EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2010 and 2011

Winter 2009/10

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, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it .

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Highlights

- In 2010, the recovery of the world economy will be driven by a strong expansion of production in many emerging markets. Rising exports will be the main driver of the recovery in the euro area. We expect GDP to grow around 1.7% and 1.2% during 2010 and 2011, respectively. What impedes the recovery is the state of labour markets. In fact, unemployment will continue to rise well into 2011, partly because firms with low capacity utilization will no longer be able to keep workers in employment.
- The most important reason for the recovery of the real economy appears to be renewed – although still fragile – confidence on financial markets. Official interest rates close to zero and substantial purchases of highly rated assets by important central banks have drastically increased the attractiveness of more risky assets.
- However, at the end of December 2009, financial markets have put the very solvency of Greece into doubt. If need be, the EU – or member states – would surely help in order to prevent an open solvency crisis, although this would make financing government debt more expensive for all euro area countries.
- Inflation in the euro area will grow slowly up to an expected average annual rate of 1.3% in 2010. Price stability is not expected to be affected by expansionary monetary and fiscal policy and inflation will remain well below the ECB target rate during the forecasting horizon.

Table 1 Economic outlook for the Euro area

	2007	2008	2009	2010: 1st half		2010: annual		2011: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					1.4		1.2		0.5
GDP	2.7	0.6	-3.9	1.9	2.5	1.7	2.3	1.2	2.0
					1.2		1.3		1.3
Potential Output	1.5	1.5	1.0	1.3	1.4	1.4	1.5	1.5	1.6
					-0.5		-0.4		-0.3
Private Consumption	1.6	0.3	-1.1	0.1	0.6	0.2	0.8	0.5	1.3
					1.6		1.4		1.3
Government Consumption	2.3	2.1	2.3	2.0	2.4	1.8	2.2	1.7	2.1
					-2.5		-1.8		0.8
Fixed Capital Formation	4.7	-0.3	-10.1	-0.9	0.6	-0.2	1.4	2.7	4.6
					7.1		6.1		2.0
Exports	6.2	1.0	-13.5	8.6	10.1	7.4	8.5	3.9	5.7
					5.0		4.7		2.0
Imports	5.4	0.9	-11.3	6.4	7.8	6.0	7.1	3.7	5.4
					10.0		10.3		11.0
Unemployment Rate	7.5	7.5	9.4	10.2	10.4	10.5	10.7	11.5	11.9
					2.3		2.1		1.4
Labour Cost Index	2.7	3.5	4.0	2.5	2.7	2.3	2.5	1.7	2.0
					2.0		2.1		1.4
Labour Productivity	0.9	-0.2	-2.4	2.4	2.7	2.3	2.5	1.7	2.0
					0.9		0.8		0.9
HICP	2.1	3.3	0.3	1.3	1.7	1.5	2.2	1.7	2.5
					-2.9		-0.7		-0.7
IPI	3.7	-1.7	-15.4	-1.7	-0.5	1.1	2.9	1.5	3.7

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 2010 and 2011

The world economy: growth resumes, but upswing not in sight

At the end of 2009, the world economy is slowly recovering. In the US and in the Eurpean Union, production started expanding in the third quarter; in Japan it did already so in the second. The Japanese export industries benefit from the surge of demand in East and South Asia in general and in China in particular. World trade in goods has rebounded particularly strongly in the second half of 2009; but still, monthly volumes were in autumn not higher than in 2006. Nevertheless, commodity prices have been on an upward trend since April. Oil prices are in December, with about 70 US-Dollars per barrel (Brent), as expensive as towards the end of the upswing in summer 2007. This fact is part of the wider picture of rebounding asset prices all over the world. Looking at values on stock markets, indices of S&P 500 for the US and Euro Stoxx 50 for the euro area are about 45% higher than they were at their trough in March. Prices for corporate bonds in advanced economies have increased as well. Even more spectacular was the rebound of asset prices in the emerging markets.

Thus, the most important reason for the recovery of the real economy appears to be renewed – although still fragile – confidence on financial markets. This confidence is, by itself, the achievement of economic policy that stabilized the financial sector worldwide. In particular, official interest rates close to zero and substancial purchases of highly rated assets by important central banks have drastically increased the attractiveness of more risky assets. This expansive monetary policy and direct financial support have stabilized banks as well. However, the flows of credit to business are steadily ebbing in the US and in Western Europe, although private investment is already stabilizing. Banks not only face high default risks of their clients, but still try to mend their balance sheets that have been damaged by the financial crisis. Credit conditions will stay restrictive in 2010, impeding the recovery of private investment. For this reason, central banks in the US and Western Europe will keep interest rates at their ultra-low levels for most of the year, although the ample provision of liquidity and government support for banks will be carefully reduced. Fiscal policy will, in the aggregate, be about neutral next year, with expansive stances in some countries like Japan and Germany and a change to restrictive policies in some countries that risk losing the confidence of investors due to very high deficits or debt levels.

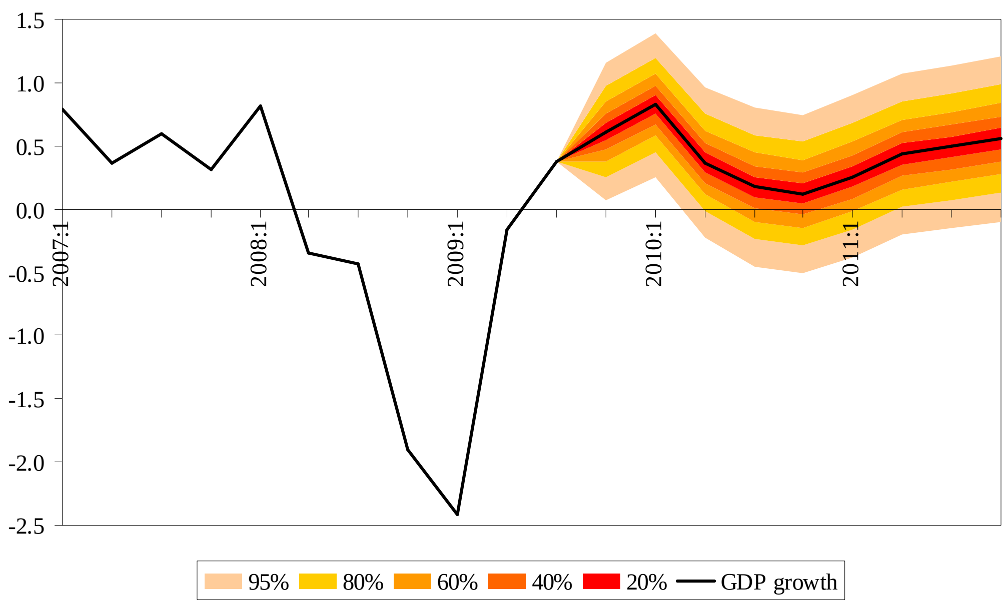
In 2010, the recovery of the world economy will to a high degree be driven by a strong expansion of production in many emerging markets. Exporters of commodities will benefit from high prices. The upswing in China will, at least for the horizon of this forecast, be sustainable, because growth is, to a large extent, driven by rising productivity, and because the Chinese government appears to have the will and the means for continuing an expansive policy. In the advanced countries, however, an upswing is not in sight. The dampening factors here relate to the fact that the global imbalances are being reduced since the outbreak of the crisis. The rebalancing will continue, but come at considerable short term costs: Where current account deficits were (in absolute terms) highest before the crisis, i.e. in the US, Great Britain, and Spain, growth rates in asset prices, in particular for property, were high during the past decade, and these prices fell by much during the recent crisis, reducing private wealth and tax revenues. Private and government consumption will adapt to more meagre prospects now. Adapting demand and supply, in particular for non-tradable goods, will require stronger currencies of surplus countries, above all relative to the US-dollar. This has not happened with the Renminbi, because the Chinese government repegged it to the dollar in the summer 2008. A main risk for the world economy in 2010 will be that this peg will not only be maintained, but that it will induce other governments to keep the exchange rates of their currencies constant relative to the dollar block. In this case, a central mechanism for equalizing supply and demand of goods on world markets would be broken.

The euro area: a split recovery?

At the end of 2009, the recession in the euro area seems to have ended. Production expanded slightly in the third quarter, for the first time in one and a half years. Government consumption and exports contributed positively to growth. Final demand of private agents inside the area, however, continued to shrink, although the fall in investment activity has decelerated. Consumption of private households was, looking at the whole year, almost stable; this is remarkably resilient, given the massive fall in production. Real disposable incomes have kept on well, partly thanks to various measures of fiscal policy. Compensation of employees was quite stable as well, but hourly labour costs increased markedly up to the summer, due to short term working schemes that were frequently used in Germany, but also in Austria and Italy. Because prices (in terms of the GDP deflator) increased by far less, profits fell markedly, and the high debt load of firms in the euro area increased further. In addition, as discussed above, credit conditions offered by banks are and will stay restrictive in 2010. On the other hand, the ECB-indicator of real financing costs fell during 2009 to quite a low level in autumn. But capacity utilization is low, the crisis of the construction sector in some countries is far from over, and the strong expansion of public investment will soon come to an end. Thus, fixed capital investment will be no more than stagnant in 2010. Production, however, will get some support from firms that rebuild (or reduce more slowly) their inventories. The main driver of growth will be rising exports (though slightly dampened by the revaluation of the euro in 2009), mainly to quickly recovering emerging economies.

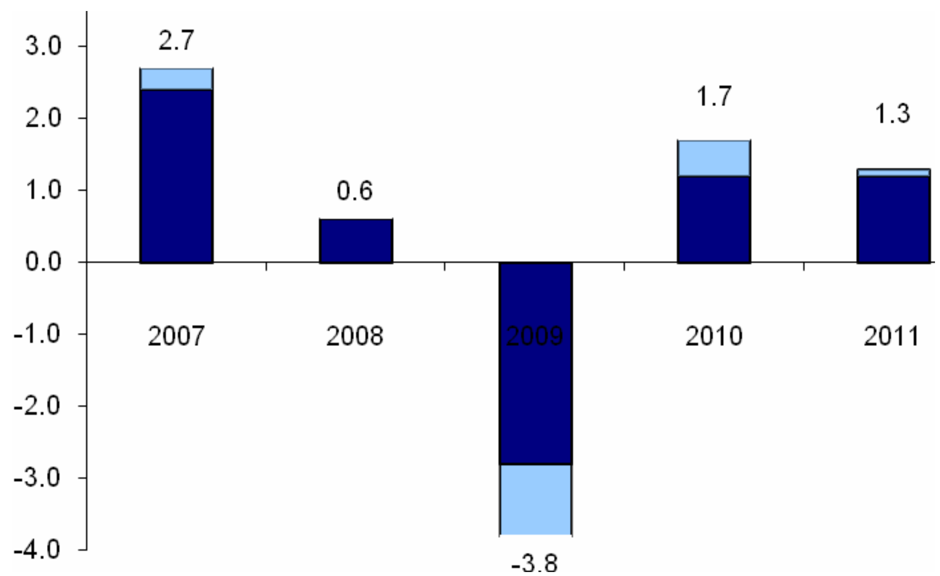
Confidence of firms and consumers has been steadily improving since spring, and it will reach pre-crisis levels during 2010. However, the state of labour markets will impede the recovery in 2010. Unemployment will continue to rise well into 2011, partly because firms with low capacity utilization will no longer be able to keep workers in employment. This will dampen consumption because compensation of employees will be depressed and prudential savings will rise. All in all, the economy will lose momentum during 2010 and will only slowly gather way in 2011.

Figure 1 Quarterly GDP growth rates and confidence bands



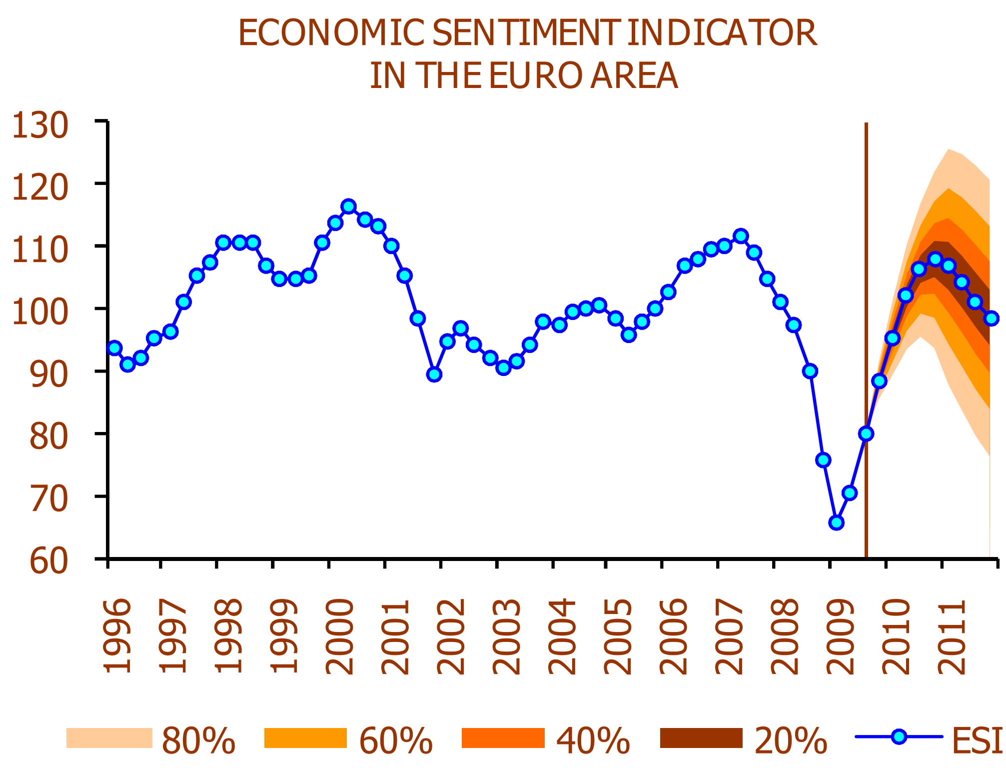
Percentage change over previous quarter

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



Taking a closer look at the industrial production index evolution and forecasts will confirm this idea. The fall in the production of durable consumption, capital and intermediate goods accumulated in 2009 has been dramatic, with negative year on year rates around 20%. The IPI and its main components have been improving since summer 2009 but recovery will take time. Year on year rates are expected to remain negative for two more quarters while the average annual growth rate will be just slightly positive in 2010 (1.10%) and 2011 (1.50%).

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

	2005	2006	2007	2008	2009	2010	2011
Durable	-0.95	4.36	1.19	-5.74	-18.40	-1.68	2.13
Non Durable	1.05	2.67	2.45	-1.45	-3.15	1.70	2.68
Capital	2.51	5.98	6.73	-0.08	-20.96	0.36	5.67
Intermediate	0.56	4.82	3.69	-3.36	-20.00	0.71	-0.80
Energy	-2.67	-0.98	-0.99	1.38	-7.45	5.36	-4.04
Total	1.30	4.22	3.71	-1.67	-15.40	1.10	1.50

As for inflation, it is not a mayor concern in the near future. HICP data show that the expansionary fiscal and monetary policy didn't generate, up to the moment, any observable inflationary effect. Inflation is expected to grow slowly over the forecast horizon, always reaming below the ECB target. Low inflation is usually good news but must be sided by moderate growth in nominal wages. Real wages cannot be allowed to grow too fast in order to achieve any significant jobs creation in the next couple of years.

A serious risk for the economy in the euro area is the possibility of a split recovery: in autumn, the small increase in production came from a northern block of countries around France and Germany. Other countries, mainly in the south, lag behind. In this region, the housing sector is in recession or (in Spain) in a deep crisis, and public finances are in precarious conditions. At the end of December, financial markets have put the very solvency of Greece into doubt, and risk spreads for Spanish bonds – though much lower than for Greek ones – have increased as well. If need be, the EU – or member states – would surely help in order to prevent an open solvency crisis. This, however, would probably make financing government debt more expensive for all euro area countries.

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 clearly on the optimistic side, but only for 2010. This is true for investment activity. What is even more important, we forecast a substantial contribution of the external economy, as exports benefit from the strong recovery in many emerging markets, while imports stay muted. For 2011, however, this impulse is no longer in place, while consumption will still be sluggish due to high unemployment.

Industrial production forecasts are below the consensus expectations for 2010 while inflation projections are slighty above those of other institutions for both 2010 and 2011.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF		ECB		OECD		Consensus	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
GDP	1.7	1.3	0.7	1.5	0.3	na	0.8	1.2	0.9	1.7	1.3	na
Priv. Consumption	0.2	0.6	0.2	1.0	-0.1	na	0.3	1.0	0.4	1.3	0.3	na
Gov. Consumption	1.8	1.8	1.1	1.0	1.9	na	1.1	1.1	0.7	0.9	1.9	na
Fixed Capital Form.	-0.2	2.7	-1.9	2.1	-2.4	na	-1.6	0.3	0.8	3.4	0.2	na
Unemployment rate	10.5	11.4	10.7	10.9	11.7	na	na	na	10.6	10.8	10.5	na
HICP	1.5	1,7	1.1	1.5	0.8	na	1.3	1.4	0.9	0.7	1.2	na
IP	1.1	1.5	na	na	na	na	na	na	na	na	3.4	na

EU: European Commission, Economic Forecast, Autumn 2009; IMF: World Economic Outlook, October 2009; ECB: ECB Monthly Bulletin, December 2009, OECD: Economic Outlook, November 2009; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2009. 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 US and Japan recover in 2010 with rates that are close to the potential growth rates of these economies. World trade will expand at healthy rates, but lose a bit of momentum from summer 2010 onwards. Oil prices are expected to keep the relatively high levels they had in early December. 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

	2009	2010	2011
US GDP Growth Rate	-2.4	2.6	2.8
US Consumer Price Inflation	-0.3	2.0	1.5
US Short Term Interest Rate (December)	0.2	0.8	3.0
US Long Term Interest Rate (December)	3.5	4.1	4.4
Japan GDP Growth Rate	-5.7	1.4	2.0
Japan Consumer Price Inflation	-1.2	-0.9	-0.5
Japan Short Term Interest Rate (December)	0.7	0.7	1.8
Japan Long Term Interest Rate (December)	1.5	1.5	2.0
World Trade Growth Rate	-11.2	7.2	6.5
Oil Price (December)	77	78	80
USD/Euro Exchange Rate (December)	1.49	1.49	1.49
100Yen/Euro Exchange Rate (December)	1.32	1.32	1.32

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.