

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2008 and 2009



Winter 2007/08

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.

Participating Institutions:

IGIER, Università Bocconi (Coordinator)

Team Leader: Massimiliano Marcellino (massimiliano.marcellino@uni-bocconi.it)

Centre d'Etudes Prospectives et d'Informations Internationales (CEPII)

Team Leader: Lionel Fontagné (fontagne@cepii.fr)

Global Insight

Team Leader: Emilio Rossi (emilio.rossi@globalinsight.com)

The Halle Institute for Economic Research (IWH)

Team Leader: Axel Lindner (Axel.Lindner@iwh-halle.de)

The Department of Economics, European University Institute (EUI)

Team Leader: Michael Artis (michael.artis@iue.it)

Anàlisi Quantitativa Regional (AQR), Universitat de Barcelona

Team Leader: Jordi Suriñach (jsurinach@ub.edu)

Instituto Flores de Lemus (IFL), Universidad Carlos III

Team Leader: Antoni Espasa (espasa@est-econ.uc3m.es)

Department of Applied Economics (DAE), University of Cambridge

Team Leader: Sean Holly (sean.holly@econ.cam.ac.uk)

Coordinator of the Report: Massimiliano Marcellino

Report closed on December 18th, 2007

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2008 and 2009

Highlights

- Recent data point to much more muted growth dynamics in 2008 than in the past year. One cause is the prolonged oil price hike during 2007. The second and more important cause is the intensification of tensions on world financial markets. Due to problems in the financial sector, credit expansion will slow next year in the euro area as well as in the US. This will dampen demand in the real economy.
- Consumer prices have recently risen significantly, and wages, on average, continue to grow only very moderately. This means that real wages will not be substantially higher next year than in 2007, and the expansion of private household consumption will continue to be sluggish.
- Because of healthy employment growth, high profits, and strong demand for euro area products from oil exporting countries, activity will, after a significant slow down during winter, accelerate. At the beginning of 2009, production is forecasted to expand at a rate of about 2 %.
- Due to recent developments in oil and food prices (and second-round effects), the risk of average annual inflation in 2008 exceeding 2% is very high.

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
					1.2		1.1		1.4
GDP	1.5	2.8	2.6	1.7	2.2	1.7	2.3	2.0	2.7
					2.0		2.0		1.9
Potential Output	1.8	1.9	2.1	2.1	2.2	2.1	2.2	2.1	2.2
					1.2		1.0		0.9
Private Consumption	1.5	1.8	1.5	1.8	2.4	1.7	2.3	1.7	2.4
					1.5		1.5		1.1
Government Consumption	1.4	1.9	2.0	1.9	2.3	1.8	2.2	1.5	1.9
					-0.1		0.2		1.1
Fixed Capital Formation	2.7	4.9	4.5	1.7	3.6	2.2	4.3	3.3	5.5
					3.3		3.0		4.7
Exports	4.5	7.8	6.1	4.4	5.4	4.0	4.9	5.9	7.0
					2.8		2.8		4.7
Imports	5.2	7.6	5.3	4.2	5.5	4.1	5.2	6.1	7.7
					7.1		7.0		6.8
Unemployment Rate	8.9	8.3	7.5	7.3	7.5	7.2	7.5	7.1	7.5
					2.9		2.9		2.7
Labour Cost Index	2.7	2.6	2.6	3.1	3.3	3.1	3.3	3.0	3.3
					-0.2		-0.2		0.4
Labour Productivity	0.7	1.4	0.7	0.3	0.7	0.3	0.8	0.9	1.5
					2.6		2.1		1.3
HICP	2.2	2.2	2.1	2.8	3.0	2.5	2.9	1.8	2.3
					3.1		1.6		0.5
IPI	1.3	4.0	3.9	3.9	4.7	2.6	3.6	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

At the end of 2007 the prospects for next year are much more clouded than the most recent data on economic activity would suggest: output grew in the third quarter 2007 at rates that are above potential in the US, in the European Union, and in Japan, and world trade expanded healthily, partly due to high growth dynamics in the emerging markets economies. One cause for our cautious prospects is the prolonged oil price hike during 2007. Crude Oil is, with almost 90 dollars per barrel (Brent) in mid December, about 40 % more expensive than it was one year before (and about 30 % more expensive if calculated in euros). The second, and more important, cause of concerns is the intensification of tensions on world financial markets.

In the US and in the European Union, fears of counterparty risks have increased the spreads between short-term interbank rates and government bonds of the same maturity to new highs in December. After markets appeared to calm down at the beginning of October, surprisingly large write downs by important banks (mostly of asset backed securities) have revealed that the crisis of structured credit is far from over. The background of these tensions is the intensification of the subprime mortgage crisis in the US. House prices keep falling and foreclosure rates are on the rise. Because markets trading asset backed securities that are linked to subprime mortgages have almost broken down, marking these assets to the market is all but impossible. One reason why it is so difficult to predict when the trough of these twin crises will be reached is that they evolve in vicious cycles. A topical example is that the financial status of some specialist insurers that write guarantees for debt issuers has suffered during the crisis; if these institutions were downgraded, the rating of all issuers guaranteed by them would suffer, giving new strain to the insurers themselves.

The turmoil on financial markets is not only a liquidity crisis. Capital ratios of important banks are suffering too as write downs diminish equity and banks have to put onto their balance sheets more and more risky assets that were formerly held by special purpose vehicles. The prospect of sliding capital ratios of banks has already triggered a tightening of credit standards. The expansion of credit will slow next year, in particular in the US, but to a certain extent also in the European Union. This will dampen demand in the real economy.

Central banks cannot solve the structural problems of the financial markets, but they will continue to provide the money markets with enough liquidity to prevent an outbreak of an acute liquidity crisis. The Fed will mitigate the consequences for the real economy by setting its key interest rate at levels that stimulate the economy; it has al-

ready lowered its key rate by one percentage points and we think it will continue on this path a bit further in 2008.

The prospects of a slowing economy and monetary easing in the US have caused the dollar to depreciate. In mid December, it has lost about 12 % against the euro since the beginning of 2007. In principle, the cheap dollar mitigates the present weakness of the US economy and the longer run problem of high current account deficits. Financial markets in the US and in Europe will benefit from investments by sovereign wealth funds of emerging markets countries with large current account surpluses. In general, the high growth dynamics in these countries will help avoiding a recession in the industrialized countries, but the upswing of the past few years will come to an end.

The euro area

The upswing in the euro area was, according to the national accounts data, still alive in the third quarter, with investment activity healthily growing by annualized 3.7%. At that time, however, expectations of firms and private households began to get more sceptical about the short term future of the euro area economy. Confidence indicators are still falling towards the end of the year. By now it has become clear that in 2008 the economy will have to cope with several adverse shocks.

The first shock is the mentioned turmoil in financial markets. An effect of the globalization is that European banking is almost as strongly affected by the crisis of subprime credit in the USA as US-banks are. The most recent lending survey of the ECB reveals that banks on balance have tightened credit standards as early as in October. The tightening applies in particular to the credit for firms and to housing credit. This trend will probably continue during the winter. As a consequence, the real cost of the external financing of euro area non-financial corporations, which has been rising over the year 2007, will continue to do so in 2008. This trend coincides with the distinct weakening of housing markets in most euro area countries, and in particular in Spain and Ireland. All in all, the upswing of investment activity in the euro area that has lasted for the past 2 ½ years will come to an end.

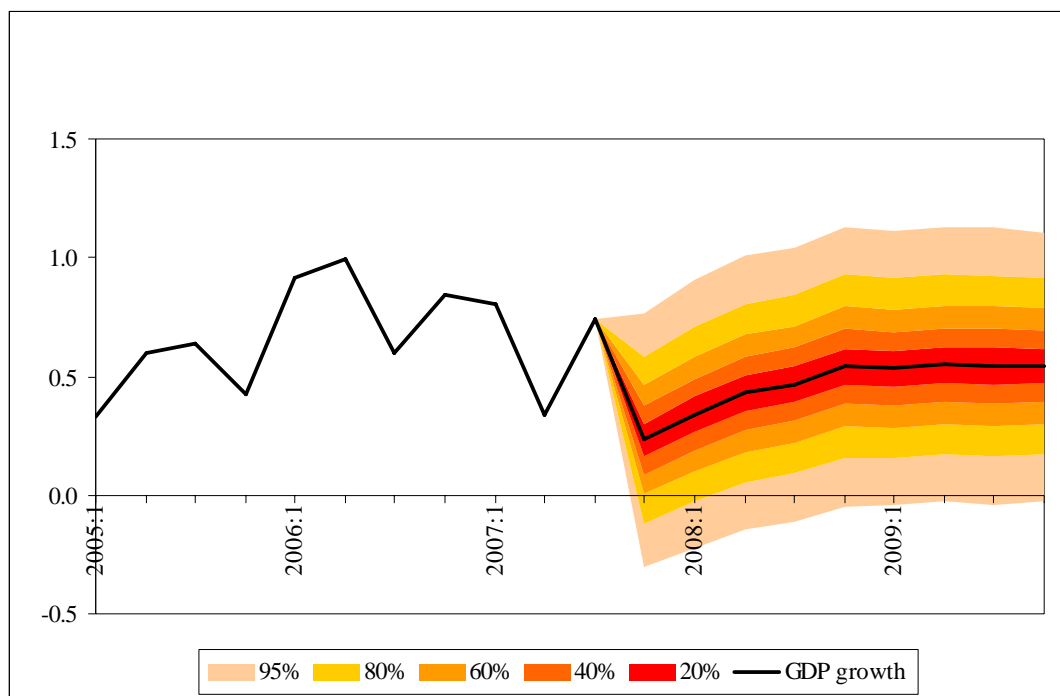
The second adverse shock is the appreciation of the euro: the real effective exchange rate has risen by about 3 ½ % since summer, weakening a bit the competitive position of producers in the euro area. On the other hand, it mitigates the losses in the purchasing power of consumers due to the international price hike for energy during 2007. Still, consumer prices have risen significantly, and wages, on average, continue to grow only very moderately, in spite of healthily expanding employment and sporadic agreements on strong pay rises in some industries. This means that real wages will not be substan-

tially higher in 2008 than in 2007, and the expansion of private household consumption will, contrary to what we expected in reports earlier this year, continue to be sluggish.

That said, a limited stimulus for consumption can be found in the – as yet – high level of job security, since the unemployment rate has been falling during the past 2 ½ years and will continue to do so, albeit to a decreasing degree. The healthy expansion of employment can be attributed, at least in part, to moderate wage growth during the past years; the counterpart of this fact is that profits are high, supporting investment activity in 2008. In addition, producers in the euro area have good chances of benefiting more than producers in most other regions from a strong increase in demand from oil exporting countries. Thus, there are good reasons to predict that activity will, after a significant slow down during winter, accelerate by and by. At the beginning of 2009, production will expand with the potential growth rate of about 2 %. This forecast is, however, conditioned on the assumption that financial markets will stabilize in the summer of 2008.

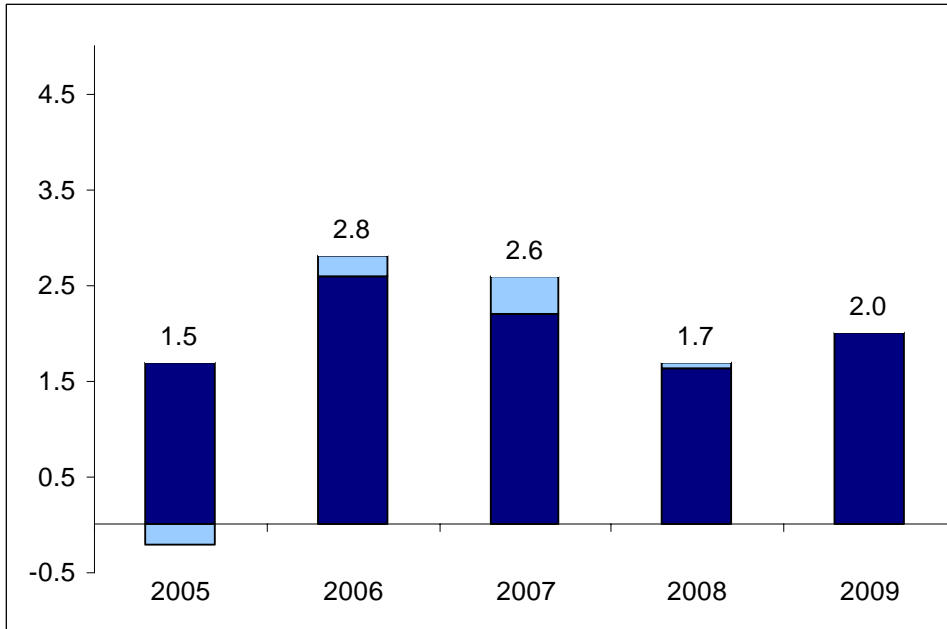
The Euro Area Economic Sentiment Indicator has displayed a deceleration since May of 2007, which has also been reflected in GDP growth (see Figure 3). The forecasts for this indicator also confirm the slowdown of the euro area economy.

Figure 1 Quarterly GDP growth rates and confidence bands



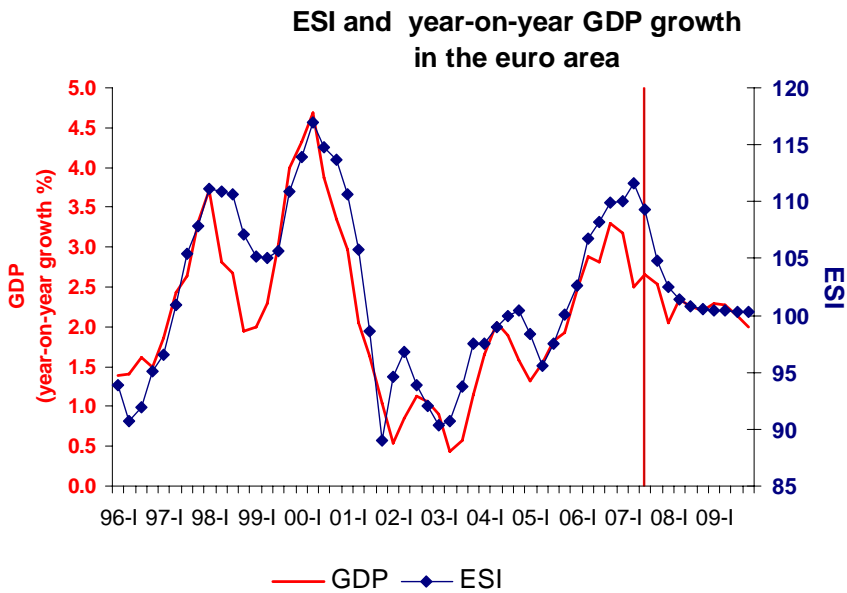
Percentage change over previous quarter

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 and GDP growth rates



From a supply-side perspective, the expected reduction in the GDP growth for 2008 is mainly driven by a reduction in the contribution of the industrial, services and construction sectors. As stated in our previous report, the construction sector would reduce its contribution to almost 0% (see table 2).

Table 2 Contributions of production sectors

Year	GDP Growth	Agriculture	Industrial	Construction	Services			Net taxes
					Market	Financial	Public	
2003	0.80%	-0.13%	0.05%	0.00%	0.13%	0.39%	0.18%	0.18%
2004	2.00%	0.24%	0.37%	0.04%	0.47%	0.38%	0.33%	0.17%
2005	1.50%	-0.11%	0.17%	0.07%	0.31%	0.64%	0.27%	0.15%
2006	2.80%	-0.03%	0.71%	0.25%	0.55%	0.75%	0.25%	0.33%
2007	2.60%	0.01%	0.66%	0.18%	0.55%	0.72%	0.27%	0.21%
2008	1.70%	0.01%	0.36%	0.00%	0.43%	0.56%	0.22%	0.12%
2009	2.00%	0.02%	0.34%	0.05%	0.47%	0.68%	0.28%	0.17%

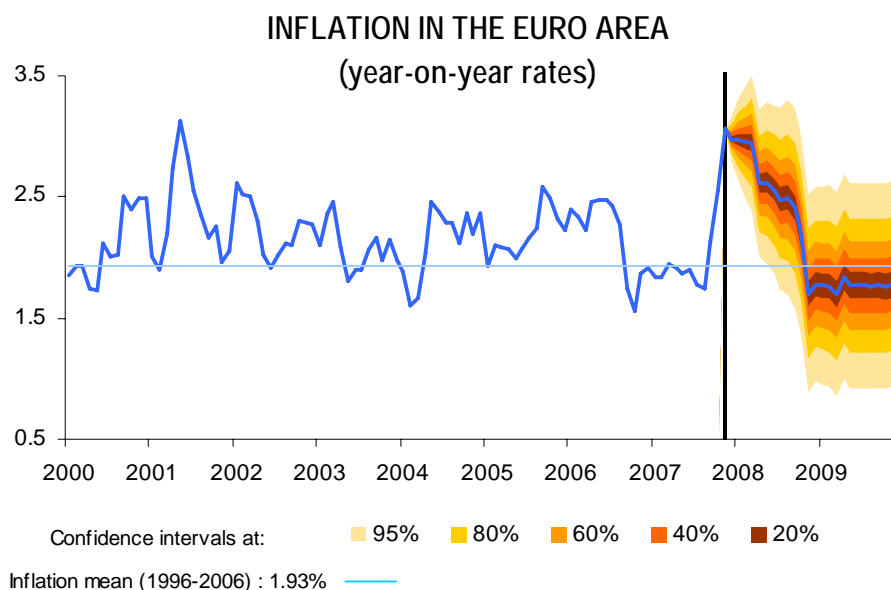
The industrial production index has also started a moderate deceleration. With information until October, the forecast for the average annual growth rate of the index for next year falls to 2.5% (down from 3.5% registered in 2007). For 2009 the industrial growth projection is 2.0%. The average annual rates of growth in the monthly industrial indexes of production for different industries classified according to the destination of goods are shown in Table 3. In energy goods, the annual growth rate will increase from -0.9% in 2007 to 3.0% in 2008, but the remaining sectors' growth rate will deteriorate. The improved performance of the energy sector attenuates the fall in the IPI growth of 2008.

Table 3 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%	6.1%	4.4%	3.6%
Durable	-4.4%	0.1%	-1.0%	4.2%	2.0%	0.6%	0.5%
Intermediate	0.3%	2.4%	0.9%	4.9%	3.8%	2.1%	2.2%
Non Durable	0.3%	0.6%	0.7%	2.2%	2.9%	0.7%	1.1%
Energy	2.8%	2.2%	1.3%	0.9%	-0.9%	3.0%	1.5%
Total EMU	0.3%	2.2%	1.3%	4.0%	3.5%	2.5%	2.0%

With regards to inflation, the risk of average annual inflation in 2008 exceeding 2% is very high with symptoms of moderation only found at the end of 2008 (see figure 4). The high inflation rate projected for the Euro Area is not only a consequence of high rates in oil prices, but also an important increase of the year-on-year rates in both processed –which are part of the core component of inflation— and non processed foods. The new forecasts for the average annual inflation rate for food for 2008 have been revised upwards, so the euro area will be facing rates of around 4.3% for processed and 3.4% for unprocessed food.

Figure 4. Year-on-year inflation and confidence bands



In addition to the usual risks coming from the foods and energy components of inflation –which might be attenuated by the favourable exchange rate against the dollar and by the projected deceleration in economic activity—, it is still unclear what is going to be the impact of prospective interventions of the monetary authorities in their attempt to calm down the current financial turmoil. On the 12th of December, the Bank of Canada, the Bank of England, the European Central Bank, the Federal Reserve, and the Swiss National Bank announced measures designed to address the liquidity requirements in short-term funding markets. In case the implementation of such measures turns out to have an indirect effect on the long term component of money growth (M3), we would face an imminent upside risk to inflation.

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconomic model, described in detail in the EFN Spring 2002 report. Table 4 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 forecasts for 2008 are quite similar and close to the potential growth rate. For 2009, however, our forecast is a bit more pessimistic than the rest. The main reason is that, as explained in the previous section, we no longer expect a strong rebound of private consumption.

The EFN forecasts for inflation are in line with the ECB projections, with a pessimist outlook for 2008 (with an average rate of 2.5%) with an improvement over 2009 (see Table 4). However, institutions like the IMF and OECD foresee an inflation rate slightly higher than 2% over 2008 and 2009. The European Commission forecast for 2009 is exactly 2%.

Table 4 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	2.0	2.2	2.1	2.1	na	2.0	2.1	1.9	2.0	1.9	na
Priv. Consumption	1.7	1.7	2.1	1.9	2.1	na	1.9	2.0	2.1	2.1	1.9	na
Gov. Consumption	1.8	1.5	2.1	2.0	1.8	na	1.6	1.5	1.6	1.5	1.6	na
Fixed Capital Form.	2.2	3.3	2.9	2.6	3.3	na	2.4	2.3	2.2	2.4	2.5	na
Unemployment rate	7.2	7.1	7.1	7.1	6.8	na	na	na	6.4	6.4	7.1	na
HICP	2.5	1.8	2.1	2.0	2.0	na	2.5	1.8	2.2	2.3	2.3	na
IP	2.5	2.2	na	na	na	na	na	na	na	na	2.1	na

EU: European Commission, European Economy, No. 7, 2007 (Autumn); IMF: World Economic Outlook, September 2007; ECB: ECB Monthly Bulletin, December 2007; OECD: Economic Outlook, No. 82, December 2007; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2007. 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 5 below. For the US, GDP growth will clearly be below potential in 2008; in 2009 there will be a tentative recovery. The slow down in Japan is assumed to be moderate. Inflation will stay at quite a high level for much of 2008 in the US, while deflation in Japan comes to an end. An oil price of 80 (86) dollar per barrel is expected for the end of 2008 (2009). The dollar is, from the point of view of purchasing power parities, clearly undervalued now. The current valuation is justified by the fear of a recession in the US. The assumption of a slowly appreciating dollar is consistent with the forecast that a recession can be avoided in the US.

Table 5 Variables of the world economy

	2007	2008	2009
US GDP Growth Rate	2.2	2.1	2.5
US Consumer Price Inflation	2.8	2.6	1.9
US Short Term Interest Rate	4.4	4.1	4.4
US Long Term Interest Rate	4.6	4.7	5.1
Japan GDP Growth Rate	1.9	1.8	1.9
Japan Consumer Price Inflation	0.0	0.4	0.4
Japan Short Term Interest Rate	0.8	1.1	1.5
Japan Long Term Interest Rate	1.7	2.0	2.4
World Trade	6	7.5	7.4
Oil Price	90	80	86
USD/Euro Exchange Rate	1.37	1.43	1.38
100Yen/Euro Exchange Rate	1.61	1.60	1.54

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 (2007) and OECD (2007). Oil price (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: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.