CESifo, a Munich-based, globe-spanning economic research and policy advice institution

The EEAG Report on the European Economy 2014

The Road towards Cohesion

Macroeconomic Outlook

Switzerland

Austerity

Banking Union

EEAG European Economic Advisory Group @ CESifo

The EEAG Report
on the European Economy
2014

EEAG Report on the European Economy ISSN 1865-4568

Publisher and distributor:

CESifo Group Munich
Poschingerstraße 5
81679 Munich, Germany
Phone: +49 (0)89 9224-0
Fax: +49 (0)89 9224-1409
www.cesifo.org

Suggested citation

EEAG (2014),
The EEAG Report on the European Economy,
CESifo, Munich 2014

EEAG European Economic Advisory Group @ CESifo

Foreword

The euro area's economy emerged from a recession in spring 2013, with the sovereign debt and banking crises easing over the course of last year. However, a closer look at the performance of individual countries reveals that the euro area's economy is not out of the woods yet. Economic performance varied significantly across the euro area's member states in 2013, with imbalances in competitiveness manifesting themselves in persistent debt accumulation and mass unemployment in the periphery, despite some reforms. Expanding on topics that were discussed in previous issues, this year's report of the European Economic Advisory Group at CESifo (EEAG), the thirteenth of the series, shows that austerity is still necessary to achieve a rebalancing of relative prices within the euro area and offers a critical analysis of the concept of a unified banking system, which suffers from the attempt to implicitly socialise legacy assets, rather than offering a convincing bail-in strategy. Regardless of the diversity of the euro area, the report emphasises the importance of remaining on "The Road to Cohesion" and proposes Switzerland as a successful example. Despite its separate language groups, Switzerland has managed to build a functioning state with a decentralised structure based on the no-bailout principle, after being created as a defence union with a common army.

The EEAG, which is collectively responsible for all parts of the report, consists of a team of six economists from five countries. This year, the Group is chaired by Ákos Valentinyi (Cardiff Business School) and includes Giuseppe Bertola (EDHEC Business School), John Driffill (Birkbeck College), Harold James (Princeton University), Jan-Egbert Sturm (KOF Swiss Economic Institute, ETH Zurich) and myself (Ifo Institute and University of Munich). The members participate on a personal basis and do not represent the views of the organisations that they are affiliated with.

I would like to express my gratitude for the valuable assistance provided by the scholars and staff at CES and Ifo who helped to prepare the report. This year's participants were Nadjeschda Arnold and Christopher Weber (assistants to the group), Tim Oliver Berg, Atanas Hristov, Nikolay Hristov and Michael Kleemann (economic forecast), Lisa Giani Contini and Julio Saavedra (editing), Christoph Zeiner (graphics), Katja Kügler and Elisabeth Will (typesetting) and Ines Gross (cover). I also wish to thank Swiss Re for hosting our autumn meeting.

Hans-Werner Sinn
President, CESifo Group
Professor of Economics and Public Finance
Ludwig Maximilian's University Munich

Munich, 27 February 2014

The EEAG Report on the European Economy 2014

Contents

Authors: The members of the European Economic Advisory Group at CESifo

TABLE OF CONTENTS

Recommendations for Europe

Chapter 2 SWITZERLAND: RELIC OF THE PAST, MODEL FOR THE FUTURE?

- **Learn from the Swiss approach to diversity management.** The European Union faces difficult choices and disagreement within and across its member countries. The Swiss approach to diversity management can be seen as a useful model for Europe. Europeans have always tried to homogenise their countries' national cultures, and cultural heterogeneity across European Union member countries is increasingly problematic. The Swiss, by contrast, are both very much aware of their internal cultural diversity, and very proud of their country, conscious of the advantages of belonging to it.
- **Embrace pragmatic compromises as a way of laying firm foundations for common institutions and policies.** The Swiss Confederation's institutional structure is increasingly similar to that which the European Union is currently struggling to develop. Swiss history suggests that European citizens and policy-makers may more clearly see the advantages of togetherness, and perhaps find it easier to proceed towards political union, as changes in the world's geopolitical situation make it increasingly necessary for the European Union to deploy a common foreign policy.
- **Adopt both a common legal and regulatory infrastructure, and a comprehensive and rigorous fiscal system.** European nation states have long implemented single-market frameworks and redistribution schemes that have only recently been introduced by the Swiss Confederation. Switzerland, by contrast, has pioneered public debt brakes and relies on the threat of bankruptcy to ensure responsible and prudent lending and borrowing at lower levels of government. All of these institutional features are only slowly and problematically being extended to the euro area and the European Union.

Chapter 3 AUSTERITY: HURTING BUT HELPING

- **Euro area policy-makers should deal with the periphery's debt overhang.** Debt levels still appear to be far from sustainable levels for several periphery countries. High debt levels are likely to act as a drag on growth, as servicing debt requires the transfer of resources from debtors to creditors. Slow growth, however, will exacerbate the debt overhang problem. Debt rescheduling should be seen as a way of dealing with the problem, provided that the further reforms required do take place in periphery countries.

- **Countries in which the crisis has permanently changed the growth outlook need to accept some degree of fiscal austerity and embrace downward wage flexibility.** Weak domestic demand moderates price and wage inflation, supporting the real devaluation path that is needed to restore the competitiveness lost during the boom years. That path can be followed in less costly manner and at a faster pace if wages adjust flexibly.
- **Periphery countries should make their labour markets more flexible.** Productive resources need to be reallocated across industries and firms. While austerity deepens the crisis, high unemployment largely reflects the slow and painful character of labour reallocation processes in situations where uncertainty and institutions make firms keen to fire, but reluctant to hire. Labour market reforms could considerably accelerate the structural reallocation of labour and shorten the recession.
- **The fiscal policy framework in the periphery countries should be strengthened** to lend more credibility to the fiscal programs. In the absence of such a framework, credibility can only be gained through frontloading the fiscal programme, which is typically more costly in terms of output and employment than a more back-loaded programme. As debt levels are still high in some periphery countries, and austerity will be with them for some time, such a framework is all the more important to reduce the short-term cost of austerity.

Chapter 4 BANKING UNION: WHO SHOULD TAKE CHARGE?

- **The ECB's Comprehensive Assessment of Financial Institutions needs to be as rigorous and transparent in reality as claims suggest it will be.** Only a full revelation of legacy problems can ensure that the concept of a banking union does not appear to be a scheme for channelling resources to those euro area member states with weak banking industries. This perception would undermine political support for the necessary centralisation of bank supervision, regulation and resolution.
- **Clarification of who will pay for the legacy problems revealed by the Comprehensive Assessment is essential.** The costs should logically be borne by the member states responsible for past supervision. Since this weakens the link between weak sovereigns and banks in the short run, member states should be eligible for ESM support under appropriate conditions.
- **The list of creditors exempt from bailing-in should be kept short.** The principle of bailing-in some creditors of failing banks is sound. But a long list of exemptions may make it difficult to ensure that banks have enough contingent liabilities to meet reasonable recapitalisation needs.

Summary

The world economy showed strong signs of recovery in 2013, with the United States providing solid support. The euro area's economy also performed better last year than in 2012, although its performance varied across the different member states. The sovereign and banking crises have also eased, but the situation nevertheless remains fragile. Mass unemployment in several euro area countries is keeping social tensions at a high level; while internal and external rebalancing continues in the periphery. The sovereign debt crisis may have eased in 2013, but it certainly was not resolved; and debt levels increased further. Although several reforms on euro area level are being implemented, their outcome and impact remain uncertain. This year's EEAG report emphasises that supporting cohesion between member states, as well as maintaining fiscal and regulatory discipline, is crucial for Europe.

Chapter 1 of the report discusses the immediate macroeconomic outlook for the global economy, with a particular focus on the European situation. Chapter 2 focuses on Switzerland, and specifically on the lessons that Europe can learn from the Swiss experience in maintaining cohesion while supporting diversity, and in reaching pragmatic compromises in the creation of common institutions and policies. Chapter 3 analyses the much debated issue of austerity and highlights that fiscal discipline is not only needed to ensure the long-term sustainability of public debt, but also for external rebalancing, which is vital to the long-term sustainability of the euro. Finally, Chapter 4 looks at plans and measures to implement a banking union in Europe and discusses who will pay for future banking crises, and who will end up footing the bill for the latest crisis.

Chapter 1
Macroeconomic Outlook

Last year saw a slight acceleration in the pace of global economic expansion. Global development was – as in the years prior to 2013 – characterised by strong heterogeneity amongst individual regions. For the first time in over four years, the developed countries, and particularly the United States and the United Kingdom, became the driving forces behind the current and ongoing economic recovery.

The emerging economies will nevertheless continue to grow at rates that are higher than those seen in industrialised countries; but their pace of growth is, for structural reasons, unlikely to increase this year. Several key emerging economies are experiencing a marked flattening out of their population growth, which slows down the increase in labour force potential and thus also reduces potential growth. In addition, China sustains losses vis-à-vis other emerging markets due to the relatively rapid increase in its labour costs, which noticeably impacts competitiveness. Moreover, there are a growing number of signs to suggest that the potential of the Chinese model of growth based on capital accumulation is slowly running out of steam.

In the developed economies, real GDP growth rates gradually started to increase in 2013. In the United States, the contractionary impetus provided by fiscal policy was more than compensated for by improved domestic demand. Private consumption in the United States will probably continue to grow, supported by further improvements in the employment and housing markets, as well as to lending conditions. Business investment should also benefit from the recovery in domestic demand and the continued pursuit of highly expansionary monetary policy, which will secure relatively favourable refinancing conditions. Finally, the fiscal impulse will be less contractionary than last year.

In Japan, monetary and fiscal policy has been extremely expansionary since the beginning of 2013, which boosted private consumption and investment expenditure, while the domestic export industry reaped the benefits of a severely weakened yen. Although this scenario has allowed Japan's economy to expand strongly during the past winter months, its economic growth is expected to gradually decline over the year, as the positive fiscal impulse is bound to ebb away, while structural problems are likely to persist.

Most importantly for the world economy, spring 2013 saw the European Union finally emerge from the recession that had plagued it since the end of 2011. The EU economy has recorded moderate growth since then and has finally ceased to choke the world economy. This development was supported by reduced fiscal austerity, as well as fading uncertainty regarding the future of the currency area.

Several euro area countries nevertheless continue to suffer from very high public and/or private debt. The situation in the Portuguese, Spanish, Italian and Greek banking sectors also remains highly fragile. In addition, these economies are suffering from both a lack of competitiveness and weak domestic demand, as the price adjustments required have not fully materialised. Progress with necessary fundamental structural reforms is slow due to sturdy socio-political resistance, the generous provision of aid funds from the European relief package, the relaxation of fiscal policy objectives granted by the European Commission at the beginning of 2013, as well as the European Central Bank's (ECB) measures to reduce country-specific risk premiums on interest rates. Many governments have seen these measures reduce both their previously very high funding costs and massive market pressure to carry out structural reforms. At the same time, however, these policy measures have helped to take the existing anxiety out of the financial markets and thereby support the moderately changing economic climate in Europe. Without a strong self-reinforcing economic recovery the sustainability of such accommodating policies may, however, be called into question.

Overall, the economic situation in the euro area remains unclear. The moderate recovery that began last spring is nevertheless expected to continue this year; and this change compared to the previous two years does imply a positive impulse for the world economy. The negative impulse coming from fiscal austerity measures is expected to weaken further. In addition, net exports will also have a favourable effect, both due to the continuing weak imports noted in crisis countries and the moderate upturn in the world economy. Finally, the ongoing pressure on domestic prices in some of the structurally weak countries is expected to lead to an improvement in their international competitiveness. Accordingly, the euro area is likely to benefit somewhat more strongly from the recovery in world trade than in the past.

Domestic demand in the United Kingdom is likely to undergo an increasing revival this year, supported by an improvement in the asset positions of private households and expansionary monetary policy.

All in all, total economic production in the world looks set to increase by 3.0 percent in 2014, following 2.3 percent in 2013.

Inflation is expected to accelerate slightly in the advanced economies, with the exception of the euro area. The effect of the value added tax increase scheduled for April 2014 is playing an important role in Japan. Given the moderate development of commodity prices in recent months, inflation in emerging economies is not expected to provide any incentive to tighten monetary policy.

Chapter 2
Switzerland: Relic of the Past, Model for the Future?

In the aftermath of World War II, European nations started to deploy economic integration as the means to the end of achieving cultural and political convergence. Switzerland is an interesting exception in this context: It allows different cultures and fiercely independent political entities to coexist within its boundaries, has only slowly integrated its internal economic and institutional structure, and has not taken part in the European unification project that is challenged by the current crisis. The second Chapter of this year's EEAG report studies the origins and recent evolution of the Swiss Confederation's socio-political configuration, and outlines how some of its features may be adapted for use in the European Union.

The critical tensions that currently threaten to derail Europe's Economic and Monetary Union are largely absent in Switzerland because the Swiss Confederation is very different from the European nation states, which traditionally aimed to build consensus around centralised institutions through cultural assimilation. That approach unfortunately tended to trigger intra-European wars, is currently challenged by globalisation and migration trends, and is extremely unlikely to be implementable at the European Union level. Switzerland largely refrained from engaging in the nation-building phase of European history, remained neutral in its wars, and long maintained a fiscally decentralised and traditional type of socio-economic organisation, similar to that which prevailed throughout Europe before the Industrial Revolution. Swiss history and current policy issues, however, are deeply connected with those of its European neighbours, which have interacted with its economy through fiscal as well as market channels. Indeed, Europe influenced Switzerland's social and political configuration as the Swiss Confederation's cohesion was fostered by the need to defend itself from aggression.

Switzerland currently faces many of the welfare state and financial problems that trouble its European neighbours. It has developed an internal common market linked to the European Union's, its federal social insurance schemes are approaching the size and unsustainability typical of continental European nations, and it has faced financial and monetary crises similar to those that threaten to break up the euro area. The Swiss socio-political structure, however, appears in a better position than supranational European Union institutions to find pragmatic and democratic solutions to those problems: It supported early and effective implementation of public deficit restraints, and like the United States (but unlike European federal countries) refrains from debt mutualisation, relying on bankruptcy risk to deter excessive borrowing by sub-national public bodies.

Switzerland enjoys a successful policy performance record despite its deep internal cultural heterogeneity. The country's need to confront such heterogeneity may, in fact, be the key factor explaining its proverbial stability and its ability to devise and implement sensible economic policies. In Switzerland, cooperation is rooted in the "Konkordanz" principle of compromise between heterogeneous special interests with decentralised decision powers. This principle was developed after a civil war and required to manage the peaceful coexistence of cultures ranging from the Germanic, catholic, rural, and conservative cultures of the original Cantons, to the Protestant, Romanic, and enlightened culture of Geneva, through a large variety of multi-dimensional local cultural specificities.

Language and culture influence economic and political interactions even more forcefully than voting rights and tax obligations not only within Switzerland, but also within and across European countries. Nation states traditionally root cooperation, solidarity, and market integration in processes of cultural assimilation. Swiss history however suggests that cooperation and trade across culturally different societies, while neither easy nor riskless, is certainly possible and fruitful. Differences do not need to be eradicated when public policies and institutions seek cooperative solutions to common problems, and durable compromises are cemented by the self-enforcing realisation that breaking agreements in pursuit of immediate gains would entail larger losses.

Switzerland is becoming more similar to its European neighbours in various ways, and more tightly integrated with their financial, fiscal, and market structure. Europe may, in turn, benefit from becoming more Swiss in its approach to solving the key issue of defining and designing a new set of policies and political interactions that works consistently both at lower levels than that of legacy countries, and across the boundaries of historical nations. At the same time as the Swiss Confederation implements some institutional features of the European socio-economic system, the European Union might find it useful to implement some Swiss institutional features that are looser and less centralised than in traditional nation states, but pragmatically focused on the administrative, legal, monetary, and fiscal instruments that support market relationships, and held together by the common foreign policy and shared external concerns. The strength of such concerns may become more apparent as the evolution of the world's geo-political configuration makes it necessary for Europe to assert its common economic interests without the support of the United States.

Chapter 3
Austerity: Hurting but Helping

Since the sovereign debt crisis erupted in the euro area, there has been much discussion about the costs and benefits of fiscal adjustment or austerity during a recession. However, it also must be emphasised that austerity and the recession are also part of the adjustment process. In the course of this process the external imbalances of the euro area periphery countries are reduced, and the production factors that were misallocated in these countries during the pre-crisis boom get reallocated to their long-term sustainable use. It follows that neither austerity nor the recession was completely avoidable.

During the run-up to the crises optimistic expectations about income convergence generated an investment, and more specifically a construction boom in the periphery accompanied by ballooning current account deficits financed by private capital inflows. This demand expansion generated a faster rise in prices, including real-estate prices, in the periphery than in the core. This eroded the competitiveness of the periphery countries, which reinforced the increase in current account deficits. In addition, the boom also resulted in a misallocation of resources within countries across different activities and firms. After the onset of the financial crisis private capital flows stalled, and in some cases even reversed; and the investment boom collapsed causing a recession.

Initially policymakers in the periphery perceived the financial crisis as a temporary demand shock and, with the exception of Ireland, reacted with fiscal expansion in 2008 and 2009 to offset its recessionary effects. However, the shock turned out to be a combination of a longer-lasting negative demand and supply shock. The negative demand shock in the periphery was longer-lasting than in a normal recession because households in the periphery downwardly revised their expectations about the speed of convergence to the euro area core. A more permanent supply shock originated from the pre-crisis misallocation of production factors. Once the crisis erupted, many firms realised that the employment levels of the boom years would not only be unsupported in the short term, but also in the long run. Thus production factors, and particularly labour, had to be reallocated across firms and economic activities, resulting in sharply falling employment levels.

The financial crisis led to the European sovereign debt crisis. Firstly, the tax revenues of the boom years, particularly from the construction industry, were unsustainable in the long run. The sharp decline in tax revenues had a negative effect on government balances. Secondly, the collapse of the construction boom led to rising delinquency rates at the periphery banks. As the quality of the loan portfolio of the periphery banks deteriorated, governments had to bail out some of their banks, leading to a further worsening in fiscal positions. Thirdly, the initial efforts of the periphery governments to offset the recessionary effects of the financial crisis turned out to be ineffective, as the latter faced a more permanent demand and supply shock, instead of a temporary demand shock. In fact, the expansion itself led to further deterioration in fiscal balances.

The on-going adjustment in the euro area periphery is characterised by slowly declining prices relative to the core, by the reallocation of resources across activities, and by a slow improvement in external balances. The adjustment in prices is crucial both to external balances and labour reallocation, but hampered by several factors. Firstly, prices are sticky, so shocks are absorbed by a fall in output and employment to a larger extent. Secondly, extensive credits granted by the national central banks and fiscal rescue funds reduced pressure to implement austerity measures and hence slowed the pace of reform. Thirdly, expectations about the future path of prices were influenced by expectations regarding the break-up of the euro area. If the euro area were to break up, the currencies of periphery countries would devalue, and their prices would rise relative to those of the core countries. In periods when such a break-up was expected, prices in the periphery rose faster (fall slower) than in the absence of such expectations. In other words, such expectations slowed down internal devaluation in the periphery countries. Fourthly, labour market rigidities in the periphery countries make labour reallocation particularly slow, leading to a prolonged recession.

The adjustment towards a labour allocation and relative prices that are consistent with smaller external balances is accompanied by a recession, as is usually the case with any large-scale reallocation of labour. The recession provides incentives for periphery firms to reduce their prices and wages, which, in turn, induces the reallocation of labour. Consequently austerity did not cause the recession in itself, but it contributed to it. A certain amount of austerity is a necessary part of the post-financial crisis adjustment. Hence, neither the austerity nor the recession was completely avoidable.

Chapter 4
Banking Union: Who Should Take Charge?

The European Union is putting in place a scheme for a banking union. The concept of a banking union has come to mean the centralisation of banking regulation, supervision, resolution, and deposit insurance at the level of the euro area, with a common regulatory rule-book, supervisor, resolution authority, and deposit insurance scheme. In short, it amounts to applying single market principles to banking.

An EU Regulation for the "Single Supervisory Mechanism" came into force in November 2013. One year later, in November 2014, the ECB is due to take over supervision of the 130 largest and most important financial institutions in the euro area. Before that date, it will carry out an assessment of the balance sheets of those institutions, with a view to identify and remedy existing problems: the so-called legacy issues.

The European Commission has put forward a proposal for a Single Resolution Mechanism, on which agreement between the Council of the European Union and the Commission has now been reached. They aim to reach an agreement with the Parliament by May 2014, so that the regulation can be enacted. A common system of deposit insurance has not been given much attention yet, but is a relatively less urgent issue, given existing national provisions, which have been reinforced by changes made in December 2013, and slightly improved co-ordination of which will provide a reasonable interim solution.

The main argument in favour of a banking union is that fiscally weak governments and fragile banking systems have become too closely connected. In addition, many banks operate across national boundaries within the euro area. For these reasons, regulation and supervision could be more effectively performed by one supervisor; while the resolution of such banks could be achieved more cleanly and quickly by a single euro area authority than by national authorities attempting to coordinate with each other. Another argument often put forward is that national regulators have become too close to the banks they regulate, too susceptible to political pressure, too prone to delaying intervention and have incentives to offload costs onto the euro area as a whole. According to this line of argument, centralised supervision will be better supervision. There are euro-area-wide spill-over effects from a bank failure in a member state. Even small banks can have systemic effects.

It is efficient to pool resources to provide insurance for the costs of bank failure, rather than having individual member states pay for failures that occur in each jurisdiction. Pooling resources goes some way towards addressing the problem of institutions that are "too big to fail".

In addition, if the ECB is to act as lender of last resort to euro area banks, it needs information on their solvency, it must supervise them, it requires control, and it needs to be able to resolve failing institutions.

The principal arguments against centralisation are that it effectively represents a scheme for transferring resources to the financially weak states from the rest; and that it places too much power and responsibility in the hands of a single institution.

The idea of having a banking union follows many interventions by the EU authorities since the financial crisis that were aimed at solving the euro area's public debt and banking problems, and have enjoyed little success to date. These measures can be divided into four groups: (i) providing loans ("bailouts") to heavily indebted governments unable to access commercial markets; (ii) reinforcing banking regulation; (iii) reviving the "Stability and Growth Pact" in the form of the new "Fiscal Compact", with the aim of increasing the credibility of member states' plans for fiscal consolidation; and (iv) the ECB's provision of liquidity to banking systems and its policy of low interest rates. However, none of these measures has had the desired effect of lowering interest rates for private sector borrowers in periphery member states to the level of the rates paid in Germany and other fiscally sound, typically northern, euro area member states. Only the ECB's policy of "Outright Monetary Transactions", announced in September 2012, but not yet actually used in practice – the euro area's long sought-after "big bazooka" – has met with partial success.

It is not yet clear how effective the banking union will prove in insulating the banking system and public finances from each other in periphery member states, in improving the standards of bank supervision, and in providing a more effective mechanism for resolving failing institutions. A great deal depends on how the comprehensive assessment of banks' balance sheets is undertaken in 2014, the rigour with which the legacy issues are identified, and the financing methods used. Looking further ahead, after the ECB takes over supervision in November 2014, the banking union's impact will depend on the effectiveness of supervision and regulation by the ECB, and the way that the resolution regime operates.

The resolution authority is intended to draw as little as possible on public funds, and to use the resources of banks and their creditors to resolve failed institutions instead. The Single Resolution Mechanism, according to current EU proposals, bails in creditors, in reverse order of seniority, but only after a large number of bank liabilities have been exempted. There is concern that the list of exemptions is too long, and that banks will have insufficient liabilities that may be bailed-in to meet the costs of resolution: the targeted minimum of 8 percent may too low. As a back-up, the proposed "Single Resolution Authority" will accumulate a 55 billion euros fund, raised by a levy on banks, to be used when the resources of institutions under resolution have been exhausted. But this Single Bank Resolution Fund is likely to be too small to be useful. In any case, it will not be fully accumulated until 2026, prior to which individual countries will remain partly responsible for the costs of bank resolutions in their own jurisdictions, if the bailing-in of the banks' creditors is insufficient. This has an ambiguous effect on the attempt to separate sovereigns from banks. On the one hand, it reduces the possibility of disentangling banks and sovereigns concerning legacy assets, on the other hand it reduces the incentives of banks to further load their balance sheets with new toxic government bonds and turns the entire European banking system into a tool to absorb even more government bonds. On current plans, a scheme for a euro-area-wide mutual backstop to the Single Bank Resolution Fund will be devised, but it may not come into effect until 2026.

While the banking union could, in principle, prove a useful institution for pooling risk among states, improving the standards of bank supervision and regulation, and reversing the fragmentation of euro area banking, there remains a distinct possibility that it will, in fact, substantially act as a means of channelling resources from financially sound, predominantly northern member states to southern periphery states with financial and banking problems.

Macroeconomic Outlook

1.1 Introduction

The world economy has experienced a slight acceleration in economic growth since summer 2013 and is expected to gradually gain further momentum in 2014. Producer and consumer confidence improved in most major regions of the world. For the first time in four years, industrialised countries became the driving force behind the economic recovery. Accompanied by a monetary policy that remains extremely expansionary, private debt reductions in the United States and the United Kingdom advanced, and fiscal policy in the euro area was no longer as restrictive as in previous years. Most importantly, uncertainty regarding the future of the euro area continued to fade.

At the same time major emerging economies underwent a period of faltering. This was partly due to, or at least triggered by, uncertainty regarding the gradual tightening of monetary policy in the United States last summer. Turkey, India, Indonesia, Brazil and South Africa in particular had to cope with rapid outflows of foreign capital. As a result, the refinancing conditions for both the private and public sectors deteriorated and their currencies devaluated quite sharply.

During the summer the euro area recovered from a recession that had lasted over a year. The trigger for the recovery can be traced back to September 2012 when the European Central Bank (ECB) introduced the so-called Outright Monetary Transactions (OMT) programme, which basically implies an insurance scheme against extreme events for government bond holders in the euro area. This served to relieve the interest burden faced by governments affected by the crisis and allowed them easier access to capital markets once again. At the same time, it reduced the pressure to implement austerity programmes and thereby supported a return to less restrictive fiscal policy.

The recovery is characterised by a pronounced heterogeneity among individual member countries. The situation remains fragile and susceptible to critical distortions in many of these countries. Quite a few still face large private and/or public debts. In those countries that are most clearly affected by the crisis, i.e. Cyprus, Greece, Italy, Portugal and Spain, the steep upward trend in loans at risk is as strong as ever. As argued in previous reports, the core of the problem lies in their lack of competitiveness (EEAG 2013, Chapter 2; EEAG 2012, Chapter 2). Unless competitiveness is restored, it is only a matter of time before some of these countries fail to repay their foreign debt. Unfortunately, an irreconcilable conflict exists between short- and long-term solutions. Measures that tend to be beneficial for the cyclical position of an economy in many cases delay the restoration of competitiveness through real depreciation, thereby impeding long-term recovery.

We do expect countries affected by the crisis to continue to gradually improve their international competitiveness by further reducing (relative) price levels. Since private debt is often still very high and unemployment rates are also at historically high levels, domestic demand in these countries is, for the moment, likely to continue to decline. In addition, although they have improved, refinancing conditions remain rather poor due to the unstable situation of the banking system, and as such are hindering investment activity. The reduced restrictiveness of fiscal policy in recent times has acted as a stabiliser for short-term domestic demand. However, to the same extent that this discourages or postpones structural reforms, it also, in turn, weakens the forces that boost long-term competitiveness. The continued pursuit of expansionary monetary policy also serves to support the economy.

All in all, real gross domestic product (GDP) is expected to rise by 1.2 percent in the European Union this year. Whereas production in the crisis countries will increase only slightly (Spain and Portugal) or continue to dwindle (Cyprus, Greece and Italy), more robust economies like the United Kingdom, Sweden and Germany will experience a boom.

1.2 The current situation

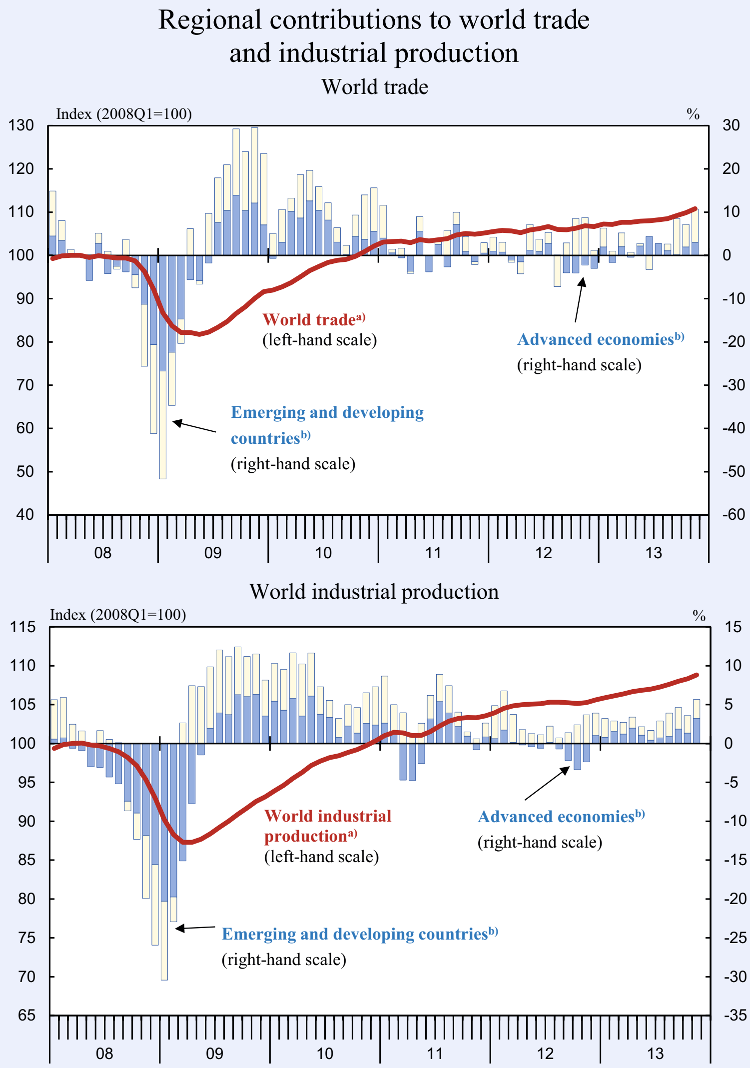
1.2.1 The global economy

Last year saw a slight acceleration in the pace of global economic expansion. Both world industrial production and world trade experienced slight gains in 2013 compared to 2012 (see Figure 1.1). Thereby, global development was – as in preceding years – characterised by strong heterogeneity amongst individual regions. While the economic situation in the advanced countries increasingly improved, some major emerging economies underwent a phase of weakness triggered not only by cyclical, but in many cases by structural factors, too. Thus, for the first time in over four years, the developed countries were the driving force behind the current economic recovery. Overall, the global rate of expansion was considerably more moderate than in the years prior to the financial crisis.

Whereas the economic climate improved during the first half of 2013 in Asia and North America, sentiment in Europe only started to follow this positive trend after the recession in the euro area officially ended, while Latin America even went into bust mode (see Figure 1.2).

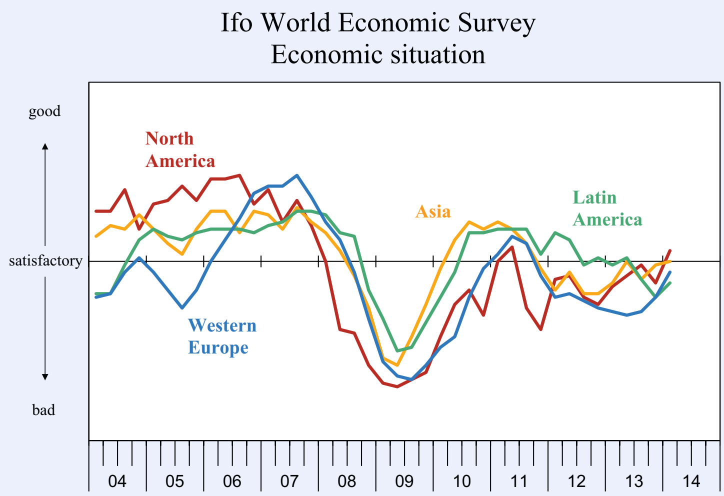
Not only the timing, but also the driving forces behind the mild recoveries in large parts of the world differed greatly from region to region and from country to country. Private households in the United States were in a position to expand their consumer spending, as they were supported by the improvement in their financial situation, favourable developments in the housing market and the increasing

Figure 1.1



[a] Three month moving average level. [b] Contribution to annualised monthly growth rate thereof.
Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor: November 2013.

Figure 1.2



Source: Ifo World Economic Survey I/2014.

elucidation of the employment situation. The contractionary impetus provided by fiscal policy was more than compensated for. Activity in the construction sector also experienced faster growth. Lastly, the economy benefited from the continued and highly expansionary monetary policy of the US Federal Reserve.

In Japan, monetary and fiscal policy has been extremely expansionary since the beginning of 2013. This boosted private consumption and investment expenditure, while the domestic export industry reaped the benefits of a severely weakened yen.

Most importantly for the world economy, by the spring of 2013 the European Union was finally in a position to free itself from the ongoing recession, which had plagued it since the end of 2011. It has recorded moderate growth since then and has therefore ceased to choke the world economy. This development was supported by reduced fiscal austerity, as well as fading uncertainty regarding the future of the currency area.

Although consumer and producer sentiments have strengthened almost everywhere in the euro area in recent months, the economic situation of individual countries remains highly heterogeneous. Several euro area countries continue to suffer from very high public and/or private debt. Furthermore, the situation in the Portuguese, Spanish, Italian and Greek banking sectors is still highly fragile. In these countries, the shares of impaired loans are increasing steadily, thereby burdening bank balance sheets. In addition, these economies are suffering from both a lack of competitiveness and weak domestic demand, as the price adjustments required have not fully materialised. The necessary fundamental reforms are delayed due to sturdy socio-political resistance, the generous provision of aid funds from the European relief package, the relaxation of fiscal policy objectives granted by the European Commission at the beginning of 2013, as well as ECB measures to reduce country-specific risk premiums on interest rates. Many governments have seen these measures reduce their previously very high funding costs, and with it the massive market pressure to carry out structural reforms. At the same time, however, these policy measures have helped to take the existing anxiety out of the financial markets and thereby support the moderately changing economic climate in Europe. Without a strong self-reinforcing economic recovery the sustainability of such accommodating policies may, however, be called into question.

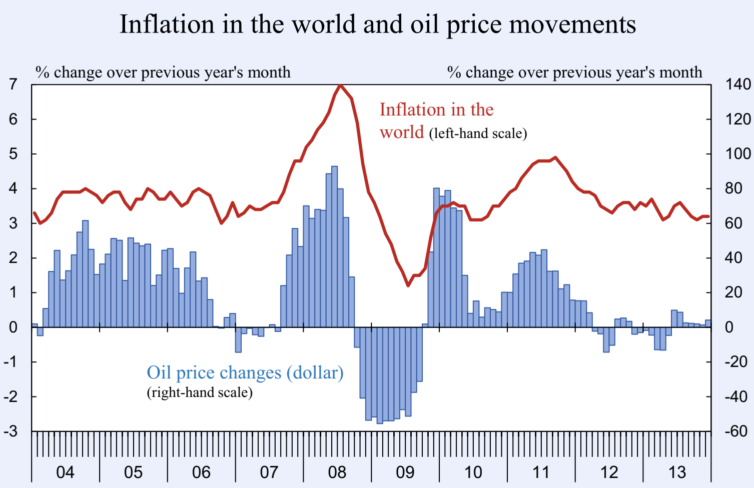
In a number of major emerging economies, the pace of economic expansion has continued to diminish since last autumn, albeit to different degrees. Both cyclical and structural factors are crucial in this respect. Many emerging economies struggled under the very weak demand from advanced economies. In the majority of the emerging world, government deficits are moderate and national debt is still relatively low. Some countries like China and Brazil used the existing fiscal and political room for manoeuvre to, at least partly, compensate for this weak demand from advanced economies by means of investment programs.

Russia, Brazil and other Latin American countries suffered from stagnating or declining commodity prices. In many cases, another important factor was the after-effects of gradual monetary and fiscal domestic tightening, which took place until about mid-2012. On top of that, many emerging countries faced some rapid outflows of foreign capital last summer, which significantly deteriorated the refinancing conditions for their private and public sectors and set numerous currencies under a massive devaluation pressure. This turmoil was partially a response to the slowdown in economic growth in the emerging economies. However, tensions in the financial and foreign exchange markets were primarily triggered by signals that a gradual tightening of monetary policy in the United States might be initiated earlier than anticipated by financial market participants. While many regions of the world were confronted with a temporary slowdown in capital inflows, currency devaluations against the US dollar and rising bond yields, these adjustments were particularly pronounced in the emerging markets (Turkey, India, Indonesia, Brazil, South Africa), where public and private debtors were in an especially vulnerable position regarding devaluations of domestic currencies. These economies have relatively high short-term funding needs denominated in US dollars. The resulting capital flows were stabilised by the end of the summer due to base rate increases and foreign exchange market intervention on the part of several of these countries' central banks, as well as the decision of the US Federal Reserve to postpone tapering of its quantitative easing policy at that time. Although this effectively contained financial market turmoil, the refinancing conditions for households, businesses and the state have – in many cases – remained more restrictive since the summer than they were previously.

In addition, the growth decline in emerging markets also underlies structural factors. Several key emerging economies are faced with a marked flattening of their population growth, slowing down the increase in labour force potential and also reducing potential growth as a result. In addition, China has sustained losses versus other emerging markets due to a relatively rapid increase in its labour costs in recent years, which noticeably impacted China's competitiveness. Moreover, there are increasing signs suggesting that the potential of the Chinese growth model based on capital accumulation is slowly being exhausted. As a result of the excessive capacities that have been established in many areas, further investments appear less profitable and therefore less attractive. China's relatively advanced state of economic development decreases the scope for productivity improvements through the adoption of existing advanced technologies. In Brazil, by contrast, the lack of infrastructure and strong government interventionism are diminishing the country's attractiveness as an investment location. In India, difficulties in the banking sector, energy supply shortages and the over-regulation of many industry sectors are very likely to impede economic expansion. Although all of these structural factors have been present for some time now, their effects were more than compensated for in the first three years after the severe downturn in the winter of 2008/2009 by the stimulating effects of massive expansionary monetary and fiscal policy measures.

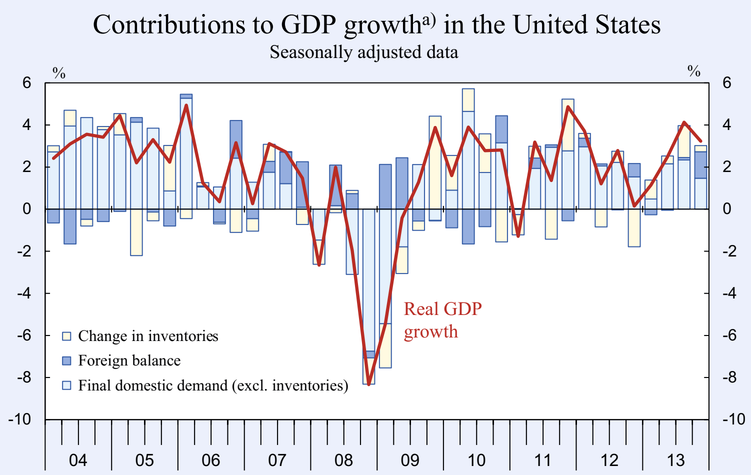
The overall weak development of the world economy, together with stagnating or declining raw material prices, allowed world inflation to remain around or slightly below 3½ percent in 2013, which was already the case throughout most of 2012 (see Figure 1.3).

Figure 1.3



Source: International Monetary Fund, International Financial Statistics, last accessed on 31 January 2014.

Figure 1.4



a) Annualised quarterly growth.
Source: Bureau of Economic Analysis, last accessed on 31 January 2014; EEAG calculations.

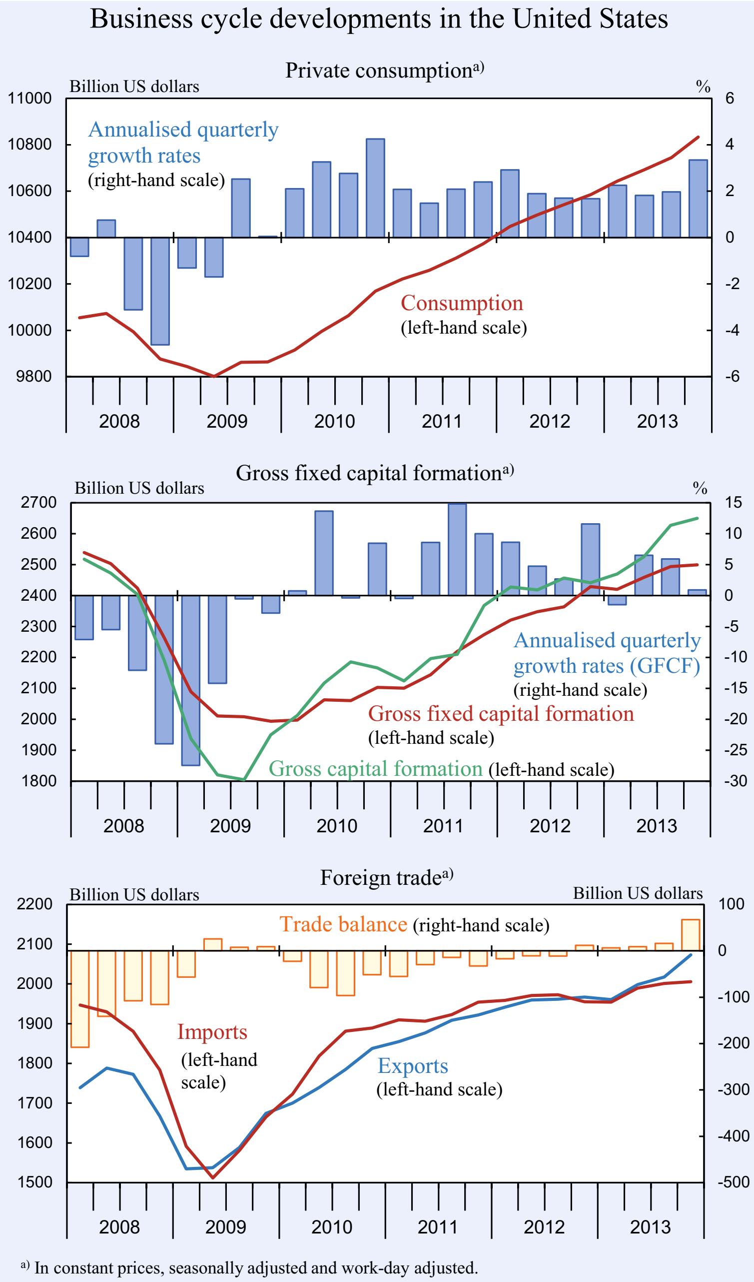
1.2.2 United States

In the United States, economic developments were driven by fiscal policy last year to quite a large extent. At the beginning of 2013, the payroll tax rate was raised by 2 percentage points, and income tax on the wealthy was also increased. In March, the so-called "sequester" – with cuts in discretionary federal spending – took effect. The combined impact of these measures slowed down the economy. Most of the dampening impulses started to phase out last summer. Whereas both government consumption and investment plummeted during the winter of 2012/13, investment contributed positively again in the third quarter of last year. As a result, the expansion rate of real GDP accelerated from an annualised 1 percent during the previous winter to over 2.5 percent last summer (see Figure 1.4). At the beginning of the fourth quarter, the budgetary dispute paralysed the federal administration for two weeks, again with a dampening effect on the overall economy.[1] The direct demand effect of a two-week "government shutdown", associated increased economic uncertainty and the implementation of some restrictive measures already planned for in the spring did result in subdued development during the fourth quarter of last year. In addition, the strong stockbuilding tendency of the third quarter stopped almost completely. The annual US real GDP growth rate consequently turned out to be 1.9 percent in 2013.

Private consumption and investment expenditure contributed differently to the overall acceleration in US economic growth last year. Private households compensated for the tax burden at the beginning of the year almost exclusively by lowering their savings rate. While private consumption growth therefore remained remarkably stable throughout most of the year and increased its pace during the fourth quarter (see Figure 1.5), most of the observed dynamics came from movements in stocks. Whereas inventory investment generated a negative growth impulse at the end of 2012, it provided strong growth impulses over the first half of 2013, and again during the third quarter when a normalisation of the weather conditions – as compared to the extremely dry weather in 2012 – led to an unusually strong increase in stocks in the agricultural sector. As far as private fixed investment is concerned, low growth in the first quarter of 2013 merely compensated for strong investment activities at the end of 2012 brought forward in anticipation of the then forthcoming fiscal consolidation. Ever since, private residential and non-residential construction activities have strongly supported overall private fixed investment. By contrast, equipment investment was particularly sluggish compared to other investment components.

After a weaker phase during last summer, the labour market has now stabilised. On average, about 200,000 jobs were created per month during the months of August to November. This allowed the unemployment rate to fall from 7.9 percent at the beginning of 2013 to 6.7 percent in December (see Figure 1.6). Never-

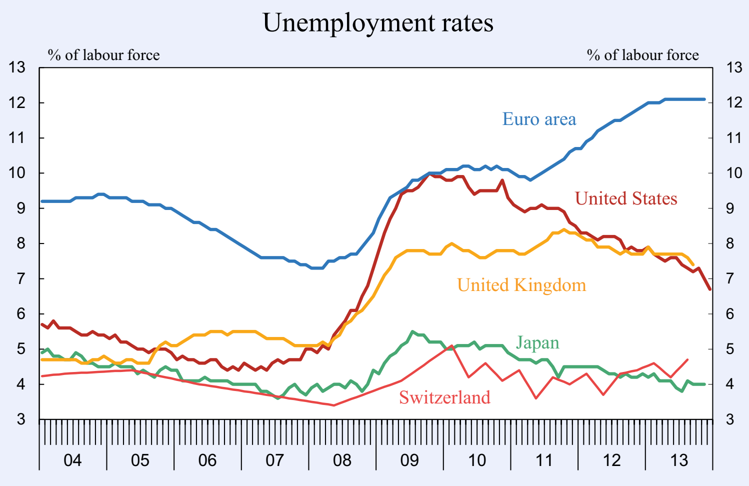
Figure 1.5



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2014.

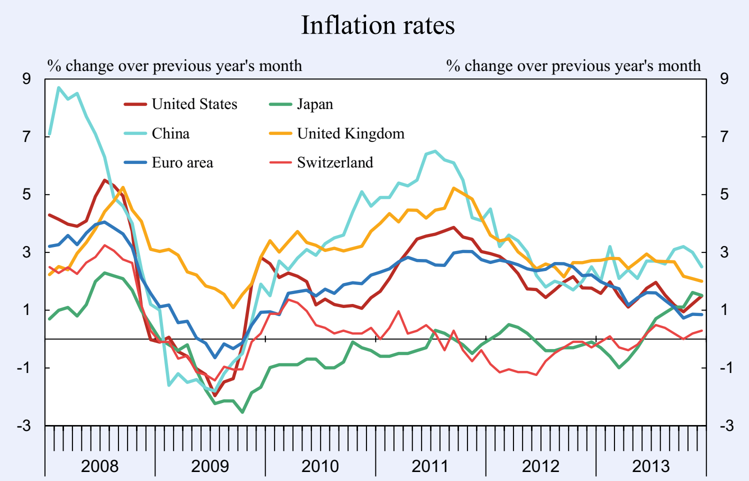
[1] As Democrats and Republicans were unable to agree on a new budget law by the end of the fiscal year on 30 September 2013, the necessary legal grounds for the approval of budgetary funds were lacking. Consequently, all non-security authorities of the US federal government had to cease their activities by 1 October. On 16 October, one day before the onset of technical insolvency due to the simultaneously reached statutory debt ceiling, only a minimal consensus for a transitional budget was initially reached. By mid-December, Democrats and Republicans had managed to agree on a draft budget for the next two years. This draft was approved in mid-January 2014 by both the Senate and the House of Representatives.

Figure 1.6



Source: OECD, Main Economic Indicators, last accessed on 14 January 2014.

Figure 1.7



Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2014.

theless, the increase in employment is still below average compared to past recovery phases in the United States and the unemployment rate is falling largely due to a continued drop in the participation rate.

After coming down in 2012, inflation stayed low, but was relatively volatile during 2013 (see Figure 1.7). As indicated by the much more stable core inflation rate, i.e. the rate of inflation excluding energy and food costs, the observed volatility was primarily due to changes in energy prices. Overall, actual inflation reached an average of 1.5 percent in 2013.

1.2.3 Asia

China's economy picked up speed over the course of 2013. After a trough in the first quarter of 2013, real GDP growth continued to increase throughout the year, resulting in an annual growth rate of 7.7 percent. Fiscal policy turned expansionary until mid-2013 to circumvent a further reduction in economic growth observed during the winter of 2012/13. The fiscal measures mainly constituted a temporary increase in public investment.

Although the service sector continues to outperform other areas of the economy and overtook industry in terms of size last year, overall strong economic development was also underlined by a substantial increase in industrial production in recent months. The main catalyst was expanding capital investment, while private consumption generated smaller impulses. China's economic growth continues to be based heavily on investment, with over 50 percent of overall growth last year linked to this demand component. In particular, the sharp rise in residential construction has led to a significant boost in investments. Due to feeble global demand, exports generated little economic momentum last year. Another reason for weak Chinese exports is the relatively sharp increase in unit labour costs in recent years. China is slowly losing its ability to compete with other emerging markets as a result. In addition, some Asian emerging countries were faced with currency devaluations last year, making them more reluctant to import goods and services from China. Export growth to the European Union only seems to have overcome its persistent weakness since the last quarter of 2013, thereby reflecting recent economic progress in that region.

Inflation in China has steadily increased from below 2 percent at the end of 2012 to about 3 percent at the end of last year. However, it is doubtful whether this can be regarded as an indication of a permanent increase in inflation. Core inflation still seems anchored at levels below 2 percent and producer prices in the industrial sector have been declining since March 2012. The latter can be interpreted as an indication of overcapacities in this sector.

The strong growth in house prices appears more worrisome. Despite signs of a slowdown, these growth rates are still multiples of overall inflation rates. The real-estate boom was caused by the low interest rates that state-owned banks are allowed to offer households on their savings and limited possibilities for investing abroad. For many households investing in real-estate is the only viable option. A liberalised capital market would, in principle, have prevented such a development from emerging. However, now that the bubble exists, there is a risk that liberalisation will act as the trigger to burst it.

The growth rate in the *Japanese* economy lost dynamics during the second half of 2013. The pace of economic expansion in Japan was nevertheless still higher than in most other OECD countries, and clearly above average from an historical perspective. The Japanese government primarily stimulated the economy by means of its expansionary fiscal policy. Private consumption took a breather, after performing exceedingly well in the first half of the year. Public investment and private construction spending remained strong, reaching double digit growth rates. By contrast, growth in private equipment investment slowed somewhat. After having shrunk throughout 2012 and stagnating early last year, the upturn in the second quarter of 2013 generated hopes for a stronger turnaround. It is disappointing for the current government that this turnaround so far failed to materialise, as the medium-term success of its policy is based on the participation of private investors in the upswing. Weak demand from emerging Asian markets caused by recent currency turmoil did exert downward pressure on net exports. This unexpected downturn manifested in rising inventories. The temporary nature of this downturn is also reflected by the overall improved business situation and the sentiment of large companies. Real GDP is expected to have risen by 1.6 percent in 2013.

The Japanese central bank continued to pursue its expansionary monetary policy in 2013. In order to achieve its new inflation target of 2 percent, it massively expanded the central bank money stock; since the beginning of 2013, the Bank of Japan's monetary base has risen by about 50 percent. Although this has not been reflected in other money supply aggregates to date, the inflation rate turned positive in early summer and stood at 1.5 percent in November. This was partially due to the steady rise in domestic energy prices. However, even excluding the prices of food and energy, consumer prices started to rise in November by 0.6 percent, which was the highest value recorded for the core inflation rate in the last 15 years. The recent increase in consumer prices is only marginally noticeable in the average annual inflation rate, which turned out to be 0.3 percent on average in 2013.

The pace of economic expansion in *India* accelerated slightly in the second half of 2013, after declining steadily since the fall of 2011. The main reason for this acceleration was the positive impact of fiscal policy. Private consumption, however, remained feeble. On the production side, the pace of economic growth in agriculture, as well as in the services sector and manufacturing, remained low. India was temporarily confronted with large capital outflows, leading to a depreciation of its currency of about 20 percent against the US dollar during the summer. The risk of a prolonged cessation of foreign capital injection caused the central bank in India to follow a more restrictive monetary policy – three increases in its key interest rate materialised since autumn – which, in turn, dampened the business cycle, but did stabilise the external value of the Indian rupee. Structural problems, like deficiencies in infrastructure and bottlenecks in energy supply are, at least partially, to blame for the overall weak economic developments in India from an historical perspective. Real GDP growth is expected to have again been only 3.9 percent last year. At 11.5 percent, the annual inflation rate, on the other hand, remains far above its average value.

After a feeble 2012, the economies of the Asian Tiger countries *(South Korea, Taiwan, Hong Kong and Singapore)* gained momentum during 2013. This was mainly due to a strong upturn in private consumption. Despite continued weakness in foreign demand, foreign trade made a positive contribution to growth in South Korea, where exports to the United States and to the European Union in particular increased. In addition, the expansionary economic policies of the South Korean government supported the recovery. Inflation is still below average by historical standards, enabling a continuation of expansionary monetary policies. All in all, overall economic production is likely to have risen in the fourth quarter at a similar rate to the previous quarter.

After their above-average growth in 2012, the emerging Asian countries *(Indonesia, Thailand, Malaysia and the Philippines)* posted lower growth rates in 2013. Weak external demand and the decline in investments have had a negative impact on all of these economies except the Philippines. Inadequate institutions, unnecessary bureaucracy and inefficiencies in the financial sector also hampered growth. The Philippines once again appears to be the exception here.

Unlike the others, the biggest of these economies, Indonesia, has faced substantial capital outflows since mid-2013. The Indonesian rupiah fell by around 30 percent against the US dollar over the course of the year. Short-term liabilities, as well as current account deficits, which had been increasing for several years, have made the country susceptible to shifts in market sentiment.

Taken together, these eight East Asian countries are expected to have seen – as in 2012 – an increase in total real GDP of 3.8 percent in 2013.

1.2.4 Latin America

The moderate pace of expansion observed since 2012 in Latin America *(Brazil, Mexico, Argentina, Venezuela, Colombia and Chile)* continued throughout 2013. This was especially driven by Brazil and Argentina, the two largest economies of the region. However, real GDP growth also slowed down significantly in Mexico. In addition to weaker external demand (especially from the United States), which led to a decline in industrial production, the government reduced its expenditure and lower construction activity was recorded. Colombia and Chile remained relatively robust by comparison. Here, the expansion of real GDP did slow down due to weaker external and domestic demand, but not to as great an extent as in the countries mentioned above.

In Brazil, the base rate (BACEN Selic target rate) gradually increased from 7.25 percent in April to 10 percent by the end of last year. By contrast, monetary policy in most other countries of the region became more expansionary. This was especially true of Mexico, where the Banxico overnight interbank rate was reduced from 4.5 percent in March to 3.5 percent in October 2013, which marks an historical low.

In anticipation of rising yields in the industrialised countries, the currencies of the countries of Latin America have been subjected to strong downward pressure since May 2013. The Brazilian Real had depreciated by around 20 percent against the US dollar by the end of August. After the US Central Bank's announcement in September that it would postpone the tapering of its asset buying program, the situation in the international capital markets calmed down again. Despite the negative impact of these strong exchange rate reactions last summer, Latin American countries are far less vulnerable than in previous (currency) crises. In addition to flexible exchange rates, most countries in the region have substantial foreign exchange reserves at their disposal, which are sufficient to stabilise their exchange rates in case of an emergency. A certain amount of risk, however, is attached to high foreign currency liabilities. In many of these countries the vast majority of external debt is recorded in foreign currency, making the holders vulnerable to currency devaluations.

In total, the Latin American economies are expected to have grown by 2.5 percent last year. In general, inflation rates have fallen since mid-2013, after having increased previously. The exceptions to this rule are Venezuela and Argentina, where inflation rates remained double-digit. Annual inflation in the region was 6.9 percent in 2013, following 6.2 percent in 2012.

1.2.5 The European economy

The cyclical situation

In spring the economy of the European Union emerged from a recession that had lasted over a year and has since been able to expand slightly. The EU economy nevertheless remains in pretty bad shape, as it is still characterised by a pronounced heterogeneity among individual member countries and remains fragile and susceptible to critical distortions in the financial market. Several member states still carry with them enormous private and/or public debt, often generated in the decade prior to the crisis. Given the weak economic development and low inflation rates of the past five years, the debt, despite consolidation efforts, increased even further. In some cases, the sustainability of public debt by international investors is still being called into question. Accordingly, Greece, Portugal, Ireland and Spain have not been able to refinance themselves, or only at capital market conditions that were politically considered unacceptable, in the past three years. This has made them dependent on grants from international institutions, like the International Monetary Fund (IMF) and the ECB; or they merely preferred the conditions required by these organisations above to those imposed by the capital market. The situation of the banking sector is also very fragile in many countries. In Spain, Portugal, Greece and Italy, the steep upward trend in loans at risk remains strong. Indeed, the political inability of these countries to implement timely and, where necessary, drastic restructuring of the banking sector, contributes to the difficulties experienced by the EU economy.

As argued in previous reports, the core of the problem lies, however, in its lack of competitiveness (EEAG 2013, Chapter 2; EEAG 2012, Chapter 2). The credit bubble has made some countries too expensive. In these countries, devaluations via price restraint are required at a scale of up to 30 percent in order to facilitate the restoration of competitiveness within the euro area. Implicit loan assistance, via TARGET2 balances (see EEAG 2013, Chapter 2) and the loans of the international community have served to alleviate the problems so far, but they have probably also protracted the real solution of the issue at hand by making the lack of competitiveness somewhat more bearable. Nevertheless, some progress has been made. Table 1.1 reveals that unit labour costs in the private economy did increase substantially, with average annual rates of well-above 3 percent in the crisis countries, since the introduction of the euro and before the euro crisis. During the last four years, these four countries have, on average, seen a decline in these unit labour costs. When taking into account the structure of competition in both export and import markets and exchange rate developments, to get a measure of international competitiveness, the picture remains largely unchanged. Although relative unit labour costs increased considerably during the 1999–2009 period, we have seen a strong decline since then. Another, albeit more

Table 1.1

Labour costs[a)]

	Compensation per employee[b)]		Real compensation costs[c)]		Labour productivity		Unit labour costs		Relative unit labour costs[d)]		Export performance[e)]		
	1999 – 2009	2010 – 2013	1999 – 2009	2010 – 2013	1999 – 2009	2010 – 2013	1999 – 2009	2010 – 2013	1999 – 2009	2010 – 2013	1999 – 2009	2010 – 2013	2013
Germany	1.0	2.3	0.2	0.8	0.4	1.2	0.5	1.3	– 1.3	– 1.3	0.7	1.6	– 1.3
France	2.7	2.5	0.9	1.2	0.6	0.9	2.2	1.2	0.6	– 1.0	– 2.6	– 0.6	– 1.6
Italy	1.8	2.1	– 0.5	0.8	– 0.4	0.0	3.0	1.2	1.5	– 1.3	– 3.7	– 0.4	– 2.3
Spain	3.1	1.5	– 0.3	1.3	0.4	2.1	3.5	– 2.3	1.8	– 4.4	– 0.9	1.9	2.8
Netherlands	3.2	1.7	0.9	0.5	0.8	0.2	2.6	1.0	1.2	– 1.5	– 0.1	0.2	–0.1
Belgium	2.6	2.5	0.7	0.6	0.7	0.5	2.2	1.8	1.0	– 0.4	– 1.7	– 1.1	– 1.5
Austria	2.2	2.1	0.7	0.2	0.9	0.4	1.2	1.8	– 0.3	– 0.3	–0.3	– 0.7	– 0.2
Greece	4.9		1.8		1.7	– 0.2	4.1	– 4.5	1.9	– 6.9	– 1.5	– 4.1	– 0.4
Finland	3.1	3.0	1.7	1.1	1.0	0.9	2.3	1.8	0.7	– 1.5	– 1.1	– 4.2	– 3.3
Ireland	4.6	0.6	2.1	0.6	1.9	1.6	3.5	– 2.3	2.6	– 4.8	2.2	– 1.2	– 1.4
Portugal	3.8	1.2	1.0	0.7	0.9	1.6	3.2	– 1.4	1.1	– 2.5	– 1.4	2.5	4.4
Slovakia	8.1	3.3	4.0	2.2	3.7	2.7	3.1	0.4	3.7	–1.8	2.6	5.4	4.1
United Kingdom	3.9	1.9	1.7	– 0.4	1.3	0.4	2.7	1.6	– 1.5	0.1	– 1.6	– 1.5	0.6
Sweden	3.1	2.4	1.3	1.4	1.4	1.6	1.9	0.5	– 1.3	3.2	– 0.5	– 1.2	– 3.3
Denmark	3.3	2.1	1.0	– 0.1	0.5	1.3	3.2	0.5	1.8	– 2.4	– 0.2	– 2.2	– 0.7
Poland	4.6	7.2	1.1	5.2	3.7	3.6	2.3	1.4	– 0.6	– 0.2	2.9	1.2	3.0
Czech Republic	6.0	3.4	3.8	3.2	3.2	0.3	2.4	1.1	3.8	– 0.4	3.0	1.8	– 1.4
Hungary	8.1	3.1	2.0	0.2	2.4	0.0	6.6	1.6	3.6	– 2.2	4.4	1.1	2.3
Iceland	6.6	5.4	1.1	1.3	2.1	– 0.4	5.3	6.8	– 3.2	5.5	1.5	– 1.9	– 0.3
Norway	4.6	4.3	– 0.4	– 0.1	0.6	0.4	4.5	3.6	2.9	3.5	– 3.2	– 4.8	– 3.0
Switzerland	1.8	1.3	0.7	1.1	0.6	0.5	1.5	0.2	0.7	3.0	– 0.2	– 1.2	0.3
Japan	– 1.1	0.9	0.1	2.3	0.7	2.0	– 1.5	– 1.6	– 1.8	– 5.8	– 3.3	– 1.6	– 2.6
United States	3.6	2.3	1.5	0.7	1.8	1.4	1.9	1.0	– 1.6	– 2.2	– 1.7	– 0.7	– 0.9
China									3.6	6.9	11.4	5.7	5.9

[a)] Growth rates for the total economy. – [b)] Compensation per employee in the private sector. – [c)] Compensation per employee in the private sector deflated by the GDP deflator. – [d)] Competitiveness: weighted relative unit labour costs. – [e)] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD Economic Outlook No. 94, November 2013.

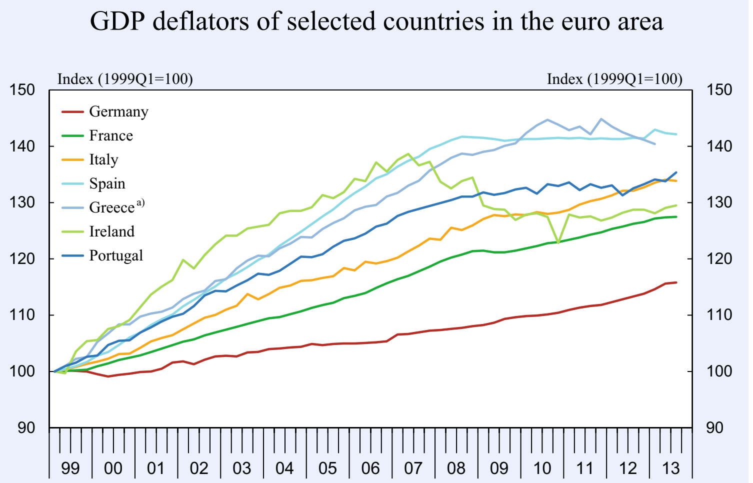
crude, measure of competitiveness is the GDP deflator. By incorporating the public sector and not correcting for productivity gains, this measure is bound to react at a slower pace and to a lesser extent. Nevertheless, some degree of convergence is also depicted by this measure (see Figure 1.8).

Although a significant part of the adjustment in the observed improvement in the trade balances (see Figure 1.9) is due to the strong decline in imports in crisis-afflicted countries, some of it is also achieved by improved competitiveness. In Portugal and Spain improved competitiveness has indeed already been reflected by gains in market shares. This is not yet the case for both Ireland and Greece. Whereas for Greece a clear reduction in the loss of export shares can be observed, data on Ireland calls into question whether an appreciable improvement in its competitiveness has been achieved. However, as Ireland already has a structural trade balance surplus, this also does not appear to be needed. The other crisis countries, however, are at the start of a long adaptation process during which they will become more competitive again by gradually deflating relative to other countries within and outside of the euro area. It still remains unclear whether these societies will be able to withstand the resulting stress, or whether political forces shall prevail that seek a quicker fix to the competitiveness problem via exiting the euro and devaluating domestic currencies.

The necessary price and wage reductions have been slowed down by the fact that, in many places, the goods and labour markets are still not sufficiently flexible. This diminishes competition and innovation pressure by means of market entry barriers. However, several member countries have initiated reforms to address such structural deficiencies over the past few years. Nonetheless, it will take some time before the necessary reforms are fully implemented, and even more time until their positive effects can actually be observed. The problem is that reduced demand, which constitutes a prerequisite for recovery, entails great hardships on the population, potentially leading to social destabilisation and unrest.

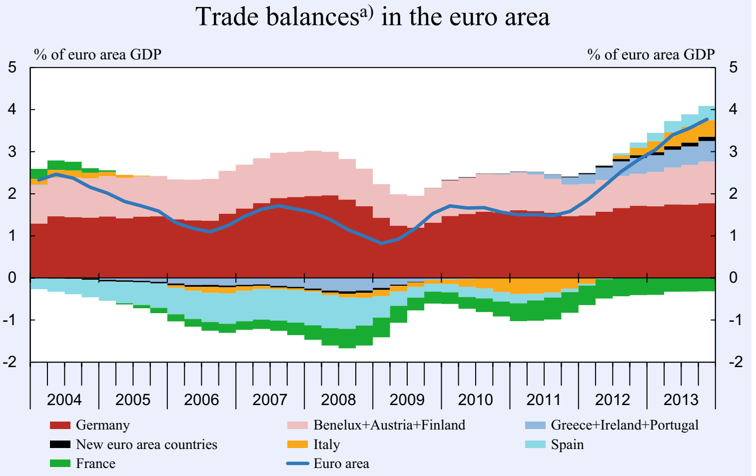
Due to reduced tensions in financial markets allowing policymakers to relax fiscal consolidation efforts, the economy of the euro area was able to start expanding again after it had shrivelled since the fourth quarter of 2011. Production not only increased in countries such as Germany and Austria that already enjoyed relatively good economic conditions, but structurally weak economies like France, Belgium, the Netherlands and Finland started to grow again after facing recessionary tendencies in varying degrees previously. The recovery was even felt in the countries severely affected by the crisis like Portugal

Figure 1.8



a) From 2011Q2 onwards, data for Greece is taken from the OECD Main Economic Indicators.
Source: Eurostat and OECD, last accessed on 31 January 2014; EEAG calculations.

Figure 1.9



a) Four quarter moving averages.
Source: Eurostat, last accessed on 31 January 2014; 2013Q4: EEAG forecast.

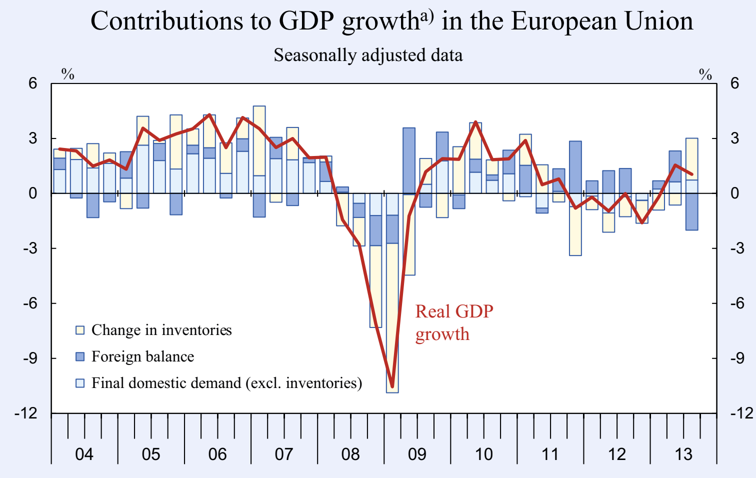
and Ireland. In Italy and Greece, the recession lost strength. All in all, real GDP is expected to have declined by 0.4 percent in the euro area and, with a growth rate of 0.0 percent, it stagnated in the European Union in 2013 compared to 2012.

Although fragile, the recovery has been supported to date by final domestic demand (see Figure 1.10). With the benefit of hindsight a key trigger to this more positive turn in the cyclical development of the euro area was the ECB's introduction of its OMT programme in September 2012. This free insurance scheme on government bonds of crisis countries that lowered government bond spreads considerably served to relieve the interest burden of governments affected by the crisis and facilitated their access to capital markets. This, in turn, allowed governments to take a more relaxed stance on budgetary discipline, as shown by public consumption growth, which turned positive again by the end of 2012. The stabilisation of investor confidence that emanated from the OMT projected more optimism about the survival of the monetary union and led to a general increase in confidence indicators across all sectors (see Figure 1.11). The investors ventured into more investments, and private households started spending more eagerly. Consequently, domestic demand in the crisis countries shrank to a lesser extent than in previous years, while expansion in private consumption and investments in the economically healthier markets accelerated slightly. In early 2013 private consumption started growing again in the European Union as a whole, after two years of continuous decline (see Figure 1.12). This was followed by positive investment growth from the second quarter onwards.

By contrast, export activities showed irregular tendencies both across countries, as well as in the European Union as a whole. While Spain and Portugal, for example, succeeded in increasing their market shares in non-European markets after the catastrophic collapse of 2009, the shares of France and Italy subsided significantly. After declining export activities during the winter of 2012/13, a strong pick up was observed for the European Union as a whole during the second quarter. This, however, did not continue during the second half of the year.

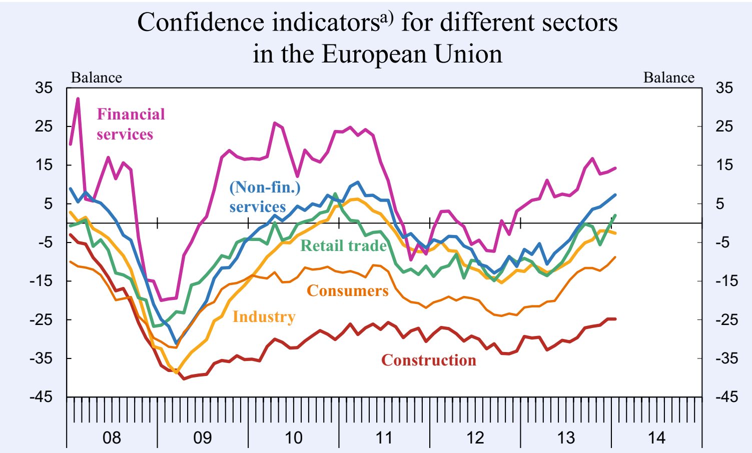
The feeble economy and the negative short-term effects of the necessary structural adjustment processes implemented by many member states have yet hardly had any positive impact on the still very unfavourable European labour market situation to date. The aggregate unemployment rate for both the European Union and the euro area only managed to stabilise at historically high levels (see Figure 1.13). Accordingly, real wage increases generally turned out to be modest, which on the one

Figure 1.10



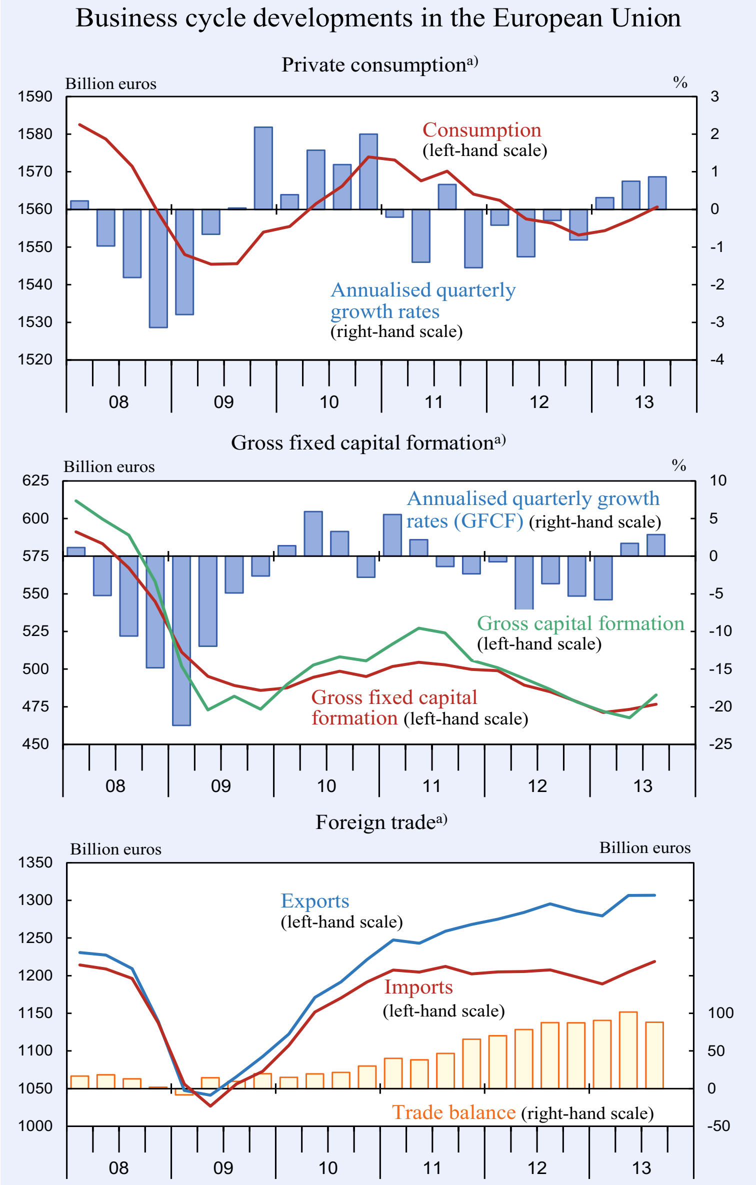
a) Annualised quarterly growth.
Source: Eurostat, last accessed on 31 January 2014; EEAG calculations.

Figure 1.11



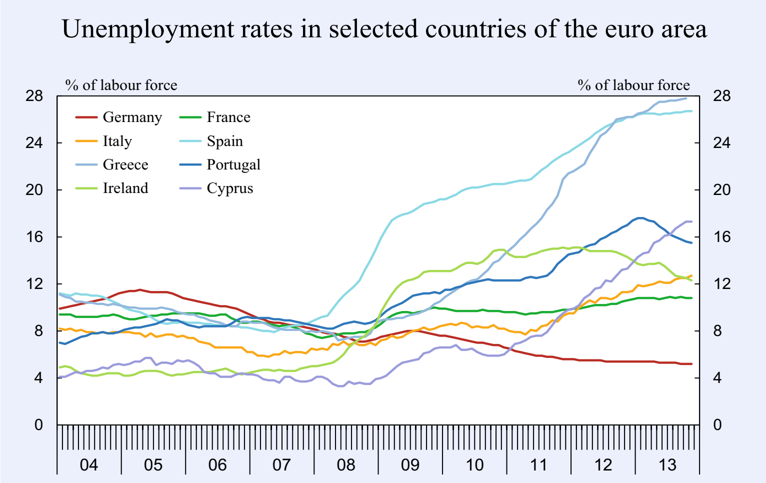
a) Arithmetic means of selected (seasonally adjusted) balances on business tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.
Source: European Commission, last accessed on 31 January 2014.

Figure 1.12



a) In constant prices, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 31 January 2014.

Figure 1.13



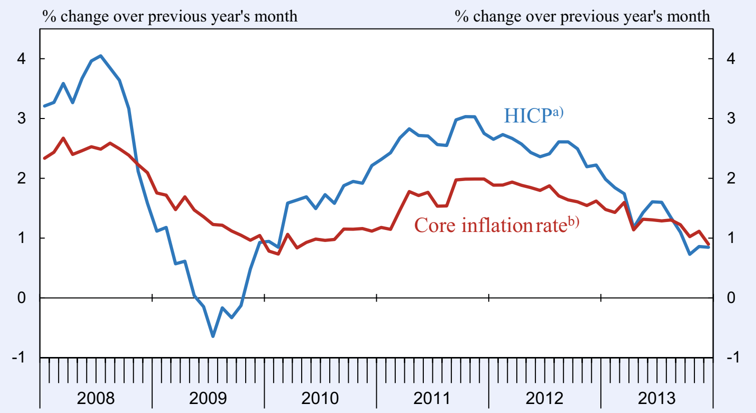
Source: Eurostat, last accessed on 31 January 2014.

hand restrained private consumption growth, but on the other constitutes a basic prerequisite for the restoration of competitiveness. A higher unemployment rate is also associated with larger concerns about preserving one's own job, as well as with lower re-employment opportunities in the event of dismissal. This serves to further dampen consumer confidence. Nevertheless, for some time now, the Irish and Portuguese labour markets have shown some significant improvements. In France and the Netherlands, the labour market situation also started to improve slightly by the end of last year. In Belgium, Finland, Italy and Spain, a turn for the better, however, is not yet discernible.

The unfavourable employment situation and the weakness of domestic demand has been causing the inflation rate in the euro area to drop since the middle of last year in all member countries, albeit to varying degrees. This trend has been supported by a decline in energy prices, the slight appreciation of the euro and the fading impact of past consumption tax increases introduced in many member states to raise tax revenues. As a result, the inflation rate for the euro area steadily dropped from 3.0 percent in November 2011 to 0.7 percent in October 2013, before increasing slightly in the following month to 0.9 percent (see Figure 1.14). Core inflation, which is adjusted for fluctuations in energy prices and prices of unprocessed food and therefore better reflects euro area specific developments, has also been declining since the autumn of 2011. It reached 0.9 percent in December. Although the downward trend was present in almost all member countries, na-

Figure 1.14

Price developments in the euro area



a) Harmonised Index of Consumer Prices (HICP). b) HICP excluding energy and unprocessed food.
Source: Eurostat, last accessed on 31 January 2014.

tional inflation rates show a high degree of heterogeneity. Now that the tax increases have largely passed through to inflation rates, the remaining and still considerable dispersion reflects the diversity of the competitive situation of the countries.

Differences across Europe

In *Germany*, the European debt crisis and weak developments in world trade did depress the overall economy during the winter of 2012/13. The economic situation has improved substantially since. Nevertheless, the contribution of the external sector did not turn out to be positive in 2013. Although exports did pick up, imports grew to an even greater extent. Larger quantities were imported from third countries, while imports from within the euro area declined. The good income prospects and favourable financing conditions have become increasingly noticeable. As a result, business confidence substantially increased. Consumers also regained more confidence in the future. This benefited both consumption and equipment investment, with the latter gaining momentum in the spring after having fallen for one-and-a-half years. In addition to the reduced uncertainty of investors about economic progress, gloomy corporate earnings prospects have brightened during the year. Due to the still slightly below-average utilisation of production capacities in the summer months, the pace of increase in equipment investment remained, however, comparatively low.

After a bad start due to adverse weather conditions, construction investment remained on an upward course. It has already benefited for some time from the flight into German assets and out of their foreign counterparts. All in all, domestic demand was the main driving force behind the German economy since spring last year. Additional impetus was generated by repairs induced by the flooding of particular regions. Real private consumption also rose in an economically robust manner. This was promoted by both good labour market conditions, which combined with low inflation, has led to considerable real wage increases and a decline in the propensity to save. Overall, the strong decline at the end of 2012 caused real GDP in 2013 to have only exceeded its 2012 level by 0.4 percent.

The demand for labour remained high. The average number of working hours increased owing to a reduction in short-time work, as well as an increase in overtime associated with a catching up of winter-related production losses. At the same time, the readiness to recruit new staff members remained high, so that social security contributions increased at a steady pace. Nevertheless, the unemployment rate did not decrease substantially. The reasons for this were the immigration from Central and Eastern Europe and the European crisis countries and a rising labour force participation of nationals.

Due to longer average working hours, unit labour costs, which rose sharply in the winter of 2012/13, could slightly subside again. Also due to the fall in energy prices, inflation remained moderate throughout the year. Overall, the consumer price level increased by 1.6 percent last year.

After developing strongly in the second quarter of 2013, the economy of *France* is likely to have shrunk again during the second half of the year. The repeated fall back into recession was mainly due to falling exports and weakened private investment. On the other hand, private and public consumption continued to contribute positively to growth. This is also reflected by imports, which have shown a strong increase in the course of last year. All in all, real GDP basically stagnated with an overall growth rate of 0.2 percent relative to 2012.

During the first nine months of last year, the unemployment rate continued to increase, albeit at a reduced pace, only to slowly start its descent in October, reaching 10.8 percent on average in 2013, which is more than double the German rate.

The rise in consumer prices declined significantly. This was not only due to the under-utilisation of capacities, but also as a result of declining energy and food prices. The average inflation rate for 2013 amounted to only 1.0 percent, after 2.2 percent in 2012.

The economy of the *United Kingdom* picked up noticeably in the course of 2013. In particular, domestic demand rose sharply; both private consumption and gross fixed capital formation expanded strongly due to improved sentiment in the private sector, which was also induced by programmes like the government-backed help-to-buy-a-home initiative. The trade deficit, however, widened in the second half of 2013, thereby offsetting the decrease observed during the first half of that year. Exports dropped significantly, while imports showed a moderate increase. Overall, real GDP in the United Kingdom is expected to have risen by 1.9 percent last year.

Despite the strong upturn, the situation of the labour market still remains bleak. The unemployment rate has remained virtually unchanged until the end of summer and has only been coming down slowly since. The average unemployment rate for 2013 turned out to be 7.5 percent. As a result, the rise in wages remained moderate. Until the end of summer the inflation rate basically stuck at a level of around 2.7 percent. The price-raising effects that resulted from the increase in government-regulated prices basically nullified the general tendency in other price components to slow down in pace. In October 2013, when these price-raising effects apparently expired, inflation fell to 2.2 percent.

The *Italian* economy has been in a recession since 2011. The high uncertainty about the course of the economic policy of the current and previous governments weighs heavily on private consumption and investment. In addition, potential growth is unlikely to be above zero percent given the structural problems related to the labour market, education, infrastructure and energy. The tax and social security burden has, especially for companies, turned exceptionally high in comparison to international standards. Furthermore, Italy is vulnerable due to its substantial public debt amounting to 133 percent of GDP in 2013, which particularly affected capital market interest rates. Real GDP is expected to have fallen by 1.9 percent last year.

For the first time in almost three years, the economy of *Spain* stopped shrinking after summer last year. There is increasing evidence that Spain has finally bounced off the economic and financial bottom and that the implemented reforms are starting to show initial successes, albeit small ones. The banking sector in Spain was recapitalised and the aid program agreed-upon with the European Union was successfully implemented. Additionally, price competitiveness of firms has improved somewhat in recent years and the current account balance has, for the first time in fifteen years, on average been in surplus last year. A large share of the improved current account position, however, can be traced back to the collapse of the domestic economy and the resulting decline in imports. Nevertheless, a significant part can be related to improvements in exports. Despite the changes for the better, real GDP is expected to have fallen once again by – 1.2 percent in 2013 relative to 2012. As a result, the unemployment rate has not yet managed to break its upward trend and reached an average of 26.5 percent last year.

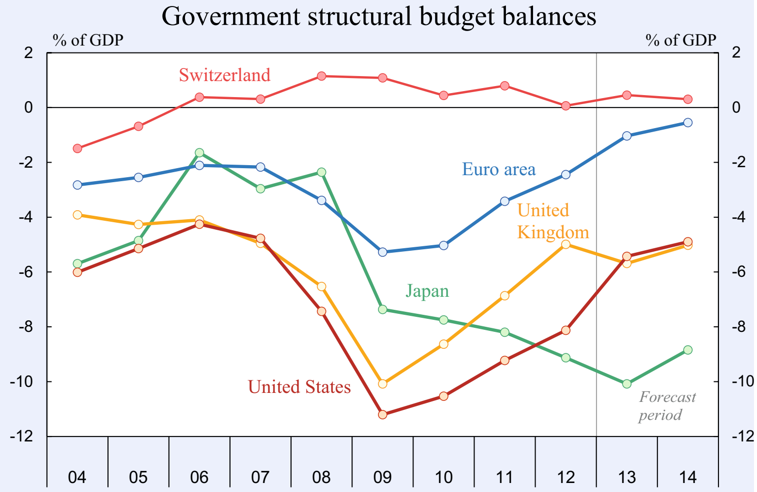
The *Central and Eastern European* member countries of the European Union (Poland, the Czech Republic, Romania, Hungary, Slovakia, Croatia, Bulgaria, Slovenia, Lithuania, Latvia and Estonia) have mostly experienced a devaluation of their currencies and/or have been able to improve their competitiveness during recent years. Combined with the slow recovery of the euro area, this has supported export growth and allowed industrial production to increase in all countries of the region, except for Croatia. Whereas the Czech Republic, Hungary and Croatia suffered from an economic decline during 2012 and the first half of 2013, they managed a turnaround during the second half. In the region, a positive growth contribution is provided by private consumption. Reduced unemployment allowed consumption to grow again last year. A mere stabilisation in consumption levels was only achieved in the Czech Republic and Croatia. Government spending growth has also passed its peak and investments remain a weak point in the region. Gross fixed capital formation declined last year in almost all countries. Related to this is weak credit growth. Since the global financial crisis, the region has experienced a decrease in the foreign liabilities of other European parent banks in particular. Vast differences can be observed across the individual countries. Whereas Hungary was affected most grievously by a deduction of cross-border capital, the Czech Republic and Poland hardly suffered from this at all.

1.3 Fiscal and monetary policy in Europe

1.3.1 Fiscal policy

In the face of historically high budget deficits and growing public debts in the advanced world, many governments have continued their efforts to consolidate their finances. Of the larger advanced economies, Japan and the United Kingdom were clear exceptions. According to OECD measures of the structural government deficit, both saw a clear deterioration last year (see Figure 1.15).

Figure 1.15



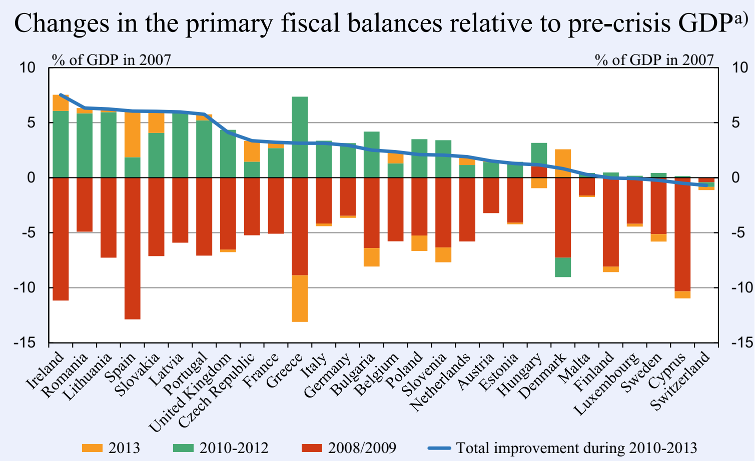
Source: OECD, Economic Outlook 94, November 2013.

Most countries in the euro area have indeed adopted massive fiscal austerity measures in the last few years. The restrictive degree of fiscal policy was particularly strong in those member countries (Cyprus, Greece, Ireland, Portugal) that either could not fully refinance themselves in the capital markets and were therefore dependent on financial assistance from the European Commission, the IMF and the ECB, often summarised as the "troika", or at times had to worry about their access to capital markets (Spain and Italy). Independent of the structural deficit measures used (OECD, IMF or the European Commission), these measures all reveal that substantial reductions in structural deficits have been accomplished since 2010.

Similarly, primary balances, i.e. fiscal positions corrected for interest payments, have also, despite the recessionary conditions under which this had to prevail, been improved in Ireland, Portugal and particularly in Spain over this period. Nevertheless, this has not been sufficient to reduce their public debt burden. Furthermore, the austerity measures only proved sufficient in Italy to reach the three-percent-mark established in the Maastricht Treaty. Spain, Greece and Portugal were once again off-track last year. In the case of Greece, this was largely due to one-off effects in the second quarter of 2013, when the deficit was strongly influenced by capital transfers related to three bank recapitalisations and a bank resolution. The transfer was triggered by banking problems caused by the default on Greek government bonds the previous year. As a result, Greece's deficit deteriorated from 9.0 percent of GDP in 2012 to a staggering 13.6 percent last year and its debt-to-GDP ratio is expected to have increased to 176.2 percent (see Table 1.2). Albeit to a somewhat lesser extent, the fiscal situation in Cyprus also deteriorated further.

The restrictive impulse was much milder in 2013 than in the previous years – or even turned positive – not only in these crisis countries, but also in many other cases. When measured by the change in the primary balances, other countries besides Greece and Cyprus in which fiscal policies turned accommodative include, in decreasing order, Bulgaria, Poland, Slovenia, Hungary, Sweden, and Finland (see Figure 1.16). Besides in Spain, Ireland and

Figure 1.16



[a)] Below the horizontal axis at zero deteriorations of the primary fiscal balance are reported; above this line improvements are shown. The sum of the three bars results in the overall change during 2008-2013.
Source: European Commission, DG ECFIN, General Government Data and AMECO, Autumn 2013.

Table 1.2

Public finances

	Gross debt[a)]				Fiscal balance[a)]			
	1999–2007	2008/2009	2010– 012	2013	1999–2007	2008/2009	2010–2012	2013
Germany	63.8	70.7	81.1	79.6	– 2.2	– 1.6	– 1.6	0.0
France	61.8	73.7	86.1	93.5	– 2.7	– 5.5	– 5.7	– 4.2
Italy	106.5	111.3	122.3	133.0	– 2.9	– 4.0	– 3.6	– 2.8
Spain	49.4	47.1	72.7	94.8	0.2	– 7.8	– 9.9	– 6.8
Netherlands	51.7	59.6	66.8	74.8	– 0.5	– 2.5	– 4.4	– 3.3
Belgium	98.6	92.5	97.8	100.4	– 0.4	– 3.3	– 3.9	– 2.9
Austria	64.7	66.5	73.0	74.8	– 1.8	– 2.6	– 3.2	– 2.5
Greece	103.3	121.3	158.5	176.2	– 5.3	– 12.8	– 9.8	– 13.6
Finland	42.1	38.7	50.5	58.4	3.9	0.8	– 2.0	– 2.6
Portugal	59.9	77.7	108.8	127.8	– 4.1	– 6.9	– 6.9	– 5.9
Ireland	31.9	54.3	104.2	124.4	1.6	– 10.5	– 17.3	– 7.2
Slovakia	40.9	31.7	45.6	54.3	– 5.3	– 5.1	– 5.8	– 3.0
Slovenia	26.2	28.6	46.7	63.2	– 2.3	– 4.1	– 5.3	– 5.8
Luxembourg	6.4	15.0	20.0	24.5	2.4	1.3	– 0.4	– 0.9
Latvia	12.7	28.4	42.3	42.5	– 1.6	– 7.0	– 4.3	– 1.4
Cyprus	64.3	53.7	73.1	116.0	– 2.7	– 2.6	– 6.0	– 8.3
Estonia	5.0	5.8	7.5	10.0	0.7	– 2.5	0.4	– 0.4
Malta	61.4	63.7	69.2	72.6	– 5.1	– 4.2	– 3.2	– 3.4
Euro area	**69.0**	**75.0**	**88.7**	**95.5**	**– 1.9**	**– 4.2**	**– 4.7**	**– 3.1**
United Kingdom	40.6	59.5	83.8	94.3	– 1.5	– 8.2	– 7.9	– 6.4
Sweden	51.5	40.7	38.8	41.3	1.3	0.6	– 0.1	– 1.1
Denmark	44.3	37.0	44.8	44.3	2.4	0.3	– 3.0	– 1.9
Poland	43.2	49.0	55.6	58.2	– 4.1	– 5.6	– 5.6	– 4.8
Czech Republic	25.2	31.6	42.0	49.0	– 3.9	– 4.0	– 4.1	– 2.9
Romania	19.5	18.5	34.4	38.5	– 2.6	– 7.4	– 5.1	– 2.5
Hungary	59.8	76.4	81.4	80.7	– 6.4	– 4.1	– 0.8	– 3.1
Croatia			50.7	59.6			– 6.4	– 5.4
Bulgaria	46.2	14.2	17.0	19.4	0.6	– 1.3	– 2.0	– 2.0
Lithuania	20.5	22.4	38.9	39.9	– 1.8	– 6.4	– 5.4	– 3.0
European Union[b)]	**61.8**	**68.3**	**83.1**	**89.8**	**– 1.7**	**– 4.6**	**– 5.0**	**– 3.5**
United States	59.7	79.8	99.1	106.0	– 2.1	– 9.7	– 9.6	– 5.8
Japan	166.1	201.0	228.1	243.5	– 6.0	– 7.3	– 9.8	– 9.5
Switzerland	63.3	50.1	49.1	48.2	0.2	1.2	0.2	0.2

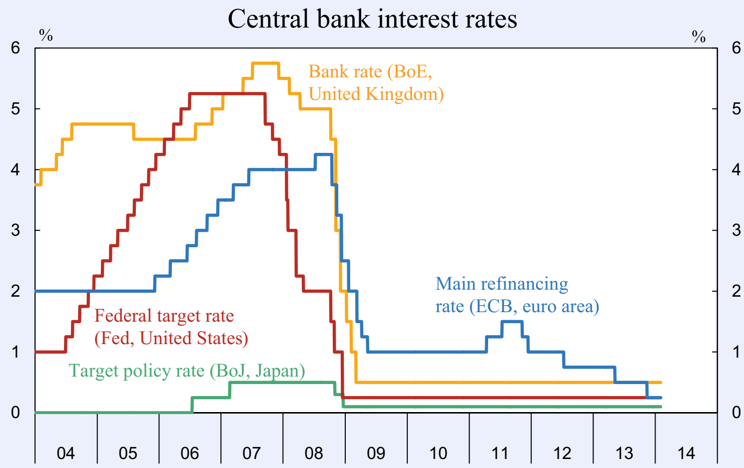
[a)] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF. – [b)] Before 2009 the European Union does not include information on Croatia.

Sources: European Commission, Autumn 2013; IMF World Economic Outlook, October 2013.

Portugal, clear negative impulses, on the other hand, were set by the governments of Denmark, Slovakia, the Czech Republic, Belgium, the Netherlands, France and Romania last year.

Over the course of this year, the public authorities will also proceed with implementing austerity measures. However, the contractionary fiscal impulse is likely to be lower than last year. To some extent this is a natural phenomenon in any austerity programme: Maintaining the savings of the previous year does not lead to an additional negative impulse – only further cuts do that and these are bound to decrease over time. Nevertheless, another reason for the restrictiveness of fiscal policy to continue to decline is the worsening of debt discipline caused by, among other things, the willingness of the European Commission to tolerate cyclical deviations from the previously agreed deficit paths, as long as the implementation of structural reforms continues. Given the difficulty of distinguishing between structural and cyclical elements, this is, in a world driven by political considerations, bound to be interpreted selectively. Furthermore, in autumn 2012 and in spring 2013 the Eurogroup, i.e. the finance ministers of the member states inside the euro area, decided to loosen consolidation requirements for several countries (Portugal, Greece, Ireland, Spain and France), even although the European Union and the IMF have already granted both Greece and Ireland further extensive relief on their debt services. Finally, fiscal consolidation efforts in Portugal are also likely to be delayed as the Portuguese constitutional court annulled numerous austerity measures. This necessitated savings in other fields, jeopardising a timely implementation. The negative fiscal impulse connected to the relief program agreed upon in spring 2013 will only increase significantly in Cyprus. Overall, the public deficit ratios are likely to continue to decline, albeit in a less pronounced manner than initially planned and less dynamically than in previous years.

Figure 1.17



Source: European Central Bank, Federal Reserve Bank of St. Louis, Bank of England, Bank of Japan, last accessed on 31 January 2014.

1.3.2 Monetary conditions and financial markets

Monetary conditions

Monetary policy in the major advanced economies retained its degree of expansion during 2013. In the face of their very low policy rates, nearing zero percent (see Figure 1.17), the central banks of the United States, the United Kingdom and Japan largely continued their unconventional measures of monetary easing. In addition, the central banks have for some time now resorted to a more intensive communication policy (forward guidance) in order to increase the effectiveness of their monetary policies. For instance, the Federal Reserve and the Bank of England tied the future path of the main policy rate and the degree of monetary expansion to specific economic goals like the unemployment rate. Accordingly, medium-term interest rate expectations will be kept low and refinancing conditions will remain favourable until the economic recovery has gained sufficient momentum.

In early November 2013 the ECB surprisingly lowered its interest rate for open market operations by a further 25 basis points to 0.25 percent. This step benefited those banks that have so far only managed to keep afloat with the help of these ECB refinancing loans. Interest rates on the interbank money market largely remained unaffected by this cut. Since the summer of 2012, the interest rate for secured loans with a maturity of three months (Eurepo) has been close to zero percent; for unsecured credits (Euribor) with the same maturity, just over 0.2 percent had to be paid. Instead of a fall, a slight increase in both rates has been observed since the interest rate cut.

The interbank money market is still not functioning properly, especially in the crisis countries, making banks there rely on the refinancing credits provided by the ECB. However, the risk premium for unsecured three-month loans fell in recent months by a further 0.05 percentage points to about 0.15 percentage points by the end of last year. This premium is only marginally higher than premiums observed before the outbreak of the crisis. Nevertheless, both the daily turnover on the interbank market and the stock of cross-border interbank loans remain significantly lower than before the onset of the crisis.

ECB refinancing funds were almost exclusively provided to the crisis countries. Well above 80 percent of the regular open market operations were conducted with commercial banks in the countries affected by the crisis. The heavily indebted commercial banks in these countries benefit from ECB interest rate cuts as the latter allow them to fund the purchase of significantly higher yielding securities at a lower cost. These commercial banks widened their holdings of domestic government bonds between late 2011 and October 2013 by almost 300 billion euros. The resulting profits allowed them to form new equity to compensate for the losses incurred due to the holdings of toxic loans and uncollectible credits.

Despite this support, the problems of the banking sector in the crisis countries remain significant. This is reflected by the historically high proportion of non-performing loans. Nevertheless, the assessment of capital markets has improved with regard to potential risks in the banking sector in the crisis countries. Both the premiums on credit default securities of the largest banks and yields on covered bonds, which constitute important funding instruments for many financial institutions, have been falling steadily since early 2012. For one thing, this was due to the significant decline in the government bond yields of crisis-afflicted countries following ECB's announcement of the OMT programme in September 2012 that allows for unlimited purchases of government bonds of countries under the ESM or EFSF umbrella. This development was, however, also supported by increased government recapitalisations and other interventions in the banking sector as of 2012.

Overall, however, the situation in the credit markets of the crisis countries was still significantly more strained than in the rest of the euro area. The interest rate on newly-granted loans to companies in the crisis countries only followed the downward trend in the money market interest rates to a limited degree. The spread between money market and lending rates continues to be historically large. This is especially true for the crisis-afflicted countries (see Figure 1.18). At the same time, the decrease in loan portfolios over the past three months is significantly greater in these crisis countries than elsewhere in the euro area. In addition to demand-related factors, due to the significantly weaker economic situation, supply-related credit market factors are also likely to play a significant role. This is corroborated by both the Bank Lending Survey (BLS) and the Survey on the access to finance of SMEs (SAFE) for the euro area. These surveys show that the lending conditions of banks in the crisis countries remain significantly more restrictive than in the rest of the euro area.

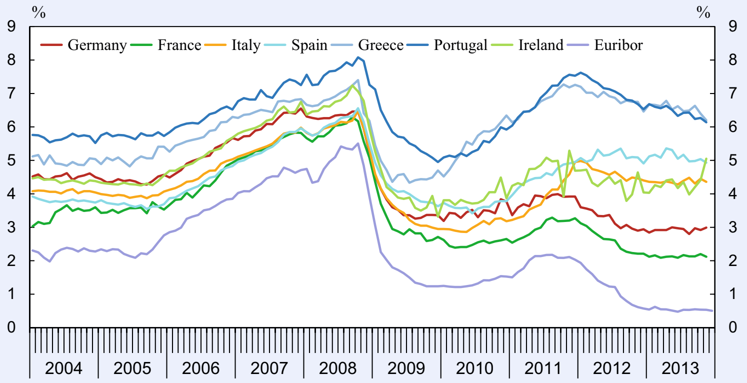
For the euro area as a whole, the volume of outstanding bank loans to the private sector continued to decline. Lending to non-financial corporations, which accounts for roughly half of total credits to the non-financial sectors of the economy, was most significantly affected in this respect (see Figure 1.19). The outstanding amount of consumer credit also continued its descent, whereas the amount of mortgages basically remained constant throughout 2013.

The ECB will maintain its expansionary policy and keep the main refinancing rate unchanged at 0.25 percent this year. Due to the heavy under-utilisation of capacities and the extremely weak economic performance in the euro area as a whole, inflation rates will remain well below the ECB target of close to, but below 2 percent.

The decline in risk premiums on capital markets in the crisis countries is expected to continue, albeit more moderately than before, in 2014. In the rest of the euro area, the capital market interest rates will show a slight increase. This is largely due to the increase in capital market interest rates in the United States, where eco-

Figure 1.18

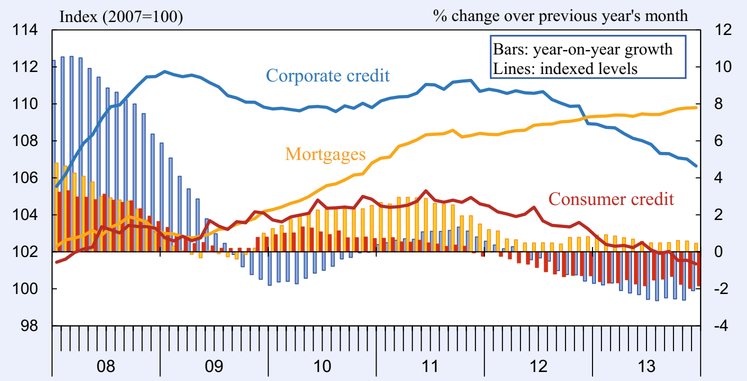
Interest rates on loans to businesses in selected countries of the euro area[a)]



a) New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 19 January 2014.

Figure 1.19

Credit developments in the euro area[a)]



a) These indexes of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1+F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details).
Source: European Central Bank, last accessed on 31 January 2014.

nomic developments will unfold far more positively than in the euro area. As a result, lending rates in the rest of the euro area will also rise slightly, while they are expected to remain unchanged in the crisis countries. Underlying this assessment is the assumption that the supply-related restrictions in local credit markets will gradually abate.

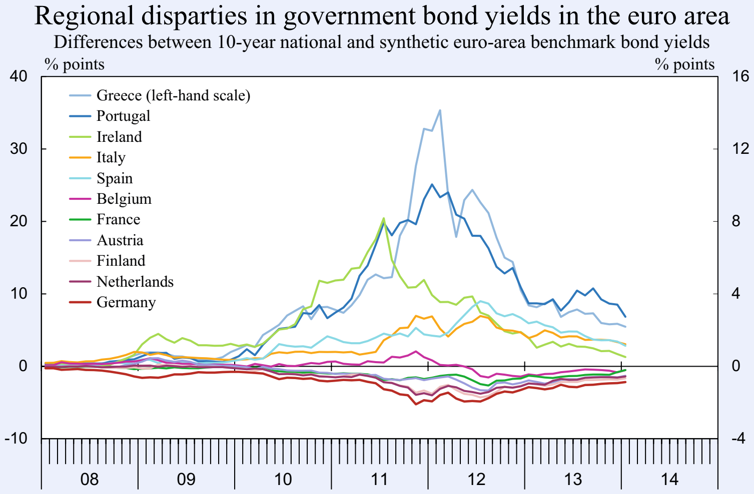
The Bank of England has made a commitment to continue with its very expansive monetary policy. It announced publicly, as part of its forward guidance policy, that the interest rate will remain unchanged at 0.5 percent as long as the unemployment rate exceeds 7 percent. This presupposes, however, that the medium-run inflation rate will remain below 2.5 percent. Similarly, inflation expectations should remain firmly anchored. The program for the purchase of asset-backed securities is still being implemented and reached a volume of 375 billion British pounds by the end of 2013. The aim of the program is to provide liquidity to commercial banks under favourable conditions and avoid a stronger increase in capital market interest rates, which could thwart the economic recovery. These monetary policy measures have helped to ease tensions in credit markets. Lending by commercial banks to the private non-banks, i.e. non-financial private enterprises and households, has recently increased. In addition, the conditions for granting credit have improved. Lending rates to the non-financial private sector have been steadily declining across the board since the summer of 2012, despite yields on government bonds being on a clear upward trend since spring of last year.

Bonds, stocks and foreign exchange markets

In the late summer of 2012, the ECB announced its readiness to purchase the government bonds of individual euro area countries under certain specific conditions and thus to support their courses (OMT programme). This notification relieved the concern felt by many investors with regard to a potential payment default of individual countries, or even about a potential breakup of the monetary union, thus allowing the previously sharply rising risk premiums on private and public debt instruments from several member states to fall.

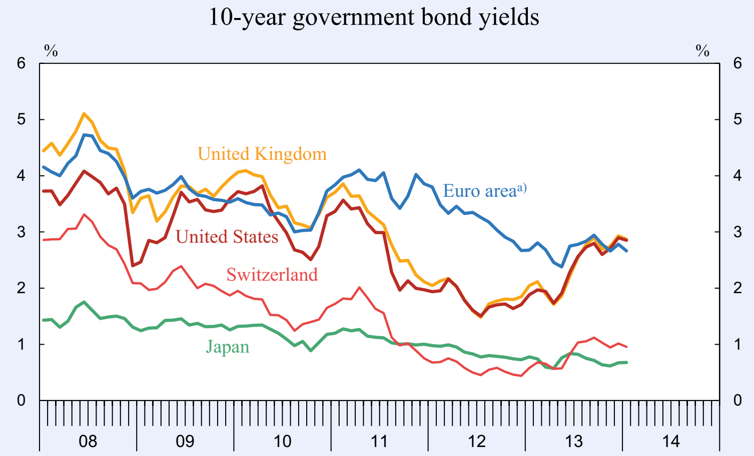
These implicit guarantees provided by the ECB with its OMT programme, together with the permanent rescue fund, ESM, have – by reversing the divergence process of government bond yields within the euro area (see Figure 1.20) – managed to bring the synthetic euro area benchmark 10-year government bond yield back to levels observed for the United States and the United Kingdom (see Figure 1.21). At the same time, the international normalisation of risk prefer-

Figure 1.20



Source: Datastream, last accessed on 31 January 2014.

Figure 1.21



[a)] The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream, last accessed on 31 January 2014.

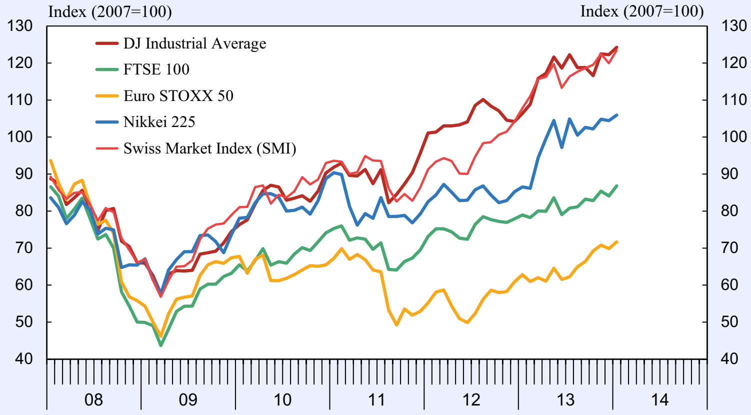
ences shifted asset allocation away from government bonds towards other bonds and in particular stocks. As a result, both government bond yields and stock market indexes were able to stay on the upward trend that they set in mid-2012.

Measured in local currencies, the Dow Jones industrial average, the Nikkei 225, the FTSE 100 and the Euro STOXX 50 improved by 22.5 percent, 59.4 percent, 11.1 percent and 14.8 percent respectively during 2013. Except for the Japanese Nikkei 225, the improvements were fairly similar from a euro area perspective (see Figure 1.22). When converting the gains of the Nikkei 225 into euros, they were, due to the realised depreciation of the Japanese yen, clearly reduced, albeit, with 22.6 percent, still considerable. Whereas Euro STOXX 50 developments, as measure for overall euro area stock developments, clearly lagged behind those of Japan and the United States in particular, looking at member-state specific movements reveals that the German stock markets have kept pace with those in the United States in recent years (see Figure 1.23).

After having increased during the second half of 2012, the dollar-euro exchange rate remained more or less stable during the first part of 2013. Subsequently, there was a steady, but small appreciation against the US dollar (see Figure 1.24). A similar picture emerges when looking at real effective changes, i.e. when correcting for inflation differentials and weighting by export shares: there has been an overall steady appreciation of the euro since

Figure 1.22

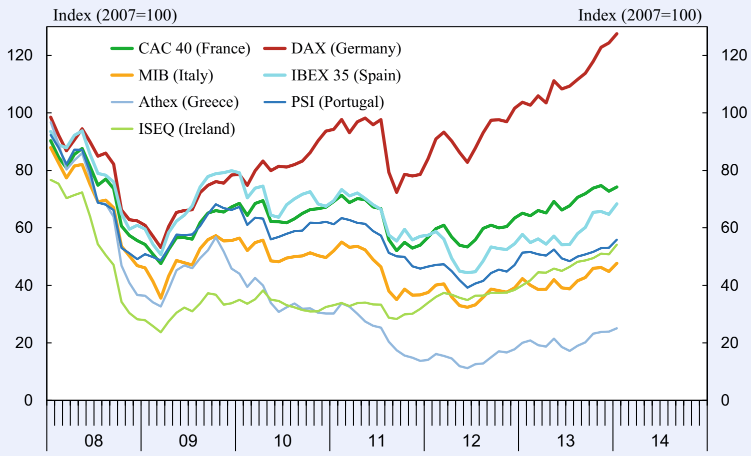
Developments in international stock markets from a euro area perspective[a)]



a) Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2014.

Figure 1.23

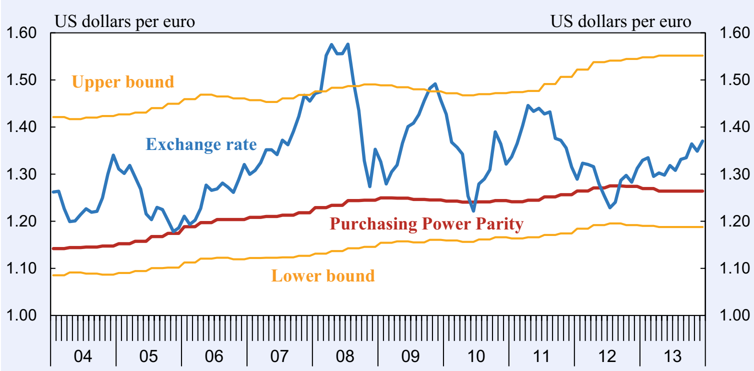
Developments of selected stock markets within the euro area



Source: Datastream, last accessed on 31 January 2014.

Figure 1.24

Exchange rate of the euro against the US dollar and PPP[a)]



a) The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The PPP upper bound represents the 75th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 25th percentile. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar.
Source: OECD Economic Outlook 93, June 2013, European Central Bank, last accessed on 3 January 2014.

mid-2012 (see Figure 1.25). As far as the other major currencies in the world are concerned, the yen depreciated substantially during the winter of 2012/13. This largely reflected the change in monetary policy of the Bank of Japan and fast-changing sentiment in financial markets regarding the importance of so-called safe haven currencies. The real effective exchange rate of China appreciated throughout a large part of last year, a process that started in autumn 2012. This reflects both the somewhat higher inflation rate in China compared to most of its trading partners, and the continued moderate appreciation of the renminbi against the US dollar, as allowed for by the Chinese central bank.

1.4 The macroeconomic outlook

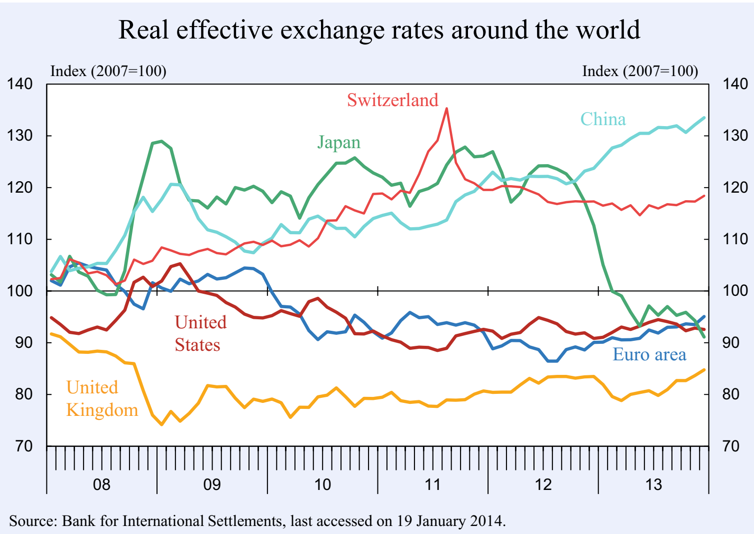
1.4.1 Assumptions, risks and uncertainties

The present forecast is based on the assumption that no further escalation of the euro crisis is to be expected. In that sense, it is also assumed that the financing of public budgets in Greece, Ireland and Portugal is guaranteed until at least the end of the forecasting period. Ireland already meets its capital requirements almost completely through the capital market, while the relief programmes granted to Greece and Portugal expire this year. Accordingly, these two countries should, in principle, return to the international capital markets. However, since both Portugal and Greece need to refinance considerable volumes of public debt in 2015 and 2016, a complete return to private capital markets appears, especially in the second case, unlikely.[2] Given weak economic development, we expect that the international community, represented by the troika, will therefore already grant Greece in particular further financial assistance this year. This will, given our assumptions, be achieved without creating new political tensions, which, in turn, will further strengthen the confidence of investors, consumers and producers within the euro area. As a result, the refinancing conditions for commercial banks, as well as private households and businesses, are not forecast to deteriorate any further.

The most crucial prerequisite here is that, despite reduced pressure on governments to carry out austerity programmes, the structural adjustments in the euro area continue, albeit at a more moderate pace. The lowering of the collateral requirements that must be satisfied to obtain liquidity from the ECB in combination with the TARGET2 system, the rescue packages of the troika together with the loosening of fiscal targets granted by the European Commission at the beginning of 2013 and the introduction of the OMT programme by the ECB all have one thing in common: By lowering market-oriented refinancing costs, they tend to reduce willingness to embrace structural reforms to promote international competitiveness. At the same time, however, the above measures alleviate short-term liquidity constraints. All in all, finding the right balance is not an easy task. We assume that the long-term structural view has not been lost from sight, as that would, at some stage, trigger the next round of escalation in the euro crisis.

A possible decoupling of long-term inflation expectations, which still oscillate at around 2 percent, from the ECB target poses another risk. This forecast is based on the assumption that no long-term deflation is to be expected on average in the euro countries. Given the expected slow economic recovery, the euro area-wide inflation rate is likely to settle well below the ECB's inflation target of just under two percent. However, a long period of low inflation could lead to a downward revi-

Figure 1.25



Source: Bank for International Settlements, last accessed on 19 January 2014.

[2] Portugal did already manage to successfully auction longer-term government bonds in January and is likely to start building a cushion this year (like Ireland did before exiting its program) in order to ease the transition and gain market confidence. Whether it will fully succeed in this attempt remains to be seen.

sion of long-term inflation expectations among investors, consumers and producers. As it is unlikely that the ECB will further reduce nominal interest rates, the decline in inflation expectations would result in an increase in real interest rates and reduce the willingness of investors and consumers to spend. In addition, wage dynamics would be more moderate. These adjustments would further slow down actual inflation and thus serve to confirm the downward adjustment of inflation expectations. This could ultimately lead to a spiral of inflation declines and successive reductions in inflation expectations, which could eventually result in a permanent deflation phase. Since nominal wages tend to be downwardly rigid, deflation would, by increasing the real cost of labour, lead to persistent underemployment. The present forecast assumes that medium- to long-term inflation expectations remain anchored to the ECB's target of below, but close to two percent. For this to happen the structural reforms targeted by several euro area countries will actually have to be implemented. This would prevent a permanent reduction in long-term growth and inflation expectations.

A further risk to this forecast lies in the formation of price bubbles by means of the highly favourable liquidity provision. This might trigger undesirable volatilities in asset and currency markets. Furthermore, since the outbreak of the financial crisis, uncertainty about inflation developments has increased significantly. Therefore, risks do arise from the various expansionary monetary measures undertaken by the central banks in advanced economies around the world.

What finally constitutes a significant risk for a major improvement in the euro area is slow progress with reforms and the restructuring of the banking sector. Many banks in Europe, especially those in the crisis-afflicted parts, require restructuring. Whether the dismantling of this time bomb is done quickly enough is difficult to tell. The formation of a banking union is an important step in this process, and we do assume that the necessary steps will be taken on time.

Some, albeit minor, risks also emerge from the elections for the European Parliament. It cannot be ruled out that the gains of the anti-European parties are so substantial that they are going to be able to block outstanding changes in legislation.

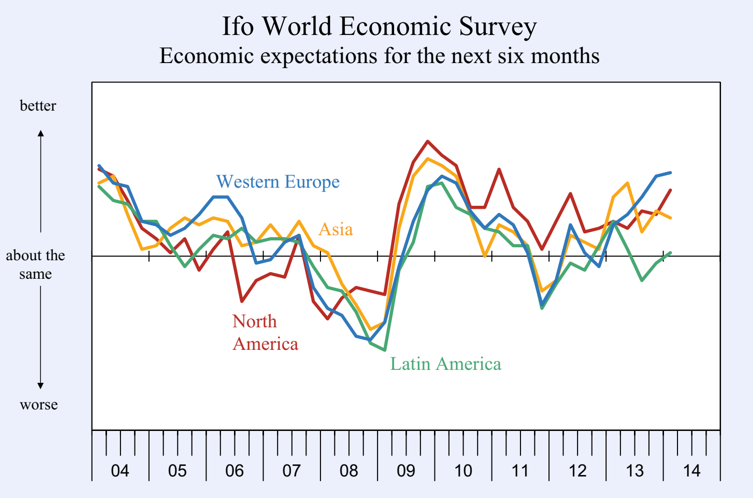
1.4.2 The global economy

The current global economic expansion will continue this year, albeit gaining momentum only moderately. The Ifo World Economic Survey and a number of other indicators of producer and consumer expectations suggest that sentiments have improved in most regions of the world (see Figure 1.26).

In contrast to the past five years, however, the emerging markets of Asia and Latin America will no longer be the driving force behind economic acceleration. This role will be fulfilled by advanced economies like the United States, the United Kingdom, and to a lesser extent Japan and the euro area. Nonetheless, the emerging economies will continue to expand at rates that are higher than those in industrialised countries. But their pace of growth is, also for structural reasons, unlikely to increase during the forecast period. Hence, whereas the contribution of Asia in particular to world economic growth will remain large, it is the increase in the growth contributions by North America and Western and Central Europe that will make the difference to world economic growth as compared to last year (see Figure 1.27).

In the developed economies, the growth rates of real GDP should gradually increase during 2014. Private consumption in the United States, supported by further improvements in the employment, housing mar-

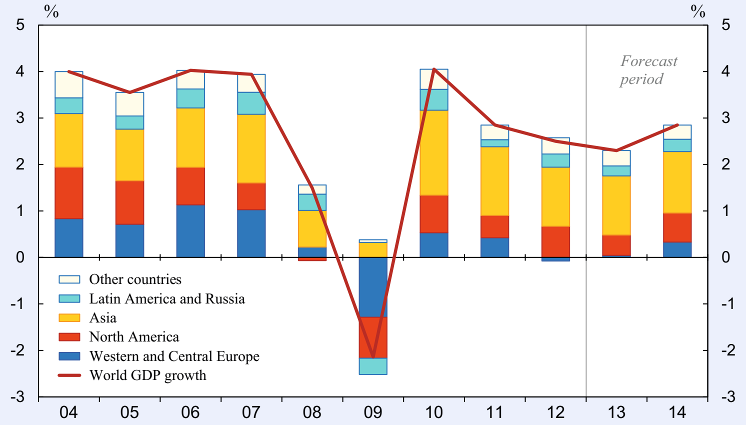
Figure 1.26



Source: Ifo World Economic Survey I/2014.

Figure 1.27

Regional contributions to world GDP growth[a)]



a) Based on market weights.
Source: IMF; calculations by the EEAG; 2013 and 2014: EEAG forecast.

ket and lending conditions, is likely to increase at an accelerated pace. Business investments should also benefit from the recovery in domestic demand and still very expansionary monetary policy, which will secure relatively favourable refinancing conditions. Finally, the fiscal impulse in the advanced economies will be less contractionary than last year.

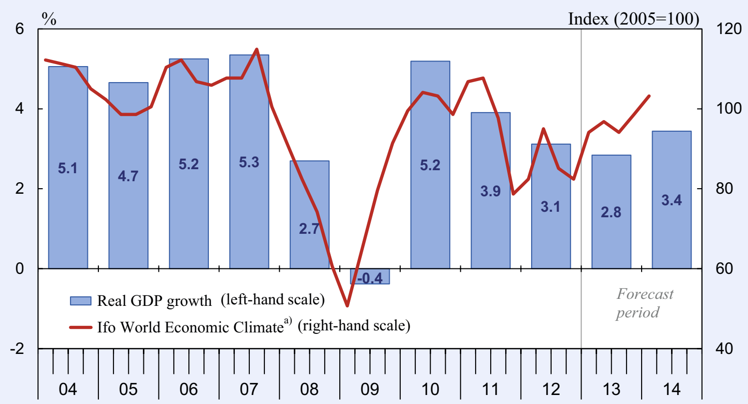
Over the course of the year, fiscal stimuli programmes initiated last year in, for example, China, Brazil and South Korea to compensate for weak demand from the advanced economies will be phased out, so that fiscal policy in most emerging countries is likely to be neutral. Triggered by the forthcoming elections, public investment programs are only expected to stimulate the economy moderately in India.

Domestic demand in the United Kingdom is likely to undergo an increasing revival this year, as it will be supported by the improvement in the asset positions of private households and expansionary monetary policy. The economic situation in the euro area remains obfuscated. Several member countries still have to struggle with some massive structural problems. Nevertheless, a moderate recovery is expected to continue during the forecast period, and this change compared to the previous two years does imply a positive impulse for the world economy. The negative impulse coming from fiscal austerity measures will decrease further. In addition, net exports should also have a favourable effect, both due to the continuing weak imports noted in crisis countries and the moderate pick-up of the world economy. Finally, on-going pressure on domestic prices in some of the structurally weak countries (Ireland, Spain, Portugal and Greece) is expected to lead to an improvement in their international competitiveness. Accordingly, the euro area is likely to benefit to a somewhat greater extent from the recovery of world trade than in the past. In Japan, the highly expansionary monetary and fiscal policy, as well as the depreciation of the yen, have allowed the economy to expand strongly during the past winter months. During the rest of the year, however, economic growth is expected to gradually decline, as the positive fiscal impulse is bound to ebb away, while structural problems are likely to persist.

All in all, the total world economic production will probably increase this year by 3.4 percent, after 2.8 percent last year (see Figure 1.28). Accordingly, world trade is expected to have expanded by just 2.0 percent in 2013, and should rise by 4.9 percent this year (see Table 1.A.1). The current accounts of most emerging countries will continue to deteriorate due to unfaltering robust growth in the realm of domestic demand. In the euro area, however, the still very feeble

Figure 1.28

World economic growth and the Ifo World Economic Climate



a) Arithmetic mean of judgements of the present and expected economic situation.
Source: IMF, World Economic Outlook, October 2013; GDP 2013 and 2014: EEAG forecast; Ifo World Economic Survey I/2014.

domestic economy should help to improve the current account balance. The current account deficit of the United States is likely to remain virtually unchanged. The acceleration of growth in goods imports is expected to be almost fully compensated for by a decline in net imports of gas and oil in the United States. Inflation is expected to rise slightly in the advanced economies, with the exception of the European Union, during the forecast period. An important role in Japan will be played by the effect of the value added tax increase scheduled for April 2014. Given the moderate development of commodity prices in recent months, inflation in emerging economies is not expected to provide any reasons for tightening monetary policy. In countries like India and Indonesia, the base rate increases implemented last summer are likely to slightly dampen the currently rather high inflation during the forecast period.

1.4.3 United States

Partially due to legal limitations, some of the spending cuts in the federal budget in the United States resulting from the sequester and the budget decisions made at the end of last year will become effective early this year. Fiscal policy will remain restrictive, as the extension of the entitlement period to unemployment benefits and the more favourable depreciation rules for companies were permanently discontinued at the beginning of this year. Even although the new budget proposal of December 2013 provides relief of about 65 billion US dollars compared to the nationwide budget cuts implied by the original sequester, no further tax increases will now take place and the defence budget will not be reduced again. However, some social expenditure is supposed to be curtailed more than originally planned. The decline in government consumption expenditure observed at the federal level this winter should subsequently give way to some slight increases again, thereby taking off the brakes activated by the sequester.

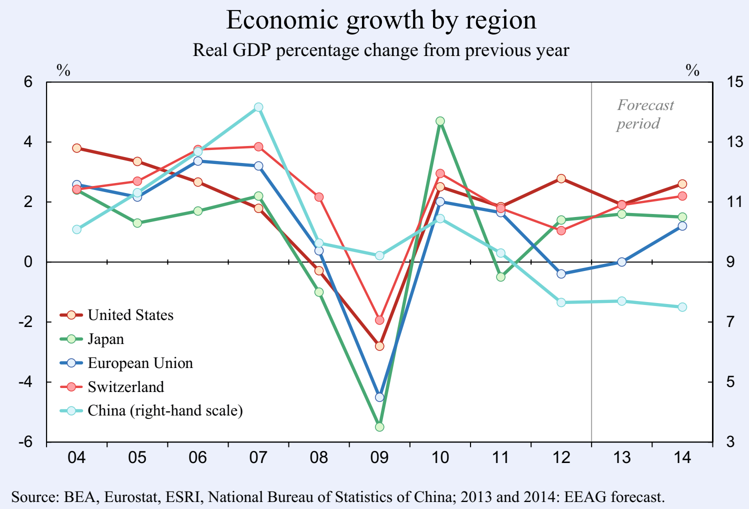
Now that the US Federal Reserve has decided to taper its bond purchasing program of Treasury securities and agency mortgage-backed securities and has signalled that it will wind down this quantitative easing policy steadily through 2014, assuming the US economy will develop as expected, the uncertainty surrounding US monetary policy should also fade. While maintaining the base rate at its historic low of 0 to 0.25 percent, US monetary policy will remain very expansionary throughout the year.

Overall, the growth rate of the US economy is bound to increase during the year. The impact of tax increases on private consumption will weaken. Improving real-estate market conditions should foster construction activity and reduce the indebtedness of households, thereby stimulating consumer demand. Little impetus, however, is to be expected from foreign trade. The acceleration of export growth as a result of the somewhat improved economic conditions around the world is expected to be more or less compensated for by increased import growth caused by improved domestic conditions.

All in all, for the United States the increase in real GDP of 1.9 percent noted last year will probably accelerate to about 2.6 percent this year (see Figure 1.29).

The inflation rate is expected to increase from the 1.5 percent recorded last year to 1.9 percent in 2014. Moreover, a decline in the unemployment rate from an average of 7.4 percent in 2013 to 6.4 percent this year is to be expected. Owing to the economic recovery and additional austerity measures undertaken in the federal budget, the budget deficit will improve in the current fiscal year to just below 3 percent of GDP.

Figure 1.29



Source: BEA, Eurostat, ESRI, National Bureau of Statistics of China; 2013 and 2014: EEAG forecast.

1.4.4 Asia

In *China*, the government's monetary policy stance is expected to remain unchanged this year. Despite the moderate increase in inflation rates throughout last year, inflation still remains well below average. Moderate positive impulses will be generated by fiscal policy. In particular, tax cuts for businesses and investments in the expansion of the railway network are planned. Leading indicators point to a continuation of the short-term dynamics. The pace of economic growth will, at least in the short run, not attenuate significantly. The structural change and the associated reduction in the excess capacity of the industry sector will lead to a slowdown of trend growth. Given the feeble external demand for Chinese products, real GDP growth is expected to materialise at 7.5 percent this year. Inflation will accelerate moderately to 3.3 percent in 2014 (after 2.6 percent in 2013).

The political leadership in Beijing plans to fundamentally restructure the Chinese economy in the coming years. In this context the factors of production in particular are to be shifted piecewise from investment and export-driven toward service- and domestic-market-oriented sectors. This change is primarily to be achieved through a number of structural reforms. Accordingly, the Hukou System – the official control system regarding place of residence – is to be liberalised, which will likely lead to an acceleration in the degree of urbanisation. Furthermore, the Chinese government is planning a land reform, whereby restrictions on the use of collectively-owned land and parcels should be relaxed. A profound liberalisation of the financial sector and reforms in public administration and budgeting have also been promised. However, these structural reforms are unlikely to unfold their effects during this year.

In *Japan*, fiscal policy is bound to exert a restrictive effect: the consumption tax is set to rise from 5 percent to 8 percent in April. However, in order not to jeopardise the economy, another economic stimulus package is due to be launched. Supported by the unabated strengthening in sentiment among large companies and expected anticipatory effects in the first quarter owing to the increase in the consumption tax and the recovery of the economic situation in key export markets, real GDP is expected to grow by 1.5 percent this year. Prices are likely to grow vigorously at 2.7 percent, of which about 2 percentage points will be due to the increase in the consumption tax. A risk for the forecast period is posed by Japan's conflict with China over an island group in the East China Sea. Should this conflict take a turn for the worse, it could lead to a boycott of Japanese products and negatively affect the economy.

The short-term outlook for *India* has become less pessimistic. Early indicators like the production of electricity, coal and cement, moved upward. In addition, the monsoon season went smoothly, so good harvests were made at the end of last year, which is bound to generate some positive stimuli for India's important agricultural sector and reduce the pressure on food prices.

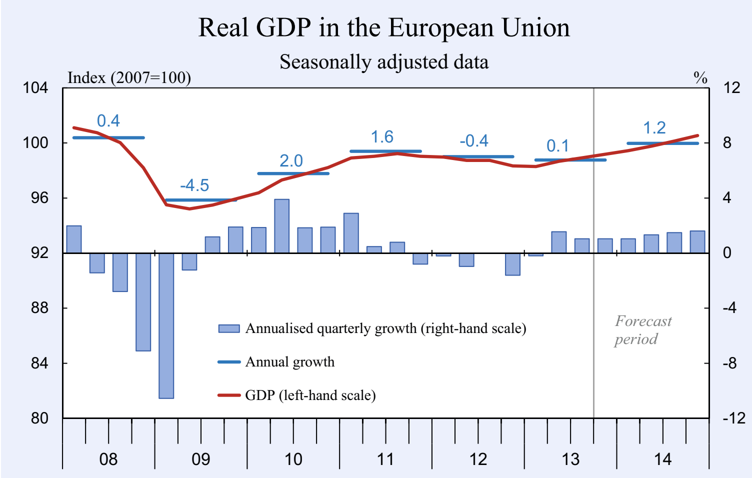
Given the relatively weak economic conditions that persist in India, the Reserve Bank of India is not expected to increase its base rate any further. Fiscal policy, in particular via public investment spending, will stimulate the economy. Government infrastructure projects in particular are expected to contribute to a revival in overall investment activity. Consumption is also expected to pick up slightly. Overall, economic activity is expected to increase slowly over the year, resulting into a growth rate of 5.6 percent. The inflation rate will probably fall to 9.2 percent in 2014, after an estimated 11.5 percent in 2013.

For the East Asian countries *(Indonesia, South Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong)* either an accelerated or an unchanged high rate of expansion is expected for this year. An increase in private consumption is likely to be the main driving force behind this expansion. It is supported by income generating activities and job creation programmes implemented by the different governments. Against this background, and in anticipation of a modest recovery in exports to the euro area and the United States, overall economic production this year is likely to rise to 4.5 percent. The inflation rate is expected to amount to 3.4 percent this year, following 3.0 percent in 2013. Part of this acceleration is due to the reduction in energy subsidies in Indonesia implemented this year.

1.4.5 Latin America

In 2014, the Latin American region, i.e. *Brazil, Mexico, Argentina, Venezuela, Colombia and Chile,* is expected to grow by 2.9 percent. The increase in real GDP in Mexico is likely to gather pace again owing to improved economic prospects for the United States. Although the FIFA World Cup in 2014 will, through increased investment activities and foreign demand, give some impulses to the Brazilian economy, growth in the country will remain below its long-run average.

Figure 1.30



Source: Eurostat; EEAG calculations and forecast.

1.4.6 The European economy

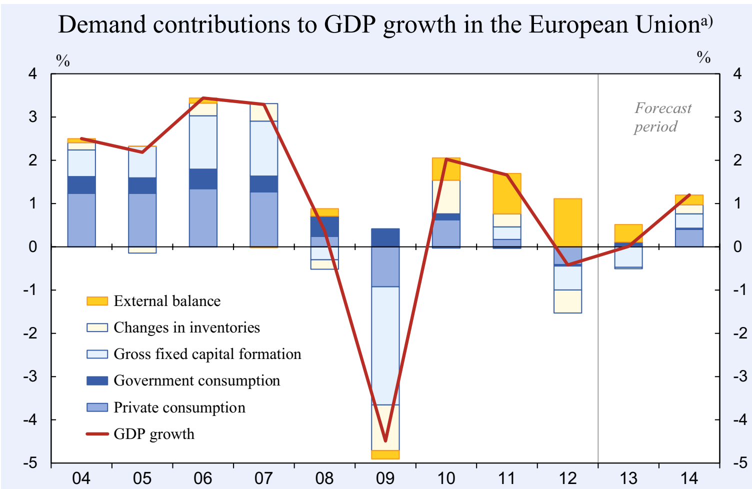
The cyclical situation

Albeit at a moderate pace, the economic recovery in the euro area is expected to continue this year (see Figure 1.30). Almost all sentiment and confidence indicators are following upward trends virtually everywhere in Europe. The driving force will be foreign trade (see Figure 1.31). Exports are likely to benefit from further improvements to conditions in the United States, as well as robust developments in Japan and in the majority of emerging economies. Furthermore, European domestic demand is expected to stabilise somewhat, which will partly be due to a noticeable reduction in the restrictiveness of fiscal policy. Combined with a further reduction in the uncertainty of private households and businesses regarding economic and political developments, this will have an increasingly positive effect on their willingness to spend and invest.

The heterogeneity between the individual member states will, however, remain very high. Business cycle developments in economically strong countries like Germany and Austria will experience a clear recovery. There, strong exports and investment-related domestic demand will continue to improve the labour market situation and thereby real wage developments. This will, in turn, allow private consumption to support further economic growth. The positive domestic and external economic outlook, the extremely favourable refinancing conditions and the still high degree of risk aversion of investors, will allow overall investment in such economies to accelerate. Finally, no contractionary impulses are to be expected from fiscal policy. Accordingly, in these countries, growth in domestic demand will contribute significantly to the increased pace of expansion.

Economic growth is likely to be somewhat weaker in countries such as Belgium, France, Italy and the Netherlands, which, although spared the fate of being labelled crisis countries under the aegis of the troika, are still struggling with country-specific structural weaknesses. Italy and France, for instance, have not yet responded to their loss of price competitiveness with the wage restraints observed in some other countries. Therefore, both these countries are expected to continue to lose world market shares and benefit relatively little from the economic upturns in Germany,

Figure 1.31



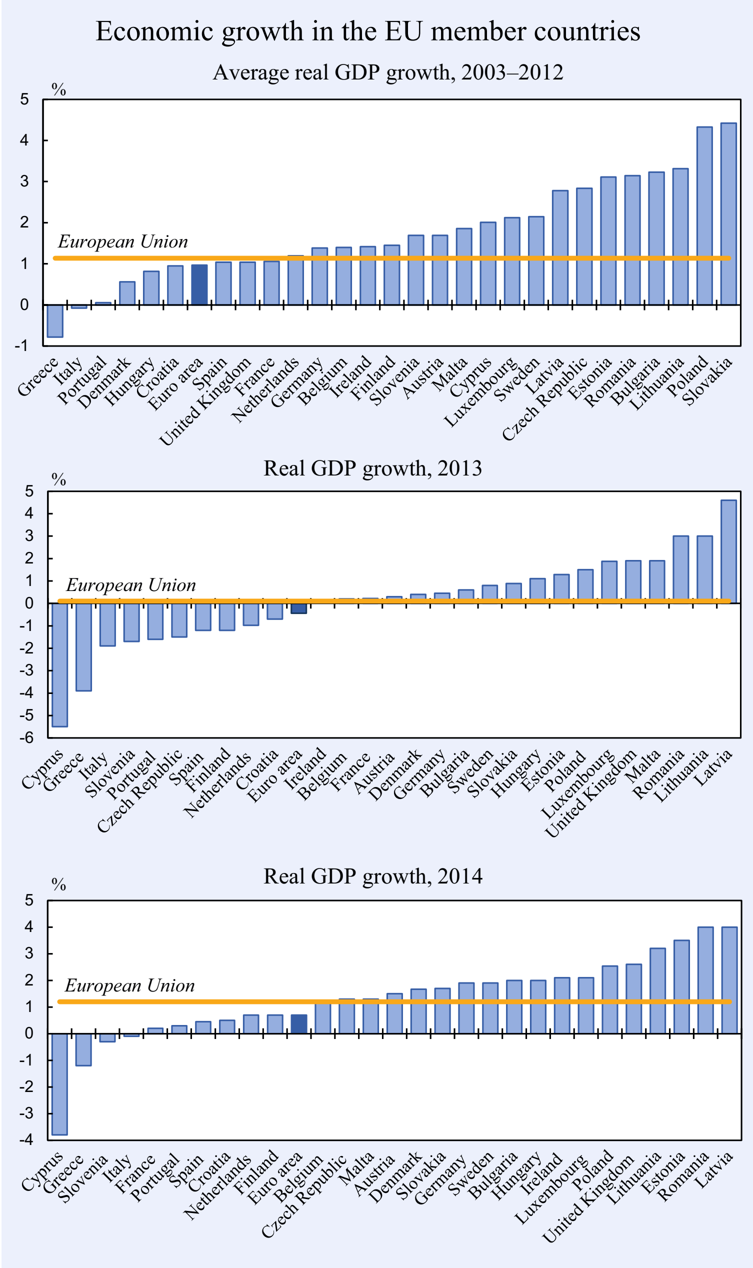
a) Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; EEAG calculations and forecast.

the United States, the United Kingdom and a number of emerging markets.

Albeit at a decreasing rate, domestic demand is expected to decline further this year in the crisis countries. Private and/or public debt is still very high in these nations. This burden will weaken aggregate demand even further. The situation in the labour market is also expected to deteriorate further, although only slightly. This will put additional stress on real income development and, therefore, on consumption. Private investment is also likely to continue to shrink, because the domestic economic outlook will improve, but at an extremely slow pace. At the same time, refinancing conditions for firms, due to the still fragile state of the banking sector, are likely to remain unfavourable. Only reduced fiscal consolidation efforts will provide some support for domestic demand. Significant positive contributions to the development of aggregate economic output will be provided by continuously shrinking imports. Exports of Ireland, Spain, Portugal and Greece are also increasingly likely to rise. All of these countries, albeit to quite varying degrees, are in the process of succeeding in improving their price competitiveness – at least relative to the stronger economies in Europe. Given the austerity policies, and in particular the wage moderation observed in Spain, Portugal and Greece over the past two years, this trend is likely to continue in 2014. Accordingly, these countries will increasingly benefit from the robust economies inside and outside of the euro area and will be able to increase their world market shares.

This year, the aggregate economies of the euro area and the European Union are expected to grow by 0.7 and 1.2 percent, respectively. Whereas real GDP will continue to shrink in Cyprus, Greece, Slovenia, and Italy, it will expand at an above average rate in Belgium, Malta, Austria, Denmark, Germany, Sweden, Ireland, Luxembourg, the United Kingdom and most of the Central and Eastern European EU member countries (with the exceptions of Slovenia and Croatia) (see Figure 1.32).

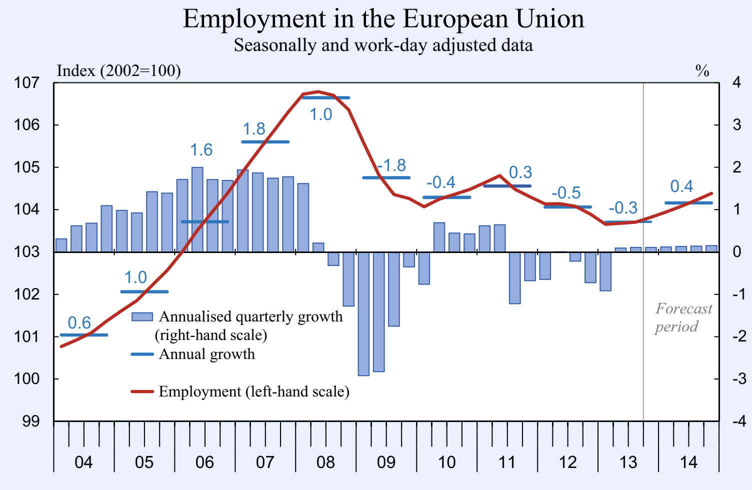
Figure 1.32



Source: Eurostat, last accessed on 19 January 2014; 2013, 2014: EEAG forecast.

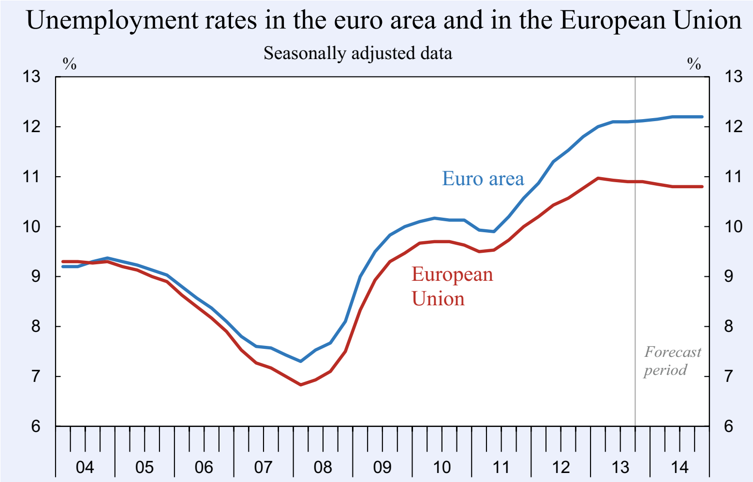
Given the feeble economic momentum, employment in the European Union will start to grow again in 2014 after having been in decline since mid-2011 (see Figure 1.33). Nevertheless, this will not be enough to have a strong impact on the unemployment rate. The latter is likely to remain at an average of 12.2 percent

Figure 1.33



Source: Eurostat; EEAG calculations and forecast.

Figure 1.34



Source: Eurostat; EEAG calculations and forecast.

in the euro area and 10.8 percent in the European Union this year (see Figure 1.34). The substantial differences in economic development between the various member states are expected to be accompanied by continued high dispersion in the national unemployment and wage developments. In the face of domestic economic weaknesses in many member countries, the inflation rate will be considerably lower than the 2 percent target set by the ECB. We expect it to weaken further to an average of 1.1 percent in the euro area in 2014. For the European Union the figure is expected to amount to 1.3 percent.

Differences across Europe

The *German* economy has probably performed above its potential this winter. This is, among other considerations, indicated by the significant rise in the Ifo Business Climate Index during last autumn and in the early winter. Assuming the latent uncertainty regarding political and economic developments in the crisis countries of the euro area does not materialise into any critical upheavals in international capital markets, this buoyancy should continue. Private consumption is expected to expand at an accelerated pace in view of the favourable employment situation and rising real earnings, which should benefit retail and consumer-related service providers. The upturn in the construction sector is expected to continue. This is underlined by increasing backlogs, particularly in residential construction. Even non-residential construction, which previously struggled during the economic downturn, is expected to increase. In terms of public construction, an improvement in municipal finances is to be noted. Moreover, as part of the flood relief fund, resources will flow into Germany's public civil engineering sector.

In view of rising export expectations, favourable financing conditions and currently close to normally utilised production capacities, investment in machinery and equipment is bound to increase.

The uptick in global demand and the stabilisation of euro area economies will provide fresh stimuli for Germany's export sector. However, over the course of the year, German exporters will lose some competitiveness to most of their trading partners. Given the relatively weak demand in the euro area, the total increase in German exports will also remain short of world trade. Since imports are likely to expand at an accelerated rate thanks to strong domestic demand, the trade surplus will slowly continue to diminish and net exports will again contribute negatively to real GDP growth this year. All in all, real GDP is expected to grow by 1.9 percent in comparison to 2013.

In the wake of the expansion of the German economy, employment growth will initially accelerate somewhat. Towards the end of the year, certain shortages in some labour market areas – especially of highly skilled workers – will become increasingly noticeable and the dynamism of employment growth is therefore expected to fall slightly. The unemployment rate is expected to decline slightly from an average of 5.2 percent in 2013 to 5.0 percent this year.

Inflation looks set to remain moderate. The pricing pressure resulting from wage increases will, to some extent, be offset by rising labour productivity. Overall, the consumer price level this year is likely to be 1.6 percent higher than in 2013.

Business tendency and consumer surveys in *France* suggest that its economy will probably move out of the doldrums by the end of this winter. However, the major upturn hoped for will most likely fail to materialise. Private consumption spending will be negatively affected by the increase in unemployment and low wage growth. The stimuli for real disposable income, and thereby private consumption, are only expected to come from continuing low inflation. The inflation rate is expected to stay at around 1.0 percent. The unemployment rate is forecast to rise from last year's 10.8 percent to 11.0 percent over the course of this year. Private investment is also likely to contribute only slightly to an increase in GDP. Firstly, profit prospects for French companies are currently rather poor. Secondly, the reductions in corporate taxes and labour costs, as announced by the French government, have essentially failed to materialise. The lack of will to pursue reforms on the part of the government is also a major reason for the low potential growth rate ascribed to the French economy and the associated lack of price competitiveness of French companies. Therefore, despite some revival of the global economy, no positive stimuli are to be expected from exports either. Only public consumption and investment look set to stabilise the economy in the short run, as any austerity measures that have been agreed upon with the European Commission, and which would be required to reduce the public deficit, have been postponed until 2015. All in all, real GDP will basically stagnate in 2014 with a growth rate of 0.2 percent.

Prospects for a continued economic recovery in the *United Kingdom* are quite favourable. Business sentiments have reached elevated levels in large parts of the economy. Even in the construction sector, the business climate improved. This was particularly driven by an increase in property prices. After falling for basically the last five years, it appears that house prices in the United Kingdom reached a trough at the end of 2012 and have been steadily increasing ever since. Consumer confidence also rose, albeit in a subdued manner. One of the supporting factors here has been the improved financial position of households.

The government is expected to stick to its plan to maintain a consolidation course until the fiscal year of 2017/18. Nevertheless, it can be assumed that the deficit will only be reduced slightly this year to avoid overburdening the economy. It will therefore only decrease to 5.3 percent of GDP, after settling at around 6.4 percent last year. As a result, the government debt-to-GDP ratio will increase further to about 97 percent in 2014, following 94.3 percent last year.

Overall, real GDP in the United Kingdom is expected to rise by 2.6 percent this year. A driving force behind the recovery is likely to be a robust expansion of domestic demand, stimulated by favourable credit conditions and the already advanced deleveraging of the household sector. At the same time, exports can be expected to rise as a result of the economic recovery of major trading partners. Despite the recovery, however, capacities are likely to remain underutilised keeping investment and price pressure subdued. The UK's inflation rate will settle at about 2.2 percent this year. The situation in the labour market remains quite tense and a rapid decrease in the unemployment rate is not to be expected. The unemployment rate could fall under 7 percent towards the end of the year. This would prompt the Bank of England to gradually reduce the degree of its extremely expansionary monetary policy. The challenge will be to accomplish this without causing disruptions in financial markets and thereby constraining the economy.

Italy is not expected to emerge from its economic recession before summer this year. Even if it should do so, a broadly-based recovery is unlikely as the uncertainty surrounding government policy is bound to remain high. On average, with an annual growth rate of – 0.1 percent, real GDP will basically stagnate in a year-over-year comparison. The slight economic recovery in the second half of 2014 will not be significant enough to bring about a turnaround in the labour market. Italy's unemployment rate is expected to rise from last year's average of 12.2 percent to 12.6 percent this year. As a result, the real disposable income of households will weigh on consumption. Some relief to the household budget is to be expected from a further drop in inflation. It is expected to decrease as a result of the continuing under-utilisation of production capacities from an average of 1.3 percent in 2013 to 1.0 percent in 2014. This might be interpreted as initiating the much-needed process of improving price competitiveness in the Italian economy.

The somewhat sub-normal rate of capacity utilisation, together with unfavourable financing conditions, constitute the reasons why no substantial economic stimuli are to be expected from gross private investment in Italy. In addition, high tax and social security burdens continue to take their toll on Italian companies. The structural benefits from the scheduled reduction of this burden in the next two years counter-financed by a reduction in government spending will not emerge immediately. Net foreign trade is expected to contribute positively to overall growth. However, this will be caused by a decline in imports, rather than an increase in exports. Imports are expected to be adversely affected by declining household incomes. Only fiscal policy is expected to have some short-term stabilising effects on the economy. Despite the high level of public indebtedness, no significant consolidation measures are scheduled. Hence, this short-term stabilising effect may result in a long-term destabilisation. A new escalation of the euro crisis thus represents a clear downside risk to this forecast.

Spain still has a long way to go before becoming competitive and healthy again. Persistently high under-utilisation of production capacities is likely to cause the inflation rate to fall even further. After 1.6 percent last year, the average inflation rate for this year is forecasted to reach – 0.1 percent. This decline in the general price level improves the competitiveness of Spanish companies, supporting the export economy. On the part of private and public consumption, however, no positive impulses are to be expected. The private sector is heavily indebted and will have to continue working on reducing its debt. For the first time in years, gross private investment will probably be able to increase slightly this year, as foreign demand for Spanish capital goods is likely to increase. The construction industry is expected to reduce its pace of decline. Overall, real GDP is expected to grow moderately with a rate of 0.5 percent this year.

During the last quarter of 2013 the number of registered unemployed persons started falling. Although a substantial share of this decline was due to migrant workers returning to their home countries and the long-term unemployed dropping out of the system, some of it can be interpreted as a first sign that the labour market reforms and wage restraints implemented in Spain are starting to take effect. Nevertheless, from a year-over-year perspective, the unemployment rate is still expected to increase slightly to an average of 26.7 percent this year (after 26.5 percent in 2013).

The susceptibility of the Spanish economy to external shocks remains high. Private household indebtedness is hardly improving, while the government deficit and debt are still high. In addition, the banking system remains vulnerable, with a large amount of toxic loans on the banks' balance sheets. So far, we have probably only seen the tip of the iceberg in this respect. Hence, the downside risks to this forecast remain substantial.

In *Central and Eastern Europe* the signs of an economic revival are increasing. Most of these countries will continue to benefit from their improved competitiveness positions built up in recent years and the slow economic recovery of the euro area. Growth in the region largely depends on demand from the euro area. Not only exports, but also credit demand, are expected to increase slightly this year because of positive economic prospects on the one hand, and as a result of further base rate cuts by some of the central banks in the region on the other. These cuts are possible thanks to the sharp decline in inflation rates. Impulses also come from a revival in domestic demand fuelled by the easing of austerity measures on the part of governments. This easing is feasible since, with the exception of Hungary, most already have comparably healthy state finances, which is supported by their credit ratings.

Overall, an acceleration in growth is slowly emerging in the region this year. This also applies to the three largest economies in the region: Poland, the Czech Republic and Romania. With already comparatively high growth rates, the outlook for the Baltic States, however, is fraught with uncertainty, as these countries have recently begun to feel the impact of the economic slowdown in Russia.

References

EEAG (2012), *The EEAG Report on the European Economy 2012*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2012.pdf.

EEAG (2013), *The EEAG Report on the European Economy 2013*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2013.pdf.

Appendix 1.A
Forecasting tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in %	GDP growth in %			CPI inflation in %			Unemployment rate[d] in %		
		2012	2013	2014	2012	2013	2014	2012	2013	2014
Industrialised countries:										
European Union	26.6	– 0.4	0.1	1.2	2.6	1.5	1.3	10.5	10.9	10.8
Euro area	19.4	– 0.7	– 0.4	0.7	2.5	1.4	1.1	11.4	12.1	12.2
Switzerland	1.0	1.0	1.9	2.2	– 0.7	– 0.2	0.3	4.1	4.4	4.4
Norway	0.8	3.3	2.0	2.5	0.7	2.1	1.9	3.3	3.2	3.2
Western and Central Europe	28.4	– 0.2	0.2	1.2	2.4	1.5	1.3	10.3	10.7	10.6
US	25.9	2.8	1.9	2.6	2.1	1.5	1.9	8.1	7.4	6.4
Japan	9.5	1.4	1.6	1.5	0.0	0.3	2.7	4.6	4.4	4.3
Canada	2.9	1.7	1.7	2.2	1.5	1.1	1.7	7.5	7.3	7.2
Industrialised countries (total)	**66.6**	**1.3**	**1.1**	**1.9**	**1.9**	**1.3**	**1.7**	**8.7**	**8.6**	**8.2**
Newly industrialised countries:										
Russia	3.2	3.4	1.3	2.0	5.1	6.7	6.0			
China	13.1	7.7	7.7	7.5	2.7	2.6	3.3			
India	2.9	3.8	3.9	5.6	9.3	11.5	9.2			
East Asia[a]	6.3	3.8	3.8	4.5	3.1	3.0	3.4			
Latin America[b]	7.8	2.6	2.5	2.9	6.2	6.9	6.8			
Newly industrialised countries (total)	**33.4**	**5.1**	**4.8**	**5.2**	**4.4**	**4.9**	**4.9**			
Total[c]	**100.0**	**2.5**	**2.3**	**3.0**						
World trade growth in %		2.4	2.0	4.9						

[a] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2012 levels of GDP in US dollars. – [b] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia and Chile. Weighted with the 2012 level of GDP in US dollars. – [c] Weighted average of the listed groups of countries. – [d] Standardised unemployment rate.

Source: EU, OECD, IMF, ILO, National Statistical Offices, 2013 and 2014: EEAG Forecast.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth in %			Inflation[a)] in %			Unemployment rate[b)] in %		
		2012	2013	2014	2012	2013	2014	2012	2013	2014
Germany	20.3	0.7	0.4	1.9	2.1	1.6	1.6	5.5	5.2	5.0
France	15.7	0.0	0.2	0.2	2.2	1.0	1.0	10.2	10.8	11.0
Italy	12.5	– 2.5	– 1.9	– 0.1	3.3	1.3	1.0	10.7	12.2	12.6
Spain	8.5	– 1.6	– 1.2	0.5	2.4	1.6	– 0.1	25.0	26.5	26.7
Netherlands	4.8	– 1.2	– 1.0	0.7	2.8	2.5	1.3	5.3	6.7	7.1
Belgium	2.9	– 0.1	0.2	1.2	2.6	1.2	1.3	7.6	8.4	8.6
Austria	2.4	0.9	0.3	1.5	2.6	2.1	1.8	4.3	4.8	4.7
Greece	1.7	– 6.4	– 3.9	– 1.2	1.0	– 0.9	– 0.6	24.3	27.4	28.0
Finland	1.5	– 0.8	– 1.2	0.7	3.2	2.2	1.6	7.7	8.2	8.3
Portugal	1.4	– 3.2	– 1.6	0.3	2.8	0.4	0.0	15.9	16.5	15.4
Ireland	1.2	0.2	0.0	2.1	1.9	0.5	0.8	14.7	13.1	12.5
Slovakia	0.5	1.8	0.9	1.7	3.7	1.5	1.7	14.0	14.2	13.9
Slovenia	0.3	– 2.5	– 1.7	– 0.3	2.8	1.9	1.3	8.9	10.2	11.0
Luxembourg	0.3	– 0.2	1.9	2.1	2.9	1.6	1.7	5.1	5.9	5.7
Latvia	0.2	5.0	4.6	4.0	2.3	0.0	2.0	15.0	12.1	11.2
Cyprus	0.1	– 2.4	– 5.5	– 3.8	3.1	0.6	0.6	11.9	16.1	18.1
Estonia	0.1	3.9	1.3	3.5	4.2	3.4	3.4	10.2	8.6	8.5
Malta	0.1	0.8	1.9	1.3	3.2	1.0	1.5	6.4	6.4	6.0
Euro area[c)]	**74.4**	**– 0.7**	**– 0.4**	**0.7**	**2.5**	**1.4**	**1.1**	**11.4**	**12.1**	**12.2**
United Kingdom	13.7	0.1	1.9	2.6	2.8	2.6	2.2	7.9	7.5	7.1
Sweden	3.1	0.9	0.8	1.9	0.9	0.4	0.9	8.0	8.0	7.8
Denmark	1.9	– 0.4	0.4	1.7	2.4	0.5	0.8	7.5	6.9	6.7
EU 21[c)]	**93.1**	**– 0.5**	**0.0**	**1.1**	**2.5**	**1.5**	**1.3**	**10.7**	**11.2**	**11.2**
Poland	2.9	1.9	1.4	2.5	3.7	0.8	1.2	10.1	10.4	10.0
Czech Republic	1.2	– 1.0	– 1.5	1.3	3.5	1.3	1.0	7.0	7.0	6.5
Romania	1.1	0.7	3.0	4.0	3.4	3.2	2.7	7.0	7.3	6.9
Hungary	0.8	– 1.7	1.1	2.0	5.7	1.8	2.0	10.9	10.4	10.0
Croatia	0.4	– 2.0	– 0.7	0.5	3.4	2.4	2.0	15.9	17.0	16.0
Bulgaria	0.3	0.8	0.6	2.0	2.4	0.5	1.0	12.3	13.0	12.0
Lithuania	0.2	3.7	3.0	3.2	3.2	1.2	1.5	13.4	11.8	10.9
New Members[d)]	**6.9**	**0.6**	**1.1**	**2.4**	**3.8**	**1.5**	**1.6**	**9.6**	**9.8**	**9.3**
European Union[c)]	**100.0**	**– 0.4**	**0.1**	**1.2**	**2.6**	**1.5**	**1.3**	**10.5**	**10.9**	**10.8**

[a)] Harmonised consumer price index (HICP). – [b)] Standardised unemployment rate. – [c)] Weighted average of the listed countries. – [d)] Weighted average over Poland, Czech Republic, Romania, Hungary, Croatia, Bulgaria and Lithuania.

Source: Eurostat, OECD, IMF, 2013 and 2014: EEAG Forecast.

Table 1.A.3

Key forecast figures for the European Union

	2011	2012	2013	2014
	Percentage change over previous year			
Real gross domestic product	1.6	– 0.4	0.0	1.2
Private consumption	0.3	– 0.7	0.1	0.7
Government consumption	– 0.2	– 0.2	0.4	0.2
Gross fixed capital formation	1.6	– 3.0	– 2.7	1.9
Net exports[a)]	0.9	1.1	0.4	0.2
Consumer prices[b)]	3.1	2.6	1.5	1.3
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 4.4	– 3.9	– 3.5	– 2.7
	Percentage of labour force			
Unemployment rate[d)]	9.7	10.5	10.9	10.8

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2013 and 2014: Forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat, 2013 and 2014: EEAG Forecast.

Table 1.A.4

Key forecast figures for the euro area

	2011	2012	2013	2014
	Percentage change over previous year			
Real gross domestic product	1.6	– 0.7	– 0.4	0.7
Private consumption	0.3	– 1.4	– 0.5	0.3
Government consumption	– 0.1	– 0.5	0.2	0.0
Gross fixed capital formation	1.6	– 4.1	– 3.2	1.2
Net exports[a)]	0.9	1.5	0.5	0.5
Consumer prices[b)]	2.7	2.5	1.4	1.1
	Percentage of nominal gross domestic product			
Government fiscal balance[c)]	– 4.2	– 3.7	– 3.1	– 2.5
	Percentage of labour force			
Unemployment rate[d)]	10.1	11.4	12.1	12.2

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2013 and 2014: Forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat, 2013 and 2014: EEAG Forecast.

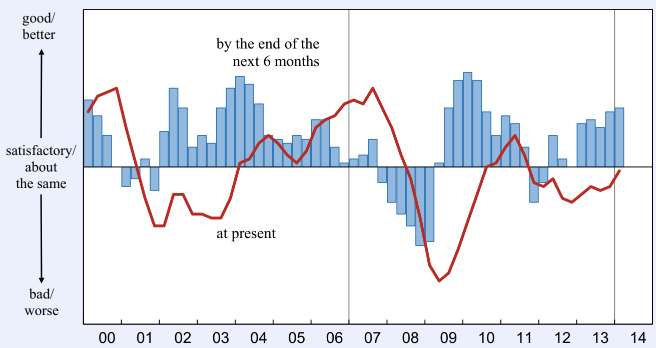
Appendix 1.B
Ifo World Economic Survey (WES)

The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organizations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2014, 1,121 economic experts in 121 countries were polled. WES is conducted in co-operation with the International Chamber of Commerce (ICC) in Paris.

The survey questionnaire focuses on qualitative information: on assessment of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The "grading" procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

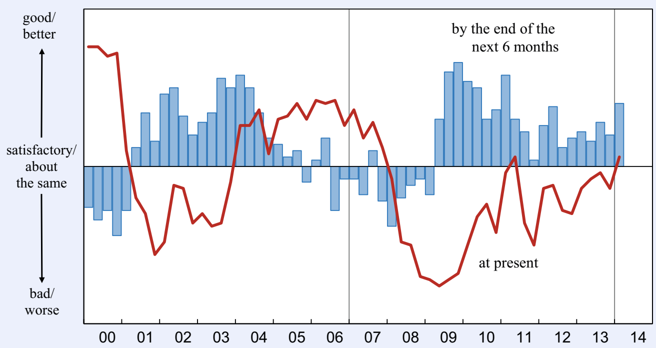
Ifo World Economic Survey (WES)

World
Economic situation



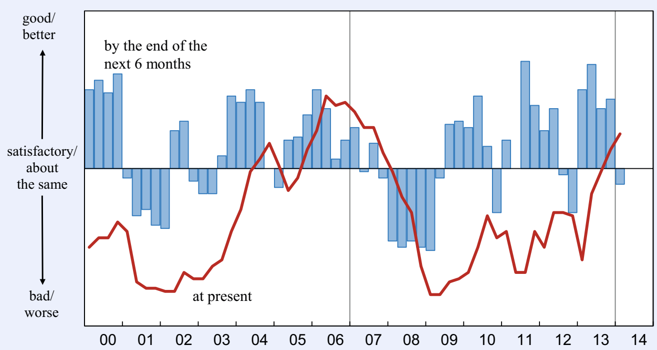
Source: Ifo World Economic Survey (WES) I/2014.

USA
Economic situation



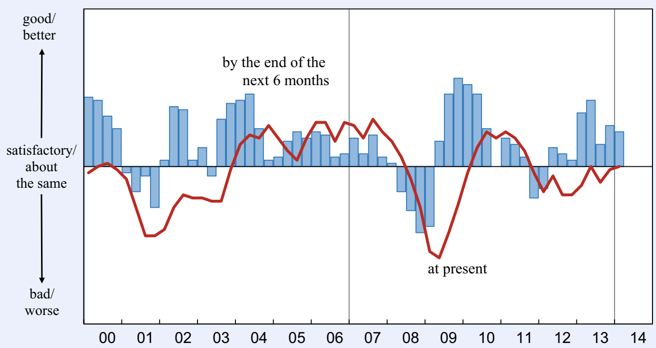
Source: Ifo World Economic Survey (WES) I/2014.

Japan
Economic situation



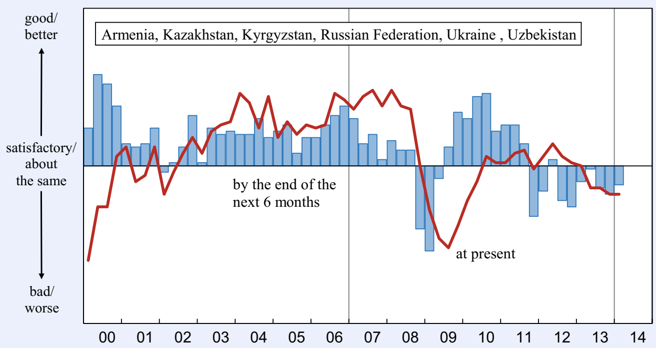
Source: Ifo World Economic Survey (WES) I/2014.

Asia
Economic situation



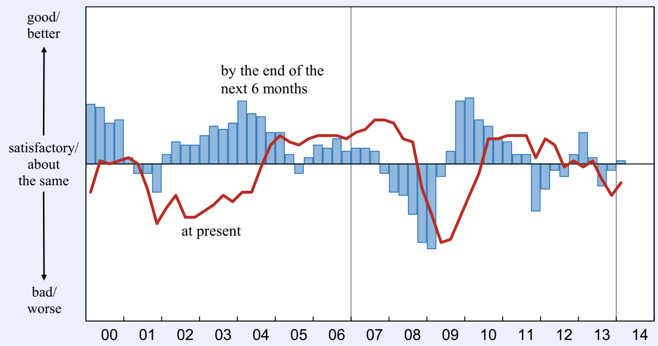
Source: Ifo World Economic Survey (WES) I/2014.

CIS
Economic situation



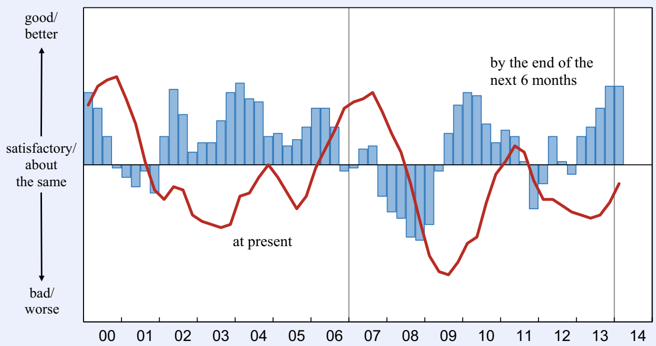
Source: Ifo World Economic Survey (WES) I/2014.

Latin America
Economic situation



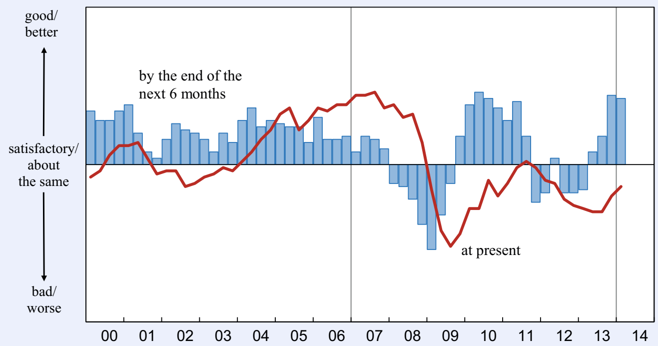
Source: Ifo World Economic Survey (WES) I/2014.

European Union (15)
Economic situation



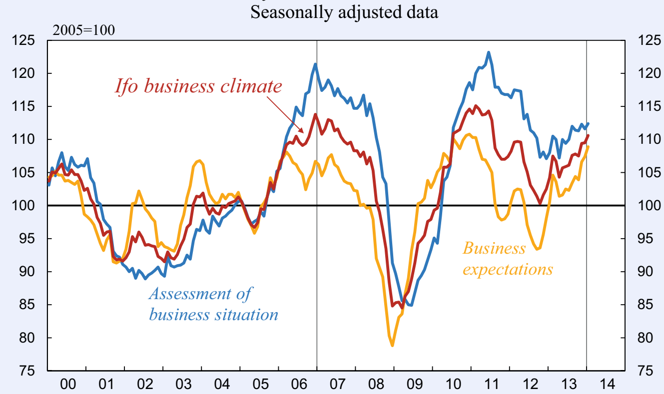
Source: Ifo World Economic Survey (WES) I/2014.

Eastern Europe
Economic situation



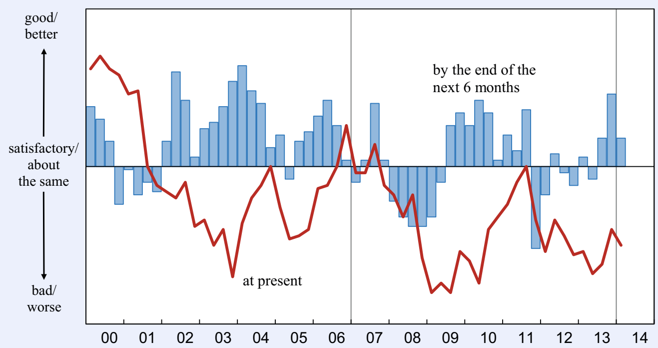
Source: Ifo World Economic Survey (WES) I/2014.

Germany: Ifo business climate[a)]
Seasonally adjusted data

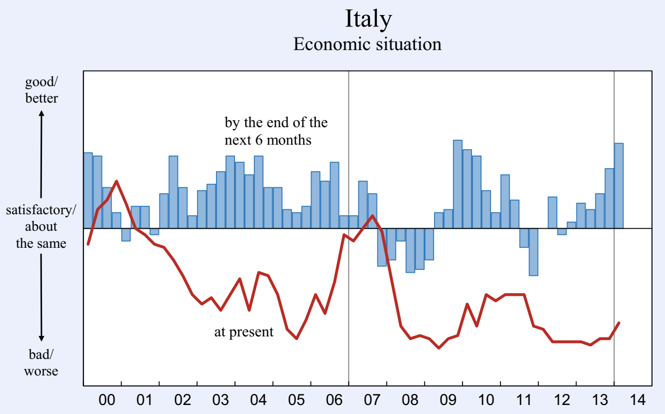


[a)] Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2014.

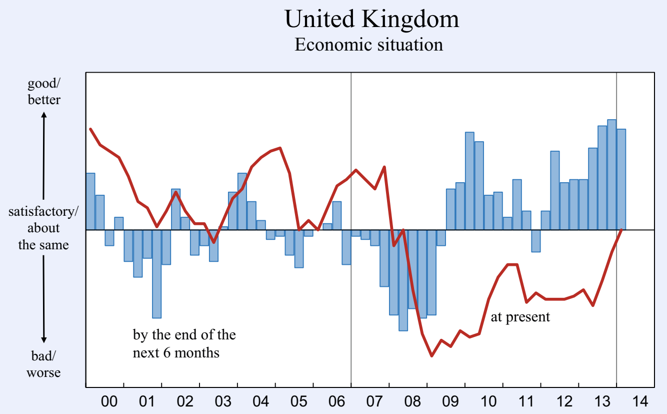
France
Economic situation



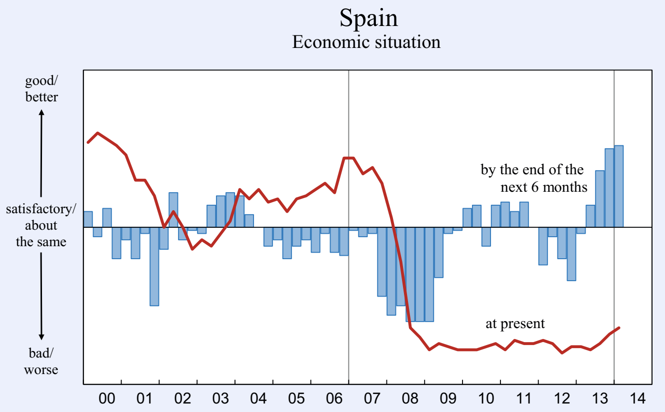
Source: Ifo World Economic Survey (WES) I/2014.



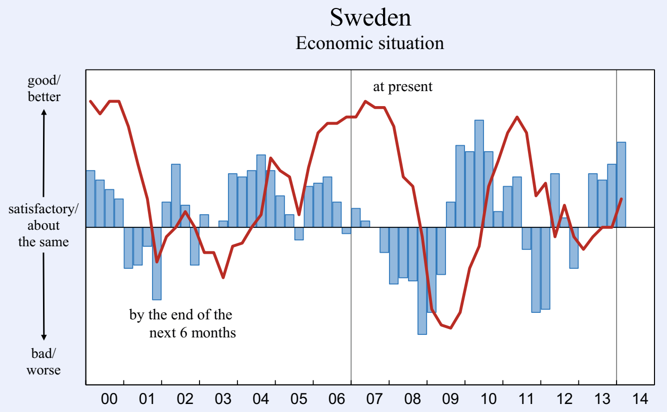
Source: Ifo World Economic Survey (WES) I/2014.



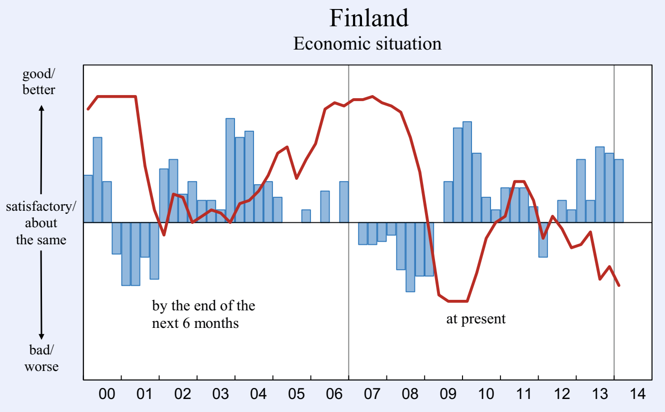
Source: Ifo World Economic Survey (WES) I/2014.



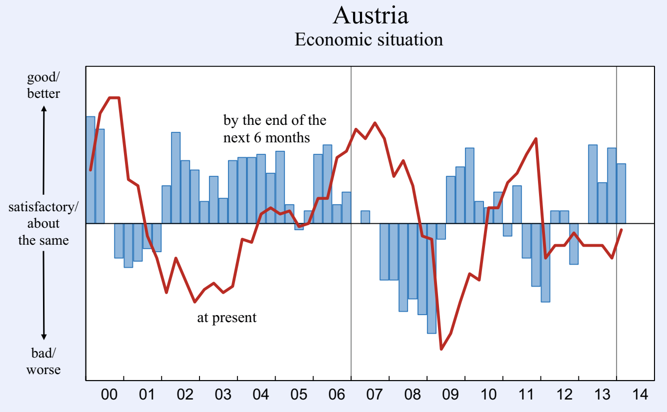
Source: Ifo World Economic Survey (WES) I/2014.



Source: Ifo World Economic Survey (WES) I/2014.

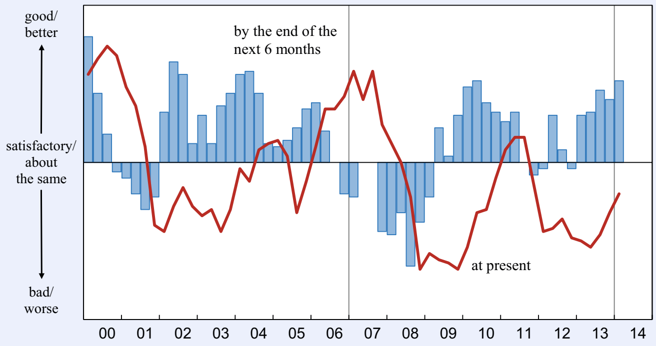


Source: Ifo World Economic Survey (WES) I/2014.



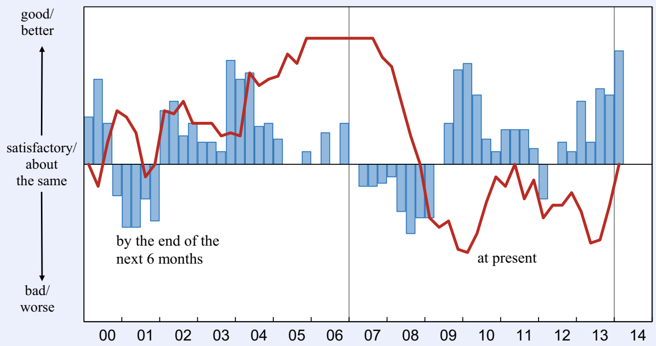
Source: Ifo World Economic Survey (WES) I/2014.

Belgium
Economic situation



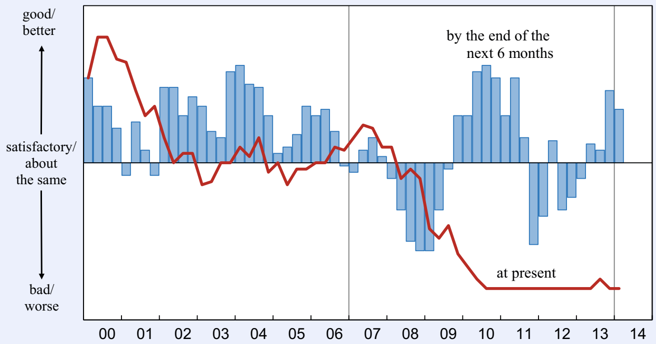
Source: Ifo World Economic Survey (WES) I/2014.

Denmark
Economic situation



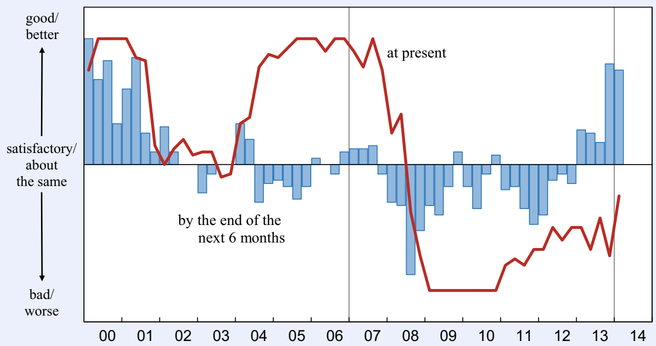
Source: Ifo World Economic Survey (WES) I/2014.

Greece
Economic situation



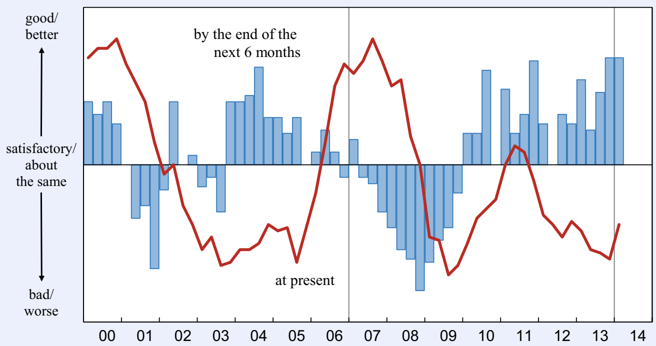
Source: Ifo World Economic Survey (WES) I/2014.

Ireland
Economic situation



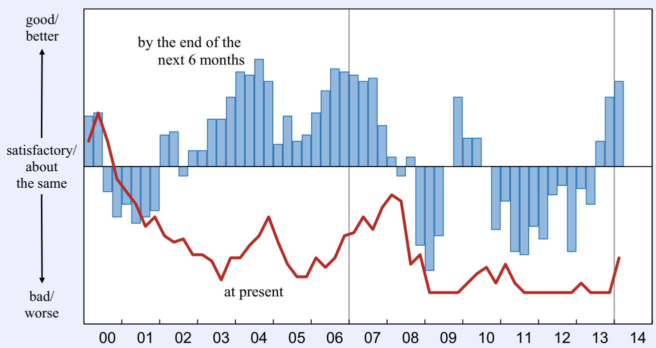
Source: Ifo World Economic Survey (WES) I/2014.

Netherlands
Economic situation



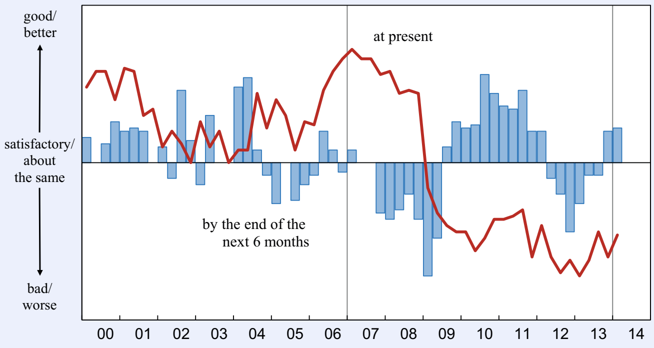
Source: Ifo World Economic Survey (WES) I/2014.

Portugal
Economic situation



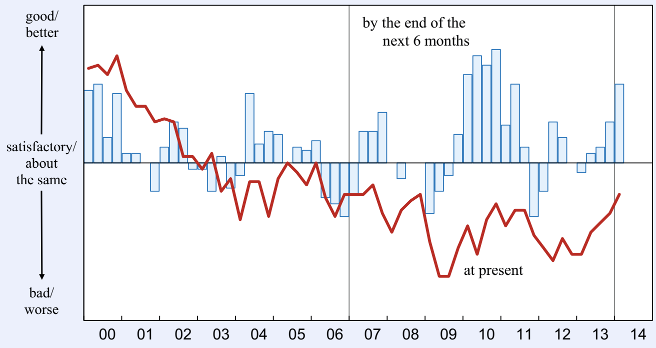
Source: Ifo World Economic Survey (WES) I/2014.

Slovenia
Economic situation



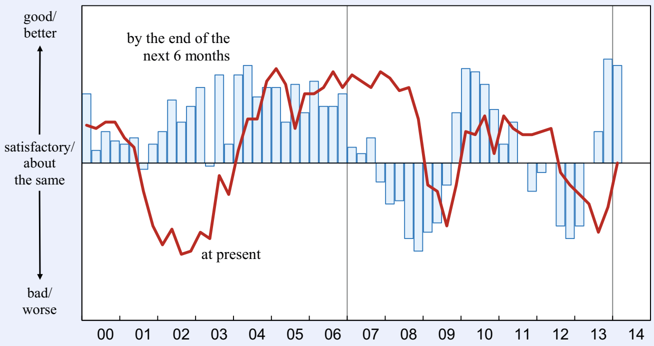
Source: Ifo World Economic Survey (WES) I/2014.

Hungary
Economic situation



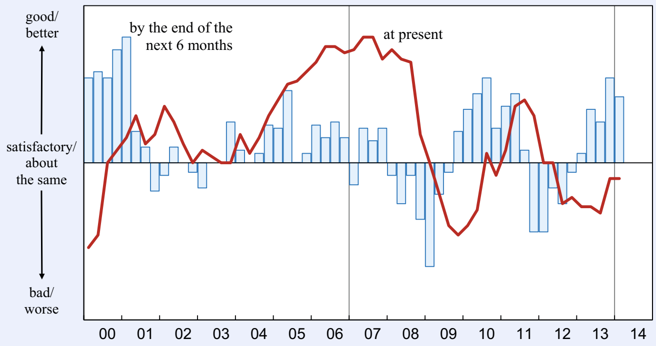
Source: Ifo World Economic Survey (WES) I/2014.

Poland
Economic situation



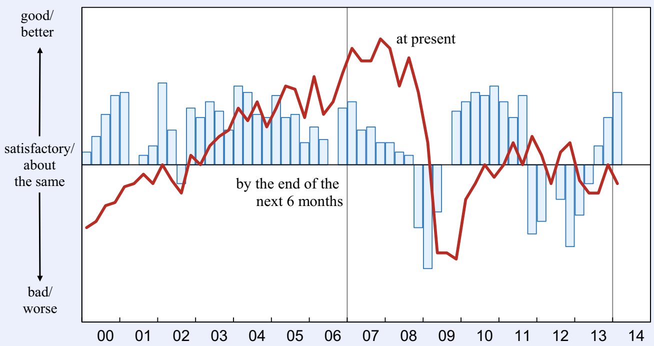
Source: Ifo World Economic Survey (WES) I/2014.

Czech Republic
Economic situation



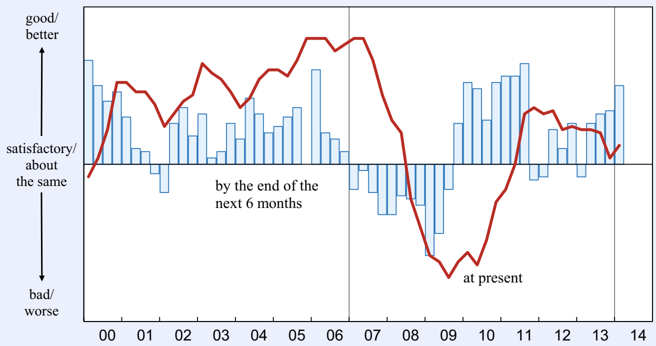
Source: Ifo World Economic Survey (WES) I/2014.

Slovakia
Economic situation

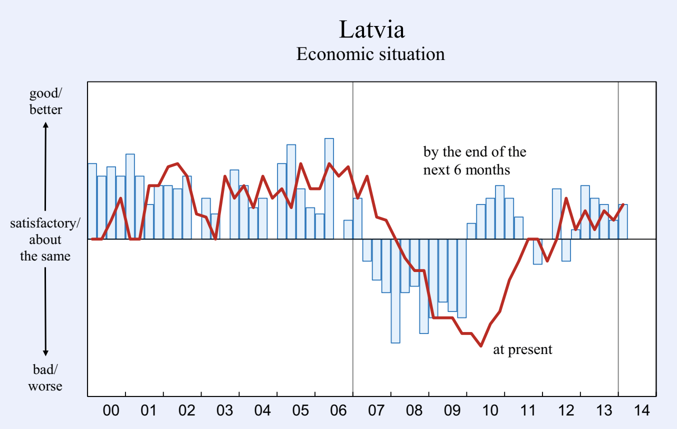


Source: Ifo World Economic Survey (WES) I/2014.

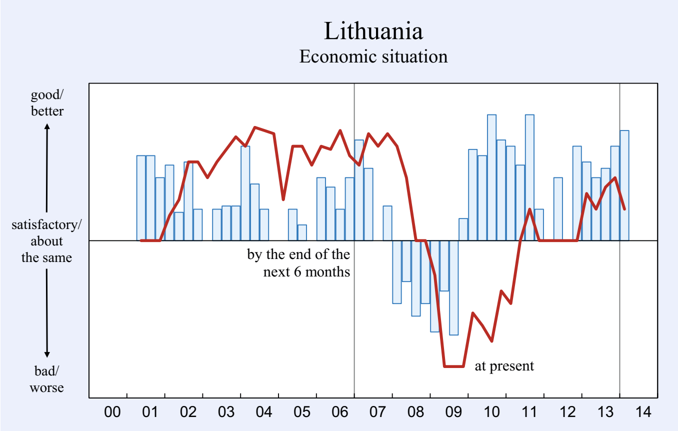
Estonia
Economic situation



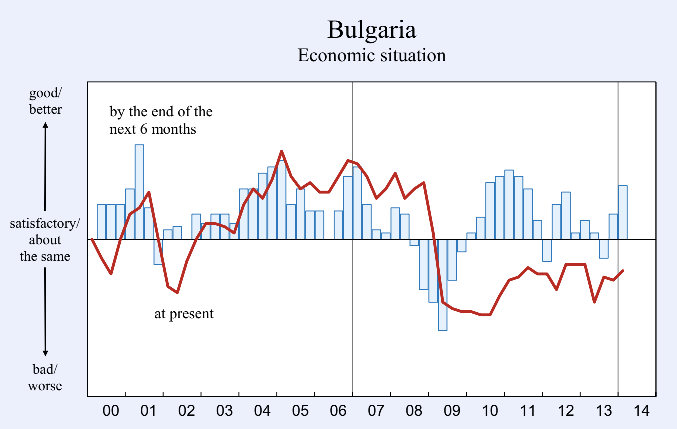
Source: Ifo World Economic Survey (WES) I/2014.



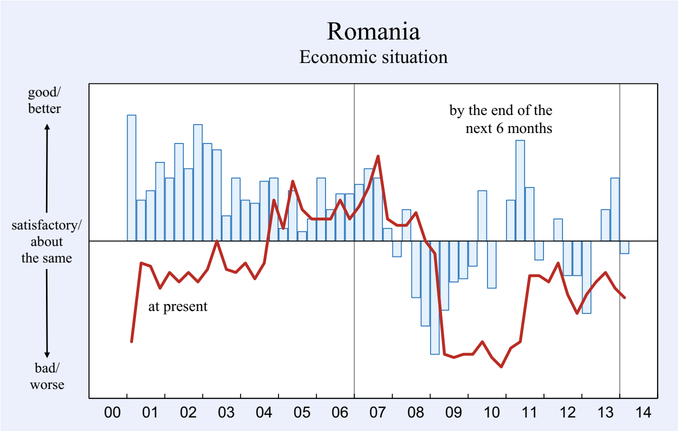
Source: Ifo World Economic Survey (WES) I/2014.



Source: Ifo World Economic Survey (WES) I/2014.



Source: Ifo World Economic Survey (WES) I/2014.



Source: Ifo World Economic Survey (WES) I/2014.

Switzerland: Relic of the Past, Model for the Future?*

2.1 Introduction

Like every European country and Europe itself, Switzerland is a collection of diverse communities connected by a web of markets and policies. The socio-economic institutions that link people and land have always evolved through history, as communication technologies altered the cultural significance of existing borders, while trade and factor mobility altered local governments' ability to enforce taxes and regulations. This Chapter reviews the often quaint and always intriguing ways in which such phenomena operate in Switzerland, and discusses whether and how the Swiss Confederation's past history and current Swiss policy issues may help us to understand the parallel evolution and similar problems experienced by other European economies and societies. At a time of critical crisis for Europe's Economic and Monetary Union project, it is very useful to study the role of social and cultural factors in shaping the challenges and opportunities of economic union and diversity management. National and cultural identities currently play a prominent role in European economic policy debates. In July 2012, for example, positions on banking union were taken by groups of economists who identified themselves as "German speaking", rather than as taxpayers of specific countries, or members of some other economic interest group.

Swiss citizens feel that they belong to their country in a way that approximates national feelings, but differs from those that prevailed over the last couple of centuries in other parts of Europe. The Swiss are very much a nation in a sense, because they are very proud of their country and there is no discussion whatsoever of breaking it up. Part of the reason for the absence of break-up tensions is, however, that the Swiss Confederation does not rely on cultural homogeneity to build consensus around centralised institutions – an approach, typical of European nation-states, that is increasingly less effective within countries, and extremely unlikely to work at the European level. Instead, the Swiss are linked by a relatively loose (but tightening) institutional framework, held together by pragmatic awareness that common problems need common solutions.

Many who hope that Europe will develop a more cohesive political structure are fond of De Rougemont's (1965) picture of Swiss federalism. Observing the Swiss indeed offers the authors and readers of this chapter plentiful opportunities to rehearse all the relevant issues of market and policy integration, including tax competition, financial regulation, labour mobility, currency adoption, and monetary and fiscal policies. As we shall see, Switzerland has become more similar to its neighbour countries and more tightly integrated with their financial, fiscal, and market structure. And Europe may arguably, in turn, benefit from becoming more Swiss in its approach to solving the key issue it faces, namely that of defining and designing a new set of policies and political interactions that works consistently both at lower levels than that of legacy countries, and across the boundaries of historical nations.

2.2 The Swiss way

The Swiss Confederation includes 26 cantons: 4 French-speaking, 1 Italian-speaking, 3 French-German bilingual cantons, 1 German-Rhaetoromanic-Italian trilingual canton and 17 German-speaking ones. Its citizens' social and political rights and obligations are traditionally derived from their membership of a commune, which is generally based on ancestry ("ius sanguinis") rather than place of birth ("ius soli"). The notion of a "place of origin" was established in the 18th century, when a child was entered in the citizen registry of his or her father's commune. The commune is still reported, in passports and other documents, where other countries show their citizens' place of birth. These historical roots help us to understand why the Swiss socio-economic model is not as individualistic as that of more market-oriented countries, but does privilege local po-

* We thank Richard Baldwin, Florian Eckert, Gebhard Kirchgaessner, Marko Koethenbuerger, Winfried Koeniger, Rafael Lalive and Benjamin Ryser for valuable feedback. All remaining errors are the authors' own.

litical interactions and choices over broader and longer-range schemes and projects. In Switzerland a modern, urban, market-oriented view of the world coexists with rural traditionalist roots. The Swiss do not like to be controlled by a distant government and like their privacy to be strictly protected, especially in financial matters, but do control each other's individual behaviour. In small communes, in the neighbourhoods of larger towns, and in work places, rules are strictly enforced not only by formal policing, but also by less formal yet no less stringent monitoring by peers, who strongly feel that law and order should be preserved, and that it is their duty to defend common property and quiet against destructive and disruptive behaviour.

2.2.1 Institutional structure

Many of Switzerland's more than 2,500 communes are still small enough to allow all important decisions to be taken by annual (or more frequent) general assemblies. Most of the population lives in larger communes, where decisions are approved by more modern, but still very frequent and comprehensive voting procedures. A similarly broad spread of decision power is observed at the top federal level of the Swiss political system: Legislative power is perfectly shared by the National Council (where cantonal representation is roughly proportional to their population) and by the Council of States (where 20 cantons are represented by 2 councillors and the other 6 by 1); there are frequent referendums on popular legislative initiatives; executive power is exercised by a government in which all major parties are usually represented.

This direct democracy and consociational ("Konkordanzdemokratie") political model tends to imply a decentralised structure for economic policies and institutions (Kirchgaessner, 2013). Cantons' and communes' tax income, wealth, and specific goods and services: The Federal Act on the harmonisation of the direct taxes of cantons and municipalities of 2000 and 2001 regulates their types, bases, and assessment timing, but allows tax rates to differ widely. The Federation imposes an income tax that is steeply progressive, but only reaches 11.50 percent maximum average and 13.20 percent maximum marginal tax rates. Value added tax is levied by the Federation since 1995 at a current standard rate of 8 percent,[1] and at even lower rates on convenience goods and lodging. This is exceptionally low compared to other OECD countries. A value added tax (VAT) was introduced much later than income taxes, so it has not yet had much time to rise. In both cases, tax rate increases are constrained by the fact that Swiss voters and cantons care less (to date) about federal tax revenues than those of lower levels of government.

Social assistance used to be a responsibility of the commune of origin, which until late 2012 was still responsible for a share of the benefits drawn by any needy citizens: Such benefits are now the responsibility of the cantons for their residents, and have become less necessary as federal social schemes were introduced. These include a basic pay-as-you-go pension scheme (AHV, "Alters- und Hinterlassenenversicherung"), which together with the disability insurance scheme (IV, "Invalidenversicherung") constitutes the first pillar of Switzerland's social insurance. The federal government also establishes and enforces the rules of the mandatory unemployment insurance scheme (ALV, "Arbeitslosenversicherung") but lower-level regional offices are responsible for the implementation of counselling, monitoring, and activation policies. Switzerland's second welfare pillar consists of occupational funded pension plans, mandatory for employees and optional for the self-employed; health insurance is similarly compulsory, and privately run by competing schemes rather than by a national health service.

Many policies and institutions are decentralised in Switzerland. Only a few tertiary education and research institutes are federal; secondary and tertiary education is organised by the cantons; and primary schools are run by communes subject to cantonal legislation, which, in turn, is at least in principle, but in practice only slowly and partially, subject to federal rules and supervision. The Federal Constitution in Switzerland is renewed at irregular intervals, and the version that has been in force since 2001 provides for common primary education standards (Article 62). It also provides for freedom of establishment (Article 24) and of commerce (Article 27), and establishes a mandate "to create a unified Swiss economic area" (Article 95). Implementation of these principles requires legislation that is only being very slowly drafted and approved (or rejected) by the cantons. The "Accord inter-cantonal sur l'harmonisation de la scolarité obligatoire" ("HarmoS") was joined at its 2007 inception by 11 cantons and has been in force since August 2009. It now covers 76.2 percent of the population after another 7 cantons joined in 2010. The Accord has, however, been rejected by 7 cantons rep-

[1] In order to refinance the invalidity insurance system, this rate has been set at 8 percent until 2017. In 2018, it will revert back to 7.6 percent.

resenting 13.5 percent of the population, and the remaining cantons have not yet decided upon the issue. Cantons regulate professional qualifications, with a few exceptions (for example, the medical professions are regulated at the federal level). As a result, services markets remain less than fully integrated within Switzerland (Cottier and Oesch, 2012).

The "Accord inter-cantonal sur les marchés publics" of 1994 (revised in 2001) provides for only some competition-oriented regulation of public procurement. Two other key institutions are organised at the federal level of government. Article 99 of the Federal Constitution establishes that an independent central bank, the Swiss National Bank (SNB), should conduct monetary policy in the interests of the country as a whole, and maintain adequate foreign currency and gold reserves. Two thirds of its profits, net of dividends to shareholders at a rate of a maximum 6 percent, are paid to the cantons, and the other third is paid to the Confederation. The SNB's mandate is to balance price stability and business cycle considerations, with price stability as a priority.

The Constitution also envisions a federal army, organised into four regional commands that liaise with cantonal authorities, but obey only Federal Council decisions. All male Swiss citizens between 19 and 34 are subject to low-paid military service (around two thirds are deemed fit for it, the others perform civilian services, or pay 3 percentage points of additional income tax until the age of 30), and about 5 percent of the force is professional. The Swiss have supported this military structure in three referenda. The latest referendum rejected the proposal to abolish compulsory military service by a vast majority of 73 percent in September 2013. Of the previous two, the referendum held after the New York terrorist attacks more strongly supported Switzerland's military structure than its predecessor held in 1984.

2.2.2 Taxes

While other federal countries also decentralise many public expenditure decisions, a key specific feature of the Swiss institutional layout is the decentralised tax system. This provides a rich field for research into tax competition, which theoretically implies stronger pressure on the public sector's performance, but also lowers revenue-raising power, and hence reduces the ability to spend on public goods and redistribution (see Feld and Kirchgaessner, 2001; Feld et al., 2003, and their references).

To detect the pressure exercised by "yardstick" competition on service providers across jurisdictions, it is necessary to identify instances where taxpayers are unlikely to exert pressure by threatening to choose a different jurisdiction. An interesting illustration is offered by the fact that in most of Switzerland, church taxes are levied at the parish level, can differ across Catholic and Protestant confessions, and tend to be similar across churches of different denomination in nearby locations (Egger et al., 2012). Swiss parishes are more likely to set performance examples for each other than to be trying to steal members from each other, as they might in more individualistic societies (like the United States) where people are much freer than in Europe to change communities. Such yardstick competition must be much weaker in countries with more centralised arrangements (as in Germany, where church tax rates are set at the federal level for individuals who choose to declare a religion).

Theory predicts, and Swiss evidence confirms, that decentralisation of tax policies should lower tax revenue through tax competition, and shift its composition from taxes to user charges. Not surprisingly, high-income people are more likely to live in low-tax localities within Switzerland. The French-speaking cantons traditionally charge higher rates but, as predicted by tax competition pressure, cantonal income tax rates are lower when the tax rates of their neighbours are low, and the lowest tax rates can be seen in Zug, Schwyz and Nidwalden, which neighbour rich Zurich where the tax rate is higher.

Tax competition, however, is clearly not strong enough to make either taxation or high-tax areas disappear. This is partly for institutional reasons. In Switzerland, inter-cantonal redistribution takes place through a federal equalisation system that has slowly grown over time and, like redistribution across municipalities within cantons, takes into account the extent to which locally-raised revenues exploit the economy's fiscal potential. Like the expenditure co-financing mechanisms of such federal fiscal systems as those of the United States and Germany (Egger et al., 2010), this partially counteracts incentives to engage in tax competition (Smart, 1998; Koethenbuerger, 2002).

The intensity of competition is, however, also limited by the fact that agglomeration economies improve productivity and make it possible to afford better amenities. A large and well-located community like Zurich, or New York, can charge higher taxes than its smaller neighbours, and still offer an attractive after-tax income. In Switzerland, competition across jurisdictions may also be weakened by the fact that traditionally local institutions and socio-political interactions offer limited support to broader economic interactions. Locally administered social and pension rights are an obvious obstacle to mobility, and such institutional barriers used to be very strong in Switzerland. All employers have been required to participate in mandatory pension schemes since 1985, but these second pillar pension rights were not fully portable until 1995. However, additional contributions to local occupational pension schemes (of which there were over 17,000 in the early 1980s, and thousands still exist) may still not be fully portable.

More interestingly, cultural features also reduce the relevance of purely economic incentives to relocate in order to exploit tax differentials. Eugster and Parchet (2011) show that while there is competition in income taxes at the language border, its spatial reach is restricted to 20 km from Switzerland's language borders. Swiss data also offer many other indications that differences of language (and potato cooking recipes, work attitudes, and presumably more general cultural features) influence many important economic phenomena not only within Switzerland, but indeed within each Swiss canton. After taking into account relevant structural economic factors, no independent influence of local language and tax rates can be detected on entrepreneurship indicators (Bergmann, 2011), and financial capital mobility is presumably even less strongly, if at all, influenced by the cultural differences that restrain labour mobility. On the Latin-speaking side of the "Roestigraben" boundary of German-speaking Switzerland, which does not always coincide with cantonal boundaries, there is a tendency to make more intense use of similar or even identical unemployment benefit entitlements (Bruegger et al., 2009), and exports are more likely to be directed to France or Italy than to Germany or Austria (Egger and Lassmann, 2011).

2.2.3 International comparisons

If not language, culture and institutions do change across the boundaries of the Swiss Confederation. The cantons and communes of the Confederation do not only differ from each other, but are also on the whole different from the European Union (EU) countries that completely surround them. We briefly illustrate some key differences by comparing aggregate Swiss indicators to those of the country's neighbours and fellow language speakers (Austria, France, Germany, Italy) and, for reasons that will become clear if they are not already, to those of Belgium and the United States.

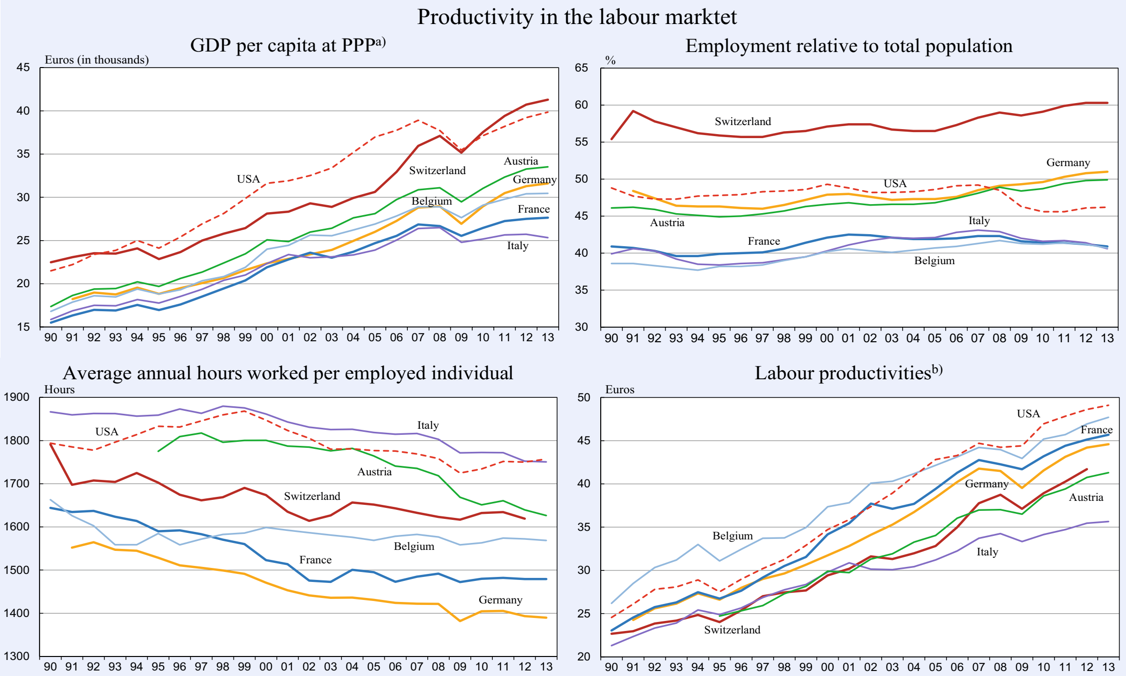
The first panel of Figure 2.1 shows that Switzerland's purchasing-power-adjusted GDP per capita, while comparable to that of the United States, is far higher than that of its immediate neighbours, chiefly because of the very high employment rate of Swiss residents (second panel of Figure 2.1): Hours per worker are in the middle of the group's range (third panel of Figure 2.1), and productivity per hour worked is actually lower in Switzerland than in all comparison countries except for Austria and Italy (fourth panel of Figure 2.1). That productivity difference partly reflects differences in capital intensity and in the employed labour force's educational qualifications. Over time, Figure 2.2 shows that after accounting for such observable factors, Switzerland's residual total factor productivity has not grown as fast as in some of its neighbouring countries: It slumped during the 1990s, recovered sharply before the Great Recession, and is currently stagnating.

The data shown in Figure 2.3 highlights an interesting Swiss peculiarity: The country's income inequality is quite different from its European neighbours. In Switzerland, taxes and subsidies reduce inequality only a little, and even less – albeit from a much lower level – than in the United States. Such cross-country comparisons are possible only for one rather recent year in the OECD set of comparable data, where Switzerland's inequality is, at the same time, the lowest for gross incomes and one of the highest for disposable incomes. Tax competition makes it difficult to implement redistribution schemes, and a "race to the bottom" outcome may not be surprising in a country where a very large share of tax revenues is raised by sub-central levels of government, and three quarters of local taxes are on income (rather than on consumption, sales, and property, as is the case in the United States and other federal systems).

It is important, however, to note that there is nevertheless some redistribution.[2] Currently, roughly a third of

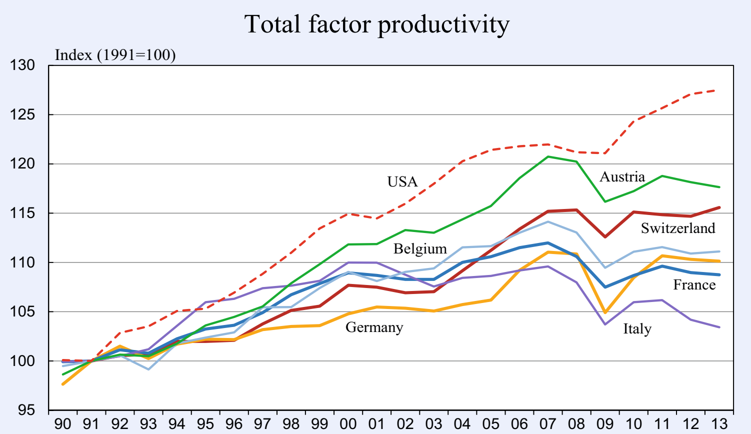
[2] See Swiss Federal Statistical Office, http://www.bfs.admin.ch/bfs/portal/de/index/news/publikationen.html?publicationID=5391.

Figure 2.1



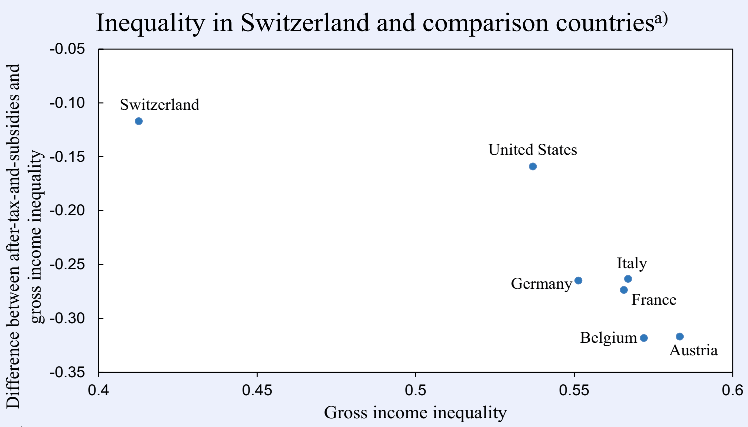
[a)] GDP is measured in PPP adjusted euros.
[b)] GDP is measured in PPP adjusted euros. Productivity is measured per hour worked.
Source: DG Ecfin / AMECO, Eurostat, last accessed 3 December 2013.

Figure 2.2



Source: DG Ecfin / AMECO, last accessed 3 December 2013.

Figure 2.3



[a)] Gini coefficients of household income per equivalent member in 2009; average of 2008 and 2009 data for United States
Source: OECD Income distribution and poverty database and EEAG calculations.

the Swiss Confederation's budget, which only amounts to some 10 percent of GDP, is spent on social welfare; about a quarter of the basic AHV pay-as-you-go pension scheme, and about half of the other IV disability insurance scheme, are funded by federal VAT and income tax revenues, rather than by contributions of current workers and employers. In addition, as shown in Figure 2.4, the incidence of mandatory private social schemes is very high in Switzerland (the highest in the OECD database at some 7 percent of income). These schemes bring its overall publicly provided or regulated social expenditure to a level comparable to those of its European neighbours, and much higher than in the United States where, as in the United Kingdom and also in the Netherlands, private voluntary social expenditure largely fills the gap to total social expenditure, which largely reflects variation in income levels and demographic factors. In Switzerland, government entities pay 21 percent of total health expenditure, and the mandatory health insurance system 35 percent; the rest is covered by other schemes, and roughly a third of the total is paid directly by private households and other direct private funds.

2.3 The Swiss exception in history and in Europe

The facts briefly reviewed above indicate that Switzerland is richer, more employed, and less dynamic than its European neighbours. In that group, its policies stand out in three related respects: Its institutional and political structures are relatively loose and decentralised, its taxes and public social expenditure are relatively low, but its military is centralised. We have also noted, however, that during the last 20 years the Swiss Confederation has introduced and refined important changes in those and other fields.

The starting point of that relatively recent evolution was a configuration that, while peculiar in modern Europe, was quite common in earlier times. Like the cantons' colourful coats of arms, in fact, the Swiss socio-economic landscape was until recently, and in some respects remains, similar to that which prevailed in medieval times, when the range of economic interactions was limited by institutions, as well as by technology.

A thousand years ago, the Holy Roman Empire provided a basic legal and cultural framework for trade, but the European economic system was far from free. Peasants were tied to their lord's land, and tariffs were charged whenever people or goods crossed a bridge or city wall. In what is now central Switzerland, the Zahringer and Kybourg feudal dynasties became extinct in the 13th century (unlike their Augsburg and Savoy neighbours that later expanded to the East and West to play important roles in European history). The Holy Roman emperor then granted a special status to the rural valleys around the Gotthard pass: Like Imperial Free Cities, some of which were also established in the area, they would be subordinate only to his central authority, and were populated by free men rather than by serfs tied by feudal obligations to the land and to a religious or lay local lord.

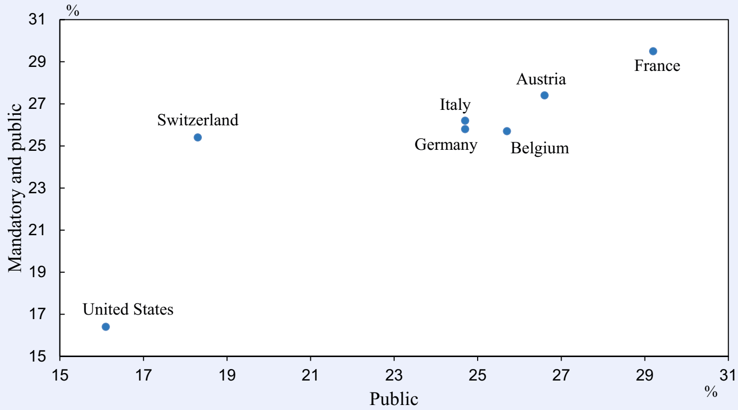
The first federation agreements across such entities were established sometime in the 13th century (1291, according to myth) between Uri, Schwyz and Unterwalden (later split into Obwalden and Nidwalden). A web of mutual support agreements later formed, with Lucerne in 1332, Zurich in 1351, Glarus and Zug in 1352, and Berne in 1353. A "Tagsatzung" central legislative and executive council had only very limited powers in this Old Confederacy of German-speaking free cities and rural communities that often fought each other. The Old Confederacy later expanded to include Fribourg and Solothurn in 1481, Basel and Schaffhausen in 1501, and Appenzell in 1513. Within it, economic activity was much freer than in the still medieval fiefdoms that surrounded it. While the rural areas provided mercenaries for European wars, city dwellers engaged in commerce and craft activities, heavily regulated by guilds, often dominated on a hereditary basis by successful families, and still subject to onerous taxes and tariffs.

2.3.1 Nation building (or not)

The events that progressively disrupted this socio-economic configuration of Europe are well known. On the cultural and political side, the authority of lay and religious sovereigns was challenged by increasingly widespread access to education and information. Even before the Enlightenment and the French revolution, the 1555 Peace of Augsburg established a "cuius region, eius religio" framework for the regulation of cultural diversity across areas of the Holy Roman Empire of the German Nation, as it was then called. The Peace of Westphalia established the principle that the rulers of each autonomous region, and the Emperor

Figure 2.4

Social expenditures[a)] in Switzerland and comparison countries



[a)] Old age, health, disability, unemployment subsidies of net national income, 2007.
Source: OECD Social Expenditure Database.

himself, should not interfere in the internal affairs of other regions. On the economic side, trade spread within and to some extent across the boundaries of these states, workers were freed of their ties to the countryside and specialised, and large-scale production could be organised in factories and cities. Between the seventeenth and nineteenth century, a process of nation formation and industrial revolutions swept Europe, and eventually reorganised its political and economic landscape around bureaucracies and constitutional democracies at the level of more or less well-defined national entities, along the borders of which trade was restricted and war, in the absence of imperial authority, was the normal way to resolve conflicts when diplomacy failed.

This process proceeded unevenly across Europe. Very small "pebble states" like San Marino, Monaco, the Channel Islands, Andorra, Liechtenstein, and Luxembourg have preserved their rather medieval character to this day; smaller states, such as Savoy and Bavaria, long served as buffers between increasingly militant European "powers". The Old Swiss Confederation briefly aspired to be a power in the decades around 1500, conquering large portions of Burgundy and Northern Italy. But the cantons did not unite against the French reaction to this move: Those that did not retreat were defeated in 1513, the Confederation pledged eternal neutrality, and Switzerland thereafter stayed on the sidelines of a nation-building phase of European history. The original cantons were content to rent mercenaries to European powers and to rule over the French, Italian, and German-speaking areas that remained under their joint control. Their landlord role there was similar to that of the English or Prussian landlords' domination of Irish or Slavic peasantry.

Nation-building interfered with such old-fashioned arrangements when the French invasion in 1798 and subsequent Austro-Russian attacks forced the cantons to tighten their ties. The Swiss all together negotiated Republican status with the French in 1803, and in 1815 the Council of Vienna implemented the Swiss sovereignty that had been recognised in 1648. It was at this stage that new cantons were formed (some French- and Italian-speaking, some German-speaking) and Switzerland reached its current configuration.[3] The new Confederation struggled for decades with the need to adopt a form of government that would, on the one hand, allow it to deal with its more modern nation-state neighbours, and reconcile its internal differences on the other.

The tension between progressive federalists and conservatives (who favoured the previous loose organisation of very independent cantons) was settled after the brief civil war of the cantons in 1848 by swift negotiation of a new constitution, closely patterned along the federalist lines of the United States of America, with a directorial rather than a presidential form of government. The Constitution established bottom-up commune-based citizenship, but endowed the Confederation with only very limited tax and regulatory powers, and did not aim at building national solidarity. It did transform the previous cantonal militias into a federal army, removing from the cantons the right to wage war with the very small military forces that remained under their control: The army draft, a powerful nation-building tool, remains to this day a key element of the Swiss socio-political infrastructure. It did not at all deploy the other main nation-building tool: To this day, as noted above, primary schooling is largely locally organised in Switzerland, and does not serve the identity-building purpose it has in traditional nations.

The year 1848 not only marks the beginning of modern Switzerland, but also a watershed for the spread, speed, and intensity of nation-building efforts in Europe. Unrest prodded France, Belgium, Germany, and Austria-Hungary to evolve towards constitutional and nationalistic governance, and the Savoy-ruled Kingdom of Sardinia to launch an Italian national project. Nations were glued together by military power, as well as by the cultural homogeneity generated by government-organised education, and by safety nets meant to prevent the social exclusion of and unrest in an urban working class that could no longer rely on village common properties and family networks for collective support. The employment-related old-age and sickness benefits introduced in unified Germany by Bismarck in the 1870s were largely motivated by the desire to build national cohesion and maintain internal peace (with obvious competitiveness implications. To control race-to-the-bottom tensions, Germany at the turn of the century tried, and failed, to achieve agreement with its trading partners on minimum welfare provision standards). The introduction and development of elaborate government redistribution systems and socio-political rights and obligation also required increasingly formal regulation of immi-

[3] Only the separation of Jura from Berne in 1979 altered it since then. The Vorarlberg region voted in 1919 by an 81 percent majority to join Switzerland, but this was opposed by Austria as well as by the winning side of World War I, and not supported by the Swiss government.

gration and citizenship, whether on the basis of ancestry, as until recently in Germany and Italy, and in Japan, or on the basis of birthplace and/or parents' residence, as in France and in the United States.

The nation-building phase of European history generated about two major wars per century, a source of technological and organisational progress, as well as of destruction, pain, and suffering. In other nations, organisational progress and industrialisation fostered economic growth and technological innovations. In Switzerland, by contrast, economic prosperity was achieved by managing to keep out of European wars after fierce initial battles with neighbouring regions. The Swiss mercenaries did fight for other countries until the 18th century, but since the formation of the new Federation they have not taken part in any European war. Of course, not every European country could have stayed out of the European wars that were triggered by national politics. Neutrality was natural for Switzerland, a country of German and French speakers who would have found it difficult to choose sides in wars that were fought by France and Germany against each other.

2.3.2 Interactions with Europe

Despite an inclination towards neutrality and a desire to shape its own society and future, Switzerland's fortunes were always deeply intertwined with European history and markets. The Swiss would clearly not be doing so well if their prosperity had to be based on opening and managing bank accounts for each other. They benefit from their freedom to formulate and implement independent policies within an integrated set of markets, and from their ability to exploit that opportunity, exerting regulatory and fiscal competition on larger, less homogeneous, and more inertial economies.

Both the Confederation's economic opportunities and its institutional structure were significantly influenced by its neighbours' revolutions and wars. For example, bank account secrecy was enforced by criminal (rather than just civil) law in 1934, primarily in reaction to France's prosecution of Swiss bank executives, and other efforts to prevent foreigners from opening Swiss bank accounts in order to evade taxes.[4] Surrounded by fascist dictatorships, Switzerland in the inter-war period built the self-image of a country that was no longer divided along ethnic and economic domination lines, and could be united and strong. A federal income tax was introduced in 1941 in would-be temporary support of the need to defend the country against the German-Austrian-Italian invasion that was carefully planned, but eventually not carried out, as well as against several mistaken bombing raids by American plane formations.

While Switzerland's geographical position made it easy for it to partake of Europe's economic progress, the Swiss economy long remained as medieval as possible for a country surrounded by nations where uniform legal and institutional frameworks made economic interactions possible beyond the circle of personal acquaintance and customary trust. Even although freedom of economic establishment was envisioned in the 1848 Constitution, and freedom of commerce in the 1874 Constitution, Switzerland has only much more recently begun to implement such principles, and to develop the welfare state safety nets and insurance schemes that make labour mobility possible within nations and beyond the boundaries of village-based socio-economic relationships.

Switzerland largely skipped the nation-building phase of European history, and the many associated wars, revolutions, hyperinflation, and excessive fluctuations resulting in social and political crisis episodes. Not surprisingly, it (and all the small "pebble states" other than Luxembourg) also remained on the sidelines of the European integration process that, in the wake of World War II, began to use market unification as a vehicle of cultural convergence, with the ultimate aim of preventing further wars. The many peculiarities of Switzerland's society and economy that originate in its non-national character make it feel that it can provide "growth, stability, and cohesion" independently, and lead it to remain separate within Europe not only politically, but also by economic barriers. A 1992 referendum narrowly rejected Swiss membership in the European Economic Area at the Confederation level (but the polls were in favour of it in all non-German cantons).

This left Switzerland free to selectively adopt European Union rules and regulation ("autonomer Nachvollzug"). The evolution of Swiss institutions has since been influenced strongly by this process. The Swiss Single Internal Market Act was only introduced in 1996, when Switzerland adopted the product market specifications harmonised in 1992 across the boundaries of all the

[4] To improve Switzerland's self-esteem and foreign image (and appease the sizable domestic minority that does not like to shelter foreign tax evaders) it was later emphasised that tightening of bank secrecy in the 1930s was chiefly meant to help German Jews to shelter their assets from the Nazi regime, also a reaction to another type of neighbouring-nation policy.

European Union countries that had long since removed technical barriers to trade. The act was revised in 2004 and, like its European Union supranational counterpart, does not do much to unify services markets, which remain strongly segmented within Switzerland. And just as the European Court of Justice plays a key role in the implementation of the Single Market within the European Union, in Switzerland the principles laid out in the 2004 revision of the Internal Market Act make it possible for its courts to enforce the freedom of services provision that canton-level regulation has been restricting despite constitutional provisions. Since Switzerland adopted European product specifications unilaterally, it was impossible for its own requirements to be taken into account by single market rules (for example, electric appliances sold in the European Union may be equipped with any of the plugs that fit one of the many sockets installed in the member countries, but not with the peculiar offset ground socket used in Switzerland). It still maintains some explicit trade barriers (most notably in food and agricultural products). Labour mobility between Switzerland and the European Union, while hampered (as is, after all, the case within the European Union) by the poor harmonisation of social and labour policies, was harmonised with the rules that apply within the European Union by the Agreement on the Free Movement of Persons that came into force on 1 June 2002, and was subsequently reaffirmed by plebiscite in 2009. These bilateral agreements are less permanent than European treaties: In mid-2013 the Federal Council invoked a safeguard clause of the Agreement, not only to extend existing limits to labour mobility from new European Union member countries, but also to establish annual quotas for the long-term employment of all European Union citizens. A referendum in February 2014, aimed at "regaining control of immigration into Switzerland," adds to pressure against the bilateral labour mobility agreement with the European Union.

2.4 Crises

During the crises regularly generated by capitalist development, markets show their limitations and the extent and character of collective policies play an even more crucial role than in normal times. A shrinking pie can make it difficult for societies to remain cohesive, but facing a common problem may foster solidarity and ease coordination.

During the 1930s Great Depression, in an increasingly tense geo-political situation, Switzerland generated a new consensus around a kind of national solidarity. At present the deep connections between Switzerland and Europe imply that its problems are much more similar to those of its neighbours than may be expected. Its welfare state, while much less pervasive than that of traditional continental European nations, faces serious sustainability problems. The actuarial present value of Swiss pension plan liabilities often far exceeds that of their assets, as is also the case for the partially funded plans that should pay the pensions of cantonal civil servants, and will only be able to do so as a result of pension cuts and additional public capital injections (such reforms are underway in Berne and some other cantons). Since the 2009 crisis, the unemployment rate has been hovering around an average of 4.3 percent, and the federal ALV unemployment insurance fund has an accumulated deficit of some 5 billion Swiss francs.[5]

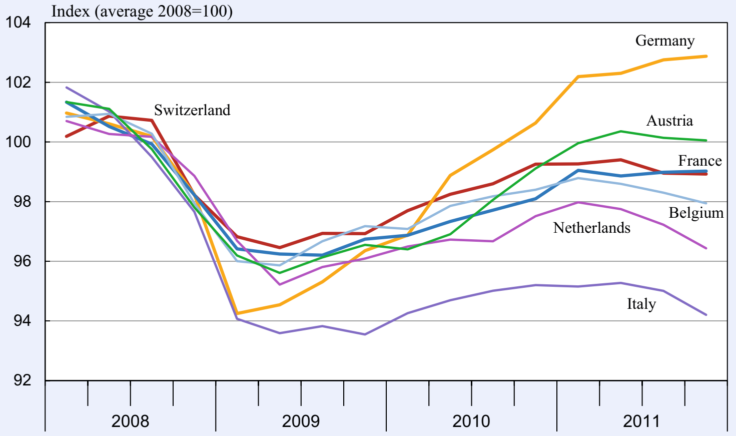
Switzerland's experience of the macroeconomic crisis that began in 2009 has been milder, but quite comparable to that of the euro area countries that surround it. Figure 2.5 shows that, in terms of real per capita income, the initial negative shock was shallower in Switzerland than in most of its neighbouring countries; consistently with Swiss stability, the subsequent rise was also much less dynamic than in Germany or Austria. The Swiss experience was comparable to that of Belgium or France in per capita terms, but better in total terms because population growth was faster in Switzerland during this period. The crisis was also not uniform across all regions of Switzerland. As Figure 2.6 shows, the experiences of the seven NUTS-2 macro regions of the Confederation were heterogeneous in the course of a crisis that, as was the case within and across other countries, featured particularly sharp declines and relatively quick recoveries in the manufacturing sector. Local economies where services or construction are more important sources of income tended to experience more persistent crises than those with a stronger manufacturing presence. Overall, the crisis experience was not significantly different, across regions of Switzerland and neighbouring euro area countries.[6] And like the crisis problems, the policies put in place to

[5] The portion of salaries over 126,000 Swiss francs is not included in the benefit replacement rate, but it has been subject to a 1 percent solidarity tax up to a ceiling of 315,000 Swiss francs since 2011, and will be taxed above this ceiling as of 2014.

[6] Across the six euro area countries shown in Figure 2.5, the population-weighted standard deviation of per capita annual real income growth rates was 1.0 percent in 2009, and 1.4 percent in both 2010 and 2011; all country-specific growth rates differed from the population-weighted average by less than 1.9 standard deviations. Across the regions of Switzerland shown in Figure 2.6, the population-weighted standard deviations were 0.5 percent, 1.8 percent, and 0.7 percent in the same years. The only statistically significant different growth rate was the Lake Geneva region's relatively shallow decline in 2009.

Figure 2.5

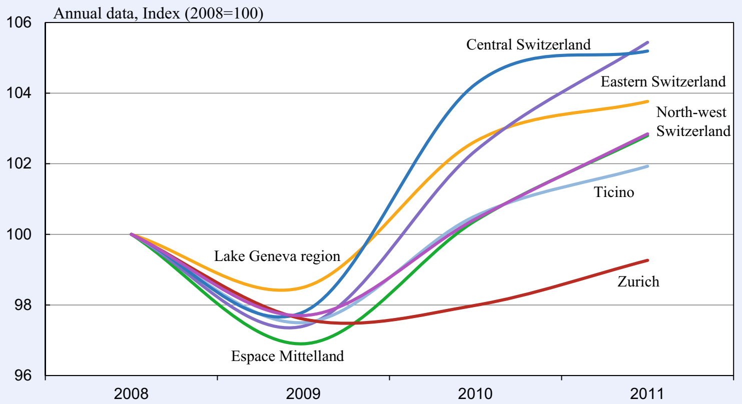
The crisis in Switzerland and neighbouring countries[a)]



[a)] Per capita real GDP in chain-linked local currency prices.
Source: Eurostat, last accessed 26 November 2013.

Figure 2.6

The crisis in macro regions of Switzerland [a)]



[a)] Real GDP per capita fall and recovery.
Source: Swiss Federal Statistical Office of the Confederation.

address them were interestingly similar, but different in Switzerland, as we discuss below.

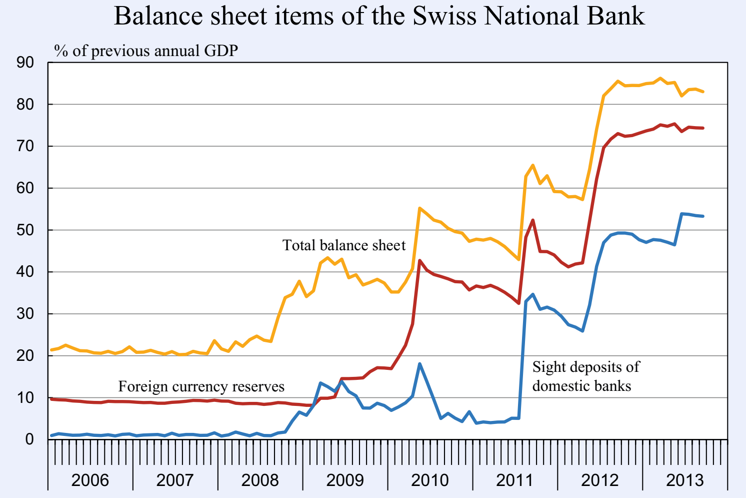
2.4.1 Finance and money

The systemic importance of Swiss banks goes far beyond the Confederation borders. The SNB and the government controversially organised a bailout of one of the two large Swiss banks, UBS. The operation was successful and ex-post profitable, but certainly very risky: It was possible for UBS to raise some equity (from a foreign sovereign fund) only because its woes narrowly predated Lehman's bankruptcy, and the deepest phase of the financial crisis. Swiss policymakers have since aimed to reduce the riskiness of the country's banking system, aiming to protect its financial infrastructure from investment banking and trading operations, and requiring larger capital. Hosting two "too big to fail" banks is dangerous for Switzerland, and the traditionalist component of Swiss public opinion does not like or trust big financial institutions and other international big business. But it clearly offers economic opportunity for at least some of the Swiss population, even though insurance, pharmaceuticals, and mid-size manufacturing are actually more important for the Swiss economy than banking.

In the crisis, the SNB chose to defend a minimum exchange rate of 1.20 Swiss francs to the euro for the same reasons that led its neighbours to adopt and maintain a single currency. Expectations of appreciation alter the exchange rate in ways that threaten money's role in denominating transactions. By accommodating portfolio shifts, and carrying risks that the public wants to avoid, monetary authorities can continue to provide the safe and liquid transaction services that make it possible for a monetary economy to function.

As a Swiss franc denomination became more attractive, preventing appreciation required the accommodation of an extremely large portfolio shift. By the end of 2012, the SNB had the fifth largest foreign currency reserves in the world, amounting to around 75 percent of the country's annual GDP. As Figure 2.7 shows, the counterpart of this was a large increase in the Swiss monetary base in the form of central bank deposits. In the euro crisis phase of the Great Recession, exchange rate management preserved the Swiss economy's ability to trade with its neighbours, preventing large income declines in the more export-oriented Swiss regions, and actually intensified its European links. The accumulation of large euro-denominated reserves at the SNB implies Swiss ownership of a significant share of European debt. This does not entitle Switzerland to any right of control over euro area and country policies, but makes it as important for Switzerland as for euro area members to look for constructive solutions to debt problems.

Figure 2.7



Source: SNB, SECO, last accessed on 26 November 2013.

pays interest (at the European Central Bank's main refinancing rate), they are riskless within a well-functioning euro system. They are more controversial than Swiss reserves, however, because the collateral requirements for central bank refinancing were reduced below investment grade in the crisis countries, and positive TARGET2 balances would constitute a legally dubious claim if the single currency were to collapse. The Swiss reserves are instead held in marketable assets with clear legal validity, yet exposed to redenomination and other euro crisis risks. In fact, when the crisis calmed down and the interventions were stopped, the SNB reported a profit of about 6 billion Swiss francs in 2012, 4.5 billion Swiss francs of which was due to a rise in the value of its foreign exchange reserves.

Almost half of the SNB's foreign exchange reserves are denominated in euro. Debt restructuring is unlikely to be a major issue, because about 70 percent of its total bond holdings are AAA-rated, but an increase in long-term interest rates would reduce the market value of those bonds. The SNB's portfolio preferences triggers declines in the market value of peripheral assets and in the interest yield of core bonds, and its attempts to diversify the risk of its euro holdings tends to put pressure on the euro exchange rate with such currencies like the Swedish krona and the Australian dollar. Use of a common currency makes it easier to trade, but also more difficult to adjust to shocks hitting regions, households, or firms within a country, or countries within a currency union. While the disadvantages of a common currency have become apparent in the debt crisis, the SNB's willingness to prevent revaluation and take on large and risky foreign exchange reserves (and the volatility caused on the fringes of the euro area and beyond by its attempts to manage the resulting risk) may cast a better light on the advantages of a single currency system.

Within the European System of Central Banks, a role that is similar to that of the SNB's foreign exchange asset purchases (meant to prevent a revaluation of the Swiss franc in the face of portfolio shifts) is played by the TARGET2 payment system balances (see Sinn and Wollmershaeuser, 2012; EEAG, 2013; Cour-Thimann, 2013; for an explicit comparison between the TARGET2 balances and the Swiss reserves, see Sinn 2012 and 2014). Relative to GDP, the TARGET2 balances are larger than the Swiss reserves for Luxembourg (255 percent by the end of 2012), but smaller for Germany (25 percent). As collateralised credit that

2.4.2 Fiscal policy

A small open economy is limited in the range of policies its government may adopt. It would be ill-advised for a small country to implement a public stimulus to support export-oriented industries. In the 1970s, Switzerland was severely affected by a worsening of the global economic climate, and the crisis was amplified by a very restrictive immigration policy, which caused a reduction in the population: In 1977 the population was 2.2 percent lower than in 1974, and this reduced domestic demand substantially. Among other woes, the Swiss watch making industry initially missed the move to quartz watches. Recovery from the crisis wan not brought about by fiscal policy, but by innovation and trade. A revival of the watch making industry came with the introduction of cheap, but elegant plastic Swatches, and Swiss tool makers and other industries regained strength when the world economy and neighbouring Germany recovered in the second half of the decade.

The Swiss are weathering the current crisis well because they recognised that a fiscal stimulus would again be ineffective in an export-driven crisis and adopted a "Schuldenbremse", a debt brake that limits its spending growth to average revenue increases over a multiyear period, based on forecast revenues, and correcting for business cycle conditions. Some infrastructure investment, financed through a special fund, as well as public transportation, is outside the structure of the debt brake; so is the social insurance system, although there are many voices calling for an equivalent control mechanism. However, the exceptions are clearly defined, and this ensures that the fiscal constraint is more binding than would be implied by generic "golden rules" excepting investment, a spending category that under political pressure can be reconfigured to include almost anything (education is investment in children and thus in the future of the country, military spending is investment in security, cultural spending is investment in cultural capital etc.).

The debt brake was devised as a response to the experience of the 1990s, when in the wake of a property bubble bursting and a substantial economic slowdown, the federal debt expanded from 12 percent of GDP in 1990 to 26 percent in 1998 (when because of the parallel expansion of cantonal debt, the total public debt was at 56 percent of GDP). In the wake of the introduction of the debt brake in 2003, after a referendum in 2001 where almost 85 percent of the voters supported the measure, the federal budget showed considerable surpluses, and continued in surplus through the post-2007 financial crisis. As a consequence, the debt share is likely to fall to below 30 percent of GDP by 2016.

The Swiss introduction of a debt brake addresses problems that are common to many other countries. It came at a propitious moment, when strong global expansion allowed a substantial economic growth that generated fiscal surpluses, and when the budgetary cuts that were needed as part of the original reform impetus did not look so painful. The Swiss term for this type of fiscal control, "Schuldenbremse" or debt brake, became an internationally accepted concept, and Germany pushed successfully for it to play a central role in formulating the European Union's response to its own fiscal crisis. Underlying the concept is a belief that high rates of debt are likely to impose costs that lower economic capacity and growth, although it has been notoriously difficult to establish a particular limit at which debt becomes dangerous, since the extent of danger depends directly on prevailing interest rates and growth rates, but also on less tangible factors such as the degree of confidence in state capacity. One of the effects of a debt brake, however, is to raise the degree of knowledge about the likely fiscal path, so that the market's perception of state capacity increases.

What makes the Swiss approach conspicuously successful in this more general context is the high degree of democratic legitimacy. Switzerland's adoption of the public borrowing limits in 2001 by a referendum majority of 85 percent compares well with the less democratic and much less effective implementation of its European Union neighbours' "Stability and Growth" and "Euro Plus" pacts, and is arguably more credible and permanent than even the balanced-budget constitutional rules that member countries have to adopt. Like the overwhelming rejection of a proposal to guarantee six weeks of annual paid holidays, the success of the debt brake proposal shows that pragmatic Swiss voters recognise economic constraints more clearly than those who, in other countries, are only too often attracted to myopic and populist policies.

Another way in which Switzerland can provide useful lessons for Europe is in its handling of local public debt. About one third of the general government debt is a liability of sub-federal entities, and all except five cantons also have debt brakes (the first measure, in St. Gallen, was introduced in 1929). The 2003 debt-brake law, moreover, sets tight quantitative limits on the ability of cantons to transfer fiscal liabilities to the federation. The fiscal responsibility of sub-federal government levels had previously been made clear when the cantons of Berne, Solothurn, Geneva, Waadt, Appenzell Ausserrhoden, and Glarus were left alone as their cantonal banks had problems in the 1990s. The formal bankruptcy of a small and profligate commune, Leukerbad, in 1998 (Blankart, 2013) eventually clarified beyond doubt that Switzerland's fiscal federalism excludes debt mutualisation. This, in turn, has a strong disciplinary effect. Swiss cantons and communes keep their debt under control because they cannot be expected to be bailed out. Their own debt-brake rules are meant to signal to financial markets that they are fiscally responsible, and financial market interest spreads between the cantons, based on rating differences, ensure fiscal restraint and prevent excessive debt accumulation. Similar arrangements are in place in the United States (see EEAG, 2013), but in the euro area, even though envisioned by Article 125 TFEU, the no-bail-out principle has – depending upon interpretation – been set aside or its implementation remains unclear and untested.

2.4.3 Tax competition

Like Luxembourg within the European Union and the small pebble states that pepper Europe (and like Delaware in the United States and such global tax havens as Bermuda or the Virgin Islands), Switzerland exerts tax competition pressure on neighbouring countries. This is superficially motivated by historical and cultural differences, and tolerated by national powers, possibly because the super-rich do not easily accept Leviathan state powers. The crisis is making a difference: As the usefulness of government powers becomes more apparent, tax havens are under attack. In 2013, the European Commission began a process of renegotiating its tax treaties with Switzerland, as well as with Andorra, Liechtenstein, Monaco, San Marino, and introducing a Directive that will extend the banking information exchange now applicable to savings to all income sources.

Such tensions are clearly on the mind of Swiss public opinion and policymakers. The Swiss movie "Der grosse Kanton" depicts an intriguing solution to tax and other tensions with Germany: The Federal Republic joins the Confederation as a twenty-seventh canton, causing concern among the Swiss because of its large public debt, as well as of its sheer size and somewhat different approach to social organisation. The Swiss Army's summer 2013 exercises considered a different scenario: Its first armoured brigade was tasked to deal with a multi-pronged invasion, aimed at the wealth of Western Switzerland's bank vaults, by the "Sâone" splinter of a French nation destroyed by unsustainable public debt and the collapse of the euro. Questioned by the Geneva newspaper "Le Matin", the unit's commander emphasised that the military do need to train "in a realistic environment" and that the exercise had been planned in 2012 when fiscal relationships were "less tense" between France and Switzerland. He offered no information as to whether the simulated invasion was successfully repelled in the exercise.

Not only concerns about less than peaceful international relations, but also considerations of fairness are making tax competition increasingly less acceptable to the Swiss themselves. Following Zurich's example in 2009, several (German-speaking) cantons have abolished by plebiscite the forfeit expenditure tax regime, which allowed foreigners with no Swiss labour income and high taxable income from abroad to be taxed only on an estimate of their expenditure on Swiss soil, and therefore to pay much lower taxes than Swiss citizens in the same situation. Those cantons' voters accepted the budgetary implications of removing such an aggressive tap into foreign tax bases. While similar plebiscites did fail in other (also German-speaking) cantons, Switzerland is slowly but clearly outgrowing tax competition. A federal plebiscite is pending on the forfeit expenditure tax regime, and in October 2013 the Swiss Confederation's government decided to join the OECD/Council of Europe multilateral convention on administrative assistance in tax matters, opening up the Swiss bank accounts of foreign taxpayers to international information requests.

2.5 Lessons for the future of Europe

Switzerland is only slowly completing its internal market, accepts tax and local public good competition across its cantons and communes, and maintains many barriers to international economic integration at the same time as it takes advantage of external tax-competition opportunities. In these and other ways it differs from its neighbours, which have developed other mixes of administration, authority, and social pressure to address the balance of moral hazard and reciprocal trust that was and remains difficult and fruitful for individuals in families, and for families in local communities. Just as Switzerland is becoming more European in these respects, so Europe may find it useful to become more Swiss in other respects.

2.5.1 Culture matters

It is certainly far from surprising to find that language and culture significantly influence economic interactions within Switzerland. More generally, in Europe and elsewhere, language (and television, cellular networks, and other media) certainly shape economic boundaries even more forcefully than voting rights and tax obligations. But culture is not everything. Just as heterogeneity does not prevent individual interactions (and, in fact, makes them more interesting), so cultural differences do not prevent economic and policy interactions across communities (and arguably make them more productive). Conflicts of economic interest are a more likely source of disagreement across regional entities than ethnic differences, and very common not only across, but also within nations, and not only between ethnic groups, but also within families. Cooperation is fortunately also very common, and is based on mutually beneficial market exchanges, as well as on the enforcement of more or less democratically agreed behavioural constraints. In a well-organised society, taste and productivity differences are magnified by specialisation and generate economic gains from well-regulated trade, and cultural differences are smoothed out to make communication and cooperation possible. Organising trade and enforcing rules requires the efficient communication of individual resources and needs, and need to be based on a clear framework of mutual understanding and trust. All of this can be achieved by different societies in different ways that evolve over time, and continue to exert an influence, even after they have long ceased to be superficially visible.

The Swiss solution to such problems and its evolution over time suggests that cooperation and trade across culturally different societies is possible and fruitful, but neither easy nor riskless. Like many Swiss things, the Konkordanzdemokratie is actually a product of the country's history and cultural heterogeneity. It was introduced after the civil war, when the (protestant) merchant bourgeoisie defeated more conservative (and catholic) corporatist cantons. The Confederation had to manage the peaceful coexistence of cultures ranging from the Germanic, Catholic, rural, and conservative culture of the original cantons, to the Protestant, Romanic, and enlightened culture of Geneva, which had fought both the Savoy and the Germanic cantons to remain independent until Napoleonic times.

The United States were also initially socially and economically diverse enough to engage in civil war in the 1860s and have largely retained this heterogeneity. Their history offers not only a model for Europe's need to unify its economy and harmonise policies, but also represents a cautionary tale as regards the difficulty of doing so. While Alexander Hamilton's famous negotiation in 1790 of an assumption of state debts by the federal government is often cited as a model for how a United States of Europe might be created, the actual developments of that historical move are less than appealing (EEAG, 2013, offers a detailed review of experiences with state debt in the United States). The individual states went on a borrowing binge in the late 1830s, which was followed by widespread default in the early 1840s. The revenue stream that was used to service the federal debt – the external tariff – was a necessary part of the Hamilton scheme, and stirred the economic (and not only cultural) tensions between the American North and the South that ultimately caused the War of Secession.

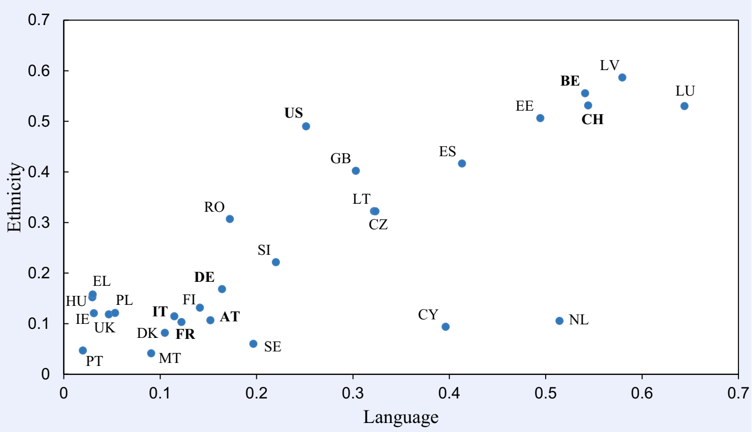
2.5.2 Dealing with diversity

Nations traditionally aim at homogenising diversity, but every society needs to manage unavoidable heterogeneity across ethnicities, families, and indeed individuals. Experiences other than the Swiss and American ones can provide equally useful insights, and deserve to be at least briefly reviewed. Switzerland is very special, but similar to other European countries in key respects. Like San Marino, Monaco, and other small countries, Switzerland has been embedded for a few centuries in a Europe that was becoming increasingly nationalistic. Like Belgium, but unlike most of the countries generated by that process, it is rather less than fully homogeneous in terms of language, religion, and culture. Figure 2.8 reports fractionalisation indices for all EU27 countries with available data, for the United States, and for Switzerland. While Switzerland does stand out in terms of overall diversity, two smaller countries are even more diverse in some respects, and Belgium is not far behind.

Linguistic minorities are present and recognised in most European countries, and culture does vary very significantly even within countries where a unified lan-

Figure 2.8

Heterogeneity within Switzerland and comparison countries



Source: Alesina et al., 2003.

guage replaces, or coexists with, local dialects.[7] Some European countries were put together through royal marriages, but most were drawn together by war – Bismarck's "blood and steel" – and Switzerland is no exception to this rule, although the 1848 War of the cantons was brief and not very violent. However, durable cooperation cannot be ensured by force and redistribution: it requires the permanent conviction of citizens of all regions to participate in a mutually beneficial deal. Public policies and institutions need to seek cooperative solutions to common problems, and to produce durable compromises cemented by the self-enforcing realisation that breaking agreements in pursuit of immediate gains would entail larger losses.

Cultural diversity has economic and policy implications. In Switzerland, it may lead Romanic speakers to enjoy spells of subsidised unemployment that are some seven weeks longer than those of their Germanic neighbours, but it does not lead the Swiss social insurance system to envision language-specific entitlements. National policies also have vastly different implications across regions in countries as diverse as Italy, Germany, and Spain, but uneasy compromises between homogeneity and diversity are the price of common market and national solidarity. Nation states traditionally root the cooperation and solidarity they need in processes of cultural assimilation, market integration, and internal migration. In Switzerland, a different sort of cooperation is rooted in the Konkordanz principle of mutually beneficial political trade and compromise between heterogeneous special interests with decentralised decision powers. The fundamental working principle for pragmatic compromises is a well-established system of subsidiarity, with decisions being left to the smallest suitable territorial units in cases where compromises would be too difficult to craft.

2.5.3 What about Belgium?

The comparison between Switzerland and Belgium is interesting not only because both countries include multiple ethnicities and main languages (and in Figure 2.8 they are close to each other and very far from Switzerland's neighbours), but also because they have similar values and lifestyles. Individual excellence tends to be viewed as domination and perceived negatively in Switzerland (de Rougemont, 1965) as well as in Belgium: more troublesome neighbour countries do boast many more internationally visible heroes, criminals, inventors, scientists, and artists.[8]

For our purpose of drawing lessons for Europe, differences across the two countries are more important than their similarities. Belgium's economic performance is more than respectable, as shown in Section 2.2, and quite comparable to Switzerland's. But its diversity-management performance is worse than Switzerland's: Francophones and Flemish speakers are increasingly disconnected in Belgium, where electoral results and political structures became so fragmented at one point as to make it impossible and apparently unnecessary to form a government for a time.

It is therefore interesting to try and relate Belgium's and Switzerland's different regional and ethnic cohesion to differences between the countries' structures and histories. Some institutional features may be relevant. The central government plays a more important role in Belgium than in Switzerland, and this makes it harder to formulate policies when interests conflict across economic and cultural lines. In Belgium, many decisions have to be made or ratified by a plurality of government levels, because the structure of subsidiary powers is not as clear as it is in Switzerland. A broad majority of the international treaties signed by Belgium touches on both regional and federal competences. Ratification of such "mixed treaties" involves a large number of legislative bodies, each of which has veto power. While in Switzerland only cantons mediate between local communities and the centre, in Belgium there is an additional level of government: three regions (one French-speaking, one Flemish-speaking, with 5 provinces each; and Brussels, which is officially bilingual). And while Switzerland has several bilingual (and one trilingual) cantons, within which stable language borders exist, only one language is used in most of Belgium's sub-federal entities. This may have made it less necessary to confront and resolve cultural issues, and Brussel's residents (who speak and think in French) disrupt traditional language borders when they relocate to Flemish-speaking suburban areas.

[7] Within the Federal Republic of Germany, the historical pattern of Protestant expansion exerts a significant influence not only on current religious beliefs, but also on more general cultural and economic differences, arguably reflecting Protestant encouragement of reading and personal learning (Becker and Woessmann, 2009); and traces of the Roman Empire's border are still visible at the so-called "Weisswurst-äquator" cultural boundary which, while much less well defined, is somewhat similar to Switzerland's "Röstigraben". Regional heterogeneity within each European country can more generally be traced back to the socio-economic conditions prevailing in pre-national states (Tabellini, 2010).

[8] Both countries have, of course, contributed very significantly to European culture. Famous Swiss artists include Paul Klee and Alberto Giacometti (the famous architect known as Le Corbusier, born in Switzerland, chose to become French), while Belgium's recent contributions include Jacques Brel and many prominent comic-strip authors.

As for historical factors, there is no equivalent to Switzerland's Wilhelm Tell in Belgian folklore. The country was not brought together by home-grown opposition to external power, but created as a buffer state by external powers after the Napoleonic wars. That new state's historical roots (in the ancient Kingdom of Burgundy, which at times also included part of what is now French-speaking Switzerland) were too loose to excite nationalist independence feelings, but Belgium's position among the powers did bring it to build a colonial empire (albeit on the initiative and as personal property of its king), and did not allow it to stay out of European wars. By contrast, Switzerland's internal cultural diversity naturally prevented international projection in the form of colonisation (hampered by lack of direct access to sea) or wars of aggression. The country's cohesion was cemented by successful neutrality-oriented organisation of military defence against clear and present external threats (de Rougemont, 1965).

The most important factor in Belgium's poor diversity management, however, is arguably the interaction between historical heritages and regional economic development patterns. Like those of Switzerland, Belgium's regions and peoples were economically as well as culturally heterogeneous, and briefly fought each other in the nineteenth century. In Switzerland, the militarily and economically dominant component was Germanic; in Belgium, it was Francophone: In the recent past, globalisation has had very different implications for the regional specialisations that happened in Belgium to coincide with cultural boundaries. While the French-speaking regions suffered the demise of European heavy industry and mining, the Flemish-speaking regions could take advantage of the trade and high-tech opportunities afforded by access to oceanic routes and by a more flexible mercantile culture. The Belgian experience of economic takeover by a previously dominated group has no parallel in the history of Switzerland, where the Germanic element exercised Konkordanz rather than centralised dominance, and did not experience the relative economic decline that raises issues of socio-political as well as cultural cohesion in Belgium.

2.5.4 And what about Europe?

Geography and history play a crucial role in shaping the economic destiny of people and regions not only in Belgium or Switzerland, but in all of Europe. Social capital, culture, reforms, and hard work may certainly explain why some become or remain rich, while others stagnate or decline. The wealth of regions, however, also depends on luck, and on shifting patterns of trade. Control of the Gotthard and other crucial mountain passes was a key determinant of the Holy Roman Emperor's decision to free the original Swiss cantons; Nuremberg and Samarkand were privileged crossroad markets until trade began to cross the Atlantic; and Bavaria, Tyrol, Veneto were transformed from peripheral battlefields into prime production and trade locations by the process that, since World War II, has been removing the economic boundaries of European Nations.

Homogeneous national identities were the political and social element of the commercial and industrial revolutions that made Europe rich, but unstable, and prone to wars. To achieve its currently elusive "growth, stability, and cohesion" objectives, the European Union project aims to dissolve them into a new type of socio-economic framework.[9] A common set of policies and institutions, however, is not easy to craft for a culturally heterogeneous society. Trust and cohesion cannot rely on traditional nationalistic feelings at the European level, and are even strained by economic woes and market failures within countries, often along ethnic and nationalistic lines as in the United Kingdom and Spain.

In Switzerland, cultural heterogeneity is widespread and multi-dimensional. Borders across languages, religions, and traditional versus progressive cultures overlap far from perfectly. They do not separate the homogeneous sets of humanity that national states would like to be. In Switzerland, each individual belongs to several of a multitude of communities. This makes it natural for power to be dispersed, and for decisions to be collegially shared. The resulting "Konkordanzdemokratie" is more conducive to conservative compromises than to the sweeping reforms that may be possible for the majoritarian decision-making processes of national political systems. The stability fostered by consensus-based democracy may support long-term investments and process innovation, but can reduce productivity growth in cases where drastic frontier innovations are necessary. Like other tradi-

[9] The transition from national to inter- or supra-national economic and policy relations effectively presents the same challenges and opportunities as that from the feudal to national level, extensively discussed by Adam Smith in Chapter IX of the Wealth of Nations (Bertola, 2007). Many of the same issues are now arising for China's "hukou" system of local citizenship rights and obligations, which is hardly compatible with an urban-industrial socio-economic organisation.

tional Swiss features, the Konkordanz style of politics is becoming less relevant as parties at the margins of the political spectrum gain political weight in Switzerland. At the same time, multiple cultural identities have become common in other countries (and it may not be a coincidence that "grand coalition" governments have been formed recently not only in Austria, where they have been nearly as common as in Switzerland, but also in Germany and in Italy).

Political developments are shaped by the evolution of communication and media technologies. While television and newspapers are still largely national in Europe, face-to-face interactions can only work at much lower levels and are so crucial as to perhaps justify Tip O'Neill's view that "all politics is local" and Montesquieu's view that democracy can only work on a small geographical scale as expressed in his Spirit of the Laws. But in a modern economy, where long-range trade exploits specialisation opportunities and economies of scale trade, and public redistribution policies replace family or village solidarity, the conflicts of interest that need to be addressed by political compromises arise along dimensions that are not geographically or ethnically local. Belonging to the same age group or the same occupation is often a more powerful source of common interests (as student revolts and labour unrest powerfully showed around 1970) than belonging to the same family, or coming from the same small village. Technological progress reduces cultural as well as physical distances:[10] Internet-based media and social networks are not constrained by geographical or political boundaries, and electronic translation may blur cultural boundaries even across the uneducated. As compromises between the economic advantages and policy disadvantages of diversity can no longer rely, as they did in the past, on the coincidence of national geographical, cultural, and political boundaries, the constant communication and monitoring needed to build democratic consensus might become possible on a larger scale than that of the Swiss communes or of the Swiss Confederation, and may even become possible on the European Union's continental scale.

The current configuration of the European Union features some, but by no means all of the key ingredients of a traditional state. It has a bureaucracy and some common rules, but no central decision-making power, no common army or foreign policy, and no political sense of common purpose. While the currently malfunctioning combination of international political compromises and supranational bureaucratic administration needs to be improved, it does not seem possible to replicate the dirigiste political model of nation states at the European level, with infrequent majority votes and the delegation of decision powers. Unfortunately, supranational politics do not appear to be the automatic consequence of economic integration that the founding fathers of the European Union hoped for. In Europe, there is an educated elite that feels comfortable in many countries, but a large majority of each country's citizens feels that migration would only offer access to low-paid jobs in other countries, and justifiably fears that, in the absence of a European harmonisation of social and labour market policies, economic integration undermines their own country's familiar safety nets. To foster trust in a supranational European socio-economic framework, it might be advisable to organise a mass version of the year-abroad experience that the Erasmus student exchange program currently offers rich university students: Young Europeans of all social groups should be enticed or obliged to work for some period in another country and using another language, as proposed by the writer Umberto Eco in 2012. A "European social year" for young people might help to build a common identity across the borders of nations where military service served a similar purpose.

It is hard, however, to envision development of a European identity so well-defined as to support supranational political decision processes. This difficulty is made evident not only by the failure of past French and German attempts to engineer continent-wide versions of their own nations' conquest-based origins, but also by the very mixed success of the European Union elites' top-down approach to supranational policy-making, which has proved unable to tackle the most politically important social and fiscal aspects of policy. The exercise of top-down decision powers has limited the democratic legitimacy of the European Union integration process, as shown by rejection of constitutional referenda and by the steady decline of European Parliament electoral turnout. Moreover, the idea that such issues as pension scheme generosity and bank supervision could be left to national subsidiarity was always theoretically dubious, and has been shattered by a crisis that clearly showed that such important matters cannot be left to uncoordinated national policies.

[10] The travel time from Geneva or Grisons to Berne in 1848, when the Swiss Confederation was established in 9 months, was measured in days (De Rougemont, 1965), and was much greater than air travel today from Stockholm or Athens to Brussels.

Montesquieu thought that empires were the better way to organise larger units. For economic governance of economically and culturally heterogeneous areas, a structure in some ways similar to that of the ancient Holy Roman Empire, or of China, might indeed be a better model than the federal national structure of the United States or Germany. The European integration process should replace the opacity of deals between national political leaders with pragmatic, explicit, and accountable compromises between socio-economic conflicts of interests that do not necessarily occur across national boundaries. It should accept the limitations that this approach implies for the scope and character of common policies and institutions, but also focus on the policy dimensions that do need to be harmonised. As in Switzerland, pragmatic policy action is also needed in Europe and is crucial to the management of a common currency and an integrated financial and fiscal system, as well as of common external positions. Unification of the European product market logically requires a single European voice at the World Trade Organization, but external unity is lacking in many other respects.[11] The slow and cumbersome organisation of the European External Action Service, headed since 2011 by the High Representative of the Union for Foreign Affairs and Security Policy, contrasts sharply with the quick and divergent reactions from the member countries' diplomatic services and foreign ministers to emerging crises like the current situation in Syria. The same security threats that in the past helped to build Swiss national identity cannot, unfortunately, be ruled out for Europe. As the United States retreats from the Middle East in the wake of its shale gas bonanza, Europe may need to develop a truly common foreign policy and military power that could, as in Switzerland, come to be seen as a necessary means for preserving peace. Although certainly unfortunate in other respects, armed neutrality may prove as helpful as it was in Swiss history in terms of fostering a European identity.

2.6 Conclusion

At the same time as the Swiss Confederation implements some institutional features of the European socio-economic system, the European Union may find it possible and useful to implement some Swiss institutional features that are looser and less centralised than in traditional nation states, but pragmatically focused on the administrative, legal, monetary, and fiscal instruments that support market relationships, and held together by shared external concerns. Imitation and learning, of course, are not the same as copying. Solutions need to be adapted to the problems that are evolving and to some extent converging in Switzerland and Europe: They entail reforms of legal, political, and policy frameworks, and need to be supported by a self-enforced sense that a future together is possible and fruitful. As in Switzerland, traditionalist views of the world will continue to interact with progressive ones in Europe too, while different cultures will continue to coexist and evolve. Europe cannot become entirely German or French, but in some ways all Europeans can become more Swiss. In a possible future, being Dutch or Portuguese might well become be as folkloristic within Europe as being from Uri has largely become in Switzerland, or being from Texas is in the United States, or as being Franconian (an ethnicity that Bavaria's alliance with Napoleon deprived of polity status) already is within Bavaria and in Germany.

[11] The segmentation of European service markets, itself rooted in historical and cultural heterogeneity, still makes it impossible to formulate and defend a common position in services-trade negotiation (Bertola and Mola, 2010).

References

Alesina, A., A. Devleeschauwer, W. Easterly, S. Kurlat and R. Wacziarg (2003), "Fractionalization," *Journal of Economic Growth* 8, pp. 155–94.

Becker, S. O. and L. Woessmann (2009), "Was Weber Wrong? A Human Capital Theory of Protestant Economic History," *Quarterly Journal of Economics* 124, pp. 531–96.

Bergmann, H. (2011), "Entrepreneurship Disparities within Switzerland – Do Tax and Language Differences Play a Role?," *Entrepreneurship & Regional Development* 23, pp. 423–548.

Bertola, G. (2007), "Welfare Policy Integration Inconsistencies," in: H. Berger and T. Moutos, eds., *Designing the New European Union*, Elsevier, Amsterdam.

Bertola, G. and L. Mola (2010), "Freedoms and Regulation in the EU: Services Provision and Temporary Mobility," *The World Economy* 33, pp. 633–53.

Blankart, C. B. (2013), "An Economic Theory of Switzerland," *CESifo DICE Report* 9, pp. 74–83.

Bruegger, B., R. Lalive and J. Zweimueller (2009), "Does Culture Affect Unemployment? Evidence from the Roestigraben," *CESifo Working Paper* No. 2714.

Cottier, T. and M. Oesch (2012), "Switzerland," in: G. Andersen, ed., *Internal Markets and Multi-level Governance: The Experience of the European Union, Australia, Canada, Switzerland, and the United States,* Oxford University Press.

Cour-Thimann, P. (2013), "Target Balances and the Crisis in the Euro Area," *CESifo Forum* 14, Special Issue.

de Rougemont, D. (1965), *La Suisse ou l'Histoire d'un Peuple Heureux*, reedited, l'Age d'Homme, Lausanne 1990.

EEAG (2013), *The EEAG Report on the European Economy* 2013, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2013.pdf.

Egger, P., M. Koethenbuerger and A. Lassmann (2012), "Crissing the Crosses: On Yardstick Competition among Christian Churches," mimeo, KOF, ETH Zurich.

Egger, P., M. Koethenbuerger and M. Smart (2010), "Do Fiscal Transfers Alleviate Business Tax Competition? Evidence from Germany," *Journal of Public Economics* 94, pp. 235–46.

Egger, P. and A. Lassmann (2011), "The Causal Impact of Common Language on International Trade: Evidence from a Spatial Regression Discontinuity Design," mimeo, KOF, ETH Zurich.

Eugster, B. and R. Parchet (2011), "Culture and Taxes: Towards Identifying Tax Competition," *Cahiers de Recherches Economiques du Departement d'Econometrie et d'Economie politique* No. 11.05.

Feld, L. P. and G. Kirchgaessner (2001), "Income Tax Competition at the State and Local Level in Switzerland," *CESifo Working Paper* No. 238.

Feld, L. P., G. Kirchgaessner and C. A. Schaltegger (2003), "Decentralized Taxation and the Size of Government: Evidence from Swiss State and Local Governments," *CESifo Working Paper* No. 1087.

Kirchgaessner, G. (2013), "Consociational Democracy, Divided Government, and the Possibility of Reforms," in: Z.T. Pallinger, ed., *Political Crisis in Europe: Direct Democratic Answers,* VS Verlag fuer Sozialwissenschaften, Wiesbaden.

Koethenbuerger, M. (2002), "Tax Competition and Fiscal Equalization," *International Tax and Public Finance* 9, pp. 391–408.

Sinn, H.-W. and T. Wollmerhaeuser (2012), "Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility," *International Tax and Public Finance* 19, pp. 468–508.

Sinn, H.-W. (2012), *Die Target-Falle: Gefahren fuer unser Geld und unsere Kinder*, Hanser, Munich.

Sinn, H.-W. (2014), *The Euro Trap: On Bursting Bubbles, Budgets and Beliefs,* Oxford University Press, forthcoming.

Smart, M. (1998), "Taxation and Deadweight Loss in a System of Intergovernmental Transfers," *Canadian Journal of Economics* 31, pp. 189–206.

Tabellini, G. (2010), "Culture and Institutions: Economic Development in the Regions of Europe," *Journal of the European Economic Association* 8, pp. 677–716.

Austerity: Hurting but Helping

3.1 Introduction

Since the sovereign debt crisis erupted in the euro area, there has been much discussion about the costs and benefits of fiscal adjustment, or austerity. While several euro area countries have experienced a rapid rise in their public debt, calling for a reduction in government deficits, the crisis has also plunged them into a deep recession. This, in turn, has limited their scope for reducing public deficits, and might even have required short-term deficit increases in some cases. However, the costs and benefits of fiscal policy depend heavily on the nature of the recession. If a recession is caused by a temporary demand shock, fiscal expansion can effectively offset its effect in terms of output and employment. If, however, it is caused by a permanent demand or supply shock, the benefits of fiscal expansion are far more limited. We argue that the shock that triggered the latest recession was of a longer-lasting nature, meaning that the benefits of any fiscal expansion would have been limited. Neither austerity, nor the recession was completely avoidable as a result.

In our previous reports (EEAG, 2012; and EEAG, 2013) we emphasised that the root of the euro area's current problems lies in the external imbalances between its core and periphery countries.[1] In the run-up to the crises optimistic expectations about income convergence generated an investment boom in the periphery, particularly in construction, accompanied by ballooning current account deficits financed by private capital inflows. This expansion in demand generated a faster rise in prices, including real-estate prices, in the periphery than in the core. The rapid price rise eroded the competitiveness of the periphery countries, which reinforced the increase in their current account deficits. Importantly, the boom was also accompanied by a misallocation of resources across different activities and firms. Both relative prices and allocations were therefore misaligned on the eve of the crisis. After its onset, private capital flows stalled, and in some cases even reversed, and the investment boom collapsed, leading to a recession. Since it takes time to reallocate labour, for example from oversized construction industries to other industries, this shock has had a long-lasting impact.

The previous argument implies that some fiscal retrenchment is necessary for the rebalancing process in the periphery. Improving fiscal balances increases domestic saving relative to investment, which helps to improve the current account. Moreover austerity, by improving fiscal balances and raising unemployment levels, also reduces aggregate demand, exerting downward pressure on prices, without which an improvement in competitiveness cannot be achieved. In addition, recession accompanied by relatively high unemployment naturally emerges during a large-scale reallocation of productive resources, particularly of labour across firms and industries. Moreover, recession tends to induce price and wage cuts, and hence leads to the necessary realignment of relative prices without which the competitiveness of the previously overheated economies cannot be re-established.

This chapter explores the notion of austerity and discusses the fundamental trade-offs policymakers are facing when making decisions about the timing and size of fiscal adjustment. It looks at the stylised facts of austerity in the euro area and highlights the macroeconomic conditions that triggered it, examines the degree to which austerity has been implemented to date and its effect on the economy. We discuss why the shock that triggered the crisis, and eventually led to austerity, was more permanent in nature.

3.2 Austerity

There has been a great debate about austerity over the past few years. However, the debate often left it in the

[1] The periphery countries of the euro area are Cyprus, Greece, Ireland, Portugal and Spain. Since Italy was also hit by the sovereign crisis, it is usually lumped together with the other five countries referred to as the GIPSIC countries. However, the roots of the Italian problem are rather different to those of the other five countries, as Italy has been facing serious structural problems and stagnation since the early 1990s.

dark what do we mean by austerity and how we measure it. In addition, to evaluate austerity, we should also be aware of the trade-offs governments face. Hence we start our analysis with a brief discussion of the definition of measurement of austerity, and the fiscal policy trade-offs.

3.2.1 Definition and measurement

We use the term "austerity" to describe fiscal policy plans and actions to improve the primary balance of the general government i.e., the balance excluding interest payments. Austerity measures generally include expenditure cuts and tax rises. Since we want to measure actual policy changes, we have to isolate the effect of fiscal policy change on the primary balance from the change caused by the economic cycle, or one-off government measures such as bank bailouts. The most frequently used measure of changes in fiscal policy is the cyclically-adjusted primary balance of the general government (see Box 3.1 for further discussion). This measure aims to correct for business cycle effects, however, it still falls short of fully isolating fiscal policy intents from its outcomes.[2] This nevertheless remains the best measure available to assess fiscal policy actions.

[2] This problem can potentially be serious. Riera-Chrichton et al. (2012) build a novel data set of the value added tax rates of 14 industrialised countries. They find that cyclical value added tax revenue changes have very little correlation with actual changes in the value added tax rate.

There are several pitfalls in the measurement of fiscal policy based on narrowly defined fiscal observables.

- The definition of fiscal policy is somewhat more difficult when central banks carry out significant quasi-fiscal activities. In particular, as discussed extensively in our last report (EEAG, 2013) there are significant current account imbalances within the euro area. During the crisis, private capital flows were less and less willing to finance the current account deficits of the euro area periphery. In addition, some countries like Italy experienced capital flight during the crisis. The European Central Bank stepped in to finance these current account deficits, or to compensate for capital flight from these countries. If a country with a flexible exchange rate were to face a similar balance-of-payments crisis, and required external assistance, it would call upon the IMF. In such an instance the financial flows would be more transparently accounted for, and they would appear on the general government accounts.
- Governments also accumulate implicit liabilities in the form of future pension and health care liabilities. Currently these liabilities are not treated as part of government debt, and any action that the government takes to alter them may or may not show up in the government account. For example, the government may nationalise private pensions. The proceeds are viewed as government revenue and can be used to lower government debt, despite

Box 3.1

Measuring cyclically-adjusted government balances and potential output

Cyclically-adjusted government balances measure government balances excluding the effects of the economic cycle and one-off budgetary measures. When the economy is booming, tax revenues are above their long-term sustainable level, and when the economy is in recession, they are below it. Changes in fiscal policy are measured by changes in government balances, excluding these temporary effects, as such changes reflect government intentions more accurately.

However, cyclically-adjusted government balances are not observable directly, they have to be estimated. Firstly, the output elasticity of various tax revenues and the unemployment elasticity of government expenditure are estimated (see Girouard and André, 2005, for more detail). Secondly, estimates of potential output and the natural rate of unemployment are used to estimate cyclically-adjusted revenues and expenditure, which together with unadjusted interest expenditure are used to calculate the cyclically-adjusted government balances.

Potential output represents the level of output that can be maintained if production factors are utilised at their long-term sustainable level. The percentage deviation of actual from potential output is referred to as the output gap. The estimates used here from the European Commission DG ECFIN / AMECO database are based on the production function approach. This approach calculates the capital stock, and the sustainable level of employment. The former is based on actual investment data, while the latter requires an estimate of the non-accelerating inflation rate of unemployment. Finally, a statistically smoothed version of total factor productivity (TFP) is calculated whereby TFP is represented as the difference between actual output and the contribution of capital and labour to output.

As we can see, the estimation of potential output is a rather complicated process marred by several conceptual and statistical issues (see Darvas, 2013; and Graff and Sturm, 2011, for a discussion of these problems). More importantly, estimates of the output gap and potential output often prove highly unstable over time, as the estimates tend to undergo substantial revisions. These problems imply that caution must be exercised when interpreting output gaps or cyclically-adjusted government balances. For example, if the actual deficit is large, and the estimated output gap is small, then the estimated cyclically-adjusted government deficit is close to the actual one, and hence appears to be large, requiring a large fiscal adjustment. However, if the output gap is mis-measured and is actually larger than the measured gap, then policymakers may implement a larger than necessary fiscal adjustment.

We will use these estimates despite the problems discussed above, as they reflect the best knowledge available about fiscal policy stance. Policymakers and researchers are aware of the issues involved. The European Commission set up the "Output Gap Working Group" to address these problems, and to ensure that potential output and output gap estimates are technically robust and transparent.

the fact that the government liabilities, including implicit pension liabilities, did not change.[3]

- The government can also use non-standard regulatory actions to implement fiscal policy. For example, it can regulate the prices of prescription drugs thereby lowering health care costs in the short run. Similarly, it can stimulate aggregate demand by cutting or freezing the price of utilities supplied by the private sector, thus replacing a subsidy, which would have counted as government expenditure. Governments are more likely to implement measures of this kind if they are under greater pressure to implement austerity measures.

Despite the problems stemming from quasi-fiscal activities, our discussion of austerity will focus exclusively on traditional fiscal variables.

3.2.2 Austerity trade-offs

Governments do not tend to implement austerity measures lightly as they face several trade-offs. The debate about austerity often overlooks these trade-offs, or the costs, benefits and risks that policymakers have to consider. Here we spell out the three major relevant trade-offs that policymakers need to take into account when implementing austerity.

Firstly, there is a trade-off between the risk of default and the cost of austerity. On the one hand, if public debt is on an explosive path at present, the government may not be able to roll over its debt, forcing it to make an even more costly fiscal adjustment in the future. On the other hand, fiscal adjustment today is costly in terms of output and employment. Hence the primary incentive to carry out austerity measures comes from the anticipated future costs of delaying it. Markets often give incentives not to postpone austerity measures when they demand higher interest rates for rolling over existing government debt. However, the empirical evidence that market pressure induces governments to carry out multi-year fiscal adjustment is weak. In a sample of 17 OECD countries Dell'Erba et al. (2013) find that only about one third of fiscal adjustments between 1980 and 2011 were related to market pressure such as higher interest rates. In the other cases governments were reacting to weak macroeconomic or fiscal fundamentals. The problem with this and similar empirical studies is that they typically measure the outcome of the interaction between fiscal policy and sovereign debt markets. However, also the potential market pressure imposed by financial markets, even if it never materialises, has an effect on governments' actions. Hence, the existing evidence cannot be interpreted as suggesting that existing or potential market pressure is not a major factor in governments' austerity decisions, nor that these unobservable, but anticipated threats would indeed be carried out in the absence of a fiscal adjustment.

It has to be emphasised that a recession may also have benefits; a fact that is relevant for trading off default risk versus austerity. The important benefit in the context of the euro crisis that we would like to highlight is that austerity supports real devaluation, which is needed by the periphery countries in order to re-establish competitiveness. This may not be an important issue if austerity applies to an entire currency union, which is connected via flexible exchange rates with the rest of the world such as the USA or the entire euro area. However, it is of the utmost relevance when it comes to single countries or regions within a currency union, as austerity helps to achieve relative price adjustment.

Secondly, there is a trade-off between front-loading the fiscal adjustment, with high short-term costs in terms of employment and output, and the credibility of fiscal policy, as back-loading the programme may lead markets to believe that it will not be fully implemented. The benefit from back-loading the programme is that this process is spread out over many years, which lowers the cost in terms of output and employment. The main drawback is that if implementation of the programme is too slow, it may lose credibility, hence market pressure in the form of higher interest rates makes the slower programme more costly. Front-loading the adjustment may prove particularly costly if the output loss generated by austerity leads to a higher, rather than a lower debt-to-GDP ratio. A higher debt-to-GDP, in turn, requires further austerity, leading to a vicious cycle of austerity measures and output loss. The risk of self-defeating austerity is likely to be large if the loss of output due to austerity is persistent. DeLong and Summers (2012) forcefully argued that in the presence of "hysteresis", output loss may well be permanent. One prominent hysteresis effect comes from the labour market. The human capital of workers who are out of work for a prolonged period of time during a deep recession depreciates, leading to a permanent loss of productivity and income. Firstly, it is unclear whether such a displacement of

[3] See our country report on Hungary in EEAG (2012), for example.

workers and the accompanying loss of human capital is inefficient, as it may represent a necessary reallocation of resources. We believe that this is likely to be the case in the current recession and will return to this issue later. Secondly, the recent quantitative work of Bi et al. (2013) suggests that only very slow fiscal adjustment is likely to avoid hysteresis effects. But it is unlikely that such a lengthy process of fiscal adjustment can be implemented in a credible fashion. Hence such a program is likely to lead to higher interest on government debt, eventually forcing the government to front-load fiscal adjustment.

Thirdly, there is a trade-off between choosing expenditure cuts and tax rises. On the one hand, the costs and benefits of each measure depend on the associated spending and tax multipliers. The existing evidence suggests that raising taxes is more costly in terms of output than cutting expenditure. In particular, there is the possibility that expenditure cuts can be expansionary as they signal future tax cuts. The resulting wealth effect leads to an increase in demand. However, empirical evidence supporting the case for expansionary austerity has proved rather elusive. Alesina and Ardegna (2010); and Alesina et al. (2012) present empirical evidence based on assessing the impact of changes in cyclically-adjusted primary deficit on output to support the case for expansionary austerity. By contrast, Guajardo et al. (2011) use an alternative identification method based on a narrative account of actual fiscal intentions, and find no evidence for expansionary austerity. The most recent study by Jordà and Taylor (2013) combines a narrative approach with a novel econometric identification method, and finds no evidence for expansionary austerity. One reason why evidence is proving so elusive may lie in the theoretical mechanism by which such expansion is supposed to work (see Bertola and Drazen, 1993). Fiscal austerity can be expansionary if the private sector's expectations about future taxes are permanently lower. Empirical measures of fiscal consolidation, even if they are complemented by a narrative approach, do not capture all of the factors affecting private sector expectations about future fiscal policy, especially during times of crisis.

3.3 Macroeconomic and fiscal conditions between 2007 and 2009

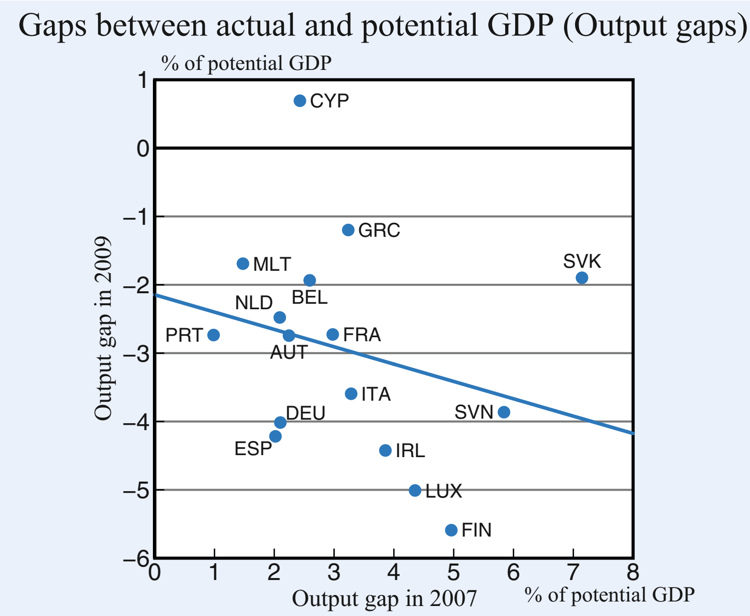
The financial crisis slowed down the euro area economies. Policymakers in the euro area initially responded with a fiscal expansion to mitigate the recession. However, the fiscal expansion could not prevent the euro area countries falling into recession, and it only set the stage for the sovereign crisis.

3.3.1 Output, external balances and competitiveness

The member states of the European Union were severely hit by the financial crisis, which triggered sovereign crises in various countries. Figure 3.1 shows the output gaps before the financial crisis in 2007, and in 2009 when the European sovereign crisis started. The figure shows that while all euro area countries were growing above their respective sustainable trend levels in 2007, two years later all but one country were in recession. Countries in which the output gap was the most positive in 2007 tended to suffer larger output losses by 2009. Interestingly, the output gap in 2009 indicates that Finland was most severely hit, while the periphery countries did somewhat better, especially Portugal and Greece. It is quite clear that the euro area was in recession by the end of 2009.

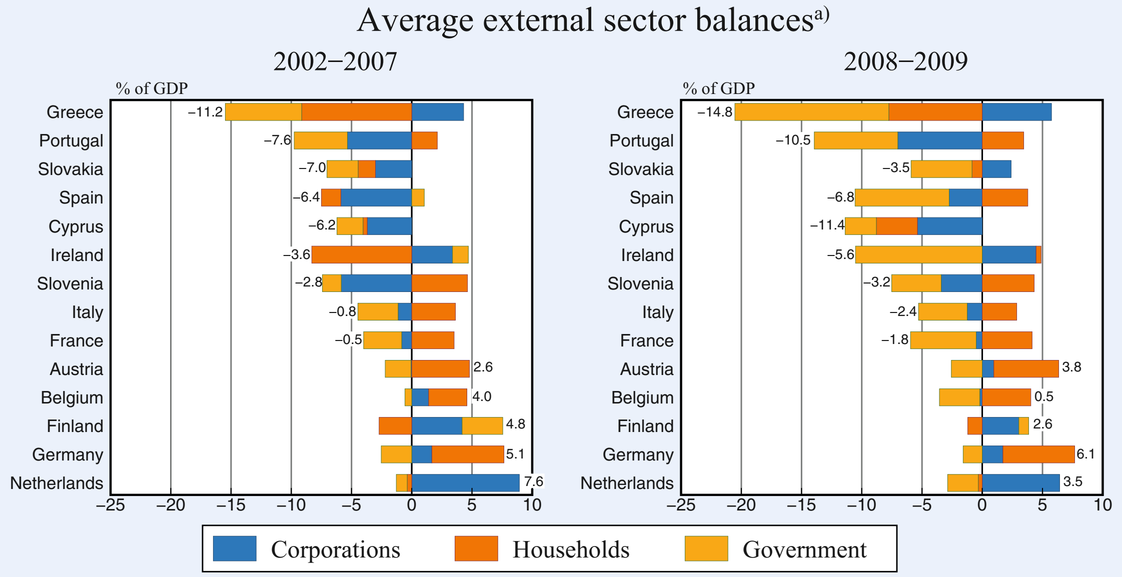
The recession had a differential impact on the euro area countries as far as external balances are concerned. Figure 3.2 shows the external balances, as

Figure 3.1



Source: DG ECFIN / AMECO and EEAG calculations, last accessed 5 November 2013.

Figure 3.2



a) The numbers on the bars indicate the sum of the three sectors' balances which is the external balance. A positive number indicates net lending and a negative number net borrowing form the rest of the world.
Source: DG ECFIN / AMECO, last accessed 5 November 2013.

measured in national accounts, disaggregated into the balances of the three domestic sectors: households, corporations and the government.[4] The left panel of the figure shows, as discussed in our previous reports (EEAG, 2012; and EEAG, 2013), that the periphery countries of the euro area operated large current account deficits. The figure also reveals that although government balances contributed significantly to this deficit in Greece and Portugal, private sector net borrowing was even more important, which is consistent with the credit boom during the pre-crisis period.[5]

The 2008–2009 period, on the other hand, seems rather different. In the first phase of the recession, before the sovereign crisis, the external balances of the periphery countries deteriorated, but this time the deteriorating balances of the government were a major contributing factor. In particular, the household sector went from being a net borrower to a net lender in Ireland and Spain as households repaired their balance sheets. For example, households' net borrowing amounted to about 8 percent of GDP on average prior to 2008 in Ireland, which turned into net lending by 2009. This reflected a huge adjustment on the part of the household sector. However, there was little sign that such adjustment was happening in Greece at the time. Greek households reduced their borrowing slightly, but government borrowing increased significantly.

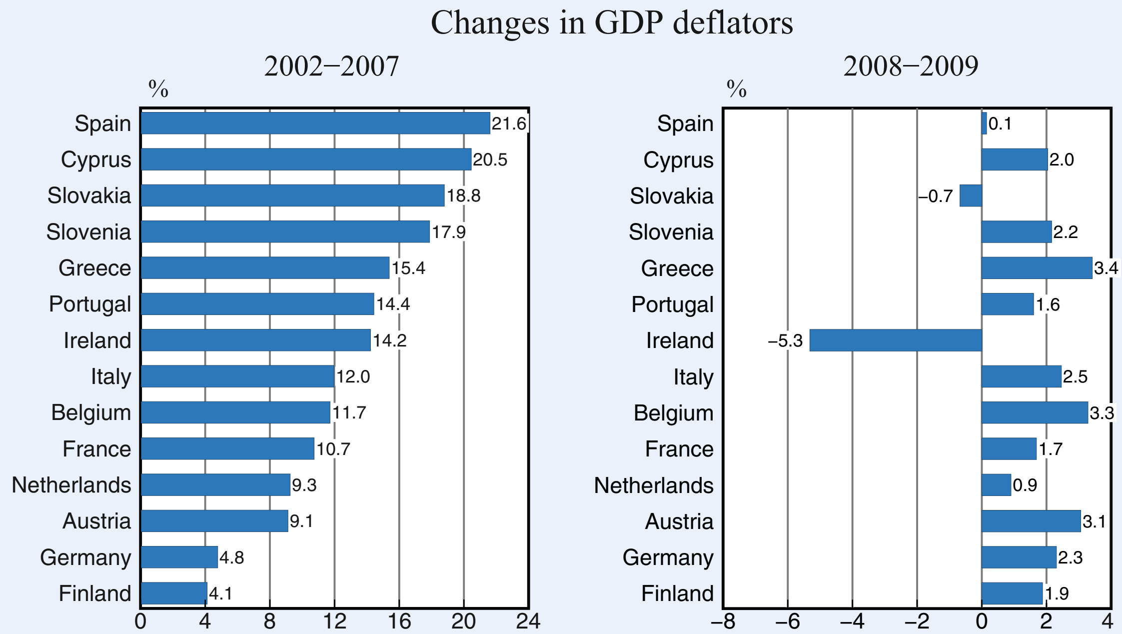
As we discussed in our previous two reports (EEAG, 2012; and EEAG, 2013), the deteriorating external balances went hand in hand with worsening competitiveness in the periphery. Figure 3.3 shows the evolution of the price levels in the euro area countries. The increase in the price levels in the periphery significantly outstripped the price increases in the core prior to 2007. However, the first phase of the recession between 2008 and 2009 already induced some adjustment in the periphery, with the exception of Greece. Households turned from net borrowers into net lenders in Ireland and Spain, where price levels also rose more slowly than in Germany. Ireland, where households carried out the largest adjustment, experienced a decrease in its price level.

3.3.2 The fiscal expansion of 2008 and 2009

The euro area countries carried out a fiscal expansion in the wake of the financial crisis. This was already suggested by Figure 3.2, which showed that the net borrowing of the euro area governments increased between 2008 and 2009 relative to pre-crisis levels. Figure 3.4 gives a more precise description of the change in fiscal policy, as it shows the cyclically-adjusted primary balance of the governments in 2007 and 2009. Government balances deteriorated in all

[4] Loosely speaking, these balances measure the difference between saving and investment in each sector. The sum of these balances corresponds to the difference between aggregate saving and investment. This equals net lending in the national accounts, which is conceptually the same as the current account.
[5] It is important to emphasise that sector balances are mere identities, thus they do not imply causal relationships.

Figure 3.3



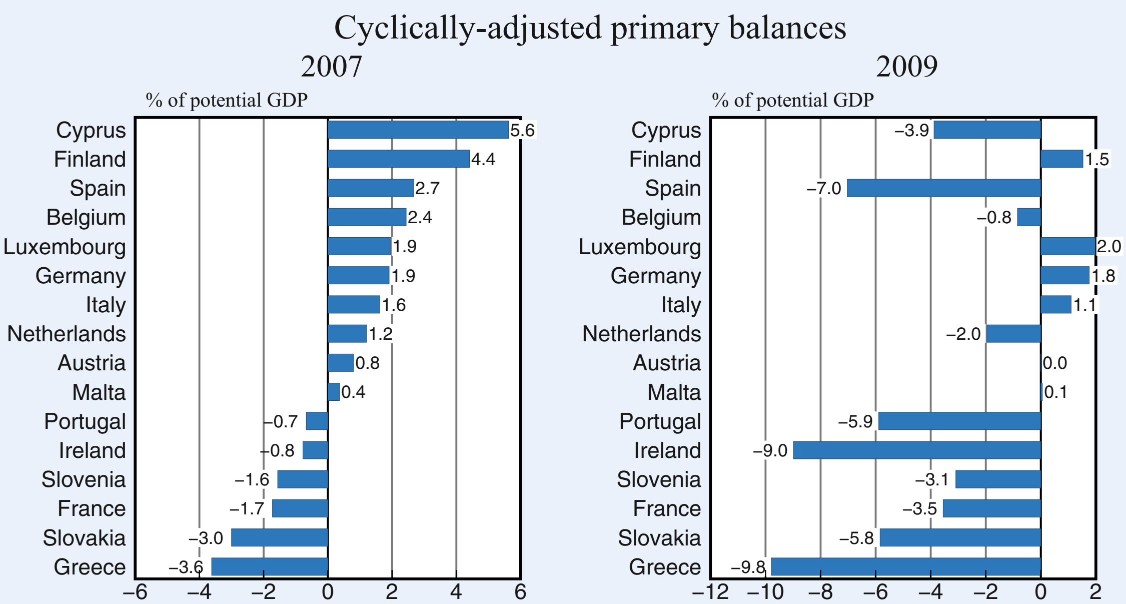
Source: Eurostat, last accessed 30 December 2013.

but one country. In some countries like Germany and Italy it changed very little, while in others such as Greece, Ireland[6] and Spain it deteriorated in a dramatic fashion. The cyclically-adjusted primary balance deteriorated by more than 8 percent of potential GDP in Ireland and Spain, and by about 6 percent in Greece. Interestingly, Italy behaved very conservatively in terms of fiscal policy, having maintained an almost unchanged primary surplus during 2008 and 2009 relative to 2007.

The crucial question, particularly in terms of the current austerity debate, is how effective was the fiscal expansion of 2008 and 2009 in mitigating the recession? Figure 3.5 plots the change in the cyclically-adjusted

[6] We replaced the government expenditure figures, excluding the interest payments of Ireland for 2009, with the average of 2010 and 2011 to eliminate the effect of the bank bailout on Irish government expenditure. Using this figure, we also recalculated the deficit figure for Ireland for 2009.

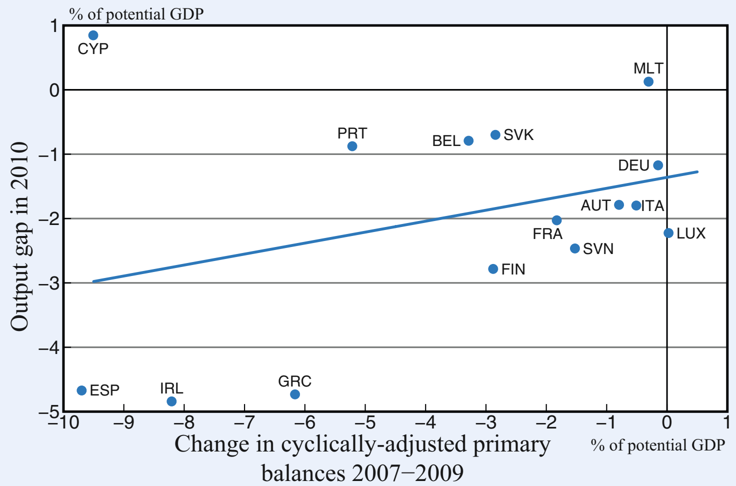
Figure 3.4



Source: DG ECFIN / AMECO and EEAG calculations, last accessed 5 November 2013.

Figure 3.5

Output gaps and changes in cyclically-adjusted primary balances



Source: DG ECFIN / AMECO and EEAG calcualtions, last accessed 5 November 2013.

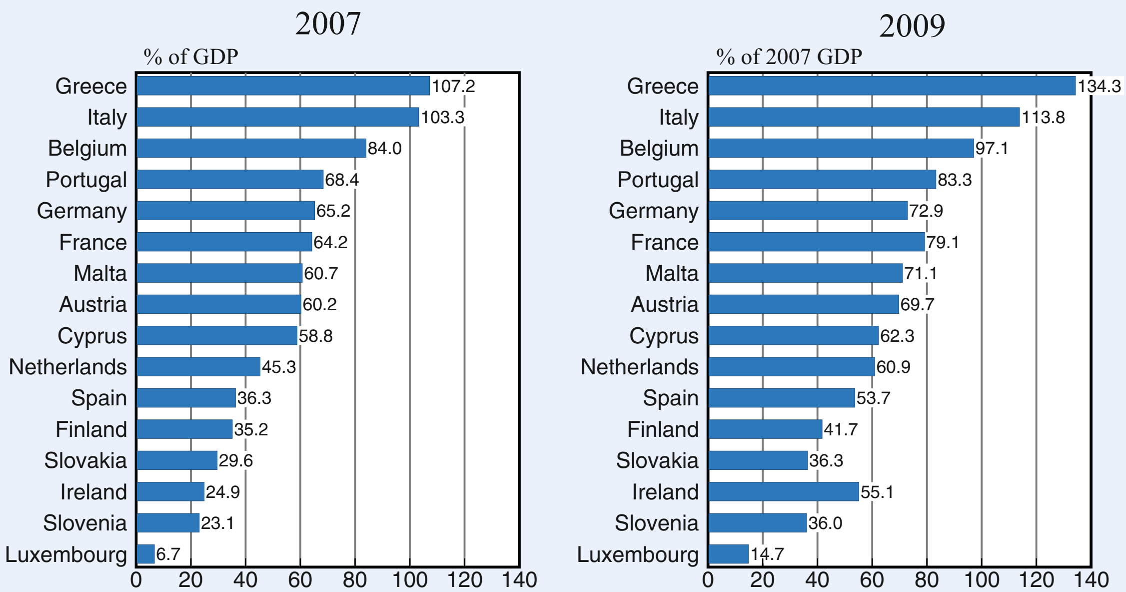
primary deficit between 2007 and 2009 against the output gap in 2010 and reveals that it was not particularly effective. If anything, greater fiscal expansion tended to be accompanied by a deeper recession. Greece, Ireland, and Spain engaged in a fiscal expansion of over 6 percent of potential GDP between 2007 and 2009, and these countries still experienced a negative output gap of over 4 percent in 2010. With the exception of Cyprus and Malta, all of the euro area countries had fallen into recession by 2010. Some countries, like Germany, experienced a relatively mild recession, but in Finland and Luxembourg the recession was deeper.

The effect of fiscal expansion on output in a recession depends on what type of shock caused the recession. If it was due to a temporary demand shock, fiscal expansion is effective in mitigating the recession. If, on the other hand, the demand shock is longer-lasting or the recession was caused by a supply shock, fiscal policy is much less effective in dealing with it. Policymakers interpreted the financial crisis of 2007–2009 as a temporary demand shock. They therefore engaged in a fiscal expansion to mitigate the recessionary effect of the financial crisis, but achieved relatively little. The fiscal expansion only seemed to lead to a rapid increase in the indebtedness of euro area governments as Figure 3.6 illustrates. Greek public debt was already above 100 percent of GDP in 2007, but increased by over 25 percentage points during the following two years relative to 2007 GDP. Ireland's public debt more than doubled during these two years, while public debt in both Spain and Portugal increased by over 10 percentage points.

In short, the first two years of the Great Recession in the euro area were characterised by worsening macroeconomic conditions, and by attempts to mitigate the

Figure 3.6

Public debt levels



Source: Eurostat, last accessed 30 December 2013.

adverse effect of the financial crisis on output and employment via expansionary fiscal policy. However, these attempts were unable to change the course of the euro area economies, indicating that the shock that hit the economy was not a temporary demand shock. The euro area economies fell into a recession. The main outcome of fiscal expansion was rapidly accumulating public debt levels in the periphery, setting the stage for the subsequent European sovereign crisis.

3.4 The fiscal retrenchment of 2009–2012

Fiscal expansion of 2007–2009 was followed by fiscal austerity of 2009–2012. Firstly, we discuss the stylised facts of austerity, then assess whether the austerity measures achieved one of their basic goals, namely, ensuring public debt sustainability. Secondly, we analyse the macroeconomic consequences of austerity.

3.4.1 Size of austerity

The sovereign crisis forced the hand of the euro area periphery countries. Ireland, Portugal and Greece were shut out from the bond markets; in other words they were unable to sell bonds on the market at an interest rate that was consistent with debt sustainability. If a country is unable to issue debt, its government faces the difficult decision of whether to try to solve the problem alone or seek external assistance. If a country decides to solve its problem alone, the solution amounts to front-loading fiscal adjustment, as it has to eliminate its primary deficit overnight since it cannot borrow. Moreover, the country is likely to default on its existing debt, as it is unable to service this debt unless fiscal adjustment leads to a significant reduction in the interest premium on it.[7] Thus, in the absence of external assistance, a major fiscal adjustment is required if the country runs a primary deficit.

As fiscal adjustment is very costly in terms of employment and output, the governments of the periphery decided to seek external assistance from the Troika (ECB, IMF and European Commission). This external assistance enabled them to back-load the fiscal adjustment required.[8] The assistance was, however, conditional to highly criticised austerity measures, which actually reduced the cost of fiscal adjustment relative to the cost that the markets would have imposed on these countries. In fact, the Troika represented the community of states that offered public credit at more favourable conditions than markets would have provided private credit. What critics of austerity often fail to realise is that the Troika did not impose constraints on borrowing at market conditions, but constraints on public or publicly guaranteed credit provided at the risk of other countries. However, this does not mean that the Troika, or other agencies providing external assistance, should not carefully consider both the scope and the time path of their austerity-mitigating measures.

Figure 3.7 shows the changes in cyclically-adjusted primary balances relative to potential output between 2009 and 2012 and the size of the primary deficit in 2012. Firstly, with the exception of Finland and Luxembourg, all of the euro area countries implemented austerity measures. Greece stands out with a 10+ percentage point improvement in its cyclically-adjusted primary balance. As many observers have noted, Greece implemented a very large adjustment, which deserves applause, as do the efforts of Ireland and Portugal. However, these austerity efforts have to be seen in context, given that the very same countries carried out a fiscal expansion in the preceding two years. The Spanish and Irish austerity measures, in particular, did not even reverse the previous expansion, while Portugal's austerity measures were about the same size as the fiscal expansion implemented during the two years previously. Greece's austerity measures did indeed exceed the size of the previous two years' fiscal expansions by about 5 percent of GDP, which is significant. On the other hand, no other euro area country had lived beyond its means to a similar degree in terms of public debt and current account deficits relative to GDP as Greece. Finally, it should also be pointed out that the only non-periphery country hit by the sovereign crisis, Italy, acted with fiscal prudence: carrying out very little fiscal expansion in 2007 and 2009, and implementing austerity measures of 3 percentage points of GDP between 2009 and 2012.

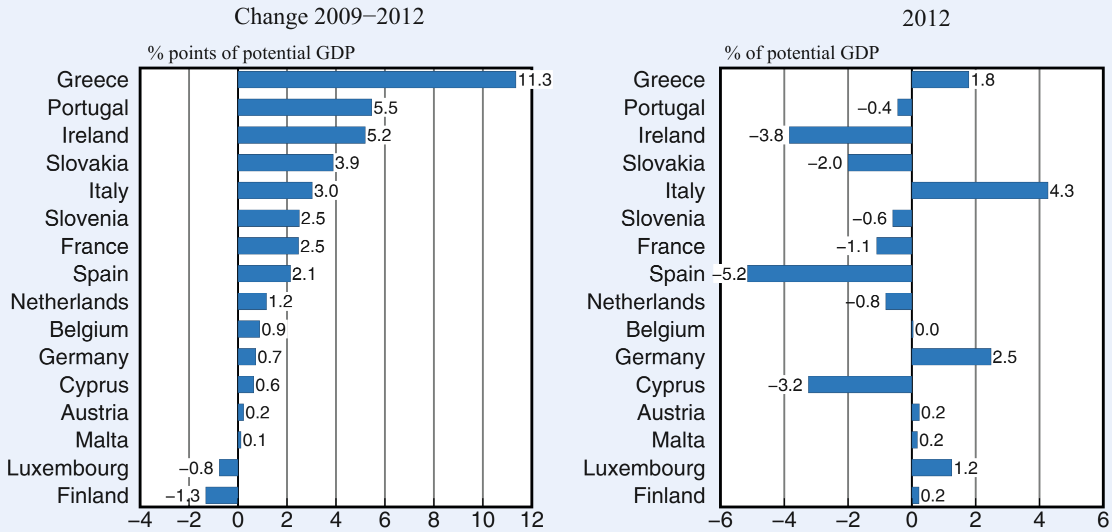
The size of the improvement in fiscal balances in the euro area between 2009 and 2012 seemed to be large,

[7] The situation is somewhat different if the government runs a primary surplus. In such instances, a default does not require a fiscal adjustment in the short run. However, the cost here is that the country will potentially be shut out from the international sovereign bond markets for a long time, which may prove costly in the future when the country wishes to borrow again.

[8] Greece received its first bailout in May 2010, and its second in February 2012. Ireland, Portugal and Cyprus received bailouts in November 2010, May 2011 and in March 2013, respectively. The Spanish government was not bailed out directly, but it received a bailout package in June 2012 to rescue its ailing banks, which would otherwise have had to have been bailed out by the Spanish government.

Figure 3.7

Cyclically-adjusted primary balances of the government[a)]



[a)] Expenditure excludes interest payments.
Source: DG ECFIN / AMECO and EEAG calculations, last accessed 5 November 2013.

particularly in Greece and Portugal. However, one crucial question remains: Was this improvement enough? As we discussed earlier, there are two implications of austerity that can help to evaluate the success of the policy. The first is whether it made public debt sustainable, and the second is whether it contributed to reducing the external imbalances of the euro area periphery. A discussion of the debt sustainability problem in this section is followed by an analysis of the imbalances issue in the next section.

3.4.2 Public debt sustainability

Testing for sustainability is usually an elaborate empirical exercise. However, a simple indicator can be calculated that allows us to assess how much austerity has been achieved in terms of stabilising public debt levels. We can calculate the cyclical primary balance that is required to stabilise a given level of debt, and then compare it with the actual primary balance. It must be emphasised that calculations of this nature rely on several assumptions, hence the results should be interpreted with caution.[9]

The starting point of this calculation is the accounting identity that describes the evolution of nominal government debt. We denote the level of nominal government debt at the end of the period t by D_t, the nominal primary balance by S_t and the nominal interest rate by i_t. Then the level of debt at the end of period t is given by

$$D_t = (1 + i_t)D_{t-1} - S_t.$$

Dividing both sides by the nominal GDP, we get after some manipulation

$$d_t = \frac{1 + i_t}{1 + \gamma_t} d_{t-1} - s_t,$$

where the lower case letters denote variables relative to nominal GDP, and γ_t denotes nominal GDP growth. Rearranging the equation further gives us the following relationship:

$$d_t - d_{t-1} = \frac{i_t - \gamma_t}{1 + \gamma_t} d_{t-1} - s_t\,.$$

If the right hand side is zero, the debt-to-GDP ratio is constant and we have the following relationship between the level of debt, nominal interest rate on the debt, nominal GDP growth and the primary balance at which the level of debt is constant:

$$s_t^* = \frac{i_t - \gamma_t}{1 + \gamma_t} d_{t-1}\,.$$

We set i_t equal to the average effective interest rate on the government debt between 2005 and 2012, which, in turn, is calculated in each year by dividing interest expenditure by the nominal gross government debt of the previous period. Similarly, γ_t is calculated as the average growth of nominal potential GDP between 2004 and 2012. Finally d_{t-1} is set equal to nominal government

[9] For a more elaborate calculation see Kanda (2011), for example.

debt over the nominal potential GDP in 2012.[10] The numbers used for the effective nominal interest rate, and nominal GDP growth are meant to capture some longer-term interest rate and growth rates. We will also briefly discuss some alternative scenarios.

The results from the sustainability calculations are shown in Figure 3.8. The interpretation of the calculations is straightforward: Without achieving the required primary balance debt is not sustainable at its current level. Bearing this in mind, we see that the current level of debt is sustainable in Italy, Germany and Luxembourg. Since in all three countries the primary balance is better than the required one, the debt level is actually falling in these countries. In Spain, Ireland, Portugal and Greece, by contrast, current primary balances are not sufficient to sustain existing levels of debt. Debt levels in these countries are actually still rising. More specifically, the difference between the required and actual primary deficits is very large for Portugal, Cyprus, Spain and Ireland; interestingly, it is smaller in the case of Greece.

Two remarks need to be made about these calculations. Firstly, there is a great degree of uncertainty about the expected future path of nominal interest rates and nominal GDP growth, the two key variables that determine the sustainability condition. For example, using the average growth rates over a period, which includes three years of strong pre-crisis growth, may be viewed as overly optimistic. Hence one should interpret these figures as indicative. The periphery countries probably face a more, rather than a less serious sustainability problem than Figure 3.8 suggests, as it is unlikely that the nominal interest rate will be lower and/or the nominal GDP growth higher than the average between 2005 and 2012. Secondly, the debt sustainability problem may have been exacerbated by the realignment of relative prices. Rebalancing requires an improvement in competitiveness i.e., a slower rise of prices in the periphery than in the core. Hence, unless real growth is significantly higher in the periphery than in the core, it will be hard to maintain sustainable levels of public debt and improve competitiveness at the same time without further improvement in the primary balance. Faster real growth than the 2005–2012 average, however, is not very likely.

3.4.3 Macroeconomic consequences

The debate about the macroeconomic effect of austerity is essentially a debate about the size of the fiscal multiplier. Firstly, we review the literature about the size of the multiplier before turning to the analysis of the austerity in the euro area.

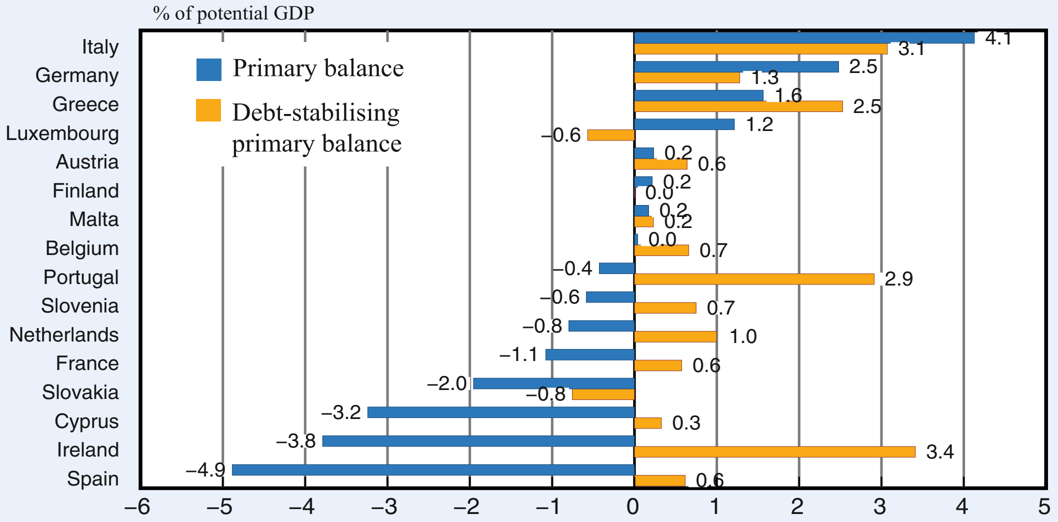
3.4.3.1 The multiplier

There is a fierce debate among economists about the macroeconomic effects of austerity. In recent years sig-

[10] Data from the DG ECFIN / AMECO Database, last accessed on 5 November 2013, is used for the sustainability calculation.

Figure 3.8

Actual primary balances at the end of 2012 and primary balances required to stabilise debt at 2012 levels



Source: DG ECFIN / AMECO and EEAG calculations, last accessed 5 November 2013.

nificant research efforts have been devoted to understanding the theoretical mechanism by which fiscal policy measures affect the aggregate economy, and to measuring their effect. This line of argument asks a relatively simple question: How large is the fiscal multiplier?

The multiplier is typically less than one in the standard frictionless neoclassical model; see Baxter and King (1993). The reason for this is that an increase in government consumption makes households poorer since they expect future tax increases. They therefore reduce their consumption. As households lower their consumption of leisure, they increase their supply of labour, which leads to a rise in output. Since the second effect typically dominates, the multiplier is positive, but less than one. However, the multiplier can be larger in the presence of price rigidities; see Christiano et al. (2011). The initial effect in a model with price rigidities is similar to that of the neoclassical model. Households increase their labour supply in response to a rise in government expenditure, as they feel poorer. There is, however, an amplifying effect on labour supply in the presence of price rigidities. Namely, those firms who cannot raise their prices due to price rigidities face higher demand, hence they hire more labour. The higher demand for labour drives up wages, as wages tend to be rigid only downwards, which induces households to supply even more labour, leading to a further increase in output.

The multiplier may be even larger in recession when the nominal interest rate is at the lower boundary of zero. The rise in government expenditure raises demand. Higher demand leads to higher expected inflation, which generates a negative real interest rate as we are at the lower boundary. This induces households to save less and to consume more, which leads to a further rise in output. The size of the multiplier then ranges between 1.5 to 2.5, according to Christiano et al. (2011) and it varies across recessions and expansions, as was also confirmed by the recent empirical study of Auerbach and Gorodnichenko (2013). Generally, empirical estimates of the multiplier vary between 0.5 to 3.5; see Ramey (2011) for an overview. After carefully reviewing the evidence, she concludes that a plausible range of estimates is between 0.8 and 1.5. If indeed the size of the multiplier is large, and 1.5 is already significant, then austerity measures have a strong negative effect on output and employment during a recession.

We have already seen, however, that fiscal expansion was not particularly effective in mitigating the recessionary effects of the financial crisis between 2008 and 2009 as the shock was probably a combination of a longer-lasting supply and demand shock. After reviewing the stylised facts about euro area austerity, we will discuss why fiscal policy may prove less effective if there is a large misallocation of resources at the beginning of the recession, if there are large external imbalances to correct, and if there is significant risk of a break-up of the euro area.

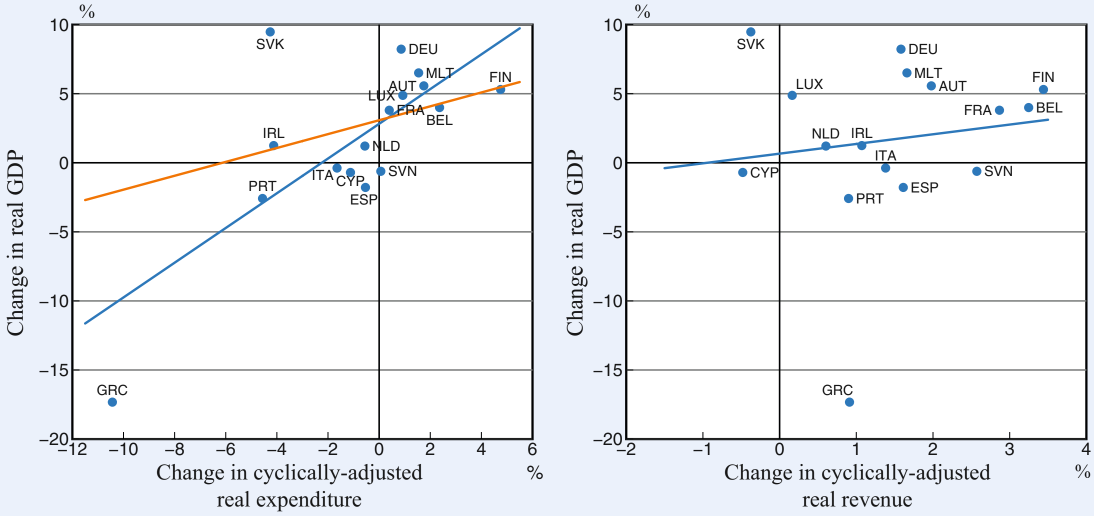
3.4.3.2 Austerity in the euro area between 2009 and 2012

We turn now to a few stylised facts about the recession in the euro area between 2009 and 2012. Figure 3.9 provides us with more clues about how austerity measures affected the economy. Here we plot the actual change in real GDP between 2009 and 2012 against the change in cyclically-adjusted non-interest expenditures and revenues of the government, respectively. The left part of the figure shows the standard effect of expenditure cuts: They have a negative effect on output. However, the strong negative effect of expenditure cuts on output again is primarily driven by Greece. Without Greece the effect still appears to be negative, but is much more muted, as shown by the orange line in the diagram. An additional observation we can make is that the loss of output over these three years was relatively modest, except for Greece. Over this period, GDP declined by about 3 percent in Portugal, by less than 2 percent in Spain, and increased by about 2 percent in Ireland. Among the periphery countries only Greece's GDP declined dramatically, by over 15 percent. In Italy, the only crisis-hit country from the core, GDP remained more or less at the same level. This means that the automatic stabilisers did work, and offset the negative effects of austerity to some extent.

Given the relatively modest size of output loss, with the exception of Greece, it is rather puzzling why the impression arose that the periphery of the euro area had been plunged into a deep recession. The answer is provided by the next graph, Figure 3.10, which plots changes in real GDP against changes in employment. Here we can see dramatic changes both between Q3 of 2007 and Q3 of 2009, and between Q3 of 2009 and Q3 of 2012. Over these two periods employment fell by over 15 percent in Greece, by about 15 percent in Spain and Ireland, and around 10 percent in Portugal.

Figure 3.9

Changes in real GDP and fiscal policy
2009–2012



Source: DG ECFIN / AMECO and EEAG calculations, last accessed 5 November 2013.

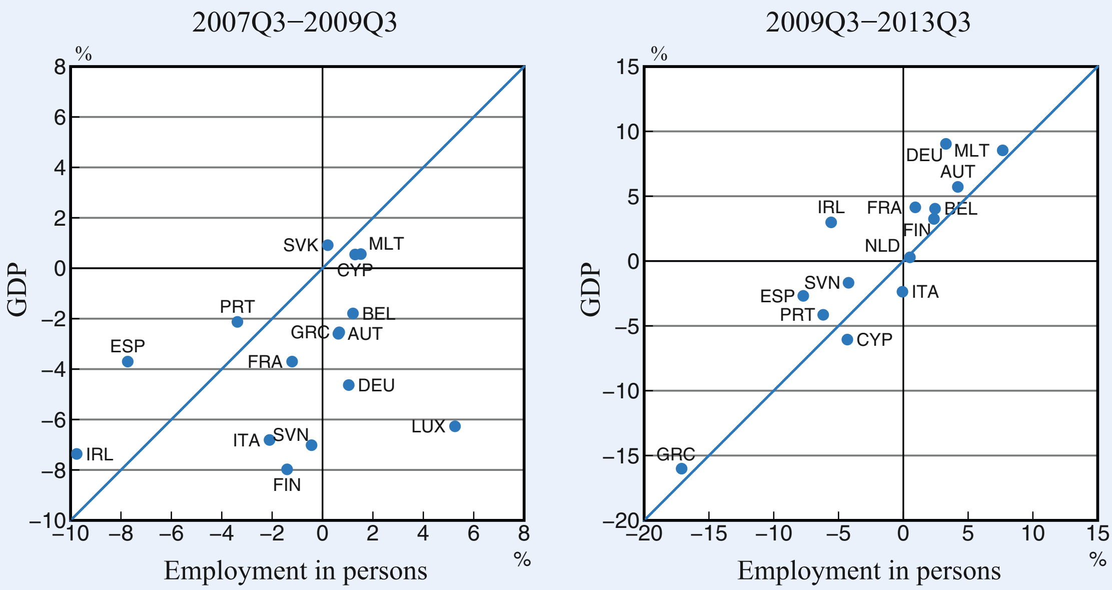
Moreover, the graph also reveals another difference between the euro area core and periphery. The change in output was larger than the change in employment in the core countries both between Q3 of 2007 and Q3 of 2009 when output fell, and between Q3 of 2009 and Q3 of 2012 when output rose. By contrast, the change in output was smaller than the change in employment in the periphery countries during both periods with the exception of Greece, where employment only changed more than output between Q3 of 2009 and Q3 of 2012. In other words, labour productivity appears to be pro-cyclical in the core countries, but counter-cyclical in the periphery.

Labour productivity tends to be pro-cyclical in general. The degree of pro-cyclicality diminished over the three decades, but it did not become counter-cyclical.[11] This fact is significant because it suggests that this recession in the periphery countries is unusual as labour productivity has increased. The standard explanation

[11] See Galí and van Rens (2010) on vanishing pro-cyclical productivity.

Figure 3.10

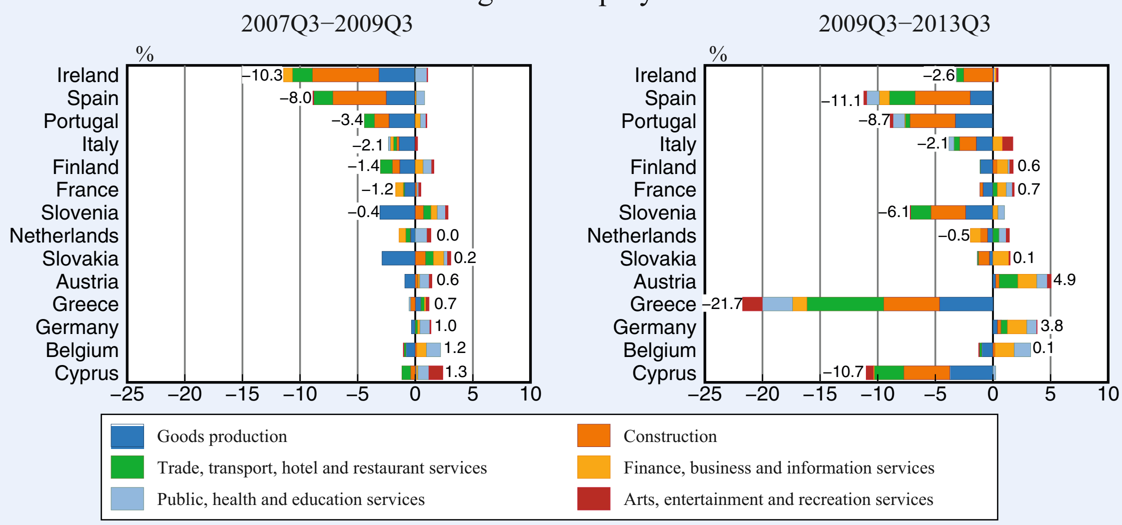
Changes in real GDP and employment[a)]



a) Data is seasonally adjusted and adjusted by working days except the GDP data of Greece which is unadjusted.
Source: Eurostat, last accessed 30 December 2013.

Figure 3.11

Changes in employment[a)]



[a)] Data is seasonally adjusted and adjusted by working days. The numbers on the bars indicate the sum of the changes in employment in the six major industries of the economy.
Source: Eurostat, last accessed 30 December 2013.

of why labour productivity may fall during recessions is that firms facing a temporary demand shock retain more workers than they need to produce their current level of output (labour hoarding). They do so to minimise the cost of laying-off workers in a recession and rehiring them in a recovery. The fact that labour productivity has risen in the periphery may suggest that firms did not expect their output to return to pre-crisis levels any time fast. In other words, they realised early on that they faced a more persistent demand and/or supply shock and laid off workers even faster than their output fell as a result.[12]

Reasons why firms in the periphery thought that they face more permanent shocks, can be gauged from Figure 3.11. This shows the changes in employment between Q3 of 2007 and Q3 of 2009 and between Q3 of 2009 and Q3 of 2013 across six major industries of the economy. Firstly, the fall in employment in both periods occurred primarily in goods production, in construction, and in trade and transport. About half of the overall employment loss in Spain and Ireland, about one third in Portugal and about one fifth in Greece occurred in the construction sector. As we discussed earlier, the investment boom that started in early 2000 collapsed, hitting the construction sector particularly strongly. Secondly, the rise in employment in both periods occurred in the service industries, excluding trade and transport. More specifically, the rise in employment in some industries occurred at the same time as the fall in employment in others.

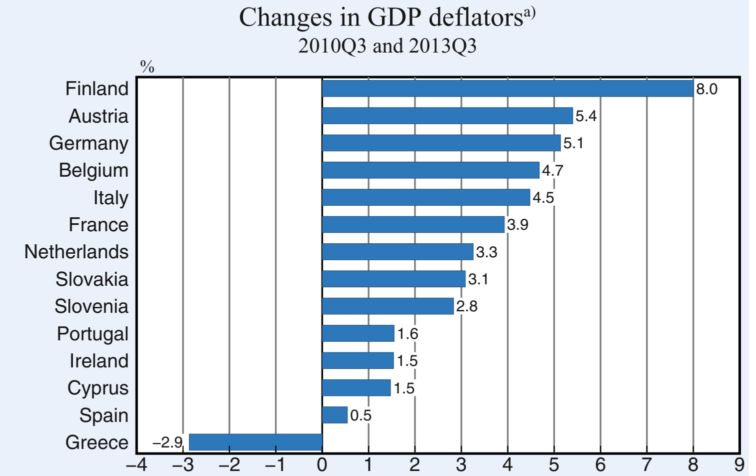
One interpretation of these facts is that the investment boom in the periphery was accompanied by a massive misallocation of capital and labour across sectors. Once the crisis hit, many firms realised that the previous employment levels in their industries were not sustainable, and employment levels in their particular industries would be permanently lower. This induced a massive reallocation of labour (and capital) across industries in the periphery countries. For workers, changing industries is costly, and usually takes a long time, hence employment levels are likely to recover only gradually and over time.

As productive resources are reallocated across industries, the periphery countries are making slow, steady progress in realigning their relative price levels. Figure 3.12 shows that the price level in all periphery countries grew more slowly than in the core between Q3 of 2010 and Q3 of 2013. In particular, the price level in Greece fell during this three year period. However, Italy, the only core country that was hit by the sovereign crisis, and had a competitiveness problem, did not improve the latter much relative to Germany.

The dangers of deflation in the euro area cannot be discussed without taking into account the realignment of

[12] It is worth noting that the observed increase in labour productivity during the latest recession is unlikely to be caused by the fact that less productive firms and jobs are eliminated first in a recession, thus raising the productivity of the remaining market players. This is improbable because this happens in all recessions, but labour productivity is still pro-cyclical and more recently a-cyclical. Hence something else has to have happened this time.

Figure 3.12



a) Data is seasonally adjusted and adjusted by working days except the data of Greece which is unadjusted.
Source: Eurostat, last accessed 30 December 2013.

crease in the private sector's net lending i.e., increased saving over investment of the sector. In all periphery countries, the corporate sector's net lending position improved as the corporate sector repaired its balance sheet by borrowing less and saving more between 2010 and 2012 than between 2008 and 2009.[13] Households also improved their net lending positions in Ireland and Portugal, but not in Spain. More worryingly, Greek households were still net borrowers of almost 10 percent of GDP at the end of 2012. A sustainable improvement in external balances requires that both domestic prices and domestic demand are consistent with this improvement. In the case of Greece, domestic private savings can be interpreted as showing that the household sector's net lending position is still too low.

relative prices. As the price levels of the periphery countries have to fall to support the reduction in their external deficits, during such a process average inflation in the euro area is likely to be low, suggesting that deflation may well occur on average. However, unlike in the United States, deflation in the euro area would be desirable if inflation would be negative in the periphery while remaining at 2 percent in the core, (Sinn 2013).

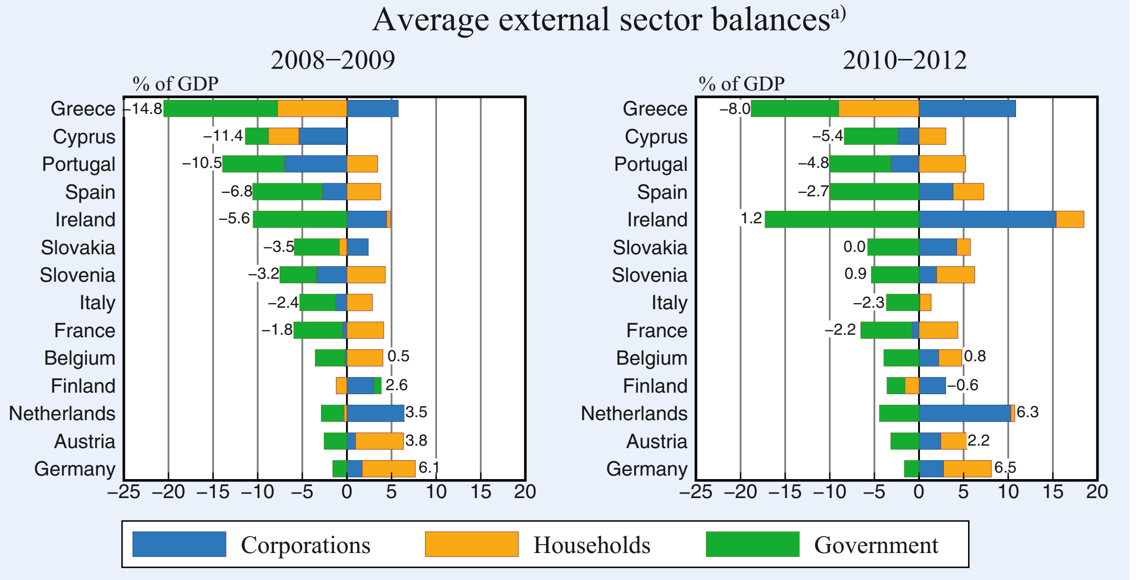
We now turn to the actual external balances of the euro area countries, which can be disaggregated across the three sectors of the economy as shown in Figure 3.13. All periphery countries improved their external balances. The improvements were accompanied by a large in-

3.4.4 Austerity and external adjustment in the euro area

The euro area periphery has been in recession since 2008, and austerity is increasingly blamed for eco-

[13] It is important to note that the improvement in corporate sector net lending was partially due to the bailout of banks in Ireland and Spain.

Figure 3.13



a) The numbers on the graphs indicate the sum of the three sectors' balances which is the external balance. A positive number indicates net lending and a negative number net borrowing from the rest of the world.
Source: DG ECFIN / AMECO, last accessed 5 November 2013.

nomic sluggishness. However, our analysis suggests a more intricate relationship between austerity and recession. Although austerity undoubtedly contributed to the recession, it was also driven by the massive reallocation of production factors needed to correct the pre-crisis misallocation. Finally, both austerity and the recession have contributed to the realignment of relative prices, which is a prerequisite for the reduction of external imbalances in the periphery.[14]

During the boom years prior to the crisis, the periphery countries experienced exuberant investment activity and private capital inflow, but lost their competitiveness, accumulated large current account deficits, and suffered the misallocation of their productive resources. Private capital flows stalled, and in some cases even reversed, after the financial crisis, resulting in the collapse of the investment boom and leading to a recession.

Initially policymakers in the periphery perceived the financial crisis as a temporary demand shock and, with the exception of Ireland, reacted with fiscal expansion in 2008 and 2009 to offset the recessionary effects of the crisis. However, the shock turned out to be a combination of longer-lasting negative demand and a supply shock. The negative demand shock in the periphery was more permanent than in a normal recession because households in the periphery downwardly revised their expectations regarding the speed of convergence with the euro area core. A more permanent supply shock originated from the pre-crisis misallocation of production factors. Once the crisis erupted, many firms realised that the employment levels of the boom years would prove unsustainable not only in the short run, but also in the long term. Thus, production factors, particularly labour, had to be reallocated across firms and economic activities, resulting in sharply falling employment levels.

The financial crisis led to the sovereign crisis in three ways. Firstly, the tax revenues of the boom years, particularly from the construction industry, were not sustainable in the long run. The sharp decline in these tax revenues had a negative effect on government balances. Secondly, the collapse of the construction boom led to rising delinquency rates on loans at the periphery banks. As the quality of the loan portfolio of the periphery banks deteriorated, governments had to bail out some of them, which lead to a further worsening of fiscal positions. Thirdly, the initial efforts of the periphery governments to offset the recessionary effects of the financial crisis turned out to be ineffective as they faced a longer-lasting demand and supply shock, instead of a temporary demand shock. But the expansion itself led to a further deterioration in the fiscal balances.

The on-going adjustment in the euro area periphery is characterised by slowly declining prices relative to the core, by the reallocation of resources across activities, and by slowly improving fiscal and external balances. The adjustment in prices is crucial both for external balances and labour reallocation. However, it is hampered by several factors. Firstly, prices are sticky, hence shocks are absorbed by a fall in output and employment to a larger extent. Secondly, extensive credits by the national central banks and fiscal rescue funds reduce pressure to implement the austerity measures and hence slow the speed of reforms. Thirdly, expectations regarding the future path of prices were influenced by expectations of the break-up of the euro area. If the euro area breaks up, periphery countries' exchange rates will devalue, and their prices will rise relative to the core countries. When such a break-up is expected, then prices in the periphery rise faster (fall slower) than in the absence of such expectations. In other words, the expectation of a break-up slows down internal devaluation in the periphery countries. Fourthly, labour market rigidities in the periphery countries make labour reallocation particularly slow, leading to a prolonged recession.

The adjustment towards a labour allocation and relative prices that are consistent with smaller external balances is accompanied by a recession, as is usually the case with any large-scale reallocation of labour. The recession provides incentives for periphery firms to reduce their prices and wages, which induces the reallocation of labour. Consequently austerity did not cause the recession in itself, but it contributed to it. How much austerity was really needed, or what combination of austerity and debt forgiveness was and is required, are issues that remain open to debate. In particular, a credible long-term fiscal framework could have given credibility to a fiscal policy, thereby reduc-

[14] Austerity or fiscal consolidation does indeed contribute to the improvement in the current account. In their careful empirical study based on a narrative approach to identifying fiscal shocks, Bluedorn and Leigh (2011) find that 1 percentage point of GDP fiscal consolidation raises the current account balance-to-GDP ratio by about 0.6 percentage points. This is a fairly large effect.

ing the need for front-loading the programme (see Blanchard and Cotarelli, 2010).

3.5 Conclusion

Since the sovereign debt crisis erupted in the euro area, there has been much discussion about the costs and benefits of fiscal adjustment, or austerity during a recession. However, it also has to be emphasised that austerity and recession are part of the adjustment process. During this process the external imbalances of the euro area periphery countries are reduced, relative goods prices fall to compensate for the excessive inflation before the crisis and the production factors that were misallocated in these countries during the pre-crisis boom get reallocated to their long-term sustainable use. Hence, neither austerity nor the recession was completely avoidable.

References

Alesina, A. and S. Ardagna (2010), "Large Changes in Fiscal Policy: Taxes versus Spending," in: J. R. Brown, ed., *Tax Policy and the Economy* 24, University of Chicago Press.

Alesina, A., Favero, C. and F. Giavazzi (2012), "The Output Effect of Fiscal Consolidations," *NBER Working Paper* No. 18336.

Auerbach, A. J. and Y. Gorodnichenko (2013), "Fiscal Multipliers in Recession and Expansion," in: A. Alesina and F. Giavazzi, eds., *Fiscal Policy after the Financial Crisis,* University of Chicago Press.

Baxter, M. and R. G. King (1993), "Fiscal Policy in General Equilibrium," *American Economic Review* 83, pp. 315–34.

Bertola, G. and A. Drazen (1993), "Trigger Points and Budget Cuts: Explaining the Effects of Fiscal Austerity," *American Economic Review* 83, pp. 11–26.

Bi, R., H. Qu and J. Roaf (2013), "Assessing the Impact and Phasing of Multi-year Fiscal Adjustment: A General Framework," *IMF Working Paper* No. 13/182.

Blanchard, O. and C. Cottarelli (2010), "Ten Commandments for Fiscal Adjustment in Advanced Economies," *iMFdirect*, 24 June, http://blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/.

Bluedorn, J. C. and D. Leigh (2011), "Revisiting the Twin Deficits Hypothesis: The Effect of Fiscal Consolidation on the Current Account," *IMF Economic Review* 59, pp. 582–602.

Christiano, L. J., M. Eichenbaum and S. Rebelo (2011), "When Is the Government Spending Multiplier Large?," *Journal of Political Economy* 119, pp. 78–121.

Darvas, Zs. (2013), "Mind the Gap! And the Way Structural Budget Balances Are Calculated," *Bruegel blog,* 12 October, http://www.bruegel.org/nc/blog/detail/article/1170-mind-the-gap-and-the-way-structural-budget-balances-are-calculated/.

DeLong, J. B. and L. H. Summers (2012), "Fiscal Policy in a Depressed Economy," *Brookings Paper on Economic Activity* Spring 2012.

Dell'Erba, S., T. Mattina and A. Roitman (2013), "Pressure or Prudence? Tales of Market Pressure and Fiscal Adjustment," *IMF Working Paper* No. 13/170.

EEAG (2012), *The EEAG Report on the European Economy* 2012, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2012.pdf.

EEAG (2013), *The EEAG Report on the European Economy* 2013, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2013.pdf.

Galí, J. and T. van Rens (2010), "The Vanishing Procyclicality of Labor Productivity," *Barcelona Graduate School of Economics Working Paper* No. 489.

Girouard, N. and C. André (2005), "Measuring Cyclically-adjusted Budget Balances for OECD Countries," *OECD Economics Department Working Paper* No. 434.

Graff, M. and J. Sturm (2011), "The Information Content of Capacity Utilization Rates for Output Gap Estimates," *CESifo Economic Studies* 58, pp. 220–51.

Guajardo, J., D. Leigh, and A. Pescatori (2011), "Expansionary Austerity: New International Evidence," *IMF Working Paper* No. 11/158.

Jordà, Ò. and A. M. Taylor (2013), "The Time for Austerity: Estimating the Average Treatment Effect of Fiscal Policy," *NBER Working Paper* No. 19414.

Kanda, D. (2011), "Modeling Optimal Fiscal Consolidation Paths in a Selection of European Countries," *IMF Working Paper* No. 11/164.

Ramey, V. (2011), "Can Government Purchases Stimulate the Economy?," *Journal of Economic Literature* 49, pp. 673–85.

Riera-Crichton, D., C. A. Végh and G. Vuletin (2012), "Tax Multipliers: Pitfalls in Measurement and Identification," *NBER Working Paper* No. 18497.

Sinn, H.-W. (2013), "Austerity, Growth and Inflation: Remarks on the Eurozone's Unresolved Competitiveness Problem," *The World Economy* 36, pp. 1–13.

Banking Union: Who Should Take Charge?

4.1 Introduction

Despite considerable scepticism and some opposition, a European Union (EU) scheme for a banking union for the euro area is taking shape. An EU Regulation for the Single Supervisory Mechanism (SSM) came into force in November 2013. In November 2014 the European Central Bank (ECB) will take over supervision of the 130 largest and systemically most important financial institutions in the euro area (see European Union, 2013a). Prior to November 2014 the ECB will carry out an assessment of the balance sheets of those institutions, with the intention of identifying and remedying existing problems: the so-called legacy issues.

It is generally agreed that there are four essential components of a banking union: a single supervisor, a single regulator, a single resolution mechanism, and a common system of deposit insurance. The schemes for the supervisor and regulator have now been agreed upon and passed into law. The European Commission put forward a proposal for a single resolution mechanism in July 2013. This proposal was discussed at meetings between the Commission and ECOFIN in December 2013. An agreement based on it is close and is likely to pass into law early in 2014 after negotiations with the European Parliament, despite several remaining points of contention between the Commission and ECB on the one hand, and various member states, notably Germany, on the other.

There is no common euro area system of deposit insurance as yet, but national schemes protect deposits of up to 100,000 euros. Changes were agreed in December 2013 intended to make these national schemes more similar and more robust.[1]

The push for a banking union actually revives an old idea that was not put into practice. In the original version of a plan for a central bank that would run a monetary union, the central bank had overall supervisory and regulatory powers. That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators. In 1990, Jacques Delors noted that the European Commission approached the question of banking supervision with an "open mind," and that the European System of Central Banks should simply "participate in the coordination of national policies, but would not have a monopoly on those policies."[2] In October 1990, when the alternates (deputies) to the European central bank governors discussed the draft articles for the central bank statute, Bundesbank Vice-President Hans Tietmeyer restated the sceptical position of his institution, which worried consistently about the moral hazard implications of central bank involvement in supervision. If the central bank took on the responsibility of regulating, it would also deliver an implicit commitment to rescue banks should there be any bad developments that it had overlooked. Tietmeyer provided a neat encapsulation of the German philosophy of regulation:

> "This did not mean from the view of the Board of the Deutsche Bundesbank that the ECB should not support the stability of the financial system, but that it should never be written down; this would be moral hazard."[3]

The ECB was thus not given overall supervisory and regulatory powers, and until the outbreak of the financial crisis in 2007/2008 this was not thought to be a problem (James, 2012).

4.2 Why the push for a banking union?

A banking union represents an unusually ambitious institutional change, shifting the responsibility for

[1] The proposed modified directive requires the banks in each member state to pay into a fund that will hold 0.8 percent of covered deposits. This funded scheme replaces a variety of poorly funded or unfunded schemes. Bank funding replaces taxpayer funding or ex-post funding from the banking industry, and the time taken to receive payments from the scheme will be gradually reduced from 20 to 7 days. (European Commission, "Commissioner Barnier Welcomes Agreement between the European Parliament and Member States on Deposit Guarantee Schemes," MEMO 13/1176, Brussels, 17 December 2013, http://europa.eu/rapid/press-release_MEMO-13-1176_en.htm.)

[2] Committee of Governors, meeting 243, Basel, 13 March 1990.

[3] Committee of Governors, alternates meeting, 16 October 1990.

bank supervision and regulation to a central euro area institution, the ECB, and setting up a centralised fund for bank resolution. The arguments for it include:

- Fiscally weak governments and fragile banking systems have become too closely connected.
- Many banks operate across national boundaries within the euro area. For these banks, regulation and supervision is better done by one supervisor; resolution of such banks is cleaner and more quickly done by a single euro area authority than by national authorities attempting to coordinate with each other.
- National regulators have become too close to the banks they regulate, too susceptible to political pressure, too prone to delay intervention and have incentives to offload costs onto the euro area as a whole. Centralised supervision will be better supervision.
- There are euro area-wide spillovers from a bank failure in a member state; even small banks can have systemic effects.
- It is efficient to pool resources to provide insurance for the costs of bank failure, rather than having individual members states pay for failures that occur in each jurisdiction. Pooling resources addresses the problem of institutions that are "too big to fail" to some extent.
- If the ECB is to act as lender of last resort to euro area banks, it needs information on their solvency, the authority to supervise them, control and the ability to resolve failing institutions.

The principal arguments against a banking union are that:

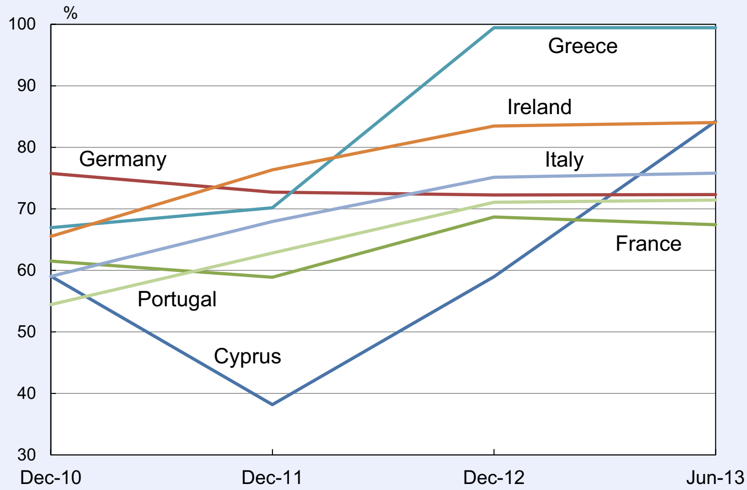
- It is effectively not an insurance scheme, but an ex-post mutualisation of write-off losses of banks resulting from funding near bankrupt states and dubious real-estate projects in southern Europe and Ireland; while it is officially argued that the banking union will exclude the socialisation of write-off losses on legacy assets, such a socialisation may, in fact, have been the true reason why policymakers have recently pressed so urgently for the banking union.
- It places too much power and responsibility in the hands of the ECB, which itself is the largest creditor of the endangered banks. Having contented itself with below-investment grade collateral, the ECB will therefore seek resolution methods that shift the burden of write-off losses onto the taxpayers of the still-solvent states of the euro area.
- As the banking union promises even more mutualisation of bank debt in the future, it will artificially dampen interest spreads below differences in bankruptcy risks and encourage zombie banks to buy even more government bonds and zombie governments to unload even more debt on their local banking sectors, as both know that they can shift their problems onto other shoulders if necessary. This will further strengthen the problematic link between banks and their sovereigns.
- As the ECB is a technocratic institution that gives small and large countries the same weight in the ECB Council, it is likely to come up with biased resolution decisions, which necessarily imply a fiscal redistribution of wealth between the countries of the euro area that, if anything, would have been a genuine task of parliaments.

The argument that weak sovereigns and fragile banking systems have become too closely connected has been made repeatedly and evidence for it has accumulated since 2010. In cases where member states have bailed out their banking systems, the ensuing increase in their national debt has worsened or totally destabilised public finances. Ireland is a prime example: When it bailed out its banks in 2009 and 2010 national debt rose from 44.2 percent of national income at the end of 2008 to 91.2 percent at the end of 2010. Bank failures and publicly-funded recapitalisations have also worsened the public debt problems of Greece. The public finances of Cyprus were overwhelmed by the costs of re-organising and recapitalising its banks in 2012. Meanwhile, the government of Spain is refusing to accept EU funds to recapitalise the banking system unless this can be done in such a way as not to affect the national debt.

Conversely, in member states whose sovereign bond yields have soared to great heights in the financial markets, commercial banks increasingly invested their funds in local government bonds during the crisis. As Figure 4.1 shows, the bank-held government bonds of the crisis countries were not primarily held in internationally diversified portfolios, but as a sample of the world's largest 64 banks shows, they were concentrated in the portfolios of the respective national banks and remained concentrated there to an even greater degree when the crisis struck. Greek government bonds, which like the government bonds of Portugal and Ireland have been given non-investment grades by the rating agencies, are practically no longer held by banks outside Greece nowadays.

Figure 4.1

Shares of government bonds held by domestic banks



Source: European Banking Authority, EU-wide Transparency Exercise 2013 Summary Report, p. 13.

However, the problematic kind of symbiosis between banks and sovereigns goes further than is commonly reported. While sovereigns bail out the banks, and banks hold government bonds in exchange, the banks then typically use these government bonds as collateral when borrowing the funds they need for buying the government bonds from their national central banks. Thus, in fact, there is not only a bilateral link between banks and their sovereigns, but also a link between both of them and the respective national central banks, which are state-owned institutions. Due to the sharing of income from monetary operations, the potential write-off losses from lending to insolvent banks are, however, socialised among the participating central banks of the Eurosystem, and hence among the national governments entitled to collect the national central banks' profit distributions.

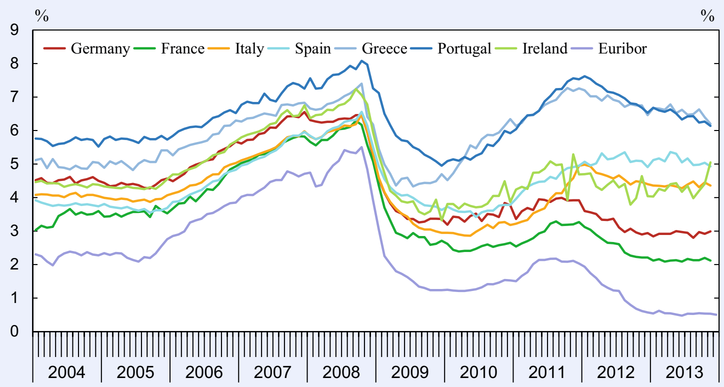
Despite this socialisation, the direct link between the banks and their own sovereigns has implied that the cost of borrowing faced by households and firms has risen in line with the interest on state bonds. This has led to higher borrowing costs for the private economy in the periphery than in the core, further deepening the recession there. The ECB has interpreted this phenomenon as an indication that its monetary policy is not transmitted effectively to the member states and used this failure as an argument to further expand the socialisation of risk by reducing the collateral requirements for its refinancing credit below investment grade. This, in turn, led to the huge TARGET2 imbalances that peaked at one trillion euros in summer 2012 (compare Sinn, 2014).

The linkages between the perceived financial robustness of governments and the borrowing costs of banks in the same country are illustrated by differences in interest rates on loans to businesses across the euro area in Figure 4.2. Before the crisis, in 2007, the gap between the highest rates (Portugal) and the lowest (France) was around 2 percentage points. In 2013 this gap was around 4.5 percentage points, with Greece and Portugal having the highest rates, while France remained the lowest. This data does not convey the full extent of the differences in credit conditions between euro area members, because it does not reveal the differences in the availability of loans, or the conditions under which loans were granted to businesses (as shown by the strength of their "business case" for the loan, for example).

The same message is conveyed by data on credit default swaps (CDS), where there is a striking similarity between government CDS spreads and banks' CDS spreads. Some data are provided in Figure 4.3. In May 2012, CDS spreads on Spanish and Italian govern-

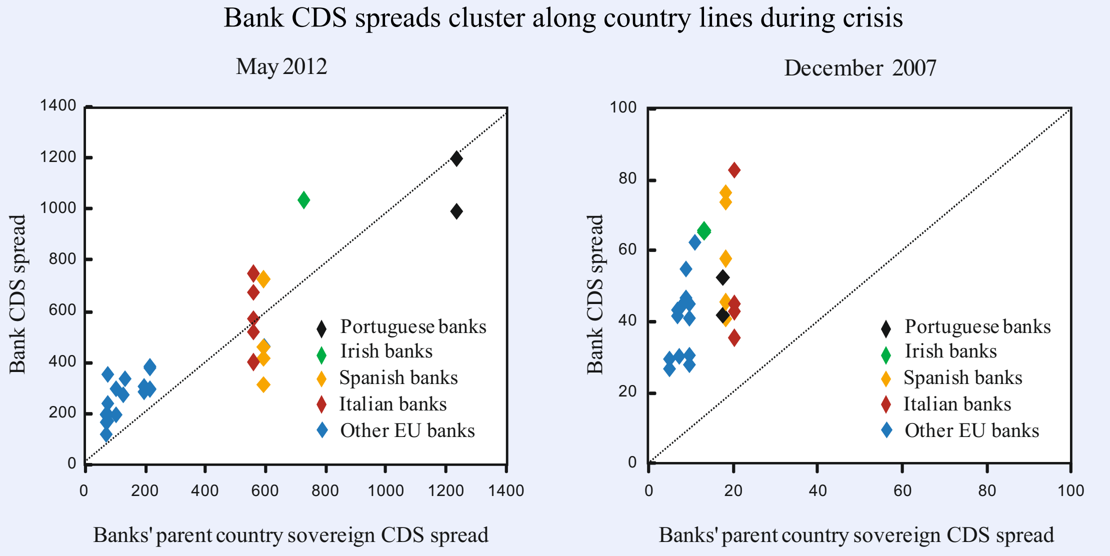
Figure 4.2

Interest rates on loans to businesses
in selected countries of the euro area[a)]



[a)] New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 19 January 2014.

Figure 4.3



Source: Dell'Ariccia et al. (2013).

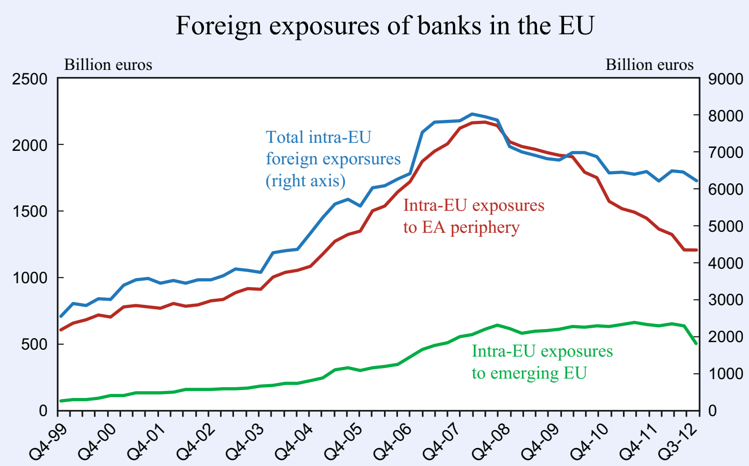
ments were just under 6 percent, and the CDS spread on banks in those two countries ranged between 4 percent and 8 percent, for Ireland the figures are 7 percent for government and 10 percent for banks, and for Portugal about 13 percent for government and 10–12 percent for banks. For Greece the figures were much higher. For other euro area countries (not facing public debt problems) the sovereign spreads were below 2 percent and the bank spreads below 4 percent. This contrasts with the pre-crisis situation in December 2007 when sovereign CDS spreads were low – all less than 0.2 percent – and the banks' spreads ranged from 0.25 percent to 0.85 percent.

More detailed analysis of the effects of the financial crisis on the costs and availability of funding for euro area banks is provided by van Rixtel and Gasperini (2013). Their data and analysis reinforce the message summarised here, namely that the gap between the highest and lowest costs of funds for banks across euro area states, and similar gaps in the costs of borrowing for their customers, have widened substantially since the financial crisis.

The variations in funding costs for banks, households and small firms across the euro area reflect the tendency of markets to differentiate between borrowers by their repayment probabilities, reversing the initial period of reckless lending and borrowing in neglect of the bankruptcy risks. It is revealed by the fall in cross-border exposure of banks in the EU since 2008 (see Figure 4.4). There has been a bigger percentage fall in intra-EU exposure to euro area periphery countries than in overall foreign exposures or exposure to emerging-EU countries.

Many commentators have remarked on the trend towards fragmentation in the euro area's financial markets. The *Financial Times* has argued that debt deleveraging will continue to hamper the euro area's recovery, as will its financial "Balkanisation," or the retreat of banks behind national borders, with large differences in interest rates paid by households and compa-

Figure 4.4



Source: Dell'Ariccia et al. (2013).

nies in various member states.[4] The euro area, says the *Financial Times*, remains a story of the "periphery" versus the "core." ECB president Mario Draghi was quoted as saying that:

> "Fragmentation is basically a little better than it was four months ago, but rather than observing dramatic improvements month by month, we are observing, by and large, a static situation."

The view of the European Commission is that:

> "Swift progress towards a banking union is indispensable to ensure financial stability and growth in the euro area and in the whole internal market. It is a crucial step to overcome the current financial fragmentation and uncertainty, to ease funding conditions for vulnerable sovereigns and banks and break the link between the two, and to re-launch cross-border banking activity in the internal market to the benefit of both euro area and non-euro area member states. Building on the regulatory framework common to the 28 members of the internal market (single rulebook), the European Commission has therefore taken an inclusive approach and proposed a roadmap for the banking union with different instruments and steps, potentially open to all Member States but in any case including the 18 currently within the euro area." (European Commission, 2013)

Failures of cross-border banks and their resolution have highlighted the weaknesses of handling these issues at national level, when it is necessary to coordinate the actions of separate national regulatory authorities and find agreement on the distribution of the costs of resolution.

4.2.1 Complex and cross-border bank resolutions

The serial bailouts of Dexia provide an example of the problems for the authorities created by cross-border banks, the weakness of stress tests, and the difficulties of unravelling the complexities of the balance sheets of such institutions. Dexia, once the world's largest lender to municipalities, has been bailed out three times, in 2008, 2011, and 2012. In 2008, it had a balance sheet of 650 billion euros, including 125 billion euros in exposure to the United States sub-prime property market. To bolster Dexia's balance sheet, Belgium, France and Luxemburg injected 6.4 billion euros of capital. Further euro area debt problems led the same three countries to rescue Dexia again in 2011 with guarantees of 90 billion euros, following difficult negotiations between France and Belgium over the share that each would provide.[5] Despite its exposures to Greece, Portugal, and other governments, Dexia passed stress tests in July 2011 with flying colours. Its Tier 1 capital ratio was 10.3 percent, whereas the required ratio at that time was 6 percent. In November 2012, however, France and Belgium added 5.5 billion euros of additional capital. At the end of 2012 Dexia still had substantial exposures to various governments: France 8 billion euros, Italy 38.4 billion euros, Spain 24 billion euros, and the United States and Canada 35 billion euros. By July 2013, France had lost 6.6 billion euros on the Dexia bailouts (according to the *Financial Times*). It appears that in 2008, Dexia had reclassified 100 billion euros of trading assets as loans so that it did not have to mark them to market, hoping to hold them to maturity and avoid losses, meanwhile increasing the apparent strength of its balance sheet. But this did not occur. A 2013 report by the Cour des Comptes, the national auditor of France, is highly critical of Dexia's supervisors, firstly for their failure to anticipate the risks that Dexia faced, and subsequently for their failure to address the problems they found.[6]

The bailout of Fortis, which operated in Belgium, the Netherlands, and Luxemburg, is another example of the problems of cross-border resolutions.[7] Fortis emerged as an enormous banking, investment management and insurance conglomerate following a spate of mergers and acquisitions in the 1990s and 2000s, with a share value of 46 billion euros in 2006 according to *Forbes Magazine*. It was undermined by the costs of acquiring part of ABN-AMRO Bank in 2007. The Benelux countries put in 11.2 billion euros of capital and substantially nationalised the bank. Later, amid acrimonious disputes among shareholders and the governments involved, the bank was broken up and various parts of it were sold off.[8]

[4] R. Atkins (2013), "Eurozone: 'Balkanisation' Remains a Serious Concern for Currency Bloc," *Financial Times*, 20 November, http://www.ft.com/intl/cms/s/0/526bcafe-47a1-11e3-9398-00144feabdc0.html#axzz2r8K9YOR2.

[5] S. Neville (2012), "Belgium and France Take Control of Dexia," *The Guardian*, 8 November, http://www.theguardian.com/business/2012/nov/08/france-belgium-dexia.

[6] H. Carnegy (2013), "France's Losses on Dexia Bailout Hit €6.6 billion," *Financial Times*, 18 July, http://www.ft.com/cms/s/0/ff693d70-efb5-11e2-8229-00144feabdc0.html#axzz2oCYnJfYC.

[7] N. Tait (2010), "IMF Seeks Bank Crisis Agency," *Financial Times*, 20 March, http://www.ft.com/cms/s/0/7b3bf52e-33c0-11df-8b99-00144feabdc0.html#axzz2oCYnJfYC.

[8] A long and thoroughly referenced article in *Wikipedia* provides intricate detail of these disputes, http://en.wikipedia.org/wiki/Fortis_%28finance%29,accessed on 22 December 2013.

4.2.2 Lessons from the Spanish experience

The experience of Spain with the failure and recapitalisation of several savings banks – the Cajas – in 2012 illustrates the problems of having regulators who are too close to the institutions they regulate. Political pressures discouraged the Banco de Espana from acting more promptly; and the problem had grown much worse by the time it eventually did take action (Wyplosz, 2012).

The Spanish banking group Bankia collapsed in May 2012, by which time Spain was not able to borrow from the markets, forcing it to seek European help. Had the problems emerged sooner, when Spain had a low debt to GDP ratio, it would not have been necessary to resort to outside help. "The three most problematic Cajas (Bankia, CatalunyaCaixa and Novagalicia) had capital deficits (to be covered partly or fully by the taxpayer) of 54 billion euros – over 5 percent of Spanish GDP[...]" (Garicano, 2012). An external report by management consultants Oliver Wyman showed that the Cajas covered up losses through 2008, 2009, and 2010. A succession of failures starting in March 2009 revealed bigger losses than had been reported. Nevertheless, the Banco de Espana did not investigate the whole savings bank system. Garicano (2012) proposes four explanations: (i) Regulators do not like to expose their own previous errors; (ii) Dynamic provisions, while good for dampening cyclical fluctuations, enabled the losses to be concealed for longer, and the provisions were not actually big enough, amounting to only 3 percent of GDP at the height in 2004; (iii) Spain did not have an appropriate resolution framework until summer 2012; (iv), the main reason in Garicano's view, is the political control of the cajas: "[...] the supervisor, confronted with powerful and well-connected ex-politicians, decided to look the other way in the face of obvious building trouble."

The experience of the Spanish banks and Dexia shows that regulatory agencies tend to be close to bank interests and often do not operate in line with taxpayers' best interests. When banks have branches in various countries they need to be supervised by an international agency that operates under strict democratic control to protect the electorate against write-off losses. Experience also shows that supervision and resolution have to go hand-in-hand.

The European decision to introduce a banking union has largely been pre-empted by the ECB Council's decision to act as a lender of last resort to troubled banks in the euro area, helping them by underbidding the interbank market with refinancing credit at conditions in terms of maturity, interest rate and collateral requirements at which private banks were unwilling to offer interbank credit. TARGET2 balances accumulated as a result that peaked at 1,000 billion euros in summer 2012 in the GIPSIC countries,[9] as we reported in our previous reports (EEAG, 2012; EEAG, 2013). By its own statutes and the Maastricht Treaty, the ECB was not intended to be a lender of last resort; it was intended not to provide banks with implicit bailout insurance and not to encourage excessively risky behaviour. However, when the crisis came, it bailed out the banks and their sovereigns to avoid the bankruptcies that would otherwise have occurred. Taking these much disputed prior decisions as given, it is understandable that the ECB now wants to supervise the banks to minimise its own investment risk. While the potential write-off losses would be fully socialised among the euro countries because they would reduce the seignorage from monetary policy operations, the ECB certainly does not want its balance sheet to be fraught with the consequences of failed bailout operations. However, the ECB cannot perform the supervisory function effectively, because it has too little information about banks' situations; and it has no authority to close down or restructure insolvent banks.

> "Intervening as lender of last resort, the ECB would provide money without any control." (Wyplosz, 2012)

This may lead to a tragedy of the commons.[10] The national authorities have an incentive to delay acknowledging that banks are in trouble as long as possible, inviting the central bank to provide cheap refinancing credit to mitigate what appears to be a mere liquidity crisis. After the rescue, the liquidity crisis turns into a solvency crisis, but as the ECB has already been dragged in, the foreseeable write-off losses have already been socialised either directly, via the ECB's system of profit sharing, or indirectly via fiscal rescue schemes like the EFSF or ESM bailing out states, which bail out local banks and protect the ECB as their main creditor. Spain is an example of this sequence of events.

In the early stages of the development of a banking union, during 2012, plans for a single supervisory mecha-

[9] GIPSIC countries include Greece, Ireland, Portugal, Spain, Italy and Cyprus.
[10] Compare Blankart (2012), Tornell and Westermann (2012), and Wyplosz (2012).

nism and a common regulatory regime met with general acceptance, while a single resolution mechanism seemed much more controversial, ran into greater opposition, and seemed far less likely to get off the ground. Some commentators feared that a half-baked banking union might emerge. They argued that a partial banking union may be worse than no union at all (Wyplosz, 2012). For example, in a situation where there is only a supervisor who only looks at large banks and no resolution authority or deposit scheme, a public debt restructuring would lead to bank failures, and the ECB would incur write-off losses from lending to local banks without having been able to constrain these banks' actions.

Basically, there are two ways out of the common pool problem. Either the Eurosystem's degree of loss socialisation is reduced or central control is enhanced. The former would imply a return to the system of harder budget constraints intended by the Maastricht Treaty whereby the ECB stops bailing out banks and their sovereigns with cheap refinancing credit provided to banks collateralised with below-investment grade government bonds. TARGET2 balances would be settled, in such a way that interest differentials would emerge reflecting differences in bankruptcy probabilities, and markets would be responsible for the allocation of capital to rivalling risky assets. Alternatively, the policy of undercutting market conditions to eliminate risk premia in interest rates would continue, but constraints would be imposed on banks and their sovereigns to prevent moral hazard, to ensure prudent lending and borrowing and to steer the allocation of scarce capital to rivalling uses. Intermediate solutions would, of course, also be possible.

The euro area countries, meanwhile, have agreed to lean very much towards the second option. The ECB will continue to act as a lender of last resort, but it will also act as a single regulator, supervisor and resolution authority. In addition, there will be a common deposit insurance system. Setting the new system up requires a transferal of powers from member states to the euro area authorities, which will imply the transfer of resources between countries. A revision of the Maastricht Treaty may possibly be needed to achieve this.

4.3 Banking union in the context of European Union policy interventions since the financial crisis

Proposals for a banking union emerged in 2012 after a long series of initiatives by the European authorities to address problems arising from the global financial crisis, the long recession that followed it, and the persistent problems of bank failure and unsustainable public debt in the euro area.

There have been four groups of initiatives. Firstly, schemes for lending to – or bailing out – governments that face problems with borrowing in capital markets; secondly, schemes for improving the supervision and regulation of financial markets; thirdly, attempts to revive the surveillance and coordination of fiscal policies; and fourthly, replacement lending by the ECB in terms of buying government bonds and providing refinancing credit at increasingly low collateral standards.

To assist euro area member states in financial difficulty, two temporary programmes were established, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), succeeded in October 2012 by the European Stability Mechanism (ESM), which has been set up as a permanent mechanism, enshrined in the Treaty Establishing the ESM and in a change in the EU Treaty, and is able to lend up to 500 billion euros. The ESM has so far agreed to loan 9 billion euros to Cyprus as part of a 10 billion euro package in May 2013, and 100 billion euros to Spain for the recapitalisation of its banking industry, agreed in late 2012, of which only 41.4 billion euros have been drawn to date. Previously the EFSF and EFSM had made loans, generally as part of larger support packages. These loans include 144.6 billion euros in EFSF loans to Greece made from 2010 onwards, loans to Ireland of which 17.7 billion euros came from the EFSF and 22.5 billion euros from the EFSM in 2010, and loans to Portugal of 26 billion euros each from the EFSF and the EFSM (parts of a 78 billion euro loan package agreed in 2011).[11]

At the same time as the establishment of these loan facilities for distressed governments, there has been a sequence of initiatives intended to improve banking supervision and regulation. In 2010, a European Systemic Risk Board was set up to deal with macroprudential regulation, and three new European Supervisory Authorities (ESAs) were founded to deal with micro-financial supervision: the European

[11] *Wikipedia* has an informative and thoroughly referenced article on the various European rescue schemes (EFSF, EFSM, and ESM) and the loan packages that have been agreed, which can be accessed from http://en.wikipedia.org/wiki/European_Stability_Mechanism; compare also Ifo Institute (2014), *The Exposure Level – Bailout Measures for the Eurozone Countries and Germany's Exposure*, http://www.cesifo-group.de/ifoHome/policy/Haftungspegel.html.

Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).[12] Together these authorities form the European System of Financial Supervision (ESFS). Meanwhile, banking regulation is being changed by the introduction of the Basel III capital requirements. The Basel III global regulatory standards on bank capital adequacy and liquidity were issued in December 2010. Based on these standards, the European Commission published a new Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) in June 2013. Financial institutions will be required to apply the new rules from 1 January 2014, with full implementation on 1 January 2019. The EBA will be heavily involved in ensuring the implementation of the CRR and the CRD IV.

To address the issues that lead to high public debt in the first place, the EU has developed a Fiscal Compact to revive and reinforce the old Stability and Growth Pact (SGP), to reinforce the surveillance and monitoring of public deficits by the EU authorities, to improve coordination of fiscal policies, and to limit the size of deficits (European Council, 2012). This came into effect on 1 January 2013 for the 16 countries that had ratified it by that point, and for other countries on the date when they actually ratified it. Compared to the old SGP it imposes a tighter definition of a balanced budget, is more explicit about the speed at which an excessive level of public debt has to be brought down, and requires member states to establish an independent fiscal advisory council to keep the deficit under surveillance and guarantee that their fiscal position are in balance or in surplus, by the definition used in the treaty.

At the same time as these structural changes were introduced, the ECB has tried to ease monetary conditions in the crisis countries, to mitigate their recession, to keep inflation from going negative (thus slowing down or preventing the necessary realignment of relative prices), to ease liquidity and funding problems faced by the banks, and to make it easier and cheaper for governments to borrow. The ECB lending rate was brought down to almost zero in the wake of the financial crisis and has remained there. Long Term Refinancing Operations have been used to make banks more independent from the capital market. The balance sheet of the ECB has been increased several-fold, paralleling the effects of similar actions undertaken by the US Federal Reserve and the Bank of England. A relocation of refinancing credit through an aggressive collateral policy has reshuffled funds from those member states with an excess, mainly in northern Europe, to those with a shortage, mainly in the south (Sinn and Wollmershaeuser, 2012; Sinn, 2012 and 2014), via the bailout of banks and their sovereigns with public international credit.

Finally, in September 2012, the ECB announced that it would be willing to use Outright Monetary Transactions (OMTs) to buy the public debt of euro area members receiving assistance from ESM programmes in secondary markets under certain conditions and in potentially unlimited amounts. Before this announcement, yields on the debt of financially weak euro area sovereigns like Italy, Portugal, Spain and Greece, had periodically risen to high levels, typically after some piece of news had alarmed the markets, giving rise to fears that the public debt and banking crises may re-intensify. Repeated assurances from the European authorities were not able to quell such fears. There had been much talk of the EU needing a "big bazooka" to fend off any conceivable speculative attack on its public debt markets and banking systems. The OMT announcement finally achieved the desired effect of calming markets by offering investors free-of-charge CDS-like insurance when buying government bonds, and has continued to maintain stability.[13] Following the insurance offer, yields on Italian and Spanish government debt immediately fell to their lowest level for several months.

Despite all these efforts, problems remain. The measures outlined above leave much of the work of banking supervision and regulation in the hands of national regulators. The cost of recapitalising or winding-up, or of resolving failed banks by some other means, remains at the level of EU member states. There is a growing belief in the crisis countries that this is not satisfactory.

4.4 Proposals and political progress with banking union

4.4.1 Supervision and regulation

Official proposals for a banking union emerged from the European Council and the euro area summit meeting on 28–29 June 2012, and more detailed plans were set out by the European Commission in September 2012 when

[12] Council of European Union, "Financial Supervision: Council Adopts Legal Texts Establishing the European Systemic Risk Board and Three New Supervisory Authorities," *PRESSE 303* 16452/10, Brussels, 17 November 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf.

[13] This is seen as remarkable in some quarters, as not a shot has yet been fired.

the SSM was proposed (European Commission, 2012). The essence of this proposal was the plan that the ECB should have "ultimate responsibility for all specific supervisory tasks related to the financial stability of all euro area banks."[14] The proposal envisaged that national supervisors would "continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions." At the same time, the Commission proposed that the EBA should develop a Single Supervisory Handbook "to preserve the integrity of the single market and ensure coherence in banking supervision for all 27 EU countries."

The Commission set out an ambitious timetable for implementing a banking union, aiming for the Council and Parliament to adopt the plan by the end of 2012. According to this timetable, the SSM would have been in place by 1 January 2013, with the ECB able to "decide to assume" supervisory responsibilities over any credit institution, "particularly those which have received or requested public funding;" from 1 July 2013 all banks of major systemic importance should have been supervised by the ECB; and, from 1 January 2014, this mandate should have been extended to banks of all sizes.

The proposals gave the ECB very wide-ranging responsibilities and powers:

> "The ECB will become responsible for tasks such as authorising credit institutions; compliance with capital, leverage and liquidity requirements; and conducting supervision of financial conglomerates. The ECB will be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action."

In the event these proposals were not put into effect according to the Commission's timetable. They were finally agreed in October 2013, and the ECB will assume ultimate responsibility for supervision of all euro area banks on 4 November 2014 (European Union, 2013a). The ECB will directly supervise the largest and most internationally active banks, with the option to take over direct supervision for the others in cases where it believes this to be appropriate, while the national authorities will be in charge of the day-to-day supervision of smaller banks. The banks under direct ECB supervision are those with assets worth over 30 billion euros, those whose assets exceed 20 percent of the host country's GDP, those located in a country that has requested or received assistance from the EFSF or ESM, or those which are among the three largest financial institutions in a country.

[14] European Commission (2012), "Commission Proposes New ECB Powers for Banking Supervision as Part of a Banking Union", *Press release* IP/12/953, Brussels/Strasbourg, 12 September, http://europa.eu/rapid/press-release_IP-12-953_en.htm.

While the SSM appears to give the ECB many powers that were previously held by the EBA, the EBA is to continue to exist, and it will be responsible for developing the "single rule book" that will guide the regulation and supervision of banks in the euro area. The European Parliament and the Council of the European Union have passed a regulation amending the role of the EBA and setting out its interactions with the ECB with its new roles (European Union, 2013b).

4.4.2 The Single Resolution Mechanism

In July 2013 the Commission proposed a procedure for resolving – winding-up – failed banks with a "Single Resolution Mechanism" (SRM) and a "Single Bank Resolution Fund" (SRF), see European Commission (2013). The Commission argues that the SRM will bring important benefits, as compared with a network of national procedures and funds. They argue that:

- Strong central decision-making will ensure rapid and effective decisions being made, avoiding uncoordinated action, minimising negative impacts on financial stability, and limiting the need for financial support;
- A centralised pool of bank resolution expertise and experience will deal with bank failure better than individual national authorities with fewer resources and experience;
- The SRF will pool resources across countries and protect taxpayers better than national funds, and provide a level playing field across participating member states;
- The SRF sidesteps problems of coordinating the use of national funds;
- The SRF eliminates the dependence of banks on sovereign creditworthiness.

It is proposed that the SRM commences operations in January 2015. The proposed legal basis for the SRM is Article 114 of the Treaty on the Functioning of the European Union (TFEU), "which allows for the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the internal market."

Under the proposal, a Single Resolution Board (SRB) will be set up to prepare and monitor resolution decisions centrally, which, it is asserted, will command the confidence of member states that the resolution process is of a high quality and is impartial (particularly as regards the local effects of resolution decisions). The resolution process will be initiated by the European Commission.

The Commission argues that its proposal satisfies the principal of subsidiarity because resolutions of failing banks create spillovers across national boundaries. Undertaking them at the European level allows such resolutions to be performed consistently across countries, following the same set of rules, and internalises what would otherwise be external effects (spillovers). It is claimed that the SRM will be able to exploit economies of scale not available to national procedures; and that national resolution procedures that may differ from one member state to the next might undermine the stability and integrity of the single market.

> "Whilst the establishment of the Single Supervisory Mechanism ensures a level playing field in the supervision of banks and diminishes the risk of forbearance, the SRM ensures that when a bank failure occurs, restructuring can be carried out at the least cost, creditors receive fair and equal treatment, and funding can be quickly deployed to its most productive use across the internal market."

The proposal contains provisions for resolving an institution by (i) selling all or part of it to another viable institution (the sale-of-business tool); selling part of the resolved institution temporarily to another (the bridge institution tool), typically creating a "good bank;" (iii) selling impaired assets to a public body to manage them (the asset-separation tool), typically the case of the "bad bank;" (iv) bailing-in creditors of the institution (the bail-in tool); that is, imposing losses on shareholders, bondholders, depositors (those deposits that are not protected by the 100,000 euro deposit guarantee schemes) and other creditors.

The intention to "bail-in" creditors has been loudly trumpeted. It is cited as a means of eliminating or reducing the costs to taxpayers and reducing moral hazard, improving the incentives of the owners of and lenders to banks to more closely monitor the latter's activities, and encouraging banks to take fewer risks, as their cost of capital will become more sensitive to the riskiness of their portfolios. The cost of resolution should to be borne by the creditors of the failed institution and the banking sector. The Commission, the SRB and the national resolution authorities should organise bank resolutions so as to minimise the need for extraordinary public support.

However, the bail-in tool is hedged about with restrictions that may, in practice, limit its usefulness. Losses will be imposed on creditors in reverse order of seniority, which is unexceptionable; but several classes of creditors are automatically exempted from bail-in. These classes include: covered deposits; secured liabilities including bonds; liabilities to employees in the form of wages, salaries and pension benefits; commercial claims for goods and services critical for the daily functioning of the institution; liabilities to a payments system with a remaining liability of seven days; and inter-bank liabilities with an original liability of less than seven days. Furthermore, additional liabilities may be excluded in exceptional circumstances. The question is: what fraction of the institution's liabilities can be bailed-in? Will there be sufficient funds to absorb the losses on the asset side and resolve the institution without needing outside assistance?

Implicit in the Commission proposal is that at least 8 percent of an institution's total liabilities and own funds should be available to be bailed-in.[15]

[15] The availability of sufficient own funds and aggregate liabilities for bail-in is mentioned at least three times – on two of which occasions the figure of 8 percent is given – in the Commission's proposal of 10 July 2013 for the SRM and SRF (European Commission, 2013):

(i) In the Explanatory Memorandum, page 13, is the following paragraph: "The primary objective of the Single Resolution Fund is to ensure financial stability, rather than to absorb losses or provide capital to an institution under resolution. The Fund should not be considered as a bailout fund. There might be however exceptional circumstances where, after sufficiently having exhausted the internal resources (at least 8 percent of the liabilities and own funds of the institution under resolution), the primary objective could not be achieved without allowing the Fund to absorb those losses or provide the capital. It is only in these circumstances when the Fund could act as a backstop to the private resources."

(ii) In the preamble to the proposal, paragraph 45 states that: "To avoid institutions structuring their liabilities in a manner that impedes the effectiveness of the bail in tool, the Board should be able to establish that the institutions hold an aggregate amount of own funds, subordinated debt and senior liabilities subject to the bail-in tool expressed as a percentage of the total liabilities of the institution, that do not qualify as own funds for the purposes of Regulation (EU) No 575/2013 of the European Parliament and of the Council16 and of Directive 2013/36/EU of 26 June 2013 of the European Parliament and of the Council17, which institutions should have at all times."

And (iii) in the proposed regulation itself, Part II, Title 1, chapter 3, Article 24, paragraph 7 provides "The [Single Bank Resolution] Fund may only make a contribution referred to in paragraph 6 provided that the contribution meets both the following criteria: (a) a contribution to loss absorption and recapitalisation equal to an amount not less than 8 percent of the total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 17, has been made by shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise; (b) the contribution from the Fund does not exceed 5 percent of the total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 17."

Nevertheless, resolution will sometimes require funds that the failed institution itself and its creditors are unable to provide. To meet these needs, the Commission proposes a SRF so that any costs incurred in connection with the use of the resolution tools that are not borne by the shareholders and the creditors of the institution under resolution will be borne by the financial industry. The Commission is at pains to emphasise that the Fund is not supposed to be a bailout fund, but is only there to ensure financial stability, not to absorb losses or provide capital to an institution that is being resolved. The argument is that the existence of a fund that can, if necessary, provide a back-stop for dealing with a failed institution, removes the danger of contagion from one institution to another, and from one member state to another. This positive spillover effect of the fund provides a justification for its being based on contributions from all of the participating member states. Pooling resources in the fund also allows for a much bigger fund to be amassed and provides better insurance. The proposal states that:

> "Since losses from any future shocks in the banking industry are likely to be concentrated at a specific moment of time in some Member States, a common European private backstop mechanism, as opposed to national backstops taken individually, will be more effective in absorbing such shocks through ex-ante and, in extreme cases, ex post contributions from the whole Euro-area banking industry. Therefore, by pooling resources at the European level, the Fund will provide a bigger "firepower" and will increase the resilience of the banking system. At the same time, spreading extraordinary ex-post contributions evenly across banks in all participating Member States will reduce the level of such contributions for each bank, limiting any pro-cyclical effect of such contributions.
>
> Moreover, a mechanism where loss absorption reaches beyond national borders can effectively break the vicious circle of the interdependence between the banking crisis in a given Member State and the fiscal position of the sovereign. In this manner, the current burden on some Member States would have been mitigated if a Single Resolution Fund had existed since the start of the financial crisis."

The intention is that the fund will hold at least 1 percent of the covered deposits in the banking system of the participating member states. The Commission argues that this should be sufficient, provided that creditors are bailed in to the extent of at least up to 8 percent of the total liabilities and own funds of the institution under resolution. This would correspond to a fund of around 55 billion euros, based on 2011 data on banks and an estimate of covered deposits in the euro area. The Commission envisages a 10 year transitional period before the fund reaches its target level, possibly up to 14 years if it has to make large disbursements in the interim period. This means annual contributions from the banking industry to the fund of around 5.5 billion euros a year. After the build-up phase, the banks would have to make contributions as their contribution basis grows or if the fund is whittled away by disbursements.

> "[…] Contributions will be calculated in line with the Bank Recovery and Resolution Directive on the basis of banks' liabilities excluding own funds and covered deposits, and adjusted to their risk profile. This means that banks which are financed almost exclusively by deposits will in practice have very low contributions. Of course, these banks will contribute to national deposit guarantee schemes."

While many of the features of the Commission's proposal described above have survived negotiations among member states and the Commission in December 2013, and are likely to survive further negotiations with the European Parliament in 2014, the proposals for providing funding for bank resolutions before the SRF is fully established (which will not be until 2026), and the proposed procedures for arranging a resolution, were the subject of much debate and argument. An agreement was reached on 18 December 2013.[16]

In the ten-year period between 2016 and 2026, while the SRF is being accumulated, the funding of bank resolutions (beyond what can be achieved by bailing-in shareholders and other creditors) will fall partly on (a) the resolution fund of the country in which the resolved bank is located, and partly on (b) the collective resolution funds of all the other member countries of the SRM. The proportions will gradually shift from (a) to (b) over the ten year period. At the end of the period, the separate national funds (or

[16] Council of the European Union (2013), "Council Agrees General Approach on Single Resolution Mechanism," *PRESSE* 564, 17602/13, Brussels, 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf and European Commission (2013), "Commissioner Michel Barnier's Remarks at the ECOFIN Council Press Conference," *MEMO* 13/1186, Brussels, 19 December, http://europa.eu/rapid/press-release_MEMO-13-1186_en.htm?locale=en.

compartments, as the official documents describe them) will no longer exist, and the fund will be fully mutualised.

The SRF may, of course, not be big enough to cover the costs of bank resolutions, not only during the build-up period 2016–2026, but also in the steady state thereafter. Where then will the resources be found? A so-called back-stop to the SRF is needed, and the form it should take was one of the hotly contested issues at the December 2013 ECOFIN meetings. The plan is that, during the build-up period, financing will come from "national sources backed by levies on banks, or from the European Stability Mechanism, in accordance with agreed procedures."[17] During this ten-year period, a common backstop will be developed, which will come into operation "at the latest after 10 years," and which will allow the SRF to borrow, and recoup the costs by imposing more levies, including ex-post levies, on the banking sector.

How will bank resolutions be triggered? Who gets to decide on the form of resolution (i.e., whether it involves splitting an institution into bad and good banks, selling off all or parts of it to other banks, winding it up, and bailing-in creditors)? And who pays? The proposed mechanism seems baroque and cumbersome. The resolution of a bank can be triggered either by the ECB notifying the SRB that a bank is failing or is likely to fail, or by the SRB itself; and the SRB will then draw up a scheme for carrying out the resolution. Decisions by the SRB will come into force within twenty-four hours of their adoption. However, the Council of the EU is able to object to or demand changes.

The proposed SRB itself is a complex body. Most resolution plans would be drawn up by a relatively small body, the "executive session" of the SRB, consisting of the executive director, four full-time appointed members, and representatives of the member states involved in the resolution. If, however, the resolution was big enough, then the "plenary session" of the SRB would be responsible for the decision; and a two-thirds majority of board members representing at least 50 percent of contributions (to the SRF) would be required.[18]

According to current plans, the SRM will come into force on 1 January 2015 and its provisions for bailing-in bank creditors and resolving failing banks will apply from 1 January 2016. What happens in the period before 1 January 2016? In this period, the resolution of failing banks and the problems revealed by the ECB Comprehensive Assessment will fall on national resources, and countries will be able to apply for assistance from the ESM "in accordance with agreed procedures."

4.5 Issues, problems and controversies

Following the agreements reached on the SRM and the SRF in December 2013, the media and commentators have been quick to assess the European Banking Union as an unwieldy affair, a typical European compromise, and at best, a partial success. The long transitional period (until 2026), before the costs of resolution will be completely mutualised, partly addresses the legacy issue. It delays the ex-post separation of the banking sector from the state of the public finances, but encourages the separation insofar as it reduces the possibilities of national governments selling their debt to their domestic banking sectors, thus making it a community problem that would later have to be solved with international fiscal transfer schemes aimed at stabilising insolvent states to avoid the losses from bank recapitalisations. The resolution procedure is complex, slow, and involves too many people. The SRF is tiny, and the ability to impose losses on bank creditors is limited by the long list of exemptions from bail-in.

4.5.1 Legacy problems

One of the issues that plagues the set-up of a banking union is the existence of undiscovered problems (non-performing loans, asset portfolios that have fallen greatly in terms of value etc.) in the balance sheets of euro area banks, problems that exist prior to the date

[17] Council of the European Union (2013), "Council Agrees General Approachon Single Resolution Mechanism," *PRESSE* 564, 17602/13, Brussels, 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf. See also Council of the European Union (2013), "The Statement of Eurogroup and ECOFIN Ministers on the SRM backstop," 18 December, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140206.pdf.

[18] The SRB will feature an executive director, four full-time appointed members, and representatives of the National Resolution Authorities of all the participating countries. All these individuals will be involved in a plenary session of the SRB. "The plenary session would be responsible for decisions that involve liquidity support exceeding 20 percent of the capital paid into the fund, or other forms of support, such as bank recapitalisations, exceeding 10 percent of funds, as well as all decisions requiring access to the fund once a total of 5 billion euro has been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50 percent of contributions."

on which the banking union takes effect, and which will require banks to be re-capitalised, shut down, merged, or dealt with in some other way. There is a clear incentive for member states not to reveal such problems before the inception of a banking union, in which case they would have to pay for the costs themselves. On the contrary, they will have every incentive to keep quiet until a later date once the banking union is obliged to undertake the necessary resolution and the costs can be shared across the union. The legacy issues are the same as pre-existing medical conditions, which a new private medical insurance policy would refuse to cover. As Buch and Weigert (2012) observe:

> "Legacy problems obstruct the transition to a new long-run institutional structure in many ways. For example, enforcing the Fiscal Compact would require significant improvements in fiscal indicators in some countries. In addition, as long as banks carry non-performing assets on their balance sheets and as long as losses on these assets have not fully been acknowledged, introducing pan-European deposit insurance would amount to the introduction of an insurance system after the insured event has already happened. This would entail severe moral hazard problems. Hence, a consistent and credible framework for bank resolution and restructuring must be a core element of a banking union. Yet, progress towards financial sector reform to date has been slow, and key elements of the reform package are unlikely to be introduced in the near future. In this sense, "legacy" problems not only refer to debt overhang but also to delayed financial sector reforms."

The EU regulation establishing the SSM discusses legacy issues in some detail. In theory they will be dealt with by the asset quality review – The Comprehensive Assessment – undertaken by the ECB between late 2013 and October 2014 (European Central Bank, 2013). The assessment will include three elements: a supervisory risk assessment, an asset quality review and a stress test. The assessment will cover 130 institutions, which together account for 85 percent of euro area bank assets. The supervisory risk assessment will examine inter alia the banks' liquidity, leverage and funding. The asset quality review will examine asset valuations, the classification of non-performing loans, valuation of collateral, and provisions against losses. The stress test will be a forward-looking view of banks' ability to absorb various shocks and will be performed in collaboration with the EBA.

Following this Comprehensive Assessment, some banks may be required to take action. This includes recapitalisation, profit retention, issuing equity, re-orientation of funding sources, asset separation and sales of assets, as appropriate. Banks will be required to have a ratio of Common Equity Tier 1 capital of 8 percent of risk-weighted assets. As risk-weighted assets often only account for a fifth of all assets, given that banks' lending to other banks and government is privileged with risk weights of only 0.2 and zero respectively, this is an extremely soft constraint that cannot be expected to really lead to prudent banking.

The December 2013 agreement on the SRM and the SRF between the Commission and the Council makes clear that the costs of dealing with legacy problems should be met by the member states where the failing banks are located. In the period between 2016 and 2026 after the bail-in principle has begun to apply, but before the SRF is fully funded, the share of costs that are mutualised gradually increases, from zero in 2016 to 100 percent in 2026. If the states cannot bear the costs, they can borrow for that purpose from the ESM under the usual conditions: Borrowing countries will need to provide fiscal and structural adjustment plans and have them approved.

ECB President Mario Draghi has said that some banks need to fail the stress tests, to establish the tests' credibility.[19] There is much fighting talk about the rigour and transparency of the Comprehensive Assessment, but recent past experience with stress tests is not encouraging. On many occasions banks have passed with flying colours, as in the case of Dexia, detailed above, only to be felled soon afterwards by some unrevealed problem or unanticipated financial shock. The effectiveness of this Comprehensive Assessment in weeding out legacy problems will be essential if the suspicions of governments in northern Europe that the banking union is another means of passing the costs of bank failures in the southern periphery (Spain, Portugal, Greece, Cyprus, Italy, and Ireland) onto them are to be dispelled.

Estimates of the capital shortfall that might be revealed range between 50 billion euros and 600 billion euros (Merler and Wolff, 2013). These figures put the smallness of the SRF, and indeed the ESM, into perspective. If capital shortfalls turn out to be large and occur in countries that already have problems with

[19] M. Steen (2013), "Draghi's Blunt Warning on Bank Stress Test," *Financial Times,* 23 October, http://www.ft.com/cms/s/0/a27d75d0-3bb5-11e3-b85f-00144feab7de.html.

high public debt and deficits, they may cause more instability in the financial markets in the short and medium-term.

4.5.2 Need to build new institutions and capacity

New euro area institutions will be needed and additional capacity, as well as extra skilled personnel in supervision, regulation etc.

> "Creating a new pan-European supervisor 'from scratch' is a daunting task and a very expensive one too, especially given the EU's current state of fiscal finances. The infrastructure that needs to be put in place and the highly skilled employees that will need to be hired in such a short period of time should not be taken lightly." (Ioannidou, 2012)

The ECB needs to recruit several thousand people to staff its new departments responsible for supervision and regulation. The process is taking place in 2013 and 2014, with many regulators being hired from national regulatory agencies. The ECB will work in collaboration with established national bodies. This nevertheless represents a major challenge and it remains to be seen how successfully effective departments can be assembled.

4.5.3 Conflict of interest at the ECB

One of the arguments in favour of moving to a euro area regulator is that it will avoid regulatory forbearance. The regulator will be less likely to be influenced by local concerns and lobby groups.

> "Moving supervision to a European level will also increase the distance of supervisors from powerful national lobbies, reducing the scope for regulatory forbearance. As the financial crisis highlighted, there is a tendency by national supervisors to side with their troubled banks in hiding information from the public and other supervisors, delaying the recognition of losses, postponing corrective measures, and resulting in larger eventual losses. The lack of sufficient independence of some national supervisors from the executive (in combination with insufficient and explicit powers to intervene) magnifies this problem. This problem is also at the heart of the current vicious cycle between bank and sovereign risk." (Ioannidou, 2012)

However, as a counter argument, there is an issue that the ECB may face a conflict between its pursuit of macroeconomic stability and its objective of financial stability. The pressure to maintain financial stability may induce the ECB to create more liquidity, or do so on easier terms, for the banking system, to promote financial stability, even at a time when macroeconomic stability demands tighter monetary actions. Monetary policy is usually countercyclical, while regulation and supervision tend to be pro-cyclical. The ECB may prove a more forbearing regulator than a local one. There is evidence from the US Fed to support this idea. The ECB may need to erect Chinese Walls between its different activities.

Moreover, there is the problem mentioned at the outset, namely that the ECB is the banks' biggest creditor and would therefore directly suffer write-off losses should a bank fail and be resolved. While this fact may induce the ECB to be a tough regulator in the future, it will surely tend to make it a soft regulator in the present when setting up stress tests to uncover hidden write-off losses from legacy assets. Unfortunately, it must be feared that the ECB will turn a blind eye to the legacy debt problem and seek solutions that sweep the true problems under the carpet until after the socialisation scheme is in operation.

On the positive side, it can be argued that information obtained from bank supervision activities may improve macroeconomic forecasting.

> "Problems in the banking sector may serve as an early indicator of deteriorating macroeconomic conditions." (Ioannidou, 2012)

There remains the unanswered question of whether the new arrangements give too much power to a single institution, which is not democratically controlled and in which the small countries, for whom the incentive to free ride on community funding is by definition bigger than for big countries, enjoy disproportionate voting rights in ECB decision-making.

4.5.4 Getting the banks to pay

The official aim of a banking union is to reduce the burden on the taxpayers of resolving failed banks, and getting the banks themselves or their creditors to pay. Imposing losses on shareholders and other creditors as far as possible through the bail-in tool is an essential plank. It is reinforced by the 55 billion euro SRF, fed by the proceeds of a levy on banks. However, some banks may fail and need resolution well before the fund is up and running and the fund may be insufficient to meet the costs, even if all of the legacy problems have been funded separately.

Some commentators argue that a levy on banks will act as a tax on banking, raising the cost of intermediation. Activity may be diverted into other channels, which may be less efficient and also prone to crises and breakdowns, just as much as banks.

> "Banks will pass on much of the tax, dependent on market structure, to other creditors in the guise of lower interest rates, higher charges and fewer services to depositors, and higher rates and charges to borrowers. In short, bank spreads between deposit and lending rates would rise." (Goodhart, 2012)

Arguably there are difficulties with any scheme of imposing a levy on banks. *Ex post* levies tend to fall on prudent banks that avoided failure at a time when they and the whole banking system were weak. *Ex ante* taxes may be set in such a way so as to discourage risky behaviour, and thus act both as an incentive to good behaviour and as a way of funding future recapitalisations. The possible problem here is that, having paid the tax in advance, banks may feel entitled to a bailout (recapitalisation) and even to have their shareholders bailed out, rather than be liquidated or taken into public ownership. Goodhart (2012) writes that while academics may argue for *ex ante* taxes, bankers prefer *ex post* levies and they are more likely to win the argument.

Various methods of bailing-in bank creditors are not costless, at least from the point of view of the banking industry. Calls on unsecured bond-holders through "CoCo" bonds (Contingent Convertible) may raise the price banks have to pay to raise long-term funding. It is worth noting, however, that even CoCos do not prevent costs from arising for taxpayers, since many unsecured bank bonds are owned by pension funds and insurance companies.

While it is true that imposing a levy on deposits will raise banks' operating costs, and that banks will pass these costs on to borrowers and depositors, this is no bad thing. Quite the opposite: it is as things should be. These changes in banks' funding arrangements are intended to correct for externalities: costs that banks have been imposing on the rest of society to bail out and recapitalise failed institutions. Requiring banks to base a larger fraction of their funding on equity rather than debt, requiring the use of CoCos, and imposing a levy on banks to pay for a resolution fund, are actions that will reduce the likely future calls of the banking industry on the rest of the economy and reduce the amount of volatility in economic activity caused by banking panics and failures. Correcting externalities generally moves the economy closer to an efficient allocation of resources. The cost of banks' raising equity has been subsidised in the past by the implicit bailout guarantee. Without it, this cost would have been higher. If, as a result, the cost of the services provided by banks goes up, this is merely removing the effects of a subsidy that should not have been there in the first place (Sinn, 2003a; Sinn, 2003b; Sinn, 2010, chapter 4; Admati and Hellwig, 2012).

The banks have often claimed that raising capital requirements, as is happening alongside the banking union proposals under Basel III and the EU's CRD IV, is costly, as the required return on capital is much greater than the yield on bonds. It has been claimed that higher capital requirements will cause funds to be tied up, sitting idle and unable to be loaned out to businesses. However, these arguments are simply wrong. They are dealt with at length by Admati and Hellwig (2012), Miles (2013), and Miles et al. (2012).

The argument that banks holding more capital causes resources to be kept idle and unable to be loaned out, appears to confuse the asset and liabilities side of the balance sheet. It may be true that if a bank holds more of its assets in the form of cash or reserves, then fewer funds are loaned out. But equity and debt are liabilities of the bank, and as such, they constitute alternative means of funding its lending activities. Using a greater proportion of equity to debt does not cause resources to be kept idle. Miles (2013) shows that the margin of banks' lending rates over the interest paid on the bonds they issue has not changed systematically; and despite large increases in leverage over long periods of time in the UK and US, there is no evidence of their using less equity and more bonds having lowered the margin. The appearance of a high required return on equity is given by the market value of banks' equity being much less than their book value. But this, in fact, means that financial markets set a lower value on the value of the banks' assets than is attributed to them by the conventions of accounting (Merler and Wolff, 2013).

Lastly, the cost of equity capital is lower than it may seem because having more equity lowers the riskiness of the returns both to the bank's bonds, and to its existing equity, and therefore lowers the returns on the bank's existing liabilities.

Consequently, there are good reasons for requiring banks to fund their operations with a considerably higher ratio of equity to debt.

4.5.5 Sovereign debt on banks' balance sheets

One of the links that binds the fortunes of the banking sector to the state of the public finances in the host state is the large fraction of the banks' assets that consists of sovereign debt. Data from the ECB show that, at the end of August 2013, over 10 percent of Italian banks' total assets were government bonds, as compared with 6.8 percent at the beginning of 2012. The corresponding figures for Spain are 9.5 percent and 6.3 percent; for Portugal 7.6 percent and 4.6 percent. Most of the increases are in bonds issued by the banks' own governments. Government bonds had grown to 5.6 percent of total euro area bank assets at the end of August 2013 from 4.3 percent at the beginning of 2012.[20]

The attraction of sovereign debt for the banks is that no capital needs to be held against it. Government bonds are not risk-weighted. Banks have been able to obtain liquidity from their central banks at very low cost, through the ECB's recycling of reserves from northern to southern Europe, which they have been able to invest in higher yielding sovereign bonds. This is another means by which banks have been able to raise profits and improve their balance sheets (insofar as they retain these profits, rather than distributing them). It is a substantial hidden subsidy to the banking industry.[21]

To break this link, rules may be needed to limit banks' exposure to particular borrowers and types of asset; the risk-weighting of sovereign debt needs to be reconsidered; and a third element is that fiscal deficits need to be brought under control so to reduce the supply of these assets.[22]

[20] C. Thompson and P. Jenkins (2013), "Bank Exposure to EU States' Bonds on Rise," *Financial Times*, 13 October, http://www.ft.com/intl/cms/s/0/9b6fb558-3270-11e3-b3a7-00144feab7de.html.

[21] To indicate the scale of the subsidy, if the banks can invest 1 trillion euro of reserves (the approximate size of the TARGET2 balances) which costs them 0.25 percent, in sovereign debt at 6 percent per annum, the profit is 57.5 billion euro per annum.

[22] J. Weidmann (2013), "Breaking the Sovereign-Banking Nexus," *Financial Times*, 1 October, http://www.bundesbank.de/Redaktion/EN/Standardartikel/Press/Contributions/2013_10_01_weidmann_ft.html.

4.5.6 Concentration, competition, and Too Big to Fail

The belief that some banks are too big to be allowed to fail, and therefore had to be recapitalised by governments, has contributed to public debt problems since 2007. However, the changes that have taken place, recapitalising banks, forcing through consolidations, mergers and takeovers, have increased concentration in banking and have effectively made the phenomenon of banks being too big to fail worse, not better. Despite the de-leveraging undertaken by banks, it is still true that the banking systems of many countries have gross assets worth several times their country's GDP, particularly in small economies, so their governments, already heavily indebted, would not be able to recapitalise them in the event of a major failure, without increasing national debt to unsustainable levels.[23]

4.5.7 Sovereign default risk, re-denomination risk, and other risks affecting borrowing costs

Breaking the bank-sovereign link is not an end in itself, of course. Some see the ultimate goal as making the cost of borrowing for households and enterprises independent of the state in which they are located in the euro area. The cost of borrowing for households and firms should be the same throughout the euro area, they maintain, so as to achieve an efficient allocation of resources across it. If there were a single market in banking, a household or firm would be able to borrow from any bank in the euro area, not necessarily one located in the same member state. The cost of borrowing would then reflect the risks associated with the loan the household or enterprise wanted to take out; and bear no relation to the risks of default by the government of the member state in which the household or enterprise is resident.

This view implicitly assumes that the European nation states have already been dissolved by creating a European federal state with a joint budget and a joint tax system. In fact, however, this is not the case and cannot be anticipated – through monetary or fiscal policy measures, decided by technocratic bodies stretching their mandate – changes which ought to require a change in the EU Treaty. As long as joint fiscal responsibility through a joint tax system and federal budget has not been created, a state, its banks and its companies are sitting in one boat and mutually sharing idiosyncratic country risks.

[23] G. Tett (2013), "Insane Financial System Lives Post-Lehmann," *Financial Times*, 12 September, http://www.ft.com/intl/cms/s/0/e622fa00-1bbf-11e3-b678-00144feab7de.html.

If there is a possibility of the member state in question leaving the euro area, then there may be an increased chance of the borrower in question being unable to repay, or of the loan being redenominated into a new currency, and this will affect the cost of borrowing. There may be a possibility of additional taxes being imposed on a borrower in a member state in fiscal difficulties, or of interest payments being taxed. These payments will and should also affect the cost of loans, so as not to water down responsibilities, not to distort the allocation of resources and not to create incentives for excessive risk-taking.

4.6 Conclusions

In principle, a banking union is a natural development for the euro area, further integrating the banking industry across member states and moving in the direction of completing the single market. If the euro area was an association of similar countries, symmetrically placed, the problems of implementing a banking union would be relatively straightforward. Among a group of basically similar countries disturbed by shocks that are to some degree idiosyncratic, but with large banking industries, with some financial institutions that are too big for an individual country to recapitalise, were they to fail, and with many financial institutions operating across the region and beyond, a suitably designed banking union could contribute to greater financial stability. It would involve no ex ante redistribution between countries. There may be some redistribution ex post depending on where bank failures occurred. But largely it would operate as a mutual insurance scheme, spreading risk through the region, and pooling resources needed to resolve the problems caused by failed banks.

The clear problem is that the euro area is very far from being such a symmetrical arrangement among similar states. Indeed, some members of the euro area have sound public finances and relatively well-supervised and regulated banks; while others have highly precarious, if not actually unsustainable, public finances and, to varying degrees, fragile financial industries with potentially large exposures to non-performing loans and other assets that are actually worth less than their recorded values and are overly-exposed to the sovereign debt of the country in which they are located. While the second group of countries are the likely beneficiaries of a banking union, and are keen on establishing one, the first group of countries are less enthusiastic. There is the prospect that the banking union may simply take resources from sound banking systems in the north to bail out unsound banking systems in the south.

By reducing the costs of funds for banks in the south, the banking union may have the effect of also reducing the costs of public borrowing for southern euro area states, and reducing the financial pressure on them to restrain public borrowing and make their finances sustainable.

The extent to which this problem emerges in practice depends on how a banking union is implemented. A key factor is how "legacy problems" are defined and dealt with. If there is a forensic examination of the balance sheets of all the banks in the euro area and a thorough identification of all the institutions in need of recapitalisation, resolution or closing down before the banking union comes into force, so that all these costs could be borne by the member states in question (or by existing provisions for lending to member states such as the EFSF and the ESM) and not mutualised through the banking union, the problem of the union being a scheme to transfer resources might be avoided. However, this is obviously unlikely to happen. The identification of legacy problems is likely to be highly imperfect and massively contentious. It will meet with fierce resistance in the troubled southern periphery countries, and, unfortunately, the ECB, the southern banks' largest creditor, can hardly be expected to have an incentive to pull the hidden write-off losses out from under the carpet.

The effects of the banking union will also depend on how effectively bank supervision and regulation is conducted after it has been set up, as well as on how the fiscal policies of member states evolve. The SSM is intended to ensure common standards of supervision and regulation across the union. There is less likely to be a persistent transfer of resources via the union to countries with a history of less rigorous supervision, the more uniformly the SSM can be applied.

To the extent that fiscally weak sovereigns are linked with fragile banking systems because banks buy up sovereign debt to use it as collateral for ECB funds, the risk weighting applied to sovereign debt by the regulator will be important. Clearly treating sovereign debt as risk-free has been inappropriate and needs to be changed. Banks in countries with fragile banking systems need to hold more diversified portfolios of assets. Finally, the rigour with which the EU Fiscal Pact is applied in future will affect the European Banking Union. The smaller the amount of public borrowing by heavily indebted states, the lower the likelihood of banks in those states overloading their balance sheets with the local sovereign's debt.

References

Admati, A. and M. Hellwig (2013), *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, Princeton University Press.

Blankart, C. B. (2012), "The Euro in 2084", *CESifo Forum* 13, Special Issue, pp. 23–8, http://www.cesifo-group.de/DocDL/Forum-Sonderheft-Jan-2012.pdf.

Buch, C. M. and B. Weigert (2012), "Legacy Problems in Transition to a Banking Union," in: T. Beck, ed., *Banking Union for Europe: Risks and Challenges,* VoxEU, 16 October, http://www.voxeu.org/article/legacy-problems-transition-banking-union.

Dell'Ariccia, G., R. Goyal, P. Koeva-Brooks and T. Tressel (2013), "A Banking Union for the Eurozone," *VoxEU*, 5 April, http://www.voxeu.org/article/banking-union-eurozone.

EEAG (2012), *The EEAG Report on the European Economy 2012*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2012.pdf.

EEAG (2013), *The EEAG Report on the European Economy 2013*, CESifo, Munich, http://www.cesifo-group.de/DocDL/EEAG-2013.pdf.

European Central Bank (2013), *Note: Comprehensive Assessment / October 2013,* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf.

European Commission (2013), "Proposal for a Regulation of the European Parliament and of the Council, Establishing Uniform Rules and a Uniform Procedure for the Resolution of Credit Institutions and Certain Investment Firms in the Framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and Amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council," *COM(2013) 520 final 2013/0253 (COD),* Brussels, 10 July, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0520:FIN:EN:PDF.

European Council (2012), *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

European Union (2013a), "Council Regulation (EU) No 1024/2013 of 15 October 2013 Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions," *Official Journal of the European Union* L 287/63, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0063:0089:EN:PDF.

European Union (2013b), "Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 Amending Regulation (EU) No 1093/2010 Establishing a European Supervisory Authority (European Banking Authority) as Regards the Conferral of Specific Tasks on the European Central Bank Pursuant to Council Regulation (EU) 1024/2013," *Official Journal of the European Union* L 287/5, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0005:0014:EN:PDF.

Garicano, L. (2012), "Five Lessons from the Spanish Cajas Debacle for a New Euro-Wide Supervisor," in: T. Beck, ed., *Banking Union for Europe: Risks and Challenges*, VoxEU, 16 October, http://www.voxeu.org/article/five-lessons-spanish-cajas-debacle-new-euro-wide-supervisor.

Goodhart, C. (2012), "Funding Arrangements and Burden-Sharing in Banking Resolution," in: T. Beck, ed., *Banking Union for Europe: Risks and Challenges,* VoxEU, 16 October, http://www.voxeu.org/article/funding-arrangements-and-burden-sharing-banking-resolution.

Ioannidou, V. (2012), "A First Step Towards a Banking Union," in: T. Beck, ed., *Banking Union for Europe: Risks and Challenges*, VoxEU, 16 October, http://www.voxeu.org/article/first-step-towards-banking-union.

James, H. (2012), *Making the European Monetary Union*, Harvard University Press.

Merler, S. and G. B. Wolff (2013), "Ending Uncertainty: Bank Recapitalisation under European Central Bank Supervision," *Bruegel Policy Contribution* No. 2013/18, http://www.bruegel.org/publications/publication-detail/publication/806-ending-uncertainty-recapitalisation-under-european-central-bank-supervision/.

Miles, D. (2013), "Bank Capital Requirements: Are They Costly?," *VoxEU*, 17 January, http://www.voxeu.org/article/bank-capital-requirements-are-they-costly.

Miles, D., J. Yang and G. Marcheggiano (2013), "Optimal Bank Capital," *The Economic Journal* 123, pp. 1–37.

Sinn, H.-W. (2003a), "Risk Taking, Limited Liability and the Competition of Bank Regulators," *Finanzarchiv* 59, pp. 305–29.

Sinn, H.-W. (2003b), *The New Systems Competition*, Yrjö Jahnsson Lectures, Basil Blackwell, Oxford.

Sinn, H.-W. (2010), *Casino Capitalism: How the Financial Crisis Came about and What Needs to Be Done Now*, Oxford University Press.

Sinn, H.-W. (2012), *Die Target-Falle: Gefahren für unser Geld und unsere Kinder*, Carl Hanser Verlag, Munich.

Sinn, H.-W. (2014), *The Euro Trap: On Bursting Bubbles, Budgets and Beliefs*, Oxford University Press, forthcoming.

Sinn, H.-W. and T. Wollmershaeuser (2012), "Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility," *International Tax and Public Finance* 19, pp. 468–508.

Tornell, A. and F. Westermann (2012), "The Tragedy of the Commons at the European Central Bank and the Next Rescue," *VoxEU*, 22 June, http://www.voxeu.org/article/tragedy-commons-european-central-bank.

van Rixtel, A. and G. Gasperini (2013), "Financial Crises and Bank Funding: Recent Experience in the Euro Area," *Bank for International Settlements Working Paper* No. 406.

Wyplosz, C. (2012), "Banking Union as a Crisis-Management Tool," in: T. Beck, ed., *Banking Union for Europe: Risks and Challenges*, VoxEU, http://www.voxeu.org/article/banking-union-crisis-management-tool.

List of Figures

List of Tables

List of Boxes

The Members of the European Economic Advisory Group at CESifo

Giuseppe Bertola
(Ph.D., Massachusetts Institute of Technology, 1988) is Professor of Economics at EDHEC Business School, on extended leave without pay from his position at Università di Torino where he has been Professore Associato (since 1993) and Ordinario (since 1996) di Economia Politica. In 1997–2003 he was full-time Professor at the European University Institute; in 1989–93 he was Assistant Professor and Assistant Director of the International Finance Section, Princeton University. He has served as a Managing Editor of *Economic Policy* (2001–08), Condirettore of *Giornale degli Economisti e Annali di Economia* (1996–2011), and a Programme Director of CEPR's Labour Economics programme (2009–2013). He has performed scientific advisory work for the European Commission, the European Central Bank, and other organizations. His research currently focuses on the structural and institutional aspects of labour and financial markets, from an international comparative perspective, particularly as regards their distributional impact and interaction with the European process of economic and monetary unification. He has applied similar methods to exchange rate and money-market policies, interactions between growth and distribution, households' durable consumption and borrowing, and educational systems. He has also published widely in the *Review of Economic Studies*, the *American Economic Review*, the *European Economic Review*, other academic journals and books, also authoring chapters in *Handbook of Labor Economics* and *Handbook of Income Distribution* (North-Holland), co-authoring *Models for Dynamic Macroeconomics* (Oxford University Press) and *Income Distribution in Macroeconomic Models* (Princeton University Press), and co-editing *Welfare and Employment in a United Europe* and *The Economics of Consumer Credit* (MIT Press).

Giuseppe Bertola
EDHEC Business School
393 promenade des Anglais
BP 3116
France
giuseppe.bertola@edhec.edu

John Driffill
(Ph.D., Princeton University, 1977) is a Professor of Economics at Birkbeck College, University of London, and a Fellow of the Centre for Economic Policy Research. He has previously worked at the University of Southampton, Tilburg University, and Queen Mary and Westfield College, University of London, and held visiting positions at Queen's University (Kingston, Canada), in Stockholm, Aarhus, Tokyo, and Paris. From 2004 to 2010 he was the Director of the UK Economic and Social Research Council's programme on World Economy and Finance. From 2000 to 2004 he was on the Council and Executive Committee of the Royal Economic Society. He has advised the House of Lords Select Committee on the European Union (Sub-Committee A: Economic and Financial Affairs) in enquiries into the euro and the Stability and Growth Pact. Most of his research has been on macroeconomics and monetary policy, and he has published in many scholarly journals, including the *American Economic Review*, the *Review of Economic Studies*, the *Journal of Monetary Economics*, and the *European Economic Review*. He has published two edited volumes, one on *A Currency for Europe*, another on *The Role of Financial Markets in the Transition Process*, and an introductory textbook, *Economics* with Joseph E. Stiglitz (W. W. Norton and Co, 2000).

John Driffill
Birkbeck College
Malet Street
London WC1E 7HX
United Kingdom
j.driffill@bbk.ac.uk

Harold James
(Ph.D. Cambridge University, 1982) is Claude and Lore Kelly Professor in European Studies and a Professor of History at Princeton University, a Professor of International Affairs in the Woodrow Wilson School, as well as a Marie Curie Visiting Professor at the European University Institute. He is Director of the Program in Contemporary European Politics and Society and serves on the editorial committee of the journal *World Politics* and is Chairman of the Academic Council of The European Association for Banking and Financial History (EABH). Before coming to the United States in 1986, he was a Fellow of Peterhouse for eight years. He was awarded with the Ellen MacArthur Prize for Economic History at the University of Cambridge in 1982, the Helmut Schmidt Prize in Economic History at the German Historical Institute in Washington, D.C. in 2004 and the Ludwig Erhard Prize for writing about economics in 2005. His research focuses on European economic history, and German history in particular. He has published and co-authored several books analysing Germany's financial history in the interwar era, the changing character of national identity in Germany and detailed studies about the Deutsche Bundesbank. His latest book, *Making the European Monetary Union* published by the Harvard University Press in 2012, deals with the role of the Committee of Central Bank Governors and the origins of the European Central Bank, giving us a deeper understanding of the European monetary crisis by tracing the decade-long process of implementing the idea of a Europe-wide monetary union and common currency, which finally morphed into the European Central Bank.

Harold James
Princeton University
History Department
129 Dickinson Hall, Princeton, NJ 08544-1017
USA
hjames@princeton.edu

Hans-Werner Sinn
is Professor of Economics and Public Finance at the University of Munich (LMU) and President of the CESifo Group. He has been a member of the Council of Economic Advisors to the German Ministry of Economics since 1989 and is a fellow of a number of learned societies. From 1997–2000 he was President of the German Economic Association (Verein für Socialpolitik) and from 2006–2009 of the International Institute of Public Finance. He holds honorary doctorates from the Universities of Magdeburg (1999) and Helsinki (2011), as well as the HHL Leipzig (2013), and an honorary professorship from the University of Vienna. He has taught at the University of Western Ontario, and held visiting fellowships at the London School of Economics, as well as at Bergen, Hebrew, Oslo, Princeton and Stanford Universities. He received awards from the University of Mannheim for his dissertation and habilitation theses, and a number of other prizes and awards from various institutions including the Corine Award (2004) for his bestseller *Ist Deutschland noch zu retten? (Can Germany be Saved?)*, and the Ludwig-Erhard-Prize for Economic Journalism (2013). He was awarded the Officer's Cross of the Order of Merit of the Federal Republic of Germany in 2005 and the Bavarian Maximilian Order in 2008. In 1999 he gave the Yrjö Jahnsson Lectures, in 2000 the Stevenson Lectures, in 2004 the Tinbergen Lectures, in 2005 the World Economy Annual Lecture, in 2007 the Thünen Lecture, in 2010 the D.B. Doran Lecture, in 2011 the European Economy Lecture, in 2012 the Van Lanschot and the Egon Sohmen Lectures, and in 2013 the Whitman, the Julian Hodge and the Booth Lectures. Sinn has published in the *American Economic Review*, the *Quarterly Journal of Economics,* the *European Economic Review,* the *Journal of Public Economics* and many other journals. He has published 11 major and 17 smaller monographs in six languages. They include titles like *Economic Decisions under Uncertainty, Capital Income Taxation and Resource Allocation, Jumpstart – The Economic Unification of Germany, The New Systems Competition, Casino Capitalism, The Green Paradox,* and *The Euro Trap*.

Hans-Werner Sinn
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich
Poschingerstr. 5
81679 Munich
Germany
sinn@ifo.de

Jan-Egbert Sturm
(Ph.D. University of Groningen, 1997) is Professor of Applied Macroeconomics, Director of the KOF Swiss Economic Institute at the ETH Zurich, President of the Centre for International Research on Economic Tendency Surveys (CIRET) and Editor of the *European Journal of Political Economy*. He was a researcher at the University of Groningen, The Netherlands, until 2001, and taught as Visiting Professor at the School of Business, Bond University, Gold Coast, Australia, in 2000 and 2005. As Head of the Department for Economic Forecasting and Financial Markets at the Ifo Institute for Economic Research, he was also Professor of Economics at the University of Munich (LMU) at the Center for Economic Studies (CES), 2001–2003. He held the Chair of Monetary Economics in Open Economies at the University of Konstanz, Germany, which was coupled with the position of Director of the Thurgau Institute of Economics (TWI) in Kreuzlingen, Switzerland, 2003–2005. In his research, Jan-Egbert Sturm relies heavily on empirical methods and statistics, concentrating on monetary economics, macroeconomics as well as political economy. His applied studies have focused on, for example, economic growth and central bank policy. He has published several books, contributed articles to various anthologies and international journals including *Applied Economics, Economics & Politics,* the *European Economic Review*, the *European Journal of Political Economy*, the *Journal of Banking and Finance*, the *Journal of Development Economics*, the *Journal of Macroeconomics, Kyklos,* the *Oxford Economic Papers, Public Choice,* and the *Scandinavian Journal of Economics*. Jan-Egbert Sturm headed the Ifo research team in the Joint Analysis of the Six Leading German Economic Research Institutes, 2001–2003. Since 2001 he has been member of the CESifo Research Network and since 2003 Research Professor at the Ifo Institute. In 2006 he was appointed member of the User Advisory Council of the Ifo Institute.

Jan-Egbert Sturm
ETH Zurich
KOF Swiss Economic Institute
WEH D 4
Weinbergstr. 35
8092 Zurich
Switzerland
sturm@kof.ethz.ch

Ákos Valentinyi
(Ph.D. European University Institute, 1997) is a Professor of Economics at Cardiff Business School, a Fellow of CEPR and a Senior Research Fellow at the Institute of Economics of the Hungarian Academy of Sciences. He was previously Professor at the University of Southampton and Head of Research at the National Bank of Hungary. He has also been a Visiting Professor at the Central European University in Budapest and Universidad Carlos III in Madrid. His research focuses on macroeconomics, economic growth, productivity differences and structural change. He has published in leading international journals including the *American Economic Review, Review of Economic Studies,* the *Review of Economic Dynamics*, and the *Journal of the European Economic Association*.

Ákos Valentinyi
Cardiff Business School
Aberconway Building, Colum Drive
Cardiff, CF10 3EU
United Kingdom
ValentinyiA@cardiff.ac.uk

The EEAG Report on the European Economy

Previous Reports

The EEAG Report on the European Economy 2013

Macroeconomic Outlook
European Imbalances
Labour Market Reforms and Youth Unemployment
US Precedents for Europe

The EEAG Report on the European Economy 2012

Macroeconomic Outlook
The European Balance-of-Payments Problem
Banking Regulation
The Swedish Model
The Hungarian Crisis
Pricing Climate Change

The EEAG Report on the European Economy 2011

Macroeconomic Outlook
A New Crisis Mechanism for the Euro Area
Greece
Spain
Taxation and Regulation of the Financial Sector

The EEAG Report on the European Economy 2010

The European Economy: Macroeconomic Outlook and Policy
A Trust-driven Financial Crisis. Implications for the Future of Financial Markets
From Fiscal Rescue to Global Debt
Implications of the Crisis for US Adjustment Needs
The Financial Crisis: Risks and challenges for the euro area

The EEAG Report on the European Economy 2009

The European Economy: Macroeconomic Outlook and Policy
Financial Crisis
Private Equity
Country Chapter: France

The EEAG Report on the European Economy 2008

The European Economy: Macroeconomic Outlook and Policy
How Much Real Dollar Depreciation is Needed to Correct Global Imbalances?
The Effect of Globalisation on Western European Jobs: Curse or Blessing?
Industrial Policy
Global Warming: The Neglected Supply Side

The EEAG Report on the European Economy 2007

The European Economy: Macroeconomic Outlook and Policy
Macroeonomic Adjustment in the Euro Area – the Cases of Ireland and Italy
The New EU Members
Scandinavia Today: An Economic Miracle?
Tax Competition
Economic Nationalism

The EEAG Report on the European Economy 2006

The European Economy: Macroeconomic Outlook and Policy
Global Imbalances
Economic Growth in the European Union
Prospects for Education Policy in Europe
Mergers and Competition Policy in Europe

The EEAG Report on the European Economy 2005

The European Economy: Current Situation and Economic Outlook for 2005
Outsourcing
Longer Working Hours - the Beginning of a new Trend?
Pensions and Children
House Prices in Europe

The EEAG Report on the European Economy 2004

The European Economy: Current Situation and Economic Outlook
Labour Market Reform in Europe
Pay-setting Systems in Europe: On-going Development and Possible Reforms
The Economics of Discrimination: Equity, Equality and Diversity in the New European Constitution
The 2004 EU Enlargement: Key Economic Issues
Acceding Countries: The Road to the Euro

The EEAG Report on the European Economy 2003

The European Economy: Current Situation and Economic Outlook
Fiscal Policy and Macroeconomic Stabilisation in the Euro Area: Possible Reforms of the Stability and Growth Pact and National Decision-Making-Processes
Rethinking Subsidiarity in the EU: Economic Principles
Financial Architecture
Should We Worry about the Brain Drain?

The EEAG Report on the European Economy 2002

The European Economy: Current Situation and Economic Outlook
The Weakness of the Euro: Is it Really a Mystery?
Fiscal and Monetary Policy
Prices, Wages and Inflation after the Euro - What Europeans Should or Should not Expect
Growth and Productivity
Welfare to Work
CAP Reform

The Authors

Giuseppe Bertola

Edhec Business School, Università di Torino

Professor of Economics at Edhec Business School, Nice, on extended leave from Università di Torino where he has been Professore di Economia Politica since 1996. Former editor of *Economic Policy*.

John Driffill

Birkbeck College, University of London
EEAG Vice-Chairman

Professor of Economics at Birkbeck College, University of London. Formerly, Director of the ESRC research programme on 'World Economy and Finance' from 2004 to 2010.

Harold James

Princeton University

Professor of History and International Affairs, Claude and Lore Kelly Professor of European Studies, and Director of the Program in Contemporary European Studies at Princeton University.

Hans-Werner Sinn

Ifo Institute and University of Munich

Professor of Economics and Public Finance at the University of Munich and President of the CESifo Group.

Jan-Egbert Sturm

KOF, ETH Zurich

Professor of Applied Macroeconomics and Director of the KOF Swiss Economic Institute, ETH Zurich. President of the Centre for International Research on Economic Tendency Surveys (CIRET) and Editor of the *European Journal of Political Economy*.

Akos Valentinyi

Cardiff University
EEAG Chairman

Professor of Economics at Cardiff Business School and a senior research fellow at the Institute of Economics of the Hungarian Academy of Sciences. Formerly, Head of Research at the National Bank of Hungary.