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Discussion Paper

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**Status Quo, Causes and Prospects of the European Economy in the
Post-Crisis Era**

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In view of Europe's economic data for the second half of 2013 and the first two quarters of 2014, the European debt crisis in the narrow sense is obviously over and the trend of the European economy's slow recovery is basically established. On the one hand, the successive implementation of initiatives such as emergency relief, fiscal consolidation, financial supervision, social security reform and enhancement of various countries' competitiveness during the crisis, improvement of relevant mechanisms, etc. showed effect, and the improvement of the external international economic environment, etc. constituted the main reason why the European economy pulled out of the crisis and gradually recovered. On the other hand, the crisis expanded the economic and social gap between the core countries and peripheral countries, and made convergence of various countries of the European Union and the Eurozone and policy coordination at the community level more difficult. Meanwhile, the expansion of the "democratic deficit" in the European Union, the augmentation of people's Eurosceptic feelings, etc. restricted the momentum of the recovery. In the future, the European economy will still grow slowly in the near term, but to get rid of deflation, technical means such as release of liquidity by the European Central Bank should mainly be relied upon instead of breakthroughs in non-political mechanisms such as member states' consent to issuance of euro bonds or unified finance. The new leaders of the European Union headed by Juncker are expected to make considerable accomplishments under the push of the trend of gradual economic recovery.

1. Status Quo of the European Economy

Nearly six years have passed since Greece's self-exposure of its seriously excessive fiscal deficit and public debt in 2009, which led to the downgrade of its rating, caused refinancing difficulties and triggered the European debt crisis. As the European Union put forward Outright Monetary Transactions (OMT) and the European Stability Mechanism (ESM) successively and completed the last two moves in response to the European debt crisis, the economy of the European Union, especially the Eurozone, finally began to pull out of the European debt crisis and gradually recover. In view of the steady stabilization in the first two quarters of this year, it is obvious that the European debt crisis in the narrow sense of forced demand for help or default and bankruptcy with stably high national bond yields and heavily indebted countries' inability to finance normally as external symbols is basically over. The basis supporting this judgment is: after

Ireland announced its complete withdrawal from the international relief plan in 2013, Portugal became the second country in the Eurozone to exit the relief plan. Quite symbolically, Greece as the original cause of this crisis, the greatest victim of the crisis and a two-time recipient of relief from the European Union, the European Central Bank and the International Monetary Fund is also heading towards recovery. On April 10 2014, the Greek government successfully issued 3 billion euros in five-year national bonds at a yield of less than 5%. This was the first time that Greece had raised funds by issuing national bonds on the international financial market, marking that Greece had basically pulled out of the European debt crisis, regained market confidence and began to return to the international capital market. Besides, the data released by Eurostat less than two weeks later showed that Greece realized a basic fiscal surplus of 3.4 billion euros in 2013. This will help Greece reach a further favorable agreement on the issue of debt reduction with the debtors. The bond yields of Italy and other countries have returned to the pre-crisis normal level.

At present, the European debt crisis in the narrow sense is over, and the European economy is in the stage of weak recovery. The specific manifestations are as follows:

1.1 National Bond Yields Show a Constantly Falling Trend

After the outbreak of the European debt crisis, the trend of various Eurozone countries' national bond yields as the main indicator of the European debt crisis in the narrow sense varied greatly. On the one hand, the national bond yields of the peripheral countries like Greece, Italy and Spain rose continuously with the augmentation of the risk of default. On the other hand, in sharp contrast with them, the national bonds of the core countries like Germany and France became market investors' hedging tools, and their yields dropped continuously. Fortunately, from the second half of 2013, the European debt crisis was controlled, market investors' confidence in the Eurozone recovered to some extent, and the national bond yields of Italy and Spain began to drop, showing the European Union's economic recovery was underway.

Comparison of the national bond yields of various Eurozone countries



Germany: national bond yield: 10 years (blue)

Spain: national bond yield: 10 years (red)

Italy: national bond yield: 10 years (green)

France: national bond yield: 10 years (purple)

Figure 1: Comparison of the national bond yields of various Eurozone countries

Source of data: Wind Information

1.2 Fluctuation of Euro Exchange Rates is Stabilizing

The euro is a global currency second only to the US dollar, and nearly one fourth of global reserve currencies are denominated in euros. Its exchange rates against major currencies such as the US dollar dropped significantly after the outbreak of the exchange crisis, but since 2013, euro exchange rates have been steadily fluctuating around 1.30. This shows the European debt crisis in the narrow sense is basically over.

Euro-US dollar – monthly candlestick chart



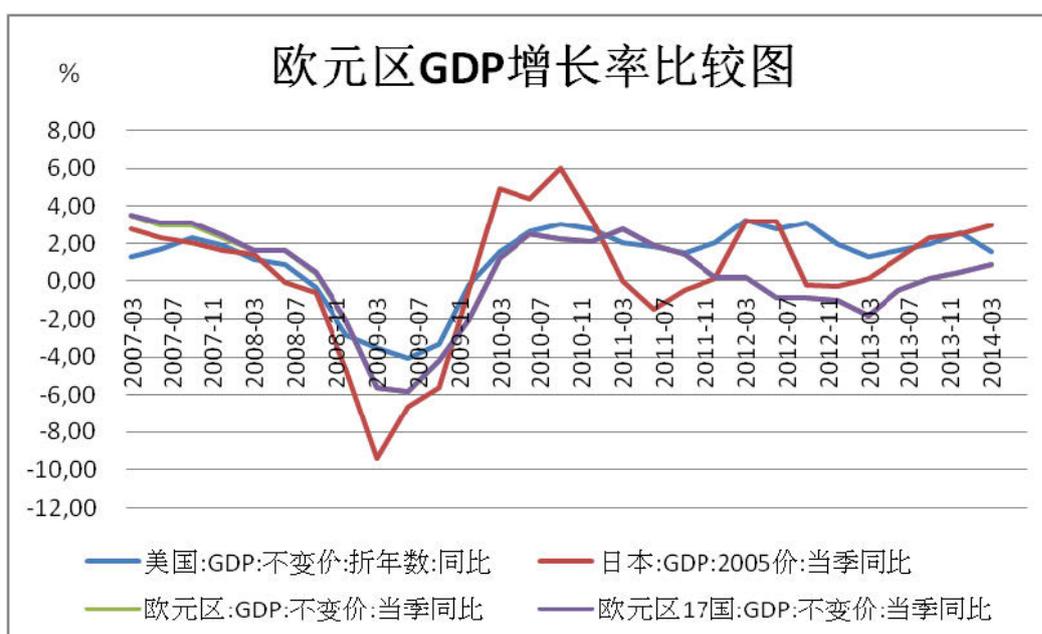
Figure 2: Trend of euro-US dollar exchange rates

Source of data: Sina Finance

1.3 Economic Growth has Turned Positive and is Slowly Recovering from the Devastation

Though under the influence of the European debt crisis, Eurozone countries suffered a serious economic recession and there was even a drop of 5.8% in 2009, Eurozone countries' GDP growth rates began to turn positive in the third quarter of 2013 and growth lasted three consecutive months. In the first quarter of 2014, the growth rate reached 0.9%, obviously showing a gradually rising trend.

Comparison of the Eurozone's GDP growth rate



USA: GDP: constant price: annualized amount: over the same period of last year (blue)
Japan: GDP: 2005 price: over the same quarter of last year (red)
Eurozone: GDP: constant price: over the same quarter of last year (green)
17 Eurozone countries: GDP: constant price: over the same quarter of last year (purple)

Figure 3: Comparison of the Eurozone's GDP growth rate
Source of data: Wind Information

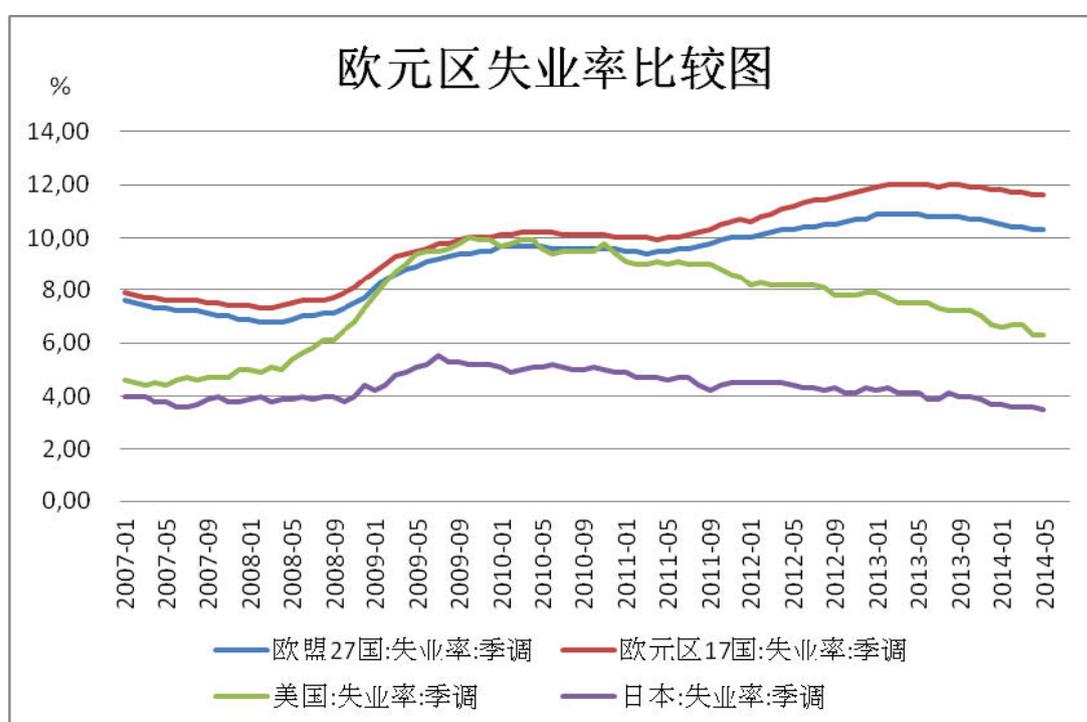
1.4 Unemployment is Still Serious, but the Worst Time is Over

The unemployment rates of the European Union and the Eurozone rose significantly after the outbreak of the European debt crisis, and reached 9.5% and 10% respectively at the end of 2009. Later, the unemployment rates of the European Union and the Eurozone showed a slowly rising trend between 2009 and the middle of 2013, ranking first among the developed economies. However, in June 2013, the European Union's unemployment rate began to drop; in the next month, the Eurozone's unemployment rate also began to drop. By the end of May 2014, the unemployment rates of the European Union and the Eurozone had

dropped from the peaks of 10.9% and 12% to 10.3% and 11.6%, close to the 2012 levels but still far from the levels of the period before the European debt crisis.

Compared horizontally, the European Union’s unemployment rate was always higher than that of Japan, but was close to that of USA in 2009. In 2010, USA gradually came out of the shadow of the subprime crisis, and the unemployment rate began to drop; in sharp contrast, the European Union’s unemployment rate began to rise with the spread of the European debt crisis and exceeded the level of the period when the US subprime crisis was most serious. As a result, at the end of May 2014, the unemployment rates of the European Union and the Eurozone were 4% and 5.3% higher than that of USA respectively.

Comparison of the Eurozone’s unemployment rate



27 EU countries: unemployment rate: seasonally adjusted (blue)

17 Eurozone countries: unemployment rate: seasonally adjusted (red)

USA: unemployment rate: seasonally adjusted (green)

Japan: unemployment rate: seasonally adjusted (purple)

Figure 4: Unemployment rates of the Eurozone, USA and Japan

Source of data: Wind Information

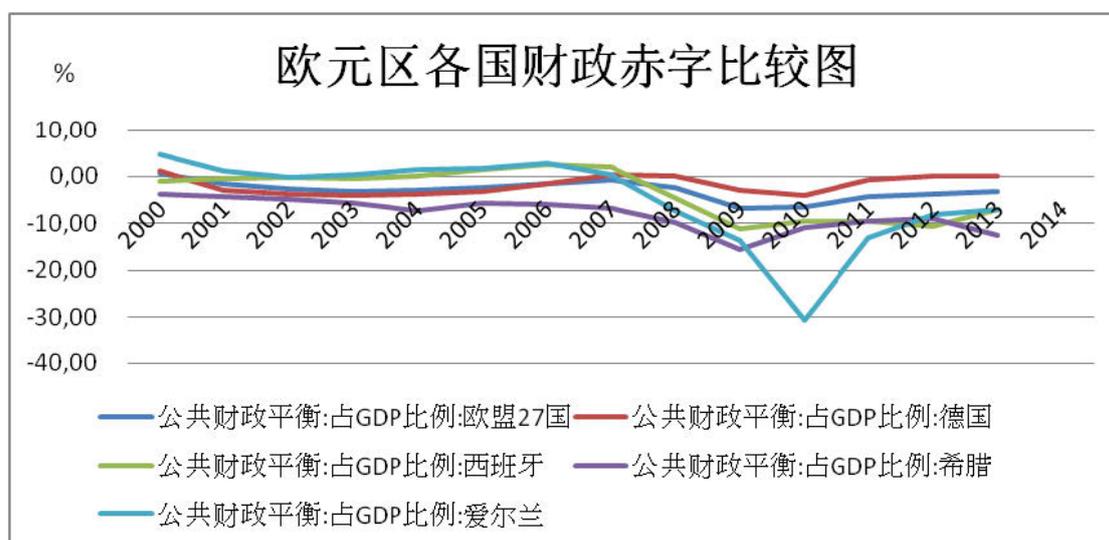
1.5 Debt Situation is Still Serious and will not Turn Better in the Short Run

The European Union’s fiscal deficit worsened rapidly at the beginning of the European debt crisis. It rose from -2.4% in 2008 to -6.8% in 2009. The situations of “PIIGS” were especially serious. To provide relief for the domestic banking sector’s crisis, Ireland increased its fiscal deficit to -30.6% in 2010. The situations

of Spain and Greece were exactly the same. With the strengthening of the European Union's fiscal consolidation measures, various countries' deficit rates began to drop in 2011, especially that of Ireland. The core countries' improvement was more prominent – for example, Germany basically achieved zero deficits in 2013.

Compared with fiscal deficits, various countries' public debts were more negative and rose every year. The EU countries' average debt rate rose from 62.2% in 2008 to 74.5% in 2009 and 80.2% in 2010, and even reached the peak of 87.4% in 2013. The situation of Greece was most serious. In 2013, its debt rate reached the new high of 175.1%.

Comparison of various Eurozone countries' fiscal deficits



Fiscal balance: as a proportion of GDP: 27 EU countries (dark blue)

Fiscal balance: as a proportion of GDP: Germany (red)

Fiscal balance: as a proportion of GDP: Spain (green)

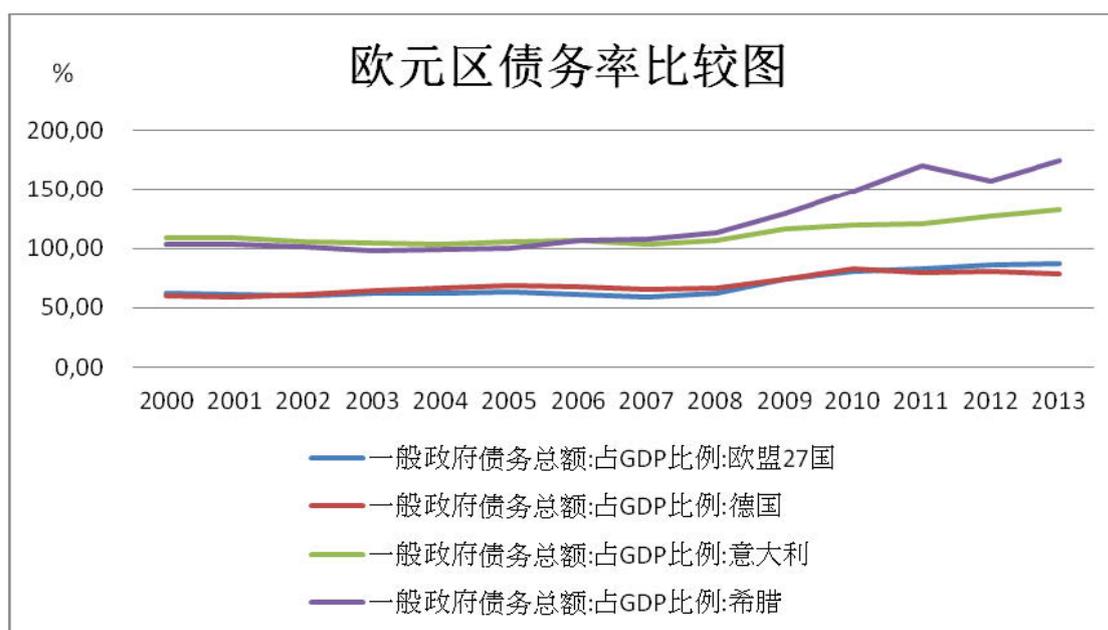
Fiscal balance: as a proportion of GDP: Greece (purple)

Fiscal balance: as a proportion of GDP: Ireland (light blue)

Figure 5: Various Eurozone countries' fiscal deficits

Source of data: Wind Information

Comparison of the Eurozone's debt rates



Total amount of general government debt: as a proportion of GDP: 27 EU countries (blue)
Total amount of general government debt: as a proportion of GDP: Germany (red)
Total amount of general government debt: as a proportion of GDP: Italy (green)
Total amount of general government debt: as a proportion of GDP: Greece (purple)

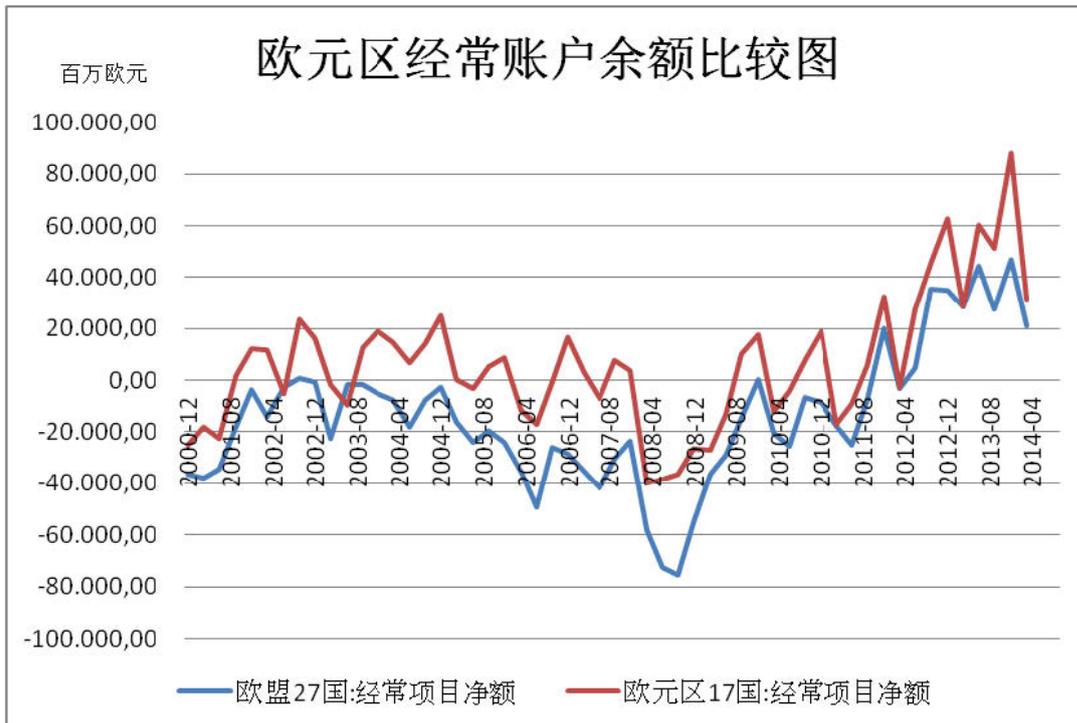
Figure 6: Comparison of the Eurozone's debt rates

Source of data: Wind Information

1.6 International Balance of Payments is Improving

Foreign trade is an important part of the European Union's economy. The European Union has registered deficits in foreign trade for a long time. After the outbreak of the European debt crisis, because the shrinking domestic demand led to the slowdown in imports, the European Union's current account balance immediately changed from the huge deficit of 2008 to a huge surplus, and the current account balance kept rising. The European Union's current account balance reached 46.8 billion euros at the end of 2013, and might further expand. Here, it is worth mentioning particularly that the improvement of peripheral countries' international balance of payments is of special significance to increasing their debt balances and improving their economic structures.

Comparison of the Eurozone's current account balance



27 EU countries: net current account balance (blue)

17 Eurozone countries: net current account balance (red)

Figure 7: Comparison of the Eurozone's current account balance

Source of data: Wind Information

Generally speaking, the European economy is in the stage of coming out of the crisis and recovering slowly, but as the saying goes, "sickness goes like reeling silk". It obviously makes people feel the recovery lacks strength and momentum. At present, the European Union's inflation level is at the four-year low of only about 0.5%. The European economy seems to have sunk into the deflationary situation of "high debt – low inflation – low growth – high unemployment".

2. Causes of the Status Quo of the European Economy

There are both positive and negative factors contributing to the status quo of the European economy.

Positive factors: On the one hand, the European Union and the Eurozone's initiatives of providing relief for default, consolidating finance and strengthening financial supervision and their policy of reforming social security and the labor market achieved a certain effect, and contributed to their coming out of the crisis and recovering the economy. First, a series of financial relief tools and mechanisms including the European Stability Mechanism were established at the EU level from zero. The European Union, the European Central Bank and the

International Monetary Fund provided more than 500 billion euros in relief successively, avoided relevant heavily indebted countries' default and exit from the Eurozone, and stabilized the situation; meanwhile, the European Central Bank effectively alleviated the European debt crisis by adopting various means such as long-term refinancing operations (LTRO) in this period, turned itself into the actual last lender, and enhanced its authority. Second, finance was reshaped and consolidated. The "Sixpack" further improved and enhanced the provisions of the Stability and Growth Pact, and collaborative initiatives such as the introduction of the "European Semester" urged member states to try to approach the goal of convergence in the fiscal compact. Besides, a financial supervision system including the European Systemic Risk Board, the banking regulator, the securities regulator and the insurance regulator was established. In particular, the establishment of the banking union blocked the path of future evolution of private bank debt into sovereign debt, and improved the ability to supervise, resist and prevent financial risks at the EU level. Third, a macro-warning and correction mechanism was established to prevent imbalance of member states' macroeconomic structures, and the Euro Pact, the Euro Plus Pact and the Europe 2020 Strategy were relied upon to strengthen various countries' competitiveness and reduce their gaps. Fourth, the welfare system was reformed. After the crisis, various EU countries, especially southern European "Mediterranean Model" countries, approached "Rhine Model" countries, deepened reform of welfare systems such as social security, emphasized individual responsibilities, curbed moral risks, tightened welfare expenditure, and made certain achievements. In terms of the labor market, various countries strengthened proactive labor policies, encouraged entrepreneurship and flexible employment, and strengthened support for employment training and employment agency. Fifth, foreign cooperation was strengthened to promote negotiation with relevant regions such as European and American free trade areas and on the China-Europe Bilateral Investment Treaty and expand the space of export demand.

On the other hand, the notable improvement of the international economic situation provided relatively strong support for the recovery of the European economy. At present, the overall world economy is in the stage of recovery. The economic performance of USA as EU's largest economic partner was not as robust as expected in the first quarter of 2014, but its recovery accelerated in the second quarter, the unemployment rate dropped to 6.1% and the annualized growth rate reached 3.1%. Meanwhile, compared with the slowdown of growth and structural adjustment in 2013, the overall economic performance of emerging economies including China was relatively stable in 2014. This will undoubtedly create a relatively loose environment for the recovery of the European economy relying on overseas markets heavily.

Negative factors: First, the existing institutional framework is restrictive. To prevent the moral risk of “free riding”, the EU Stability and Growth Pact provides the permitted upper limit of member states’ fiscal deficit and public debt. It was implemented more strictly after the crisis. As a result, the heavily indebted countries and core countries both implemented tight fiscal policies to repay the debt and meet the standard respectively, could hardly implement incentive policies without restraints, and curbed their internal demand.

Second, the economic gaps among member states of the Eurozone and the European Union, especially between the core countries like Germany and Sweden and the peripheral countries like Greece, kept expanding because of the European debt crisis, making convergence more difficult. Meanwhile, the different economic cycles of various member states naturally made implementation of united economic policies of the European Union or the Eurozone difficult, and affected the course of recovery. Economic indicators in 2013 fully show the huge differences in this period. The economic growth rates of Sweden, Poland, Greece and Italy are 1.6%, 1.6%, -3.9% and -1.9% respectively; the fiscal deficits of Germany and Greece are 0.0% and -12.7% respectively; the public debts of Sweden and Greece are 40.6% and 175.1% respectively. In May 2014, the unemployment rate of Germany was 5.1%, while that of Greece was as high as 25.1%. Meanwhile, the different economic cycles of various member states such as Germany, Sweden and France made it more difficult to implement united economic policies.

Third, the weakening of European identity awareness and the expansion of the Eurosceptic tendency restricted the momentum of the economic recovery. Because the European debt crisis impacted the life of middle- and lower-class people in various European countries, their “Eurosceptic tendency” was on the rise, which was quite obviously manifested in the European Parliamentary election held in May 2014. Some extremist anti-European and Eurosceptic parties won by a landslide and received a lot of votes such as the French Front National, the United Kingdom Independence Party and the Alternative for Germany. People in the core countries opposed saving crisis-stricken countries by fiscal transfer, and people in the peripheral countries were averse to the core countries’ requirement that they should implement strict deflation policies. Relevant countries such as the United Kingdom as one of the three largest European countries threatened to hold a referendum on whether to withdraw from the European Union, exacerbating people’s worries about the subsequent development of European integration.

Fourth, the three EU bodies of the European Commission, the European Council and the European Parliament are in transition, and the outside world does not clearly know their new policy trend and executive force yet. This also hinders the coordination of various countries’ economic incentive policies to some extent.

3. Prospects of the European Economy

In terms of the recent development trend of the European economy, generally speaking, the economy of Europe, mainly the European Union and the Eurozone, will continue its weak recovery in reversals and zigzags; in terms of countries and regions, the recovery will be unbalanced and asynchronous; in terms of the thought and result of problem solution, the possibility of technical solutions is obviously higher than that of breakthroughs in political mechanisms; in the long run, it will still depend on structural reform and innovation.

First, because of the above differences in economic performance among member states, the institutional restriction, the “democratic deficit” shown by the augmentation of Eurosceptic feelings, etc. in addition to the current lack of points of growth such as breakthroughs in industrial development in the world, the implementation, convergence and realization of the EU’s policy of enhancing its competitiveness still require a lot of time. Besides, it is expected that the current loose monetary policy can hardly achieve anything big. If liquidity idles in the financial sector, the European Union might experience a situation of long-term economic depression and low or negative interest rates similar to that of Japan in the future.

Second, the economic cycles and economic differences can hardly be united among the member states of the European Union and the Eurozone in the short run. Even well-performing core countries like Germany now have their own problems – for example, Germany’s current account surplus is more than 6% of its GDP at present and is deemed as a cause of imbalance. The general recession of the peripheral countries also makes the sustainability of Germany’s model of economic development relying on the surplus an object of criticism, and calls for more social welfare, less social injustice, etc. marked by the introduction of minimum wages will push costs higher and devastate the low-cost advantage that Germany relies on to thrive. Because of the periodical factors and its own politics, the economy of France can hardly show signs of a breakthrough in recovery in the short run.

Third, in view of the EU’s current initiatives in response to deflation, the author thinks it impossible to make great breakthroughs in mechanisms of political system establishment in a short time mainly because to issue uniform euro bonds and unite EU national fiscal mechanisms (e.g. introduction of new cross-regional transfer payments, new taxes, etc.), member states need to carry out consultation and repeated bargaining at the political level. Against the current backdrop of rising Eurosceptic feelings, obvious gaps between the core countries and the peripheral countries and constant conflict between the “deflation” and “incentive” politics after the European debt crisis, it is expected that a consensus can hardly be reached and thus form synergy to solve problems through mechanisms at the EU

level quickly. Therefore, it is more likely that the European Central Bank will be mainly relied upon to solve problems through technical treatment like the real emergency treatment during the European debt crisis so as to avoid complicated political procedures. Specifically, on June 5, 2014 the interest rate conference of the European Central Bank lowered the deposit interest rate into the negative range. Other specific easing measures include: long-term refinancing operations (LTRO), strengthened liquidity support, suspension of the SMP sterilization, expansion of balance sheets, etc. However, whether these policies can quickly boost the European economy still depends on policy conduction mechanisms. Among them, the key is whether the liquidity released by the loose monetary policy can enter the real economy instead of idling in the financial system. This requires the European Union to formulate a series of supporting policies, especially tax policies, but the expected result is obviously not quite optimistic. What the result will be remains to be seen. In the long run, industrial breakthroughs and mechanism innovation still must be relied upon to solve the problem of Europe's deflation and weak recovery.

Last, with the takeover of the European Commission by former President of the Euro group Juncker and against the backdrop of the unfolding global economic recovery, we have reason to hope the new leaders of the European Union will keep forging ahead and make great achievements. Juncker as an advocate and promoter of the European Federation can certainly seize the structural defects exposed by the European debt crisis, turn the remedial rescue initiatives adopted in the crisis such as emergency relief mechanisms, fiscal consolidation initiatives, financial supervision mechanisms, fiscal contract, the banking union and enhancement of competitiveness into mechanisms, and further deepen European integration. Now is a good opportunity of in-depth promotion. On the one hand, the improvement of the world economic environment is gradually expelling people's resentment, and on the other hand, the pain brought by the crisis is still lingering so people will not forget the bitter past when released from their suffering, and their reform consciousness has not weakened yet.