EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2008 and 2009

Spring 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 euro area economy is threatened by the present financial crisis and the downswing in the US, more than many emerging markets economies, due to the high degree of integration between European and US financial markets.
- Up to now non-residential investment in the euro area has been supported by a high level of capacity utilization, still well filled order books and, on average, quite high profitability of corporate firms in the manufacturing sector. However, the turmoil in financial markets makes external financing of investment more expensive this year, as risk premia on bond markets have risen significantly, banks try to strengthen their balance sheets, and equity finance is not attractive in times of bear markets.
- Demand from private households expands only modestly in 2008, because real incomes will be more or less stagnant, as will – at best – be household wealth, given the financial turmoil and slowing housing markets. In 2009, when the dampening effects from the downturn in the US and from financial markets fade, growth in the euro area will accelerate to rates close to potential.
- Overall, our forecasts for GDP growth are 1.4% for 2008 and 1.7% for 2009. Average annual inflation is expected to reach 3.1% this year, and a moderation to rates close to 2% is not expected until the second half of 2009.

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
GDP	1.6	2.8	2.6	1.6	1.2 2.0	1.4	0.9 2.0	1.7	1.0 2.4
Potential Output	1.8	1.9	2.1	2.0	1.9 2.1	2.0	1.9 2.1	2.0	1.8 2.2
Private Consumption	1.5	1.7	1.7	1.4	0.9 1.8	1.4	0.8 2.0	1.4	0.7 2.1
Government Consumption	1.5	2.0	2.4	1.3	0.9 1.7	1.3	0.9 1.7	1.5	1.0 1.9
Fixed Capital Formation	2.9	5.0	4.4	2.3	0.8 3.8	2.3	0.6 4.0	3.1	0.9 5.4
Exports	4.7	7.9	5.9	3.2	2.2 4.2	2.3	1.3 3.3	4.2	3.0 5.4
Imports	5.4	7.7	5.1	2.8	1.7 3.9	2.3	1.1 3.5	4.5	3.0 6.0
Unemployment Rate	8.9	8.2	7.4	7.2	7.0 7.3	7.1	7.0 7.3	7.1	6.8 7.4
Labour Cost Index	2.7	2.5	2.5	3.0	2.9 3.1	3.1	2.9 3.2	3.0	2.8 3.3
Labour Productivity	0.8	1.4	0.7	0.5	0.1 0.8	0.4	-0.1 0.9	0.8	0.3 1.3
HICP	2.2	2.2	2.1	3.3	3.0 3.5	3.1	2.8 3.4	2.1	1.5 2.6
IPI	1.3	4.0	3.5	2.7	1.9 3.5	2.5	1.5 3.5	2.2	0.7 3.7

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 and the financial crisis

The risk of a global downturn has increased in the first months of 2008. Data now show that output growth has slowed markedly in the developed world at the end of last year, with industrial production more or less stagnating in OECD countries. Since then, economic sentiment has continued to deteriorate. The causes are the deepening crisis of the US housing sector and the spreading turmoil on financial markets in North America and Europe. Rising world prices for energy, industrial commodities and food are further risk factors. Not only do they reduce real incomes for private households in most countries, they might also weaken the effectiveness of counter cyclical economic policies since, in times of growing inflationary pressure, expansionary policy risks to undermine the confidence of economic agents in price stability.

In the US, however, policy appears to be determined to take all measures that might be appropriate for preventing a serious recession that otherwise looks imminent: the key interest rate will in all likelihood be further cut to 2% in the first half of 2008, and tax brakes and investment incentives will give the US economy a fiscal stimulus of about 1 percentage point of annual GDP during this summer. A recession is nevertheless close to unavoidable: at present, house prices continue to fall, and foreclosures are on the rise. This dampens real activity via the shrinking construction sector and the negative wealth effect on private household consumption that in the first months of 2008 appears to be more or less stagnant. More acute is the destabilizing effect on the financial sector. Here, a downward spiral of falling asset prices, downgrading of ratings, and write-downs has been evolving since summer 2007. It started with those securities that were partly backed by subprime mortgages; recently it spread even to securities of public mortgage agencies, which are considered as de facto guaranteed by the government. At first only a few special structured investment vehicles of investment banks got into liquidity problems, but now even big insurers of securities are being downgraded, and hedge funds are forced to quickly reduce their leverage. In mid March, a large US investment bank could only be saved by a take-over with considerable guarantees given by the Fed to the competitor who bought the bank.

The financial crisis in the US affects, to different degrees for different regions and assets, world financial markets in general: risk spreads between interbank rates and government backed securities of similar maturity are elevated in Europe like in the US, and corporate bond spreads have been increasing in Europe considerably since summer 2007 and particularly in the first months of this year. Stock market prices both in the developed world and in emerging Asia are on a downward path since autumn 2007.

Risk spreads for sovereign debt of emerging countries have increased as welll, but by less than those for corporate bonds in the developed world.

A mild recession in the US, while surely a drag on world wide activity, would not trigger a downturn of the world economy: the share of US imports in world trade has been decreasing during this decade markedly. Indeed, domestic demand nowadays is an important engine of growth in many emerging market countries like China. In addition, financial markets in these regions are, due to strong current account balances and financial investment positions, much more independent of decisions made in New York or London than a decade ago. At the moment, the economies in Britain and in the euro area appear, due to the high degree of integration between their financial markets and those in the US, to be more at risk than many emerging markets.

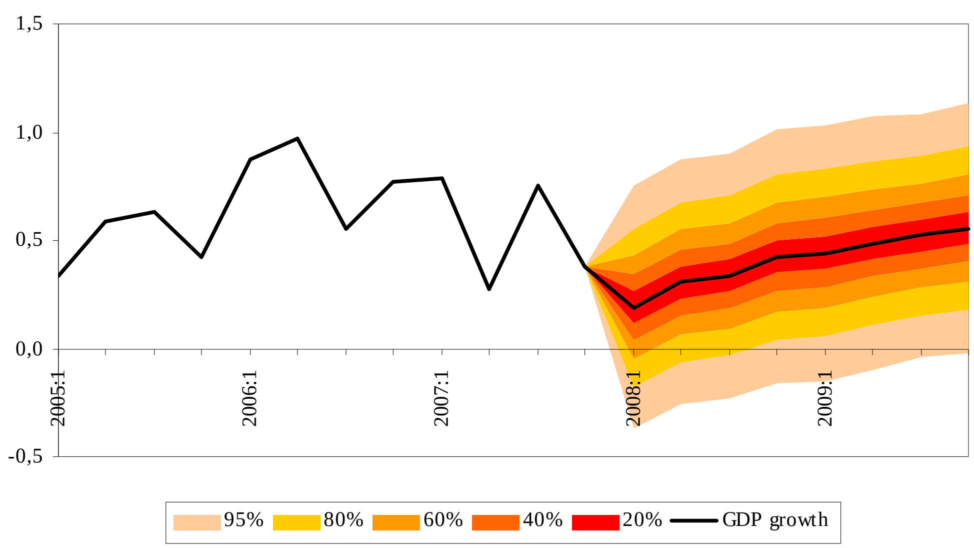
The euro area

Renewed instability on world financial markets, the accelerated appreciation of the currency, and strongly rising prices for energy, industrial commodities and food hit the economy of the euro area at a time when economic sentiment has been, albeit from quite elevated levels, on a downward trend for over half a year (according to surveys by the European Commission). National accounting data show that the economy has already lost momentum in the final quarter of 2007, with growth falling below its potential. Private household consumption was actually declining, with German figures, once again, especially weak. Retail sales that were a bit stronger for January, however, suggest that consumption has restarted growing tentatively. Meanwhile, investment activity appears to continue expanding on a healthy pace, with growth at an annual rate of about 3% in the final quarter of 2007. This is remarkable, given that the real costs of external finance have been increasing since spring of last year, that the bank lending survey signaled a tightening of credit standards as early as in October and again in January, and that housing booms have come to an end in some important member countries; in Spain, indeed, the housing sector is likely to go into recession.

Up to now non-residential investment has been supported by a high level of capacity utilization (in particular in the Netherlands and in Germany), still well filled order books and, on average, quite high profitability of corporate firms in the manufacturing sector. However, the turmoil on financial markets surely makes external financing of investment more expensive this year, as risk premia on bond markets have risen significantly, banks try to strengthen their balance sheets, and equity finance is not attractive in times of bear markets. Internal financing will, however, continue to be an option for many firms: exporters will benefit from external demand, because producers of energy south and east of the euro area will once again spend windfall profits in Europe, and because growth dynamics in trade with the Asian emerging markets will stay high. It should also be noted that not only the euro, but most important currencies as the yen and even the renminbi have appreciated markedly relative to the dollar; therefore, the loss of competitiveness for euro area producers due to the weakening dollar is limited.

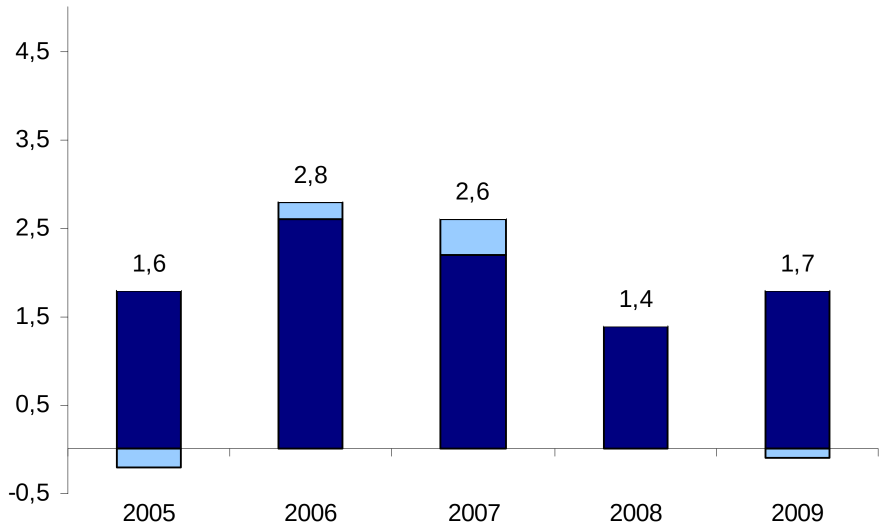
Demand from private households, however, expands only very modestly, because real incomes will be, due to inflation, more or less stagnant, as will – at best – be household wealth, given the financial turmoil and slowing housing markets. Some support for consumer demand will come from growing employment, albeit the unemployment rate will stop shrinking in 2008. All in all, the economy in the euro area will keep growing this year, but at a rate below potential. Growth will accelerate to rates close to potential when 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. However, we expect GDP growth to be only about 1.7% in 2009, increasing from 1.4% in 2008.

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

The projections for the Economic Sentiment Indicator (ESI) show that the confidence of economic agents in the evolution of the area's economy will decline progressively during 2008, subsequently recovering slightly in 2009 and stabilising at levels similar to those registered in the third quarter of 2005, when the European economy grew by 1.8%. Moreover, the likelihood of 2008 registering values as low as those found at the end of 2001 and in the first quarter of 2003, corresponding to periods of low GDP growth, continues to be practically insignificant, although it is no longer negligible in 2009 (see Figure 3).

With regards to inflation in the euro area, the last available figure released by Eurostat corresponds to the month of February, where an annual rate of 3.3% has been reached. Even if this figure is consistent with our previous forecast, the innovations found in processed food and non-energy industrial goods lead to an upwards revision in our core inflation forecasts for 2008 and 2009, expecting rates of 2.5% and 2.1%, respectively. Average headline inflation for 2008 has been revised upwards by two tenths of a percentage point to 3.1%, whereas expectations for 2009 remain unaltered, expecting an average annual rate of inflation of 2.1%. Among the possible downwards risks which could relieve inflationist pressures in the euro area, is the possibility of the demand for crude oil falling as a result of a decline in worldwide economic activity. But of course, it is also possible that the emerging markets continue to grow under the fundamentals of a strong internal demand, increasing their energy requierements and their demand for raw materials. Therefore, upsides risks to inflation remain. The range for average annual inflation that we give for 2008 is 2.8-3.4%, which is likely to capture all these risks (see figure 4).

Figure 3. Euro area Economic Sentiment Indicator

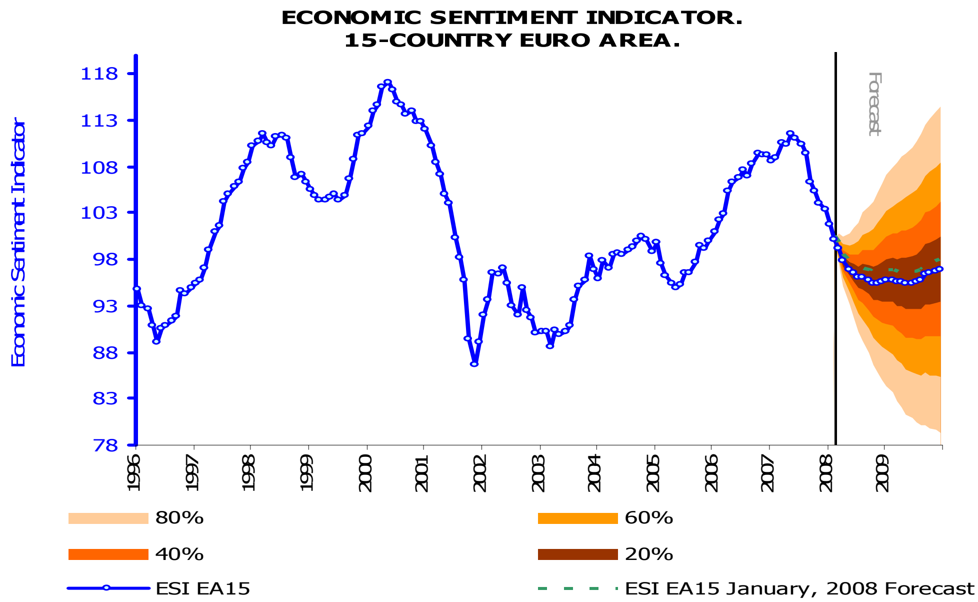
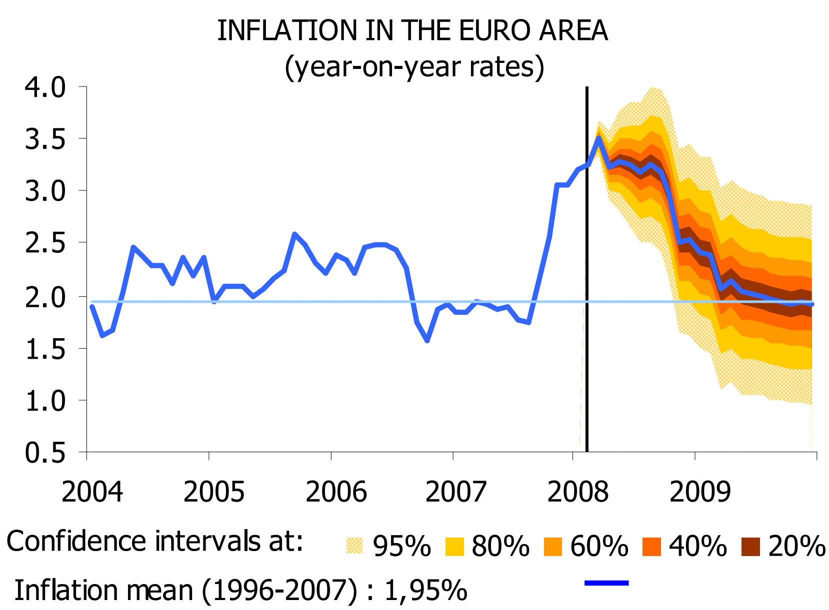


Figure 4. Euro area year-on-year inflation rates



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 2 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. EFN is a bit on the pessimistic side for 2008, but more optimistic concerning investment activity for 2009; clearly, much hinges on the assumption that the effects from the turmoil on financial markets and from the end of the housing price boom will fade in 2009.

The EFN inflation expectations are more pessimistic than the ones of all the institutions under comparison. Thus, the 3.1% rate of average annual inflation expected for 2008 is 0.4 percentage points higher than the one given by the Consensus Forecast, but only 0.2 percentage points higher than the figures published by the ECB monthly bulletin.

Table 2 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	1.4	1.7	2.2	2.1	2.1	na	1.7	1.8	1.9	2.0	1.5	1.8
Priv. Consumption	1.4	1.4	2.1	1.9	2.1	na	1.4	1.7	2.1	2.1	1.4	1.7
Gov. Consumption	1.3	1.5	2.1	2.0	1.8	na	1.6	1.5	1.6	1.5	1.5	1.7
Fixed Capital Form.	2.3	3.1	2.9	2.6	3.3	na	1.8	1.8	2.2	2.4	2.3	2.4
Unemployment rate	7.1	7.1	7.1	7.1	6.8	na	na	na	6.4	6.4	7.1	7.1
HICP	3.1	2.1	2.1	2.0	2.0	na	2.9	2.1	2.5	2.2	2.7	2.0
IP	2.5	2.2	na	na	Na	na	na	na	na	na	1.8	1.9

EU: European Commission, European Economy, No. 7, 2007 (Autumn); IMF: World Economic Outlook, September 2007; ECB: ECB Monthly Bulletin, March 2008, OECD: Economic Outlook, No. 82, December 2007; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2008. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

* According to the EU Interim Forecasts (February 2008), in 2008 the Euro area GDP growth will be 1.8 and inflation 2.6.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 3 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 spite of the downturn, inflation will stay at quite a high level for much of 2008 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 88 (90) dollar per barrel is expected for the end of 2008 (2009). We assume that the weakening of the dollar comes to an end this spring; after all, the dollar is, from the point of view of purchasing power parities, clearly undervalued now. The assumption of a slowly appreciating dollar is consistent with the forecast that a recession can be avoided in the US.

Table 3 Variables of the world economy

	2007	2008	2009
US GDP Growth Rate	2.2	1.4	2.3
US Consumer Price Inflation	2.8	3.4	2.3
US Short Term Interest Rate	4.4	2.2	3.5
US Long Term Interest Rate	4.6	3.8	4.5
Japan GDP Growth Rate	2.1	1.3	1.8
Japan Consumer Price Inflation	0.0	0.6	0.5
Japan Short Term Interest Rate	0.7	0.8	1.3
Japan Long Term Interest Rate	1.7	1.6	2.1
World Trade	5.2	5.3	6.9
Oil Price	92	88	90
USD/Euro Exchange Rate	1.37	1.50	1.45
100Yen/Euro Exchange Rate	1.61	1.60	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 (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.