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# Editorial: ECB risks making policy mistake

Since the latest EUREN forecast, the growth outlook has remained broadly unchanged with incoming data confirming the view that the recovery is likely to proceed at a muted pace. GDP growth in the Euro area is expected at about 1.5% this year and only a slight acceleration to around 1.7% in 2012. What has changed though is the rise in inflation and the concerns of the European Central Bank that the rise in inflation becomes entrenched.

Euro area headline inflation has risen to around 2.5% at the beginning of 2011. The increase has been accounted for by rises in VAT rates in a number of countries and sharp rises in energy and non-energy commodity prices. However, core inflation has remained benign at just above 1%.

## *Inflation seen below 2% in 2012*

Energy and non-energy commodity prices are likely to remain elevated for some time. Even under the assumption that tensions in North Africa and the Middle East do not escalate further, concerns over oil and gas supply and thereby risk premiums on the price of these commodities will probably stay high for much of this year. As a result, Euro area inflation will probably increase from its current levels over the next few months and remain above 2% throughout 2011.

But next year, as the effect of VAT increases at the beginning of 2011 falls out of the inflation rate, oil prices start to fall back somewhat and new crops alleviate pressures on food prices, Euro area inflation should drop back to below 2%.

## *Plenty of slack*

The risk of second-round effects seems low. Indeed, despite bottlenecks emerging in a few sectors and countries (most notably in Germany's manufacturing sector), on average in the Euro area, there is a large amount of spare capacity in the economy. In particular, slack prevails in labour markets. Unemployment rates are not expected to fall significantly from the current high levels for some time as companies attempt to restore productivity and thereby profitability by limiting new hires. This points to limited pressure on wages and hence little risk that inflation gets out of control.

## *ECB risks making policy mistake*

In this context, the ECB risks making a policy mistake by raising rates already. It is hoped that after a couple of small rate increases to reassert its credibility, the ECB will pause for some time as weak growth highlights muted underlying inflationary pressures.

## *Long list of downside risks*

The ECB should beware of downside risks to the growth outlook for the Euro area. Factors that could push growth below our baseline forecast include an intensification of tensions in the Middle East and Africa that could push oil prices to very high levels and overheating in emerging markets. While the emerging markets' monetary policy response has generally been appropriate so far, there is a risk that it is not large enough to stem an inflationary spiral. Emerging markets' central banks would then need to tighten even more aggressively which would have a negative impact on growth in these countries and hence on Euro area exports. Given the reliance on the Euro area economy on strong exports, this scenario would significantly dent growth prospects.

Moreover, the latest events in Portugal highlight that the risk of a full-blown Euro area crisis still prevails. It could be triggered by tensions in the Middle East that, by raising oil prices and lowering Euro area growth, would make fiscal targets unachievable. Weaker growth prospects mean that financial markets would lose confidence in the governments' commitment and ability to put in place institutions that deal with and prevent future crises. Contagion from Portugal to Spain, via exposure of Spanish banks to assets in the neighbour country could also be a trigger of a Euro area debt crisis.

### *EU reforms too timid*

The agreement reached by EU governments at the summit of 24-25th March is not far-reaching enough to solve the current crisis or prevent future ones. The decision to make the EFSF permanent (into the European Stability Mechanism (ESM)) and to increase its effective size was welcome. But the possibility for the EFSF and ESM to purchase bonds of distressed governments has been limited to exceptional circumstances and subject to strict conditionality so that it will be of limited use. The ECB will need to continue with its government bond purchase programme against its will. Some economic coordination measures have also been agreed upon within the 'Euro Plus Pact', such as instituting fiscal rules in national legislation, raising retirement ages or fostering movement of labour. These are all useful, but fail to address the issues at the centre of the current crisis. The more significant proposals, such as issuing Eurobonds or allowing some form of debt restructuring have been rejected. Short of significant steps toward closer fiscal union, imbalances and crises similar to the ones we have just seen will remain important problems. Closer fiscal union would imply a loss of sovereignty that Euro area governments do not seem ready to accept.

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## New EU Member States: Growth will accelerate further

### *Consumption and investment under recovery*

At the beginning of last year our forecast about the growth prospects regarding the New Member States (NMS) of the EU was still considered highly optimistic in the forecasting community, however, economic growth trends in the second half of 2010 have confirmed our expectations. The adopted stabilisation measures required largely painful social sacrifices in various new EU member countries, but they brought positive macroeconomic results. By end-2010 in all countries of the region there had been a positive turning point in growth trends. It is particularly important for long-term stability that – though with a certain delay – the formerly more sceptical international institutions and financial markets have also confirmed the improving prospects. A convincing example of the positive revaluation of the region is that by mid-March 2011 already two of the three major credit rating agencies upgraded the rating of Latvia – the country that was perceived the most vulnerable one among the NMS since Autumn 2008. Today the Latvian long-term foreign currency debts are again in the investment rating category.

GDP growth was positive in all countries of the region in the last quarter of 2010; on average it accelerated to 2.9% compared to the same quarter of 2009. The annual average rate still was negative in Romania (-1.3%) and Latvia (-0.3%), but in the region as a whole GDP expanded by 2.1%, thanks to the strong GDP growth rates of Slovakia (+4%), Poland (+3.8%) and Estonia (+3.1%) that became the latest member of the Euro area in January 2011. We expect a further acceleration of growth both in 2011 and 2012: On a regional average, GDP growth in 2011 could be around 3% and next year 3.5-4%. The acceleration will be most pronounced in the Baltic States and the two Eastern-Balkan countries where the fiscal stabilisation measures were the most painful ones in 2009 and 2010. For these countries, we forecast a GDP growth of 4-5% in 2012.

*Table 1*

**GDP growth in the New Member States**

2010 Q3 and Q4, quarter over quarter seasonal adjusted rates

| | 2010 Q3 | 2010 Q4 |
|---|---|---|
| Bulgaria | 0,7 | 1,7 |
| Czech Rep. | 0,9 | 0,5 |
| Estonia | 0,7 | 2,3 |
| Hungary | 0,6 | 0,2 |
| Latvia | 0,9 | 1,1 |
| Lithuania | 0,3 | 1,8 |
| Poland | 1,2 | 0,8 |
| Romania | -0,7 | 0,1 |
| Slovakia | 0,9 | 0,9 |
| Slovenia | 0,3 | 0,6 |

*Source: Eurostat*

There is a change going on not only in the pace but also in the structure of growth in the NMS. By mid-2010 the main factors of growth were net exports, thanks to the buoyant German import dynamics. However, in the second half of last year, although exports kept increasing strongly, consumption and investment recovered gradually boosting imports, too; first in the Central-European Slavic-speaking countries then in Bulgaria and the Baltic States – and this year we expect the same growth pattern both for Hungary and Romania. This year private consumption is expected to increase by 1.5-2% and in 2012 by 2.5-3%. The Polish economy may experience even faster consumption growth – around 3.5-4% both in 2011 and 2012. In the meantime, based on the latest corporate surveys, we might already forecast booming investment activity: we expect gross fixed capital formation to increase by 3-4% this year and by 5-6% in 2012.

## *Improving prospects on financial markets*

The financial stabilization of NMS in Central-Eastern Europe continued in the first months of 2011, the events in North-African affected the region rather positively as they eased investor distrust. Last year exchange rates were volatile – now they are stable and CDS premiums are decreasing. However there are considerable inflation pressures due to the increasing energy and food prices (more significant than in Western-Europe because their weight in the NMS consumer baskets is higher).

Among the Visegrád countries the highest inflation was measured again in Hungary (4.2%) but the CPI has an upward tendency in Poland and in Slovakia as well, meanwhile the Czech Republic could maintain its inflation around 2% which is lower than the Euro area's average (2.4%). Due to the rising consumer prices small increases in the reference rates (app. 25 base points) are expected soon by the Polish and Czech central banks. In Latvia deflation has ended and inflation could reach its highest value in early summer, thus the national bank will be exposed to tightening monetary policy (at the time being the reference rate has been 3.5% since March 2010). The increase in consumer prices has been continued in the other Baltic states as well. In Estonia, the new member of the Euro area, 5% yoy rate was measured in February, and 3% were registered in Lithuania. Among the NMS, the inflation is highest in Romania and this situation is expected to continue in 2011 with a forecast of 6% on average. The Romanian central bank has maintained its 6.25% reference rate since May 2010 but a hike in the near future is probable.

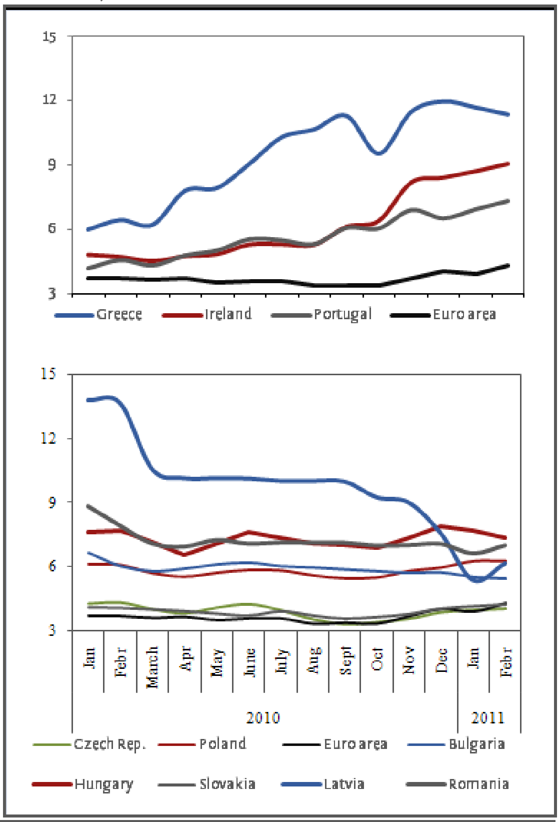
About exchange rates: in the first months of 2011 both the Hungarian forint and the Romanian Lei strengthened against the Euro and we expect further stabilization or even more appreciation. On the other hand the Polish zloty which appreciated in the second half of 2010 devalued by 5% so far in 2011 which reflects investors' pressure on the government to stabilize the budget. The Czech Koruna's rate against the Euro is permanently strong (it has strengthened 8% since January 2010).

Government bond yields also show the stabilization of the most vulnerable member states of the region. The Latvian yields, which were extremely high last year, are now below not only the yields of the Euro area periphery or Hungary and Romania but have reached the Polish and Bulgarian yield levels, too. At the time of high Greek, Portuguese and Irish yields the Hungarian and Romanian government bond yields are around 7-8% while the Czech bonds are below those of the Euro area average. All in all it is obvious that the prospects of the region are seen much more brightly by investors. While investors are afraid the Euro area financial conditions could deteriorate further, prospects for the NMS are rather good. Assuming normal economic development we expect further decreases in CDS premiums and government bond yields accompanied by stabilizing exchange rates. Inflationary pressure, a possible Euro area financial crisis and political uncertainties, however, pose certain risks to the positive outlook.

*Graph 1*

**Government bond yields in the New Member States and selected Euro area countries**

2010-2011, in %



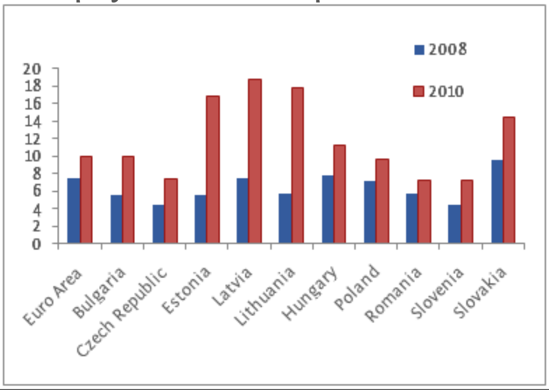

*Source: Eurostat, CEIC Database. 10 years government bonds.*

## *Demand for higher expenditures on active labour market measures*

After the crisis, all NMS experienced an increase of unemployment (Graph 2). In most of them the unemployment rates reached double-digit figures, but some of them suffered less and did not exceed the Euro area average – Slovenia, Czech Republic, Romania, and Poland. Among the countries already having introduced the Euro, Slovenia is an exception with one of the smallest increases. Forming conditions for increasing of employment is needed particularly in the three Baltic countries where the unemployment increased dramatically in the aftermath of the crisis. In Lithuania, e.g., the unemployment rate jumped from 5.8% in 2008 to 17.8% in 2010.

*Graph 2*

**Unemployment rates – Impact of the crisis**




*Source: Eurostat.*

At the end of 2010 and the beginning of 2011 the labour markets of most NMS show signs of stabilisation. Moreover, according to the Manpower Barometer of Employment Outlook the businesses in some NMS (Poland, Czech Republic, Romania and Slovenia) intend to increase employment in the 2nd quarter of 2011. But the return to the pre-crisis level will be very slow and it could take several years. In addition, the history of financial crises suggests that when a recession is caused by a banking crisis, the recovery of employment is much more protracted.

In this respect all the countries are implementing and strengthening their strategies aimed at activating the unemployed and improving their chances of getting a job. Although most NMS increased the expenditures on labour market policies in the recent years (most significantly Estonia and Latvia), expenditures on active measures are still weak, whereas the lead is still taken by passive measures. Only Slovenia and the Baltic countries spent significantly more on active measures, which already showed some results for unemployment. In Latvia, e.g., the unemployment rate decreased by 2 percentage points during 2010. Latvia implemented also several new measures: work practice in local municipalities, the youth work practice and the lifelong learning measure. The 2011 activities also include cooperation with employers and special support to priority target groups – the youth and the long-term unemployed. Youth unemployment is a massive problem in many NMS, in particular in the Baltic countries and in Slovakia. Slovakia is tackling this problem by changes in labour legislation to increase the flexibility of employment. Although employment protection had a positive impact on labour markets during the crisis, strict regulations may be an obstacle to job creation in a time of economic growth. As for the labour market in Hungary, active labour market policies are regarded to be better coordinated. According to ILO also Bulgaria should adjust its labour market policies to render help to the most needy (in January 2011 its unemployment rate got over the level of 10% as well). In all NMS also more effort has to be made to monitor and evaluate the impact of specific labour market policies with respect to future labour market policy decision-making.

## *Struggle for fiscal consolidation goes on*

Focused endeavour of Estonia for meeting the convergence criteria terminated in its successfully joining of the Euro area in January 2011. Thus it is Estonia which has currently the lowest fiscal deficit and public debt burden in all NMS. As the only country among the NMS it also managed to avoid the excessive deficit procedure imposed by the European Commission (EC) since 2009 and impact of the crisis (Hungary already since 2004). The recently elected Estonian government keeps its previous promises to balance its budget finances by 2013. With regards to the other two Euro area countries, Slovenia's plan for keeping budget deficit under the reference value proceeds at a slower rate, but the Stability Programme consolidation plan for 2010 has been kept and remains realistic also on its way for 2013 with deficit below 2% of GDP. On the other side Slovakia overshot the planned 2010 deficit of 6.3% of GDP by one and half percentage points. However cuts of expenditures adopted by the new elected government (June 2010), planned reforms of tax payroll system or increasing tax revenues are promising the right direction for getting the deficit under the target value of 3% by 2013. The public debt in Slovakia is reaching already the levels above 40 % of GDP (from 27% in 2008), while Slovenia is heading towards it (from above 30% in 2008).

Outside the Euro area, Bulgaria jumped quickly out of the excessive deficit procedure in 2010. After having reached 4% of GDP in 2010, the deficit is again heading below 3% by the end of this year. The public debt remains still relatively low (15% of GDP). The Baltic states of Latvia and Lithuania struggle to keep their budget under the reference value by 2012. Latvia did manage even to outdo the plan for 2010 by 1 percentage point, while Lithuania holds the schedule. In Czech Republic the expenditure cuts of new government were also successfully applied and improved the planned numbers by few percentage points. Romania had problems to keep the 2010 budget deficit in line with plans and its aim for 2012 is regarded now risky also by the IMF and the EU, while the government debt ratio hiked to 30% of GDP (from above 10% in 2008). Hungary did successfully hit the Stability Programme aim of 2010, but the scheduled fiscal consolidation measures remain under critique of international institutions (e.g. nationalization of pension funds). Poland's goals set for lowering the budget deficit to 2.9% of GDP by 2012 seem to be too ambitious. The forthcoming elections are holding up the government from more courageous cuts, which would interfere with potential voter's preferences. Public debts are still on the rise in all countries mainly driven by high fiscal deficits. The highest public debt ratio is found in Hungary (80%). In Poland it is over 50% (near the mandatory cuts ratio), and in many countries it increases towards 40% (Czech Republic, Latvia and Lithuania).

### *Fiscal pressures delay euro adoption*

Although the convergence criteria for Euro adoption proved to be of high motivation for maintaining fiscal budgets under control, none of the NMS outside Euro area looks like being ready to adopt the single currency before 2015. Lithuania seems to be the most realistic candidate. Still, the main problem remains the long-term sustainability of public finances. Structural reforms are needed, defining more specific measures according to the Stability Programme and also diverting negative effects of demographic ageing, which is expected to be the main obstacle to attain sustainable public finances in the NMS.

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# EUREN Inside

## New publications from EUREN institutes

### COE-Rexecode

#### A comparative study of competitiveness in France and in Germany

In the last decade, Germany overtook France in terms of external market shares and competitiveness. In a study prepared for the Ministry of Industry, a detailed analysis of factors having led to this growth differential is made. The report is downloadable (in French) under the following address:

http://www.coe-rexecode.fr/public/Analyses-et-previsions/Etudes

To order the book (in French), please follow this link:

http://www.coe-rexecode.fr/public/Analyses-et-previsions/A-noter

### RWI

#### Information or Institution? – On the Determinants of Forecast Accuracy
by Roland Döhrn and Christoph M. Schmidt

The accuracy of macroeconomic forecast depends on various factors, most importantly the mix of analytical methods used by the individual forecasters, the way that their personal experience is shaping their identification strategies, but also their efficiency in translating new information into revised forecasts. In this paper we use a broad sample of forecasts of German GDP and its components to analyze the impact of institutions and information on forecast accuracy. We find that forecast errors are a linear function of the forecast horizon. This result is robust over a variety of different specifications. As better information seems to be the key to achieving better forecasts, approaches for acquiring reliable information early seem to be a good investment. By contrast, the institutional factors tend to be small and statistically insignificant. It has to remain open, whether this is the consequence of the efficiency-enhancing competition among German research institutions or rather the reflection of an abundance of forecast suppliers.

http://www.rwi-essen.de/publikationen/ruhr-economic-papers/302/

Impressum

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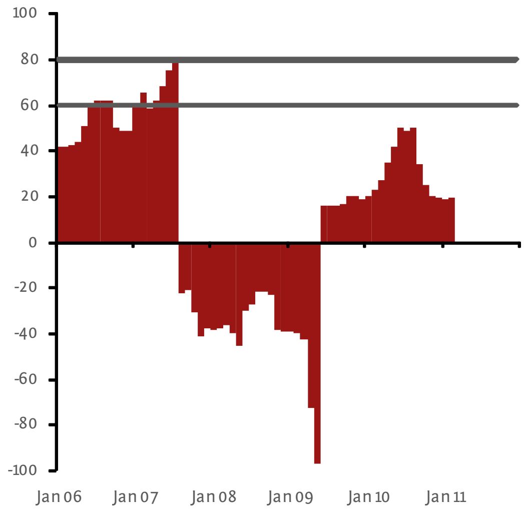
## COE-Rexecode Leading Indicator for the Euro area

The Coe-Rexecode leading indicator is looking for the next peak of the Euro area growth cycle. It must overpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent economic downturn. During the year 2010, the indicator rose from 20.4 in January to a maximum of 50.1 in August in relation with growing uncertainty regarding the perennity of the American rebound and about the financial risk of peripheral European countries. Since then, however, the indicator receded to 19.8 in February 2011, well below the first threshold. There is therefore no risk of future economic slowdown. Meanwhile, the underlying instantaneous growth, at an annual rate, as measured by the Coe-Rexecode indicator was estimated at 2.8 % in February 2011, well above the annualized growth of 1.2 % estimated by Eurostat for the last quarter of 2010.

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## Forecast of the EUREN/CEPREDE High Frequency Model

*Last update: Apr 8th, 2011*

| | 09 Q3 | 09 Q4 | 10 Q1 | 10 Q2 | 10 Q3 | 10 Q4 | 11 Q1 | 11 Q2 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Jan 10 | [-4.0;0.4] | -2.1;0.0 | 0.4;0.0 | 0.8;0.3 | | | | | -3.1 | 1.1 | |
| Feb 10 | [-4.0;0.4] | [-2.1;0.1] | 0.0;-0.2 | -0.2;-0.9 | | | | | -2.7 | 1.1 | |
| Mar 10 | [-4.0;0.4] | [-2.1;0.1] | 0.0;0.2 | -0.1;-0.8 | -0.3;0.2 | -0.1;0.2 | | | -3.3 | 1.4 | |
| Apr-10 | [-4.0;0.4] | [-2.1;0.1] | 0.2;0.2 | 0.5;-0.2 | 0.6;0.4 | 0.9;0.4 | | | -3.3 | 1.4 | |
| May-10 | [-4.0;0.4] | [-2.1;0.1] | [0.6;0.2] | 1.3;0.6 | 1.5;0.6 | 1.9;0.5 | | | -3.4 | 1.4 | |
| Jun-10 | [-4.0;0.4] | [-2.1;0.1] | [0.6;0.2] | 1.5;0.8 | 2.0;0.9 | 2.6;0.7 | | | -3.9 | 0.8 | |
| Jul-10 | [-4.0;0.4] | [-2.1;0.1] | [0.6;0.2] | 1.6;0.9 | 1.9;0.6 | 2.3;0.5 | | | -4.0 | -0.3 | |
| Sep-10 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | 2.1;0.6 | 2.7;0.8 | | | [-4.0] | -0.1 | |
| Oct-10 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | 2.2;0.1 | 3.0;1.0 | 2.9;0.2 | 2.2;0.3 | [-4.0] | 0.5 | 2.1 |
| Nov-10 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.4] | 2.8;0.9 | 2.6;0.1 | 1.9;0.3 | [-4.0] | 1.3 | 1.9 |
| Dec-10 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.4] | 2.6;0.7 | 2.3;0.1 | 1.6;0.3 | [-4.0] | 1.7 | 1.6 |
| Jan-11 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.5] | 2.0;0.1 | 1.5;-0.1 | 0.9;0.4 | [-4.0] | 1.7 | 0.8 |
| Feb-11 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.5] | [2.0;0.1] | 1.5;-0.1 | 0.9;0.4 | [-4.0] | 1.7 | 0.9 |
| Mar-11 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.5] | [2.0;0.1] | 1.5;-0.1 | 0.9;0.4 | [-4.0] | 1.7 | 0.9 |
| Apr-11 | [-4.0;0.5] | [-2.0;0.2] | [0.7;0.3] | [1.9;1.0] | [2.1;0.5] | [2.0;0.1] | 1.5;-0.1 | 0.9;0.3 | [-4.0] | 1.7 | 0.9 |

*In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.*

Common components extracted from the set of indicators included in the model seem to anticipate some deceleration for the first quarter of 2011 that could prevail until the end of the year. Nevertheless, confidence indicators show an almost unchanged recovery path compared to mid 2009, and the levels of those indicators for Germany or France are above the highest levels observed since mid nineties.

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