EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2015 and 2016

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

- At the beginning of the year 2015 crude oil is, with little more than 50 dollars per barrel (Brent), about 50% cheaper than in the summer 2014. The oil price hike is a stimulus for the whole world economy, even though the gains of energy users are matched by losses of the suppliers: oil producing countries frequently run high current account surpluses vis-à-vis the rest of the world. It is therefore plausible to assume that, reacting to the redistribution of incomes, the oil user countries will increase their spending by more than what will be lost in spending by producers.
- Investment activity in the euro area has recently been particularly weak. Remarkably, investment in Greece, Portugal, and Spain, i.e. in countries that had to accept international support during the euro crisis, has strengthened. The setback took place in the so-called core countries, including Germany. Consumption growth was also subdued. Lower oil prices, by increasing real incomes of consumers and lowering production costs for firms, should increase private consumption and, in particular, investment. Moreover, the depreciation of the euro will favour exports.
- Overall, according to our forecasts, the euro area GDP will grow by 1.3% in 2015 and by 1.6% in 2016. GDP growth is about 0.3 percentage points higher due to the impact of lower oil prices in 2015. However, these forecasts are subject to substantial uncertainty, and we do not see any significant reduction of the unemployment rate during the forecasting horizon.
- Our inflation forecast for 2015 is 0.3%, with the possibility of a mild deflation not excluded. In 2016 inflation will increase up to 1.1%, still clearly below the 2% ECB’s target. This calls for further monetary expansion, though its effects could be limited in the absence of a complementary fiscal stimulus.
- The expansionary cyclical policies should be combined with more structural reforms to enhance the competitiveness of the euro area and its growth potential, which in our forecasts remains quite limited. In fact, we expect potential output to grow by only 0.4% both in 2015 and 2016.

Table 1 Economic outlook for the Euro area

	2012	2013	2014	2015: 1st half		2015: annual		2016: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	-0.7	-0.5	0.8	1.5	0.5 2.5	1.3	0.5 2.1	1.6	0.6 2.6
Potential Output	0.2	0.1	0.4	0.6	-0.4 1.6	0.4	0.0 0.7	0.4	0.0 0.8
Private Consumption	-0.7	-0.4	0.8	0.6	0.0 1.2	0.8	-0.1 1.6	0.7	-0.3 1.7
Government Consumption	0.0	0.0	0.9	0.4	-0.3 1.1	0.6	0.0 1.1	0.4	-0.3 1.0
Fixed Capital Formation	-3.4	-2.4	0.7	1.8	-1.7 5.2	1.0	-1.9 4.0	3.0	-0.4 6.3
Exports	2.4	2.0	3.8	6.1	4.3 7.9	5.9	4.4 7.4	6.3	4.7 7.9
Imports	-1.1	1.2	3.9	6.3	3.8 8.9	6.4	4.2 8.6	6.1	3.8 8.4
Unemployment Rate	11.3	12.0	11.6	11.1	10.5 11.7	11.1	10.6 11.7	10.9	10.1 11.7
Labour Cost Index	2.4	1.2	1.2	2.2	1.6 2.9	1.9	1.4 2.5	2.6	1.8 3.4
Labour Productivity	-0.2	0.3	0.5	1.2	0.4 2.0	0.9	0.2 1.5	1.3	0.5 2.0
HICP	2.5	1.4	0.4	0.2	0.1 0.4	0.3	-0.3 0.9	1.1	0.1 2.1
IPI	-2.5	-0.6	0.6	0.5	-1.0 2.0	0.9	-1.1 2.9	1.5	1.2 4.2

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 2015 and 2016

The world economy: oil price crash adds to regional divergences

At the beginning of 2015, the main economic regions continue to diverge: the USA and Britain are in an upswing, whereas production in the euro area is only little more than stagnating, and in Japan production has been decreasing for the past two quarters. In China growth dynamics continue to slow down. The Russian economy is at the brink of a financial crisis: the currency has, during the second half of 2014, lost almost 40% of its value relative to the dollar, as confidence erodes due to economic sanctions related to the Ukrainian conflict and, even more importantly, due to the precipitous fall of oil prices since summer 2014.

In early January crude oil is, with little more than 50 dollars per barrel (Brent), about 50% cheaper than in the summer. The main causes are twofold: first, slowing growth in emerging markets dampens demand for oil, because production in emerging economies frequently is highly energy-intensive. Second, supply has expanded by much recently, driven in particular by unconventional oil and gas extraction in the USA. Saudi-Arabia, the decisive swing-producer on world oil markets, has decided not to stabilize the price by reducing its own supply. The motivation is as follows: with a low price, US producers will stop expanding supply from unconventional sources, as it no longer pays off, and the traditional producers will be able to defend their market share. As long as the Saudi government has this objective in mind (and supply is not interrupted for other reasons), oil prices will probably stay markedly lower than during the past four years, when they hovered between 100 and 110 dollars.

Everywhere, much lower oil prices dampen price dynamics significantly. This is one reason why monetary policy in countries with buoyant economies, such as the USA and Britain, will only very slowly become less expansive. In the euro area and in Japan, central banks intend to further apply some forms of quantitative easing to stimulate the weak economies. The Japanese government has announced another, albeit moderate, fiscal program and will abstain from a formerly planned second consumption tax hike in 2015. Since fiscal policy will be neutral or only slightly restrictive in the euro area and the USA, Britain is the only large advanced economy where fiscal consolidation will continue markedly in 2015 and 2016. Policy in some emerging markets such as in Brazil, however, is bound to be restrictive in order to preserve confidence in economic stability. The most notable example is Russia, where the central bank in mid December tried to stabilize the rouble by increasing the key interest rate from 10.5% to 17%. Clearly, a major risk for the world economy is that the oil price fall triggers deep economic crises in producer economies such as Russia that, mainly by way of financial markets, spills over to other economies.

If such grave crises can be avoided, most advanced economies will benefit from low oil prices. This is true even more so for those emerging economies that import most of their energy. Real incomes of consumers will be lifted and production costs for firms will be reduced. There is also a good chance for a stimulus for the whole world economy, even though the gains of energy users appear to be matched by losses of the suppliers: oil producers save a lot of their income; the 18 largest ones had, in 2013, a current account surplus vis-à-vis the rest of the world of almost a quarter of their GDP. It is therefore plausible to assume that, as the price fall distributes income from oil producers to users, the latter ones will increase their spending by more than what will be lost in spending by producers. Thus, chances are good that the speed of growth in the world economy, having been at about average level in 2014, will be a bit higher in 2015 and 2016.

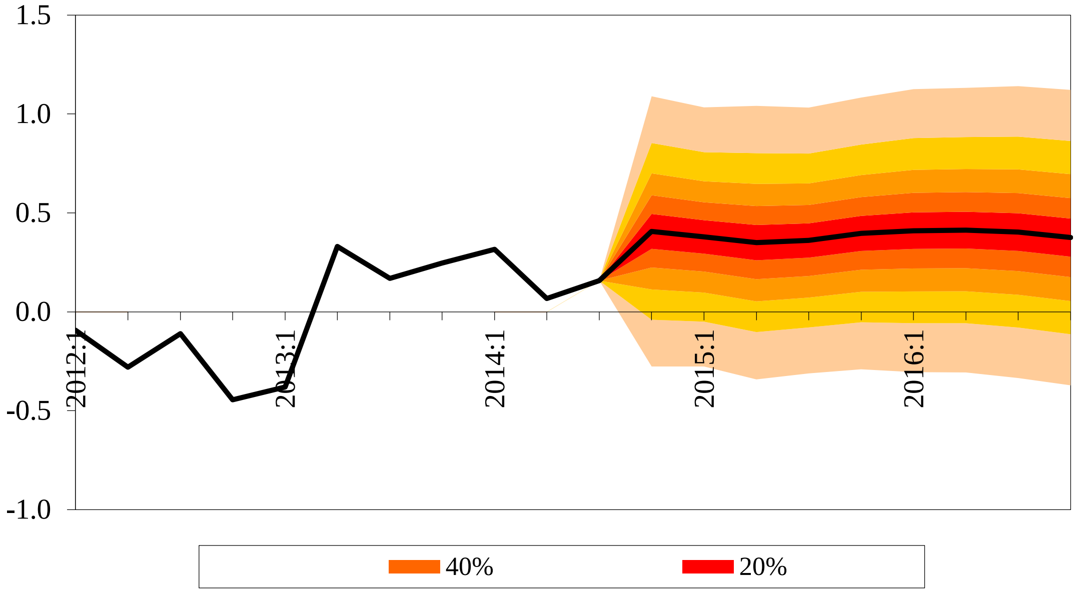
The euro area economy: a difficult recovery

A clear indication for a marked recovery in the euro area is still missing. Production expanded by about 0.5% (annualized) during the two mid-year quarters. Particularly weak was investment activity, with gross fixed capital accumulation shrinking by 1.7% (again annualized). Remarkably, investment in Greece, Portugal, and Spain, i.e. in countries that had to accept international support during the euro crisis, has strengthened, and the setback took place in the so-called core countries, including Germany. In contrast, exports, growing by more than 4%, performed reasonably well, while private consumption expanded by about 1 ½%.

Particularly worrying is the situation in Italy. The potential for production has, according to estimates of the European Commission, been decreasing since the Great Recession in 2009, and the capital stock (gross fixed assets excluding housing) has been shrinking since 2012. The unemployment rate has started increasing again in the summer, and is now well above 13%.

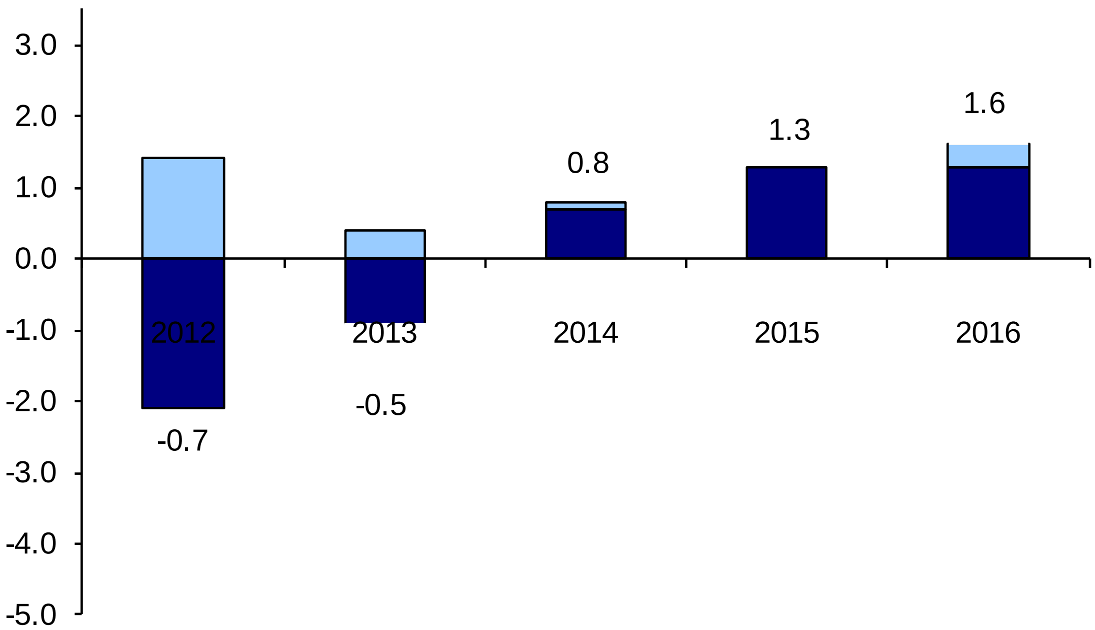
The labour market in the euro area as whole has stabilized: employment and the number of hours worked have been slowly increasing for more than a year, and the unemployment rate fell to 11.5%. Since August, however, the rate has stopped decreasing, and expectations for a significant recovery have been disappointed. This is one cause why the policy of consolidating public households has come to an end in most countries. The new Commission’s investment program is, however, not a decisive turn to expansive fiscal policy, since overall public expenditure will barely rise. The short run effects of the program will probably be minor.

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

The economy still appears sluggish during this winter. Confidence indicators (see Figure 3) and order books have little moved during the past months. For the whole year a strong recovery is not in sight, because it is still unclear whether structural reforms in important member countries will be realized. In addition, firms and, in particular, private households can only slowly reduce their debt burdens, and banks will not stop trying to strengthen their capital in 2015. Two external factors, however, will give a sizable stimulus to the economy: the real effective exchange rate of the euro is nearly 10% lower than in spring 2014 and at a level below its long run mean, strengthening the international competitiveness of euro area firms. Even more important is the fall of the oil price by more than 40% (calculated in euros) since summer 2014. As mentioned above, real incomes of consumers will be lifted and production costs for firms will be reduced. According to the simulations carried out with the EFN model, GDP growth will be 0.3 percentage points higher due to an oil price of 53 dollars instead of 108 dollars in 2015.

All in all, the euro area economy will, according to our forecast, grow by 1.3% in 2015 and by 1.6% in 2016, with a rather stable performance across the quarters (see Figure 1) and most of the growth coming from domestic demand (see Figure 2).

Figure 3 Economic Sentiment Indicator and confidence bands

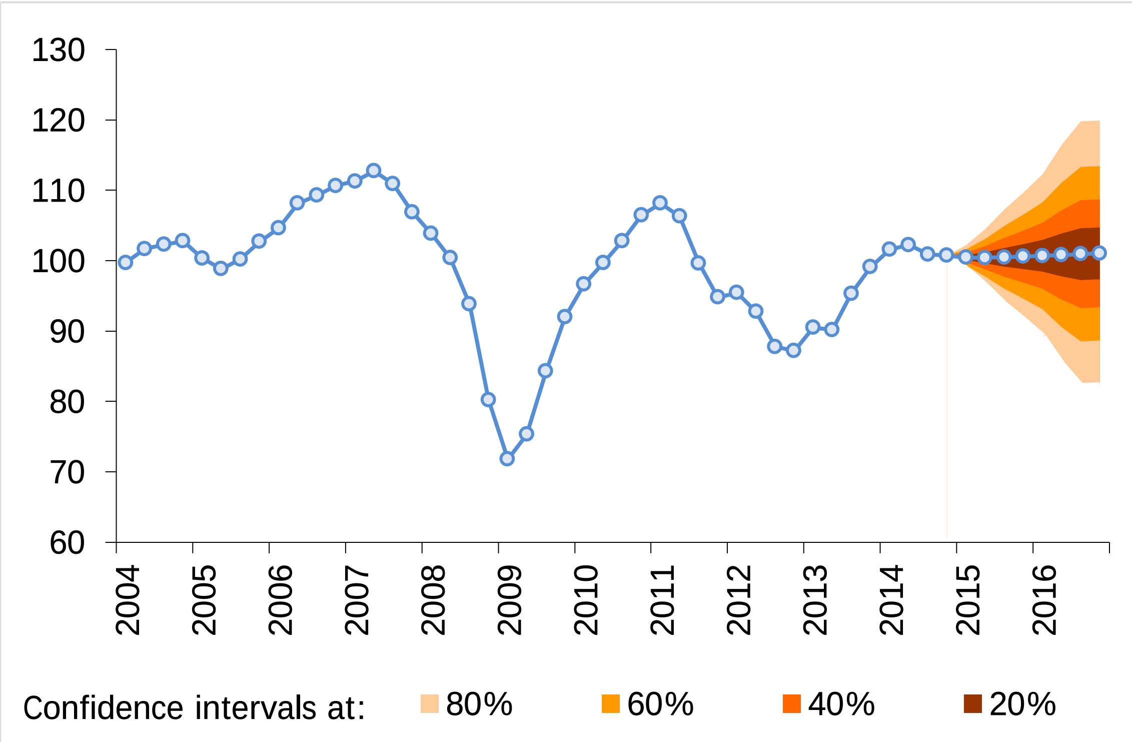
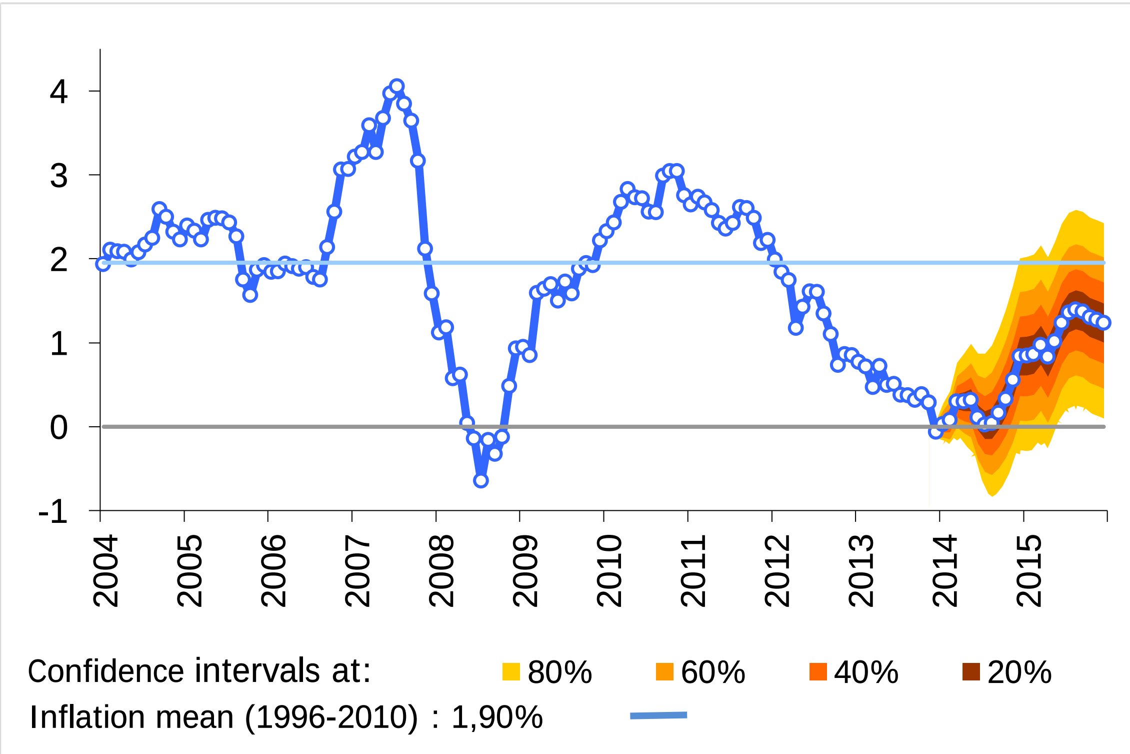


Table 2 Annual average rates for industrial production in the euro area

	2011	2012	2013	2014	2015	2016
Durable	0.7	-4.9	-3.5	-1.2	-2.8	-1.2
Non Durable	1.0	-2.1	-0.1	3.1	2.2	2.5
Capital	8.5	-1.1	-0.5	1.6	1.5	2.7
Intermediate	4.1	-4.5	-1.0	1.1	-0.4	0.6
Energy	-4.5	-0.4	-1.1	-5.4	0.0	0.8
Total	3.4	-2.5	-0.7	0.6	0.9	1.5

Figure 4 HICP and confidence bands



Industrial production with also expand, by about 0.9% in 2015 and 1.5% in 2016, with the largest contributions coming from non-durable and capital goods (see Table 2).

Finally, our inflation forecast for 2015 is 0.3%, with the possibility of a mild deflation not excluded (see Figure 4). In 2016 inflation will increase up to 1.1%, still clearly below the 2% ECB's target. This calls for further monetary expansion, though its effects could be limited in the absence of a complementary fiscal stimulus.

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.

The EFN forecast is relatively optimistic for 2015, because we think that the steep fall in the oil price and the weaker euro will stimulate the otherwise sluggish economy. Aggregates of final demand grow mostly a bit slower than those of other forecasts; this is compensated by a buildup of inventories that currently stay at very low levels.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
GDP	1.3	1.6	1.1	1.7	1.3	na	1.0	1.5	1.1	1.7	1.1	na
Priv. Consumption	0.8	0.7	1.1	1.4	1.2	na	1.3	1.2	1.0	1.3	1.2	na
Gov. Consumption	0.5	0.4	0.3	0.8	0.2	na	0.4	0.4	0.4	0.6	0.6	na
Fixed Capital Form.	1.0	3.0	1.7	3.9	2.0	na	1.4	3.2	1.2	3.1	1.3	na
Unemployment rate	11.1	10.9	11.3	10.8	11.2	na	11.2	10.9	11.1	10.8	11.3	na
HICP	0.3	1.1	0.8	1.5	0.9	na	0.7	1.3	0.6	1.0	0.6	na
IP	0.9	1.5	na	na	na	na	na	na	na	na	1.4	na

EU: European Commission, Economic Forecast, November 2014; IMF: World Economic Outlook, October 2014; ECB: ECB Monthly Bulletin, December 2014, OECD: Economic Outlook, November 2014; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2014. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

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. We assume that the oil price will, after its steep fall at the end of 2014, rise in 2015 and 2016, but only very slowly. Growth in world trade accelerates, but stays below the trend of the past 20 years or so. The exchange rates of the dollar and the yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2014	2015	2016
US GDP Growth Rate	2.3	3.0	2.8
US Consumer Price Inflation	1.7	1.3	1.9
US Short Term Interest Rate (December)	0.1	1.0	1.8
US Long Term Interest Rate (December)	2.3	2.7	3.8
Japan GDP Growth Rate	0.3	1.2	1.0
Japan Consumer Price Inflation	2.8	1.4	1.5
Japan Short Term Interest Rate (December)	0.2	0.2	0.4
Japan Long Term Interest Rate (December)	0.4	0.6	0.8
World Trade Growth Rate	3.4	4.6	4.6
Oil Price (December)	70	53	57
USD/Euro Exchange Rate (December)	1.25	1.25	1.25
100Yen/Euro Exchange Rate (December)	1.43	1.43	1.43

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 (2014). 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.