EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2012 and 2013

Summer 2012

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Pierre Werner Programme of the Robert Schuman Centre for Advanced Studies at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/DepartmentsAndCentres/RobertSchumanCentre/Research/Economic MonetaryPolicy/EFN/Index.aspx.

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Highlights

- In 2012 and 2013 we expect world production to grow modestly, since external conditions have deteriorated as growth dynamics appear to be declining in important emerging economies. However, the euro area crisis remains the central risk factor for the world economy
- Euro area GDP is expected to decline 0.2 percent in 2012 when compared to 2011; for 2013 we expect fiscal policy to be a bit less restrictive and private investment to increase, with GDP expanding by 0.9%. The unemployment rate will remain well above 11%.
- In this context, the southern euro area member states will stay in recession this year, and most probably next year too, as the fiscal consolidation will go on, the structural reforms will need time to yield beneficial effects, and the real sector will be largely out of reach of the expansive monetary policy of the ECB because of the crisis of the financial sector. Elsewhere in the area, growth will be dampened by these deep recessions through several channels, such as a further weakening external demand and the postponement of spending decisions because of higher uncertainty. This will affect industrial production that, according to our expectations, this year will shrink by at least 1%.
- Important underlying assumptions of this forecast are that reforms will continue to be successfully implemented in the southern countries, there will be no major bank failures, and firms and households in the euro area will largely continue to act on the premise that policy will, in the long run, be able to master the euro area debt crisis. In fact, the ECB will probably still have the means to prevent a systemic financial crisis, but banking is now largely fragmented on national lines and the uncertainty in financial markets about the future of the currency union will be a heavy burden for the real economy.
- The important moderation of the international prices for energy since our last report has motivated a significant reduction in our expected inflation, now at 2.2% in 2012 and 1.3% in 2013. In a climate of slowing output growth, our inflation forecast increases the likelihood of new cuts in the ECB reference rate in the short or medium term.

Table 1 Economic outlook for the Euro area

	2009	2010	2011	2012: 1st half		2012: annual		2013: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					-0.5		-0.6		0.2
GDP	-4.4	2.0	1.5	-0.1	0.3	-0.2	0.2	0.9	1.7
					0.5		0.5		0.6
Potential Output	0.7	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.8
					-0.4		-0.5		-0.1
Private Consumption	-1.2	0.9	0.2	-0.3	-0.1	-0.2	0.1	0.5	1.1
Government Consumption*	2.6	0.7	-0.3	-0.5		-0.7		-0.2	
					-2.8		-3.6		-0.6
Fixed Capital Formation	-12.4	0.0	1.4	-2.3	-1.7	-2.2	-1.0	1.9	4.3
					2.6		2.5		5.7
Exports	-12.7	11.2	6.2	3.1	3.5	3.3	4.2	7.1	8.5
					-0.2		0.6		5.7
Imports	-11.4	9.6	3.9	0.3	0.7	1.4	2.3	7.2	8.7
					10.9		11.0		11.1
Unemployment Rate	9.6	10.1	10.2	11.0	11.1	11.2	11.4	11.6	12.2
					2.1		2.3		2.0
Total hourly labour costs	2.7	1.5	2.8	2.4	2.7	2.6	2.8	2.3	2.6
Labour Productivity					0.4		0.3		1.0
(output per head)	-2.6	2.5	1.4	0.5	0.7	0.6	1.0	1.5	2.1
					2.4		1.9		0.4
HICP	0.3	1.6	2.7	2.6	2.7	2.2	2.4	1.3	2.3
					-3.1		-3.2		-1
IPI	-14.9	7.3	3.5	-1.6	-0.1	-1.2	0.8	1.7	4.4

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

* Currently, government consumption is highly influenced by the need of fiscal consolidation in many euro area countries, a situation that is not appropriately captured by the model. Hence, we assume a time path of government consumption that is compatible with the consolidation programs of the member countries.

Economic Outlook for 2012 and 2013

Darkening clouds over the euro area economy

In the summer of 2012, the euro area debt crisis is again intensifying, and the financial and political stability of the monetary union is at stake once more. As so often during the past years, recent measures taken by European policy to contain the crisis seem to have brought no more than a temporary stabilization of confidence on financial markets. At present, the crisis has two focal points: first, it is unclear whether Greece will avoid open default by continuing the (possibly renegotiated) adjustment program and, if not, whether the country will keep the common currency and what contagious effects a default or an exit would have for other euro area crisis countries. The second focal point is Spain: at the end of May, financial markets regarded the bail out request by the savings bank Bankia as indication of further needs of the Spanish financial sector due to rising burdens of the housing crisis; this reinforced doubts about the sustainability of the Spanish treasury. With the intention of preventing the risk premia of public debt from rising further, Spain, in the first half of June, requested support from the European partners and the IMF. Unlike the previous recipients, Greece, Ireland, and Portugal, Spain is meant to use the capital only for its banks, and the conditionality attached to the support will only relate to the financial sector. Nevertheless, the support will raise the burden of public debt for Spain, possibly by 10 percentage points relative to annual GDP. Moreover, the upward trend was not simply triggered by one piece of bad news: right after the second three-years refinancing operation of the ECB had been concluded and banks had spent parts of their fresh liquidity for government bonds, risk spreads started upwards again. Other causes were news about the Spanish government lowering its target for deficit reduction in 2012 and about a dilution of planned labour market reforms in Italy. Still, strains on financial markets have not reached the dimension they had at the end of last year; for example, the level of implicit volatility on European stock markets is still markedly lower; moreover, the spread between collateralized and uncollateralized credit on the interbank money market is, with about 60 basis points in mid June, about half as high as in December. All in all, this year and next, policy, in particular by the ECB, will probably still have the means to prevent a systemic financial crisis, but the fact that banking is now largely fragmented on national lines inside the euro area and the uncertainty on financial markets about the future of the currency union will be a heavy burden for the real economy.

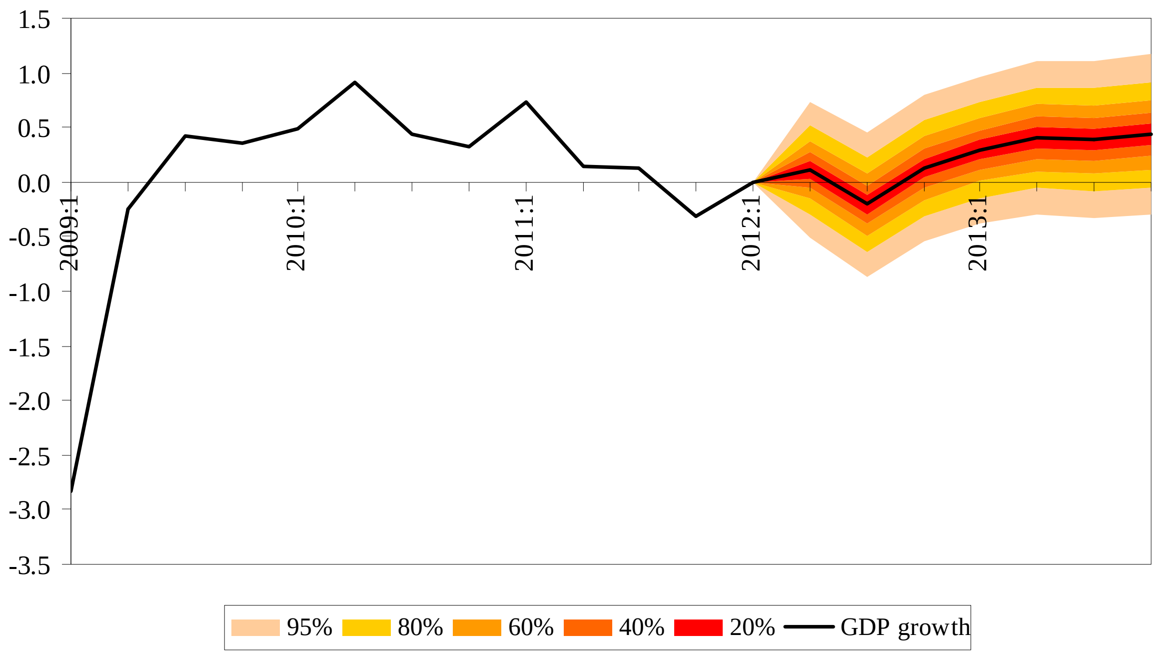
External conditions are comparably stable, but they have deteriorated as well: world trade has stopped expanding during springtime, and worldwide sentiment in the manufacturing sector fell in May. The upswing in the US is only moderate, as disappointing labour market data have shown recently. Growth dynamics appear to be declining in important emerging economies: in China, the downturn of the housing sector slows economic expansion, in India, inadequate infrastructure more and more limits the potential for growth, and in Brasil, the industrial sector has lost international competitveness and is currently in stagnation. In each country, monetary policy acted by cutting interest rates: in Brasil in the summer of last year, in India in this April, and in China in June. All this will help to keep world production modestly growing. And the euro area crisis remains the central risk factor for the world economy.

Deep recessions in the south of the euro area, slowing growth in the north

Production in the euro area stagnated in the first quarter of 2012. A surprisingly strong expansion of GDP by 0.5% in Germany balanced out with shrinking production in Spain (by 0.3%) and a particularly strong reduction in Italy (by 0.8%), while the French economy continued to stagnate. Only the external balance prevented the euro area economy from shrinking for the second quarter in a row: exports expanded by about a percentage point, while imports were almost flat, as was private household consumption expenditure. Investment in fixed capital and in inventories continued to decline. All in all, internal demand is on a downward path since spring 2011. This is not surprising given housing and banking crises as well as deep budget cuts in large parts of the euro area. In the area as a whole, general government expenditure has been stagnating in nominal terms since autumn 2010, shrinking markedly in real terms. Since summer of 2011, real disposable incomes are shrinking as well; they are presently lower than on the eve of the Great Recession in 2007. Private households have up to now kept their propensity to consume about stable; their saving rate is, at about 13 ½ % (final quarter of 2011), quite low by historical standards, although reasons for higher prudential savings such as uncertainties about the future course of the debt crisis and worrying employment prospects are ample. Employment has been falling since summer; in this time, the rate of unemployment has risen by 1 percentage point in the euro area, but by no less than 2 percentage points in Italy and by more than 3 in Spain. More recent news points to a declining or, at best, stagnating production in the coming quarters. Manufacturing as well as construction continued on their downward path in April. Economic confidence that appeared to stabilize in spring is waning again, in particular among firms, as the debt crisis intensifies and strong momentum from external demand is not in sight. According to the most recent bank lending survey, demand for loans for investment purposes is expected to decrease further.

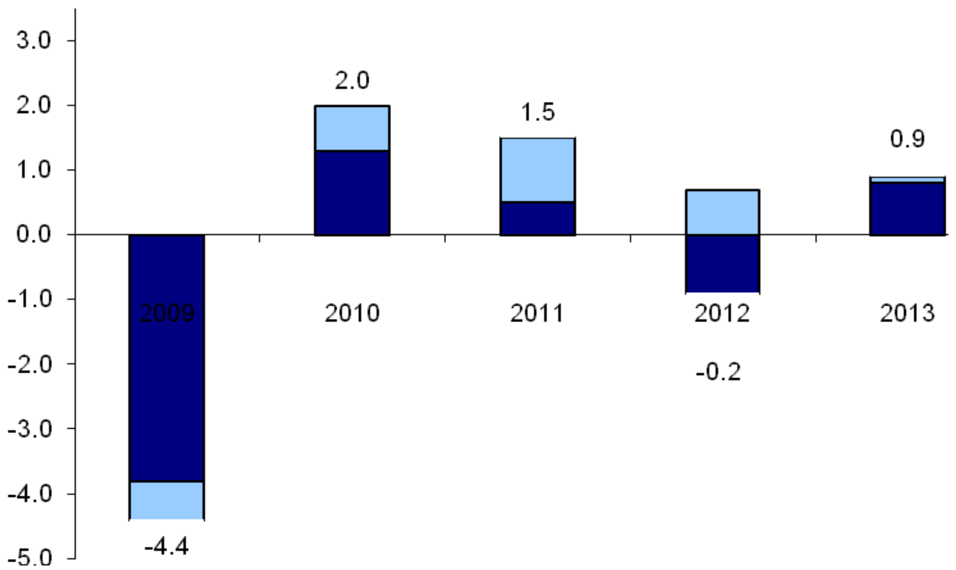
The southern countries will stay in recession this year, and most probably next year too, as the fiscal consolidation will go on, the structural reforms will need time to yield beneficial effects, and the real sector will be largely out of reach of the expansive monetary policy of the ECB because of the crisis of the financial sector. Elsewhere in the area, growth will be dampened by these deep recessions through several channels, such as a further weakening in external demand and the postponement of spending decisions because of higher uncertainty. However, private households and firms in the north will benefit from low external financing costs that have fallen again early this year. This is one reason why this report does not forecast a deep recession for the euro area as a whole. Still, GDP is forecast to be 0.2 percent lower in 2012 than in 2011. For 2013 we expect fiscal policy to be a bit less restrictive and private investment to catch up, with overall production expanding by 0.9%, which is a bit higher than the presently quite low rate of potential growth. The unemployment rate will remain well above 11%. Important underlying assumptions of this forecast are that reforms will continue to be successfully implemented in the southern countries, there will be no major bank failures, and firms and households in the euro area will largely continue to act on the premise that policy will, in the long run, be able to master the euro area debt crisis.

Figure 1 Quarterly GDP growth rates and confidence bands



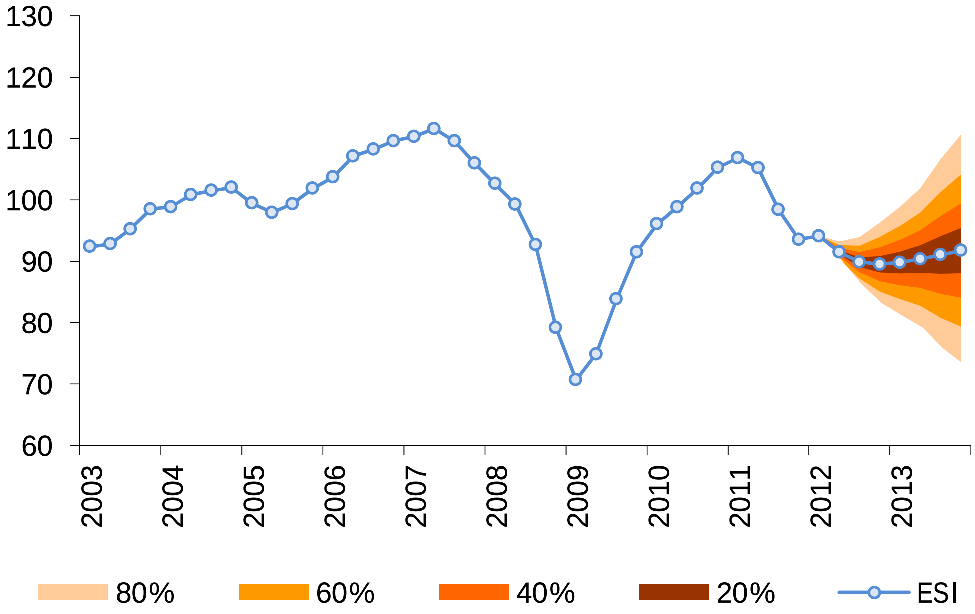
Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



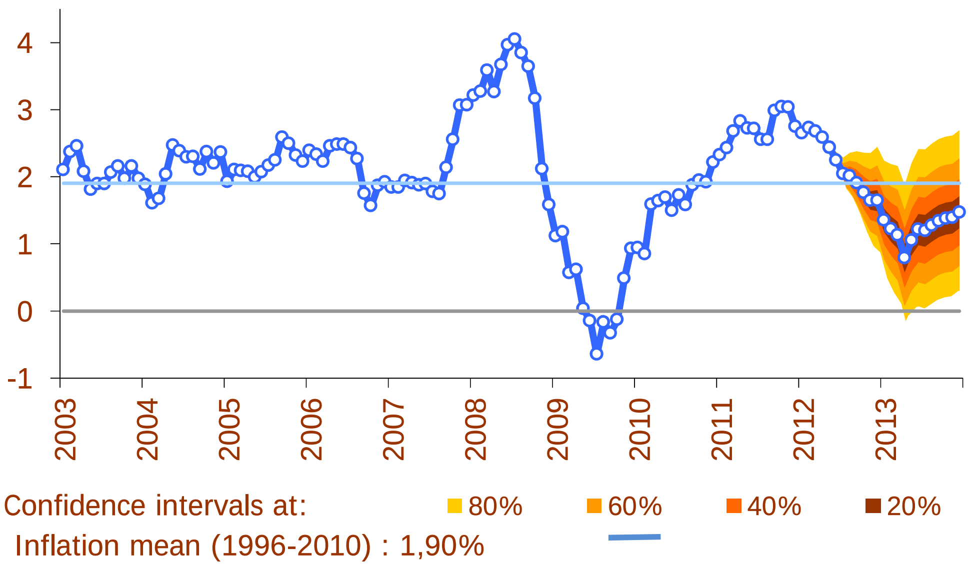
Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Figure 3 Economic Sentiment Indicator and confidence bands



Inflation in the euro area does not seem yet to be significantly adjusting to the current output stagnation. Since September 2011, core inflation has only declined by 0.2 pp, to an annual value of 1.8% in May. However, our total inflation forecasts have notably decreased since our previous report. The increasing concerns about the rate of recovery of most developed economies have motivated an important moderation in the international price of energy, causing the above-mentioned reduction of our inflation expectations. Consequently, the inflation profile for the next few months has changed, bringing 5 months forwards –to July– the time when euro area inflation could be around the ECB's 2% target. This evolution of the inflation expectations in addition to the growing negative impact of the uncertainty related to the European financial and public debt crisis on the the euro area real economy, increases the likelihood of new cuts in the ECB reference rate in the short or medium term.

Figure 4 HICP and confidence bands



Last, the growth differential between industrial production in central and peripheral European countries increased again in the last months. The greatest annual decrease in industrial production in April was in Italy, together with Spain and Portugal (9.2%, 8.3% and 7.6%, respectively). Although German industry broke its upwards trend of the last three months with a small year-on-year 0.8% contraction in April, its evolution is still much different from the contraction in industry in peripheral Europe. Among the largest euro area economies, only French and Dutch industries registered positive year-on-year rates (2% and 4.7%, respectively). All in all, the prospects for the aggregate industrial production have notably worsened due to the increasing weakness of the leading indicators, which anticipate further contracions. In May, the ICI was -11.3 points (lowest since February 2010), while the manufacturing PMI was 45 points, the lowest value since June 2009. As shown in table 2, production of capital goods will continue to be the only engine of industrial growth during 2012.

Table 2 Annual average rates for industrial production in the euro area

	2008	2009	2010	2011	2012	2013
Durable	-5.4	-17.4	2.7	0.4	-4.9	-3.0
Non Durable	-1.3	-3.0	3.1	0.6	-2.4	-0.1
Capital	-0.3	-20.9	9.2	8.8	2.2	5.7
Intermediate	-3.3	-19.2	10.0	4.3	-2.8	1.0
Energy	0.0	-5.5	3.8	-4.8	-2.2	-1.9
Total	-1.7	-14.9	7.3	3.5	-1.2	1.7

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The EFN forecast stands out in that it predicts a more optimistic view of private consumption evolution accompanyied by a more intense reduction in fixed capital formation in 2012 but also a marked increase in the unemployment rate in 2013. One reason is that the participation rate is still – albeit at a slower pace since the beginning of the Great Recession – rising in the euro area.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF**		ECB		OECD		Consensus	
	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013
GDP	-0.2	0.9	-0.3	1.0	-0.3	0.9	-0.1	1.0	-0.1	0.9	-0.4	0.7
Priv. Consumption	-0.2	0.5	-0.6	0.5	-0.6	0.4	-0.4	0.5	-0.5	0.3	-0.5	-0.2
Gov. Consumption	-0.7	-0.2	-0.8	0.0	-0.8	-0.2	-0.2	0.0	-0.8	-0.5	-0.5	-0.2
Fixed Capital Form.	-2.2	1.9	-1.5	1.9	-1.5	0.9	-2.1	1.5	-1.8	1.3	-2.0	0.7
Unemployment rate	11.2	11.6	11.0	11.0	10.9	10.8	na	na	10.8	11.1	11.0	11.2
HICP	2.2	1.3	2.4	1.8	2.0	1.6	2.2	1.6	2.4	1.9	2.3	1.7
IP	-1.2	1.7	na	na	na	na	na	na	na	na	-1.4	1.6

EU: European Commission, Economic Forecast, Spring 2012; IMF: World Economic Outlook, April 2012; ECB: ECB Monthly Bulletin, June 2012, OECD: Economic Outlook, June 2012; Consensus: Consensus Economics Inc., Consensus Forecasts, May 2012. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 4 below. We assume a moderate upswing in the US for this and for next year. The expected expansion of world trade in 2012 is quite low, since its acceleration at the end of 2011 turned out to be short-lived. Oil prices have fallen markedly since March, as world production appears to be slowing and political risks in the Middle East subsided somewhat. Prices are assumed to stay at their present level of about 100 dollars per barrel (Brent) in 2012 and to rise only modestly next year.

Table 4 Variables of the world economy

	2011	2012	2013
US GDP Growth Rate	1.7	2.3	2.5
US Consumer Price Inflation	3.1	2.3	2.1
US Short Term Interest Rate (December)	0.01	0.1	0.3
US Long Term Interest Rate (December)	2.0	2.4	2.9
Japan GDP Growth Rate	-0.7	2.0	1.5
Japan Consumer Price Inflation	-0.3	-0.1	0.0
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	1.0	1.1	1.2
World Trade Growth Rate	6.0	4.0	6.0
Oil Price (December)	108	100	103
USD/Euro Exchange Rate (December)	1.32	1.24	1.24
100Yen/Euro Exchange Rate (December)	1.03	1.00	1.00

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2012). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.