EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2005 AND 2006

European Forecasting Network

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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 August, hurricane Katrina closed down most of crude oil production and refining at the US-coast of the Gulf of Mexico, and hurricane Rita could create additional problems. If the capacity for production and refining oil is significantly reduced in the US beyond 2005, a downturn of US and world growth is quite probable. Spot and future prices for oil and gasoline, however, are about the same as those before Katrina. In our view the markets are correct; thus, in this forecast, the effects of the Katrina shock on the world economy are only temporary and modest.
- Katrina happened when the world economy appeared to continue on its healthy growth path. Although world trade growth was sluggish in the first quarter, early indicators suggest that it has regained momentum from the second quarter onwards.
- Despite the assumption of a significantly higher oil price for the rest of this year and 2006, our forecast has not altered much from our last update in June. Indeed, we predict euro area growth for 2006 being 0.2 percentage points higher than we did in June.
- The major risk for the world economy in 2005 and the coming year comes from consumption of US households: Higher interest rates put an end to the house price boom. This could, in combination with the energy price hike, weaken private demand. While more cautious spending of the US consumer is welcome from a balance of payments perspective, an abrupt change could depress world demand on a noticeable scale.
- Inflation in the euro area will increase till y-o-y rates around 2.7% in the first months of 2006. Then will decline till rates close 1.7% at the end of that year.
- Most countries in the euro area are experiencing negative short term real interest rates, and only Finland and Germany register positive rates around one per cent.

Table 1 Economic outlook for the Euro area

	2002	2003	2004	2005 1st half	2005: annual Point Forecast	2005: annual Interval Forecast	2006: annual Point Forecast	2006: annual Interval Forecast
GDP	0.9	0.7	1.7	1.2	1.3	1.1 1.5	1.8	1.3 2.3
Potential Output	2.5	2.0	1.9	1.8	1.8	1.6 2.1	1.8	1.1 2.5
Private Consumption	0.9	1.1	1.2	1.2	1.2	1.0 1.5	1.6	1.0 2.2
Government Consumption	2.6	1.3	2.6	0.9	1.1	0.9 1.3	1.7	1.3 2.1
Fixed Capital Formation	-2.3	0.4	1.4	0.9	0.9	0.2 1.6	1.7	-0.4 3.8
Exports	2.0	0.6	5.5	3.4	3.5	2.8 4.1	5.9	4.1 7.7
Imports	0.5	2.5	5.6	4.7	3.9	3.2 4.6	5.8	3.8 7.8
Unemployment Rate	8.3	8.7	8.8	8.8	8.8	8.7 8.9	8.8	8.7 9.3
NAIRU	8.2	8.1	8.3	8.4	8.6	8.5 8.6	8.7	8.7 9.2
Labour Cost Index	3.3	2.7	2.3	3.0	3.2	3.1 3.4	2.9	2.4 3.4
Labour Productivity	0.4	0.5	1.2	0.4	0.5	0.2 0.9	1.4	0.6 2.3
HICP	2.2	2.1	2.1	2.0	2.2	1.7 2.7	2.2	1.3 3.1
IPI	-0.5	0.3	2.0	1.3	1.1	0.1 2.1	2.0	1.9 3.1

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 2005 and 2006

The world economy

At the end of summer 2005, the world economy has to cope with a further oil price shock. Destructions by the hurricane Katrina at the end of August closed down most of US crude oil production and refining at the Gulf of Mexico. The decision to release emergency stocks by the member states of the International Energy Agency has brought prices back to pre-Katrina levels of about 65 dollars (Brent). This is, however, 30% higher than in June, when our forecast assumed a more or less constant price for the rest of 2005. Oil prices have been strongly increasing for more than 2 years; in real terms they are at an all time high except a few years after the second oil crisis of 1979. Former oil price hikes of similar magnitude have triggered economic crises; this time, however, the world economy has up to now been resilient. One explanation for the difference is that recent oil price hikes have not been caused by reduced oil supply, but are the result of a rapid increase of world demand due to the industrialization in Asia, especially China. Thus, they just dampen the increased rate of world growth. Katrina, however, is a supply shock. If the capacity for production and refining oil is significantly reduced in the US beyond 2005, a downturn of US and world growth is quite probable. But spot and futures prices for oil and gasoline are about the same as those before Katrina. Our forecast agrees with the expectations of the markets; hence, the effects of the Katrina shock on the world economy will only be modest.

Katrina happened when the world economy appeared to continue on its healthy growth path. The expansion of output in the US stayed high during the first half of 2005, and recent data on consumption were particularly strong. Japan’s moderate upswing continues. In China, the administrative measures to prevent overheating appear to have done their job: prices have ceased to rise in the summer, while real growth rates are still impressive. Imports, however, appear to expand at lower rates than last year. This is one reason why world trade was sluggish in the first quarter of this year. In addition, import demand in the euro area was particularly weak at the beginning of the year. Early indicators, however, suggest that world trade growth has regained momentum from the second quarter onwards.

Nearly all large economies benefit from both high profits of firms and low nominal and real interest rates. This unusual combination can plausibly be explained by the increasingly influencial role some emerging market economies like China play on the world markets for capital and labour: competition from cheap and productive labour improves the position of firms in wage bargaining. At the same time, emerging market countries like China, India and Russia use their high current account surpluses to pile up large amounts of currency reserves. This adds to world savings and helps keeping interest rates at capital markets low. In addition, low inflation rates due to the competitive pressure from emerging market economies enable central banks of the US and the euro area to keep official interest rates low. As long as these favourable conditions continue, the world economy will be resilient in spite of high oil prices and a further rise of US short term interest rates at a measured path. This scenario is the basis of our economic forecast in the euro area.

The major risk for the world economy in 2005 and the next year comes from consumption of US households: higher interest rates put an end to the house price boom. This could, in combination with the energy price hike, weaken private demand and induce US households to raise their savings rate, which at present fluctuates around zero. While this reaction is welcome from a balance of payments perspective, an abrupt change could depress world demand on a noticeable scale.

The euro area

Output growth in the euro area has stayed low since autumn 2004, and industrial production was still flat in summer. Most recent data on industrial production, order books and economic sentiment indicators suggest a slight improvement, see Figure 1. This is in accordance with signs of a pick up in the pace of world trade in the second half of the year. Exports, in particular to oil exporting countries, will support the economy in the forecasting period.

Growth of private consumption was rather slow during the first half of the year. Consumer confidence even weakened, as labour market perspectives have not substantially changed. People still appear unconvinced of the effectiveness of structural reforms in some important member countries. Moreover, high energy bills will depress consumption growth in the rest of 2005. This effect is forecast to be weaker next year, when oil prices stop rising.

Investment growth is anaemic too, given the favorable financial conditions: profits are still high, stock markets have been upbeat during the summer, while long term interest rates are at an all time low. Credit standards of banks applied to the approval of loans to enterprises have, according to the ECB Bank Lending Survey, eased significantly in the first half of the year. The financial environment will be supportive in the rest of this and in the next year, but the general picture of – by international standards – only moderate investment dynamics will not change.

Aggregate demand is sluggish in most euro area economies. There are, however, significant structural divergences between national developments. German industrial production, in particular, has been on an upward trend during the year, while production in the other larger economies is stagnant. One explanation is that unit labour costs in Germany have increased considerably less than in the rest of the euro area, making German firms more competitive. Moreover, globalisation causes strong demand for capital equipment, helping the large capital goods sector in Germany, while at the same time competition increased in sectors like the textile industry which have some importance in southern Europe. But still, industrial confidence is not stronger and industrial investment is not more dynamic in Germany than in the rest of the area.

Weak demand in most parts of the euro area means that at present it is not a serious problem that a single monetary policy has to be conducted for the whole region. Interest rates will be unchanged for much of the forecasting horizon: the new oil price hike is no reason for a more expansive policy, as long as energy prices will continue to have little effect on aggregate demand; but it is no reason for raising interest rates either, as long as there are no second round effects via wage-price spirals. The monetary pillar of the ECB's strategy, however, shows that medium term risks for price stability are building up due to the very low level of (real and nominal) interest rates. The ECB will therefore start raising interest rates in the summer of 2006, albeit moderately. Thus, monetary policy will be expansive over the entire forecasting horizon. Fiscal policy will keep its more or less neutral stance.

All in all, production in the euro area will expand by 1.3 % in 2005 and by 1.8 % in 2006; hence, the output gap widens this year and will not shrink in 2006. This fact puts pressure on employment; however, the recent labour market reforms in some member countries will prevent the unemployment rate from rising and support the participation rate over the forecasting horizon.

Figure 1 Euro Area Economic Sentiment Indicator.

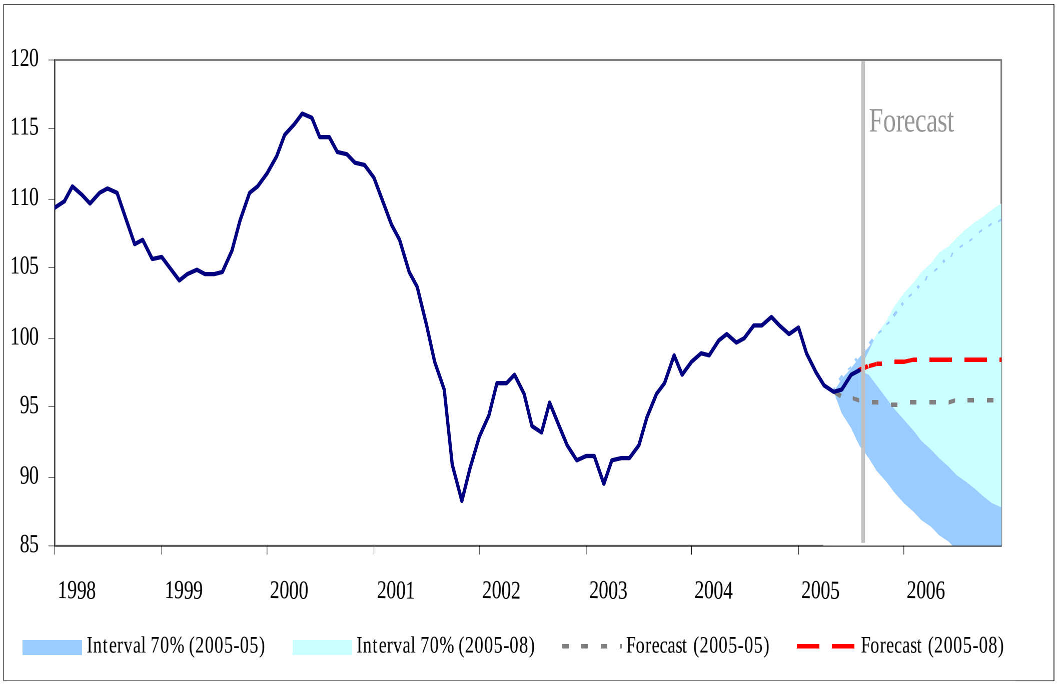
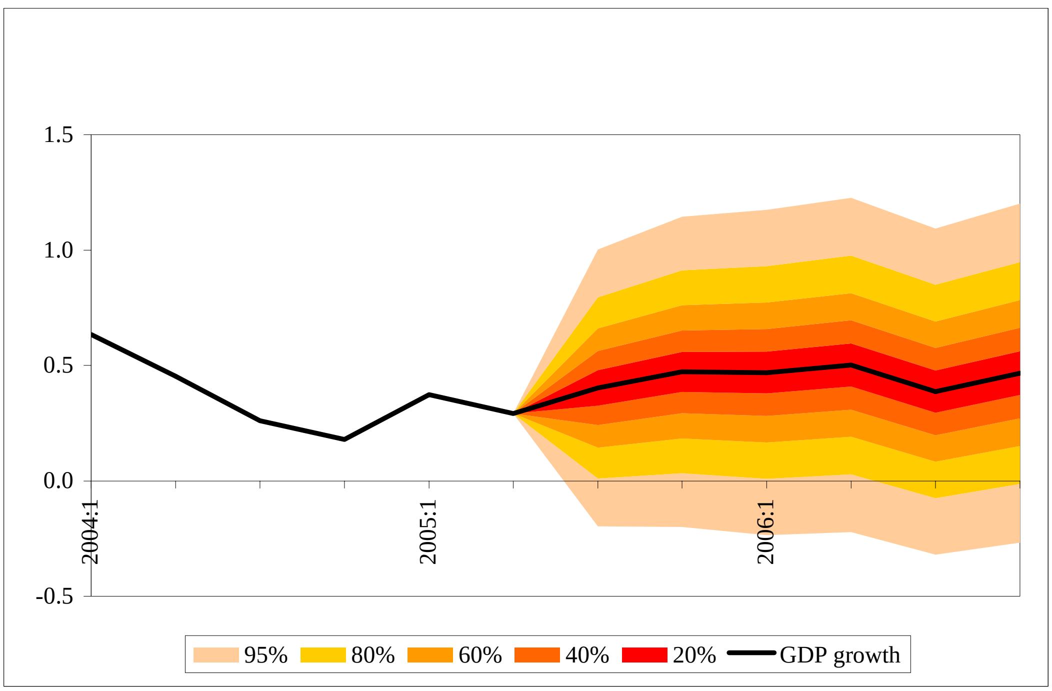
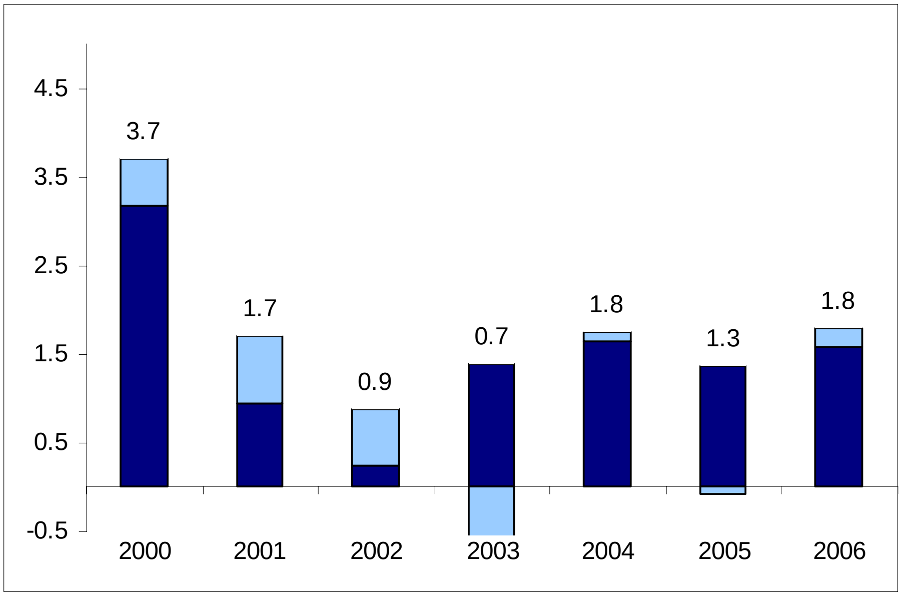


Figure 2 Quarterly GDP growth rates and confidence bands



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	1.7%	0.0%	0.3%	0.0%	1.6%	-0.1%
2002	0.9%	0.0%	0.0%	0.0%	1.0%	-0.1%
2003	0.7%	-0.1%	0.0%	0.0%	0.6%	0.1%
2004	2.1%	0.2%	0.5%	0.1%	1.3%	0.0%
2005	1.3%	0.0%	0.3%	0.0%	1.1%	0.0%
2006	1.8%	0.0%	0.4%	0.0%	1.4%	0.0%

From a supply-side perspective, GDP growth in 2005 and 2006 is driven by expansion in services, but the low industrial sector contribution lowers GDP growth expectations for 2005 relative to 2004 (Table 2). The services sector was responsible for about 65%

of GDP growth in 2004 and a higher proportion (above 80%) is expected for 2005 and 2006.

The average annual rates of growth for different industries classified according to the destination of goods are shown in table 3. The recovery in the production of intermediate goods has been interrupted in 2005. The production of durable goods will still be declining in 2005 and 2006. Next year, the industries producing capital and, to a lesser extent, energy goods continue to dominate total growth of industrial production; industries producing non durable goods will grow a bit faster than this year. The strongest recovery for 2006 is expected in the intermediate goods production sector, pushing to the IPI growth to 2.0%.

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Capital	6.7%	2.4%	8.2%	1.8%	-1.7%	-0.2%	3.0%	3.3%	3.6%
Durable	4.2%	1.3%	6.2%	-2.1%	-5.5%	-4.6%	-0.1%	-0.4%	-0.7%
Intermediate	3.6%	1.9%	6.3%	-0.7%	-0.1%	0.4%	1.8%	0.3%	1.7%
Non Durable	3.0%	1.1%	0.9%	0.8%	0.7%	0.3%	0.7%	1.0%	1.1%
Energy	1.7%	0.8%	1.9%	1.4%	1.1%	3.0%	2.5%	1.5%	1.7%
Total EMU	3.8%	1.8%	5.3%	0.4%	-0.5%	0.3%	2.0%	1.1%	2.0%

As in our last report, core inflation forecasts remain at around 1.4% for what is left of 2005, conditional on the EU trade policy concerning cheap imports of some manufactured goods, especially from China. These cheap imports have brought the year-on-year inflation rate forecast for non-energy industrial goods close to zero for the end of 2005. For 2006, the core inflation is expected to grow by nearly 0.2 percentage points to 1.6%. Energy inflation in the euro area registered an annual rate over 11% in August and is expected to reach values over 14% for the rest of 2005 and the first quarter of 2006. This item does not weight more than 8.6% in the HICP of the euro area, but its contribution to total inflation in the mentioned period is expected to be as large as that of core inflation (see figure 6).

Due to the evolution of energy prices, total inflation will increase from 2.2% in August to an average 2.5% in the last quarter of 2005 and to 2.7% in the first two months of 2006. Then total inflation is expected to decrease to 1.7% at the end of 2006.

The fan chart in figure 4 shows that the probability of fulfilling the inflation target in the last quarter of 2006 is high. On the basis of this forecast, we expect that the ECB will not change its reference interest at least for the next twelve months. The forecast inflation differential between the U.S. and the euro area will rise in the remaining months of 2005 due to the evolution of energy prices which in US will oscilate with year-on-year rates between 20 and 32% up to April 2004.

Figure 4 Inflation forecast and confidence bands (y-o-y rate)

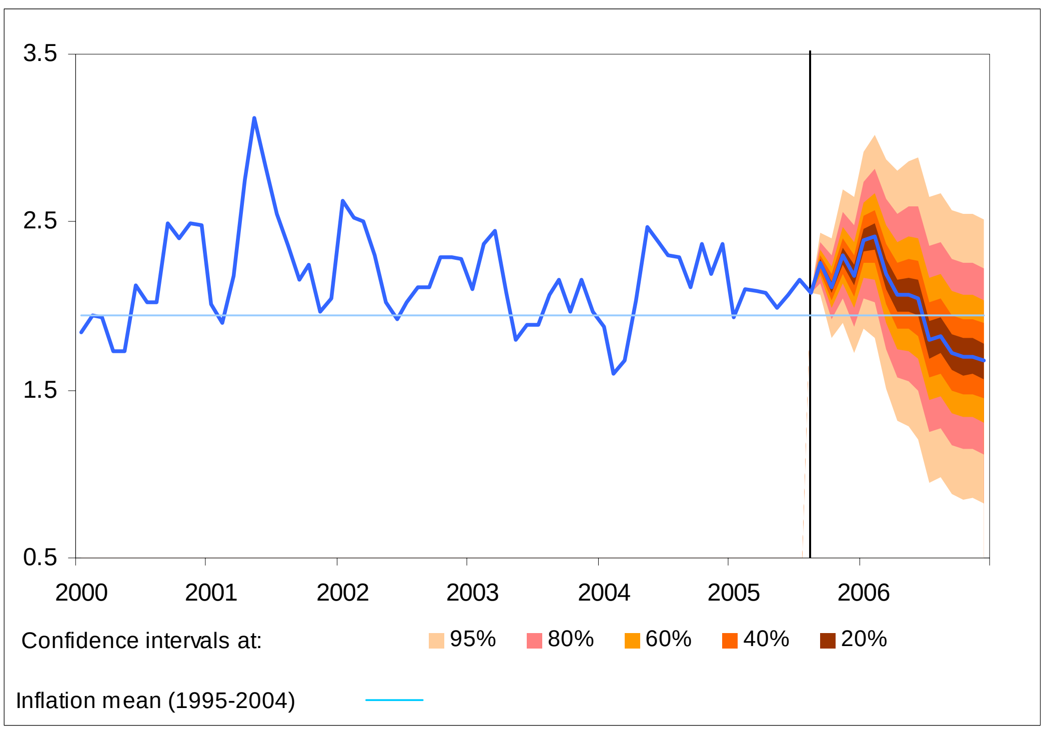


Figure 5 Box diagram of euro area countries dispersion of inflation

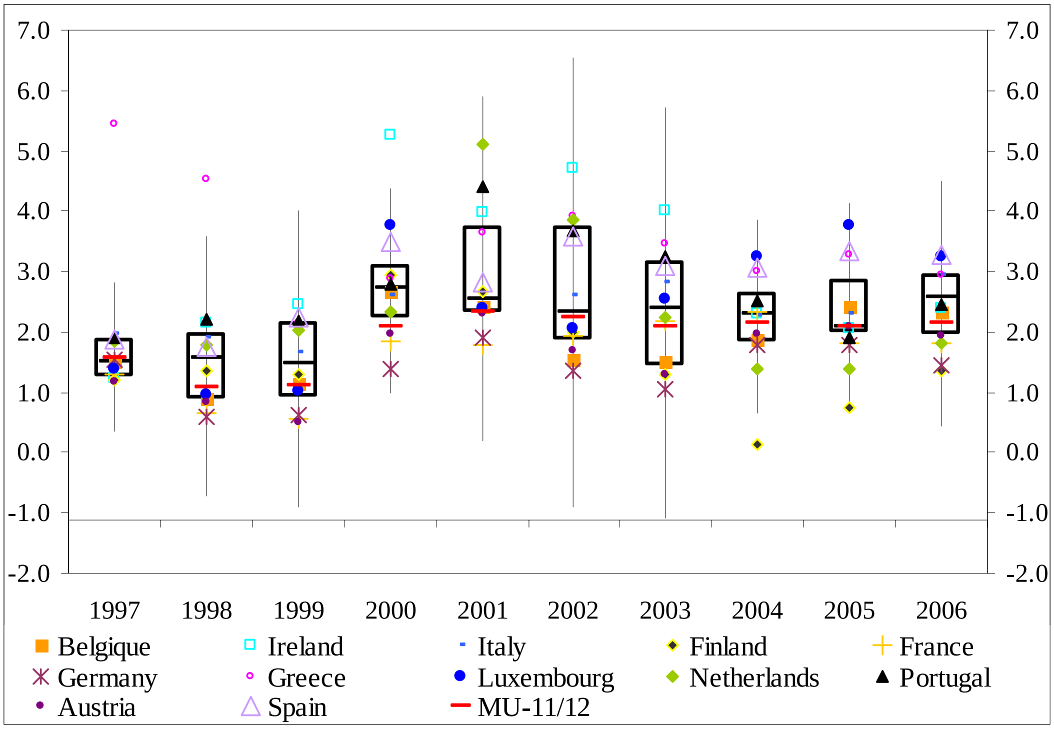
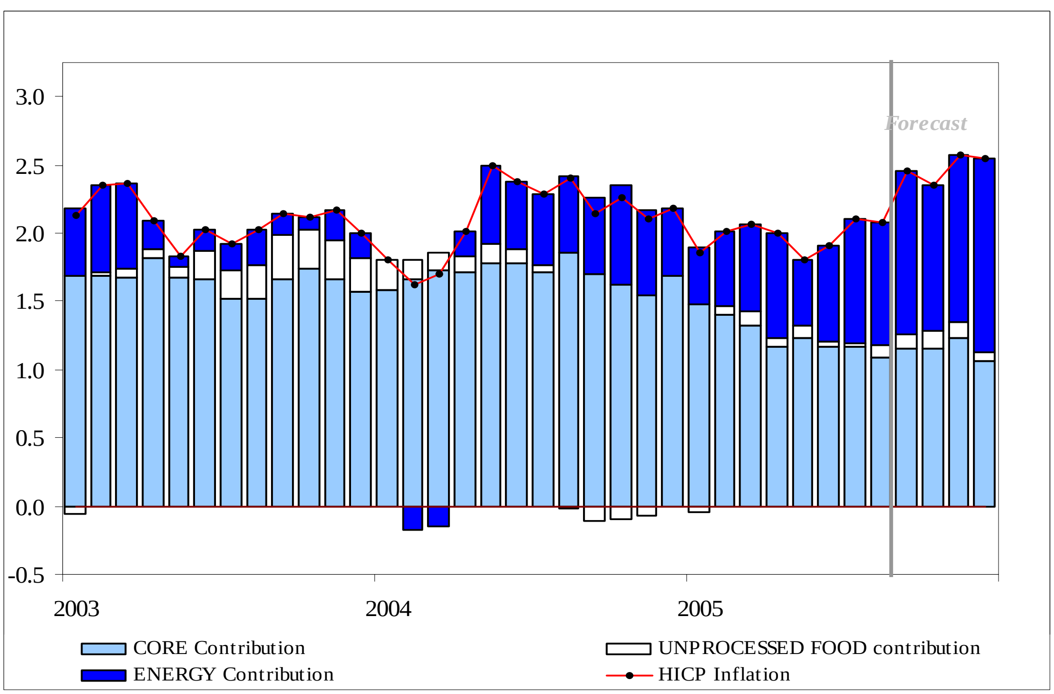


Figure 6 Inflation in the euro area and contributions of main components (y-o-y rate)



By country, the forecasts for 2005 and 2006 continue to indicate that the highest inflation in the euro area will be for Luxembourg, Spain and Greece with average annual rates over 3% in these years. The lowest inflation rates are expected for Finland, Netherlands and Germany (see Table 4).

Short term real interest rates in the euro area present a considerable differential, in some cases as much as two percentage points. Most euro area countries register negative real interest rate favouring business and domestic indebtedness and only two, Finland and Germany, experience positive (but still low) real interest rates of around 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	3.80	2.84	-1.66	-0.65
Portugal	2.93	2.80	-0.80	-0.60
Luxembourg	3.54	2.77	-1.40	-0.58
Greece	3.01	2.77	-0.88	-0.58
Belgium	3.01	2.61	-0.87	-0.41
Italy	2.70	2.58	-0.57	-0.38
Ireland	2.40	2.41	-0.27	-0.22
Netherlands	1.96	1.97	0.17	0.22
Austria	1.90	1.94	0.23	0.26
France	2.34	1.78	-0.21	0.41
Finland	1.30	1.40	0.83	0.79
Germany	1.57	0.97	0.57	1.22

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 forecasts of the European Commission and the OECD were made in spring and thus could not take the recent oil price hike into account. This is one reason why they are, on the whole, more optimistic. However, our forecast has not altered much from our last update in June. Indeed, we predict a GDP growth for 2006 being 0.2 percentage points higher than we did in June. The more recent GDP forecasts, including those by the IMF, are virtually identical for GDP. In addition, the OECD interim assessment in September forecasts, like this report, 1.3 % GDP growth for the euro area.

Investment is on a lower path than in all other forecasts, likely due to our pure model based approach which suggests that the weakness of investment will not vanish abruptly.

On inflation, our forecast for 2006 is higher than that of other institutions, possibly because it takes into consideration the evolution of the crude oil prices; we likewise estimate an increase in goods core inflation for this year.

Table 5 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
GDP	1.3	1.8	1.6	2.1	1.2	1.8	1.3	1.8	1.2	2.0	1.3	1.7
Priv. Consumption	1.2	1.6	1.6	1.8	1.2	1.4	1.3	1.3	1.3	1.7	1.3	1.5
Gov. Consumption	1.1	1.7	1.4	2.0	1.1	1.8	1.1	1.6	1.0	2.0	1.2	1.5
Fixed Capital Form.	0.9	1.7	2.8	3.7	1.5	3.0	1.2	2.9	2.0	3.0	1.4	2.5
Unemployment rate	8.8	8.8	8.8	8.5	8.7	8.4	na	na	9.0	8.7	8.9	8.7
HICP	2.2	2.2	1.9	1.5	2.1	1.8	2.2	1.9	1.8	1.3	2.0	1.7
IP	1.1	2.0	na	na	na	na	na	na	na	na	0.7	2.0

EU: European Commission, European Economy, No. 2, 2005 (Spring); IMF: World Economic Outlook, September 2005; ECB: ECB Monthly Bulletin, September 2005, OECD: Economic Outlook, No. 77, May 2005; Consensus: Consensus Economics Inc., Consensus Forecasts, August 2005. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

Box 1: Variables of the world economy

Important variables indicating 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 65 (60) dollar per barrel is expected for the end of 2005 (2006). From the perspective of the international 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, and a similar evolution holds relative to the yen.

Table 6 Variables of the world economy

	2005	2006
US GDP Growth Rate	3.6	3.3
US Consumer Price Inflation	3.0	2.5
US Short Term Interest Rate	3.0	3.5
US Long Term Interest Rate	4.7	5.3
Japan GDP Growth Rate	1.6	1.5
Japan Consumer Price Inflation	-0.2	0.2
Japan Short Term Interest Rate	0.2	0.5
Japan Long Term Interest Rate	1.7	2.0
World Trade	6.0	7.1
Oil Price	65	60
USD/Euro Exchange Rate	1.25	1.25
100Yen/Euro Exchange Rate	1.35	1.35

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 ot bher variables in percent.