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AIECE General Report

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I. Recent developments

Global economic prospects have deteriorated markedly over the last six months. Much of this is due to the heightened uncertainty surrounding Europe's sovereign debt crisis. There is widespread agreement among policy makers – ranging from the IMF, European Commission and European Central Bank to individual heads of state both within and outside the Euro Area – that resolution to the crisis requires urgent, comprehensive and coordinated action. Yet 17 months after the first bail-out programme was introduced in Greece, policy makers have yet to deliver a strategy that promises a credible prospect of growth and an end to rising debt profiles within the Euro Area.

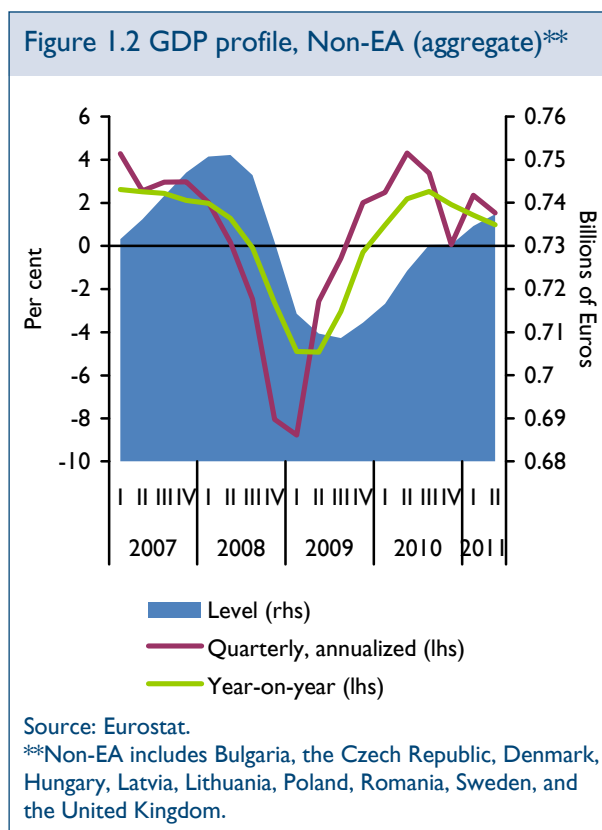
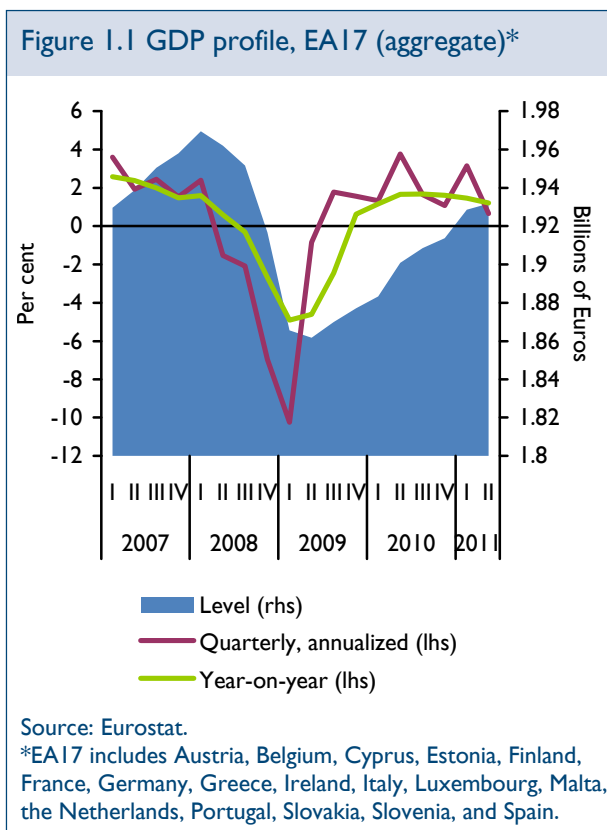
European policy makers have recently unveiled the outline of a new programme that they hope will resolve the crisis. The agreement entails a 50 per cent discount on notional Greek debt held by private investors; a new EU-IMF multi-annual programme financing up to 100 billion euro to be put in place by the end of the year; strengthening the monitoring of the implementation of reforms agreed with the EU and IMF; leveraging the resources of the European Financial Stability Fund (EFSF) to yield approximately 1 trillion euro; recapitalisation of the EU banking system; measures to improve the governance of the Euro Area and strengthen fiscal coordination. Whether or not these proposals are enough to transform the economic outlook, stabilise financial markets and resolve the crisis is the key uncertainty around not just the European forecast, but also global prospects.

This report reviews recent developments in the European economies, and collates the latest forecasts of the AIECE Institutes. It should be borne in mind that many of the forecasts behind this report were finalised before the end of September 2011. Given the rapidly shifting economic landscape, central views of some Institutes may have changed in the interim.

I.1 GDP growth

At the previous meeting in May it seemed that the worst of the 'Great Recession' was over. However since then, the European economy has been met with new problems surrounding the Euro Area debt crisis.

After what appeared to be promising headway with the growth of the European economy at the start of the year, with growth in the Euro Area recording 0.8 per cent in the first quarter, the growth path of the



European economy has faltered since. The second quarter recorded quarterly growth of just 0.2 per cent, and recently released figures report a similar rate of expansion in the third quarter.

The recent troubles have affected countries both within and outside of the Euro Area.

Year-on-year growth in the Euro Area, as shown in Figure 1.1, remained relatively constant throughout 2010 and the first part of 2011 at between 1.5–1.7 per cent. However the annual rate of growth declined through the first half of 2011. The volatility of growth has been much more pronounced in the annualized quarterly measure, which saw a sharp drop from 3.2 per cent in the first quarter of this year to 0.7 per cent in the second.

Year-on-year growth in the EU countries outside the Euro Area has been less constant, and has been falling steadily over the past year from 2.5 per cent in the third quarter of 2010 to 1 per cent in the second quarter of 2011. Quarterly annualized growth was strong mid-2010, recording 4.3 per cent in the second quarter. It declined sharply through the rest of the year, recording just a little above 0 per cent in the final quarter of 2010. Despite a brief improvement in the first quarter of 2011, it nevertheless slowed by almost one percentage point between the first and second quarters of 2011.

The split between ‘emerging’ and ‘advanced’ economies remains pronounced, even just within Europe.

Figure 1.3 shows annualised quarterly growth for the second quarter of 2011 in each of the EA17 countries. Most countries performed better than the EA17 and the EU27 groups in aggregate, with annualised quarterly growth rates above 1 per cent. Estonia and Ireland performed particularly well, recording growth of 7 and 6.3 per cent, respectively. Some of the large countries in the Euro Area, Germany and France for example, performed less well, growing at an annualised rate of just 0–0.5 per cent in that quarter. Portugal was the only country in the group that contracted.

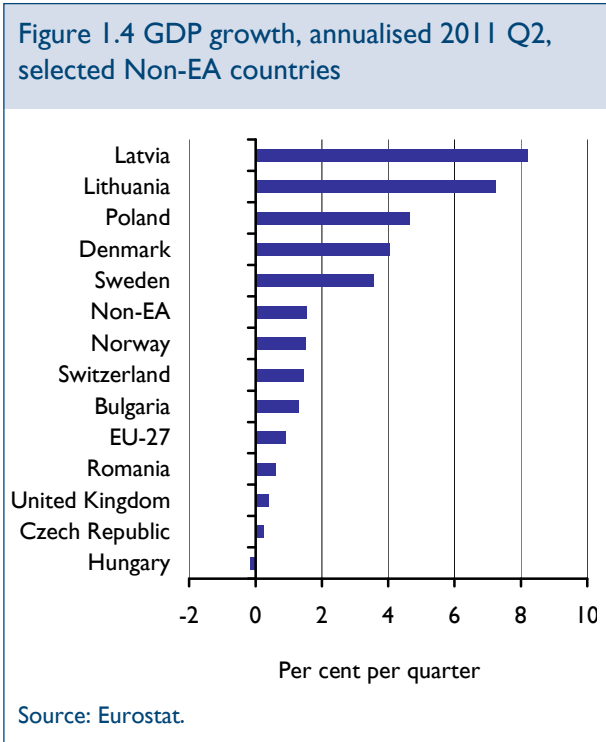
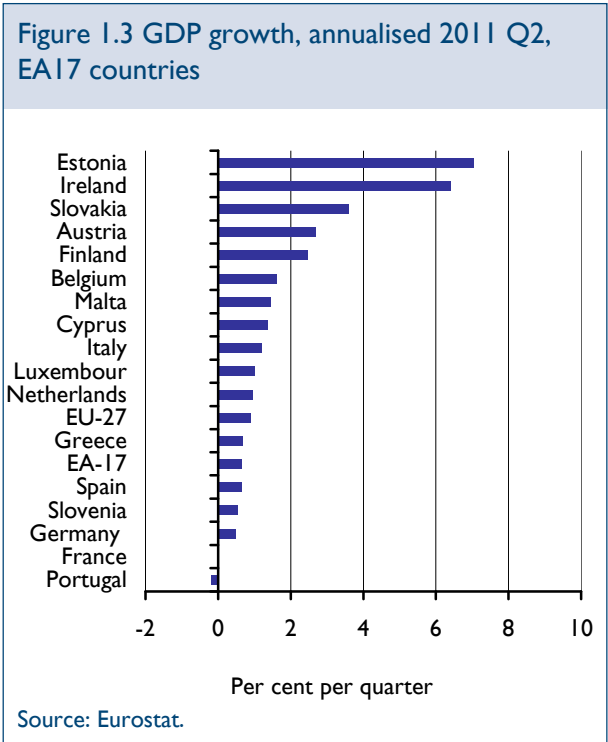


Figure 1.4 shows annualised quarterly growth for the second quarter of 2011 in a selection of European countries outside the Euro Area. Again, most recorded growth rates above that of the EU27 aggregate. Latvia and Lithuania had high growth rates of 8.2 and 7.2 per cent, respectively. The UK grew by just 0.4 per cent in that quarter, and Hungary contracted. Iceland is not pictured below, but declined by 11 per cent.

There are clear distinctions between the drivers of growth in different countries, and between the Euro Area and the rest of Europe.

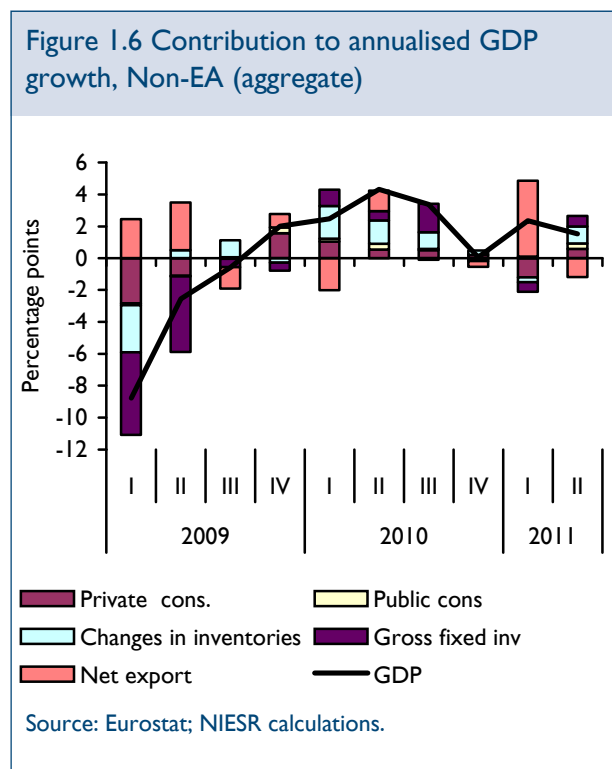
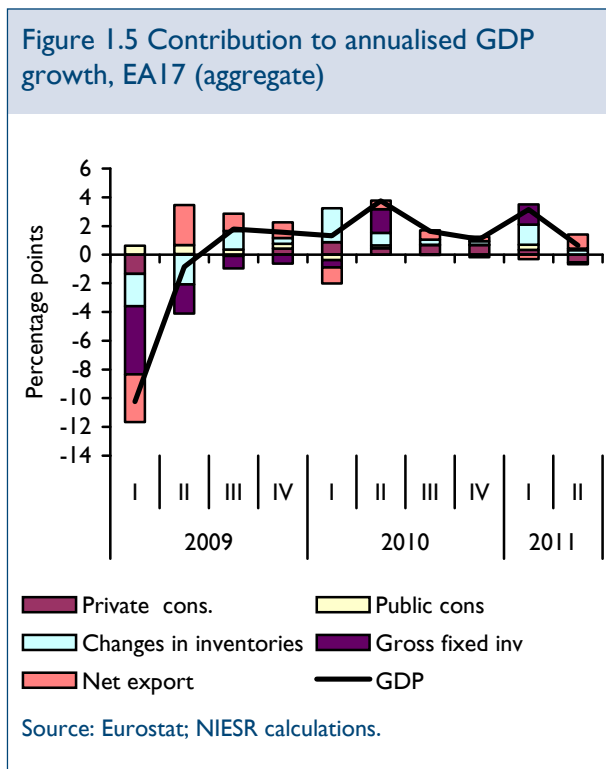


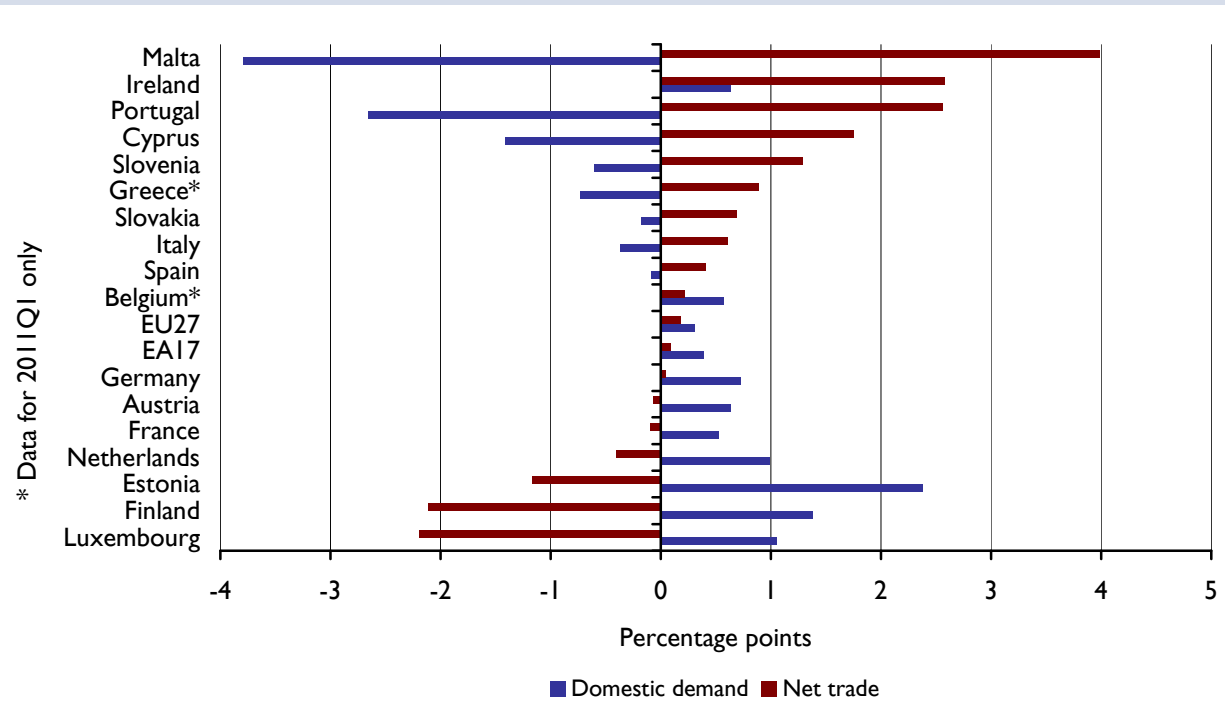
Figure 1.5 shows the profile of GDP growth in the EA17 as a whole over the past two and a half years, broken down into its various components. At the start of 2009, just at the end of the recession, the only positive contributor to Euro Area growth was public consumption, while private consumption, investment, destocking and net exports all weighed heavily on the Euro Area economy. The situation gradually improved over the next few quarters, as net exports, inventories and finally investment started to rise. In the second quarter of 2011, private consumption fell, pulling down growth, and net exports, investment and stock-building only marginally compensated for this. Notable is the lack of public sector consumption in the last quarter, as governments have begun to consolidate their budgets.

Figure 1.6 shows contributions to growth of the EU excluding the Euro Area. Net exports were more robust than in the Euro Area at the start of 2009 and at the start of 2011, pulling up growth in the first quarters of those years. The public sector has played a less prominent role in boosting growth in the Non-EA aggregate than in the Euro Area.

The following figures detail drivers of growth at the country level, showing contributions to quarterly growth from net trade and domestic demand over the first half of 2011. On the whole, the inverse relationship played by the components of growth is evident, ranging from entirely externally-driven Malta to domestic demand-driven Estonia. Only Belgium and Germany have had positive contributions from both components (although please note that the data is incomplete for Belgium). In aggregate, the Euro Area and the rest of the EU as a whole have seen positive contributions to growth from both external and domestic demand over the first half of the year, although notably the Euro Area has been driven by domestic demand which contributed 0.4 percentage points to growth.

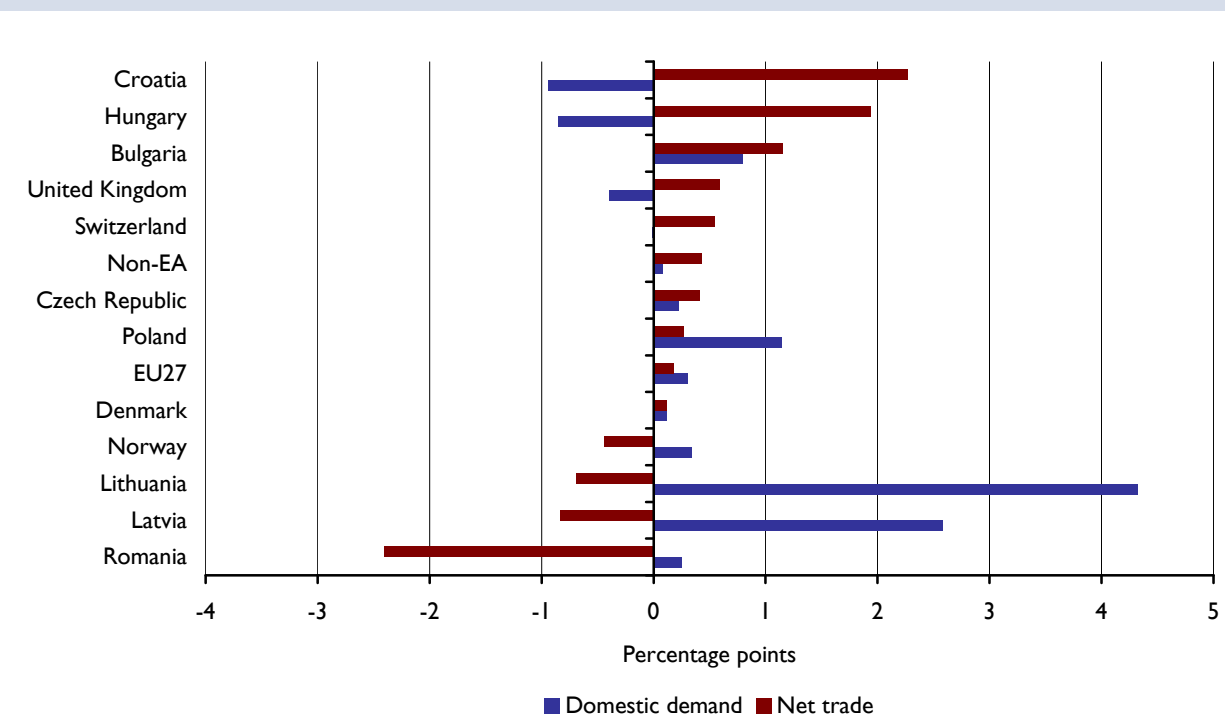
The inverse relationship between external and domestic demand has been less marked for the non-Euro Area countries, although it is still present. Growth in the EU excluding the Euro Area has been driven by net trade, which contributed 0.4 percentage points to growth. Latvia and Lithuania have seen particularly strong contributions from domestic demand, and Croatia and Hungary from net trade.

Figure I.7 Contribution to quarterly GDP growth, average over 2011 Q1 and Q2, EA17 countries



Source: Eurostat; NIESR calculations.

Figure I.8 Contribution to quarterly GDP growth, average over 2011 Q1 and Q2, Non-EA countries



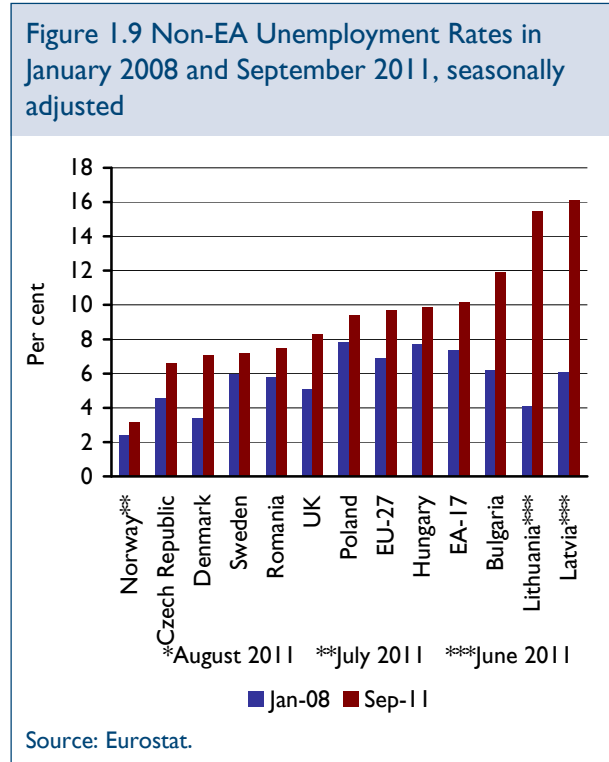
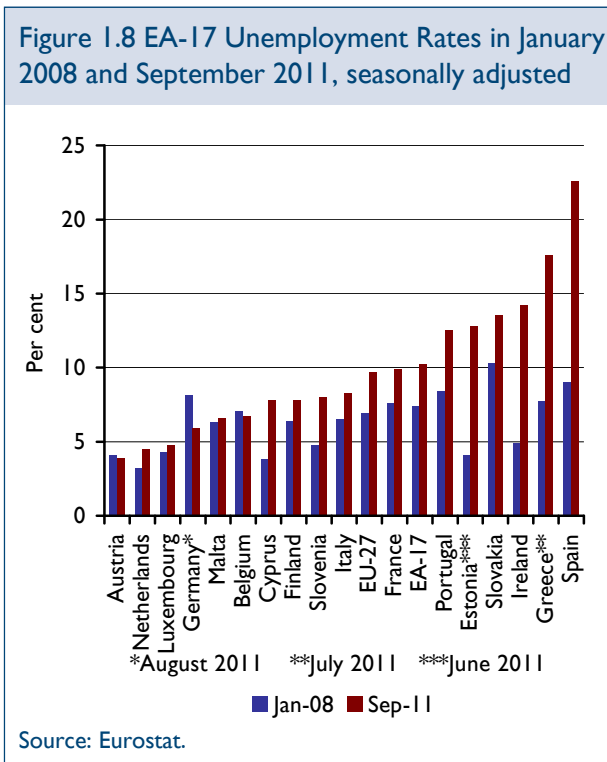
Source: Eurostat; NIESR calculations.

1.2 Labour markets and productivity

Labour market conditions vary widely across different European countries.

Whilst many countries in the Euro Area have recovered to their pre-recession rates of unemployment, others remain far off. The unemployment rate in Spain reached 22.6 per cent in September, two and a half times that at the beginning of 2008. In contrast, unemployment rates in Austria, Belgium and Germany have fallen below pre-crisis figures.

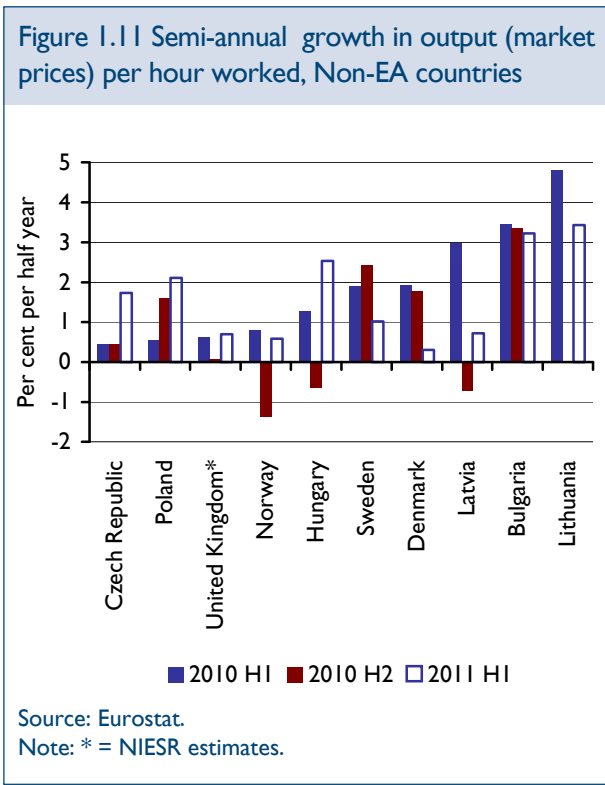
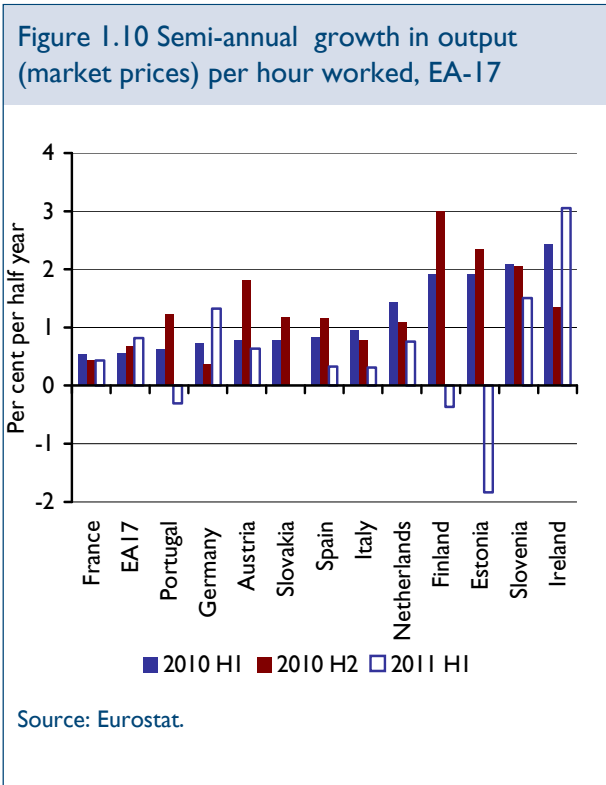
Among the European economies outside the Euro Area illustrated in figure 1.9, no country has yet regained its pre-crisis rate of unemployment. In particular, Latvia and Lithuania remain far above pre-crisis levels, at 16.1 and 15.5 per cent of the labour force, respectively.



In some countries labour productivity has suffered as a result of adverse economic conditions.

Within the Euro Area, many countries saw productivity drop in 2008 and 2009 in response to the recession. This is common during recession, and reflects for the most part labour hoarding in expectation of a recovery in demand. Since early 2010, several countries such as Germany and Ireland have increased their rates of productivity growth. However others, most notable Estonia, Finland, Portugal and Slovakia have seen growth in productivity cease or decline, particularly throughout the beginning of 2011.

Labour market responses outside the Euro Area have been similarly diverse, although many countries saw declines in productivity take place a little earlier, in the second half of 2010. The United Kingdom and Norway have experienced low or declining rates of productivity growth throughout the period shown, as has Latvia excluding the beginning of 2010. Poland and the Czech Republic have seen increasing productivity growth over the period. Excluding the second half of 2010, Hungary and Lithuania have also experience strong rates of productivity growth.



Short-run trends in productivity are explained by firms’ responses to uncertainty in the economy. Across different European countries firms have had mixed responses, including both labour-shedding and labour-hoarding.

Table 1.1 summarises the responses of different institutes to question 5a of the survey – ‘is there evidence of labour hoarding [in your country]’? Of the twenty countries represented for this question, twelve responded that there had been evidence of labour-hoarding, as employment had remained unexpectedly robust and/or productivity had plummeted.

In several countries, labour-hoarding happened in response to deliberate policies promoting conditions in the labour market. For instance, in Germany, Switzerland and Slovenia, short-time compensation schemes were implemented allowing firms to retain employees by reducing their working hours. The Italian CIG scheme similarly aided the retention of employees by sustaining employee income when their working hours were reduced. Aside from specific measures aimed at addressing the impact of the crisis on employment, the pre-existence of rigid labour-market legislation protecting employees and making labour-shedding expensive for firms may have boosted employment in some countries (e.g. Slovenia).

Table 1.1 Summary of institutes' survey responses to Question 5a – Is there any evidence of labour hoarding [in your country]?

Austria	No. Subsidized part-time work schemes supported employment in 2009 but the recovery since then has been strong enough to eliminate any overhangs. Employment was still growing at a monthly rate of 0.1% August, but job vacancies started to shrink at around May.
Belgium	Yes - the 2009 recession had a smaller impact on Belgian domestic employment than initially expected. The fall in employment (in number of persons) was restricted by a sharp decline in hourly labour productivity and working time. As a result, hours worked in the private sector dropped by about 3%, but the decrease in the number of persons remained limited to 1% in 2009. The economic recovery in 2010 led to a recovery in hourly labour productivity, furthered by growth in GDP in the first half of 2011.
Czech Republic	No, there is no evidence of labour market hoarding in the Czech Republic.
Denmark	The productivity gap of one percent could be interpreted as an indication of the employment being one percent too high relative to production. This gap is significantly smaller (in numerical terms) than what it was in 2009 and 2010.
Finland	Yes, there is evidence of labour hoarding during the recession; this resulted in a 3.9 per cent decline in labour productivity. In 2010, it increased to +3.9 reflecting the rather strong growth, but fell again in 2011 to 1.4%. The projection for 2012 is a further growth to 1.9%.
France	No relevant figures to analyse labour hoarding, however the 2008-2009 recession highlighted difficulties in matching supply and demand with competencies, particularly in the manufacturing sector.
Germany	Yes, during the Great Recession the extent of labour hoarding by firms in Germany was the highest ever observed since World War II. By 2011, however, the number of short-time workers and hours on working-time accounts do not suggest any significant amount of labour hoarding anymore.
Greece	No evidence of labour market hoarding in Greece as unemployment is expected to reach around 20% at the end of the year, demonstrating a negative relation between demand and unemployment.
Hungary	Yes, in the construction sector- output fell at an average rate of 8.5% during the last six quarter, while employment fell only by less than 3%. A great number of companies kept the major part of its work force in spite of declining demand, by offering employees reduced wages and shorter working hours temporarily. However productivity is slowly growing, since employment growth is even weaker than economic growth
Ireland	No.
Italy	Yes during the 2008-2009 recession, particularly through the use of Cassa Integrazione Guadagni Ordinaria (CIG), the scheme which helped firms to reduce the numbers in hours worked by sustaining workers' income. The number of hours authorised by CIG increased greatly from 2008 to 2010 but has now levelled off.
Netherlands	Yes – at the start of the crisis in 2008/2009, firms were reluctant to lay-off workers as the labour market was tight. A brief, sharp downturn was expected and as the financial situation of firms was good, they could afford to keep their workers. It is uncertain how firms will react in particular next year, when production growth will falter again. As the financial balances of firms are still rather strong, it is still believed that unemployment will rise slower than expected when looking at the production growth.
Norway	Not more than one could expect in a downturn. Migration has contributed more than before to labour market flexibility.
Poland	No – low probability of labour hoarding in sectors severely affected by global crisis, such as industry and manufacturing. In 2009 there was a slowdown in economic activity in the labour market. The volume of industrial production decreased by 3.5 per cent with a fall in industrial employment by 6.1 per cent; in manufacturing, the levels of production and employment declined by 3 per cent and 7.4 per cent correspondingly.
Serbia	No - there has been a rise in the unemployment rate, from 19.2% in October 2010 to 22.2% in April this year, along with the share of long-term unemployed active job seekers which rose from 13.8% to 16.3%. This marked the continuation of a downward tendency dating back to October 2008.
Slovenia	Yes- for two reasons: rigid labour legislation with very difficult and expensive dismissal procedures, and the introduction of a short term crisis measure in 2009-2010, subsidising the wages for employees on temporary lay offs and shorter working hours. After these measures were ended, many workers remained employed, but underutilised. There is also labour hoarding in the public sector, where the number of employees is still rising despite government commitments to reduce number of employees by 1% per year.
Slovakia	During the recession companies, in particular transnational ones, tended to keep the amount

Spain	of employees unchanged, therefore they did not need to hire new employees.
Sweden	Yes. Yes- labour market hoarding occurred during the financial crisis as employment fell less than expected, given the historical relationship between growth in GDP and in employment. However as the economy is now performing well and with the return of confidence in 2012, companies will be expected to keep most of their employees and there will be a decrease in the number of employment opportunities.
Switzerland	Yes- the recent recession saw an increase in labour hoarding compared to past recessions, as firms faced difficulties in finding skilled workers during upswings. Additionally, short-time compensation schemes and an unusually quick rebound in demand have supported labour hoarding.
United Kingdom	We think that much of the recent productivity weakness has been due to labour hoarding. The response of real product wages over the recession enabled firms to hold onto their skilled labour. Looking ahead we expect this to persist. However, a drive for increased productivity would come at the expense of the improvement in the labour market that we currently expect.

1.3 Public deficit and debt

The story is less contrasted between European countries when it comes to government debt. With the exception of Bulgaria, all European countries saw a rise in government debt relative to GDP between 2007 and 2010, although Euro Area countries tend to have larger debt stocks than non-Euro Area countries.

The majority of Euro Area countries have debt stocks exceeding 50 per cent of GDP. Greece is by far the most indebted, and as of 2010 the debt stock reached nearly 150 per cent of GDP. Italy, Belgium, Ireland and Portugal similarly have high levels of debt, ranging between 90 and 120 per cent of GDP. At the other end of the scale, Estonia had very low levels of debt in 2010, at just 6.7 per cent of GDP.

Government debt is, on the whole, much lower outside of the Euro Area, and the majority of Non-EA countries have debt stocks below 50 per cent of GDP. In 2010, Hungary and the UK had by far the worst debt-GDP ratios at around 80 per cent. For the UK this represented a huge increase on the 2007 figure of 44 percentage points. At the low end of the scale, Bulgaria had a debt stock of 16.3 per cent of GDP in 2010, down one percentage point from 2007.

Almost uniformly across Europe, government budgets are in deficit, and exceed 3 per cent of GDP.

Within the Euro Area, the majority of countries recorded deficits in excess of 3 per cent of GDP, but less than 10 per cent of GDP in 2010, with the exceptions of Greece and Ireland. The latter recorded a vast deficit of over 30 per cent of GDP for that year, although this reflects exceptional factors related to bank recapitalisation that do not require upfront financing. Estonia, on the other hand, was more or less in balance in 2010, while deficits in Luxembourg and Finland were below 3 per cent of GDP. For all countries in the Euro Area, 2010 budgets signified a worsening on 2007.

Outside the Euro Area, budgets also worsened between 2007 and 2010, with the exception of Hungary whose position improved on 2007 when it held the largest deficit in the group shown. The United Kingdom recorded the largest deficit in 2010, at just over 10 per cent of GDP, just slightly below that of Greece. Of all the non-EA countries, only Sweden did not record a deficit in 2010, and its budget was largely in balance, while the deficit in Denmark was marginally below 3 per cent of GDP.

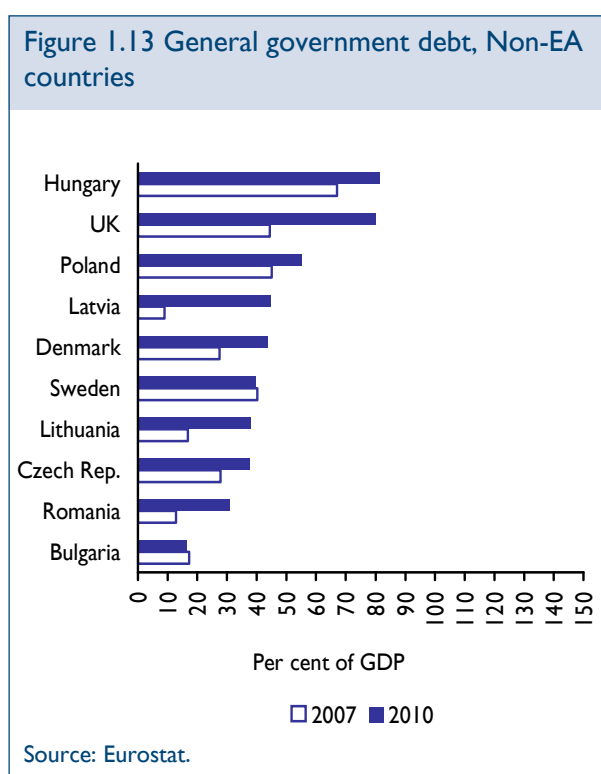
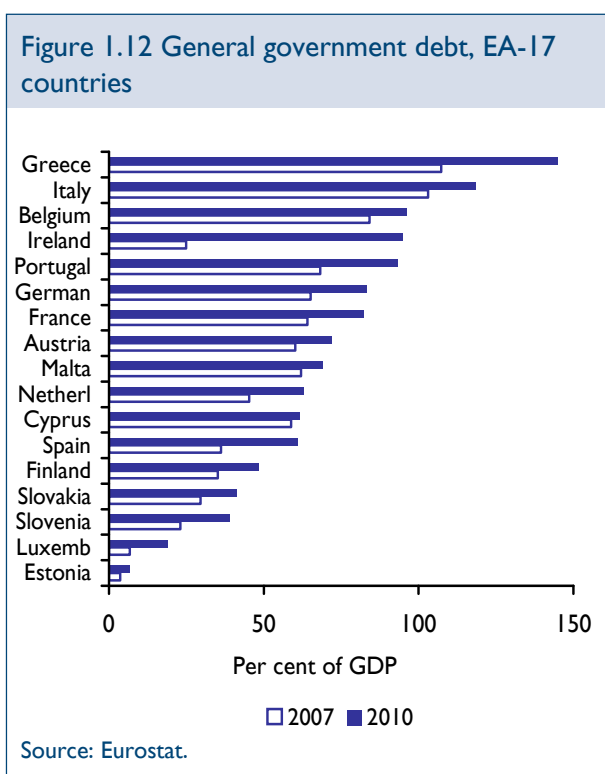
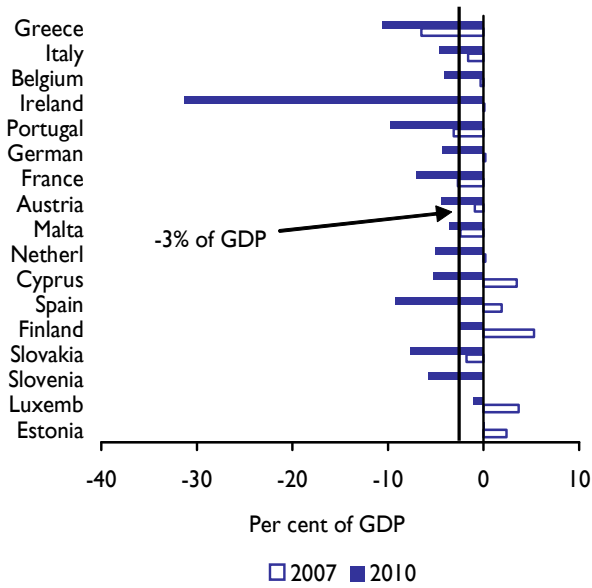
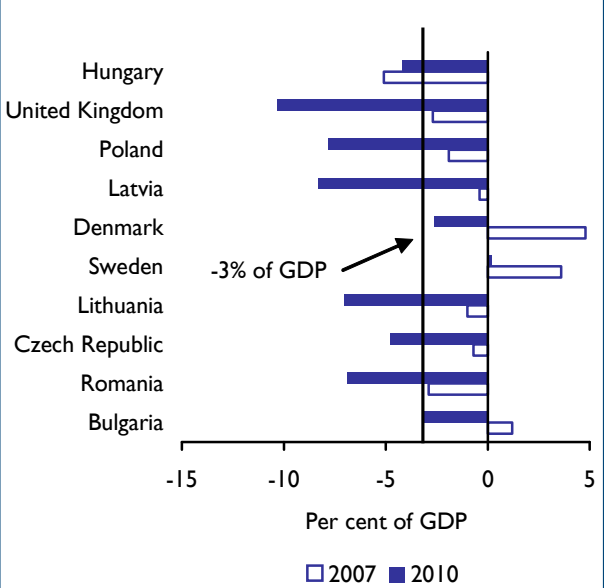


Figure I.14 General government budget balance, EA17 countries



Source: Eurostat.

Figure I.15 General government budget balance, Non-EA countries



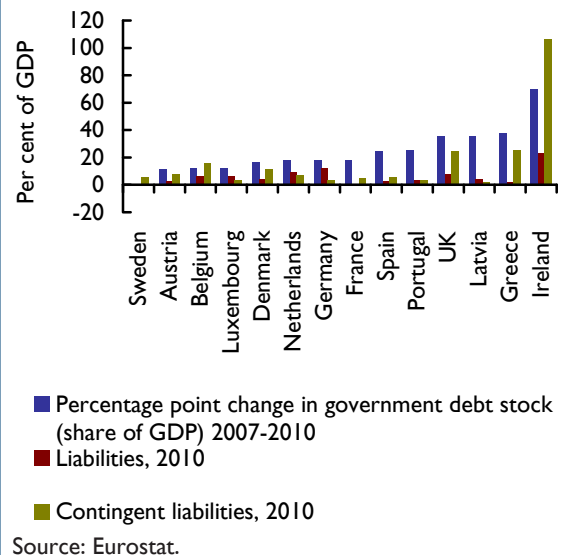
Source: Eurostat.

1.3.1 Debt attributable to financial bailouts

Costs of financial bailouts have contributed significantly to the debt stock in many countries.

The past couple of years have witnessed numerous instances where it was necessary for governments to intervene in their country's financial systems. This has placed an additional burden on the debt stock, over and above any fiscal stimulus and automatic stabiliser effects during the recession. Figure 1.16 illustrates the magnitude of this burden in selected European countries and the extent to which the recent increase in the debt stock is directly attributable to bank bail-out costs. Government liabilities related to support of financial institutions can account for about half or more of the rise in government debt since 2007 in Germany, Belgium, Luxembourg and the Netherlands. A significant portion of the debt rise – 20 per cent or more – is also attributable in the UK, Ireland, Denmark and Austria. The indirect costs are higher in Ireland, where for accounting purposes a significant share of bailout costs have accrued onto the deficit. The figure also shows contingent liabilities related to support of the financial sector in each country, which reflect, for example, state guarantees to depositors. Contingent liabilities are particularly high in Ireland, Greece and the UK. This increases the risk of default over and above the actual debt stock, and especially in Ireland has been an important factor behind the recent high yield spreads.

Figure I.16 Government support to financial institutions, share of debt



Source: Eurostat.

1.4 Inflation

Headline inflation has been high in most European countries, but this is chiefly attributable to high oil prices.

In the Euro Area, many countries have experienced high inflation in recent months. Estonia recorded annual headline inflation of 5.4 per cent in September, and Slovakia 4.4 per cent. However in most countries these inflationary pressures are attributable to temporary pressures from volatile commodities such as oil and food. Core inflation – that is, inflation excluding influences from energy, food, alcohol and tobacco – is much lower in almost all countries, indicating that once price inflation from the more volatile commodities is removed, there is no significant inflation. Indeed in Ireland, excluding these items indicates deflationary pressures in the economy. The only exceptions are Italy and perhaps Austria, where core inflation is only a little below headline inflation, indicating underlying inflationary pressures in the economy.

Figure 1.17 Consumer price inflation (measured by HICP), Core and Headline rates, September 2011, EA17 countries

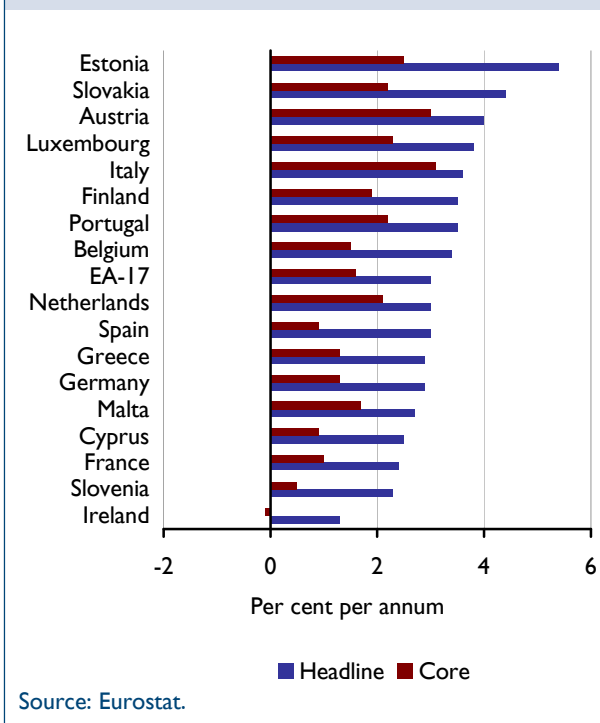
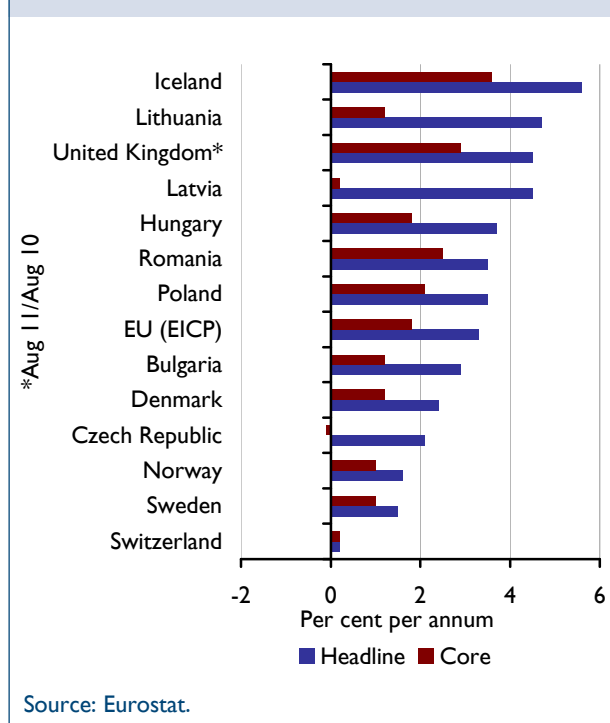


Figure 1.18 Consumer price inflation (measured by HICP), Core and Headline rates, September 2011, Non-EA countries



Outside the Euro Area, European headline inflation has recorded high rates in many countries, particularly Iceland, Lithuania, the United Kingdom and Latvia, which recorded annual inflation of between 4½ and 5½ per cent. However in Norway, Sweden and Switzerland headline inflation has been quite low. Excluding energy, food, alcohol and tobacco again illustrates that most inflationary pressures are coming from temporary factors, except in Switzerland where headline and core inflation are equal, but near zero.

However, it is important to note that in Portugal and the United Kingdom, the most recent inflation figures will reflect some temporary feed-through from indirect taxes, which were raised at the beginning of the year. Germany on the other hand lowered indirect taxes in the third quarter of this year, which will have placed downwards pressure on price inflation.

I.5 Housing markets

Most European housing markets were significantly hit by the crisis, but began to recover in 2010. The current economic downturn is challenging this recovery in many economies.

Figure 1.19 illustrates the survey responses from AIECE members to question 3 in the survey regarding conditions in housing markets. The Irish housing market was particularly hit by the crisis. According to ESRI, real house prices in Ireland fell by a sharp 27.5 per cent between 2007 and 2010, and should continue to fall in 2011 and 2012 due economic uncertainty and negative expectations. The UK also saw a sharp drop over this period, as real house prices fell by over 10 per cent, and are expected to fall by a further 5.2 per cent this year as a result of the deteriorating economic outlook.

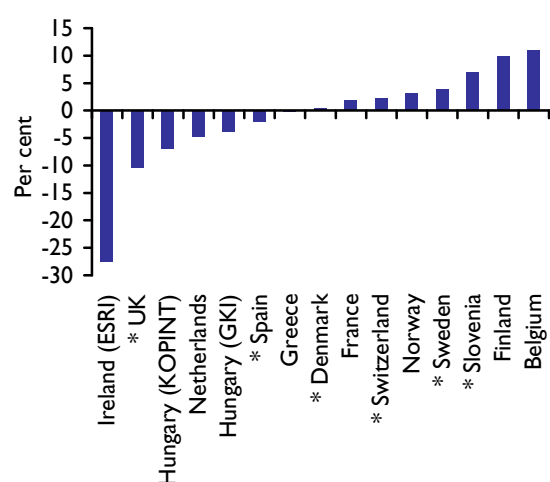
The situation on the Greek housing market is a surprising one, considering the ongoing debt-crisis. The KEPE indicates the ongoing crisis have not been translated into considerably lower house prices, mainly due to existing rigidities on the market. This includes low leveraging of the majority of the building companies, use of equity capital to finance the construction of new houses which immune them from interest rate volatility and the ‘wait-and see’ strategy from property developers. Moreover, a number of building companies started building new houses when the market was at its peak in 2005, before the introduction of the VAT on new residential buildings, facing high building and labour costs. They are now unwilling to sell their stock at lower prices to avoid great losses.

At the other end of the scale, housing markets in Finland and Belgium seem to have fared well despite the crisis, and real house prices continued to grow through the financial crisis until 2010. The FPB estimates that real house prices in Belgium in 2010 stood 11 per cent above their 2006 levels, with a sharp rise in the year before the financial crisis. ETLA estimates that house prices in Finland grew by 10 per cent between 2007 and 2010.

The crisis revealed the important role of housing markets in promoting financial stability. Many institutes consider house prices to be overvalued, despite downwards corrections in many countries.

Table 1.2 summarises the responses of the institutes to the question on overvaluation in the housing market. Eight of the sixteen institutes that responded to this question believe that house prices are overvalued in their country. CEPREDE notes that in Spain, house prices remain high despite expectations of a fall for the third consecutive year of 6.7 per cent in 2011, and negative prospects going forward.

Figure 1.19 Change in real house prices between 2006 and 2010



Source: AIECE survey responses
Note: *Countries where institutes consider real house prices to be overvalued.

Table 1.2 Summary of AIECE institutes' responses to Survey Question 3 – Are house prices overvalued in your country?

Country	Institute	Response
Austria	WIFO	No
Belgium	FPB	No
Czech Rep.	CCS&F	No
Denmark	DEC	Yes (5-10%)
Finland	ETLA	No
Germany	DIW	No (with exceptions)
Hungary	GKI	No
Ireland	ESRI	No
Netherlands	CPB	No
Serbia	FTRI	Yes
Slovenia	SKEP	Yes
Slovakia	SAVBA	Yes
Spain	CEPREDE	Yes
Sweden	CSE	Yes
Switzerland	KOF	Yes
UK	NIESR	Yes

In Denmark, the DEC estimates that real house prices have fallen about 20 per cent below their 2008 peak, reducing overvaluation from 30 per cent to 5-10 per cent. This fall reversed in 2010, and prices are expected to grow by 5 per cent this year. In contrast, CSE believe that house prices in Sweden are also overvalued, and house prices rose by 4 per cent over 2007-10.

In Slovenia, SKEP indicates that house prices remain high and overvalued despite stabilising about 10 per cent below their pre-crisis levels and forecasting a further fall by 1.5 per cent this year. The introduction of a property tax in 2013 may force some correction in the market.

Many institutes responded that house prices in their country did not appear to be overvalued. Notably, although house prices in Belgium remained above their 2006 levels in 2010, the FPB believe they reflect market fundamentals such as mortgage rates, disposable income, unemployment and the population size. Real house price are expected to continue to rise over 2013.

I.6 Topic for discussion – are we too gloomy?

Table 1.3 compares AIECE forecasts for quarterly GDP growth in the EA17 from May 2011 with actual data. The May forecast for growth of 0.4 per cent in the first quarter of 2011 was substantially weaker than the actual outturn of 0.8 per cent. Conversely, the forecasts for the second and third quarters of this year were overly optimistic, although only by a small amount.

Table 1.3 and the subsequent charts detail the most recent outturn of GDP growth data from Eurostat, for the third quarter of 2011 where available, including the flash estimates for the EA-17 and the EU-27. Quarterly figures show that Cyprus, Portugal and the Netherlands contracted in the last quarter. Belgium, Bulgaria, the Czech Republic and Spain saw no growth for that quarter. Romania and the Baltic countries saw strong growth.

Table 1.3. EA17 growth; May forecasts compared with actual outturns

Date	May 2011 forecast (annualized)	May 2011 forecast (implied quarterly)	Actual outturn
2011 Q1	1.7	0.4	0.8
2011 Q2	1.5	0.4	0.2
2011 Q3	1.3	0.3	0.2

Source: Eurostat.

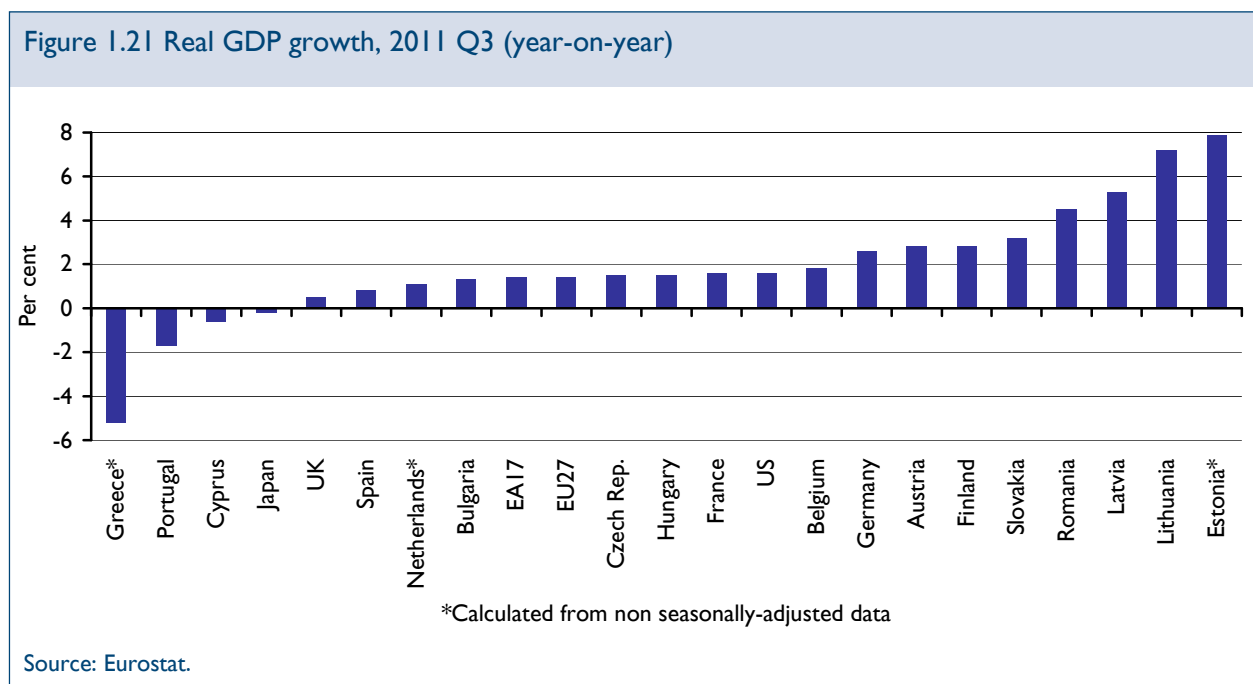
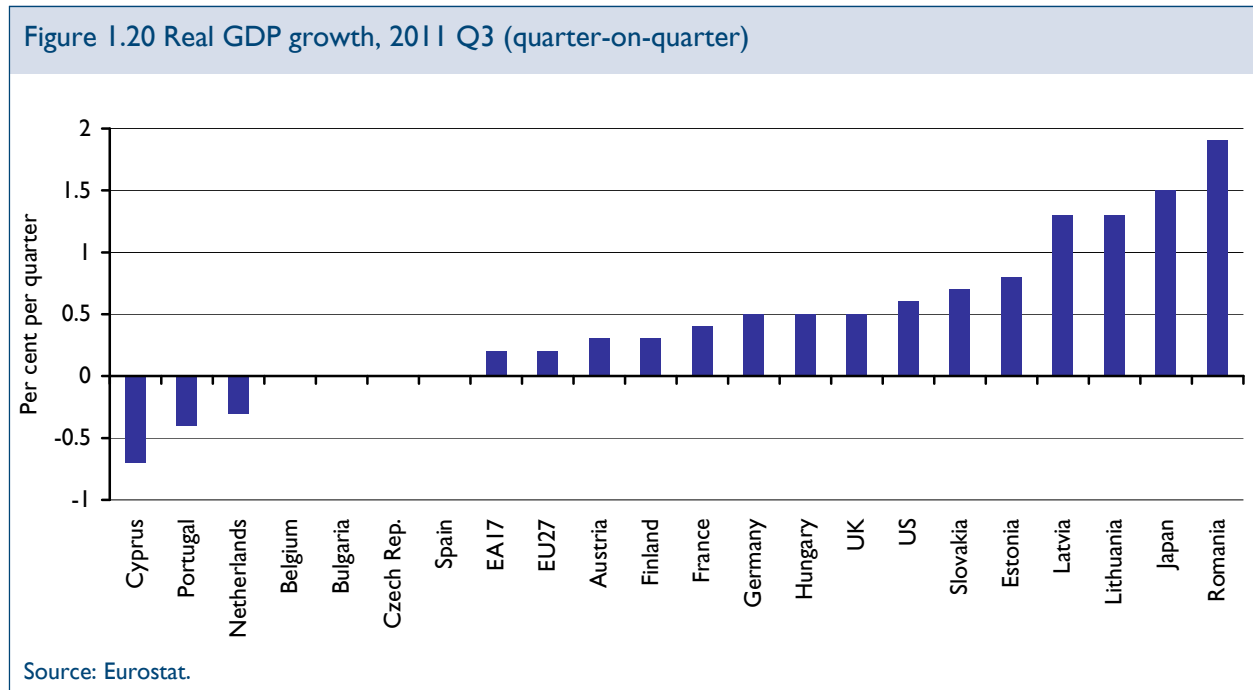
Considering growth between the third quarter of 2011 and that of 2010, Greece has contracted significantly, as well as Portugal and Cyprus to a lesser extent. The Baltic countries, Slovakia, Romania, Austria, Finland and Germany all saw healthy rates of growth.

Table 1.4 Growth rates of GDP

Country	2011 Q1	2011 Q2	2011 Q3	Percentage change between 2010 Q3 and 2011 Q3
EA17	0.8	0.2	0.2	1.4
EU27	0.7	0.2	0.2	1.4
Austria	0.9	0.5	0.3	2.8
Belgium	0.9	0.4	0.0	1.8
Bulgaria	0.5	0.3	0.0	1.3
Cyprus	-0.3	0.2	-0.7	-0.6
Czech Rep.	0.9	0.1	0.0	1.5
Estonia	3.1	1.7	0.8	7.9*
Finland	0.3	0.6	0.3	2.8
France	0.9	-0.1	0.4	1.6
Greece	-	-	-	-5.2*
Germany	1.3	0.3	0.5	2.6
Hungary	0.5	0.2	0.5	1.5
Latvia	1.1	2.0	1.3	5.3
Lithuania	2.1	1.8	1.3	7.2
Netherlands	0.7	0.2	-0.3	1.1*
Portugal	-0.6	-0.1	-0.4	-1.7
Romania	0.5	0.2	1.9	4.5
Slovakia	0.8	0.8	0.7	3.2
Spain	0.4	0.2	0.0	0.8
UK	0.4	0.1	0.5	0.5
Japan	-0.7	-0.3	1.5	-0.2
US	0.1	0.3	0.6	1.6

Source: Eurostat, *not seasonally-adjusted

While estimates for large European countries such as Italy have not yet been released, some of the figures below may appear more positive than expected, given the air of pessimism hanging over the European economy.



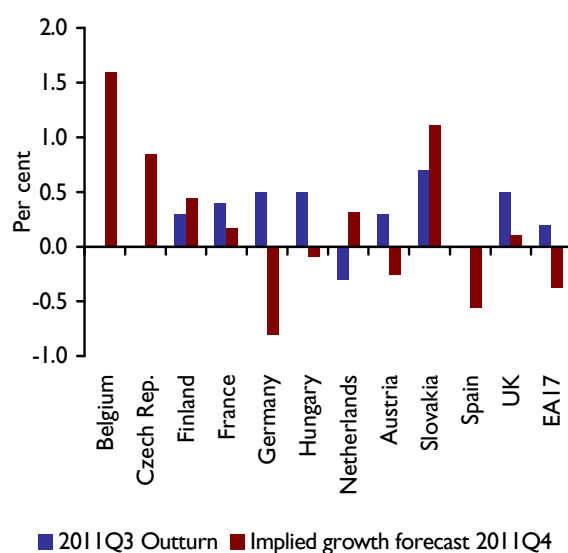
2. Outlook for 2011–2012

2.1 GDP growth

Short-term forecast: 2011Q4

Data releases for the third quarter of 2011 that materialised just prior to the production of this report, give some indication of the accuracy of our short-term forecasts and estimates of GDP growth in the year as a whole. The preliminary estimates for GDP growth in Belgium, Czech Republic and the Netherlands for the third quarter was weaker than expected by the participating Institutes, whereas growth was slightly stronger than expected in Germany, France and Spain. The figure below illustrates the outturns for GDP growth in 2011Q3 (according to the preliminary estimates) and also the implied rates of growth for the fourth quarter of 2011 if the Institutes forecasts for 2011 as a whole are to be met. The figures imply relatively strong growth in Belgium, the Czech Republic and Slovakia, suggesting that our estimates for this year may be overly optimistic. Projections for Germany and Spain (and the Euro Area as a whole), on the other hand, may be unduly pessimistic for this year, as a sharp contraction would be required in the final quarter of this year in order to meet the forecasts produced prior to the release of the third quarter data.

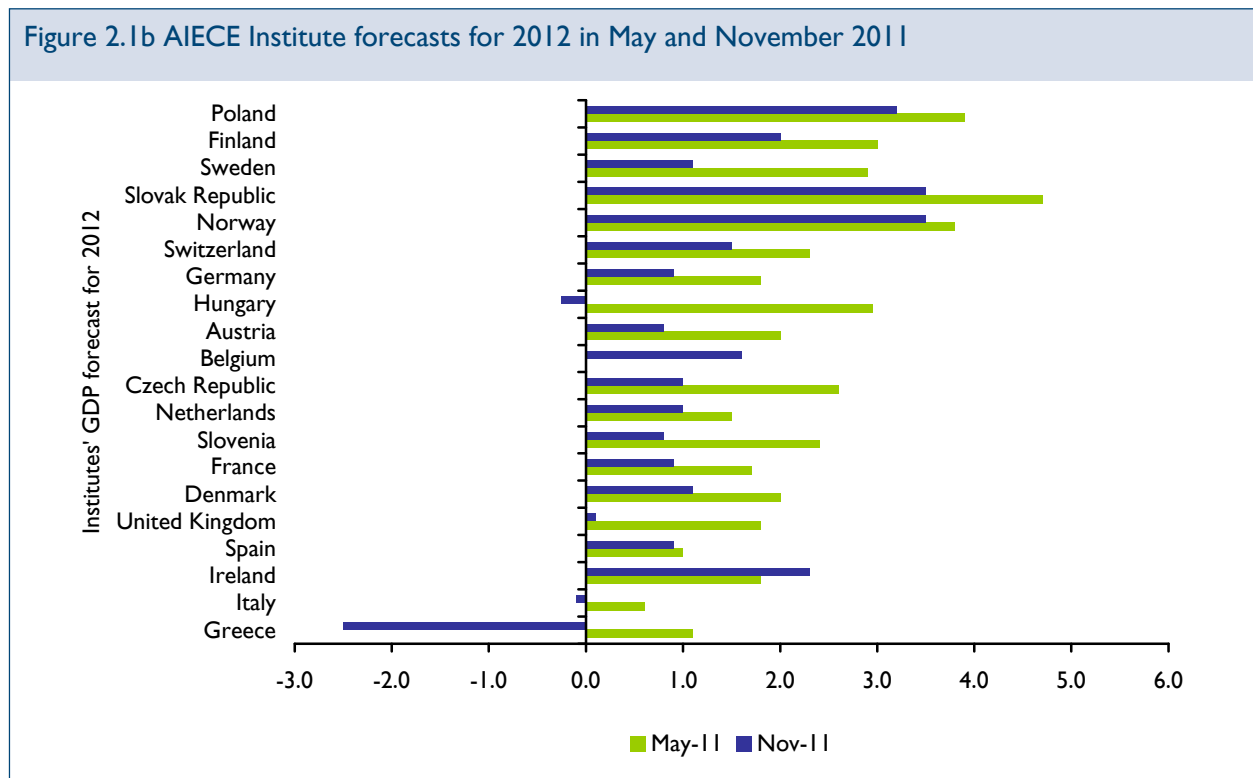
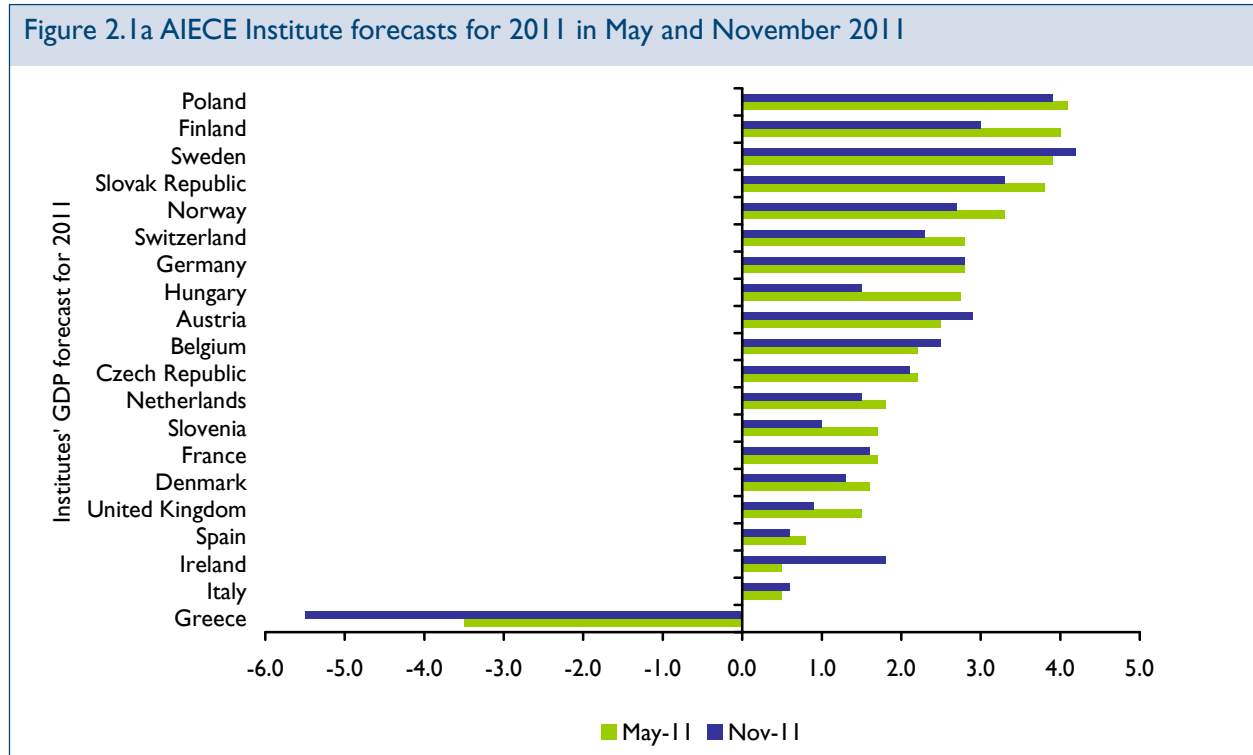
Figure 2.1 GDP growth in 2011 Q3 and implied growth in 2011 Q4



Note: The implied growth for 2011 Q4 is calculated as the Institutes' forecasts for GDP growth in 2011 as a whole, less the outturn for the first three quarters of the year.

Medium-term forecast: 2011–2012

In general, country forecasts have been revised down by the AIECE Institutes since May 2011. Figures 2.1a and 2.1b show our latest projections against those made six months ago. All Institutes have downgraded their forecasts for 2012 since May, and most have also revised projections down for this year as well. The exceptions are Sweden, Austria, Belgium, Ireland and Italy, where prospects this year are slightly more favourable than anticipated, while the average forecast of the AIECE Institutes for Germany is unchanged.



Euro Area

The majority of institutes forecast a slight deceleration of GDP growth in the Euro Area this year, and a further, deeper slowdown next year.

After the growth of 1.7 per cent recorded in 2010, the Institutes, on average, expect that the single currency block's economy will expand at 1.6 per cent annually in 2011 and 1 per cent in 2012.

Figure 2.2 GDP growth in the Euro Area in 2011 and 2012 (Institutes' forecasts)

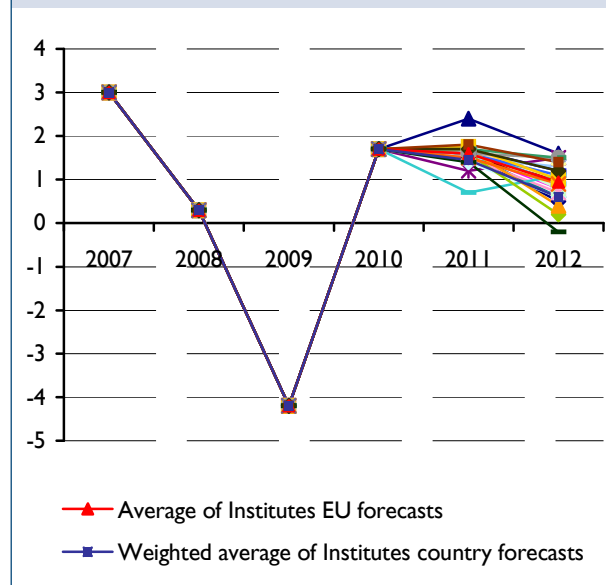


Table 2.1 AIECE members' forecasts for the Euro Area

	2011	2012
Minimum	0.7	-0.2
Maximum	2.4	1.6
Median	1.6	1
Average	1.6	1
Weighted average	1.5	0.6

The aggregation of individual institutes forecasts' for their countries suggests that the slowdown will be even deeper. The discrepancy between the average of Institutes' forecasts for the Euro Area and the weighted average of individual Institutes' forecasts for their countries rises over time, from 0.1 in 2011 to 0.4 in 2012.

About 65 per cent of AIECE members project a worsening of the macroeconomic situation in the Euro Area this year, and about 80 per cent forecast a deceleration of the annual growth rate next year. About 10 per cent of institutes expect that GDP growth in the Euro Area will accelerate this year, and 6 per cent project that the annual GDP growth rate in 2012 will be higher than in 2011.

The distribution of Institutes' forecasts for the Euro Area varies across forecasting horizons. While the forecasts for 2011 are relatively normally distributed, the distribution of forecasts for 2012 is much more skewed. Kurtosis is also much higher. This can be attributable to an increase in the degree of uncertainty.

Figure 2.3 Per cent of Institutes forecasting improvement, stabilisation or worsening of growth prospects in the Euro Area

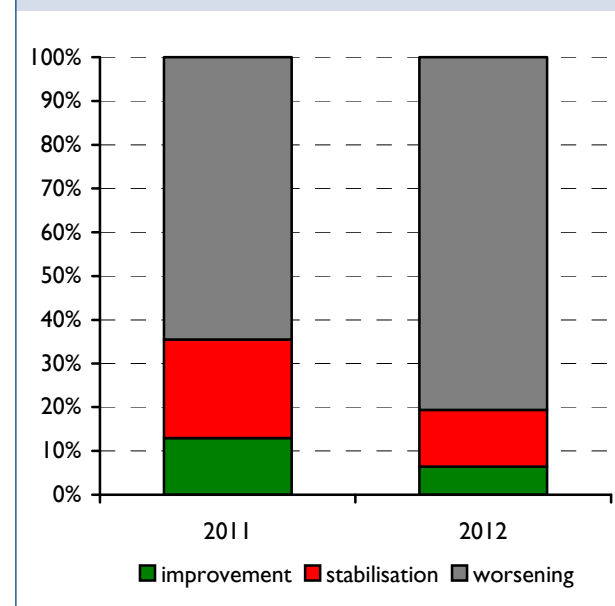


Figure 2.4 The distribution of Institutes' forecasts for the Euro Area in 2011 and 2012

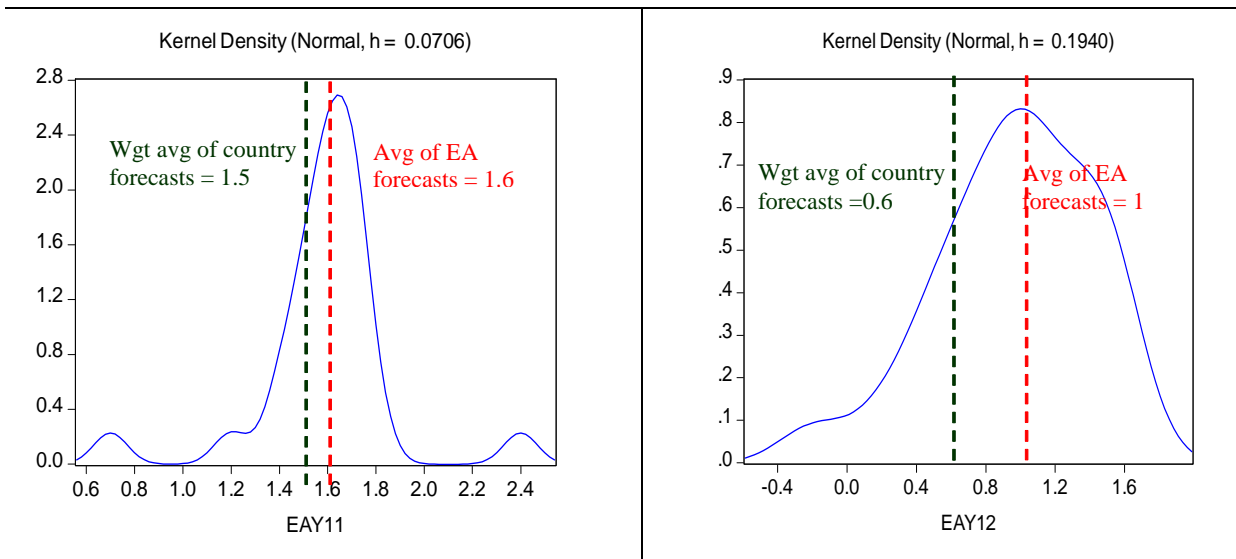
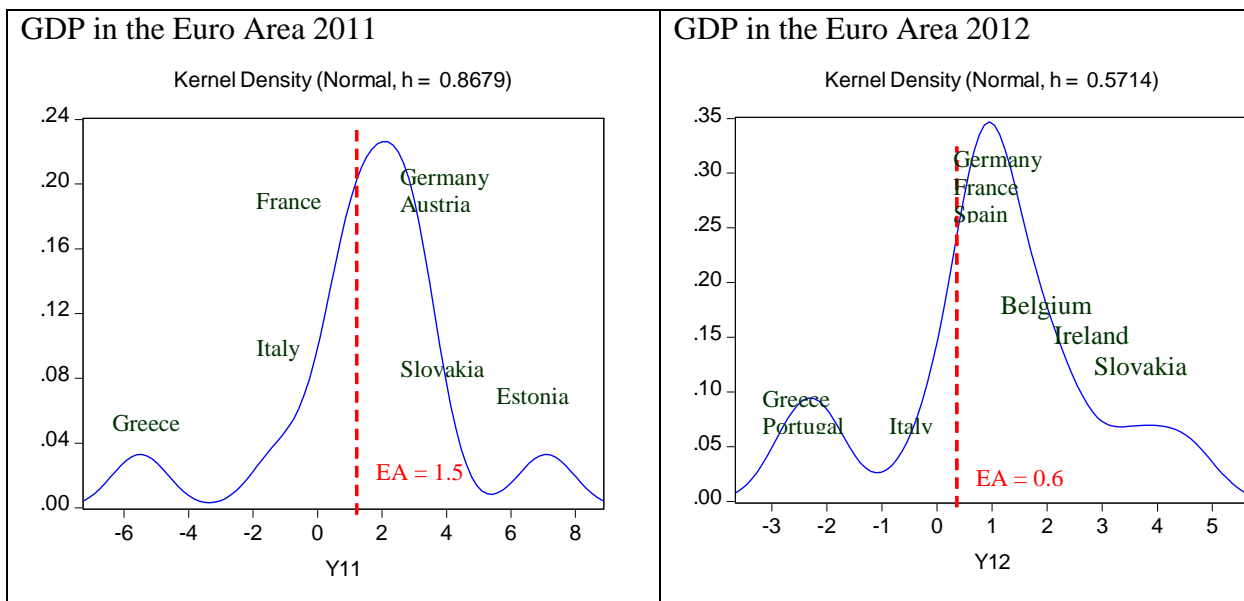


Figure 2.5 GDP growth in the Euro Area – country forecasts



GDP divergences across the Euro Area economies remain wide. Greece is expected to decline by 5.5 per cent this year, and Italy and Spain are forecast to grow by a mere 0.6 per cent. On the other hand, Germany, Austria and Finland will expand by about 3 per cent. The smaller new members of the Euro Area, Slovakia and Estonia, are forecast to grow at a much faster pace than the Euro Area average of 1.5 per cent. In 2012, all economies except Greece are projected to record lower growth rates than in 2011.

European Union

GDP growth in the European Union is expected to slow down slightly – see figure 2.6. The AIECE members forecast that in 2011 the European Union economy will expand at 1.7 per cent annually, and in 2012 GDP growth will slow down to 1.2 per cent – see table 2.2.

The average of institutes' forecasts for the EU as a whole is higher than weighted average of institutes' forecasts for their own countries. This implies that the majority of institutes perceive the situation in their own country as relatively worse than in the European Union as a whole.

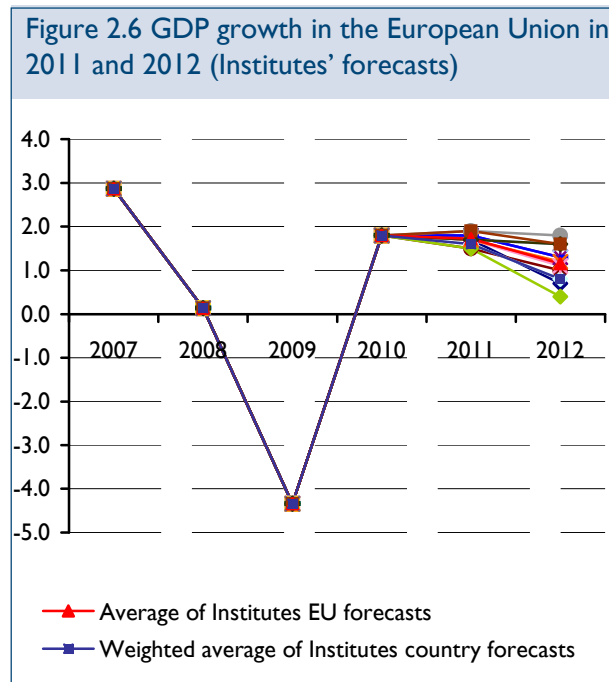


Table 2.2 AIECE members' forecasts for the European Union

	2011	2012
Minimum	1.5	0.4
Maximum	1.9	1.8
Median	1.7	1.2
Average	1.7	1.2
Weighted average	1.6	0.8

Institutes' forecasts for this year range from 1.5 to 1.9 per cent, while in 2012 GDP growth is forecast as low as 0.4 and as high as 1.8. The dispersion of the forecasts for the next year is three times bigger than for this year which reflects the much higher uncertainty.

More than 80 per cent of AIECE members expect that the macroeconomic situation in Europe will worsen this year. 55 per cent of institutes project a stabilisation of growth in the European Union in 2012.

Figure 2.7 Per cent of Institutes forecasting improvement, stabilisation or worsening of growth prospects in the EU (relative to the previous year)

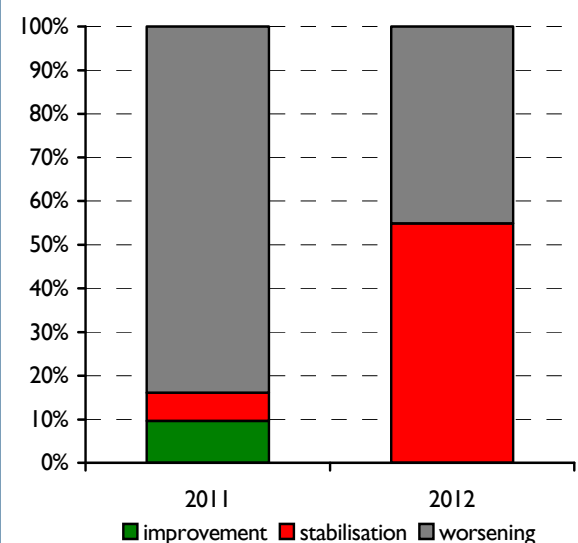
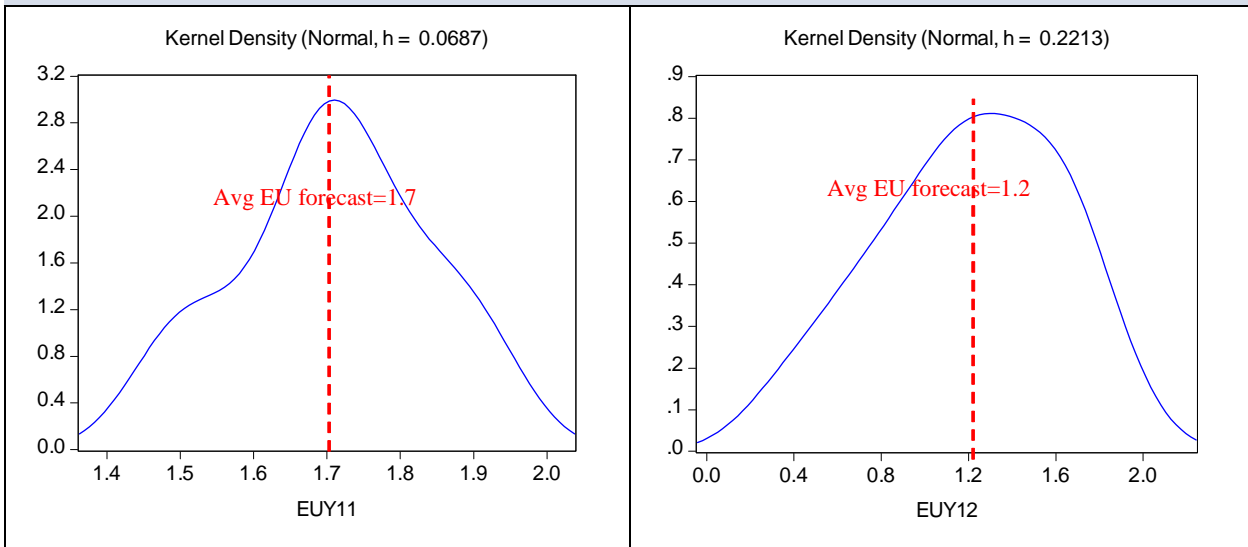


Figure 2.8 shows the distribution of Institutes' forecasts for the European Union in 2011 and 2012. The forecasts for the EU are much more evenly distributed than the forecasts for the Euro Area (resembling a triangular distribution). The dispersion of the forecasts is, however, much smaller.

Figure 2.8 The distribution of Institutes' forecasts for the EU in 2011 and 2012



AIECE countries

Figure 2.9 shows GDP growth rates forecast for individual AIECE countries – members of the Euro Area, European Union and other European economies.

The institutes expect a relative improvement of growth prospects in 2012 in: Greece, Spain, Ireland, Slovakia, and Norway. A stabilisation is expected in Serbia. All other AIECE countries are forecast to slow down. The biggest slowdowns (of close to 2 percentage points or more) are expected to materialise in Sweden, Austria, Germany, and Hungary.

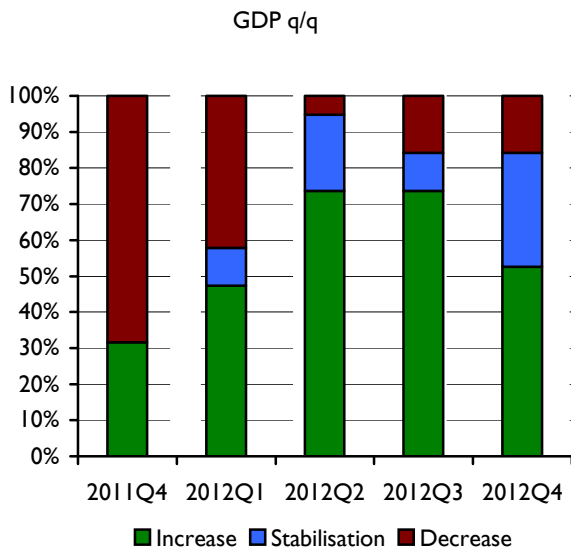
The average quarterly growth rate across individual institutes' forecasts for their countries indicates a slowdown, whose extremum is expected to materialise in the first quarter of 2012. The second part of the year should see an acceleration in the quarterly growth rate across the AIECE countries. The quarterly profile suggests that the majority of institutes do not expect a recession (two quarters or more of declining GDP) in their countries, there are however exceptions (such as for example Italy).

Figure 2.9 GDP growth in AIECE countries

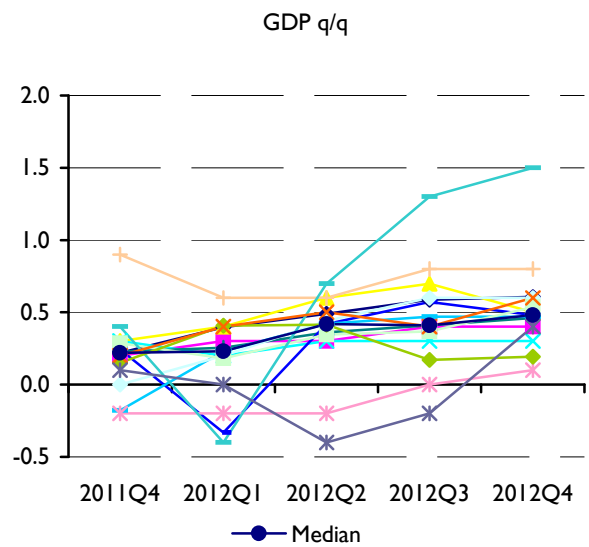


Figure 2.10 The quarterly GDP profile

Institutes expecting an increase/stabilisation/decrease in q/q GDP growth in their countries

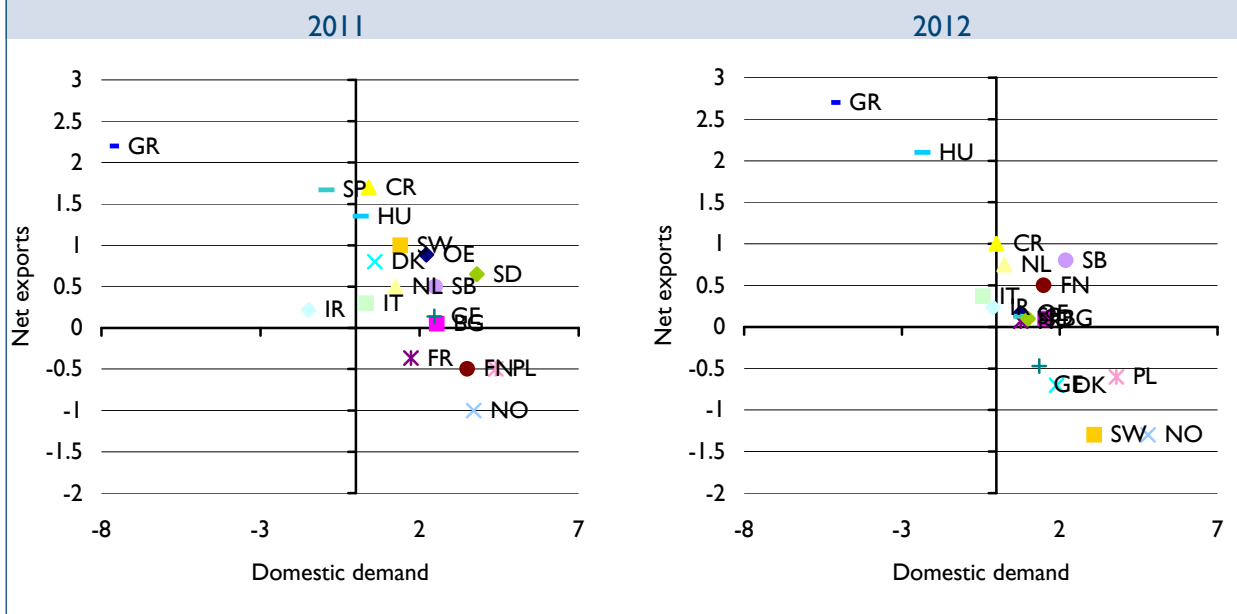


Institutes' forecasts – quarterly GDP growth in their countries)

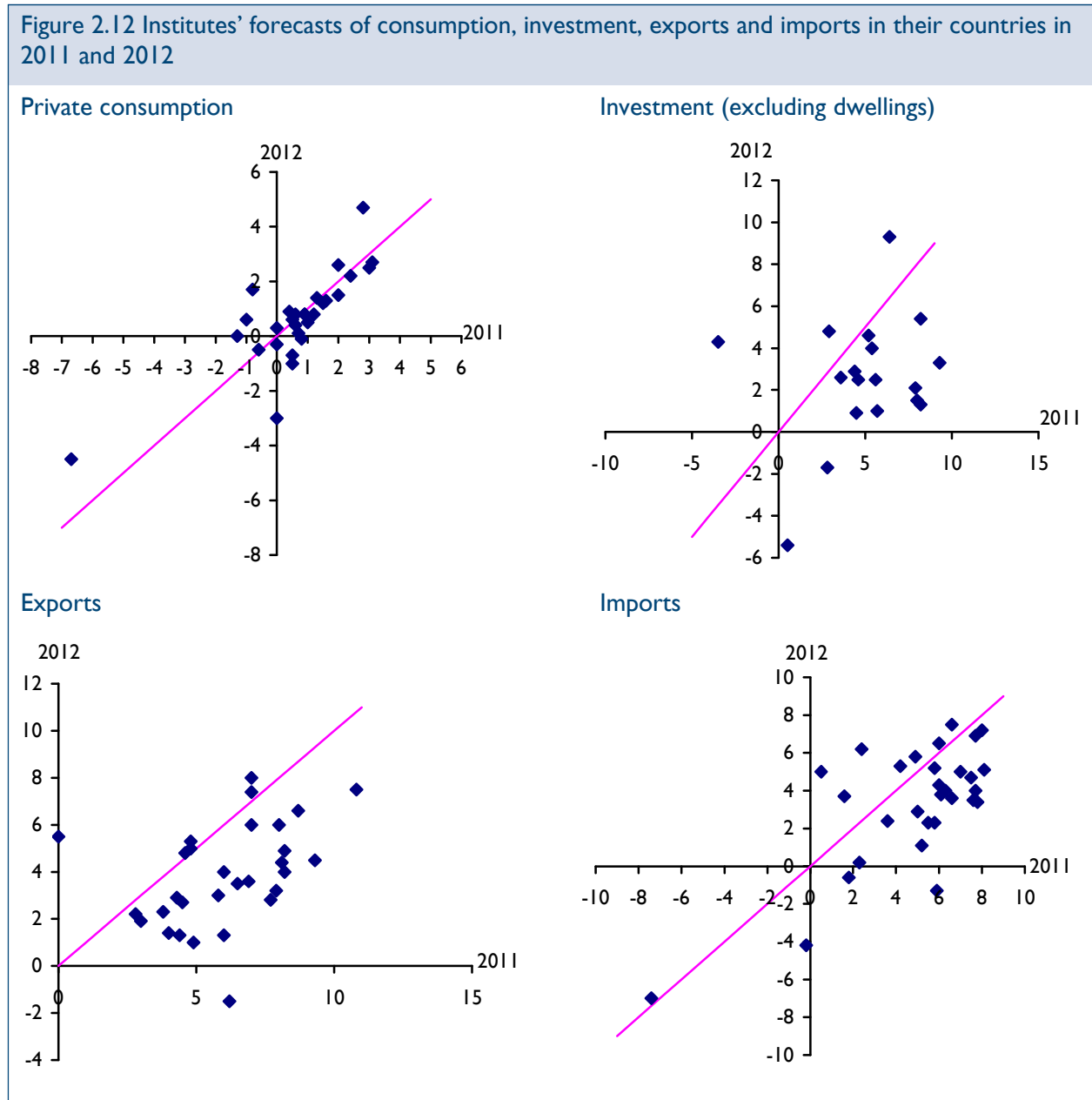


GDP growth in most AIECE countries is expected to be driven by both domestic and external demands, with relative weights of the two components depending on country-specific factors (such as, inter alia, openness). The institutes expect that next year will see lower contributions of both domestic demand and net exports to growth than this year.

Figure 2.11 Institutes' forecasts for their own countries – domestic demand vs net exports



The Institutes forecast that the rate of growth of all major components of GDP: consumption, investment, exports and imports, in their countries, will decline in 2012 as compared to 2011 – see figure 2.12.



2.2 Inflation

Euro Area

The Institutes expect an acceleration of inflation in 2011, to about 2.6 per cent. Next year should see a decrease in inflation to 1.7. The median of institutes' forecasts for 2012 is somewhat lower than the weighted average of Institutes' forecasts for inflation in their own countries – see table 2.3.

All institutes forecast an increase in inflationary prospects in 2011. All institutes project that inflation will decrease in 2012.

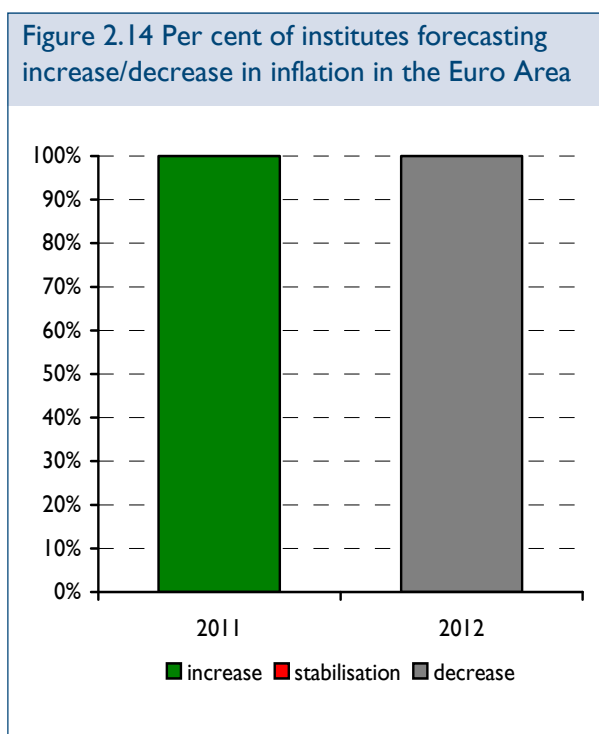
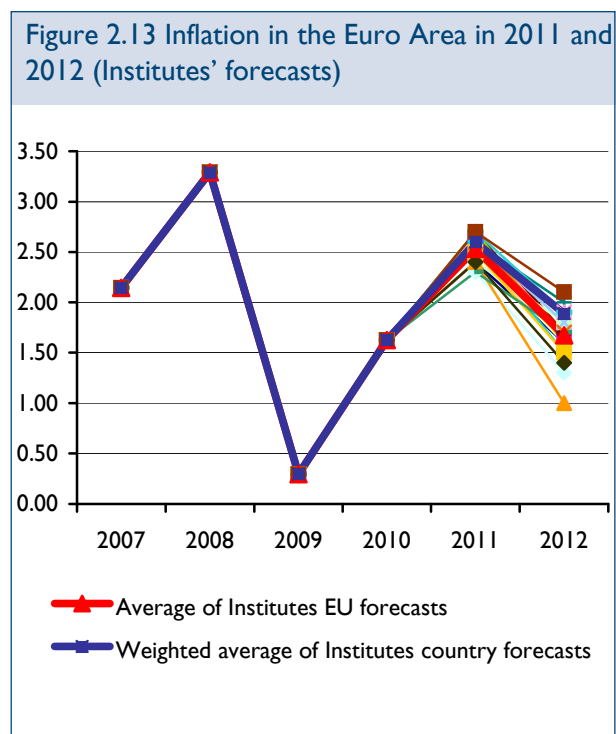
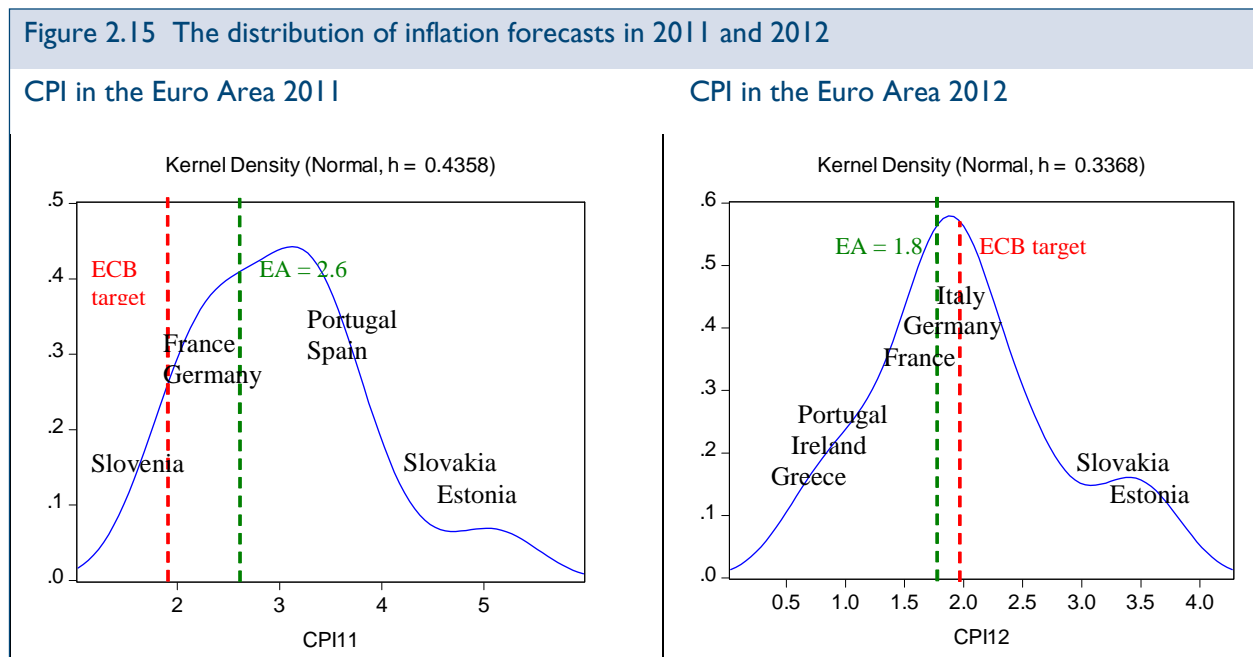


Table 2.3 AIECE members' inflation forecasts for the Euro Area

	2011	2012
Minimum	2.3	1.0
Maximum	2.7	2.1
Median	2.6	1.7
Average	2.5	1.7
Weighted average	2.6	1.9

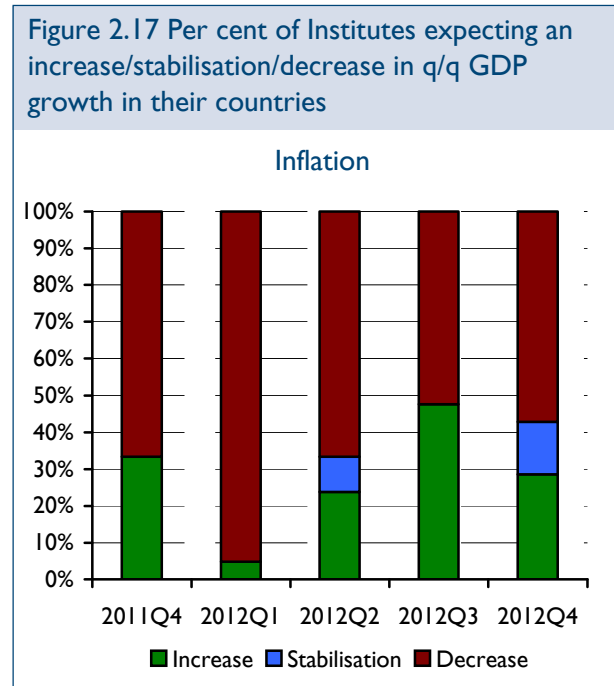
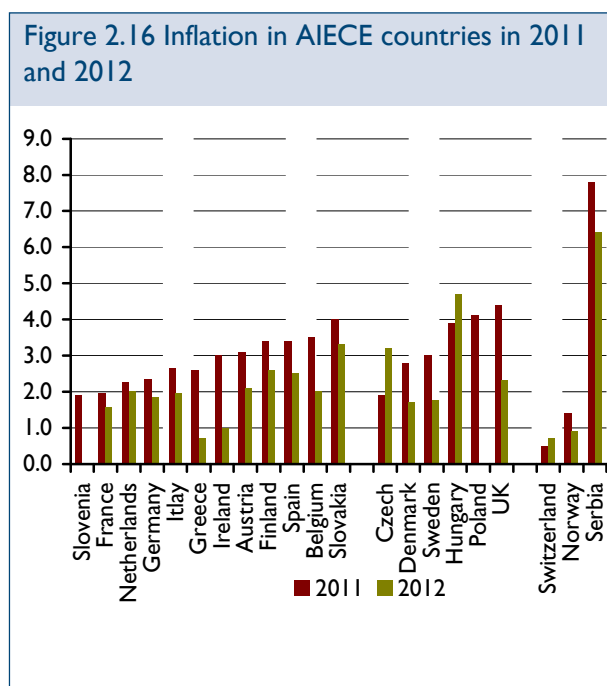
Figure 2.15 shows the distribution of forecast inflation outcomes in 2011 and 2012. The institutes expect that inflation in the majority of countries will remain above the ECB target in 2011. The average inflation in the Euro Area should move closer to the target in 2012.



AIECE members

Figure 2.16 shows inflation forecasts for all AIECE countries. The lowest inflation rate amongst Euro Area countries is expected to materialise in Slovenia and France. Inflation is forecast to amount to close to 2 per cent in 2011. The highest inflation is expected in Belgium and Slovakia. Among the non-Euro Area members the lowest inflation is forecast for the Czech Republic. Poland and the UK will see inflation above 4 per cent. Among the non-EU countries Switzerland is expected to record inflation below 1 per cent, and Serbia - close to 8 per cent.

The majority of institutes expect that inflation will decrease throughout 2012, although, starting from the second quarter of 2012 the number of institutes forecasting gradual increases in inflation rises.



2.3 Unemployment

Euro Area

Figure 2.18 shows institutes' forecasts for unemployment in the Euro Area. The unemployment rate is projected to remain high. The average of institutes' forecasts suggests that the unemployment will level at about 10 per cent both in 2011 and 2012.

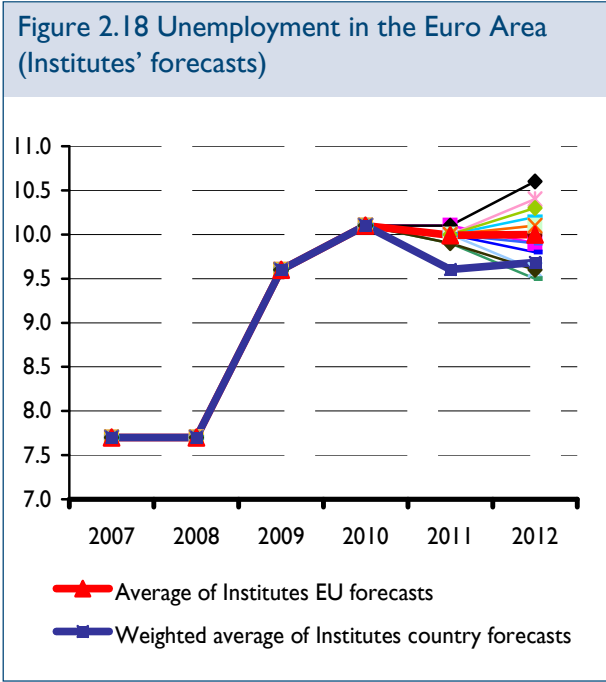
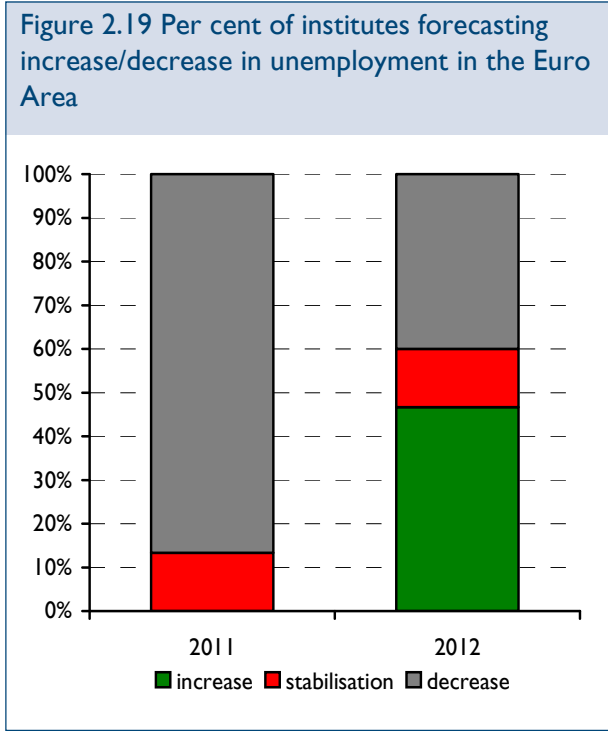


Table 2.4 AIECE members' unemployment forecasts for the Euro Area

	2011	2012
Minimum	9.9	9.5
Maximum	10.1	10.6
Average	10.0	10.0
Weighted average	9.6	9.7

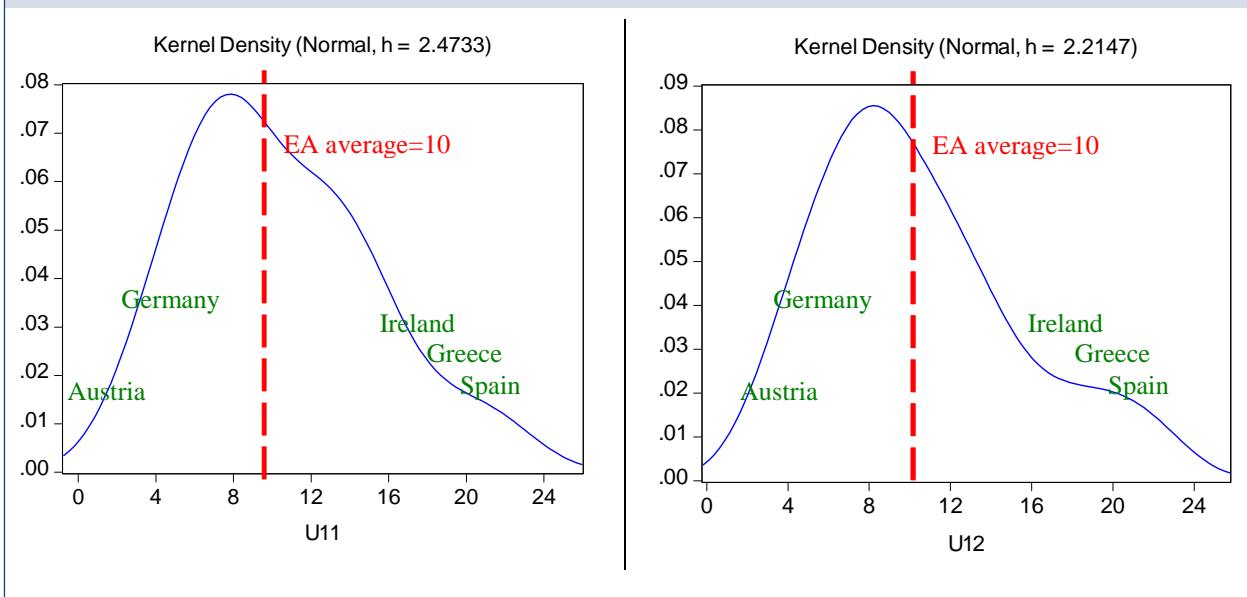
The dispersion of institutes' unemployment forecasts is relatively low for 2011. It rises somewhat in 2012 with the minimum forecast at 9.5 per cent and the maximum at 10.6 per cent.

The majority of AIECE members expect a minimal (0.1) decrease in the unemployment rate in 2011 from the 10.1 per cent recorded in 2010. About 50 per cent of the institutes project that the unemployment rate in the Euro Area will rise in 2012.



The lowest unemployment rates are forecast for Austria, Netherlands and Germany, and the highest – for Spain, Greece and Ireland, both in 2011 and 2012 – see figure 2.19 which shows the distribution of the unemployment rates across the Euro Area countries

Figure 2.19 The distribution of unemployment forecasts in 2011 and 2012



AIECE countries

Figure 2.20 shows the rates of unemployment forecast by the institutes for their countries.

The majority of institutes expect that unemployment will either increase or remain unchanged throughout the forecast horizon.

Figure 2.20 Unemployment in AIECE countries in 2011 and 2012

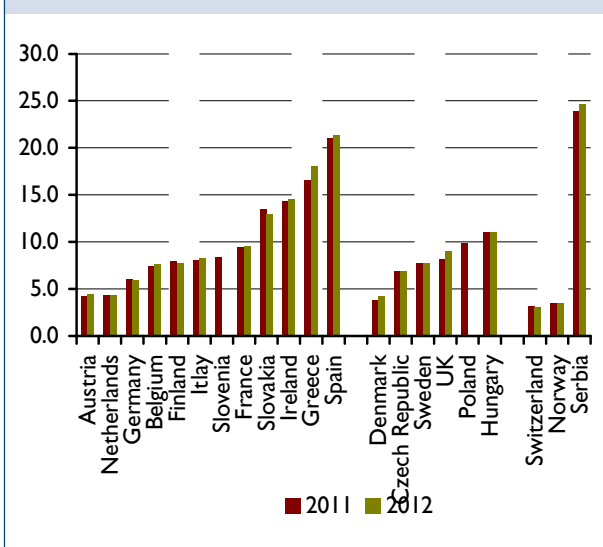
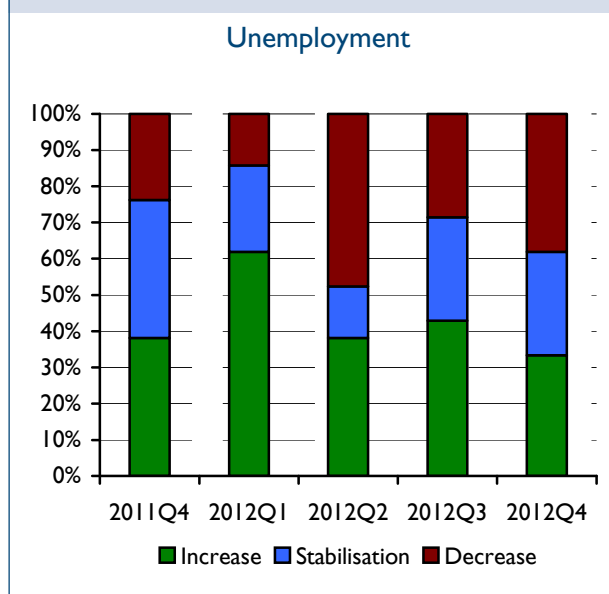


Figure 2.21 Per cent of Institutes expecting an increase/stabilisation/decrease in unemployment in their countries



2.4 Oil prices

The institutes assume that, on average, the price of oil will remain relatively stable over the forecast horizon, oscillating around 108 USD per barrel – see figure 22. The quarterly profile of the median oil price reveals that the institutes expect a decrease in oil prices in the fourth quarter of 2011 and a gradual increase in the price of oil throughout 2012.

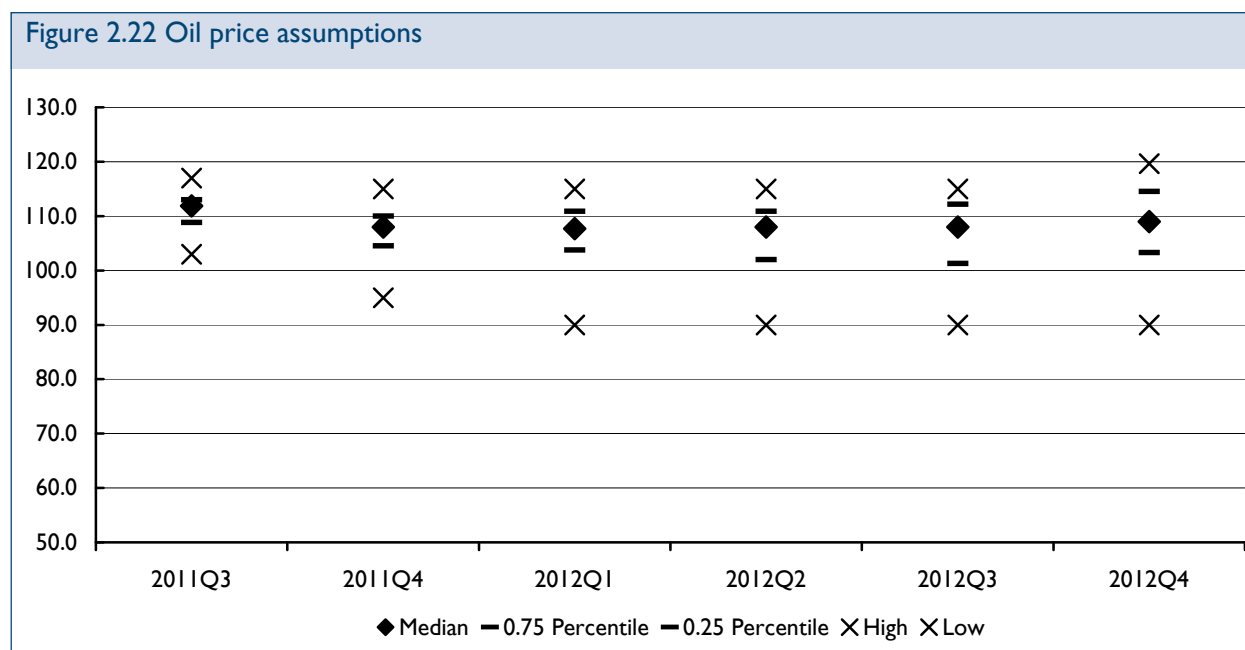
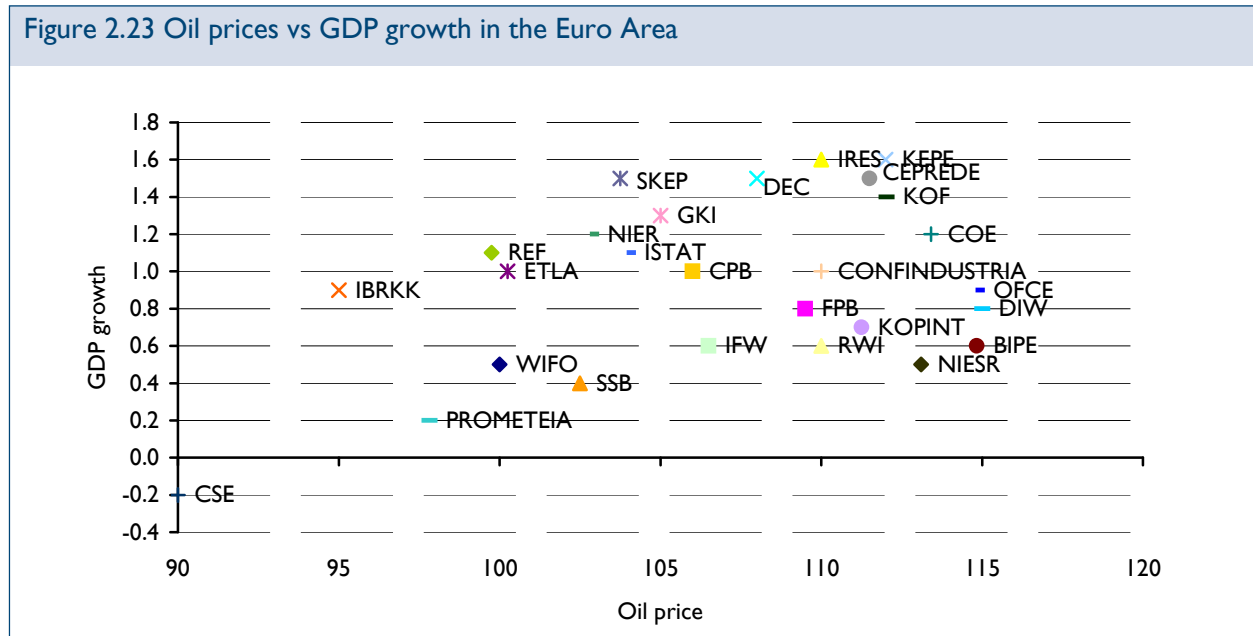


Table 2.5 Oil price assumptions' characteristics

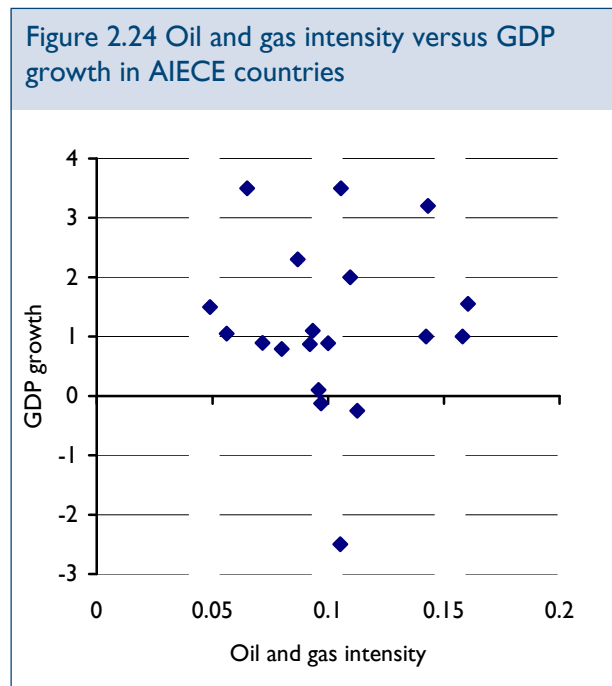
	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4
Mean	110.5	106.4	106.7	106.2	106.5	107.9
Median	111.9	108.0	107.7	108.0	108.0	109.0
High	117.0	115.0	115.0	115.0	115.0	119.7
Low	103.0	95.0	90.0	90.0	90.0	90.0

To inspect whether varying assumptions on oil prices could have an impact on AIECE members' forecasts of the Euro Area GDP we plot the average prices of oil forecast by individual institutes for 2012 against their Euro Area GDP forecasts for 2012.



In principle, there is no clear evidence of a monotonous relationship between the oil price and GDP growth for the Euro Area as forecast by individual AIECE members. However, if we remove outliers, there is a slightly positive trend visible in the data suggesting that higher oil prices correspond to higher forecast GDP growth rates. This may imply that the Institutes differ in how they perceive prospects for the world economy. Better prospects for the global economy are reflected both in higher assumed oil prices, as well as higher project GDP growth rates for the Euro Area. The gloomier world outlook corresponds to lower expected oil prices and worse prospects for the Euro Area economy. Should this be the case, IRES and CEPREDE should expect better prospects for the world economy than PROMETEIA or WIFO.

Figure 2.24 shows the relationship between individual AIECE countries' GDP growth forecasts for 2012 and their oil intensity (As of 2010). There is no clear monotonous relationship between the intensity of oil in individual countries and the countries' GDP growth rates which indicates that, at the current juncture, there are other factors at play, relatively more significant than the price of oil (the scale of exposure to the Greek debt, the size of fiscal imbalances or the level of openness).



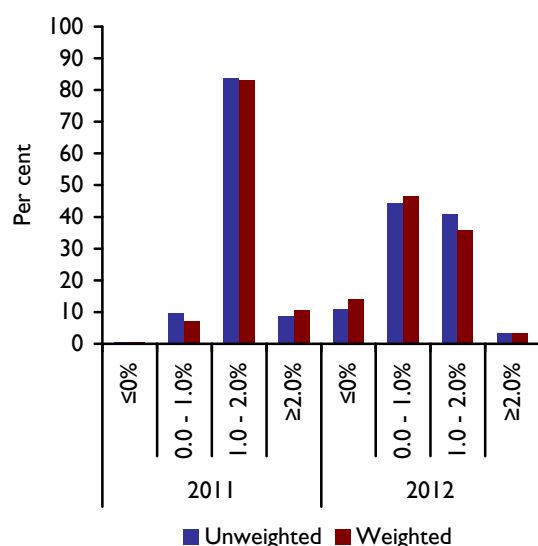
3. Key risks and uncertainties

In this section we address the key risks and uncertainties surrounding the outlook for Europe. The key risk and main uncertainty is obvious: the evolution of the sovereign debt crisis in the Euro Area. But other risks to the forecast do exist: issues surrounding the sustainability of the US public finances; while further falls in the oil price poses an upside risk to our GDP forecasts to name two. The Euro Area crisis dominates the outlook in Europe.

Beginning with uncertainties: AIECE member institutes were asked to provide the probability distributions around their forecasts for GDP and inflation for this year and next¹. The responses for country are presented in Appendix A of this report. Where a country is represented by more than one institute, the distributions of these institutes have been combined as per the simple method applied by the ECB to the ECB's *Survey of Professional Forecasters* (see Bowles *et al.* 2007). Throughout we assume these distributions are normal. We chose a consistent set of bins to use in this analysis. For some AIECE member institutes the section of the frequency distribution chosen was perhaps not large enough. With a GDP forecast to contract by 5.5 per cent this year KEPE's probability distribution is captured entirely by the left hand tail of our imposed probability distribution. While ETLA's forecast for GDP growth of 3 per cent per annum this year is captured almost entirely by the right hand tail of our imposed probability distribution.

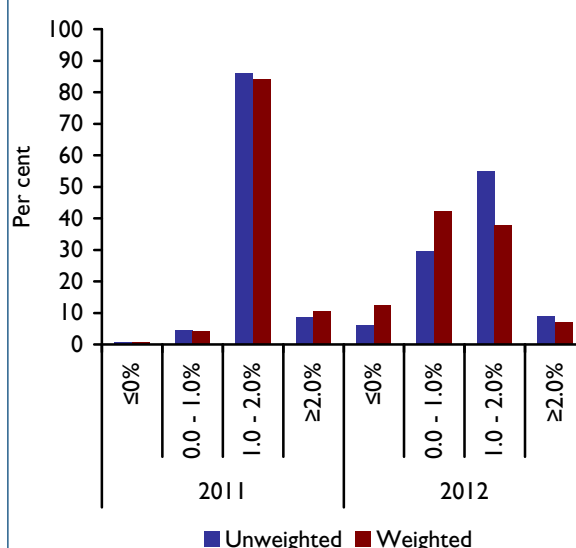
The combined probability distributions for GDP forecasts for the Euro Area and EU are presented in figures 3.1 and 3.2. There is little difference between the unweighted and weighted (by GDP in 2010 adjusted for Eurostat/OECD PPPs) distributions around the GDP forecasts. The aggregate distribution for AIECE member institutes growth forecasts attaches an 84 per cent (82 per cent on a weighted basis) probability to GDP growth between 1 and 2 per cent in the Euro Area and, but only 41 per cent (36 per cent weighted) chance to this outcome in 2012.

Figure 3.1 Combined probability distributions for Euro Area GDP growth in 2011 and 2012



Source: AIECE member institutes.
Notes: Weighted using Eurostat/OECD PPP adjusted GDP weights for 2010.
Sample: 18 responses

Figure 3.2 Combined probability distributions for EU GDP growth in 2011 and 2012

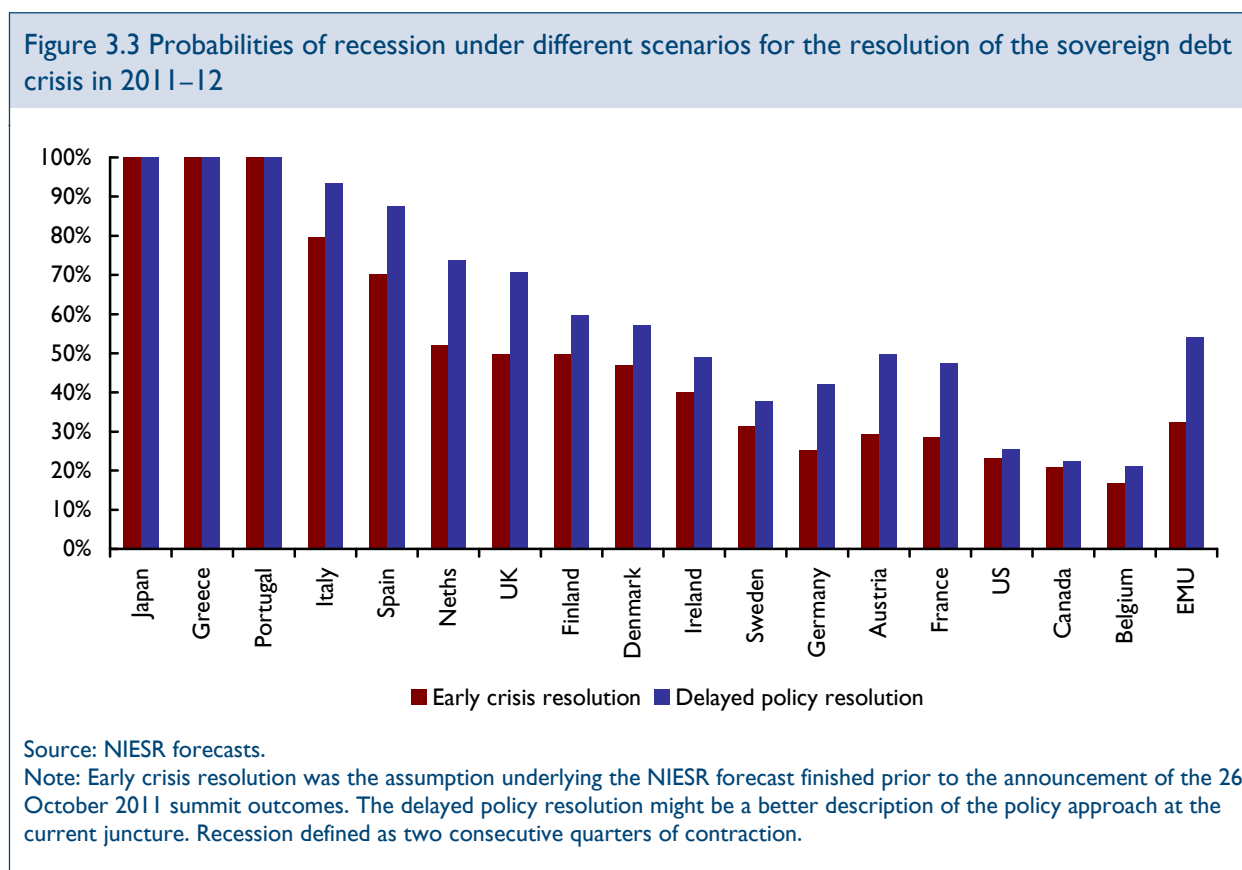


Source: AIECE member institutes.
Notes: Weighted using Eurostat/OECD PPP adjusted GDP weights for 2010.
Sample: 11 responses

3.1 Risks of recession

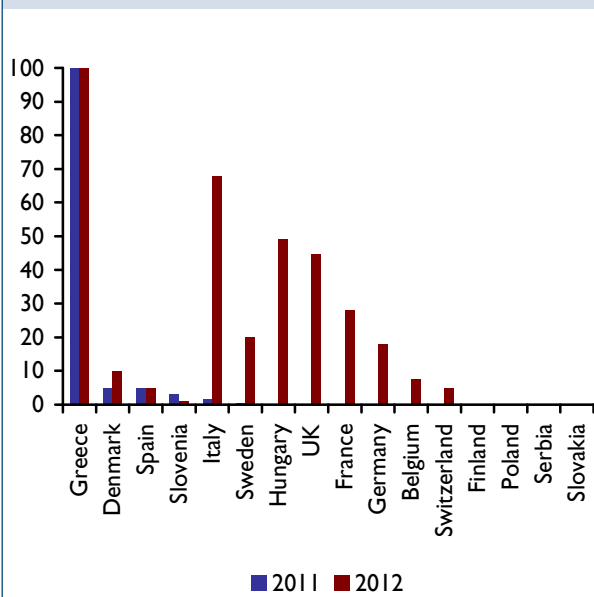
The risk of recession within Europe has increased significantly since the last AIECE meeting. A fall in output has already happened in one instance: data for the Netherlands in the third quarter of this year highlights this (a quarterly contraction of 0.3 per cent). Some European countries remain in recession (Greece and Portugal). The evolution of the Euro Area crisis is the key to economic outlook of all AIECE member countries.

We lead this section on the risk of recession by highlighting how the probabilities NIESR attaches to a technical recession change under different Euro Area policy assumptions. In order to undertake this analysis we used stochastic simulations using our global econometric model, NiGEM, around our baseline forecast from October 2011 and our alternative ‘delayed policy resolution’ to determine the probability of recession in the major economies. As figure 3.3 shows the delayed resolution has heightened the probability of recession. Unsurprisingly the increase in the probability of a technical recession in 2011 and 2012 is unanimous across all countries examined. The difference in increases in probability is in part determined by the dynamics of those economies.



Member institutes were not asked about the probability of technical recessions occurring in their countries, rather they were asked what they thought the probability of annual output growth falling in certain ‘bins’ of a histogram. One of these bins was a year-on-year fall in output. Figure 3.4 reports the probability of output falling in particular countries according to the AIECE member institutes. Aside from Greece, the probability of recession is currently low in most other countries represented by a member institute. Looking forward to 2012 there is a noticeable increase in the probability of output falling. The exception is Finland, Poland and Serbia where the probability of output falling is put at zero. Averaging the German AIECE member institutes’ responses gives a probability of 18 per cent to German output falling in 2012. The average for France (given by French AIECE member institutes) is 28 per cent. For the UK, the probability of output falling rise from around 0 per cent in 2011 to 45 per cent in 2012. For Hungary, the average probability of Hungarian output falling in 2012 is 49 per cent. For Italy, the average probability of output falling increases from 2 per cent in 2011 to 68 per cent in 2012, according to Confindustria, Prometeia and REF. A noticeable exception is Slovenia, where SKEP suggests a pattern in the opposite direction to the rest of the AIECE’s member institutes views about their own respective countries: the probability of output falling in 2011 is 3 per cent, but this is lowered to 1 per cent for 2012.

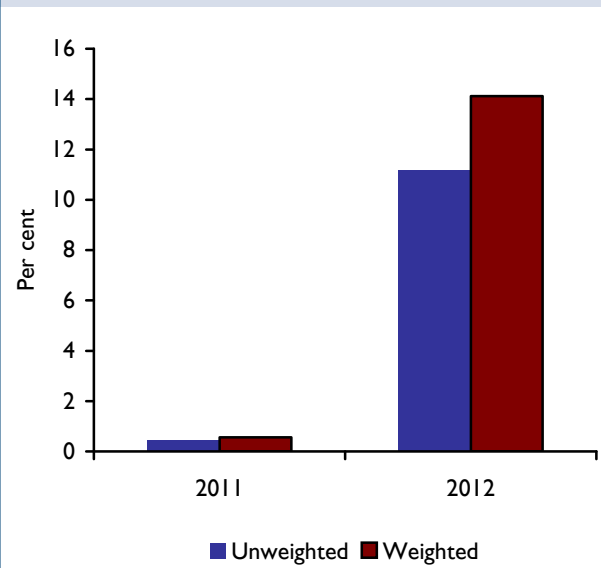
Figure 3.4 Probability of annual output falling in 2011 and 2012



Source: AIECE Institutes.

Note: Where more than one institute responded for a country the arithmetic mean of the probabilities is reported.
Sample: 24 responses.

Figure 3.5 Probability of Euro Area output falling in 2011 and 2012



Source: AIECE Institutes.

Note: Weighted using Eurostat/OECD PPP adjusted GDP weights for 2010.

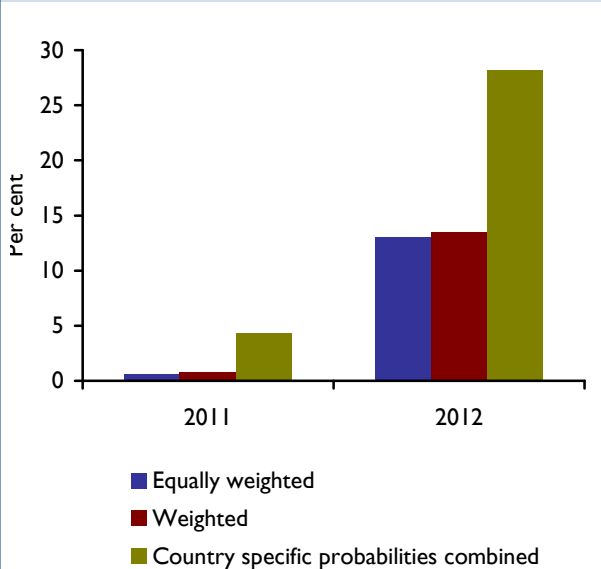
Sample: 20 responses.

AIECE member institutes were also asked for their views on the probability of output falling in the Euro Area and the EU as a whole. AIECE member institutes attach a very small probability to output falling this year, given the current vintage of data for 2011. Next year, the probability of output falling increases quite markedly, to around 22 per cent on an unweighted basis or 16.5 per cent when response are weighted by PPP adjusted GDP (figure 3.5).

Restricting our analysis of the probability of output falling in the Euro Area to Euro Area member institutes response only, we see the probability of output falling in 2012 to 13 and 13.5 per cent on an unweighted and weighted basis, respectively (figure 3.6). Does this mean that Euro Area member institutes are more optimistic about the outlook for the Euro Area than the non-Euro Area member institutes? Interestingly, if we weight the probabilities of output falling in the respective Euro Area member institutes own country then we see the probability of recession rise to over 28 per cent. Are Euro Area member countries more pessimistic about their own country's outlook than for the rest of the Euro Area?

For the EU as a whole AIECE member institutes attached a lower probability to output falling in 2012 than for the Euro Area as a whole (figure 3.7). There is a much greater discrepancy between the unweighted and weighted scores, suggesting that

Figure 3.6 Probability of Euro Area output falling in 2011 and 2012, Euro Area member institutes only



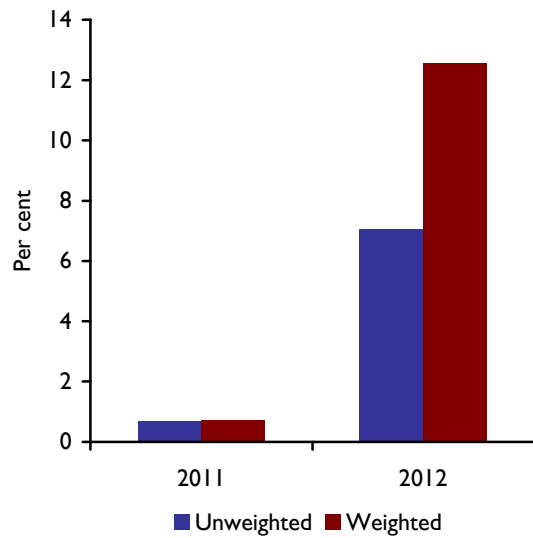
Source: AIECE member institutes

Notes: weighted using Eurostat/OECD PPP adjusted GDP weights for 2010. Country specific probabilities are combined using the PPP adjusted GDP weights.

Sample: Euro Area member institutes only; 15 responses.

AIECE member institutes representing the larger countries attach a greater probability to EU output falling in 2012. Kiel (Germany) attach a probability of 25 per cent to output falling in the EU as a whole in 2012, followed by BIPE (France) who attach a probability of 18 per cent to the same outcome. NIESR (UK) only attaches a 6.6 per cent probability to EU aggregate output falling in 2012, but an equal probability to BIPE with regards to the outcome of output growth below 1 per cent per annum.

Figure 3.7 Probability of EU output falling in 2011 and 2012

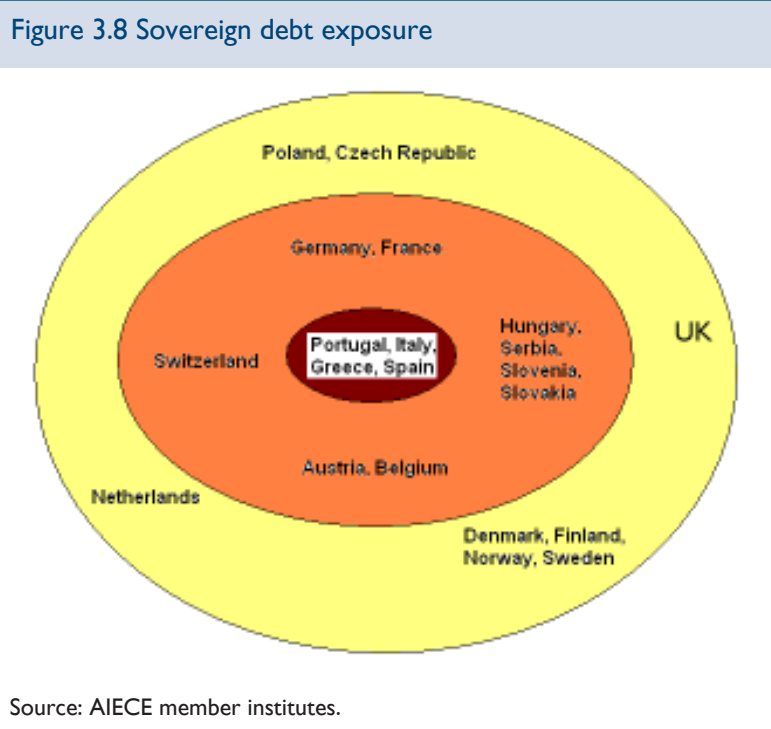


Source: AIECE member institutes
 Notes: weighted using Eurostat/OECD PPP adjusted GDP weights for 2010.
 Sample: 11 responses.

3.1 Banking sector vulnerabilities

3.1.1 Sovereign debt exposure

AIECE member institutes were asked about the exposure of their country’s banking system to euro member sovereign and banking sector defaults. The answers from the member institutes demonstrate once more that Portugal, Italy, Greece and Spain are at the epicentre of the crisis. Ireland seems to be a special case. Although the country is highly exposed to its own debt, the current economic prospect looks sound and exposure to potential sovereign and bank debt defaults in other countries is very low. Figure 3.8 attempts to illustrate the degree of exposure within Europe:



Source: AIECE member institutes.

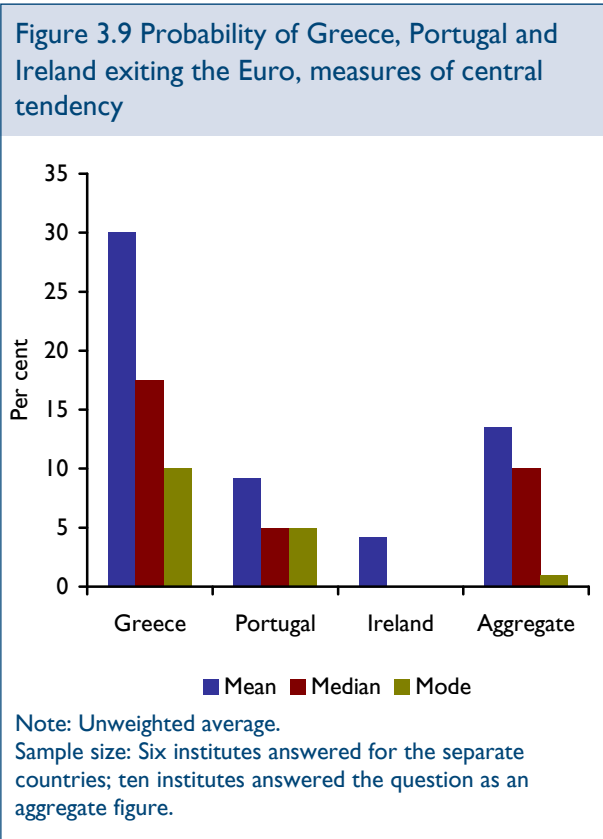
The graph highlights how the epicentre of the crisis impacts on other countries. The countries in the orange field are fairly robust but would feel the impact of eventual defaults in the ‘epicentre’ economies due to banking and debt ties. This is especially true for Germany and France. The countries in the yellow field seem to be robust. However, contagion could well suck the banking systems of those that appear least exposed towards the epicentre of the crisis. Informational asymmetries still abound across banking systems. As DEC (Denmark) notes “Danish banks are probably not very sensitivity to the Greek, Italian, Portuguese or Spanish credit risks, but we have no hard facts to support it.” But RWI (Germany) summarise the magnitude of a default by the Italian and Spanish sovereigns: “Default of the Italian or Spanish sovereign would have devastating consequences”.

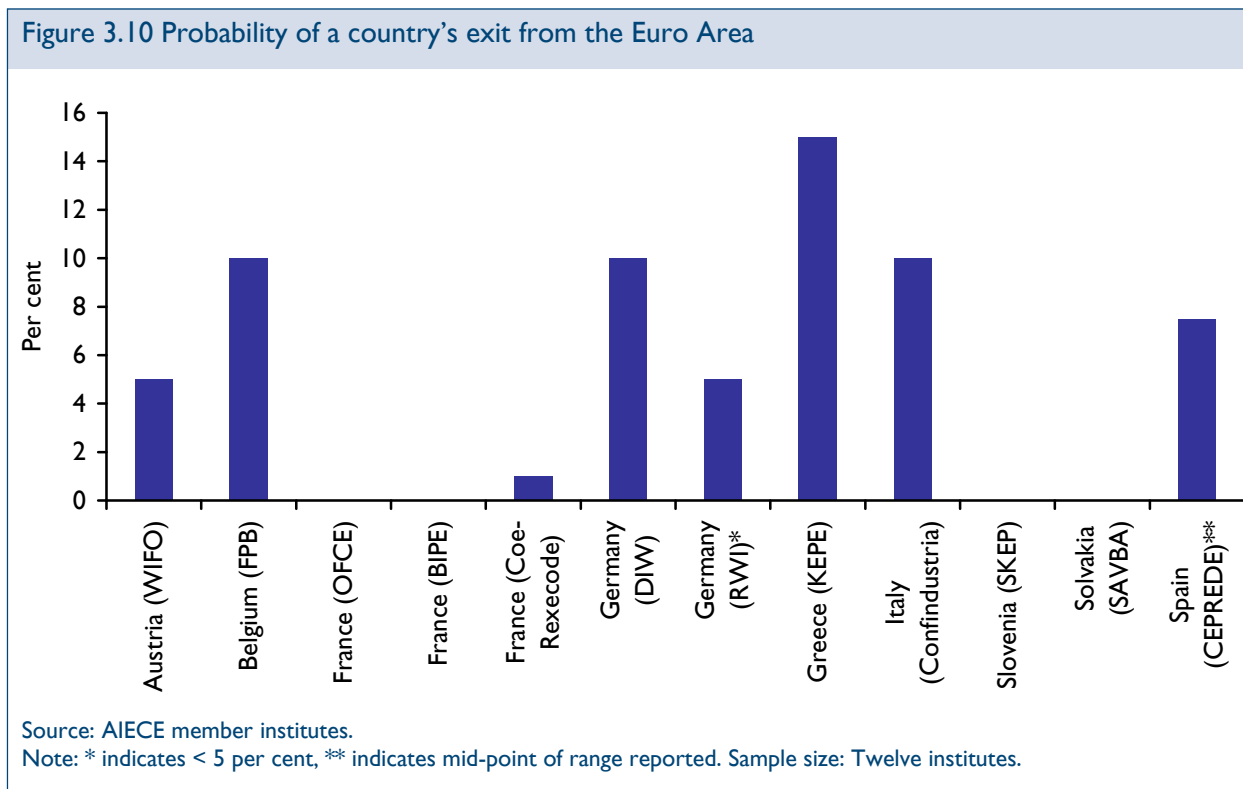
3.2 Prospects for EMU

The Euro Area crisis has not been resolved since the May AIECE meeting. Indeed the crisis has spread, infecting the general economic outlook for most European economies. It has got to the position where European policy-makers are now openly talking about the possibility of Greece leaving the Euro. At the same time there are still countries committed to joining the Euro. As CCS&F state: “the Czech Republic will fulfil the conditions of accession in 2013”. But they also go on to caveat the discussion of accession to the Euro with the following; “when it applies for membership depends on the time taken for the Euro-crisis to be resolved”. Other non Euro Area AIECE member institutions attach a significantly lower probability to their respective countries joining the Euro Area, with Kopint (Hungary), IBRKK (Poland) and KOF (Switzerland) all stating that the current problems in the Euro Area have had negative effects on the probabilities of their countries joining the Euro within the next 5 years. NIESR (UK) highlight the political obstacle to joining the Euro: the major partner in the coalition government is opposed to joining the Euro. With the next general election in May 2015 there is little chance of the UK undertaking proceedings towards accession.

Unsurprisingly, AIECE member institutes were asked questions concerning scenarios where Euro Area member countries might exit the Euro. The first focused on whether those countries currently receiving as bailout from the Troika would exit the Euro Area. A greater probability of exit was given for Greece, followed by Portugal and then Ireland. The mean probability for Greece’s exit is distorted by a noticeable outlier, which attaches a 75 per cent chance to Greece leaving the Euro. Removing this outlier would result in the mean probability dropping from 30 to 21 per cent. The views accompanying these probabilities were just as diverse. One AIECE member institute thought an exit scenario “very unlikely”. AIECE member institutes have noted the barriers to exit: “it is even impossible constitutionally without leaving the EU”; “The exit from the currency area might be even more difficult than entry and besides it is not foreseen in any official document”. Others pointed to the costs of exit, “The cost of leaving the euro zone is very high in terms of financial market turmoil during the transition period...”. Other member institutes have highlighted it is more likely that the “Euro Area will move closer together (e.g. fiscal union, Euro bonds)” (figure 3.9).

But there are AIECE member institutes who think the exit from the Euro Area, especially for Greece is quite likely as “they will not regain competitiveness without leaving the Euro” or as another institute noted, “Greece may have to leave the Euro-Area because it will be unable to fulfil conditions of the bail-out procedure.” Portugal, and particularly Ireland were seen as less likely candidates for Euro Area exit. Box 3A presents some of the potential equilibria for Greece following its exit from the Euro Area. In all cases the short term costs to the Greek economy are severe.





AIECE member institutes were also asked about the probability of their country leaving the Euro Area (figure 3.10). Of the responses given (12 institutes) the probability of exit ranged from 0 per cent (Slovenia, Slovakia, France (OFCE and BIPE)) to 15 per cent (Greece).

AIECE member institutes were also asked about the probability of Germany and its' neighbours leaving the euro. AIECE member institutions that did answer this question (22 responded) unanimously focused on the question of Germany. Most member institutes attached a relatively low probability to such an event. German institutes attached probabilities of 0 per cent (DIW) or less than 1 per cent (RWI). Larger probabilities to such an event were provided by member institutes, with the largest probability attached at 20 per cent (by a non-Euro Area member institute). Most member institutes stressed the importance of Germany for the survival of the Euro Area, and the importance of the Euro Area to Germany. As one institute put it “Germany needs to be in the euro area in order to prevent a major appreciation of its exchange rate”. Some institutes approached it from a cost-benefit analysis, with the cost of supporting Euro Area members in difficulty significantly less than the costs of a Euro Area break up.

Box 3.A Scenario: What would a Greek exit from EMU look like?

The possibility of ‘allowing’ or ‘forcing’ a Greek exit from EMU as a solution to the Euro Area debt crisis has been hinted at by some policymakers and actively supported by certain commentators. It is dangerous even to contemplate such a move, as the minute it becomes acknowledged as a serious proposal we would expect to see a run on Greek banks, collapse of the financial system and widespread bankruptcy, which could turn what may have been considered a remote possibility into an inevitable outcome, with possible contagion to other economies. Nonetheless, it is important to wade through the thought experiment so that policymakers can make informed choices.

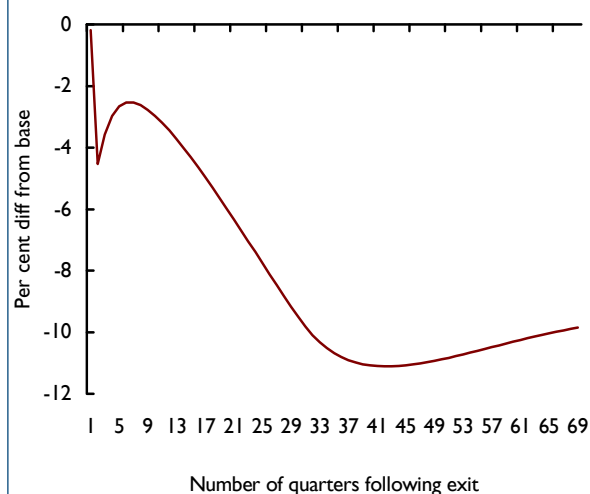
Eichengreen (2007) and Deo et al. (2011) highlight some of the technical, legal and political obstacles to EMU exit, which may prove prohibitive, at least in the short-term. These include legal barriers to imposing restrictions on the free movement of capital or persons while remaining within the EU; complications with cross-border banks operating within or outside Greece; exit will take time – simply to reprogramme ATM machines and reach political agreement – leading to immediate capital flight. We abstract from these difficulties and assume a quick and straightforward currency redenomination is achieved. There remains a high degree of uncertainty around what exactly would happen to the Greek economy in the event of a withdrawal from EMU. The two key developments that we take as essentially given are: a severe disruption to the financial sector; and a sharp devaluation of the new currency, as investors will attach a high risk premium to it. In this section we consider three alternative scenarios that could follow from an EMU exit. In the first scenario, bank lending is essentially frozen for one quarter due to the disruption, and the exchange rate depreciates by 50 per cent due to the high risk premium attached to assets denominated in the new currency. The magnitude of the depreciation was arbitrarily chosen so that the effective default on external debt is the same as in our baseline scenario. This may be a conservative estimate. In Argentina the exchange rate depreciated by 65 per cent during pesification in 2002. However, exchange rate realignments related to the ERM crisis of 1992–3 were somewhat more modest than in our scenario. The UK effective exchange rate depreciated by only 10 per cent on its exit. However, the ERM realignments of 1992–3 were not against the same background that we see today.

While we take these first two reactions as given and common to all three of our scenarios, some of the other potential developments are far less certain. Our second EMU exit scenario looks at the impact of a default on all externally held government debt. We will show that a devaluation would lead to an effective default on external debt if all government liabilities are redenominated into the new currency, but the interest liabilities of the government are unchanged and continue to cripple the economy. Defaulting on the external debt acts as a boost to the economy, as it significantly reduces the debt burden of the government, but without any wealth losses within the Greek economy.

The risk premium on the new currency means that investors demand a higher rate of return in order to be willing to invest in Greece. This pushes up interest rates, and reduces investment and the equilibrium capital stock within the Greek economy. In our third scenario, we consider the effects that high levels of capital inflows could have, especially if it were to materialise in the form of FDI, offsetting the loss in domestic investment.

In figure 3.11 we illustrate the estimated impact on Greek GDP of our two key developments that we believe will necessarily follow an EMU exit (although the magnitude of the shocks are far less certain): a freeze on bank lending for one quarter as a result of financial turmoil and a risk premium on the new currency that drives a 50 per cent devaluation. Output falls initially in response to the freeze in bank lending, and then remains permanently below base. The negative impact in the long run is a reflec-

Figure 3.11 Impact of exchange rate risk premium and freeze in bank lending on GDP



Source: NiGEM.

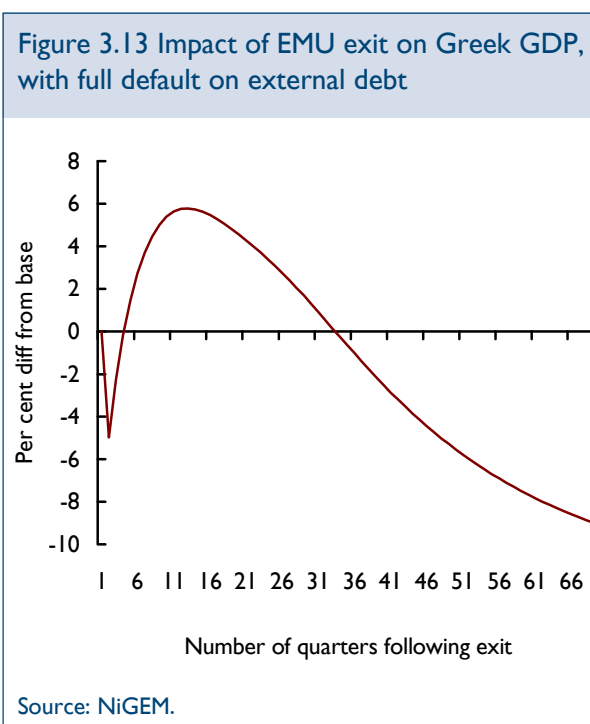
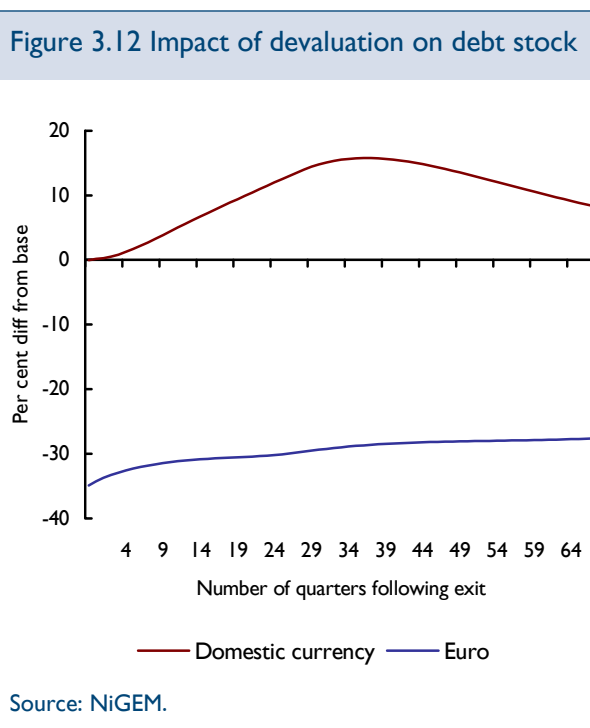
tion of the higher borrowing cost demanded by the risk premium on the exchange rate. Clearly EMU exit in itself is not guaranteed to improve the economic outlook in Greece.

We assume that were Greece to leave EMU, all government debt would be redenominated into the new currency. External investors will view this as an effective default, since the value of the asset will decline markedly in euro terms. However, the Greek government receives nothing in the way of interest relief, in contrast to the explicit default underlying our baseline scenario. Figure 3.12 illustrates the impact of the devaluation on the stock of government debt, both in terms of the new currency and in euro. In new currency terms, the stock of debt is unchanged in the short term, and rises above base over the succeeding years, due to the negative impact of the shock on long-run potential output. In euro terms, the asset loses more than 30 per cent of its value immediately.

As external debt holders will consider a devaluation as a default anyway, and Greece will have lost access to any foreign borrowing for a sustained period, there is a strong argument for introducing an explicit default on government debt in addition to the de facto default that comes through the devaluation, as was the case, for example, with Argentina in 2001–2. As our second EMU exit scenario, we make the assumption that Greece defaults on 100 per cent of its external debt, but not on its domestically held debt. This brings with it a significant improvement in public finances, as interest liabilities come down sharply, and we would expect to see some tax relief introduced as a result, as Greece is expected to run a primary surplus next year. At the same time, there are none of the negative wealth effects feeding through the consumption and investment channels in the domestic economy, as all the losses are absorbed abroad.

Figure 3.13 illustrates the expected impact of our second EMU exit scenario on GDP in Greece. Following the initial negative impact caused by the banking sector disruption, the level of output rises above base for an extended period, reflecting the tax cuts introduced when government interest payments fall. Over the longer term, output falls back below base, as we have done nothing to affect the risk premium on Greek assets and its effect on investment and the equilibrium capital stock. While this scenario would allow some benefits to the Greek economy over five years or so, we should also consider the implications of an external default, which is unlikely to be viewed favourably by creditors. Greece might find itself in an isolated position, with no access to external finance for several years. It may also entail withdrawal from the EU as well as the EMU, which would have a whole host of implications that are beyond the scope of this note but which are likely to depress GDP. Greece could also face the prospect of legal action against it by foreign creditors.

Default, exit from EMU and devaluation would not necessarily lead to economic disaster, as the example of Argentina shows; Argentina has experienced a long period of sustained high export-led growth, and this success is often attributed to the high inflows of foreign capital that flooded the economy following the default and devaluation in 2002. In our third and final EMU exit scenario, we consider the possibility of inflows of foreign capital to Greece to offset the

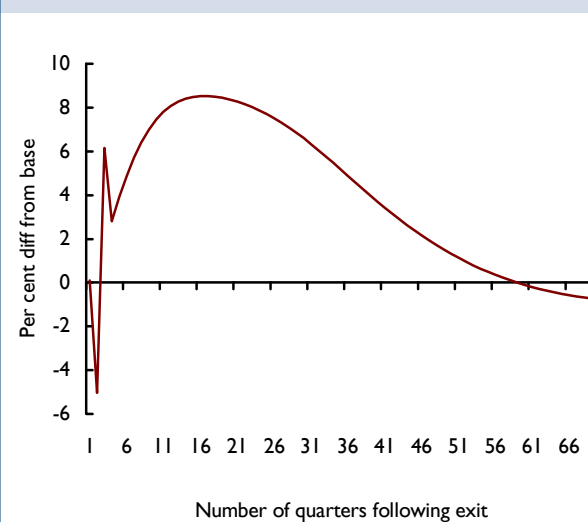


loss in domestic investment. Foreign investors face a different borrowing cost from domestic investors, and may identify significant profit opportunities if they can borrow at their home rates to invest in assets priced in the new devalued Greek currency. We assume that capital inflows begin in the second quarter of the simulation, following the first quarter of financial turmoil. This fully offsets the long-run effect of higher borrowing costs on output, and we see a significant positive effect on output in the first few years, as illustrated in figure 3.14.

While there may be some precedence that suggests capital will flow towards countries with new devalued currencies, modelling capital flows is notoriously challenging, and there is no guarantee that sufficient quantities of capital will reach Greece to fully offset the loss of domestic investment following a default. If capital inflows are in the form of short-term speculative flows rather than FDI, domestic investors will be more hesitant to use the funds to undertake fixed capital investment, as they face a risk of the rapid withdrawal of funding.

There are also a number of additional risk factors that should be considered when assessing the potential impact of EMU exit on the Greek economy. These include: the possibility of mass emigration, especially of skilled labour, towards higher wages in the other EU countries; a longer freeze on bank lending than the single quarter allowed for in our three scenarios; the implication of EU exit if that follows by necessity an EMU exit – these might include trade barriers, at least partly offsetting any competitiveness gains from the weaker exchange rate; and we cannot write-off the possibility of extreme social turmoil and civil unrest. All in all it would seem to be a high-risk strategy, with no guarantee that it will necessarily improve the outlook for the Greek economy.

Figure 3.14 Impact of EMU exit on Greek GDP, with external default and capital inflows



Source: NiGEM.

NOTE:

1 AIECE member institutes were asked to provide forecasts for the annual rate of consumer price inflation in the final quarter of 2011 and 2012.

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- Bowles, C., Friz, R., Genre, V., Kenny, G., Meyler, A. and Rautanen, T. (2007), The ECB Survey of Professional Forecasters (SPF): review after eight years experience, ECB Occasional Paper No. 59.
- Deo, S., Donavan, P. and Hathaway, L. (2011), 'Euro break-up – the consequences', UBS Investment Research, Global Economic Perspectives.
- Eichengreen, B. (2007), 'The break-up of the Euro Area', NBER Working Paper No. 13393.

Appendix A. AIECE Member Institutes probability distributions around their forecasts for own country GDP growth and HICP inflation rates

Figure A.1 Belgium: probability distribution for annual GDP forecasts

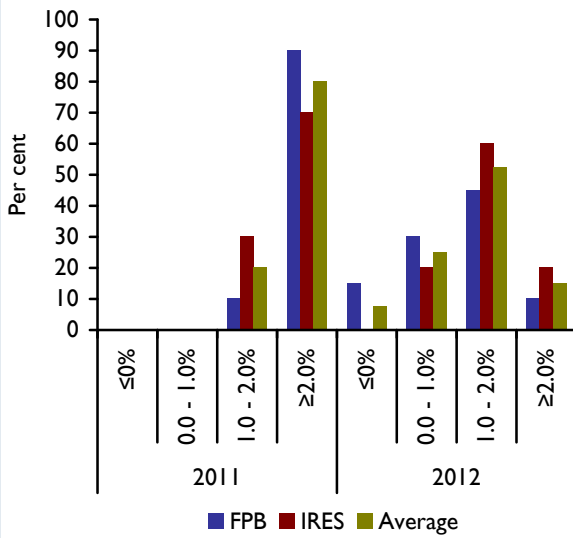


Figure A.1 Belgium: probability distribution for inflation forecasts

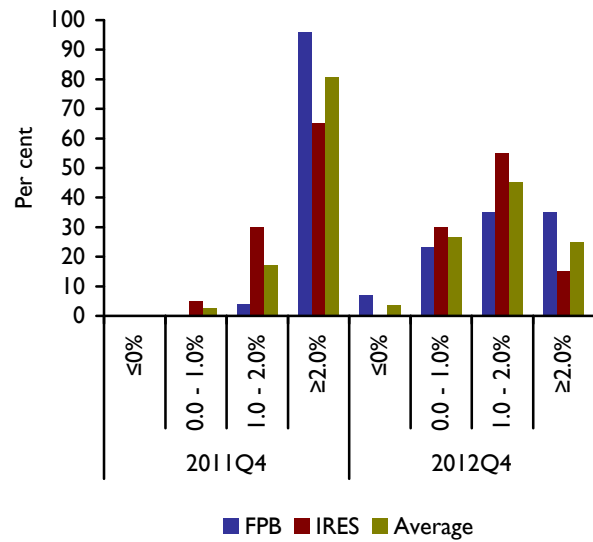
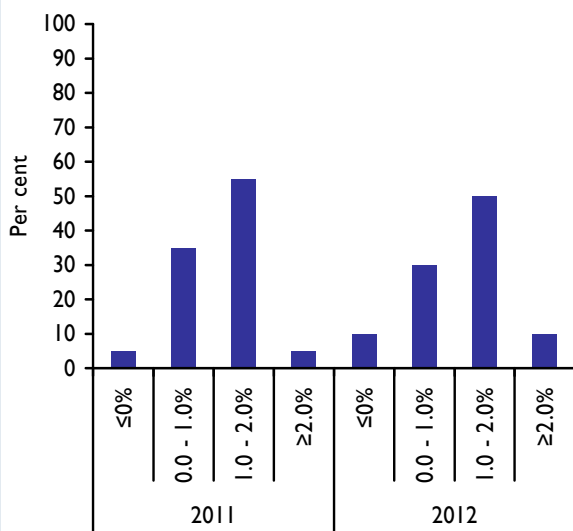
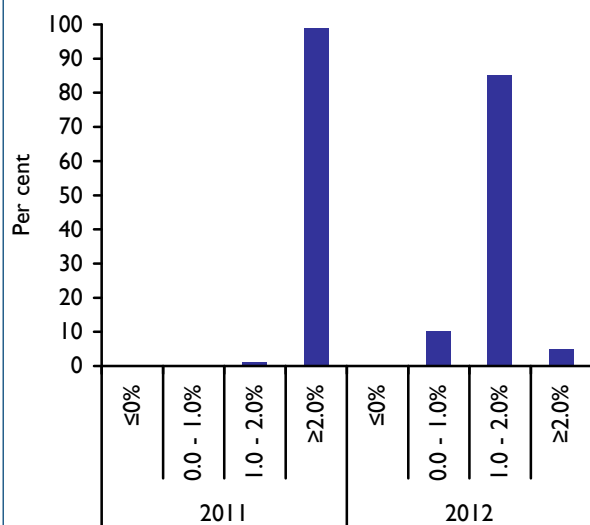


Figure A.3 Denmark: probability distribution for annual GDP forecasts



Source: DEC.

Figure A.4 Finland : probability distribution for annual GDP forecasts



Source: ETLA.

Figure A.5 Finland : probability distribution for inflation forecasts

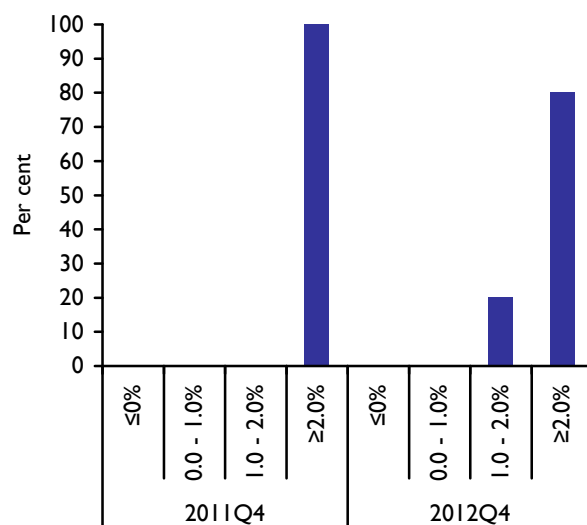


Figure A.6 France: probability distribution for annual GDP forecasts

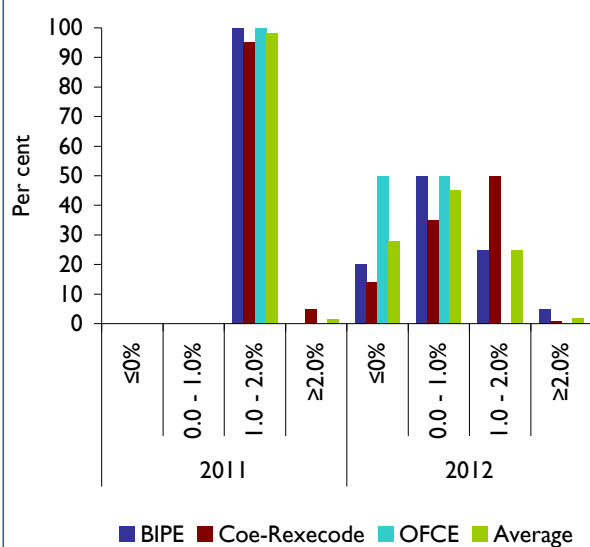


Figure A.7 France: probability distribution for inflation forecasts

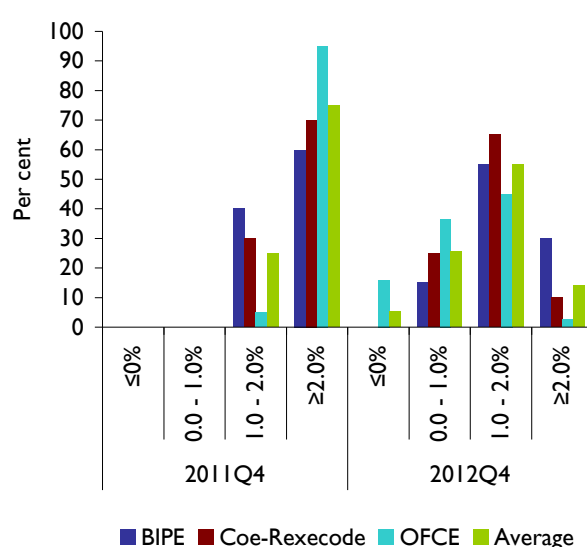


Figure A.8 Germany: probability distribution for annual GDP forecasts

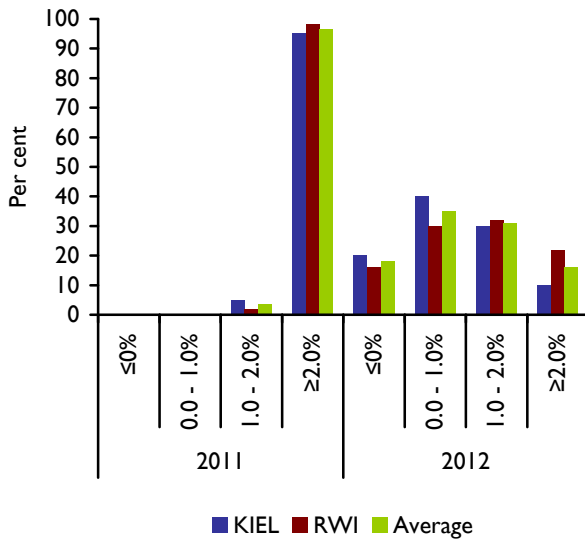


Figure A.9 Germany: probability distribution for inflation forecasts

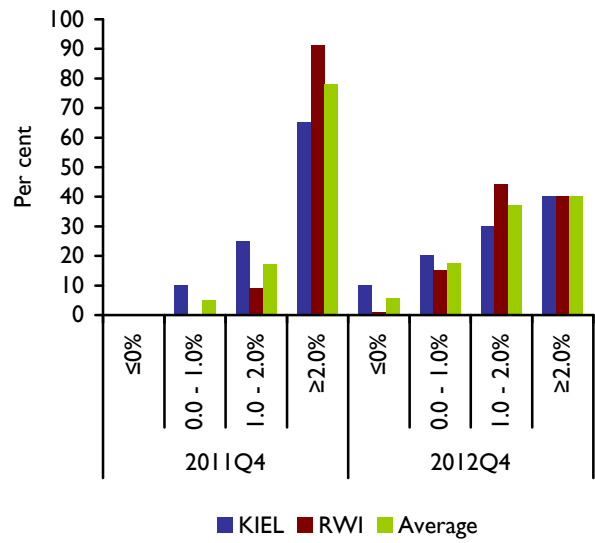


Figure A.10 Greece: probability distribution for annual GDP forecasts

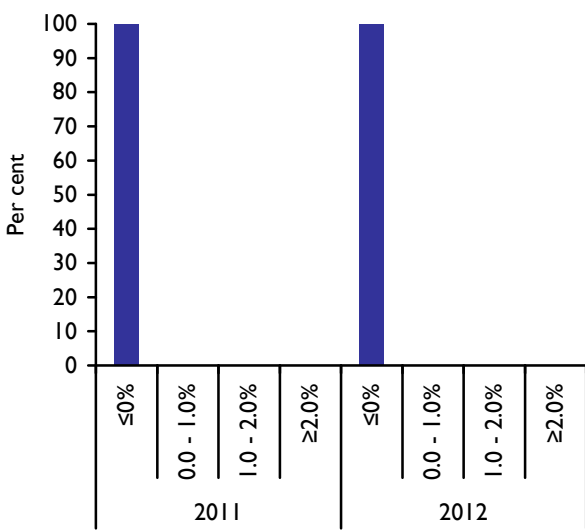
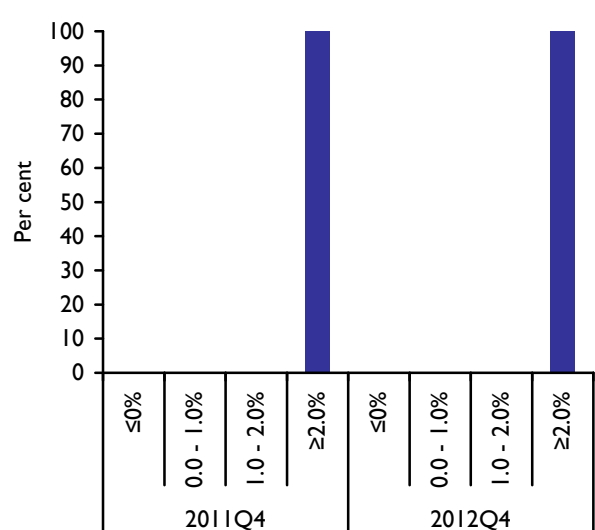


Figure A.11 Greece: probability distribution for inflation forecasts



Source: KEPE.

Figure A.12 Hungary: probability distribution for annual GDP forecasts

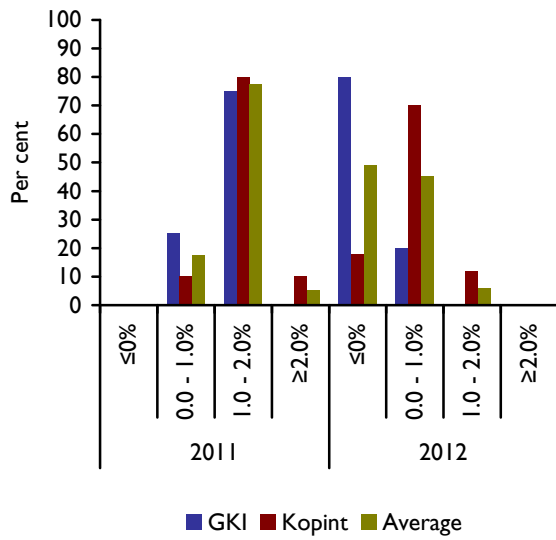


Figure A.13 Hungary: probability distribution for inflation forecasts

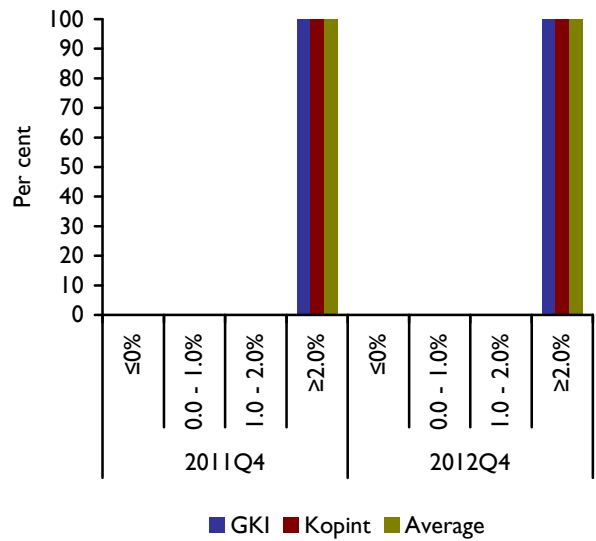


Figure A.14 Italy: probability distribution for annual GDP forecasts

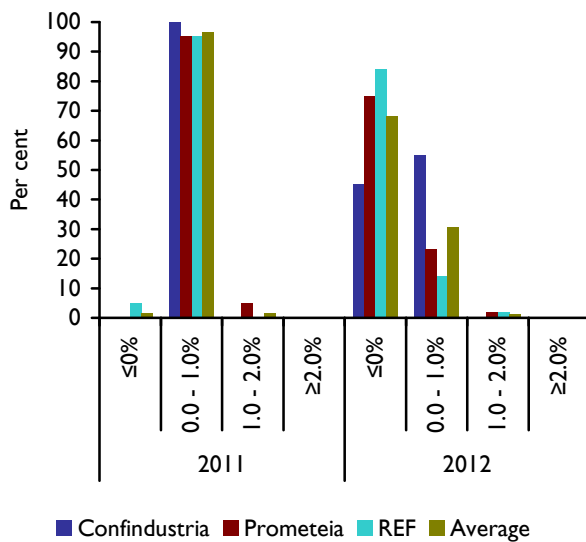


Figure A.15 Italy: probability distribution for inflation forecasts

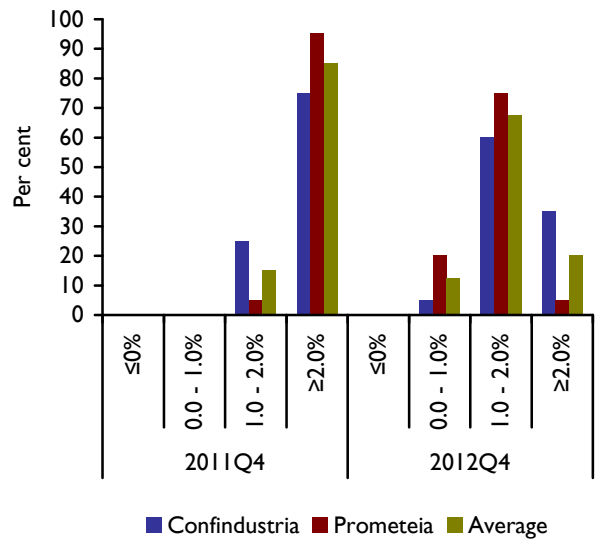
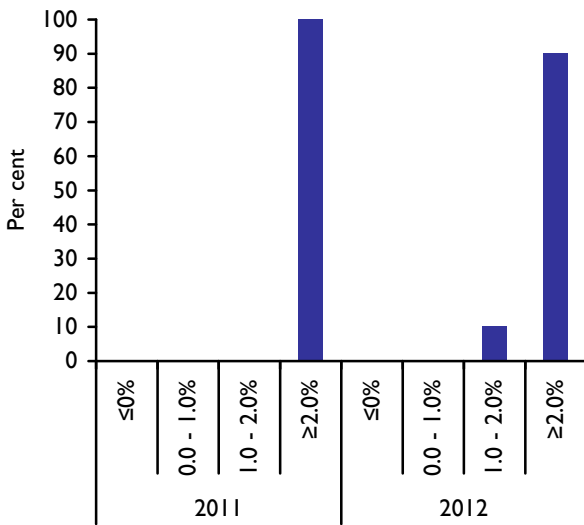


Figure A.16 Poland: probability distribution for annual GDP forecasts



Source: IBRKK.

Figure A.17 Poland: probability distribution for inflation forecasts

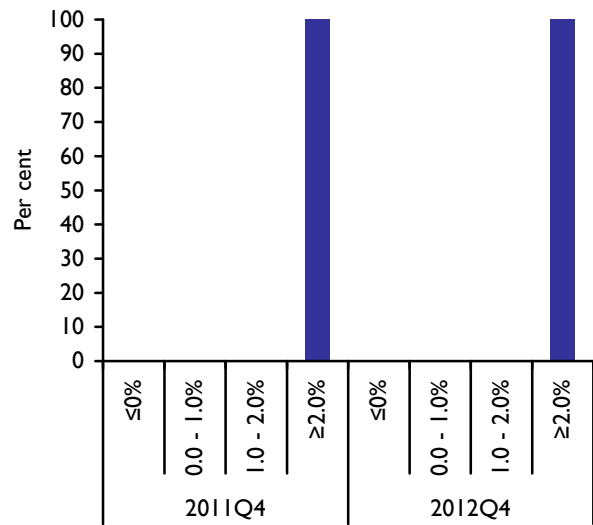
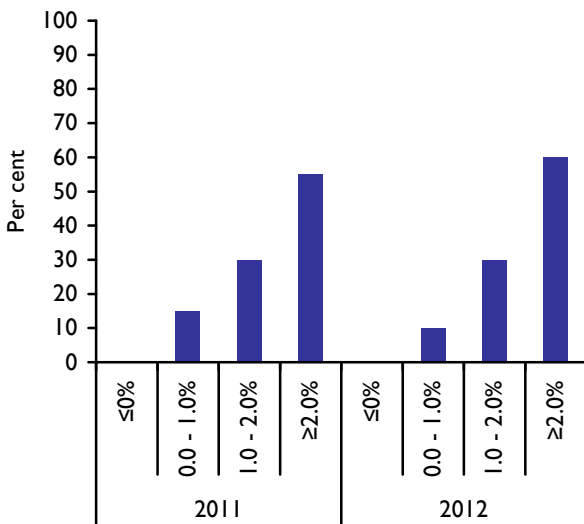


Figure A.18 Serbia: probability distribution for annual GDP forecasts



Source: FTRI.

Figure A.19 Serbia: probability distribution for inflation forecasts

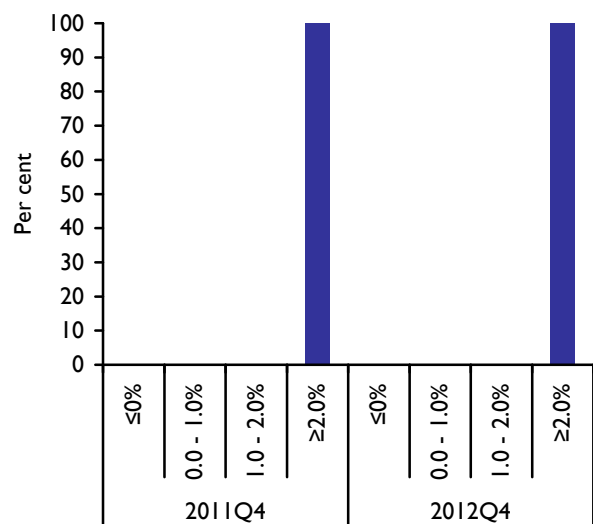
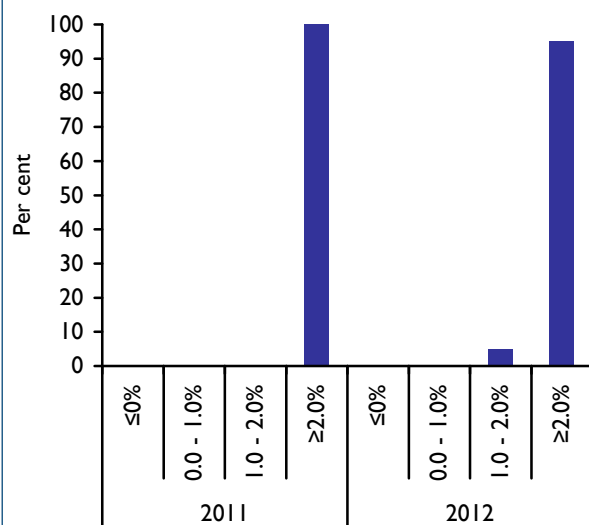


Figure A.20 Slovakia: probability distribution for annual GDP forecasts



Source: SAVBA.

Figure A.21 Slovakia: probability distribution for inflation forecasts

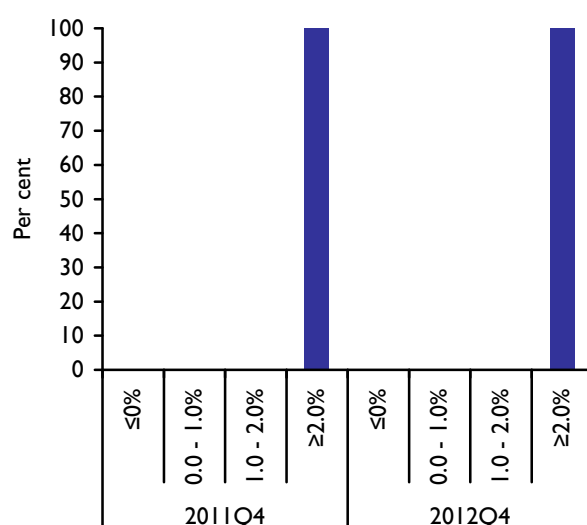
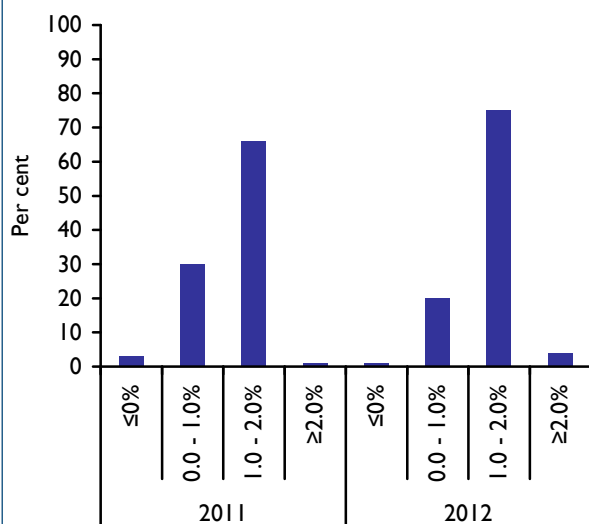


Figure A.22 Slovenia: probability distribution for annual GDP forecasts



Source: SKEP.

Figure A.23 Slovenia: probability distribution for inflation forecasts

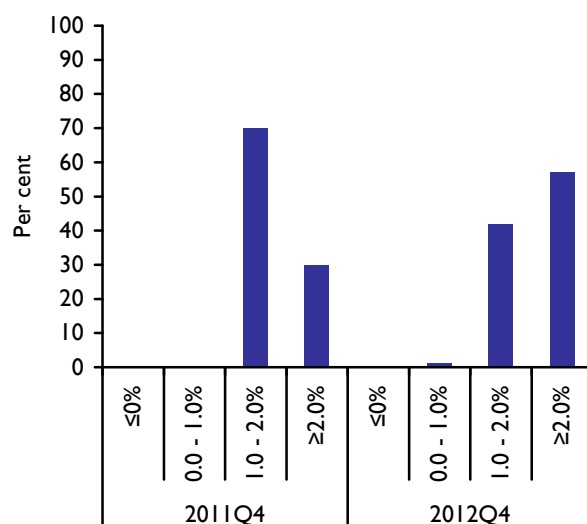
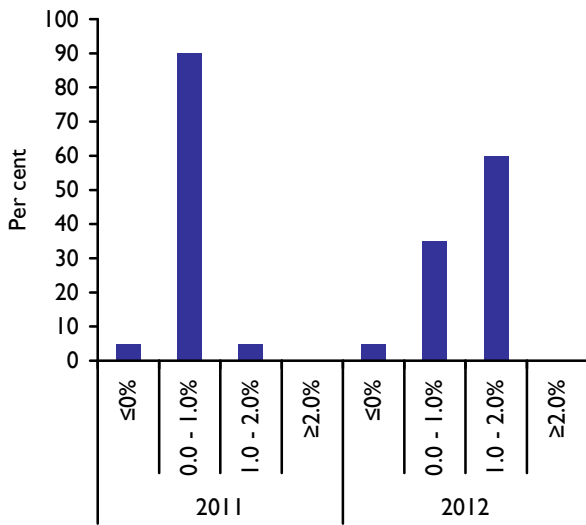


Figure A.24 Spain: probability distribution for annual GDP forecasts



Source: CEPREDE.

Figure A.25 Spain: probability distribution for inflation forecasts

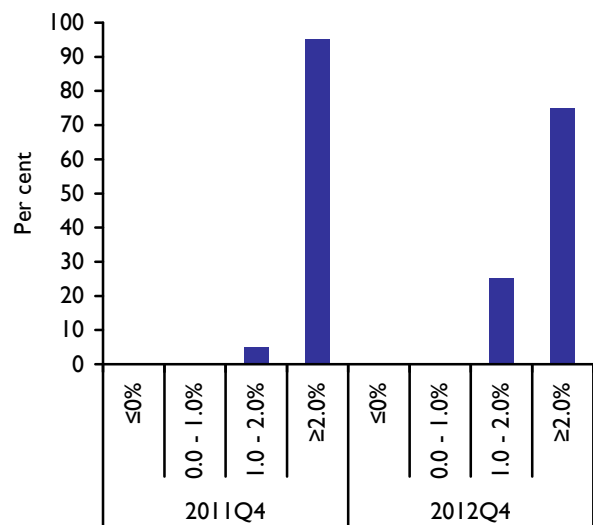


Figure A.26 Sweden: probability distribution for annual GDP forecasts

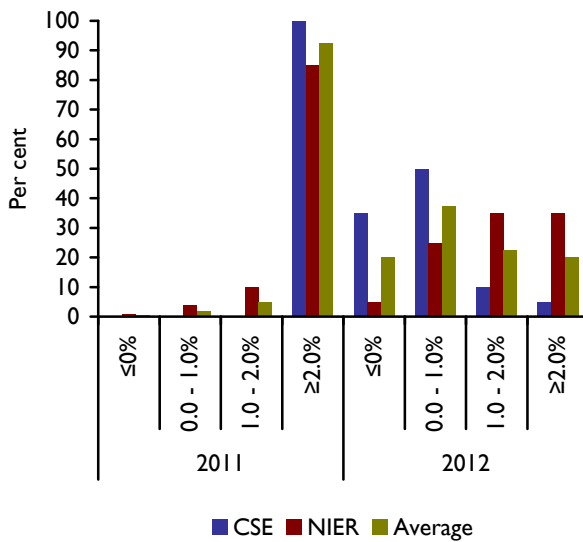


Figure A.27 Sweden: probability distribution for inflation forecasts

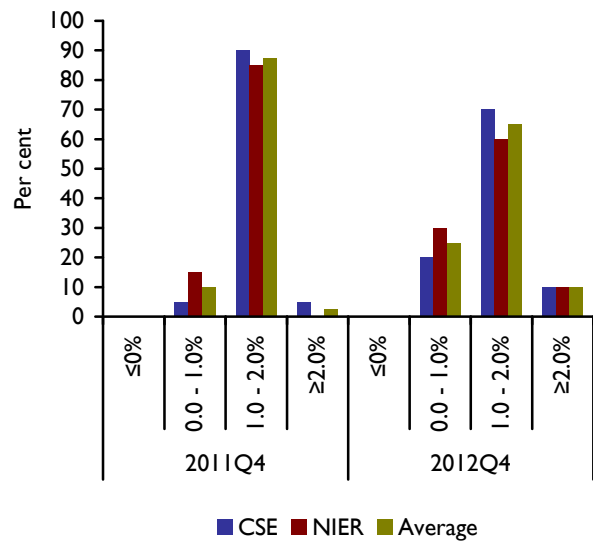
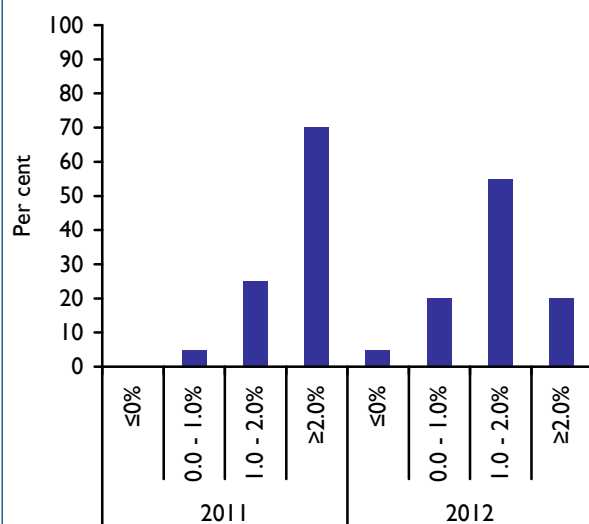


Figure A.28 Switzerland : probability distribution for annual GDP forecasts



Source: KOF.

Figure A.29 Switzerland: probability distribution for inflation forecasts

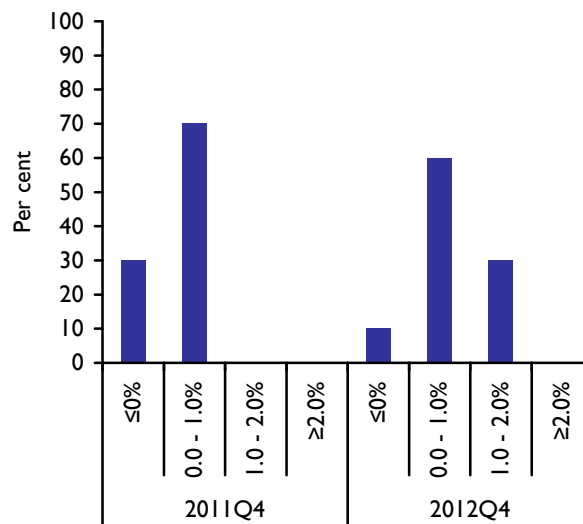
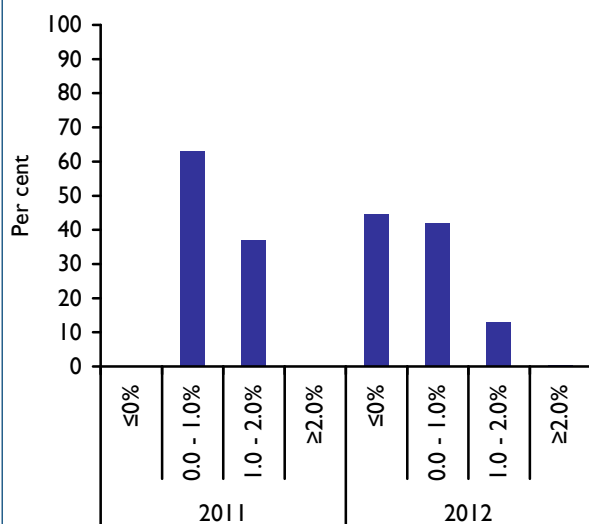
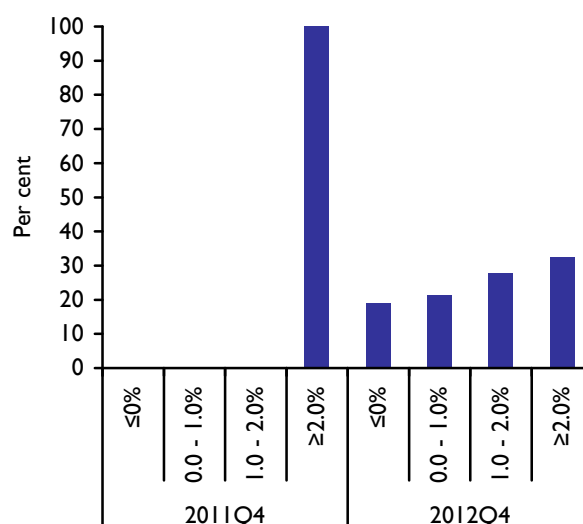


Figure A.30 UK: probability distribution for annual GDP forecasts



Source: NIESR.

Figure A.31 UK: probability distribution for inflation forecasts

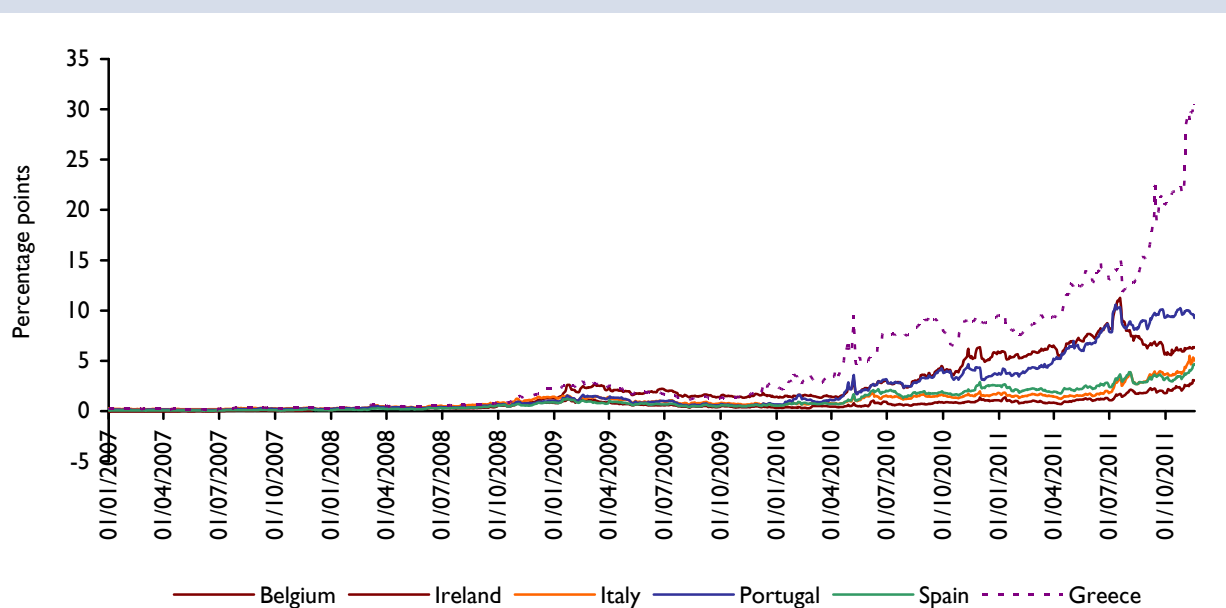


4. Banking crisis→sovereign crisis→banking crisis: can we break the cycle?

The sovereign debt crisis in the Euro Area continues to deepen. On 26 October 2011, European leaders put forward an outline of the next set of steps to be taken to tackle the sovereign debt crisis, but there is no evidence that financial markets have accepted the plan as credible. A key plank of any resolution of the crisis is the delivery of sustainable public finances across the Euro Area.

Financial integration in the Euro Area led to the situation where different member states' sovereign debt was largely treated as substitutes, bearing the same level of risk. Prior to the establishment of the euro this was not the case. Greece maintained a margin over EMU country bond yields until it joined the single currency area in 2001, but this quickly dissipated once it became clear that the country had gained entry to the Euro Area. This convergence occurred despite the clear statement in the Treaty of Maastricht that member States retained full responsibility for their own debts. However, over the course of 2010 and 2011, both the bond and money markets in the Euro Area became increasingly divergent, and government debt within the Euro Area is clearly no longer guaranteed a risk-free status. Figure 4.1 illustrates the yield spreads on 10-year government bonds in selected Euro Area economies over those in Germany.

Figure 4.1 Spread on 10-year government bonds over Germany



Source: Derived from Datastream series.

The links between sovereign crises and banking crises are strong, and well documented in the literature (see CGFS, 2011). The financial crisis of 2008-9 necessitated a massive bail-out of the banking systems in several European economies. In the first section of this report (Section 1.3.1, Debt attributable to financial bailouts) we illustrate the rise in government debt resulting directly from this exceptional role played by the government, and costs have been particularly high in Ireland, the UK, Germany, the Netherlands and Belgium. The comment on Ireland below explains that this has increased the government debt burden by 40 per cent of GDP, and is the primary cause behind the subsequent sovereign difficulties affecting Irish economy.

While Greece also suffered fiscal costs associated with the banking crisis, the sovereign crisis currently facing the economy is more deeply rooted in ongoing fiscal and macroeconomic deterioration of the economy in the years leading up to the global crisis. The declining value of Greek government debt as an asset has a negative impact on financial wealth holdings in the economy as a whole, and most significantly affects the asset base of the banking system, pushing Greek banks towards insolvency, with a secondary banking crisis looming over the country.

The situation in Italy has not reached the proportions of Greece, but has similar roots in the longer-term issues of growth and competitiveness in the Italian economy, and lack of credibility in consolidation measures put forward. The Italian case illustrates the dangerous potential role of self-fulfilling financial market expectations in driving a crisis. Financial markets do not view the policy proposals as sufficiently credible to restore public finances and the economy to growth, putting upward pressure on bond yields. Higher borrowing costs entail a rise in future interest liabilities, which in turn requires additional consolidation measures to meet specified targets, making existing policy even less credible, pushing bond yields up further. If the pressures on Italian sovereign debt were to deepen to the extent that losses suffered by the banking system led to concerns over bank solvency, this could have widespread repercussions both across Europe and also worldwide, given the strong international linkages of the European and global financial systems.

4.1 Comment on the Greek economy

Aristotelis Koutroulis (arkoutr@kepe.gr), KEPE

The financial crisis that erupted in mid-September 2008 contributed to a rapid weakening of public finances in most euro area economies including Greece. However, the ongoing fiscal crisis in Greece has deeper roots. It is basically the result of highly expansionary policies and the corresponding deterioration of certain macroeconomic fundamentals in the years preceding the global crisis. Thus, while Greece is not the only country within the Euro to be facing fiscal imbalances, safeguarding the sustainability of Greek public finances looks especially challenging.

Against this background, Greek economic authorities with the technical and financial support of the Troika (ECB, European Commission and IMF) since May 2010 legislated and adopted a series of fiscal austerity measures that are unprecedented in the recent history of Greece. On the expenditure side, these measures include cuts in public sector wages and pensions as well as reductions in supplementary pensions and lump-sums paid on retirement. To reduce the wage bill and other costs the government has also established a labour reserve for excess staff. At the same time, a number of public sector units are due to be closed, merged or downsized. On the revenue side, in addition to special lump-sum taxes on personal income and real estate, the personal income tax base has been widened.

So far, the deficit-reducing effects of the above measures have been smaller than expected. Specifically, the 2011 government deficit is projected to be a little bit lower than 9% of GDP. As for the gross public debt-to-GDP ratio, it is expected to exceed 162% in the same year. These poor results are attributed to the deeper contraction of economic activity, the delay in the implementation of the government's privatization program and the deficiency of the public administration to deal with tax evasion. Last but not least, the public's strong opposition and resistance to the government's austerity measures and the corresponding social unrest have played a negative role as well.

Looking ahead, the dynamics of the Greek public debt will be driven by five main factors: (i) the percentage of the nominal discount on public debt held by private investors, (ii) the government's primary budget balance over the next years, (iii) the economy's nominal growth rate, (iv) the successful execution of the government's privatization plans and, (v) the materialization of the government's contingent and implicit liabilities (e.g. liabilities that take the form of guarantees to support the banking sector and liabilities that are related to future pension rights and public health spending).

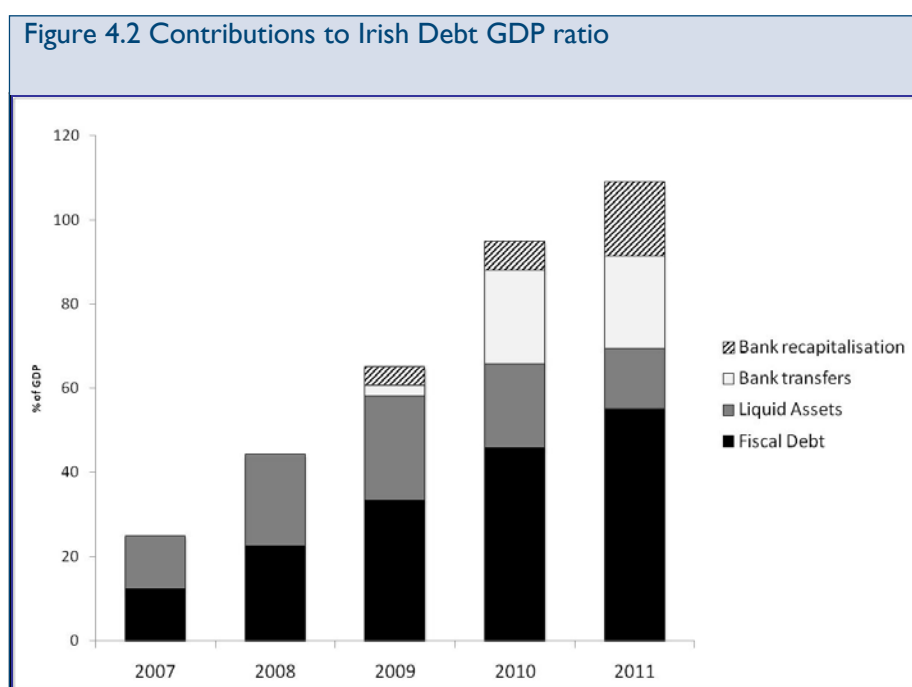
With the exception of the first factor which is subject to the negotiations between Greek officials and the government's private creditors, the remaining determinants of debt sustainability depend crucially on the government's commitment to its fiscal consolidation and privatization plans and the implementation of deep-rooted structural reforms that will restore the economy's competitiveness and support long-run growth.

To sum up, Greece has just entered a phase of transition from a regime characterized by the persistence of large fiscal imbalances and the presence of a disproportionately large public sector to a regime in which healthy public finances will lay down the foundations for sound and solid growth. Admittedly, this transition will be difficult, painful and time-consuming.

4.2 Comment on the Irish Economy

John Fitzgerald, ESRI

Following on the collapse in the Irish property market in 2007-8, the domestic financial system also imploded. As a result of a guarantee of the Irish banking system issued by the Irish government at the end of September 2008 the Irish taxpayer took on responsibility for the debts of Irish owned banks. While at the time the government anticipated that none of the guaranteed banks were insolvent, as it has turned out two of them had very large deficits and the others required major recapitalisation. The result has been a dramatic increase in Irish indebtedness as shown in Figure 4.2. At the end of this year the gross debt to GDP ratio will be just under 110%, of which 40 percentage points will be directly attributable to the bail-out of the banks. The rest of the dramatic increase in debt arises from the collapse in the domestic economy and resulting very serious deterioration in the public finances.



On the basis of current forecasts the gross debt to GDP ratio should peak at between 110 and 115% of GDP next year while the net debt to GDP ratio will peak at between 100% and 105% of GDP before falling below 100% in 2015. (The Irish government holds significant liquid financial assets which are netted off the gross debt figure.)

To tackle the massive deterioration in the public finances successive governments have pursued a major programme of cuts in expenditure and increases in taxation. This programme aims to reduce the deficit to below 3% of GDP by 2015 from around 10% of GDP this year.

Table 4.1 Ex Ante Fiscal Adjustment, € billion

	2008-10	2011	2012	2013	2014	2011-14
Revenue	5.6	1.4	1.6	1.3	1.1	5.4
Expenditure	9.2	3.9	2.2	2.3	2.0	10.4
Total	14.7	5.3	3.8	3.5	3.1	15.7
% of 2010 GDP	9.4	3.4	2.4	2.2	2.0	10.1

The composition of the *ex ante* fiscal adjustment over the period 2008-14 is shown in Table 4.1. *Ex post* the effect on government borrowing is substantially less due to the deflationary nature of these cuts.

The fiscal adjustment of a cumulative 20 per cent of GDP over the period 2008-14 has already taken a heavy toll on growth and will continue to impact negatively over the coming years. Nonetheless, the multiplier effects of such cuts are less in a very open economy like Ireland than in larger more closed economies. As a result, the economy has returned to growth of around 1.8% this year. While the last forecast envisaged growth of 2.3% in 2012, recent developments at the EU level will require a substantial revision to this figure. For every one per cent reduction in world GDP (especially US GDP), Irish GDP falls by around 1.4 percentage points.

4.3 Comment on the Italian economy

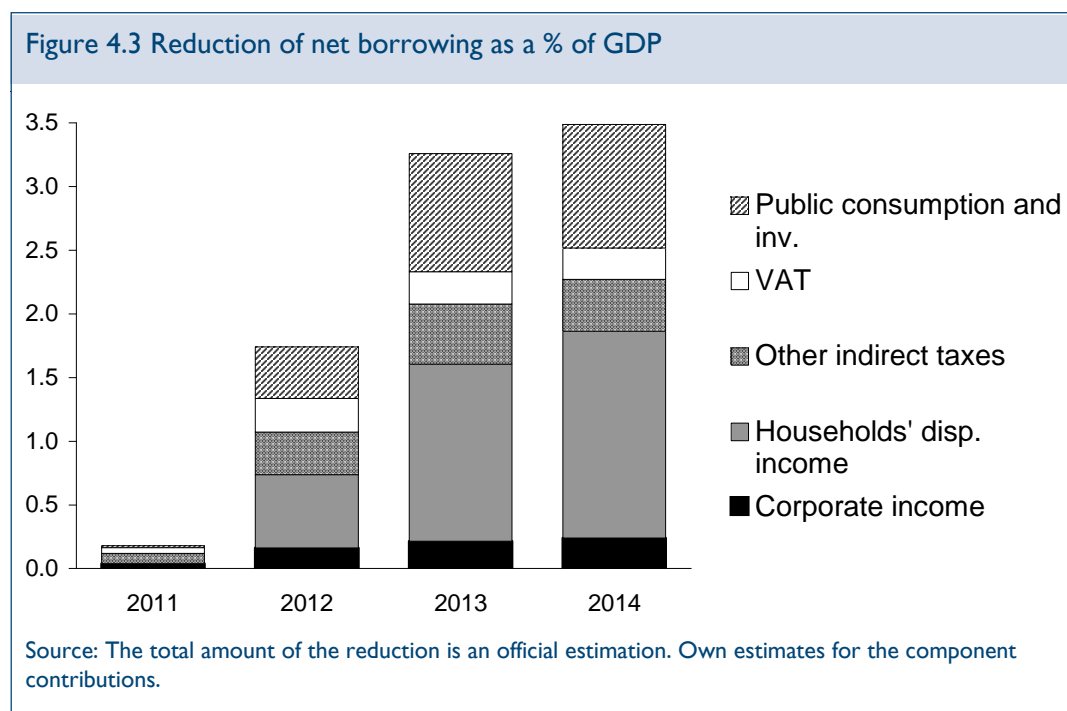
Stefania Tomasina (Prometeia) and Sara Signorini (REF)

Recent developments and fiscal correction

In 2010 the Italian public deficit was reduced to 4.6% of GDP from the negative peak of 5.4% in 2009. The improvement reflects weak revenue offset by a contraction of expenditures, mainly due to cuts in public investment.

During the summer, the Italian Government approved two austerity packages for the years 2011-2014 (Decree Law 98/2011 and Decree Law 138/2011). Together, the two packages provide a reduction of the net borrowing that is officially estimated as €2.8 billion in 2011 (0.2% of GDP), 28.3 billion in 2012 (1.7% of GDP), 54.3 and 59.8 billion in 2013 and 2014 respectively (3.3 and 3.5% of GDP). About 65% of the adjustment will come from revenues increase, bringing savings of €39 billion in 2014; spending cuts are estimated to save €20.5 billion in 2014.

The household sector will be the most affected by the measures. Around €9 billion in 2012 and €27 billion in 2014 (one third of the total adjustment in 2012 and nearly 50% in 2014) is expected from measures that will reduce household disposable income: fiscal and welfare cuts, tax on income derived from financial assets, solidarity contributions on high incomes and on high pensions, savings on public employment, measures on the pension system. In addition, other measures, estimated in around 15% of the total adjustment, will impact on households' purchasing power: the increase in stamp tax on securities accounts, measures on gaming and excise taxes. Finally, the purchasing power will be negatively affected by the increase of the VAT rate from 20% to 21%, which is expected to add about 0.5 percentage points to inflation in 2012.



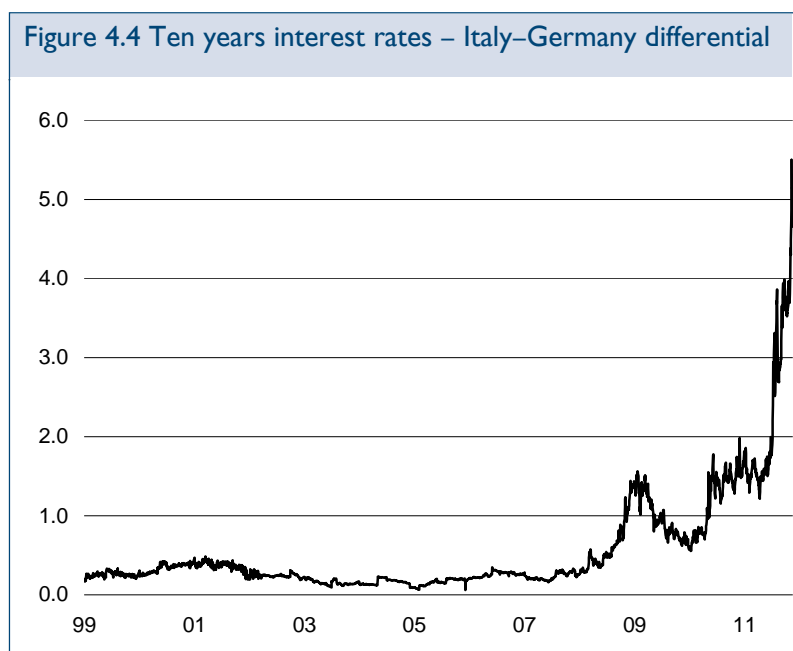
Only a small part of the adjustment will affect firms directly: corporate income measures (surtax on energy sector, increase in the rate of the regional tax on productive activities applying to bank and insurance companies and others) account for 6 billion.

Spending cuts in direct public consumption and investments amount to around 18 billion. A large part of spending cuts will be achieved through local government expenditures, 6.4 billion, and savings on the healthcare system, 5 billion.

The credibility problem

The fiscal package described above aims to address the main issue for Italian public finances at the moment, i.e. the reduction of public debt. The size of the correction is consistent with the level of Italian structural deficit (which is around 3% of GDP, 1% being the cyclical component) and the aim of reducing the debt/GDP ratio, which would require a public balance between 0 and 1.5% of GDP, depending on the speed of the adjustment. In order to reach this balance level, the required correction size would range between 2 and 3% of GDP, while the approved package includes an extra correction of 0.5% of GDP.

Nevertheless, despite the apparent adequacy of the size of the correction, the increasing spread for Italian sovereign bonds signals that financial markets still consider the probability of a consistent improvement of Italian public finances very low.



There are two main reasons behind the Italian sovereign debt crisis and the rise in spreads, other than the uncertainty of governance that affects the EMU itself.

On one side, there is a **high degree of uncertainty** around the effective realisation of the measures laid down by the (now former) Government, partly due to a lack of credibility in the Italian political system, judged unsuitable to fulfil the implementation of the package. In fact, a large part of the adjustment (20bn in 2014, 1/3 of the total adjustment and half of the total measures on revenues) depends on a review of entitlements and tax expenditures, and on a fiscal reform that aims at shifting the fiscal burden from direct to indirect taxation. The Government is committed to implement the reforms by September 2012, but the summer decree only defined some very general principles, postponing the adoption of concrete measures. Even if a safeguard clause, which implies linear cuts to tax reliefs and exemptions and/or a further increase in VAT or other indirect taxes, were introduced to protect against the event that the reform will not be completed by that date, financial markets do not seem to trust in the success of the plan.

On the other side, and perhaps more important from the financial markets view, **the Italian economic policy of the last two years failed to address the main issues of the Italian economy, i.e. growth and competitiveness**. One important occasion for the Government to show a certain commitment to implement enhancing-growth measures was missed: the National Reform program issued in April did not include any credible plan for structural reforms, giving excessive importance to reforms such as fiscal federalism or to measures to address tax evasion, without taking concrete action to sustain GDP growth. Only small steps towards liberalizations, both in the private sector and in local public services, were included in the latest Stability Law approved in November, but the timing is now late, especially considering the fact that some past measures of the same Government had moved exactly in the opposite direction (for example, the re-introduction of minimum tariffs in private professions, which was now withdrawn with the Stability law). In addition, the design of the fiscal package itself is not growth-oriented. In fact, on the expenditure side, almost 30% of the savings will come from cuts to local governments, that will either reduce investments

(almost half of Italian public investment is done by local administrations) and social expenditure, or raise local taxes and tariffs to overcome the shortening of resources, thus adding more pressure on households in terms of lower services or higher taxes. As mentioned above, the packages weigh for the most part on households, while political issues prevented the Government from shifting the burden on higher income categories (for instance, the abolition of “ICI”, the Italian property tax, was the main electoral promise of the former Government).

As a result of the **inadequacy of the current economic policy**, in a context of almost zero growth, with no concrete reform and with high uncertainty related to several measures, the envisaged fiscal adjustment is not likely to be completed. In addition, excessive austerity will depress growth, with a negative impact on the fiscal balance itself. The consequent rise in interest rate spreads bears an extra risk for the fiscal consolidation, due to the increase in interest expenditure, creating a vicious circle where the pessimistic mood of the markets becomes self-fulfilling.

On this background, the newly appointed Government, with Mario Monti as Prime Minister, is expected to reverse this negative trend, reassuring financial markets not only with an additional fiscal correction, but mostly with the implementation of credible structural reforms enhancing growth. Since the new Ministers were designated only on Thursday 17th November and they will be in force as of Saturday 19th November, it is still too early to give a clear assessment of the new Government’s plans, so our forecasts are based on the measures that were already approved.

The impact of the fiscal correction on growth

According to our estimates, the overall impact of the package on economic activity (assuming almost complete *ex-ante* effectiveness of the measures) is a loss of about 1.4% of GDP in the period 2012-2014 (with respect to a baseline scenario without fiscal adjustment) of which 0.7% in 2012, 0.4% in 2013 and 0.3% in 2014.

More than 40% of the negative effect on GDP comes from the impact on private consumption, deriving mainly from the measures that directly affect households’ disposable income, that will be reduced by 2% overall. Moreover, real disposable income will be negatively affected by the increase in VAT, with an impact on GDP of 0.2%. In our estimates, expenditure reductions explain one third of the negative effect on GDP: cuts in public demand for consumption and investments will affect economic activity by 0.5%.

Our assessment is consistent with a less favourable GDP growth than was assumed in the latest official estimates, and will have an effect on the projected decline in public net borrowing. In particular, we expect that the “close to balance” position will not be completely achieved in 2013. The deficit to GDP ratio is estimated between 1 and 1.8% in 2013 and between 0.8% and 1.6% in 2014.

Additional costs for the economy

The debt crisis will have negative effects on the Italian economy through different channels.

- 1) **Households.** Losses for households will derive both from the depreciation of sovereign bonds held by the private sector and from losses on the stock exchange, where Italian firms suffer from the lack of confidence in the economic situation of the country. Higher interest rates will also affect households in the cost of mortgages, but this effect is now relatively small, since it will only concern future contracts.
- 2) **Firms.** The cost of borrowing may affect also firms, and turn into a new credit crunch, given the weak economic situation mixed with the higher difficulties of more indebted firms; the recession may also induce firms to pause their investment decisions, with a further negative impact on growth.
- 3) **Real estate.** The rise in interest rates will cause a dampening of the already weak demand of the real estate sector, due to worse credit condition for households on the demand side, and to worse condition on the supply side, given difficulties for real estate firms in obtaining credit from banks.
- 4) **Public finances.** As mentioned above, rising spreads will cause higher interest expenditures due to higher rates on new debt issue. A 1 percentage point rise in rates generates in three years a higher interest expenditure of 0.5 per cent of GDP, thus eroding part of the austerity package.

All in all, and without any counter-action, risks of a new recession during the winter are very high, and all the GDP components are expected to decline during the next two quarters, at least.

4.4 Fiscal programmes and options

The table below reports the fiscal consolidation programmes in the countries represented by the AIECE over the next few years. Policy is due to tighten almost everywhere, in an effort to correct the rise in the government debt burden since the onset of the financial crisis, and to instil confidence in debt sustainability within the Euro Area. Tightening measures are expected to be especially stringent in Ireland, the UK, Poland, Italy and the Czech Republic. With the exception of Italy, tightening measures in these countries are biased towards spending cuts. Consolidation measures in France and Italy are biased towards tax rises, whereas policy plans are more balanced in Germany, Finland and Hungary.

Table 4.2 Fiscal consolidation plans (% GDP)

Country			Size			
			2011	2012	2013	2014
Austria	WIFO	Total	0.9	0.4	0.1	0.1
		of which expenditure cuts	0.5	0.3	0.1	0.1
		of which revenue increase	0.4	0.2	0.0	0.0
Belgium	Budget for 2012 delayed	...	...	...	...
Czech R.	CCS&F	Total	2.1	0.8	0.7	0.6
		of which expenditure cuts	1.6	0.6	0.4	0.5
		of which revenue increase	0.5	0.2	0.3	0.1
Denmark	DEC	Total	0.1	0.1	0.8	...
		of which expenditure cuts	0.0	0**	0.7	...
		of which revenue increase	0.1	0.1	0.1	...
			**Fiscal loosening of 0.5% GDP – bringing forward investment plans – is being considered			
Finland	ETLA	Total	...	1.0	0.1	...
		of which expenditure cuts	...	0.4	0.1	...
		of which revenue increase	...	0.6	0.0	...
France	Coe-Rexecode	Total	1.2	1.0	...	...
		of which expenditure cuts	0.3	0.3	...	...
		of which revenue increase	1.0	0.7	...	...
	OFCE	Total	1.4	1.4	1.0	1.2
		of which expenditure cuts	0.4	0.5	0.5	0.5
		of which revenue increase	1.1	0.9	0.5	0.7
Germany	RWI	Total	0.6	0.2	...	...
		of which expenditure cuts	0.3	0.1	...	...
		of which revenue increase	0.3	0.1	...	...
Greece						
Hungary	GKI	Total	...	2.2-2.6	...	...
		of which expenditure cuts	...	1.0	...	...
		of which revenue increase	...	1.2-1.6	...	...
	KOPINT	Total	...	2.5	...	...
		of which expenditure cuts	...	1.1	...	...
		of which revenue increase	...	1.4	...	...
Ireland	ESRI	Total	3.4	2.3	1.9	1.8
		of which expenditure cuts	2.5	1.4	1.2	1.2
		of which revenue increase	0.9	0.9	0.7	0.6

Cont./

Table 4.2 Fiscal consolidation plans (% GDP) (continued)

Country			2011	Size		
				2012	2013	2014
Italy	Confindustria	Total	0.2	1.5	1.6	0.2
		of which expenditure cuts	0.0	0.5	0.6	0.1
		of which revenue increase	0.2	1.0	1.0	0.1
	Prometeia	Total	0.2	1.5	1.6	0.2
		of which expenditure cuts	0.0	0.5	0.6	0.1
		of which revenue increase	0.2	1.1	0.8	0.2
Netherlands	CPB	Total	0.8	0.6	0.6	0.6
		of which expenditure cuts	...	...	...	...
		of which revenue increase	...	...	...	...
Norway						
Poland	IBRKK	Total	1.3	1.8	0.8	0.5
		of which expenditure cuts	0.7	1.4	0.7	0.5
		of which revenue increase	0.6	0.4	0.1	0.0
Serbia	FTRI	Total	4.1	4.0	...	...
		of which expenditure cuts	...	...	...	...
		of which revenue increase	...	...	...	...
Slovenia	SKEP	Total	1.8	...	...	...
		of which expenditure cuts	1.6	...	...	...
		of which revenue increase	0.2	0.3	...	...
Slovakia	SAVBA	Total	2.9	1.0	1.0	...
		of which expenditure cuts	...	...	...	...
		of which revenue increase	...	...	...	...
Spain						
Sweden	NIER	Total	0.0	0.0	0.0	0
		of which expenditure cuts	...	...	...	...
		of which revenue increase	...	...	...	...
Switzerland	KOF	Total	0.0	0.0	0.0	0
		of which expenditure cuts	...	...	...	...
		of which revenue increase	...	...	...	...
UK	NIESR	Total	2.1	1.8	1.0	1.0
		of which expenditure cuts	1.0	1.6	1.0	1.0
		of which revenue increase	1.1	0.2	0	0

4.5 Debt auctions and financing needs

The bail-out programmes agreed for Greece, Ireland and Portugal will allow the governments to borrow at rates well below what they would face on the open market for the time being – provided targets agreed with the Troika are adhered to. Outside these countries, government borrowing costs are market driven, and at recent auctions Italy and Spain have had to pay a higher rate of interest than the rates offered under the bail-out programmes. In the first half of this month there were two major bond auctions in Italy. The gross yield on 5-year debt issued on 14-15 November was 6.29 per cent. Upcoming auctions in the last week of November could act as a confidence test for the new Italian government. On 17 November, the Spanish government held an auction for 10-year bonds, and the weighted average rate on the debt was 6.975 per cent.

The fiscal implications of the higher interest rates depend both on the quantity of borrowing, and the historical borrowing costs of maturing debt. Current borrowing needs depend on the stock of maturing debt in each period, which needs to be reissued at the current borrowing rate, as well as the financing needs to cover the current deficit. Table 4.3 below reports the stock of maturing debt in selected European countries to 2013. Italy, Belgium, Portugal, France, Spain and the Netherlands all have more than 10 per cent of GDP in maturing debt per annum over this period. The high deficits in Portugal, Greece, Spain and France exacerbates the borrowing requirements in these countries, and it is perhaps not surprising that sovereign debt is the more vulnerable economies of Italy and Spain are under pressure.

Table 4.3 Maturing government debt: 2011–2013 (per cent of GDP)

	2011	2012	2013
Italy	18.5	21.1	17.7
Belgium	18.0	18.9	18.5
Portugal	16.1	17.9	18.0
Greece	15.7	9.6	9.7
France	14.1	16.2	16.2
Spain	13.4	15.4	15.0
Netherlands	12.5	13.2	14.2
Finland	9.8	8.7	8.2
Germany	9.1	9.4	7.4
Ireland	8.7	5.3	8.1
United Kingdom	7.0	7.6	8.2
Sweden	5.4	4.9	2.2

Source: IMF Fiscal Monitor, Sept 2011

4.6 Implications of a default on government debt

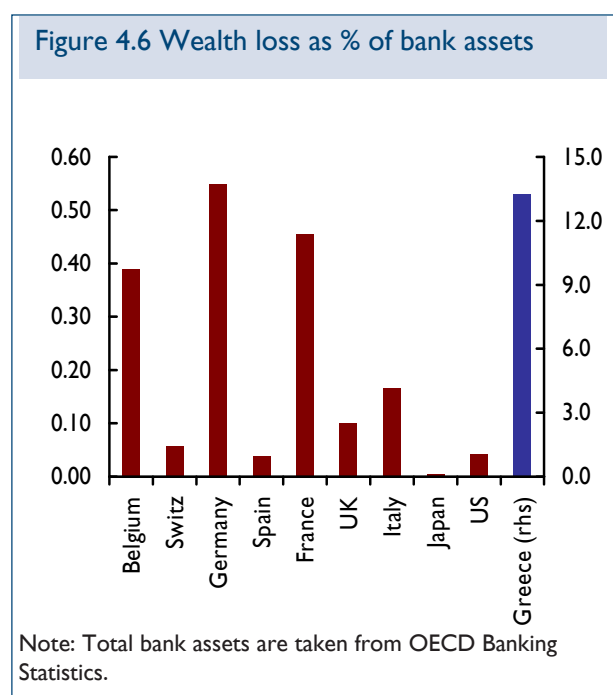
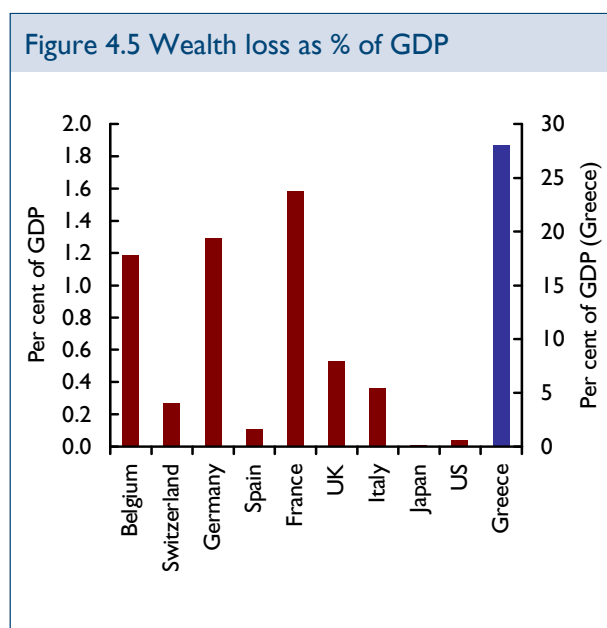
Comment by Dawn Holland and Simon Kirby, NIESR

A default on government debt entails both costs and benefits to the defaulting economy, and an assessment of the macroeconomic impact of any default (voluntary or other) should consider both sides.

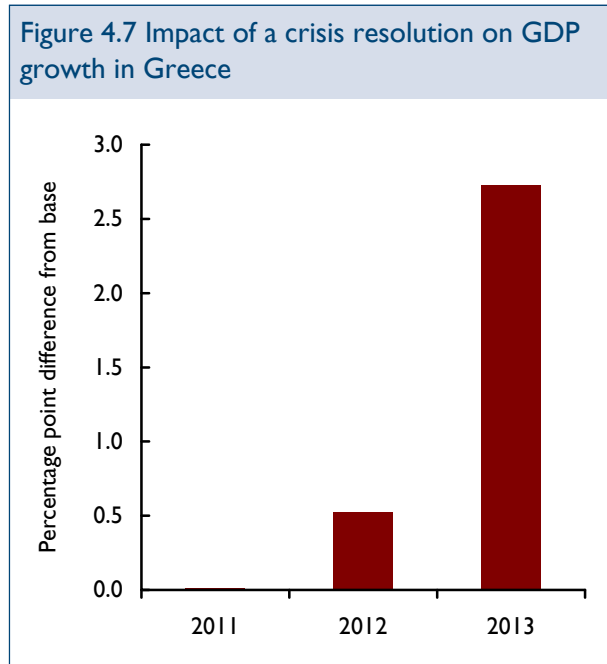
If a default is viewed by financial markets as sufficient to restore sustainable public finances, while at the same time there are sufficient policies in place to mitigate against the losses – notably in the banking sector – yields on government bonds can be expected to begin to decline towards those in Germany from the high levels illustrated in figure 4.1 above, although the process of adjustment may take several years. If high public sector borrowing costs imply high private sector borrowing costs, the relief in bond spreads will allow a higher level of investment and smoother consumption path than we would expect without the default. In addition, a default that restores fiscal sustainability may allow a less austere fiscal adjustment going forward, supporting domestic demand. These are the main macroeconomic benefits of a default.

However, a default on government debt must also be seen as a loss to the lenders both within the defaulting country and elsewhere if some of this debt is held abroad. As discussed by Holland, Kirby and Orazgani (2011) there are two losses to consider: the loss to the perceived financial wealth of the personal sector through bonds held directly and via institutional investors; and the loss to the asset base and hence capital adequacy in the banking sector. A decline in personal sector financial wealth can be expected to have a negative effect on consumer spending in the short-term¹. While a comprehensive program will ensure that a plan is in place to recapitalise banks that suffer significant losses from a default, we should expect a rise in bank lending margins, in order to gradually recover the losses over time. This can be expected to affect output through the investment channel.

Figure 4.5 illustrates NIESR's estimates of a 50 per cent default on Greek government debt to financial wealth in selected countries as a per cent of GDP, while figure 4.6 shows this as a per cent of total bank assets in the economy. The former gives a guide to the wealth effect to expect through the consumption channel, whereas the latter illustrates the bank losses to be recouped through higher lending margins, which feed into the investment channel. We assume that banks in Greece recapitalise gradually over four years, while banks elsewhere recapitalise over two years. At the macro level, the magnitude of the shock to bank asset bases is relatively small in countries outside of Greece. However, the solvency of individual banks may come under question, as evidenced by the recent bailout of the French-Belgian bank, Dexia, in recent weeks. Whether this exacerbates the growth and debt spiral depends critically on how banks are managed through this process.

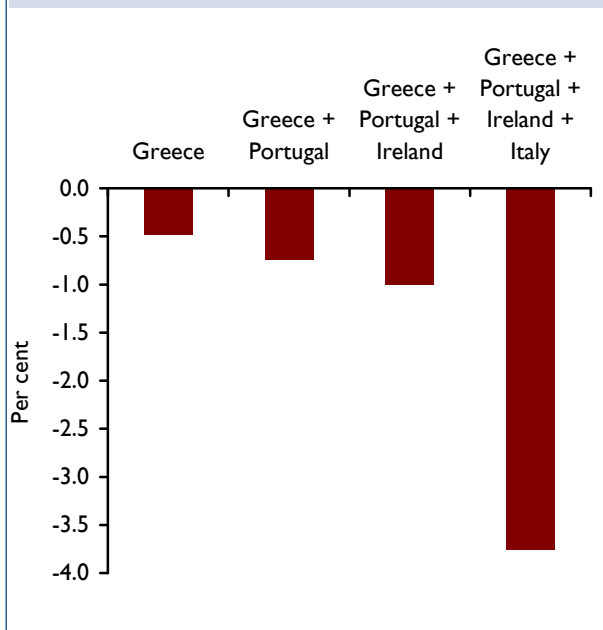


We assume that a programme is put in place to provide ample funds to recapitalise banks that come under stress, preventing contagion of the default through the banking system. If policy makers fail to meet this requirement, we could see a sharp drop in bank lending, as in the 2008-9 crisis. Figure 4.7 illustrates NIESR's estimates of the effect of a 50 per cent Greek default on output in Greece economies after taking into account the factors detailed above. As private sector borrowing is restricted by the high risk premium on government debt (CGFS, 2011) the decline in the premium more than offsets the rise in lending margins and wealth effects, while the debt write-down allows a somewhat looser fiscal stance. However, if the risk premium on government down does not come down as rapidly as assumed in this scenario, a default could have a negative effect on the outlook for Greece.



Outside of Greece the effects are small under our assumption of no default or banking sector contagion. However, a “successful” default in Greece (one that has positive macroeconomic effects) could lead other vulnerable sovereigns, such as Portugal, to request a similar treatment, leading to multiple sovereign defaults. Figure 4.8 above illustrates the impact that a 50 per cent write-down on sovereign debt would have on Euro Area-wide banking assets, under a scenario of default contagion. Close to 1 per cent of bank assets in Germany, France and Belgium would be lost as a result of contagion of a Greek default to both of the other countries under bail-out programmes, Portugal and Ireland. This may be enough to push the Euro

Figure 4.8 Loss to Euro Area bank assets of 50% default in



Area economy into a banking crisis. A 50 per cent default in Greece, Portugal, Ireland and Italy, however, would wipe out 18 per cent of bank assets in Italy, and more than 2 per cent of banks assets in France, Germany and Belgium. In aggregate this would imply a loss of 3½–4 per cent of Euro Area banking assets. As there is little prospect that the funds available to recapitalise failing banks would be sufficient without recourse to either ECB or IMF support, this scenario would make a severe banking crisis in Europe inevitable. We should bear in mind that for a default to be a voluntary choice, the Italian government must believe that the economy would be better off with a default than without one, and this is clearly unlikely to be the case.

NOTE

1 While the debt write-down entails a decline in future tax liabilities of the personal sector that may offset the wealth loss, the dynamic response to the two differ markedly if consumers are myopic. The loss in wealth is likely to lead to higher precautionary savings and a degree of credit rationing from the banking sector.