EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2011 and 2012

Spring 2011

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)

University of Birmingham, Department of Economics
Team Leader: Anindya Banerjee (a.banerjee@bham.ac.uk)

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

The Department of Economics, European University Institute (EUI)
Team Leader: Giancarlo Corsetti (Giancarlo.corsetti@eui.eu)

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

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Highlights

- Our baseline scenario for the world economy in 2011 and 2012 is a continuation of the upswing, because growth dynamics continue to be high in emerging economies, monetary policy will in general continue to be expansive, and the factors that dampen the recovery in many advanced economies are slowly declining.
- There are two main downward risks for this prospect: first, low interest rates and high growth might drive commodity prices to disruptive levels. Second, waning confidence in financial markets might enhance volatility and enforce further extensive measures of consolidation in advanced economies.
- For the euro area the growth perspectives are less bright. We expect GDP to grow by around 1.9% in 2011 and 1.7% in 2012, not enough to bring the unemployment rate back below 10%.This forecast assumes that the crisis of confidence in public finance in the euro area can be contained. In this case, the modest recovery will continue, this year mainly driven by strong external demand. Fixed capital formation, driven by low real interest rates, will become the main engine of growth in the second half of 2011 and in 2012.
- Due to the higher external demand, industrial production remained quite strong during 2010 and forecasts have been revised upwards. We expect industrial production to grow at 5.5% during 2011 and at 3,5% in 2012, nearly recovering pre-crisis levels.
- While core inflation remains at historically low values, energy and food prices will probably keep inflation in the euro area above the ECB target throughout this year: we forecast a 2.4% average inflation rate in 2011. Given this scenario, increases in the ECB policy rate in 2011 are quite probable, starting in April, but overall the reduction in the expansive stance of monetary policy will be slow. We expect inflation to drop to 1.4% in 2012, due to the ECB policy and easing of pressures in commodity markets.

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	1.5 2.4	1.9	1.3 2.4	1.7	0.9 2.4
Potential Output	1.4	0.7	0.5	0.8	0.7 0.9	0.9	0.8 1.0	1.1	1.0 1.2
Private Consumption	0.4	-1.1	0.8	1.1	0.7 1.6	1.2	0.6 1.8	1.5	0.6 2.3
Government Consumption*	2.3	2.4	0.7	0.4		0.1		0.5	
Fixed Capital Formation	-0.8	-11.4	-0.7	0.8	-0.6 2.3	1.7	-0.3 3.8	5.2	2.2 8.1
Exports	1.0	-13.2	10.9	10.2	9.2 11.1	9.3	8.2 10.3	6.9	5.6 8.1
Imports	0.8	-11.9	8.9	8.3	7.1 9.4	8.6	7.4 9.9	7.8	6.3 9.4
Unemployment Rate	7.5	9.4	10.0	10.1	9.8 10.3	10.2	9.9 10.4	10.2	9.7 10.7
Total hourly labour costs	3.4	2.9	1.3	1.5	1.2 1.8	2.0	1.6 2.4	2.3	1.8 2.8
Labour Productivity (output per head)	-0.4	-2.2	2.1	2.0	1.7 2.4	1.8	1.5 2.2	1.2	0.7 1.7
HICP	3.3	0.3	1.6	2.4	2.1 2.7	2.4	1.9 2.9	1.4	0.4 2.4
IPI	-1.8	-14.9	7.2	6.3	4.8 7.8	5.5	3.6 7.4	3.6	1.0 6.2

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 the 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

The worldwide upswing: threatened by political upheavals and a natural disaster

In the first months of 2011, the world economy is in a cyclical upswing. Production and trade have expanded strongly during winter and will, according to rising indicators for confidence of firms and households in most countries, continue to do so in the coming months. The acceleration of the upswing in the second half of 2010 is partly due to economic policy in the US. Since the Federal Reserve's plans for a new round of quantitative easing were communicated in late August, stock market prices have been rising in most advanced economies, and a bunch of measures reducing tax burdens have again stimulated US consumer spending at the end of 2010. In addition, production and trade in Emerging Asia, after restocking had slowed down in the summer, gained new momentum in autumn, stimulating exports and industrial production in Japan as well, before the country was hit by the tsunami and nuclear disaster in March.

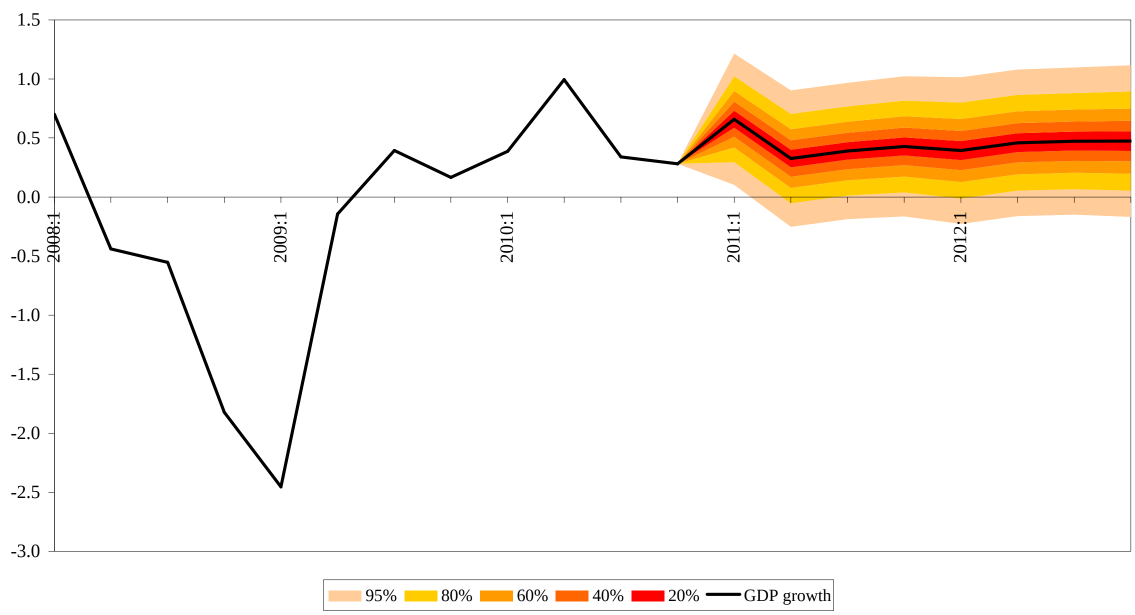
The engine of this upswing is a very expansive monetary policy in most countries. This stance may be justified for many advanced economies, where repercussions of the financial crisis still prevent production from reaching full capacity, but not for booming emerging market economies. Nevertheless, key interest rates are mostly very low in these countries (with the notable exception of Brazil), if, e.g., compared with respective nominal output growth rates. High present values of asset returns are associated with rising commodity prices worldwide. For example, stock prices (measured by the MSCI world index) have increased by 20% since August 2010, and the price of crude oil (Brent) was up by 20% in early January when compared to the previous year, even before the upheavals in the Arab world made the price soar to about 115 dollars. The political upheavals themselves were, at least partly, caused by the commodity price boom. The boom led to food price hikes that triggered unrest in some countries where large parts of the population spend most of their income for food.

Our baseline scenario for the world economy in 2011 and 2012 is a continuation of the upswing. In fact, growth dynamics continue to be high in emerging economies and the factors that dampen the recovery in many advanced economies are slowly declining. There are, however, several downward risks to this prospect. First, low interest rates, high growth and reduced supply might drive commodity prices to disruptive levels. In such a scenario, earnings of commodity producers could not be recycled smoothly enough to keep world demand growing. The second risk is that fiscal consolidation in many advanced economies will have more restrictive effects than assumed in our forecast. In particular, this can happen if waning confidence in financial markets increases volatility and enforces extensive measures of consolidation. The final risk is that the natural and nuclear disaster in Japan causes a grave recession of the country's economy (the third largest in the world), though at the moment this is not so probable.

Upswing, recovery, and stagnation in the euro area

The euro area economy grew by 1.7% in 2010 and we expect it to grow by 1.9% in 2011 and 1.7% in 2012 (see Figure 1). While restocking of inventories was the major source of the recovery in the first half of 2010, its more moderate continuation in the second half was mainly driven by the external balance of goods and services. A similar trend will continue in 2011, while domestic demand will become more important in 2012 (see Figure 2).

Figure 1 Quarterly euro area GDP growth rates and confidence bands

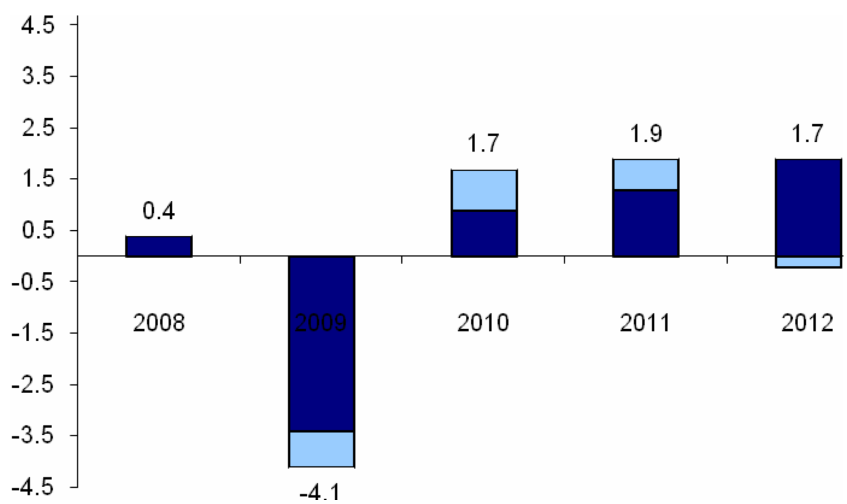


Percentage change over previous quarter

The aggregate euro area growth perspectives mask substantial heterogeneity at the country level. In fact, at the beginning of 2011, the single economies of the member states stand in three different phases of the business cycle: where governments struggle against a crisis of confidence, economies are in recession (Greece, Ireland and, more recently, Portugal) or stagnation (Spain); a strong upswing has developed in Germany and in some smaller countries such as Finland or Austria; and economies such as France and Italy recover slowly from the crisis. In Germany, the share of highly cyclical capital goods in total exports is large. Hence, production suffered a great deal when world trade collapsed two years ago, but now it benefits more from the worldwide upswing. In addition, low interest rates stimulate construction more, since fundamental determinants of house prices such as price-to-rents ratios suggest that price levels are not yet particularly high.

Developments in national labour markets differ accordingly: during the year 2010, employment did not change much in the euro area; but while the unemployment rate shrank by 0.8 percentage points in Germany, it increased by 1.2 points in Spain.

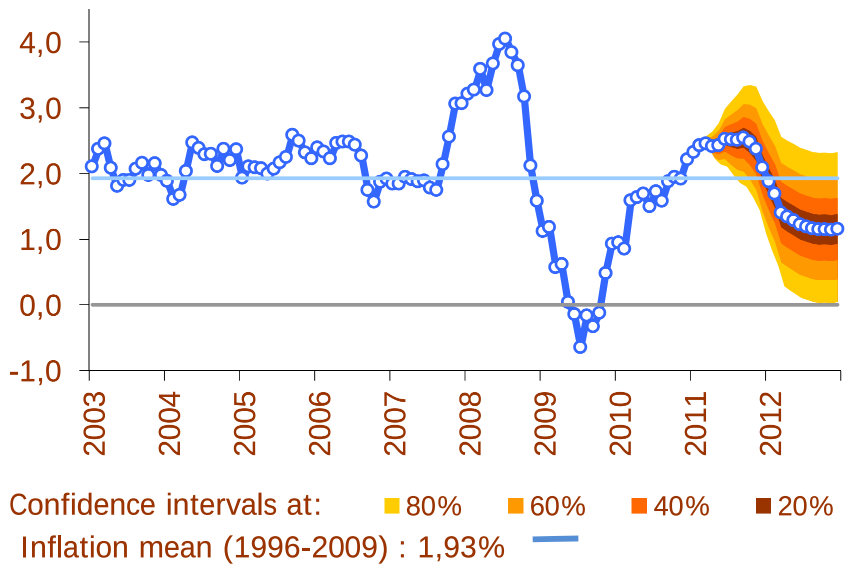
Figure 2 Contributions of domestic components and net exports to GDP growth



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

The ECB took financial markets by surprise when it signalled an interest rate rise in early March. Still, according to our forecast, it will be slow in reducing the expansive stance of its monetary policy. In fact, the ECB’s recent announcement had much to do with the fact that, even if core inflation remains at historically low values, energy and food prices could keep inflation in the euro area above the ECB target throughout this year. Where labour markets are particularly strained, as in Spain and Greece, wages and labour costs also tend to fall, but not enough to compensate the increase in food and energy prices (and in taxes). Still unsure about the extent of the Libyan conflict and about the final impact of the Japanese natural disaster, it becomes even more difficult to predict the evolution of commodity prices and its impact on inflation in the short to medium term. At this moment, we expect commodity prices to remain high but stable, relaxing the inflationary pressures in the euro area starting from the end of 2011. Under this scenario, we expect a 2,4% average value for 2011 but a 1,4% average inflation rate for 2012 (see Figure 3). These forecasts are based on the assumption of a stable euro/dollar exchange rate - around 1.38 - and on a modest incresase of oil price in 2012 up to 116$ /barrel.

Figure 3. HICP inflation and confidence bands



Year on Year rates

Taking this forecast into account, coupled with the delicate situation of certain peripheral economies which still suffer the aftershocks of the European debt crisis and which must still carry out further fiscal adjustments, adds further question to the consequences of the announced ECB strategy. In fact, fiscal policy will be sharply restrictive: the final effects of the crisis-related stimulus packages phase out and are being replaced by in some countries drastic measures to consolidate public finances. In spite of the programs – or maybe because of them – economic confidence has been steadily rising and is now at its highest since October 2007 (Figure 4). This forecast assumes that the crisis of confidence in public finances can be contained. In this case, the modest recovery will continue in 2011, mainly driven by strong external demand. Fixed capital formation, stimulated by still low real interest rates, will become the main engine of growth in the second half of 2011 and in 2012. In this context, industrial production, and mainly its two heaviest components (intermediate goods and capital goods), will, most likely, strongly benefit from the good performance of the euro zone exports (see Table 2).

Figure 4 Economic Sentiment Indicator and Confidence bands

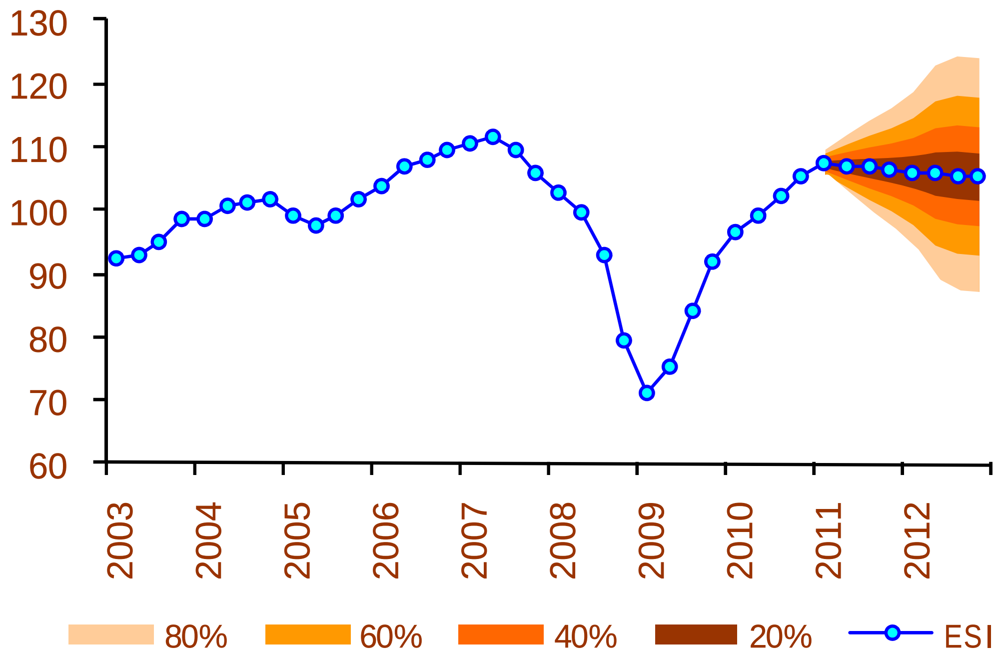


Table 2. Annual average growth rates for industrial production in the euro area

	2006	2007	2008	2009	2010	2011	2012
Durable	4.6	1.3	-5.7	-17.4	2.6	2.3	0.2
Non Durable	2.5	2.6	-1.5	-3.1	3.3	0.6	0.6
Capital	6.0	6.6	-0.2	-20.7	8.8	10.7	7.2
Intermediate	4.9	3.8	-3.5	-19.2	9.8	6.5	3.4
Energy	0.6	-0.9	0.3	-5.4	3.7	0.6	1.3
Total	4.2	3.7	-1.8	-14.9	7.2	5.5	3.6

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 stronger growth this year than in 2012. The reason is that we see a substantial contribution from the external economy mainly in 2011, when exports benefit from a dynamic expansion of world trade, while imports will strongly expand in both years. For 2012, we predict high investment growth, it should be noted, that is not unusual during a recovery. According to this forecast, beneficial effects from low interest rates will dominate headwinds from fiscal consolidation.

Concerning inflation, EFN forecasts show the highest figure in 2011 mainly due to our revision schedule. As for 2012, our forecast remains among the lowest, given the expected stabilization of commodity prices.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF**		ECB		OECD		Consensus	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
GDP	1.9	1.7	1.5	1.8	1.5	na	1.7	1.8	1.7	2.0	1.6	1.7
Priv. Consumption	1.2	1.5	0.9	1.4	0.9	na	1.0	1.3	1.0	1.7	1.0	1.3
Gov. Consumption	0.1	0.5	-0.1	0.2	-0.2	na	0.1	0.2	0.0	-0.1	0.3	0.3
Fixed Capital Form.	1.7	5.2	2.2	3.6	1.6	na	1.9	3.1	1.6	2.8	2.8	3.2
Unemployment rate	10.0	10.0	10.0	9.6	10.0	na	na	na	9.6	9.2	9.9	9.6
HICP	2.4	1.4	1.8	1.7	1.5	na	2.3	1.7	1.3	1.2	2.0	1.8
IP	5.5	3.6	na	na	na	na	na	na	na	na	4.1	3.4

EU: European Commission, Economic Forecast, Autumn 2010; IMF: World Economic Outlook, October 2010; ECB: ECB Monthly Bulletin, March 2011, OECD: Economic Outlook, November 2010; Consensus: Consensus Economics Inc., Consensus Forecasts, February 2011. 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 March 2011, in 2011 GDP growth in the Euro area will be 1.6% and HICP inflation will be 2.2%.

**According to the IMF update of January 2011, GDP growth in the Euro area will be 1.5% in 2011 and 1.7% in 2012.

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 modest upswing in the US for this and next year. Prospects for Japan have abruptly deteriorated due to the grave consequences of the tsunami. World trade will continue to expand at healthy rates, although it loses some momentum during this spring. Oil prices are expected to rise, albeit modestly, from the already high levels they had in March. Nominal exchange rates are assumed to be constant.

Table 4 Variables of the world economy

	2011	2012
US GDP Growth Rate	3.2	3.3
US Consumer Price Inflation	2.0	2.0
US Short Term Interest Rate (December)	0.4	1.0
US Long Term Interest Rate (December)	4.0	4.5
Japan GDP Growth Rate	1.0	2.4
Japan Consumer Price Inflation	0.0	0.0
Japan Short Term Interest Rate (December)	0.3	0.5
Japan Long Term Interest Rate (December)	1.4	1.8
World Trade Growth Rate	8.3	6.6
Oil Price (December)	113	116
USD/Euro Exchange Rate (December)	1.38	1.38
100Yen/Euro Exchange Rate (December)	1.13	1.13

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 (2011). The oil price is in US dollars 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.