EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2007 AND 2008

Spring 2007

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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Highlights

- Our forecast for GDP growth in the euro area is 2.5% for 2007 and 2.1% for 2008. World financial markets will not be as supportive for growth in the rest of 2007 as they were last year. Asset prices will probably rise much slower, and risk spreads will be slightly higher. The mild deceleration of GDP growth in the US, combined with the US$/euro exchange rate, will not be supportive for exports. However, there will be a positive evolution of private consumption and investment, which will drive GDP growth in the euro area. From a supply-side perspective, the sectors experiencing higher growth will be industry and market and financial services
- The favourable developments in the labour markets of the euro area will continue this year, with a further decline in the unemployment rate and an expected acceleration of wage growth. The latter will sustain an increase in private consumption that, as mentioned, will lead to higher GDP growth.
- A main risk for our positive forecast, which might be even more relevant in 2008, is a possible downturn of the housing market in some countries that would lead to a slump in consumer demand. Spain might be particularly vulnerable, because the housing boom in that country is combined with a loss in competitiveness due to rising unit labour costs. A significant devaluation of the dollar is also another important risk to take into consideration.
- Notwithstanding sustained GDP growth, there is a high probability that inflation in the euro area will remain below 2% in 2007. This is mainly due to the expected evolution in energy prices, which will compensate the higher core inflation in 2007 than in 2006, as well as the strength of the euro. For 2008, our forecast for euro area inflation is 2%.
- Conditional on the forecasts for inflation and on the expected evolution of the real economy, there will likely be further increases in the ECB reference interest rate throughout 2007, up to 4-4.25%.

Table 1. Economic outlook for the Euro area

	2004	2005	2006	2007: 1st half		2007: annual		2008: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					2.3		1.9		1.4
GDP	2.0	1.4	2.6	2.7	3.2	2.5	3.0	2.1	2.9
					1.9		1.9		1.7
Potential Output	1.8	1.6	1.7	2.0	2.1	2.1	2.2	2.0	2.2
					1.9		1.9		1.4
Private Consumption	1.5	1.4	1.8	2.3	2.8	2.4	3.0	2.2	3.0
					1.2		1.0		0.9
Government Consumption	1.4	1.4	2.1	1.5	1.9	1.4	1.9	1.4	1.8
					2.4		1.4		0.1
Fixed Capital Formation	2.2	2.5	4.5	3.6	4.9	3.1	4.8	2.5	4.7
					6.1		5.1		4.0
Exports	6.9	4.2	8.4	7.2	8.2	6.2	7.2	5.2	6.4
					5.6		5.1		3.9
Imports	6.7	5.2	7.8	6.8	7.9	6.3	7.4	5.3	6.8
					7.4		7.2		6.6
Unemployment Rate	8.8	8.6	7.8	7.6	7.8	7.5	7.8	7.2	7.7
					2.4		2.4		2.3
Labour Cost Index	2.4	2.4	2.5	2.6	2.8	2.6	2.9	2.7	3.2
					0.9		0.6		0.2
Labour Productivity	1.0	0.7	1.4	1.3	1.7	1.0	1.5	0.8	1.5
					1.6		1.5		1.4
HICP	2.1	2.2	2.2	1.7	1.8	1.8	2.1	2.0	2.6
					2.6		2.0		0.7
IPI	2.0	1.3	3.8	3.3	4.0	2.9	3.8	2.1	3.5

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

Economic Outlook for 2007 and 2008

The world economy

In the spring of 2007, international financial markets have experienced some turbulence. During the final week of February, stock price indices in the main economies fell considerably, the Dow Jones Industrial by about 4% and the Nikkei by 8%. Even more pronounced were the losses in emerging markets. Credit spreads for corporate as well as for sovereign bonds that were not of first rate quality widened significantly. Since then, however, markets seem to have stabilized. Fears that a sudden and strong appreciation of the yen could provoke heavy losses of “carry traders” who have borrowed in yen in order to invest in higher yielding currencies appear to be overdone. Indeed, the backlash should be considered in perspective: developments on world financial markets had been extremely favourable since summer last year; comparing US and European stock prices in mid March with their level a year before still gives the picture of healthy growth, and risk spreads are still low by historical standards.

News has, in general, not been disappointing in the first months of this year. Profits are still high in all important economies, and the moderation of profit growth in the US was long expected. Moreover, fourth quarter data from Europe and Japan point clearly to a continuation of the upswing in these regions. The reasons for a more subdued mood of capital markets lie mainly in mixed data for the US: weak investment activity and the housing downturn have impaired confidence. Data on delinquencies for subprime mortgages were particularly worrying. However, insolvency rates for mortgages are not high in historic perspective, and average house prices appear not to fall on average, but to rise at lower rates. Consumption of private households is still strong, as is growth of household income.

The trigger of the downturn on world financial markets was a temporary collapse of stock prices in Shanghai. Output growth, however, appears to be even accelerating in China; policy had to react by further tightening restrictive measures. In general, growth dynamics continue to be strong in most emerging market economies. Commodity exporting countries still benefit from rising prices – although price dynamics has, on average, abated since last summer; oil sells at about 60 dollars (Brent), a high price though roughly 10 dollars lower than the peak.

In the rest of 2007 financial markets will most certainly not be as supportive for growth as they were last year: asset prices will rise much slower, and risk spreads will be a bit higher.

The outlook for monetary policy is as follows. In the US, inflation forecasts for 2008 in terms of the PCE (2.2%), which is the inflation indicator more closely followed by the FED, are considerably above the central tendency established by the monetary authority for this year (1.75-2.00%). Hence, the FED is not expected to cut interest rates until it has some guarantees that its inflation targets will be met. The ECB has signalled that it is still prepared to tighten policy further. The lifting of Japanese interest rates in February will be probably followed by another step, when later this year inflation rates will become clearly positive.

All in all, growth dynamics of the major economies will probably converge: while the upswing in Europe and in Japan will slow down slightly during 2007, output growth in the US will accelerate at the end of 2007 and continue stronger in 2008 with the nearing of presidential elections. As production in the industrialized countries will be more or less close to capacity, the world economy will expand at a rate close to the potential growth path. This path, however, is steeper than in the 80s or 90s of the last century, thanks to the high growth dynamics in most emerging markets economies.

Financial markets are a major risk factor: while low interest rates have generally strengthened the present upswing, capital costs were relatively low in particular for risky investment projects; this can be explained by the spread of new sophisticated financial instruments like collateralized debt obligations that diversify risk more efficiently among investors. It is an open question whether these instruments will proof as useful shelters this year, when economic conditions might be somewhat more difficult.

The euro area

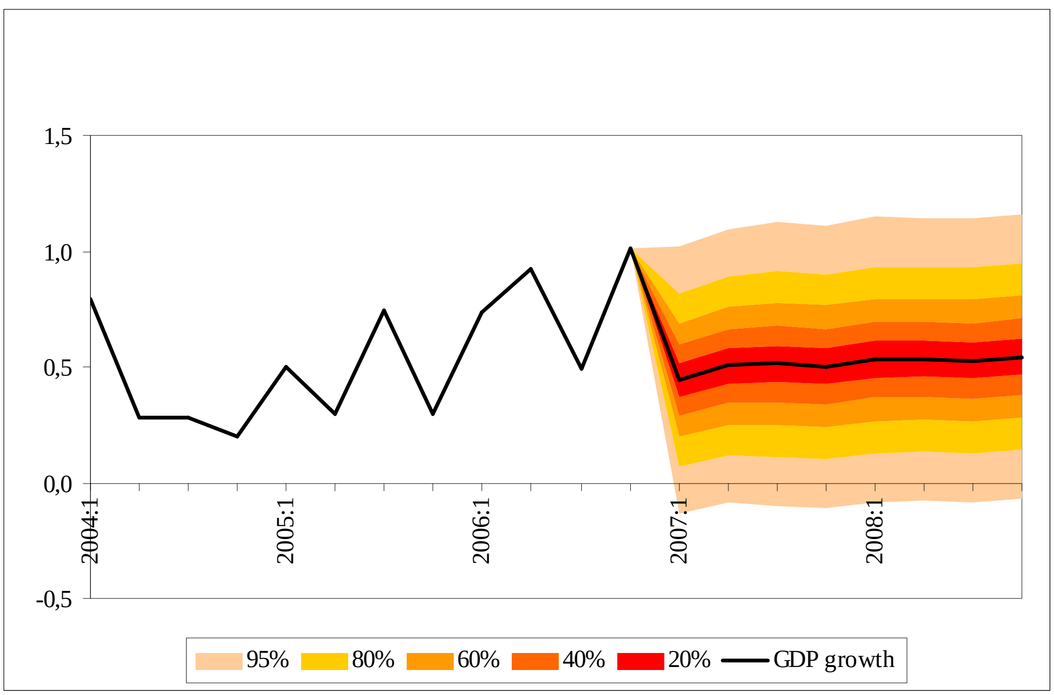
At the end of 2006, the upswing in the euro area gained momentum. Exports performed particularly well: their growth rate in the fourth quarter was the highest since 2000. Investment grew healthily with about the average speed for 2006. Private consumption, however, continues to expand only moderately.

The stronger performance of investment as compared to consumption is easily explained: capital is still relatively cheap thanks to low real interest rates, low risk spreads and – at least until March – buoyant stock markets. Unit labour costs have been rising very slowly: wage growth continued on a moderate path and labour productivity rose, which is partly a cyclical phenomenon. All this contributed to healthy profits and made investment and hiring of workers more attractive. Employment growth has accelerated over the past year, and the unemployment rate is, with about 7½ %, at its lowest since the euro area was formed.

In view of all the above, chances are good that the favourable developments on the labour markets will continue this year, that unemployment will decrease and that the upswing will finally be reflected in an acceleration of wage growth. This will provoke consumers to spend more, and the driving force for growth in 2007 will be consumption of private households, and private investment.

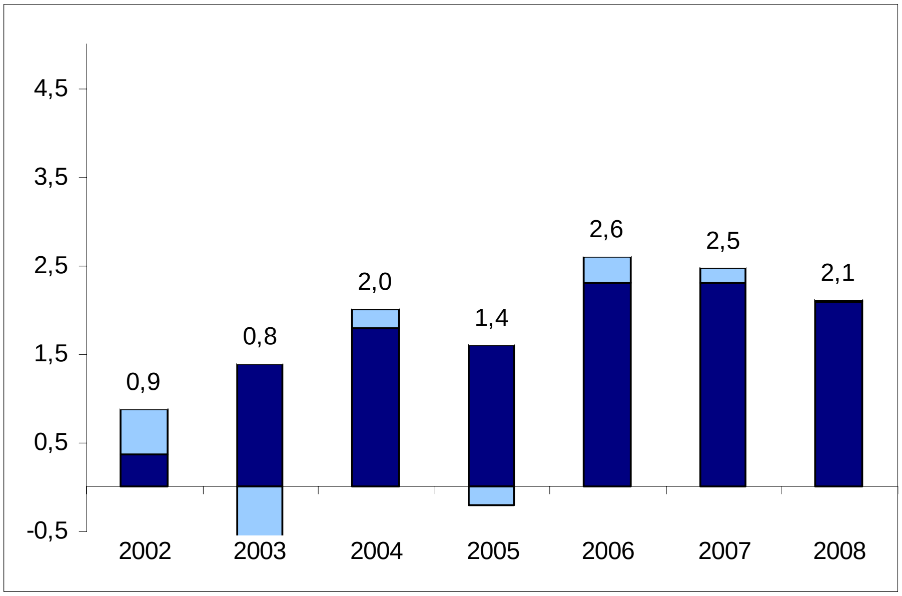
Overall, we expect a GDP growth of 2.5% in 2007 and 2.1% in 2008 in the euro area. The evolution of the quarterly GDP growth rate, and the uncertainty about it, are presented in Figure 1. Figure 2 reports the contribution of domestic components and net exports to GDP growth, and Figure 3 the expected evolution of the Economic Sentiment Indicator, which indicates a substantial stability in the economic agents´ confidence in the evolution of the euro area economy.

Figure 1. Quarterly GDP growth rates and confidence bands



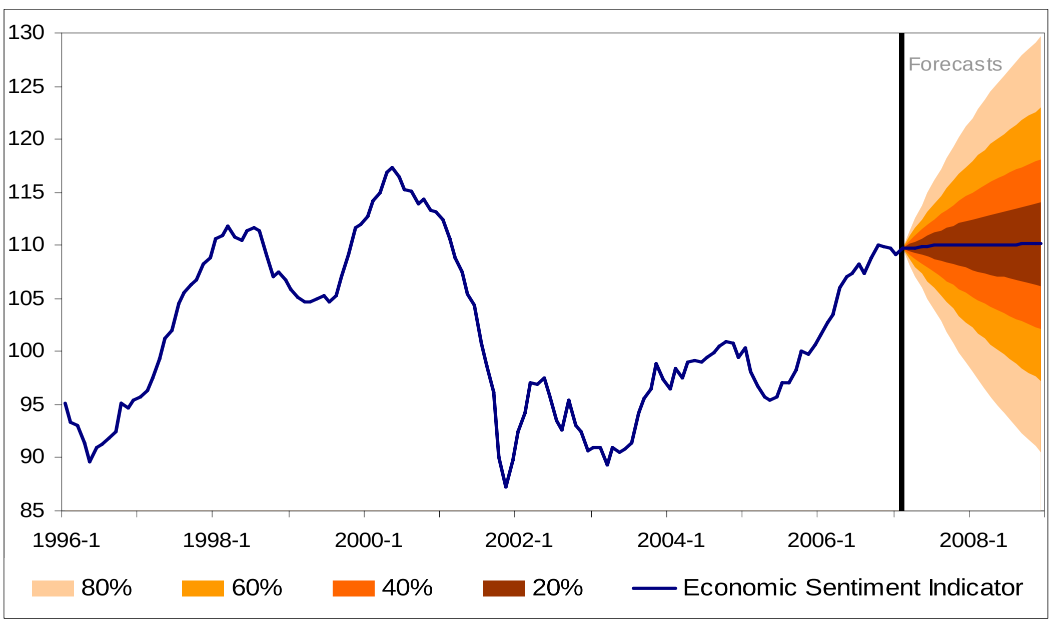
Percentage change over previous quarter

Figure 2. Contribution of domestic components and net exports to GDP growth



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

Figure 3. Euro Area Economic Sentiment Indicator



From a supply-side perspective, in 2006 the market and financial services sector and the industrial sector played a key role for growth in the euro area, see Table 2. Their contribution amounted up to 74% of the total. Although smaller, the contribution from the construction sector was noticeable, as it increased from 0,06pp in 2005 to 0,19pp in 2006. In 2007, market and financial services and industry are expected to remain the key sectors for growth, even though with a slightly lower contribution, about 66%, resulting from a smaller input from the industrial sector.

Table 2. Contributions of production sectors to GDP growth

					Services			
Year	GDP Growth	Agriculture	Industrial	Construction	Market	Financial	Public	Net taxes
2003	0,80%	-0,12	0,01	0,03	0,03	0,45	0,28	0,12
2004	2,00%	0,27	0,30	0,09	0,49	0,45	0,30	0,10
2005	1,40%	-0,11	0,30	0,06	0,28	0,54	0,18	0,15
2006	2,60%	-0,01	0,69	0,19	0,56	0,66	0,24	0,27
2007	**2,50%**	**-0,02**	**0,52**	**0,17**	**0,55**	**0,68**	**0,29**	**0,32**
2008	**2,10%**	**-0,01**	**0,33**	**0,12**	**0,47**	**0,63**	**0,28**	**0,27**

Early this year, industrial production has held its high level. The same is true for confidence in the industrial and the service sector. The latest available data on the euro area Industrial Production Index (IPI) showed an annual growth slightly greater than expected. Forecasts for 2007 and 2008 have been revised upwards to 2.9% and 2.1%, respectively, as the result of this upwards innovation and of the forecasts regarding the economic agents’ confidence in the industrial sector.

The average annual rates of growth in the euro area Industrial Production Index for different industries classified according to the destination of goods are reported in Table 3. For all the industries, a smaller growth is forecast in 2007 than in 2006. However, expected rates are still above those for the last years, before the recovery in 2006. The industries with a stronger expected slowdown are durable consumer goods and energy. For the latter, a negative rate is expected in 2007.

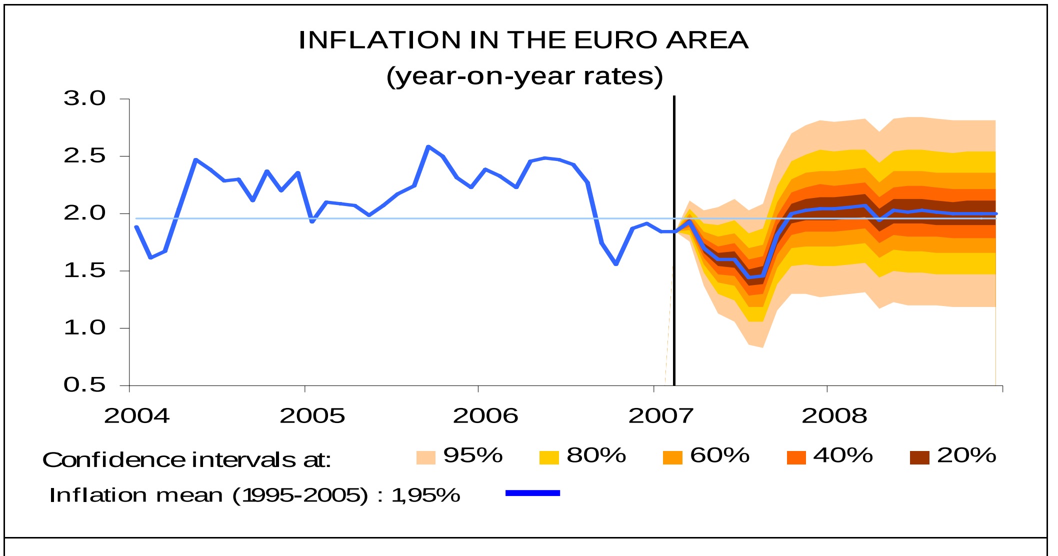
Table 3. Annual average rates for industrial production in the euro area

	2002	2003	2004	2005	2006	**2007**	**2008**
Capital	-1.6%	-0.1%	3.3%	2.8%	5.5%	**4.5%**	**3.3%**
Durable	-6.1%	-4.4%	0.1%	-0.9%	4.2%	**1.5%**	**0.4%**
Intermediate	-0.1%	0.3%	2.2%	0.9%	4.9%	**4.6%**	**2.2%**
Non Durable	0.7%	0.4%	0.6%	0.7%	1.9%	**1.5%**	**0.9%**
Energy	1.5%	2.8%	2.0%	1.2%	0.7%	**-2.9%**	**1.2%**
Total EMU	-0.4%	0.3%	2.0%	1.3%	3.8%	**2.9%**	**2.1%**

Regarding inflation in the euro area, since our last report, we have revised the forecasts for 2007 mildly downwards, to 1.8%, and upwards those for 2008, to 2.0%. More precisely, we expect the annual inflation rate, currently at 1.8%, to show a progressive fall of up to 0.4pp until July 2007 and to reactivate from then onwards, ending the year at levels close to 2.0%, and stabilising at those levels in 2008, see Figure 4.

With an 80% probability, inflation in 2007 will be in the interval 1.5-2.0, and the likelihood of meeting the ECB target is above 90%. The impact of the German VAT increase, which so far is estimated at approximately 0,1pp in the euro area, has not put into danger the compliance with the inflation target. However, the high probability of an inflation rate below 2% (and lower than last year) responds more to the behaviour of the prices outside the core component than to the core component, as our forecast for core inflation is higher than for 2006.

Figure 4. Year on year inflation and confidence bands



Given the expected evolution of the real economy and our inflation forecasts, further increases of the ECB reference interest rate up to 4-4.25% by the end of 2007 are likely.

To conclude, the positive perspectives for the euro area economy emerging so far from this Report have, however, to cope with some adverse factors that have partly been discussed above. First, the performance of the US economy will be sluggish in the first part of 2007, reducing the outlook for European export firms and for European firms and private households holding US assets. Second, there is the possibility of a further devaluation of the US$. Third, and connected with the US slowdown, the outlook for financial markets is not as favourable as last year. Finally, economic policy in the euro area is slightly more restrictive: the ECB will probably raise its main interest rate to 4-4.25%, and fiscal policy is fairly restrictive in Italy and in Germany. All in all, the upswing will lose momentum as early as in spring, but – leaving, of course, aside external shocks – output growth will stay at rates that are slightly above the growth rate of capacity.

Two additional euro area-specific risk factors for our positive outlook are related to the labour and housing markets. The continuously increasing demand for skilled labour could lead to wage- and price dynamics that induce the ECB to tighten monetary policy more drastically than forecast here. Moreover, a downturn of the housing market in some countries, more likely in 2008, might lead to a slump in consumer demand. It might be argued that especially countries like Spain are vulnerable, because the housing boom of the past years in these countries appears to have been accompanied by a loss in competitiveness due to rising unit labour costs.

Comparison with alternative forecasts

The forecasts presented above are obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 4 presents a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts/projections, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

The more recent GDP forecasts, namely those of EFN, ECB, and Consensus Economics, are quite similar for 2007. However, we forecast a more dynamic expansion of private household consumption, mainly due to more favourable developments on the labour markets. For 2008, our forecast is not as optimistic as that of the ECB staff, mainly because we forecast that the conditions for investment will not stay as favourable as they have been in the recent past.

On inflation, EFN forecasts coincide with those presented by the latest ECB macroeconomic projections, according to which inflation is expected to average between 1.5% and 2.1% in 2007 and between 1.4% and 2.6% in 2008. All the forecasts from EFN; ECB and Consensus Forecast give a higher inflation in 2008 than in 2007, reaching the upper limit of the ECB target. The EU and OECD forecasts in the Table below show the contrary, a decreasing path, especially the EU ones, but it must be said that these forecasts were presented in the Autumn 2006, so they are not as up to date as the others are. In fact, the European Commission interim forecast shows an inflation forecast for 2007 of 1.8%, instead of 2.1% (with GDP growth for 2007 revised upwards to 2.4%). This interim forecast does not cover 2008.

Table 4. Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
GDP	2.5	2.1	2.1	2.2	2.0	na	2.5	2.4	2.2	2.3	2.3	2.1
Priv. Consumption	2.4	2.2	1.6	2.1	1.7	na	2.1	2.3	1.7	2.3	1.8	2.0
Gov. Consumption	1.4	1.4	1.4	1.4	1.5	na	1.3	1.5	1.6	1.7	1.6	1.5
Fixed Capital Form.	3.1	2.5	3.0	3.0	3.6	na	3.7	3.5	4.2	3.2	3.8	3.2
Unemployment rate	7.5	7.2	7.7	7.4	7.7	na	na	na	7.4	7.1	7.3	7.1
HICP	1.8	2.0	2.1	1.9	2.4	na	1.8	2.0	1.9	1.8	1.8	1.9
IP	2.9	2.1	na	na	na	na	na	na	na	na	2.6	2.2

EU: European Commission, European Economy, No. 5, 2006 (Autumn); IMF: World Economic Outlook, September 2006; ECB: ECB Monthly Bulletin, March 2007, OECD: Economic Outlook, No. 80, November 2006; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2007. 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 5 below. For the US, GDP growth will be below potential in 2007 and about at potential in 2008. Japan is assumed to continue its healthy growth path. Inflation will slow in the US in 2007 due to sluggish demand and energy prices that have decreased, while deflation in Japan comes to an end. An oil price of 60 (62) dollar per barrel is expected for the end of 2007 (2008).The euro is assumed to be stable relative to the dollar.

Table 5. Variables of the world economy

	2007	2008
US GDP Growth Rate	2.4	3.0
US Consumer Price Inflation	2.0	2.3
US Short Term Interest Rate	5.0	4.9
US Long Term Interest Rate	4.8	5.1
Japan GDP Growth Rate	2.1	2.2
Japan Consumer Price Inflation	0.1	0.5
Japan Short Term Interest Rate	0.7	1.3
Japan Long Term Interest Rate	1.8	2.2
World Trade	7.5	7.2
Oil Price	60	62
USD/Euro Exchange Rate	1.32	1.32
100Yen/Euro Exchange Rate	1.52	1.52

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 (2007) and OECD (2006). Oil price (end of period) in US dollar per barrel, all other variables in percent.