Editorial: An upswing with several question marks

2009 will enter economic history as the year with the worst performance since World War II, with the noticeable exception of China and few other emerging countries. On the positive side, confidence grew in the second half of the year indicating that the worst might be over. Global output seems to be on the rise again. In the Euro area, GDP increased in the third quarter for the first time since the beginning of 2008. Despite all signs of relief, several questions arise about the sustainability and the strength of the upswing. We focus here on four topics among a long list of hot issues.

What is the potential growth in the Euro area?
In EUREN News 3/2009 we discussed the consequences of the crisis on potential growth. It is now widely accepted that a sharp recession can affect potential growth, through a lower increase of the capital stock and also because of the consequences high unemployment has on the skills of the labour force in the long run. Indeed, the level of activity remains quite low compared to the pre-crisis level. For instance, industrial order books in the Euro area last November were 25% lower than at their peak reached two years before.

Will global imbalances lead to new bubbles?
Imbalances in the global current accounts have been an important factor leading to the crisis: the huge U.S. current account deficit was partly financed by China which thus recycled its trade surpluses. Hence, it fed a dangerous cycle, keeping interest rates at a very low level. During the crisis, global imbalances have been reduced, but they have not disappeared as China keeps its exchange rate fixed against the U.S. dollar despite a large trade surplus, and thus floods the markets again with cheap money. So, there is still the risk of a new bubble in one of the asset markets.

How to alleviate the public debt burden?
Economic policy has taken an extremely stimulating stance to boost the economies. In the wake of the depth of the crisis it was wise to do so but now the time has come to design an exit strategy. For monetary policy, the first step will be to cut back the quantitative easing measures to reduce liquidity. On the fiscal side, part of the problem might disappear with the upswing gaining momentum. Tax receipts reacted very strongly to the recession. For instance, the income tax paid by corporations in France was nearly halved in 2009. Of course, a reverse effect might provide better news than expected on public finances in 2010 and 2011. But the level of the fiscal deficit is so high in some countries, that a reduction of fiscal imbalances will require a restrictive stance for several years.

How is the business cycle influenced by global changes?
Despite the depth of the recent recession, it must not be forgotten that structural changes are on the way. China has become the number one exporter in the world in 2009. Will it also become a locomotive for the world economy? At the same time, China has also become the biggest car market, with significant consequences for climate change. Another question is whether the increasing pressure to "green the economy" will trigger technological changes that boost growth, or will it add additional costs? The main challenge for forecasters is always to discriminate in real time to what extent economic developments reflect the usual business cycle, and how much they can be attributed to structural changes. This time, the task is especially tough.

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The EUREN Winter Forecast 2010

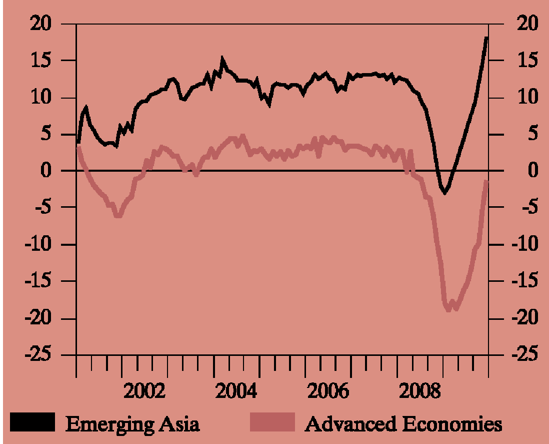
International economy is improving

In the second half of 2009 the international economy recovered somewhat from the deep recession it had fallen into during the winter of 2008/09. Production started to increase and world trade revived. However, the level of economic activity is still considerably lower than it was before the crisis, and not all economies are participating in the upswing. On the one hand, production is growing fast in many Asian countries, which are particularly benefiting from the large stimulus package in China (Graph 1). On the other hand, most industrialised countries are not fully out of the doldrums. Although rising slightly, capacity utilisation is still extremely low.

For 2010, the EUREN institutes expect expansion to remain rather modest in the industrialised countries, as it still is burdened by a number of factors[1]. Unemployment will continue to rise for some time, dampening consumer demand. Investment should have reached a trough but will only recover sluggishly, given the low capacity utilisation and tight financial conditions for companies, as the banking sector is still under stress and the solvency of many creditors was damaged by the crisis. Furthermore, fiscal policy will be less expansionary than it was in 2009. The US economy will expand slowly, and even more so the Japanese (Table 1).

Graph 1

Industry Production in Advanced Economies and Emerging Asian Markets
2001–2009; year over year change in %



Source: FERI and RWI calculations. Figures for Asia smoothed.

Table 1

Exogenous and international variables
Percentage changes unless otherwise indicated

	2007	2008	2009[a]	2010[a]
World trade	7.3	3.0	–13.0	7.0
United States				
GDP	2.1	0.4	–2,5	2.6
Inflation	2.9	3.8	–0.3	2.4
3m interest rates	5.3	3.0	0.8	0.5
10y Gvt bond yield	4.6	3.7	3.3	4.1
Japan				
GDP	2.4	–1.2	–5.4	1.3
3m interest rates	0.7	0.7	0.4	0.4
10y Gvt bond yield	1.7	1.5	1.3	1.5
China, GDP	13.0	9.1	8.5	9,5
US dollar/euro	1.37	1.47	1.40	1.42
Oil price Brent				
US$/barrel	72.4	97.6	61.0	82.0
Percentage changes	10.7	34,8	–37,5	34,4

[a]EUREN Forecast.

China was back to double-digit growth rates at the end of 2010 and it will continue to grow fast. But fiscal policy will be less stimulating here, too, reducing the pace of the expansion a bit. Nevertheless, the Asian region will continue to grow fairly strong.

Against the background of the diverging situation in the industrialised countries on the one hand and the emerging markets on the other, world trade is expected to grow at a modest rate. A good deal of the forecasted annual growth rate of 7% in 2010 results from the carry-over, which results from the recovery in the second half of 2009.

Inflation rates will most probably be significantly higher in 2010 than they were in the last year. However, this mainly reflects the fact that raw material prices are back on an upward trend, after experiencing a sharp,

1 This forecast was finalised in Vienna on January 22nd, 2010.

but relatively short decline in the second half of 2008. The EUREN institutes expect commodity prices to grow further. The oil price is forecast to reach 82 $/b (Brent) on average in 2010. But core inflation remains low in view of low capacity utilisation and a weak wage pressure due to the deteriorated labor markets. Against this background, central banks can be expected to keep interest rates low. But they will start to reverse their quantitative easing measures.

Euro area economy has left the trough of the cycle

In the Euro area, seasonally adjusted real GDP expanded for the first time in the third quarter 2009 after having contracted for five quarters. The growth of 0.4% with respect to the previous quarter (qoq) was driven by net exports and by changes in stocks, while final domestic demand (excluding inventories) declined.

The recovery was clearly led by improving prospects for the global economy. On the back of rising external demand, in particular from emerging Asia, real exports of goods and services expanded strongly by 1.3% qoq. Although imports also grew significantly by 1.2%, net exports contributed slightly to the increase in Euro area production. Recent indicators like the OECD composite leading indicator and the global Purchasing Managers' Index (PMI) for manufacturing industries indicate a continued global recovery in the fourth quarter, supporting Euro area exports.

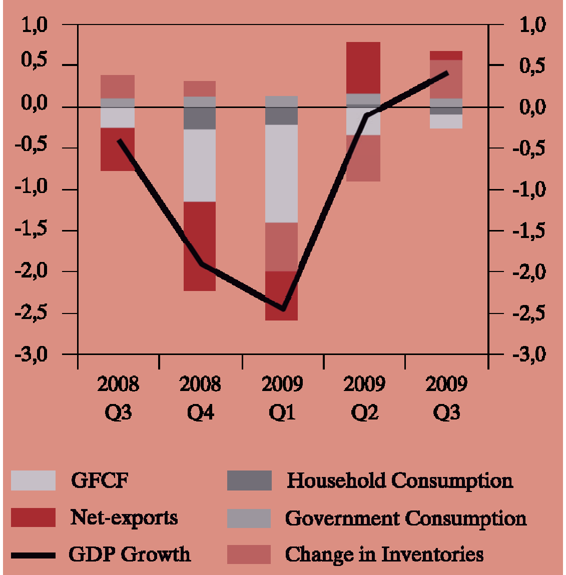
After five quarters of decline, industrial production increased in line with foreign demand by 2.3% qoq in the third quarter. In October/November the upward trend prevailed with production volumes exceeding the volume of the third quarter by 0.9% on average. Also new orders in the manufacturing sector rose significantly in the third quarter. After a dip in October, they resumed their upward trend in November, pointing to a further improvement of industrial production.

In line with rising output, firms have started to increase their capacity utilisation, which is nevertheless far below its long-term average. The still low capacity utilisation and continuously difficult financing conditions held back fixed capital formation in the third quarter, even though the decline of 0.8% qoq means a considerable slowing of the speed of decrease compared to previous quarters. The decline was the result of an accelerated contraction of both housing and non-housing construction investment. In contrast, investment in equipment increased for the first time since the third quarter 2008. However, sizeable spare capacity will probably slow capital formation in the medium term. In addition, the ECB Bank Lending Survey indicates that commercial banks in the Euro area continued to tighten their credit standards in the fourth quarter, and bank managers expect a further tightening in the first quarter 2010. As a result, it can be expected that fixed capital formation remained subdued in the final quarter.

Changes in inventories contributed positively to GDP growth in the third quarter, as the inventory drawdown slowed. This signals that companies have already adjusted their stocks to the lower demand to a large extent.

Graph 2

Euro area: GDP-Growth and its components
Contributions to Growth



Source: EUROSTAT.

Private consumption remained more or less flat in the third quarter. Seemingly, the deterioration of the labour market started to outweigh the positive effects of the fiscal stimulus measures taken by several Member States, while the positive effects of reduced energy prices on real income began to offset. Employment continued to decline by 0.5%, the same rate as in the second quarter. In the fourth quarter, the labour market deteriorated further. The unemployment rate continued to increase, reaching 10% in December. Weak retail sales and car registrations indicate that private consumption remained sluggish in recent months. On the positive side, consumer confidence indices improved recently.

All in all, the positive trend in GDP growth in the Euro area should have resumed. However, this improvement is to a large extent owed to a strong policy support and temporary factors like the adjustment of stocks.

There's no room for additional impulses of economic policy

In reaction to the sharp economic contraction, monetary and fiscal policy gave stimuli that were unprecedented in peacetime. Interest rates are at their historical lows; in addition large liquidity support measures and quantitative facilities support the financial markets. At the same time, fiscal deficits soared and enormous public debts were accumulated. It is evident that these policies cannot be sustained. The main task of monetary and fiscal policy is now to make clear their exit strategies, i.e. how, when and how fast to reduce the policy stimuli.

Focusing on monetary policy, the ECB's Repo rate went down to its historic low in May 2009 and it has been kept at this level. As inflation is low and inflation expectations are still anchored, these low rates can be maintained for some time. The EUREN institutes estimate inflation at around 1.3% throughout the year, well below the ECB target of 2%. Therefore they do not foresee any change in the ECB Repo rate during 2010.

Table 2

General Government Balances
2007 – 2010; in % of GDP

	2007	2008	2009[a]	2010[a]
Austria	–0.6	–0.4	–4.3	–5.5
Belgium	–0.2	–1.2	–5.9	–5.8
Finland	5.2	4.5	–2.8	–4.5
France	–2.7	–3.4	–8.3	–8.2
Germany	0.2	0.0	–3.4	–5.0
Greece[1]	–3.7	–7.7	–12.7	–8.7
Ireland	0.3	–7.2	–12.5	–14.7
Italy	–1.5	–2.7	–5.3	–5.3
Netherlands	0.2	0.7	–4.7	–6.1
Portugal	–2.6	–2.7	–8.0	–8.0
Spain	1.9	–4.1	–11.2	–10.1
Euro Area	–0.6	–2.0	–6.4	–6.9

Sources: European Commission Forecast Autumn 2009. – [1]Updated Stability Programme January 2010. – [a]Forecast.

However, this does not mean that the ECB will not tighten its policy during 2010. Before changing interest rates it will cut back its liquidity providing measures. Thus signalling a less expansionary policy, the 3 months Euribor rates as well as 10 years bond yields can be expected to rise somewhat towards the end of the year. The annual average, however, will slightly be lower than in 2009.

Regarding fiscal policy, the majority of Euro area members have implemented fiscal packages in the past year that will provide stimuli for 2010, too. On a Euro area average, fiscal deficits in relation to GDP are estimated to be more than 4 percentage points higher in the third quarter of 2009 than they were one year before. In some countries, e.g. Spain, which was hit particularly hard, the swing was even more than 8 percentage points of GDP.

Against this background, it does not seem realistic that additional measures will be taken. On the contrary, we expect fiscal policy to get more restrictive in some countries to address the huge imbalances. For 2010, the EUREN institutes therefore expect fiscal policy to be only slightly expansionary, mainly due to measures already implemented in 2009.

All in all, the financial crisis puts a burden on fiscal policy for the years to come. In the Euro area, the average debt to GDP ratio has risen by about 10 percentage points within one year. At the upper end, Ireland can be found with an increase by more than 23 percentage points by the third quarter of last year. At the other end, Germany's and Austria's indebtedness grew by just 6 percentage points.

A slow recovery for Euro area

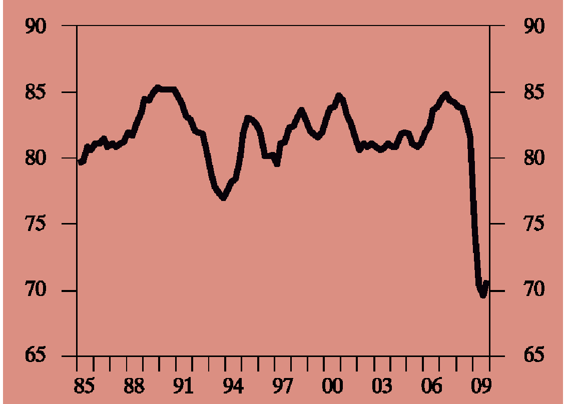
According to the EUREN institutes forecast, the Euro area economy will slowly recover in 2010, after the sharp recession of the past year. The improving international economic environment is leading the upswing of the Euro area economy, which is already visble in the rebound in exports since last summer. The improvement observed in the second half of the year helped to limit the losses of activity. However, they are huge: the EUREN institutes estimate a reduction in Euro area GDP of 4% on average in 2009.

Due to the profile of activity in 2009, the year 2010 will benefit of a positive carry-over in terms of annual average growth. Nonetheless, it should be kept in mind that some of the factors that helped the upswing observed in the second half of 2009 were temporary, with only transitory effects. Some of the incentives introduced expired at the end of 2009 and will dampen demand in the first months of 2010 (e.g. the wreckage premium for used cars). Another aspect to consider are price developments: after a period of very moderate inflation (even a slight decrease of the price level in the central months of 2009), we should expect a phase of stronger inflation; at least in the first part of the year, given the base effect for commodity prices. Consumer prices should grow at a rate of 1.3% on average in 2010, far below the target of the ECB, but with some acceleration with respect to 2009. These two effects can drag some of the recovery of private consumption: but a more relevant drag for this component comes from the labour market evolution.

Even in a scenario of a continued upswing in the growth rates, one should keep in mind the huge losses in production, due to which levels of economic activity are still far below those observed before the crisis. Lower activity, even if improving, means an excess of production capacities and thus the need for further corrections in labour demand. Therefore, the reduction in employment can be expected to continue in 2010, given the lagged reaction of the labour market to activity. The increase in unemployment, which was held back in the last months in many countries (as Germany, Italy or Austria) by the use of special arrangements such as short-time work, will continue, and the unemployment rate is likely to reach 10.4% at the end of the year. The loss of jobs and only weak growth of real wages (an acceleration is expected only in Germany, due to the statistical effect of outphasing of the short-time work), will drag private consumption growth, which will be limited to merely 0.2% according to the EUREN forecast.

Graph 3

Euro area: Capacity Utilisation in Industry
1985–2009; in %

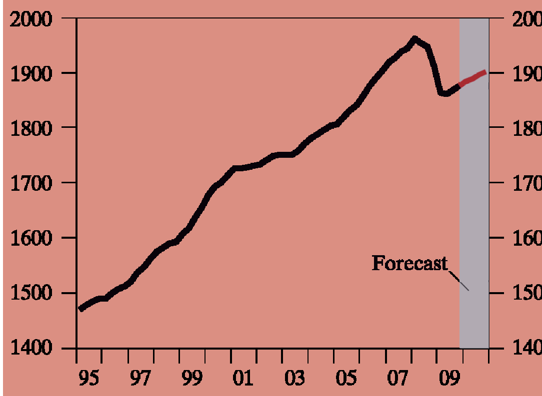


Source: ECB. European Commission Survey.

The forecast of investment hides diverging trends in the two main components that tend to counterbalance each other. Investment in construction is expected to shrink further in 2010, given the negative recent trend and the continued correction in housing investment, especially in Spain and Ireland. Some improvement could be expected in non-residential construction, due to the positive effects of public investment (e.g. in Germany). For the non-construction component (mainly machinery and equipment) different factors

Graph 4

Euro area: Gross Domestic Product
1985–2009; in bn Euro



Source: EUROSTAT, EUREN Forecast.

are at work. The extremely low capacity utilisation will probably limit the pace of the recovery in the coming years, since capital formation would not need to grow too much (unless for replacement of obsolete plants or innovation investment). But given the huge decline of gross investment observed in 2009, some increase should be expected. In some countries, gross fixed capital formation will also be supported by policy measures. In Germany, more favourable depreciation rules are still valid in 2010, but will be abandoned at the end of the year, which may stimulate companies to bring forward some investment decisions. In Italy, a fiscal incentive to support investment in machinery has been renewed for 2010.

External demand will give a positive contribution to growth in 2010. An improvement in international trade in combination with a slight depreciation of the euro during the second half of the year should help the recovery of Euro area exports. Even with an acceleration of import growth, given the revival of internal demand, net exports can be expected to provide a positive and not marginal contribution to GDP growth (0.7 percentage points) in 2010.

In conclusion, the Euro area economy is on a recovery path, albeit a quite mild one. The support from policies will gradually fade, and this will further lessen the intensity of growth. The losses recorded in the annus horribilis 2009 won't be balanced before years.

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Table 3

Euro area forecast

	2007	2008	2009[a]	2010[a]	2009 I	2009 II	2009 III	2009 IV[a]	2010[a] I	2010[a] II	2010[a] III	2010[a] IV
	Annual % change (unless indicated otherwise)				q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	1.6	0.4	–1.1	0.2	–0.4	0.1	–0.1	0.1	0.0	0.1	0.1	0.1
Public consumption	2.3	2.0	2.4	1.8	0.6	0.6	0.6	0.4	0.4	0.4	0.4	0.4
Gross fixed capital formation	4.8	–0.4	–10.9	–1.4	–5.4	–1.6	–0.8	–0.6	–0.2	–0.2	0.1	0.4
Change in inventories[1]	2.4	0.6	–3.1	1.0	–2.0	–0.7	0.4	0.7	0.2	0.1	0.2	0.2
Domestic demand	0.0	0.1	–0.4	0.4	–0.7	–0.6	0.5	0.4	0.1	0.0	0.0	0.0
Exports	6.3	1.0	–13.7	5.2	–8.6	–1.2	3.1	1.2	1.2	1.2	1.2	1.2
Imports	5.5	1.0	–11.5	3.6	–7.4	–2.8	3.0	1.0	0.8	0.8	0.9	0.9
Net exports[1]	1.6	0.4	–1.1	0.2	–0.4	0.1	–0.1	0.1	0.0	0.1	0.1	0.1
GDP	2.8	0.6	–4.0	1.3	–2.5	–0.1	0.4	0.5	0.3	0.3	0.3	0.3
Unemployment (% of labour force)	7.5	7.5	9.4	10.4	8.8	9.3	9.6	10.0	10.2	10.4	10.5	10.6
Compensation per employee, yoy	2.5	3.2	1.5	1.8	1.9	1.6	1.4	1.2	1.8	1.8	1.8	1.8
Consumer price (HICP), yoy	2.1	3.3	0.3	1.3	1.0	0.2	–0.4	0.4	1.4	1.2	1.3	1.2
Current account balance (%GDP)	0.4	–1.5	–1.1	–1.0								
3m interest rates (% per annum)	4.3	4.6	1.2	0.9	2.0	1.3	0.9	0.7	0.7	0.8	0.9	1.0
ECB repo (end of period)	4.0	2.5	1.0	1.0	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0
10y Gvt bond yields (% per annum)	4.3	4.3	3.8	3.8	3.9	3.9	3.8	3.7	3.6	3.7	3.8	4.0

EUREN estimates. – [a]forecast. – [1]Contribution to growth.

New Papers from EUREN-Institutes

RWI

Forecasting Private Consumption: Survey-based Indicators vs. Google Trends

by Torsten Schmidt and Simeon Vosen

In this study we introduce a new indicator for private consumption based on search query time series provided by Google Trends. The indicator is based on factors extracted from consumption-related search categories of the Google Trends application Insights for Search. The forecasting performance of the new indicator is assessed relative to the two most common survey-based indicators - the University of Michigan Consumer Sentiment Index and the Conference Board Consumer Confidence Index. The results show that in almost all conducted in-sample and out-of-sample forecasting experiments the Google indicator outperforms the survey-based indicators. This suggests that incorporating information from Google Trends may offer significant benefits to forecasters of private consumption.

Ruhr Economic Papers #155; http://www.rwi-essen.de/rep

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Coe-Rexecode

Moderate growth of world trade in November

by Alain Henriot and Aurelie Heuze

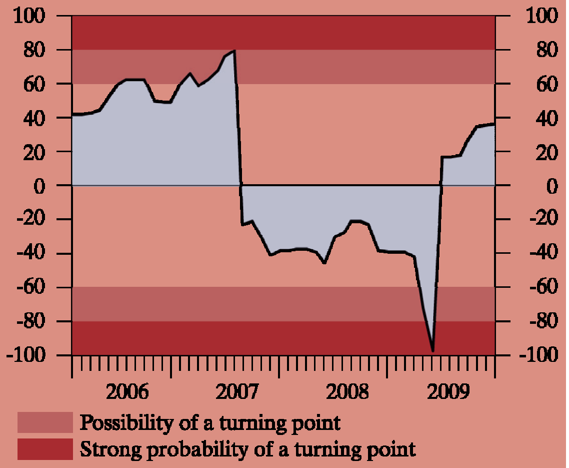
According to our estimates, world imports in volume terms recorded a moderate growth in November, quite similar to that observed in October. The increase in imports of emerging countries is somewhat higher than in developed countries. In particular, Germany experienced a strong contraction of its imports in November. Among emerging areas, the contrast is high between emerging Asia showing a progression of its purchases by 7 % compared to a year ago, and Eastern Europe whose import volumes, despite a recent relief, are still 25 % below the level observed a year ago

Coe-Rexecode World trade indicator, November 2009; http://www.coe-rexecode.fr/public/Indicateurs-et-graphiques/Indicateurs-Coe-Rexecode/Indicateur-de-la-demande-mondiale/Moderate-growth-of-world-trade-in-November

Coe-Rexecode Leading Indicator for the Euro Area

In May 2009, the leading indicator had sent strong signals that the trough of the growth cycle would be reached in the third quarter of 2009 (see EUREN-News #3-2009), implying that the underlying growth rate should overpass the trend growth rate, once the trough is reached. However, the financial crisis has substantially lowered trend growth in the Euro area. Standard filter techniques estimate it to be around 1% at the end of 2009. After a 1.7% GDP growth on an annual rate in 2009Q3, the result for the last quarter of 2009 is subject to intense speculation even if this quarter is already behind us. According to the consensus forecast the average estimate is an annual growth of 2.6%, while the Coe-Rexecode indicator of underlying growth is even over 3%. The EUREN forecast points at 2%. The EUREN projection for 2010 implies rates which are only slightly over trend growth.

Currently, the leading indicator is used to look for the next peak of the growth cycle, assuming that we are now in its ascendant phase. The leading indicator must surpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent reversal of the present rebound. In December 2009, the indicator stood at 37.1, far below the 60 threshold.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: January 21st, 2010

	2008	09Q1	09Q2	09Q3	09Q4	2009	10Q1	10Q2	2010
Nov-08	1.2	–0.2 ; *0.1*				0.0			
Dec-08	1.1	–0.6 ; *0.1*				–0.5			
Jan-09	0.9	–1.8 ; *–0.4*	–2.0 ; *–0.4*			–2.0			
Feb-09	0.8	–2.4 ; *–0.8*	–2.7 ; *–0.5*	–2.9 ; *–0.4*	–2.7 ; *–0.5*	–2.7			
Mar-09	[**0.7**]	–2.7 ; *–0.8*	–3.5 ; *–1.1*	–3.6 ; *–0.3*	–2.6 ; *–0.5*	–3.1			–0.9
Apr-09	[**0.7**]	[–2.7 ; *–0.7*]	–3.2 ; *–0.8*	–3.1 ; *–0.1*	–2.0 ; *–0.4*	–2.7			–0.5
May-09	[**0.7**]	[–3.8 ; *–1.7*]	–3.0 ; *0.6*	–2.5 ; *0.3*	–1.2 ; *–0.4*	–2.6			0.5
Jun-09	[**0.7**]	[**–4.7** ; *–2.6*]	–3.9 ; *0.6*	–2.9 ; *0.8*	–1.0 ; *0.3*	–3.1			1.1
Jul-09	[**0.7**]		–3.7 ; *0.8*	–2.3 ; *1.2*	–0.2 ; *0.5*	–2.7			1.1
Sep-09	[**0.6**]	[**–4.9** ; *–2.6*]	[**–4.7** ; ***0.8***]	–3.1 ; *1.3*	–0.7 ; *0.7*	–3.3			1.4
Oct-09	[**0.6**]			–3.2 ; *1.2*	–0.7 ; *0.8*	–3.3			1.4
Nov-09	[**0.6**]			–3.3 ; *1.1*	–0.7 ; *0.8*	–3.4			1.4
Dec-09	[**0.5**]	[**–5.0** ; *–2.4*]	[**–4.8** ; ***–0.2***]	[**–4.1** ; *0.4*]	–1.6 ; *0.6*	–3.9	0.9 ; *0.0*	1.2 ; *0.2*	0.8
Jan-10	[**0.5**]	[**–5.0** ; *–2.5*]	[**–4.8** ; ***–0.1***]	[**–4.0** ; *0.4*]	–2.1 ; *0.0*	–4.0	0.4 ; *0.0*	0.8 ; *0.3*	0.5

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.
Eurostat has slightly revised GDP figures for recent quarters showing a more pronounced slowdown at the beginning of 2009 and slightly less negative figures for the third quarter. Nevertheless, recently released indicators for the fourth quarter included in the model were worse than expected leading to a downward revision of the figures for Q4. All in all, the recovery path seems to be weaker than shown in our previous report.

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