EUREN-News

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Editorial: Are fiscal consolidation and economic growth compatible?

The Spanish economy, like many others in the Euro area, is facing a fiscal consolidation process, combined with weak economic growth, which may end up causing a significant reduction in GDP growth rates or even a contraction of GDP in the short term. In fact, expectations for growth in Spain have deteriorated significantly in recent months leading to increasing uncertainty about the sustainability of Spanish debt.

The ultimate effect of this reduction is uncertain, and empirical evidence tells us that the circumstances in which this consolidation is implemented may significantly alter the final effect on economic growth.

The analysis of past episodes of fiscal consolidation shows that there are, at least, three factors that can offset the harmful effects of fiscal consolidation on growth: the reduction in prices, although not in the volume of the activity of the public sector, lower purchases of imported products and, finally, the partial compensation of public spending by private spending.

In 150 cases of deficit reduction by more than 1% of GDP identified in the past, an average reduction of the deficit of around 2.5% of GDP resulted on average in a slightly positive effect on the real GDP growth rate, jointly with an average reduction of inflation rates by around 0.6 points and increased financing needs of the private sector similar to the observed reduction in the public sector.

These results are consistent regardless of the circumstances in which they occurred in terms of membership of a monetary union, and whether they occurred during periods of growth above or under potential. They are also valid whatever the stages of business cycle (acceleration or deceleration), and even with GDP growth below 1%.

Only in the 19 cases in which the reduction of public deficit exceeded 4% of GDP a slightly negative effect on growth rates of real GDP can be observed.

By statistical analysis of the effects seen in all EU-27 countries from the 1980s to the present we can draw that it has been possible to address these processes to reduce the public deficit without having caused serious damage on the real GDP growth rate. It would be useful to identify the conditions that allow the compensation of the harmful effects of these adjustments, and therefore finding the best way to tackle these settings with the least damage on the real activity.

The first two of the three aforementioned compensating effects can be generated almost automatically by reducing public spending and its effect on containment of domestic demand. Concerning the substitution of public by private spending, the higher savings of the public sector must be offset by lower private savings, keeping the overall levels of consumption and investment almost unchanged. In other words, reduced needs of public sector funding should be offset by an increase of those of the private sector. However, to produce this substitution effect, on the one hand, private agents must perceive favourable expectations to compensate the restraint in public spending with its own consumption and investment, and, on the other hand, these agents must have in perspective an increase of their funding needs, either by reducing their financial assets, or by an increase in their liabilities (credit to the private sector).

Unfortunately, at present, the credit crunch and deteriorating expectations are not the most suitable circumstances to facilitate this substitution and it does not seem that this compensation will have a significant effect in the current economic climate.

Contact Julián Pérez||julian.perez@ceprede.es

UK: Chancellor puts reform of the tax system at the top of the Budget agenda

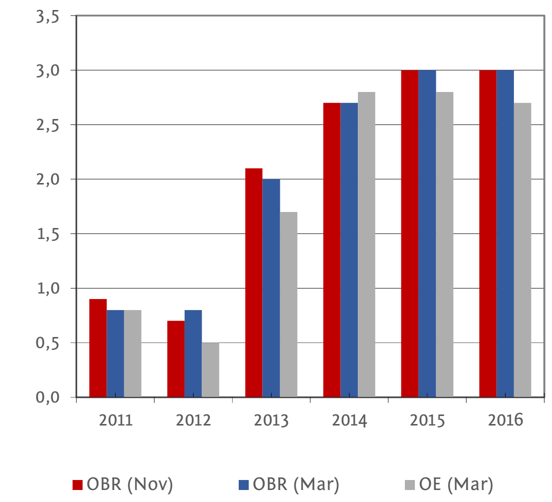
The 2012 Budget came two years into what is now a seven year austerity programme. The Government has made reasonably good progress to date, reducing borrowing from £155.8bn (11.1% of GDP) in 2009-10 to £135.8bn (9.3% of GDP) in 2010-11, and, with one month of data still to be published, it appears that further steady progress was made in 2011-12. Indeed, prior to a poor set of figures for February, it had even looked as borrowing might come in much lower than the independent Office for Budget Responsibility (OBR) had forecast in November. Until January, PSNBX (Public Sector Net Borrowing excluding financial interventions) had been running £1.5bn a month lower than in 2010-11, but February's figure was £6.3bn higher than a year earlier. This turnaround appears to be a function of the pattern of departmental spending, which has been backloaded to a much greater extent than in previous years. In our view this is partly due to departments taking a very cautious view because they are wary of overspending in the current climate and is partly a function of there now being greater flexibility to carry forward underspends. As such, PSNBX looks likely to come in at around £126bn (8.3% of GDP) for 2011-12. This would represent further progress, but would still leave the Government with some distance to go to reach its ultimate goal of eliminating the structural deficit.

The OBR had caused a considerable headache for the Chancellor (Ministry of Finance) in November by making significant downgrades to its economic forecasts and upgrades to its projections for borrowing and, crucially, the size of the structural deficit. This had forced the Chancellor to announce additional cuts to current spending for 2015-16 and 2016-17 in his Autumn Statement in order for the OBR to be able to judge that the Government was still complying with its fiscal mandate. However, with borrowing falling in line with the November projections and the growth outlook little changed – a poorer than expected performance at the end of 2011 was offset by a stronger recovery in early 2012 – the OBR was able to present the Chancellor with a remarkably similar set of forecasts to before (see Graph 1). This meant that there was no pressure to tighten the policy stance by any further, but equally there was no leeway to offer any stimulus and, as such, the Chancellor

Graph 1

Forecasts for GDP growth

%



Source: Oxford Economics (OE), Office for Budget Responsibility (OBR) presented a package of measures which was fiscally neutral.

The Autumn Statement had seen the Chancellor announce a number of small-scale, low cost, microeconomic spending measures aimed at boosting the productive potential of the UK economy. The Budget represented a switch of emphasis, with the package of measures being largely concentrated on reforming the tax system, with a clear focus on business. Reducing the main rate of corporation tax has been a central plank of the Government's policy to date and the Chancellor announced a further 1 percentage point reduction here. This takes the main rate down to 24% – compared with 28% two years ago – with further reductions planned to take it to 22% by April 2014. There was also a reduction of the top rate of income tax from 50% to 45%. The top rate had been introduced by the previous government as a largely political measure and reducing it at a time when the UK is in the middle of a long and painful austerity programme represented somewhat of a gamble for the Chancellor. However, there was a wealth of anecdotal evidence that such a high rate was acting as a powerful disincentive for executives to do business in the UK, thus offsetting some of the benefits of a low corporate tax rate, while a study by HM Revenue & Customs showed that the top rate was yielding relatively little revenue.

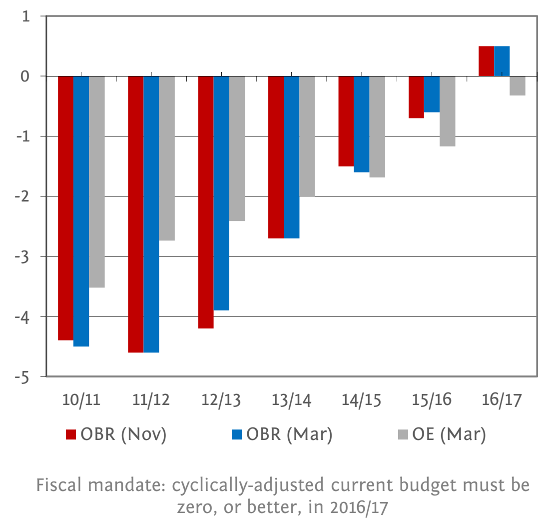
These measures form part of the Government's plan to create the "most competitive tax system in the G20" which, the Government hopes, will be sufficient to encourage business to play a greater role in the recovery. There is some logic behind this strategy; UK firms have built up their largest cash surpluses in thirty years, with large firms enjoying both healthy balance sheets and good access to credit at low cost, so business certainly has the resources to play a significant role. However, to date they have been reluctant to spend, either on investment or recruitment, citing uncertain growth prospects as the key constraint – the Government has been able to do little to ease those concerns and in trying to improve the general climate for business is clearly playing a long game.

Aside from corporates, the lower end of the income distribution were also beneficiaries in the Budget, with the income tax personal allowance set to rise by £1,100 to £9,205 in 2013-14. This would represent the third successive increase at a rate well above the rate of inflation and is aimed at achieving the increase to £10,000 by 2015 which is enshrined in the coalition agreement.

However, in order to pay for these tax cuts, there were tax rises elsewhere. Most controversial was a freeze in age-related income tax allowances. This was presented as a tax simplification measure but is set to raise more than £1bn a year for the Exchequer and played an important role in ensuring that the Budget was revenue neutral. A new stamp duty rate of 7% was introduced for properties sold for more than £2mn, along with a clampdown on various tax avoidance schemes, with both measures aimed at taking more tax revenues from higher earners to offset their gains from the reduction in the top rate of income tax.

Graph 2

Cyclically-adjusted current balance
% of GDP,



Source: Oxford Economics, Office for Budget Responsibility

Given the significant constraints that the austerity programme placed upon the Chancellor, this was a reasonably promising Budget and the pro-business measures should enhance the attractiveness of the UK as a place to do business. The progress made to date on the austerity plan is encouraging, although there remains a long road ahead – most of the retrenchment to date has come through higher taxation and around 90% of the planned current spending cuts are still to be made. Furthermore, we are concerned that the Chancellor may have to announce additional tightening further down the line, because the forecasts on which his plans are based look a touch optimistic. We think that the financial crisis has caused significant damage to potential output and, therefore, argue that the recovery is likely to be weaker than that forecast by the OBR. Our weaker forecast for growth means that we think that borrowing is unlikely to fall as quickly, while our weaker forecast for potential output means that a greater share of the reduction in borrowing is cyclical in nature. Therefore, while the OBR continues to judge that the Chancellor is complying with his fiscal mandate, i.e. that there is a greater than 50% chance of achieving cyclically-adjusted current balance by the end of 2016-17, our forecast shows this target being narrowly missed, with the gap being around 0.3% of GDP (see Graph 2).

Contact: Andrew Goodwin // agoodwin@oxfordeconomics.com

EUREN Inside

The RWI/ISL Container-Throughput-Index: A new Indicator of international trade

The Container Throughput Index is a joint project of RWI with the Institute of Shipping Economics and Logistics (ISL). It aims at providing timely information on short-term trends in international trade. The index is based on the consideration that containers have become the most important means of transporting processed products. Therefore, the global container throughput and international trade can be expected to be highly correlated.

As a part of their monthly reporting many ports publish data on container throughput expressed in twenty foot equivalent units (TEU). ISL collects these data systematically in its port database. Currently, the database covers 72 ports providing time series of monthly figures which are long enough to be integrated into the indicator. In these ports about 60% of world container throughput is handled.

Calculating the indicator starts about 20 days after the end of each month. At that time about 25 ports have already publish information about the container throughput in the latest month, which allows a flash estimate of the indicator. Data still missing are forecast using statistical time series models. Thereafter, the data are added up and the sum is adjusted for seasonal and calendar effects. Furthermore, the trend-cycle component of the seasonally adjusted figures is estimated to eliminate irregular influences. One month later, as a rule data on about 60 ports are available. Then an update of the figures already published is made and a new flash estimate for the latest month is released.

Hitherto, the RWI/ISL-Container Throughput Index shows a close correlation with world trade. The index provides valuable input into business cycle analyses, since it is available 3 to 4 months in advance of data on world trade published by international organisations, and 1 month in advance of the first estimates of world trade volumes.

The monthly press release in English and the data can be found on the RWI webpage:

http://en.rwi-essen.de/forschung-und-beratung/wachstum-und-konjunktur/projekte/containerumschlagindex/

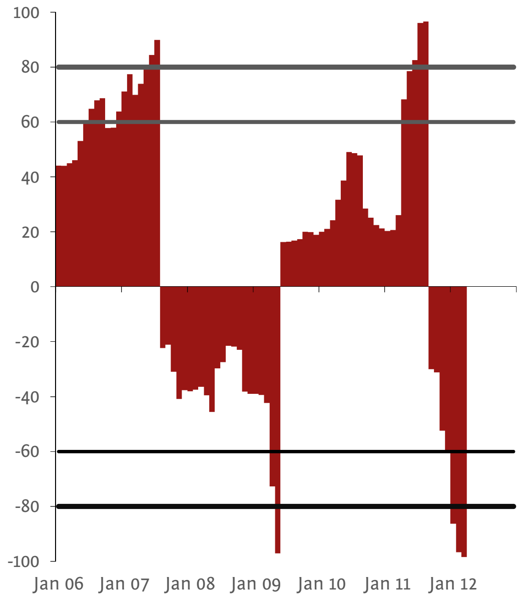
Impressum

The European Economic Network (EUREN) is a network of European economic research institutes, which was formed in 1999. Members of EUREN are:

- Centre d'Observation Economique et Recherche pour l'Expansion de l'Economie et le Developpement des Entreprises (Coe-Rexecode), Paris, France
- Centre of Planning and Economic Research (KEPE), Athens, Greece
- Centro de Predicción Económica (CEPREDE), Madrid, Spain
- Institut für Höhere Studien (IHS), Vienna, Austria
- Institute of Informatics and Statistics (INFOSTAT), Bratislava, Slovakia.
- Kopint-Tarki Economic Research Institute (Kopint-Tarki), Budapest, Hungary
- Oxford Economics, Oxford, United Kingdom
- Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI Essen), Essen, Germany
- Ref Ricerche, Milan, Italy

Coe-Rexecode Leading Indicator for the Euro area: Exit of the recession any soon?

According to the start-end recession indicator (IESR), the slowdown anticipated by the Coe-Rexecode leading indicator IARC already in June 2011 turned into a recession at the end of 2011. However, this signal was given in real time in early March 2012 because one series entering the indicator was substantially revised upwards: the unemployment rate. With this revision and new negative data on car sales, the IESR is exceeding the 0.5 signalling threshold since November 2011 (computed in January). This was confirmed by the underlying instantaneous growth rate which turned negative in September 2011. The uncertainty about future developments is quite high. On one hand, the recession indicator is clearly showing a downward movement. But the latest data are from February and it is known as lagging. On the other hand, IARC has dropped from -60.5 in December 2011 to -86.3 in January 2012, crossing the -80 threshold, which indicates with a strong probability an upturn in the following three months. In February and March, the indicator reached -96.7 and -98.4. This means the Euro area growth rate could return to its annualised trend growth estimated at 1.2 % in the second quarter of 2012. The underlying instantaneous growth rate also turned positive recently to 0.6 % at an annual rate in March.



Contact: Jacques Anas // janas@coe-rexecode.fr

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: April 10th, 2012

	11 Q1	11 Q2	11 Q3	11 Q4	12 Q1	12 Q2	12-Q3	12_Q4	2011	2012
Nov-10	2.6;0.1	1.9;0.3							1.9	
Dec-10	2.3;0.1	1.6;0.3							1.6	
Jan-11	1.5;-0.1	0.9;0.4							0.5	
Feb-11	1.5;-0.1	0.9;0.4							0.9	
Mar-11	1.5; -0.1	0.9;0.4	0.5;0.2	0.6;0.1					0.9	
Apr-11	1.5; -0.1	0.9;0.3	0.5;0.2	0.6;0.2					0.9	
May-11	**[2.5;0.8]**	2.1;0.5	1.8;0.3	2.0;0.2					2.1	
Jun 11	**[2.5;0.8]**	2.1;0.6	1.8;0.3	2.0;0.2					2.1	
Jul-11	**[2.5;0.8]**	2.0;0.5	1.6;0.2	1.7;0.2					2.0	
Sep-11	**[2.5;0.8]**	**[1.7;0.3]**	1.6;-0.2	1.7;0.4					1.6	
Okt 11	**[2.5;0.8]**	**[1.7;0.3]**	1.2;-0.1	1.4;0.5	1.7;1.2	1.8;0.2	1.7;-0.3	1.6;0.4	1.7	1.7
Nov-11	**[2.5;0.8]**	**[1.7;0.3]**	**[1.4;0.1]**	1.0;0.2	1.4;1.1	1.3;0.2	1.3;-0.4	1.4;0.3	1.5	1.3
Dec 11	**[2.5;0.8]**	**[1.7;0.3]**	**[1.4;0.1]**	0.7;-0.4	0.6;0.7	0.6;0.2	1.2;0.7	1.9;0.3	1.5	1.1
Jan 12	**[2.5;0.8]**	**[1.7;0.3]**	**[1.4;0.1]**	0.6;-0.4	0.3;0.5	0.4;0.2	1.1;0.8	1.9;0.4	1.5	0.9
Feb 12	**[2.4;0.8]**	**[1.7;0.3]**	**[1.4;0.1]**	**[0.7;-0.4]**	0.0;0.2	0.0;0.1	0.8;1.0	1.8;0.5	[1.5]	0.7
Mar 12	**[2.4;0.8]**	**[1.7;0.3]**	**[1.4;0.1]**	**[0.7;-0.4]**	0.2;0.3	-0.3;-0.4	-0.5;0.0	-0.2;-0,1	[1.5]	-0.3

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

Even though some of the soft indicators for expectations send out some positive signals in the first months of this year, it is still too soon to talk about a real recovery in the GDP growth path. In fact, most of the hard indicators like industrial production, steel production, car registrations or exports have started the year with even lower rates than those registered at the end of 2011.

Contact: Julián Pérez // julian.perez@uam.es