieved of about 110 billion US dollars. At the same time, the decline in aggregate demand would dampen economic recovery in the second half of this year.

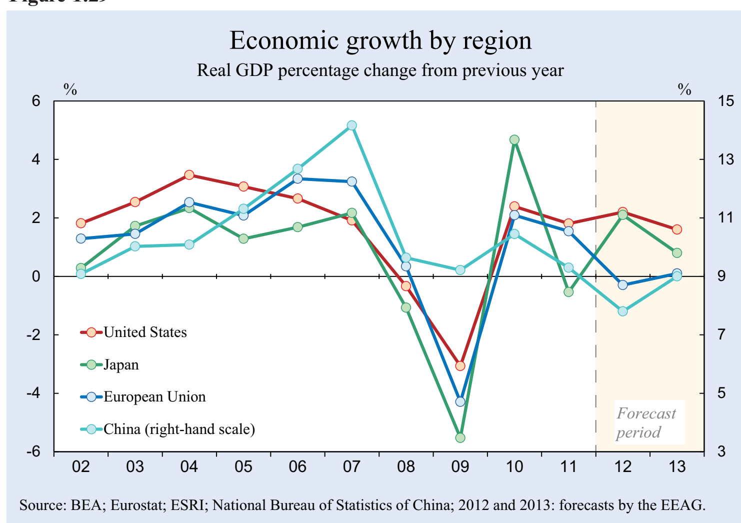
Besides a direct reduction in government consumption, the vast proportion of the restrictive impulses would have taken the form of higher taxes weighing down private consumption. In the last-minute agreement reached earlier this year, these taxes are now largely off the table, while the tax reductions implemented under President Bush have largely been made permanent. Nevertheless, about 30 percent of the consolidation measures implied by the fiscal cliff have become active thanks to this last-minute agreement. We assume that another 10 percent will take effect this spring. The remaining 60 percent have thereby either been avoided permanently, or delayed until next year.

The protracted negotiations over the entire fiscal cliff have already generated heightened policy uncertainty over the eventual tax and spending landscape in the United States. Thanks to expectation formation, the dampening effects of these negotiations were already felt somewhat at the end of 2012, but their main impact will materialise during the first half of this year. The budget deficit for the current fiscal year would drop to approximately 5 percent of GDP in this scenario.

Against the background of continued high unemployment, as well as the uncertainty regarding fiscal policy, the Federal Reserve will continue to follow an extremely expansionary monetary policy. It announced in September that it was going to expand its programme to purchase mortgage-backed securities to 40 billion US dollars each month. Unlike previous measures, this programme known as “Quantitative Easing 3” is not time-limited. The Federal Reserve plans to keep interest rates at a historic low of 0–0.25 percent and to continue its bond purchases until the situation on the labour market has improved significantly. This represents an extension of “Operation Twist”, a programme to increase the maturity of government bonds held by the Federal

Reserve. Expiring securities in its portfolio purchased under previous programmes are also still being continuously replaced. The Federal Reserve is attempting to increase the degree of monetary expansion and to reduce long-term interest rates for mortgage loans in order to create favourable investment conditions, as well as to further support the recovery in the real-estate market.

Figure 1.29



Source: BEA; Eurostat; ESRI; National Bureau of Statistics of China; 2012 and 2013: forecasts by the EEAG.

Good refinancing conditions and a stabilising upswing in the real-estate market will provide relief to household budgets and support consumer behaviour. In view of this development and the upcoming consolidation of the federal budget deficit, a further reduction in the private savings rate is likely. This may compensate for some of the dampening effects of fiscal consolidation.

Despite the extremely expansionary monetary policy, the risks to price stability remain relatively low against the background of currently weak economic growth. However, the recent rise in the price index for rental and owner-occupied residential property suggests that a continued recovery in the real-estate market could drive up prices in the medium term.

Largely due to the dampening effect of increased uncertainty on business and household investment, economic activity in the United States is expected to have been weak this winter. The lack of an agreement to avoid the fiscal cliff last year; followed by the debate over the necessity of increasing the federal debt ceiling in early 2013 and the lack of a federal budget for the second half of the current fiscal year fed uncertainty. In the underlying fiscal scenario, the US economy is therefore expected to do little more than stagnate in early 2013, but should gain some momentum over the course of the year driven by the catching-up effects and the recovery in the real-estate market. The continuing failure to reach an agreement on medium-term fiscal policy represents a downward risk to the forecast.

Due to the economic slowdown among major US trading partners this winter, exports are not expected to provide much stimulus in the short run either. However, the consolidation efforts in the United States will also significantly reduce import demand, meaning that net foreign trade will still be able to make a small, but positive contribution to overall economic growth in 2013.

The increase in average annual GDP will slow down from 2.2 percent in 2012 to 1.6 percent this year (see Figure 1.29). Weak economic conditions are likely to provide only a slight decline in unemployment from an average of 8.1 percent in 2012 to 7.8 percent in 2013. For the same reason inflation will remain moderate this year, averaging at around 2.1 percent.

1.4.4 Asia

Several leading indicators suggest that the recently increased pace of expansion in *China* will continue. Industrial production picked up at a slightly faster pace during the last few months of 2012. In addition, different Purchasing Managers' indices for the manufacturing and service sectors have recently brightened and moved back into the expansion zone. These positive signals indicate an increase in private investment dynamics, which also benefit from public infrastructure projects that were brought forward.

Private consumption should provide a powerful stimulus as per capita disposable income in the third quarter of 2012 increased by over 10 percent versus the previous year's level, with very moderate inflation rates that are currently around 2 percent. Consumer confidence indices have also risen in recent months, with retail sales seeing rapid growth recently. The high wage rises are, however, increasingly wearing away the price competitiveness of the Chinese economy, with

the real exchange rate jumping by close to 6 percent in 2012. This effect is likely to impact exports already suffering from the continuing weak demand from Europe. Due to growing domestic demand, imports, however, are likely to expand at even higher rates, causing foreign trade to stop contributing positively to Chinese GDP growth. All in all, economic growth in China has bottomed out and will gain some momentum again to reach 9 percent this year.

The on-going confrontation with China over the Senkaku/Diaoyu Islands will continue to hamper foreign trade with *Japan*. As a result of the unofficial boycott of Japanese products by the Chinese population, exports of Japanese cars to China dropped by a stunning 75 percent from July to October 2012. In September the trade balance against China therefore went into the red for the first time since data have been recorded.

As long as the outlook for Japan's export markets remains overcast, a weak recovery in the economy is expected for 2013. Weak consumer and producer confidence and the gradually decreasing public reconstruction investments caused by the earthquake and tsunami disaster in 2011 will prevent the domestic economy from supporting growth. The change in government and the recent implementation of two stimulus packages amounting to approximately 11 billion euros should create some albeit weak impulses from fiscal policy. A total increase in GDP of 0.8 percent is expected. Despite continuing expansionary monetary policy, the subdued economic growth will keep inflation at about – 0.2 percent.

The economy of *India* should slowly pick up this year. Although the persistently high inflation rate will restrain the Indian central bank from cutting interest rates substantially, exports are likely to accelerate as a result of better economic developments in important export destinations for India, China and the United States. Accordingly, GDP growth looks set to increase from 3.7 percent in 2012 to 4.6 percent this year. After 9.4 percent in 2012, inflation will continue to soar at 8.2 percent in 2013.

Supported by an expansive fiscal policy and an improved external environment, the economic growth in other Eastern and Southern Asian countries should remain stable and GDP will expand by 4.5 percent this year.

1.4.5 Latin America

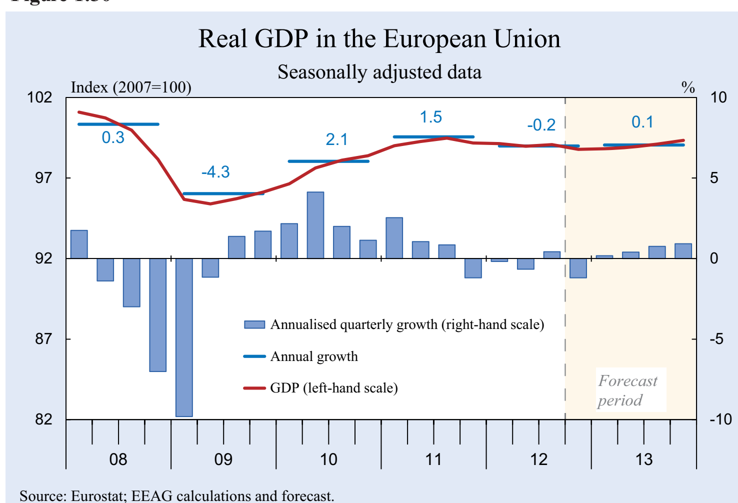
In 2013, the Latin American region, i.e. *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*, is expected to grow by 3.6 percent (following 2.4 percent in 2012). Growth will be driven by improving conditions in Brazil, the largest economy in the region, and increased momentum in China, which is a major consumer of raw materials coming from this region. The interest cuts implemented and public investments in the pipeline for the FIFA World Cup in 2014 should boost Brazil's economy. Elsewhere in Latin America inflation rates have now fallen to a degree such that monetary policy can be relaxed. Overall, this allows the region to return to what can be considered more or less potential growth.

1.4.6 The European economy

The cyclical situation

The aggregate economic performance of the European Union is expected to have fallen in the fourth quarter of 2012 and looks set to stagnate during the first half of 2013 (see Figure 1.30). This is suggested by the majority of leading sentiment indicators. These seem to have managed a turnaround in early winter at extremely low levels, after having suffered strong ero-

Figure 1.30



Source: Eurostat; EEAG calculations and forecast.

sion in the previous six months. Multiple stress factors were probably instrumental in unfavourable economic developments in the remaining winter months. The contractive impulse of fiscal policy in several member states will have driven down domestic demand in Europe. In addition, the uncertainty arising from the European debt crisis has probably led to a decline in private investment and dampened private consumption. Moreover, financing conditions for households and businesses in many member states have remained exceptionally poor to date. Finally, the fiscal tightening in the United States at the beginning of 2013 is expected to have dampened the expansion of exports during the winter months. No further deterioration in producer and consumer confidence is expected, and macroeconomic uncertainty will not increase over the course of the year ahead.

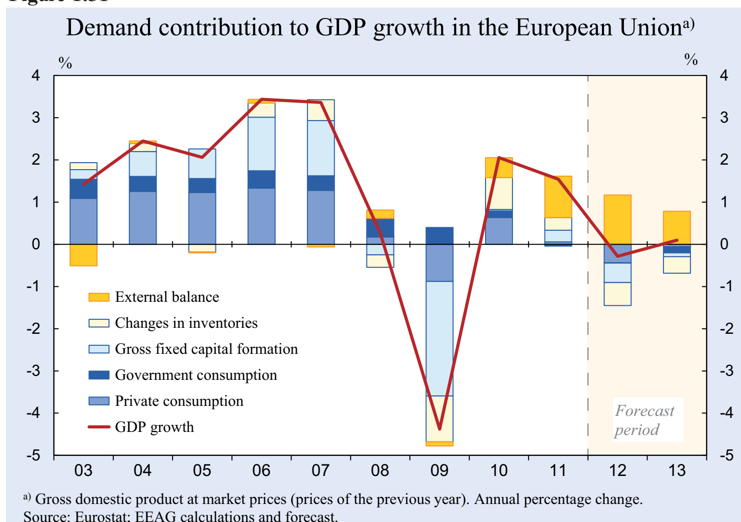
Accordingly, these factors are no longer significant additional negative factors weighing down on the European economy, but nor are they positive factors either. However, domestic demand will shrink further in the course of the year 2013 (see Figure 1.31). Restrictive fiscal policies, albeit less restrictive than in the previous year, will dampen private and public spending and investment spending in almost all member states. The continued worsening of the labour market and the further efforts to reduce private debt, especially in Spain and Ireland, will also put additional strain on the willingness of private households to spend. Business investment is also likely to decline further in the first half of this year. The very low capacity utilisation in many countries and weak domestic prospects will be significant. In the crisis countries financing conditions have even worsened of late, which will additionally complicate the accumulation of capital.

In the second half of 2013, private investment is likely to stabilise somewhat. This will be supported by continued expansionary monetary policies and increased growth in exports. Private investment should also benefit significantly from the acceleration of the pace of expansion in emerging markets and the slight growth expected in the United States in the current year. As imports are likely to remain very weak during this period, net foreign trade will provide a strong positive economic momentum. GDP growth in Europe will pick up slightly in the course of the year, although it is likely to remain extremely low.

All in all, GDP in the European Union decreased by 0.3 percent last year and is basically expected to stagnate at 0.1 percent growth this year. The economic gap among the individual member states should continue to grow in the forecast period (cf. Table 1.A.2–Table 1.A.4). Aggregate production in the crisis countries will continue to shrink with the exception of Ireland. In these countries fiscal policy will be much more restrictive than in the rest of Europe. Although financing conditions in the crisis countries have already started to improve and despite more expansionary monetary policy, they are likely to remain unfavourable, at least relative to the European core countries. After a temporary period of weakness this winter, stable economies like Germany, Finland and Austria will benefit in the rest of 2013 from relatively stronger demand from emerging markets and domestic forces; and will therefore continue to expand, if only moderately.

The weakness of the economy will continue to reduce employment in the European Union (see Figure 1.32) and thereby lead to a further rise in the overall unemployment rate from 10.5 percent last year to 10.9 percent this year (see Figure 1.33), with already large regional differences increasing further. Given the high rate of unemployment, wage increases will be very moderate, gradually slowing the rate of inflation. The recent increases in excise duties, as well as higher prices for energy and food will gradually also lose their impact. With a phasing out of these tax increases taking

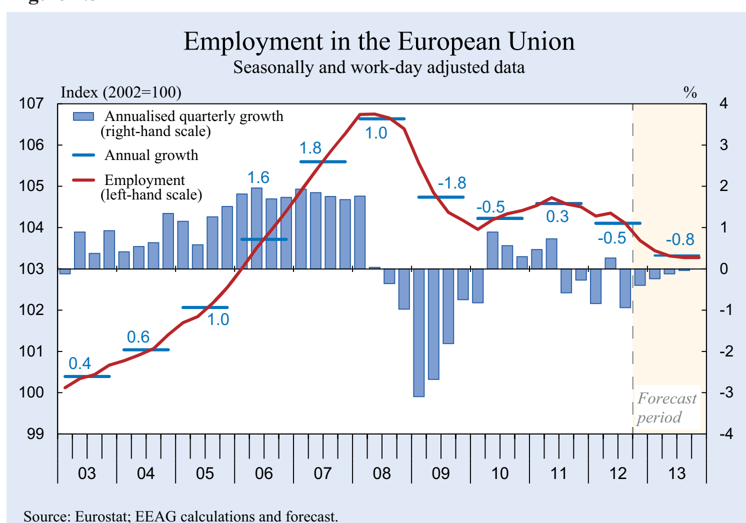
Figure 1.31



Demand contribution to GDP growth in the European Union[a)]

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

Figure 1.32



place mostly in the crisis countries, the upward pressure on inflation in these economies will be significantly below the euro area average. In the aggregate, the rate of inflation should have declined to 2.5 percent last year, before further weakening to 1.8 percent this year. Thus, the core inflation rate, which particularly reflects the underlying momentum in the economy, should fall from 1.6 percent in October 2012 to 1.3 percent at the end of 2013. This will take the inflation rate well below the ECB's target inflation rate of just under 2 percent.

Differences across Europe

Over the course of 2013 the *German* economy should experience an upswing. If the euro crisis does not escalate and remains in line with the baseline scenario, domestic upward forces and rising demand for German export goods from outside the European Union should boost the economy. Private consumption and investment in equipment and machinery look set to pick up clearly as a result; a surge in foreign orders indicates that exports should also increase. International trade will not, on balance, make any direct contribution to an increase in GDP, as imports will be equally widespread due to livelier domestic demand. The steady increase in building permits indicates that construction activity will remain an engine for growth.

When comparing the fourth quarter of 2013 with the fourth quarter of 2012, the German economy is expected to expand by 1.4 percent. However, due to the low starting level caused by the weak winter, the average annual growth rate in GDP in 2013 will be just 0.7 percent (see Figure 1.34). There will be no significant growth in employment. The number of persons employed in 2013 should only be around 35,000 people higher than the previous year's value. The number of unemployed will increase during the winter months, but should gradually fall again over the course of the year ahead. Due to the abandoning of training measures, there will be a measured annual increase of 60,000 persons in 2013. The unemployment rate is expected to fall slightly from 5.5 percent in 2012 to 5.4 percent this year. The German inflation rate was 2.2 percent in 2012 and is expected to weaken to 1.7 percent this year.

France will see its economy grow by a very moderate 0.3 percent this year. Private investment will at best see a moderate increase due to the continuing uncertainty about the further course of the euro crisis and the subdued earnings prospects of companies. Companies will also face a 10 billion euro tax increase in 2013. Hollande's government has paved the way for consolidation measures in 2013 amounting to a total of 30 billion euros. A third of this amount is to be achieved by keeping nominal budgets constant and thereby reducing

Figure 1.33

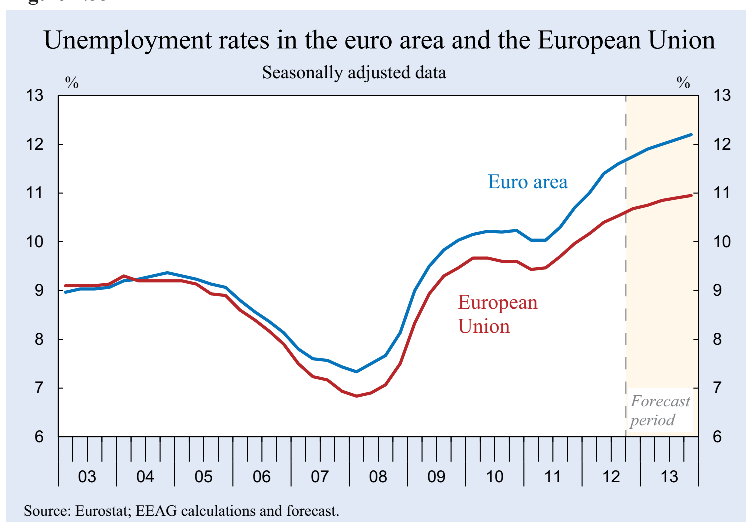
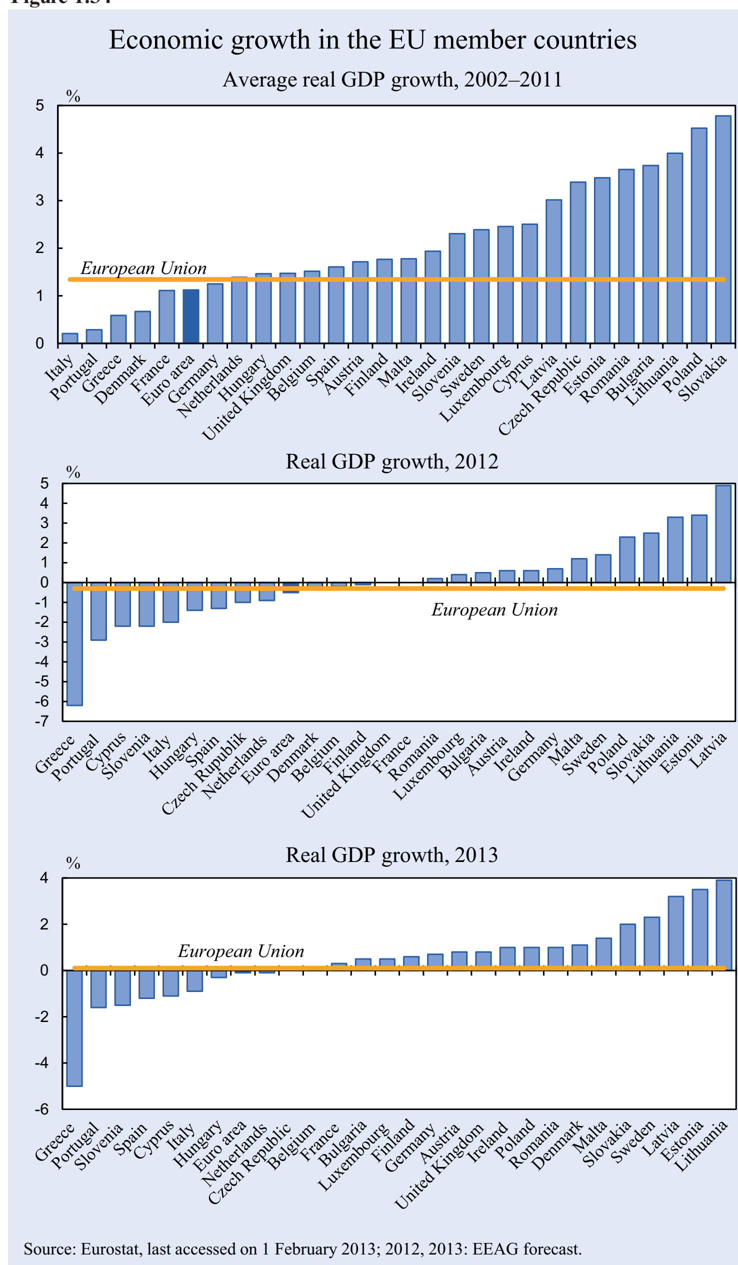


Figure 1.34



Source: Eurostat, last accessed on 1 February 2013; 2012, 2013: EEAG forecast.

expenditure in real terms. The remaining 10 billion euros will affect private households in the form of tax hikes and reduce the disposable income already threatened by rising unemployment. Consumer spending is therefore expected only to make a limited positive contribution, although decreasing inflationary pressure should create some breathing space in household budgets. Exports are expected to be a drag on the economy because France has gradually lost its price competitiveness and its share of the world market in recent years (see Chapter 2).[4]

The above-mentioned consolidation measures are not likely to go far enough to achieve the stated goal of an overall government deficit of 3 percent in relation to GDP in 2013. One of the reasons for this is that this goal is based upon overly optimistic economic conditions. The government of President Hollande is thus under pressure to adopt further consolidation measures in the near future, which could also strain the economy over the forecast period. In addition to a large public debt, the French economy has other structural aberrations that particularly affect price competitiveness and the labour market. Countermeasures could include reducing labour costs and a simpler protection against dismissal. If labour market reforms are actually implemented, this will probably only begin to have any impact by the end of the forecast period.

The unemployment rate is expected to rise further to 11.1 percent in 2013. Inflation, on the other hand, is expected to decrease to 1.8 percent this year due to under-utilised production capacity.

In the forecast period, the *United Kingdom* is not expected to fall back into recession, but should instead experience a moderate expansion. This is indicated by the leading indicators, which have mostly improved since autumn. The recovery of the labour market will drive domestic demand, despite restrictive fiscal policies. Although the unemployment rate has been declining since autumn 2011 when it reached 8.4 percent, it remains relatively high compared to an average rate of just over 5 percent between 2000 and 2008. Moreover, the central bank's funding conditions have improved since the August introduction of the "Funding for Lending" programme, under

[4] The tax-breaks decided for French companies are supposed to lower labour costs and thereby allow companies to regain some of their lost competitiveness. Furthermore, a new agreement between unions and employers will introduce flexible working times, but will not tackle the problem of worker protection. However, to the extent that these measures prove effective, the benefits will probably not materialise during our forecasting horizon.

which the Bank of England provides liquidity at market rates to commercial banks depending on their loan portfolios. Since then, the credit conditions, particularly for households, have improved slightly. Finally, foreign demand is also expected to improve somewhat in 2013. Although the weak dynamics in the euro area will negatively affect exports, support will come from the emerging Asian markets.

Total economic output this year is expected to grow by 0.8 percent in the United Kingdom. Unemployment is expected to slowly drop to an average level of 7.6 percent in 2013, while inflation is expected to slow down only slightly, despite the overall weak economy. Due to the large increase in university tuition fees last autumn, inflation will probably only drop to 2.4 percent this year.

Italy will narrowly escape recession during the forecasting period. After continued negative growth during the first quarters, GDP will stagnate over the course of this year, which, given its initial position at the start of the year, should result in an average growth rate of – 0.9 percent in 2013. The uncertain political situation continues to have an overall dampening effect. Gross investment is likely to suffer from state consolidation, restrictive credit provision, high interest rates and capital flight. Private consumption will also be unable to make a positive contribution because unemployment is expected to rise and disposable income will be impacted by a VAT increase of 1 percentage point on July 1, 2013. State expenditure is also likely to fall due to the envisaged consolidation measures. Only net exports are expected to make a positive contribution, as imports are likely to continue to decline and exports will increase slightly. However, if Italy does not rapidly bring forward structural reforms aimed at cutting its product prices, exports will barely be able to contribute positively to GDP growth during the forecast period.

Due to the recession, the average unemployment rate will rise to 11.7 percent this year. The recession should keep inflation down to on average 2.3 percent, while any stronger decline will be prevented by the VAT increase.

The *Spanish* economy is likely to remain in a structural crisis until the end of the forecast period. GDP will shrink significantly by 1.2 percent this year. Private consumption spending will suffer under households' efforts to cut their debt and from falling disposable income. Disposable income will be dampened, especially by rising unemployment and state consolidation measures. State consumption is also likely to fall further. As a rapid and sustainable solution to the banking crisis is not yet in sight, private investment will continue to contribute negatively to the economy until the end of 2013. Only net exports are expected to continue to rise because imports are falling due to decreasing incomes and exports are increasing as a result of improved competitiveness. Whereas the trade balance turned already positive last year and will improve further, the current account is still in deficit. The latter will not be completely eliminated before the end of the forecast period.

As a result of the recession, Spain's average unemployment rate is expected to rise to 26.8 percent this year. Due to a continuing decline in economic performance and expiring VAT effects, the change in consumer prices is expected to fall to 1.8 percent this year.

Portugal and *Greece* are expected to remain in recession this year. *Ireland*, on the other hand, is likely to see a moderate expansion dampened by the on-going restructuring of the construction and banking sector. The moderate expansion is not likely to be sufficient to bring about a change in the Irish labour market and unemployment will continue to increase in all three crisis countries, albeit to varying degrees.

During the forecast period, most economies in *Central and Eastern Europe* (except for Hungary) are likely to benefit from orderly government finances after massive austerity and reform measures. These orderly public finances will be an important pillar of their creditworthiness. One weakness, however, remains the position of the banking sector, which is still overwhelmingly controlled by foreign banks in the region. The high percentage of Greek banks in Romania and Bulgaria is a cause for concern. However, Western European parent banks have also deleveraged their debt and credit risks significantly in other countries in the region. Although international institutions can prevent an uncoordinated withdrawal of funds from the transition countries with the establishment of the Vienna Initiative, the Western European banks have reduced their loan portfolios in Eastern Europe.[5] However, there were significant differences between the countries of Eastern Europe in this respect. While Hungary was affected to a much

[5] The European Bank Coordination Vienna Initiative was launched in January 2009 to provide a framework for coordinating the crisis management and crisis resolution of financial sector issues that were highlighted by the economic downturn and involved large cross-border bank groups systemically important in Central and Eastern Europe. It has brought together public and private sector stakeholders of EU-based cross-border bank groups present in that region.

greater extent, the cross-border capital reduction by banks was relatively low in the Czech Republic and Poland, the two largest economies in the region. Capital reduction was also cushioned by inflows of EU funds. The European Commission, the European Bank for Reconstruction and Development (EBRD) and the International Monetary Fund again provided extensive aid packages to avoid jeopardising the economic recovery in the region. By 2014, a total of 30 billion euros will have been made available for the Eastern European countries (including Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania). Around 30 percent of this sum is intended to support the financial sector and thereby improve the availability of credit. Current deleveraging and the high proportion of non-performing loans (in Hungary, Romania and Bulgaria their share is currently estimated at 15 to 20 percent) are affecting lending and therefore investment activities. There are also demand-side reasons for the slowdown in lending. A speedy turnaround is not expected given the decelerating economic momentum.

During the forecast period, recessionary trends will continue in most countries of the region, especially in Hungary and the Czech Republic. Countries like Bulgaria and Romania are threatening to slip into recession because of their high dependence on exports and weak domestic demand. Poland is struggling to compensate for the weakness in export demand in its domestic market, and no revitalising impulses can be expected in terms of fiscal policy. The economic slowdown will complicate the return of public deficits, resulting in governments having to maintain their restrictive stance in terms of fiscal policy. In general, all indicators point to a cyclical deterioration in the region during the forecast period.

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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 %		
		2011	2012	2013	2011	2012	2013	2011	2012	2013
Industrialised countries:										
European Union	28.8	1.5	– 0.3	0.1	3.0	2.6	1.9	9.7	10.5	10.9
Euro area	21.5	1.4	– 0.5	– 0.1	2.7	2.5	1.8	10.2	11.4	12.1
Switzerland	1.0	1.9	1.0	1.2	0.1	– 0.7	0.2	4.0	4.3	4.5
Norway	0.8	1.4	3.1	2.3	1.2	1.0	1.4	3.3	3.2	3.2
Western and Central Europe	30.7	1.6	– 0.1	0.2	2.9	2.4	1.9	9.5	10.3	10.7
United States	24.8	1.8	2.2	1.6	3.1	2.2	2.1	9.0	8.1	7.8
Japan	9.6	– 0.6	2.1	0.8	– 0.3	– 0.1	– 0.2	4.6	4.4	4.3
Canada	2.8	2.6	2.0	1.9	2.9	1.7	1.8	7.5	7.3	7.2
Industrialised countries (total)	**67.9**	**1.4**	**1.1**	**0.9**	**2.5**	**1.9**	**1.6**	**8.6**	**8.6**	**8.7**
Newly industrialised countries:										
Russia	3.0	4.3	3.0	2.5	6.6	6.5	6.0	–	–	–
China	12.4	9.6	7.8	9.0	5.4	2.7	2.8	–	–	–
India	2.7	7.0	3.7	4.6	8.9	9.4	8.2	–	–	–
East Asia[a]	5.8	4.3	3.6	4.5	4.6	3.5	3.8	–	–	–
Latin America[b]	8.2	4.0	2.4	3.6	7.2	6.0	6.4	–	–	–
Newly industrialised countries (total)	**32.1**	**6.5**	**4.9**	**5.8**	**6.1**	**4.6**	**4.7**	**–**	**–**	**–**
Total[c]	**100.0**	**3.0**	**2.3**	**2.5**	**3.7**	**2.8**	**2.6**	**–**	**–**	**–**
World trade growth in %		5.8	2.4	3.6						

[a] Weighted average of Indonesia, South Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2011 levels of GDP in US dollars. – [b] Weighted average of Argentina, Brasil, Chile, Columbia, Mexico, Peru, Venezuela. Weighted with the 2011 level of GDP in US dollars. – [c] Weighted average of the listed groups of countries. – [d] Standardised unemployment rate.

Source: Eurostat, OECD, IMF, ILO, National Statistical Offices, 2012 and 2013: forecasts by the EEAG.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth			Inflation[a]			Unemployment rate[b]		
		in %						in %		
		2011	2012	2013	2011	2012	2013	2011	2012	2013
Germany	20.3	3.0	0.7	0.7	2.5	2.2	1.7	5.9	5.5	5.4
France	15.8	1.7	0.0	0.3	2.3	2.3	1.8	9.6	10.4	11.1
Italy	12.5	0.6	– 2.0	– 0.9	2.9	3.0	2.3	8.4	10.6	11.7
Spain	8.5	0.4	– 1.3	– 1.2	3.1	2.1	1.8	21.7	25.1	26.8
Netherlands	4.8	1.1	– 0.9	– 0.1	2.5	2.8	2.2	4.4	5.3	6.0
Belgium	2.9	1.8	– 0.2	0.1	3.5	2.6	1.6	7.2	7.4	7.8
Austria	2.4	2.7	0.6	0.8	3.6	2.6	1.7	4.2	4.3	4.5
Greece	1.7	– 7.1	– 6.2	– 5.0	3.1	1.1	– 1.0	17.7	24.3	26.4
Finland	1.5	2.7	– 0.1	0.6	3.3	3.1	2.1	7.8	7.7	8.1
Portugal	1.4	– 1.6	– 2.9	– 1.6	3.6	2.8	0.7	12.9	15.7	16.6
Ireland	1.2	1.4	0.6	1.0	1.2	1.9	1.0	14.7	14.9	15.1
Slovakia	0.5	3.2	2.5	2.0	4.1	3.7	2.1	13.6	13.9	14.1
Slovenia	0.3	1.0	– 2.2	– 1.5	2.1	2.8	2.0	8.2	8.4	9.2
Luxembourg	0.3	1.7	0.4	0.5	3.7	2.9	1.7	4.8	5.1	5.4
Cyprus	0.1	0.5	– 2.2	– 1.1	3.5	3.1	1.4	7.9	11.7	13.5
Estonia	0.1	8.3	3.4	3.5	5.1	4.2	3.7	12.5	10.1	9.9
Malta	0.1	1.6	1.2	1.4	2.5	3.3	2.5	6.5	6.4	6.7
Euro area[c]	**74.6**	**1.4**	**– 0.5**	**– 0.1**	**2.7**	**2.5**	**1.8**	**10.2**	**11.4**	**12.1**
United Kingdom	13.8	0.9	0.0	0.8	4.5	2.9	2.4	8.0	7.9	7.6
Sweden	3.1	3.8	1.4	2.3	1.4	0.9	1.5	7.5	7.7	7.8
Denmark	1.9	1.1	– 0.3	1.1	2.7	2.4	1.6	7.6	7.7	8.1
EU-20[c]	**93.3**	**1.4**	**– 0.3**	**0.1**	**3.0**	**2.5**	**1.8**	**9.7**	**10.7**	**11.2**
Poland	2.9	4.3	2.3	1.0	3.9	3.7	2.9	9.6	10.1	10.1
Czech Republic	1.2	1.9	– 1.0	0.0	2.1	3.5	1.4	6.7	6.9	7.1
Romania	1.1	2.1	0.2	1.0	5.8	3.4	3.5	7.4	7.1	7.5
Hungary	0.8	1.6	– 1.4	– 0.3	3.9	5.7	5.4	10.9	10.9	11.1
Bulgaria	0.3	1.8	0.5	0.5	3.5	2.4	2.5	11.3	12.3	12.0
Lithuania	0.2	5.9	3.3	3.9	4.1	3.2	3.0	15.3	12.9	12.3
Latvia	0.2	5.2	4.9	3.2	4.2	2.3	2.0	16.3	14.9	14.0
New members[d]	**6.7**	**3.2**	**0.9**	**0.8**	**3.9**	**3.7**	**3.0**	**9.4**	**9.5**	**9.6**
European Union[c]	**100.0**	**1.5**	**– 0.3**	**0.1**	**3.0**	**2.6**	**1.9**	**9.7**	**10.5**	**10.9**

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

Source: Eurostat, OECD, IMF, 2012 and 2013: forecasts by the EEAG.

Table 1.A.3

Key forecast figures for the European Union

	2010	2011	2012	2013
	Percentage change over previous year			
Real gross domestic product	2.1	1.5	– 0.3	0.1
Private consumption	1.1	0.1	– 0.7	– 0.1
Government consumption	0.7	– 0.1	0.0	– 0.7
Gross fixed capital formation	0.2	1.4	– 2.4	– 0.5
Net exports[a)]	0.5	1.0	1.2	0.8
Consumer prices[b)]	2.1	3.0	2.6	1.9
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 6.5	– 4.4	– 3.6	– 2.9
	Percentage of labour force			
Unemployment rate[d)]	9.7	9.7	10.5	10.9

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2012: forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat, 2012 and 2013: forecasts by the EEAG.

Table 1.A.4

Key forecast figures for the euro area

	2010	2011	2012	2013
	Percentage change over previous year			
Real gross domestic product	2.0	1.4	– 0.5	– 0.1
Private consumption	0.9	0.1	– 1.1	– 0.5
Government consumption	0.7	– 0.1	– 0.2	– 0.9
Gross fixed capital formation	– 0.1	1.5	– 3.6	– 1.1
Net exports[a)]	0.7	0.9	1.7	1.0
Consumer prices[b)]	1.6	2.7	2.5	1.8
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 6.2	– 4.1	– 3.3	– 2.6
	Percentage of labour force			
Unemployment rate[d)]	10.1	10.2	11.4	12.1

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2012: forecasts of the European Commission. – [d)] Standardised unemployment rate.

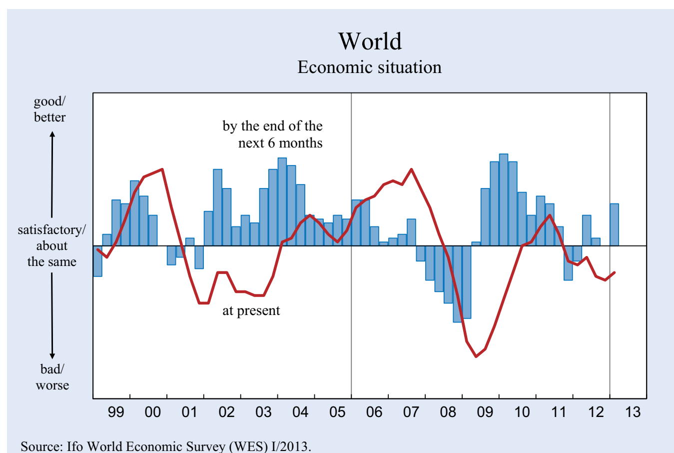
Source: Eurostat, 2012 and 2013: forecasts by the EEAG.

Appendix 1.B
Ifo World Economic Survey (WES)

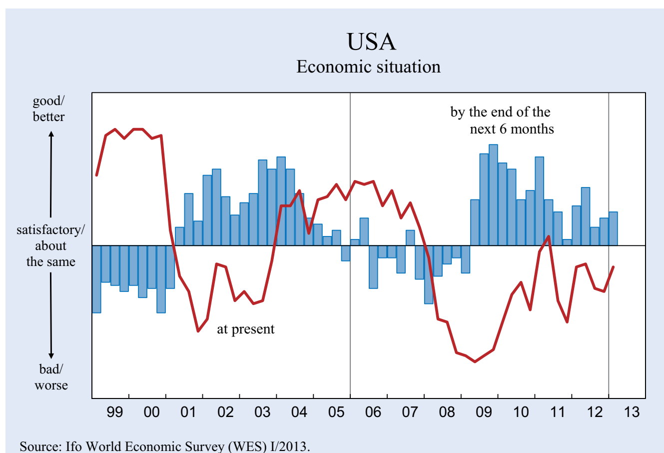
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organizations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2013, 1,169 economic experts in 124 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/2013.



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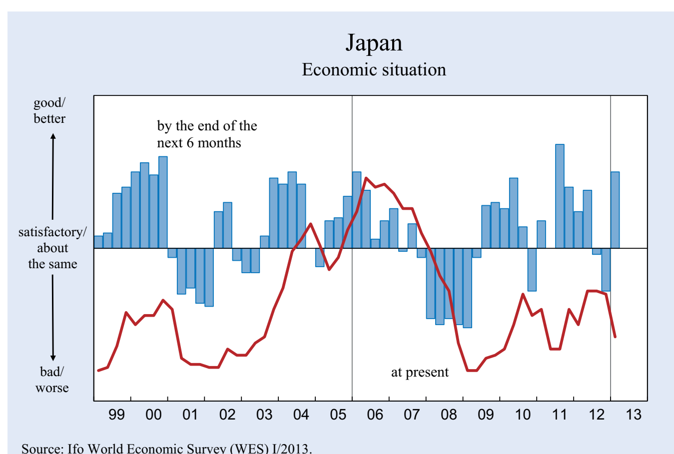

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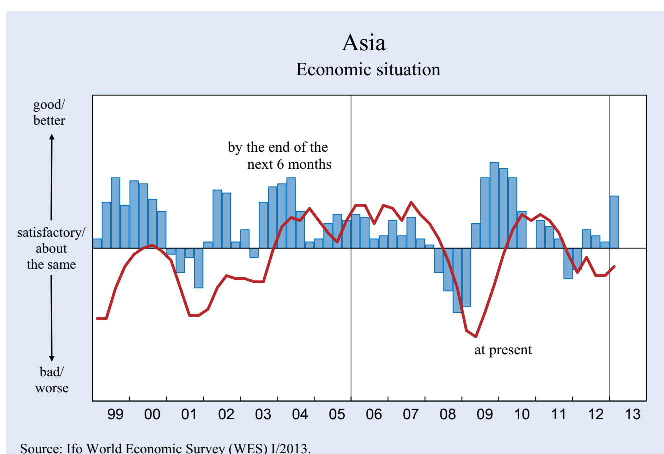

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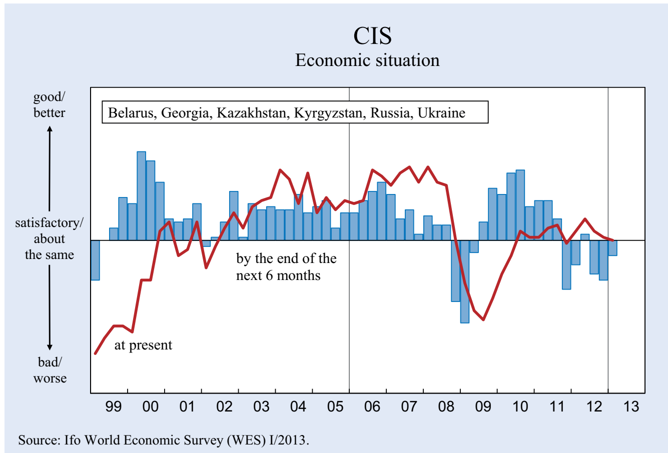

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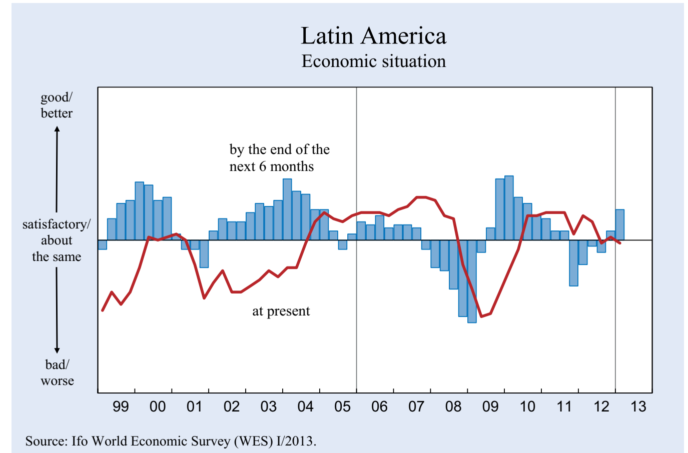

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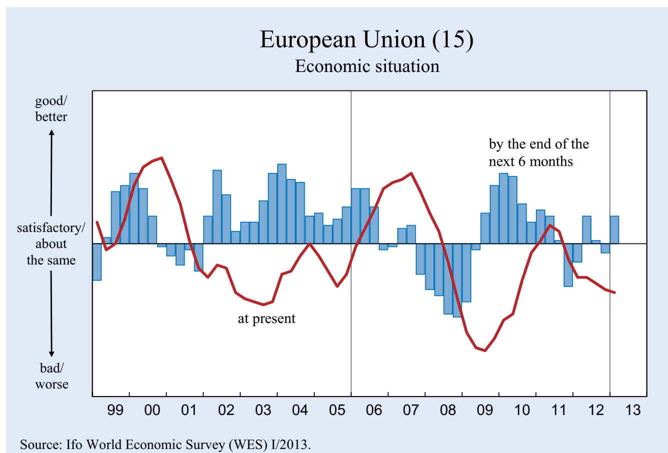

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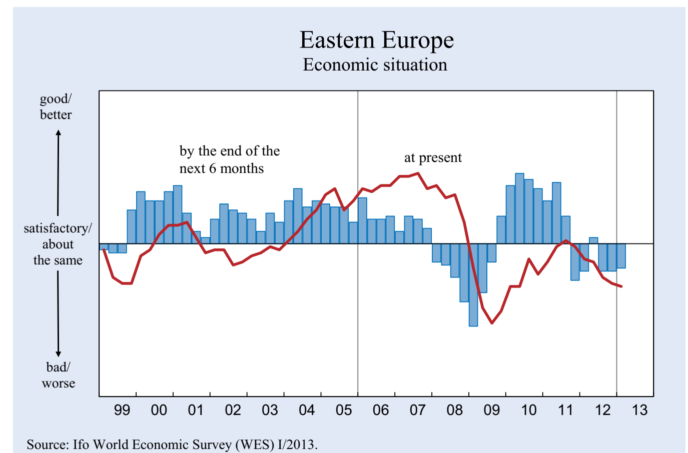

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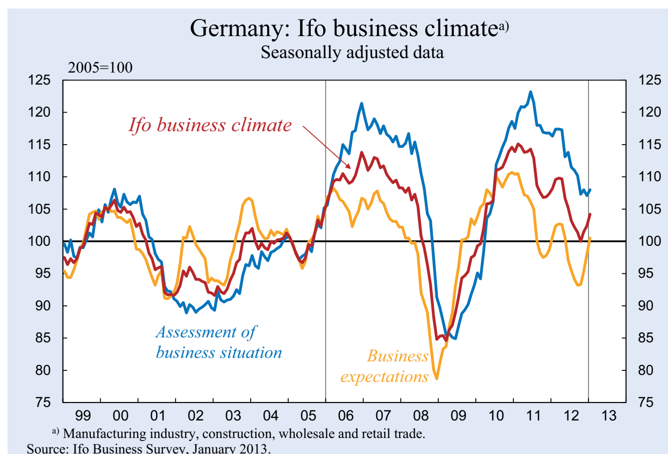
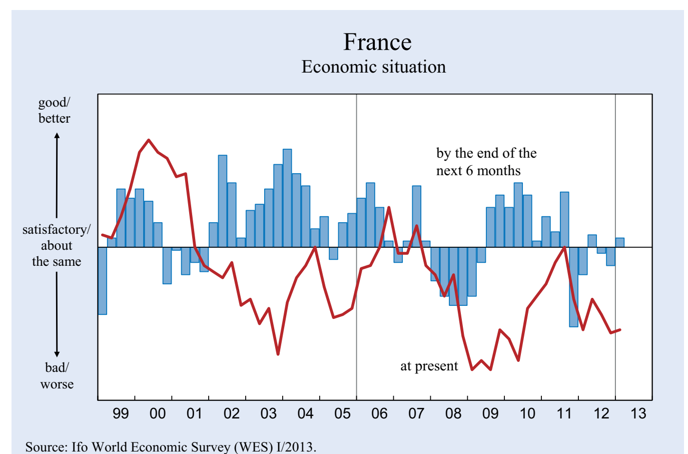


[a] Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2013.



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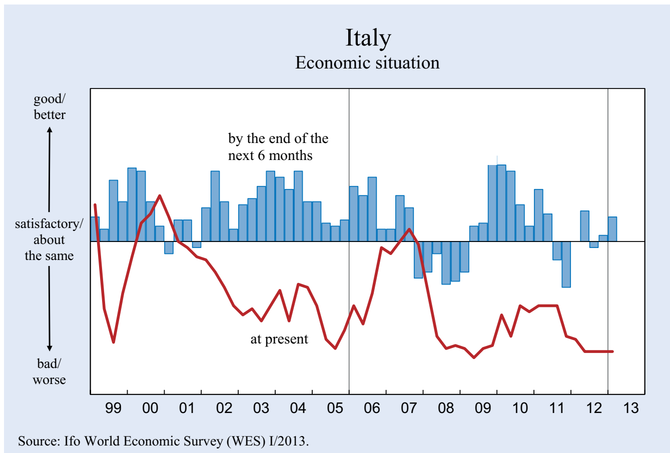

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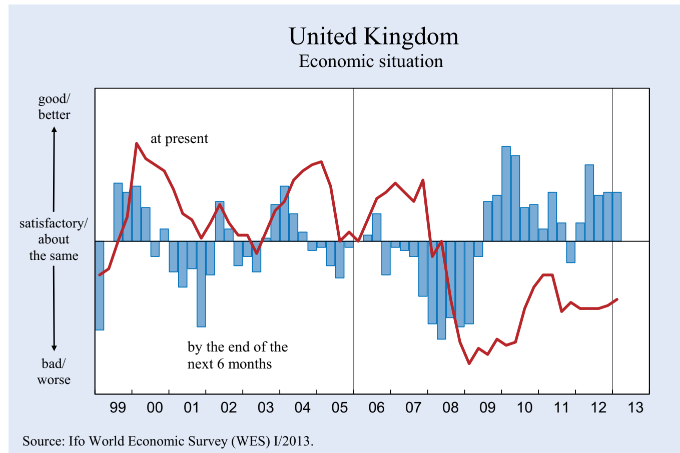

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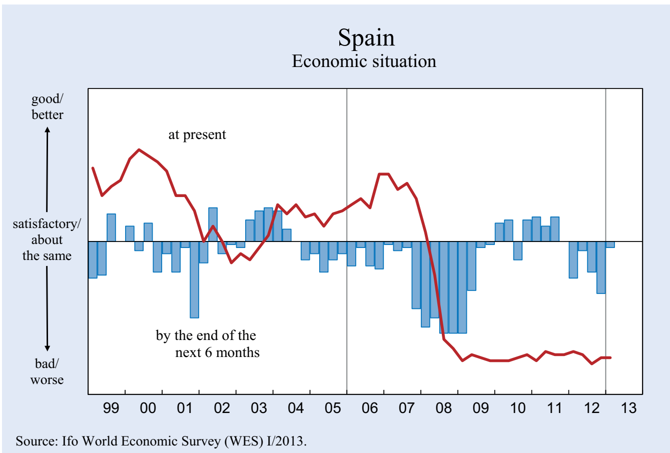

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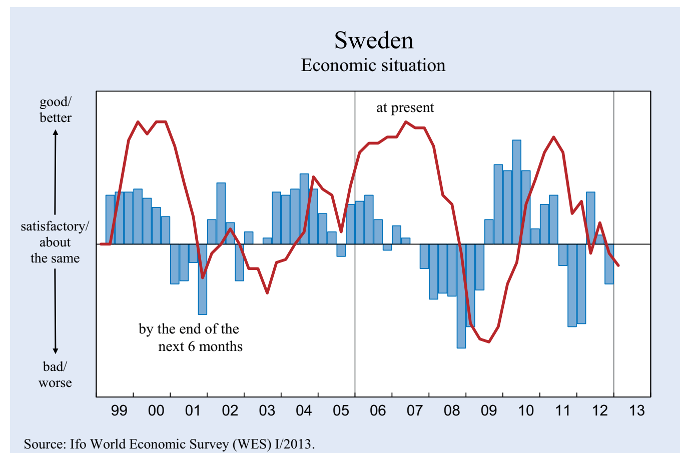

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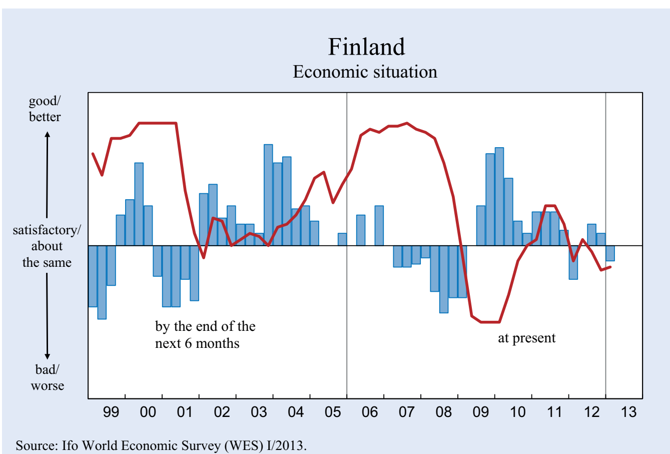

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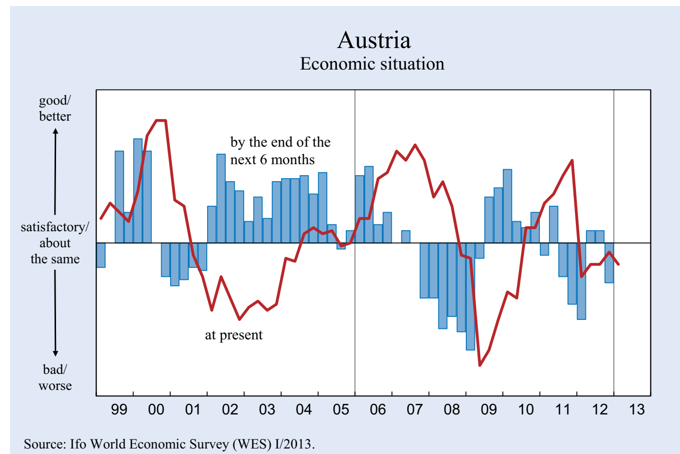

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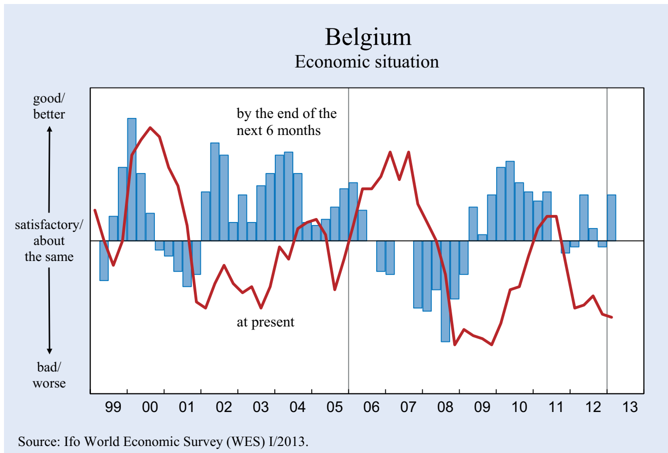

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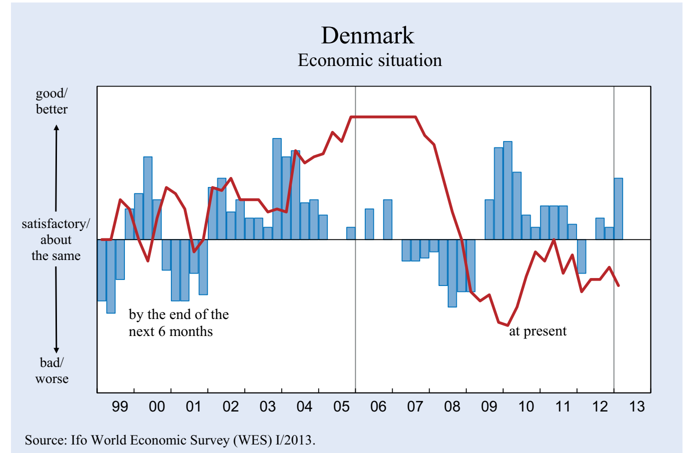

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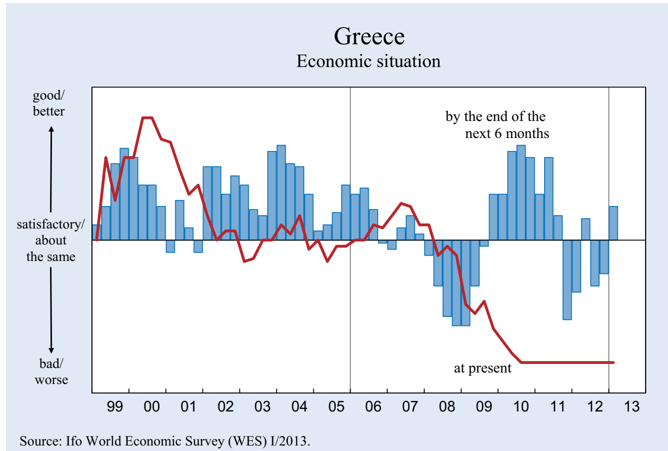

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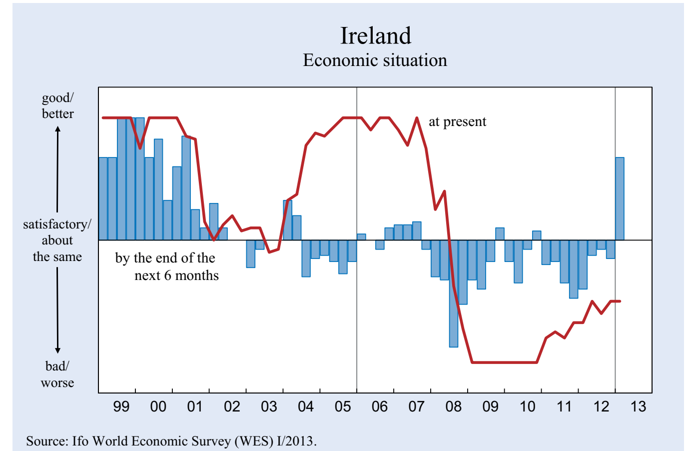

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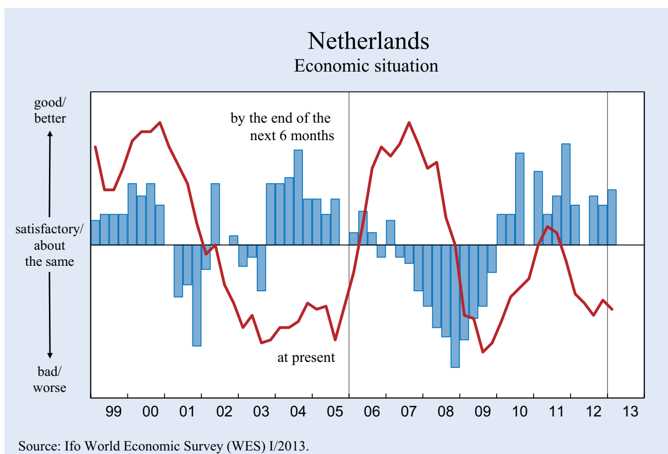

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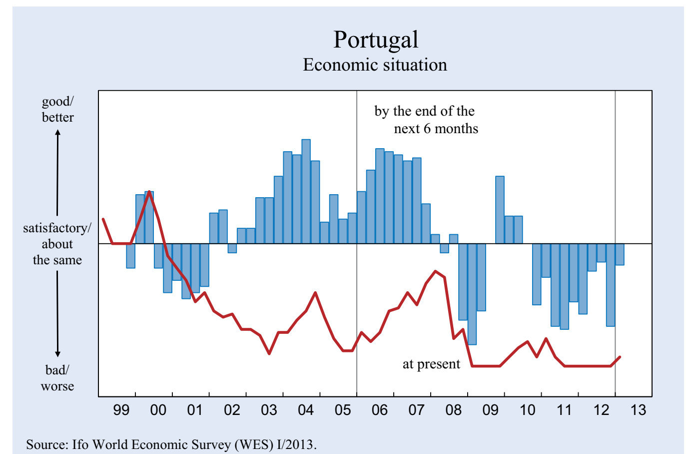

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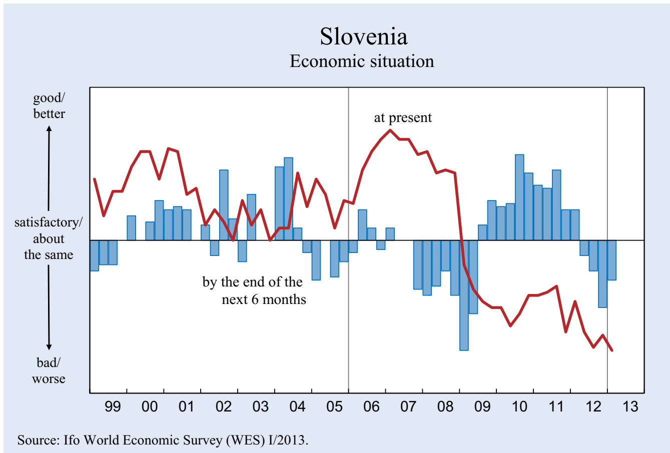

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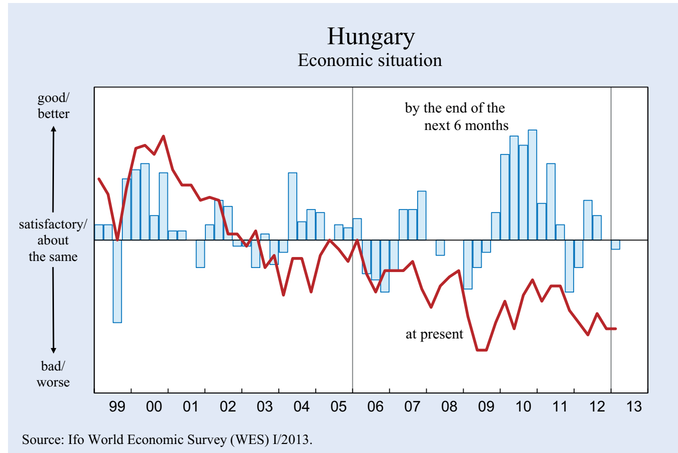

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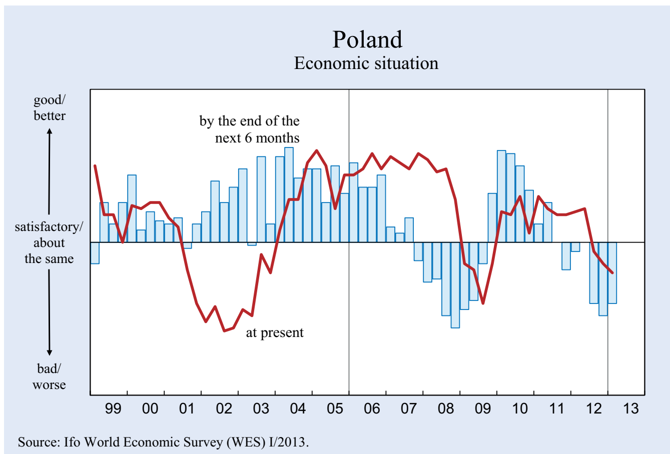

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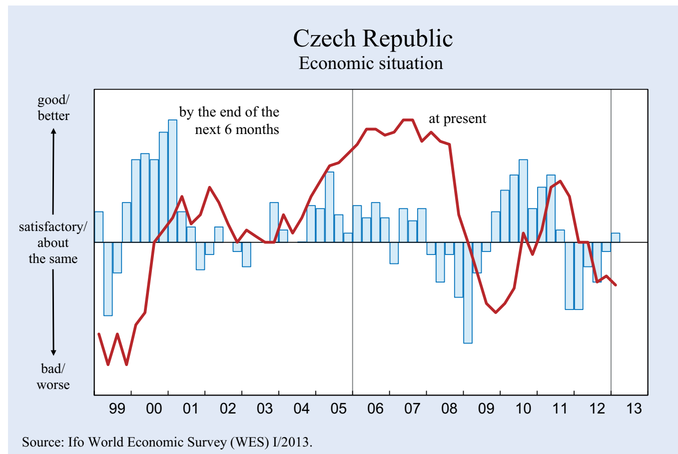

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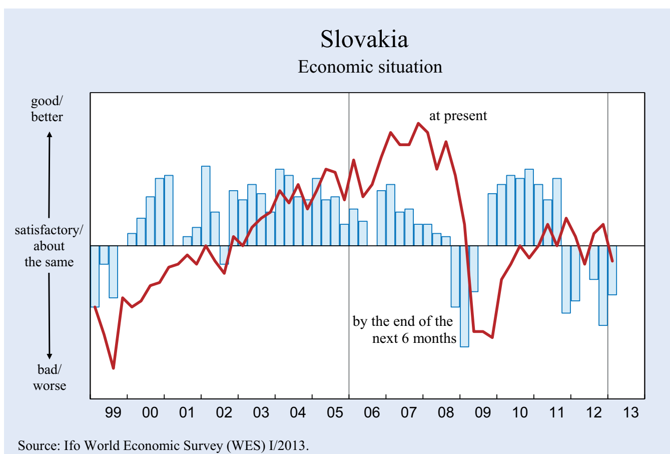

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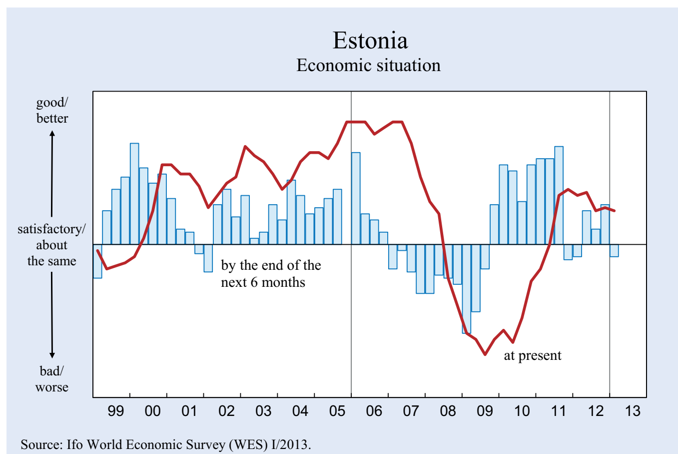

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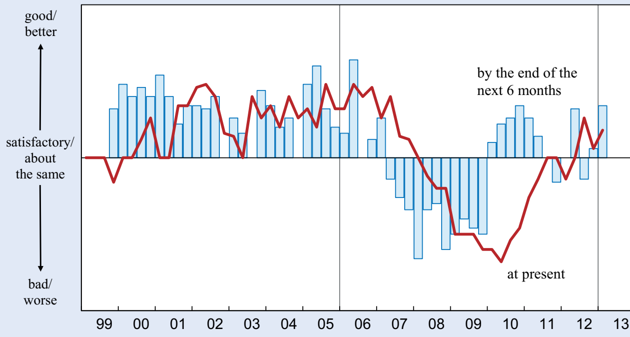

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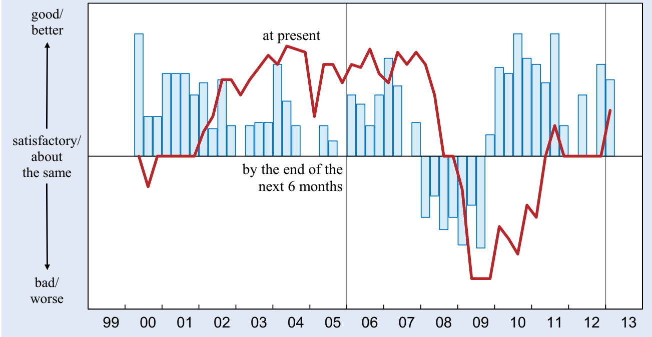

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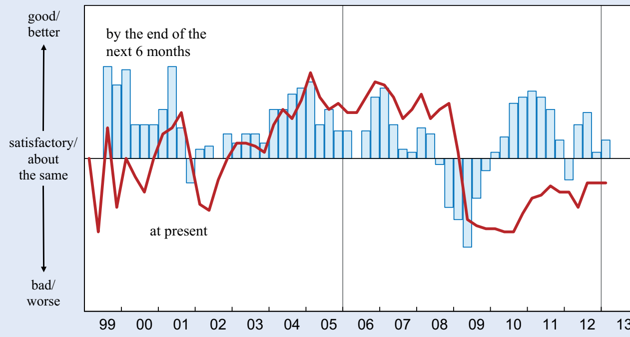

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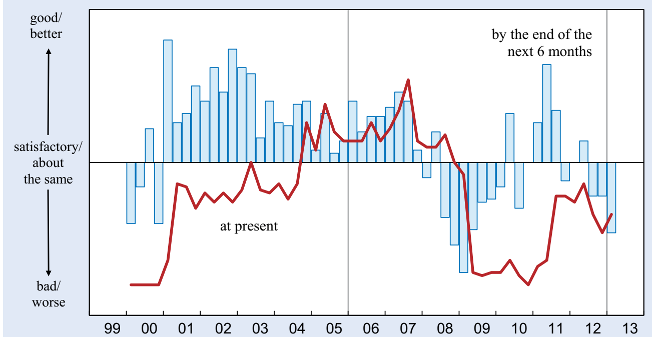

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