EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2009 and 2010

Summer 2009

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://efn.eui.eu* .

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Highlights

- The euro area is experiencing an unprecedented drop in economic activity in the first semester of 2009. Private consumption is expected to decrease by more than 1% compared with the same period a year earlier, investment by about 10%, and exports by 16%. The only support to aggregate demand comes from public consumption, which increases by 1.5%.
- We do not forecast any major improvement in the euro area economy for the rest of 2009. We expect a year on year decrease of 4.5% in the euro area Gross Domestic Product (GDP) for 2009, with a drop of 1.2% in private consumption, 9.4% in investment, and 14.9% in exports.
- Industrial production also fell at a record pace in the first part of 2009. The year on year rate is now close to bottom at about -19%, and there will be only a minor recovery in the coming months, with a final result for 2009 close to -16%.
- The relative resilience of private consumption in the euro area is mostly related to the only mild increase in the unemployment rate in several member states, with the remarkable exception of Spain and Ireland. Short time working schemes allow firms to keep workers (and their human capital) at relatively low costs. But clearly, these schemes are only attractive if demand is expected to resurge in a not too distant future. Hence, we expect unemployment to progressively increase from 7.5% in 2008 to 9.5% in 2009, and further to about 11% in 2010.
- Uncertain economic perspectives and, more important, difficult financing conditions have prevented investment, and will continue to impede it well into 2010.
- Chances for a moderate upswing in 2010 come mostly from an inversion in the investment path in the second part of next year, and from an expected positive growth dynamics in emerging economies, in the absence of major external shocks, which should stimulate euro area exports. Overall, we expect a GDP growth of 0.7% for the euro area in 2010, while industrial production will continue to contract but at a lower rate, -4.5%.
- In this recessionary scenario, inflation continues to fall, much as expected. However, while the food prices are decelerating fast, those of services and manufactured goods are remarkably stable. Hence, a further cut of 25 basis points in the official ECB interest rate cannot be excluded but is not very probable. Its effects, however, would be limited.

Table 1 Economic outlook for the Euro area

	2006	2007	2008	2009: 1st half		2009: annual		2010: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					-5.1		-4.9		-0.2
GDP	2.9	2.7	0.7	-4.9	-4.7	-4.5	-4.1	0.7	1.5
					1.5		1.5		1.5
Potential Output	1.8	1.8	1.8	1.5	1.6	1.6	1.6	1.6	1.7
					-1.3		-1.6		-1.0
Private Consumption	2.0	1.6	0.4	-1.1	-0.8	-1.2	-0.7	-0.1	0.8
					1.3		0.7		-0.1
Government Consumption	1.8	2.3	1.8	1.5	1.7	1.1	1.4	0.4	0.9
					-11.0		-10.5		-1.2
Fixed Capital Formation	5.4	4.7	0.0	-10.5	-9.9	-9.4	-8.4	0.9	3.1
					-16.4		-15.6		-0.3
Exports	8.2	5.8	1.0	-16.0	-15.5	-14.9	-14.2	1.0	2.3
					-12.6		-13.0		-0.7
Imports	8.1	5.3	1.1	-12.1	-11.6	-12.2	-11.5	0.9	2.5
					8.9		9.4		10.6
Unemployment Rate	8.3	7.4	7.5	9.0	9.1	9.5	9.7	11.1	11.6
					3.8		3.6		2.4
Labour Cost Index	2.5	2.7	3.5	3.9	3.9	3.7	3.7	2.6	2.9
					-4.0		-3.5		0.9
Labour Productivity	1.3	0.8	-0.1	-3.8	-3.6	-3.1	-2.8	1.5	2.0
					0.5		0.2		0.9
HICP	2.2	2.1	3.3	0.6	0.7	0.5	0.8	1.7	2.5
					-19.2		-18.0		-6.6
IPI	4.2	3.8	-1.7	-18.7	-18.2	-16.2	-15.4	-4.5	-2.4

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 2009 and 2010

The world economy: a few buds in the frost

In early summer of 2009, the world economy is in the midst of a deep recession. Industrial production in OECD countries has been falling for well over a year and is now 18% lower than at its peak at the beginning of 2008; this is the level it reached ten years ago. World trade has shrunk even more drastically: according to IMF data, it is now, in real terms, about 30% lower than at its peak in October 2008. According to Eichegreen and O'Rourke (2009)[1], world trade is falling much faster now than in 1929-30. This is highly alarming given the prominence attached in the historical literature to trade destruction as a factor compounding the Great Depression.

The recession is mainly the result of the worldwide financial crisis, with the insolvency of Lehman Brothers in September last year as the trigger of the acute slump. Policy all over the world reacted with drastic measures to stabilize financial markets: the major central banks set key interest rates close to zero and flooded the money markets with liquidity, banks were frequently forced to strengthen their capacity to absorb losses by taking in capital from public sources. Governments also announced that they will take over risky assets in large volumes to exonerate banks' balance sheets. The measures have, for the time being at least, succeeded in stabilizing financial markets: risk spreads in interbank money markets have been falling since autumn, as have spreads between private and public bond yields, although they are still mostly at high levels. Important banks notified healthy first quarter profits, although the forecasts for the next quarters are not so optimistic. The weakening of the dollar since March is another sign for markets calming down, since, as a safe haven, it had appreciated during the most turbulent times of the crisis. The tentative stabilization of the financial sector has bred cautious optimism about the real economy: stock markets have recovered stongly from their trough in early March; still, indices are not higher than where they stood in October. Similarly, the oil price bounced back to about 70 dollars in mid June, driven by rising optimism of financial investors.

That said, hard indicators for an end of the fall in production are still far from conclusive. China is the only major economy that seems to have ecaped recession and now to forge ahead. But it is so far not clear whether a Chinese upturn, driven to a large extent by public investment in infrastructure, will, via import growth, give world trade a marked stimulus. What is quite certain, however, is that in most developed countries deleveraging in the financial sector will continue to hamper investment and spending, as will unease with quickly rising government debt and growing fears for monetary stabil-

[1] Available at http://www.voxeu.org/index.php?q=node/3421

ity and, in the case of the US and of Britain, high debt levels of consumers. All in all, no more than a stabilization of the world economy can be expected for the second half of this year. Chances for a moderate upswing in 2010 come not least from the fact that growth dynamics in emerging markets economies are, to a a large extent, determined by endogenous social developments in these countries and will, in the absence of major external shocks, prevail in the coming years as they did during the last decade. One major risk factor is that a wave of crisis-related protectionism might impede the resumption of the globalization process. In fact, protectionist measures have already been implemented by quite a few countries.

The euro area: in most precarious conditions

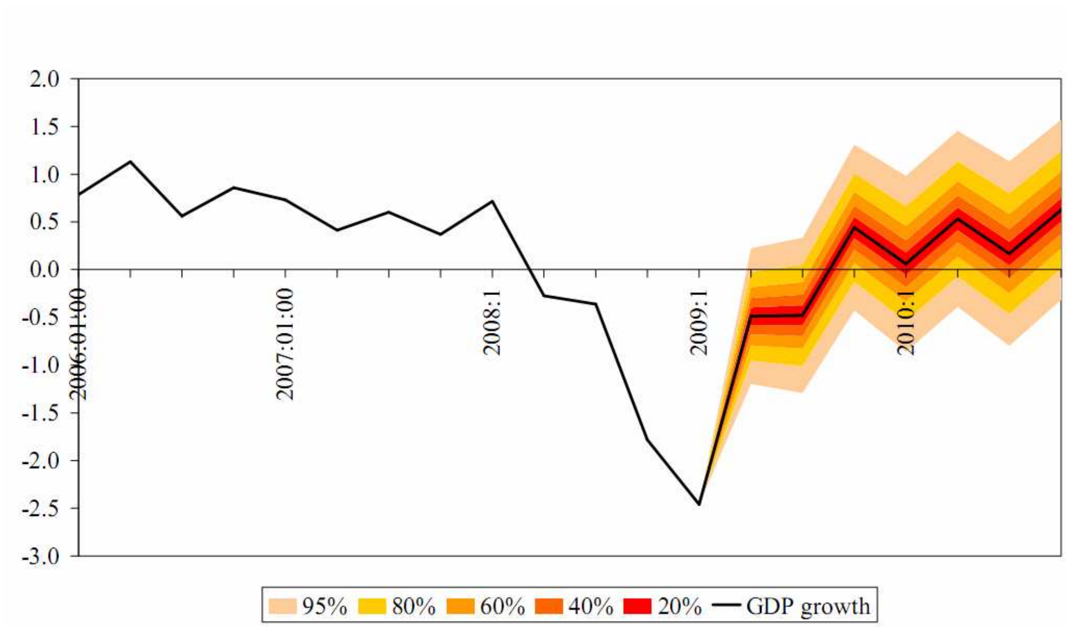
The euro area has, up to now, not been at the centre of the financial crisis, but in the first quarter of 2009, contraction of output was, with more than 2 %, stronger than in the USA or in Britain, though less severe than in Japan. Exports fell for the second time in a row by more than 7%; the decline in imports was a bit less pronounced. Fixed capital formation continued to contract markedly, while inventories that had involuntarily been built up at the end of last year were slashed drastically. Private consumption, however, just stagnated. One explanation for the relative resilience of households is that employment keeps up surprisingly well in most member states, with the notable exceptions of Spain and Ireland. Elsewhere, short time working schemes allow firms to keep workers and so their human capital at relatively low costs. But clearly, these schemes are only attractive if demand is expected to resurge in a not too distant future.

Investment activity as well as employment depends, at present more than ever, on financial conditions for nonfinancial firms. The picture here is not easy to read: on the one hand, real costs of the external financing of non-financial corporations are – albeit still high – coming down since the end of last year, prompted by very low key interest rates and slowly easing tensions on financial markets. On the other hand, banks have tightened their credit standards further in the first quarter, though at a slower rate. Therefore, and as a consequence of poor perspectives for investment activities, the volume of loans to non-financial corporations has been receding in the first half of 2009. In all probability, difficult financing conditions will continue to impede investment well into 2010. This is so because the banking sector has, unlike those in the US and Britain, not been forced to recapitalize by supervisors, and because bank loans are the major instrument for financing capital formation in the euro area. In addition, banks in several euro area countries are still exposed to potentially large losses in Central and Eastern Europe.

Still, destocking will slow down during the coming quarters, which means that inventories will contribute positively to growth. Fiscal programs will begin to take some effect through public investment in the second half of this year. Housing, however, is bound to stay weak, as the real estate markets in Spain and Ireland are in structural crises and house prices in other countries such as France are falling as well. Whether this recession will slowly abate or change into an outright depression, however, hinges on whether industry will stabilize, and this will depend on world trade. Our forecast of a stabilizing euro area economy is built on the assumption that most of the fall in trade during this recession has already happened and that world trade will start growing again in the final quarter of this year. One risk factor that is particularly relevant for Europe is the precarious state of some Central and East European countries where high current account deficits have to be reduced and, at the same time, central banks try to defend currency pegs to the euro in order to avoid balance sheet problems.

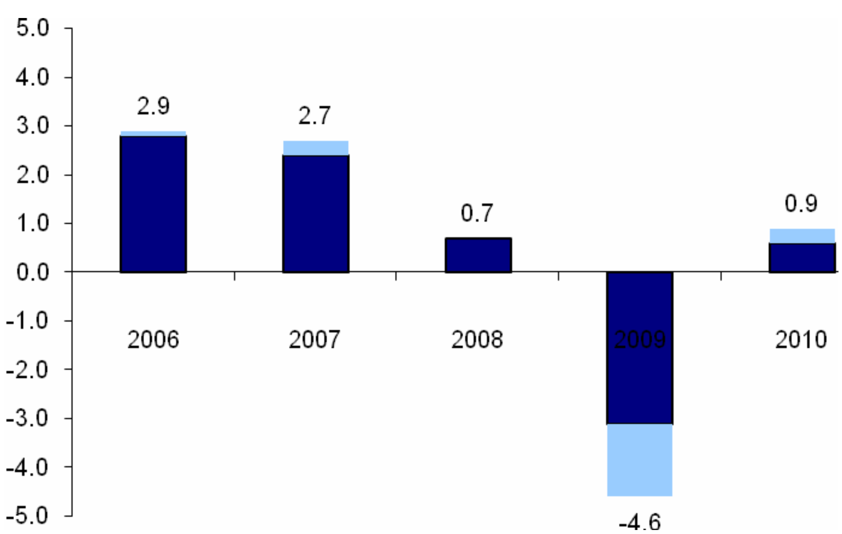
Even if some confidence indicators have improved in the last few months, the outlook for the industrial production remains very negative. The forecasts for 2009 and 2010 have changed only slightly from our previous report. We expect the Industrial Production in the euro area to fall by 16.2% during this year and by 4.5% next year. The decrease in industrial production will be particularly strong in Intermediate, Capital and Durable consumption goods. Industrial production is probably the single variable that most dramatically reflects the magnitude of the economic crisis in Europe. During the last quarter, a combination of several factors led this variable to reach, month after month, a new historical minimum. On one side, cheap money and easy access to bank credit have favoured, during the last years, the accumulation of excess capacity and excess inventories. Now that the downturn has come, the adjustment in industrial production is being proportional to the excess of the past. On the other side, the heart of industrial production in the euro area is export, and international trade is now at minimum. The American consumers are no longer able to sustain global demand, and it is doubtful that the relative strength that some emerging economies are showing will help European exports. As said above, the forecast of a stabilizing euro area economy is based on the assumption that most of the fall in trade has already happened, and that world trade will start growing again in the final quarter of 2009. Nevertheless, the recovery in industrial production will be probably slow, and the competition in international markets will be fierce when it arrives.

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

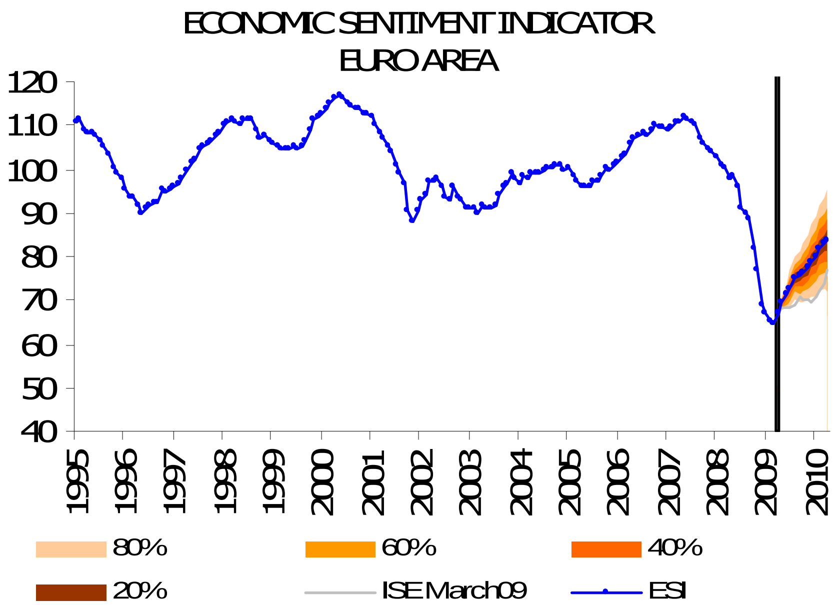
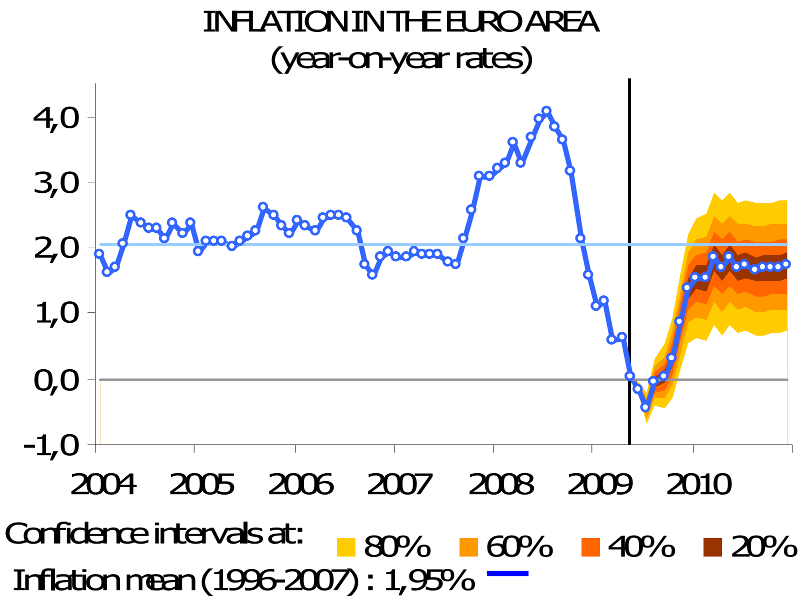


Table 2. Annual average rates for industrial production in the euro area

	2004	2005	2006	2007	2008	2009	2010
Durable	0.15	-0.97	4.29	1.41	-5.64	-18.32	-8.34
Non Durable	0.42	1.01	2.66	2.46	-1.22	-3.63	-0.93
Capital	2.86	2.55	5.91	6.71	-0.33	-21.05	-9.16
Intermediate	2.31	0.62	4.96	3.76	-3.32	-21.89	-9.61
Energy	2.69	1.00	0.40	-1.13	-0.56	1.93	1.29
Total	2.13	1.31	4.22	3.75	-1.73	-16.16	-4.46

Regarding inflation, annual rates have been falling much as expected. Energy prices are driving inflation rates down and year on year inflation rates are expected to be slightly negative in June and July. Subsequently, inflation will start to rebound and the year on year rate will be above 1.0% by the end of 2009. Overall, consumer prices in the euro area have showed remarkable stability even in a situation of deep recession and high volatility in the prices of energy and raw materials. The fall in aggregate demand has caused some important changes in consumer prices dynamics but those changes were not dramatic. The prices of processed and unprocessed food are slowing down somewhat more than anticipated by our models, while the prices of services and manufactured goods are increasing in line with our forecasts. Deflation risk is no more an issue in the euro area and monetary policy is now focusing on providing appropriate financing to the productive system. The ECB has set the official interest rate at 1.0% and opened the door to a further small cut (25 bp). Even if the self-imposed 1.0% downward limit was relaxed, a constant interest rate seems the most likely policy for the next few months.

Figure 4. Euro Area Inflation Rate and confidence bands



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 Inc.

The EFN forecast is on the optimistic side concerning next year. This is particularly true for investment activity. Note that the quite substantial fiscal programs of member countries take effect via investment instead of government consumption, and that most of the spending will, due to implementation lags, be realized not before 2010.

As for inflation, the EFN forecasts are generally higher than those of the other institions, expecially for 2010. As Table 3 shows, we expect inflation in 2010 to be around 1.7%, close to the ECB targe level, while the second highest forecast is just 1.2%.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2008	2009
GDP	-4.5	0.7	-4.0	-0.1	-3.5	0.6	-4.6	-0.3	-4.1	0.3	-4.2	0.3
Priv. Consumption	-1.2	-0.1	-0.9	-0.3	-1.3	-0.5	-0.9	-0.4	-1.3	-0.1	-1.0	0.2
Gov. Consumption	1.1	0.4	2.0	1.7	2.3	2.1	1.7	1.3	1.5	1.2	1.7	1.9
Fixed Capital Form.	-9.4	0.9	-10.4	-2.7	-11.2	-3.7	-11.2	-4.1	-9.0	-2.2	-10.2	-1.2
Unemployment rate	9.5	11.1	9.9	11.5	10.1	11.5	na	na	10.1	11.7	9.6	10.9
HICP	0.5	1.7	0.4	1.2	0.4	0.6	0.3	1.0	0.6	0.7	0.4	1.2
IP	-16.2	-4.5	na	na	na	na	na	na	na	na	-0.7	2.0

EU: European Commission, Economic Forecast, Spring 2009; IMF: World Economic Outlook, April 2009; ECB: ECB Monthly Bulletin, June 2009, OECD: Economic Outlook, Interim Report, March 2009; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2009. 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 US and Japan will be in a deep recession in 2009 and tentatively recover in 2010. Prices in these countries will be declining next year. The massive decrease in world trade this year is forecasted to abate, giving way to slowly accelerating growth in 2010. Oil prices are expected to keep the level they have in mid June 2009. As well, the exchange rates of dollar and yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2008	2009	2010
US GDP Growth Rate	1.1	-2.9	1.0
US Consumer Price Inflation	3.8	-0.6	1.7
US Short Term Interest Rate (December)	0.1	0.3	1.6
US Long Term Interest Rate (December)	2.4	3.4	3.9
Japan GDP Growth Rate	-0.7	-7.0	0.8
Japan Consumer Price Inflation	1.4	-1.2	-0.6
Japan Short Term Interest Rate (December)	0.1	0.6	1.0
Japan Long Term Interest Rate (December)	1.5	1.5	1.7
World Trade Growth Rate	2.0	-15.0	2.0
Oil Price (December)	41	68	71
USD/Euro Exchange Rate (December)	1.34	1.40	1.40
100Yen/Euro Exchange Rate (December)	1.23	1.32	1.32

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 (2009). 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.