EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2005 AND 2006

European Forecasting Network

WINTER 2004

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. 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 two semi-annual reports, in the spring and in the autumn, with updates in the winter and summer. 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 .

Participating Institutions:

IGIER, Università Bocconi (Coordinator)
Team Leader: Massimiliano Marcellino (massimiliano.marcellino@uni-bocconi.it)

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

Global Insight
Team Leader: Emilio Rossi (emilio.rossi@globalinsight.com)

The Halle Institute for Economic Research (IWH)
Team Leader: Christian Dreger (cdr@iwh-halle.de)

The Department of Economics, European University Institute (EUI)
Team Leader: Michael Artis (michael.artis@iue.it)

Anàlisi Quantitativa Regional (AQR), 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 13 December 2004

THE EURO AREA IN 2005 AND 2006

Highlights

- The upswing of the world economy continues over the forecasting period, but at a lower rate. The recent oil price hike has dampened economic activity. Fiscal stimuli in the US have diminished, and China has already begun to take measures to cool down its economy from overheating. Growth rates of world trade are expected to decline slightly to about 7 percent, after 8.5 percent in 2004.
- A rise of interest rates by the Federal Reserve and more cautious household spending behaviour will stabilize the current account deficit in the US, and the euro will not further appreciate against the US dollar. One euro will cost 1.28 dollars in 2005, depreciating to 1.20 dollars in 2006, in line with purchasing power parity.
- The recovery in the euro area lags behind the world business cycle, and the forecasts have been revised downwards. GDP growth is expected to be at around 1.7 in 2005, and will accelerate to 1.9 in 2006. Due to the appreciation of the euro and the slowing upswing of the world economy, the contribution of net exports to GDP growth is 0, and growth will be mainly driven by the evolution of consumption and investment.
- Consumers in the euro area appear to be cautious in view of the budget problems in many member states, as well as of sustainability problems affecting the pay-as-you-go pension and health insurance systems. Although financial conditions are favourable investment activities will not accelerate markedly. This hampers growth and employment prospects in the euro area in the long run.
- Inflation forecasts represent a downward revision of the annual rates of the headline inflation in the euro area for what is left of 2004 and the first two quarters of 2005. About the ECB monetary policy, there is no room for a looser monetary policy for the time being and a tighter monetary policy can be expected over the forecasting horizon.
- Compared to other forecasts, the EFN outlook is more cautious, possibly due to our pure econometric-model-based approach. Moreover, positive effects arising from recent structural reforms in some member countries are not taken into account, as they will only accrue slowly in the coming years.

Table 1 Economic outlook for the Euro area

	2002	2003	2004	2005: 1st half		2005: annual		2006: annual	
			Point Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	0.9	0.5	1.7	1.7	1.1 2.2	1.7	1.1 2.3	1.9	1.1 2.7
Potential Output	2.5	2.3	2.1	2.0	1.6 2.5	2.0	1.5 2.5	1.8	1.0 2.5
Private Consumption	0.6	0.9	1.1	1.5	0.9 2.1	1.7	1.1 2.3	1.8	1.0 2.5
Government Consumption	3.0	1.6	1.8	2.1	1.7 2.5	1.9	1.5 2.3	1.5	0.9 2.1
Fixed Capital Formation	-0.7	-0.5	1.2	3.3	0.4 6.2	3.7	0.3 7.2	3.0	-1.7 7.6
Exports	1.9	0.2	6.0	5.8	4.2 7.3	5.3	3.7 6.7	5.9	3.9 8.0
Imports	0.5	1.9	6.1	7.4	5.4 9.4	6.3	4.1 8.5	6.1	3.0 9.0
Unemployment Rate	8.4	8.9	8.9	8.8	8.6 9.0	8.7	8.5 9.0	8.5	8.0 8.9
NAIRU	8.4	8.4	8.4	8.5	8.3 8.7	8.5	8.3 8.7	8.5	8.1 8.9
Labour Cost Index	3.7	2.8	2.2	2.0	1.5 2.4	2.2	1.8 2.7	2.7	2.1 3.3
Labour Productivity	0.4	0.0	1.0	1.0	0.2 1.8	1.2	0.5 2.0	1.9	0.8 2.9
HICP	2.2	2.1	2.1	2.0	1.4 2.6	1.9	1.0 2.9	1.8	0.9 3.1
IPI	-0.5	0.3	2.3	2.4	1.6 3.2	1.7	0.6 2.8		

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2004 and 2005

The world economy

The upswing of the world economy continues, but since spring 2004 it has been losing some of its momentum, partly because economic policies have become less expansive. Although the monetary conditions remained highly supportive, fiscal impulses in the US have diminished and the other global driving force, China has been taking administrative steps to cool down the overheated economy, and its central bank increased interest rates for the first time in nine years. Strikingly, however, the effects of these measures appear to be moderate in the two power houses of the world economy, while lower export growth has contributed to a significant slowdown in Japan and, to a lesser extent, in the European Union.

A further dampening factor was the spectacular oil price hike. After reaching record levels of over 50 US-dollars (Brent) in October, oil prices have decreased to around 40 US-dollar at the beginning of December. Especially private consumption was negatively affected by high-energy costs. On the other hand, corporate investment, supported by the still expansive monetary policy, has gained more and more momentum and has been expanding vigorously.

In the face of increased economic activity, monetary policy will adhere to its slowly tightening path over the forecasting period, which means that it will continue to support the economy, albeit to a lower degree. However, no more stimuli from fiscal policy can be expected for 2005 in the US, where economic activity will expand at a slower rate. The forecasts for Japan are especially precarious, as the national accounts show a very dynamic expansion for the first half of 2004 and an almost stagnating economy in the second half. The best bet is that the upswing of 2004 will continue during the next two years, albeit at a more moderate rate. The comparatively modest expansion in the European Union will continue.

Overall the world economy seems to be strong enough to mitigate the negative effects of the reduction of economic policy stimuli and the strong oil price increases. Indeed, the oil price hike is not so much an external shock to the world economy as the result of its strong growth dynamics. This report assumes that oil prices will be at around 45 US-dollar (Brent) at the end of 2004, falling to around 40 US-dollar at the end of next year.

Oil prices are expected to stay at this level in 2006. This will slowdown the economic upswing, but it will not put an end to it.

A second serious risk to the world economy is posed by the possibility of a further weakening of the US-dollar. With one euro trading against 1.34 dollars in the second week of December, the dollar has fallen since September by about 9%. Many economists have long argued that a weakening dollar is inevitable given the large current account deficit of the US. These voices have attracted even more attention as the deficit has widened in the first half of this year to well above 5% of GDP. However, as has been emphasized earlier by the EFN, exchange rates are not the central parameters that have to adjust in order to correct the structural imbalance of the US current account. The choice is not between products originating from different currency areas. Instead, the intertemporal decisions of firms, the government and US households to consume lead to large capital imports. The counterpart of these imports is the current account deficit. Therefore, changes in intertemporal prices, i.e. interest rates, or a change in the expectations about future incomes in the US will play the major role in reducing the deficit. Hence, this forecast assumes that a rise of interest rates by the Federal Reserve and more cautious spending behaviour of US households will stabilize the current account deficit in 2005, and that one euro will cost on average 1.28 dollar in 2005, depreciating to 1.20 dollars on average in 2006, in line with the international parity conditions. But clearly, a further temporary weakening of the dollar cannot be excluded, with negative effects for industries in the euro area. However, the dollar has lost value not only relative to the euro, but also to other important currencies including the Yen. Up to now, other central banks, notably the Bank of Japan, have not prevented an appreciation of their currencies vis-à-vis the dollar by massive interventions on currency markets. If this policy continues the negative effects of a weakening dollar for producers in the euro area will be moderate, even if the dollar weakens a bit further in the coming months.

The euro area

The expansion of economic activity in the euro area still lags behind the worldwide upswing. While economic activity picked up markedly during the first half of 2004, a strong upswing has not been realized, because internal demand remained sluggish; the revival was mainly driven by strong net exports which benefited from a booming world economy.

Consumer spending expanded only very moderately during the summer and autumn of 2004. National accounts data as well as the confidence indicator published by the European Commission do not point to a significant acceleration. Consumers appear to be cautious in view of the budget problems in many member states, as well as of sustainability problems of the pay-as-you-go pension systems. In addition, the oil price hike puts a downward pressure on real incomes. Finally, due to a muted development of house prices in some countries during the past years, real estate wealth has not supported consumption in the euro area as strongly as it did in other regions. Where house prices have gone up significantly, institutional barriers of real estate credit do not allow households to cash in the increase in the value of their real estate property.

Fixed capital formation revived modestly in the autumn, after stagnating during the summer. What is really missing, however, are clear indicators for a strong rebound. This is a striking fact given the favourable and partly still improving financial conditions: real interest rates are low, stock market quotes went up significantly in the autumn, and quarterly results of firms have been largely favourable this year. Real unit labour costs have been falling since the last quarter of 2003. Furthermore, some need to modernize the capital stock should have accumulated during the last four years of weak investment, all the more so as nowadays a considerable share of the capital stock refers to fast depreciating ICT. However, according to business survey data of the European Commission, capacity utilization in the manufacturing sector is still slightly under average. These data are in line with the fact that industrial production was virtually flat during summer and autumn; the oil price hike appears to take its toll on production. All in all, while short-term indicators as business confidence or order books point to a continuation of the moderate upward trend, (see figure 3) investment will not be the driving force of economic activity before 2005. While this impedes the upswing in the short run, the relatively weak investment activity over the past decade is a cause of concern for the long run competitiveness of European firms.

Production in the euro area will expand by 1.7% in 2005 and by 1.9% in 2006. Hence, the output gap will not be shrinking before 2006. As already mentioned, this forecast is derived under the assumption that oil prices will be at around 45 US-dollar (Brent) at the end of 2004, falling to around 40 US-dollar in 2005 and 2006. The last oil price hike dampened GDP growth in the euro area by about 0.2 percentage points, see the Autumn 2004 EFN report. Headline inflation in 2005 will be, with 1.9%, about 0.3 percentage higher than in the baseline scenario of a constant oil price, and will amount to 1.8% in 2006. Thus, the ECB will meet its target in both years. This is facilitated by a slower year-on-year rate of import prices in 2005 due to the recent depreciation of the dollar.

The somewhat higher real effective exchange rate of the euro and the slowing upswing of the world economy will turn the contribution of net exports to output growth slightly negative in 2005. Fixed capital formation will expand with rates that are higher than those of overall output in both 2005 and 2006, but the bulk of demand growth will come from private consumption.

The rise in the unemployment rate has been quite moderate in comparison to previous cycles. Although the recent downturn started already in 2001, the NAIRU in the euro area is still 2 percentage points lower than in the mid 1990s. The greater resilience of the labour market might be traced to structural reforms in the second half of the 1990s like higher availability of fixed term contracts, see OECD (2004). This has increased the job content of output growth. But even a more flexible labour market reacts to the business cycle with some delay. Indicators for business expectations about the evolution of employment point only to a slow improvement in the months to come, and the unemployment rate will only slowly begin to decrease in 2005, sinking a bit more in 2006. The participation rate will not resume the rising trend it had at in the eve of the economic downturn. Surely, there is potential for increasing the labour market performance by further structural reforms. For example, employment protection legislation has been eased for temporary, but almost not for regular work. Opening clauses for collectively bargained wages and working times should be less complicated.

The forecast of a slowly improving labour market needs some caveat: if unions tried to achieve compensation of the oil price rise for workers, employment would suffer from two adverse effects: first, labour would become more expensive relative to capital, and second, the ECB would step in by raising interest rates, because it will not be willing to accommodate a wage-price spiral. Both effects will hamper the recovery.

Figure 1 Quarterly GDP growth rates and confidence bands

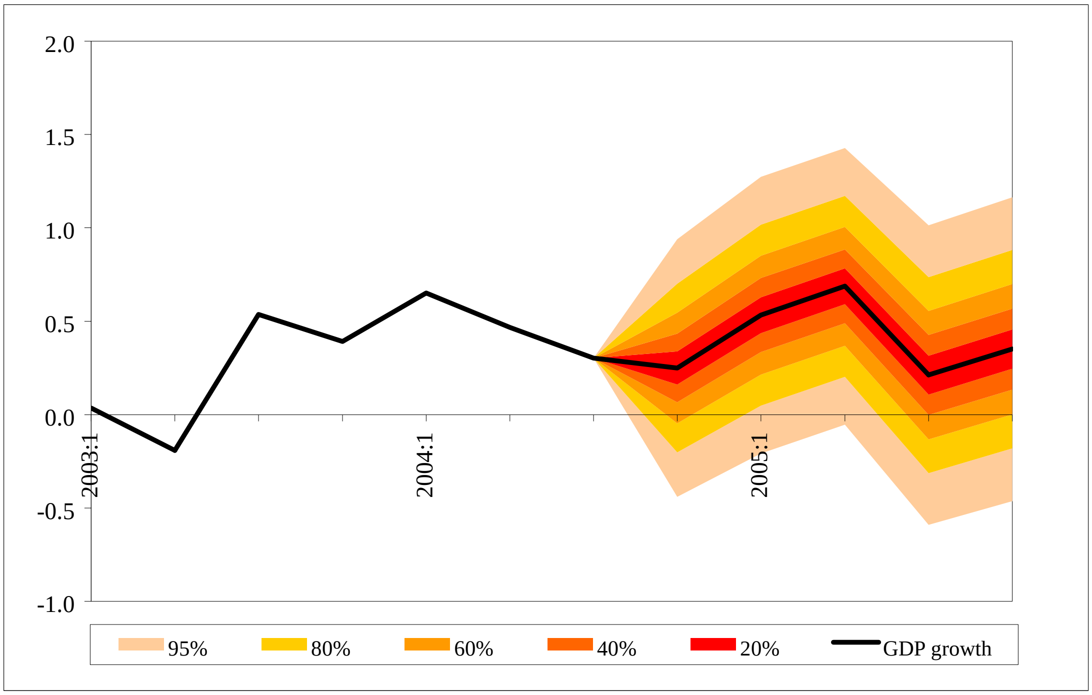


Figure 2 Contributions of domestic components and net exports to GDP growth

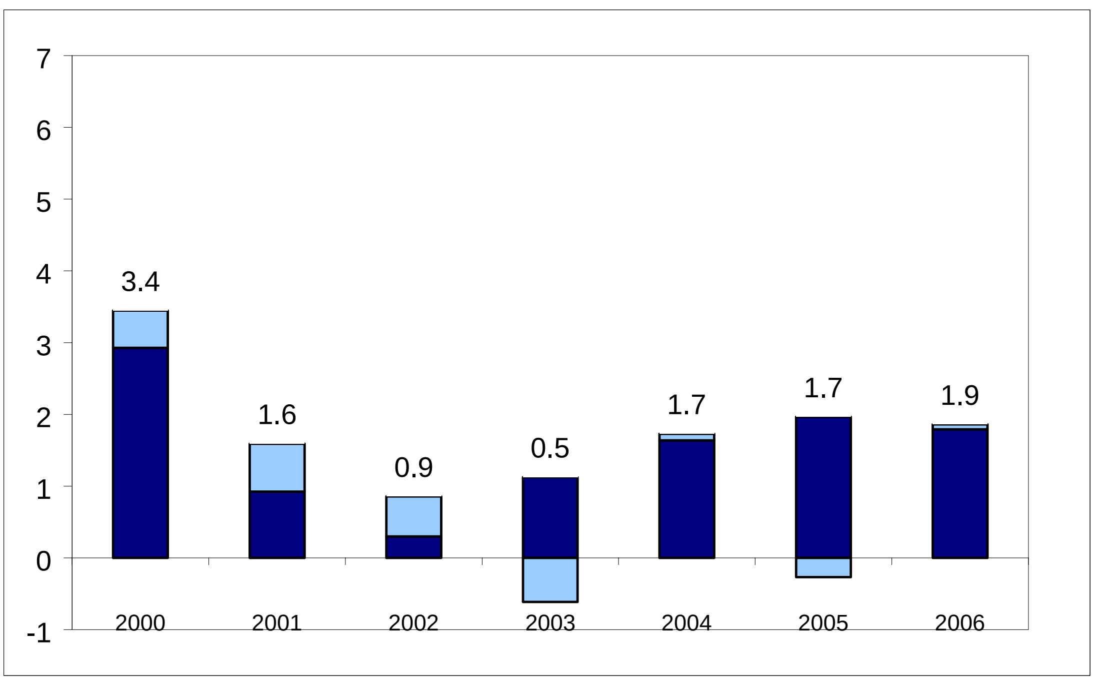


Table 2. Contributions of production sectors

Year	GDP growth	Agriculture	Industrial	Construction	Services	Net taxes
1999	2.84	0.08	0.24	0.12	2.11	0.29
2000	3.51	-0.01	0.93	0.14	2.54	-0.09
2001	1.60	-0.03	0.06	-0.02	1.75	-0.16
2002	0.86	0.02	0.03	-0.03	0.87	-0.03
2003	0.51	-0.09	0.00	-0.03	0.62	0.01
2004	1.70	0.07	0.47	0.02	1.09	0.05
2005	1.70	-0.01	0.47	-0.03	1.32	-0.05
2006	1.90	0.01	0.46	0.00	1.41	0.02

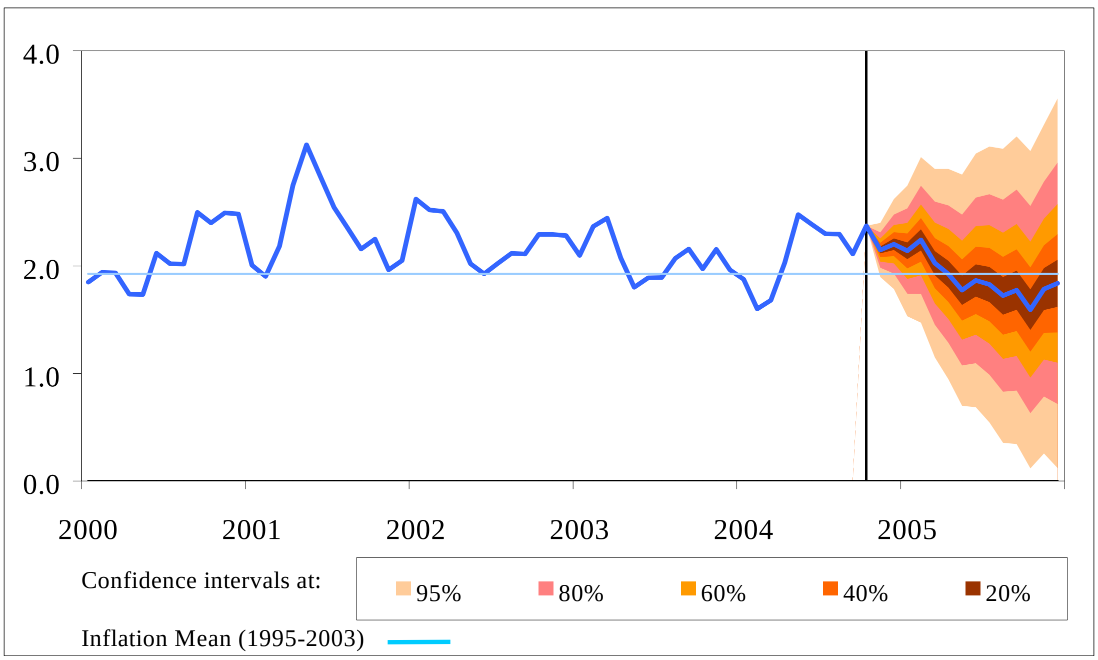
From a supply-side perspective, GDP growth is mainly driven by the expansion in the services (Table 2). This sector is responsible for about 65% of GDP growth in 2004 and about 75% in 2005 and 2006. The contribution of the industrial sector will be rather stable over the forecasting period. The average annual rates of growth for different industries classified according to the destination of goods are shown in Table 3. The highest rates of growth are shown by capital goods followed by intermediate and energy goods. For durable goods, a stabilization is expected for the period to come.

Table 3 Annual average rates for industrial production in the euro area

	1998	1999	2000	2001	2002	2003	2004	2005
Capital	6.7	2.4	8.2	1.6	-1.6	-0.0	3.6	2.7
Durable	4.2	1.3	6.1	-2.1	-5.6	-4.3	0.3	-1.9
Intermediate	3.7	1.9	6.2	-0.6	0.2	0.2	2.2	1.7
Non Durable	2.1	1.2	0.9	0.8	0.6	0.2	0.9	0.8
Energy	1.6	0.8	1.9	1.3	1.1	3.0	2.7	2.3
Total EMU	3.8	1.8	5.2	0.4	-0.5	0.3	2.3	1.7

Compared to our last forecast, main upwards innovations in inflation have come from international crude oil prices in euros. Unprocessed-food and the core index, have experienced mild downward innovations. For 2004, we forecast a total average inflation rate of 2.1%, with a probability of 80% of being above of 2%. The risk of deflation diminished several months ago (figure 4). The recent inflation performance is characterized by the stability of annual core inflation, with rates around 2.1%, and by the high volatility of annual energy inflation. The forecast for headline inflation is 1.9% for 2005 and 1.8% for 2006. This forecast represent a downward revision of headline inflation for what is left of 2004 and the first two quarters of 2005. For 2005, Brent future markets indicate no further increase in prices and the year-on-year-rates of inflation will systematically fall from the 2.2% of the beginning of the year to 1.8% in the last quarter, with a average annual rate of 1.9% for 2005.

Figure 4 Annual Forecast for the HICP Inflation and confidence bands



Source: Eurostat and UC3M. Date: November 23rd, 2004

By country, we expect total annual inflation rates of 2.1% in Germany, 3.5% in Spain, 2.3% in Italy and 2.2% in France in 2004. Inflation will reveal significant differences between countries, leading to a wide range of real interest rates in the different member states, which go from negative values in Ireland (-0.61%) and Spain (-0.38%) to positive values in Germany (1.28%) and Finland (1.19%) in 2005. Other member countries will experience real interest rates close to 0, which should favor investment. The dispersion of national inflation rates attained a high relative level in the 2001-2003 period, which was, however, reduced in 2004. The inflation rate for the euro area as a whole, which is calculated as the weighted average of the inflation rates of the different countries, is below the median throughout the period, showing that countries with more weight have the lower inflation rates (Germany, France).

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macro-econometric model, described in detail in the EFN Spring 2002 report (available from the EFN website, www.efn.uni-bocconi.it). Table 4 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.

While investment and private consumption are on a lower path than in other forecasts, our outlook for government consumption is higher. These issues are related, as government has behaved anti-cyclically in the past. Hence, if the outlook for domestic demand is more pessimistic, government consumption is likely to be stronger. Also, because at present the Stability and Growth Pact is de facto in abeyance, its restrictions appear to be less binding.

Naturally, the forecasts for 2006 differ more than those for the year to come. Compared with the numbers of the OECD, our forecast is much more cautious, possibly due to our pure model based approach, which excludes the forecast of positive effects from recent structural reforms in some member countries. Besides this technical point, it seems reasonable to assume that the positive impacts of the reforms on the macroeconomic performance will only slowly accrue over the coming years.

Table 4 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
GDP	1.7	1.9	2.0	2.2	2.2	na	1.9	2.2	1.9	2.5	1.7	na
Priv. Consumption	1.7	1.8	1.7	2.0	2.1	na	1.6	2.0	1.6	2.4	1.5	na
Gov. Consumption	1.9	1.5	1.1	1.6	1.5	na	0.8	1.2	1.1	1.1	1.5	na
Fixed Capital Form.	3.7	3.0	3.2	3.6	3.4	na	3.2	3.7	2.9	3.8	2.5	na
Unemployment rate	8.7	8.5	8.9	8.6	8.7	na	na	na	8.6	8.3	8.9	na
HICP	1.9	2.0	1.9	1.7	1.9	na	2.0	1.6	2.0	1.7	1.8	na
IP			na	na	na	na	na	na	na	na	2.3	na

EU: European Commission, European Economy, No. 5, 2004 (Autumn); IMF: World Economic Outlook, September 2004; ECB: ECB Monthly Bulletin, December 2004, OECD: OECD Economic Outlook, No. 76, December 2004; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2004. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

Box 1: Variables of the world economy

Important variables indicating the state of the world economy are shown in the Table 5. For the US and Japan, GDP growth is roughly 3.5 and 2.0 percent over the next two years, respectively, pointing to some moderation when compared to 2004 (US: 4.4, Japan: 4.3). Inflation will remain moderate in the US, while the deflation process in Japan comes to an end. A roughly constant oil price of 40 dollar per barrel is expected over the forecasting period. The Euro is predicted to stay at relative high levels in 2005. In 2006, a slight depreciation against the US dollar and the Yen is expected, which is in line with the international parity conditions. In the exchange rate equations, purchasing power parity holds as a long run relationship.

Table 5 Variables of the world economy

	2005	2006
US GDP Growth Rate	3.4	3.6
US Consumer Price Inflation	2.4	2.2
US Short Term Interest Rate	3.0	3.5
US Long Term Interest Rate	5.3	5.5
Japan GDP Growth Rate	1.8	2.0
Japan Consumer Price Inflation	0.0	0.2
Japan Short Term Interest Rate	0.2	0.5
Japan Long Term Interest Rate	1.9	2.0
World Trade	6.8	7.0
Oil Price	40	40
USD/Euro Exchange Rate	1.28	1.20
100Yen/Euro Exchange Rate	1.34	1.30

Apart from the development of world trade, long-term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (2004) and the OECD (2004). Oil price in US dollar per barrel, all other variables in percent.