EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2012 and 2013

Spring 2012

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 Pierre Werner Programme of the Robert Schuman Centre for Advanced Studies 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://www.eui.eu/DepartmentsAndCentres/RobertSchumanCentre/Research/EconomicMonetaryPolicy/EFN/Index.aspx.

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Highlights

- In the first months of 2012 there were some mild signs of improvement in the world economy, to a large degree due to political measures taken in the euro area at the end of 2011. In particular, the ECB secured financing of banks by offering liquidity for as longs as three years and by easing standards for collateral.
- However, the southern countries of the euro area will stay in recession for most of the year 2012: planned fiscal consolidation in Spain and Italy has a magnitude of about 3% relative to GDP, in Portugal and Greece the restriction is even larger. The structural reforms need time to take beneficial effects, and the real sector is largely out of reach of the expansive monetary policy.
- It is still uncertain whether another solvency crisis of a euro area member state can be avoided. The main risk is now that deep recessions in the southern countries caused by the drastic consolidation programs might undermine confidence of financial investors in the viability of the reform processes.
- In spite of recessions in the southern countries, euro area GDP is forecast to stagnate in 2012, mainly because demand in some member states (notably in Germany and, to a lesser extent, in France) and from abroad will expand moderately.
- Although our inflation forecasts have risen considerably since last report, the ECB mandate for price stability in the medium term has not been significantly threatened in the last few months. The year-on-year HICP rate is expected to be around 2% already in December this year. Considering the external and transient nature of the recent inflationist tensions and the weak economic situation in the euro area, the ECB is not expected to change its expansive monetary policy stance in the short or medium term.

Table 1 Economic outlook for the Euro area

	2009	2010	2011	2012: 1st half		2012: annual		2013: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	-4.2	1.9	1.4	0.0	-0.5 0.5	0.0	-0.5 0.6	0.9	0.1 1.7
Potential Output	0.7	0.4	0.5	0.5	0.4 0.6	0.6	0.5 0.7	0.8	0.6 0.9
Private Consumption	-1.2	0.9	0.2	-0.3	-0.6 0.0	-0.1	-0.5 0.3	0.5	-0.2 1.2
Government Consumption*	2.6	0.5	0.1	-0.7		-0.7		0.0	
Fixed Capital Formation	-12.0	-0.5	1.4	-1.3	-2.5 0.0	-0.5	-2.1 1.1	2.6	0.2 5.2
Exports	-12.7	11.3	6.1	3.5	2.3 4.6	4.0	2.8 5.3	6.7	5.1 8.2
Imports	-11.6	9.6	3.9	1.8	0.7 2.8	3.2	2.0 4.3	7.1	5.5 8.7
Unemployment Rate	9.6	10.1	10.2	10.7	10.6 10.9	10.9	10.7 11.1	11.4	10.9 11.9
Total hourly labour costs	2.7	1.5	2.8	2.4	1.9 3.0	2.6	2.0 3.3	2.5	1.6 3.3
Labour Productivity (output per head)	-2.4	2.3	1.3	0.6	0.1 1.0	0.7	0.3 1.1	1.4	0.8 2.0
HICP	0.3	1.6	2.7	2.6	2.4 2.8	2.4	2 2.8	1.4	0.4 2.4
IPI	-14.9	7.3	3.5	-1.1	-1.1 0.3	-0.3	-2.5 1.9	1.8	-0.8 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.

*This forecast differs from our usual approach of deriving government consumption endogenously in the EFN econometric model. Currently, government consumption is highly influenced by the need of fiscal consolidation in many euro area countries, a situation that is not appropriately captured by the model. Hence, we assume a time path of government consumption that is compatible with the consolidation programs of the member countries.

Economic Outlook for 2012 and 2013

Financial markets and the world economy: prospects for a moderate revival

In the first months of 2012, the world economy has recovered a bit from its shaky condition during the second half of 2011. At that time, the crisis of confidence in public finances of euro area states was the main cause for worldwide pessimism and high risk aversion all over the world. Spain and Italy, both pivotal members of the currency union, were close to be cut off from financial markets, as were many European banks whose soundness depended on the quality of European sovereign bonds they kept on their balance sheets. At present, although risk premia for Spanish and Italian bonds are still high and volatile, the outbreak of a financial crisis in the euro area seems less likely. To a large degree, the credit for the stabilization goes to the ECB that has secured financing of the banking sector by offering, for the first time, liquidity for as long as three years in two tenders (in December and at the end of February) and by easing standards for collateral bidders have to provide. The tenders met high demand and risk premia for banks fell markedly (though to still very elevated levels). Clearly, as the interbank money market in the euro area is, to a large degree, replaced by public provision, the dissemination of private information through market activity is being reduced as well. Thus, a policy that is successful for the time being might cause latent long run costs. To improve the short-run effects, it would be also important to announce now that financing will be renewd at maturity, in case of need.

Italian and Spanish government bond yields also fell during the winter, since sovereign insolvencies triggered by banking crises now appeared less likely, and because banks used the newly acquired liquidity to buy bonds, pushing up prices. In addition, economic sentiment was raised by policies in the southern states: structural reforms, in particular of social security systems and labour markets, have been conducted or are being pushed by the respective governments. However, it is still uncertain whether all this will be enough to avoid another solvency crisis of a euro area member state. Yields rose again in March and April, though not to levels reached during last autumn. The main risk factors are now deep recessions that will be caused by the drastic consolidation programs implemented by member states and that might undermine confidence of financial investors in the viability of the reform processes.

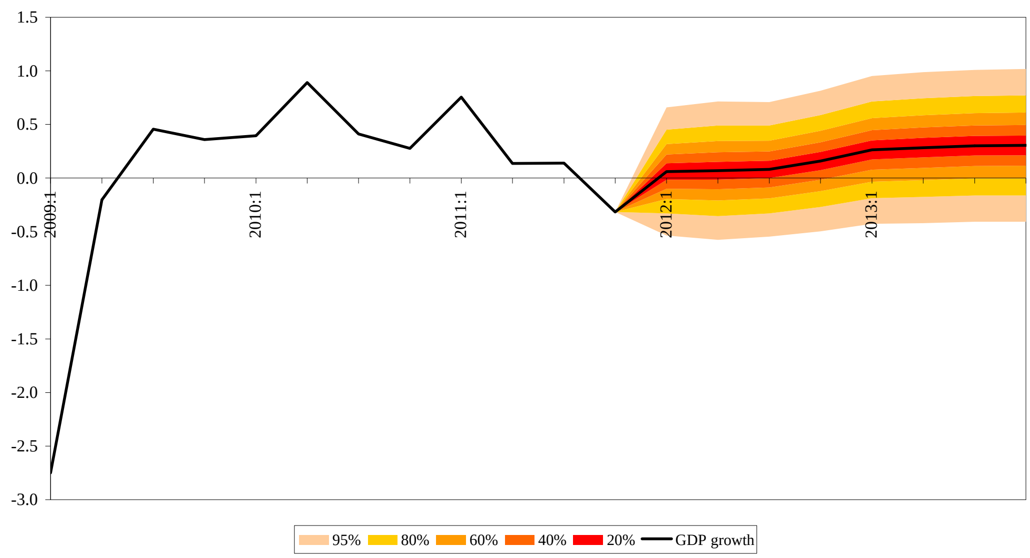
Outside Europe, the economic situation mostly improved. The US in particular appears to slowly overcome the structural impediments of falling property prices and heavily indebted house owners. In Asia, some dampening factors are fading: firstly, the break in international production processes by the two natural disasters in Japan (tsunami in March 2011) and Thailand (floods mainly in October); second, some restrictive policy measures in China that put an end to an unsound housing boom in 2011. What will be a drag on economic expansion in the world is, however, the hike in oil prices (about 120 dollars per barrel Brent in mid of April), mainly due to the political tensions around the Iranian nuclear program. Since the upswing in the US will stay modest and fiscal consolidation will keep the economies in the European Union in stagnation, and since growth dynamics in China appear to be losing momentum, the world economy is likely to expand only modestly in 2012, and we predict world trade to grow by little more than 4 %.

The euro area: stagnation in 2012, with deep recessions in the southern countries

In the final quarter of 2011, production in the euro area fell by 0.3%. Among the larger economies, only the French expanded (by 0.2%). Exports in the currency union also fell, mainly because of declining intra-area trade. Internal demand has been shrinking since spring 2011. This is to a large degree due to budget cuts in most member states: public investment activity has been declining since summer 2009, and public consumption shrank in the second half of 2011. Private households, in contrast, kept their propensity to consume stable; their saving rate was, at about 13.5 %, quite low by historical standards (data for the first three quarters of 2011 available). Still, in the final quarter of the year, private consumption also declined. Factors dampening private spending abound: the trend for real disposable income is downward since, due to price hikes on markets for energy and commodities, consumer prices rise quickly (with annual rates of more than 2.5 % since spring 2011). House prices in a number of countries continue to fall. Further reasons for higher prudential savings are uncertainties about the future course of the fiscal crisis and worrying employment prospects. Since last summer, employment has been falling, and the rate of unemployment has risen by 0.8 percentage points to 10.8% (February). But aggregated data give little insight for labour markets that – due to high barriers to entry – vary widely from country to country. While unemployment stayed constant or decreased in Belgium, Finland, Germany, and Ireland, it increased strongly in Portugal, Spain, and Italy, but also in the Netherlands. Compensations of employees per head grew at the moderate rate of 2.4% in 2011, but much slower in the southern countries. As Eurostat data for hourly labour costs show, the strong slowdown of wage dynamics was mostly (with the exception of Greece) confined to the public sector; that said, wages in the business sector are likely to markedly slow down or even fall in all southern countries in 2012.

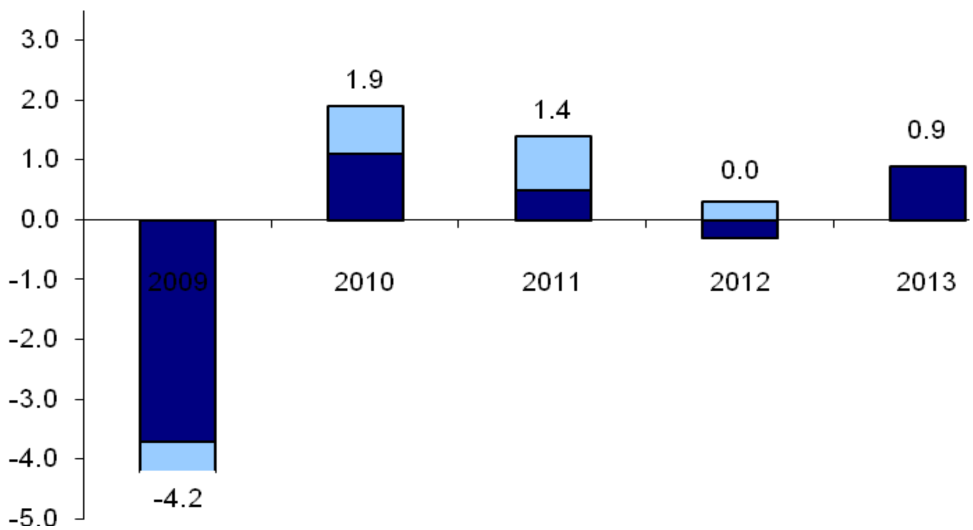
Late in autumn of 2011 economic confidence was, according to surveys of the European Commission, at its lowest. Since then the policy measures mentioned above have raised confidence a bit, but a clear upward trend is not in sight. The southern countries will probably stay in recession for most of the year 2012: planned fiscal consolidation in Spain and Italy has a magnitude of about 3% relative to GDP, in Portugal and Greece the restriction is even larger. The structural reforms will need time to take beneficial effects, and the real sector is largely out of reach of the very expansive monetary policy, not least because beginning in June 2012, financial institutions in the European Union will have to fulfil more demanding requirements for capital. Banks are reacting by tightening their credit standards, and costs of investment for firms and households will, in spite of the liquidity glut, not go down markedly. Still, this report does not forecast a deep recession for the euro area as a whole, mainly because demand in some member countries (notably in Germany and, to a lesser extent, in France) and from abroad will expand moderately. GDP is forecast to stagnate in 2012. For 2013 we expect fiscal policy to be less restrictive and production to expand by 0.9%, which is a bit higher than the presently quite low rate of potential growth. Important underlying assumptions of this forecast are that reforms continue to be successfully implemented in the crisis countries and that Spain and Italy, as well as the major European banks, will further be able to raise capital on financial markets at sustainable costs.

Figure 1 Quarterly GDP growth rates and confidence bands



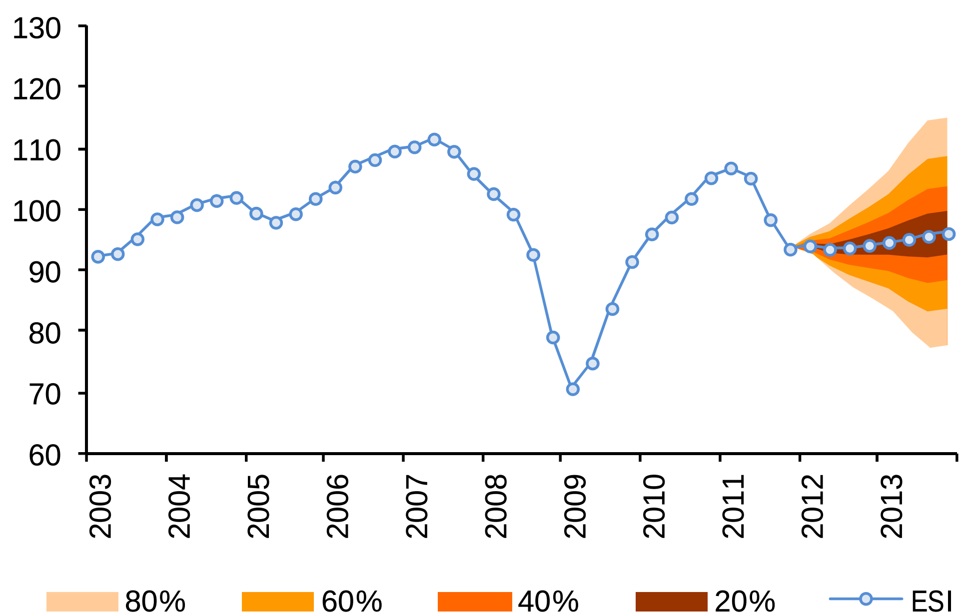
Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



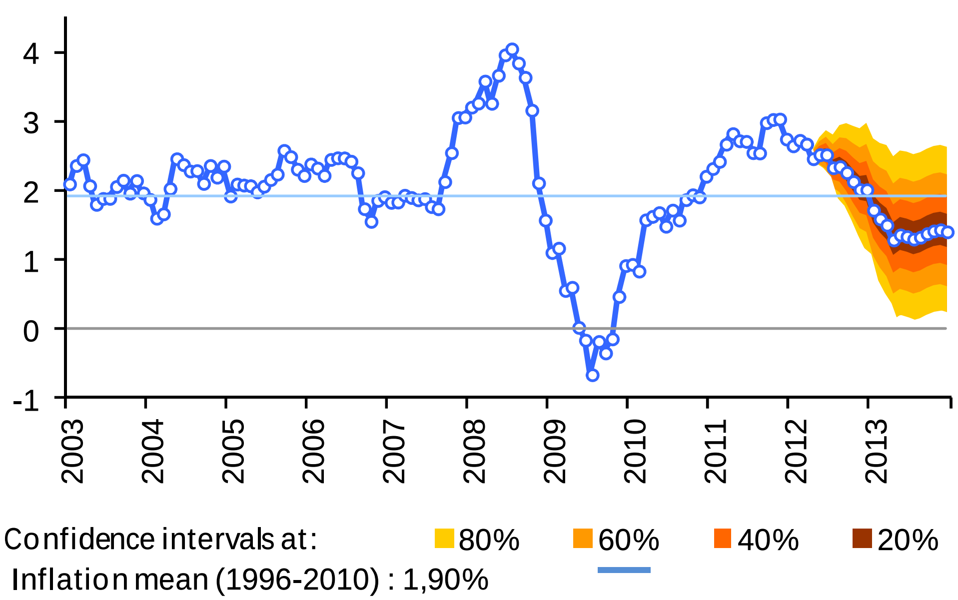
Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Figure 3 Economic Sentiment Indicator and confidence bands



Concerning inflation prospects, although our forecasts have risen considerably since last report, the ECB mandate for price stability in the medium term has not been significantly threatened in the last few months. We predict average inflation to be 2,4% in 2012, but the year-on-year HICP rate will be around 2% already in December this year. The main cause for the revision of our inflation forecast is a new rise in energy inflation. The geopolitical tension with Iran and the new deterioration of the euro area debt crisis have taken oil prices in euros to a new historical high. Considering the external and transient nature of this tension and the weak economic situation in the euro area, the ECB is not expected to change its expansive monetary policy stance in the short or medium term. Also, the injections of liquidity provided by the ECB in December and February seem unlikely to generate dangerous inflationist pressure, as this money will in all probability not reach the economy in the form of strong credit expansion in the medium term.

Figure 4 HICP and confidence bands



With regards to euro area industry, the trend of tentative recovery seen in the last few months appears to have vanished. All the industrial confidence indicators fell this month after growing for the last three. This does not only affect peripheral euro area countries, but also central nations. Indeed, the soft data was significantly worse in March for Germany and France than for Italy and Spain. The reduction in our forecasts for European industry is due to a reduction in our expectations for both the domestic and the foreign economic dynamics. In line with the decline in the labour market and reduced private consumption forecasts, the expected growth of non-durable good production has also fallen considerably. Indeed, growth will be negative throughout the forecasting period. On the other hand, the forecasts for capital and intermediate good production have also fallen significantly, in line with our reduced export forecasts. The growth of emerging economies undergoing an industrialisation process could slow down more than previously forecasted due to steps taken to control inflation.

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

	2008	2009	2010	2011	2012	2013
Durable	-5.4	-17.4	2.7	0.4	-5.0	-3.5
Non Durable	-1.3	-3.0	3.1	0.6	-2.3	-0.2
Capital	-0.3	-20.9	9.2	8.8	3.8	6.3
Intermediate	-3.3	-19.2	10.0	4.3	-2.1	0.4
Energy	0.0	-5.5	3.8	-4.8	-0.1	-1.0
Total	-1.7	-14.9	7.3	3.5	-0.3	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 forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The EFN forecast stands out in that it predicts a marked increase in the unemployment rate in 2013. One reason is that the participation rate is still – albeit at a slower pace since the beginning of the Great Recession – rising in the euro area.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF**		ECB		OECD		Consensus	
	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013
GDP	0.0	0.9	0.5	1.3	1.1	na	-0.1	1.1	0.2	1.4	-0.4	0.9
Priv. Consumption	-0.1	0.5	0.4	0.1	0.6	na	1.0	1.3	0.1	0.9	-0.3	0.6
Gov. Consumption	-0.7	0.0	-0.2	0.3	-0.1	na	-0.3	0.8	-0.3	-0.2	-0.5	0.0
Fixed Capital Form.	-0.5	2.6	0.5	2.9	1.8	na	-1.2	1.4	-0.4	2.3	-1.1	1.5
Unemployment rate	10.9	11.4	10.1	10.0	9.9	na	na	na	10.3	10.3	10.8	10.8
HICP	2.4	1.4	1.7	1.6	1.5	na	2.4	1.6	1.6	1.2	2.2	1.7
IP	-0.3	1.8	na	na	na	na	na	na	na	na	-1.3	1.8

EU: European Commission, Economic Forecast, Autumn 2011; IMF: World Economic Outlook, October 2011; ECB: ECB Monthly Bulletin, March 2012, OECD: Economic Outlook, November 2011; Consensus: Consensus Economics Inc., Consensus Forecasts, February 2012. 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 2012, in 2012, GDP growth in the Euro area will be -0.3% and HICP inflation will be 2.7%.

**According to the IMF update of January 2012, GDP growth in the Euro area will be -0.5% in 2012 and 0.8% in 2013.

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 a moderate upswing in the US for this and for next year. The expected expansion of world trade in 2012 is quite low, but this is, to a large degree, due to the stagnation of trade in the second half of 2011. Oil prices are assumed to keep their high levels reached in March, because world production is expected to accelerate in 2012 and political risks in the middle east are unlikely to subside substantially.

Table 4 Variables of the world economy

	2011	2012	2013
US GDP Growth Rate	1.7	2.3	2.6
US Consumer Price Inflation	3.1	2.3	2.0
US Short Term Interest Rate (December)	0.01	0.1	0.5
US Long Term Interest Rate (December)	2.0	2.4	3.2
Japan GDP Growth Rate	-0.7	1.9	1.5
Japan Consumer Price Inflation	-0.3	-0.2	0.0
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	1.0	1.1	1.2
World Trade Growth Rate	6.0	4.1	6.5
Oil Price (December)	108	122	122
USD/Euro Exchange Rate (December)	1.32	1.32	1.32
100Yen/Euro Exchange Rate (December)	1.03	1.10	1.10

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 (2012). 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.