EUREN-News

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Editorial: Stability and Growth Pact – flexible enough

At the summit at the end of June, European Union heads of government agreed that growth-boosting structural reforms should be rewarded with more time to improve public finances. This concession was made in response to pressure from the Italian prime minister to shift the emphasis from austerity to growth. At least, it was stated that this shift shall take place under existing EU budget rules.

During the past four years, reducing budget deficits was the main concern of most political leaders in the Euro area. This was important to regain financial market confidence. However, now that the peak of the sovereign debt crisis seems overcome, in many countries high unemployment and low economic growth are ranked highest on the political agenda.

Under EU rules, governments have to strive towards a budget close to balance or in surplus, excluding business cycle impacts as well as one-off measures. In addition – and as the financial crisis has revealed this is at least equally important – public debt levels exceeding 60 percent in relation to GDP have to be reduced.

Governments of countries with very high debt levels have repeatedly argued that the fiscal rules should be interpreted more growth-friendly since only high economic growth would allow the repayment of debt in the long run. The current fiscal policy framework already incorporates some flexibility since it includes the option that governments can be given more time to reach the medium term objective if they undertake reforms that have a verifiable positive impact on economic growth. Until now, this option has never been used.

It is certainly correct that economic growth is key for reducing public debt. Growth creates public revenues from higher company profits and rising employment, it reduces expenditures for unemployment benefits, and last but not least it raises the denominator in the debt-to-GDP ratio.

However, growth-enhancing reforms do not necessarily require additional spending. Institutional reforms like those simplifying the creation of new business, tax incentives for private spending on research and development or labour market reforms can be achieved without major additional spending or reduced revenues. Furthermore, such reforms are to a large extent self-financing. It is also by no means clear spending on which reforms should be excluded when calculating the budget balance. Such “flexibility” entails the danger that politicians claim any spending as growth-enhancing expenditures that should be excluded from the budget deficit. In addition, investor and consumer confidence would certainly be strengthened if governments committed themselves to sound public finances, since the private sector would then expect a lower tax burden in the future.

There is a real danger that financial markets punish lax public finances by demanding again higher interest rates. This might provoke an even more expansionary monetary policy by the ECB, and governments might be tempted to spend more, taking advantage of low government bond yields. In the end, sound public finances are in the utmost interest of each government.

Contact: *Klaus Weyerstrass // klaus.weyerstrass@ihs.ac.at*

The EUREN Summer Forecast 2014

A moderate recovery continues

Diverging trends between developed and emerging

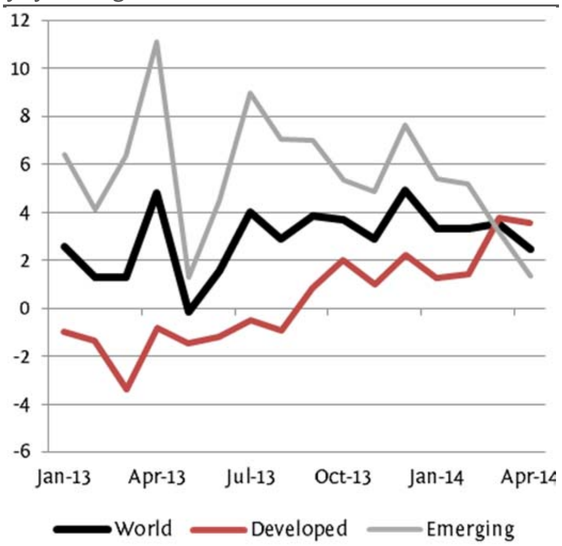
In recent months, developments of the international environment, in general terms, more or less followed the lines that we pointed out in our previous report. All in all, a gradual recovery of global growth was observed, associated with opposite trends in developed economies, which show a cyclical acceleration, and the emerging ones, which experienced moderating rates of expansion.

Thus, during the first quarter, the pace of GDP growth accelerated in both the Euro area and Japan, while the United States and major emerging economies, except India have experienced a certain moderation in their growth rates.

The differences between developed economies cab partially be explained by weather conditions (extremely cold winter in the U.S.) and fiscal policy (increase of the VAT in Japan on April 1st). The divergences between advanced and emerging economies are also mirroring the evolution of world trade. Whilst developed economies showed a stronger increase of imports during the recent months, expansion slowed considerably in the emerging economies. As a result of these two trends, the average growth for world trade remains more or less stable compared to late 2013 (graph 1).

Graph 1

Index of World Imports
yoy change in %



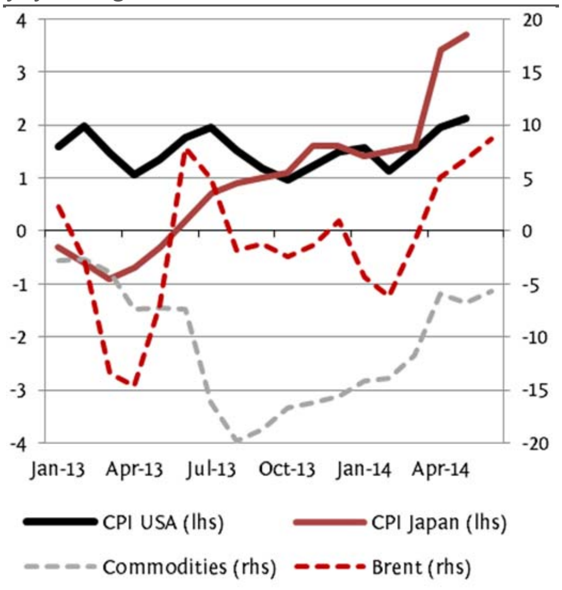
Source: CPB

With the real economy developing in line with the expectations, there are also no surprises in the financial and foreign exchange markets. Intervention rates of the central banks remained at historic lows, while the Euro fluctuated in a band of about three cents against the US Dollar, and showed a slight depreciation against the currencies of key emerging countries in recent weeks.

As price developments are regarded, headline inflation remained fairly moderate during the first months of the year, except for Japan, where the increase of VAT since April pushed

Graph 2

International Price development
yoy change in %



Source: The Economist, Bureau of Labor Statistics and Japan SB.

Table 1

Exogenous and international variables

2012 – 2015; Percentage changes unless otherwise indicated

	2012	2013	2014[e]	2015[e]
World trade	2.4	3.0	4.3	5.4
United States				
GDP	2.8	1.9	2.3	2.9
Inflation	2.1	1.5	1.7	1.9
3m interest rates	0.43	0.27	0.20	0.60
10y Gvt bond yield	1.79	2.34	2.80	3.30
Japan				
GDP	1.4	1.5	1.5	1.2
3m interest rates	0.20	0.16	0.20	0.30
10y Gvt bond yield	0.86	0.72	0.70	1.10
China, GDP	7.8	7.7	7.4	7.3
US dollar/euro	1.28	1.33	1.37	1.37
Oil price Brent				
US$/barrel	111.8	108.8	108.6	110.3
Percentage changes	0.6	-2.5	-0.2	1.5

[e]*EUREN Forecast*

inflation above 3%. Commodity markets have started a recovery since the beginning of this year. In the case of oil, prices where above previous year's levels since March of this year.

A bit less optimistic forecasts

In view of these developments, our current assessment of the international environment is slightly less optimistic than a few months ago. Our new forecasts show somewhat lower growth rates, both for world trade, as well as for GDP in the United States and in China, where our new estimate lies some tenths below previous forecasts. Growth of world trade was revised to 4.3% in this year and 5.4% in the next, down from 5.0% resp. 5.5%.

In line with this lower growth in economic activity we have also revised downward price expectation, both for oil, where our current projections point towards $ 109-110 per barrel this year and next, as well as U.S. inflation, which has been downward revised by about two tenths in each year.

Meanwhile, both interest rates and exchange rates would remain fairly stable around current values as large short-term changes in the monetary policies of the major economies are not expected.

Despite this somewhat less optimistic view, the global recovery seems to be stable. Nevertheless, we should not forget that new risks may worsen the international environment. They result from the political instability in Eastern Europe and the raise of violence in Middle East which possibly will affect oil markets.

On the other hand, a scenario cannot be ruled out in which expansion might speed up, induced by a higher than expected reactivation of domestic demand in both, developed and emerging countries.

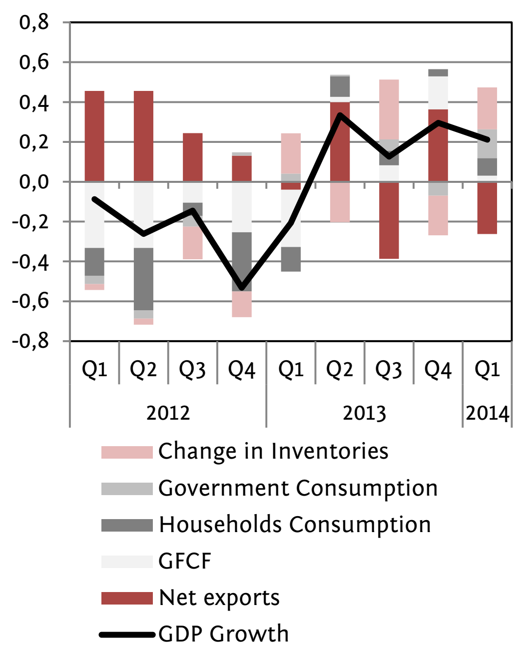
Euro area: Moving towards more robust growth

Improving general economic conditions were sustained in the Euro area, where in the first 2014 quarter real GDP growth amounted to 0.9% on a y-o-y basis and continued to be positive for the fourth consecutive quarter on a q-o-q basis (0.2%).

Graph 3

Euro area: Growth of GDP and its components

Contributions to growth percentage points



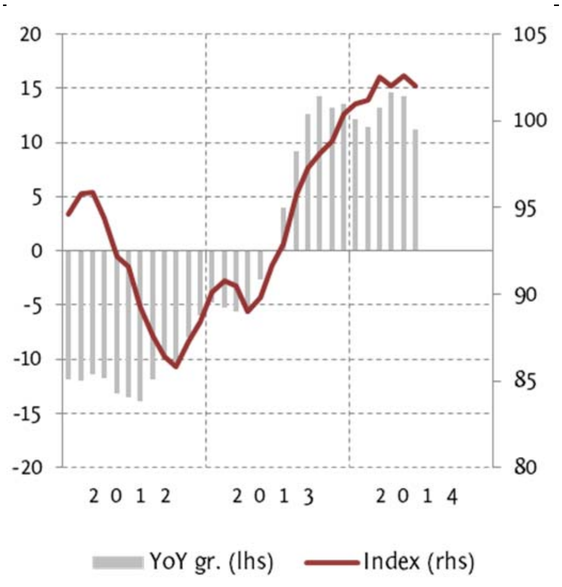
Source: Eurostat.

The main drivers of q-o-q GDP growth varied between the last quarter of 2013 and the first quarter of 2014, as becomes evident from the contributions of the individual GDP components (Graph 3). More specifically, the last quarter of 2013 was characterized by a significant positive contribution of net exports, accompanied by an appreciable positive contribution of GFCF and a negative contribution of change in inventories. In contrast, in the first quarter of 2014 the positive contributions of consumption, both private and public, GFCF and change in inventories were offset by the negative contribution of net exports.

Taking into account that the contribution of net exports to growth had also been negative in the third quarter of 2013, the latest figures confirm that the impact of the external sector was quite erratic in the recent quarters. Looking at the same time the q-o-q rates of change of exports and imports in the last three quarters under examination, it becomes evident that exports do not yet show signs of robust improvement. This last observation is important with respect to the question of the potential contribution of GDP components in supporting a more steady growth path in the Euro area in the upcoming quarters.

Graph 4

Euro area Economic sentiment Indicator



Source: Eurostat.

Still, according to the signs as reflected by the recent course of the Economic Sentiment Indicator for the Euro area, expectations with regard to the upcoming general economic conditions appear to continue to be particularly favourable (Graph 4). Since March 2014, the index has settled around 102, reaching levels not observed since mid-2011, while y-o-y positive percentage changes even approached 15%.

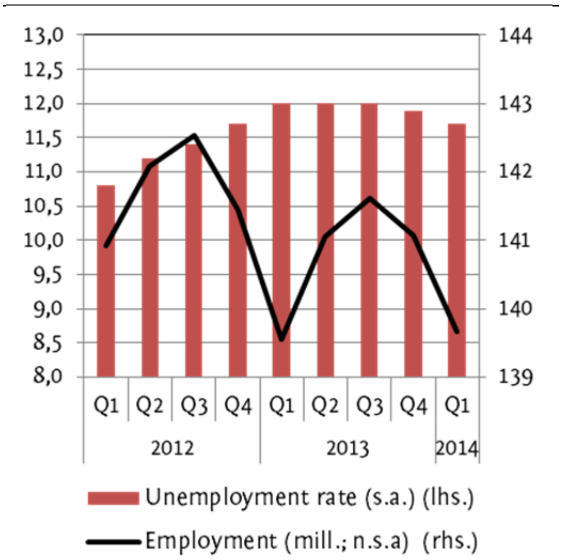
Unemployment remains an unresolved issue and price developments deserve attention

Despite improving sentiment, significant adverse conditions continued to persist in the labour market, as indicated by still particularly high unemployment rates (Graph 5). More specifically, unemployment rates in the Euro area continued to lie above 11.5%. Nevertheless, it is essential to note that after the peak of 12% reached in the first half of 2013, the last quarter of 2013 and the first quarter of 2014 were characterized by two consecutive declines in the respective rates.

These developments reflect, on the one hand, more favourable conditions in certain Euro area countries. On the other hand, they mirror a potential halt in the rise of unemployment,

Graph 5

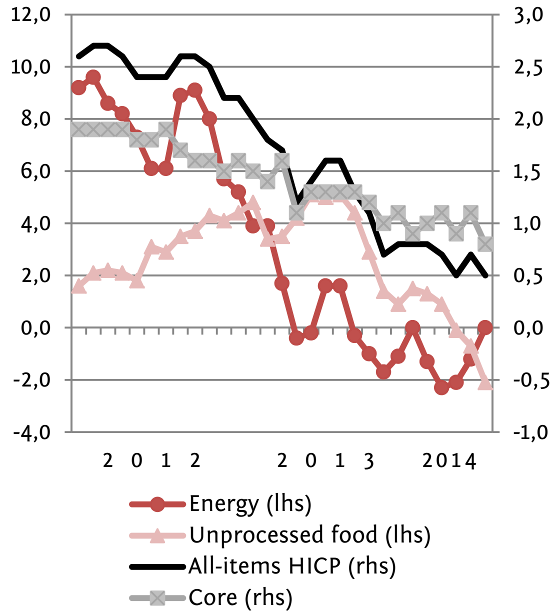
Euro area Labour Market Performance



Source: Eurostat.

Graph 6

Euro area Harmonized Consumer price Index
Y-o-Y growth rates



Source: Eurostat.

if not the begin of a gradual deceleration in those countries, which still face the most severe problems in their labour markets. It should be further noticed that employment recorded a marginal increase (0.08%) in the first quarter of 2014, as compared to the respective quarter in 2013.

Price developments in the Euro area deserve particular attention, as inflation continued to slow down over the recent months. Since September 2013, core inflation keeps moving above headline inflation, which relates to declining prices for unprocessed food and energy as well. In the first case, a considerable and continuous decline has led to a negative y-o-y rate of -2.1% in May 2014. At the same time, changes in energy prices kept moving in negative territory since August 2013, with the exception of the rates recorded in December 2013 and May 2014 (Graph 6).

ECB introduced the negative interest rate

With the world economy recovering and the situation in the Euro area improving, also the banks seem to become stronger gradually. However, monetary policy of the Fed and the ECB stepped into different directions. While the Fed has continued tapering and reduced the volume of purchases, ECB has eased policy once more and introduced even a negative interest rate on deposits in June 2014.

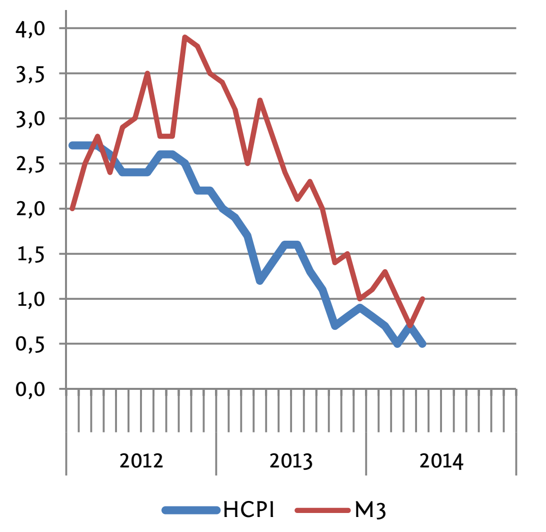
Since Euro area inflation is expected to remain considerably below 2% for a prolonged period, the ECB decided to lower interest rates to historical minimum. Considering that the deposit rate was already at 0% and the rate for main refinancing operations at 0.25%, a cut in the refinancing rate to 0.15 % meant the deposit facility rate was lowered to −0.10%.

All in all, the continuing low inflation stands for a risk for further development in Euro area. Inflation is slowing also in the "healthy" economies such as Germany and Austria. Moreover, very weak growth in M3 aggregate raises fears that inflation will anchor at low levels for a longer period (Graph 7). However, as ECB measures are also targeted to support consumption and domestic demand, the deflation should not be expected in the outlook.

The ECB stated that interest rates will not be changed for a longer period. Thus markets continue to expect a prolonged period of low interest rates and supportive monetary policy for the Euro area. To spurt this view, the ECB announced additional monetary policy measures to enhance the functioning of the monetary policy transmission mechanism and lending to the real economy. More specifically, a series of targeted longer-term refinancing operations (TLTROs) was introduced, aimed at improving bank lending to the non-financial private sector – households and non-financial corporations (excluding loans to households for house purchase) – over a window of two years. Furthermore, preparatory work related to outright purchases of asset-backed securities (ABS) was intensified.

Graph 7

Euro area: Harmonized Consumer Price Index and broad money aggregate M3.
YoY growth rate.



Source: Eurostat, ECB.

The upcoming TLTROs is meant to provide an attractive means of refinancing for banks to ease credit conditions and spur new lending. In this way, banks can play their part in providing sufficient financing to the real economy and help the Euro area economy to return to sustainable long-term growth and employment. However, the projections still assume that financial fragmentation in the Euro area will remain a problem for the transmission of monetary policy impulses. Credit conditions are thus suspected to remain tight in many countries, and credit outstanding can continue to decline for some time, albeit at a slower pace.

Restrictive fiscal policy is fading out

Euro area general government deficit in 2013 amounted to 3.0% of GDP, a bit lower as estimated in winter (3.1%). This is a sharp reduction since the great recession, as the rate laid above six per cent in two consecutive years. In 2013, net borrowing was almost € 60 bn lower than in 2012. The largest improvement was achieved by Spain (€ 37 bn according to the first data release). However, its deficit ratio is still high; it dropped from 10.6 to 7.1% of GDP.

In its latest spring forecast, the European Commission expects the deficit rate to decline to 2½% of GDP in this year and will remain about the same in 2015. These figures do not need extra adjustments for the present report, considering that the EUREN growth forecast is only a bit lower and the inflation forecast is identical. The fiscal balance will be influenced by declining expenditures. However, they only partially reflect consolidation efforts; in Spain, Greece, Portugal and Slovenia bank recapitalisation had led to a considerable increase of public expenditure in the past, but this only was a once off effect. The Commission expects the revenue ratio – after having risen significantly between 2011 and 2013 – to decline in 2014 and 2015, since different temporary tax increases might expire end limited tax cuts are planned.

These processes lead to a nearly unchanged structural balance of the general government 2014-2015 in the Euro area. This gives reason to assume that after three years of tight restrictions fiscal policy will not hinder the domestic demand during the forecast period.

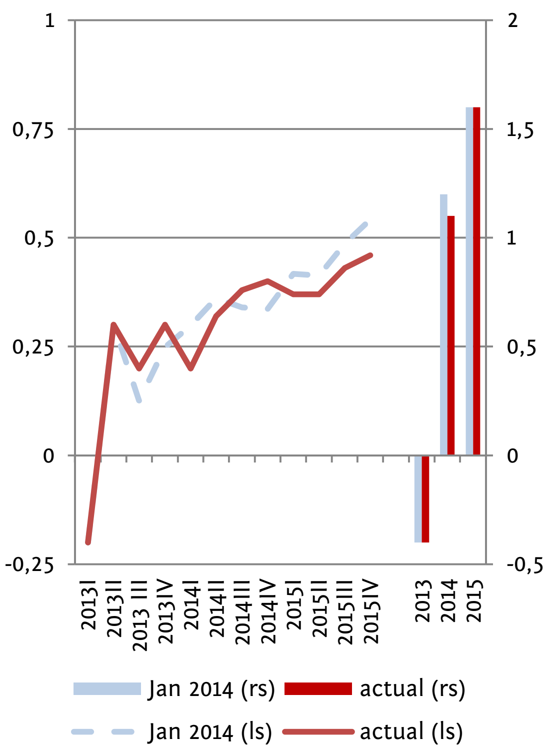
Recovery gaining momentum in the Euro area

During the recent months there has been an increasing number of signs that a recovery has started in the Euro area. Nevertheless, it still would be too early to speak about a robust growth. For this year, we expect Euro area GDP to grow by 1.1% and by 1.6% in 2015. The forecasted rate for 2014 is slightly lower than in the previous EUREN forecast due to a less vigorous economic performance in the first half of the year (graph 8). For 2015, the EUREN institutes expect a similar GDP growth as in their January forecast.

Graph 8

Revision of the forecast of Euro area GDP against the winter forecast 2014

qoq rates (not annualized) and annual averages



Source: EUREN estimates

It is good news that growth is wider based than before as the various components of domestic demand are increasingly supporting overall growth. However, differences between member states remain substantial: Germany with an expected GDP rate of 2% GDP continues to be the locomotive of the Euro area economy, whilst the other big countries like France or Italy are still suffering from internal imbalances hindering the improvement of economic performance. Attention should be paid to the fact that after years of a sharp decline of economic activity Greece now shows signs of a slight expansion in this year.

Since Q2 2013 private consumption is on a rising trend, and according to our forecast, the moderate growth of 0.7% in this year might be doubled in the next. Growing real incomes of households, low inflation and low interest rates are all supportive to consumption.

Table 2

Euro area forecast

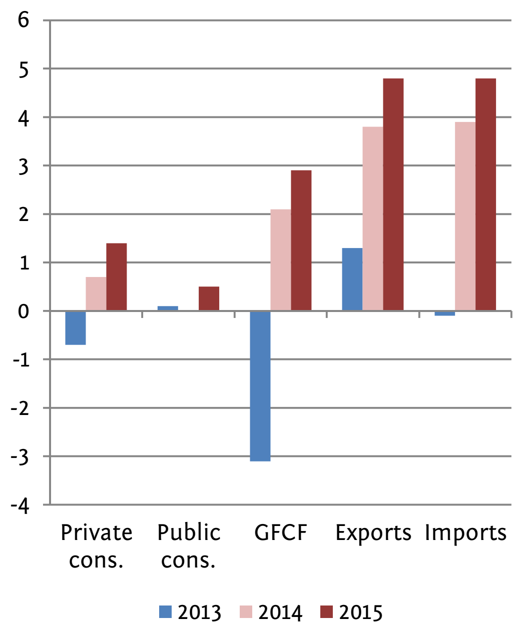
	2012	2013	2014[f]	2015[f]	2013 IV	2014 I	2014 II[f]	2014 III[f]	2014 IV[f]	2015[f] I	2015 II	2015 III	2015 IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	-1.4	-0.5	0.7	1.4	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4
Public consumption	-0.5	0.2	0.3	0.5	-0.4	0.3	0.2	0.1	0.1	0.1	0.2	0.2	0.2
Gross fixed capital formation	-4.1	-3.1	2.1	2.9	0.9	0.3	0.5	0.6	0.6	0.7	0.8	0.9	0.9
Change in inventories[1]	-0.5	-0.1	0.1	-0.1	-0.2	0.02	0.02	-0.04	-0.01	-0.03	-0.01	-0.01	0
Domestic demand	-2.2	-0.9	1.0	1.4	-0.1	0.4	0.2	0.3	0.3	0.3	0.4	0.4	0.5
Exports	2.5	1.1	3.8	4.8	1.4	0.3	1.0	1.3	1.2	1.2	1.2	1.2	1.2
Imports	-1.0	0.1	3.9	4.8	0.7	0.8	1.0	1.3	1.2	1.2	1.3	1.3	1.3
Net exports[1]	1.5	0.5	0.2	0.1	0.4	-0.2	0.1	0.1	0.1	0.0	0.1	0.1	0.1
GDP[1]	-0.7	-0.4	1.1	1.6	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.5
Unemployment (% of labour force)	11.4	12.1	11.7	11.4	11.9	11.8	11.7	11.7	11.6	11.5	11.4	11.3	11.3
Compensation per employee, yoy	1.7	1.6	1.3	1.7	1.4	1.3	1.3	1.3	1.3	1.5	1.7	1.8	1.9
Consumer price (HICP), yoy	2.5	1.4	0.8	1.2	08	0.7	0.7	0.8	0.9	0.9	1.1	1.2	1.4
Current account balance (%GDP)	1.3	2.0	2.4	2.5									
3m interest rates (% per annum)	0.58	0.22	0.25	0.30	0.24	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3
10y Gvt bond yields (% per annum)	3.92	3.00	2.5	3.0	2.97	2.7	2.3	2.4	2.5	2.8	3.0	3.1	3.2
ECB repo (end of period)	0.75	0.25	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15

This forecast was finished on 25 June 2014. – [f]EUREN forecast. – [1]Contribution to growth

Graph 9

Euro area: GDP forecast by components

Contributions to growth in %



Source: Eurostat; EUREN Forecast

As fiscal tightening will show some ease in the forecast period, a slight growth of public consumption can be reckoned with. Of course there are countries with severe debt problems (like Greece, Italy) where public consumption will continue to shrink further.

As it is typical for a recovery, gross fixed capital formation will expand over proportionate to GDP (graph 9). The EUREN institutes forecast an increase by 2.1% in this year, and by 2.9% in the next year. Here again, there are substantial differences between the countries. Italy and France can be expected having still negative rates, whilst countries such as Germany, Austria, and Slovakia show a robust recovery. Considering the long period of shrinking and delayed investments (investment in the business sector has been shrinking in relation to GDP since 2008), and rather favourable financing conditions, investment is still moderate, which can be interpreted as a sign that the confidence of investors has not been fully re-established yet. This notion is supported by the rather disappointing data on the development of loans to non-financial corporations.

Given our forecast of the international environment, external demand can be expected to pick up over the forecast horizon. However, due to the muted outlook for the emerging economies, the expansion of exports should be supported mainly by industrialised economies. For this year we reckon with an export growth of 3.8%, only slightly below our winter forecasts and with a more dynamic expansion by slightly below 5% in next year. As a consequence of stronger domestic demand, imports will pick up at a similar rate as exports. Thus, the contribution of net exports to growth will be rather moderate.

EUREN institutes expect a stable exchange rate of the Euro around 1.37 USD/EUR. Since monetary policy will keep its expansive stance, interest rates will continue to stay at the present low level. However, we do not expect the Euro area to fall into deflation. The decline of inflation rate to 0.8% in this year mainly reflects falling raw material prices and a rather high unemployment. With growth and demand accelerating and raw material prices not declining further, we expect an inflation rate of 1.2% in 2015. Nevertheless, consumer price inflation will stay below the inflation target of the ECB.

Despite of some improvement unemployment rates will remain high in most of the Member States also hindering a more powerful recovery. This is not only affecting consumer confidence, but also hinders public finances to let automatic stabilisers work. The EUREN institutes forecast only a very sluggish improvement of the Euro area labour market, with an average unemployment rate of above 11% for the whole forecast period, and with continued large heterogeneity across countries.

The main negative risks to the outlook are related to the development of external environment. A slower than expected growth of emerging countries, an escalation of the Ukrainian crises, and a stronger monetary tightening or another political stand-still in US fiscal policies could impede Euro area growth significantly. On the internal side, a slowing of the reform process in some Member States or a failure of the reform of the institutional framework of the Euro area might cause a renewed loss of confidence, which also would have negative consequences on overall growth. However, with a more dynamic external environment than expected, and confidence of Euro area consumers and enterprises improving, the recovery could gain a stronger momentum than forecasted here.

Contact:

György Barabas|| barabas@rwi-essen.de
Jana Juriová || juriova@infostat.sk
Katalin Nagy|| katalin.nagy@kopint-tarki.hu
Julián Pérez || julian.perez@uam.es
Ekaterini Tsouma || etsouma@kepe.gr

Imprint

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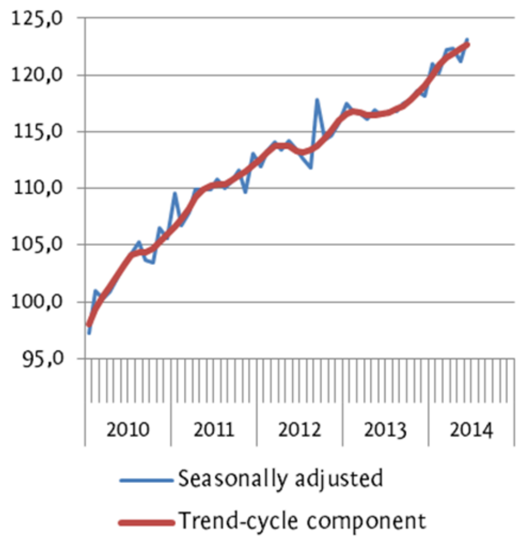
- Ref Ricerche, Milan, Italy

Editor of this issue: Roland Döhrn

RWI/ISL Container Throughput Index: World Trade on an Upward Trend

According to the flash estimate, container throughput in the leading global seaports increased considerably in June against the previous month and jumped to a historic high. Since container throughput shows a close correlation with world trade this is a strong indication that the global exchange of goods is still on an upward trend. However, compared to the last months of 2013, expansion has clearly lost momentum.

The index is based on data of 75 world container ports covering approximately 60% of worldwide container handling. The ports are continuously monitored by ISL as part of the institute's market analyses. Because large parts of international merchandise trade are transported by ship, the development of port handling is a good indicator for world trade. As many ports release information about their activities only two weeks after the end of the respective month, the RWI/ISL Container Throughput Index is a reliable early indicator for the activity of the global economy.



RWI/ISL calculations. 2008 = 100. June 2014: flash estimate.

Updated July 23rd, 2014

Contact: *Roland Döhrn || doehrn@rwi-essen.de*

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: July 14st, 2014

	13Q3	13Q4	14Q1	14Q2	14Q3	14Q4	2013	2014	2015
Jan-13	-0,7;*0,2*	-0,1;*0,0*					-0,8		
Feb-13	-0,6;*0,4*	0,0;*0,0*					-0,7		
Mar-13	-0,7;*0,3*	0,0;*0,1*					-0,7		
Apr-13	-0,6;*0,1*	0,0;*0,0*					-0,6		
May-13	-0,6;*0,0*	-0,5;*-0,5*					-0,7		
Jun-13	-0,4;*0,3*	0,2;*0,0*					-0,5		
Jul-13	-0,3;*0,3*	0,1;*-0,3*					-0,5		
Sep-13	-0,2;*0,4*	0,2;*-0,2*	0,4;*0,0*	0,8;*0,7*			-0,5	0,8	
Oct-13	-0,1;*0,5*	0,3;*-0,2*	0,5;*-0,1*	0,7;*0,5*			-0,4	0,8	
Nov-13	-0,4;*0,1*	0,6;*0,5*	1,0;*0,2*	1,0;*0,3*			-0,4	1,1	
Dec-13	[**-0,4**;*0,1*]	0,6;*0,5*	1,1;*0,2*	1,1;*0,3*			-0,4	1,1	
Jan-14	[**-0,4**;*0,1*]	0,6;*0,5*	1,1;*0,2*	1,2;*0,4*			-0,4	1,1	
Feb-14	[**-0,4**;*0,1*]	0,5;*0,4*	0,8;*0,1*	1,1;*0,5*			[**-0,4**]	1,2	
Mar-14	[**-0,4**;*0,1*]	[**0,6**;*0,3*]	1,0;0,3	1,2;0,4			[**-0,4**]	1,3	
Apr-14	[**-0,4**;*0,1*]	[**0,6**;*0,3*]	1,0;*0,2*	1,2;*0,5*			[**-0,4**]	1,3	
May-14	[**-0,4**;*0,1*]	[**0,6**;*0,3*]	[**0,9**;*0,2*]	1,3;*0,8*	1,5;*0,3*	1,4;*0,2*	[**-0,4**]	1,2	
Jun-14	[**-0,4**;*0,1*]	[**0,6**;*0,3*]	[**0,9**;*0,2*]	1,2;*0,7*	1,4;*0,3*	1,4;*0,2*	[**-0,4**]	1,2	1,5
Jul_14	[**-0,4**;*0,1*]	[**0,6**;*0,3*]	[**0,9**;*0,2*]	1,1;*0,6*	1,4;*0,4*	1,7;*0,6*	[**-0,4**]	1,3	1,7

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

During the last six months, the forecasts of the High Frequency model remained more or less stable unchanged, confirming that the expected recovery is on its way. The current estimate points at an annual GDP growth of 1.3% in 2014. Nevertheless, there are still some doubts about the strength of the recovery, since some indicators lost momentum in the recent months. Looking beyond, the first estimates for 2015 points at a further slight increase of the GDP rate albeit it may stay below 2%.

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