EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2015 and 2016

European Forecasting Network

Spring 2015

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

- Recent movements on world markets for commodities, currencies and capital stimulate the world economy, but they entail also considerable risks: income losses of energy exporting countries might trigger financial crises with worldwide repercussions; crises might also emerge from financial distress of emerging market debtors with liabilities denominated in US dollars. Extremely low interest rates might not only trigger stock and bond price booms, but also more volatility if investors become fearful of financial bubbles.
- Quite a few conditions are highly beneficial for a recovery of the euro area economy: governments and large corporations benefit from ultra-low bond yields, banks' composite costs of debt financing have been converging during the past two years to very low levels, and borrowing costs for non-financial corporations have come down markedly. Prices for stocks, bonds and (on average) houses have gone up. Real disposable incomes of private households have risen due to oil prices. The real effective exchange rate is about 10% lower in March 2015 than it was a year ago, strengthening the price competitiveness of firms in the euro area.
- According to our forecasts, the euro area GDP will grow by 1.6% in 2015 and by 2.1% in 2016. Structural impediments, however, still limit the ability of the euro area economy to grow strongly: firms and, in particular, private households are only slowly reducing their heavy debt burdens, and confidence will not fully come back in France and Italy, as long as reform processes are inconclusive in both countries and as long as unemployment is not coming down markedly.
- Our inflation forecast for 2015 is 0.1%, with the possibility of a mild deflation not excluded. In 2016 inflation will increase up to 1.3%, still clearly below the 2% ECB's target. This calls for continued monetary expansion, though its effects could be limited in the absence of a complementary fiscal stimulus, in particular in those countries where the implementation of structural reforms brings long term gains but short term losses.

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	-0.8	-0.5	0.9	2.0	1.2 2.8	1.6	1.0 2.2	2.1	1.3 2.9
Potential Output	-0.2	-0.2	0.9	0.8	0.4 1.2	1.0	0.6 1.3	0.7	0.3 1.1
Private Consumption	-1.3	-0.7	1.0	1.5	0.6 2.4	1.6	0.9 2.3	1.2	0.4 2.1
Government Consumption	-0.0	0.3	0.7	0.6	0.0 1.2	0.6	0.2 1.1	0.6	0.0 1.2
Fixed Capital Formation	-3.7	-2.5	1.0	3.4	0.8 6.1	2.4	0.4 4.5	4.4	1.2 7.6
Exports	2.4	2.0	3.7	6.6	5.0 8.3	6.0	4.8 7.3	7.7	6.1 9.3
Imports	-1.1	1.2	3.8	6.5	4.1 8.9	6.0	4.2 7.7	7.6	5.3 10.0
Unemployment Rate	11.3	12.0	11.6	11.0	10.5 11.5	11.1	10.8 11.5	10.6	9.9 11.3
Labour Cost Index	2.4	1.2	1.1	1.7	1.1 2.3	1.5	1.0 1.9	2.5	1.7 3.2
Labour Productivity	-0.2	0.3	0.3	1.5	0.8 2.2	1.0	0.4 1.6	1.6	0.9 2.2
HICP	2.5	1.4	0.4	0.1	0.0 0.2	0.1	-0.4 0.6	1.3	0.3 2.3
IPI	-2.4	-0.7	0.7	1.8	0.2 3.4	2.1	0.1 4.1	1.6	-1.1 4.3

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

Low oil prices and a strong dollar: both boon and peril for the global economy

Cyclical positions of the major advanced economies have been differing widely for some time now; during past winter, these differences somewhat decreased: the upswings in the US and Britain slowed down a bit, while the recovery in the euro area appears to be strengthening, and production in Japan, after contracting during summer 2014, started growing again. Growth in the emerging economies slowed a bit due to the downswing of the housing sector in China and shrinking production in Russia.

The Russian downswing is much more a consequence of the oil price fall than of the economic sanctions by the US and the EU. With about 55 US dollars per barrel (Brent) at the end of March, oil is now half as cheap as in summer 2014. Cheaper energy causes inflation rates decreasing in advanced economies to levels below 1% or even (such as in the euro area) into negative territory. In China, consumer price inflation is no higher than about 1.5%. Other consequences of the oil price fall are depreciating currencies of oil producing economies so diverse as Norway, Nigeria, and, above all, Russia, with the Ruble gone down almost as precipitously as the oil price.

Since the oil price is denominated in US dollars, the price fall might partly be explained by the strong appreciation of the dollar (and currencies, such as the Renminbi, pegged to it) relative to most currencies such as the British pound, the yen, and in particular relative to the euro (from about 1.35 US-Dollar during last summer to about 1.10 at the end of march). The backdrop is a US economy that looks robust compared to many other economies, and in particular to the euro area. While key interest rates in both economies are basically nil, the Fed is expected to start raising the federal funds rate this year, while the ECB just started its version of quantitative easing. Expectations of key interest rates in the euro area staying basically zero or even negative for a long time have led to negative yields for a wide range of euro area government bonds with top rating. More generally, yields at or close to record lows push up stock prices in many advanced economies.

All in all, conditions in 2015 are quite favourable for most advanced economies: financing costs are low, while fiscal policies are close to neutral everywhere outside the UK; real disposable incomes of private households are rising, and production costs go down, both due to lower energy costs. In addition, weaker economies get support from the appreciation of the dollar. The strong movements on world markets for commodities, currencies and capital, however, entail risks of their own: income losses of energy exporting countries such as Russia might trigger financial crises with worldwide repercussions; crises might also emerge from financial distress of emerging market debtors with liabilities denominated in US dollars and assets or revenues in domestic currencies. Extremely low interest rates might not only trigger stock and bond price booms, but also more volatility if investors become fearful of financial bubbles. The euro area faces the special risk of the reform process in Greece collapsing. An exit of the country from the currency union, while certainly pushing Greece back into crisis, would probably not be disastrous for the remaining partners in the short term, but might entail a considerable loss of confidence in the future of the common currency. And the situation in Ukraine remains worrying.

The euro area economy: a strengthening recovery

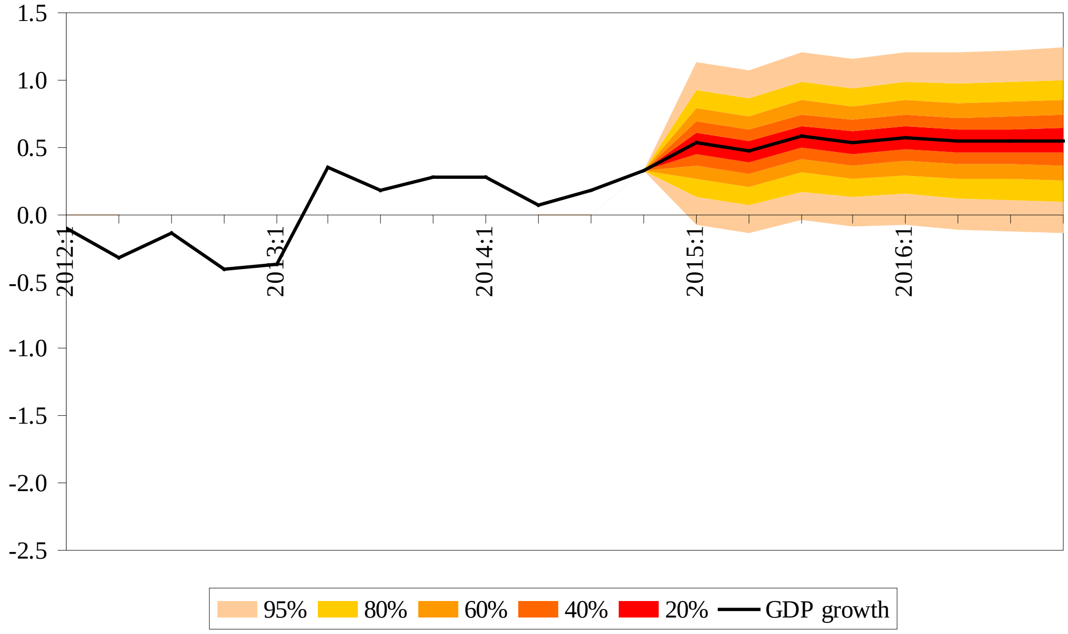
At present a couple of signs point to a strengthening recovery in the euro area. At the end of 2014, production grew, with 0.3%, somewhat faster than in previous quarters. Consumption of private households and fixed capital formation expanded even a bit faster than GDP. Momentum came mainly from Germany, where production had stagnated during summer, Spain and Portugal, as well as the Netherlands, while production in France and Italy barely moved: slightly upwards in the former and a bit downwards in the latter country.

The expansion in euro area output was matched by about equal employment growth, if measured by the number of employees. The number of hours worked, however, rose markedly faster, by 0.6%. Hours have been slowly accelerating for 2 years now. The recovery in employment has apparently continued at the beginning of 2015. The rate of unemployment fell in January to 11.2%, which is 0.6 percentage points lower than 12 months before. Looking at labour markets in different member countries, the picture is similar to that for production growth, but not exactly so: unemployment in Italy has decreased a bit recently, and hours worked went up a little, while both are basically constant for France. This finding corresponds to the fact that retail sales have accelerated recently in all larger economies including Italy, but with the exception of France.

France is also the only large economy where fiscal policy is – albeit mildly – restrictive, while the fiscal stance in the rest of the euro area is all in all neutral; in Germany it is even expansive. Monetary conditions should support growth in the whole area. The diverse unconventional measures of the ECB have certainly helped improving financial conditions a lot: governments and large corporations benefit from ultra-low bond yields, banks' composite costs of debt financing have been converging during the past two years in all large economies to very low levels, banks' balance sheets have stopped declining in 2014, and borrowing costs for non-financial corporations have come down markedly this year – although differences between countries are still large. Asset prices have been rising; prices for stocks in particular, but, at least on average, for houses as well. Finally, the euro area economy should benefit from two strong exogenous stimuli: first, real disposable incomes of private households have risen and production costs of firms have come down due to oil prices that are, measured in euros, about 40% lower in the first quarter 2015 than a year ago, in spite of the depreciation of the currency; second, the real effective exchange rate is about 10% lower in March 2015 than it was a year ago, strengthening the price competitiveness of firms in the euro area. All in all, quite a few conditions are highly beneficial for a recovery of the euro area economy. If growth will, according to this forecast, be no higher than 1.6% in 2015 and 2.1% in 2016, it is because structural impediments still limit the ability of the euro area economy to grow strongly: firms and, in particular, private households are only slowly reducing their heavy debt burdens, and confidence will not fully come back in France and Italy, as long as reform processes are inconclusive in both countries. The Greek example, indeed, shows that such processes might even be reversed. Finally, the unemployment rate remains well above 11% in the area, with peaks in the southern countries.

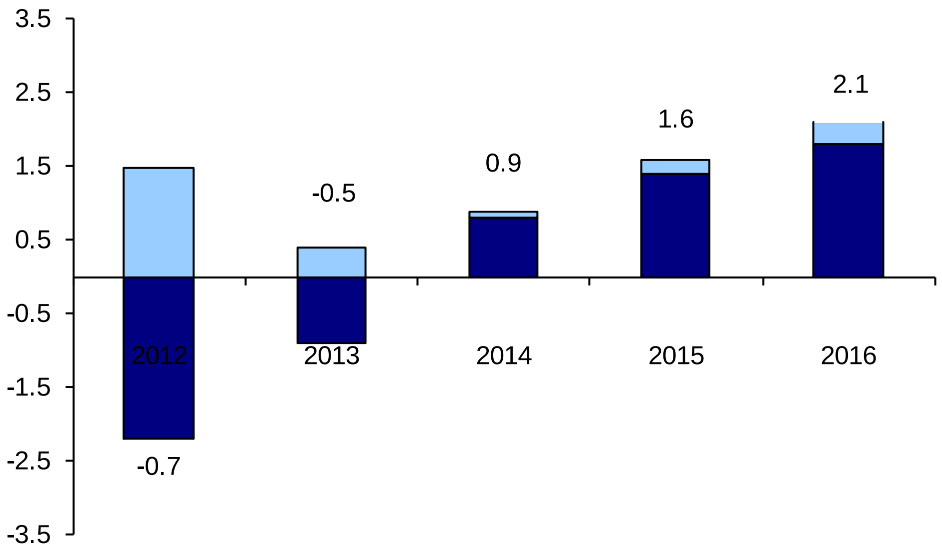
As for inflation, since January expectations have increased mildly. Average annual inflation for 2015 is currently forecasted at 0.1% (±0.49). For 2016 it is expected to rise, albeit only to 1.3% (±0.97). The main factor that is contributing to the increase in inflation is the partial recovery in fuel prices observed during last two months.

Figure 1 Quarterly GDP growth rates and confidence bands



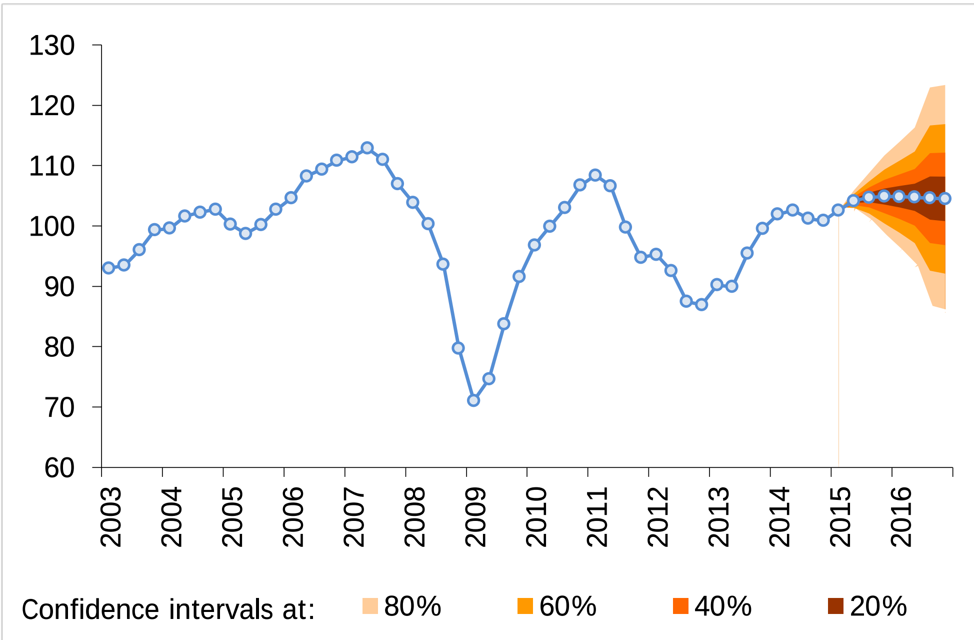
Percentage change over previous quarter

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



At this time, the likelihood of average inflation ending 2015 at less than zero is 43.4%. Only at the end of 2016 there is 40% or more likelihood of seeing inflation figures of more than 1.5%. These inflation forecasts, and the evolution of credit and monetary supply, provide coverage for the QE undertaken by the ECB.

Figure 4 HICP and confidence bands

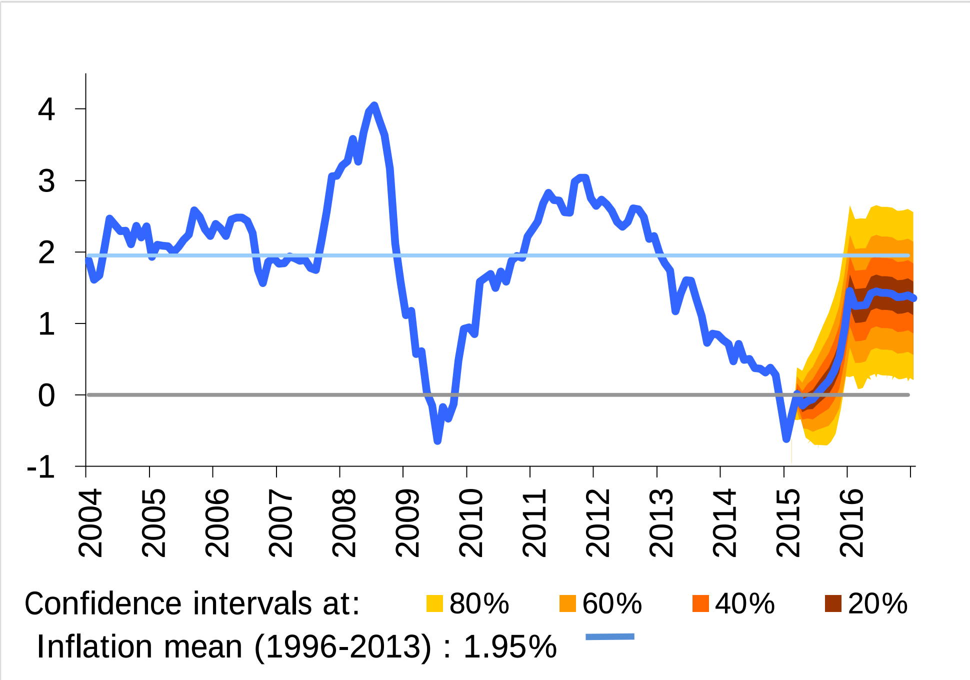


Table 2 Annual average rates for industrial production in the euro area

	2011	2012	2013	2014	2015	2016
Durable	0.8	-4.7	-3.2	-0.8	1.0	0.9
Non Durable	0.9	-2.2	0.0	3.1	2.0	2.3
Capital	8.4	-1.1	-0.5	1.7	2.9	2.8
Intermediate	4.2	-4.5	-1.0	1.1	1.3	1.0
Energy	-4.4	-0.2	-0.7	-5.6	0.8	-1.0
Total	3.5	-2.5	-0.7	0.7	2.1	1.6

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, because we think that the steep fall in the oil price and the weaker euro will stimulate the otherwise sluggish economy. In 2016, growth accelerates according to the EFN forecast in spite of slower growth in private consumption, because firms will invest more in fixed capital and rebuild 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	1.6	2.1	1.3	1.9	1.3	na	1.5	1.9	1.1	1.7	1.4	1.7
Priv. Consumption	1.6	1.2	1.6	1.6	1.2	na	1.8	1.6	1.0	1.3	1.6	1.4
Gov. Consumption	0.6	0.6	0.4	0.9	0.2	na	1.0	0.6	0.4	0.6	0.7	0.7
Fixed Capital Form.	2.4	4.4	2.0	4.4	2.0	na	1.7	4.1	1.2	3.1	1.5	2.7
Unemployment rate	11.1	10.6	11.2	10.6	11.2	na	11.1	10.5	11.1	10.8	11.2	10.8
HICP	0.1	1.3	-0.1	1.3	0.9	na	0.0	1.5	0.6	1.0	0.0	1.2
IP	2.1	1.6	na	na	na	na	na	na	na	na	1.3	2.3

EU: European Commission, Economic Forecast, February 2015; IMF: World Economic Outlook, October 2014; ECB: ECB Economic Bulletin, March 2015, OECD: Economic Outlook, November 2014; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2014. ECB figures correspond to their macroeconomic projections.

* Euro area GDP growth will, according to the IMF WEO update of January 2015, be 1.2% in 2015 and 1.4% in 2016.

** Euro area GDP growth will, according to the interim assessment of the OECD of March 2015, be 1.4% in 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. We assume that the oil price will, after its steep fall at the end of 2014, rise in 2015 and 2016, but only slowly. Growth in world trade accelerates a bit, 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 constant from March 2015 onward.

Table 4 Variables of the world economy

	2014	2015	2016
US GDP Growth Rate	2.4	3.1	2.9
US Consumer Price Inflation	1.6	0.3	2.1
US Short Term Interest Rate (December)	0.03	0.8	1.8
US Long Term Interest Rate (December)	2.2	2.7	3.8
Japan GDP Growth Rate	-0.1	1.1	1.7
Japan Consumer Price Inflation	2.7	0.7	1.1
Japan Short Term Interest Rate (December)	0.1	0.2	0.3
Japan Long Term Interest Rate (December)	0.5	0.6	0.8
World Trade Growth Rate	3.5	4.5	4.5
Oil Price (December)	63	62	67
USD/Euro Exchange Rate (December)	1.21	1.10	1.10
100Yen/Euro Exchange Rate (December)	1.43	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 (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.