EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2007 and 2008

Summer 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 .

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Highlights

- In early summer, the world economy continues to expand at a swift pace. Due to sluggish expansion of US demand and less benign monetary conditions, however, world production will temporarily lose momentum. But healthy growth of profits and private income in the US indicate that the chances for a recovery in the States later this year and a continuation of the worldwide upswing are good.
- The upswing in the euro area continues as well. Investment activity was particularly dynamic during spring, but will slow down a bit in the coming quarters, partly due to rising interest rates. Private consumption will, to a large extend, fill the gap, supported by accelerating wage income growth. GDP growth is expected at 2.6% this year and 2.2% in 2008.
- A main risk for this forecast is that overheating labour markets could lead to wage- and price dynamics that induce the ECB to tighten monetary policy more drastically than forecast here. This risk relates to the uncertainty of whether the recent acceleration of productivity growth is a mere cyclical phenomenon or whether potential output growth in the euro area has, due to increased competition and labour market reforms, increased.
- Inflation is expected to be at 1.9% in 2007 and to reach 2.0% in 2008, at the border of the ECB target.

Table 1 Economic outlook for the Euro area

	2004	2005	2006	2007: 1st half		2007: annual		2008: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.0	1.5	2.7	2.8	2.6 3.0	2.6	2.2 2.9	2.2	1.5 2.9
Potential Output	1.9	1.7	1.8	1.8	1.7 1.9	1.9	1.8 2.0	2.1	1.9 2.4
Private Consumption	1.5	1.5	1.7	1.4	1.2 1.6	1.6	1.2 2.0	2.5	1.8 3.2
Government Consumption	1.4	1.4	2.0	1.9	1.7 2.1	1.8	1.5 2.0	1.3	0.9 1.7
Fixed Capital Formation	2.3	2.6	4.8	6.7	6.0 7.3	6.0	4.9 7.3	2.5	0.1 4.9
Exports	6.9	4.2	8.3	6.2	5.7 6.8	5.4	4.7 6.1	5.2	4.1 6.3
Imports	6.8	5.0	7.9	6.4	5.9 7.0	5.9	5.0 6.7	5.2	3.7 6.5
Unemployment Rate	8.8	8.6	7.9	7.2	7.1 7.3	7.0	6.8 7.2	6.7	6.2 7.2
Labour Cost Index	2.4	2.4	2.5	2.7	2.6 3.0	2.8	2.7 3.0	3.3	2.9 3.7
Labour Productivity	1.0	0.7	1.4	1.4	1.2 1.6	1.1	0.8 1.4	0.8	0.2 1.4
HICP	2.1	2.2	2.2	1.9	2.0 1.8	1.9	2.1 1.7	2.0	2.5 1.5
IPI	2.1	1.3	4.0	2.8	2.6 3.0	2.3	1.6 3.0	1.9	0.5 3.4

Percentage change in the average level compared with the same period a year earlier, 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 2007 and 2008

The world economy

In early summer, the world economy continues to expand at a swift pace. Japan and the European Union are in an upswing, and in the East Asian growth centres China and India policy measures had to be taken to dampen the exuberant demand growth. The downswing in the US, however, has become more pronounced during the past winter. Demand from the States is still pivotal for the world economy, and sluggish US import growth appears to be a main reason for the slow down of world trade during the past few months. Still, the American slow down has not put an end to the worldwide upswing. One explanation is that the problems in the US are centered around the recession of the housing market, and that direct links of this sector to world markets are weak. Furthermore, fears that the housing slump will destabilize mortgage banks and even the US financial sector in general have so far not materialized. On the contrary, in the US and worldwide, financial markets are buoyant, risk spreads are still very low, and stock markets have quickly overcome the small set backs in February/March. The dollar has stabilized after its fall relative to the euro in April. There are two explanations for financial markets being so benign during the present upswing: first, new sophisticated financial instruments like collateralized debt obligations diversify risk more efficiently among investors. Second, emerging markets economies, above all China, generate huge current account surpluses that are invested on world financial markets; in addition, stock market evaluations of firms are supported by high profit margins that derive, in part, from competition of cheap and qualified labour that keeps wage pressure low in most developed countries. All in all, financial conditions are still favourable, although monetary policy has not been accommodative in the US for a while, is restrictive in the UK, and has recently moved to a neutral stance in the euro area. These policies appear necessary in view of inflationary pressures that have not yet abated unambiguously in the US and are building up in the European Union. Japan, where the price level is stubbornly stagnant or even deflating, is the notable exception: The Bank of Japan will not raise interest rates as long as inflation is definitely in positive territory.

World production and trade will probably lose a bit of momentum up to the summer, due to sluggish expansion of demand from the US and, all in all, less benign monetary conditions will take their toll. However, healthy growth of profits and private income in the US indicate that the chances for a recovery in the States are good. This is likely to happen in the second half of 2007, when the recession in the construction sector will have abated. The upswings in Europe and Japan will continue, albeit at more moderate rates.

Indeed, there are considerable upside risks for this scenario: financial conditions on world markets might become even more supportive if recent signals of a change in the investment strategy of countries with high current account surpluses, such as China and Russia, are not misleading. A preference shift of these huge public investors from government bonds to private assets and to a higher risk-return mix could stimulate real investment activities internationally. On the other hand, downside risks of the recent past still apply. One source of risk is possibly adverse effects of the recently developed financial instruments when economic conditions might become somewhat more difficult. For example, markets might have diversified risk to such a degree that in the end no investor is willing to shoulder monitoring costs. While this sort of risk is difficult to assess, another type is more obvious: oil prices are high and highly volatile, and prices of industrial raw materials have strongly increased since the beginning of the year; both facts point to the risk that the scarcity of raw materials might slow down the expansion of global output.

The euro area

The upswing in the euro area continues in early summer. Quarterly national accounts data show that in spring the expansion, with an annualized rate of 2.4 %, has, for the fifth quarter in a row, been higher than the trend growth rate. This is all the more remarkable given that in Germany the increase of the standard VAT tax rate by three percentage points as from January 1st has induced consumers to spend more at the end of 2006 and less at the beginning of this year; consequently, consumption of private households shrank in Germany and even a bit in the whole euro area. Indeed, private consumption was distinctly less dynamic than production in most member states.

There is a second German anomaly that blurs the underlying trends: late registrations of exports in the German statistics at the end of last year led to artificially high export growth that entailed weak numbers for Germany and, to a lesser extent, for the whole area at the beginning of 2007. The underlying export performance, however, was still strong.

Growth of gross fixed capital formation was, with an annualized rate of nearly 10 %, even higher than during the boom year 2000. Mild weather helped the construction sector. More generally, the explanations for the strong performance of investment in our last EFN Report still apply, albeit to a lesser degree. In particular, although since the beginning of the year fixed income yields have increased by about 40 basis points at the short end and by about 60 points for long term capital, in historical perspective, real and nominal interest rates are still not high. In addition, risk spreads are low and stock markets are buoyant. Unit labour costs are rising very slowly and even stagnated in the last quarter of 2006: wage growth continued on a moderate path and labour productivity rose, which is, at least partly, a cyclical phenomenon. All this has contributed to healthy profits and has made hiring of workers and investing more attractive. The latter activity is further supported by the fact that capital utilization in the manufacturing industry has, according to the survey of the European Commission, steadily risen and is now higher than at the height of the boom in 2000. The same survey tells us that business confidence is also high, albeit no longer increasing.

The favourable outlook for real economic activity together with the strong dynamics of monetary aggregates has led the ECB to the conclusion that monetary policy should switch to a neutral or even restrictive stance. The bank has signaled that it might very well raise its key interest rate further to 4.25% in the second half of 2007. In addition, fiscal policy is on the restrictive side in Germany and Italy, and foreign demand will be less supportive due to the slack in the US. Therefore, although investment will continue to expand at a fast pace for the rest of the year, it will grow at slower rates than in the first quarter.

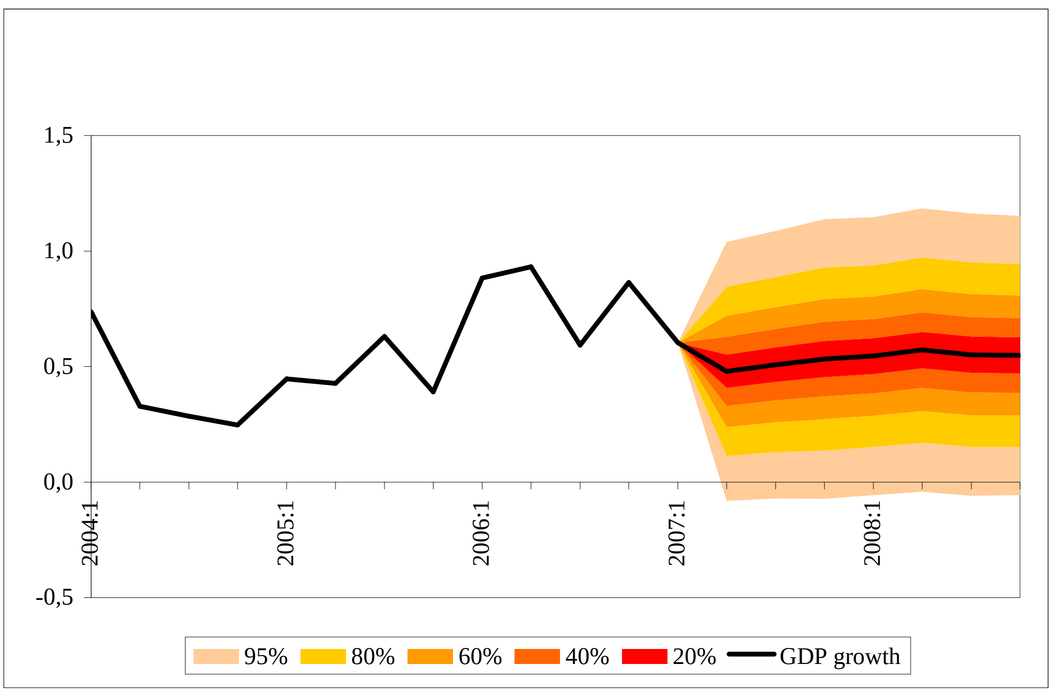
Private consumption, however, should fill the gap. Employment growth has accelerated over the past year and the unemployment rate is, with 7.1 % (April), at its lowest since the euro area was established. Chances are good that the favourable developments on the labour markets will continue, that unemployment will decrease further – albeit at a slower pace – and that the upswing will finally be reflected in an acceleration of wage growth. All this will provoke consumers to spend more. Indeed, consumer confidence has already increased strongly during the past few months. All in all, the upswing will lose a bit of momentum, but – leaving aside, of course, external shocks – output growth will stay at rates that are slightly above the growth rate of capacity.

There are two major euro area-specific risk factors for this forecast: a slump at European housing markets, and overheating labour markets. As to the first, our Spring Report has mentioned the risk that the rise in interest rates might trigger a downturn on the booming housing markets in some countries, which might lead to a slump in the construction industry and weaken, by way of lower asset prices and adverse income effects, consumer demand. House price growth is indeed moderating in many countries, and the expansion of mortgage lending has declined considerably during spring. The construction sector is the only one with dwindling confidence – since autumn of past year, according to the Commission's survey. The same indicator shows, however, that confidence is still stable in Spain, which is the country where housing markets seem especially overstretched. Thus, a housing market slump similar to that in the US appears to be a risk scenario not before 2008.

A near term risk is that overheating labour markets could lead to wage- and price dynamics that induce the ECB to tighten monetary policy more drastically than forecast here. Recent wage agreements look, by and large, still moderate, but scarcities could become critical for workers with highly specific skills and might affect the wage drift instead of basic payments. In the end, this risk relates to a central macroeconomic question: is the recent acceleration of productivity growth a mere cyclical phenomenon and do we have already a large output gap, or does potential output in the euro area, possibly due to increased competition and labour market reforms, grow at a faster pace than in the past decade?

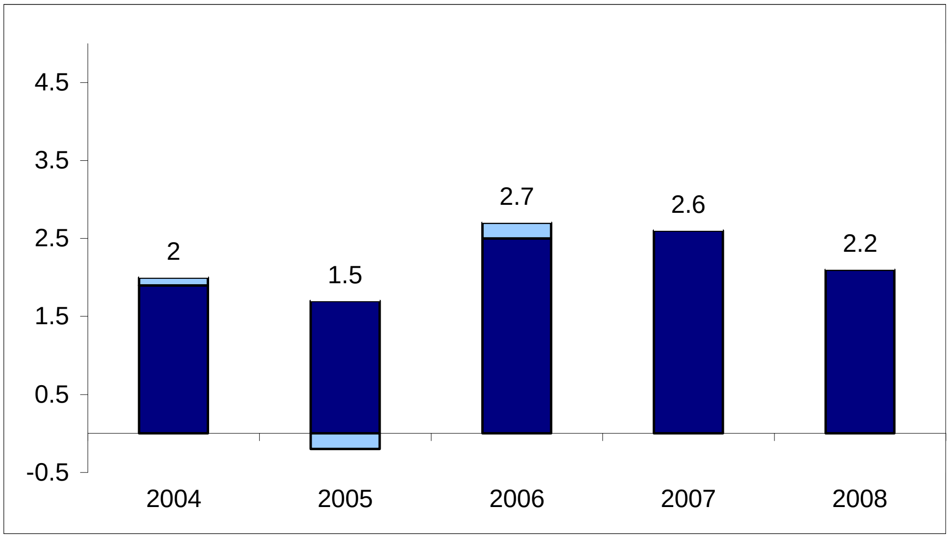
Overall, we expect a GDP growth of 2.6% in 2007 and 2.2% in 2008 in the euro area. The evolution of the quarterly GDP growth rate, and the uncertainty about it, are presented in Figure 1. Figure 2 reports the contribution of domestic components and net exports to GDP growth.

Figure 1. Quarterly GDP growth rates and confidence bands



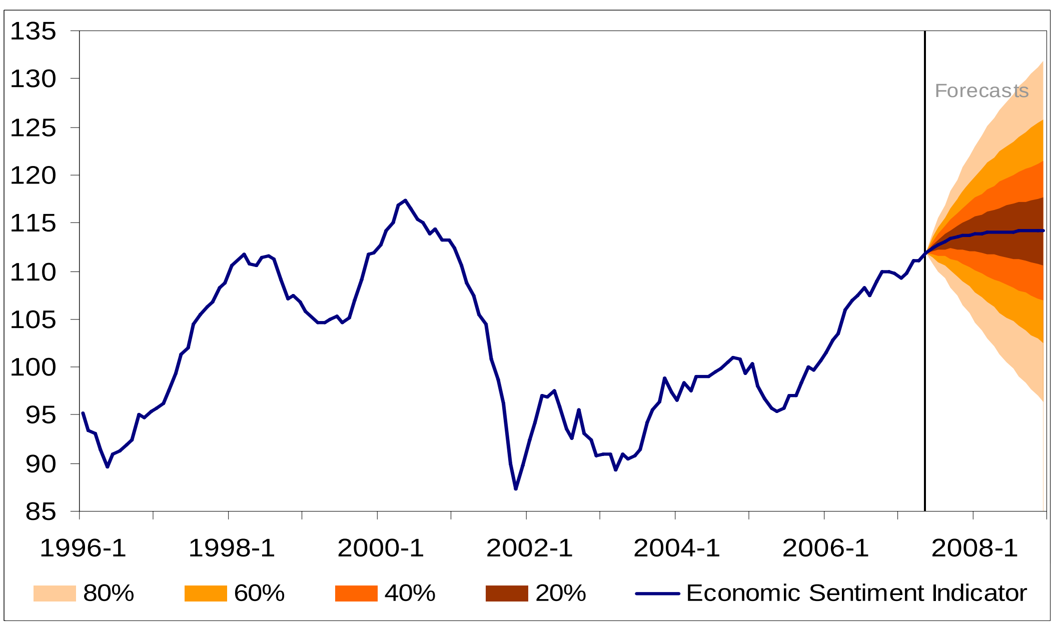
Percentage change over previous quarter

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



Adding to the information coming from the Quarterly National Accounts, more recent information with regards to the outlook for real economic activity is provided by the Economic Sentiment Indicator, for which May 2007 figures are already available. The indicator performed in May better than expected, especially due to increased confidence of economic agents in the consumption and retail trade sectors. Forecasts updated with this information are shown in Figure 3, according to which a slight improvement in the confidence of economic agents in the evolution of the euro area economy during the next few months is expected, subsequently stabilising from the fourth quarter of 2007 on.

From a supply-side perspective, the industrial sector together with the market and financial services sectors are expected to continue accounting for approximately 65-70% of the economic growth in the euro area. Table 2 shows the contributions of each production sector. The slight slowdown expected for 2007 in comparison with 2006 mainly reflects a smaller contribution to growth from the industrial sector.

Table 2. Contributions of production sectors

					Services			
Year	GDP Growth	Agriculture	Industrial	Construction	Market	Financial	Public	Net taxes
2003	0.80%	-0.12%	0.07%	0.01%	0.08%	0.39%	0.19%	0.17%
2004	2.00%	0.26%	0.25%	0.04%	0.56%	0.44%	0.29%	0.16%
2005	1.50%	-0.10%	0.23%	0.08%	0.34%	0.53%	0.24%	0.18%
2006	2.70%	-0.03%	0.70%	0.24%	0.53%	0.64%	0.26%	0.36%
2007	**2.60%**	**0.02%**	**0.55%**	**0.25%**	**0.52%**	**0.66%**	**0.29%**	**0.32%**
2008	**2.20%**	**0.02%**	**0.35%**	**0.19%**	**0.46%**	**0.61%**	**0.28%**	**0.29%**

During the first quarter of 2007, the Industrial Production Index (IPI) in the euro area behaved as expected or slightly above expectations, and it registered rates similar to those in 2006 (3,6%). In April 2007, however, it has performed worse than expected as the result of downwards innovations in practically all sectors, excluding non-durable consumer goods. Industrial Confidence Indicator figures for May 2007 show also a worse than expected behaviour, and the updated forecasts indicate that a peak could have been reached in May, expecting a downwards trend in 2007 and 2008, but tending to stabilize in the last quarter of this year at levels higher than those registered when the sector experienced a low growth rate (2001-2003) These developments have led to a downwards revision of the forecasts for IPI growth rate in 2007 and 2008, which are now 2.3% and 1.9% respectively, 0.6 and 0.3pp lower than the forecasts shown in our last report.

The average annual rates of growth in the euro area Industrial Production Index for different industries classified according to the destination of goods are reported in Table 3. The smaller growth rate expected for 2007 in comparison with 2006 comes from a lower dynamism in all sectors, excluding non-durable consumer goods, although capital and intermediate goods are expected to consolidate the recovery experienced in 2006 and show rates significantly above those in 2005. For the energy sector, a negative contribution to IPI growth rate is expected in 2007.

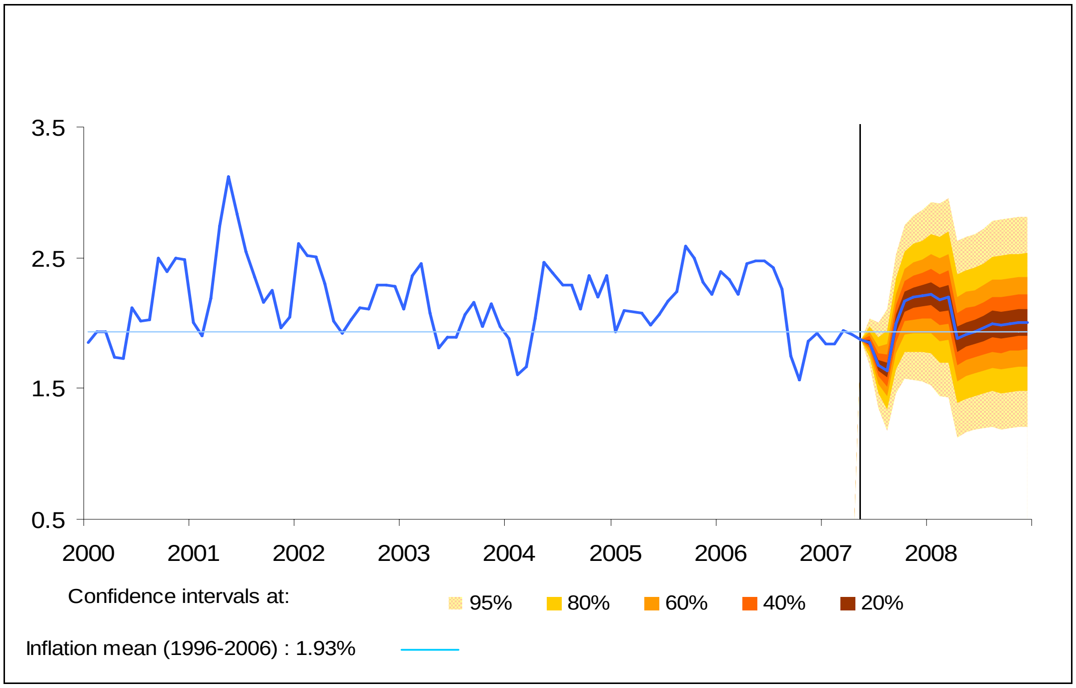
Table 3. Annual average rates for industrial production in the euro area

	2002	2003	2004	2005	2006	**2007**	**2008**
Capital	-1.5%	-0.1%	3.3%	2.8%	5.9%	**4.7%**	**3.1%**
Durable	-6.1%	-4.4%	0.1%	-0.9%	4.2%	**0.3%**	**0.0%**
Intermediate	-0.1%	0.4%	2.3%	0.9%	5.0%	**3.1%**	**1.8%**
Non Durable	0.7%	0.4%	0.6%	0.7%	2.1%	**2.1%**	**1.0%**
Energy	1.5%	2.8%	2.0%	1.3%	0.7%	**-4.5%**	**0.9%**
Total EMU	-0.4%	0.3%	2.1%	1.3%	4.0%	**2.3%**	**1.9%**

Regarding inflation in the euro area, since our last report, we have revised slightly upwards the forecasts for 2007, as the result of the evolution of energy prices, for which a higher growth rate is now expected, and as the result of slightly higher growth rates expected for the prices of services and processed food. Therefore, our current forecasts indicate an annual average growth rate in HICP of 1.9% in 2007 and 2.0% in 2008, at the border of the ECB target.

As shown in Figure 4, HICP annual growth rates, currently at 1.9% are expected to moderate slightly in the central months of the summer, favoured by the evolution of components outside core inflation. Subsequently, it is expected to rise and end the year at around 2.2%, and after a first quarter of 2008 at these values, stabilize at 2,0%, favoured by more moderate core inflation.

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



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 5 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the staff of the ECB, the OECD, and Consensus Economics Inc.

Most forecasts for 2007 are quite similar, but opinions diverge on whether the upswing will noticeably lose steam in 2008. The EFN stands out in pronounced swings for the private demand aggregates. One reason for this is that this forecast takes already into account that first quarter data surprised with strong investment and weak consumption.

On inflation, forecasts for 2007 range between 1.8% and 2.0%, and for 2008, all forecasters here consider that it will either increase or stay the same, that is, forecasts range between 1.9% and 2.0%, bordering the ECB target. EFN forecasts stay in the middle of the range considered for inflation in 2007 (1.9%). For 2008, EFN expects HICP to reach the ECB target. The more pessimistic expectations are those coming from the IMF, according to which inflation will reach 2.0% in 2007 and will stay there in 2008.

Regarding industrial production, EFN forecasts consider a slightly higher growth in 2007 than those coming from the Consensus, but expect for 2008 lower growth.

Table 5 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
GDP	2.6	2.2	2.6	2.5	2.3	2.3	2.6	2.3	2.7	2.3	2.5	2.2
Priv. Consumption	1.6	2.5	2.1	2.4	1.7	2.0	1.9	2.2	2.0	2.3	1.8	2.0
Gov. Consumption	1.8	1.3	1.8	1.8	1.4	1.6	1.5	1.5	1.8	1.6	1.6	1.5
Fixed Capital Form.	6.0	2.5	4.4	3.6	4.1	3.6	4.9	3.5	4.3	3.0	4.2	3.2
Unemployment rate	7.0	6.7	7.3	6.9	7.3	7.1	na	na	7.1	6.7	7.2	7.0
HICP	1.9	2.0	1.9	1.9	2.0	2.0	2.0	2.0	1.8	2.0	1.9	1.9
IP	2.3	1.9	na	na	2.0	na	na	na	na	na	2.2	2.1

EU: European Commission, European Economy, No. 2, 2007 (Spring); IMF: World Economic Outlook, 2007; ECB: ECB Monthly Bulletin, June 2007, OECD: Economic Outlook, No. 81, May 2007; Consensus: Consensus Economics Inc., Consensus Forecasts, May 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 6 below. For the US, GDP growth will be below potential in 2007 and about at potential in 2008. Japan is assumed to continue its healthy growth path. Inflation in the US will recede only slowly, while the price level in Japan will not rise noticeably before 2008. The oil price is assumed to stay high, but below the record level of August last year, and the euro is assumed to be stable relative to the dollar.

Table 6. Variables of the world economy

	2007	2008
US GDP Growth Rate	2.1	2.8
US Consumer Price Inflation	2.4	2.3
US Short Term Interest Rate	4.9	4.9
US Long Term Interest Rate	4.7	4.9
Japan GDP Growth Rate	2.3	2.1
Japan Consumer Price Inflation	0.1	0.5
Japan Short Term Interest Rate	0.7	1.0
Japan Long Term Interest Rate	1.8	2.1
World Trade	7.0	7.5
Oil Price	65	70
USD/Euro Exchange Rate	1.34	1.34
100Yen/Euro Exchange Rate	1.61	1.60

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 (2006). Oil price (end of period) in US dollar per barrel (Brent), all other variables in percent.