EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

Spring 2013

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 2013, the expansion of the world economy will be a bit stronger than in 2012. Growth in Asia should be more dynamic than in 2012, and the US economy appears to robustly withstand the restrictive and unstable US fiscal policy, thanks to a very expansionary monetary policy.
- In spring 2013, the euro crisis is clearly less acute than in 2012. One indicator for this is that in February the liabilities of the Spanish and Italian central banks to the rest of the Eurosystem were by almost a quarter lower than at their maximum in August. Moreover, the inconclusive elections in Italy and the present crisis in Cyprus have only modestly raised risk premia for Italian government bonds, and premia for Spanish bonds stayed about constant. However, for the crisis of confidence in the euro not to return, it is crucial that signs of a stabilizing real economy in the southern member states become visible in the course of this year.
- The consensus is for a swift return of the German economy to growth. Elsewhere, firms and households are, for good reasons, still uncertain and hence limit their investment and consumption. In the southern European countries, and probably also in France, the recession will not end at least before the second half of 2013. One relevant factor is that although financial conditions for banks have markedly improved, this improvement has not yet reached nonfinancial firms and private households in these countries.
- Overall, we forecast euro area GDP to be -0.3 percent lower in 2013 than in 2012, a downward revision from the positive growth of 0.2% we expected in our last report. The situation should improve in 2014, with an expected GDP growth of about 1.3%. However, this will not be sufficient to lower the unemployment rate, which actually could further increase to about 12.6%.
- In the current context of economic sluggishness, our inflation forecasts have slightly decreased, mostly in line with the updated ECB expectations. Our inflation expectations for 2013 have moderated to a y-o-y rate of 1.6%, and they remain subdued also in 2014, at about 1.4%. The likelihood for the ECB to cut interest rates has moderately increased.

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	-0.6	-0.6	-0.1 -0.1	-0.3	-1.0 0.3	1.3	0.3 2.3
Potential Output	0.7	0.4	0.5	0.3	0.2 0.4	0.3	0.2 0.4	0.3	0.1 0.5
Private Consumption	0.9	0.1	-1.3	-1.0	-1.3 -0.6	-0.9	-1.3 -0.4	1.1	0.4 1.8
Government Consumption*	0.7	-0.1	0.0	-0.3		-0.3		0.2	
Fixed Capital Formation	-0.1	1.5	-4.1	-4.8	-7.3 -2.4	-4.0	-6.9 -1.0	2.5	-1.0 6.1
Exports	11.2	6.3	2.6	2.5	1.3 3.6	2.3	0.9 3.7	5.1	3.2 7.0
Imports	9.6	4.2	-1.0	0.6	-0.7 1.8	1.0	-0.6 2.6	5.6	3.5 7.8
Unemployment Rate	10.1	10.2	11.4	12.0	11.8 12.2	12.2	12.0 12.5	12.6	12.0 13.2
Total hourly labour costs	1.6	2.7	2.2	2.1	1.8 2.4	2.1	1.7 2.5	1.7	1.1 2.2
Labour Productivity (output per head)	2.5	1.2	0.2	0.3	0.1 0.7	0.5	0.0 1.0	1.7	1.1 2.4
HICP	1.6	2.7	2.5	1.7	1.5 1.9	1.6	1.1 2.1	1.4	0.4 2.4
IPI	7.2	3.1	-2.4	-1.0	0.0 -2.0	0.3	-1.7 2.3	1.6	-1.1 4.3

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.

*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 2013 and 2014

The world economy: moderately gaining pace while euro risks still linger

Prospects for the world economy slightly brightened up during the first months of 2013. Since autumn 2012, confidence of firms has been rising almost everywhere. More recently, world industrial production and international trade have moderately accelerated. The cyclical position of most advanced economies, however, is still weak: in the final quarter of 2012, production was about stagnant in the US and Japan and shrank in the euro area and the United Kingdom. The recent upwards movement comes, once more, from important emerging economies: production in China has been, according to official data, expanding by about 8% since summer 2012, and during last winter quite a few highly export-oriented East and South Asian economies benefited from an acceleration of the inter-asian trade. In addition, the turn to a markedly expansive policy in Japan is set to revive the Japanese economy, at least temporarily. While growth in Asia should be more dynamic this year than in 2012, the US economy appears to robustly withstand the restrictive and unstable US fiscal policy. All in all, there is a good chance that the world economy in 2013 will expand slightly stronger than last year.

During winter, firms gained a bit of confidence in Europe as well. This is mainly due to the fact that the euro crisis has become less acute. The turning point was last summer when the ECB, with its OMT program, promised, if needed, unlimited intervention into the bond markets, and thus prevented investors from coordinating on a run-equilibrium that would force euro area sovereigns out of capital markets. Since then, risk premia for Spanish and Italian government bonds fell drastically by 2 ½ percentage points. In February, elections in Italy put the reform process in the country into doubt and in March, European policy handled the financial crisis in Cyprus by restructuring the large Cypriot banks and imposing losses on large deposits. Since then, however, risk premia for Italian bonds have risen only modestly (by about 0.6 percentage points up to mid-March), and contagion to other government bonds was not discernible. Confidence has, to a certain extent, returned to Spanish and Italian banks as well, and the Eurosystem, via national central banks, no longer has to finance capital flight. On the contrary, in February, liabilities of the Bank of Spain and the Bank of Italy to the rest of the Eurosystem were by almost a quarter lower than they were at their maximum in August, and claims of the Bundesbank have continued to recede in March.

For all these beneficial shifts of sentiment on financial markets, however, it is not clear whether the euro crisis has peaked. Indeed, for the crisis of confidence in the euro not to return, it is crucial that in the course of this year signs for a stabilization of the real economy in the southern member states become visible. Otherwise, a loss of confidence on financial markets might force the ECB to fulfil its commitment to intervene on bond markets, which might very well undermine political support for the common currency in the core countries of the euro area.

The euro area economy: a widening split for most of 2013

In spite of easing financial conditions, the recession of the euro area economy continues. In the fourth quarter of 2012, GDP fell markedly by 0.6%. In Italy and Spain, the deep recession got worse, and production in France was lower than a year ago. Hitherto production in Germany also shrank by 0.6%, mainly because German exports were, as those from the rest of the currency union, declining. Besides, in the last quarter of 2012 industrial production in the euro area shrank by 3.0%, the worse decay rate of this second phase of the crisis, affecting all the main countries of the euro area, both the central and the peripheral ones. Having experienced its fifth consecutive negative year-on-year rate in that quarter, we still expect two additional quarters of industrial production decay, which is one quarter longer than in the initial phase crisis (2008-2009). The decay was slightly more moderate in January 2013, but still included all central euro area countries. Driven by strong demand from emerging economies, the production of capital goods will continue to be the most dynamic group in the euro area industry, as shown by table 2.

Private consumption in the euro area has also been falling during 5 quarters in a row. At present, real disposable income of private households is declining by about 1 ½ per year.

While nominal compensation per employee is swiftly slowing, hikes of administered prices and VAT increases prevent inflation from falling quickly. However, the stable but negative trend of our core inflation expectations suggests an increasing likelihood that the euro area HICP will be significantly below the ECB target, not only in 2014 but also this year, see figure 4.

On the labour market, workers face a high risk of losing their jobs: since summer 2011 the rate of unemployment has steadily risen to 12.0% (February), and employment has been falling.

Investment has also been shrinking since summer 2011, in the fourth quarter by 1.2%. As demand is weak, capacities need not be expanded, and declining property prices in many countries signal that housing is no profitable investment. The real costs of external financing, however, are at a record low and should support investment activity, though there remain substantial heterogeneity across euro area countries. Financial conditions for banks in southern Europe have indeed markedly improved, but this improvement has not yet reached nonfinancial firms and private households in the southern countries. During the past months, the difference between the interest rates to be paid in Spain and Italy and those in France or Germany has even widened.

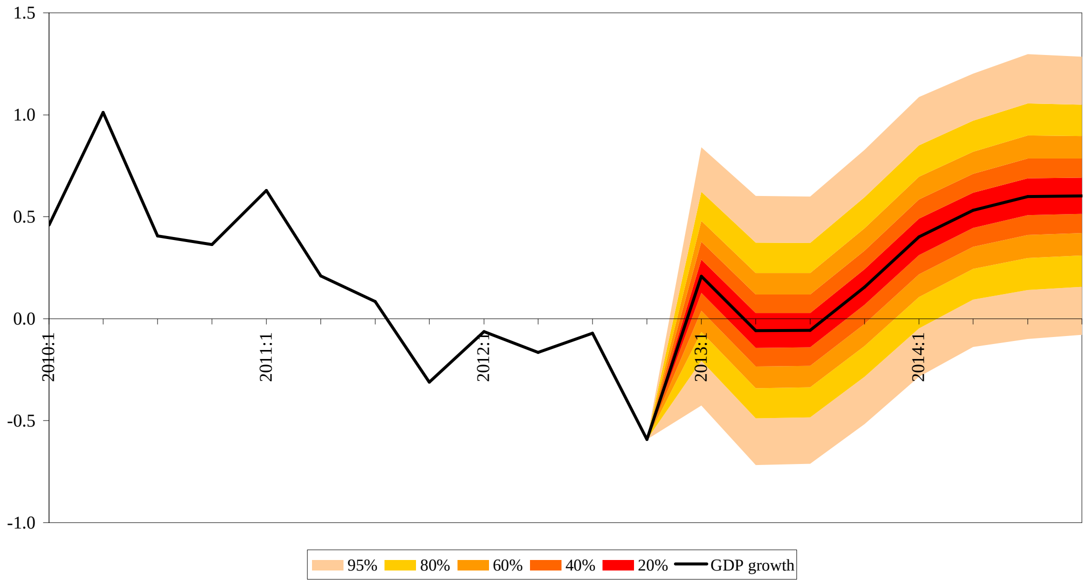
Efforts for fiscal consolidation will continue to weigh on the economy in 2013, albeit at a somewhat smaller scale than in 2012, when the sum of expenditure cutbacks and tax increases was about 1.5% relative to GDP. This year, it will be about 0.8%. The targets set in the stability and adjustment programs were, in most cases, missed in 2012, as will be those for 2013. This forecast does not assume that policy will try to close the gap by tightening measures of fiscal consolidation. Instead, in 2014, fiscal policy will be about neutral.

A moderately positive momentum comes from net exports, since the world economy will expand a bit stronger. Contrary to last year, however, the exchange rate will not support demand, because the return of confidence in the euro and the more expansionary stance of other important central banks such as the Federal Reserve Board caused the currency to appreciate in the second half of 2012. At present, the US-dollar exchange rate is, at about 1.30, only a bit lower than a year ago.

There is consensus for a swift return of the German economy to growth; financial conditions are very favourable, fiscal policy is about neutral, and export firms will benefit from the moderately accelerating world demand. In other larger economies, confidence has, at least until recently, also been rising, but it is still at very low levels. As was argued above, firms and households have enough reasons for being sceptical. In the southern European countries, but probably also in France, the recession will not end at least before the second half of 2013.

All in all, we forecast euro area GDP to be -0.3 percent lower in 2013 than in 2012, with a downward revision with respect to our previous forecast of positive growth of 0.2%. In 2014, if reforms continue to be, by and large, successfully implemented, the euro area economy should start to slowly close its wide output gap with an expected growth for the euro area GDP of 1.3%.

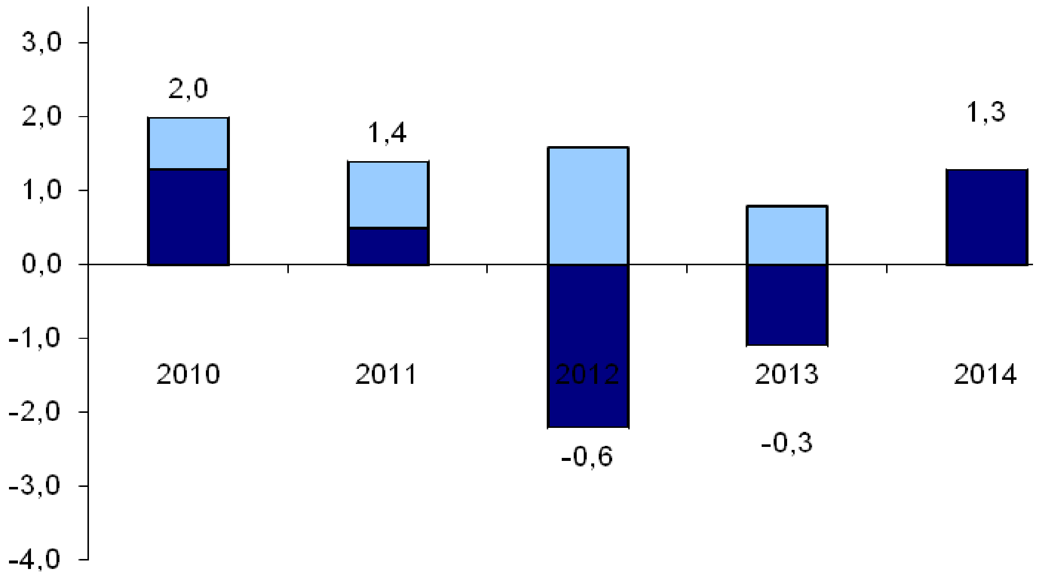
Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Regarding inflation, and as previously mentioned, expectations for 2013 and 2014 have moderated to an average y-o-y rate of 1.6% and 1.4% respectively, in line with the recently updated ECB forecasts. In fact, in the last ECB meetings Mario Draghi has acknowledged a deeper debate on the level of the interest rate among the members of its Executive Board. Therefore, the likelihood of near future changes in the ECB interest rate policy, although it remains low, has moderately increased.

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

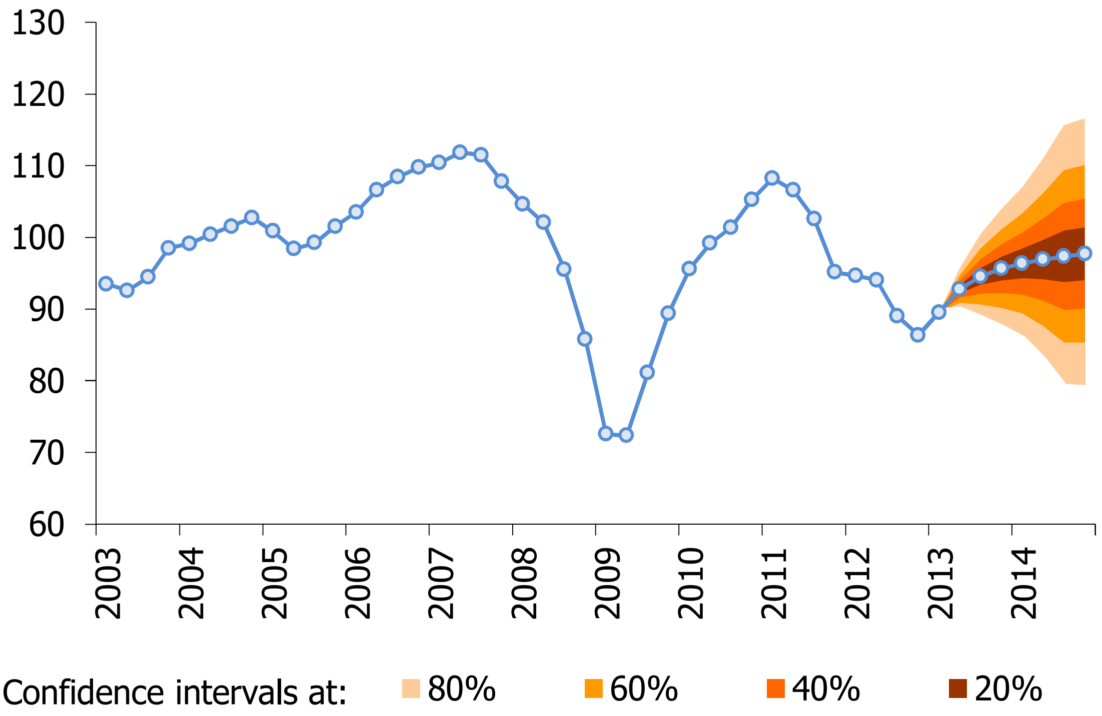


Figure 4 HICP and confidence bands

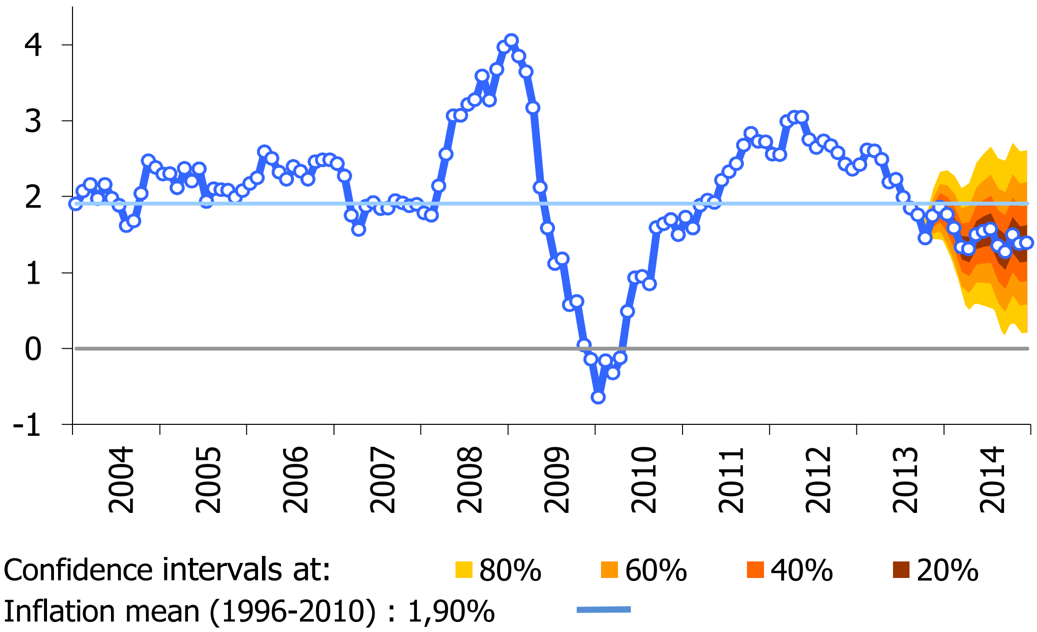


Table 2 Annual average rates for industrial production in the euro area

	2009	2010	2011	2012	2013	2014
Durable	-17.3	2.6	0.4	-4.6	-2.2	-0.9
Non Durable	-3.2	2.9	0.7	-2.1	1.2	0.8
Capital	-21.3	8.9	8.2	-1.2	0.9	3.1
Intermediate	-19.6	9.8	3.7	-4.4	-0.1	1.6
Energy	-5.3	3.9	-4.3	-0.1	-1.6	-0.3
Total	-15.2	7.2	3.1	-2.4	0.3	1.6

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.

While the numbers on GDP are quite similar, the EFN forecast stands out in that it predicts quite a strong contraction of private demand in 2013 and a comparably strong rebound in 2014. The ECB forecast suggests the same contraction but with a smaller rebound. Net external demand dampens the swing (see figure 2). In addition, we forecast a marked increase in the unemployment rate even in 2014. One reason is that the trend of the participation rate is, in spite of recession, still rising in the euro area.

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	-0.3	1.3	- 0.3	1.4	0.2	na	-0.5	1.0	-0.1	1.3	-0.4	0.9
Priv. Consumption	-0.8	1.1	-0.7	0.9	-0.3	na	-0.8	0.6	-0.2	0.9	-0.8	0.4
Gov. Consumption	-0.3	0.2	-0.2	0.5	-0.6	na	-0.5	0.4	-0.3	0.4	-0.4	-0.1
Fixed Capital Form.	-3.9	2.5	-1.8	2.4	0.2	na	-2.4	1.3	-1.9	2.1	-2.4	1.2
Unemployment rate	12.2	12.6	12.2	12.1	11.5	na	na	na	11.9	12.0	12.2	12.2
HICP	1.6	1.4	1.8	1.5	1.7	na	1.6	1.3	1.6	1.2	1.7	1.6
IP	0.3	1.6	na	na	na	na	na	na	na	na	-1.1	2.0

EU: European Commission, Economic Forecast, Winter 2013; IMF: World Economic Outlook, October 2012; ECB: ECB Monthly Bulletin, March 2013, OECD: Economic Outlook, November 2012; Consensus: Consensus Economics Inc., Consensus Forecasts, April 2013. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

*According to the IMF report for the G20 meeting in February 2013, GDP growth in the Euro area will be -0.2% in 2013 and 1.0% in 2014.

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. While US growth will be dampened by restrictive fiscal policies in 2013, the Japanese economy is forecast to expand healthily. One reason is that the Japanese economy has gained competitiveness by the recent strong depreciation of the Yen. We predict world trade to expand faster, but still only modestly.

Table 4 Variables of the world economy

	2012	2013	2014
US GDP Growth Rate	2.2	2.1	2.7
US Consumer Price Inflation	2.1	1.9	2.1
US Short Term Interest Rate (December)	0.1	0.2	0.4
US Long Term Interest Rate (December)	1.7	2.3	2.8
Japan GDP Growth Rate	1.9	1.3	1.3
Japan Consumer Price Inflation	0.0	0.1	1.9
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	0.8	1.0	1.2
World Trade Growth Rate	2.6	4.0	5.5
Oil Price (December)	110	112	114
USD/Euro Exchange Rate (December)	1.31	1.30	1.30
100Yen/Euro Exchange Rate (December)	1.10	1.25	1.25

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.