EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2014 and 2015

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, 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/Projects/EFN/Home.aspx.

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Highlights

- In autumn 2014, world production continues to be expanding at a moderate rate, a bit faster than at the beginning of the year. A strong upswing of the world economy is, however, not in sight: the US upswing continues but is not probable to gain more pace, and the Chinese economy has to cope with severe problems in the financial and the housing sector.
- Important conditions for a stronger recovery are in place: the fall in financing costs allows euro area governments to conduct fiscal policies that are, on average, clearly less restrictive than in the years before, and nonfinancial firms benefit from a shrinking burden of interest payments. Interest rates for bank credit in the southern economies are now slowly going down. However, the recovery will stay sluggish as long as firms and households lack confidence in the economic policy of important member states. In fact, economic confidence in the euro area declined somewhat during summer in part due to news on the conflict between Russia and the west, although only about 5% of all exports leaving the euro area go to Russia or Ukraine.
- Production growth in the euro area slowed down to stagnation in the second quarter, mainly due to a decline in Germany related to a weather effect. Demand in the rest of the euro area continued to slowly expand. In this context, we forecast that the euro area economy will expand by 1.3% in 2015, after 0.9% in 2014.
- 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 0.5%. In 2015 inflation will also remain subdued, at about 1.1%.

Table 1 Economic outlook for the Euro area

	2011	2012	2013	2014: 2nd half		2014: annual		2015: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.6	-0.7	-0.4	1.0	0.4 1.6	0.9	0.6 1.2	1.3	0.4 2.3
Potential Output	0.5	0.2	0.0	0.1	-0.2 0.4	0.1	-0.1 0.3	0.4	0.1 0.7
Private Consumption	0.3	-1.4	-0.7	0.7	0.3 1.2	0.6	0.4 0.9	0.6	-0.3 1.4
Government Consumption	-0.1	-0.6	0.1	0.7	0.3 1.1	0.7	0.5 0.9	0.4	-0.2 1.0
Fixed Capital Formation	1.6	-4.0	-2.9	1.7	-0.7 4.0	1.6	0.4 2.8	2.8	-0.2 5.7
Exports	6.5	2.5	1.4	3.5	2.3 4.8	3.2	2.6 3.8	5.8	4.0 7.5
Imports	4.5	-0.9	0.4	4.4	2.9 5.9	3.9	3.2 4.7	5.9	3.7 8.2
Unemployment Rate	10.1	11.3	12.0	11.5	11.2 11.8	11.6	11.4 11.7	11.4	10.9 12.0
Total hourly labour costs	2.7	2.4	1.2	1.6	1.3 1.9	1.4	1.2 1.5	2.6	2.0 3.2
Labour Productivity (output per head)	1.4	0.0	0.4	0.7	0.2 1.1	0.6	0.4 0.8	1.2	0.6 1.9
HICP	2.7	2.5	1.4	0.5	0.6 0.4	0.5	0.6 0.4	1.1	2.0 0.2
IPI	3.4	-2.5	-0.6	1.4	2.3 0.5	1.2	2.1 0.3	1.3	3.5 -1.9

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is1the 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

The world economy: Moderate growth continues

In autumn 2014, world production continues to be expanding at a moderate rate, a bit faster than at the beginning of the year. The US economy made the difference: While US production contracted at the beginning of the year due to extremely cold weather, it bounced back in the summer. At that time the Chinese economy expanded a bit stronger as well, but recent data now point to a deceleration, triggered by a downswing in the housing sector. The growth performance of other large economies is similarly mixed: it is unclear whether the upswing in Japan will continue, after Japanese production markedly contracted following the increase in the consumption tax rate in the second quarter. In Brazil, where exporters of commodities have to cope with the stagnation of world commodity prices and policy is restrictive in order to fight inflation, the economy is in recession. Production in Russia stagnates due to the Ukrainian crisis and the strong political tensions with the US and the European Union. While the upswing in Britain continues, the recovery of the euro area has faltered in the summer. As a consequence of all this, world trade was very weak in the first half of the year. At present, however, confidence indicators and order books point to a moderate pickup of growth in most regions. Indeed, many conditions are still largely friendly for growth. This is also true for the euro area. Between June and September the ECB has reacted to slowing inflation dynamics with some unconvential expansive measures, such as a negative deposit rate and longer-term refinancing operations that give banks some incentives not to decrease their loan books or to shrink them at a slower rate. In contrast, since output gaps are regarded as receding 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 continues but is not probable to gain more pace, and the Chinese economy has to cope with severe problems in the financial and the housing sector. More generally, trend rates of growth in all 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, and thus will continue to keep growth rates down in the coming years.

Geopolitical developments pose serious risks for the world economy: the conflict between Russia and the west, in particular, could affect the supply of gas for much of Europe in the coming winter. Oil prices, however, have fallen to below 100 Dollars in September due to increasing supply of oil in the US and slow growth of industrial production in emerging markets economies.

The euro area economy: a stalled recovery

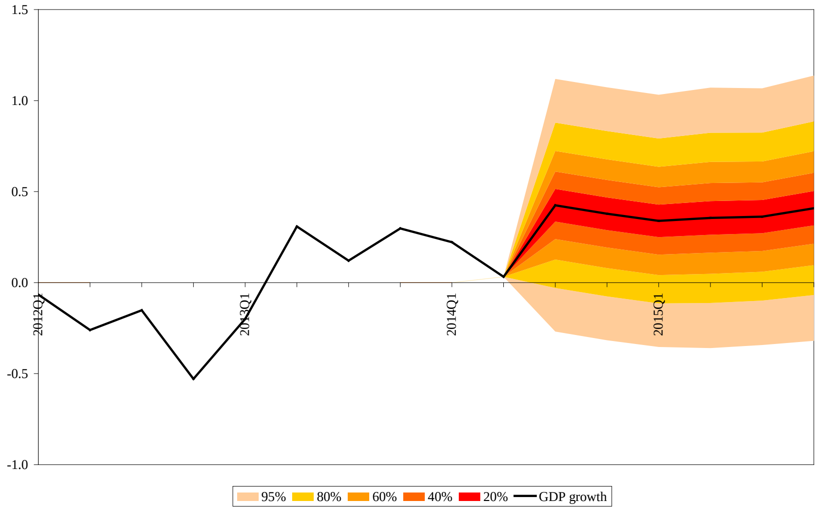
In the second quarter of 2014, production was stagnant in the Euro area, after an increase of 0.2% at the beginning of the year. The slow down was due to a decline in Germany, where private consumption was weak and seasonally adjusted constructon activity was lower than in the first quarter, when weather conditions had been very favourable. Demand in the rest of the euro area continued to slowly expand with investment in equipment even accelerating. Employment rose as it has been doing for a year now, and even by a bit more than in previous quarters. The unemployment rate decreased further, albeit very slowly. Still, economic confidence, according to most indicators, declined somewhat during summer. One explanation for this is that expectations of a strengthening recovery were disappointed by the actual development. In addition, confidence might have been dented by news on war in Syria and Iraq and in particular by the conflict between Russia and the west. It should be noted, however, that only about 5% of all exports leaving the euro area go to Russia or Ukraine.

In important other respects, conditions are in place for a stronger recovery: official interest rates around zero and the search for yields on financial markets has depressed yields for government bonds; for Spain and Italy, they are at present, with about 2.2% for those with maturity of 10 years, markedly lower than yields for US government bonds. The fall in financing costs allows euro area governments to conduct fiscal policies that are, on average, clearly 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. Interest rates for bank credit in the southern economies are now slowly going down. All in all, a further explanation for the sluggish recovery is needed, and a lack of confidence in the economic policy of some member states is an obvious candidate: the French economy has been stagnating for a year now, and Italy slipped back into recession in the first half of 2014. In both countries governments are focused on economic reform, but have not managed to convince the public that they will be able to realize their projects. So long as this does not change, the recovery in the euro area will in all probability stay sluggish.

We forecast that the euro area economy will expand by no more than 1.3% in 2015, after 0.9% in 2014 (see Figure 1), mostly driven by domestic demand (see Figure 2).

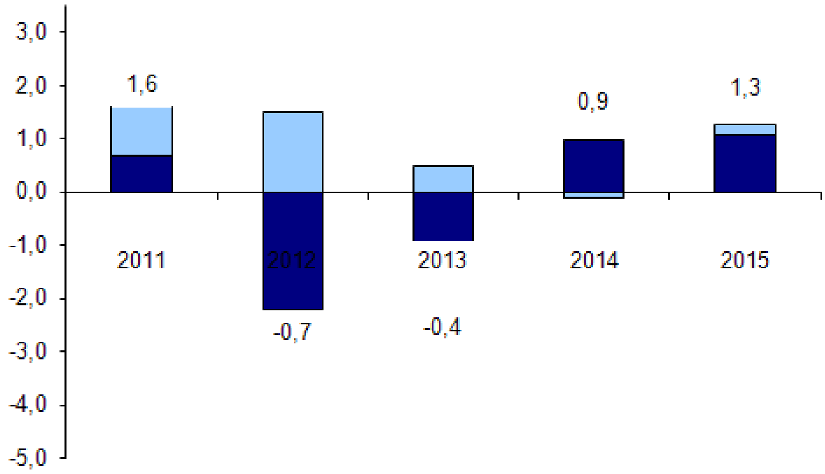
Industrial production is also expected to expand, by 1.1% in 2014 and 1.3% in 2015, mainly due to growth in the sectors *capital* and *non durable goods* (see Table 2). This moderate recovery will not substantially change the economic sentiment (Figure 3) or increase inflation over the next two years. In particular, our inflation forecast for 2014 is 0.5%, slightly up to 1.10% in 2015 (see Figure 4).

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

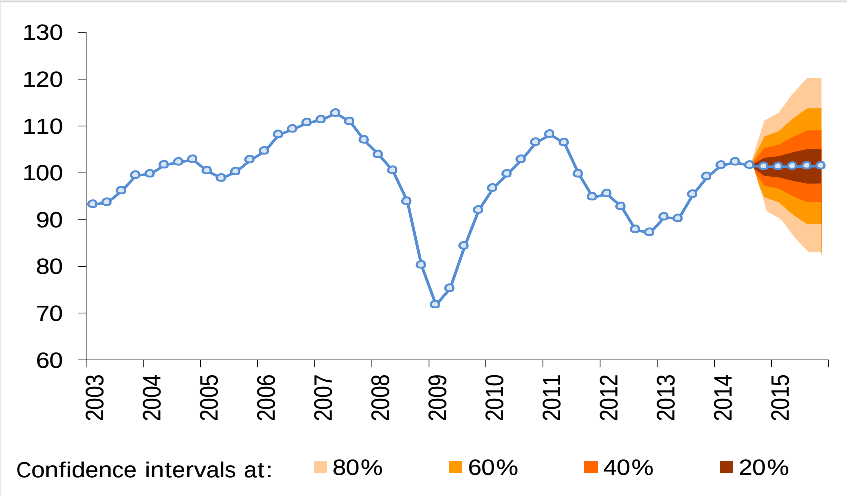


Figure 4 HICP and confidence bands

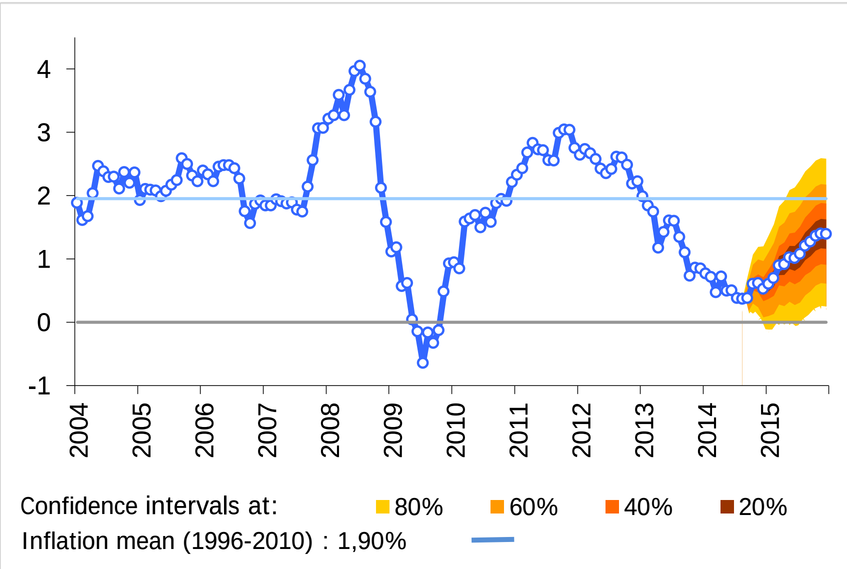


Table 2 Annual average rates for industrial production in the euro area

	2010	2011	2012	2013	2014	2015
Durable	2.7	0.7	-4.9	-3.5	0.4	-1.5
Non Durable	2.9	1.0	-2.1	-0.1	3.5	2.5
Capital	9.0	8.5	-1.1	-0.5	2.4	1.9
Intermediate	10.0	4.1	-4.5	-1.0	1.5	0.2
Energy	3.9	-4.5	-0.4	-1.1	-5.3	-0.1
Total	7.3	3.4	-2.5	-0.7	1.2	1.3

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.

While the numbers of the more recent forecasts on GDP are quite similar, the EFN stands out in that it predicts only weak growth of private consumption in 2015, because an important determinant of private consumption is, according to our forecast, potential output, that has grown very slowly recently.

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	0.9	1.3	1.2	1.7	1.2	1.5	0.9	1.6	1.4	1.8	0.9	1.4
Priv. Consumption	0.6	0.6	0.8	1.3	0.6	1.0	0.7	1.4	0.9	1.4	0.7	1.2
Gov. Consumption	0.7	0.4	0.7	0.5	0.3	-0.2	0.7	0.4	0.4	0.1	0.6	0.5
Fixed Capital Form.	1.6	2.8	2.3	4.2	2.2	2.6	1.1	3.1	2.4	3.7	1.4	2.5
Unemployment rate	11.5	11.4	11.8	11.4	11.9	11.6	11.6	11.2	11.7	11.4	11.7	11.4
HICP	0.5	1.1	0.8	1.2	0.9	1.2	0.6	1.1	0.7	1.1	0.6	1.1
IP	1.2	1.3	na	na	na	na	na	na	na	na	1.4	2.5

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

*According to the IMF World Economic Outlook Update, July 2014, forecasts for GDP growth are 1.1 for 2014 and 1.5 for 2015.

** According to the OECD Economic Outlook Update, September 2014, forecasts for GDP growth are 0.8 for 2014 and 1.1 for 2015.

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 forecast 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. Oil prices are assumed to stop falling. 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	2.2	2.1	3.1
US Consumer Price Inflation	1.5	1.9	2.0
US Short Term Interest Rate (December)	0.1	0.0	0.7
US Long Term Interest Rate (December)	2.9	2.8	3.5
Japan GDP Growth Rate	1.5	1.2	1.3
Japan Consumer Price Inflation	0.4	2.8	1.8
Japan Short Term Interest Rate (December)	0.1	0.2	0.3
Japan Long Term Interest Rate (December)	0.7	0.6	0.9
World Trade Growth Rate	2.8	3.5	4.6
USD/Euro Exchange Rate (December)	111	100	102
100Yen/Euro Exchange Rate (December)	1.37	1.30	1.30

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.