EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2012 and 2013

European Forecasting Network

Autumn 2012

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 Pierre Werner Programme of the Robert Schuman Centre for Advanced Studies 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/EconomicMonetaryPolicy/EFN/Index.aspx.

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Highlights

- In the Autumn of 2012, economic growth in the world is rather anemic, and it will probably stay very moderate in the rest of this year and in 2013. Production in most emerging markets countries will pick up during winter, but not by much, while restrictive or less expansive fiscal policies will dampen demand in most advanced economies and in particular in Europe.
- In the euro area, we expect GDP to shrink by around -0.2% in 2012 and grow by about 0.7% in 2013, mostly driven by higher exports and a limited rebound in consumption. Our industrial production forecast has been revised downwards with respect to the Summer report, now we expect a growth rate of -1.9% in 2012 and 1.4% in 2013.
- The fall in the number of employed persons came to a halt in the second quarter, since the contraction of employment slowed markedly in southern Europe. The number of hours worked, however, continued to shrink. Downward pressure on wages lowered the growth rate (year on year) of hourly labor costs by half a percentage point to about 2% in the second quarter. However, the unemployment rate is expected to remain above 11%.
- The latest move by the ECB has a good chance of preventing a further deterioration of financial conditions in the southern countries. Private households and firms in the north will further benefit from low external financing costs that are on a downward trend since early this year.
- Additional pressures on the supply side in the international energy market are the main drivers of the important upwards revision of our total inflation forecast, which is now 2.6% for 2012. However, medium term inflation expectations continue to be in line with the ECB's mandate, and our forecast for 2013 is 1.9%. In the current context, with neither confidence, economic activity and credit flows improving, this increase in forecast inflation is not expected to change the ECB's expansionary monetary policy stance.

Table 1 Economic outlook for the Euro area

	2009	2010	2011	2012: 2nd half		2012: annual		2013: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					-0.6		-0.4		-0.1
GDP	-4.4	2.0	1.4	-0.2	0.3	-0.2	0.0	0.7	1.5
					0.6		0.6		0.6
Potential Output	0.6	0.3	0.4	0.7	0.8	0.7	0.8	0.7	0.8
					-0.9		-0.9		-0.2
Private Consumption	-1.0	1.0	0.1	-0.5	-0.2	-0.7	-0.5	0.3	0.9
Government Consumption*	2.6	0.8	-0.2	-0.3		-0.2		-0.7	
					-5.4		-4.0		-4.1
Fixed Capital Formation	-12.7	-0.1	1.4	-3.8	-2.3	-3.3	-2.5	-1.0	2.1
					2.1		2.6		3.0
Exports	-12.4	11.1	6.1	3.2	4.3	3.1	3.6	4.5	6.0
					-0.2		-0.4		1.3
Imports	-10.9	9.4	4.0	1.0	2.1	0.2	0.7	3.2	5.0
					11.3		11.2		11.3
Unemployment Rate	9.6	10.1	10.1	11.5	11.8	11.3	11.4	11.8	12.2
					2.3		2.0		2.0
Total hourly labor costs	2.7	1.6	2.7	2.8	3.2	2.3	2.5	2.3	2.6
Labor Productivity					0.1		0.2		0.8
(output per head)	-2.6	2.5	1.2	0.5	0.8	0.4	0.6	1.3	1.8
					2.3		2.5		1.0
HICP	0.3	1.6	2.7	2.5	2.7	2.6	2.7	1.9	2.8
					-2.8		-3.1		-0.8
IPI	-14.9	7.3	3.4	-1.6	-0.4	-1.9	-0.7	1.4	3.6

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 2012 and 2013

Slowing growth and European debt crisis provoke bold moves by Fed and ECB

In the autumn of 2012, economic growth in the world is rather anemic; production in most regions has been weak for some time: the recovery in the US began to slow down early this year; production has been shrinking in the euro area and in Britain since the autumn 2011; and the temporary rebound of production in Japan appears to have ended this summer. Already in 2011, economic expansion in emerging markets, and in China in particular, began slowing down markedly. World trade has all but stagnated in the first half of 2012.

The present weaknesses are still linked to the Great Recession in 2008/09. Since a strong recovery fails to materialize in most advanced economies, expected permanent incomes come down and agents try to adjust their financial position. Consumers in the US spend more cautiously and governments in Europe take strong efforts to improve their fiscal positions – by political choice in the UK and under pressure from financial markets in the southern member countries of the euro area. Many emerging markets countries had recovered quickly from the Great Recession, not least thanks to expansionary economic policy; but now, the high growth dynamics of the last decade appear to be unsustainable in China, India, and Brazil, since accumulating structural problems cannot be suppressed in the long run by demand management. All in all, growth in the world economy will probably stay very moderate in the rest of this year and in 2013. Production in most emerging markets countries will pick up during winter, but not by much. Restrictive (or, in the case of Japan, less expansive) fiscal policies will dampen demand in most advanced economies, even if fiscal policy in the US is able to steer clear of the “fiscal cliff” at the beginning of next year. Monetary policy, however, has recently done what it could to help stabilizing demand in the advanced economies.

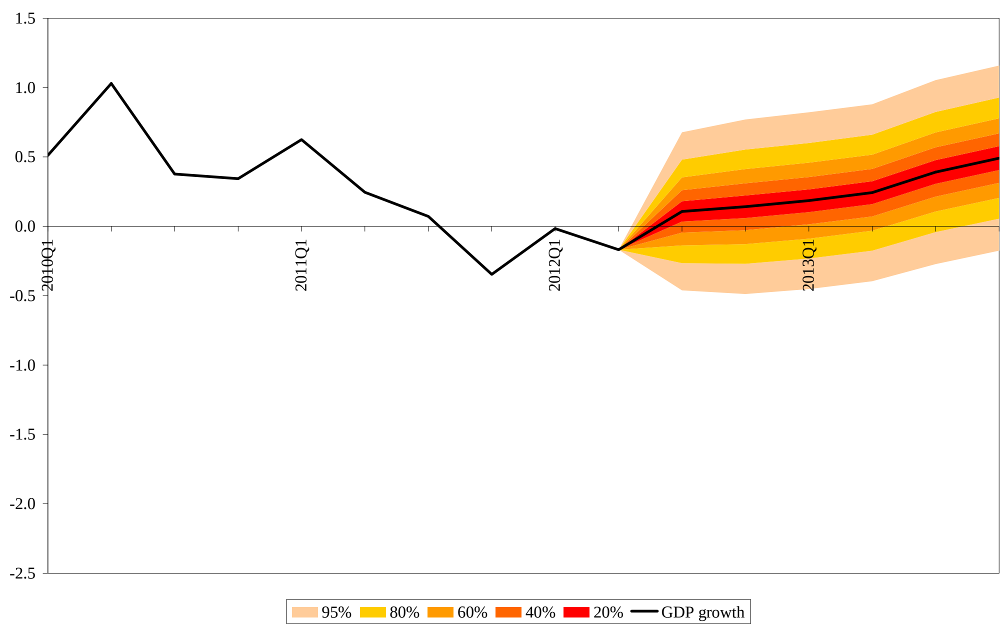
Late in summer, ECB and Fed reacted to the slowdown by announcing a new round of asset purchases. Both authorities did, for the first time, not mention any quantitative limit for their programs. The ECB intends to purchase government bonds of those member states that will commit to a precautionary or adjustment program linked to support from the European Stability Mechanism. By showing the will of, in effect, monetizing public debt, the ECB intends to ensure, in its own wording, a “proper transmission of monetary policy” that is jeopardized by widening differences in financial conditions inside the euro area; in particular, the aim is to stop the latent capital flight from southern European banks that is caused by doubts on the solvency of the states in crisis and on the permanence of the currency union.

Financial markets received the steps of both ECB and Fed rather well. Stock prices went up and risk spreads for Spanish and Italian bonds went down markedly. The move will, however, only become a success if the flows of capital from the southern banks come down significantly. This will only happen if investors become more confident of the viability of the reform processes in Spain and Italy. Sure enough, there will be no safe future for the currency union if its central bank monetizes public debt on a permanent basis, and indeed this is not the approach taken by the ECB.

The euro area economy: close to the trough?

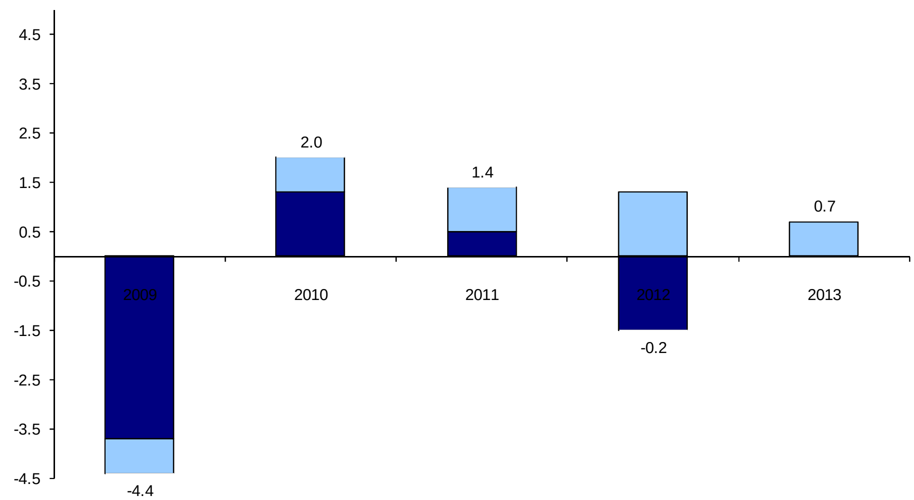
Production in the euro area has been receding since last winter, in the second quarter of 2012 by 0.2%. Since autumn 2011, production in France is stagnating, in Spain and Italy it steadily declines. Internal demand is weak all over the euro area, while exports, supported by the fall in the effective exchange rate of the euro, expanded quite healthily in the first half of the year. Surprisingly, public consumption expanded a bit in this period, in spite of the fiscal crises. Public gross fixed capital formation, however, has been shrinking since the second half of 2009, housing investment does so since summer 2011, and investment in equipment since autumn. All in all, firms reduced fixed investment by about 1% in the first half of 2012; private households cut consumption back by about 0.2%. The trend in private consumption is negative since early 2011, mainly because of declining employment. At 11.3%, the unemployment rate was in July more than one percentage point higher than a year ago. The downward pressure on wages lowered the growth rate (year on year) of hourly labor costs by half a percentage point to about 2% in the second quarter. Interestingly, the fall in employment came to a halt in the second quarter, since contraction of employment slowed markedly in southern Europe; the number of hours worked, however, continued to shrink. Confidence indicators indicate that at least the southern countries will stay in recession for the rest of this year and for some time in 2013, as the fiscal consolidation will go on and the structural reforms will need time to yield beneficial effects. The latest move by the ECB, however, has a good chance of preventing a further deterioration of financial conditions in the southern countries. Private households and firms in the north will further benefit from low external financing costs that are on a downward trend since early this year. All in all, GDP is forecast to be 0.2 percent lower in 2012 than in 2011. For 2013 we expect fiscal policy to be a bit less restrictive and net exports to expand, with overall GDP growing by 0.7%. The unemployment rate will continue to rise, although employment will probably stabilize. Important underlying assumptions of this forecast are that reforms will continue to be successfully implemented in the southern countries, there will be no major bank failures, and firms and households in the euro area will largely continue to act on the premise that policy will, in the long run, be able to master the euro area debt crisis.

Figure 1 Quarterly GDP growth rates and confidence bands



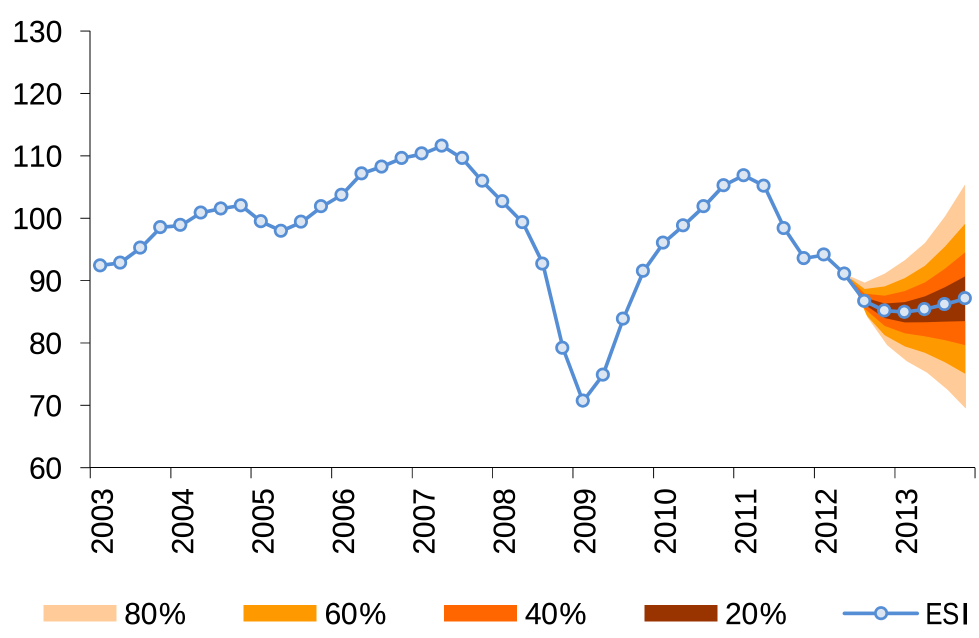
Percentage change over previous quarter

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



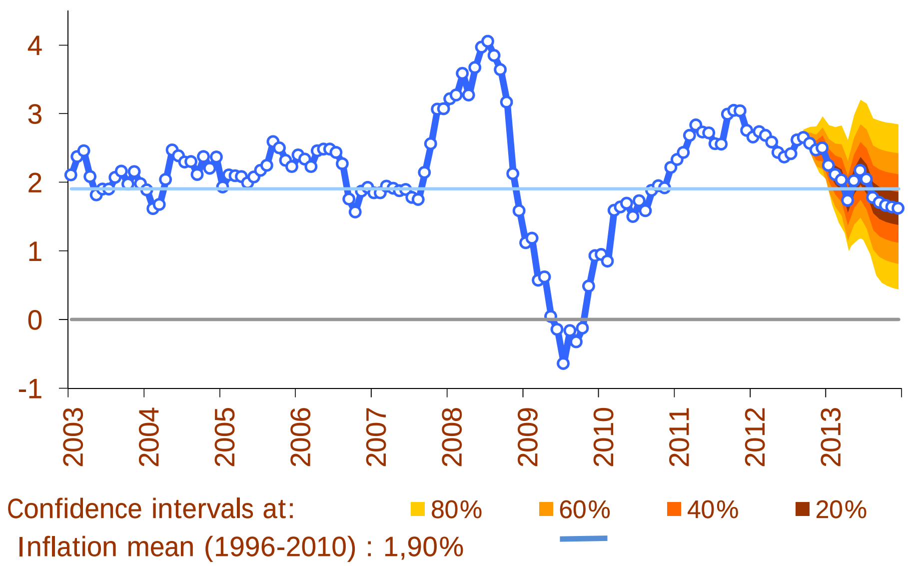
Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Figure 3 Economic Sentiment Indicator and confidence bands



Concerning price dynamics, despite the economic slowdown and the worsening of our GDP forecasts, inflation forecasts have been revised upwards significantly since our last report. Increasingly high energy prices, caused by additional pressures on the supply side, are the main drivers of the important upwards revision of the total inflation expectations. The average total inflation rate expected for 2012 and 2013 has increased by 0.4 and 0.6 percentage points, up to 2.6% and 1.9%, respectively. The date when total inflation rate will be around the ECB's 2% target has been delayed until next march 2013. However, medium term inflation expectations continue to be in line with the ECB's mandate. In the current context, with neither confidence, nor economic activity, nor credit flows improving, this increase in forecast inflation is not expected to change the ECB's expansionary monetary policy stance.

Figure 4 HICP and confidence bands



Last, the production of capital goods has been the main driver of the significant downwards revision of the expected growth for the total industrial production in the euro area, especially for 2012. Expectations for the production of consumption goods continue worsening in a context of a marked reduction in private consumption expectations. The production of capital goods, the only group with positive growth rate for 2012 in our previous report, will now stagnate according to our revised forecast. Investment is not only decreasing in the euro area, due to restrictive fiscal policies and increasing uncertainty over its debt crisis, but also in some of the main emerging markets, given their slight economic slowdown and the re-design of their growth policies. Although some growth differential still remains between the industrial production growth of central and southern peripheral euro area countries, in the recent months even the industries of Germany (-1.7%), France (-3.3%) and Netherlands (-2.5%) are experiencing significant year-on-year negative rates of growth.

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

	2008	2009	2010	2011	2012	2013
Durable	-5.4	-17.4	2.7	0.7	-6.0	-4.1
Non Durable	-1.3	-3.0	3.1	0.5	-2.4	-0.3
Capital	-0.3	-20.9	9.2	8.8	0.1	4.2
Intermediate	-3.4	-19.2	10.0	4.0	-3.2	1.2
Energy	0.0	-5.5	3.8	-4.8	-1.0	-1.2
Total	-1.7	-14.9	7.3	3.4	-1.9	1.4

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 is more on the optimistic side for 2013, compared to more recent forecasts. This is so because we see a significant contribution to growth from net foreign demand and a more resilient private consumption. However, we still see a marked increase in the unemployment rate in 2013, because the participation rate is – albeit at a slower pace since the beginning of the Great Recession – rising in the euro area.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF**		ECB		OECD		Consensus	
	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013
GDP	-0.2	0.7	-0.3	1.0	-0.3	0.9	-0.4	0.5	-0.1	0.9	-0.5	0.2
Priv. Consumption	-0.7	0.3	-0.6	0.5	-0.6	0.4	-0.9	0.0	-0.5	0.3	-0.7	0.0
Gov. Consumption	-0.2	-0.7	-0.8	0.0	-0.8	-0.2	-0.3	-0.2	-0.8	-0.5	-0.2	-0.4
Fixed Capital Form.	-3.3	-1.0	-1.5	1.9	-1.5	0.9	-3.3	0.5	-1.8	1.3	-2.9	-0.1
Unemployment rate	11.3	11.8	11.0	11.0	10.9	10.8	na	na	10.8	11.1	11.2	11.6
HICP	2.6	1.9	2.4	1.8	2.0	1.6	2.5	1.9	2.4	1.9	2.4	1.8
IP	-1.9	1.4	na	na	na	na	na	na	na	na	-2.2	0.7

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

**According to the IMF World Economic Outlook Update, July 2012, forecasts for GDP growth are -0.3 for 2012 and 0.7 for 2013

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 slow recovery in the US continues for this and for next year. The expected expansion of world trade in 2012 is very low, since it barely grew during the first half of the year, but we assume that the acceleration of trade will only be very modest in 2013. In spite of a sluggish word economy, oil prices are assumed to stay at their present quite high levels of about 112 dollars per barrel (Brent) in 2012 and 2013, because political risks in the Middle East will continue to put upward pressure on prices.

Table 4 Variables of the world economy

	2011	2012	2013
US GDP Growth Rate	1.8	2.2	2.1
US Consumer Price Inflation	3.1	2.0	2.0
US Short Term Interest Rate (December)	0.01	0.1	0.2
US Long Term Interest Rate (December)	2.0	1.8	2.5
Japan GDP Growth Rate	-0.7	2.4	1.3
Japan Consumer Price Inflation	-0.3	0.1	0.0
Japan Short Term Interest Rate (December)	0.3	0.3	0.3
Japan Long Term Interest Rate (December)	1.0	0.9	1.2
World Trade Growth Rate	5.7	2.5	4.0
Oil Price (December)	108	112	112
USD/Euro Exchange Rate (December)	1.32	1.30	1.30
100Yen/Euro Exchange Rate (December)	1.03	1.02	1.02

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.