EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2014 and 2015

Spring 2014

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 recovery of the world economy starting by mid-2012 is now being consolidated. Although growth dynamics are currently less marked in emerging markets countries, the situation of the advanced economies has significantly improved. World trade is expected to grow again close to 5% during 2014 and 2015.
- The euro area economy has left the recession behind during 2013. Low interest rates in a context of price stability, the progressive improvement in fiscal policy and the slow recovery of confidence are the main drivers for this upturn. For 2014 and 2015, we expect a GDP growth of 1.2% and 1.6%, respectively.
- Confidence is improving as real incomes have stopped falling in 2013 and net wealth of private households has started rising again due to the upward trend of housing prices. However, euro area labour markets are still out of balance, although the unemployment rate is no longer increasing in most euro area countries.
- Our inflation forecast for 2014 is 0.8%. In 2015 inflation will also remain subdued, at about 1.3%. However, the probability of an area wide deflation in the next year is very low.
- The main uncertainty for these forecasts is related to financing conditions of the euro area. Although external financing costs for firms are now at a record low for about a year, the volume of credit keeps declining and the situation could worsen depending on the outcome of the ECB Asset Quality Review and the way the single supervisory mechanism is implemented.

Table 1 Economic outlook for the Euro area

	2011	2012	2013	2014: 1st half		2014: annual		2015: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					0.5		0.5		0.6
GDP	1.6	-0.7	-0.5	1.1	1.7	1.2	2.0	1.6	2.5
					0.0		0.1		0.2
Potential Output	0.2	0.4	-0.1	0.2	0.3	0.3	0.5	0.4	0.6
					0.3		0.1		0.1
Private Consumption	0.3	-1.4	-0.7	0.8	1.2	0.8	1.4	1.0	1.8
					0.0		-0.1		0.1
Government Consumption	-0.1	-0.5	0.2	0.3	0.7	0.4	0.8	0.6	1.1
					-0.8		-1.3		0.4
Fixed Capital Formation	1.6	-4.1	-3.0	1.5	3.7	1.5	4.2	4.2	8.1
					3.1		3.3		4.3
Exports	6.5	2.5	1.3	4.3	5.6	4.8	6.4	6.2	8.1
					3.7		3.8		4.4
Imports	4.5	-0.9	0.1	5.3	6.9	5.8	7.7	6.8	9.3
					11.8		11.7		11.4
Unemployment Rate	10.1	11.4	12.1	12.0	12.3	12.0	12.5	12.0	12.6
					1.4		1.6		1.6
Labour Cost Index	2.6	2.2	1.5	1.7	2.1	2.0	2.5	2.3	3.0
					0.7		0.7		0.8
Labour Productivity	1.4	0.0	0.5	1.2	1.6	1.3	1.8	1.5	2.2
					0.5		0.4		0.3
HICP	2.7	2.5	1.4	0.8	1.1	0.8	1.3	1.3	2.3
					0.4		0.9		0.4
IPI	3.4	-2.5	-0.7	2.5	4.4	2.9	4.9	3.1	5.8

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 2014 and 2015

The world economy: advanced economies in better shape

Most indicators suggest that the world economy is in reasonably good shape in the first months of 2014. This is mainly due to the advanced economies, where growth picked up in the course of last year and appears to keep a pace of expansion that is slightly above its trend rate since the turn of the century. The euro area starts slowly recovering from recession, and the economies of the US, the UK, and of Japan are in an upswing. Since summer 2013, strong Japanese import growth gives considerable stimulus to emerging Asia. Domestic cycles in emerging markets economies, however, are quite diverse, and the speed of expansion is, for this group of countries, only moderate. In addition, in the last summer, expectations of raising US interest rates had triggered turbulences on exchange markets that induced policy in some emerging markets countries to raise interest rates or even to restrict capital movements. Meanwhile, the situation has stabilized in some places such as India and Indonesia. Turmoil, however, has intensified in those countries, such as Argentina or Turkey, where it partly had its roots in political risks. Above all, the political crisis in the Ukraine and the Russian intervention made the US-Dollar exchange rate of the Ukrainian Griwna and the Russian Ruble fall by more than 10% in the first months of this year, and stock markets in Russia tumbled.

Financial markets, meanwhile, no longer expect official interest rates in the US to rise anytime soon. Forward guidance by central banks has persuaded the public that key rates in all large advanced economies are expected to stay close to the zero lower bound at least in 2014, although unemployment in the US and in Britain has receded surprisingly fast. Price dynamics, however, are still slowing, with inflation rates below 2%. The Japanese central bank is still fighting entrenched deflationary tendencies by expanding the monetary base at an unprecedented degree, and the ECB struggles looking for additional instruments that might reduce the risk of deflation while fulfilling the particular requirements of the currency union. Headwinds from fiscal policies are, in most countries, markedly weaker than in the past years: in the euro area policy is only slightly restrictive, and the dampening effects in the US continue to recede, not least because the impasse for fiscal policy in Congress has been overcome. The Japanese government cushions the restrictive shocks of the consumption tax increase with help of additional stimulus measures in 2014.

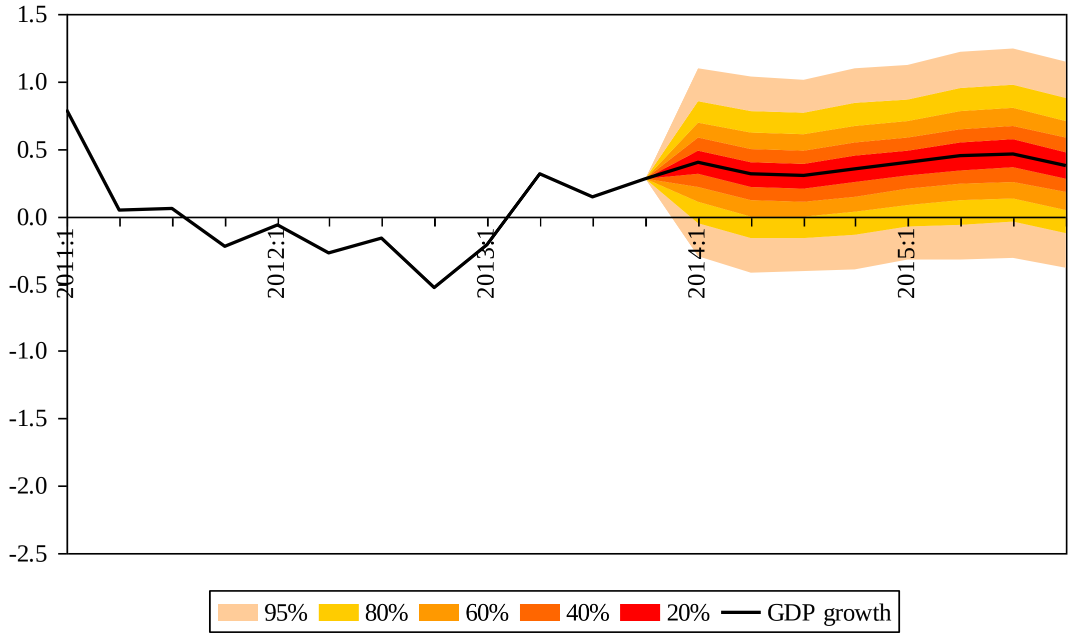
Policy is not the only cause why the world economy has a good chance to keep its recent speed of expansion in 2014 and 2015. In the US debt of private households goes, relative to income, down, while private wealth is rising, and the energy sector is booming due to the fracking technology. In the euro area, the strong export performances of Spain and Portugal during the past four years may partly be regarded as early rewards for structural reforms. Long run perspectives for France and Italy have brightened at least a bit due to stronger reform efforts, though structural rigidities in these countries will prevent the recovery in the euro area from developing into a strong upswing anytime soon. Structural problems are also at the root of the slowdown of growth dynamics in many emerging markets countries. Chinese data were weak recently, indicating that the stimuli from China to the world economy will continue to recede in 2014 and 2015. Prices for energy and industrial raw materials have more or less stagnated for about two years; this stabilizes economic expansion in many places, but hurts growth in countries, such as Brazil and Russia, that export these goods. All in all, prospects for moderate growth of world production in 2014 and 2015 are good, but a strong upswing is not in sight.

The euro area economy: slowly recovering

The euro area recession ended in the first quarter of 2013; afterwards, production has been slowly increasing, at the end of the year by 0.3%. Cyprus is the only member country that is definitely still in recession, but growth dynamics are nowhere high, with the German expansion (by 0.3%) as the strongest among the larger economies. The stimulus from foreign demand has been modest, with exports picking up a bit stronger at the end of the year. The latter has been one of the main factors involved in the euro area industry performing better than expected during the last quarter of 2013. Besides, since early summer, private households are expanding consumption, and investment is slowly accelerating.

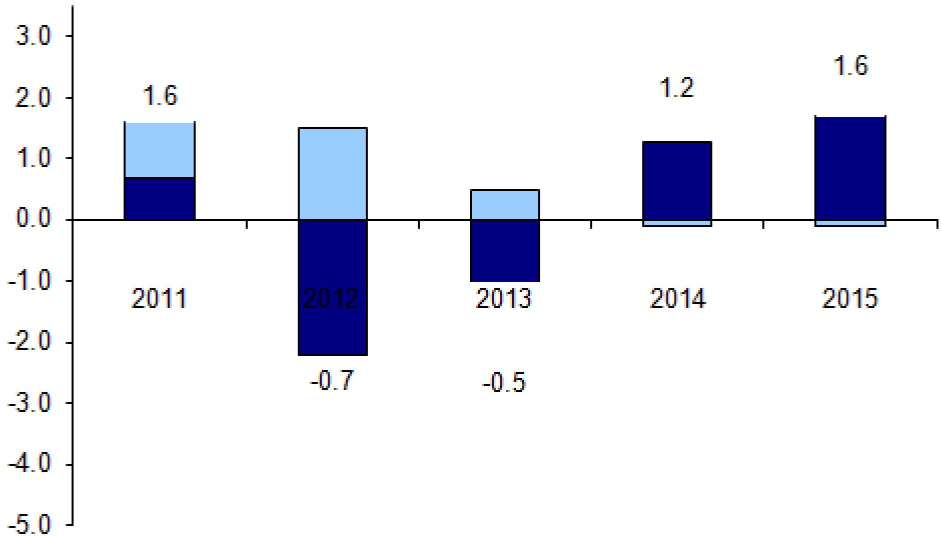
There are several causes for the recovery: the shrinkage of oversized sectors such as the Spanish construction industry is phasing out, fiscal policy becomes less restrictive, official interest rates continue to be very low, and confidence in the future of the currency union not only returned, but has strengthened right up to the present. Confidence is important for every decision to spend; in addition it has improved financing costs for governments (and allowed fiscal policy to ease a bit), and for private agents as well. Real external financing costs for firms as measured by the ECB are now at a record low for about a year, mainly because of low costs of market based debt and of quoted equity. Private households benefit from low interest rates as well. Although their debt burden has little changed in the past years, their payment burden went down markedly due to the fall in interest rates. Real incomes have stopped falling in 2013; not least because tax hikes due to austerity measures have largely run out. Net wealth of private households has started rising again, mainly thanks to the housing market: house prices rise or do no longer fall, according to the quarterly rate of change of the indices calculated by Eurostat, in all the larger economies – with the notable exception of Italy.

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

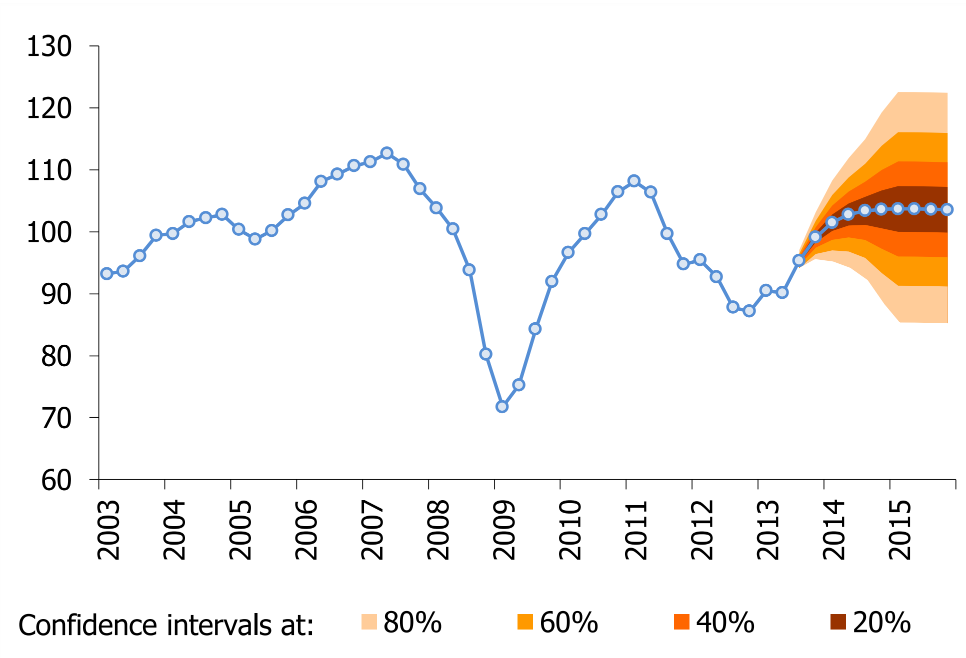


Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Another reason why confidence is on the rise is that labour markets are, in the aggregate, no longer deteriorating; employment and the unemployment rate (at 12%) were about constant throughout 2013. That said, labour markets are still out of balance in many countries (and unemployment is still rising in some others like in Italy). As a consequence, nominal wage dynamics have gone down to about 1 ½ % on average on an annual basis.

Price dynamics are accordingly slowing down as well. Despite this, the probability of HICP inflation becoming negative in a 12 months horizon has not significantly increased since January 2013, as figure 4 shows.

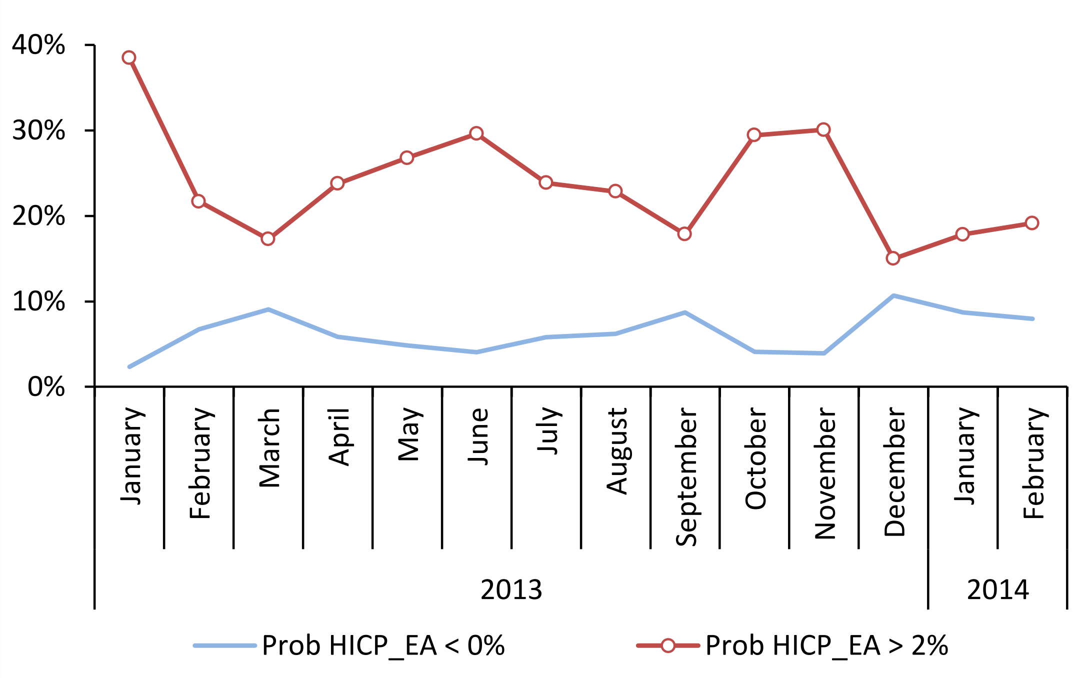
Figure 3 Economic Sentiment Indicator and confidence bands



The drivers of the recovery in 2013 will be supportive in 2014 and 2015 as well; fiscal policy will be less restrictive in 2014 and might even become slightly expansive in 2015. Key interest rates are sure to stay close to zero. From this perspective, the rise in most euro area confidence indicators seems quite natural. The ECB has, however, every reason to stick to a policy that is as expansive as the political framework allows, not only because inflation expectations decreased significantly in the last months (our average expected rate for 2014 has reduced by 0.4 pp to 0.8%), but also because the financial sector is still deeply fragmented in the euro area and thus the monetary transition mechanism is, at least for the southern economies, still impaired. Mainly (but not exclusively) in these countries banks are still struggling with a rising amount of nonperforming loans and therefore can hardly afford to expand their portfolio. This year's Asset

Quality Review by the ECB is an additional incentive for banks to shrink their balance sheets in order to improve their capital ratios. As a consequence, the volume of credit for firms keeps on declining and does so by more than what the cyclical position of the euro area economy would suggest. The difficult financing conditions in particular for small and medium enterprises in the southern economies will be a drag on the recovery in 2014 and 2015. In addition, the potential growth rate of the euro area economy is probably still very low and the output gap limited, and thus every upswing will entail comparatively small grow rates, will be short-lived, or both. All in all, we forecast that the euro area economy will expand by 1.2% in 2014 and by 1.6% in 2015.

Figure 4 Probability of the YoY Euro Area HICP inflation rate to be under 0% or above 2% in the next 12 months (Forecasts from January 2013)



One major uncertainty for forecasts of the euro area at present is the question what effect the Asset Quality Review and the start of the single supervisory mechanism will have for financing conditions of the euro area. Clearly, these policy measures are an opportunity for the currency union, but major failures during their implementation, for example a failed recapitalization of important banks, could put the recovery at risk.

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

	2010	2011	2012	2013	2014	2015
Durable	2.7	0.7	-4.9	-3.5	2.1	5.7
Non Durable	2.9	1.0	-2.1	-0.1	1.3	1.1
Capital	9.0	8.5	-1.1	-0.5	5.5	5.7
Intermediate	10.0	4.1	-4.5	-1.0	3.4	2.8
Energy	3.9	-4.5	-0.4	-1.1	-3.5	-0.8
Total	7.3	3.4	-2.5	-0.7	2.9	3.1

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.

Predictions for GDP are, even for 2015, quite similar. The EFN forecast is relatively optimistic on fixed capital formation in 2015, because we think that, on the one hand, user costs of capital in countries that are less affected by the crisis will stay at very low levels, and, on the other hand, restrictions in public spending for infrastructure and investment in the housing sector (in particular in Spain) will cease to drag investment down. Quite high is the EFN forecast for unemployment in 2015. We still see a rising trend in labour supply, while to us the recovery in 2014 and 2015 appears not to be strong enough to increase labour demand significantly.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF*		ECB		OECD		Consensus	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
GDP	1.2	1.6	1.2	1.8	1.0	na	1.2	1.5	1.3	1.8	1.1	1.4
Priv. Consumption	0.8	1.0	0.7	1.4	0.5	na	0.7	1.2	0.8	1.3	0.7	1.1
Gov. Consumption	0.4	0.6	0.5	0.7	-0.3	na	0.4	0.4	0.5	0.2	0.3	0.5
Fixed Capital Form.	1.5	4.2	2.3	3.6	1.3	na	2.1	2.7	2.3	3.5	1.9	2.6
Unemployment rate	12.0	12.0	12.0	11.7	12.2	na	na	na	12.1	11.8	12.0	11.7
HICP	0.8	1.3	1.0	1.3	1.5	na	1.0	1.3	1.2	1.2	0.9	1.3
IP	2.9	3.1	na	na	na	na	na	na	na	na	2.1	2.6

EU: European Commission, Economic Forecast, February 2014; IMF: World Economic Outlook, October 2013; ECB: ECB Monthly Bulletin, March 2014, OECD: Economic Outlook, November 2013; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2014. ECB figures correspond to their macroeconomic projections.

* The IMF world economic outlook update of January 2014 forecasts euro area GDP growth of 1.0% in 2014 and 1.4% in 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 recovery in the US will speed up in 2014. Growth in world trade accelerates, but stays below the trend of the past 20 years or so. Oil prices are expected to be about constant in real terms. The exchange rates of the dollar and the yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2013	2014	2015
US GDP Growth Rate	1.9	2.9	3.0
US Consumer Price Inflation	1.5	1.6	1.9
US Short Term Interest Rate (December)	0.1	0.1	0.3
US Long Term Interest Rate (December)	2.9	3.4	3.7
Japan GDP Growth Rate	1.5	1.6	1.3
Japan Consumer Price Inflation	0.4	2.4	1.7
Japan Short Term Interest Rate (December)	0.1	0.2	0.4
Japan Long Term Interest Rate (December)	0.7	0.8	1.1
World Trade Growth Rate	2.8	4.5	4.8
USD/Euro Exchange Rate (December)	111	110	112
100Yen/Euro Exchange Rate (December)	1.37	1.37	1.37

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.