The European Economy in the Medium Term

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Tables can be found in the annex.

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1.1 The AIECE medium term outlook

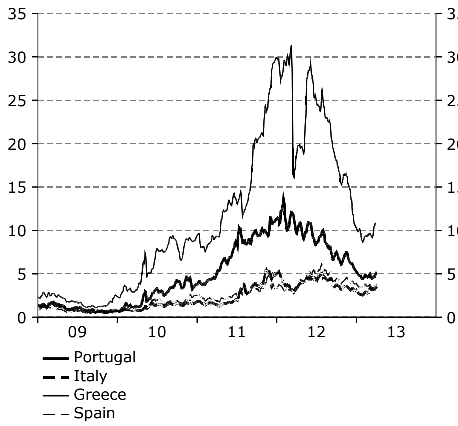
THE BACKDROP

Four years after the fall of Lehman Brothers, the global economy is still characterized by the repercussions of the large credit expansion that led to the crisis. The fast recovery around the turn of the year 2009/2010 has been followed by a decline in growth. The end of 2012 was especially weak and the common assessment that the recovery – like earlier recoveries after financial crises – will be slow and bumpy has so far been vindicated. Even though many forecasters expect cyclical forces and continued expansionary monetary policy to induce a global recovery sometime this year, the route to a balanced economic situation and sustainable debt levels is long for many developed economies, not least in Europe. Stretched public finances severely restrict further fiscal policy measures, large parts of the financial sector has to deleverage further and productivity growth has been dismal the last few years.

At the moment, incipient signs of a cyclical recovery have been seen in the US and the Chinese economy seems to gather some momentum. While Europe clearly will benefit from a recovery in those markets, most European countries seem to be in worse shape. Even though conditions in financial markets at the moment are more relaxed than a year ago (see FIN233 Diagram 1), the backdrop for most AIECE institutes is feeble or negative growth, high unemployment and political and social unrest.

FIN233 Diagram 1 Selected Government Bond Interest Rates, Difference over German bonds

Percent, daily values, 5-days moving average



Note: 10-year maturity.

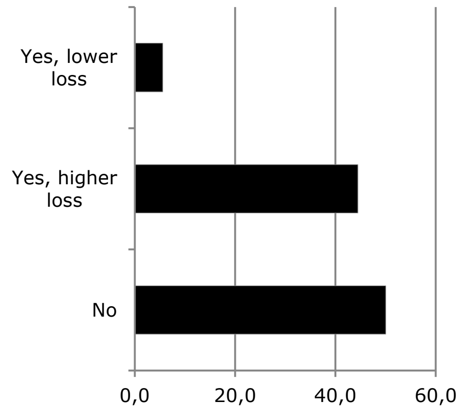
AIECE INSTITUTES HAVE FURTHER ELEVATED THE ASSESSED IMPACT OF THE FINANCIAL CRISIS

That the financial and debt crisis has hit Europe hard is thus unquestionable. But what will the effects be looking forward and how much of the losses suffered will be recovered ? Four years ago, the AIECE institutes were asked to assess the impact on their respective economies of the financial crisis. For obvious reasons – the crisis had erupted only a few months earlier – the common assessment was rather vague and not very coherent. Two years later, in early 2011, many institutes, not least from the so called peripheral countries had adjusted upward their assessments of the expected loss in output generated by the financial and debt crisis. On the one hand, some political and institutional progress had been made and during 2010 growth was decent or in some cases even strong. On the other hand, it had become clear that upcoming challenges were huge as business cycle indicators for peripheral countries had begun to decline and nervousness in financial markets persisted.

This time around and a further two years later, slightly more than 40% of the (responding) institutes say that they have upgraded the extent to which the financial and debt crisis has induced a permanent loss in output in their own economy. Some 5% have lowered the estimated effects, which leaves half of the

Figure 2 Have you changed your view on what permanent loss of output has been induced by the financial and debt crisis? Q3

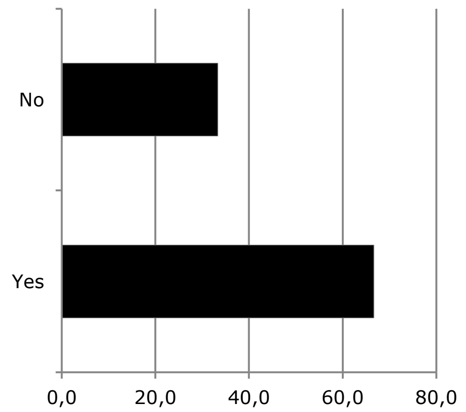
Share of respondents, percent



Source: AIECE community.

Figure 3 Do you agree that global productivity growth will be considerably lower ahead compared to the last couple of decades? Q7

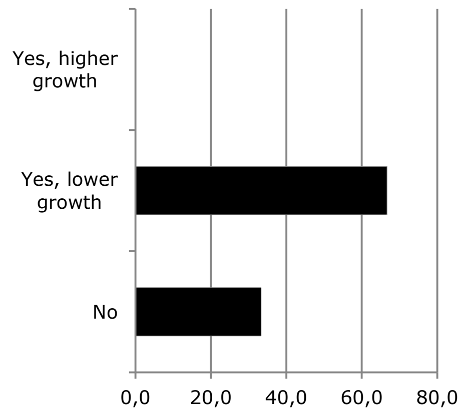
Share of respondents, percent



Source: AIECE community.

Figure 4 Have you changed your view of 2013–2015 growth since spring 2011? Q2

Share of respondents, percent



Source: AIECE community.

institutes not having changed their assessment since 2011 (see Figure 2). It is probably safe to say that most institutes today judge the financial and debt crisis to have had a significant negative permanent (long-term?) impact.

MEDIUM TERM GROWTH PROJECTIONS HAVE BEEN REDUCED

An increasing amount of commentators argue that global productivity growth will weaken (or have already weakened?) considerably compared to the last decades. While weak capital deepening in the wake of the present slump can be expected to weigh on productivity growth in the next few years, the more longlasting explanation put forward is the relative lack of innovation and major technological breakthroughs. Considering also the unfavourable demographics in large parts of the world, this would not bode well for global GDP growth.

This pessimistic view is to some extent also shared by AIECE as two out of three institutes expect lower productivity growth in the global economy in the coming years than during the last couple of decades (see Figure 3). While it is not possible to detect whether respondents believe there to be a link between this phenomenon and the effects of the financial crisis mentioned above (for instance that budget restraints following the financial crisis will hamper investments in R&D and thus productivity growth) by and large it is probably fair to treat these as two mainly separate phenomena.

In any case, most institutes (2 out of 3 of those responding) say that they have lowered their medium term growth projections for their own countries compared to their assessment in 2011 (see Figure 4). No institute has raised their growth projections.

The unweighted average trend GDP growth reported by the institutes for 2013-2017 is 1,7%. While clearly higher than trend growth during 2008-2012 (on average calculated by the institutes to -0,4%), it is exactly half the rate calculated for the period 2003-2007. Particularly low growth is expected in Italy (0,5%). At the high end is Poland (3,1%) and Ireland (3,0%).

To sum up, the general outlook for medium term GDP growth is rather bleak. This raises the question if policy decisions in the foreseeable future have to be based on growth assumptions that are very different from what has been the case during the last decade. Some commentators are talking about (more or less explicitly stated) social contracts having to be rewritten. Indeed, current social and political unrest in Europe could be interpreted as the byproduct of that process already having been initiated.

CREDIT CONDITIONS IN MOST MEMBER COUNTRIES EXPECTED TO TIGHTEN

A large component of the buildup to the crisis and the present challenges is related to the behaviour in the financial markets. Having lent too generously, banks and other financial actors have now been forced to deleverage. This is an ongoing process. Regardless of the merits of a more cautious approach to lending and debt, continued deleveraging would hamper growth in the short to medium run and thus delay the recovery.

Most institutes, around two thirds, believe that bank credit conditions will be tighter in the years ahead than during the decade preceding (the eruption of) the financial crisis (see Figure 5). Some 20% believe that bank credit conditions will be laxer. Answers indicate a little less tightening in the money market (see Figure 6).

In Italy, Ireland, Finland, Slovenia and Greece credit conditions are expected to be much tighter. It is interesting to note that credit conditions in Spain (referring to banks as well as to the money market) are expected to become somewhat laxer in the years ahead. Private deleveraging to date and a relatively well-capitalized banking sector will result in laxer credit conditions in Germany as well.

Figure 5 How will bank credit conditions for non-financial firms and households be over the next 5 years compared to the decade before 2009? Q4

Share of respondents, percent

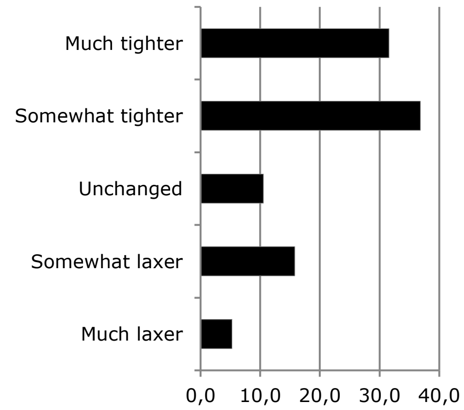
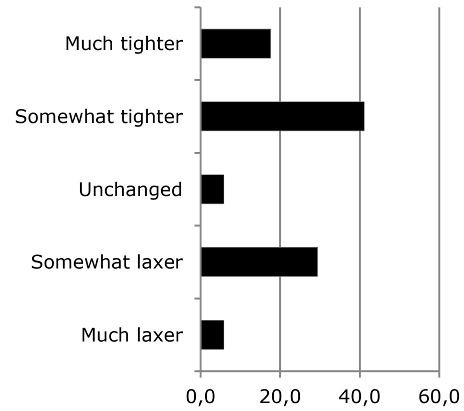


Figure 6 How will borrowing costs for non-financial firms be over the next 5 years compared to conditions during the decade before 2009? Q5

Share of respondents, percent



Source: AIECE community.

1.2 Savings imbalances and medium term growth

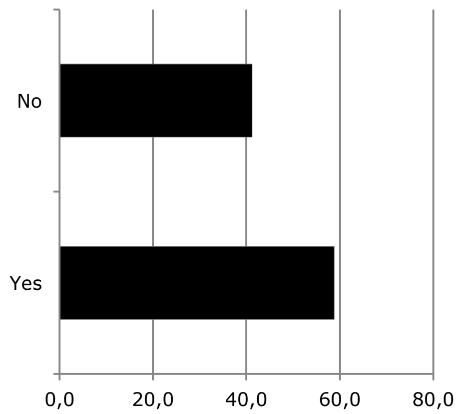
AIECE INSTITUTES SPLIT REGARDING GLOBAL RE-BALANCING AND ITS POSSIBLE GROWTH EFFECTS

A factor potentially affecting growth in the next few years is the possible re-balancing of savings positions and competitiveness in different countries, not least in the euro area. Slightly less than 60% of the institutes do expect continued significant re-balancing of savings positions globally during the next few years (see Figure 7). Such re-balancing will normally be associated with a changing industrial and business structure as production will become less (more) oriented towards domestic demand and more (less) towards external demand, a process which could be expected to take some time.

Among the institutes that expect continued global re-balancing, some 60% expect this to weigh on medium term growth. Most of these institutes do not expect any large effects (see Figure 8). However, a quite large minority expect positive effects. In sum, the number of institutes that either do not expect continued global re-balancing, or if they do, do not expect this to weigh negatively on growth constitute some 60% of the total number of institutes.

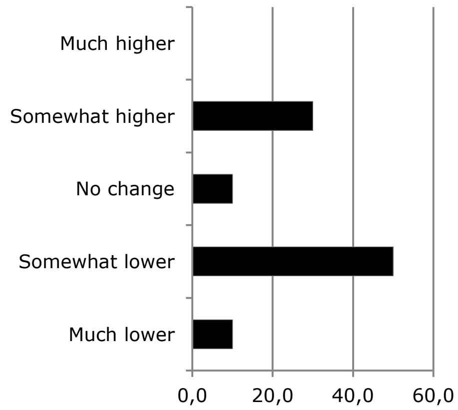
Figure 7 Do you expect significant continued re-balancing globally during the next few years? Q9

Share of respondents, percent



Source: AIECE community.

Figure 8 Compared to a "no re-balancing scenario", what change in global GDP growth over the next few years is consistent…? Q10
Share of respondents, percent



Source: AIECE community.

Re-balancing in the euro zone

Many commentators argue that capital flows from higher income so-called core countries to lower income so-called peripheral countries since the introduction of the euro have resulted in savings imbalances in the euro zone that lies at the heart of the present crisis.

FINANCIAL FLOWS FROM TO THE CORE TO THE PERIPHERY IN ACCORDANCE WITH THEORY

In theory, capital flows from one country to another could reflect fundamentals, e.g. demographics, preferences or production factor availability. This would - leaving aside savings patterns with the rest of the world – seem to imply that the peripheral countries in the euro zone should have a tendency to borrow from the core countries. This in turn should bring about convergence in productivity and income levels as access to capital enables productivity-enhancing investments.

HOWEVER, CONVERGENCE FAILED TO MATERIALIZE

It turns out that, so far, only the first part of the above-mentioned narrative has materialized. Generally speaking and in net terms at least, capital has indeed flowed from the core to the periphery.

The birth of the euro meant that these capital flows were supported by a reduction of the perceived risk of investing in the periphery. Some analysts claim that home (i.e. EMU) bias resulting from regulations and other institutional setups also has played a large role. Other types of financial liberalization and innovation also played a role. Together with the common monetary policy, these capital flows contributed to a substantial reduction in interest rates in the periphery. As inflation remained higher in the periphery, real interest rates came to be lower in the periphery than in the core.

But in contrast to mainstream economic theory, economic convergence has not materialized since the start of the euro. Actually, to some extent, quite the opposite has happened. The vast inflows of capital to a large extent seem to have reduced private saving in the periphery and to have been channelled to increased consumption and investments in construction and real estate. Growth in productive, private investments remained weak. This induced large current account deficits in the periphery, but did not induce much convergence towards the core in terms of productivity and income. Actually, at least up until 2007 the difference in total factor productivity seems to have widened since the introduction of the euro, while income per capita in the periphery hardly increased up until 2007 – and probably has fallen if you consider the last few years.

HALF OF AIECE INSTITUTES BELIEVE THAT THIS HAS CONTRIBUTED TO SIGNIFICANT SAVINGS IMBALANCES

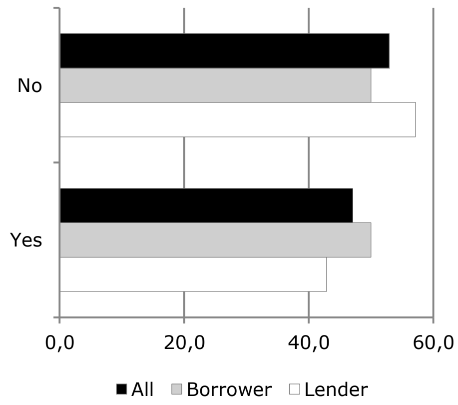
To the extent that funding from abroad is being channeled to improductive use and feeding asset price bubbles, or more generally that too few resources are set aside or invested for the benefit of future consumption, it could be said to constitute an imbalance. On the other hand in countries which are net lenders, excessive dependence on the export sector and a tendency to forsake current domestic consumption could constitute an imbalance in the form of excess lending.[1]

50% of the institutes from borrower countries believe that a significant portion of their current account deficit is due to imbalances (see Figure 9). Slightly more than 40% of the institutes from lender countries attribute a significant part of their current account surpluses to imbalances. That means that slightly less than half of the responding institutes believe that their current account positions are due to imbalances.

It is perhaps interesting to note that the two German institutes that answered the questionnaire have opposite views on whether their large current account surplus to a significant degree constitutes an imbalance or not. The implications for other countries of the different views on this issue are not clear, however, since the institute that identifies an imbalance does not believe that the German current account surplus will be changed much at all during the next decade. Judging by the comment of one of the institutes, the main explanation for the current account not shrinking faster is the demographic development in Germany ahead.

Figure 9 Does a significant portion of 2012 current account surplus/deficit constitute an imbalance? Q11

Share of respondents, percent



Source: AIECE community.

WHEN LENDERS DEEMED DEBT LEVELS AS UNSUSTAINABLE, CAPITAL FLOWS DRIED UP

The lack of convergence gradually eroded the solvency of borrower countries and put their ability to service and pay back loans into question. While there has not been any episodes where current account deficits in the periphery can be said to have exploded since the birth of the euro, they have been permanent and thus over time contributed to accumulating foreign debt. Servicing this increasing debt of course further compounds current account deficits. Once debt levels in the periphery had reached a level that lenders deemed as unsustainable, private capital flows abruptly dried up leaving sovereigns (tax payers) and the ECB to try to close the gap.

The periphery must now adapt to a situation with less capital flowing in from abroad. In other words, current account deficits must be brought down and eventually turned into surpluses.

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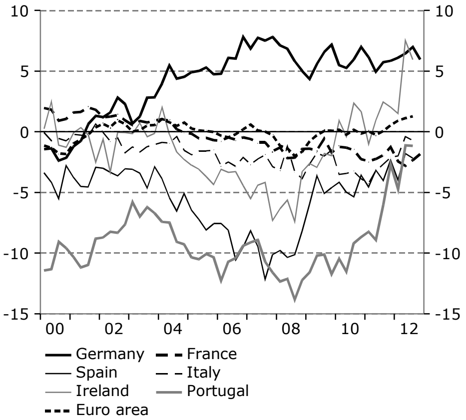
[1] In making decisions over consumption over time, a lender obviously has to include the risk of default on the part of the borrower.

INT742 Diagram 11 Current Account in Selected Countries

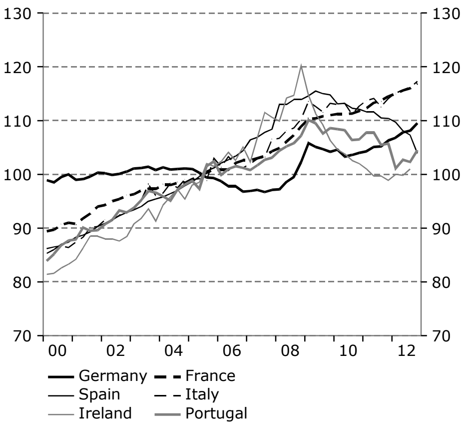
Percent of GDP, seasonally adjusted quarterly values



Source: OECD.

INT740 Diagram 10 Nominal Unit Labour Cost in Selected Countries

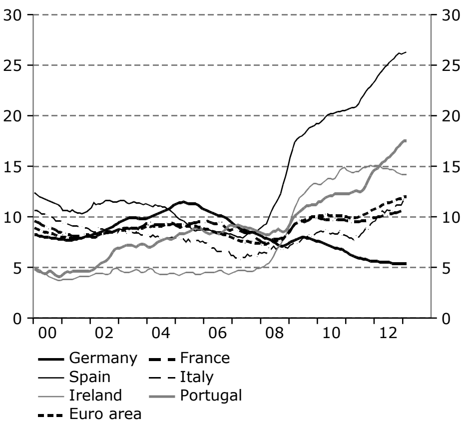
Index 2005=100, seasonally adjusted quarterly values



Source: Eurostat.

INT731 Diagram 12 Unemployment in Selected Countries

Percent of labour force, seasonally adjusted monthly values



Source: Eurostat.

Roughly, a current account balance improvement can either be achieved by an increase in exports or decrease in imports.

THE ADJUSTMENT PROCESS HAS BEGUN

To date, the process of cost adjustment and current account adjustment at least on the face of it seems to be under way and has been so for some time (see INT742 Diagram 11). With the exception of Italy, unit labour costs have fallen relative to the core countries (see INT740 Diagram 10). Preferably, the adjustment process should be driven exclusively by productivity and exports. However, high unemployment and reduced domestic demand seem to play a large role (see INT731 Diagram 12). Correcting imbalances in the periphery of the euro zone via higher exports is at least in the short run deterred by the global slump and by the loss of competitiveness during the boom years. The absence of large increases in exports has meant that lower imports has been part of the adjustment process. This in turn has gone hand in hand with lower domestic demand. In order for exports to play a bigger role ahead, costs, mainly labour costs, have to be reduced. Such a development risk, at least initially, to be associated with even higher levels of unemployment. Productivity and competitiveness must also increase. The cost development in France is also a bit worrying and unemployment is high.

Developments in the core are going in the direction of re-balancing as well. For instance, German unit labour costs have grown faster than in the periphery since the crisis erupted.

…BUT STILL HAS A LONG WAY TO GO

Even though the re-balancing process clearly has started, most observers believe that there is still a long way to go. It will take a long time for more balanced *flows* to bring *stocks* in order. An important question is how much of the ongoing re-balancing that is structural and how much that is cyclical. If a large part is explained by cyclical factors, the probability of a durable solution is lower. Eventually, the economies will emerge from the economic slump and productivity and costs could well resume to follow unsustainable paths. Probably as a result of the question in the questionnaire not being optimally stated, all of the AIECE institutes believe that both cyclical and structural forces explain the re-balancing process so far.

THE AIECE INSTITUTES TAKE ON FUTURE RE-BALANCING

The AIECE institutes expect re-balancing to continue. This applies to the development of wages and unit labour costs in the coming years (see Figure 13 and Figure 14). In borrower countries, most institutes expect the continued re-balancing to be associated with lower growth in hourly wages. However, some 40% expect no change or even higher growth in hourly wages. When introducing productivity, i.e. focusing on unit labour costs, a higher share of institutes from borrower countries expect re-balancing to be associated with a lower trajectory.

Half of the lender country institutes expect re-balancing to be associated with higher growth in hourly wages and some 30% with higher growth in unit labour costs. (see Figure 13 and Figure 14). A significant minority (30%) expect lower growth in wages and unit labour costs, however. This perhaps raises the question of how large the internal devaluation in peripheral countries has to be in order to address the existing imbalances. The general picture could nevertheless be said to be in line with theory, where those countries that have experienced capital inflows and high costs will see a reduction of labour costs ahead, while at least to some extent the opposite applies to those countries that have exported capital while keeping costs in check.

Most institutes expect the re-balancing process to be associated with an improvement of public finances (see Figure 15). Roughly, this applies in equal amount to institutes from borrower and lender countries.

So what are the implications for GDP growth of this re-balancing of debts positions and costs in the medium term? A minority of some 30% of the institutes from borrower countries believe that continued re-balancing and the ensuing structural changes in themselves will be associated with lower growth in their own economies in the coming years (see Figure 16). 60% expect higher growth. Institutes from lender countries are less optimistic as some 20% expect re-balancing to go hand in hand with higher growth and some 40% expect it to be associated with lower growth.

1.3 Issues for discussion

IFW:

2 Ultra-expansionary monetary policies over a prolonged period of time in all major economic areas (US, EA, UK, Japan)

3 Is there still a consensus on monetary policy and the role of the ECB in the EA, if not, what are the perspectives for the stability and integrity of the currency union

4 Future of the EA in case of a lack of structural reforms in crisis countries.

Rexecode:

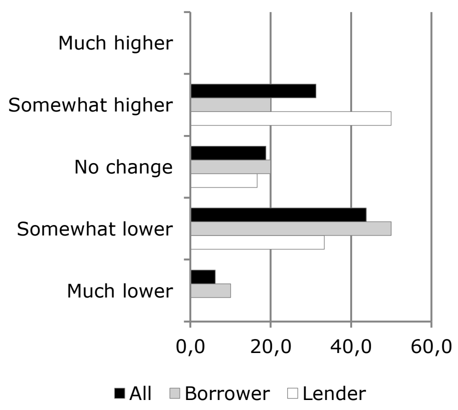
5 1, Is a re-industrialisation process occurring in the US and is there any room of manoeuver to see such a process in EU ? What are its necessary conditions? 2, What will be the extent of labor migration between European countries ? And how does this process matter for European construction ?

NIER:

6 Austerity…

Figure 13 Compared to a "no re-balancing" scenario, what change in growth in hourly wages is consistent…? Q12

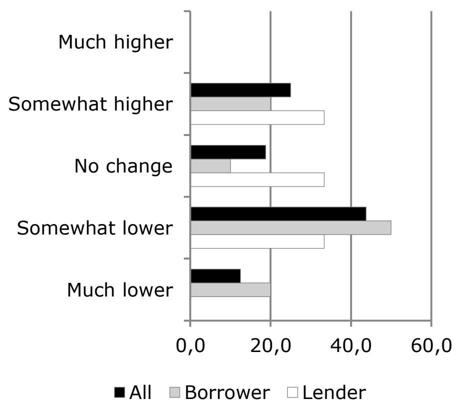
Share of respondents, percent



Source: AIECE community.

Figure 14 Compared to a "no re-balancing" scenario, what change in unit labour cost growth is consistent…? Q12

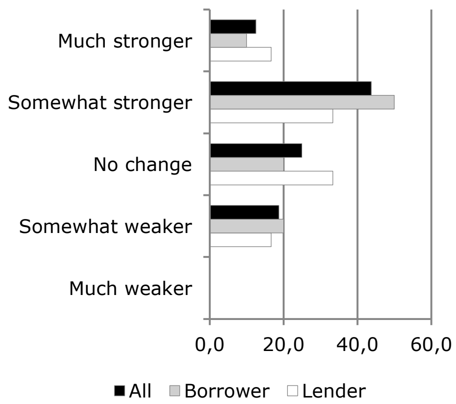
Share of respondents, percent



Source: AIECE community.

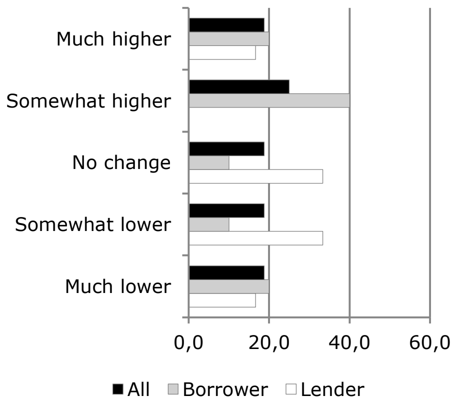
Figure 15 Compared to a "no re-balancing" scenario, what change in public finances is consistent…? Q12

Share of respondents, percent



Source: AIECE community.

Figure 16 Compared to a "no re-balancing" scenario, what change in GDP growth is consistent…? Q12
Share of respondents, percent



Source: AIECE community.

7 How much of the re-balancing lately and in the near future that is due to cyclical forces is an important question. Unfortunately, the question in the questionnaire was not optimally put, which could explain why 100% of the institutes answered "both" to the question of cyclical and structural explanations, respectively (more alternatives should have been given). But maybe we could discuss the topic at the meeting.

8 It seems that SME:s face much tighter financing conditions than larger firms. In contrast to the latter, SME:s are more or less confined to bank borrowing. Given further bank deleveraging ahead, is there a risk that this will persist over the medium term?

9 Of those institutes that expect continued re-balancing of savings positions in the global economy 50% do not expect this to weigh on global growth, while the other 50% do expect negative effects. It would be interesting to hear each sides arguments. Are different answers a matter of difference in time perspectives?

10 Related: Most institutes, not least from "borrower countries" do not expect negative growth effects from a continued re-balancing process in the coming years. In the long run, convergence implies higher growth in the periphery (at least in comparison to growth in the core). One could, however, fear that structural changes and related frictions will dampen growth in the short and medium term. Does the answer to the question on re-balancing and growth depend on the view of how long the re-structuring of the economy will take? Or that institutes take different time perspectives? Or is it plausible that re-balancing in the periphery will be associated with higher growth already in the short run?

11 On many accounts, Spain seems to have come quite a bit in its re-balancing process. For instance according to official statistics, unit labour costs have fallen since 2009. Are these numbers reliable?

12 It seems that the view of AIECE is the German current account surplus will not change very much in the next few years. Judging also by the answers from other countries, this would imply that the EU/euro zone will have a substantial current account surplus visavis the rest of the world. Since many non-european countries also face stern demographic challenges ahead, how realistic is this? What parts of the world economy will accommodate euro zone/EU increased savings ?