EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2009 and 2010

Spring 2009

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://efn.eui.eu* .

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Highlights

- For much of 2009, falling external demand will be the main drag on production in the euro area, with exports expected to decrease by about 13% in 2009. At the same time, the structural problems of the financial sector, combined with the uncertainty on future economic perspectives, will continue to impede investment, which will be reduced by about 6% in 2009.
- Consumers will benefit from the increase in real wages that started in the summer of 2008 and will – due to the slow reaction of wage setting to the business cycle in most European countries – continue for the year 2009. Thus, private consumption will, albeit shrinking modestly (-0.6%) because of rising unemployment, be a stabilizing factor for the economy in the euro area. A positive contribution will also come from public consumption, whose growth is forecasted at 1% for 2009 and 0.5% for 2010.
- Overall, we expect GDP in the euro area to shrink by 2.8% in 2009, with a modest increase of 0.4% in 2010. This forecast is subject to substantial uncertainty, the interval forecast for growth in 2009 ranges from -3.6% to -2.1%, and it is conditional on a tentative stabilization of financial markets and the real sector, since governments will continue supporting ailing institutions. One major risk factor is that some euro area countries might no longer be able to do so, due to budgetary and debt problems.
- Industrial production in the euro area will fall sharply during both 2009 and 2010. The average decline will be of 16.3% and 3.2% respectively. Investment, intermediate and durable consumer goods are mainly responsible for this slump.
- Consumer prices in the Euro Area are showing somewhat more stability than in the US. HICP inflation is expected to fall to 0.5% during this year, but to increase to around 1.9% in 2010. The risk of deflation for the Euro Area economy is negligible. The core inflation index, which does not include energy and unprocessed food, will be around 1.6% during both years.
- The expected paths for growth and inflation leave room for the ECB to further cut interest rates. However, the inflationary consequences of more aggressive policies, such as quantitative easing, could be worrying.

Table 1. Economic outlook for the Euro area

	2006	2007	2008	2009: 1st half		2009: annual		2010: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					-3.7		-3.6		-0.7
GDP	2.9	2.6	0.8	-3.1	-2.6	-2.8	-2.1	0.4	1.5
					1.7		1.7		1.6
Potential Output	1.9	1.9	2.1	1.8	1.9	1.8	1.9	1.8	1.9
					-1.3		-1.5		-1.4
Private Consumption	2.0	1.6	0.5	-0.7	-0.1	-0.6	0.3	-0.2	0.9
					0.8		0.6		0.0
Government Consumption	1.8	2.2	2.0	1.2	1.6	1.0	1.3	0.5	1.1
					-8.1		-7.9		-2.4
Fixed Capital Formation	5.6	4.4	0.4	-6.8	-5.6	-6.2	-4.5	0.1	2.5
					-14.0		-14.0		-1.3
Exports	8.3	5.9	1.5	-12.8	-11.5	-12.7	-11.4	0.7	2.6
					-12.0		-13.0		-2.2
Imports	8.2	5.3	1.5	-10.8	-9.5	-11.5	-10.1	0.2	2.4
					8.4		8.7		9.4
Unemployment Rate	8.3	7.4	7.5	8.6	8.8	8.9	9.1	10.0	10.7
					2.5		2.4		2.1
Labour Cost Index	2.4	2.7	3.1	2.7	2.8	2.6	2.7	2.4	2.6
					-3.0		-2.7		0.0
Labour Productivity	1.4	0.8	-0.2	-2.6	-2.2	-2.2	-1.7	0.7	1.4
					0.4		0.1		1.1
HICP	2.2	2.1	3.3	0.6	0.8	0.5	0.9	1.9	2.7
					-15,8		-18.0		-5.3
IPI	4.0	3.4	-1.7	-17.0	-18.2	-16.3	-14.6	-3,2	-1.1

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.

Economic Outlook for 2009 and 2010

The world economy: in recession

In spring 2009 the world economy is in its deepest downturn since the Great Depression. World production (measured by weighting GDP at present exchange rates) fell at the end of last year, as the recessions in the US, in the EU and in Japan became deeper. Particularly severe is the slump in world trade since autumn 2008. Apparently, the intensification of the financial crisis after the insolvency of Lehman Brothers in September has played a fatal role: investment projects around the world have been cancelled, and bank credits for financing international trade became much more difficult to attain. Consequently, in those countries where export sectors are the driving engine of the economy, as in Japan or in Germany, the fall in production was particularly deep. The financial crisis hits more directly those countries that run high current account deficits or that have to serve high liabilities denominated in foreign currencies. Here, in particular in some Central and Eastern European countries, capital inflows dry up and currencies are under pressure. The large emerging market countries China and India are also in a downturn, but not, at least up to now, in a recession.

Leading indicators such as confidence surveys or data for orders give no signs for stabilization at present. Fiscal stimuli, in particular the substantial programs of the US and of China, will not take full effect before summer. Monetary policy is very expansive in most countries by now, with key interest rates close to zero and central banks applying "unconventional measures" like "quantitative easing" in the US and Britain. But the crisis of the financial sector prevents a full transmission of the stimulus to the real sector, at least in the US and in parts of Western Europe. Markets for risk capital seem to share this view: stock prices have plunged again in February. That said, risk premia on the wholesale money markets in the US and the EU have retreated somewhat from their peaks in autumn, as have risk premia for bonds of firms with good, but not excellent ratings. If the financial sector is spared from new shockwaves, financial conditions should improve somewhat over the year. However, as the worsening state of the real sector will put more strain on banks everywhere, a tentative stabilization is plausible since governments will continue supporting ailing institutions. One major risk factor is that some countries might not be able to do so, as the example of Iceland has shown last autumn.

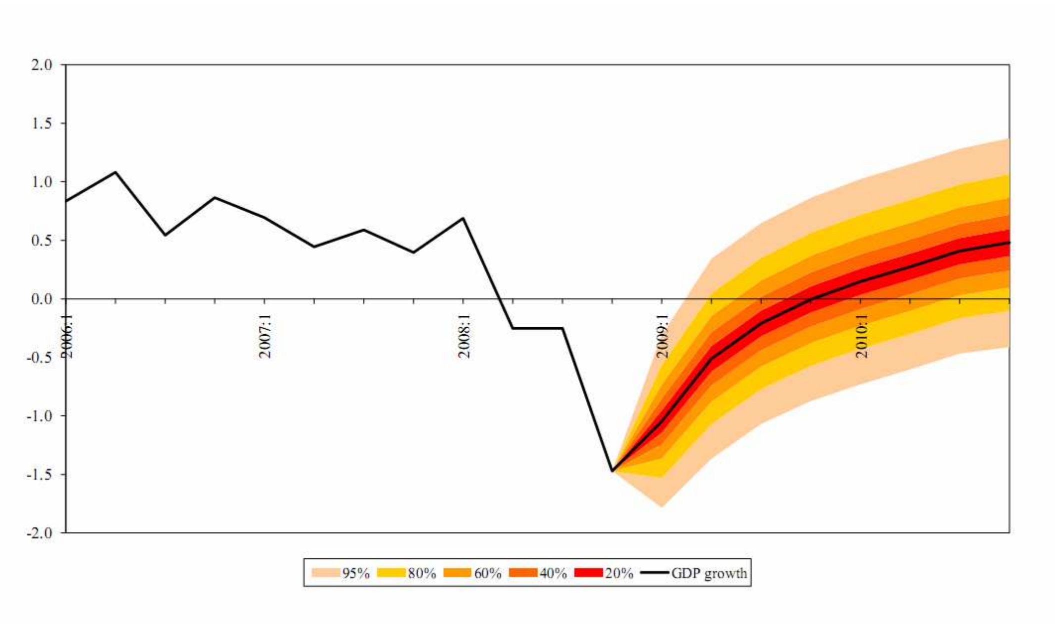
All in all, our forecasts are based on the cautiously optimistic scenario that production in the US and in Japan stops contracting at the end of 2009 and China continues growing, so that world trade will stabilize this year. An upswing of the world economy is not in sight, at least not for 2009 and most of 2010. For this to happen, two conditions will have to be fulfilled: first, the banking sector in the US and in Europe must credibly recover from their structural ills. Second, the global imbalances have to be dealt with: since the US will, in all probability, no longer be available as the destination of excess world supply of goods, demand has to come from different sources. The economies with high current account surpluses during the recent past come into mind: expanding private demand beyond temporary fiscal programs will be a major task for economic policy in China, Japan, and Germany in the coming years.

The euro area: slump of industrial production

In the last quarter of 2008, the decline of output accelerated in the Euro area. Private households, for the first time in this downturn, cut expenditure on consumption markedly. Investment had been falling since summer, partly due to the housing crises in Spain and Ireland; at the end of the year the fall was, with 2.7% relative to the second quarter, by far the steepest in the history of the currency union. Even more spectacular is the drop in foreign trade: exports contracted by more than 7%, imports by 5 ½%. Exports of goods and services were, in real terms, lower than two years ago. As can be inferred from balance-of-payment figures, the trade in goods is more affected than that in services. This fits in with the fall in industrial production that had begun early in 2008 and has accelerated to over 3% relative to the previous month in January. Assessments of order books (according to the survey by the European Commission) point to declining demand during the next quarters. Confidence is falling precipitously – not only in industry, but also in the construction sector and in services, as well as among consumers.

For much of 2009, falling external demand will be the main drag on production. At the same time, the structural problems of the financial sector will continue to impede investment, although data from the ECB do not show a marked change to the worse: according to the bank lending survey of January, banks expect to further tighten their credit standards, but, for the first time since the crisis began, to a lesser extent. Real costs of financing calculated by the ECB are high, but have stopped rising recently – possibly owing to the rate cuts and other expansive measures taken by the central bank, but also due to weak demand for capital. In addition, the problems of the financial sector aggravate the housing crises in Spain and Ireland and put stress on other housing markets. Finally, the steep increase in risk premia for sovereign bonds of those member states that are perceived as vulnerable (in particular Greece, Ireland, and, to a lesser extent, Italy) limits the scope these states have for fiscal action. Still, fiscal programs in many member states will dampen the recession: public investment will grow and the disposable income of private households will be supported. Consumers will also benefit from the increase in real wages that started in the summer of 2008 and will – due to the slow reaction of wage setting to the business cycle in most European countries – continue for the year 2009. Thus, private consumption will, although shrinking because of rising unemployment, keep up relatively well.

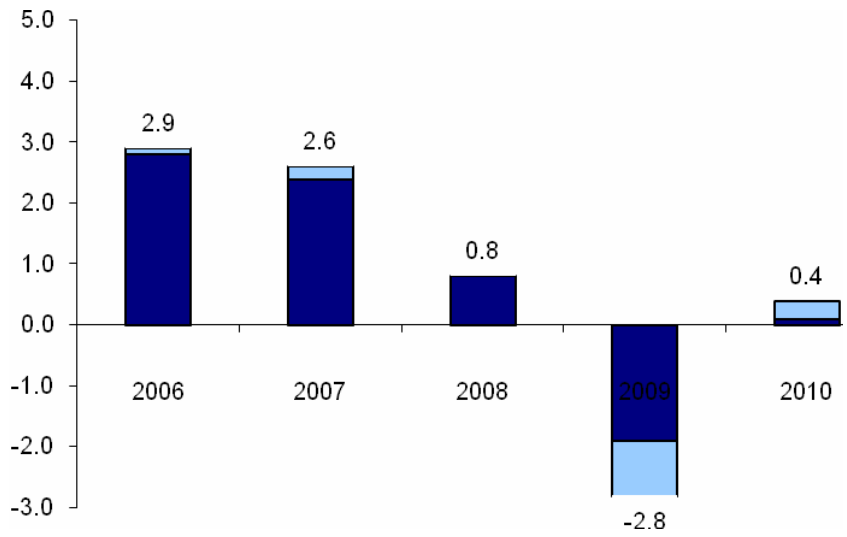
Figure 1. Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter.

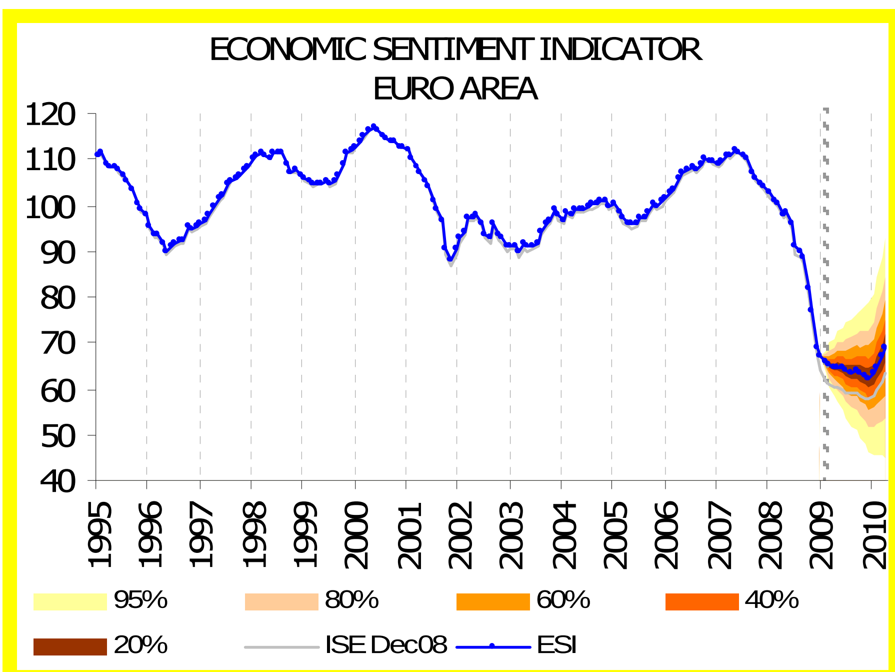
We forecast that the recession in the euro area bottoms out at the end of 2009, and that output will start expanding faster than the potential for production at the end of 2010. Overall, we expect GDP in the euro area to shrink by 2.8% in 2009, with a modest increase of 0.4% in 2010. As mentioned in the first section, this forecast depends on the crucial assumptions that world trade stabilizes during this year, and that major shocks from the financial markets will be absent or can quickly be contained.

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



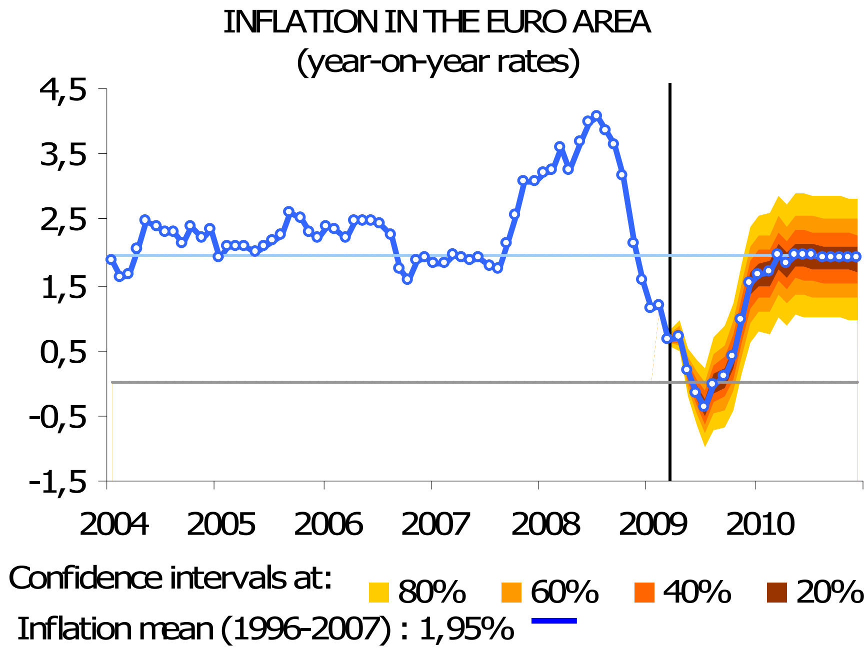
In the next two years we expect industrial production to fall sharply in the euro area. The fall will comprise all sectors, excluding energy, and will be extremely intense in capital and intermediate goods and in durable consumption goods. On one side, this decline is due to the contraction of investment and international trade flows, as it was suggested in the first section of the report. On the other side, the credit crunch that firms and consumers are facing as a consequence of the financial crisis is harming the capacity of economic agents to finance their purchase/investment, worsening the recession in the industrial sector. The deep crisis of the industrial sector is being particularly harmful to the German economy which, in spite of maintaining high productivity gains in the last years, a reasonable level of public and private debt and a stable housing market, is now facing maybe the worst economic crisis since World War II.

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

	2004	2005	2006	2007	2008	2009	2010
Capital	3,42	2,99	5,87	5,99	-0,21	-23,20	-8,94
Durable	0.09	-0.73	4.39	1.10	-5.41	-20.9	-6.64
Intermediate	2.31	0.88	4.94	3.87	-2.77	-24.11	-3.87
Non Durable	0.64	0.73	2.21	2.47	-2.77	-3.61	-1.41
Energy	2.24	1.43	0.70	-0.60	0.72	1.30	1.65
Total EMU	2.12	1.39	4.00	3.41	-1.65	-16.31	-3.23

Regarding inflation, although headline inflation jumped to an all times high during last summer, the sharp fall in oil prices is now driving inflation rates down with similar speed and magnitude. Also the economic crisis and the fall in aggregate demand are increasing the downward pressure on consumer prices, especially on industrial goods. We expect the average inflation rate to be as low as 0.5% in 2009 while year on year monthly rates will probably be slightly negative in July and August. In spite of these figures, the risk of deflation for the Euro Area economy is still negligible. Apart from energy related products, the evolution of prices of other goods and services is being extremely stable. Core inflation will be around 1.6% in both 2009 and 2010 and we do not expect this figure to drop below 1.0% during the forecast horizon.

Figure 4. Euro Area Inflation Rate and confidence bands



Considering the expectations on inflation and growth it is not a surprise that the ECB has decided to lower the official interest rate to its historical minimum, 1.5%. In recent declarations the ECB board has made clear that further cuts are possible but that a zero interest rate strategy is outside the policy options considered by the European Central Bank. The markets have interpreted these warnings as a signal that 1% is the lower bound for the official interest rate in the euro area, and that this bound will be reached before the summer, although the exact timing of the new cuts is still not clear. Together with the interest rate policy, the ECB has transmitted to the markets its intention to further provide ample liquidity to banks and to continue its supplementary longer-term refinancing operations but, at the same time, to tighten the conditions on the collateral required to access that liquidity. Overall the monetary policy of the ECB remains more conservative and rigid than other central banks (FEB, BOJ and BOE). While it is now widely accepted that restoring the confidence in and within the financial system is a necessary condition for the real economy to recover, the actions that the ECB might take in this direction are constrained by the lack of effective surveillance and normative power.

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 GDP forecast of the EFN is very close to the consensus forecast with a view on investment that is a bit less gloomy and with growth rates for government consumption that are weaker than in the consensus forecast. In this context, it should be recalled that the fiscal programs mainly boost public investment, but not government consumption.

The inflation forecasts of the EFN are quite below the average figure for 2009, but only slightly lower that the consensus and ECB estimations. With respect to 2010, it seems that most institutions forecast a slower convergence of the average inflation rate toward its long term average, while our figures (1.9%) are closer to those published by the European Commission.

Table 3. Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF*		ECB		OECD		Consensus	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2008	2009
GDP	-2.8	0.4	-1.9	0.4	0.2	na	-2.7	0.0	-0.6	1.2	-2.6	0.5
Priv. Consumption	-0.6	-0.2	-0.1	0.3	-0.1	na	-0.7	0.2	0.2	1.2	-0.7	0.5
Gov. Consumption	1.0	0.5	1.6	1.2	1.6	na	1.7	1.5	1.2	1.2	1.8	1.8
Fixed Capital Form.	-6.2	0.1	-5.5	-0.7	-0.6	na	-7.2	-2.3	-4.4	1.0	-6.8	-0.3
Unemployment rate	8.9	10.0	9.3	10.2	8.3	na	Na	na	8.6	9.0	9.0	9.9
HICP	0.5	1.9	1.0	1.8	1.9	na	0.4	1.0	1.4	1.3	0.6	1.5
IP	-16.3	-3.2	na	na	na	na	na	na	na	na	-0.7	2.0

EU: European Commission, Interim Forecast, January 2009; IMF: World Economic Outlook, September 2008; ECB: ECB Monthly Bulletin, March 2009, OECD: Economic Outlook, No. 84, December 2008; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2009. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

*According to the IMF update of March 2009, GDP growth in the Euro area will be -3.2% in 2009 and 0.1% in 2010.

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 that the US and Japan will be in a deep recession in 2009 and tentatively recover in 2010. Prices in these countries will be declining in 2009, and also in 2010 in Japan. We forecast a massive decrease in world trade in 2009. Oil prices are expected to be much lower than they were during most of 2008, but to recover from their lows in December. The exchange rates of dollar and yen relative to the euro are assumed to be stable.

Table 4. Variables of the world economy

	2009	2010
US GDP Growth Rate	-2.9	1.0
US Consumer Price Inflation	-0.9	1.5
US Short Term Interest Rate	0.3	1.0
US Long Term Interest Rate	3.1	3.8
Japan GDP Growth Rate	-4.3	0.4
Japan Consumer Price Inflation	-0.8	-0.2
Japan Short Term Interest Rate	0.7	1.0
Japan Long Term Interest Rate	1.5	1.7
World Trade	-10	0.9
Oil Price	51	57
USD/Euro Exchange Rate	1.30	1.30
100Yen/Euro Exchange Rate	1.27	1.27

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (2009). The oil price is in US dollar per barrel (Brent, last month of period), all other variables are in percent. 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.