EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2006 and 2007

Winter 2005/06

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

- At the end of 2005, the upswing of the world economy continues due to strong investment activity. The chances are good that the investment upswing will continue during the forecasting horizon, because the rapid integration of emerging market economies makes capital comparatively scarcer and investment more attractive.
- Growth of production in the euro area has accelerated during 2005 and, since summer, production has expanded at a faster pace than the long run trend. This is mostly due to higher investment, stimulated by low real interest rates, upbeat stock markets, and higher profits related to the limited increase in unit labour costs, lower than the inflation rate since summer 2004.
- The favourable conditions for investment will by and large continue, as will the upswing of investment activity. Private consumption will remain stable, while government consumption and net exports will slightly increase, mostly due to, respectively, the less stringent interpretation of the Maastricht criteria and the appreciation of the dollar. Overall, production will expand by 2.1 % in 2006 and by 2.0 % in 2007; this is, in both years, roughly equal to the potential growth rate of the euro area.
- Inflation is expected to remain over 2% for the next six months, but there is a 60% probability that it will fall below 2% by the end of 2006, related to better medium term perspectives for energy prices. Core inflation should also remain below 2%. Overall, there appear to be no major economic justifications for a tightening of the ECB monetary policy, but the ECB might nonetheless increase the key interest rates in 2006 by up to half a percentage point.

Table 1 Economic outlook for the Euro area

	2003	2004	2005	2006: 1st half		2006: annual		2007: annual	
			Point Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	0.7	1.8	1.5	2.1	1.5 2.6	2.1	1.5 2.6	2.0	1.4 2.7
Potential Output	2.2	2.2	1.9	2.1	1.9 2.4	2.1	1.9 2.6	2.0	1.6 2.7
Private Consumption	1.1	1.4	1.3	1.5	0.9 2.1	1.7	1.2 2.3	1.9	1.2 2.6
Government Consumption	1.6	1.1	1.3	1.8	1.4 2.3	1.6	1.2 2.0	1.6	1.1 2.1
Fixed Capital Formation	0.8	1.7	2.4	3.5	1.6 5.5	2.9	0.5 5.0	2.3	-0.2 4.8
Exports	1.3	5.8	4.3	7.9	6.2 9.8	6.9	5.2 8.5	5.8	3.7 7.9
Imports	3.0	5.9	4.7	7.3	5.3 9.1	6.6	4.8 8.3	6.0	3.8 8.1
Unemployment Rate	8.7	8.8	8.5	8.1	7.8 8.4	8.1	7.7 8.4	8.2	7.6 8.9
NAIRU	8.1	8.1	8.3	8.1	7.8 8.4	8.1	7.7 8.5	8.4	7.7 9.2
Labour Cost Index	3.1	2.5	2.4	2.3	2.0 2.6	2.5	2.2 2.8	2.8	2.4 3.2
Labour Productivity	0.5	1.1	0.9	1.1	0.5 1.7	1.1	0.5 1.7	1.7	0.9 2.6
HICP	2.2	2.1	2.2	2.3	1.9 2.6	2.0	1.4 2.5	1.8	1.2 2.4
IPI	0.4	-0.5	1.1	2.2	1.4 3.0	1.8	0.8 2.8	1.8	0.3 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

The world economy

At the end of 2005, the upswing of the world economy continues due to strong investment activity: in the US, reconstruction after the devastating hurricanes in the Gulf region temporarily quickens the fast pace of capital accumulation even more; in Japan, investment has gained momentum since the beginning of 2005; the same is true for the euro area since summer. China, the new power house of the world economy, has stood out for its exceptionally high investment rates for years. Exports of capital goods from industrial countries to China, however, had slowed in the first half of 2005. In autumn, these exports again expand at a high rate.

The reasons for strong investment are, on the one hand, high profits and the expectations of firms that these are going to stay in the foreseeable future; on the other hand, the costs of raising capital are low: stock prices have been on a rising trend since spring 2005; long term interest rates have increased only a bit since summer; they are still low. Financial markets expect inflation to stay low in the medium and long run, in spite of rising headline rates due to the oil price hike in the course of 2005. The central banks of the US and of the euro area kept their credibility as effective guardians of price stability by an active monetary policy: the Federal Reserve Board has continued raising the target rate for federal funds "at a measured pace" up to now; the ECB raised interest rates by a quarter percentage point at the beginning of December for the first time in five years.

There is a simple, but powerful explanation for the fact that profits are high in most countries: the integration of emerging market economies has made capital comparatively scarcer and investment more attractive, because the supply of labour – qualified as well as unqualified – has increased significantly. It is probable that this effect will continue for the foreseeable future; therefore, the chances are good that the investment upswing will continue during the forecasting horizon. A considerable risk factor is the possibility of a further oil price shock due to a break down of capacity in one of the major producer countries, because spare capacity is very limited all over the world. Oil prices have receded a bit since their peak after the hurricanes temporarily stopped much of production in the Gulf of Mexico. With 59 US-dollars per barrel (Brent), prices are still 30 % higher than at the beginning of 2005. Apparently these high prices have not put an end to the upswing: differently from the oil price shocks in the last century, they are driven by expansion of demand instead of disruption of supply; furthermore, there are, up to now, no noticeable second round effects via wage-price spirals.

What the oil price hike has done, however, is a world wide change of the terms of trade, with implications for the distribution of world income, for trade flows and international financial flows. This year, the sum of current account surpluses of the big oil producing countries will be around twice as large as that of the Asian emerging market countries (including China). At the same time, the current account deficit of the US has been boosted significantly by the rise of the bill for oil imports. In 2006, the US current account deficit will amount to 7 % in relation to gross domestic product. The deterioration of the international investment position cannot last forever, nor can the saving rate of US households stay negative, as it did in 2005. Thus, a major risk for the world economy in 2006 and 2007 comes from an abrupt fall of US demand, possibly triggered by higher interest rates and the end of the US house price boom.

The euro area

At the end of 2005, the economy of the euro area fits well in the favourable picture of the world economy. Growth of production has accelerated during the year, and since summer, production has expanded at a pace which is faster than the long run trend. The recovery comprises all main components of demand, albeit to a different degree: exports have benefited from the acceleration of world trade; in addition, the appreciation of the dollar relative to the euro (by almost 10 % in the course of 2005) has helped producers from the euro area. Investment grew in the second half of the year with a rate not matched since the boom year 2000. The favourable conditions for investment, especially low real interest rates and upbeat stock markets, at last appear to stimulate investment in the euro area. Healthy profits benefit from the fact that since summer 2004 unit labour costs have been rising at a rate below inflation.

Unemployment has been on a slowly downward trend since autumn 2004. Still private consumption has only slightly revived, partly because high energy bills reduced the purchasing power of consumers. There is, however, a more fundamental reason for the sluggish dynamics of consumption: important motives behind the – relative to other industrialized countries – quite high saving rate of private households are of a long term nature; these motives are old-age provisions in economies with unfavourable demographics and the fact that during the past couple of years, the fiscal policies of many, and in particular of big member countries, lack sustainability.

These facts will not change fundamentally in 2006 and 2007, and thus consumption growth will only slowly gain momentum. Some additional support might come from the labour market: unemployment will continue to decrease for cyclical reasons, but also because labour market reforms in big member countries have started to take effect. In addition, the upswing of the world economy will continue. Export growth, in particular into oil producing and emerging market countries, will be substantial. The stimulating effects of the dollar appreciation in 2005, however, will phase out in the course of next year.

The favourable conditions for investment will by and large continue, as will the upswing of investment activity. The ECB will add no more than half a percentage point to the current level of key interest rates in 2006; long term real interest rates will rise, but will still be at a low level. Government consumption will expand at a slower rate than output, as it is typical for an upswing, yet slightly more than in the previous years.

However, the expected development of the Euro Area Economic Sentiment Indicator has deteriorated, Figure 1, suggesting that the euro area recovery is not going to improve much more in 2006. It seems that the strength showed by the recovery process during the summer has stabilised in the autumn months. A similar conclusion is obtained by analysing the Industrial Production index.

All in all, production is expected to expand by 2.1 % in 2006 and by 2.0 % in 2007, Figure 2, with a preeminent role for internal demand, Figure 3. The figures for expected growth are, in both years, roughly equal to the growth rate of the potential output in the euro area.

Figure 1 Euro Area Economic Sentiment Indicator

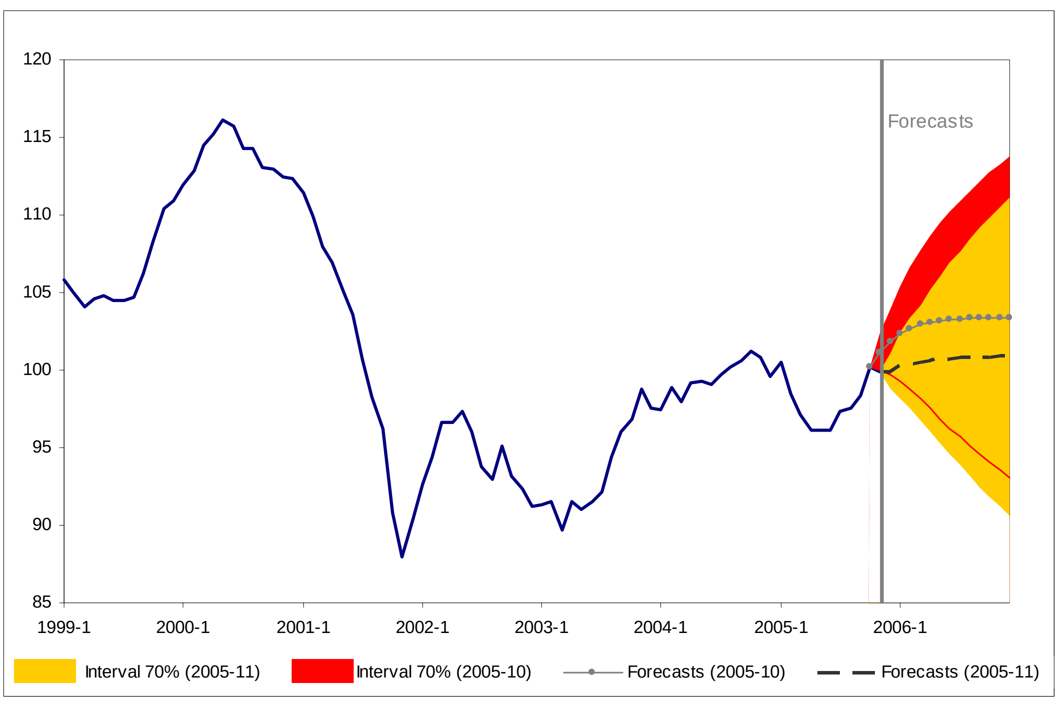
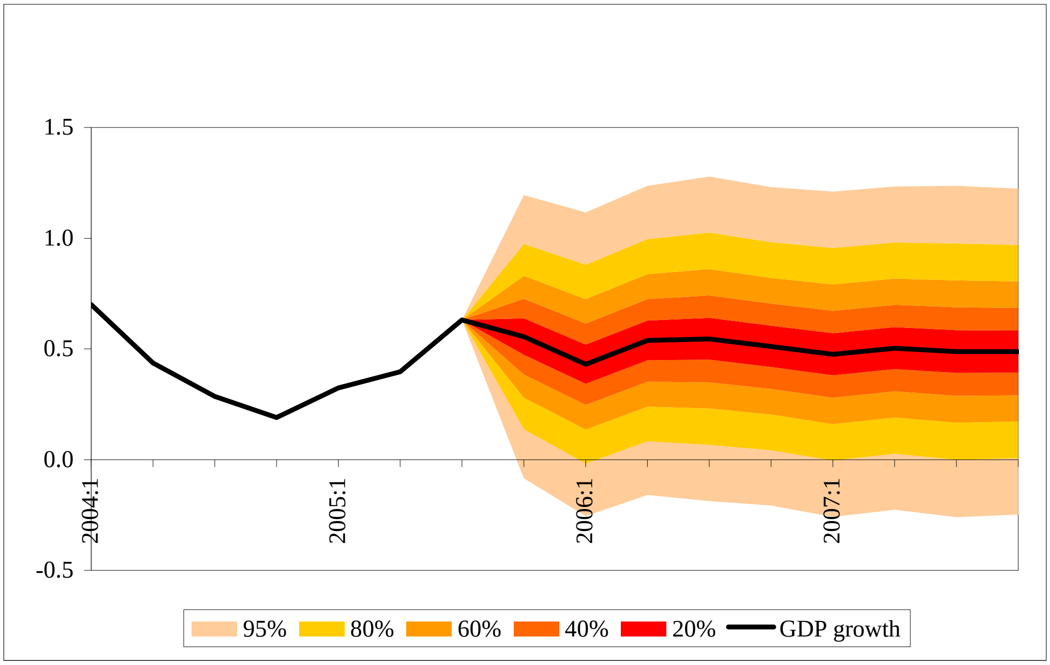
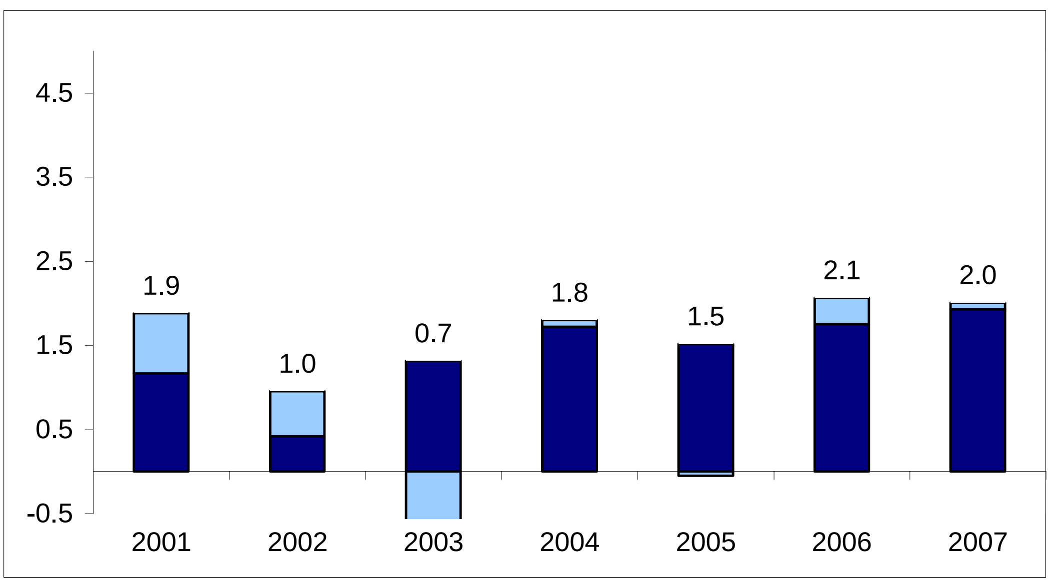


Figure 2 Quarterly GDP growth rates and confidence bands



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

Year	GDP growth	Agriculture	Industrial	Construction	Services	Net taxes
1999	2.8%	0.1%	0.4%	0.1%	1.9%	0.3%
2000	3.7%	0.0%	1.0%	0.1%	2.6%	-0.1%
2001	1.9%	-0.03%	0.2%	0.1%	1.6%	0.1%
2002	1.0%	0.0%	0.0%	0.0%	1.0%	0.0%
2003	0.7%	-0.1%	0.0%	0.0%	0.6%	0.1%
2004	1.8%	0.1%	0.3%	0.1%	1.3%	0.1%
2005	1.5%	0.0%	0.2%	0.1%	1.1%	0.1%
2006	2.1%	0.0%	0.4%	0.1%	1.4%	0.2%
2007	2.0%	0.0%	0.4%	0.1%	1.4%	0.1%

From a supply-side perspective, GDP growth for 2006 and 2007 is driven by expansion in services and the industrial sectors, Table 2. The average annual rates of growth for different industries classified according to the destination of goods are shown in Table 3. Recovery in the production of intermediate goods has been slightly interrupted in 2005, but it is expected to continue in 2006 and 2007. The production of durable goods will maintain negative variation rates in 2006 and 2007. Capital and, to a lesser extent, non-durable and intermediate goods will largely be responsible for total industrial production growth. The highest recoveries for 2006 and 2007 are expected in the intermediate goods and capital goods production sector, pushing IPI growth up to 1.8%.

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Capital	6.7%	2.4%	8.2%	1.9	-1.7	-0.2	3.0	2.6	3.3	3.0
Durable	4.2%	1.3%	6.2%	-2.1	-5.5	-4.6	-0.1	-1.2	-0.3	-0.2
Intermediate	3.6%	1.9%	6.3%	-0.7	-0.1	0.4	1.8	0.8	2.1	1.7
Non Durable	3.0%	1.1%	0.9%	0.8	0.7	0.2	0.6	1.0	1.0	0.9
Energy	1.7%	0.8%	1.9%	1.4	1.1	2.9	2.6	0.2	-0.3	1.3
Total EMU	3.8%	1.8%	5.3%	0.4	-0.5	0.3	2.0	1.1	1.8	1.8

Compared to our last report, core inflation will continue at moderate values of around 1.6% until the first quarter of 2006 (Figure 4), after which it is expected to increase gradually to close to 1.8%. Growth in core inflation is explained by the higher forecasts for goods inflation, whereas inflation in services will continue to remain stable in this period. The real macroeconomic figures (quarterly) and economic indicators (monthly) indicate that the real economy will probably not be pushing inflation up for many months. However, due to persistence in core inflation, unexpected upwards shocks would lead to sustained non-compliance with the total inflation target, making additional changes in monetary policy possible.

Outside core inflation, unprocessed food, after registering average inflation rates of less than 1% in 2004 and 2005, is expected to be around 2.0% in 2006 and 2007. Energy prices are expected to reduce their rates of growth in 2006, and even register slightly negative rates at the end of the year.

Figure 6 shows annual year-on-year total inflation forecasts for the final months of 2005 and 2006, together with different confidence intervals. The graph shows that the probability of compliance with the target in the next six months is very low, but there is a probability of about 60% for compliance at the end of 2006. This is because there are good perspectives for unprocessed food and energy product prices, which are considered in total but not in core inflation. In conclusion, worse perspectives for core inflation coincide with an improvement in the perspectives for other prices, largely energy products.

By country, the forecasts for 2005, 2006 and 2007 continue to indicate that the worst results in the euro area will be for Luxembourg, Spain and Greece, with average annual rate close to 3% in these years. The lowest inflation rates are expected for Finland, the Netherlands and Germany.

Short term real interest rates in the euro area continue to present a considerable differential, in some cases as much as two percentage points. Most euro area countries register positive real interest rates which are nevertheless still very low. Only the Netherlands, Austria, France, Finland and Germany, experience significant positive real interest rates around or over one per cent (Table 4).

Figure 4 Forecasts for the Core Inflation in the Euro Area (year-on-year rates)

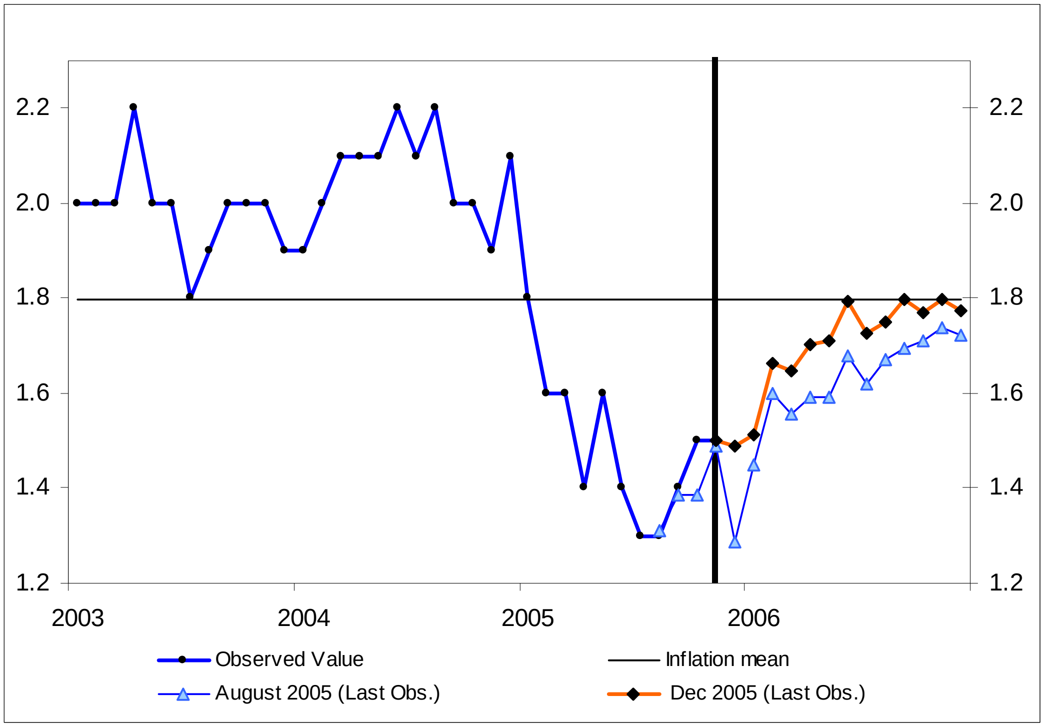


Figure 5 Forecasts for the Core Inflation in the Euro Area (year-on-year rates)

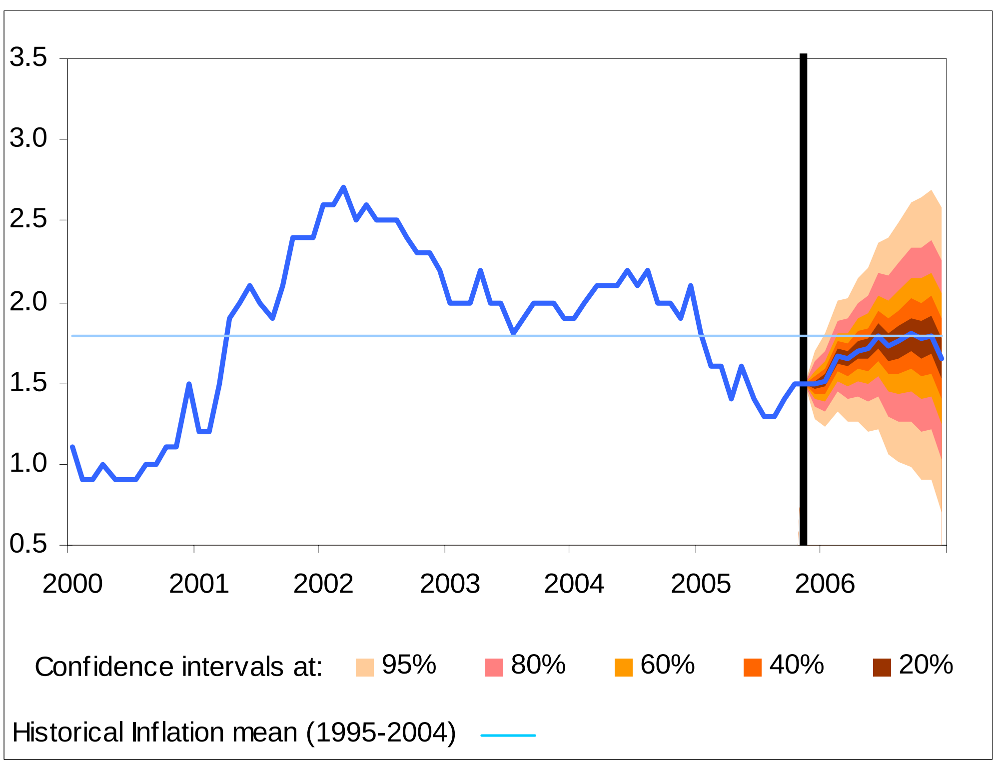


Figure 6 Forecasts for the Inflation in the Euro Area (y-o-y rate)

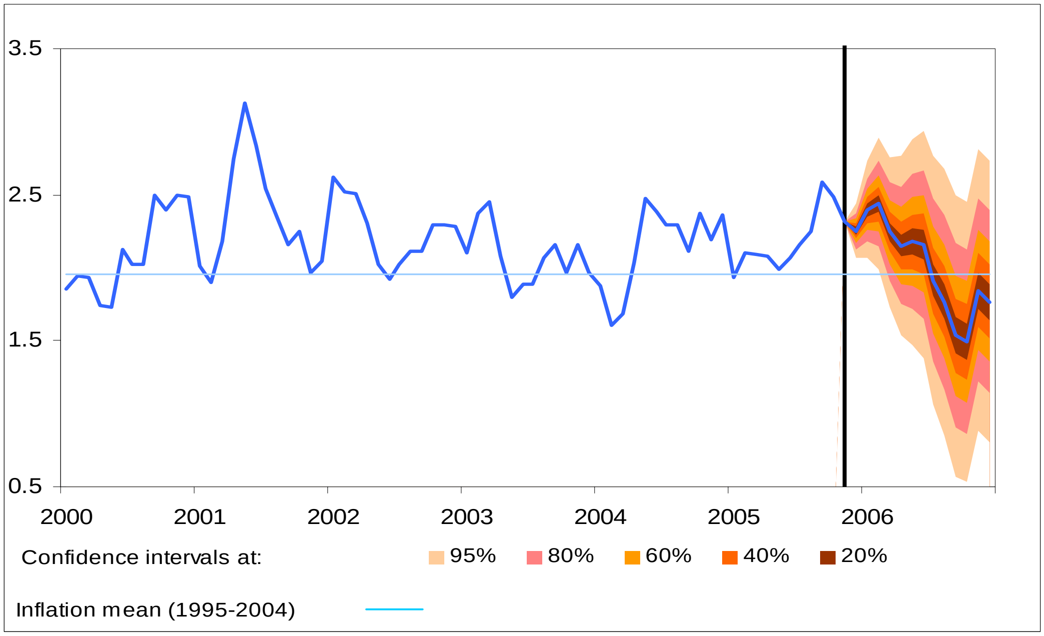


Table 4 Inflation expectations and actual real interest rates

	Inflation expectations		Actual real interest rates	
	Three Months	One Year	Three Months	One Year
Spain	3.06	2.89	-0.60	-0.14
Greece	3.11	2.87	-0.65	-0.11
Portugal	2.87	2.77	-0.41	-0.01
Italy	2.43	2.55	0.03	0.20
Luxembourg	2.92	2.51	-0.46	0.25
Ireland	2.48	2.49	-0.02	0.27
Belgium	2.40	2.26	0.06	0.50
Netherlands	1.97	1.97	0.49	0.78
Austria	1.70	1.78	0.76	0.98
France	1.62	1.71	0.84	1.05
Germany	1.66	1.30	0.81	1.46
Finland	0.96	0.97	1.50	1.78

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 for 2006 and 2007 are quite similar. However, while we forecast that the upswing in investment activity will peak in 2006, other forecasts predict a more prolonged investment cycle.

On inflation, EFN estimates are similar to the forecasts published by other institutions for 2006, indicating a range of 1.8%-2.2%. In almost all cases, slightly lower inflation rates are expected in 2006 than in 2005.

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	2.1	2	1.9	2.1	2	na	1.9	1.9	2.1	2.2	1.7	na
Priv. Consumption	1.7	1.9	1.4	1.9	1.4	na	1.4	1.4	1.3	1.9	1.4	na
Gov. Consumption	1.6	1.6	2	1.5	1.4	na	1.6	1	1.8	1.5	1.5	na
Fixed Capital Form.	2.9	2.3	3.1	3.2	3	na	3.1	3.1	3.4	3.6	2.5	na
Unemployment rate	8.1	8.2	8.5	na	8.4	na	na	na	8.4	8.1	8.5	na
HICP	2.0	1.8	2.2	1.8	1.8	na	2.1	2	2.1	1.6	1.9	na
IP	2	na	na	na	na	na	na	na	na	na	2.2	na

EU: European Commission, European Economy, No. 5, 2005 (Autumn); IMF: World Economic Outlook, September 2005; ECB: ECB Monthly Bulletin, December 2005, OECD: Economic Outlook, No. 78, November 2005; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2005. 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 slowing a bit next year to potential. Japan is assumed to continue its moderate growth path. Inflation will slow in the US in 2006 due to more stable energy prices, while deflation in Japan comes to an end. An oil price of 55 (60) dollar per barrel is expected for the end of 2005 (2006). From the perspective of the interest parity conditions, a slight depreciation of the dollar would be expected; however, the current account deficit in the US works in the opposite direction. Overall, the euro is predicted to be stable relative to the dollar.

Table 6 Variables of the world economy

	2005	2006	2007
US GDP Growth Rate	3.6	3.3	3.3
US Consumer Price Inflation	3.4	3.0	2.5
US Short Term Interest Rate	3.4	4.5	4.7
US Long Term Interest Rate	4.3	4.9	5.0
Japan GDP Growth Rate	2.2	1.9	2.0
Japan Consumer Price Inflation	-0.2	0.3	0.8
Japan Short Term Interest Rate	0.1	0.1	0.7
Japan Long Term Interest Rate	1.4	1.7	2.3
World Trade	6.3	7.8	6.6
Oil Price	55	60	62
USD/Euro Exchange Rate	1.24	1.24	1.25
100Yen/Euro Exchange Rate	1.37	1.35	1.32

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 (2005) and OECD (2005). Oil price (end of period) in US dollar per barrel, all other variables in percent.