EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2010 and 2011

Spring 2010

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 world economy will recover during 2010 and 2011 thanks to ultra-low key interest rates in industrial countries and to the strong growth in emerging markets economies. In the euro area, however, the phasing out of expansive fiscal policies and fiscal consolidation will drag down demand; rising exports will be the main driver of the recovery. Internal demand will have a positive (although small) contribution to growth in 2011. We expect euro area GDP to grow around 1.2% and 1.6% during 2010 and 2011, respectively.
- Due to rising exports, the industrial sector will resume positive growth in the short run but the intensity of the recovery will be moderate and insufficient to compensate the sharp fall of 2009: at the end of 2011, the industrial production index is expected to be still 10% below its pre-crisis levels.
- For the first time in its short history, the euro area is struggling with a crisis of confidence in the sustainability of the monetary union. Our forecast is based on the assumption that, with the help of the program adopted at the beginning of April, Greece will be able to meet its financial obligations and will carry out the required reforms. However, downside risks are high. One adverse effect of the current situation that might gain importance is that the interest rate burden of firms and households could increase quickly in spite of low key interest rates. This will occur if higher yields for government bonds take effect on the financing costs for private agents; this is a cause for concern because debt ratios for firms, but also for consumers, have been on a rising trend for years in the euro area and are now on record levels.
- Inflation expectations in the euro area continue to be very low. Forecasts were revised downwards after the weak HICP data of January and February. We now expect HICP inflation to be 1.2% in 2010 and 1.3% in 2011. The only risks for inflation come from oil and raw materials prices which are showing signs of significant increases in the world markets. Moreover, the movements in the currency markets that have been protecting the euro area from price fluctuations of crude oil are changing. The price in euros of Brent oil has increased by more than 12% from December 2009.

Table 1. Economic outlook for the Euro area

	2007	2008	2009	2010: 1st half		2010: annual		2011: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					0.5		0.6		0.8
GDP	2.7	0.6	-4.1	1.0	1.5	1.2	1.8	1.6	2.3
					0.7		0.9		1.3
Potential Output	1.5	1.4	0.8	0.8	0.9	1.0	1.1	1.4	1.5
					-0.6		-0.6		-0.3
Private Consumption	1.6	0.4	-1.1	-0.2	0.2	-0.1	0.5	0.5	1.3
					1.2		0.9		0.9
Government Consumption	2.3	2.0	2.2	1.5	1.8	1.3	1.6	1.3	1.8
					-4.5		-3.1		0.2
Fixed Capital Formation	4.8	-0.5	-11.1	-3.0	-1.4	-1.3	0.6	2.6	5.1
					5.2		5.6		5.9
Exports	6.2	1.0	-13.4	6.6	8.1	7.1	8.7	7.8	9.9
					3.7		4.4		4.9
Imports	5.4	1.0	-12.0	5.0	6.4	5.9	7.5	6.8	8.7
					10.2		10.3		10.6
Unemployment Rate	7.4	7.5	9.4	10.3	10.5	10.5	10.7	11.1	11.5
					2.0		2.1		1.6
Total hourly labour costs	2.7	3.5	3.5	2.3	2.7	2.4	2.7	1.9	2.2
					1.7		1.9		1.3
Labour Productivity	0.9	-0.2	-2.4	2.1	2.4	2.3	2.7	1.7	2.2
					0.9		0.8		0.2
HICP	2.1	3.3	0.3	1.2	1.5	1.3	1.8	1.2	2.2
					0.4		0.7		-0.8
IPI	3.7	-1.7	-14.9	1.9	3.4	2.6	4.5	1.8	4.4

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

Worldwide recovery, but crises of confidence in Europe

In Spring 2010, the world economy keeps up recovering. Industrial production has expanded strongly at the end of last year, and international trade even more so. In some emerging markets, above all in Asia, but also in Brazil, first signs of overheating may be detected in some sectors. In industrial countries, however, capacity utilization is still low, and a strong upswing is not in sight. In the US, albeit gross domestic product expanded healthily at the end of 2009, employment that shrank drastically during the crisis is still not on a stable upward trend. The pick-up in Japan stems mainly from increasing demand from neighbouring countries and from fiscal incentives for private consumption. The United Kingdom has up to now barely put recession behind, and the euro area, for the first time in its short history, is even struggling with a crisis of confidence in the sustainability of the monetary union.

Since Greece revised its forecast on the public deficit drastically upwards in October, yields on Greek government bonds and credit default swap spreads have shot up (standing at 300 to 400 basis points for bonds with maturity of 6 years in the first half of April, with high volatility). In spite of severe austerity programs announced by the government, investors see serious solvency risks for Greece. On April 11th, euro area member states agreed on terms of a financial support program for Greece that includes a monitoring mechanism in which the European Commission, the European Central Bank, and the International Monetary Fund will be involved. Our forecast is based on the assumption that, with the help of this program, Greece will be able to meet its financial obligations this and next year, and will implement the national reform process that is necessary for successful consolidation. However, bond yields of other euro area countries, notably Portugal, Spain, and Italy, have soared as well; the state of public finance in all these countries is precarious, either due to high debt, or to deficits, or both. Trust in the stability of the euro suffered as well. The common currency lost about 10% relative to the dollar between October and the time this forecast is produced (first half of April).

The recession has caused public deficits to shoot up in nearly all industrial countries, but in particular where crises of the financial and the housing sector took place. In these economies, like the United States, the United Kingdom, or Spain, assets of private households and firms plunged deeply, and employment has declined by much, because firms do not expect a quick recovery of the "bubble sectors" finance and housing. The end of expansive fiscal policy – and in many places, indeed, a turn to consolidation –, awkward financial positions of private households and low employment will be a drag on the recovery in 2010 and 2011. What will keep the recovery of the world economy going, is the continuation of ultra-low key interest rates in industrial countries and strong growth in emerging markets economies, not only in Asia, but also where, as in Latin America, economies benefit from the renewed price hikes for energy and commodities.

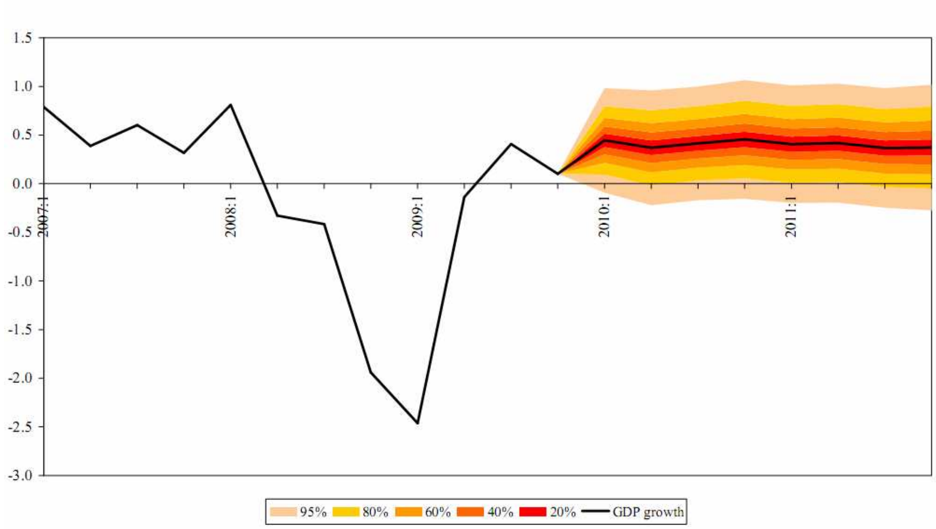
The euro area: a slow and split recovery

In the euro area, industrial production expanded strongly at the beginning of 2010. This was, however, to a large degree caused by the cold winter that induced energy production to shoot up. Industry is on an expanding trend, but markedly less dynamic than in most other regions. Indeed, national accounts data indicate that the recovery came almost to a halt at the end of last year. Consumption of private households was, at best, stagnating throughout the year 2009, and investment contracted further, though at a more moderate rate than during the first half of the year. Overall production grew a bit, with the external sector as the driving factor, as exports expanded much stronger than imports.

A positive outlook for exports explains why recent surveys show that business confidence is still improving quickly. Another stimulus is the fact that the real cost of the external financing of euro area non-financial corporations, as measured by the ECB, has fallen to a record low, although credit conditions offered by banks are, as a consequence of the financial crisis, still tight. Loans to non-financial corporations have, for the first time for about a year, stopped falling in February. For these reasons, confidence of firms and consumers has been steadily improving during the last months, but it will not reach pre-crisis levels during 2010 and, in fact, will fall again during our forecasting horizon. Private consumption is dampened by dim income prospects, in particular for employees; real disposable income has been shrinking in the second half of 2009, as the nominal compensation per employee was almost stagnating and employment was shrinking. But the most important reason to explain the expected fall in confidence is that the rise in unemployment continues, albeit at a slower pace. The phasing out of expansive fiscal policies in 2010 and 2011 and very restrictive policies in those countries that suffer a loss of confidence will drag down demand and reduce employment again. That said, the policy of consolidation appears to be unavoidable, since the deterioration of confidence on financial markets has to be stopped. Another effect that will, to some degree, dampen the adverse effects of the crisis of confidence, is the weakening of the euro, as it makes production in the euro area more competitive. Indeed, further rising exports, mainly to strongly growing emerging economies, is the main reason why we forecast a continuation of the recovery this year and in 2011, albeit at quite a slow pace. Fixed capital formation will not recover before 2011, as the crises of the housing sector continue, and investment in equipment picks up only very modestly this year. Production, however, will get some support from firms that rebuild (or reduce more slowly) their inventories.

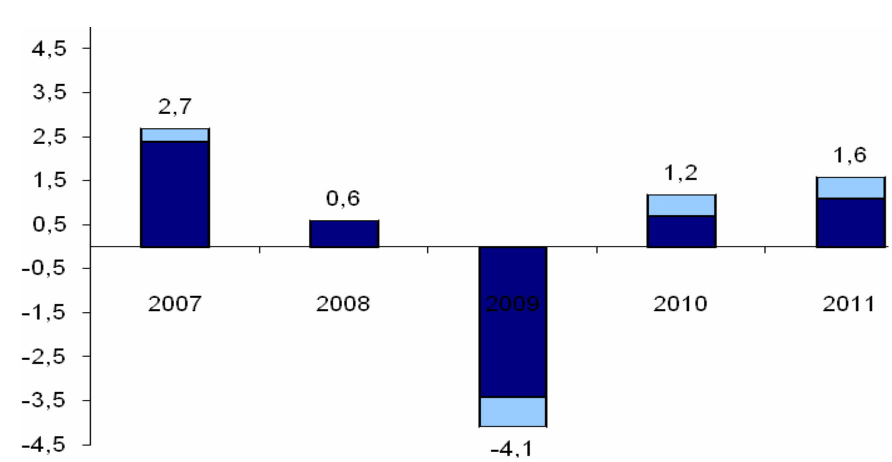
Overall, we expect GDP to grow by about 1.2% in 2010 and 1.6% in 2011. Interestingly, these figures are much lower than the corresponding values for the United States, where consensus forecasts are close to 3% for both 2010 and 2011. This fact signals that, in addition to cyclical issues, there remain severe structural problems in the euro area and, more generally, in the European economy, which the Lisbon strategy did not really manage to address.

Figure 1. Quarterly GDP growth rates and confidence bands



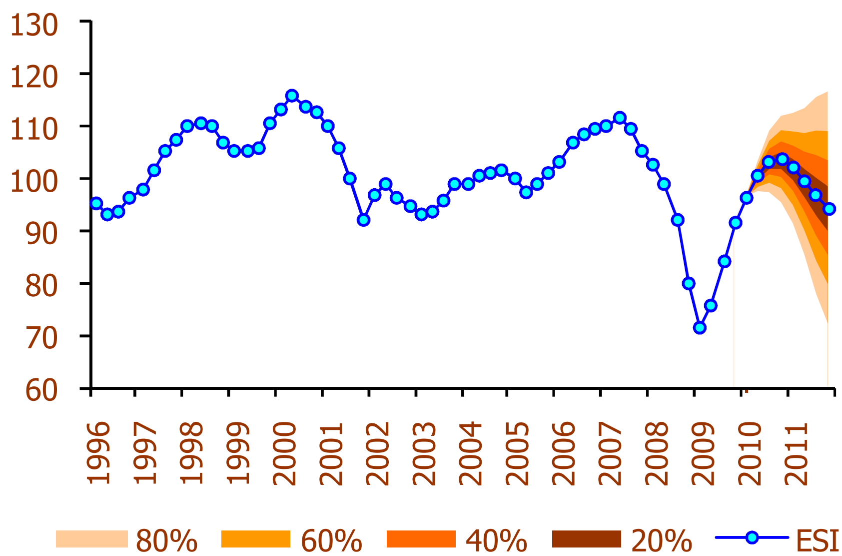
Percentage change over previous quarter

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



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

Figure 3. Economic sentiment indicator and confidence bands



As for industrial production, forecasts remained quite stable with respect to our Winter Report. The average annual rate of growth forecasted for the industrial production index in 2010 is 2.6%, with a mild slow down expected for 2011 (1.8%). In the current year, both sectors producing consumption and investment goods are expected to grow with positive rates. Capital and intermediate goods will be contributing the most to the recovery of industrial production, with average growth rates around 3.0%. The European industry will resume positive growth in the short run, but the intensity of the recovery will be largely insufficient to compensate the sharp fall experienced in 2009: at the end of 2011, the industrial production index is expected to be still 10% below its pre-crisis levels.

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

	2005	2006	2007	2008	2009	2010	2011
Durable	-0.80	4.73	1.38	-5.67	-17.29	1.77	-0.81
Non Durable	1.08	2.67	2.50	-1.40	-3.01	1.11	0.29
Capital	2.52	5.96	6.75	-0.10	-20.94	3.45	4.14
Intermediate	0.58	4.85	3.74	-3.30	-19.21	2.74	2.57
Energy	1.41	0.62	-0.93	0.27	-5.90	3.45	-2.34
Total	1.31	4.23	3.72	-1.68	-14.94	2.60	1.81

Regarding inflation, expectations in the euro area have been revised downwards with respect to our previous report. The average annual rate forecast for 2010 fell from 1.5 to 1.3% (±0.47) and from 1.7 to 1.2% (±0.96) for 2011. All components, except energy goods, contributed to this change. Non-energy industrial goods hit a zero annual inflation rate in February and we forecast that they will show negative annual inflation figures in the following months. As for food prices, we expect the annual rate to start increasing in the next months while inflation in the service sector will remain fairly stable between 1.4 and 1.5%. In the first two months of this year, consumer prices have shown downward innovations in the components of the core inflation. On the contrary for energy prices the innovations in those months have been upwards, in line with the expectation of the world economy recovering further.

Overall, the price dynamics within the euro area seems largely under control and inflationist pressures depend mainly on energy prices and on the changing pattern in the euro/dollar exchange rate. The movements in the currency markets have been protecting the euro area from price fluctuations of crude oil. This trend appears to have changed in the last quarter and the price in euros of Brent oil increased by more than 12% from December 2009. As it was argued above, the recovery of the world economy appears to be stronger than initially expected. The price of oil and raw materials starts reflecting this fact and this represents the main risk for prices at the moment. It is not just oil, also steel and iron ore will affect price stability in the next months. The new market system that is being negotiated for these products is expected to raise steel prices by 40% during 2010. It will be important in the near future to assess which part of this increase is transmitted to the euro area consumers.

Summarising, the growth forecasts for the euro area for 2010 and 2011 are rather modest and, in addition, the downside risks are high. One adverse effect of the current of crisis of confidence in the euro area economy that might gain importance is that the interest rate burden of firms and households could increase quickly in spite of low key interest rates. This will occur if higher yields for government bonds take effect on the financing costs for private agents and it is a cause for concern because debt ratios for firms but also for consumers have been on a rising trend for years in the euro area and are now on record levels.

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 EFN forecast is clearly on the optimistic side. The reason is mainly that we forecast a substantial contribution of the external economy, as exports benefit from the strong recovery in many emerging markets, while imports stay muted. For 2011, however, we do not see a revival of private consumption, because unemployment will continue to rise during much of the forecasting period, as short-term working schemes will gradually phase out.

As for inflation, our expectations are basically in line with those published by other institutions. Our forecast for 2010 seems to be slightly above the average while the 2011 figure appears to be somewhat lower.

Table 3. Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF**		ECB		OECD		Consensus	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
GDP	1.2	1.6	0.7	1.5	1.0	1.6	0.8	1.5	0.9	1.7	1.1	1.5
Priv. Consumption	-0.1	0.5	0.2	1.0	-0.1	na	0.1	1.1	0.4	1.3	0.2	1.0
Gov. Consumption	1.3	1.3	1.1	1.0	1.9	na	0.6	0.9	0.7	0.9	1.6	1.2
Fixed Capital Form.	-1.3	2.6	-1.9	2.1	-2.4	na	-1.8	0.9	0.8	3.4	-0.6	2.5
Unemployment rate	10.5	11.1	10.7	10.9	11.7	na	na	na	10.6	10.8	10.4	10.5
HICP	1.3	1.2	1.1	1.5	0.8	na	1.2	1.5	0.9	0.7	1.1	1.4
IP	2.6	1.8	na	na	na	na	na	na	na	na	2.7	2.9

EU: European Commission, Economic Forecast, Autumn 2009; IMF: World Economic Outlook, October 2009; ECB: ECB Monthly Bulletin, March 2010, OECD: Economic Outlook, November 2009; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2010. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

*According to the EU interim forecast of February 2010, in 2010, GDP growth in the Euro area will be 0.72% and HICP inflation will be 1.1%.

**According to the IMF update of January 2010, GDP growth in the Euro area will be 1.0% in 2010 and 1.6% in 2011.

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 recover in 2010 with rates that are a bit above potential growth in these economies. World trade will expand at healthy rates, but lose a bit of momentum in the first half of 2010. Oil prices are expected to keep their relatively high levels they had in March. The weakening of the euro is assumed to come to an end.

Table 4. Variables of the world economy

	2010	2011
US GDP Growth Rate	3.1	3.0
US Consumer Price Inflation	2.2	1.9
US Short Term Interest Rate (December)	0.8	1.2
US Long Term Interest Rate (December)	4.2	4.5
Japan GDP Growth Rate	1.9	1.6
Japan Consumer Price Inflation	-1.1	-0.3
Japan Short Term Interest Rate (December)	0.7	0.7
Japan Long Term Interest Rate (December)	1.4	1.8
World Trade Growth Rate	9.0	6.4
Oil Price (December)	79	81
USD/Euro Exchange Rate (December)	1.37	1.37
100Yen/Euro Exchange Rate (December)	1.24	1.24

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.