EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2008 and 2009

Summer 2008

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. 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, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it .

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Highlights

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- The world economy is bound to slow further this year, but severe recessions are not in sight. The most serious risks might stem from the political economy of emerging market countries: macroeconomic turbulences are certain to emerge if price signals from energy markets are further suppressed and inflation is not curbed by less expansive monetary policies.
- Activity in the euro area was surprisingly resilient at the beginning of this year. The main engine of growth continues to be investment in fixed capital. However, demand from private households will continue to expand only very modestly, because real disposable income is, due to high inflation, stagnant this year. Moreover, employment growth slows, and unemployment has already ceased to fall.
- The euro area economy will expand slowly for the remaining three quarters of 2008, and growth will not accelerate to rates close to potential before the end of 2009, when the dampening effects from the downturn in the US and turmoil in financial markets should fade. GDP growth is expected at 1.7% in 2008, and 1.3% in 2009.
- Energy and food prices drive euro area inflation to its historical maximum: 3.7% in May. Year on year inflation is expected to further increase, reaching a peak of 3.9% in August 2008, and closing the year with an average rate of 3.5%. However, things should improve next year, with an average expected rate of 2.1%, due to more restrictive monetary policy and the slowdown of the economy combined with lower growth in raw material prices.

Table 1 Economic outlook for the Euro area

	2005	2006	2007	2008: 1st half		2008: annual		2009: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					1.8		1.3		0.6
GDP	1.6	2.8	2.6	2.0	2.2	1.7	2.1	1.3	2.0
					2.0		1.9		1.9
Potential Output	1.9	2.0	2.0	2.1	2.1	2.0	2.1	2.0	2.1
					0.7		0.4		0.4
Private Consumption	1.6	1.8	1.6	1.0	1.2	0.8	1.3	1.2	2.0
					1.2		1.0		1.0
Government Consumption	1.5	2.0	2.3	1.4	1.7	1.4	1.7	1.5	1.9
					3.0		1.9		0.2
Fixed Capital Formation	3.1	5.2	4.5	3.6	4.1	3.1	4.2	2.3	4.3
					4.5		2.8		1.9
Exports	4.7	7.9	6.0	5.0	5.4	3.5	4.3	3.0	4.1
					3.5		2.0		1.7
Imports	5.6	7.6	5.3	4.1	4.7	2.9	3.8	3.2	4.6
					7.0		7.0		6.9
Unemployment Rate	8.9	8.3	7.4	7.1	7.2	7.2	7.3	7.2	7.5
					2.8		2.8		2.7
Labour Cost Index	2.7	2.5	2.6	2.9	2.9	3.0	3.1	2.9	3.1
					0.6		0.3		-0.1
Labour Productivity	0.8	1.4	0.7	0.8	1.0	0.6	1.0	0.4	0.9
					3.4		3.3		1.7
HICP	2.2	2.2	2.1	3.5	3.5	3.5	3.7	2.1	2.6
					2.2		1.3		1.5
IPI	1.3	4.0	3.5	3.0	3.8	2.3	3.3	2.0	3.5

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 2008 and 2009

The world economy: inflationary pressure on the rise and financial risks not over yet

In the first half of 2008, prospects for the world economy are overshadowed by a seemingly endless oil price hike and by the fragile condition of financial markets in the US and Western Europe. Given these impediments, world production proved to be remarkably resilient during springtime. It is still unclear whether the US economy is contracting or not, although many experts have been regarding recession as unavoidable for some months; while the slump in the housing sector has not reached its trough yet, private consumption appears to be still growing and net exports are, supported by the weak dollar, quite dynamic. Recent data on production in Europe were mixed but, in the aggregate, a bit better than expected. Economic growth in Japan surprised on the upside in the first quarter, mainly thanks to strong exports. They can be attributed, by a large extent, to the still high growth dynamics in emerging Asia. Some indicators, however, point to a slow down of worldwide activity in the second quarter: world trade appears to be slowing, and the strong price increases for industrial raw materials have, on average, come to a halt since April. This is also the case for staple food.

Oil prices, however, continue their price hike; they have roughly doubled in the year to June. A growing attention to the scarcity of reserves has certainly been an important factor for the revaluation of crude oil and other exhaustible ressources during the last few years. Prices for most commodities, however, have slowed down since springtime, but the oil price did not. The main reason is that world oil demand has up to now reacted little to the most recent price hike. From OECD countries, it stagnated in 2007 and is in decline this year, but demand from emerging markets has continued to rise smoothly. The reasons are mainly political: many emerging markets governments subsidize the oil price for households and firms heavily and thus prevent the price signal from inducing demand to decline. While this policy is becoming too expensive for ever more governments, it will still be viable for China and for oil exporting countries for some time. Clearly, a continuation of the price hike throughout 2008 would damage the world economy heavily; the loss of domestic demand in countries that import their energy could not be compensated by rising imports from oil exporting economies.

In the developed world, policy appears to react to the inflationary push from the commodity price hikes. The focus of central banks is shifting from stabilizing financial markets to defending the credibility of their (implicit or explicit) inflation targets: markets now expect short term interest rates to go up in the US and in the euro area. The danger of a renewed turmoil on financial markets, however, is still imminent: risk spreads and insurance premia have receded somewhat in April, but remain elevated since then. Conditions on the interbank money markets in the US and Europe, as shown by the yield difference to government bonds, are particularly tense. Obviously, many banks are in a prolonged process of strengthening their balance sheets. As a consequence, credit supply will slow markedly, and financial conditions for firms and households will, in all probability, worsen in the coming quarters in the US and in the European Union.

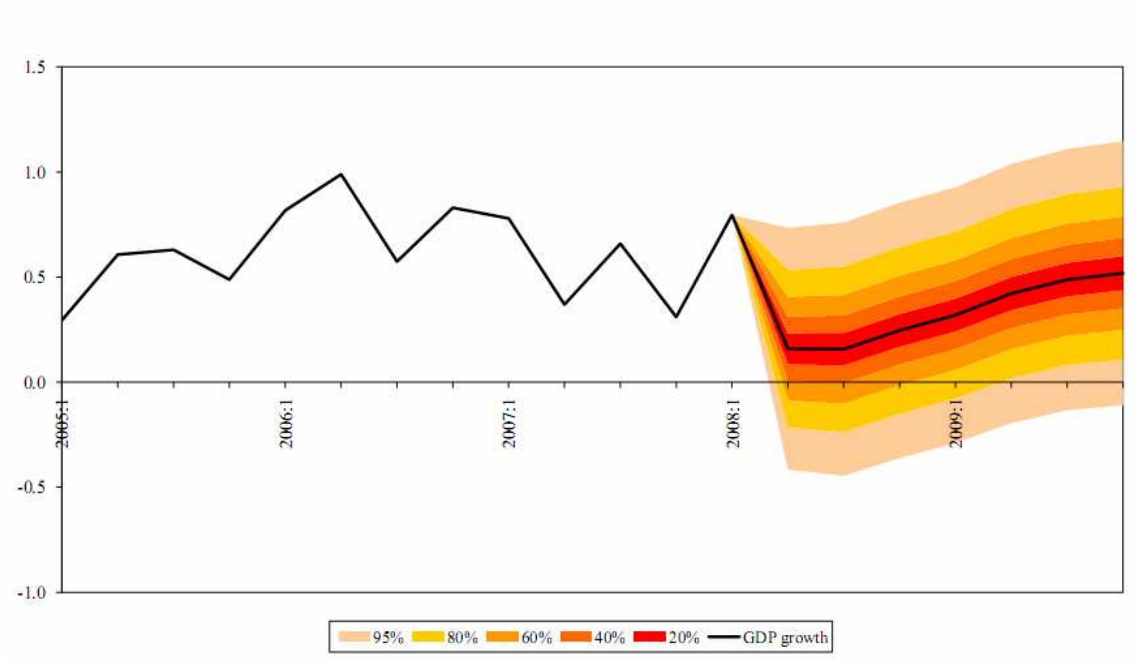
All in all, the world economy is bound to slow further this year, but severe recessions are not in sight, not even in the US, where massive tax rebates are supporting consumer demand up to autumn. The most serious risks for 2009 might stem from the political economy of emerging market countries: macroeconomic turbulences are certain to emerge if price signals from energy markets are further suppressed and inflation is not curbed by monetary policies that are targeted at price stability.

The euro area: a soft landing

Activity in the euro area was surprisingly resilient at the beginning of this year. In spite of the financial turmoil, rising commodity prices, and the rising effective exchange rate of the euro, production grew at a quarterly rate that is, with 0.8 %, well above the potential growth rate. Exports and imports expanded by almost 2%. Private household consumption, however, was, like in the last quarter of 2007, about stagnating; this is not so surprising, given that, due to the price hikes, real incomes were more or less stagnating as well. The main engine of growth was investment in inventories as well as in fixed capital. For two years now, investment in the euro area has been in a healthy upswing. The official statsitics probably exaggerate the dynamics a bit, as it still adjusts construction data for a winter season that this time, like last winter, did not hamper activity by much. Leading indicators suggest that activity is slowing down markedly during summer. Economic sentiment is, according to the surveys of the European Commission, on a declining trend since summer of last year, the same is true for industrial orders, but the updated Economic Sentiment Indicator forecast (including data until May) shows an upwards revision in the confidence of economic agents in the euro area economy, interrupting the continuous decline found since the second quarter of 2007. Subsequently, the ESI is expected to recover somewhat in 2009, stabilising at levels slightly lower than those registered in the last quarter of 2005, when economic growth was 2% (see figure 3). The April industrial production index (IPI) confirmed that the deceleration in manufacturing will continue and will affect nearly all industrial sectors (see table 2). The forecasts for industrial production growth for 2008 and 2009, are 2.3 and 1.9%, respectively. The chances for a soft landing of the investment upswing are, however, good: capacity utilization is, though falling, still at a high level, and external demand is likely to grow reasonably well; euro area exporters benefit from the fact that important oil producers will continue to spend a lot of their windfall profits in nearby Europe. Conditions for financing investment internally are favourable in the non financial sector, where profitability of firms is still high. Profits will, however, be squeezed by the coming slow down. External financial conditions, by contrast, have been slowly deteriorating for a year and will continue on this path, as the most recent bank lending survey of the ECB suggests. The main reason is the turmoil on financial markets: risk spreads for corporate bonds are close to the high levels they reached at the beginning of the decade, and the stock market performance has been weak since the beginning of the year. Moreover, many European banks have to strengthen their balance sheets the same way as US banks do; indeed, write downs on assets based on credit have, up to now, been larger for European banks than for those in the US. Thus, the strong growth of loans to non-financial firms will decelerate markedly over the course of the year. Demand from private households will continue to expand only very modestly, because real disposable income per household is, due to high inflation, stagnant this year. Moreover, employment growth slows, and unemployment has already ceased to fall. All in all, the economy in the euro area will expand at rates below potential for the remaining three quarters of 2008, and growth will not accelerate to rates close to potential before the dampening effects from the downturn in the US and from financial markets fade. This will, according to this forecast, only be the case in the course of 2009. Output is forecasted to be 1.7% larger this year than in 2007, and to grow by 1.3% in 2009.

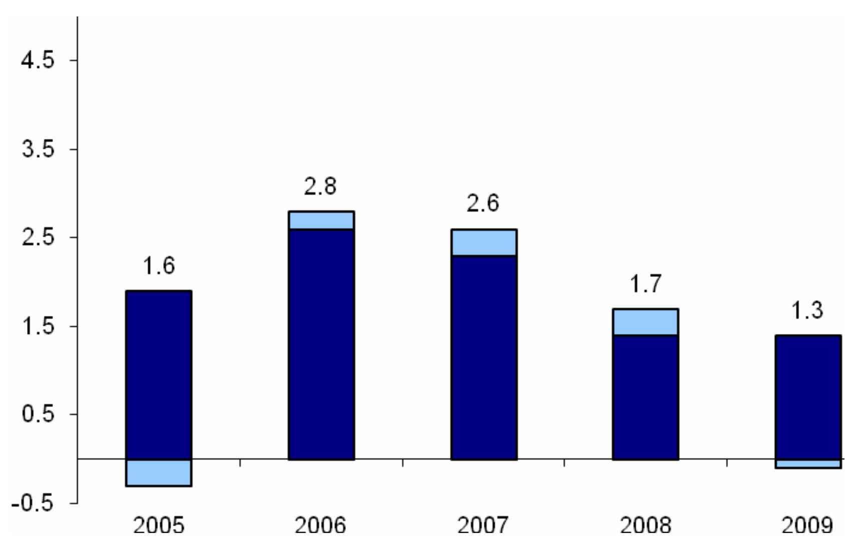
The broad picture of the economic cycle outlined above misses important trends that as yet are confined to specific sectors and regions, but that are risk factors for the euro area as a whole: the housing sector is in recession not only in the US, but also in Ireland and Spain. Thanks to budget surpluses in 2007 and low public debt, fiscal policies in both countries have some leeway to limit the dampening effects of the crisis in the housing sector. But the two economies (as well as those of Greece and Portugal) have, during a long period of economic boom, built up large current account deficits. The revaluation of real estate might induce households and firms to consolidate their financial positions; the drag on demand stemming from such a structural adaptation might become stronger than any stimulus that expansionary fiscal policy was able produce.

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 the columns indicate overall GDP growth

Figure 3 Euro Area Economic Sentiment Indicator

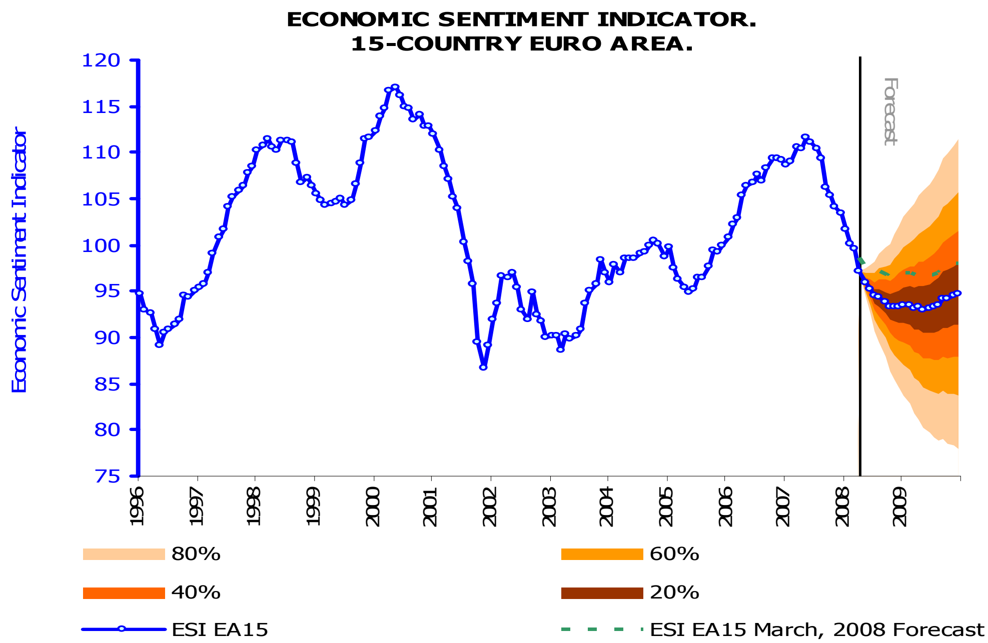


Table 2 Annual average rates for industrial production in the euro area

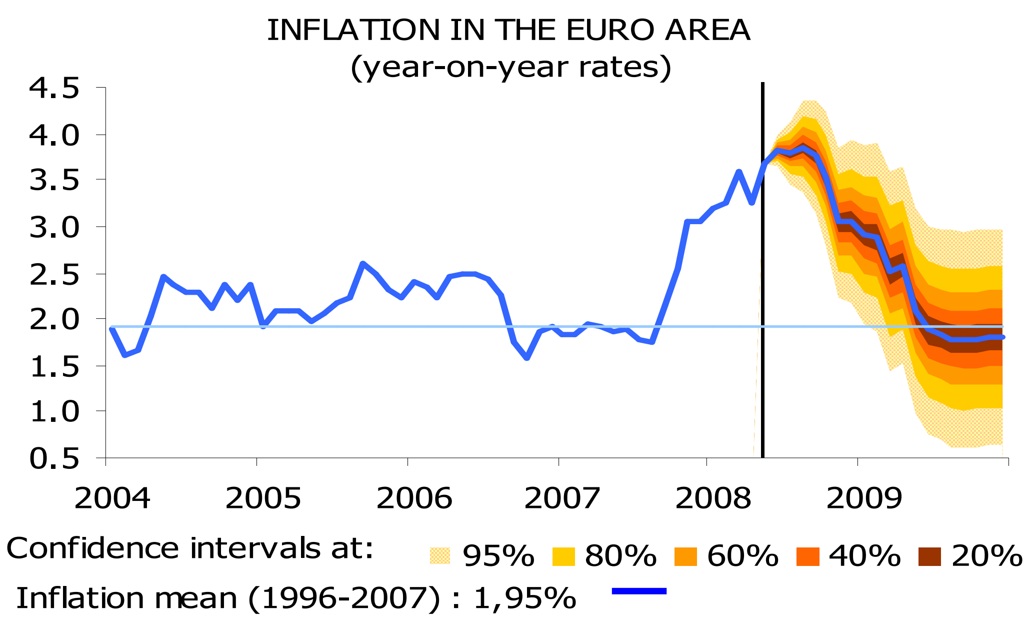
	2003	2004	2005	2006	2007	2008	2009
Capital	-0.1%	3.4%	2.8%	5.9%	5.9%	5.1%	3.4%
Durable	-4.4%	0.1%	-1.0%	4.2%	1.1%	-1.3%	0.2%
Intermediate	0.3%	2.4%	0.9%	4.9%	3.8%	1.5%	1.8%
Non Durable	0.3%	0.6%	0.7%	2.2%	2.5%	0.6%	0.9%
Energy	2.8%	2.2%	1.3%	0.8%	-0.3%	1.7%	1.7%
Total EMU	0.3%	2.2%	1.3%	4.0%	3.4%	2.3%	2.0%

In this moment, inflation is the big issue for the euro area economy. In May, the year on year inflation rate was 3.7%; the highest level in the euro area history. We expect inflation to reach its maximum in August, with a value of 3.9%, while we forecast an average inflation rate for 2008 of 3.5%. Inflation will slowly decline during 2009, reaching a yearly average of 2.1% (see figure 4).

The explosive inflation pattern that we have been observing since September 2007 and that will continue at least till the beginning of 2009, has been driven by energy and food prices. The unusual tensions still present in those markets (oil price grew 10% in the last month) should impose some caution about long term inflation forecasts. In particular, note that the inflation reduction we forecast for next year is conditional on a reduction in the growth rate of raw material prices, and on a tighter monetary policy and lower growth. Under these circumstances, core inflation is showing a remarkable stability and we recently revised downward our forecasts to 2.3 % for 2008 and 1.8% for 2009.

The reference interest rate has been kept constant at the level of 4% for 12 months. In the last few weeks the ECB announced that, with all probability, the official interest rate will be increased by 25 basis points in the 3rd of July meeting. Even if a tighter monetary policy was not completely unexpected given the inflation and growth data, it should be noted that the credit crunch is amplifying the effects of monetary policy on the real economy. When markets assumed the interest rate rise, the 12 months euribor rate jumped to 5.45%, 1.45 points above the actual official interest rate.

Figure 5 Inflation in the Euro Area



Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model. A detailed description of an early version of the model gives the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics. The forecasts on output are by and large very similar. The EFN stands out with its low figures for private consumption due to a more pessimistic assessment of real disposable incomes, and it is more optimistic concerning investment dynamics.

In general, inflation forecasts for 2008 are worse than those published three months ago. EFN and ECB present less optimistic inflation forecasts for 2008, while in 2009 there is a wider consensus concerning the achievement of the ECB inflation target.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
GDP	1.7	1.3	1.7	1.5	1.4	1.2	1.8	1.5	1.7	1.4	1.7	1.4
Priv. Consumption	0.8	1.2	1.4	1.5	1.4	1.2	1.3	1.5	1.3	1.6	1.0	1.4
Gov. Consumption	1.4	1.5	1.9	1.7	1.9	1.9	1.8	1.7	1.7	1.7	1.5	1.7
Fixed Capital Form.	3.1	2.3	2.0	1.2	1.8	1.0	2.4	1.2	2.0	0.8	2.9	1.7
Unemployment rate	7.2	7.2	7.2	7.3	7.3	7.4	na	na	7.2	7.4	7.2	7.2
HICP	3.5	2.1	3.2	2.2	2.8	1.9	3.4	2.4	3.4	2.4	3.3	2.3
IP	2.3	2.0	na	na	na	na	na	na	na	na	2.0	1.6

EU: European Commission, European Economy, No. 1, 2008 (Spring); IMF: World Economic Outlook, April 2008; ECB: ECB Monthly Bulletin, June 2008, OECD: Economic Outlook, No. 83, June 2008; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2008. 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. For the US, GDP growth will clearly be below potential in 2008; in 2009 there will be a very tentative recovery. Japan is also assumed to slow down markedly in 2008. In spite of the downturn, inflation will stay at quite a high level for much of this year in the US, and the price hikes for energy and food cause the price level in Japan to increase a bit. An oil price of 120 (125) dollar per barrel is expected for the end of 2008 (2009). We assume that the weakening of the dollar comes to an end this summer. The assumption of a slowly appreciating dollar is consistent with the forecast that a recession can be avoided in the US.

Table 4 Variables of the world economy

	2008	2009
US GDP Growth Rate	1.3	1.9
US Consumer Price Inflation	3.8	2.4
US Short Term Interest Rate	1.8	2.9
US Long Term Interest Rate	3.8	4.3
Japan GDP Growth Rate	1.3	1.6
Japan Consumer Price Inflation	0.8	0.5
Japan Short Term Interest Rate	0.9	1.2
Japan Long Term Interest Rate	1.5	1.9
World Trade	5.9	5.8
Oil Price	120	125
USD/Euro Exchange Rate	1.53	1.45
100Yen/Euro Exchange Rate	1.59	1.54

Apart from the development of world trade and long-term interest rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (May 2008). Oil price (WTI, end of period) in US dollar per barrel, all other variables 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: new 90-<120 day certificates of deposit. Japan long-term interest rates: 10-year treasury bills.