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Macroeconomic Outlook

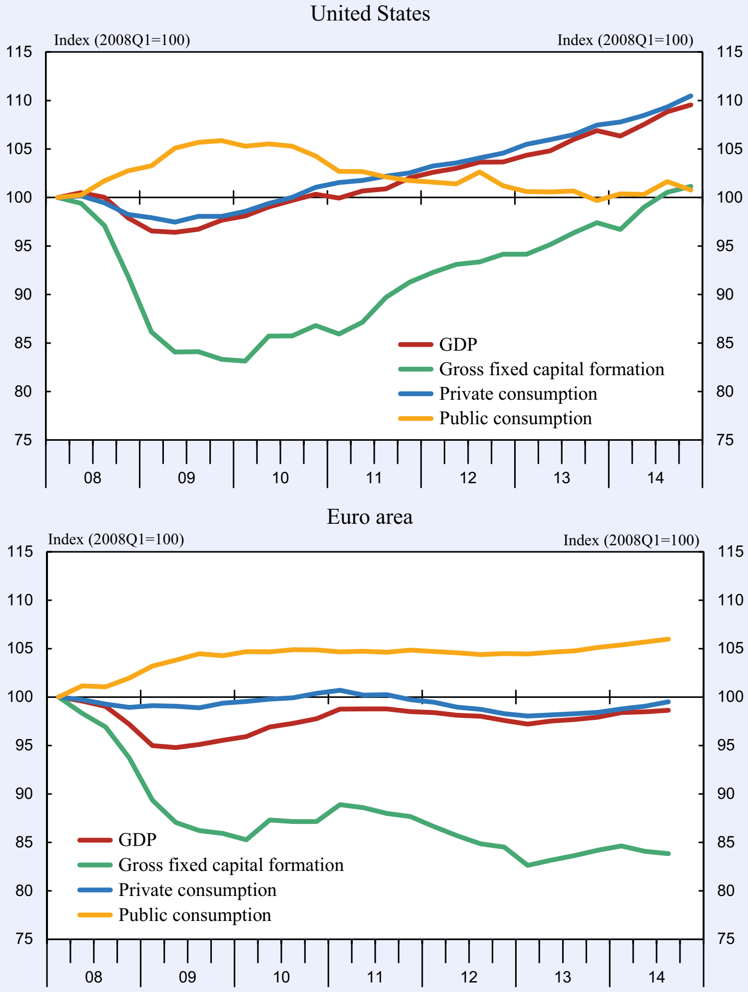
1.1 Introduction

The world economy managed to remain in recovery mode last year and is expected to gradually gain some further momentum in 2015. The diverging developments between and within regions will, however, persist. Monetary policy differed substantially among emerging countries in 2014; and this year it will also begin to drift apart within the industrialised world. The economic situation in the United States and the United Kingdom should allow for monetary policy to become less expansionary. Monetary policy in the euro area, however, is still moving in the opposite direction. Although it has helped to reduce uncertainties related to the viability of the monetary union and the stability of the financial system, which should have created incentives for firms and households to invest, actual investment dynamics have proven flat to date. Numerous international conflicts, as well as the renewed discussion of a potential Greek exit from the euro area, are counteracting the monetary stimulus provided by the European Central Bank.

Whereas the business sector in the United States clearly regained confidence in the future outlook of the US economy, firms in Europe remain reluctant to invest (see Figure 1.1). The US government has used the economic recovery to reverse the increase in public consumption and, in that sense, has behaved in a clearly anti-cyclical manner. In the euro area, on the other hand, the role of the public sector increased substantially during the crisis, and there are no signs that this is going to be reversed any time soon. On the contrary, the pressure to implement austerity and structural reform programmes has receded in the last two years; and public consumption has risen again in the euro area as a result. Progress in the crisis-afflicted countries to improve international competitiveness by ultimately reducing relative price levels will remain slow and hampered by occasional flare-ups of political uncertainty.

Figure 1.1

Domestic spending developments
in the United States and the euro area



Sources: US Bureau of Economic Analysis and Eurostat, last accessed on 31 January 2015.

In Europe, the recovery is largely being supported by the sharp fall in oil prices and the depreciation of the euro. While the first factor is benefitting producers and consumers of energy, the second mainly supports firms with competitive positions in international markets. Partly because of differences in competitiveness, the economic recovery will differ across the European Union member states (see Table 1.A.2). Of the larger economies, Spain is likely to grow significantly faster than the euro area average, while France and Italy are likely to experience only low growth. The latter two countries have been suffering for years from similar structural problems like high government spending, significant tax and social contribution burdens on firms, inflexible labour markets and overregulation of the private economy, leading to strong deindustrialisation. In addition, French and Italian firms have lost price competitiveness since the introduction of the euro. Their shares of world trade have decreased markedly as a result. Hesitant attempts, at best, have been made at the political level to slowly improve this situation.

The mild economic recovery in Europe in 2015 will be supported not only by the weaker euro and lower oil prices, but also by structural reforms that have already been initiated, as well as reduced consolidation efforts. On the other hand, high public debt levels still pose a significant risk to stability as the recent re-emergence of suspicion towards Greece shows. If renewed doubts about the sustainability of sovereign debt were to arise in other euro area member states, this could lead to a fresh escalation of the euro crisis. Uncertainty regarding the future course of a new Greek government has already led to increases in Greek bond yields. Another downside risk for the economy of the euro area is a renewed escalation of the Ukraine / Russia conflict. The real economic recovery would also probably be weaker if demand from abroad, and especially from emerging markets, turned out to be lower than expected. The recovery, however, could be even stronger should oil prices or the euro continue to fall.

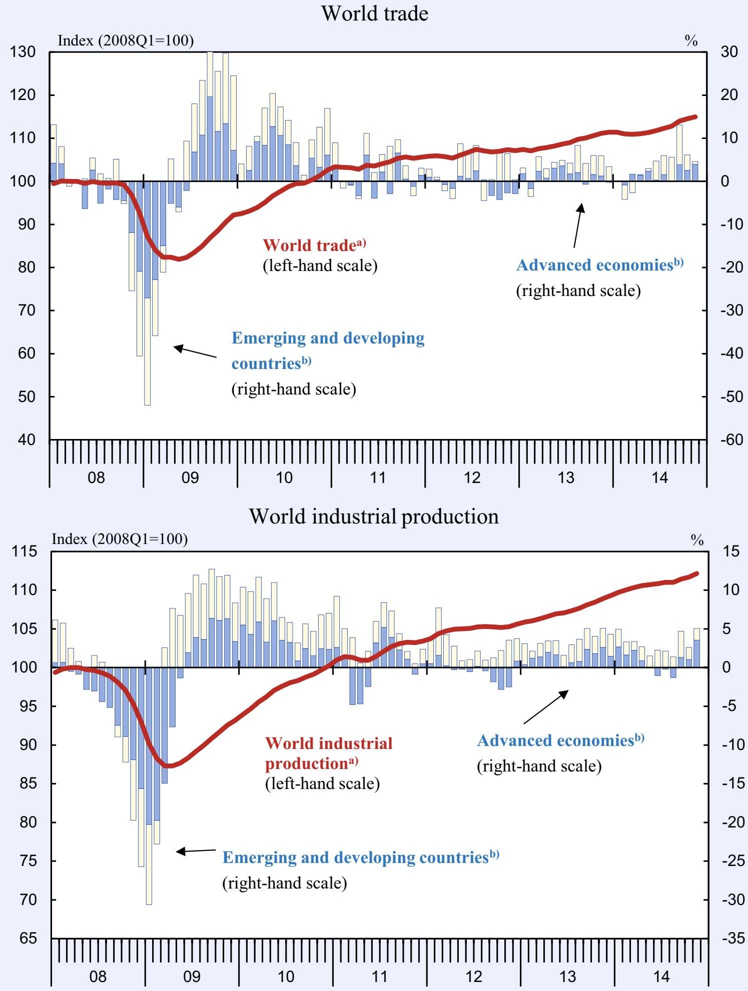
1.2 The current situation

1.2.1 The global economy

Whereas the pace of global industrial production slowed markedly during the summer half of 2014, the growth rate of world trade accelerated (see Figure 1.2). Global industrial production grew only half as much in the second and third quarters of 2014 as in the previous winter half-year. This development mainly reflects the significant slowdown in economic momentum in the advanced economies, where industrial out-

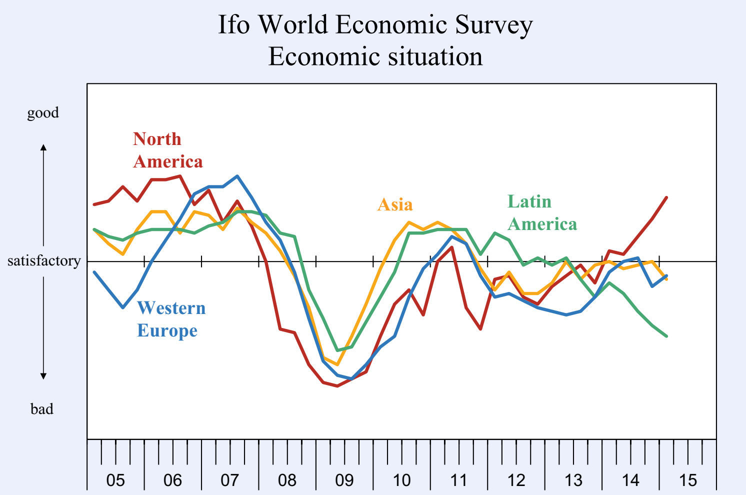
Figure 1.2

Regional contributions to world trade
and industrial production



$^{a)}$ 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 2014.

Figure 1.3



Source: Ifo World Economic Survey I/2015.

put virtually stagnated during the summer. The increased dynamics in world trade are largely due to a normalisation of trade in the emerging economies.

Over the course of last year, the Ifo World Economic Survey results started to paint an increasingly diverging picture of assessments of the global economy by economic experts (see Figure 1.3). Whereas the economy of North America continued to improve, the opposite was basically true of the economies of Latin America.

Economic developments in the euro area and in Japan were the main triggers for the overall slowdown in economic growth in the advanced economies observed since spring 2014. The slowdown in the euro area was not least the result of growing scepticism about the willingness of the French and Italian governments to urgently undertake key structural reforms in their labour and product markets, and to embark on a clear, substantial and credible course of fiscal consolidation. This "reform gridlock" continues to weigh on the attractiveness of both countries for investors, adversely affecting their medium-term growth prospects. Along with growing pessimism, economic sanctions related to the political conflict with Russia had a dampening effect on economic activity in the euro area in summer 2014.

In Japan, aggregate economic performance declined during the second and third quarters. The country therefore fell into its fourth technical recession (as measured by at least two consecutive quarters of negative growth) since 2008. This was due mainly to the VAT increase in April 2014, which led to a sharp decline in private consumption.

Aggregate production in the United States and in the United Kingdom, on the other hand, continued to show robust growth rates, and employment growth even accelerated. The recovery in these countries is more advanced than in the euro area and is supported by the improved asset position of households, a well-capitalised banking sector and monetary policy that remains very expansionary.

In contrast to most industrialised countries and despite interest rate hikes, the emerging economies continued to grow moderately during 2014. As in the industrialised world, however, the underlying economic dynamics were very heterogeneous across the emerging markets. Whereas the pace of expansion in India and many economies of East Asia accelerated significantly, Latin America witnessed a substantial decline in growth.

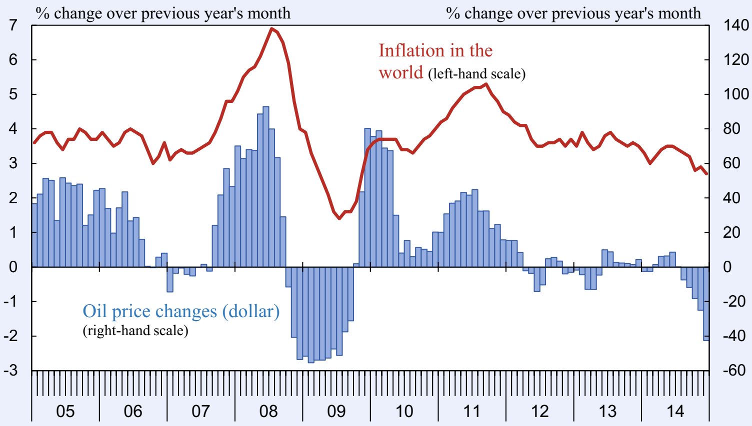
In India, the fading of political uncertainty after the parliamentary elections in April / May 2014 and the willingness signalled by the new government to carry out much-needed structural reforms improved the investment climate. In addition, various public infrastructure investments were made, which had been placed on hold last winter. Several East Asian countries benefited from strong growth in private domestic demand, not least resulting from the growing prosperity of the population. The Chinese economy performed robustly during the summer of 2014. The government has taken a number of supportive measures to counter the downturn in momentum seen in China's industrial and construction sectors at the beginning of the year. For the time being at least, these measures have helped to stabilise growth rates close to the government's target of 7.5 percent.

In Latin America aggregate industrial production actually declined during the first half of 2014 and has only started recovering slowly since then. While Mexico profited from the recovery in the United States, the economies of Brazil and Argentina have been heavily burdened by steadily falling commodity prices since 2011. In addition, already huge structural problems in Argentina have been exacerbated further and the unresolved dispute with foreign investors related to the public debt restructuring carried out in 2001 has noticeably constrained the country's access to international financial sources.

Despite the geopolitical tensions in Eastern Europe and in the Middle East, the oil price declined substantially in 2014, particularly during the fourth quarter of the year. After peaking in June 2014, the price of a barrel of Brent Crude fell by over 40 percent to reach 57 US dollars by the end of 2014. This decline was largely driven by (expected) supply-side changes, such as the continuing expansion of oil production in the USA (fracking) and increased production in Iraq. However, for many weaker than expected economic developments also imply that some demand-side aspects cannot be ruled out. Inflation rates all around the world started to decline during the last months of 2014 as a result (see Figure 1.4).

Figure 1.4

Inflation in the world and oil price movements



Source: International Monetary Fund, International Financial Statistics, last accessed on 31 January 2015.

1.2.2 United States

While the US economy was dominated in the first quarter of 2014 by the effects of a harsh winter, the subsequent quarters revealed a strong underlying growth momentum (see Figure 1.5). Economic output increased by well over an annualised 4.5 percent during the summer half-year. This was primarily due to increases in domestic demand, with private consumption growing at about 3 percent and private fixed investment by over 8.5 percent during the same period (see Figure 1.6). Except for in the third quarter, the strong performance of the domestic economy has, via a rise in import growth, led foreign trade to contribute negatively to GDP growth.

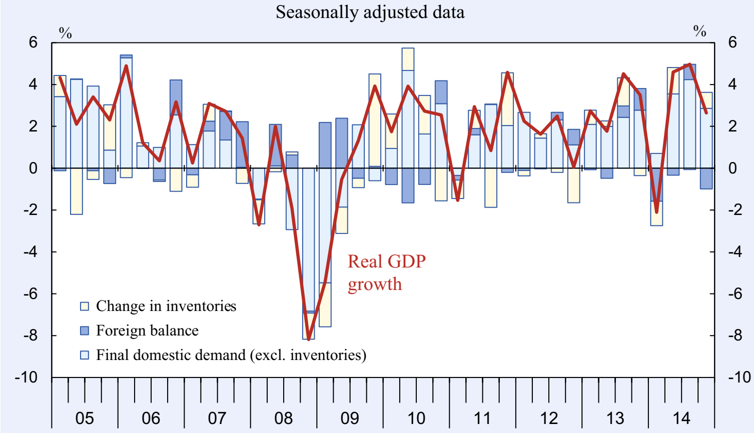
Despite initially unfavourable weather conditions, around 240,000 new jobs per month have been created since the beginning of 2014, which comes close to the levels of previous recoveries. Employment was able to exceed pre-crisis levels for the first time in May last year as a result, and the participation rate, which had been declining since 2008, has started to stabilise. Furthermore, the unemployment rate dropped significantly from 6.7 percent in early 2014 to 5.6 percent in December of last year (see Figure 1.7).

In view of the weaker than average dynamics of this recovery and slightly under-utilised capacities until recently, inflation in the United States has remained relatively low to date, despite ultra-loose monetary policy. Although the annual inflation accelerated in the first half of 2014 from close to 1.5 percent at the turn of 2013/14 to about 2 percent last summer, the rate of inflation subsequently fell back to 0.7 percent in December (see Figure 1.8). The sharp decline in oil

Figure 1.5

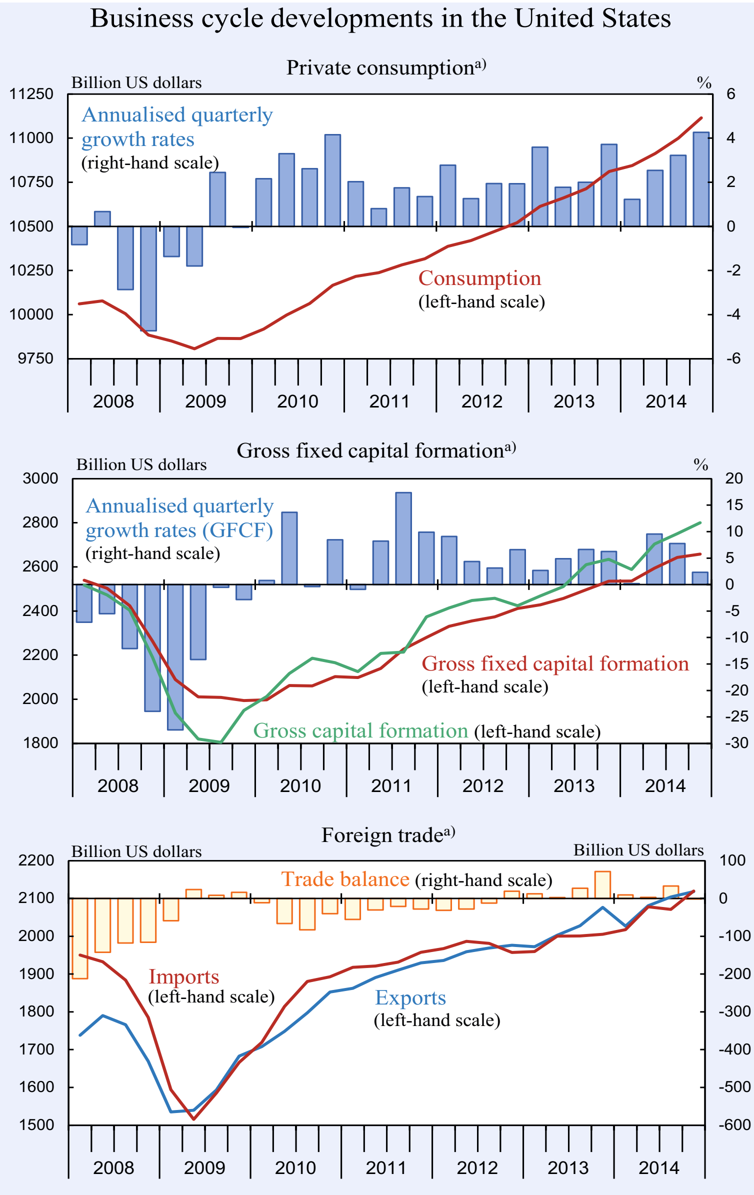
Contributions to GDP growth[a)] in the United States

Seasonally adjusted data



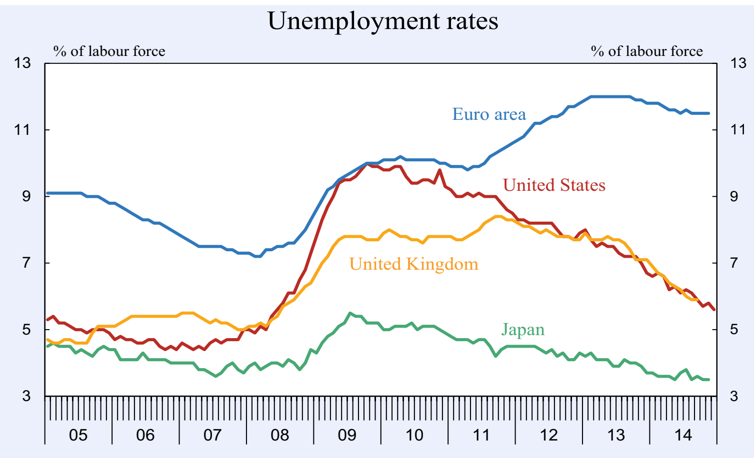
a) Annualised quarterly growth.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2015; EEAG calculations.

Figure 1.6



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2015.

Figure 1.7



Source: OECD, Main Economic Indicators, last accessed on 31 January 2015.

prices and a strengthening of the US dollar are the root causes of this downturn.

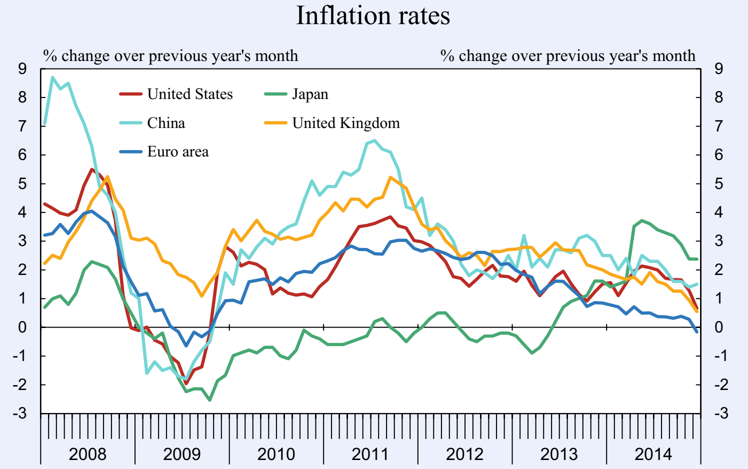
1.2.3 Asia

In *China*, the economy gathered speed over the course of last year. After a slight trough at the beginning of the year, GDP growth picked up again during summer. This was mainly supported by private consumption. However, the government also introduced a number of measures to support the economy after its weak start to 2014. For instance, additional investment in the rail network and tax breaks for small businesses successfully boosted production over the summer.

In contrast to previous periods, overall weaker impulses emanated from investment. The slowdown in investment activity was mainly due to a cooling down of the property market and, in turn, residential construction. Due to significant oversupply, property prices started to stagnate at the beginning of 2014. In some regions they even fell slightly. House prices in China have been falling steadily since spring 2014. For the first time since mid-2013, net exports also provided a positive contribution to growth, mainly during the second half of last year. This is not only due to higher export growth, but also to lower intermediate goods demand stemming from weaker investment activity.

Economic development in *Japan* deteriorated significantly last year. After a strong first quarter, which was characterised by extensive advance purchases triggered by the upcoming value added tax

Figure 1.8



Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2015.

increase from 5 percent to 8 percent in April last year, GDP fell in the subsequent two quarters. A government stimulus package, which was planned to amount to about 1 percent of GDP, failed to offset this downturn. The main reasons for the decline were both lower investments and weak consumer demand. The latter was to be expected as a counter-movement to pre-emptive purchases in the first quarter.

Last December, the inflation rate in Japan was 2.4 percent, after peaking at 3.7 percent in May. About 2 percentage points of current inflation rates are due to the increase in value added tax. On the other hand, relatively stable core inflation indicates that most of the more recent fall in the inflation rate probably reflects the oil price shock; and both are only of a temporary nature.

The economic performance of *India* improved over the course of last year. Positive momentum for this acceleration came from both external and domestic demand. Consumer confidence, for instance, also improved because of the reduced inflation rate which, in turn, fostered real income growth. After two-digit CPI inflation rates through parts of 2013, inflation subsequently followed a downward trend, reaching 4.4 percent in November last year.

The outcome of the parliamentary elections in May 2014 increased optimism about future economic developments, inducing private investment to start growing again slightly, after having been subdued in 2013 and early 2014. The new government raised expectations of a series of structural reforms, including labour market liberalisation.

In the Asian Tiger countries *(South Korea, Taiwan, Hong Kong and Singapore)*, the pace of economic expansion accelerated slightly last summer. Both external and domestic demand growth increased somewhat compared to the beginning of last year. As usual, however, economic developments differed substantially across these countries. Whereas the most significant growth contributions in Taiwan and Singapore came from private consumption and investment, growth in South Korea and Hong Kong was driven by an increase in public demand triggered by a variety of policy decisions. In addition, the central bank in South Korea reacted to the slowdown in growth by cutting its base rate by 25 basis points in both August and October.

In the emerging Asian countries *(Indonesia, Thailand, Malaysia and the Philippines)*, growth accelerated somewhat, after a weak first quarter of 2014. Although the region was still burdened by the weak global economy and a multitude of restrictive fiscal policies, this was more than offset by the increase in private consumption.

1.2.4 Latin America and Russia

The overall economic expansion of the Latin-American region *(Brazil, Mexico, Argentina, Venezuela, Columbia and Chile)* remained subdued in the first half of last year. This was at least partly caused by weaker demand globally and low commodity prices. Consequently, net exports contributed only marginally to overall growth, and most of the stimulus came from private consumption. Investments stagnated again; and even started to decelerate over the course of the year. This was most evident in Brazil, where output declined during the first half of last year. More restrictive monetary policy, which constituted the response to increased capital outflows and the resulting devaluation as of mid-2013, worsened the financial conditions for households and firms. As of the beginning of 2014 steadily rising inflation was instrumental in three interest hikes at the beginning of the year and two in November and December.

The central banks in Colombia and Argentina have also recently increased their interest rates. Whilst high inflation was central to monetary tightening in Colombia, the hike in Argentina reflected the central bank's concerns over currency depreciation. Despite substantial purchases of Argentine pesos by the central bank, which melted down the country's foreign reserves from around 52 billion US dollars in early 2011 to 27 billion US dollars in spring last year, its currency has lost almost 50 percent of its value against the US dollar since 2011 – most of which occurred in early 2014. The decline in reserves has more or less halted now, at least temporarily. Although the technical default, which occurred in the summer of 2014, did not trigger an immediate crisis, it means that a return to the international capital markets has receded to the future. In an attempt to improve the current account balance, import controls were increased. The increasing interventionism and high macroeconomic imbalances that have accumulated over the years (excessive fiscal policy, high inflation) are counterproductive to attracting foreign investments, which are also important to circumventing a further decline in foreign reserves.

Although inflation was above-target, interest rates were lowered in both Chile and Mexico last year. In both countries, monetary policy is trying to support the economy. Overall, the region is likely to have expanded by only 0.9 percent in 2014.

The Ukraine crisis hit *Russia* in the midst of a long ongoing phase of weak economic developments. Due to spiralling geopolitical tensions and sanctions between Russia and the West, the existing core problems of the Russian economy, such as the low diversification of investment activities and international capital flight, have been further exacerbated. The withdrawal of capital, which has been ongoing since 2009, accelerated at the beginning of last year. With the move towards a floating flexible exchange regime rate in early November, the depreciation of Russia's exchange rate reached a climax in mid-December. Overall, the rouble depreciated by over 30 percent against the euro and by 40 percent against the US dollar last year. To prevent an even stronger fall, the Russian central bank was forced to increase its interest rates stepwise during the year. Its base rate reached 17 percent by the end of the year.

Uncertainty and unfavourable financial conditions dampened investment, leading to a fall in gross fixed capital investment in the first half of 2014 compared to the previous year. Despite the generally unfavourable economic conditions, industrial production performed better than expected. This occurred for several reasons: firstly, many sectors benefited from a ban on imports of Ukrainian goods and the production losses in the Donbass region. These primarily include companies in metal production and processing, the arms industry and food processing. Furthermore, Russia's import restrictions helped the domestic food industry and agricultural sector to increase their production. In addition, the strong devaluation of the rouble discounted domestic goods compared to imported goods. Lastly, the state expanded its contracts with local companies. Overall, industrial production increased by 1.4 percent during the first eleven months of 2014 as compared to the same period in 2013.

Nevertheless, and although private consumption was one of the major pillars of the Russian economy previously, this demand component developed less dynamically than the years before. Retail sales in 2014 rose more slowly than in 2013. Inflation, which increased from 6 to 9 percent during the year, also placed a burden on real disposable income. After basically stagnating throughout the year, GDP has probably increased by 0.7 percent in 2014 as compared to 2013. This is largely due to falling gross fixed capital investment, weak private consumption and declining exports.

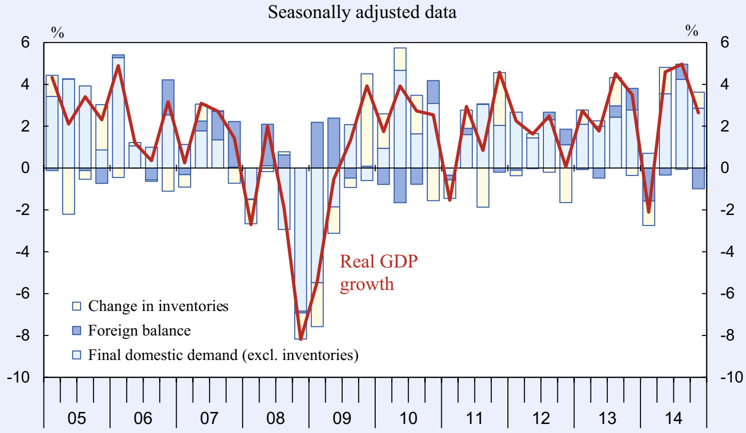
1.2.5 The European economy

The cyclical situation

After four quarters of real GDP growth at annualised rates of around 1.5 percent, the recovery in the European Union continued at a slower pace. During the two summer quarters of 2014 growth amounted to approximately 1 percent (see Figure 1.9). After a deep and prolonged recession, output expanded for seven quarters in a row: from the last quarter of 2011 until the first quarter of 2013. The degree of expansion was extremely low in 2014 and remained well below that of previous recoveries. In addition, economic activity over the summer was weaker than expected last spring. One reason for this were fresh doubts as to whether the French and Italian governments are willing and able to carry out the necessary labour and product market reforms, as well as initiating a credible consolidation of their fiscal budgets. Similarly, changes in

Figure 1.9

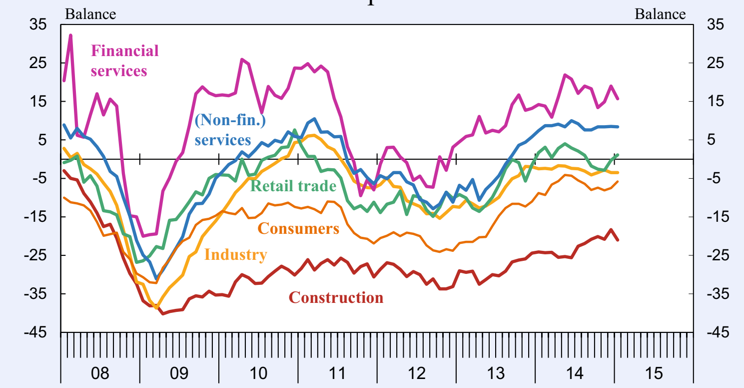
Contributions to GDP growth[a)] in the United States
Seasonally adjusted data



[a)] Annualised quarterly growth.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2015; EEAG calculations.

Figure 1.10

Confidence indicators[a)] for different sectors in the European Union



[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 2015.

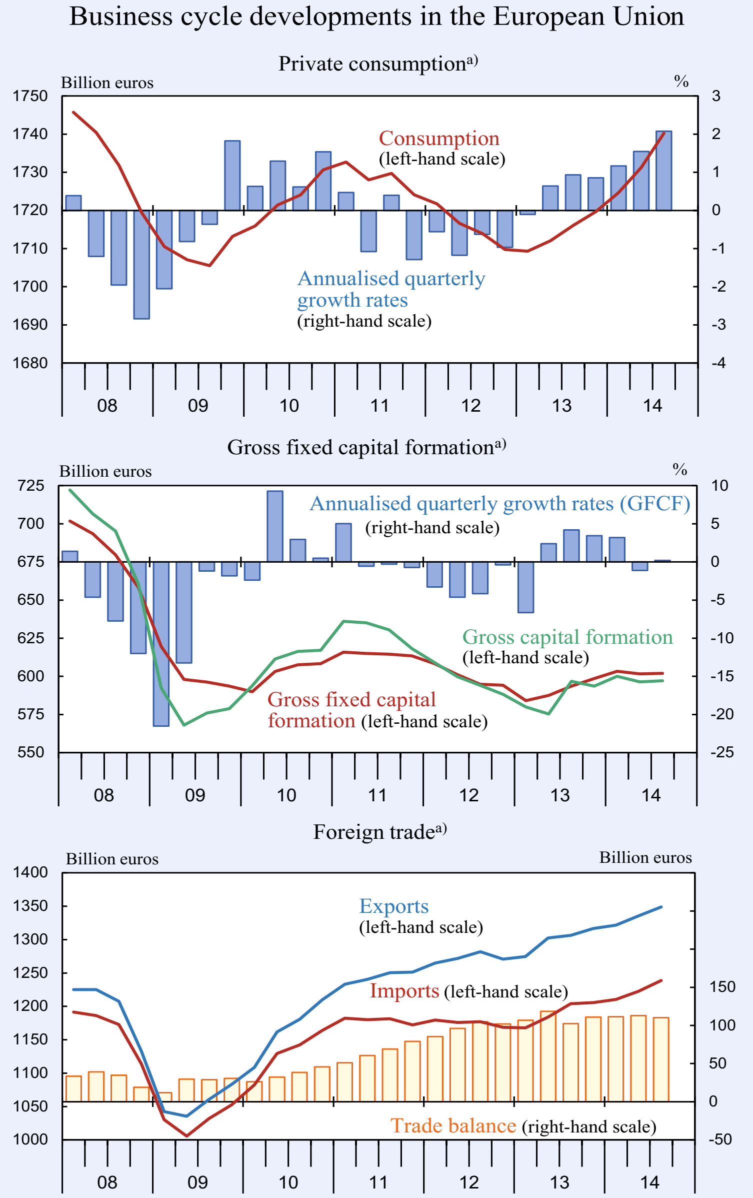
minimum wage laws and an effectively reduced retirement age lowered investment incentives in Germany. Other constraints included the political conflicts in the Ukraine and the Middle East. All of these events had a clear negative impact on business confidence in Europe. As a result, gross fixed capital investment declined during the summer half of 2014.

Over the course of last year the growth contributions from private consumption in particular, as well as from public consumption, increased steadily. Government final consumption expenditure mainly benefited from the fact that fiscal consolidation measures did expire in some member states and no significant new measures were adopted. Private consumption continued to grow and reached, albeit at only a moderate 2 percent, its highest quarterly growth level since 2007 to date in the third quarter of 2014 (see Figure 1.11). The small, but steady decline in inflation rates did relieve household budgets and thus supported this development. The recovery in consumer spending was reflected in the steady growth in consumer confidence in 2013 and early 2014 (see Figure 1.10). During the summer months confidence fell somewhat again, stabilising in autumn at a level that was still relatively high historically. Hardly any stimulus came from net exports, as both exports and imports picked up to a similar extent over the course of 2014 (see Figure 1.9). After stagnating in the European Union and contracting by 0.5 percent in the euro area in 2013, growth in real GDP reached 1.3 and 0.8 percent in these areas respectively in 2014.

The recovery in Europe has also helped to stabilise the labour market. The unemployment rate in the euro area stood at 11.5 percent in November 2014, which is slightly lower than at its peak of 12 percent in September 2013. Employment also increased slightly during last year, although it still remains well below pre-crisis levels. Without higher growth, a more substantial and sustainable recovery of the labour market probably remains a long way off.

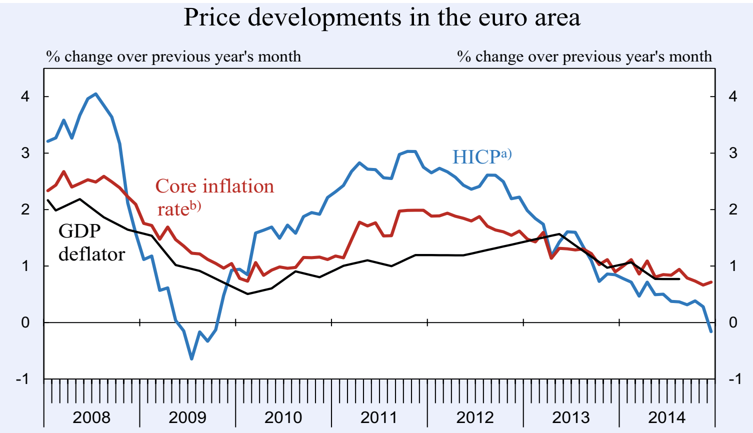
Inflation in Europe has turned to historically low levels. The average inflation rate in 2014 of 0.4 percent in the euro area (and 0.6 in the European Union) was well below the medium-term target of the European Central Bank (ECB) of below or close to 2 percent. In autumn 2011, it stood at 3.0 percent and has fallen almost continuously since. For two years now, inflation has been below target (see Figure 1.12). The core inflation rate (headline inflation excluding energy and unprocessed food) stood at just 0.7 percent at the end of last year, down from 2.0 percent in autumn 2011. The fall in core inflation, as also shown by reduced increases in the GDP deflator, mainly reflects the continued under-utilisation of production capacities and the low scope for firms to increase prices as a result.

Figure 1.11



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 31 January 2015.

Figure 1.12



a) Harmonised Index of Consumer Prices (HICP). b) HICP excluding energy and unprocessed food.
Source: Eurostat, last accessed on 31 January 2015.

Furthermore, the necessary efforts in crisis countries to improve competitiveness through wage and price reductions are also exerting deflationary pressures on the euro area as a whole. Finally, the price effects of past tax increases (e.g. increases in value added tax rates) have almost completely faded. That overall inflation fell more strongly than the core rate was due to falling energy and food prices. All in all, however, the risk of entering a self-reinforcing deflationary spiral of falling prices and demand still appears to be low, albeit rising.

Differences across Europe

The economy of *Germany* cooled down significantly during the summer half of 2014. At the beginning of the year, real GDP had risen dynamically at an annualised rate of 3.1 percent during the first quarter. This, however, was partly driven by favourable weather conditions; the mild winter did boost construction investment. Partly as a correction, economic output decreased in spring. However, this also reflected a much weaker underlying trend than was assumed during the winter. In the subsequent third quarter overall economic production barely increased. On balance, real GDP stagnated during the summer of 2014. As a result, the utilisation rate decreased in industry, but remained slightly above its long-run average.

The weakness of the German economy during summer was largely related to firms increasingly returning to replacement investments, after investing quite heavily in the acquisition of new equipment in the previous winter season; leading to a decline in gross capital formation. Business sentiment has deteriorated since the beginning of 2014. It was weakened not only by the economic risks in the world and in the euro area and the uncertainties in the wake of new and old international crises, but also by the costly and employment-reducing reform projects of the German government. A legal minimum wage with high coverage and full pensions at the age of 63 were decided upon. Industry players downwardly revised their investment plans as a result.

During the second quarter, construction investment shrunk due to weather-related rebound effects. The deterioration in the overall investment climate itself was felt during the third quarter. Favourable financing conditions were neither able to provide enough countervailing impulses to construction nor to equipment investment. These overall unexpected changes in sentiment also led to a strong reduction in inventories and therefore had a negative effect on overall production.

Only consumption developed robustly during the summer months. Promoted by an increase in the real income of households, price adjusted private consumption expanded remarkably. Government consumption also increased substantially. Overall economic development was also propped up by foreign trade: although both imports and exports increased, the latter did so at a faster pace, resulting in a positive contribution from net exports. Taken together these developments, however, were not enough to offset the investment-driven decline in domestic demand.

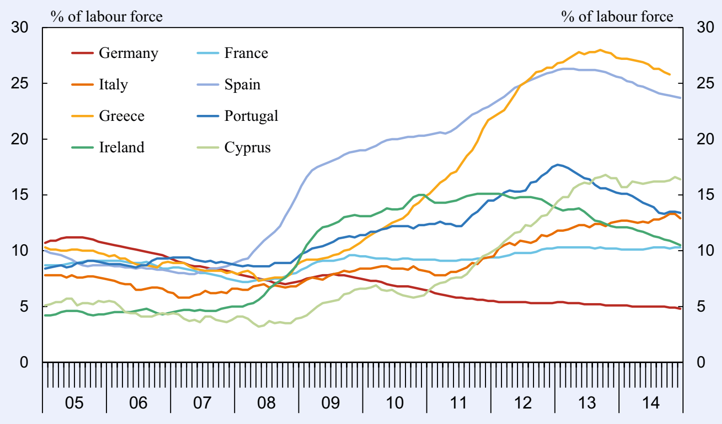
Employment continued to develop favourably, albeit at a gradually slower pace over the course of the year. The unemployment rate hardly declined as a result (see Figure 1.13).

During the first half of 2014, *France* almost fell back into a recession, which was followed by weak economic growth during the second half of last year. As in 2013, the strongest spending impulses came from the government sector. The loss in competitiveness, combined with the weak willingness to carry out the structural reforms necessary in the longer-run, have placed a heavy burden on the private economy. The willingness of firms to invest is very low and gross fixed capital formation is therefore falling steadily. Exports have so far neither benefited from Europe's slow recovery, nor the reduced value of the euro, resulting in hardly any positive dynamic in the labour market. The unemployment rate hardly changed and reached 10.3 percent at the end of last year.

The economic recovery in the *United Kingdom,* which began in early 2013, continued throughout 2014. As in 2013, the recovery was largely driven by domestic demand. Both private consumption and investment continued to provide strong impulses and government spending also contributed significantly during the summer. Despite the economic recovery and the rapid recovery of the labour market – the unemployment rate fell from 7.1 percent at the end of 2013 to below 6 percent at the end of 2014 – with wage and inflation dynamics remaining weak. Consumer prices rose, even without considering the significant drop in energy and food prices in October, by only 1.5 percent compared to the previous year.

Figure 1.13

Unemployment rates in selected countries of the euro area



Source: Eurostat, last accessed on 31 January 2015.

In *Italy* investments have been continuously falling since the beginning of 2011, reaching levels in 2014 that had previously last been seen in 1997. The country has now been in recession since mid-2011. Although the decline in production has started to abate, mainly because private consumption stopped falling and the export-oriented sectors are benefiting somewhat from the overall recovery in Europe, a turnaround has not yet been achieved. With ever-changing governments constantly reversing course, it is difficult to create an environment in which long-term investment decisions appear fruitful and a general wait-and-see attitude seems to have captured the Italian business sector. Moreover, Italy remains vulnerable to any increased tensions in government bond markets, with its public debt amounting to 132 percent of GDP in 2014. Real GDP is expected to have fallen by 0.4 percent last year.

In mid-2013 the economy of *Spain* pulled out of recession. Since then, GDP growth has accelerated slowly, reaching an annualised 2.0 percent growth rate in the third quarter of 2014. With the exception of public consumption, all major spending components have contributed significantly to this recovery. Albeit still at historically high levels, the unemployment rate is benefiting from this turn for the better and has steadily been declining since the end of 2013.

In Portugal real GDP has also been on an upward trend since spring 2013. Even Greece emerged from its deep and prolonged recession at the start of 2014. Mainly export growth, as well as private consumption and investment more recently, have positively contributed to this change. In both countries, the effects of the turnaround are already noticeable in their labour markets. Unemployment has been steadily falling throughout 2014. Although the labour market is also improving in Cyprus, its economy is still shrinking. Together with Italy, Cyprus remained the only euro area member state in recession last year.[1]

In the *Central and Eastern European* member states of the European Union, economic recovery has slowed somewhat since mid-2014. This was mainly due to weaker demand from the euro area. Although export growth was still strong until the middle of the year, it lost momentum somewhat in the third quarter. Domestic demand was robust almost everywhere. Except in Croatia, consumer spending, supported by low price dynamics, continued to grow in the region. Government consumption increased markedly in several countries during the second half of the year. Equipment investments also made an overall positive contribution to the increase in GDP in the region. Their expansion was facilitated by the significant revival in Eastern European credit markets. Nevertheless, large differences between countries continue to prevail. While firm lending recently increased again in Poland, the Czech Republic and Bulgaria, borrowing remains difficult for companies in Romania, Hungary and Croatia.

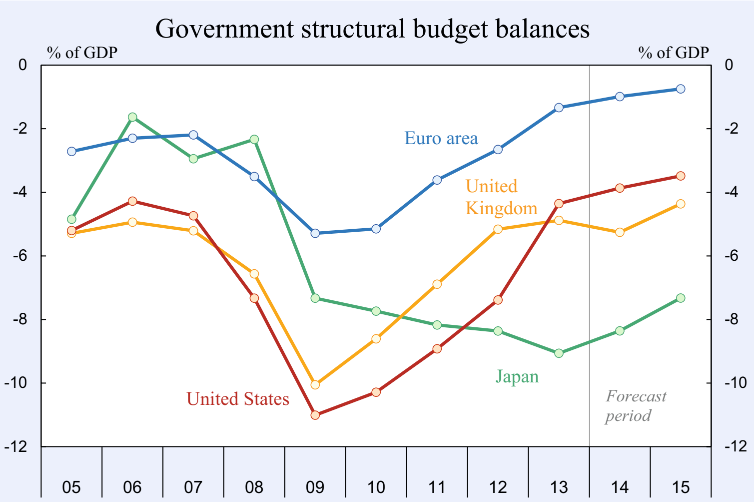
1.3 Fiscal and monetary policy

1.3.1 Fiscal policy

The restrictiveness of fiscal policy will abate in the major advanced economies, albeit to differing degrees. Although fiscal policy in the United States will continue to reduce its structural budget deficit, the scheduled spending cuts that fall within this and last years' budgets are significantly lower than those in 2013 (see Figure 1.14). In addition, many federal states are planning to increase their spending again.

In Japan, value added tax (VAT) was increased by three percentage points in April 2014. This measure is supposed to act as the trigger initiating fiscal consolidation in the years ahead, which in the light of a public debt approaching 250 percent of GDP, appears to be desperately needed. At the same time, a temporary stimulus package was introduced in a bid to mitigate some of the negative impact of the VAT increase. Nevertheless, fiscal policy in Japan was highly con-

Figure 1.14

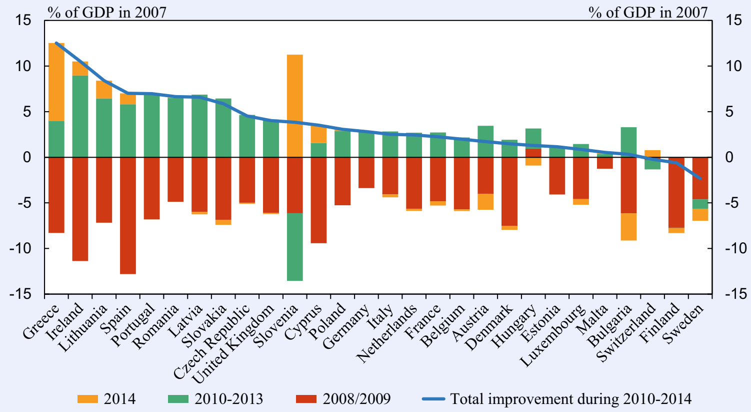


Source: OECD, Economic Outlook 96, November 2014.

[1] Although the annual growth rate for Finland is also negative for 2014, it managed to emerge from recession in spring last year. Finland is suffering from a decline in one of its key industries, as well as weak external demand from the euro area and Russia – one of Finland's main trading partners.

Figure 1.15

Changes in the primary fiscal balances relative to pre-crisis GDP[a)]



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 result in the overall change during 2008-2014.
Source: European Commission, DG ECFIN, General Government Data and AMECO, Autumn 2014.

tractionary last year. Although a further VAT increase scheduled for October 2014 was postponed until 2017, fiscal policy will remain restrictive, as previous stimulus packages are set to expire.

In the majority of emerging economies, fiscal policy is likely to have a mostly neutral effect. China was the only economy that was substantially supported by public investment programmes in 2014. Furthermore, the Chinese government has indicated its willingness to extend these infrastructure investments once again, should its economy continue to lose momentum. The Russian government is being forced to intervene and stimulate its economy so as to mitigate the negative effects on the industrial and banking sectors of economic sanctions related to the political conflict with the West.

In the United Kingdom the consolidation effort is also gradually waning. In the euro area, fiscal policy is similarly becoming less restrictive after three to four years during which much-needed consolidation efforts did generate clear negative economic impulses in many places (see Figure 1.15). Not only does the low interest rate environment create incentives for debt-financed spending, the European Commission also relaxed the deficit and debt reduction plans for many member states in 2013. Nevertheless, it is quite clear that these revised fiscal targets will not be met by countries like France and Italy. The French government announced as early as September that it will not meet its budget target of 3.8 percent in 2014, as provided by the (relaxed) stability programme of the European Commission. It appears very unlikely that it will reach its deficit target of 3 percent this year either. In Italy, fiscal deficits are also higher than planned. The Italian government does not want to respond to its deteriorating fiscal position caused by lower than expected economic growth with additional consolidation measures. Although in the latest assessment of the European Commission, the government was given three more months to bring the 2015 budget into line with EU requirements, it appears likely that the European Commission will act in an accommodative manner again. Whereas this will take the pressure off in terms of short-term economic developments, the combination of very high public debt and low growth outlooks could, however, raise fresh doubts about the solvency of some individual euro area countries; and thereby give rise to renewed turmoil in financial markets. Furthermore, the credibility of any European agreement on fiscal constraints is further reduced. While deficits, especially when adjusted for cyclical effects, have been falling in recent years, according to the autumn forecast of the European Commission hardly any further declines are likely for this year. In France and Italy in particular, some increases in structural deficits appear likely, as no significant additional consolidation measures are scheduled.

The budgetary situation in the crisis-afflicted countries of Cyprus, Greece, Ireland, Portugal and Spain has improved noticeably. With the exception of Spain, all of these countries have probably achieved a primary surplus in 2014. Spain is also making substantial progress towards this goal. Both the improving economic situation and temporary increases in particular tax rates up until the end of last year allowed Spain to outperform its deficit target of 5.8 percent of GDP. The scheduled income tax reform will probably lead to a temporary increase in Spain's budget deficit.

In light of the continuing recovery, the overall government deficit for the euro area and the European Union is expected to decline slightly to 2.6 percent in 2014 from 2.9 percent in 2013 (see Table 1.1). Hardly any further consolidation is to be expected this year. The very hesitant recovery will, for example via somewhat higher employment, lead to a slight improvement in the budgetary situation in many member states. In addition, the strong decline in government bond yields

Table 1.1

Public finances

	Gross debt[a]				Fiscal balance[a]			
	1999–2007	2008/2009	2010–2013	2014	1999–2007	2008/2009	2010–2013	2014
Germany	62.2	68.6	78.5	74.5	– 2.2	– 1.5	– 1.2	0.2
France	62.3	73.3	87.0	95.5	– 2.5	– 5.2	– 5.2	– 4.4
Italy	102.9	107.4	120.4	132.2	– 2.9	– 4.0	– 3.4	– 3.0
Spain	48.2	46.1	76.4	98.1	0.2	– 7.7	– 9.0	– 5.6
Netherlands	49.3	55.6	63.8	69.7	– 0.6	– 2.6	– 3.9	– 2.5
Belgium	100.8	95.8	102.6	105.8	– 0.5	– 3.3	– 3.7	– 3.0
Austria	66.2	74.1	81.9	87.0	– 2.2	– 3.4	– 2.7	– 2.9
Greece	102.3	118.0	162.3	175.5	– 5.3	– 12.6	– 10.5	– 1.6
Finland	40.6	37.2	51.1	59.8	3.8	0.8	– 2.0	– 2.9
Portugal	59.6	77.6	115.0	127.7	– 4.3	– 6.8	– 7.2	– 4.9
Ireland	31.1	52.4	110.9	110.5	1.6	– 10.5	– 14.7	– 3.7
Slovakia	40.5	32.1	47.8	54.1	– 5.3	– 5.1	– 4.6	– 3.0
Slovenia	25.7	28.1	52.0	82.2	– 2.3	– 4.0	– 7.6	– 4.4
Luxembourg	6.6	15.0	20.8	23.0	2.5	1.4	0.1	0.2
Latvia	12.2	27.5	42.1	40.3	– 1.7	– 6.5	– 3.3	– 1.1
Cyprus	59.2	49.7	76.1	107.5	– 2.5	– 2.4	– 5.3	– 3.0
Estonia	5.0	5.8	8.1	9.9	0.7	– 2.5	0.1	– 0.4
Malta	65.5	65.3	68.8	71.0	– 5.0	– 3.8	– 3.1	– 2.5
Euro area	**69.0**	**75.0**	**88.7**	**94.7**	**– 1.9**	**– 4.2**	**– 4.2**	**– 2.6**
United Kingdom	39.8	58.7	82.8	89.0	– 1.8	– 7.9	– 7.8	– 5.4
Sweden	49.0	38.5	36.9	40.3	1.1	0.6	– 0.6	– 2.4
Denmark	43.6	36.9	45.0	44.1	2.3	0.2	– 2.4	– 1.0
Poland	43.2	49.0	54.6	49.1	– 4.1	– 5.6	– 5.1	– 3.4
Czech Republic	24.6	31.4	42.6	44.4	– 3.7	– 3.8	– 3.1	– 1.4
Romania	19.5	18.2	34.8	39.4	– 2.6	– 7.2	– 4.3	– 2.1
Hungary	58.9	75.0	79.4	76.9	– 6.3	– 4.1	– 3.7	– 2.9
Croatia[b]	28.2	40.2	63.2	81.7	– 2.9	– 4.3	– 6.1	– 5.6
Bulgaria	45.0	13.7	17.0	25.3	0.5	– 1.3	– 1.8	– 3.6
Lithuania	20.5	22.2	38.1	41.3	– 1.8	– 6.3	– 5.4	– 1.1
European Union[b]	**61.8**	**68.3**	**82.9**	**88.1**	**– 1.7**	**– 4.6**	**– 4.6**	**– 3.0**
United States	47.2	79.4	100.1	105.6	– 2.6	– 10.3	– 8.9	– 5.5
Japan	167.0	201.0	231.6	245.1	– 5.9	– 7.3	– 9.0	– 7.1
Switzerland	63.3	50.1	49.1	47.2	0.2	1.2	0.3	0.5

[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] Data on Croatia is only available from 2001 onwards.

Sources: European Commission, Autumn 2014; IMF World Economic Outlook, October 2014.

will further dampen government interest payments. Therefore, the deficit ratio for the euro area as a whole is forecast to continue to decline slightly to 2.4 percent this year.

1.3.2 Monetary conditions and financial markets

Monetary conditions

Monetary policy in the major advanced economies remains very accommodative. However, the degree of expansion started to diverge in the various regions as of the beginning of last year. Differences in the degree of utilisation of production factors, and therefore potential inflationary pressures, are mainly responsible for this divergence. Given the robust economic development in the United Kingdom and in the United States, the central banks of these countries stopped their programmes to buy securities as early as in mid-2012 and October 2014 respectively. Both countries are also expected to start increasing their interest rates again this year. Nevertheless, and in accordance with statements made under the heading of "forward guidance", both central banks will continue to pursue expansionary monetary policy for quite some time to come.

In Japan, on the other hand, the degree of monetary expansion has increased again. At the start of 2013 the Bank of Japan announced that it would try to achieve its inflation target of 2 percent in two years' time by resorting to massive quantitative easing. Given the unexpectedly sharp economic downturn in the summer of 2014 and a still very weak core inflation rate, the Bank of Japan decided in early November to expand its monthly purchases of securities by over 20 percent to 80 trillion yen. Given that the Bank of Japan's uncollateralised overnight call rate is already at a historical low of 0.1 percent and is almost zero, no interest rate changes are expected for this year.

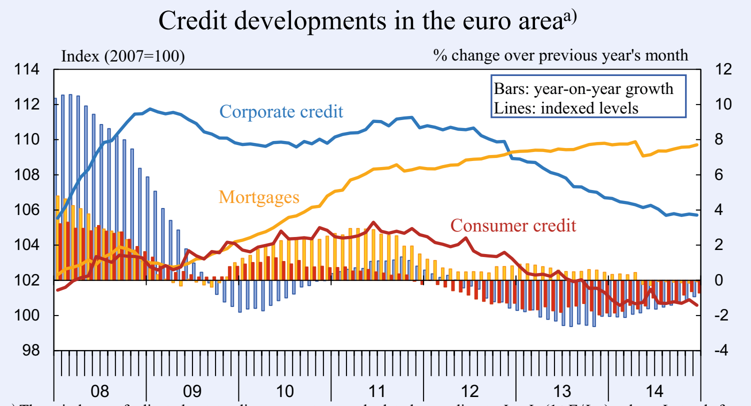
The central bank of China has also become more expansionary in recent months. Triggered by the slowdown in the construction sector and the real-estate market, it relaxed liquidity provision in some sectors slightly over the summer (while keeping restrictions in place in areas where the risk of a bubble appears highest). In addition, it lowered its base rate by 40 basis points to 5.6 percent in November. In view of historically low inflation rates, the Chinese central bank is likely to loosen its monetary policy stance again as soon as the economy is expected to slow down noticeably.

Most central banks in emerging economies have been forced to raise their key interest rates several times in recent months. This was either aimed at fighting inflation that was considered to be too high (Brazil) or at counteracting the devaluation of their exchange rates triggered by the monetary policy shift in the United States (India, Indonesia). Russia's central bank also increased its interest rate sharply and intervened massively in the foreign exchange market to counteract the strong depreciation of the rouble. It came under pressure in spring as a result of the Russian-Ukrainian conflict. Facing dwindling foreign exchange reserves and continuing withdrawal of capital, the Russian central bank decided in early November 2014 to stop its foreign exchange intervention and, at least for the time-being, have a fully floating Russian currency.

ECB monetary policy has become more expansionary as production capacity remains underutilised and the inflation rate has fallen almost continuously. In addition, lending has not picked up in the euro area either. Whereas corporate credits have been falling since the end of 2011 and consumer credits stabilised last year at low levels, only mortgages appear to be benefitting from the low interest rate environment and are increasing slowly (see Figure 1.16). In two steps of 10 basis points each, the main refinancing rate was lowered to 0.05 percent in June and September last year (see Figure 1.17). This also caused the deposit rate to turn negative in June. As a result, the banking sector has since withdrawn most of its excess reserves from the ECB system (see Figure 1.18).

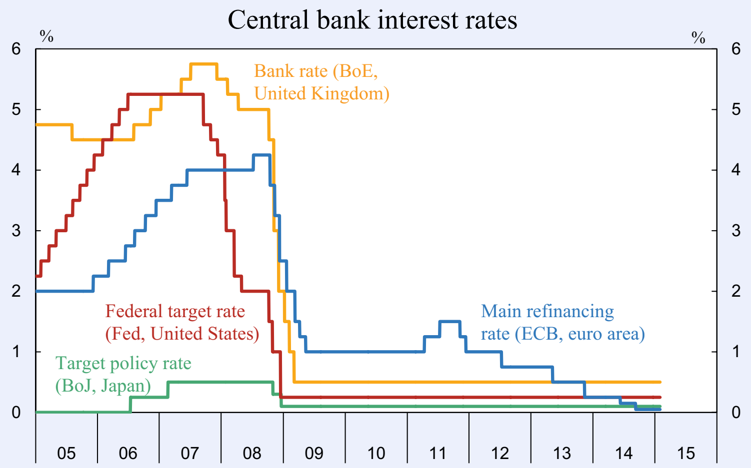
With these steps, the ECB clearly signalled that all conventional interest rate policy measures have now

Figure 1.16



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). A specific securitisation operation in France has led to a downward level shift in mortgages in May 2014.
Source: European Central Bank, last accessed on 31 January 2015.

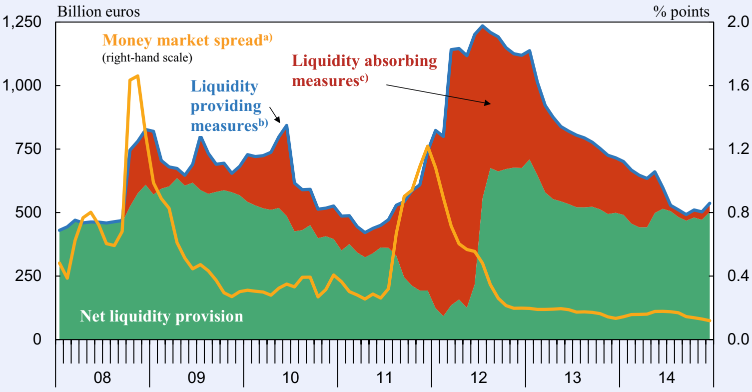
Figure 1.17



Source: European Central Bank; Federal Reserve Bank of St. Louis, Bank of England, Bank of Japan, last accessed on 31 January 2015.

Figure 1.18

Liquidity provision by the ECB and the money market spread



[a)] Difference between the 3-month (unsecured) Euribor and the 3-month (secured) Eurepo (monthly average).
[b)] Monthly average of main and longer-term refinancing operations and the use of the marginal lending facility of the ECB. [c)] Monthly average of the use of the deposit facility and fixed-term deposits at the ECB.
Source: European Central Bank, last accessed on 31 January 2015.

finally been exhausted. Its governing council subsequently decided on a number of additional measures to revive lending in the euro area and drive inflation back to its target. These include the unlimited allocation of liquidity within the main refinancing operations, which has been extended until the end of 2016. Furthermore, so-called Targeted Longer-Term Refinancing Operations (TLTRO) were introduced that were auctioned in September and December last year and intended to provide cheap four-year funding at a fixed 0.10 basis point mark-up over the prevailing MRO rate percent interest rate to the banking sector. These funds were supposed to be linked to the amount of credit provided by the bank to the private economy which, however, is difficult, if not impossible, for the ECB to control. Although the banking sector would, in principle, have been able to borrow up to approximately 400 billion euros under this programme, the programme only managed to allot around 80 billion euros in September and 130 billion euros in December.

The ECB also started a purchase programme for asset backed securities and covered bonds in order to further strengthen lending by banks to the private sector. In mid-January both programmes amounted to only around 35 billion euros. This could be due to the fact that unlike in the United States, and to a lesser extent, the United Kingdom, most firm-funding in Europe takes place via bank loans instead of issuing bonds, making European financial markets smaller and much less liquid. The intention, however, is to further develop these markets in the euro area. In view of the ECB's stated goal of expanding its balance sheet by around 1 trillion euros to reach around 3 trillion euros – the level of early 2012 – the disappointing volumes of previous measures and the further decline in inflation, which turned negative in December 2014 for the first time in five years, prompted the ECB to further extend its asset purchase programme.

In January the ECB decided to buy 60 billion euros of securities every month starting in March 2015 until September 2016. The ECB will not only buy private sector debt, but will also purchase the central government bonds of euro area countries as well as, although to a lesser extent, bonds from European agencies and institutions. Central government debt will be bought according to the equity share of member countries in the ECB. This programme's goal is to increase the liquidity of banks and decrease the opportunity costs of lending by lowering the return on alternative investments. An additional incentive for banks to undertake further lending is the currently negative overnight deposit facility at the ECB. To avoid the sharing of hypothetical losses due to haircuts or the defaults of single countries, the majority of central government bonds will be bought by their respective central bank.

The ECB has now used up most of its options to further loosen monetary policy, and has urged the governments of the euro area countries to swiftly implement additional product and labour market reforms. Such reforms are necessary because monetary policy can only strike an accommodative stance, while it is down to individual governments to make improvements to the business environment for firms that will boost investment activity.

To what extent the extended asset purchases are legal according to the current treaties remains somewhat unclear. The government bond-buying Outright Monetary Transactions (OMT) programme launched in 2012 is currently being reviewed by the EU's highest court. The first report indicates that the programme is to be considered legal. This makes it more likely that the ECB's extended asset purchase programme will also be considered to fall within its mandate.

The situation in the money markets continued to ease further over the course of 2014. The money market spread between not-secured and secured loans in the money market currently stands at just over 0.1 percentage points, indicating increased confidence between banks (see Figure 1.18). At the height of the financial crisis in the autumn of 2008 and during the euro crisis at the end of 2011 and early 2012, the interest rate premium was sometimes above 1 percentage point. There is also growing evidence that cross-border interbank trade is increasing again, although the volume is still significantly lower than its pre-crisis levels. Increased transparency regarding the capital requirements of the largest banks in the euro area, as created by the Asset Quality Review and the ECB's bank stress test, will support the further normalisation of the interbank market. Compared to its predecessors, the latest banking stress test was both more extensive and restrictive. Nevertheless, not all doubts about the resilience of the banking sector have been allayed. In particular, it has not been investigated whether and how a prolonged deflation period would affect the stability of systemically important banks.

Bonds, stocks and foreign exchange markets

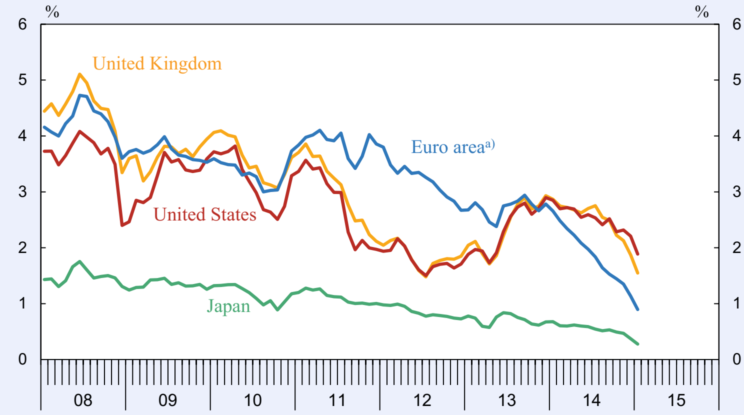
In bond markets yields have fallen due to the low inflation rates, the recent ECB decisions and in anticipation of further monetary policy measures. An extension of the asset purchase programmes of corporate and government bonds seems likely. Interest rates on ten-year government bonds fell substantially over the course of 2014 and, at the end of last year, stood at only 1.1 percent for the synthetic euro-area benchmark bond (see Figure 1.19). With the exception of Greece, yields on government bonds of crisis-afflicted countries continued their downward trend and within euro area disparities continued to abate (see Figure 1.20). Growing uncertainty regarding the future course of Greek policy as of October led to a substantial increase in the risk premium on Greek government bonds.

Yields on corporate bonds of any rating, and particularly on covered bonds, also decreased significantly. Although to a lesser degree, this also holds for firms located in countries with strong credit ratings. These covered bonds play an important role in bank finance and are currently trading at historically low levels.

However, the low funding costs of the banking sector are not yet reflected in the lending rates for non-financial corporations in the crisis countries. Since the beginning of 2012 these rates have varied between 3.5 to 5.5 percent, which is substantially higher than the rates that firms in highly creditworthy member states have to pay and comparable to the levels faced by the crisis-afflicted countries in 2005 (see Figure 1.21). This is due to both demand and supply-side effects. Firstly, the creditworthiness of many companies in the crisis countries is poor due to a deep recession and the

Figure 1.19

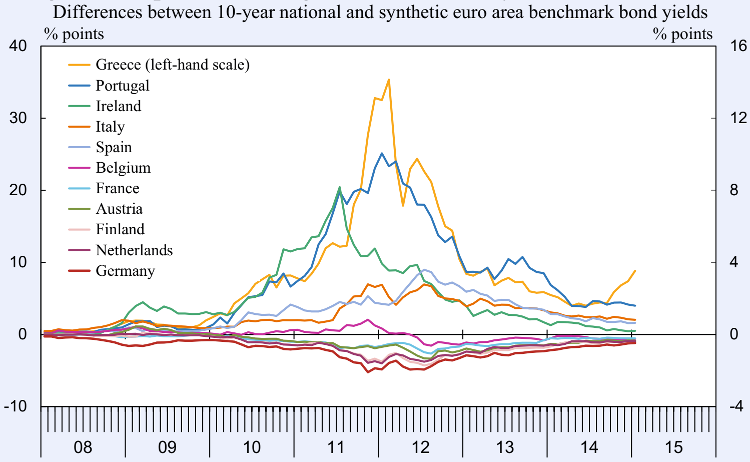
10-year government bond yields



[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 2015.

Figure 1.20

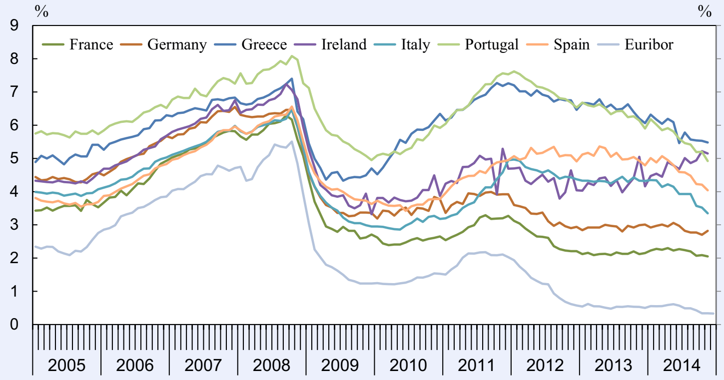
Regional disparties w.r.t. government bond yields in the euro area
Differences between 10-year national and synthetic euro area benchmark bond yields



Source: Datastream, last accessed on 31 January 2015.

Figure 1.21

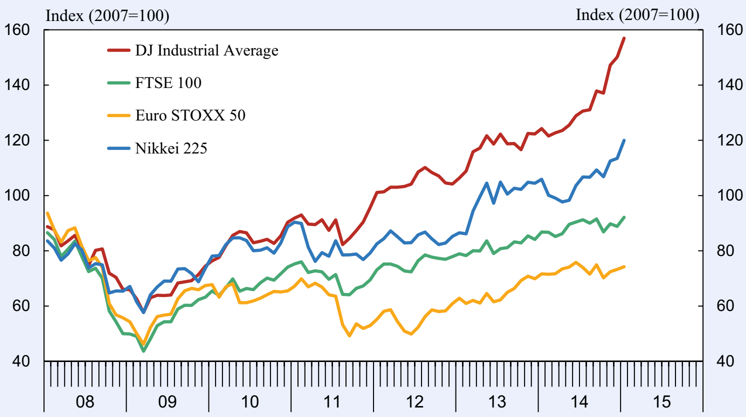
Interest rates on loans to businesses
in selected countries of the euro area[a)]



[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 31 January 2015.

Figure 1.22

Developments in international stock markets



[a)] Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2015.

bursting of credit bubbles, implying that the relatively high lending rates reflect appropriate risk premiums. Secondly, the fact that the lower refinancing costs of banks are not fully transmitted to lending rates for the non-financial corporate sector also points to supply-side constraints. Many banks in the crisis countries continue to hold high and still rising inventories of impaired loans, resulting in a reluctance to lend. A sustainable consolidation of bank balance sheets has still not been fully accomplished. This reluctance to lend is also reflected in the development of loan portfolios. Whereas the volume of outstanding loans in non-crisis countries has started to increase slightly, those in the crisis countries continues to shrink, albeit at declining rates.

All in all, financial conditions, for households and firms are likely to continue to remain favourable in Europe. In the euro area, monetary policy is further increasing its expansionary stance and interest rates will remain low. Differences between the crisis-hit countries and those that enjoy high credit ratings within the euro area, however, remain and are only slowly decreasing as the recovery of the former countries' banking sectors is still far from complete. Lending is therefore only likely to revive very slowly.

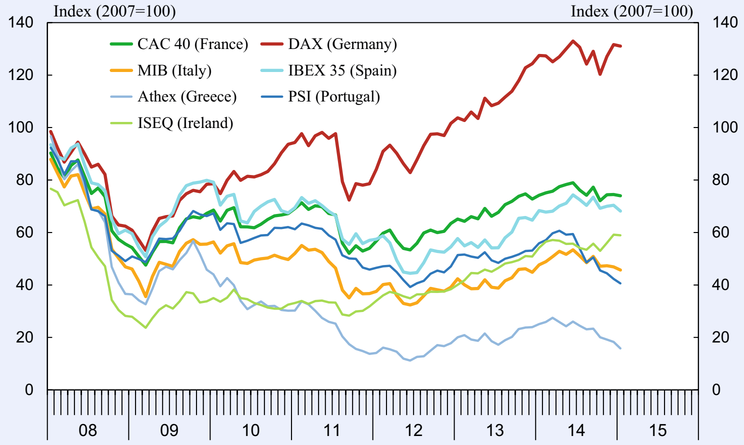
The international normalisation of risk preferences continued to shift asset allocation away from government bonds and towards other bonds, and particularly stocks. As a result, stock market indexes remained on the upward trend that they set in mid-2012, for the first half of last year at least (see Figure 1.22). Measured in local currencies, the Dow Jones industrial average, the Nikkei 225 and the Euro STOXX 50 improved by 10.3 percent, 11.8 percent and 4.8 percent respectively during 2014. The FTSE 100 was the only index that stagnated. The appreciation of the US dollar in particular, but also of the British Pound made the gains more pronounced from a euro area perspective.

When financial markets started to realise that the economic recovery in the euro area was not as buoyant as some had expected, some corrections did take place during the second half of last year (see Figure 1.23). In the end, the Athex (Greece) and the PSI (Portugal) witnessed overall declines of around 20 percent over the year. The Irish ISEQ, by contrast, experienced a gain of approximately 16 percent in 2014.

From spring last year onwards, the euro entered a clear depreciation course against the US dollar (see Figure 1.24). The increase in the growth differential between the United States and the euro area, combined with the prospect of even more diverging monetary policy regimes, has made the US dollar more attractive and the euro less so. A similar picture emerges when looking at real effective changes, i.e. when correcting for inflation differentials and weighting by ex-

Figure 1.23

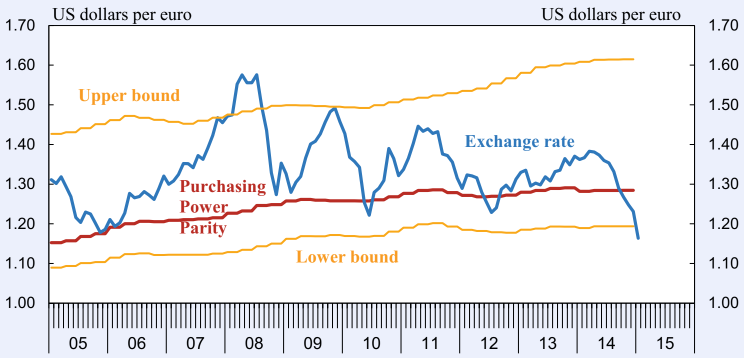
Developments of selected stock markets within the euro area



Source: Datastream, last accessed on 9 January 2015.

Figure 1.24

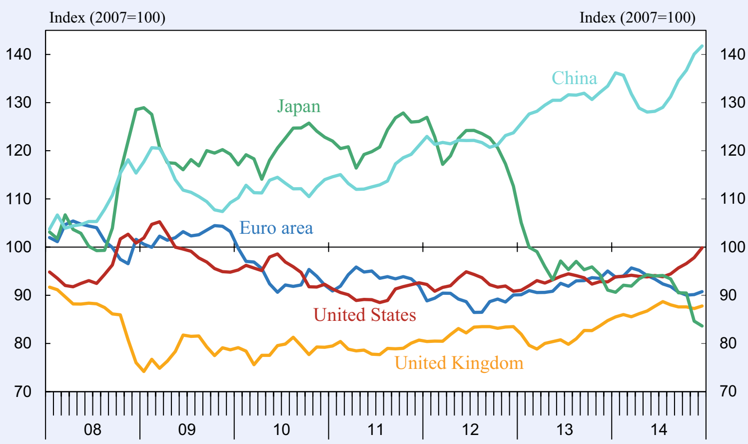
Exchange rate of the euro against the US dollar and PPP[a)]



a) The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The PPP upper bound represents the 75th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 25th percentile. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar.
Source: OECD Economic Outlook 96, November 2014, European Central Bank, last accessed on 31 January 2015.

Figure 1.25

Real effective exchange rates around the world



Source: Bank for International Settlements, last accessed on 31 January 2015.

port shares: there has been an overall clear depreciation of the euro since spring 2014, whereas the US dollar has been appreciating in real terms against the Unites States' major trading partners' currencies since mid-2014 (see Figure 1.25).

As far as the other major currencies in the world are concerned, the yen went through another depreciation phase from the summer of last year onwards. This was again largely triggered by further (expected) loosening of monetary policy in Japan. After an initial real depreciation phase prompted by monetary policy and ensuing movements in the nominal exchange rate vis-à-vis the US dollar during spring 2014, the real effective exchange rate of China started appreciating strongly again in 2014. This reflects both the somewhat higher inflation rate in China compared to most of its trading partners, and the newly set-in moderate appreciation of the renminbi against the US dollar.

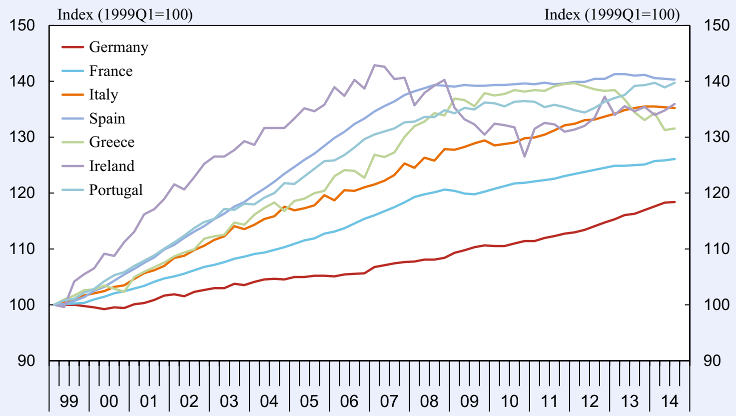
1.4 The macroeconomic outlook

1.4.1 Assumptions, risks and uncertainties

The poor economic shape of several euro area countries continues to pose a major risk to the global economy. Despite the structural reforms that have been carried out in Spain, Ireland, Portugal and Greece over the past three years, the necessary adjustments are far from complete, and numerous structural problems persist. This is reflected, among other things, in the slow pace of relative price adjustment (see Figure 1.26). In order to restore their

Figure 1.26

GDP deflators of selected countries in the euro area



Source: Eurostat and OECD, last accessed on 31 January 2015; EEAG calculations.

competitiveness within the euro area and keep their external debt at sustainable levels, former crisis countries must lower their relative prices. If they fail to do so, these countries remain fragile and vulnerable to changes in sentiment. The elections in Greece are a case in point. As a result, government bond yields for that country have clearly increased. However, at the time of writing, this effect has not spilled over to other countries (Spain, Portugal, France and Italy). So far at least, financial markets do not see a big risk of contagion from recent developments in Greece to other countries. Compared to 2012, the European Union now has more safeguards in place against possible contagion (bailout funds, commitment of the ECB as lender of last resort and a partial banking union), which appear to be credible. The ongoing reform gridlocks in France and Italy are also potentially worrisome. These impasses reduce the medium-term growth prospects of the two economies and could, in principle, give rise to doubts about their solvency in financial markets.

The low inflation rate in the euro area also remains a risk. Core inflation has steadily slowed from 2 percent at the end of 2011 to 0.7 percent by the end of last year. The longer the phase of low inflation persists, the greater the risk that inflation expectations will lose their anchor. This, in turn, could further increase downward pressure on inflation. In a scenario that is still to be considered extreme, the euro area could slip into deflation. A falling price level would increase the real value of nominal debt. Given the high public and private debt levels in many places in the euro area, this could be a heavy burden on growth. Currently, however, long-term inflation expectations for the euro area still appear to be quite well anchored. Furthermore, a substantial part of the current slowdown in inflation stems from falling energy and food prices. The core inflation rate adjusted for these components is currently more than twice as high as the overall rate of inflation and is most likely to average at around one percent this year. Furthermore, part of the reduction in inflation is to be endorsed as it reflects the structural adjustment that is taking place in the euro area. Structurally weak euro area countries are striving to improve their international competitiveness. This requires that the prices of their products increase less than elsewhere or even decline. Indeed, there are clear indications that (slow) progress is being made in labour costs and thereby competitiveness (see Table 1.2). All euro area countries have shown reductions in relative unit labour costs during the period 2010–2014, while these reductions have been more pronounced in the crisis-inflicted countries of Greece, Spain, Ireland and Portugal.

Further geopolitical risks relate to the ongoing conflict between Russia and the Ukraine and the Islamic threat in the Middle East. An escalation of the Russian-Ukrainian conflict could cause a spiral of mutual sanctions between Russia and the West and an increase in overall uncertainty. An escalation of the crisis in the Middle East could lead to an increase in oil prices given that this region is still one of the world's leading oil producers.

Finally, considerable risks are to be associated with the recent hikes in asset prices. The indices of some major stock markets rose sharply, despite the relatively weak global economy. In the United States, price-earnings ratios in 2014 reached levels last seen in the years 2006/2007. Hence, these ratios are very high by historical standards. Accordingly, it is possible that some segments are already overheated again. A sharp correction could worsen the wealth position of households and the financing conditions for firms, and thereby have negative implications for the world economy. Finally, in China there is a risk that the decline in housing prices, observed since the middle of last year, may accelerate. As the real-estate boom in the last five years was associated with a massive credit expansion,

Table 1.2

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	2010–2014	1999–2009	2010–2014	1999–2009	2010–2014	1999–2009	2010–2014	1999–2009	2010–2014	1999–2009	2010–2014	2014
Germany	1.0	2.5	0.1	1.0	0.3	1.2	0.7	1.5	– 1.2	– 0.7	0.3	1.3	1.3
France	2.7	2.0	1.1	1.1	0.7	0.9	2.1	1.0	0.4	– 0.8	– 2.1	– 0.4	– 0.4
Italy	2.2	1.2	– 0.2	0.1	– 0.4	0.1	3.1	1.1	1.5	– 1.0	– 3.8	– 0.6	– 0.5
Spain	3.5	0.2	0.2	0.0	0.5	1.6	3.7	– 1.5	2.1	– 3.3	– 1.1	0.9	0.9
Netherlands	3.3	1.7	0.9	0.7	0.8	0.6	2.4	0.6	0.9	– 1.6	– 0.4	0.0	1.4
Belgium	2.7	2.2	0.8	0.5	0.8	0.6	2.2	1.5	0.7	– 0.5	– 1.1	0.3	0.7
Austria	2.1	1.9	0.5	0.4	0.9	0.2	1.4	1.7	– 0.3	– 0.1	– 0.6	– 0.6	– 2.7
Greece	5.0	– 3.9	1.8	– 3.3	1.4	– 0.8	4.5	– 3.3	2.3	– 5.3	0.1	– 1.6	6.0
Finland	3.2	2.4	1.7	0.6	1.0	0.6	2.2	1.7	0.3	– 1.2	– 0.6	– 3.9	– 1.6
Ireland	5.2	– 0.9	2.4	– 1.3	1.7	1.9	3.8	– 1.0	2.7	– 3.2	2.4	1.4	9.3
Portugal	3.7	0.0	0.7	– 0.6	0.9	0.9	3.2	– 1.4[f)]	0.8	– 1.7	– 1.3	2.2	– 0.1
Slovakia	7.7	2.6	3.7	1.9	3.7	2.5	3.1	0.6	3.5	– 1.3	4.3	4.4	1.4
United Kingdom	4.1	2.1	1.8	0.0	1.2	0.7	2.8	0.9	– 1.4	0.8	– 1.3	– 2.3	– 4.6
Sweden	3.3	1.7	1.5	0.6	1.5	1.1	2.6	1.4	– 0.8	2.4	– 0.7	– 0.3	0.3
Denmark	3.6	1.5	1.3	– 0.3	0.6	0.9	3.0	0.8	1.5	– 1.7	0.0	– 2.3	– 1.5
Poland	5.5	3.1	1.8	1.3	3.7	2.5	2.3	1.2	– 0.7	– 0.2	2.6	1.8	1.0
Czech Republic	6.0	1.1	3.6	0.3	3.0	1.0	2.6	0.8	3.8	– 2.0	4.5	2.2	5.2
Hungary	8.5	1.7	2.3	– 0.9	2.5	0.3	6.5	2.1	3.4	– 1.9	5.5	0.7	3.9
Iceland	6.7	5.6	1.3	2.8	2.4	0.1	4.9	5.1	– 3.7	5.1	1.5	– 0.3	0.8
Norway	5.0	3.3	– 0.1	– 0.6	0.6	0.2	4.5	3.8	2.7	2.4	– 3.2	– 4.5	– 2.5
Switzerland	1.7	0.6	0.7	0.5	0.8	0.4	1.3	0.3	0.3	2.6	– 1.1	– 0.8	– 13.3
Japan	– 1.3	0.1	– 0.1	0.9	0.7	1.4	– 1.5	– 0.8	– 1.8	– 5.6	– 3.4	– 0.6	4.9
United States	3.7	1.8	1.5	0.2	1.8	1.2	1.9	1.3	– 1.6	– 0.8	– 1.8	– 0.6	0.5
China									3.9	4.6	12.5	5.0	3.7

[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. – [f)] Covers the period 2010–3.

Source: OECD Economic Outlook No. 96, November 2014.

a stronger than expected correction could weaken the Chinese economy more than forecast. As China is the world's second largest economy, this would also negatively impact our outlook for the world economy.

This forecast is based on the assumption that a barrel of Brent crude will cost 60 US dollars this year on average, after reaching a price close to 100 US dollars on average in 2014. Exchange rates are assumed to fluctuate around their values observed in recent months, which implies that the euro will trade at around 1.20 US dollars.

1.4.2 The global economy

The global economic slowdown has become evident since mid-2014 in the significant reduction in the Ifo World Economic Climate, as well as in a variety of other national indicators. The economic expectations derived from the Ifo World Economic Survey suggest that the global rate of expansion this winter season will remain subdued, despite some improvement (see Figure 1.27).

The fall in oil prices during the last quarter of 2014 is likely to be an additional factor supporting global economic developments this year. Lower oil prices are mainly likely to benefit oil consumers such as the advanced economies, as well as China, India and the economies of East Asia. In these countries the energy costs of households and firms will decline relative to their income. For oil-exporting countries like Brazil, Russia and many economies in the Middle East, the strong decline in oil prices means a loss of national income.

The cheaper oil price is supporting the slow, but steady acceleration in the advanced economies, which, in turn, is allowing the world economy to slowly gain momen-

Box 1.1

Revision of the System of National Accounts

In Europe, a general revision of the System of National Accounts (SNA) took place last year. From the third quarter of 2014 onwards, European countries started to generate national account statistics using the so-called European System of Accounts 2010 (ESA 2010), which is based on the System of National Accounts (SNA 2008) as developed by the United Nations. The previous version (ESA 95) was discontinued after the release of figures for the second quarter of 2014. Unless mentioned differently, this chapter uses ESA 2010 (or SNA 2008) figures throughout.

As compared to the previous system, the quantitatively most significant change relates to the accounting of research and development (R&D) expenditure. Previously, R&D expenditure by firms was treated as an intermediate input and, as a result was not directly included in GDP. Now this is treated as investment activities and therefore directly enters into gross fixed capital formation, which in turn is, via the national income account identity, part of GDP. Consequently, the R&D expenditure of firms directly increases GDP. The government's R&D expenditure was previously part of government consumption. This, like public investment, is now also recorded as part of gross fixed capital formation. Public consumption spending thereby declines to the same extent. Overall, GDP is therefore not affected by this change in the year it is spend. However, this will lead to an increase in GDP in the following years. Gross value added of the public sector is determined from the cost side. As the depreciation of R&D expenditure increases – in a bookkeeping sense – costs, this will lead to an increase in GDP.

Another GDP-effective amendment relates to the assignment of military goods in national accounts. According to the previous ESA 95, military equipment that can be used by civilians (such as barracks) were recorded as fixed capital investment. All other military equipment (such as tanks) were recorded as an intermediate input and thereby increased government consumption. In the new system, military weapons systems that are used for more than one year are counted as assets and their acquisition is recorded as investment. This reflects the fact that weapons are used continuously for the provision of security services. As with public R&D expenditure, the acquisition of these military goods is GDP-neutral in the year of acquisition. In the following years, GDP increases due to depreciation on these weapons systems.

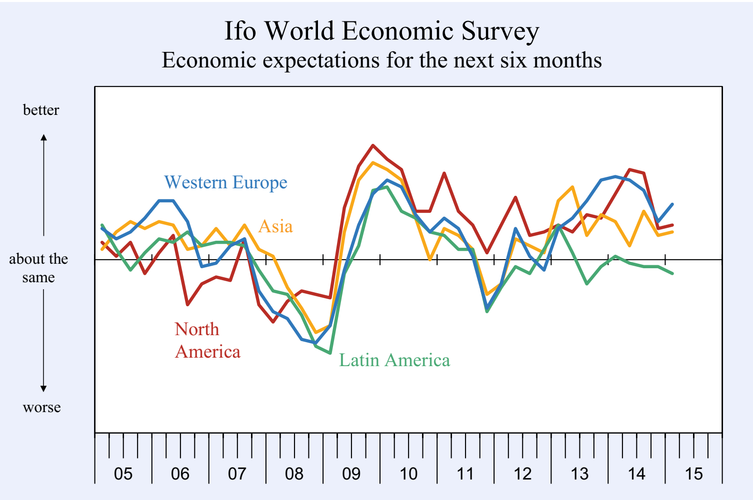
Furthermore, the definition of economic sectors has been changed in certain situations. In general, it appears that more economic units are allocated as part of the government sector. On the expenditure side, this means that a GDP-neutral shift in the consumption of private organisations towards that of the government sector has taken place.

Another innovation is the recording of goods sent abroad for processing without change of ownership (and vice versa). Previously, these goods were reported as exports when shipped and as imports on their return, with an increase in value as a result. According to ESA 2010, only the import of value added is now recognised. Several other smaller changes relate to insurance and pension payments. Furthermore, a harmonisation of the kind of illegal activities accounted as part of GDP took place.

All in all, this revision led to an increase of 3.3 percent on average in nominal GDP in the euro area during the period 1995–2013. Thanks to the revision, the investment share of GDP increased by 1.4 percentage points on average. The private and public consumption share decreased by 0.9 and 0.5 percentage points respectively. Both import and export shares declined by 1.9 percentage points on average, leaving the contribution of net exports basically unchanged. The deficit and debt ratios of the public sector have, in general, fallen slightly.

Not all countries have been affected to the same extent. Whereas all countries have, on average, seen an upward revision in the level of GDP (albeit not in every year), the average growth rate has declined for some countries (e.g. Germany, Italy and Greece). The level shifts also differ. In particular, the Netherlands, Italy and Ireland now have a larger share of euro area wide GDP. Germany, France, Spain and Greece have lost some relative importance.

Figure 1.27

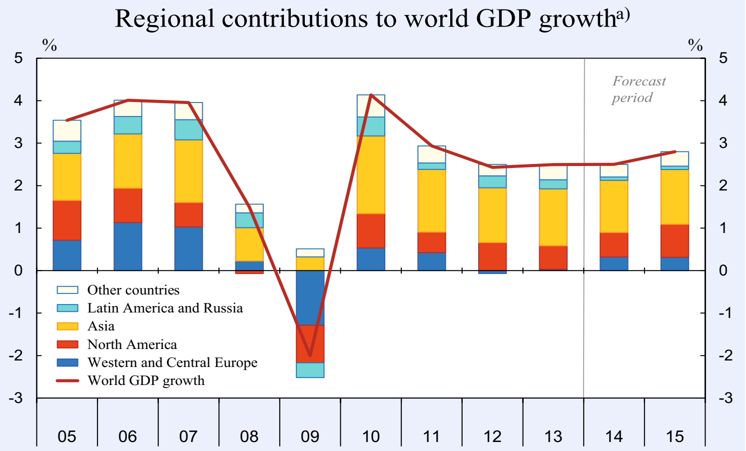


Source: Ifo World Economic Survey I/2015.

tum. The recovery in North America in particular, largely driven by the United States, is expected to continue resulting in its strongest growth contribution since the start of the global financial crisis (see Figure 1.28). In India, as well as several emerging countries in Latin America, aggregate production growth is likely to pick up somewhat during the forecast period. Numerous structural problems, on the other hand, will act as a brake on growth in important advanced economies (euro area, Japan), as well as in some major emerging economies (Brazil, Argentina). The Chinese economy is expected to see a somewhat lower growth rate, as intended by the political leadership. All of this will make the growth contributions coming from these regions roughly comparable to those of last year.

In the United States, domestic demand will provide for a strong recovery during the forecast period. The improved financial situation of households and enterprises, increasing improvements in the labour and housing market, the expansionary monetary policy, and the decreasing restrictiveness of fiscal policy in the United States are all of importance. In addition, the sharp fall in energy and commodity prices will support the economy overall.

Figure 1.28



a) Based on market weights.
Source: IMF; EEAG calculations. 2014 and 2015: EEAG forecast.

emergent restrictive fiscal policy, the recent fall in the real income of private households, as well as structural weaknesses such as a shrinking workforce, strong segmentation in the energy and service sectors, as well as over-regulation and rigidness in labour and product markets do not allow for more than a slow recovery.

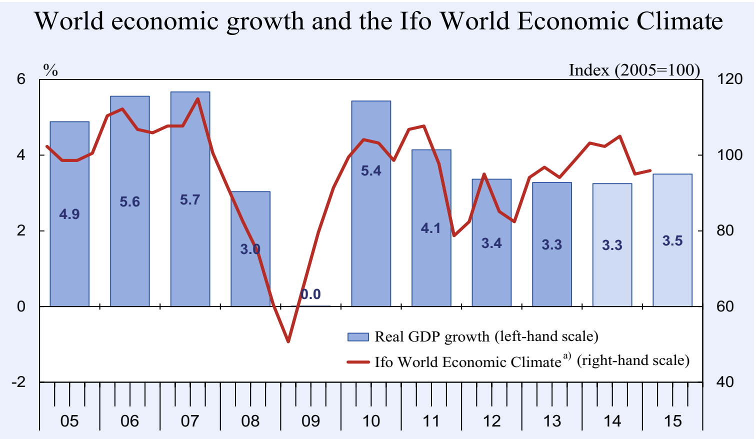
The pace of growth in the emerging economies in 2015 will be comparable to last year. A number of structural factors will cause growth to remain below levels seen during the decade before the global financial crisis. Financing conditions are also expected to continue to deteriorate, because long-term interest rates in the United States will increase with the ongoing recovery, which will make emerging economies less attractive for many global investors. Nevertheless, China's economy is expected to remain resilient and India should expand dynamically. Only the commodity-exporting economies of Latin America and Russia are likely to go through a period of economic weakness due to the sharp fall in commodity prices. In addition, Russia is likely to suffer from economic sanctions and a sharp withdrawal of foreign capital triggered by the Russian-Ukrainian conflict.

In the United Kingdom strong growth in domestic demand is the primary cause driving the robust recovery. In the euro area, the recovery will probably also continue during the forecast period, albeit at a much slower pace than in the United States or the United Kingdom. The economy of the euro area will benefit from not very restrictive fiscal policy, more expansionary monetary policy and the decline in energy prices. In addition, the depreciation of the euro is likely to support exports to the rest of the world. However, many member countries of the euro area continue to suffer from massive structural problems that will weigh heavily on economic development. In many places the banking sector is still inadequately capitalised, the debt of households and firms remains high, international competitiveness is relatively low, and product and labour markets are still not very flexible. While some countries (Spain, Ireland, Portugal and Greece) are implementing some structural reforms, and are thereby increasing their attractiveness and competitiveness, the Irish case – in which many reforms were initiated in 2009 – shows that it takes time before such reforms can bear fruits. In France and Italy, however, many much-needed reforms have so far failed to materialise. Accordingly, these countries are expected to hardly expand at all over the forecast period and may therefore prove a heavy burden on growth within the monetary union.

In Japan, the pace of expansion is expected to remain low this year. Although monetary policy remains very expansionary, the

All in all, and largely driven by the continuing recovery in the United States, world GDP will increase by 3.5 percent this year, after 3.3 percent in 2014, when using purchasing-power-parity adjusted weights to aggregate the economies (see Figure 1.29). Using

Figure 1.29



a) Arithmetic mean of judgements of the present and expected economic situation.
Source: IMF, World Economic Outlook, November 2014; GDP 2014 and 2015: EEAG forecast; Ifo World Economic Survey I/2015.

market prices, world economic growth will reach 2.8 percent this year, after 2.5 percent in 2014. Accordingly, world trade is expected to have expanded by just 2.6 percent in 2014. Although it will remain subdued from a longer-term perspective, its growth rate will manage to rise to 4.0 percent this year (see Table 1.A.1).

Due to robust growth in domestic demand, the current accounts of most emerging economies will continue to deteriorate. In the euro area, however, the gradually improving export performance of some member countries and their rather moderate domestic economic expansion will lead to an improvement in the current account balance. The current account deficit of the United States is likely to remain virtually unchanged. Rising growth in the imports of goods and services in the United States are almost fully compensated for by a further expansion of gas and oil exports.

1.4.3 United States

After fiscal policy turned restrictive again during the winter of 2013/14, it took a more neutral stance in the course of last year. During the summer half, public spending contributed significantly to the increase in gross domestic product. Over the past two years, both spending cuts and cyclically higher tax revenues have led to a significant reduction in the budget deficit. As a result of the Republican majority in Congress and a Democratic president, no further significant consolidation efforts are to be expected until the next presidential election in 2016. Hence, the federal budget deficit is only going to improve slightly for cyclical reasons. For the fiscal years 2014 and 2015 it is expected to be 2.8 percent and 2.7 percent of gross domestic product respectively.

Despite significant improvements in the labour market, the Federal Reserve is only slowly abandoning its ultra-loose monetary policy stance. The low inflation rate and the high vulnerability of international capital markets are prompting the Federal Reserve to move cautiously. Last year the Federal Reserve reduced the volume of its purchasing programme for mortgage-backed securities and government bonds stepwise from 85 billion US dollar a month in December 2013 to zero in October 2014. However, the US central bank will still refrain from bringing its balance sheet back to pre-crisis levels – and until further notice it will replace expiring papers with new ones. Regarding future interest rate policy, the projections of the members of the relevant Federal Open Market Committee suggest that the target for the federal funds rate will be raised for the first time in the first half of this year from its current low of 0–0.25 percent. The federal funds rate is expected to reach a level of about 1 percent by the end of 2015. Hence, monetary policy will become less expansionary, although the continued negative real short-term interest rates will continue to stimulate the economy.

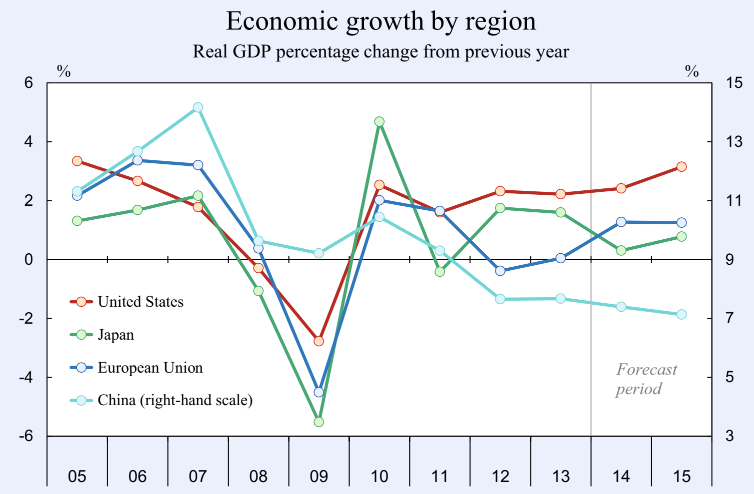
Survey-based economic indicators suggest that during the winter private consumption and machinery and equipment investment continued to show high rates of expansion. Ongoing improvements in the labour market and the substantial fall in oil prices will support private consumption and boost the economy as a whole. Manufacturing activity is showing signs of gathering pace and improved business confidence will further support investment activity. The growth contribution of net exports, on the other hand, is expected to show a gentle slowdown. Weak growth abroad and the increased value of the US dollar will dampen US export growth. Furthermore, previously weak import demand will normalise. Nevertheless, the overall rate of economic expansion should remain strong, since low inflation and strong labour market developments are about to support real disposable income and thus private consumption. In addition, after a year in which construction investment developed only weakly and remained well below historically normal levels, it should be able to contribute to an improvement in the growth rate once again.

All in all, real GDP growth of 2.4 percent in 2014 will accelerate to about 3.2 percent this year (see Figure 1.30). Both the oil price shock and the stronger US dollar will allow the inflation rate to slow down from 1.7 percent in 2014 to 1.1 percent this year (see Table 1.A.1). Finally, the unemployment rate, which averaged at 6.2 percent last year, is expected to decline further to 5.5 percent on average in 2015.

1.4.4 Asia

In *China* a further weakening of the real-estate market will lead the authorities to increase its infrastructure investment. The National Development and Reform Commission of China already approved several new major construction projects at the end of last year, in-

Figure 1.30



Source: BEA; Eurostat; ESRI; National Bureau of Statistics of China; 2014 and 2015: EEAG forecast.

cluding 16 railway stations and 5 airports. This will provide additional impulses to construction to countervail the weakening property market.

The People's Bank of China has reacted to the recently economic slowdown and fall in inflation by easing liquidity conditions for regional banks in particular. In November last year, it also lowered its base interest rate by 0.4 percentage points to 5.6 percent. The inflation rate in November last year was only 1.4 percent, the lowest level since November 2009 and well below the official inflation target of 4 percent.

On the one hand, the low inflation and the weakening of construction activities might induce the central bank to increase its expansionary efforts. On the other hand, defective developments in the real-estate sector in the past may move to the foreground. Above and in comparison to historical standards, lending by shadow banks to domestic building investors has increased very sharply in recent years. The central bank may therefore attempt to tighten lending in this area to counteract further misallocation. Steps towards further liberalisation of household savings rates in November 2012 also point in this direction: allowing banks to set savings rates more freely will, at least in the longer run, lead to more competition between banks, lower banks' mark-ups and raise saving rates (although it will not necessarily lead to higher lending rates for firms). This will make real-estate investments less attractive, thereby reducing the aforementioned misallocation.

For the forecast period a variety of indicators suggest that the pace of growth will continue to gradually slow down. Industrial production began to decelerate in recent months. In addition, survey indicators have weakened. However, strong forecast consumer demand and the still abundant scope of fiscal policy to act make it unlikely that there will be any significant economic slowdown in China. All in all, after growth of 7.4 percent in China's real GDP in 2014, it will expand by 7.1 percent this year.

In October 2014, the Bank of *Japan* further relaxed its expansionary monetary policy. In order to achieve its inflation target of 2 percent, it increased the annual purchase volume of government bonds and exchange-traded funds (ETFs) by 10 trillion yen to 80 trillion yen (which amounts to about 16 percent of GDP). These additional measures are intended to suppress the already very low long-term interest rates further and prevent a further fall in the inflation rate.

The loose monetary policy of the central bank is likely to have contributed significantly to the depreciation of the yen, which has lost about 30 percent of its real value in the past three years (see Figure 1.25). A marked increase in exports as a result of this improvement in competitiveness is, however, not likely, at least in the short term. Firstly, large companies have already moved a significant part of their production capacities abroad and therefore can only partially benefit from the devaluation. Secondly, the costs of imported inputs have increased significantly due to the devaluation. For many, especially small and medium-sized companies, this has a dampening effect on earnings and inhibits the production and export of goods and services.

Fiscal policy will become more restrictive over the course of 2015. Although the government has postponed the next increase in value added taxes, originally planned for October 2015, for one and a half years, no further stimulus measures are scheduled after the end of the last programme.

Overall, economic growth will remain low in Japan. Declining real household incomes are likely to continue to weigh on consumer spending. In addition, the disappointing structural reforms initiated by the current government mean that corporate investments will continue to stagnate. Structural factors (shrinking population, rigid labour markets with lifetime employment contracts, over-regulation in many product and service markets) remain a drag on growth. Overall, output is expected to rise by about 0.8 percent this year, after 0.3 percent in 2014. Inflation should lie at around 2.0 percent this year, versus 2.8 percent in 2014.

Although fiscal policy in *India* is likely to remain focused on consolidating the government's budget, it will not increase its degree of restrictiveness any further this year. On the one hand, the government is planning to cut various subsidies such as those on fuel in order to reduce the state budget deficit. On the other hand, however, significant public investments to improve India's ailing transport and energy infrastructure have been announced. Although the inflation rate has managed to fall below the inflation target of 6 percent, the restrictive stance of monetary policy is not expected to diminish. The fall in inflation since the beginning of 2014 was mainly due to the strong slowdown of inflation in food prices, whose fluctuations are usually substantial, but purely temporary.

A variety of leading indicators suggests that the Indian economy has continued to pick up during these winter months. Growth is expected to accelerate slightly due to robust domestic demand, and despite deficient infrastructure and the recent rise in refinancing costs. The increased business confidence and the planned expansion of public spending on infrastructure is likely to boost aggregate investment. Private consumption is expected to benefit from rising real incomes. Consumption growth will therefore be able to accelerate. All in all, real GDP will grow by 7.1 percent this year after 6.1 percent in 2014.

Economic growth in the group of Asian Tiger countries *(South Korea, Taiwan, Hong Kong and Singapore)* is expected to accelerate somewhat this year, fuelled mainly by domestic demand. Private consumption and investment will benefit from a brightening of labour market conditions and the improved financial situation of households and firms. A more expansionary fiscal stance in Hong Kong and South Korea will further strengthen domestic demand this year. Furthermore, exports will continue to expand at a rapid pace, especially given the expected robust recovery in the United States. The outlook for the emerging Asian countries *(Indonesia, Thailand, Malaysia and the Philippines)* is rosy. Thanks to accelerating domestic demand and an increase in trade flows between the countries of this region, the pace of economic growth is expected to continue to increase. When these two groups of countries are taken together, real GDP is expected to expand by 4.3 percent this year after 3.8 percent in 2014; while inflation is expected to accelerate from 3.4 percent last year to 3.8 percent in 2015.

1.4.5 Latin America and Russia

There are signs of a slow economic recovery in the Latin-American region *(Brazil, Mexico, Argentina, Venezuela, Columbia* and *Chile)* this year. After industrial production in most countries declined for several months in a row, a return to more positive developments has been seen recently. Although this suggests that the worst is over, overall economic growth is expected to increase only slightly this year, with the two economic heavyweights of the region, Brazil and Argentina, despite some forecast improvements, still falling far short of their past growth performance. Whereas Brazil continues to suffer from its unresolved structural problems (high tax burden, bureaucracy and infrastructure bottlenecks), in Argentina unfavourable economic conditions (such as import and capital controls), high inflation and the technical default of last summer are dimming the outlook for this year. Furthermore, as long as Argentina fails to reach an agreement with those creditors who have not been rescheduled after the 2001-default (the so-called Holdouts), the financing of further deficits will prove difficult. More than ever, the government is likely to depend on monetising its government debt, which will continue to fuel the already high inflation rate. Venezuela continues to suffer from the recent fall in oil prices. Inflation will continue to soar and the economy is in a recessionary state. Mexico and Colombia, which saw relatively high growth rates last year, will lead the region in the year ahead as well. Mexico, in particular, will benefit from the upturn in the United States. Business sentiment in the manufacturing sector has brightened significantly from the middle of 2014 onwards, with comprehensive reforms paving the way for a higher long-term growth rate. Overall, the region's growth rate is expected to reach 2.0 percent in 2015.

In *Russia*, the value of the rouble is likely to remain under pressure as the withdrawal of capital is expected to continue. About half of Russian state revenues stem from the export of raw materials. Whereas the fiscal accounts are denominated in depreciating roubles, its oil exports are invoiced in an appreciating dollar. The depreciation of the rouble is therefore cushioning commodity price related losses in the state budget.

There are, however, also substantial risks and costs associated with the rouble devaluation. For instance, the burden associated with debt denominated in foreign currencies increases. About three quarters of Russia's foreign debt, which amounted to 731 billion US dollars mid-2014, is denominated in foreign currencies. The largest debtor is the corporate sector (216 billion US dollars), followed by the banking sector (170 billion US dollars). The solvency of the banking sector is currently, in principle, backed up by the central bank, which has foreign currency reserves amounting to 420 billion US dollars (in early December 2014). The ratios of total external debt (foreign and local currency) to exports (35 percent) and to GDP (123 percent) are also below the thresholds that the World Bank considers problematic. Although for some individual debtors, especially in the corporate sector, liquidity problems might occur, an area-wide default is not to be expected this year.

This year, Russia is likely to slide into a recession. The strong fall in energy prices will reduce export revenues, which in 2012 and 2013 contributed significantly to overall economic growth and, in general, to the financing of the state budget. The continued devaluation of the rouble will increase the cost of imports and thus lead to a further increase in inflation. Thus, private consumption is hardly likely to expand further. As a result of the rise in inflation, the central bank will continue to increase its key rate. The unfavourable financial conditions will further dampen investment. This will be partially offset by an increase in government investment, which could be financed out of the National Wealth Fund, the volume of which amounts to about 82 billion US dollars or 5 percent of Russian GDP. International capital markets on the other hand will initially remain virtually closed for both state and industry. Stimuli are expected from industrial production as a result of the import substitution policy. If these stimuli are strong enough, the Russian economy may avoid a recession. However, the downside risks associated to further capital withdrawals and the wider implications of the oil price collapse effectively outweigh such an upside scenario.

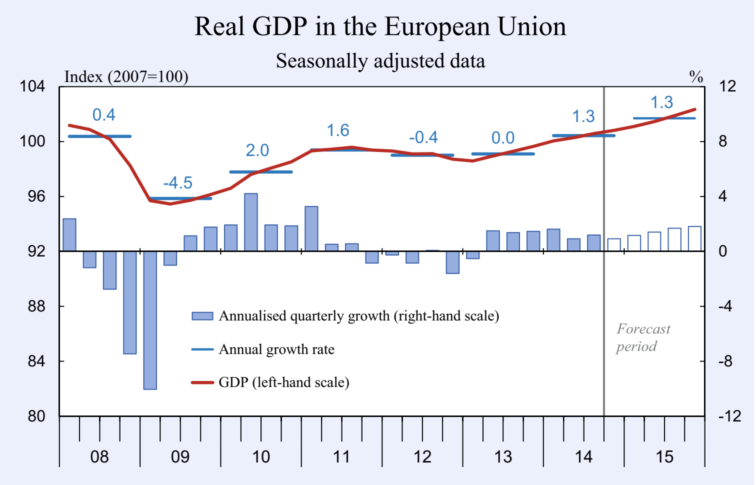
1.4.6 The European economy

The cyclical situation

The economic recovery in Europe, and particularly in the euro area, is expected to continue this year. However, there is still no real upswing in sight, as shown by the confidence indicators of the European Commission (see Figure 1.10) and the results of the Ifo World Economic Survey (see Figure 1.27 and Appendix 1.B), the latter of which sharply deteriorated during the second half of last year. The pace of expansion is likely to increase only slightly in the coming quarters, and to remain well below previous recoveries, partly because numerous structural problems in the euro area remain unresolved. For the European Union, we expect a growth rate of 1.3 percent this year (see Figure 1.31), while the rate for the euro area is forecasted to be 0.9 percent.

Both investment and private consumption are likely to increase slightly in the near future. The former will also benefit somewhat from the less restrictive lending practices of the banking sector. The completed review of the asset quality of banks by the ECB has strengthened confidence in the stability of the banking sector somewhat. This has a positive impact on private investment. However, the high and still rising debt ratio of the corporate sector will continue to have a damp-

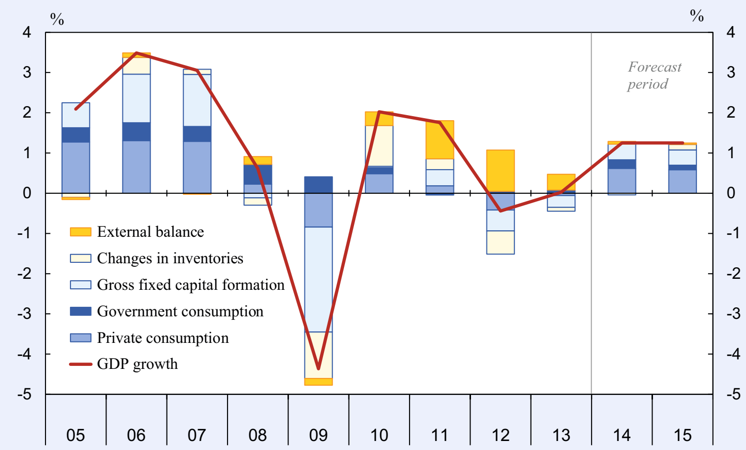
Figure 1.31



Source: Eurostat; EEAG calculations and forecast.

Figure 1.32

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



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

ening effect on the supply of credit. As a result of geopolitical conflicts, uncertainty grew over the course of 2014. This will fade gradually, prompting firms to pick up deferred investment projects. In addition, rising demand will gradually allow firms to also think about increasing capacities in addition to carrying out replacement investments.

Private consumption is expected to continue to benefit from the extremely low price increases that free up the budgets of households. More specifically, the sharp drop in energy prices will increase real disposable income. Furthermore, continued favourable financing conditions in some member states will make the purchase of durable consumption goods appear attractive. However, many households – especially those in crisis-hit countries – are forced to spend a significant portion of their disposable income on servicing existing debts. This will, at least partly, counteract positive impulses.

As consolidation efforts have come to a virtual standstill in many member states and no new restrictive measures are expected to be taken, fiscal policy will be neutral this year. Net exports will contribute positively as external demand, particularly from the United States, is likely to pick up gradually. The large increase in the value of the US dollar relative to the euro in recent months makes it attractive for US firms and consumers to import goods and services from the euro area. However, since imports into the euro area are also expected to grow stronger, the growth contribution of net exports will fall significantly short of that in previous recoveries (see Figure 1.32).

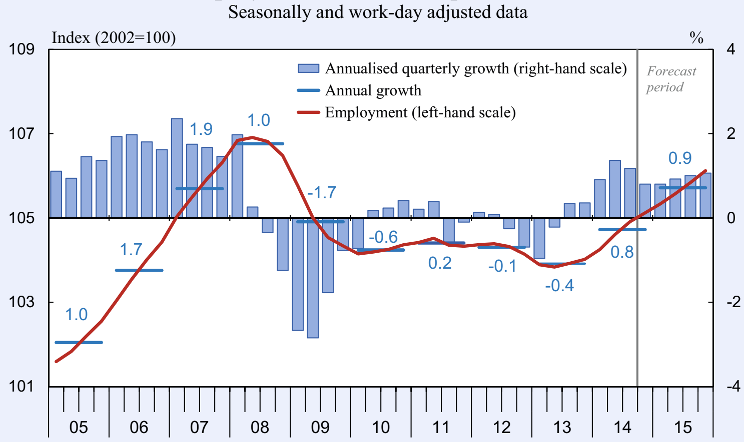
Although employment did pick up both in the euro area and in the European Union, the labour market situation is likely to remain tight and not to gain further speed during 2015 (see Figure 1.33). Despite promising reforms that have been launched by some member states aimed at reducing rigidities in the labour market and thereby structural unemployment, it will take time for these reforms to take their full effect. In addition, the economic recovery is too slow to bring about a sustainable reduction in cyclical unemployment. All in all, the average unemployment rate for 2015 is forecast to be 9.9 percent, after 10.2 percent last year (see Figure 1.34).

Since the underlying trend remains weak, the negative output gap will hardly be reduced this year. Inflation is therefore likely to remain low and only increase gradually. After 1.3 percent on average in 2013, the euro area inflation rate has fallen to 0.4 percent last year and will on average reach 0.4 percent again this year, implying a steady increase over the course of the year. This forecast is based on stable oil and food prices and a fairly constant euro / US dollar exchange rate.

Figure 1.33

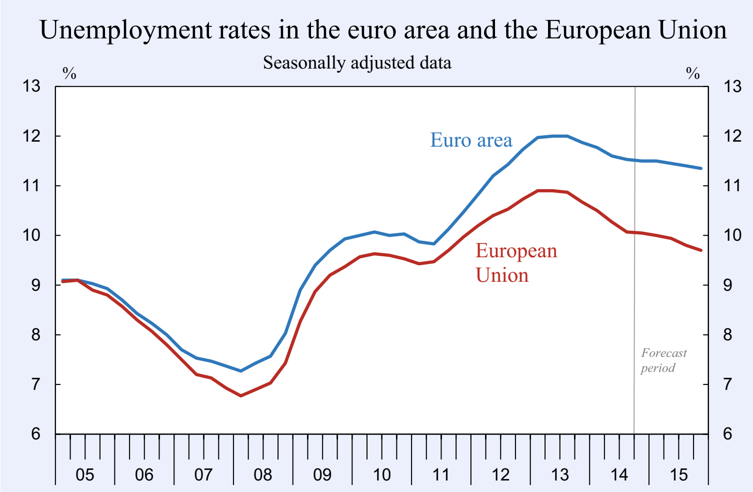
Employment in the European Union

Seasonally and work-day adjusted data



Source: Eurostat; EEAG calculations and forecast.

Figure 1.34



Source: Eurostat; EEAG calculations and forecast.

Differences across Europe

After a trough in growth during summer last year, the economy of Germany is expected to regain momentum again. Several indicators show that total output in the final quarter of 2014 is likely to have increased slightly. Seasonally adjusted production in the manufacturing sector rose during the final months of the year. Both domestic and foreign incoming orders have risen again. The sharp decline in crude oil prices creates terms-of-trade gains that increase purchasing power and thereby overall demand. Consumer confidence maintained an upward trend, indicating that private consumption will continue to support economic growth going forward.

Like Germany, *France* will also go through a weak phase before the recovery sets in again this winter. The latter will be driven by some improvements in construction activity and a slight acceleration of investment. France's low level of competitiveness and capacity utilisation will keep real GDP growth well below the euro area average at 0.4 percent. Accordingly, inflation will also fall below the euro area average to reach 0.3 percent on average.

In light of weak inflation dynamics in the *United Kingdom*, the Bank of England is expected to continue to keep its monetary policy expansionary and only raise its official bank rate from its historic low of 0.5 percent by the second half of 2015.

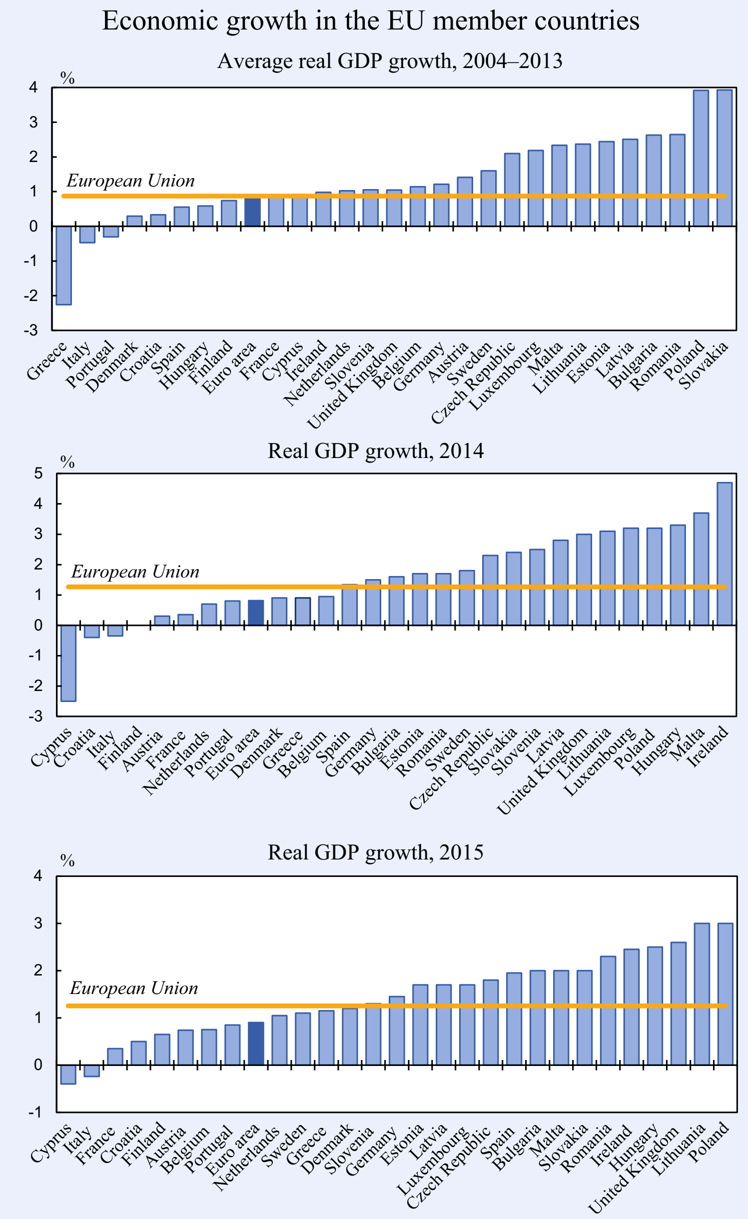
The leading indicators speak for some weakening of economic dynamics in these winter months. Although still at a high level, both consumer and business confidence have weakened slightly in the dominant services sector, trade and construction. The industry climate, however, has brightened up further. Overall, the British economy is expected to continue its strong growth sequence, although the recovery is likely to slow gradually in the face of a closing output gap. In 2014, gross domestic product is expected to grow by 3.0 percent, and by 2.6 percent in 2015 (see Figure 1.35). Thus foreign trade will continue to have a dampening effect because the pound has appreciated in terms of the nominal effective exchange rate by almost 10 percent since the spring of 2013, and demand from the euro area, the main trading partner of the United Kingdom, is likely to remain limited due to local economic weakness. The unemployment rate will continue to decline, although at a slower pace than in previous months. On average, it is expected to be 6.2 percent for 2014 and 5.5 percent in the following year. Inflation will probably accelerate slightly over the course of the year, staying below the 2 percent target of the central bank, and will reach the same average of 1.5 percent as last year.

In the course of 2015 *Italy* will move out of recession. The major impetus for GDP growth will have to come from foreign trade. A domestically induced recovery looks improbable, given the structural and political problems that the country faces. Subsequently, however, these impulses might lead to improvements in private consumption and investment. All in all, this will nevertheless not be enough to turn the average growth rate of real GDP positive in 2015. Inflation will remain low this year at an average rate of 0.2 percent.

Business sentiment in *Spain* suggests that the manufacturing sector will be able to gain further momentum. The real-estate sector also seems to have reached its trough, with housing prices starting to stabilise last year. Renewed consumer confidence, a looser fiscal position and improved productivity will support growth in 2015. After 1.3 percent in 2014, growth will pick up to reach 2.0 percent on average this year. This will allow the average unemployment rate to slowly fall to 23.0 percent on average in 2015.

Albeit somewhat weaker, a continuation of the economic recovery is emerging in the *Central and Eastern European* region. No real stimuli are to be expected from foreign trade. Although price competitiveness has recently improved in many countries in the region, weak economic developments in the euro area will hamper exports. Furthermore, Russia's sanctions against the European Union and the Russian import substitution programme are heavily affecting Poland, where the share of exported goods to Russia amounted to 8 percent of total exports in 2013. With the exception of Croatia, positive impulses are expected from domestic demand in all countries of the region. The decline in unemployment and low inflation will further support the purchasing power of consumers. Given the low inflation rates, central banks are expected to introduce further interest rate cuts. This will have a positive impact on investment dynamics in the region. Leading indicators suggest that the expansion of industrial production, especially in the Czech Republic and Hungary will continue. Fiscal policy will become less restrictive than in previous years in many places, including the Czech Republic, Romania and Poland.

Figure 1.35



Note: Data for Lithuania start in 2005.
Source: Eurostat, last accessed on 31 January 2015; 2014, 2015: EEAG forecast.

References

European Central Bank (2010), "Euro Area Statistics, Technical Notes," *Monthly Bulletin*, December.

Appendix 1.A
Forecasting tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP	GDP growth			CPI inflation			Unemployment rate[d)]		
		in %						in %		
	in %	2013	2014	2015	2013	2014	2015	2013	2014	2015
Industrialised countries:										
EU 28	26.6	0.0	1.3	1.3	1.5	0.6	0.6	10.8	10.2	9.9
Euro area	19.4	– 0.5	0.8	0.9	1.3	0.4	0.4	12.0	11.6	11.4
Switzerland	1.0	1.9	1.9	1.9	– 0.2	0.0	– 1.4	4.4	4.6	4.4
Norway	0.8	2.0	2.2	1.9	2.1	2.1	2.1	3.3	3.2	3.2
Western and Central Europe	28.4	0.1	1.3	1.3	1.4	0.6	0.7	10.6	10.0	9.7
US	25.9	2.2	2.4	3.2	1.5	1.7	1.1	7.4	6.2	5.5
Japan	9.5	1.5	0.3	0.8	0.4	2.8	2.0	4.0	3.6	3.5
Canada	2.9	2.0	2.3	2.5	1.0	1.9	1.5	7.1	6.9	6.7
Industrialised countries (total)	**66.6**	**1.2**	**1.6**	**2.0**	**1.3**	**1.4**	**1.0**	**8.5**	**7.8**	**7.3**
Newly industrialised countries:										
Russia	3.2	1.3	0.7	– 2.0	6.8	7.8	12.2	.	.	.
China	13.1	7.7	7.4	7.1	2.6	2.1	2.3	.	.	.
India	2.9	4.7	6.1	7.1	10.9	6.9	6.5	.	.	.
East Asia[a)]	6.3	3.8	3.8	4.3	3.2	3.4	3.8	.	.	.
Latin America[b)]	7.8	2.5	0.9	2.0	9.2	9.6	7.2	.	.	.
Newly industrialised countries (total)	**33.4**	**4.9**	**4.4**	**4.5**	**5.4**	**5.1**	**5.1**	.	.	.
Total[c)]	**100.0**	**2.5**	**2.5**	**2.8**	.	.	.	.	.	.
World trade growth in %		**2.8**	**2.6**	**4.0**	.	.	.	.	.	.

[a)] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand. Philippines, Singapore and Hong Kong. Weighted with the 2013 levels of GDP in US dollars. – [b)] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, Chile. Weighted with the 2013 level of GDP in US dollars. – [c)] Weighted average of the listed groups of countries. – [d)] Standardised unemployment rate.

Sources: EU, OECD, IMF, ILO, National Statistical Offices, 2014 and 2015: 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 %		
		2013	2014	2015	2013	2014	2015	2013	2014	2015
Germany	20.8	0.1	1.5	1.5	1.6	0.8	0.6	5.2	5.1	4.9
France	15.6	0.3	0.4	0.4	1.0	0.6	0.3	10.3	10.2	10.6
Italy	12.0	– 1.9	– 0.4	– 0.2	1.3	0.2	0.2	12.2	12.8	13.6
Spain	7.8	– 1.2	1.3	2.0	1.5	– 0.2	0.0	26.1	24.5	23.0
Netherlands	4.8	– 0.7	0.7	1.1	2.6	0.3	0.6	6.7	6.8	6.4
Belgium	2.9	0.3	1.0	0.8	1.2	0.5	0.5	8.4	8.5	8.3
Austria	2.4	0.2	0.3	0.7	2.1	1.5	1.5	4.9	5.0	4.8
Finland	1.5	– 1.2	0.0	0.7	2.2	1.2	1.2	8.2	8.6	8.7
Greece	1.3	– 3.9	0.9	1.2	– 0.9	– 1.4	– 0.9	27.5	26.5	25.5
Portugal	1.3	– 1.4	0.8	0.9	0.4	– 0.2	0.0	16.4	14.2	14.0
Ireland	1.3	0.2	4.7	2.5	0.5	0.3	0.6	13.1	11.4	10.5
Slovakia	0.5	1.4	2.4	2.0	1.5	– 0.1	0.5	14.2	13.2	12.4
Slovenia	0.3	– 1.1	2.5	1.3	1.9	0.4	0.4	10.1	9.7	9.4
Luxembourg	0.3	2.0	3.2	1.7	1.7	0.7	0.5	5.9	6.0	5.7
Lithuania	0.3	3.3	3.1	3.0	1.2	0.2	1.2	11.8	10.6	9.1
Latvia	0.2	4.2	2.8	1.7	0.0	0.7	0.9	11.9	11.4	11.4
Cyprus	0.1	– 5.4	– 2.5	– 0.4	0.4	– 0.3	0.0	15.9	16.2	16.9
Estonia	0.1	1.6	1.7	1.7	3.2	0.5	1.1	8.6	7.5	6.7
Malta	0.1	2.5	3.7	2.0	1.0	0.8	0.8	6.4	5.9	5.7
Euro area[c)]	**73.5**	**– 0.5**	**0.8**	**0.9**	**1.3**	**0.4**	**0.4**	**12.0**	**11.6**	**11.4**
United Kingdom	14.9	1.7	3.0	2.6	2.6	1.5	1.5	7.6	6.2	5.5
Sweden	3.2	1.3	1.8	1.1	0.4	0.2	0.9	8.0	8.0	7.7
Denmark	1.9	– 0.5	0.9	1.2	0.5	0.3	1.0	7.0	6.6	6.2
EU 22[c)]	**93.5**	**– 0.1**	**1.2**	**1.2**	**1.5**	**0.6**	**0.6**	**11.1**	**10.6**	**10.3**
Poland	2.9	1.6	3.2	3.0	0.8	0.1	0.5	10.3	9.0	8.2
Czech Republic	1.2	– 0.9	2.3	1.8	1.4	0.4	1.3	7.0	5.7	5.4
Romania	1.1	3.1	1.7	2.3	3.2	1.4	1.8	7.3	6.9	6.6
Hungary	0.7	1.1	3.3	2.5	1.7	0.0	1.6	10.2	7.4	7.0
Croatia	0.3	– 1.0	– 0.4	0.5	2.3	0.2	0.4	17.3	16.0	16.0
Bulgaria	0.3	0.9	1.6	2.0	0.4	– 1.6	0.3	13.0	11.5	11.0
New Members[d)]	**6.5**	**1.2**	**2.6**	**2.4**	**1.5**	**0.3**	**0.9**	**9.3**	**8.1**	**7.6**
European Union[c)]	**100.0**	**0.0**	**1.3**	**1.3**	**1.5**	**0.6**	**0.6**	**10.8**	**10.2**	**9.9**

[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 and Bulgaria.

Source: Eurostat, 2014 and 2015: EEAG forecast.

Table 1.A.3

Key forecast figures for the European Union

	2012	2013	2014	2015
	Percentage change over previous year			
Real gross domestic product	– 0.4	0.0	1.3	1.3
Privat consumption	– 0.7	– 0.1	1.1	1.0
Government consumption	0.2	0.4	1.0	0.5
Gross fixed capital formation	– 2.6	– 1.5	2.0	1.9
Net exports[a)]	1.1	0.4	0.1	0.0
Consumer prices[b)]	2.6	1.5	0.6	0.6
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 4.2	– 3.2	– 3.0	– 2.7
	Percentage of labour force			
Unemployment rate[d)]	10.5	10.8	10.2	9.9

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2014 and 2015: forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat; 2014 and 2015: EEAG forecast.

Table 1.A.4

Key forecast figures for the euro area

	2012	2013	2014	2015
	Percentage change over previous year			
Real gross domestic product	– 0.7	– 0.5	0.8	0.9
Private consumption	– 1.3	– 0.7	0.9	0.7
Government consumption	– 0.2	0.2	0.9	0.4
Gross fixed capital formation	– 3.4	– 2.4	0.7	0.7
Net exports[a)]	1.4	0.4	0.2	0.3
Consumer prices[b)]	2.5	1.3	0.4	0.4
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 3.6	– 2.9	– 2.6	– 2.4
	Percentage of labour force			
Unemployment rate[d)]	11.3	12.0	11.6	11.4

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2014 and 2015: forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat; 2014 and 2015: EEAG forecast.

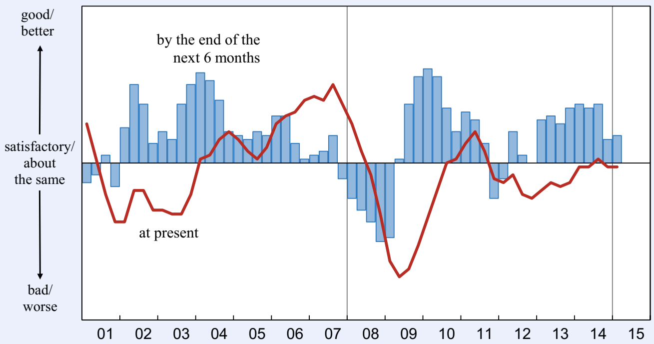
Appendix 1.B
Ifo World Economic Survey (WES)

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 2015, 1,071 economic experts in 117 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.

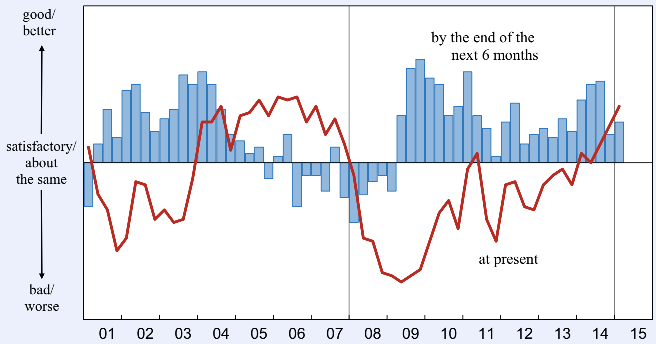
Ifo World Economic Survey (WES)

World
Economic situation



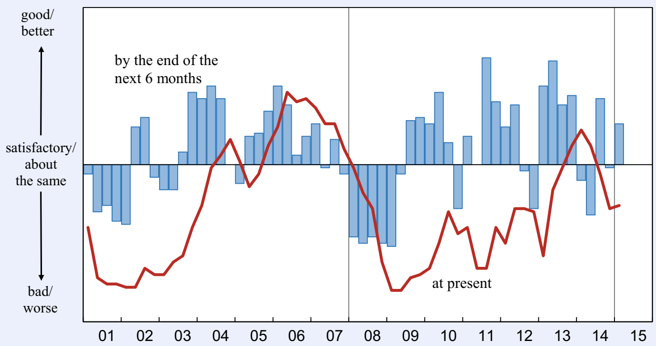
Source: Ifo World Economic Survey (WES) I/2015.

USA
Economic situation



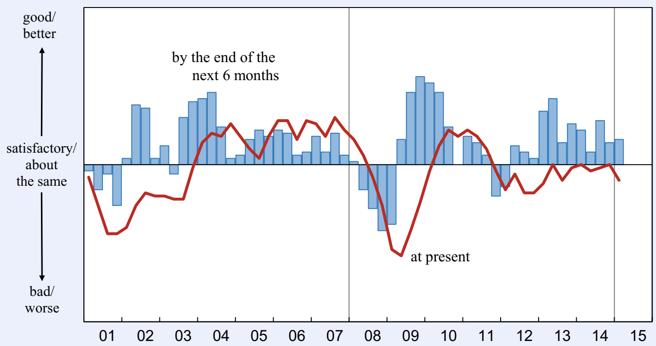
Source: Ifo World Economic Survey (WES) I/2015.

Japan
Economic situation

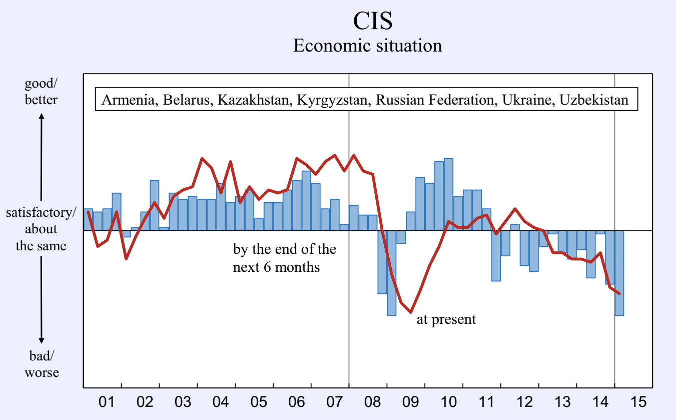


Source: Ifo World Economic Survey (WES) I/2015.

Asia
Economic situation



Source: Ifo World Economic Survey (WES) I/2015.



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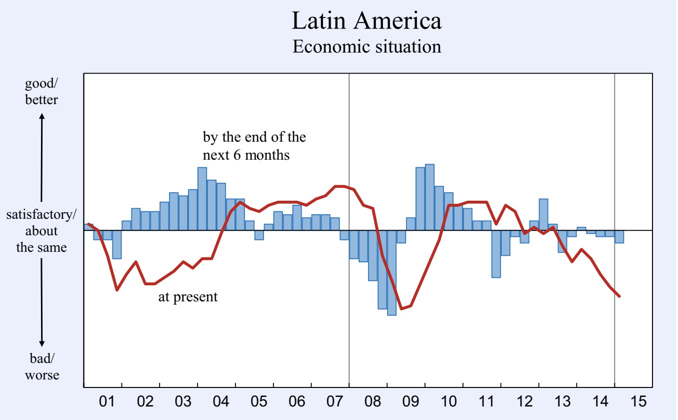

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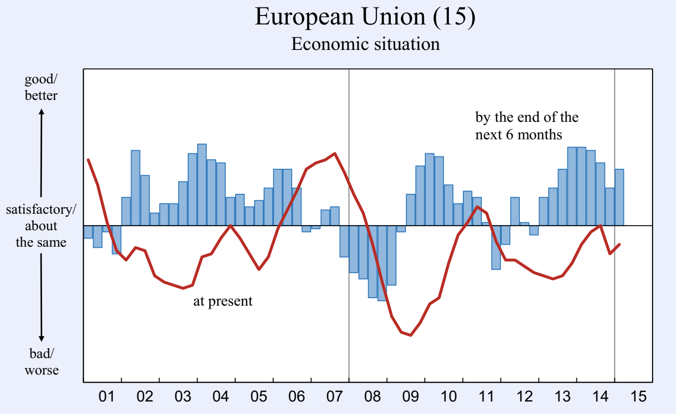
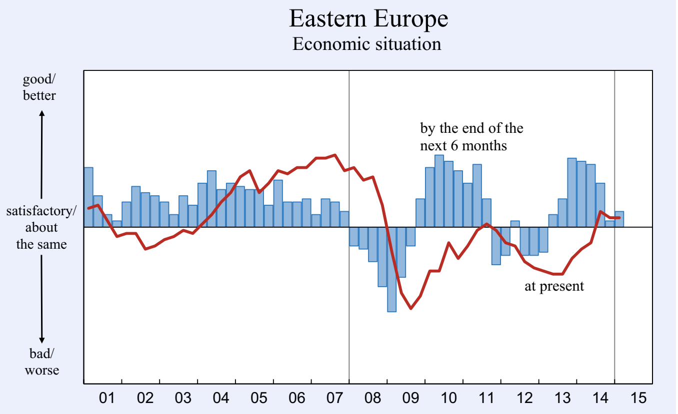


Source: Ifo World Economic Survey (WES) I/2015.



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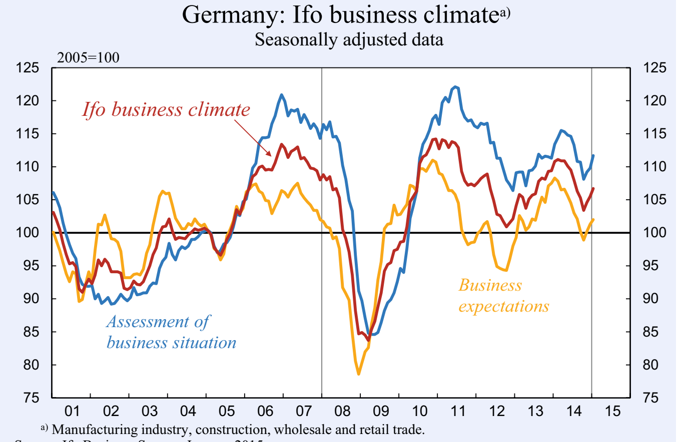
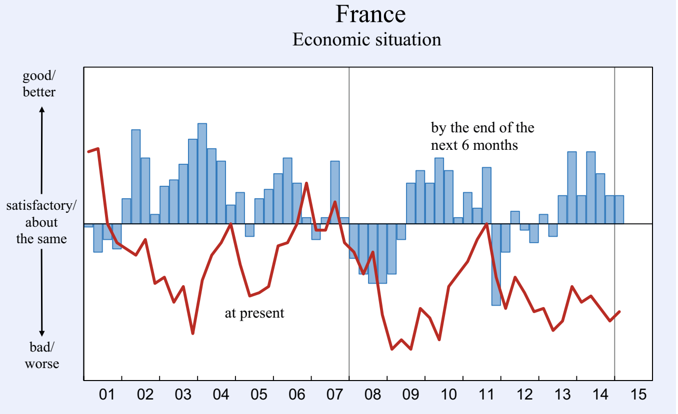
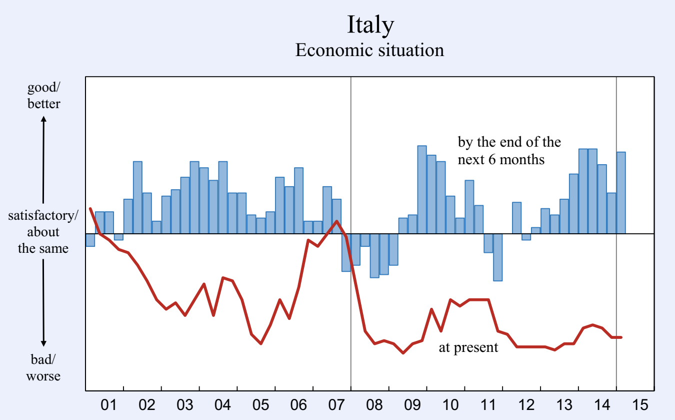


[a] Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2015.



Source: Ifo World Economic Survey (WES) I/2015.



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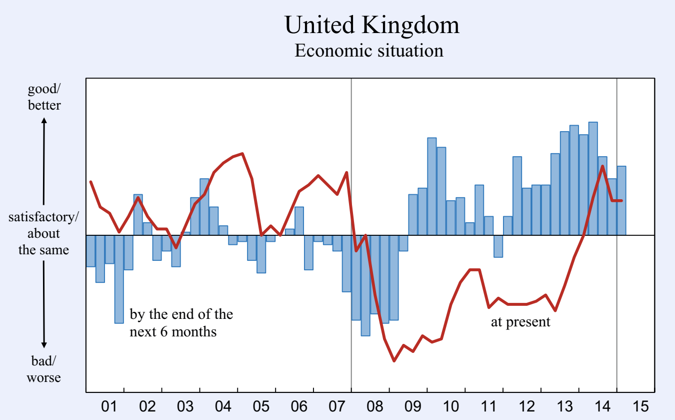

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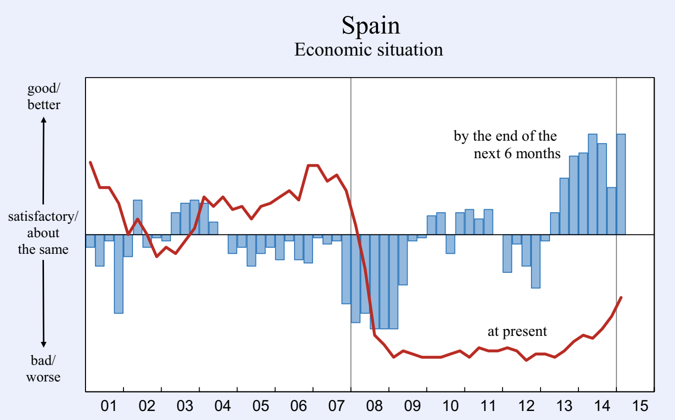

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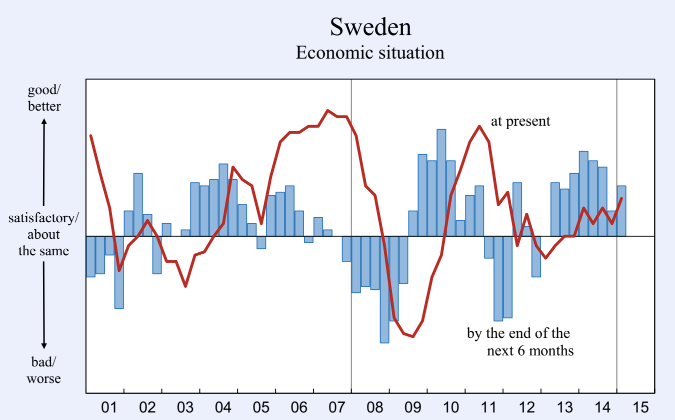

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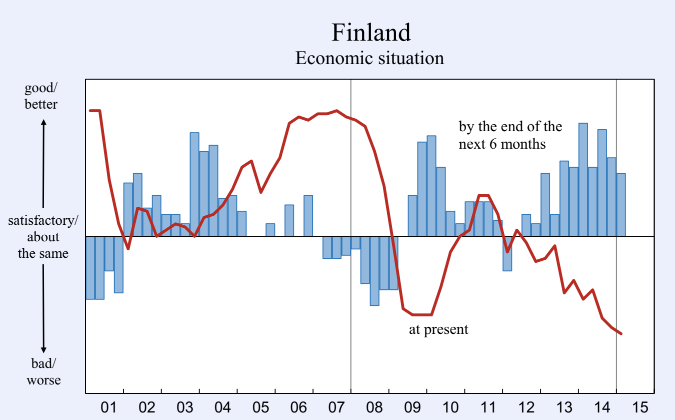
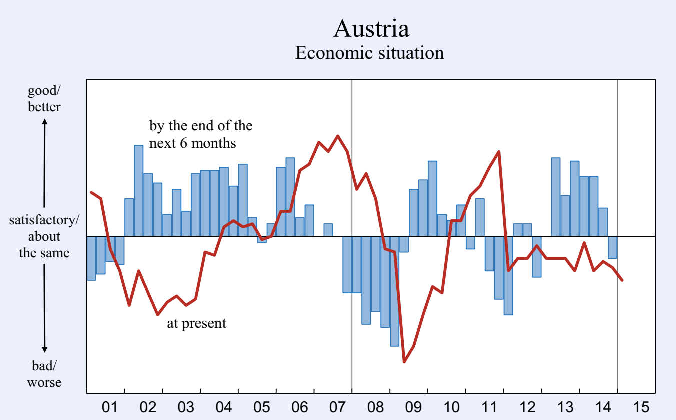
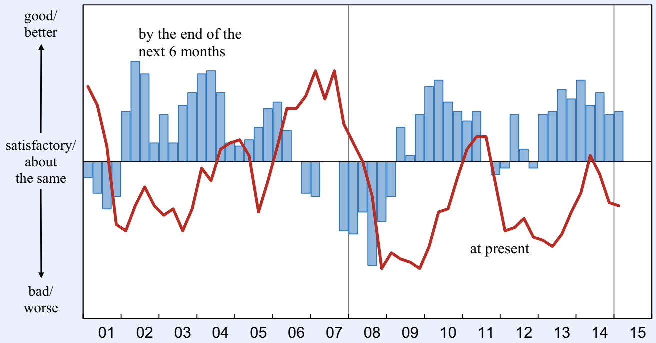


Source: Ifo World Economic Survey (WES) I/2015.



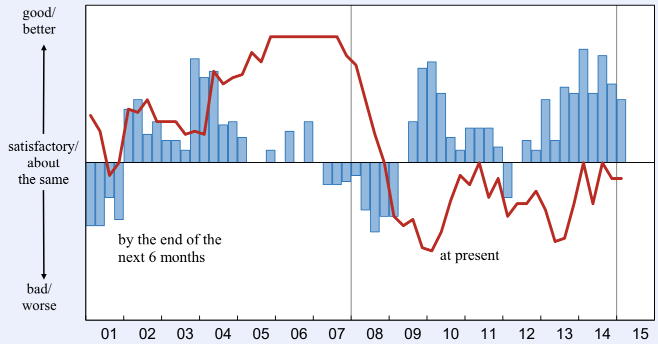
Source: Ifo World Economic Survey (WES) I/2015.

Belgium
Economic situation



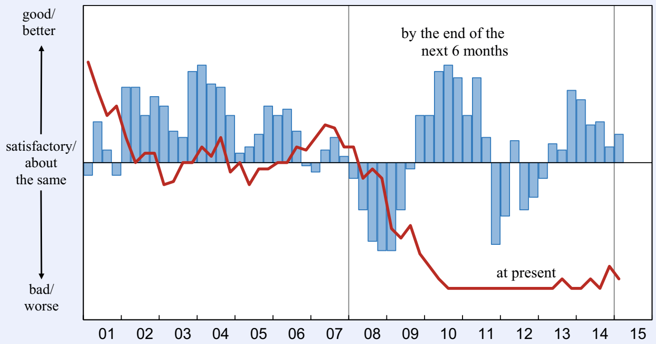
Source: Ifo World Economic Survey (WES) I/2015.

Denmark
Economic situation



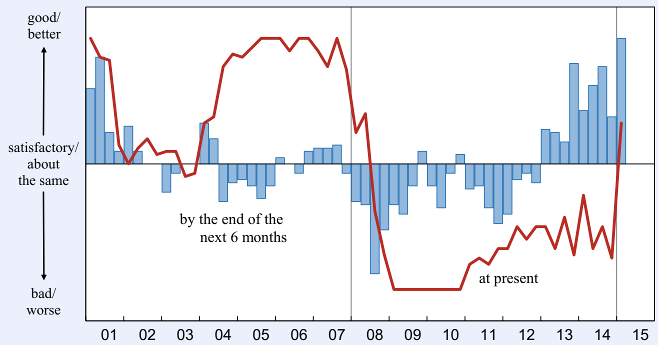
Source: Ifo World Economic Survey (WES) I/2015.

Greece
Economic situation



Source: Ifo World Economic Survey (WES) I/2015.

Ireland
Economic situation



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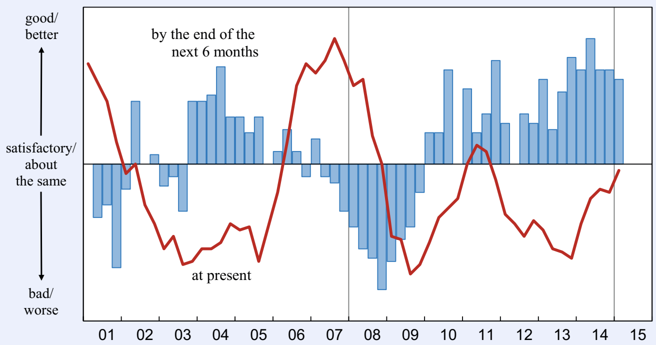
Netherlands
Economic situation



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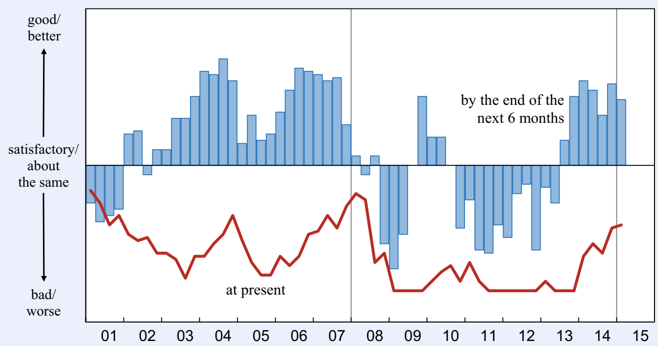
Portugal
Economic situation



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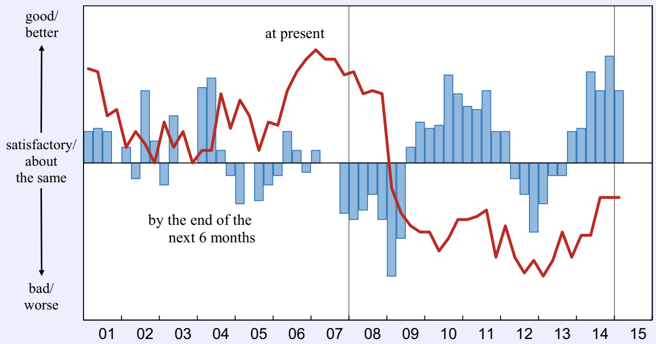
Slovenia
Economic situation



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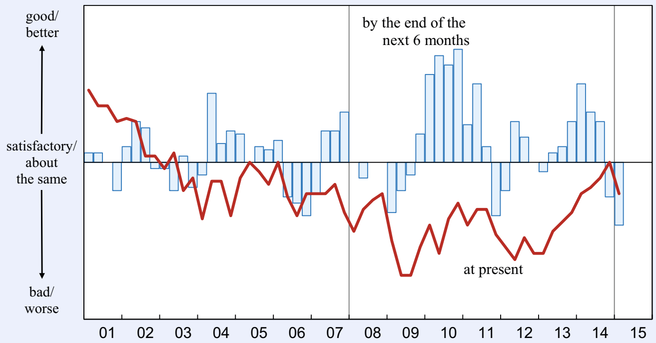
Hungary
Economic situation



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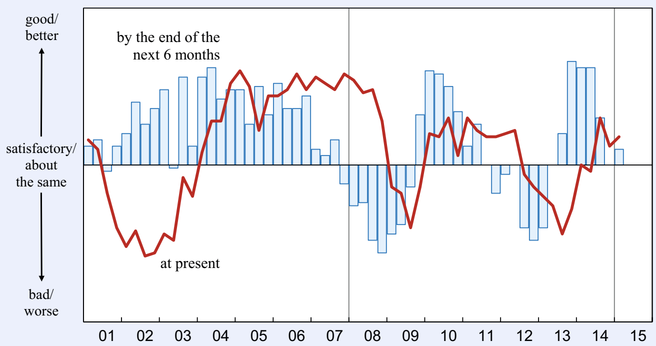
Poland
Economic situation



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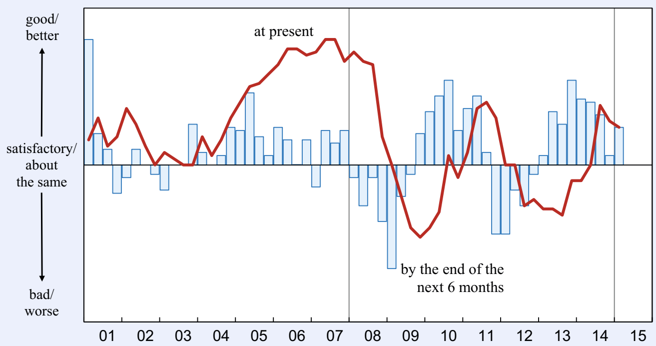
Czech Republic
Economic situation



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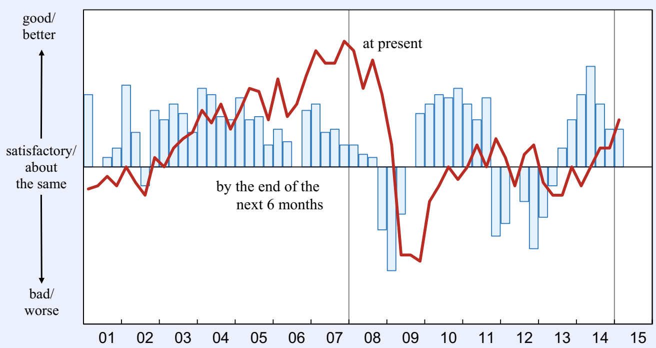
Slovakia
Economic situation



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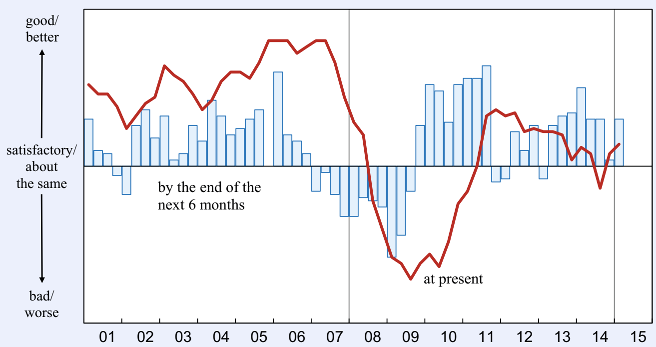
Estonia
Economic situation



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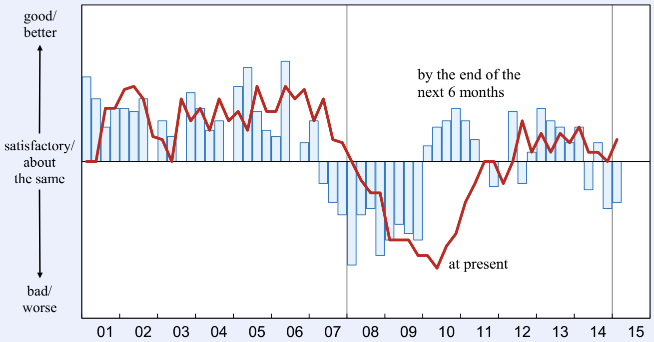
Latvia
Economic situation



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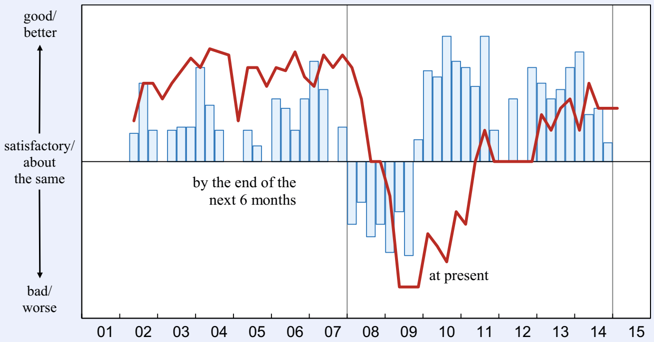
Lithuania
Economic situation



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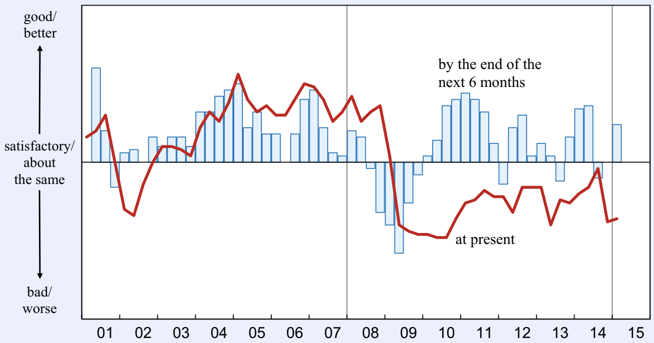
Bulgaria
Economic situation



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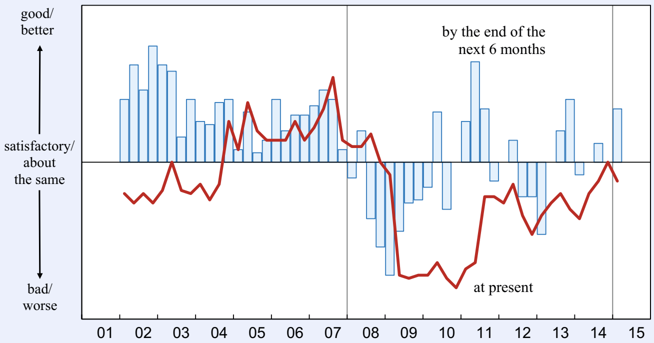
Romania
Economic situation



Source: Ifo World Economic Survey (WES) I/2015.