Editorial

The Euro area economy is in an upswing. GDP is estimated to have grown in the past year at a rate of 2.7% which is the highest rate since 2000. Most forecasters, including the EUREN network, expect that the upswing will continue in this year, even if growth will moderate somewhat. At the same time the ECB has raised its key interest rate since December 2005 by 125 basic points. So far the ECB was quite successful to assure price stability. Also thanks to the decline of energy prices inflation is below the 2% threshold now. Despite of the capacity utilisation rising there is reason that the ECB can stay relaxed on interest rates. Wage increase is still moderate compared to earlier years and productivity growth is speeding up with capacity utilisation rising. Hence there is little reason for the corporate sector to lift prices due to higher production costs.

But there still are some risks. With unemployment going down wages may rise stronger than in the past. In particular in Germany, trade unions have already claimed for considerably higher wage increases than before. As the industry sector is facing a strong demand, companies might consent to higher wage claims to avoid strikes. As there is still ample liquidity in the Euro area there is the danger this will translate into higher inflation.

Compared to earlier business cycles monetary policy has still a slightly expansionary stance. Oddly, some politicians argue the current policy of the ECB is even too restrictive. They make the point that monetary policy favours a strengthening of the Euro against the Dollar and thus erodes the competitiveness of the Euro area industry. Indeed, in the wake of the strong growth of the world economy in the last year and the high current account deficit of the United States, the performance of the Euro area in the world market was not very impressing. Its current account was just balanced in 2006 compared to giant surpluses in Japan and other Asian countries. However, at a second look this argument is not very convincing. Of course, calculations of equilibrium exchange rates suggest that the Euro is overvalued to some extent, but this is only a part of the problem. The exchange rate is the same for all Euro area members, but some did very well in the international markets – e.g. Germany, Finland, and the Netherlands –, whereas others were running into higher deficits. Therefore, also internal factors must be blamed.

Even if the Euro/Dollar rate would be the main problem, it is not very wise to assign the responsibility for the exchange rate to the ECB. Implicitly the ECB surely pays attention to the exchange rate. When the Euro appreciates, the dampening effect on inflation and output can make the ECB more relaxed. To load an explicit exchange rate target on the ECB would drive it into conflicts. Under the condition of free capital markets price stability and exchange rate targets are mostly incompatible. Assumed the ECB lowers its key interest rates now to trigger a depreciation of the Euro it is almost sure that inflation picks up. What this will mean for the real exchange rate, which is decisive for price competitiveness, is an open question.

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Solid upswing in the Euro area

The EUREN Forecast Winter 2006/07

International economy less buoyant but still favourable

During 2006 the growth of the international economy moderated somewhat. Above all the US economy was less dynamic, because the housing boom ended. The question is, whether this will trigger a downswing in the US and in the world economy. The EUREN assessment is that growth of global economy will moderate in 2007, but it will continue to be quite strong compared to the long term average.

This forecast is consistent with the "soft-landing" of the US economy. We expect GDP to grow at a rate of 2.1% after 3.3% in 2006. The slowing is reflected in a negative contribution of residential investment to GDP growth of about 1 percentage point during the second half of 2006. Also consumer spending was less buoyant. Nevertheless it is expected that the impact of the recession in the housing sector will be limited, because the negative wealth effect of falling house prices is partly compensated by higher share prices. Furthermore, labour market conditions continue to be favourable Hence US consumers will make only a modest correction in their spending. This assessment is supported by the fact that consumer confidence indicators were above analysts' expectations recently.

Also in the Asian region expansion will be more moderate, but the upswing will not end. In China expansion is forecasted to go back from 10.7% to 9.7% in 2007, whereas in Japan the economy is expected to grow at a rate close to 2 percent, around 0.3 percentage points lower than 2006.

With production growing slower the US demand for raw materials is expected to fall. Furthermore the high prices in recent years had a positive impact on supply. Hence conditions in world oil markets will be less tight, which is already reflected in rising stocks of refined products, including heating oil. Nevertheless, OPEC will, most probably reduce output to stabilise prices. With economic expansion in the emerging economies remaining vigorous, we expect oil prices to stay around $60 a barrel in 2007. However, with warmer than usual weather conditions, which are already easing household demand for heating oil, the risk on oil prices is on the downside.

Under these conditions inflationary pressure in the US is expected to ease. We forecast consumer prices to rise by 2.2% only after 3.2% in 2006. In accordance with the soft landing of the economy and lower inflation the Fed is expected to ease monetary conditions and reduce the federal funds rate towards the end of 2007.

In line with the expected slowing of the world economy world trade is predicted to grow at a rate of 7% in 2007 compared to 9% in 2006. This scenario could be the start of a rebalancing of the world economy. With growth in the US slowing, also the current account will improve slightly, which eases the pressure on the Dollar exchange rate. Hence we assume the Dollar will depreciate only moderately against the Euro.

Table 1

Exogenous and international variables
Percentage changes unless otherwise indicated

	2004	2005	2006	2007[f]
World trade	10.6	7.4	9.0	7.0
United States				
GDP	3.9	3.2	3.3	2.1
3m interest rates	1.56	3.51	5.2	5.1
10y Gvt bond yield	4.27	4.29	4.8	4.6
Japan				
GDP	2.1	2.7	2.2	1.9
3m interest rates	0.03	0.03	0.3	0.7
10y Gvt bond yield	1.49	1.35	1.8	2.2
China, GDP	10.1	10.2	10.8	9.7
US dollar/euro	1.24	1.24	1.26	1.35
Yen/US dollar	108.2	110.1	116.2	112.3
Oil price. Brent				
US$/barrel	38.2	54.5	65.3	63.0
Percentage changes	32.6	42.4	19,8	-3.5

[f]EUREN forecast.

However, there is a downside risk. If the slowdown in the US will e.g. by more pronounced, this could trigger a stronger depreciation of the Dollar which would have more severe repercussions for the rest of the world.

Euro area growth gained momentum in 2006

After some years of low growth, economic activity in the Euro area accelerated in 2006. In the first three quarters GDP grew at a 2.6% rate which is fairly high compared an average of 1.2% over the last for years. If this rate can be maintained, growth could come back to the trend rate observed in the second half of the 1990s.

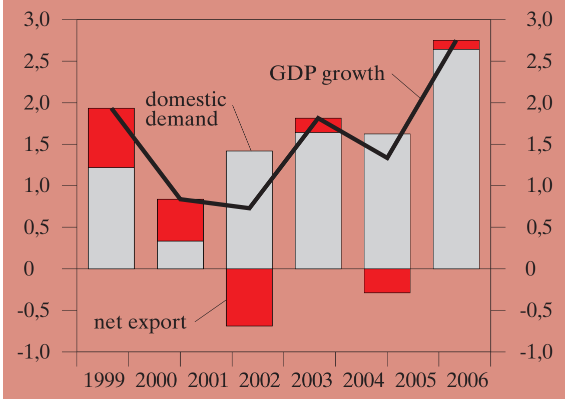
The stronger expansion can be explained, at least partially, by the acceleration in Germany and Italy where growth has been particularly sluggish before. In Italy GDP rate jumped from 0.1% in 2005 to 1.8% in 2006, in Germany from 1.1% to 2.5%. Anyway, also the rest of the Euro area recorded a strengthening.

In Germany the economy was pulled by two engines, exports and investment in equipment. Thanks to the strong world trade and the improved price competitiveness exports increased at an annual rate of about 12%. With capacity utilisation rising companies started to investment in equipment, which was supported by favourable interest rates that were still low and improved depreciation opportunities. As a result, industrial activity accelerated strongly, working as a flywheel for industrial sector in the Euro area. In the latter, industry production in 2006 was approximately 3.5% higher compared the same period in the previous year before.

Even if the upswing was triggered by the revival of external demand, net exports contributed little to growth, because the increase of domestic demand and the high import content of exports stimulated import activity (Graph 1). With industry recovering capacity utilisation climbed almost to its previous peak. Furthermore, financial conditions continued to be favourable and corporate profit margins improved. Hence investment spending accelerated, nearly doubling their growth rate compared to 2005. In addition, construction investments have been supportive, not at least because the ten years decline in construction in Germany came to an end.

Graph 1

Contributions to GDP growth
1999 to 2006



Source: European Commission.

Consumer spending showed no clear trend but was characterized by a stop-and-go: a pick-up in the first quarter was followed by a drop in the second and a new rise in the third. But there is good news for private consumption as employment growth strengthened on a broad base, covering almost all sectors. This increasingly translates into higher disposable income. Even if labour force continued to rise, employment growth was strong enough to bring unemployment rate down. It gradually fell and reached 7.7% in October which is the lowest rate since spring 2001. The better labour market conditions are not only sustaining disposable income, but also brighten consumer confidence, even if it has not yet reached the previous peak of 2001.

In general, almost all recent indicators suggest that the Euro area economy continues to be in a strong cyclical position. Despite of the dampening factors, the ECB's interest rates rises, the slowdown of the US economy, and the appreciation of the Euro, business confidence is still high. The European Commission confidence indicator for the industry sector recently even was above its peak during the previous expansion phase of 2000 (Graph 2). For service sector, the confidence indicator has stabilised on a high level, after some strong improvements at the beginning of 2006.

EUREN forecast for 2007

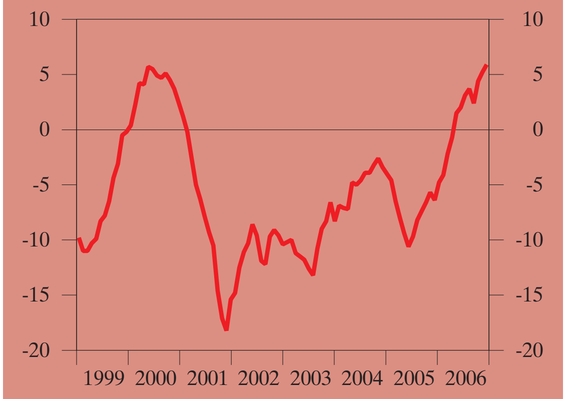
Hence, the upswing in the Euro area seems to be rather solid as it is based on many sectors and it is drawn by at least two engines, buoyant investment and dynamic exports, and increasingly also supported by private consumption. Indeed, the Coe-Rexecode leading indicator does not announce a sharp slowdown of the activity (see page 8). Thus the economy should continue to grow above trend, which is estimated to be around 1.7% per annum.

Temporary drag from the German VAT hike

In 2007, private consumption will be affected negatively by the more restrictive stance of fiscal policy in Germany. The hike if the VAT – the "normal" rate was lifted from 16% to 19% – and the reduction of subsidies will reduce disposable income significantly. The negative effect will be aggravated during the first months by the fact that consumer might have put forward purchases of durables into the last months of 2006 to benefit from the then still lower VAT. However, this negative trend in private consumption will be temporary. On the other hand, households will benefit from the rather mild inflation. Since August 2006 energy prices (whose share in the consumer price index is 9%) decreased significantly due to the decline of the oil prices. As a result, headline inflation came down (Graph 3). Now it is in line with core inflation which has been remarkably stable around 1.5% over the last two years. Even under our assumption that oil prices will be stable around 60 dollars a barrel, headline inflation should continue to be close to core inflation. Assuming the impact of the VAT hike on German inflation to be around one percentage point, the impact on Euro area inflation will be about 0.3 percentage points. All in all, we forecast that inflation in the Euro area will be 1.9% in 2007 on

Graph 2

Euro area: industrial confidence indicator
1999 to 2006



Source: European Commission.

average. Thus the rate is expected to be slightly below ECB reference value of 2%.

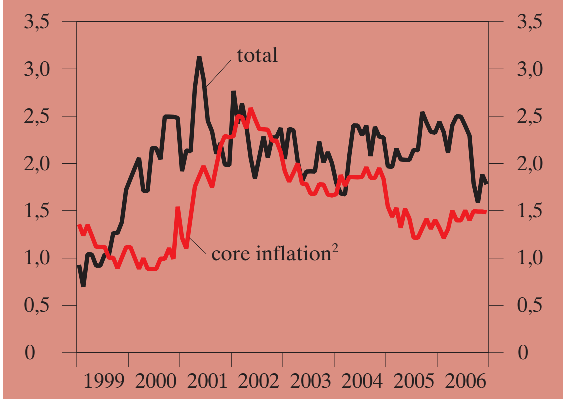
Several factors can be identified to explain this rather low level of inflation. The increasing share of suppliers from low labour costs countries is one of them. The decline of prices of technological products, in particular electronic goods, also helped to keep inflation low. But the key element is wage moderation. The strong increase in oil price during the last four years did not spill over to wages. In the second quarter of 2006, the latest data available, compensation per employee was only 2.3% higher than one year. Even if this means a stronger increase compared to 2005 (1.6%) the rate is low in a historic perspective. In our forecast, we assume that wage moderation will continue. Compensation per employee is expected to rise by 2.4% on average in 2007. However, there is an upward risk, as wage negotiations in Germany will take place in the spring of 2007, when the inflationary effect of the VAT hike will be felt strongest. This might encourage a more pronounced rise in wages. Moreover, the improved labour market situation bears the risk of higher wage increases.

Labour market situation continues to improve

The unemployment rate has decreased significantly during the last two years (Graph 4). This does not only reflect the better business cycle situation. It is also the result of employment policies in several countries, which include increased incentives to work for young and old people, measures to reduce labour costs, and reforms spurring the effectiveness of the employment services. Furthermore demographic trends helped to reduce unemployment, as the rise in labour force slowed down. We expect that the fall of unemployment will continue in 2007. However, as GDP growth will decelerate in the course of the year, employment growth can be expected to moderate with the usual lag. After a 1% rise in 2006, it will increase by 0.5% in 2007. Taking into account that labour force increases by around 0.4% per year, employment growth will be strong enough to reduce unemployment, particularly as productivity usually goes down with growth slowing. We forecast the unemployment rate to reach 7.5% on average in 2007, after 8% in 2006. However, the decline is expected to be concentrated on the first half of year whereas unemployment rate is assumed to be almost stable in the second half of 2007. It is worth noting that it is close to the non-accelerating wage rate of unemployment (NAWRU) which the European Commission estimated to be 7.8% in 2006 recently. However, the NAWRU has decreased significantly since it peaked at more than 9% in mid-1990's, which can be explained by the structural reforms many countries have undertaken in their labour markets. Hence the risk that the fall of unemployment will translate into higher wages should not be assessed too high.

Graph 3

Euro area: Inflation[1]
1999 to 2006



Source: European Commission. – [1]Harmonised consumer price index. – [2]Excluding food and energy.

Table 2

Euro area forecast

	2003	2004	2005	2006[e]	2007[f]	2006 I	2006 II	2006 III	2006[f] IV	2007 I[f]	2007 II[f]	2007 III[f]	2007 IV[f]
Private consumption	1,2	1,5	1,3	1,9	1,7	0,7	0,3	0,6	0,7	0,0	0,6	0,5	0,5
Public consumption	1,8	1,2	1,4	2,2	1,6	0,9	0,1	0,8	0,5	0,5	0,0	0,4	0,5
Gross fixed capital formation	1,0	2,1	2,6	4,8	3,6	1,0	2,3	0,8	0,8	0,8	0,8	0,7	0,8
Domestic demand	0,2	0,2	0,1	0,0	0,1	–0,4	2,3	0,8	0,8	0,8	0,8	0,7	0,8
Exports	1,5	1,8	1,7	2,6	2,2	0,4	1,0	0,7	0,7	0,3	0,5	0,5	0,6
Imports	1,1	6,8	4,2	8,4	5,6	3,8	1,1	1,7	1,6	1,3	1,3	1,2	1,2
GDP[1]	0,8	1,9	1,4	2,7	1,9	0,8	1,0	0,5	0,5	0,3	0,4	0,4	0,5
Unemployment (% of labour force)	8,7	8,9	8,6	7,9	7,5	8,1	7,8	7,8	7,7	7,6	7,5	7,4	7,4
Compensation per employee[1], yoy	2,0	2,1	1,6	2,1	2,4	1,9	2,1	2,2	2,3	2,5	2,5	2,4	2,3
Consumer price (HICP), yoy	2,1	2,1	2,2	2,2	1,9	2,3	2,5	2,1	1,8	2,0	1,8	1,7	2,0
Current account balance (%GDP)	0,5	0,8	0,0	0,0	–0,2								
3m interest rates (% per annum)	2,30	2,10	2,20	3,08	3,89	2,61	2,89	3,22	3,58	3,70	3,95	3,95	3,95
ECB repo (end of period)	2,00	2,00	2,25	3,50	3,75	2,50	2,75	3,00	3,50	3,50	3,75	3,75	3,75
10y Gvt bond yields (% per annum)	4,16	4,14	3,44	3,85	3,98	3,56	4,05	3,97	3,83	3,83	4,00	4,00	4,10

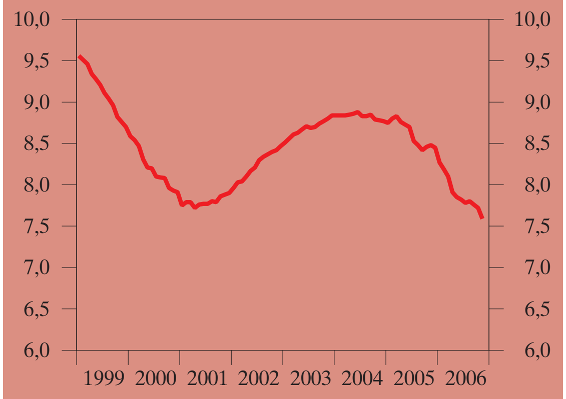
[e]Estimate. – [f]EUREN forecast. – [1]Not seasonally adjusted.

The ECB will raise its key interest rate only modestly

The ECB has started a phase of monetary tightening in December 2005. The rapid expansion of credits and the risk of higher wage increases will make the ECB inclined to push the key interest rate upwards further. On the other hand, headline inflation is expected to remain below 2% and the end of monetary tightening in the US could discourage the ECB to increase rates one more. The EUREN institutes assume that the ECB will raise its key interest rate once more by 0.25 percentage points in the spring of 2007. After that it will keep it at this level. Long-term interest rates are forecasted to increase slightly in the wake of higher US rates. As a result, the yield curve would be slightly positive at the end of 2007.Of course, this projection is conditioned by the assumption that oil price is stable. If it were again on the rise in 2007, pushing headline inflation higher than expected, the Federal Reserve and even more probably the ECB would continue to increase their key rates.

Graph 4

Euro area: Unemployment rate[1]
1999 to 2006



Source: European Commission. – [1]Seasonally adjusted.

Exports are expected to loose momentum

Under the interest rate scenario underlying our forecast the Euro exchange rate against the Dollar can be supposed to be pushed upwards in the first half of 2007. However, the EUREN institutes see no strong appreciation but forecast a stabilisation around 1.35 Dollar per Euro in the second half of the year. Nevertheless, the appreciation will translate into a loss of markets shares of European exporters. In particular the depreciation of the Yen against the Euro in 2006 has already increased the competitive pressure on the Euro area exporters. This effect, however, is expected to alleviate in the course of 2007 as we assume the Yen will appreciate against the Euro again. Because of the slowdown of world trade growth and an erosion of price competitiveness, the Euro area exports would grow only by 5.6% in 2007, compared to 8.4% in 2006.

Investment still on the rise although rates moderate

With capacity utilisation rising further and financial conditions still being favourable we expect the upswing in investment to continue in 2007. In particular investment in equipment will remain strong, although growth should loose momentum in the course of the year. In Germany, investment is stimulated since 2006 by favourable depreciation rules which will be valid until the end of 2007 only. Therefore we expect companies to increase fixed capital formation in the final quarter not to miss this deadline. Concerning the housing sector, a deceleration can be expected in previously booming countries as Spain. Its negative effect on the Euro area construction sector can partly be offset by the stabilisation of the German market, which had registered a severe contraction during the last ten years.

Fiscal policy will take a more restrictive stance

Following the adjustment programs that will be implemented in some countries in 2007, fiscal policy can be expected to have a more restrictive stance. In particular in Italy the government has set into force measures to consolidate the budget. In Germany, the fiscal impact of higher taxes and the cutting of subsidies will not be offset by lower contributions to the unemployment insurance and additional spending on R&D and family aide. The restrictive effect is estimated to be about 20 bn Euro. According to calculations by the European Commission, the cyclical adjusted public, which we use as a measure of policy stance, will be reduced by 0.5% of GDP.

All in all, EUREN forecasts a continuation of the upswing in the Euro area, but at lower rates. GDP is expected to grow by 1.9% in 2007, after a 2.7% rise in 2006 which was more than one percentage point above the annual average of the last five years. The quarterly profile will be characterised by slower growth in the first half of the year, which reflects the changes in fiscal policy in Germany and Italy. However, the upswing will remain robust, which constitutes an acceleration in the second half of 2007. At the end of the year, an annualised rate of about 2% is forecasted, which is around the growth potential.

This forecast is based on all information available before the 5th January

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COE-Rexecode Leading Indicator for the Euro Area

The leading indicator for the Euro area (IARC) is used to anticipate the next economic slowdown[1]. In December the indicator stands at 54.6, down from 55.2 in November. After a period of doubt about the future between July and September, when the IARC indicator was close to 60, the latest figures indicate that the possibility of a slowdown in the next nine months has decreased. This implies that the growth rate of the Euro area, even though it is forecasted to decrease slightly in 2007, can be expected to stay above trend growth, which is estimated at 1.7%.

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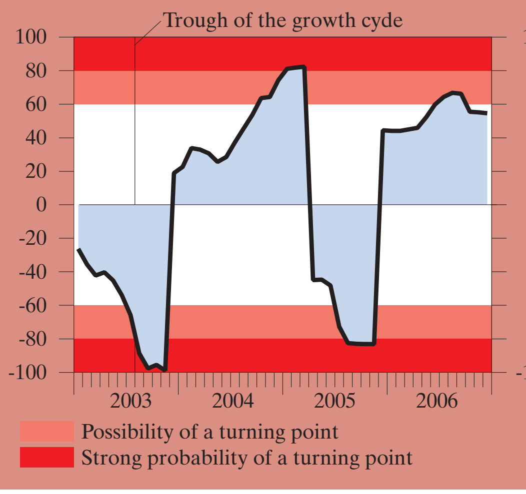
[1]An economic slowdown occurs when the growth rate decreases under the GDP trend growth rate.



Forecast of the EUREN/CEPREDE High Frequency Model

Last update: 10 January 2007

	GDP (year on year)			
	06Q2	06Q3	06Q4	07Q1
jul-06	2,29	2,29	2,37	
aug-06	2,70	2,63	2,48	
sep-06	[2,7]	2,54	2,41	
oct-06		2,73	2,66	
nov-06		2,83	2,81	2,78
dec-06		[2,6]	2,68	2,61
jan-07	[2,8]	[2,7]	2,78	2,86

	GDP (quarter on quarter)				2006
	06Q2	06Q3	06Q4	07Q1	
jul-06	0,69	0,71	0,37		2,24
aug-06	1,10	0,63	0,15		2,48
sep-06	[0,9]	0,64	0,17		2,51
oct-06		0,75	0,26		2,57
nov-06		0,73	0,38	0,72	2,64
dec-06		[0,5]	0,34	0,87	2,54
jan-07	[1,0]	[0,5]	0,48	0,88	2,62

In brackets: GDP-Data published by EUROSTAT.

The January update of the EUREN/CEPREDE model confirms the estimates published in the previous EUREN-News. The latest figures indicate that the Euro area most probably has grown in 2006 at an annual rate of 2,6%. The forecast for 2006 Q4 is revised upward slightly. The estimate for 2007 Q1 shows that the upswing is set to continue; the year over year rate is 2,8%, which is above the December estimate. However, the model has not fully incorporated yet that private consumption can be supposed having picked up in Germany in December, because of the VAT increase on 1 Jan. 2007. Hence, it can be expected that the estimate for 2006 Q4 will be revised upward in the next month whereas the 2007 Q1 estimate might be too optimistic.

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Impressum
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