



100 YEARS  
UNDERSTANDING  
AND SHAPING  
THE GLOBAL ECONOMY

EU Parliament /EU Commission Annual Conference | Vilnius, 27 March 2015  
*The European Union And Global Trends: Political And Economic Changes*

# **E(M)U Economic Outlook – Stronger Growth Calls for Structural Reforms**

---

Prof. Dr. Stefan Kooths  
Kiel Institute for the World Economy, Forecasting Center

# The Kiel Institute for the World Economy

---



## Key messages

---

- The European economy is on the verge of recovery
  - » On aggregate, moderate expansion of economic activity
  - » The economic situation remains diverse among EU member states
  - » Underutilization of production capacities in some countries and overheating in other parts of the euro area not to be misinterpreted as a macroeconomic equilibrium on the aggregate level
  - » Post-crisis sluggish growth is a typical pattern for countries suffering from severe capital stock distortions (= flipside of financial crisis)
- No destabilizing deflation
  - » Recent oil price slumps stimulate economic activity
  - » Core inflation is low, but there is no deflation spiral in sight
  - » Resolution of production structure distortions (mismatch-problems) dampens inflation pressure

## Key messages

---

- The labor market conditions are improving
  - » Functional adjustments of wages in most crisis countries
- Fiscal consolidation comes to a stop
  - » Further improvements of budget balances are cyclical or due to low interest rates, but not caused by further structural adjustments
- The economic situation in Greece remains extremely difficult
  - » But: Little potential spill-overs to the rest of the euro area
- The ultra-low interest rate regime becomes increasingly risky
  - » “Quantitative Easing” works in liquidity crises, not as a GDP booster
  - » The longer the low rate of interest prevails the more the capital stock and the production structure as well as financial claims adopt causing new distortions and making exit strategies more difficult

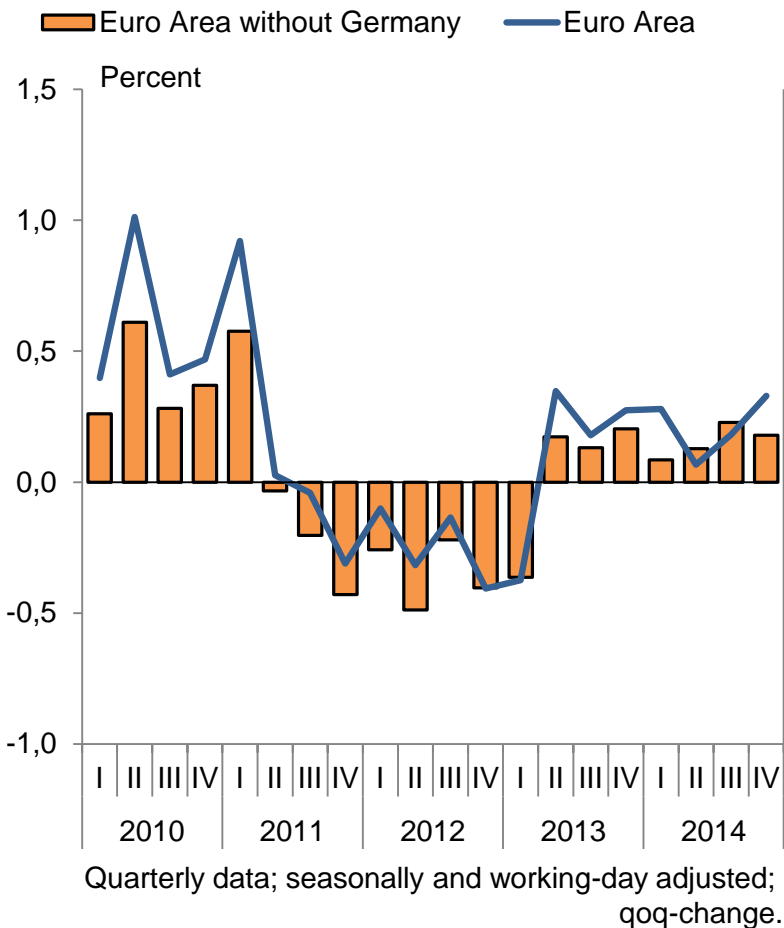
# Key messages

---

- Macroeconomic stimulus vs. structural reforms
  - » Deficit spending or ultra-permissive monetary policy are no viable substitutes for structural reforms to boost economic growth in Europe
  - » From the perspective of fiscal federalism, European programs (like the “Juncker investment initiative”) are hardly a solution unless they address the provision of clearly identified public goods on the community level
  - » Mismatch resolving structural reforms: Ownership is key
- The MIP should stay focused on early crisis warning
  - » The European Macroeconomic Imbalance Procedure (MIP) is prone to divert from its key crisis prevention focus and expand to an overarching mechanism of policy coordination
  - » Serious conflicts with the principle of subsidiarity
  - » Weakening the early-warning mechanism

# Economic activity slightly gaining momentum

## Gross Domestic Product

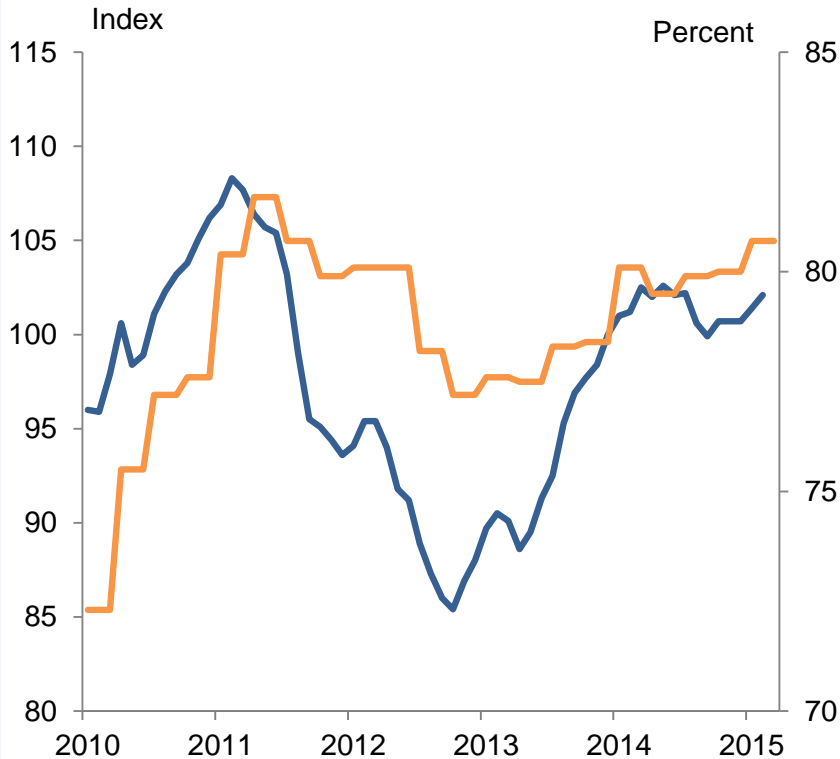


- 2014: + 0.9 percent
  - » Potential: + 0.6 (EU Com)
- Q4: + 0.3 percent
  - » Net exports absorbing 0.2 pp
  - » Investment picks up, after a decrease between Q2, Q3

# Early indicators

## Economic Sentiment and Capacity Utilization

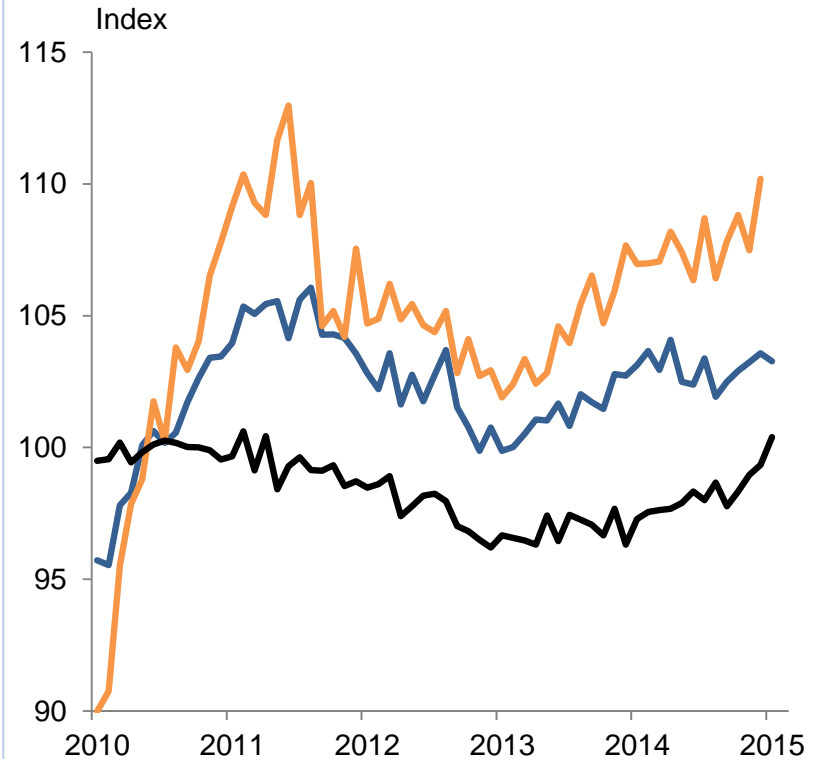
— Economic Setiment Indicator — Capacity Utilization (rhs)



Monthly data, seasonally adjusted.

## Production, Orders, Sales

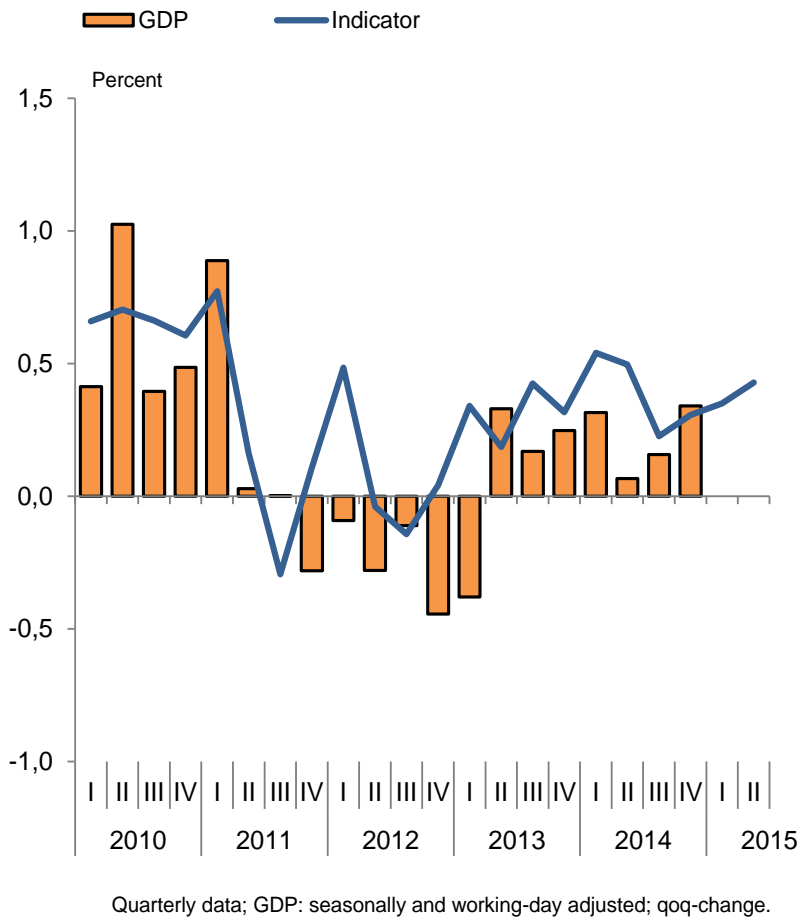
— Industrial Production — New Orders — Retail Sales



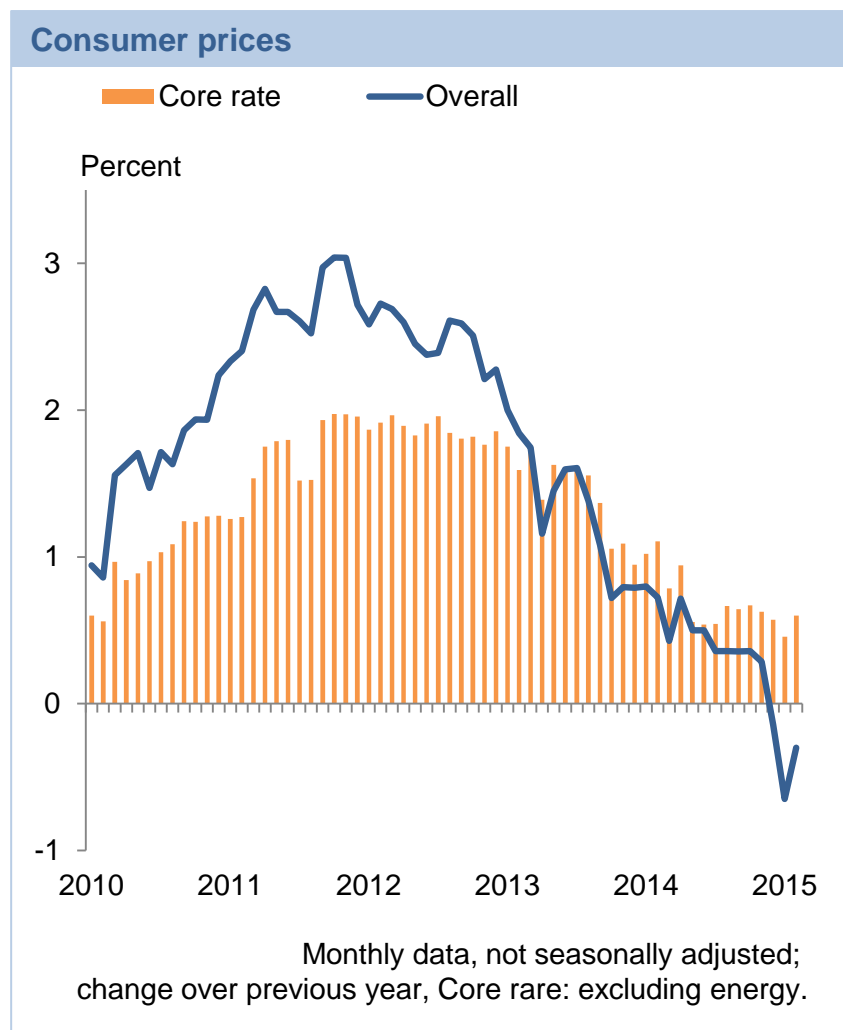
Monthly data, volume, seasonally adjusted.

# Euroframe indicator

## Euroframe Indicator and GDP in the Euro Area

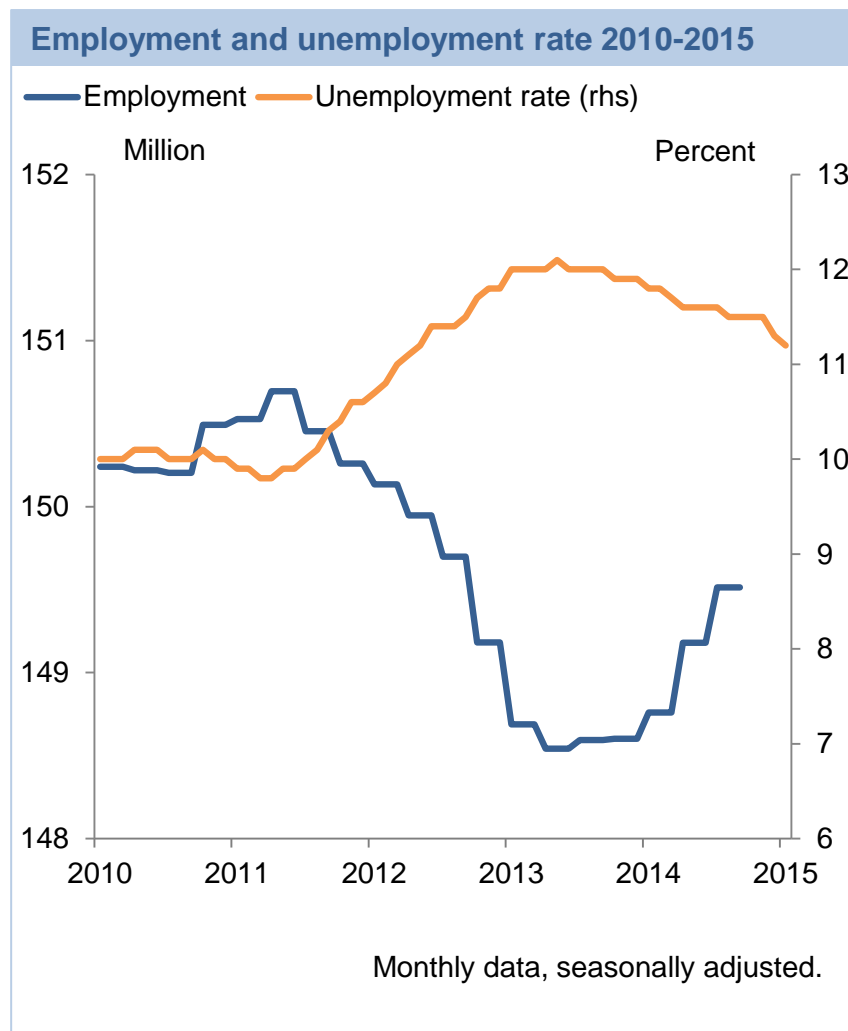


# Disinflation, not deflation



- Recently, consumer prices decreased due to sharp drop in oil price
- Core inflation flat since mid-2014 (0.5 – 0.7 percent)
- Two types of deflation
  - » Good deflation: Reflecting productivity gains/structural adjustments
  - » Bad deflation: Caused by money supply contractions

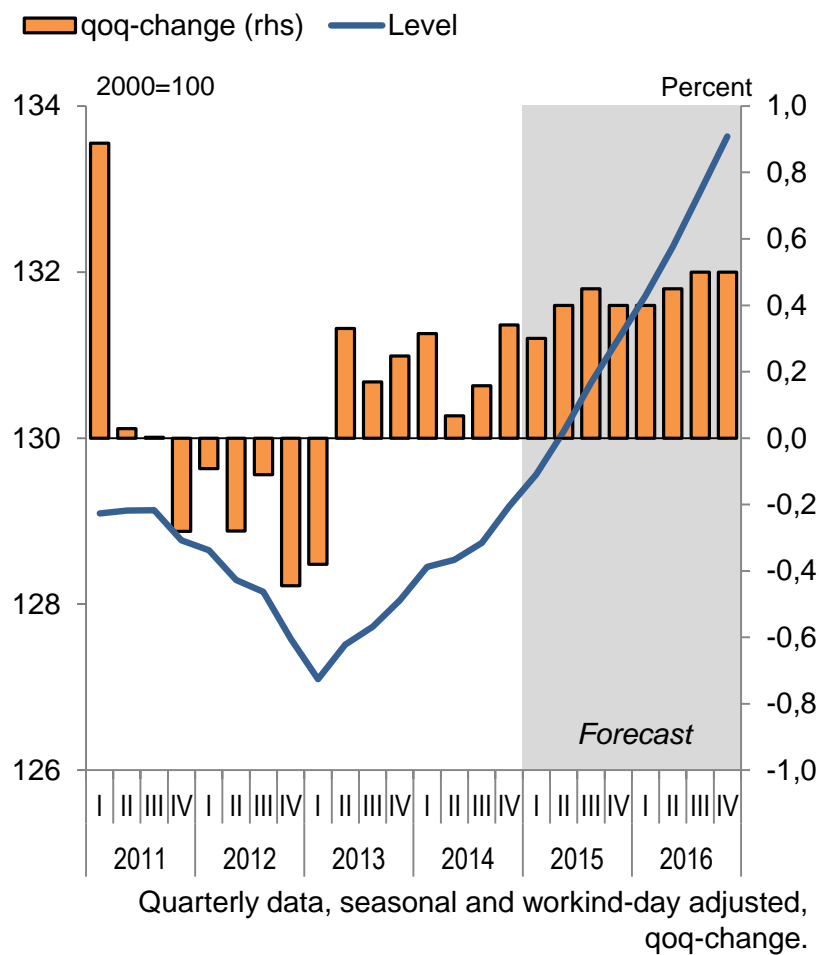
# Labor market



- Wage dynamics in most crisis countries significantly below EMU average
- Delta to pre-crisis wage levels
  - » Greece: – 18 percent
  - » Cyprus: – 8 percent
  - » Portugal: – 4 percent
- No significant wage response in Spain
- Wages rising again in Ireland

# Outlook for the euro area: Overall economic activity

## GDP in the euro area



- 2014: + 0.9 percent
- 2015: + 1.3 percent
- 2016: + 1.7 percent

# Outlook for the euro area: GDP drivers

---

- Domestic factors in the driver's seat
  - » Euro area benefits from oil price decreases
  - » Effects differ from country to country
  - » Improvement of labor market conditions
  - » Fiscal policy: Neutral (2015), slightly expansionary (2016)
  - » Private investment to benefit from decrease in overall uncertainty
  
- Accelerating exports
  - » Stronger growth in world trade  
+ 3.3 percent (2014), + 4.0 percent (2015), + 5.0 percent (2016)
  - » Significant depreciation of the euro
  - » However, only minor growth absorption of net exports

# Inflation picks up, fiscal consolidation stops

---

## ■ Consumer Prices

- » Price dynamics remain muted  
+ 0.4 percent (2014), 0.0 percent (2015), + 1.1 percent (2016)
- » No further decline in the inflation
  - Depreciation of the euro
  - Capacity utilization increases
  - Oil price expected to increase over the forecast horizon

## ■ Public Finances

- » Fiscal balance in relation to GDP: Consolidation stops
  - 2.5 percent (2014), – 2.3 percent (2015), – 2.1 percent (2016)
- » Deficit reductions due to cyclical factors and lower refinancing costs

## Euro area outlook: Main aggregates

	2013	2014	2015	2016
Gross domestic product	-0.4	0.9	1.3	1.7
Domestic demand	-1.0	0.8	1.2	1.7
Private consumption	-0.7	1.0	1.3	1.5
Public consumption	0.1	0.7	0.7	1.0
Fixed investment	-2.9	1.0	1.5	2.7
Change in stocks	0.0	-0.1	0.0	0.0
Net exports	0.5	0.1	0.1	0.1
Exports	1.4	3.7	4.2	5.8
Imports	0.4	3.8	4.3	6.1
Consumer prices	1.3	0.4	0.0	1.1
Unemployment rate	11.9	11.6	11.1	10.5
Current Account	2.2	2.4	2.5	2.6
Budget Balance	-3.0	-2.5	-2.3	-2.1

Gross Domestic product: volume; change over previous year. — Change in stocks, net export: contribution to GDP growth. — Consumer Prices: Harmonized Index of Consumer Prices (HICP). — Unemployment rate: ILO. — Budget Balance: in relation to GDP.

Source: Eurostat, *National Accounts*; own calculation; gray: IfW forecast.

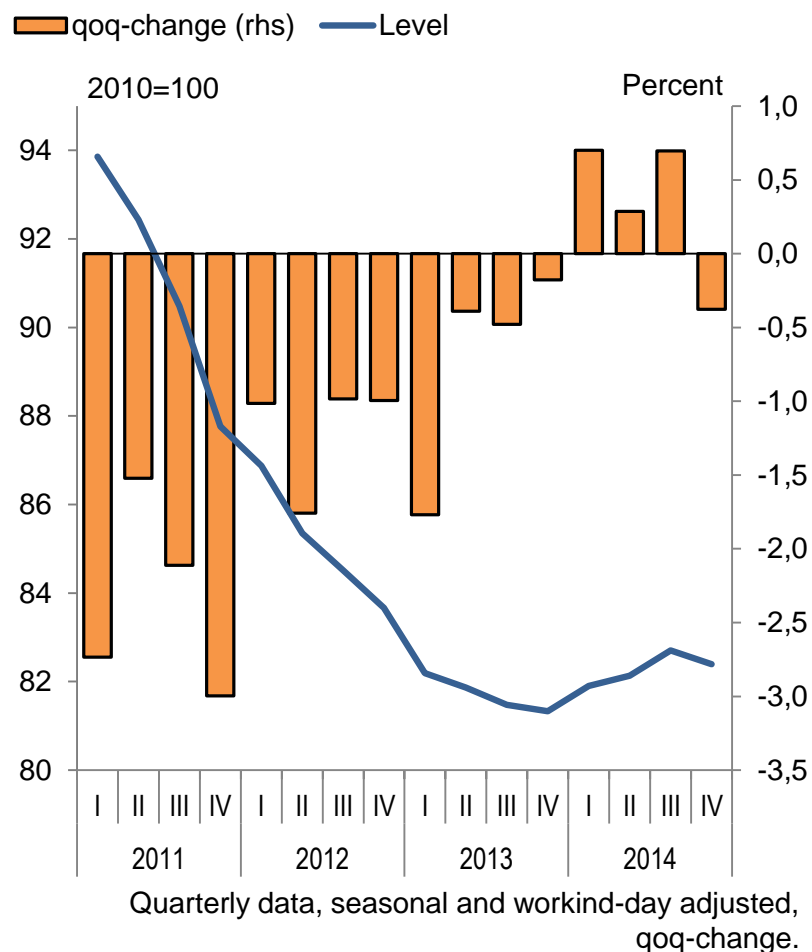
# Euro area outlook by country

	Weight	GDP			Consumer Prices			Unemployment rate		
		2014	2015	2016	2014	2015	2016	2014	2015	2016
Germany	28,3	1,6	1,8	2,0	0,8	0,1	1,5	5,0	4,7	4,4
France	21,3	0,4	0,9	1,3	0,6	0,1	0,8	10,2	10,2	10,0
Italy	16,2	-0,4	0,5	1,1	0,2	0,0	0,7	12,7	12,8	12,5
Spain	10,6	1,4	2,2	2,3	-0,2	-0,3	0,8	24,4	22,3	20,8
Netherlands	6,5	0,8	1,4	1,7	0,3	-0,2	0,9	7,4	7,2	6,9
Belgium	4,0	1,0	1,1	1,8	0,5	-0,2	1,0	8,5	8,4	8,0
Austria	3,2	0,3	1,0	1,9	1,5	0,7	1,5	5,0	4,9	4,7
Finland	2,0	-0,1	0,9	1,7	1,2	0,3	1,1	8,7	8,8	8,4
Greece	1,8	1,0	-1,0	1,0	-1,4	-1,0	0,5	26,5	26,5	25,0
Portugal	1,7	0,9	1,3	1,6	-0,2	-0,1	0,7	14,1	12,8	11,7
Ireland	1,8	5,0	3,0	3,5	0,3	0,0	1,0	11,3	9,2	7,5
Slovakia	0,7	2,4	3,3	4,0	-0,1	0,1	1,4	13,2	11,8	10,9
Luxembourg	0,5	3,4	2,5	3,3	0,7	0,0	1,3	6,0	5,9	5,7
Slovenia	0,4	2,6	2,8	3,3	0,4	-0,2	0,3	9,8	9,4	8,2
Lithuania	0,4	2,9	3,3	3,8	0,2	-0,6	0,5	10,7	9,3	8,0
Latvia	0,2	2,4	3,5	4,0	0,7	0,3	1,5	10,9	10,4	9,8
Estonia	0,2	2,6	3,8	4,1	0,7	0,3	1,5	10,9	10,4	9,8
Cyprus	0,2	-2,0	0,5	1,5	0,5	-0,1	1,1	7,4	6,0	5,2
Malta	0,1	3,0	2,6	2,5	-0,3	-0,2	0,4	16,1	16,5	16,0
Euro area	100,0	0,9	1,3	1,7	0,4	0,0	1,1	11,6	11,1	10,5
Euro area w/o Germany	71,7	0,6	1,1	1,6	0,3	0,0	0,9	13,9	13,4	12,7

Weights: Based on nominal GDP in 2013. — Percentage change over previous year— 2015 and 2016 forecast. — Source: Eurostat, National Accounts, Price Statistics, Labor Statistics; own calculations.

# Greece

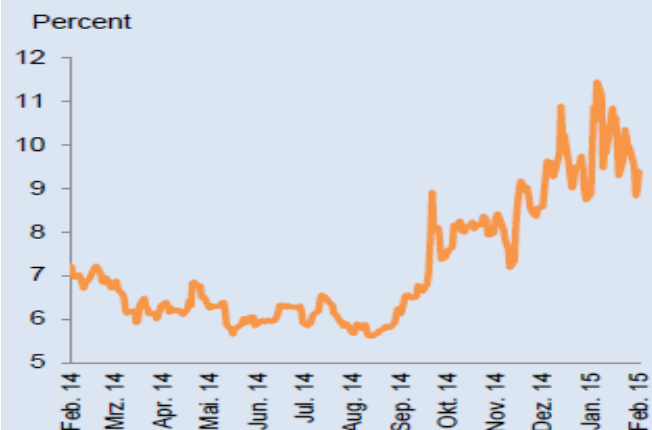
## GDP in Greece



- First signs of a recovery in 2014:
  - » GDP: + 0.7 percent
- Uncertainty increased substantially over the last months
- We expect a drag on economic activity in 2015

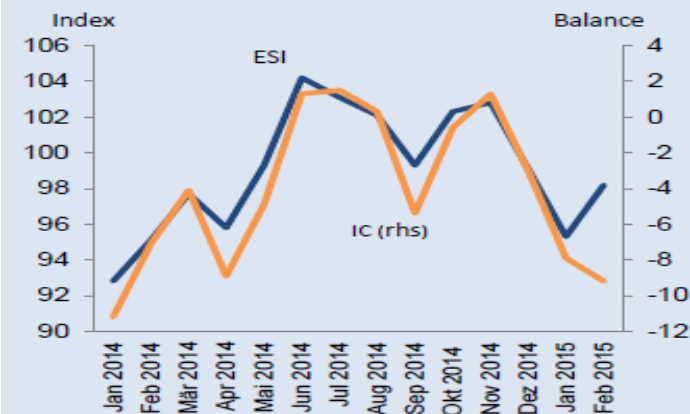
# Greece

**Government bond yield, 10-year, 2014–2015**



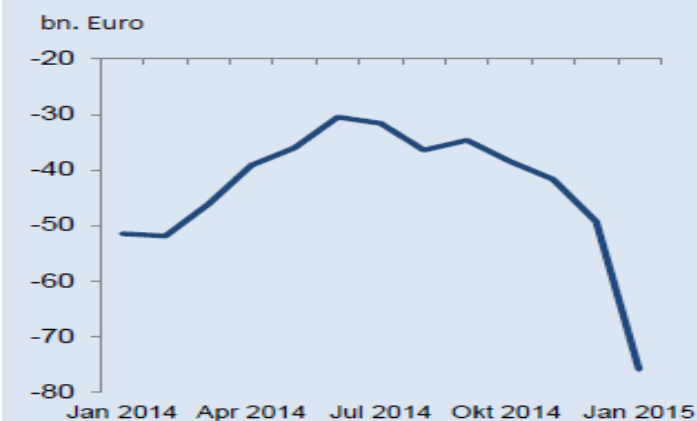
Daily data.

**Sentiment Indicators 2014–2015**



ESI: Economic Sentiment. IC: Industrial Confidence. Monthly data.

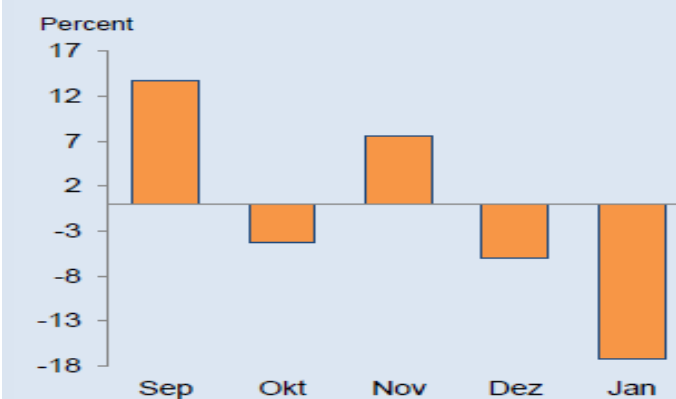
**Target2-Balance 2014–2015**



Monthly data.

Source: Eurocrisis Monitor, Universität Osnabrück.

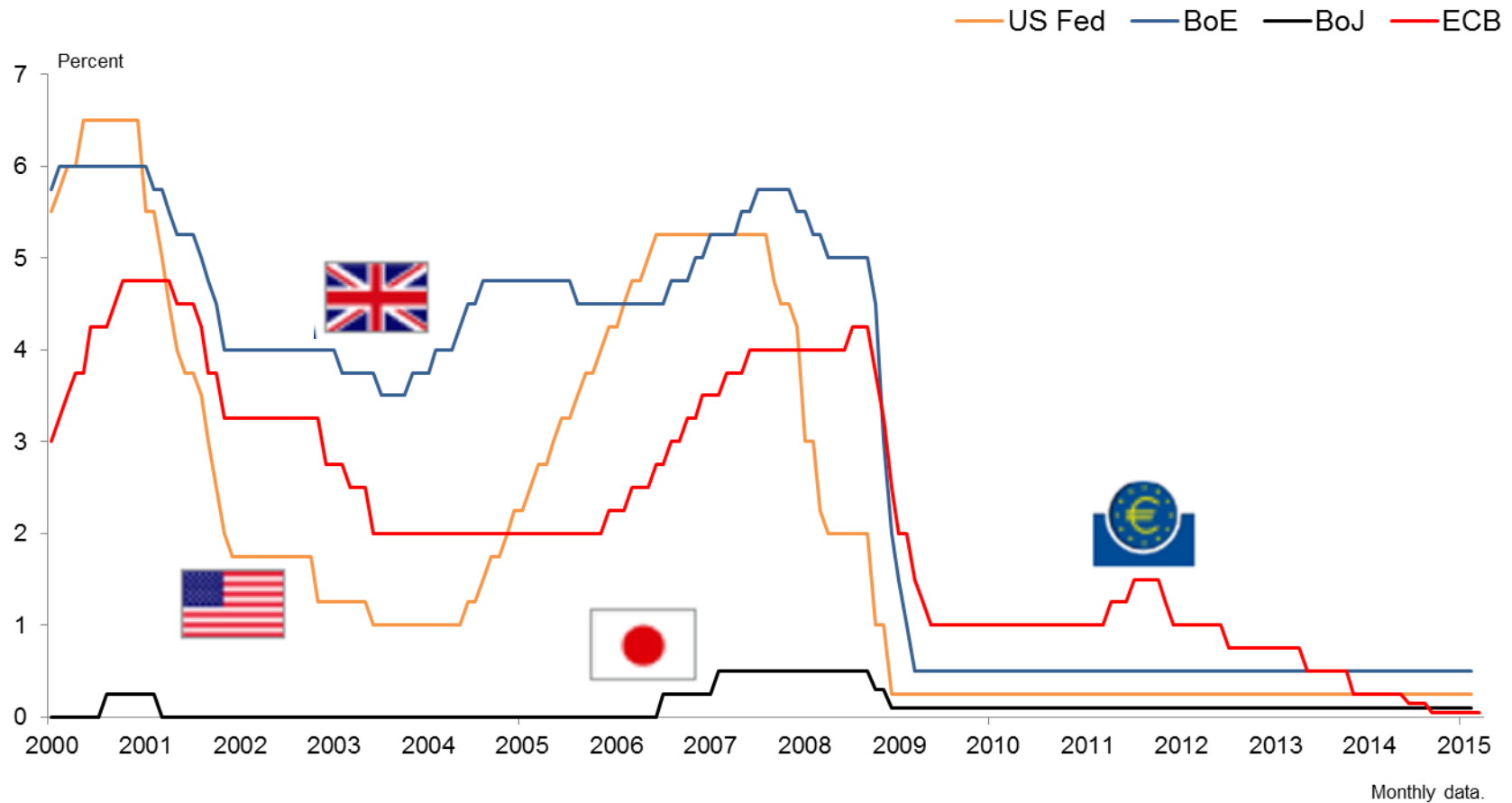
**Government revenues 2014/2015 (change over previous year)**



Source: Greek Ministry of Finance, Monthly data; own calculations.

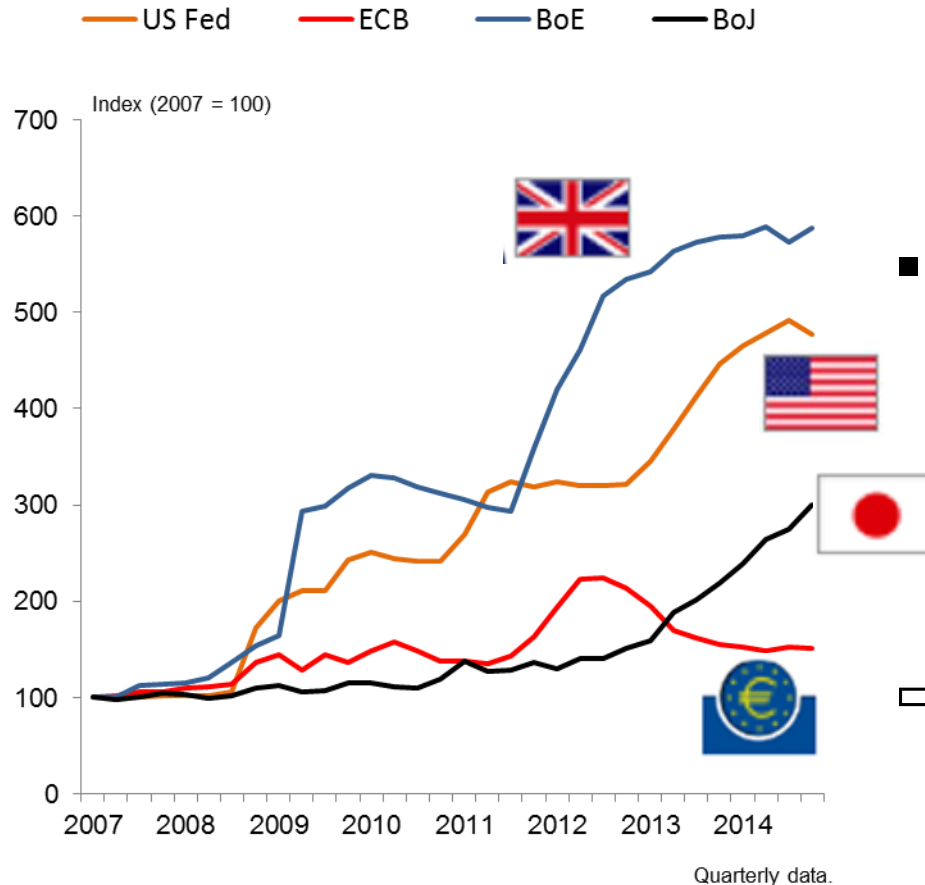
# Monetary policy at the zero lower bound

## Monetary policy rates



# „Quantitative Easing“ at work

## Monetary base



- Type 1:  
Liquidity provision in times of financial turmoil

- Type 2:  
Boosting demand at the zero lower bound

⇒ **Missing exit experience:  
The story is not over yet**

# The role of interest in society

---

## Interest rates ...

- ... just another policy instrument for short-run aggregate demand management?
  
- ... or the price of time preference?
  - » Coordination of saving/investment decisions
  - » Shaping capital stock/production structure  
(= future production portfolio possibilities)
  - » Reflected in all other prices

⇒ **„Capital gives money time to cause trouble.“ (Garrison)**

# The role of central banks

---

- „Buying time“
  - » If interest is the price of time, why does buying more time go along with decreasing interest rates?
  - » Buying time = delaying adjustments (by increasing debt)
- „Heroes of the financial crisis“ (C. Lagarde)
  - » No link between pre-crisis credit expansion and the financial crisis?
  - » Addressing crisis symptoms with instruments that provoked distortions of the capital stocks in the first place (fighting debt with debt)
- „Central banks always manipulate interest rates“
  - » Not necessarily so (policy rates may follow market rates)
  - » Doses matter

Institut  
für Weltwirtschaft



ISW

Institute  
for the World Economy

ISW

