EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2011 and 2012

Summer 2011

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.

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Highlights

- The worldwide upswing has lost momentum, but it will overcome the present slowdown. Monetary policy is overall still accommodative, and growth dynamics continue to be high in emerging market countries.
- For the euro area, we expect GDP to grow by around 1.9% in 2011 and 1.7% in 2012, not enough to bring the unemployment rate back significantly below 10%. In fact, in a large core region of the euro area the upswing is well under way; this region includes, apart from Germany and some smaller economies, France, Belgium and the Netherlands. However, the crisis of confidence in the ability of EU institutions to master the fiscal crises is a major threat to the continuation of the upswing.
- Our industrial production growth forecast remains stable at 3.6% for 2012, while the slight upwards revision for this year, up to 5.8%, is due to the expected improvement in investment dynamics this year that compensates the downwards revision of our external demand forecast.
- In a context of energy prices moderation, the upwards revision of our core inflation expectations is responsible for the increase in our total HICP inflation forecasts for 2011 and 2012, up to 2.7% and 1.7% respectively. However, we still believe that the reduction in the expansive stance of monetary policy will be slow, due to the potential damaging effects that an all too rapid monetary policy normalization might have on exports, industrial production and growth.

Table 1 Economic outlook for the Euro area

	2008	2009	2010	2011: 1st half		2011: annual		2012: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	0.3	-4.1	1.7	2.1	1.9 2.3	1.9	0.5 2.3	1.7	0.9 2.5
Potential Output	1.4	0.7	0.5	0.6	0.5 0.7	0.7	0.6 0.8	1.0	0.8 1.2
Private Consumption	0.3	-1.2	0.8	1.0	0.8 1.2	1.0	0.6 1.4	1.2	0.4 2.0
Government Consumption*	2.2	2.4	0.5	0.9		0.7		0.4	
Fixed Capital Formation	-0.8	-11.8	-11.1	3.5	2.9 4.1	4.2	3.0 5.4	4.5	2.2 6.8
Exports	0.9	-13.1	11.2	8.2	7.7 8.7	7.4	6.5 8.2	6.8	5.5 8.1
Imports	0.8	-11.8	9.5	7.3	6.8 7.8	7.0	6.0 7.9	6.9	5.4 8.4
Unemployment Rate	7.6	9.5	10.1	10.0	9.9 10.1	9.9	9.8 10.1	9.8	9.4 10.3
Total hourly labour costs	3.6	2.8	1.5	2.5	2.4 2.6	2.8	2.5 3.0	2.6	2.2 3.0
Labour Productivity (output per head)	-0.5	-2.3	2.1	2.0	1.8 2.1	1.8	1.6 2.1	1.6	1.1 2.1
HICP	3.3	0.3	1.6	2.6	2.4 2.8	2.7	2.4 3.0	1.7	0.7 2.6
IPI	-1.6	-14.8	7.4	6.1	4.6 7.6	5.8	4.0 7.6	3.6	1.2 6.0

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 the EFN forecasting model and based on 2000 stochastic simulations.

*Since the winter report 2010, we depart from our usual approach of deriving government consumption endogenously in the EFN econometric model. 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 2011 and 2012

The world economy: a soft patch

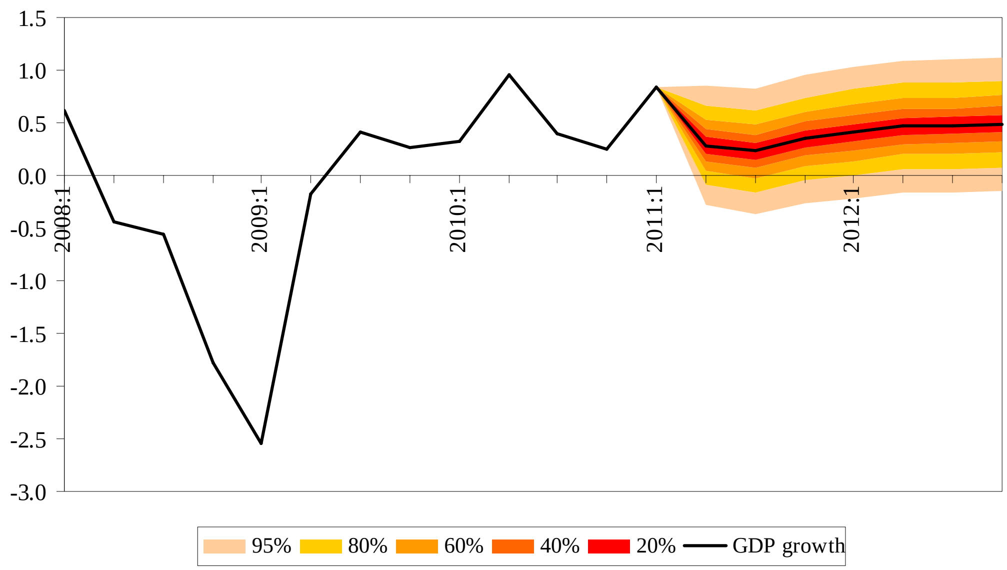
In early summer of 2011, the upswing of the world economy has temporarily stalled. The strong rebound of production in the second half of 2010 was already slowing early this year, but during springtime world industrial production was falling, and world merchandize trade tumbled in April by more than 2%. The natural and nuclear disaster in Japan (on March 11th) is more damaging for the world economy than most experts at first anticipated: in Japan itself, confidence is shaken by the fact that containing the nuclear radiation at Fukushima turns out to be a long term challenge, and energy supply has become a bottleneck factor for production for some time to come. The drag on production outside Japan comes from broken trade supply chains, in particular in motor industries in emerging Asia and in the US. Still, the disaster will, in all probability, not impair the world economy as a whole for more than some months during this summer. Medium term expectations, however, have diminished as well around the globe: sentiment indicators have been sliding everywhere, as well as (since May) prices on world stock markets and yields for top-rated bonds. A major reason for this is the retreat of expansive economic policies. The turnaround was partly made some time ago (China) or more recently (euro area), or it is expected to start soon but slowly (the end of quantitative easing in the US). If the cooling down of buoyant markets eases inflationary pressures in Asia and Latin America, it could indeed improve the medium term prospects of these economies. But things look completely different in the US: here the housing sector is still in deep crisis, with house prices steadily falling since last summer, employment dynamics are still weak, and industrial production has lost momentum during springtime. Confidence about the prospects is undermined by political deadlocks about the future path of fiscal consolidation. This point is even truer for the euro area, albeit in a completely different setting: the crisis of confidence in the ability of EU institutions to master the fiscal crises appears to be a major threat to the continuation of the upswing.

This report, however, is built on the assumption that politics will not become a destabilizing factor for the rest of this year and in 2012. Under this assumption, we forecast a modest continuation of the worldwide upswing. Monetary policy is, despite small restrictive steps by many central banks, overall still very accommodative, and growth dynamics continue to be high in emerging market countries. The most serious risk, apart from a possible transition of the fiscal crises into financial ones in the euro area and in the US, is the high level and volatility of commodity prices. In particular, although crude oil is now (end of June) at about 108 dollars (Brent) nearly 15% cheaper than in April, this is still a record price except for a brief period in summer 2008, shortly before the start of the Great Recession.

The euro area: upswing in the core

First quarter growth was surprisingly strong in the euro area, with an annualized rate of 3.4%. It was driven by a surge in investment activity. The acceleration can partly be explained by the strong winter in wide geographical areas during the final months of 2010: construction firms tried to make up for the loss of production when weather conditions improved. But investment in equipment picked also markedly up. Consumption of private households and exports have been continuing paces of expansion that are more or less stable since the summer of 2010 and that are compatible with a modest upswing.

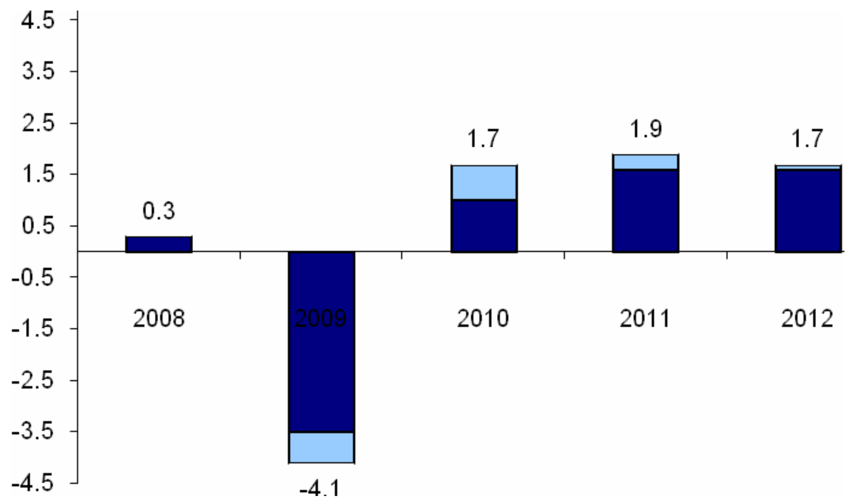
Figure 1 Quarterly euro area GDP growth rates and confidence bands



Percentage change over previous quarter

Of course, growth dynamics still differ by much in the single member countries. However, it is now fair to speak of a large euro area core region where the upswing is well under way: this includes not only Germany with small neighbouring countries, but also France, Belgium and the Netherlands. The south still lags much behind, with Spain and Italy more or less stagnating and Greece and Portugal, together with Ireland, in the grip of recessions that are the result of the grave fiscal crises of these countries. In the euro area as a whole, the strong growth dynamics of industrial production have clearly been slowing during the first half of the year. Confidence of firms is, according to surveys such as those of the European Commission, also waning, although from quite elevated levels. All this conforms to the state of the world economy described in the first section of this report.

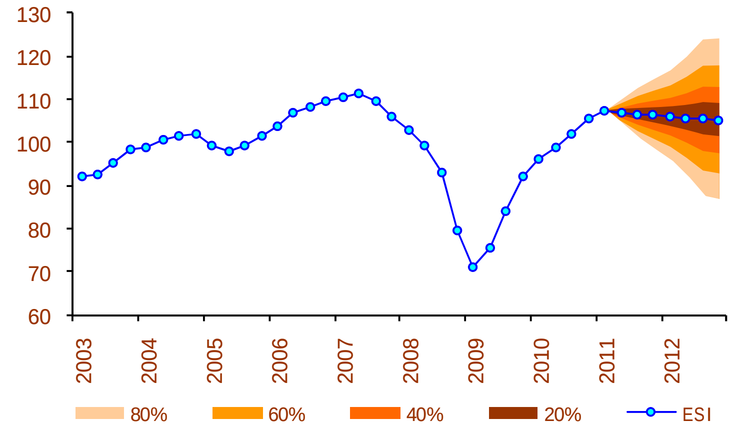
Figure 2 Contributions of domestic components and net exports to GDP growth



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

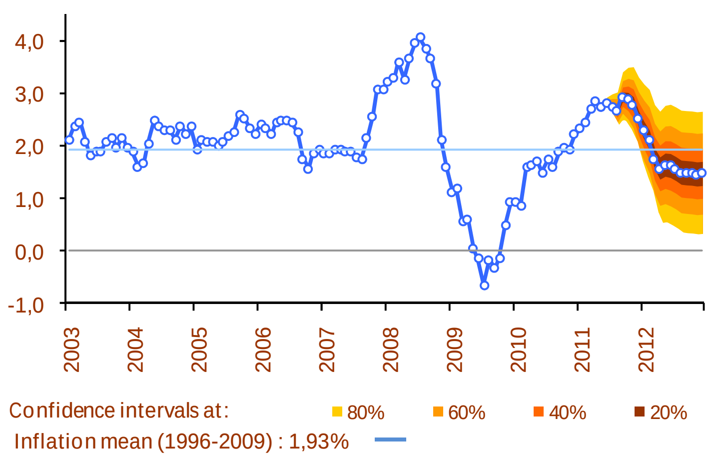
In many respects, the euro area economy appears to be on a long way back from the grave recession to normality: employment is expanding again, but at such a slow pace that the rather high unemployment rate is nearly stable at about 10%. Growth rates of wages and of productivity have been expanding recently at about equal rates; unit labour costs are stable and profits are further improving. Real costs of external financing for firms are still relatively low, but bank credit to nonfinancial corporations has only started growing a bit, since most financial institutions are still only cautiously expanding their loan book and many firms finance their projects internally. All in all, if policy succeeds in containing the fiscal crises of the peripheral member states – admittedly a big if –, chances are good that the upswing will continue in the second half of 2011 and in 2012, but not at too brisk a pace, as fiscal policies will be restrictive in all member countries and the ECB will normalize monetary policy by ending non-standard measures and prudently raising interest rates. Hence, our forecasts for euro area GDP growth are 1.9% for 2011 and 1.7% for 2012. The expected quarter on quarter growth rates are reported in Figure 1, together with measures of forecast uncertainty, while Figure 2 shows that the bulk of future growth will be due to higher domestic demand. Figure 3 presents our expected evolution of the Economic Sentiment Indicator, which should only mildly decline over 2011 and 2012 from the current levels.

Figure 3 Economic Sentiment Indicator and Confidence bands



In a context of energy prices moderation, the upwards revision of our core inflation expectations is responsible for the increase in our total HICP inflation forecasts for 2011 and 2012, up to 2.7% and 1.7% respectively (see figure 4). Besides, our latest forecasts indicate that none of the countries representing more than 1% of the total euro area GDP will reduce their HICP inflation to 2% before December 2011, with the consequence of euro area inflation being above the target level for at least 15 months. However, we still believe that the reduction in the expansive stance of monetary policy will be slow, due to the potential damaging effects that a too quick monetary policy normalization might have on exports, industrial production and growth.

Figure 4 HICP inflation and confidence bands



Year on Year rates

Regarding industrial production, the recent appreciation of the euro could well be behind the poor dynamics of exports and the sluggishness of industry in the most export oriented countries over the last months. This suggests that a further appreciation of the common currency above our baseline scenario could put at risk, more than previously expected, the future short-term dynamics of euro area industrial production. However, the improvement of our investment forecasts compensates the expected deceleration of exports. The increasing importance of investment in the euro area confirms, even more than before, the production of capital and the production of intermediate goods as the main engines of growth for industrial production over the forecasting horizon. Our industrial production growth forecast remains stable at 3.6% for 2012 and increases to 5.8% for 2011, see Table 2.

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

	2006	2007	2008	2009	2010	2011	2012
Durable	4.6	1.3	-5.3	-17.3	2.7	3.5	-0.2
Non Durable	2.5	2.6	-1.3	-2.9	3.4	2.2	1.7
Capital	6.0	6.8	0.1	-20.8	9.5	10.1	8.4
Intermediate	4.8	4.0	-3.4	-19.0	10.1	7.8	2.5
Energy	0.4	-0.7	0.2	-5.3	3.7	-2.9	-0.4
Total	4.2	3.9	-1.6	-14.8	7.4	5.8	3.6

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 quite close to the consensus. However, we predict a more dynamic growth of fixed capital formation. This is based on the assumption that governments manage to consolidate mainly via lower consumption expenditures and avoid drastically cutting public investment in order to preserve the productive capacities of the euro area economy. It should also be born in mind that the countries where open fiscal crises inhibit private investment activities account for only a very small part of the overall euro area economy. In the rest of the area, private investment benefits from low real interest rates.

As for inflation, EFN forecasts are basically in line with those of other institutions, with the exception of IMF's ones, mainly due to their different forecast revision schedule.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF*		ECB		OECD		Consensus	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
GDP	1.9	1.7	1.6	1.8	1.6	1.8	1.9	1.7	2.0	2.0	2.0	1.7
Priv. Consumption	1.0	1.2	0.8	1.2	1.1	1.3	0.9	1.3	0.8	1.4	1.1	1.2
Gov. Consumption	0.7	0.4	0.2	0.3	-0.1	-0.1	0.1	0.2	0.0	-0.1	0.6	0.3
Fixed Capital Form.	4.2	4.5	2.2	3.7	1.9	3.0	3.1	3.5	2.5	3.4	3.0	3.2
Unemployment rate	9.9	9.8	10.0	9.7	9.9	9.6	na	na	9.7	9.3	9.8	9.5
HICP	2.7	1.7	2.6	1.8	2.3	1.7	2.6	1.7	2.6	1.6	2.6	1.9
IP	5.8	3.6	na	na	na	na	na	na	na	na	4.9	3.5

EU: European Commission, Economic Forecast, Spring 2011; IMF: World Economic Outlook, April 2011; ECB: ECB Monthly Bulletin, June 2011, OECD: Economic Outlook, May 2011; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2011. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

*According to the IMF world economic outlook update of June 2011, GDP growth in the Euro area will be 2.0% in 2011and 1.7% in 2012.

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. The prospects for Japan have drastically clouded due to the natural and nuclear disaster, but forecasts for the US are also markedly lower than they were in spring. Still, world trade will expand at healthy rates, but lose some momentum in 2012 when the recovery from the Great Recession has come to an end. Oil prices are expected to rise slowly from the levels they had in June. Exchange rates are assumed to be constant.

Table 4 Variables of the world economy

	2011	2012
US GDP Growth Rate	2.5	3.1
US Consumer Price Inflation	3.0	2.1
US Short Term Interest Rate (December)	0.3	1.0
US Long Term Interest Rate (December)	3.6	4.2
Japan GDP Growth Rate	-0.7	3.2
Japan Consumer Price Inflation	0.3	0.2
Japan Short Term Interest Rate (December)	0.3	0.5
Japan Long Term Interest Rate (December)	1.4	1.6
World Trade Growth Rate	8.2	6.5
Oil Price (December)	112	118
USD/Euro Exchange Rate (December)	1.46	1.46
100Yen/Euro Exchange Rate (December)	1.15	1.15

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 (2011). 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.