EUREN-News

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Editorial: The lessons from the Cyprus crisis

The political stand still in Italy after the elections and the turmoil in the banking sector in Cyprus provide two lessons: The first is that the situation in the Euro area is still fragile and new disturbances may arise any day. The second is that financial markets reacted to the bad news only for some days and went back to normality very soon. The latter observation suggests that financial markets still belief in the promise the ECB gave in September 2012 by announcing the Outright Monetary Transactions to defend the Euro. Obviously, the markets have been calmed so far without the ECB having bought any sovereign bond.

Thus, it looks like European politicians have gained time and they should use it to bring forward institutional reforms in the Euro area. The developments in Cyprus suggest that rules are needed urgently how to deal with insolvent banks. There should be a clear rule for a bail in of owners and creditors and also a clear order according to which the different groups should be liable. Owners and shareholders should step in first, followed owners of bank bonds.

To what extent also holders of bank accounts should be liable is an ambiguous question. On the one hand, it is important to avoid bank runs because they also could infect solid banks. Therefore haircuts on bank accounts should be avoided as far as possible. This particularly holds for accounts below 100.000 € for which the deposit protection applies. On the other hand excluding holders of accounts entirely can set the wrong incentives. Some banks could build on a business model offering a high interest on bank accounts hoping to be bailed out by the taxpayer when things go wrong.

In this context Cyprus is a special case. The capital provided by owners and shareholders was low, and bank bonds where almost nonexistent. Thus a haircut could not be avoided. But also in Cyprus it was wrong to announce initially there should be a haircut on all accounts, also on those for which the deposit protection applies. Savers in many countries have been unsettled, and in Cyprus the access to bank accounts had to be controlled very strictly to avoid a bank run.

The European Commission had announced to set in place a Singe Resolution Mechanism for insolvent banks in 2018. After the latest events Commissioner Barnier was cited in the press that these rules could come earlier. If this really can be achieved this would be good news for the Euro area. As long as no clear rules exist how to deal with insolvent banks – and the same applies to insolvent states – the current situation will be prolonged and the ECB must continue to intervene. Up to now inflation expectations in the Euro area are anchored indicating that the ECB has not lost credibility yet. But some day the liquidity created in the past will translate into higher inflation and it can be very costly then to bring inflation expectations down.

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UK: Is there more cause for optimism than the weak GDP data suggest?

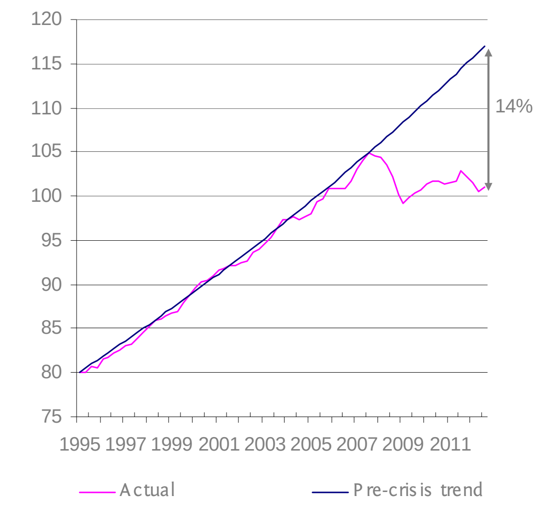
UK recovery has disappointed expectations

The UK recovery has consistently disappointed expectations over the past three-and-a-half years. GDP remains nearly 3% short of its early-2008 peak and is around 14% below the level it would have been had the pre-recession trend continued. Literature on past crises would suggest that the financial crisis has caused permanent damage to potential output which might account for roughly 5 percentage points (ppts) of this gap, while a similar amount of the shortfall can be attributed to weak demand caused by fiscal consolidation, tight credit conditions and the impact of the Eurozone crisis. However, this still leaves a sizeable proportion of the gap to the pre-crisis trend unaccounted for. In our view, the strength of other indicators would suggest that there is a good case that the level of GDP has been under-reported.

Graph 1

Output per worker

2009 = 100



Source: Oxford Economics, Haver Analytics

GDP growth could have been under-reported

The strength of the labour market provides the most obvious evidence of this. Productivity has slumped over the past five years and is now around 14% below where it would have been had the pre-recession trend continued (see Graph 1). A large part of this gap has occurred in the past eighteen months – while GDP flat-lined in 2012, the level of employment rose by 584,000 which, with almost 600,000 redundancies over that period, meant that nearly 1.2 million new jobs were created, the vast majority of them in the private sector. This was a rate of job creation which hadn't previously been seen since the mid-1990s, a time when the UK economy had been growing by around 3½% a year.

Some commentators have sought to address this productivity slump by citing explanations such as the substitution of labour for capital, labour hoarding or the existence of zombie companies as reasons why productivity may have fallen back. However, in our view these arguments are not compelling. For instance, in many industries there is little substitutability between labour and capital, so this effect must be, at most, marginal. The other arguments may go some way to explaining the experience of the recession, but would appear to hold little weight when trying to explain the trends of the past couple of years. For example, the relatively shallow decline in employment during the recession would appear to offer some justification of the labour hoarding argument, but surely companies would not still be carrying excess staff now, more than three years on, in the hope that the illusive recovery finally comes through. Similarly, the existence of zombie companies would have contributed to some labour hoarding, but not to the new jobs created since.

Cross country comparisons of productivity trends also suggest that the UK experience has been at odds with most other countries, notably the US. And it is not just the labour market data which appears to tell a different story to the GDP figures; data from business surveys, as well as a number of sectoral indicators, point to firmer levels of activity, particularly since mid-2011. We feel that there is sufficient evidence to suggest that the true level of GDP might be as much as 3ppts higher than the current data would suggest, with the bulk of the shortfall being in the services sector. The most likely cause of the problems is the use of gross price data as proxies for value added deflators which, in a time of high input cost inflation, could be leading the estimates of the deflators to be too high.

Reasons for optimism that growth will pick up

If the recent performance of the UK economy may have been better than the data currently suggest then what of future prospects? Three factors make us optimistic that growth will pick up over the next couple of years:

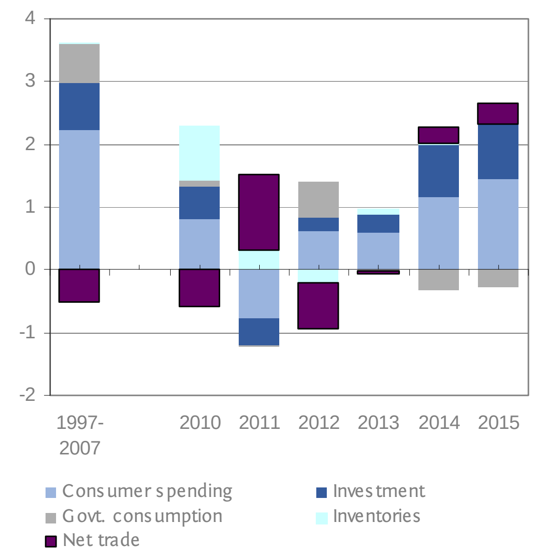
- **Lower inflation will support purchasing power** – though CPI inflation is likely to remain close to – or even above – 3% over the first half of the year, it should drop back over the second half of the year and then fall below the 2% target in 2014. We expect oil prices to drop back over 2013H2 and for recent upward pressures from food prices to abate, while spare capacity will continue to bear down on margins. Lower inflation will provide greater support to household purchasing power, which will be augmented by April's large increase in the income tax personal allowance.
- **Corporate confidence will strengthen, supporting investment** – the recovery in business investment was reasonably firm in 2012, though it remains around 13% below previous peaks. We expect the recent improvement in investor sentiment to be followed by a similar strengthening in corporate confidence. This should encourage firms to release their accumulated cash surpluses for investment projects and recruitment.
- **The export outlook will continue to improve** – net trade reduced GDP growth by 0.9ppts last year as exports fell. However, the external outlook has begun to improve, led by the US and emerging markets. Though the Eurozone – the UK's most important export market – will continue to struggle, we expect growth in world trade (weighted by UK export shares) to accelerate from 1.7% in 2012 to 3% this year and 6% in 2014, underpinning a pickup in export growth. The benefits of a weaker pound should also begin to feed through by 2013H2.

These factors should lead to a build-up of momentum behind the recovery, particularly from the second half of this year, and we expect GDP to grow by 0.7% in 2013 and by 1.9% in 2014 (see Graph 2).

Graph 2

Contributions to GDP growth

% points



Source: Oxford Economics

We estimate that the UK currently has an output gap of almost 6%, implying a large amount of spare capacity. This should help to keep inflation low while also allowing the Bank of England to maintain a very loose policy stance for a prolonged period, supporting a strong recovery through the medium-term. We expect GDP growth to accelerate to just under 3% a year by 2017. However, by UK standards this would still represent a sub-par recovery, with deleveraging from households and the government continuing to exert a drag on growth through the medium term.

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Forecast for UK (Annual percentage changes unless specified)	2011	2012	2013	2014	2015	2016
Domestic Demand	-0.6	1.4	0.6	1.7	2.1	2.3
Private Consumption	-1.1	1.2	1.0	1.5	2.0	2.5
Fixed Investment	-2.9	1.5	0.8	5.4	6.3	5.8
Stockbuilding (% of GDP)	0.4	0.3	0.2	0.2	0.2	0.2
Government Consumption	-0.3	2.2	0.2	-0.7	-0.4	-1.0
Exports of Goods and Services	4.5	-0.2	-0.1	3.5	4.4	5.4
Imports of Goods and Services	0.0	2.7	-0.3	2.7	3.4	3.9
GDP	1.0	0.3	0.7	1.9	2.4	2.8
Industrial Production	-0.6	-2.4	-0.1	1.2	1.1	1.3
CPI	4.5	2.8	2.8	1.9	1.6	1.5
Current Balance (% of GDP)	-1.3	-3.7	-3.1	-3.0	-2.8	-2.4
Government Budget (% of GDP)	-7.9	-6.5	-6.1	-5.6	-4.6	-3.4
Short-Term Interest Rates (%)	0.9	0.8	0.5	0.5	0.5	0.7
Long-Term Interest Rates (%)	3.1	1.9	2.2	2.4	2.6	3.2
Exchange Rate (US$ per £)	1.60	1.59	1.48	1.43	1.47	1.50
Exchange Rate (Euro per £)	1.15	1.23	1.16	1.18	1.25	1.28

EUREN Inside

RWI

On April 18th the joint forecast of the leading German economic research institutes has been published. The full text (in German) can be found here:
http://www.rwi-essen.de/gd

A summary in English is available here: http://en.rwi-essen.de/presse/mitteilung/113/

COE-Rexecode

A new study on the feasibility of reaching the deficit objective in France can be found here (in French): http://www.coe-rexecode.fr/public/Analyses-et-previsions/Etudes-Notes-publiques/Deficit-public-de-3-7-du-PIB-en-2013-objectif-deja-hors-d-atteinte-pour-la-France

COE-Rexecode has published a new study on the impact of a carbon tax on the French economy (in French): http://www.coe-rexecode.fr/public/Analyses-et-previsions/Lettre-de-Coe-Rexecode/L-impact-economique-d-une-taxe-carbone-en-France

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
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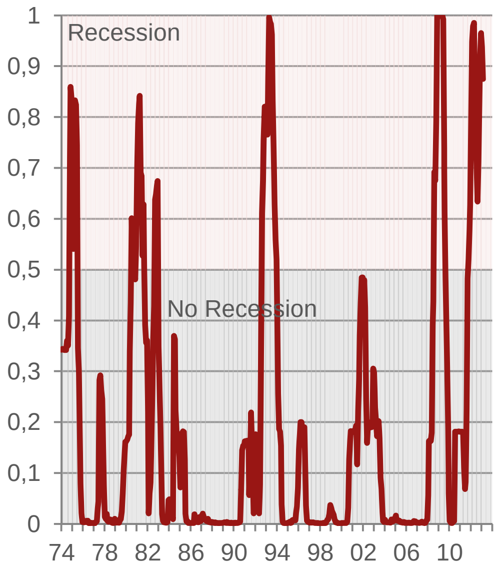
Start-End Recession Index: recession probability still high but slightly decreasing

The start-end recession indicator (IESR) has slightly decreased from 0.94 in January 2013 to 0.87 in February but still remains above the 0.5 threshold above which the area is in recession. The present recession has lasted five quarters since the business cycle peak was reached in the third quarter of 2011. This is the longest recession in the area so far. The underlying euro area growth rate (IRC), only based on survey results (BCI, ESI and expectations in retail trade) seems becoming positive since the beginning of the year (0.6% at an annual rate in March). This would not however contradict a still slight negative growth in the first quarter of 2013. But, as indicated by the leading indicator (see below), the recession should end somewhere during the first semester. The IESR indicator gives persistent signals but lags the recession exit by one quarter generally. A delayed signal of recession exit will be given when the 0.5 threshold is overpassed.



Updated April 10, 2013

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Forecast of the EUREN/CEPREDE High Frequency Model

Last update:March 20th, 2013

	12 Q1	12 Q2	12 Q3	12 Q4	13 Q1	13 Q2	13-Q3	13_Q4	2012	2013
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*]**	-0.4;*-0.3*	-0.6;*-0.1*	-0.6;*-0.3*					-0.4	
Jul 12	**[0.0;*0.1*]**	-0.4;*-0.3*	-0.7;*-0.2*	-0.7;*-0.3*					-0.4	
Aug 11	**[0.0; *0.1*]**	-0.3;*-0.2*	-0.5;*-0.1*	-0.5;*-0.4*					-0.3	
Sep-11	**[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 11	**[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
Dec 12	**[0.0; *0.0*]**	**[-0.5;-0.2]**	**[-0.6;-0.2]**	-0.9;*-0.6*	-1.1;*-0.2*	-1.1;*-0.1*	-0.6;*0.3*	0.1;*0.1*	-0.5	-0.7
Jan 13	**[0.0; *0.0*]**	**[-0.5;-0.2]**	**[-0.6;-0.2]**	-1.0;*-0.6*	-1.2;*-0.3*	-1.1;*-0.1*	-0.7;*0.2*	-0.1;*0.0*	-0.5	-0.8
Feb 13	**[0.0; *0.0*]**	**[-0.5;-0.2]**	**[-0.6;-0.2]**	**[-0.9;-0.6]**	-1.1;*-0.3*	-1.1;*0.0*	-0.6;*0.4*	0.0;*0.0*	**[-0.5]**	-0.7
Mar-13	**[0.0; *0.0*]**	**[-0.5;-0.2]**	**[-0.6;-0.2]**	**[-0.9;-0.6]**	-1.1;*-0.3*	-1.1;*-0.1*	-0.7;*0.3*	0.0;*0.1*	**[-0.5]**	-0.7
Apr-13	**[0.0; *0.0*]**	**[-0.5;-0.2]**	**[-0.6;-0.2]**	**[-0.9;-0.6]**	-1.0;*-0.2*	-0.8;*0.1*	-0.6;*0.1*	0.0;*0.0*	**[-0.5]**	-0.6

In brackets: GDP data published by EUROSTAT. In italics: quarter on quarter rates.

Almost all indicators included in our High frequency model have shown some improvement in the first quarter of 2013 compared to the previous one. Nevertheless, it is important to note that this improvement means a less negative rate, and not a real recovery. Therefore, the current forecast for GDP growth in YoY terms remains negative. Looking at specific indicators, the worst signals came recently from external trade, both exports and imports outside the EU.

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