Macroeconomic Outlook

1.1 Introduction

The world economy has experienced a slight acceleration in economic growth since summer 2013 and is expected to gradually gain further momentum in 2014. Producer and consumer confidence improved in most major regions of the world. For the first time in four years, industrialised countries became the driving force behind the economic recovery. Accompanied by a monetary policy that remains extremely expansionary, private debt reductions in the United States and the United Kingdom advanced, and fiscal policy in the euro area was no longer as restrictive as in previous years. Most importantly, uncertainty regarding the future of the euro area continued to fade.

At the same time major emerging economies underwent a period of faltering. This was partly due to, or at least triggered by, uncertainty regarding the gradual tightening of monetary policy in the United States last summer. Turkey, India, Indonesia, Brazil and South Africa in particular had to cope with rapid outflows of foreign capital. As a result, the refinancing conditions for both the private and public sectors deteriorated and their currencies devaluated quite sharply.

During the summer the euro area recovered from a recession that had lasted over a year. The trigger for the recovery can be traced back to September 2012 when the European Central Bank (ECB) introduced the so-called Outright Monetary Transactions (OMT) programme, which basically implies an insurance scheme against extreme events for government bond holders in the euro area. This served to relieve the interest burden faced by governments affected by the crisis and allowed them easier access to capital markets once again. At the same time, it reduced the pressure to implement austerity programmes and thereby supported a return to less restrictive fiscal policy.

The recovery is characterised by a pronounced heterogeneity among individual member countries. The situation remains fragile and susceptible to critical distortions in many of these countries. Quite a few still face large private and/or public debts. In those countries that are most clearly affected by the crisis, i.e. Cyprus, Greece, Italy, Portugal and Spain, the steep upward trend in loans at risk is as strong as ever. As argued in previous reports, the core of the problem lies in their lack of competitiveness (EEAG 2013, Chapter 2; EEAG 2012, Chapter 2). Unless competitiveness is restored, it is only a matter of time before some of these countries fail to repay their foreign debt. Unfortunately, an irreconcilable conflict exists between short- and long-term solutions. Measures that tend to be beneficial for the cyclical position of an economy in many cases delay the restoration of competitiveness through real depreciation, thereby impeding long-term recovery.

We do expect countries affected by the crisis to continue to gradually improve their international competitiveness by further reducing (relative) price levels. Since private debt is often still very high and unemployment rates are also at historically high levels, domestic demand in these countries is, for the moment, likely to continue to decline. In addition, although they have improved, refinancing conditions remain rather poor due to the unstable situation of the banking system, and as such are hindering investment activity. The reduced restrictiveness of fiscal policy in recent times has acted as a stabiliser for short-term domestic demand. However, to the same extent that this discourages or postpones structural reforms, it also, in turn, weakens the forces that boost long-term competitiveness. The continued pursuit of expansionary monetary policy also serves to support the economy.

All in all, real gross domestic product (GDP) is expected to rise by 1.2 percent in the European Union this year. Whereas production in the crisis countries will increase only slightly (Spain and Portugal) or continue to dwindle (Cyprus, Greece and Italy), more robust economies like the United Kingdom, Sweden and Germany will experience a boom.

1.2 The current situation

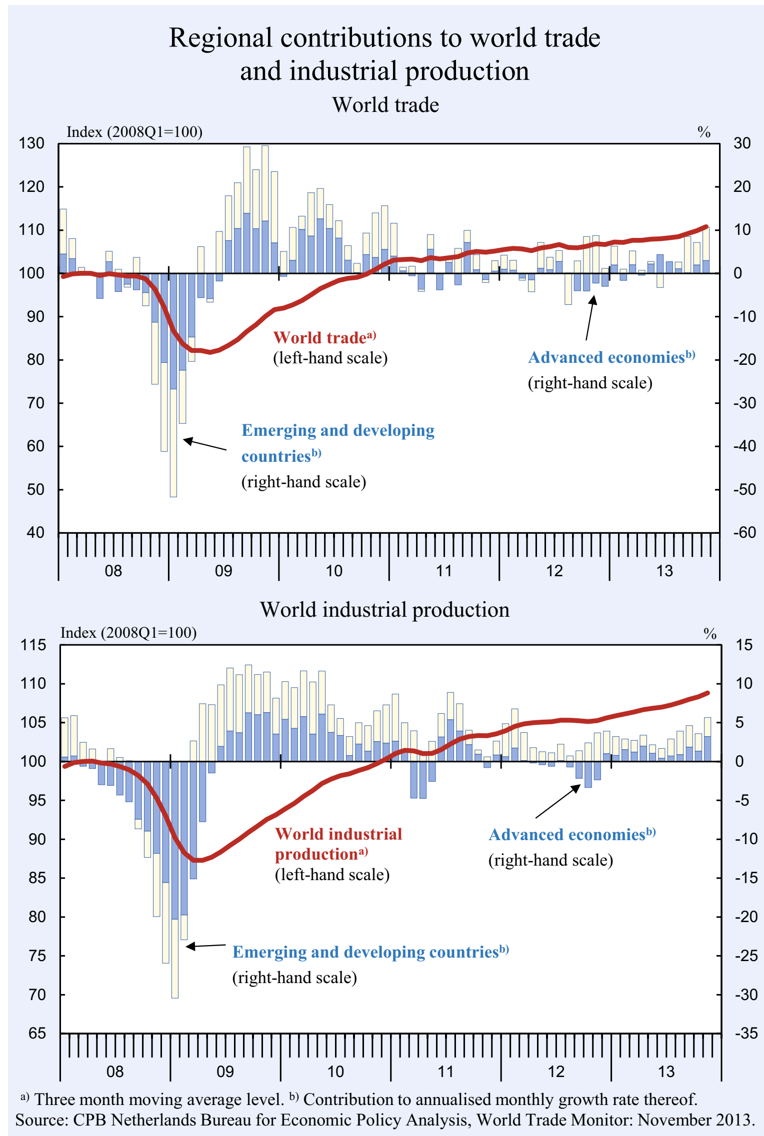
1.2.1 The global economy

Last year saw a slight acceleration in the pace of global economic expansion. Both world industrial production and world trade experienced slight gains in 2013 compared to 2012 (see Figure 1.1). Thereby, global development was – as in preceding years – characterised by strong heterogeneity amongst individual regions. While the economic situation in the advanced countries increasingly improved, some major emerging economies underwent a phase of weakness triggered not only by cyclical, but in many cases by structural factors, too. Thus, for the first time in over four years, the developed countries were the driving force behind the current economic recovery. Overall, the global rate of expansion was considerably more moderate than in the years prior to the financial crisis.

Whereas the economic climate improved during the first half of 2013 in Asia and North America, sentiment in Europe only started to follow this positive trend after the recession in the euro area officially ended, while Latin America even went into bust mode (see Figure 1.2).

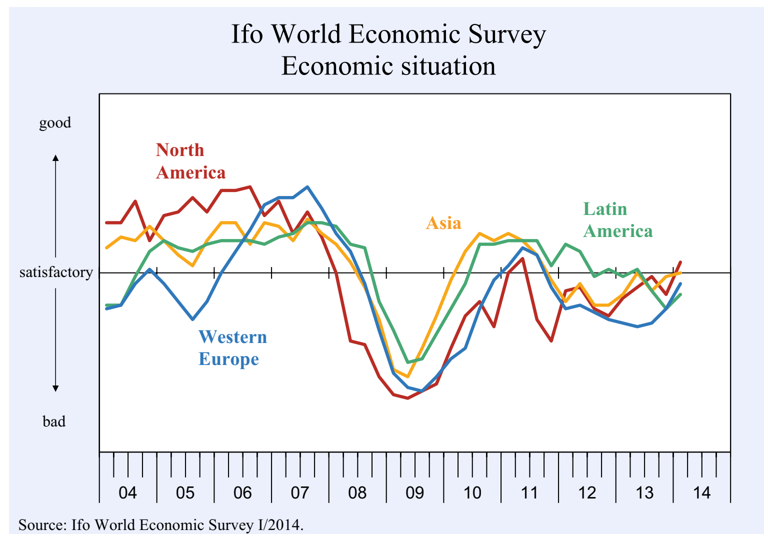
Not only the timing, but also the driving forces behind the mild recoveries in large parts of the world differed greatly from region to region and from country to country. Private households in the United States were in a position to expand their consumer spending, as they were supported by the improvement in their financial situation, favourable developments in the housing market and the increasing

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: November 2013.

Figure 1.2



Source: Ifo World Economic Survey I/2014.

elucidation of the employment situation. The contractionary impetus provided by fiscal policy was more than compensated for. Activity in the construction sector also experienced faster growth. Lastly, the economy benefited from the continued and highly expansionary monetary policy of the US Federal Reserve.

In Japan, monetary and fiscal policy has been extremely expansionary since the beginning of 2013. This boosted private consumption and investment expenditure, while the domestic export industry reaped the benefits of a severely weakened yen.

Most importantly for the world economy, by the spring of 2013 the European Union was finally in a position to free itself from the ongoing recession, which had plagued it since the end of 2011. It has recorded moderate growth since then and has therefore ceased to choke the world economy. This development was supported by reduced fiscal austerity, as well as fading uncertainty regarding the future of the currency area.

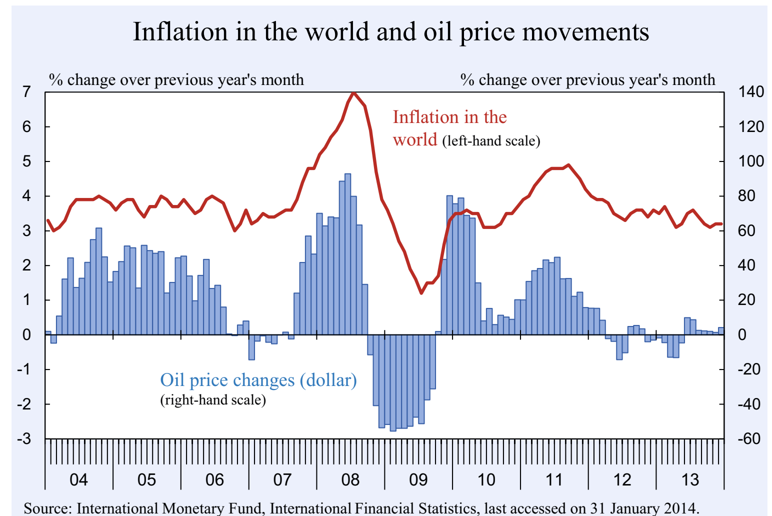
Although consumer and producer sentiments have strengthened almost everywhere in the euro area in recent months, the economic situation of individual countries remains highly heterogeneous. Several euro area countries continue to suffer from very high public and/or private debt. Furthermore, the situation in the Portuguese, Spanish, Italian and Greek banking sectors is still highly fragile. In these countries, the shares of impaired loans are increasing steadily, thereby burdening bank balance sheets. In addition, these economies are suffering from both a lack of competitiveness and weak domestic demand, as the price adjustments required have not fully materialised. The necessary fundamental reforms are delayed due to sturdy sociopolitical resistance, the generous provision of aid funds from the European relief package, the relaxation of fiscal policy objectives granted by the European Commission at the beginning of 2013, as well as ECB measures to reduce country-specific risk premiums on interest rates. Many governments have seen these measures reduce their previously very high funding costs, and with it the massive market pressure to carry out structural reforms. At the same time, however, these policy measures have helped to take the existing anxiety out of the financial markets and thereby support the moderately changing economic climate in Europe. Without a strong self-reinforcing economic recovery the sustainability of such accommodating policies may, however, be called into question.

In a number of major emerging economies, the pace of economic expansion has continued to diminish since last autumn, albeit to different degrees. Both cyclical and structural factors are crucial in this respect. Many emerging economies struggled under the very weak demand from advanced economies. In the majority of the emerging world, government deficits are moderate and national debt is still relatively low. Some countries like China and Brazil used the existing fiscal and political room for manoeuvre to, at least partly, compensate for this weak demand from advanced economies by means of investment programs.

Russia, Brazil and other Latin American countries suffered from stagnating or declining commodity prices. In many cases, another important factor was the after-effects of gradual monetary and fiscal domestic tightening, which took place until about mid-2012. On top of that, many emerging countries faced some rapid outflows of foreign capital last summer, which significantly deteriorated the refinancing conditions for their private and public sectors and set numerous currencies under a massive devaluation pressure. This turmoil was partially a response to the slowdown in economic growth in the emerging economies. However, tensions in the financial and foreign exchange markets were primarily triggered by signals that a gradual tightening of monetary policy in the United States might be initiated earlier than anticipated by financial market participants. While many regions of the world were confronted with a temporary slowdown in capital inflows, currency devaluations against the US dollar and rising bond yields, these adjustments were particularly pronounced in the emerging markets (Turkey, India, Indonesia, Brazil, South Africa), where public and private debtors were in an especially vulnerable position regarding devaluations of domestic currencies. These economies have relatively high short-term funding needs denominated in US dollars. The resulting capital flows were stabilised by the end of the summer due to base rate increases and foreign exchange market intervention on the part of several of these countries' central banks, as well as the decision of the US Federal Reserve to postpone tapering of its quantitative easing policy at that time. Although this effectively contained financial market turmoil, the refinancing conditions for households, businesses and the state have – in many cases – remained more restrictive since the summer than they were previously.

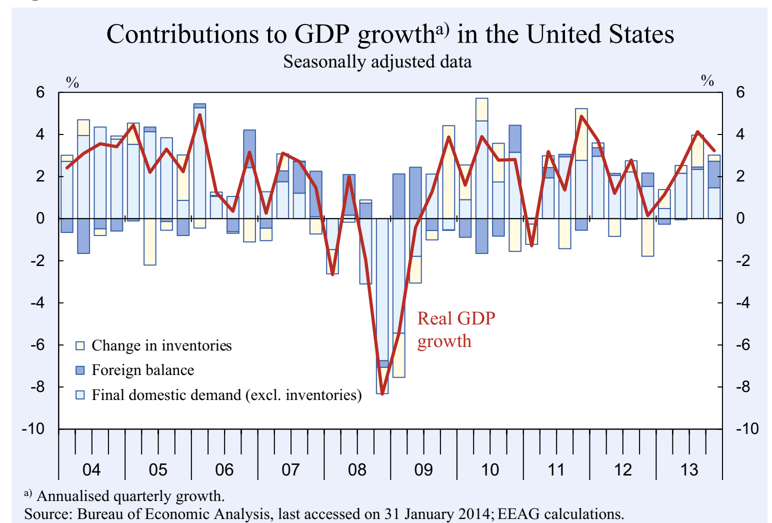
In addition, the growth decline in emerging markets also underlies structural factors. Several key emerging economies are faced with a marked flattening of their population growth, slowing down the increase in labour force potential and also reducing potential growth as a result. In addition, China has sustained losses versus other emerging markets due to a relatively rapid increase in its labour costs in recent years, which noticeably impacted China's competitiveness. Moreover, there are increasing signs suggesting that the potential of the Chinese growth model based on capital accumulation is slowly being exhausted. As a result of the excessive capacities that have been established in many areas, further investments appear less profitable and therefore less attractive. China's relatively advanced state of economic development decreases the scope for productivity improvements through the adoption of existing advanced technologies. In Brazil, by contrast, the lack of infrastructure and strong government interventionism are diminishing the country's attractiveness as an investment location. In India, difficulties in the banking sector, energy supply shortages and the over-regulation of many industry sectors are very likely to impede economic expansion. Although all of these structural factors have been present for some time now, their effects were more than compensated for in the first three years after the severe downturn in the winter of 2008/2009 by the stimulating effects of massive expansionary monetary and fiscal policy measures.

Figure 1.3



Source: International Monetary Fund, International Financial Statistics, last accessed on 31 January 2014.

Figure 1.4



[a] Annualised quarterly growth.
Source: Bureau of Economic Analysis, last accessed on 31 January 2014; EEAG calculations.

The overall weak development of the world economy, together with stagnating or declining raw material prices, allowed world inflation to remain around or slightly below 3½ percent in 2013, which was already the case throughout most of 2012 (see Figure 1.3).

1.2.2 United States

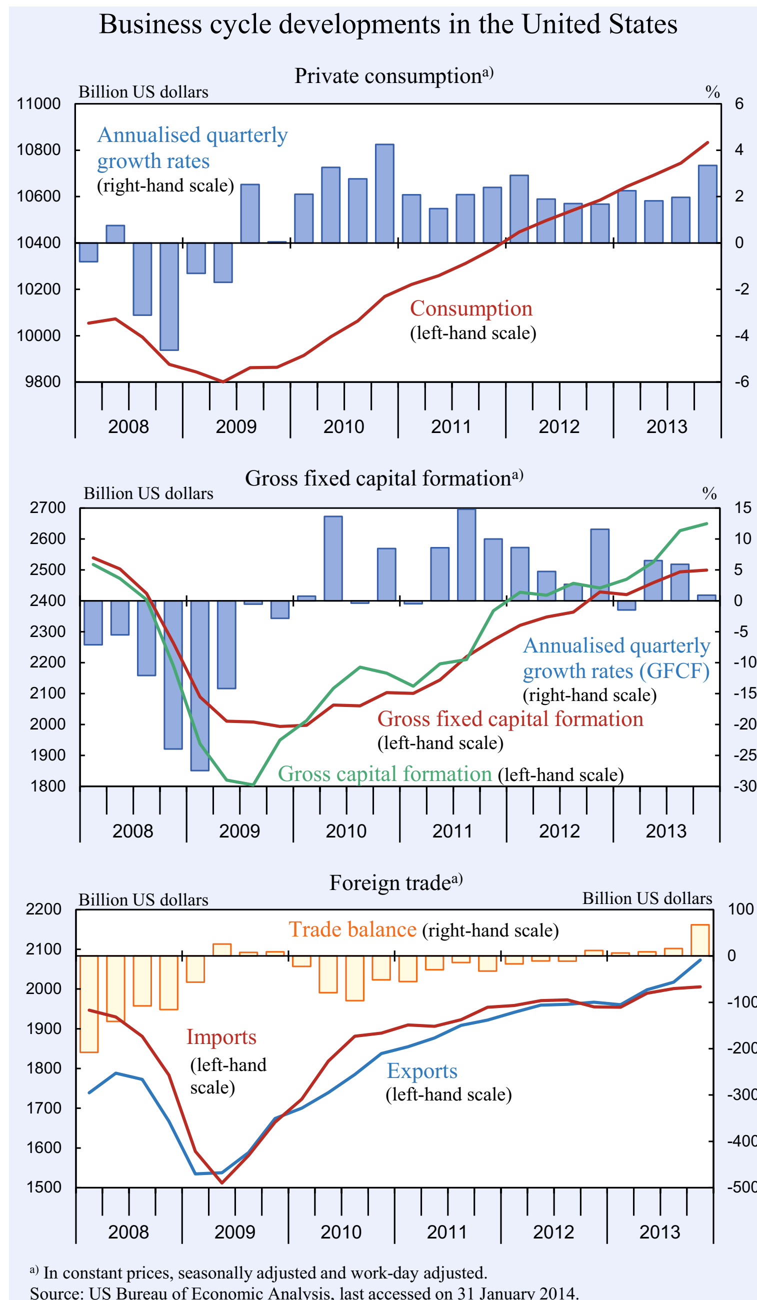
In the United States, economic developments were driven by fiscal policy last year to quite a large extent. At the beginning of 2013, the payroll tax rate was raised by 2 percentage points, and income tax on the wealthy was also increased. In March, the so-called "sequester" – with cuts in discretionary federal spending – took effect. The combined impact of these measures slowed down the economy. Most of the dampening impulses started to phase out last summer. Whereas both government consumption and investment plummeted during the winter of 2012/13, investment contributed positively again in the third quarter of last year. As a result, the expansion rate of real GDP accelerated from an annualised 1 percent during the previous winter to over 2.5 percent last summer (see Figure 1.4). At the beginning of the fourth quarter, the budgetary dispute paralysed the federal administration for two weeks, again with a dampening ef-

fect on the overall economy.[1] The direct demand effect of a two-week "government shutdown", associated increased economic uncertainty and the implementation of some restrictive measures already planned for in the spring did result in subdued development during the fourth quarter of last year. In addition, the strong stockbuilding tendency of the third quarter stopped almost completely. The annual US real GDP growth rate consequently turned out to be 1.9 percent in 2013.

Private consumption and investment expenditure contributed differently to the overall acceleration in US economic growth last year. Private households compensated for the tax burden at the beginning of the year almost exclusively by lowering their savings rate. While private consumption growth therefore remained remarkably stable throughout most of the year and increased its pace during the fourth quarter (see Figure 1.5), most of the observed dynamics came from movements in stocks. Whereas inventory investment generated a negative growth impulse at the end of 2012, it provided strong growth impulses over the first half of 2013, and again during the third quarter when a normalisation of the weather conditions – as compared to the extremely dry weather in 2012 – led to an unusually strong increase in stocks in the agricultural sector. As far as private fixed investment is concerned, low growth in the first quarter of 2013 merely compensated for strong investment activities at the end of 2012 brought forward in anticipation of the then forthcoming fiscal consolidation. Ever since, private residential and non-residential construction activities have strongly supported overall private fixed investment. By contrast, equipment investment was particularly sluggish compared to other investment components.

After a weaker phase during last summer, the labour market has now stabilised. On average, about 200,000 jobs were created per month during the months of August to November. This allowed the unemployment rate to fall from 7.9 percent at the beginning of 2013 to 6.7 percent in December (see Figure 1.6). Never-

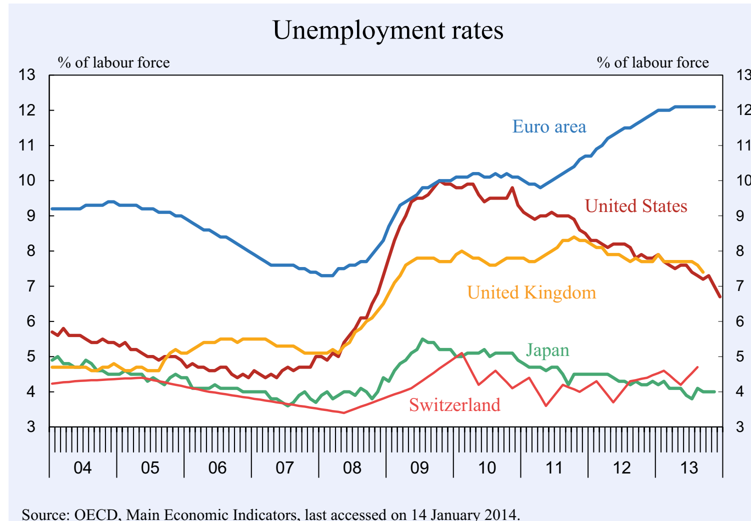
Figure 1.5



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2014.

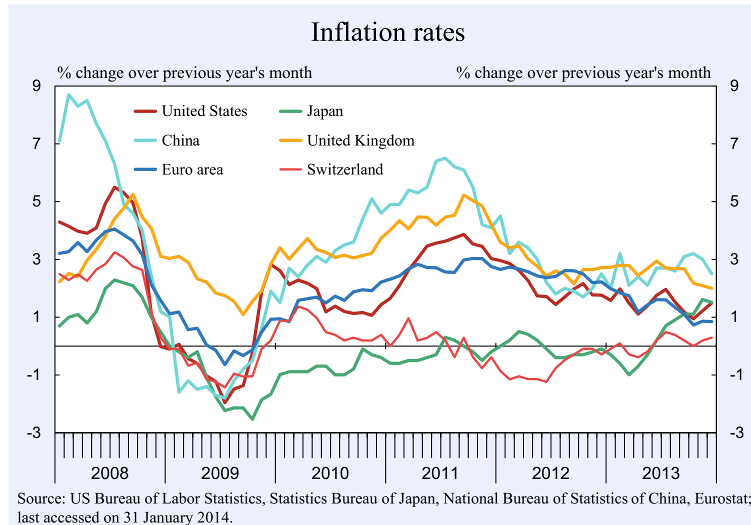
[1] As Democrats and Republicans were unable to agree on a new budget law by the end of the fiscal year on 30 September 2013, the necessary legal grounds for the approval of budgetary funds were lacking. Consequently, all non-security authorities of the US federal government had to cease their activities by 1 October. On 16 October, one day before the onset of technical insolvency due to the simultaneously reached statutory debt ceiling, only a minimal consensus for a transitional budget was initially reached. By mid-December, Democrats and Republicans had managed to agree on a draft budget for the next two years. This draft was approved in mid-January 2014 by both the Senate and the House of Representatives.

Figure 1.6



Source: OECD, Main Economic Indicators, last accessed on 14 January 2014.

Figure 1.7



Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2014.

theless, the increase in employment is still below average compared to past recovery phases in the United States and the unemployment rate is falling largely due to a continued drop in the participation rate.

After coming down in 2012, inflation stayed low, but was relatively volatile during 2013 (see Figure 1.7). As indicated by the much more stable core inflation rate, i.e. the rate of inflation excluding energy and food costs, the observed volatility was primarily due to changes in energy prices. Overall, actual inflation reached an average of 1.5 percent in 2013.

1.2.3 Asia

China's economy picked up speed over the course of 2013. After a trough in the first quarter of 2013, real GDP growth continued to increase throughout the year, resulting in an annual growth rate of 7.7 percent. Fiscal policy turned expansionary until mid-2013 to circumvent a further reduction in economic growth observed during the winter of 2012/13. The fiscal measures mainly constituted a temporary increase in public investment.

Although the service sector continues to outperform other areas of the economy and overtook industry in terms of size last year, overall strong economic development was also underlined by a substantial increase in industrial production in recent months. The main catalyst was expanding capital investment, while private consumption generated smaller impulses. China's economic growth continues to be based heavily on investment, with over 50 percent of overall growth last year linked to this demand component. In particular, the sharp rise in residential construction has led to a significant boost in investments. Due to feeble global demand, exports generated little economic momentum last year. Another reason for weak Chinese exports is the relatively sharp increase in unit labour costs in recent years. China is slowly losing its ability to compete with other emerging markets as a result. In addition, some Asian emerging countries were faced with currency devaluations last year, making them more reluctant to import goods and services from China. Export growth to the European Union only seems to have overcome its persistent weakness since the last quarter of 2013, thereby reflecting recent economic progress in that region.

Inflation in China has steadily increased from below 2 percent at the end of 2012 to about 3 percent at the end of last year. However, it is doubtful whether this can be regarded as an indication of a permanent increase in inflation. Core inflation still seems anchored at levels below 2 percent and producer prices in the in-

dustrial sector have been declining since March 2012. The latter can be interpreted as an indication of overcapacities in this sector.

The strong growth in house prices appears more worrisome. Despite signs of a slowdown, these growth rates are still multiples of overall inflation rates. The real-estate boom was caused by the low interest rates that state-owned banks are allowed to offer households on their savings and limited possibilities for investing abroad. For many households investing in real-estate is the only viable option. A liberalised capital market would, in principle, have prevented such a development from emerging. However, now that the bubble exists, there is a risk that liberalisation will act as the trigger to burst it.

The growth rate in the *Japanese* economy lost dynamics during the second half of 2013. The pace of economic expansion in Japan was nevertheless still higher than in most other OECD countries, and clearly above average from an historical perspective. The Japanese government primarily stimulated the economy by means of its expansionary fiscal policy. Private consumption took a breather, after performing exceedingly well in the first half of the year. Public investment and private construction spending remained strong, reaching double digit growth rates. By contrast, growth in private equipment investment slowed somewhat. After having shrunk throughout 2012 and stagnating early last year, the upturn in the second quarter of 2013 generated hopes for a stronger turnaround. It is disappointing for the current government that this turnaround so far failed to materialise, as the medium-term success of its policy is based on the participation of private investors in the upswing. Weak demand from emerging Asian markets caused by recent currency turmoil did exert downward pressure on net exports. This unexpected downturn manifested in rising inventories. The temporary nature of this downturn is also reflected by the overall improved business situation and the sentiment of large companies. Real GDP is expected to have risen by 1.6 percent in 2013.

The Japanese central bank continued to pursue its expansionary monetary policy in 2013. In order to achieve its new inflation target of 2 percent, it massively expanded the central bank money stock; since the beginning of 2013, the Bank of Japan's monetary base has risen by about 50 percent. Although this has not been reflected in other money supply aggregates to date, the inflation rate turned positive in early summer and stood at 1.5 percent in November. This was partially due to the steady rise in domestic energy prices. However, even excluding the prices of food and energy, consumer prices started to rise in November by 0.6 percent, which was the highest value recorded for the core inflation rate in the last 15 years. The recent increase in consumer prices is only marginally noticeable in the average annual inflation rate, which turned out to be 0.3 percent on average in 2013.

The pace of economic expansion in *India* accelerated slightly in the second half of 2013, after declining steadily since the fall of 2011. The main reason for this acceleration was the positive impact of fiscal policy. Private consumption, however, remained feeble. On the production side, the pace of economic growth in agriculture, as well as in the services sector and manufacturing, remained low. India was temporarily confronted with large capital outflows, leading to a depreciation of its currency of about 20 percent against the US dollar during the summer. The risk of a prolonged cessation of foreign capital injection caused the central bank in India to follow a more restrictive monetary policy – three increases in its key interest rate materialised since autumn – which, in turn, dampened the business cycle, but did stabilise the external value of the Indian rupee. Structural problems, like deficiencies in infrastructure and bottlenecks in energy supply are, at least partially, to blame for the overall weak economic developments in India from an historical perspective. Real GDP growth is expected to have again been only 3.9 percent last year. At 11.5 percent, the annual inflation rate, on the other hand, remains far above its average value.

After a feeble 2012, the economies of the Asian Tiger countries *(South Korea, Taiwan, Hong Kong and Singapore)* gained momentum during 2013. This was mainly due to a strong upturn in private consumption. Despite continued weakness in foreign demand, foreign trade made a positive contribution to growth in South Korea, where exports to the United States and to the European Union in particular increased. In addition, the expansionary economic policies of the South Korean government supported the recovery. Inflation is still below average by historical standards, enabling a continuation of expansionary monetary policies. All in all, overall economic production is likely to have risen in the fourth quarter at a similar rate to the previous quarter.

After their above-average growth in 2012, the emerging Asian countries *(Indonesia, Thailand, Malaysia and the Philippines)* posted lower growth rates in 2013. Weak external demand and the decline in investments have had a negative impact on all of these economies except the Philippines. Inadequate institutions, unnecessary bureaucracy and inefficiencies in the financial sector also hampered growth. The Philippines once again appears to be the exception here.

Unlike the others, the biggest of these economies, Indonesia, has faced substantial capital outflows since mid-2013. The Indonesian rupiah fell by around 30 percent against the US dollar over the course of the year. Short-term liabilities, as well as current account deficits, which had been increasing for several years, have made the country susceptible to shifts in market sentiment.

Taken together, these eight East Asian countries are expected to have seen – as in 2012 – an increase in total real GDP of 3.8 percent in 2013.

1.2.4 Latin America

The moderate pace of expansion observed since 2012 in Latin America *(Brazil, Mexico, Argentina, Venezuela, Colombia and Chile)* continued throughout 2013. This was especially driven by Brazil and Argentina, the two largest economies of the region. However, real GDP growth also slowed down significantly in Mexico. In addition to weaker external demand (especially from the United States), which led to a decline in industrial production, the government reduced its expenditure and lower construction activity was recorded. Colombia and Chile remained relatively robust by comparison. Here, the expansion of real GDP did slow down due to weaker external and domestic demand, but not to as great an extent as in the countries mentioned above.

In Brazil, the base rate (BACEN Selic target rate) gradually increased from 7.25 percent in April to 10 percent by the end of last year. By contrast, monetary policy in most other countries of the region became more expansionary. This was especially true of Mexico, where the Banxico overnight interbank rate was reduced from 4.5 percent in March to 3.5 percent in October 2013, which marks an historical low.

In anticipation of rising yields in the industrialised countries, the currencies of the countries of Latin America have been subjected to strong downward pressure since May 2013. The Brazilian Real had depreciated by around 20 percent against the US dollar by the end of August. After the US Central Bank's announcement in September that it would postpone the tapering of its asset buying program, the situation in the international capital markets calmed down again. Despite the negative impact of these strong exchange rate reactions last summer, Latin American countries are far less vulnerable than in previous (currency) crises. In addition to flexible exchange rates, most countries in the region have substantial foreign exchange reserves at their disposal, which are sufficient to stabilise their exchange rates in case of an emergency. A certain amount of risk, however, is attached to high foreign currency liabilities. In many of these countries the vast majority of external debt is recorded in foreign currency, making the holders vulnerable to currency devaluations.

In total, the Latin American economies are expected to have grown by 2.5 percent last year. In general, inflation rates have fallen since mid-2013, after having increased previously. The exceptions to this rule are Venezuela and Argentina, where inflation rates remained double-digit. Annual inflation in the region was 6.9 percent in 2013, following 6.2 percent in 2012.

1.2.5 The European economy

The cyclical situation

In spring the economy of the European Union emerged from a recession that had lasted over a year and has since been able to expand slightly. The EU economy nevertheless remains in pretty bad shape, as it is still characterised by a pronounced heterogeneity among individual member countries and remains fragile and susceptible to critical distortions in the financial market. Several member states still carry with them enormous private and/or public debt, often generated in the decade prior to the crisis. Given the weak economic development and low inflation rates of the past five years, the debt, despite consolidation efforts, increased even further. In some cases, the sustainability of public debt by international investors is still being called into question. Accordingly, Greece, Portugal, Ireland and Spain have not been able to refinance themselves, or only at capital market conditions that were politically considered unacceptable, in the past three years. This has made them dependent on

grants from international institutions, like the International Monetary Fund (IMF) and the ECB; or they merely preferred the conditions required by these organisations above to those imposed by the capital market. The situation of the banking sector is also very fragile in many countries. In Spain, Portugal, Greece and Italy, the steep upward trend in loans at risk remains strong. Indeed, the political inability of these countries to implement timely and, where necessary, drastic restructuring of the banking sector, contributes to the difficulties experienced by the EU economy.

As argued in previous reports, the core of the problem lies, however, in its lack of competitiveness (EEAG 2013, Chapter 2; EEAG 2012, Chapter 2). The credit bubble has made some countries too expensive. In these countries, devaluations via price restraint are required at a scale of up to 30 percent in order to facilitate the restoration of competitiveness within the euro area. Implicit loan assistance, via TARGET2 balances (see EEAG 2013, Chapter 2) and the loans of the international community have served to alleviate the problems so far, but they have probably also protracted the real solution of the issue at hand by making the lack of competitiveness somewhat more bearable. Nevertheless, some progress has been made. Table 1.1 reveals that unit labour costs in the private economy did increase substantially, with average annual rates of well-above 3 percent in the crisis countries, since the introduction of the euro and before the euro crisis. During the last four years, these four countries have, on average, seen a decline in these unit labour costs. When taking into account the structure of competition in both export and import markets and exchange rate developments, to get a measure of international competitiveness, the picture remains largely unchanged. Although relative unit labour costs increased considerably during the 1999–2009 period, we have seen a strong decline since then. Another, albeit more

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)]		
	1999–2009	2010–2013	1999–2009	2010–2013	1999–2009	2010–2013	1999–2009	2010–2013	1999–2009	2010–2013	1999–2009	2010–2013	2013
Germany	1.0	2.3	0.2	0.8	0.4	1.2	0.5	1.3	–1.3	–1.3	0.7	1.6	–1.3
France	2.7	2.5	0.9	1.2	0.6	0.9	2.2	1.2	0.6	–1.0	–2.6	–0.6	–1.6
Italy	1.8	2.1	–0.5	0.8	–0.4	0.0	3.0	1.2	1.5	–1.3	–3.7	–0.4	–2.3
Spain	3.1	1.5	–0.3	1.3	0.4	2.1	3.5	–2.3	1.8	–4.4	–0.9	1.9	2.8
Netherlands	3.2	1.7	0.9	0.5	0.8	0.2	2.6	1.0	1.2	–1.5	–0.1	0.2	–0.1
Belgium	2.6	2.5	0.7	0.6	0.7	0.5	2.2	1.8	1.0	–0.4	–1.7	–1.1	–1.5
Austria	2.2	2.1	0.7	0.2	0.9	0.4	1.2	1.8	–0.3	–0.3	–0.3	–0.7	–0.2
Greece	4.9		1.8		1.7	–0.2	4.1	–4.5	1.9	–6.9	–1.5	–4.1	–0.4
Finland	3.1	3.0	1.7	1.1	1.0	0.9	2.3	1.8	0.7	–1.5	–1.1	–4.2	–3.3
Ireland	4.6	0.6	2.1	0.6	1.9	1.6	3.5	–2.3	2.6	–4.8	2.2	–1.2	–1.4
Portugal	3.8	1.2	1.0	0.7	0.9	1.6	3.2	–1.4	1.1	–2.5	–1.4	2.5	4.4
Slovakia	8.1	3.3	4.0	2.2	3.7	2.7	3.1	0.4	3.7	–1.8	2.6	5.4	4.1
United Kingdom	3.9	1.9	1.7	–0.4	1.3	0.4	2.7	1.6	–1.5	0.1	–1.6	–1.5	0.6
Sweden	3.1	2.4	1.3	1.4	1.4	1.6	1.9	0.5	–1.3	3.2	–0.5	–1.2	–3.3
Denmark	3.3	2.1	1.0	–0.1	0.5	1.3	3.2	0.5	1.8	–2.4	–0.2	–2.2	–0.7
Poland	4.6	7.2	1.1	5.2	3.7	3.6	2.3	1.4	–0.6	–0.2	2.9	1.2	3.0
Czech Republic	6.0	3.4	3.8	3.2	3.2	0.3	2.4	1.1	3.8	–0.4	3.0	1.8	–1.4
Hungary	8.1	3.1	2.0	0.2	2.4	0.0	6.6	1.6	3.6	–2.2	4.4	1.1	2.3
Iceland	6.6	5.4	1.1	1.3	2.1	–0.4	5.3	6.8	–3.2	5.5	1.5	–1.9	–0.3
Norway	4.6	4.3	–0.4	–0.1	0.6	0.4	4.5	3.6	2.9	3.5	–3.2	–4.8	–3.0
Switzerland	1.8	1.3	0.7	1.1	0.6	0.5	1.5	0.2	0.7	3.0	–0.2	–1.2	0.3
Japan	–1.1	0.9	0.1	2.3	0.7	2.0	–1.5	–1.6	–1.8	–5.8	–3.3	–1.6	–2.6
United States	3.6	2.3	1.5	0.7	1.8	1.4	1.9	1.0	–1.6	–2.2	–1.7	–0.7	–0.9
China									3.6	6.9	11.4	5.7	5.9

[a)] Growth rates for the total economy. – [b)] Compensation per employee in the private sector. – [c)] Compensation per employee in the private sector deflated by the 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. 94, November 2013.

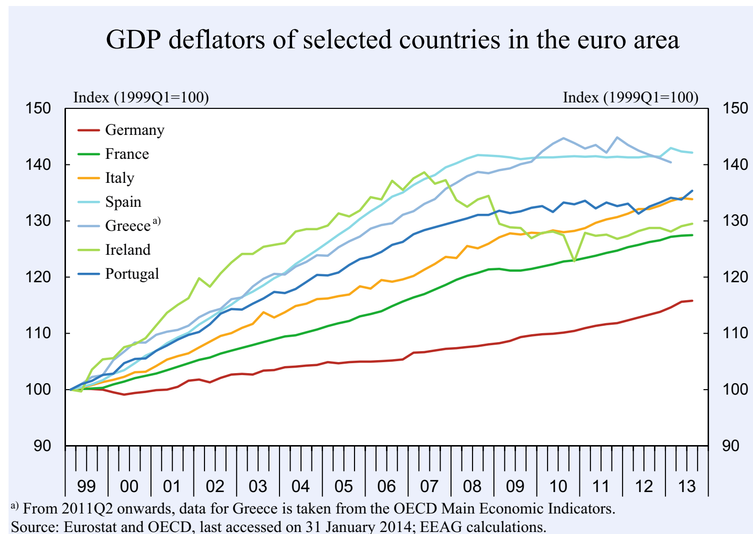
crude, measure of competitiveness is the GDP deflator. By incorporating the public sector and not correcting for productivity gains, this measure is bound to react at a slower pace and to a lesser extent. Nevertheless, some degree of convergence is also depicted by this measure (see Figure 1.8).

Although a significant part of the adjustment in the observed improvement in the trade balances (see Figure 1.9) is due to the strong decline in imports in crisis-afflicted countries, some of it is also achieved by improved competitiveness. In Portugal and Spain improved competitiveness has indeed already been reflected by gains in market shares. This is not yet the case for both Ireland and Greece. Whereas for Greece a clear reduction in the loss of export shares can be observed, data on Ireland calls into question whether an appreciable improvement in its competitiveness has been achieved. However, as Ireland already has a structural trade balance surplus, this also does not appear to be needed. The other crisis countries, however, are at the start of a long adaptation process during which they will become more competitive again by gradually deflating relative to other countries within and outside of the euro area. It still remains unclear whether these societies will be able to withstand the resulting stress, or whether political forces shall prevail that seek a quicker fix to the competitiveness problem via exiting the euro and devaluating domestic currencies.

The necessary price and wage reductions have been slowed down by the fact that, in many places, the goods and labour markets are still not sufficiently flexible. This diminishes competition and innovation pressure by means of market entry barriers. However, several member countries have initiated reforms to address such structural deficiencies over the past few years. Nonetheless, it will take some time before the necessary reforms are fully implemented, and even more time until their positive effects can actually be observed. The problem is that reduced demand, which constitutes a prerequisite for recovery, entails great hardships on the population, potentially leading to social destabilisation and unrest.

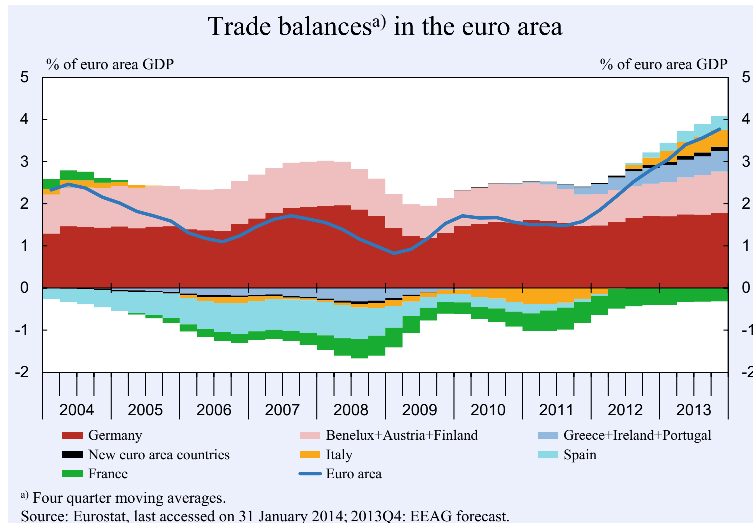
Due to reduced tensions in financial markets allowing policymakers to relax fiscal consolidation efforts, the economy of the euro area was able to start expanding again after it had shrivelled since the fourth quarter of 2011. Production not only increased in countries such as Germany and Austria that already enjoyed relatively good economic conditions, but structurally weak economies like France, Belgium, the Netherlands and Finland started to grow again after facing recessionary tendencies in varying degrees previously. The recovery was even felt in the countries severely affected by the crisis like Portugal

Figure 1.8



a) From 2011Q2 onwards, data for Greece is taken from the OECD Main Economic Indicators.
Source: Eurostat and OECD, last accessed on 31 January 2014; EEAG calculations.

Figure 1.9



a) Four quarter moving averages.
Source: Eurostat, last accessed on 31 January 2014; 2013Q4: EEAG forecast.

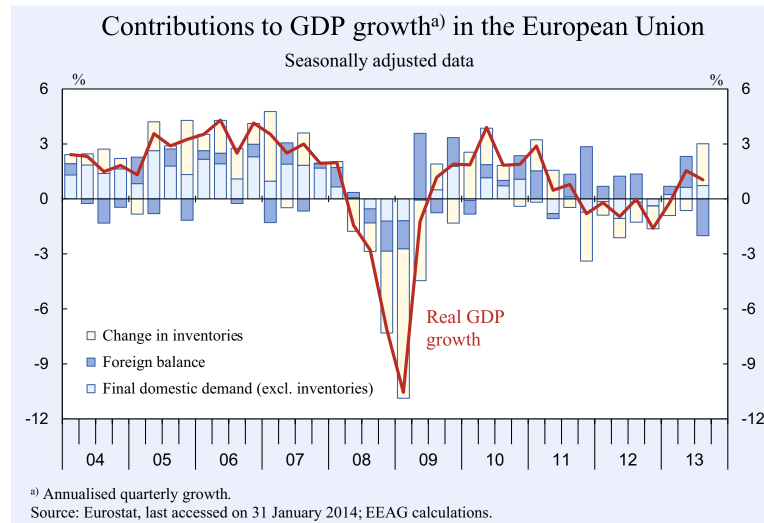
and Ireland. In Italy and Greece, the recession lost strength. All in all, real GDP is expected to have declined by 0.4 percent in the euro area and, with a growth rate of 0.0 percent, it stagnated in the European Union in 2013 compared to 2012.

Although fragile, the recovery has been supported to date by final domestic demand (see Figure 1.10). With the benefit of hindsight a key trigger to this more positive turn in the cyclical development of the euro area was the ECB's introduction of its OMT programme in September 2012. This free insurance scheme on government bonds of crisis countries that lowered government bond spreads considerably served to relieve the interest burden of governments affected by the crisis and facilitated their access to capital markets. This, in turn, allowed governments to take a more relaxed stance on budgetary discipline, as shown by public consumption growth, which turned positive again by the end of 2012. The stabilisation of investor confidence that emanated from the OMT projected more optimism about the survival of the monetary union and led to a general increase in confidence indicators across all sectors (see Figure 1.11). The investors ventured into more investments, and private households started spending more eagerly. Consequently, domestic demand in the crisis countries shrank to a lesser extent than in previous years, while expansion in private consumption and investments in the economically healthier markets accelerated slightly. In early 2013 private consumption started growing again in the European Union as a whole, after two years of continuous decline (see Figure 1.12). This was followed by positive investment growth from the second quarter onwards.

By contrast, export activities showed irregular tendencies both across countries, as well as in the European Union as a whole. While Spain and Portugal, for example, succeeded in increasing their market shares in non-European markets after the catastrophic collapse of 2009, the shares of France and Italy subsided significantly. After declining export activities during the winter of 2012/13, a strong pick up was observed for the European Union as a whole during the second quarter. This, however, did not continue during the second half of the year.

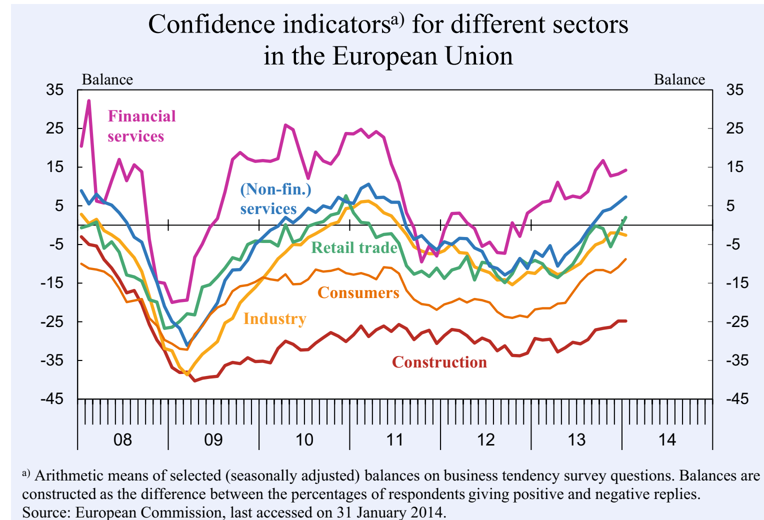
The feeble economy and the negative short-term effects of the necessary structural adjustment processes implemented by many member states have yet hardly had any positive impact on the still very unfavourable European labour market situation to date. The aggregate unemployment rate for both the European Union and the euro area only managed to stabilise at historically high levels (see Figure 1.13). Accordingly, real wage increases generally turned out to be modest, which on the one

Figure 1.10



a) Annualised quarterly growth.
Source: Eurostat, last accessed on 31 January 2014; EEAG calculations.

Figure 1.11



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 2014.

Figure 1.12

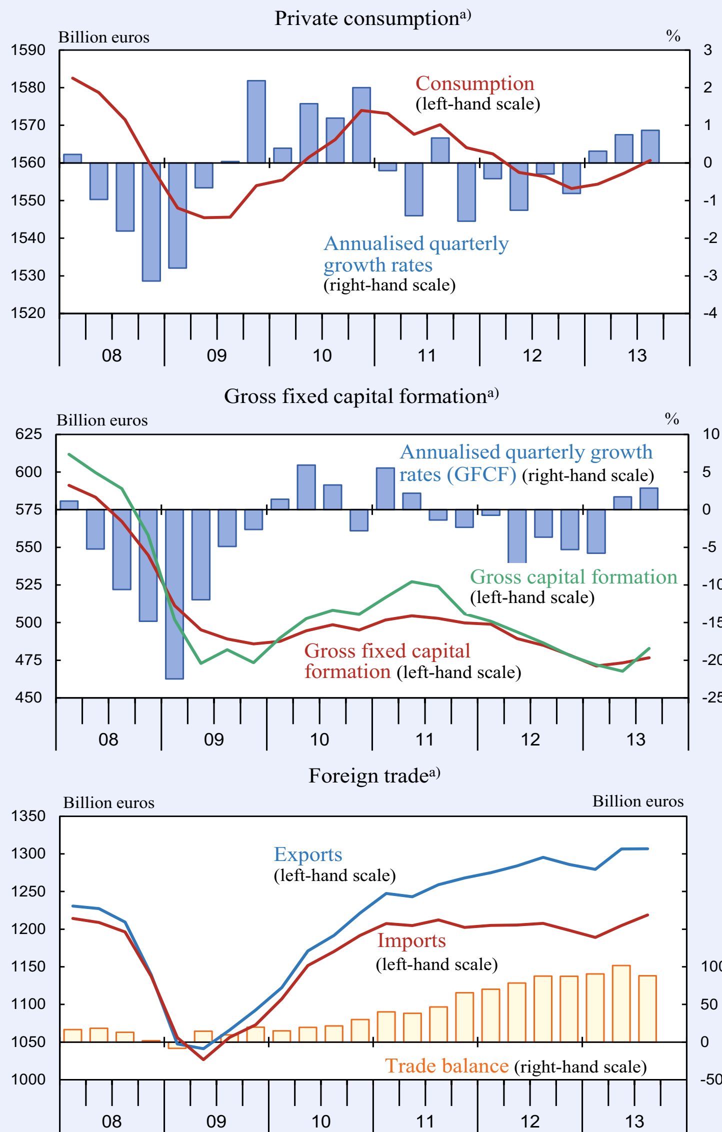
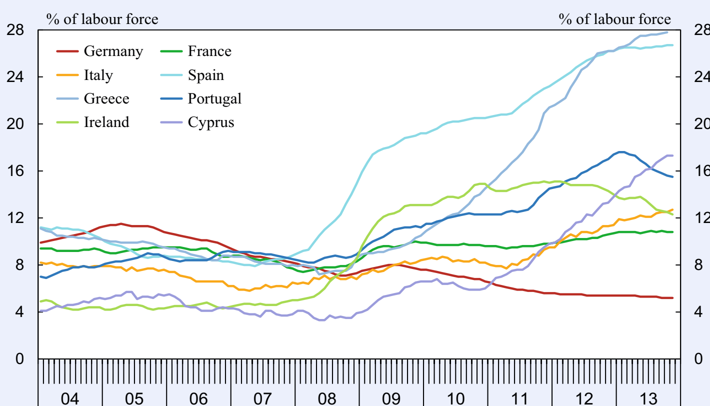


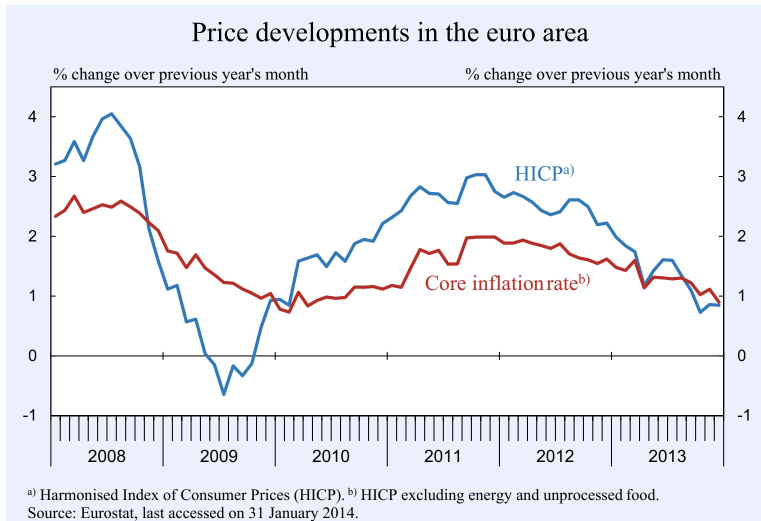
Figure 1.13



hand restrained private consumption growth, but on the other constitutes a basic prerequisite for the restoration of competitiveness. A higher unemployment rate is also associated with larger concerns about preserving one's own job, as well as with lower re-employment opportunities in the event of dismissal. This serves to further dampen consumer confidence. Nevertheless, for some time now, the Irish and Portuguese labour markets have shown some significant improvements. In France and the Netherlands, the labour market situation also started to improve slightly by the end of last year. In Belgium, Finland, Italy and Spain, a turn for the better, however, is not yet discernible.

The unfavourable employment situation and the weakness of domestic demand has been causing the inflation rate in the euro area to drop since the middle of last year in all member countries, albeit to varying degrees. This trend has been supported by a decline in energy prices, the slight appreciation of the euro and the fading impact of past consumption tax increases introduced in many member states to raise tax revenues. As a result, the inflation rate for the euro area steadily dropped from 3.0 percent in November 2011 to 0.7 percent in October 2013, before increasing slightly in the following month to 0.9 percent (see Figure 1.14). Core inflation, which is adjusted for fluctuations in energy prices and prices of unprocessed food and therefore better reflects euro area specific developments, has also been declining since the autumn of 2011. It reached 0.9 percent in December. Although the downward trend was present in almost all member countries, na-

Figure 1.14



a) Harmonised Index of Consumer Prices (HICP). b) HICP excluding energy and unprocessed food.
Source: Eurostat, last accessed on 31 January 2014.

tional inflation rates show a high degree of heterogeneity. Now that the tax increases have largely passed through to inflation rates, the remaining and still considerable dispersion reflects the diversity of the competitive situation of the countries.

Differences across Europe

In *Germany*, the European debt crisis and weak developments in world trade did depress the overall economy during the winter of 2012/13. The economic situation has improved substantially since. Nevertheless, the contribution of the external sector did not turn out to be positive in 2013. Although exports did pick up, imports grew to an even greater extent. Larger quantities were imported from third countries, while imports from within the euro area declined. The good income prospects and favourable financing conditions have become increasingly noticeable. As a result, business confidence substantially increased. Consumers also regained more confidence in the future. This benefited both consumption and equipment investment, with the latter gaining momentum in the spring after having fallen for one-and-a-half years. In addition to the reduced uncertainty of investors about economic progress, gloomy corporate earnings prospects have brightened during the year. Due to the still slightly below-average utilisation of production capacities in the summer months, the pace of increase in equipment investment remained, however, comparatively low.

After a bad start due to adverse weather conditions, construction investment remained on an upward course. It has already benefited for some time from the flight into German assets and out of their foreign counterparts. All in all, domestic demand was the main driving force behind the German economy since spring last year. Additional impetus was generated by repairs induced by the flooding of particular regions. Real private consumption also rose in an economically robust manner. This was promoted by both good labour market conditions, which combined with low inflation, has led to considerable real wage increases and a decline in the propensity to save. Overall, the strong decline at the end of 2012 caused real GDP in 2013 to have only exceeded its 2012 level by 0.4 percent.

The demand for labour remained high. The average number of working hours increased owing to a reduction in short-time work, as well as an increase in overtime associated with a catching up of winter-related production losses. At the same time, the readiness to recruit new staff members remained high, so that social security contributions increased at a steady pace. Nevertheless, the unemployment rate did not decrease substantially. The reasons for this were the immigration from Central and Eastern Europe and the European crisis countries and a rising labour force participation of nationals.

Due to longer average working hours, unit labour costs, which rose sharply in the winter of 2012/13, could slightly subside again. Also due to the fall in energy prices, inflation remained moderate throughout the year. Overall, the consumer price level increased by 1.6 percent last year.

After developing strongly in the second quarter of 2013, the economy of *France* is likely to have shrunk again during the second half of the year. The repeated fall back into recession was mainly due to falling exports and weakened private investment. On the other hand, private and public consumption continued to contribute positively to growth. This is also reflected by imports, which have shown a strong increase in the course of last year. All in all, real GDP basically stagnated with an overall growth rate of 0.2 percent relative to 2012.

During the first nine months of last year, the unemployment rate continued to increase, albeit at a reduced pace, only to slowly start its descent in October, reaching 10.8 percent on average in 2013, which is more than double the German rate.

The rise in consumer prices declined significantly. This was not only due to the under-utilisation of capacities, but also as a result of declining energy and food prices. The average inflation rate for 2013 amounted to only 1.0 percent, after 2.2 percent in 2012.

The economy of the *United Kingdom* picked up noticeably in the course of 2013. In particular, domestic demand rose sharply; both private consumption and gross fixed capital formation expanded strongly due to improved sentiment in the private sector, which was also induced by programmes like the government-backed help-to-buy-a-home initiative. The trade deficit, however, widened in the second half of 2013, thereby offsetting the decrease observed during the first half of that year. Exports dropped significantly, while imports showed a moderate increase. Overall, real GDP in the United Kingdom is expected to have risen by 1.9 percent last year.

Despite the strong upturn, the situation of the labour market still remains bleak. The unemployment rate has remained virtually unchanged until the end of summer and has only been coming down slowly since. The average unemployment rate for 2013 turned out to be 7.5 percent. As a result, the rise in wages remained moderate. Until the end of summer the inflation rate basically stuck at a level of around 2.7 percent. The price-raising effects that resulted from the increase in government-regulated prices basically nullified the general tendency in other price components to slow down in pace. In October 2013, when these price-raising effects apparently expired, inflation fell to 2.2 percent.

The *Italian* economy has been in a recession since 2011. The high uncertainty about the course of the economic policy of the current and previous governments weighs heavily on private consumption and investment. In addition, potential growth is unlikely to be above zero percent given the structural problems related to the labour market, education, infrastructure and energy. The tax and social security burden has, especially for companies, turned exceptionally high in comparison to international standards. Furthermore, Italy is vulnerable due to its substantial public debt amounting to 133 percent of GDP in 2013, which particularly affected capital market interest rates. Real GDP is expected to have fallen by 1.9 percent last year.

For the first time in almost three years, the economy of *Spain* stopped shrinking after summer last year. There is increasing evidence that Spain has finally bounced off the economic and financial bottom and that the implemented reforms are starting to show initial successes, albeit small ones. The banking sector in Spain was recapitalised and the aid program agreed-upon with the European Union was successfully implemented. Additionally, price competitiveness of firms has improved somewhat in recent years and the current account balance has, for the first time in fifteen years, on average been in surplus last year. A large share of the improved current account position, however, can be traced back to the collapse of the domestic economy and the resulting decline in imports. Nevertheless, a significant part can be related to improvements in exports. Despite the changes for the better, real GDP is expected to have fallen once again by – 1.2 percent in 2013 relative to 2012. As a result, the unemployment rate has not yet managed to break its upward trend and reached an average of 26.5 percent last year.

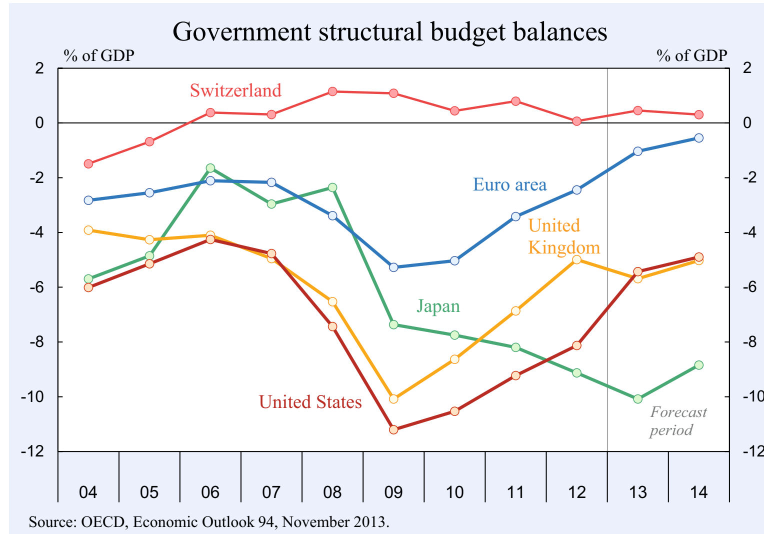
The *Central and Eastern European* member countries of the European Union (Poland, the Czech Republic, Romania, Hungary, Slovakia, Croatia, Bulgaria, Slovenia, Lithuania, Latvia and Estonia) have mostly experienced a devaluation of their currencies and/or have been able to improve their competitiveness during recent years. Combined with the slow recovery of the euro area, this has supported export growth and allowed industrial production to increase in all countries of the region, except for Croatia. Whereas the Czech Republic, Hungary and Croatia suffered from an economic decline during 2012 and the first half of 2013, they managed a turnaround during the second half. In the region, a positive growth contribution is provided by private consumption. Reduced unemployment allowed consumption to grow again last year. A mere stabilisation in consumption levels was only achieved in the Czech Republic and Croatia. Government spending growth has also passed its peak and investments remain a weak point in the region. Gross fixed capital formation declined last year in almost all countries. Related to this is weak credit growth. Since the global financial crisis, the region has experienced a decrease in the foreign liabilities of other European parent banks in particular. Vast differences can be observed across the individual countries. Whereas Hungary was affected most grievously by a deduction of cross-border capital, the Czech Republic and Poland hardly suffered from this at all.

1.3 Fiscal and monetary policy in Europe

1.3.1 Fiscal policy

In the face of historically high budget deficits and growing public debts in the advanced world, many governments have continued their efforts to consolidate their finances. Of the larger advanced economies, Japan and the United Kingdom were clear exceptions. According to OECD measures of the structural government deficit, both saw a clear deterioration last year (see Figure 1.15).

Figure 1.15



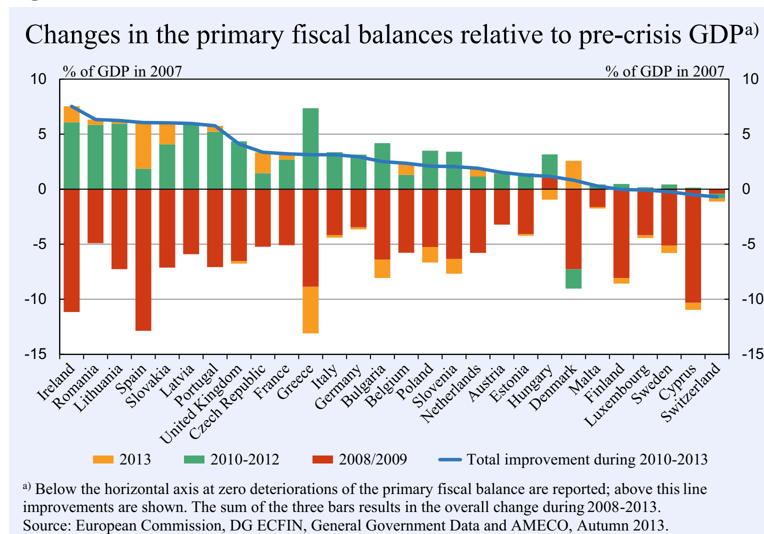
Source: OECD, Economic Outlook 94, November 2013.

Most countries in the euro area have indeed adopted massive fiscal austerity measures in the last few years. The restrictive degree of fiscal policy was particularly strong in those member countries (Cyprus, Greece, Ireland, Portugal) that either could not fully refinance themselves in the capital markets and were therefore dependent on financial assistance from the European Commission, the IMF and the ECB, often summarised as the "troika", or at times had to worry about their access to capital markets (Spain and Italy). Independent of the structural deficit measures used (OECD, IMF or the European Commission), these measures all reveal that substantial reductions in structural deficits have been accomplished since 2010.

Similarly, primary balances, i.e. fiscal positions corrected for interest payments, have also, despite the recessionary conditions under which this had to prevail, been improved in Ireland, Portugal and particularly in Spain over this period. Nevertheless, this has not been sufficient to reduce their public debt burden. Furthermore, the austerity measures only proved sufficient in Italy to reach the three-percent-mark established in the Maastricht Treaty. Spain, Greece and Portugal were once again off-track last year. In the case of Greece, this was largely due to one-off effects in the second quarter of 2013, when the deficit was strongly influenced by capital transfers related to three bank recapitalisations and a bank resolution. The transfer was triggered by banking problems caused by the default on Greek government bonds the previous year. As a result, Greece's deficit deteriorated from 9.0 percent of GDP in 2012 to a staggering 13.6 percent last year and its debt-to-GDP ratio is expected to have increased to 176.2 percent (see Table 1.2). Albeit to a somewhat lesser extent, the fiscal situation in Cyprus also deteriorated further.

The restrictive impulse was much milder in 2013 than in the previous years – or even turned positive – not only in these crisis countries, but also in many other cases. When measured by the change in the primary balances, other countries besides Greece and Cyprus in which fiscal policies turned accommodative include, in decreasing order, Bulgaria, Poland, Slovenia, Hungary, Sweden, and Finland (see Figure 1.16). Besides in Spain, Ireland and

Figure 1.16



a) Below the horizontal axis at zero deteriorations of the primary fiscal balance are reported; above this line improvements are shown. The sum of the three bars results in the overall change during 2008-2013.
Source: European Commission, DG ECFIN, General Government Data and AMECO, Autumn 2013.

Table 1.2

Public finances

	Gross debt[a]				Fiscal balance[a]			
	1999–2007	2008/2009	2010– 012	2013	1999–2007	2008/2009	2010–2012	2013
Germany	63.8	70.7	81.1	79.6	– 2.2	– 1.6	– 1.6	0.0
France	61.8	73.7	86.1	93.5	– 2.7	– 5.5	– 5.7	– 4.2
Italy	106.5	111.3	122.3	133.0	– 2.9	– 4.0	– 3.6	– 2.8
Spain	49.4	47.1	72.7	94.8	0.2	– 7.8	– 9.9	– 6.8
Netherlands	51.7	59.6	66.8	74.8	– 0.5	– 2.5	– 4.4	– 3.3
Belgium	98.6	92.5	97.8	100.4	– 0.4	– 3.3	– 3.9	– 2.9
Austria	64.7	66.5	73.0	74.8	– 1.8	– 2.6	– 3.2	– 2.5
Greece	103.3	121.3	158.5	176.2	– 5.3	– 12.8	– 9.8	– 13.6
Finland	42.1	38.7	50.5	58.4	3.9	0.8	– 2.0	– 2.6
Portugal	59.9	77.7	108.8	127.8	– 4.1	– 6.9	– 6.9	– 5.9
Ireland	31.9	54.3	104.2	124.4	1.6	– 10.5	– 17.3	– 7.2
Slovakia	40.9	31.7	45.6	54.3	– 5.3	– 5.1	– 5.8	– 3.0
Slovenia	26.2	28.6	46.7	63.2	– 2.3	– 4.1	– 5.3	– 5.8
Luxembourg	6.4	15.0	20.0	24.5	2.4	1.3	– 0.4	– 0.9
Latvia	12.7	28.4	42.3	42.5	– 1.6	– 7.0	– 4.3	– 1.4
Cyprus	64.3	53.7	73.1	116.0	– 2.7	– 2.6	– 6.0	– 8.3
Estonia	5.0	5.8	7.5	10.0	0.7	– 2.5	0.4	– 0.4
Malta	61.4	63.7	69.2	72.6	– 5.1	– 4.2	– 3.2	– 3.4
Euro area	**69.0**	**75.0**	**88.7**	**95.5**	**– 1.9**	**– 4.2**	**– 4.7**	**– 3.1**
United Kingdom	40.6	59.5	83.8	94.3	– 1.5	– 8.2	– 7.9	– 6.4
Sweden	51.5	40.7	38.8	41.3	1.3	0.6	– 0.1	– 1.1
Denmark	44.3	37.0	44.8	44.3	2.4	0.3	– 3.0	– 1.9
Poland	43.2	49.0	55.6	58.2	– 4.1	– 5.6	– 5.6	– 4.8
Czech Republic	25.2	31.6	42.0	49.0	– 3.9	– 4.0	– 4.1	– 2.9
Romania	19.5	18.5	34.4	38.5	– 2.6	– 7.4	– 5.1	– 2.5
Hungary	59.8	76.4	81.4	80.7	– 6.4	– 4.1	– 0.8	– 3.1
Croatia			50.7	59.6			– 6.4	– 5.4
Bulgaria	46.2	14.2	17.0	19.4	0.6	– 1.3	– 2.0	– 2.0
Lithuania	20.5	22.4	38.9	39.9	– 1.8	– 6.4	– 5.4	– 3.0
European Union[b]	**61.8**	**68.3**	**83.1**	**89.8**	**– 1.7**	**– 4.6**	**– 5.0**	**– 3.5**
United States	59.7	79.8	99.1	106.0	– 2.1	– 9.7	– 9.6	– 5.8
Japan	166.1	201.0	228.1	243.5	– 6.0	– 7.3	– 9.8	– 9.5
Switzerland	63.3	50.1	49.1	48.2	0.2	1.2	0.2	0.2

[a] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF. – [b] Before 2009 the European Union does not include information on Croatia.

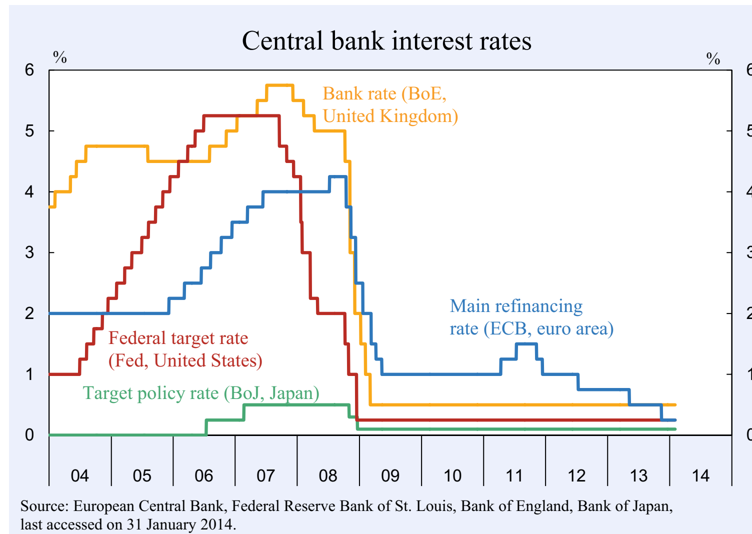
Sources: European Commission, Autumn 2013; IMF World Economic Outlook, October 2013.

Portugal, clear negative impulses, on the other hand, were set by the governments of Denmark, Slovakia, the Czech Republic, Belgium, the Netherlands, France and Romania last year.

Over the course of this year, the public authorities will also proceed with implementing austerity measures. However, the contractionary fiscal impulse is likely to be lower than last year. To some extent this is a natural phenomenon in any austerity programme: Maintaining the savings of the previous year does not lead to an additional negative impulse – only further cuts do that and these are bound to decrease over time. Nevertheless, another reason for the restrictiveness of fiscal policy to continue to decline is the worsening of debt discipline caused by, among other things, the willingness of the European Commission to tolerate cyclical deviations from the previously agreed deficit paths, as long as the implementation of structural reforms continues. Given the difficulty of distinguishing between structural and cyclical elements, this is, in a world driven by political considerations, bound to be interpreted selectively. Furthermore, in autumn 2012 and in spring 2013 the Eurogroup, i.e. the finance ministers of the member states inside the euro area, decided to loosen consolidation requirements for several countries (Portugal, Greece, Ireland, Spain and France), even although the European Union and the IMF have already granted both Greece and Ireland further extensive relief on their debt services. Finally, fiscal consolidation efforts in Portugal are also likely to be de-

layed as the Portuguese constitutional court annulled numerous austerity measures. This necessitated savings in other fields, jeopardising a timely implementation. The negative fiscal impulse connected to the relief program agreed upon in spring 2013 will only increase significantly in Cyprus. Overall, the public deficit ratios are likely to continue to decline, albeit in a less pronounced manner than initially planned and less dynamically than in previous years.

Figure 1.17



Source: European Central Bank, Federal Reserve Bank of St. Louis, Bank of England, Bank of Japan, last accessed on 31 January 2014.

1.3.2 Monetary conditions and financial markets

Monetary conditions

Monetary policy in the major advanced economies retained its degree of expansion during 2013. In the face of their very low policy rates, nearing zero percent (see Figure 1.17), the central banks of the United States, the United Kingdom and Japan largely continued their unconventional measures of monetary easing. In addition, the central banks have for some time now resorted to a more intensive communication policy (forward guidance) in order to increase the effectiveness of their monetary policies. For instance, the Federal Reserve and the Bank of England tied the future path of the main policy rate and the degree of monetary expansion to specific economic goals like the unemployment rate. Accordingly, medium-term interest rate expectations will be kept low and refinancing conditions will remain favourable until the economic recovery has gained sufficient momentum.

In early November 2013 the ECB surprisingly lowered its interest rate for open market operations by a further 25 basis points to 0.25 percent. This step benefited those banks that have so far only managed to keep afloat with the help of these ECB refinancing loans. Interest rates on the interbank money market largely remained unaffected by this cut. Since the summer of 2012, the interest rate for secured loans with a maturity of three months (Eurepo) has been close to zero percent; for unsecured credits (Euribor) with the same maturity, just over 0.2 percent had to be paid. Instead of a fall, a slight increase in both rates has been observed since the interest rate cut.

The interbank money market is still not functioning properly, especially in the crisis countries, making banks there rely on the refinancing credits provided by the ECB. However, the risk premium for unsecured three-month loans fell in recent months by a further 0.05 percentage points to about 0.15 percentage points by the end of last year. This premium is only marginally higher than premiums observed before the outbreak of the crisis. Nevertheless, both the daily turnover on the interbank market and the stock of cross-border interbank loans remain significantly lower than before the onset of the crisis.

ECB refinancing funds were almost exclusively provided to the crisis countries. Well above 80 percent of the regular open market operations were conducted with commercial banks in the countries affected by the crisis. The heavily indebted commercial banks in these countries benefit from ECB interest rate cuts as the latter allow them to fund the purchase of significantly higher yielding securities at a lower cost. These commercial banks widened their holdings of domestic government bonds between late 2011 and October 2013 by almost 300 billion euros. The resulting profits allowed them to form new equity to compensate for the losses incurred due to the holdings of toxic loans and uncollectible credits.

Despite this support, the problems of the banking sector in the crisis countries remain significant. This is reflected by the historically high proportion of non-performing loans. Nevertheless, the assessment of capital markets has improved with regard to potential risks in the banking sector in the crisis countries. Both the premiums on credit default securities of the largest banks

and yields on covered bonds, which constitute important funding instruments for many financial institutions, have been falling steadily since early 2012. For one thing, this was due to the significant decline in the government bond yields of crisis-afflicted countries following ECB's announcement of the OMT programme in September 2012 that allows for unlimited purchases of government bonds of countries under the ESM or EFSF umbrella. This development was, however, also supported by increased government recapitalisations and other interventions in the banking sector as of 2012.

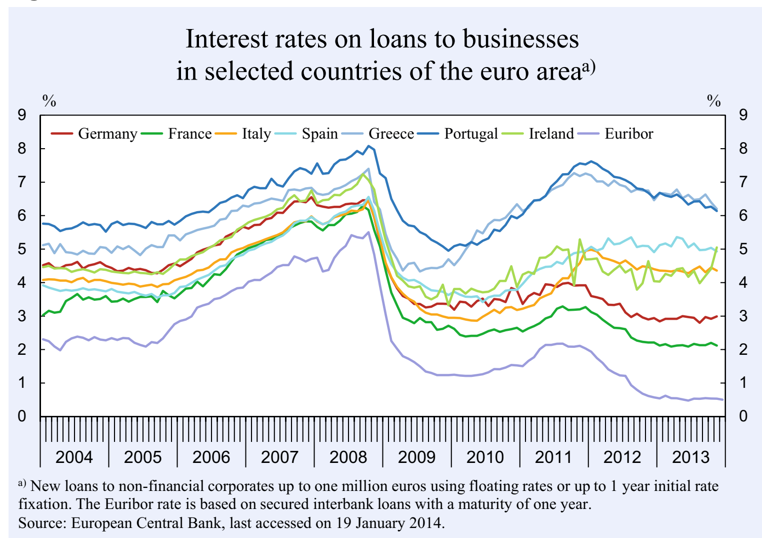
Overall, however, the situation in the credit markets of the crisis countries was still significantly more strained than in the rest of the euro area. The interest rate on newly-granted loans to companies in the crisis countries only followed the downward trend in the money market interest rates to a limited degree. The spread between money market and lending rates continues to be historically large. This is especially true for the crisis-afflicted countries (see Figure 1.18). At the same time, the decrease in loan portfolios over the past three months is significantly greater in these crisis countries than elsewhere in the euro area. In addition to demand-related factors, due to the significantly weaker economic situation, supply-related credit market factors are also likely to play a significant role. This is corroborated by both the Bank Lending Survey (BLS) and the Survey on the access to finance of SMEs (SAFE) for the euro area. These surveys show that the lending conditions of banks in the crisis countries remain significantly more restrictive than in the rest of the euro area.

For the euro area as a whole, the volume of outstanding bank loans to the private sector continued to decline. Lending to non-financial corporations, which accounts for roughly half of total credits to the non-financial sectors of the economy, was most significantly affected in this respect (see Figure 1.19). The outstanding amount of consumer credit also continued its descent, whereas the amount of mortgages basically remained constant throughout 2013.

The ECB will maintain its expansionary policy and keep the main refinancing rate unchanged at 0.25 percent this year. Due to the heavy under-utilisation of capacities and the extremely weak economic performance in the euro area as a whole, inflation rates will remain well below the ECB target of close to, but below 2 percent.

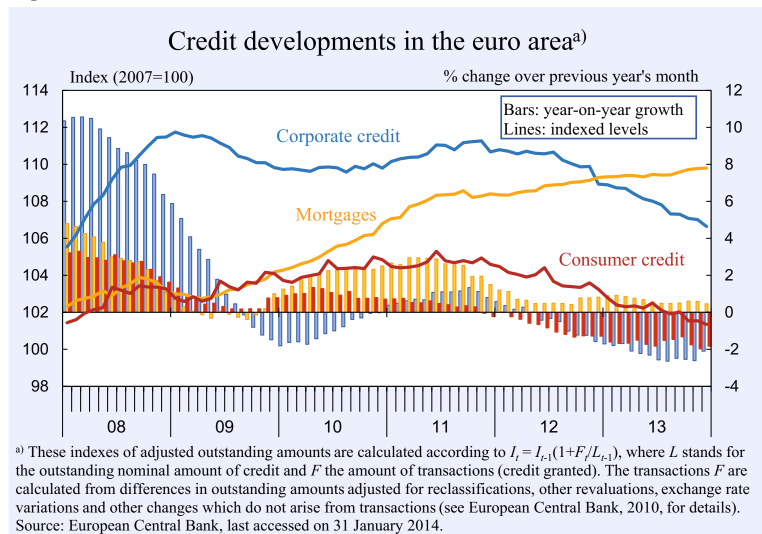
The decline in risk premiums on capital markets in the crisis countries is expected to continue, albeit more moderately than before, in 2014. In the rest of the euro area, the capital market interest rates will show a slight increase. This is largely due to the increase in capital market interest rates in the United States, where eco-

Figure 1.18



a) New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 19 January 2014.

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 2014.

nomic developments will unfold far more positively than in the euro area. As a result, lending rates in the rest of the euro area will also rise slightly, while they are expected to remain unchanged in the crisis countries. Underlying this assessment is the assumption that the supply-related restrictions in local credit markets will gradually abate.

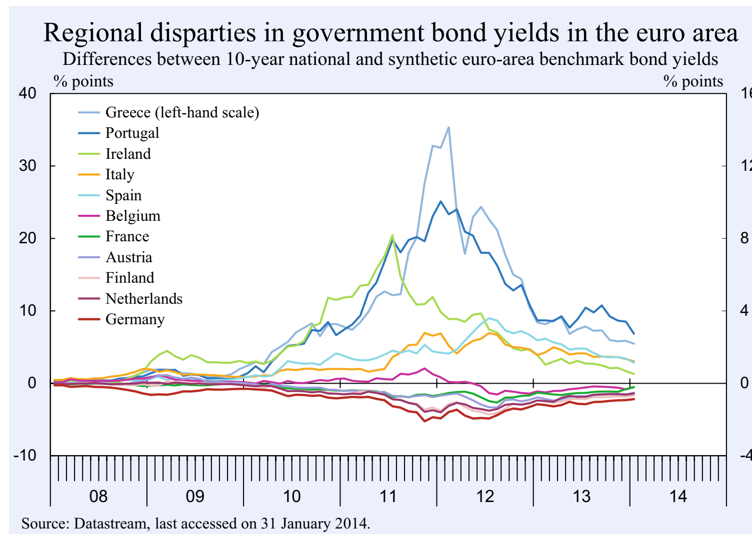
The Bank of England has made a commitment to continue with its very expansive monetary policy. It announced publicly, as part of its forward guidance policy, that the interest rate will remain unchanged at 0.5 percent as long as the unemployment rate exceeds 7 percent. This presupposes, however, that the medium-run inflation rate will remain below 2.5 percent. Similarly, inflation expectations should remain firmly anchored. The program for the purchase of asset-backed securities is still being implemented and reached a volume of 375 billion British pounds by the end of 2013. The aim of the program is to provide liquidity to commercial banks under favourable conditions and avoid a stronger increase in capital market interest rates, which could thwart the economic recovery. These monetary policy measures have helped to ease tensions in credit markets. Lending by commercial banks to the private non-banks, i.e. non-financial private enterprises and households, has recently increased. In addition, the conditions for granting credit have improved. Lending rates to the non-financial private sector have been steadily declining across the board since the summer of 2012, despite yields on government bonds being on a clear upward trend since spring of last year.

Bonds, stocks and foreign exchange markets

In the late summer of 2012, the ECB announced its readiness to purchase the government bonds of individual euro area countries under certain specific conditions and thus to support their courses (OMT programme). This notification relieved the concern felt by many investors with regard to a potential payment default of individual countries, or even about a potential breakup of the monetary union, thus allowing the previously sharply rising risk premiums on private and public debt instruments from several member states to fall.

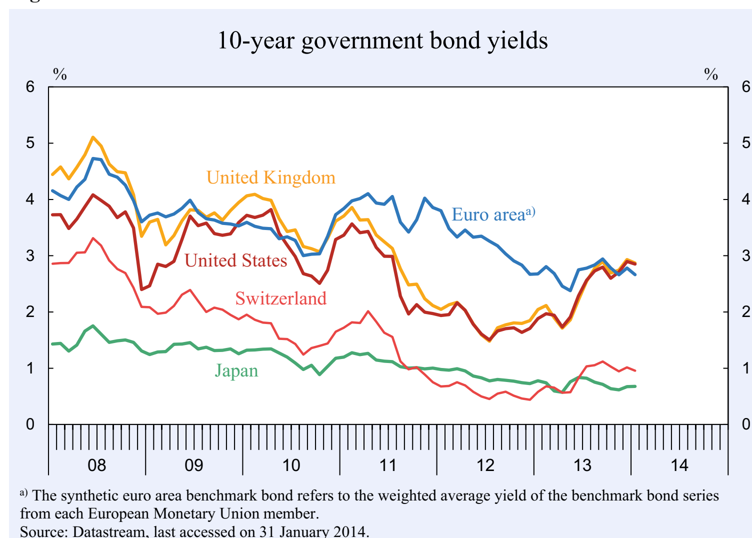
These implicit guarantees provided by the ECB with its OMT programme, together with the permanent rescue fund, ESM, have – by reversing the divergence process of government bond yields within the euro area (see Figure 1.20) – managed to bring the synthetic euro area benchmark 10-year government bond yield back to levels observed for the United States and the United Kingdom (see Figure 1.21). At the same time, the international normalisation of risk prefer-

Figure 1.20



Source: Datastream, last accessed on 31 January 2014.

Figure 1.21



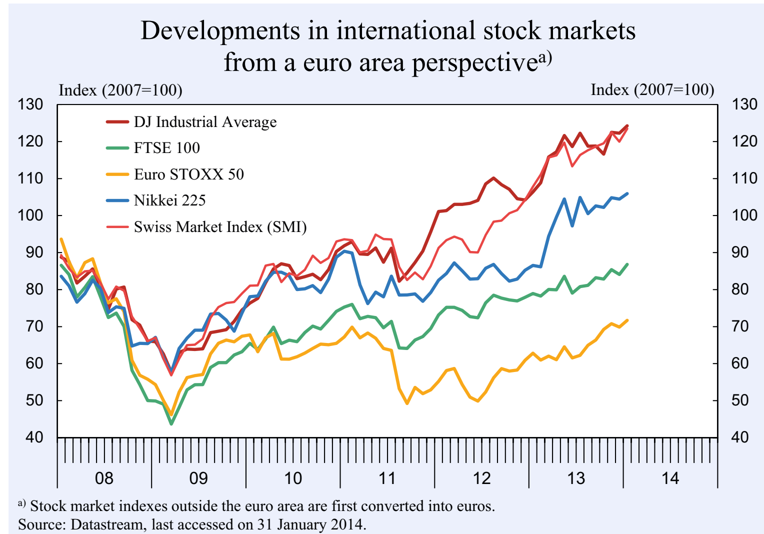
a) The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream, last accessed on 31 January 2014.

ences shifted asset allocation away from government bonds towards other bonds and in particular stocks. As a result, both government bond yields and stock market indexes were able to stay on the upward trend that they set in mid-2012.

Measured in local currencies, the Dow Jones industrial average, the Nikkei 225, the FTSE 100 and the Euro STOXX 50 improved by 22.5 percent, 59.4 percent, 11.1 percent and 14.8 percent respectively during 2013. Except for the Japanese Nikkei 225, the improvements were fairly similar from a euro area perspective (see Figure 1.22). When converting the gains of the Nikkei 225 into euros, they were, due to the realised depreciation of the Japanese yen, clearly reduced, albeit, with 22.6 percent, still considerable. Whereas Euro STOXX 50 developments, as measure for overall euro area stock developments, clearly lagged behind those of Japan and the United States in particular, looking at member-state specific movements reveals that the German stock markets have kept pace with those in the United States in recent years (see Figure 1.23).

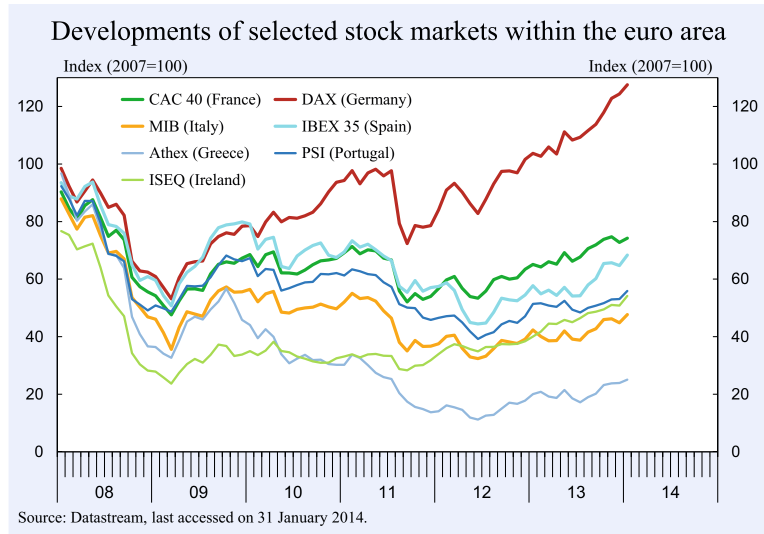
After having increased during the second half of 2012, the dollar-euro exchange rate remained more or less stable during the first part of 2013. Subsequently, there was a steady, but small appreciation against the US dollar (see Figure 1.24). A similar picture emerges when looking at real effective changes, i.e. when correcting for inflation differentials and weighting by export shares: there has been an overall steady appreciation of the euro since

Figure 1.22



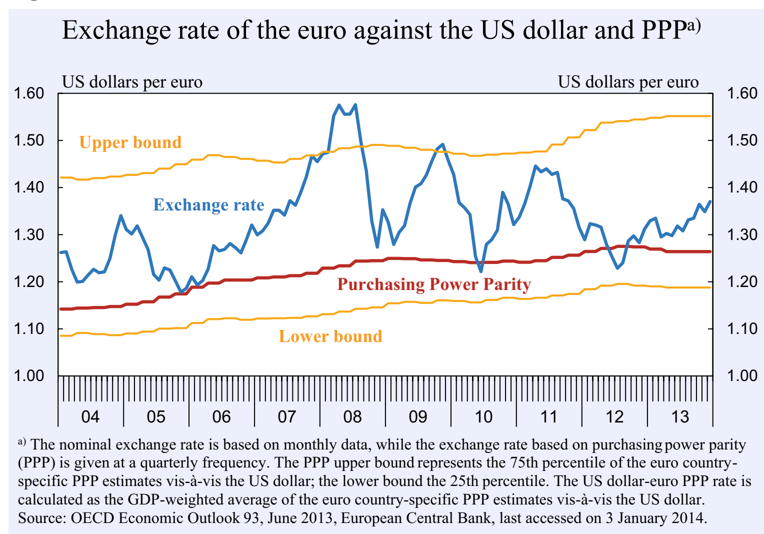
a) Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2014.

Figure 1.23



Source: Datastream, last accessed on 31 January 2014.

Figure 1.24



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 93, June 2013, European Central Bank, last accessed on 3 January 2014.

mid-2012 (see Figure 1.25). As far as the other major currencies in the world are concerned, the yen depreciated substantially during the winter of 2012/13. This largely reflected the change in monetary policy of the Bank of Japan and fast-changing sentiment in financial markets regarding the importance of so-called safe haven currencies. The real effective exchange rate of China appreciated throughout a large part of last year, a process that started in autumn 2012. This reflects both the somewhat higher inflation rate in China compared to most of its trading partners, and the continued moderate appreciation of the renminbi against the US dollar, as allowed for by the Chinese central bank.

1.4 The macroeconomic outlook

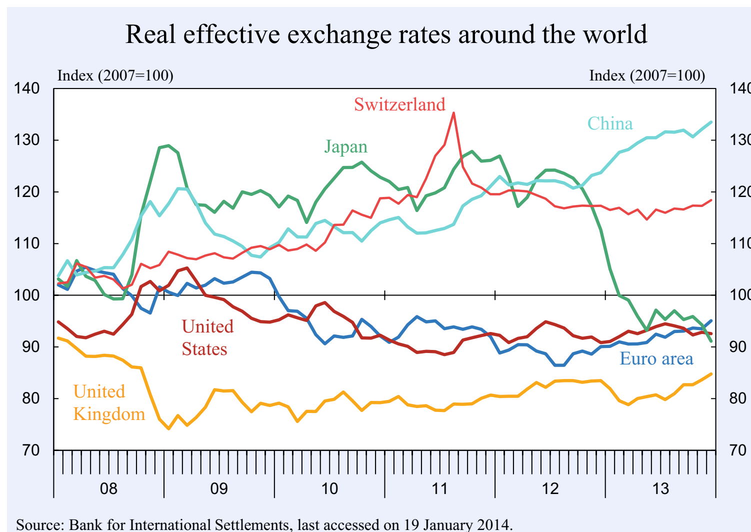
1.4.1 Assumptions, risks and uncertainties

The present forecast is based on the assumption that no further escalation of the euro crisis is to be expected. In that sense, it is also assumed that the financing of public budgets in Greece, Ireland and Portugal is guaranteed until at least the end of the forecasting period. Ireland already meets its capital requirements almost completely through the capital market, while the relief programmes granted to Greece and Portugal expire this year. Accordingly, these two countries should, in principle, return to the international capital markets. However, since both Portugal and Greece need to refinance considerable volumes of public debt in 2015 and 2016, a complete return to private capital markets appears, especially in the second case, unlikely.[2] Given weak economic development, we expect that the international community, represented by the troika, will therefore already grant Greece in particular further financial assistance this year. This will, given our assumptions, be achieved without creating new political tensions, which, in turn, will further strengthen the confidence of investors, consumers and producers within the euro area. As a result, the refinancing conditions for commercial banks, as well as private households and businesses, are not forecast to deteriorate any further.

The most crucial prerequisite here is that, despite reduced pressure on governments to carry out austerity programmes, the structural adjustments in the euro area continue, albeit at a more moderate pace. The lowering of the collateral requirements that must be satisfied to obtain liquidity from the ECB in combination with the TARGET2 system, the rescue packages of the troika together with the loosening of fiscal targets granted by the European Commission at the beginning of 2013 and the introduction of the OMT programme by the ECB all have one thing in common: By lowering market-oriented refinancing costs, they tend to reduce willingness to embrace structural reforms to promote international competitiveness. At the same time, however, the above measures alleviate short-term liquidity constraints. All in all, finding the right balance is not an easy task. We assume that the long-term structural view has not been lost from sight, as that would, at some stage, trigger the next round of escalation in the euro crisis.

A possible decoupling of long-term inflation expectations, which still oscillate at around 2 percent, from the ECB target poses another risk. This forecast is based on the assumption that no long-term deflation is to be expected on average in the euro countries. Given the expected slow economic recovery, the euro area-wide inflation rate is likely to settle well below the ECB's inflation target of just under two percent. However, a long period of low inflation could lead to a downward revi-

Figure 1.25



Source: Bank for International Settlements, last accessed on 19 January 2014.

[2] Portugal did already manage to successfully auction longer-term government bonds in January and is likely to start building a cushion this year (like Ireland did before exiting its program) in order to ease the transition and gain market confidence. Whether it will fully succeed in this attempt remains to be seen.

sion of long-term inflation expectations among investors, consumers and producers. As it is unlikely that the ECB will further reduce nominal interest rates, the decline in inflation expectations would result in an increase in real interest rates and reduce the willingness of investors and consumers to spend. In addition, wage dynamics would be more moderate. These adjustments would further slow down actual inflation and thus serve to confirm the downward adjustment of inflation expectations. This could ultimately lead to a spiral of inflation declines and successive reductions in inflation expectations, which could eventually result in a permanent deflation phase. Since nominal wages tend to be downwardly rigid, deflation would, by increasing the real cost of labour, lead to persistent underemployment. The present forecast assumes that medium- to long-term inflation expectations remain anchored to the ECB's target of below, but close to two percent. For this to happen the structural reforms targeted by several euro area countries will actually have to be implemented. This would prevent a permanent reduction in long-term growth and inflation expectations.

A further risk to this forecast lies in the formation of price bubbles by means of the highly favourable liquidity provision. This might trigger undesirable volatilities in asset and currency markets. Furthermore, since the outbreak of the financial crisis, uncertainty about inflation developments has increased significantly. Therefore, risks do arise from the various expansionary monetary measures undertaken by the central banks in advanced economies around the world.

What finally constitutes a significant risk for a major improvement in the euro area is slow progress with reforms and the restructuring of the banking sector. Many banks in Europe, especially those in the crisis-afflicted parts, require restructuring. Whether the dismantling of this time bomb is done quickly enough is difficult to tell. The formation of a banking union is an important step in this process, and we do assume that the necessary steps will be taken on time.

Some, albeit minor, risks also emerge from the elections for the European Parliament. It cannot be ruled out that the gains of the anti-European parties are so substantial that they are going to be able to block outstanding changes in legislation.

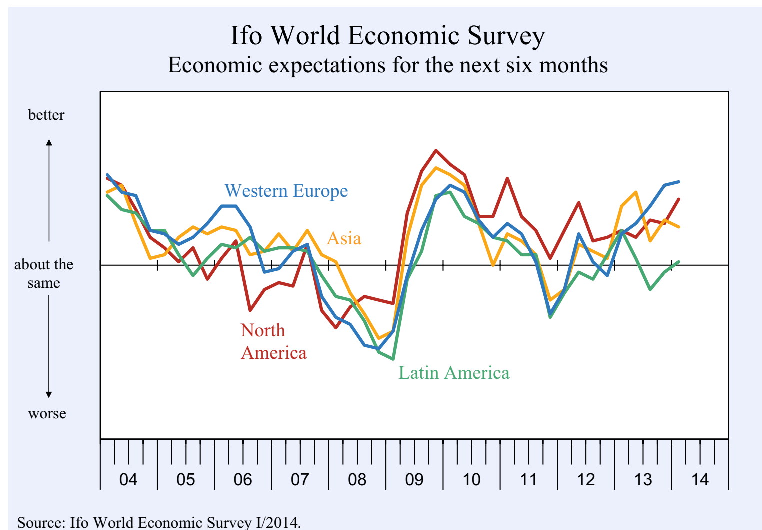
1.4.2 The global economy

The current global economic expansion will continue this year, albeit gaining momentum only moderately. The Ifo World Economic Survey and a number of other indicators of producer and consumer expectations suggest that sentiments have improved in most regions of the world (see Figure 1.26).

In contrast to the past five years, however, the emerging markets of Asia and Latin America will no longer be the driving force behind economic acceleration. This role will be fulfilled by advanced economies like the United States, the United Kingdom, and to a lesser extent Japan and the euro area. Nonetheless, the emerging economies will continue to expand at rates that are higher than those in industrialised countries. But their pace of growth is, also for structural reasons, unlikely to increase during the forecast period. Hence, whereas the contribution of Asia in particular to world economic growth will remain large, it is the increase in the growth contributions by North America and Western and Central Europe that will make the difference to world economic growth as compared to last year (see Figure 1.27).

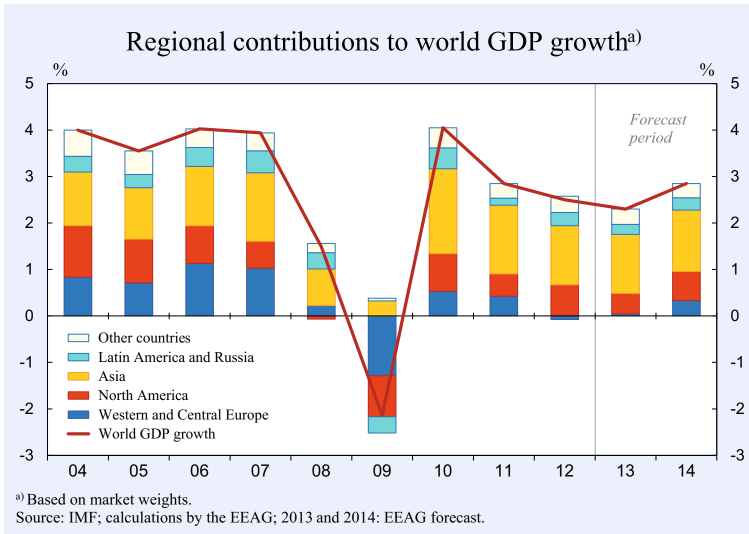
In the developed economies, the growth rates of real GDP should gradually increase during 2014. Private consumption in the United States, supported by further improvements in the employment, housing mar-

Figure 1.26



Source: Ifo World Economic Survey I/2014.

Figure 1.27



a) Based on market weights.
Source: IMF; calculations by the EEAG; 2013 and 2014: EEAG forecast.

from fiscal austerity measures will decrease further. In addition, net exports should also have a favourable effect, both due to the continuing weak imports noted in crisis countries and the moderate pick-up of the world economy. Finally, on-going pressure on domestic prices in some of the structurally weak countries (Ireland, Spain, Portugal and Greece) is expected to lead to an improvement in their international competitiveness. Accordingly, the euro area is likely to benefit to a somewhat greater extent from the recovery of world trade than in the past. In Japan, the highly expansionary monetary and fiscal policy, as well as the depreciation of the yen, have allowed the economy to expand strongly during the past winter months. During the rest of the year, however, economic growth is expected to gradually decline, as the positive fiscal impulse is bound to ebb away, while structural problems are likely to persist.

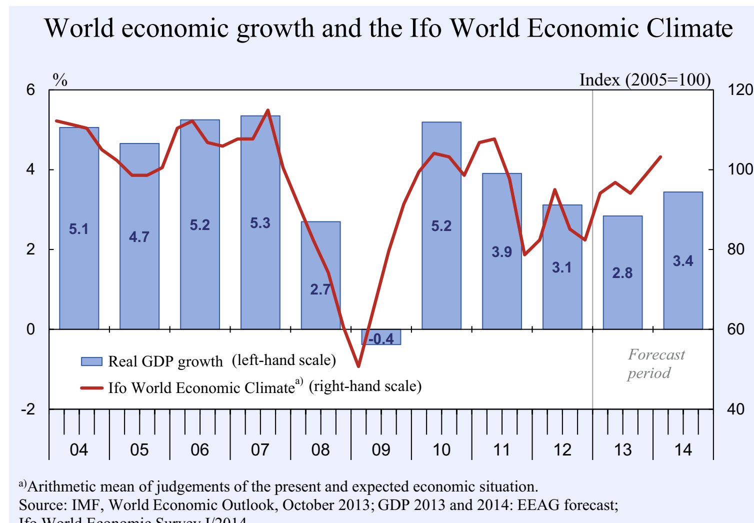
ket and lending conditions, is likely to increase at an accelerated pace. Business investments should also benefit from the recovery in domestic demand and still very expansionary monetary policy, which will secure relatively favourable refinancing conditions. Finally, the fiscal impulse in the advanced economies will be less contractionary than last year.

Over the course of the year, fiscal stimuli programmes initiated last year in, for example, China, Brazil and South Korea to compensate for weak demand from the advanced economies will be phased out, so that fiscal policy in most emerging countries is likely to be neutral. Triggered by the forthcoming elections, public investment programs are only expected to stimulate the economy moderately in India.

Domestic demand in the United Kingdom is likely to undergo an increasing revival this year, as it will be supported by the improvement in the asset positions of private households and expansionary monetary policy. The economic situation in the euro area remains obfuscated. Several member countries still have to struggle with some massive structural problems. Nevertheless, a moderate recovery is expected to continue during the forecast period, and this change compared to the previous two years does imply a positive impulse for the world economy. The negative impulse coming

All in all, the total world economic production will probably increase this year by 3.4 percent, after 2.8 percent last year (see Figure 1.28). Accordingly, world trade is expected to have expanded by just 2.0 percent in 2013, and should rise by 4.9 percent this year (see Table 1.A.1). The current accounts of most emerging countries will continue to deteriorate due to unfaltering robust growth in the realm of domestic demand. In the euro area, however, the still very feeble

Figure 1.28



a) Arithmetic mean of judgements of the present and expected economic situation.
Source: IMF, World Economic Outlook, October 2013; GDP 2013 and 2014: EEAG forecast; Ifo World Economic Survey I/2014.

domestic economy should help to improve the current account balance. The current account deficit of the United States is likely to remain virtually unchanged. The acceleration of growth in goods imports is expected to be almost fully compensated for by a decline in net imports of gas and oil in the United States. Inflation is expected to rise slightly in the advanced economies, with the exception of the European Union, during the forecast period. An important role in Japan will be played by the effect of the value added tax increase scheduled for April 2014. Given the moderate development of commodity prices in recent months, inflation in emerging economies is not expected to provide any reasons for tightening monetary policy. In countries like India and Indonesia, the base rate increases implemented last summer are likely to slightly dampen the currently rather high inflation during the forecast period.

1.4.3 United States

Partially due to legal limitations, some of the spending cuts in the federal budget in the United States resulting from the sequester and the budget decisions made at the end of last year will become effective early this year. Fiscal policy will remain restrictive, as the extension of the entitlement period to unemployment benefits and the more favourable depreciation rules for companies were permanently discontinued at the beginning of this year. Even although the new budget proposal of December 2013 provides relief of about 65 billion US dollars compared to the nationwide budget cuts implied by the original sequester, no further tax increases will now take place and the defence budget will not be reduced again. However, some social expenditure is supposed to be curtailed more than originally planned. The decline in government consumption expenditure observed at the federal level this winter should subsequently give way to some slight increases again, thereby taking off the brakes activated by the sequester.

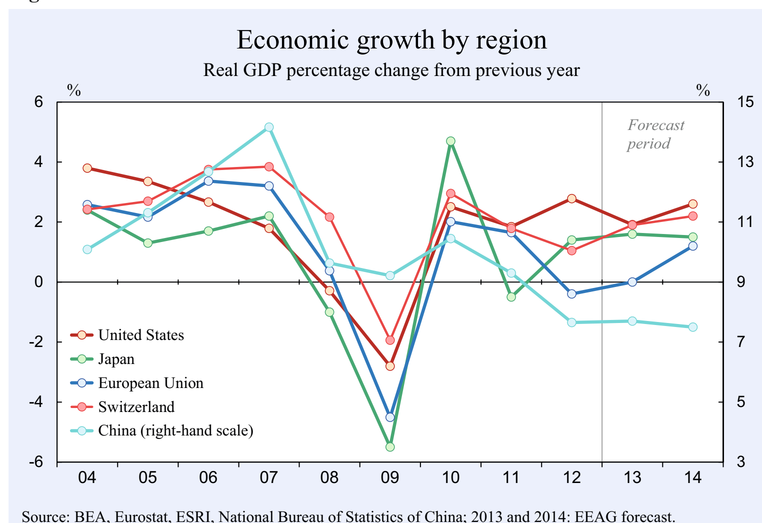
Now that the US Federal Reserve has decided to taper its bond purchasing program of Treasury securities and agency mortgage-backed securities and has signalled that it will wind down this quantitative easing policy steadily through 2014, assuming the US economy will develop as expected, the uncertainty surrounding US monetary policy should also fade. While maintaining the base rate at its historic low of 0 to 0.25 percent, US monetary policy will remain very expansionary throughout the year.

Overall, the growth rate of the US economy is bound to increase during the year. The impact of tax increases on private consumption will weaken. Improving real-estate market conditions should foster construction activity and reduce the indebtedness of households, thereby stimulating consumer demand. Little impetus, however, is to be expected from foreign trade. The acceleration of export growth as a result of the somewhat improved economic conditions around the world is expected to be more or less compensated for by increased import growth caused by improved domestic conditions.

All in all, for the United States the increase in real GDP of 1.9 percent noted last year will probably accelerate to about 2.6 percent this year (see Figure 1.29).

The inflation rate is expected to increase from the 1.5 percent recorded last year to 1.9 percent in 2014. Moreover, a decline in the unemployment rate from an average of 7.4 percent in 2013 to 6.4 percent this year is to be expected. Owing to the economic recovery and additional austerity measures undertaken in the federal budget, the budget deficit will improve in the current fiscal year to just below 3 percent of GDP.

Figure 1.29



Source: BEA, Eurostat, ESRI, National Bureau of Statistics of China; 2013 and 2014: EEAG forecast.

1.4.4 Asia

In *China*, the government's monetary policy stance is expected to remain unchanged this year. Despite the moderate increase in inflation rates throughout last year, inflation still remains well below average. Moderate positive impulses will be generated by fiscal policy. In particular, tax cuts for businesses and investments in the expansion of the railway network are planned. Leading indicators point to a continuation of the short-term dynamics. The pace of economic growth will, at least in the short run, not attenuate significantly. The structural change and the associated reduction in the excess capacity of the industry sector will lead to a slowdown of trend growth. Given the feeble external demand for Chinese products, real GDP growth is expected to materialise at 7.5 percent this year. Inflation will accelerate moderately to 3.3 percent in 2014 (after 2.6 percent in 2013).

The political leadership in Beijing plans to fundamentally restructure the Chinese economy in the coming years. In this context the factors of production in particular are to be shifted piecewise from investment and export-driven toward service- and domestic-market-oriented sectors. This change is primarily to be achieved through a number of structural reforms. Accordingly, the Hukou System – the official control system regarding place of residence – is to be liberalised, which will likely lead to an acceleration in the degree of urbanisation. Furthermore, the Chinese government is planning a land reform, whereby restrictions on the use of collectively-owned land and parcels should be relaxed. A profound liberalisation of the financial sector and reforms in public administration and budgeting have also been promised. However, these structural reforms are unlikely to unfold their effects during this year.

In *Japan*, fiscal policy is bound to exert a restrictive effect: the consumption tax is set to rise from 5 percent to 8 percent in April. However, in order not to jeopardise the economy, another economic stimulus package is due to be launched. Supported by the unabated strengthening in sentiment among large companies and expected anticipatory effects in the first quarter owing to the increase in the consumption tax and the recovery of the economic situation in key export markets, real GDP is expected to grow by 1.5 percent this year. Prices are likely to grow vigorously at 2.7 percent, of which about 2 percentage points will be due to the increase in the consumption tax. A risk for the forecast period is posed by Japan's conflict with China over an island group in the East China Sea. Should this conflict take a turn for the worse, it could lead to a boycott of Japanese products and negatively affect the economy.

The short-term outlook for *India* has become less pessimistic. Early indicators like the production of electricity, coal and cement, moved upward. In addition, the monsoon season went smoothly, so good harvests were made at the end of last year, which is bound to generate some positive stimuli for India's important agricultural sector and reduce the pressure on food prices.

Given the relatively weak economic conditions that persist in India, the Reserve Bank of India is not expected to increase its base rate any further. Fiscal policy, in particular via public investment spending, will stimulate the economy. Government infrastructure projects in particular are expected to contribute to a revival in overall investment activity. Consumption is also expected to pick up slightly. Overall, economic activity is expected to increase slowly over the year, resulting into a growth rate of 5.6 percent. The inflation rate will probably fall to 9.2 percent in 2014, after an estimated 11.5 percent in 2013.

For the East Asian countries *(Indonesia, South Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong)* either an accelerated or an unchanged high rate of expansion is expected for this year. An increase in private consumption is likely to be the main driving force behind this expansion. It is supported by income generating activities and job creation programmes implemented by the different governments. Against this background, and in anticipation of a modest recovery in exports to the euro area and the United States, overall economic production this year is likely to rise to 4.5 percent. The inflation rate is expected to amount to 3.4 percent this year, following 3.0 percent in 2013. Part of this acceleration is due to the reduction in energy subsidies in Indonesia implemented this year.

1.4.5 Latin America

In 2014, the Latin American region, i.e. *Brazil, Mexico, Argentina, Venezuela, Colombia and Chile,* is expected to grow by 2.9 percent. The increase in real GDP in Mexico is likely to gather pace again owing to

improved economic prospects for the United States. Although the FIFA World Cup in 2014 will, through increased investment activities and foreign demand, give some impulses to the Brazilian economy, growth in the country will remain below its long-run average.

1.4.6 The European economy

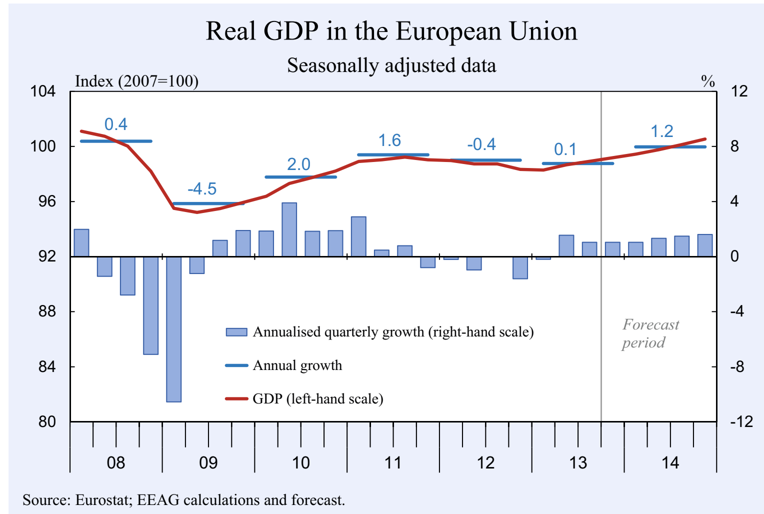
The cyclical situation

Albeit at a moderate pace, the economic recovery in the euro area is expected to continue this year (see Figure 1.30). Almost all sentiment and confidence indicators are following upward trends virtually everywhere in Europe. The driving force will be foreign trade (see Figure 1.31). Exports are likely to benefit from further improvements to conditions in the United States, as well as robust developments in Japan and in the majority of emerging economies. Furthermore, European domestic demand is expected to stabilise somewhat, which will partly be due to a noticeable reduction in the restrictiveness of fiscal policy. Combined with a further reduction in the uncertainty of private households and businesses regarding economic and political developments, this will have an increasingly positive effect on their willingness to spend and invest.

The heterogeneity between the individual member states will, however, remain very high. Business cycle developments in economically strong countries like Germany and Austria will experience a clear recovery. There, strong exports and investment-related domestic demand will continue to improve the labour market situation and thereby real wage developments. This will, in turn, allow private consumption to support further economic growth. The positive domestic and external economic outlook, the extremely favourable refinancing conditions and the still high degree of risk aversion of investors, will allow overall investment in such economies to accelerate. Finally, no contractionary impulses are to be expected from fiscal policy. Accordingly, in these countries, growth in domestic demand will contribute significantly to the increased pace of expansion.

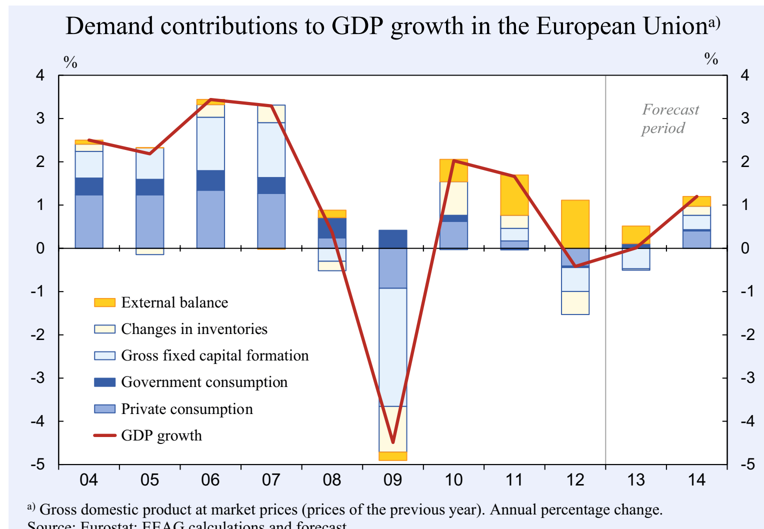
Economic growth is likely to be somewhat weaker in countries such as Belgium, France, Italy and the Netherlands, which, although spared the fate of being labelled crisis countries under the aegis of the troika, are still struggling with country-specific structural weaknesses. Italy and France, for instance, have not yet responded to their loss of price competitiveness with the wage restraints observed in some other countries. Therefore, both these countries are expected to continue to lose world market shares and benefit relatively little from the economic upturns in Germany,

Figure 1.30



Source: Eurostat; EEAG calculations and forecast.

Figure 1.31



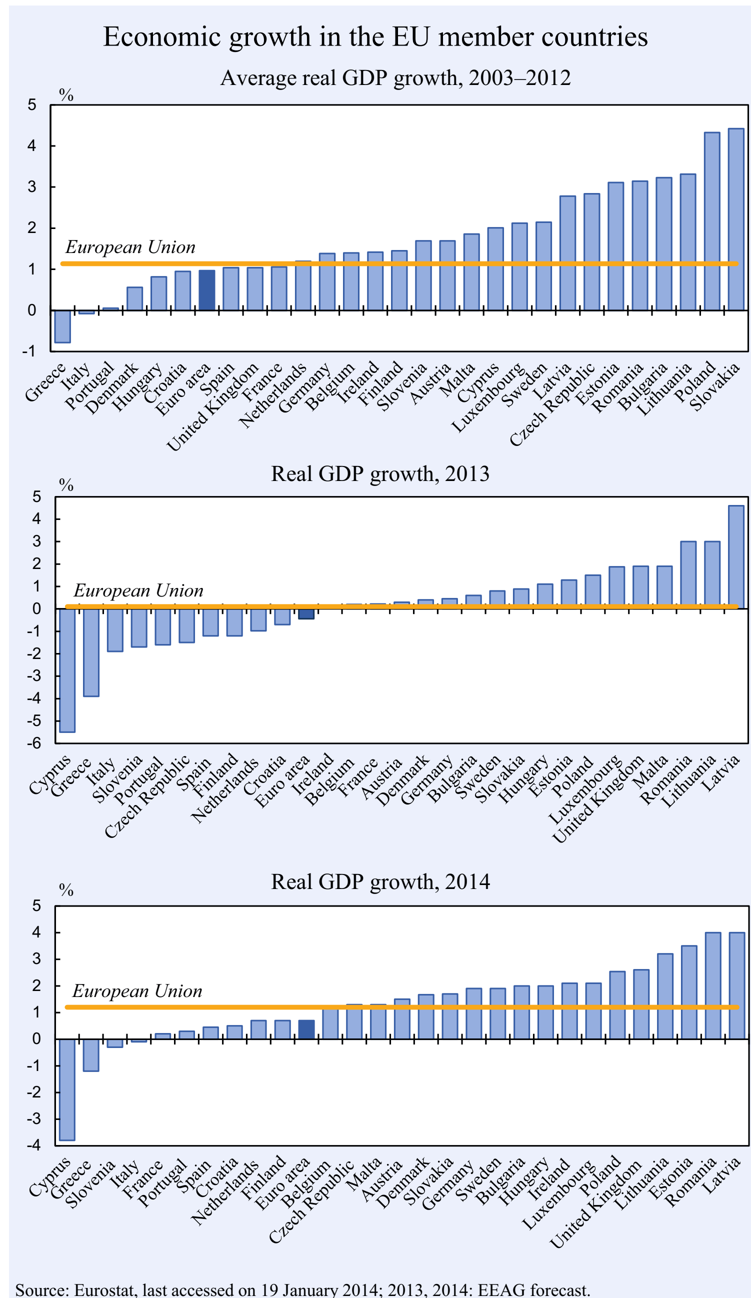
[a)] Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; EEAG calculations and forecast.

the United States, the United Kingdom and a number of emerging markets.

Albeit at a decreasing rate, domestic demand is expected to decline further this year in the crisis countries. Private and/or public debt is still very high in these nations. This burden will weaken aggregate demand even further. The situation in the labour market is also expected to deteriorate further, although only slightly. This will put additional stress on real income development and, therefore, on consumption. Private investment is also likely to continue to shrink, because the domestic economic outlook will improve, but at an extremely slow pace. At the same time, refinancing conditions for firms, due to the still fragile state of the banking sector, are likely to remain unfavourable. Only reduced fiscal consolidation efforts will provide some support for domestic demand. Significant positive contributions to the development of aggregate economic output will be provided by continuously shrinking imports. Exports of Ireland, Spain, Portugal and Greece are also increasingly likely to rise. All of these countries, albeit to quite varying degrees, are in the process of succeeding in improving their price competitiveness – at least relative to the stronger economies in Europe. Given the austerity policies, and in particular the wage moderation observed in Spain, Portugal and Greece over the past two years, this trend is likely to continue in 2014. Accordingly, these countries will increasingly benefit from the robust economies inside and outside of the euro area and will be able to increase their world market shares.

This year, the aggregate economies of the euro area and the European Union are expected to grow by 0.7 and 1.2 percent, respectively. Whereas real GDP will continue to shrink in Cyprus, Greece, Slovenia, and Italy, it will expand at an above average rate in Belgium, Malta, Austria, Denmark, Germany, Sweden, Ireland, Luxembourg, the United Kingdom and most of the Central and Eastern European EU member countries (with the exceptions of Slovenia and Croatia) (see Figure 1.32).

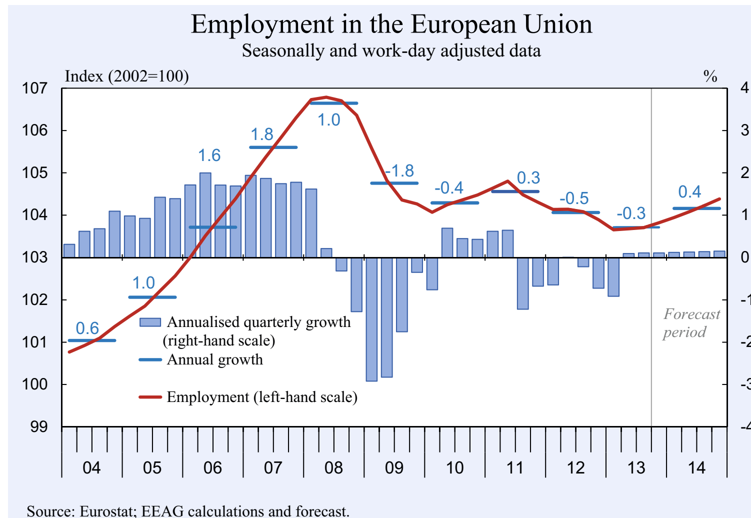
Figure 1.32



Source: Eurostat, last accessed on 19 January 2014; 2013, 2014: EEAG forecast.

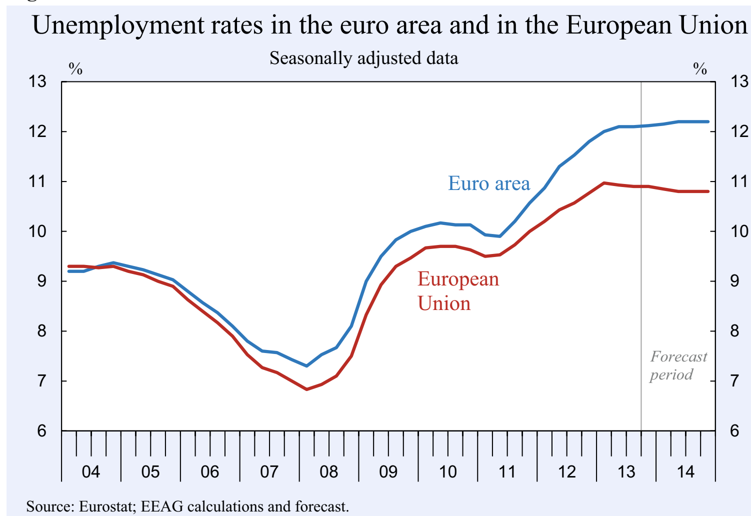
Given the feeble economic momentum, employment in the European Union will start to grow again in 2014 after having been in decline since mid-2011 (see Figure 1.33). Nevertheless, this will not be enough to have a strong impact on the unemployment rate. The latter is likely to remain at an average of 12.2 percent

Figure 1.33



Source: Eurostat; EEAG calculations and forecast.

Figure 1.34



Source: Eurostat; EEAG calculations and forecast.

in the euro area and 10.8 percent in the European Union this year (see Figure 1.34). The substantial differences in economic development between the various member states are expected to be accompanied by continued high dispersion in the national unemployment and wage developments. In the face of domestic economic weaknesses in many member countries, the inflation rate will be considerably lower than the 2 percent target set by the ECB. We expect it to weaken further to an average of 1.1 percent in the euro area in 2014. For the European Union the figure is expected to amount to 1.3 percent.

Differences across Europe

The *German* economy has probably performed above its potential this winter. This is, among other considerations, indicated by the significant rise in the Ifo Business Climate Index during last autumn and in the early winter. Assuming the latent uncertainty regarding political and economic developments in the crisis countries of the euro area does not materialise into any critical upheavals in international capital markets, this buoyancy should continue. Private consumption is expected to expand at an accelerated pace in view of the favourable employment situation and rising real earnings, which should benefit retail and consumer-related service providers. The upturn in the construction sector is expected to continue. This is underlined by increasing backlogs, particularly in residential construction. Even non-residential construction, which previously struggled during the economic downturn, is expected to increase. In terms of public construction, an improvement in municipal finances is to be noted. Moreover, as part of the flood relief fund, resources will flow into Germany's public civil engineering sector.

In view of rising export expectations, favourable financing conditions and currently close to normally utilised production capacities, investment in machinery and equipment is bound to increase.

The uptick in global demand and the stabilisation of euro area economies will provide fresh stimuli for Germany's export sector. However, over the course of the year, German exporters will lose some competitiveness to most of their trading partners. Given the relatively weak demand in the euro area, the total increase in German exports will also remain short of world trade. Since imports are likely to expand at an accelerated rate thanks to strong domestic demand, the trade surplus will slowly continue to diminish and net exports will again contribute negatively to real GDP growth this year. All in all, real GDP is expected to grow by 1.9 percent in comparison to 2013.

In the wake of the expansion of the German economy, employment growth will initially accelerate somewhat. Towards the end of the year, certain shortages in some labour market areas – especially of highly skilled workers – will become increasingly noticeable and the dynamism of employment growth is therefore expected to fall slightly. The unemployment rate is expected to decline slightly from an average of 5.2 percent in 2013 to 5.0 percent this year.

Inflation looks set to remain moderate. The pricing pressure resulting from wage increases will, to some extent, be offset by rising labour productivity. Overall, the consumer price level this year is likely to be 1.6 percent higher than in 2013.

Business tendency and consumer surveys in *France* suggest that its economy will probably move out of the doldrums by the end of this winter. However, the major upturn hoped for will most likely fail to materialise. Private consumption spending will be negatively affected by the increase in unemployment and low wage growth. The stimuli for real disposable income, and thereby private consumption, are only expected to come from continuing low inflation. The inflation rate is expected to stay at around 1.0 percent. The unemployment rate is forecast to rise from last year's 10.8 percent to 11.0 percent over the course of this year. Private investment is also likely to contribute only slightly to an increase in GDP. Firstly, profit prospects for French companies are currently rather poor. Secondly, the reductions in corporate taxes and labour costs, as announced by the French government, have essentially failed to materialise. The lack of will to pursue reforms on the part of the government is also a major reason for the low potential growth rate ascribed to the French economy and the associated lack of price competitiveness of French companies. Therefore, despite some revival of the global economy, no positive stimuli are to be expected from exports either. Only public consumption and investment look set to stabilise the economy in the short run, as any austerity measures that have been agreed upon with the European Commission, and which would be required to reduce the public deficit, have been postponed until 2015. All in all, real GDP will basically stagnate in 2014 with a growth rate of 0.2 percent.

Prospects for a continued economic recovery in the *United Kingdom* are quite favourable. Business sentiments have reached elevated levels in large parts of the economy. Even in the construction sector, the business climate improved. This was particularly driven by an increase in property prices. After falling for basically the last five years, it appears that house prices in the United Kingdom reached a trough at the end of 2012 and have been steadily increasing ever since. Consumer confidence also rose, albeit in a subdued manner. One of the supporting factors here has been the improved financial position of households.

The government is expected to stick to its plan to maintain a consolidation course until the fiscal year of 2017/18. Nevertheless, it can be assumed that the deficit will only be reduced slightly this year to avoid overburdening the economy. It will therefore only decrease to 5.3 percent of GDP, after settling at around 6.4 percent last year. As a result, the government debt-to-GDP ratio will increase further to about 97 percent in 2014, following 94.3 percent last year.

Overall, real GDP in the United Kingdom is expected to rise by 2.6 percent this year. A driving force behind the recovery is likely to be a robust expansion of domestic demand, stimulated by favourable credit conditions and the already advanced deleveraging of the household sector. At the same time, exports can be expected to rise as a result of the economic recovery of major trading partners. Despite the recovery, however, capacities are likely to remain underutilised keeping investment and price pressure subdued. The UK's inflation rate will settle at about 2.2 percent this year. The situation in the labour market remains quite tense and a rapid decrease in the unemployment rate is not to be expected. The unemployment rate could fall under 7 percent towards the end of the year. This would prompt the Bank of England to gradually reduce the degree of its extremely expansionary monetary policy. The challenge will be to accomplish this without causing disruptions in financial markets and thereby constraining the economy.

Italy is not expected to emerge from its economic recession before summer this year. Even if it should do so, a broadly-based recovery is unlikely as the uncertainty surrounding government policy is bound to remain high. On average, with an annual growth rate of – 0.1 percent, real GDP will basically stagnate in a year-over-year comparison. The slight economic recovery in the second half of 2014 will not be significant enough to bring about a turnaround in the labour market. Italy's unemployment rate is expected to rise from last year's average of 12.2 percent to 12.6 percent

this year. As a result, the real disposable income of households will weigh on consumption. Some relief to the household budget is to be expected from a further drop in inflation. It is expected to decrease as a result of the continuing under-utilisation of production capacities from an average of 1.3 percent in 2013 to 1.0 percent in 2014. This might be interpreted as initiating the much-needed process of improving price competitiveness in the Italian economy.

The somewhat sub-normal rate of capacity utilisation, together with unfavourable financing conditions, constitute the reasons why no substantial economic stimuli are to be expected from gross private investment in Italy. In addition, high tax and social security burdens continue to take their toll on Italian companies. The structural benefits from the scheduled reduction of this burden in the next two years counter-financed by a reduction in government spending will not emerge immediately. Net foreign trade is expected to contribute positively to overall growth. However, this will be caused by a decline in imports, rather than an increase in exports. Imports are expected to be adversely affected by declining household incomes. Only fiscal policy is expected to have some short-term stabilising effects on the economy. Despite the high level of public indebtedness, no significant consolidation measures are scheduled. Hence, this short-term stabilising effect may result in a long-term destabilisation. A new escalation of the euro crisis thus represents a clear downside risk to this forecast.

Spain still has a long way to go before becoming competitive and healthy again. Persistently high under-utilisation of production capacities is likely to cause the inflation rate to fall even further. After 1.6 percent last year, the average inflation rate for this year is forecasted to reach – 0.1 percent. This decline in the general price level improves the competitiveness of Spanish companies, supporting the export economy. On the part of private and public consumption, however, no positive impulses are to be expected. The private sector is heavily indebted and will have to continue working on reducing its debt. For the first time in years, gross private investment will probably be able to increase slightly this year, as foreign demand for Spanish capital goods is likely to increase. The construction industry is expected to reduce its pace of decline. Overall, real GDP is expected to grow moderately with a rate of 0.5 percent this year.

During the last quarter of 2013 the number of registered unemployed persons started falling. Although a substantial share of this decline was due to migrant workers returning to their home countries and the long-term unemployed dropping out of the system, some of it can be interpreted as a first sign that the labour market reforms and wage restraints implemented in Spain are starting to take effect. Nevertheless, from a year-over-year perspective, the unemployment rate is still expected to increase slightly to an average of 26.7 percent this year (after 26.5 percent in 2013).

The susceptibility of the Spanish economy to external shocks remains high. Private household indebtedness is hardly improving, while the government deficit and debt are still high. In addition, the banking system remains vulnerable, with a large amount of toxic loans on the banks' balance sheets. So far, we have probably only seen the tip of the iceberg in this respect. Hence, the downside risks to this forecast remain substantial.

In *Central and Eastern Europe* the signs of an economic revival are increasing. Most of these countries will continue to benefit from their improved competitiveness positions built up in recent years and the slow economic recovery of the euro area. Growth in the region largely depends on demand from the euro area. Not only exports, but also credit demand, are expected to increase slightly this year because of positive economic prospects on the one hand, and as a result of further base rate cuts by some of the central banks in the region on the other. These cuts are possible thanks to the sharp decline in inflation rates. Impulses also come from a revival in domestic demand fuelled by the easing of austerity measures on the part of governments. This easing is feasible since, with the exception of Hungary, most already have comparably healthy state finances, which is supported by their credit ratings.

Overall, an acceleration in growth is slowly emerging in the region this year. This also applies to the three largest economies in the region: Poland, the Czech Republic and Romania. With already comparatively high growth rates, the outlook for the Baltic States, however, is fraught with uncertainty, as these countries have recently begun to feel the impact of the economic slowdown in Russia.

References

EEAG (2012), *The EEAG Report on the European Economy 2012*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2012.pdf.

EEAG (2013), *The EEAG Report on the European Economy 2013*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2013.pdf.

Appendix 1.A
Forecasting tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in %	GDP growth in %			CPI inflation in %			Unemployment rate[d] in %		
		2012	2013	2014	2012	2013	2014	2012	2013	2014
Industrialised countries:										
European Union	26.6	– 0.4	0.1	1.2	2.6	1.5	1.3	10.5	10.9	10.8
Euro area	19.4	– 0.7	– 0.4	0.7	2.5	1.4	1.1	11.4	12.1	12.2
Switzerland	1.0	1.0	1.9	2.2	– 0.7	– 0.2	0.3	4.1	4.4	4.4
Norway	0.8	3.3	2.0	2.5	0.7	2.1	1.9	3.3	3.2	3.2
Western and Central Europe	28.4	– 0.2	0.2	1.2	2.4	1.5	1.3	10.3	10.7	10.6
US	25.9	2.8	1.9	2.6	2.1	1.5	1.9	8.1	7.4	6.4
Japan	9.5	1.4	1.6	1.5	0.0	0.3	2.7	4.6	4.4	4.3
Canada	2.9	1.7	1.7	2.2	1.5	1.1	1.7	7.5	7.3	7.2
Industrialised countries (total)	**66.6**	**1.3**	**1.1**	**1.9**	**1.9**	**1.3**	**1.7**	**8.7**	**8.6**	**8.2**
Newly industrialised countries:										
Russia	3.2	3.4	1.3	2.0	5.1	6.7	6.0			
China	13.1	7.7	7.7	7.5	2.7	2.6	3.3			
India	2.9	3.8	3.9	5.6	9.3	11.5	9.2			
East Asia[a]	6.3	3.8	3.8	4.5	3.1	3.0	3.4			
Latin America[b]	7.8	2.6	2.5	2.9	6.2	6.9	6.8			
Newly industrialised countries (total)	**33.4**	**5.1**	**4.8**	**5.2**	**4.4**	**4.9**	**4.9**			
Total[c]	**100.0**	**2.5**	**2.3**	**3.0**						
World trade growth in %		2.4	2.0	4.9						

[a] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2012 levels of GDP in US dollars. – [b] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia and Chile. Weighted with the 2012 level of GDP in US dollars. – [c] Weighted average of the listed groups of countries. – [d] Standardised unemployment rate.

Source: EU, OECD, IMF, ILO, National Statistical Offices, 2013 and 2014: EEAG Forecast.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth in %			Inflation[a)] in %			Unemployment rate[b)] in %		
		2012	2013	2014	2012	2013	2014	2012	2013	2014
Germany	20.3	0.7	0.4	1.9	2.1	1.6	1.6	5.5	5.2	5.0
France	15.7	0.0	0.2	0.2	2.2	1.0	1.0	10.2	10.8	11.0
Italy	12.5	– 2.5	– 1.9	– 0.1	3.3	1.3	1.0	10.7	12.2	12.6
Spain	8.5	– 1.6	– 1.2	0.5	2.4	1.6	– 0.1	25.0	26.5	26.7
Netherlands	4.8	– 1.2	– 1.0	0.7	2.8	2.5	1.3	5.3	6.7	7.1
Belgium	2.9	– 0.1	0.2	1.2	2.6	1.2	1.3	7.6	8.4	8.6
Austria	2.4	0.9	0.3	1.5	2.6	2.1	1.8	4.3	4.8	4.7
Greece	1.7	– 6.4	– 3.9	– 1.2	1.0	– 0.9	– 0.6	24.3	27.4	28.0
Finland	1.5	– 0.8	– 1.2	0.7	3.2	2.2	1.6	7.7	8.2	8.3
Portugal	1.4	– 3.2	– 1.6	0.3	2.8	0.4	0.0	15.9	16.5	15.4
Ireland	1.2	0.2	0.0	2.1	1.9	0.5	0.8	14.7	13.1	12.5
Slovakia	0.5	1.8	0.9	1.7	3.7	1.5	1.7	14.0	14.2	13.9
Slovenia	0.3	– 2.5	– 1.7	– 0.3	2.8	1.9	1.3	8.9	10.2	11.0
Luxembourg	0.3	– 0.2	1.9	2.1	2.9	1.6	1.7	5.1	5.9	5.7
Latvia	0.2	5.0	4.6	4.0	2.3	0.0	2.0	15.0	12.1	11.2
Cyprus	0.1	– 2.4	– 5.5	– 3.8	3.1	0.6	0.6	11.9	16.1	18.1
Estonia	0.1	3.9	1.3	3.5	4.2	3.4	3.4	10.2	8.6	8.5
Malta	0.1	0.8	1.9	1.3	3.2	1.0	1.5	6.4	6.4	6.0
Euro area[c)]	**74.4**	**– 0.7**	**– 0.4**	**0.7**	**2.5**	**1.4**	**1.1**	**11.4**	**12.1**	**12.2**
United Kingdom	13.7	0.1	1.9	2.6	2.8	2.6	2.2	7.9	7.5	7.1
Sweden	3.1	0.9	0.8	1.9	0.9	0.4	0.9	8.0	8.0	7.8
Denmark	1.9	– 0.4	0.4	1.7	2.4	0.5	0.8	7.5	6.9	6.7
EU 21[c)]	**93.1**	**– 0.5**	**0.0**	**1.1**	**2.5**	**1.5**	**1.3**	**10.7**	**11.2**	**11.2**
Poland	2.9	1.9	1.4	2.5	3.7	0.8	1.2	10.1	10.4	10.0
Czech Republic	1.2	– 1.0	– 1.5	1.3	3.5	1.3	1.0	7.0	7.0	6.5
Romania	1.1	0.7	3.0	4.0	3.4	3.2	2.7	7.0	7.3	6.9
Hungary	0.8	– 1.7	1.1	2.0	5.7	1.8	2.0	10.9	10.4	10.0
Croatia	0.4	– 2.0	– 0.7	0.5	3.4	2.4	2.0	15.9	17.0	16.0
Bulgaria	0.3	0.8	0.6	2.0	2.4	0.5	1.0	12.3	13.0	12.0
Lithuania	0.2	3.7	3.0	3.2	3.2	1.2	1.5	13.4	11.8	10.9
New Members[d)]	**6.9**	**0.6**	**1.1**	**2.4**	**3.8**	**1.5**	**1.6**	**9.6**	**9.8**	**9.3**
European Union[c)]	**100.0**	**– 0.4**	**0.1**	**1.2**	**2.6**	**1.5**	**1.3**	**10.5**	**10.9**	**10.8**

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

Source: Eurostat, OECD, IMF, 2013 and 2014: EEAG Forecast.

Table 1.A.3

Key forecast figures for the European Union

	2011	2012	2013	2014
	Percentage change over previous year			
Real gross domestic product	1.6	– 0.4	0.0	1.2
Private consumption	0.3	– 0.7	0.1	0.7
Government consumption	– 0.2	– 0.2	0.4	0.2
Gross fixed capital formation	1.6	– 3.0	– 2.7	1.9
Net exports[a)]	0.9	1.1	0.4	0.2
Consumer prices[b)]	3.1	2.6	1.5	1.3
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 4.4	– 3.9	– 3.5	– 2.7
	Percentage of labour force			
Unemployment rate[d)]	9.7	10.5	10.9	10.8

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2013 and 2014: Forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat, 2013 and 2014: EEAG Forecast.

Table 1.A.4

Key forecast figures for the euro area

	2011	2012	2013	2014
	Percentage change over previous year			
Real gross domestic product	1.6	– 0.7	– 0.4	0.7
Private consumption	0.3	– 1.4	– 0.5	0.3
Government consumption	– 0.1	– 0.5	0.2	0.0
Gross fixed capital formation	1.6	– 4.1	– 3.2	1.2
Net exports[a)]	0.9	1.5	0.5	0.5
Consumer prices[b)]	2.7	2.5	1.4	1.1
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 4.2	– 3.7	– 3.1	– 2.5
	Percentage of labour force			
Unemployment rate[d)]	10.1	11.4	12.1	12.2

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2013 and 2014: Forecasts of the European Commission. – [d)] Standardised unemployment rate.

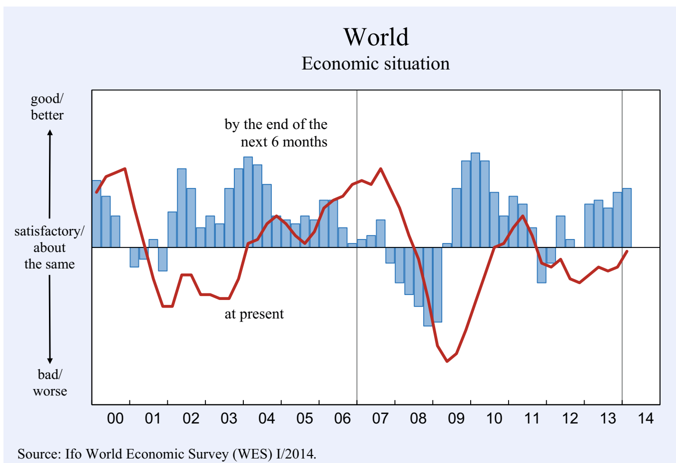
Source: Eurostat, 2013 and 2014: EEAG Forecast.

Appendix 1.B
Ifo World Economic Survey (WES)

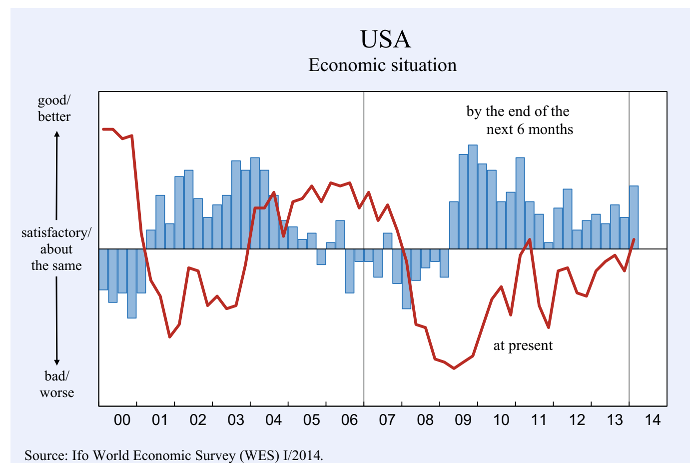
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organizations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2014, 1,121 economic experts in 121 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/2014.



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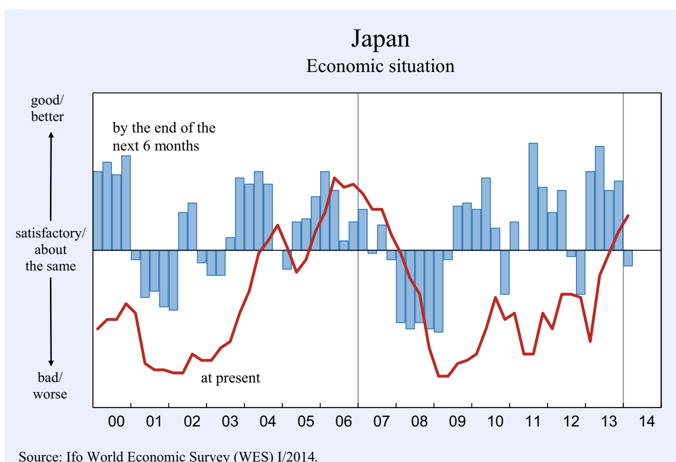

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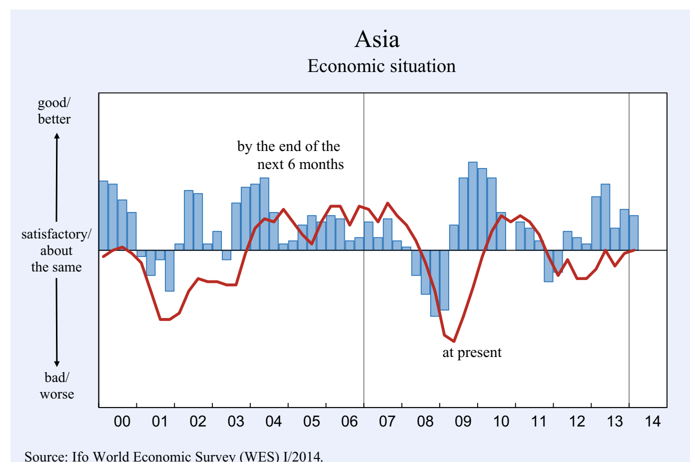
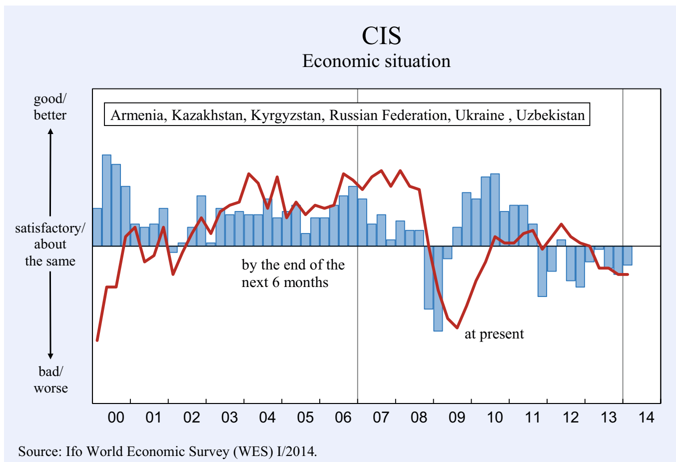


Source: Ifo World Economic Survey (WES) I/2014.



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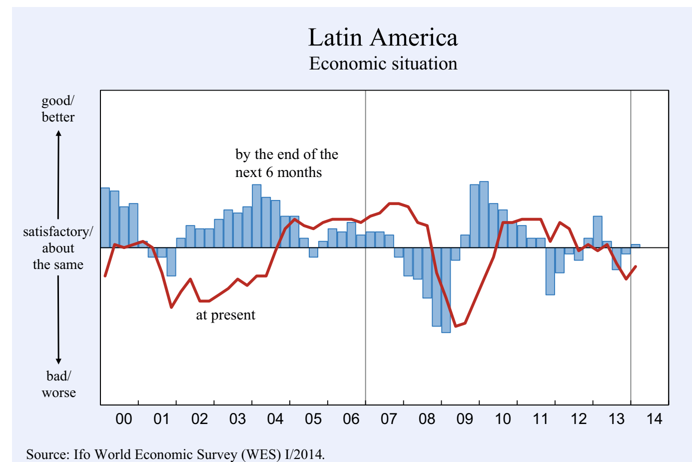

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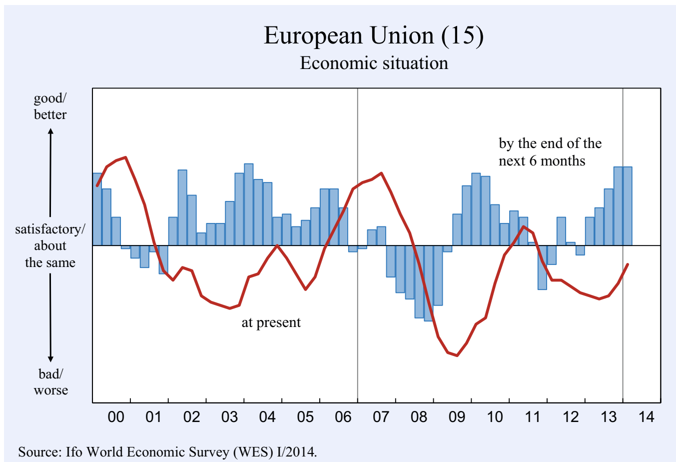

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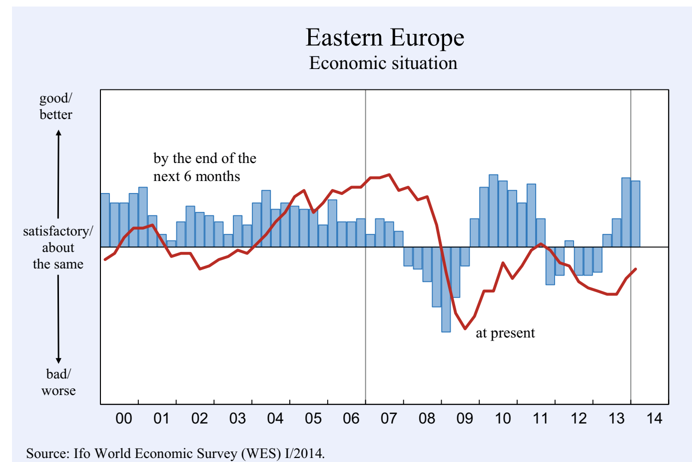

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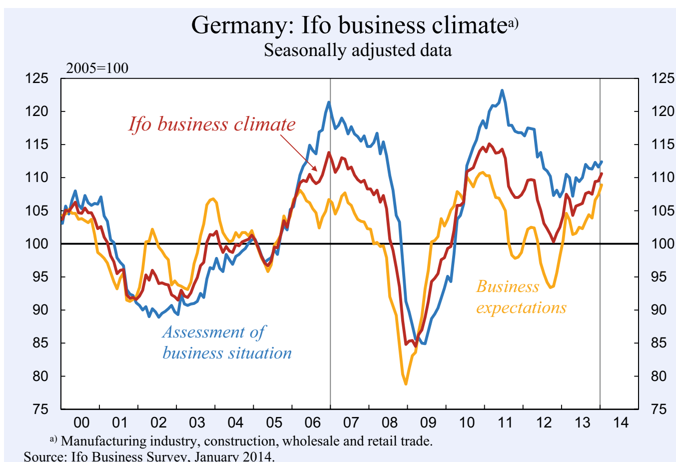
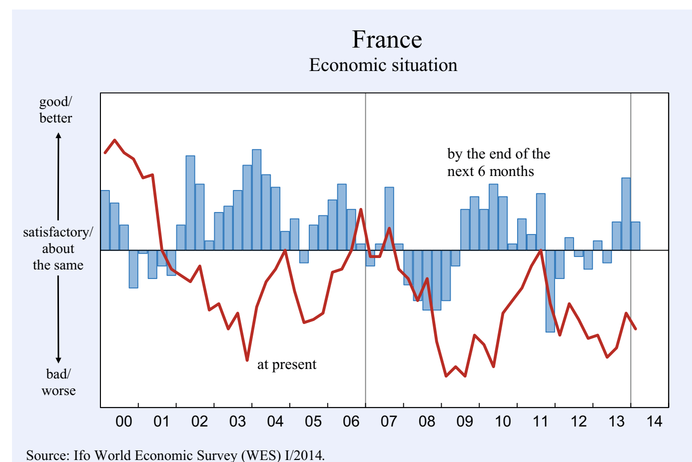
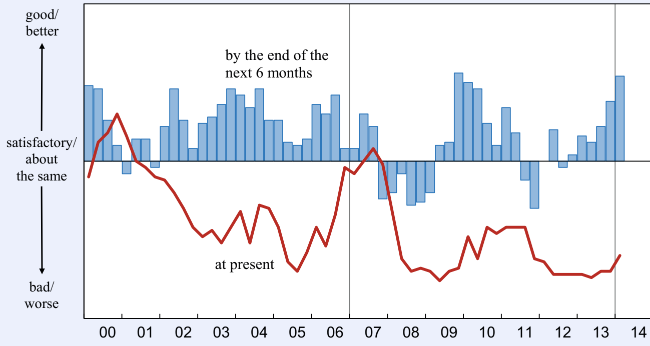


a) Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2014.



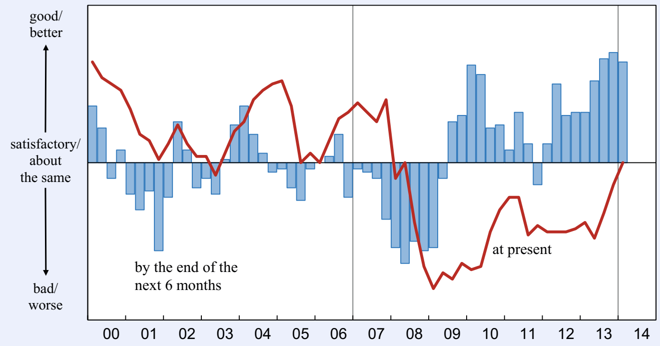
Source: Ifo World Economic Survey (WES) I/2014.

Italy
Economic situation



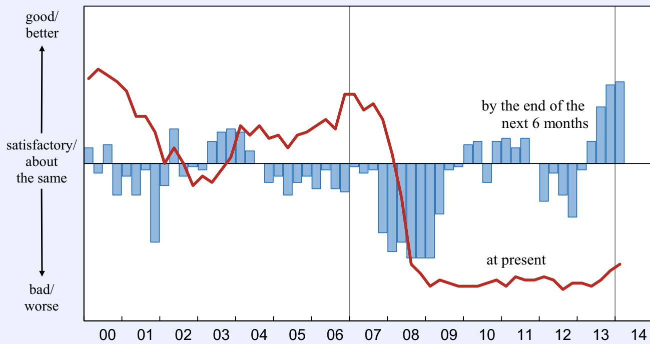
Source: Ifo World Economic Survey (WES) I/2014.

United Kingdom
Economic situation



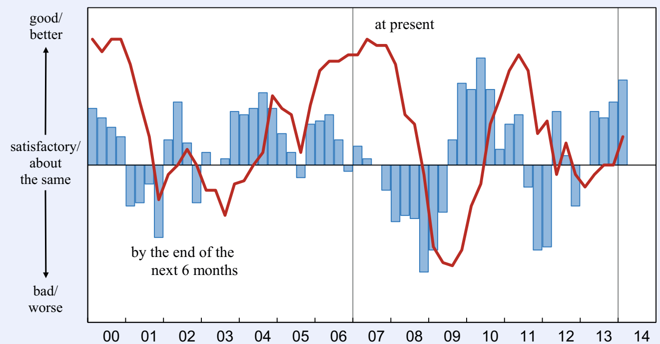
Source: Ifo World Economic Survey (WES) I/2014.

Spain
Economic situation



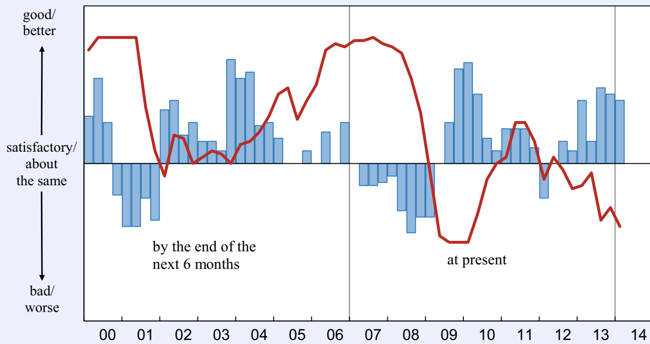
Source: Ifo World Economic Survey (WES) I/2014.

Sweden
Economic situation



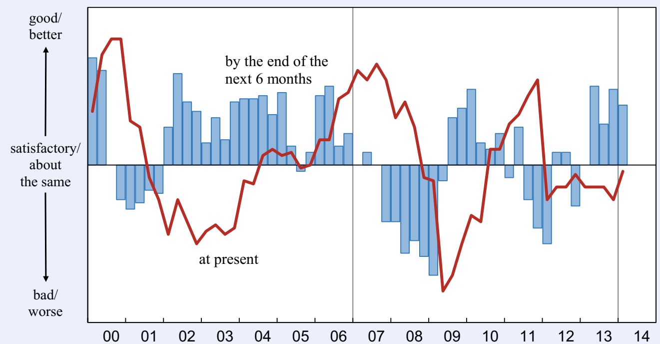
Source: Ifo World Economic Survey (WES) I/2014.

Finland
Economic situation

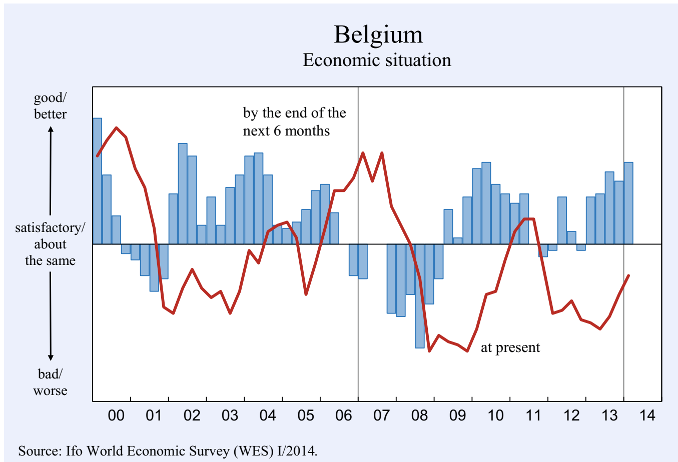


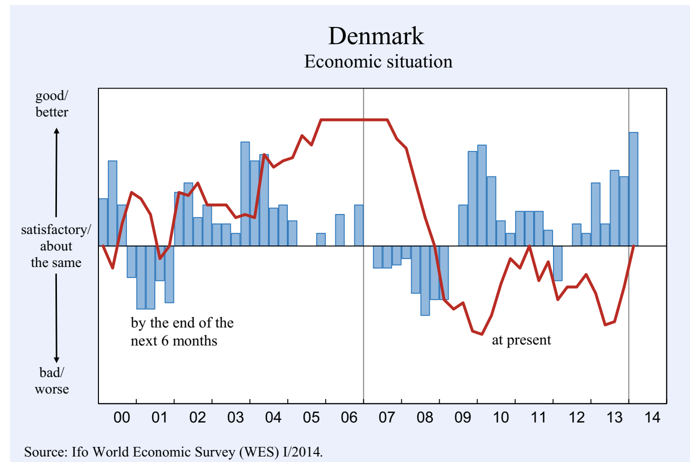
Source: Ifo World Economic Survey (WES) I/2014.

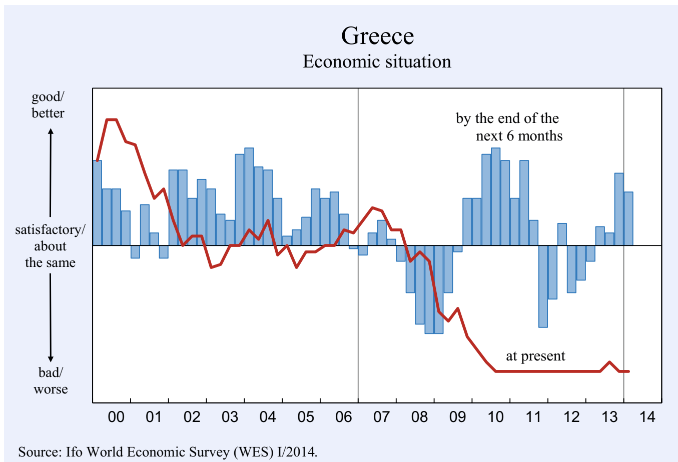
Austria
Economic situation

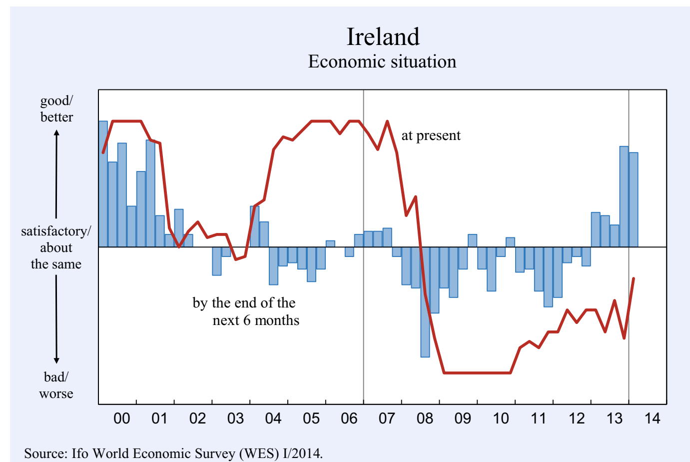


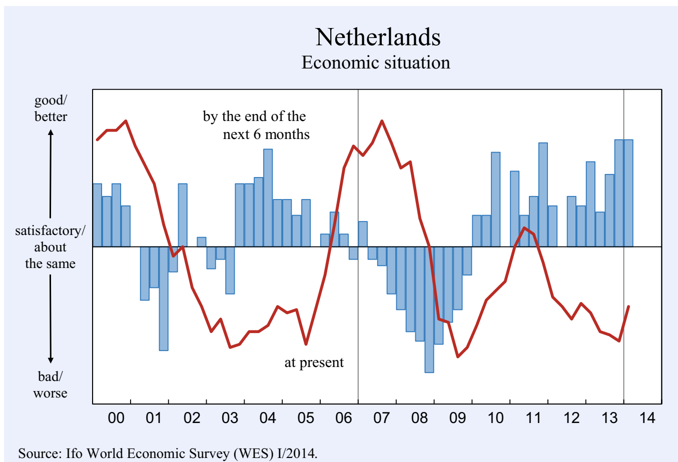
Source: Ifo World Economic Survey (WES) I/2014.

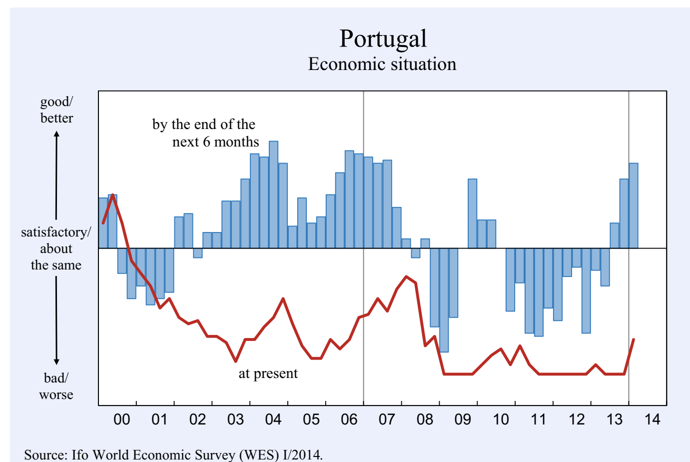

Belgium
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.

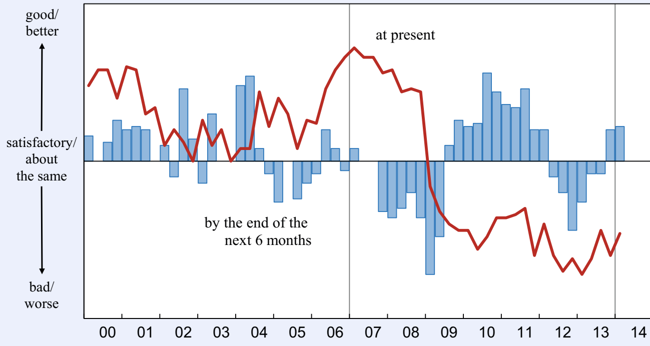

Denmark
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.


Greece
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.


Ireland
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.


Netherlands
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.


Portugal
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
00 01 02 03 04 05 06 07 08 09 10 11 12 13 14
Source: Ifo World Economic Survey (WES) I/2014.



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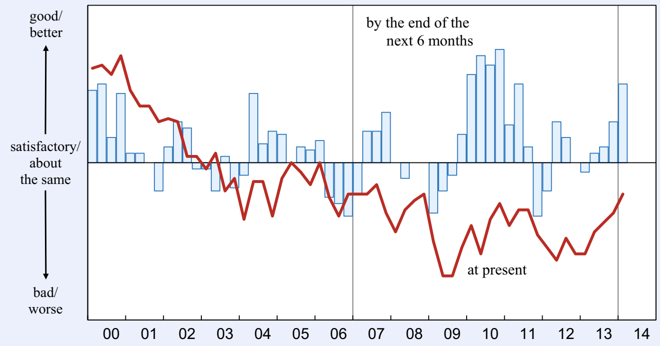

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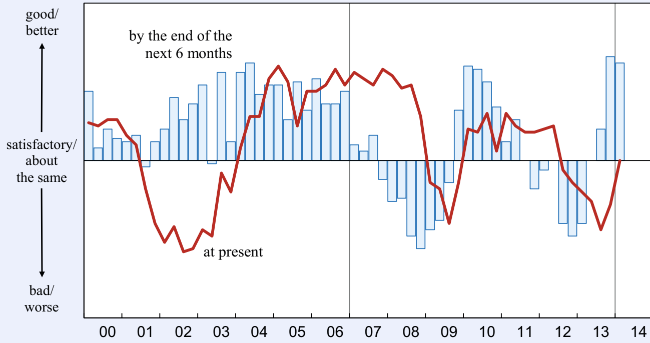

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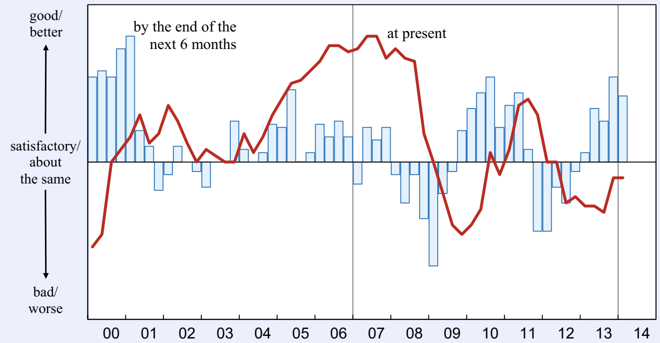

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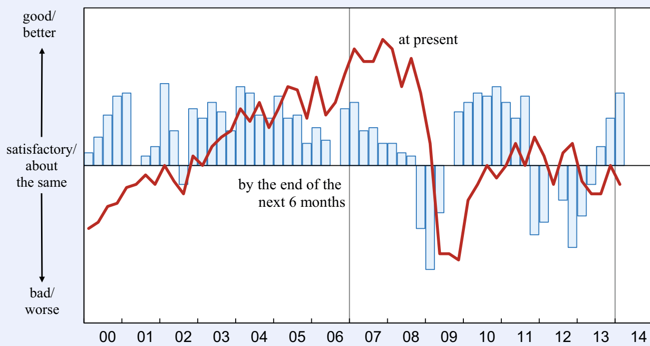

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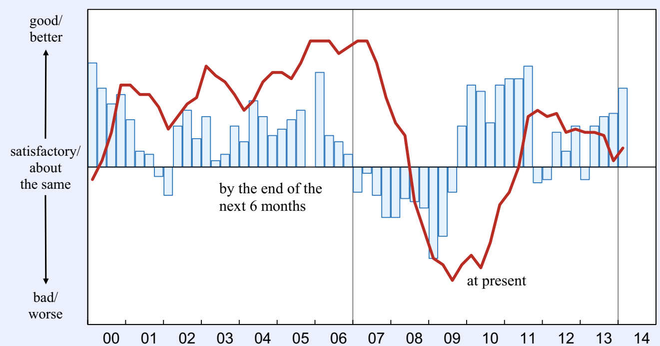

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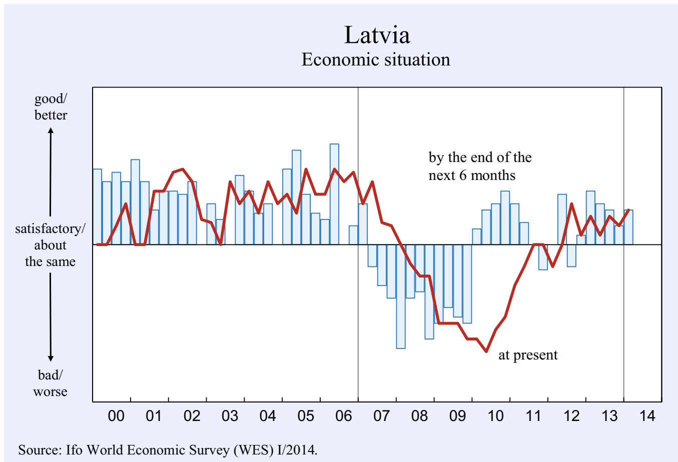

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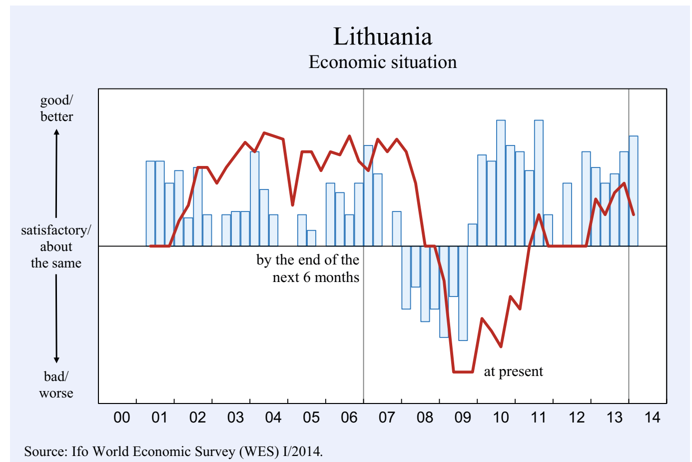

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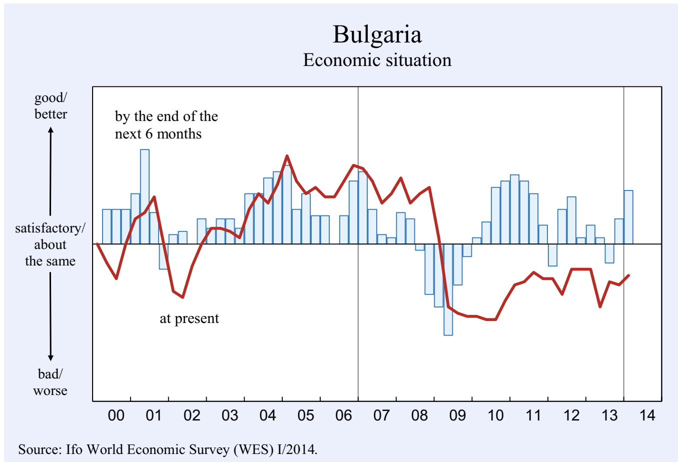

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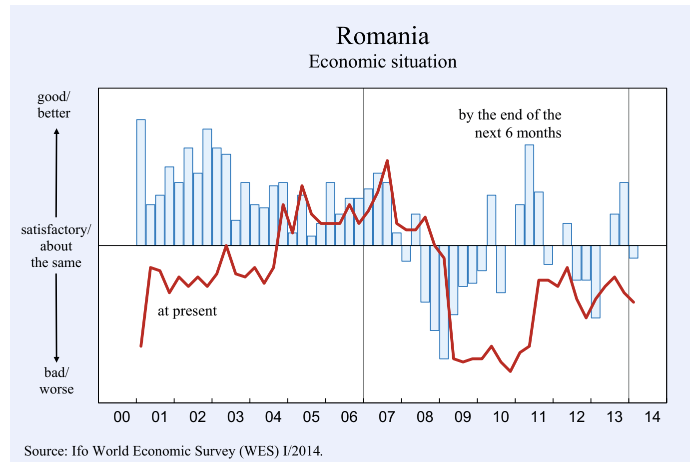

Source: Ifo World Economic Survey (WES) I/2014.