EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2006 AND 2007

Summer 2006

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

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Highlights

- In early summer, financial markets have brought some dark clouds over the bright state of the world economy. While the specific point in time of the downturn was a surprise, one main cause appears to be clear: worldwide monetary policy becomes ever less expansive, and its future path is now difficult to predict. As a consequence, markets lose liquidity and the risks for investors are rising.
- The euro area economy started quite well into the year 2006. Exports surprised on the positive side; investment, however, was disappointing. This may partly be explained by weak construction activity caused by the long winter in some member countries.
- In spite of the downturn on financial markets, fundamentals in the euro area are beneficial enough to support a continuation of the modest upswing: revisions for profits of European firms are on average positive and the real costs of financing expenditure for investment and consumption are still low. Investment will continue to benefit from the moderate evolution of labour costs. Employment will be further expanding, and increased job security will continue to slowly raise confidence of private households.
- It is highly likely that inflation will not fall below 2% in 2006 and during the first months of 2007. This probability is over 60% for every month except September and October, and the likelihood of exceeding 2.5% is nearly 50% in quite a few months. In the second half of 2007, however, the probability of an inflation rate above 2% falls to 40%.

Table 1 Economic outlook for the Euro area

	2003	2004	2005	2006: 1st half		2006: annual		2007: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					1.8		1.6		1.4
GDP	0.8	2.1	1.3	2.0	2.2	1.9	2.2	1.9	2.4
					1.3		1.5		2.1
Potential Output	1.8	1.6	1.3	1.4	1.4	1.6	1.7	2.3	2.4
					1.5		1.5		1.5
Private Consumption	1.2	1.6	1.3	1.7	2.0	2.0	2.4	2.4	3.2
					1.4		1.1		1.0
Government Consumption	1.7	1.0	1.2	1.6	1.8	1.4	1.7	1.4	1.8
					2.2		1.6		1.4
Fixed Capital Formation	0.8	2.3	2.3	2.7	3.1	2.4	3.2	3.1	4.7
					7.3		6.2		4.1
Exports	1.2	6.6	3.8	8.2	9.1	7.8	9.4	6.4	8.9
					7.8		6.5		4.6
Imports	3.0	6.6	4.7	8.6	9.4	7.9	9.4	7.0	9.5
					7.9		7.7		7.2
Unemployment Rate	8.7	8.9	8.6	8.0	8.0	7.8	7.9	7.5	7.8
					8.1		8.0		7.4
NAIRU	8.1	8.2	8.3	8.1	8.2	8.1	8.2	7.6	7.9
					2.1		2.2		2.7
Labour Cost Index	3.0	2.5	2.6	2.2	2.2	2.4	2.6	3.0	3.4
					0.8		0.5		0.3
Labour Productivity	0.4	1.2	0.6	1.0	1.2	0.8	1.0	0.7	1.1
					2.36		2.1		1.4
HICP	2.1	2.1	2.2	2.4	2.44	2.3	2.5	1.9	2.3
					2.7		1.6		0.3
IPI	0.3	2.0	1.2	3.2	3.7	2.6	3.6	1.8	3.3

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2006 and 2007

The world economy

Production in most industrial and emerging markets countries continued to expand briskly in the first half of the year. However, in late spring, financial markets have brought some dark clouds over the bright state of the world economy. In April and May a first sign of increasing nervousness emerged: the US-Dollar fell significantly, in particular relative to the Euro. Volatility soon began increasing on many financial markets. Stock valuations have gone down worldwide; on many emerging markets the decline was drastic. Bond markets have shown more resilience, but the risk premia emerging sovereigns and private firms have to pay have increased significantly.

The outbreak of nervousness on financial markets is not easy to explain. One reason is the fear of higher inflation in the US and of a restrictive reaction of the Federal Reserve Board. This would accelerate the slow down in the US economy, which up to now is expected to be only modest. The increase in risk aversion of investors has, however, led to a flight to quality that still means rising demand for US assets. Thus, US stocks have up to now been more resilient than those in most other regions. The more fundamental cause for the recent developments is the fact that worldwide monetary policy becomes ever less expansive. As a consequence, markets lose liquidity and investors become more choosey. In addition, the future path of monetary policy is less clear than in the recent past. While the specific point in time and the speed of the reactions was unforeseeable, the development was, in principal, expected by many forecasters, and it is no more than a normalization: volatility and interest rates are still not high by historical standards and risk spreads are still very low.

Thus, the chances are good that the real sector of the world economy will cope with less benign financial conditions. The boom of prices for oil and many industrial commodities has for now come to an end – albeit on a very high level – as these goods are now regarded as high risk investments. The most probable picture for the world economy in this year and in 2007 is a modest deceleration to its potential growth path. This path is, due to the growth processes in Asia, in this decade probably higher than that of the 80s and 90s.

The major risks to this forecast come from a more abrupt weakening of private US demand, and from a renewed oil price hike. Both points are now and for the foreseeable future standard risk factors, given the ever widening current account deficit of the US economy, and given the political liability of important oil producing countries. Recent turbulences on financial markets have, however, added a special risk factor: some emerging markets are still much more vulnerable to heightened nervousness of financial investors. From this perspective it is reassuring that commodity prices are still high, as they are important sources of revenue for some more fragile emerging economies.

The euro area

The euro area economy started quite well into the year 2006. With an annualised quarterly rate of 2.4 %, output expansion was above the potential growth rate. As so frequently in the recent past, exports surprised on the positive side, while investment was disappointing. The latter is partly due to weak construction activity imposed by the long winter in some member countries. Industrial production continued to expand in spring; the most recent data, however, appear to signal slowing growth in this sector. This coincides with the deterioration on financial markets. While stock markets had been particularly buoyant in the euro area during winter and early spring, the losses of late spring were here more pronounced than in the US. One reason for the abrupt change was certainly the appreciation of the euro in April and May; this was, however, partly reversed in June.

Beneficial fundamentals are still in place to support a continuation of the modest upswing: revisions for profits of European firms are on average positive. The real costs of financing expenditure for investment and consumption are still low. It is thus not surprising that the dynamics of loans to the private sector have strengthened further, leading to an acceleration of money supply growth. The ECB has made it clear that it regards the high monetary dynamics as a risk to price stability. Accordingly, forecasters and financial markets expect that short-term interest rates will continue to rise during this and next year. Thus, less beneficial financial conditions together with weaker stimuli from the world economy (in particular from the US) will slow the upswing in the euro area a bit. Still supportive, however, will be the dynamics on European labour markets. Investment will continue to benefit from the moderate evolution of labour costs. There is a good chance that employment will be further expanding, and increased job security will continue to slowly raise confidence of private households. In addition, consumption benefits from high dynamics of residential property prices in most member countries; these appear to be only slightly slowing. In the first half of 2007, consumption of private households will be dampened somewhat by the increase of value added tax in Germany (by three percentage points for most items).

Major risks for this forecast are the possibility of a further decline of sentiment on financial markets and uncertainties about fiscal policies in large member countries: the effects of the tax increases in Germany are difficult to forecast, as their dimension does not have a precedent in this country. In Italy, given its high deficit ratio of 4.1 % in

2006, sharp restrictive measures appear to be unavoidable in the near future, with negative implications for aggregate demand that are difficult to predict.

Considering the latest information about the Euro Area Economic Sentiment Indicator, the May figure consolidates the economic recovery that the euro area started to experience in the second half of 2005. In particular, the probability that the indicator will fall to the local minimum level observed in early 2005 is now small. The projection of the indicator using non-linear univariate models shows that it will continue to recover in the next quarter, after which the situation will stabilise (see Figure 1.).

Figure 1 Euro Area Economic Sentiment Indicator

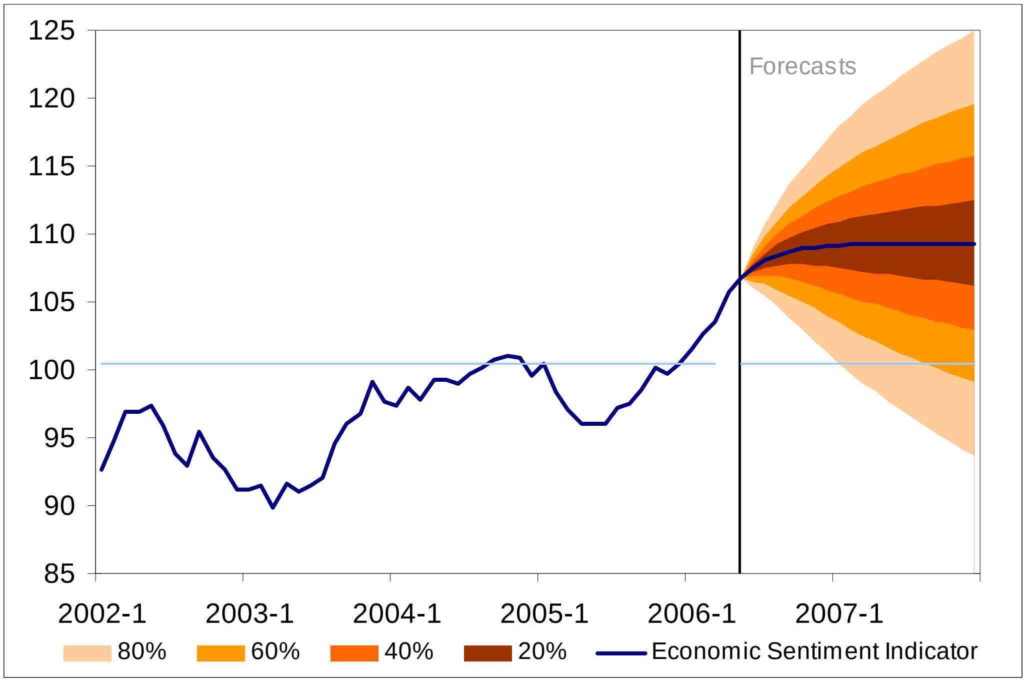
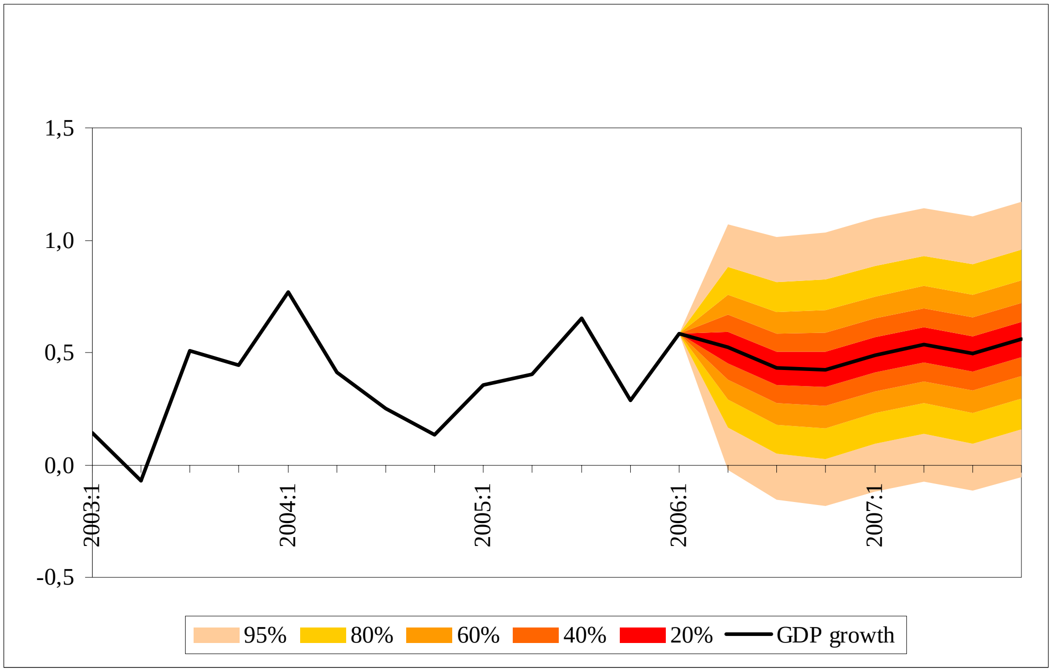
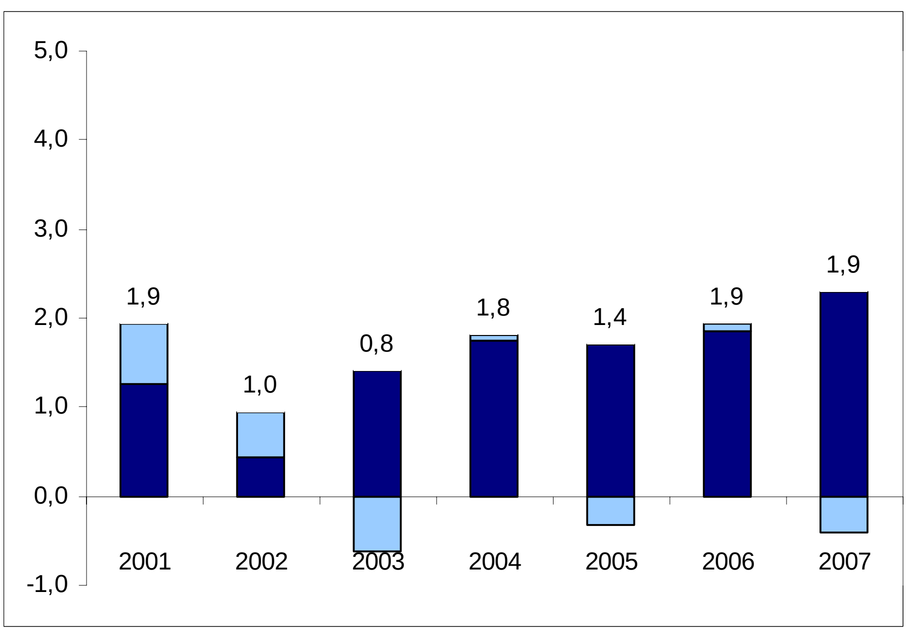


Figure 2 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 3 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.

Table 2 Contributions of production sectors

					Services			
Year	GDP Growth	Agriculture	Industrial	Construction	Market	Financial	Public	Net taxes
2001	1.9%	0,0%	0.3%	0.1%	0.5%	0.7%	0.3%	0.1%
2002	1.0%	0.0%	0.0%	0.0%	0.2%	0.4%	0.4%	0.0%
2003	0.8%	-0.1%	0.1%	0.0%	0.1%	0.4%	0.2%	0.1%
2004	1.8%	0.2%	0.5%	0.1%	0.4%	0.4%	0.2%	0.1%
2005	1.4%	-0.1%	0.2%	0.0%	0.4%	0.5%	0.2%	0.1%
2006	1.9%	0.0%	0.4%	0.0%	0.4%	0.6%	0.2%	0.2%
2007	1.9%	0.0%	0.4%	0.0%	0.4%	0.7%	0.2%	0.2%

From a supply-side perspective, GDP growth for 2006 and 2007 is driven by expansion in services, in particular financial services, and the industrial sector (Table 2). The services sector will be responsible for more than 60% of GDP growth in 2006 and it is expected that this proportion will persist in 2007.

The average annual rates of growth for different industries classified according to the destination of goods are shown in table 3. All sectors increase their growth rates for 2006 and the highest recoveries are expected in the intermediate goods and durable goods production sector, pushing IPI growth up to 2.6%. For 2007, the growth rate forecasts for all sectors are lower than in 2006, especially for durable goods, so the IPI growth rate for 2007 will be around 1.8%.

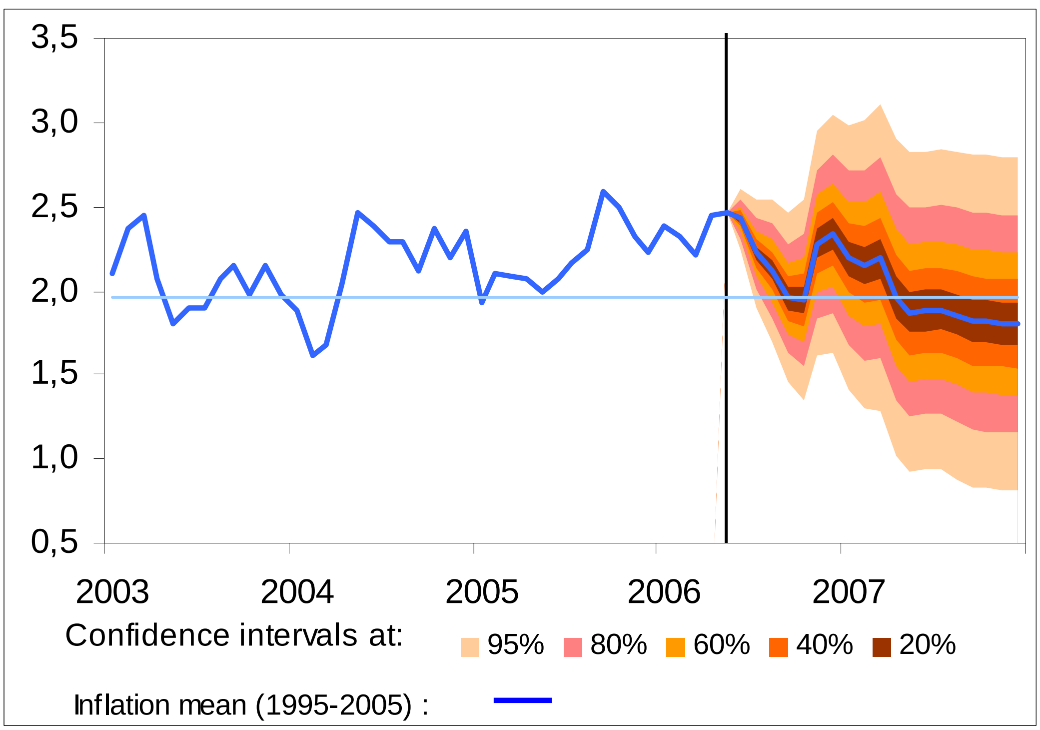
Table 3 Annual average rates for industrial production in the euro area

	2001	2002	2003	2004	2005	2006	2007
Capital	1.8%	-1.6%	-0.1%	3.2%	2.7%	3.8%	2.1%
Durable	-2.0%	-6.3%	-4.5%	0.1%	-0.9%	1.5%	-0.1%
Intermediate	-0.8%	-0.1%	0.3%	2.2%	0.9%	2.9%	1.9%
Non Durable	0.8%	0.7%	0.3%	0.6%	0.8%	1.0%	0.9%
Energy	1.4%	1.5%	3.0%	2.0%	1.2%	2.5%	1.1%
Total EMU	0.4%	-0.4%	0.3%	2.0%	1.2%	2.6%	1.8%

The forecasts for the mean annual total and core inflation rates for 2006 and 2007 are 2.3 and 1.9% for total and 1.5 and 1.6% for core inflation. Inflation forecasts in the euro area show occasional values of over 2% up to April 2007, tending to converge towards a rate of 1.8% (±0.6) at the end of the year. As forecasts, they are affected by a certain degree of uncertainty, and the fan chart (see Figure 4) shows the levels of uncertainty affecting different ranges of values around the forecast inflation rate pathway. Figure 4 shows that it is highly likely that inflation will not fall below 2% in 2006. This probability is over 60% for every month except September and October, and the likelihood of exceeding 2.5% is nearly 50% in quite a few months. In the second half of 2007, however, the likelihood of failing to meet the inflation target falls to 40%.

The forecasts for 2007 are estimated without including the effects that VAT increases could have on prices. Such an increase necessarily affects the results of one or two months but, in the longer run, it should have an anti-inflationist nature.

Figure 4 Forecasts for the Inflation in the Euro Area (y-o-y rate)



By country, the inflation forecasts for 2006 and 2007 indicate that the worst results in the euro area will be for Spain, Luxembourg and Greece, with average annual rate over 3% in these years. The lowest inflation rates are expected for Germany., Finland and the Netherlands.

Actual real interest rates in the euro area present a considerable differential, in some cases as much as two percentage points. Only France, the Netherlands, Finland and Germany experience positive real interest rates, over one per cent (see table 4).

Table 4 Inflation expectations and actual real interest rates

	Inflation expectations		Actual real interest rates	
	Three Months	One Year	Three Months	One Year
Spain	3.27	3.04	-0.31	0.31
Luxembourg	3.12	2.87	-0.16	0.49
Greece	3.08	2.91	-0.12	0.44
Ireland	2.95	2.87	0.01	0.48
Italy	2.60	2.81	0.36	0.54
Portugal	2.57	2.64	0.39	0.71
Belgium	2.53	2.47	0.43	0.89
Austria	2.08	2.06	0.88	1.30
France	1.95	1.86	1.01	1.50
Netherlands	1.81	1.89	1.15	1.47
Finland	1.49	1.37	1.47	1.99
Germany	1.41	1.29	1.55	2.07

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 ECB, the OECD, and Consensus Economics Inc.

The GDP forecasts are quite similar. However, the revival of private consumption is a bit stronger in our forecast, in particular for 2007 (due to our more optimistic forecast for the labour market), and the expected evolution of fixed capital formation is lower in 2006.

Table 5 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
GDP	1.9	1.9	2.1	1.8	2.0	1.9	2.1	1.8	2.2	2.1	2.1	1.8
Priv. Consumption	2.0	2.4	1.7	1.4	1.6	1.6	1.6	1.1	1.5	1.7	1.8	1.4
Gov. Consumption	1.4	1.4	2.0	1.2	1.8	1.2	1.8	1.2	1.9	1.4	1.6	1.4
Fixed Capital Form.	2.4	3.1	4.2	2.4	3.4	3.3	3.4	3.2	3.5	3.7	3.1	3.1
Unemployment rate	7.8	7.5	8.4	8.2	8.3	8.1	na	na	8.2	7.9	8.1	7.9
HICP	2.3	1.9	2.2	2.2	2.1	2.2	2.3	2.2	2.1	2.0	2.2	2.1
IP	2.6	1.8	na	na	na	na	na	na	na	na	2.9	2.0

EU: European Commission, European Economy, No. 2, 2006; IMF: World Economic Outlook, April 2006; ECB: ECB Monthly Bulletin, June 2006, OECD: Economic Outlook, No. 79, May 2006; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2006. 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 and Japan, GDP growth is expected to slow down during the forecast horizon. Inflation is assumed to abate in the US in 2006 and 2007 because the expansionary monetary policy comes to an end; in addition, we assume more stable energy prices. An oil price of 66 (63) dollars per barrel is expected for the end of 2006 (2007). Deflation in Japan has come to an end. Recent data on world trade during spring were disappointing. Thus, world trade is assumed to expand not as dynamic in 2006 as we assumed in our spring report. Rising interest rates in the euro area and the current account deficit in the US will slightly weaken the US dollar relative to the euro. The yen, on the contrary, appreciates: this is in line both with interest rate parities and with the differential between inflation rates; moreover, growth in Japan outpaces that in the euro area.

Table 6 Variables of the world economy

	2006	2007
US GDP Growth Rate	3.4	2.8
US Consumer Price Inflation	3.4	2.5
US Short Term Interest Rate	4.9	4.8
US Long Term Interest Rate	4.9	5.2
Japan GDP Growth Rate	2.9	2.2
Japan Consumer Price Inflation	0.5	0.6
Japan Short Term Interest Rate	0.2	0.9
Japan Long Term Interest Rate	1.9	2.4
World Trade	7.5	7.0
Oil Price	66	63
USD/Euro Exchange Rate	1.26	1.28
100Yen/Euro Exchange Rate	1.40	1.38

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