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Give Recovery a Chance

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Independent Annual Growth Survey 2016[1]

Give Recovery a Chance

The ongoing recovery of the EA economy is too slow to achieve a prompt return to full employment. Despite apparent improvement in the labour market, the crisis is still developing under the covers, with the risk of leaving long-lasting "scars", or a "scarification" of the social fabric in the EA. Moreover, the EA is lagging behind other developed economies and regardless of a relatively better performance in terms of public debt and current account, the current low rate of private investment is preparing a future of reduced potential growth and damaged competitiveness. So far, the Juncker Plan has not achieved the promised boost to investment. The internal rebalancing of the EA may fuel deflationary pressure if it is not dealt with through faster wage growth in surplus countries. Failure to use fiscal space where it is available will continue to weigh down on internal demand. Monetary policy may not succeed in the future in avoiding a sharp appreciation of the Euro against our trade partners' currencies. Such an appreciation of the real effective exchange rate of the Euro would lock the EA in a prolonged period of stagnation and low inflation, if not deflation.

A window of opportunity has been opened by monetary policy since 2012. Active demand management aimed at reducing the EA current account combined with internal rebalancing of the EA is needed to avoid a worrying "new normal". Financial fragmentation has to be limited and compensated by a reduction of sovereign spreads inside the Euro area. Active policies against growing inequalities should complement this approach. Public investment and the use of all policy levers to foster a transition toward a zero carbon economy are ways to stimulate demand and respect the golden rules of public finance stability.

[1] This text summarizes the 2016 iAGS. It was produced by a team involving 4 institutes AK Wien (Austria), ECLM (Denmark), IMK (Germany), OFCE (France) and with the financial support of the S&D group of the European Parliament. The authors are Franziska Disselbacher, Georg Feigl, Markus Marterbauer, Christa Schlager, Matthias Schnetzer, Sepp Zuckerstätter (AKw) ; Lars Andersen, Thea Nissen, Signe Dahl (ECLM) ; Peter Hohlfeld, Thomas Theobald, Andrew Watt (IMK) ; Guillaume Allègre, Christophe Blot, Jérôme Creel, Bruno Ducoudré, Raul Sampognaro, Aurélien Saussay, Sébastien Villemot (OFCE) ; coordination by Xavier Timbeau (OFCE).

It looks like the EMU is on the way to recovery. However, the Great Recession is not over and a strong and steady recovery is essential to limit and repair the damages that a prolonged period of unemployment has produced. The moment is also critical to avoid the persistence of low inflation or deflation, also known as secular stagnation. Even with a clearing of the labour market, such a trap would entail sustained downward pressure on wages, part-time jobs especially for households' secondary source of income (often women), underuse of qualification and skills, low wages and a growing number of discouraged job seekers and working poor. It would mimic full employment through a low rate of unemployment, but it would be a social disaster. It is imperative to avoid that prospect.

The word recovery is misleading. It mostly means the end of acute recession but does not guarantee that the Euro area economy, and hence the world economy, are back to "normal". The increase of EA current account surplus and falling expectations of inflation in the US or the EA (see figure 5. below) shows that a persistent liquidity trap is still likely. Monetary policies in developed countries can end up in a currency war and contribute to a global stagnation. More positive signs should not be taken as proof of an exit from the 2008 crisis, and, once again, Mario Draghi's warning that monetary policy alone is not enough should be considered with utmost attention. As we have argued in the 2015 iAGS, fiscal discipline in the EA is without any doubt a necessary condition for an expansive monetary policy and a rebuild of confidence. But failing to stimulate demand will come at a high cost. There are plenty of opportunities in the transition to the zero carbon economy to provide a stimulus. This can be done while achieving public finance stability by applying a golden rule where new debt is matched by the creation of physical assets with positive (social) value. Current tools, such as the Juncker Plan, are not sufficient to decisively engage in such a transition and to avoid the possibility of stagnation. As we proposed in chapter 4 of 2015 iAGS, privatizing the social returns of the transition to a zero carbon economy with a carbon price is part of the solution, but requires compensation for (temporary) losers.

A too-slow recovery

The current recovery reflects a process of closing output gaps and increasing investment from very low historical levels. As we have analysed at length in previous iAGS reports, the diminution of recessive forces explains a large part of the return to growth. Table 2 summarizes the combined effect of the sovereign debt crisis, massive fiscal consolidation and some selected external factors on growth for the EA. In 2015, and probably in the coming years, expansive monetary policy, depreciation of the effective exchange rate of the Euro, and a pause in fiscal consolidation will contribute strongly to the recovery. Favourable and probably temporary factors like the fall in oil prices strengthen the recovery but the recent slowdown in emerging economies, which is partly correlated to the evolution of raw materials prices, raises some concerns. Financial events and their associated wealth effects, along with the postponing of already delayed investment projects could also put these positive prospects at risk – not to mention geopolitical tensions, which may reallocate investment projects.

Table 1: Summary of iAGS 2016 forecasts

	GDP growth in volume (%/y)			2015 revision (difference from March 2015 forecast)	2016 revision (difference from March 2015 forecast)
	2015	2016	2017		
Germany	1.8	2.0	1.8	+0.4	-0.3
France	1.1	1.8	2.0	0.0	+0.1
Italy	0.8	1.6	1.2	+0.3	+0.9
Spain	3.2	3.4	3.0	+1.1	+1.1
Netherlands	2.0	1.7	1.8	+0.6	-0.2
Belgium	1.3	1.5	1.4	+0.1	+0.1
Finland	0.3	1.0	1.5	-1.0	-0.2
Austria	0.8	1.4	1.7	-0.5	-0.2
Portugal	1.6	1.8	1.8	+0.2	-0.2
Greece	0.1	-0.1	1.8	-1.8	-2.0
Ireland	6.4	3.7	3.6	3.6	+1.1
Euro zone	**1.6**	**2.0**	**1.9**	+0.3	+0.4
United Kingdom	2.5	2.0	1.8	+0.4	+0.2
Sweden	2.7	2.9	2.7		
Denmark	1.8	2.0	2.0		
EU-15	**1.7**	**2.0**	**1.9**		
13 new MS	2.8	3.2	3.2		
EU-28	**1.8**	**2.1**	**2.0**	+0.3	+0.4

Sources: IMF; OECD; national accounts; iAGS 2016 calculations and forecasts, november 2015.

We forecast an annual growth rate for the Euro area of 1.6% year on year (yoy) in 2015, 2.0% yoy in 2016 and 1.9% yoy in 2017 (table 1). That is a confirmation of the positive signs observed in 2014 and implies that the decrease in unemployment would continue. Some countries are near full employment (Germany), while Spain experiences a rapid decrease in unemployment (2 points/y) albeit from a very

high level (23% in 2015). The unemployment rate in France and Italy stabilizes and then decreases slowly.

Table 2: Breakdown of short term forecast

	2010	2011	2012	2013	2014	2015	2016	2017
GDP	2.0	1.7	-0.8	-0.2	0.9	1.6	2.0	1.9
effect of … on GDP								
Oil price deviation from 100$/b	0.0	-0.3	-0.2	0.0	0.1	0.5	0.3	0.2
Price competitiveness	0.3	0.4	0.5	0.1	-0.2	0.3	0.4	0.2
Financial conditions	0.0	-0.1	-0.9	-0.3	0.0	0.1	0.0	-0.2
Fiscal policy	-0.2	-1.3	-2.4	-1.3	-0.6	-0.2	-0.2	-0.3
2014 Emerging countries slowdown	0.0	0.0	0.0	0.0	-0.2	-0.4	-0.2	-0.2
Carry on (quarterly profile)	0.1	0.4	-0.2	-0.4	-0.3	-0.5	-0.3	0.3
Other					-0.1	0.0	0.1	0.0
Sum of above effects	0.2	-1.0	-3.1	-1.8	-1.1	-0.1	0.1	0.0
Growth in the absence of effects	2.1	3.2	2.8	2.1	1.6	1.7	1.9	1.9
Potential growth	0.9	0.9	0.8	0.8	0.9	0.9	0.9	1.1
Output gap	-2.0	-0.8	-2.0	-2.9	-2.9	-2.2	-1.1	-0.3

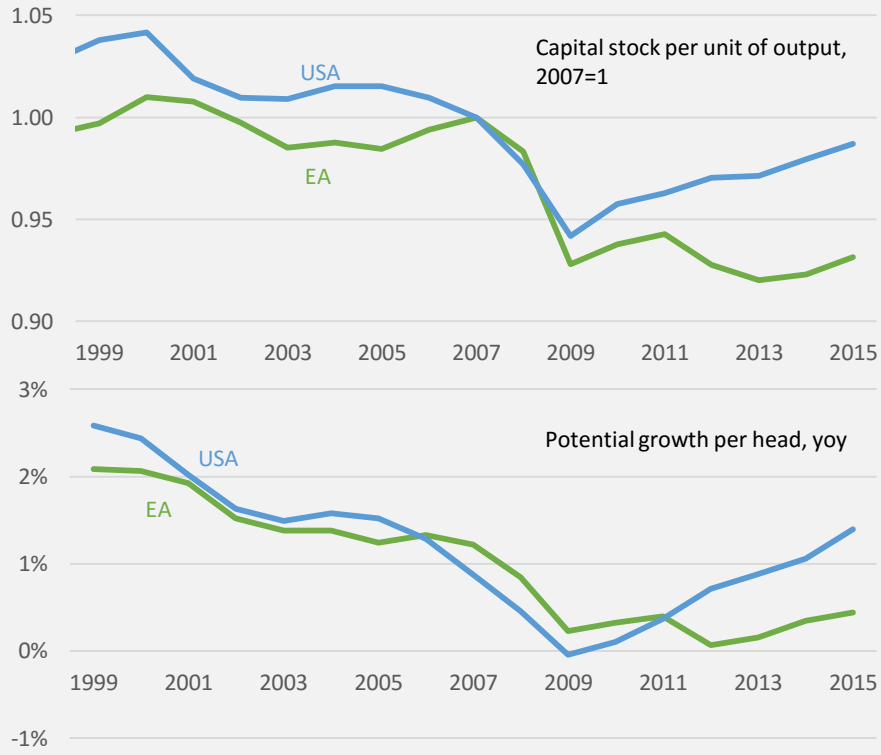
Sources: iAGS 2016 calculations and forecasts, november 2015.

Nevertheless, the recovery remains worryingly weak. The speed at which unemployment has been reducing is far too low. At the current pace of reduction, the 2007 pre-crisis rate of unemployment would not be reached again before 2022. Compared to the US or UK recovery or even to the 2011 phase of growth, output gaps are closing at a slow pace. Moreover, the closing gaps are hiding an untold fact. The measured gap is between actual output and potential output. Potential output is a non-observable concept, built upon estimates (see box 1). Recent evaluation of potential output for EA (by ECFIN or OECD) have been revised downward, meaning that the closing of the gaps is being done from the bottom (increase in actual output) and from the top (decrease in potential output). This is not the case for the US, or at least not to the same extent. Revising downward potential output is a way to acknowledge the long term impact of the financial crisis. Historical analyses from the IMF have shown that usually a financial crisis reduces potential and trend growth in the aftermath of the crisis. However, this analysis is not able to provide a quantified link between a sound measure of the intensity of a financial crisis and its impact on growth. So it may justify a reduction in prospects for potential growth without asserting it quantitatively.

Box 1: production function method and potential output

The production function method, as defined by the European Commission in the economic paper #535, November 2014, uses information about production factors to estimate potential output. This method relies on information about factor usage, namely unemployment rate or unemployment gap and capacity utilization rates. However, an assumption is made about the stock

of capital, supposed to be a good measure of the factor availability and to be at its equilibrium level. This assumption carries 2 errors which, in most situations, cancel each other out. On the one side, as capital stock is based on past investment through the inventory calculation, it is inert and not very sensitive to a slump in investment, when this slump is not too prolonged (as compared to the depreciation rate). Considering capital stock as close to optimal level is thus mainly considering that the optimal level of capital stock has not changed over the recent past. When a recession occurs, this assumption leads to a backward looking measurement of potential growth. The second error is that the measurement of capital is wrong in recession. The capital stock estimate is built using a constant physical depreciation rate and accumulating investment. In a severe recession, however, it is likely that depreciation is not simply physical but is also grounded by economic consideration. Moreover, when overinvestment precedes the recession, it is also likely that some of the capital stock will turn out to be unsuited to future needs as stated by relative prices. Hence, some of the capital stock is going to be unprofitable and will be depreciated for that reason and because of physical wear. As a consequence, in a recession, the inventory method of estimation of the capital stock will overestimate the capital stock. Considering the capital stock as optimal and overestimating it usually yields a conservative and inert estimation of potential output. This implies that the potential rate of growth is not influenced by the outcome of the recession as long as it is a mild one. In a severe and prolonged recession, after a few years, lower levels of investment will reduce productive capital stock estimates and will push forward the conclusion that the loss in capital stock is indicating a harsher reduction in potential output. Fiscal rules, relying on potential output estimates, will close the game by imposing a reduction of demand as an adjustment to a lower prospect for future output. The graph below illustrates that phenomenon, by displaying output per unit of productive capital and potential growth for the Euro area and US economies, according to ECFIN evaluation (AMECO database, November 2015).

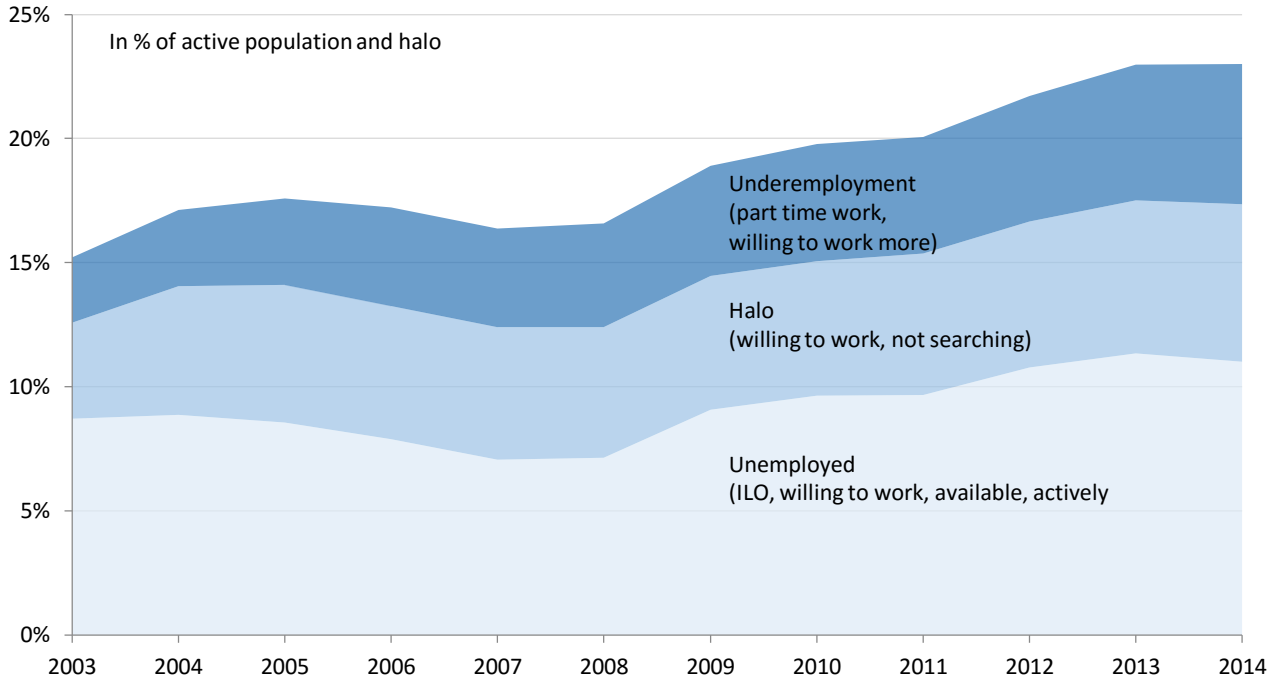


However, the main reason for the difference in revisions between US and EA prospects for potential growth is the consequence of lower productive investment during the crisis in the Euro area than in

the US, due to the sovereign debt crisis in the EA. Following the production function method, potential output is estimated based on an evaluation of the stock of productive capital. A smaller investment rate leads to reduced capital accumulation and hence to a lower estimate of potential output. In the future, a rebound in investment will reconstitute capital stock and one can expect potential output to be revised upward. But, by considering that potential output is lower, current fiscal rules force adjustment of public spending accordingly, fueling a procyclical fiscal policy in the short span of a few years, adding a medium term bias to the existing short term one.

As a complement to poor medium-run prospects for growth, we argue in chapter 2 of the 2016 iAGS that a process of "scarification" of the labour market is under way. The slow reduction in unemployment is going on, indeed. But long term underemployment (as well as very long term unemployment) is increasing. Labour market halo (people willing to work but not actively searching and thus not counted as unemployed in the ILO sense) and labour underutilization (people working part time and willing to work more) are increasing in the EA (figure 1.). Overall, labour underutilization (summing up halo and underemployment) is increasing despite what looks like an improvement of the labour market. This process suggests that dual labour markets have developed, where the frontier between inside and outside is not the existence of a work contract but rather qualification or age, and that they are growing apart everywhere in the EA. It also implies that the gender gap, especially in the dimension of involuntary part time work, is also increasing. The slow drift of unemployment, on the ILO definition, into a fuzzier phenomenon means also that it is less visible and less reachable by public policies.

Figure 1. Unemployment, underemployment and halo in the EA



Source: LFS, Eurostat, 2016 iAGS calculations.

The result is more Europeans suffering from severe material deprivation. In the countries that experience the biggest increases in severe material deprivation, the rate among children tends to be even higher, indicating that they are hit harder than any other age groups. One out of 6 children growing up with a single parent in the Eurozone lives in a household with severe material deprivation. The share of single parents experiencing severe material deprivation is twice as large as in households with dependent children in general. Lack of opportunities during childhood is likely to have long-term consequences for the individuals concerned as well as for society as a whole.

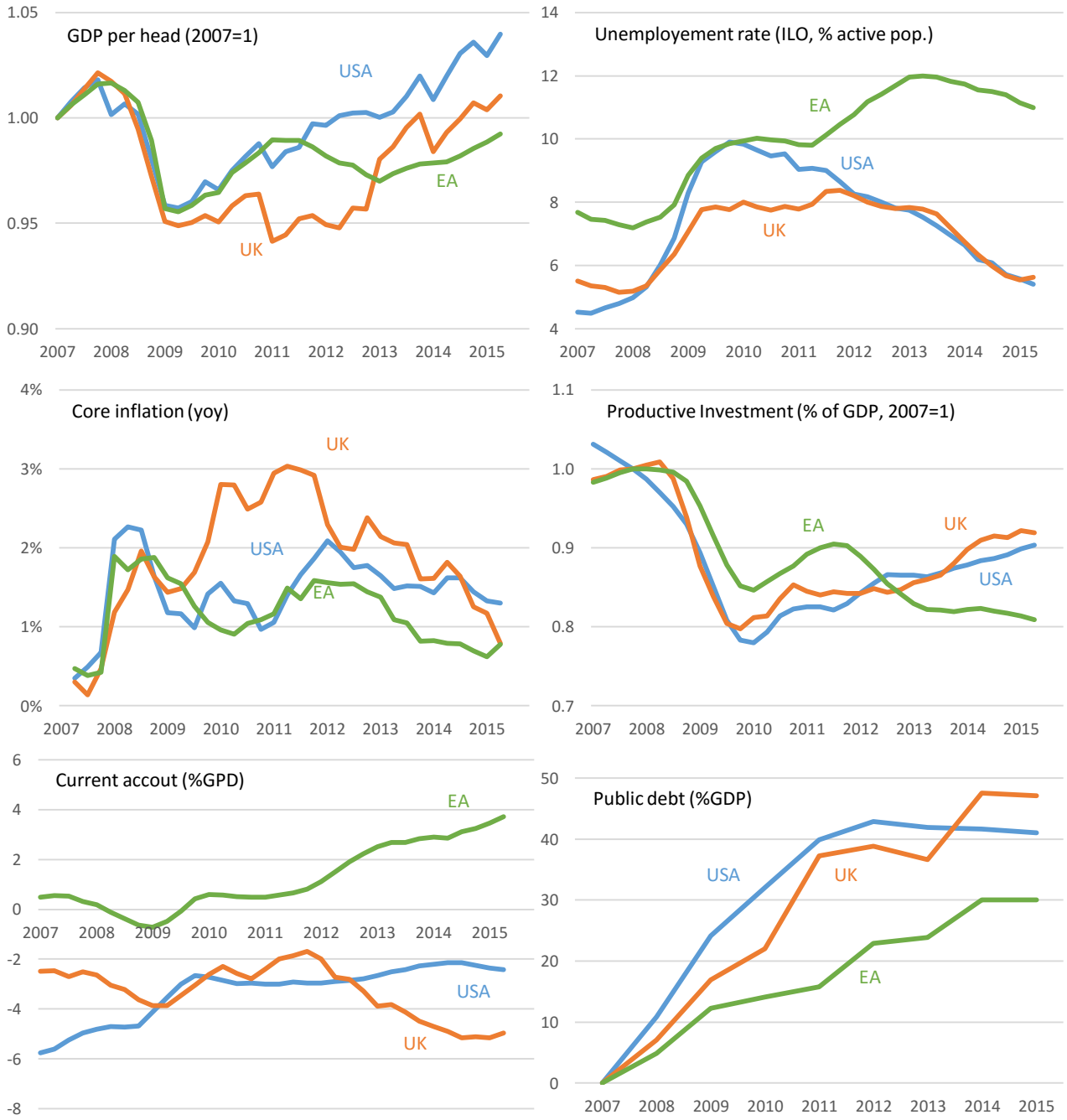
Euro area is lagging behind

The 2008 crisis originated in the melt down of the financial and banking system in the US, following the subprime crisis. The close interconnection of banks and financial institutions between developed countries made the financial shock a common one. But the Euro area experienced a second dip in 2011 due to the sovereign debt crisis. The possibility of a default of some states in the Euro area, facing potential shutdown of their access to financial markets without alternative financing through their central bank and limited capital flow, led, in crisis countries, to a combined increase of sovereign and private sector interest rates due to bank exposure and financial fragmentation of the Euro area, and a strong fiscal consolidation in response to pressures on public debt financing. As previously analysed in

the 2013 iAGS and following reports, fiscal multipliers were high in crisis countries as a consequence of high unemployment, banks being under stress and carrying damaged balance sheets and fears of deflation (threatening to hit the zero lower bound or ZLB). Fiscal consolidation in times of high fiscal multipliers is self-defeating and contributed to the Euro area crisis. The sovereign debt crisis was (temporarily) solved with the stepping in of the European Central Bank (ECB), first in 2012 (the famous "whatever it takes") and in early 2015 with quantitative easing.

Comparing EA aggregate indicators to those of the US or UK helps to measure how costly the sovereign debt crisis was (figure 2.). GDP per head is still below its 2007 level whereas the US economy has undergone a significant recovery. This is even more striking given that the initial impact of the crisis was roughly equivalent in 2008-2009 and that, starting in late 2009, the first phase of recovery was as quick for the EA as it has been for the US economy. It is often argued that without structural reforms, growth cannot be experienced in most EA countries. This short episode of recovery is a clear refutation of that hypothesis. More important than GDP per head, unemployment has risen in two steps and has reached a high level. Since 2014, unemployment has started to decrease, but at a slow pace. As will be detailed later on, enduring a high level of unemployment, even a decreasing one, has certain consequences.

Figure 2. EA vs USA vs UK



6 graphs that show that the Euro area has performed worse than US or UK, except for current account and public debt. OECD eo98 (national accounts), iAGS 2016 calculations.

First, it puts downward pressure on wages and price level, fuelling a "lowflation" and risking deflation. This is displayed on the core inflation graph, where the EA clearly underperforms the US economy. Second, because unemployment insurance schemes in the Euro area are limited in time, unemployment is slowly transforming into other forms of labour slack. Even more worrying, productive investment is now well under the level of 2007 while It has sharply bounced back in the US and UK. Less accumulation of productive capital will diminish the potential for future jobs and output and

could damage the competitivenessof the EA. This is the core of the medium term procyclicality of the potential production estimate that, combined with current fiscal rules, will lead to a long lasting fiscal consolidation.

The current account and public debt graphs display more positive information, at least compared to the USA or UK. The public debt increase has been significantly lower in the Euro area than in the USA or UK. Current account and public debt performance both convey the information that the Euro area has been saving more than the USA or the UK over the crisis. This is a perfect illustration of Keynes' paradox of thrift, where excess savings in a period of duress extends the crisis.

Looking forward: debt dynamic and internal rebalancing of the Euro area

After a huge effort toward consolidation which cost the Euro area a double dip, there is now a pause in the contractionary fiscal policy. As shown on figure 3. aggregate public debt in the Euro area is stabilized and will decrease in the following years under the hypotheses that present structural public deficits remain unchanged, sovereign interest rates normalize, inflation expectations remain anchored to the ECB target, financial fragmentation has no impact on private sector financing and potential growth in the medium term is as forecast by the 2015 ageing report central scenario (Table 3). The results of such simulations are sensitive to a large number of hypotheses as we have argued in previous reports and as is documented in chapter 3 of the 2016 iAGS. Numbers should be considered with care, but they indicate trends and allow for "what if" scenarios. Under those assumptions, EA aggregate public debt would decrease to 65% GDP in 2035 but country specific evolutions are diverse. Some countries (Germany, Ireland, Portugal[2]) are overshooting the 60% ratio, suggesting that they have some fiscal space, whereas others (France, Italy, Spain, Belgium) do need further fiscal consolidation to bring their debt to GDP ratio back to 60%. One might question the necessity to reduce debt back to 60% and, given that the no bail out rule prevails, accept different ratios of debt to GDP as long as debt is stabilized. This question is quite important as aiming for a 60% ratio of public debt will come at a cost in terms of output, unemployment and welfare. The impact of a higher but stable public debt to GDP ratio is unclear and bringing it down uniformly is justified only if one wants to protect from future crises and unwanted increases in public debt.

[2] Portugal has currently a positive structural surplus for public finances. That comes from a huge fiscal consolidation and a largely negative gap. The ability of Portugal to overshoot the debt to ratio threshold depends on whether there is no reverse in fiscal policy (fiscal policy acceptance) and that Portugal is able to recover from the current recession (output gap will close in the near future). Failing to meet one or two of these conditions would prevent Portugal to reach 60% GDP debt to GDP ratio.

As pointed to by the Macroeconomic Imbalances Procedure (MIP), the current competitiveness situation is unbalanced. Only pre-crisis external deficit countries have achieved adjustment, while external surplus countries have even increased their current account surpluses. To restore internal balance, nominal adjustment in surplus countries has to be a priority for economic policy in the EA. Significant fiscal stimulus or wage increases would help delivering the necessary additional import demand to reduce those imbalances and would create additional demand with positive spillover effects on growth and employment for deficit countries.

Table 3: projection of public debt

	Public debt (%GDP)		Structural balance (%GDP)		GDP growth rate (% yoy)		Inflation rate (% yoy)	
	2020	2035	2020	2035	2016-20	2021-35	2016-20	2021-2035
Germany	57	24	0,8	1,4	1,3	1,0	1,8	2,0
France	95	97	-2,7	-3,6	1,9	1,4	1,2	2,0
Italy	123	80	0,3	1,1	1,2	0,2	0,7	2,0
Spain	96	89	-2,3	-2,7	2,3	1,4	1,1	2,0
Netherlands	67	62	-1,4	-1,9	1,7	1,3	1,2	2,0
Belgium	102	87	-2,0	-2,1	1,8	1,5	0,9	2,0
Portugal	110	49	0,9	2,5	1,9	1,0	0,9	2,0
Ireland	76	21	0,9	2,6	2,6	1,8	1,8	2,1
Finland	65	74	-2,4	-3,3	2,1	1,6	1,3	2,0
Austria	83	69	-1,3	-1,5	1,6	1,4	1,2	2,0
Euro area	87	65	-0,8	-0,8	1,7	1,1	1,3	2,0

Source: AMECO (nov. 2015) for historical data. iAGS model simulation, forecasts and hypothesis, November 2015. Structural deficits in 2020 can be different from 2015 data because of change in potential growth endogeneous to the model and variation in sovereign rates.

However, if the painful and counter-productive process of one-sided adjustment of Germany (implicitly acting as the reference country) continues, a large adjustment is still needed (see Table 4). In order to realize this kind of adjustment, we suppose that wage moderation is going to occur during the next 20 years. For instance, France would need a 1%/y (21% over 20y) wage moderation relative to Germany. Inflation in France would be lower by 1% which would thus entail a stricter fiscal stance in order to correct for negative impacts of inflation on debt dynamic (as the nominal sovereign interest rates depend on EA inflation, nominal sovereign rate minus nominal growth would be higher in France than in the reference scenario). If all EA countries engage in wage moderation according to the last column of table 4, then relative inflation will be lower in those countries. That adjustment is possible with Germany keeping its rate of inflation as close as possible to 2% (asymmetric adjustment) or by accepting higher inflation in Germany, through wage policies for instance (symmetric adjustment). Tighter fiscal stance due to lower inflation in adjusting countries has an impact on all countries, as

displayed in table 5, due to spillovers from trade integration, inflation and competitiveness and fiscal rules.

Financial fragmentation, as developed in chapter 3 of the 2016 iAGS adds to the risks of deflation. Because of the linking of private sector rates to sovereign rates inside each country, the increase of real sovereign rates is matched by an increase of real private sector rates.

Table 4: Nominal adjustment for value added prices (relative to Germany)

	2008	2009	2010	2011	2012	2013	2014
Germany	0	0	0	0	0	0	0
France	-21	-18	-18	-21	-22	-17	-21
Italy	-35	-29	-40	-38	-22	-13	-10
Spain	-63	-40	-37	-35	-25	-16	-20
Netherlands	-5	6	6	4	5	7	1
Belgium	-40	-36	-17	-37	-27	-25	-27
Portugal	-116	-106	-90	-56	-37	-18	-24
Ireland	-31	-34	-29	-31	-33	-22	-16
Finland	5	-1	-8	-34	-37	-33	-28
Austria	18	15	12	1	3	6	1

Source: 2016 iAGS calculations, historical data from AMECO november 2015. Germany is taken as a reference in order to compare adjustment through time. It does not presume the way the relative internal adjustment must be made.

Table 5: Loss/gain of relative nominal adjustment on EA countries

	Using fiscal space in all countries		Not using fiscal space in all countries	
	No Euro appreciation	Euro appreciation	No Euro appreciation	Euro appreciation
Germany	0.1	0.0	0.0	-0.2
France	-0.3	-0.4	-1.0	-1.2
Italy	0.1	-0.3	-0.1	-0.8
Spain	-0.1	-0.1	-0.1	-0.1
Netherlands	0.1	0.1	0.2	0.1
Belgium	-0.1	0.0	0.1	0.3
Portugal	-0.1	0.0	-0.1	0.0
Ireland	0.0	0.0	0.0	-0.1
Greece	0.0	0.0	0.5	0.4
Finland	-0.3	-0.2	0.0	0.1
Austria	0.2	0.2	0.3	0.2
Euro area	0.0	-0.1	-0.2	-0.4

The Impact is defined as the average loss of output, or equivalently of the increase in unemployment, over the period 2016-2035, each year. Source: iAGS calculations, historical data from AMECO November 2015. Euro appreciation in scenario without using fiscal space is higher (25% REER) than in scenario using fiscal space (10% REER) because of a lower EA current account in that scenario. See chapter 3 of 2016 iAGS for discussion.

Box 2: aggregate fiscal stance

Using the aggregate fiscal stance as a tool to conduct macroeconomic policy is appealing. A common currency implies many externalities between countries which justifies caring about aggregate variables. The first (and the most commented) externality is through trade, increasing when integration of economies is higher. Public debt is another one, as countries contribute to the global market equilibrium, determining jointly the aggregate supply of public debt, which results in the equilibrium sovereign rate in the Euro Area. The current account is another one, as we argue, especially when the zone is near or in a global liquidity trap. Using aggregate fiscal stance as a target for the EA and then breaking down a compatible fiscal stance for each country would be a progress for policymaking in the European semester.

We propose here two ways to calculate the aggregate fiscal stance. The first one is a weighted sum of the variation of structural balance. These figures assess to a certain extent the evolution of deficits in the long run, once the cyclical effects are purged. This figure depends crucially on the way structural deficits are calculated and hence on the assumptions about the potential output used in this calculation. Even under common budgetary assumptions, the evolution of structural balance can evolve in very different ways (see lines 2 and 3 of the table below). As we have argued (box 1), it is better to use a medium term potential instead of a shorter term potential. Current calculations by ECFIN seem to use a short term potential and we propose a somewhat different view in the following table.

Aggregate Fiscal Stance	2014	2015	2016	2017
iAGS	0.1	-0.1	-0.1	0.2
ECFIN, Autumn Forecast	0.3	-0.1	-0.1	-0.1
ECFIN, based on OECD's output gap	0.4	0.0	-0.1	-0.1

Note: The 2017 change of structural balance is computed on a no-policy change scenario by ECFIN, and the iAGS scenario takes into account commitments of Member States in their last Stability Programmes. Source: Ameco, OECD, Draft Budgetary Plans and Stability Programmes.

On the basis of this indicator, the aggregate fiscal stance in the Euro Area is neutral or slightly expansionary in 2015 and 2016. However, if the Member States implement the fiscal policy announced in their Stability Programme, fiscal consolidation will start again in 2017.

If the change of the structural balance shows that the fiscal policy is neutral in the whole Euro Area, the assessment of its economic impact needs to be completed. According to several authors[3] the multipliers of public expenses –which are decreasing in most of the bigger Euro Area economies– are higher than those associated with tax changes –which are decreasing and should have an expansionary impact. This is particularly true when output gaps are negative. When the composition and the localisation of the fiscal impulses are taken into account, the assessment of the aggregate fiscal stance needs to be modified for 2015 and 2016.

Hence, the second indicator of the aggregate fiscal stance proposed is based on a weight that takes into account the macroeconomic impact of fiscal policy[4]. As widely discussed, the effects of fiscal multipliers vary over the cycle and according to the composition of the fiscal policy. Time profile of impacts may also produce "apparent" fiscal multipliers far different from commonly used values for fiscal multipliers. The following table provides estimates of aggregate fiscal stance based on impact.

[3] Since the start of the Great Recession there is a growing literature on this topic. See C. Blot, M. Cochard, J. Creel, B. Ducoudré, D. Schweisguth and X. Timbeau (2014) for a survey, S. Gechert (2015) for a meta-regression analysis, Auerbach and Gorodnichenko (2012) or Blanchard. And Leigh (2013) for some examples.

[4] In the US, the Brookings Institute publishes a fiscal barometer built by the Hutchins Center on Fiscal & Monetary Policy (http://www.brookings.edu/research/interactives/2014/fiscal-barometer) very close to our proposal.

Impact of fiscal policy on EA GDP (points GDP)	2014	2015	2016	2017
iAGS	0.0	0.1	-0.1	-0.2
ECFIN, Autumn Forecast	-0.1	0.2	0.0	0.1
ECFIN, based on OECD's output gap	-0.3	0.0	-0.1	0.1

Source: Ameco (Autumn Forecast 2015) and OECD (eo97).

When the composition and the localisation of the fiscal impulses are taken into account, the assessment of the aggregate fiscal stance is radically modified. Fiscal policy will be slightly contractionary in 2016 (-0.1 point of GDP) in spite of the decrease in the aggregate structural balance. This paradox can be explained by the localisation of the impulsion, which has low impact in Germany (increase of 0.1 point of the German GDP associated with a fiscal impulsion of 0.4 point) and the composition of the expansion in Italy (tax cuts for 0.7 point of GDP with a multiplier of 0.6 and an effort in expenses of 0.2 points of GDP with a multiplier of 1.5) and in Spain (effort in expenses of 0.2 point of GDP and tax cuts for 0.2 point of GDP: while the fiscal stance looks neutral, the impact on GDP is negative).

The apparent paradox of a fiscal loosening with recessionary effects raises the matter of the fiscal space – expansionary policies should be larger in unconstrained countries– and the flexibilities in the application of SGP –expansion should be done in countries with high multipliers. Analysing the situation of each Member State vis-à-vis the SGP, it appears that very few countries have fiscal space with respect to the rules of European budgetary governance. Only Germany would have some fiscal space but the efficiency of a German based stimulus would be limited, at least from a GDP point of view. This raises the question of the creation of a common fiscal capacity that would enable implementation of a counter-cyclical budgetary policy, especially when there is no scope for monetary policy like a situation of liquidity trap and deflation.

Taking into account the very high levels of unemployment and underemployment in figure 1., even the highest value of the fiscal impulse (+0.1% GDP) is far too low to deliver significant fiscal stimulus. A coordinated increase of public investment with a focus on the Europe 2020 targets would be a proper policy change for a more balanced economic policy. With the implementation of the golden rule of public investment, such a stimulus could be achieved in line with the European fiscal rules. A. Truger (2015) made a concrete proposal on how to design and implement the golden rule for public investment in Europe.

Box 3: Economic implications of the refugee surge

In the summer of 2015 Europe was suddenly and unexpectedly confronted with a dramatic increase in the number of refugees seeking sanctuary and asylum. The “refugee crisis”, as it is often portrayed, raises primarily humanitarian, political and ethical issues, both for individual Member States and for the European Union as a whole. Against this background, the sharp rise in refugee inflows also raises questions about the likely economic, fiscal and labour market effects. There is still uncertainty about the size of current inflows or their likely distribution across Member States.

Most refugees arrived via the Mediterranean/Aegean Sea in Greece and Italy, many subsequently heading for core EU countries overland via Hungary or countries of the former Yugoslavia. The inflow rose steadily to over 60,000 by the end of 2014 from 20,000 since 2012. The number of asylum registrations shot up dramatically, reaching over 130,000 in August 2015. Figures for Germany are available until October, with almost 55,000 registrations in that country alone. Hungary, Sweden and Austria, in view of their smaller size, have also been disproportionately affected. These figures substantially understate the true extent of the refugee inflow due to delays in registering the asylum seekers. Of the asylum seekers registered in 2015 more than 70% were male and under 30% female and they are younger than average EU population. At just under 19% the share of the EU population under 18 is considerably lower than among refugees (27%). Moreover, the average age within the working-age population is substantially higher among EU-residents: The asylum-seeker data indicates that more than half of the total intake (55%) are aged between 18 and 34, while a further 18% are aged between 35 and 64. For the EU population the proportions are more or less

reversed: just 21% of the overall population consists of (potential) workers in the younger age category, while 41% are in the 35-64 age bracket. To put it another way, an intake of 1.25 million refugees adds just under a quarter of one percent to the EU overall population, but 0.64% to the younger working-age cohorts and just 0.1% to the 35-64-year age bracket. Moreover, it seems likely that – even if a more effective redistribution and relocation system is established in time – a substantial proportion of the incoming refugees will settle in Germany.

The realisation of positive economic effects of this demographic flow depends on the successful labour market integration of incoming refugees. Combining the large share of younger refugees with uncertainty about their qualifications and known language barriers clearly suggests a need for a substantial investment in providing early and comprehensive language tuition for all refugees, followed by swift integration in school, tertiary education and vocational training programmes and paid employment. Member State policies regarding the asylum process itself will also be decisive for the speed with which refugees enter the domestic labour market. Normally, until refugee status has been formally granted, asylum-seekers are not permitted to take up formal paid employment. This suggests that reducing application processing times is an important way of reducing the time during which refugees are dependent on welfare benefits. In any case educational and other integration procedures should be available as early as feasible, where possible before formal recognition, to promote social and also economic integration.

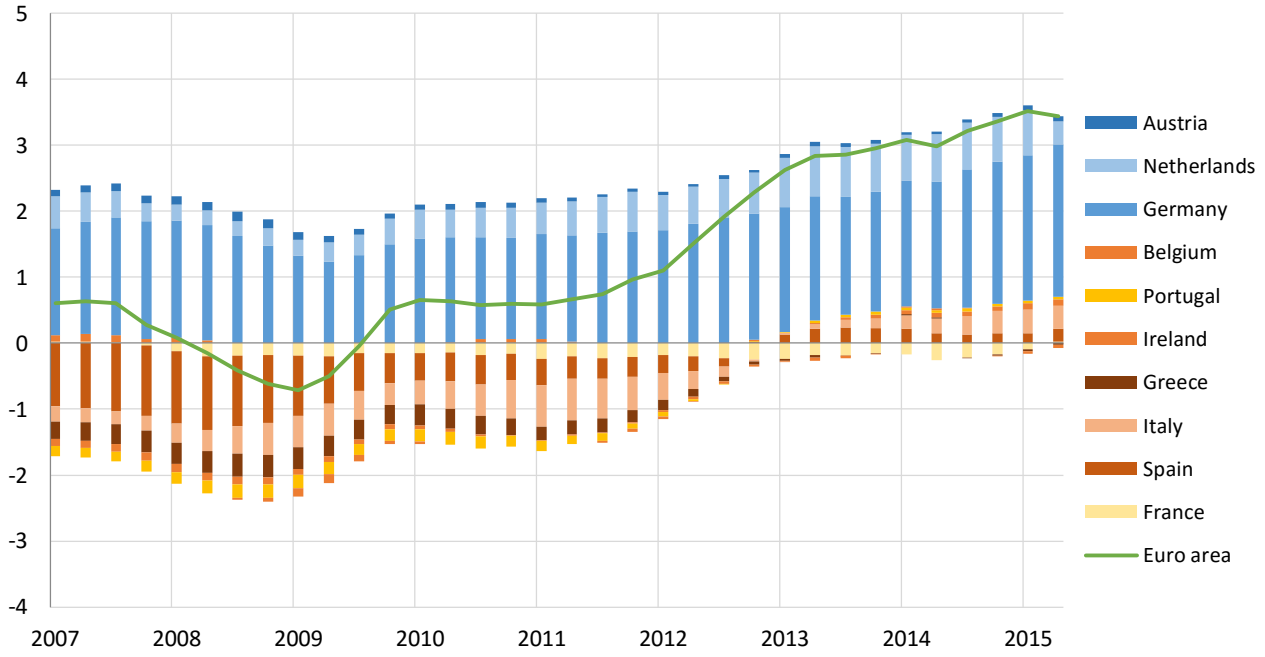
Heightened competition on the labour market from refugees almost certainly implies a potential for income redistribution among the native population from the bottom up. Given that this pressure comes on top of existing trends towards greater social inequality (see Chapter 2 of the 2016 iAGS), policymakers should be conscious of and take appropriate steps to mitigate such effects. Financing educational and language-proficiency programmes (which will intensify competition in the middle and the top, rather than at the bottom of the distribution) out of progressive income taxation would seem appropriate in this context, for instance. A number of commentators have called for the abolition of minimum wages and other labour market liberalisation measures in order to ease the integration of refugees and migrants into the labour market. This will lead to resentment amongst native workers, stoke social tensions, and be grist to the mill of the xenophobes. The right approach to maintaining and expanding employment opportunities is to institute active educational and labour market policies as indicated above and to address the real causes of high unemployment in EU countries.

Arrival and transit countries must shoulder the fiscal costs of ensuring the safe arrival, registration and recognition, initial accommodation, food and healthcare, and onward passage of refugees, while maintaining security. For some of this expenditure compensation is available from EU funds. Estimations of the size of this additional fiscal spending generally point to modest effects. The European Commission in its Autumn Forecast foresees additional spending averaging out at 0.2% in the current year, rising slightly in destination countries the following year. Sweden is forecast by the Commission to experience the largest spending boost, of around 0.5% in 2015. To the extent that fiscal targets are maintained, it is implied that additional spending on refugees will need to be offset by cuts in other budget areas. However, in our view, the multiplier on fiscal expenditures on refugees is likely to be substantially in excess of one. Refugees are "credit-constrained households" par excellence, while the import leakage (especially the extra-European leakage) of spending on support services, housing etc. is likely to be extremely limited. And for as long as there is a significant negative output gap, additional induced spending rounds are to be expected from the higher private-sector incomes generated by the additional government purchases. A short-run boost to European GDP of several decimal points of one percent seems plausible on this basis. "Front-line" states, most prominently Greece, but also countries such as Italy and Spain should benefit from transfers by other EU countries. Funding from the EU's Asylum, Migration and Integration Fund or the European structural funds should be expanded. And demands to exclude the additional spending on refugees, which undoubtedly has a European dimension, when evaluating national budget positions should be given a favourable hearing.

War of currencies and secular stagnation

Most EA countries with current account deficits prior to 2007 are now in surplus. Belgium and Slovakia are the last exceptions in 2015. Current account performance is linked to output gaps that are still negative in some Euro area countries. Our calculations show however that this effect is fading away (it is true mainly for Spain, see chapter 3 of the 2016 iAGS) and that current account performance is close to the structural one, given the current effective exchange rate. It could be considered a result of wage deflation.

Figure 3. Current account in % of EA GDP

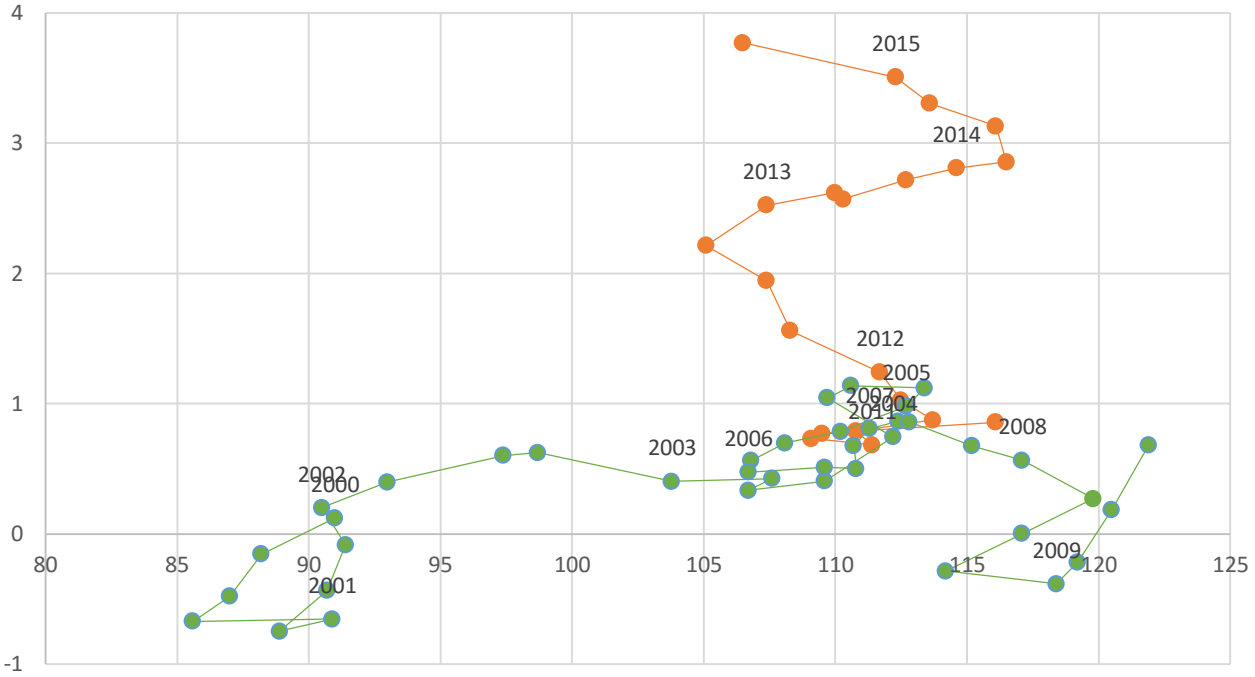


Upward shift of current account is a consequence of lower raw material prices, low internal demand and unconventional monetary policy. Source: national accounts, ECB, iAGS 2016 calculations. Current account is cumulated over 4 quarters.

The growing surplus of current account for the Euro area implies that a strong pressure is building on the appreciation of the Euro against its trading partners' currencies. Since the sovereign debt crisis in 2010 and after 2012 – mostly since 2014 – expansionary and unconventional monetary policies have counterbalanced this effect and have pushed the effective nominal exchange rate downwards (see figure 4.). By postponing appreciation of the effective exchange rate, the increase in the current account (competitiveness effect) has been amplified. Low energy and raw material prices, low demand in the EA, due to both public and private deleveraging, have reduced imports and have also contributed to the increase of the current account of the Euro area. This has led to a record high current account surplus for the Euro area of 3.8% of GDP (more than 400 bn€ for the sum of the last 4 quarters). In 2014, the current account surplus of the EA exceeded the current account deficit of the US economy

and was more than twice the current account surplus of China). To avoid increasing global imbalances, the EA's surplus has to be brought down close to zero by increasing aggregate demand.

Figure 4. EA Nominal Effective Exchange Rate versus EA current account



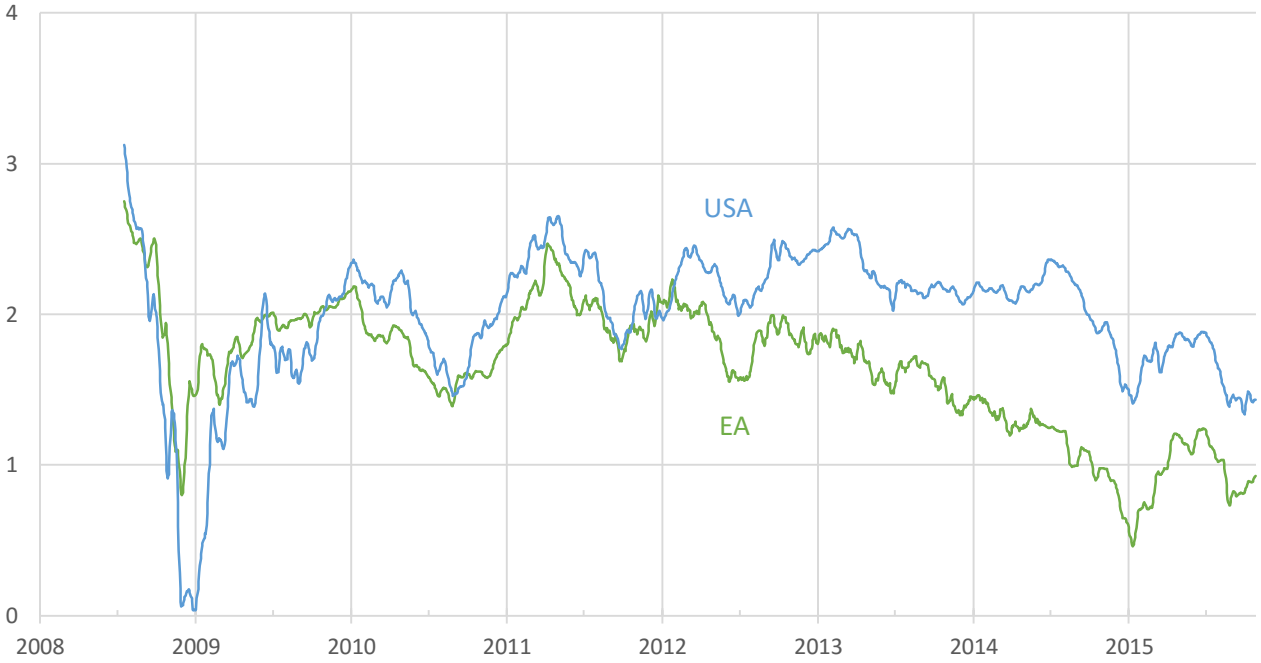
Source: Effective Exchange Rate, broad partners, ECB. EER is 100 in Q1 1999, increase shows appreciation of Euro against trade partners currencies. Current account is for Euro area countries, in % of EA GDP, from national accounts (Eurostat). Real exchange rate of euro brings the same pattern.

Figure 4. suggests a change in regime around 2011, that is to say concomitant with the sovereign debt crisis. In this new regime, record current accounts were made possible without appreciation (nominal or real) of currency and without corrective consequences of appreciation. When Euro area monetary policy will cease to be more unconventional than monetary policy from other countries (mainly the USA), chances are high that a strong appreciation of the Euro will occur. Our estimate is that a 25% appreciation of Euro effective exchange rate would reduce the current account surplus. This will reduce the competitiveness of the Euro and drag down export driven demand, weigh down on inflation, and finally depreciate assets held by European countries that are denominated in currencies other than the Euro[5], triggering a negative wealth effect. In other words, unconventional monetary policy is pushing the Euro downwards allowing the EA to increase its current account position and save the extra revenue, building forces that may reduce demand further and lower inflation in the future.

[5] Because current accounts of most EA countries are now in surplus, it means that large surplus countries are accumulating assets outside the EA, at least on a consolidated basis. There is no accurate way to know the exchange risk borne on those newly accumulated assets, but as the consolidated counterparts are mostly the USA and the UK one can imagine that the exchange risk is on the surplus countries side. That is a neat change from the previous period (2000-2010) when assets accumulated by Eurozone surplus countries were matched by liabilities of deficit countries, and thus, denominated in the same currency, bearing no exchange risk. The risk has proven to be of another nature.

As the EA is currently experiencing low inflation and is close to deflation, such a future adverse shock would then precipitate the advent of long lasting stagnation. In that regard, there are similarities between the EA and the Japanese economy in the 1990's. As explained in a recent paper by Caballero, Fhari and Gourinchas[6], one can export a liquidity trap through currency war and it is possible to win some relief. But it is a zero sum game and it is likely that foreign countries will react by also trying to use the depreciation weapon in their own interest. It could turn into a negative sum game if ongoing depreciations fuel a long lasting stagnation. Figure 5. shows that the fear of low inflation has not disappeared and may be moving, for now, from the Euro area to the USA.

Figure 5. Inflation expectations



Inflation expectations are measured using 5 Years Forward 5 Years Swap. Source: Datastream

Once again the EA is at a crossroad and bears a huge responsibility. As Mario Draghi said in Jackson Hole on August 2014, monetary policy alone cannot lift the EA out of the stagnation trap ahead[7]. External surplus and the induced upward pressure of the effective Euro exchange rate is an additional channel for spillovers among Euro area Member States. The common currency means that EA economies are closely linked through trade. The TSCG adds fiscal rules and thus when facing a common adverse shock in 2011, EA economies engaged altogether in fiscal consolidation, amplifying its impact. Record external surplus will again link EA economies through the consequences of an appreciating

[6] Caballero, R. J., Farhi, E., & Gourinchas, P.-O. (2015). Global Imbalances and Currency Wars at the ZLB. NBER Working Papers, (21670). See also http://www.voxeu.org/article/welcome-zlb-global-economy.

[7] *"it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy", www.kansascityfed.org/~/media/files/publicat/sympos/2014/2014draghi.pdf?la=en.*

Euro. Monetary policy, because of the zero lower bound, will not succeed in stimulating the economy in that situation. For that reason, failing to reduce current account surplus by a strong boost in demand (public or private), will negatively affect all EA countries. For that reason, external surplus is not a matter for a country to decide alone and should, on the contrary, be considered a matter of common interest.

We show in chapter 3 of the 2016 iAGS using simulations from the iAGS model that the current account surplus increases the links between EA economies. It is well known that openness of trade in a fixed currency framework is important (we have used this argument in previous iAGS reports). The scenario of an appreciating Euro due to excessive current account surpluses and normalisation of monetary policy in the EA will depress external demand in all EA countries, regardless of their current account position. Imbalances displaced outside of the Euro area would then reappear inside the EA. The magnitude of this channel (according to our simulations) makes the responsibility of EA countries with high surpluses (e.g. Germany) greater than ever. The impact of those spillover effects is illustrated in table 5, where the nominal adjustment impact of average GDP for the next 20 years is augmented by the impact of the Euro appreciation. Not using the fiscal space available to some countries would imply a negative impact of 0.3% of GDP each year from 2016 to 2035 for the EA as a whole. This spillover would be significant for Italy and France (around 1% GDP each year), but would also affect Germany (0.2% GDP).

Box 4: The Juncker Plan and the role of EIB since the crisis

On 26 November 2014, the European Commission announced an initiative to launch a 315 bn€ investment plan in Europe. This so-called "Juncker Plan" aims at increasing investment volumes in the European Union, which were still 370 bn€ below their historical pre-crisis level in 2014. However, the investment package will not result from increased public investments. Rather, it is to be achieved through highly leveraged investments conducted by the European Investment Bank through a new vehicle, the European Fund for Strategic Investments, with a triple focus: infrastructure, innovation and SMEs.

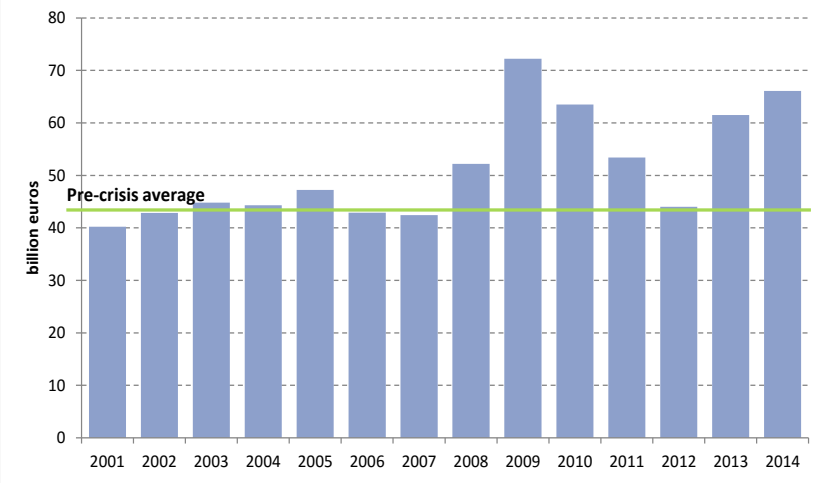
Ultimately the European Union has only mobilized a 16 bn€ guarantee from its budget. Combined with 5 bn€ of EIB's own resources, this provides the EFSI with 21 bn€ in initial funding. The remaining 294 bn€ of the Juncker plan are expected to come from the private sector, through a leverage ratio on EIB's investments greater than 15.

The Juncker plan thus turns out to be yet another round of increase of the EIB capital and leverage, the third one since the 2008 crisis. In 2009, the EIB Board of Governors had approved a 67 bn€ increase in the Bank's subscribed capital[8], followed in 2012 by a decision of the European Council to increase lending activity by 60 billion over the period 2013-2015, with an annual target of 65 to 70 bn€[9]. However, an analysis of EIB's yearly disbursements (figure below) reveals that the 2009 spike was short-lived, with annual lending in 2012 falling back to pre-crisis levels, and that both 2013 and 2014 have fallen slightly short of EIB's stated goals.

[8] EIB press release 2009-057-EN, 3 April 2009.

[9] EIB press release 2013-025-EN, 28 February 2013.

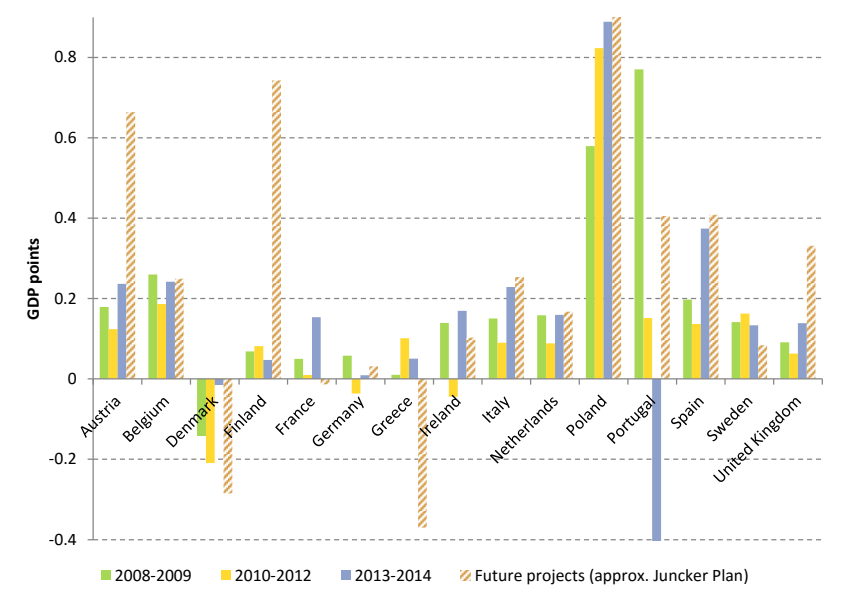
Annual loans disbursed by the EIB (2001-2014, 2014 euros)



Source: EIB data, 2016 iAGS calculations.

Through these successive increases in lending activity, the EIB has been recast as the European Union's main tool of contra-cyclical economic intervention. Yet, the breakdown by country of the increase in activity since 2009 shows it has not necessarily been targeted towards countries which needed the most assistance (figure below). In particular, relative to GDP, Spain received less of an increase in EIB investments than Sweden between 2010 and 2012; Portugal has received much less since 2013 even though its output gap still stands at -5.8% (eo98); Italy has benefited less than Austria since 2009 while its output gap over the period was more than twice as large, and Greece has received less of a boost from EIB since 2009 than the United Kingdom. Since the crisis, the country which has benefitted the most from EIB's increased activity is Poland, even though it has also been one of the most consistently performing economies throughout the period.

Increases in EIB lending activity from pre-crisis baseline (in GDP points)



Source: EIB data, 2016 iAGS calculations

The increase over baseline lending for future projects in the EIB financing pipeline can be used as a proxy for the investment increment attributable to the Juncker Plan. It should be noted that as of November 2015, only 9 projects had been formally launched under the Juncker Plan label – some of these future projects may therefore not be linked to the Plan. Yet, even if we attribute the entire

differential over baseline to the Plan, the main beneficiaries relative to their GDP, Austria, Finland and Poland are not the countries in the direst need of additional investments in Europe. In particular, Greece would experience a decrease from baseline EIB lending.

To be most effective, the Juncker Plan would need to target those countries that have experienced the worst investment and output gap to date. As it stands, it follows in the footsteps of previous expansions of EIB activity, increasing the overall balance sheet of the institution while failing to rebalance it geographically. This failure undermines the effectiveness of the EIB's interventions in helping Europe's recovery. The 2015 iAGS report (Chapter 3) set out a model by which fresh bond issuance by the EIB could be incorporated within the ECB's QE programme, financing additional public investment by the Member States.

Box 5: The Reports of the Five Presidents and the policy proposal of the Commission

The recent Report of the Five Presidents has highlighted the necessity of progress in the EU in four directions: achieving "a genuine Economic Union, (…) a Financial Union, (…) a Fiscal Union, (and) a Political Union". The associated roadmap for completing the EMU includes a greater focus on employment, a better implementation of the Macro Imbalances Procedure, a better assessment of fiscal stance and fiscal sustainability, the completion of the Banking Union and the launch of a Capital Markets Union. They thus point to a very large set of ambitions which renews the debate about the consistency of the existing 6-pack, 2-pack and fiscal compact, which were mainly related to fiscal and competitiveness issues, and are now encompassing the issue of financial stability with the introduction of Banking and Capital Markets Unions. The Report raises an important question: is it possible to close the unemployment gap, achieve public finance sustainability, reduce macro imbalances, and ensure the liquidity and solvency of financial institutions at the same moment?

Macro imbalances can be reduced through an improvement in relative competitiveness inside the Euro area. Wage moderation, fiscal devaluation, structural reforms concentrated in deficit countries can, in principle, contribute to that but would feed deflationary pressures in the EA. Furthermore, such a policy would decrease internal demand and the induced REER appreciation could reduce external demand gains to zero, leaving an overall reduction in demand. Hence, ensuring a return to price stability and the fight against deflation and fiscal consolidation would be harder. Fiscal sustainability has been mostly achieved through fiscal consolidation and the confidence channel has not proven (to say the least) very powerful in providing a compensation for the adverse effect on growth. As a result, growth and possibly future growth are lowered, rendering the Capital Market Union less appealing. Finally, weight on demand and insistence on competitiveness bring a large external surplus for the EA.

In that context, fulfilling at least partially those contradictory targets, would be better achieved with a combination of an investment plan, a more decisive monetary push, and faster wage growth in surplus countries.