European Economic Network EUREN

EUREN-News

3|2012
11|6|2012

Editorial: Channels of European debt crisis contagion, lingering risks and inherent challenges

The persisting and alarmingly deepening European sovereign debt crisis featured at the top of the agenda during the most recent G8 summit. Strains and pressures are intensifying worldwide against the backdrop of culminating unrest over the future of the Eurozone and the potential severe effects of crisis contagion both inside and outside Europe. Market sentiment is yet far from easing, following the failure of Greek parties to agree upon a coalition government after the early May election and the scheduling of new elections to be held on 17 June 2012. The underlying prolonged period of uncertainty and the stalling of an awaited stabilisation now threaten to accentuate crisis propagation mechanisms through reinforcing the features of shocks transmission and excessive responses. With agents having become increasingly risk averse over the course of the ongoing crisis, country linkages and market interactions operate as channels for wider and quicker spreading of instability on the basis of both existing idiosyncratic imbalances and systemic weaknesses.

The considerable risk of a more pronounced contagion, triggered by the current debt crisis, lies in its two intrinsic dimensions. The first dimension pertains to the direct interconnections which characterize the Euro area economies, through which a serious shock in one country is transmitted to countries with similar vulnerabilities. The transmission is driven by further loss of confidence and a changed perception about the sustainability of already existing, but until then 'tolerated' imbalances. The second dimension mirrors the predominant interdependence across financial markets within the Eurozone but also worldwide and unfolds in two levels. In the first level, a sovereign distress in one country spreads to the financial sector of otherwise 'balanced' economies due to direct exposure to the problematic country's debt. In the second level, economies and markets that are not necessarily directly linked to the shock country are affected via their dependence on the exposed intermediate financial market. This mechanism is driven by the high susceptibility of the financial system to shocks' transmission and the built-in risk of widespread waves of losses. The working of this dimension of contagion is well exemplified by the structure and functioning of the banking system, through which stress in banks exposed to European sovereign debt is transmitted to other financial markets and economies, on the basis of deteriorating financing conditions and rising financing costs.

The lingering concern about extensive crisis contagion is now further reinforced on the back of revived speculations and discussions upon a potential Greek exit from the Eurozone. Greece leaving the Euro would practically imply the failure of the common European currency, as it stands; it could, hence, not be interpreted by market participants as a successful development in the direction of confronting internal imbalances and systemic risk and shielding the existing common currency construction from shocks. The anticipation could arise that the solution against severe disorders can any time be that a 'problem' member will exit the common currency. This would hardly enhance confidence in the resilience and stability of the European monetary union and could create additional unrest with potential adverse effects that would not only weigh heavily on exchange rates, stock markets and the banking system, but also take their toll on economic growth.

The inherent challenge the Eurozone faces lies in dynamically intervening to weather the crisis and to mitigate the contagion risks, especially in the absence of fiscal federalism and political union. Clearly, the proper response to the distress that has prevailed is to directly confront the weaknesses and imbalances, which lie at the roots of crisis emergence and transmission. The fundamental task is to tackle fiscal disorders through strict implementation of fiscal consolidation programmes, within a rational framework that provides a fair balance between austerity and growth. Most importantly, however, the challenge lies in undertaking actions collectively and in a coordinated manner, through targeted and decisive policies addressing the vulnerabilities underlying the monetary union and the dysfunctions characterizing the global financial system. In this respect and with regard to prospective measures to be implemented in order to deal with financial imperfections, the degree of integration should be given serious consideration. Adaptive operations such as the European banks' restructuring and deleveraging process, for example, should progress in an orderly and coordinated manner in order not to end up in a liquidity withdrawal in interdependent markets, with a credit crunch as a probable outcome. This would again undermine financial stability worldwide, through reactivating crisis transmission channels and revitalizing the vicious circle of shock transmission.

The current fragile situation and the associated ominous prospects must not be considered as a deadlock, but as an opportunity for a more active involvement and stronger policy reinforcement. Action by determined governments and resolute financial authorities can trigger a sequence of positive reactions starting with the strengthening of credibility and the restoration of confidence, a first step to break the chain of crisis contagion.

Ekaterini Tsouma//etsouma@kepe.gr

Slowdown in New Member States

Growth will remain moderate

Negative impact of slowdown in Euro area

The upswing that the New Member States (NMS) experienced after the 2009 recession came to a halt in mid-2011. In the second half of 2011 growth moderated significantly, consistent with the development in the Euro area. Though, unlike the Euro area the quarterly GDP growth rates in the NMS were still positive on average (0.5%) by the end of 2011. Growth, however, was only borne by half of the NMS, in particular by Latvia, Poland and Slovakia. On the contrary, signals of recession were recorded in Slovenia and the Czech Republic (Table 1).

Nevertheless, the 2011 annual average was positive in all NMS, in the region as a whole GDP increased by 3.2%. As we already expected in our forecast last year, the highest rates were recorded in the Baltic countries: especially Estonia showed an outstanding rate of 7.6%. Strong growth is also registered in Poland and Slovakia.

Table 1

GDP growth in New Member States

in %

	Quarter on quarter			Year over year		
	2011 Q3	2011 Q4	2012 Q1	2011 Q3	2011 Q4	2012 Q1
Bulgaria	0,2	0,3	:	1,6	1,6	:
Czech Rep.	-0,1	-0,1	:	1,3	0,6	:
Estonia	0,9	-0,2	:	8,0	5,1	:
Hungary	1,5	1,1	:	1,4	1,2	-1,5
Latvia	1,2	0,8	0,8	5,9	5,9	:
Lithuania	-0,1	0,0	-1,3	6,7	5,2	4,4
Poland	0,9	1,0	0,8	4,0	4,2	3,8
Romania	1,1	-0,2	:	3,4	2,2	:
Slovakia	0,7	0,8	0,8	3,2	3,3	3,2
Slovenia	-0,3	-0,6	0,2	-0,2	-1,5	-0,8

Source: Eurostat

Last year the structure of growth changed. Nevertheless, in most NMS net exports were still the main factor (growing strongly especially in Slovak and Czech Republic). However, the increase was a result of moderating imports rather than of a stronger expansion of exports. The recovery of investment continued, with growth accelerating to 5.6% in the region as a whole in the last quarter of 2011. Consumption, on the other hand, contributed little to growth. It was strong only in the Baltic countries and Poland, the leading position belonging to Lithuania (6.4% by the end of 2011).

The first results for 2012 indicate a further moderation. Thus, we expect that the deceleration of growth in the region will get stronger in 2012 than we forecasted in the previous year. The main reason seems to be that the development in the Euro area remains subdue. The fiscal consolidation throughout the European countries can be expected to put an additional drag on growth (increased taxation). The more negative outlook is supported by the recent sentiment indicators which mostly were showed a downward trend (Table 2).

Table 2

Economic sentiment in NMS

monthly seasonal adjusted indicators

2012	Jan	Feb	Mar	Apr	May
Bulgaria	96,5	93,6	96,9	95,5	95,7
Czech Rep.	89,5	91,0	91,2	89,1	87,1
Estonia	101,4	102,0	103,8	102,8	101,9
Hungary	83,4	87,4	92,8	92,2	85,4
Latvia	105,3	105,7	103,8	102,8	102,3
Lithuania	100,5	100,4	99,8	100,3	99,9
Poland	91,2	92,9	95,1	92,8	92,0
Romania	94,3	95,6	94,5	95,7	97,9
Slovakia	95,6	93,0	97,9	98,9	97,4
Slovenia	92,9	91,2	92,2	85,8	85,2

Source: Eurostat

On a regional average, GDP growth in 2012 is supposed to reach 1.6%, slightly improving to 2.2% in 2013. The expected slowdown in the Euro area will affect the region via both trade and financial channels. On the one hand exports will continue to slow down and on the other hand the bank-related capital outflows are expected to persist. The deceleration will be most pronounced in Slovenia (where the recession has already begun in the middle of 2011). Hungary will probably pass through a mild recession this year, too. It experienced a pronounced deceleration in exports at the beginning of this year and its consumption and investments have not been growing already for a longer period. In 2012 and 2013 the highest growth rates are still expected in the Baltic countries (though there are signals of declining exports, too). A moderate growth could be kept in Poland and Slovakia, mostly due to net exports, though the fiscal consolidation could slightly dampen the expansion in Slovakia. In Romania and Bulgaria exports are significantly affected by the weakening demand from the Euro area, thus they are forecasted also to grow at slower rates.

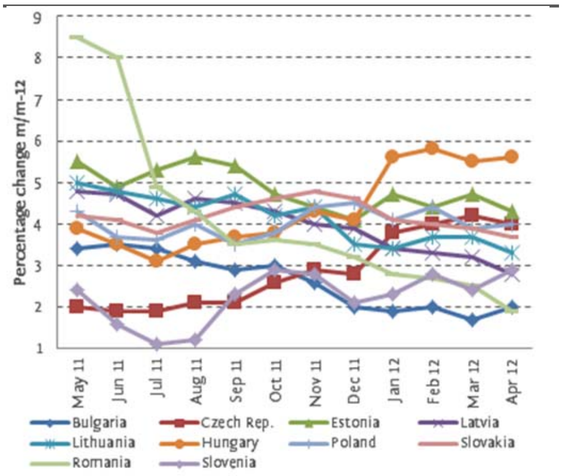
Creeping consumer inflation over the region

As shown in Graph 1 consumer prices reflect rather diverging trends. Common features are that the source of price increase is mainly exogenous, because weak domestic demand keeps inflationary pressure low. In some of the countries of the region administrative measures (like tax adjustments) generate price increases. International energy price increases infiltrate into the price index in a short time and cause two digits growth in the prices of energy carriers.

With the exception of Hungary, Romania and Slovenia, consumer prices increased remarkably strongly in 2011. During the first months of 2012, due to rising energy prices and in some cases to administrative measures inflationary pressure seems to continue. In April 2012, the highest inflation in the region was registered in Hungary (5.6%), in the Czech Republic (4.0%) and Poland (4%). In Hungary, the annual rate is set to increase to 5.8% in 2012 from last year's 3.9%, although the hike is largely due to one-off factors: the increase in excise taxes in late 2011 and in the VAT, which was raised from 25% to 27% in this year. In the case of the Czech Republic the effect of rising oil and food prices was amplified by the depreciation of the Czech koruna in the last quarter of 2011. Furthermore, the rise of the VAT rate contributed to the inflationary pressure. As another VAT increase has already been announced, inflation may rise further during the year. In Poland inflation is fuelled above all by the depreciation of the zloty which leads to rising import prices. Due to sluggish domestic demand and stagnating real wages internal inflationary pressure will ease. In Romania consumer prices show a remarkable moderation, but the disinflation process will not continue since the higher world market prices for oil, food etc. will be passed through increasingly.

Graph 1

HICP rates in the New Member States



Source: Eurostat

Among the NMS Euro area members, inflation was quite high in Estonia (4.3%), which was due to short-term consequences of the introduction of the euro; therefore fluctuating price levels (due to the statistical base-effect) can be expected in this and the next year, however the amplitude will be decreasing. In the case of Slovakia (4.2%), rising energy and commodity prices as well as the adjustment of the VAT rate led to strong price increases last year, however these impacts may ease in 2012. In Slovenia inflation remains moderate; this is partly the consequence of sluggish domestic demand.

Monetary policy in Eastern Europe is to a large extent influenced by international trends and global financial market developments. Although the exogenous price shocks are the same for all countries, some central banks were confronted with considerable exchange rate fluctuations which reflect the lack of confidence and growing risk aversion of financial market participants. The effects of these factors are hard to be handled, especially when fiscal austerity measures are also constraining economic growth. Depending on the level of inflation and the rating of the countries according to their indebtedness, the central bank base rates show large differences. The highest rates among non-Euro area NMS are recorded in Hungary and Romania. Here the central banks have limited room to cut the base rate as markets react very sensitive to any measures easing monetary restrictions. In Poland the central bank used to react strongly to inflationary pressure, so if international price tendencies and the devaluation of the zloty will continue in the medium term, the central bank may increase interest rates. The Czech monetary policy currently supports growth by low rates, but monetary policy may start to become more restrictive in the course of the year as a reaction to the price shock. A moderately higher interest rate would not jeopardize financial stability (government bond rates, CDS coupons, CZK rates against EUR and USD etc.) and the growth outlook, but it would help to contain inflation which could stimulate the economy in the short run.

Restrictive fiscal policies and austerity measures will hinder to resume a sustainable growth path in most countries in the region. Thus due to sluggish private and government final consumption there will be moderate demand driven inflationary pressure, and hence there should be no reason for central banks to raise interest rates.

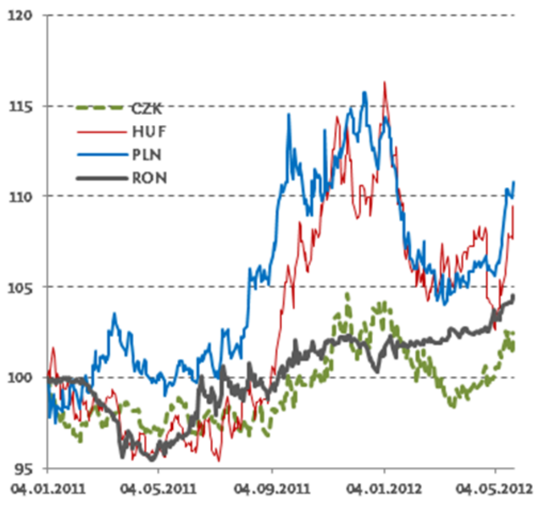
New equilibrium exchange rates against the euro

The exchange rate movements of the NMS currencies were determined primarily by country specific factors and less by regional tendencies. However, the loss of confidence and rising risk aversion of financial investors in response to the Greek crisis fostered depreciation pressures. Best performing was the Czech koruna, which remained – with some fluctuations – relatively stable against the euro (Graph 2). On the contrary, the Hungarian forint and the Polish zloty depreciated sharply, over a short period in late 2011 the latter even stronger than the first. Both currencies lost 6-7% against the euro in the first quarter of this year. In the case of Hungary uncertainty about the new IMF agreement will continue to cause exchange rate fluctuations until the agreement is signed.

Graph 2

NMS exchange rates against the Euro

Jan 4th 2011 = 100



Source: ECB

Taken as a whole, all major NMS currencies significantly weakened against the euro during last year. At the time being, we do not see any signs that this process will be reverted. In the case of the currencies mentioned above, it is most likely that volatility will remain high. Other non-Euro NMSs have pegged their currencies to the euro.

High unemployment in most of the countries

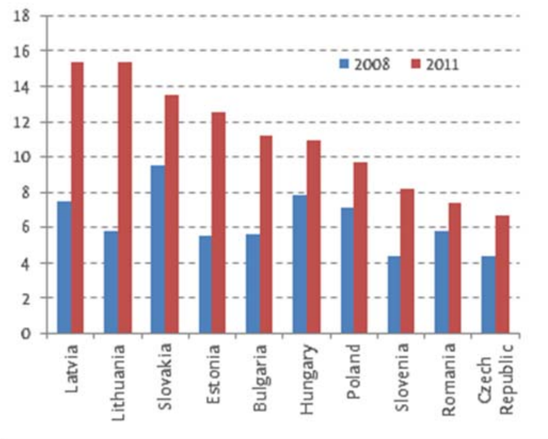
Since the beginning of the crisis unemployment rates have substantially increased in all NMS and the heterogeneity of the countries' performance became more marked (Graph 3).

Taken as a whole, macroeconomic conditions have worsened in all countries. Not only the net inflow but also the stock of FDI, which is an important driver of job creation, shrunk substantially since 2007. Fiscal austerity measures with moderate, in some cases decreasing government consumption expenditures, a less vigorous development in the private sector, and gloomy export outlooks have also consequences for the labour markets.

Graph 3

Unemployment rates

2011 compared to 2008, in %



Source: Eurostat

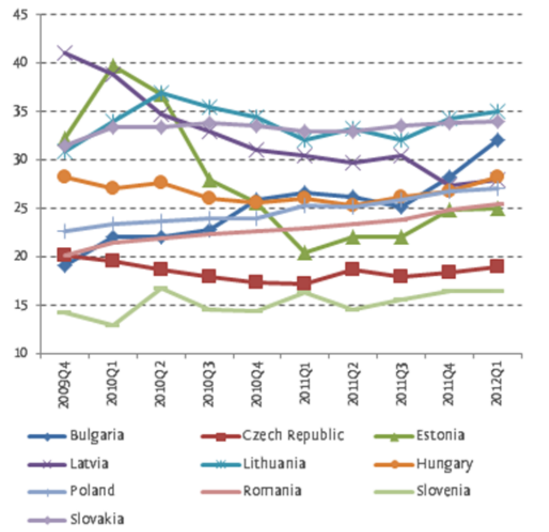
Unemployment is still extremely high in the Baltic States and in Slovakia, although growth was above the regional average in these countries, so that they were able to counterbalance the losses suffered in 2009 quite quickly. In Hungary unemployment is much higher than it used to be, and the newly introduced active labour market measures (like public work) will not be sufficient to ease the situation in the short run. The Czech labour market performs quite well; however it is greatly influenced by the export performance of the country which is the major determinant of growth. Due to sluggish exports the unemployment rate is expected to rise above 7% this year and stay at this level next year as well.

In Romania the relatively favourable unemployment rate hides the problem of a low employment ratio (58.5%, 2011), high inactivity and stubbornly high unemployment of young people, which are often not filed as unemployed.

In the two Baltic States, which show the highest unemployment rates, skill mismatches and high long-term unemployment are the biggest challenges. In Slovakia and in Estonia macroeconomic conditions explain the labour market situation. In Poland, the country which resisted the consequences of the crisis best, the labour market is robust and the unemployment rate is still lower than it was before the crisis. In Slovenia job losses were the consequence of the crisis in the construction sector, whilst in Hungary most jobs were shed in the private sector.

Graph 4

Unemployment rate, age group less than 25 years



Source: Eurostat

Despite these differences, unemployment among young people is a common problem for all countries in the region. With the exception of the Czech Republic and Slovenia it is much higher than the EU27 or Euro Area average (graph 4).

Taken together, the Q1 data and the dimmed growth prospects suggest that no improvement in the labour market situation can be reckoned with for this year. GDP forecasts for the ten NMS for 2012 and 2013 indicate a growth between 1.5 and 2.5% and this will not be sufficient to alter the labour market situation. Thus the average unemployment rate in the region will remain around 10%. In most countries a reform of the pension system is on the agenda which will bring about an increase of the average pension age. With the availability of additional jobs being limited, this might push unemployment even higher.

Little effort for structural reforms in CEE

The budget deficits of most NMS declined in 2011, and this trend should continue in 2012, under the condition that there will be no major economic slowdown - another phenomenon beyond the control of national governments, also because the NMS economies are mostly linked to the major EU economies.

Fiscal consolidation efforts of the NMS seem to be stimulated mostly be pressure from financial markets. The EU institutions push national governments towards fiscal discipline by threatening to limit the access to funds (e.g. to Hungary, Poland or Lithuania) or imposing sanctions within the “Six-Pack”.

The measures taken are quite often unconventional and non-structural. Hungary’s endeavour to bring the deficit below 3% of GDP in 2011 has only been successful with the help of unsustainable one-off measures (nationalization of pension funds). Slovenia has got into difficulties as capital boosts into state-owned firms resulted in an incredible deterioration of the budget deficit plans (still over 6% in 2011, and problems at financial markets). In Slovakia the planned reforms of the tax payroll system have been cancelled due to the exchange of governments in early elections and replaced by a not so ambitious plan to improve the budget balance by a ½ ratio of expenditures/revenues. This approach brings risks of choking domestic consumption, investment and job growth – but nevertheless, raising taxes is the most popular instrument in most NMS, particularly after elections.

In some NMS drastic expenditure cuts became effective. Latvia managed to decrease its deficit from almost 10% of GDP in 2011 to 3.5% in 2012 (Latvia experienced a drop of real GDP of almost 20% between 2007 and 2010, the largest in the EU, even ahead of Greece). The deficit ratio of Romania fell from 9% in 2009 to 5.2% in 2011. Despite slower growth the government still sticks to the plan to push it below 3% in 2012, because it relies on IMF loans. In Lithuania the deficit has been above the 3% limit for five years now, and going below the threshold in this year is threatened by the deterioration of GDP growth.

On the edge of meeting the fiscal targets are Slovenia and Poland, where newly elected governments agreed to bring down the deficit to 3% in 2012. But this plan is jeopardized by slow EU growth. The Czech government has introduced spending cuts to stick to the original plan to get the deficit to 3.5% of GDP in 2012 and 2.9% in 2013.

Only Bulgaria and Estonia appear to have their budgets under control. Bulgaria is showing fiscal discipline to keep the goal for a balanced budget in 2013, with a planned 2012 deficit of 1.4% of GDP, after reaching 2.1% in 2011.

Estonia is the only NMS which is not in the Excessive Deficit Procedure, as it realised a budget surplus and a very low government debt in 2011 (6% of GDP). But the government aims at spurring domestic demand and will fall probably again into a small deficit, however, using own reserves, not relying on markets.

Keeping the budget deficit growth below the nominal GDP growth can be effective for lowering the government debt in the long run, but no one can rely now on future growth. Not pursuing the path of structural reforms can bring a loss of national governments' credibility in front of the financial markets, voters or EU institutions.

Table 3
Summary of forecasts

	GDP (yoy)		HIPC (yoy)		Unemployment rate	
%	2012	2013	2012	2013	2012	2013.
Bulgaria	0.5	1.9	3.0	3.0	11.5	12.5
Czech Rep.	0.0	1.5	3.3	2.0	7.2	7.2
Estonia	2.4	3.8	3.5	2.8	11.6	10.5
Hungary	-1.0	1.5	5.8	3.7	11.2	11.0
Latvia	3.5	3.6	2.7	2.5	14.8	13.2
Lithuania	2.8	3.5	2.9	2.8	15.5	15.0
Poland	2.7	2.6	3.8	2.8	9.8	9.6
Romania	2.2	2.9	3.0	3.5	7.9	8.0
Slovakia	2.2	2.0	3.4	2.7	13.5	13.5
Slovenia	-1.4	-1.1	2.1	2.0	8.5	8.8
NMS aver.	1.6	2.2	3.6	2.9	9.9	9.8

Contact:
Jana Juriová || juriova@infostat.sk
Katalin Nagy || katalin.nagy@kopint-tarki.hu
Peter Vakhal || peter.vakhal@kopint-tarki.hu
Miroslav Klúčik || klucik@infostat.sk

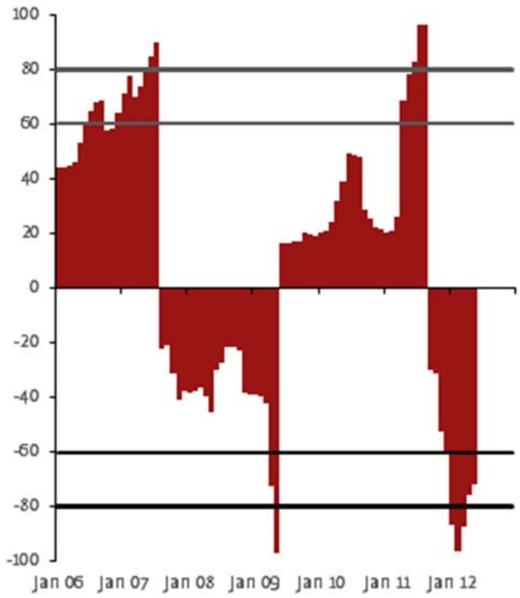
Impressum

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 from the recession delayed

In April and May 2012, the IARC indicator turned back above the -80 threshold, thus cancelling the previous signal of an economic rebound in the three coming months. This was mainly due to the quite unusual double-dip worsening of the industrial opinion survey in the euro area, the aggravated turmoil in the stock markets and the lower wholesale price expectations. The IARC indicator stands now at -72.1 in May and may possibly recede above -60 in June, which would mean no exit of the slowdown in the coming nine months. The uncertainty in the euro area has never been so high despite a global environment still supportive: lower international raw material prices, low interest rates and worldwide growth albeit at a reduced pace. The start-end recession indicator (IESR) is above the 0.5 threshold without however converging towards one because of the industrial production which has not yet turned globally into recession. The heterodox situation among the countries cyclical evolutions is entailing a confused characterization of the euro area aggregate. The underlying growth rate in May 2012 is 0.2 % at an annual rate. Finally, the zero growth of the first quarter gives an accurate summary of the current situation: economic stagnation.



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

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: May 31th, 2012

	11 Q1	11 Q2	11 Q3	11 Q4	12 Q1	12 Q2	12-Q3	12_Q4	2011	2012
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	
Oct 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]	-0.2
Apr 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	0.3;0.4	-0.2;-0.3	-0.3;0.0	0.1;0.0	[1.5]	0.0

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

The EUROSTAT flash estimate points to a lower GDP growth in the first quarter 2012 than forecasted by the HFM. While our estimate in April was a qoq rate of 0.4%, the Eurostat figure goes down to zero. Including the Eurostat figure into the model caused some downward revisions in our forecast. Looking at the forecasted trends for specific indicators makes us assume that the Euro area has not touched ground yet and may enter a technical recession in the next quarters. As a resume, our forecast now shows an annual average GDP rate of -0,4 for 2012 which is four tenths below the April estimate.

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