EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2014 and 2015

Winter 2013/14

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

- During 2013, the world economy has recovered from a soft spot that had started in summer 2012, and chances are good that the speed of expansion in world production observed in the second half of 2013 will be kept up in 2014. Growth of world trade, however, is markedly lower than it should be if correlations of the past 20 years were still valid. The uncertain prospects for trade are a serious risk factor, in particular for export oriented economies, in 2014 and beyond.
- The euro area economy left the recession behind during 2013. The recovery, however, will not turn into a strong upswing because private households and firms are not convinced that the structural reforms by now implemented are enough to ensure better long run growth prospects. For 2014 and 2015, we expect a GDP growth of 1.2% and 1.7%, respectively.
- Although economic activity starts to recover, and even taking into account that labour costs will only increase in line with inflation and productivity, unemployment rates in the euro area will not decline significantly along our forecasting horizon, remaining well above 12%.
- Our inflation forecast for 2014 has dropped to a y-o-y rate of 1.2%. Inflation will remain subdued also in 2015, at about 1.4%. However, we assign zero probability to an area wide deflation in the next two years.
- The effects of the recent ECB rate cut are exptected to be very limited both on inflation and on real activity. In fact, the monetary transmission mechanism continues to be seriously hindered by the lack of access to credit by the non-financial private sector in some member countries.

Table 1 Economic outlook for the Euro area

	2011	2012	2013	2014: 1st half		2014: annual		2015: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.6	-0.7	-0.4	0.9	0.2 1.6	1.2	0.3 2.0	1.7	0.7 2.7
Potential Output	0.2	0.4	0.0	0.3	0.1 0.5	0.3	0.1 0.5	0.6	0.4 0.8
Private Consumption	0.3	-0.4	-0.5	0.6	0.0 1.2	0.9	0.2 1.6	1.4	0.5 2.2
Government Consumption	-0.1	-0.5	0.3	0.5	0.1 1.0	0.5	0.0 1.0	0.5	0.0 1.0
Fixed Capital Formation	1.6	-4.1	-3.5	0.4	-2.5 3.4	1.4	-1.6 4.4	4.6	0.8 8.3
Exports	6.5	2.5	1.2	4.4	2.7 6.0	5.0	3.3 6.7	6.3	4.3 8.2
Imports	4.5	-1.0	0.2	5.2	3.1 7.2	5.8	3.7 7.8	7.2	4.7 9.6
Unemployment Rate	10.1	11.4	12.1	12.1	11.8 12.5	12.2	11.8 12.6	12.4	11.8 13.0
Labour Cost Index	2.7	2.2	1.6	2.0	1.6 2.5	2.1	1.6 2.6	2.0	1.4 2.6
Labour Productivity	1.4	0.0	0.4	1.2	0.6 1.8	1.4	0.8 1.9	1.6	0.9 2.3
HICP	2.7	2.5	1.4	1.1	0.5 1.7	1.2	0.4 2.0	1.4	0.4 2.4
IPI	3.4	-2.5	-0.9	1.3	0.1 2.5	1.8	-0.3 3.9	2.5	-0.2 5.2

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 2014 and 2015

The world economy in 2014: in better shape

At the end of 2013, world production expands at a speed that is close to average growth for the past 15 years. Thus, since spring 2013, the world economy has recovered from a soft spot that had started in summer 2012. In the first half of 2013, advanced economies strengthened, with an upturn in Japan and the recession in the euro area running out, while growth in most emerging markets economies lost some momentum. Meanwhile, growth of the Chinese economy has picked up again.

Surveys on sentiment of managers show that expectations are in general on the rise. Financial markets are particularly optimistic. The trend on world stock markets is upwards since summer 2012, and option prices for stock indices show that investors expect low volatility in the coming months. Prices for stocks from emerging markets countries, however, declined significantly in the summer and have not fully recovered at the end of the year. Confidence in the stability of economies with high current account deficits, Brazil, Turkey, India and Indonesia in particular, has waned; markets doubt whether these economies will be able to attract enough capital when, with advanced economies recovering, bond yields will pick up again.

Still, the world economy is, all in all, stabilizing, not least because commodity prices have been more or less constant for more than a year. Partly as a consequence, inflation rates have been falling in many countries, in particular in the US, in the UK and in the euro area. Monetary policy will stay expansive as long as such a course can reasonably be defended, since the central banks in the US, UK, Japan and the euro area have committed to keeping interest rates low for the foreseeable future. Fiscal policy is heterogeneous and it is difficult to judge its effects: as to the US, it is an open question whether the compromise between the two parties in December about the budget is enough to restore confidence in the fiscal framework of the country. For Japan, it is not clear whether the marked increase of the consumption tax in April 2014 will stall the upswing, and to what extent the stimulus package announced by the government will dampen the restrictive effect of the tax rise. In this respect, it is remarkable that in the UK an upswing has developed in spite of the continued effort of the government to bring structural public deficits down. In emerging markets economies, the structural impediments have dampened growth in recent years, but in the most important region, in East Asia, the slow down appears to have stopped for the time being. All in all, chances are good that the speed of expansion in world production observed in the second half of 2013 will be kept up in 2014. Growth of world trade appears, however, with about 3%, about as strong as the expansion of world production, and thus markedly lower than it should be if correlations of the past 20 years were still valid. The uncertain prospects for trade are, indeed, a serious risk factor in particular for export oriented economies in 2014 and beyond.

The euro area economy: starting a slow recovery

In the course of the year 2013, the euro area economy left the recession behind. In the third quarter, however, production expanded much slower than before, by no more than 0.1%. Of the larger economies, only Germany grew markedly; Spain and the Netherlands came, with a slight expansion, out of recession, and production in Italy declined by less than before. The French economy, however, appears to be still in stagnation. Expansion in the euro area as a whole was smaller than before because growth of exports almost stalled. The pace of internal demand was in both quarters about the same, with construction activity, for the first time in two and a half years, changing from decline to expansion. Consumption was supported by rising asset prices: stock market valuations went up and, what is more important, house prices appear to be, on average, no longer falling. This is even true for the Netherlands with its serious property slump; in Spain the fall in house prices has slowed down recently.

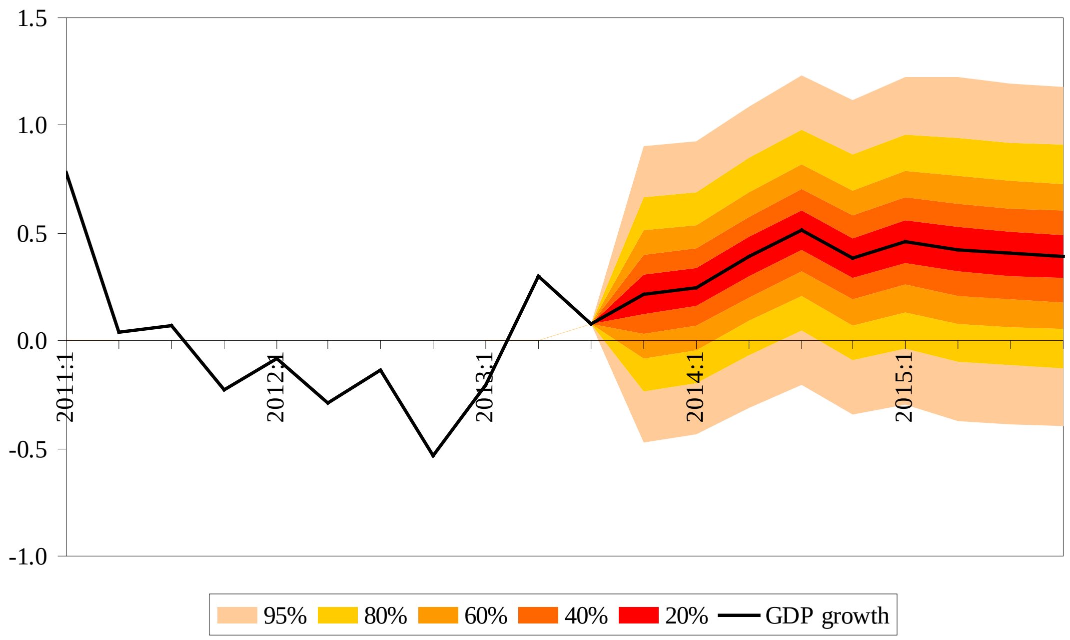
At the same time, employment almost stopped falling in the third quarter of the year. The rate of unemployment was in October, at 12.1%, not higher than in April. The small expansion of production by itself cannot fully explain the tentative stabilization of the labour market; youth employment schemes in France have helped. Labour markets are still, of course, out of balance in many countries. As a consequence, nominal wage dynamics have gone down to about 1 ½ % on average on an annual basis.

Nevertheless, since spring 2013, sentiment of managers is on the rise, suggesting that the slow recovery of production in the euro area will continue during winter 2013/14. There is some reason for being a bit more optimistic than before: the ECB has lowered its key interest rate to 0.25 % in November, and in those countries where the transmission mechanism between monetary policy and the real economy is not broken, financial conditions are very favourable, with real costs of external financing now at a record low.

The slow retreat of the housing crisis in the Netherlands and even in Spain means that drags on growth begin a sluggish decline. In addition, fiscal policies in 2014 will be much less restrictive than before. This results from the draft budget plans that were submitted to the European Commission in autumn. According to these plans, restrictive measures amount to about ¼ % relative to GDP in the euro area. Probably, the actual policies in many countries will be even less restrictive – or, as in the case of Germany, indeed more expansive. The stimulus from external trade, however, will be limited, although the world economy looks like expanding a bit more briskly. This is so because the competitiveness of euro area firms has suffered from the appreciation of the euro (by almost 5 percent since November 2012). Above all, the recovery will not turn into a strong upswing because private households and firms in some member countries are not convinced that the structural reforms by now implemented are enough to ensure better long run growth prospects.

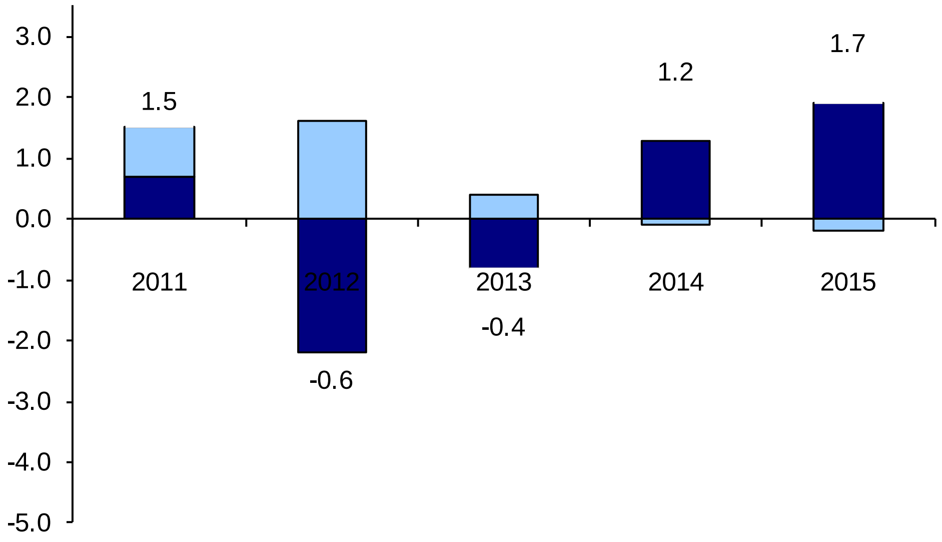
According to our forecast, GDP in 2014 will be 1.2% higher than in 2013. In 2015, production will accelerate to 1.7%. However, the unemployment rate will be about constant. As to industrial production, our forecasts improved for 2014 by 0.7% (to the new y-o-y average of 1.8%), mostly due to the important upwards revision of the series in the last months and also because of the confidence index has recently performed a little better than expected.

Figure 1 Quarterly GDP growth rates and confidence bands



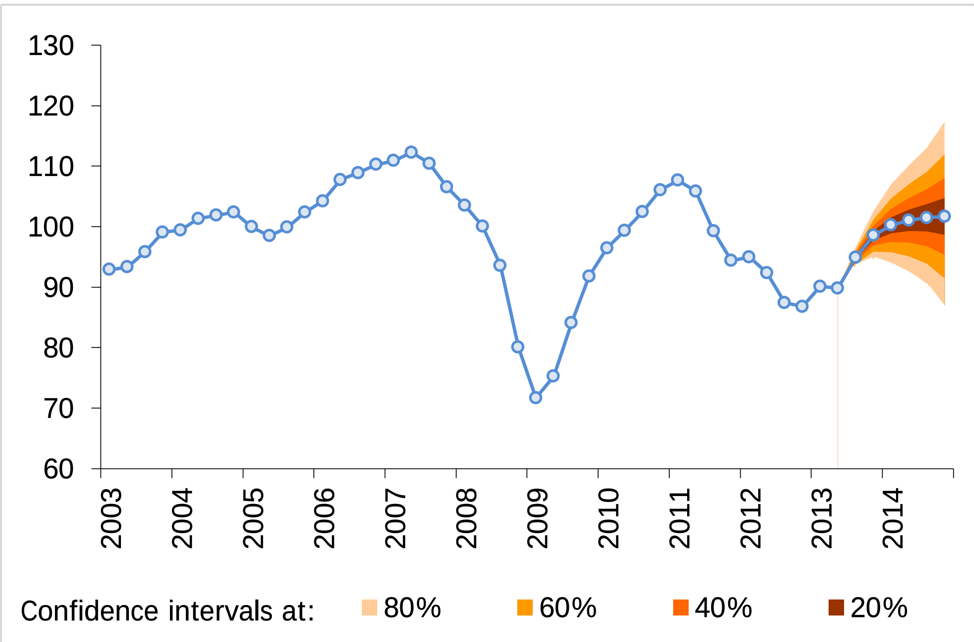
Percentage change over previous quarter

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



Taking into account our forecasts for economic activity, price dynamics are accordingly slowing down. After having fallen to a 3-years low last October (0.7%), the euro area y-o-y HICP remained beneath 1% in November, which is still too far from the historic average and the ECB target. Our inflation expectations for 2014 have moderated to a y-o-y rate of 1.2%, and they remain subdued also in 2015, at about 1.4%. However, we assign zero probability to an area wide deflation in the next two years.

Low current and expected inflation, together with the 0.2 pp reduction in euro area GDP growth in the third quarter (to a q-o-q rate of 0.1%), supported the ECB's recent decision to cut its basic rate by 25 bp, to 0.25%. The rate cut alone, however, is unlikely to bring inflation close to the 2% target throughout the forecasting period, or to stimulate real economic activity. In fact, the monetary transmission mechanism continues to be seriously hindered by the lack of access to credit by the non-financial private sector.

Figure 4 HICP and confidence bands

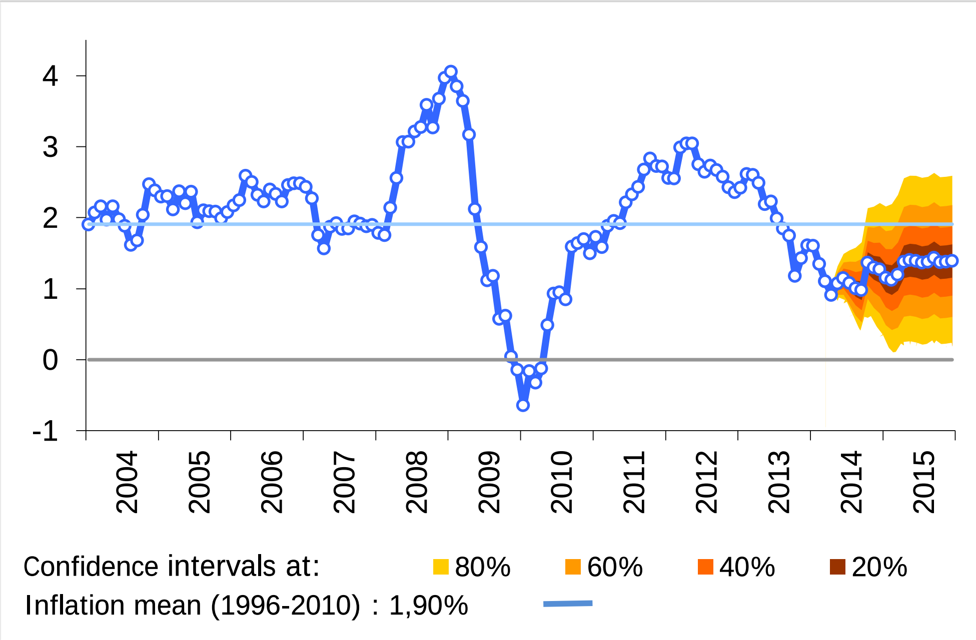


Table 2 Annual average rates for industrial production in the euro area

	2010	2011	2012	2013	2014	2015
Durable	2.7	0.7	-4.9	-4.1	-1.7	3.2
Non Durable	2.9	1.0	-2.1	-0.3	0.0	-0.3
Capital	9.0	8.4	-1.2	-0.9	3.3	4.9
Intermediate	10.0	4.1	-4.6	-1.0	2.7	2.4
Energy	3.9	-4.4	-0.4	-1.1	-1.4	0.6
Total	7.3	3.4	-2.5	-0.9	1.8	2.5

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.

Predictions for GDP are, even for 2015, quite similar. The EFN forecast is relatively optimistic on fixed capital formation in 2015, partly because we think that user costs of capital in countries that are less affected by the crisis will probably stay at very low levels. Quite high is the EFN forecast for unemployment in 2015. We regard that the trend in labour supply is still rising, while we do not see that the recovery in 2014 and 2015 will be strong enough to increase labour demand significantly.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
GDP	1.2	1.7	1.1	1.7	1.0	na	1.1	1.5	1.3	1.8	1.0	na
Priv. Consumption	0.9	1.4	0.6	1.3	0.5	na	0.7	1.2	0.8	1.3	0.6	na
Gov. Consumption	0.5	0.5	0.3	0.7	-0.3	na	0.3	0.4	0.5	0.2	0.3	na
Fixed Capital Form.	1.4	4.6	1.9	3.6	1.3	na	1.6	2.8	2.3	3.5	1.4	na
Unemployment rate	12.2	12.4	12.2	11.8	12.2	na	na	na	12.1	11.8	12.2	na
HICP	1.2	1.4	1.5	1.4	1.5	na	1.1	1.3	1.2	1.2	1.1	na
IP	1.8	2.5	na	na	na	na	na	na	na	na	1.9	na

EU: European Commission, Economic Forecast, November 2013; IMF: World Economic Outlook, October 2013; ECB: ECB Monthly Bulletin, December 2013, OECD: Economic Outlook, November 2013; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2013. 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 recovery in the US will speed up in 2014. Growth in world trade accelerates, but stays below the trend of the past 20 years or so. Oil prices are expected to be about constant in real terms. 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

	2013	2014	2015
US GDP Growth Rate	1.7	2.6	2.9
US Consumer Price Inflation	1.5	1.8	2.2
US Short Term Interest Rate (December)	0.1	0.1	0.3
US Long Term Interest Rate (December)	2.9	3.2	3.7
Japan GDP Growth Rate	1.9	1.6	1.0
Japan Consumer Price Inflation	0.2	2.3	2.4
Japan Short Term Interest Rate (December)	0.2	0.2	0.4
Japan Long Term Interest Rate (December)	0.7	0.9	1.2
World Trade Growth Rate	2.2	4.3	5.0
USD/Euro Exchange Rate (December)	1.35	1.35	1.35
100Yen/Euro Exchange Rate (December)	1.39	1.39	1.39

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 (2013). 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.