EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2010 and 2011

Summer 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, http://efn.eui.eu.

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Highlights

- The world economy is recovering, largely driven by upswings in most emerging market economies. Although growth in these regions is apparently calming down at present, the euro area will still be benefiting from the momentum of a healthily expanding world trade for much of the remaining year.

- Rising exports will be the main driver of the recovery in the euro area during the first half of 2010. We expect euro area GDP to grow by around 1.0% in 2010 and 1.6% in 2011, respectively. Due to this increase in external demand, the growth rate of the industrial production index has also gained momentum: during 2010 the industrial production index is expected to grow around 7%, though only at about 3% in 2011.

- In the coming winter, the momentum coming from external demand will decline and the effects of fiscal consolidation in Europe will increasingly be felt, but private consumption and investment should then recover and more than offset the negative effects from the slowdown in exports and the fiscal tightening.

- The main risks for this forecast come, once again, from turmoil in financial markets: At present, worries about the financial strength of some euro area states and banks appear to amplify each other. Banks suffer from overexposure to public debt of dubious quality, while governments face the risk of new burdens from failing banks, in particular due to their overexposure to ailing construction sectors.

- Inflation is expected to remain stable around a 1.5% year on year rate during 2010 and 2011. These projections assume a mild increase in oil prices during the forecasting horizon and a relatively stable euro/dollar exchange rate.

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
					0.7		0.8		1.2
GDP	2.7	0.5	-4.1	0.8	0.9	1.0	1.2	1.6	2.0
					0.5		0.7		1.0
Potential Output	1.5	1.4	0.8	0.6	0.7	0.8	0.9	1.1	1.2
					-0.1		-0.1		0.3
Private Consumption	1.6	0.3	-1.1	0.0	0.1	0.1	0.3	0.7	1.1
					1.4		0.9		-0.1
Government Consumption	2.3	2.2	2.2	1.7	2.0	1.3	1.7	0.3	0.7
					-4.5		-3.2		1.0
Fixed Capital Formation	4.6	-0.6	-11.1	-4.1	-3.7	-2.4	-1.7	2.4	3.9
					7.4		7.9		8.3
Exports	6.2	0.9	-13.4	7.8	8.2	8.6	9.3	9.4	10.5
					7.1		7.5		6.7
Imports	5.5	1.0	-12.0	7.5	7.9	8.1	8.7	7.8	8.9
					9.9		10.1		10.6
Unemployment Rate	7.4	7.5	9.4	10.0	10.1	10.2	10.3	10.8	11.0
					2.0		2.1		2.0
Total hourly labour costs	2.4	3.5	2.7	2.1	2.0	2.2	2.3	2.3	2.5
					1.6		1.5		1.7
Labour Productivity	0.9	-0.2	-2.4	1.7	1.8	1.7	1.9	2.0	2.4
					1.2		1.3		0.6
HICP	2.1	3.3	0.3	1.3	1.4	1.5	1.7	1.5	2.4
					6.6		5.0		0.7
IPI	3.7	-1.7	-15.1	7.2	7.8	6.9	8.8	3.0	5.3

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

Worldwide production recovers, but the European crisis of confidence shakes financial markets

In summer 2010, the world economy is split between a real sector that continues recovering and financial markets that show, with periods of significant stock market losses and increased volatility, declining confidence in the robustness of the recovery.

Worldwide industrial production has now almost reached its peak level of spring 2008, while world trade has made up for about two thirds of the losses it suffered during the great recession. This recovery is still largely based on an upswing in most emerging markets economies. In some of them, such as China, India, and Brazil, monetary policy has turned to tightening. In China, accelerating wages and housing prices indicate that the expansion is at the brink of overheating; it appears to be already slowing down this summer. Other economies will probably follow this path in the second half of 2010. At present, however, the industrial countries are still benefiting from the momentum coming from emerging markets. This is true for export oriented economies such as Japan and Germany as well as for the industrial sectors in North America, although domestic demand in the US is still being dragged down by the sluggish recovery of employment.

It is, however, primarily the precarious state of public finances in some euro area countries that clouds the outlook – not only for the currency union and its banking sector, but increasingly for the stability of world financial markets at large. Since May 2010, the state of Greece has effectively no longer access to international capital markets and relies on a joint euro area/IMF financing package. The additional establishment of an European Financial Stabilization mechanism has temporarily halted possible contagion to other sovereign debtors (in particular to Portugal, Ireland, Spain or Italy), that also face major fiscal challenges, albeit not as daunting as those for Greece. Although the new mechanism should prevent liquidity shortages during the next two to three years, risk spreads for government bonds of the aforementioned countries have been on a rising trend up to the beginning of July 2010. Worries about the liquidity of European banks and states appear to amplify each other: banks suffer from overexposure to public debt of waning quality, while governments face the risk of new burdens from banks that might fail due to their overexposure to the ailing construction industry.

Our forecast is based on the assumption that a renewed systemic banking crisis in Europe as well as an acute sovereign debt crisis can be avoided; thus the downside risks are substantial. In any case, the end of expansive fiscal policies – and in many places a sharp turn to austerity –, awkward financial positions of private households and low employment creation will be a drag on the recovery in 2010 and 2011. This is true for the euro area, but to some degree for the United Kingdom and the United States as well. 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 market economies.

The euro area: the slow and split recovery continues

Industry in the euro area is participating in the worldwide upswing of this sector, with production of intermediate goods expanding strongly. Production of consumer durables, though, is much less dynamic. This reflects, as national accounts data for the first quarter of the year show, still stagnating private consumption, but strongly recovering exports. In addition, firms react to this recovery by rebuilding (or reducing more slowly) their inventories. Investment in machinery and equipment shrank, but at a markedly slower rate than before, while construction investment was still on a falling trend. All in all, production during spring continued on the very anaemic growth path that had begun during summer of last year.

A positive outlook for exports explains why recent surveys show that business confidence continues to improve. Loans to non-financial corporations appear to have stopped falling in the first half of the year. However, resurging turmoil on financial markets has made financing via equity more expensive and widened risk spreads for private bonds. As a result, the real cost of the external financing of euro area non-financial corporations, as measured by the ECB, has increased a bit recently, but it has to be stressed that it is still very low.

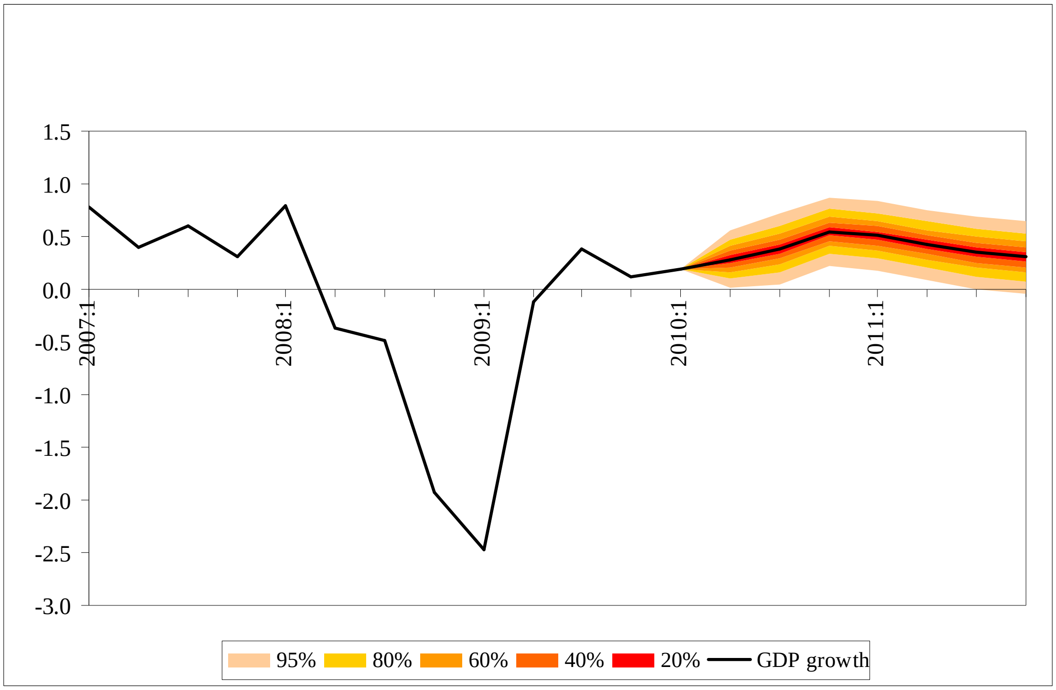
Private consumption is dampened by uncertain income prospects, in particular for employees, although employment appears to have stopped shrinking in the first half of 2010, and the compensation of employees is, with the phasing out of many wage cutting short term labour schemes, no longer falling. The main drag on consumption will come from fiscal policy: expansive fiscal policies come to an end everywhere, and in those countries that suffer a loss of confidence, they become sharply restrictive. Lower public expenditure is, of course, mirrored by losses of private income. 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 (by about 12% relative to its October 2009 value, as measured by the nominal effective exchange rate), since 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 modest recovery this year and in 2011, albeit at a slowing pace, as the upswing of world trade will calm down in the second half of this year and the effects of fiscal consolidation in Europe become increasingly felt.

Fixed capital formation will not recover before 2011, as the crises of the housing sector continue, and investment in equipment and machinery picks up only very modestly this year. However, production will get some support from firms that rebuild their inventories. Private consumption will grow only very modestly, and not before 2011.

Given the present uncertainty about the monetary union, downside risks for this forecast are high. As the spring report predicted, financing costs of firms have gone up recently, and this process could quickly accelerate, in case ever increasing yields for government bonds took more and more effect on the financing costs for firms. This is a cause for concern because debt ratios for firms have been on a rising trend for years in the euro area and are now on record levels.

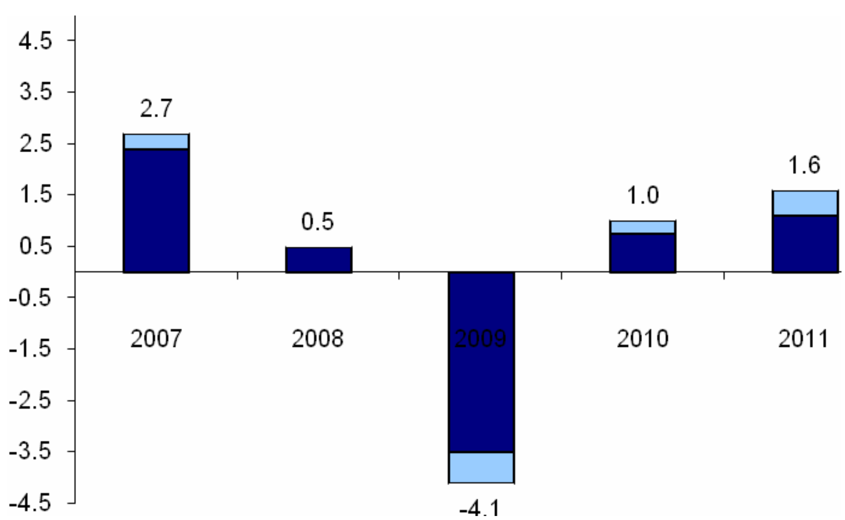
The recent turmoil's in the financial markets, the financing difficulties faced by various euro area members and the weak labour market situation have clearly affected the confidence of the economic agents. Although, as previously mentioned, there has been some improvement in business confidence, the economic sentiment indicator for the euro area declined sharply in May 2010 after 12 months of continuous and relatively fast growth. Data for June 2010 has also confirmed that decline, although there has been a methodological break in May 2010 and it is still not clear how the old and the new series can be combined. For this reason, the current projection, which clearly indicates a consolidation of the downward trend in the confidence indicator, should be taken with some caution.

Figure 1. Quarterly GDP growth rates and confidence bands



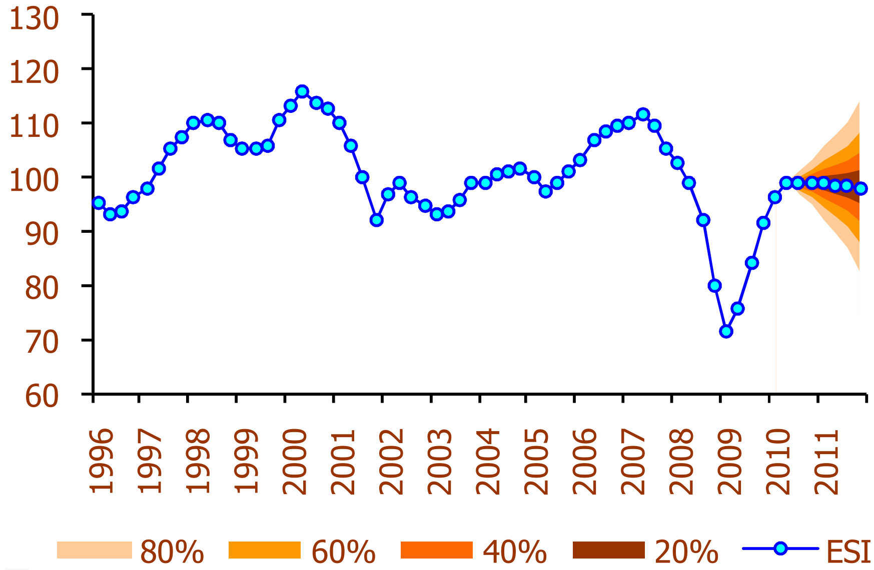
Percentage change over previous quarter

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

Figure 3. Economic Sentiment Indicator and confidence bands



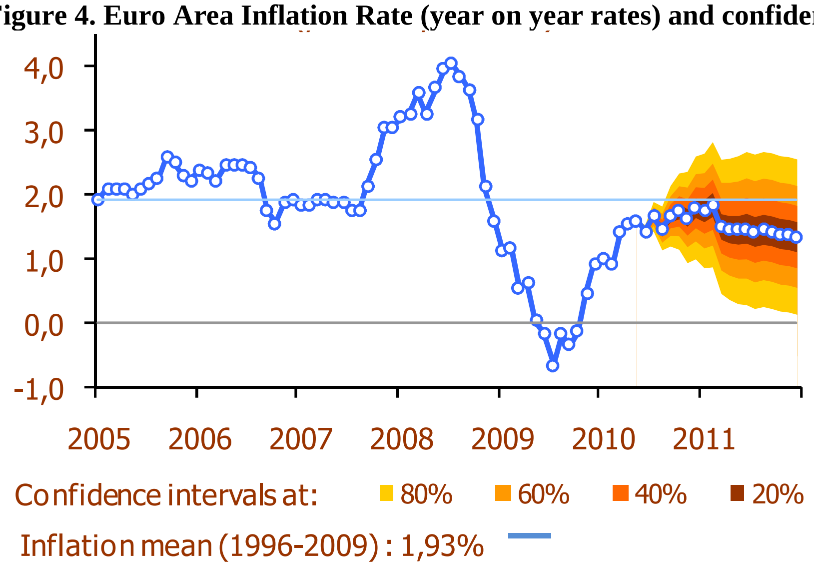
As for industrial production, the recovery of the industrial sector has gained momentum in the last few months but the upward trend in the yearly growth rates has probably come close to a maximum. The industrial production index is expected to grow, on average, by 7.1% in the first semester of 2010 and slow down to 6.9% in the whole year. As for 2011, we expect a grow rate of just 3.0%. Over the forecast horizon, all sectors 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 above 8.0%. 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 during the last years. In fact, the boost given by the depreciation of the euro in the currency market is likely to be over and, taking into account consumption stagnation, the stock rebuilding stage will soon phase away. It should also be mentioned that the recovery of the industrial sector does not seem to be homogeneous across euro area countries. While Italy, France and Germany are leading the recovery with growth rates close or above 10%, other members of the euro zone (like Spain, Portugal and Greece) are lagging well behind and do not seem to be able to catch up with the recent upturn.

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

	2005	2006	2006	2008	2009	2010	2011
Durable	-0.8	4.7	1.4	-5.7	-17.5	2.0	0.0
Non Durable	1.1	2.7	2.5	-1.4	-3.0	2.3	1.9
Capital	2.5	6.0	6.6	-0.1	-21,4	8.2	5.2
Intermediate	0.6	4.8	3.7	-3.4	-19.2	10.4	2.6
Energy	1.5	0.6	-0.9	0.3	-5.7	3.1	2.6
Total	1.3	4.2	3.7	-1.7	-15.1	6.9	3.0

Regarding inflation, we expect year on year rates to remain below the 2.0% level during the entire forecasting period. Energy prices rose steadily in the last year, contributing significantly to the upswing of headline inflation. We assume that the upward trend in the oil prices is almost over, expecting just a mild increase of those prices in 2011. According to our forecasts year on year rates will to continue to rise until the first quarter of 2011 and stabilize around an average 1.5% rate in the following period. 1.5% is our forecast for the average annual rate for 2010 and 2011.

Figure 4. Euro Area Inflation Rate (year on year rates) 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 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. But we also predict a modest recovery of fixed capital formation. 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. For similar reasons, our forecasts for the industrial production index are also slightly more optimistic than the last consensus estimates for both 2010 and 2011.

As for inflation, our forecasts are basically in line with those of other institutions with the exception of the IMF's latest projections that are significantly 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	1.0	1.6	0.9	1.5	1.0	1.5	1.0	1.2	1.2	1.8	1.1	1.4
Priv. Consumption	0.1	0.7	0.0	1.1	0.1	1.0	0.1	0.7	0.1	1.0	0.2	0.8
Gov. Consumption	1.3	0.3	0.9	0.3	0.8	0.4	0.8	0.4	0.5	0.2	1.4	0.8
Fixed Capital Form.	-2.4	2.4	-2.6	1.8	-0.4	1.9	-2.3	0.3	-2.2	2.2	-1.6	2.3
Unemployment rate	10.2	10.8	10.3	10.4	10.5	10.5	na	na	10.1	10.1	10.3	10.3
HICP	1.5	1.5	1.5	1.7	1.1	1.3	1.5	1.6	1.4	1.0	1.4	1.5
IP	6.9	3.0	na	na	na	na	na	na	na	na	5.7	2.3

EU: European Commission, Economic Forecast, Spring 2010; IMF: World Economic Outlook, April 2010; ECB: ECB Monthly Bulletin, June 2010, OECD: Economic Outlook, May 2010; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2010. 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 4 below. We assume that the US and in particular Japan recover in 2010 with rates that are above potential growth in these economies. 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 June. 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	3.3	3.1
US Consumer Price Inflation	1.7	1.7
US Short Term Interest Rate (December)	0.4	1.9
US Long Term Interest Rate (December)	3.8	4.3
Japan GDP Growth Rate	3.2	1.7
Japan Consumer Price Inflation	-1.0	-0.2
Japan Short Term Interest Rate (December)	0.5	0.7
Japan Long Term Interest Rate (December)	1.5	1.6
World Trade Growth Rate	11.3	6.5
Oil Price (December)	80	82.5
USD/Euro Exchange Rate (December)	1.23	1.23
100Yen/Euro Exchange Rate (December)	1.12	1.12

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.