EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2005 AND 2006

Summer 2005

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 2005 the upswing of the world economy slows down to moderate growth. Expansion dynamics are high in most emerging market economies and close to potential in the US; however, high commodity prices, in particular for crude oil, continue to dampen world economic growth. Moreover, China gives weaker impulses for world trade due to the restrictive measures of Chinese economic policy.
- Rising interest rates and more cautious household spending behaviour will stabilise the current account deficit in the US at the end of 2005. As a result, the chances are good that the recent appreciation of the dollar versus the euro will last. Our forecast is an exchange rate of 1.27 for 2005 and 1.24 for 2006.
- Despite quite favourable financial conditions, business investment will only gradually gain momentum in the euro area. In 2005, the y-o-y rates are positive, but show a slight downward trend. Acceleration is expected not before 2006. Private consumption will modestly increase. Consumers in the euro area appear to be cautious in view of the budget problems in many member states, as well as of sustainability problems affecting pay-as-you-go pension and health insurance systems, and the weak performance of national labour markets.
- Since the first quarter of national accounts data indicated only a slow acceleration in the euro area, this outlook is a bit more cautious than the one published by the EFN in March. Also, oil prices are again on record levels, and economic sentiment indicators point to a reduction of economic growth in growth in 2005.
- Due to the pressure of international oil prices, our inflation forecasts for the euro area have been revised upwards to 2.1% in 2005 in spite of a significant improvement in goods core inflation. In view of this figure, we continue to forecast that the European Central Bank is unlikely to change its reference interest rate until mid-2006. For this year we expect an inflation rate of about 2.0%.
- The forecast is also slightly more pessimistic than some others, possibly due to our strictly econometrically based approach, with models not taking into account the recent structural reforms in some member countries. We think that the positive effects of these reforms will not materialise in a short period of time but rather gradually over the coming years. Neither is the burden of political turbulence inside the euro area on economic sentiment captured by these models.

Table 1 Economic outlook for the Euro area

	2002	2003	2004	2005: 1st half		2005: annual		2006: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					1.1		1.0		1.1
GDP	0.9	0.7	1.7	1.3	1.4	1.3	1.5	1.6	2.0
					1.3		1.4		1.3
Potential Output	2.5	2.0	1.9	1.6	2.0	1.8	2.1	1.9	2.5
					1.2		1.1		0.7
Private Consumption	0.9	1.1	1.2	1.4	1.6	1.4	1.6	1.3	1.8
					1.2		0.7		1.1
Government Consumption	2.6	1.3	2.6	1.4	1.6	1.0	1.3	1.7	2.1
					0.2		-0.8		-1.3
Fixed Capital Formation	-2.3	0.4	1.4	1.0	1.7	0.5	1.8	1.7	4.7
					2.7		2.2		3.1
Exports	2.0	0.6	5.5	3.4	4.0	3.2	4.3	4.8	6.5
					3.4		1.9		2.5
Imports	0.5	2.5	5.6	4.1	4.9	3.1	4.3	4.7	6.9
					8.7		8.8		8.9
Unemployment Rate	8.3	8.7	8.8	8.8	9.0	9.0	9.1	9.2	9.5
					8.5		8.7		8.6
NAIRU	8.2	8.1	8.3	8.6	8.7	8.6	8.8	8.8	9.1
					1.5		1.7		2.0
Labour Cost Index	3.3	2.7	2.3	1.7	1.9	2.0	2.3	2.5	3.0
					0.6		0.7		1.0
Labour Productivity	0.4	0.5	1.2	1.0	1.4	1.0	1.4	1.6	2.1
					2.1		1.7		1.6
HICP	2.2	2.1	2.1	2.2	2.3	2.1	2.5	2.0	2.4
IPI	0.4	-0.5	0.2			0.0	-0.4	1.4	0.9
							0.4		1.5

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

Since autumn of last year, the world economy has no longer been experiencing a strong upswing, but continues to grow at a healthy pace. Demand stayed strong in the world's growth centres. However, leading indicators point to a deceleration in the US, and China is no longer providing strong impulses to world trade, because import growth has slowed significantly. The Japanese economy, which was stagnant for much of last year, started growing in the first quarter due to stronger domestic demand. Growth in the euro area, however, has not accelerated during the first half of the year. Thus, world trade growth has gradually fallen since the summer of 2004.

An upswing cools down when rising demand encounters limited supply. Once again the limiting factor for the world economy is oil. Present or expected scarcities have so far kept crude oil prices at record levels of above 50 dollars per barrel. We expect oil prices to fall only slightly to 47 dollars per barrel (Brent) over the forecasting horizon. Other production factors, however, are apparently not scarce and support the evolution of the economy: wages have risen only modestly in industrial countries due to strong competition from cheap labour in emerging markets, particularly China. Interest rates are at a historic low in the US, the euro area and Japan. Furthermore, spreads between the yield of high quality credit and riskier debtors are still low. Favourable capital market conditions are a result of the high level of liquidity, which itself derives from the fact that monetary policy has been expansive for years in most regions. All in all, cheap capital and labour input helped profits stay quite high, and stock valuations have remained stable in spite of some weak indicators in the US and euro area. Therefore, the chances that a significant downswing can be avoided are good.

While monetary policy has lowered interest rates, raised prices of assets, including real estate, and stimulated demand in most world regions, prices for manufactured goods are still quite stable. This is due to efficiency gains derived from new production techniques and the globalisation of industrial production. Because monetary policy in the US is being tightened only slowly and will remain more or less unchanged in the euro area and Japan this year, monetary conditions will still be favourable in 2005.

For 2006, the world economy will have to cope with the burden of a monetary policy changing from an expansive to a neutral stance. This will be the case for the US and, to a much lesser extent, the euro area and possibly even Japan. This policy switch is associated to two risk factors: first, a rise in interest rates and the end of the house price boom could induce US households to normalise their savings rate. While this reaction is welcome in principle, an abrupt change could depress world demand on a noticeable scale. The second risk is that non-prime rate debtors – sovereign debtors as well as private ones – would be affected most, because higher interest rates could imply increasing spreads for the same reasons that unusually low interest rates have caused very low risk spreads. This means a possible return of a financial crisis scare. If both risks can be avoided, however, the chances are good that, in 2006 as well as this year, strong growth dynamics, especially in emerging markets countries, will keep the world economy on its growth path.

The euro area

Expansion in the euro area was still slow in spring. The slight improvement in the national accounts data in the first quarter was partly due to statistical problems related to working day irregularity data adjustments. Economic sentiment, as measured by EU Commission indicators, has been falling since the beginning of the year, and industrial production is at best stagnating. Since the growth of world trade has decelerated, impulses from external trade will only be moderate this year.

Demand from both private households and firms is weak. This is no great surprise as far as consumer spending is concerned: real wages have been stagnating on average, as has the high unemployment rate. Planned and completed labour market reforms in some member countries, particularly Germany and France, added to the uncertainty of households – notwithstanding the fact that reforms have a good chance of being beneficial in the long run.

The sluggish path of private investment is disappointing. Here, the conditions for an upswing have been good for quite a while: profits have soared considerably, and interest rates have stayed low. Equity prices have been on a rising trend this year, which is remarkable in the dim light of weakening confidence indicators. Since the second half of 2004, according to the ECB Bank Lending Survey, credit standards of banks applied to the approval of loans to enterprises are being eased on average. Against this favourable background, stagnating investment is cause for concern.

Behind the sluggish dynamics of the euro area economy are significant divergences between national developments. For example, during the last two years, industrial production in Germany has done much better than in Italy. One explanation is that unit labour costs rose faster in Italy. Moreover, globalisation caused 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 are more important in Italy. These structural processes were, at a macroeconomic level, obscured by the fact that the Italian construction sector, driven by rising house prices, performed much better than in Germany. But clearly, property prices will in the medium term be affected by the competitiveness of local industries.

Thus, demand is weak in most parts of the euro area, albeit for somewhat diverging reasons. Thus, the fact that monetary policy has to be set uniformly for the whole region is, at least at present, not a serious problem. As the monetary pillar of the ECB's strategy hints at medium term risks for price stability, we do not predict that interest rates will be lowered. The short term effect of such a measure would anyhow be very limited, because, as already mentioned, monetary conditions are already very favourable. They have even improved by the fall of the euro in relation to the dollar following the rejection of the EU Constitution in France and the Netherlands. We do not expect the ECB to start raising interest rates before the summer of 2006, and even then only moderately. Thus, monetary policy will be expansive over the entire forecasting horizon. Fiscal policy will keep its more or less neutral stance.

According to the general economic sentiment indicator, economic growth perspectives in the euro area for 2005 are clearly lower than for 2004. At the end of 2004, the indicator started to become sluggish and this trend has increased in the first few months of this year. A forecast of the indicator reveals a fall during 2005. This is consistent with our macroeconomic forecasts based on national accounts data. All in all, production in the euro area will expand by 1.3 % in 2005 and by 1.6 % in 2006; hence, the output gap will not be closed. The unemployment rate is expected to increase slightly over the forecasting horizon. The participation rate will not resume the rising trend it had on the eve of the economic downturn.

Figure 1 Euro Area Economic Sentiment Indicator.

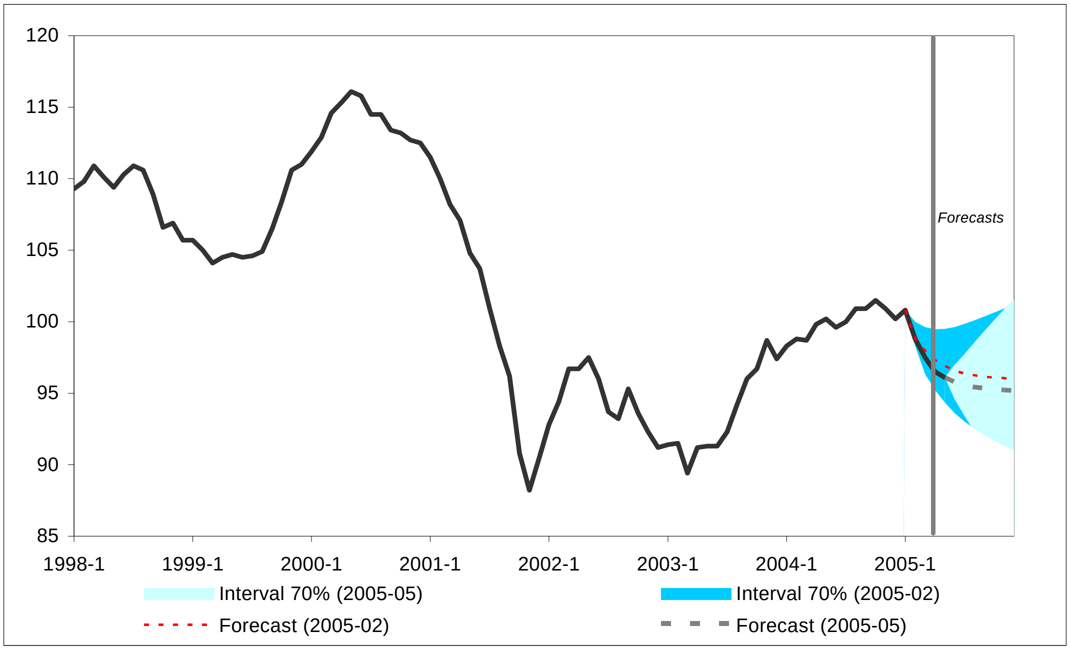
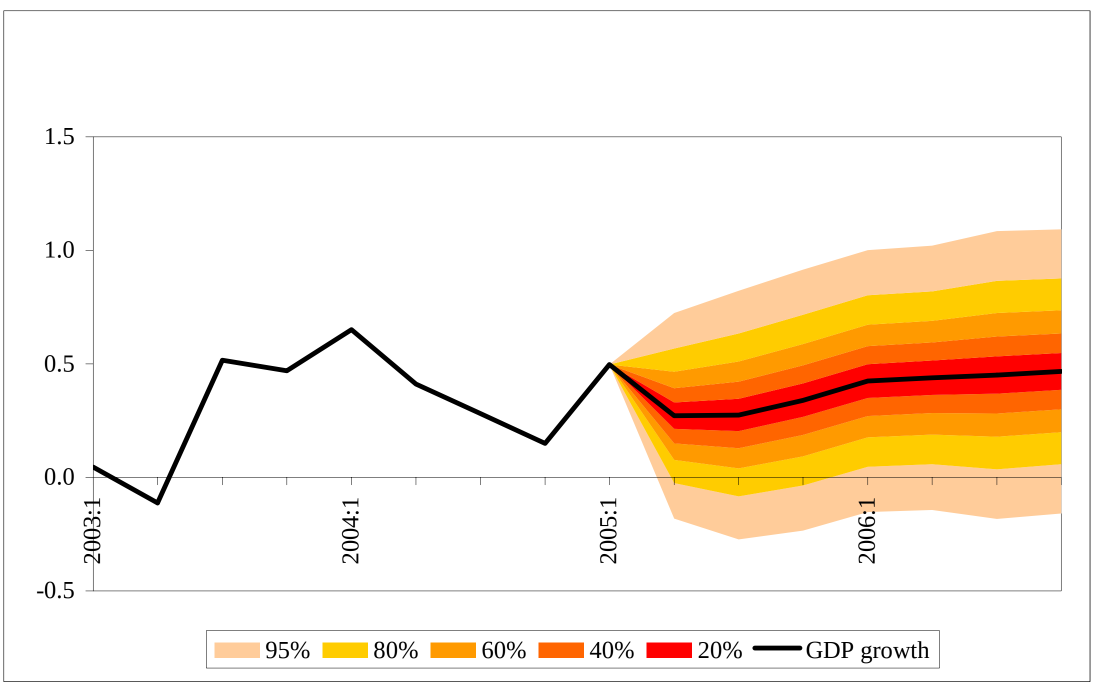
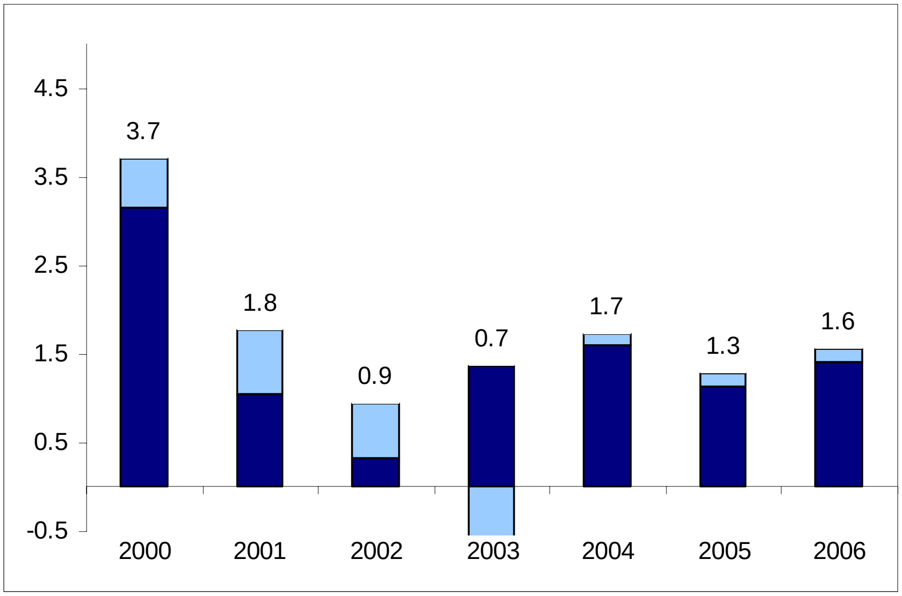


Figure 2 Quarterly GDP growth rates and confidence bands



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%	1.8%	0.3%
2000	3.7%	0.0%	0.6%	0.1%	2.4%	0.5%
2001	1.7%	0.0%	0.3%	0.0%	1.5%	-0.1%
2002	0.9%	0.0%	0.0%	0.0%	1.0%	0.0%
2003	0.7%	-0.1%	0.0%	0.0%	0.8%	0.0%
2004	2.0%	0.1%	0.5%	0.1%	1.3%	0.0%
2005	1.3%	0.1%	-0.1%	-0.1%	1.3%	0.1%
2006	1.6%	0.1%	0.2%	0.0%	1.2%	0.1%

From a supply-side perspective, GDP growth 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 90%) 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 capital goods was interrupted in 2005 and production of durables will continue with negative rates around 2.5%. The highest recoveries for 2006 are expected in the goods production sector, mainly durable and intermediate goods.

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Capital	1.6%	-1.6%	-0.1%	1.6%	-1.6%	-0.1%	2.9%	0.6%	2.6%
Durable	-2.1%	-5.6%	-4.3%	-2.1%	-5.6%	-4.3%	-0.1%	-2.6%	-0.5%
Intermediate	-0.6%	0.2%	0.2%	-0.6%	0.2%	0.2%	1.9%	-0.7%	1.1%
Non Durable	0.8%	0.6%	0.2%	0.8%	0.6%	0.2%	0.7%	-0.1%	0.6%
Energy	1.3%	1.1%	3.0%	1.3%	1.1%	3.0%	2.2%	1.6%	1.8%
Total EMU	0.4%	-0.5%	0.2%	0.4%	-0.5%	0.2%	1.9%	0.0%	1.4%

Compared to our last report, after the reductions in core inflation observed at the beginning of the year (see graph 2), due to the effects of greater openness to imports from countries like China, the appreciation of the euro and moderate growth in internal demand, core inflation is expected to stabilise at around 1.5% until the end of the year, depending on the evolution of new measures applicable to the import of some manufactured goods. With these economic growth and inflation forecasts, we continue to predict that the ECB is unlikely to change its reference interest rate until mid-2006. The fan chart shows that there is a probability of around 50% that average annual inflation will not be greater than 2.1% during 2005. For the second half of 2006 the probability of a rate below the historical mean (1995-2004) is nearly 60%. In fact inflation in the euro area during the past ten years shows stationary behaviour and will revert around to its mean value by mid-2006. Due to the good performance of core inflation in the euro area, the differential with the U.S. has been favouring the euro area since the end of 2004, and this is not expected to change in 2005.

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

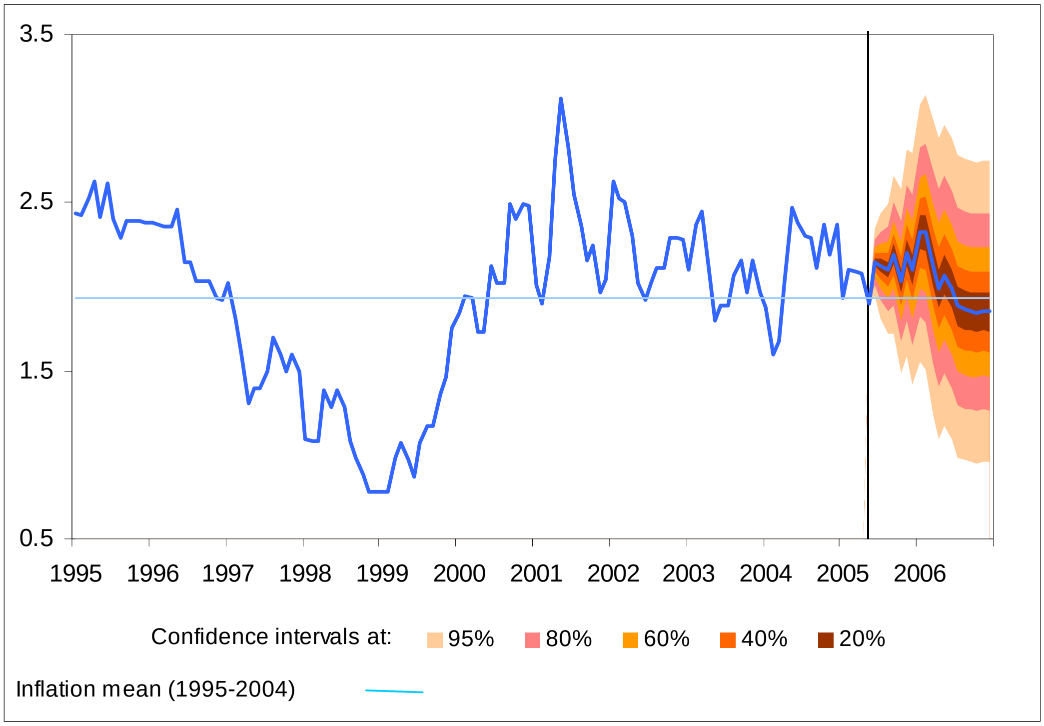
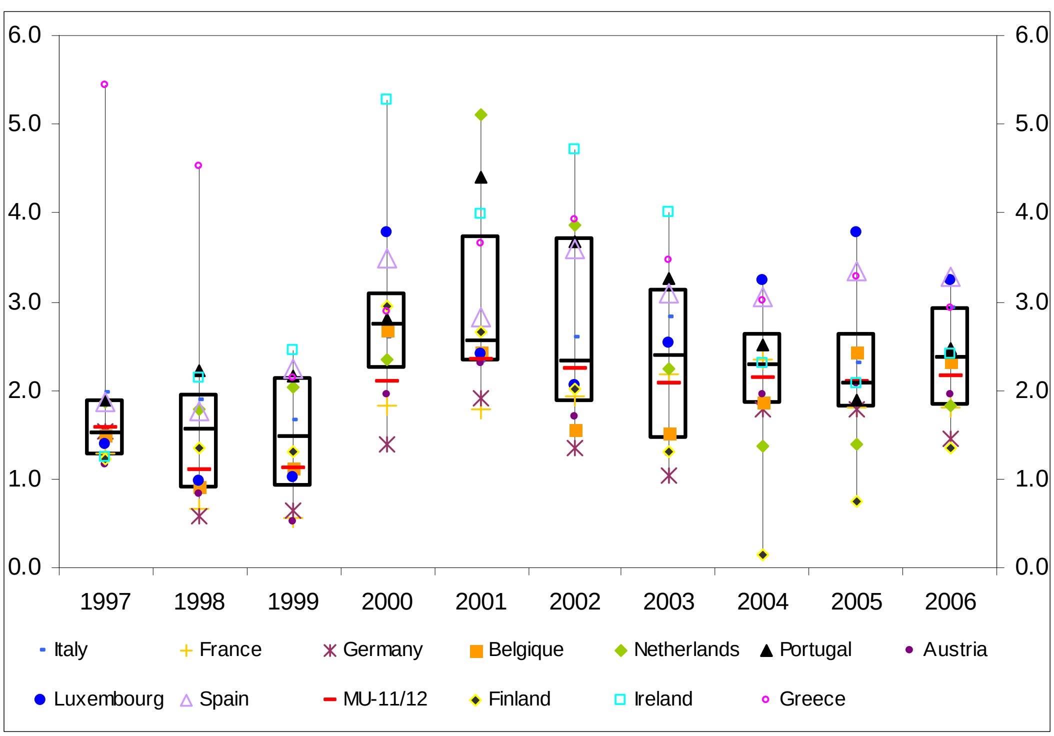


Figure 5 Box diagram of euro area countries dispersion of inflation



By country, the forecasts for 2005 continue to indicate that the worst results in the euro area will be for Luxembourg, Spain and Greece, with 3.8%, 3.4% and 3.3%, respectively. The lowest inflation rates are expected for Finland with 0.8, Netherlands with 1.4% and Germany and France with 1.8%. Forecast median inflation for the countries in the euro area has fallen to 2.1% for 2005 from 2.3% in 2004; the differences in inflation through euro area countries for 2005 will be similar to 2004 and a reduction is expected for 2006. This dispersion is reflected in actual real interest rates, however all countries but Finland and Germany show negative or near zero actual real interest rates, encouraging business and domestic indebtedness.

Table 4 Inflation expectations and actual real interest rates

	Inflation expectations		Actual real interest rates	
	Three Months	One Year	Three Months	One Year
Spain	3.48	3.08	-1.36	-0.96
Greece	3.04	2.80	-0.93	-0.69
Luxembourg	3.66	2.77	-1.54	-0.66
Italy	2.84	2.82	-0.72	-0.71
Portugal	2.28	2.53	-0.16	-0.41
Ireland	2.30	2.39	-0.19	-0.28
Belgium	2.39	2.20	-0.27	-0.09
Austria	1.94	1.97	0.17	0.14
Netherlands	1.69	1.88	0.42	0.23
France	1.79	1.77	0.32	0.34
Finland	1.19	1.40	0.93	0.71
Germany	1.67	1.25	0.45	0.86

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.

Investment is on a lower path than in other forecasts, likely due to our pure model based approach which suggests that the weakness of investment will not vanish abruptly. Naturally, the forecasts for 2006 differ more than those for the year to come. Our forecast is more cautious: for us, it seems reasonable to assume that the positive impacts of the recent structural reforms in some member countries on the macroeconomic performance will only slowly accrue over the coming years. The figures are substantially revised downwards with respect to the previous EFN report, mostly due to the consequences of historical data revision.

On inflation, our forecast for 2006 is higher than that of other institutions, possibly because it takes into consideration the future evolution of the crude oil prices in euros; 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	1.6	1.6	2.1	1.6	2.3	1.4	2.0	1.2	2.0	1.3	1.8
Priv. Consumption	1.4	1.3	1.6	1.8	1.6	2.1	1.4	1.6	1.3	1.7	1.4	1.7
Gov. Consumption	1.0	1.7	1.4	2.0	1.1	1.4	0.9	1.6	1.0	2.0	1.2	1.4
Fixed Capital Form.	0.5	1.7	2.8	3.7	2.5	3.4	1.6	3.5	2.0	3.0	1.6	2.7
Unemployment rate	9.0	9.2	8.8	8.5	8.7	8.4	na	na	9.0	8.7	8.9	8.7
HICP	2.1	2.0	1.9	1.5	1.9	1.7	2.0	1.5	1.8	1.3	1.9	1.7
IP	0.0	1.4	na	na	na	na	na	na	na	na	0.8	2.0

EU: European Commission, European Economy, No. 2, 2005 (Spring); IMF: World Economic Outlook, April 2005; ECB: ECB Monthly Bulletin, June 2005, OECD: OECD Economic Outlook, No. 77, May 2005; Consensus: Consensus Economics Inc., Consensus Forecasts, June 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 is slightly slowing over the next two years. After relatively high GDP growth in 2004 (stemming from the upswing at the beginning of the year), the dynamics in 2005 will be lower in Japan, and are expected to accelerate in 2006 again. Inflation will remain moderate in the US, while the deflation process in Japan comes to an end. An oil price of 47 dollar per barrel is expected for 2005 and 2006. The Euro is predicted to recover slightly from its fall after the unsuccessful referenda in 2005. In 2006, a slight depreciation against the US dollar and the Yen is expected, in line with international parity conditions: in the exchange rate equations, purchasing power parity holds as a long run relationship.

Table 6 Variables of the world economy

	2005	2006
US GDP Growth Rate	3.4	3.3
US Consumer Price Inflation	2.8	2.5
US Short Term Interest Rate	3.0	3.5
US Long Term Interest Rate	4.7	5.3
Japan GDP Growth Rate	1.0	1.7
Japan Consumer Price Inflation	-0.1	0.2
Japan Short Term Interest Rate	0.2	0.5
Japan Long Term Interest Rate	1.7	2.0
World Trade	6.3	5.5
Oil Price	47	47
USD/Euro Exchange Rate	1.27	1.24
100Yen/Euro Exchange Rate	1.34	1.34

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 in US dollar per barrel, all other variables in percent.