THE EUROPEAN ECONOMY IN THE MEDIUM TERM

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ETLA (The Research Institute of the Finnish Economy) prepared this report using questionnaires completed by 13 AIECE institutes. On the basis of the answers we assess that in the medium term the EU countries could be confronted with the following structural problems: (1) the need to increase R&D and infrastructure investments in order to raise productivity; (2) the need to prepare for the challenges of ageing and lower labour force growth; (3) the need to increase cooperation between countries when facing political challenges, for instance Brexit; and (4) the need to rethink the EU's fiscal policy rules together with the monetary policy tools available for the ECB. There are also other issues that arise, starting from financial stability and continuing to very country-specific problems. We begin by discussing the projections of the main economic indicators.

Country Forecasts

In the following graphs we present the forecasts by the AIECE institutes for their respective countries. The presented forecast is the average for the years 2019–2023. Figure 1 shows the expected growth rate in GDP in the different countries as well as the institutes' forecasts for GDP growth in the euro area. Growth is expected to be fastest in Hungary, Slovenia, Norway and Greece. Apart from Norway, this development supports income convergence. Of the countries covered, Italy and Germany score the slowest expected growth rates.

The average of the forecasts for euro area GDP growth is 1.4 per cent. This is lower than the expected 1.9 per cent GDP growth rate for the US. However, the difference is largely explained by faster population growth in the latter. Both the euro area and the United States are expected to grow 0.5 percentage points slower than they did in 2014–2018. On the other hand, world GDP growth is expected to be 3.4 per cent which is the same as during the past five years on average.

Export growth is expected to be the fastest in Greece and Hungary, the slowest in Finland and Italy (see Figure 2). Total export growth is expected to outperform import growth in Finland, Austria, Denmark, Greece, Sweden, the UK, and Norway thus supporting overall growth in these countries. The average growth rate in exports in Germany is expected to be a full percentage point lower than that of imports. In Greece, the difference is +1 percentage point.

The institutes differ in their estimate of world goods' trade growth in 2019–2023. These forecasts are also presented in Figure 2. The estimates vary between 2.4 and 3.9 per cent. The average is 3.2 per cent which is faster than during 2014–2018 when world goods exports grew by 2.9 per cent.

Consequently, even though world GDP growth is expected to remain as fast as it was in 2014–2018 and growth in global goods exports is expected to pick up, GDP growth in the EU is expected to slow down. Growth in Hungary is expected to be supported by domestic demand with rapid private consumption and investment growth (see Figures 3 and 4). This contributes to import growth outpacing exports. Scandinavia and Slovenia are also expected to see strong growth in private consumption. Investment growth is expected to be solid in Greece over the coming years. On the other hand, investment growth in Sweden and Italy seems very sluggish, and not much better in Germany.

Figure 1: GDP growth (2019–2023), %

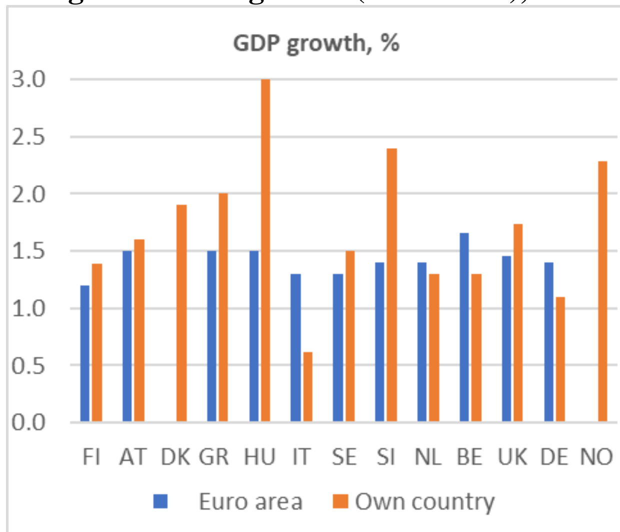


Figure 2: Exports and imports (2019–2023), %

Figure 3: Private consumption (2019–2023), %

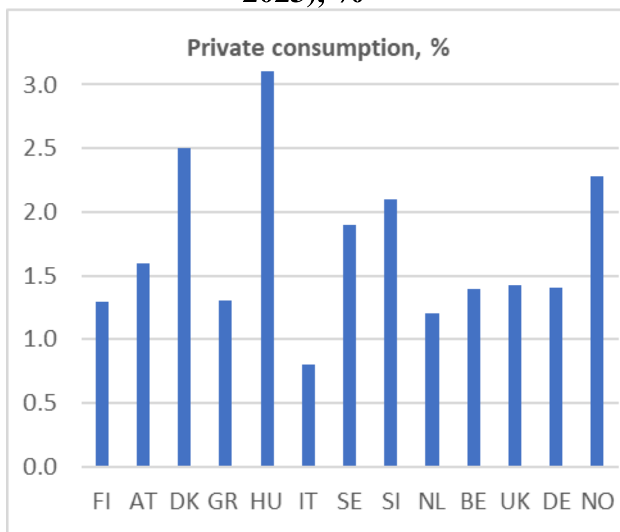
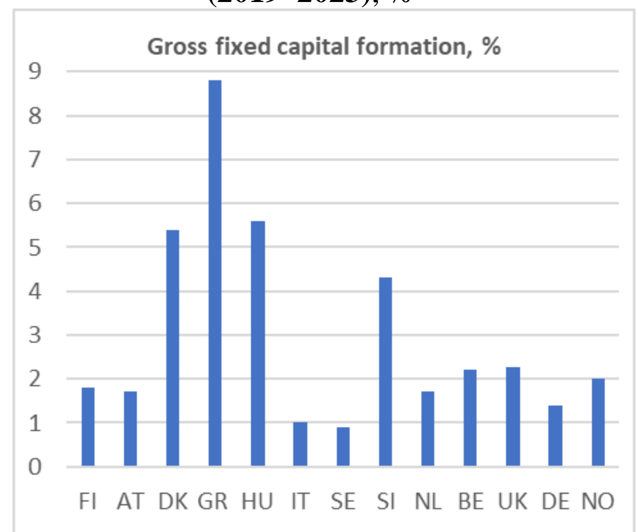


Figure 4: Gross fixed capital formation (2019–2023), %



We do not have forecasts for some countries' current account (Figure 5). The large surpluses in Norway and the Netherlands are expected to hold on in 2019–2023, as is the moderate deficit in the UK.

Consumer price inflation is expected to be the slowest in Greece and Italy (see Figure 6). Domestic price pressures remain contained under high unemployment (see Figure 7). Inflation is highest in Hungary, a catching-up economy. Nominal convergence is a part of the catching-up process.

Average consumer price inflation rate in the euro area is expected to be 1.7 per cent, which is faster than the 0.8 per cent in 2014–2018 but still short of the central bank's target. The range for euro area inflation forecasts is from 1.5 to 2.0 per cent. That inflation is expected to pick up despite a slowdown in economic growth may be caused by a tighter labour market.

Figure 5: Current account (2019–2023), % of GDP

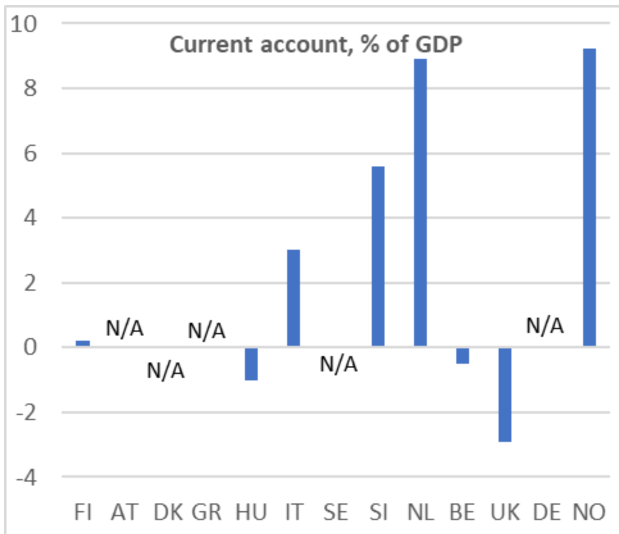


Figure 6: Consumer price inflation (2019–2023), %

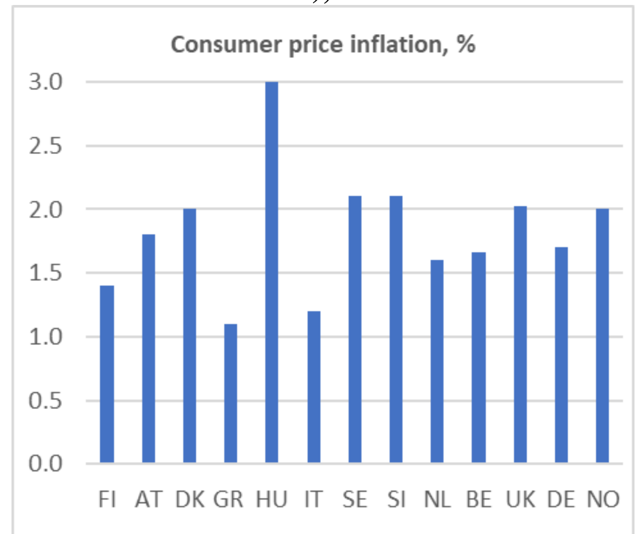


Figure 7: Unemployment rate (2019–2023), %

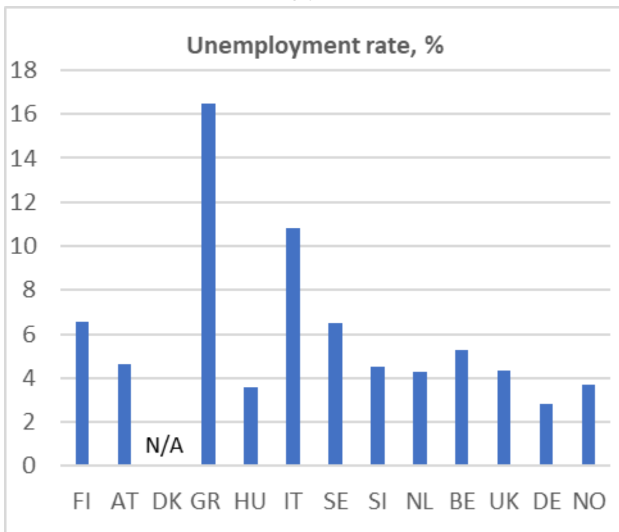
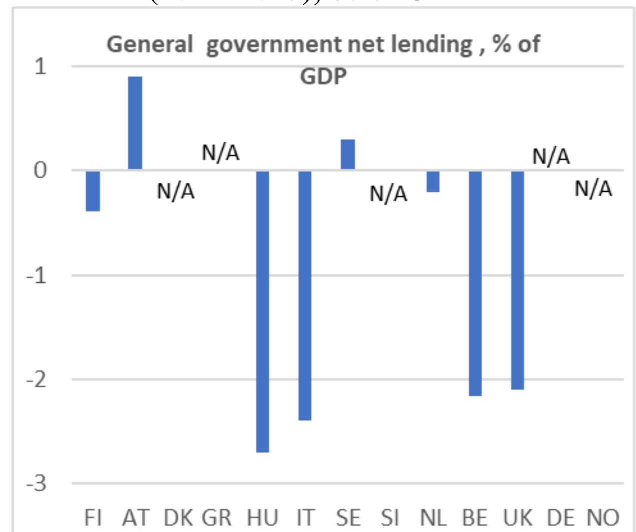


Figure 8: General government net lending (2019–2023), % of GDP



Forecasts for the EU

Table 1 presents the average forecasts for the euro area and the EU in 2019–2023 by the AIECE institutes along with the minimum and maximum forecasts. Relative to 2014–2018, GDP growth is expected to slow down by 0.5 percentage points per annum. Consumption is not expected to slow down by as much, only by 0.2 percentage points. On the other hand, investment growth may fall by a full percentage point.

Growth in both exports and imports is expected to slow down, but by as much in the euro area, so the impact of net exports on the slowdown in GDP growth is close to zero. In the EU as a whole–presumably including the UK, but not specified in the questions–import growth may slow down a little more than export growth.

Table 1 Forecasts for the European Union, %

	2014 – 2018	2019 – 2023	Min	Max
GDP (vol.)				
Euro area	1.9	1.4	1.2	1.5
EU	2.1	1.6	1.3	1.8
Private consumption (vol.)				
Euro area	1.5	1.3	1.1	1.5
EU	1.9	1.7	1.6	1.8
Public consumption (vol.)				
Euro area	1.2	1.2	0.9	1.5
EU	1.2	1.2	1.0	1.3
Gross fixed investment (vol.)				
Euro area	3.3	2.3	1.9	2.8
EU	3.4	2.5	1.9	3.0
Exports of goods and services (vol.)				
Euro area	4.5	2.9	2.4	4.0
EU	4.5	3.5	2.5	4.5
Imports of goods and services (vol.)				
Euro area	4.7	3.1	2.5	4.0
EU	4.8	3.6	2.5	4.5
HICP (Consumer price inflation)				
Euro area	0.8	1.7	1.5	2.0
EU	0.9	2.0	1.7	2.7
Unemployment rate				
Euro area	10.0	7.5	6.5	8.0
EU	8.2	6.5	5.4	7.0

We saw earlier that growth in the volume of world goods exports is expected to accelerate relative to 2014–2018, but here growth in the total exports of the EU countries is expected to slow down markedly.

The average unemployment rate is expected to decrease by 2.5 percentage points in the euro area relative to the preceding five-year period. Labour market reforms are needed to lower structural unemployment in many countries.

The price of crude oil is generally expected to rise in 2019 – 2023 (see Table 2 and Figure 9), but the spread between the lowest and highest expected price naturally widens as time passes. Two institutes expect nominal USD crude oil prices to peak in 2019 and start a decline after that, while the others expect a flat or rising trend.

Crude oil prices have been rising during 2019 so the timing of the forecasts affects the expectations. In early May, the price was around 70 US dollars. If this level were to be sustained for the rest of the year, the average price for a barrel of Brent crude would be almost 69 dollars this year.

Central bank policy rates are expected to rise slowly (see Figure 10). On average, fastest development is expected in the euro area. Despite expected slowdown in GDP growth and the inflation rate not reaching the ECB's target, the central bank's policy rate is expected to rise. US GDP growth will also slow down, but policy rates are expected to continue to rise. This may be because of a tightening labour market.

Table 2 Assumptions: crude oil and interest rates

	2014- 2018	2019	2020	2021	2022	2023
Brent, USD per barrel	64.9	65	66	66	68	70
Central bank policy rates, %		**2019**	**2020**	**2021**	**2022**	**2023**
- Euro area		0.0	0.1	0.4	0.7	1.0
- USA		2.6	2.5	2.6	2.8	2.9
- Japan		-0.1	-0.1	0.0	0.0	0.2
- UK		0.8	0.8	1.0	1.2	1.4

Figure 9: Brent, USD per barrel

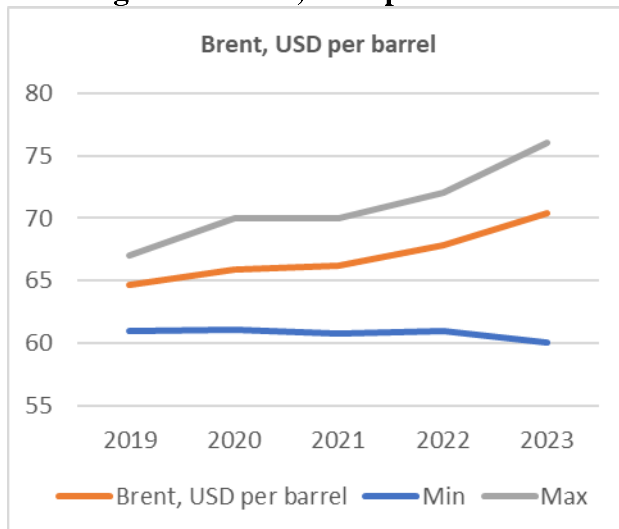
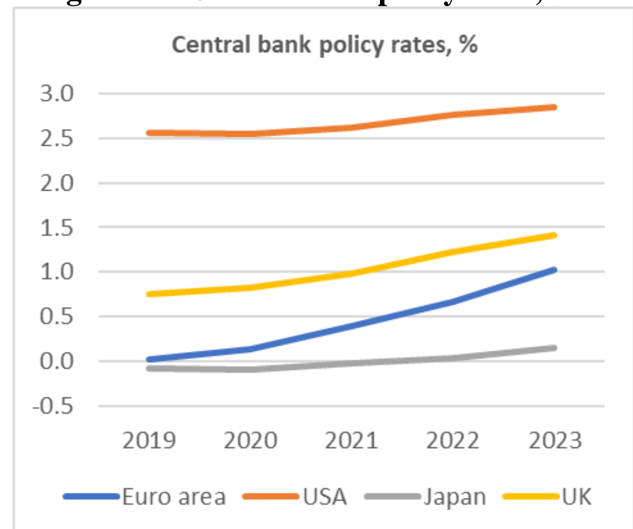


Figure 10: Central bank policy rates, %



Country questions

Fiscal policies and risks to economic outlook in the medium run

Respondents from different AIECE institutes find that authorities have taken some decisions to improve growth in the next five years in the AIECE member countries. On fiscal policy side, the most important ones have been lowering unit labour cost with a competitiveness pact (Finland), citizenship income (Italy), higher social spending and higher wages in the public sector (Slovenia), tax cuts and outlay increases (the Nertherlands), higher spending in particular on health services (the UK), automatic inflation adjustment of income tax thresholds (Germany), and tax cuts (Norway). The most important structural policy measures taken have been a pension reform, implemented already in 2015 (Finland), privatisation and utilisation of public assets (Greece), a reduction in labour taxes (Slovenia), and ’efficiency measures’ (Norway).

However, respondents also comment that decisions have simultaneously been taken to impair growth in the medium run. Among those decisions have been expiring investment incentives (Italy), a scheduled reduction of tax free income in 2020 (Greece), increased taxation of capital and corporates (Slovenia), cuts in education investments (Finland), continued ambition to keep spending in most areas unchanged in real terms (the UK), increase in the fiscal burden by expanding pension liabilities (Germany), and lower growth in public consumption and investments together with increased inequality and fiscal evasion (Norway).

The ECB and the EU Commission have many times stressed the importance of structural reforms in enhancing economic growth in the EU member countries. The answers provided by the institutes show that some policy measures have indeed been implemented in the countries that answered the questionnaire. However, the ambitions in structural reforms should be set higher considering many challenges – secular stagnation, climate change, and rapid automation, among other things – in the next five years and later on. Also, one should keep in mind that some sort of a recession is very likely in Europe in the next five years – in fact we are probably very close to seeing one right now in some EU countries. Yet we know that it is less painful to implement structural reforms in good times when there is an abundance of jobs and other opportunities available in the society, to compensate the potential losers of the reforms.

This takes us to risks. Six out of 13 institutes that answered the questionnaire judged Brexit a serious risk to economic growth for their respective country. Only institutes in Switzerland and Italy do not consider Brexit an important risk to their countries' growth. Also, institutes in 4 out of the 13 countries assess an increase in oil prices a significant risk to their economic growth. From other sources of risks, institutes in Switzerland and Italy consider a renewed sovereign debt crisis in the euro area a very important risk to growth in their countries. Yet until recently, the yields of 10-year government bonds have mostly decreased in the EU countries. Thus, one could assume that this 'good' state of affairs is not deemed long-lasting by the institutes.

Furthermorea financial crisis in China is seen as an important risk to growth by institutes in Finland and Ireland. On the other hand, the rise in populism is judged a moderate risk by most institutes. The rise in populism is assessed a very serious risk to economic growth only in the Netherlands. One channel through which populism could impair economic growth is by lowering chances of forming a majority governments and this way blocking effective decision-making. The other channel is simpler: by straight action, the effects of which we are currently seeing for instance in France.

Ten out of the 13 respondents from different institutes saw US trade policy as a very damaging for their countries' growth in the medium term. This was considered especially detrimental for growth in Finland, Norway and Greece. Also, a wide consensus was found on the significance of risks coming from a slowdown in the world economy. Only one institute (from the Netherlands) did not see this as an important factor contributing to medium-term growth.

Among other factors that could significantly hinder economic growth in the medium run, the respondent from Switzerland wanted to stress a risk of no agreement between Switzerland and the EU on their future bilateral relationship; an institute from Hungary mentioned weakness in the ability of most domestic firms to shift from a low-wage production to a higher-value added mode of operation; and an institute from Slovenia raised the issue of geopolitical tensions in the ex-Yugoslavian countries and the crisis in Russia.

Competitivity issues

Productivity is seen as the most important factor determining competitiveness in the medium run, according to the institutes that answered the questionnaire. This should not come as a surprise, as long-run economic growth is almost entirely tied to productivity growth. However, institutes also stressed the importance of unit labour costs in determining competitiveness. In fact, unit labour costs is probably the most commonly used concept in defining price competitiveness of a country. Among small open economies the concept is extremely important, and this is also reflected in answers from institutes representing countries such as Switzerland, Sweden, Ireland and Norway, which all stress the importance of unit labour costs in determining competitiveness in the medium run.

Yet the industrial structure is seen almost equally important, according to answers by the institutes from Norway and Ireland. Institutes from Switzerland and Sweden also raise the exchange rate as an important factor determining their countries' competitiveness in the medium run.

The institutes from Switzerland, Hungary and Germany think that infrastructure investments in their home countries are sufficient (sufficient defined here at the scale from 6 to 10). Instead, the institutes from the UK and Norway considered the infrastructure investments in their country being close to completely insufficient. When asked to name the biggest constraint on infrastructure investments, the answers ranged from long building procedures to lack of skilled labour, public debt issues and privatisation.

Figure 11. Public investments to GDP ratio, %, larger EU countries (current prices)

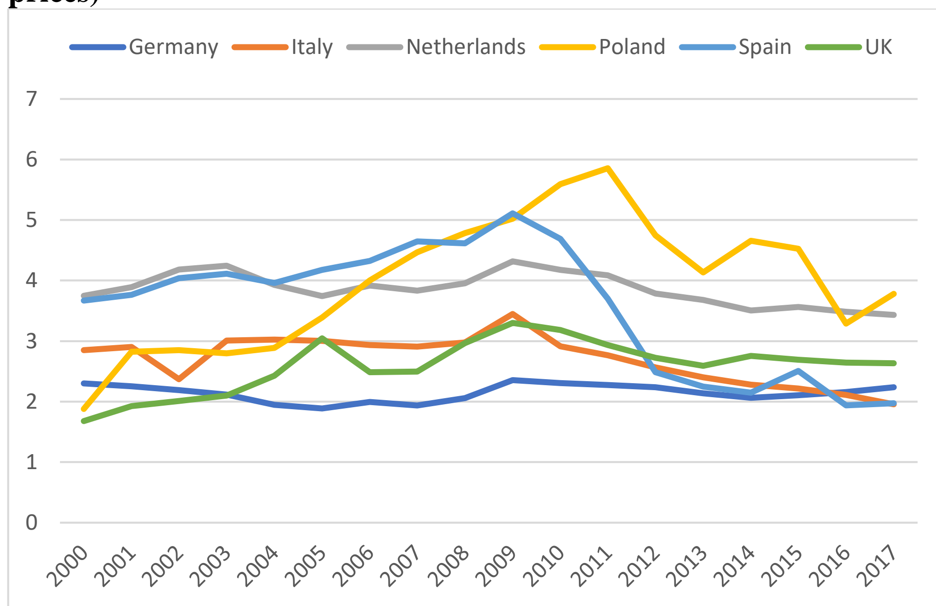
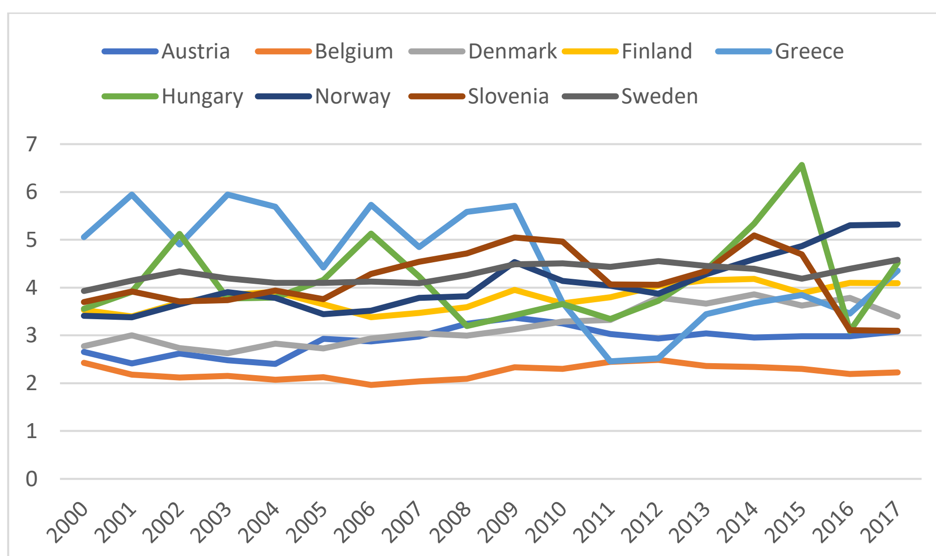


Figure 12. Public investments to GDP ratio, smaller EU countries (current prices)



The data shows that the share of public investments in GDP is in many EU countries lower than it was in years before the financial crisis. Also, IMF (2014) finds that the stock of public capital has declined significantly relative to GDP over the past three decades across advanced and developing economies. According to the IMF, this reflects a trend decline in public investment from about 4 per cent of GDP in the 1980s to 3 per cent of GDP this decade.

Thus, it is possible to argue that countries that have under-invested in infrastructure and yet have reasonable, well-defined investment plans, meaning that it can be shown that these could improve long-run potential output, should seize the opportunities provided by low real interest rates. The benefits of these kinds of well-planned public investments are calculated for instance by the IMF in their World Economic Outlook (2014). They find that, for a sample of advanced countries, a one percentage point of GDP increase in public investments could increase GDP by about 0.4 per cent in the same year and by 1.5 per cent after four years. This multiplier is pretty much in line with the research by Gechert (2015), a meta-regression analysis of 104 studies on fiscal multiplier effects.

A counter-argument for increasing public investments is their possible crowding-out effects on private sector investments. However, the case for increasing public investments can be stressed now when it looks clear that GDP growth is slowing down in many advanced countries, implying that crowding-out effects on private investments should remain small.

Five out of the 13 institutes that answered the questionnaire judge that public involvement in research and development (R&D) activities is well organised and financially sufficient in their home countries (scores between 6 and 10). The opposite position – completely insufficient – was taken by institutes from Norway, Greece and Hungary.

Six respondents assessed that from the fiscal point of view, their home country is sufficiently prepared to meet the challenge of lower labour force growth (scores between 6 and 10). On the other hand, institutes from Greece and the UK find that their countries are quite unprepared for the demographic challenge.

This issue will become more important in near future. For instance, The 2018 Ageing Report (2018) made by the EU Commission shows that fiscal costs linked to pensions, health care and long-term care are expected to rise significantly over the coming decades, as Europe's population continues to age rapidly. The report finds that the EU's old-age dependency ratio (people aged 65 and above relative to those aged 15 to 64) is expected to increase by 21.6 percentage points, from 29.6% in 2016 to 51.2% in 2070. This implies that the EU would go from having 3.3 working-aged people for every person aged over 65 years to only 2 working-aged persons. Although the greatest costs from the demographic change will materialise only in the long run, preparations to make pension systems and public finances sustainable should be started as soon as possible. Work-based immigration shouldnaturally be a part of the solution to the problem.

Ten respondents assessed that the financial system in their country is relatively stable (scores between 6 and 10). Worries concerning the stability range from non-performing bank loans to low banking sector profitability, housing prices and renewed euro crisis (combined with a banking crisis). However, none of the institutes judges the current state of the financial system in their country particularly unstable.

EU-related questions

From convergence to Brexit
Over time, we expect to see productivity and income convergence across the internal market. Indeed, with some exceptions, this has happened with especially the new member countries that joined the EU in 2004/2007 growing faster and thus catching up with the EU15 countries. We asked what the EU should do in the medium term to enhance convergence.

The highest score (with a range from 1 to 10) was given to increasing competition in the internal market (average of 6.7 points with answers varying between 1 and 9 points) followed by having EU-wide investment programmes (6.5 points, range 3–10), and using regional policy instruments in the EU budget (6.3 points, range 3–10). The least favoured was harmonising national tax policies (3.6 points, range 1–8). As can be seen from the results, the answers were not very uniform. Ten institutes answered this question.

Our Brexit-related question asked for the likely situation at the end of this year. Some answers arrived already before new information on the timetable was given by the EU and the UK. The respondents had therefore some asymmetric information. Revoking Article 50 was deemed the most unlikely event, followed by Ms May's deal. No Deal came in second. The option 'other' was on average deemed the most probable. However, when asked to specify, votes therein were divided between a new deal (3), a further delay (2), and a couple of empty answers. So, anything is possible…

The respondents finally gave their views on whether Brexit will change the member countries' support for greater cooperation within existing EU institutions. The average over the probabilities was that 54 per cent said there to be no change, 34 per cent expected an increase and 31 per cent a decrease in cooperation.

Secular stagnation, monetary policy and fiscal rules
Six out of nine respondents think that the weak economic development in the EU can be associated with the secular stagnation hypothesis (association defined an answers being ranging between 6 and 10), an idea first presented by Alvin Hansen in the 1930s. In short, secular stagnation describes an economy with an increasing propensity to save and a decreasing propensity to invest. The result is excessive savings that acts as a drag on demand, reducing growth and inflation, and the imbalance between savings and investment which pulls down real interest rates. This kind of an economy is also typically associated with weak productivity and modest labour supply growth.

In this economy, when significant growth is achieved, it comes from dangerous levels of borrowing that translate excess savings into unsustainable levels of investment (which in the US case emerged as a housing bubble), the point stressed for instance by Lawrence Summers. Interestingly, the weights given for the relevance of the secular stagnation hypothesis range between 3 (institute from Germany) and 9 (institute from Italy), hence not all institutes share the view of importance of the hypothesis. On average, respondents believe in the secular stagnation hypothesis with an intensity score of 6.4.

The probability of a systemic risk in EU financial markets in the medium term is on average placed at 24 per cent with a range of 0–40 per cent. Somewhat related to this, asset price bubbles are worrying ten respondents with an average answer of 6.7 points (out of 1–10 with 10 being extremely worried). Here the range in answers was between 5 and 10 points.

Six out of ten respondents assess that the current ECB mandate is appropriate. Those respondents that do not share this view comment, for instance, that beyond price stability, the ECB's target should

include economic growth and employment. In addition, one respondent remarks that the current mandate focuses too little on imbalances (financial and distribution wise). The ECB's mandate can indeed be questioned, if not for other reasons, but, at least due to fact that the ECB has been incapable of delivering its current mandate, an inflation below but close to 2 per cent, for many years.

If not changing the whole mandate, which is a delicate and complicated issue, one step ahead could be a reassessment of the monetary policy tool pack available for the ECB – an idea supported for instance by Olli Rehn, candidate for the ECB's next president. He has also mooted an idea of letting inflation run above its target for a limited period. Villeroy de Galhau, governor of the Banque de France, has instead proposed compensating banks for charges associated with negative interest rates. This idea of a tiering system for negative deposit rates – now at minus 0.4 per cent – has also attracted wider attention.

Four out of eight respondents argue that the current fiscal policy stance in the EU is appropriate, whereas three institutes judge that it is too contractionary. Only one institute argues that the current fiscal policy stance is too expansionary. Thus, it is possible to infer that, on average, institutes lean to the view that the fiscal policy stance is perhaps slightly too contractionary. Fiscal policy is, however, expansionary this year in the euro area. In general, looser fiscal policy could help the ECB reach its inflation target as well as support social policy aims set by national governments. Nevertheless, timing of fiscal policies is also important: it should be used in case of a substantial slowdown in economic growth, not when growth continues to be strong and the output gap is clearly positive.

Most of the institutes assess that the current fiscal rules in the EU are not appropriate. The fiscal rules have been criticised by many economists and politicians for being too technical, complex, opaque and consequently inefficient. Also, they have been criticised for hampering the use of counter-cyclical fiscal policy measures when needed. However, three out of nine institutes assess that the fiscal rules themselves are well-defined, but it is their implementation, instead, which is the problem while the EU Commission lacks the enforcement ability.

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