EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2009 and 2010

European Forecasting Network

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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 wide recovery will put an end to the recession in the euro area in the second half of 2009, but chances for a robust upswing for the year 2010 are slim. We expect GDP to fall around 4.0% in 2009, but a positive growth rate of 0.8% in 2010. However, as unemployment will continue to rise and fiscal policy in member countries with high budget deficits will become restrictive, private consumption is expected to decrease by -0.5% in 2010. Public consumption, public investment and exports will support aggregate demand.

- Industrial production has bottomed out in the second quarter of 2009. Nevertheless, industrial recovery will take time and average growth rates are expected to be just slightly positive in 2010 (1.1%). It is worth mentioning that this figure has improved significantly since our last report, as world trade has started to recover and some firms are restocking their inventories or reducing them at a slower rate than in the first half of the year. However, private investment will be declining well into next year, as capacity utilization is extremely low and the real costs of financing are not as attractive as interest rate figures appear to suggest.

- The HICP evolution is expected to remain stable during 2009 and most of 2010. In fact, inflation expectations confirm that price stability is one of the virtues of the euro area and that inflation fears should not limit, for the moment, fiscal and monetary counter-cyclical policies.

- The main risk for the world economy is that policy fails to adapt to a new post-crisis environment. One challenge is the correct timing for reducing the extremely expansive policy stance and public support for the financial sector; another is regulatory reform of the financial sector that has the potential to stabilize or destabilize confidence of households and firms.

Table 1 Economic outlook for the Euro area

	2006	2007	2008	2009: 2nd half		2009: annual		2010: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					-3.7		-4.2		0.0
GDP	3.0	2.7	0.7	-3.2	-2.7	-4.0	-3.8	0.8	1.6
					1.0		1.0		1.4
Potential Output	1.6	1.6	1.6	1.1	1.2	1.1	1.2	1.5	1.6
					-1.4		-1.3		-1.4
Private Consumption	2.0	1.6	0.3	-0.9	-0.5	-1.0	-0.8	-0.5	0.3
					1.7		2.0		1.0
Government Consumption	1.9	2.1	2.2	2.0	2.3	2.2	2.4	1.4	1.7
					-10.0		-10.5		-2.2
Fixed Capital Formation	5.5	4.9	-0.5	-8.6	-7.3	-9.9	-9.2	0.1	2.4
					-13.4		-15.1		1.7
Exports	8.3	5.8	1.2	-12.4	-11.4	-14.6	-14.2	3.0	4.3
					-12.8		-13.1		0.4
Imports	8.1	5.2	1.2	-11.8	-10.9	-12.7	-12.2	2.1	3.7
					9.9		9.5		10.9
Unemployment Rate	8.3	7.4	7.5	10.0	10.2	9.6	9.7	11.4	11.8
					2.9		3.2		2.1
Labour Cost Index	2.5	2.7	3.5	3.0	3.1	3.3	3.4	2.3	2.5
					-1.6		-2.4		1.4
Labour Productivity	1.4	0.9	-0.2	-1.2	-0.9	-2.2	-2.0	2.0	2.5
					-0.1		0.3		0.9
HICP	2.2	2.1	3.3	0.1	0.3	0.3	0.4	1.6	2.4
					-13.4		-16.0		-3.9
IPI	4.2	3.7	-1.7	-11.0	-8.7	-14.9	-13.8	1.1	5.9

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 2009 and 2010

The world economy: reanimation seems to succeed

In late summer 2009, the sharp recession appears to have come to an end. Industrial production is on the rise again in most countries, as is world trade. In the second quarter output decreased at a markedly slower rate in the US and in the UK, and was already up in Japan, which benefits from the apparently swift recovery in Asia. The Asian revival started in China, where since early summer the authorities stimulated the economy by drastically expanding credit and adopting huge public investment programs.

Policy is also behind the improving conditions for the economies in the US and in Western Europe. It succeeded in stabilizing financial markets by applying a wide range of different measures such as guarantees for bonds emitted by financial institutions and public capital for banks with low equity cushions. Confidence has, to a certain degree, returned to the markets, as is indicated by the fall in risk premia, in particular those between unsecured and secured credit at the interbank money markets. But these premia are still very high if compared with their levels before the turmoil broke out in summer 2007. Key interest rates of close to nil for the main currencies and the abundant provision of liquidity by central banks contribute to the stabilization of the financial sector. As a consequence, markets appear to expect a quick recovery of the world economy: prices for stocks in developed economies and for oil and industrial commodities on world markets have rebounded since March. In the US and in the UK, house prices are – at least for the time being – no longer falling. In most countries, surveys show a gradual retreat of pessimism among firms and private households. In the second half of 2009, the world economy will benefit from these expectations. Some support comes from public investment, since many fiscal programs still have to be implemented. That said, chances are low that the recovery will gain much momentum during this year and the next: firstly, fiscal policy will become restrictive in 2010 in a number of countries that are especially hard hit by the crisis. Second, drastically lower asset prices have undermined the financial position of households and banks, in particular in those countries, such as the US and Britain, where a housing bubble has burst. Moreover, banks will still be exposed to the pressure of putting balance sheets in order, as losses from insolvencies of debtors will not abate quickly.

The main risk for the world economy, however, is that policy fails to adapt to a new post-crisis environment: one challenge is the correct timing for reducing the extremely expansive policy stance and the public support for the financial sector; another is reforming the regulation of the financial sector at an international level. Steps in this direction have the potential to stabilize or to destabilize the economic agents' confidence that is so crucial for a thorough recovery of the world economy.

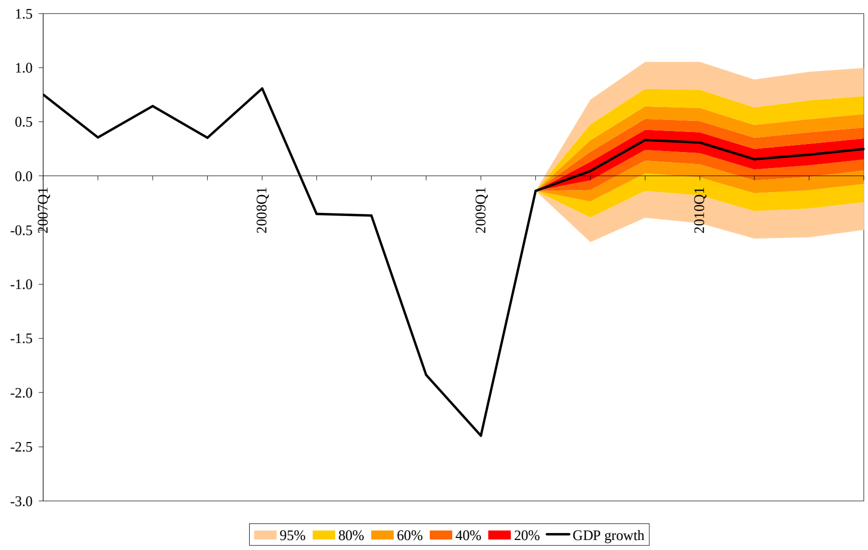
The euro area: good prospects for the recession to end, slim chances for an upswing

In the euro area, national accounts data for the second quarter surprised on the positive side: output contracted slightly, but by far less than during the winter. Private households spent even a bit more than at the beginning of the year. This was partly due to expansionary policy measures in several member states: additional transfers and tax reductions stabilized disposable income, and car scrapping schemes induced consumers to buy new cars – although, as a consequence, spending for other consumer durables declined markedly. Exports decreased further, albeit at a slower rate than at the beginning of the year. Imports fell even more than exports, so that the external trade as a whole dampened the decline in output. Investment activity declined as well, but again, at a markedly slower rate than in the two preceding quarters.

Confidence of firms and consumers has been steadily improving since March. Information about activity during the summer suggests that the recession might already have come to an end: industrial orders and export volumes start to rise again. For the rest of the year, some momentum will come from firms restocking their inventories or reducing them at a slower rate than in the first half of the year. Fixed investment, however, will be declining well into next year: capacity utilization is extremely low and the real costs of financing are not as attractive as interest rate figures appear to suggest: though key interest rates will be kept low in this year and in 2010, banks have been tightening their lending conditions for two years now and will not ease them by much any time soon. Indeed, larger firms react by expanding their funding via debt securities. Financing investment activity with retained earnings will be limited, because profits fall as unit labor costs go up. This is particularly true for those firms that try to avoid suspension of staff on a large scale.

Short-time working schemes are subsidized in some member states, and with good results: employment in manufacturing kept up relatively well, given the drastic fall in output in this sector. Nevertheless, unemployment has risen by more than 2 percentage points to 9 ½ percent in the year to July. Much of this increase came from redundancies in the construction sector, in particular in Spain. In the euro area as a whole employment will, as a lagging indicator of the business cycle, continue to decrease during the rest of the year and for much of year 2010. Rising unemployment will dampen the real disposable income of private households and induce them to increase their precautionary savings. In addition, fiscal policy will, in the aggregate, be more or less neutral in 2010, when in some countries investment programs decided upon earlier this year will finally put into practice, while in countries with critical fiscal positions, governments have already declared their intention to limit public deficits. All in all, the world wide recovery will put an end to the recession in the euro area in the second half of 2009, but chances for a robust upswing are slim, even for the year 2010.

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 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

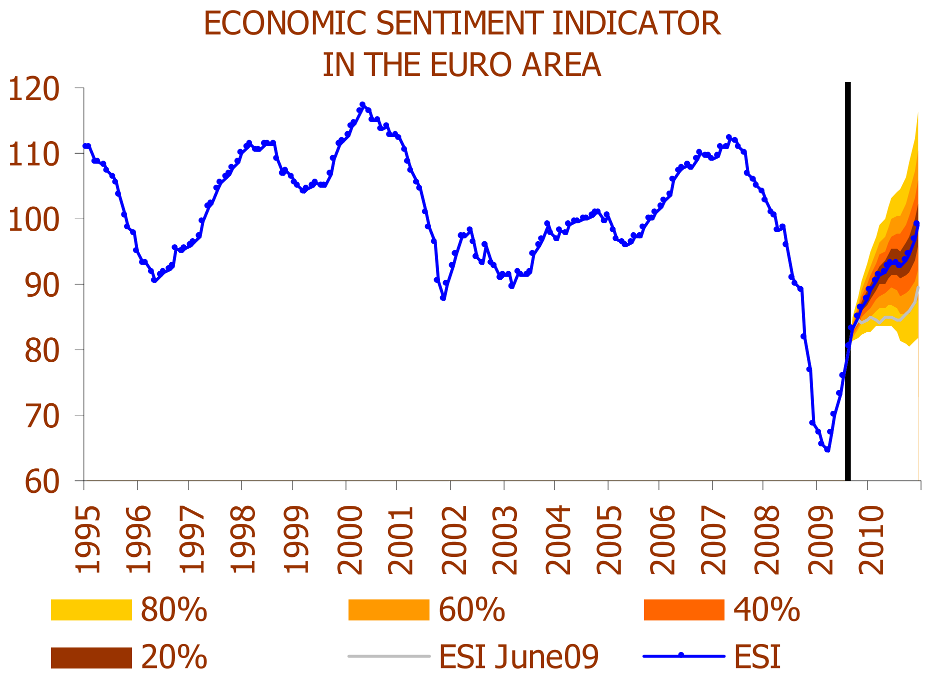


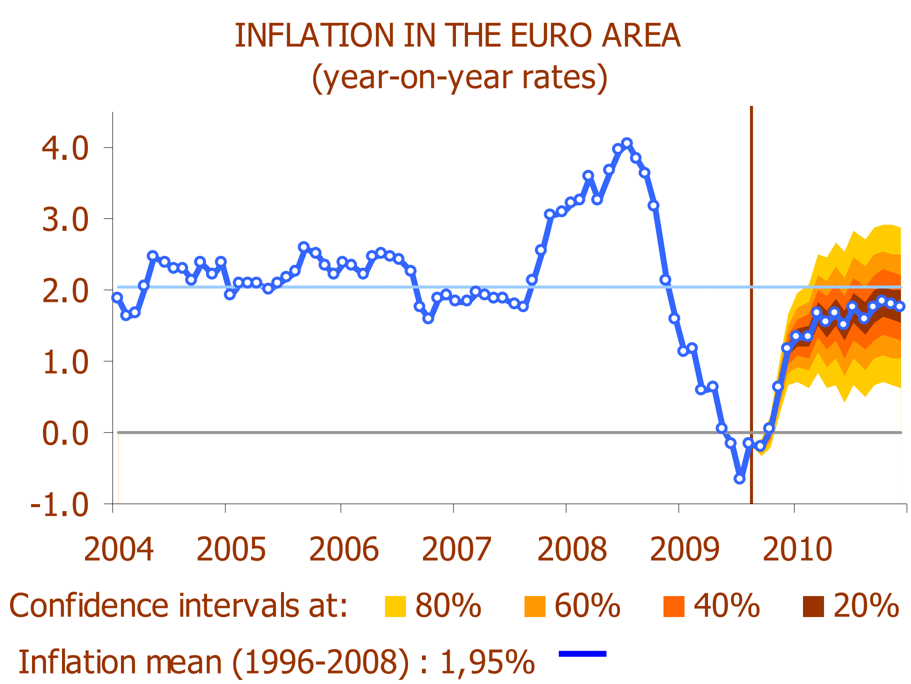
Table 2 Annual average rates for industrial production in the euro area

	2004	2005	2006	2007	2008	2009	2010
Durable	0.09	-0.95	4.37	1.32	-5.63	-18.69	-1.52
Non Durable	0.44	1.07	2.69	2.48	-1.42	-2.74	1.46
Capital	2.78	2.52	5.96	6.74	-0.27	-20.38	0.77
Intermediate	2.34	0.55	4.87	3.72	-3.32	-20.09	1.15
Energy	4.03	-2.67	-0.97	-0.99	1.12	-5.31	3.45
Total	2.07	1.29	4.24	3.71	-1.72	-14.92	1.06

Taking a closer look to the industrial production index evolution and forecasts will confirm this idea. The fall in the production of durable consumption, capital and intermediates goods accumulated in 2009 has been dramatic, with negative year on year rates well exceeding 20%. The IPI and its main components bottomed out between April and June of 2009 but recovery will take time. Year on year rates are expected to remain negative three more quarters while the average annual growth rate will be just slightly positive in 2010 (1.06%). As strange as it might sound these are good news compared to the previous report, where industrial production was expected to continue to fall quite remarkably in 2010.

As for inflation, annual rates for the 1st half of 2009 have been in line with our forecasts: 0.6%. During last year inflation rates have been falling rapidly but while the deceleration has been very intense in food and energy prices it was moderate in industrial goods and services, in spite of the ongoing economic recession. Year on year inflation rates became negative in June and reached an historical minimum in July. According to our forecasts inflation will return to positive values in November this year but will remain beneath 2.0% throughout the forecasting horizon. The rise expected for the next few months will also largely depend on crude oil prices remaining at around 50 euros/barrel. However, we should also consider that the significant fall in core inflation –mainly caused by processed food prices- is also coming to an end and core inflation is expected to rise after December 2009. Actual inflation expectations confirm that price stability is one of the virtues of the euro area and that inflation fears should not limit, for the moment, fiscal and monetary counter-cyclical policies.

Figure 4. Euro Area Inflation Rate 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 on the optimistic side concerning next year. This is, in particular, true for investment activity. Note that the quite substantial fiscal programs of member countries take effect via investment instead of government consumption, and that most of the spending will, due to implementation lags, be realized not before 2010.

Industrial production forecasts are now very much in line with the consensus expectations while inflation projections remain slightly below those of other institutions for 2009 and definitely above average forecasts for 2010.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF**		ECB		OECD***		Consensus	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2008	2009
GDP	-4.0	0.8	-4.0	-0.1	-3.5	0.6	-4.1	0.2	-4.8	0.0	-3.9	1.0
Priv. Consumption	-1.0	-0.5	-0.9	-0.3	-1.3	-0.5	-0.9	-0.1	-1.3	-0.2	-0.9	0.2
Gov. Consumption	2.2	1.4	2.0	1.7	2.3	2.1	1.6	1.4	1.3	1.4	2.2	1.9
Fixed Capital Form.	-9.9	0.1	-10.4	-2.7	-11.2	-3.7	-11.0	-3.2	-11.1	-1.3	-10.1	-0.4
Unemployment rate	9.6	11.4	9.9	11.5	10.1	11.5	na	Na	10.0.	12.0	9.5	10.8
HICP	0.3	1.6	0.4	1.2	0.4	0.6	0.4	1.2	0.5	0.7	0.3	1.2
IP	-14.9	1.1	na	na	na	na	na	Na	na	Na	-14.8	1.3

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

*European Commission Interim Forecast, September 2009: GDP growth -4.0% in 2009.
**IMF World Economic Outlook upgrade, July 2009: GDP growth -4.8% in 2009, -0.3% in 2010.
***OECD Interim Assessment, September 2009: GDP growth -3.9% in 2009.

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 will be in a deep recession in 2009 and recover in 2010, growing at close to potential rates. The massive decrease in world trade this year is assumed to have come to a halt, giving way to moderately accelerating growth in 2010. Oil prices are expected to keep the level they have in mid September 2009. As well, the exchange rates of dollar and yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2008	2009	2010
US GDP Growth Rate	0.4	-2.5	2.1
US Consumer Price Inflation	3.8	-0.5	1.8
US Short Term Interest Rate (December)	0.1	0.3	1.4
US Long Term Interest Rate (December)	2.4	3.4	3.9
Japan GDP Growth Rate	-0.7	-5.3	1.6
Japan Consumer Price Inflation	1.4	-1.2	-0.6
Japan Short Term Interest Rate (December)	0.1	0.6	1.0
Japan Long Term Interest Rate (December)	1.5	1.5	1.7
World Trade Growth Rate	2.1	-13.6	4.3
Oil Price (December)	41	68	70
USD/Euro Exchange Rate (December)	1.34	1.40	1.40
100Yen/Euro Exchange Rate (December)	1.23	1.32	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 close to those of Consensus Economics (2009). 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.