EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2010 and 2011

European Forecasting Network

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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 euro area economy benefits from dynamic growth of exports to the emerging markets. Exports to Asia in particular have exceeded their peak level of spring 2008 as early as at the beginning of this year. Firms reacted by restocking and investing in equipment.

- The growth hike of the second quarter, however, will not be repeated, as it was favored by special factors. We expect euro area GDP to grow by around 1.6% in 2010 and 2011. The upswing of world trade calms down in the second half of this year and the effects of fiscal consolidation in Europe become increasingly felt.

- For these reasons, the boom of industrial production is coming to an end. Annual growth rates have been declining since May and are expected to continue do so in the next months. The Industrial Production Index will grow more than 6% in 2010 but by only 1.3% in 2011. The production of intermediate goods is expected to slow down faster than other sectors while the production of capital goods will remain strong throughout 2010.

- The possibility of an intensifying crisis of confidence in the euro area is a significant downward risk for this forecast. That said, it is reassuring that financing costs recently receded for Spain, by far the largest among the peripheral states.

- Inflation expectations are well anchored and consumer prices are evolving according to our projections without major shocks in the non-energy components. Annual inflation rates are expected to reach 2.0% at the end of the current year and to stabilize soon after at around 1.8%.

- Table 1 Economic outlook for the Euro area

	2007	2008	2009	2010: 2nd half		2010: annual		2011: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.8	0.4	-4.1	2.1	1.6 2.6	1.6	1.4 1.9	1.6	0.8 2.3
Potential Output	1.4	1.4	0.7	0.9	0.8 1.0	0.7	0.6 0.8	1.1	1.0 1.3
Private Consumption	1.6	0.4	-1.1	1.0	0.5 1.5	0.7	0.5 1.0	0.8	0.0 1.6
Government Consumption	2.3	2.3	2.4	0.6	0.3 0.9	0.8	0.6 1.0	0.2	-0.2 0.6
Fixed Capital Formation	4.6	-0.8	-11.3	1.7	0.3 3.1	-0.6	-1.3 0.1	2.8	0.7 4.9
Exports	6.2	0.8	-13.1	11.9	10.4 13.3	10.4	9.6 11.1	8.0	6.4 9.7
Imports	5.6	0.6	-11.7	11.8	10.2 13.1	10.3	9.5 11.0	6.5	4.8 8.2
Unemployment Rate	7.4	7.5	9.4	10.2	10.0 10.4	10.0	9.8 10.2	10.6	10.2 11.0
Total hourly labour costs	2.7	3.5	2.9	2.3	2.0 2.6	2.1	2.0 2.3	2.3	1.9 2.7
Labour Productivity	1.0	-0.4	-2.2	2.1	1.7 2.5	2.2	2.0 2.4	1.7	1.2 2.2
HICP	2.1	3.3	0.3	1.8	1.6 2.0	1.6	1.5 1.7	1.8	0.9 2.7
IPI	3.7	-1.8	-14.9	5.2	3.0 7.4	6.1	4.9 7.3	1.3	-1.7 4.3

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 2010 and 2011

Recovery in most advanced economies fragile, crisis of confidence in the euro area not over

In autumn 2010, advanced economies and emerging markets are at different points in the economic cycle: most Asian and Latin American countries have nearly completely recovered from the Great Recession. Due to the high growth dynamics of these economies, world trade has almost reached its pre-crisis level. In most advanced economies, however, the recovery still does not run smoothly: output in the US and in Japan has, after a strong expansion during the winter, slowed down markedly during summer. The jump in European production in the second quarter was made possible by strong demand from emerging markets countries and by some stimulus from the inventory cycle, in particular in the UK. The world economy has decoupled mainly because the problems that lay at the roots of the crisis are still heavy burdens on important advanced economies, in particular on the US and Western European countries. These burdens, though their weigh naturally varies from place to place, are very much alike: the bursting of the housing bubble has impaired the net asset position of private households. The construction sector and property-related services have shrunk markedly and will not fully recover any time soon. Thus, laid-off workers have to search employment in sectors they are ill prepared to work in. Above all, fiscal policy moves from an expansive to a restrictive stance, either by phasing out significant stimuli, as in the US, or by switching to drastic consolidation, as in the UK or in the peripheral euro area economies. Here, a loss of confidence in the sustainability of public finances on capital markets in April and May forced a financial support package for Greece and the creation of the Financial Stabilization Mechanism (both backed by euro area states and the IMF), as well as drastic fiscal turnarounds and some structural reforms in all peripheral economies. The consolidation programs have so far been implemented with reasonable success. However, risk spreads between returns on government bonds from peripheral countries and returns of AAA-rated bonds have not receded over the summer. Greece is virtually shut out from markets for long term capital, and financing costs have risen worryingly for Ireland (due to higher burdens of the Irish banking crisis) and Portugal. Thus, a renewed intensification of the crisis of confidence in the euro area is a significant downward risk for this forecast, as it was for the EFN summer forecast. That said, it is reassuring that financing costs receded for Spain, by far the largest among the peripheral countries.

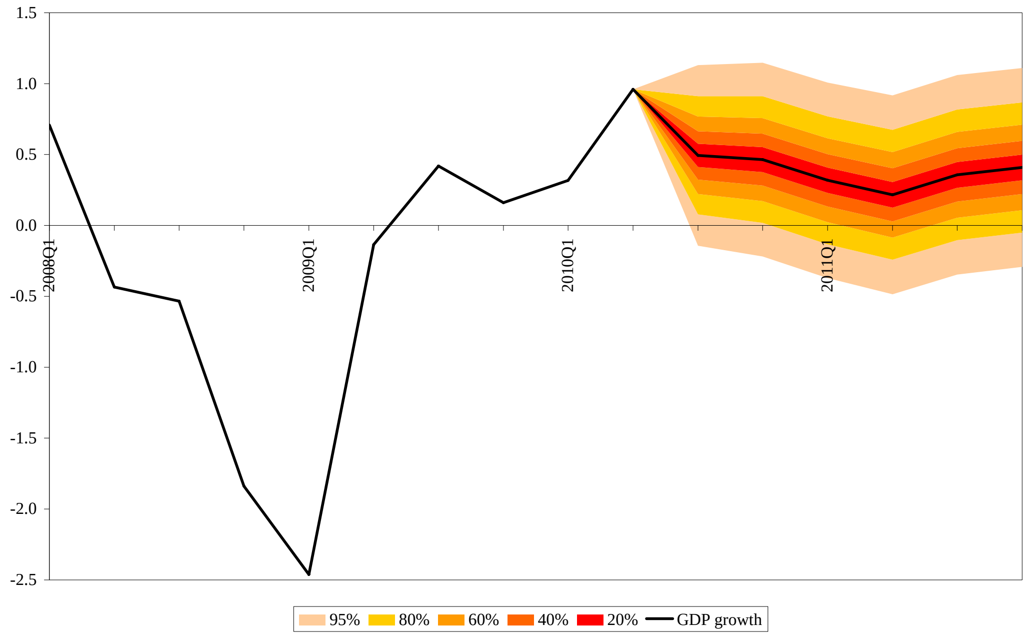
The ECB will continue to ease the strains by buying government bonds from peripheral economies and by keeping official rates at their ultra low levels. Similar monetary policies will be conducted by the Bank of England, the Fed, and the Bank of Japan as well. But the scope for expansive policy has become limited in most advanced economies. As the upswing in Asia and Latin America is already calming down, exogenous conditions for growth in the euro area will not improve in the coming quarters.

Euro area production: temporary stimulus from boom of exports to emerging markets

For the time being, however, the euro area economy benefits from dynamic growth of exports to the emerging markets. This stimulus explains much of the strong acceleration of growth in the second quarter (see figure 1). Exports to Asia in particular have exceeded their peak level of spring 2008 as early as at the beginning of this year. Firms reacted by restocking and investing in equipment, contributing almost half of second quarter growth. In addition, construction firms were busy making up for low the activity due to unusually cold weather during the winter. Demand from private households picked up as well. This generally favorable picture masks, however, diverging cycles in the single member states. Consumption, for example, was particularly high in Spain, since an increase of the standard tariff of the value added tax in July was an incentive to spend earlier. This tax will, of course, depress consumption during the rest of the year. The Greek economy continues to shrink due to the drastic consolidation of the public sector and due to the confidence crisis in the Greek financial sector. In contrast, the German investment goods sector has benefited from recovering world demand. In addition, construction activity in this country is stimulated by the very low interest rates, as the housing sector is not undergoing a post-bubble-crisis. All these divergences show up in the labor markets: employment was more or less stable in the first half of the year, but in that time span, the unemployment rate decreased by half a percentage point in Germany (to 6.9% in July), and increased by more than one percentage point in Spain (20.3%).

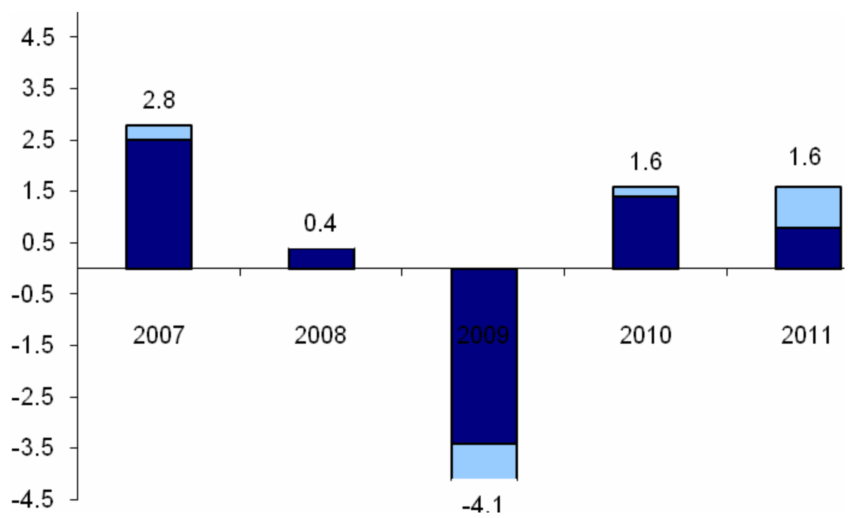
Strong regional divergences will continue for the rest of the year and during 2011. The high degree of European integration, however, means that the single economies cannot decouple completely. It is therefore still sensible to give a forecast of the euro area economy in general. A stagnating number of employees and the phasing out of many wage cutting short term labor schemes imply that the nominal compensation of employees has started growing this summer. This will support private consumption. Fiscal policy, however, will be a drag on private consumption: expansive policies come to an end everywhere, and in those countries that suffer a loss of confidence, they become sharply restrictive. Lower public expenditure is mirrored by losses of private income.

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

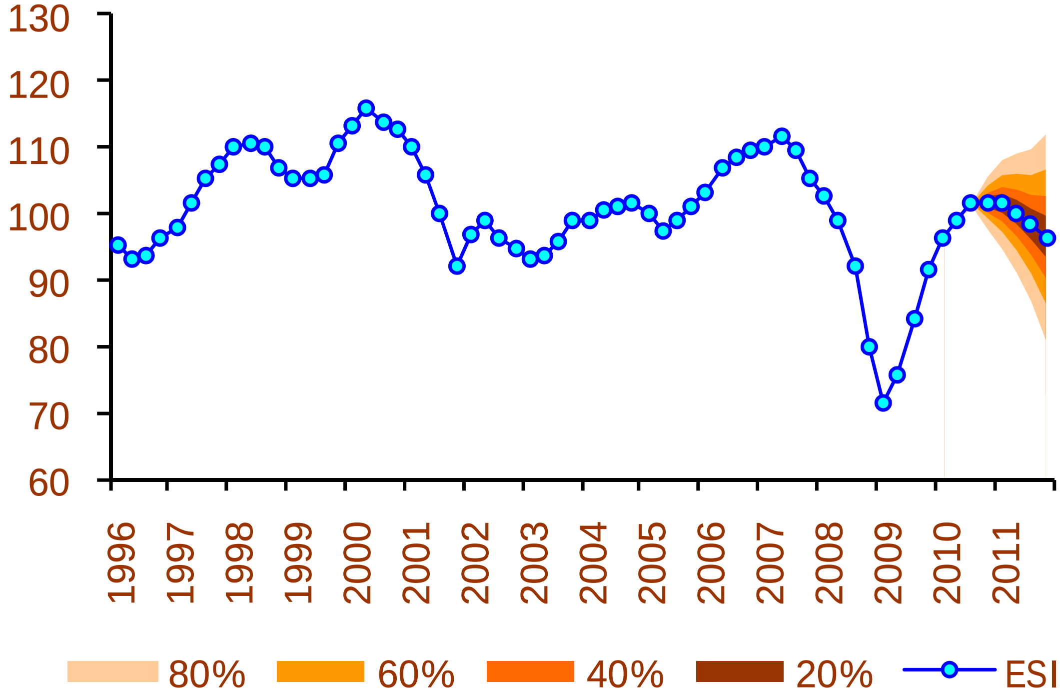
Investment by firms will further benefit from high profit margins. Indeed, nonfinancial corporations have, in the aggregate, recently financed their investment completely with retained earnings. Moreover, real costs of external financing are still relatively low, although a bit higher due to higher costs of quoted equity in the wake of the turmoil on stock markets in the first half of 2010. The crisis of the housing sector, however, continues in some countries, notably in Spain. Further rising exports, mainly to strongly growing emerging economies, is the main reason why we forecast a modest recovery this year and in 2011. The growth hike of the second quarter will not be repeated, as it was favored by the special factors mentioned above. Furthermore, the upswing of world trade calms down in the second half of this year and the effects of fiscal consolidation in Europe become increasingly felt. Overall, our expected growth of real GDP is 1.6% in both 2010 and 2011.

The forecasts for the Industrial Production Index (table 2) and the Economic Sentiment Indicator (figure 3) also seem to confirm that the European economy is cooling down. As for the industrial sector we expect the reduction of activity to be widespread to all sectors and somewhat more intense in the intermediate goods branch. The cumulated growth forecasted for 2011 and the remaining part of 2010 is close to 7.5%, which represents less than a half of the cumulated fall experienced between 2008 and 2009. As it was said before, the recovery of the industrial sector is showing remarkable asymmetries across regions. While Germany and, to a lesser extent, Italy and France have performed above expectations in the first semester, Portugal Greece and Spain have showed virtually no sign of recovery apart from some growth motivated by public subsidies.

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

	2005	2006	2007	2008	2009	2010	2011
Durable	-0.8	4.7	1.4	-5.7	-17.5	2.7	-0.2
Non Durable	1.1	2.7	2.5	-1.5	-3.1	2.7	0.8
Capital	2.5	5.9	6.6	-0.2	-20.9	6.6	2.8
Intermediate	0.6	4.8	3.8	-3.5	-19.2	8.6	1.5
Energy	1.5	0.6	-0.9	0.3	-5.5	4.3	-0.6
Total	1.4	4.2	3.7	-1.8	-14.9	6.1	1.3

Figure 3 Economic Sentiment Indicator and Confidence bands



As for inflation, we believe that expectations remain well anchored. Consumer prices in all the main sectors are evolving according to expectations without any major shock. Forecasts were revised upwards with respect to the summer report due to a moderate increase in oil price expectations while core inflation remains remarkably stable. Annual rates are expected to keep rising until January 2011, when we expect inflation to be around 2.0%. Subsequently, annual rates will decline mildly and stabilize around 1.8%.

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 the forecasts of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

The more recent GDP forecasts are close to each other. The EFN is on the optimistic side by predicting a modest recovery of fixed capital formation in 2011. This is based on the assumption, among others, that governments manage to consolidate mainly via lower consumption expenditure and avoid drastically cutting public investment in order to preserve the productive capacities of the euro area economy. Note that other forecasts that have a similar growth rate for GDP but are more pessimistic on internal demand have to predict an even larger contribution from the external sector than we do (see figure 2), or a substantial contribution from the inventory cycle.

As for inflation, our forecasts for 2010 are perfectly in line with ECB projections and slightly above those of other institutions. With respect to 2011, we expect an average annual growth rate of HICP of 1.8%, one tenth of the point above the Commission and the ECB forecasts. In both years our estimates lie above consensus' estimates.

Table 3 Comparison of EFN forecasts with alternative forecasts for the euro area

	EFN		EU*		IMF**		ECB		OECD		Consensus	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
GDP	1.6	1.6	0.9	1.5	1.0	1.5	1.6	1.4	1.2	1.8	1.6	1.4
Priv. Consumption	0.7	0.8	0.0	1.1	0.1	1.0	0.2	0.8	0.1	1.0	0.6	0.8
Gov. Consumption	0.8	0.2	0.9	0.3	0.8	0.4	0.8	0.5	0.5	0.2	1.0	0.4
Fixed Capital Form.	-0.6	2.8	-2.6	1.8	-0.4	1.9	-1.5	0.7	-2.2	2.2	-0.8	2.5
Unemployment rate	10.0	10.6	10.3	10.4	10.5	10.5	na	na	10.1	10.1	10.0	10.0
HICP	1.6	1.8	1.5	1.7	1.1	1.3	1.6	1.7	1.4	1.0	1.5	1.6
IP	6.1	1.3	na	na	na	na	na	na	na	na	6.8	3.7

EU: European Commission, Economic Forecast, Spring 2010; IMF: World Economic Outlook, April 2010; ECB: ECB Monthly Bulletin, September 2010, OECD: Economic Outlook, May 2010; Consensus: Consensus Economics Inc., Consensus Forecasts, September 2010. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

*Interim forecast of the European Commission in September 2010 for GDP growth in 2010: 1.7%

**IMF World economic outlook update in July for GDP growth in 2010: 1.0%; for 2011: 1.3%.

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. Accordingly, the recovery in the US and in Japan will stay feeble in 2011. World trade will expand at healthy rates, but lose some momentum in the second half of 2010. Oil prices are expected to slowly rise from the levels they had in September. The nominal value of the euro is assumed to stay constant.

Table 4 Variables of the world economy

	2009	2010	2011
US GDP Growth Rate	-2.6	2.7	2.4
US Consumer Price Inflation	-0.3	1.6	1.4
US Short Term Interest Rate (December)	0.1	0.2	0.6
US Long Term Interest Rate (December)	3.5	2.9	3.7
Japan GDP Growth Rate	-5.3	3.0	1.3
Japan Consumer Price Inflation	-1.4	-0.9	-0.3
Japan Short Term Interest Rate (December)	0.5	0.4	0.4
Japan Long Term Interest Rate (December)	1.3	1.2	1.3
World Trade Growth Rate	-10.9	10.5	6.0
Oil Price (December)	75	80	84
USD/Euro Exchange Rate (December)	1.48	1.30	1.30
100Yen/Euro Exchange Rate (December)	1.31	1.11	1.11

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 (2010). 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.