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Editorial: Rethinking European Integration

In retrospective, European integration often followed the same sequencing. It started with a step towards economic integration and the hope was that political integration will follow someday. This strategy did not cause many problems, as long as the political dimension of the integration was limited. However, in the early 1990s when the internal market was completed and the Monetary Union was set on the agenda, economic integration reached a new quality while political integration remained slow.

Thus, the integration became unbalanced. On the one hand, a single monetary policy was established when the monetary union started, and the EMU-members gave up the exchange rate as an adjustment instrument. On the other hand, fiscal integration consisted of a handful of rules which politicians considered to be not very binding and which they took accordingly not very serious. Most politicians believed they were as independent in their national policies has they had been before entering the monetary union.

For many years, these deficits did no harm to the economy. The countries which potentially had suffered most from the loss of the exchange rate as an adjustment instrument benefitted substantially from the decline in interest rates that followed the entering of the monetary union. The latter was something like a windfall profit which was used in quite different ways; in some countries it led to boom in housing investment, in others on private consumption. And often the governments benefited most because the costs of serving debt declined considerably.

If this analysis is right, the main challenge for the European Union is to restore its institutional setup. Some progress has already been made. The 'six-pack' was set in force and a general agreement was reached on the fiscal union. However, with a strong fiscal policy actor still missing, the ECB became the general purpose answer to all challenges arising: To stabilize production, the main refinancing rate was reduced to a historic low; to ensure the solvency of the banking system, a unlimited supply of liquidity was provided to banks; to reduce the refinancing costs of governments, at first the SMP and later the OMT program were launched; finally, also the responsibility for supervising European banks will according to the existing plans be given to the ECB.

For politicians this strategy might be attractive, As long as the ECB acts there is no need to go to the national parliaments and to ask them for additional financial resources to stabilize the Euro. But the strategy is also risky: The more the ECB is involved to more difficult is may be to exit from these policies when price stability is in danger.

Therefore new institutions are needed which take responsibilities from the ECB. However, progress will be difficult to achieve. Now a banking union is on the top of the agenda. With banks acting in the Euro area as a whole, and causing problems all over Europe when they fail, a European supervision body is necessary. But already the creation of such a body bears conflicts. Some want establish it as soon as possible since a banking union in their eyes is a prerequisite for using European money to restructure national banks. Others claim that such a union should be introduced stepwise not to set the wrong incentives. Some consider a European guarantee for deposits to be an absolutely necessary part of a banking union; others interpret it as a further step towards a transfer union that must be avoided.

Behind these different views often mask differences in the national preferences on policy styles. It would be too easy to say it is the conflict between centralism and federalism, because often those preferring a federal solution often call for a powerful European body to control the policies of the individual states. Whatever the division of responsibilities between the European and the national level will be: Europe has to rethink its integration strategy.

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Fiscal Policy in the European Union

In autumn the EUREN institutes traditionally present their outlook on public finances in their home countries. This is a good time for such a survey because the year is almost over and therefore the current situation become clearer. Moreover, many governments have presented their budget for the next year, which clarifies their plans for the next year.

The impression one gets of the tendencies in fiscal policy very much depends on the angle you look on it. Focussing on the change of the budget balance over time, it becomes evident what progress has been made in consolidation. In the Euro area budget deficit decreased from more than 6% relative to GDP to about 3%. At the moment it even looks like the outcome for 2012 might be even somewhat better than expected. Between summer and autumn the commission revised its forecast of the deficit in 2012 slightly downward: The projections from the EUREN institutes suggest that the result could be even somewhat better. At least in many countries the deficit forecast is below the commission's expectation, even if only slightly.

The progress in consolidation looks less impressing when focussing on the changes in

Table 1
Budget Balances in the EU: The European Commission's expectations

	Summer 2012				Autumn 2012			
	2010	2011	2012	2013	2010	2011	2012	2013
Euro Area	-6,2	-4,1	-3,2	-2,9	-6,2	-4,1	-3,0	-3,4
Austria	-4,5	-2,6	-3,0	-1,9	-4,5	-2,5	-3,2	-2,7
Belgium	-3,9	-3,9	-3,1	-3,3	-3,8	-3,7	-3,0	-3,4
France	-7,1	-5,2	-4,5	-4,2	-7,1	-5,2	-4,5	-3,5
Finland	-2,8	-0,9	-1,0	-0,6	-2,5	-0,6	-1,8	-1,2
Germany	-4,3	-1,0	-0,9	-0,7	-4,1	-0,8	-0,2	0,0
Greece	-10,5	-9,2	-7,3	-8,4	-10,7	-9,4	-6,8	-5,5
Ireland	-31,2	-13,0	-8,3	-7,5	-30,9	-13,4	-8,4	-7,5
Italy	-4,5	-3,8	-1,9	-1,0	-4,5	-3,9	-2,9	-2,1
Netherlands	-5,0	-4,6	-4,4	-4,6	-5,1	-4,5	-3,7	-2,9
Portugal	-9,8	-4,2	-4,7	-3,1	-9,8	-4,4	-5,0	-4,5
Spain	-9,3	-8,5	-6,4	-6,3	-9,7	-9,4	-8,0	-6,0
Slovakia	-7,7	-4,8	-4,8	-5,1	-7,7	-4,9	-4,9	-3,2
Slovenia	-6,0	-6,4	-4,3	-3,8	-5,7	-6,4	-4,4	-3,9
Hungary	-4,3	4,2	-2,6	-3,0	-4,4	4,3	-2,5	-2,9
Poland	-7,9	-5,1	-3,0	-2,5	-7,9	-5,0	-3,4	-3,1
Sweden	-0,1	0,1	-0,5	-0,1	0,3	0,4	0,0	-0,3
United Kingdom	-10,2	-8,3	-8,0	-6,9	-10,2	-7,8	-6,2	-7,2
EU	-6,5	-4,5	-3,8	-3,4	-6,5	-4,4	-3,6	-3,2

Source: European Commissiom, Public Finances in the EU 2012; European Econom,ic Forecast Autumn 2012.

the forecast for 2013. Compared to summer, the EC revised its forecast for the Euro area to the negative side. But taking into account the latest projections of the EUREN institutes, the outlook again looks somewhat brighter, at least for the most countries – the only exception is Italy.

However, in the current situation it is extremely difficult to say how budget balances will evolve. The forecast, in general, are based on two assumptions which are strongly interlinked. The first is the forecast for the tax base which can be approximated by nominal GDP. Here, most forecasters are quite pessimistic which may the seed for some upward revisions in the course of 2013. The second is the assumption on the fiscal multiplier. In the latest World Economic Outlook the IMF gives some evidence, that multipliers may be larger in the current situation. This would imply that the negative effect of consolidation measures will be larger, which could result in a higher than expected deficit.

Country Reports

Austria: Structural budget balance will improve gradually

Table 2

Projection of public finances: Austria

2011 – 2013; Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	2.7	0.8	1.3
Nominal GDP	5.0	2.8	3.0
Government expenditures[1]	50.5	51.7	51.4
Government revenues[1]	48.0	48.6	49.0
Fiscal balance[1]	-2.5	-3.1	-2.4
Debt Ratio	72.4	74.7	75.4

[f]IHS Forecast- [1]Percent of nominal GDP

Despite the favourable economic development, at least in the first half of the year, and discretionary consolidation measures, the general budget deficit increases in 2012. This is mainly caused by additional capital injections to the banking sector. On the back of further consolidation measures becoming effective at the beginning of 2013, the general budget deficit should decline again. The structural deficit is envisaged to decline from 2.0% of GDP in 2011 to 1.2% in 2013. Despite the improvement of the fiscal balance, the debt ratio will increase further in 2012 and 2013, mainly due to additional measures in the context of the European debt crisis (in particular payments to the ESM), before it should start to decline in 2014.

The budget for 2013 is based on the stabilization and growth package of spring 2012. This package comprises an expense-focused bundle of consolidation measures totalling EUR 27.8 bn in the period 2012 to 2016) which are largely already adopted. The government plans to combine structural reforms in the areas of pensions, healthcare, public administration, public funding and the labour market, increasing expenditures for education, universities, as well as research & development. The long-term sustainability of the public budget shall be secured by the implementation of a debt brake at the federal government level. According to the Austrian debt brake, from 2017 onwards the structural budget deficit of the central government shall not exceed 0.35% of GDP, and the Federal States (*Länder*) as well as the municipalities must have balanced budgets. Due to lack of support from the opposition in Parliament, this law could not be established on the constitutional level.

With the 2013 budget, there will be a system change to accrual-based budgeting and accounting and performance budgeting. This means that on all levels of the budget, the respective resources used will be compared with the outcome objectives and outputs of the individual ministries and budget managing bodies. The budget 2013 moreover sees first-time application of the new budget breakdown according to global budgets and detail budgets.

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France: a strong consolidation process largely based on additional receipts

The new government that emerged from the Presidential elections in May 2012 faces a worsening of the economic situation, jeopardising the consolidation process of public finances. In July a corrected budget was adopted, including mainly additional receipts. The 2013 budget released early October includes additional tax hikes and a strong moderation of fiscal expenditures, even though the latter will not decline in absolute terms. The government expects to reach the 3% threshold next year. But the official assumption for real economic growth on which the budget is based (0.8 % in real terms) appears too much optimistic in the current context. Therefore, we expect that fiscal deficit would reach 3.5% of GDP, in absence of new corrective measures. If we consider that potential growth is around 1.5%, it implies that the structural efforts will be around 1.9% of GDP. In case of lower economic growth, reaching the 3% target would imply a structural effort still stronger.

According to the government, the fiscal burden would be shared into one third through lower fiscal expenditures and two thirds through additional fiscal receipts. Households and companies will have to contribute respectively to 40 and 60% of the increase of taxes.

Table 3
Projection of public finances: France
2011 – 2013; Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	1.7	0	0.2
Nominal GDP	3.1	1.5	1.7
Government expenditures[1]	50.2	50.8	51.7
Government revenues[1]	55.4	55.6	55.2
Fiscal balance[1]	-5.2	-4.8	-3.5
Debt Ratio	86.0	89.5	91.5

[f]Coe-Rexecode Forecast- [1]Percent of nominal GDP

Moreover, the government focuses also on a long term strategy for the French economy, mainly concentrating on the improvement of its competitiveness. Initially, it offset the decision of the previous government to cut employers social contributions compensated by a VAT increase, arguing that this measure would weigh on private consumption and economic growth. But the government has recently announced that it would implement such a scheme at the beginning of 2014, in order to transfer € 20 bn to companies through tax credit.

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Germany: Balanced Budget in in 2012

Over the last two years fiscal policy in Germany has been restrictive. The cyclically adjusted balance was reduced by about 0.5 percentage points in both years. The actual general government budget improved considerably, turning from a 4.1% deficit in 2010 to a balanced budget in 2012. This improvement is partly due to special factors. In 2010, the deficit was blown up by significant transfers to “bad banks” which had been founded to restructure two banks which had come in trouble after the financial crisis. But these were one-off-effects. The second reason for the reduction of the deficit was that the growth in Germany was particularly “tax intensive”: Whereas exports or investment as a rule generate only small increases in tax receipts, a rise in labour income favours the income tax as well as the contributions to the social security system. Finally, low interest rates, falling labour market spending and the expiry of the economic stimulus package reduce expenditure increase. The central government and the state governments still ran deficits, whilst local governments and in particular the social security funds ran surpluses.

Table 3

Projection of public finances: Germany

2011 – 2013; Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	3.0	0.7	0.3
Nominal GDP	3.9	2.1	1.9
Government expenditures[1]	45.3	44.9	44.9
Government revenues[1]	44.5	45.0	44.6
Fiscal balance[1]	-0.8	0.1	-0.4
Debt Ratio	80.5	82.5	81.3

RWI Forecast- [1]Percent of nominal GDP.

In 2013, fiscal policy will be slightly expansive. On the one hand some of the measures set in place in the 2011 consolidation package will work. On the other hand, some expansionary fiscal measures have been introduced. Thus, the rate of the contribution to the statuary pension scheme will be reduced at the beginning of 2013 from 19.6 to 18.9 %, because the pension insurance fund reserves overshoot significantly the upper reserve limit at the end of 2012. Furthermore to government plans to reduce the fiscal drag which will result in a revenue loss of € 1.9 bn in 2013. As a consequence of the expansive fiscal policy and the economic slowdown a general government deficit is likely to reappear in 2013 which could reach ½% of GDP.

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Greece: Drastic fiscal adjustment despite persistently deep recession

Despite being confronted with considerably worse than anticipated general economic conditions during 2012, significant progress has been made in further correcting fiscal imbalances in Greece.

The General Government deficit is expected to close at around 6.8%, well near the 6.7% target set by the 2012 supplementary budget. Nevertheless, the primary deficit 2012 target has been revised upwards (from 1% to 1.5%), against the backdrop of lower than expected tax receipts and social security contributions as well as higher than anticipated social benefits, on account of the deeper than forecasted economic recession. At the same time, General Government debt developments remain unfavourable. Despite the reduction by €106 bn. through the voluntary bonds exchange under the PSI programme, debt-to-GDP ratio dynamics are not yet stemmed, to a significant degree due to the adverse evolution of nominal GDP.

Table 5

Projection of public finances: Greece

2011– 2013;
Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	-7.1	-6.4	-4.5
Nominal GDP	-6.1	-6.9	-5.4
Government outlays[1]	51.8	49.6	48.3
Government receipts[1]	42.3	42.8	43.0
Fiscal balance[1]	-9.4*	-6.8	-5.3
Debt Ratio[1]	170.6	175.2	188.7

*[f]KEPE Forecasts- [1]Percent of nominal GDP. *EDP balance (swaps transactions are included).*

Further advances in public finances in the medium term are seen to be related to a deeper rationalisation in government expenditure and to more effective and efficient mechanisms for the utilization of public resources. To promote improvement in fiscal adjustment and the overall compliance with the programme, a bulk of additional measures and decisions have been introduced by the Omnibus Law, the new Medium Term Fiscal Strategy 2013-2016 and the 2013 Budget.

The fiscal adjustment path, which has been extended by two years, is mainly expenditure-based and front-loaded. From the total of the envisaged €13.5 bn. measures for the period 2013-2014, 71.9% refer to government outlays, while 28.1% concern government revenues. The adjustment foreseen for 2013 represents 2/3 of the total 2013-2014 fiscal adjustment. Still, an unwinding in Greek debt is not expected before 2015, whereby the path of deceleration will heavily depend on progress with the privatization programme and the exploitation of public assets.

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Hungary: New restrictive measures ahead

The current situation in respect of public finances is characterized by contradictory trends in Hungary. Budget revenues in several categories – corporate taxes, most of all – will certainly be below the target, as a result of ongoing recession. On the other hand, VAT revenues may exceed the target, thus cushioning somewhat the revenue losses from corporate taxes, but the most recent data on VAT revenue inflows raise some doubt in this respect as well. As regards the central budget, both the revenues and expenditures are to fall short of the projections, but on balance, the central budget deficit will likely end up higher than projected by the (revised) budget plan. At the same time, the surplus of extra-budgetary funds will also overshoot the annual target (thanks to the revenue overshoot and the much less than projected expenditures of the Employment Fund). Taken as a whole, there is still a good chance that the overall deficit of the general government will not miss the target (government forecast: 2.7% of GDP) substantially.

Table 6

Projection of public finances: Hungary

2010 – 2012

Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	1.6	-1.2	0.0
Nominal GDP	5.0	3.2	3.6
Government outlays[1]	49,6	48,7	49,0
Government receipts[1]	44,6	45,7	46,1
Fiscal balance[1]	-4,1	-3,0	-2.9
Debt Ratio	80.8	78.0	78.0

[f]Kopint Forecast- [1]Percent of nominal GDP. The effect of transfer of compulsory private pension funds savings into the state pension fund is out of consideration.

The government envisages a 2.7% deficit, as a percentage of GDP for 2013. This is based on the assumption that the GDP will grow by 0.9%, while inflation will hit 5.2%. According to our views the above inflation projection is realistic, but in our opinion the growth assumption seems to be overly optimistic.

There is limited information available about the details of the 2013 budget. The original version (of June 2012) presented a restrictive budget, with a real growth of primary surplus. But this version was based on unrealistic assumptions (1.6% GDP growth) and the government admitted itself later that there was a HUF 500 bn gap between the assumed and realistically expected fiscal outcome. To bridge this gap, the government announced three action plans in rapid succession in the course of October and November this year. These action plans imply a total adjustment of expenditures by a total sum of HUF 824 bn (appr. 3% of the GDP).

The first austerity package of October 5 2012 was rejected by the EU Commission – presumably some of the measures included were either at odds with the EU *Acquis* or overly optimistic like the plan to increase revenues by HUF 95 bn by obligating the retail sector to establish the direct online link between the tax authority and their cash registers. The envisaged measure to unilaterally decrease the proportion of state co-financing of EU-financed projects may be an example for the former.

The second austerity package of October 17 2012 seems to be fiscally feasible, by and large. However, some of the measures included – most of all, the full-scale continuation of the banking tax – may have significant detrimental effects on future growth prospects

This third austerity package of November 16 2012 entails a jump in the tax burden of the energy sector and the gambling sector, and a centralization and generalization of tax on public utilities.

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Italy: Ambitious austerity package

Within two years, from the peak of 5.4% in 2009, Italian public deficit was reduced to 3.9% of GDP as a result of the very ambitious correction packages that were approved in the past two years, both by the previous and by the current Government.

Even if the austerity measures are supposed to have effects until 2014, worsening macroeconomic conditions pushed the Government to revise downward their objective to reach a balanced budget already in 2013.

In the new Government projections, only the structural deficit will be close to balance in 2013, while the government deficit is only expected to be reduced below 2% of GDP in 2013, and to reach 1.3% of GDP in 2015. In Government's projections for public debt the ratio with GDP will start to decline in 2013, to reach 114.4% in 2015.

Two main decrees were approved since the summer. The first is the "spending review" decree, which is supposed to raise resources from a rationalization process of public outlays. The aim of the decree is mainly to implement expenditure savings in areas of the public sector where the efficiency is lower. The second is the Stability Law, which will not change much the picture for public deficit projections, since the resources raised by the decree compensate for tax cuts and increase in expenditures.

Table 7
Projection of public finances: Italy
2011 – 2013; Percentage changes unless otherwise indicated

	2011	2012^f	2013^f
Real GDP	0.4	-2.3	-1.0
Nominal GDP			
Government outlays	50.6	51.6	51.8
Government receipts	46.6	48.7	49.3
Fiscal deficit[1]	-3.9	-2.9	-2.5
Debt Ratio[1]	120.7	126.7	128.9

^{f}REF Forecast- [1]Percent of nominal GDP

The table displays REF Ricerche's estimates for next years in Italian public finances. The deficit/GDP ratio is expected to fall in the coming years, but to a less extent compared to official projections, leading to a 2.3% deficit/GDP ratio in 2014. The difference with Government projections depends essentially on a more pessimistic view on GDP growth and macroeconomic conditions, but overall REF Ricerche sees Italian public finances on the same envisaged track.

Risks for Italian public finances may be to the downside. If GDP growth continues to remain below its potential for a long period, it should be necessary to further push the austerity programmes, in order to reach the balance budget objective originally planned to meet the European conditions for Italy to have access to the EFSF. But a further fiscal correction, after an overall correction of 100bn in three years (as facial value) can further depress an economy that is already very weak. On the other hand, it is possible that Italy will benefit from the possibility of accessing the EFSF, in terms of lower interest rates and lower interest expenditure, so that a further fiscal correction for 2014-2015 could be avoided.

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Slovakia: Safely balancing above the abyss

The commitment of the 2012 elected government to bring the deficit below 3% of GPD in 2013 is declared clearly. Under realistic estimates this year's deficit will come at a slightly lower level than the expected 4.9%. Next year's goal will take consolidation measures amounting as much as 3% of GDP of the 2013 budget.

Table 8

Projection of public finances: Slovakia

2011 – 2013; Percentage changes unless otherwise indicated

	2011	2012[f]	2013[f]
Real GDP	3.2	2.3	2.0
Nominal GDP	4.9	3.5	3.2
Government expenditures	2.0	5.2	0.8
Government revenues	5.6	5.7	0.5
Fiscal balance[1]	-4.8	-4.7	-2.9
Debt Ratio	43.3	50.4	52.2

[f]INFOSTAT Forecast- [1]Percent of nominal GDP

Mostly the measures are on the revenue side (2/3 ratio), bearing the risk of unfulfilled expectations from the side of taxpayers given the newly introduced changes in the tax and social contributions legislative. But the major risk for the small and open economy is the downward revision of its growth, mainly due to persisting negative sentiment of the largest trading partners of Slovakia (Germany). Appreciable risks are also the regional budgets of which consolidation measures cannot be enforced by legislation, despite the consolidation agreement with the general government.

The new constitutional law has established a new institutional budget responsibility watchdog – an independent fiscal institution called Council for Budget Responsibility. Its goals are clear – watching closely every budget established by the government by highlighting any potential risks, help to improve transparency of public finances, and helping the policy makers to achieve more qualified decisions based on independent expert opinions.

The law has introduced gradual sanctioning mechanism for excess debt ratio level (above 50%). This will probably have to come into force according to the new introduced budget for 2013-2015. Government is planning the debt ratio level of 56% by 2015 rising from 43% of GDP in 2011. The increase is mostly the result of new debt (deficit budget financing), commitments to ESM and EFSF (2-3% of GDP) and creation of reserves (3-4% of GDP).

Generally, the fiscal situation is considered as satisfactory as evidenced also by the confidence at markets of government bonds. However, the situation can deteriorate quickly as soon as the GDP growth falls below 0%. For a small and open economy this is the worst case scenario, not very likely so far, but as such it may arrive very quickly, and the stiff and unreformed public government institutions fail to respond to such situations sufficiently.

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Spain: More work to do than it was done

Looking at the short run indicators and despite all the announcements and climate of strong spending cuts and increased taxes, the reality is that progress in reducing the deficit is very slow, and even seems to show a tendency to increase to throughout 2011 and 2012.

Nevertheless it is important to note that some of the measures taken in recent months (deleting the Christmas extra pay for public employees and raising VAT rates) will have a significant effect in recent months, and the public deficit will come down in the last quarter. Even given a good performance of revenues at the end of the year, along with the expected expenditures cuts, it will be very difficult to reach a deficit lower than 7% of GDP for 2012.

As far as crisis in sovereign debt, during the second and third quarter, financial markets increased the pressure on Spanish debt, although it managed to cover the prescribed emission targets without an excessive increase in cost. As a result of these tensions, and the dynamics of the debt itself, interest payments of General Government have been increasing over the year, although they remain at levels of 3.0% of GDP, just four tenths above the values at the end of 2011.

Table 9

Projection of public finances: Spain

2011– 2013;

Growth rates for GDP and GDP ratio for the rest

	2011	2012f	2013f
Real GDP	0.4	-1.6	-1.2
Nominal GDP	1.4	-0.9	-0.1
Government outlays[1]	42.9	42.5	40.7
Government receipts[1]	33.8	34.8	36.3
Fiscal balance	-9.1*	-7.5	-4.3
Debt Ratio[1]	68.4	78.7	83.8

1 Capital transfers between administrations are settled.

The change in the objectives of fiscal consolidation approved by ECOFIN last July together with the estimated deviation for the present year 2012 will increase the effort required in 2013 and 2014 to reach the new goals, thus prolonging the contractive effects of such consolidation. Although, initially, the change in the consolidation path was made to softening the fiscal efforts in the short-term, cumulative deviations in 2012 make that the current path for deficit reduction be much more intense, both in 2013 as in 2014. As a resume, we could remark that the change in the consolidation path expands the harmful effects and threatens growth in 2013 and also in 2014.

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UK: Autumn Statement is big on policies but will do little to promote growth

The Autumn Statement, delivered on 5 December, was a Budget in all but name, with a long list of policy announcements, but overall it is difficult to see it doing much to promote growth. The major surprise was that, despite the deterioration in the economic outlook since the Budget, the Office for Budget Responsibility's (OBR) forecasts allowed the Chancellor to make it fiscally neutral.

The OBR was forced to make deep downgrades to its growth forecasts and they now look much more sensible, particularly for the short-term. The OBR now forecasts GDP growth of -0.1% and 1.2% for 2012 and 2013 – down from 0.8% and 2.0% in March – which is broadly in line with both our forecasts and the market consensus. These revisions to the growth forecasts have led to sizeable upgrades to the OBR projections for Government borrowing, although comparison with the previous forecasts has been rendered almost impossible by a series of statistical fudges.

Nevertheless the judgement on the all-important 'fiscal mandate' – where the OBR must be able to give a probability of 50% or more that the cyclically-adjusted current budget will be balanced over the next five years – appears to be have driven not by the intricacies of the public finances forecasts, but by the OBR's volte-face on the output gap. Last year the OBR had attributed the bulk of the deterioration of the public finances to structural factors. However, despite an almost identical backdrop, they have decided that this year it is almost all down to cyclical factors. Taken in isolation, the conclusion that the OBR has come to this year looks eminently sensible and chimes in with our reading of what has happened. But given that it runs contrary to the precedent they had set last year and contradicts the methodology that the OBR had established, it is bound to raise some difficult questions. Such a significant change of view also makes forecasting the future behaviour of the OBR more challenging.

Table 10

Projection of public finances: UK

2011– 2013;

Percentage changes unless otherwise indicated

	2011	2012f	2013f
Real GDP	0.9	-0.1	1.2
Nominal GDP	3.6	2.2	3.3
Government expenditure [1]	45.2	43.1	44.4
Government receipts[1]	37.3	38.0	38.3
Public Sector Net Borrowing[1]	7.9	5.1	6.1
Public Sector Net Debt[1]	66.4	74.7	76.8

f OBR Forecasts [1] Percent of nominal GDP in financial years.

The greater short-term focus on capital spending looks sensible, but the Chancellor has been too timid – he could have increased capital spending by more than £5bn (0.3% of GDP) and could also have done so without cutting current spending. Similarly other pro-growth measures, such as the 1% cut in the rate of corporation tax and more generous investment allowances, send out the right signals but the impact on growth will be negligible and it does represent an opportunity missed.

The extra cuts to current spending were designed to demonstrate that the pain was being shared across the income distribution; at one end, benefits will be uprated by 1% a year for three years, rather than by inflation, while at the other tax relief has been restricted on larger pension pots.

Given that the OBR forecasts show the Chancellor complying with the fiscal mandate a year ahead of schedule in 2016/17, and with almost the same margin for error as before, it is difficult to see why he has announced further austerity in 2017/18. We can only speculate that he is trying to build himself something of a buffer – in the event of further forecast downgrades in March this will reduce the chances of the Chancellor having to announce yet more austerity measures in the Budget.

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EUREN Inside

New Item on the EUREN Website

The COE-REXECODE indicators, which are published on the last page of every issue of the EUREN News will now also be available on a monthly base on the EUREN website. The start-end recession indicator as well as the Leading Indicator for the Euro area will be presented there including a short commentary.

http://euren-network.eu/indicators.html

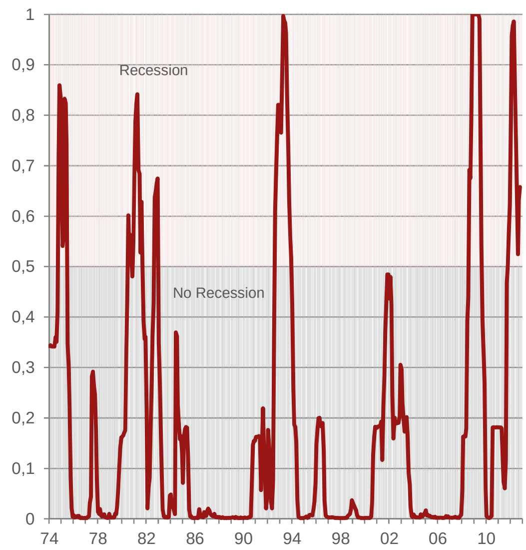
Impressum

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, Germany
- Ref Ricerche, Milan, Italy

Coe-Rexecode Start-End Recession Index for the Euro Area: Recession in euro area confirmed

The start-end recession indicator (IESR) is above the 0.5 threshold since October 2011 but the signal was given in real time only in April 2012 (see EUREN-news 2/2012) due to employment data revisions. The CEPR recently confirmed the start of the euro area recession in the third Quarter of 2011. The IESR converged towards one in April 2012 and receded thereafter to 0.52 in August. Since August, the IESR is increasing again to reach an estimated 0.66 in October. There is therefore a possible reinforcement of the recession since September due to a quite strong fall of the industrial production, a relapse of confidence and a sharp drop in car registers. The underlying growth rate (IRC) in November 2012 stands at -1.3 % at an annual rate. The IARC indicator stands at -68.4 in November 2012, still far from the -80 threshold which has to be crossed in order to send a signal of imminent economic rebound. But it nevertheless shows a possibility of rebound in the next 9 months because financial variables are positively oriented.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: November 19th, 2012

	12 Q1	12 Q2	12 Q3	12 Q4	13 Q1	13 Q2	13-Q3	13-Q4	2012	2013
Oct-11	1,8;*1,2*	1,8;*0,2*	1,7;*-0,3*	1,6;*0,4*					1,7	
Nov-11	1,4;*1,1*	1,3;*0,2*	1,3;*-0,4*	1,4;*0,3*					1,3	
Dec-11	0,6;*0,7*	0,6;*0,2*	1,2;*0,7*	1,9;*0,3*					1,1	
Jan-12	0,3;*0,5*	0,4;*0,2*	1,1;*0,8*	1,9;*0,4*					0,9	
Feb-12	0,0;*0,2*	0,0;*0,1*	0,8;*1,0*	1,8;*0,6*					0,7	
Mar-12	0,2;*0,3*	-0,3;*-0,4*	-0,5;*0,0*	-0,2;*-0,1*					-0,2	
Apr-12	0,3;*0,4*	-0,2;*-0,3*	-0,3;*0,0*	0,1;*0,0*					0,0	
May-12	**[0,0;*0,1*]**	-0,3;*-0,2*	-0,4;*0,0*	-0,2;*-0,2*					-0,2	
Jun-12	**[0,0;*0,1*]**	-0,4;*-0,3*	-0,6;*-0,1*	-0,6;*-0,3*					-0,4	
Jul-12	**[0,0;*0,1*]**	-0,3;*-0,2*	-0,5;*-0,1*	-0,5;*-0,4*					-0,3	
Sep-12	**[0,0;*0,0*]**	**[-0,5;*-0,2*]**	-0,7;*-0,1*	-0,7;*-0,4*	-0,6;*0,1*	-0,5;*-0,1*	-0,3;*0,1*	0,2;*0,1*	-0,5	-0,3
Oct-12	**[0,0;*0,0*]**	**[-0,5;*-0,2*]**	-0,6;*-0,2*	-0,9;*-0,6*	-1,0;*-0,1*	-0,9;*-0,1*	-0,5;*0,2*	0,3;*0,2*	-0,5	-0,5
Nov-12	**[0,0;*0,0*]**	**[-0,5;*-0,2*]**	-0,6;*-0,2*	-0,9;*-0,5*	-1,2;*-0,3*	-1,0;*0,0*	-0,7;*0,1*	0,2;*0,4*	-0,5	-0,7

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

Although there have not been too many changes in the indicators during the last month, they seem to confirm the deceleration process observed through the second half of the year. Almost all indicators included in the model, both hard indicators such as soft ones, point at somewhat stronger deceleration. The small changes have not led to any significant revision of the estimate for the end of this year 2012, But they have led to diminished expectations for the full year 2013. The High Frequency Model now forecasts a contraction of GDP which is slightly stronger in 2013 than it is expected for this year.

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