

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2008 and 2009



Autumn 2008

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

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Highlights

- The short term outlook for activity in the euro area is clouded, as industrial production has been falling during summer, and confidence is still on a declining trend. Production will be little more than stagnating for the rest of the year, not least because financing costs will not fall or even rise further, as risk premia for credit, bonds and equity will reach higher levels.
- The average yearly growth rate of the industrial production index will be close to zero in both 2008 and 2009. By component, there is a widespread decline in expectations in all sectors except energy. Especially striking is the fall in the growth rates of Capital, Durable and Intermediate Goods.
- GDP growth is expected to be 1.2% in 2008 and 1% in 2009, well below potential. Growth in private consumption will be particularly limited, at 0.4% in 2008 and 1.1% in 2009.
- More pessimistic growth expectations have, however, led to price movements that start to remove the negative shocks by which the downturn was partly triggered in the first place: the euro has depreciated relative to the dollar since end of June, and oil prices have receded markedly.
- Thanks to the pessimistic growth expectations and the decrease in oil prices, inflation expectations have somewhat improved in the last two months. We expect inflation to continue to fall to 2.9% by the end of this year, registering values close to 2% from April 2009 on.
- Concerning the possibility of a serious crisis in euro area housing markets, there is some reason for cautious optimism: housing finance is on a more solid basis than in the US, and indebtedness of private households is much lower than either in the US or in Britain.

Table 1. Economic outlook for the Euro area

| | 2005 | 2006 | 2007 | 2008: 2nd half | | 2008: annual | | 2009: annual | |
|-------------------------|------|------|------|-------------------|----------------------|-------------------|----------------------|-------------------|----------------------|
| | | | | Point Forecast | Interval Forecast | Point Forecast | Interval Forecast | Point Forecast | Interval Forecast |
| | | | | | 0.2 | | 1.0 | | 0.2 |
| GDP | 1.7 | 2.8 | 2.6 | 0.7 | 1.1 | 1.2 | 1.4 | 1.0 | 1.7 |
| | | | | | 2.0 | | 2.0 | | 1.8 |
| Potential Output | 1.9 | 2.0 | 2.0 | 2.1 | 2.2 | 2.1 | 2.2 | 1.9 | 2.0 |
| | | | | | -0.5 | | 0.1 | | 0.1 |
| Private Consumption | 1.7 | 1.9 | 1.5 | 0.0 | 0.6 | 0.4 | 0.7 | 1.1 | 2.1 |
| | | | | | 1.1 | | 1.3 | | 1.0 |
| Government Consumption | 1.5 | 1.9 | 2.4 | 1.5 | 1.9 | 1.5 | 1.7 | 1.5 | 2.0 |
| | | | | | -0.9 | | 1.1 | | -0.7 |
| Fixed Capital Formation | 3.2 | 5.6 | 4.3 | 0.6 | 2.0 | 1.8 | 2.5 | 1.5 | 3.7 |
| | | | | | 0.3 | | 2.4 | | 1.2 |
| Exports | 4.9 | 7.9 | 6.1 | 1.3 | 2.2 | 2.9 | 3.4 | 2.2 | 3.2 |
| | | | | | 2.4 | | 1.6 | | 1.0 |
| Imports | 5.6 | 7.8 | 5.5 | 2.9 | 3.3 | 2.2 | 2.8 | 2.5 | 4.0 |
| | | | | | 7.2 | | 7.2 | | 7.2 |
| Unemployment Rate | 8.9 | 8.3 | 7.4 | 7.4 | 7.6 | 7.3 | 7.4 | 7.5 | 7.7 |
| | | | | | 3.3 | | 3.2 | | 3.4 |
| Labour Cost Index | 2.7 | 2.5 | 2.7 | 3.5 | 3.7 | 3.3 | 3.4 | 3.7 | 4.0 |
| | | | | | -0.6 | | -0.1 | | -0.3 |
| Labour Productivity | 0.7 | 1.2 | 0.8 | -0.2 | 0.2 | 0.1 | 0.3 | 0.4 | 1.0 |
| | | | | | 3.3 | | 3.4 | | 1.6 |
| HICP | 2.2 | 2.2 | 2.1 | 3.4 | 3.5 | 3.5 | 3.6 | 2.1 | 2.6 |
| | | | | | -2.3 | | -1.0 | | -1.7 |
| IPI | 1.4 | 4.1 | 3.5 | -1.4 | -0.5 | 0.1 | 1.2 | 0.0 | 1.7 |

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 model and based on 2000 stochastic simulations.

Economic Outlook for 2008 and 2009

The world economy: financial crisis hits again as advanced economies are slowing

At the end of summer 2008, world financial markets have again fallen into major turmoil. In September, the US state had to put Fannie Mae and Freddie Mac, the two large government-sponsored mortgage banks, into “conservatorship”; this means that most of the securities that are backed by new mortgage loans will now be implicitly guaranteed by the US government. A few days later, however, the government refused to bail the investment bank Lehman Brothers out of insolvency; as the value of Lehman-related assets is now in doubt, the stability of financial markets again appears to be at risk, even though the announced US plan for public intervention appears to have somewhat stabilized the financial markets, at least temporarily.

The ensuing financial turmoil has its roots in the continuing crisis of the US housing sector: house prices are falling with hardly slowing speed, and delinquencies of mortgage loans are steadily on the rise. US production, however, was surprisingly resilient during the first half of 2008. While the US benefited from net exports supported by a weaker dollar and strongly expansive monetary and fiscal policies, most other advanced economies slowed sharply during summer. This is the case for Western Europe and in particular for the UK, where the crisis of London’s financial sector affects the economy, and where the housing sector appears to enter a recession similar to that of the US. In Japan, output even contracted in the second quarter.

The worldwide clouding of economic prospects put an abrupt end to the price hike in commodity prices; crude oil is about 30% cheaper in mid September than at the price peak in early June. Abating inflationary pressure means that central banks in emerging markets see less need for tightening monetary policies. Here, in particular in China, growth has, up to now, kept up quite well.

Looking ahead, in the US the renewed turmoil on financial markets will add to the slow down that is clearly on the horizon, as indicated for example by the latest weak employment and consumption data. Production in the advanced economies will be little more than stagnating for the rest of the year, not least because the financing costs of investment projects will not fall or even rise further, as risk premia for credit, bonds and equity will be staying at elevated levels. This pattern will only change when the housing markets stabilize. For the US, this might happen in the first half of next year. Up to then, expansion in emerging economies will also slow, but here chances are good that growth dynamics will stay healthy.

The major risk for the world economy is spreading contagion in the financial markets; another risk factor is that commodity prices have become so volatile: this forecast

assumes that growth dynamics are stable in Asia, and that the advanced economies do not slide into recession. However, a renewed price hike might very well reveal that the roots of the present downturn are not only house price bubbles and the mispricing of financial risk, but also limits to world growth due to the scarcity of natural resources.

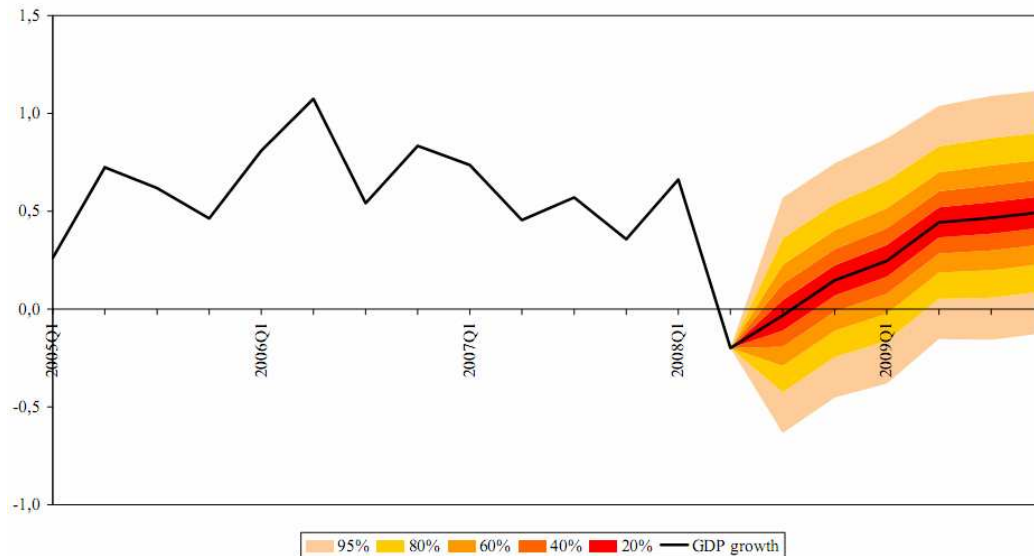
The euro area: risks of a hard landing

Activity in the euro area, after growing strongly at the beginning of 2008, shrank in the second quarter. Exports decreased due to the Euro appreciation and weakening world demand; private households reduced their spending, because the price hike in commodities, energy and food reduced real disposable income; and investment fell. Construction activity was particularly weak, although official statistics probably exaggerate the decline, as it still adjusts data for a winter season that did not hamper activity by much. Employment was still expanding, but the unemployment rate increased as well, from 7.2% to 7.3%. The short term outlook is clouded: industrial production has been falling during summer, and confidence, according to the surveys of the European Commission, is still on a declining trend that started in summer of last year.

More pessimistic expectations have, however, led to price movements that start to remove the negative shocks by which the downturn was partly triggered in the first place: the euro has depreciated by about 10% relative to the dollar since end of June, and world oil prices have receded markedly. Slowing inflation might give room for interest rate cuts in the near future, although the ECB is, at present, still concerned about the risks to price stability. One reason for the ECB being so much more hawkish than the Fed is that wage growth is flat in the US, but has accelerated in the euro area since summer of last year, partly due to indexation rules for wage setting in some countries. Wage growth does not appear to be unreasonably high, but from the point of view of the ECB it indicates, together with some signs of slightly rising long-term inflation expectations, the risk that the recent oil price shock might trigger, via second-round-effects, an inflationary process. Thus, markets are prepared not to see any rate cuts this year. At present, the real cost of external financing for non-financial corporations is, according to the ECB, higher than at any time since 2003, and the ongoing financial crisis will prevent financial conditions from easing this year. Therefore, the deceleration of loans to non-financial firms and of investment activity will continue during the coming quarters. While real disposable income is starting to rise again thanks to slowing inflation, less beneficial labour markets will prevent private households from reducing their saving rate. Supportive will be demand from emerging markets that keeps exports growing. All in all, the economy in the euro area will expand at rates below potential up to the summer of next year, when the dampening effects

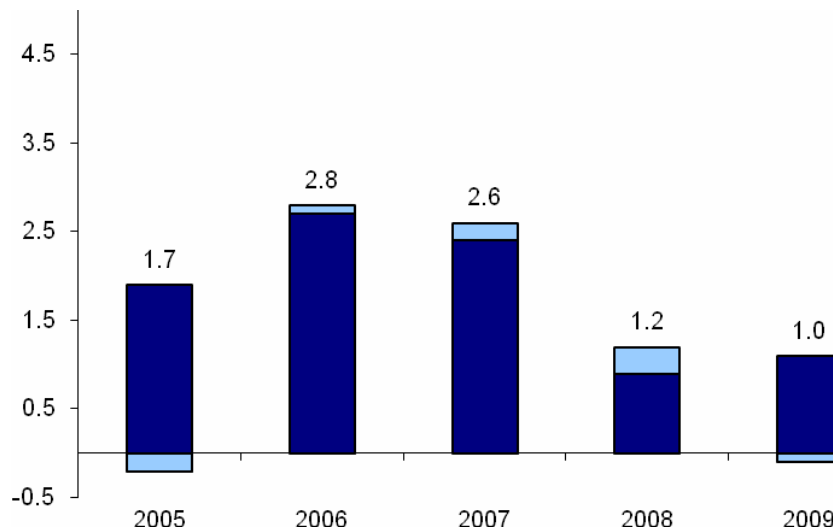
from the downturn in the US and from financial markets will slowly fade. Output is forecasted to be 1.2% larger this year than in 2007, and to grow by 1.0% in 2009.

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

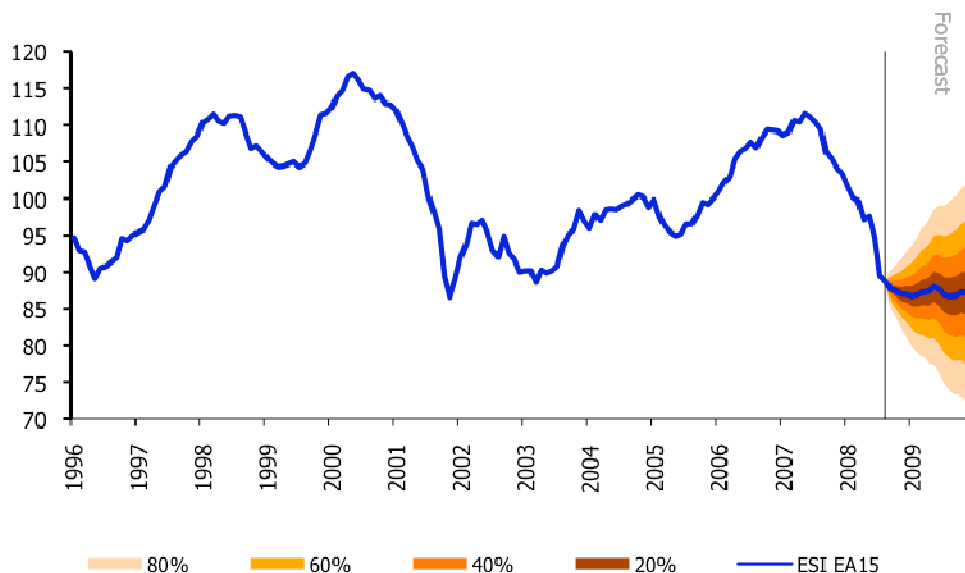


Domestic demand dark, net exports light area. Percentage points, figures above the columns indicate overall GDP growth

The downward risks for this outlook are considerable. The crisis of the housing markets in Spain and in Ireland will be a drag on growth in the euro area, probably up to the end of 2009, but several other euro area countries (e.g. France and the Netherlands) look vulnerable too, as house prices appear to be elevated from a historical perspective and have started to slow recently. There is also, however, reason for cautious optimism: housing finance is clearly on a more solid basis in the euro area than in the US. In addition, although indebtedness of private households has increased over the past five years markedly, it is much lower than either in the US or in Britain.

Concerning market expectations, the August Economic Sentiment Indicator (ESI) for the euro area fell again to the lowest level since 2003. It fell by 0.7 points to 88.8. By sector, economic agents continue to reduce their confidence in industry, whereas it grows considerably in services after last months' decrease. The confidence indicator forecast has been constantly falling in the last few months, especially in July when it fell by more than 5%. The forecasts based on the August figure show an end to this trend, with confidence improving in some sectors. Economic agents continue to expect the economy to gradually deteriorate, although less than in the last few months and this trend will end in the last quarter of 2008. The ESI will then recover slowly throughout 2009, although it will remain low during the entire year (see figure 3).

Figure 3. Economic Sentiment Indicator and confidence bands



Industrial production expectations declined heavily during the last three months. By component, there is a widespread decline in expectations in all sectors except energy,

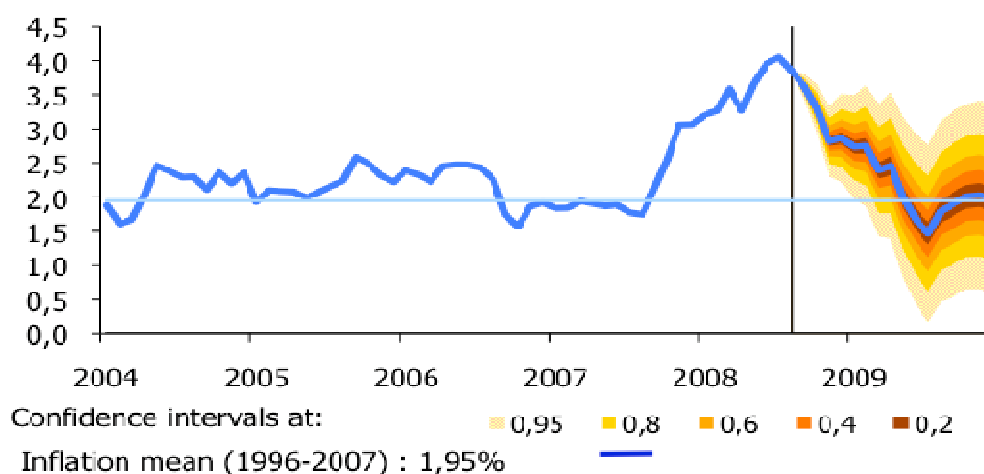
the least correlated component with the economic cycle. Especially striking is the fall in the growth rates of Capital, Durable and Intermediate Goods that in 2008 will be between 4 and 5 percentage points below the 2007 figures.

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

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--------------|------|------|------|------|------|------|------|
| Capital | -0.1 | 3.4 | 3.0 | 5.9 | 5.9 | 1.8 | -0.2 |
| Durable | -4.4 | 0.1 | -0.7 | 4.4 | 1.2 | -4.1 | -3.4 |
| Intermediate | 0.3 | 2.3 | 0.9 | 5.0 | 3.8 | -0.9 | -0.1 |
| Non Durable | 0.3 | 0.6 | 0.7 | 2.2 | 2.5 | -0.3 | 0.3 |
| Energy | 2.9 | 2.2 | 1.4 | 0.8 | -0.5 | 1.4 | 2.0 |
| Total EMU | 0.3 | 2.2 | 1.4 | 4.1 | 3.5 | 0.1 | 0.1 |

Since the last EFN report, the inflation expectations have been revised downwards thanks to the heavy reduction in oil prices. Headline inflation started to decline in August with a 3.8% year on year rate, 2 decimal points below the July figure. Inflation is expected to continue to fall to 2.9%(±0.42) by the end of the year, registering values close to 2% from April 2009 onwards. Nevertheless, in August the core inflation rate was slightly higher than expected, largely due to the evolution of Services and Manufactured Goods' prices. Hence, the core inflation profile for the next months will be slightly higher than previously estimated.

Figure 4. Euro Area Inflation Rate and confidence bands



This is bad news for the euro area economy because changes in core index components, although small, are usually more persistent. Considering the weak demand figures of the euro area's quarterly accounts, this price increase is very likely to reflect second round effects and a generalized increase in production costs. It is also important to note that after September we will see a gradual fall in core inflation year on year rates depending solely on processed food. This is due to the end of the "step effect" generated by the sudden price increase of processed food registered in September/October of 2007. After the heavy increases that took place at the end of last year, processed food prices continued to grow at their usual month-on-month rates, compatible with annual rates of around 3.0%. After 12 months, this change of level will be completely absorbed and annual rates will return to their regular levels.

Taking into account this information, the declining expectations for GDP growth in the euro area and the drastic worsening of the financial crisis on the world markets, the pressure on the ECB to immediately relax monetary policy will be considerably greater. However, rates are expected to remain stable in the short term and a cut in interest rates does not seem likely before December 2008.

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model. A detailed description of an early version of the model gives the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics. GDP numbers are very similar in the more recent outlooks of EFN, ECB and of the consensus, but also to the EU and the OECD interim forecasts. The EFN forecast for fixed capital formation in 2009 is relatively optimistic because the problems in the euro area housing sector are regarded as less severe than, for example, in the US and Britain.

The EFN forecasts for inflation are in line with those of ECB and consensus for 2008 and slightly more optimistic for 2009.

Table 3. Comparison of EFN forecasts with alternative forecasts

| | EFN | | EU | | IMF | | ECB | | OECD | | Consensus | |
|---------------------|------|------|------|------|------|------|------|------|------|------|-----------|------|
| | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 |
| GDP | 1.2 | 1.0 | 1.7 | 1.5 | 1.4 | 1.2 | 1.4 | 1.2 | 1.7 | 1.4 | 1.3 | 0.9 |
| Priv. Consumption | 0.4 | 1.1 | 1.4 | 1.5 | 1.4 | 1.2 | 0.7 | 1.1 | 1.3 | 1.6 | 0.5 | 0.9 |
| Gov. Consumption | 1.5 | 1.5 | 1.9 | 1.7 | 1.9 | 1.9 | 1.7 | 1.6 | 1.7 | 1.7 | 1.6 | 1.7 |
| Fixed Capital Form. | 1.8 | 1.5 | 2.0 | 1.2 | 1.8 | 1.0 | 1.6 | 1.4 | 2.0 | 0.8 | 2.0 | 0.6 |
| Unemployment rate | 7.3 | 7.5 | 7.2 | 7.3 | 7.3 | 7.4 | na | na | 7.2 | 7.4 | 7.3 | 7.6 |
| HICP | 3.5 | 2.1 | 3.2 | 2.2 | 2.8 | 1.9 | 3.5 | 2.6 | 3.4 | 2.4 | 3.5 | 2.4 |
| IP | 0.1 | 0.0 | na | Na | na | Na | na | na | na | na | 0.7 | 0.7 |

EU: European Commission, European Economy, No. 1, 2008 (Spring); IMF: World Economic Outlook, April 2008; ECB: ECB Monthly Bulletin, September 2008, OECD: Economic Outlook, No. 83, June 2008; Consensus: Consensus Economics Inc., Consensus Forecasts, September 2008. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

European Commission Interim Forecasts, 2008 (September), GDP growth in 2008: 1.3, HICP inflation in 2008: 3.6.

OECD Interim Assessment, 2008 (September), GDP growth in 2008: 1.3.

IMF World Economic Outlook update, 2008 (July), GDP growth in 2008 and 2009: 1.7 and 1.2.

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. While US growth is assumed to be clearly below potential in 2009, world trade gains strength during next year. Oil prices will, according to the assumptions, increase a bit from their level of about 100 dollars in mid September.

Table 4. Variables of the world economy

| | 2008 | 2009 |
|--------------------------------|------|------|
| US GDP Growth Rate | 1.8 | 1.4 |
| US Consumer Price Inflation | 4.5 | 2.9 |
| US Short Term Interest Rate | 1.8 | 2.6 |
| US Long Term Interest Rate | 3.9 | 4.4 |
| Japan GDP Growth Rate | 1.1 | 1.3 |
| Japan Consumer Price Inflation | 1.4 | 0.9 |
| Japan Short Term Interest Rate | 0.9 | 1.1 |
| Japan Long Term Interest Rate | 1.6 | 1.8 |
| World Trade | 4.2 | 5.0 |
| Oil Price | 114 | 116 |
| USD/Euro Exchange Rate | 1.5 | 1.4 |
| 100Yen/Euro Exchange Rate | 1.6 | 1.5 |

Apart from the development of world trade and long-term interest rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (August 2008). Oil price (WTI, end of period) in US dollar per barrel, all other variables in percent. US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short-term interest rate: new 90-<120 day certificates of deposit. Japan long-term interest rates: 10-year treasury bills.