Association d'Instituts Européens
de Conjoncture Economique (AIECE)

AIECE General Report: Part 1

For the AIECE Spring Meeting 2017
Frankfurt, May 4−5, 2017

NATIONAL INSTITUTE OF ECONOMIC RESEARCH (NIER), KUNGSGATAN 12-14, BOX 3116, SE-103 62 STOCKHOLM
+46 8 453 59 00, REGISTRATOR@KONJ.SE, WWW.KONJ.SE/ENGLISH

Authors

Peter Svensson, peter.svensson@konj.se
Emanuela Iancu, emanuela.iancu@konj.se
Göran Österholm, goran.osterholm@konj.se

National Institute of Economic Research

Kungsgatan 12-14
103 62 Stockholm

Contents

1. Global backdrop

THE GLOBAL RECOVERY CONTINUES

Despite disruptive political events and geopolitical tensions, the recovery in the global economy continues. Deflationary pressures seem to be abating and global industrial production has begun to grow faster. Even though exports plummeted, GDP-growth in the US was healthy in the fourth quarter of last year and surveys and monthly data suggest a further increase in growth at the beginning of this year. In a number of large emerging markets, including Brazil and Russia, GDP has more or less stabilized and most forecasters expect timid recoveries to ensue.

On the back of renewed strength in the manufacturing sector, Chinese growth increased to 6.9 percent the first quarter of this year compared to a year earlier. Most data point to continued robust growth in the short term. Still, many analysts regard a hard landing of the Chinese economy as one of the most important risks to the global economy (see the section on Risks and Challenges for Europe). In India, annual growth slowed down to slightly less than 7 percent in the second half of 2016. Some of the slowdown was most likely a result of the disruptive effects of the bank note reform launched at the end of last year. The Indian economy looks set to resume its growth rate of more than 7 percent annually during the next couple of years.

On average, AIECE institutes believe that global GDP-growth will increase from 3.1 percent 2016 to 3.4 percent 2017 and 3.6 percent in 2018 (see Diagram 1).

INFLATION ON THE RISE

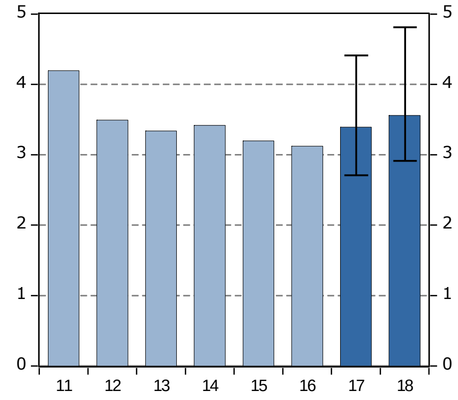
After a couple of years of low price increases, inflation has increased globally. Even though a temporary boost from food and energy prices can be expected to fade away from headline inflation in the coming months, core inflation seems to be firming. In the US, CPI increased by 2.4 percent in March compared to a year earlier, while core inflation (excluding food and energy) was 2.0 percent. In most European countries, inflation has increased lately. Even though consumer price inflation in China has not taken off yet, it is worth to notice that for the first time since the beginning of 2012, producer prices started to increase at the end of last year and that development has continued this year as well. AIECE institutes expect a continued increase in the price of crude oil, but at a slow pace (see Diagram 2).

A SHIFT IN THE GLOBAL POLICY MIX

Even though inflation is on the rise, monetary policy will continue to support growth. Nevertheless, a shift has begun and it has been a while since any noticeable new expansionary monetary policy measures was introduced. In the US, the Fed has

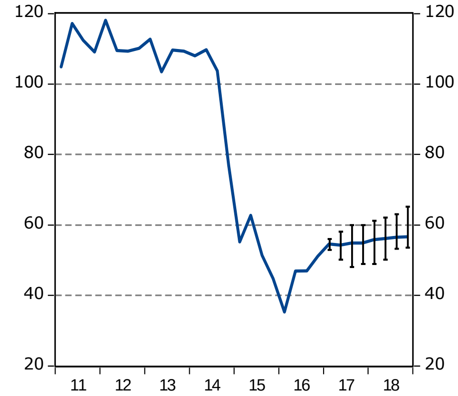
Diagram 1 Global GDP

Percentage change



Source: Macrobond and all AIECE institutes, the same weight for each institute.

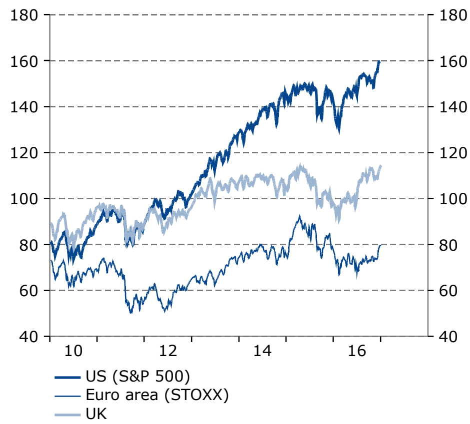
Diagram 2 Crude oil prices



Source: Macrobond and all AIECE institutes, the same weight for each institute.

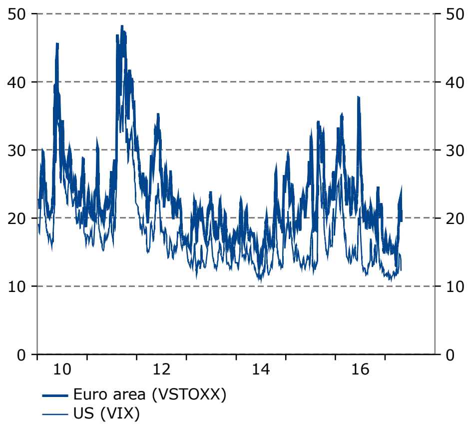
Diagram 3 Stock prices

5-day moving average



Sources: Standard & Poor's, STOXX and Macrobond.

Diagram 4 Stock price volatility
5-day moving average



Sources: STOXX, Chicago Board Options Exchange and Macrobond.

Diagram 5 Government bond yields
5-day moving average

Source: Macrobond.

already increased policy rates three times and is expected to continue to lift rates this year and beyond.

Widespread skepticism regarding the room for monetary policy to maneuver and the effects of any further measures seem to have increased expectations that fiscal policy should be more active in bringing back economies to balance. Probably the most vivid example is the US, where fiscal policy looks set to become more expansionary. Given the size of the US economy, this could induce a demand injection globally. However, US public debt exceeds 100 percent of GDP and is rising. An observation is that public finances in many of the countries that most would need demand-enhancing measures are weak. In addition, according to most observers, the US economy is close to full resource utilization, and so might not be the best example of a country where fiscal policy should be active in increasing demand. A more expansionary fiscal policy will put pressure on the Fed to react to any demand-stimulating measures and prevent the economy from over-heating (see the section on Risks and Challenges for Europe).

FINANCIAL MARKETS HAVE FARED WELL LAST COUPLE OF MONTHS

In general, asset prices have developed quite well the last few months. Stock prices have increased in most countries (see Diagram 3). Furthermore, stock price volatility, often interpreted as a measure of risk appetite in financial markets, are at low levels (see Diagram 4).

One result of the (anticipation of) shift in policy mix is a reduction (ceteris paribus) in demand for government bonds from central banks and an increase in supply of bonds from governments. This would under normal circumstances translate into an increase in interest rates. This is also what has been observed worldwide (see Diagram 5). Higher inflation and an improved outlook for the global economy are other factors behind the increase in interest rates.

2. Euro area outlook

GDP GROWTH CONTINUED TO BE STABLE AT THE END OF LAST YEAR

Successes for EU-sceptic movements, disruptive geopolitical events both at home and abroad and fragile banks are just some of the challenges experienced by euro area countries during the last couple of years. With policy rates of the ECB around zero and public debt levels above the stipulated upper limit, the room for economic policy to maneuver has been restrained. Still, quarterly GDP growth in the euro area has been quite stable and fluctuated between 0.2 and 0.5 percent since the beginning of 2013 (see Diagram 6).[1] During the same period, unemployment has decreased from its peak of slightly above 12 percent to 9.5 percent in February 2017(see Diagram 7).

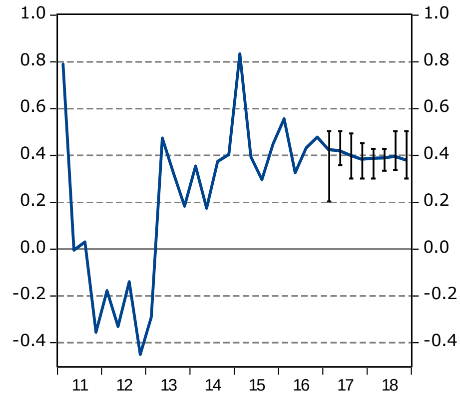
The last quarter of 2016, GDP increased by 0.4 percent compared to the previous quarter in seasonally adjusted terms. After having registered a fall the previous quarter, gross fixed capital formation increased by 0.6 percent. Household consumption growth edged up slightly to 0.4 percent. Trade (including intra-trade) was rather buoyant, with exports rising by 1.5 percent and imports rising by 2.0 percent compared to the previous quarter.

SURVEYS AND MONTHLY DATA POINT TO CONTINUED RECOVERY

The growth rate of retail trade in the euro area as a whole was somewhat reduced in 2016 compared to 2015. The last observation, from February of this year, saw an increase of yearly growth to slightly less than 2 percent, though. Yearly growth in industrial production (excluding construction) has hovered around 2 percent the last two years. This is above the mean growth rate since 1992, even when excluding the weak period 2008-2009. In January of this year, the growth rate dropped to 0.5 percent but this was mostly due to a very strong figure in January of last year.

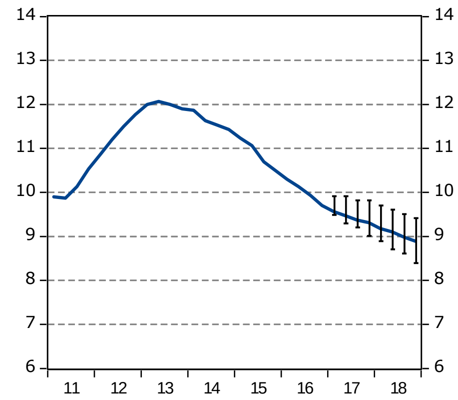
Most tendency surveys have shown continuous improvement since the beginning of 2013 and continued to do so in the beginning of this year (see Diagram 8). All of the main indexes are now clearly above their historical mean values, signaling above normal growth. In sum, the development of monthly data and tendency surveys indicate that the recovery continued at the beginning of 2017 and will continue in the near future. This is a view shared by AIECE institutes who expect quarterly GDP growth to be 0.4 percent per quarter during the first two quarters of this year (see Diagram 6).

Diagram 6 Euro Area GDP
Percentage change, seasonally-adjusted quarterly values



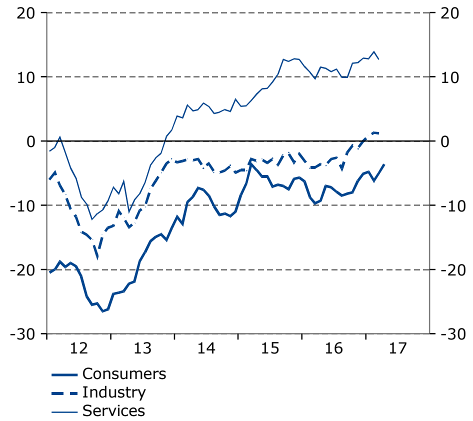
Sources: Macrobond and all AIECE institutes, the same weight for each institute.

Diagram 7 Euro Area Unemployment rate
Percent of labour force, seasonally-adjusted quarterly values



Sources: Macrobond and all AIECE institutes, the same weight for each institute.

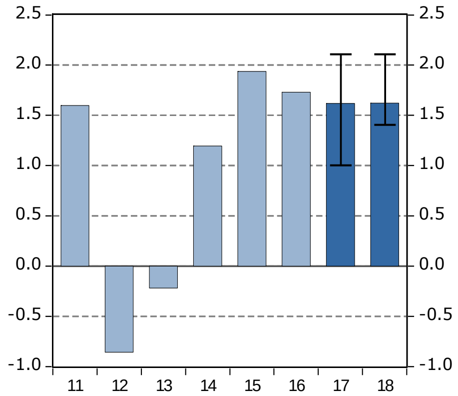
Diagram 8 Euro area tendency indicators



Sources: European Commission and Macrobond.

[1] With the exception of the 0.8 percent growth recorded the first quarter of 2015.

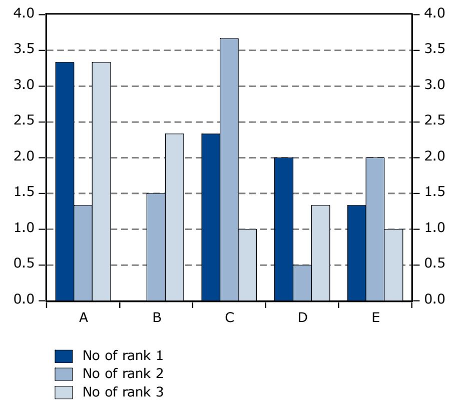
Diagram 9 Euro Area GDP
Percentage change



Sources: Macrobond and all AIECE institutes, the same weight for each institute.

Diagram 10 Positive factors for 2017 growth

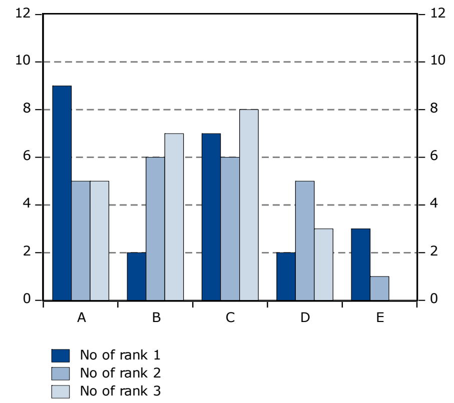
A: An initially low level of fixed investment
B: A competitive exchange rate level
C: Monetary policy
D: Fiscal policy
E: Other



Source: AIECE institutes from euro area, the same weight for each country.

Diagram 11 Positive factors for 2017 growth in the euro area

A: An initially low level of fixed investment
B: A competitive exchange rate level
C: Monetary policy
D: Fiscal policy
E: Other



Source: All AIECE institutes, the same weight for each institute.

RECOVERY OF INVESTMENTS AND MONETARY POLICY WILL DRIVE GROWTH THIS YEAR

Even though growth in the euro area has been stable and unemployment has decreased, the recoveries after the financial crisis and the European debt crisis have been slow and, by most measures, resource utilization is still low. That, in turn, implies that there should be room for above trend growth in the coming years. In line with this reasoning, AIECE institutes' expect GDP to grow by 1.6 percent in 2017 with answers ranging from 1.0 percent to 2.1 percent (see Diagram 9).

Judging by the answers from institutes from euro area countries, important drivers of growth in 2017 will be monetary policy and the low initial level of investments (see Diagram 10). This is in line with the answers regarding the euro area as a whole given by all AIECE institutes (see Diagram 11).

After years of low investment growth following the financial crisis, gross fixed capital investments in relation to GDP is still depressed in the euro area as a whole. However, capacity utilization rates are now above normal, indicating a need to expand the capital stock. Also, there should be pent up demand for replacement investments (i.e. investments done in order to replace worn out capital).

NON-FINANCIAL FIRMS WILL HAVE ACCESS TO FINANCING

For investments plans to be realized, they have to be matched by access to financing (at a reasonable cost). Credit has been constrained in many parts of the euro area during the last couple of years. Banks – which are the main source of financing for non-financial firms' in the euro area – have consolidated balance sheets. This, in turn, has reduced the capacity and/or willingness of banks to lend, especially in the so called crisis countries of southern Europe. At the same time, the development of another source of financing - own profits - has been rather lackluster. The interest rates on non-financial firms' bonds have been low in a historical perspective, but in practice this funding channel is not open to all non-financial firms.

Looking ahead, most AIECE institutes' believe that access to financing in the euro area as a whole will not be a problem. Out of 21 answering institutes, 14 were of this view, while 7 indicated that access to financing will become a problem. Of those institutes that do expect access to financing to be restrained, the answers as to where the source of this shortage lies was spread rather evenly between internal funding, market financing and bank lending, with the latter receiving slightly more answers than the other two. All in all, AIECE institutes expect investments to grow by 2.4 percent in 2017 (see Diagram 12).

When it comes to household consumption, AIECE institutes on average foresee a more modest development with consumption growth in the euro area declining to 1.5 percent in 2017 (see Diagram 13).

EXTERNAL DEMAND WILL FIRM

Export growth has been a major driving force in the recovery of many euro area member countries during the last couple of years. Global growth is expected to be 3.4 percent in 2017. According to AIECE institutes, the euro will be more or less unchanged against the dollar during the coming two years. The mean forecast from AIECE institutes from the euro area regarding export growth in their own country (the resulting aggregate thus including intra-trade) suggests that export growth will be higher in both 2017 and 2018 compared to 2016, but also that growth will be somewhat weak in a historical perspective.

ROUGHLY THE SAME DRIVERS OF GROWTH IN 2018

According to the answers from all AIECE institutes regarding the euro area, the two main drivers of growth next year will be monetary policy, followed by a recovery of the investment level (see Diagram 14 and Diagram 12). Judging from the answers of institutes from the euro area regarding their own economy, investments and monetary policy are still ranked high, but "other factors" become more prominent (see Diagram 15). Among other factors, improving external demand is mentioned the most. Household consumption growth is not expected to increase though (see Diagram 13) All in all, AIECE institutes expect GDP-growth next year for the euro area as a whole to be 1.6 percent, i.e. the same growth rate as in 2017.

LABOUR MARKET CONDITIONS ARE EXPECTED TO CONTINUE TO IMPROVE

Labour market developments in the euro area have steadily improved during the last couple of years. Employment increased by 1.1 percent in the last quarter of 2016 compared to the last quarter of 2015, down from a yearly growth rate of 1.4 percent in both the second and third quarters (see Diagram 16). Unemployment has fallen during the last couple of years and the 9.5 percent level reached in February is the lowest since the beginning of 2009.

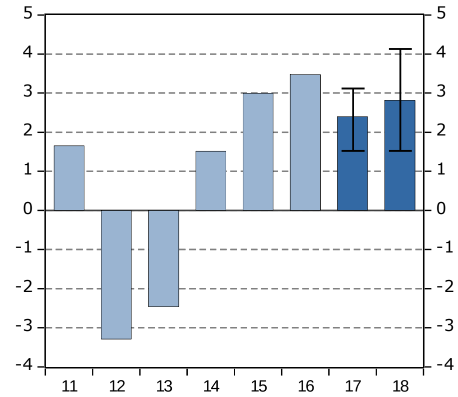
GDP is expected to increase at an above trend pace in the coming two years, which implies that employment will continue to grow robustly. AIECE institutes expect unemployment to fall to 8.9 percent by the end of 2018 (see Diagram 7).

UNEMPLOYMENT LEVELS STILL DIFFER A LOT

Still, 8.9 percent is higher than the level of equilibrium unemployment in the euro area of 7.9 percent as assessed by AIECE institutes. A one-size-fits-all monetary policy has been seen as a risk to labour market developments. Levels of unemployment differ considerably between member countries (see Diagram 17). In Germany, unemployment is just under 4 percent. This is the lowest level since at least January 1991. In France, Italy and

Diagram 12 Euro Area Gross fixed capital formation

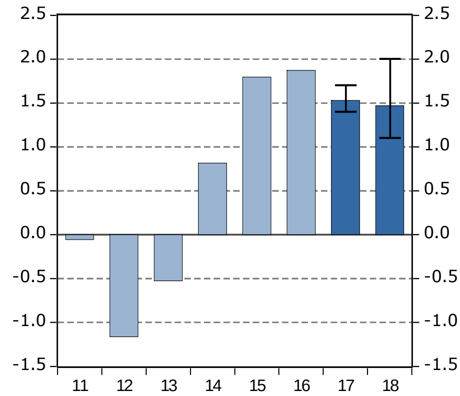
Percentage change



Sources: Macrobond and all AIECE institutes, the same weight for each institute.

Diagram 13 Euro Area Private consumption

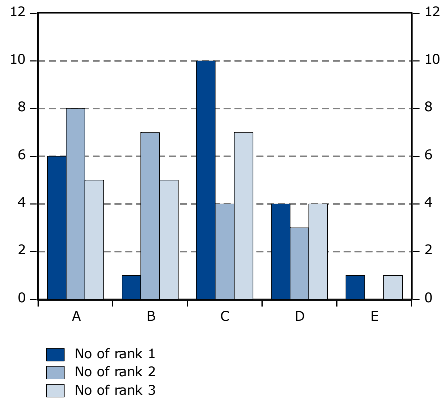
Percentage change



Sources: Macrobond and all AIECE institutes, the same weight for each institute.

Diagram 14 Positive factors for 2018 growth in the euro area

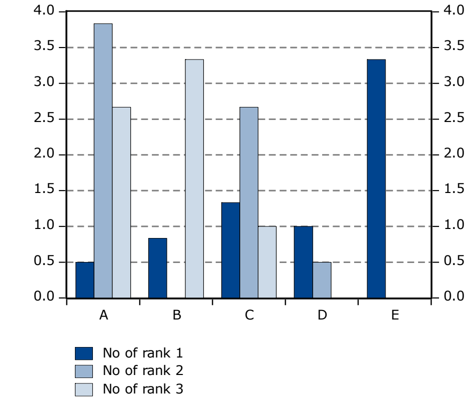
A: An initially low level of fixed investment
B: A competitive exchange rate level
C: Monetary policy
D: Fiscal policy
E: Other



Source: All AIECE institutes, the same weight for each institute.

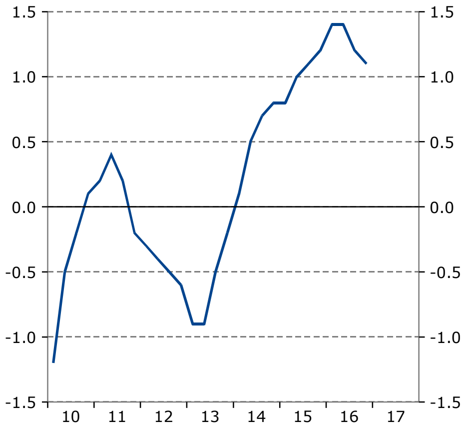
Diagram 15 Positive factors for 2018 growth

A: An initially low level of fixed investment
B: A competitive exchange rate level
C: Monetary policy
D: Fiscal policy
E: Other



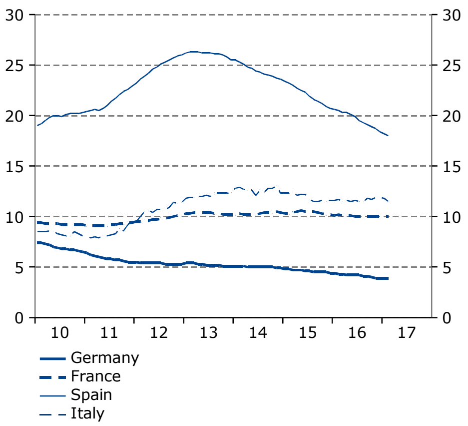
Source: AIECE institutes from euro area, the same weight for each country.

Diagram 16 Euro area yearly growth of employment



Sources: Eurostat and Macrobond.

Diagram 17 Unemployment in euro area member countries



Sources: Eurostat and Macrobond.

especially Spain, there has also been a reduction in the unemployment rate, but the levels are still well above the unemployment level in Germany.

AIECE INSTITUTES DO NOT AGREE ON LABOUR MOBILITY POLICY

The large differences in unemployment levels seem to imply that labour mobility might not be high enough in the euro area. At the same time, from a political point of view, Brexit and successes for EU-sceptic political movements might be an indication of the social and political costs of pan-european labour mobility.

AIECE institutes are highly divided in their views on whether labour mobility in the euro area is high enough. Some institutes believe that mobility is not high enough, while others think it is. There is also the view that mobility, given the lack of fiscal union, is too high. Suggestions on how to increase labour mobility include harmonization of labour laws, removing taxes that distort moving decisions, tackling language barriers, portability of pension rights and social insurance synchronization. On the other hand, one institute answered that migration is not for everyone and that those that want to emigrate can find a job, while the rest should not be forced to move.

When it comes to measures at a national level to reduce unemployment, most AIECE institutes believe that these are insufficient (see Diagram 18). Institutes from France and Spain deem measures to be very insufficient. While not being a member of the euro zone (and EU), the Norwegian institute also believes that the measures in Norway are very insufficient. Only three institutes, one each from Germany, Denmark and the UK believes that no more measures are needed, since unemployment is already low. These are of course countries where unemployment is low compared to the levels in most of the other countries represented by AIECE institutes.

INFLATION HAS RISEN LATELY…

In the wake of the euro area debt crisis, inflation in the euro area fell from 3 percent at the end of 2011 to 0,7 percent two years later and further to −0.6 percent in January 2015. A large part of the deep fall in headline inflation was explained by the development of global oil and food prices. Apart from this, the HICP inflation excluding energy, food, alcohol and tobacco fell substantially from 1.6 percent at the end of 2011 to 0.7 percent two years later.

Headline inflation has increased markedly during the last couple of months, reaching 2 percent in February, followed by a dip to 1.5 percent in March (see Diagram 19). Core inflation, though, fell back to 0.7 percent in March. In sum, inflation has still some way to go before reaching the monetary policy target of the ECB of below but close to 2 percent.

One exception to this pattern is that inflation in Spain has increased rather much lately, from around −1 percent last summer to 3 percent in February and 2.1 percent in March, thus surpassing inflation rates in Germany and France.

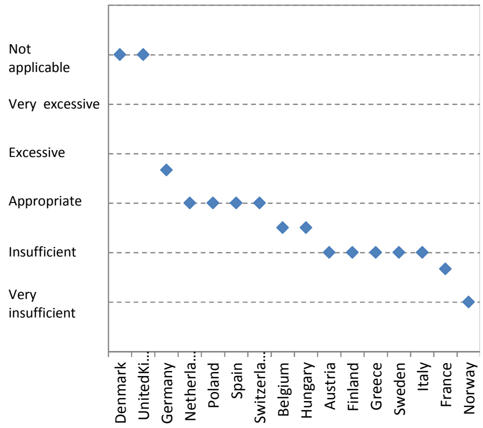
…BUT ECB TARGET WILL BE NOT BE MET

Resource utilization in the euro area looks set to continue increasing gradually. This perception is mirrored in AIECE institutes' forecast of a continued drop in the unemployment rate. In addition to this, there are signs that inflation is on the rise globally. In line with this, AIECE institutes expect inflation in the euro area to increase from 0.2 percent in 2016 to 1.6 percent in 2017. In 2018, HICP inflation is expected to fall back to 1.4 percent (see Diagram 20) The ECB monetary policy target is thus not expected to be met.

Topics for discussion

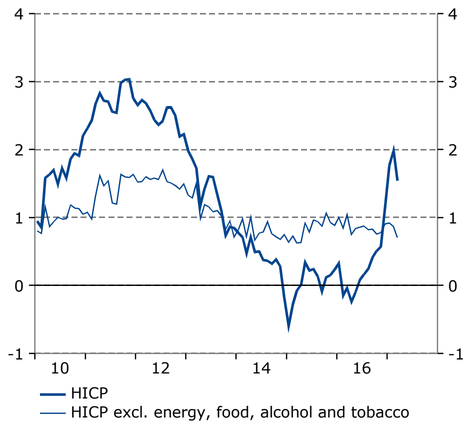
- Should more be done to increase labour mobility in the euro area? Or are political upheavals and social unrest a warning to decision makers against pressing on for more measures?
- Judging by the answers from the AIECE institutes, access to credit will not act as a constraint on the expected increase in investment demand in the euro are as a whole. However, are there member countries where this will be an issue in the coming years?
- Most AIECE institutes expect household consumption growth in the euro area to drop and be rather low from a historical perspective in the coming two years. What are the main reasons for this? Is stronger household consumption an upside risk to the forecast?
- Inflation in euro area member countries have converged the last few years. Is this a development that is expected to continue?

Diagram 18 Current measures to reduce unemployment



Source: All AIECE institutes, weighted average for each country.

Diagram 19 Euro area inflation



Sources: Eurostat and Macrobond.

Diagram 20 Euro Area CPI

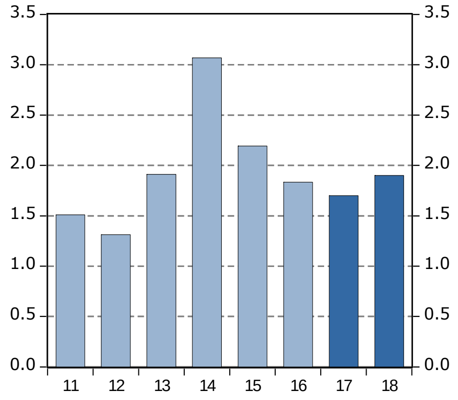
Percentage change, seasonally-adjusted quarterly values

Sources: Macrobond and all AIECE institutes, the same weight for each institute.

3 Non Euro area countries

3.1 EU country developments

Diagram 21 United Kingdom GDP
Percentage change



Source: Macrobond and AIECE institutes

UNITED KINGDOM

Domestic demand is likely to be weak in both 2017 and 2018. Consumption growth is projected to moderate as nominal wage growth will fall below inflation leading to a loss of purchasing power for households. While gross fixed capital investment is expected to contract in 2017, it will resume growth in 2018. This is a result of firms delaying productive investment until the uncertainty emanating from UK's trading relationship with the EU begins to dissipate. The external sector will most likely have a positive contribution to GDP growth: while the increase in competitiveness is expected to support export growth, the positive development will largely be the consequence of a fall in imports resulting from the weak domestic demand conditions. Inflation is already above Bank of England's 2 percent target and is likely to increase further. It is projected to peak at some point between the end of this year and the beginning of the next, followed by a gradual return towards the target level. Despite this, monetary policy is expected to remain loose to support the real economy, as policy makers see through the temporary inflation shock.

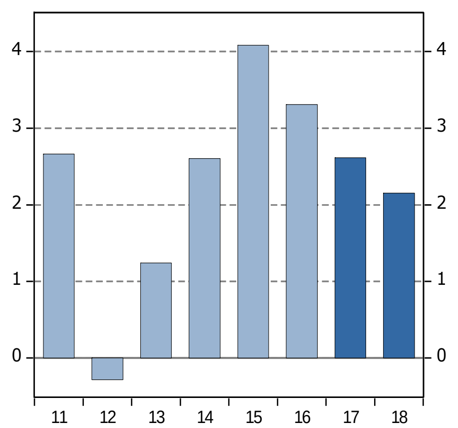
SWEDEN

Swedish GDP grew by 1.0 percent in the fourth quarter of 2016. Subsequent monthly data and confidence indicators suggest that GDP will continue to grow relatively rapidly in the first and second quarters of 2017. An investment-led recovery in the OECD countries supports Swedish exports, which will make a relatively large contribution to GDP growth this year and next. Swedish AIECE institutes expect that an increase in world demand will contribute to the recovery of Swedish industry.

Growth is, however, being held back by domestic demand. Last year, government consumption grew very quickly as a result of a sharp increase in spending on refugee reception. This year and next, growth in government consumption will be much lower. Housing investment continued to rise rapidly last year and accounts for more than 5 percent of GDP. Increasing labour shortages is now, however, holding back housing investments, despite a strong demand. Gross fixed capital formation will therefore be a much weaker growth driver in 2017 and 2018.

GDP growth will gradually slow from 3.3 percent in 2016 to 2.1 percent in 2018 (see Diagram 22), despite interest rates remaining very low and fiscal policy being slightly expansionary. The output gap will widen slightly and peak in 2018. The demand for labour will thus continue to rise. There are, however,

Diagram 22 Sweden GDP
Percentage change



Source: Macrobond and AIECE institutes

considerable shortages of skilled labour, especially in the public sector. This will slow down employment growth a bit and unemployment reaches a trough at 6.5 percent in 2018.

In spite of a rising labour shortage, wage growth has not taken off. One reason is that the relatively low wage growth in the euro area has had a restraining effect on negotiated wages in Sweden. The scarcity of skilled labour means that wage growth will pick up to around 3 percent in 2017 and 2018. This is not enough to push inflation much higher, and inflation is expected to remain below the target of 2 percent for another three years.

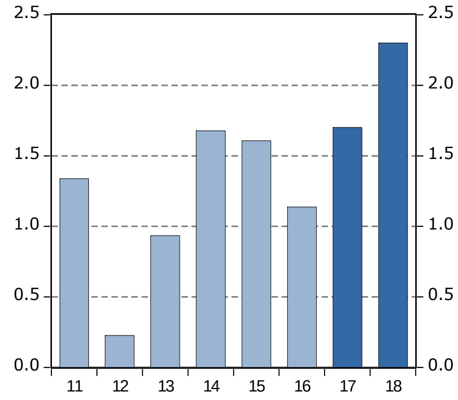
DENMARK

The Danish economy continues to improve. The growth of real GDP is expected to be around 1.7 percent in 2017 and 2.3 percent in 2018 (see Diagram 23). The output gap will be reduced from its current level of −1.1 percent to −0.6 percent in 2018. The modest recovery since the end of the crisis is expected to continue to be driven by domestic demand with a growing contribution from investment. With steadily rising house prices in real terms, further incentives for residential investments are provided in coming years.

Employment will continue to rise steadily and the unemployment rate will continue to fall gradually reaching 3.0 percent in 2018. Denmark is experiencing shortage of skilled labour, particularly in the construction sector.

The growth in consumer prices has recently been dampened by a fall in prices of non-energy industrial goods and of energy. Nevertheless, inflation is expected to gradually pick up over the next two years, as the effect of lower energy prices abate and capacity utilization increases.

Diagram 23 Denmark GDP
Percentage change



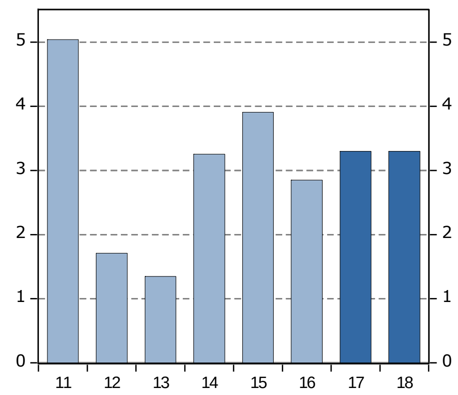
Source: Macrobond and AIECE institutes

POLAND

In 2017 GDP should rise in the range between 3.3−3.6 percent (see Diagram 24). Consumption is still a main growth driver. Inflation is slowly going up. Unemployment is low – according to BAEL (Polish Labour Force Survey) 5.6 percent. Growth in investment demand is forecasted to continue and investment should increase by over 6 percent due also to EU transfers (energy and transport are the main field). External equilibrium will be preserved. The zloty should slightly strengthen. In 2017 consumption should be strong due also to bigger social transfers.

In 2018 the first effects of the postponed wave retirement due to reduced retirement age are possible; that could increase the budgetary burden and eventually lead to a fall in the employment rates.

Diagram 24 Poland GDP
Percentage change

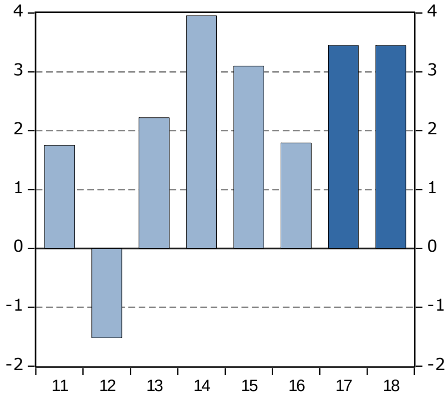


Source: Macrobond and AIECE institutes

HUNGARY

The rate of Hungary's GDP growth slowed down to below 2 percent in 2016 mainly due to the decline of the inflow of EU sources and the resulting fall in investments. With the recovery

Diagram 25 Hungary GDP
Percentage change



Source: Macrobond and AIECE institutes

of EU transfers, GDP growth is expected to be in the range between 3.2 - 3.7 percent in both 2017 and 2018 (see Diagram 25). Growth is projected in all sectors with the exception of agriculture, where a "natural decline" is expected after last year's uptick. In particular, growth in the construction sector has resumed after last year's fall and trade's contribution to overall growth will continue even after last year's rapid expansion. Following the completion of a large scale investment project, a boost from automotive exports is expected in 2018.

Gross fixed capital formation is forecasted to mount by 8 percent in 2017 and 12 percent in 2018 after the 15.5 percent fall in 2016. Consumption is likely to be up by 5 percent in 2017 and 4 percent in 2018 following the 4.2 percent increase in 2016. Although external and internal equilibria will deteriorate slightly, they remain favourable. Inflation will accelerate, from 0.4 percent in 2016 to 2.5 percent in both 2017 and 2018.

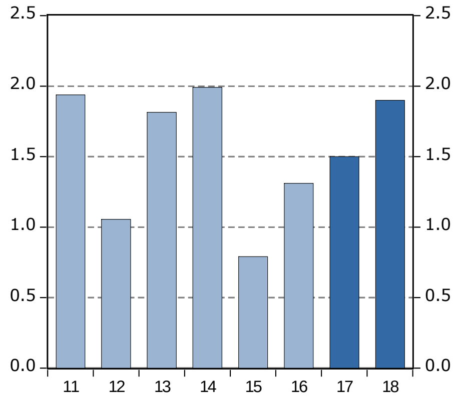
Employment is improving, unemployment is decreasing and companies' intentions to employ are favourable. There is labour shortage in many areas, and households' fear of unemployment is at its lowest level in almost 20 years.

The Hungarian general government deficit will be below 3 percent of GDP in 2017 and 2018 for the sixth consecutive year, with the government debt on a declining path. There are several drawbacks to this path such as the anti-growth tax structure, the degradation of large redistribution systems, the lack of transparency of fiscal policy and the nationalization of private pension fund assets. Improvement of the balance can be attributed mainly to EU transfers and more recently, to the tax credit for growth.

3.2 Other European countries

SWITZERLAND

Diagram 26 Switzerland GDP
Percentage change

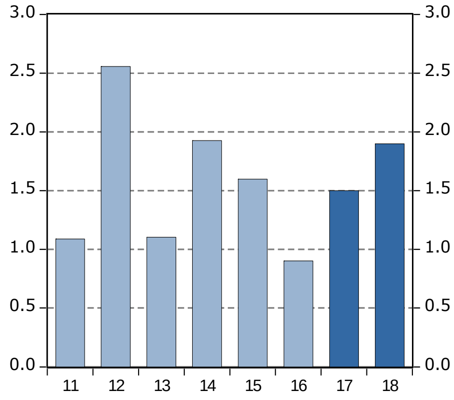


Source: Macrobond and AIECE institutes

Swiss GDP rose by 1.3 percent in 2016, a considerable improvement from 0.8 percent in 2015. Nevertheless the considerable deceleration registered in the second half of 2016, indicates near-term risks. The Swiss AIECE institute expects GDP to maintain a relatively higher growth pace over the next two years, expanding by 1.5 percent in 2017 and 1.9 percent in 2018 (see Diagram 26). The recovery in the euro area is expected to lift export demand going forward. The appreciation of the Swiss franc since 2015 continues being a burden for exports and some other sectors of the Swiss economy. Private consumption by contrast will keep a steady growth pace of around 1 percent per year.

The Swiss National Bank kept interest rates negative in 2016 and the Swiss AIECE institute forecasts that the central bank policy rate will be kept at −0.7 for the coming two years. Inflation has been in negative territory since 2013. Consumer prices are projected to rise by 0.3 percent both in 2017 and in 2018.

Diagram 27 Norway GDP
Percentage change



Source: Macrobond and AIECE institutes

NORWAY

As a consequence of the fall in demand from the petroleum industry, the Norwegian economy has been in a clear cyclical downturn since the autumn of 2014. However, there are signs that the decline is coming to an end, and the projections of the Norwegian AIECE institute indicate a cautious economic upturn through 2017.

Several factors are expected to prompt growth to gather pace in 2017. Firstly, the decline in petroleum investment is now expected to taper off due to a higher expected oil price and reduced costs. Furthermore, the upswing in mainland business investments is also expected to continue, although growth will probably not be very strong. Growth in the Norwegian export market is assumed to improve somewhat. This, coupled with the time-lagged effects of improved competitiveness, will contribute to reversing the decline in exports in 2017.

Inflation is likely to be substantially lower in 2017 than in 2016. Wages, on the other hand, will increase slightly more, and as employment is also likely to rise, household real disposable income will increase more than in 2016, even if interest rates are not assumed to fall further. Growth in household consumption should therefore revive. While house prices and housing investment are expected to rise almost as strongly in 2017 as in 2016, they are both expected to fall a little at the end of the projection period.

Fiscal policy will continue to be expansionary in 2017, but considerably less so than last year. From 2018 onwards, we do not expect any expansionary impulses from fiscal policy, providing the economy is not subjected to new strong negative shocks. Projections show that unemployment will remain fairly stable through the year, with somewhat higher growth in employment, but also in the labour supply.

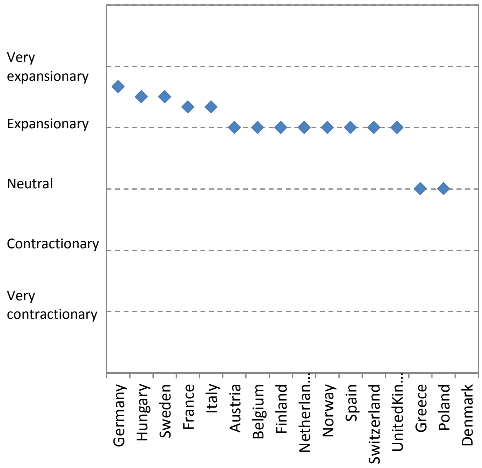
Topics for discussion

- The steep fall in Sterling following the Brexit vote will be a hit to households' real income. Against the background of households' savings ratio that is already low in a historical perspective, do you foresee that households will significantly decrease savings to counter the mentioned negative income effects?
- How is the economy of your country affected by the accelerated recovery in the Euro area?
- Given the current situation in your country, how do you assess the risk of bubbles brewing in some sectors of your economy? What measures should be taken to counter the negative effects of a possible bubble burst?
- How does the development of the economy in your country depend on Brexit negotiations? Will some sectors of your economy be severely affected by the outcome of the negotiations?

4 Monetary policy

Weak inflation made the ECB cut the key interest rates in March 2016. At the same time the ECB increased the pace of net asset purchases from €60 billion to €80 billion a month. Since then the key interest rates have remained at historically low levels and broad money has continued to increase. Despite the accommodative monetary policy in place, inflation has remained weak during most of 2016. But towards the end of 2016 headline inflation picked up, mainly due to increases in unprocessed food prices and energy prices compared to the previous year. Core inflation remains, however, weak to date. Already in December 2016 the ECB decided to decrease the net asset purchases back to €60 billion a month starting in April 2017 through to the end of the year. In March, the ECB revised upwards its projection of headline inflation for 2017 to 1.7 percent.

Diagram 28 Expected monetary policy stance for each country 2017



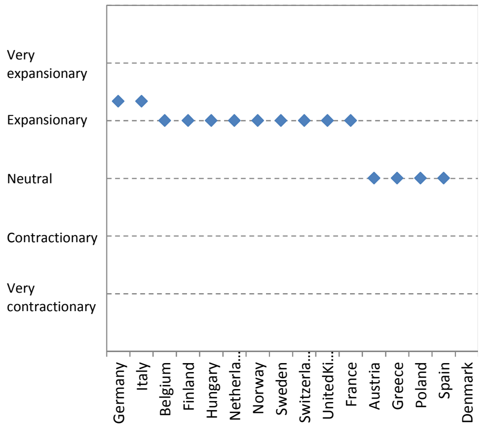
Source: All AIECE institutes, weighted average for each country..

POLICY EXPECTATIONS AND PREFERRED MONETARY POLICY STANCES

A majority of AIECE institutes from the euro area expect the monetary policy to be either expansionary or very expansionary in their country during 2017 and 2018 (see Diagram 28 and Diagram 29). Furthermore, the majority of those institutes find that an expansionary or a very expansionary monetary policy is the most appropriate one for 2017 (see Diagram 30 and Diagram 31). The number of institutes that prefer a neutral monetary policy 2018 is, however, almost equal to the number of institutes that prefer an expansionary or very expansionary policy. The answers from non-euro area respondents to these four questions follow a similar pattern.

Some of the survey answers display well known differences among euro area economies. Five of the AIECE institutes from the euro area, of which three from Germany, one from France and one from the Netherlands, expect that ECB's monetary policy stance will be more accommodative 2017 and 2018 than considered suitable. The institute from Greece expects a tighter monetary policy than appropriate for the Greek economy in the coming two years.

Diagram 29 Expected monetary policy stance for each country 2018



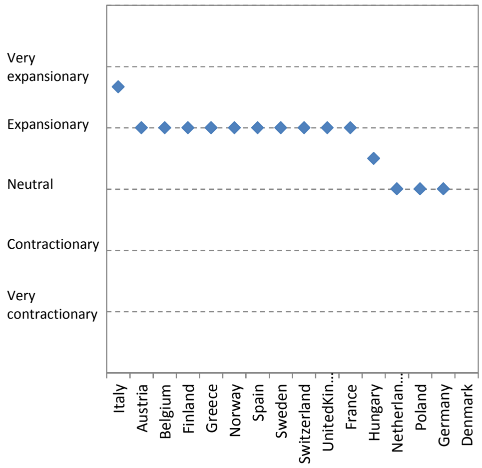
Source: All AIECE institutes, weighted average for each country.

MAIN RISKS ASSOCIATED WITH ECB'S NET ASSET PURCHASES

The ECB's primary objective is to maintain price stability in the euro area. However, when interbank interest rates are below zero and non-standard measures are used to further loosen monetary policy, it might come at the cost of other imbalances. These imbalances could, by themselves, constitute a risk for the economy.

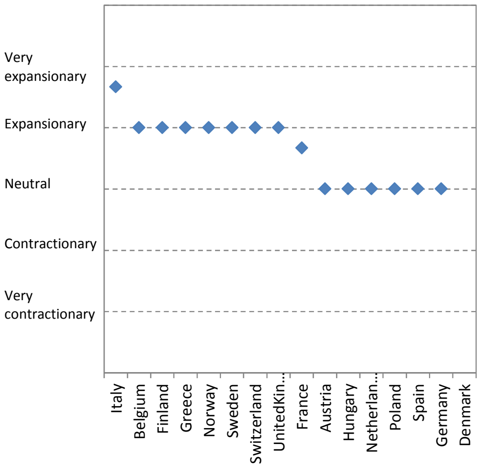
The AIECE institutes see asset-price bubbles, misallocation of resources and a reduced willingness for structural reforms as the three major risks associated with the asset purchase program

Diagram 30 Suitable monetary policy stance for each country 2017



Source: All AIECE institutes, weighted average for each country.

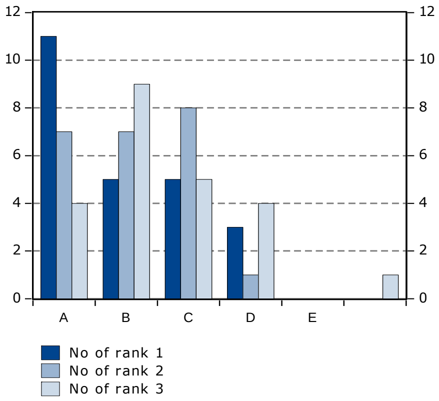
Diagram 31 Suitable monetary policy for each country 2018



Source: All AIECE institutes, weighted average for each country.

Diagram 32 Please choose the three main risks associated with ECB's net asset purchases and rank them from 1 to 3, where 1 is the most risky

A: Asset price bubbles
B: Misallocation of resources/capital
C: Reduced willingness for structural reforms
D: Worldwide exchange rate competition
E: Excessive inflation in the middle to long term
F: Other



Source: All AIECE institutes, same weight for each institute.

(see Diagram 32). Eleven institutes consider asset-price bubbles as the greatest risk, while five institutes believe that the greatest risk of the asset-purchase program is lower willingness to accomplish structural reforms. Another five of the institutes see misallocation of resources as the greatest risk. One respondent mentions a reduced willingness for expansionary fiscal policy as one of the main risks. Another institute argues that, at the moment, the net asset purchases do not carry any important risks to financial stability.

SEQUENCING OF TIGHTENING ACTIONS AND FINANCIAL STABILITY

Risks associated with expansionary monetary policy are often discussed, both among practitioners and researchers. However, there is also an ongoing debate about the sequencing of actions that the ECB should take when normalizing the monetary policy. This debate intensified around the time of ECB's monetary policy meeting in March 2017. It seems as if some banks in the euro area are strong advocates of normalizing interest rates out of the negative zone before the ECB ends the QE programs. The negative deposit rate for banks is difficult to pass on to saving customers and is a particular problem for banks with excessive reserves. Banks in euro area countries also report decreasing margins on lending.[2] Therefore, some argue that ending the expansion of ECB's balance sheet before normalizing interest rates could be a source of financial instability in the euro area.

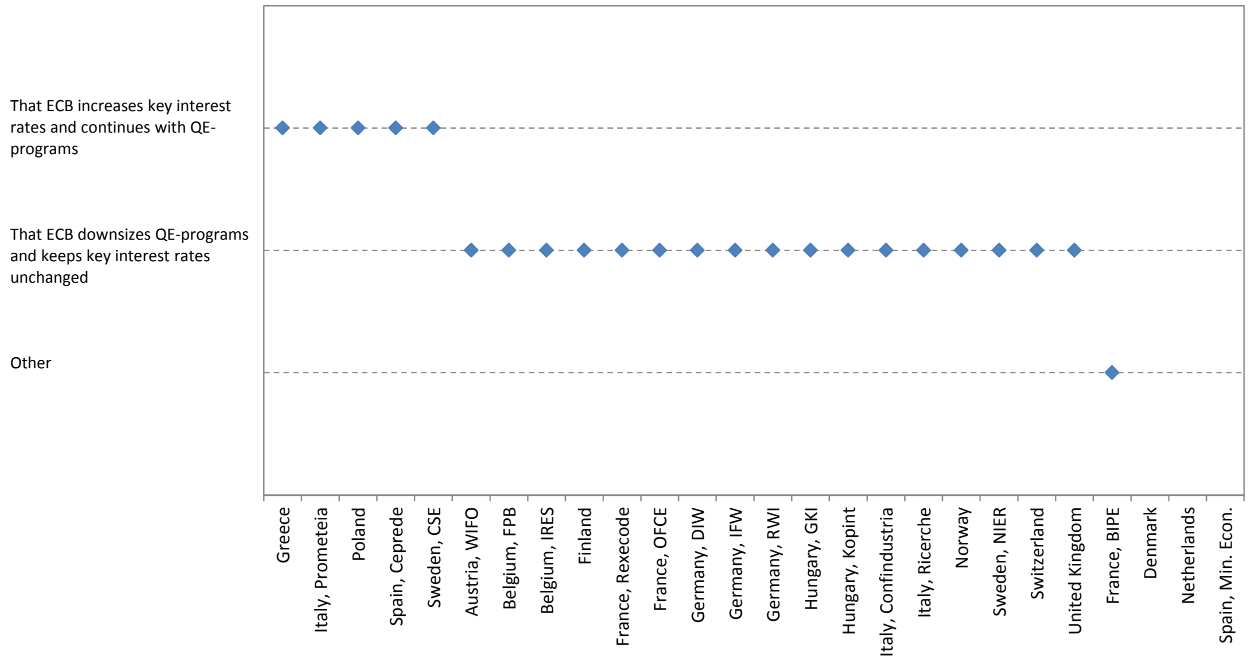
Seventeen of the AIECE institutes believe, however, that downsizing the QE program before increasing the key interest rates is the least risky sequencing of actions if the ECB intends to tighten monetary policy (see Diagram 33). One respondent specifies that the least risky alternative is to stop the QE program, maintain base money and keep the main refinancing interest rate at zero. Five respondents see an increase in interest rates before downsizing the QE program as the least risky alternative.

Similar to the previous question, a majority of the institutes expect the ECB to downsize the QE program and keep the key interest rates unchanged in case of a tighter policy stance (see Diagram 34). However, compared to the number of institutes that find this sequencing least risky, four more institutes expect the ECB to use it. Three respondents expect the ECB to begin the tightening process by increasing interest rates.

---

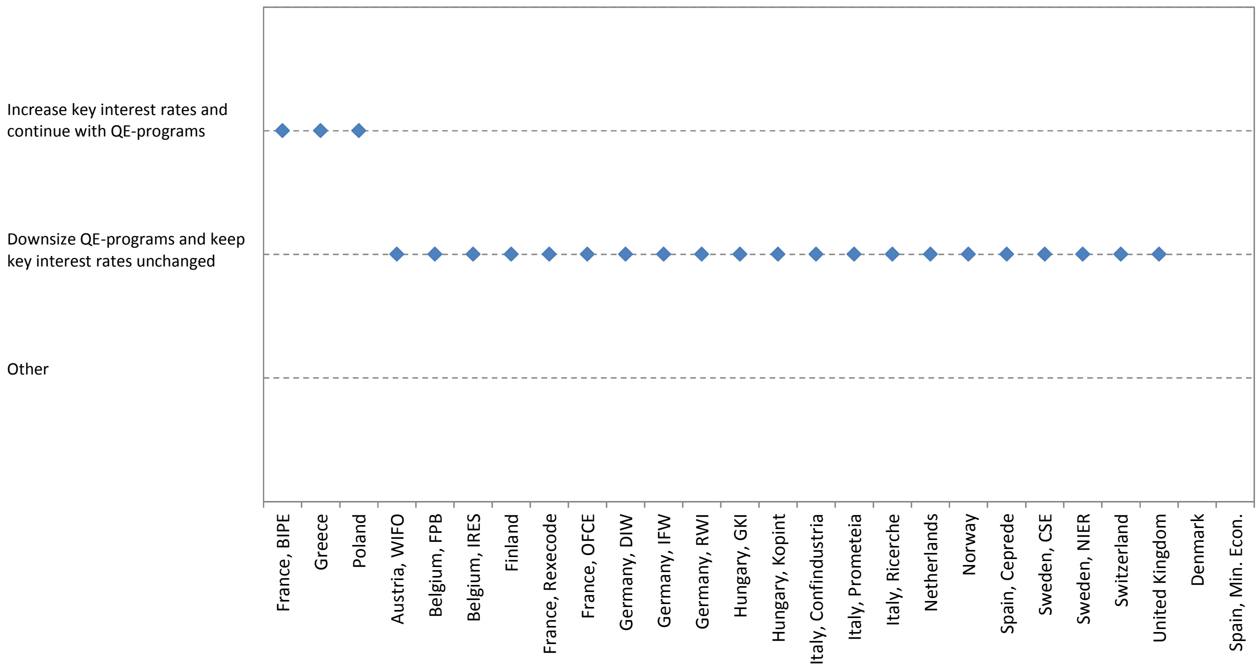
[2] See "The euro area bank lending survey", January 2017, ECB.

Diagram 33 Assume that ECB begins to tighten monetary policy. With respect to financial stability in the euro area, which alternative do you think is least risky?



Source: AIECE Institutes.

Diagram 34 Assume that ECB begins to tighten monetary policy. What do you think that ECB will do?

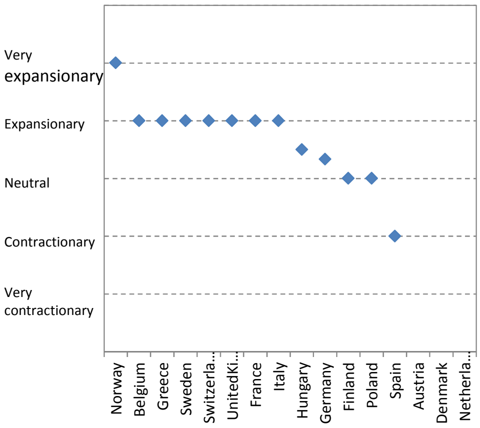


Source: AIECE Institutes.

Topics for discussion

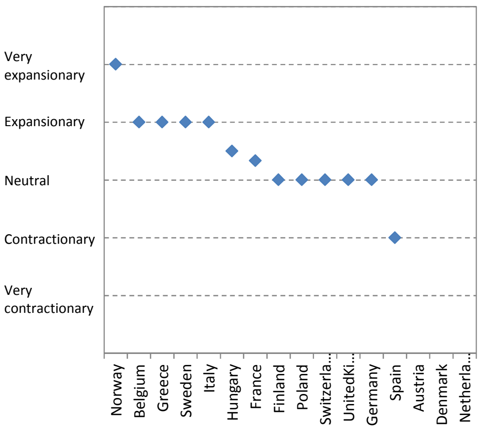
- How could the sequencing of tightening actions be expected to harm financial stability?

Diagram 35 Suitable aggregate fiscal policy stance in the euro area 2017



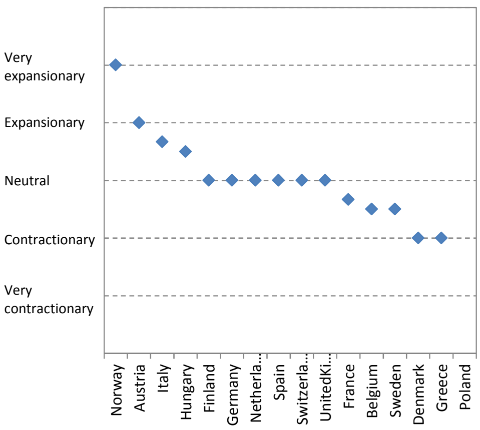
Source: All AIECE institutes, weighted average for each country.

Diagram 36 Suitable aggregate fiscal policy stance in the euro area during 2018



Source: All AIECE institutes, weighted average for each country.

Diagram 37 Suitable fiscal policy stance 2017



Source: All AIECE institutes, weighted average for each country.

5 Fiscal policy and public finances

HIGH LEVELS OF PUBLIC DEBT, BUT DEBATE MOVING TOWARDS MORE EXPANSIONARY FISCAL POLICY

With the ongoing debate on the efficiency and negative spillover effects from unconventional monetary policy intensifying, attention to fiscal policy as a stabilization tool has increased. Not least in the euro area, striking the right balance between stabilization on the one hand and sustainability of public finances on the other hand is a complex and difficult question. In general, those countries that need to consolidate are the same countries that from a cyclical perspective should pursue an expansionary fiscal policy.[3]

After having bottomed out at 65 percent as a share of GDP in 2007, gross public debt in the euro area rapidly increased to 94 percent in 2014. Since then, improved growth and low interest rates have contributed to a reduction in public debt as a share of GDP. Consolidation measures, to a large extent implemented already in 2011-2013, have also contributed to this development. Expected by the Commission to decline slightly to 92 percent in 2016, public debt is still a large problem in the euro area, however.

There has been an improvement in the aggregate budget balance for the euro area in the last couple of years. According to calculations by the Commission, some of this improvement has been the result of cyclical factors. After improvements in 2011-2013, the so called structural balance – the change of which is normally interpreted as a measure of the fiscal stance - for the euro area as a whole has not improved much to date.

MOST AIECE INSTITUTES BOTH PREFER AND EXPECT FISCAL POLICY TO BE EITHER NEUTRAL OR EXPANSIONARY

With most member countries still experiencing a slump and unemployment being higher than the equilibrium or structural rate, on the face of it there are both arguments for consolidation (in order to reduce debt) and for an expansionary fiscal policy in the euro area as a whole. Judging by the answers from all AIECE institutes, the fiscal stance in the euro area as a whole ought to be expansionary this year then moving towards neutral next year (see Diagram 35 and Diagram 36).

While it is clearly important to consider "aggregation issues" such as spillovers from higher demand, contagion in the form of higher interest rates and non-linearities, fiscal policy obviously needs to differ between member states. In its report on public finances, the Commission identifies 12 countries in the euro area

[3] This is of course in addition to the normal challenges when designing fiscal policy in a monetary union.

where stabilization needs are high, i.e. where fiscal policy *ceteris paribus* should be expansionary. The only major country not belonging to this group is Germany. Unfortunately, generally the same countries that from a stabilization point of view should pursue an expansionary fiscal policy are also found to be the countries that, from a sustainability point of view (in the medium term), need to consolidate.[4]

Looking at the answers from AIECE institutes from euro area countries regarding the proper fiscal stance in their own countries, a slightly different picture emerges compared to what is seen in diagrams Diagram 35 and Diagram 36. Quite a number of institutes believe that a neutral fiscal stance is warranted in their respective countries this year and next year (see Diagram 37 and Diagram 38). Institutes from France, Belgium and Greece would like to see a contractionary policy in their home countries this year and in some cases next year as well. On the other hand, institutes from Austria and Italy prefer an expansionary policy in their home countries.

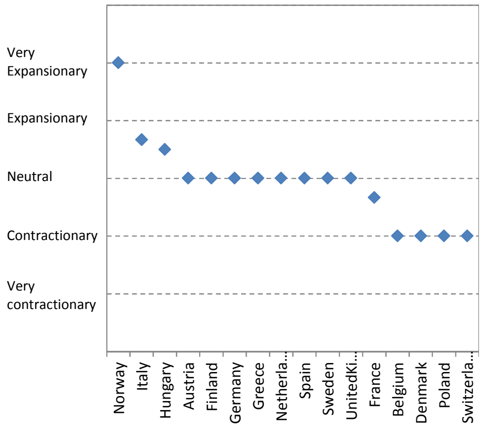
Turning to what kind of fiscal stance AIECE institutes expect for the euro area as a whole in the coming two years, almost all expect it to be either neutral or expansionary (see Diagram 39 and Q434 Diagram 40). The pattern is slightly different compared to the answers regarding what fiscal stance is deemed proper. In the latter case, the answers indicate an expansionary policy this year and then moving towards neutral, while on average there seems to be expectations of a neutral stance this year, moving towards expansionary next year. It should be said, however, that the differences are not large and the mentioned patterns not so clear-cut.

Topics for discussion

- Interest rates on government borrowing are exceptionally low and will increase in the future. Is there a risk that this is not fully considered when assessing the sustainability of public finances in some euro area countries?
- Even if one comes to the conclusion that from a national point of view, it is not appropriate for the fiscal stance in Germany to be expansionary, would this conclusion change if the stabilization of the business cycle in the euro area as a whole is consid-ered? *Should* the latter be considered?

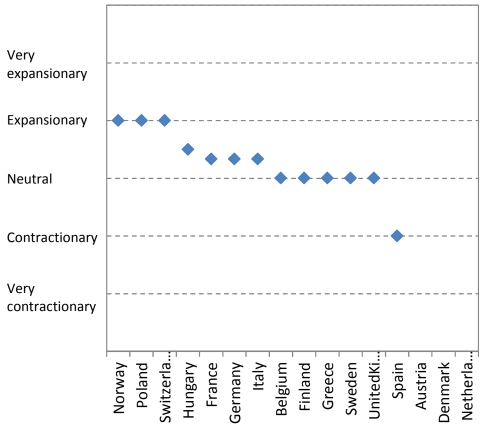
[4] To analyze stabilization needs in the medium term, the Comission uses the S1 indicator, i.e. the cumulated change in the structural primary balance needed from 2017 to 2021 in order to bring general government debt to 60 percent of GDP by 2031, and the so called debt sustainability analysis (DSA) which is a qualitative assessment based on debt projections under different scenarios.

Diagram 38 Suitable fiscal policy stance 2018



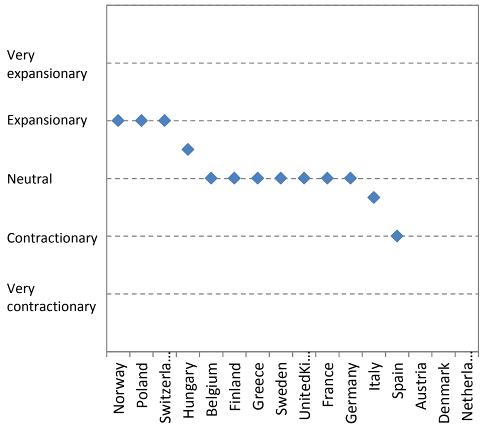
Source: All AIECE institutes, weighted average for each country.

Diagram 39 Expected aggregate fiscal policy stance in the euro area during 2017



Source: All AIECE institutes, weighted average for each country.

Q434 Diagram 40 Expected aggregate fiscal policy stance in the euro area during 2018



Source: All AIECE institutes, weighted average for each country.

6 Risks and challenges for Europe

RE-BALANCING IN CHINA MAY BE ABRUPT

China has been a major growth engine for the global economy during the last couple of decades, especially after the financial crisis 2009. During the period 2010-2016, Chinese growth has constituted a third of world growth (PPP adjusted figures). Since 1990, a quarter of global growth has originated in China. The fast growth of demand has increased imports and China is today one of the world's largest export destinations. Despite a large decline compared to 2014, the country's share in world merchandise imports[5] in 2015 was 10 percent, the same as its share in commercial services. Thus, significant changes in Chinese demand growth would inevitably reverberate across the globe and have an impact on the development of other countries' exports.

The high growth rate of the Chinese economy during the last couple of decades has to a large extent been driven by capital accumulation. Between 1990 and 2015, gross fixed capital formation as a share of GDP increased from 25 percent to 44 percent, one of the absolutely highest levels in the world. While it is natural for low and middle income countries to invest more than high income countries, most observers claim that the capital stock in China is being built up at too fast a pace. Signs of this include low levels of capacity utilization, especially in state owned industrial companies, difficulties for firms to increase prices and lackluster profit developments. Presently, swats of office and residential space are left idle, especially in third tier cities. Many analysts worry about the state of the financial sector, with soaring credit growth and an increase in non-performing loans.

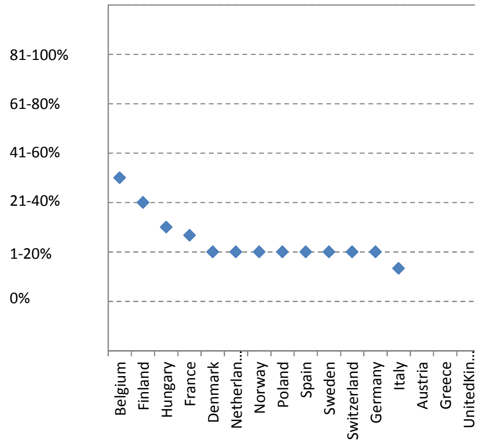
Although there are some signs that the re-balancing of the Chinese economy may have begun, e.g. a small drop in the investment share and rising producer prices, most observers seem to think that the process still has a long way to go before balance is reached. During the last couple of years as the Chinese government seems to have given priority to short term growth over re-balancing, credit supply – which to a large extent is controlled by the authorities – has increased fast, as has infra structure investments.

The seemingly unavoidable re-balancing of the Chinese economy can either happen gradually or abruptly. In the latter case, GDP and import growth would slow down markedly. Given the size of the Chinese economy, this would have a significant impact on other countries, especially since such a scenario would most likely involve disruptions in global financial markets and affect confidence around the globe. AIECE institutes rank the risk to the European economy of a hard landing in China

[5] Including intra-EU trade.

more or less in the middle of the ten possible alternatives regarding risks to growth in Europe given in Diagram 45. Moreover, most institutes assess that the there is a 1−20 percent risk of a Chinese hard landing, but some institutes believe that the risk is higher than that (see Diagram 41).

Diagram 41 Risk of a hard landing in China (GDP growth reduction of at least 3 percentage points)



Source: All AIECE institutes, weighted average for each country.

THE TRUMP PRESIDENCY INCREASES UNCERTAINTY

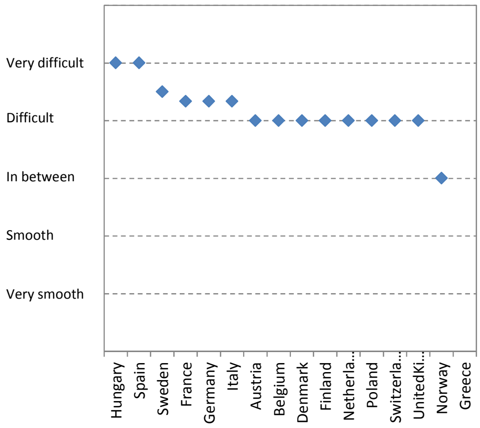
Judging by policy initiatives and statements so far, President Trump's economic policy might turn out to be unconventional. Even though gambits have not always been easy to interpret, most observers seem to agree that the most important elements of the new president's economic policy are i) infra structure projects, ii) tax reductions (mainly aimed at high income households and companies), iii) de-regulation, and iv) restrictive trade- and immigration policies. The uncertainty regarding which proposals the new administration will wish to implement and also succeed in implementing is still high, though. So far - and especially in the run up to the election and the initial period after the election - financial markets seem to have focused on the positive growth effects of what has been labeled *trumponomics*. Many observers have interpreted that as a sign that markets have chosen to emphasize the tax reduction, de-regulation and infra structure investments parts of mr Trump's policy and played down (or failed to correctly assess) the implications of other parts. At the same time, most short to medium term macroeconomic forecasts seem to be based on the assumption that only a part of what mr Trump has stated on economic policy will become reality, especially disregarding policies aimed at restricting the movement of goods, services and labour. That, in turn, have meant that the assessed effects of *trumponomics* on the European economy in most cases are deemed to be small. However, given the size of the US economy and the unpredictability of US economic policy, it would seem that uncertainties and risks are high.

After a rather short period in office, the new administration has surprised many observers by advancing proposals related to the more restrictive elements of *trumponomics*. It can be argued that this "surprise element" can be seen in the movements in financial markets during the last couple of weeks.

If *trumponomics* is implemented in full (or to a larger extent than generally expected) US and global growth should be higher in the short run as infrastructure investments and tax reductions boost demand. However, the risk is that the positive net effect will be short lived. Many indicators suggest that the US economy operates at near full capacity. A more expansionary fiscal policy risk stoking inflation. In such a scenario, the Federal Reserve would raise interest rates at a higher pace than otherwise, cooling off the economy and putting upward pressure on the US dollar and interest rates globally.

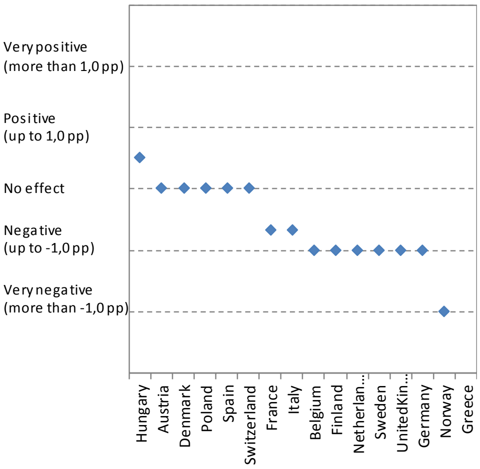
Also, the prospects of weaker public finances could create concern and, through confidence effects and asset price changes,

Diagram 42 Brexit negotiations 2017 and 2018



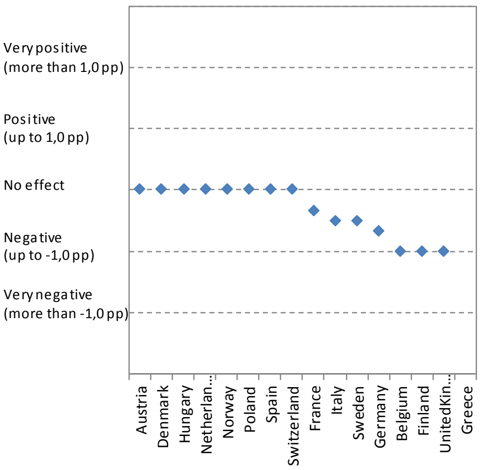
Source: All AIECE institutes, weighted average for each country.

Diagram 43 GDP growth effects of Brexit referendum in UK 2017



Source: All AIECE institutes, weighted average for each country.

Diagram 44 GDP growth effects of Brexit in your economy 2017



Source: All AIECE institutes, weighted average for each country.

give rise to negative macroeconomic effects already in the short run. In addition, it can be assumed that a greater level of public debt implies that fiscal policy will be more restrictive further ahead than otherwise would have been the case. In short, it seems that there is a real risk that the full implementation of the new president's policy will create a boom-bust cycle.

A more structural and long lasting effect on world growth could result from a change in US trade policy along the lines promised by mr Trump during the election campaign. As previously mentioned, at least initially most observers assumed that a rather small part of that trade agenda will be driven through during the next couple of years. Lately, however, quite a number of initiatives on trade policy have been launched and some even surpass what has been indicated earlier. The consequence of some of these initiatives would likely be US non-compliance with WTO rules. The introduction of tariffs and other trade barriers would reduce trade and international specialization and disrupting global value chains. Retaliation from other nations and trade wars would of course serve to exacerbate these effects.

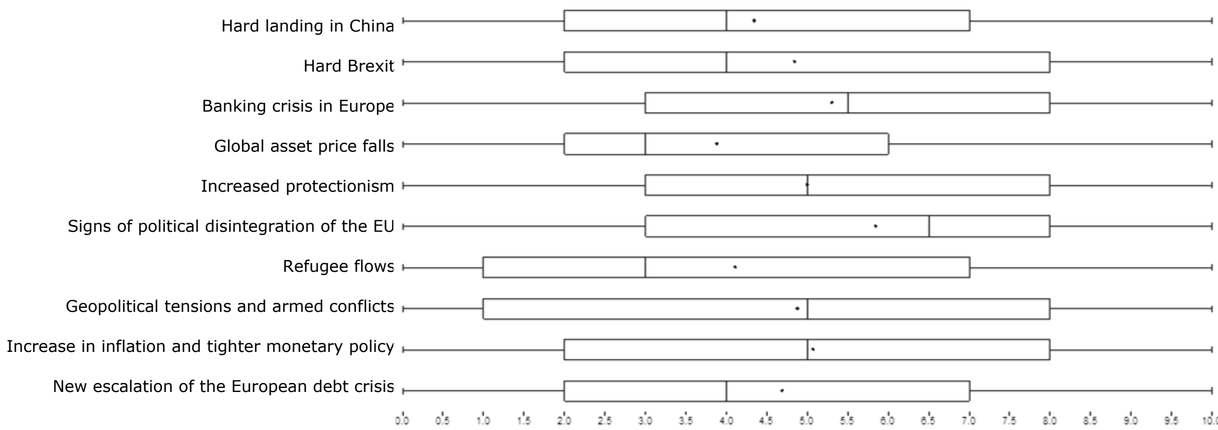
ARE WE HEADING FOR A HARD BREXIT?

At the end of March this year the UK activated Article 50, setting in motion the UK:s departure from the EU. So far, most (but not all) economic data have defied forecasts of disruptive effects stemming from the referendum result. It is still early days, though, and on the political front positions taken by various factions have been rather combative and some kind of Hard Brexit seems to be the most likely scenario.

Even though the UK will be an EU member for at least another two years and the full effect of Brexit lies far ahead, effects on confidence, asset prices, and real household income originating from exchange rate movements can affect growth already in the run-up to the final withdrawal from EU. These short run effects, in turn, can be assumed to be highly dependent on how the negotiations between the EU and UK are perceived to develop.

Almost all AIECE institutes believe that the negotiations between the UK and the EU will be either difficult or very difficult (see Diagram 42). A slight majority of AIECE institutes expect Brexit to lower growth in the UK by up to 1 percentage points in 2017 compared to what it would have been had the referendum resulted in the UK staying in the EU (see Diagram 43). However, many expect no effect, and in a few cases, even a positive effect. When it comes to the effect on GDP in their own countries, a slight majority does not expect any impact, while a substantial minority expect effects of up to 1 percentage point (see Diagram 44).

Diagram 45 Downside risks for growth in Europe



Source: All AIECE institutes, weighted average for each country. The dots represent the mean, the vertical lines the median and the box represents the first and third quartiles (middle 50 percent of the data).

Topics for discussion

- Even though it should be noted that the answers were rather evenly spread, "Signs of political disintigration in the EU" is ranked at the top among the alternatives given in Diagram 45. What are the main risks that you see in this regard?
- To assess the health of Chinese financial institutions is very hard for outsiders to do. Do you think that some major risks, including for the global economy, are hidden in the Chinese financial sector?
- Would it be fair to say that the risks regarding US growth are positive in the short run, but negative further ahead? If so, when will the second, negative, phase begin?
- Do you think that the collapse of the post-war order regarding regulating international trade and trade policy is a genuine risk?
- Do you foresee a risk of major disruptions in supply chains used by European companies as a result of US trade policy and/or Brexit?
- How do you think that the snap election in the UK will affect Brexit negotiations?

7 The state of European banks and banking regulation after the global financial crisis

Banking regulation came under renewed scrutiny in the aftermath of the global financial crisis as banks around the world proved to be insufficiently capitalized to weather the financial storm. This triggered a wave of state interventions funded with taxpayers' money.[6] The legacies from a sluggish economic recovery and additional hits from the sovereign debt crisis that started in 2010 have left many European banks in a poor state. Financial regulation brought forward by international standard-setting bodies after the global financial crisis is aimed at strengthening the resilience of the banking sector and at providing a resolution agenda for failing financial institutions. A drawback of this extensive regulation is that it can put additional constraints on several European banks in the short to medium term, many of which are already confronted with low profit margins by historical standards. The effects of these regulations on the banking sector in the short term are highly debated between market participants and regulators. To the extent that the supply of credit will be affected by these measures, GDP growth in many European countries could also be adversely affected in coming years.

CAPITAL REGULATIONS AND THE RESOLUTION PROCESS OF EUROPEAN BANKS

The purpose of the banking regulations that are being developed since the end of the global financial crisis is twofold: 1) to reduce the likelihood of bank failure in case of severe distress and 2) if a bank does fail, then a comprehensive resolution regime provides effective arrangements for authorities to deal with the failing bank while minimizing the likelihood and amount of a state intervention funded with taxpayers' money. There are two regulation packages implemented to achieve these goals at EU-level.

Capital Requirement Regulation and Directive IV

The Capital Requirement Regulation and the Capital Requirement Directive IV (CRR/CRDIV) implement a series of banking reforms, known as Basel III, developed by the Basel Committee on Banking Supervision (BCBS). These reforms regulate the quality and quantity of capital of a bank, its liquidity position and its leverage ratio. These measures are aimed at increasing

[6] In the period 2008−2015, the total cost of directly supporting the financial system in Europe (capital injections and asset relief excluding guarantees on liabilities) amounted to 4,5 percent of 2015 EU GDP.

banks' resilience by addressing specific shortcomings that surfaced during the latest financial crisis.

Bank capital regulation under Basel III includes several capital requirements relative to the total capital and to the capital buffers a bank must hold.

The *total capital* of a bank consists of Common Equity Tier1 (CET 1), the best type of capital and also the one that absorbs losses first, as well as additional Tier 1 and Tier 2 capital. The new regulation requires CET1 to be raised from 2 to 4.5 percent of the risk weighted assets (RWA) while the total Tier 1 capital has to be at least 6 percent of RWA. The requirement on the total capital being at least 8 percent of RWA implies that the 2 percent difference can be filled with Tier 2 capital. The capital requirements started to be implemented in 2013 with a phase-in period of 6 years. The latest monitoring report from the European Banking Authority (EBA) over a sample of 229 European institutions shows that European banks hold capital above the levels that would result if CRR/CRDIV requirements were already fully implemented.[7]

In addition to these minimum requirements on the capital level, the new banking regulation introduces several *capital buffers* that banks need to hold at all times.

The *capital conservation buffer*, whose objective is to conserve the bank's capital, amounts to 2.5 percent of RWA. This buffer is to be implemented with equal yearly increments over a phase-in period of 4 years starting 2016 in all EU countries.

The purpose of the *countercyclical capital buffer* is to counter the procyclicality of the financial system by accumulating capital when the cyclical risks are increasing and releasing it when the cycle turns and credit losses grow, countering in this way the risk that the supply of credit is constrained by regulatory capital requirements. It is up to each national supervisor to set the level of this capital buffer between 0 and 2.5 percent of RWA for the financial institutions under its supervision. Among European countries, only Sweden, Norway and the Czech Republic have set a countercyclical capital buffer above 0 percent that the banks in their jurisdictions need to hold.[8]

Systemically important institutions are subject to additional buffers due to the negative externalities they may bring into the system and to their potential contribution to market distortions. The mandatory surcharge for Global Systemically Important Institution (*G-SII buffer*) will be set between 1 and 3.5 percent of RWA and is to be decided by the competent authorities. It is phased-in from 1 January 2016. Other Systemically Important Institution (*O-SII*) may also be subject to a similar kind of buffer that can be set by the competent national authority between 0

[7]See CRDIV-CRR/Basel III monitoring exercise-Results Based on Data as of 31 December 2015, September 2016, European Banking Authority

[8]This information was last updated by the European Systemic Risk Board on the 18 April 2017
https://www.esrb.europa.eu/national_policy/ccb/applicable/html/index.en.html

and 2 percent of RWA. In addition to the G-SII and O-SII surcharges, European financial institutions can be subject to a Systemic Risk Buffer (SRB), a regulation developed outside the Basel Committee. As stipulated in CRD IV, it is up to the competent authority of each Member State to introduce a SRB in order to "prevent and mitigate long-term non-cyclical systemic or macro-prudential risks with the potential of serious negative consequences to the financial system and the real economy in a specific Member State".[9]

All capital buffers described above must consist of CET1 capital and together they form what is called the *combined buffer requirement*.

With respect to banks' excessive leverage, a new rule targeting the *leverage ratio* of financial institutions has been in place since the beginning of 2015. Current regulation requires only the calculation and public disclosure of the banks' leverage ratio. The new law proposal issued by the European Commission at the end of 2016 constrains banks to hold enough Tier 1 capital to cover at least 3 percent of their non-risk weighted assets and certain off-balance sheet items. This regulation is intended to serve as a backstop to the risk-based capital requirements.

On top of these more stringent capital requirements, BCBS has introduced two measures aimed at promoting sound liquidity management. The short-term Liquidity Cover Ratio (LCR) ensures that the banks have enough liquid assets to cover the expected net cash outflows under a stressed period of 30 days. In accordance with provisions in the CRR, European financial institutions shall comply with the minimum LCR of 70 percent as of 1 January 2016 and reach 100 percent by January 2018. In its latest report, EBA notes that over 90 percent of the banks in the sample already comply with the 100 percent fully phased-in LCR minimum requirement and that the average LCR across all banks in the sample is 134 percent.[10] In November 2016, the European Commission proposed a new measure, the Net Stable Funding Ratio (NSFR), intended to address the maturity mismatches over the entire balance sheet of a financial institution. The NSFR requires banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities.

BANK RECOVERY AND RESOLUTION DIRECTIVE

The Bank Recovery and Resolution Directive (BRRD) is a set of regulations adopted by the European Parliament and the Council in 2014 which lays out a resolution agenda for failing banks to follow in a crisis situation. The aim of the resolution process is primarily to alleviate the burden of bank failures on tax payers and public resources and ensure the provision and continuity of

---

[9] In many cases, it is the highest buffer between the G(O)-SII and SRB that applies.

[10] See The EBA Report on Liquidity Measures under article 509(1) and the Review of the Phase-in of the Liquidity Coverage Requirement under article 461(1) of the CRR", December 2016, European Banking Authority

essential banking operations. Bail-in is one of the tools included in BRRD which achieves the aforementioned goals "by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution."[11]This is achieved by writing down debt or converting it into equity. BRRD requires competent resolution authorities to determine a Minimum Requirement for own funds and Eligible Liabilities (MREL) that a credit institution in its jurisdiction is supposed to hold at all times and which are to be used in its own resolution process. Each responsible resolution authority decides on a case by case basis on *the type* of eligible liabilities and on *the ratio* of MREL to total liabilities and own funds.

MREL consists of *a loss absorption amount* that should, as a baseline default, be equal to the prudential capital requirements established by the supervisory authority and *a recapitalization amount* which is set to cover the capital requirements of the failing institution post-resolution as well as the need to maintain sufficient market confidence. It is at the discretion of each resolution authority to decide upon the phase-in of this measure since it became national law early 2016.

In November 2016, the European Commission released a new legislative proposal to review MREL and to adopt the Total Loss Absorption Capacity (TLAC), a standard developed by the Financial Stability Board (FSB) and BCBS. TLAC shares the same purpose as MREL but has slightly different technical requirements and applies only to Global Systemically Important Banks (G-SIBs). This regulation is aimed to be applied as of 2019 with a phase-in of tree years.

THE STATE OF THE EUROPEAN BANKING SECTOR

The low profitability of European banks can be seen as both a consequence and a cause of the weak economic environment. Central banks in Europe have long maintained an accommodative policy in order to boost demand and counter disinflationary pressures. Low interest rates and central banks' interventions cut both ways: they support economic growth and aim at maintaining price stability, while also in many cases reducing banks' net interest margins. Other sources of low profitability are banks' business models which entail in many cases high costs of funding and the increased competition from technologically advanced non-banking companies, the so called FinTechs. In some countries, the prolonged period characterized by weak economic growth also contributed to an increased share of non-performing loans as part of total assets and these have further depressed banks' profits.

The previous year's fall of bank shares in several European countries reflects markets' worries about the future profitability

[11] Directive 2014/59/EU of the European Parliament and of the Council

of banks. Sustained profits are needed to maintain capital levels through adverse economic cycles, extend credit to households and companies, meet future increases in regulatory requirements, and pay dividends to shareholders.[12]

THE IMPACT OF THE BANKING REGULATION ON EUROPEAN BANKS AND ON THE EUROPEAN ECONOMIES

The market structures of banking sectors across the countries of the European Union are very heterogeneous as are the challenges they are facing at present. On this backdrop, it is expected that banks' responses to these regulation packages will be very diverse across individual countries. AIECE institutes' answers to questions related to the banking regulations reviewed in this section reflect in part these expectations.

General theoretical underpinnings suggest that additional capital requirements that are meant to increase the resilience of the financial sector and to reduce the risk of a financial crisis in the long run, might lead to higher lending rates for customers in the short run, possibly resulting in lower lending and lower GDP. The fundamental reason behind this is the higher cost of equity funding relative to debt funding, this cost being passed on to some extent to banks' clients.

Most studies assess that at EU level, the higher capital and liquidity requirements as stipulated under CRR/CRD IV – that have as an overreaching goal to strengthen the resilience of the EU banking sector – will only have a *limited impact* on the cost of funding *in the long run*, which in turn will have a small effect on investment and aggregate output. An IMF study, for example, assesses the cumulative impact of regulatory reforms on lending rates in Europe to be limited to 18 basis points[13].[14] This estimation is in line with previous impact studies from OECD and BIS.[15] A recent study by BIS concludes that the benefits[16] of the Basel III regulatory package and the additional TLAC requirement for G-SIBs clearly outweigh the costs.[17] A study performed by the Institute of International Finance in 2011 can be seen as

---

[12] See Global Financial Stability Report—Fostering Stability in a Low-Growth, Low-Rate Era, October 2016, International Monetary Fund

[13] 1 basis point is equivalent to 0.01 percent.

[14] See Elliott and Santos "Estimating the Cost of Financial Regulation", Staff Discussion Note, 2012, International Monetary Fund

[15] For a review of major international empirical studies, see Allen et. al "Structural Changes in European Financial Systems: The impact of Regulatory Framework on Investment in the European Union", in Investment and Investment Finance in Europe, European Investment Bank, Luxembourg, 2013. As the authors point out, the results of these studies are subject to considerable uncertainty due to the complex nature of the globalized banking system and the usage of stylized models that cannot appropriately capture the interplay of various regulations.

[16] The benefits from higher capital requirements are considered to be a diminished probability for a banking crisis and lower estimated costs in case the crisis does occur.

[17] See Fender and Lewrick"Adding it all up: the macroeconomic impact of Basel III and outstanding reform issues", BIS Working Paper No 591, 2016

an outlier in this context.[18] According to calculations for the central scenario for the Euro Area, the impact of these regulations leads to an increase in real lending rates of about 290 basis points per year and a cumulated decline in the real GDP level of 3 percent over 5 years.

Regarding the argument of banks' recapitalisation in the resolution process, the issuance of MREL instruments will most likely increase banks' costs of debt, further reducing their profits.[19] In their latest publication, EBA estimates that, at an aggregated level across the EU, these higher costs of bank financing will lead to an increase in the lending spread[20] between 1.3 to 2.6 basis points and an annual reduction of the GDP level ranging between 0.6 and 6 basis points.[21][22] The effects are expected to vary widely across countries. Nevertheless, weighing these costs against the gains of a reduction in the probability of a crisis and the total cost of the crisis, EBA concludes that the overall net benefits are positive and range between 17 and 91 basis points of the annual GDP level.

AIECE INSTITUTES ANSWERS TO THE SURVEY

Thirteen AIECE institutes from eleven different countries have answered the questions related to banking regulation and its impact on the banking sector and the overall economy. Where two or more institutes from the same country have provided answers to these questions, their view on each particular issue can be considered similar.

Regarding the effects of these regulation packages on the banking sector, most responding AIECE institutes agree on their benefits towards increasing financial stability. Institutes from four participating countries assess these regulations to have only a marginal effect on the banking sector and institutes in three other countries foresee lower profits for their banks. As one institute points out, low profits will constrain banks' ability to raise capital to meet the specified requirements. Only four of the institutes participating in this survey assess a negative impact of the regulation packages on the supply of credit, though to various degrees. One of these institutes judges that tightening the supply of credit will slow down the recovery of the economy. On the bright side, one AIECE member estimates the im-

---

[18]See The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework, Institute of International Finance, 2011

[19]It is highly likely that the effect of MREL instruments will be different across banks depending on various factors such as the size of the bank, its business model, the structure of the banking sector as well as the capacity of the market to absorb these instruments.

[20]The lending spread is defined as the difference between lending rates and deposit rates.

[21]See Final Report on MREL;Report on the Implementation and Design of the MREL Framework, European Banking Authority, 2016

[22]These estimations are based on a series of assumptions and are subject to several limitations.

pact of regulation on credit supply will only lead to more stable credit growth.

Some AIECE institutes consider that these regulations can have a positive effect on banks' in their country by reducing the cyclicality in the economy as well as improving banks' risk management. On the negative side, institutes in a couple of countries fear that these regulations and the uncertainty coupled to the current issues under debate will have a negative impact on banks in their country and their business models.

When asked about which measures will affect the banking sector the most, the majority of responding AIECE institutes assess Basel III regulations to have the greatest impact, some institutes specifically naming the increased capital requirements to be most significant. Only two institutes think that Bail-in regulation will have the greatest impact in their country, while one institute points out that it is the combined effect of all new regulations that matters.

CONCLUSIONS

Since the Global Financial Crisis, national and supranational law makers have implemented a new set of enhanced financial regulations that are aimed at strengthening the resilience of the banking sector and at providing a resolution agenda for crisis situations. The measures in place require financial institutions to hold more and better capital, more liquidity and to issue new instruments that can be used to recapitalize the failing institution. These measures can lead to higher costs of financing and, given the precarious state of banks in some countries, they can induce spillover effects into the real economy via the supply of credit. Assessment studies show that, at the aggregate EU level, the impact on lending rates and the real economy are rather small. Nevertheless, given different economic situations and particular characteristics of the banking sectors in each country, differences across Member States are to be expected. These conclusions are reflected in answers of AIECE member institutes.

Topics for discussion

- Do you think that any of the bank regulations implemented after the global financial crisis is posing a disproportionate burden on the banking activity in your country?
- Do you assess there is a need to further tighten European bank regulation by restricting the use of internal rating-based models used in determining the amount of capital banks need to hold?