



The Uncertainty and Asymmetric Info on Markets: The Case of European Economic Behaviour under Risk and Financial Crises

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Abstract

The economic recovery continues at a moderate pace in the euro area¹. Sustaining and strengthening growth in the euro area requires continued policy efforts to support a balanced adjustment in the private and public sectors, improve the adjustment capacity and increase the economy's competitiveness and growth potential in the medium to long term. The pace of growth is hampered by legacies of the most recent economic and financial crises, including ongoing external rebalancing, high levels of public and private debt, high unemployment, as well as persistent structural rigidities in national labour and product markets.

KeyWords: Financial Crisis; European Union; Economic Situation; Growth; Labour market.

Jel codes: G15, G18, F33, E60, E61

1. Introduction

The European economy is in the midst of the deepest recession since the 1930s, with real GDP projected to shrink by some 4% in 2009, the sharpest contraction in the history of the European Union.

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Although signs of improvement have appeared recently, recovery remains uncertain and fragile. The EU's response to the downturn has been swift and decisive.

Investment remains weak on account of these factors but also of other bottlenecks, such as unfavourable business environments, public-administration inefficiencies as well as obstacles to access to finance [1].

The Greek economy demonstrated a remarkable resilience in 2015, reflecting inelastic private consumption and a positive contribution of net exports. Growth is expected to resume in the second half of 2016 and to pick up in 2017 thanks to the return of confidence and the impact of structural reforms. Following stronger than expected public finances in 2015 and the additional fiscal package currently finalized by the Authorities, the general government balance is expected to improve further.

2. A Macroeconomic Analysis of Current Issues

Economy more resilient than expected in 2015 Real GDP in 2015 turned out to be slightly negative, at -0.2% that is over 1 pp. better than expected after the imposition of capital controls in July 2015. Economic activity was backed by the surprising resilience of private consumption, positive net exports and by an acceleration of public investment at the end of the year.

Greece's current account deficit has been improving since 2011 and it is expected to turn positive in 2016, as past and ongoing structural reforms improve external competitiveness. Unemployment fell in 2015 and is projected to continue declining over the forecast horizon, amid marked declines in wage growth and significant reforms over recent years, the gradual recovery of the economy, and employment schemes promoting labour participation. HICP deflation continued in 2015 and prices are projected to fall further in 2016 - albeit at a moderate pace - as the impact of lower oil prices and weak demand are expected to outweigh the inflationary impact of a VAT hike. HICP inflation is projected to turn positive in 2017. Uncertainties around the forecast remain large. The projected recovery is contingent on the timely conclusion of the first review of the ESM programme, as well as positive financial market and trade developments. Upside risks could come from a faster-than-expected pick-up in business and consumer confidence. The downside risks are related to a failure to fully deliver on the reform programme, a higher-than-expected negative impact of the refugee crisis on trade and tourism, as well as the slowdown in global trade [2].

The resilience of the economy, the fiscal consolidation in the second half of 2015 and certain large positive one-off factors helped Greece achieve - according to the program definition (62) - a primary surplus of 0.7% of GDP in 2015, overachieving the primary balance target of -0.25% of GDP [2].

The recapitalization of the banking sector completed in late 2015 deteriorated temporarily the fiscal balance by 4.2 pps., pushing the headline deficit to 7.2% of GDP in 2015. Notwithstanding the over-performance in 2015, additional savings are envisaged by the government, amounting cumulatively to 3% of GDP through 2018, in order to reach the program's primary surplus targets of 0.5% of GDP in 2016, 1.75% of GDP in 2017 and 3.5% of GDP in 2018. The adjustment package includes 1% of GDP from a comprehensive reform of the pension system, 1% of GDP from personal income tax reform, ¼% of GDP from changes in the VAT standard rate, ¾%

of GDP from adjustments to the public sector wage bill, and in motor vehicle taxation and consumption taxes, primarily on energy products, alcoholic beverages, and tobacco. Based upon the primary balance targets, the headline deficit is projected to fall to 3.1% of GDP in 2016 and 1.8% of GDP in 2017. The debt-to-GDP ratio is expected to increase from 176.9% in 2015 to 182.8% in 2016 due to the clearance of arrears which was postponed from 2015 to 2016 and to program disbursements taking place in 2016 instead of 2015 given past delays in completing reviews. The debt-to-GDP ratio is expected to start declining in 2017. Downside risks to the fiscal forecast include spending from the refugee crisis, as well as possible delays in the implementation of the reforms with a budgetary impact. Upside risks stem mainly from revenue administration reforms and revenue buoyancy in light of the strong revenue collection witnessed in the second half of 2015 [2].

3. The European Economic Behaviour Approach

Denmark: GDP growth has been positive in eight of the nine latest quarters, and is estimated to have reached 1.2% on an annual basis in 2015. According to the Commission's winter 2016 forecast, GDP is projected to grow by 1.7% in 2016 and 1.9% in 2017. The economic recovery is expected to be driven by both domestic demand and exports. Private consumption has become an important driver of GDP growth. It has been supported by rising real disposable income, due to the increase in employment, wage growth and low inflation. A sharp increase in the household savings rate in 2015 partly reflects the fact that the savings rate has been artificially low, especially in 2014. This is due to high tax payments linked to the restructuring of capital pension funds together with an increase in 2015 in the change in net equity in pension funds. The asset position of households has improved partly due to a rise in house prices since mid-2012. The level of consumer confidence is consistent with continued growth in private consumption, reaching a historically high level last spring, but decreasing somewhat over the last six months [3].

Both the corporate and household sectors have reduced investments after the crisis. Both the corporate and household sectors have gone through a balance sheet consolidation process in the period after the crisis. In this period both sectors have increased their savings. As regards business investment, the consolidation process seems to have come to an end and, based on the current high savings level, investment is expected to start picking up¹. Households invested heavily in housing before the crisis. Their high financial leverage developed on the background of low interest rates, tax incentives in the form of tax deductibility of mortgage interest payments, and attractive loans. After the crisis, loans to households dropped and have increased only moderately since. While interest rates remain low, tax deductibility has been decreased and mortgage banks have taken measures to reduce incentives for taking up riskier types of loans. Against this background, investment in housing might pick up more gradually [3].

Germany: Economic growth has been stable in recent years with domestic demand, notably private consumption, as the main growth driver. Real GDP growth stood at 1.6 % in 2014 and 1.7 % in 2015, according to first official results. The growth pattern has evolved with domestic demand having become a key growth driver. Notably, private consumption has strengthened, supported by the strong performance of the labour market and temporary factors such as low energy prices. The labour market weathered the crisis well and the unemployment rate has decreased to a postreunification low. By contrast, the recovery in private investment has

been uneven and despite recent efforts, public investment remains low. Public investment has been falling and its share in GDP remains below the euro area average despite the large public investment backlog. Some areas of corporate investment, notably in machinery and equipment investment, still have not caught up with pre-crisis levels, in spite of the supportive financing conditions and strong corporate profits [4].

Private investment would *inter alia* benefit from further changes to the tax system and the removal of sector-specific barriers. The complexity of the tax system remains a hindrance to private investment. no progress has been made *inter alia* regarding the reform of the local trade tax.

In addition, elements of regulation in business services and regulated professions that remain unchanged, including professional qualifications requirements, legal form and shareholding requirements might be holding back investment (see Section 2.6). Unchanged planning regulations in certain federal states create entry barriers regarding retail, while the complex and slow process for electricity grid expansion might be hampering investment in the energy sector [4].

Belgium: The Belgian economy has been recovering at a slow pace. After having settled at around 1.3 % in 2014 and 2015, real growth is forecast to rise to 1.7 % in 2017 as companies start reaping the benefits of improved competitiveness and employment growth provides broader support to household spending. At the same time, a less supportive external environment risks delaying the transmission of improving competitiveness into export, investment and job growth. Lower growth compared with pre-crisis performance is in line with lower estimates for potential growth as a result of weakened productivity growth. A fall in potential growth entails long-term risks, particularly in view of the challenges Belgium faces as regards the long-term sustainability of its public finances [5].

The Belgian GDP has grown by 1.3 % both in 2014 and 2015. This modest growth rate is expected to continue in 2016, according to the Commission's 2016 winter forecast, with growth accelerating to 1.7 % next year, its best rate in many years.

Private consumption is estimated to have risen by 1.4 % in 2015, making it the main growth driver (Figure 1.1). Wage growth has been curtailed in recent years, as will be discussed in more detail in Section 2.2. So far, low inflation pressures and income tax cuts have limited the impact on households' purchasing power. However, rising inflation is set to limit real income gains in 2016 and 2017, despite further tax cuts. As a consequence, consumption growth is projected to shift into a lower gear, growing by 0.9 % and 1.2 % respectively in 2016 and 2017 [5].

France: In France, growth is expected to remain moderate, as investment is projected to pick up only gradually and net exports to remain a drag on growth. After three years of weak activity, GDP growth improved to 1.1 % in 2015, supported by favorable external factors. In particular, growth benefited from reduced oil prices, the euro's depreciation and policy measures to reduce the cost of labor and strengthen competitiveness. France's economy is expected to gradually further accelerate, driven by private consumption on the back of a dynamic households' purchasing power. However, France's growth rate remains below the euro-area average. In recent

years, GDP growth has been held back by investment. The recovery in investment is expected to only take hold in 2017, as policy measures to reduce the cost of labor and strengthen competitiveness are expected to foster business confidence with a lag. Inflation has fallen to 0.1 % in 2015 and is expected to increase only moderately to 0.6 % in 2016. Moreover, the slowdown in emerging markets and the recent financial market turmoil might weigh on the economic outlook [6].

Acceleration in investment is projected from 2017 onwards. Investment will mainly be supported by the gradual recovery of aggregate demand, against a background of favorable credit conditions, reinforced by the European Central Bank (ECB) monetary policy. Measures to reduce labor costs and improve firms' profit margins, i.e. the EUR 20 billion 'Crédit'Impôt pour la Compétitivité et l'Emploi' (CICE) (tax credit for competitiveness and employment) and the EUR 10 billion additional cuts in employers' social contributions planned under the 'responsibility and solidarity pact' (RSP), are expected to further boost investment only from 2017 onwards. However, equipment investment is not expected to return to its pre-crisis level in the medium term, so the extent of the recovery will be limited [6].

The weakness of equipment investment points to the fragility of the recovery. Equipment investment remains 8 % below its pre-crisis level and lower than in other Member States. Several studies highlight the structural weakness of equipment investment, which declined as a percentage of total gross fixed capital formation from 28.5 % in 2000 to 21.5 % in 2013. Weak profit margins of firms, particularly in manufacturing, have weighed on investment. The ongoing measures to lower labor costs, namely the 'tax credit for competitiveness and employment' (CICE) and the 'responsibility and solidarity pact' (RSP), together with lower oil prices and the depreciation of the euro, have recently improved the financial position of companies, without having yet triggered any turnaround in investment [6].

United Kingdom: Economic growth has been strong in recent years as the United Kingdom emerged from recession to grow above long-run averages. Robust growth was accompanied by low inflation and a robust labor market as employment increased rapidly while price and wage pressures were subdued. However, the external position deteriorated. The strong performance was driven by a number of internal factors. Accommodative monetary policy, increased resilience of the banking sector, an efficient and competitive labor market, increased corporate profitability and growing confidence among households and firms supported growth. Economic growth is now on a firm trajectory. After peaking in 2014 at 2.9 %, growth moderated to 2.3 % in 2015 and is expected to settle at rates of 2.1 % in 2016 and 2017. Domestic demand, in particular private consumption, is projected to continue to drive growth. Business investment has been strong and is expected to continue growing solidly. However, net exports are expected to still detract from growth [7].

Cyprus: Cyprus benefited from an economic adjustment program, during which it emerged from recession, stabilized its financial sector, and consolidated its public finances; yet many challenges remain. Considerable economic imbalances, including an unstable and oversized financial sector and fiscal imbalances, led Cyprus to require financial assistance in June 2012. During the program, the European Commission monitored the correction of imbalances in liaison with the European Central Bank (ECB), and, where relevant, with the International Monetary Fund (IMF). Credit tightening and the need for corporate balance-sheet restructuring led

to a contraction of the economy and, consequently, to a surge in unemployment. Despite the many good achievements during the program, the crisis has left legacy issues [8].

Investment is still dampened by high corporate debt, and the housing market remains depressed. Credit to the economy continues to be subdued and banks struggle with a very high ratio of non-performing loans (around 55% on loans to households and non-financial corporations). This high level of non-performing loans weighs on banks' profitability and on their capacity to build up capital buffers. New lending is constrained by lack of viable projects in which to invest due to high private indebtedness and non-compliance with financial contracts. SMEs are overly dependent on bank lending, while alternative financing remains limited, which significantly hampers their ability to invest and grow [8].

Regarding the progress in reaching the national targets under the Europe 2020 Strategy, Cyprus has either reached or is making progress towards its targets on reducing greenhouse gas emissions, increasing the share of renewable energy, improving energy efficiency, reducing early school leaving and increasing the tertiary education attainment. On the other hand, progress towards Europe 2020 targets on the employment rate, investment in research and development and the reduction of poverty and social exclusion appears limited [8].

The public sector is not fully efficient. The public administration is marked by one of the highest wage bills (as percentage of GDP) in the euro area, but its efficiency (as measured by efficiency indicators) remains average. In particular, performance could be enhanced by increased mobility, the introduction of performance incentives, and increased availability of e-government services. While Cyprus' fiscal balances are back on track, there are still inefficiencies in allocating spending and collecting revenue. State-provided utilities (the Cyprus Telecommunications Authority and the Electricity Authority of Cyprus, in particular) are marked by high prices and are still relatively shielded from competition [8].

Austria: After four years of slow economic growth, the Austrian economy is expected to expand. Austria's economy has been on a rather flat growth path since 2012, but the growth rate is projected to pick up from 0.7 % in 2015 to around 1½ % in 2016 and 2017. This acceleration is expected to be driven by private consumption and housing investment. Investment activity has been sluggish, but is expected to pick up due to improved confidence, favorable financing conditions and the need to renew equipment. The unemployment rate is expected to stay contained at around 6 %. Inflation should return to almost 2 % in 2017 as the dampening effect of energy prices fades. The tax reform and additional expenditure on refugees and migrants add pressure to the fiscal outlook. The headline deficit of 1.6 % in 2015 is nonetheless projected to stabilize at 1.7 % in 2016 and 2017. Public debt increased in 2014-2015 due to the impact of financial sector measures, but is projected to fall to 84 % of GDP in 2017 [9].

Sluggish investment activity has been an important reason for slow economic growth in Austria in recent years. Subdued investment followed in the wake of overall weak export market prospects, including relatively pronounced market share losses of Austrian exporters. It coincided also with declining corporate profits and a continuous reduction of non-financial corporate debt along with muted corporate credit growth. At the same time, major banking groups have been addressing their challenges from low profitability, increasing non-

performing loans in their foreign subsidiaries, and important foreign currency loan exposures. This went hand-in-hand with supervisory and regulatory action, both in Austria and at the European level, which set a necessary focus on building capital buffers and de-risking of bank balance sheets. Moreover, government bank support measures taken in the past to preserve financial stability and restructure distressed banks have continued to impact on public finances. Although the banking sector has remained resilient, some issues in relation to specific banks have impacted on investor sentiment, what has been reflected in bank capital costs. The 2015 Council recommendation to Austria already recognized these challenges and pointed to the need to address potential financial sector vulnerabilities [9].

Consumer price inflation has held up compared with other euro area countries. Inflation remains stable and positive. This is due to price increases in services like renting and hospitality (tourism sector). Core consumer prices and, more recently, headline consumer prices are developing faster in Austria (Figure 1.5). Inflation, which stood at 0.8 % in 2015, is expected to increase to just under 2 % in 2016-2017 in line with the pick-up in economic activity and the fading impact of low energy prices [9].

Overall, In October 2016, the European Commission, estimate¹ of the consumer confidence indicator² remained broadly unchanged in both the EU (-0.1 points to -6.5) and the euro area (+0.2 points to -8.0) compared to September 2016.

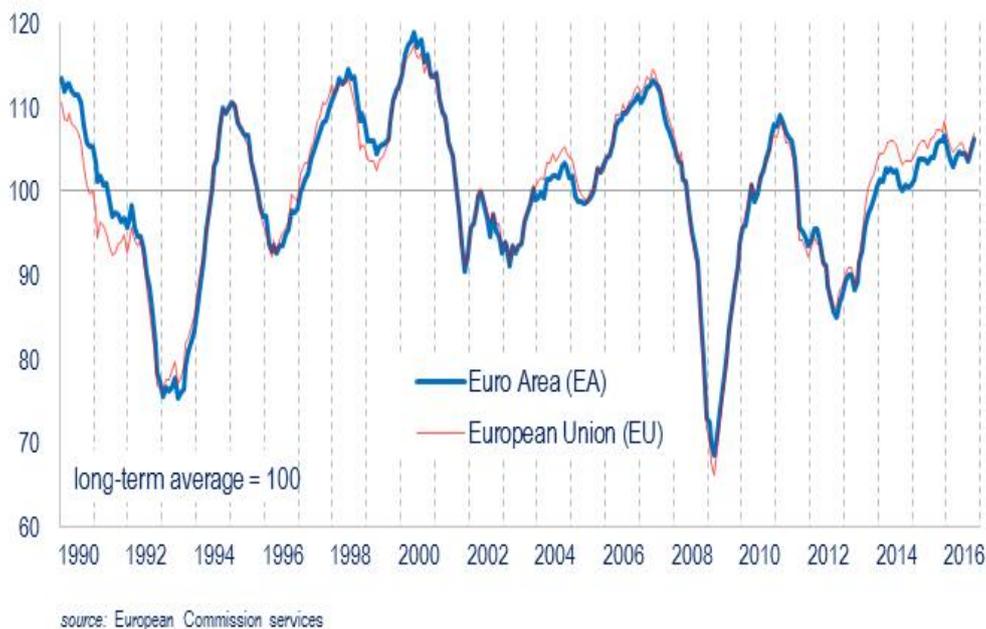


Figure 1: Consumer Confidence indicator

Source: http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm, 15/10/2016

Additionally, the Economic Sentiment increases strongly in both the euro area and the EU. In October, the Economic Sentiment Indicator (ESI) increased by 1.4 points in both the euro area (to 106.3) and the EU (to 106.9).

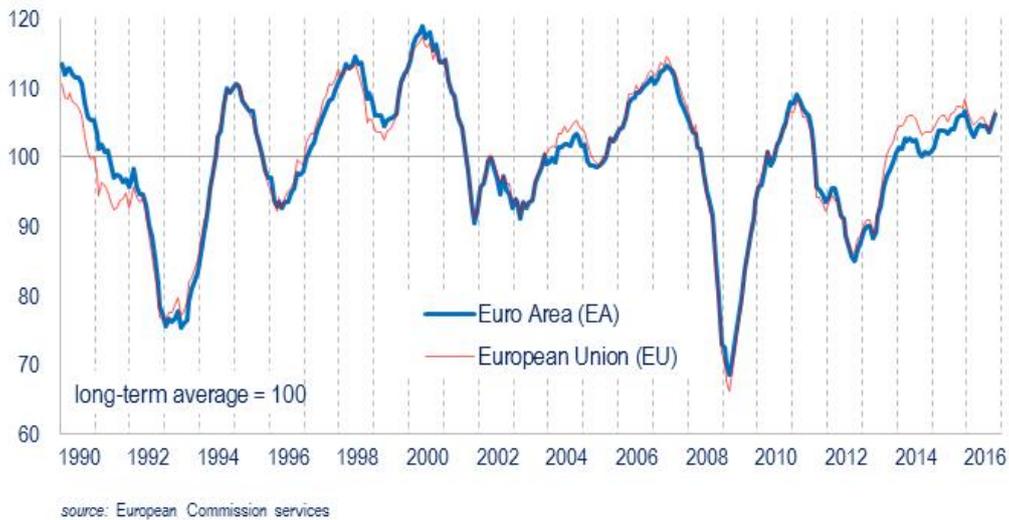


Figure 2: Economic sentiment indicator.

Source:http://ec.europa.eu/economy_finance/db_indicators/surveys/documents/2016/esi_2016_10_en.pdf, 15/10/2016

4. Concluding Remarks

The European Commission euro area Member States take action, individually and collectively, within the Euro group in the period 2016-2017 to:

- a. Pursue policies that support the recovery, foster convergence, facilitate the correction of macroeconomic imbalances and improve adjustment capacity. To this end, Member States, particularly those with large stocks of private and foreign debt, should implement reforms that enhance productivity, foster job creation, raise competitiveness and improve the business environment. Member States with large current account surpluses should implement as a priority measures that help channelling excess savings toward the domestic economy and thereby boost domestic investment.
- b. Implement reforms that combine (i) flexible and reliable labour contracts that promote labour market transitions and avoid a two-tier labour market; (ii) comprehensive lifelong learning strategies; (iii) effective policies to help the unemployed re-enter the labour market, (iv) modern social protection systems that support those in need and provide incentives for labour market integration and, (v) open and competitive product and services markets. Reduce the tax wedge on labour, particularly on low-earners, in a budgetary-neutral way to foster job creation.
- c. Maintain the planned broadly neutral fiscal stance in 2016. With a view to 2017, reduce public debt to restore fiscal buffers while avoiding pro-cyclicality, in full respect of the Stability and Growth Pact. Differentiate the fiscal effort by individual Member States taking into account their respective position vis-à-vis the requirements under the SGP and their stabilisation needs, as well as spill overs across euro area countries. To this end, discuss the euro area fiscal stance in time for the preparation and

presentation of the Stability Programmes and the Draft Budgetary Plans.

- d. Facilitate the gradual reduction of banks' non-performing loans and improve insolvency proceedings for businesses and households. In Member States with large stocks of private debt, promote an orderly deleveraging, including by facilitating the resolution of unviable private debt [1].

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