

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2005 AND 2006



Spring 2005

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. 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, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it.

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Report closed on March 18th, 2005

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Highlights

- The upswing of the world economy continues over the forecasting period, driven by high growth dynamics in the US and in most emerging markets economies. High commodity prices, however, in particular for crude oil, continue to dampen world economic growth.
- Rising interest rates and more cautious household spending behaviour will stabilize the current account deficit in the US at the end of 2005. As a consequence, the chances are good that the dollar will appreciate a bit against the euro. Our forecast is an exchange rate of 1,30 dollars per euro for 2005 and 1,25 for 2006.
- Despite quite favourable financial conditions, business investment will rise only modestly. This expansion, however, will contribute significantly to overall growth of the euro area economy in 2005 and 2006, because consumption will increase even less. Consumers in the euro area appear to be cautious in view of the budget problems in many member states, as well as of sustainability problems affecting the pay-as-you-go pension and health insurance systems, and the weak performance of national labour markets.
- This outlook is a bit more cautious than the one published by the EFN in December, because output growth in the final quarter was disappointing and oil prices are again on record levels. Moreover, the economic sentiment indicators point to a reduction of economic growth in 2005. Given this scenario, we consider very probable that the European Central Bank will keep its reference interest rate at 2.0% at least until the last quarter of 2005.
- In spite of the pressure of the international oil prices on the domestic inflation for the euro area, our forecasts for 2005 have been revised downwards to 1.7% due to a significant improvement in goods core inflation. The latter is due to a deterioration of the economic expectations, as measured by the economic sentiment indicators, and to the appreciation of the euro. For 2006 we expect an inflation rate of about 1.9%.

Table 1 Economic outlook for the Euro area

	2002	2003	2004	2005: 1st half		2005: annual		2006: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					0.9		1.1		1.2
GDP	0.9	0.5	1.8	1.3	1.7	1.5	1.8	1.8	2.3
					1.2		1.4		1.2
Potential Output	2.4	1.9	1.7	1.6	2.1	1.8	2.2	1.8	2.4
					0.7		0.9		0.9
Private Consumption	0.7	1.0	1.1	1.1	1.6	1.4	1.8	1.5	2.1
					0.8		1.0		1.2
Government Consumption	3.0	1.6	1.6	1.3	1.8	1.5	1.9	1.8	2.3
					1.0		0.4		0.1
Fixed Capital Formation	-2.5	-0.6	1.7	2.5	3.9	2.3	4.2	3.0	5.7
					4.3		3.9		3.5
Exports	1.9	0.2	5.4	5.5	6.7	5.3	6.6	5.3	7.1
					5.9		4.3		2.9
Imports	0.5	2.0	5.8	7.3	8.6	5.9	7.5	5.0	7.1
					8.4		8.6		8.5
Unemployment Rate	8.2	8.7	8.8	8.7	8.9	8.8	9.0	8.8	9.2
					8.3		8.4		8.3
NAIRU	8.2	8.2	8.3	8.5	8.6	8.6	8.7	8.6	9.0
					1.5		1.7		2.1
Labour Cost Index	3.6	2.8	2.2	1.8	2.1	2.1	2.5	2.5	2.9
					0.4		0.6		1.1
Labour Productivity	0.3	0.4	1.4	0.9	1.4	1.0	1.4	1.7	2.3
					1.2		0.9		0.9
HICP	2.2	2.1	2.1	1.7	2.2	1.7	2.6	1.9	2.9
					0.9		0.5		0.7
IPI	-0.5	0.3	2.3	1.5	2.1	1.5	2.5	1.8	2.9

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from the EFN forecasting models and based on 2000 stochastic simulations.

Economic Outlook for 2005 and 2006

The world economy

The upswing of the world economy continues, but during the second half of 2004 it has lost some of its momentum. Demand stayed strong in the world's growth centers, in the US and in China, but the economy in the euro area nearly fell back into stagnation in the final quarter of 2004. The Japanese economy even slightly contracted during the summer of 2004. In both cases, growth is so anemic that it is stopped by quite small variations. World trade as a whole seems to have slowed in autumn. The picture of a fundamentally robust world economy, however, is still valid. Output growth rates are still healthy in many and quite diverse economies: the upswing continued in the United Kingdom as well as in Central Europe, and many emerging markets economies benefit from still high prices for commodities and energy.

A distinct feature of the present upswing is the very favorable situation for business investment: profits are generally high, even in Japan and Germany, where internal demand is sluggish. The efforts to cut costs in the aftermath of the bursting new economy bubble have, it appears, been very successful. Of much help are developments on important factor markets: wages rose modestly in the industrial countries due to strong competition from cheap labor in emerging markets, in particular in China. As to capital costs, interest rates are historically low in the USA, in the euro area and in Japan. In addition, spreads between the yield of high quality credit and that of riskier debtors are historically low. The favorable conditions on capital markets are a consequence of the high level of liquidity, which by itself results from the fact that monetary policy has been expansive for years in most regions.

While monetary policy has lowered interest rates, raised prices of assets including those for real estate, and furthered demand in most regions of the world economy, prices for manufactured goods are still quite stable. This fact is due to efficiency gains of new production techniques and of the globalization of industrial production. The supply of commodities, however, is much less flexible. This explains the price hike for commodities and for crude oil in particular during the last three years. In March, cold weather in the winter in much of the northern hemisphere has caused oil prices to reach October's all time record levels of 52 dollars (Brent). Usually, demand eases a bit in the second quarter of the year. This justifies our assumption that oil prices (Brent) will be around 45 dollars in 2005. For 2006, a slight decrease to 40 dollars is expected. Because monetary policy in the US is being tightened only on a measured path and will stay more or

less unchanged in the euro area and in Japan this year, the monetary conditions will help the world economy to continue on its healthy growth path for the year 2005.

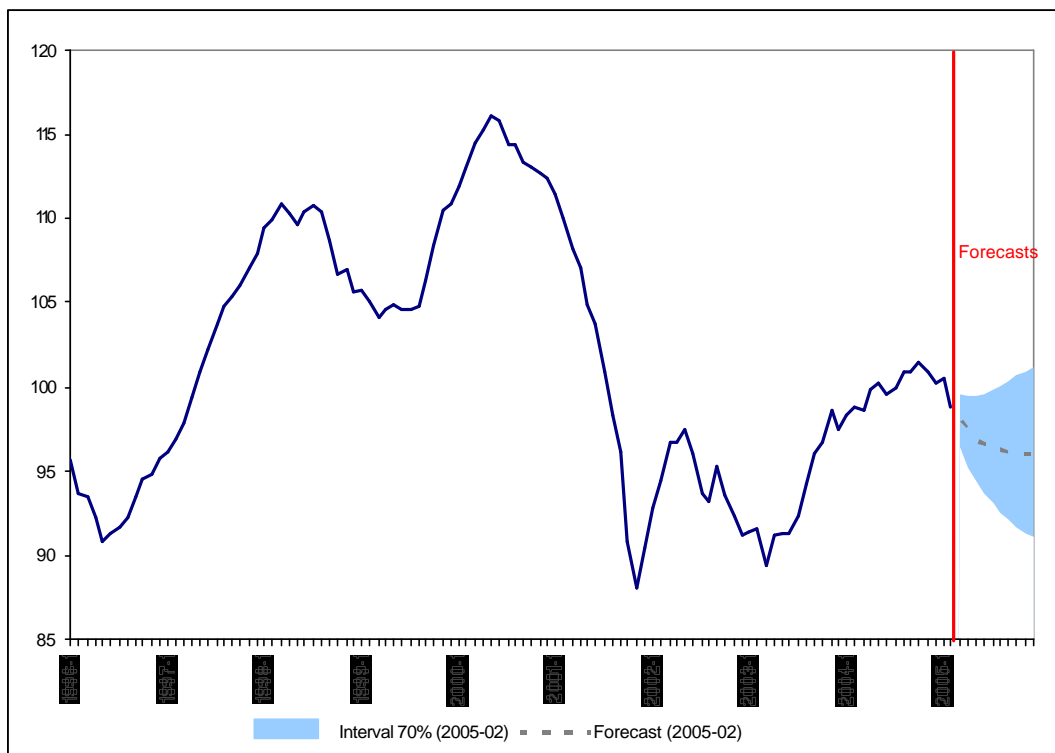
For 2006, the world economy will have to cope with the burden of a monetary policy which changes from an expansive to a neutral stance. This will be the case for the US and, to a lesser extent, for the euro area and possibly even for Japan. Connected with this policy switch are two risk factors: first, higher interest rates and an end of the house price boom could induce US households to normalize their recently very low savings rate. While this adaptation is, in principle, welcome, an abrupt change could depress world demand on a noticeable scale. The second risk is that non-prime rate debtors – sovereign debtors as well as private ones – would be affected most, because higher interest rates could imply higher spreads for the same reasons why at present unusually low interest rates have provoked very low risk spreads. This means that the scare of financial crises might come back. If both risks can be avoided, however, the chances are good that, in 2006 as well as this year, the strong growth dynamics especially in emerging markets countries will keep the economy on its growth path.

The euro area

Expansion in the euro area has slowed in the course of 2004, coming almost to a halt in the final quarter. The deceleration is mainly an effect of lower export growth in the second half of the year. This ran parallel to a deceleration of world trade as a whole. The appreciation of the euro relative to the dollar (by about 6% since the end of 2003) is only partly to blame for lower export growth, because relative to other currencies supply from the euro area gained competitiveness, and thus the real effective exchange rate stayed quite stable. The chances are good that exports will regain momentum this spring, thanks to the still quite strong dynamics of the world economy.

With the publication of the latest Economic Sentiment Indicator for February, 2005, we observe a heavy downwards innovation, slowing down the recovery process in place since the second quarter of 2003. We also estimate that this situation will worsen in the coming months to reach the same Economic Sentiment Indicator values at the end of the year as were registered at the end of 2003; this can be seen on Graph 1, which shows our forecasts estimated with non-linear models for this indicator with its corresponding confidence intervals. This worse evolution of the general indicator corresponds to a similar development in most sectors. In particular in the industrial sector we have updated our forecasts for the index of industrial production to 1.5% from the 1.7% estimated in the previous report.

Figure 1 Euro Area Economic Sentiment Indicator.



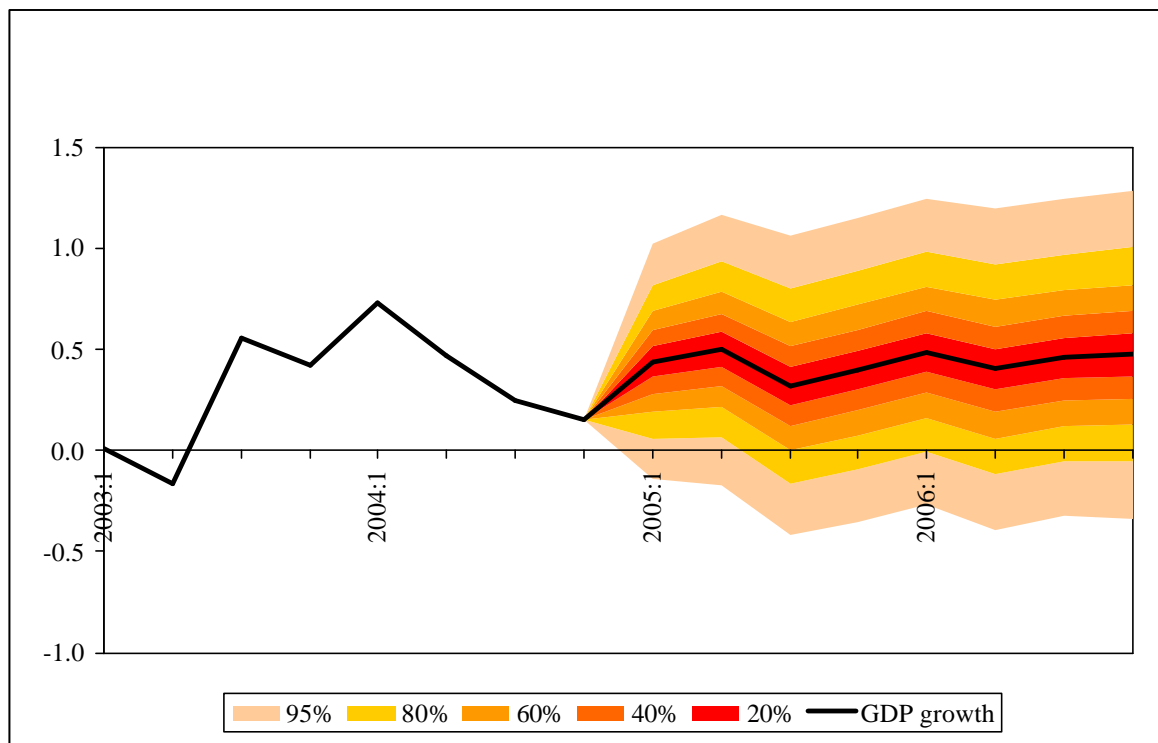
The euro area is the laggard in the present world business cycle: internal demand remained weak throughout the year 2004; this holds true in particular for private household spending. Consumer confidence has been stagnating during the winter. This cannot come as a great surprise: real wages stagnate on average, as does the high unemployment rate. Planned and realized labour market reforms in some member countries, in particular in Germany and France, added to the uncertainty of households – notwithstanding that reforms have good chances to be beneficial in the long run.

The conditions for an upswing of investment have been much better for quite a while. What has been said for the world economy as a whole, applies for the euro area as well: profits went up strongly, as did equity prices, and interest rates stayed low. Since the second half of 2004, according to the Bank Lending Survey of the ECB, credit standards of banks applied to the approval of loans to enterprises were being eased on average. Against this favourable background, the performance of gross fixed capital formation was weak in 2004, but it got a bit stronger in the second half of the year. It is, however, not clear whether this trend continues in spring, as indicators for industrial production and industrial confidence have been stagnating or even fallen a bit in the winter. For the whole of 2005, however, investment will be a driving force of the economy, because profits and financial conditions continue to be favourable. Capacity utilization

in the industry has now, according to the survey conducted by the European commission, reached an average level. We expect that the ECB will not start raising interest rates at least before the autumn, and the steps will be moderate. Thus, monetary policy will be expansive well into 2006, although to a decreasing degree. Fiscal policy will keep its more or less neutral stance.

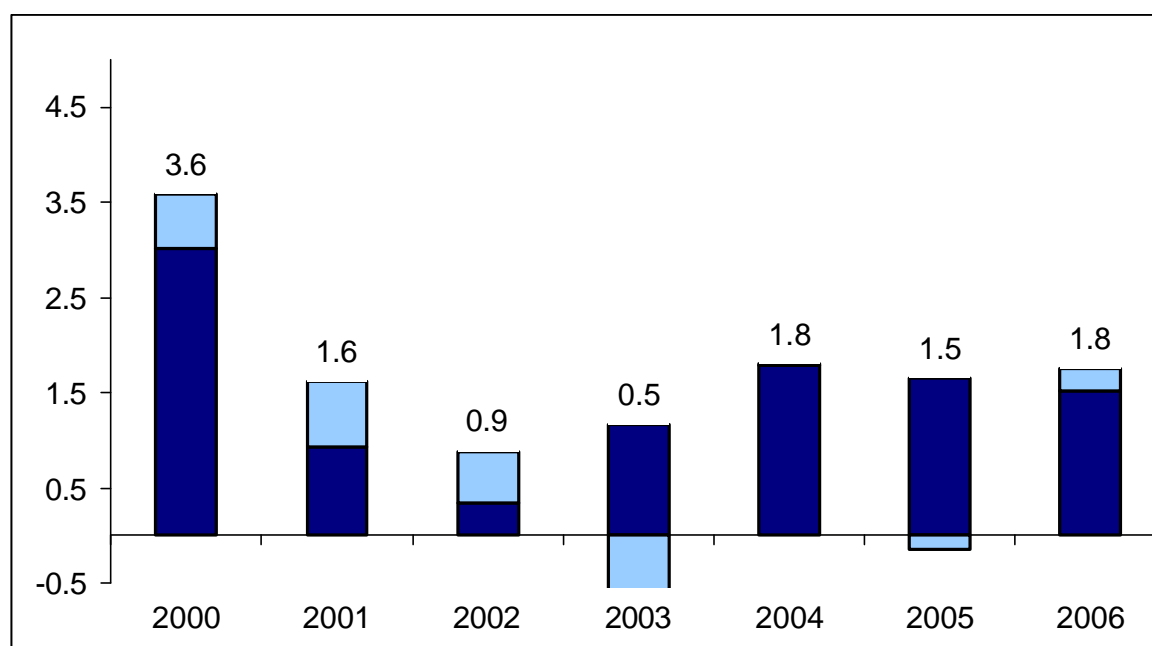
All in all, production in the euro area will expand by 1.5 % in 2005 and by 1.8 % in 2006. Hence, the output gap will not be shrinking. The unemployment rate is expected to be almost stable over the forecasting horizon. The participation rate will not resume the rising trend it had at in the eve of the economic downturn.

Figure 2 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 3 Contributions of domestic components and net exports to GDP growth



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

Table 2 Contributions of production sectors

Year	GDP growth	Agriculture	Industrial	Construction	Services	Net taxes
1999	2.8%	0.1%	0.2%	0.1%	2.1%	0.3%
2000	3.5%	0.0%	0.9%	0.1%	2.5%	-0.1%
2001	1.6%	-0.1%	0.1%	0.0%	1.7%	-0.1%
2002	0.9%	0.0%	0.1%	0.0%	0.9%	-0.1%
2003	0.5%	-0.1%	0.0%	0.0%	0.6%	0.0%
2004	2.0%	0.1%	0.6%	0.0%	1.2%	0.1%
2005	1.5%	0.1%	0.0%	0.0%	1.4%	0.1%
2006	1.8%	0.0%	0.2%	0.0%	1.5%	0.1%

From a supply-side perspective, in this report again GDP growth is mainly driven by the expansion in the services (Table 2). This sector was responsible for about 65% of GDP

growth in 2004 and a higher proportion around 85% is expected for 2005 and 2006. The contribution of the industrial sector will increase slightly during the forecasting period. The average annual rates of growth for different industries classified according to the destination of goods are shown in table 3. The recovery in the production of capital goods has been interrupted in 2005 and production of durables will continue with negative rates of change around 2%. The recovery in non-durables is a minor one and further improvements are not foreseen for 2006.

Table 3 Annual average rates for industrial production in the euro area

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Capital	1.6%	-1.6%	-0.1%	1.6%	-1.6%	-0.1%	3.0%	1.4%	2.8%
Durable	-2.1%	-5.6%	-4.3%	-2.1%	-5.6%	-4.3%	-0.3%	-2.3%	-0.4%
Intermediate	-0.6%	0.2%	0.2%	-0.6%	0.2%	0.2%	1.9%	2.6%	1.9%
Non Durable	0.8%	0.6%	0.2%	0.8%	0.6%	0.2%	0.6%	1.1%	0.9%
Energy	1.3%	1.1%	3.0%	1.3%	1.1%	3.0%	2.2%	-0.1%	1.4%
Total EMU	0.4%	-0.5%	0.2%	0.4%	-0.5%	0.2%	1.9%	1.5%	1.8%

Compared to our last report, the significant downwards innovations in core inflation in January and February led to a reduction in our forecasts, with an annual core inflation rate of 1.2% expected for March, representing about forty percent less than the 2004 mean value. The annual mean for the total inflation rate in 2005 is forecasted at 1.7%. The evolution of energy prices will generate a specific monthly profile for the year-on-year total inflation rate, which is expected as follows. From March on, the rate will decrease for three consecutive months to recover values near to 1.8% in July, August and September and stabilising at around 1.5% from October to December, with the average annual rate for 2005 forecast at 1.6%. With these forecasts, the likelihood of compliance with the ECB inflation target from April on is over 50% and it is therefore very likely that the ECB will not alter its reference interest rate until the last quarter of 2005. For 2006, the forecast for total inflation increases up to 1.9%.

Figure 4 HICP inflation and confidence bands

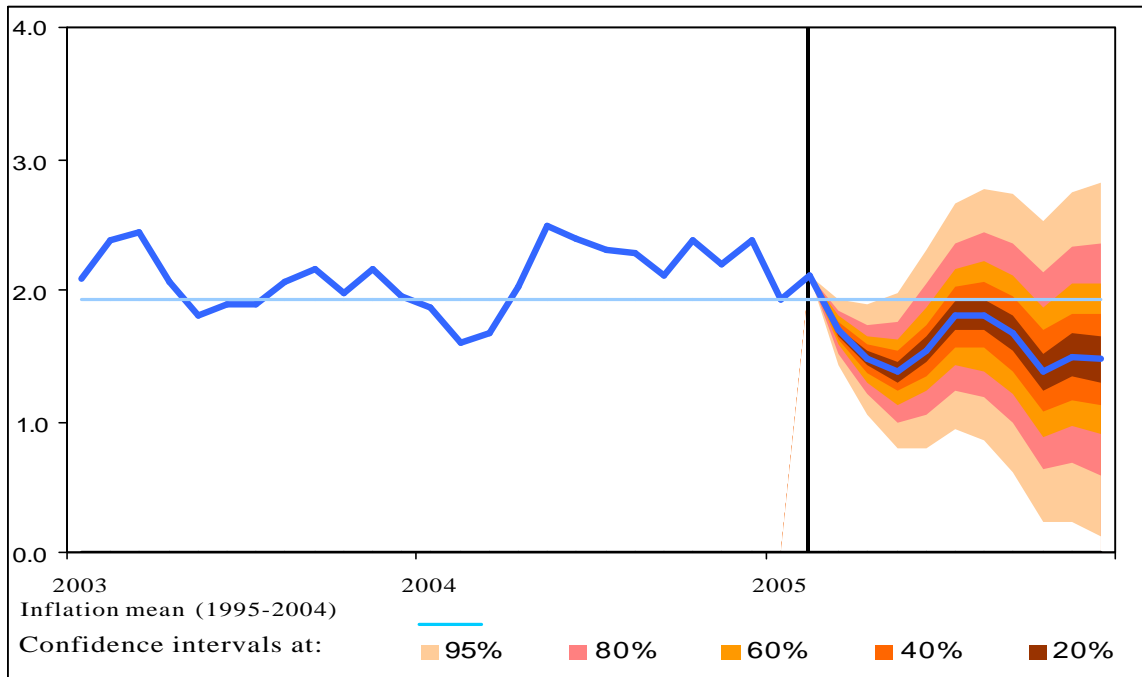
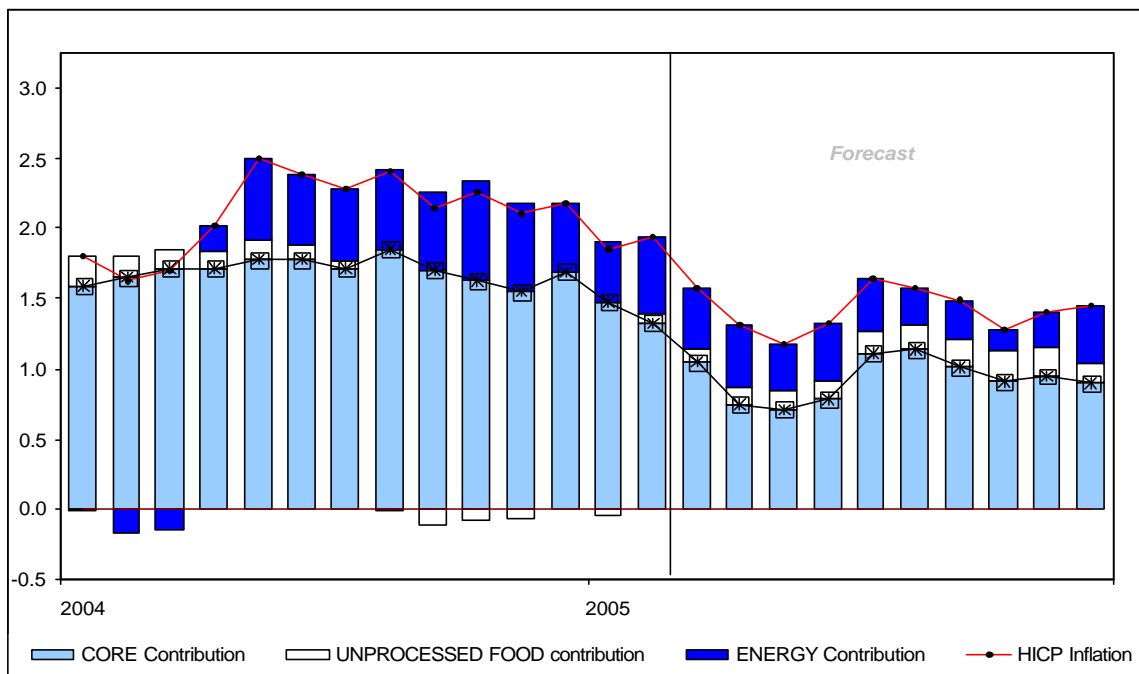


Figure 5 HICP inflation and contributions of main components.



By country, the annual average inflation rates expected for Germany, France and Italy are 1.6%, 1.7% and 2.1% and 2.9% for Spain. Inflation forecasts for France, Italy, Germany and Belgium have fallen because of the important downwards innovations in January and February. However, these shocks have not occurred in countries like Spain, Greece, Ireland, Luxembourg or Portugal, representing slight increases in forecast mean inflation. Consequently, the real interest rates calculated from these inflation forecasts will show differences of up to 2.5 percentage points. However, half the countries show interest rates quite close to zero on both sides, which should favor investment. The wide range of real interest rates in the different member states go from negative values in Italy (-0.6%) and Spain (-0.6%) to positive values in Germany (1.1%) and Finland (0.9%) in 2005.

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconomic model, described in detail in the EFN Spring 2002 report. Table 1.4 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.

While investment and private consumption are on a lower path than in other forecasts, our outlook for government consumption is higher. These issues are related, as government has behaved anti-cyclically in the past. Hence, if the outlook for domestic demand is more pessimistic, government consumption is likely to be stronger. Also, because at present the Stability and Growth Pact is de facto in abeyance, its restrictions appear to be less binding.

Naturally, the forecasts for 2006 differ more than those for the year to come. Compared with the numbers of the OECD, our forecast is much more cautious, possibly due to our pure model based approach, which excludes the forecast of positive effects from recent structural reforms in some member countries. Besides this technical point, it seems reasonable to assume that the positive impacts of the reforms on the macroeconomic performance will only slowly accrue over the coming years.

Table 2 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
GDP	1.5	1.8	2.0	2.2	2.2	na	1.9	2.2	1.9	2.5	1.6	2.0
Priv. Consumption	1.4	1.5	1.7	2.0	2.1	na	1.6	2.0	1.6	2.4	1.5	1.9
Gov. Consumption	1.5	1.8	1.1	1.6	1.5	na	0.8	1.2	1.1	1.1	1.3	1.4
Fixed Capital Form.	2.3	3.0	3.2	3.6	3.4	na	3.2	3.7	2.9	3.8	2.6	3.1
Unemployment rate	8.8	8.8	8.9	8.6	8.7	na	na	na	8.6	8.3	8.8	8.6
HICP	1.7	1.9	1.9	1.7	1.9	na	1.9	1.8	2.0	1.7	1.8	1.7
IP	1.5	1.8	na	na	na	na	na	na	na	na	1.8	2.4

EU: European Commission, European Economy, No. 5, 2004 (Autumn); IMF: World Economic Outlook, September 2004; ECB: ECB Monthly Bulletin, February 2005; OECD: OECD Economic Outlook, No. 76, December 2004; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2005. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

Box 1: Variables of the world economy

Important variables indicating the state of the world economy are shown in the table below. For the US, GDP growth is roughly 3.5 over the next two years, respectively. After a relatively high GDP growth in 2004 (which stems from the upswing in the beginning of that year), the evolution in 2005 will be much slower in Japan, and is expected to slightly accelerate in 2006 again. Inflation will remain moderate in the US, while the deflation process in Japan comes to an end. An oil price of 45 dollar per barrel is expected for 2005. The price will slightly drop to 40 dollar in 2006. The Euro is predicted to stay at relative high levels in 2005. In 2006, a slight depreciation against the US dollar and the Yen is expected, which is in line with the international parity conditions. In the exchange rate equations, purchasing power parity holds as a long run relationship.

Table 3 Variables of the world economy

	2005	2006
US GDP Growth Rate	3.5	3.4
US Consumer Price Inflation	2.4	2.2
US Short Term Interest Rate	3.0	3.5
US Long Term Interest Rate	4.7	5.3
Japan GDP Growth Rate	1.1	1.8
Japan Consumer Price Inflation	0.0	0.3
Japan Short Term Interest Rate	0.2	0.5
Japan Long Term Interest Rate	1.7	2.0
World Trade	6.9	6.1
Oil Price	45	40
USD/Euro Exchange Rate	1.30	1.25
100Yen/Euro Exchange Rate	1.37	1.34

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (2005) and OECD (2004). Oil price in US dollar per barrel, all other variables in percent.