# EFN REPORT

# ECONOMIC OUTLOOK FOR THE EURO AREA IN 2013 and 2014

European Forecasting Network

**Summer 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

- The structural problems in emerging economies, the still mild recovery in the USA and the on-going crisis in the euro area will probably keep world economic growth subdued at least for the rest of 2013.
- Current and expected future monetary policy in Japan and, in particular, in the USA have heightened volatility in global bond and stock markets, including those of the euro area, though much less than during the crisis episodes.
- The process of consolidation of public finance in many euro area countries has become slightly less ambitious but it will continue to weigh on the economy in 2013, though less than in 2012. For this reason and for the lower expected global growth, we have revised downward our GDP forecasts for 2013 from previous reports. Now, we expect GDP to be -0.5 per cent lower in 2013 than in 2012, with considerable risks of an even stronger contraction.
- In 2014, when fiscal policy might be close to neutral, and if reforms continue to be, by and large, successfully implemented, the euro area economy should start to close its wide output gap with an expected GDP growth of about 1.2%, again subject to downwards risks. Moreover, this will not be sufficient to lower the unemployment rate, which actually could further increase to about 12.5%.
- The interest rates cut in May 2013 shows the will of the ECB to keep monetary policy expansive, but credit conditions and lending rates remain quite heterogeneous across the member countries.
- Despite the interest rate cut, euro area inflation is still very likely to remain significantly below the ECB target throughout our forecasting period. Our inflation expectations for 2013 have moderated to a y-o-y rate of 1.5%, and they remain subdued also in 2014, at about 1.4%.

## 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 | 1.5 | -0.6 | -0.9 | -1.1<br>-0.7 | -0.5 | -1.2<br>0.1 | 1.2 | 0.2<br>2.2 |
| Potential Output | 0.0 | 0.2 | 0.4 | 0.2 | 0.0<br>0.4 | 0.3 | 0.2<br>0.4 | 0.3 | 0.0<br>0.5 |
| Private Consumption | 1.0 | 0.2 | -1.3 | -0.9 | -1.1<br>-0.7 | -0.6 | -1.0<br>-0.2 | 0.5 | -0.3<br>1.3 |
| Government Consumption* | 0.8 | -0.1 | -0.4 | -0.4 | | -0.3 | | -0.1 | |
| Fixed Capital Formation | -0.3 | 1.4 | -4.3 | -4.8 | -6.1<br>-3.6 | -3.7 | -5.7<br>-1.8 | 2.2 | -1.2<br>5.5 |
| Exports | 11.2 | 6.3 | 2.7 | 0.6 | 0.0<br>1.1 | 1.2 | 0.2<br>2.3 | 6.6 | 4.8<br>8.5 |
| Imports | 9.7 | 4.2 | -0.8 | -1.1 | -1.8<br>-0.4 | 0.1 | -1.2<br>1.4 | 6.5 | 4.2<br>8.9 |
| Unemployment Rate | 10.1 | 10.2 | 11.4 | 12.1 | 12.0<br>12.2 | 12.2 | 12.0<br>12.4 | 12.5 | 12.1<br>13.0 |
| Total hourly labour costs | 1.7 | 2.7 | 2.0 | 2.1 | 2.0<br>2.3 | 2.1 | 1.8<br>2.4 | 2.0 | 1.3<br>2.6 |
| Labour Productivity (output per head) | 2.5 | 1.3 | 0.1 | -0.2 | -0.4<br>0.0 | 0.2 | -0.2<br>0.6 | 1.7 | 1.0<br>2.4 |
| HICP | 1.6 | 2.7 | 2.5 | 1.6 | 1.5<br>1.7 | 1.5 | 1.3<br>1.7 | 1.4 | 0.4<br>2.4 |
| IPI | 7.3 | 3.2 | -2.4 | -1.3 | -2.6<br>0.0 | 0.1 | -1.7<br>1.9 | 2.6 | 0.2<br>5.0 |

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

### *A sluggish world economy*

In summer of 2013 the world economy expands at a moderate pace, disappointing expectations from the beginning of the year. At that time, rising confidence of firms in many regions appeared to indicate that activity would accelerate over the coming quarters. This indeed happened in the US and Japan in the first quarter, while the British economy started growing again, and in the euro area the decline in production slowed markedly. In China, however, the economy has been slowing down since the start of the year, and world trade continues to expand at low rates. Stagnating or decreasing prices for commodities and, in spite of high tensions in the Middle East, crude oil, also indicate a sluggish world economy.

Most recent confidence surveys do not add up to a clear picture, with brightening perspectives in some countries, particularly Japan, but diminishing expectations in the BRIC countries. The latter appear to be more than cyclical phenomena, having some long run components as well. While structural problems such as less favourable demographics have been known for some time now, it is still difficult to detect their traces in economic activity because of the deep disruptions of the Great Recession, including the rebound and the effects of extreme policy measures.

The structural problems in emerging markets economies, the still mild recovery in the USA and the on-going crisis in the euro area will probably keep world economic growth subdued, at least for the rest of 2013. This is in spite of financing costs that are very low in many regions, as expansive monetary policies have kept bond yields low and valuations of stocks rising, at least until recently.

Indeed, monetary policies appear to reach the limits of their effectiveness: volatilities on bond and stock markets have increased in early summer, triggered by strategic uncertainty about possible effects of policy measures by the Fed as well as by the Bank of Japan. The double and contradictory objective of low long term interest rates and a quick end to deflation has added to heightened volatility on bond and stock markets in Japan, and the prospect that quantitative easing in the USA might soon start to be tapered off has raised the yield of 10-years government bonds by about half a percentage point since beginning of May 2013. Government bond yields in the euro area have followed suit. But given that volatility on world financial markets has heightened and consolidation of public households in the euro area has become slightly less ambitious, bond and stock markets have stayed comparably calm in the euro area.

***The euro area economy: prospects for a gradual stabilization***

While external conditions have not improved and world financial markets have become slightly worse in early summer 2013, the recession of the euro area economy also continues. In the first quarter of the year GDP shrank by 0,2%, after -0,6% at the end of 2012.

Production fell more slowly mainly due to stabilization in Germany. In most other countries, the cyclical situation was largely unchanged, although private households have stopped slashing their consumption. As their disposable income continues to decline by roughly 2% in real terms, households have to save less: their saving rate is, with little more than 12%, about two percentage points lower than in the years before the Great Recession.

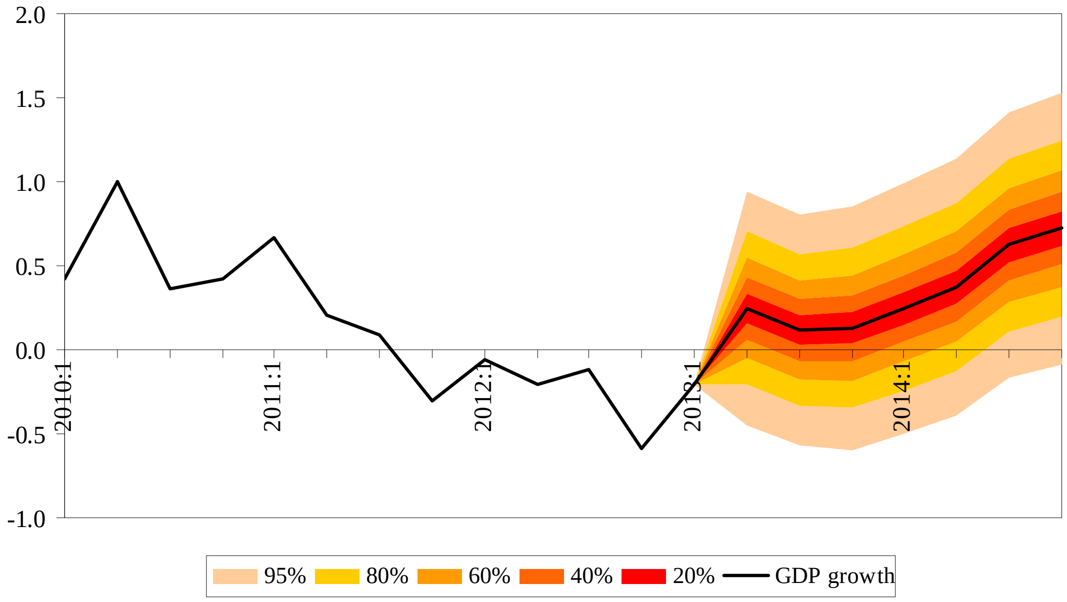
Households still face high risks of losing jobs: the unemployment rate has risen steadily (to 12.2% in April), and the decline in employment even accelerated in the first quarter of 2013.  The unusually cold weather in many regions that depressed construction activity might have played some role here, but investment in equipment continued on its downward path as well.

Clearly, with domestic demand falling due to on-going adjustment processes in important sectors such as housing and still very restrictive fiscal policies, a major incentive to invest that might remain is the reallocation of production for exports. Exports of goods to economies outside the euro area, however, have been sluggish since autumn of 2012, partly due to the appreciation of the euro (by about 5% in real terms) in the second half of 2012, and exports according to national accounts (including services and intra-area trade) fell markedly during the winter. However, our long term exports forecast has slightly increased in the context of an expected more favourable value of the euro in the coming months.

Consequently, the recovery of the industrial production in the euro area is now stronger than previously forecasted, which comes in line with the important improvement of the industrial confidence indicators in the last few months. Given the worsening expectations for domestic demand, the production of capital goods has again increased its leading role on the euro area industry.

Moreover, in the last months core countries seem to recover the wide positive differential with peripheral industries. In April, while industry in central euro area countries has ceased, or is about to cease, to register negative growth rates (Germany, France or Holland), the peripheral countries continue to register significant reductions of their industries (Italy, Spain or Greece).

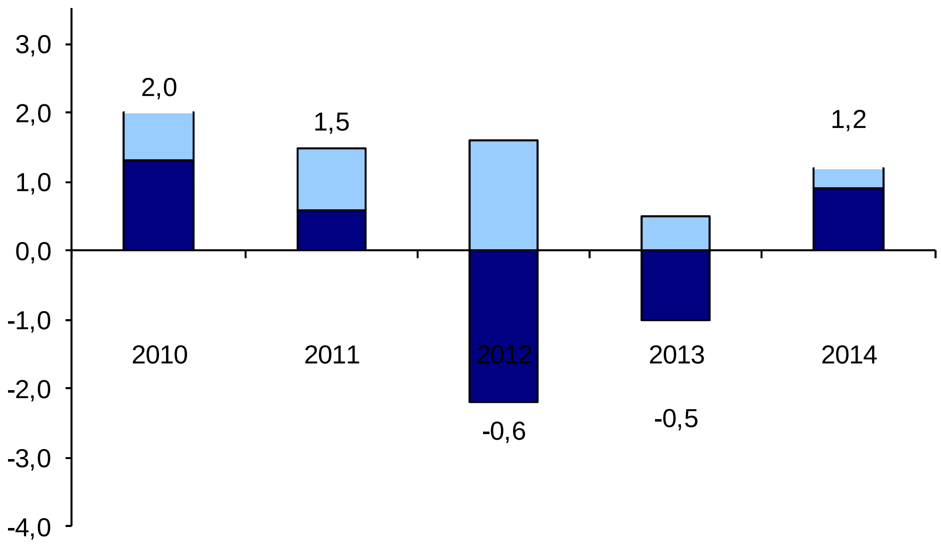
**Figure 1 Quarterly GDP growth rates and confidence bands**




Percentage change over previous quarter

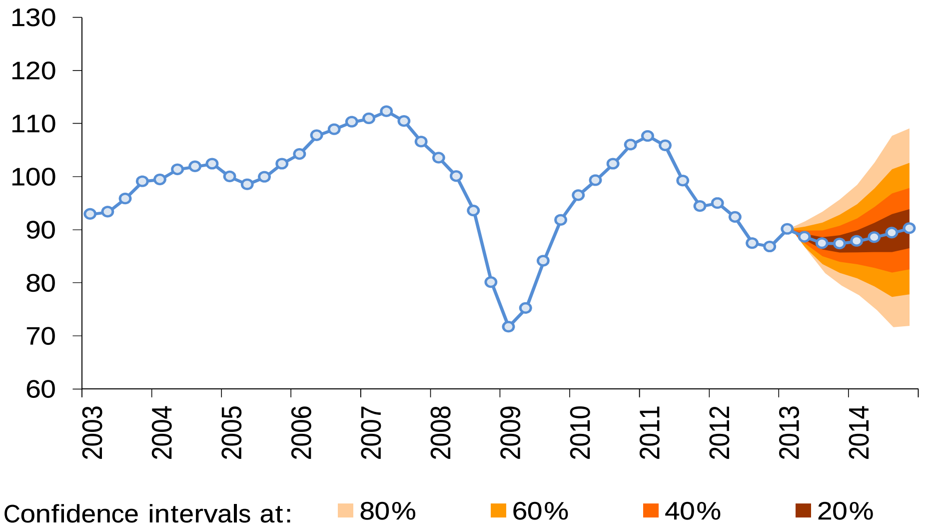
On the other side, still supporting investment activity is the low real costs of external financing, mostly in euro area central countries. In Spain and Italy, the costs of corporate bond financing have, following the declining sovereign risk spreads, fallen significantly, but still remain very high. The interest rates cut by the ECB in May documents the will of the ECB to keep monetary policy expansive. But for small and medium sized firms that rely mostly on bank credit, financial conditions will stay heterogeneous and indeed difficult in many member countries. One important indicator, the difference between the interest rates to be paid in Spain and Italy and those in northern countries, is not shrinking.

**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**




Efforts for fiscal consolidation will continue to weigh on the economy in 2013, but at a smaller scale than in 2012, according to the recent stability programs of member countries that were, by and large, endorsed by the European Commission. Summing up all the budgetary measures that are planned in this year's stability programs of the member countries gives a fiscal effort of about 1% relative to GDP, after an effort of more than 1.5% in 2012. In addition, we expect a moderately positive momentum from net exports to regions outside the euro area, since data for the most recent months indicate a modest recovery of external demand. Surveys on confidence of firms and private households show that expectations are not further eroding or tentatively improving.

Thus, output will more or less stagnate for the rest of the year, with an overall reduction of about 0.5% in 2013, subject to downwards risks. In 2014, when fiscal policy might be close to neutral, and if reforms continue to be, by and large, successfully implemented, the euro area economy should start to close its wide output gap, with an expected GDP growth of about 1.2%, again subject to downwards risks.

When it comes to prices, despite the ECB rate cut in May 2012, euro area inflation is still very likely to remain significantly below the ECB target throughout the forecasting period. In fact, the increase in year-on-year inflation in May, fully reflected in the core component, does not respond to an interruption in the price reduction process, but is solely due to Eastern holidays and the fact that it occurred entirely in March, which led to a special reduction in service prices in April. Therefore, our inflation expectations for 2013 have moderated to a y-o-y rate of 1.5%, and they remain subdued also in 2014, at about 1.4%.

**Figure 4 HICP and confidence bands**

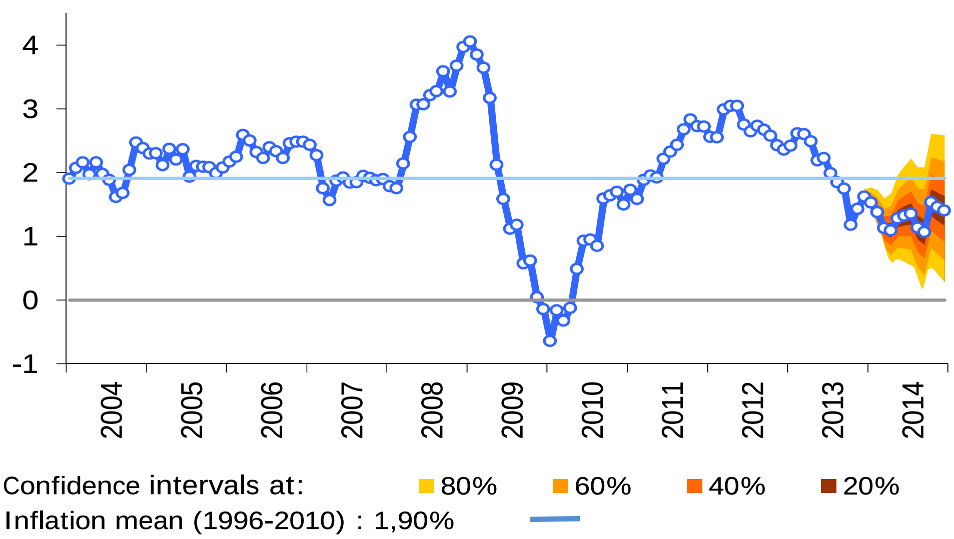


**Table 2 Annual average rates for industrial production in the euro area**

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Durable | -17.3 | 2.6 | 0.4 | -4.4 | -3.7 | -1.7 |
| Non Durable | -3.2 | 2.9 | 0.7 | -2.3 | 0.5 | 0.7 |
| Capital | -21.3 | 8.9 | 8.2 | -1.1 | 0.9 | 5.6 |
| Intermediate | -19.6 | 9.8 | 3.7 | -4.3 | -0.9 | 2.5 |
| Energy | -5.3 | 3.9 | -4.3 | -0.2 | 0.3 | -0.2 |
| Total | -15.2 | 7.2 | 3.1 | -2.4 | 0.1 | 2.6 |

## 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 gross fixed capital accumulation in 2013, reflecting very low investment in the first quarter. 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 | -0.5 | 1.2 | -0.4 | 1.2 | -0.3 | 1.1 | -0.6 | 1.1 | -0.6 | 1.1 | -0.6 | 0.8 |
| Priv. Consumption | -0.6 | 0.5 | -0.9 | 0.7 | -1.0 | 0.8 | -0.8 | 0.6 | -0.8 | 0.4 | -0.7 | 0.4 |
| Gov. Consumption | -0.3 | 0.1 | 0.0 | 0.5 | -0.2 | 0.1 | -0.1 | 0.6 | 0.0 | 0.3 | -0.4 | -0.1 |
| Fixed Capital Form. | -3.7 | 2.3 | -2.6 | 2.3 | -2.2 | 1.3 | -2.9 | 1.8 | -1.3 | 2.2 | -3.2 | 1.2 |
| Unemployment rate | 12.2 | 12.5 | 12.2 | 12.1 | 12.3 | 12.3 | na | na | 12.1 | 12.3 | 12.3 | 12.4 |
| HICP | 1.5 | 1.4 | 1.6 | 1.5 | 1.7 | 1.5 | 1.4 | 1.3 | 1.5 | 1.2 | 1.5 | 1.5 |
| IP | 0.1 | 2.6 | na | na | na | na | na | na | na | na | 1.0 | 1.9 |

EU: European Commission, Economic Forecast, Spring 2013; IMF: World Economic Outlook, April 2013; ECB: ECB Monthly Bulletin, June 2013, OECD: Economic Outlook, May 2013; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2013. 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. While US growth will be dampened by restrictive fiscal policies in 2013, the Japanese economy is forecasted to expand healthily, as the Japanese economy has gained competitiveness by the recent strong depreciation of the Yen and expansive economic policy of the new government that came into office at the beginning of 2013 has raised confidence in Japan. We predict world trade to still expand only modestly.

**Table 4 Variables of the world economy**

| | 2012 | 2013 | 2014 |
|---|---|---|---|
| US GDP Growth Rate | 2.2 | 1.9 | 2.7 |
| US Consumer Price Inflation | 2.1 | 1.6 | 2.2 |
| US Short Term Interest Rate (December) | 0.1 | 0.1 | 0.2 |
| US Long Term Interest Rate (December) | 1.7 | 2.3 | 2.8 |
| Japan GDP Growth Rate | 2.0 | 1.4 | 1.5 |
| Japan Consumer Price Inflation | 0.0 | 0.0 | 1.9 |
| Japan Short Term Interest Rate (December) | 0.3 | 0.2 | 0.3 |
| Japan Long Term Interest Rate (December) | 0.8 | 0.8 | 1.2 |
| World Trade Growth Rate | 2.7 | 3.2 | 5.0 |
| Oil Price (December) | 110 | 104 | 107 |
| USD/Euro Exchange Rate (December) | 1.31 | 1.30 | 1.30 |
| 100Yen/Euro Exchange Rate (December) | 1.10 | 1.28 | 1.28 |

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 (2013). 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.