Economic Assessment of the Euro Area

Winter 2013/2014

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Summary Table

Table 1: Summary of Key Forecast Indicators for Euro Area

	2013	2014	2015
Output Growth Rate	-0.4	1.3	1.6
Inflation Rate (Harmonised)	1.4	1.2	2.0
Unemployment Rate	12.1	12.0	11.3
Govt. Balance as % of GDP	-2.9	-2.4	-1.6

1. Introduction

Since EUROFRAME published its economic assessment of the Euro Area last year (EUROFRAME, 2013) relatively little has changed. Our forecast for 2013 was almost identical to our latest estimate for growth in that year and we are again forecasting growth in the Euro area economy in 2014 of 1.3 per cent. However, some of the detail is different. Last year we envisaged a slow turnaround in the world economy and the outturn has been broadly as expected, although world GDP growth was slightly disappointing. Growth in the US was less vigorous than we had anticipated and the slowdown in growth in the emerging economies turned out to be more protracted than expected.

2. Key Developments and Global Outlook

In the fifth year after the financial crisis and related Great Recession began, the world economy continues to grow. However, the world growth rate in 2013 was clearly weaker than in the pre-crisis years. While emerging economies have, for the most part, continued growing strongly, their growth rates have also decelerated and the slowdown experienced since 2011 has been more pronounced; it appears to be more structural in nature than had previously been thought. Exchange rate movements played an important role, especially with the strong depreciation of the yen in 2012 vis-à-vis most currencies, while the yuan was appreciating.

In spite of the problems in the US in reaching agreement on fiscal policy, the US economy grew by 1.8 per cent in 2013 (Table 1). With less uncertainty about fiscal policy this year the US economy seems likely to grow by around 2.6 per cent with slightly faster growth of 2.8 per cent envisaged for 2015. We see the growth in China continuing to slow from an estimated 7.6 per cent in 2013 to just under 7 per cent in 2015.

The recovery in the US economy and also in the EU economy in 2014 should contribute to an acceleration in the growth of world trade. After exceptionally low growth in 2012 of 2.4 per cent, and of 3.1 per cent in 2013, we now expect world trade to grow by 6.4 per cent in 2014 (Table 5).and by a similar amount in 2015 (7 per cent).

The headline inflation in major economies has decelerated and rates have converged globally across the world in 2013 to levels below the central bank targets and such low rates are expected to prevail in 2014. In 2015 prices are expected to rise slightly as economic growth strengthens.

Inflation has been strongly affected by changes in energy prices and, to a smaller extent, by changes in food prices. The core inflation rate, excluding energy and food prices, has been fairly stable, at a low level, in recent years. The US shale energy boom continued to reshape the US and the global energy markets. The US and global energy prices diverged and the US energy bill even decreased in the fall of 2013, both absolutely and in relation to its competitors, due to inadequate arbitrage possibilities. This can also be seen in the divergence of consumer prices of energy, although exchange rate fluctuations are also a major factor explaining different rates of energy price inflation, especially in the case of Japan. In 2012 energy price inflation rose by 0.9 per cent in the US, while the rises in Japan and in the Euro Area (HICP) were 3.8 and 7.6 per cent, respectively. In November 2013, energy prices for consumers decreased by 2.4 per cent in the US, rose by 7.1 per cent in Japan (October) and decreased by 1.1 per cent the Euro Area (y/y). Food prices have developed moderately also in China, where it is one of the key policy goals.

In the fall of 2013, the core inflation rate, excluding energy and food, fell to around 1.7 in the US and slightly below 1 per cent in the Euro Area. In Japan, core inflation showed a modest rise after an average 1 percent annual decrease in 2009-2012. Low inflation has been related to stagnant economic growth in the industrialised after the Great Recession of 2008/9.

The main central banks of the industrialised countries have different goals, which imply different strategies, not least because economies are at different stages of the business cycle. With short-term interest rates at the zero lower bound and central bank assets at an uncomfortably high level, the central banks have resorted to forward guidance, while also considering strategies to achieve a smooth exit from unconventional monetary policies. This approach is designed to keep inflation expectations in control in the longer-run, but has led to some uncertainty in global financial markets in the course of last year.

The Federal Reserve in the environment of low inflation and improving economy started to "taper" in December 2013, i.e., it started to decrease its monthly asset purchases from 85 billion dollars by 10 billion. It has also committed to low steering rates until the unemployment rate falls below 6.5 percent and the forecast inflation rate significantly exceeds the 2 percent target. In December 2013, the ECB decreased its steering rates to 0.25 per cent in response to a downward surprise in inflation and only very gradual improvements in the real economy. With risks weighted to the downside the ECB expects short rates to remain at their "present or lower level for an extending period". In Japan the central bank has accelerated strongly its purchases of government bonds as a part of the stimulus program "Abenomics" in an effort to 'kick-start' their economy.

We assume that accommodative stance of the global monetary policies will be tightened starting from the US in early 2015, followed by the UK. Interest rates in the Euro Area and in Japan are expected to remain low for most of the next two years.

3. Forecast for the Euro Area

In the course of 2013, the Euro Area economy has slowly moved out of recession. Real GDP has grown in both the second and the third quarters of the year after six consecutive quarters of declining output. Employment seems to have stabilized in the second half of the year, and the unemployment rate has remained unchanged at 12.1 per cent since April.

The growth momentum is, however, still weak. While sentiment indicators have substantially improved, reflected in the recent estimates of the EUROFRAME-Indicator , this suggests that euro area quarterly GDP growth rate could be around 0.5 per cent at the turn of 2013/2014. "Hard" data on economic activity, such as retail sales, industrial production or new orders received, have, until very recently, not embarked on a clear upward trend. However, euro area industrial production increased by 3 per cent in November 2013 compared with November 2012, instead of a mere 0.5 per cent in October 2013. The recovery is also still unbalanced from a regional perspective, with Italy and also France being laggards among the major economies.

The outlook for the Euro Area has improved, in part due to a stabilization of the situation in the financial markets. Following the announcement of the ECB's OMT programme in late summer 2012, the spreads of sovereign bond yields of crisis countries over German Bund yields, have moderated, although spreads are still elevated compared to pre-2008 levels. In spring 2013, by asserting that rates would remain low for an extended period of time, the ECB embarked on an attempt to guide market expectations of future interest rate policy, in order to check an increase in long term interest rates that was underway in the wake of anticipation of monetary tightening in the US. In December, in response to decelerating inflation and incoming data that the pace of recovery in the real economy was painfully slow, the ECB even lowered the main refinancing rate once again to a record low of 0.25 per cent. While the direct impact of this on activity will probably be limited, the move suggests that the ECB is firmly committed to stemming deflationary pressures and keeping monetary policy accommodative for quite some time to come. We assume short term rates do not rise before the end of 2015.

Fiscal policy is expected to be less of a drag on economic activity over the forecast horizon than in recent years (Table 9). The fiscal impulse will amount to around a negative 0.3 per cent of GDP in 2014 and 2015, after roughly -0.7 per cent in 2013 and -1.3 in 2012[1]. This should contribute to the expected recovery in the Euro Area economy this year and next. The Box below gives details of the change in fiscal policy in Germany following last autumn's election.

Based on the assumptions of continued monetary stimulus, more moderate fiscal restraint and an improving external environment, we expect the recovery in the Euro Area to gradually strengthen and broaden this year and next. Real GDP is forecast to rise by 1.3 and 1.6 per cent in 2014 and 2015,

[1] The Table does not include details of fiscal policy in Euro Area countries other than those mentioned in the Table. If these other countries were included the Euro Area total would probably be slightly more negative than shown in the Table.

respectively (Table 2). Exports are projected to accelerate markedly, and external trade is forecast to continue to contribute significantly to economic growth. Domestic demand is expected to gradually improve with investment being the main driver on the back of improving sentiment and low interest rates. Private consumption on the other hand will remain sluggish as real personal disposable income growth should remain slow. Given the large amount of economic slack in the Euro Area on aggregate, consumer price inflation is expected to remain low in 2014 at 1.2 per cent, before rising to 2 per cent next year as the economic recovery proceeds. Unemployment should gradually decline, although it will remain unacceptably high in many countries for an extended period of time.

Box: Fiscal policy in Germany after the election

In December 2013, three months after the election, the new government agreed on a coalition treaty. Due to the political character of such a treaty measures are still vague and the calculation of the fiscal impact still relies on a broad set of assumptions.

The government decided upon a number of measures that will increase public spending by a total of 23 billion euro until 2017 when the next general election is scheduled to take place. Nevertheless, the fiscal impulse in 2014 and 2015 will probably be small. There a several measures concerning the pension system which will increase government spending by 3 ½ billion this year and 6 billion per year from 2015 onwards. This will be financed without raising the rate of contribution to the public pension system but prevents a decrease of the contribution rate that would otherwise have occurred. Additional benefits from the nursing care insurance, by contrast, will in 2015 lead to an increase in the contribution rate to this scheme.

Furthermore the coalition agreed on an increase in investment spending as well as on additional grants from the federal level to the municipalities, which in fact are the main investor in Germany as far as the public sector is concerned. However, due to institutional conditions, above all long planning periods, induced demand is expected to be limited this year and next. Taking into account both policy changes due to the coalition treaty and older measures discretionary measures, they will amount to around 0.3 per cent of GDP in 2014 and close to zero in 2015.

4. Central and Eastern Europe (CEE) outside the Euro Area

In 2013 the absence of growth in the Euro Area, as well as weak domestic demand, kept growth rates low in CEE countries, including Poland (1.4 per cent). Croatia and the Czech Republic continued to be in recession, Bulgaria stagnated while Hungary and Romania picked up gradually. The highest and most stable growth was observed in Lithuania (over 3 percent). Private consumption and investment were particularly weak and, with decelerating inflation, monetary policies became more expansionary. A number of central banks in CEE decreased their key monetary policy rates, with Hungary and Romania providing most substantial easing. Investment in Poland, though experiencing some improvement in business sentiment, suffered from the slowdown of EU funds (after an intensive inflow in 2012 during preparation for the EURO2012). The main contributors to growth in the region in 2013 were net exports and public consumption. Public consumption remained stable as a number of countries delayed fiscal tightening. Although intra EU-trade remained subdued, net exports grew in the majority of CEECs. The reason for this was decline in demand of imported goods along with the expansion of exporters into non-EU markets (the largest increase in exports was experienced by Romania: 9.6 percent). Because of supply factors and weak domestic demand inflation in CEE was kept at low level. As a result of shrinking domestic demand and investment, employment fell in the region. The largest increase in the unemployment rate (of 2 percentage points) was in Croatia, which has the highest unemployment rate among CEE countries (approximately 19 per cent at the end of 2013). However, some countries have seen a downward trend in the unemployment rate (such as Lithuania and the Czech Republic).

With an improving economic outlook for the Euro Area, we forecast an improvement in the economic situation of CEE countries in 2014 and 2015. Growth in the region will be driven to a large extent by the Polish economy, which is forecast to grow by 2.6 percent in 2014 and by 3.0 percent in 2015. The main drivers of this acceleration in growth will be domestic demand (both consumption and investment). The contribution of net exports will remain positive, though at lower levels due to growth in imports. We expect that Czech Republic and Croatia will return to a stable growth path in the forecast period. In the Czech Republic growth will be driven by private consumption but also muted by imports resulting from increased demand. In Croatia GDP is forecast to increase slightly, by 0.5 per cent in 2014. In Hungary, GDP growth is expected to speed up gradually to 2 percent in 2015. We also forecast that the regional labour market will show a slight improvement in 2014.

Appendix: Forecast Tables

Annex Table 1: Summary of Key Forecast Indicators for Euro Area

	2009	2010	2011	2012	2013	2014	2015
Output Growth Rate	-4.4	1.9	1.6	-0.6	-0.4	1.3	1.6
Inflation Rate (Harmonised)	0.3	1.6	2.7	2.5	1.4	1.2	2.0
Unemployment Rate	9.6	10.1	10.1	11.4	12.1	12.0	11.3
Govt. Balance as % of GDP	-6.4	-6.2	-4.2	-3.7	-2.9	-2.4	-1.6

Annex Table 2: Euro Area Forecast Details

	annual percentage change						
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Consumption	-0.9	1.0	0.3	-1.4	-0.5	0.3	0.6
Private investment	-14.4	0.2	2.1	-3.8	-3.2	1.3	3.2
Government expenditure	2.4	0.1	-0.2	-0.9	0.0	0.5	0.4
Stockbuilding	-0.9	0.7	0.2	-0.4	-0.1	0.1	0.2
Total domestic demand	-3.6	1.3	0.7	-2.1	-0.9	0.7	1.2
Export volumes	-12.3	11.4	6.6	2.7	1.3	5.6	6.7
Import volumes	-10.8	9.8	4.6	-0.8	0.2	5.1	6.5
GDP	-4.4	1.9	1.6	-0.6	-0.4	1.3	1.6
Average earnings	3.0	1.1	1.6	1.7	1.0	1.0	2.2
Harmonised consumer prices	0.3	1.6	2.7	2.5	1.4	1.2	2.0
Private consumption deflator	-0.5	1.7	2.4	2.1	1.2	1.1	2.0
Real personal disposable income	0.0	-0.6	-0.5	-1.8	-1.4	0.3	0.8
Standardised unemployment rate, %	9.6	10.1	10.1	11.4	12.1	12.0	11.3
Govt. balance as % of GDP	-6.4	-6.2	-4.2	-3.7	-2.9	-2.4	-1.6
Govt. debt as % of GDP	80.0	85.4	87.3	90.6	95.3	94.0	91.5
Current account balance as % of GDP	-0.2	0.1	0.1	1.3	1.8	2.3	2.5

Annex Table 3: Real GDP in Major Economies

	annual percentage change										
	World	**OECD**	**China**	**EU-27**	**Euro Area**	**USA**	**Japan**	**Germany**	**France**	**Italy**	**UK**
2009	-0.6	-3.5	8.9	-4.5	-4.4	-2.8	-5.5	-5.1	-3.1	-5.5	-5.2
2010	5.2	3.0	10.4	2.0	1.9	2.5	4.7	3.9	1.6	1.7	1.7
2011	4.0	1.9	9.3	1.7	1.6	1.8	-0.4	3.4	2.0	0.6	1.1
2012	3.2	1.6	7.8	-0.4	-0.6	2.8	1.4	0.9	0.0	-2.6	0.3
2013	3.1	1.3	7.6	0.0	-0.4	1.8	1.6	0.4	0.3	-1.8	1.9
2014	4.0	2.2	7.1	1.5	1.3	2.6	1.6	1.7	1.2	0.7	2.0
2015	4.0	2.5	6.9	1.8	1.6	2.8	1.9	2.0	1.5	1.3	2.1

Annex Table 4: Private Consumption Deflator in Major Economies

	annual percentage change								
	OECD	**EU-15**	**Euro Area**	**USA**	**Japan**	**Germany**	**France**	**Italy**	**UK**
2009	0.4	0.0	-0.5	-0.1	-2.4	0.0	-0.7	-0.1	1.9
2010	1.9	2.1	1.7	1.7	-1.7	2.0	1.1	1.5	4.0
2011	2.4	2.7	2.4	2.4	-0.8	2.0	2.1	2.8	3.9
2012	2.1	2.1	2.1	1.8	-0.8	1.6	1.9	2.8	2.6
2013	1.6	2.0	1.2	1.2	-0.2	1.6	0.5	1.3	3.0
2014	2.2	2.4	1.1	1.6	1.8	1.8	1.0	0.7	2.5
2015	2.6	2.2	2.0	2.4	1.5	1.9	1.7	2.3	1.7

*

Annex Table 5: World Trade Volume and Prices

	annual percentage change		
	World trade volume	**World export prices ($)**	**Oil price($per barrel)**
2009	-10.4	-17.8	61.8
2010	12.5	10.4	78.8
2011	5.8	3.0	108.5
2012	2.4	4.7	110.4
2013	3.1	1.9	107.2
2014	6.4	3.9	106.4
2015	7.0	5.8	105.7

Annex Table 6: Interest Rates

	Per cent per annum							
	Central bank intervention rates				Long-term interest rates			
	USA	**Japan**	**Euro Area**	**UK**	**USA**	**Japan**	**Euro Area**	**UK**
2009	0.3	0.1	1.3	0.6	3.2	1.3	3.7	3.7
2010	0.3	0.1	1.0	0.5	3.2	1.2	3.3	3.6
2011	0.3	0.1	1.2	0.5	2.8	1.1	3.9	3.1
2012	0.3	0.1	0.9	0.5	1.8	0.8	3.2	1.8
2013	0.3	0.1	0.6	0.5	2.3	0.7	2.7	2.4
2014	0.3	0.1	0.3	0.5	3.0	0.8	3.0	2.9
2015	0.9	0.1	0.3	0.7	3.3	1.0	3.2	3.1
2012Q1	0.3	0.1	1.0	0.5	2.0	1.0	3.5	2.1
2012Q2	0.3	0.1	1.0	0.5	1.8	0.9	3.4	1.8
2012Q3	0.3	0.1	0.8	0.5	1.6	0.8	3.2	1.7
2012Q4	0.3	0.1	0.8	0.5	1.7	0.7	2.8	1.8
2013Q1	0.3	0.1	0.8	0.5	1.9	0.7	2.7	2.0
2013Q2	0.3	0.1	0.6	0.5	2.0	0.7	2.5	1.9
2013Q3	0.3	0.1	0.5	0.5	2.7	0.8	2.8	2.7
2013Q4	0.3	0.1	0.4	0.5	2.7	0.6	2.7	2.8
2014Q1	0.3	0.1	0.3	0.5	2.8	0.7	2.8	2.8
2014Q2	0.3	0.1	0.3	0.5	2.9	0.7	2.9	2.8
2014Q3	0.3	0.1	0.3	0.5	3.0	0.8	3.1	2.9
2014Q4	0.3	0.1	0.3	0.5	3.1	0.9	3.2	2.9
2015Q1	0.6	0.1	0.3	0.5	3.2	0.9	3.2	3.0
2015Q2	0.8	0.1	0.3	0.6	3.3	1.0	3.2	3.0
2015Q3	1.0	0.1	0.4	0.8	3.4	1.0	3.3	3.1
2015Q4	1.3	0.2	0.5	0.9	3.5	1.1	3.3	3.2

Annex Table 7: Nominal Exchange Rates

	Annual percentage change						
	USA	**Japan**	**Euro Area**	**Germany**	**France**	**Italy**	**UK**
2009	7.0	15.6	2.1	2.0	1.7	2.5	-10.5
2010	-3.1	4.0	-3.2	-3.8	-3.1	-3.4	-0.5
2011	-3.0	6.8	0.9	0.5	1.0	1.3	-0.2
2012	3.4	2.2	-1.9	-2.0	-2.0	-1.6	4.2
2013	3.0	-16.3	3.0	2.9	3.3	4.1	-1.1
2014	2.0	-3.1	2.0	1.9	2.3	3.1	5.1
2015	0.4	-0.5	0.4	0.3	0.4	0.6	0.2

Annex Table 8: Bilateral Exchange Rates

	Bilateral rate against US$		
	Yen	Euro	Sterling
2009	93.6	0.720	0.641
2010	87.8	0.755	0.647
2011	79.8	0.719	0.624
2012	79.8	0.778	0.631
2013	97.5	0.754	0.640
2014	102.7	0.736	0.610
2015	103.5	0.735	0.611
2012Q1	79.3	0.763	0.636
2012Q2	80.1	0.780	0.632
2012Q3	78.6	0.799	0.633
2012Q4	81.2	0.771	0.623
2013Q1	92.3	0.757	0.645
2013Q2	98.8	0.765	0.651
2013Q3	98.9	0.755	0.645
2013Q4	100.1	0.737	0.617
2014Q1	102.5	0.736	0.610
2014Q2	102.5	0.736	0.610
2014Q3	102.8	0.736	0.610
2014Q4	103.1	0.736	0.611
2015Q1	103.3	0.736	0.611
2015Q2	103.5	0.735	0.611
2015Q3	103.6	0.734	0.611
2015Q4	103.7	0.733	0.610

*Annex Table 9: Fiscal Impulse in Selected Euro Area Economies (per cent of GDP)**

	Percentage of GDP						
	Euro Area	Germany	France	Italy	Netherlands	Finland	Ireland
2011	-0.8	-0.5	-1.4	-0.5	-0.8	-0.3	-3.4
2012	-1.3	-0.2	-1.5	-3.2	-0.7	-0.3	-2.3
2013	-0.7	0.5	-1.4	-0.8	-2.1	-1.2	-2.1
2014	-0.3	0.3	-0.8	0.2	-1.7	-0.7	-1.5
2015	-0.3	0.0	-0.8	-0.1	-0.9	-0.3	0.0

* The fiscal impulse is the change in the deficit attributable to legislative/policy changes implemented in the given year. The Euro Area aggregate excludes countries not mentioned in the Table.