Editorial: Outlook for 2008 – Financial turmoil will take its toll

As conditions in international financial markets remain fragile, any assessment of the future performance of the world economy depends on the depth of a US economic downturn and on the likelihood and the magnitude of a global spillover. There is little doubt that the US economy is in a phase of lower growth. The housing market is undergoing a severe downturn, and consumer price inflation has reached four percent. Private consumption in the U.S. is particularly vulnerable to these developments. Therefore, most forecasters expect GDP growth of only 1% on an annual base in the final quarter of 2007 and the first quarter of 2008.

What about the rest of the world? Can it decouple? Are we observing an asymmetric global economic downturn?

The immediate effects of the financial and banking crisis, at the global level, have, so far, been largely confined to the financial sector. The most immediate global effects relate to a general tightening in credit conditions.

Even though the economies in Asia and Europe are in a relatively strong position to avoid a severe downturn, one should expect some reduction in economic growth in both regions. Given its reliance on US imports, Asia will be mainly affected through the trade channel, in the case of a sharp downturn in US consumption. For Europe, financial markets can be expected to be the most important transmission mechanism. Tight credit conditions and higher costs of borrowing most probably will affect investment more than consumption.

Even though economic conditions in the Euro area remain reasonably robust, there are already some signs of a slowing of growth, particularly in the housing market. For the next few quarters, economic activity in the Euro-area is expected to moderate.

The rise in global inflation is an additional cause of concern. Inflation expectations are rising everywhere, fueled by the price of oil and food.

Will inflation expectations continue to rise?

In the Euro area food and fuel prices keep inflation persistently above the ECB target. At the same time employment is growing at the strongest pace since 2001. There is already some evidence that both developments start to spill over to wages. The period of moderate wage increases may be coming to an end. And this may cause a cost push in the Euro area.

Under these circumstances, the possibilities of monetary policy to react to an economic slowdown are limited. The inflation outlook justifies a neutral policy stance at best. Therefore, using money market operations to react to the financial crises by providing ample liquidity to the markets may be the best the ECB can do currently, as this is not in conflict with its price stability objective.

In conclusion, the Euro area economy is still underpinned by strong fundamentals, but recent developments in financial markets will take their toll on real growth in the coming months. According to our forecasts, economic growth in the euro area is expected to decelerate from 2.6% in 2007 to 1.9 in 2008.

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1 This forecast was finished on December 20th, 2007.

The EUREN Forecast Winter 2007/08

World economy still growing strong, but loosing momentum

During the course of 2007 some kind of global decoupling seems to have taken place. On the one hand, industrialized countries experienced a slowdown, while on the other hand, emerging countries continued to grow strong, contradicting their usual procyclical movement with the US economy. However, as a whole, the world economy lost momentum.

The main reason for this deceleration has been the slowing of growth in the US, which partly was caused by the subprime crises. Nevertheless, the US economy grew by 4.9% in the third quarter, as exports accelerated strongly as a consequence of the strong depreciation of the dollar. Moreover, the negative effects of the subprime crises were partly offset by still positive developments in the labour market. Yet, subsequent quarters are likely to be less buoyant as it seems to be difficult to maintain the same export growth rates and consumption expenditure can be expected to suffer from a slowdown in employment growth. In all, the US economy is expected to grow with 2.3% in 2007 and 2.1% in 2008.

The Federal Reserve has acted quickly to cushion the consequences of the subprime crisis by cutting interest rates sharply. Until the end of 2007 the monetary committee has lowered the target for the federal funds rate to 4.25%. For the next months we expect additional cuts. But there still are concerns that the liquidity-crisis on the money market will spill over to credit supply, so that the interest rate cuts may not have the expected effects. The growing interest rate-differential has induced a strong appreciation of the euro to at most 1.49$/ . However, the EUREN institutes expect a slight appreciation of the dollar during the course of 2008.

Table 1

Exogenous and international variables
Percentage changes unless otherwise indicated

	2005	2006	2007	2008
World trade	7.5	9.2	7.5	7.0
United States				
GDP	3.1	2.9	2.3	2.1
3m interest rates	3.6	5.2	5.3	4.1
10y Gvt bond yield	4.3	4.8	4.6	4.4
Japan				
GDP	1.9	2.2	2.0	1.7
3m interest rates	0.1	0.3	0.8	1.0
10y Gvt bond yield	1.4	1.7	1.7	1.7
China, GDP	9.9	11.1	11.3	10.5
US dollar/euro	1.24	1.26	1.37	1.42
Yen/US dollar	110.8	116.2	117.6	112.1
Oil price Brent US$/barrel	55.2	66.3	72.7	90.0
Percentage changes	42.4	20.1	9.7	23.8

Source: OECD, IMF, EUREN forecast.

Expansion in the emerging economies as well as developing countries remained strong. In particular, China's GDP grew by 11.5% in the third quarter of 2007, fuelled by both internal and external demand. This rate was only slightly lower than in the previous quarter. For 2008, we forecast GDP to grow at a rate of 10.5%. India is expected to show a similar profile on a somewhat lower level, so that the annual rate may be around 9%. Taking into account the increasing importance of these countries for the international economy, world trade is likely to grow with 7% in 2008 (after 7.5% in 2007), which is once again above the long term average.

Inflation edged up in almost all countries in recent months. Driving forces were another increase of the oil price peaking at hundred dollars per barrel, and a hike in food prices. The latter is caused by several factors, such as crop failure above all in Australia, an increased demand for agricultural commodities to produce bio fuel, and, finally, a stronger demand for cereals from emerging markets. Futures contracts as well as lower growth, however, speak in favour of an easing of inflationary pressures in the course of 2008. This forecast is based on the assumption that oil prices will fall slightly to 90$ per barrel.

Slight attenuation in Euro area economic activity

The crisis in the U.S. real estate sectors is likely to affect the Euro area economy via two channels. Firstly, a slowdown in the US in combination with the devaluation of the Dollar results in a lower demand for European exports, both directly and indirectly via third-country effects. Secondly, some European banks are engaged in the US subprime market and hence have to deduct for depreciation which might bring about corresponding adjustments in their workforce as well as credit supply.

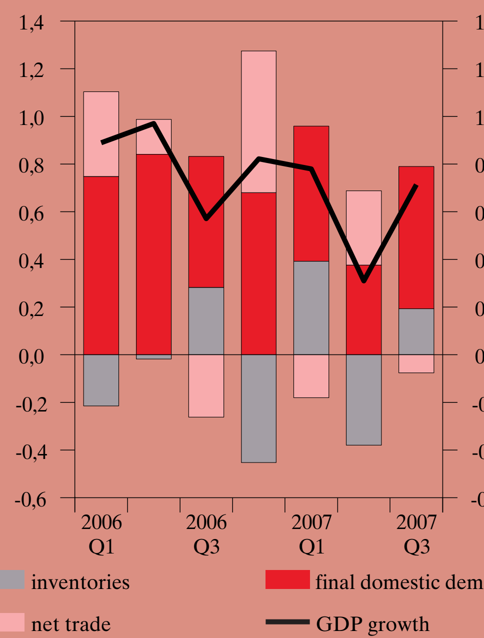
Until now, the negative impact seems to have been limited. In the third quarter of 2007, the Euro area economy expanded by 2.4 % on an annual basis and thus more rapidly than during the second quarter and also slightly stronger than trend growth. In fact, exports have recovered, even within a less favourable international environment, in particular despite the appreciation of the Euro. However, imports accelerated and net trade in sum weighed on growth (graph 1). The latter was due to strong growth in equipment investment, which exhibits a high import content. However, construction investment, in particular housing investment, weakened. Whereas private consumption was particularly slack at the beginning of the year, which reflected the increase in VAT in Germany, it recovered in subsequent quarters, fuelled by buoyant employment growth. All in all, domestic demand remained the driver of growth in the Euro area.

In the third quarter of 2007, for which the most up to date figures are available, employment grew at a quarterly rate of 0.3%, which is less buoyant than before. However, the latest revision shows an even stronger pickup in employment at the beginning of 2007, owing to more favourable figures for the construction sector. Therefore, the recently lower figure do in our view not indicate the start of a deterioration of the labour market situation. The European Commission's surveys still show positive employment expectations and employment growth was still above historical standards. Inversely, the unemployment rate in the Euro Area declined to 7.2 % in November. Although the series was quite substantially revised upwards due to a change of the census in Germany[2], this is the lowest level since the introduction of the harmonized labour market statistics. More recent figures still show a positive underlying trend. After the reduction of unemployment rather stalled during spring and summer, there was again a noticeable drop in in the last months of 2007. We assume the unemployment rate to be already slightly below the NAIRU, which is 7.6% according to our estimate. We therefore expect a somewhat higher inflationary pressure stemming from wage growth in 2008.

Graph 1

Euro area: Real GDP growth and contributions

2006 and 2007; %



Source: Eurostat.

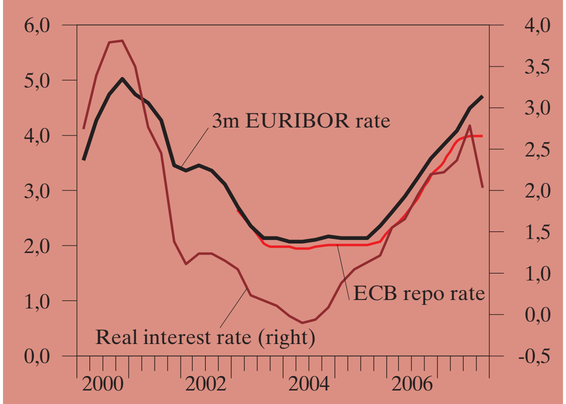
2 The source of the German figures is now the Labor Force Survey (LFS) and is more in line with registered unemployment.

Monetary authority has to deal with a dilemma

The European Central Bank, contrary to its American counterpart, kept interest rates stable since the outbreak of the real estate crisis. But the ECB postponed a interest rate rise it had already announced for autumn of 2007. It justified this decision with the risks stemming from the real estate market in the US, in particular with the tensions on the money market which emerged because of uncertainty about the banks' engagement in the US subprime market. As an additional measure the ECB repeatedly provided liquidity to the money market. However, it has not been able to calm the market up to now. Recently, the financial turmoil even aggravated and the spreads between uncollateralized EURIBOR-rates and collateralized rates like the EUREPO widened further (graph 2). Banks in the Euro area reacted to the rise in refinancing costs with a more restrictive lending policy. Surveys point towards a worsening of credit conditions in particular for large companies whereas regulations for consumers deteriorated only slightly.

Graph 2

Euro area: Short term interest rates
2000 to 2007; in %



Source: ECB.

Meanwhile, inflation rose sharply. In December, the harmonized consumer prices index was 3.1% higher than one year ago. The increase was mainly caused by higher energy and food prices. In the short term, the EUREN institutes expect the food prices to rise even further, as increasing costs of cereals will translate into higher meat prices. Furthermore, agricultural supply is presumably not as flexible in the short run. As the ECB has no impact on raw material markets, though, it will not react to the higher inflation as long as the expectations on future prices are consistent with price stability in the medium term. The Consumer Survey of the European Commission, however, shows that inflation expectations over the next 12 months have risen markedly since August.

The ECB therefore is in a dilemma of higher inflation expectations on the one hand and a less buoyant economic activity on the other. As the aftermath of the subprime crisis is likely to be felt until the middle of 2008, the EUREN institutes expect the ECB to maintain interest rates at their current level. For the second half of 2008, we forecast inflation rates to come down somewhat, as is indicated by future contracts on agricultural commodities. Therefore we anticipate no change in the ECB's key interest rates.

Fiscal stance becomes loose

Public finances in the Euro Area improved markedly in 2007. We estimate the aggregate fiscal deficit to have declined by 0.7 percentage points to 0.8 %. The reason for the improvement is threefold. Firstly, buoyant growth led to lower cyclical expenses as well as higher tax receipts. Secondly, temporary measures like the repayment of VAT on company cars in Italy, which put a strain on the 2006 budget, have been discontinued. Thirdly, the fiscal stance has been strongly restrictive in Germany, and to a lesser extent in Portugal. Overall, the cyclically adjusted budget balance decreased by about 0.5 percentage points.

The efforts to improve the fiscal position are, however, not adequate in most of the countries experiencing a medium-term unbalanced budget. This especially holds this year, when only Greece is likely to reduce its structural deficit according to the Maastricht Treaty by 0.5 percentage points. Other countries use additional receipts to reduce social contributions or tax rates for companies. The EUREN institutes are therefore expecting that the cyclically adjusted budget balance will not be further reduced next year[3]. As the Euro area economy will grow less buoyantly in 2007, the aggregate Euro area deficit will remain stable, too.

Slight moderation of activity at the end of 2007 and the beginning of 2008

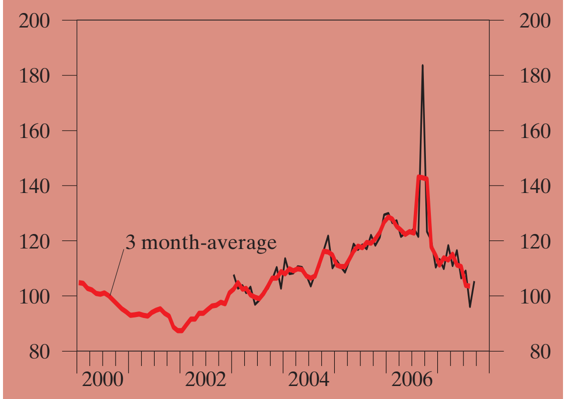
For the next months, the EUREN institutes forecast the expansion in the Euro area to loose speed. This slowdown is caused by several factors. The first is the appreciation of the Euro. The euro-dollar exchange rate has recently been close to 1.50 $/€. In nominal effective terms, the Euro exchange rate has increased by 6.5% between January 2007 and December 2007. This should translate into a lower world market share of Euro area exporters. Furthermore, we expect world trade to be less dynamic in 2008. Consequently, exports are expected to increase by only 5.1% in 2008, after 6.1% in 2007.

At the same time, internal demand is forecasted to be dampened by two factors. Firstly, our last forecast, which was published in the summer of 2007, was based on the assumption that – following the wage negotiations in Germany – wage growth would accelerate slightly in 2008. This in combination with higher employment fuelled the expectation that private consumption would be a key element of resilience of economic activity in the Euro area

Graph 3

Euro area: Housing permits

2000 to 2007; 2000=100

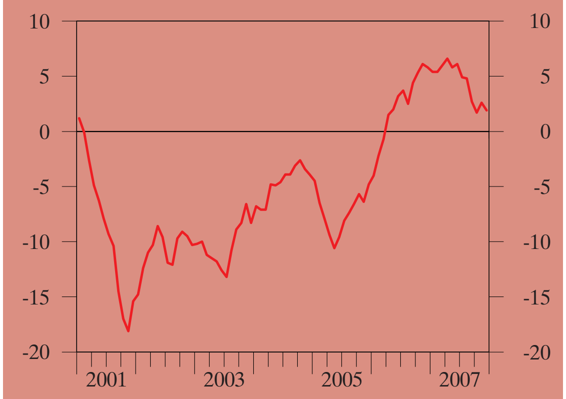


Source: Eurostat.

Graph 4

Euro area: Industrial confidence indicator

2001 to 2007



Source: Eurostat.

next year. Yet, recent hikes in food and energy prices have pushed up inflation thus causing a drop in households' purchasing power. Consumption of private households will thus grow by only 2% in 2008. Although this increase is one percentage point higher than the 2001-2006 average, it will only be slightly higher than the growth rate of households' spending in 2006.

A second internal factor for a moderation of economic growth stems from the housing market, which has reached a turning point in the Euro area (graph 3). In the past, housing market trends in the Euro area member countries have differed markedly. Nevertheless, construction has been a leading sector of economic activity in the Euro area since 2003. Since autumn 2006, however, housing permits show a clear downward trend. This indicates a deceleration in residential investment. Construction investment altogether should have grown by about 3% in 2007 and presumably by only 1.5% this year. This implies a particularly pronounced adjustment in those countries that have benefited from a boom

3 For a more detiled analysis of the fiscal policy on the Euro area see EUREN-News #4/2007.

in the housing sector, mainly in Spain and in Ireland. Our forecast entails that between 2006 and 2008, the contribution of residential investment to total investment growth would be reduced by one percentage point.

After the strong growth in 2007Q3, the economic expansion is supposed to have been a bit weaker in the fourth quarter and it will presumably also be somewhat lower in early 2008. This forecast is in line with the Coe-Rexecode leading indicator which points to a fall of GDP growth below the trend (estimated at 2.3%) in the coming months. The EUREN/Ceprede high frequency model indicates a quarter on quarter GDP increase of 0.5% in 2007Q4. Although the model is a bit more optimistic for 2008Q1, some specific factors which cannot be anticipated by the model could dampen GDP growth. For instance, business investment in Germany is expected to be lower for some months because of less favourable depreciation rules coming into effect in January 2008 which encouraged companies to bring forward investment expenditures into 2007.

In the second half of 2008, the drag on economic growth should progressively disappear. Firstly, a stabilisation of interest rates in the US is assumed, which may bring the depreciation of the dollar to an end in the mid of 2008. This could alleviate the competitive pressure on Euro area exporters. Secondly, as we suppose the oil price to stabilize and the agricultural commodity markets to be more in balance, inflationary pressures should abate. This will strengthen households' purchasing power. As a result, GDP growth should accelerate in the second half of this year to a rate close to potential growth (around 2%).

All in all, GDP growth in 2008 is projected to reach 1.9% after 2.6% in 2007 and 2.9% in 2006. Yet, this implies that the output gap is still slightly negative at the end of 2008. This follows from the European Commission's latest forecast, which predicts under the assumption of a GDP growth of 2.2% that the output gap will be –0.1% in 2008. As the EUREN forecast is less optimistic, it implies a widening of the output gap, to about –0.4%.

The main risk of this scenario regards the international environment. If the emerging countries grow weaker than expected, this, together with rather sluggish US growth, will put an additional drag on the Euro area economy. The constitution of the banking system is another major risk.

Table 2

Euro area forecast

	2004	2005	2006	2007[1]	2008[1]	2007				2008[1]			
						I	II[1]	III	IV[1]	I	II	III	IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	1.5	1.6	1.9	1.5	2.0	0.0	0.6	0.5	0.5	0.4	0.5	0.6	0.6
Public consumption	1.3	1.4	1.9	2.0	2.0	0.9	0.2	0.6	0.5	0.5	0.5	0.5	0.6
Gross fixed capital formation	1.9	2.8	5.2	5.0	2.9	1.8	0.0	0.9	1.4	0.3	0.8	0.7	0.6
Domestic demand	1.6	1.8	2.7	2.4	2.3	1.0	0.0	0.8	0.8	0.4	0.6	0.5	0.5
Exports	6.5	4.7	8.0	6.1	5.1	0.9	0.8	2.5	0.5	1.2	1.3	1.4	1.5
Imports	6.3	5.5	7.6	5.6	6.1	1.4	0.1	2.7	1.2	1.1	1.8	1.5	1.6
GDP[2]	1.8	1.6	2.9	2.6	1.9	0.8	0.3	0.7	0.5	0.4	0.4	0.5	0.5
Unemployment (% of labour force)	8.9	8.9	8.3	7.5	7.1	7.7	7.5	7.4	7.3	7.2	7.1	7.0	6.9
Compensation per employee[2], yoy	2.1	1.6	2.2	2.0	2.3	2.1	1.8	2.1	2.1	2.2	2.3	2.3	2.3
Consumer price (HICP), yoy	2.1	2.2	2.2	2.1	2.1	1.9	1.9	1.9	2.9	2.6	2.0	2.0	1.9
Current account balance (% GDP)	0.4	0.7	–0.1	0.1	–0.2								
3m interest rates (% per annum)	2.11	2.19	3.08	4.28	4.23	3.82	4.07	4.50	4.70	4.50	4.20	4.10	4.10
ECB repo (end of period)	4.14	3.44	3.86	4.30	4.33	4.08	4.43	4.48	4.20	4.30	4.30	4.30	4.40
10y Gvt bond yields (% per annum)	2.00	2.25	3.50	4.00	4.00	3.75	4.00	4.00	4.00	4.00	4.00	4.00	4.00

[1]EUREN estimates. – [2]Not seasonally adjusted.

Although a credit crunch is not the most likely scenario for Europe, the latest ECB bank lending survey points towards tighter credit conditions, especially for large firms.

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COE-Rexecode Leading Indicator for the Euro Area

Since last May 2007, all of the components of the leading indicator for the Euro area have successively anticipated an economic slowdown[1], even lately the stock market index. Since the underlying growth rate of the Euro area is now heading below the trend rate, which is estimated to be 2.2%., the indicator has now turned to negative and one can look forward point to the trough of the current slowdown. This will be the case when it will surpass the –60 and then the –80 threshold which means that it sends a strong signal of an imminent economic recovery. In November 2007, the indicator was at –33,6 and thus far away from these thresholds, showing no sign of possible recovery in the short term.

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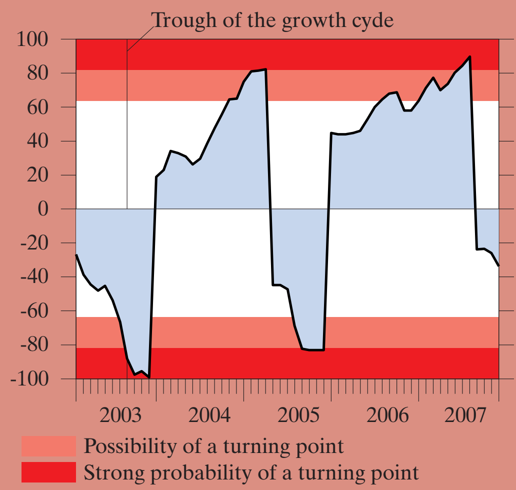
[1]An economic slowdown occurs when the current GDP growth rate decreases under its trend growth.



Forecast of the EUREN/CEPREDE High Frequency Model

Last update: December 15, 2007

	07Q1	07Q2	07Q3	07Q4	2007	08Q1	08Q2	2008
nov–06	2.78; *0.72*	;	;	;				
dec–06	2.61; *0.67*	;	;	;				
jan–07	2.86; *0.88*	;	;	;				
feb–07	2.85; *0.64*	;	;	;	2.51			
mar–07	3.00; *0.50*	2.86; *0.85*	;	;	2.62			
apr–07	2.81; *0.31*	2.38; *0.57*	;	;	2.27			
may–07	3.05; *0.55*	2.83; *0.78*	;	;	2.56			
jun–07	[3.0; *0.6*]	2.78; *0.68*	2.53; *0.35*	;	2.61			
jul–07	;	2.74; *0.64*	2.64; *0.50*	2.31; *0.57*	2.67			
aug–07	;	2.66; *0.46*	2.51; *0.45*	2.28; *0.67*	2.61			
sep–07	[3.2; *0.7*]	[2.5; *0.3*]	2.34; *0.44*	2.16; *0.72*	2.51			
oct–07	;	;	2.41; *0.51*	2.13; *0.51*	2.56	2.07; *0.75*		2.05
nov–07			2.59; *0.69*	2.30; *0.51*	2.68	2.28; *0.78*		2.03
dec–07	[3.2; *0.8*]	[2.5; *0.3*]	[2.7; *0.7*]	2.27; *0.47*	2.67	2.23; *0.76*	2.15; *0.22*	2.04

In brackets: GDP-Date published by EUOSTAT. In italics: quarter on quarter rates.

The December update of the EUREN/CEPREDE model forecasts for 2007Q4 a somewhat lower quarter on quarter rate than the in the previous months. For 2008Q2 the model is somewhat more optimistic. However, the indicators the model is based on do not contain qualitative information such as the change in the depreciation rules which can be expected to dampen investment in Germany. The first estimate for 2008Q2 the reveals a GDP rate which is below trend growth confirming the result of the COE-Rexecode indicator.

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Impressum
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