

# **EFN REPORT**

## **ECONOMIC OUTLOOK FOR THE EURO AREA IN 2009 and 2010**



**Winter 2008/09**

## 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](http://www.efn.uni-bocconi.it) or by e-mail at [efn@uni-bocconi.it](mailto:efn@uni-bocconi.it).

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### **ECONOMIC OUTLOOK FOR THE EURO AREA IN 2009 and 2010**

#### **Highlights**

- Economic policy will not be able to stop recessions in the developed economies during the first half of 2009; positive announcement effects will be limited because economic agents feel that a recovery is conditioned on a stabilizing financial sector.
- For the recession to end, two conditions are crucial: first, government intervention into financial markets has to be effective for some time, so that agents revise their pessimistic views on the short term stability of systemically important banks. Second, the fall in house prices has to subside visibly, at least in the US, so that balance sheets of institutions holding assets based on real estate can stabilize.
- In the euro area, the financial crisis will curb production in various ways. In particular, first, it aggravates the housing crisis in Spain and Ireland and undermines housing markets elsewhere; second, the end of the world wide investment boom hits producers of investment goods; and, last, the steep increase in risk premia for bonds issued by states with high debt levels or deficit quotas limits their scope for fiscal action.
- As a consequence, our GDP growth forecast for 2009 has been substantially reduced, to -0.5%, with a slight recovery expected in 2010, to 0.8%. Industrial production forecasts have also worsened. The expected average growth rate has been revised downwards to a negative 3.1% for 2009 and will be only slightly positive (0.2%) in 2010.
- Inflation expectations in the euro area have fallen sharply since the last report mainly due to the fall in energy prices and, more recently to the fall in food prices. We now forecast HICP inflation to be 1.1% in 2009 and 2.3% in 2010. The consolidation of the inflation reduction process paves the way for the ECB to further reduce the official interest rate during the next months.

**Table 1 Economic outlook for the Euro area**

|                         | 2006 | 2007 | 2008 | 2009: 1st half    |                      | 2009: annual      |                      | 2010: annual      |                      |
|-------------------------|------|------|------|-------------------|----------------------|-------------------|----------------------|-------------------|----------------------|
|                         |      |      |      | Point<br>Forecast | Interval<br>Forecast | Point<br>Forecast | Interval<br>Forecast | Point<br>Forecast | Interval<br>Forecast |
| GDP                     | 2.9  | 2.6  | 1.0  | -0.7              | -1.4<br>0.0          | -0.5              | -1.2<br>0.3          | 0.8               | -0.1<br>1.6          |
| Potential Output        | 1.9  | 2.0  | 2.2  | 2.0               | 1.9<br>2.1           | 1.8               | 1.7<br>1.9           | 1.6               | 1.4<br>1.7           |
| Private Consumption     | 1.9  | 1.6  | 0.2  | -0.1              | -1.0<br>0.7          | 0.2               | -0.7<br>1.1          | 1.3               | 0.3<br>2.3           |
| Government Consumption  | 1.9  | 2.3  | 1.9  | 2.0               | 1.5<br>2.6           | 1.7               | 1.1<br>2.3           | 1.2               | 0.6<br>1.7           |
| Fixed Capital Formation | 5.5  | 4.3  | 1.4  | -3.2              | -5.1<br>-1.2         | -2.8              | -4.8<br>-0.7         | -0.4              | -2.7<br>1.9          |
| Exports                 | 8.3  | 5.9  | 3.1  | -0.8              | -2.0<br>0.4          | -1.1              | -2.1<br>-0.1         | 1.0               | -0.2<br>2.2          |
| Imports                 | 8.2  | 5.4  | 2.6  | -0.9              | -2.5<br>0.7          | -1.2              | -2.7<br>0.3          | 1.7               | 0.1<br>3.4           |
| Unemployment Rate       | 8.3  | 7.4  | 7.5  | 7.8               | 7.6<br>8.0           | 8.0               | 7.7<br>8.2           | 8.3               | 7.9<br>8.6           |
| Labour Cost Index       | 2.4  | 2.7  | 3.1  | 3.4               | 3.2<br>3.6           | 3.3               | 3.1<br>3.5           | 3.0               | 2.7<br>3.2           |
| Labour Productivity     | 1.3  | 0.8  | -0.1 | -1.1              | -1.7<br>-0.6         | -0.7              | -1.4<br>-0.1         | 0.5               | -0.2<br>1.2          |
| HICP                    | 2.2  | 2.1  | 3.3  | 1.0               | 0.7<br>1.3           | 1.1               | 0.5<br>1.7           | 2.3               | 1.5<br>3.1           |
| IPI                     | 4.0  | 3.5  | -0.7 | -3.7              | -4.6<br>-2.8         | -3.1              | -4.2<br>-2           | 0.2               | -1.6<br>1.8          |

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**

### ***Financial crisis draws world economy to the brink of recession***

At the end of 2008 most of the developed economies are in recession, and the world economy is in a steep downturn. Production fell in autumn in the US, in the Euro area, in Britain and in Japan, and everywhere indicators suggest that the fall will continue during winter. Emerging markets economies had kept up well until summer, but since then, their growth has decelerated markedly.

The downswing had, as aggregate industrial production of OECD countries shows, begun as early as in the winter of last year. Actually, according to the NBER, the recession in the US started in December 2007. Up to the summer the main factor for the deterioration was not the financial crisis, but the price hikes in markets for energy and commodities. These supply shocks caused inflation and inflation expectations to go up. In summer, the price hikes broke down, not least because the short term outlook was steadily deteriorating. Since then expectations for inflation are falling everywhere, but those for growth as well, because the world economy now has been hit by a demand shock: the worsening of the financial crisis, in particular after the fall of the US-investment bank Lehman Brothers in September. At present, downward spirals on financial markets, on markets for goods and for labour reinforce each other. Financial market stress plays a particularly important role: risk spreads on yields and losses in asset values are even higher than during the last downturn at the beginning of the decade. Financial conditions for firms continue to deteriorate: costs for equity and bond yields are on the rise, credit conditions are tightening, and the bases for collateral that has to be pledged to lenders are shrinking. The financial position of households is also worsening, in particular where, as in the US, in Britain, Spain and Ireland, housing values are falling.

Economic policy in most countries has strongly reacted to the deteriorating situation: “unorthodox” measures are used to satisfy the expanded demand for liquidity from banks. Since September, interest rates were slashed by the Fed, the ECB, the Bank of England, and other central banks. Because doubts about the solvency of financial institutions in the US and in Europe are at the heart of the crisis, public money is being put into guarantees for bank debt, for the acquisition of high risk-securities that are stuck in the balances of banks, and into a recapitalization of systemically important banks. Fiscal programs are planned in many countries, such as the US and big members of the European Union; and a particularly sizable one has been announced by China.

Chances, however, that these policy measures will stop recessions in the developed countries during the first half of 2009 are slim. Fiscal programs need some time to take

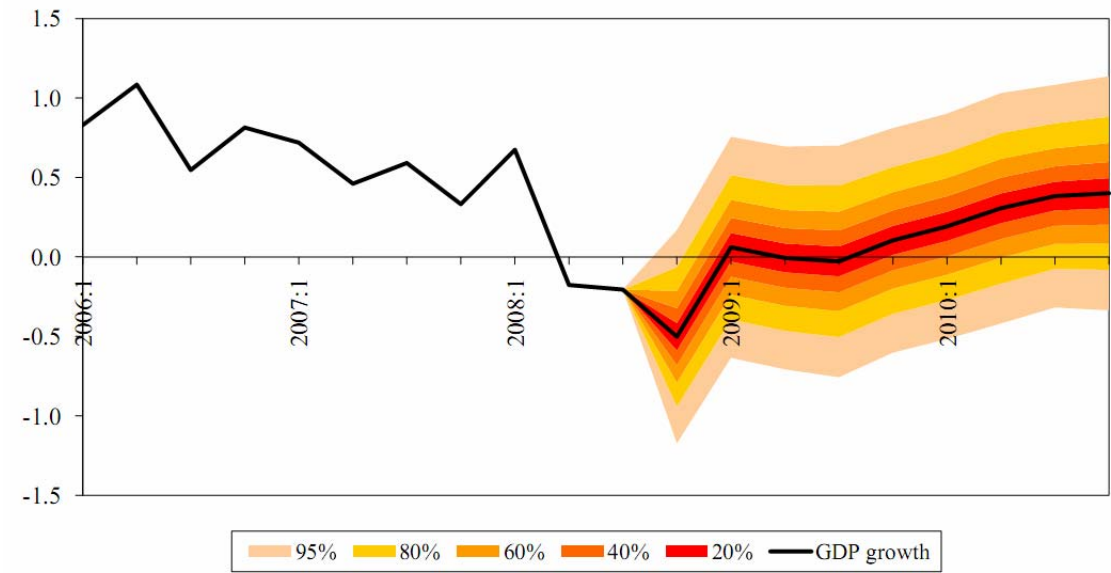
effect. Interest cuts will not revive the real economy as long as the transmission process is dysfunctional due to the banking crisis. In general, positive announcement effects will be limited because economic agents feel that a recovery is conditioned on a stabilizing financial sector. Supportive for most developed countries is, however, the steep fall in prices for energy and commodities. For the recession to end, two conditions appear to be crucial: first, government intervention into financial markets has to be effective for long enough so that agents revise their pessimistic views on the short term stability of systemically important banks in the US and in Europe. Risk premia should then recede markedly. Second, the fall in house prices has to subside visibly, at least in the US, due to shrinking supply. In such a situation, asset values backed by real estate and thus balance sheets of institutions holding these assets should stabilize as well. Our forecast of a tentative revival in the second half of 2009 is based on the assumption that both conditions are met to an increasing degree starting from summer 2009. But clearly, the downward risks of this forecast are high, in particular because the deteriorating real economy might do a lot of damage to the financial sector during the coming quarters, preventing stabilization.

### ***The euro area: housing crises and weak exports depress investment***

Production has been falling in the Euro area since the second quarter of 2008. Private consumption was stagnant during the whole year and, in addition, after springtime export dynamics began to slow markedly, and investment has been shrinking. The latter is partly due to the housing crisis in Spain and Ireland. In addition, the clouding of prospects has caused firms to reduce their investment budgets. Industrial capacity utilization was high at the beginning of the year but has, according to the survey of the European Commission, been falling steeply ever since. Confidence is falling precipitously – in industry, but also in the construction sector and in services, as well as among consumers. While a main reason for this downfall is surely the evolving financial crisis, the turmoil on world financial markets has also produced some beneficial side effects for firms and households in the euro area: the fall of the euro relative to the dollar (by about 15% between June and December) has made European producers more competitive; meanwhile the bursting of the price bubble for energy (by about 60% for crude oil during the same period) and commodities has boosted real incomes. In addition, growth of nominal wage income has accelerated in 2008 and will not collapse swiftly, as labour markets are mostly sluggish in the euro area. Thus, private income and consumption should, in spite of recession, keep up reasonably well. The downside of this are accelerating unit labour costs, since productivity will be at best stagnating, as firms will try to keep dismissals low while production falls further during winter. Still, unemployment

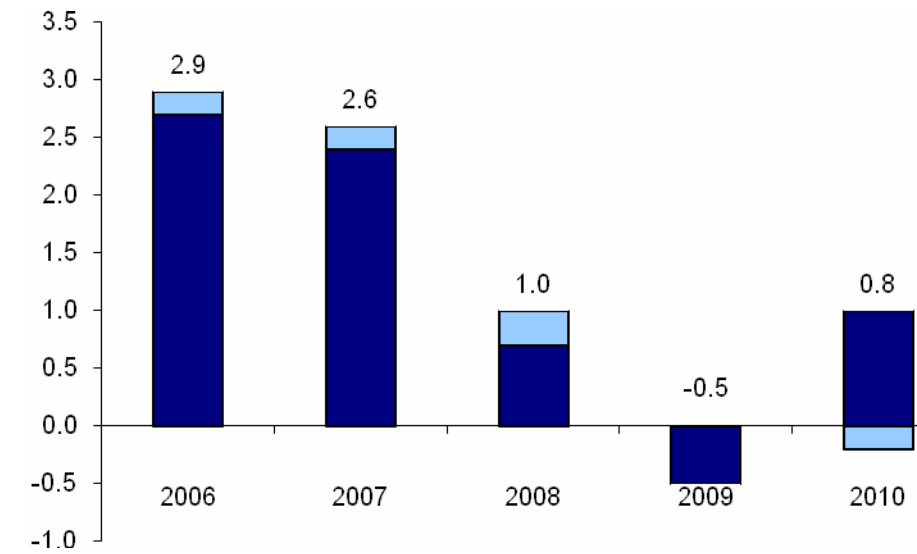
has already increased by half a percentage point since spring (to 7.7% in October) and is due to rise further.

**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**



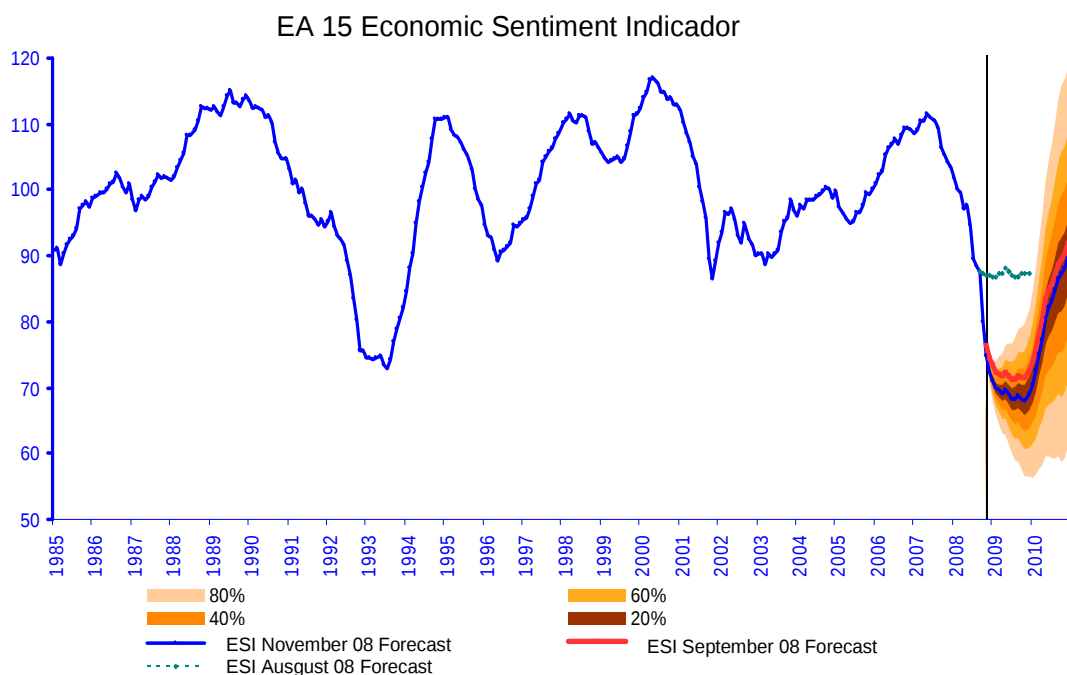
Domestic demand dark, net exports light area. Percentage points, figures above the columns indicate overall GDP growth

The economy in the euro area will not start to recover before the end of 2009; instead, the financial crisis will curb production by rising financing costs, and in various indirect ways: it aggravates the housing crisis in Spain and Ireland and undermines housing markets where, as in France, they are in weak conditions. In addition, the end of the world wide investment boom hits the producers of investment goods especially hard; the importance of motor industries for Europe comes to mind. Finally, the steep increase in risk premia for bonds issued by states (as Italy or Greece) with high debt levels or deficit quotas limits the scope these states have for fiscal action.

Overall, we expect euro area GDP to shrink by 0.5% in 2009, and to increase by a meagre 0.8% in 2010.

In line with this negative perspective, we expect that the confidence of economic agents, as measured by the Economic Sentiment Indicator (ESI), will continue to fall sharply during the next months reaching values even lower than in the 1993 crisis. With respect to the forecast published in our autumn report (the green line in figure 3) the revision has been dramatic. Recovery will start at the end of 2009 but the index will remain below 100 points during all the forecasting period. The decline was widespread to all the index components being particularly intense, during the last months, in the service sector. The repeated announcements of rescue plans have failed to restore confidence.

**Figure 3. Economic Sentiment Indicator and confidence bands**



The fast deterioration of economic expectations is confirmed by industrial production forecasts. The revision with respect to the previous report has been dramatic especially for durable consumer goods, capital and intermediate goods. The fast fall in investment and exports and the limited ability of households to finance durable goods purchases is driving the industrial sector towards the worst crisis since the introduction of the common currency. We expect industrial production to decline in all sectors during 2009 being energy the only exception (see table 2). While the production of durable consumer goods will continue to fall during 2010, our forecasts indicate for this year small but positive growth rates for the other sectors and for the overall index. According to our forecasts, the year on year growth rate of the industrial production index will reach its bottom during the current and the next quarter, while it will start recovering in the second half of 2009, timidly at first, and not reaching positive rates until the second half of 2010.

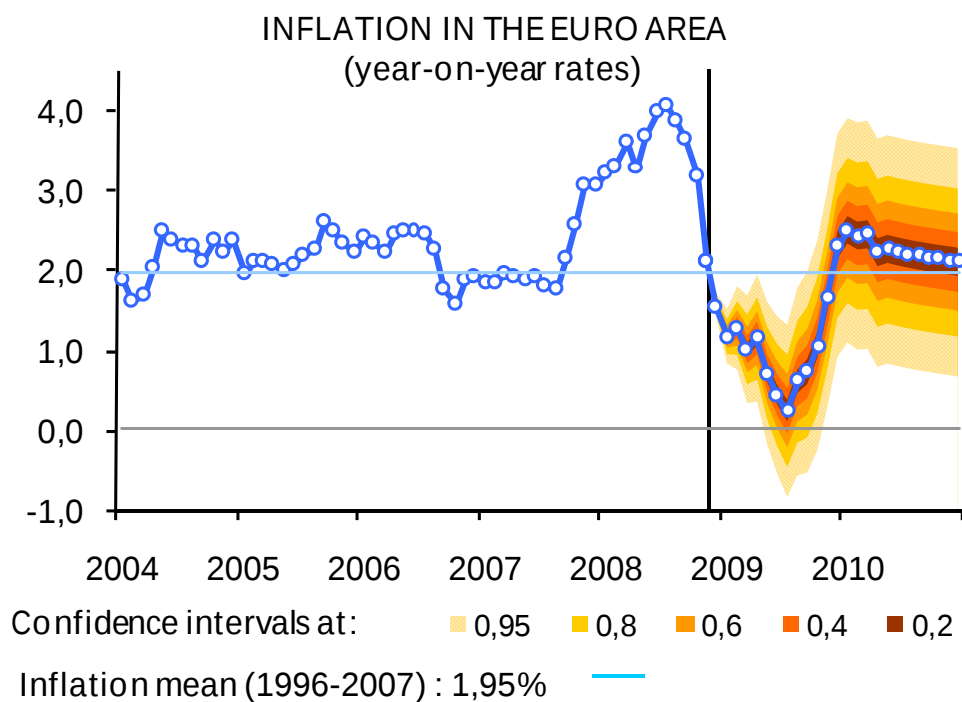
**Table 2 Annual average rates for industrial production in the euro area**

| ANNUAL GROWTH RATES IN THE IPI AND SECTORS IN THE EURO AREA |      |                |             |               |                    |        |       |
|-------------------------------------------------------------|------|----------------|-------------|---------------|--------------------|--------|-------|
|                                                             |      | Consumer Goods |             | Capital Goods | Intermediate Goods | Energy | TOTAL |
|                                                             |      | Durable        | Non Durable |               |                    |        |       |
| ANNUAL AVERAGE RATES                                        | 2004 | 0,9            | 0,5         | 3,5           | 2,3                | 0,9    | 1,9   |
|                                                             | 2005 | -0,8           | 0,6         | 2,7           | 0,6                | 0,0    | 1,0   |
|                                                             | 2006 | 4,0            | 2,0         | 5,7           | 4,4                | -0,8   | 3,4   |
|                                                             | 2007 | 1,0            | 1,4         | 5,7           | 3,5                | -1,1   | 2,9   |
|                                                             | 2008 | -4,9           | -1,5        | 0,3           | -1,8               | 0,6    | -0,7  |
|                                                             | 2009 | -8,8           | -1,8        | -3,7          | -4,7               | 4,1    | -3,1  |
|                                                             | 2010 | -1,3           | 0,3         | 0,2           | 1,4                | -0,8   | 0,2   |

On the positive side, since the last EFN report inflation expectations have declined considerably, without making deflation a highly likely scenario. This is mainly due to the fall in oil and energy prices and, more recently, to the favorable evolution of food prices. The last figure observed (November 2008) and the new forecasts confirm the consolidation of the inflation reduction process after the maximum values registered in the summer of 2008. The fall in oil prices has also intensified during the last weeks due to the renewed weakness of the dollar relative to the euro. At the same time, growth in food prices is also slower, with greater than expected falls, causing a new significant downwards revision to our forecasts. Finally, manufactured prices, the inflation rate of which had risen in the last 4 months, have fallen again to 0.9%, one tenth of a point less than in October. Core inflation has declined as expected since the last report and is now expected to remain stable around 2.0% in both 2009 and 2010. The forecast headline inflation for 2009 has been revised downwards to 1.1% ( $\pm 0.55$ ). The year-on-year rates are expected to touch bottom in July with values of less than 0.5%. When the strong impact of falling oil prices is over, inflation will rise slightly to around 2.4% ( $\pm 0.92$ ) in

December, 2009, with an average rate of 2.3% ( $\pm 0.79$ ) in 2010. These forecasts are based on the steady rising of oil prices starting from the first months of 2009 and continuing till the end of 2010, when we expect oil prices to be around 50 euros/barrel. In view of these figures and the heavy deceleration in the euro area economies, the European Central Bank does not appear to have obstacles in continuing to reduce the official interest rate. A cut of at least 25 base points in the January meeting has already been discounted by the market. The official interest rate is likely to drop below 2.0% during 2009.

**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 GDP forecasts of EFN, IMF (November update), ECB and OECD are very similar. The more pessimistic view from the consensus forecast might be explained by the fact that banks dominate this survey. On the one hand, they might have better information on the severity of the financial crisis, on the other hand, they might tend to overestimate its relevance for the real economy.

Regarding inflation forecasts, there seems to be a widespread agreement about the fact that headline inflation will be below 2.0% in 2009. We actually expect the average yearly rate to be 1.1%, the lowest value among the considered forecast. This might be explained by the fact that the EFN figures have been revised using the last figure available (17 of December). We expect headline inflation to be 2.3% in 2010, slightly above the forecasts of the other institutions. This difference is likely to depend on different scenarios for energy prices.

**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                 | -0.5 | 0.8  | 0.1  | 0.9  | 0.2  | na   | -0.5 | 1.0  | -0.6 | 1.2  | -0.9      | na   |
| Priv. Consumption   | 0.2  | 1.3  | 0.4  | 1.0  | -0.1 | na   | 0.2  | 1.2  | 0.2  | 1.2  | 0.0       | na   |
| Gov. Consumption    | 1.7  | 1.2  | 1.2  | 1.0  | 1.6  | na   | 1.6  | 1.6  | 1.2  | 1.2  | 2.0       | na   |
| Fixed Capital Form. | -2.8 | -0.4 | -2.6 | 0.2  | -0.6 | na   | -4.5 | -0.7 | -4.4 | 1.0  | -3.6      | na   |
| Unemployment rate   | 8.0  | 8.3  | 8.4  | 8.7  | 8.3  | na   | na   | na   | 8.6  | 9.0  | 8.4       | na   |
| HICP                | 1.1  | 2.3  | 2.2  | 2.1  | 1.9  | na   | 1.4  | 1.8  | 1.4  | 1.3  | 1.4       | na   |
| IP                  | -3.1 | 0.2  | na   | na   | na   | na   | na   | na   | na   | na   | -2.7      | na   |

EU: European Commission, European Economy, No. 7, 2008 (Autumn); IMF: World Economic Outlook, September 2008; ECB: ECB Monthly Bulletin, December 2008, OECD: Economic Outlook, No. 84, December 2008; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2008. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

\*According to the IMF update of November 2008, GDP growth in the Euro area will be -0.5% in 2009.

## 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 stagnating next year. We forecast a decrease in world trade next year. Oil prices are expected to be much lower than they were during most of 2008, but to recover from their lows in December. The exchange rates of dollar and yen relative to the euro are assumed to be stable in 2009 and 2010.

**Table 4 Variables of the world economy**

|                                | 2008 | 2009 | 2010 |
|--------------------------------|------|------|------|
| US GDP Growth Rate             | 1.2  | -1.3 | 1.6  |
| US Consumer Price Inflation    | 4.0  | 0.3  | 1.5  |
| US Short Term Interest Rate    | 1.4  | 1.1  | 2.0  |
| US Long Term Interest Rate     | 3.7  | 4.0  | 4.2  |
| Japan GDP Growth Rate          | 0.4  | -0.9 | 0.6  |
| Japan Consumer Price Inflation | 1.6  | 0.1  | 0.0  |
| Japan Short Term Interest Rate | 0.7  | 0.7  | 1.0  |
| Japan Long Term Interest Rate  | 1.5  | 1.5  | 2.0  |
| World Trade                    | 3.5  | -1.6 | 0.9  |
| Oil Price                      | 98   | 64   | 82   |
| USD/Euro Exchange Rate         | 1.47 | 1.30 | 1.30 |
| 100Yen/Euro Exchange Rate      | 1.53 | 1.25 | 1.25 |

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 (2008) and OECD (2008). The oil price is in US dollar per barrel (average of period), all other variables are 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: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.