The European Economy

1. The current situation and the macroeconomic outlook

After a deep economic recession during the winter of 2008/2009, which was triggered by a US-led financial crisis, many countries went through a stabilisation period and now seem to have entered a recovery phase. Global monetary and fiscal policies have prevented a worse outcome and lie at the roots of the current recovery. Furthermore, the search for liquidity during the crisis has created an inventory cycle which will also drive growth for the time being.[1] However, the restructuring process within the banking sector is far from being completed and the too low national saving rate in the US has not reached structurally sustainable levels yet. Consequently, the fading out of fiscal and monetary stimulus measures this year will likely leave the world economy struggling to achieve growth in the years to come. Relatively sound economic conditions allow emerging countries to witness a revival of their economies. Their domestic economies will remain the growth engines for the world economy.

Although the roots of the crisis lie in the US, of the larger economic regions, Japan and the European Union suffered the most. This can partly be explained by the much more pronounced economic policy reactions of US officials and partly by the sharp correction in global imbalances. The US trade account improved substantially, exporting part of its problems to the rest of the world. On the other hand, Japan and Europe saw a clear deterioration of their external balance and thereby acted – together with many emerging markets – as shock absorbers for the world.

[1] When discussing the cyclical situation in the European Union in Section 1.3.6, we clarify what is meant by the inventory cycle.

The European economy will only temporarily experience somewhat higher growth. Although business prospects of firms have improved, problems within the banking sector remain. This will lead to a more restrictive credit supply which, together with continued underutilisation of production factors, will suppress especially investments. Worsening labour market conditions, small wage increases and somewhat higher inflation will lead to a reduction in real disposable income, thereby reducing consumption growth. Overall growth will remain subdued at least this year.

1.1 The current situation

1.1.1 The global economy

The world economy seems to have overcome its worst recession since the World War II. World trade and industrial production having collapsed during winter 2008/2009, both have started to pick up again more recently (see Figure 1.1). Besides massive fiscal stimulus packages and expansionary monetary policy, this process is supported by a still comparatively low oil price and a turnaround in the worldwide inventory cycle.

According to the Ifo World Economic Survey, the world economic climate indicator rose in the fourth

Figure 1.1

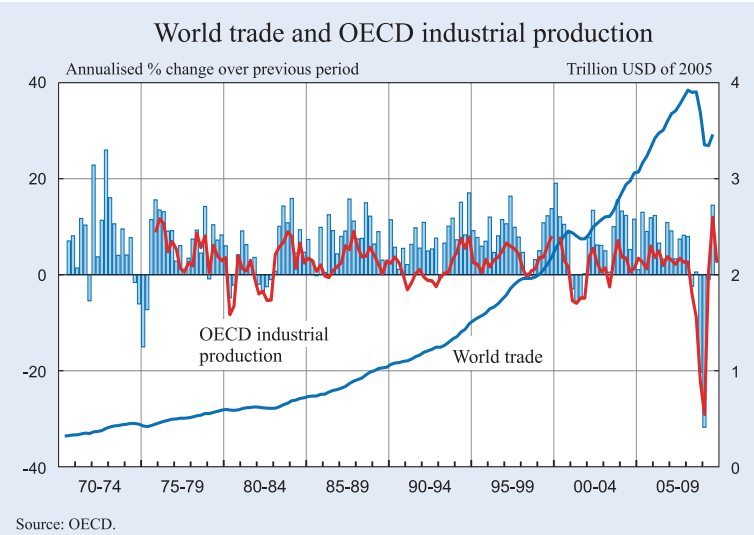
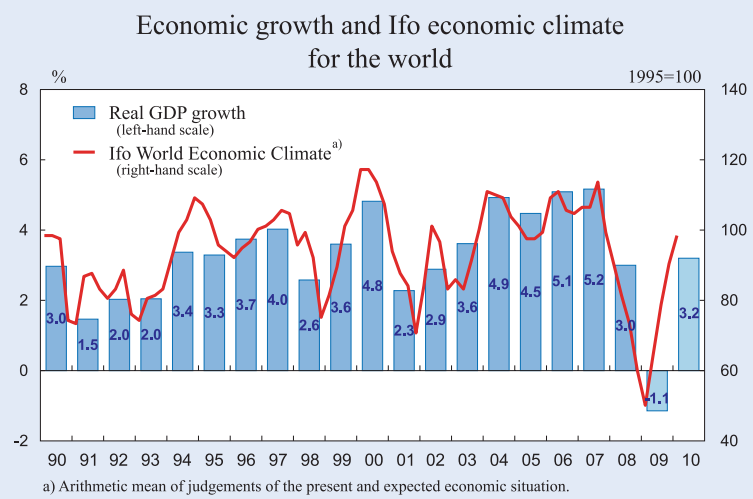


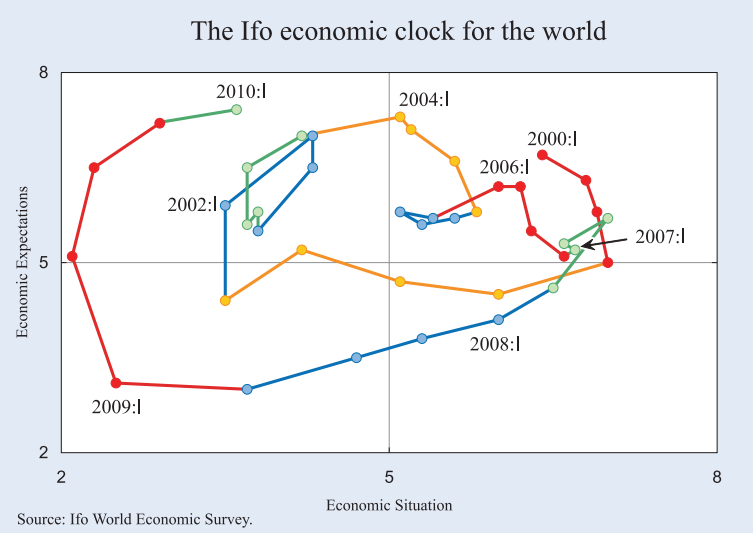
Figure 1.2



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

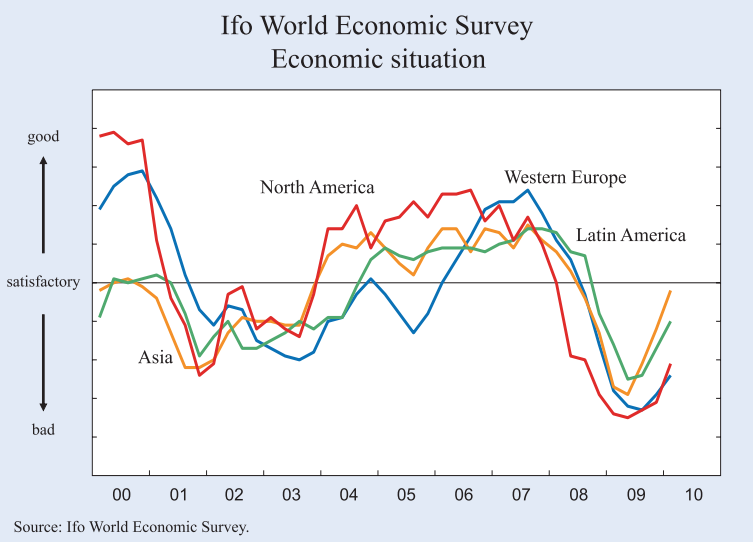
Source: IMF, World Economic Outlook Database October 2009 (GDP 2009 and 2010: EEAG forecast); Ifo World Economic Survey (WES) I/2010.

Figure 1.3



Source: Ifo World Economic Survey.

Figure 1.4



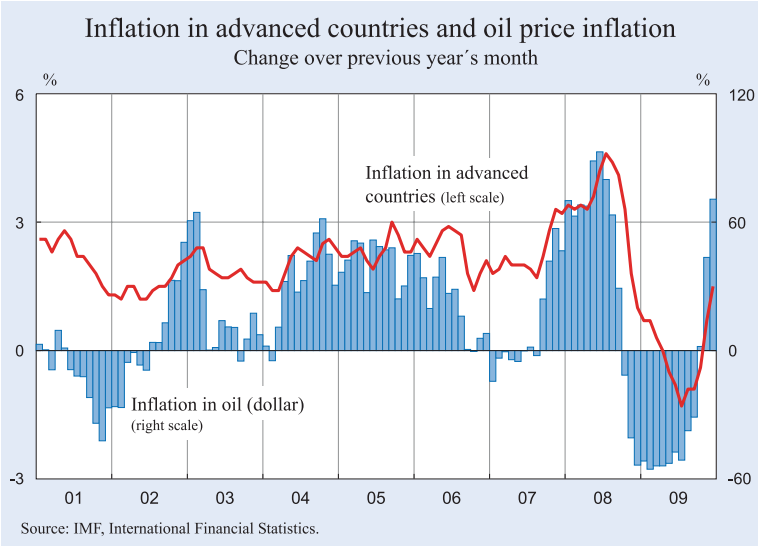
Source: Ifo World Economic Survey.

quarter of last year (see Figure 1.2). This was its third consecutive increase. The two underlying components of the Ifo economic climate indicator, i.e. the current assessment and the expectations for the next six months, tend to move in a clockwise manner over the business cycle (see Figure 1.3). As of late, the increase of the overall indicator not only resulted from more favourable expectations for the next six months, but increasingly also from less negative appraisals of the present economic situation. Nevertheless, the current economic situation is still assessed as worse than it was after the attack on the World Trade Center in 2001.

The improvement of the current economic situation took place in all major regions in the world. Especially the assessments in Asia are noteworthy. Not only did that region recover first, but it also has seen the largest improvement in this sentiment indicator since the onset of the crisis. In Western Europe and North America, the assessment of the current economic situation only improved slightly and remained at historically unfavourable levels in the fourth quarter of 2009 (see Figure 1.4).

After having fluctuated steadily around 2 percent since the mid-1990s, inflation in the advanced countries strongly picked up to well above 4 percent in summer 2008 before subsequently dropping to – 1.3 percent in July last year. Besides the economic upswing up until mid-2008 and the economic crisis afterwards, mainly oil and other raw material price have caused these strong fluctuations in inflation rates (see Figure 1.5). Whereas the oil price

Figure 1.5



peaked at around 130 US dollars per barrel in summer 2008, it fell to about 40 US dollars in winter 2008/2009. This winter it is fluctuating around 75 US dollars again.

1.1.2 United States

In the *US* the deepest recession since the World War II has come to an end in the third quarter of 2009. With an annualised increase in GDP of 2.2 percent in the third and even 5.7 percent in the fourth quater the overall economic dynamism was as high as last seen two years ago. Nevertheless, due to the sharp decline during the winter of 2008/2009, GDP in 2009 ended up 2.4 percent lower than in 2008 (see Table A.1).

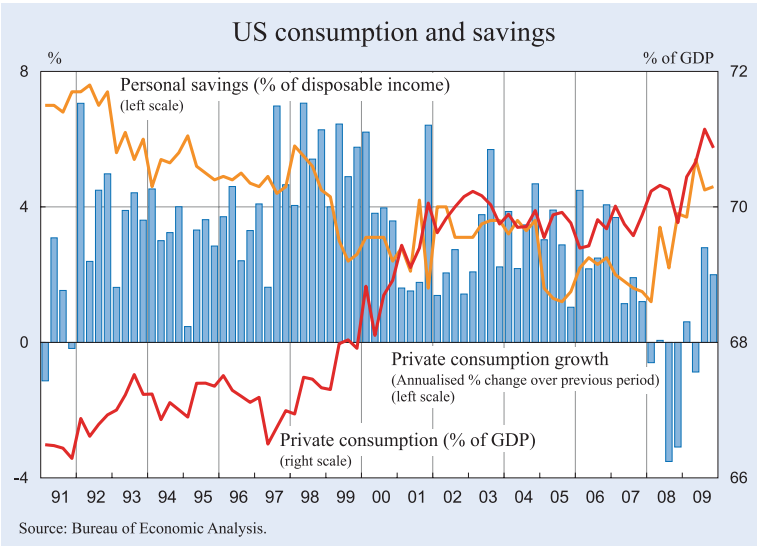
In particular, a strong increase in private consumption was responsible for the positive development in the third quarter of last year. Private consumption expanded by 2.8 percent. Its contribution to overall growth was 2 percentage points – the biggest among all demand side components (see Figure 1.6). The increase in private consumption was largely driven by the sharp rise in public transfer payments as part of the government stimulus packages. In particular, the "Cash for Clunkers" program, which ran in summer, temporarily led to a substantial increase in car sales and thereby can explain around half of the GDP increase in the third quarter. With the program running out at the end of August, car sales broke down again. The uplift in private consumption in the third quarter can only partly compensate for its loss throughout the year; private consumption overall fell by – 0.6 percent in 2009.

The private saving rate has been steadily increasing from 1.2 percent of disposable income in the first quarter of 2008 to up to 5.4 percent in the second quarter of 2009, before it subsequently fell somewhat to 4.5 percent in the third quarter.

This pattern is also apparent in the falling credits granted to households, in particular in the area of credit cards. Despite these developments, the share of consumption in GDP rose substantially in 2009. Whereas the consumption share hovered around 62 percent in the 1960s and 1970s, moved up to 67 percent in the 1990s, and increased to about 70 percent in the 2000s, it has even surpassed 71 percent in the third quarter of 2009 and thereby reached its highest level at least since World War II (see Figure 1.6).

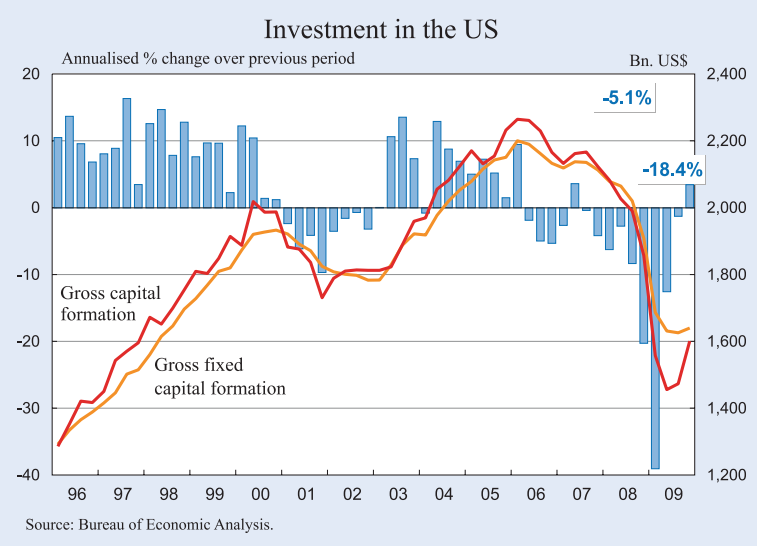
The strongest negative growth contribution last year came from investment (see Figure 1.7). Gross fixed capital formation plummeted by around 18 percent; when including the sharp drop in inventories, the

Figure 1.6



resulting gross capital formation even fell by close to 24 percent. Quite different from 2008, this decline in investment was more or less similar across its different components. Whereas in 2007 and in 2008 only residential investment put a burden on total investment, investment in non-residential structures and equipment and software took a similar blow last year as did residential investment. The turn in the inventory cycle allowed total investment growth to turn positive again in particular during the fourth quarter of last year. Investment in equipment and software, which accounts for more than half of total investments, no longer shrunk, but still remained weak. In particular, the extremely low capacity utilisation rate in industry is responsibly for this. Although capacity utilisation reached its trough in June last year with 68.3 percent, it remains, with 71.3 percent in November, at a historically low level (its long-run average equals 81.1 percent). For basically the same reason, non-residential construction investment is still reporting substantial negative growth (an annualised – 15.4 percent in the fourth quarter). The only component of gross fixed capital formation that appears to have bounced back is residential investment. After 14 quarters of strong negative growth, it contributed for the first time positively to US growth again and rose with an annualised 18.9 percent in the third quarter.

Figure 1.7



The domestic problems led to a sharp fall in the demand for foreign goods and services over the year. The fall in exports on the other hand was clearly less pronounced. Consequently, the US trade balance was able to improve substantially last year; its contribution to GDP growth was approximately one percentage point. In that sense, the US economy was able to partly export its domestic crisis to the rest of the world and in that way contributed towards reducing global imbalances. As compared to the pre-crisis period (2007QI–2008QI), it was able to improve its trade balance by around 2.5 percentage points (see Figure 1.8). On the absorbing end of this shock stood, amongst others, Japan and the euro area. Looking at exports and imports individually, after having fallen for respectively 4 and 7 quarters in a row, both made a sharp turnaround in the third quarter of last year.

Due to the economic crisis, the unemployment rate in the US has doubled from 5 percent in spring 2008 up to 10 percent in autumn last year, the highest rate since 1983 (see Figure 1.9). The business cycle recovery so far has hardly led to a relief on the labour market. The number of employees continued to decrease up until the end of last year, albeit at a slower pace.

Figure 1.8

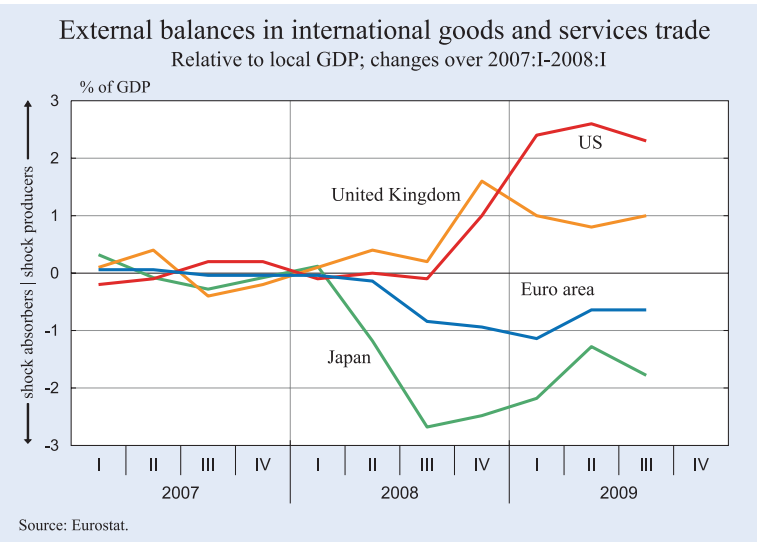
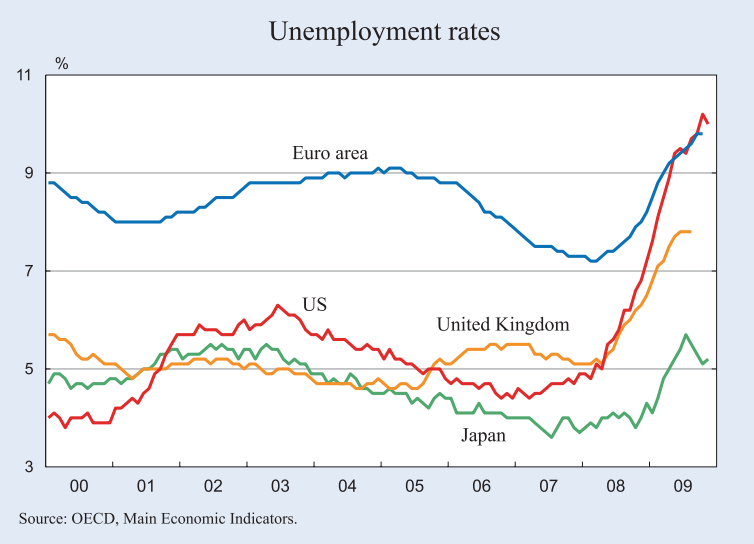


Figure 1.9



After eight months of negative inflation, the price level started to increase again in November relative to the year before. The inflation development was determined above all by the recovery of energy and raw material prices. Nevertheless, the increase in the core index for personal consumption expenditure – which is the preferred inflation measure of the Federal Reserve – remained in October last year, with 1.4 percent, at a low level.

After approximately three years, real-estate prices stopped falling in mid-2009. Since its peak in spring 2006, house prices fell by more than 30 percent. Since summer last year, some moderate price increases have been observed. To a large extent, this development can be traced back to the massive subsidies and tax reliefs of the US government. During the fiscal year 2009, the fiscal support to the real-estate market, for instance the First-Time Home Buyer Credit, added up to about 300 billion US dollars. Only when state support runs out, however, will it be possible to judge whether the recovery on the real-estate market will remain sustainable. A continuation of the drop in real-estate prices would lead to additional write-offs on mortgage-backed securities and again endanger the stability of the banking system.

Since early summer, the interbank market increasingly shows signs of relaxation. The risk premia banks have to pay to get unsecured money, as measured by the difference between the 3-month LIBOR Eurodollar rate and the Federal Reserve's Fed Fund rate, at the end of last year reached a pre-crisis level of 10 basis points again. Consequently, the Federal Reserve has started drawing back its liquidity support continuously. Nevertheless, as a result of increasing its massive intervention programs to lower long-term lending rates, in particular for mortgages, its balance sheet is still expanding further. Furthermore, whereas the Federal Reserve in October of last year stopped purchasing US government bonds, it still continues to buy bonds of state-owned mortgage suppliers and mortgage-backed securities during the first quarter of this year.

Supported by the extensive measures of the Federal Reserve, mortgage interest rates have clearly fallen since the end of 2008. Accordingly, since the second quarter of 2009, banks have started to register an increase in the number of mortgage loan applications. Nevertheless, on account of the high unemployment rate and the rising loan failure rates, banks remain reluctant to grant these requests. In spite of improved conditions on the interbank market, the climax in loan failures has not yet been reached. This will put further strains on the capital base of the banking system.

The US government budget registered a record deficit in 2009. At the end of the fiscal year in September the budget deficit amounted to 1.4 trillion US dollars or 9.9 percent of GDP (as compared to 3.2 percent in fiscal 2008) and thereby reached its highest level since 1945. The increase is just as much due to a decline in revenues as to an increase in expenses. On the expenditure side, especially spending to rescue banks (TARP) and the financial support for the state-owned mortgage suppliers stand out. The stimulus package (ARRA), which was decided in February last year, is a burden to both the expenditure as well as the revenue side.

1.1.3 Japan, China, India and other Asian countries

After having been hit the hardest amongst the large economies in the world during winter 2008/2009, the economic recovery in *Japan* set in already in the second quarter of last year. Nevertheless, with modest annualised growth rates of 2.7 and 1.3 percent in the second and third quarters, respectively, only part of the more than 10 percent annualised drop during the winter could be made up for. The most important dri-

vers for the mild recovery were foreign trade and private consumption. Favoured by the strong increase of exports, the growth contribution of net exports to GDP growth mounted to 6.1 percentage points in the second quarter and to 3.0 percentage points in the third quarter. Private consumption increased by an annualised 4.8 and 3.8 percent in respectively the second and third quarter. On the other hand, investments continued to fall at double-digit rates throughout the year.

The favourable developments since the second quarter of last year have likely continued throughout the rest of last year. Although no quarterly national accounts statistics for the fourth quarter of last year are available at the time of writing, other economic data point in this direction. Here especially the results of the Tankan business tendency survey, according to which the business and profit situation of Japanese manufacturers have further improved, are to be mentioned. However, also at current levels, the indicators are still at historically low levels. This matches the positive developments in industrial production, which has meanwhile risen seven months in a row, but remains well below its long-run average. The recovery is not only felt by industry, but is also reflected by indexes on developments in the service sector and in the economy as a whole, which have improved strongly. In addition, consumer sentiment surveys send out similar signals. Nevertheless, to a large extent, these positive developments are based upon government stimulus measures to promote in particular purchases of durable consumption goods. Hence, Japan is likely to show a further increase in GDP in the fourth quarter of 2009. This can, however, not prevent the annual growth rate for 2009 from falling to – 5.3 percent.

The unemployment rate at the beginning of last year still was still at about 4 percent, but it subsequently rose sharply into the summer, reaching a peak of 5.7 percent in July due to the economic crisis. Ever since, it has shown signs of a gradual decline again reaching 5.1 percent in October last year. However, according to survey results, firms are still planning to cut back employment. Furthermore, part of this positive development is caused by an increase in government subsidised employment. The unemployment rate is likely to be much higher without these measures.

As the uncollateralised overnight call rate in Japan hover around 0.1 percent since the end of 2008, leaving hardly any room for manoeuvre, the Japanese central bank has introduced a number of additional measures to stabilise the financial markets and to improve the supply of credit to the economy. These include buying up government and firm bonds as well as stocks.

To counteract the economic crisis, the Japanese government has introduced several economic stimulus packages with a total volume of approximately 5 percent of GDP. The associated additional spending together with the cyclical reduction in revenues has caused the budget deficit to increase to 8 percent of GDP in 2009.

Over the summer *China* was able to return to nearly pre-crisis growth levels. GDP grew by an annualised 7.9 and 8.9 percent in the second and third quarter of last year, respectively. A comparison of the first three quarters with those of 2008 reveals an impressive growth rate of 7.7 percent. Therefore, it appears likely that the self-assigned goal to achieve an annual growth rate of about 8 percent in 2009 will nearly be reached. We assume that it will amount to 7.8 percent in 2009. To a large extent this performance is caused by a strong increase in investment activity initiated by huge fiscal and monetary stimulus programs of the government. Besides stimulating private consumption, the government stimulus programs above all concentrated on investments in public infrastructure, with a special focus on transport infrastructure, the health sector and the underdeveloped western part of the country.

The quick stimulus measures that fuelled imports of commodities together with a hesitant stabilisation of the world economy caused the trade surplus of China to shrink during the first part of last year. During the second half of last year also the revival of exports, due to improved economic conditions around the world as well as the weakness of the renminbi against most currencies as a result of the weakness of the dollar, the trade surplus has recovered and contributed positively to economic growth. Although the Chinese authorities allowed for a steady nominal appreciation of the renminbi between July 2005 and July 2008, it has since returned to close to a fixed exchange rate vis-à-vis the US dollar.

After the favourable developments in the second and third quarter of 2009, the outlook for the fourth quarter also remains positive. As compared to the year before, industrial production increased by 16.1 per-

cent in October which once again was substantially stronger than in September in which its growth rate amounted to 13.9 percent. In addition, the positive outlook is underpinned by different survey results on the business situation in manufacturing. Furthermore, retail trade also managed to report increasing growth rates during the second half of last year. This was partly due to government support, i.e. increased subsidies on consumer goods. The positive picture is completed by exports statistics, which show that total exports in October lay only just 13.8 percent below its level a year before and thereby recovered clearly from its nadir reached in summer last year.

India experienced a strong increase of economic activity in the second and third quarter of last year. After during winter 2008/2009 GDP only expanded by about 4.4 percent as compared to the year before, year-over-year growth was able to increase to 6.0 and 6.7 percent in respectively the second and third quarter of last year. Early indicators suggest that especially in the last quarter of 2009 production will expand strongly. Overall the annual GDP growth rate for 2009 is expected to be 6.1 percent.

While the important agricultural sector for the Indian economy could – on account of the late start of the monsoon rains – not contribute as much as expected to the economic recovery, this was more than compensated for by the developments in the manufacturing and above all the services sector. Industrial production increased by 8.3 percent in the third quarter as compared to the year before; the services sector even showed an increase of 9.3 percent. These economic developments have likely continued during the last months of last year. Business sentiment indicators for the aggregate economy and the manufacturing sector show an unbroken upward trend. Also the clear increase of retail- and wholesale prices confirm a continuation of these dynamics.

The relatively stable economic development of India explains itself, on the one hand, by the fact that its economy is less open than many other emerging economies. On the other hand, services play an important role for Indian exports. Trade in services show less of a cyclical pattern than those in industrial goods.

The other East Asian countries of *Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan* and *Thailand* benefited from the favourable business cycle developments in China. In spring 2009 these economies started a swift recovery. Before, this region was also struck by the global recession. As most of these economies are export-oriented, they were especially hard hit by the massive reduction in world trade.

A comparison of the economic developments in these countries shows the close link between the recession and the fall in world trade. Those countries which are hit the hardest, i.e. Taiwan and the two trade centres, Hong Kong and Singapore, are also the most open economies in this region. The recessions in some of the bigger countries, most notably Indonesia, were somewhat milder.[2]

However, the fall-out in industrial production and foreign trade only lasted for a short time. Production reached its trough already at the beginning of last year and thereby earlier than elsewhere in the world. Since then, economic activity regained pre-crisis levels in many countries, with the strong momentum of the high-tech industries and terminating inventory adjustments as the key drivers. The strong recovery was also supported by expansionary monetary and fiscal policy as implemented worldwide. The fact that economic policy in Asia was more effective, quicker and stronger than elsewhere can, on the one hand, be explained by a banking system that was largely spared from the financial crisis that hit the US and Europe. On the other hand, the substantial current account surpluses built up in the past lessened the impact of reduced capital flows as compared to other emerging countries.

1.1.4 The rest of the world

After the economic crisis during the winter of 2008/2009, the Latin America countries of *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela* managed to stabilise their economies relatively early. They benefited from the recovery in raw material prices that started in the beginning of 2009. The region managed to get over the financial crisis better than other regions. After a dramatic increase in risk premia on most government bonds during the winter, they have quickly fallen again. Presently they are moving again around levels that prevailed before the start of the crisis. More or less the same holds for the exchange rates of most currencies: they depreciated sharply during the winter. However, since then they have basically recovered again. Latin America managed to escape a

[2] A similar pattern is discussed in Chapter 5.

more severe impact of the worldwide trust crisis by not having high current account deficits and therefore by not being very dependent upon large net capital inflows. On top of that, the financial sectors in these countries are less connected to those centres that were at the core of the financial crisis. Furthermore, by historical standards the macroeconomic fundamentals appear in general quite healthy and the public finances in order.

Nevertheless, the individual countries developed quite heterogeneously. Mexico is having difficulties overcoming a recession that has lasted for more than a year. Its economy is heavily dependent upon developments in the US. In particular, industry in the northern part of the country is closely intertwined with the US market. Furthermore, the decline of transfer payments of migrants has led to income losses in Mexico. Also the impact of swine flu, the fall in oil revenues and the hard-hit car industry should not be ignored. The position of Brazil, the second largest economy in the region, is more favourable. The export sector is more diversified on a regional level; China has become the most important trading partner even before the US. Furthermore, international trade plays a less important role in Brazil as compared to Mexico. Although Brazil was also hit by a sharp recession in the winter of 2008/2009, it has already been on an expansion course again since spring last year based on its robust domestic demand. All together, GDP in 2009 is expected to turn out 2.2 percent lower than in 2008 in Latin America as a whole.

The global economic and financial crisis hit *Russia* full force. The global drop in the demand for raw materials and the associated fall in raw material prices led to a massive decline in export revenues. In addition, domestic factors, including problems in the financial industry and the bursting of a speculative bubble in the real-estate market, contributed to a sharp fall in investments.

Rising unemployment and falling real incomes dampened private consumption. Although the Russian economy started to stabilise by the summer of last year, a clear recovery as in other emerging markets does not appear to have set in. Industrial production has freed itself from its low in May last year, but has not regained pre-crisis growth levels. Also growth in retail trade has been low throughout 2009. Real gross domestic product shrank by 8.0 percent in 2009 compared to 2008.

Nevertheless, the economic environment has visibly improved. With the recovery of raw material prices, the withdrawal of foreign capital decreased, and the rouble, which had lost up to 40 percent of its value to the US dollar, appreciated clearly again. Against this background and in view of falling inflation rates, the central bank has loosened its monetary policy stance gradually since the beginning of last year. However, firm credit rates are still high and the supply of credit by the banks remains restrictive. The government has counteracted by granting interest subsidies and state guarantees. However, the approval process of authorities runs slowly, and the beneficiaries are primarily big enterprises in strategically important sectors.

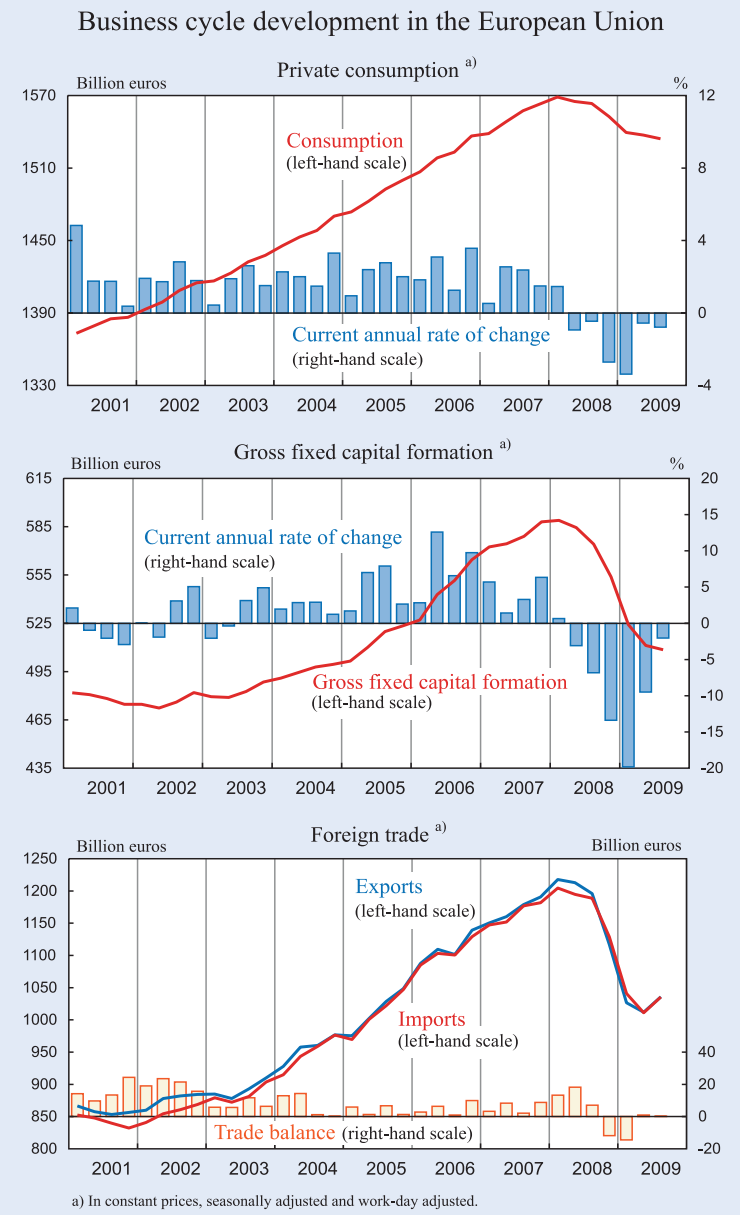
1.1.5 The European economy

After a drop of 5.1 percent from its peak in the first quarter of 2008, GDP in the European Union started to recover during the second half of 2009. Real economic growth reached an annualised 1.0 percent in the third quarter as compared to the second quarter of last year. Nevertheless, private consumption continued to fall and also overall gross fixed capital formation remained on the decline, albeit at a slower pace (see Figure 1.10). Hence, besides government consumption, foreign trade and changes in inventories were able to contribute positively to economic growth (see Figure 1.11).

Due to the unwinding real estate prices, for instance in Ireland, Spain and the United Kingdom, residential investment has been falling sharply since the second quarter of 2008 and has now reached levels last seen in 2002. After a substantial drop in 2008, other construction investments, however, roughly stabilised last year. Since the third quarter, investment in machinery and transport equipment also seems to have stopped falling further and is showing first signs of recovery. Especially, transport equipment has benefited substantially from several stimulus programs of governments throughout Europe.

Both exports and imports plummeted during the winter of 2008/2009. Since the third quarter of last year, both started to pick up again. The trade balance worsened over the course of the year as the fall in exports surpassed those in imports. Hence, net trade contributed negatively to GDP growth. If one views the net demand shock around the world in terms of changes in the trade balance, then it becomes apparent which countries have had a “shock-producing” effect on the rest of the world. Within the euro area,

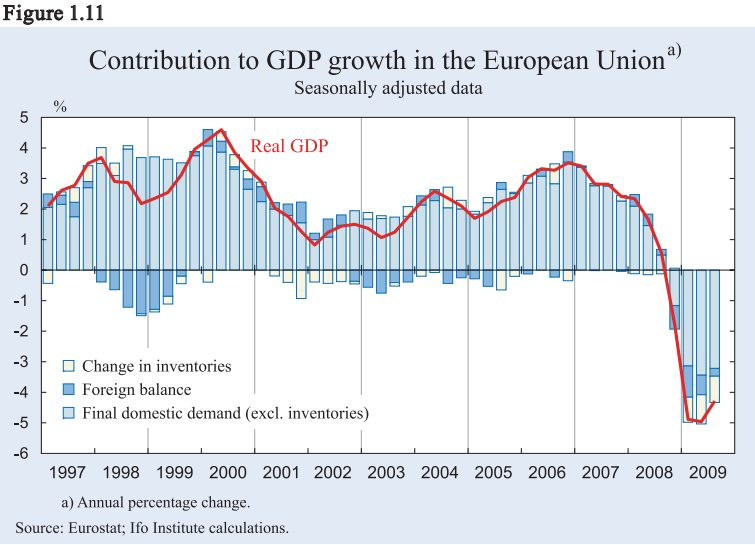
Figure 1.10



a) In constant prices, seasonally adjusted and work-day adjusted.

Sources: Eurostat; Ifo Institute calculations.

Figure 1.11



a) Annual percentage change.

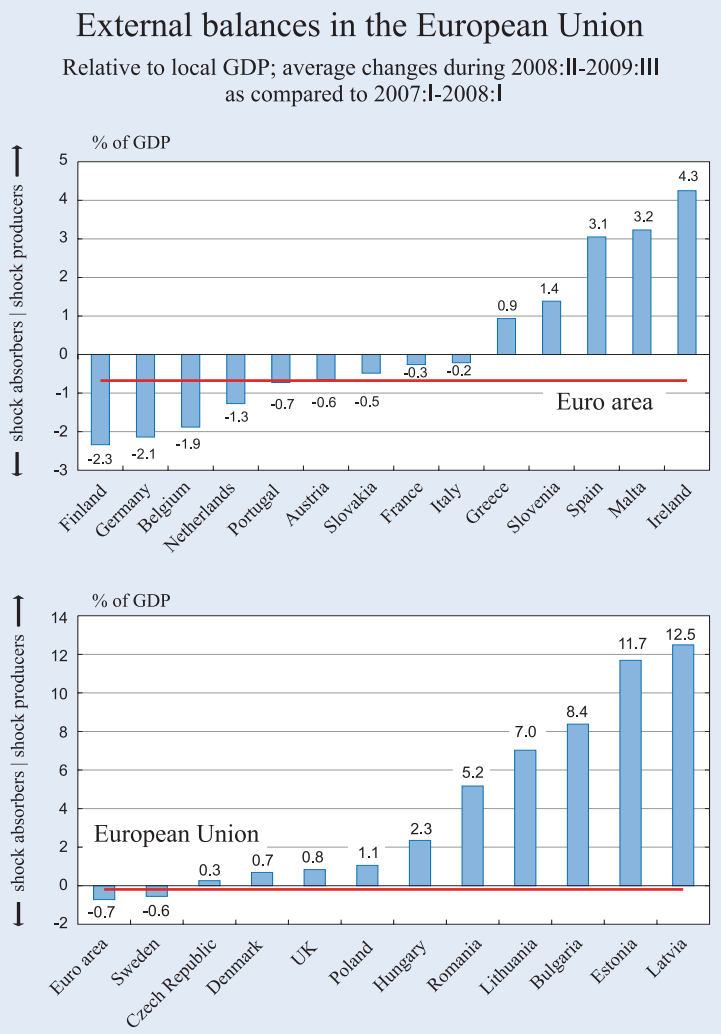
Source: Eurostat; Ifo Institute calculations.

these include above all Spain, Malta and Ireland. By contrast, in Finland, Germany, Belgium and the Netherlands imports have fallen less sharply than exports (see Figure 1.12). This group of countries helped alleviate or absorb the shock within the euro area. This was possible inter alia because these countries did not have to correct a real-estate bubble. With the exception of Slovenia, all East European member countries of the European Union have seen clear improvements in their external balances during the crisis. Especially those countries which kept the exchange rate vis-à-vis the euro stable, i.e. Bulgaria, Estonia, Latvia and Lithuania were also those that experienced the strongest improvement in their external balance. To do this, however, they had to stick to a relatively restrictive monetary policy stance thereby suppressing their domestic economies. As discussed in Chapter 5, this is especially true for Latvia which, on the verge of a balance of payments crisis, has no alternative other than abandoning its peg.

Mainly as a consequence of the drop in oil prices, inflation rates in the European Union fell until summer last year (see Figure 1.13). In the euro area even the price level – as measured by the harmonised index of consumer prices (HICP) – fell slightly between June and October. Although in the last months of the year, inflation picked up again somewhat, core inflation has not yet stopped falling. In November the latter remained at 1.0 percent.

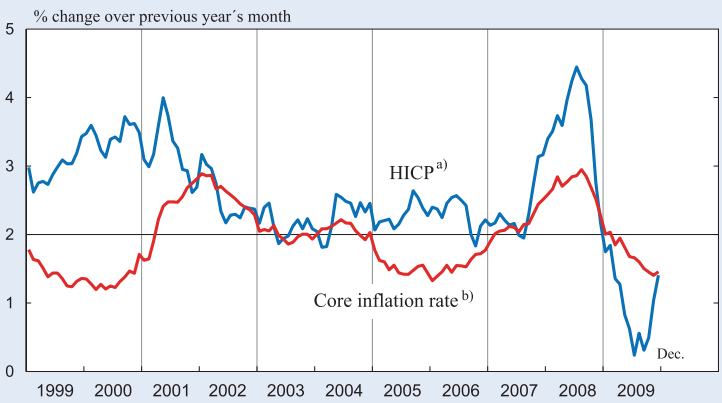
With the sole exception of Poland, all countries went through a deep recession last year, and the

Figure 1.12



Source: Eurostat.

Figure 1.13



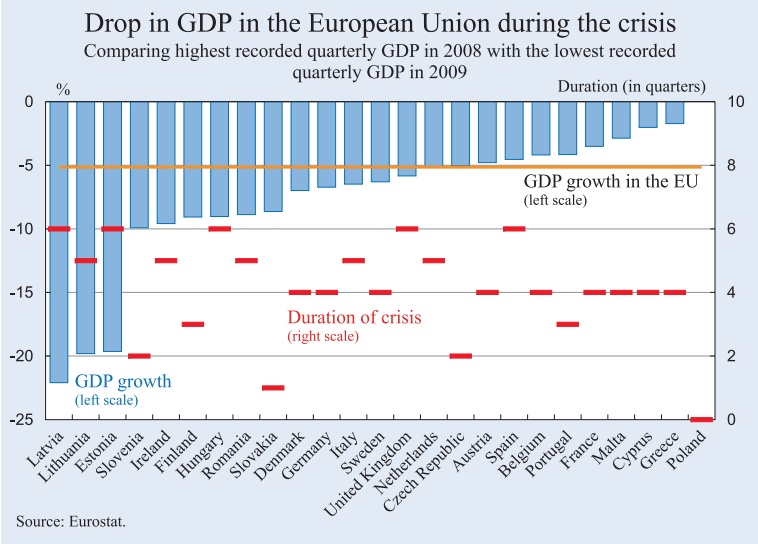
a) Harmonised Index of Consumer Prices.
b) HICP excluding energy and unprocessed food.
Source: Eurostat.

regional differences within the European Union were substantial (see Figure 1.14). A comparison of the peak in the first quarter of 2008 with the trough in the second quarter of 2009 reveals that the European Union – and with it the euro area – contracted by 5.1 percent over a period of five quarters. Especially the three Baltic States – Estonia, Latvia and Lithuania – were hit hard by the economic crisis and saw their GDP dropping by approximately 20 percent. Whereas Lithuania came out of recession in the third quarter of last year, the situation has not yet improved markedly in the other two Baltic States. These economies have already been shrinking for six quarters in a row. The only other central and eastern European member country having such a prolonged recession phase is Hungary.

Of the western and southern European member countries, only Cyprus, Greece, Spain and the United Kingdom were still in recession in the third quarter of last year. All other countries returned to positive growth. For instance, in Austria, Belgium, Germany, Italy and Portugal the turnaround was relatively strong (with annualised quarterly growth rates above 2 percent), whereas Finland, France, Ireland, Malta and the Netherlands were nevertheless able to report annualised growth rates between 1.0 and 1.7 percent.

In *Germany*, the economy stabilised in spring last year. In the second quarter, real GDP expanded by an annualised 1.8 percent, in the third quarter this was even 2.9 percent. On account of the drop during the preceding winter semester of nearly 6 percent, overall economic activity – and in particular that in the export-oriented industries – remained, however, all in all, at a low level. Capacity utilisation in manufacturing is still approximately 10 percentage points below its long-run average.

Figure 1.14



Decisive for the German economic recovery was first of all the improved state of the world economy. German exports, which were especially hard hit by the worldwide drop in confidence and international trade due to Germany's specialisation towards investment goods and durable consumption goods, were able to grow in the second half of 2009. In many of Germany's trading partner countries, expansionary fiscal and monetary policies became effective and inventories were built up again. Secondly, domestic investment – stimulated by fiscal packages directed towards public construction – started to recover. Furthermore, inventory developments gave a strong positive impulse to growth as well. However, private consumption, which was boosted by numerous expansionary stimulus measures during the first half of 2009, declined sharply. As the government subsidies for scrapping older cars stopped, especially car sales dropped. The overall increase in domestic demand was associated with a decline in the external balance. Although exports strongly increased, imports went up even more during the second half of 2009 as a consequence of the inventory impulse. As compared to the first half of last year, GDP managed to increase at a rate of 1.2 percent during the second half. However, and as a consequence of the strong decline during the winter of 2008/2009, GDP still fell by 5.0 percent in 2009 as compared to 2008.

Although the economic crisis has become apparent in the labour market as well, its consequences have, however, remained remarkably moderate. Job losses were above all registered in the manufacturing sector. Important for the moderate decline in employment were the strong expansion of short-time work and the depletion of credits on working hour accounts. In addition, while full-time employment has sunk, part-time employment has increased. In the course of 2009, the average number of working hours sank by 2.2 percent after already having been reduced by a similar order of magnitude in 2008. At the same time – due to a fall in labour productivity – unit labour costs rose sharply (see Table 1.1). The unemployment rate increased somewhat during the first half of 2009. Since July, it seems to have stabilised at 7.6 percent, leading to an average unemployment rate of 7.5 percent in 2009.

Whereas most European economies left the recession behind them in the third quarter of last year, quarterly GDP growth in the *United Kingdom* was still negative. Nevertheless, also here the signs are improving. During the second half of 2009, private consumption and gross fixed capital formation stopped falling and exports started to pick up. Private consumption, which during the first half of last year sank by an annualised 4.8 percent was able to stabilise basically thanks to the UK version of the "Cash for Clunkers" program. However, the increased car purchases led to a quicker increase of imports as compared to exports, which in turn prevented GDP from growing during the second half of last year. Government spending continued to contribute positively to economic growth, albeit at a slower pace.

The economy of *France* expanded with restraint during the second half of last year. GDP rose by an annualised 1.1 percent in the third quarter, after having increased by the same amount the quarter before. Private consumption stagnated and investments kept falling at a higher pace. Although the decline in non-residential investment started to slow down, residential investment continued its descent in an unbroken manner. However, the external balance improved somewhat as exports grew more than imports. In addition, the increase in GDP during the second half of last year was promoted by a further increase in government spending.

During the second half of last year, the *Italian* economy revived unexpectedly strongly. GDP rose in the

Table 1.1

Labour costs

	Compensation per emloyee[a)]		Real compensation costs[b)]		Labour productivity[c)]		Unit labour costs[c)]		Relative unit labour costs[d),e)]		Export performance[f)]	
	2006–08	2009	2006–08	2009	2006–08	2009	2006–08	2009	2006–08	2009	2006–08	2009
Germany	1.5	– 1.1	0.2	– 2.1	1.1	– 4.8	0.4	4.3	– 3.1	1.4	1.4	– 0.5
France	3.0	1.2	0.5	0.2	0.7	– 1.2	2.2	2.5	1.3	– 1.8	– 3.8	1.8
Italy	2.2	– 0.5	– 0.1	– 2.9	– 0.3	– 4.0	3.2	5.2	2.9	10.1	– 4.7	– 7.7
Spain	3.8	3.1	0.5	2.8	0.7	2.9	4.0	1.4	3.4	0.6	– 1.7	– 1.5
Netherlands	3.1	2.5	1.1	2.8	1.0	– 3.4	2.0	6.3	1.0	3.0	– 0.5	4.0
Belgium	3.5	0.0	1.4	– 1.3	0.6	– 2.6	3.0	3.0	1.4	1.5	– 2.3	– 0.9
Austria	3.1	2.6	1.1	1.9	1.2	– 3.8	2.1	5.9	– 1.0	1.8	– 1.6	– 0.3
Greece	4.1	5.1	0.9	3.3	2.2	0.1	3.1	4.9	2.4	0.3	– 2.7	– 2.4
Finland	3.7	2.5	1.5	1.5	1.4	– 4.4	2.4	6.7	– 3.2	7.3	0.3	– 12.0
Ireland	3.9	– 2.7	2.7	1.2	0.4	0.1	3.6	– 2.9	0.1	– 5.1	– 0.3	11.9
Portugal	2.9	3.5	0.2	2.9	0.6	– 0.4	2.5	3.7	– 0.6	– 1.2	– 0.3	– 1.5
Slovak Republic	8.8	3.4	6.5	4.0	5.9	– 3.6	2.1	4.6	7.8	5.9	4.1	– 6.0
Luxembourg	3.0	0.2	– 1.9	1.5	– 0.2	– 4.4	3.5	5.6	6.0	12.7	2.5	1.3
Euro area	2.4	0.8	0.2	– 0.2	0.6	– 2.4	2.1	3.8	0.7	4.4	na	na
United Kingdom	3.5	0.5	0.6	– 0.7	1.2	– 2.6	2.3	3.9	– 1.8	– 9.5	– 2.9	1.8
Sweden	2.6	1.2	0.0	– 1.0	0.7	– 2.4	2.4	4.1	0.1	– 0.8	– 1.1	0.6
Denmark	3.9	4.4	1.2	4.9	– 0.6	– 1.7	4.5	5.5	3.6	1.5	– 1.8	4.2
Poland	4,2	5.2	1.3	1.8	2.1	1.1	4.1	4.1	0.8	– 18.3	2.0	5.8
Czech Republic	6.7	1.5	4.7	– 1.6	3.2	– 2.7	3.0	3.8	4.5	– 2.1	4.5	0.4
Hungary	5.8	5.9	1.2	3.5	2.2	– 2.6	4.5	6.3	1.0	– 5.1	5.2	4.6
United States	3.5	– 0.8	0.7	– 2.1	1.1	1.3	2.6	– 1.1	– 4.5	9.7	0.6	2.6
Japan	– 0.2	– 2.7	0.6	– 2.7	1.1	– 3.6	– 0.2	1.3	– 5.0	8.5	– 0.2	– 15.8

[a)] Compensation per employee in the private sector. – [b)] Compensation per employee deflated by GDP Deflator. – [c)] Total Economy. – [d)] Manufacturing sector. – [e)] Competitiveness– weighted relative unit labour costs in dollar terms. – [f)] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares

Source: OECD Economic Outlook 83 and 84 databases.

third quarter by an annualised 2.4 percent after it had shrunk by an annualised 1.9 percent in the second quarter. The development in industrial production confirms that the Italian economy has surpassed its trough. Besides an improvement in the external balance also increases in private and public consumption contributed to this turnaround. Investments, on the other hand, kept on falling throughout the year. In spite of the improved situation after summer, GDP will shrink on account of the very weak first half of the year and the severe drop in private investments by 4.8 percent in 2009.

Nevertheless, Italy continues to face structural factors which reduce its international competitiveness. Labour productivity declined faster as compared to other euro area member countries. Consequently, unit labour costs rose markedly, reducing the competitiveness of many Italian firms even further.

From the second quarter of 2008 onwards, economic activity in *Spain* has been falling – albeit since the first quarter of 2009 at a reduced pace. The positive impulses set by public consumption and the external balance could still not outweigh the reduction in investments. Private consumption stabilised during the second half of the year.

As measured by labour market developments, Spain numbers amongst those European countries in which the economic crisis has been most painful. This is caused in particular by the breakdown of its real-estate market. The bursting of the real-estate bubble induced above all two negative effects on the Spanish economy. On the one hand, households and firms are confronted with a negative wealth effect which dampens their consumption and investment demand and at the same time limits their access to loans. On the other hand, it led to massive lay-offs in the construction sector. Consequently, unemployment increased from 9 percent in early 2008 to close to 20 percent at the end of last year. This rise in unemployment was furthermore aggravated by rigidities in the labour market. Due to the indexation of many wages, the increased inflation in 2008 has led to upward adjustments of nominal wages, outpacing those in many neighbouring countries. However, nominal wages turned out to be too rigid to be substantially lowered during the crisis. To circumvent a substantial gap between real wage and labour productivity growth, firms were forced to reduce employment more than otherwise would have been the case.

The East European member countries of the European Union were hit hard by the world economic crisis. Over the year, real GDP of the new member countries that are not part of the euro area fell by 3.5 percent (see Table A.2). Although a quick recovery is not in sight, stabilisation tendencies can be observed here as well. For instance, industrial production did not sunk further – or even increased slightly in some countries – during the third quarter of 2009. With respect to investment the rate of decrease is falling. Firm expectations have improved since the beginning of last year in nearly all of these countries, and also consumer confidence has brightened somewhat despite the rise in unemployment. As imports fell more strongly than exports throughout the region, the current account deficits have been reduced quite clearly. After several years of deficits, the Baltic States even registered a current account surplus in 2009. Inflation has strongly decreased in all countries, but is – with 5.6 percent last year – still relatively high in Romania.

1.2 Fiscal and monetary policy in Europe

1.2.1 Fiscal policy

The economic crisis induced governments all over the world to pursue expansionary fiscal policies. While government expenditures rose as a result of the massive economic stimulus packages, government revenues fell on account of the sharp recession, the tax breaks as well as the reduction in employment. Consequently, the public finance situation in the member countries of the European Union has deteriorated sharply. The deficit to GDP ratio has consequently increased from – 2.3 percent in 2008 to – 6.9 percent last year (see Table 1.2).

The current year will be a challenging and decisive year for euro area policy-makers and the euro area economy. Looking back on 2009, solid groundwork was put in place to go forward. The European Economic Recovery Plan (EERP), launched in December 2008, helped cushion the collapse of economic activity. Without the EERP, the contraction of euro area GDP would have been deeper. Designed for a two-year period, it will continue to provide valuable support this year.

Part of the government responses to the crisis are automatic, in the sense that without direct government action revenues fall relative to GDP, e.g. due to the progressive tax system, and expenditures rise, e.g.

Table 1.2

Public finances

	Gross debt[a)]				Fiscal balance[a)]			
	2001–2006	2007	2008	2009	2001–2006	2007	2008	2009
Germany	64.0	65.0	65.9	73.1	– 3.2	0.2	0.0	– 3.4
France	62.3	63.8	67.4	76.1	– 2.9	– 2.7	– 3.4	– 8.3
Italy	105.8	103.5	105.8	114.6	– 3.4	– 1.5	– 2.7	– 5.3
Spain	47.6	36.1	39.7	54.3	0.2	1.9	– 4.1	– 11.2
Netherlands	50.8	45.5	58.2	59.8	– 1.2	0.2	0.7	– 4.7
Belgium	97.0	84.2	89.8	97.2	– 0.4	– 0.2	– 1.2	– 5.9
Austria	65.0	59.5	62.6	69.1	– 1.6	– 0.6	– 0.4	– 4.3
Greece	99.6	95.6	99.2	112.6	– 5.1	– 3.7	– 7.7	– 12.7
Ireland	30.1	25.1	44.1	65.8	1.2	0.3	– 7.2	– 12.5
Finland	42.2	35.2	34.1	41.3	3.5	5.2	4.5	– 2.8
Portugal	58.7	63.6	66.3	77.4	– 3.9	– 2.6	– 2.7	– 8.0
Slovakia	40.1	29.3	27.7	34.6	– 4.4	– 1.9	– 2.3	– 6.3
Slovenia	27.3	23.3	22.5	35.1	– 2.4	0.0	– 1.8	– 6.3
Luxembourg	6.4	6.6	13.5	15.0	1.5	3.7	2.5	– 2.2
Cyprus	66.4	58.3	48.4	53.2	– 3.5	3.4	0.9	– 3.5
Malta	66.3	62.0	63.8	68.5	– 5.3	– 2.2	– 4.7	– 4.5
Euro Area	**68.9**	**66.0**	**69.3**	**78.2**	**– 2.4**	**– 0.6**	**– 2.0**	**– 6.4**
United Kingdom	40.0	44.2	52.0	68.6	– 2.4	– 2.7	– 5.0	– 12.1
Sweden	51.2	40.5	38.0	42.1	0.9	3.8	2.5	– 2.1
Denmark	42.2	26.8	33.5	33.7	2.4	4.5	3.4	– 2.0
Poland	44.6	45.0	47.2	51.7	– 5.0	– 1.9	– 3.6	– 6.4
Czech Republic	28.9	29.0	30.0	36.5	– 4.7	– 0.7	– 2.1	– 6.6
Hungary	58.8	65.9	72.9	79.1	– 7.3	– 5.0	– 3.8	– 4.1
Romania	19.8	12.6	13.6	21.8	– 1.9	– 2.5	– 5.5	– 7.8
Lithuania	20.4	16.9	15.6	29.9	– 1.5	– 1.0	– 3.2	– 9.8
Bulgaria	42.8	18.2	14.1	15.1	1.0	0.1	1.8	– 0.8
Latvia	13.4	9.0	19.5	33.2	– 1.3	– 0.3	– 4.1	– 9.0
Estonia	5.0	3.8	4.6	7.4	1.2	2.6	– 2.7	– 3.0
EU27	**61.5**	**58.7**	**61.5**	**73.0**	**– 2.3**	**– 0.8**	**– 2.3**	**– 6.9**

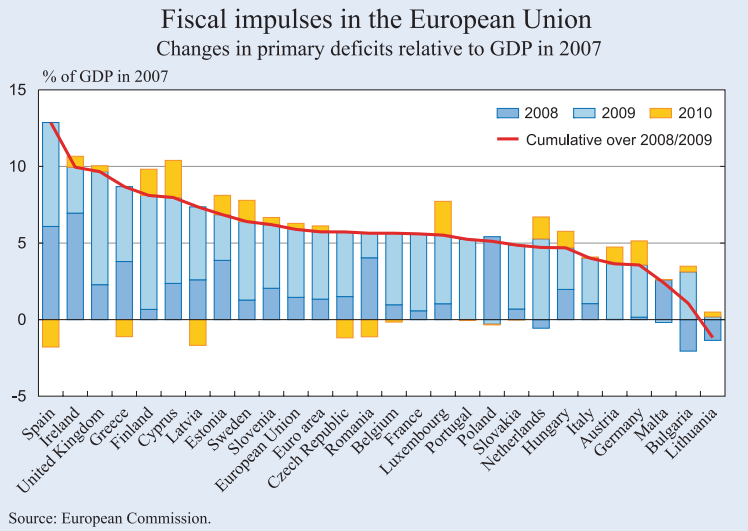
[a)] As a percentage of gross domestic product; definitions according to the Maastricht Treaty.

due to increased unemployment and welfare benefits. The severity of the economic crisis and especially the near meltdown of the financial system in autumn 2008 created a situation in which most governments agreed that it would not be sufficient to rely solely on these so-called automatic stabilisers. However, as the output smoothing capacity of automatic stabilisers varies substantially across countries (see Girouard and André, 2005) – many measures came in the form of guarantees and the actual size of many individual programs are hard to determine – it is quite challenging to come up with comparable estimates of the fiscal impulses given by the public sector during the crisis across countries. A relatively straightforward summary measure, however, is the change in the primary deficit of the general government throughout the crisis. It includes both discretionary measures taken by the general government as well as the automatic stabilisers. Furthermore, as it is generally believed that changes in interest payments by the government do not have a strong impact on the economy and are not intended as such, the primary balance – which excludes these – is likely to be a better measure than the change in the fiscal balance per se.

Compared to their share of pre-crisis GDP (i.e. in 2007), the primary deficit in both the euro area and the European Union increased by 4.4 percentage points in 2009, after already having increased by, respectively, 1.3 and 1.5 percentage points in 2008 (see Figure 1.15). The differences across countries and the two crisis years are substantial. Whereas the governments in Spain and Ireland already stimulated their economies in 2008, those in Finland and the United Kingdom became more active in 2009. In Italy and Germany government actions were – relative to the rest of Europe – more conservative.

Structural deficits – that part of the deficit which cannot be attributed to automatic stabilisers, i.e. the business cycle – also increased substantially around the world. This indicates that to a considerable extent the increase in deficits was induced by discretionary policy. Compared to the US and Japan, its increase in the

Figure 1.15



Source: European Commission.

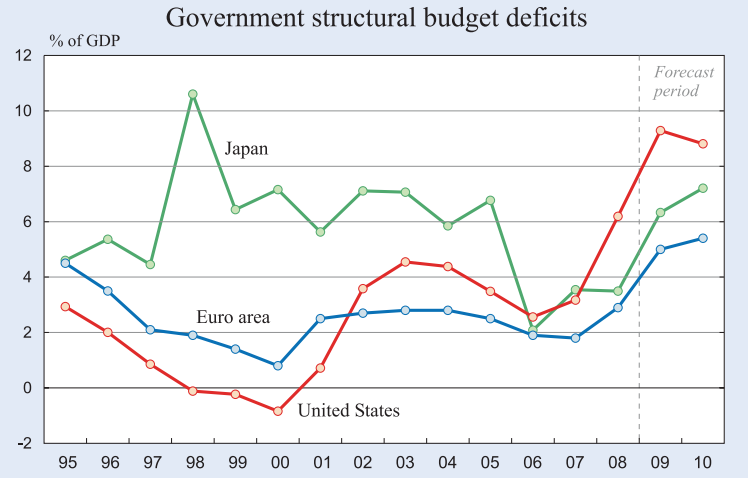
euro area was slightly less dramatic last year. Also for 2010, the increase in the structural deficit in the euro area is expected to be less than in the US and Japan (see Figure 1.16).

The public finance situation will worsen in the years to come. Last year, only Finland and Luxembourg, as members of the European Monetary Union (EMU), managed to keep their deficits below 3 percent of GDP. However, it is to be expected that all EMU member countries will breach this deficit criteria this year. As a consequence the European Commission has opened new deficit procedures against many countries, including Austria, Germany and Italy, while deficit procedures are already running against France, Greece, Ireland, Malta and Spain. Its purpose is to start reducing budget deficits from 2011 onwards and to suppress it below 3 percent of GDP by 2013. Given the weakness of the European economy, it is to be expected that the deficit-to-GDP ratio will reach 7 percent this year (see Table A.3).

The increased indebtness of European governments together with slowly rising interest rates will raise the debt burden. Government interest expenses are bound to rise in the years to come and crowd out other types of government spending. This is already a good reason for governments to prepare and communicate exit and consolidation strategies to return to sound and sustainable public finances again. More importantly, such strategies are needed to strengthen overall macroeconomic stability and to guarantee that any future crisis can again be relieved by appropriate fiscal policy measures.

After several years of consolidation, public finances in *Germany* ran into difficulties in 2009. Whereas the fiscal balance had improved from an average of – 3.2 percent during 2001–2006 to + 0.2 percent in 2007, it is calculated to be – 3.4 percent last year. Mainly due to lower tax receipts, government revenues sank by 2.0 percent in 2009. In addition to the economic crisis, the reduction in tax receipts was also partly caused by the tax revision for firms in 2008. Government expenditures increased by 4.8 percent in 2009. The reasons for this substantial increase are manifold. First, the deterioration of the labour market has led to higher expenditures on unemployment benefits and short-time work. Second, due to new arrangements with hospital and general practitioners, health expenses went up. Third, personnel expenses of the state expanded after substantial wage hikes. Fourth, transfer payments increased substantially, also due to the old-car scrappage program, which has cost the German government approximately 5 billion euros. Finally, triggered by the

Figure 1.16



Source: OECD, Economic Outlook 86, December 2009 and European Economic Forecast, Autumn 2009; 2009 and 2010 OECD forecast for USA and Japan; European Commission forecast for the Euro Area.

economic stimulus packages, public investment increased by 7.5 percent.

The financial situation of the German government is expected to deteriorate further also this year – albeit at a lesser pace. The burden falls on both the income side – as a result of an income tax reform and cyclical reductions in tax revenues – as well as the expenditure side – caused by increased transfers and public investments.

Fiscal policy will start to have a dampening effect on economic development in the *United Kingdom.* The immense increase of the deficit-to-GDP ratio to 12.1 percent last year will force the government to curtail expenditures and raise taxes. Already at the start of this year the temporary reduction of the value added tax from 17.5 percent to 15 percent has ended. This will restrain private consumption at least temporarily.

The public finance situation in *France* has worsened noticeably not only as a result of the massive economic stimulus measures but also on account of the cyclically reduced tax revenues and social security contributions. Furthermore, the cost to support banks has taken its toll. The public deficit rose to 8.3 percent of GDP last year. Although the European Commission has already initiated a deficit procedure for France, concrete consolidation measures have not been decided. The fiscal budgets only indicate a moderate reduction of deficits with the goal of fulfilling the deficit criterion of the European Stability and Growth Pact again by 2013 at the earliest.

On account of an already high debt-to-GDP ratio exceeding 100 percent before the crisis, the Italian government did not have much room to manoeuvre. Accordingly it limited itself to a small economic stimulus package in 2009. Even so, its deficit rose to 5.3 percent of GDP last year. In the absence of clear consolidation plans by the Italian government, the European Commission decided in November last year to open a deficit procedure against Italy. The public deficit should be reduced to less than 3 percent of GDP by 2012 at the latest. The required reforms will dampen the economic recovery in the years to come.

The tense economic situation and the large-scale stimulus programs initiated by the government have worsened the fiscal position of Spain dramatically. A deficit of 11.2 percent of GDP resulted in 2009. Induced by the deficit procedure initiated by the European Commission, the Spanish government decided to begin with the necessary consolidation of its finances already in 2010. In September last year, Spain presented a package of tax increases which will amount to 1.1 percent of its GDP. It contains the cancelation of various tax breaks, the increase of the value added tax by two percentage points to 18 percent, as well as a rise in capital income taxes. In spite of these restrictive measures, the economic situation will not allow the deficit-to-GDP ratio to fall substantially anytime soon.

1.2.2 Monetary conditions and financial markets

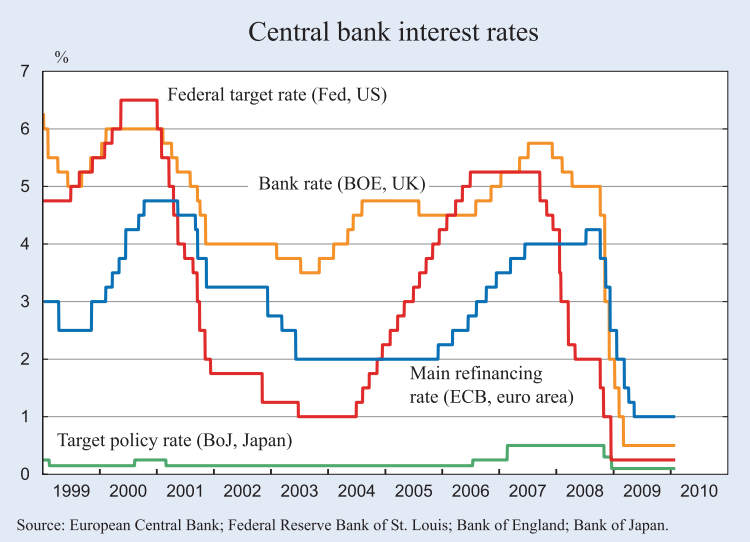
Monetary conditions

After September 2008, monetary policy in the western world was first of all directed towards securing the refinancing of private banks. After the bankruptcy of Lehman Brothers, trust in especially the banking system was devastated and only cutting interest rates would not have been sufficient to prevent a meltdown of the financial system as we know it. Hence, a series of unconventional measures were undertaken which basically implied that central banks turned into the main providers of liquidity on interbank markets.

Whereas the Federal Reserve and the Bank of England cut their key policy rates from 2.0 and 5.0 percent to 0.25 and 0.5 percent, respectively, since October 2008, the ECB reduced it from 4.25 percent to 1.0 percent in May 2009 (see Figure 1.17). More importantly, all three introduced non-standard measures to combat the crisis. For instance, the ECB embarked on a policy of fully accommodating banks' liquidity and extended the range of open market operations to include euro operations with maturities of one month, six months and one year, as well as operations providing US dollar and Swiss franc liquidity. In addition, the ECB has started purchasing euro-denominated covered bonds in July last year – a program which is targeted to buy up to 60 billion euros by June 2010.

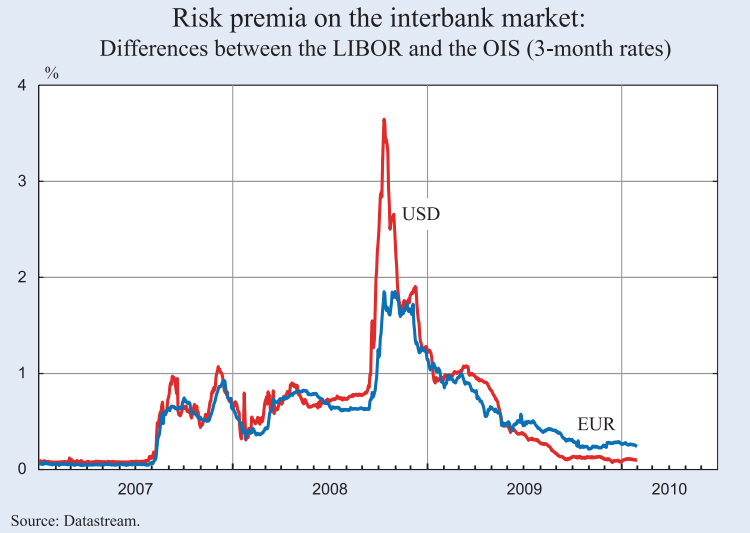
As a consequence, the average maturity of these credits to the banking system increased further and the share of the once "main" refinancing operations with a maturity of one week only reached 8 percent in November of last year. This caused the overnight interbank rate to be, on average, only 0.4 percent and hence substantially below the interest rates to be paid

Figure 1.17



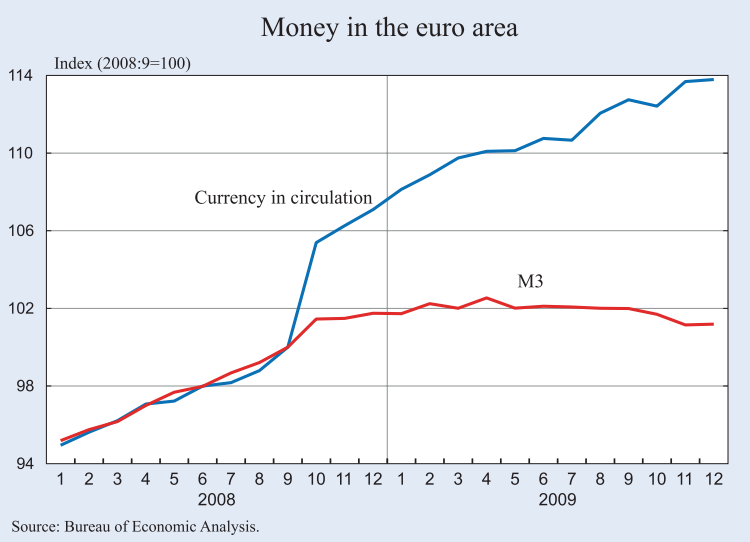
Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan.

Figure 1.18



Source: Datastream.

Figure 1.19



Source: Bureau of Economic Analysis.

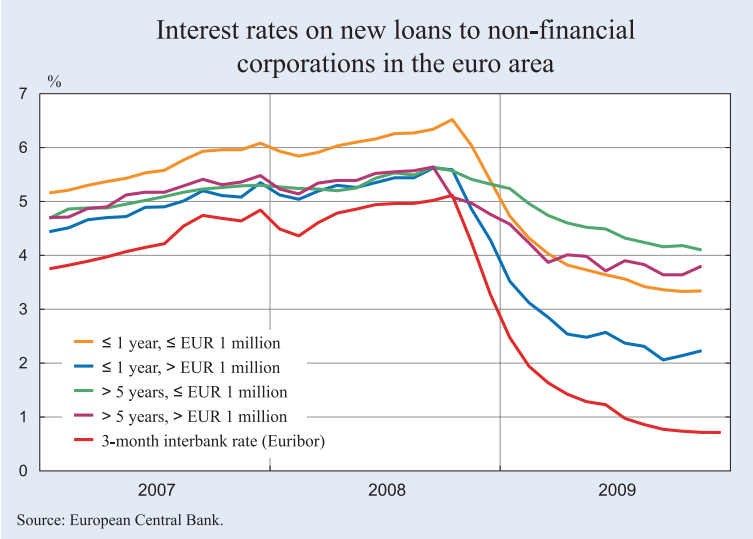
to the ECB for its open market operations. Also the 3-month unsecured interbank rate (Euribor) decreased substantially throughout the year and reached an average of 0.7 percent during the last two months of 2009. Furthermore, these unconventional measures were successful in steadily bringing back the risk premium in the interbank markets for unsecured money to close to pre-crisis levels (see Figure 1.18).

The unconventional measures have not only caused central banks' balance sheet to blow up since the start of the crisis, but the narrowly defined concepts of money, which are under close control by the central banks, have also been expanded substantially. In the euro area, the narrowest concept of money, i.e. currency in circulation, went up by closed to 14 percent since September 2008 (see Figure 1.19). Similarly, the monetary aggregate M1 grew by over 15 percent over the same period. A look, however, at broader concepts of money, which stress the role of the banking sector in the money creation process, gives a completely different picture. Since October 2008 there has practically been no movement in the most commonly used money supply measure, M3. In a year-on-year comparison, M3 shrank by 0.6 percent in December last year. Hence, although the ECB has provided the banking sector with ample liquidity to circumvent further problems within that sector, this additional liquidity has not been fully passed on to the private economy but merely prevented M3 from falling. This is not only observed in the euro area and can explain why central banks all over the world have changed their focus

slowly away from rescuing the banking sector towards securing credit supply to non-financial corporations and households over time.

The lowering of interest rates by the ECB has also been reflected in falling lending rates for the non-financial sector. Until November last year the decline of the 3-month interbank rate, as measure of the refinancing costs of banks, since its peak in October 2008 equalled 440 basis points. For large loans, i.e. those above 1 million euros, with a maturity up to one year more than 80 percent of this was transmitted to the firms (see Figure 1.20). On the other hand, the interest rates on long-term loans and especially those below 1 million euros remained relatively stable – only a third of the reduced refinancing costs were transmitted. To a large extent this reflects that the present expansionary monetary policy stance is not expected to last forever. Obviously, however, this is also raising the profitability of credit business of banks, at least in the short term.

Figure 1.20



Despite these interest rate developments, credit volumes to the non-financial sector have not been able to pick up (see Figure 1.21). Whereas credit to households started stagnating in mid-2008, corporate credits have been falling since early 2009. The annual growth rate of the latter was – 2.7 percent in December last year. From May 2009 onwards household loans to finance house purchases are picking up again slightly. Mortgage loans were 1.7 percent higher last December as compared to the year before.

This indicates that it continues to be more difficult to acquire bank credits than it was before the crisis started. However, in both the US and the euro area, it has so far been difficult to find clear evidence in favour of an already existing credit crunch, in the sense that due to own balance sheet problems banks are reluctant to supply new credits to healthy firms coming up with solid business plans. It still appears to be the case that – due to the loss in confidence and a general decline in demand for goods and services – the demand for credit has simply fallen. This is also reflected by the results of the business tendency surveys published by the European Commission. While the percentage of firms reporting that financial constraints are limiting their production possibilities has somewhat increased from 3.3 and 4.0 percent in the second quarter of 2008 to 4.9 and 4.4 percent at the end of last year, respectively, the percentage of firms in the manufacturing and construction sectors reporting that the lack of demand was causing them problems increased by 32.6 and 17.3 percentage points during the same period, respectively (see Figure 1.22).

Figure 1.21

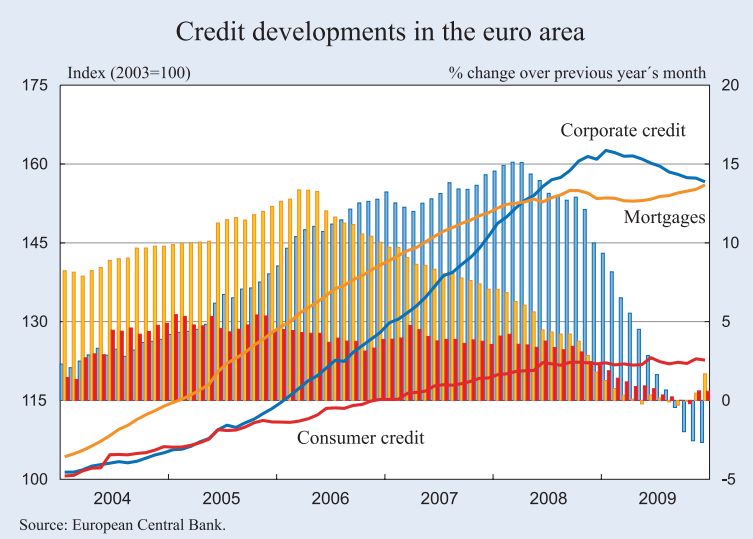
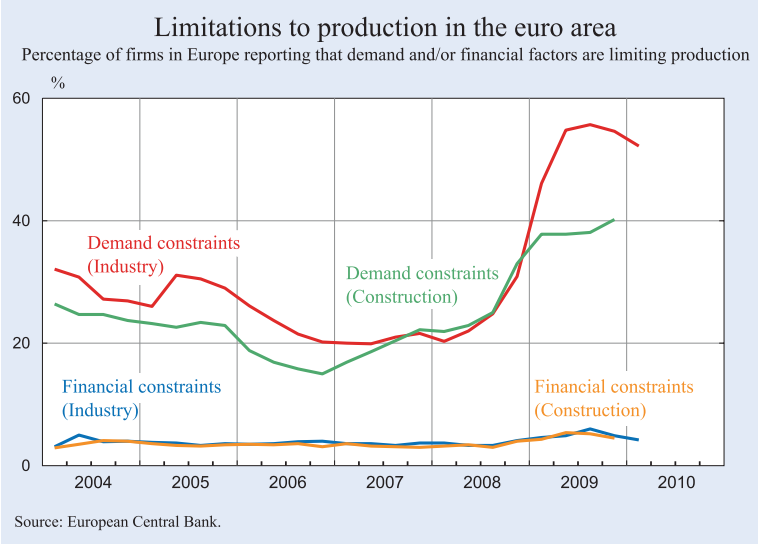


Figure 1.22



However, demand is slowly starting to pick up again and firms might soon be willing to invest in the future again. Consequently, the still prevailing problems within the banking sector might soon reveal that the banks' willingness to supply credits is indeed strongly hampered. That would restrain a swift recovery and therefore it is certainly something to worry about in the time to come. A sudden introduction of increased capital requirements for banks, which is certainly needed in the medium term to avoid similar banking crises in the future, could further hinder the credit supply by banks.

In Germany it appears that especially larger firms are already confronted with rather restrictive behaviour of banks (see Box 1.1). Not only have interest rates on large new loans been falling less than in other euro area countries, also a unique business tendency survey in which firms are directly asked about the willingness of banks to supply them with credit suggests that

Box 1.1

Is there a credit crunch in Germany?

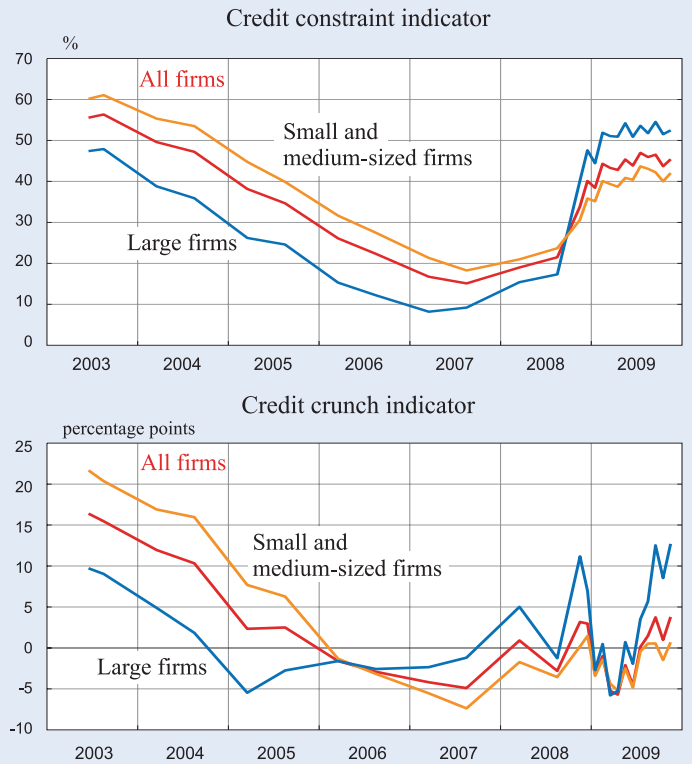
Since the outbreak of the financial crisis and in particular since the bankruptcy of Lehman Brothers, the share of firms in the German manufacturing sector that have indicated a restrictive willingness of banks to lend steadily increased from 15 percent to about 45 percent (see Figure 1.23). These results of the so-called credit constraint indicator are based on approximately 2,300 responses to a monthly survey conducted by the Ifo Institute for Economic Research. The firms are asked to provide information on banks' credit supply conditions by responding to the following question: "How would you assess the current willingness of banks to extend credit to businesses"? The answers to choose from are "accommodating", "normal" and "restrictive". While in regular times large firms typically have better access to credit, one of the characteristics of the current financial crisis is that in particular these firms, at least in Germany, are more credit constrained than small and medium-sized firms.

A tightening of the banks' credit supply conditions in an economic downturn is nothing unusual, however. In order to identify a credit crunch, which is commonly defined "as a significant leftward shift in the supply curve for loans" (Bernanke and Lown, 1991), we need to adjust the survey responses for the regular determinants of the supply curve, in particular "the safe real interest rate and the quality of potential borrowers" (ibid.). Using a conditional fixed-effects logistic model where the dependent variable is a binary choice variable, which measures the firms' perception of the banks' credit conditions, Düwel et al. (2010) estimate a credit crunch indicator in a two-step procedure.

In a first step they regress the response to the credit question on a set of both firm-specific and macroeconomic variables. The firm-specific variables, which are also taken from the monthly Ifo survey, are used as proxies for the quality of a firm. They measure the firms' current state of business and its current volume of orders in hand. The macroeconomic variables measure the overall economic activity and the banks' refinancing costs. In a second step, they replace the macroeconomic variables by T-1 time dummies, where T is the number of surveys between June 2003 (when the credit question was first asked) and November 2009. The idea is that the time dummies capture both types of variations of banks' lending practices over time: the macro factors (overall economic activity and banks' refinancing costs) and some remaining factors, which are qualified as bank-specific determinants of credit supply. Finally, a credit crunch indicator is generated which takes that part of the (leftward) shifts in the credit supply curve that are neither explained by firm-specific nor macroeconomic factors and, hence, are likely to be caused by bank-specific factors. Technically, the credit crunch indicator is calculated as the difference between the predicted probabilities of a restrictive credit supply policy for high-quality firms (i.e. for firms which assess their current business situation as "good" and their volume of orders as "relatively high") of the second and the first step of the regression.

At the end of 2008 and early 2009 government intervention, like the massive public sector equity support to banks, was initially able to reduce the probability of a restrictive access to credit for high-quality firms in Germany. However, the credit crunch indicator has been steadily rising since. It changed from negative to positive mid-2009 and reached a value of +4 percentage points by the end of the year. In a historical perspective this is still to be considered low. However, across firm size substantial differences emerge. Given the massive deterioration of the firms' quality during the recession and the evolution of the macroeconomic determinants of credit supply, the situation for small and medium-sized firms turns out to be "normal". On the other hand, the restrictive stance of the banks' lending practices has reached unprecedented levels and is as such perceived to be high by large firms.

Figure 1.23



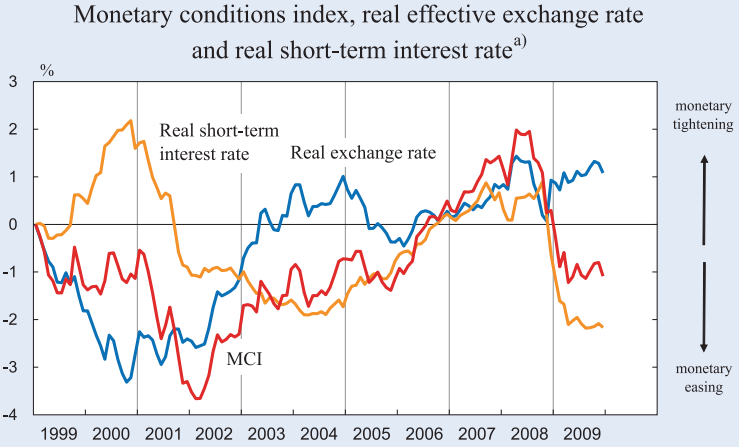
Notes: The credit constraint indicator measures the share of firms in the German manufacturing sector (in percent) indicating a restrictive willingness of banks to lend. The credit crunch indicator measures the contribution (in percentage points) of bank specific factors to the probability of a restrictive credit supply policy for high-quality firms. Large firms have more than 250 employees.

Source: Düwel et al. (2010); Ifo Business Survey.

especially the bigger firms have increasingly had problems acquiring new loans. The reduction in business activity of major foreign banks from Germany, which maintained above all relationships with these larger firms, can explain why these firms face such problems. Roughly half of the decline in credit to the manufacturing sector during the third quarter of last year can be explained by the pullback of foreign banks.

Although nominal interest rates continued to fall last year, this does not automatically imply that the overall monetary conditions have improved. Not only credit supply behaviour of banks matter in that respect, also inflation and exchange rate developments are important to determine the monetary conditions in the euro area. Whereas inflation rates fell, limiting the reduction in real interest rates, the euro continued to appreciate in real effective terms. All in all, monetary conditions as measured by the weighted average of the real short-term interest rate and the real effective exchange rate remained relatively constant and still slightly above its long-run average throughout last year (see Figure 1.24).

Figure 1.24



a) MCI index is calculated as a weighted average of real short-term interest rates (nominal rate minus core HCPI inflation rate) and the real effective exchange rate of the euro.

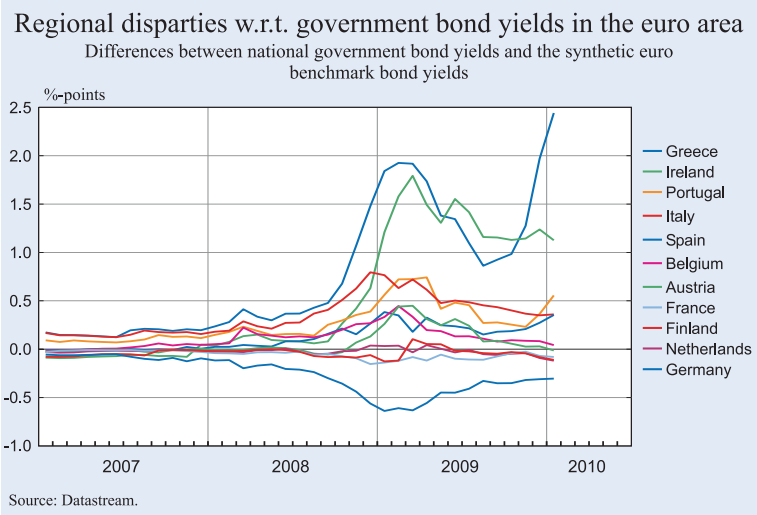
Source: European Central Bank, Ifo Institute calculations.

The ECB will leave its main refinancing rate at its low level this year. However, the ECB has already announced that it will move successively away from its policy of providing unlimited liquidity and repurchasing arrangements with longer maturities. Therefore, money market interest will start rising and thereby approach the main refinancing rate of 1 percent during the year. Given the large output gap and the extremely modest inflation developments, the ECB will not start increasing its own interest rates at least until the end of 2010.

Also the Bank of England will stick to its accommodative monetary policy stance. Not only inter-

est rates are low, also the British pound has depreciated substantially against the euro since the start of the crisis and has not recovered from it since. The Bank of England left its bank rate at 0.5 percent and once more increased the size of its program to buy government bonds by 25 billion UK pounds to 200 billion UK pounds in November last year.

Figure 1.26



Source: Datastream.

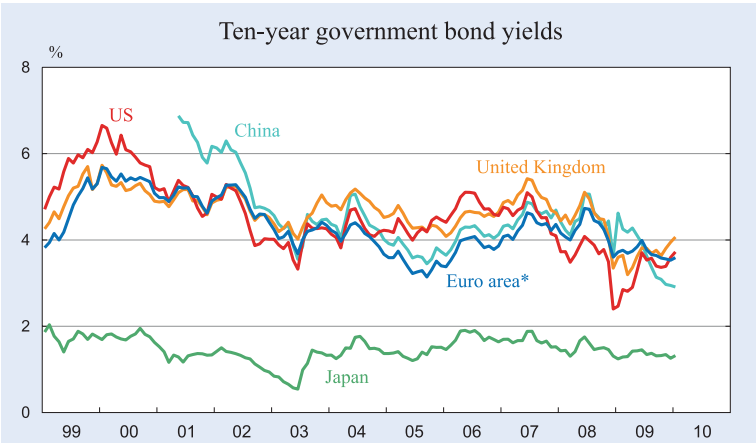
Bonds, stocks and foreign exchange markets

At the peak of the economic crisis the flight to quality lowered government bond yields of the US, Japan and large European economies substantially. Throughout the first half of last year, as confidence picked up again, this process was at least initially reversed. Only in China did government bond yields continue to fall almost consistently since early 2009. Comparing the yield level at the end of 2009 with one year before reveals a decrease of close to 70 basis points for China, whereas during the same period in the US yields increased by almost 120 basis points. In Japan and in the euro area, levels have not changed much (see Figure 1.25).

The surge towards safe assets caused higher risk premia on corporate bonds and government bonds of smaller economies during the crisis months. The reversal has occurred since spring last year. The yields on corporate bonds have fallen due in particular to a decline in risk premia. Yields on corporate bonds of the highest quality (AAA) and a maturity of two years have in the euro area decreased by approximately 100 basis points since early 2009; those with BBB ratings saw a decline of about 250 basis points in yields.

With respect to government bonds, the only exception of the above-described pattern is Greece. The spread between its government bonds and the synthetic (i.e. its weighted average) government bond for the euro area reveals that since the end of summer the default risk of the Greek government has risen sharply again. In January this year, its government bond yield was almost 245 and 275 basis points above those for the euro area and Germany, respectively (see Figure 1.26). With a fiscal deficit of 12.7 percent – the highest in the European Union – and a debt level of well above 110 percent of its GDP last year (with the prospect of reaching the highest level within the European Union here as well), financial markets do not consider public finances in Greece to be sustainable anymore.[3]

Figure 1.25

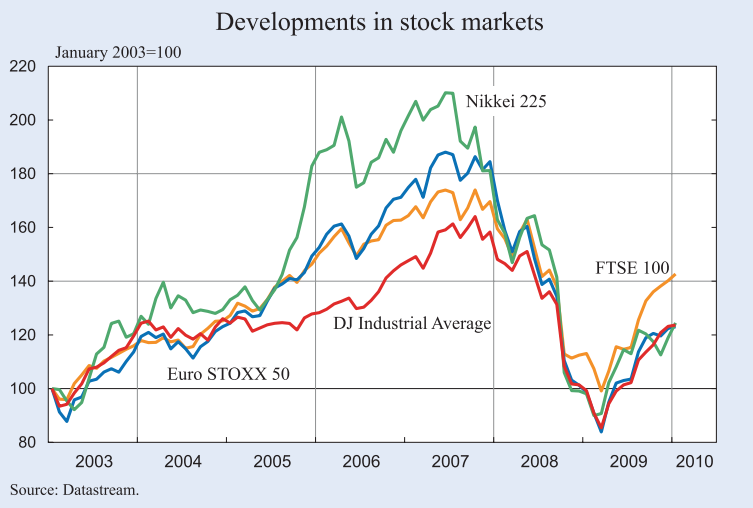


* The synthetic Euro benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream.

Another positive influence on the financial conditions for especially larger firms has been the increase in stock market prices in early spring last year. Also due to the low interest rate environment, by the end of last year, the Euro

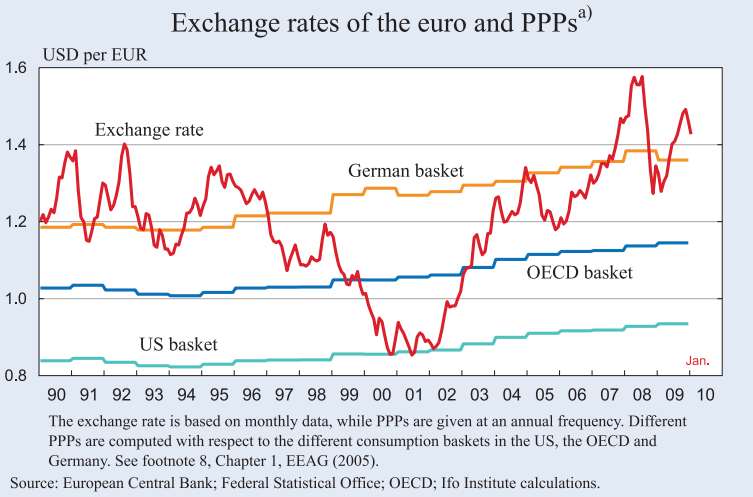
[3] See Chapter 5 for more discussion on this issue.

Figure 1.27



Source: Datastream.

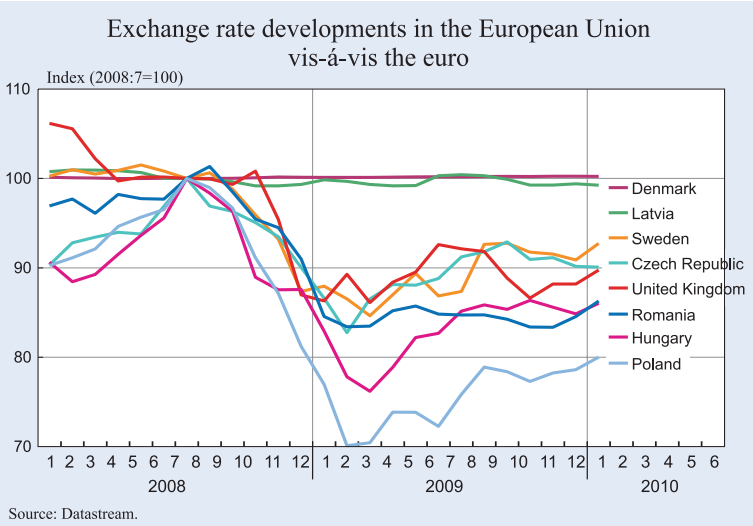
Figure 1.28



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

Source: European Central Bank; Federal Statistical Office; OECD; Ifo Institute calculations.

Figure 1.29



Source: Datastream.

STOXX 50 improved by 47 percent since its trough in March and has reduced its gap to its highest level reached in June 2007 to 35 percent (see Figure 1.27). Comparing the peak and trough reveals that during the crisis a drop of 55 percent occurred. Similar figures hold for basically all major stock market indexes around the world. After having experienced a drop of 50 percent during the crisis, they have all gained about 40 percent by the end of last year, thereby reducing the fall to approximately 30 percent. Furthermore, overall volatility in stock markets – as for example measured by the implied volatility on the S&P 100 and which has become known as the financial "fear factor" – has decreased substantially.[4]

Not only were bond and stock markets in turmoil during the crisis, but also exchange rates were quite volatile during that period. Whereas the euro sharply depreciated against the US dollar during the crisis, it regained much of its strength again during the course of last year (see Figure 1.28). The historically strong euro is reducing international competitiveness of its member countries and shifting at least part of the burden of the economic crisis on to euro area.

Also within Europe exchange rates moved quite a bit during the year. The depreciation of the currencies of EU member countries against the euro has helped cushion the crisis in those economies. The currencies which had clearly given way during the crisis, i.e. the Czech crown, Hungarian forint, Polish zloty, Romanian leu, and the UK pound, partly made up for their losses during spring and summer last year (see Figure 1.29). Still all of them remain at values below those observed shortly before the crisis. On the one hand, this will

[4] See Bloom and Floetotto (2009) and http://www.stanford.edu/~nbloom/ on this.

benefit their competitiveness. On the other hand, for the eastern European countries, whose debt is largely denominated in euros, it also implies a higher foreign debt burden.

1.3 The macroeconomic outlook

1.3.1 The global economy

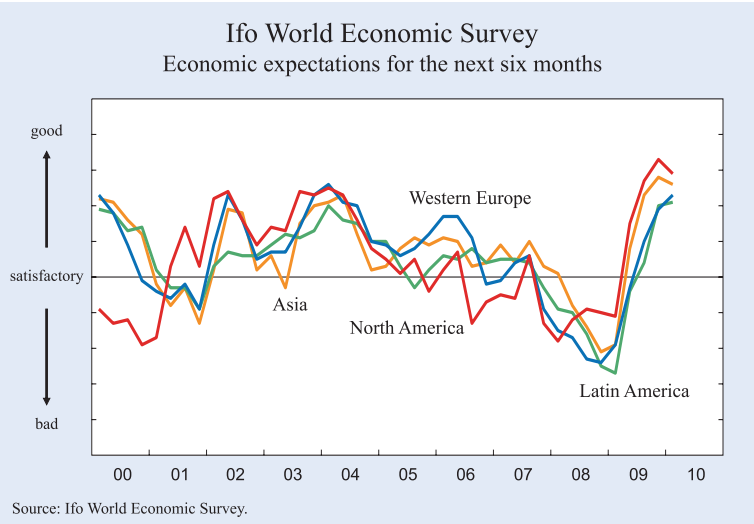
In the course of 2009, most countries in the world moved out of recession or at least witnessed a stabilisation of their economies. Coming from mostly historical lows, expectations of the Ifo World Economic Survey have skyrocketed in all major regions of the world economy and even reached a historical high in Asia (see Figure 1.30). Given the tremendous fall – which can only be partly reflected in these kinds of surveys due to the bounded nature of the answering categories – many participating experts have realised that their economies have hit rock-bottom and that factually anything else than an improvement of the situation is becoming more and more unrealistic. Furthermore, it is likely that they have also updated their beliefs about what could be the worst state of the world. Hence, given the relative nature of these survey questions and the changed focal point, one has to be careful not to draw too strong conclusions from them in the present situation. Nevertheless, it is safe to say that experts around the world increasingly tend to agree that the economic recovery will continue in the months to come.

Although not all problems have been solved, the uncertainty concerning future business cycle developments has diminished – although remaining high in an historical perspective – and the sales prospects of many firms have improved, however, after often having reached historical lows. The huge fiscal stimulus measures and expansionary monetary policy stance have prevented an even worse outcome. Industrial production has started its recovery after its sharp fall and also the normalisation of world trade is underway. The latter is also due to the improved trade finance possibilities which were severely constrained during the crisis.

However, the world economic recovery will only temporarily turn out to be stronger than in autumn last year. Structural problems, which suppress economic growth, continue to be large. For instance, credit supply of banks will remain restrictive. A credit crunch in the light of the increased demand for external funds is becoming more likely. However, the strong under utilisation of production capacities will continue and thereby keep the demand for net investments comparatively low. Furthermore, the labour market situation will not only remain depressed, but will slightly deteriorate further, dampening private consumption.

Furthermore, uncertainties, mistrust and panic-stricken reactions all around the world during the peak of the crisis have triggered a general de-leveraging process throughout the economy and have led to a surge in liquidity demand.[5] To generate liquidity, many firms were forced to reduce inventories substantially. Stabilisation also implies that this process of reducing inventories has been stopped and for the time-being even reversed. Such inventory cycles, however, are generally not long-lived and the currently observed positive impulses are bound to end anytime soon.

Figure 1.30



Source: Ifo World Economic Survey.

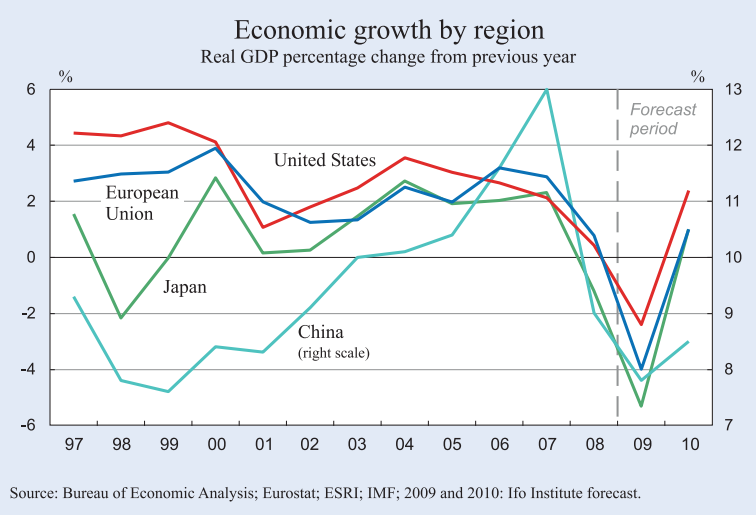
Finally, policy impulses, i.e. additional policy measures, which so far have not only stabilised but also revived the world economy, will become weaker during our forecasting horizon. Especially fiscal policy stimulus will fade and even turn negative. The fiscal balance situation in most countries has worsened dramatically and will continue to do so in the years to come. If they have not already done so, governments must inevitably develop strategies

[5] Chapter 2 discusses in more detail the role trust plays in financial markets.

to reduce fiscal deficits and subsequently implement them. This will retard the recovery process further. Hence, the world economy will start lose momentum during 2010.

After an unprecedented drop since World War II of minus 2.3 percent last year, we expect world GDP to increase by 2.5 percent in 2010. Hence, world economic growth will stay below its long-run average.[6] Combined with a usual increase in labour supply and further technological progress, this will not prevent unemployment rates from continuing to rise. Inflation will accelerate somewhat, but also stay well below its long-run average.

Figure 1.32



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

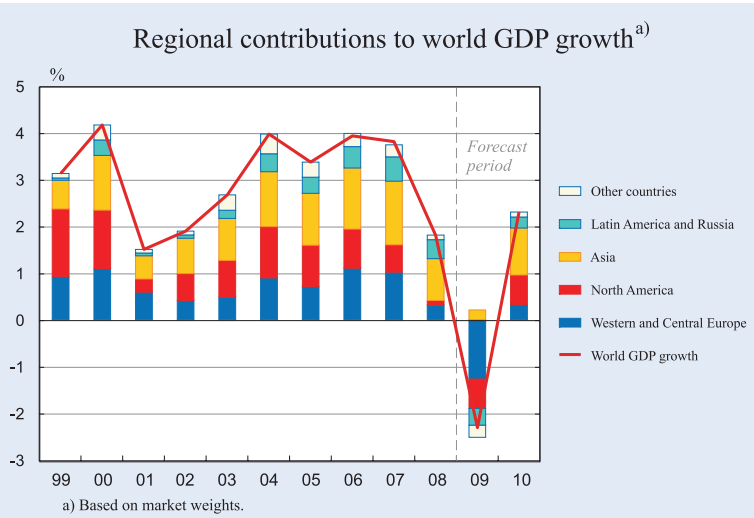
Despite the economic crisis in Japan, the only region that still managed to contribute to economic growth positively last year was Asia (see Figure 1.31). Its growth contribution this year will reach almost pre-crisis levels again. The two regions that remain well-below their potential are North America and Europe. Of the four major regions in the world, it is evident that none of them will reach pre-crisis levels again this year (see Figure 1.32).

1.3.2 United States

Although the recession has ended, the US economy still has to conquer its structural problems. US consumers have been living beyond their means for too long. To allow for a way back to sustainable growth, US consumers are in a process of curtailing their consumption. This process has already set in but needs to continue during our forecasting horizon. However, it should ultimately not be compensated for by an increase in public deficits – as presently is the case.[7] Furthermore, although the worse seems to be over for the banking industry, a continuation of write-offs – as predicted by the IMF (2009) – is highly likely and government interference in the banking and real estate sectors will consequently remain high. On top of that – and as discussed in more detail in Chapter 3 – fiscal sustainability is a new issue that will stay on the agenda for the years to come.

The fiscal stimulus package will unfold its biggest influence on the deficit in fiscal 2010 when about 400 billion US dollars of the estimated 787 billion US dollars becomes effective. On top of that, rising social expenses, particularly in areas related to the labour market and the health sector, will hardly result in a lowering of the budget deficit in fiscal 2010 despite the reduction in expenses related to banking sector. Therefore, the debt-to-GDP ratio will surpass 90 percent this year. This will further limit the

Figure 1.31



a) Based on market weights.

Source: IMF; calculations by the EEAG; 2009 and 2010: forecast by the EEAG.

[6] This figure is based on market prices. If instead purchasing-power-parity adjusted weights were used – and therefore emerging markets would receive higher weights – our growth forecasts would be 3.2 percent in 2010 (see Figure 1.2).
[7] See Chapter 4 on this.

room for manoeuvre of the US government in the years to come.

Many banks are still not willing to add mortgage loans onto their own balance sheets. Consequently, approximately 95 percent of all new mortgage loans are currently issued and securitised by the government supported enterprises, Fannie Mae, Freddie Mac and Ginnie Mae. These mortgage-backed securities are mainly bought by the Federal Reserve. Hence, terminating this kind of monetary assistance – as scheduled for the first quarter this year – will put a substantial burden on the mortgage market. Besides increases in mortgage interest rates and a further rationing of mortgage supply, it is quite possible that this will trigger further reductions in real estate prices. Also to alleviate this, the Federal Reserve will continue its zero-interest rate policy throughout this year.

Although monthly data on private consumption give a relatively upbeat impression of the fourth quarter of last year, consumer sentiment surveys, on the other hand, indicate that consumer confidence remains low. In particular, the persistently tense labour market situation is responsible for this. The sharp rise in unemployment is increasingly restraining income developments of households. The increase in nominal wages has already slowed down noticeably and real wages will be under pressure more and more especially now that the negative base effect on inflation caused by the drop in energy prices last year has ended. Due to falling interest and dividend income, real disposable income – the most important determinant of private consumption – already fell during the third quarter of last year.

Reducing the indebtedness of households will increasingly restrain consumption. Saving rates have already increased from approximately 1 percent in early 2008 to around 4.5 percent at the end of last year. This process is likely to continue as is also shown by reduced lending to households, in particular with respect to credit card loans. Consumer loans have already sunk nine months in a row up until October last year. With the expiration of state support in the course of 2010, private consumption will hardly expand anymore.

Investment will stop declining. Although the situation on the real-estate market remains fragile, residential construction already stopped falling during the second half of last year. More stable business conditions will induce the same with respect to non-residential construction investments and investments in equipment and software. Credit constraints and subdued domestic developments will prevent fixed capital formation from taking a lead in the US recovery.

Although both exports and imports will continue to grow, the weak dollar and the constraints on domestic demand will allow net exports to contribute positively to economic growth. Consequently, the current account deficit will continue to be reduced – albeit at a slower pace than last year.

Driven by extensive monetary and fiscal policy as well as cyclically-determined inventory investments, overall production will still noticeably expand during this winter half-year. However, as the impact of these supportive elements will weaken and the heavy burdens on private consumption will remain, GDP growth will lose its momentum. After a decline of 2.6 percent last year, GDP will expand by 1.9 percent this year. The unemployment rate will reach an average of 9.5 percent this year.

After the recession and the fall in energy prices caused inflation in the US to even turn negative last year, consumer prices will start to increase again at very moderate rates. For this year, we expect annual inflation to equal 1.6 percent.

1.3.3 Japan, China, India and other Asian countries

Although *Japan* will continue its recovery in the short run, the medium-term expectations are quite bleak. Whereas both private consumption and exports allowed for relatively positive developments during the last three quarters of 2009, it is to be expected that only the latter will remain the main driver of growth this year. The Japanese export economy benefits from its geographical proximity to Asian emerging markets, which are experiencing a surge in domestic demand.

Especially the slack in private consumption will suppress the domestic economy. As most of the consumption-oriented stimulus packages are expected to be phased out in the first half of 2010, a setback in consumption growth is likely. With the prolonged duration of the under-utilisation of production capacities, both employment and wages are expected to decrease. Furthermore, the persistent deflation will attenuate private demand. Although exports will remain the main pillar for economic growth based on the surge in demand from China, the strong yen –

reaching a 14-year peak against the US dollar at the end of November last year – will nevertheless restrain the export-dependent Japanese economy.

The Japanese authorities take these risks seriously and have – contrary to other governments in the Asian region – initiated new measures to stimulate the economy. At the beginning of December last year, the Japanese government launched an additional stimulus package of 7.2 trillion yen (54 billion euros) directed towards domestic demand to prevent the menacing drop in consumption. The Bank of Japan has announced intentions to stick to its low-interest rate policy for the time being and has once again provided liquidity of more than 10 trillion yen (76 billion euros) to the banking sector to boost credit supply.

Consequently, these measures will further increase public deficit and debt as a percentage of GDP this year. The latter will surely surpass 200 percent this year. Although the public finance situation is unlikely to be sustainable in the long run, the situation in Japan is – in an international comparison – quite unique. Although the public sector has been dissaving for decades, the savings rate of the private sector more than compensates for this. Japan for years has already been a net creditor to the rest of the world. Hence, it has at least thus far been relatively easy for the Japanese government to finance its debt domestically at low cost – the 10-year government bond yield hovers at around 1.3 percent presently. Approximately 90 percent of Japanese government debt is owned by Japanese individuals.

In 2010, the positive impulses from the world economy, and in particular from China, will prevail over the domestic problems. All in all, economic growth will amount to 1.0 percent (after – 5.3 percent last year).

The short-term economic prospects for China remain quite positive. This can especially be traced back to government policy which succeeded – with a massive stimulus program – in strengthening its economy without relying on outside impulses. The program is scheduled to run out by the middle of this year and will not be fully compensated for by impulses from the rest of the world. As a consequence, GDP growth will equal 8.5 percent this year.

This optimistic view is not clouded by an increase in inflation. After having been partly negative during last year, it will stay below 3 percent this year. Furthermore, according to official statistics, the unemployment rate in urban regions remains low. Also from the exchange rate side no negative impulses are to be expected. In spite of criticism from abroad, the Chinese government appears to be retaining its policy of keeping a fixed exchange rate to the US dollar, thereby continuing to subsidise its export-oriented economy via a strongly undervalued renminbi.

In principle, the room to manoeuvre for the Chinese government remains large. The success of the stimulus packages have induced larger than expected government revenues. Thus, the fiscal deficit reached only around 3 percent of GDP last year and the public debt remains modest. Nevertheless, economic policy is increasingly putting a burden on the Chinese economy by aggravating unbalanced economic developments. Already during the past years gross capital formation, at a share of more than 40 percent, was extremely high – even larger than the share of private consumption (about 35 percent).[8] As a clear focus of the economic stimulus package is to support investment activity of large, often state-controlled, enterprises, their weight will even increase further. In the medium term, many of these investments may prove to be misdirected, unprofitable and may lead to overcapacities in some sectors. Furthermore, the strong increase in credit growth has induced a boom in both stock and real-estate markets which might turn out to be bubbles.

Also *India* has to a large extent been able to remain close to its long-run growth path throughout the crisis. The outlook for this year remains favourable and its growth rate is bound to remain robust. We expect an increase of GDP by about 6.8 percent.

In light of this, both government and central bank have announced that they will terminate their stimulus measures. At the end of last year, the government announced that it would reduce its funds to support the economy this year. This was not only triggered by the improved economic situation, but also by the estimated large budget deficits of 7 percent of GDP both last and this year. Also at the end of last year, the central bank of India announced its aspiration to raise interest rate in the first quarter in 2010 again. Among the central banks in Asia, it thereby takes the lead. Higher inflation forecasts have probably been

[8] In a typical developed country, these figures are around 20 percent and 65 percent, respectively.

decisive for this decision. Due to low precipitation already in October last year, food prices have surged. The inflation rate is likely to increase to beyond 5 percent this year.

In the remaining emerging economies of Asia, i.e. *Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan* and *Thailand*, the recovery will continue. Although domestic demand will also pick up, the region will mainly benefit from economic developments in China. Hence, the current account surplus of the region will – after having been reduced last year – increase again. GDP of these East Asian countries will grow by a moderate 3.5 percent this year.

1.3.4 The rest of the world

The present recovery of the global economy and its subsequent slow-down will also affect Latin America and Russia.

For the Latin American countries of *Argentina, Brazil, Chile, Colombia, Mexico* and *Venezuela*, sound economic conditions assure that its recovery can continue to be largely driven by domestic factors. Consequently, the current account deficit which has emerged during the crisis – and reflects the buffering function of this region for the world economy during the crisis – will remain negative throughout our forecasting period. GDP having shrunk by 2.2 percent last year, the region will expand by 3.1 percent in 2010.

Not all countries in this region will recover at the same speed. Whereas growth will remain comparatively strong in Brazil as a result of the robust domestic demand, it will be much weaker in Mexico. The latter continues to suffer from its proximity to and thereby dependence on the US economy. Some of the countries benefit from the recent increase in raw material prices.

Economic activity in *Russia* will only increase gradually. GDP growth is expected to rise by only 1.5 percent this year, after having fallen by 8.0 percent in 2009. Especially the recovery of investment will be slow. The worldwide increase in demand for raw material – and in particular from China, the second most important trading partner of Russia – will, on the other hand, be supportive.

Private consumption will be stimulated by expansionary fiscal policy. For instance, whereas pensions fell back relative to wages in recent years, they are scheduled to increase substantially this year. As a downside of these measures, the public finance situation has already worsened substantially last year –the budget deficit rose to 7 percent of GDP in the first half of 2009 as compared to a surplus of a similar magnitude the year before. It is bound to deteriorate further, albeit at a slower pace. Parts of the deficit are and will be financed by withdrawals from the stabilisation fund that is fed by raw material proceeds. Its size, however, is shrinking quickly. Whereas it amounted to 16.2 percent of GDP on average in 2008, it was only 12.7 percent in August 2009.

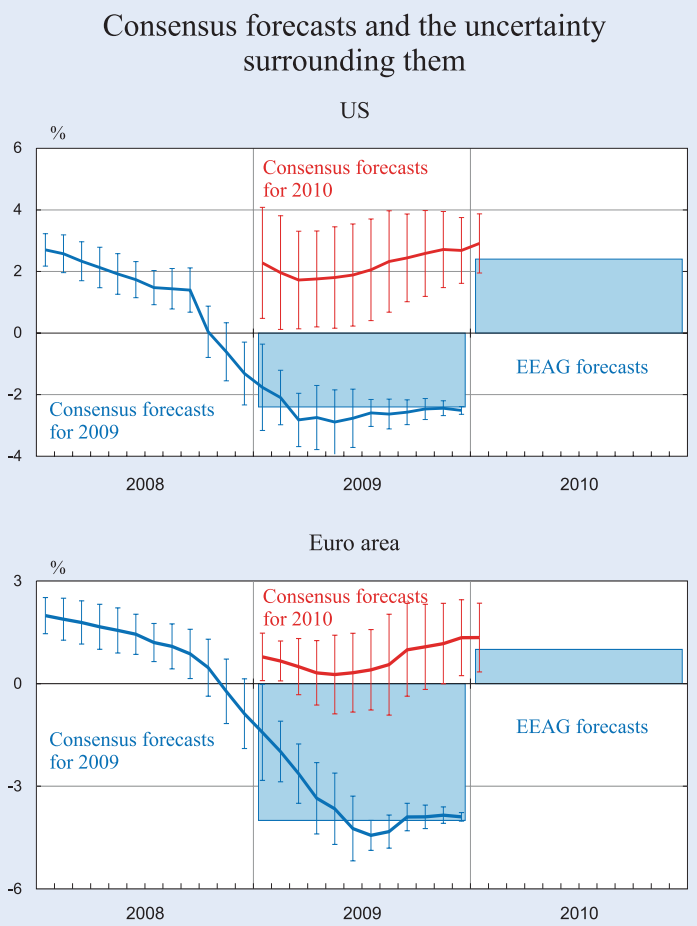
1.3.5 Assumptions, risks and uncertainties

This forecast rests on the technical assumption that oil price will move around 75 US dollars per barrel and the euro exchange rate stabilises at around 1.45 US dollars. World trade is expected to increase by 5.0 percent this year, after having dropped by 11.0 percent in 2009.

Although the banking crisis appears to be under control and the world economy is slowly recovering, uncertainty about economic prospects remains high. Whereas the maximum spread between forecasts of (approximately 25) different institutes in the US, as measured by its 95 percent confidence interval, has been around 70 basis points for the years 2005 until 2007, it increased to approximately a 100 and 150 basis points for 2008 and 2009, respectively. For 2010 the largest amount of uncertainty amongst professional forecasters was registered in early 2009; the spread even reached 185 basis points (see Figure 1.33). In the latest data we have seen a reduction to 96 basis points, which is historically still large. For the euro area a similar picture emerges, albeit its peak with respect to the forecast disagreement for 2010 was in August 2009.

In our forecast the economies of industrialised countries and especially the US will only recover slowly. However, several leading indicators have improved substantially in recent months. In our view, besides the technical problems with many of these survey-based indicators mentioned in Section, this is largely due to the extraordinarily expansionary economic policies carried out by government and monetary authorities around the world. Its stimulus impact could be much stronger if the multipliers are bigger than we expect. In that case, the

Figure 1.33



Notes: The solid lines show the consensus forecasts for 2009 and 2010, respectively, at their publication dates.

The error bands are based upon the standard deviation of approximately 25 economic forecasts produced by professional forecast institutes in these regions and show a 95 percent confidence interval around the consensus forecast.

The blue bars show the EEAG forecasts for these years as published in this report.

Source: Consensus Economics Inc.; EEAG.

private economies would not only stabilise but also go into a sustainable and self-supporting upswing.

Furthermore, our US scenario is based upon the idea that private consumption will have to remain subdued until structural problems of the US economy are overcome. If, on the other hand, US consumers do not increase their saving rates by as much as we assume, the US economy might perform – from a business cycle perspective – better than expected. By bringing our US forecast closer to what is currently the consensus, this would also uplift our forecast for the rest of the world.

However, there is also the risk that the world economy will slip into recession again especially if the credit supply by banks should be restricted more and longer than expected. This would above all happen when capital ratios of banks continue to erode as a consequence of further massive write-offs. According to calculations of the IMF (2009), still pending write-offs continue to jeopardise financial market stability. The fragility of financial markets became apparent at the end of last year as seen by the reaction of stock markets to financial difficulties in Dubai and Greece. An intensification of the banking crisis as a result of other shocks could send financial markets into a downward spiral. This would undoubtedly have negative consequence on the world economic climate.

Another risk for the world economy lies in the challenge for policymakers to reverse their expansionary course appropriately. Phasing out expansionary policy should ideally occur when the economy – in particular private domestic demand – has stabilized and is able to revive gradually without further fiscal or monetary impulses. However, if governments decide to cut back their stimulus measures too early, many economies would fall back into recession. This holds both for monetary policy as well as fiscal policy. The latter could be tempted to limit the massive expansion of budget deficits by introducing consolidation measures too quickly. Indeed, also waiting too long before reducing stimulus measures contains considerable risks; it could easily cause a drop in confidence in the sustainability of monetary and fiscal policy. Should central banks maintain their expansionary course much longer, this could lead to an increase in inflation expectations. Also the likelihood that a new bubble emerges somewhere in financial markets would be high as a result of a persistent increase in liquidity. Already now it cannot be ruled out that the recovery on financial markets is unsustainable.

For fiscal policy, high public deficits could also result in a credibility problem by which the room to manoeuvre would be seriously limited. In case governments do not succeed in communicating their consolidation efforts credibly, this would seriously reduce

trust and lead to an increase of the capital market interest rates. This would, in turn, increase the interest burden of public finance.

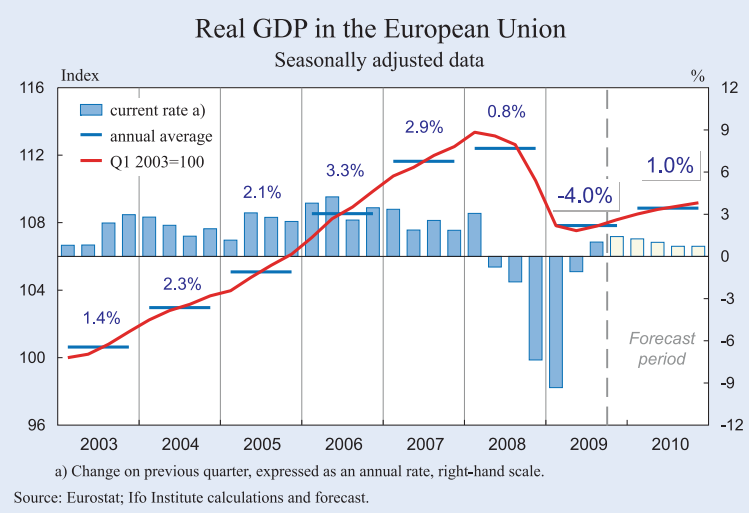
1.3.6 The European economy

The cyclical situation

The deep economic recession has moved from a stabilisation phase mid-2009 into a moderate recovery. Coming from historical lows, consumer and producer confidence are on the mend and pointing upward. The recovery is likely to continue in the coming quarters. It is still doubtful though whether it will turn into a self-supporting upswing. Several restraining factors remain. Credit supply is bound to become more restrictive also because the past recession will for the time being continue to create additional write-offs. Capacity utilisation rates will – after their severe drop during the crisis – only slowly move away from their historically low levels. Consequently, the situation on the labour market will continue to deteriorate. Hence, as soon as stimulus measures and impulses from the inventory cycle wear off, the European Union is likely to fall back to a phase of low growth. After having sunk by 4.0 percent last year, GDP will rise to 1.0 percent this year (see Figure 1.34).

Of the demand components, only gross fixed capital formation will continue to contribute negatively to economic growth this year (see Figure 1.35). Investments will first continue to fall, but during the course of the year increase moderately. A combination of low profits, tougher financing conditions and low growth prospects will continue to put a burden on firms' willingness to in-

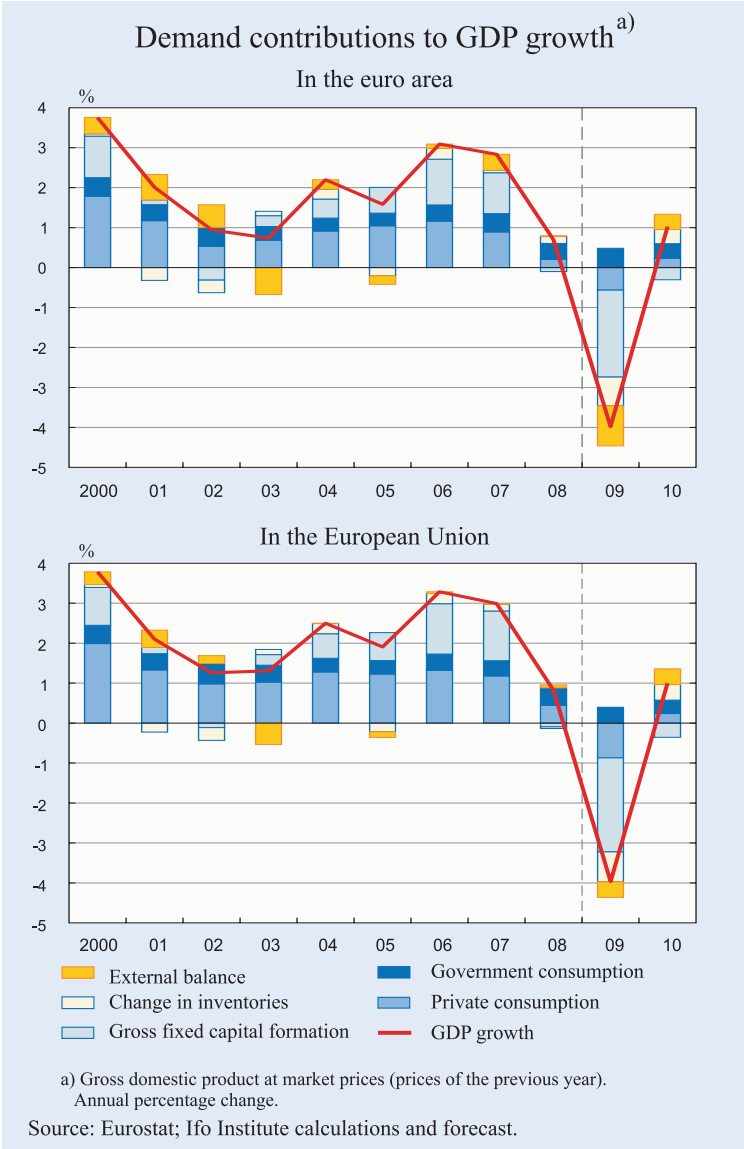
Figure 1.34



a) Change on previous quarter, expressed as an annual rate, right-hand scale.

Source: Eurostat; Ifo Institute calculations and forecast.

Figure 1.35

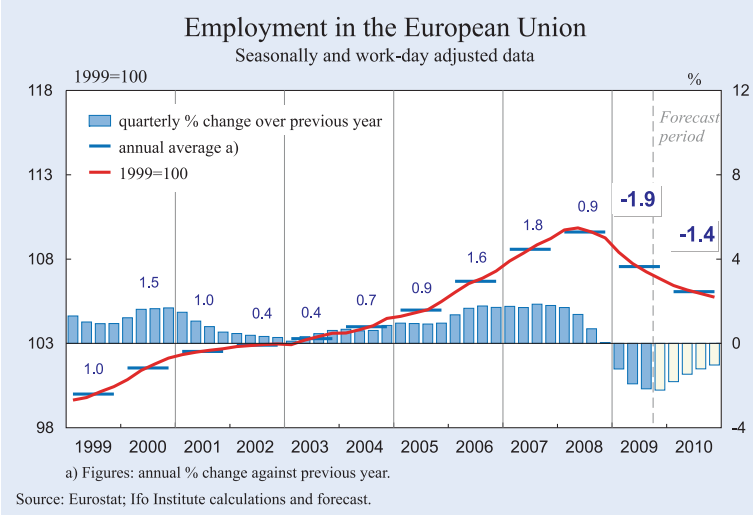


a) Gross domestic product at market prices (prices of the previous year). Annual percentage change.

Source: Eurostat; Ifo Institute calculations and forecast.

vest. Although machinery and equipment investment is likely to pick up somewhat during the year, the large fall in 2009 will prevent annual rates from turning positive. Despite the first signs of stabilisation on housing markets, residential investment continues to shrink, albeit at a slower pace. Also non-residential construction will continue to report negative growth. Stimulated by fiscal measures, only infrastructure investment will show moderate growth this year.

Figure 1.36



a) Figures: annual % change against previous year.

Source: Eurostat; Ifo Institute calculations and forecast.

A relatively strong impulse will come from investment in inventories. Whereas during the crisis the speed at which inventories were emptied out was extraordinary (to increase firm liquidity), it was also clear that this process was not sustainable. In the meantime inventories are still falling, albeit at a slower pace. Already the reduction in the rate of decline is creating a positive impulse for economic growth. The decline in inventories is bound to turn into an increase. Therefore, the positive impulses will remain during the first half of this year. Once inventories have been restored, their cyclical influence is likely to diminish again.

The largest demand component, i.e. private consumption, will deliver only a small positive contribution to economic growth in the European Union. It will expand only moderately as a result of the precarious situation on the labour market and the reduced real wage growth. Lower nominal wage growth together with moderately increased inflation rates will suppress developments in real disposable income.

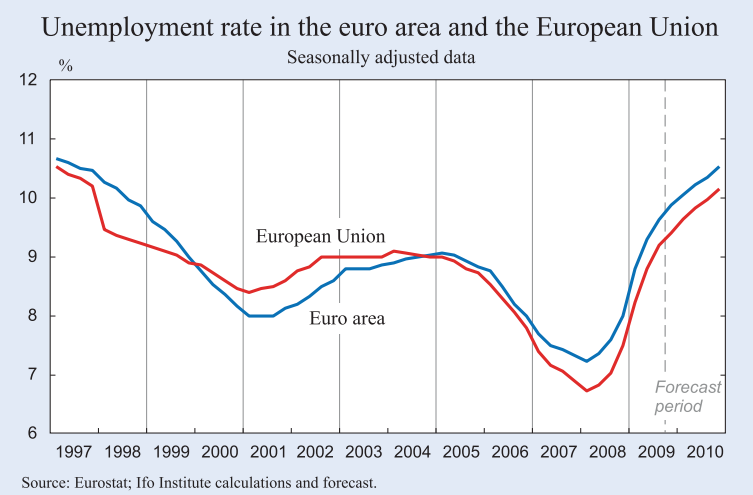
Stronger growth in emerging markets together with moderate developments within the European Union will allow net exports to contribute positively again to overall growth, thereby increasing the prevailing trade account surplus again after its shrinkage last year. Both exports and imports will grow, albeit the latter at a somewhat slower pace.

Employment, sectoral output and inflation

On account of its lagging characteristics with respect to the business cycle, the labour market situation will further deteriorate in Europe. After having declined by a – considering the depth of the crisis – moderate 1.9 percent last year, the number of employees will continue to decrease by another 1.4 percent this year (see Figure 1.36). As a near mirror-image, the unemployment rate will continue to rise reaching an average of 10.3 and 9.9 percent in the euro area and the European Union, respectively (see Figure 1.37).

Developments of individual sectors throughout the crisis have been quite different. Their prospects also vary substantially. Fiscal stimulus packages almost always have – for political reasons – a focus on domestic markets. Although the economic crisis mainly

Figure 1.37

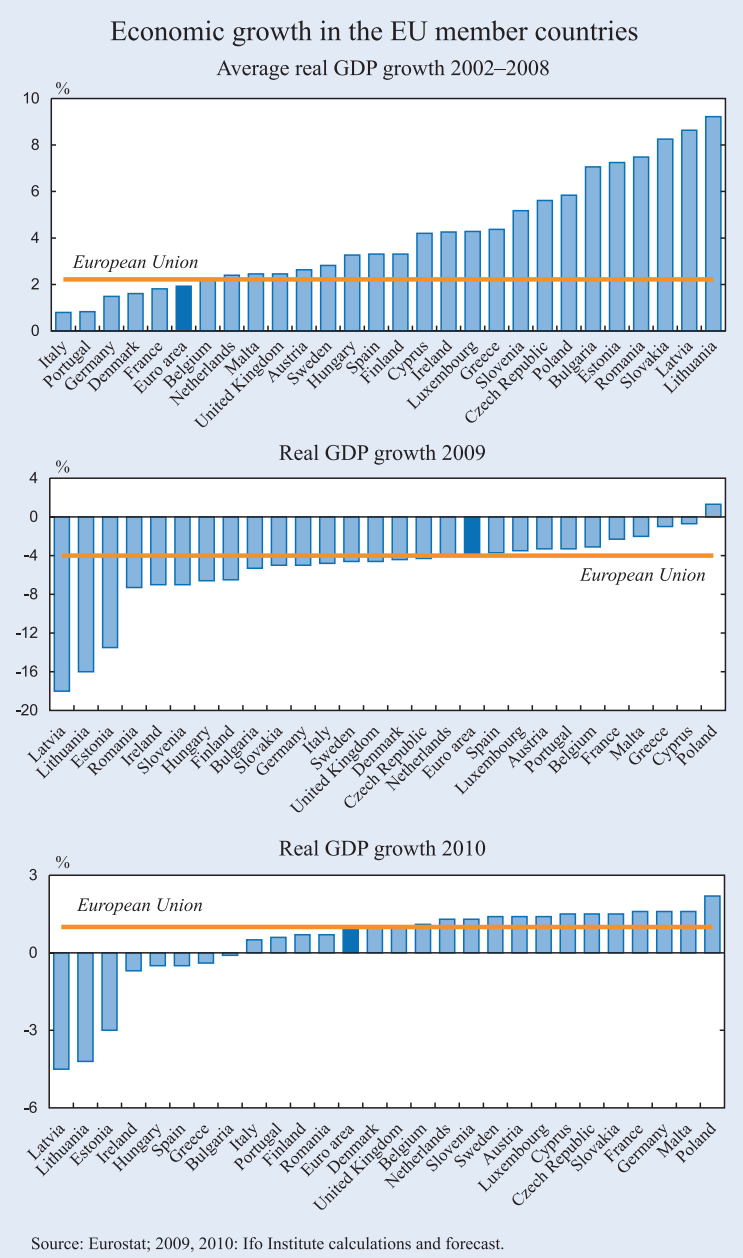


Source: Eurostat; Ifo Institute calculations and forecast.

evolved within the export-oriented manufacturing and the domestic-oriented construction sectors, to a large extent only the latter could benefit from supportive government actions. As the turn-around in international trade seems to have been accomplished, this is, however, less clear for construction investment in Europe. Nevertheless, fiscal stimulus measures are bound to fade out, not least because of the sharply deteriorated public finance situation in many countries. This suggests that there will be a relative shift of economic problems away from the export-oriented sectors towards the domestic economy and in particular the construction sector.

This is further supported by consumer behaviour. Whereas in some European countries consumption was able to act as a buffer during the crisis, labour market and income developments are likely to suppress that. As a consequence, and given that emerging markets are continuing to develop, export-oriented sectors are likely to regain some of their growth, whereas those that focus more on the US and EU consumers will suffer the aftermath of the economic crisis.

Figure 1.38



Source: Eurostat; 2009, 2010: Ifo Institute calculations and forecast.

The increase in prices will all together accelerate somewhat, but – given low capacity utilisation rates and stable inflation expectations – remain restrained. The increase in consumer prices will be 1.2 percent in the European Union in 2010 (after 0.8 percent last year). In the euro area, the inflation rate will equal 0.9 percent in 2010 (after 0.3 percent last year).

Differences in output growth within Europe

Economic developments in *Germany* remain subdued in a historical perspective – albeit above the EU average (see Figure 1.38). Although endogenous business cycle forces are gaining strength, the impact of economic stimulus measures will gradually fade. Furthermore, credit constraints will increase and labour market conditions deteriorate. The German economy remains weak and a self-supporting upswing is not obvious.

Given world economic developments, German exports will only grow moderately. Together with weak domestic developments, imports will show a similar profile and the external balance will only marginally contribute to economic growth. Machinery and equipment investments will only rise a little as capacity utilisation rates are still low and financial con-

straints increase. At the end of this year, the removal of degressive depreciation schemes might lead to a short and temporary uplift in investment activity. For the time being, infrastructure investments will continue to benefit from the fiscal stimulus measures. However, construction of commercial buildings will show negative growth this year. At the beginning of this year, disposable income and hence private consumption have received an impulse as child benefits and tax exemption for dependent children have been increased. However, this will only temporarily increase dynamics. Furthermore, car sales will drop further as the car scrappage scheme has ended. The savings rate remains high in view of labour market uncertainty and stagnant economic developments. Real GDP will increase by 1.6 percent this year.

Leading indicators in the *United Kingdom* give a positive but still restrained picture with respect to the recovery of private consumption and investment. Consumer confidence and the business climate have improved during the last months. However, they remain below their long-term averages. In spite of expansionary monetary policy, credit supply of banks remains restrictive largely because banks' balance sheet problems have still not been fully solved. This puts a burden on the recovery of residential and non-residential investments and purchases of durable consumption goods. Another restraint on private consumption is the high unemployment rate, which averaged 7.8 percent last year. Because labour productivity has fallen sharply, the unemployment rate is bound to increase further. It is estimated to reach 9.2 percent this year, on average. On the other hand, real-estate markets appear to have stabilised on account of better loan conditions and a somewhat positive wealth effect. All together the British economy will only slowly recover. Improved export possibilities due to the weak pound and the recovery of the world economy will allow the United Kingdom to enter into a stabilisation phase in which GDP will grow by 1.0 percent this year. The inflation rate will remain near its target value of 2 percent.

For the economic development in *France*, the increase of government consumption will be decisive during the first part of the year. Hence, the French economy will initially be able to revive itself, although business cycle prospects remain mixed. Industrial production has risen recently and also leading indicators have once more improved largely on account of positive expectations. However, the labour market situation has continuously deteriorated. Furthermore, capacity utilisation rates remain at historically low levels after having fallen deeply at the beginning of last year. The initial increase of GDP might level out in the course of the year as a result of the phasing out of economic stimulus measures. Overall GDP will rise by 1.6 in 2010.

The *Italian* economy will continue to suffer from its low degree of competitiveness and therefore only marginally benefit from the recovery of world demand. Although the manufacturing industry has so far carried out a number of substantial restructuring measures which have led to a relative improvement in particular with respect to product quality, within the scope of this restructuring many firms depend on credit supply and therefore currently face two problems: A more restrictive credit supply by banks and at the same time the weakness of domestic and foreign demand. This year, production will recover only slowly. GDP in Italy will increase by 0.5 percent. The strongest positive impulses will come from private consumption. In addition, tax breaks on machinery and equipment investments are scheduled until the end of June. This will temporarily reduce the fall in investment. The slow recovery of the world economy will strengthen Italian exports.

The sharp decline in house prices and construction activity, the resulting substantial rise in unemployment, its weak international competitiveness and the scheduled restraint in fiscal policy will altogether constrain economic development in *Spain* during our forecasting horizon. The high unemployment rate, reaching 20 percent on average this year, will decrease wage income and thereby dampen private consumption. Furthermore, the risk of unemployment will encourage precautionary savings. The large number of unsold houses remains a considerable burden on the construction sector. Hence, a continuation of the recession is to be expected. Real GDP will decrease by 0.5 percent this year (after a 3.7 percent decline in 2009).

The consequences of the worldwide economic recession will retard economic recovery in the central and eastern European region more than in other regions in the world. Although, with the help of international financial institutions, a breakdown of financial and economic systems has been prevented, the necessary adaptations to the new situation are still on the agenda. A return to credit-based growth financed by foreigners seems unlikely in the years to come. Domestic

demand will remain weak in view of rising unemployment rates, reduced tax receipts, and the pressure to consolidate public finances. Altogether, GDP of the region will only grow by 1 percent this year. Caused by persistent, although weak, consumption growth, the two largest central and eastern European Union member countries, the Czech Republic and Poland, will be able to outperform the others and grow faster than the EU average. Especially the recessions in the three Baltic States, Estonia, Latvia and Lithuania, will remain deep.

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Appendix 1:
Forecasting tables

Table A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in%	GDP growth			CPI inflation			Unemployment rate[d)]		
		in %								
		2008	2009	2010	2008	2009	2010	2008	2009	2010
EU27	34.0	0.8	– 4.0	1.0	3.5	0.8	1.2	7.0	9.0	9.9
Euro Area	25.1	0.6	– 4.0	1.0	3.3	0.3	0.9	7.6	9.4	10.3
Switzerland	0.9	1.8	– 2.0	1.1	2.4	– 0.5	0.5	3.5	3.8	4.4
Norway	0.8	2.1	– 1.4	2.0	3.8	2.4	1.7	2.5	3.5	3.7
Western and Central Europe	35.8	0.9	– 3.9	1.0	3.5	0.8	1.2	6.9	8.8	9.7
US	26.7	0.4	– 2.4	2.4	3.8	– 0.4	1.6	5.8	9.2	9.5
Japan	9.1	– 0.7	– 5.3	1.0	1.4	– 1.3	– 0.4	4.0	5.3	5.8
Canada	2.8	0.4	– 2.4	2.2	2.4	0.3	1.6	6.1	8.3	8.7
Industrialised countries total	74.4	0.5	– 3.5	1.6	3.3	0.1	1.2	6.1	8.4	9.1
Newly industrialised countries										
Russia	3.1	5.6	– 8.0	1.5	·	·	·	·	·	·
China and Hongkong	8.4	8.7	7.8	8.5	·	·	·	·	·	·
India	2.2	7.3	6.1	6.8	·	·	·	·	·	·
East India[a)]	5.0	3.0	– 1.5	3.5	·	·	·	·	·	·
Latin America[b)]	6.9	3.7	– 2.2	3.1	·	·	·	·	·	·
Newly industrialised countries total	25.6	5.8	1.2	5.1	·	·	·	·	·	·
Total[c)]	100.0	1.8	– 2.3	2.5	·	·	·	·	·	·
World trade, volume	–	–	– 11.0	5.0	·	·	·	·	·	·

[a)] Weighted average of Indonesia. Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. Weighted with the 2006 GDP levels in US dollars. – [b)] Weighted average of Argentina, Brasil, Chile, Columbia, Mexico, Peru, Venezuela. Weighted with the 2006 GDP levels in US dollars. – [c)] Sum of the listed groups of countries. Weighted with the 2008 GDP levels in US dollars.. – [d)] Standardised unemployment rate.

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

Table A.2

GDP growth, inflation and unemployment in European countries

	Share of total GDP in%	GDP growth			Inflation[a]			Unemployment rate[b]		
		in %								
		2008	2009	2010	2008	2009	2010	2008	2009	2010
Germany	20.0	1.3	– 5.0	1.6	2.8	0.2	0.6	7.3	7.5	7.9
France	15.6	0.4	– 2.3	1.6	3.2	0.1	0.8	7.9	9.6	10.2
Italy	12.6	– 1.0	– 4.8	0.5	3.5	0.8	1.1	6.8	7.7	8.8
Spain	8.7	0.9	– 3.7	– 0.5	4.1	– 0.3	0.9	11.4	18.5	20.0
Netherlands	4.8	2.0	– 4.0	1.3	2.2	1.0	1.2	2.8	3.5	5.0
Belgium	2.8	1.0	– 3.1	1.1	4.5	0.0	1.1	7.0	8.0	9.1
Austria	2.3	2.0	– 3.3	1.4	3.2	0.4	1.0	3.9	4.6	5.7
Greece	1.9	2.0	– 1.0	– 0.4	4.2	1.3	1.5	7.7	9.6	11.0
Finland	1.5	1.0	– 6.5	0.7	3.9	1.6	1.4	6.4	8.3	9.5
Ireland	1.5	– 3.0	– 7.0	– 0.7	3.1	– 1.7	– 0.3	6.0	12.0	13.6
Portugal	1.3	0.0	– 3.3	0.6	2.6	– 0.9	1.2	7.8	9.7	10.6
Slovakia	1.3	6.2	– 5.0	1.5	3.9	0.9	1.9	9.5	11.6	12.3
Slovenia	0.3	3.5	– 7.0	1.3	5.6	0.9	1.7	4.4	5.9	6.8
Luxembourg	0.3	0.0	– 3.5	1.4	4.1	0.0	1.6	4.9	6.3	7.6
Cyprus	0.1	3.6	– 0.7	1.5	4.4	0.2	2.3	3.6	5.4	6.1
Malta	0.0	2.1	– 2.0	1.6	4.7	1.9	2.0	6.0	7.2	9.0
Euro area[c]	**74.2**	**0.6**	**– 4.0**	1.0	**3.3**	**0.3**	**0.9**	**7.6**	**9.4**	**10.3**
United Kingdom	14.6	0.5	– 4.6	1.0	3.7	2.1	1.6	5.6	7.8	9.2
Sweden	2.6	– 0.2	– 4.6	1.4	3.4	1.9	2.0	6.3	8.4	9.1
Denmark	1.9	– 0.9	– 4.4	1.0	3.6	1.1	1.5	3.4	5.9	6.4
EU 19[c]	**93.3**	**0.6**	**– 4.1**	1.0	**3.3**	**0.6**	**1.0**	**7.1**	**9.0**	**10.0**
Poland	2.9	5.0	1.3	2.2	4.2	4.0	2.5	7.1	8.2	8.5
Czech Republic	1.2	2.5	– 4.3	1.5	6.3	0.6	1.6	4.4	6.5	7.2
Romania	1.1	7.3	– 7.3	0.7	7.9	5.6	3.3	5.8	7.0	8.1
Hungary	0.8	0.6	– 6.6	– 0.5	6.1	4.0	3.8	7.8	9.8	10.6
Lithuania	0.3	2.8	– 16.0	– 4.2	11.1	4.2	2.0	5.9	14.5	17.0
Bulgaria	0.3	6.0	– 5.3	– 0.1	12.0	2.5	2.7	5.6	7.0	8.1
Latvia	0.1	– 4.6	– 18.0	– 4.5	15.3	3.3	4.2	7.5	18.1	20.0
Estonia	0.1	– 3.6	– 13.5	– 3.0	10.6	0.2	1.2	5.6	14.5	16.5
EU 8	**6.7**	**4.1**	**– 3.5**	**0.9**	**6.3**	**3.5**	**2.6**	**6.5**	**8.6**	**9.4**
EU 27[c]	**100.0**	**0.8**	**– 4.0**	**1.0**	**3.5**	**0.8**	**1.2**	**7.0**	**9.0**	**9.9**

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

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

Table A.3

Key forecast figures for the euro area

	2007	2008	2009	2010
	Percentage change over previous year			
Real gross domestic product	2.7	0.6	– 4.0	1.0
Private consumption	1.5	0.4	– 1.0	0.4
Government consumption	2.3	2.0	2.4	1.7
Gross fixed capital formation	4.7	– 0.5	– 10.0	– 1.5
Net exports[a]	0.4	0.0	– 1.0	0.4
Consumer prices[b]	2.1	3.3	0.3	0.9
	Percentage of nominal gross domestic product			
Government fiscal balance	– 0.6	– 2.0	– 6.4	– 7.0
	Percentage of labour force			
Unemployment rate[c]	7.5	7.6	9.4	10.3

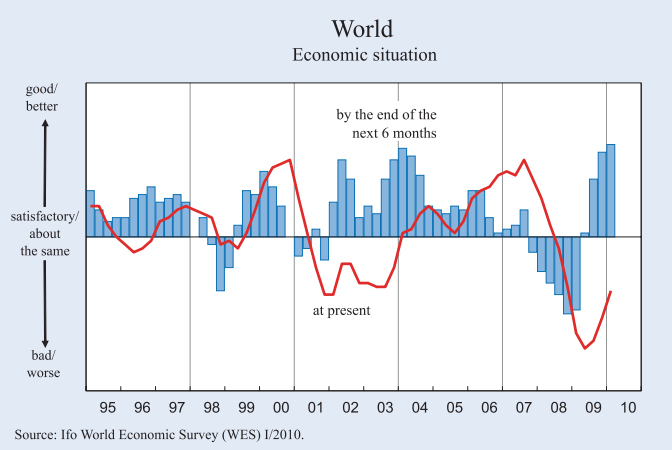
[a] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b] Harmonised consumer price index (HCPI). – [c] Standardised unemployment rate.

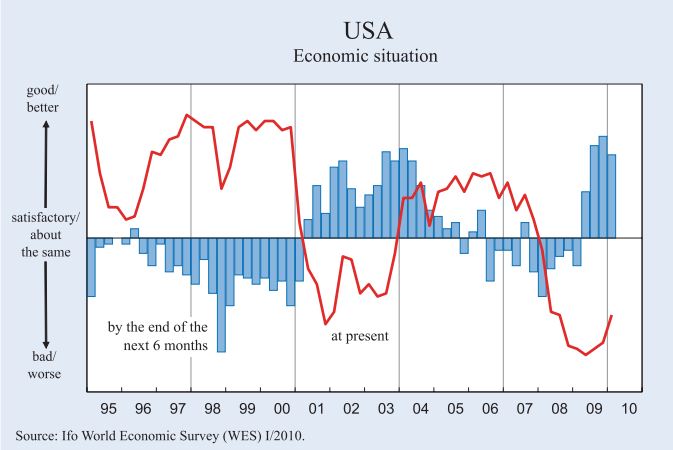
Source: Eurostat; 2009, 2010 and 2010: forecasts by the EEAG.

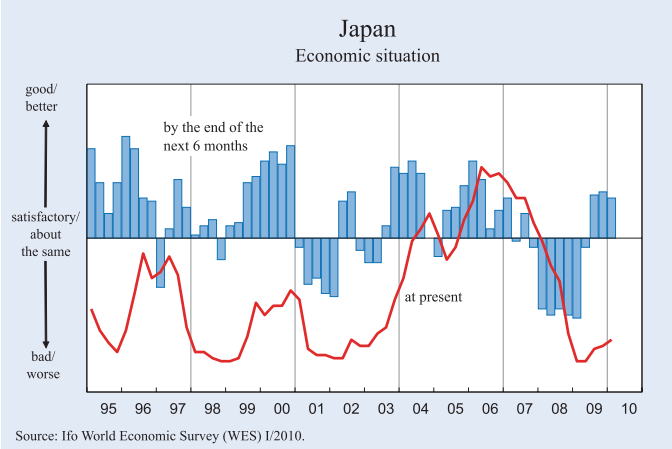
Appendix 2:
Ifo World Economic Survey (WES)

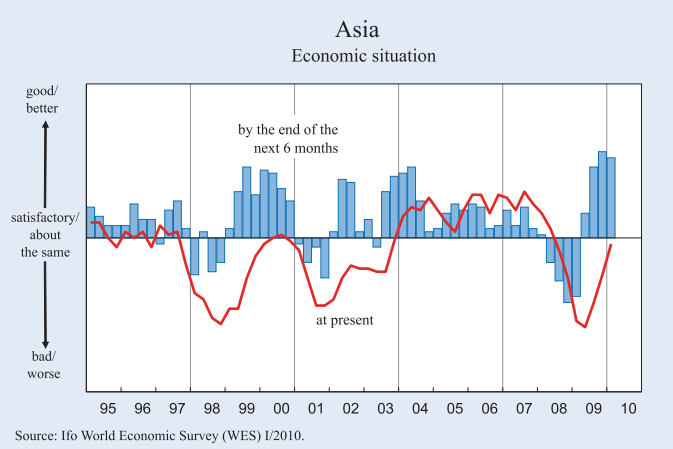
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organisations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In 2009, 1,026 economic experts in 88 countries were polled. WES is conducted in co-operation with the International Chamber of Commerce (ICC) in Paris. The survey questionnaire focuses on qualitative information: on assessment of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The "grading" procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

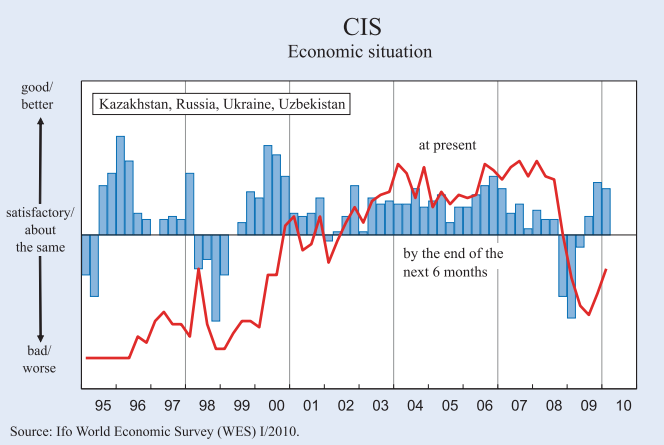
Ifo World Economic Survey (WES)

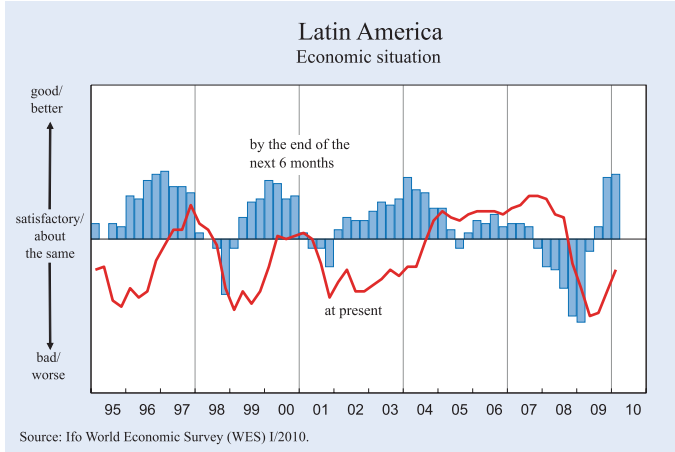


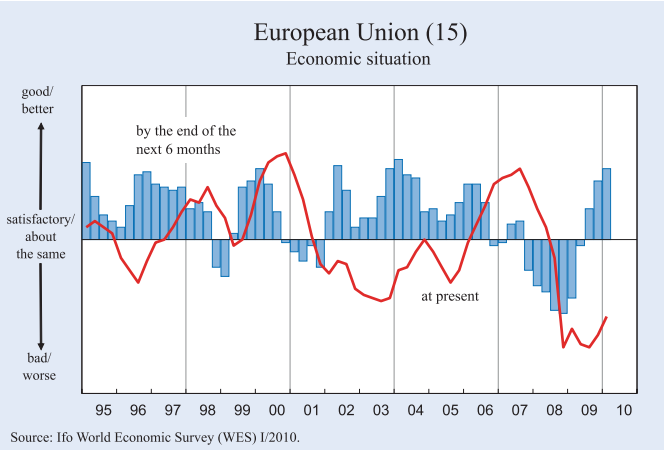


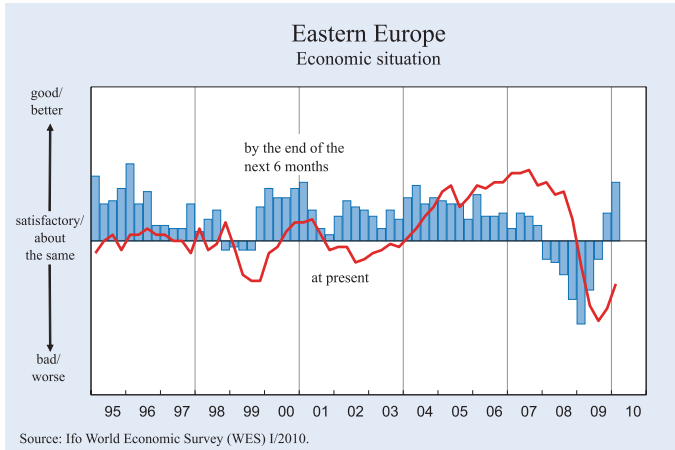


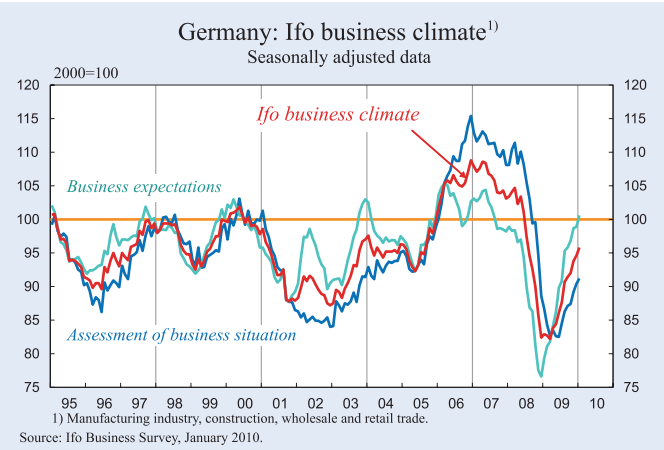


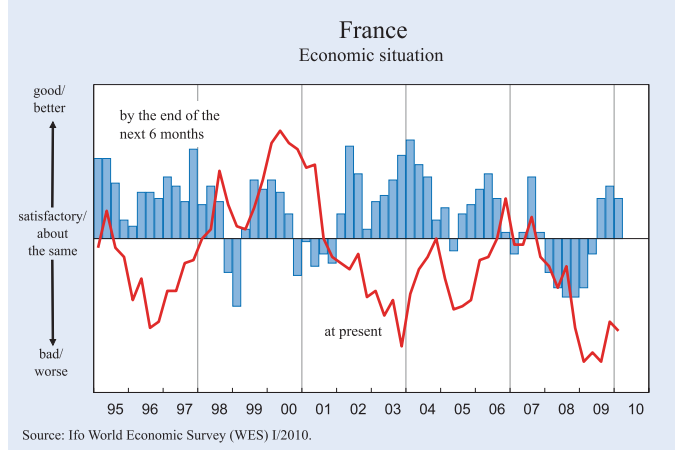

CIS
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
Kazakhstan, Russia, Ukraine, Uzbekistan
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

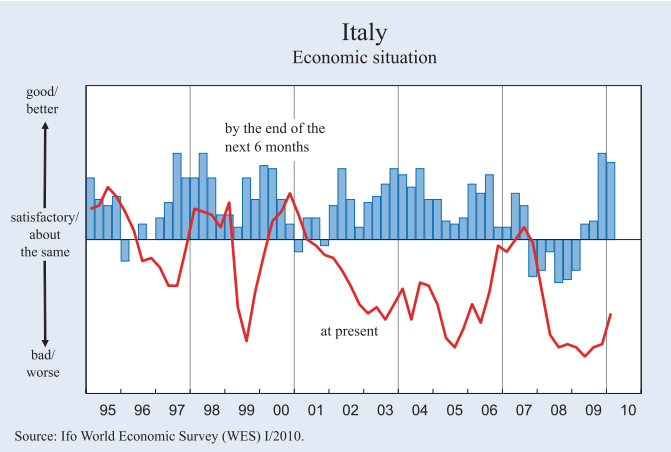

Latin America
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

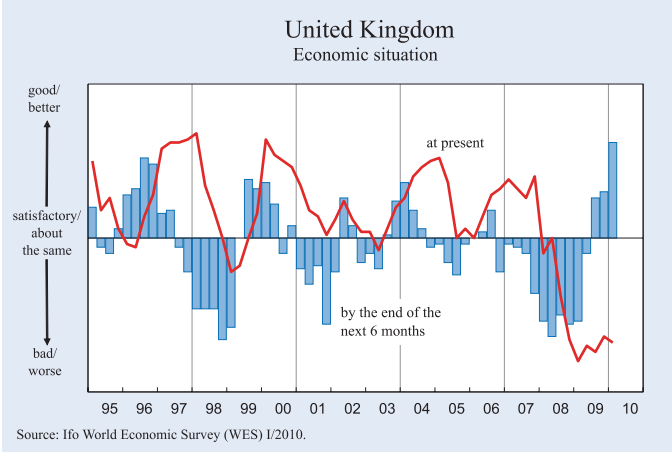

European Union (15)
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

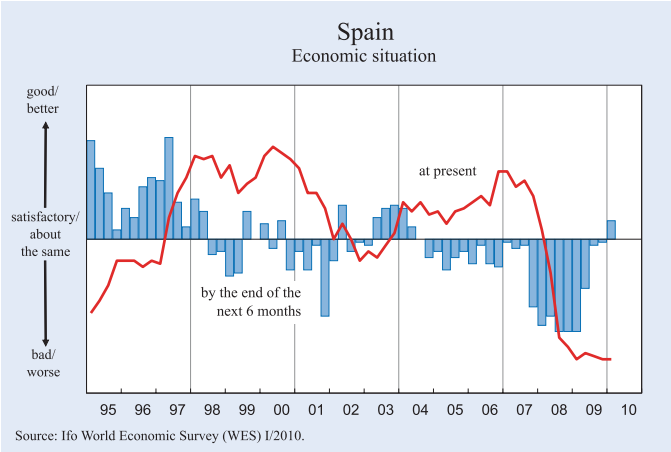

Eastern Europe
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

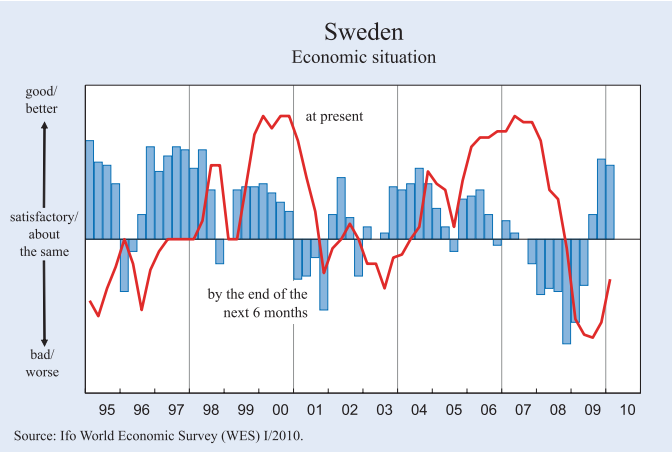

Germany: Ifo business climate1)
Seasonally adjusted data
2000=100
120
115
110
105
100
95
90
85
80
75
Ifo business climate
Business expectations
Assessment of business situation
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
1) Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2010.

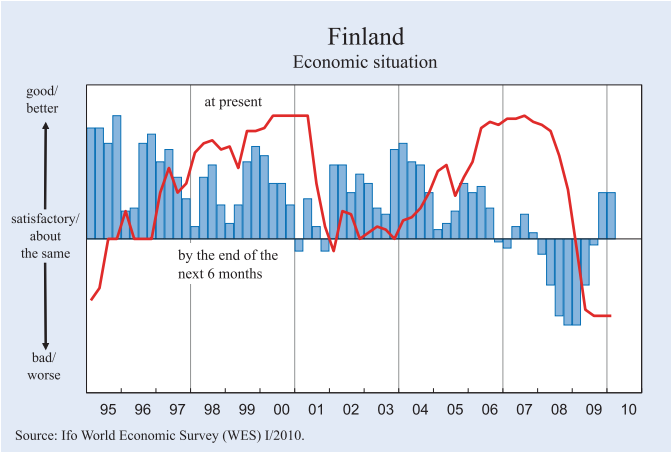

France
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

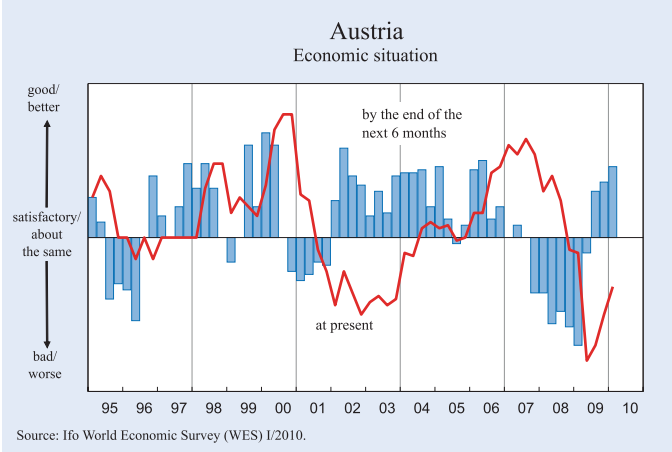

Italy
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

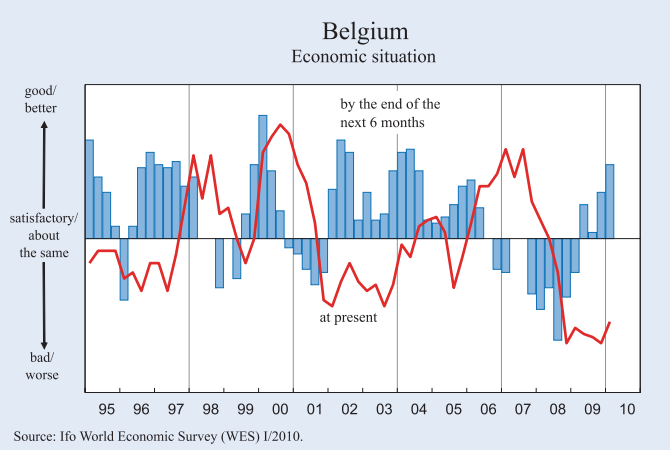

United Kingdom
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

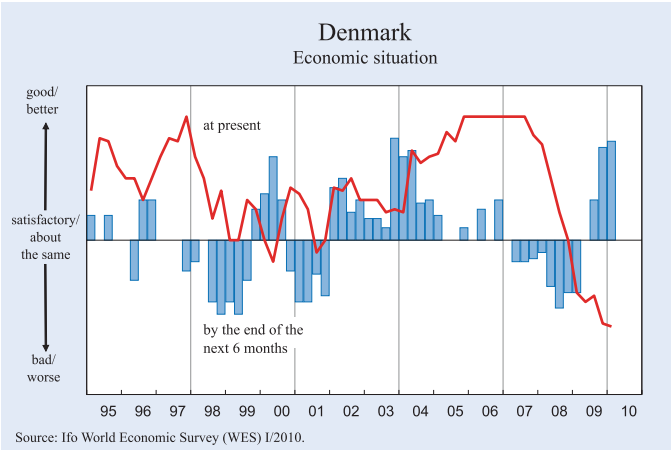

Spain
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

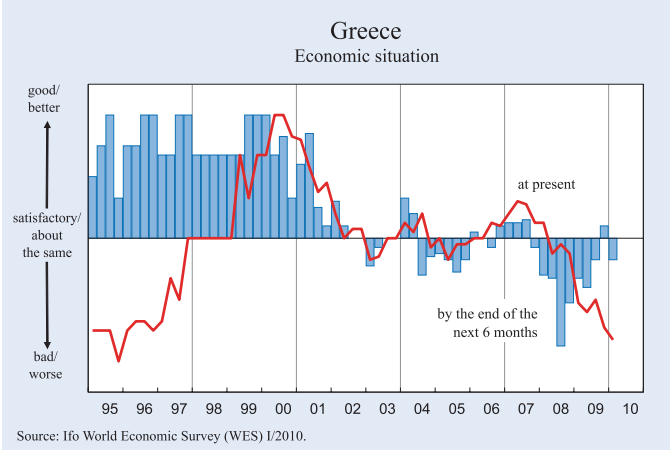

Sweden
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

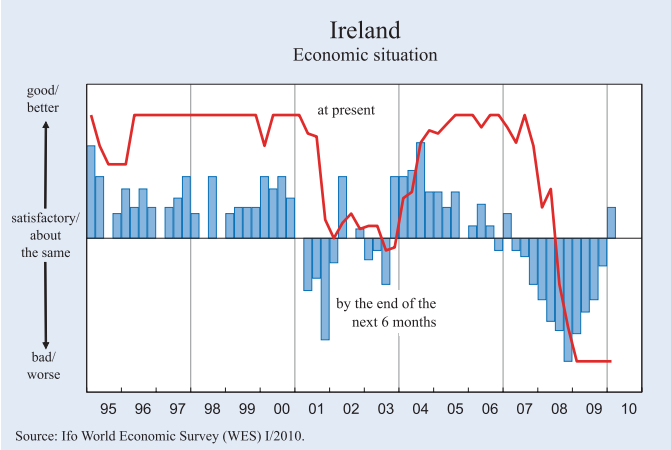

Finland
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

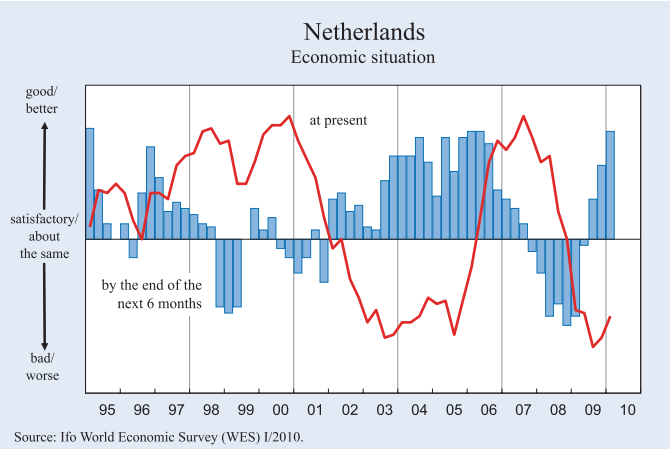

Austria
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

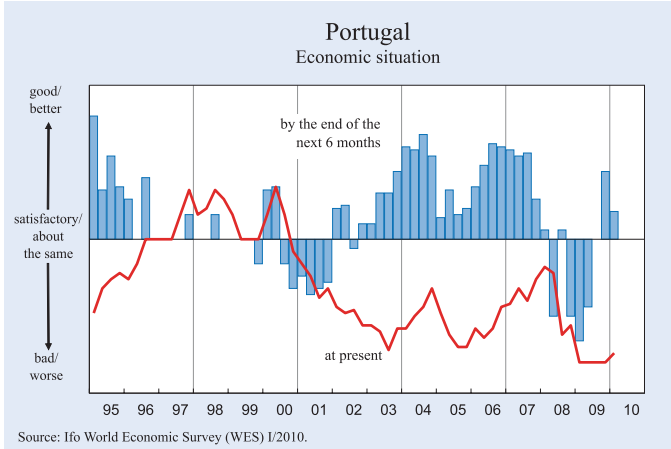

Belgium
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

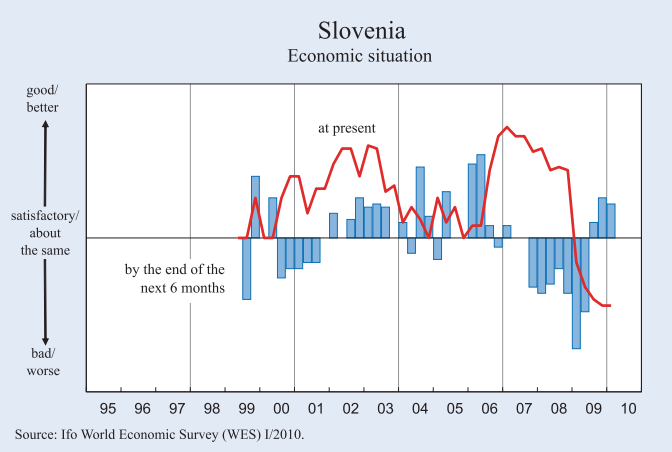

Denmark
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

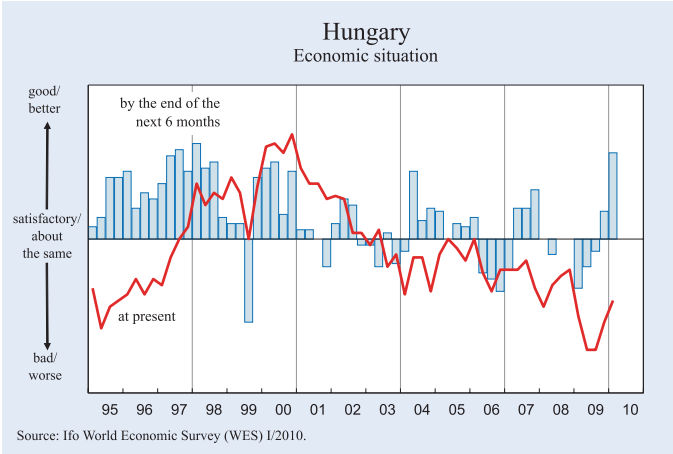

Greece
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

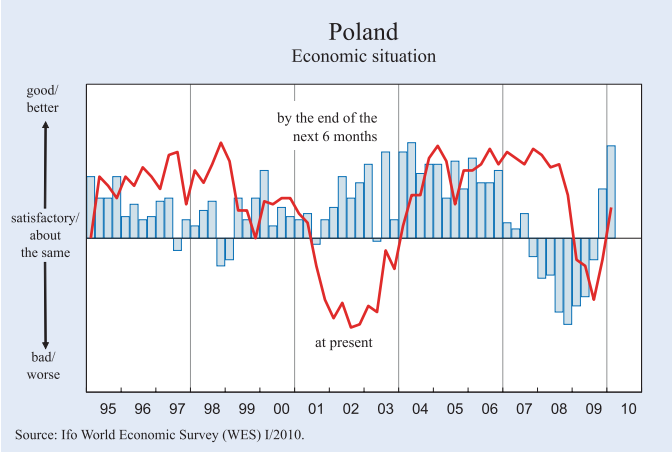

Ireland
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

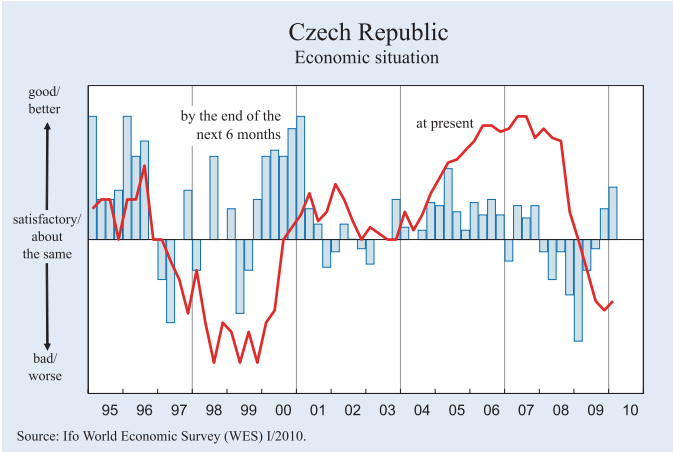

Netherlands
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

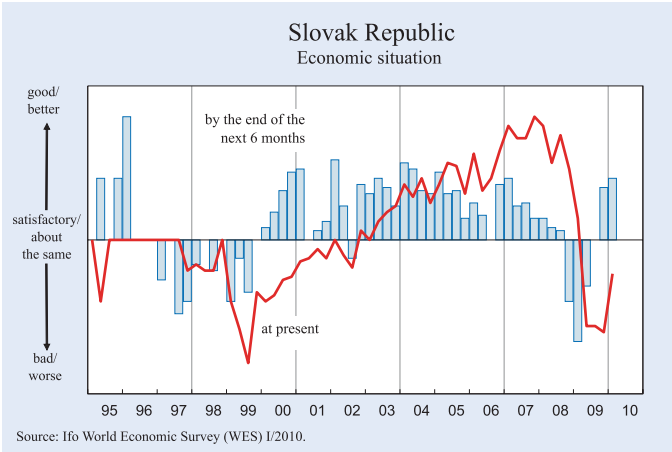

Portugal
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

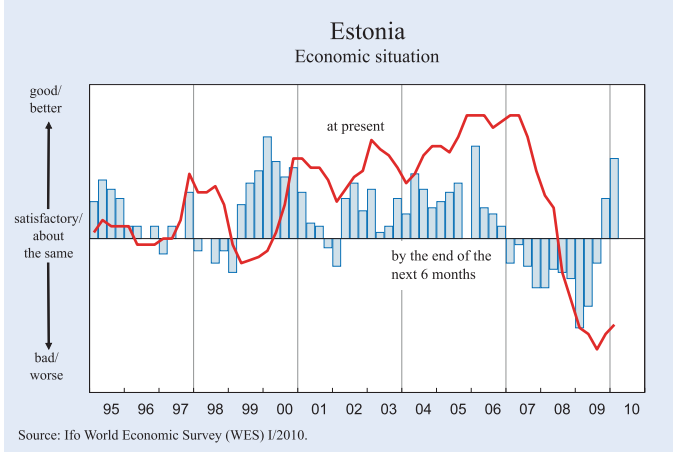

Slovenia
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

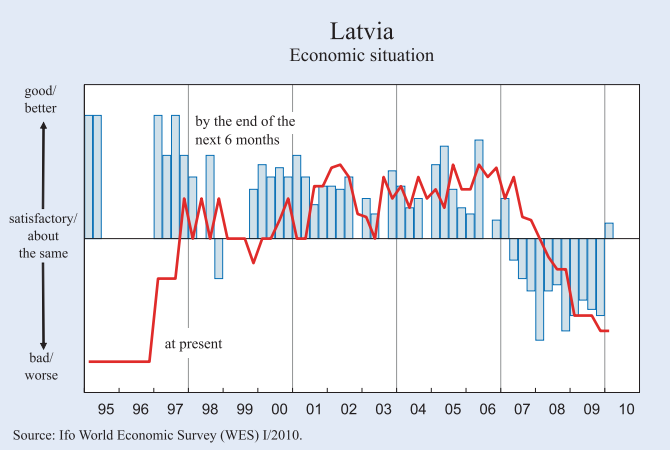

Hungary
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

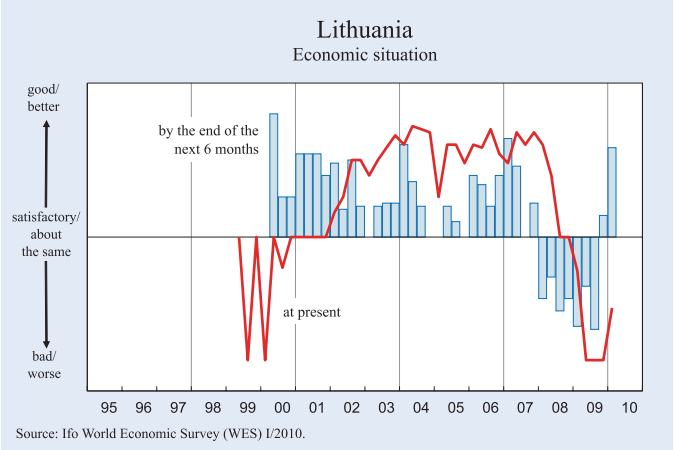

Poland
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

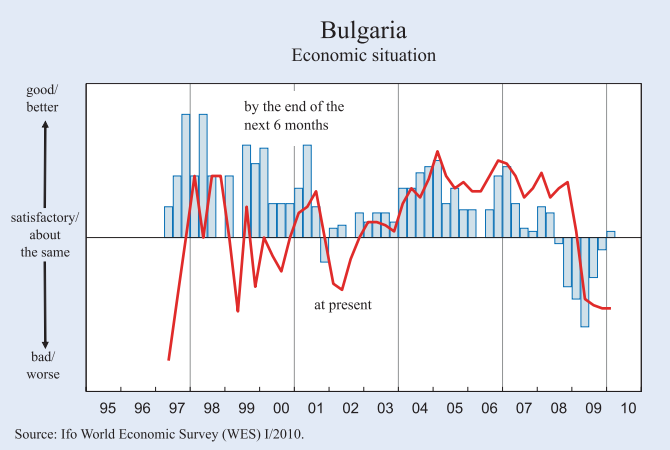

Czech Republic
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.

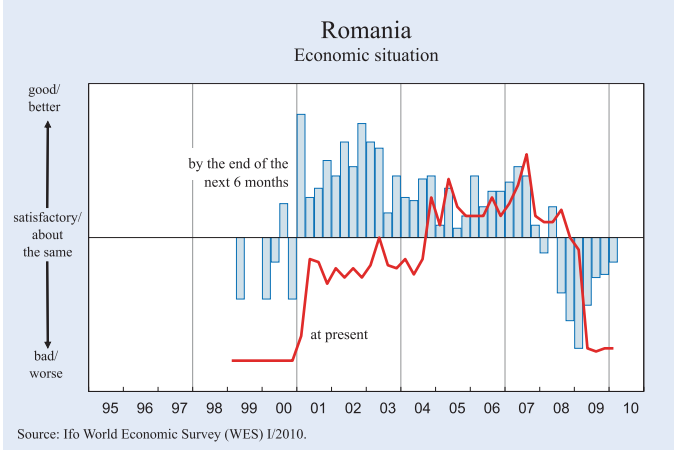

Slovak Republic
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.


Estonia
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
at present
by the end of the
next 6 months
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.


Latvia
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.


Lithuania
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.


Bulgaria
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.


Romania
Economic situation
good/
better
satisfactory/
about
the same
bad/
worse
by the end of the
next 6 months
at present
95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
Source: Ifo World Economic Survey (WES) I/2010.