EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2011 and 2012

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

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Highlights

- In most advanced economies, strained public finances compel central banks to keep their expansive course, while interest rates in most emerging markets continue to be relatively low, if compared to their high potential growth rates. Thus, expansive monetary policies throughout the world, while giving cause for concern regarding long run macroeconomic stability, brighten the growth prospects for 2011.
- Developments in the group of countries that are neither booming nor in stagnation will be pivotal for the euro area economy in 2011. Economic sentiment indicators appear to suggest that important core countries are benefiting more and more from the upswing in Germany. In addition, the crisis of confidence in 2010 has weakened the common currency and thus improved the competitiveness of firms producing in the euro area.
- We expect euro area GDP to grow by around 1.7% in 2011 and 1.6% in 2012, not enough to bring the unemployment rate back below 10%. In addition, this forecast is made under the assumption that the fiscal crisis will not drastically damage financial conditions and economic confidence of firms and households. This serious downward risk is indicated by present sovereign risk spreads that price in a high probability for some form of debt restructuring that would implicate sizable losses for private creditors. In such a case, the stability of the European banking sector would be at stake, as it is a major creditor of the sovereign debtors that face a crisis of confidence.
- Due to the higher external demand, industrial production remained quite strong in the second semester and forecasts have been revised upwards. We expect industrial production to grow a 7.1% during this year and close to 3.0% in both 2011 and 2012.
- Inflation expectations have risen slightly since the last report, pushed by energy and goods prices. We forecast a 2.0% average inflation rate in 2011 that will drop to 1.7% in 2012.

Table 1 Economic outlook for the Euro area

	2008	2009	2010	2011: 1st half		2011: annual		2012: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	0.4	-4.1	1.7	1.9	1.3 2.5	1.7	1.1 2.4	1.6	0.9 2.3
Potential Output	1.4	0.7	0.6	0.9	0.8 1.1	1.0	0.9 1.1	1.1	0.9 1.2
Private Consumption	0.4	-1.1	0.7	1.0	0.4 1.6	1.1	0.4 1.8	1.4	0.6 2.1
Government Consumption*	2.3	2.3	0.7	0.4		0.2		0.4	
Fixed Capital Formation	-0.8	-11.3	-0.9	3.1	1.3 5.0	3.1	1.2 5.0	2.7	0.6 4.9
Exports	1.0	-13.2	10.0	9.2	8.0 10.4	8.2	7.0 9.3	6.6	5.3 7.9
Imports	0.7	-11.9	10.2	7.3	6.0 8.6	6.5	5.3 7.8	6.2	4.8 7.7
Unemployment Rate	7.5	9.4	10.0	10.2	10.0 10.5	10.3	10.0 10.6	10.5	10.0 10.9
Labour Cost Index	3.5	2.9	1.7	2.1	1.7 2.4	2.3	1.9 2.6	2.2	1.7 2.6
Labour Productivity	-0.5	-2.2	2.1	1.8	1.3 2.3	1.6	1.2 2.1	1.3	0.7 1.8
HICP	3.3	0.3	1.6	2.1	1.5 2.7	2.0	1.2 2.8	1.7	0.7 2.7
IPI	-1.8	-14.9	7.1	3.0	1.7 4.3	2.5	0.6 4.4	3.1	0.7 5.5

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 2011 and 2012

Confidence crisis in Europe overshadows worldwide recovery

At the end of 2010 the sovereign debt crisis in the euro area has intensified; it now jeopardizes both the stability of the financial sector and the economic recovery in Europe. In November, Ireland, after Greece in spring, became the second euro area state to call for international financial help. After rescue was agreed on, the confidence of investors dwindled regarding Spain and, to a lesser extent, Italy. More generally, investors doubt the political will of euro area member states to put together ever more expansive rescue packages. Even after the recent reform, it is not clear whether the European Financial Stability Facility will have enough resources in case a country as large as Spain has to ask for support. Moreover, the facility is an instrument thought to solve crises of liquidity, not those of solvency. What will happen if insolvency becomes apparent for one state or another? Sovereign risk spreads price in a high probability for some form of debt restructuring that would implicate sizable losses for private creditors at some point in time during the next years. In such a case, the stability of the European banking sector, as a major creditor of the states at risk, would be at stake. Not surprisingly, insurance premia for bonds of European banks have increased markedly since October.

The European sovereign debt crisis has intensified, because the Greek, the Irish, and also the Portuguese government are likely to miss their budget cut targets for 2010. The general economic environment, however, continues to improve in Europe and in the world. The recovery in the US – after a soft spot earlier in 2010 – apparently accelerated in the second half of the year, and will (at least in the short run) benefit from expansionary monetray as well as fiscal programs that were decided in autumn. As to Asia, confidence indicators for China and India point to accelerating growth during winter, though in the presence of inflationary concerns. This will stimulate neighbouring economies such as Japan, which is apparently slowing down at the end of 2010. In addition, interest rates in most emerging markets will, in spite of some tightening of monetary policy, continue to be relatively low, if compared to the mostly high potential growth rates. In most advanced economies, strained public finances compel monetary policies to keep their expansive course of either purchasing substantial amounts of government debt, or providing liquidity for banks that are heavily engaged in risky state bonds. All in all, while the stance of monetary policy in the world gives cause for concern for the long run macroeconomic stability, it brightens the growth prospects for 2011. World trade, that decelerated markedly during the summer of 2010, is likely to gain momentum early next year.

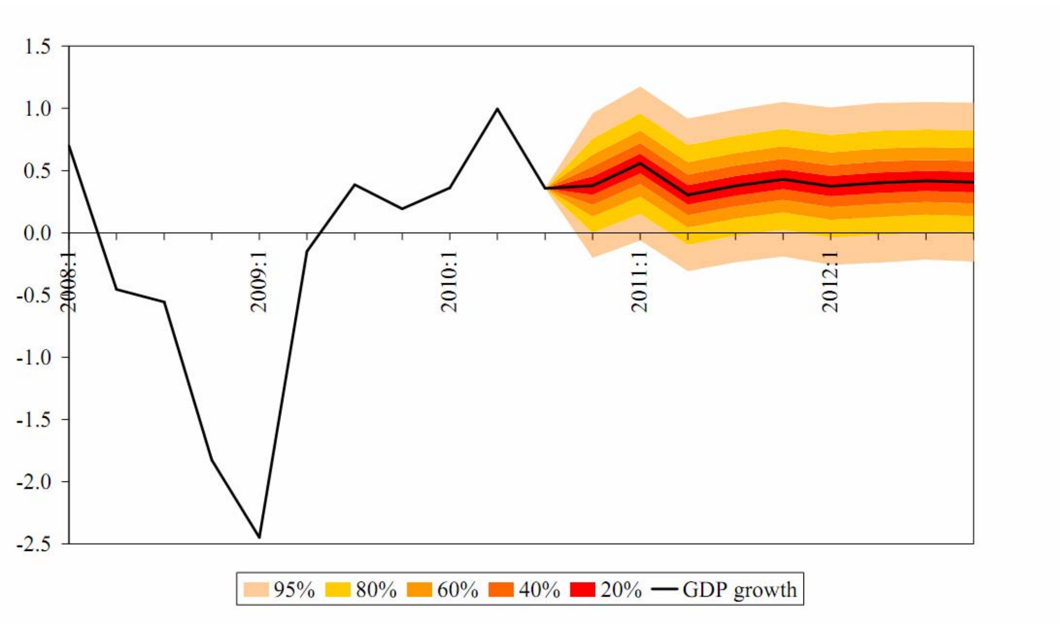
The euro area economy: recovery continues nonetheless

At the end of 2010, the recovery of the euro area economy continues, albeit at a more moderate pace than during spring and summer. Consumption of private households has been slowly, but steadily expanding since autumn 2009. It has now reached the level of the first half of 2008, on the eve of the financial and economic crisis. Exports strongly rebounded up to the summer; in autumn, their expansion lost some momentum. Still, exports of goods to destinations outside the euro area are also close to their pre-crisis level. Since summer, firms react to encouraging export demand growth with more investment, particularly in equipment. The weaker expansion of investment demand in the third quarter may partly be due to weaker public spending, as programs to stimulate the economy are phasing out and fiscal adjustment programs, in particular in member states with crises of confidence, set in.

In general, private agents are tentatively expanding their spending since both their income and wealth have markedly recovered in 2010. The value of financial assets has been increasing since the start of the year. Property has been gaining value since spring. House prices are up in most countries (with the notable exceptions of Spain, Ireland and Italy), as interest rates are, for all maturities, extraordinary low. The recovering economy has led to strongly rising profits. Indeed, at present the non-financial sector is, in the aggregate, able to finance its investment costs completely from retained earnings. The volume of labour employed in the private sector has been slowly increasing during the whole year, mainly because short term labour arrangements phased out. The number of employed persons stopped decreasing during summer, and since then it is about stagnating.

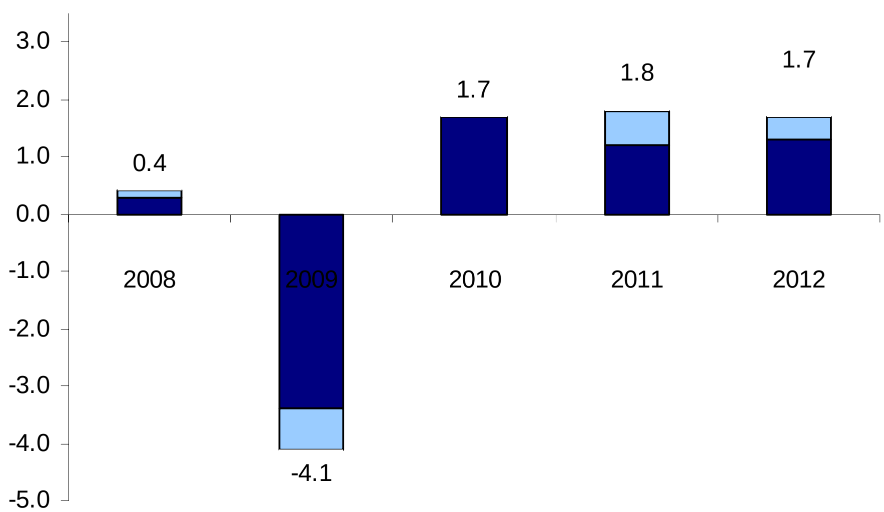
Of course, data refering to the euro area as a whole mask drastic differences regarding economies in the single member states. An upswing becomes apparent in Germany, Austria, and in all likelihood in Finland. In Greece, Portugal, and Ireland, however, efforts to reduce the excessive public deficits result in shrinking or stagnating economies. What will be pivotal for the the euro area economy in 2011? What happens in the large group of countries that are between the two extremes. Economic sentiment indicators for France, Belgium, and the Netherlands suggest that important core countries are benefiting more and more from the upswing in Germany. In addition, the confidence crisis of 2010 has weakened the common currency and thus improved the competitiveness of firms producing in the euro area. All in all, chances are good that the moderate recovery will, in spite of the drastic fiscal adjustment programs in the member states subject to confidence crises, continue in 2011 and 2012. Hence, we forecast euro area GDP to grow by about 1.7% in 2011 and 1.6% in 2012.The major risk for this forecast, however, is that a further worsening of the fiscal crisis will drastically damage financial conditions and economic confidence of firms and households. Moreover, even if actual growth will be close to our expected values, the unemployment rate will not be reduced below 10% in the next two years.

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

Taking a closer look to the industrial sector, it is now evident that industrial production growth has remained quite strong in the second semester of 2010, mainly thanks to capital and intermediate goods. Our forecasts are therefore updated upwards, with an average expected growth of euro area industrial production of 2.5% for 2011. As for 2012, we expect moderate growth to continue and anticipate a 3.1% increase in the average industrial production level. At the same time, it is worthwhile noting again the heterogeneity among euro area members. Core European countries are doing fine and, provided the euro does not appreciate significantly, they will probably continue to do so in the next two years, recovering and in some cases overcoming their pre-crisis levels. Meanwhile, the industrial sector in Greece, Spain and Portugal is showing to be unable to catch up and to benefit from the surge in global demand. There has been almost no recovery in industrial production in these countries and growth expectations remain weak.

Figure 3 Economic Sentiment Indicator and Confidence bands

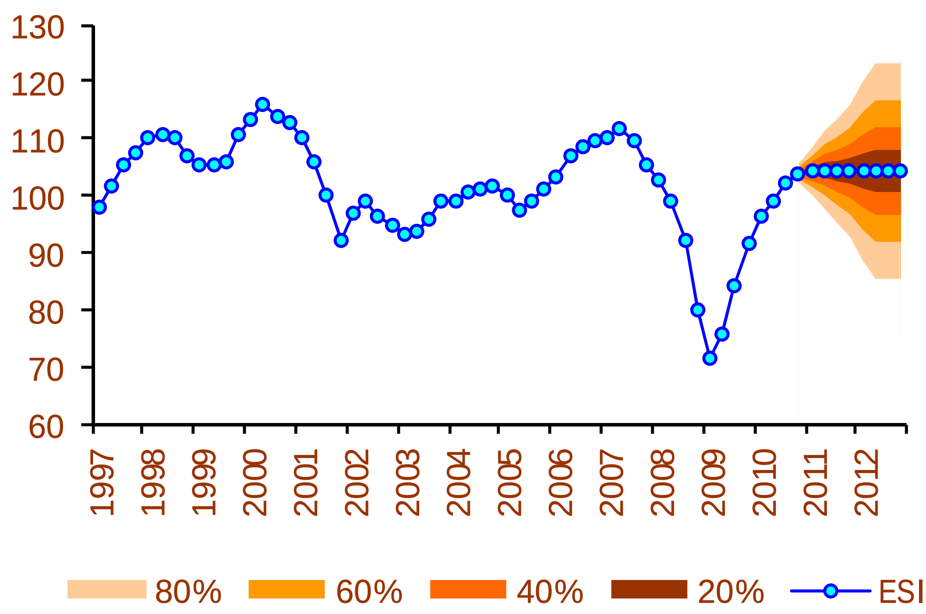


Table 2 Annual average growth rates for industrial production in the euro area

	2006	2007	2008	2009	2010	2011	2012
Durable	4.6	1.3	-5.7	-17.4	3.2	1.0	1.3
Non Durable	2.7	2.5	-1.5	-3.0	3.7	1.3	2.2
Capital	5.9	6.6	-0.2	-20.8	8.3	4.4	4.0
Intermediate	4.8	3.8	-3.4	-19.2	9.8	2.7	2.9
Energy	0.6	-0.9	0.3	-5.3	3.5	0.3	3.1
Total	4.3	3.7	-1.8	-14.9	7.1	2.5	3.1

As for inflation, we expect a 2.0% average value for 2011, two decimal points above the figure published in our EFN autumn report. The increase is due mainly to energy prices, which have been rising steadily in the last few months. As for inflation main components, we have been observing some mild upwards innovations in the prices of goods, probably depending on raw materials prices which have been increasing during all 2010, while inflation in the services sector continues to slowly decrease. We expect the annual rate of inflation to move above the 2.0% level from December 2010 to February 2011. Subsequently, inflation in the euro area is expected to stabilize close but below 2.0%, that is exactly were the ECB wants it to be. Overall, inflation keeps evolving according to our expectations and we don't expect price stability to be a major cause for concern in the near future.

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 a bit on the optimistic side, but only for 2011. This is particularly true for investment activity. One reason for the swiftly fading upswing in investment is that the potential growth rate the model generates is small. This is so because total factor productivity of the euro area economy has been growing slowly during the past decade; moreover, population growth is decreasing rapidly.

Our inflation forecasts are slightly above those of other institutions, especially in 2011. As for 2012, our projections are in line with those from IMF and two decimal points below the ECB. The industrial production forecasts of the EFN are slightly more pessimistic than consensus with respect to next year while there is no possible comparison for 2012.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2011	2012	2011	2012	2011	2011	2011	2012	2011	2012	2011	2012
GDP	1.7	1.6	1.5	1.8	1.5	na	1.4	1.7	1.7	2.0	1.5	na
Priv. Consumption	1.1	1.4	0.9	1.4	0.9	na	0.9	1.4	1.0	1.7	0.9	na
Gov. Consumption	0.2	0.4	-0.1	0.2	-0.2	na	-0.1	0.3	0.0	-0.1	0.4	na
Fixed Capital Form.	3.1	2.7	2.2	3.6	1.6	na	1.3	2.6	1.6	2.8	2.6	na
Unemployment rate	10.3	10.5	10.0	9.6	10.0	na	na	na	9.6	9.2	9.9	na
HICP	2.0	1.7	1.8	1.7	1.5	na	1.8	1.5	1.3	1.2	1.6	na
IP	2.5	3.1	na	na	na	na	na	na	na	na	3.2	na

EU: European Commission, Economic Forecast, November 2010; IMF: World Economic Outlook, October 2010; ECB: ECB Monthly Bulletin, December 2010, OECD: Economic Outlook, November 2010; Consensus: Consensus Economics Inc., Consensus Forecasts, December 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 recovery in the US gains pace only slowly in 2011 and 2012, and that expansion in Japan loses momentum. World trade is back on its long term growth path. Oil prices are expected to be about constant in real terms. 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

	2010	2011	2012
US GDP Growth Rate	2.8	2.7	3.0
US Consumer Price Inflation	1.6	1.5	2.0
US Short Term Interest Rate (December)	0.2	0.3	1.5
US Long Term Interest Rate (December)	2.8	3.4	4.2
Japan GDP Growth Rate	3.5	1.1	1.3
Japan Consumer Price Inflation	-0.8	-0.3	-0.5
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	1.2	1.2	1.5
World Trade Growth Rate	11.5	6.0	6.9
Oil Price (December)	90	92.5	95
USD/Euro Exchange Rate (December)	1.34	1.34	1.34
100Yen/Euro Exchange Rate (December)	1.10	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 (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.