

1|**2014** 13|2|2014

Editorial: Greek EU Presidency - A twofold challenge

Greece holds the rotating Presidency of the Council of the European Union in the first half of 2014, and thus in a quite critical time period for economic developments in the country. Against the backdrop of European elections in May, the Greek "Presidency of Hope for more Europe and hope for a better Europe" becomes essential on a European level as well. So, the Greek Government faces a twofold challenge: live up to expectations on both domestic and European grounds.

On the domestic level, the Greek Presidency has to tackle several difficulties. Some are related to the fear that European elections might turn into a protest vote against the role of the Troika and austerity programmes in the country. Others are linked to the necessity to negotiate a more permanent solution for the Greek debt, taking advantage of the primary budget surplus ahead of schedule and first indications of an upcoming turnaround in economic activity. In any case, the coalition government cannot afford to allow these risks to translate into severe political instability in the country. On European grounds, the Greek Government has, admittedly, fairly limited room for manoeuvre. First, the available budget at the disposal of the Greek Presidency, amounting to €50 million, is rather small. Second, the time period to discuss proposals and/or complete negotiations before the elections of the European Parliament in May, being less than five months, is rather short. Nonetheless, times are decisive, with Euroscepticism spreading across Europe and among both, creditors and debtors, among Eurozonemembers and non-members and even among candidate countries. At the same time, economic recovery in Europe remains fragile, with unemployment being still on the rise and social cohesion weakening further.

The focus is primarily on growth, a prerequisite to guarantee job creation and to promote social cohesion. Employment policies should be enhanced and the access to finance instruments improved, in particular for small and medium sized enterprises. Towards this end, the role of a European Instrument, the European Investment Bank, in financing labour-intensive projects strengthened. In the field of further EU and Eurozone integration, the Greek Presidency sets its focus on the completion of the Banking Union within the given timeframe as an essential condition for the creation of a mechanism absorbing negative financial shocks and, more generally, the preservation of financial stability. The third priority refers to an issue with significant national but also European dimension, as far as it concerns all European countries with EU external borders. Migration and refugee flows should be treated via extensive and comprehensive management on a EU level, whereby the issue of proportionality in burden sharing assumes particular importance. Finally, the redefinition of the EU maritime policies presents a horizontal priority of the Greek Presidency and aims at establishing a balance between the exploitation of the potentials of the Sea and a sustainable management of resources.

Along these lines, the major priorities set by the Greek Presidency of the EU attempt to form a bridge connecting concrete national with more general European goals. In other words, the specified agenda aims at providing solutions to both strengthening the trust in the European project and its future development and leading the Greek economy out of the recession and away from the need for further financial aid programmes.

Contact: Ekaterini Tsouma // etsouma@kepe.qr

www.euren-network.eu 1 | 10

The EUREN Winter Forecast 2014

A recovery is on its way

In their Winter Forecast 2014 the EUREN institutes see a brightening outlook for the global economy for 2014, and they expect even some acceleration of growth for 2015. Whilst the outlook for the advanced economies, where sentiment indicators suggest a steadily upward trend, has improved clearly there are still uncertainties concerning the emerging economies. They currently suffer from substantial capital outflows which might regain momentum if the FED takes concrete steps towards monetary tightening. In general, stronger external demand, partly triggered by a depreciation of the currency, will fuel growth in most cases, whilst domestic demand remains rather weak in a number of countries. In general monetary policy will keep its accommodative stance in most advanced countries as no inflationary pressure has to be reckoned with and the economic recovery is still not robust enough. In case of several emerging economies, however, radical monetary adiustments seem to be unavoidable. Fiscal consolidation will be continued to a different extent in the forecast period as well.

With global growth gaining momentum the expansion of world trade will reach about 5% this year, to a large extent borne by the import demand of advanced economies. Along with higher GDP growth next year, this rate may rise to 5.5%.

Oil markets are not expected to cause substantial risks to the growth scenario. The EUREN institutes assume only a slight increase of the Brent oil price to 111 resp. 113 \$/barrel provided no substantial market disturbances occur on the supply side.

Upswing in the advanced economies

Under these assumptions the EUREN Institutes expect an acceleration of US GDP growth to 2.7% for this year with a further improvement to 3% for 2015. This assessment

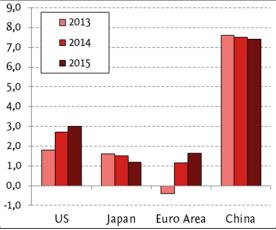
is based on the assumptions that the Fed will proceed carefully in tapering, and that the fiscal drag will ease as a result of the recent budget agreement for this year and only a moderate fiscal tightening for 2015. U.S. growth will be supported by a healthy domestic demand not at least due to a further improvement of labor market. In Japan growth will remain moderate as fiscal stimulus may only partly compensate the impact of tax adjustments.

In the Euro Area a slow recovery has started, however with great differences between member states. Consequently the recovery will be slow in countries which are still under fiscal stress, whilst others can benefit to a larger extent from the improvement of external conditions. In non-Euro Area countries forecasts seem to brighten as well. In the UK easier credit conditions and improved confidence are contributing to a buoyant growth of investments.

However, downward risks continue to be substantial, e.g.: growth differences between regions remain high. The sovereign debt crisis in the Euro area is still on the agenda and

Graph 1

Regional pattern of the EUREN forecast
yoy change in %



Source: Forecast of the EUREN institutes

Table 1
Exogenous and international variables
2012 - 2015; Percentage changes unless otherwise
indicated

	2012	2013 ^e	2014 ^e	2015 ^e
World trade	2.4	3.1	5.0	5.5
United States				
GDP	2.8	1.8	2.7	3.0
Inflation	2.1	1.5	1.9	2.1
3m interest rates	0.43	0.27	0.30	0.80
10y Gvt bond yield	1.79	2.34	3.00	3.60
Japan				
GDP	1.4	1.6	1.5	1.2
3m interest rates	0.20	0.16	0.16	0.16
10y Gvt bond yield	0.86	0.72	0.80	0.90
China, GDP	7.8	7.6	7.5	7.4
US dollar/euro	1.28	1.33	1.36	1.36
Oil price Brent				
US\$/barrel	111.8	109.0	111.0	113.0
Percentage changes	0.6	-2.5	1.8	1.8

^eEUREN Forecast

fiscal constraints impede economic performance in the indebted countries. Under these circumstances the reduction of growth of the monetary base in the US may have a larger impact on global growth than expected here.

Emerging markets suffers from capital outflow

Growth paths in the emerging countries currently diverge considerably. From a global perspective the economic performance of China is of outstanding importance. Here we expect some slowdown of growth in the forecast period despite of the rebound of investment activity in the recent two quarters. It is a question whether this will be of a temporary effect due to policy induced structural adjustments. In a number of other emerging countries relatively weak domestic demand, tightening financial conditions and increased capital flow volatility may provide downward risks in the next two years.

Euro area: jobless recovery without inflation

During the second half of 2013 a significant rebound of Euro area economy has been registered. This is mirrored in the ESI indicator that, after suffering a slight drop in the March

Graph 2

Euro zone Economic Sentiment Indicator



Source: European Commission

and April, restarted a strong upward trend showing positive yoy rates since July (graph 2). At the end of the year with recovery rates not seen since mid-2010, although in absolute levels we would still be below the records reached in early 2011.

The recovery in activity indicators has been reflected in the growth rates of real GDP, which after six consecutive quarters of contraction, have shown a positive sign in the second quarter of 2013. Data released up to know let us expect that these positive rates have been kept during the second half of the year.

Looking at the contributions of the different components of GDP we can see that in the second quarter growth mainly reflected high net exports, thanks to a quite dynamic export performance that offset the revival of imports.

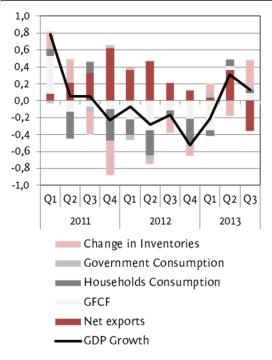
By contrast, net exports showed a negative contribution to GDP growth in the third quarter which was for the first time since the first quarter of 2010. However, this negative contribution was offset by a more vivid

3 | 10

Graph 3

Euro area: Growth of GDP and its components.

Contributions to growth percentage points



Source: Eurostat:

domestic demand, mainly reflecting a change in inventories, but also a recovery of GFCF.

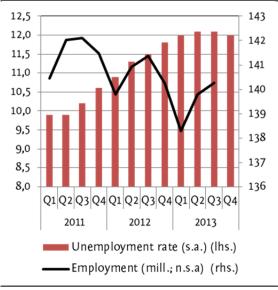
The recent change in the contribution of the external sector has been induced from both sides: Imports have been recovering parallel to the recovery of domestic demand. At the same time Extra-Euro area exports, which had progressively lost momentum in the quarters before, showed a negative rate during the third quarter.

This recovery in economic activity has not yet been reflected in the labor market. Job losses continue on balance; employment in the third quarter of 2013 was more than a million lower than in the same quarter last year (graph 4). The unemployment rate increased further compared to the values achieved in 2012, although the increase slowed significantly during the second half 2013 and even showed signs of an improvements during the last three months.

Graph 4

Euro area: Labor market performance.

Total employment and Unemployment rate



Source: Eurostat

Inflation slowed down at the same time significantly. With tensions in the energy having disappeared, HICP rates converged towards core inflation after having surpassed a rise in the prices of unprocessed food between April and August.

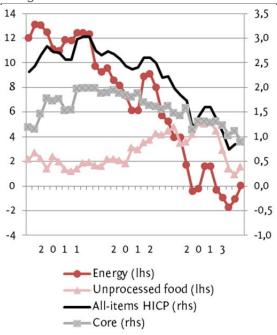
During the last months of 2013 the headline inflations rate even declined strongly as a result of negative rates in the energy component in combination with very low rates for unprocessed food. The move in the core rate was less pronounced. In any case, both HIPC growth rates as well as core inflation were well below the ECB target of 2% at the end of 2013.

ECB changes its communication

In November 2013 the ECB reacted to the weak economic outlook and the deterioration of expected inflation and lowered the rate for main refinancing operations by 25 basis points to 0.25%. The interest rate on the deposit facility was left unchanged by 0%.

Graph 5

Euro area Harmonized Consumer Price Index. YoY growth rate.



Source: Eurostat.

Additionally to the conventional interest rate policy, the ECB intensified the effort to influence the expectations about future interest rates. In July the ECB announced that the "Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time" (Introductory statement and Q&A, 4 July 2013), which was confirmed in the following press conferences.

The more explicit expectation management by the ECB has started a debate on the aim of this change in policy communication. Does it represent a commitment to low interest rates in the sense of Woodford¹, designed to lead an economy out of a liquidity trap? Or is this more of a clarification that the ECB expects growth and inflation to be low in the near future, which will result in low interest rates?

The ECB emphasizes that its forward guidance does not include any commitment². In this sense it has to be understood as an information device to inform the public about the ECB's assessment of future economic activity. While greater transparency on future interest rates does seem to be an enhancement in the policy strategy, it is unclear to what extent the expectation management by the ECB entails any additional information to the public.

Therefore, it remains unclear whether the introduced measures will be sufficient to lead the Euro area out of a liquidity trap, in case of a negative shock to economic development. On the other hand, the ECB's emphasis on the reliance on a reaction function (Introductory statement and Q&A, 1. August 2013) allows us to estimate future interest rates given a historic reaction function. Given projection as laid out in this report with inflation expectations and economic activity slowly accelerating, this would imply an increase in the interest key interest rate of about 25 basis points in the second half of 2015.

Less drag from fiscal policy

As for the fiscal policy, the situation in the Euro area did change significantly since our last forecast, only a slight loosing of fiscal consolidation can be observed across the countries. After the crisis most European countries had to trim their excessive fiscal deficits. The policy of spending cuts and tax increases, however, had negative consequences on aggregate demand and led to an increase of unemployment. Nowadays, after some improvement in fiscal deficits and given the rise of an anti-austerity climate in Europe, it seems reasonable to suppose some slippage

www.euren-network.eu 5 | 10

Woodford, M. (2012). Methods of Policy Accommodation at the Interest-Rate Lower Bound, presented at the Jackson Hole symposium, August 2012

Praet, P. (2013). Forward Guidance and the ECB. In: den Haan, W., Forward Guidance: Perspectives from Central Bankers, Scholars and Market Participants. www.voxeu.org

of fiscal policy. Thus, it is expected that the worst part of the fiscal adjustment is over and the negative impulse from fiscal policy will be smaller this year.

According to the latest European Commission forecast (autumn 2013) the budget balance in the Euro area improved last year nominally to -3.1% of GDP, structurally to -1.5% of GDP. This year fiscal stance will be less restrictive in most countries, and better growth prospects should contribute to slight improvement in public deficits. Nevertheless they will remain above 3% in relation to GDP above all in Spain, Ireland, Portugal, France, Slovenia, and Greece. However, the biggest progress is expected for Greece where the budget balance should reach -3.7% in 2014 which should mean a structural surplus. In the second half of this year Greece plans its exit from the European support schemes and to go back to the financial markets. On the opposite side, Germany as the only country in the Euro area expects a nominal and also structural budget surplus in 2014.

A gradual recovery is underway in the Euro area

In the third quarter of 2013, quarterly GDP growth in the Euro area returned to positive

Table 2 Euro area forecast territory, and also in the last quarter of 2013 it should have remained positive. In 2014 and more so in 2015, growth is expected to firm up and to become more and more driven by domestic demand as the correction of accumulated macroeconomic imbalances is making progress.

Rising real income, supported by low inflation and increasing consumer confidence on the back of the increasing general economic outlook will support private consumption. However, due to the still very high unemployment in some member states consumption will only reach muted growth rates.

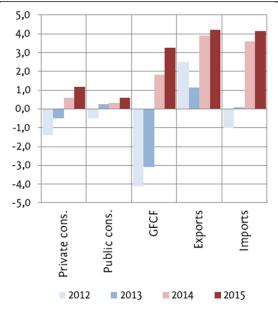
Fixed capital formation is backed by improving profit expectations and exceptionally low interest rates. On the other hand, deleveraging has not yet been completed in some member countries. In this respect, the legacies of the crisis like deleveraging, financial fragmentation, and rebalancing needs will continue to weigh on investment.

	2012 2013 2014 ^f 2015 ^f 2013			2014 ^f			2015 ^f						
					IV ^f	1	II ^f	III ^f	IV^{f}	1	- 11	111	IV
	Annu	al % ch	nange (unless			q-o-q%, seasonal adjusted						
	ind	icated	otherv	vise)		(unles	s indi	cated	other	wise)		
Private consumption	-1.4	-0.5	0.6	1.2	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.4	0.4
Public consumption	-0.5	0.2	0.3	0.6	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Gross fixed capital formation	-4.1	-3.1	1.8	3.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0	1.1
Change in inventories ¹	-0.5	-0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Domestic demand	-2.2	-0.9	0.9	1.5	0.1	0.2	0.2	0.3	0.4	0.3	0.4	0.5	0.5
Exports	2.5	1.1	3.9	4.2	0.8	1.0	1.2	1.0	0.8	0.9	1.1	1.3	1.5
Imports	-1.0	0.1	3.6	4.2	0.5	0.8	1.0	0.9	0.9	0.8	1.1	1.3	1.5
Net exports ¹	1.5	0.5	0.3	0.2	0.2	0.1	0.2	0.1	0.0	0.1	0.0	0.0	0.1
GDP^1	-0.7	-0.4	1.2	1.6	0.2	0.3	0.4	0.3	0.3	0.4	0.4	0.5	0.5
Unemployment (% of labour force)	11.4	12.1	12.0	11.8	12.1	12.1	12.0	12.0	11.9	11.9	11.8	11.8	11.7
Compensation per employee, yoy	1.7	1.6	1.7	1.9	1.6	1.6	1.7	1.7	1.8	1.8	1.8	1.9	1.9
Consumer price (HICP), yoy	2.5	1.4	1.1	1.5	0.8	0.9	1.1	1.1	1.2	1.4	1.4	1.5	1.6
Current account balance (%GDP)	1.3	2.0	2.2	2.3									
3m interest rates (% per annum)	0.58	0.22	0.22	0.36	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.30	0.70
10y Gvt bond yields (% per annum)	3.92	3.00	3.10	3.45	3.00	3.10	3.10	3.10	3.10	3.10	3.20	3.50	4.00
ECB repo (end of period)	0.75	0.25	0.25	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50

This forecast was finished on 17 January 2014. – ¹ EUREN forecast. – ¹ Contribution to growth

Graph 6

Euro area: GDP forecast by components
Contributions to growth in %

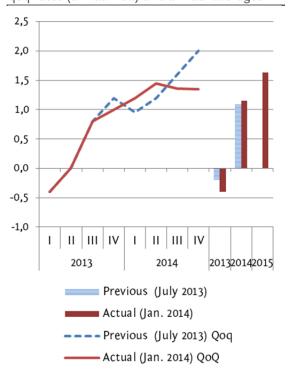


Source: Eurostat; EUREN Forecast

Hence, the recovery of capital formation will be heterogeneous across countries. This applies in particular to construction investment. In countries with stable economic fundamentals the low interest rates are leading to a rise of real estate prices which supports construction activities. In countries which are still confronted with rebalancing needs in the banking sector the stimulus from monetary policy is only slowly and gradually transmitted to the real economy. There, investment is held back. Overall, the contribution of domestic demand to GDP growth will increase in the forecast period (figure 6).

External demand should pick up over the forecast horizon, but less than earlier expected, on account of a weakened outlook for growth in emerging market economies and the past appreciation of the euro vis-à-vis some other important currencies. However, this appreciation effect should fade over time, as the EUREN institutes expect a stable euro exchange rate over the forecast horizon. Exports should be supported by the continuously robust growth in industrialised economies.

Graph 7
Revision of the forecast of Euro area GDP against the Summer forecast 2013
qoq rates (annualized) and annual averages



Source: EUREN estimates

The forecasted growth rate of GDP in 2014 is nearly the same as in the previous EUREN forecast. However, the recovery is expected to be more muted, which materializes in a lower than previously expected growth in the second half of 2014 (figure 7).

The major obstacle to a more powerful recovery is the still elevated unemployment in some Member States. This not only depressed consumer confidence, but also puts strain on public finances due to the working of automatic stabilisers. The EUREN institutes forecast only a very gradual improvement of the Euro area labour market with large heterogeneity across countries.

On account of stable exchange rates and international raw material prices, as well as low domestic price pressure due to the high unemployment and the large negative output gap, consumer price inflation is expected to drop to just over 1% on average in 2014. In

2015, inflation should pick up somewhat on the back of improving economic conditions. However, since the output gap is closing only slowly, also next year average Euro area inflation should stay well below the 2% level which the ECB views as consistent with price stability.

The main negative risks to the outlook are related to vulnerabilities of the banking sector and financial markets. Renewed financial market stress and loss of confidence cannot be excluded if reform progress in the Member States or regarding the European institutional framework slows down. Furthermore, slower than expected growth in the emerging

markets cannot be ruled out. Risks are also related to market overreactions to more restrictive US monetary policies or to a repeated political stand-still in US fiscal policies. On the other hand, Euro area growth could also be higher than forecasted here if confidence strengthens faster, positively affecting consumption and investment.

Contact:

Jana Juriová || juriova@infostat.sk Katalin Nagy|| katalin.nagy@kopint-tarki.hu Martin Micheli|| micheli@rwi-essen.de Julián Pérez || julian.perez@uam.es Klaus Weyerstrass || weyerstr@ihs.ac.at

EUREN Inside

New discussion paper:

Uncertainty and Episodes of Extreme Capital Flows in the Euro Area

During the Euro Area crisis huge changes in international capital flows occurred associated with a high level of economic uncertainty. While it is evident that both factors are able to trigger or amplify economic shocks posing a threat for economic activity it is a natural question whether they are related. The aim of this paper is to analyse the link between different measures of uncertainty and episodes of extreme capital flows for the core Euro Area countries using gross capital flows. We find that country-specific risk factors seem to play a more important role than global risk factors. Moreover, country-specific uncertainty seems to be more relevant for foreign direct investors.

Ruhr Economic Paper #461. DOI: 10.4419/86788521

Imprint

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

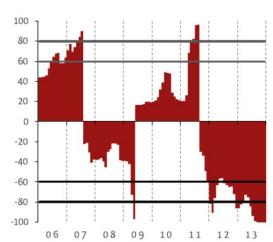
- Centre d'Observation Economique et Recherche pour l'Expansion de l'Economie et le Developpement des Entreprises (Coe-Rexecode), Paris, France
- Centre of Planning and Economic Research (KEPE), Athens, Greece
- Centro de Predicción Económica (CEPREDE), Madrid, Spain
- Institut für Höhere Studien (IHS), 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

Editorial board: Roland Döhrn (RWI), Denis Ferrand (Coe-Rexecode), Jana Juriová (INFOSTAT), Scott Livermore (OEF), Katalyn Nagy (Kopint-Tarki), Fedele de Novellis (Ref Ricerche), Julian Perez (CEPREDE), Ekaterini Tsouma (KEPE), Klaus Weyerstrass (IHS)

Editor of this issue: Roland Döhrn

Leading Indicator: signals of a recovery get clearer

The recession indicator IESR crossed the 50 % threshold in April 2013 and dropped to 4 % last December, showing that the recession is over in the Euro area. The IARC indicator - presented in the chart - crossed the -80 threshold in June 2013 and has converged towards -100 since then. This signals a growth cycle trough in the third quarter of 2013 entailing that growth will climb above the trend annualized rate estimated at 0.9 % thereafter. The first GDP growth estimates do not yet confirm this forecast. However, financial variables continue to be positively oriented: The ECB refinancing rate has been reduced on November 13, 2013 and the stock market remains bullish even amidst higher volatility. Survey results for producers of intermediate goods are strongly improving. The global production has gained strength with a 3.5 % and 3.7% GDP increase in the second and third quarters of 2013. If the forecast is confirmed, the turning points ABCD sequence will be respected with a recession trough in the first quarter of 2013 followed by a growth trough in the third quarter.



An indicator above 80 signals a slowdown (peak of the cycle), an indicator below -80 a rebound (trough of the cycle).

Updated February 11, 2013

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

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: January 21st, 2014

	13Q1	13Q2	13Q3	13Q4	14Q1	14Q2	2013	2014
Nov-12	-1,2;-0,3	-1,0;0,0	-0,7;0,1	0,2;0,4			-0,7	
Dec-12	-1,1;-0,2	-1,1;-0,1	-0,6;0,3	0,1;0,1			-0,7	
Jan-13	-1,2;-0,3	-1,1;-0,1	-0,7;0,2	-0,1;0,0			-0,8	
Feb-13	-1,1;-0,3	-1,1;-0,0	-0,6;0,4	0,0;0,0			-0,7	
Mar-13	-1,1;-0,3	-1,1;-0,1	-0,7;0,3	0,0;0,1			-0,7	
Apr-13	-1,0;-0,2	-0,8;0,1	-0,6;0,1	0,0;0,0			-0,6	
May-13	-1,0;-0,2	-0,8;0,1	-0,6;0,0	-0,5;-0,5			-0,7	
Jun-13	[-1,0;-0,2]	-0,8;0,1	-0,4;0,3	0,2;0,0			-0,5	
Jul-13	[-1,0;-0,2]	-0,7;0,3	-0,3;0,3	0,1;-0,3			-0,5	
Sep-13	[-1,0;-0,2]	[-0,7 ; <i>0</i> , <i>3</i>]	-0,2;0,4	0,2;-0,2	0,4;0,0	0,8;0,7	-0,5	0,8
Oct-13	[-1,0;-0,2]	[-0,7 ; <i>0,3</i>]	-0,1;0,5	0,3;-0,2	0,5;-0,1	0,7;0,5	-0,4	0,8
Nov-13	[-1,1;-0,3]	[-0,7 ; <i>0</i> ,3]	-0,4;0,1	0,6;0,5	1,0;0,2	1,0;0,3	-0,4	1,1
Dec-13	[-1,1;-0,3]	[-0,7 ; <i>0,3</i>]	[-0,4 ; <i>0</i> , <i>1</i>]	0,6;0,5	1,1;0,2	1,1;0,3	-0,4	1,1
Jan-14	[-1,1;-0,3]	[-0,7; 0,3]	[-0,4; <i>0,1</i>]	0,6;0,5	1,1;0,2	1,2;0,4	-0,4	1,1

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

Since most of the indicators included in the high frequency model are known for the entire year 2013, it confirms the idea that the recovery of economic activity will continue during the fourth quarter of 2013 in the way we have been expecting it in recent months. Nevertheless, the average GDP rate in the year 2013 should be somewhere around -0.4%, with a fourth quarter showing positive yoy rates of about half a percentage point.

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