EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2011 and 2012

European Forecasting Network

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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 Schuman Centre 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

- High growth dynamics and demand coming from emerging markets will slow only modestly in the rest of 2011 and in 2012, but the intensification of the financial turmoil and the doubts about the ability of the European Union to contain the consequences of possible defaults will hamper world economic growth considerably in our forecasting horizon.

- For the euro area, we expect GDP to grow by around 1.6% in 2011 and 0.8% in 2012, not enough to bring the unemployment rate back below 10% and substantially less for 2012 than in our Summer report. Many private households and firms will adopt a wait-and-see attitude while, to restore confidence in the euro area sovereign debt, fiscal policy will become even more restrictive.

- Our industrial production forecast has also been revised downwards with respect to the Summer report, now we expect a growth rate of 3.7% in 2011 and 1.6% in 2012, mostly due to the relative deterioration of the euro area external demand.

- Because of energy prices and aggregate demand moderation, our inflation forecasts for 2011 and 2012 are reduced to 2.6% and 1.3% respectively.

- Lower inflation and growth forecasts, combined with the intensification of the financial turmoil and the announced restrictive fiscal policy in many euro area countries, make us suggest that the next interest rate decision of the ECB should be a fast and substantial cut, notwithstanding the September value for HICP inflation.

Table 1 Economic outlook for the Euro area

	2008	2009	2010	2011: 2nd half		2011: annual		2012: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	0.4	-4.2	1.8	1.3	0.8 1.7	1.6	1.4 1.9	0.8	0.0 1.5
Potential Output	1.4	0.7	0.5	0.8	0.7 0.9	0.7	0.6 0.8	1.0	0.8 1.1
Private Consumption	0.3	-1.2	0.8	0.2	-0.2 0.6	0.5	0.3 0.7	0.6	-0.2 1.3
Government Consumption*	2.3	2.5	0.5	0.0		0.3		0.1	
Fixed Capital Formation	-0.9	-12.0	-0.8	3.2	1.8 4.5	2.9	2.2 3.6	2.6	0.3 4.9
Exports	0.9	-13.0	10.8	5.9	4.9 6.9	6.9	6.4 7.4	5.3	4.0 6.6
Imports	0.9	-11.7	9.1	4.5	3.5 5.5	5.5	5.0 6.0	5.3	3.8 6.7
Unemployment Rate	7.6	9.6	10.1	10.3	10.0 10.1	10.1	10.0 10.2	10.4	10.0 10.8
Total hourly labour costs	3.5	2.7	1.6	3.0	2.7 3.3	2.7	2.5 2.9	2.6	2.1 3.1
Labour Productivity	-0.5	-2.4	2.2	1.1	0.7 1.5	1.3	1.1 1.5	1.1	0.6 1.5
HICP	3.3	0.3	1.6	2.6	2.3 2.9	2.6	2.5 2.7	1.3	0.4 2.2
IPI	-1.6	-14.8	7.5	2.1	0.7 3.5	3.7	2.5 4.9	1.6	-0.6 3.8

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 the EFN forecasting model and based on 2000 stochastic simulations.

*Since the winter report 2010, we depart from our usual approach of deriving government consumption endogenously in the EFN econometric model. 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 2011 and 2012

The world economy and financial markets: from a soft patch into a downturn

The slowdown that was thought to be temporary during the summer has now developed into a downturn of the world economy: while the breakdown of Japanese industrial production caused by the natural and nuclear disasters is quickly overcome, economic sentiment continues to fall all over the world, and in particular in the US and in Europe. World stock prices are, at the beginning of October, on average almost 20% down since mid July. Uncertainty is particularly high in financial markets in the euro area, where a banking crisis similar to that in 2008/09 appears to be imminent: mistrust in some European banks is reflected by high risk premia for short term credit on the money market and for credit default swaps against bank defaults, as well as by large volumes of excess liquidity hoarded by euro area banks. All this is a consequence of the sovereign debt crisis in the euro area: trust in the ability and the will of governments to cut high deficits and stimulate growth is waning, and so is trust in government bonds and in those banks that keep large volumes of them in their books. But what is also cast into doubt is the ability of the European Union to contain the consequences of possible defaults – by states or by big banks –, as political resistance against rescue measures like the reformed European Financial Stability Facility (EFSF) has been growing during the summer in stable member countries.

The euro area debt crisis is the most important but not the only cause for the deteriorating economic outlook. Growth in the US has disappointed this year, and unemployment is not receding. Thus, expectations have turned down because the stimulus from expansive fiscal policies – even if Congress can agree on a limited program for employment – will decline in the coming quarters, and the scope for monetary policy, after ultra-expansive and unconventional measures have not been successful for years – appears to be very limited. All in all, the financial crisis of 2008/09 seems to take effects that will drag down growth in many advanced economies for some years more: the debt overhang of private households depresses the construction sector and private consumption in the US, while the public debt overhang in many euro area states forces governments to restrict their spending and threatens financial stability in Europe. If most observers – and indeed our forecasts – still do not predict a world recession, it is for the emerging markets economies: they have been slowing during this year as well, but this was largely the desired result of contractive (or less expansive) policies that were meant to fight inflation. Although inflationary pressure is only slowly receding, policy could, if need be, quickly become more expansive again. The process of decoupling from, or rather the ceasing dependence on, the advanced economies has certainly advanced further since 2008. Thus, the chances are good that growth dynamics and demand coming from emerging markets will continue to be high in the rest of the year and in 2012. This appears to be a wide spread expectation; otherwise, prices for commodities would not have been relatively stable during the recent turmoil on world financial markets.

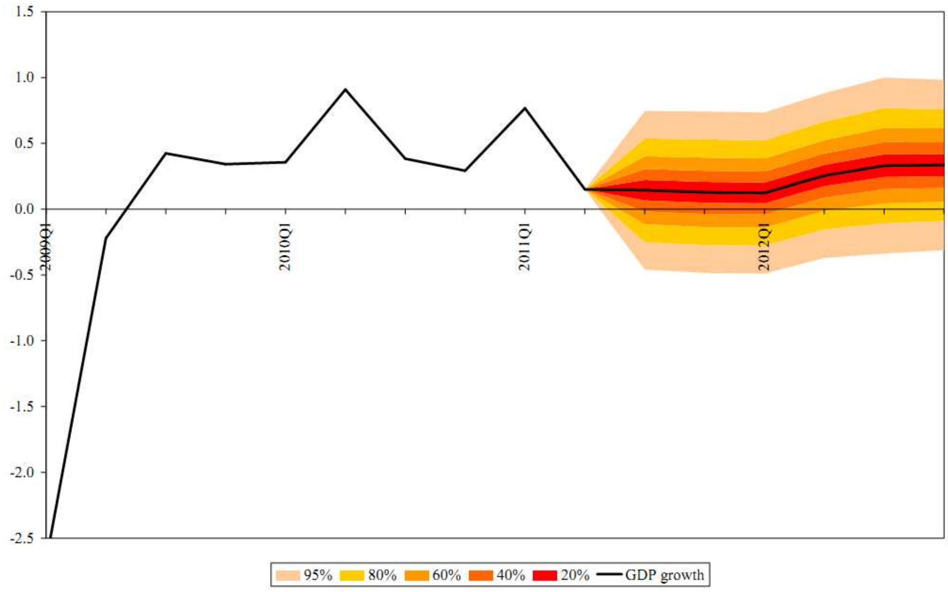
The euro area: on the brink of recession

In the second quarter of 2011, the moderate upswing that had begun two years ago almost stalled. Consumption of private households even contracted. Some fiscal measures might have played a role here: the French car scrapping premium had phased out, and Germany raised taxes on tobacco. More important were the high international prices for commodities that peaked in April (at a historical maximum, if expressed in euro), and eased only a bit in the months later: real disposable income of private households has probably decreased during the first half of 2011. Investment slowed markedly, mainly because construction activity was lower than in the first quarter, when it had been particularly buoyant due to favorable weather conditions in some countries. All in all, the euro area economy slowed during the first quarter, but not as strong as GDP data suggest. The same can be said about some larger economies that had expanded quickly before, such as Germany, the Netherlands and France, while Italy and Spain continued their slow growth path.

The financial turmoil will be a drag on growth via different channels: banks that fight a loss of confidence will have to strengthen their balance sheets and tighten credit standards. Risk spreads for companies, particularly in countries with a sovereign debt crisis, have already gone up. In general, many private households and firms will adopt a wait-and-see attitude: it is rational to delay irreversible investment decisions in times of uncertainty. Moreover, and in order to restore confidence in the euro area sovereign debt, fiscal policy is and will be restrictive, with a negative fiscal impulse of almost one percentage point relative to GDP this year. In some countries, e.g. in Spain, consolidation appears to be less than what was planned in their stability programs, but the loss of confidence on financial markets forces new spending cuts (for example in Italy and even in France) that will weaken private demand. And so far there are no credible plans to foster medium term growth.

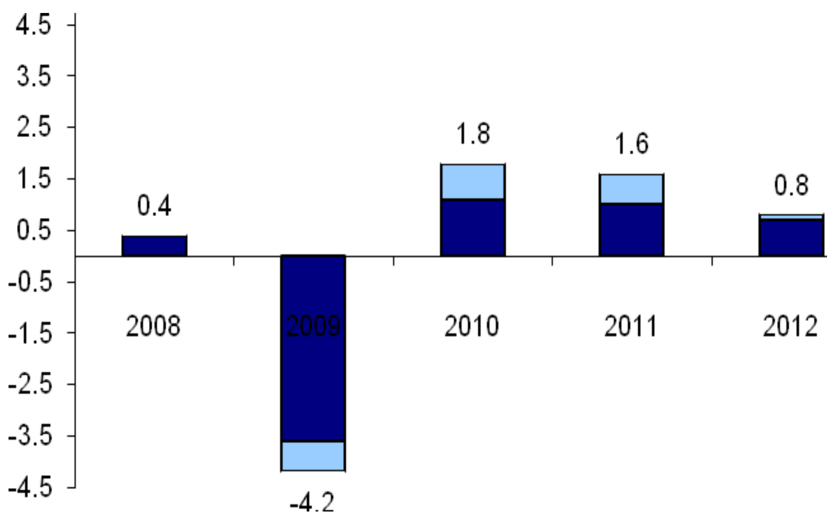
Hence, we have revised downwards our forecasts for euro area GDP growth, to 1.6% for 2011 and 0.8% for 2012. The expected quarter on quarter growth rates are reported in Figure 1, together with measures of forecast uncertainty, while Figure 2 shows that the bulk of future growth will be due to domestic demand. Figure 3 presents our expected evolution of the Economic Sentiment Indicator, which should only mildly decline over 2011 and 2012 from the current levels. It is worth mentioning that this forecast rests on the assumption that the crisis of confidence, though not completely solved in this year and in the next, will be at least contained. This means that, for example, if a Greek default turns out to be unavoidable, contagion effects are limited and, in particular, economic policy manages to keep the European financial sector stable. At present, this is an optimistic, but not an unrealistic assumption. Given this, the most probable course for the euro area economy is near stagnation in the winter, with a slow restart during 2012.

Figure 1 Quarterly euro area GDP growth rates and confidence bands



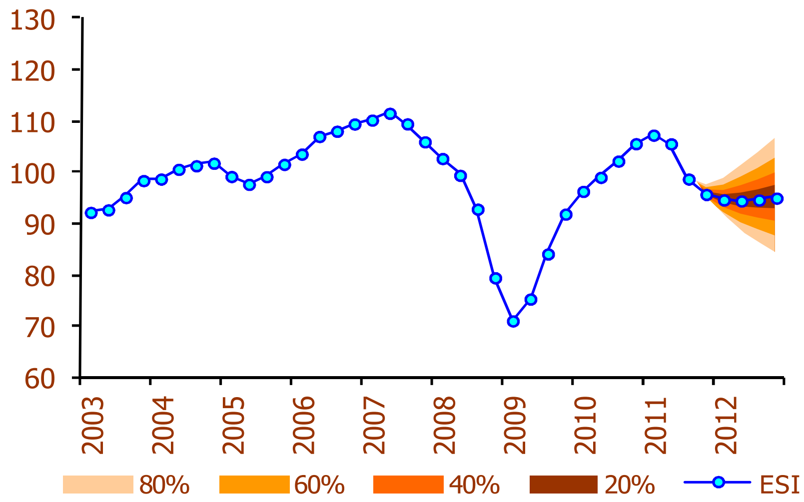
Percentage change over previous quarter

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

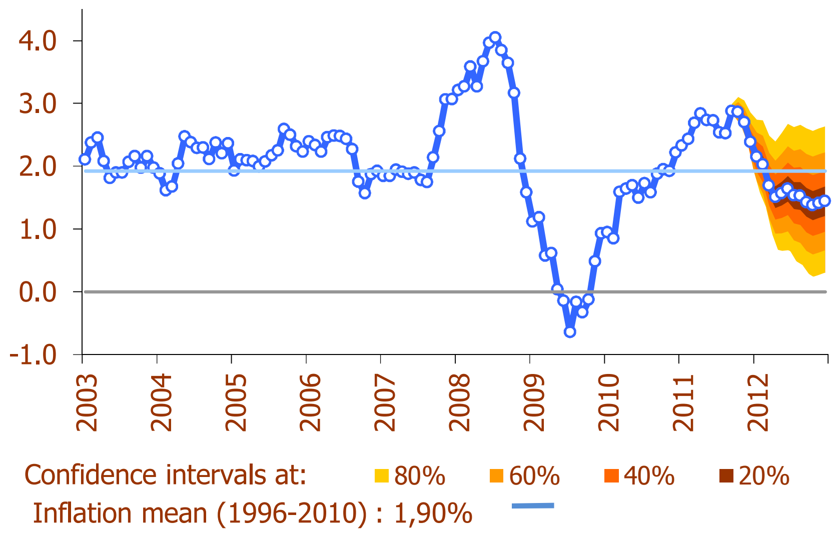
Figure 3 Economic Sentiment Indicator and Confidence bands



Since the euro area appeared to recover and inflation was quite high (above 2.5%), the ECB began to normalize its policy stance by raising the key interest rate in early April and July. But in the second half of July, the financial turmoil intensified, and the ECB reacted by resuming special long term liquidity operations and purchases of government bonds (now including Spanish and Italian ones). Moreover, the slowdown in the path of inflation forecasts for 2012, with an average annual rate of around 1.3 (see figure 4), already advanced in our previous reports, permits us to affirm that now the ECB should cut the interest rate, fast and substantially.

The reduction in inflation is mainly due to the expected evolution of energy prices and to a certain moderation in the growth of prices for non-energy industrial goods. The recent evolution of these prices is, however, difficult to evaluate, due to the changes in seasonality caused by the new methodology for the prices of seasonal goods introduced by Eurostat in 2010, which have been complied by the different countries at distinct moments in time.

Figure 4 HICP inflation and confidence bands



Year on Year rates

Regarding industrial production, with the exception of durable goods, our expectations have been revised downwards for all components, with intermediate goods suffering the most significant downturn. As a consequence, and given the recent evolution of other indicators such as the euro area external demand, our industrial production growth forecast has been revised downwards to 3.7% in 2011 and 1.6% in 2012 (from 5.8% and 3.6% respectively), see table 2.

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

	2006	2007	2008	2009	2010	2011	2012
Durable	4.6	1.3	-5.3	-17.3	2.6	0.6	3.6
Non Durable	2.5	2.6	-1.3	-2.9	3.4	1.1	0.3
Capital	6.0	6.8	0.1	-20.8	9.4	9.2	7.3
Intermediate	4.8	4.0	-3.4	-19.0	10.1	4.0	-1.0
Energy	0.4	-0.7	0.2	-5.3	3.8	-4.4	-1.1
Total	4.2	3.9	-1.6	-14.8	7.5	3.7	1.6

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 Inc.

The EFN forecast is relatively pessimistic; we think that the sovereign debt crisis will be a strain on real activity due to high uncertainty and rising costs of external financing. However, we still predict a reasonably dynamic growth of fixed capital formation. This is based on the assumption that governments manage to consolidate mainly via lower consumption expenditures and avoid drastically cutting public investment in order to preserve the productive capacity of the euro area economy.

As for inflation, while EFN forecasts are in line with all other institutions for 2011, the higher pessimism on the 2012 GDP growth motivates the negative differential between EFN and the other institutions' inflation forecasts for that year.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
GDP	1.6	0.8	1.6	1.8	1.6	1.1	1.6	1.3	2.0	2.0	1.7	1.0
Priv. Consumption	0.5	0.6	0.8	1.2	0.3	0.6	0.5	0.8	0.8	1.4	0.7	0.9
Gov. Consumption	0.3	0.1	0.2	0.3	0.1	-0.1	0.3	-0.1	0.0	-0.1	0.4	0.1
Fixed Capital Form.	2.9	2.6	2.2	3.7	2.6	1.8	2.9	3.1	2.5	3.4	2.8	2.2
Unemployment rate	10.1	10.4	10.0	9.7	9.9	9.9	na	na	9.7	9.3	10.0	9.9
HICP	2.6	1.3	2.6	1.8	2.5	1.5	2.6	1.7	2.6	1.6	2.6	1.8
IP	3.7	1.6	na	na	Na	na	na	na	na	na	4.1	2.4

EU: European Commission, Economic Forecast, spring 2011; IMF: World Economic Outlook, September 2011; ECB: ECB Monthly Bulletin, September 2011, OECD: Economic Outlook, May 2011; Consensus: Consensus Economics Inc., Consensus Forecasts, September 2011. 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. Forecasts for the US have been steadily falling since spring. Since activity in almost all advanced economies is slowing, world trade is expected to expand with rates that are below trend. US and Japanese interest rates will stay at their extraordinary low levels. Oil prices are expected to be constant for the rest of 2011 and to rise slowly in 2012. Exchange rates are assumed to be constant.

Table 4 Variables of the world economy

	2011	2012
US GDP Growth Rate	1.6	2.1
US Consumer Price Inflation	3.1	2.1
US Short Term Interest Rate (December)	0.1	0.1
US Long Term Interest Rate (December)	2.5	3.2
Japan GDP Growth Rate	-0.5	2.4
Japan Consumer Price Inflation	-0.2	-0.2
Japan Short Term Interest Rate (December)	0.3	0.3
Japan Long Term Interest Rate (December)	1.1	1.3
World Trade Growth Rate	5.9	5.0
Oil Price (December)	112	116
USD/Euro Exchange Rate (December)	1.40	1.40
100Yen/Euro Exchange Rate (December)	1.06	1.06

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 (2011). 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.