



Editorial: What is behind the recent downturn?

Once having passed the early stages of the financial crisis, the financial markets seemed to have settled down. However, this obviously only was a short period of rest before new trouble started. Since news on public debt became increasingly alarming, concerns arose about the solvency as well as quality of sovereign debt of some Euro area members, causing large fluctuations in foreign exchange markets to the point that the spectre of an end of the single European currency appeared.

In fact, since the Euro had reached its maximum rate against the dollar late in the last year, depreciation started that worsened after the Greek debt crisis in early May. For some days, the euro even was rated below 1.20 \$/. European political leaders saw the continuity of the European currency endangered and even discussed the exit of some of its current members, with all the problems and uncertainties that would cause.

The tensions in the financial markets have forced the joint action by all Euro area members. In particular, they accelerated the process of fiscal consolidation that had become increasingly necessary after the strong expansionary policies implemented in the recent past to mitigate the effects of the crisis. Of course, the speed up of consolidation will have a negative effect on the still weak economic recovery, and it will dampen growth expectations for the next years.

At this point, one might ask for the reasons, why the financial markets reacted so hefty just at a time when there were clear signs of a recovery of the real economy.

On the one hand, the inflation risk is still very limited. Despite more and more indicators showing a recovery of activity, inflation expectations are declining to an underlying rate close to one percent. In addition, there is still considerable slack in capacity, as well as labour markets, which will

be a shield against a quick increase in wages and inflation.

On the other hand, in some sectors the problems that triggered the crisis have only partially been settled and further corrections are needed, which will also affect the real economy. Although positive macroeconomic and business data have caused some euphoria in the markets, it is plausible to assume that the deleveraging process is still in its beginning in many economies and will probably need significant time to be completed.

Finally, it is considered that low economic growth will hinder the correction of imbalances in public accounts, so that some member states will continue to accumulate debt for years, and this debt can be placed in the market only at a higher price.

Apparently, therefore, the financial markets act as a “controller” or “guarantor” of economic policy orthodoxy, monitoring governments to act properly. This situation is paradoxical to some extent, considering that it was the governments which tried to tame the financial markets just a few months ago after the excesses that led to the financial crisis.

On the other hand, public bonds have an important share in the portfolios of many financial institutions and investors. Thus, any increase in the profitability of bonds represents an increase of overall performance of these portfolios, much needed in times when there are no particularly attractive alternatives.

In any case, the recent episode of exchange rate volatility and pressure on bond markets should be taken serious. They indicate that more convergence among fiscal policies of all members of the single currency area is needed and that policy co-ordination mechanisms must be strengthened.

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The EUREN Summer Forecast 2010

Recovery of the world economy with imbalances

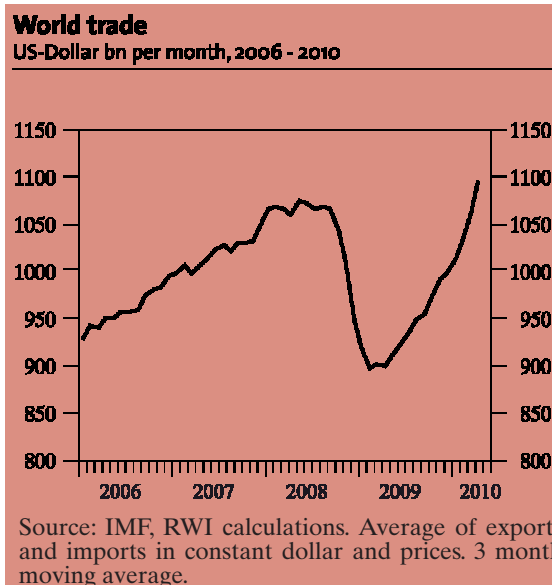
The EUREN institutes expect a recovery of the global economy. However, a considerable downward risk remains, since there is a split between developments in the real economy and on the financial markets. Whilst quite many indicators suggest that the recession is over and growth is picking up in all major economies, financial markets signal that risks of renewed turbulences and volatility should be reckoned in the future as well. It is still not entirely clear how far the ongoing recovery is supported by the fiscal stimulus packages and to what extent it will sustain without state interventions. Most industrialized countries will have to follow controversial goals during the coming period: governments will try to encourage growth and promote job creation on the one hand, and handle fiscal imbalances and enforce some kind of fiscal consolidation on the other.

Output below pre-crisis level in developed economies

Despite most industrialized countries being back to growth, the level of output will remain below the pre-crisis level. For the emerging economies, on the other hand, robust growth is expected with output surpassing clearly the level of 2008. However, the emerging markets might experience some corrections in the course of next year that may affect industrialized economies, too. Despite of growth rates picking up, the situation on labour markets will mostly remain sluggish; especially the developed countries are far from a job-rich recovery.

Despite of low interest rates, the financial sector has not recovered yet. Therefore, monetary policy is expected to stay expansionary. We expect that short-term interest rates will remain low in the US until the mid of the year as well as in Japan. Long-term benchmark rates will pick up as well, especially in countries with

Graph 1



severe debt problems. However, credit conditions have not improved yet and will drag investment activity in some industrialized countries this year as well.

As a positive sign, after a more than 10% drop last year world trade has been expanding dynamically in the recent months; it may grow at a two-digit rate this year. However, this partly reflects a carry-over effect. Next year, world trade growth is expected to slow down with economic policies being less supportive in many countries.

With the rebound of global demand, raw material prices started to rise again. In their forecast, the EUREN institutes assume a further but rather mild increase. The oil price is expected to reach 85 USD/barrel by the end of 2011.

Varying country profiles

According to our forecast, China will remain the engine of world economic growth until the end of next year. GDP is expected to grow by 11% in 2010. The expansion is still supported by the large stimulus program reaching some 10% of GDP. It helped to counterbalance the downturn of global demand by encouraging domestic investment and household consumption. However, the program will phase out, and China reacted to the growing pressure from abroad and announced an appreciation of the yuan against the dollar. Therefore we expect growth to slow down next year to 9.5%.

For the U.S. economy, forecasts currently look rather mixed. The labour market is still depressed, thus private consumption will not be as lively as it used to be. Private households still suffer from the consequences of the crisis, whilst investments, net exports and inventory building will support growth. Thus, GDP might expand by somewhat more than 3% this year. However, a slowdown is plausible next year, especially when the Fed starts to tighten monetary policy. With capacity utilisation increasing, inflation will rise as well, but it will remain below 2%. Japan will continue to suffer from deflation despite the fact that the recovery is rather

Mild upswing in the Euro area

In the Euro area the economy has also left the trough of the recession. However, the upswing has been mild up to now, mainly borne by changes in inventories (graph 2). The expansion is still dampened by many factors. Problems in the housing market in Spain have not been settled yet. The sovereign debt crisis enforced a restrictive fiscal policy in some countries. Furthermore, unemployment is still on the rise, dragging down private consumption.

However, there is increasing evidence that growth has taken up speed in the meantime. In April, industrial production was up by 5% compared to the end of last year, and new orders were 7% higher. In June, the business climate was increasing for the 15th consecutive month.

Table 1

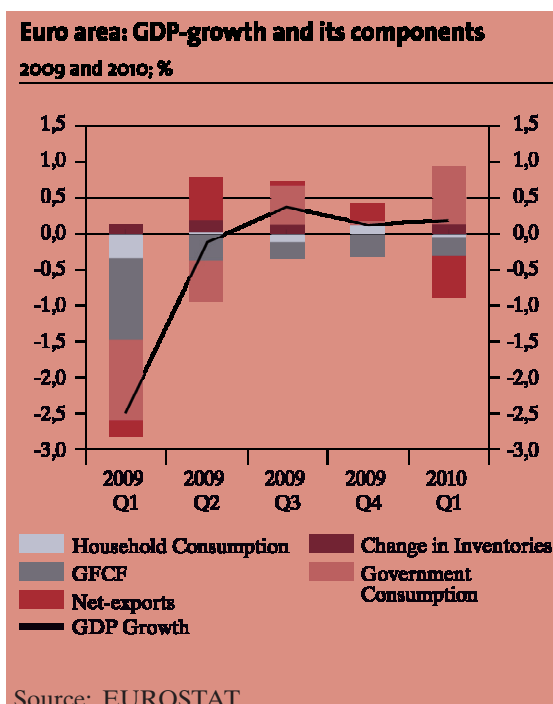
Exogenous and international variables				
Percentage changes unless otherwise indicated				
	2008	2009	2010e	2011e
World trade	2.8	-10.7	12.0	6.6
United States				
GDP	0.5	-2.4	3.1	2.9
Inflation	3.8	-0.4	1.9	1.5
3m interest rates	2.97	0.56	0.5	1.6
10y Gvt bond yield	3.67	3.26	3.8	4.4
Japan				
GDP	-1.2	-5.2	3.0	1.5
3m interest rates	0.74	0.35	0.2	0.2
10y Gvt bond yield	1.47	1.33	1.4	1.5
China, GDP	9.3	8.5	11	9.5
US dollar/euro	1.46	1.39	1.26	1.20
Oil price Brent				
US\$/barrel	97.2	61.5	79.4	83.6
Percentage changes	34.8	-36.7	29.1	5.2

EUREN Forecast



strong, mainly driven by dynamic exports and revived private consumption. However, Japan's public debt is extremely high (almost 200% of nominal GDP) and the fiscal deficit will remain high at 7% to 8% relative to GDP. A sovereign debt crisis could be avoided as national savings are fairly high, keeping external debt low. Now the government has announced consolidation measures for the next year which will dampen the expansion.

Graph 2





Against this background, the EUREN institutes estimate that the Euro area economy grew by 0.5 over the previous quarter in 2010Q2. The expansion was mainly supported by exports, but also gross investment should have contributed to growth, however, mainly reflecting a normalisation after the unusually cold winter which caused a sharp decline of construction activity. In general, indicators show that the construction sector is not out of the doldrums yet. Also private consumption remained depressed, with consumer climate

Policy stance will become tighter

A slow process of normalization of monetary policy

Monetary policy played a substantial role in the consolidation phase of the economy. The ECB maintained the rate of main refinancing operations at 1% for more than one year now. The Eonia, the 1-day interbank interest rate for the Euro area, has even been lower (around 0.3% on average in the past 12 months). Indeed, the ECB has not only lowered considerably its key interest rates as did other central banks in the world, but has also provided private banks with a huge amount of liquidity.

Six months ago, it could be expected that the ECB would start to normalize its monetary policy as soon as the real economy gave signs of revival. However, the Greek crisis which rapidly turned into a European sovereign debt crisis, put the ECB under pressure to react to the tensions in the security markets which were caused by the increasing worries about the solvability of European governments. Therefore, the ECB announced on May 10th 2010 to conduct interventions in the Euro area private and public debt securities market. In this context, the economic

Governments start fiscal consolidation

During the recent recession, fiscal deficits had jumped to unprecedented levels in many countries. Not all of the increase was cyclical. In many cases, structural deficits had already been high before the crisis, and the crisis uncovered weaknesses, e.g. a high reliance on tax receipts in booming sectors, that aggravated this problem. As a consequence, financial markets became

and retail sales having stagnated more or less at their low levels.

Despite all positive signs, GDP is still by more than 4% below the pre crisis level, and accordingly capacity utilisation is low. This limits the companies' ability to raise prices. Therefore core inflation remained moderate at 0.8% in the first half of this year. As energy prices increased considerably at the same time due to higher oil prices, in June the HICP nevertheless was 1.4% above last year's level.

environment seems too fragile to expect that the ECB will tighten monetary policy soon.

Therefore, we expect that the ECB will start to raise its key interest rates not before spring 2011. At the end of 2011 the Repo rate might be fixed at 1.5%, which would still be low in a historic perspective. In parallel, the ECB might try to reduce the liquidity made available to the banking sector. When the one year refinancing operation ended at July 1st, this has only been compensated partially by shorter operations. The 3 months and 6 days operation together reached only 55% of the previous ones. However, the ECB will be cautious in doing so as the Euro area banking system has recently again shown signs of weakness, and there are also risks ahead. So it is unclear which impact higher default rates will have on the banking sector. Also the consequences of new rules on capital requirements that might be implemented by the Basel 3 framework have to be considered. As the inflationary pressures can be expected to remain modest, the ECB has room for manoeuvre to act carefully.

increasingly nervous. For quite a long time they had neglected high fiscal deficits, which is indicated by extremely low differences in government bond yields. For the first time in 2009, and even more in the spring of 2010, interest rate spreads of high deficit countries in particular against German government bonds increased. Thus,

Box



How interpreting the recent movements of the Euro exchange rate?

In the wake of the sovereign debt crisis, the Euro devalued against almost all currencies. In December 2009, the exchange rate was close to 1.50 US Dollar per Euro, not far from its historical peak in the first half of 2008 (close to 1.60). Then the Euro depreciated markedly to reach 1.20 \$/ in mid-June 2010. Since then, it recovered somewhat. It is clear that the Euro is put under pressure by rising doubts about the sustainability of public finances in some Member countries. Up to now, markets obviously have not been convinced by the huge program adopted jointly by European governments, the IMF and the ECB to support Euro area members with payment problems. This is indicated by risk premia remaining high and the Euro staying weak after the program was announced. For our forecast, a central question is which Euro exchange rate is consistent with the current macroeconomic situation.

The assessment whether an exchange rate is adequate with respect to the macroeconomic environment is based on the idea of an equilibrium exchange rate. However, what an equilibrium rate means can be interpreted in several ways, depending on the time horizon. In the very short run (the hour, the day), foreign exchange markets can always be considered to be in an equilibrium in the sense that the market is cleared at the current exchange rate. In a longer perspective (the month, the quarter), interest rate differentials can be considered a key factor to explain exchange rate movements. This does not necessarily mean there is a direct link between the current interest rate differential and the current exchange rate, but it can be seen as a forward looking indicator: if markets anticipate an increase in US key interest rates while expecting the Euro area interest rates to remain unchanged, they will favour the US dollar. In a still longer horizon, over the year or several years, the exchange rate will be influenced by current account disequilibria. The central idea is that exchange rates should move in a direction that helps to balance the current account (FEER models). According to this approach, the Euro should appreciate against the Dollar to counteract the US current account deficit. In the very long run, finally, the exchange rate should be fixed at a level at which the purchasing power of a given amount of money is the same in both countries (purchasing power parity). If we focus on the Euro/Dollar exchange rate, the OECD estimated the PPP rate to be around 1.15 \$/ . Thus, at the current rate the Euro is not particularly weak.

Thus, different estimates of the equilibrium exchange rate may appear a bit contradictory, and they must always be interpreted according to the time horizon one has in mind. However, given the various theoretical backgrounds, the concept of an equilibrium rate doesn't help the forecaster. Some papers have shown that the random walk often performs better than theory based models of exchange rate movements. That's why we adopt here the technical assumption to maintain the exchange rate at the level reached when completing this forecast of 1.20 \$/ . This approach is also applied in the forecasts of international organizations, mainly because they do not want to interfere in exchange rate developments.

It follows from our assumption that in 2010 the Euro will depreciate by 9% against the US dollar compared to 2009. According to simulations with the Oxford model, all other things equal, a depreciation of 10% of the effective exchange rate of the Euro stimulates Euro area GDP by 1.1% in the current year in case of no change in monetary policy, and by 0.6% if interest rates are raised to combat inflation.

financial markets currently serve as some kind of controller of public finances.

As a consequence, governments in the Euro area but also in other countries initiated measures to consolidate their budgets. In a situation in which the recovery is still fragile a simultaneous shift towards a restrictive fiscal policy in many countries bears the danger that the dampening effects are self-enhancing. However, for some countries there is no alternative. They have to take hard measures to reduce deficits because they otherwise will not be able to refinance their public debt. For the others, starting consolidation "when the recovery is strong enough" may be a dangerous ambition, because we only know by hindsight when this was the case, but fiscal policy has to be made forward looking.

Stressed between consolidation necessities on the one hand and the risk that an ambitious reduction of the deficits may pull the economy back into recession on the other hand, a consolidation strategy might help which convinces the markets that the problem will be tackled in a sustainable way. It will enable to reduce the structural deficits orderly, avoiding hefty cuts in a single year.

Quite a lot of countries have announced such consolidation plans in the meantime. In some countries, the restrictive impact will exceed 1% of GDP in the next year (Table 2). Germany, on the other hand, plans to reduce its deficit in smaller steps. All in all, fiscal policy will become restrictive, but it will not be too restrictive to endanger the recovery.

The gradual recovery of the Euro area economy continues

The EUREN institutes expect the recovery of the Euro area economy to remain on track throughout 2010 and 2011. In the second quarter, the execution of construction projects which had to be

postponed in winter due to the exceptionally bad weather conditions in large parts of the Euro area will temporarily support GDP. However, notwithstanding this temporal boost, no acceleration of the



Table 2

Selected measures	Volume ¹ , timing and status of the package	Discretionary impact on GDP-growth ² (% of GDP)		
		2010	2011	2012
Austria				
Up to now, only some general guidelines have been announced:	4 bn. € 2011 planned	0	1.4	To be specified
Until 2014, the general budget deficit should be reduced from 4.7% of GDP (2010) to 2.3 %				
40 % of the consolidation should be generated by higher revenues, 60 % by lower expenditures				
For 2011, the deficit is planned to be reduced by 4 bill. euro (1.4 % of GDP): 1.5 bill. euro expenditure cuts by the central government, 800 million euro contribution from the <i>Länder</i> , 1.7 bill. euro by tax increases				
It has been specified how specific budget categories (like foreign policy, labour market policies) should be affected, but no specific measures have been concluded so far				
Germany				
New Taxes on nuclear fuel elements, on air transport, and on the banking sector, cutting subsidies (€ 8 bn)	27 bn €	0	0.4	0.3
Spending cuts in social and in labour market policy (€ 11 bn)	2011–2014			
Cuts in military spending (€ 2 bn)	Planned			
Reduction of public consumption, amongst others by reducing wages and staff in the public sector (€ 4 bn)				
France				
Commitment to a stabilization of government expenses in nominal terms (excluding interest paid and pensions: €36 bn ³). Measures announced: general revision of public policies (€ 10 bn cumulated from 2011 to 2013), replacement of 1 out of 2 retiring civil servants, cuts in social benefits	39 bn €	0	1	0.5
Reduction in fiscal expenses (€ 10 bn)				
Retirement reform (increase in taxes : € 3,7 bn, reduction of expenses : €4 bn)	2011–2013			
Control of health expenditures (€ 2,4 bn)	Planned ³			
Italy				
Increasing revenues in particular by fighting tax evasion	25.2 bn €	0.0	0.9	0.6
Measures of decreasing expenditures				
Cuts in public administration expenditure				
Cuts in public wages	2011–2013			
Cuts in social security expenditures				
Cutting expenditures of local governments				
Spain				
Reduction in public employees' wages (–5% average) (€ 6.2 bn)	16.7 bn €	0.5	1,1	
Freeze of social benefits (no inflation update for pensions) (€ 1.4 bn)				
Removal of support for babies born (€ 1.3 bn)	July 2010–2011 Approved			
Cut in international development aid packs. (€ 0.6 bn)				
Cut in Central Government investment (infrastructure) (€ 6 bn)				
Cut in Regional government's total expenditures. (€ 1.2 bn)				

¹Deviation of the Budget balance in the end year of the program compared to baseline. – ²Primary impulse without secondary macroeconomic effects. – ³Deviation of the level of expenditures in the end year of the program associated with the commitment to stabilize government expenditures in nominal terms compared to the level of expenditures associated with a stabilization of the ratio of public expenditures / potential GDP. The discretionary impact in % of GDP takes into account an increase in interest paid (+10 % per year) and in pensions (+4 % per year). While including these expenses, the deviation of the level of public expenditures obtained with the attainment of the commitment compared to the level of expenditures associated with a stabilization of the ratio of public expenditures / potential GDP is about € 19 bn at the end year of the program.

underlying growth trend is expected over the forecast period. In 2010, the recovery is sustained by fiscal policy measures put in place in 2009, as well as by a re-building of inventories. Over the course of the forecast

period, these effects will abate, but private investment will gain some momentum. Taken together, the EUREN institutes forecast real GDP growth rates of 1% in 2010 and 1.2% in 2011.

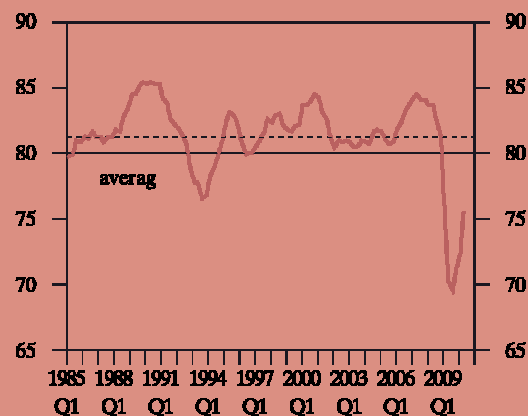
Several forces are holding back the recovery in the Euro area. Sizable fiscal and current account imbalances are prevailing in several countries. Concerns about sovereign solvency are hampering the normalisation of financial market conditions. Deleveraging among households and companies also has not been completed so far, putting a brake on investment. Moreover, despite signs of stabilisation, the labour market situation will remain weak. In addition, as a consequence of the financial crisis and the severe recession, parts of the capital stock might have become obsolete, so that potential output might be lower than previously estimated.

Finally, the measures already implemented or announced by some Member States to consolidate public finances are likely to hold back private and public consumption in the forecast period. However, refraining from reducing deficits would most likely hamper the upswing, too, as this would have a negative impact on expectations of financial market participants. As the events in spring have shown, a further growth of public debt levels would result in higher long-term interest rates, thus negatively affecting business investment in the medium to long term.

Both in international and historical perspectives, the forecasted recovery will remain rather gradual and subdued. Its pattern, however, should be much the same as in the past. In the past, recoveries of the Euro area were mostly export-led: first, a pick-up in exports feeds through to investment activity; second, investment growth leads to employment growth which, in turn, stimulates private consumption. Since the external environment has already improved considerably, the current upswing seems to follow a similar pattern. Driven in particular by the emerging Asian economies, but also the US economy, world trade is currently expanding at high rates. This stimulates Euro area exports. In addition, price competitiveness is supported by the depreciation of the Euro observed in spring. This will especially benefit exports of low and medium technology goods where the price is the key determinant of foreign demand.

Graph 3

Capacity utilisation in Euro area industry 1985-2009, in %



Source: European Commission.



The currently high growth of world trade is to some extent a normalisation after the sharp drop observed in 2009. Hence, world trade and thus Euro area exports will lose momentum in 2011. In addition, due to the expected stabilisation of the Euro exchange rate, the stimulus from the improved price competitiveness will abate over time. Nevertheless, net exports will contribute positively to GDP growth in the Euro area throughout the entire forecast period. The second stage of the typical Euro area upswing, i.e. the transmission of the export-led increase in industrial production to equipment investment, is currently impeded by several factors. First, capacity utilisation in industry, though having recovered recently from its historic low recorded in the third quarter 2009, is still well below its long-term average. Second, access to external financing is still restricted as concerns about credit quality and the health of the European banking sector are prevailing. Hence, the replacement of outdated capital goods and the introduction of new products will remain the main investment motives in the period ahead. Residential construction is also unlikely to recover strongly in this year and the next, despite low rates for housing loans. There is still a considerable overhang in the housing market in some countries. Furthermore, the still high risk to become unemployed may deter households from major purchases and housing investment. Furthermore, also for private households access to bank loans is



Table 3

Euro area forecast	2008	2009	2010 ^f	2011 ^f	2010				2011 ^a			
					I	II ^f	III ^f	IV ^f	I	II	III	IV
					Annual % change (unless indicated otherwise)				q-o-q%, seasonal adjusted (unless indicated otherwise)			
Private consumption	0.3	-1.2	0.0	0.5	-0.1	0.0	0.0	0.1	0.1	0.2	0.2	0.2
Public consumption	2.2	2.7	1.7	0.6	0.6	0.4	0.3	0.2	0.1	0.1	0.1	0.1
Gross fixed capital formation	-0.9	-10.9	-2.5	1.6	-1.1	0.6	0.0	0.3	0.2	0.5	0.7	1.0
Change in inventories ¹	0.1	-0.8	1.0	0.0	0.9	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	0.5	-3.4	1.0	0.8	0.8	0.4	0.1	0.2	0.1	0.2	0.3	0.3
Exports	0.7	-13.2	7.8	5.2	2.5	2.5	1.0	1.0	1.1	1.3	1.4	1.5
Imports	0.8	-11.9	7.5	4.1	4.0	1.5	0.7	0.9	1.0	1.1	1.1	1.3
Net exports ¹	0.0	-0.7	0.2	0.5	-0.6	0.3	0.1	0.0	0.0	0.0	0.1	0.0
GDP ¹	0.4	-4.1	1.0	1.2	0.2	0.5	0.2	0.2	0.2	0.3	0.4	0.4
Unemployment (% of labour force)	7.6	9.4	10.1	10.3	10.0	10.1	10.2	10.3	10.3	10.3	10.3	10.2
Compensation per employee, yoy	3.4	1.5	1.5	1.7	1.4	1.5	1.6	1.6	1.6	1.6	1.7	1.7
Consumer price (HICP), yoy	3.3	0.3	1.5	1.6	1.1	1.5	1.7	1.7	1.7	1.6	1.5	1.5
Current account balance (%GDP)	-1.7	-0.6	-0.3	-0.1								
3m interest rates (% per annum)	4.6	1.2	0.7	1.1	0.7	0.7	0.7	0.7	0.8	1.0	1.2	1.5
ECB repo (end of period)	2.5	1.0	1.0	1.5	1.0	1.0	1.0	1.0	1.0	1.3	1.5	1.5
10y Gvt bond yields (% per annum)	4.4	4.0	3.7	3.7	4.1	3.8	3.5	3.4	3.5	3.6	3.8	4.0

EUREN estimates.– ^fforecast. – ¹Contribution to growth.

negatively affected by the repercussions of the financial crisis, like a loss of equity available as collateral, as well as the problems in the banking industry. In 2010, public investment will still be supported by infrastructure projects which formed parts of the fiscal stimulus packages put into place during the recession. In 2011, these stimuli will abate, in some countries expenditure might even be cut as a part of the fiscal consolidation programs. All together, the EUREN institutes expect gross fixed capital formation to recover only gradually. Due to the sharp contraction in the first quarter of this year, the annual average will even decline further in 2010. For 2011, we expect a small positive rate.

Private consumption is held back by bleak labour market perspectives in large parts of the Euro area. In addition, due to the low inflation rate in 2009, high unemployment and wage cuts in the public sector, only moderate wage increases can be expected for 2010 and 2011. Real disposable income is furthermore impeded by higher inflation.

The price development is largely driven by the pattern of raw material prices, in particular the oil price. From the record highs reached in summer 2008, the outspreading recession led to a sharp decline of oil prices

until spring 2009. Due to increasing demand, particularly in the emerging Asian economies in line with the beginning recovery of the world economy, the oil price increased again from summer 2009 onwards. The consequences for energy prices in the Euro area were amplified by the depreciation of the Euro during spring 2010. Under the assumption that the oil prices will increase only slightly and that the Euro exchange rate will stabilise, the impact of the international energy prices on Euro area inflation will fade away over time. Core inflation should continue to be low, as there is still considerable excess capacity. Some price pressures will be exerted from rising indirect taxes and administered prices in some Member States as part of the fiscal consolidation measures. All together, HICP inflation is expected to average 1.5% in 2010 and 1.6% in 2011.

The labour market usually reacts to a revival of the real economy with a time lag. In an upswing, companies first increase the working time and re-establish productivity which were reduced during the recession, before recruiting new staff. Currently, this effect is even more pronounced than in previous business cycles, as in many countries (especially Germany and Austria) the governments subsidised temporary reductions in working time. In addition, companies

were hesitant to lay off qualified staff so as to avoid skill shortages in the upswing. Therefore, only a modest increase in employment is expected over the forecast period. In addition, the forecasted recovery will exceed trend productivity far enough to create a sizeable number of new jobs. Hence, the unemployment rate will continue to increase slightly well into 2011 and

only start to decline towards the end of the forecast horizon. In terms of annual averages, unemployment rates of 10.1% in 2010 and 10.3% in 2011 are expected.

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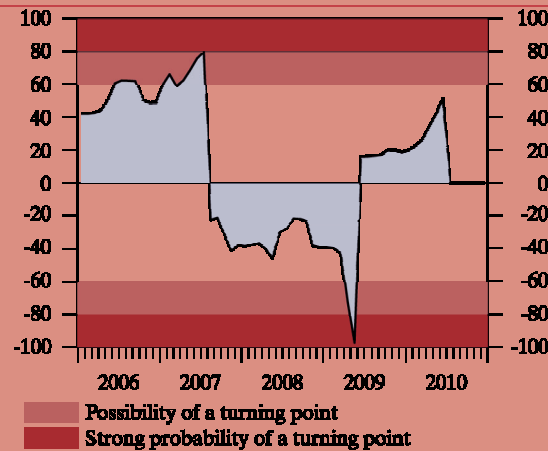
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COE-Rexecode Leading Indicator for the Euro Area

The recent turmoil on the stock markets in combination with the negative assessment of future public debts leads to a questioning about growth next year. Our leading indicator may partially bring an indication to the possibility of an economic slowdown implied by new budget constraints. Despite very low disappointing growth in the last quarter of 2009 (+0.1%) and the first quarter of 2010 (+0.2%), we still continue assuming that the euro area GDP shifted in the third quarter of 2009 to the ascendant phase of the growth cycle. This means growth over the trend growth rate estimated now at 1% on an annual rate. This is in line with our underlying growth rate estimated at 2% in June 2010. The Coe-Rexecode leading indicator is now looking for the next peak. It must overpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent economic reversal of the present rebound. During the first half of 2010, the indicator rose from 19.9 in January to 50.0 in June but still stands below the first 60 threshold. Therefore, there is no sign of future slowdown. The Coe-Rexecode Start-End recession index sticks to zero in April 2010 (last available estimate), meaning a extremely low probability to be in recession.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: July 7, 2010

	09Q1	09Q2	09Q3	09Q4	2009	10Q1	10Q2	10Q3	10Q4	2010
Mar-09	-2.7; -0.8	-3.5; -1.1	-3.6; -0.3	-2.6; -0.5	-3.1					
Apr-09	[-2.7; -0.7]	-3.2; -0.8	-3.1; -0.1	-2.0; -0.4	-2.7					-0.9
May-09	[-3.8; -1.7]	-3.0; 0.6	-2.5; 0.3	-1.2; -0.4	-2.6					-0.5
Jun-09	[-4.7; -2.6]	-3.9; 0.6	-2.9; 0.8	-1.0; 0.3	-3.1					0.5
Jul-09		-3.7; 0.8	-2.3; 1.2	-0.2; 0.5	-2.7					1.1
Sep-09	[-4.9; -2.6]	[-4.7; 0.8]	-3.1; 1.3	-0.7; 0.7	-3.3					1.1
Oct-09			-3.2; 1.2	-0.7; 0.8	-3.3					1.4
Nov-09			-3.3; 1.1	-0.7; 0.8	-3.4					1.4
Dec-09	[-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			1.4
Jan-10	[-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			0.8
Feb-10	[-5.0; -2.5]	[-4.8; -0.1]	[-4.0; 0.4]	[-2.1; 0.1]	[-4.0]	-0.2; -0.5	-0.2; -0.9			-0.3
Mar-10						-0.1; -0.5	-0.1; 0.8	-0.3; 0.2	-0.1; 0.2	-0.1
Apr-10						0.0; -0.4	0.5; -0.2	0.6; 0.4	0.9; 0.4	0.5
May 10	[-5.0; -2.5]	[-4.8; -0.1]	[-4.0; 0.4]	[-2.2; 0.0]	[-4.0]	[0.6; 0.2]	1.3; 0.6	1.5; 0.6	1.9; 0.5	1.3
Jun 10							1.5; 0.8	2.0; 0.9	2.6; 0.7	1.7
Jul 10							1.6; 0.9	1.9; 0.8	2.3; 0.5	1.6

In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

After having been revised upward significantly in May, the latest estimation of the HFM shows a slightly downward revision for the second half of the year. However, figures for the second quarter remain quite strong, showing a qoq GDP growth rate just one tenth below 1%. Looking at the specific indicators' trends, sentiment and confidence indicators improved still in the second quarter compared to previous one. Those indicators linked to exports and industry improved most, and – in a regional perspective – the indicators for Germany.

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Impressum

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