THE EUROPEAN ECONOMY: MACROECONOMIC OUTLOOK AND POLICY

1. Introduction

The financial crisis triggered by the bursting of the US real-estate bubble has spread over the entire world to different degrees and markedly slowed down world economic growth in 2008. This year, all major regions in the world will be in recession.

In the second half of 2008, economic growth in the United States became persistently negative. The economic slowdown which started to emerge already in 2004 turned into a full-blown recession. For the first time since 1991, private consumption growth turned negative on both a quarterly and annual basis. The crisis in the US banking sector reached a new level in September when the US government decided not to bail out Lehman Brothers. Although authorities were able to prevent a bank run, they could not stop the sharp deterioration in business and consumer sentiment.

Combining the severity of the financial crisis with the structurally too low national saving rate and the associated too high current account deficits, it is most likely that the US economy will continue to underperform relative to other parts of the world and its own history in the years to come.

As in many parts of the world, the sharp hike in commodity prices pushed inflation in the European Union higher than expected. Along with the continuing international financial market crisis, this led to a significantly worse economic situation in Europe. This situation was compounded by the strength of the euro and the sharp downturn in property markets in Ireland, Spain and the United Kingdom.

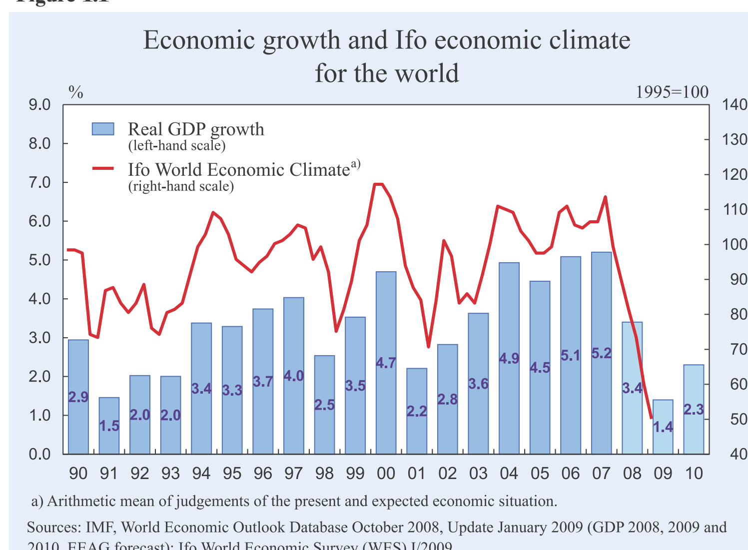
The downturn during the second half of 2008 started to become quite pronounced especially in the large European economies. Quarterly GDP growth in Germany, Italy and Spain all declined during the third quarter of 2008 and basically stagnated in France. Both orders and production in manufacturing sectors fell dramatically during recent months. Also future business outlook and consumer confidence plummeted during this time. The faltering expansion of the world economy, the continuing fall of property prices in some European economies and the financial market problems will continue to have negative effects on all European countries. Both the euro area and the European Union will go through a deep recession this year. Not until 2010 do we expect quarterly growth rates to turn positive again.

2. The current situation

2.1 The global economy

After four years of extraordinarily strong growth, the expansion of the world economy clearly slowed down in 2008. World GDP increased at an average rate of 3.4 percent last year (see Figure 1.1). Especially during the second half of 2008, the slowdown accelerated more than expected in our previous EEAG report. The severe crisis on the international financial markets, which

Figure 1.1

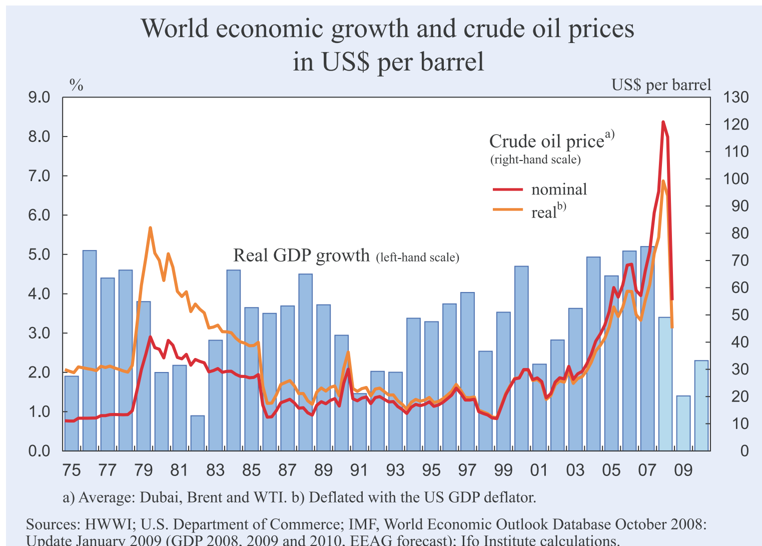


a) Arithmetic mean of judgements of the present and expected economic situation.

Sources: IMF, World Economic Outlook Database October 2008, Update January 2009 (GDP 2008, 2009 and 2010, EEAG forecast); Ifo World Economic Survey (WES) I/2009.

started in the United States with the breakdown of the subprime mortgage market in 2007, has spread to almost all parts of the global economy. The speed and the magnitude at which this took place – especially since autumn of last year – is unprecedented. The sharp fall in asset prices caused negative wealth effects and at the same time indicated a drop in growth expectations. On top of that, balance sheet problems within the banking sector have meanwhile created severe credit constraints for firms and households in several countries.

Figure 1.3



a) Average: Dubai, Brent and WTI. b) Deflated with the US GDP deflator.

Sources: HWWI; U.S. Department of Commerce; IMF, World Economic Outlook Database October 2008: Update January 2009 (GDP 2008, 2009 and 2010, EEAG forecast); Ifo Institute calculations.

The economic climate indicator of the Ifo World Economic Survey, conducted among over 1,000 economic experts in about 90 countries, continued its fall in the most recent survey. The indicator shows that the world economy passed its peak in autumn 2007 and decelerated throughout 2008.

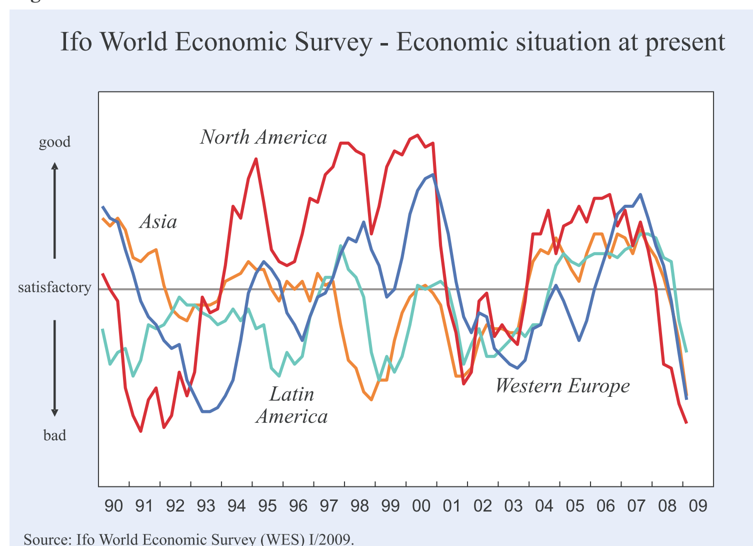
In sharp contrast to the early 1990s, when the world economy also went through a recession, this time all major regions in the world seem to be moving in parallel. The judgements of the current economic situation in North America, Western Europe, Asia and Latin America were all still at a neutral or above neutral level at the beginning of 2008 (see Figure 1.2) and have almost synchronously deteriorated since then.

Since 1993, i.e., for more than a decade, the inflation rate for industrial countries has steadily fluctuated at comfortable levels between 1 and 3 percent. This markedly changed last year: a rapid increase occurred during the first half of the year pushing consumer price inflation levels to above 4 percent during the summer. After this stronger than expected upsurge, inflation rates are coming down again. Besides the turn in the economic cycle, mainly oil and other raw material prices have caused these relatively strong fluctuations in inflation rates. Especially the oil price surged to unprecendented levels, reaching a peak in July. At the end of the year, it was back again at levels last seen in 2005 (see Figure 1.3).

2.2 United States

Up until the second quarter of last year, the US economy still experienced positive – albeit somewhat lower – growth than it had between 2004 and 2006. Although employment already started to fall in January, production did increase and most of the available business cycle indicators pointed towards a continuation of moderate growth. From a demand-side perspective, a fiscal stimulus plan of about 170 billion US dollars was able to keep private consumption growth positive during the first half of 2008.

Figure 1.2

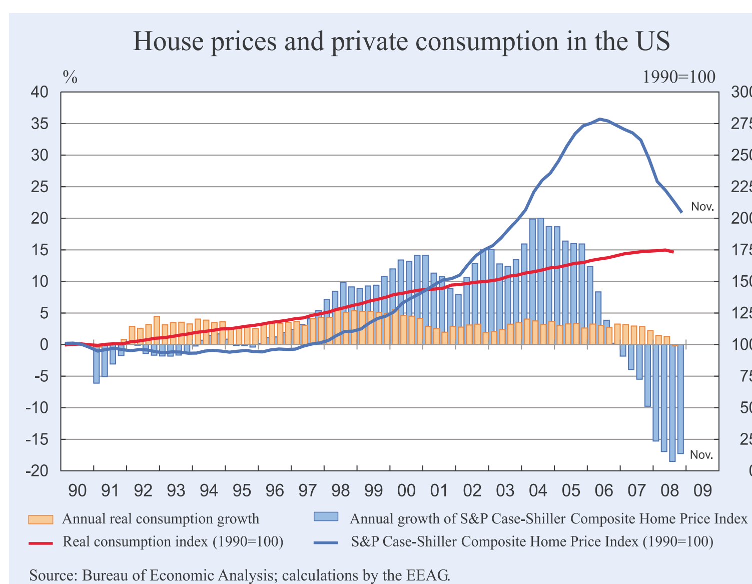


Source: Ifo World Economic Survey (WES) I/2009.

The situation, however, changed dramatically at the end of the summer. At least partly due to strikes at General Motors and Boeing and hurricane Gustav,

industrial production and capacity utilisation plummeted in August. Also the oil price surge in the summer began to dampen demand and production in the car and airplane industries. Finally, and probably most noteworthy, in September the US government decided against a bailout of the investment bank Lehman Brothers. In hindsight, this decision brought the world financial system to a near collapse. Subsequently, purchasing manager indexes and other sentiment indicators dropped, which pointed to a further drop in investment activities. The fall in real-estate prices, which by that time appeared to have slowed, accelarated once more; residential construction activities plummeted again from already historically low levels. While residential fixed investment has been falling since the beginning of 2006, equipment and software investments also started to decrease early last year.

Figure 1.4



Source: Bureau of Economic Analysis; calculations by the EEAG.

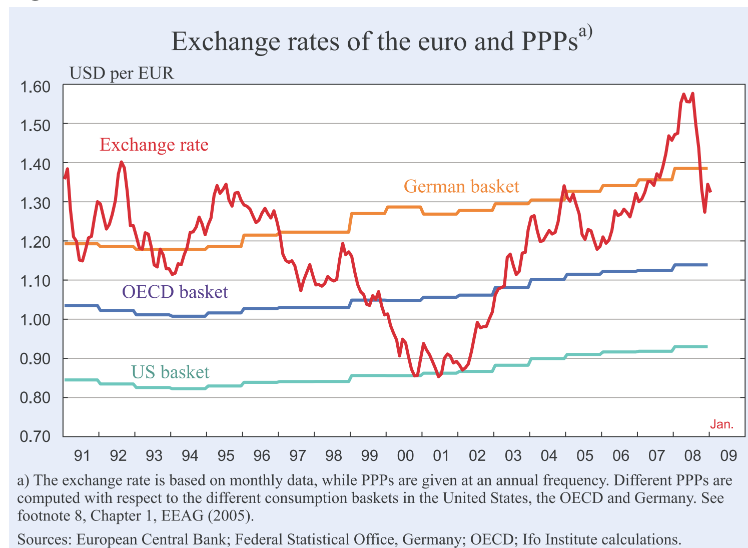
Most importantly for US growth performance, however, was the fact that the above-mentioned fiscal stimulus programme proved unable to stimulate private consumption for more than one or two months (April and May 2008). From June onwards, personal consumption expenditures declined. In the third quarter, private consumption decreased for the first time since 1991, and consumption continued to decline for the rest of the year. Especially consumption of durable goods faced a sharp drop.

Consequently, last year's quarterly GDP growth turned negative by an annualised 0.5 and 3.8 percent in the third and fourth quarter, respectively.

Using the common definition of a recession to be a situation in which GDP growth turns negative for at least two quarters in a row, the United States has been in a recession ever since.[1]

The deflating of the housing price bubble continued throughout the year (see Figure 1.4). National house price indexes decreased by close to 25 percent since their highest levels in summer 2006. Furthermore, other indicators for the real estate market in the United States, like house sales and new privately owned home construction, are at historical lows. As a consequence, residential investment continued to fall at double-digit rates throughout the year. Thus far, only non-residential construction investment has continued to grow.

Figure 1.5



a) The exchange rate is based on monthly data, while PPPs are given at an annual frequency. Different PPPs are computed with respect to the different consumption baskets in the United States, the OECD and Germany. See footnote 8, Chapter 1, EEAG (2005).

Sources: European Central Bank; Federal Statistical Office, Germany; OECD; Ifo Institute calculations.

[1] According to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the US economy has been in recession since the beginning of 2008. In their view "a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators." Especially labour market indicators are the reason why they decided on January 2008 as the start of the recession, the last peak month having been December 2007.

At the same time mortgage default rates have risen, and banks have tightened their lending rules for households and firms. As a result, growth in mortgage debt has now slowed down to levels last seen at the beginning of the 1970s.

The depreciation of the US dollar during the first half of 2008 improved the external trade situation in the United States (see Figure 1.5). Export growth surged at 12.3 percent in the second quarter and exports managed to keep on growing in the second half of the year – albeit at a slower pace. On the other hand, imports have been shrinking for five consecutive quarters now. Net exports were thus the most important growth engine for the US economy last year.

The slowdown in economic activity also became visible on the labour market. Since the beginning of last year, the number of employed persons has dropped by more than 2.6 million. This decline in employment ranges over most sectors but in particular the construction, manufacturing and transport sectors. As a result, the rate of unemployment rose to 7.2 percent in December last year, the highest level in 14 years.

Despite the strong deterioration of labour market conditions, nominal wages continued to develop quite robustly. Average nominal hourly wage rates for the non-agricultural part of the economy were 2.6 percent higher than the year before. Correcting for the tax rebates in the second quarter, this implies that real disposable income, which is by far the most important determinant of private consumption expenditures, is still rising, albeit moderately.

Primarily due to temporary tax relief, the savings rate (personal saving as percentage of disposable personal income) increased from basically zero percent in the previous quarters to 2.5 percent in the second quarter. At a rate of 1.1 percent in the third quarter, the saving rate was still above levels we have seen in previous years.

The budget deficit in fiscal 2008, which ended at the end of September last year, increased to 455 billion US dollars, i.e., 3.3 percent of GDP, as a result of both lower revenues as well as increased expenditures. The strongest decline on the income side was due to the fall in corporate taxation as a consequence of reduced firm profits. At the same time, the increase in expenditures by 9 percent was the highest since 1990. Besides increased military expenditures due to US engagement in Iraq and Afghanistan, in particular the tax rebates intended to support private consumption and the involvement in eight large US banks have put their burden on the government budget.

For fiscal 2009 and as a reaction to the persistent crisis in the banking and financial systems, the US government decided to implement a sizeable rescue package and enacted on 3 October 2008 the Emergency Economic Stabilization Act of 2008. This created the Troubled Asset Relief Program (TARP), a 700 billion dollar fund aimed at resuscitating the US financial system. The funds are used to provide guarantees for banks and other financial institutes as well as to purchase nonliquid, difficult-to-value assets ("toxic assets") from these institutions up to the end of 2009. Its purpose is to facilitate the restructuring of balance sheets and to strengthen confidence and trust in the banking system.

Strong increases in energy prices caused the inflation rate to reach its highest level since the early 1990s with 5.6 percent in July 2008. Since then, it has noticeably sunk and reached 0.1 percent in December. The core inflation rate – the rate preferred by the Federal Reserve for assessing monetary policy – did not show these large fluctuations and most of time remained slightly above 2 percent last year, the level the Federal Reserve considers to be acceptable.

The financial crisis led the Federal Reserve to cut their target rate from 5.25 percent in September 2007 to only 0.25 percent at the end of last year. The first six steps took place at the end of 2007 and early 2008. After a pause throughout spring and summer, three additional cuts followed at the end of last year.

2.3 Japan, China, India and other Asian countries

Since the second quarter of last year the *Japanese* economy has been shrinking. GDP fell by 1.8 percent in the third quarter after it already sank by 3.7 percent the quarter before. Private consumption growth weakened but remained quite resilient throughout the year. However, the main reason for the fall in GDP was the negative growth contribution of net exports. As a consequence, export-oriented firms facing the gloomy worldwide outlook drastically cut their fixed capital investments for four consecutive quarters.

Whereas the direct consequences of the financial crisis on Japan have so far been relatively moderate, the deterioration of the world economic outlook appears to be more dramatic for the largest economy in Asia.

The upswing during the last few years has been largely based upon foreign trade. Exports to China have been stagnating for most of the second half of 2008 and eventually started to fall towards the end of the year. They could thus no longer compensate the falling exports to Europe and especially the United States as still was the case during the first half of last year. The sharp appreciation of the yen and the fall in import prices caused by the worldwide reduction in raw material prices have stimulated imports in the third quarter. Consequently, the growth contribution of net exports turned negative.

Weak business cycle conditions induced the Bank of Japan to lower its target for the uncollateralized overnight call rate twice in the last months of 2008 by a total of 40 basis points to 0.1 percent now. These were the first interest rate cuts in Japan since 2001. The inflation rate slowed to 1.0 percent in November amid falling energy prices. On average it will reach 1.4 percent for the year 2008.

The labour market situation has started to deteriorate somewhat since the beginning of 2008. The number of employed persons fell and the unemployment rate edged up to 4.1 percent in 2008 (as compared to 3.9 percent the year before). Nominal wages hardly increased while in real terms they actually decreased somewhat, reflecting the price increases since the beginning of 2008.

Also in *China* the economic expansion has cooled off. GDP increased by "only" about 9.4 percent last year as compared to 11.9 percent in 2007. This slowdown especially took place during the second half of 2008 with annual growth moderating from a peak of 12.6 percent mid 2007 to 9 percent in the third quarter.

In particular industrial production, which contributes about half of GDP, showed a perceptibly weaker expansion. In addition to production closures during the Olympic Games, primarily reduced growth in export orders caused by the world economic slowdown was responsible for this development. It was further intensified by the deteriorating price competitiveness of the Chinese economy. In real effective terms, the Chinese currency appreciated by about 15 percent since the start of 2008. Most segments of the domestic economy, notably consumption, seem to have held up reasonably well so far and thus managed to partly compensate for this decline in external demand.

The direct effects of the international financial crisis on the Chinese banking system have been quite limited up to now. Chinese banks have hardly been involved in the US mortgage market and face relatively strict financial controls. Nevertheless, stock market indexes have plummeted by about 50 percent since the beginning of last year.

Partly due to the still relatively restrictive monetary conditions during the first part of 2008, investment has started to become less dynamic. In particular, the real estate market, which already threatened to overheat, has begun to cool off noticeably. Thus, the rise in house prices has clearly started to slow and house sales are falling. A collapse of the real estate market could seriously affect the already staggering Chinese economy.

For that reason, monetary policy changed course during the second half of last year and the People's Bank of China have reduced target rates and reserve-requirement ratios in several steps since autumn.

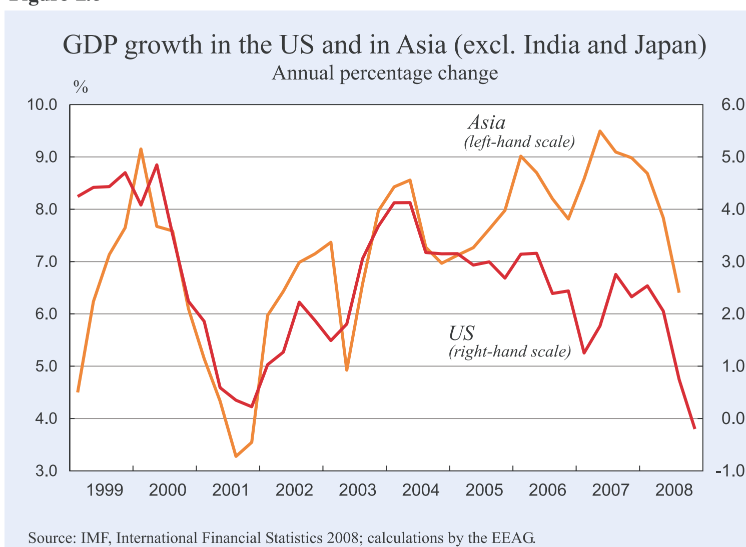
After four years of strong economic growth, the economy of *India* started to slow last year. In the spring of 2008, the country still had the lowest inflation rate of the big emerging economies. During the summer, however, consumer inflation rates doubled to about 9 percent, and growth in wholesale prices even tripled to more than 12 percent. Besides the high raw material prices on the world market, crop failures due to bad weather were the main cause of these price-propelling effects. Furthermore, the strong devaluation of the rupee induced a sharp increase in import prices. During the last months of last year and driven by sharply lower commodity prices, inflation started to slow down again.

On the other hand, during the first half of 2008 exports grew by 15 percent as compared to the first half of 2007, benefitting from the relatively lower prices of Indian products on world markets. Furthermore, strong wage increases and higher foreign remittances boosted private consumption.

Initially higher interest rates triggered by the upsurge in inflation already caused investment dynamics to slow down early in the year. On balance, industry, construction and the service sector already showed lower growth rates since the start of 2007. Only income in the agricultural sector – which amounts to 18 percent of GDP – benefited from the higher agricultural prices on the world market during the first half of last year.

Latest data show that economic activity slowed significantly during the second half of 2008. Corporate profits fell sharply, while a fall-off in spending on consumer durables, such as cars, augurs ill for private consumption growth. Furthermore, capital flows are reversing.

Figure 1.6



Source: IMF, International Financial Statistics 2008; calculations by the EEAG.

The weakening of the economy induced the Reserve Bank of India (RBI) to start easing monetary policy by reducing restrictions on lending to the property sector, raising the limit on export credit finance available to banks and cutting key interest rates. In an attempt to mitigate the impact of large capital outflows, the RBI is trying to encourage deposits from non-resident Indians and is considering liberalising restrictions on foreign direct investment.

Nevertheless, GDP growth will be reduced by 2 percentage points as compared to the last two years and will reach a level of 7 percent in 2008.

As in Japan and India, the economic growth in the rest of Asia (which includes *Hong Kong, Indonesia, Malaysia,* the *Philippines, Singapore, South Korea, Taiwan* and *Thailand*) is quite dependent upon developments in the United States. The correlation between the economic development in this region and that of the United States has been quite high and stable for several years. Despite this correlation, the growth differential between these two regions has clearly increased since 2005. Whereas Asia (excl. Japan and India) experienced about 3.5 percentage points higher growth than the United States in the period 1999–2004, this growth differential has increased to approximately 6 percentage points since then.[2] Improved fiscal budgets and net foreign exchange reserves have increased the likelihood that – despite the high correlation – the growth differential will prove to be persistent (see Figure 1.6).

This group of emerging economies in Asia initially continued their upswing during the first half of 2008 and have since experienced diverse developments. While most of the economies have only seen moderate declines in their growth rates so far, others, most notably Singapore, has shown a more virulent slowdown or has already gone into recession.

Inflation tended to increase in most of these countries throughout most of 2008. One of the reasons was the reduction in energy subsidies, which previously dampened the domestic price increase. The overall decline in raw material prices has already started to reduce inflation to some degree. However, the sharp increase in the core inflation rate since the beginning of the year indicates that second-round effects cannot be completely ruled out yet. Nevertheless, monetary policies throughout most East Asian economies turned sharply over the final months of 2008, as the focus shifted from concerns about inflation to growth prospects.

Except for South Korea, consumption growth slowed down due to both higher inflation rates and increased import prices (both reducing real income). Meanwhile, exports have remained relatively robust for some time. The depreciation of some currencies and an intensification of trade within Asia have been able to soften the effects of reduced demand from western countries.

Largely driven by ongoing, strong import growth, the trade surpluses and the growth contributions of net exports decreased substantially. Especially imports of investment goods remained quite robust in most of these economies. Overall, GDP growth declined by 1 percentage point as compared to 2007 and reached 4.5 percent in 2008.

[2] Neither including India nor Japan alters this conclusion: the growth differential has increased by an average of about 2 percentage points after 2004.

In general emerging markets have so far been able to play a stabilising role in the current crisis. Although, their savings allowed the huge US current account deficit and consequently the US consumer boom to be possible in the first place, it is precisely the reserves they have built up that are now helping to stabilise the global economy. For example, they are preventing any renewed build-up in speculation against Asian currencies. The budget surpluses that have been accumulated over the years are now being used to prevent a sharp downturn in domestic demand. In addition, continued demand from emerging markets has helped dampen an even sharper downturn in exports from industrialised nations. The sovereign wealth funds of emerging countries have also been buying up financial stocks in Europe and the United States, which has helped to avert numerous bankruptcies.

2.4 The rest of the world

Although growth weakened in the Latin American region (i.e. *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*) during the second half of last year, annual rates in general stayed well above 4 percent. As in the previous year, the only exception was Mexico: it suffered from its dependence upon the US economy. During the first part of the year most countries still benefited from the high raw material prices. However, in particular for the net exporters of energy, raw materials and food, the tide changed radically during the second half of 2008 when commodity prices tumbled from record highs and financing conditions worsened sharply.

The surge of inflation especially due to increased food prices led central banks in the region to tighten monetary policy. In the meantime, the financial crisis has put an end to this and interest rate cuts have already been implemented.

In most of the Latin American economies the fiscal situation has clearly improved in recent years. For instance, Brazil's primary fiscal surplus amounted to approximately 4 percent of GDP last year. This will give governments some leeway to soften the consequences of the global crisis, which is increasingly spreading to this region as well.

During the first half of the year total production in *Russia* continued to expand strongly. In particular, domestic demand was responsible for this. Whereas consumption was able to hold up reasonably well, investment was no longer able to reach double-digit growth rates. The increased inflation rate was mainly responsible for this. Furthermore, the financial crisis made it more problematic to finance new projects.

During the past years it was mainly external capital that financed new firm activities, with an increasing share of loans denominated in foreign currencies. This financing form continued to grow during the first half-year of 2008. Beginning with the conflict in Georgia and the intensification of the credit crisis, investor sentiment changed and Russia had to cope with massive outflows of capital. In addition, reduced external demand, especially from Europe, worsening terms of trade conditions, and still growing imports caused net exports to fall considerably.

The consumer price level continued to rise by double-digit rates last year. The persistent inflation trend was not only caused by rising food prices but is also due to the strong expansion of the money supply. High foreign exchange receipts from oil exports have been used to finance the expansionary financial policy stance. During the first half of the year, the Russian central bank reacted to the inflationary environment by increasing base rates.

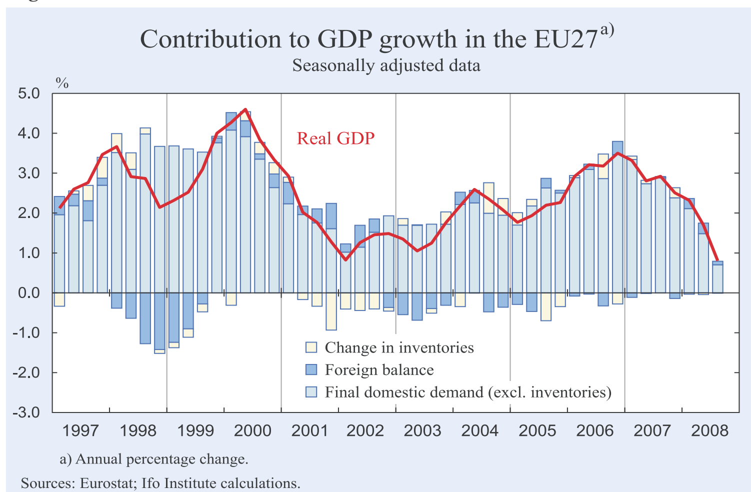
Monetary policy changed course in autumn when financial turbulence reached the Russian banking sector. The central bank intervened in the money market, was forced to cut the minimum reserve requirements and the stock exchange was temporarily closed down. Furthermore, the high volatility on foreign exchange markets caused the Russian central bank to widen the rouble trading corridor several times, while continuing to spend substantial amounts of foreign-exchange reserves to try to prevent a larger devaluation. During the second half of the year, foreign exchange reserves fell by over 150 billion US dollars.

2.5 The European economy

After a still relatively positive outlook at the beginning of last year, the economic climate deteriorated markedly as the year progressed. The turbulence on international financial markets as well as the collapse in sentiment seen within the industrial sector and amongst consumers throughout Europe in the second half of the year have increasingly been reflected by data on real economic output.

Real GDP sank 0.8 percent in the third quarter within the European Union (EU27). A decline in production was also reported for the previous quarter. The

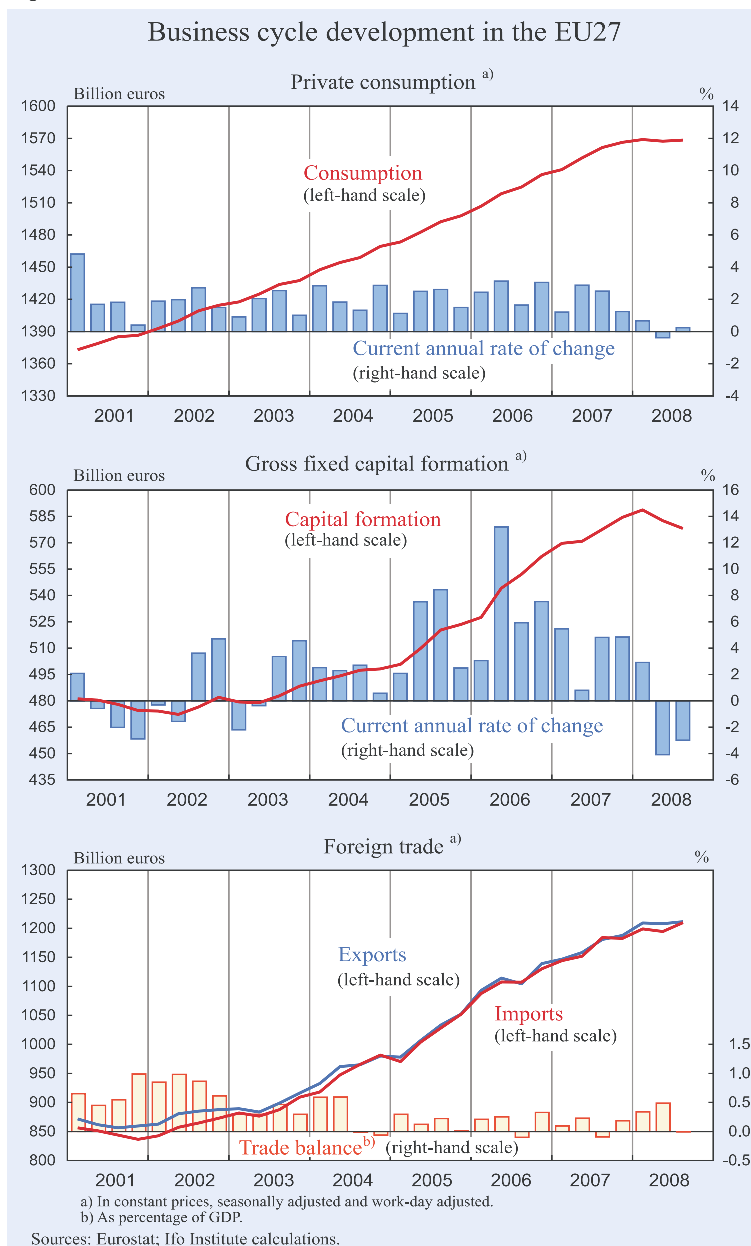
Figure 1.7



a) Annual percentage change.

Sources: Eurostat; Ifo Institute calculations.

Figure 1.8



a) In constant prices, seasonally adjusted and work-day adjusted.
b) As percentage of GDP.

Sources: Eurostat; Ifo Institute calculations.

figures were the worst since the data was first recorded in 1995. Given that most available indicators report negative growth for the last quarter of 2008 and the first quarter of this year, the European economy has been in recession since the second quarter of last year. At present, most member countries face negative growth. This means that unlike in the past, national demand shortfalls will not be offset by growth in other countries and final domestic demand in the European Union has reached an all-time low (see Figure 1.7).

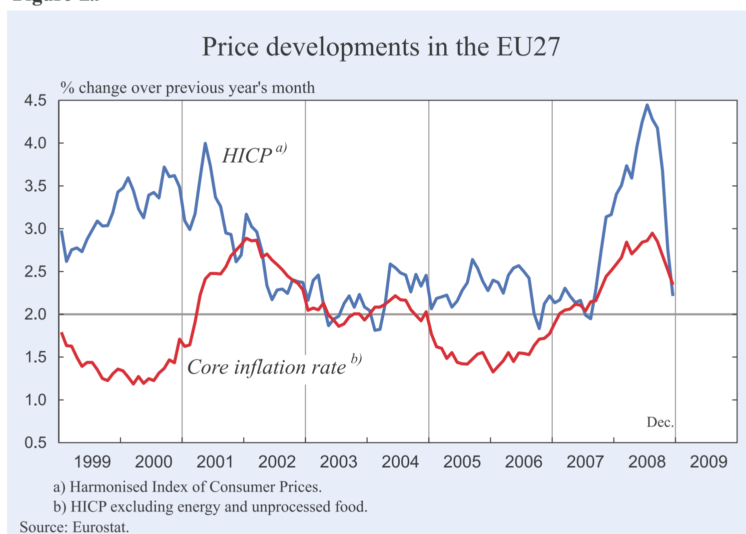
However, the downturn is not affecting all parts of the European economy to the same extent. Indeed, there is a distinction between individual industrial sectors and their respective operating conditions. Following the financial sector and the construction sector in some EU member countries, the automobile industry is also finding itself struggling to cope with a massive drop in global demand. Production of motor vehicles and motor vehicle components in Germany in October, for example, fell by 13.2 percent in year-on-year terms, and incoming orders shrank by a sizeable 32.8 percent in November. Further declines, which will also impact the supplier industry, appear unavoidable.

After a still positive growth in the first quarter, investment plummeted in the remainder of last year (see Figure 1.8). Especially in those countries facing a sharp downturn in the property market, in particular Ireland, Spain and the United Kingdom, there have been large falls in residential investment spending throughout the year. (The drop in sentiment indicators was followed by a rapid deterioration in non-resi-

dential investment spending, which deteriorated quickly during the second half of last year.) Given the high investment levels at the beginning of last year, the annual growth rate for 2008 for the EU27 nevertheless remained slightly positive.

Whereas private consumption was still an important pillar for economic growth in Europe in 2007, it basically stagnated in 2008. Initially, this was especially due to a fall in consumer spending in Germany caused by increased inflation rates during the first quarters, slowly deteriorating labour market conditions and sharply deteriorating financial prospects. However, quickly falling inflation rates (positively affecting real income development) at the end of last year allowed consumption to pick up again slowly.

Figure 1.9



a) Harmonised Index of Consumer Prices.
b) HICP excluding energy and unprocessed food.
Source: Eurostat.

Despite the strength of the euro, net exports contributed positively to GDP growth in the European Union last year. The slowdown in export growth was met by a comparable fall in import growth rates. Only at the end of the year did the trade surplus start to fall as imports grew somewhat faster.

Employment kept growing in the European Union throughout last year – albeit at a continuously slower pace. With the increase in the labour force, however, the unemployment rate reached its lowest rate of 6.8 percent during the first quarter last year. Thereafter it steadily increased to 7.2 percent in November.

Temporarily, the increase in prices accelerated noticeably in the entire European Union during the first part of 2008 (see Figure 1.9). The inflation rate – measured by the harmonised index of consumer prices (HICP) – increased from 3.4 percent in January to 4.4 percent in July. Above all, this was induced by the strong increase in oil prices observed in the first half-year of the year. Oil prices started to fall in the middle of July. Subsequently, the official inflation rate decreased to 2.8 percent in November. Although less dynamically than in 2007, core inflation (the growth in the HICP excluding energy and crude food) continued to increase until reaching a peak of 2.9 percent in August. Since then it reversed and slowed down to 2.5 percent in November.

Against the backdrop of moderate wage growth and favourable economic conditions in the past years, nominal wage increase accelerated last year in the euro area. Average compensation per employee grew by 3 percent in the private sector (as compared to 2 percent on average during 2005–2007). As the economic situation started to deteriorate relatively early in the United Kingdom, one of the major economies in Europe, wage growth already lost some momentum last year. Given that consumer prices increased by 3.3 percent in the euro area and 3.7 percent in the United Kingdom, this implies that real wages declined last year. From a supply-side perspective, real wage compensation still increased somewhat in the euro area as the GDP deflator did not go up by as much as the consumer price index. Although growth in real wage compensation cost was kept below that of the United States and Japan, the lower productivity growth in the euro area also dominated when calculating unit labour costs (see Table 1.1).

After two years of high growth and an exceptionally high growth rate in the first quarter of last year, the *German* economy fell into recession. Whereas high inflation caused consumption to fall during the first half of the year, it managed to reach subdued growth levels again during the second half. Increased government spending and moderate investment growth allowed small but positive impulses to come from the domestic economy. The growth contribution of net exports, on the other hand, turned negative during the last two quarters. Although Germany managed to improve its competitiveness (as measured by the relative unit labour costs in dollar terms) for the fifth year in a row, exports started falling in the third quarter.

Table 1.1

Labour costs

	Compensation per emloyee[a)]		Real compensation costs[b)]		Labour productivity[c)]		Unit labour costs[c)]		Relative unit labour costs[d),e)]		Export performance[f)]	
	2005–07	2008	2005–07	2008	2005–07	2008	2005–07	2008	2005–07	2008	2005–07	2008
Germany	0.8	2.3	– 0.2	0.7	1.5	0.1	– 0.9	2.4	1.4	4.3	1.5	0.2
France	3.1	2.9	0.8	0.6	1.2	0.3	1.9	2.5	– 3.2	– 2.1	– 3.3	– 2.0
Italy	2.3	3.9	0.3	0.0	0.1	– 1.0	3.0	5.6	– 11.1	8.5	– 4.0	– 4.5
Spain	2.6	4.1	– 1.2	0.8	0.0	1.2	3.5	3.5	1.0	na	– 2.4	– 0.7
Netherlands	2.2	3.4	0.3	1.7	1.4	0.8	0.7	2.8	3.0	– 2.6	– 0.8	0.1
Belgium	3.3	3.5	0.9	1.4	1.2	– 0.1	2.0	3.5	0.5	– 2.4	– 3.7	– 0.9
Austria	2.7	2.3	0.7	– 0.3	1.9	0.3	1.0	2.4	– 0.9	0.0	– 1.3	– 1.4
Greece	7.2	6.8	4.0	3.4	2.6	1.9	4.2	4.6	0.4	1.4	– 4.0	– 2.4
Finland	3.2	5.6	1.7	2.3	2.3	0.4	1.1	5.3	0.6	1.1	– 1.0	– 1.4
Ireland	5.9	5.6	3.6	6.5	1.8	– 1.9	4.0	8.1	2.8	4.9	– 0.3	– 0.7
Portugal	3.6	3.6	0.8	1.4	1.1	– 0.3	2.4	4.8	– 2.9	0.2	– 1.4	– 1.4
Slovak Republic	9.6	7.9	7.5	3.0	6.4	4.9	1.7	2.8	2.2	4.3	7.1	1.1
Luxembourg	3.8	2.7	0.2	1.3	1.9	– 1.6	2.0	4.4	– 0.8	– 5.5	1.4	– 0.9
Euro area	2.0	3.0	0.0	0.5	0.9	0.0	1.4	3.4	– 0.6	na	na	na
United Kingdom	3.8	2.5	1.2	– 0.8	1.8	0.1	2.1	2.8	0.1	3.0	– 2.5	– 2.4
Sweden	3.4	3.5	1.7	– 0.2	2.1	– 0.2	1.3	4.1	3.9	2.1	– 0.8	– 1.0
Denmark	4.3	4.2	2.0	0.7	1.3	– 0.9	2.5	5.4	1.8	3.1	– 1.4	– 1.3
Poland	2.8	9.4	0.2	6.0	2.1	1.7	2.8	6.7	0.2	– 0.9	1.0	0.6
Czech Republic	6.3	7.5	4.9	5.1	5.0	3.1	1.3	5.0	0.5	10.7	4.8	4.7
Hungary	6.0	8.3	2.1	2.5	2.9	3.2	3.8	5.6	7.3	– 22.1	5.6	2.1
United States	3.8	3.5	0.7	1.2	1.1	1.6	2.8	2.2	– 3.3	na	– 0.1	2.8
Japan	– 0.3	0.7	0.7	1.7	1.7	0.8	– 1.2	0.8	4.7	– 24.7	0.0	0.5

a) Compensation per employee in the private sector. – b) Compensation per employee deflated by GDP Deflator. – c) Total Economy. – d) Manufacturing sector. – e) Competitiveness– weighted relative unit labour costs in dollar terms. – f) 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 83 and 84 databases.

As an exporter of investment goods Germany was particularly hard hit by the decline in economic sentiment around the world. At the same time imports remained on an expansion path.

As the final quarter of 2008 was the second consecutive quarter-on-quarter contraction, the *United Kingdom* entered recession in the third quarter. Whereas consumers in the United Kingdom started to reduce their consumption in the second quarter, investment had already fallen since January. Expansionary fiscal policy and improved net exports – mainly due to a fall in imports – kept GDP from decreasing until the third quarter. Hence, in contrast to the situation in Germany, while domestic demand growth was strongly negative in the United Kingdom, net exports were positive during the second half of the year.

Inflation in the United Kingdom surged to a 16-year high of 4.4 percent in July. While rising energy and food prices were the main drivers, detailed inflation data also revealed a broad-based rise in prices of other goods and services. Wage inflation remained subdued and UK home prices continued to drop. Depending on the indicator that is used, the latter have dropped by close to 20 percent since their peak at the end of 2007.

Despite a slowdown, domestic demand in *France*, continued to increase and was able to compensate for the negative growth contributions of net exports. Since the second quarter of last year investment growth also turned negative leaving private and public consumption to keep GDP growth positive. Of the five largest European economies, France is thereby the only one which so far has not been in recession as defined by two consecutive quarters of negative GDP growth. It is not as dependent on foreign trade in manufacturing as Germany, is not as heavily involved in the banking crisis as the United Kingdom and is not confronted with large corrections on real estate markets like Spain.

The labour market situation in France remained stable throughout the year in spite of the menacing economic crisis. The unemployment rate only increased slightly.[3] It amounted to 7.9 percent in October, after it stood at a low of 7.7 percent in January 2008.

[3] However, as discussed in Chapter 4, this incipient increase in unemployment has triggered a pro-active response from the government in the form of a "jobs package" and further fiscal stimulus.

The *Italian* economy is in recession. GDP fell by an annualised 0.5 percent in the third quarter after it already decreased by 0.4 percent in the second quarter of last year. The Italian recession is broad-based. Private consumption has been stagnating for quite some time. Consumer confidence has fallen to a record-low level. Investment, which already turned negative in mid-2007, is constrained by more restrictive financing conditions as well as weak construction activities due to restrained house price developments. For the most part, however, it is the lull in foreign demand for Italian goods that is putting a burden on the Italian economy. This, in turn, is caused by strong competition on world markets (due to the unfavorable product composition of Italian exports), the continuously deteriorating international competitiveness of the Italian economy largely due to strongly increasing unit labour costs, as well as the general economic decline of the world economy.

GDP in *Spain* fell by about 0.2 percent in the third quarter of 2008, after it rose by a similar amount during the first half of the year. Private consumption also dropped in the third quarter. Investments started falling in the second quarter. The growth contribution from net exports remained stable – overall exports rose, while imports fell. As also the fourth quarter is expected to report negative growth, the economy of Spain has thus slipped into recession. Especially the bursting of the real estate bubble is putting a strain on the expansion of domestic demand. Starting in the second quarter of 2008, house prices began to decline after having basically doubled since 2001. This fall in real estate prices is negatively affecting private consumption due to a lasting increase in the implicit debt burden of mortgages. This increase has occured, first, because the value of the provided securities has dropped. Secondly, due to variable interest rate conditions at which mortgage loans in Spain are normally granted and the increased risk premium set by banks, interest costs are likely to increase in the future. The willingness of Spanish banks to grant credit has already clearly decreased as a result of the increased probability of failure.

Although most of the large economies in Europe entered recession in 2008, most smaller EU member countries did not report negative growth rates at least until the fourth quarter of last year. The exceptions were *Denmark, Estonia, Ireland* and *Sweden*. In Denmark, Estonia and Ireland private consumption went into a slump. For Sweden, negative growth was mainly caused by a fall in net exports.

Box 1.1

Monetary policy transmission and house prices in Europe

According to theory, a contraction in monetary policy should have a negative effect on house prices. Given that home ownership determines to a large extent wealth positions of households, this in turn affects consumption decisions. The ongoing deregulation of mortgage markets in Europe will in principle increase the importance of this monetary transmission channel. However, there is no real consensus regarding the relevance of this theoretical channel in the empirical literature. Given the high degree of heterogeneity in mortgage markets across the European Union, these effects are bound to differ from one country to the next. Within Europe mortgage credit relative to GDP ranges between 15 in Italy to 111 percent in the Netherlands; the typical maturity varies between 15 to 30 years and typical loan-to-value ratios between 50 and 112 percent. Furthermore, the degree to which variable versus fixed interest rates are used varies greatly among countries.

In a recent study, Carstensen et al. (2008) empirically estimated the impact of monetary policy on house prices on a subset of 13 European countries for the period 1995–2006.[1] Besides real house prices and nominal short-term interest rates as an instrument for monetary policy, the variables included are both real GDP and its deflator.

They find that, in general, nominal house prices increase as a reaction to an expansionary monetary policy shock. Furthermore, nominal house prices are less sticky than average prices, since house prices adjust to their starting level within 5 years, whereas other prices do not. Initially 12 percent and after five years roughly a third of the volatility in real house prices can be explained by monetary policy.

Although in general house prices co-move with key macroeconomic variables after a monetary policy shock, the study found large heterogeneity amongst countries. For that reason, the authors endogenously divide the data set in two distinctive groups.[2]

It turns out that monetary policy, both in the long and short run, had stronger effects on house price developments in Denmark, Ireland, the Netherlands, Sweden, Spain and the United Kingdom than in Austria, Belgium, Finland, France, Germany, Italy and Portugal. Although the last two years have not been included in their sample, the three economies currently suffering from unwinding real estate prices – Ireland, Spain and the United Kingdom – all belong to the group that in the past has strongly responded to monetary policy action. As described in the 2007 EEAG report, at least Ireland and Spain have experienced a prolonged period in which interest rates were well below optimal levels, from their perspectives.

[1] The sample countries are Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.
[2] There is no general agreement on how to separate countries into groups; usually the separation is based on subjective indicators. To be as objective as possible Carstensen et al. (2008) cluster countries into distinctive groups taking account of the reaction of real house prices to a monetary policy shock. The groups of countries – a strong reaction group and a weak reaction group – are endogenously identified by using a distance measure that is determined by the absolute value of the difference between cumulated impulse responses. The impulse responses across the two groups of countries are compared afterwards to assess the macro-economic effects of movements in real house prices after a change in interest rates.

In the East European member countries of the Europen Union, the economic expansion in the first half-year slowed down during the rest of 2008. Over the year, real GDP of these new member countries that are not part of the euro area increased by about 4.8 percent (see Table A.2). In most countries, and especially in *the Czech Republic, Poland* and *Slovakia*, consumption continued to increase substantially. Investments also expanded robustly in these countries, whereas they fell in *Estonia, Hungary* and *Latvia*. Overall, the trade balance deteriorated somewhat.

3. Fiscal and monetary policy in Europe

3.1 Fiscal policy

Despite the continuing increase in tax receipts, the public finance situation in general, in both the euro area as well as the whole EU27, no longer improved last year. The fiscal deficit as a percentage of GDP increased from 0.6 to 1.3 percent of GDP for the euro area and from 0.9 to 1.6 percent in the EU27 (see Table 1.2). In contrast to the United States, the structural budget deficit in the euro area increased only slightly last year (see Figure 1.10).

Except for Portugal and Romania, the consolidation of public finances ceased, and both actual and cyclically-adjusted fiscal balances deteriorated. The countries that exhibited fiscal surpluses last year are Bulgaria, Denmark, Ireland, Luxembourg, the Netherlands and Sweden. Now that Europe is in recession, fiscal consolidation is no longer at the top of the agenda. Especially since the autumn, member states have continuously announced rescue packages, first of all for the banking sector and more recently also for the other parts of the economy.

Given the global nature of the crisis, co-ordination is important and the European Commission acted by

Table 1.2

Public finances

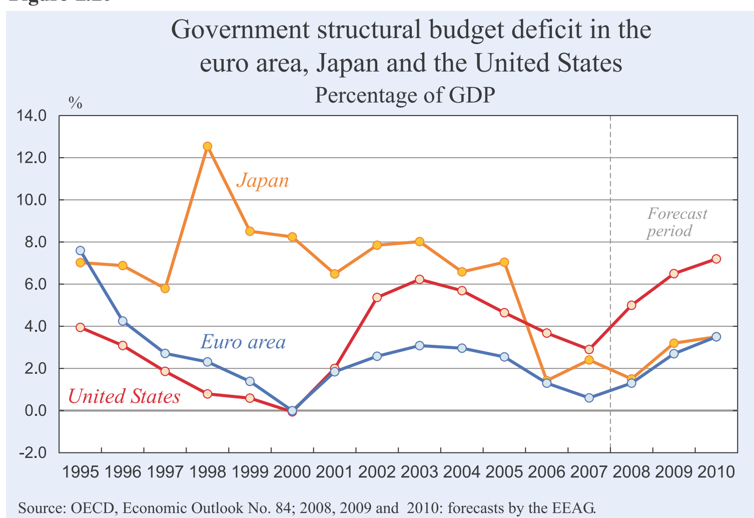
	Gross debt[a]				Fiscal balance[a]			
	2001–2005	2006	2007	2008	2001–2005	2006	2007	2008
Germany	63.3	67.6	65.1	64.3	–3.5	–1.5	–0.2	0.0
France	61.7	63.6	63.9	65.4	–3.0	–2.4	–2.7	–3.0
Italy	105.7	106.9	104.1	104.1	–3.5	–3.4	–1.6	–2.5
Spain	49.2	39.6	36.2	37.5	–0.1	2.0	2.2	–1.6
Netherlands	51.5	47.4	45.7	48.2	–1.5	0.6	0.3	1.2
Belgium	99.0	87.8	83.9	86.5	–0.5	0.3	–0.3	–0.5
Austria	65.5	62.0	59.5	57.4	–1.6	–1.5	–0.4	–0.6
Greece	99.9	95.9	94.8	93.4	–5.5	–2.8	–3.5	–2.5
Ireland	42.7	39.2	35.1	31.6	3.4	4.1	5.3	5.1
Finland	31.1	24.7	24.8	31.6	0.8	3.0	0.2	–5.5
Portugal	57.4	64.7	63.6	64.3	–3.9	–3.9	–2.6	–2.2
Slovakia	42.1	30.4	29.4	28.8	–4.5	–3.5	–1.9	–2.3
Slovenia	27.4	26.7	23.4	21.8	–2.6	–1.2	0.5	–0.2
Luxembourg	6.3	6.6	7.0	14.1	1.5	1.3	3.2	2.7
Cyprus	66.7	64.6	59.5	48.2	–3.9	–1.2	3.5	1.0
Malta	66.7	63.9	62.2	63.1	–5.9	–2.3	–1.8	–3.8
Euro Area	**68.9**	**68.3**	**66.1**	**66.6**	**–2.6**	**–1.3**	**–0.6**	**–1.3**
United Kingdom	39.4	43.4	44.2	50.1	–2.3	–2.7	–2.8	–4.2
Sweden	52.3	45.9	40.2	34.7	0.5	2.3	3.6	2.6
Denmark	44.0	30.5	26.2	21.1	–5.3	5.2	4.5	3.1
Poland	43.9	47.7	44.9	43.7	–5.1	–3.8	–2.0	–2.3
Czech Republic	28.8	29.6	28.9	26.6	–1.9	–2.7	–1.0	–1.2
Hungary	21.4	12.4	12.9	13.4	–6.9	–2.2	–2.6	–3.4
Romania	57.4	65.6	65.8	65.4	–1.8	–9.3	–5.0	–3.4
Lithuania	20.9	18.0	17.0	17.5	0.6	–0.4	–1.2	–2.7
Bulgaria	46.8	22.7	18.2	13.8	–1.5	3.0	0.1	3.3
Latvia	13.9	10.7	9.5	12.3	1.0	–0.2	0.1	–2.3
Estonia	5.1	4.3	3.5	4.2	–2.0	2.9	2.7	–1.4
EU27	**61.5**	**61.3**	**58.7**	**59.8**	**–2.5**	**–1.4**	**–0.9**	**–1.6**

[a] As a percentage of gross domestic product; definitions according to the Maastricht Treaty.

Source: Eurostat and European Commission

announcing the so-called European Economic Recovery Plan at the end of last year. Its immediate priority is to improve confidence in the financial system and subsequently mitigate the impact of the crisis on the real economy.

Figure 1.10



Source: OECD, Economic Outlook No. 84; 2008, 2009 and 2010: forecasts by the EEAG.

The Recovery Plan consists of two pillars. First on the list is a scheduled fiscal impulse of 200 billion euros, which is approximately 1.5 percent of EU GDP. The major part, 170 billion euros, consists of the national stimulus programmes which have partly already been unveiled by member states. The remaining 30 billion will be directly funded by the EU. Its clear focus is on increasing government spending towards areas which are hit most by the crisis and from where the largest multiplier effects can be expected. Accordingly, transfers are directed towards the unemployed and low-income households, to guarantees and loan subsidies, and to temporarily reduce value-added taxes. The second pillar focuses on the continuation of structural reforms to promote potential growth and general resilience of the European economy. These

reforms include reducing administrative burdens for firms, increasing labour market flexibility, and investing in infrastructure, human capital and "green" technologies, all of which have their roots in the Lisbon Strategy.

Despite this attempt to coordinate fiscal action within Europe, countries have reacted quite differently to the economic downturn.

For instance, whereas the *German* banking sector was supported swiftly and with large sums of money, for a long time the central government appeared to be unwilling to act boldly in the area of fiscal policy. Thus far, 20 German banks are considering participating in the 500-billion-euro bank rescue package put in place by the government in mid-October.

Initially, the German government announced a stimulus package of about 6 billion euros for 2009 and 2010, which contained a tax rebate when buying a new car, more favourable depreciation allowances for firms and tax deductability of bills from craftsmen for households. More recently, the Bundestag (the lower house of German parliament) passed a package of measures, supposedly worth approximately 30 billion euros, which would be roughly 1.2 percent of German GDP.

At the end of November the *UK* government announced a package which amounts to 22 billion euros, i.e., about 1 percent of GDP. Its main ingredient is a reduction of the value-added tax by 2.5 percentage point to 15 percent as of 1 December 2008 until the end of 2009. This alone reduces tax revenue by 14 billion euros. This temporary cut is indeed likely to boost the domestic retail sector. So far, retail sales in the United Kingdom have been relatively stable. However, as the country has been hit particularly hard by the financial and property crisis, a collapse in the retail sector should only be a matter of time. Infrastructure spending is to be increased by 3.3 billion euros. According to the pre-budget report the entire package will reduce the effect of the downturn by 0.5 percentage points.

France has unveiled a 26 billion euro stimulus package, which is equivalent to about 1.3 percent of GDP. Besides massive subsidies for medium-sized businesses, the plan earmarks 10.5 billion euros for infrastructure and R&D expenditure research, and the support of local authorities. The French economics minister said the plan should create 80,000 to 110,000 new jobs, making up for the expected disappearance of some 90,000 jobs next year due to the crisis.

Prime Minister Silvio Berlusconi said that *Italy* will take measures that amount up to 80 billion euros to support the Italian economy. This would be about 5 percent of GDP. However, many economists have already pointed out that the vast majority of this money is no more than a recycling of existing funds. The measures include a temporary freeze on regulated energy prices and road tolls, 2.4 billion euros in tax breaks for poorer families and some marginal easing of the direct and indirect tax burden for companies.

During the second half of last year, *Spain* announced various measures to cushion the impact of the economic slowdown and soaring unemployment. Most recently, the government said it will spend an extra 11 billion euros on public works and other stimulus measures to create 300,000 jobs in 2009. The package includes 6 billion euros in tax cuts and 4 billion euros of liquidity to credit-strapped companies and households. The plan, equivalent to roughly 1 percent of Spanish GDP, furthermore includes 800 million euros in aid for the auto sector.

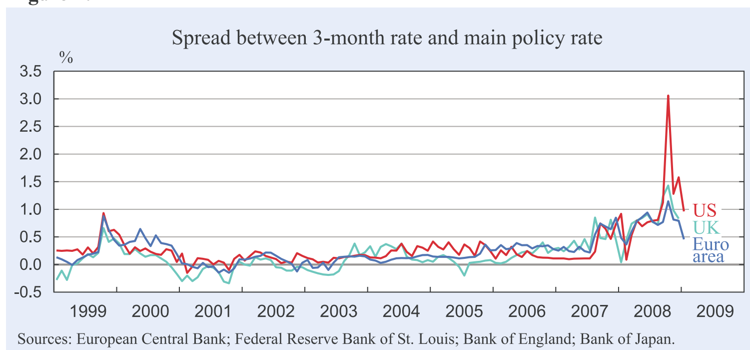
Other countries within the European Union have also announced programs of similar orders of magnitude. For instance, in *the Netherlands,* the government communicated a so-called "liquidity impulse" of 6 billion euros, which equals roughly 1 percent of GDP. It includes allowing companies to write down investments sooner than usual.

3.2 Monetary conditions and financial markets

The financial crisis

In summer 2007, the financial crisis was triggered by announcements that some banks around the world were in financial distress due to losses on investments in US mortgage-backed securities. Overly optimistic expectations about future growth and interest rates in combination with various subsidies and other policy interventions led to unsustainably high house prices in the United States. Ex post, it is obvious that a correction of this bubble, as it is often labelled in the public debate, had to occur. Its bursting has led to a sharp reevaluation of associated mortgage-backed securities. Strong interlinkages between balance sheets of financial institutions have consequently triggered a severe loss in mutual confidence within the banking sector.

Figure 1.11



Sources: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan.

This in turn caused the need for further write-downs and losses, and a downward spiral set in.

In early 2008, the reduction in money market interest rate spreads, which with hindsight was only temporary, appeared to signal that perhaps the worst was over (see Figure 1.11). However, what started with the loan defaults in the US subprime sector affected a steadily widening variety of financial markets over the course of the past year. As it turned out, the subprime mortgage crisis did not actually reach a critical stage until September 2008. Then, liquidity contracted severely in the global credit markets, and several investment banks and insurers in the United States threatened to turn insolvent. The spread between the three-month interbank rates and the policy rates reached unprecendented levels in the United States and Europe. Whereas the spread peaked with an average of 306 basis points in the United States in November, it was still 115 basis points in the euro area that same month. In response, the US government announced a series of comprehensive steps to address the problems, following a series of stand-alone decisions whether to intervene or not. For instance, a liquidity facility for American International Group (AIG) was created on September 16. Furthermore, the Federal Reserve basically took over Fannie Mae and Freddie Mac – the government sponsored enterprises that are behind a vast majority of new mortgage lending in the United States. However, it did not intervene to prevent the bankruptcy of Lehman Brothers, which nowadays is considered to have triggered an unprecendented wave of mistrust and thereby an almost complete drain off on interbank markets. This near-collapse of world-wide financial systems was only prevented by decisive actions of central banks around the world – they basically turned into the main provider of liquidity on interbank markets.

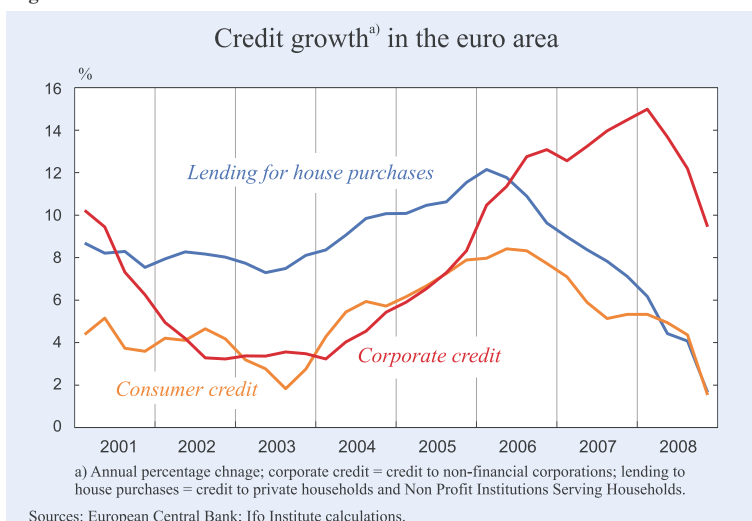
Chapter 2 of this year's EEAG report is devoted entirely to the financial crisis. Here we highlight its most importance consequences for economic developments. Most importantly, the loss in confidence amongst bankers has widened to a general drop in sentiment. Households started to fear a loss in their financial savings, and firms projected the situation of the financial markets onto the real economy. Prospects deteriorated more sharply than otherwise would have been the case, causing a withdrawal of investment plans (including residential investments) and a cut-back in the consumption of durable goods (such as cars).

The other channel through which the banking crisis affects household and firm decisions is via the willingness of banks to supply credit. As already argued in last year's EEAG report, it is in general difficult to come up with statistical evidence that clearly refutes or proves the existence of a credit crunch scenario.[4] To do so, we would need to know the excess-demand for or the under-supply of credits instead of the actual quantity and price, i.e., interest rate. A credit crunch does not necessarily show up in higher risk premia enclosed in market interest rates – balance sheet problems on the side of the bank might simply lead them to become more selective without an increase in the price. Nor is a fall in credit volumes necessarily a result of the reduced credit supply – it might simply be demand which is falling. It would, however, be difficult to associate a credit crunch with increasing credit volumes.

After a short pause during the winter last year, interest rates for new loans to households and firms in the euro area continued to increase slowly until the summer. This process, which started in early 2006, seems to have come to a halt in more recent months. This pattern is most pronounced for loans with maturities of more than five years – constituting more than half of the total credit volume. With respect to credit volumes, the patterns have been clear since early last year (see Figure 1.12). Although credit to non-financial corporations remains, growing at reduced levels, annual growth rates fell from 15 percent in the first

[4] A situation in which banks constrain their credit supply to still profitable projects is usually labelled a credit crunch. This would in general be caused by balance sheet problems on the part of the bank. This does not include situations in which banks constrain the credit supply because formerly profitable investment projects are no longer considered profitable, for instance, due to a changing economic environment.

Figure 1.12



a) Annual percentage chnage; corporate credit = credit to non-financial corporations; lending to house purchases = credit to private households and Non Profit Institutions Serving Households.

Sources: European Central Bank; Ifo Institute calculations.

quarter of 2008 to 12.2 percent in the third. Especially the last few months have seen sharp falls in growth rates. The decline in growth of both consumer credits and mortgages – which started already in 2006 – continued throughout the year. Annual growth rates decreased to approximately 4 percent at the end of the third quarter of last year.

At least up until autumn, financial turbulence did not seem to have a great impact on credit data. Potential explanations might be that corporations made use of pre-committed credit lines and did not reduce their demand for bank credit as much because direct access to financial markets was even more restrained. More recently, however, the impact of the financial crisis has started to show up more clearly in credit data. This situation is likely to continue to worsen as especially survey data has pointed out. For Europe, we can fall back on the results of business tendency surveys, which ask firms about their financial constraints, and on the bank lending survey conducted by the ECB among the private banks within the euro area.

In the business tendency surveys published by the European Commission, firms in manufacturing, the services and construction are asked on a quarterly basis whether financial constraints are limiting their production capabilities. Figure 1.13 shows that indeed within the services sector the percentage of firms indicating they are financially constrained has increased to close to 16 percent in the last quarter. In manufacturing and construction, we also see an increase – albeit less pronounced.

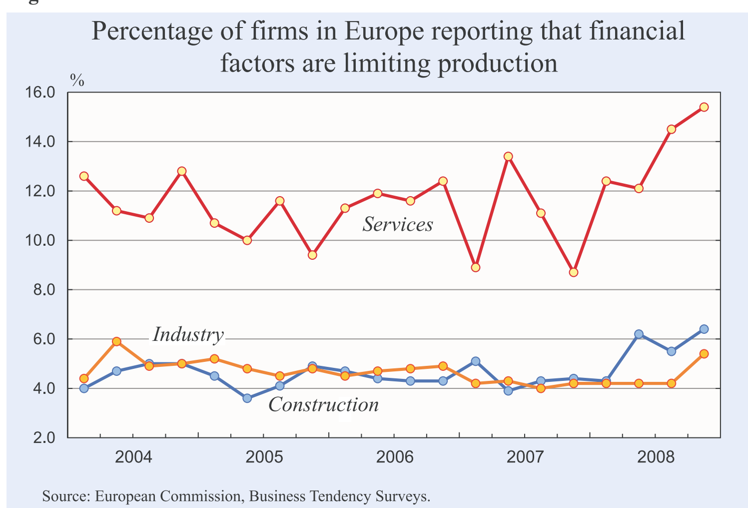
In particular, the bank lending survey of the ECB indicates that banks have already tightened their lending conditions substantially and plan to continue to do so in the coming months. The net percentage of banks expecting a tightening of credit standards in the first quarter of this year increased to 66 percent. This figure stood at only 3 percent five quarters earlier. However, the most important reason mentioned by the banks for this tightening in credit standards is the expected deterioration of future economic activity.

Although more and more evidence is pointing towards a further lowering of credit growth in the near future, it is still too early to tell whether this is due to the balance sheet problems of banks, and thereby the start of a real credit crunch in the euro area, or due to the deterioration of the economic climate and thereby increased default risks of investment projects.

Monetary conditions in Europe

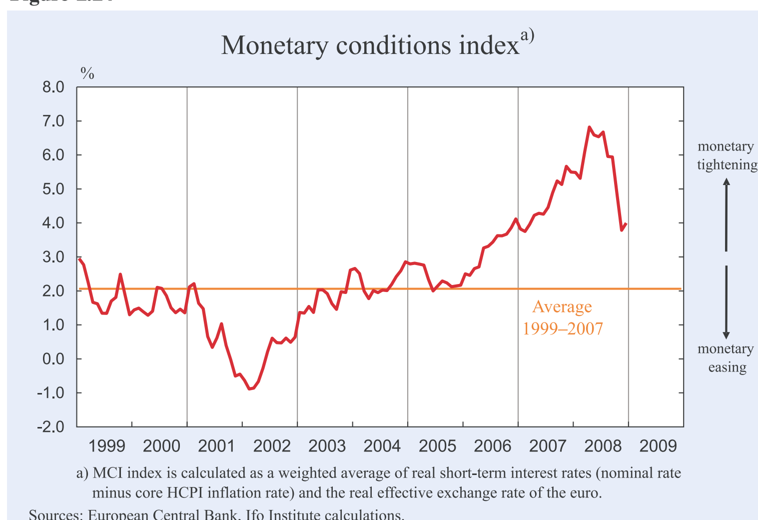
After an additional tightening at the beginning of last year due to a further appreciation of the euro, mone-

Figure 1.13



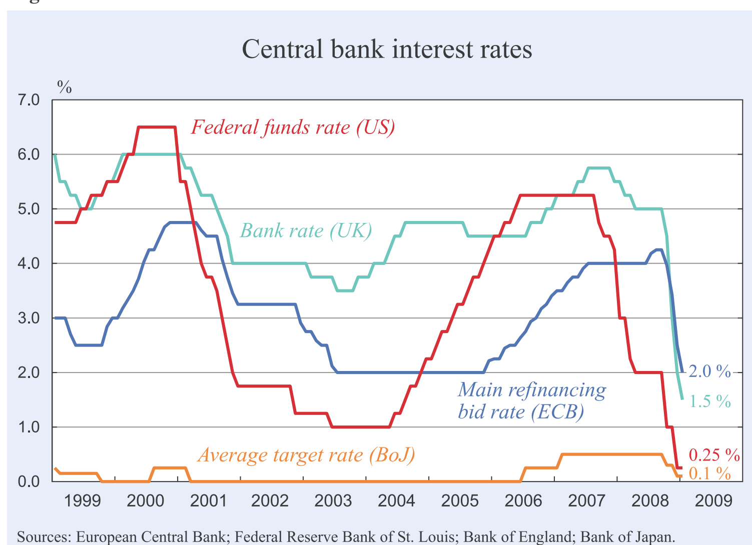
Source: European Commission, Business Tendency Surveys.

Figure 1.14



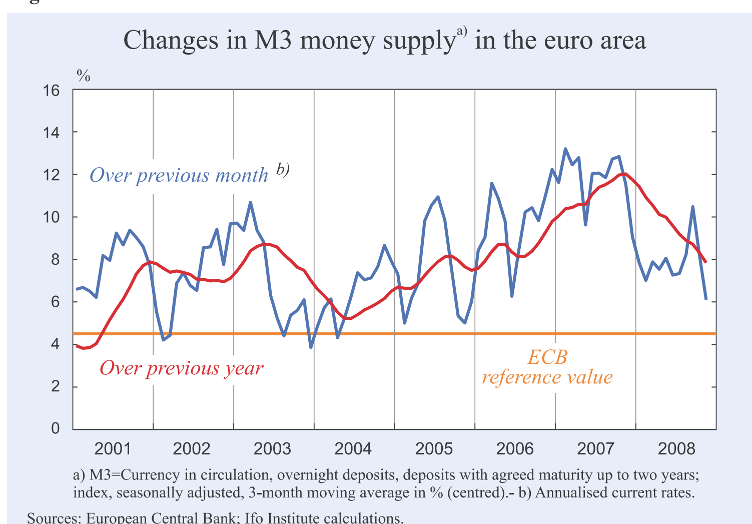
a) MCI index is calculated as a weighted average of real short-term interest rates (nominal rate minus core HCPI inflation rate) and the real effective exchange rate of the euro.
Sources: European Central Bank, Ifo Institute calculations.

Figure 1.15



Sources: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan.

Figure 1.16



a) M3=Currency in circulation, overnight deposits, deposits with agreed maturity up to two years; index, seasonally adjusted, 3-month moving average in % (centred).- b) Annualised current rates.
Sources: European Central Bank; Ifo Institute calculations.

tary conditions remained tight until summer last year (see Figure 1.14). In early July, the ECB even increased its main refinancing rate by 25 basis points to a level of 4.25 percent (see Figure 1.15). Especially the interest rate cuts of the ECB starting from early October have loosened monetary conditions in the euro area. During the autumn, though, problems in the European interbank market kept money market interest rates well above the main refinancing rate. The reduction in the money market spreads loosened monetary conditions at an even faster pace at the end of last year. Nevertheless, the still strong euro prevents our monetary conditions indicator from falling below its long-run average.

Mirroring the developments on the credit market, the annual growth rate of money supply, as measured by M3, fell throughout the year (see Figure 1.16). At the end of 2007 it stood at about 12 percent; this has now fallen to close to 8 percent. Last year was thereby the eighth year in a row in which M3 growth exceeded the ECB reference value of 4.5 percent. The banking crisis, however, becomes evident when we look at the more narrowly defined measures of money. For instance, M1 has basically stagnated since last summer after having had a stable growth rate of around 6 percent throughout 2007.

Reduced growth forecasts caused the Bank of England to cut its bank rate from 5.75 percent to 5 percent in three steps during winter 2007/2008. After keeping it fixed until early October, the outbreak of the economic crisis induced a sharp fall of 350 basis points to a historically low level of 1.5 percent in January this year.

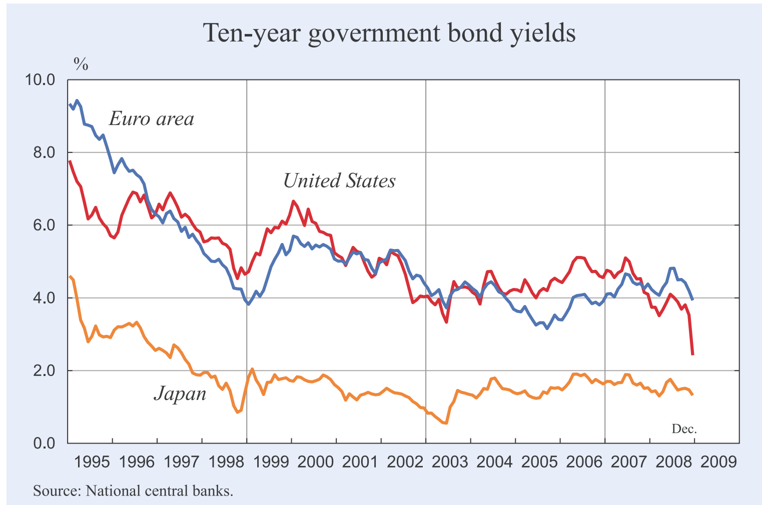
Bonds, stocks and foreign exchange markets

During the first half of 2008, government bond yields in euro area member states first increased by about 80 basis points and then subsequently fell by 130 basis points until the end of the year (see Figure 1.17). Whereas at the beginning of the year there were indications that problems on financial markets would stabilize, an increased surge towards safe assets not only led to the fall in government bond yields but also caused corporate bond yields to rise. This increased risk aversion is reflected in the rise in the interest differential between corporate and government bonds (see Figure 1.18). These spreads have now reached unprecedented levels.

Although volatile, stock markets stagnated during the first half of 2008 (see Figure 1.19). The volatility increased further during the second half of the year and stock indexes plummeted everywhere around the world. Since its peak, the Euro STOXX 50 fell by about 45 percent; the US, UK and Japanese stock indexes faced similar declines. Overall, stock markets have now almost reached the lows reported in early 2003. The sharp interest rate cuts around the world were not able to prevent this.

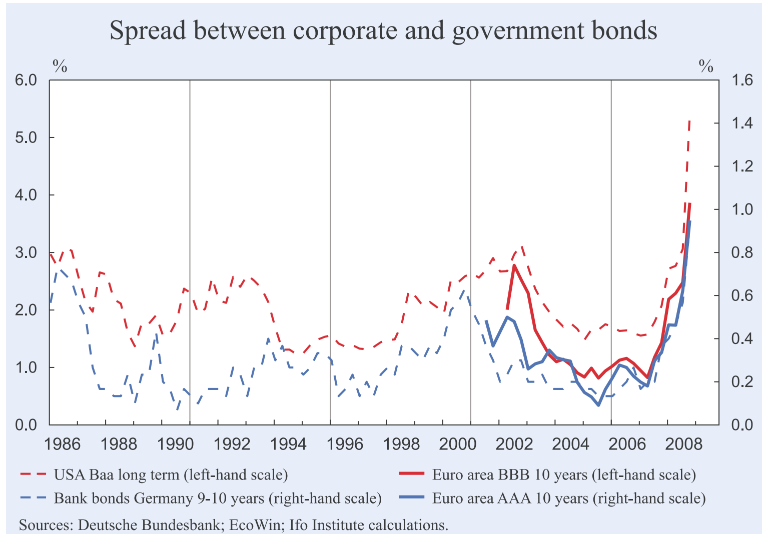
Not only are stock markets in turmoil, also exchange rates have been fluctuating heavily since the start of the financial crisis. Until July 2008, the US dollar continued to drop steeply against the euro and reached its all time monthly low at a 1.58. Subsequently, it bounced back to 1.34 in December (after the low in November). In real effective

Figure 1.17



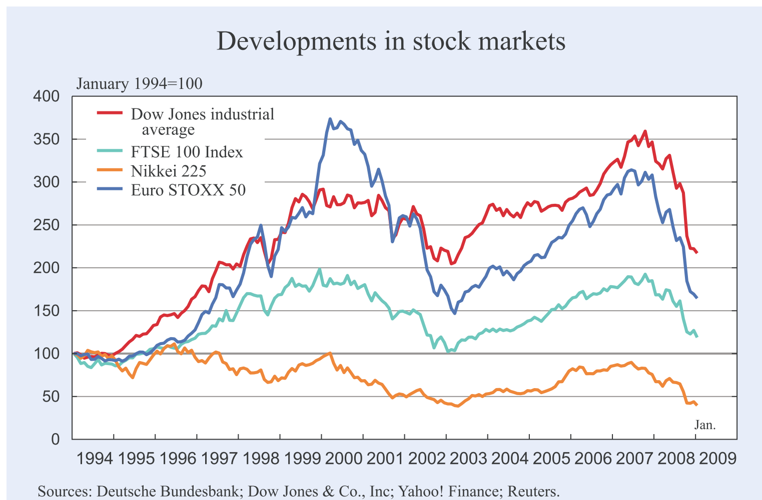
Source: National central banks.

Figure 1.18



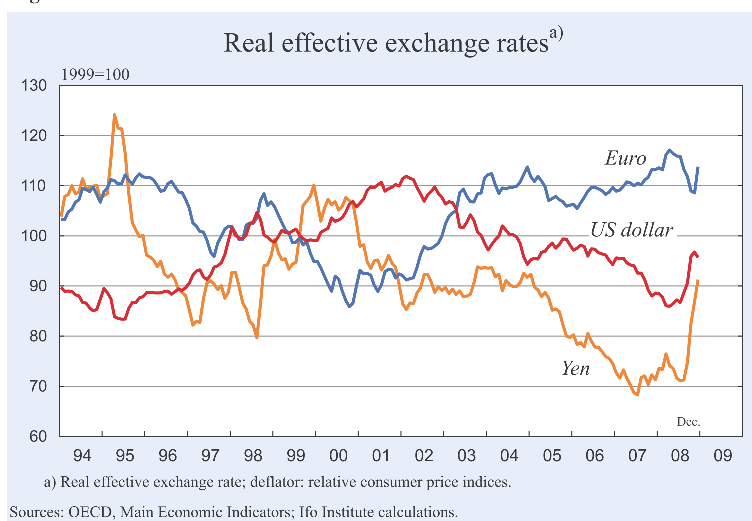
Sources: Deutsche Bundesbank; EcoWin; Ifo Institute calculations.

Figure 1.19



Sources: Deutsche Bundesbank; Dow Jones & Co., Inc; Yahoo! Finance; Reuters.

Figure 1.20



a) Real effective exchange rate; deflator: relative consumer price indices.

Sources: OECD, Main Economic Indicators; Ifo Institute calculations.

terms, the euro is now back at average levels of 2004–2006 (see Figure 1.20).

Unlike in Sweden and the United Kingdom, the central bank in Denmark is focusing on keeping its exchange rate vis-à-vis the euro stable. The turmoil on financial markets and the thereby induced flight towards quality, which is also associated with country size, has put pressure on currencies of smaller economies. The central bank of Denmark was therefore forced to raise interest rates on two separate occasions in October, thereby widening the spread between Danish and euro area rates. The increases were partially reversed in early November, following a cut in euro area rates. Partly triggered by these problems, the Danish government has again raised the possibility of holding a referendum on whether to join the euro area.

To keep the currency board arrangements in Estonia and Lithuania and the pegged exchange rate regime in Latvia alive while at the same time not having a complete withdrawal of foreign capital, money market interest rates have increased sharply in these countries during the past months. This is now putting a large burden on their domestic economies. The other new EU member states have seen clear depreciation of their local currencies. To stop this process, the central banks in many of these countries have also increased interest rates.

4. The economic outlook for 2009 and 2010

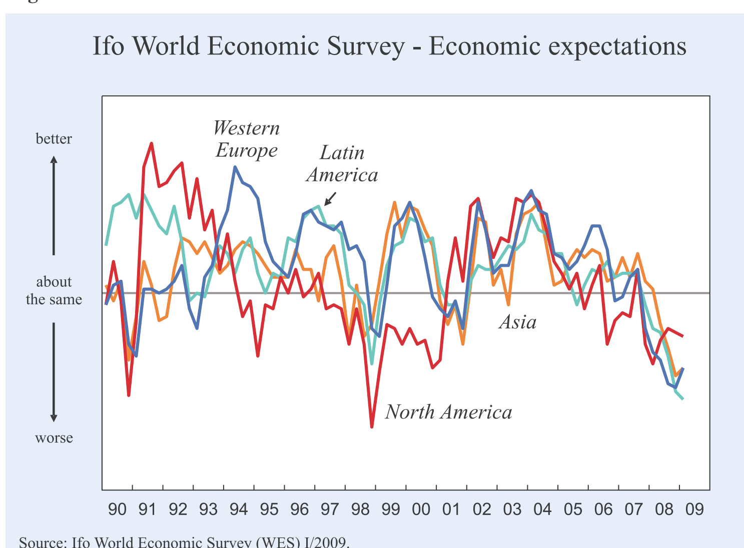
4.1 The global economy

Most regions of the world economy are in recession. The expectations of the participants of the Ifo World Economic Survey indicate that this winter, growth is expected to fall further. Although expectations in North America seem to have reached a trough during last winter, the outlook for Asia has never been as bleak since the start of the survey in 1990 (see Figure 1.21).

Whereas the Ifo World Economic Survey asks participants for their expectations for the upcoming 6 months, the survey of Consensus Economics amongst professional forecasters covers the entire year 2009. Figure 1.22 converts these monthly survey results into expectations for the upcoming 12 months. The initially expected moderate slowdown turned into a sharp fall in growth forecasts around the world in autumn last year. Many forecast institutes still appear to be in the process of adjusting their estimates downward.

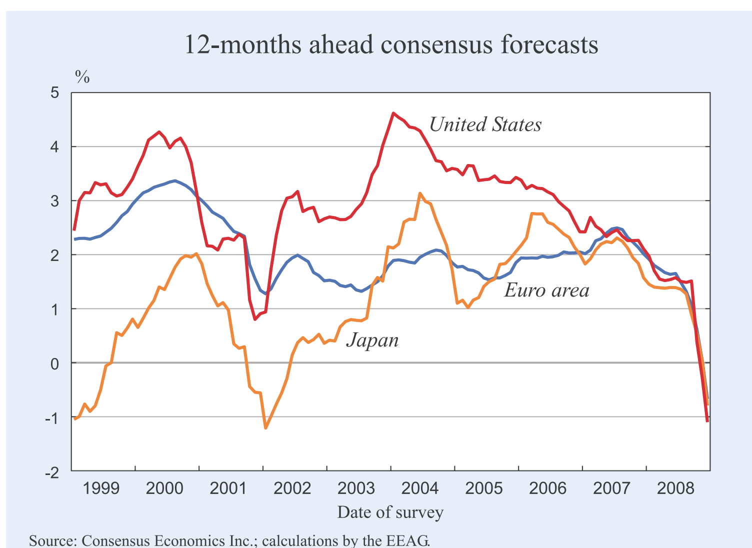
The uncertainty concerning future business cycle developments has stayed at a historically high level.

Figure 1.21



Source: Ifo World Economic Survey (WES) I/2009.

Figure 1.22



Source: Consensus Economics Inc.; calculations by the EEAG.

The underlying problems that have triggered the current world economic downswing remain virulent. The fall in US real estate prices continues and has even picked up speed again in recent months, and the situation on international financial markets remains critical. However, as compared to last year, it has become clear that it will not be possible to keep the problems isolated to the US real estate and international financial markets. Mainly via sharply falling sentiment around the world, the real economy has also fallen into a slump.

Currently, all economic indicators – regardless of which region or sector they refer to – point in the same downward direction. Moreover, the speed of the downturn as well as the levels already reached are truly unique. Most worrisome is that still no bottom seems to have formed.

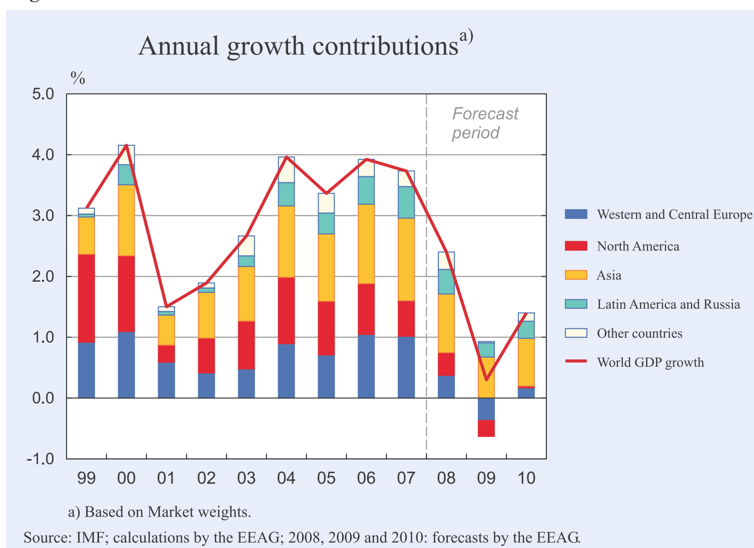
In the current situation, which is characterised by a high degree of pessimism, it is difficult to identify factors that could, in the short run, brake the recession. A glimmer of hope stems from the stimulus packages initiated by many governments around the world. However, the continuously changing situation on this front and the general uncertainty felt by economic agents makes it difficult to estimate the magnitude of these programs and their effects.

Another positive aspect is the drop in the inflation rate, which above all is driven by the marked drop of the prices for food and raw materials. This should strengthen the purchasing power of consumers. Finally, it is still possible that the current mood is an exaggeration of the actual and future situation, in which case it could turn swiftly. The discrepancy between expectations and the appraisal of the present, actual situation is still exceptionally large in many countries.

Nevertheless, we expect world economic growth to stay well below potential during our forecasting horizon. For 2009, we expect the weighted average growth rate in our sample of 49 countries when using GDP at market prices as weights to be a mere 0.3 percent (see Table A.1). Considering an annual world population growth rate of 1.2 percent, world per capita GDP growth will even turn negative this year. Over the last 40 years, this only occurred twice (in the recession years 1982 and 1991). Measured by this, the recession is deep but not exceptional in the post-war period.

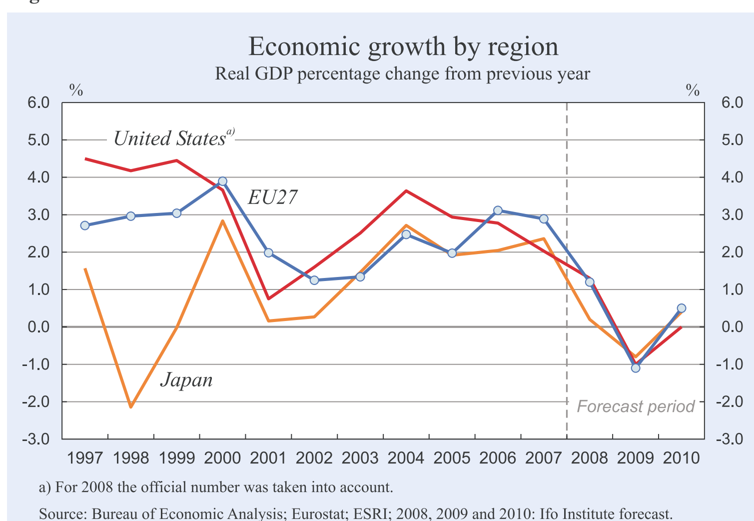
From a welfare perspective, it makes sense to correct these figures for the lower price levels in China and other emerging economies. Using such purchasing-power-parity adjusted data increases the annual

Figure 1.23



a) Based on Market weights.
Source: IMF; calculations by the EEAG; 2008, 2009 and 2010: forecasts by the EEAG.

Figure 1.24



a) For 2008 the official number was taken into account.

Source: Bureau of Economic Analysis; Eurostat; ESRI; 2008, 2009 and 2010: Ifo Institute forecast.

growth rate for the world economy to 1.4 percent in 2009 (see Figure 1.1).

The deteriorated firm expectations, the global banking crisis, the real estate problems in some countries and the general decline in wealth positions around the world have all put downward pressure on real economic activity. Given the severity of the crises, a quick turnaround does not appear likely.

Albeit much less than in the previous years, Asia, Latin America and Russia still continue to add positive contributions to world economic growth this year. These barely manage to compensate for the sharp negative growth contributions coming from both North America (in particular the United States) and Western Europe (see Figure 1.23). Looking at the three major industrialised regions in the world in isolation, Figure 1.24 highlights that they have become – and will stay – almost synchronised during this and the next year.

4.2 United States

The recession in the United States will continue throughout the year. Only at the end of 2010 is a slow recovery expected. This downturn will be so persistent mainly because US consumers have been living beyond their means for too long. To allow for a way back to a sustainable growth path, this behaviour must now be corrected.

As described in previous EEAG reports, low interest rates, too loose credit allocation policies of banks as well as associated increases in house prices resulted in consumption growth that exceeded income growth in past years. The bursting of the real estate bubble since mid-2007 has made it clear that this cannot be sustained. Real estate prices have been falling ever since and a landing is not to be expected soon. Futures contracts imply that market participants expect house prices to decline by another 15 percent before reaching a trough in the course of 2010.

The situation has been worsened by the subsequent crisis on the international financial markets that caused large depreciations and write-downs in bank balances. Although government intervention has prevented a collapse of the banking system, it could not circumvent a general fall in financial asset prices and to contamination of other sectors of the economy. Because of falling capital ratios and to insure adequate risk provisions, banks are increasingly reducing their willingness to supply credit to both households and firms.

The negative wealth effects and increased credit constraints together with the deteriorating labour market conditions will all put a heavy burden on private consumption in the years to come. Adaptation delays will force consumption growth to stay negative or at least below potential for a longer period of time. This will dampen import demand and thereby reduce the new indebtedness to the rest of the world. This adjustment process will not be completed quickly and will hence hinder the recovery of the world economy for quite some time. Nevertheless, the fall in consumption will not continue at the same pace that we have seen in the last two quarters. Both falling inflation rates and the business cycle programmes initiated by the new US administration will stimulate consumption demand to some degree.

Investment will decline. Forward-looking indicators for the real estate market in the United States, like building permits, still point towards a further slowdown. Consequently, residential investment will continue to put a burden on economic growth. Furthermore, firms face deteriorating sales and profit perspectives, and more restrictive credit conditions. The latter will hit particularly small- and medium-sized firms, which usually finance themselves through bank credits. This will restrain equipment and software

investment. Investment in non-residential structures, which has so far been an important pillar for growth in the United States, will tend to weaken as well. It will not be before mid-2010 that investment demand will pick up again and contribute to economic growth in the United States. By then, investment in equipment and software will reach its cyclical trough, and house prices are expected to bottom out.

From a demand side perspective, only net exports will be able to contribute positively to economic growth. Although export growth will slow down considerably due to the economic malaise in many of the trading partners of the United States, the fall in domestic demand will keep import growth lower. After five quarters of negative growth, the latter will nevertheless slowly turn positive again.

Overall, this will result in a contraction of the US economy of 1 percent in 2009 and stagnation in 2010 (see Table A.1). The deterioration of labour market conditions will continue. The unemployment rate will increase on average to 7.5 percent both this and next year.

The recession and the fall in energy prices will cause inflation to reduce further to 0.3 percent this year. In 2010, consumer prices will grow by 1.3 percent on average. Although inflation rates might turn negative for some months, medium- to long-run inflation expectations appear to be well anchored at a level of 2.5 percent for the United States. Furthermore, core inflation rates appear to be relatively stable as well. We therefore do not expect deflation problems to occur within our forecasting horizon.

4.3 Japan, China, India and other Asian countries

Economic expectations remain bleak in *Japan*. Business expectations have deteriorated sharply due to the somber outlook for the world economy and consumer confidence also continues to fall, reaching its lowest level in 26 years in November. Although it is not yet clear how strongly the financial crisis will affect the Japanese economy, banks have started to become more risk averse and credit conditions show signs of worsening. Furthermore, the slowdown of world economic growth has reduced the willingness of the large export-oriented firms in Japan to invest. Accordingly, investment will continue to slump.

Due to the fall in raw material prices, inflation rates will temporarily turn negative in the middle of this year leading to an overall fall of prices by 0.2 percent in 2009. However, it is not likely that this will turn into a persistent and broadly based decline in prices as Japan experienced in the 1990s. In contrast, the lower prices might actually support the purchasing power of households and thereby prevent a stronger fall in consumption. Nevertheless, the somewhat deteriorating labour market conditions together with fading consumer confidence will lead to a weakening of private consumption.

Overall, the recession in Japan will continue. Domestic demand will hardly expand over the next two years. Given the weak economic conditions of Japan's major trading partners, it can no longer be expected that foreign trade will deliver any growth impulses. GDP will decline by 0.8 percent this year to subsequently grow by a moderate 0.4 percent in 2010.

This recession will not be as severe as the one in the mid-1990s or those in the United States and Europe. Although stagnating demand from China will not bring any growth impulses, Japan's high export share to China will at same time assure some degree of stabilisation. Furthermore, as compared to the 1990s, firms have hardly accumulated debt. Hence they have much higher capital ratios and have not built up excess capacities. On top of that, credit conditions are much more favourable in Japan than in the United States or Europe, and signs of a real estate bubble have been very limited so far.

Because of the economic crisis it has become more and more difficult for the Japanese government to achieve its aim of achieving a primary budget surplus in the fiscal year 2011. Presently government debt is still substantial. At the same time the government approved several economic programmes last year. Credit guarantees are scheduled for small- and medium-sized enterprises, the transport industry is to be supported, public building projects will be financed, tax rebates for households are scheduled, new mortgages are to be subsidised and capital injections for regional banks are planned. The deficit ratio will clearly rise above 3 percent during the current and the upcoming year.

As all of the major developed economies are in recession (especially the United States), export- and investment-driven expansion in *China* (incl. *Hong Kong*) will be affected more strongly in 2009 and 2010. At the same time, inflation will slow down further. This

will allow the Chinese central bank to continue to reduce its key interest rate and the minimum reserve requirements of banks.

To support domestic demand, which is also fading, the central government has announced an economic stimulus package of 4 trillion yuan (450 billion euros) to be spent in 2009 and 2010. The funds are intended to finance programs in 10 major areas, such as low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and rebuilding after disasters like the earthquake of 12 May 2008. The policies include a comprehensive reform in value-added taxes, which would cut industry costs by 120 billion yuan. Commercial banks' credit ceilings will be abolished to channel more lending to priority projects, rural areas, smaller enterprises, technical innovation and industrial rationalisation through mergers and acquisitions. Provincial governments have drawn up plans that will bring total spending to 10 trillion yuan (1.1 trillion euros), more than twice the original programme announced by the central government on 9 November. This amounts to about 16 percent of nominal GDP.

These extensive measures will, however, not be able to offset the reduced demand from abroad. Furthermore, weak labour market and wage developments will put a burden on private consumption and will therefore counter the positive impulses that come from the fiscal stimulus and lower inflation. GDP growth is expected to fall to 7.5 percent this and the next year (after 9.4 percent last year).

Despite the slowdown in export growth, it is not likely that China's current account surplus will start shrinking any time soon. A weakening of the domestic economy but especially falling raw material prices will cause (nominal) import growth to be reduced by at least the same rate.

As compared to other emerging economies, *India's* growth is based much more on its own savings. Its savings rate has gone up from about 25 percent since the first years of this century to more than 35 percent today. For that reason, India could turn out to be relatively insulated from global financial problems. Nevertheless, India has also become more and more integrated with the global economy. Exports plus imports are now 45 percent of GDP, so the global recession will certainly affect India as well although to a lesser extent than most other emerging market economies, which are generally much more dependent upon international trade.

The upcoming general election scheduled for this spring has already created a relatively loose fiscal policy stance. It thereby will become difficult for the government to respond to the impact of the global financial crisis with supplementary fiscal measures. On the other hand, the global financial crisis has already triggered a complete reversal of monetary policy, which we expect to be followed by further interest rate cuts this year. Despite the reversal of the commodity price boom, India will – because of its loosened fiscal policy stance – remain highly vulnerable to upward inflationary pressures in 2009. GDP growth will decline overall to 6 percent this year and 6.2 percent in 2010.

In the remaining emerging economies of Asia, i.e. *Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan* and *Thailand*, GDP growth will also slow down further. Although domestic demand will continue to grow in most economies for some time (as labour markets will remain tight for the coming months), the world economic situation will negatively affect their trading sectors. Countries like the Philippines, which have specialised in the production of electronic goods, will suffer the most. Consequently, the high current account surplus of the region will be substantially reduced this year. GDP of these East Asian countries will grow by only 3 percent this and 3.2 percent the upcoming year.

4.4 The rest of the world

The present cooling of the global economic climate not only affects the larger economic regions of North America, Western Europe and Asia, but also Central and Eastern Europe, Russia and Latin America.

We anticipate that central banks in the Latin American region, i.e. *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*, will relax their monetary policy stance as both inflation pressure and growth prospects are subdued. Furthermore, against this external backdrop many governments will curb public investment and engage in counter-cyclical policies. Prudent macroeconomic policies in the past will allow for this. Declining raw material prices, collapsing external demand and exchange rate depreciations will deteriorate current accounts of those Latin American economies that have based their recent upswing largely on commodity exports.

Overall the region will see a marked decline of growth from 4.2 percent last year to 3.1 and 3.3 percent this and the upcoming year.

Real GDP growth in *Russia* is expected to slow to an average of 2 percent this year and 3.5 percent in 2010. This reflects the impact of financial turmoil, lower commodity prices and weak energy sector production. Furthermore, domestic demand growth will also weaken. The impact of much lower oil prices on exports will outweigh this and the current-account surplus will be sharply reduced in the next two years. Almost entirely based on oil revenues, Russia has increased government spending excessively in the past few years. Despite lower oil prices and thereby more binding fiscal constraints, fiscal policy is bound to stay expansionary. After a fiscal tightening during the past few quarters, the government at the end of last year announced a package of measures to support the real economy amid the financial turmoil. The package includes cuts in corporate and other taxes, faster amortisation schedules and support for small business. The possibility of a further steep devaluation of the rouble and an increase in insolvencies of firms that have built up too many short-term foreign credits present the main risks to macroeconomic stability in Russia.

4.5 Assumptions, risks and uncertainties

When forecasting the economic development for the world economy, we have assumed that credit growth will clearly slow down as a result of the economic downturn and the associated deterioration of credit risks. More accommodativing monetary policy will cause lending rates to continue to fall, although with considerable delays. The risk premiums on corporate bonds, which have strongly increased, will stay at high levels and aggravate financing via capital markets.In addition, no further negative shocks are assumed, and the oil price is expected to fluctuate in a range between 40 and 50 US dollars throughout the estimation period.

The likelihood of a broadly-based credit crunch has increased. It is still possible that other financial assets like credit card claims or credit default swaps will undergo write-downs. If associated with a further deterioration of trust amongst banks and, as a consequence, additional corrections in their balance sheets, this could well lead to a severe cut in credit lines around the world.

On the other hand, it is also possible that the monetary conditions will turn out to be less restrictive and that banks will be able to cut lending rates more quickly and by more than expected. The interest rate cuts by central banks around the world have been swift and substantial. Also, the newly created instruments by central banks and in particular the Federal Reserve, which have enabled a de facto unlimited provision of central bank money, could slowly show their impact and stimulate economic activity more than expected. Furthermore, the government guarantees on deposits could help defuse the liquidity problems faced by banks during our forecasting horizon. If mistrust amongst banks were successfully reduced, high risk premia on the interbank market would fall. That would reduce refinancing costs and end the costly behaviour of private banks to hoard central bank money.

The persistently high current account deficit makes the economic forecast for the United States especially risky. If foreign investors raise their risk assessments with regard to the US capital market, this could lead to a general withdrawal of foreign capital and a fall in the US dollar. Consequently, interest rates would mount and both private consumption and business investment would suffer even more.

4.6 The European economy

The cyclical situation

The credit crisis has turned into a recession in large parts of the world; consumer and producer confidence have crumbled, and the euro is still relatively strong. Accordingly, most member countries are or will soon be in recession. This means that, unlike in the past, national demand shortfalls will not be offset by growth in other countries, and growth in final domestic demand in the European Union will reach an all-time low. Against this backdrop, the situation is unlikely to stabilise soon. Whereas the European Union managed to grow by 1.1 percent last year, we expect GDP to shrink by 1.2 percent this year. Only in 2010 will economic growth turn positive again and reach a subdued level of 0.5 percent (see Figure 1.26).

Of the demand components, only private and public consumption will be able to contribute positively to economic growth this year (see Figure 1.27). Reduced inflation rates will support developments

Box 1.2

Deflation in Europe?

After having suffered from high inflation rates during the first half of 2008, we have observed a strong decline in inflation rates thereafter. With the slowdown in economic activity, a number of analysts now fear deflation. Deflation is a substantial threat for modern economies; it directly reallocates wealth from borrowers to lenders. It therefore appears to be especially worrisome for economies that carry a high burden of debt, like the United States. The more severe and indirect consequence is that if prices fall, people tend to postpone consumption, which reduces demand for goods and services and leads to a further fall in prices. A vicious cycle begins, which makes it even more worrisome as there is no easy way out. How pressing is the issue today?

To assess this we first decompose past inflation rates into its energy component and what is usually labelled "core inflation", i.e., the inflation rate excluding price developments of energy and unprocessed food. While the aggregate inflation rate also moved up, core inflation has remained quite stable. Hence, price increases in the euro area were mainly due to the rise in energy prices. Energy prices have been rising sharply since the autumn of 2007 and falling since the summer of 2008. Already a stabilisation of energy prices will – via the so-called base effect – result in a correction of inflation levels one year later. Hence, due to the sharp oil price increases a year ago, we now see inflation rates falling; assuming the oil price stabilises, the fall in oil prices last autumn will lead to rising inflation rates this autumn.

To turn negative inflation rates into a fall in domestic spending, i.e. into what is usually meant with a real deflation scenario, inflation expectations need to be negative as well; spending is delayed if households and firm expect prices to fall in the future. Figure 1.25 shows the inflation expectations for the euro area at 12 and 24 month horizons as reported by the ECB survey of professional forecasters. Although both one and two year ahead forecasts are presently falling somewhat, they are coming from high levels and are still far from becoming negative. In fact, expectations appear to be remarkably anchored around a value of 2 percent, i.e. the target inflation rate of the ECB. Data from other sources, like Consensus Economics or the EU Consumer Survey, show rather similar developments, i.e. also point downwards in recent time but are not anywhere near historically low levels.

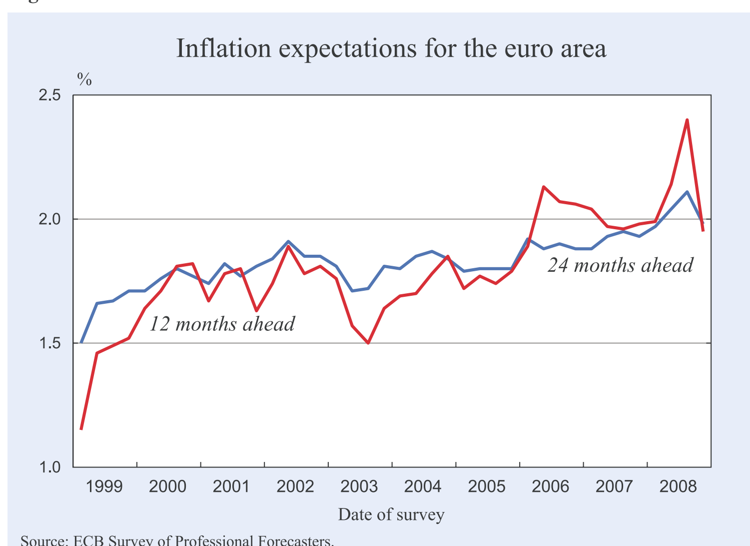
To sum up, given the current stance of the economy it is certainly more adequate to state that we are currently in a period of disinflation rather than at the gates of deflation. Core inflation has remained relatively and remarkably stable over the last one and half years and has hardly been affected by the current fall in energy prices. Considering survey data on inflation expectations, we observe some moderation but clearly not too worrisomely low or negative levels.

in real disposable income. Nevertheless, the generally increased job uncertainty will keep consumption growth at moderate levels over our forecasting horizon. Those countries suffering a real estate crisis will face substantially lower consumption growth. Not only do real estate prices affect the profitability of building houses and thus residential investment, they are also an important determinant of household wealth and hence of private consumption.

Investment will put a major burden on growth in Europe this year. A combination of falling profits, tougher financing conditions and lower growth prospects has sharply reduced the willingness of firms to invest. However, when banking normalises and cuts in central bank interest rates start to reach the firm level, the tide might start to turn in the second half of this year, notably for equipment investment. Corrections in housing markets normally take more time, and thus it will not be until 2010 before residential investment begins to normalise. We expect a moderate growth contribution from investment demand in 2010.

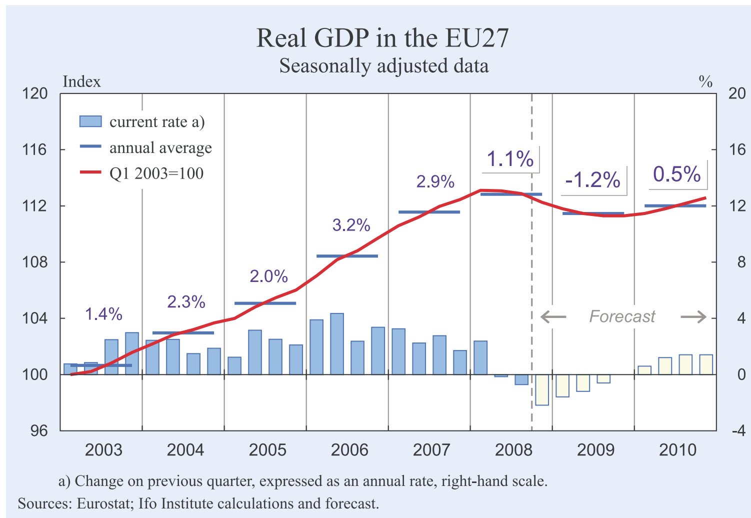
Much weaker demand from the rest of the world will lead to a slowdown of export growth. As import growth will not fade to the same extent, the growth con-

Figure 1.25



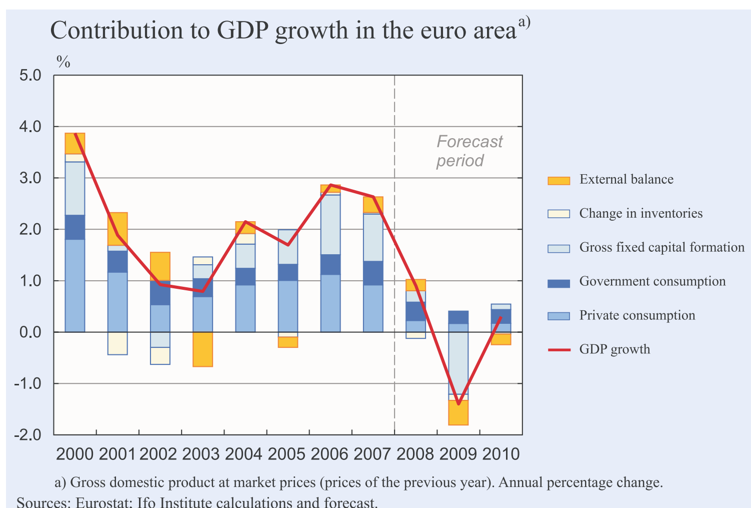
Source: ECB Survey of Professional Forecasters.

Figure 1.26

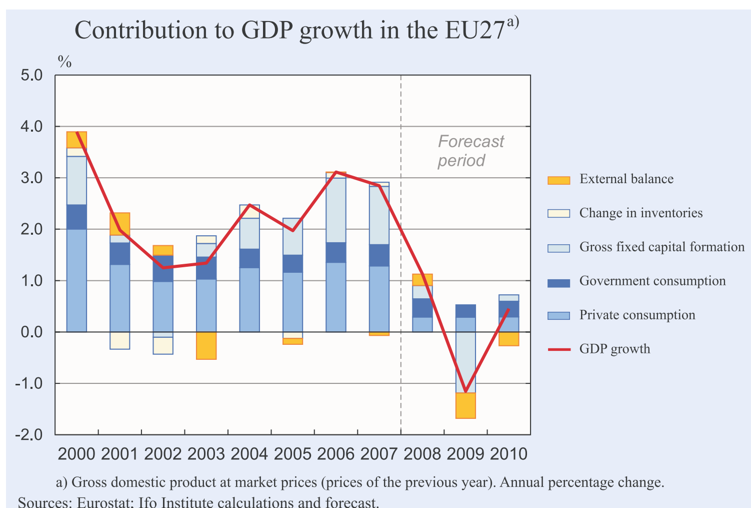


a) Change on previous quarter, expressed as an annual rate, right-hand scale.
Sources: Eurostat; Ifo Institute calculations and forecast.

Figure 1.27



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



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

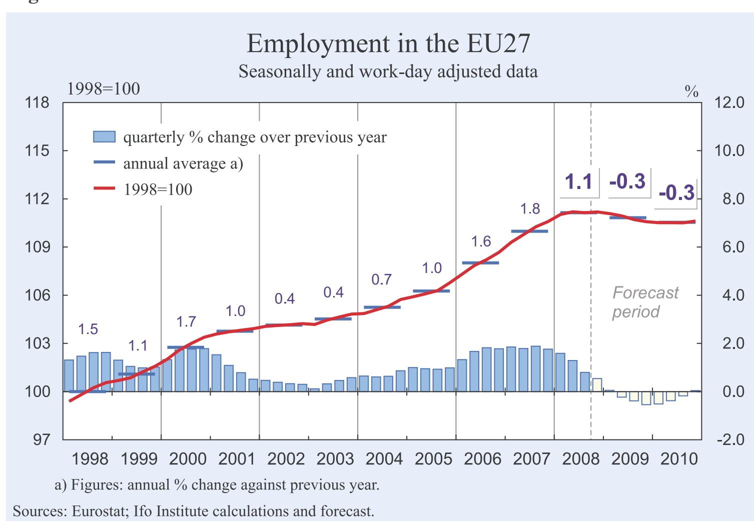
tribution from net exports will clearly turn negative this year.

Employment, sectoral output and inflation

Weak business cycle developments will lead to a fall in employment both this and next year (see Figure 1.28). After reaching a peak in the first half of 2008, the output gap in the European Union has now been closed. It will continue to widen throughout most of our forecasting horizon. As a consequence the unemployment rate will rise to 8.1 percent in 2009 and 8.6 percent next year (see Figure 1.29).

A number of factors need to be considered when estimating the potential risk of crises affecting individual sectors. First of all, it seems expedient to distinguish between sectors that focus on the domestic market and those that are export-oriented. In the case of companies that generate the majority of their sales abroad, it is important to distinguish between individual markets. While demand in the United States, the United Kingdom and Spain has indeed fallen sharply, economies in most emerging markets are continuing to develop, albeit at a more moderate pace. Although the outlook for almost all European companies is likely to worsen, consumer-focused sectors are likely to be less seriously affected. This is because they tend to benefit from the still-favourable – albeit deteriorating – state of the labour market and the growth in real incomes enjoyed by private households. The latter is a direct result of the continuing decline in the rate of inflation this year. The increase in consumer prices will be

Figure 1.28



a) Figures: annual % change against previous year.
Sources: Eurostat; Ifo Institute calculations and forecast.

1.6 percent in 2009. In 2010, we will see some normalisation towards a level of 1.8 percent. Furthermore, factors such as the share of commodities in production (whose global market prices, denominated in dollars, have mostly seen sharp declines of late) as well as wage levels (a number of recent wage settlements were concluded when the outlook for certain sectors appeared upbeat) also have a role to play in the performance of the individual sector.

Differences in output growth within Europe

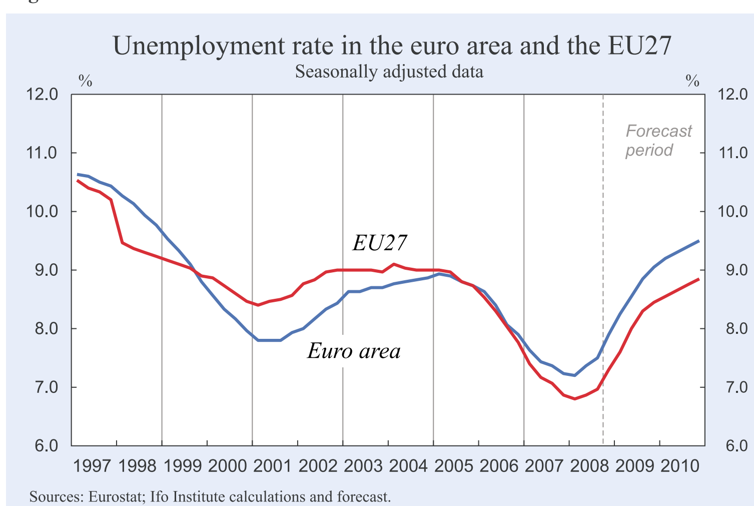
Given the weakness of the world economy, the economic development of single countries will largely depend upon domestic demand. On both fronts, *Germany* is expected to be hit relatively hard (see Figure 1.30). Large parts of the economy are very much dependent upon international trade. The share of manufacturing involved in producing investment goods is relatively high. It is therefore no surprise that the growth contribution of net exports reached an average of 1.1 percentage points during the previous upswing period 2004–2007. As a comparision, it only amounted to 0.1 percentage point for the euro area as a whole. At the same time, private consumption in Germany has been weak for years now and a strong turnaround is not expected any time soon. Furthermore, the German government has been relatively reluctant to stimulate domestic demand. Taken all together, this will keep annual real GDP growth negative throughout our forecasting horizon.

In the *United Kingdom,* the wide fallout from the financial crisis, falling house prices, sharply rising unemployment and weak foreign demand will all contribute to real GDP contraction in 2009. Weaker price pressure, lower interest rates, a more competitive currency, and a gradual improvement in external demand should support some recovery in activity from 2010, but the pace of growth will be sluggish, reflecting the huge scale of balance-sheet adjustment taking place in the private sector.

Albeit less pronounced, also *France* will go through a recessionary phase. The increase in private consumption will only be moderate. Mainly falling investments will turn GDP growth negative in 2009. Due to the economic situation in which major trading partners find themselves, net exports will hardly improve. Inflation will notably fall and the unemployment rate will increase this year.

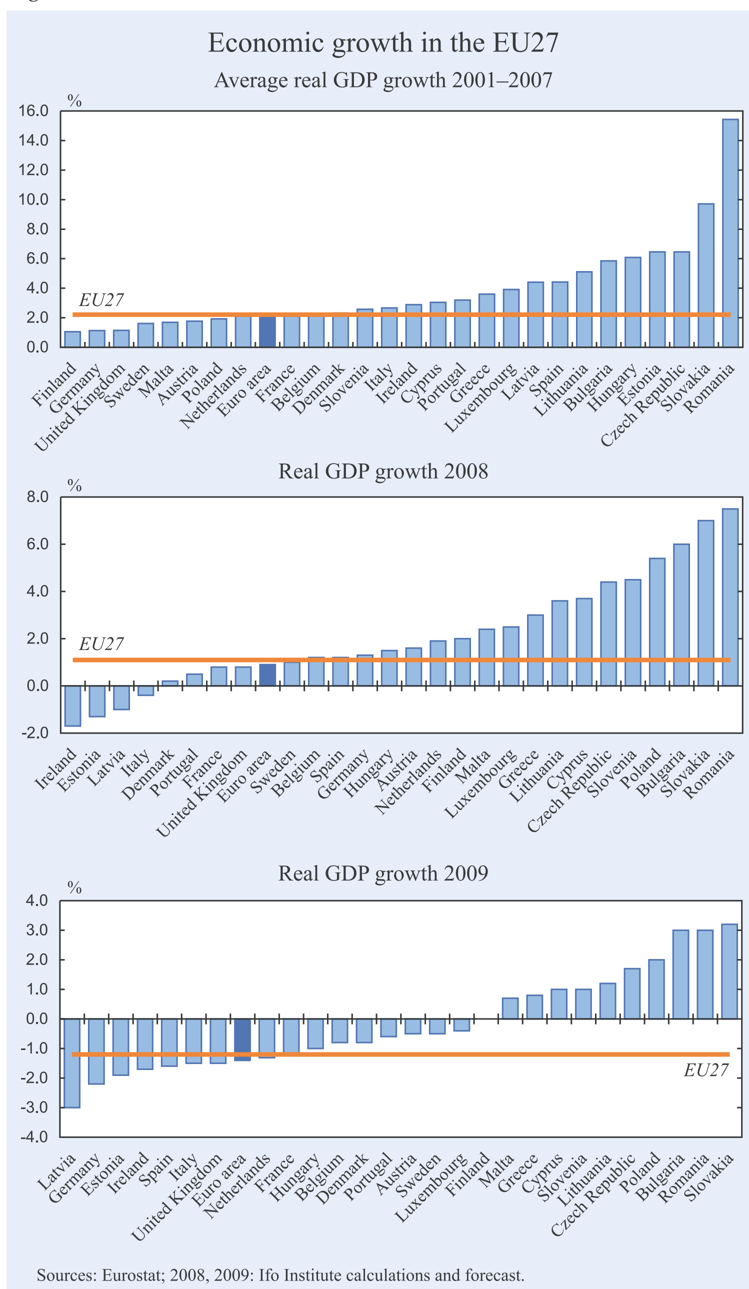
For the second year in a row, GDP growth in *Italy* will be negative this year. Besides the world economic downturn, it is the lack of competitiveness of the Italian economy which has turned this into a rather deep recession.

Figure 1.29



Sources: Eurostat; Ifo Institute calculations and forecast.

Figure 1.30



Sources: Eurostat; 2008, 2009: Ifo Institute calculations and forecast.

Since 1996, its export performance has been worsening – a process which does not appear to be ending any time soon.

As in the United Kingdom, the real estate sector is placing a drag on the *Spanish* economy. However, whereas house prices have already tumbled quite a bit in the United Kingdom, it appears that in Spain the real drop has still to occur. Negative consumption and investment growth will lead to a negative GDP growth rate of – 1.6 percent this year.

Most of the smaller economies in Europe are heavily dependent on external demand simply due to their size. As a consequence, economic growth will fall in each of these countries as well.

At the start of this year, *Slovakia* joined the euro area. Although economically not very important for European developments, with a population close to 5.5 million and a share of 1.3 percent in the euro area's GDP, it is nevertheless the biggest East European member state after Poland. With the help of large foreign investments, Slovakia in recent years has turned into a modern market economy. All major sectors have been privatised; and, for instance, the banking sector is now almost completely in foreign hands. Sound fiscal and business friendly policies – like a 19 percent flat tax rate – have allowed growth to be high in recent years. The main advantages of the euro adoption for Slovakia will be the reduced currency risk for exporters and a more stable environment for foreign direct investment. Nevertheless, there is a danger that now that the euro has been adopted, the present government will turn to more state-interventionist policies, which will reduce its attractiveness for foreign investors.

Although it will clearly level off as well, economic growth in most new EU member states will remain positive. Real GDP of the region will increase by only 1.6 percent in the current year and 2.9 percent next year. Mainly domestic demand will keep growth from turning negative. Inflation will level off and the unemployment rates will increase.

The new member states that face negative annual growth during our forecast horizon are *Estonia, Hungary, Latvia* and *Lithuania*. The three Baltic states were in the group of front-runners when it comes to economic growth in past years. However, the financial turmoil has turned their large current account deficits into serious problems. Domestic demand will keep growth rates positive albeit lower in *Bulgaria, the*

Czech Republic, Poland and *Romania* this and next year.

5. Macroeconomic policy

5.1 Fiscal policy

Whereas the previous upswing reduced fiscal deficits and debt positions throughout Europe in the years before, the tide clearly changed last year. A large part of the previous consolidation was simply due to extraordinary economic growth. Although it should have been clear that any upswing is followed by a downswing, politicians were not able to use the past few years to cut government spending enough to be really prepared for subsequent budgetary pressures. However, now that many countries in the world are sliding into or are already in recession, policymakers around the world have nevertheless fully embraced traditional models of stabilization via demand management.

From a European perspective, it is troubling that certain countries such as France and Italy have been running large deficits even in the past few years. This in principle is tying their hands in the present situation. In the light of the acute nature of the financial market crisis, the European Commission is willing to accept a temporary overshoot of the 3 percent deficit limit as anchored in the Maastricht Treaty. Nevertheless, it implies that public borrowing and debt will sharply rise to dangerously high levels in the coming years. Future governments will face severe fiscal constraints, which will necessitate further increases in tax burdens and/or spending cuts to keep public finances sustainable in the long run. When such future taxes are recognized by private agents, this in turn might reduce the effectiveness of current fiscal stimuli, as people could decide to save their additional disposable income to provide for future taxes.

Whereas monetary policy is decisive when it comes to stabilising the financial system, it seems to have become less effective in stimulating the real economy. The general loss in confidence and the emergence of severe credit constraints in parts of the world have made the transmission of monetary policy weaker and more uncertain. With a drop in credit and the emergence of constraints, so the argument goes, increasing public spending and granting tax relief should sustain demand, hence production and employment. The global nature of the crisis and the fact that most economies have become quite open to trade strongly motivate the implementation of co-ordinated fiscal intervention.

First of all this assumes that fiscal stimulus packages are temporary and effective. History shows that packages financed by additional state spending tend to be difficult to reverse. In its recent economic outlook, the International Monetary Fund (IMF, 2008) analysed the effectiveness of anti-cyclical fiscal policies. It reached the conclusion that while discretionary fiscal policy interventions could certainly help to dampen the impact of recessions, this was only the case if the economic situation was properly understood and the additional state spending was clawed back at a later date, which is certainly not guaranteed. Automatic stabilisers such as unemployment insurance (whose expenditure increases during a crisis, while rising revenues are recorded during the recovery phase) are generally more effective ways of stimulating the economy. The current crisis could consequently present an opportunity to structure automatic stabilisers more effectively, without this resulting in a permanent rise in the ratio of government expenditure to GDP. To make packages easily reverseable, governments can also focus on already planned growth-promoting investments in education, research and infrastructure and decide to implement them earlier rather than creating new projects.

The next presumption is that governments need to counteract quickly and vigorously the emergence of a dangerous market co-ordination failure in the economy, consisting in the running dry of credit markets. If the problem is to jump start an economy that is sliding into this coordination failure, the size and timing of the intervention is important. The package needs to be large and implementation rapid. Especially with investment projects, where normally considerable planning is required, this is not always easy to realise.

Depending on the constitutional set up, cutting taxes can be implemented on relatively short notice. However, the experience of the US economic stimulus package in the second quarter of last year is sobering with respect to its effectiveness. Only a small part of the rebate was used by households to increase consumption. The money mostly went into savings or to repay outstanding debts. Without the tax rebate, it is likely that consumption would have sunk moderately in the second quarter. Given the

large drop in the third quarter, it restrospectively looks like it would have been better to have had the rebates in that quarter instead – if at all. This again highlights one problem associated to discretionary fiscal policy: the timing.

Krugman (2008) strongly argues for a massive stimulus package in the United States, proposing the following back-of-the-envelope calculation: assume that the natural rate of unemployment in the United States is approximately 5 percent. By Okuns's law, every point of unemployment above the natural rate corresponds to a 2 percent output gap (the difference between current and potential output). If unemployment were to rise to 8.5 percent, for instance, the output gap would be about 7 percent. How much fiscal stimulus is needed to close this gap? The answer to this question depends on the output multiplier effects of fiscal interventions.

Even with a multiplier close to 2, the required intervention should be as high as 4 percent of GDP, that is, about 600 billion dollars. However, a multiplier close to 2 is likely to be an exaggeration. General transfers to the public are not likely to translate into substantial increases in aggregate demand for domestic goods and services due to precautionary savings and import leakages. More in line with estimates in the literature would be a multiplier of around 1, thereby almost doubling the required size of the intervention.

Such an intervention may in principle turn out be too large ex post. Krugman argues that this would not be a problem, as far as macroeconomic conditions are concerned: monetary policy can always tighten and correct the mistake. However, it should be recognized that by transferring resources to households, future taxes and therefore tax distortions will likely increase. Too large a fiscal stimulus in the form of transfers to households entails a social cost in terms of higher future distortions even if its stimulating effect on the economy is neutralized by monetary contraction. Unfortunately, what monetary policy cannot be expected to do in the present situation is to compensate for fiscal policy if this is too contractionary. "Fiscal policy should take risks in the direction of boldness."

While many are now focusing on size, it is important not to lose sight of basic conditions under which fiscal policy is most likely to succeed. In other words, there is a risk that an exclusive focus on size may be insufficient, or perhaps even counterproductive. How and where to intervene is going to be crucial. In what follows, we spell out two conditions that are not receiving sufficient attention.

Making fiscal expansions truly temporary

The effect of a fiscal expansion depends on how the expansion is financed. This applies not only to the short-term debt-tax mix used to finance a current increase in government expenditure, but also – and perhaps even more importantly – to the long-term financing source, i.e., taxes versus spending cuts in the future. The impact of an increase in current expenditure can be strengthened in the latter case, that is, if complemented with a credible plan ensuring that its cost will be at least in part financed by a reduction in expenditure at some point in the future. This is the case for two reasons. The first is derived from an important lesson of both Keynesian and neoclassical models, that future spending cuts tend to reduce the long-term interest rate. This in turn will have positive effects on current consumption and investment decisions. The second reason is that a commitment to lower future spending reduces the overall tax burden of the expansion. For both reasons, future spending cuts will help contain the negative effects on spending plans by firms and households that are currently not credit-constrained and therefore immediately respond to long-term fiscal decisions.

Admittedly, a commitment to reduce spending in the future may lack credibility, especially in a situation like today, when the uncertainty about the length and the overall fiscal implications of the crisis is enormous. Even in countries with explicit fiscal rules (like the United Kingdom), one may doubt if these provide sufficient commitment devices.

It may nonetheless pay to identify measures that are inherently temporary, i.e., matched by future cuts in spending. An obvious example consists of measures that bring forward in time planned investment projects thereby raising current spending, while simultaneously reducing future spending. This is of course no perfect solution to the problem of commitment but matches the attributes of the temporary fiscal expansions we are arguing for.

The argument in favour of such policy applies with unusual force for some countries. The main issue is that while the cost of fiscal rescue is highly uncertain, it is likely to raise public liabilities in a substantial way. It is hard to expect that the impact of fiscal expansions will be the same across countries with

very different initial budgetary conditions – Italy versus France. Empirical work supports this view. Based on a sample of OECD countries, for instance, Corsetti et al. (2008b) clearly find that the response of consumption to increasing government spending is much lower and even negative in economies with high debt and deficits relative to economies with better initial conditions.

In countries that are currently burdened by high public debt and problematic fiscal conditions, the design of spending and tax interventions that are truly temporary is likely to be a prerequisite for their effectiveness.

An example of a type of fiscal policy that is more likely to be successful is tranfers from the central government to local governments that are facing severe reductions in tax revenues. Local governments are often constrained in their abilities to borrow when the tax base falls cyclically. There is therefore a risk that local government consumption becomes procyclical, leading to lay-offs when the economy turns into recession. Even if some countries arguably should have a falling trend in government consumption, now is a bad time to lay off public-sector employees. Transfers to local governments in fiscal distress is therefore likely to be a quite cost effective way of stabilizing employment in the times ahead. A way of making sure that these transfers are temporary is to construct a system where the central government guarantees local tax revenues calculated on the potential (cyclically adjusted) tax base, rather than the actual.

Accompanying fiscal expansion with accommodating monetary policy

As argued by, for example, Corsetti et al. (2008a), fiscal policy is more effective if monetary policy is accommodative. In other words, for fiscal stimulus to work, central banks should not adhere too narrow-mindedly to their mandate of price stability – a criticism often raised against the Bank of Japan in the "lost decade". This risk is hopefully small today, as there is widespread awareness about the severity of the crisis.

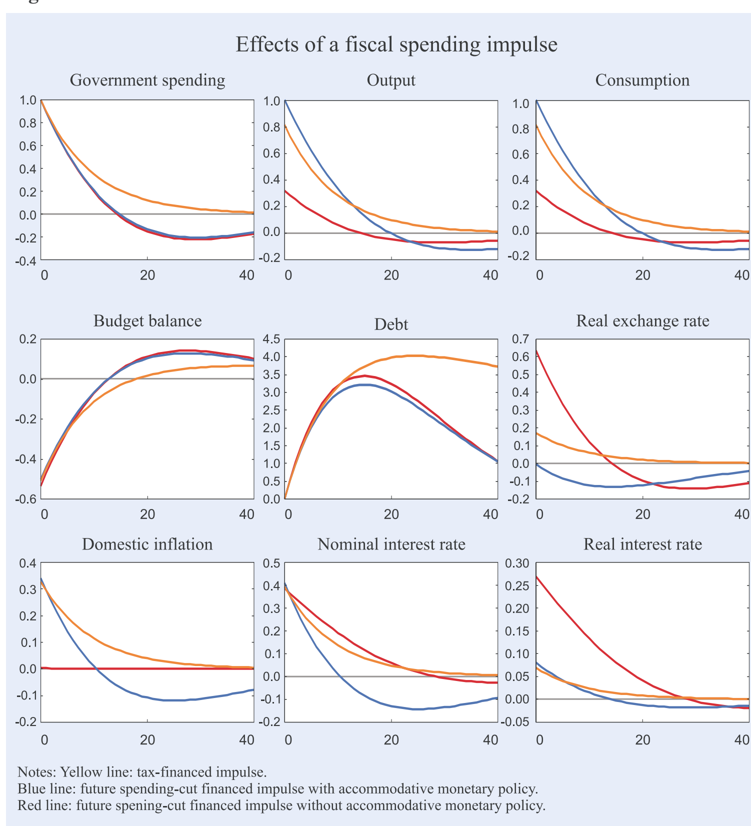
Nonetheless, one could envision a situation in which, even if policy interest rates were brought close to zero, it would still be possible that the overall monetary stance of the economy remains too tight. In this situation, the lower bound of zero for nominal interest rates – while providing a rationale for a fiscal expansion – may at the same time limit the effectiveness of fiscal intervention of a given size.

A closer look at the mechanism

In what follows, the argument in favour of future spending cuts and accommodating monetary stance is illustrated using the results of an exercise based on a standard new-Keynesian model. The goal is to track the macroeconomic consequences of an unexpected increase in government spending in an economy which is otherwise undisturbed (Corsetti et al. 2008a). Of course, government spending can mean a lot of different things (infrastructure investment, public employment, etc.) and governments are now discussing policy interventions in response to a strong deterioration of the overall macroeconomic conditions rather than an exogenous policy change which would be news to the economy. Yet the purpose of the exercise is to show to what extent the transmission of fiscal policy through the real economy depends on the financing mix and an accommodating monetary stance. The mechanism is illustrated for the case of an open economy which, for simplicity, is assumed to be small. Also the exercise assumes away credit-constrained agents, whose presence would increase the consumption multiplier above what is reported.

Figure 1.31 shows the evolution of government consumption, private consumption, output, the government budget balance and debt, the real exchange rate, inflation and interest rates over 40 quarters in response to an increase in government spending by one percent of (quarterly) GDP. All variables are expressed relative to their trend values (note that a negative value for the nominal interest rate means a fall relative to the initial value). Quantity variables are expressed as a percentage of quarterly GDP; the real exchange rate is measured in percentage deviation relative to its pre-intervention value; interest rates and inflation are measured in annualized percentage points. Each graph includes three lines. The yellow line refers to a spending shock that is entirely financed by taxes (such taxes may be levied today or in the future – this is irrelevant here given that taxes are non-distortionary and that households and firms are not credit-constrained). The blue and red lines refer to a spending shock that is partly financed by cuts in spending in the future: in the upper left panel this becomes apparent from government spending falling below trend about 3 to 4 years after the initial measures were taken. The red lines refer to the case of no monetary accommodation as the central bank pur-

Figure 1.31



Notes: Yellow line: tax-financed impulse.
Blue line: future spending-cut financed impulse with accommodative monetary policy.
Red line: future spening-cut financed impulse without accommodative monetary policy.

sues complete price stability; the blue lines to the case of accommodative monetary policy – in the sense that central banks adopt a Taylor Rule with a relatively low coefficient on inflation.

The message from Figure 1.31 is unequivocal: the response of consumption is positive for the "right mix" of accommodative monetary policy and financing by spending cuts in the future, but negative either when spending is entirely financed through higher taxes (the yellow lines) or when the monetary reaction is non-acccommodating (the red lines). Comparing the difference in the response of consumption and output across monetary stances (accommodating, not accommodating), one can observe a gap of about half a percentage point of GDP through many quarters.

Monetary accommodation is measured by the difference in the response of real interest rates depicted by the blue and the red lines in the lower right panel (ex ante real rates): under the accommodating stance (red lines) real rates are lower by about a quarter of a percentage point (annualized) relative to the tight monetary stance (blue lines). Importantly, under the "right" policy mix the path of real short-term interest rates implies a fall in the long-term real interest rate, because future short rates fall below their long-term average value.

A new item for international policy coordination?

Looking at the results of the exercise above, one could express concern regarding real exchange rate depreciation that, in the exercise, accompanies fiscal expansion cum monetary accommodation. Depreciation may be seen as an unwelcomed beggar-thy-neighbour effect of domestic policies – by which domestic economic activity is sustained by "stealing" foreign demand.

Irrespectively of whether spillovers from exchange rate movements are negative (a matter of considerable debate), we stress here that exchange rate depreciation will be contained, or eliminated altogether, when fiscal expansion is co-ordinated across borders. The main conclusions from the analysis can be in fact applied also at a global level: for the world as a whole, fiscal policy is most effective when implemented with the right financing and monetary policy mix.

As an independent item in an agenda for international policy co-operation, these considerations could actually contribute to the success of the joint fiscal initiative. Countries should be aware of the benefits from pursuing fiscal plans where current expansions are partly matched by offsetting correction of spending in the future.

5.2 Monetary policy

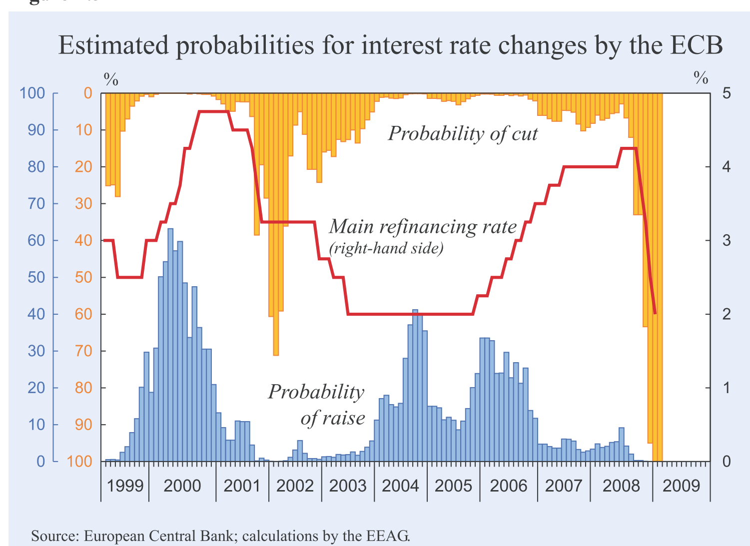
As compared to other major central banks in the world, the reaction of the European Central Bank has been relatively modest. As the problems in Europe associated with the banking crisis initially appeared to remain isolated within the banking sector itself, the ECB restricted its attention to the supply of liquidity on the money markets. Furthermore, the upsurge in inflation kept the ECB from cutting interest rates for a long time. Only until the banking crisis reached new levels in autumn and started to obviously infect other

parts of the economy as well, were interest rates cut by a total of 225 basis points up to January this year. Although this was only done in four steps and within a historically short period of time, the reaction of the ECB was clearly not as bold as that of the Swiss National Bank, the Bank of England or the Federal Reserve. Whereas it can be argued that the domestic situation in the United Kingdom and the United States required larger steps, this is certainly not the case for Switzerland.

Given that the ECB has a reputation of being more prudent, the question is whether or not additional steps can be expected. As in previous EEAG reports (2007; 2008), we use Taylor Rule estimates to put the most recent actions of the ECB in its own historical perspective and to analyse whether additional steps are to be expected, given its own past behaviour. The Taylor Rule assumes that central banks seek to keep expected output and inflation close to their target rates. To capture growth and inflation expectations, we use consensus forecasts as published monthly by Consensus Economics Inc. as employed by, for instance, Sturm and Wollmershäuser (2008).

Figure 1.32 shows the implied probabilities when using the estimated Taylor Rule to predict the likelihood of interest rate changes to be made at the next ECB governing council meeting. Given that since October last year, 12-months-ahead inflation expectations have been continuously falling and economic growth forecasts really plummeted, the implied target rate as estimated by the Taylor Rule has sharply decreased and at the end of the year stood close to zero, which is well below the level of the actual main refinancing rate. Accordingly, the probability that we will see further interest cuts by the ECB is still at a historically high level and basically equals one.

Figure 1.32



Source: European Central Bank; calculations by the EEAG.

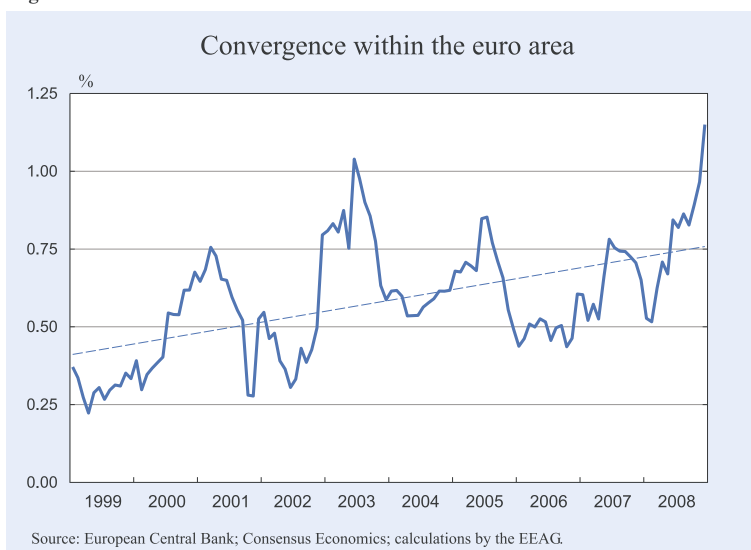
Hence, we do not expect the interest rate cut of January 15 to have been the last. An interesting question is whether all euro area member countries prefer to see the same cuts. That would be the case if business cycles within the euro area were highly synchronised. Whether the introduction of the euro ten years ago has caused business cycles to synchronise overall is still strongly debated. At the time the move towards one currency was discussed, many argued that business cycles in Europe were not synchronised enough to label it an optimal currency area. If economic situations differ too much between member countries, a single monetary policy cannot be adequate for all countries at the same time. Frankel and Rose (1998), however, put forward the influential idea that business cycle convergence would almost automatically emerge once the common currency were in place. Over time, the euro area would become an optimal currency area. Now that the euro is celebrating its tenth anniversary, we have opted to use our Taylor Rule framework to shed light on the question whether the euro area is indeed a self-enforcing optimal currency area.

To do so, we need to compare actual interest rates as set by the ECB with what would have been optimal for each member country if it were still able to set its own interest rate. We assume that the counterfactual monetary policy rule of national central banks is similar to that of the ECB. That allows us to use the parameters found when estimating the Taylor Rule for the euro area for each individual country.[5] Using country-specific growth and inflation expectations, we can create counterfactual country-specific policy rates and compare these with actual ECB rates.[6] Hence, for each member country we have hereby constructed a measure that summarizes the inflation and growth cycle situation relative to the euro

[5] For more details as to how this is done, we refer to the 2007 EEAG report and Sturm and Wollmershäuser (2008).

[6] To be sure that structural differences in growth and inflation have not driven our results, we substract the average of each country policy rate differential first. Hence, by construction the country-specific cyclical policy rate differential is zero on average.

Figure 1.33



Source: European Central Bank; Consensus Economics; calculations by the EEAG.

area aggregate. In a next step we aggregate this country-specific information to the euro area level and thereby create a single indicator for business and inflation cycle synchronisation as relevant for the monetary authorities.[7]

Figure 1.33 shows our convergence measure. A higher value implies that inflation and growth cycles differ more between euro area member states. Obviously, sometimes it is easier for the ECB to conduct a common policy suitable for all member countries than at other times. For instance after 9/11, all countries were hit to a similar extent as the shock was of a purely international and exogenous nature. However, that does not appear to be the case at present. Whereas relative to other countries, Ireland and Spain would presently prefer stronger cuts in interest rates, the opposite situation prevails in Austria, Belgium, Finland and Greece. Although all euro member countries have been hit by the economic crisis, the differences between implied target rates vary more widely at present than at any time during the past. This does not appear to be an artifact of last year. There seems to be a more general upward trend in this divergence measure. Hence, growth and inflation cycles seem to diverge over time.[8]

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[7] This aggregation consists of two steps. In the first step, we for simplicity assume that misalignments in upswings are as bad as in downswings and hence take the absolute values of the implied policy rate differences. In the second step, we have to decide what weights we want to attach to each individual member country. From a positive point of view, the primary objective of the ECB is price stability. This has been defined by its Governing Council to imply a year-on-year increase of the HICP for the euro area that does not exceed 2 percent in the medium term. The euro area HICP is basically a GDP-weighted average of the country-specific harmonised consumer price indexes. Hence, if we assume that decision-making in the ECB Governing Council always results in policy decisions that maximise the welfare of the whole monetary union, i.e. the members of the council take a truly euro area perspective, we should use GDP shares to weigh the individual country policy rate differentials as well.

[8] This result is robust with respect to different weighting schemes. Whether we use equal weights or weights based upon the number of representatives in the ECB Governing Council does not affect these conclusions.

Appendix 1:
Forecasting tables

Table A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in%	GDP growth			CPI inflation			Unemployment rate[d]		
		in %								
		2008	2009	2010	2008	2009	2010	2008	2009	2010
EU27	34.5	1.1	– 1.2	0.5	3.6	1.6	1.8	7.0	8.1	8.6
Euro Area	25.0	0.9	– 1.4	0.3	3.3	1.2	1.5	7.5	8.7	9.4
Switzerland	0.9	1.8	– 0.5	0.6	2.4	0.6	1.4	3.5	3.7	4.2
Norway	0.8	2.6	1.0	1.2	3.6	2.2	2.2	2.6	2.9	2.8
Western and Central Europe	36.2	1.1	– 1.1	0.5	3.6	1.6	1.8	6.9	8.0	8.5
US	28.2	1.3	– 1.0	0.0	4.3	0.3	1.3	5.7	7.5	7.5
Japan	9.0	0.2	– 0.8	0.4	1.4	– 0.2	0.0	4.1	4.5	4.4
Canada	2.9	0.7	– 0.3	1.1	2.5	1.3	1.6	6.1	7.0	6.8
Industrialised countries total	76.3	1.1	– 1.0	0.3	3.6	0.9	1.4	6.1	7.3	7.5
Newly industrialised countries										
Russia	2.6	6.3	2.0	3.5						
China and Hongkong	7.1	9.4	7.5	7.5						
India	2.2	7.0	6.0	6.2						
East India[a]	5.2	4.5	3.0	3.2						
Latin America[b]	6.5	4.2	3.1	3.3						
Newly industrialised countries total	23.7	6.4	4.6	4.9						
Total[c]	100.0	2.3	0.3	1.4						
World trade, volume		3.2	0.5	1.5						

[a] Weighted average of Indonesia. Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. Weighted with the 2006 GDP levels in US dollars. – [b] Weighted average of Argentina, Brasil, Chile, Columbia, Mexico, Peru, Venezuela. Weighted with the 2006 GDP levels in US dollars. – [c] Sum of the listed groups of countries. Weighted with the 2007 GDP levels in US dollars.. – [d] Standardised unemployment rate.

Source: EU; OECD; IMF; National Statistical Offices; 2008, 2009 and 2010: forecasts by the EEAG.

Table A.2

GDP growth, inflation and unemployment in European countries

	Share of total GDP in%	GDP growth			Inflation[a]			Unemployment rate[b]		
		in %								
		2008	2009	2010	2008	2009	2010	2008	2009	2010
Germany	19.7	1.3	– 2.2	– 0.2	2.8	0.9	1.4	7.3	7.8	9.0
France	15.4	0.8	– 1.2	0.3	3.2	1.0	1.5	7.8	8.4	9.3
Italy	12.5	– 0.4	– 1.5	0.2	3.5	1.3	1.3	6.8	7.8	8.2
Spain	8.5	1.2	– 1.6	0.3	4.2	1.8	1.8	11.2	16.5	17.1
Netherlands	4.6	1.9	– 0.7	1.0	2.2	1.5	1.7	2.8	3.2	3.4
Belgium	2.7	1.2	– 0.8	0.7	4.5	1.6	1.7	7.1	7.2	7.5
Austria	2.2	1.6	– 0.5	0.8	3.3	1.3	1.5	3.8	4.2	4.5
Greece	1.9	3.0	0.8	1.5	4.3	2.2	2.7	7.8	8.1	8.4
Finland	1.5	2.0	0.0	1.3	3.8	2.0	2.1	6.4	7.0	7.1
Ireland	1.5	– 1.7	– 1.7	1.5	3.2	1.1	1.8	6.3	7.8	7.8
Portugal	1.3	0.5	– 0.6	0.5	2.7	1.2	1.5	7.7	8.6	8.9
Slovakia	1.3	7.0	3.2	4.5	3.9	2.8	3.7	9.6	11.1	10.8
Slovenia	0.3	4.5	1.0	1.8	5.8	2.0	2.8	4.5	5.0	5.2
Luxembourg	0.3	2.5	– 0.4	1.7	4.2	1.8	2.1	4.4	4.7	4.9
Cyprus	0.1	3.7	1.0	1.8	4.4	2.1	2.5	3.8	3.9	4.0
Malta	0.0	2.4	0.7	1.6	4.6	2.0	2.6	5.8	6.2	6.4
Euro area[c]	**72.8**	**0.9**	**– 1.4**	0.3	**3.3**	**1.2**	**1.5**	**7.5**	**8.7**	**9.4**
United Kingdom	16.6	0.8	– 1.5	0.3	3.7	2.1	2.2	5.6	7.2	7.5
Sweden	2.7	1.0	– 0.5	1.4	3.4	1.7	1.9	6.2	6.8	7.0
Denmark	1.8	0.2	– 0.8	1.2	3.6	1.6	1.8	3.5	3.6	3.9
EU 19[c]	**94.0**	**0.9**	**– 1.4**	0.4	**3.4**	**1.4**	**1.7**	**7.1**	**8.4**	**9.0**
Poland	2.5	5.4	2.0	3.0	4.2	3.1	3.6	7.1	7.7	7.5
Czech Republic	1.0	4.4	1.7	3.5	6.3	2.4	2.9	4.5	5.3	5.1
Romania	1.0	7.5	3.0	4.5	7.9	4.0	4.5	5.9	6.4	6.4
Hungary	0.8	1.5	– 1.0	1.0	6.1	3.6	4.0	7.9	9.0	9.5
Lithuania	0.2	3.6	1.2	– 1.0	11.1	8.5	7.7	5.6	5.9	6.7
Bulgaria	0.2	6.0	3.0	4.0	12.1	7.3	8.5	5.8	6.1	6.4
Latvia	0.1	– 1.0	– 3.0	1.0	15.4	12.4	11.9	7.1	9.2	9.6
Estonia	0.1	– 1.3	– 1.9	1.2	10.7	8.8	8.3	5.8	9.0	9.5
EU 8	**6.0**	**4.8**	**1.6**	**2.9**	**6.3**	**3.8**	**4.3**	**6.4**	**7.1**	**7.1**
EU 27[c]	**100.0**	**1.1**	**– 1.2**	**0.5**	**3.6**	**1.6**	**1.8**	**7.0**	**8.1**	**8.6**

[a] Harmonised consumer price index (HCPI). – [b] Standardised unemployment rate. – [c] Sum of the listed countries.

Source: EUROSTAT; OECD; IMF; 2008, 2009, 2010: forecasts by the EEAG.

Table A.3

Key forecast figures for the euro area

	2007	2008	2009	2010
	Percentage change over previous year			
Real gross domestic product	2.6	0.9	– 1.4	0.3
Private consumption	1.6	0.4	0.3	0.3
Government consumption	2.3	1.8	1.2	1.3
Gross fixed capital formation	4.2	1.0	– 5.5	0.5
Net exports[a]	0.3	0.2	– 0.5	– 0.2
Consumer prices[b]	2.2	3.3	1.2	1.5
	Percentage of nominal gross domestic product			
Government fiscal balance	– 0.6	– 1.3	– 2.7	– 3.5
	Percentage of labour force			
Unemployment rate[c]	7.4	7.5	8.7	9.4

[a] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b] Harmonised consumer price index (HCPI). – [c] Standardised unemployment rate.

Source: Eurostat; 2008, 2009 and 2010: forecasts by the EEAG.

Appendix 2:
Ifo World Economic Survey (WES)

The World Economic Survey (WES) assesses world-wide economic trends by polling transnational as well as national organisations on current economic developments in their respective countries. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In 2008, 1,001 economic experts in 92 countries were polled. The WES is conducted in co-operation with the International Chamber of Commerce (ICC) in Paris. The survey questionnaire focuses on qualitative information: assessments of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since it reveals economic changes earlier than conventional 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. Overall 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.

The Ifo World Economic Climate Index fell in October 2008 to the lowest level for more than 20 years (60.0; 1995=100). The decline is primarily the result of more unfavourable assessments of the current economic situation, but also the expectations for the coming six months have continued to worsen.

World economy: Global downswing

The world economic climate continued to deteriorate in October 2008. On a global average, the assessments of the present economic situation fell in October clearly below the satisfactory level. The economic expectations for the next six months have again been downgraded. The economic downturn has clearly become global. This time the cooling of the Ifo World Economic Climate has not only affected the major economic regions – North America, Western Europe and Asia – but also Central and Eastern Europe, Russia, Latin America and Australia. In October, the economic expectations in the US brightened somewhat for the third time in succession. However, the assessments of the present economic situation in the US have been strongly down-graded. In Western Europe the economic climate indicator has again declined in nearly all countries. In particular, the assessments of the current situation clearly worsened. The economic expectations remained pessimistic. In Asia, the assessments of the current situation deteriorated as well. The six-month outlook for the Asian economy remains on low level, too. Particularly unfavourable appraisals of the economic situation have been given in Japan, South Korea and Taiwan.

Overall, the data confirm a global recessionary trend. At present, it appears realistic, that the economic climate index will remain in a recessionary period for the first half of 2009. In many countries, the WES experts stated that insufficient demand has become the major economic problem at present. However, there are also supportive factors for the global economy, such as the falling oil and energy prices, easing inflation, declining interest rates and the multiple governmental economic stimulus programs in the US, Western Europe and Asia. The downward pressure for the global economy is still the weak consumption sector in the US and the unprecedented spread of the financial crisis with its unpredictable impact on the global economy.

Western Europe: Strong economic decline

The economic climate indicator for Western Europe further deteriorated in October. Particularly the assessments of the present economic situation have been strongly downgraded. The economic expectations remained negative.

For the euro area the overall economic climate index strongly declined. In almost all countries of the euro area the assessments of the present economic situation deteriorated in October, particularly strong in Italy, Belgium, France, Austria and Germany. In Ireland and Portugal the assessments of the present economic situation remain particularly low. The economic expectations have been seriously downgraded in both countries. In the other countries of the euro area, the economic expectations for the next

six months remained pessimistic. WES experts in all euro area countries expect a pronounced economic weakening in the beginning of 2009. They named "insufficient demand" as the most important economic problem at the present.

Outside the euro area the economic climate index also fell in October. In Sweden, Norway, Denmark, Switzerland and the UK the assessments of the present economic situation further deteriorated in October; the present economic situation in Switzerland and Norway was still regarded as good by the surveyed economists. In Sweden and Denmark the present economic performance declined after October, when it was still described as satisfactory. In the UK, in contrast, the present economic performance is described as very weak. Also here, WES experts emphasised that "insufficient demand" is aggravating the economic downturn as a consequence of the financial crisis. Further economic slow-down is expected in these countries in the next six months.

North America: Economic climate index falls further

The economic climate indicator in North America deteriorated in October. However, unlike the other regions, the economic expectations for the next six months have been up-graded somewhat in the US. But the assessments of the present economic situation deteriorated strongly, reaching the historically lowest level since the introduction of WES in 1983. Lack of confidence in the government's economic policy was named by the surveyed economist as the most important economic problem at present. The October survey was launched before Barack Obama won the presidential election.

In Canada both the assessments of the present economic situation and economic expectations have been downgraded.

Central and Eastern Europe: Economic cooling

The economic climate cooled also in Central and Eastern Europe. The assessments of the present economic situation strongly deteriorated in October, although remaining close to the satisfactory level, on average. The economic expectations for the next six months have been downgraded again and are pointing to lower economic growth rates in the near-term.

The economic climate deteriorated in all EU countries of the region. However, the present economic situation is still assessed as satisfactory or favourable in most countries, except Hungary, Latvia and Estonia. The economic expectations have been downgraded in all new EU countries (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and Slovakia) and point to economic cooling in the next six months.

The economic climate deteriorated somewhat also in the three countries surveyed outside the European Union – Albania, Croatia and Serbia – due to a downgrade of economic expectations for the next six months. However, in all three countries the assessments of the present economic situation were even upgraded somewhat in October compared to the July survey. The surveyed WES experts described the present economic performance as satisfactory in Albania, Croatia and Serbia. An economic deterioration has been forecasted for the next six months by the surveyed economists in Croatia. In Albania and Serbia the economy is expected to stabilise at the current level, according to WES experts.

CIS: Economic climate index drops

The overall economic climate index for CIS countries covered by WES (Russia, Ukraine, Kazakhstan, Kyrgyzstan and Uzbekistan) dropped sharply in October. Both components of the economic climate index – the assessment of the present economic situation and economic expectations – have been strongly downgraded.

The economic climate deteriorated particularly strongly in Russia. The assessments of the present economic situation have been sharply downgraded. However, the surveyed economists described the current economic performance as satisfactory, whereas the economic expectations for the next six months have become clearly pessimistic. Russia is expecting a decline in global demand for its primary exports of goods. Also credit-driven private consumption and business investments are expected to weaken in the coming months. As an important economic problem the surveyed economists named high inflation. For the Ukraine even higher inflation was reported. The present economic situation here has been described as weak by the surveyed economists. Further economic deterioration has been forecasted for the coming months. Lack of confidence in government's eco-

nomic policy is, according to WES experts, the most important economic problem in the Ukraine at present. In contrast, a stable economic climate prevails in Kazakhstan. The present economic situation continues to be satisfactory here. The surveyed economists expect further moves to economic stabilisation in the next six months. Also in Uzbekistan a favourable economic climate prevails, according to WES experts, however, this is not the case in Kyrgyzstan, where the present economic performance remains weak.

Asia: Economic climate deteriorates

Similarly, in Asia the economic climate strongly deteriorated and has fallen to the lowest level since 2001. Both the assessments of the present economic situation and economic expectations for the next six months have again been downgraded for the region, in October.

The economic climate index fell further in all major Asian economies except Pakistan, where the economic expectations have been up-graded somewhat. However, the present economic performance in Pakistan is judged by WES experts as being very weak, although it is not expected to deteriorate further in the course of the next six months. The present economic performance was assessed in Japan, South Korea and Taiwan far below the satisfactory level and much worse than in the preceding quarter. In Japan and South Korea further economic deterioration is expected by the WES experts, with pronounced weakening of the capital expenditures and private consumption. In Taiwan the surveyed economists expect the economy to stabilise at the current level, although exports have been forecasted to decline in the next six months. Lack of confidence in the government's economic policy was named as an important economic problem by the surveyed economists in Taiwan. The economic climate index deteriorated strongly also in China. Export growth is foreseen to weaken strongly in the next six months. The economists also emphasised that domestic demand is insufficient in China at present. Further economic deterioration is expected also in Indonesia, Thailand and Malaysia. However, the present economic situation in Malaysia is still assessed as "satisfactory" by the majority of surveyed economists. Satisfactory was also the assessment of the present economic performance in Hong Kong, Singapore and the Philippines by the WES experts. However, also here the prospects appear to be rather clouded. Particularly in Hong Kong and the Philippines WES experts expect that capital expenditures, private consumption and the export sector will weaken strongly in the course of the next six months.

In India the economic climate also cooled somewhat but not considerably. The present economic situation here was assessed as being satisfactory in October. The economic expectations for the next six months have been downgraded only slightly, pointing to a moderate economic cooling. Inflation poses the most important economic problem at present. The same applies to Vietnam, where the assessments of the present economic state have been even up-graded somewhat over the preceding July survey. The expectations point to an economic stabilisation in the next six months. Private consumption is even expected to pick up somewhat. Bangladesh was one of the few countries where the surveyed economists assessed the present economic state as above satisfactory. Although inflation is also here one of the main economic topics, the overall economic expectations are positive, pointing to a strengthening of capital expenditures and the export sector in the course of the next six months.

Oceania: Economic slowdown continues

Economic slowdown continues in Australia. For the first time since 2001 the assessments of the present economic situation slipped below the satisfactory line. The economic expectations point to a further economic cooling in the next six months. Growth of capital expenditures and private consumption are expected to decline strongly. The export sector, however, remains buoyant, according to WES experts. Also inflation, which is generally easing on a global average, remains an important economic problem in Australia.

In New Zealand, the economic climate index improved somewhat in October over the July survey. However the present economic situation is still assessed as far below the satisfactory level. The economic expectations for the next six months have been up-graded somewhat but are still generally cautious. Lack of international competitiveness and inflation continue to be the country's most important economic problems at present, according to WES experts.

Latin America: Economic weakening

The global economic weakening has also reached Latin America. The economic climate index fell in October in Latin America as a whole. However, diverging economic trends still predominate in the region.

The present economic situation continues to be favourable, according to the surveyed economists, in Brazil, Chile, Panama and Paraguay. However, the economic expectations for the next six months here have been strongly down-graded, as in Latin America in general, and point to a pronounced economic cooling. Private consumption, capital expenditures and the export sector are expected to weaken in the near-term. Also in Peru, Trinidad and Tobago and Uruguay the present economic performance received high marks on the WES scale. However, the economic expectations for the next six months have also become generally cautious. In Argentina and Colombia the economic expectations have also deteriorated, although the present economic state was assessed as satisfactory in October. In Argentina, inflation and lack of confidence in government's economic policy were named as the most important economic problems at present. Far below the satisfactory level is how the surveyed economists described the present economic state in Bolivia, Ecuador, El Salvador, Guatemala, Mexico and Venezuela. The economic expectations in all these countries point to an economic weakening in the next six months, particularly relating to capital expenditures and private consumption.

Near East: Economic climate cools moderately

The economic climate has also cooled somewhat in countries surveyed in the Near East. However, in the majority of countries the present economic situation continues to be assessed similarly favourable, so in Jordan, Kuwait, Saudi Arabia and United Arab Emirates. The economic expectations point to a moderate cooling in the next six months and a generally stable economic performance. In contrast, a pronounced economic deterioration is expected by the surveyed economists in Israel; although, currently the economic performance is assessed as above the satisfactory level here as well. In Turkey, the assessments of the present economic situation have been strongly downgraded. The economic expectations for the next six months have remained cautious, although the export sector is expected to rebound somewhat. Further economic deterioration is expected by the surveyed economists in Iran. Also in Lebanon economic recovery remains subdued, according to WES experts.

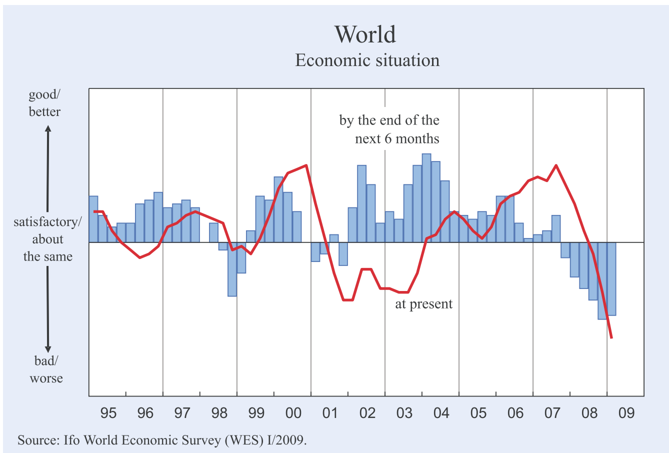
Africa: Economic downturn in South Africa

The economic climate index improved somewhat in South Africa in October over the July survey. Both the assessments of the current economic situation and economic expectations for the coming six months have been upgraded slightly. The present economic situation is now assessed close to the satisfactory level. However, the economic expectations, although less pessimistic than in the preceding surveys of 2008, are still pointing to further economic deterioration in the next six months. Capital expenditures, private consumption and the export sector are expected to weaken further in the coming months, according to WES experts. Unemployment, lack of skilled labour and inflation continue to be the country's most important economic problems, crime and AIDS are the country's most important social problems at present.

An economic deterioration is also expected by the WES experts surveyed in the North African countries, Morocco, Tunisia, Egypt and Algeria, as well as in Tanzania, Nigeria and Mauritius. In Kenya, however, the surveyed economists expect a strengthening of the economy in the next six months, with growing private consumption and exports.

Fewer and fewer economists assess the economy for WES in Zimbabwe. Many of them have left the country or have no access to communication media. The information that reaches us reflects that the disastrous economic and political circumstances continue to prevail in the country and may even further aggravate in the near term.

Ifo World Economic Survey (WES)



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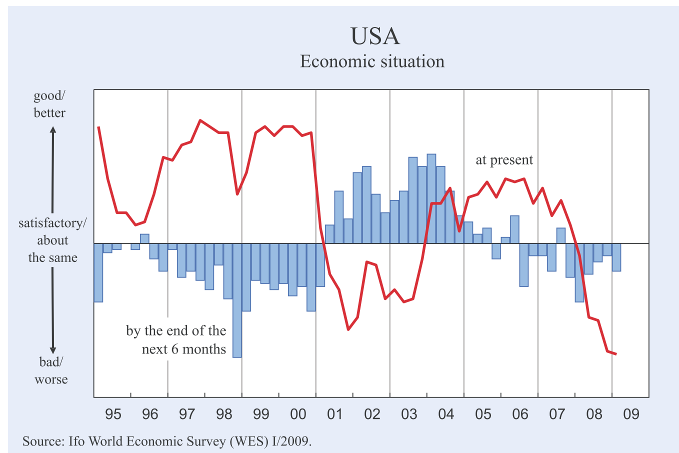

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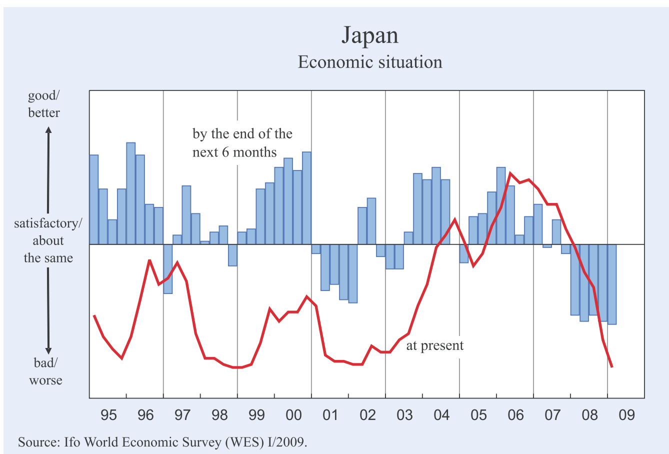

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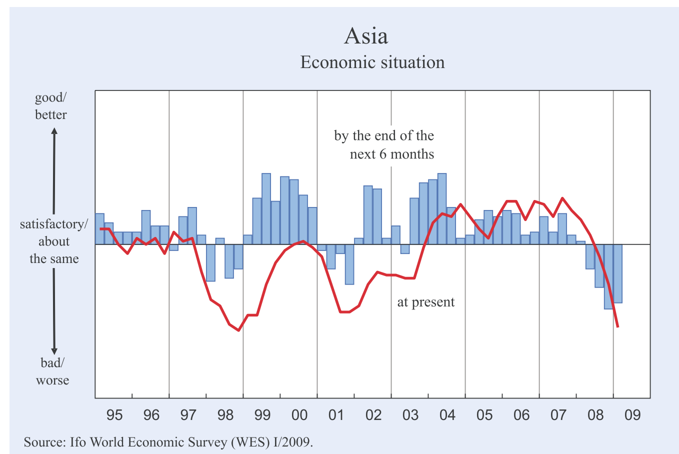

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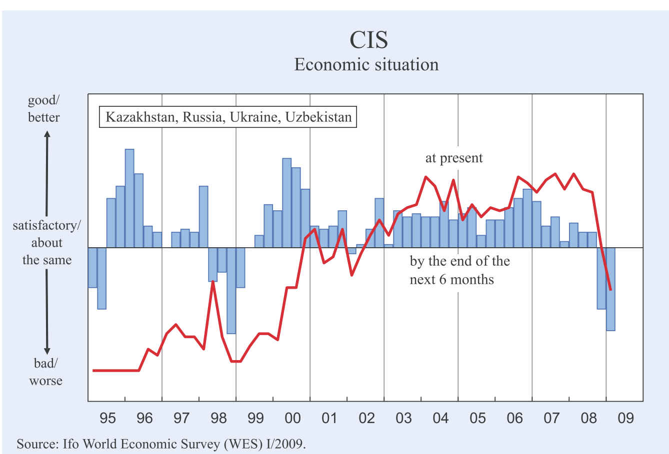

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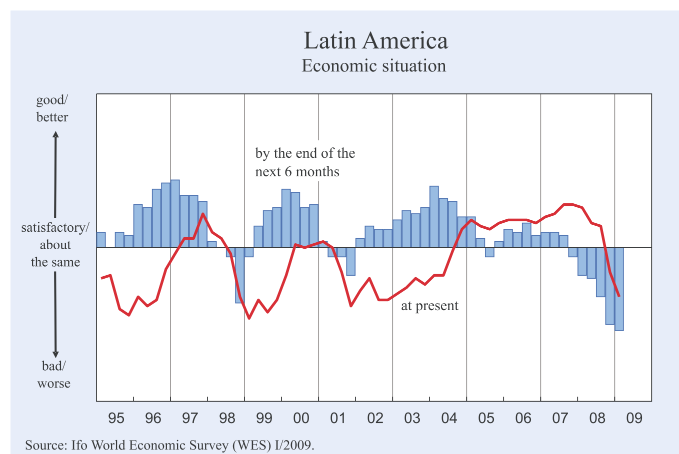

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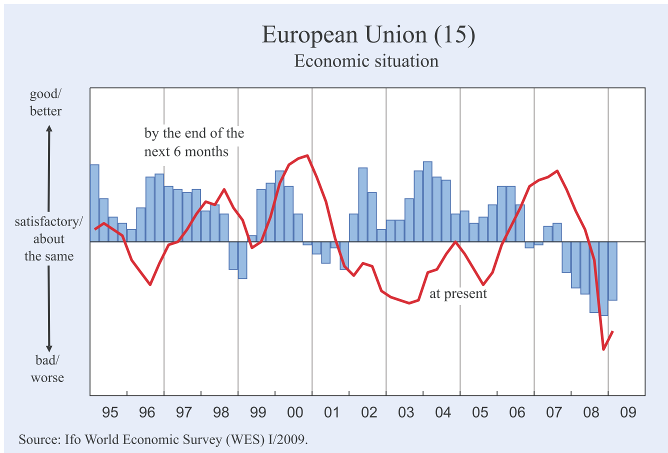
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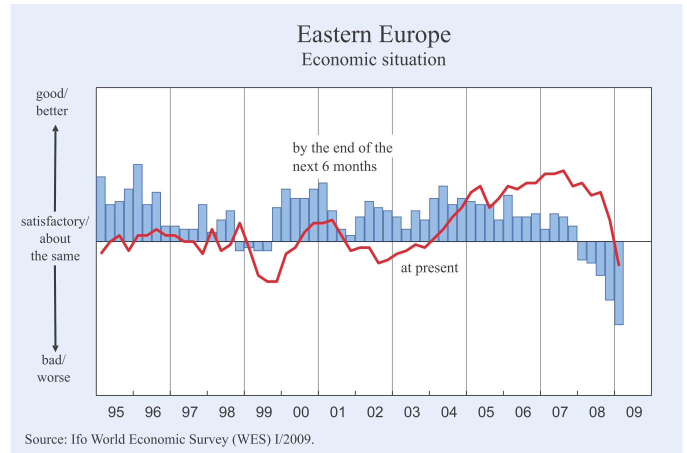
Source: Ifo World Economic Survey (WES) I/2009.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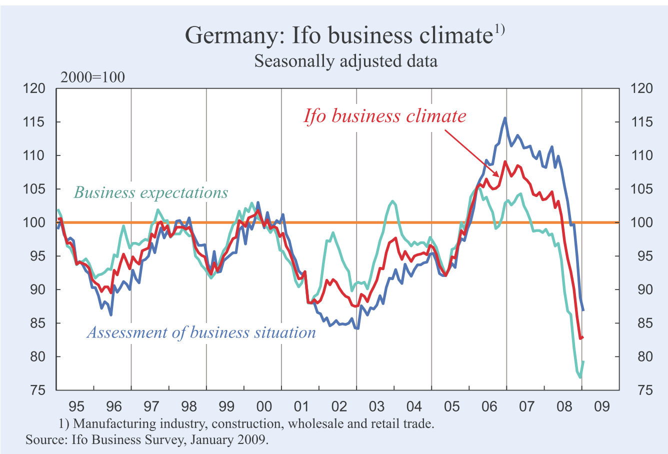
Germany: Ifo business climate1)
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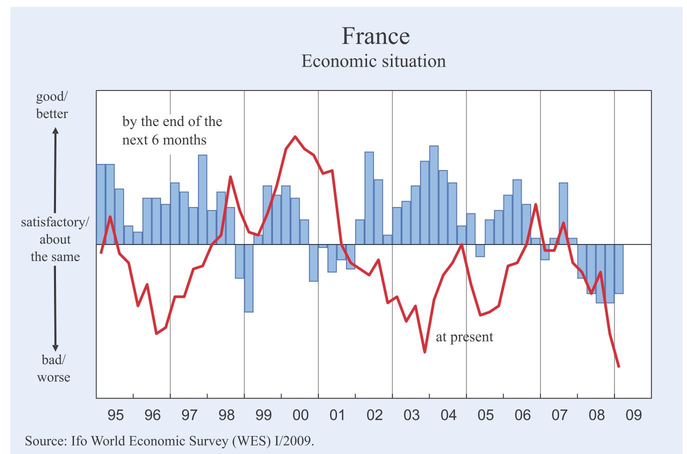
1) Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2009.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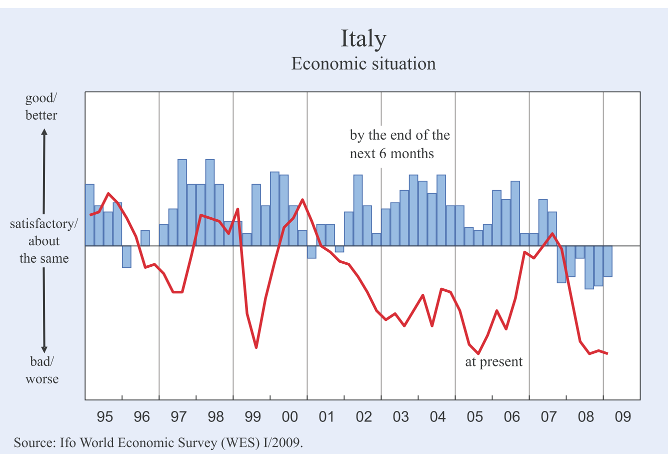
Source: Ifo World Economic Survey (WES) I/2009.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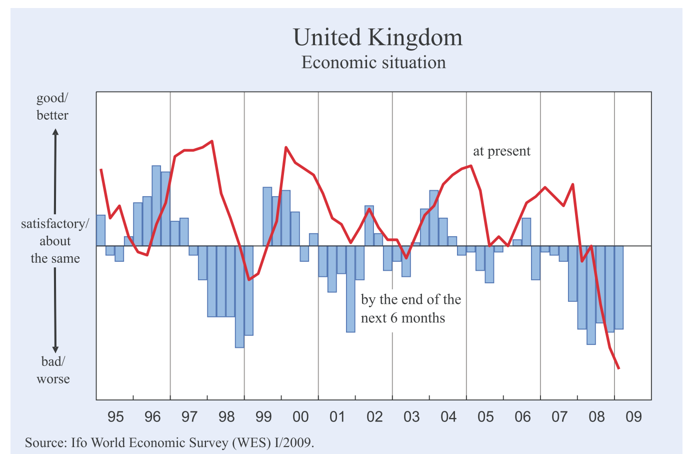
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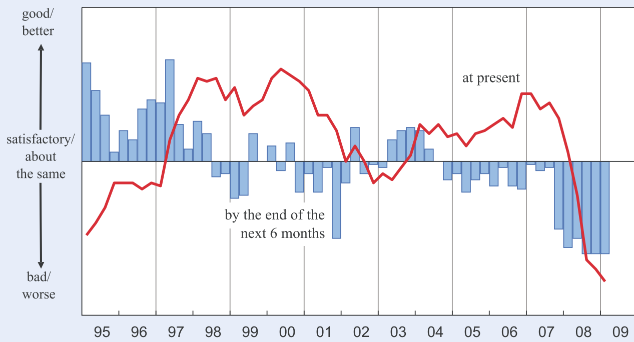

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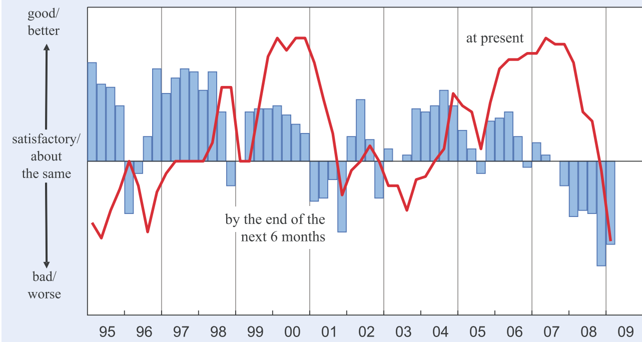

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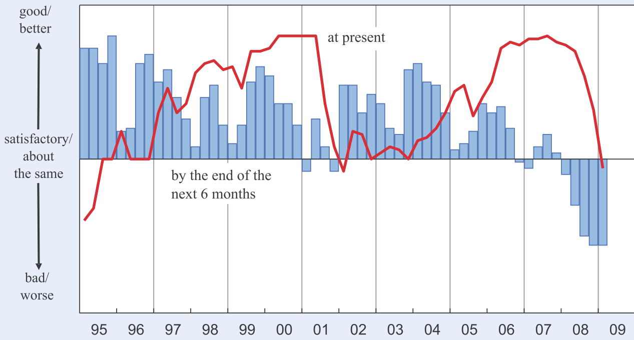

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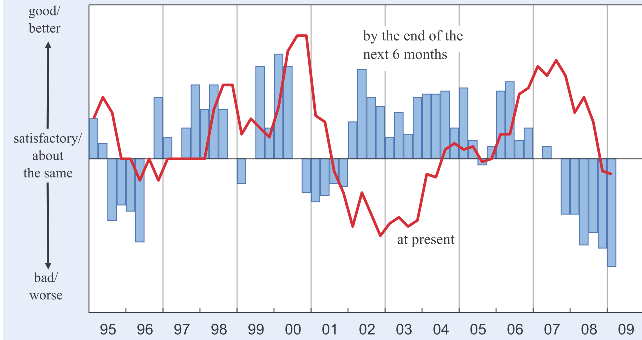

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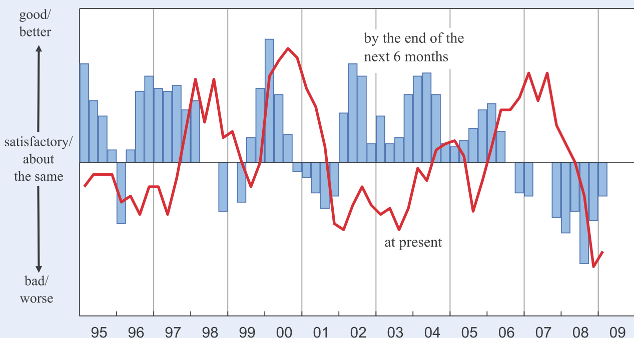

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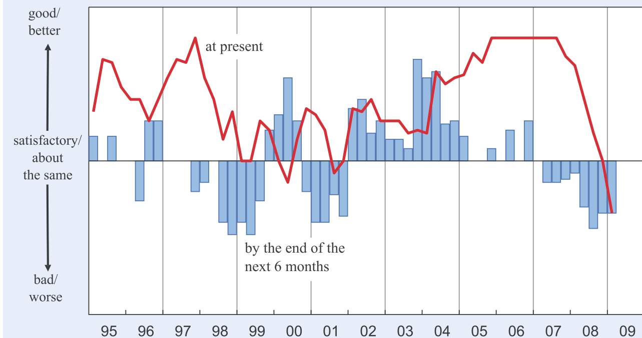

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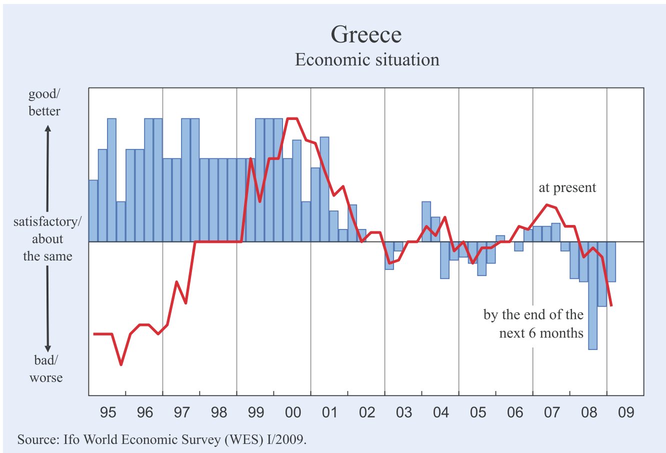

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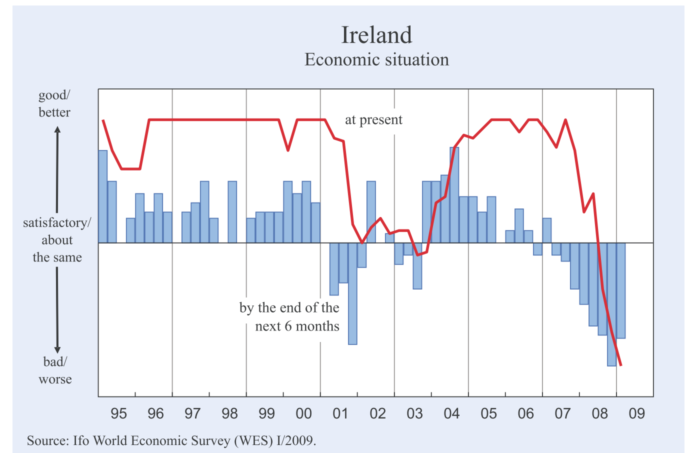

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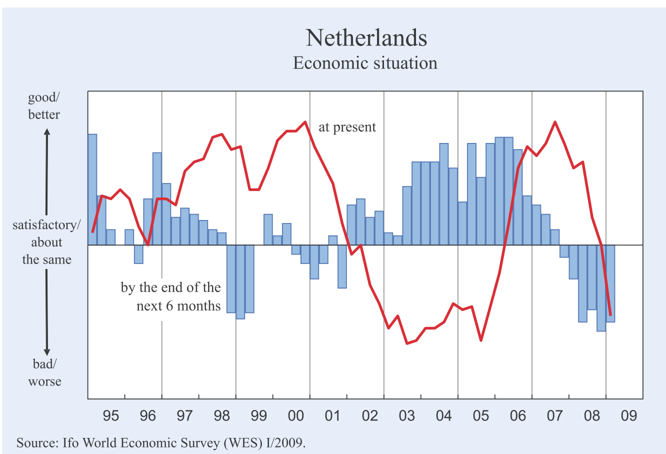

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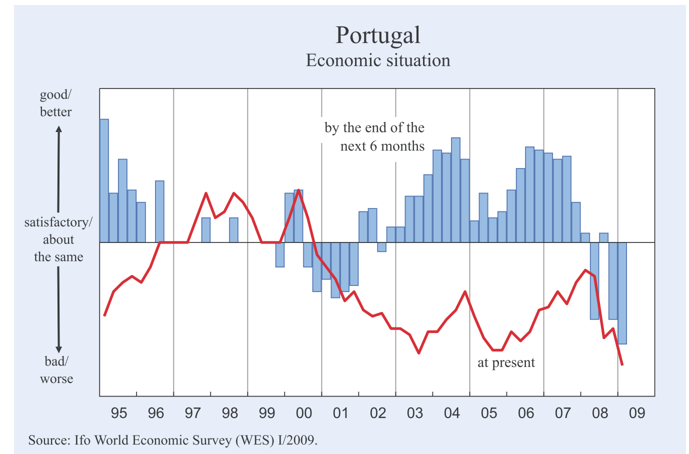

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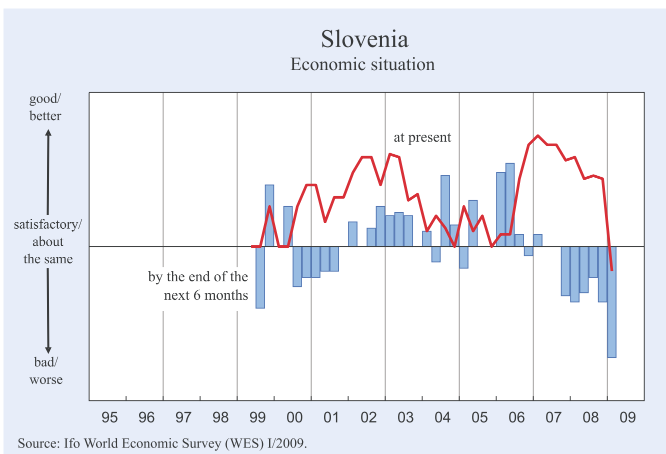

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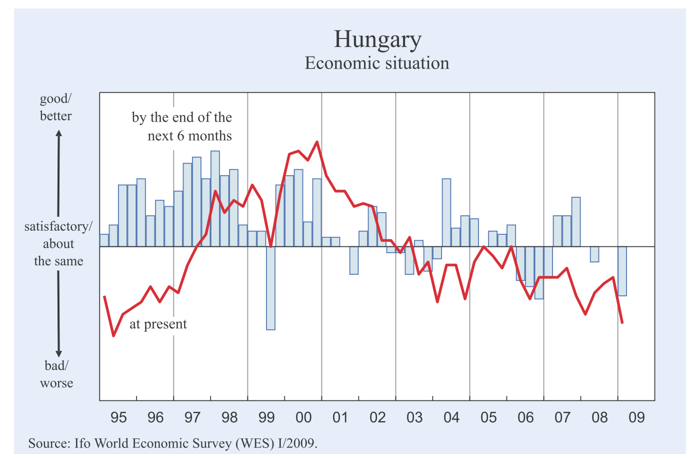

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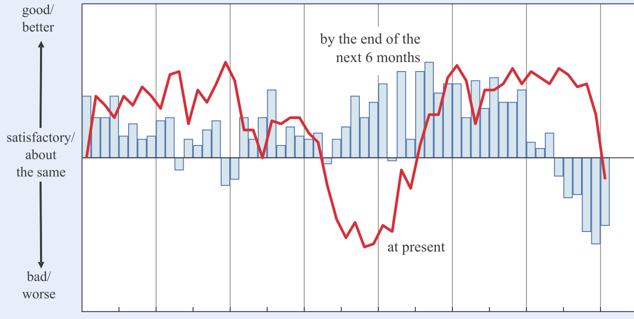

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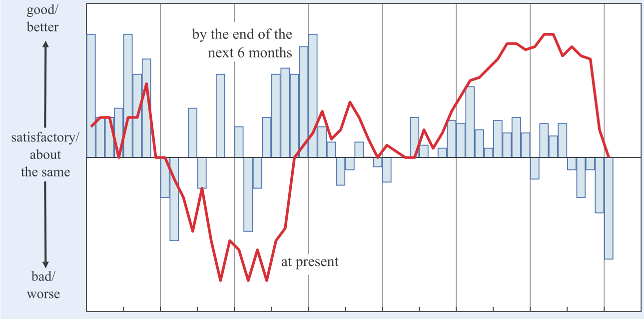

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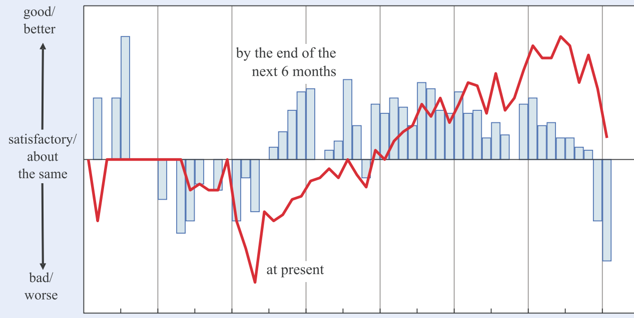

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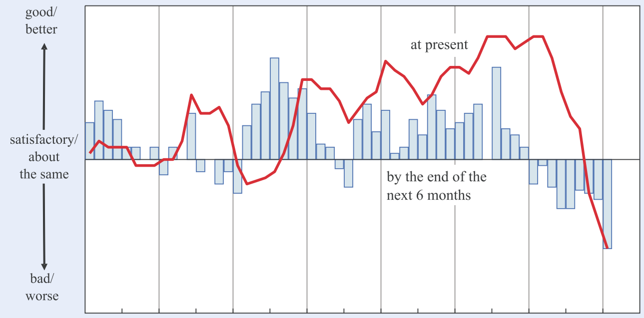
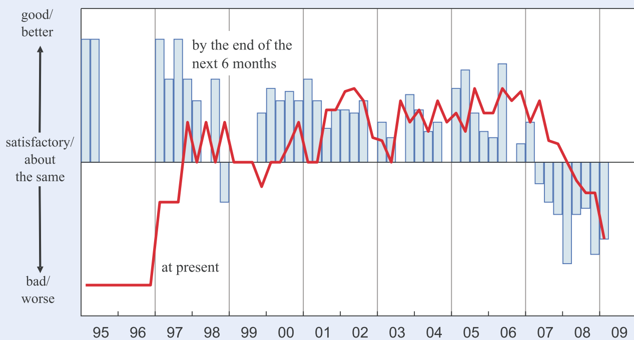
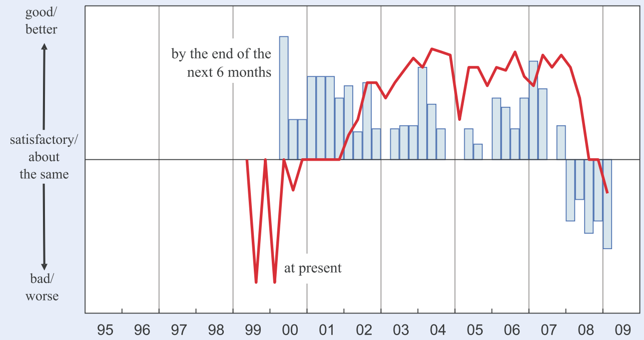


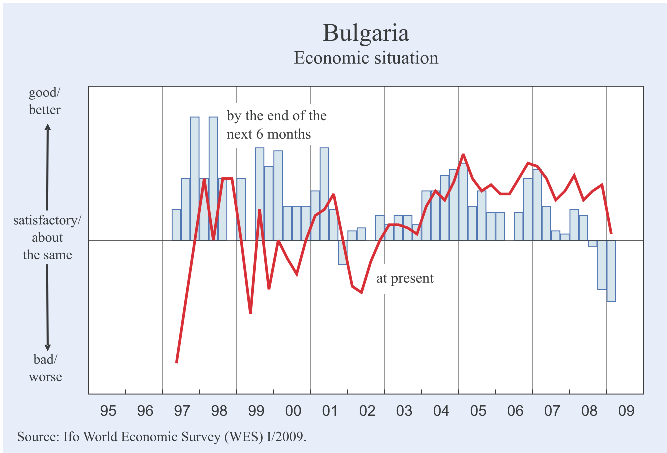
Source: Ifo World Economic Survey (WES) I/2009.



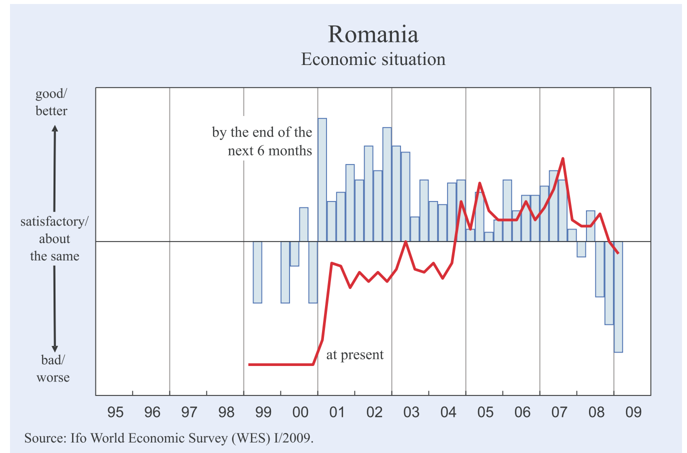
Source: Ifo World Economic Survey (WES) I/2009.



Source: Ifo World Economic Survey (WES) I/2009.



Source: Ifo World Economic Survey (WES) I/2009.



Source: Ifo World Economic Survey (WES) I/2009.