EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

Winter 2012/13

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://www.eui.eu/DepartmentsAndCentres/RobertSchumanCentre/Research/Economic MonetaryPolicy/EFN/Index.aspx.

Participating Institutions:

Robert Schuman Centre, European University Institute (*Coordinator*)
Team Leader: Massimiliano Marcellino (massimiliano.marcellino@eui.eu)

Centre d´Etudes Prospectives et d´Informations Internationales (CEPII)
Team Leader: Lionel Fontagné (fontagne@cepii.fr)

The Halle Institute for Economic Research (IWH)
Team Leader: Axel Lindner (Axel.Lindner@iwh-halle.de)

Anàlisi Quantitativa Regional (AQR-IREA), Universitat de Barcelona
Team Leader: Jordi Suriñach (jsurinach@ub.edu)

Instituto Flores de Lemus (IFL), Universidad Carlos III
Team Leader: Antoni Espasa (espasa@est-econ.uc3m.es)

Department of Applied Economics (DAE), University of Cambridge
Team Leader: Sean Holly (sean.holly@econ.cam.ac.uk)

Coordinator of the Report: Massimiliano Marcellino

Report closed on January 11th, 2013

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

Highlights

- At present, economic growth is low in most regions of the world, but confidence indicators in countries such as China, Brazil and Russia have markedly risen in the final months of the year, suggesting that the world economy is likely to get some momentum from emerging markets in 2013.
- The ECB succeeded in restoring confidence for the time being: risk spreads for Spanish and Italian bonds have come down markedly, and the capital flight out of the financial sector of the southern member states of the euro area has stopped.
- The recession causes adjustment processes in the euro area: the participation rate is going up since falling real disposable incomes of private households and less attractive pension claims induce many people to look for jobs on already strained labour markets. Furthermore, external imbalances swiftly decline in the countries in crisis, and seasonally adjusted trade balances are now positive in Portugal, Italy, and Spain. A quick turnaround, however, is not in sight.
- Unemployment rates will continue to increase for the whole year of 2013, and private wealth will probably continue to shrink in most member states, as property prices have to fall further. All in all, GDP is forecast to be 0.2 percent higher in 2013 than in 2012, from the previously forecasted growth of 0.7%.
- The situation should slightly improve in 2014, with an expected GDP growth of about 1.1%. However, this will not be sufficient to lower the unemployment rate, which actually could further increase to about 12.6%.
- Inflation expectations for 2013 have moderated to a y-o-y rate of 1.6% due to a reduction in expected energy inflation in the last months. Inflation should remain subdued also in 2014, at about 1.5%. Thus, the ECB can keep its expansive course for the foreseeable future, butwe expect no further interest rate cuts in the short to medium term.

Table 1 Economic outlook for the Euro area

	2010	2011	2012	2013: 1st half		2013: annual		2014: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.0	1.4	-0.4	-0.1	-0.6 0.5	0.2	-0.4 0.9	1.1	0.3 1.8
Potential Output	0.1	0.3	0.6	0.7	0.6 0.9	0.7	0.6 0.8	0.7	0.5 0.8
Private Consumption	0.9	0.1	-1.1	-0.9	-1.2 -0.6	-0.6	-0.9 -0.3	0.3	-0.3 0.9
Government Consumption*	0.7	-0.1	-0.2	-0.3		-0.4		-0.2	
Fixed Capital Formation	-0.1	1.5	-3.7	-2.8	-5.1 -0.5	-1.4	-3.9 1.1	2.7	-0.3 5.7
Exports	11.1	6.3	3.0	3.4	2.1 4.7	3.6	2.2 5.0	4.9	3.2 6.4
Imports	9.6	4.2	-0.4	1.5	0.2 2.9	2.1	0.6 3.6	4.6	2.8 6.2
Unemployment Rate	10.1	10.2	11.4	11.8	11.6 12.0	12.0	11.8 12.3	12.6	12.1 13.1
Labour Cost Index	1.6	2.7	2.0	2.4	2.0 2.9	2.2	1.8 2.7	1.5	0.9 2.1
Labour Productivity	2.5	1.2	0.2	0.4	-0.1 0.8	0.8	0.3 1.2	1.4	0.8 1.9
HICP	1.6	2.7	2.5	1.7	1.2 2.2	1.6	0.9 2.3	1.5	0.5 2.5
IPI	7.3	3.4	-2.2	-0.5	-1.5 0.5	1.0	-1.2 3.2	2.4	-0.3 5.1

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. We think that at present government consumption is highly influenced by the fiscal crises in the euro area, factors that are not appropriately captured the model. Instead, we assume that the time path of government consumption is compatible with the consolidation programs of the member countries.

Economic Outlook for 2012 and 2013

The world economy: still sluggish, but with some chances for a modest revival in 2013

In 2012, economic growth was low in most regions of the world. In the euro area, production has been shrinking since the end of 2011, and the British economy barely stagnated in 2012. In the US, anxieties about the fiscal course in 2013 have dampened the recovery at the end of the year. The Japanese economy appears to be falling back into recession, as exports have been falling since summer due to weak demand from Europe and China. In important emerging economies such as China, India, and Brazil, expansion slowed already in 2011. Growth of world trade is, with about 2 ½ % in 2012, particularly slow. Recent data about container turnovers do not indicate a recovery of trade at the end of the year.

However, confidence indicators in countries such as China, Brazil and Russia have markedly risen in the final months of the year, suggesting that the world economy is likely to get some, albeit limited, momentum from emerging markets in 2013. The Chinese economy in particular appears to pick up, as the downswing of the property marked is bottoming out, infrastructure projects have started at a large scale, and a more expansionary monetary policy has caused credit volumes to rise. In general, policy in emerging market countries nowadays has considerable scope for helping the private sector if need be, much more so than policy in most advanced economies, where key interest rates have been close to zero for years and high debt and deficit rates that put the sustainability of public finances into question enforce consolidation of public households. Fiscal policy in 2013 will be markedly restrictive in the euro area and in Britain. This is also true for the US, although the President and Congress have come to an agreement about which parts of the expansionary measures ending at the turn of the year are going to be prolonged.

The most serious risks for the world economy, however, are still linked to the European crisis of confidence. While the recession in the real economy of the euro area continues, the crisis of the financial sector has calmed down since late summer. The turning point was the announcement of the ECB to purchase government bonds of member states that will commit to a precautionary or adjustment program linked to support from the European Stability Mechanism. By showing the will of, in effect, monetizing public debt, the ECB succeeded in restoring confidence for the time being: risk spreads for Spanish and Italian bonds have come down by almost 2 percentage points, and the capital flight out of the financial sector of the southern European member states has stopped. This development will need time to take beneficial effects on financial conditions in the southern member states, and the capital flight will resurge as soon as investors start losing confidence in the viability of the reform processes in Spain and Italy. Our forecast is based on the assumption that there will be no major fall-backs of confidence in 2013 and 2014.

The euro area economy: recession and adjustments

Production has been shrinking for more than a year in the euro area. The decline in the third quarter of 2012 was, however, with -0.1% rather small, not least because the drop of output in Italy and Spain was, with -0.2% and -0.3% respectively, less than before. Industrial production has experienced negative year-on-year growth rates since the end of 2011. This decay has been accelerating since the second quarter of 2012, affecting the core economies of the euro area as well. In November, the industrial production in Germany and France experienced a y-o-y contraction of above 3%.

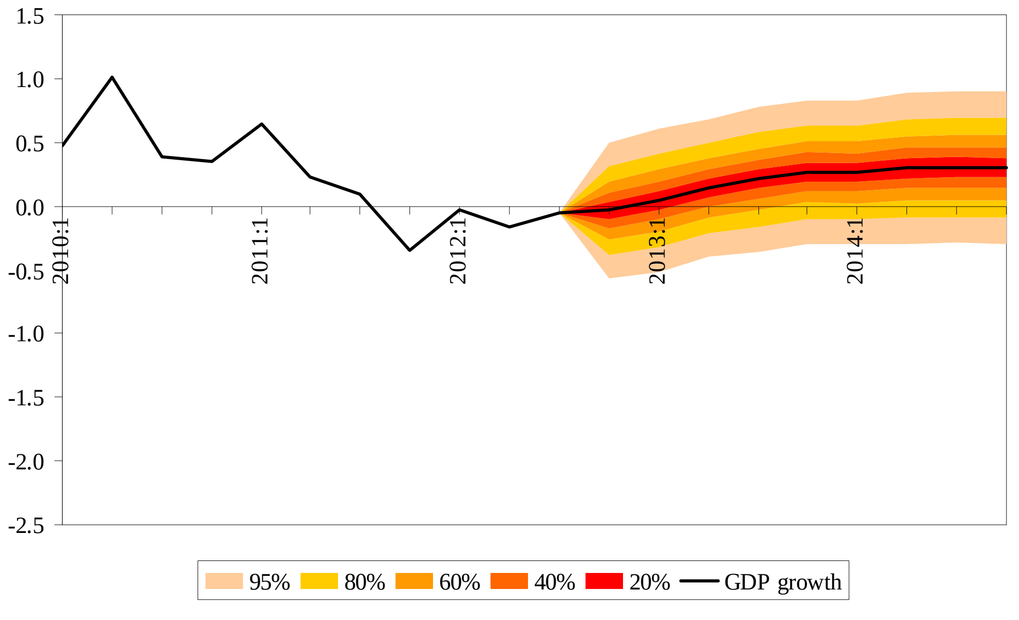
Trends in demand that have been around for some time continued: mainly due to domestic weakness, imports have been expanding by less than exports since summer 2010. Fixed investment is in retreat since 2011, as is the trend in government consumption. The same holds for consumption of private households, as real disposable incomes are declining, in 2012 by about 1 ½ %. Private households react by saving less: in the first half of 2012, their saving rate fell, for the first time since the currency union came into being, below 13%. This decline was partly caused by markedly (by about 2 ½%) rising consumer prices, since energy became more expensive and indirect taxes were raised in order to consolidate public households. Direct tax rates rose as well, while gross incomes of private households increased by little, because, since summer of 2011, the volume of paid labour is shrinking and the unemployment rate is on the rise (from about 10% to 11.8% in November 2012). Since 2011, remarkably, the participation rate has been going up as well: falling real disposable incomes of private households and less attractive pension claims induce many people to look for jobs on already strained labour markets. A further effect of the recession is the swift decline of external imbalances in the countries in crisis due to weak domestic demand. In the second quarter 2012, seasonally adjusted trade balances were positive in Portugal, Italy, and Spain. The latter country’s external balances benefit, in addition, from healthily expanding exports.

Efforts for fiscal consolidation in the euro area will continue in 2013, but at a somewhat smaller scale than in 2012, when the sum of expenditure cutbacks and tax increases was about 1.5% relative to GDP. In 2013, it will be about 1%. We expect a moderately positive momentum from net exports, since the world economy will expand a bit stronger. A swift turnaround, however, is not in sight. Despite the moderated upwards revision of our euro area exports expectations, our forecast for the industrial production growth has notably decreased since the previous report as a consequence of the industries of the core economies having been more seriously affected by the crisis in the second half of

2012. Unemployment rates will continue to increase for the whole year of 2013, and private wealth will probably continue to shrink in most member states, as property prices have to fall further. All in all, GDP is forecast to be 0.2 percent higher in 2013 than in 2012, from the previously forecasted growth of 0.7%. For 2014 we expect fiscal policy to be close to neutral and monetary policy still to be very loose, with overall GDP growing by 1.1%. Assumptions that applied to all our forecasts in 2012 are central for this one as well: we expect that reforms will continue to be successfully implemented in the southern countries and firms and households in the euro area will largely continue to act on the premise that policy will, in the long run, be able to master the euro area debt crisis.

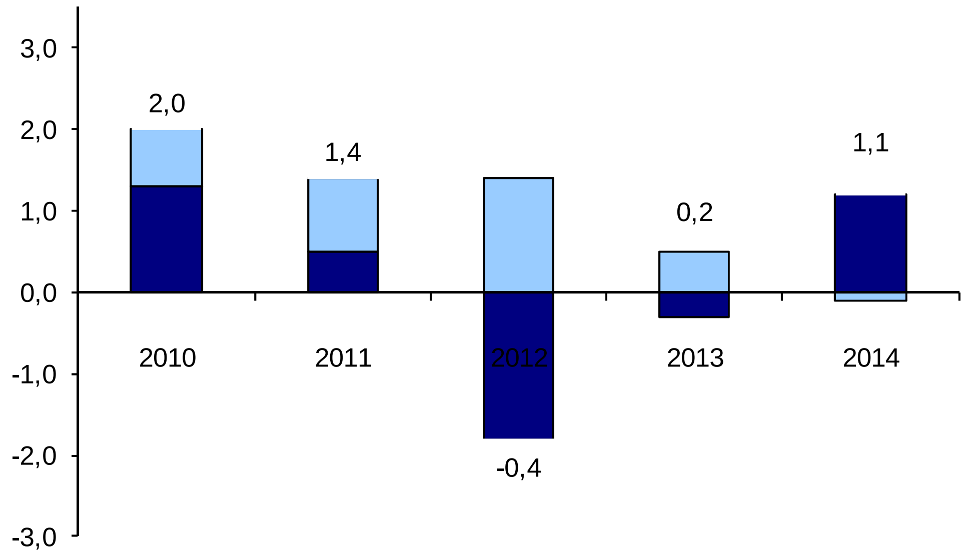
Inflation expectations for 2013 have moderated to a y-o-y rate of 1.6% due to a reduction in expected energy inflation in the last months. Assuming no further tensions in the international energy markets in the coming months, its contribution to total inflation is now close to zero for the rest of the forecasting period. Although this moderation in inflation expectations provides the ECB with more room to manoeuvre, specially having recently reduced its euro area GDP growth forecast, the ECB monetary policy will remain expansive during 2013 but no further interest rate cuts are expected in the short to medium term.

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

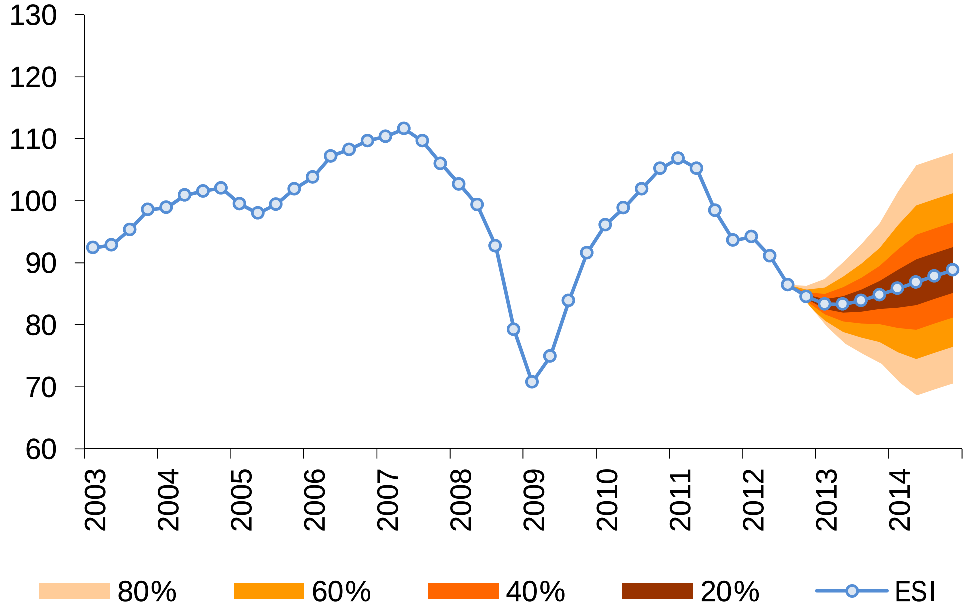


Figure 4 HICP and confidence bands

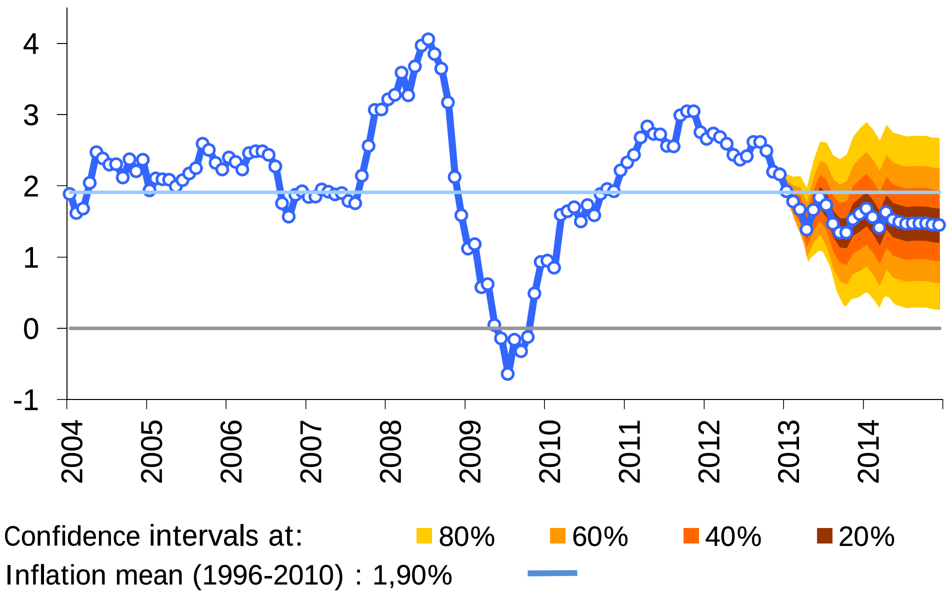


Table 2 Annual average rates for industrial production in the euro area

	2009	2010	2011	2012	2013	2014
Durable	-17.4	2.7	0.6	-4.8	-2.1	-2.4
Non Durable	-3.0	3.1	0.5	-2.3	0.2	0.3
Capital	-20.9	9.2	8.6	-0.8	2.7	3.3
Intermediate	-19.2	10.0	4.1	-3.6	0.8	0.9
Energy	-5.4	3.8	-4.4	-0.4	-0.5	-0.3
Total	-14.9	7.3	3.4	-2.2	1.0	2.4

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.

As to GDP in 2013, our forecast is a bit on the upside. This is mainly due to a more optimistic view on net exports. In addition, we forecast investment to recover in the course of 2014, since in countries that are less affected by the crisis of confidence the user costs of capital will probably stay at very low levels. Quite high is our forecast for unemployment in 2014. The rise in labour supply that accelerated in the middle of the recession in 2012 will continue, while we do not see that the recovery in 2014 will be strong enough to increase labour demand significantly. Our inflation expectations remain in line with that of the ECB.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
GDP	0.2	1.1	0.1	1.4	0.2	na	-0.3	1.0	-0.1	1.3	-0.1	na
Priv. Consumption	-0.6	0.3	-0.4	1.0	-0.3	na	-0.6	0.5	-0.2	0.9	-0.3	na
Gov. Consumption	-0.4	-0.2	-0.4	0.6	-0.6	na	-0.6	0.4	-0.3	0.4	-0.5	na
Fixed Capital Form.	-1.4	2.7	-0.6	2.5	0.2	na	-2.6	1.3	-1.9	2.1	-1.5	na
Unemployment rate	12.0	12.6	11.8	11.7	11.5	na	na	na	11.9	12.0	12.0	na
HICP	1.6	1.5	1.8	1.6	1.7	na	1.6	1.4	1.6	1.2	1.9	na
IP	1.0	2.4	na	na	na	na	na	na	na	na	-0.1	na

EU: European Commission, Economic Forecast, November 2012; IMF: World Economic Outlook, October 2012; ECB: ECB Monthly Bulletin, December 2012, OECD: Economic Outlook, November 2012; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2012. 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 recovery in the US will continue in 2013, albeit at a slower pace, and that it will speed up in 2014. Growth in world trade accelerates, but stays below the trend of the past 20 years. Oil prices are expected to increase only moderately in real terms. The exchange rates of the dollar and the yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2012	2013	2014
US GDP Growth Rate	2.2	1.9	2.8
US Consumer Price Inflation	2.1	2.0	2.0
US Short Term Interest Rate (December)	0.1	0.1	0.3
US Long Term Interest Rate (December)	1.7	2.3	2.8
Japan GDP Growth Rate	1.8	0.6	0.8
Japan Consumer Price Inflation	0.0	-0.2	1.3
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	0.8	0.9	1.2
World Trade Growth Rate	2.5	4.0	6.2
Oil Price (December)	109	114	118
USD/Euro Exchange Rate (December)	1.30	1.30	1.30
100Yen/Euro Exchange Rate (December)	1.08	1.08	1.08

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.