

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2014 and 2015



Summer 2014

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/EconomicMonetaryPolicy/EFN/Index.aspx>.

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Highlights

- World growth disappointed at the beginning of the year, when in the US extremely cold weather caused production to contract, the recovery in the euro area stumbled and the slowdown of the Chinese economy continued. At present, however, confidence indicators and order books point to a moderate pickup of growth in most regions.
- Prices on markets for energy, real and financial assets have reacted little to recent bad news about rising geopolitical risks in the Middle East and Eastern Europe up to now. A sudden increase of risk aversion or a change of beliefs among investors could trigger a swift deterioration of financial conditions for the world economy.
- In the euro area, strong stimuli from abroad are not to be expected and private households continue to keep their real spending about constant. Investment has been expanding since summer 2013, but at a very moderate rate. In this context, our forecast for GDP growth is 1.1% in 2014 and 1.6% in 2015.
- For 2014 and 2015, we do not see any significant reduction of the unemployment rate, because employment dynamics will stay weak due to subdued growth and the still rising participation rate in the euro area.
- Our inflation forecast for 2014 is 0.6%. In 2015 inflation will also remain subdued, at about 1.0%. In this context of very low price dynamics, monetary policy keeps the recovery alive: official interest rates around zero and the search for yields on financial markets have depressed yields for government bonds; the fall in financing costs allows euro area governments to conduct fiscal policies that are much less restrictive than in the years before, with tax cuts in Italy, France, and Spain starting this year. Nonfinancial firms benefit from a shrinking burden of interest payments, and the availability of bank loans for small and medium enterprises has improved since 2012 in most countries.

Table 1 Economic outlook for the Euro area

	2011	2012	2013	2014: 1st half		2014: annual		2015: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.6	-0.7	-0.4	0.9	0.7 1.1	1.1	0.7 1.6	1.6	0.7 2.6
Potential Output	0.2	0.5	0.0	0.0	0.0 0.1	0.1	0.0 0.3	0.4	0.1 0.6
Private Consumption	0.3	-1.4	-0.7	0.6	0.4 0.8	0.9	0.4 1.3	1.3	0.4 2.1
Government Consumption	-0.1	-0.6	0.1	0.3	0.1 0.5	0.3	0.0 0.6	0.4	-0.2 0.9
Fixed Capital Formation	1.6	-4.0	-2.9	2.1	1.1 3.1	2.4	0.6 4.2	4.3	1.1 7.5
Exports	6.5	2.5	1.4	3.6	3.1 4.2	4.1	3.1 5.1	5.8	3.8 7.7
Imports	4.5	-0.9	0.4	4.2	3.5 4.9	4.9	3.6 6.2	6.6	4.4 8.9
Unemployment Rate	10.1	11.3	12.0	11.7	11.6 11.8	11.7	11.5 11.9	11.7	11.1 12.4
Total hourly labour costs	2.6	2.2	1.4	2.2	2.0 2.4	2.5	2.2 2.9	2.6	2.0 3.2
Labour Productivity (output per head)	1.3	0.0	0.5	0.8	0.6 0.1	1.1	0.7 1.4	1.7	1.1 2.3
HICP	2.7	2.5	1.4	0.6	0.6 0.6	0.6	0.8 0.3	1.0	2.0 0.1
IPI	3.4	-2.5	-0.7	2.7	3.6 1.8	1.9	3.4 0.4	2.4	4.6 0.2

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.

Economic Outlook for 2014 and 2015

A moderately growing world economy

In summer 2014, world production appears to be expanding at a moderate rate. Growth disappointed at the beginning of the year, when in the US extremely cold weather caused production to contract, the recovery in the euro area stumbled, and the slowdown of the Chinese economy continued. As a consequence, according to data from the Dutch CPB Institute, world trade, and in particular that in emerging Asia, declined. At present, however, confidence indicators and order books point to a pickup of growth in most regions. Conditions are still largely friendly for growth. In June the ECB has reacted to slowing inflation dynamics with some unconventional expansive measures, such as a negative deposit rate and longer-term refinancing operations that give banks special incentives to expand their loan books. In contrast, since output gaps are regarded as shrinking quickly in Britain and more gradually in the US, markets expect the Bank of England to start raising rates in the coming winter and the Fed to do so somewhat later. Still, official interest rates will in all probability stay very low in advanced economies in the coming years, and financial investors at present demand quite low premia for more risky assets. A strong upswing of the world economy is, however, not in sight: the US upswing has not come to an end, but it now looks less dynamic than many forecasters believed only recently, and the Japanese economy has slowed down due to a consumption tax hike in April. Moreover, trend rates of growth in the BRICs, the big emerging markets economies, have been falling for a couple of years. Though causes differ widely from country to country, they all have their structural nature in common, which will continue to keep growth rates down in the coming years.

Problems of the Chinese economy pose a particular risk for world production growth in this year and in 2015. Declining property prices might evolve to a Chinese housing crisis that would affect private households, developers, and local governments, and thus the performance of the Chinese economy as a whole. Another risk for the world economy comes from geopolitical developments: the conflict between Russia and Ukraine could affect energy supply for much of Europe in the coming winter, and the civil wars in Syria and Iraq threaten oil exports from the Middle East. Oil prices, however, are still, with about 113 Dollars per barrel in early July, not much higher than during the past three years, and oil futures point to expectations of lower prices going forward. Indeed, what puts the global economy most at risk right now is that prices on

markets for energy, real and financial assets have reacted little to all these bad news up to now. A sudden increase of risk aversion or a change of beliefs among investors might lead to a swift deterioration of financial conditions for the world economy.

The euro area economy: recovery plodding on

Production in the euro area has been expanding by about 0.2% in each of the past four quarters. At the beginning of 2014, growth was, with 0.8%, buoyant in Germany, partly because a mild winter allowed unusually strong construction activity, and (with 0.4%) quite healthy in Spain, while production was about constant in France and Italy, and receded in the Netherlands, Portugal, Finland, Estonia, and Cyprus. In the euro area as a whole, private households continue to keep their real spending about constant; investment has been expanding since summer 2013, but at very moderate rates that are not compatible with an upswing. With world trade very sluggish at the beginning of 2014, export growth was as well only moderate.

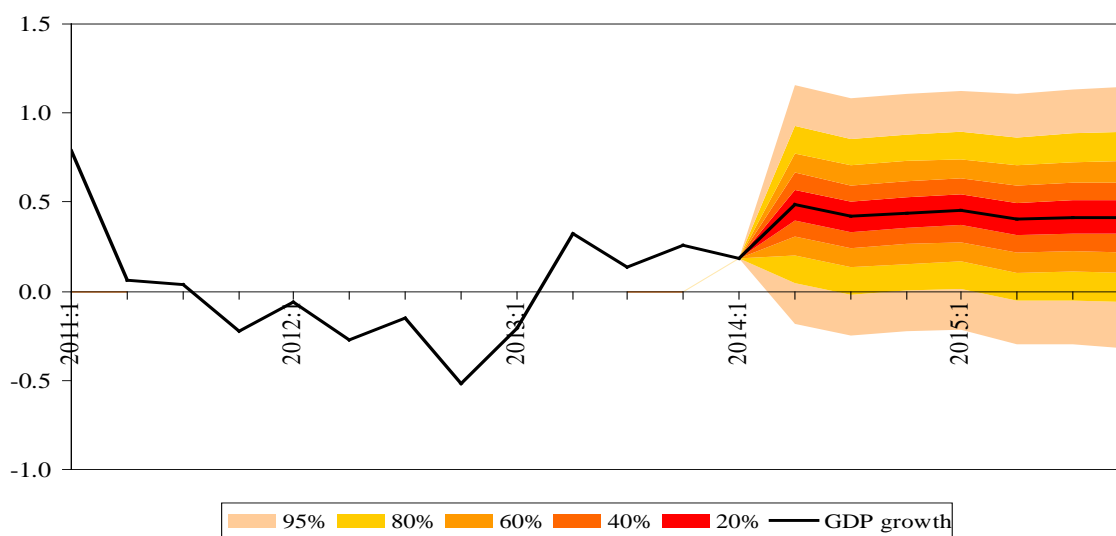
Little movement can be detected on labour markets: for about a year now employment has been about stagnating. It is therefore doubtful whether the decline of the unemployment rate (from 12% in September 2013 to 11.7% in May) is an indicator for receding stress on labour markets. The stabilization of employment has however, together with less negative effects from direct taxes and moderate wage growth, caused real disposable income in the euro area to slightly expand during winter 2013/14. In particular, the precipitate fall in real incomes has come to an end in most stressed countries.

What keeps the recovery alive is above all monetary policy: official interest rates around zero and the search for yields on financial markets have depressed yields for government bonds; for Spain and Italy, they are at present, with about 2.7% for those with maturity of 10 years, at the same level as yields for US government bonds. The fall in financing costs allows euro area governments to conduct fiscal policies that are much less restrictive than in the years before, with tax cuts in Italy, France, and Spain starting this year. Nonfinancial firms benefit from a shrinking burden of interest payments. This is one reason why profits (measured by gross operating surplus) are starting to recover, albeit from very low levels. Although interest rates for bank credit in the southern economies are still much higher than those in the euro area core, the availability of bank loans for small and medium enterprises has, according to the SAFE survey of the ECB and the Commission, improved since 2012 in most countries, such as in Spain and Portugal, though not in Italy. Thus, all in all, chances are good that the euro area economy will continue on its path of a very moderate recovery. Indicators for economic confidence and assessments of order books are no longer downbeat, but they have, on

average, stopped rising in the first quarter 2014. Strong stimuli from abroad are not to be expected, as world growth is not dynamic and the external value of the euro is relatively high.

Overall, we forecast that the euro area economy will expand by 1.1% in 2014 and 1.6% in 2015. Industrial production is also expected to grow, by 1.9% in 2014 and 2.4% in 2015. This moderate recovery will not substantially increase inflation over the next two years. Our forecast for 2014 is 0.6%, slightly up to 1.0% in 2015.

Figure 1 Quarterly GDP growth rates and confidence bands

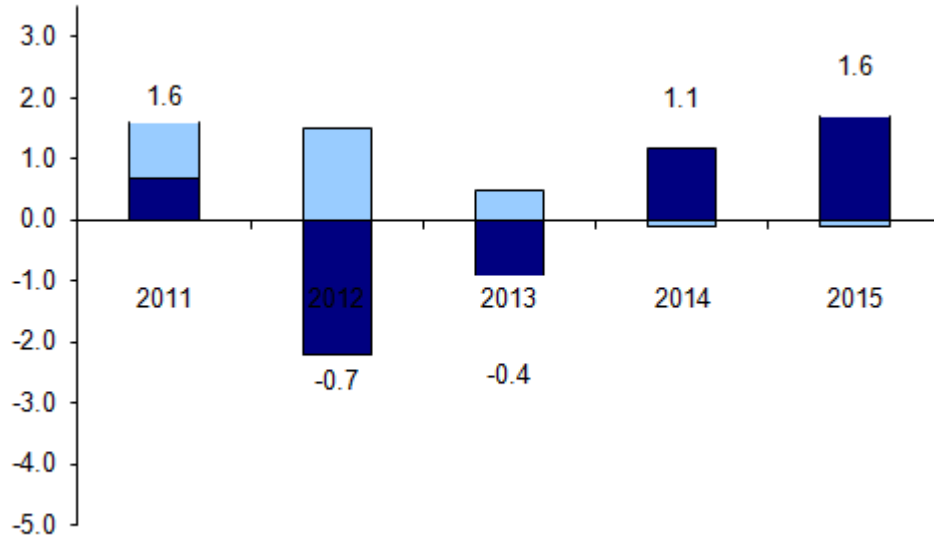


Percentage change over previous quarter

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

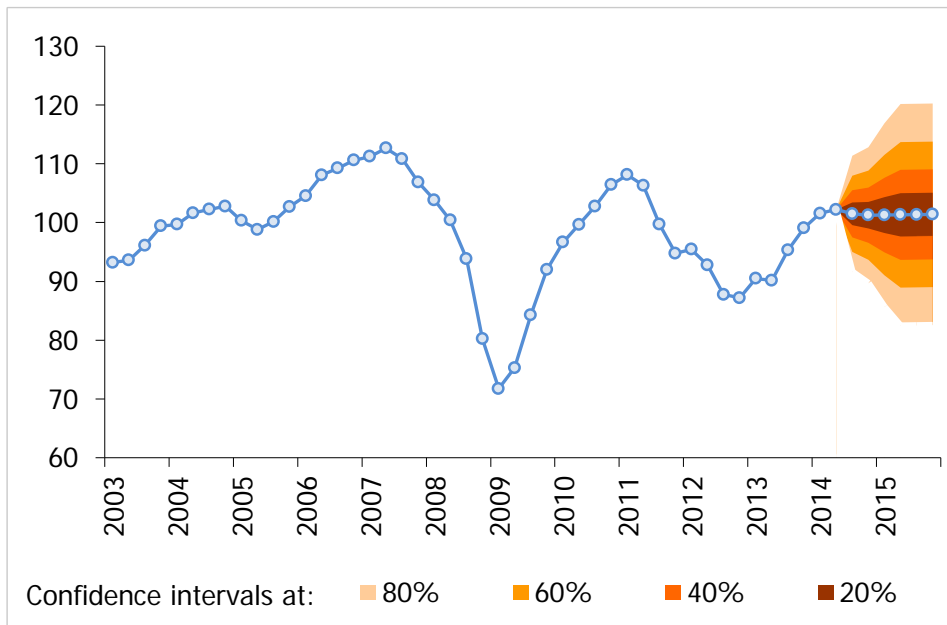
	2010	2011	2012	2013	2014	2015
Durable	2.7	0.7	-4.9	-3.5	1.6	5.1
Non Durable	2.9	1.0	-2.1	-0.1	2.5	1.8
Capital	9.0	8.5	-1.1	-0.5	2.3	3.0
Intermediate	10.0	4.1	-4.5	-1.0	3.2	2.6
Energy	3.9	-4.5	-0.4	-1.1	-4.8	0.2
Total	7.3	3.4	-2.5	-0.7	1.9	2.4

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



Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconomic 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.

While the numbers on GDP are quite similar, the EFN forecast stands out in that it predicts no significant reduction of the unemployment rate, because employment dynamics will stay weak, while the trend of the participation rate is still rising.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
GDP	1.1	1.6	1.2	1.7	1.2	1.5	1.2	1.5	1.4	1.8	1.1	1.5
Priv. Consumption	0.9	1.3	0.8	1.3	0.6	1.0	0.7	1.2	0.9	1.4	0.7	1.2
Gov. Consumption	0.3	0.4	0.7	0.5	0.3	-0.2	0.4	0.4	0.4	0.1	0.3	0.5
Fixed Capital Form.	2.4	4.3	2.3	4.2	2.2	2.6	2.1	2.7	2.4	3.7	2.3	2.9
Unemployment rate	11.7	11.7	11.8	11.4	11.9	11.6	na	na	11.7	11.4	11.8	11.5
HICP	0.6	1.0	0.8	1.2	0.9	1.2	1.0	1.3	0.7	1.1	0.7	1.2
IP	1.9	2.4	na	na	na	na	na	na	na	na	1.9	2.8

EU: European Commission, Economic Forecast, Spring 2014; IMF: World Economic Outlook, April 2014; ECB: ECB Monthly Bulletin, June 2014, OECD: Economic Outlook, May 2014; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2014.

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 production in the US and in Japan are forecasted to expand with rates that are a bit higher than what is generally considered as the respective potential growth rate, world trade is predicted to expand only very moderately. Contrary to, e.g. the ECB in its recent projections, we assume stable, instead of falling, oil prices. The Japanese economy at long last appears to overcome deflation, while consumer prices in the US rise according to this forecast with a rate that the Fed should be comfortable with.

Table 4 Variables of the world economy

	2013	2014	2015
US GDP Growth Rate	1.9	2.3	3.1
US Consumer Price Inflation	1.5	1.8	1.9
US Short Term Interest Rate (December)	0.1	0.2	0.7
US Long Term Interest Rate (December)	2.9	3.3	3.7
Japan GDP Growth Rate	1.5	1.3	1.3
Japan Consumer Price Inflation	0.4	2.6	1.8
Japan Short Term Interest Rate (December)	0.1	0.2	0.3
Japan Long Term Interest Rate (December)	0.7	0.8	1.2
World Trade Growth Rate	2.8	3.5	5.0
USD/Euro Exchange Rate (December)	111	110	112
100Yen/Euro Exchange Rate (December)	1.37	1.36	1.36

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.