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- Working Group on Long-term Issues and Structural Change -

The European Economy in the Medium Term

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The report is based on the AIECE institutes medium-term forecasts and their answers to the questionnaire. The tables providing the medium-term scenarios and potential output estimates can be found in Annex I and II, respectively. We would like to thank all the member institutes that answered the questionnaire.

1 The medium-term outlook in perspective

1.1 Changes in medium-term outlook diverge

In spring 2011, the recovery of the European economy from the deep recession following the global financial crisis is almost two years underway. The massive contraction of output was followed by a relatively modest upturn of economic activity. While this is more or less in line with expectations held two years ago – although the decline of economic activity was still generally underestimated in early 2009 – this is not necessarily true with respect to developments in individual countries. Mirroring the image of a Europe consisting of three groups of economies – the first one experiencing a swift recovery of output and robust growth, a second one with moderate rates of economic growth, and a third group suffering from severe problems of adjustment – the AIECE institutes' assessment of the medium-term outlook in their respective countries has changed in different directions since two years ago. On the one hand, projections of medium-term growth have been raised significantly in Germany and Finland reflecting mainly a surprisingly buoyant external demand and stronger than expected recovery of investment. On the other hand the outlook over the medium term has deteriorated substantially in Greece, Ireland and Spain mainly as a result of fiscal adjustment in response to the sovereign debt crises. Less government spending and higher taxes are also cited to have contributed to a downward revision of the medium-term outlook for the UK and the Netherlands. No major changes in the assessment of growth in the medium-term have been made for Italy, Belgium, Austria, Poland, Denmark and Hungary.

1.2 Significant permanent loss in output as a result of the Financial Crisis

Empirical evidence suggests that recoveries after recessions that were associated with housing market busts and/or banking crises are typically associated with a (more or less) permanent loss in output as recoveries tend to be delayed and gradual compared to recoveries after "normal" recessions.[1] The recent evolution of output Europe has been consistent with these findings as recoveries were particularly weak in those countries that have been hit directly by a crash in the housing market or bank failures on a large scale. Growth in the euro area as a whole has been modest and has hardly exceeded the trend rate of growth seen in the years before the crisis so far, suggesting that there has been a significant long-term loss in output inflicted on the economy.

The large majority of AIECE institutes that have responded share this view. A permanent loss of output – equivalent to a level shift in the production potential – is diagnosed not only in Ireland, Spain and the United Kingdom where wealth destruction was most pronounced and the economic structure came under severe adjustment pressure in the course of the crisis, but also in most other countries due to lower investment ratios (cited for Austria, Hungary), loss in export market share (Finland) and low growth in export markets (Slovenia), permantly reduced labour productivity (Germany), fiscal drag

[1] See for example Reinhart, Carmen M., and Kenneth S. Rogoff (2008). "Is the 2007 US Subprime Crises so Different? An International Historical Comparison." American Economic Review 98, 2. 339–344; or N. Jannsen and J. Scheide (2010), This time is not different: Growth patterns after the Crisis. Kiel Policy Brief 22, http://www.ifw-kiel.de/wirtschaftspolitik/politikberatung/kiel-policy-brief/kpb22.pdf

(Netherlands, Ireland, UK). The size of the permanent loss in production potential is estimated to be in the range of 3 % for the Netherlands and Belgium, 3–4 % for the UK, and even up to 10 % for Ireland. There are, however, a few countries for which no significant permanent effect on output from the financial crisis is expected to remain. This group includes Switzerland, Poland and, interestingly, Greece where the impact of the (first wave) financial crisis is being regarded as negligible given limited exposure of the Greek banking system to toxic assets.

2 Economic environment and policy assumptions

2.1 External environment

All institutes base their projections on a scenario with relatively moderate growth in the industrial countries. Average annual growth in the period 2011–2015 is expected to be between 2.5 and 3.1 % in the United States and between 1.4 % and 2.2 % in the European Union. At the same time, world trade is generally forecast to grow relatively swiftly at rates between 7.1 % and 8.8 % per annum – with ETLA and NIESR being exceptions who give world trade growth of 6 % and 5.7 %, respectively –, implying an assumption of continued strong economic growth outside the industrial countries. Exchange rates are typically either held constant or changing only modestly in line with forward rates.

2.2 Monetary policy

The medium-term projections are assuming a modest monetary tightening with the ECB's key policy rate being gradually increased to around 2.5 by the end of 2012 or 2013. Some institutes expect further tightening afterwards but even in that case, with short-term interest rates at 3 % or 3.5 %, respectively, monetary policy would remain at least somewhat expansive. Factors cited that would lead the ECB to remain more accommodative than a standard Taylor-Rule would suggest include the sovereign debt crisis and a weak dollar exchange rate. Outside the euro area, central banks are expected to tighten more or less in line with the ECB in Denmark and Switzerland, while the Bank of England is assumed to deliver according to market expectations. The Polish central bank is expected to fluctuate from contractionary to expansionary over the forecast horizon in response to a changing cyclical position, and in Hungary the forecast is based on a stagnating – or even declining – NBO reference rate.

2.3 Fiscal policy

Fiscal policy is expected to be restrictive over the forecast horizon in almost all countries, with Belgium being an exception where the forecast is based on the traditional no-policy-change assumption. In some countries, where the need for fiscal adjustment is especially pronounced (partly as a result of negative attitudes on the financial markets), the fiscal drag over the next years is substantial, amounting to several percentage points annually over a number of years. Given the significance of this factor over the coming years it might be useful to present the assumptions underlying the AIECE medium-term assessments on a country-by country basis.

In the euro area, the already agreed-upon consolidation measures in ***Austria*** are forecast to lower the general government deficit to below 3 % by 2012. The fiscal saving is evenly spread to tax increases and expenditure cuts, respectively. The consolidation path currently envisaged would further reduce the deficit to about 2 % in 2015. Gross debt should stabilize at about 72 % of GDP in 2013. In ***Spain***: fiscal consolidation will keep on track during the next years till the stabilization objective of 3% of GDP will have been reached. In ***Germany*** the medium-term fiscal policy is pre-determined by the constitutional "debt brake" clause which urges fiscal policy on a consolidation path that brings the federal structural deficit continuously down to 0.35 percent of GDP by 2016 (starting from an estimated 2.5 percent in 2011). The ***Italian*** government is planning to reduce the fiscal deficit to balance in 2014 according to the recently released Fiscal Policy Plan. Prometeia, however, expects this target to be too ambitious due to the slow growth expected for these years and, consequently, the reduction to be more gradual. It is worth noting that the primary balance will turn into surplus already this year. The ***Irish*** government has to deal with one of the largest fiscal adjustment problems in Europe. It is assumed that the government's intention to implement a further major discretionary reduction in government borrowing in 2012-14 will be implemented as planned. This will involve a further €9 billion in tax increases or cuts in expenditure over the 3 years 2012-14. Government will cut / tax a further 5.5 % of GDP ex ante over next 3 years. Massive fiscal restriction will also prevail in ***Greece*** over the forecast horizon. The medium-term scenario is based on fiscal assumptions that are in line with the economic adjustment programme for Greece from winter 2011. The budget deficit is expected to fall below EUR 14.9 billion (6.4 % of GDP) in 2012, EUR 11.4 billion in 2013 (4.8 %) and EUR 6.4 billion (2.6 %) in 2014. Although there is no official target for the 2015 deficit, the government aims at a 2015 general government deficit of 1 percent of GDP or below. Stabilising the public sector is also regarded the key policy challenge in ***Finland***, although on a very different level. The forecast assumes that taxes will be raised to collect more revenues, including a rise of the VAT by 1 per cent. In ***Slovenia*** the currently envisaged medium-term fiscal framework aims at reducing the general government deficit to below 3 % of GDP and at stabilising general government gross debt below 45 % in 2013. General government debt would reach 60 % of GDP by 2015 without efficient structural measures being enacted.

Outside the euro area, the most significant fiscal adjustment over the forecast horizon is taking place in the **United Kingdom**. The government has announced to that it plans to balance the budget on a structural basis by the fiscal year 2015/16 with more than two thirds of the deficit reduction contributed by expenditure cuts. The tax increase part of the programme has, however, been frontloaded. In ***Denmark*** the structural budget is planned to improve by 1½ percentage points in relation to GDP until 2013 by reduced expenditure growth and some tax increases (which are part of a tax reform that was underfinanced in 2008-09). In ***Hungary,*** the government aims at decreasing the rate of fiscal redistribution (as a percentage of GDP) and at improving the efficiency in several areas of the public sector. The fiscal deficit is projected to remain under the Maastricht threshold, and the rate of public debt is forecast to slowly decrease. The ***Polish*** deficit is assumed to decline to 3 per cent of the GDP deficit by 2012 and below this ceiling after. In ***Switzerland*** the fiscal policy will be slightly restrictive, and the budget surplus will slightly increase.

2.4 Impact of the European sovereign debt crises

In view of the ongoing sovereign debt crises in euro area countries – starting from Greece and spreading to Ireland and Portugal – AIECE institutes have been asked in the questionnaire whether the impact of the sovereign debt crises on the medium-term outlook is strongly negative, somewhat negative or not significant. According to the answers of the responding institutes, the impact is strongly negative in a relatively small group countries. A strong impact can be clearly expected for Greece, Ireland and, to a somewhat lesser extent, Spain where an increased fiscal burden of servicing government debt has accelerated fiscal and structural adjustment programmes. Risk premia have not only risen for government debt but also in the private sector in these countries. In addition, uncertainty and bad expectations are leading firms and private households to increase savings putting further downward pressure on domestic demand. In addition to these countries a strong negative impact of the sovereign debt crisis is also seen for Slovenia as a result of a relatively high burden for this country from the EFSF and ESM mechanisms.

The group of countries that are somewhat negatively affected in terms of their medium-term outlook includes the Netherlands, Italy, Finland, Hungary, Poland, the UK and Switzerland. Various reasons are given for this assessment, such as an increase in the spreads on the country's government bonds (Italy, Poland), (potential) financial market turmoil (Finland), world trade or lower export market growth due to depressed euro area absorption (the Netherlands, Hungary, Switzerland), home currency appreciation vis-à-vis the euro (Switzerland). The impact on the German economy is not seen uniformly by the responding German institutes. While the DIW expects that the medium-term outlook is affected somewhat negatively (mainly due to the adverse effects of financial market uncertainties), the Kiel Institute expects no significant impact as it sees conflicting forces at work and the net effect of the sovereign debt crisis on the German economy quite unclear. On the one hand the recession in the countries directly affected weakens demand for the German export industries (but their market share is relatively small), on the other hand the risen risk awareness makes Germany a relatively more attractive place to invest, bringing real interests rates down to historically low levels (with positive effects on housing demand in particular). In addition, the current sovereign debts crisis keeps the monetary policy stance more expansionary than it otherwise would have been implying further stimulation of investment via lower interest rates compared to those that an independent German monetary authority would choose. Other countries that are not significantly affected according to the assessment of the responding institutes are Austria, Belgium (although the risk is noted that a crisis could build if politicians would ultimately fail to form a government as markets could perceive this as a sign of major uncertainty regarding the future of the country), and Denmark. The share of countries strongly affected in the total of the responding countries weighted by GDP is 17 % for the European Union (22 % for the euro area). The share of the countries not affected is 36 % (44 %) in the case that Germany is included in this group, or 9 % else.

2.5 Effect of higher commodity prices

Commodity prices have recovered swiftly from the lows seen in early 1999 at the height of the financial crisis and have recently reached new record levels in many cases despite the modest pace of economic recovery in the developed world. While oil prices are still significantly below the absolute peak levels recorded in summer 2008, on a three month moving average basis they have almost closed in on the all-time high. For the medium-term projection, oil prices are generally assumed constant (in nominal or real terms) although some forecasts are based on the assumption of a temporary decline from the current elevated levels. A number of institutes assume commodity prices in general to rise further in real terms over the medium term reflecting strong demand from emerging economies.

As to the impact of higher commodity prices on the European economies, the general attitude is that the high level of commodity prices contributes to the subpar growth momentum embedded in the forecast. Still higher prices for vital commodities, such as oil, would be negative for European growth but not dramatically, as long as oil price and commodity prices are demand-driven. In that case a counterbalancing effect can be expected to come from external demand (1) directly from the commodity exporting countries (that are usually in a process of restructuring their economies triggering higher demand for infrastructure goods) and (2) indirectly via increased demand for more efficient machinery equipment and machinery (e.g. less energy consuming facilities, alternative energy production techniques). The negative income effects resulting from higher import prices are to a large extent compensated for by increased export opportunities, a factor which is particularly important in Germany given the German product mix. In the case of a oil price increases that are driven by supply side shocks the negative impact would be more pronounced. Other risks associated with higher commodity prices is that higher inflation could trigger a sharp tightening of monetary policy, particularly in the case that inflation expectations would threaten to rise. Another concern is that high food and oil prices could result in political and social turmoil in the developing and emerging countries.

3 Medium-term outlook

3.1 Medium-term outlook for the individual countries

The growth prospects for Europe are modest, especially if the low level of output relative to previous trend levels or potential output is considered. Expected average annual growth over the period 2011-2015 ranges from 0.6 % in Greece to 4.1 % in Poland (full tables of the medium-term scenarios can be found in Appendix I). While growth in most countries shows an improvement over the preceding 5-year period which includes the mega recession associated with the global financial crisis, the level of growth remains moderate and in a number of countries even below the growth over the five years 2001-2005 (which includes the relatively shallow 2001 recession year).

Some countries face a severely restricted outlook for domestic demand. This includes ***Spain*** where both public and private activities are under pressure. With an only modest contribution of net external trade expected it will prove difficult to reduce the high rate of unemployment reached during the crisis significantly over the forecast horizon. The outlook for ***Greece*** is even worse with growth expected to remain stuck below 1 % in the period until 2015. In this country, net exports are even expected to continue to be a drag on growth. The most promising outlook for the countries currently depressed by the sovereign debt crisis is for ***Ireland*** where GDP growth is expected to recover to almost 3 % annually based on strong contribution from net exports and a gradual recovery of investment.

The ***UK*** economy is expected to become more balanced over the medium term. Retrenchment by the government and household sectors will inhibit the UK's recovery, leading to a sustained period where output is below capacity. The permanent loss of output will limit the rebound in gross fixed investment as the current capital-ouput ratio is considerably above the desired level. It is the external sector that is likely to drive the economy forward partly as a result of the depreciation of sterling since 2007 that should feed through into more robust export growth. The weakness of the domestic economy will limit import demand growth going forward allowing a significant positive contribution to UK economic growth. Weaker domestic consumption and therefore, increased national saving should lead to the UK's current account back into surplus over the medium term.

The growth performance of ***Italy*** remains weak over the forecast horizon with only 1 % annual growth over the forecast horizon. While private demand should expand only slowly and public demand is forecast almost stagnating, the external sector is expected to gradually improve compared with the performance during the previous decade. Very modest growth compared to the country's performance over the past ten years is projected for Slovenia. Recovery will initially be driven by exports before investment is expected to follow in 2012-13, albeit with a large degree of uncertainty. Relatively stable growth, albeit at a moderate level of around 1 ¼ %, is projected for the **Netherlands** where fiscal restraint and supply side restrictions from the labour market are inhibiting growth.

On a more positive note, medium-term growth is forecast to be substantially stronger than in the 5-year periods 2001-2005 and 2006-2010 in ***Germany***. The current strong growth momentum will, however, decelerate over the forecast horizon. In the short term export growth is expected to slow; the pronounced investment cycle is expected to peak in 2011 (in terms of growth rates) and 2012 (in terms of share in GDP), respectively. Over the forecast horizon, production is increasingly driven by domestic demand reflecting a stronger labour market and sound economic fundamentals. Relatively strong output growth is also expected in **Belgium** and in **Austria** with exports a major contributor to the improved performance.

The medium-term prospects for **Hungary** are modestly favourable. An average growth rate of 3-3.5% is likely for 2011-2015 which means that Hungary would start catching up with the euro area again following some years of relative decline. An even more agile growth is unlikely, since domestic demand will recover only at a slow pace, and there are limits to growth from the supply-side, like the relative scarcity of easily available high-skilled workforce. The present state of the education system is not reassuring concerning labour supply perspectives.

3.2 Potential output estimates and Output Gaps

Potential output is on a declining trend in most European countries that are covered by the answers to our questionnaire (see Appendix II for detailed tables). There are, however, two major exceptions to this rule: In Germany potential output growth is estimated to accelerate to 1.2 % in 2011-15 from 1.0 % in 2006-2010, and the growth rate of the production potential in Italy is calculated to accelerate to 0.7 % from 0.4 %. A slightly higher potential output growth over the forecast horizon than in the previous five year period is also envisaged for Hungary.

Most respondents use a production function approach to estimate potential output, often leaning on the EU-Commission approach. In addition, a capacity utilization approach based on the physical capital is used (ETH-Kof), and a HP-Filter for the short term (IBRKK). Some AIECE institutes do not adhere to the concept of a production potential at all. But even those who do have to be aware of the principle uncertainty about the level of current potential output in real time, which has been greatly increased in the course of the Great Recession (see the nice discussion of this issue in the CPB presentation in this AIECE WG's session in spring 2009).

The estimates of the responding institutes of potential output and its components are documented in Appendix II. They imply in most cases that the output gap is not closed by 2015. This is in contrast to an often used procedure in medium-term forecasting where it is assumed that an output gap (of modest sizes) will be closed by the end of the forecast horizon. This time around, however, in many countries estimates of potential output yield an output so large that closing it by 2015 would imply unreasonably high growth rates in the years of the projection period that follow the short-term forecast horizon.

Another option to deal with the problem would be revising down potential output as suggested by ESRI for Ireland:”While the (above) table shows an output gap of 10% (actual/potential) in 2015 we believe that the crisis has permanently reduced potential output by between 5% and 10% in a way not captured in the above table. Thus the economy will be closer to potential output in 2015 than this table would suggest.”

3.3 Policy measures that affect potential output growth

The productive potential of the economy can be influenced by policy measures that either change available labour, by affecting structural unemployment or the labour participation rates, or impact on labour productivity. Structural policies that affect unemployment or labour participation have been taken in most countries, although quantitative assessment is in most of the cases difficult at the current juncture.

In Austria and Germany the opening of the domestic labour markets for all workers from the first wave new member countries of the EU on May 1st 2011 will increase the labour force although by modest amounts. Estimates for Germany arrive at a number of 120000 immigrants from these countries per year. Other policies in Germany, namely the broadening of minimum wage regulations to more and more sectors of the labour market, may slightly raise the rate of structural unemployment in the medium term.

Reducing the possibility of early retirement is pursued in a number of countries (Belgium, Denmark, Greece, Poland). In Greece this has been part of a comprehensive pension reform which is expected to raise the labour participation rate substantially in the medium term. In addition the Greek government has pushed through a deregulation of the so-called “closed professions”. As a result new firms in the service industry have the potential to improve the (structural) unemployment picture by generating sufficient employment opportunities for those unemployed workers that hold university degrees.

In Spain the labour market reforms and pension system changes may affect both supply and demand for labour with unclear implications for the unemployment rate.

The dual character of the Hungarian economy needed measures to support long term unemployed mainly with low skills. A communal work programme “Pathway to Work”; had been introduced to support employment of those long term unemployed who had no work experience with an obligatory training element and support in jobs on the primary labour market with some chance to get labour experience and path to the labour market. The program proved to be expensive and has been eliminated by the new government and replaced by communal work programmes that will be initiated in cooperation with communal investments and the business sector initiations. A low labour participation rate is a general feature of the Hungarian labour market, partly due to the low participation of the youth and elder age groups and also the low share of part time employment and high share of disability and early retirement. Contribution relief for employing disadvantaged workers is an important tool in improving their labour market chances. They are available to employers hiring school leavers, people returning from parental leave and the long-term unemployed (particularly those aged 50 or over and the low-skilled). The targeted reduction increases the chances of disadvantaged jobseekers when applying for a job. The Start Card program aims at (i) employers who hire young entrants with the Start Card (ii) Start Plus scheme aims at supporting long-term unemployed, parents with young children and people caring for family members to return to work. (iii) Start Extra Card aims to support the employment of groups most disadvantaged in the labour market: people aged over 50 years, people with low education; (iii) Start Region has been linked to the Pathway to Work programme.

Policy initiatives that explicitly address labour productivity growth are less numerous. In countries like Ireland and Spain, structural changes of the economy – a shift away from building and construction with relatively low productivity to the tradable sector and services – is reflected in increased labour productivity. In Greece structural productivity growth i is expected to be affected by: (a) the opening of the closed professions, (b) the the privatization of the public utilities (e.g. Electricity, Telecommunications, Water supply, etc) and (c) the efficient use of the public property. Other policy initiatives mentioned in the responses to the questionnaire include increased public credit and tax subsidies in Belgium and the use of EU funds for public investment in physical infrastructure and programmes for developing the skills of the work force in Poland and Hungary.

4 Risks and points for discussion

The institutes were asked to point at major risks for the outlook that should be discussed in the meeting.

The most frequently mentioned problem was the European sovereign debt crisis, risks of contagion to other countries or even extension to large countries like US or Japan, potential financial market turmoil on a global scale resulting from this. Connected to this is the issue of the persistent weakness of the European banking system.

Other topics for discussion include:

- the problem of macroeconomic policy mix (fiscal consolidation vs. monetary tightening)
- the potentially inflationary impact of massive liquidity expansion (is there a risk of a ketchup-bottle effect?
- medium-term outlook for the US
- sustainability of emerging economy growth, especially China
- energy markets and climate change policies and their impact on the medium-term outlook (especially after the recent nuclear catastrophe in Japan)