EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

Autumn 2013

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, and currently partly financially supported by the Schuman Centre at the European University Institute. 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, http://www.eui.eu/DepartmentsAndCentres/RobertSchumanCentre/Research/Economic MonetaryPolicy/EFN/Index.aspx.

Participating Institutions:

Robert Schuman Centre, European University Institute (*Coordinator*)
Team Leader: Massimiliano Marcellino (massimiliano.marcellino@eui.eu)

Centre d´Etudes Prospectives et d´Informations Internationales (CEPII)
Team Leader: Lionel Fontagné (fontagne@cepii.fr)

University of Birmingham, Department of Economics
Team Leader: Anindya Banerjee (a.banerjee@bham.ac.uk)

The Halle Institute for Economic Research (IWH)
Team Leader: Axel Lindner (Axel.Lindner@iwh-halle.de)

Anàlisi Quantitativa Regional (AQR-IREA), 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

Report closed on October 3rd, 2013

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

Highlights

- In autumn 2013, the expansion of world output has slightly accelerated. The recovery of advanced economies has gathered pace in the first half of the year, and since summer, the slowdown of the Chinese economy has stopped. In other BRIC countries, however, growth appears to be on a downward path.
- The recovery in the euro area is partly a result of special effects such as a rebound of construction after a particularly cold winter. Other positive factors, however, are longer lasting. Above all, doubts about the future of the currency union have receded substantially. As a consequence, private households and firms are more prepared to take spending decisions. For these reasons, we have revised upward our GDP forecasts for 2013, to -0.3 per cent lower in 2013 than in 2012 (from -0.5 expected in the summer).
- For 2014, we expect a GDP growth of about 1.0% that will keep unemployment at similar levels to the ones observed in 2013 (12.3%). However, the strength of the recovery in 2014 will, to a large extent, depend on financial conditions for private households and firms, in particular in Spain and Italy. The question whether banks will be able and willing to expand credit depends on their own refinancing conditions. In fact, rapid improvements cannot be expected, because risks in the balance sheets of the banks will only very slowly decline as the economy is recovering.
- Our inflation expectations for 2013 have moderated to a y-o-y rate of 1.5%, and they remain subdued also in 2014, at about 1.4%. Taking this into account and despite the improving growth figures, monetary policy in the euro area is expected to remain markedly accommodative in the short to medium term, as reflected by the ECB’s forward guidance strategy.

Table 1 Economic outlook for the Euro area

	2010	2011	2012	2013: 2nd half		2013: annual		2014: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.0	1.5	-0.6	0.2	-0.4 0.8	-0.3	-0.6 0.0	1.0	0.0 2.0
Potential Output	0.0	0.2	0.4	0.1	-0.1 0.2	0.0	-0.1 0.1	0.3	0.1 0.5
Private Consumption	1.0	0.3	-1.4	0.1	-0.4 0.5	-0.5	-0.7 -0.2	0.7	-0.1 1.5
Government Consumption*	0.6	-0.1	-0.6	0.1		0.0		0.1	
Fixed Capital Formation	-0.4	1.6	-3.9	-3.1	-5.4 -0.7	-3.8	-5.0 -2.7	1.8	-1.3 4.9
Exports	11.7	6.4	2.5	2.4	1.2 3.6	1.4	0.8 2.0	5.8	4.1 7.6
Imports	10.1	4.3	-1.1	2.0	0.5 3.5	0.4	-0.4 1.2	6.0	3.9 8.2
Unemployment Rate	10.1	10.2	11.4	12.2	12.0 12.4	12.2	12.0 12.3	12.3	11.9 12.8
Total hourly labour costs	1.7	2.6	2.2	1.6	1.2 2.0	1.6	1.4 1.8	2.0	1.5 2.6
Labour Productivity (output per head)	2.4	1.3	0.1	1.0	0.5 1.5	0.6	0.4 0.8	1.3	0.6 2.0
HICP	1.6	2.7	2.5	1.4	1.2 1.6	1.5	1.4 1.6	1.4	0.5 2.3
IPI	7.3	3.2	-2.4	0.2	-0.5 0.9	-0.7	-1.2 -0.2	1.1	-0.9 3.1

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

*Currently, government consumption is highly influenced by the need of fiscal consolidation in many euro area countries, a situation that is not appropriately captured by the model. Hence, we assume a time path of government consumption that is compatible with the consolidation programs of the member countries.

Economic Outlook for 2013 and 2014

Shifting dynamics in the world economy

In autumn 2013, the expansion of world output has slightly accelerated. The recovery of advanced economies has gathered pace in the first half of the year, and since summer, the slowdown of the Chinese economy has stopped. Growth of other large emerging economies, however, is still slowing, and risks of serious economic disruptions loom.

Though growth rates are still much higher in the emerging markets, the dynamics of the world economy have, at least for the time being, shifted in favour of the advanced economies. The moderate upswing in the US, up to now, withstands the drag of restrictive policies quite well. In Japan, very expansive policies have succeeded in generating an upswing in the first half of 2013. At the same time, the British economy overcame stagnation, with sentiment of firms and private households rising substantially. Even the euro area is no longer in recession.

However, in emerging markets, among them in all the BRIC countries, growth appears to be on a downward path – notwithstanding recently better data from China. Closing the productivity gap to the advanced economies becomes more and more difficult, and the need of dealing with shortcomings such as inefficient provisions of public goods and dysfunctional capital markets are felt more urgently. If these economies, in addition, run large current account deficits, they risk sudden stops of capital when international investors lose confidence. Such a situation came for, among other countries, India, Brazil and Turkey, when, during summer, long term interest rates in the US rose as investors expected the Fed to taper off its quantitative easing program. Emerging markets appeared to become a less attractive place for foreign capital and exchange rates fell rapidly. But in September, international capital and currency markets calmed down again. One reason was that the Fed, surprisingly, did not start the taper, since the bank feared rising long term interest rates could damage the economy. Ironically, rising interest rates had been the Fed's own doing: in the first half of the year, the central bank had tried to guide markets forward by giving detailed conditions for the start of the taper, and when these appeared to be met, markets reacted – too strongly, in the eye of the Fed.

For the rest of 2013 and for 2014, however, it is erratic fiscal, not monetary policy that will be a major risk for the moderate upswing in advanced economies. In the US, policy appears to be doomed to erratic emergency steps by the political blockade in Congress;

for Japan, it is still unclear whether the government will really start consolidating the public household, as the consumption tax increase will be accompanied by an additional stimulative fiscal package in April.

The euro area economy: out of recession, but risks still loom

The euro area recession appears to have ended in the first half of 2013. Having declined for one and a half years, output expanded by 0.3%. The expansion was quite strong in France and Germany, while in Italy and Spain the decline was much slower than before. In the area as a whole, private households spent more, and investment activity went up, for the first time for over two years. Exports expanded significantly, and as imports did so by less, trade contributed to output growth. Labour markets begin to stabilize: the unemployment rate stopped rising in March, and even went a bit down to 12% in July.

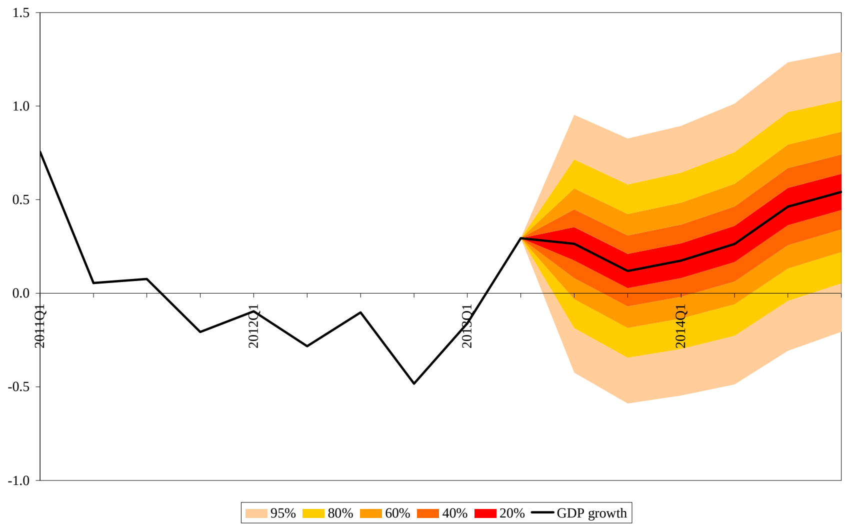
The recovery is partly a result of special effects: construction rebounded strongly after a particularly cold winter, and very strong production data for the French aircraft industry were probably an outlier. Other positive factors, however, are longer lasting. Above all, doubts about the future of the currency union have receded substantially. As a consequence, private households and firms are more prepared to take spending decisions. In addition, fiscal policies are a bit less restrictive than last year. Finally, dampening effects of some structural adjustments start to fade, such as the losses in employment in the construction sector in Spain.

The euro area economy appears to continue slowly expanding in the second half of the year. Sentiment indicators are still on the rise, albeit from low levels. External trade will be supportive, although only modestly, as some larger emerging markets economies are slowing down and the real effective exchange rate of the euro has appreciated since summer.

The strength of the recovery in 2014 will to a large part depend on financial conditions for private households and firms, in particular in Spain and Italy. The question whether banks will be able and willing to expand credit depends on their own refinancing conditions. Rapid improvements cannot be expected, because risks in the balance sheets of the banks will only very slowly decline as the economy is recovering. The ECB will review the assets of large European banks in 2014, before it will take responsibility for the supervision of the banks in autumn 2014. But this supervision carries its own risks, in particular for public finances of fiscally weak countries: the ECB might find capital lacking, and some large banks, unable to attract private capital, might have to apply for public help. In any case, fiscal policies are bound to stay restrictive, although significantly less so than in the past two years.

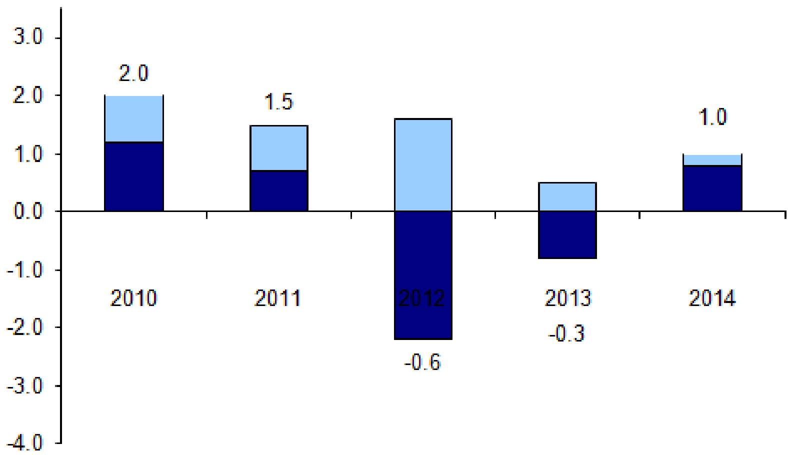
All in all, the recovery will be very slow. According to our forecast, output in 2013, having started on a low level, will decline by 0.3%. In 2014, it will grow by 1%. The unemployment rate will be about constant.

Figure 1 Quarterly GDP growth rates and confidence bands



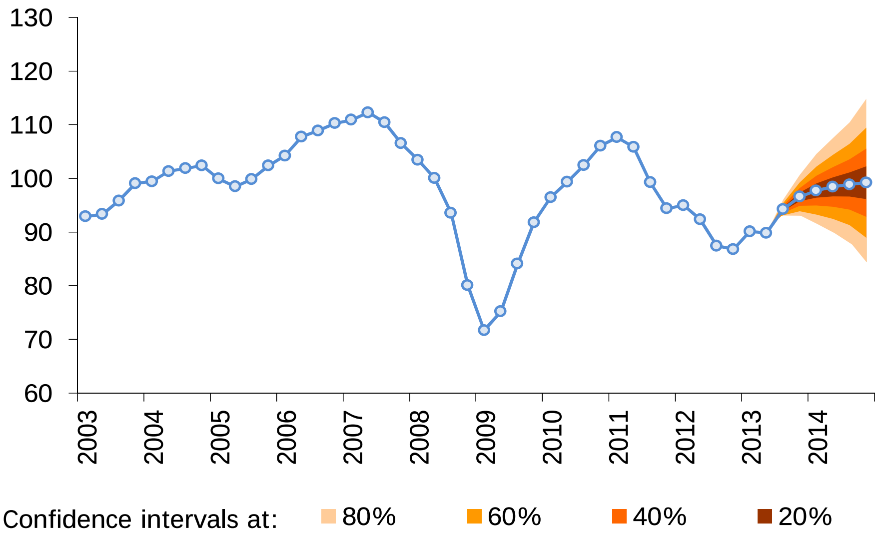
Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Figure 3 Economic Sentiment Indicator and confidence bands



Regarding prices, HICP inflation in the euro area continues to move away from ECB's medium term objective, having fallen in September to a year-on-year rate of 1.1%, the lowest since February 2010. Despite the improving growth figures and the important inflation moderation in the recent months, monetary policy in the euro area is expected to remain markedly accommodative in the short to medium term, as reflected by the effectively applied ECB's forward guidance strategy.

Figure 4 HICP and confidence bands

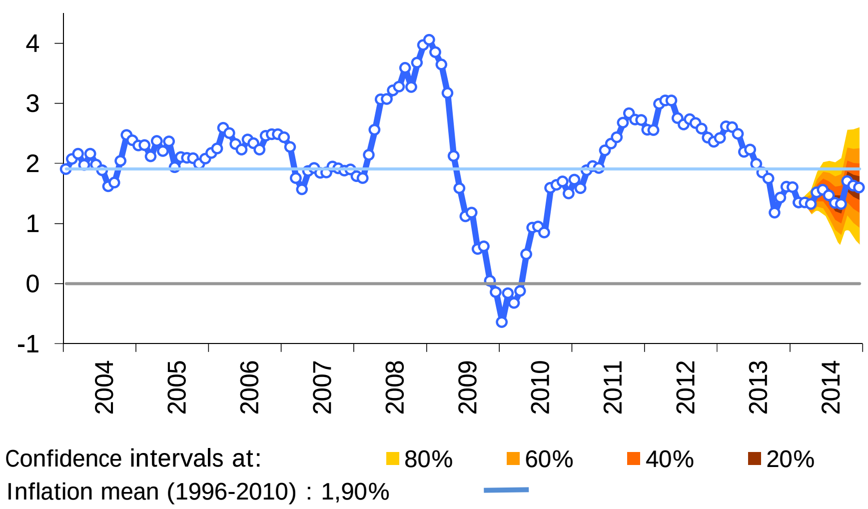


Table 2 Annual average rates for industrial production in the euro area

	2009	2010	2011	2012	2013	2014
Durable	-17.4	2.7	0.6	-4.5	-3.1	-1.5
Non Durable	-3.3	2.9	0.8	-2.1	-0.1	0.2
Capital	-21.2	8.9	8.2	-1.1	-0.7	2.3
Intermediate	-19.7	10.0	3.8	-4.4	-1.2	1.2
Energy	-5.1	3.9	-4.7	-0.2	-0.3	-0.1
Total	-15.1	7.3	3.2	-2.4	-0.7	1.1

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 3 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.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF**		ECB		OECD		Consensus	
	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
GDP	-0.3	1.0	-0.4	1.2	-0.3	1.1	-0.4	1.0	-0.6	1.1	-0.4	0.9
Priv. Consumption	-0.5	0.7	-0.9	0.7	-1.0	0.8	-0.7	0.7	-0.8	0.4	-0.6	0.5
Gov. Consumption	0.0	0.1	0.0	0.5	-0.2	0.1	-0.1	0.6	0.0	0.3	0.0	0.1
Fixed Capital Form.	-3.8	1.8	-2.6	2.3	-2.2	1.3	-3.6	1.8	-1.3	2.2	-3.6	1.3
Unemployment rate	12.2	12.3	12.2	12.1	12.3	12.3	na	na	12.1	12.3	12.2	12.3
HICP	1.5	1.4	1.6	1.5	1.7	1.5	1.4	1.3	1.5	1.3	1.5	1.5
IP	-0.7	1.1	na	na	na	na	na	na	na	na	-0.5	2.0

EU: European Commission, Economic Forecast, Spring 2013; IMF: World Economic Outlook, April 2013; ECB: ECB Monthly Bulletin, September 2013, OECD: Economic Outlook, May 2013; Consensus: Consensus Economics Inc., Consensus Forecasts, September 2013. ECB figures correspond to their macroeconomic projections.

**According to the IMF World Economic Outlook Update, July 2013, forecasts for GDP growth are -0.6 for 2013 and 0.9 for 2013

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 4 below. While US growth is being dampened by restrictive fiscal policies in 2013, the Japanese economy expands healthily, as the Japanese economy has gained competitiveness by the recent strong depreciation of the Yen and expansive economic policy of the new government that came into office at the beginning of 2013 has raised confidence in Japan. We predict world trade to expand slowly. Indeed, since 2011 growth dynamics of world trade have, absolutely and compared to world output growth, been very weak.

Table 4 Variables of the world economy

	2012	2013	2014
US GDP Growth Rate	2.8	1.6	2.7
US Consumer Price Inflation	2.1	1.5	1.9
US Short Term Interest Rate (December)	0.1	0.1	0.2
US Long Term Interest Rate (December)	1.7	2.8	3.3
Japan GDP Growth Rate	2.0	1.9	1.7
Japan Consumer Price Inflation	0.0	0.1	2.2
Japan Short Term Interest Rate (December)	0.3	0.2	0.2
Japan Long Term Interest Rate (December)	0.8	0.8	1.0
World Trade Growth Rate	2.4	2.3	3.6
Oil Price (December)	110	110	112
USD/Euro Exchange Rate (December)	1.31	1.32	1.32
100Yen/Euro Exchange Rate (December)	1.10	1.32	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 close to those of Consensus Economics (2013). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.