

# **EFN REPORT**

## **ECONOMIC OUTLOOK FOR THE EURO AREA IN 2015 and 2016**



**Summer 2015**

## 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/Projects/EFN/Home.aspx>.

### *Participating Institutions:*

European University Institute, Robert Schuman Centre for Advanced Studies (*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)

Universitat de Barcelona, Anàlisi Quantitativa Regional (AQR-IREA)

*Team Leader:* Jordi Suriñach (jsurinach@ub.edu)

Universidad Carlos III, Instituto Flores de Lemus (IFL)

*Team Leader:* Antoni Espasa (espasa@est-econ.uc3m.es)

University of Cambridge, Faculty of Economics

*Team Leader:* Sean Holly (sean.holly@econ.cam.ac.uk)

*Coordinator of the Report:* Massimiliano Marcellino

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**ECONOMIC OUTLOOK FOR THE EURO AREA IN 2015 and 2016**

**Highlights**

- External conditions for the euro area economy are still favourable, albeit somewhat less so than at the beginning of the year. Oil prices are by more than a third lower than they were on average in 2014, but about 10 USD higher than in January. Long term interest rates are still very low, but by half a percentage point higher than in January. Worldwide growth in production and trade has disappointed in the first quarter of 2015, and recent leading indicators point to no more than a slightly faster expansion of world production for the rest of the year.
- The risks of contagion from the Greek crisis to the partner countries appear limited, because financial exposure to the Greek banking sector has been very much reduced. The EU nowadays has instruments with considerable power to fight losses of confidence, and the other countries that received financial assistance in the euro crisis appear politically much more stable, and their economies (including that of Cyprus in the first quarter of this year) have started growing at quite satisfactory rates.
- According to our forecasts, the euro area GDP will grow by 1.6% in 2015 and by 2.1% in 2016, as negative factors slowly become less important. Both private consumption and investment will expand at a good pace, and the unemployment rate will diminish, but still remain above 10% by the end of 2016. The main risk is that the Greek crisis has a more negative effect on confidence than initially expected.
- Our inflation forecast for 2015 is 0.2%, with the possibility of a mild deflation not excluded. During the first quarter of 2015 rising oil prices were the main contributors to the ascending inflation expectations, while during the second quarter upward surprises over expected inflation have come from manufactured goods and services. For 2016, we expect that inflation will increase up to 1.2%, still below the 2% ECB's target.

**Table 1 Economic outlook for the Euro area**

	2012	2013	2014	2015: 1st half		2015: annual		2016: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	-0.9	-0.4	0.8	1.2	1.0 1.4	1.6	1.2 2.0	2.1	1.3 3.0
Potential Output	-0.2	-0.2	0.8	1.0	0.9 1.2	0.9	0.6 1.1	0.7	0.3 1.1
Private Consumption	-1.3	-0.7	1.0	1.8	1.6 2.0	1.8	1.4 2.2	1.6	0.8 2.4
Government Consumption	-0.1	0.2	0.6	0.6	0.3 1.0	0.6	0.1 1.0	0.5	0.0 1.1
Fixed Capital Formation	-3.7	-2.4	1.1	1.6	0.8 2.5	2.8	1.3 4.3	4.1	1.4 6.9
Exports	2.7	2.0	3.8	4.6	4.1 5.1	5.5	4.6 6.4	7.3	5.8 8.9
Imports	-0.8	1.2	4.0	5.6	4.9 6.2	6.3	5.1 7.5	7.2	5.1 9.2
Unemployment Rate	11.3	12.0	11.6	11.2	11.0 11.3	11.0	10.7 11.3	10.4	9.7 11.1
Labour Cost Index	2.4	1.2	1.2	1.9	1.7 2.1	2.0	1.7 2.3	2.4	1.9 3.1
Labour Productivity	-0.3	0.4	0.3	0.5	0.3 0.7	1.0	0.6 1.3	1.5	0.9 2.2
HICP	2.5	1.4	0.4	-0.1	0.0 -0.2	0.2	0.5 -0.1	1.2	2.2 0.2
IPI	-2.5	-0.7	0.9	2.0	2.5 1.5	1.9	3.7 0.1	1.7	4.1 0.7

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 2015 and 2016**

### ***Euro area has good chances to withstand headwinds of Greek crisis***

At the beginning of July 2015, forecasting the euro area economy is not an easy task. Macroeconomic models such as that used by EFN are poor instruments for detecting the effects of the recent events: the difficult last-minute negotiations between Greece and its creditors about a new bail-out deal is a serious test of financial stability in the euro area and, consequently, of the real economy in Europe as well. A forecast on the euro area has not only become more uncertain; now it is even uncertain what group of countries such a forecast will refer to in the coming years. The Greek state is on the brink of insolvency, and since the ECB has limited the Emergency Liquidity Assistance to the Greek banking sector at the end of June, Greece imposes capital controls to block further outflows of funds.

We are still confident that an agreement can be found but, even in case of a negative outcome, we expect the short-term effects on the euro area economy to be limited, as the share of Greece's GDP is no more than 1.8%. More importantly, the risks of contagion to the partner countries appear not too high, for several reasons. Financial exposure to the Greek banking sector has been very much reduced during the past years. The European Union has, with the European Stability Mechanism and the ECB's Outright Monetary Transactions, instruments with considerable power to fight losses of confidence. What is even more, the other countries that received financial assistance appear politically much more stable, and their economies (including that of Cyprus in the first quarter) have started growing at quite satisfactory rates. Although risk spreads between yields of government bonds of former crisis countries relative to those of Germany went up a bit after the break down of the Greek negotiations, yields were still not higher than they were in autumn 2014. Euro area stock market prices have declined in May and June, but at the beginning of July, they are still markedly (by about 10% for the Euro Stoxx 50 index) higher than at the end of 2014. Thus, our forecasts remain purely based on the EFN Macroeconometric model and have not been modified due to the recent political events and the associated uncertainty.

### ***Low oil prices are slow in stimulating the world economy***

External conditions for the euro area economy are still favourable, albeit somewhat less so than at the beginning of the year. Oil prices are, with about 60 USD (Brent), by more than a third lower than they were on average in 2014, but about 10 USD higher than in January. Fiscal policy is about neutral in most advanced economies, and monetary policy holds its very expansionary stance. Long term interest rates are, with about 0.8% for

German government bonds of 10 years to maturity, still very low, but by half a percentage point higher than in January. Worldwide growth in production and, once more, particularly in trade has disappointed in the first quarter of 2015. US GDP even contracted a bit, due to cold weather and strikes at important ports. Growth dynamics in emerging market economies, in particular in East Asia, continued to decline, and instability in the Chinese financial markets could further worsen the situation. Recent leading indicators point to no more than a slightly faster expansion of world production for the rest of the year, in particular due to rising demand in the US, where private households apparently begin to spend what they have saved because of lower energy prices since last autumn.

### ***Moderate recovery of the euro area continues***

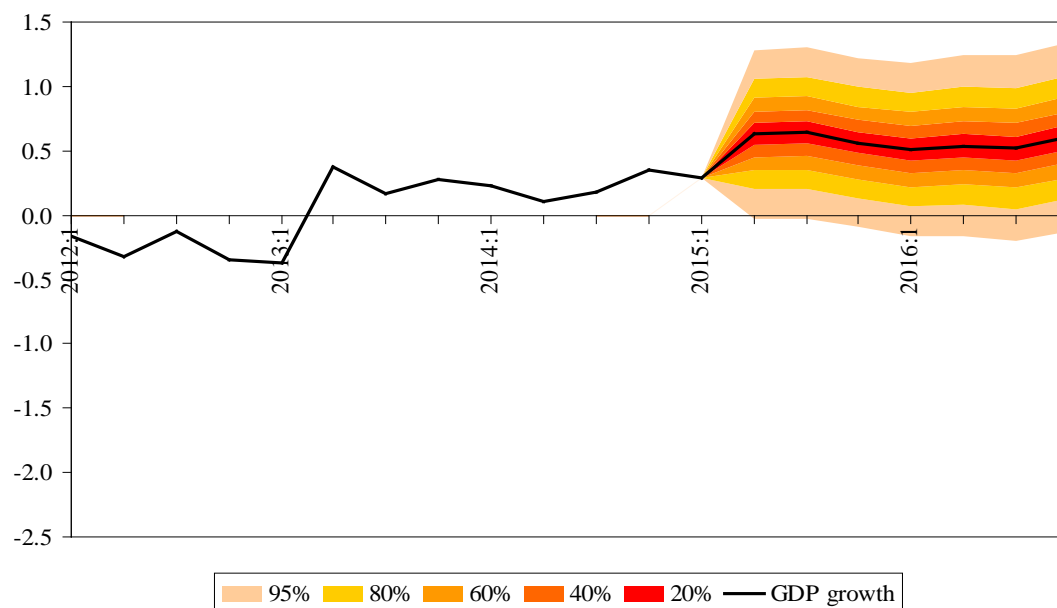
During winter, production in the euro area has expanded by an annualized rate of about 1.5%. Differently from world growth as a whole, the economy has not slowed down, but even accelerated a bit. Consumption of private households has been expanding by almost 2% (again at an annualized rate) since summer 2014, and investment activity has been slowly gaining pace. In the first quarter of 2015, investment in housing has expanded in all larger euro area economies, with the exception of France. Demand in that country, however, grew even a bit faster than on average in the euro area, due to markedly rising private consumption. Italy saw the first notable increase of quarterly production since the year 2011, and the strong recovery in Spain and in the Netherlands continued. The moderate expansion in euro area output is matched by about equal employment growth. The rate of unemployment has been slowly falling for two years, from 12.1% in summer 2013 to 11.1% in May.

According to sentiment indicators and surveys, the moderate recovery seems to continue. The main factors supporting and weakening the recovery have not changed by much since the beginning of the year: monetary conditions should support growth. Governments and large corporations benefit from bond yields that are still very low, banks' composite costs of debt financing have been converging during the past two years in all large economies to very low levels, banks' balance sheets have stopped declining in 2014, and borrowing costs for non-financial corporations have come down markedly this year. Due to the fall in oil prices at the end of last year, the real disposable income of private households in the euro area has risen and production costs of firms have come down. However, structural impediments still limit the ability of the euro area economy to grow strongly: firms and, in particular, private households are only slowly reducing their heavy debt burdens, and confidence will not fully come back in France and Italy, as long as reform processes are inconclusive in both countries.

Nonetheless, the very expansive ECB monetary policy, including non-conventional measures, has started to markedly manifest its effects. Regarding prices, our inflation expectation for 2015 have increased 0.1 pp since our last forecast, reaching now 0.2% ( $\pm 0.3$ ), after being consistently accelerating since January. During the first quarter of 2015 rising oil prices were the main contributors to the ascending inflation expectations. However, during the second quarter, upward surprises about expected inflation have come from manufactured goods and services, particularly those related to leisure and personal care, in line with the mentioned increase in private consumption. This trend could find complementary support in the recent loans-to-households data: in May a year-on-year 0.9% growth was recorded, the highest value since March 2012.

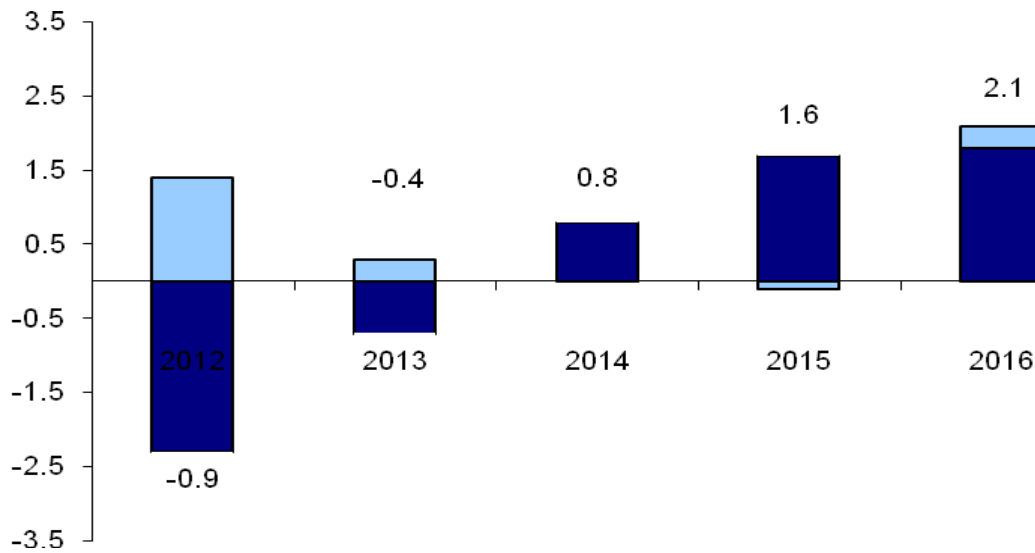
All in all, the euro area economy is forecast to grow by 1.6% in 2015 and by 2.1% in 2016, as the negative factors slowly become less important. Both private consumption and investment will increase, as well as industrial production, and the unemployment rate will be reduced to about 11% this year and 10.4% in 2016. Of course, as previously mentioned, a main risk for this positive scenario is that the Greek crisis might undermine confidence in the economic future of the euro area economy.

**Figure 2 Quarterly GDP growth rates and confidence bands**



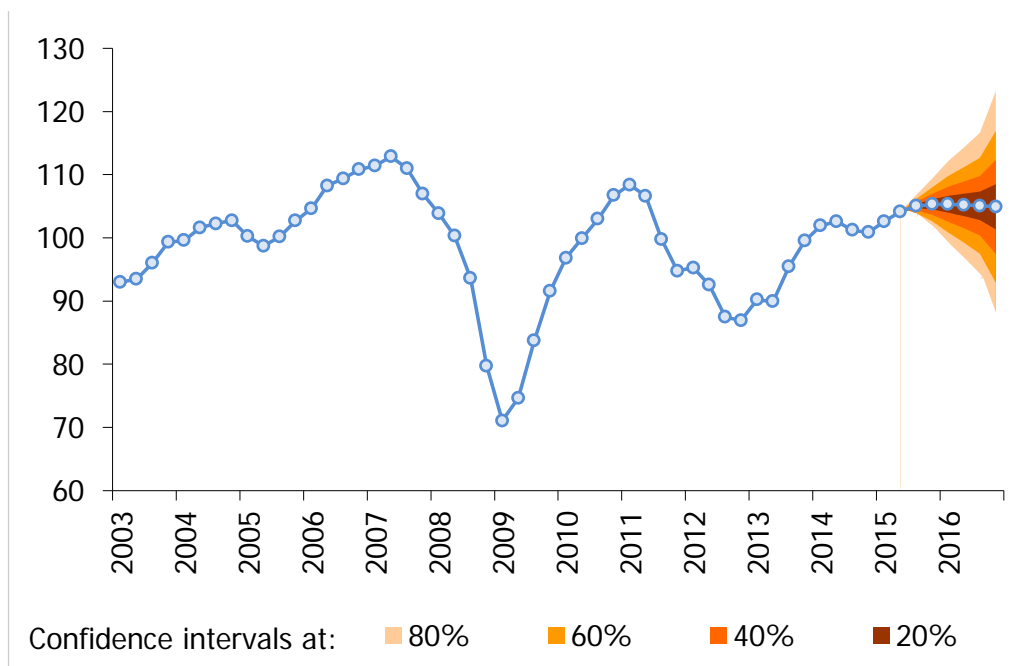
Percentage change over previous quarter

**Figure 3 Contributions of domestic components and net exports to GDP growth**



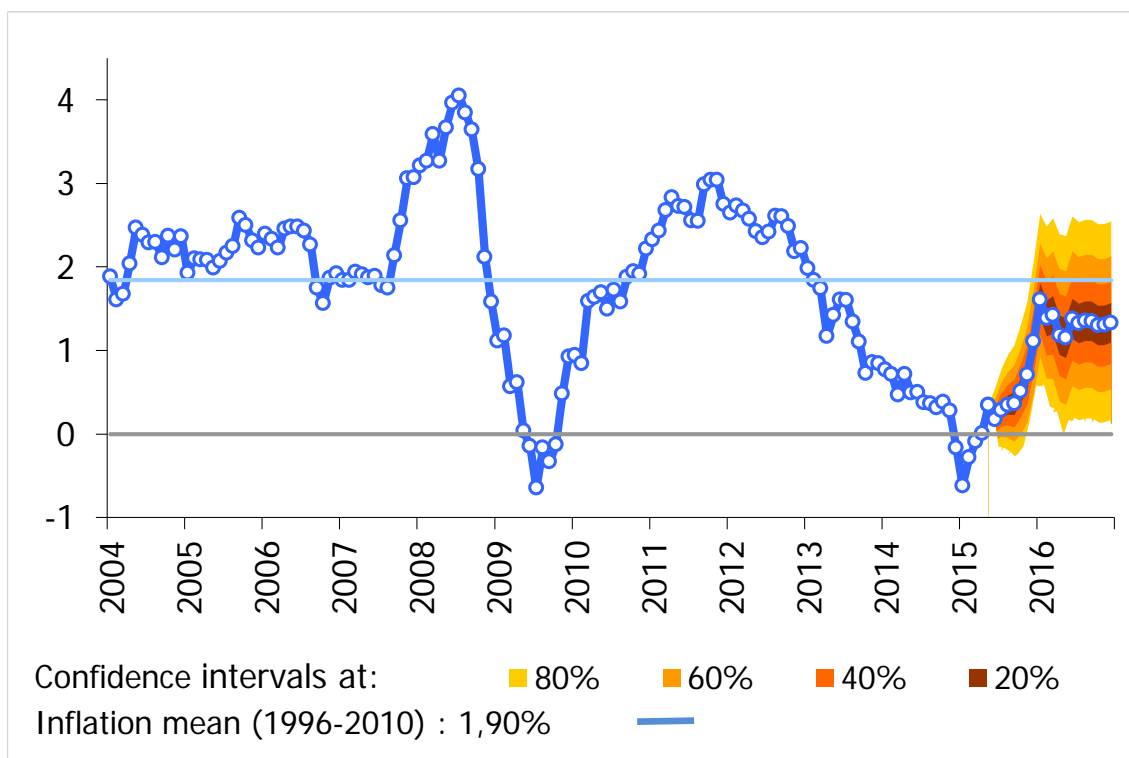
Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

**Figure 4 Economic Sentiment Indicator and confidence bands**





**Figure 5 HICP and confidence bands**



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

	2011	2012	2013	2014	2015	2016
Durable	0.8	-4.7	-3.2	-1.6	6.6	12.2
Non Durable	0.9	-2.2	0.0	2.2	0.9	2.4
Capital	8.4	-1.1	-0.5	1.4	5.4	7.6
Intermediate	4.2	-4.5	-1.0	3.2	4.3	5.9
Energy	-4.4	-0.2	-0.7	-1.6	1.2	0.8
Total	3.5	-2.5	-0.7	1.4	3.2	4.5

### *Comparison with alternative forecasts*

The forecasts presented above were obtained from the EFN macroeconomic 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 relatively optimistic, because we think that the steep fall in the oil price and the weaker euro will stimulate the economy. In 2016, growth accelerates according to the EFN forecast in spite of slower growth in private consumption, because firms will invest more in fixed capital and rebuild inventories that currently stay at very low levels.

**Table 3 Comparison of EFN forecasts with alternative forecasts**

	EFN		EU		IMF		ECB		OECD		Consensus	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
GDP	1.6	2.1	1.5	1.9	1.5	1.6	1.5	1.9	1.4	2.1	1.5	1.8
Priv. Consumption	1.8	1.6	1.8	1.6	1.7	1.5	1.8	1.8	1.0	1.3	1.7	1.6
Gov. Consumption	0.6	0.5	0.6	0.8	0.7	0.5	0.7	0.4	0.4	0.6	0.8	0.7
Fixed Capital Form.	2.8	4.1	1.7	4.0	1.5	2.4	2.0	3.5	1.2	3.1	1.8	3.0
Unemployment rate	11.0	10.4	11.	10.5	11.1	10.6	11.1	10.5	11.1	10.5	11.1	10.6
HICP	0.2	1.2	0.1	1.5	0.1	1.0	0.3	1.5	0.0	1.3	0.2	1.3
IP	3.2	4.5	na	na	na	na	na	na	na	na	1.9	2.6

EU: European Commission, Economic Forecast, May 2015; IMF: World Economic Outlook, April 2015; ECB: June 2015 eurosystem staff macroeconomic projections for the euro area, OECD: Economic Outlook, June 2015; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2015.

### *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 oil price will, after its tentative recovery at the beginning of 2014, continue to rise in 2015 and 2016, but only slowly. Growth in world trade stays far below its trend of the past 20 years or so. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from July 2015 onward.

**Table 4 Variables of the world economy**

	2014	2015	2016
US GDP Growth Rate	2.4	2.2	2.8
US Consumer Price Inflation	1.6	0.2	2.1
US Short Term Interest Rate (December)	0.03	0.7	1.7
US Long Term Interest Rate (December)	2.2	2.5	3.8
Japan GDP Growth Rate	-0.1	1.0	1.7
Japan Consumer Price Inflation	2.7	0.7	1.0
Japan Short Term Interest Rate (December)	0.1	0.2	0.2
Japan Long Term Interest Rate (December)	0.5	0.6	0.8
World Trade Growth Rate	3.5	3.2	4.0
Oil Price (December)	63	64	65.5
USD/Euro Exchange Rate (December)	1.21	1.13	1.13
100Yen/Euro Exchange Rate (December)	1.43	1.38	1.38

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 (2014). 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.